PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - MARCH 2018

planner Redwood

Agenda

- Introduction
- Economic Outlook
- Fiscal Policy
- International Outlook
- Interest Rates
- Foreign Exchange
- Stock Market

planner Redwood

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

"Independence doesn't mean you decide the way you want."

"Independence means you decide according to the law and the facts."

Stephen Breyer – Associate Judge – US Supreme Court

Introduction

Brazil has lately been experiencing very turbulent times, a huge institutional mess both in the economy and in politics,, but the ludicrousness displayed by some judges in our Supreme Court has gone overboard.

Attempts are rampant not only to rid him of the jail at any cost, but still somehow enable former President Lula to run again for the presidency in this year's election. This March, a Habeas Corpus - HC was filed by former President Lula's defense team to prevent the arrest of the leader of the PT, causing several days of tension across markets and sending out noisy signals to investors and global observers of how the Brazilian justice system works... in essence, and accounting for differences among countries, a disrespect for lower courts' rulings.

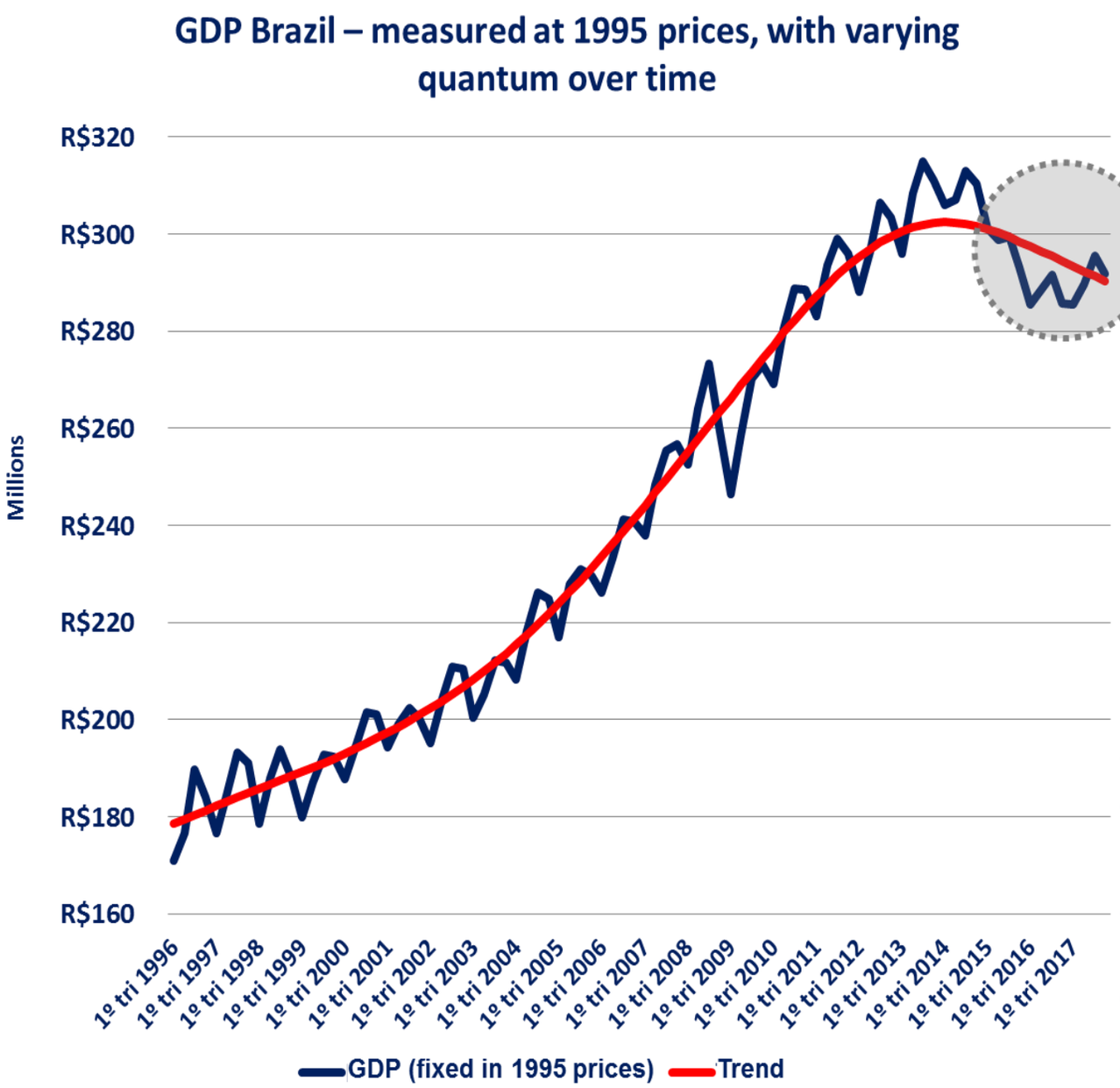
The Brazilian people are fed up with corruption, and can no longer endure the endless stream of scandals, malfeasances and mismanagement of public money. They have gone through the worst recession in its history and still a soaring and bitter unemployment level, while important public officials manage, with innumerable resources, not to pay for their crimes. These convicted felons have the support of some judges and the competence of excellent lawyers who know all the breaches and loopholes within the law, and so, in the whole of what is possible and within the limits of interpretation of the law, they manage to postpone the fulfillment of their sentences. The good news is that the Federal Supreme Court - STF, has ruled against this HC and other Constitutional Declaratory Actions (ADC) intended to change understanding of the prison after conviction in the Appeals Court. We are about to enter a new phase, in which we will recover our so-called economy, with the rigor and honesty that make people proud of their nationality, and not being humiliated all around- mocked both inside and outside our country. The STF, despite some supreme shame, is able to ratify this new phase, in which the economy is already on point, but which requires speedy justice and political will to move forward to new achievements. The statements by the Associate Judge of the Supreme Court, Stephen Breyer, which opens this report, fit this moment of our judiciary power: "Independence does not mean you decide the way you want." ... and ... "Independence means you decide according to the laws and the facts."

Overseas, as expected, the month of March was quite agitated regarding a possible Trade War in the face of the new tariffs on several goods the US "promises" to impose. Our assessment is that after one adjustment or another (due indeed) Donald Trump will cool down the measures, whose initial purpose was hugely wide range of countries, while the same focus will be between US and China. That is to be expected, otherwise it will be a typical lose-lose game. China has exemplarily *minimized* the threats (for now) on account of some misalignment and other more important matters to take care of - a beautiful strategy to contain the American impetus without undue damage. The economic outlook for the US justifies maintaining the gradual increase of interest rates by the FED, whereas in Europe this does not seem to fall short of reality yet. The Eurozone, however, has seen the unemployment rate drop, at the same time as inflation accelerated to 1.4% in March - close to the ECB target. In Japan, despite the "optimistic" outlook for the medium and long terms, in the short run indicators have been disappointing: Services and Composite PMI (which covers manufacturing) fell further than analysts had expected.

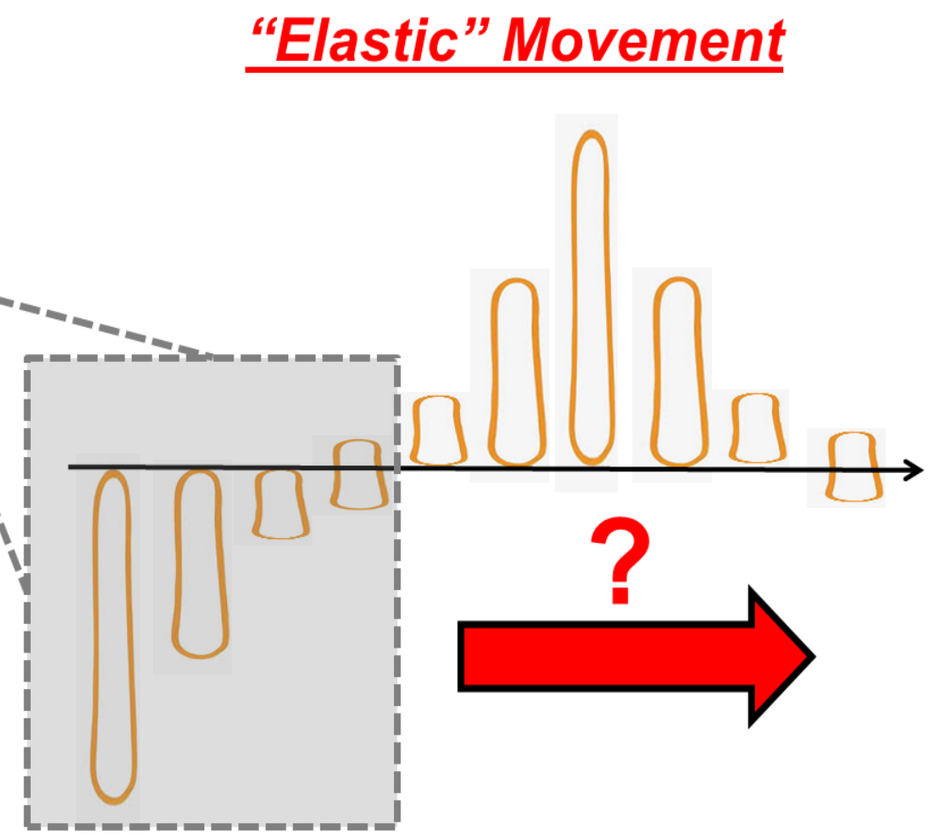
In this environment, US Treasuries closed the month at 2.7389%. S&P varied -2.69%, NIKKEI closed at -2.78%, DAX -2.73% and FTSE -0.87%. Ibovespa ended the month at 0.01% and IBrX at 0.08%. Highs within the month for DIF19 at 6.555% and DIF21, 8.43%. The NTN-B 2050 ended the month at 5.1713%, and the Dollar (Ptax) at R $ 3.3238.

planner Redwood

Economic Outlook



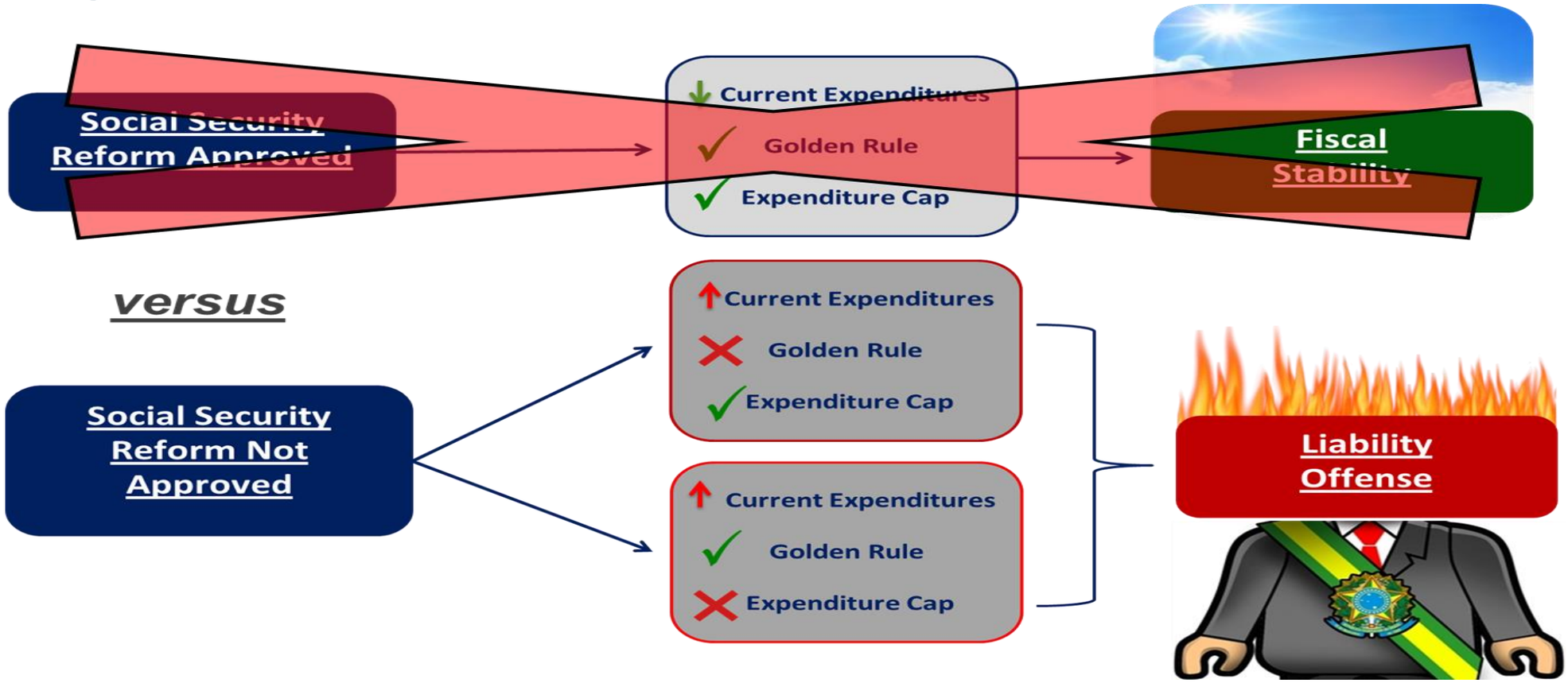
Source: IBGE and Redwood Projections | Elaborated by Planner Redwood



There seems to be little doubt, as was suggested last month, that the Brazilian economy is expected to expand in 2018 and 2019, without ruling out a *new* political crisis or simply the host of risks and uncertainties linked to the upcoming October elections, with direct impacts on the activity. A stronger path of job creation also seems very likely, notably due a flagrantly reversing idle capacity.

It is in this sense that we present the graph above, whose behavior is intended to demonstrate what lies ahead should structural reforms be brought to a halt. Once again both the window of opportunity and the timing, whether domestic or foreign, offer all possibilities to adjust and change our fate. It is not difficult to understand the reasons why investors are reluctant ... Brazil needs to prove itself as an interesting and reliable choice.

Fiscal Policy



There's a growing "feeling" that Brazil has a spending slump for 2018. In 2017, the primary deficit was BRL 110 billion, while the target set for both 2017 and 2018 was/is BRL 159 billion. This "sentiment" is corroborated by the reaction of tax revenues due to the already mentioned economic recovery. We at Redwood agree on a possible, if not circumstantial, short-lived improvement with positive impacts only in 2018 for purposes of meeting goal and the expenditures cap. It is impossible, as of this moment to ensure categorically the same situation for 2019. In order to comply with the Golden Rule, then, balancing out more than BRL 200 billion will require a herculean effort - with measures ranging from the payback by the BNDES of funds advanced by the Treasury - as well as various disengagements from previous policies -, to a finer and closer management of discretionary expenses and expenditures on salaries and social security benefits.

The pension reform has not been approved thus far, but there is no plan B ... we will have to face the problem. However, much more than that, the heart of the matter is reducing the size of the state, accelerating the agenda of privatizations and other actions on the same direction. The Expenditure Cap (**EC**), for example, harshly attacked by the left-leaning runner-ups to the presidency, will soon become the biggest villain. Why? Bernard Appy gives us a hint with his interpretation that the EC presents is at least two facets to it, namely: it limits both the expansion of federal spending and the growth of spending to the inflation rate, the latter having the power to make the former unfeasible.

This is a matter of choice!

International Outlook

The past month was overly stressful with the possibility of an unprecedented Trade War due to the actions taken by President Donald Trump. Markets rattled. Little by little the panic was being controlled and the real intentions surfaced: Trump's "problem" is not exactly with the world (though it "will be" for some), but with China.

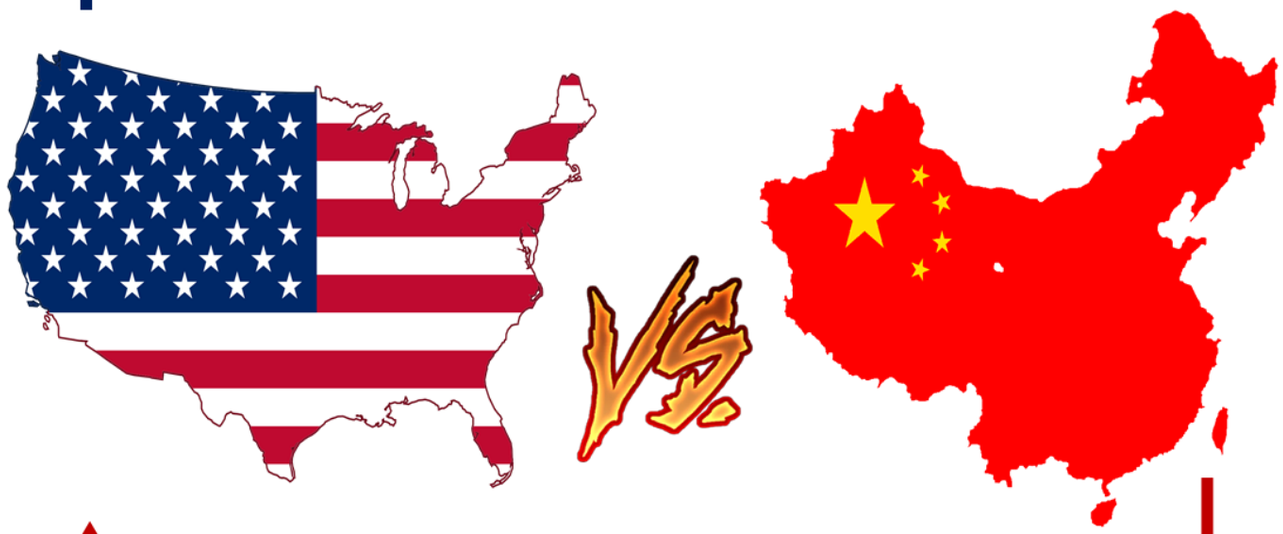
Still, without detracting from the potential for disruption that the US can promote, these appear to be timely and long overdue adjustments - despite the long list of products targeting new tariffs. The retaliations from China will not be long, but the Chinese seem quite calm and parsimonious, especially since they know well where the touchy nerves are. In this issue, the fact is that these attitudes are extremely harmful to both. It's a typical lose-lose case.

China, on its turn, has other important actions to coordinate, especially within its own country. President Xi Jinping considers his country's financial stability to be a matter of national security. In this sense, PBoC will expand its efforts to maintain financial stability, reduce systemic risks and support financial and social stability by controlling leverage, limiting both loans and risk of the parallel banking sector. It is, as you can see, a constrained "freedom", where the market can play a decisive role, but the government is always there... tuturing "efficiency".

In Europe, the Eurozone recorded a decline of 141,000 unemployed persons, and although in line with the projected, the unemployment rate of the region fell from 8.6% in January to 8.5% in February, reaching the lowest level since December 2008. No less important, but also predicted, was the rise of inflation at 1.4% year-on-year in March, gaining momentum from the 1.1% increase seen in February - approaching the Central Bank target (ECB), which is slightly below 2.0%.

Anyway, were it not for Donald Trump rocking the boat, this would have been an easy month...

- **In 2015, China imported USD 165 billion in goods and services from the US;**
- **US is a provider of global liquidity.**



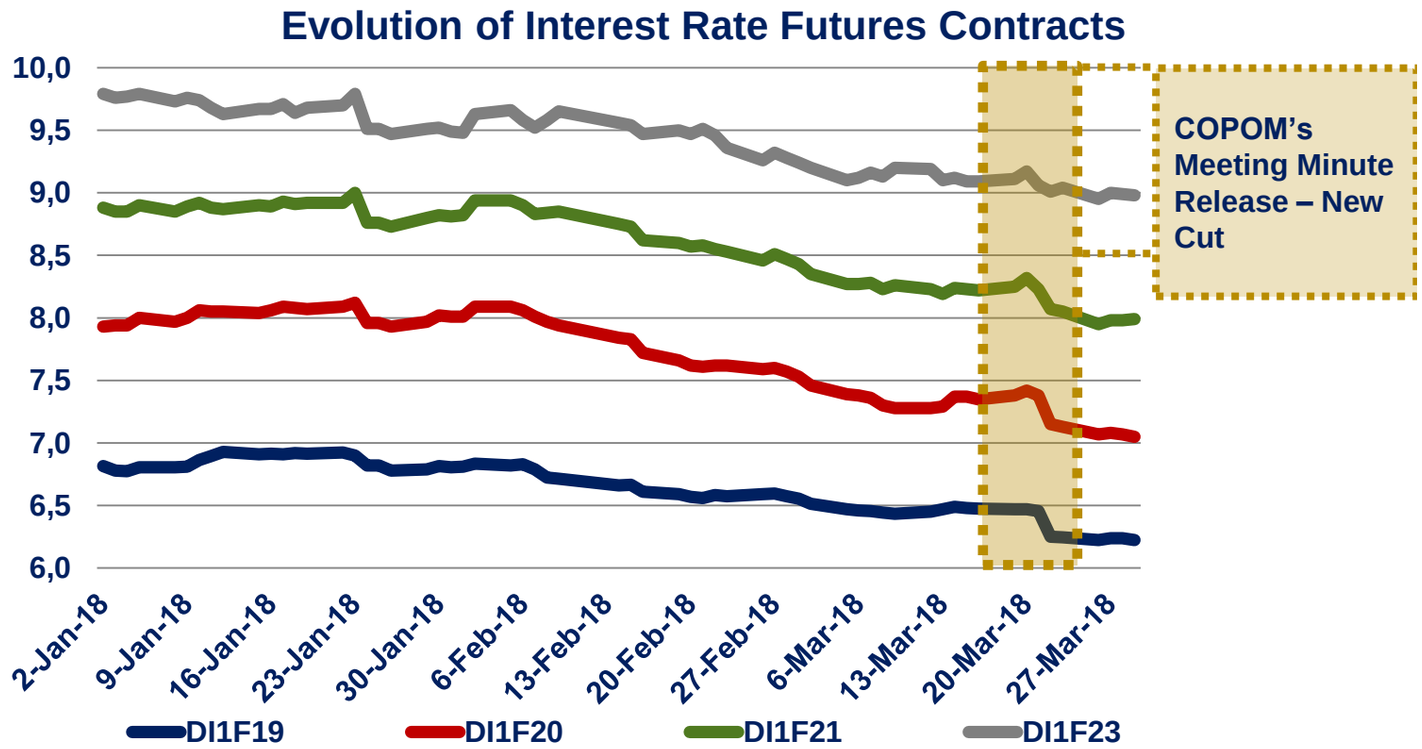
- **In 2015, US imported USD 216 billion in goods and services from China;**
- **Chinese are the main creditors of US public debt.**

Source of GDP projections: *The US-China Business Council (USCBC)I*

Interest Rates

For those who expected a stable and quiet trajectory for the Brazilian interest rate market throughout 2018, March raised strong emotions and the reshaping of market expectations.

COPOM's new cut of 25 base-points from the baseline interest rate, which led to a SELIC at 6.25%, was already expected unanimously by the market, which had already priced this last cut this year at DI 19. This would close the sharp cycle of falling interest rates, which began in 2016, when the rate was at 14.25%. However, the surprise element came with the minute issued by the Brazilian monetary authority, which had as its central argument the room observed by members of the policy board for an additional cut in interest in the next meeting (scheduled for May). The basis for this (now openly declared) decision lies in the dormant inflation, which still risks closing 2018 below the lower band of its target, and also hinges on the concern with the consistency of economic recovery. Thus, a new cut is justified by the Bacen, even though his sole mandate is the stability of the national monetary system, and already presenting interest rates below its natural rate.



Source: Broadcast | Elaborated by Planner Redwood

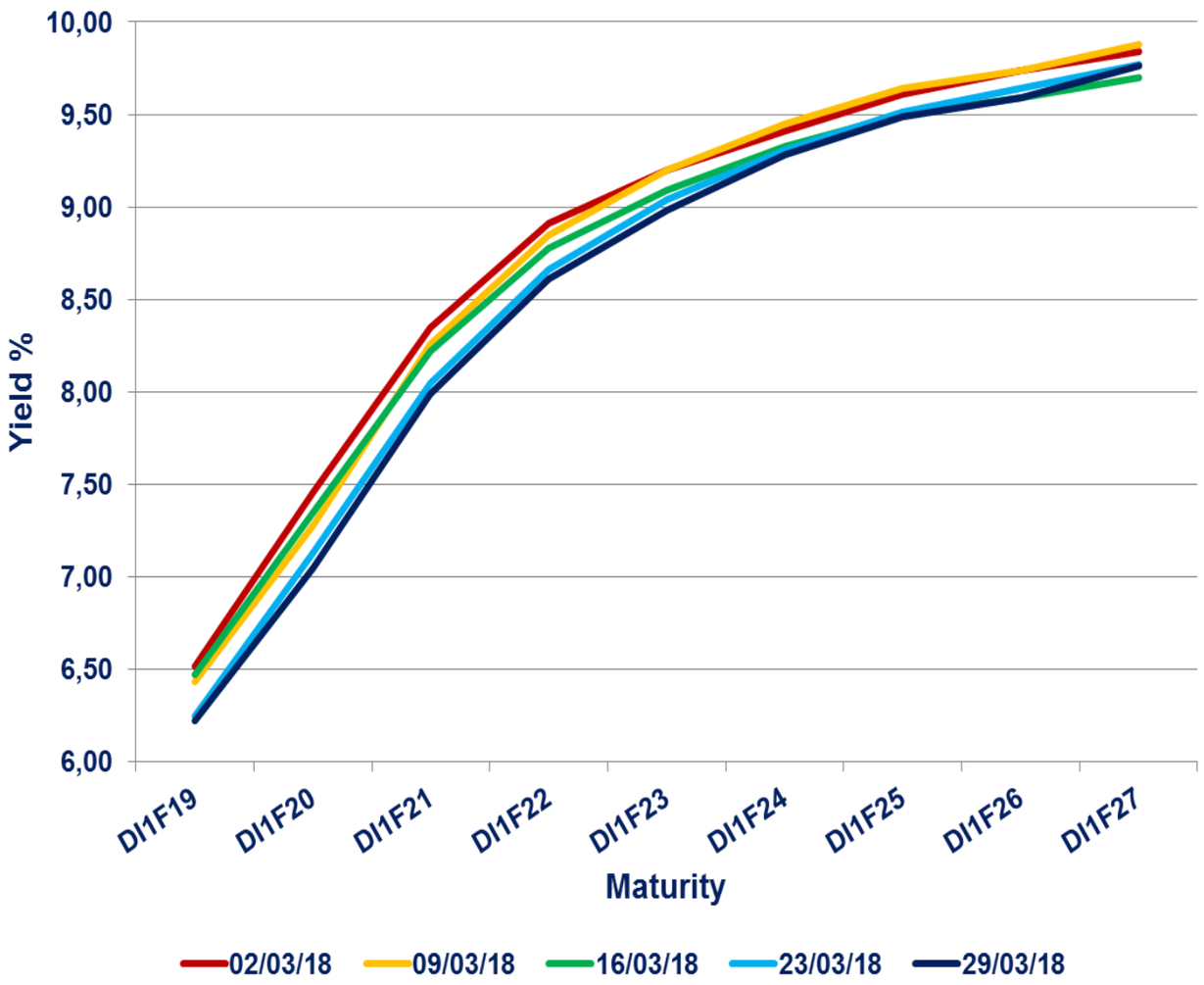
This surprising resolution meant that the returns on short-term futures contracts, which had been stabilized for some time, fell sharply, realigning the slope of the Yield Curve to a new level. The magnitude of this last cut still leaves room for some volatility. We at Redwood, after re-evaluating our models and the scenario in a *holistic* way, came to believe that a greater easing of monetary policy - especially by successive price index drops, *underperforming* economic activity and a still high unemployment rate - will cause BACEN to promote a new interest rate cut. As always, our *unfortunate* mission is not to say what the BACEN **should** do, but fundamentally what it **will** do. Thus, we believe in a further 25-b.p. reduction.

It may well be that, with this "turnaround", short term gains may appear once again. But for a medium- and long-term horizon, with SELIC likely to rise to levels close to its equilibrium level, the strategy of "shortening" the portfolios may be of little benefit. We do not deny here that there is room for gains at the shorter vertices. But as we say, keep "the finger trigger-ready".

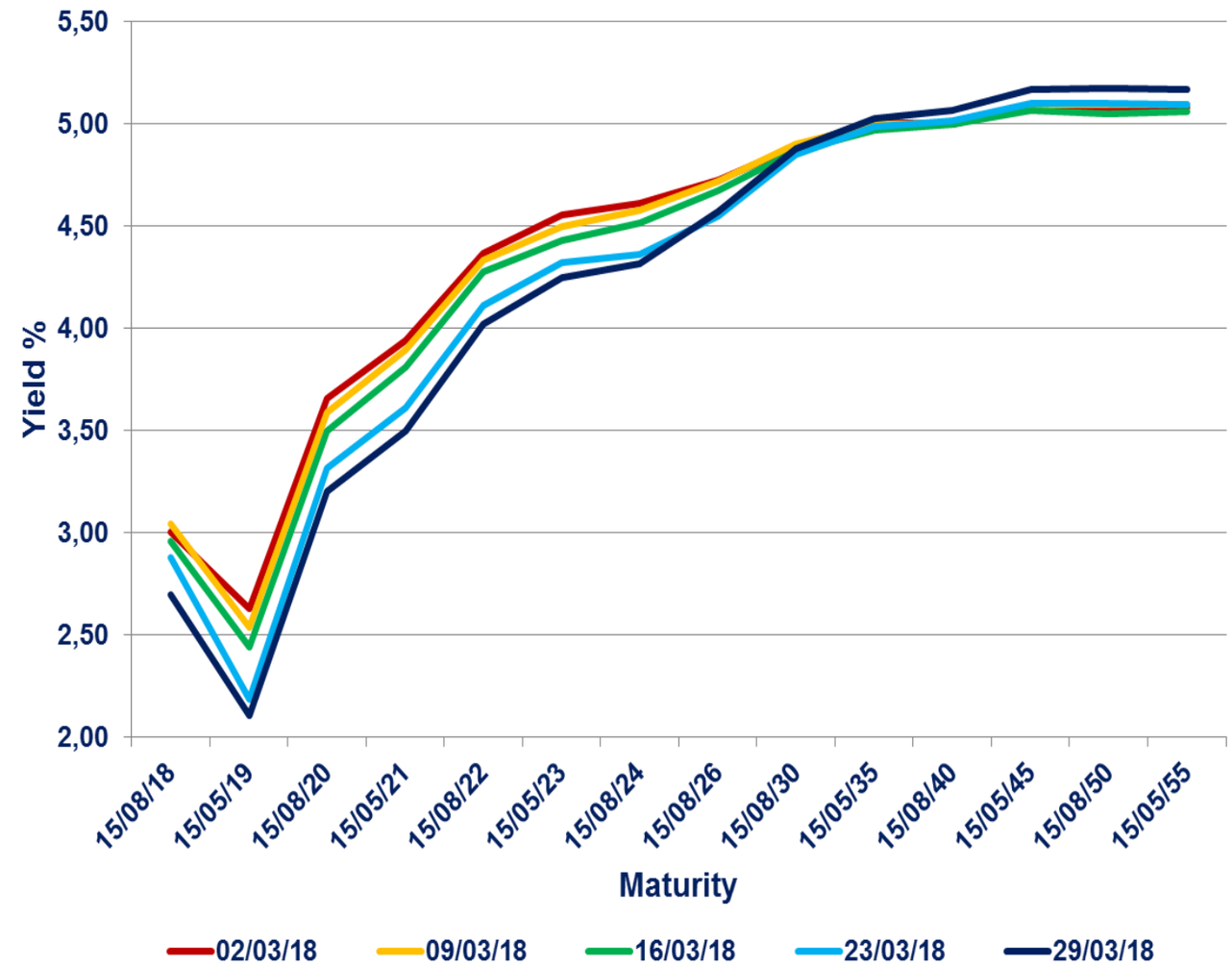
Coupled with this, in a scenario intensified by the economic and political events that affect all markets such as this one, the traditional idea of setting up a fixed-income position to "protect capital" with "risk-free" assets and simply waiting should not prove to be a good strategy. Real capital protection, especially for those who turn to fixed-income markets, will require risk and financial management based on technique and experience.

Weekly Interest Rates

Yield Curve Diagram



NTN-B Diagram

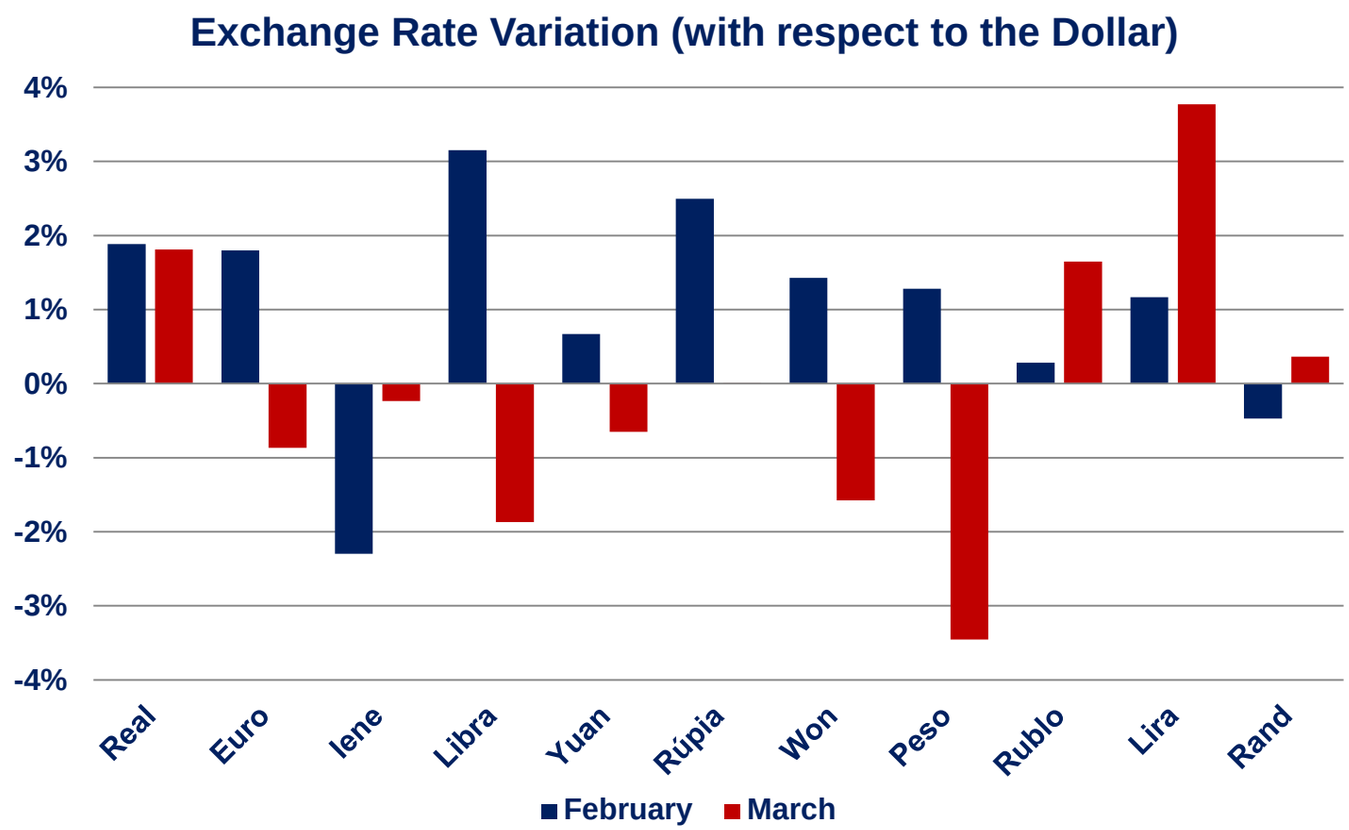


Foreign Exchange

For those who have been "off the planet" for the past 30 days, and would like to update themselves on what has happened, politically and economically, in the world and in Brazil during this period, nothing would be more appropriate than appreciating the dynamics of the currency market.

Suffering from the pressure coming from internal and external events, the Dollar rose its "floor" trading price in the spot market, starting in the third week of the month, leaving the margins of BRL 3.25 and seeking levels closer to BRL 3.30 , with reasonable potential to advance further. As we have previously predicted in this report, the mismatch between the country risk and the market value of the currency cannot be sustained for long. We did not expect the adjustment of the perception of country risk to occur so quickly, which began to rise with greater intensity from the outset of the Brazilian supreme court ruling on the habeas corpus plea. Such an event seems to have triggered a new general perception by the market on the still uncertain scenario for the 2018 presidential elections.

Besides the elements of internal pressure, which already have a non-negligible magnitude, we also had the global movements linked to the possibility of a worsening Trade War. The Real did not escape a global devaluation movement against the Dollar amid aversion to risky assets and currencies, even though a scenario of enhanced animosity between the US and China is still unlikely, given how interconnected these economies are.



Source: Blooomberg | Elaborated by Planner Redwood

Also at the end of the month, the Central Bank went back to auctioning for the rolling over of contracts maturing in April, in the amount of USD 2 billion. The new contracts, scheduled to be deployed in May, have a cut-off rate for repurchase of BRL 3.331672.

Thus, the Ptax Dollar ended the month at BRL 3.3238, up 2.43% in the month.

However, although it has been a complicated month in March, not everything you see in the future is bleak. Agents, as well as us at Redwood, have Increasingly retreated under the rising odds of a major trade war. Instead, what is really going on is a move towards a revision of the conditions currently established in international trade.

Aside from this perception, the government still had a surprising success in the auction of the 15th package of oil reserves exploration (BRL 8bn directly in the government cash register) in March, which should have a significant positive impact on the net inflow of foreign exchange. Combining the normalization of the global risk perception with the net inflow of resources and the mitigation of electoral risks, a new cycle of consistent appreciation of the Brazilian currency is quite likely. In this sense and corroborated by our traditional models of medium and long-term exchange rate forecasting, we deviate significantly from the estimates advanced by the main players in the market.

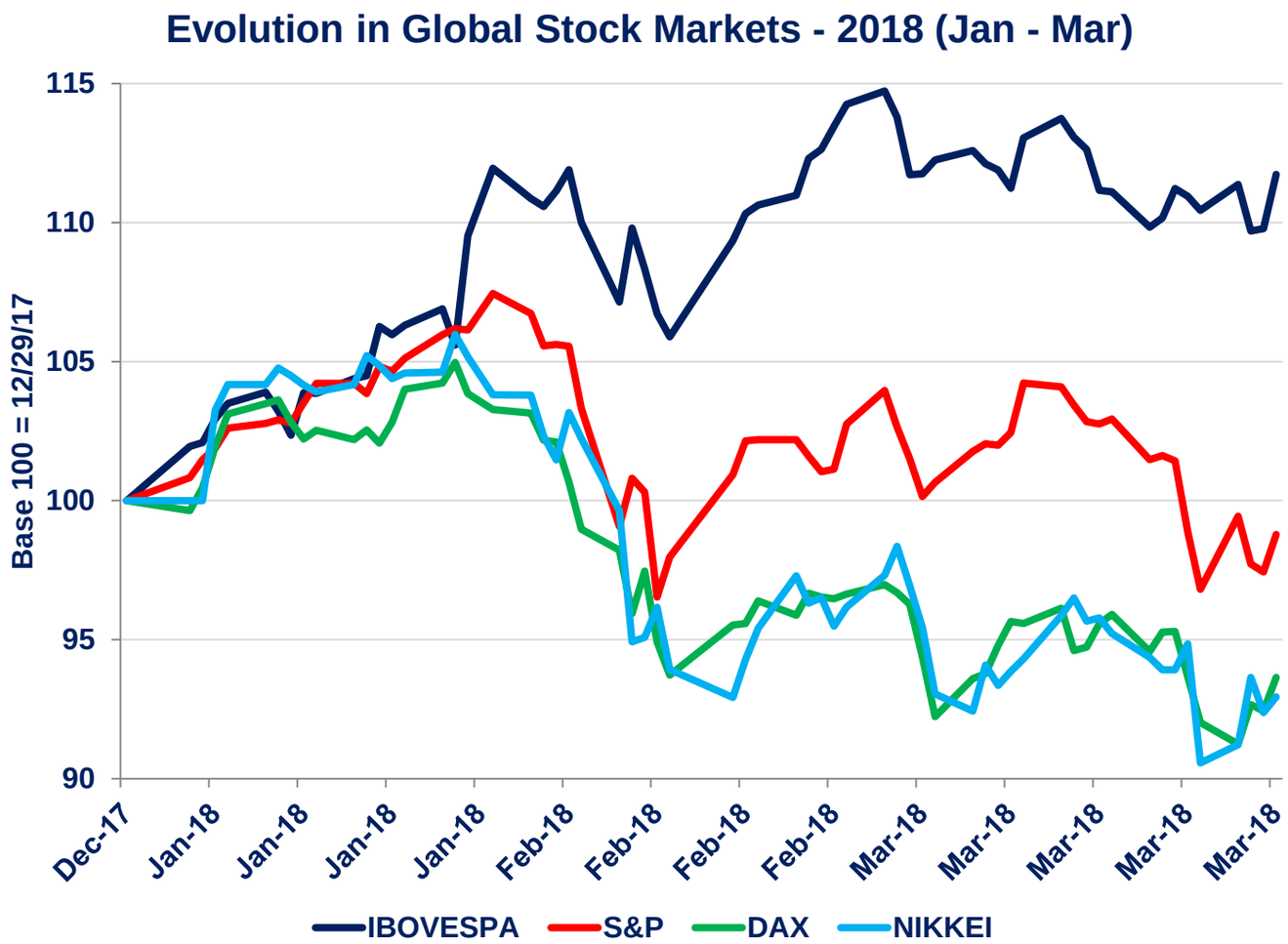
Stock Market

The main index of the Brazilian stock market (Ibovespa) recorded a 1.78% rise in March, quoted at 85,366 points. Thus, investment in stocks was the most profitable option for the first quarter of 2018, largely influenced by the resumption of confidence and household consumption, a factor that has recently stimulated economic activity. Within the year the Ibovespa has accumulated returns of 11.73%.

However, such high does not reflect what was perceived by investors in the second half of this month.

Strongly intertwined with the performance of global stock markets, the Brazilian stock market suffered and did not escape the impacts of global risk aversion with the rising tensions of a possible trade war between the US and China. This pressure was further strengthened by the fact that the steel and aluminum manufacturing and export sectors, which were the heart of the discussion that triggered the protectionist measures issued by President Trump, is widely represented among the main Brazilian publicly traded companies.

Throughout the month, however, with the announcement that Brazil would be among the countries initially exempt from these trade-related measures, the second-order effects were softened, which has not led the last few weeks to feel any less troubled. With political events linked to the judgment of Lula's plea for a HC, tensions and fears about the direction of the 2018 electoral process have surfaced. It is only with these risks having been mitigated that agents can once again review the fundamentals of companies to see how far we can go (at least, that's what they should do!).



Source: Broadcast & Bloomberg | Elaborated by Planner Redwood

In March it was worthy of note the merger between Suzano Papel e Celulose and Fibria. In order to get a grasp of the result of such an operation, the company will handle approximately 49% of the planet's market share, with an aggregate export of BRL18 billion (2017 data). It will be the largest Brazilian non-financial company in the agribusiness sector, with total investments for 2018 initially forecast at BRL 6.4 billion.

As we have remarked regularly, even though the stock market has potential upside, the inherent risks in correcting its current level loom large. Some cases like the Fibria-Suzano merger can bring significant returns. However, such opportunities are not and will not even be the rule (and therefore will require a team that is capable of reaping gains of that nature and with such negotiating perspective). The performance of the first quarter can not be overlooked - either as a fool's rally or a consistent recovery. But what are the chances that it will repeat itself in the upcoming months, and on what grounds? And what are the risks embedded in such allocation?

The truth is that, just as in fixed income, here too the challenges of making money will require high management expertise.

DISCLAIMER

This material has been prepared by Planner Redwood Asset Management Administração de Recursos LTDA. (Redwood) and is for information purposes only and does not constitute a recommendation for investment, offer or solicitation of an offer to acquire securities or any financial instrument. The information, opinions, estimates and projections refer to the present date and may contain information about future events and these projections / estimates are subject to risks and uncertainties related to factors that exceed our ability to control or estimate accurately, such as market competitive environment, fluctuations of currency value and inflation, changes in regulatory and governmental entities, a well as other aspects that may differ materially from those projected without prior notice. The information herein contained is based on the best available information collected from public, official or credible sources, which we believe to be reliable and of good faith. However, they have not been independently verified and, neither express nor implied warrant is given as regards their accuracy. We are not responsible for any omissions or errors, and even as we have taken all precautions to ensure that the information contained herein is not false or misleading, Redwood is not responsible for its accuracy or completeness. The opinions expressed solely reflect our opinions at the moment. We reserve the right at any time to buy or sell such securities. These projections and estimates should not be construed as a guarantee of future performance. Redwood undertakes no obligation to publish any revisions or update such projections and estimates in light of events or circumstances that may occur after the date of this document. This material is provided for the exclusive use of its recipients and its contents may not be reproduced, redistributed, published or copied in any form, in whole or in part, without the express permission of Redwood.

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