PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - MAY 2018

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Agenda

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

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

"I am routinely called upon to respond to this question: is there a way out for Brazil? I answer that there are three: the airport of Galeão, the airport of Cumbica and liberalism. "

Roberto Campos – Economist, diplomat and Brazilian politician

Introduction

May was the month of skidding, and strong!

The month kicked off with the certainty that Monetary Policy would lead the Selic to 6.25%. This conviction was of the whole market, in view of the innumerable declarations by the BACEN Chairman, Ilan Goldfajn, that they saw it that way. For a BACEN that follows an Inflation Targeting regime, one of the most important tools at its disposal, and of aid to all, is communication. Ilan has greatly improved the BACEN's "dialogue" since he took over and, although the Selic has not been cut down as expected, the attitude itself was on point, but its signaling has checked the credibility precisely of this tool: communication.

Soon after, we had the truckers' strike. We will not go into whether it is a rightful claim or not, after all the entire society suffers with the situation of the country. However, one must ponder the feasibility of conceding to such claims, since they will be afforded by the rest of society. In a series of misunderstandings and impressive inability to manage the crisis, President Temer almost gave in to all demands - he was knocked out. Now, with such precedent and the claim for egalitarian "justice", other strikes are looming.

However, nothing was more daunting than the stance of Petrobras president Pedro Parente. A respected, competent and seasoned professional, who has enormous merit just by having fully "recovered" the company, after the hurricane of incompetence and corruption that was rampant there. He "succumbed" in the strongest test of governmental political interference. He should have resigned immediately and thus denied to give in – he jeopardized the credibility so arduously built and sealed his fate and possibly that of the company over which he properly presided. Intellectual and professional honesty, firmness of purpose, and conviction of the ideas, all of which have always governed his conduct should have been defended at all costs - including the "price" of his post. The market "priced" his attitude instantaneously, in very close correspondence to the scenario in which he had left the presidency... with the difference that had he fought to execute his ideas, perhaps the result and/or legacy would be quite different. The interventionism that he fought so hard to counter has finally prevailed. Truly a pity! In a moment of presidential elections and of pressing need to change the order of things in Brazil, the phrase that opens this Commentary by Roberto Campos seems perfect: *"I am routinely called upon to respond to the question: is there any way out for Brazil? I answer that there are three: the airport of Galeão, the airport of Cumbica and liberalism".*

Overseas, in May some important advances were made. In Italy, after a months-long standoff, a cabinet was formed which gathers anti-establishment and some extreme right-wing names (Liga) with the Prime Minister Giuseppe Conte ahead in agreement with the 5-Star Movement populists. Italian President Sergio Mattarella reneged the composition suggested by Conte (especially for finance secretary), but approved of economics professor Giovanni Tria – despite his criticism of the centralization of European Union policies, although he defends Italy's permanence in the Euro Zone. In Spain the replacement of Prime Minister Mariano Rajoy by the leader of the Socialist Party (PSOE), Pedro Sánchez, caused, alongside Italy's *imbroglio*, much anticipation in financial markets. The sovereign bonds of these two countries underwent strong bearish pressures, stoking their yields and contaminating even German bonds' spreads – which is deemed the safest asset in Europe. In the US, President Trump doubles down on his promises and, after months of negotiations, announces tariffs on steel and aluminum imports from Canada, Mexico, and the European Union, also reaching Brazil. Attention now turns to Donald Trump's meeting with North Korean leader Kim Jong-un to be held in early June in Singapore. That meeting could come up with a proposal for a definitive agreement on the denuclearization of North Korea and the official end of the Korean War – "concluded" 65 years ago without a peace agreement.

In this environment, US Treasuries closed the month at 2.8586%. S&P varied 2.16%, NIKKEI closed at -1.18%, DAX with -0.06% and FTSE -9.15%. The Ibovespa ended the month at -10.87% and the IBrX at -10.91%. Highs within the month for DIF19 6.785% and DIF21 in 8.94%. The NTN-B 2050 ended the month at 5.7027%, and the Dollar (Ptax) at R $ 3.7370.

Economic Outlook

The GDP of the 1st QTR 2018 was released, and it came out much worse than we had figured.

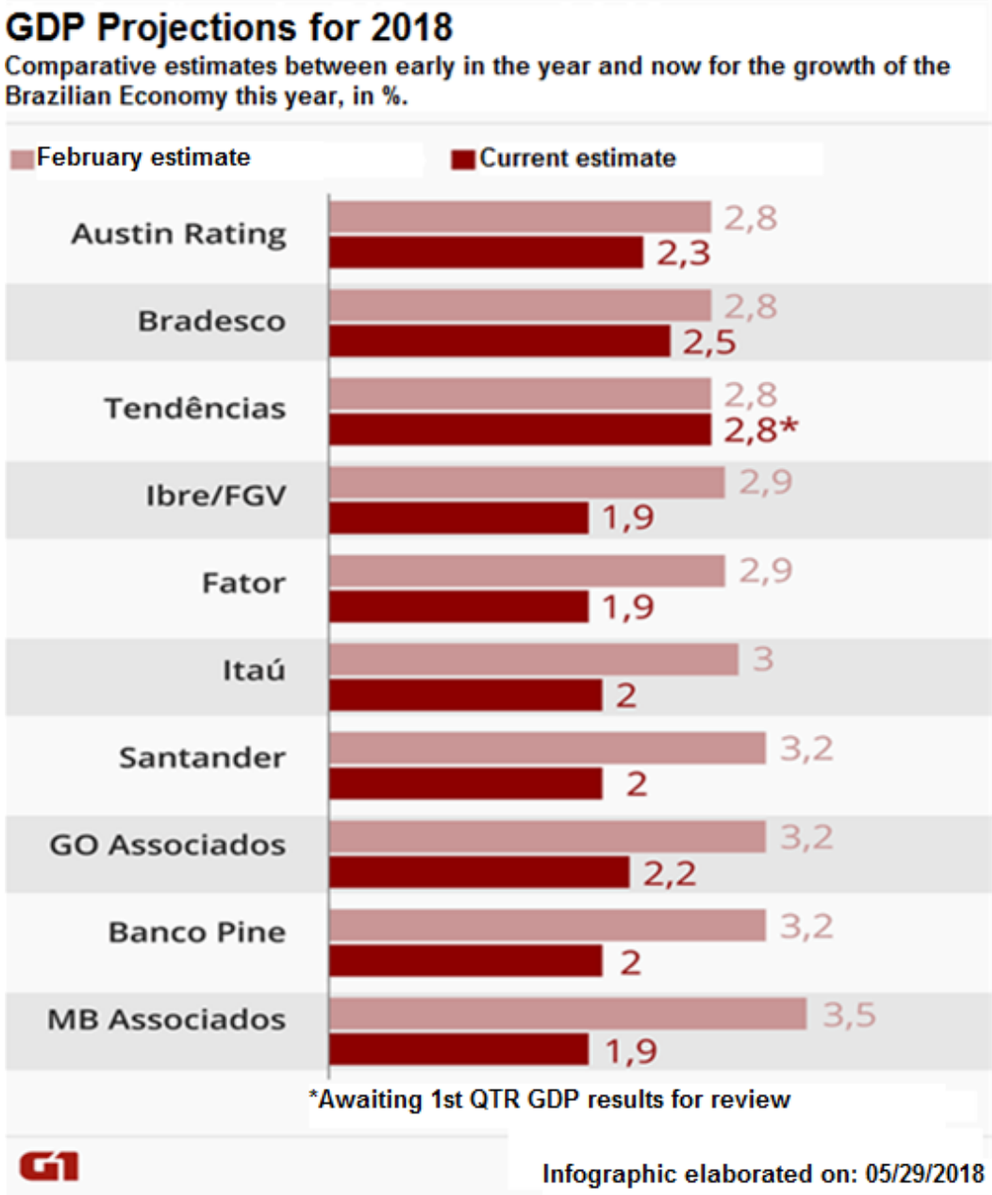
The economic recovery, as we have reiterated, will be very slow, but the signals brought by the recently released sectoral GDP figures, coupled with the truckers' strike and its impacts, turned even bleaker the perspectives for the speed of recovery of activity. This is not a new dip in economic performance as it is an additional cooling to an already in motion slowdown process. In this sense, we expect a broad and general re-evaluation of our economy, whose first figures released (including our initial simulations) now point to a 2% growth in 2018.

In the first QTR 2018 the Brazilian GDP grew 0.4% on the previous QTR, and only 1.2% in relation to the 1st QTR 2017 – quite feeble, almost half of what we expected. Although too soon for new round of longer-term predictions, the only certainty is confirmation of a really weak recovery pace. A more detailed analysis shows that construction and the service sector continue to perform poorly. This finding has direct repercussions in the labor market - the unemployment rate is not responding as expected. In this way, household consumption, which corresponds to 60% of GDP, is impacted by unemployment, thus affecting demand very harshly.

Coupled with unemployment, corroboration of this scenario comes from indebtedness (households and corporations) which still looms quite high - household defaults have once again risen. In the same tone of doom, investments falter. Governments on all levels do not invest for obvious reasons and in the private sector fear and political uncertainties have taken over. The confidence index of entrepreneurs leaved no doubt as it plunged to its lowest level since November 2017.

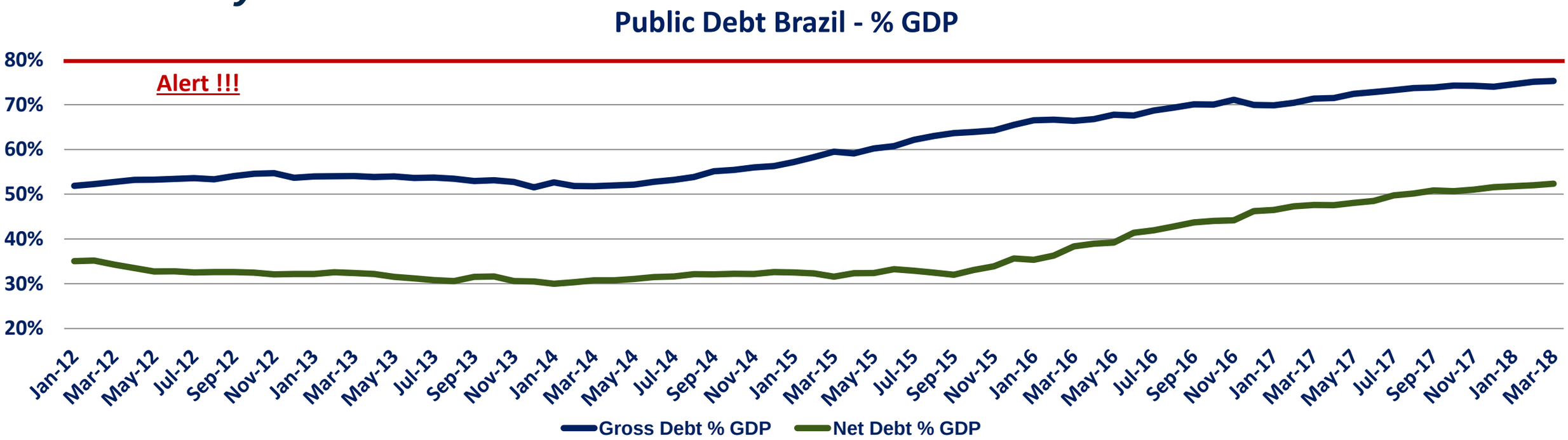
With an widely unpopular Government, the continuity of reforms (much has already been done!) is but a fairy tale, and the economic agenda will not advance in Congress. In addition, with a political framework up to the moment of absolute uncertainty of who will be the new leader of the Nation (we necessarily need a reformist), the resumption of investments and therefore stronger economic recovery is out of the picture.

Last but not least, the truck drivers' strike has had consequences that we have not yet been able to measure. Much more than the damage to manufacturing, its impact on the 2nd QTR 2018 GDP and the precedent it opened up in the face of a perplex government, unequipped to manage the crisis, the episode weakens the flank so that current politicians seize the opportunity in a populist way.



At the juncture in which we find ourselves, this is all we do not need. It is a fact that a wave of pessimism has taken over Brazil in recent weeks, but several effects of the strike are surmountable – all it takes is enough serenity, a firm grip to resist pressures and attempts by opportunists on duty to take control and hence reestablish order. More than the earthquake itself, we must now take heed of the after-shocks... the October elections are still too far away and we cannot endure for long the volatility seen in recent days. Brazil will not be able to handle it.

Fiscal Policy



Source: BACEN | Elaborated by Planner Redwood

The second- and third-order effects of GDP crunch will be felt directly here. It is not enough that shortages are rampant, the demands by truckers, which were mostly complied with by the Government, impose additional direct expenditures of approximately BRL 10 billion; financing these latter invites all sorts budgetary and financial juggling and contortionism that do not fall far short of invertebrateness. With a lower GDP and the elasticity of revenue to the latter, we will have a lower tax collection with higher expenses... the result is potentially affected on both sides. The Debt to GDP ratio, our solvency ratio, tends to deteriorate.

The adjustment of public finances is crucial. In the recent strike episode, had the Government performed less painfully, the brunt could have been shared with the productive sector. As it stood, society will shoulder everything through adjustments in the economy and fiscal impact. In order to compensate for subsidies and other expenses, corrective measures will be required: budgetary relocations and transfers, supplementation and/or other sources of funds (extraordinary revenues, such as the Pre-salt concession agreement). The blanket is far too short and there is no room for anything else. The eventual irresponsibility of any further concessions now will compromise the next administration's budgetary balance.

Meeting the deficit target for 2018, credible up until last month, seems to be in jeopardy now. The inflexibility of the economic team presented so far, with incredible honesty to their convictions, seems shaken. Politicians orbiting the sphere - that up to date has been very technical, meaning the economic team - anticipate the legacy of the truckers' strike, namely, demands of all sorts coming from various groups of society that will need to be met - after all, elections are coming soon - and are counting on the understanding and sensitivity of economic authorities.

The country's fiscal situation is already too daunting. At a time when Government economists need to optimally manage the available resource in the coming months until the elections, Congress can not be counted on to ”cooperate” in this task. We will count on the technical and professional honesty of the economic team ... but honesty is only true when it is in fact tested. The time has come. We will see.

International Outlook

If our domestic front fell far short of best in May, the international situation was not helpful either.

The international environment was less favorable to Brazil due to general and specific factors. Among the general factors, we will be adversely affected by the prospect of lower growth in the world economy. It has also forcefully entered the radar an eventual fourfold Fed interest rate hike, not threefold as we still hope - this possible event has impacts (capital flight, Dollar price increase, etc.), as well as everything else in the financial market - long before it actually happens. In more specific ways, the announcement of US protectionist measures and the fear (again) of a trade war, with direct effects on our exports to America, will hamper Brazil's trade balance.

Aside from these issues, which are, or should be, duly "priced", Brazil suffers less than other emerging countries and has the possibility of getting around this situation with less friction and exposure.

There is hardly any doubt that a new world order is under way, with ample examples like BREXIT, Trump, Catalonia, Macron, etc., but is it now the turn of Italy? A coalition government will be formed after almost three months of an institutional crisis that wreaked strong repercussions in several segments, especially in the country's sovereign bonds this May. Italy has the second largest debt-to-GDP ratio, only behind Greece, now around 130% of GDP, and will have a mix of populists and right-wing members, but whose first priorities are to implement measures ranging from the reduction of the minimum age for retirement, generalized tax cuts, and a universal income program (Basic Income of 780 euros per month per person). Where will the money come from? Well, part of it stems from cutting spending on immigrant assistance programs. European Union leaders have already realized that a non-aligned Italy can do "damage" (despite the "good" momentum of a growing Eurozone, high levels of consumer confidence, labor market and price dynamics), and in this sense a joint and orderly assessment of the essential reform of the Euro Zone is the best way forward. Angela Merkel of Germany, on account of the financial relationship between the two countries, has already taken initiatives towards strengthening relations.

In China, liquidity injections via medium-term loans by the PBoC remained stable compared to last month, but the People's Bank extended a net amount around 80 billion Yuan in loans to three state-owned banks through supplementary credit, the purpose of which is, as a rule, to support infrastructure projects. In line with the "strong hand" approach, the Chinese government tries to curb "excess" lending in the country and, in order to avoid credit risks, local regulators will establish a system that will allow banks to share information on loans. Other forms of regulation, such as control of withdrawals from money market funds, through the implementation of tariffs, will also be put in place to contain the rapid expansion of this market.

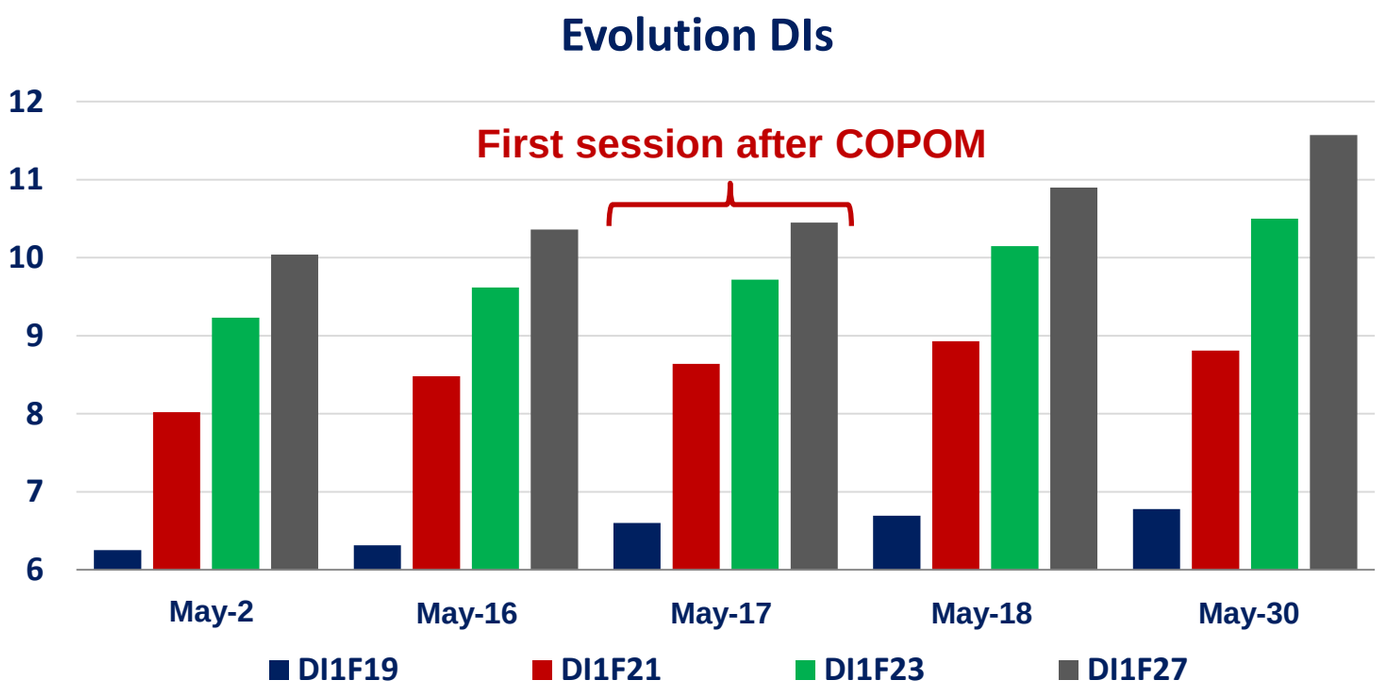
In the US, the economy is going very well, thank you very much. The US GDP will grow around 3%, with inflation near the target (PCE core at 1.9%) and unemployment rate below 3.8%. The creation of 233,000 jobs, which is much higher than expected, has immediate consequences both internally and externally: for the Americans, this indicates that the labor market is already quite tight (almost full employment), and therefore the rate of decline in the unemployment rate should be lower and, for this and other reasons, the FED interest rate should rise (as mentioned above) not by 3, but by 4 times this year. For the rest of the world, higher interest rate hikes by the Fed, in addition to the impact on monetary policies of other central banks around the world, especially for emerging countries, has the power to shake markets - starting with the prices of currencies.

For us Brazilians, this chain effect is neither new nor should surprise or even frighten us, because we have lived with this expectation in recent years and have had time to adjust. Right?

Interest Rates

Brazilian financial markets were bullied in May, largely due to errors in the conduct of economic policy, which triggered the commitment of the last support of the Temer administration, the economic dream team. As for the conduct of monetary policy, the blunder came from whom was recently considered the best central banker in the world, Ilan Goldfajn.

We know that under the inflation targeting system, the most important instrument of a monetary authority is its communication to the economic agents, especially the market, who, relying on diligent guidance, weighs the predictability factor in the pricing of assets. Thus, it is not correct, nor advisable, that the president of the Brazilian monetary authority would signal an additional cut on interest rates (as signaled) only to retreat from doing so only a few days later. The market, as is well known, hardly forgives misbehavior. There was immediate re-pricing and consequent change in the slope of the interest curve. The DI 21, which until day 16 was at 8.48 points closed at 8.64 points on the first day after the COPOM decision was announced, reaching 8.93 points in the next trading session. In popular parlance, the BACEN signaled to the left and then turned right! However, the decision to keep the Selic rate at 6.5% in view of increasing fuel prices and the appreciation of the dollar does not seem to miss the mark, if one considers ”the increase in external risk". Inflation seems on the verge of ”showing up." Justice be done, it is long the search for a conservative Central Bank, one that only follows a unique mandate, namely, to preserve monetary stability. The mistake lied in the instrument, but not in the end itself. Ultimately, the BACEN corrected the route not to hit the other car!



Source: Broadcast | Elaborated by Planner Redwood

There is another point that needs to be carefully considered by the monetary policy that is signaled by the market in the yield curve in recent weeks. Our models already showed that short-term real interest rates were mostly below the level they should be and, in this sense, the curve should fit especially in these vertices, promoting an increase of the short-term coupons in a disproportionate magnitude with respect to the long-term vertices. In other words, short coupons went up and the long ones would have a smoother path. In fact this happened and the whole liquid Interest Rate Term Structure curve was still ranging below 10%. However, in this month of May and in view of the vulnerability findings to which we *are still* subject, we observe a strong inclination of the yield curve. Unfortunately, this is a bad sign the diagnosis of which we know quite well. The financial market is known for its overreactions, especially in the short term, which tend to soften subsequentially in order to reflect reality. However, the streak of "misfortunes" of both the financial conditions the country witnessed in the last month and the results of the macro indicators, leave us no doubts that the environment has changed – and a lot at that.

Therefore, it is imperative to interpret the market (with all necessary filters) and to act properly - as has already been done by Central Banks of Turkey, Argentina and Indonesia (mainly because the devaluation of their currencies); also blunders such as the one we have seen this past month must not be repeated, at the cost of losing control at a time when it is expected that at least BACEN continues to do the good job it always does.

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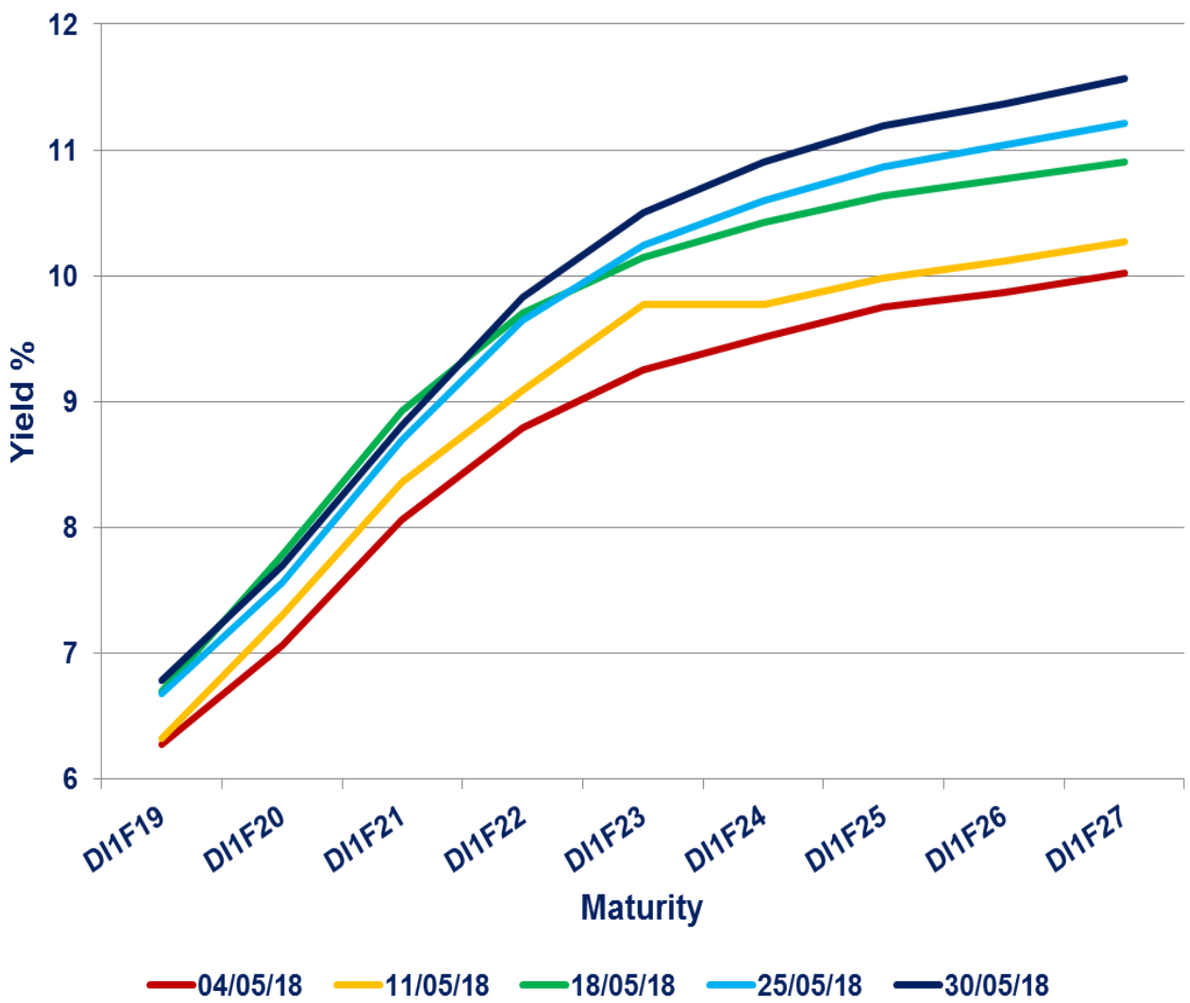
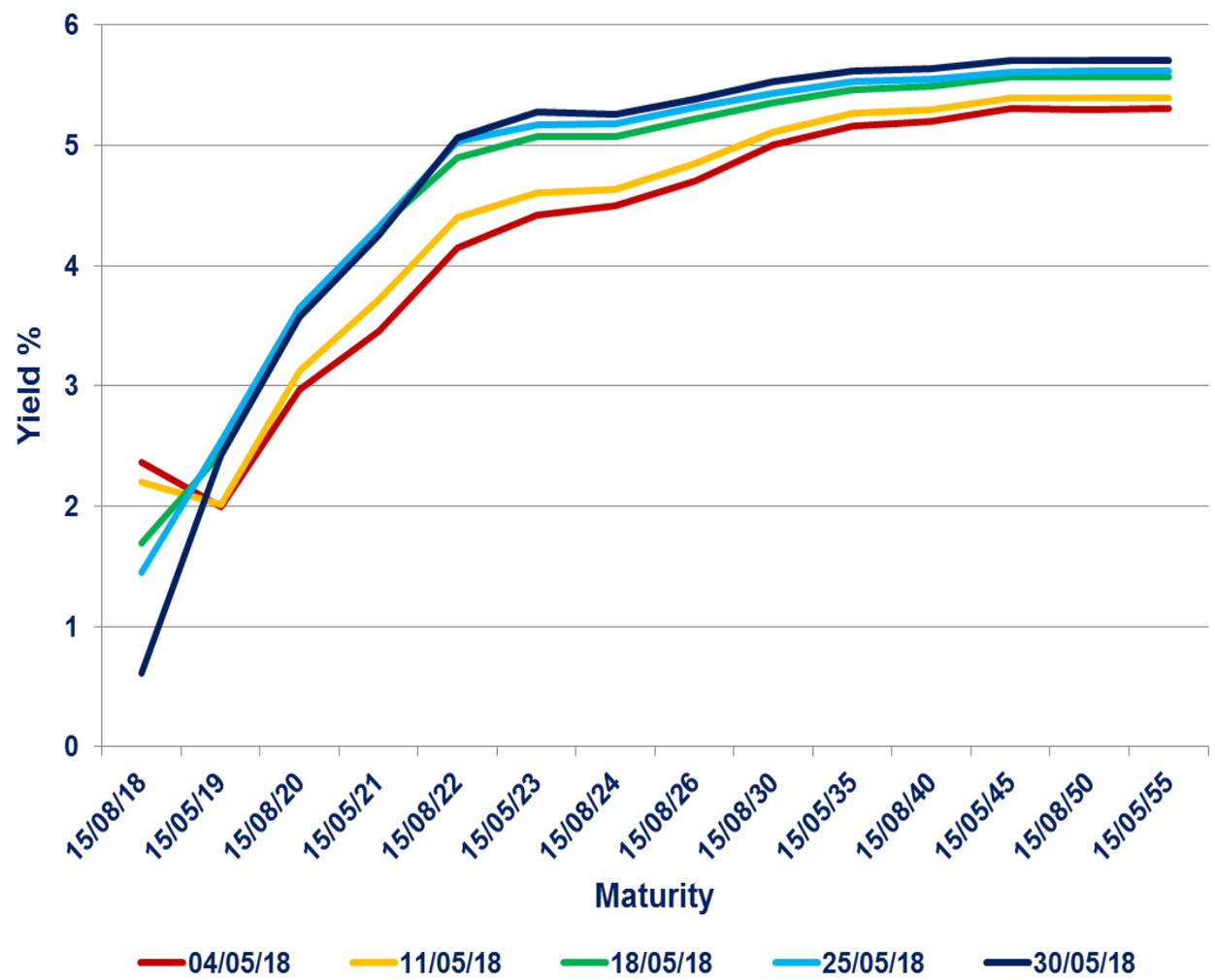
Weekly Interest Rates

Yield Curve Diagram



NTN-B Diagram

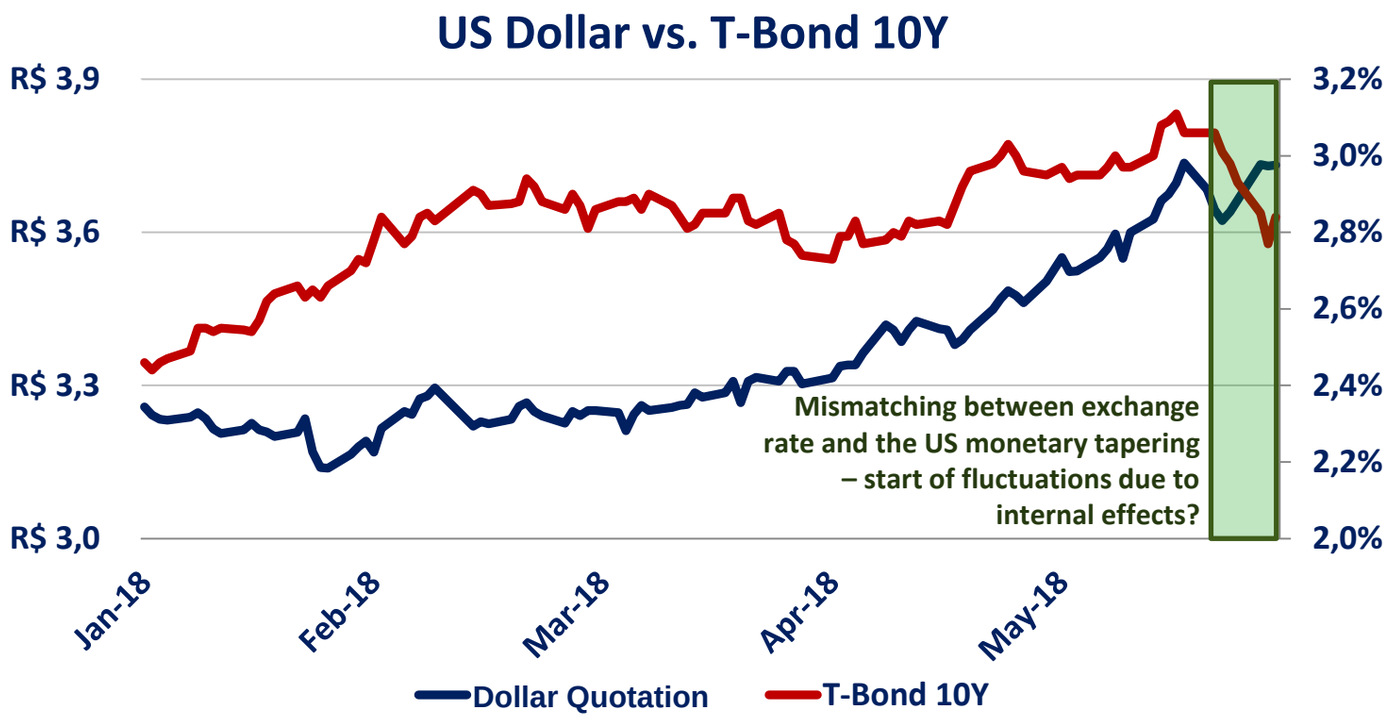


Effects of the drastic plunge in quotes for the NTN-B 2018 vertice refers to the payment of the last coupon and the proximity to maturity.

Foreign Exchange

The currency market had already been hit by strong volatility a few months ago, as referred to in our previous comments. However, the fundamentals for this phenomenon were linked to the normalization of US interest rates, the main determinant of the fluctuation of the Dollar in the recent period. What was observed in May, however, reflects the deviation of this characteristic movement.

With the political and economic uncertainties generated by the truckers' strike, the exchange rate has strongly reflected internal aspects, mainly related to the failure to manage the crisis and its subsequent fiscal cost. The latter, a cost that we could not afford given the current fragility of public finances. The BRL10 billion in tax exemption will most likely not be fully compensated, and the granting of so much fiscal benefits to a category can and should generate similar claims in other sectors. Thus, our solvency ratio (Gross Debt/GDP) is dangerously close to the critical level of 80%, altering (even more) the general perception on Brazil risk, and thus, leading to a new round of devaluation of the Real. In this line, there is an important acknowledgement we have been signaling without effective capture of our main model, namely: the level of the Brazilian 5-year CDS.



Source: Federal Reserve and Broadcast | Elaborated by Planner Redwood

Although uncomfortable with year-end projections in the face of short-term economic pressures, we thought more likely an adjustment of the Dollar's price than a stronger CDS move. Honest mistake. The CDS would most surely react in the face of political fragility threatening essential pillars of economic policy (in particular the fiscal), there is zero possibility of Congressional assistance for any reform further down the road, a less benign external landscape, and finally the damage in all sectors caused by the episode of the truckers' strike. Therefore, the re-pricing of the CDS has come to stay - at least until the year-end elections and/or a greater definition of the country's political direction.

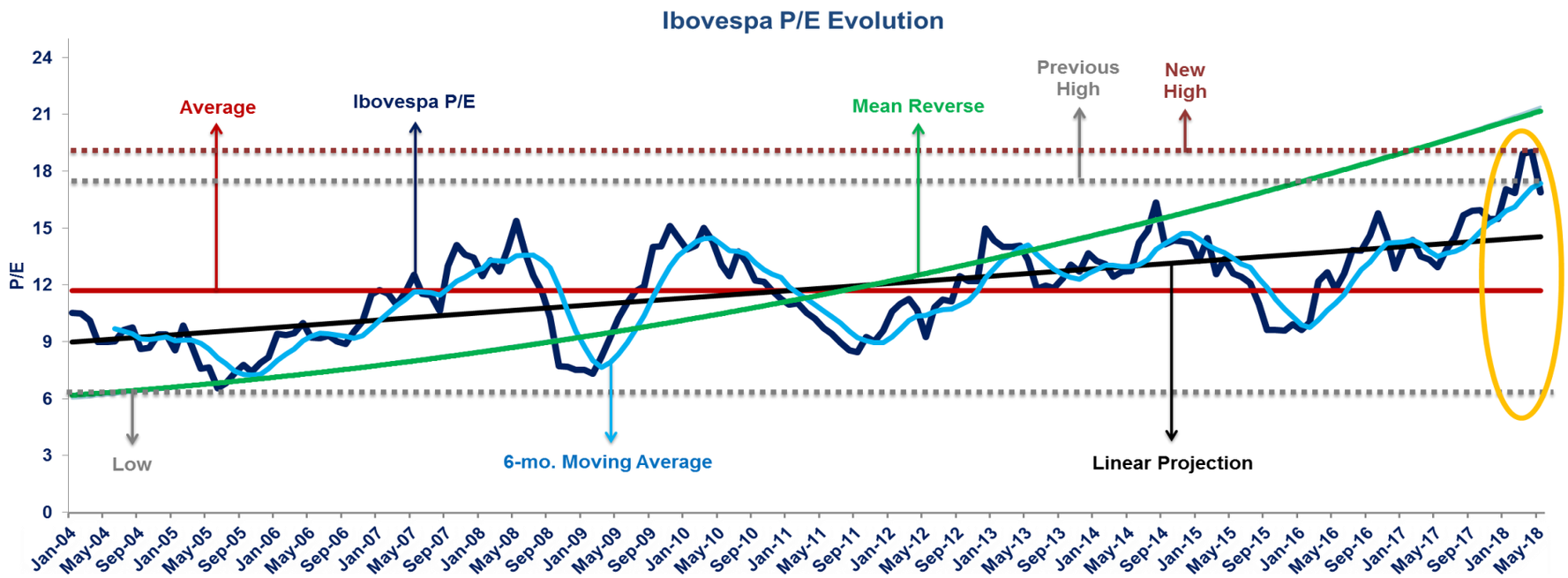
In this scenario, it was already expected that the Central Bank would intervene more sharply with its already traditional swap issues, which effectively happened. The strategy of providing liquidity and containing volatility applied by the monetary authority led the stock of derivatives to US$ 29.5 billion. As Chairman Ilan Goldfajn himself stated in an interview this month, at the BACEN "we have no prejudice against swap." Of course they do not (and several in the market applaud!), what they have is a clear (though dynamic) level that provides the BACEN a comfortable management of its exchange rate policy. To BACEN? Really? Note the cost of this "containing volatility" strategy, which in May alone made the monetary authority record a loss of more than BRL 4 billion. Whether such a strategy is effective and worthwhile when weighed against its cost, we have already registered our position several times in the past: **no**!

The fact remains that even with the announcement that the intervention strategy will resume until the next month, the Real lost value against the US Dollar in May at 7.35%, the worst figure since September 2015.

Keep the liquidity supply, BACEN, the financial market is grateful!

Stock Market

Marked by the demonstrations linked to the truck drivers' strike and by the misguided conduct of the main Brazilian State-owned Company, the month of May has brought the worst figures to the stock market since the distant September 2014. The Ibovespa declined significantly by 10.87% throughout the month, landing at 76,753 points. To analyze such a drop, it is impossible to elude the glaring driver behind such a movement: Petrobras. The cornerstone for the recovery of the company's market value after the start of the Temer administration was precisely the commitment to a price-setting policy favorable to the company's financial stability rather than to populist and often shady political interests, as observed throughout the previous government.



Source: Bloomberg | Elaborated by Planner Redwood

Such commitment to the guidelines of competent management governed by market principles was based on the CEO appointed to run the company, Pedro Parente. Now, near the turning off of the lights, we see the ruin of this foundation. As put forward in the introduction to this comment, the dismay with Parente's caving in to political pressures from the Executive branch and his consent to such a condition (reflected when he did not promptly resigned his post) led to the "re-pricing" of Petrobras' shares (and their contagion), protagonists of the vertiginous plunge of the market index.

The market "already knew" and Parente only proved, with due limitations and adjustments, that the one who occupies the chair of Petrobras's presidency, maintaining the company's current schizophrenic property structure – divided between the State and the private sector -, will be, as in Greek mythology, subject to the sword of Damocles, so that he will always be faced with the possibility that power will be taken away suddenly or that he will fall into complete disgrace. In Petrobras's wider time perspective, Parente's period was but "one-day long"; however, different from Damocles, Parente was intelligent and courageous most of the time - unfortunately failed at the worst moment: his exit.

However, one must not overlook the fact, that for some time we have warned in this report, that Ibovespa's P/E ratio showed levels very close to its "maximum potential", and that the risk of seeking such gain would come at the cost of considerable downside potential. And as the chart above makes clear, the end result was no different. Apart from the "free-lunch" climate established with the record levels reached by the stock market in the last months, economic fundamentals were not in place to sustain that trend.

As in all markets, a consistent recovery is now held hostage by the route taken by our macroeconomic trends. With falling expectations regarding economic activity and the "discouraged" advance in investment rates, we still have some ground to go on before embarking on a new quest for historical highs.

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