PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - APRIL 2018

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

"Justice delayed is justice denied."

William E. Gladstone – former UK Prime Minister

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Introduction

Former President Lula is in jail.

Lula's arrest was the event of the month, and his most faithful companions promise to loudly "resist" and protest to what they consider to be an absurd imprisonment "without any material evidence." PT gets us all tired. The Left disfavors and pays a disservice to Brazil with its misrepresentations of reality and crooked interpretations of right and wrong, and its contempt for intellectual honesty. They intend to carry out this idea, and know that it can bear some fruit, because this what they sowed in recent years in the three branches of power and instilled in many of the unsuspecting minds of the suffering and credulous Brazilian people.

Despite the havoc and mess experienced even by the standards of Brazilian judicial system, in particular for the case in point, Lava Jato has amassed successive wins and has promoted, even in the highest Court - the STF -, debates and quarrels among supreme court justices, thereby exposing the inner workings of an institution under ongoing "adjustment" and ventilating surprising statements, such as proffered by Minister Luís Roberto Barroso to Minister Gilmar Mendes, to "cleanse the soul" of the Brazilian people. In short, the bleak realization we're in the midst of the heyday of interrupted dialogue and common sense.

Lula is long past due in jail, and whether he'll stay there for the term of his sentence is a big unknown. It is likely that convictions from other trials will come, not before facing a fair trial ... but it is not known how long this will take. Condemned are we the people to repair his and his successor's misguided policies, whose legacy was the largest recession ever seen in the history of this country. We are gradually emerging from a very dark period. Destroying always comes easier than building ... and rebuilding the country from this catastrophe will demand a lot of time and effort. This effort requires understanding and unity, both of which are lacking in those who say that there has been a coup against Brazilian democracy and independence - to think otherwise is not an option. These such groups are very harmful, for they have always made anger their main political weapon, but on the other hand Brazil resists and good men appear at the time when democracy and justice are strengthened. It is in this sense that the quote by the former Prime Minister of the United Kingdom William E. Gladstone and quoted by the Attorney General of the Republic Raquel Dodge, on the occasion of the Session of the Superior Council of the Public Prosecutor's Office on April 03, which opens this Comment, needs to be taken very seriously in a reflection by all, because it fits this moment that we live in our country and we need to change: "Justice delayed is justice denied."

Across the world, the month of April had significant events, both in the political world and in economics and finance. A huge breakthrough in the imminent conflict with North Korea has been reached, with prospects of delivering its nuclear arsenal if the United States agrees not to attack the country - a deserver relief for the world, to be seen in the coming weeks. In China, asset management regulations should tighten market liquidity conditions, and the PBoC cautiously follows up on events. In the United States the 10-year T-Note advance to above 3% triggered all sorts of monetary policy re-evaluations, while the Dodd-Frank Act is at risk of not being approved by the Senate. In the realm of political and diplomatic relations, US President Donald Trump was with Chancellor Angela Merkel and during his visit to the United States, French President Emmanuel Macron, who despite their differences regarding some of Trump's ideas, discussed the state of the important nuclear agreement with Iran. Should the latter be conducted with the same philosophy as in the case of North Korea, it is possible that we'll have equally satisfactory results.

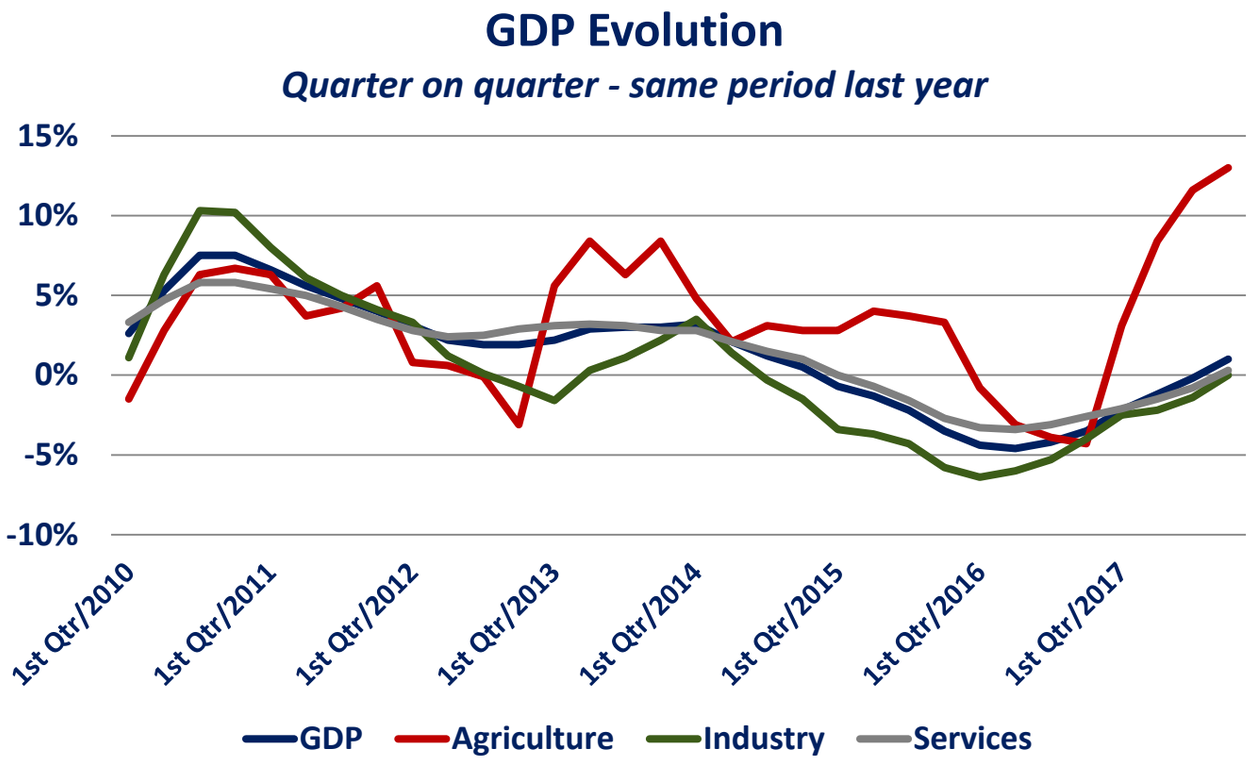
In this landscape, US Treasuries closed the month at 2.9531%. S&P increased by 0.27%, NIKKEI closed at 4.72%, DAX at 4.26% and FTSE at 7.00%. The Ibovespa ended the month at 0.88% and the IBrX at 0.82%. Highs in the month for DIF19 at 6.28% and DIF21 at 8.17%. The NTN-B 2050 ended the month at 5.2724%, and the Dollar (Ptax) at BRL 3.4811.

Economic Outlook

Economic recovery following the hurricane of the PT administration will be marked by the slow and tenuous sustainability in the short term, for the various reasons that affect any aftershock predicament: low investment rate, unstable confidence indexes, fiscal rampant, lax labor market and systemic corruption to be debased.

Despite the apocalyptic period, the 2017 GDP leaves no doubt as to whether the recession is over, and the numbers point to a "consistent" but not rapid recovery. On the supply side, agriculture is always surprising, but manufacturing as a whole has not yet risen to grace (transformation industry goes well, while building stumbles) and Services – largest job creator -, evolves less intensely.

This short-term variability greatly affects consumer assessments, and therefore their expectations. Especially this month, diminishing consumer expectations on the labor market led the Consumer Confidence Index tumbling down, a result that compensated for more than half of the increase registered in March. In fact, according to Consumer Survey coordination, consumers in all income strata are less optimistic about the economic situation in the coming months, influenced notably due to labor market expectations.



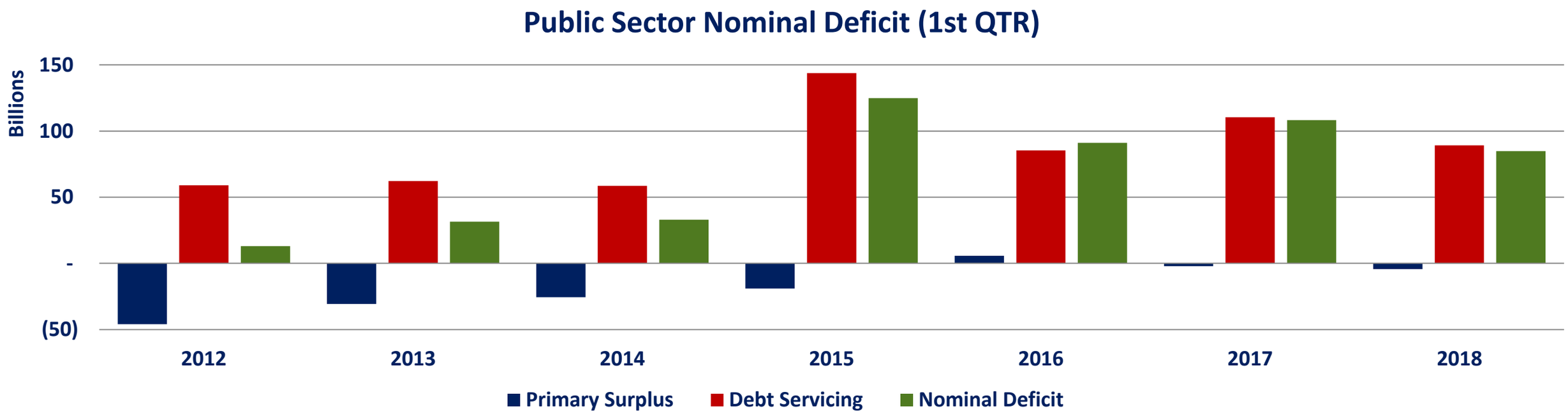
Source: IBGE | Elaborated by Planner Redwood

A dropping indicator that measures optimism in the economy was also accompanied by the fall of those measuring the financial situation of households. Registered in all classes, the negative highlight was on low-income classes which face lower purchasing power. As a result, the indicator measuring current satisfaction and optimism about the economy in the following months has receded.

Along these lines, some economists claim that cyclical recovery with sustainable growth are different phenomena, since, according to advocates, with the improving demand, it is natural for sectors to respond by increasing supply. The resumption of the level of activity in various sectors would be a natural reflection of the rekindling of demand after the recession. This seems somewhat tautological to us, and we should not expect any movement other than that, since entrepreneurs (and society at that) will not expand productive capacity before any significant use of the present idle capacity. This movement basically follows from the above, and it brings with it the natural restlessness and mistrust of a process that will be quite difficult.

In addition, it should not be forgotten that in the absence of increased savings and investment, it will not be possible to expand the country's productive capacity. Our rate of investment remains far behind those enjoyed by emerging countries, currently around 16 percent of GDP, and in order to grow sustainably to what we envision for 2018 and 2019 in subsequent years, this rate should climb above 20 percent. The frustration of this goal will ratify the self-fulfilling prophecy of cyclical recovery. However, this lies far from current expectations and is indeed true, since the recovery in the machines and equipment sector has not been in trouble at all, especially when comparing it with the negative rates of 7%, 22.3% and 15.6% for years of 2014, 2015 and 2016, respectively. In addition, the increase in this type of investment occurred at a time when BNDES disbursements were cut down, which is inkling of a real recovery.

Fiscal Policy



Source: BACEN | Elaborated by Planner Redwood

The primary deficit of the overall public sector (Central Government, states, municipalities and state-owned companies, except for Petrobras and Eletrobrás) ended the first quarter still on the positive side, mainly due to the record-breaking effect of January, the best surplus in the history for that month at BRL 46.9 billion. However, the primary deficit of the overall public sector of BRL 25.14 billion in March is the largest negative outcome since the beginning of the historical series initiated by the BACEN in 2001 for the month - February registered a deficit of BRL 17.4 billion, and in March 2017, a deficit of BRL 11.05 billion. The main highlight for the current deficit was the anticipation of judicial ruling payments amounting to BRL 9.5 billion, but, even if the latter were taken out, it would be the worst deficit for March within the series.

In this respect, the net public sector debt (DLSP) increased 0.3% against February, reaching 52.3% of Gross Domestic Product in March. On the other hand, the government's gross debt closed last month at approximately BRL 5.0 trillion, which represents 75.3% of GDP. This is the highest percentage within the historical series, started in December 2006, and still growing. We have repeatedly pointed out here that this is the main solvency indicator used by the country-risk-rating agencies. Despite the figures presented, the result was in line with market expectations, which indicates, at least for the moment being, and with the actions taken in this direction, to meet the target for the year 2018. It is worth remembering that the deficit target of the overall public sector considered by the current administration is BRL 161.3 billion for this year.

Everything under control, then? Nothing of the sort! The new Secretary of the National Treasury, Mansueto Almeida, does not miss a single opportunity to underline the situation of "shortages" we are experiencing, our extreme limitations and the rally to which we will be subject in a short period of time if no restructuring measures are taken to rebalance the government’s finances. An election year makes this task even harder to fulfill, but failing to respect budgetary balance and the government's ability to pay has already proven to have drastic consequences.

International Outlook

The presidents of North and South Korea have come together to put an end to this war between these two countries that drags on for years - interrupted by an armistice in 1953. North Korean dictator Kim Jong-un promised the president of South Korea , Moon Jae-in, who will deliver his nuclear arsenal if the US signs a non-aggression pact and formally end the war.

Did Donald Trump "diplomacy" work then? Better be militarily robust not to enter into wars, but rather to avoid them? It is possible that yes, but much caution is especially important with Kim Jong-un, since his history does not offer much confidence and credibility. In any case, the gesture of good faith and the attempt to approach the Americans on the part of the dictator during the meeting with the two presidents does not seem to have been rhetorical. Kim Jong-un is said have scheduled for May, inviting experts and journalists from the US and South Korea to accompany the dismantling of the country's nuclear testing site. One way or another, there is a chance for peace, and the great broker of this situation, the United States, articulates a historic encounter between Donald Trump and Kim Jong-un.

Yet across Asia, the US seems to move forward with its commercial purposes and without the fuss envisioned at the beginning of Trump's "negotiations" and his team. US Treasury Secretary Steven Mnuchin said he was optimistic about improved trade talks with China on tariffs and the US economy. Here too it is prudent to be optimistically cautious, but the progress of negotiations has reached a level of *serenity*, and discussions on trade issues and their effective imbalance will advance, possibly somewhat more pragmatically, towards intellectual property rights, technology transfers and joint ventures.

China skillfully face this "problem" of commercial warfare, so far without any vehement opposition or effective confrontation - and could retaliate by imposing tariffs on agricultural products and other items such as airplanes. Anything really. The strategy, or lack thereof, may be cherry-picking the real and imminent problems to be tackled - domestic (economy and markets - liquidity management by the PBoC to prevent excessive market deceleration, and a very sharp interest rate hike), or even geopolitical (such as trying to participate in a possible multilateral agreement for the solution of the Korean War).

If on the Chinese side dealing with the new-normal of Donald Trump has been somehow circumvented, in Europe and especially Germany, the Secretary General of the Federation of German Industry, Joachim Lang, stated that the United States tariffs on steel and aluminum imports are "absurd" and could threaten thousands of jobs in the steel industry. He further stated that "the European Union is not threatening US national security" and that the case should therefore be referred to the World Trade Organization. As the continent's largest GDP, the German economy has presented disappointing data on its activity level. In this regard, Germany is once again joining France and the United Kingdom in trying to prevent the United States from applying import tariffs on steel and aluminum after the deadline of May 1st for the European Union to be exempted. However, the Eurozone is expected to enjoy a robust growth rate this year (2.3%), driven mainly by high levels of consumer and business confidence. The dynamics of prices and the labor market are also in good shape. Another important point is that the budget deficit of the Euro Zone should decrease in 2018 and 2019.

Last but not least for the world, the 10-year T-Note interest rate above 3% has shaken the markets, and may signal the beginning of the end of the Central Banks' quantitative easing. Another important aspect of the month relates to legislation reformulating Dodd-Frank, an attempt to reverse the financial rules implemented after the 2008 crisis and provide more regulatory relief for banks, which is not likely to be approved should it return to the Senate.

In fact, many good news and impacts across the planet, but it is definitely not possible to please everyone and have everything all at once.

Interest Rates

The interest rate market was buoyant in April, following the tone imposed on a global level by the momentum gained by the US Dollar against other global currencies. This movement was fundamentally linked to expectations with the US interest market, which, amid the monetary normalization process being conducted by the Fed, saw 10-year Treasury rates temporarily outperform the symbolic 3% rate mark.

We can interpret the effects on our interest market as twofold. The first reflects more directly the effect of exchange rate devaluation on inflation (with more direct and short-term impacts on the IGP-M, and with a sequential pass-through to the IPCA), since the exchange rate is among the prices determining the level of prices, with a high level of diffusion among them. Given the weight of our trade balance in the prices of domestically available goods, variations that are consistent and therefore change the level of the exchange rate are likely to impact the rate of inflation implicitly expected by the market.

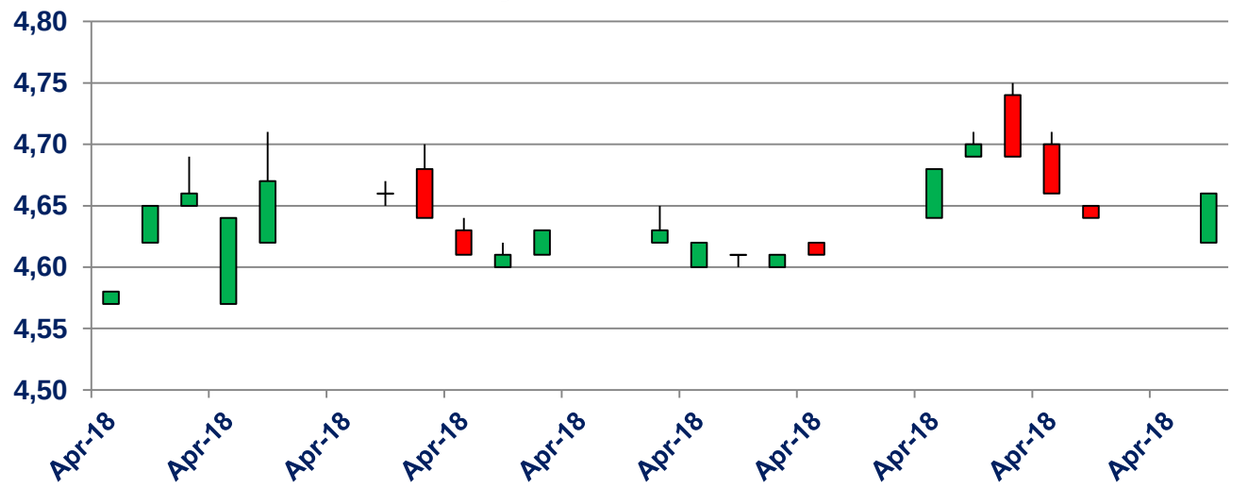
The second, more indirect, effect is linked to the fact that with US interest rates (which we can assume to be an asset very close to what is considered in the literature as a risk-free asset) rising significantly, the premium required by investors to assume "Brazil-risk" (which, admittedly, is a country in need of reforms and very close to a still fuzzy electoral process) grows, and in many cases disproportionally more than entailed by its cause.

One of the methods we can use to evaluate this relationship is by the International Interest Parity model, which composes the methodological framework used by Redwood for interest rate analysis. In this model, we seek to observe the behavior of the domestic interest rate given a projection for the international risk-free rate, ceteris paribus. It follows a logic of equilibrium between international rates with no arbitration gains via carry trade.

International Interest Rate Parity – Redwood (10-year Vertices)

	NTN-B	T-Bond	CDS	Spread
Mean	5,67%	2,15%	3,51%	-0,05%
Standard Deviation	0,68%	0,37%	0,75%	0,41%
15-Mar-18	4,69%	2,82%	2,56%	-0,72%
Floor 2018	5,03%	3,57%	2,12%	ε
Floor 2019	5,35%	4,32%	1,61%	ε

Monthly Evolution NTN-B 2026



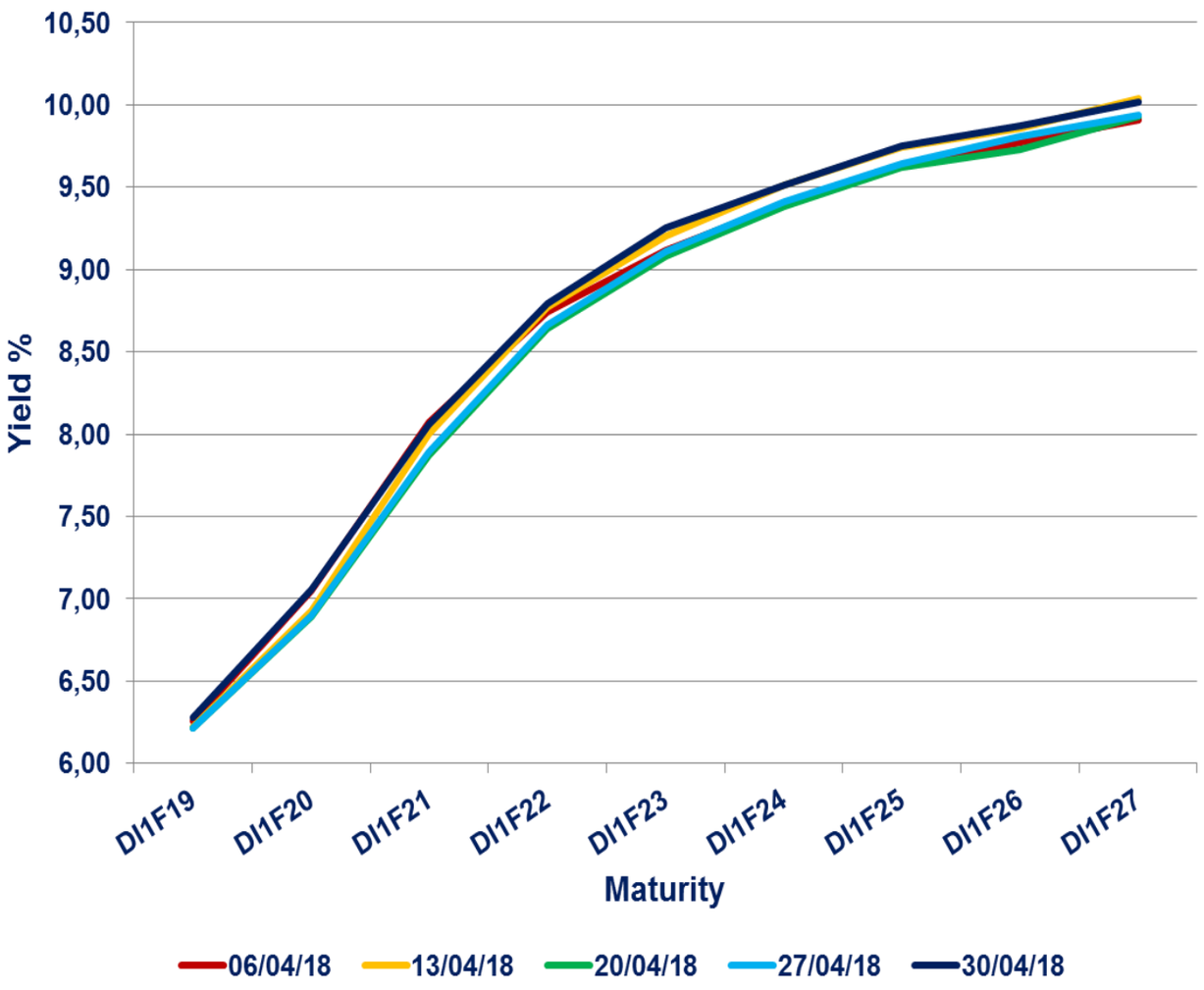
Source: Economática, Federal Reserve and Broadcast | Elaborated by Planner Redwood

At the end of March this model already showed that, in order to maintain a reasonable level of international parity between US and Brazilian interest rates and its fundamental principle of a "global balance", once projected FED hikes are factored in, it is imperative that our interest rates be adjusted in the same direction.

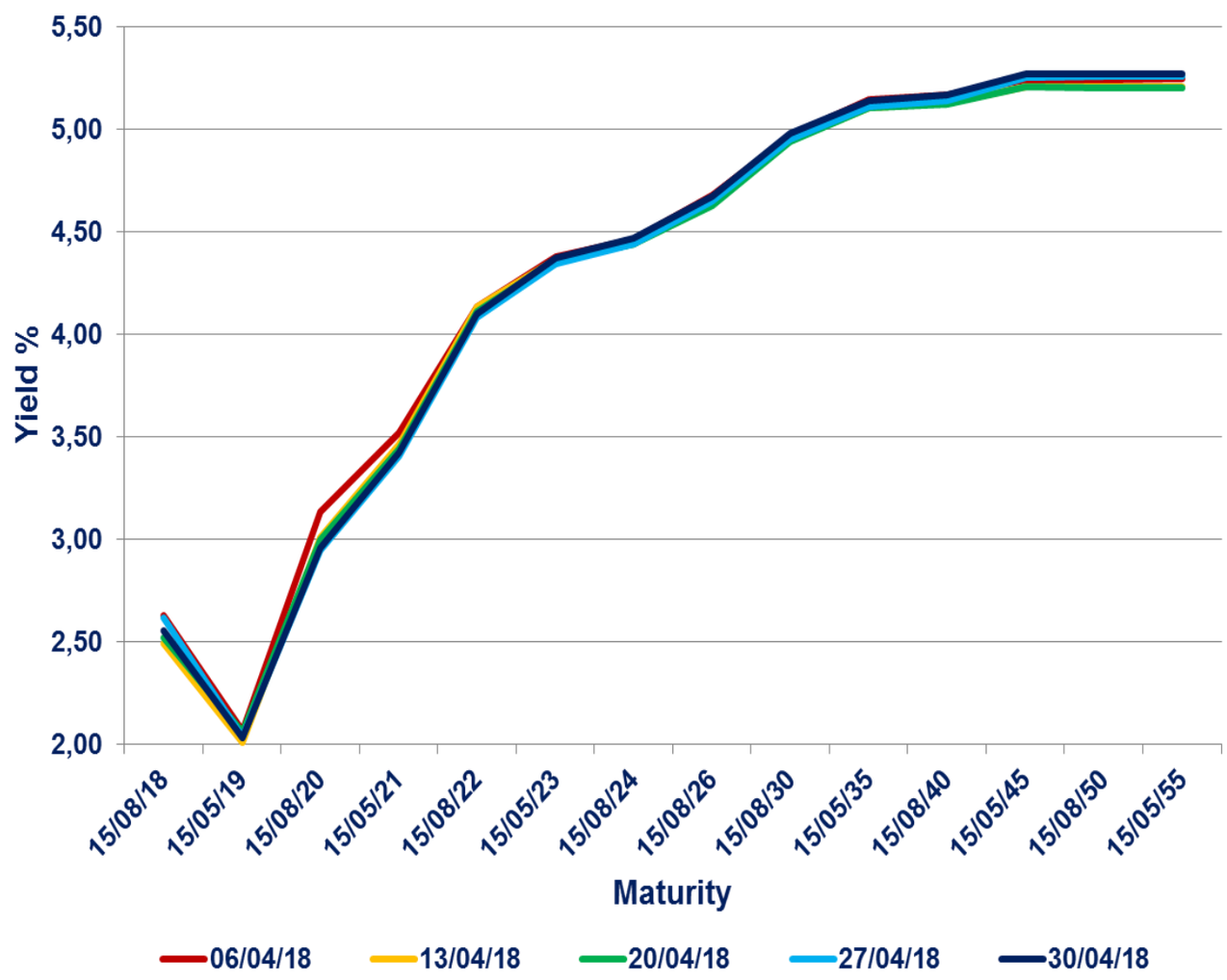
Our Monetary Policy points to another trajectory, in the face of countless other economic reasons for it. Given the correlations, this "clash" and noises only occur in the short term. With SELIC on its historical floor, and given the possibility of further reduction, short-term international capital fluctuations are likely to bring volatility, but dynamic convergence is seen as inexorable.

Weekly Interest Rates

Yield Curve Diagram



NTN-B Diagram

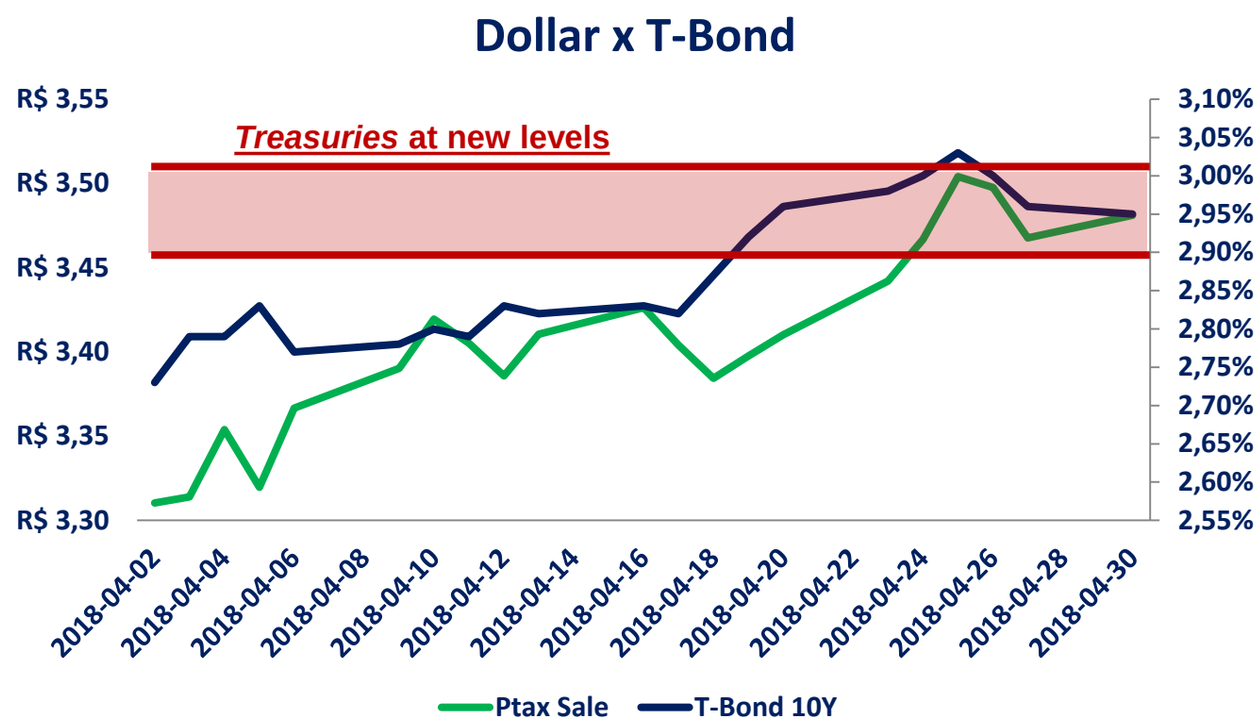


Foreign Exchange

At the beginning of the year, we experienced a significant appreciation of the Real against the US currency, which was traded at BRL 3.122, very close to the levels we estimate as the band of equilibrium for the level of risk currently practiced for Brazil. A really important signal for the trajectory of the currency market over the course of the year that began. However, what was observed ran diametrically opposed to our expectations. From January to April the Real depreciated 10.1% (Ptax sale).

According to an IBRE study*, the recent exchange rate behavior is explained 5% by domestic factors, 45% by external tensions and the remaining 50% are tied to the process of normalization of US interest rates. Even with the abundance of international liquidity that we still experience and persistently low interest rates in other developed countries, emerging currencies seem to suffer from *fly-to-quality* movements. Whether these are correct or precipitous movements, we will soon find out. The uncontested truth that emerges, however, is that Brazilian financial markets experienced strong volatility this past April, a volatility that was reflected in the strong devaluation of the Brazilian currency.

The explanation comes precisely from the 10-year T-Bonds rate, which has overcome the "psychological barrier" of 3%, an important feat for consolidating the still expected highs for US interest rates.



Source: Federal Reserve & BACEN | Elaborated by Planner Redwood

Along with the Dollar quote reaching BRL 3.5150 on the 25th, its maximum within the month, came the Central Bank's statement that it will fight against the "Perverse Exchange Rate" (sic), given the sufficient clearance guaranteed by our international reserves and the "low" stock of currency swaps currently held by our currency custodian. At times like this, it is up to us as both economy and society to decide whether or not we will definitely raise the floating exchange rate flag. And that includes even the moments of greater volatility.

As for the cost of such intervention, which all our pockets directly bear, the BACEN recorded a loss of BRL 1.302 billion only up to the 20th of this past month. So much for the "low" level of swaps with which BACEN is comfortable.

If the best for the Foreign Exchange Policy is to do nothing at all, or, the less that the exchange rate is manipulated by its effects and the more it is fixed by focusing on its cause, our hopes of a truly free and floating exchange rate are cut down to zero - if BACEN accepted in anyway the study cited above. External tensions and normalization of American interest, accounting for 95% of movements with a little more persistence over time tend to trigger, with a history such as ours, further interventions, direct actions by the BACEN.

Should it be any different this time? Can we have an exchange rate policy that assesses balances and "imbalances" in the short and long terms? We'll know soon!

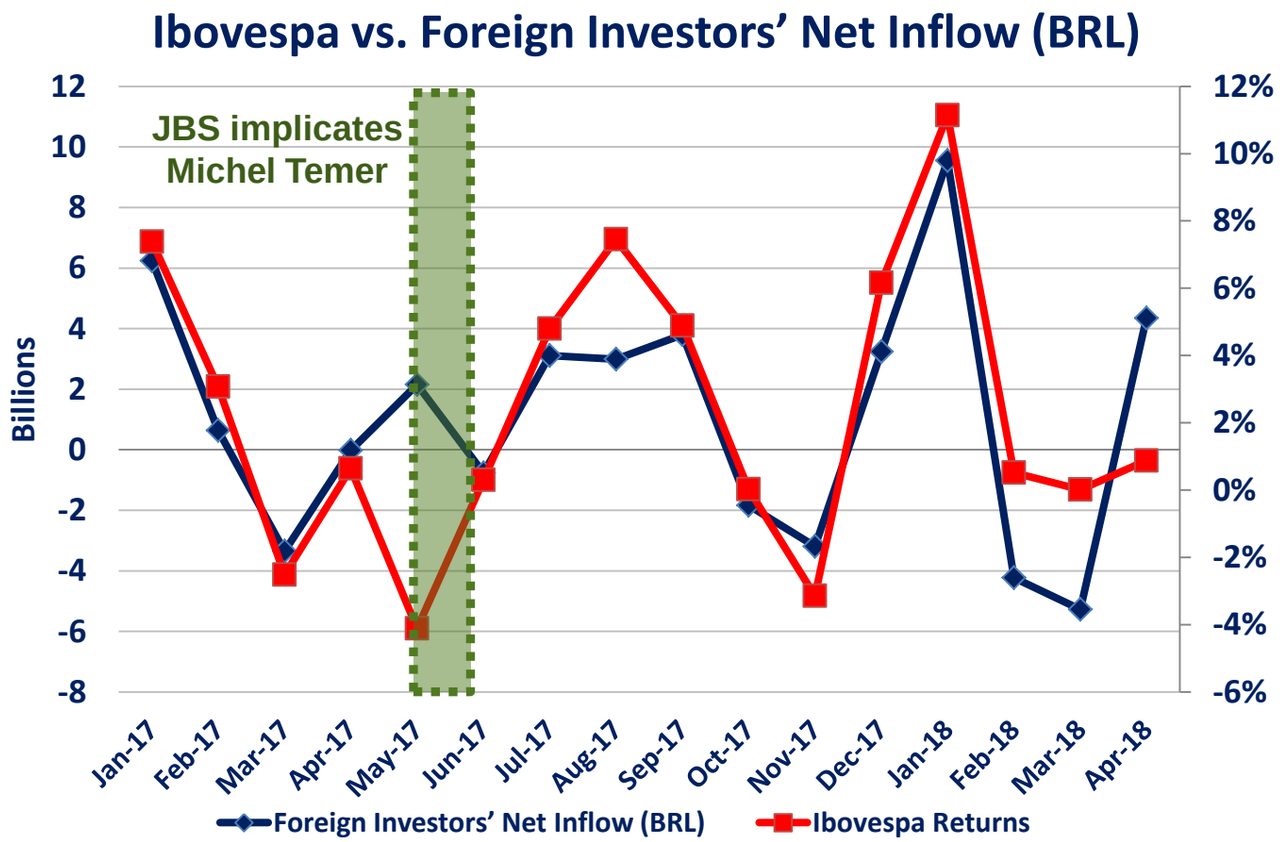
Source * :http://portalibre.fgv.br/main.jsp?lumPageId=402880811D8E34B9011D9CCBFDD1784C&contentId=8A7C82C5557F25F20157E26D013E359B

Stock Market

In a month marked by surprising instability in the financial markets and significant losses for investors positioned in exchange and interest rates, the stock market once again performed quite well, maintaining its position as the current "sweetheart" among Brazilian markets.

The Ibovespa appreciated 0.88% in April, marking 86,113 points, and recording the fifth consecutive month of highs. Were it not for the negative performance in November, amid the realization of profits and corrections, the main index of the Brazilian stock exchange would register 11 consecutive monthly highs. It is also worthy of note that this month witnessed such a positive result despite some pressure from abroad, mainly due to the poor performance of the Dow Jones and S&P 500 indexes that are both relevant to our stock market.

An important part of this appreciation has been the first quarterly financial statements of the year, which in general points to the consolidation of an increasingly better microeconomic scenario in contrast with the recent past of Brazilian companies (even with macro fundamentals still under a sluggish recovery). Reflecting this new moment was the new acquisition that gave the tone of the Stock Exchange at the end of April. *Kroton* bought a 73.35% share of *Somos Educação* previously owned by *Tarpon Investimentos*. Big companies making risky investment decisions aimed at expansion is a sign that optimism is beginning to run wider among economic agents, even though the aggregate view still signals an erratic recovery.



Source: B3 and Broadcast | Elaborated by Planner Redwood

In this line, assets linked to companies that have their revenues highly exposed to exchange rate risk, such as Suzano Papel e Celulose (which has been appreciating since the recent acquisition of Fibria), have pulled their gains with the new level in which the Dollar is traded. The average daily trading volume at B3 was BRL 10.293 billion in April, and also brought the foreign investor back, with a net inflow of more than BRL 4 billion. With foreigners holding around 50% of the Brazilian stock market, the ongoing view is that the exchange-rate-adjusted Ibovespa quotation allows us to assess its real attractiveness with more precision.

Some negative cases apart, such as the current crisis involving the change of management at BRF, and with the high downside risk linked to the expected upside potential, evidenced by the maximums reached in the Ibovespa P/E index, the Brazilian stock market moves on. It is perhaps the main proof today that the realignment of macroeconomic policy was important not only for the preservation of stability but also in changing the trend of the agents' expectations. It should, however, be heeded that economic activity has not yet fully unfolded. There is a high degree of idle capacity in manufacturing, and unemployment still pains more than 13 million Brazilians, a predicament that has strangled many long-term productive investment decisions. Coupling these factors with the political uncertainties of a troubled electoral scenario, one must shed some constrained optimism on the stock market, which may still be brought to fruition, but much at the mercy of its strong exposure to the flow of foreign investments.

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planner Redwood

Avenida Brigadeiro Faria Lima, 3900 – 10º andar

São Paulo – SP. CEP 04538-132

+55 11 2172 2600

www.planner.com.br

redwood@planner.com.br