PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - JULY 2018

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Agenda

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

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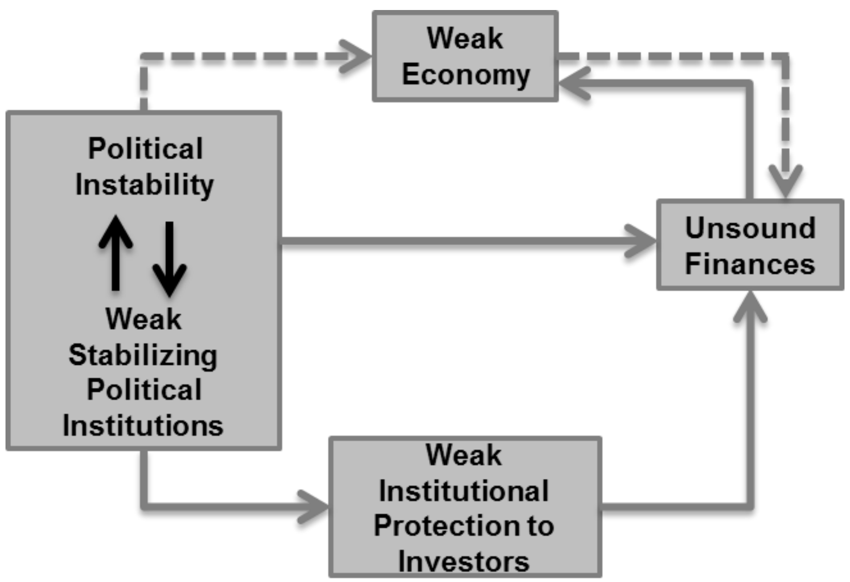
Epigraph of the month... a propos of Brazil's current predicament.

"We are not educated well enough to perform the necessary act of intelligently selecting our leaders."

Walter Cronkite – American Broadcast Journalist (CBS Evening News)

Introduction



Having reviewed economic assumptions/perspectives and realigned the probable scenarios, from now on we will comment on the ideas and proposals by the presidential candidates, and thus provide a better understanding of how the economy can perform according to each government platform.

However far from a clear-cut structure of voter preference in recent times, the month of July has evolved a great deal in terms of party coalitions and alignment of possible candidates for vice president. Despite the notion that vice-president is an empty suit, since re-democratization three vice-presidents came to take office (José Sarney, Itamar Franco and Michel Temer), but it has been quite troublesome for each postulant to find his/her match. At any rate, choosing these names, as a rule, increments the allied base of support, increases the time of the free radio and television adds that a candidate is eligible to, whilst also increasing votes in a given region, political group or sector.

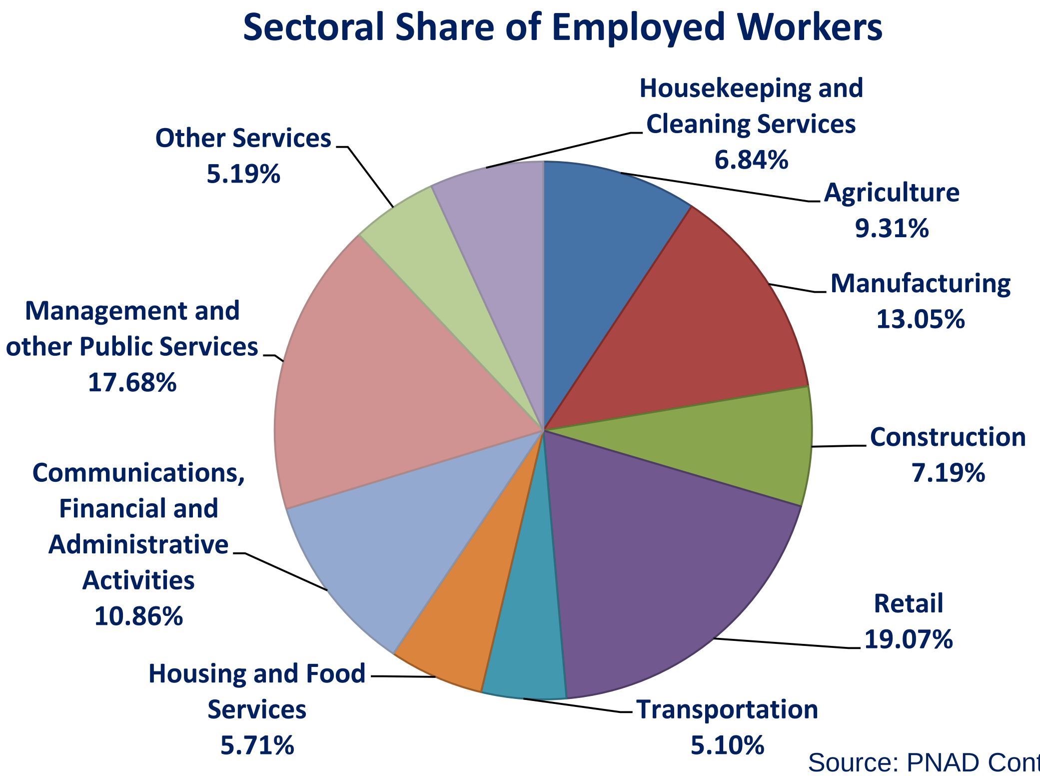
In this line, the names of the candidates for president and vice-president are defined in the party national conventions at the beginning of August and on the AUG/15th the deadline for registration of party candidacy in the Superior Electoral Court. Really? Hope so. In Brazil, anything can happen... one should not doubt it. The PT will not let go of Lula's running and will pursue this goal to the fullest, at the cost of even greater political instability.

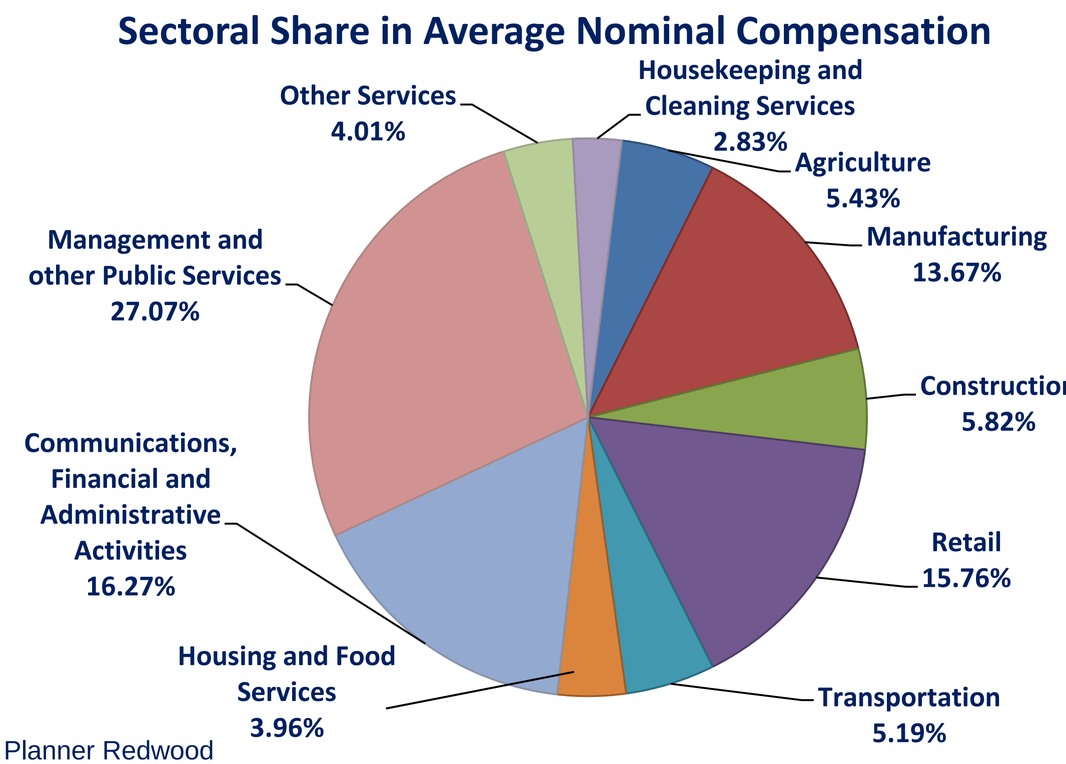
Political instability that has imposed a significant burden on our economy, our finances, and our institutions, and has increasingly driven Brazil from the foreign investors' radar. Yes, although the scenarios are clearer, this does not mean that they are good enough or in the same direction. No, they're not. The political environment we live in is a troubled one, and the *normal* electoral process (even without Lula!), apart from absolute unpredictability, can also reserve unpleasant surprises. Brazil's governability will hang by a thread throughout these elections, due either to the ability of the future ruler to deal with Congress, or by the quality of its administration's program to ensure approval of reforms needed to improve public finances and economic growth. The risk of lacking governability exists, and our Congress has *learned how to pursue* a president's impeachment, but at a very high cost. Let's hope that the opening phrase of this American journalist Walter Cronkite, which fit our last presidential elections quite well, does not continue to identify us: "*We are not educated well enough to perform the necessary act of intelligently selecting our leaders*."

Overseas, the events of July were largely a sequel to June. In China, PBoC continues to heavily inject resources into the market. More bluntly, it encouraged banks to lend more credit as the Chinese economy looks set to slow down. In other words, the PBoC intends to continue to reduce the financing costs of companies in order to boost the real economy. Still in Asia, the BoJ raised the 10-year JGB interest rate ceiling from 0.1% to 0.2% and applied a "dovish" tone to its monetary policy stance, thus committing to keep interest rates low "for an extended period of time ". In Europe, the disappointing quarterly GDP of the Euro Zone and moderate inflation support the "cautious" ECB stance, which is no different from the gradual normalization of monetary policy implemented so far. Lastly, in the United States comes a confirmation of the good news: strong growth in due course, unemployment rate now with new prospects end-of-year lows around 3.8% and inflation absolutely contained. Whereas its policies have positive economic and financial effects now and in the next two years, some of them (such as the "Trade War") need to be coordinated and circumvented, for in the medium-long run they will demand sharp adjustments. Yet another point: in the upcoming congressional elections, Trump can not lose the majority, or else it would be a huge setback not only for the continuity of his actions and projects, but especially for any reelection prospects.

In this environment, US Treasuries closed the month at 2.9598%. S&P varied 3.60%, NIKKEI closed at 1.12%, DAX at 4.06% and FTSE 100 UK at 1.46%. The Ibovespa ended the month at 79,220 points (at 8.88%) and the IBrX at 32,610 points (8.84%). Monthly highs for DIF19 at 6.895% and DIF21 at 9.38%. The NTN-B 2050 ended the month at 5.7417%, and the Dollar (Ptax) at BRL 3.7549.

Economic Outlook





Source: PNAD Contínua (IBGE) | Elaborated by Planner Redwood

Following the economic collapse for two consecutive years, last year's feeble recovery and the frustration of the first forecasts for economic activity this year, mainly due to non-continuity of reforms, political instability and crisis management disaster amid the truckers' strike, other macro variables seem to corroborate this more challenging landscape. The unemployment rate is the bluntest and most representative aspect of our current predicament. We closed the 2nd Qtr. with a 12.4% unemployment rate against 13.1% of the 1st Qtr. 2018, a progressively better figure, albeit filled with informal jobs, lower quality jobs and with a strong lack of confidence on account that in this reduction, there is a great contingent of discouraged workers - those who have quit looking for a job. The IBGE estimates that today we have a reduction in unemployment due to the increase in the employed population, which would be positive news were it not for the drop in formal contract jobs - we are currently with the lowest number of formally employed workers in the private sector within the time series.

Indeed, in line with our projections, the second-order effects of the truckers' strike on agents' confidence have materialized along with the worsening of financial condition indices - with some cooling in recent days from its post-strike high -, but notably in foreign currency markets, interest rates and country risk. Bleaker expectations directly jeopardize investments and consumption and without restoring confidence of businessmen and consumers, the resumption of economic activity is unlikely to gain traction.

With the overview of our current and future economy, public finances (especially social security), which the graphs above show - as regards the item Administration & Public Services - terrifying. The first one, which deals with the number of employed workers, would already be absurd with almost 18% rate of the vacant jobs, marginally behind only Retail, but when analyzed under the light of average nominal income per sector, Retail hovers above 27%! It is ludicrous! Not enough for your taste? Do you know the performance of the labor market described above? Well, despite the serious fiscal restrictions on the public sector, it hired 588 thousand in the last quarter.

It is the countercyclical policy of now that will cost us even more sharply in the future. The State must be minimal and do its best - Brazil can not stand it any longer!

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Fiscal Policy

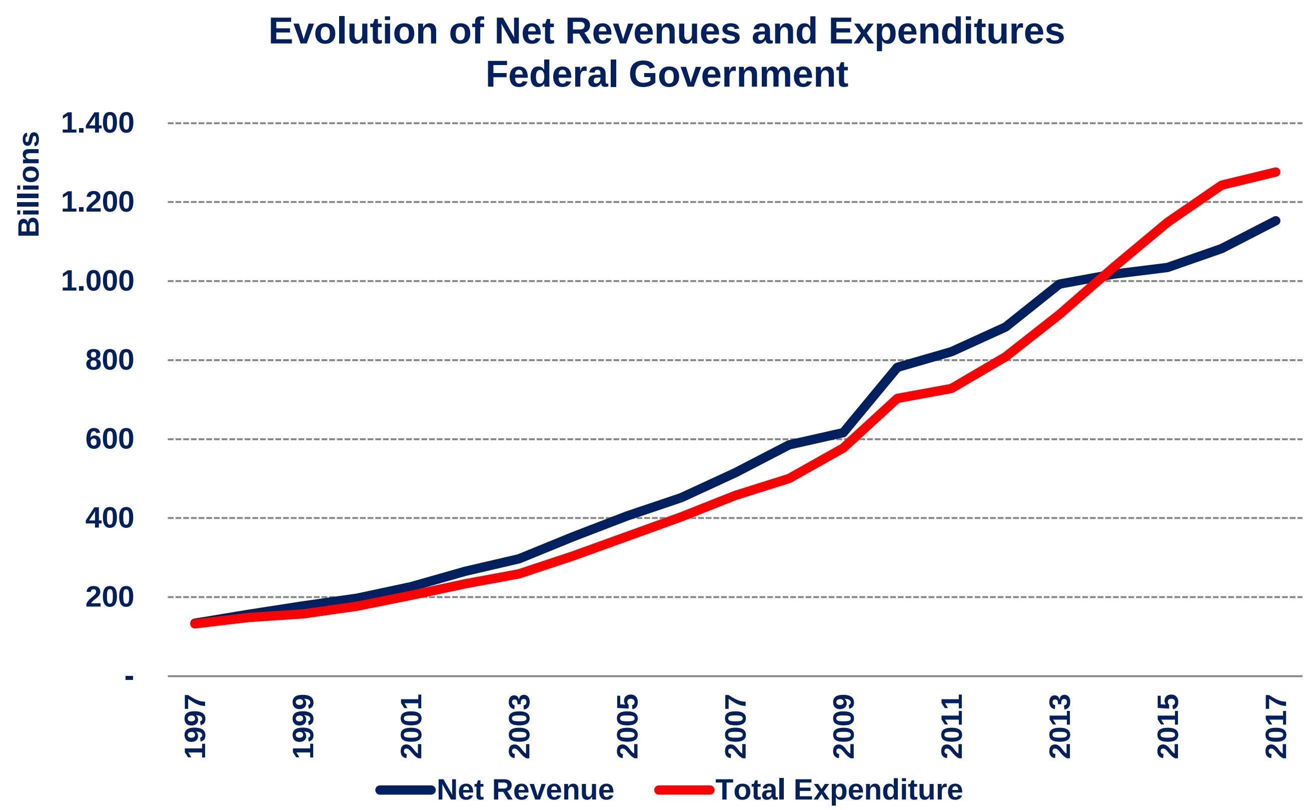
Persistent primary deficit feed an expanding public debt.

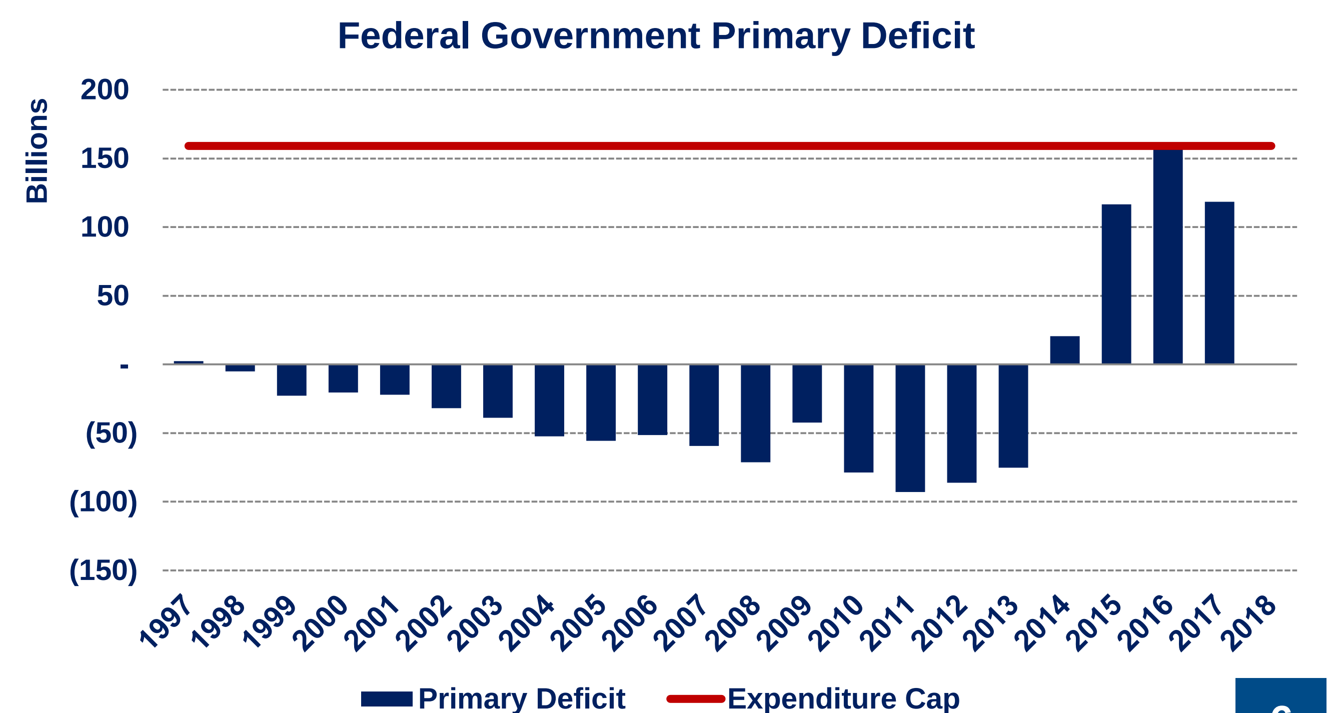
With punctual and specific improvements, government's difficulties with the fiscal accounts do not stop. The consolidated public sector (Central Government, States, Municipalities and State Companies, with the exception of Petrobras and Eletrobras) presented a primary deficit of BRL 13.5 billion in June, equivalent to BRL 14.4 billion in the first half of 2018. In the same period last year the result was better, due to a 2% increase in revenues and a 1.1% decrease in public sector expenses, according to the chart beside. At any rate, the difficulty remains when it comes to generating surpluses, and the second semester as a rule does not perform quite well as the first, which points to less promising results. Still, given the mega Expenditure Cap approved of BRL 161.3 billion (set high to provide room for maneuver!), it is possible the government has some chance of not breaking its budget limit.

But in general the figures reinforce concerns about the public debt trajectory. With the substantial reduction in economic activity this year and the decline in GDP projections for 2019, fiscal revenue is losing momentum and spending is not slowing down. The country's gross debt continues to expand, now at 77.2% of GDP, to approximately BRL 5.2 trillion. Gross debt is the result of the sum of federal, state and municipal government bonds/liabilities, excluding the Central Bank and state banks, and is currently the highest percentage in the data series. This trajectory reinforces the country's inability to balance its accounts, and refers to the eternal concerns of solvency capacity, especially by risk-rating agencies. They are well aware of the debt dynamics, of the necessary reforms, and of what is behind the non-"explosion" of the Gross Debt-to-GDP ratio at this time, notably the return of BNDES funds (prepayment), which will not be of the same magnitude in the years to come.

There is no mystery besides just collecting more and spending less, but the process of implementing this and choosing what and how to do it, setting up priorities and measures of impact, is far from trivial. For example, the government has just resumed the possibility of taxing exclusive funds, thus reissuing a failed project from last year with prospects now of raising about BRL 10.7 billion. On the other hand, this year alone, the total tax relief is expect to amount to BRL 270 billion... 25 times the amount expected with the above reissued taxation.

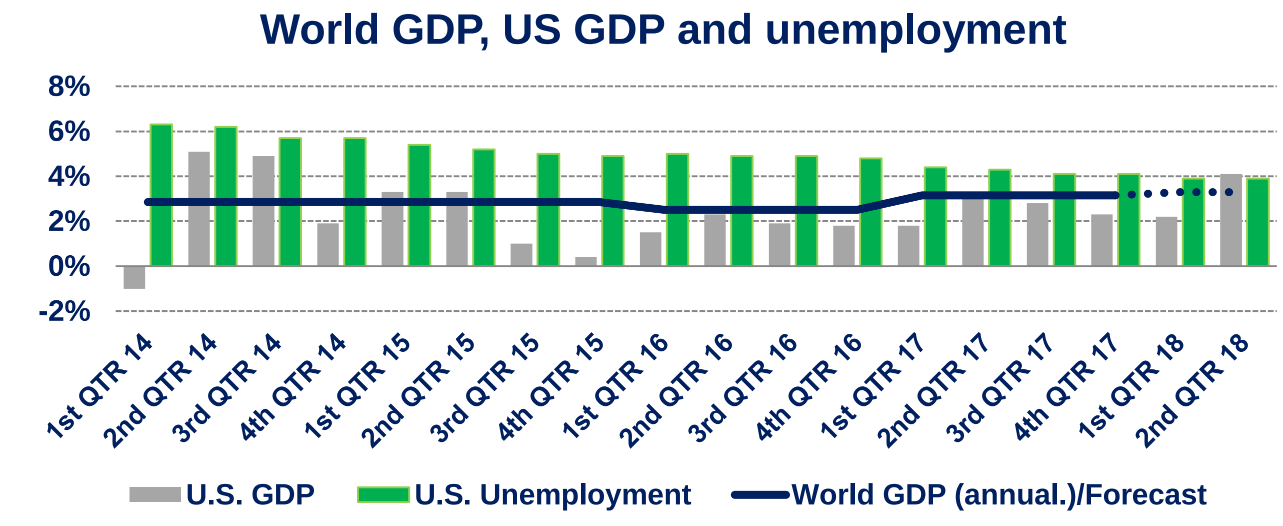
Oh! One should keep in mind that hurting savers is not a good idea anywhere in the world... after all, one of the immediate effects may be the transfer of domestic savings abroad... examples abound. Nothing replaces "talent"!





Source: National Treasury of Brazil | Elaborated by Planner Redwood

International Outlook



Source: World Bank and Federal Reserve | Elaborated by Planner Redwood

Facts are no match for arguments!

The chart beside clearly depicts the observed reality, with greater or lesser acknowledgement of the causalities and even its lingering effects, but the reflexes of the growing US activity in the last quarter of 4.1% are exceptional. The good news does not stop there: the labor market is strong (projected 3.6% unemployment rate by the end of the year – Citi/Dana Peterson), and inflation at levels close to what monetary policy predicted.

Donald Trump, who has a totally different style to lead the country, but absolutely in line with his promise (and by many discredited), shakes traditional premises and imposes a politically incorrect pace, whose results strongly impact the "world order." Global leaders were not and still do not seem to be prepared for this kind of posture of the largest economy on the planet. It is really difficult to find rationality in the political-economic stance held by the American commander-in-chief whose volatility in the decision-making process does not allow us to identify a consistent pattern of actions – which is not say that it does not exist, but simply that the complexity far exceeds the traditional one and whose cooperation and realignment paths of purpose are hard to grasp and/or accept. At any rate, the main "threat" of Trump's policy now lies in the so-called Trade War, which involves major countries and treaties. In the realm of trade agreements, the US negotiations appear to be more advanced than the NAFTA (North American Free Trade Agreement), especially Mexico. Also with Europe, the roads suggest a cooling down of nerves, after the US government imposed tariffs on steel and aluminum imports and the immediate retaliation of Europe, which in turn provoked new threats by Trump to impose even greater restrictions on imports of cars from European countries. It signals that the United States will "immediately begin" to negotiate with the European Union trade agreements on agricultural products and energy, promising "a real deal" to sell more agricultural products and liquid natural gas to the Old Continent. Until second order or new understanding, so we are and so America is becoming Great Again. It will be very important for the rest of the world to both understand this mechanism and adjust to it - this new normal may stay for good, notably if the US economy figures continue to improve, with Donald Trump himself facing another term.

In China, contrary to the expectations a cooling Trade War with Europe and Mexico, further friction is expected in this segment with the Americans. However, this is not the greatest of its problems and China has conducted with reasonable wisdom, above all because knows and understands its fragilities well in this field, and in allocating time and effort, other matters stand out. The performance of the economy seems to show signs of weakening. PBoC is constantly injecting liquidity into the economy, but now a subtle and important guideline has been waved at financial institutions so that what was once a focus on risk control has becomes a combination of avoiding and fighting financial risk. In addition to the commitment to improve access to credit for small and micro companies, this measure is an indication of the country's focus on growth that seems to bother more than other problems. Still in Asia, the BoJ has made a marginal adjustment to the Japanese government's 10-year bond interest rate - far from the market's expectations, and a sign that monetary policy will remain slack.

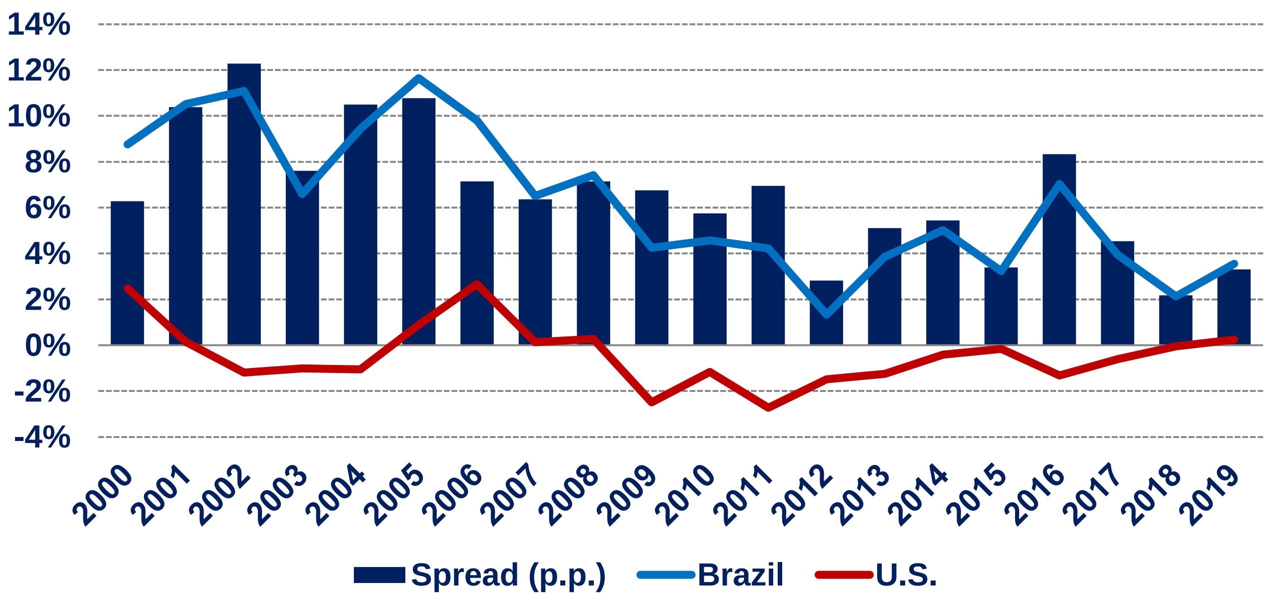
In Europe, the growth of the euro area of only 0.3% of GDP in the 2nd Qtr. compared to the previous one was disappointing and this reinforces the prospects that the ECB will remain on its gradual monetary tapering policy, including maintaining the option to extend its asset purchases until next year if the downturn persists. An important highlight is Greece, although its economy is still weak and unemployment is high, its structural reforms point to some recovery, but with unquestionable market recognition: its 5-year CDS is below 400 points. What a win!

Interest Rates

The month of July ended with drops along the Yield Curve, still reflecting the adjustment of the expressive high seen in May with the truckers' strike. The DI 20 recorded a decrease of 45 bp, while the DI 21 had a reduction of 39 bp and, at the longest vertex, the DI 25 had a decrease of 56 bp. However, the anticipation lies at the beginning of the month of August, which will begin with another "super Wednesday", when COPOM and the FED will announce the decisions for Brazilian and American interest rates. As expected by us at Redwood, both rates will be maintained at 6.50% and 1.75%, respectively. However, the most relevant point will lie in the direction that the Reports (market announcements) will ratify, given SELIC's tendency to maintain its current levels until the end of this year, and signaling that new increases (we expect two) will come to the FED Funds. Such a perspective will be an important part of the “north” guiding the Brazilian financial markets from now on.

In terms of the dispute over the attractiveness of foreign capital flows, three pillars are fundamental, as is usual for any investment (based at least on some knowledge of the facts). The first one is return, which in the case is reflected in the real interest paid, being the main measure of competitiveness compared to the other countries.

Real Interest Rate Evolution



Source: Blooomberg and Economática | Elaborated by Planner Redwood

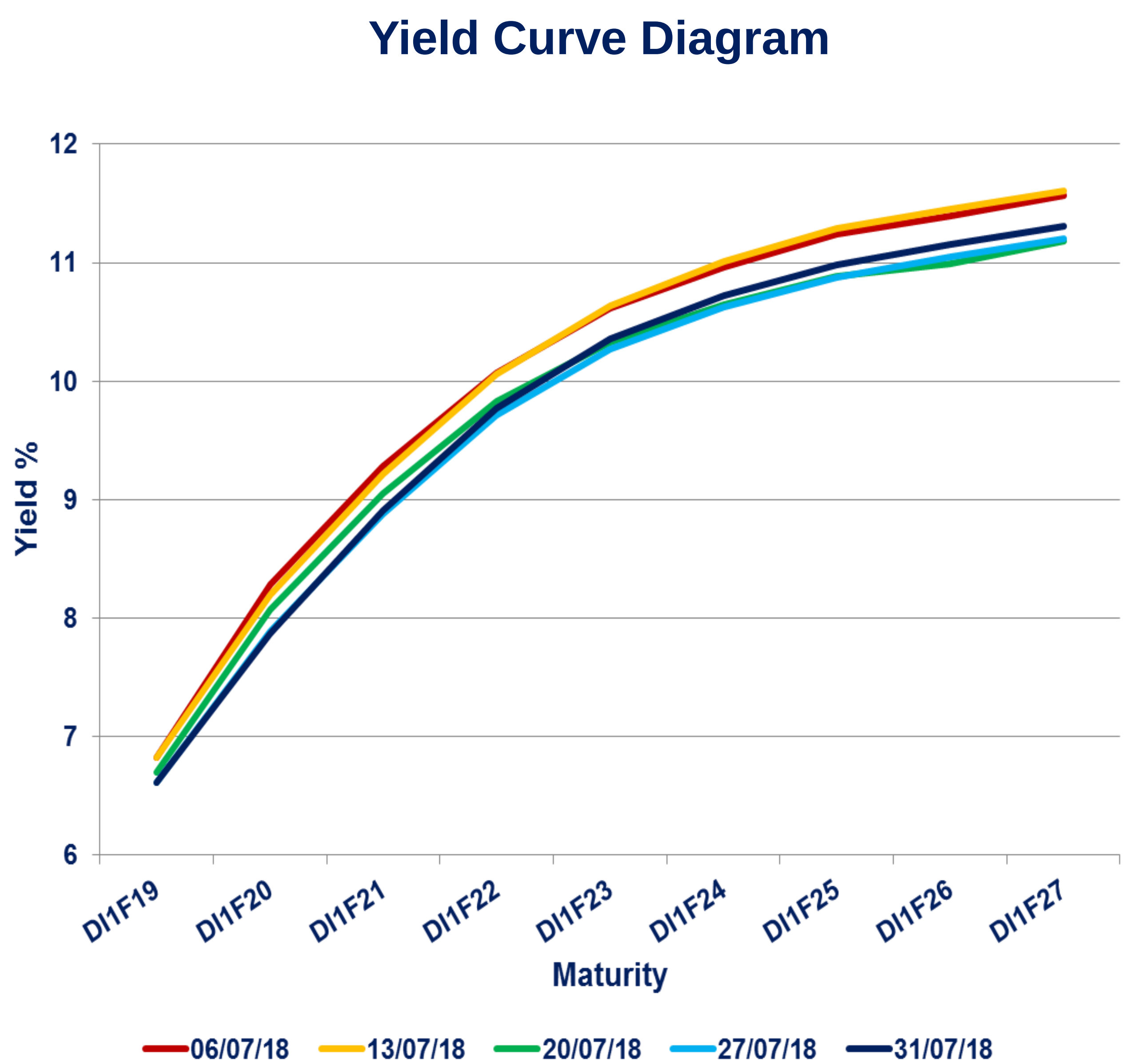
With US GDP growing at around 4.1% as in the second quarter of this year, unemployment below its natural rate and inflation (still) gradually improving, there are plenty of reasons for raising the US interest rate by at least 0.5% this year. What may seem little, in reality will imply a relative gain in competitiveness with respect to the Brazilian premium, since the largest economy on the planet is once again increasingly moving towards "significant" positive real interest rates.

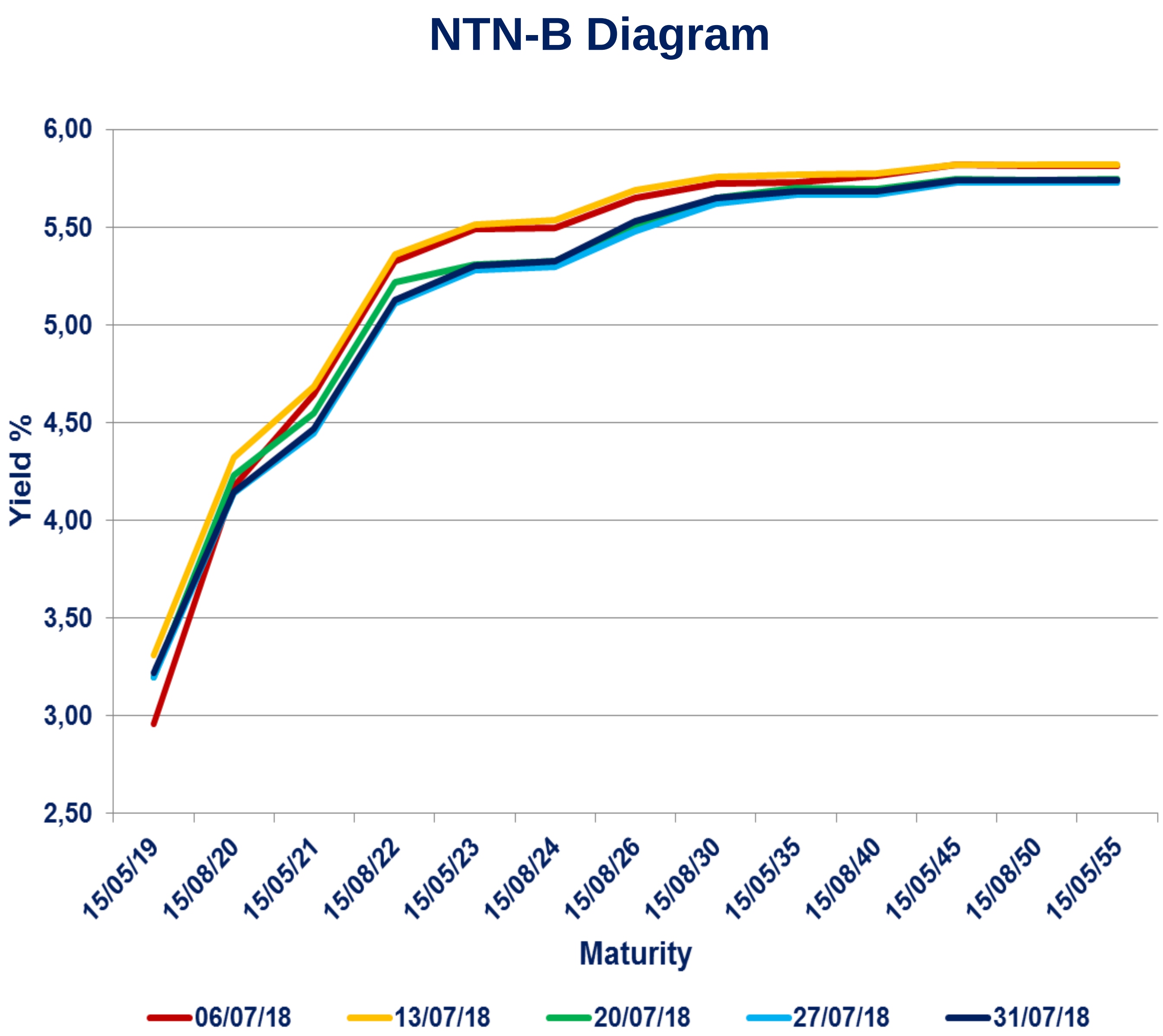
The second but no less important point taken into account by any foreign investor is the level of capital risk. For obvious reasons and widely discussed in this space, Brazil has a very low rating level, even lower than that attributed to other emerging countries that are not very different in their economic structure. In addition to experiencing a troubled political scenario in recent months, one which will probably be fierce from the month of August with the start of the presidential race, nothing guarantees the stability of our current credit rating. Any risk-adjusted return analysis, therefore, does not favor us. An immediate reflex of this observation will be the unequivocal increase in the spreads of tradings to be carried out, the only way to market adjustment.

Regarding the last of the three pillars – liquidity, it does not pose a problem in the international aspect, given the size of our economy and of our market. On the domestic side, the Treasury has been active with net repurchases of BRL 22 billion in bonds between May and July. According to those responsible for federal securities debt management (in an interview of Estado de São Paulo newspaper), the purpose of such a measure is to "help investors to reassess asset values." This attitude, in essence, resembles that strategy that was restarted strongly in June which, combined with BACEN's "exchange rate policy", was a joint action aimed at rebalancing and adequately ”signaling" to markets. The Treasury/BACEN duet, which sought to give greater functionality to the market by creating mechanisms to unwind investor positions, at this time somehow it also comes as an ”aid." We are definitely prisoners of the rigid intelligence of those who are reluctant at any cost to accept adjustments through markets, magnanimously confident in their differentiated knowledge and power of reorganization.

The effectiveness of such a measure? The financial market thanks!... The government behaves indeed like a *mother*.

Weekly Interest Rates





Source: Broadcast | Elaborated by Planner Redwood

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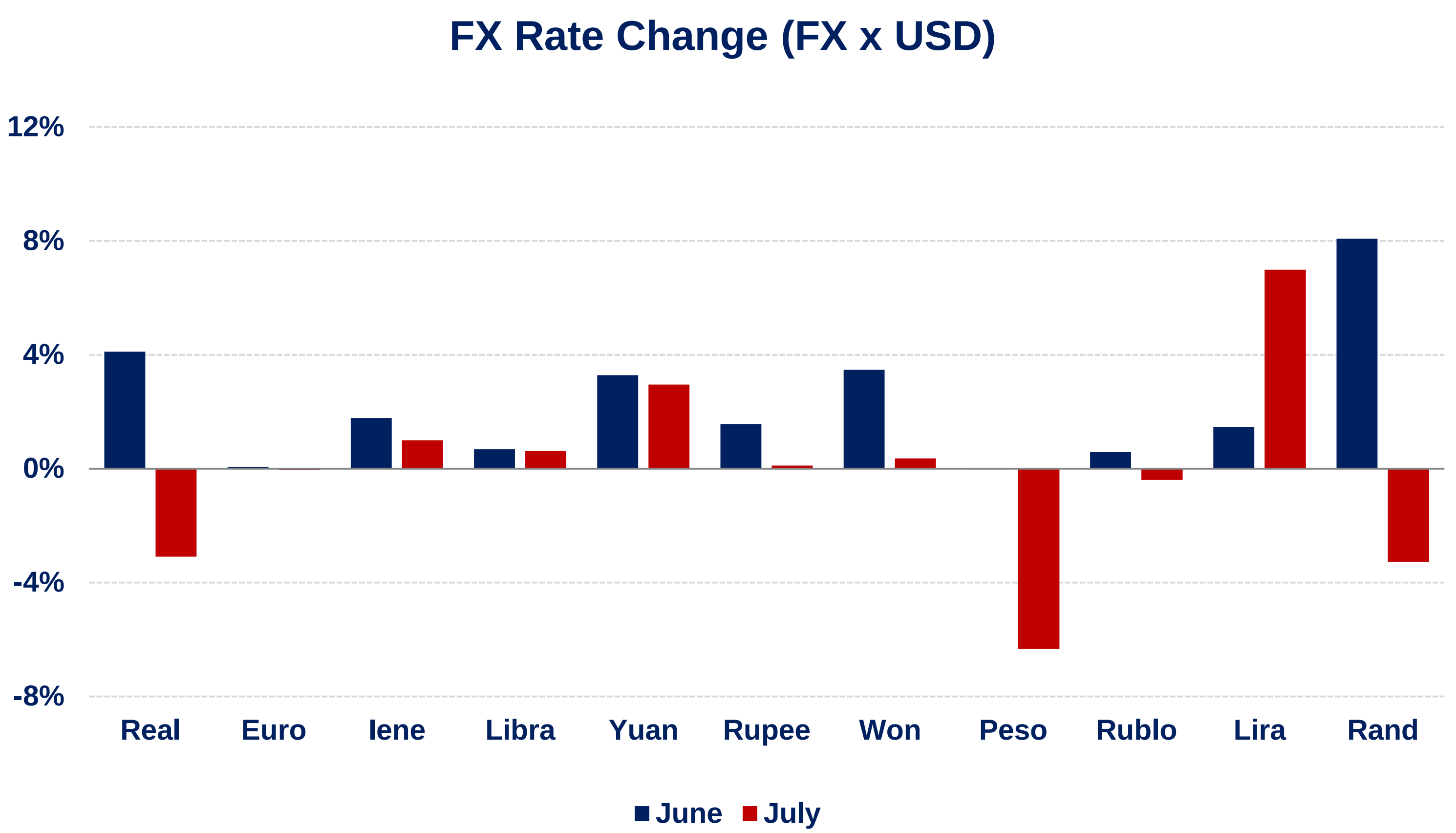
Foreign Exchange

The cycle of continuous devaluation of the Real against the Dollar that started in February of this year has ended in July, with a rise of 3.15% in the Brazilian currency value, closing at BRL 3.7549 (Ptax). Still, without deeming it to be just a *pit stop*, the year 2018 accumulates an expressive high of 13.51% in the quotation of the US currency.

Aside from domestic issues behind this movement, we have, on the external front, cooled commercial tensions led by Europe, which signed a historic trade agreement with Japan and succeeded in "softening" President Donald Trump's threats to its exports. These events had a positive impact on the currencies of major emerging countries and helped to reduce overall risk aversion among investors. On the other hand, with regard to internal vectors, the financial market optimistically welcomed the alliance between Geraldo Alckmin and the so-called "Centrão" (central party coalition, with high legislative representation and exposure time). By seeing in Alckmin the greatest assurance that the necessary reforms will come when compared to the other presidential candidates (notably those who have any chance of success) and factoring into prices an increase in the possibility of their victory, markets have been taken by a growing wave of optimism. These internal and external aspects, political and commercial, although momentary, have guided and interrupted this cycle of devaluation, but that does not yet suggest a consistent reversal.



Source: Blooomberg and Economática | Elaborated by Planner Redwood

In fact, what we can actually expect with some degree of certainty is that the month of August and the beginning of the electoral process will bring with it strong volatility for the Dollar, and that the absence of Central Bank interventions, as we observed in July, should not be repeated. Reinforced by the movement of foreign capital flows described in the previous section of this comment, which will put pressure on the devaluation of the Real, we may have new swap-rollover rounds, possibly already in the beginning of August, where BACEN signals a total rollover of its current stock of USD 5.255 billion.

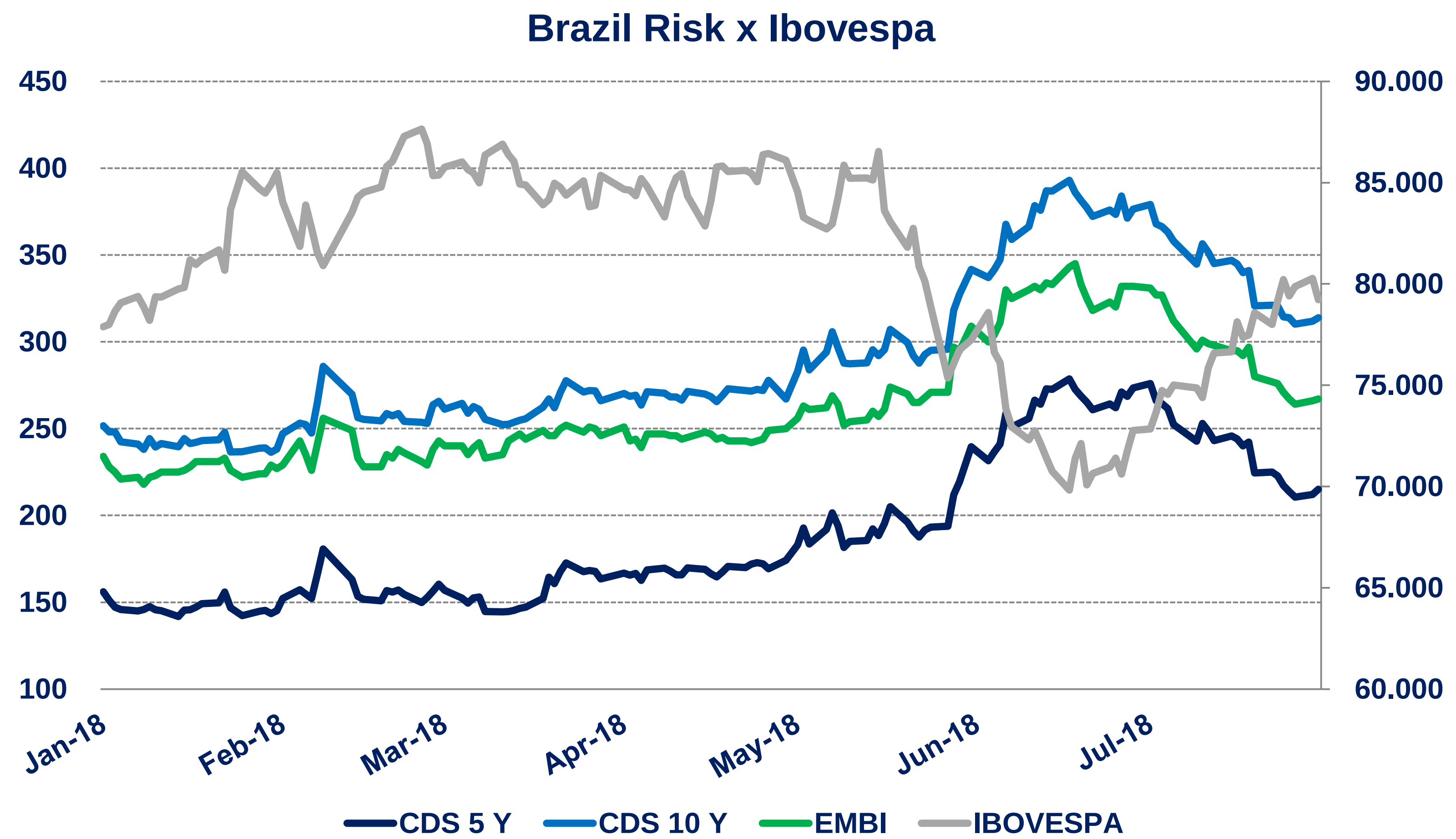
However, something that has caught our attention in recent months has been reflected in the following question: could the government benefit directly from the currency devaluation? Regarding compliance with the so-called Golden Rule, it seems that, considering that the financial result of the BACEN, all else constant, in the face of the devaluation of the Real, the gains of the Institution increase, because the value in BRL of international reserves rises - currently around USD 370 billion. The rule has been altered and improved over time (for balancing of BACEN's books), but currently a positive net result is transferred to the National Treasury and used to reduce public debt, lowering government borrowing requirements.

No, BACEN has a serious exchange rate policy and is totally independent of the government, and would not lend itself so easily to submission... would not even turn a blind eye. It has much to lose.

Stock Market

After two months of devaluation, the Ibovespa had a strong increase of 8.88% in July. To a large extent, this expressive rise is explained by the strong optimism seen in the market with the momentum gained by Geraldo Alckmin's presidential campaign, since he is seen as the most committed and qualified candidate to carry out the reforms (in particular the social security system, the source of our greatest problems). The financial volume in the month was BRL 9,538 billion. Another important factor for the recovery of trades is linked to the first part of quarterly results disclosed, wherein we observe that the recovery of the value of Brazilian companies is still diffuse. While we had some positive highlights such as Eletrobras and Braskem, others frustrated the expectations of important market analysts such as Itaú Unibanco, Cielo and Raia Drogasil.

This diffusion is inkling that we may be approaching a new stage for the Brazilian stock market, as new opportunities for gain are beginning to emerge. According to our Price/Earnings indicator, we are not yet at a point where the Ibovespa will surely bring consistent appreciation potential, but we are fast approaching this situation. Apart from soon-to-come volatility (and may come strongly in the upcoming months) the moment of reassessing positions in stocks seems to be reaching interesting levels.



Source: Broadcast and Blooomberg | Elaborated by Planner Redwood

Contrary to the possible valuation of the Ibovespa we find the predominant role of the external investor in the Brazilian stock market. As we said, globally risk-adjusted premiums (especially in the US) may encourage the outflow of capital, which has direct effects on the Brazilian stock market index. Considering these factors and the natural impacts that the Brazilian stock exchange faces amid this political and financial imbroglio, we at Redwood believe that the Dollar-measured Ibovespa may fluctuate between the ranges of 17,466 and 18,866 as its floor and that of 22,928 and 24,600 as its cap - for pessimistic and optimistic estimates, respectively. In this sense, the Credit Default Swap (CDS) is one of the main factors for the understanding of the direction in which the Brazilian stock exchange will point out. Thus, the forces exerted on this indicator from both external events and the possible maintenance of tensions between US-China and internal events ("electoral volatility") could play a decisive role in bringing new investments back to the stock market.

The moment for the stock market really seems to be improving... some *momentum* perhaps... but in fact the range of projections (+16.6% and -17.2%) without a more assertive probabilistic weight suggests a lot of caution. We are still much more in the field of uncertainties than in risk-taking.

We'd better stick with the measurable variables, only.

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