SEPTEMBER - 2018

MONTHLY COMMENTARY

PLANNER REDWOOD ASSET MANAGEMENT

planner Redwood

SUMMARY

EPIGRAPH OF THE MONTH... A PROPOS OF BRAZIL'S CURRENT PREDICAMENT.

(WE ARE) AT THE ELEVENTH HOUR.

BIBLICAL TALE OF WORKERS HIRED LATE IN THE DAY

(THE FINAL HOUR IN THE RUN-UP TO A CRUCIAL MOMENT OR A SIGNIFICANT EVENT).

01
INTRODUCTION

Wake up Brazil! The Giant shall no longer sleep.

Once again we are faced with the possibility of changing Brazil's course. In the days prior to a new presidential election, we witnessed the Nation confronted with a daunting decision between what recent opinion polls have come to depict as two poles: on the one hand the Workers' Party - PT (led by its main spokesperson and convicted felon former president Lula) and the other a Retired Army Captain (with his vice-president, also a retired Army General, both viewed as brutes and unsophisticated). For some a difficult choice, they still bet on a third way; others, by ideology, opportunism and even fear, prefer to grant PT the benefit of the doubt.

In fact, it is clear that any outcome may bring some frustration, but it is one thing to choose the certainty of failure, either by doubling down on everything we have seen in the last 14 years and/or continuity and more of the same; and another thing is to opt for the possibility of success. The "center" candidacy leads us to continuity and the lack of the imperative need to break with the *status quo*, as the *give-and-take* disguised as effective discourse both in guidance and in the "abilities" of the policies required to promote democracy and good management.

On the side of our deepening crisis, there is the return of the PT. Yes, judging from their proposals and government plan we will see much more than we have seen under the leadership of Dilma Rousseff; the catastrophe will be final. Why? For the simple fact that their track record is an undeniable disaster, and if elected now, people will be legitimizing all their past misdeeds and delivering a free pass for future atrocities - in all segments.

On the other hand, the double Captain-General with a strong "developmentalist-nationalist" history learns quickly and fits quite comfortably with the only possible way out for Brazil: liberalism. We must give ourselves the right, at least once in our lives, to "experience" what has worked in countries like England and the United States. Brazil has already been a "laboratory" of finances of all sorts, and a home for intelligent thinking - in this line of reasoning - like the Real Plan, which worked well... so, others of same lineage, will also work. In the political field, however, the PT is very explicit in what it claims by the voice of one of its exponents: it is about "overtaking power". Nothing is more anti-democratic, crude and rude. It is the submission of the State and the Nation. We need the complete cleansing of what has been done in the last 14 years. The low competitiveness of other candidates in the first round of voting and redirection of these votes in an eventual second round may jeopardize Brazil's likely success and seal its future. It is imperative to discuss the issue of useful voting, and especially the message of victory in the first round may represent. The fact is that the phrase that opens this Comment precisely translates the moment that we live, and we expect to be the last attitude of the Brazilian people: *"We are at the eleventh hour "*.

Overseas, advances and intensification of crises marked September. On the side of advances, there are trade agreements for a new NAFTA, with clear advantages for the US, and relations between the Koreas. On the crisis side, Argentina has replaced its Central Bank chairman and has further increased its basic interest rate, now 65% yearly. Still in the crisis deepening ballpark we also find Turkey, with its President Erdogan imposing "limits" to what he considers reasonable economic policy.

In the UK, the reversal of BoE President Mark Carney's resignation was a positive sign, although insufficient to resolve the BREXIT imbroglio. Still in Europe, Italy presses upon its budget constraints and its targeted deficit is not pleasing many observers, as it may exceed the 3% of GDP threshold established by the EU due to its optimism, designed to foster growth for the Italian economy. In China, PBoC interference in markets this month was lower, but trade relations with the US seem nowhere near a solution in the short term. Finally, central banks around the world focus their attention on the US economy and the Fed's monetary policy, as US economic activity is growing around 4.2% (2nd QRT 18) and a further increase is expected this year.

In this environment, US Treasuries closed the month at 3.0612%. S&P changed 0.44%, NIKKEI closed at 5.49%, DAX with -0.95% and FTSE 100 UK 1.05%. The Ibovespa ended the month at 79,342 points (3.48%) and IBrX at 32,611 points (3.23%). Monthly highs for DIF19 at 6.94% and DIF21 at 10.18%. The NTN-B 2050 ended the month at 5.98%, and the Dollar (Ptax) at BRL 4.0039.

02 ECONOMIC OUTLOOK

If economic activity numbers in Brazil show a meager growth this year - something around 1% - the numbers of unemployment are no less frustrating, especially when analyzing qualitatively.

In fact, the 2018 GDP has been reduced in both measures: supply and demand. On the supply side, agriculture and manufacturing have fallen, but services tend to reasonably maintain their performance. On the demand side, we project drops in household and government consumption, for obvious reasons of unemployment/disposable income and availabilities, respectively. The Gross Fixed Capital Formation (GFCF) for 2018 will have marginal improvement; a major frustration that, to some extent, will carry its statistical effect through o 2019. Although strongly dependent on the outcome of the upcoming elections, in particular by its effects on expectations and improving confidence levels (leading indicators), the level of GDP as a rule does not react much in the short term, but it can consolidate a trajectory or reverse trend when in binary situation like our current one.

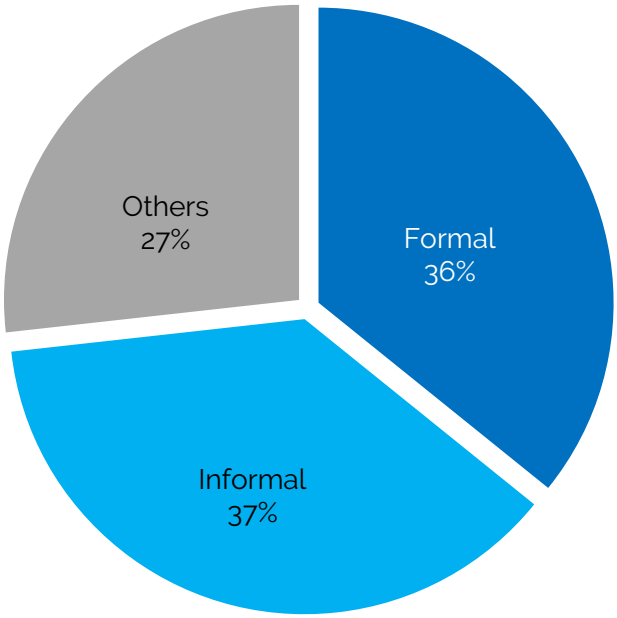
In sum - and excluding the political issues impacting our macro scenario (including the risks of carrying out the necessary adjustments and reforms to enhance productive capacity) - we evaluate that the Brazilian economy is in a slow and very gradual evolution. The current high level of idle capacity, combined with an external environment of greater monetary tightening in the developed world and the risk of a worsening commercial war and its impacts, are reflected in a lower appetite for risk in emerging countries and, hence, Brazil.

Nationwide unemployment, meanwhile, added up to 12.7 million people looking for jobs in the quarter ended in August this year. There is some quantitative improvement there, but no real reason to rejoice. According to the Brazilian Institute of Geography and Statistics (IBGE), employment rate (percentage of employed persons in the working-age population) was estimated at 54.1% in the quarter up to August of this year, against 53.6% in the quarter ended in May. When compared to the quarter through August of last year, employment level was 54.0%. Still according to IBGE, the total number of formal jobs in the private sector shrank 1.3% in the quarter ended in August 2018, when compared to the same quarter of 2017, meaning that the country lost 444 thousand jobs with a formal contract in the period of one year. Without the need for formal contracts, the private sector increased job creation by 4.0% in one year, an additional crowd of 435,000 employees, while self-employment grew by 1.9% in the period, with 437 thousand more. The public sector generated 257 thousand positions, an advance of 2.2% in the employment.

If the rise in informality is preferable to rising unemployment, we need to understand that job creation has increased just enough to absorb population growth over the period under review. In addition, it is important to note that the increase in informality invites natural cuts on these workers' purchasing power, since the loss of the formal ties, as a rule, reflects on substantially lower wages.

This will definitely not suffice!

Employment Composition - PNAD Aug 2018



Source: *IBGE – PNAD Contínua | Elaborated by Planner Redwood*

03 FISCAL POLICY

In the run-up to the election of a new president, it is important to grasp a general idea of how public accounts are doing.

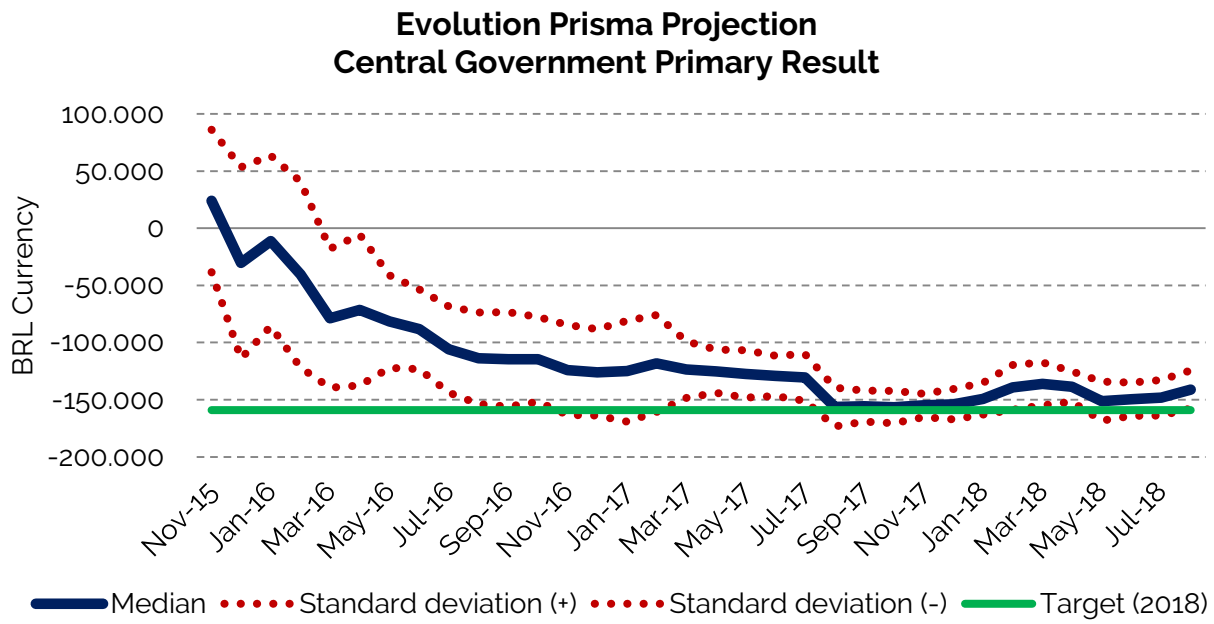
According to Central Bank data, the consolidated public sector (Central Government, states, municipalities and state entities, excluding Petrobras and Eletrobras) with a targeted deficit of BRL 161.3 billion for 2018, registered a primary deficit of BRL 16.9 billion - the worst result for August since 2016. Within the year up to August, this deficit amounts to BRL 34.7 billion (0.77% of GDP) and in 12 months, BRL 84.4 billion (1.25% of GDP). From the perspective of the nominal deficit for the consolidated public sector, in August it amounted to BRL 76.9 billion, thus accumulating BRL 323.5 billion (7.15% of GDP) within the year and in 12 months the astronomical figure of a balance of BRL 503 billion (7.45% of GDP).

Regardless of the commendable efforts by the current economic team, which has enjoyed some achievements, the above figures are a curse. The net debt of the public sector, with a reduction of 1 percentage point from July to August (effect of the devaluation of the Real - considered foreign exchange-linked liabilities and assets in foreign currency, such as international reserves), recorded a 51.2% share of the GDP, while the main solvency indicator of a country, Gross Debt/GDP, reached 77.3% in August. In fact, not even the payment of BRL 70 billion from the BNDES to the Treasury was able to prevent the advance of the Brazilian gross debt which, in nominal terms, reached BRL 5.22 trillion. The reasons and justifications are always the same, with the primary expenditures increasing (differences in income and expenses), interest service on the debt (an important expense - this month also "contaminated" by "exchange rate policy" - see Exchange commentary below), the rise of the Dollar which, with respect to the Real, increases the exchange rate-linked share of the gross debt (here the effect of the exchange devaluation occurs only on the liabilities side), etc. In the end, the only certainty is that governments (federal, state and municipal) are spending more than they collect, and to cover the gap, they provide themselves with more debt

In this line, should we fail to contain the primary deficit, debt will not be equated either. If the latter ever happens, a sequencing of good reflexes will be noticed, the most important being the signaling of sound finances with consequent identification of improvements in our ability to fulfill our debt contracts. What is the impact? Most likely, a shrinking debt servicing account. That simple. And what is the motto for the next government? Social security reform (pensions consumed 98% of central government net income in the 12 months ending in August) and overall control of expenses. The issue here is that pension reform will depend on the approval by Congress - CN, which will require perhaps a lengthier time than the agonizing situation of public accounts can stand. Containing primary deficits is fundamental in the short term... easier said than done and it sounds borderline irresponsible, especially if one disregards the government machine and all the bureaucracy involved. However, there is a way out... and the plan (known!) can be implemented with a new government legitimized to do so.

Thus, despite undeniable advances in government finances, the overall picture is quite bleak and urgently needs a distinguished, disruptive even, stance, in the sense of a trend reversal - without suggesting any illegal but certainly "unconventional" and very energetic, especially those not dependent on CN approval. More than a few measures can be put to work in this direction, but they will need guiding hand in changing the current *modus operandi*.

It will hurt, but it's our only way out!



Source: *National Treasure of Brazil – Prisma Fiscal | Elaborated by Planner Redwood*

04 INTERNATIONAL OUTLOOK

The world has its eyes on the Fed. The US economy corroborates its strength with the latest GDP revision for the second quarter with an annualized rate of 4.2%. The Fed's very own forecasts point to an unemployment rate around 3.5% and inflation on target. In other words, everything is going great for the Yankees, but it is likely that the Fed will surprise with its monetary policy, which would affect the whole world. Thus, monitoring the performance of the Fed (assuming its independence) over the years, under different governments and economic situations, can be a good "behavioral" indicator associated with its statements regarding economic and financial takes on both the US and the world economies.

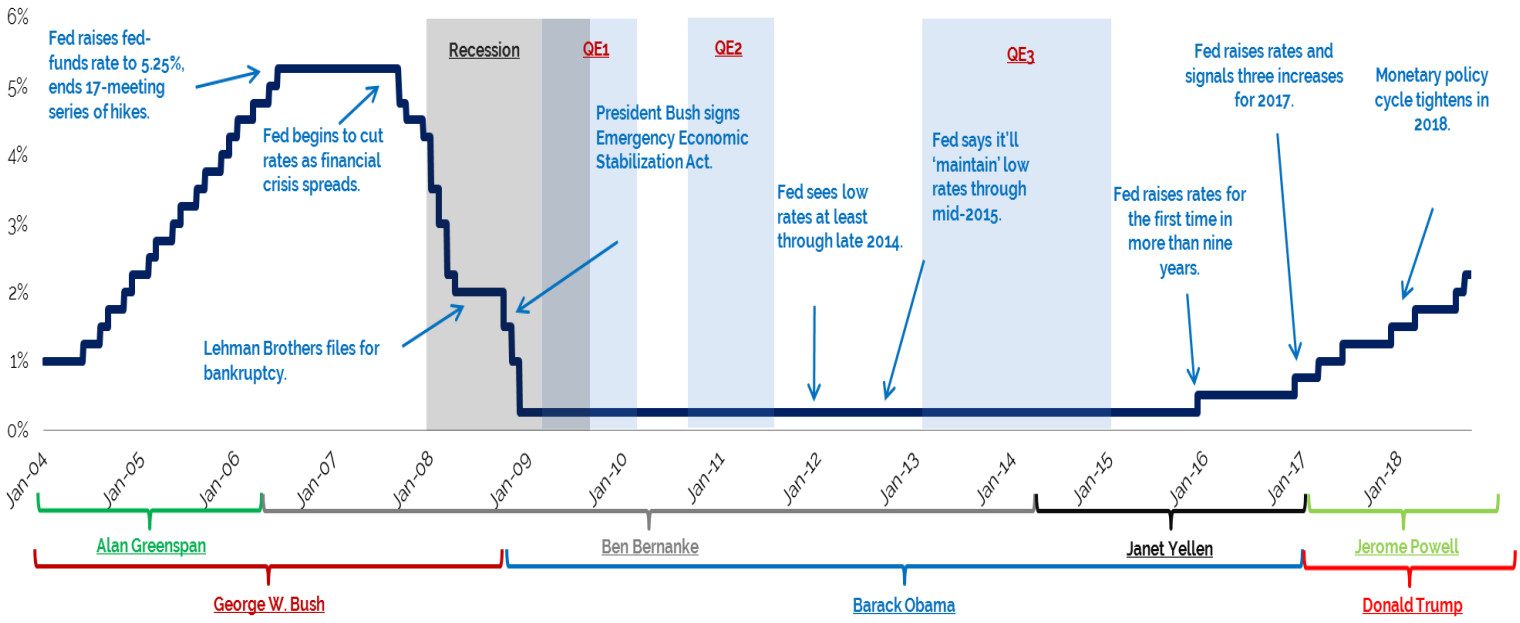
In Europe, for the executive board member of the European Central Bank (ECB), Benoît Coeuré, despite uncertainties clouding trade relations, the Euro Zone's economic growth should go on, with downward unemployment rate. He believes that price pressures are gradually increasing, and that monetary policy normalization (which is already in place) should continue, but at a "gradual pace". He claims to expect interest rates to remain at their current level until the summer of 2019, but that the reduction in net asset purchases will close until Dec. 18.

We have our doubts on this. Firstly, the situation in Italy and its budget proposal, which draws up a deficit target quite far greater than the one expected by the EU authorities, and secondly, due to BREXIT's growing stalemate. Only these two examples are enough to shake, and much, the optimism of Benoît Coeuré. Truth is that "equilibrium" is very unstable in Europe.

In Argentina, the "agreement" with the IMF has evolved, but far shorter of what the market expected. The "costs" already present last month have worsened in September. The interest rate is now 65% on annual basis, the Argentine central bank's chairman (BCRA) has been replaced and the current inflation target has been abandoned in order to establish nominal targets for monetary base growth, with a zero growth target from now until June 2019. It is full-fledged Milton Friedman's monetarism... which will promote a huge liquidity squeeze and a monetary contraction in real terms with implications for the real economy. Goals set, they know the effects are coming.

Finally, the agreement that replaces NAFTA - called USMCA – has been signed. No further details, but it seems Donald Trump got what he wanted. In the limit, as the saying goes, *a bad deal is better than a good fight*... so Mexico and Canada must have cleverly thought. China should think as well.

Fed Funds Evolution



Source: *Federal Reserve St. Louis | Elaborated by Planner Redwood*

05 INTEREST RATES

The interest rate market reflected, in September, the substantial improvement when compared to the stress experienced recently. In large part, this is due directly to the adjustment in the perception of risk as regards to emerging countries affected by the exchange crises in Argentina and Turkey (in this case, originated from the trade war with the US).

With such "temporarily" mitigated threats, or at least their potential contagion effect, investment flow fostered falling interest rates in the local market. The DI 2020 registered a 4.37% drop, closing the month quoted at 8.31%, while DI 2021 closed at 9.57%, representing 2.55% fall. In the long vertice of the curve, DI 2025, which had a monthly decrease of 2.73%, closed at 11.77%.

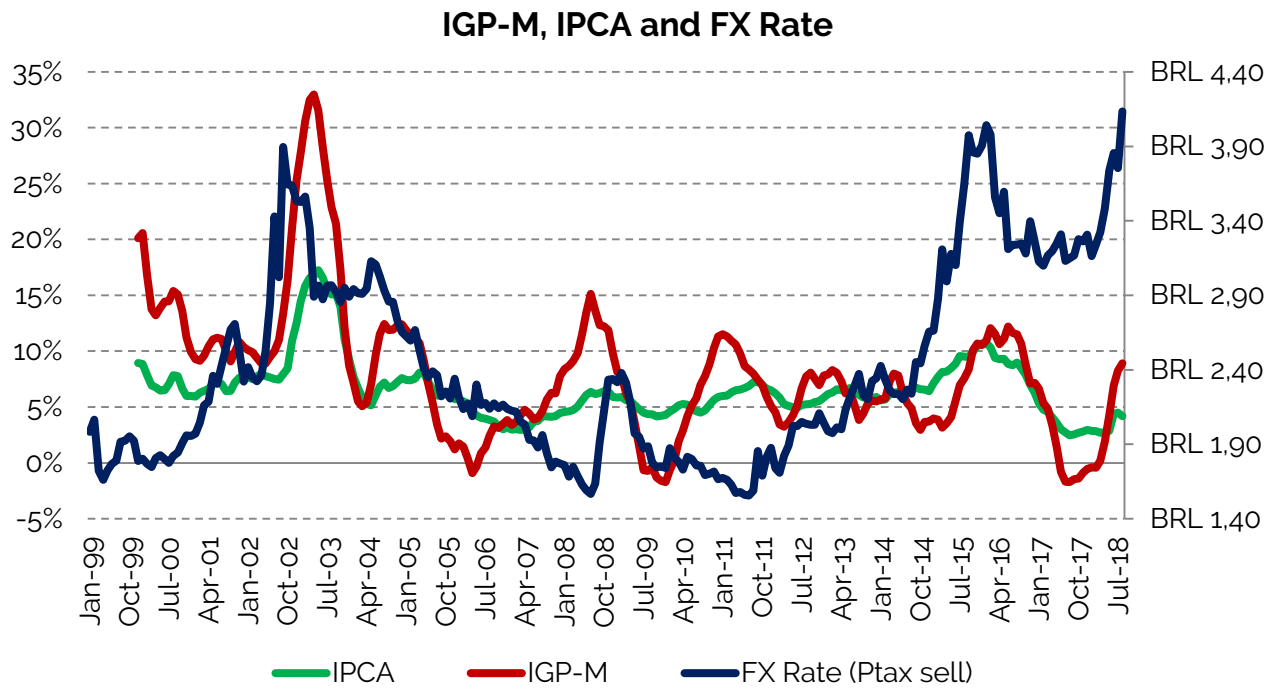
A local factor also favoring such a slowdown was the August IPCA, which indicated 0.09% disinflation within the month, hence calming the market as to recently raised alarm that inflation for the year would hit the target in advance. Expectations still seem anchored.

However, it stands to reason to be concerned about a possible inflationary acceleration in the upcoming months. A fundamental component for determining the price level in Brazil is linked to the exchange rate and its direct pass-through effect on prices.

This latter has a stronger impact on the IGP-M index which, in the face of the devaluation of the Real in recent months, hiked from 1.90% to 8.91% in August, in a 12-month window. If we consider an average pass-through time between IGP-M and IPCA close to 6 months, as is indicated in the economic literature, it is clear that there may be some grounds for a non-negligible inflationary spurt.

For this (should be necessary and sufficient - in favor of) and other reasons (such as idle capacity and unemployment - against) we are more openly discussing a possible anticipation of a series of interest rate hikes by the BACEN - which we at Redwood do not believe, in view of our model of the BACEN reaction function, that "precludes" any increase during the presidential race. However, nothing "prevents" the BACEN from performing its "homework" immediately after the election. In this case, monetary policy could be tightened on account of the target center being tuned to 4.25% in 2019, thus narrowing the margin/gap in both domestic and external quite daunting scenarios. The increase in SELIC will come, doubts remaining as to the intensity and especially to its timing. If victory is bestowed on an orthodox, conservative, and liberal candidate who pushes for essential adjustments and reforms, privatizations, and the opening of the economy, everything can be smoother. Otherwise, it will not be easy for BACEN to fulfill its mission.

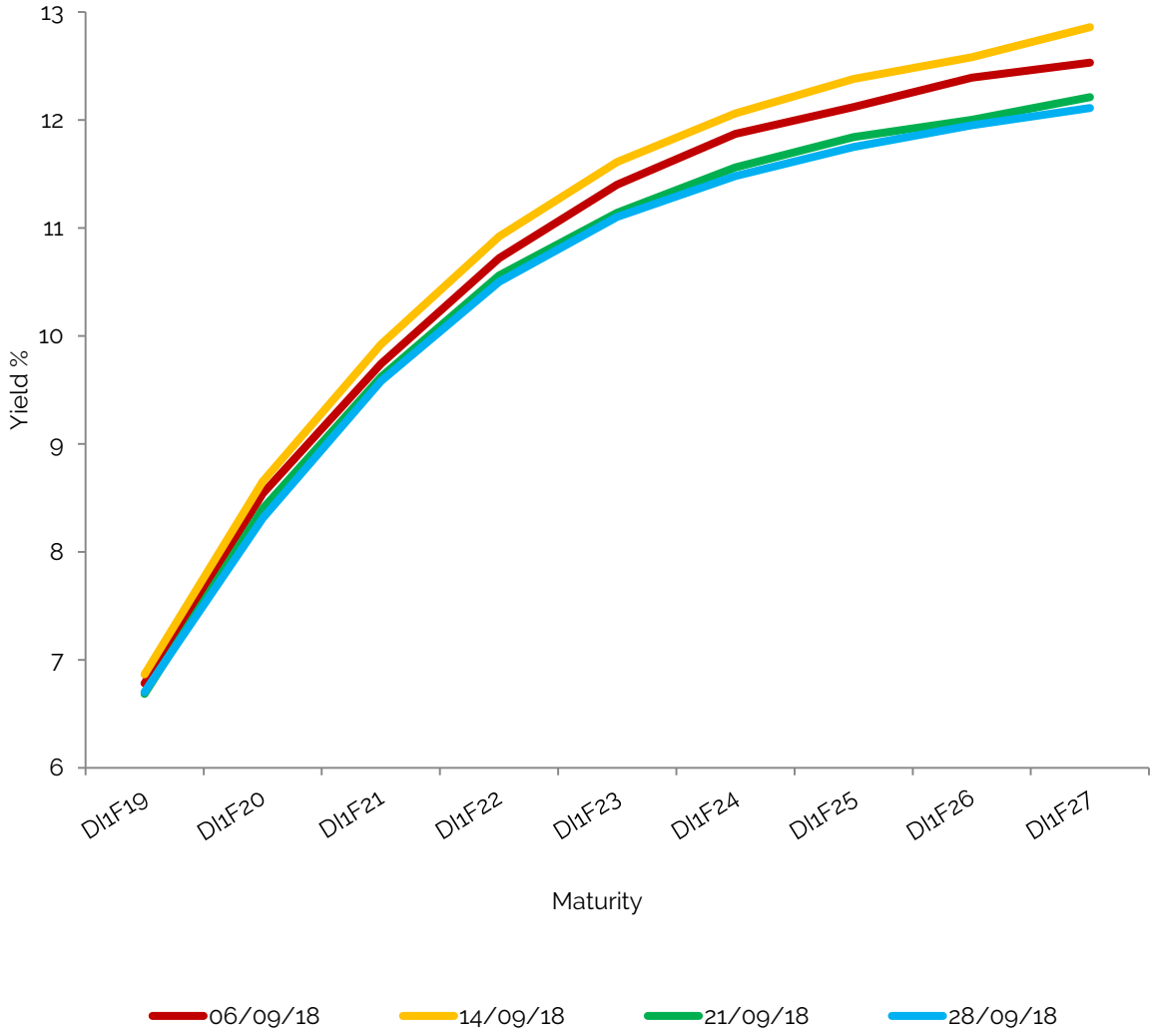
It is better, then, to seize low interest rates for now... in the medium run, adjustments will come!



Source: *IBGE , IPEA and Broadcast | Elaborated by Planner Redwood*

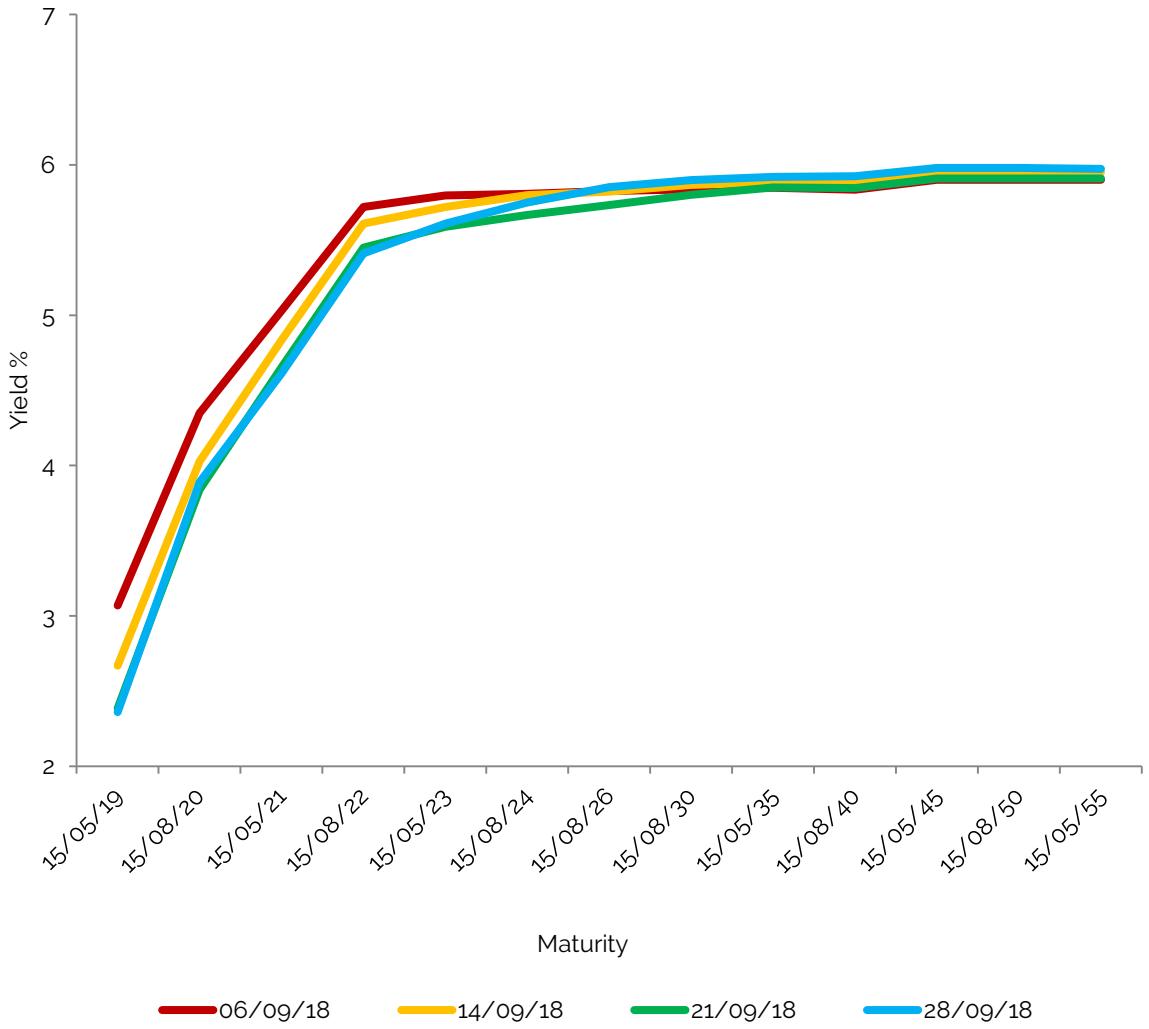
WEEKLY **INTEREST RATES**

ETTJ



WEEKLY **INTEREST RATES**

NTN-B



06 FOREIGN EXCHANGE

Once again, the dominant effect in the Brazilian foreign exchange market came from international factors, although, of course, domestic political effects play a significant role. As discussed in this report, it is noteworthy that our exchange rate is fundamentally determined by factors such as the external perception of country risk (expressed, for example, by CDS contracts) and the international-domestic interest rate differential.

In September, these components pressed upon the Brazilian currency in different directions. With local market interest rates falling and the significant increase in US Treasuries (T-Note of 10 years hit 3.20% within the month), the interest rate differential, which expresses the risk premium, was heavily compressed. Were this change in the risk-return ratio to prevail, one could expect the devaluation of the Brazilian currency against the dollar, based on the net outflow of capital. That's not what happened... and for a fairly clear reason.

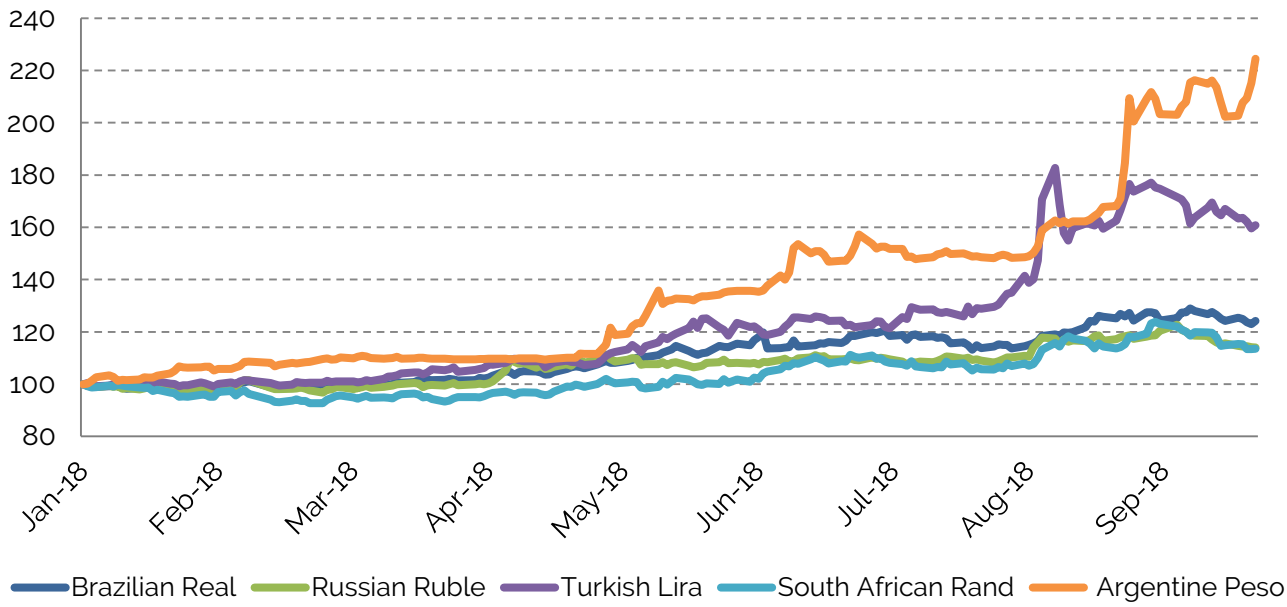
If there were a fall in the effective return, as it actually did, it would be more than offset by the external perception of a lower country risk, which outweighs the fall in return. Hence, there followed the appreciation of the Brazilian currency against the Dollar in September.

Even to varying degrees, it is clear that the Real is subject to the general perception about the basket of emerging markets currencies prevailing on international markets, "for better and worse." Even with the rise of anti-reformist and less pro-market candidates, international investors have "rationalized" an improvement in our risk.

This understanding makes us once again dissatisfied with the BACEN's "Exchange Rate Policy". The absurdity of market intervention aiming at controlling volatility (which also clearly underpins the desire to control the level of the exchange rate) is not an answer to either of those problems. The intrinsic volatility of the Dollar that we have been following on (at various times) does not seem to bear any correlation or any causal effect with the actions and interventions of BACEN, none at all. Volatility, which has skyrocketed in recent weeks, has melted in recent days due to the perceived lower risk associated with the advantage of the conservative candidate in the race. This policy is no longer simply innocuous and, to the extent to which it has been implemented, has significantly affected the interest payments on its swap transactions. Yes, interest payments increased in August due to losses in the foreign exchange swap, accounting for BRL 28.6 billion of BRL 60 billion in total interest disbursements. Were it not for the swap, there would be a reduction in interest-related expenditures in August 2018 on August 2017... hummm... screw the nominal deficit!

Once the clock approaches the eleventh hour and the key decision on where the country is headed, the remaining issue is how much longer will internal pressures on the dynamics of our exchange rate be attenuated? The twelfth-hour ring of the clock will answer this question...

Currency Crisis
(Jan18 = Base 100)



Source: *Blooomberg | Elaborated by Planner Redwood*

07 STOCK MARKET

In the midst of a wave of lower Brazil risk and the return of foreign capital flows, the stock market enjoyed fairly good results in September, after a "painful" August. The Ibovespa had a monthly appreciation of 3.48%, closing at 79,342 points. However far from its peak within the year (close to 89,000 points in February), it did come as a relief for the investor, who at the beginning of the month had accumulated a near zero return within the year.

A key factor behind this result lies in the fact (already detailed in other occasions) that foreign investment holds almost half of the total Brazilian stock market. Thus, at times of positive capital inflow, the positive trend is confirmed by the rise of stock indexes, such as the Ibovespa. Under this approach for the foreign investor, the Dollar-measured Ibovespa appreciated 3.86% in September, closing at 19,590, reaching its high at 27,376 points on 02/26/18 and its low at 17,742 points on 09/13/18.

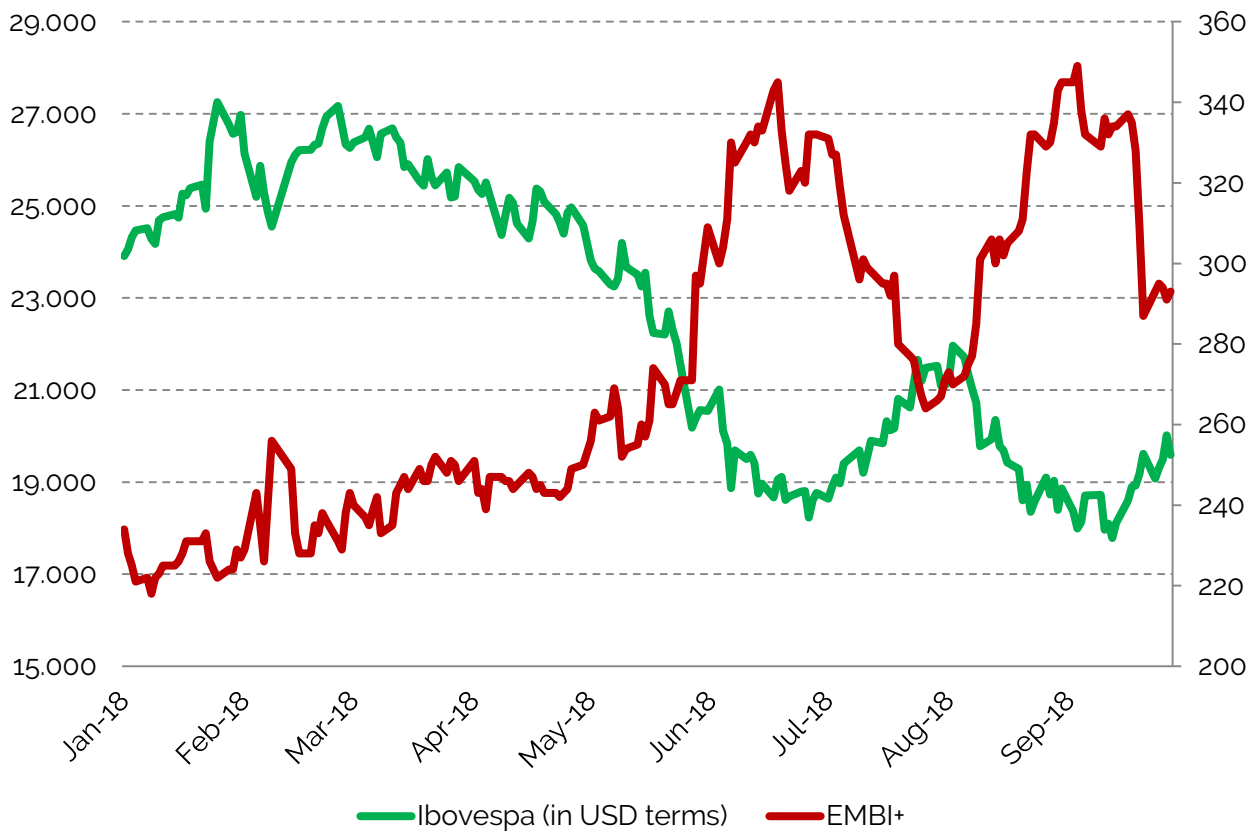
Even so, stocks display a relevant singularity with respect to other assets that make up the "Brazil package", a specificity that will be decisive for the next steps. The uncertainties pervading the stock market are linked to the fact that the stock market may be more sensitive to domestic risk factors. This is fundamentally due to the direct connection between the traded assets and the profitability of the real economy, which is sensitive to the level of economic activity and production - although, as a rule, with some lag. These factors have a greater relative weight in the valuation/devaluation process and are crucial for macro allocation choices, as well as tactics.

Under this instability a group of companies stands out; they play a fundamental role as a natural hedge alternative. Such a group is composed of commodities producers/exporters and, hence, its revenues are favored by the depreciation of the exchange rate in the face of deteriorating local markets. Given that prices for their products are determined internationally, there is an immunization of its activities/performance in relation to the internal oscillations, especially linked to demand forces (or lack thereof!).

The obvious caveat is that this situation applies especially to the short-term, and may be useful in a provisional rebalancing of portfolios. To the extent that these companies hold strong productive linkages to other sectors of the supply chain, in case of persistent adverse scenario, this hedge will of course cease.

Given the caveat, it is possible that in the upcoming landscape, there may arise good/specific investment opportunities. The key variable is linked, of course, to the choice of the economic model coming from the government plan of the president elect and his economic team, with consequent growth potential lying ahead, past this stage...

Ibovespa Evolution (in USD terms) and EMBI Brazil



Source: *Broadcast and IPEA | Elaborated by Planner Redwood*

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