PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - JUNE 2018

planner Redwood

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Epigraph of the month... a propos of Brazil's current predicament.

"Prediction is very difficult, especially if it's about the future."

Nils Bohr – Danish Physicist, Nobel laureate (1922)

Introduction

June was the month of redoing the math and resetting economic and financial projections – all of them!

It is a routine job for economists and financial market players to monitor and analyze their projections and estimates, but although few promote substantial changes in their models in the short term, an important effect is now being observed: many are adjusting their forecasts with variations no less than significant. Not surprising. The political and economic events of recent weeks, the more challenging external environment, the uncertainties in this year's electoral process and, finally, the truckers' strike, which triggered the collapse of expectations and catalyzed greater pessimism, all settled the wide and general need for a reassessment of macroeconomic scenarios.

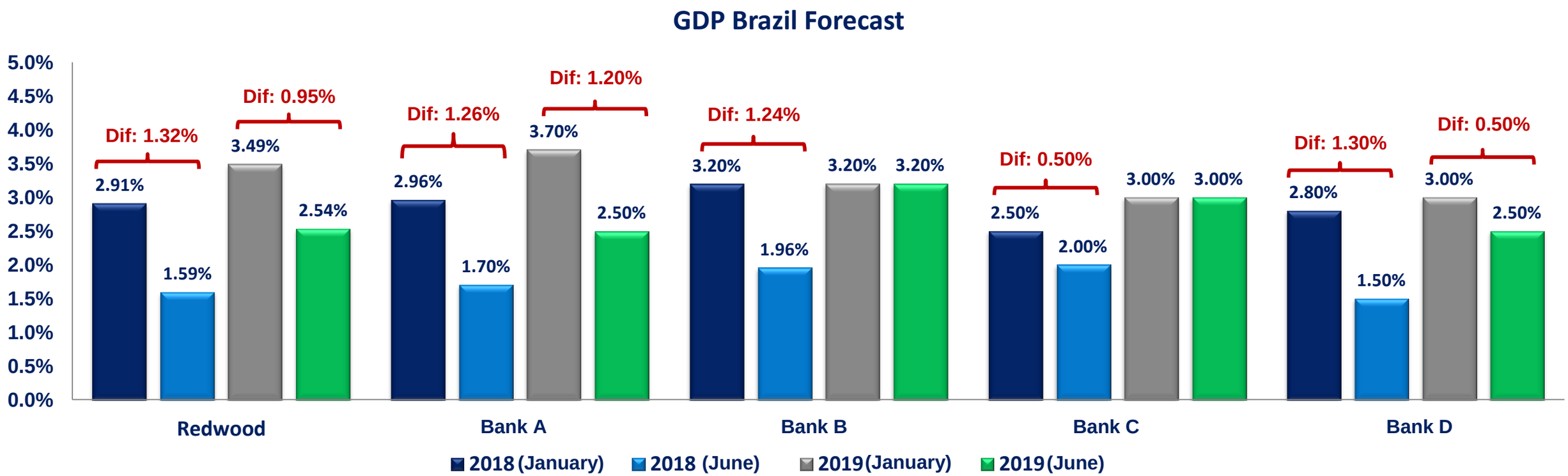
All these facts, especially because of the singularity of these events taking place simultaneously, have greatly increased the degree of uncertainty in the economy. The strike of the truck drivers, definitive inflection point, has as its first effect a "supply shock" with shortages and "transient" price increases. The second, no less important an effect will be the contamination of confidence indexes which will impact economic recovery, jobs and, as a consequence, aggregate demand. The latter effect, yet to materialize, may have more lasting and intense repercussions, all depend on the level and persistence of this contagion.

However, regardless of these facts, our most recent projections point to a very different scenario from that envisaged in the beginning of 2018 and even to the numbers estimated in the 2nd QTR 18, which were already less optimistic. The frustration in job creation is to highlight, but the pace of economic recovery (already slow, from the outset), has declined significantly. Public finances also do not help; to get an idea of the scale of the problem, we are moving towards a Debt-to-GDP ratio of 77% and 79.8%, for 2018 and 2019, respectively. Furthermore, the threshold of non-compliance with the Golden Rule will soon be reached. How did the scenarios change so dramatically? They have not changed. Only the probabilities ascribed for more pessimistic scenarios have grown heavier... It is all the same, especially for those who depend and "bet" on Brazil... but at least it signals a correction of aims. Anyway, the opening sentence of this comment by the Danish physicist Nils Bohr sums up the "art" of making economic predictions: "*Making predictions is very difficult, especially if it is about the future.*"

Overseas, the month of June was marked by the escalation of latent problems. In Europe, the humanitarian crisis of frequent migrations to the continent is dramatic, as Italy, under its newly elected government, has tightened its policy to refuse ships to dock in its ports, while also promoting in Germany a situation of profound disagreement between Angela Merkel and his Homeland Secretary Horst Seehoster. This crisis led to speculation on the likely resignation of the Secretary, since in his assessment, the agreement signed by the EU was "insufficient", hereby failing to meet the conditions he had proposed to postpone the shutdown of German borders. In China, the PBoC once again have injected resources (liquidity) into the banking sector, amounting to approximately USD 100 billion for medium-term credit. The Chinese also seem to patiently wait for the new possible repercussions in the face of Trump's harsh tone on US trade issues with Europe – meant to threaten with more sanctions - China may have much to "profit" from this. Still in the US, it does not seem plausible that the election of a leftwing candidate in Mexico, coupled with Trump's recent grievances with Canada's Trudreau, could aid NAFTA negotiations - quite the contrary. Finally, the Fed continues to signal its successive interest rate hikes, with "concrete" possibilities of at least two further increases in 2018 (bringing the rate to 2.25%) and two more hikes in 2019, ending the latter year at 2.75%.

In this environment, US Treasuries closed the month at 2.8601%. S&P changed 0.48%, NIKKEI closed at 0.46%, DAX at -2.37% and FTSE 100 UK at -0.54%. The Ibovespa ended the month at -5.20% and the IBrX at -5.19%. Monthly highs for DIF19 at 7.615% and DIF21 at 10.44%. The NTN-B 2050 ended the month at 5.9105%, and the Dollar (Ptax) at BRL 3.8555.

Economic Outlook



Source: Major Banks & Redwood Scenarios| Elaborated by Planner Redwood

The chart above leaves no doubt about the size of the adjustment and how pessimism gained momentum.

For those rising from a recession, as we had in recent years with PT, which was already a constrained growth rate (2.91%), has now become a total frustration with projected 1.59% - especially if we take into consideration the weak growth in 2017 of 1%. In addition, there seems to be a fairly established "consensus" between our projections and the major banks' views, around 1.75%... the government still bets on 2.5% growth, but the BACEN already points out in its analyzes a projected 1.6 % rate. Whether the GDP fall in 2018 will have this magnitude or not, it is beside the point, but the downward trajectory will be bringing all the natural consequences of this movement. However, it is not yet certain, taking into account the projections by other important market players, what will be the impacts on the GDP of 2019. This non-change in forecasts by some stems fundamentally from a more conservative stance of waiting a little longer and in the face of some macro signals and possibly certain definitions of the political field, the directions of economic activity in 2019. For us at Redwood, our preferred scenario at the moment foresees the win of a pro-reform candidate. The mediocrity of growth in the upcoming years reflects exactly this premise, and anything other than that scenario would be much worse. It is worth recalling that growing between 2.5% and 3% would not fall far short of our Potential GDP, that is, without higher levels of productivity, mediocre is in fact an optimistic outcome.

The loss of economy's momentum has a most damaging consequence, namely, of not cutting down unemployment rates. Although we still believe in gradual improvement, the unemployment rate still looms very high, and, as we have warned, formal jobs have been shifted to the informal sector. In addition, we now see this phenomenon (with repercussions in statistics) of workers' distrust of the economy and, consequently, of finding any work placement, which improves the employment rate, given they are no longer considered unemployed. Besides the difficulties of estimation, we have statistical measures that are not very helpful either.

In short, projections of activity and employment are quite bleak, and the solution lies far beyond the short term.

Fiscal Policy

According to the May figures released by the BACEN, general government debt reached "meager" BRL 5.13 trillion, or some 77% of GDP.

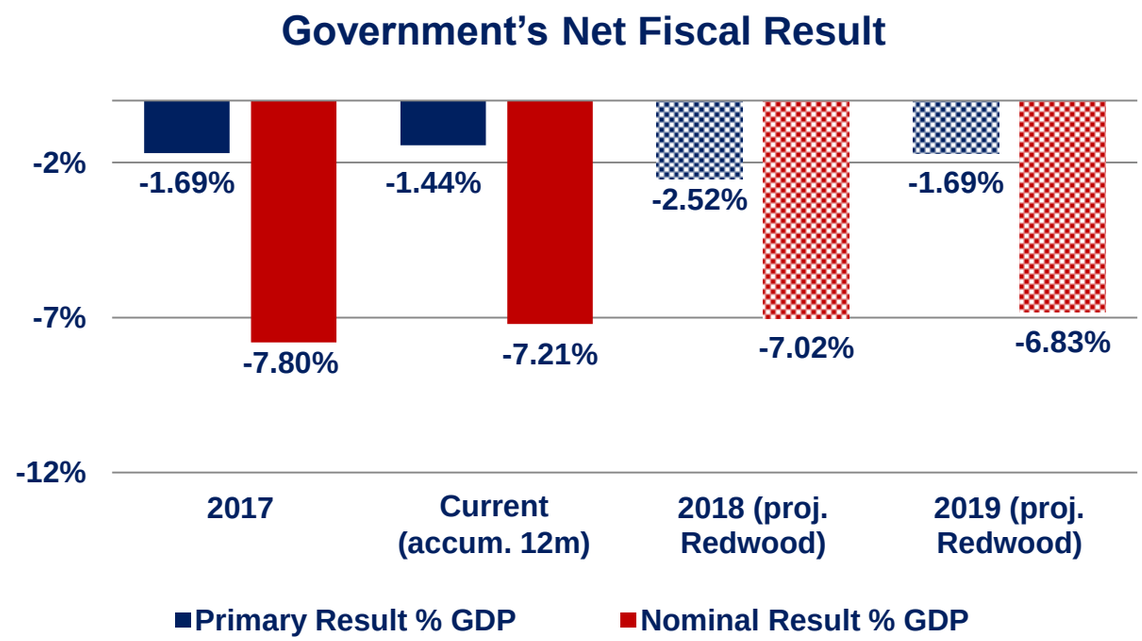
There is no doubt that the increased public deficit is related to higher mandatory expenses, especially by the those on Social Security. The central government closed the month with a primary deficit of BRL 11.12 billion, in spite of the combined result of the Treasury and the Central Bank of Brazil (BACEN), which was a surplus of approximately R $ 4 billion - INSS expenses entered sinking the final result. The mismatch between INSS accounts and other accounts is an affront.

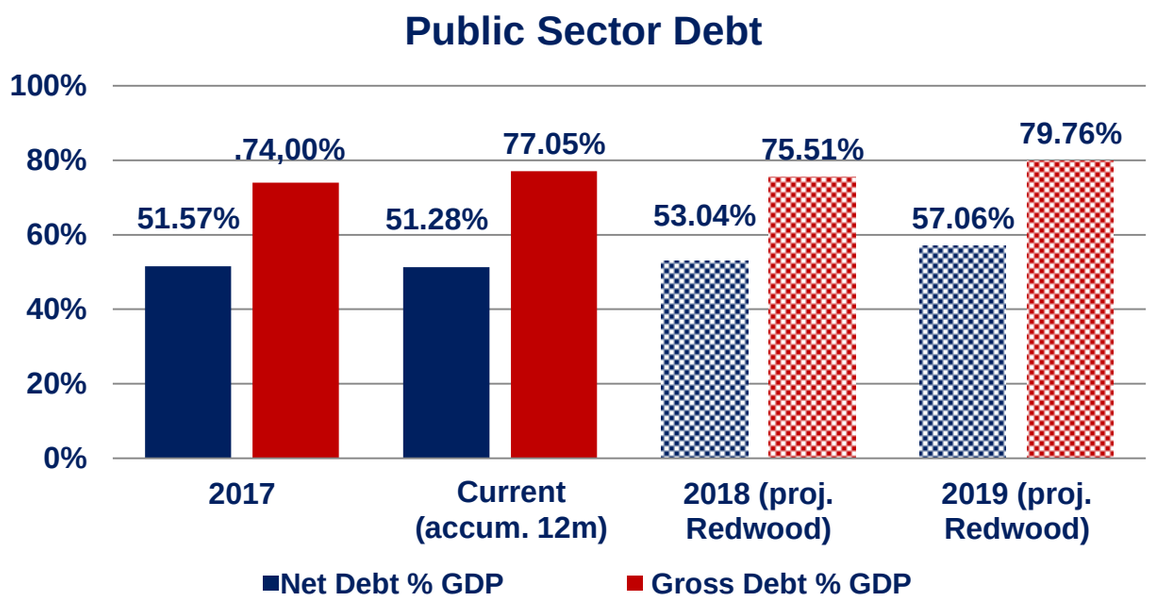
Efforts seem to be in vain (although they are not!), for the negative results prevent it from evolving in the payment of interest already due on public debt, translating into an accumulation that adds, in the net result of the public sector, a nominal deficit of BRL 480 billion, or 7.21% of GDP. We don not mean to insinuate any heterodoxy on our part, but only to identify, as in the chart on the side, the magnitude of this number and its trajectory, a classic obstacle to the reduction of interest.

The pace of fiscal recovery is, as we have always reiterated in this space, linked to the mother of all reforms: Social Security. It does not matter how far-reaching it is, but we need to start doing something (in this administration there are no more chances) in the 1st QTR 19. This is one of our basic premises: to launch the pension reform, although dehydrated in relation to the initial project or the ideal one. In this regard, once the presidential campaign actually begins (after the World Cup), we can have the candidates' outlined programs and their proposals on how to tackle this problem.

However, while the proposals tread the tight rope, the managing finances in the present becomes more and more important, either due to the peculiarities of management and focus as such, or due to the opportunistic impetus that emerges in moments like these to approve new expenditures through Congress. In addition, we cannot forget the commented slowdown of economic activity that results in lower tax revenues. This fact leaves even less room for maneuver for the government, which makes reaching the targeted deficit even more difficult this year. The intervention of the Supreme Court, with the injunction of Minister Ricardo Lewandowski, in order to subject the sale/privatization of public companies to the approval of the Congress, corroborates such difficulty.

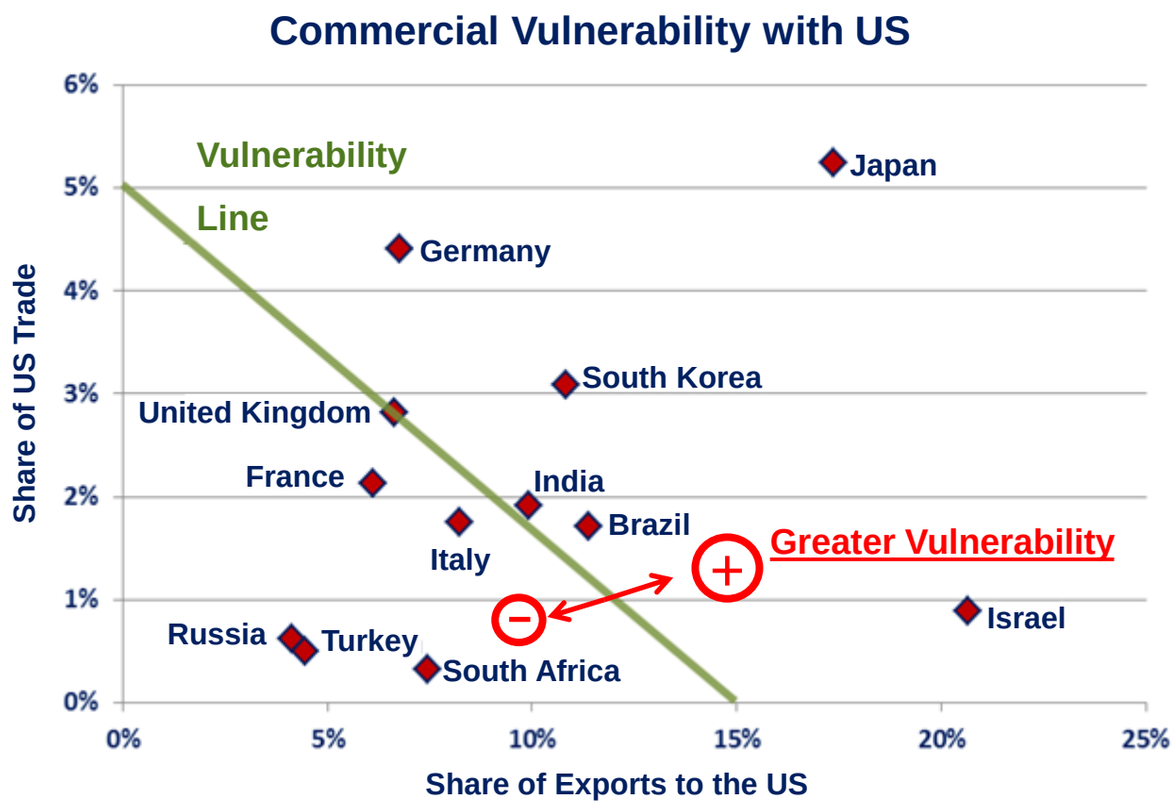
Many playing against, lack of appeal, interference and inability on all sides... it will be difficult to take Brazil on good standards to the end of the year.





Source: IPEA and Central Bank of Brazil | Elaborated by Planner Redwood

International Outlook



Source: World Bank & United States Census Bureau | Elaborated by Planner Redwood

Country	Export/GDP	Share of Exports to the US	Percentage of US Trade Balance	Share of US Trade	GDP (US$)
Canada *	30.89%	58.61%	2.14%	14.96%	1,653,042,795,255.04
France	30.88%	6.13%	1.92%	2.12%	2,582,501,307,216.42
Germany	47.24%	6.77%	8.00%	4.41%	3,677,439,129,776.60
Italy	31.30%	8.24%	3.96%	1.76%	1,934,797,937,411.33
Japan	16.12%	17.38%	8.66%	5.25%	4,872,136,945,507.59
United Kingdom	30.53%	6.63%	-0.40%	2.81%	2,622,433,959,604.16
Total G7	-	-	**24.28%**	**31.31%**	**17,342,352,074,771.10**
Brazil	12.57%	11.40%	-0.98%	1.71%	2,055,505,502,224.73
China *	19.76%	20.91%	47.20%	16.34%	12,237,700,479,375.00
India	18.87%	9.92%	2.88%	1.91%	2,597,491,162,897.67
Russia	26.04%	4.14%	1.26%	0.62%	1,577,524,145,963.17
South Africa	29.77%	7.44%	0.34%	0.33%	349,419,343,614.09
Mexico *	37.88%	72.15%	8.92%	14.34%	1,149,918,794,765.73
Israel	30.27%	20.66%	1.18%	0.89%	350,850,537,827.28
Turkey	24.84%	4.45%	-0.04%	0.49%	851,102,411,118.12
South Korea	43.09%	10.83%	2.91%	3.08%	1,530,750,923,148.70
Total Emerging Mkts	-	-	**63.67%**	**39.71%**	**22,700,263,300,934.50**
Rest of the World	-	-	**12.05%**	**28.98%**	**-**

*: *Outliers* ruled out from graph analysis to avoid distortion, as well for being clear targets of the current US trade policy.

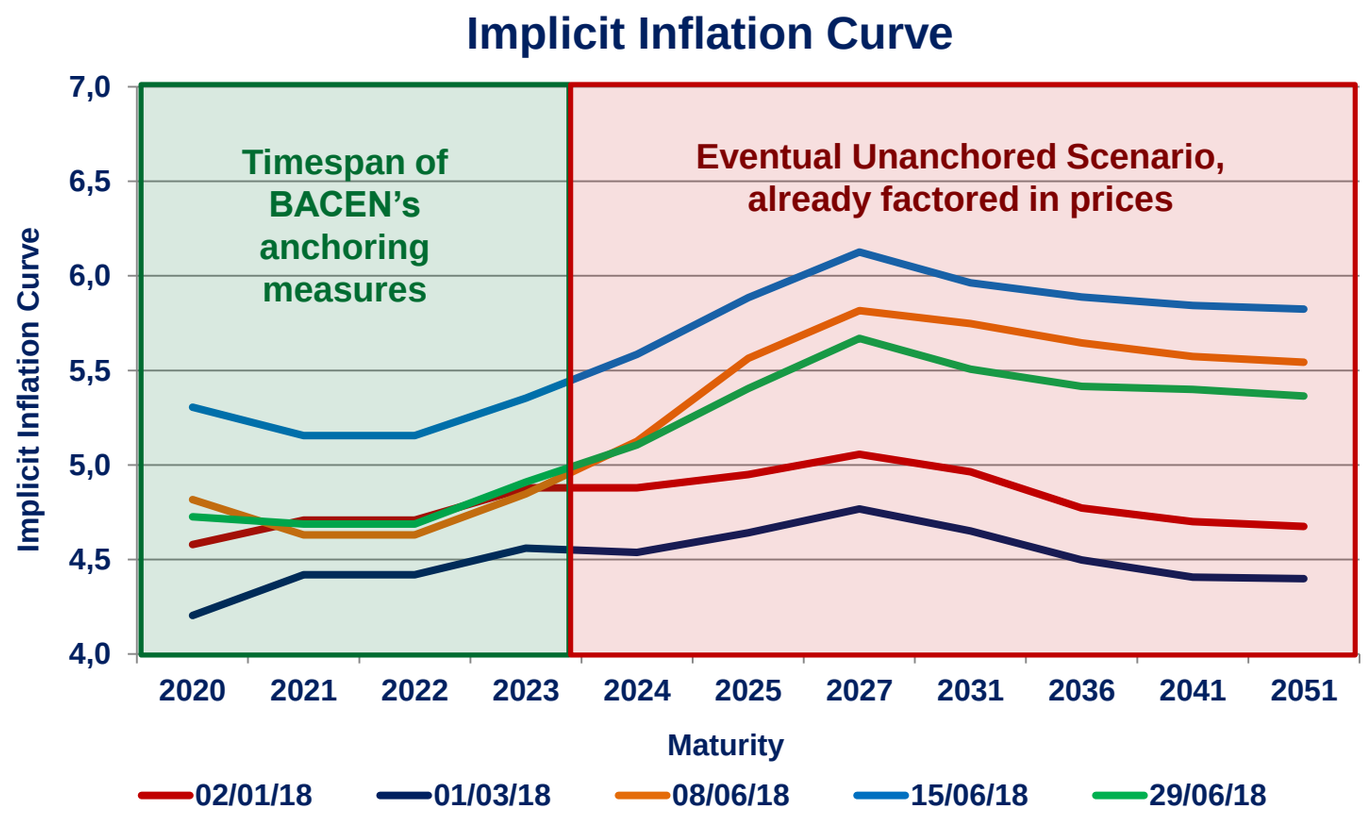
Overseas, June stirred up ongoing problems. In Europe, especially in Germany, the immigration crisis has triggered misunderstandings with Interior Minister and Leader of the German Christian Social Union (Horst Seehofer), although further tensions could be circumvented so that the coalition government of Angela Merkel does not ”perish”, a satisfactory and permanent agreement on immigration policy does not seem credible. Relevant as well, the British government is also in trouble. The British Chamber of Commerce, two years after the approval of BREXIT and numerous inaccuracies (tariffs, taxes, customs, aviation, etc.), has underlined that the patience of companies is about to reach a "breaking point". In this vein, UK Conservative Party Leader Jacob Rees-Mogg demanded that Prime Minister Theresa May deliver on her BREXIT promises, or else she risks igniting a revolt that could lead to a collapse of her cabinet. On the other hand, in the Euro Zone unemployment and inflation rates do not show large variations and the ECB signals with the "continuity" of monetary stimuli. In China, following last month (when 60.5 billion yuans were injected to finance infrastructure projects), it repeated the dose this month with 663 billion yuan, at 3.3% rate. In addition, the PBoC has resumed explicitly guiding the depreciation of the Yuan, but at the same time the president of the bank says that it closely monitors the swings in the foreign exchange market, acting to avoid Dollar spikes... a challenging understanding of it. Finally, we have the election of Mexico with the rise of López Obrador (populist and leftist) because of the traditional parties' attrition against Mexican public opinion, especially because of the current president's weakness to face Trump. Good luck!

However, the most relevant issue of the month and involving everyone was the imminence of a Trade War. The chart and table above are worth more than a thousand words!

Interest Rates

The month of June was responsible for capturing the negative performance of the Brazilian financial markets in the second quarter. With the end of the cycle of cuts in the SELIC rate, which was driven to the level of 6.5% pa, the perspective is that maintaining the current trend few investments will overcome inflation this year, which gained speed once again following the supply shock arising from the truckers' strike.

This perspective was also the determining factor for the increases observed in the yield curve throughout June, as depicted by the chart on the right, which represents the implicit inflation expected by the market. Besides the natural attention that we can attribute to the expectation for the short term, it is worth mentioning the convergence toward levels close to 6% in the longest vertices. With the economy generally out of line and with the widening market perception of the small chances of having enough fiscal reforms in 2019, any pressure on the price index would be unavoidable (even with the signals of an even lower inflation targets from 2020). With this, the DI1F21 closed at 9.310% reflecting a high of 50 bp. in June, while the DI1F25 closed at 11.54%, monthly high of 35 bp.



Source: Broadcast | Elaborated by Planner Redwood

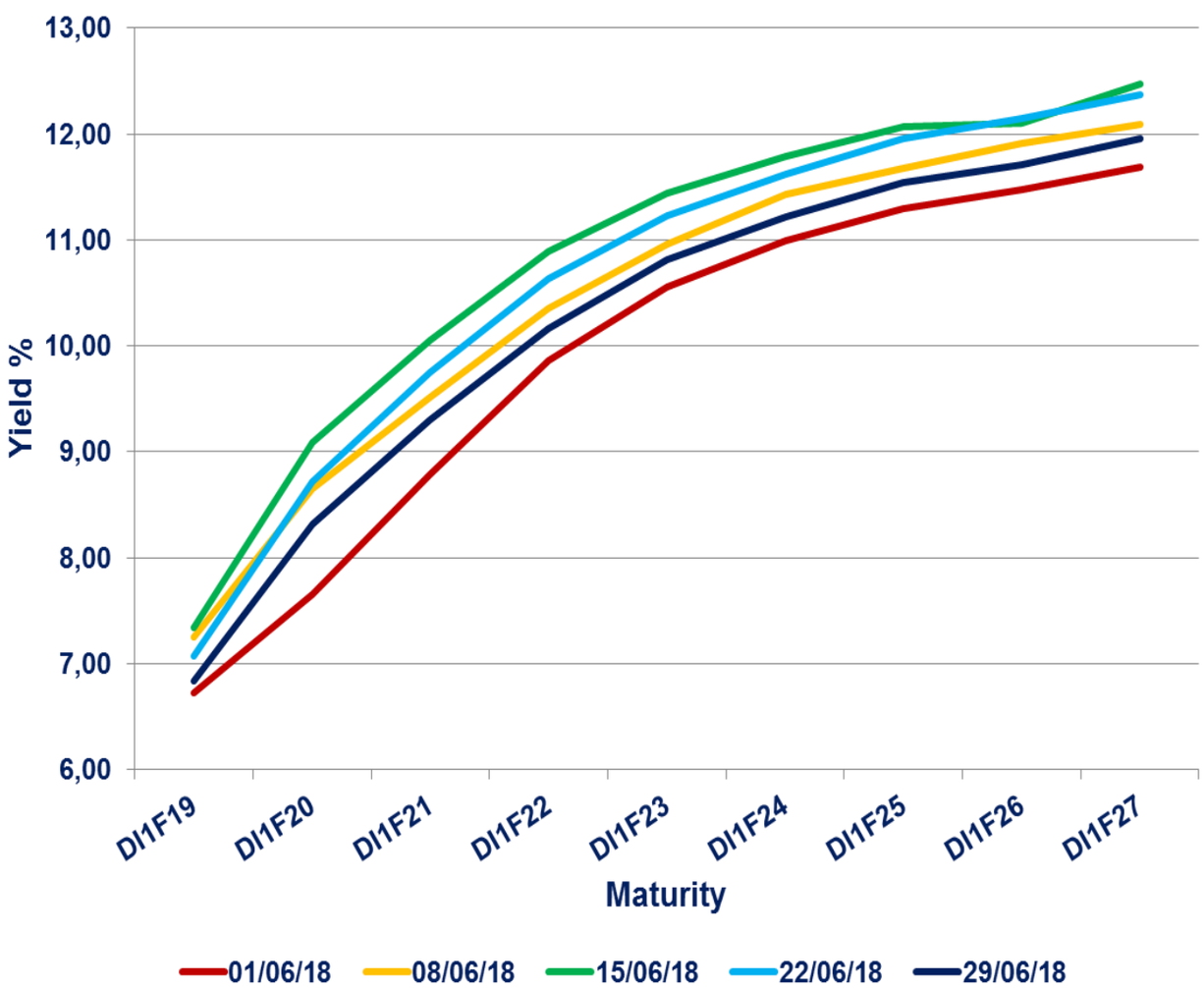
We at Redwood believe that over the next year we should have a cycle of high interest rates, as the gradual recovery of economic activity proceeds. With the BACEN without a double mandate (like the Fed) and the one and "only" guardian of the currency (although it considers in its calculations other variables), some increase would already be welcomed later this year, thereby avoiding the compromise of the inflation target already in the beginning of 2019 - in order to prevent more intense and recurrent measures throughout the year. However, as history shows us, as well as our proprietary BACEN Reaction Function model, in the six months preceding presidential elections the COPOM does not promote changes in interest rates, especially hikes, a major symptom of the lacking independence of the monetary authority.

In this context, the upcoming months in the Brazilian interest market will begin to reflect the expectations regarding the outcome of the electoral campaign that is about to begin. The stability of rates at historically low levels will essentially pass through the entry of a pro-reform government and committed to the system of inflation targets. Otherwise it is not unlikely that we will return to the situation observed in the Dilma era, and the movements seen in the last weeks will be just the beginning of a considerable reversion process. However, precisely because of the lack of definition of the candidates with real chances and the assessment of their ideas, as well as the potential and enormous chances of adversity coming from abroad (especially increases of FED interest rates and the Trade War), the market has *not yet* adequately factored all of this into prices. Thus, it is possible that future interest rates will fluctuate around this level (due to external tensions), but they will cool a little (if decoupled from the Dollar) without devising a more deteriorated scenario, thereby more closely reflecting the fundamentals of anchored inflationary expectations than movements of the market. This has been in fact the BACEN's motto, that *there is no mechanical relation between the exchange and the interest rates*. Here is BACEN using its "main" tool: communication.

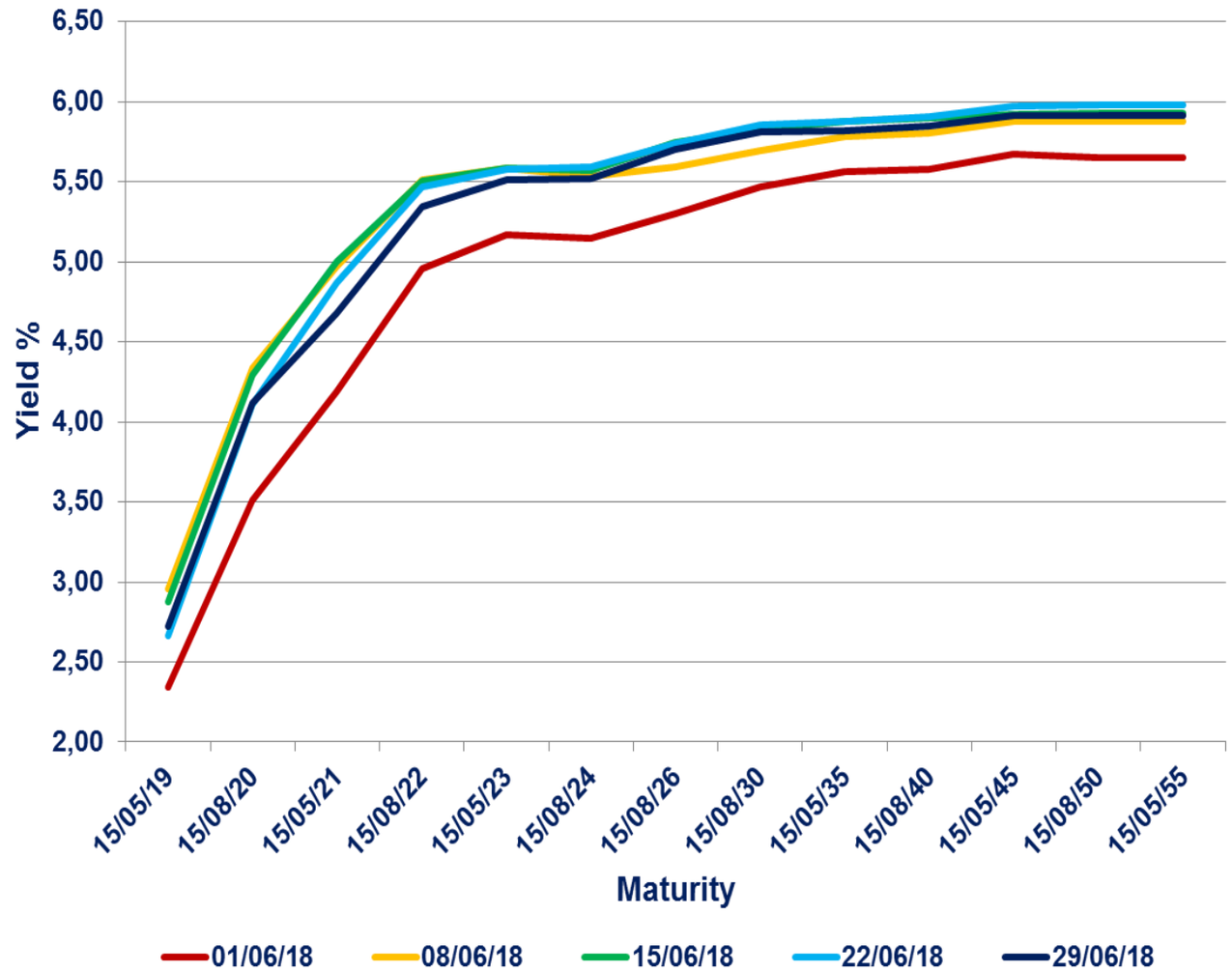
For the short term, anything goes, and we also believe in leprechauns!

Weekly Interest Rates

Yield Curve Diagram



NTN-B Diagram



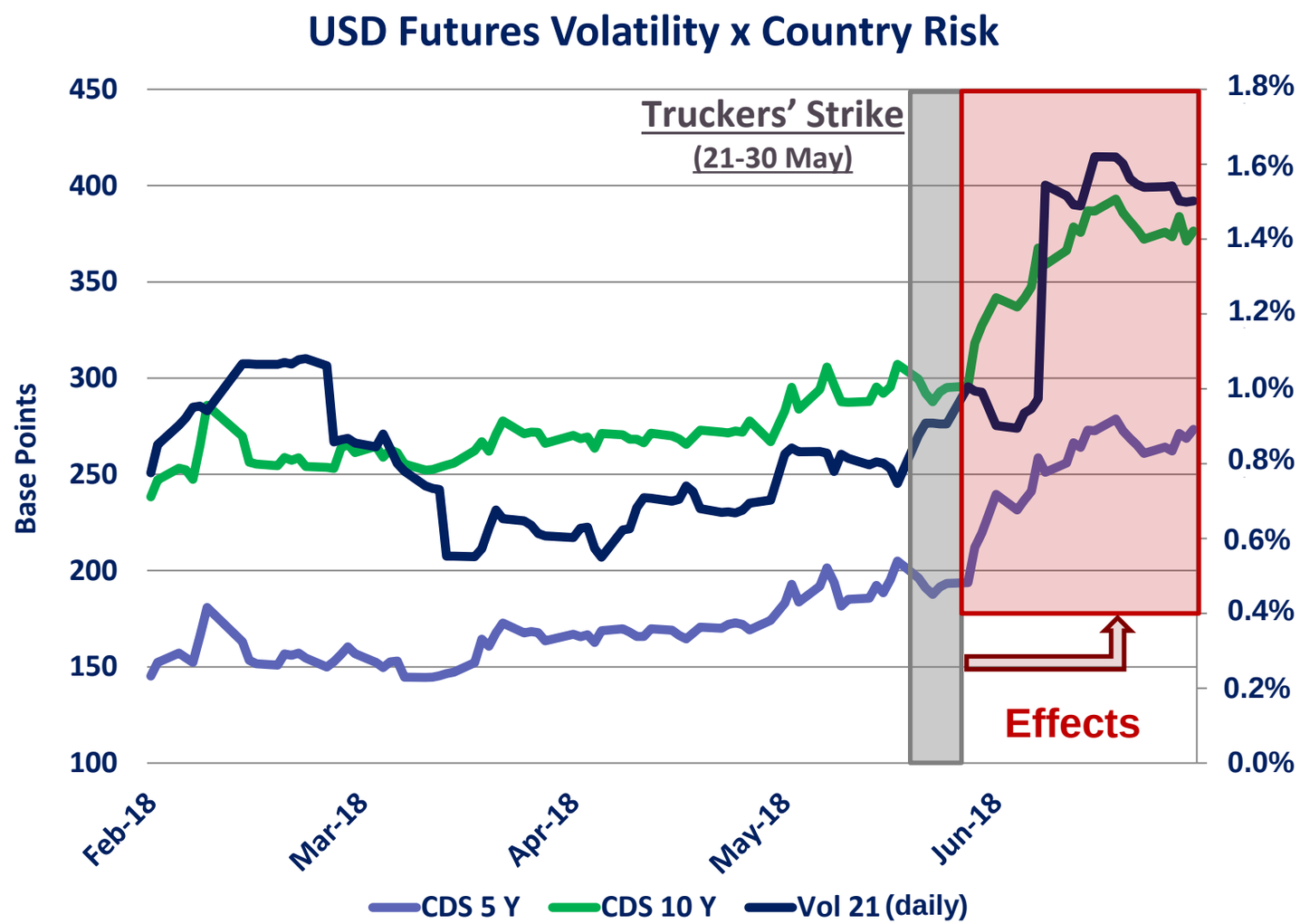
Source: Broadcast | Elaborated by Planner Redwood

Foreign Exchange

With increasing internal and external pressures in the near horizon, volatility of the dollar, both the "spot" and the "future" prices have increasingly reflected the amplified perception of our country risk, which has been constantly adjusting to moderate standards, and accelerated again throughout the second quarter.

Regarding external pressures, the outlook takes on more obvious contours of a possible US trade war, pulling down the price of emerging currencies, especially due to the not insignificant weight that exports to the US have in their exporting patterns. Although President Donald Trump's focus is clearly on the realignment of trade policy with China, the second and third order effects can and should impact production and exports by undeveloped countries, which in different measures are sensitive to the level of global output growth.

As for domestic pressures, Brazil's increased risk is in line with the complete disarray of the country's macroeconomic outlook. The volatility of the Dollar futures contracts indicates that the monthly appreciation of the US dollar against the Real will not stop in June (5th consecutive high) and, with the interest differentials (internal and external) and the additional upswing of the CDS, no significant advances of the American currency can be dismissed. With proximity to the effective beginning of the electoral process and the virtual loss of the next semester in terms of macroeconomic management (in particular by the definition of monetary policy), we can only watch the constant interventions of the BACEN in pursuit of what it denominates Exchange Rate Policy.



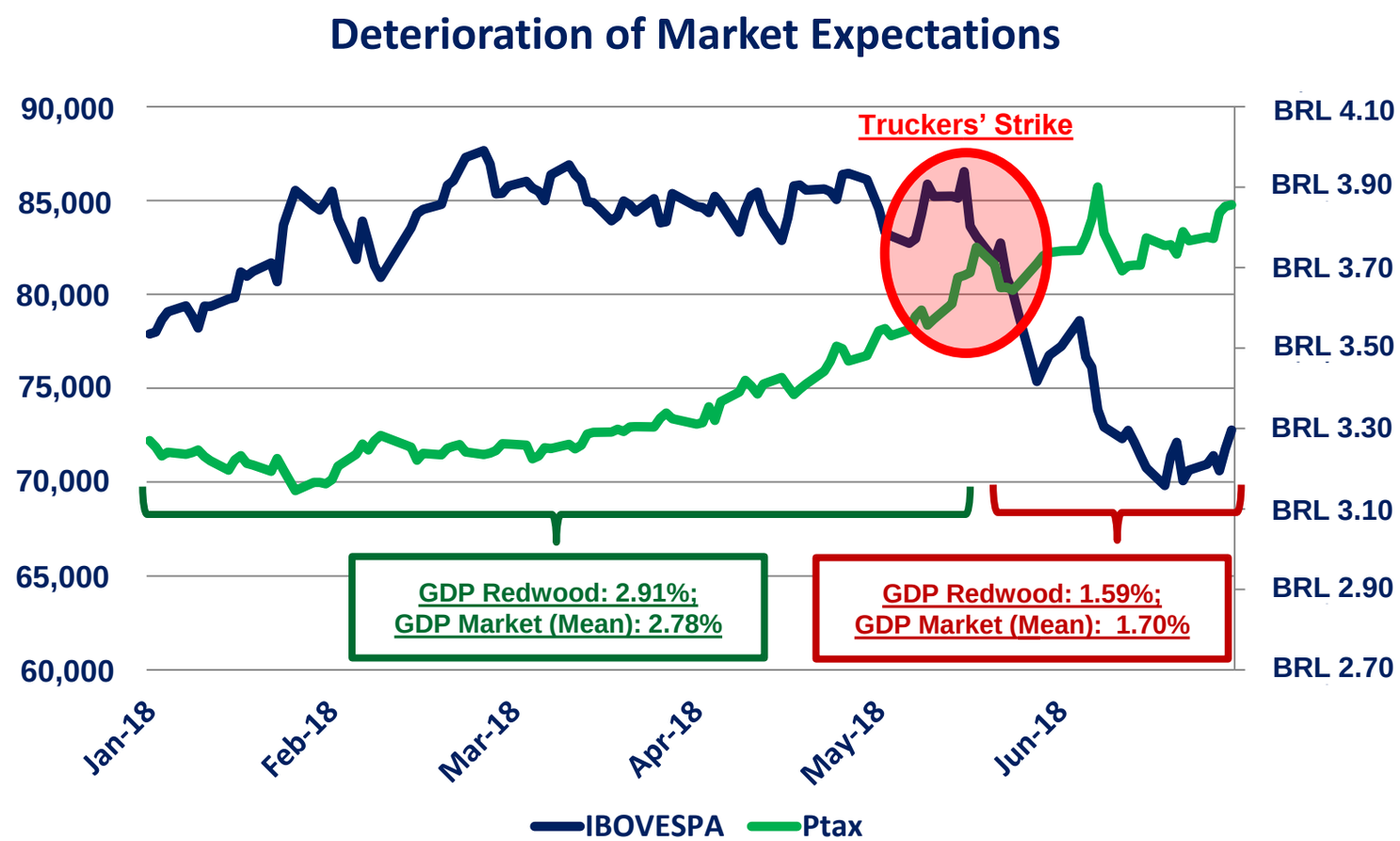
Source: Blooomberg e Economática | Elaborated by Planner Redwood

In this scenario, the Central Bank has already initiated and escalated its level of activity in the foreign exchanges market, after the complete roll-over of the swap contract stock, launching auctions with guaranteed repurchase agreements. In the midst of attempting to make the foreign exchange market more functional, through its (sorry, it would be anyone's) unsuccessful strategy to contain volatility, at least there still remains some common sense in not compromising the level of reserves in the medium-long terms. Yes, more than ever we are possibly on the edge of a crisis (Trade War) with potentially greater effects than the 2008 crisis, and maintaining our foreign exchange reserves is imperative. Very dependent on external financing and without sufficient reserves to accommodate a sharper shock (which has only just begun), the turbulence in the foreign exchange markets has already made a significant victim: Argentina. The country had to resort to the IMF.

We know this story well, and the long-missed Mario Henrique Simonsen always warned: "*Inflation cripples, but the exchange rate is fatal.*"

Stock Market

Finding rationality in stock exchange movements (in the short run) is itself an irrational act. Albeit too abstract, we sometimes raise the discussion on the determinants of stock market movements, especially when we focus on a macro portfolio allocation perspective, and at the heart of this discussion lies the indisputable fact that stock market movements are grounded on the level of economic activity. It is not plausible to assume that stock prices in the aggregate will rise uniformly and consistently in a landscape of fragile recovery of economic growth, just as it is delusional to assume that with buoyant activity we will not have the growing emergence of new attractive asset opportunities and growing upside potential. In plain English, there is no way to disregard, in the medium and long terms, the disconnect of a stock index that is representative of the economic advances or retractions.



Source: Broadcast | Elaborated by Planner Redwood

That being said, our claim that the Ibovespa P/E ratio pointed to a considerable downside risk held up, with the main benchmark of the stock exchange showing a meager return up to June. Within the month, there was a 5.1% plunge, while in the second quarter the drop was of expressive 14.76% (a 4.7% decline in the first half). The adjustment of expectations for the year 2018, which came after the attempt to accommodate the projections of the effects of the truckers' strike and the growing tension around the direction of the electoral process starting in July, was a dominant factor for the retreat of the index, which fell below 70,000 points in that period. The consequence of this scenario is the year with the greatest drop in new public offerings (IPOs) since 2008, marked by the effects of the international crisis. The first half ended with the withdrawal of eight companies that had already filed their applications with the CVM and another 11 that planned to effect the protocols throughout the year, between IPOs and Follow-ons.

The "consistent" recovery of the economy is left for 2019 and beyond. It is possible that the stock market will again be among the most attractive options for profitability amid historically low interest rates (between 6.50% and 7.50%), once the political risks of this electoral process are overcome. Thus, it will be crucial to combine the constant exacerbated reactions of the market (now down) with the eventual economic recovery (including sectoral evaluations), and to invest with a long-term focus on Value Companies traded at very low prices.

Crises create opportunities. Patience, expertise and determination define the game. Let's stay tuned!

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