PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - AUGUST 2018

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

"In Brazil, even the past is uncertain"

Pedro Malan – former Finance Minister of FHC Administration

Introduction

Source:http://divulgacandcontas.tse.jus.br/divulga/#/candidato/2018/2022802018/BR/280000625869

Former President Lula has been deemed unfit to run for the presidency and has had the registration of his candidacy rejected by the TSE.

In fact, the decision of the Superior Electoral Court to contest PT's Lula's claim to run for the Presidency restores normalcy to the electoral campaign, since the question was a no-brainer from the start even for those not seasoned in legal procedures: a candidate convicted by a judicial body cannot claim to hold an public office, as this is clearly stated in Complementary Law 135/2010 - the Clean Record Act. Thus, Lula's candidacy was downright an offense on the law, that is, Lula, with a dirty record, is glaringly ineligible. In this vein, as a candidate, Lula is past, a turned page... especially in Minister Barroso's understanding, wherein the TSE's decision as "definitive".

However, PT's lawyers claim that there are appeals and that the STJ and STF may come to suspend ineligibility, even after the TSE's decision. In addition, they seek any whisper of hope in the votes of Ministers Edson Fachin and Rosa Weber, once Fachin has shown that PT's thesis (abiding by the "decision" of the UN Human Rights Committee) is defensible and Rosa Weber made clear that until the STF comes to an agreement, Lula should be able to keep his candidacy. In addition, in an absolutely inexplicable move, the TSE decided that the coalition could continue with the campaign adds, provided that Lula does not engage in the campaign directly until the full replacement of his candidacy is carried out.

The incontestable fact is that all the havoc created around this seems to have been premeditated, aiming to turn the Brazilian judicial courts into electoral platform. In this sense, the institutions did speak out. At such a crucial moment for the country, the TSE has shown a decisiveness and speed – both essential in the face of the tight deadlines within a much shorter electoral campaign than the previous ones -, and it is hoped that there will be no further proceedings in higher courts.

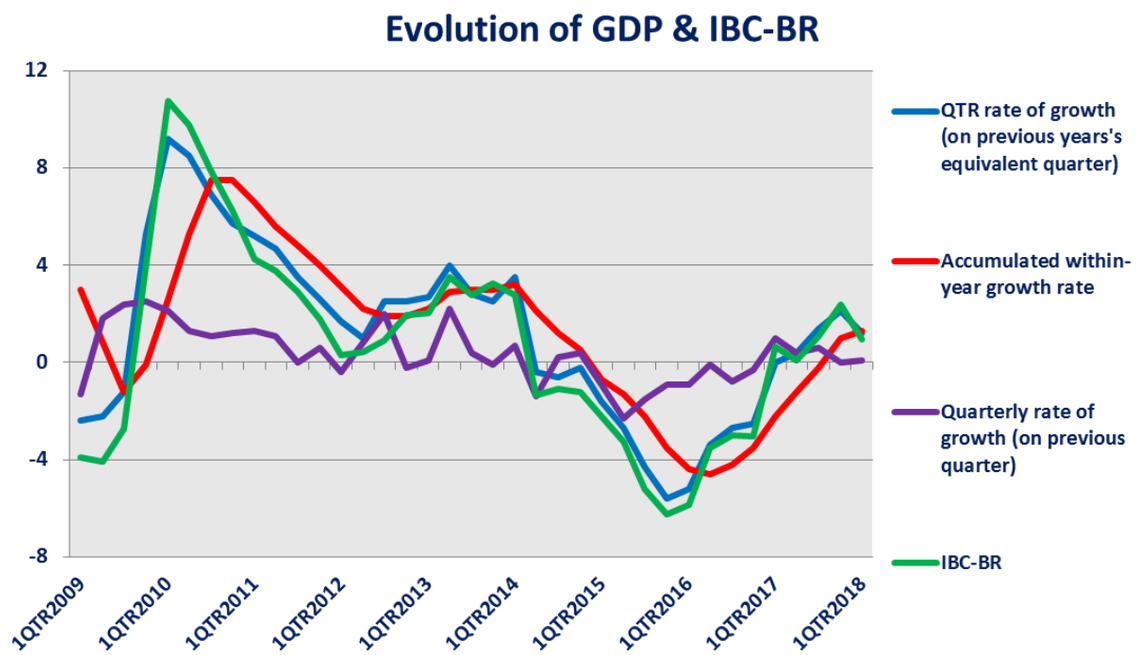
It is part of the democratic game to exhaust all possibilities, and the PT has already claimed it will appeal the decision of the TSE and will fight for Lula's candidacy "by all means". However, for Lula this is enough ... he can, and he is likely to abundantly help (from his prison cell) his protégé, given his "immense relevance" in the process, but the clarity of the platforms running and the process itself are also given, and Lula is out of the race. Let's just hope that the electoral turmoil thus far experienced soon dissipates and that the opening sentence of this former Minister Pedro Malan's comment, as disconcerting as it is unlikely, does not apply to this moment: *"In Brazil, even the past is uncertain."*

Overseas, especially emerging markets are facing difficult times. Argentina has been hit hard by the crisis, to the point that its government has requested an early withdrawal of a rescue package already agreed with the IMF. The fast-paced devaluation of its currency led the Argentine Central Bank to raise its interest rate to 60% annual rate, in the hopes of containing the outflow of dollars. In Turkey, sentiment is also overwhelmed and an increase in the interest rate is expected, but below the market expectation and also of lower intensity than the one seen in Argentina. The country will face lower growth and longer period of a forceful adjustment. In the US, President Donald Trump goes on to say that he must repair the worst trade agreements ever made by any country in the world. In the United Kingdom, the ever-changing transition period for BREXIT (expected to happen in March 29th, 2019) continues to shake the country and thus confirms the first casualty: BoE president Mark Carney will step down next year. In China, PBoC continues to inject resources into the financial system to provide liquidity to the economy. The country is also considering resuming financing in Africa as a way to strengthen its economic presence in the continent.

In this environment, US Treasuries closed the month at 2.8604%. S&P varied 3.01%, NIKKEI closed at 1.38%, DAX at -3.45% and FTSE 100 UK, at -4.08%. The Ibovespa ended the month at 76,678 points (-3.21%) and IBrX, at 31,591 points (-3.13%). Monthly highs for DIF19 at 6.93% and DIF21, at 9.91%. The NTN-B 2050 ended the month at 5.86%, and the Dollar (Ptax) at BRL 4.1353.

Economic Outlook

GDP	QTR rate of growth (on previous years's equivalent quarter)			Quarterly rate of growth (on previous quarter)		
	4 QTR 2017	1 QTR 2018	2 QTR 2018	4 QTR 2017	1 QTR 2018	2 QTR 2018
GDP	2.10	1.20	1.00	0.00	0.10	0.20
Agriculture	6.10	-2.60	-0.40	0.00	1.30	0.00
Manufacturing	2.70	1.60	1.20	0.70	0.10	-0.60
Construction	-1.60	-2.20	-1.10	0.10	-0.40	-0.80
Services	1.70	1.50	1.20	0.10	0.10	0.30
Retail	4.40	4.50	1.90	0.20	0.10	-0.30
Real Estate	2.10	2.80	3.00	0.40	0.40	1.20
Household Consumption	2.60	2.80	1.70	0.00	0.40	0.10
Government Consumption	-0.40	-0.80	0.10	0.10	-0.30	0.50
GFCF	3.80	3.50	3.70	1.80	0.30	-1.80
Exports	9.10	6.00	-2.90	-1.20	1.80	-5.50
Imports	8.10	7.70	6.80	1.90	0.80	-2.10



Source: IBGE | Elaborated by Planner Redwood

The figures mentioned above leave not much room for doubt. Economic activity in Brazil is slow, almost halted. There is widespread frustration with the pace of economic growth, reinforced by pessimism around global uncertainties and domestic electoral stress, thereby fueling volatility and tension in the financial markets. If the source of the problems is to be found in politics, also corroborate in the weakness of economic activity dynamic, possibly the deteriorating confidence levels, an overly optimistic expectation at the beginning of the year, and the frustration of job creation amid very low investment and savings rates than expected. All this placed in a context where growth is much, much lower than potential GDP.

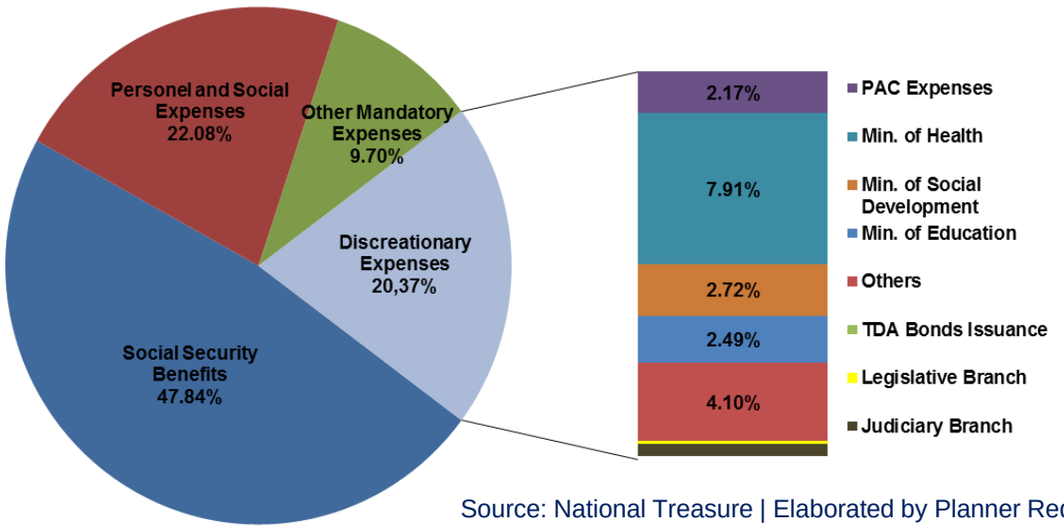
The level of confidence held by the Brazilian business community is fast eroding. Under the criteria of quarterly moving averages, the Getúlio Vargas Foundation's Business Confidence Index (ICE) dropped again in August, registering its fifth consecutive monthly decline. ICE consolidates the confidence indexes of the four sectors covered by the Business Surveys produced by FGV IBRE: Industry, Services, Commerce and Construction. Being at low levels, these indicators suggest that the economy will continue to evolve very gradually, thus affecting expectations and feeding back on this vicious cycle. Why so? Because one of the most important factors breeding uncertainty and insecurity today is the impact of the presidential campaign on investors' and consumers' expectations. It is not reasonable to assume that confidence can rise consistently until the end of October, that is, until the election process is over. After that, expectations will be conditioned to the outcome of electoral ballots - simple as that.

High unemployment still hinders advances by household consumption, but there is nothing more disturbing than the numbers displayed in the gross fixed capital formation – GFCF. This latter means inviting future growth; without it, we are bound to mediocre progress. More robust growth will only come with investment (you can not rely on consumption alone), and fundamentally private investment! This is why we must first solve the structural fiscal imbalance; otherwise there is no way to imagine any significant public investments.

The solutions are given and the chance to correct our past mistakes are looming close. Less interventionism and more liberalism. More order for more progress.

Fiscal Policy

Composition of Primary Expenditures - Central Government



Source: National Treasure | Elaborated by Planner Redwood

Next president will face a very serious fiscal challenge, with no chance to postpone essential reforms, especially and, above all, social security.

However, few are the candidates who have a structured plan and who, despite some effort and willingness to understand, are able to sell their practical package for the dynamics of the process and the consequent fiscal balance. Anyway, the bottom line is that the best-performing candidates are all committed to adjusting public finances and almost everyone assumes that tax increases are not on their platform/government plan. In other words, there is not enough detail in the proposals to make such proposition credible, not even further explanations on how to shape and change all expenditures. On the other hand, several of them attack one of the main instruments developed for a gradual and systematized adjustment: the Expenditure Cap. In fact, there is no way out of fiscal discipline without this measure, which does not, in addition, preclude other complementary actions.

Among the measures rarely invested in currently is the focus on a tax reform that tackles tax incentives. We need to reassess the poorly and broadly targeted benefit structure to specific sectors and thus correct distortions built within the tax system that amount to, only tax incentives considered, 4.5% of GDP with virtually no substantial return. The math simply does not hold. Public sector spending reached 20% of GDP, and next year, civil servant wages and salaries and Social Security will increase by BRL 66 billion.

Measures and suggestions that have always been revisited in this space involve a combination of increased revenues (especially on the efficiency side) and cost reductions. The World Bank itself, at the request of former Minister Levy, released a report[1] last year on the effectiveness of government expenditures with a focus on redesigning inefficient programs. However, it is easy to understand why the suggestions and recommendations have failed to bear any fruits, since they affect interest groups ranging from public servants (wages and pensions on average 67% above the private sector), to entrepreneurs who find themselves mired in tax exemptions. In fact, the alternatives do exist and fortunately a fair share of the advisors to the main presidential candidates is aligned to a greater or lesser extent with the prescriptions that do work. Exception made to the PT team, who takes a different stand, according to Guilherme Mello, one of those responsible for PT's economic program in the presidential campaign: "PT's idea has a different premise than most of the other candidacies. We will first reactivate the economy and job creation; only then will we tackle the fiscal deficit." We see, it seems the tail can indeed wag the dog.

Within the realm of functionality, the current economic team moves on, albeit mildly and absolutely constrained by the other government branches' fiscal oversight (mostly agreed upon by the Commander-in-Chief), with some probable success in achieving the fiscal target this year. Given the methodological differences in outcomes, consolidated financial statements released by BACEN - which include the results by the central government (federal government and Central Bank), state and municipal governments and state companies (excluded Petrobras and Eletrobrás) - showed that the primary deficit until Jul/18 reached BRL 17.8 billion. Still on the negative side, but it translates into a much better result than the one observed in the same period last year (a BRL 51.3 billion deficit) and 2016 (BRL 36.5 billion). Since it is common to see increased spending in personnel and welfare expenses, among others, in the second half of the year, meeting the targeted deficit is, with no additional surprises, totally doable. Regardless of this potential outcome, Social Security accounts, which are already highly deficient, will continue to worsen - that is, without the Social Security reform, however rigorous is the fiscal gear, the public deficit will continue to grow.

[1]"A fair adjustment: efficiency and equity of public spending in Brazil".

International Outlook

A major financial crisis looms over emerging markets!

Some are more vulnerable and others less susceptible to, but still under target of such movements such as Brazil (on account of abundant reserves and "balanced" current accounts), they suffer with the global volatility due mainly to the new normal set by the US. It is really a sharp movement/friction in several segments (commercial, political, economic, military, etc.) that, although not more insulated, has the largest economy on the planet setting the point of imbalance that fuels this new order. By not having a defined pattern, the predictability of the "world order" is impaired, and with this and until the new dynamic is reasonably understood, movements of greater risk aversion, speculative or even of simple hedge-seeking are exacerbated, thus affecting quite substantially the countries more economically and institutionally fragile, as well as those which failed to properly do their "homework." This is what happened to Turkey. There, inflation is expected to rise above 20% this year, activity suffers and currency devaluation scares and jeopardizes the smooth running of the economy. It has not been any different with our Argentine neighbors, more recently. The prescription will not be very different from all of the other countries in the same situation, that is, a major fiscal shock. In this sense, the Argentine government has already signaled upcoming measures such as cutting costs (for some analysts still insufficient) and tax raises, in a clear movement of greater austerity aiming at a balanced primary budget until 2019 (previously predicted for 2020) and a surplus of 1% of GDP in 2020 (-3.9% of GDP last year and -2.6% of GDP this year). It is obviously a quite high burden to be borne by the Argentine society, a bitter remedy to correct distortions of the past, but that will take effect if carried forward. The IMF seems to believe in the government's actions and has agreed to extend support to Argentina. It will work out fine!

In Europe, there has been no significant change in monetary policy news from the European Central Bank (ECB) in the past 30 days, with its gradual course of normalization in place. For Yves Mersch, a member of the ECB's board, the financial sector in Europe faces "a series of challenges" with "weak" performance and issues such as the need for deleveraging and dealing with stricter regulations, as a result of the recent financial crisis. The Manufacturing, Services and Composite PMIs for the Eurozone and especially for Germany, France and the United Kingdom remain above the 50-point mark, but in all of the PMI of Industry in August shows a contraction, and in the UK it reached record lows in 25 months. In the political field, the British are still under pressure from Brussels for greater concessions in their BREXIT strategy. The lack of consensus between the UK and the European Union (EU) is glaring. The EU's chief negotiator for the BREXIT, Michel Barnier, "strongly opposes the ideas of Prime Minister Theresa May on trade between the two sides after the British exit of the European block. According to Barnier, the UK's offer on customs is illegal and the suggestion of common rules on goods to be followed by both sides would "kill" the European project. Tensions do not stop there, as Italy is on the verge of its budget project for the next fiscal year to be presented to the EU, and investors are keenly aware of the possibility that the 3% of GDP cap to the public deficit set by the block will not be met. Faced with this, Economy Minister Giovanni Tria said that the Italian government will honor its commitments to the EU and asserted that the actions to be taken will calm down financial markets. Italy continues with Fitch BBB rating, but now with a negative outlook, from a stable one.

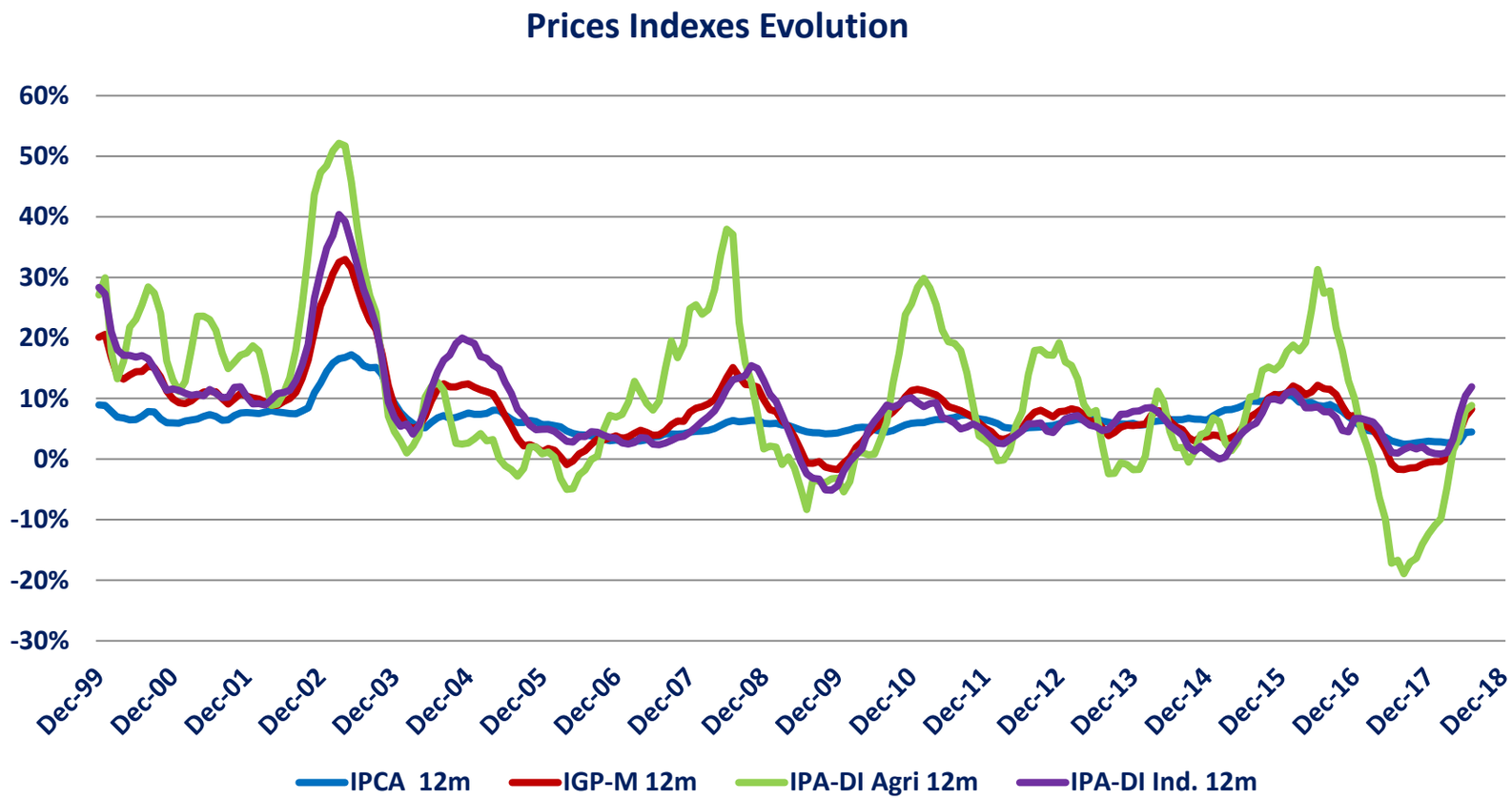
In Asia, China seems not to interrupt its successive market interventions with massive resource injections, whilst also "resuming" its projects in Africa with USD 60 billion in funding through assistance, investments and loans. In Japan, the BoJ chairman Haruhiko Kuroda, seems increasingly "optimistic." He believes that global markets have rebounded to levels seen before the 2008 financial crisis and, after an ultra-accommodative policy, the BoJ cut down on traded volume in the Japanese public bonds market (JGBs) and allowed the JGB-10-years to fluctuate more broadly.

In the US, Donald Trump continues his "crusade" against "all else" and with results, at least for the short term, meaningful to the American people. Highlight this month is the *new* NAFTA, but at least here the solution seems faster with Mexico... Canada should still adjust if it wants to take part in it, according to Trump. In this case, the American president must agree with his Congress. *Ooops*, new normal! Or doesn't' he?

Interest Rates

August was the month in which the financial markets fell under the weight of the electoral volatility inherent in the process of electing the next President. Among available investments (at least liquid assets considered), not surprisingly, profitability stood out in the hands of the FX funds, as the US dollar skyrocketed last month, followed by a steady rise in future interest rates and a fall by Ibovespa, in line with the explosive movement of Brazil-risk (expressed by EMBI and CDS). In the midst of a perfect storm, the complete deterioration of the so-called "Brazil Package", largely due to the irresponsibility of some in getting the country mired in uncertainties.

As for the future interest rate market, all the vertices along the ETTF shifted. While the DI 19 recorded a 4.38% rise in relation to the previous month's closing figure, all other vertices showed increases close to 10%, as in the case of DI 21, which registered a rise of 0.91 p.p., thus reaching the level of 9.82%. It should also be noted that all maturities from 2022 onward already have rates above 10% and over 12% when considered from 2025 onwards.



Source: IPEADATA | Elaborated by Planner Redwood

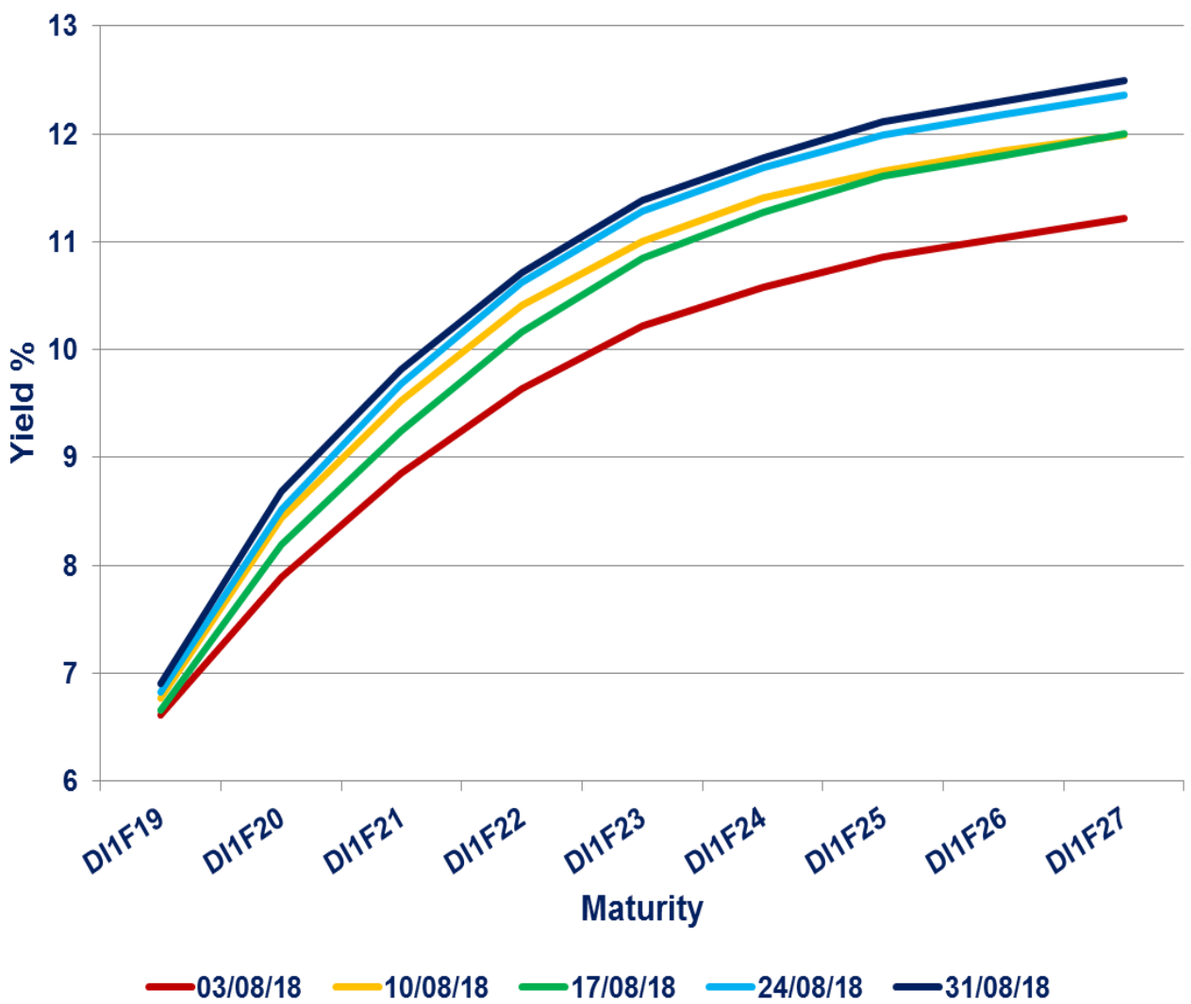
The effect of the volatility described above on such movement is quite clear-cut. However, there is another relevant point to be considered in this analysis, given the expected behavior of price indices and the anchoring of expectations, and the effects dictated by the exchange rate that are inherent to such dynamics. The rise in the price of the US currency already reflects its direct impact on the IGP-M, which accumulates an 8.26% inflation rate in the past 12 months. Once the close-to-6-months window for the pass-through between IGP-M and IPCA, the increase in interest rate futures contracts already begins to reflect, to some extent, the possibility that inflation, hitherto controlled and anchored within the near horizon, accelerates and therefore the outlook for a "soft" monetary tightening for next year will be revised to more consistent tightening.

Whether Monetary Policy will run tighter or not will depend, as well as external scenarios, etc., also, of the results of the polls. This is because, depending on the new president, we may have expectations adjusted to one side or another, according to his convictions and propensities for the reforms - remember that the fiscal unrest "prevents" reduction in interest rates. Apart from this, in spite of the contagion effect of the currency devaluation, other variables (which Central Bank also considers!) such as economic activity and unemployment, do not point to SELIC increases.

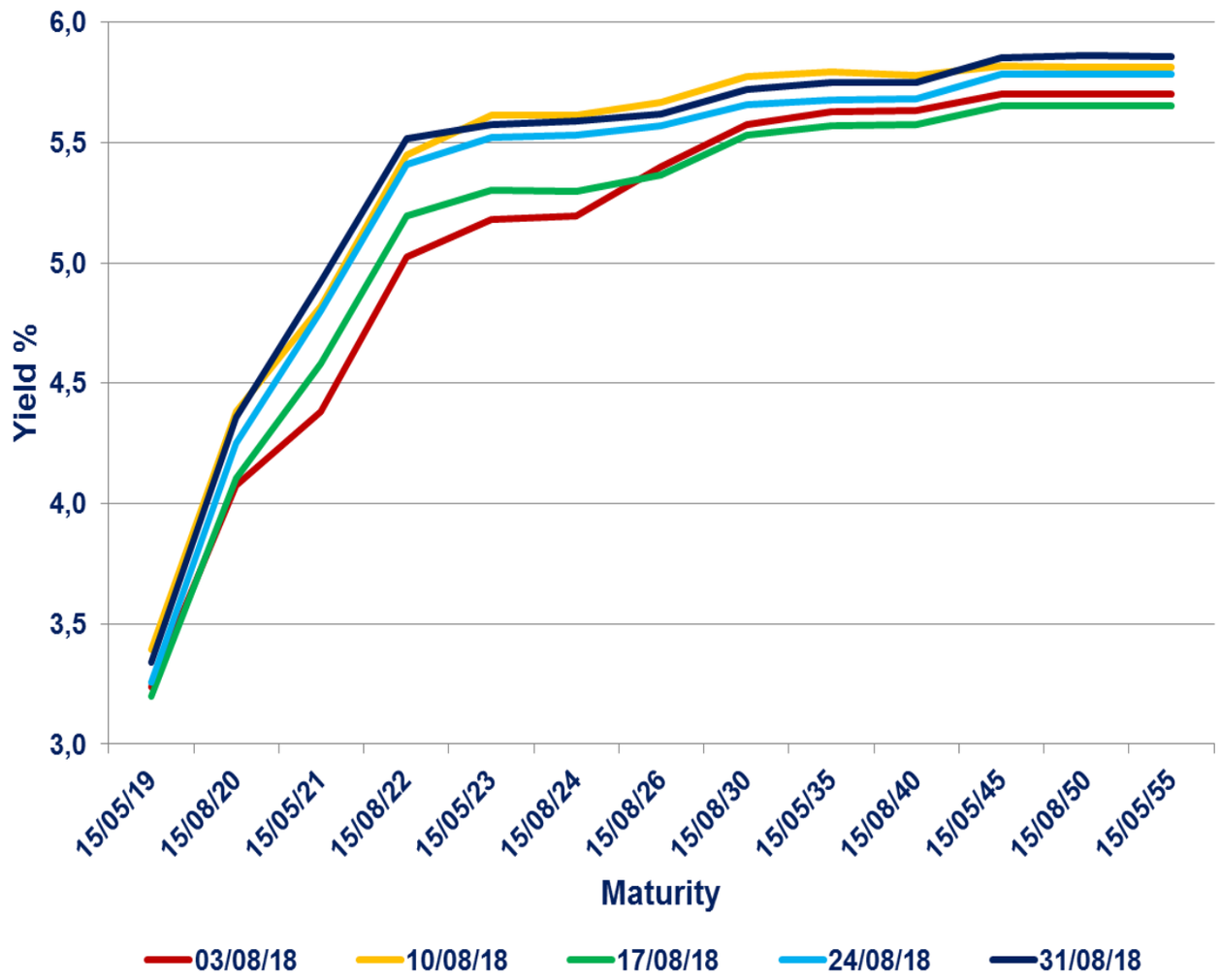
What remains certain is that until the elections, under dark or bright skies, SELIC will remain where it is.

Weekly Interest Rates

Yield Curve Diagram



NTN-B Diagram



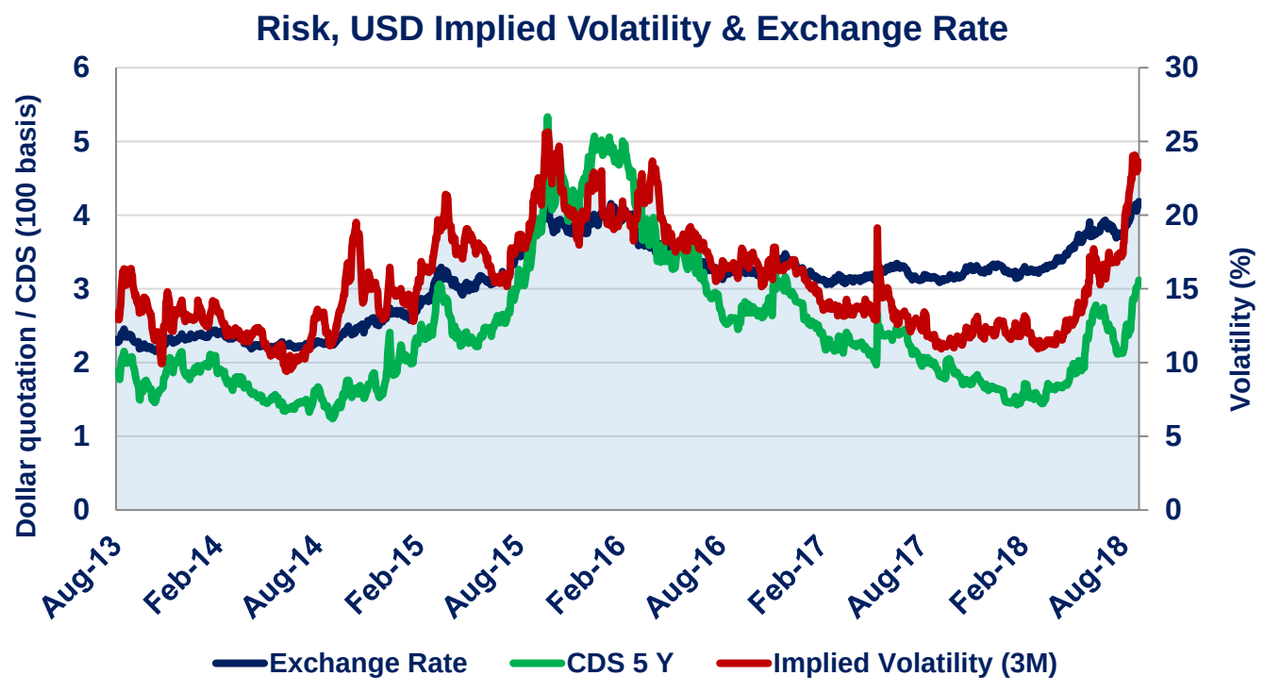
Source: Broadcast | Elaborated by Planner Redwood

Foreign Exchange

Some images are worth a thousand words.

For those less familiar with the world of finance and market behavior, the question of what are the significance of volatility and its practical effects, it is enough to present a chart describing the behavior of the exchange rate. Especially during this year, this has been thus far filled with strong emotions apart from the electoral process, such as the effects of the new American trade policy and its tension with the Chinese government, the crisis in Turkey, truckers' strike, among others. The result of this combination of factors is the movement of the dollar, which this year alone had its low running close to BRL 3.12 and reached a high of 4.21 (this latter, it is worthy of note, close to the end of this month).

As can be seen in the accompanying chart, which includes not only the exchange rate but also its volatility (implicit in the 3-month option contracts), the strong fluctuations in the US currency price have sanctioned its rising trend and resulted in a 25.01% real appreciation over the course of this year. However, the causes of such behavior derive from economic events and factors, which in turn feed into agents' expectations.



Source: Blooomberg | Elaborated by Planner Redwood

Within this past month, the crises of the Turkish Lira (devaluation of 33.08% against the US dollar) and of the Argentine peso (devaluation of 34.46% against the US dollar), as well as political instability in Brazil, played an important role in the Brazilian Real stability, as was widely discussed above. In situations of this nature, it is recurrent in economic history the indiscriminate outflow of capital from emerging markets – selectivity is binding only on the way in.

Amid this whirlwind of negative information, what has "played in our favor" is precisely what is likely to be the only positive legacy of the PT administrations (even if the merit for such achievements does not belong to them), the comfortable level of foreign reserves. On the opposite side of our peers described above, the fairly reasonable level of outstanding external debt, a "balanced" current account and international reserves of approximately USD 380 billion do protect us from the possible dissemination of the country's perception of insolvency and, consequently, from capital outflows and further speculative attacks. Thus, the preservation of this asset is imperative, and any divergent proposal in this respect should not be entertained, even if some of the current presidential candidates fail to realize such triviality.

In this line, it is imperative to "look after" these reserves, especially, also, by the insertions of the BACEN via what is denominated Exchange Rate Policy. Up until August 31, the loss on swaps amounted to BRL 36.4 billion by cash flow method and BRL 29.7 billion by accrual methods. On the other hand, foreign reserves have delivered within the year a positive net result, including foreign exchange operations. Is this good? It does not seem to be. After all, BACEN always warns that in relation to foreign exchange swap operations and the administration of foreign reserves, the local authority does not aim at profit-making, but provides hedge to the market in times of volatility (in the limit, control of volatility, not of price level) and maintain a liquidity buffer for times of crisis. Really? Is it getting it done?

The chart says it all!

Stock Market

The stock market failed to dodge the negative effects that afflicted the Brazilian financial market. The Ibovespa closed the month quoted at 76,678 points, reflecting a fall of 3.21% and accumulating gain in the year of 0.36% (agree, zero!). But even more important than the stock exchange in BRL terms, we should be aware of the behavior of the Dollar's impact, since most of the volume traded in the stock market comes from foreign investors. In this case, the Ibovespa presented a loss of 10.59% in August and accumulates within the year losses up to 18.16%. And the future prospect is far from any better...

Broadening analytical scope, unprejudiced and, in the limit, aligned with the long run, we look beyond the fundamentals. Thus, considering the graphical analysis and the principles of the Dow theory, the candlestick chart on the side indicates that it is not impossible to imagine the dollarized index falling to the resistance of 11,847. With the highlighted possible reversal in the loop, what we have is the prospect of worsening until the end of the year and possibly still early next year. The anticipation of this movement and the positions sold to foreign investors can and should accentuate the downward movement of the index measured in local currency, which in a way feeds back into the general perception of a fall.

Ibovespa in USD terms

Source: Broadcast | Elaborated by Planner Redwood

But to what extent are the fundamentals for such devaluation any solid? Although corporate balance sheets show some improvement at overall levels, data on economic growth itself is not very encouraging. As discussed in the Economic Activity section of this report, although marginal growth has improved in recent quarters, this is not reflected when analyzing the growth records against the same quarters of previous years, much as a result of the fall in household consumption and of agricultural activity. But across the data on the Brazilian GDP, none is more disheartening for the stock market than the significant fall in GFCF (in the last quarter, a marginal drop of 1.80%).

Investment means hiring future productive capacity, which in principle will be reflected in higher revenues and profit margins. As long as the "hiring of future growth" does not arrive, it is difficult to imagine a new long and consistent cycle of highs in the stock market. It is that simple. Everything else basically turns to (speculative?) short and medium term movements.

For these reasons, the main index of the Brazilian stock exchange has a price range also strictly tied to the results of the polls. There is unequivocally a symbiosis of the Ibovespa with the guidelines set by the new ruler of the country. A new *reformist* president will immediately enjoy investors' "benefit of the doubt". In fact, for investors, the nuances of opinion of potential candidates are of little significance; what is really worth is their consistency, the feasibility of their government plans, and the constitutionality of their actions.

A good plan that results in order and progress will flood Brazil with resources. There is no shortage of opportunities!

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