PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - OCTOBER 2018

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

"Economists may be more naïve about politics than politicians about the economy"

Eduardo Giannetti – Brazilian Economist.

Introduction

Brazil has a new president-elect: Jair Messias Bolsonaro.

The election of Jair Bolsonaro is a milestone in Brazil's history, not only by breaking the decades-long polarization between PT and PSDB, but mainly because of his 10 million votes margin ahead of his opponent. A victory based on the campaign promises that result in a strong repositioning of Brazilian society. This is a shift towards the right-wing policies, a huge step regarding what we have experienced in the economy, domestic and foreign policy, education, culture, health and public safety.

In fact, our society's disgust comes from the various crises we are going through. The economic crisis that devastated the country, with consequences so harmful to both employment and income, accompanied by rampant corruption, also stirred up the yearning to recover the morale of our people. Jair Bolsonaro represents this sentiment, that is, an alternative path to our ills; a point off the curve in relation to the politically correct and a hope of realignment of forces toward order and progress. Its little explored platform of government contains the essence of what is expected: not a savior of the fatherland, but a technical and honest government... enough to start up the reconstruction of Brazil.

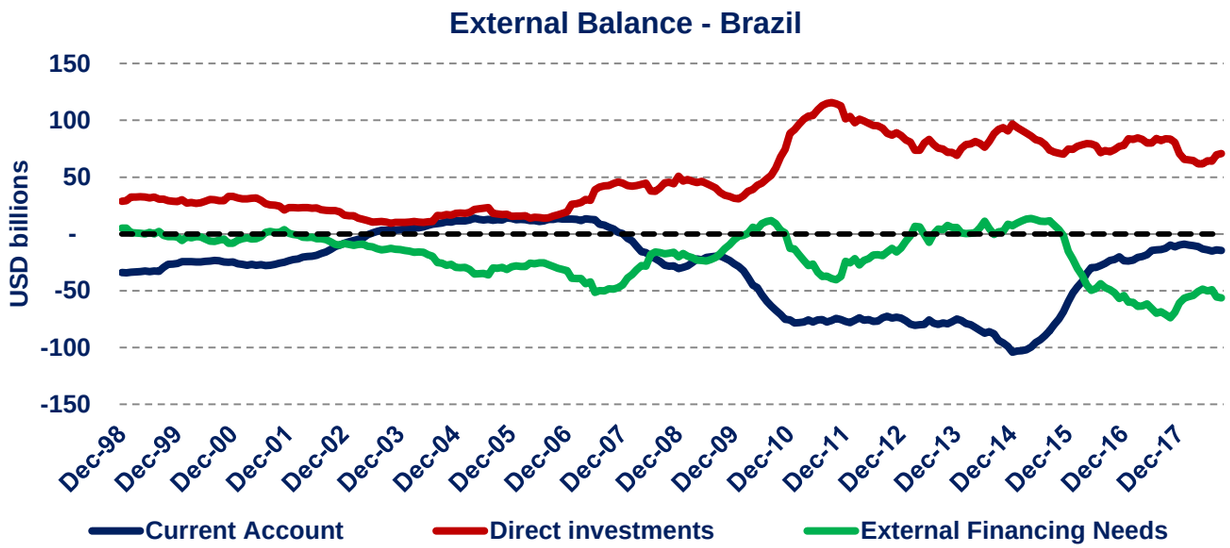
On the side of structuring a technocratic government, it seems that we will have a government with "Superministers" - and all with full autonomy to assemble their teams. Among them we can cite Paulo Guedes (Economy), Marcos Pontes (Science and Technology), General Augusto Heleno (Defense) and Sérgio Moro (Justice), all with exemplary qualifications for future positions. This initial line-up does not deviate from the promises of the campaign, whilst also appealing to investors and improving expectations (stock market rises and Dollar, interest and country risk fall) and already changing the mood for the return of investments to the country. The honeymoon started well.

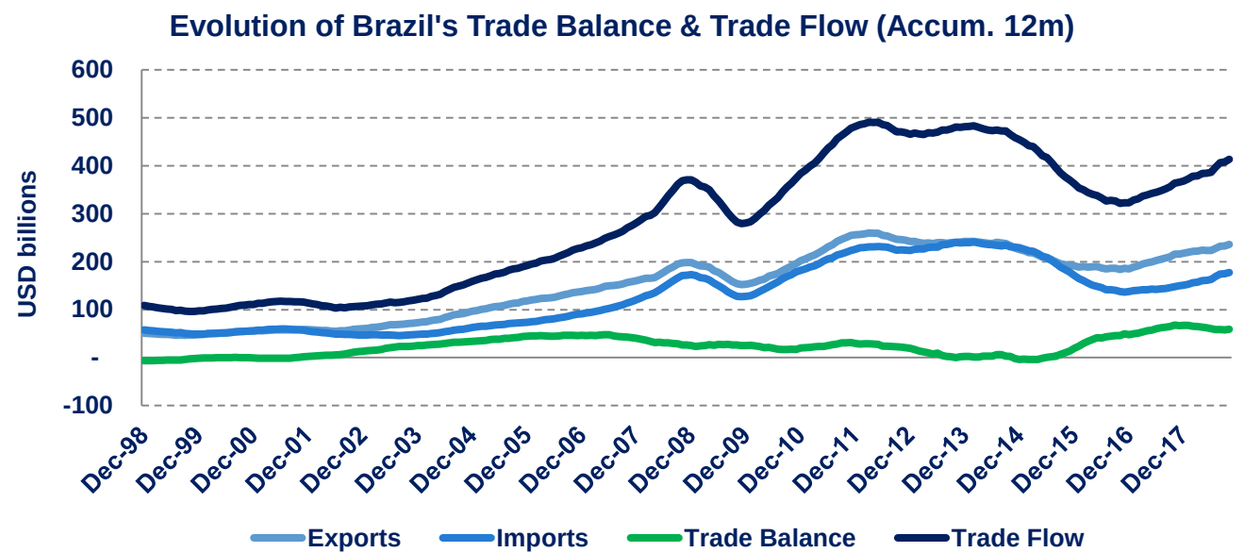
This phenomenon of the rise of the right in Brazil is not an isolated fact, no. In fact, we are "tagging along" forces that explain BREXIT, Donald Trump and, more recently, the direction Italy chose, among others. Fundamentally with different reasons, but with several points in common, Brazil will be an important "player" in this new political-economic world board, especially in Latin America. The new order is not always well received, and sometimes rejected with vigor. There are many interests to be opposed, and the very change itself carries insecurities and breakdowns of a diverse set of privileges. For this reason, and by evaluating the predecessor examples, the horizon does not show an easy path. Policy planning and steadiness must be strong, cohesive, and fine-tuned. Executive power can do a lot but has limits. Counting on Congress and convincing it of the needs of the country that economists and other technicians will present will not be an easy task, but combining strategies and capacity for political coordination, at variance past experience, will be fundamental. Thus, the quote recently remembered by the economist Eduardo Giannetti that opens this Commentary properly reflects the moment that we live: "*Economists can be more naïve about politics than the politicians about the economy*".

Overseas, difficulties marked the month, especially for investors. World stocks suffered the largest monthly decline in six years, although the fundamentals appear not to have substantially changed in order to justify the movement. Two major economies corroborate this interpretation: US and China. In the US, the economy grows, unemployment is at 3.7% and wages are on the rise... all in the midst of a "complacent" monetary policy by the FED. In China, PBoC failed to further inject capital by credit line for the medium term, but did so in a permanent line, in addition to reducing reserve requirements and volume of commercial banks' reserves. Politically speaking, October did not fall short. The deadline for a reasonable BREXIT agreement is fast approaching and Theresa May's strategy seems to be rejected by almost everyone: the EU, Labor Party and many in the Conservative party. Russia has sent a delegation to Venezuela under the pretext of assisting in a plan against the total collapse of the country's economy... perhaps a response to the US on its ideas about Cuba, Nicaragua and Venezuela. After some time, North Korea again threatens to resume the development of nuclear weapons should the United States fail to fulfill its promise to withdraw its economic sanctions. Last but not least, we now have a migrant caravan heading to the US... a humanitarian crisis with no possibility of a satisfactory outcome for latinos... and in the meantime the so-called American Midterm Elections... quite a "fuel" to boost rhetoric on both sides.

In this environment, US Treasuries closed the month at 3.1435%. The S&P varied -6.94%, NIKKEI closed at -9.12%, DAX at -6.53% and FTSE 100 UK at -5.09%. The Ibovespa ended the month at 87,424 points (10.19%) and the IBrX at 36,009 points (10.42%). Monthly highs for DIF19 at 6.668% and DIF21 at 9.52%. The NTN-B 2050 ended the month at 5.196%, and the Dollar (Ptax) at BRL 3.7177.

Economic Outlook





Source: Ministry of Industry, Foreign Trade and Services and Central Bank of Brazil | Elaborated by Planner Redwood

Economic activity in Brazil will be quite sluggish this year, the same being expected for the unemployment rate. Meanwhile, optimism is gaining strength for 2019 onwards, notably by the promises of Paulo Guedes (future Minister of the Economy) of strong pace in privatizations, some progress in the Pension Reform later this year (or at least use that already voted in the Special Committee of the Chamber - a new Constitutional Amendment would be avoided), fiscal adjustment, reduction of the State, the opening of the economy, among other measures. These signs and measures to be taken "right away", while lacking a structured and connected plan, promote a differentiated environment for expectations.

In fact, the above-mentioned structured economic plan will have at least six months to show what it is all about. In general, every government enjoys some period of "trust", a deadline to adjust and start up its administration. Thus, despite the likely hostile opposition, especially in Congress, the renewal in the House of Representatives may be inkling that the latter "understands" the urgent need of reforms to support economic recovery. Apart from naïveté, responsibility must prevail. In addition to the macro-actions, it is not possible to discontinue the ongoing microeconomic reforms and the effective increase in competitiveness, which are fundamental for raising potential output.

If in this year we will not see a greater than 1.2% of GDP growth, moving forward on the reforms front will take us closer to our potential growth around 3% already in 2019. The Balance of Payments is robust in several of its items. One of them is the Trade Balance, whose chart above leaves no doubt as to its positive performance. We should close 2018 with almost USD 60 billion in trade surplus - a strong outcome from any perspective. Additionally, our current account deficit is estimated at less than USD 15 billion by 2018, around 0.8% of GDP - very low and easily covered by the USD 67 billion forecast of Foreign Direct Investment (FDI). By 2019, both items may perform well, although a more challenging scenario is not discarded for Current Accounts due to a more troubled external landscape with higher interest rates, slightly lower growth and unfavorable commodity prices.

Finally, unfortunately, there is no way to disregard the September Manufacturing Survey, wherein output falls short of a consistent recovery. In any case, it also does not appear to be an indicator of increased pessimism, especially as confidence and the labor market are gradually performing better. The feeling that manufacturing sector is slipping is not uncalled for, but this will also be addressed by the new conservative agenda.

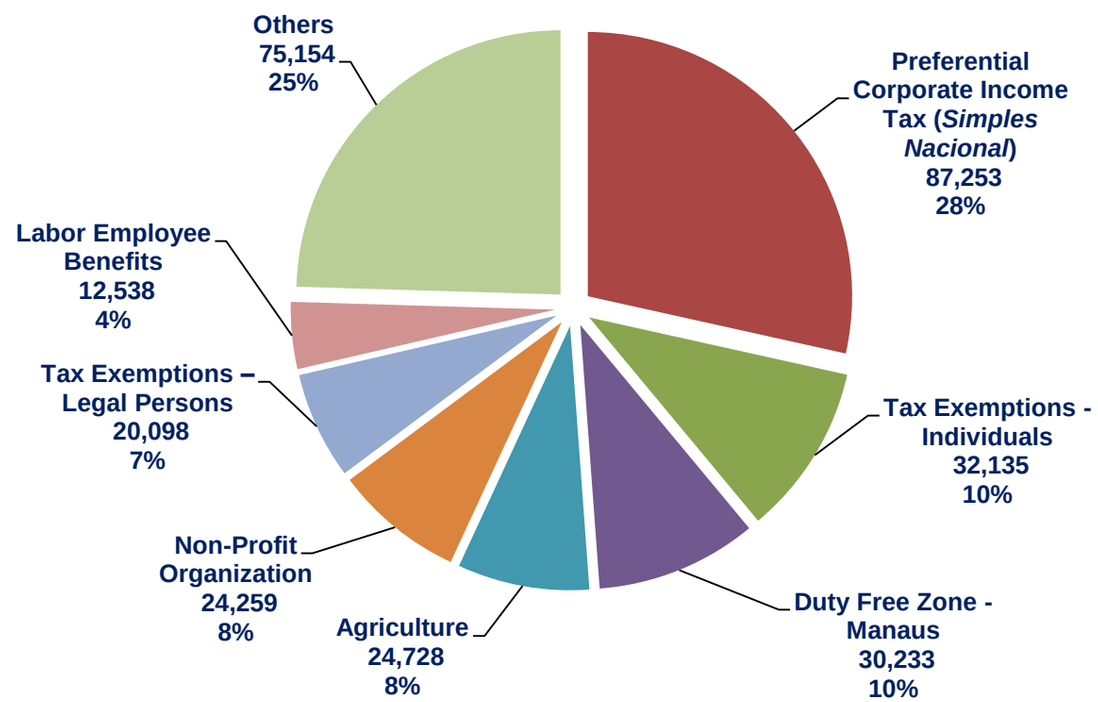
Fiscal Policy

The mantra of "total control of spending" must go on.

It is no wonder the litany goes beyond mere rhetoric. Expenditures have outpaced revenues for years, and this chronic mismatch, given the nature of these earmarked expenses and liabilities assumed over the years all rise "automatically". They now need enhanced control, not only with the preservation of recent mechanisms such as the Expenditure Cap, but also with new attitudes to break the inertia and *modus operandi* we have witnessed thus far.

If tackling expenses is the mantra, the improvement in tax collection also can not be forgotten. There is no argument here for increasing the tax burden, because it is already around 33%, an unfairly high level for our economic standards. In fact, our tax burden is equivalent to that of several developed countries, and we rank 14th in the world. However, being among the largest tax burdens in the world is not all, qualitatively analyzing our rate of return to society's welfare (as understood Tax Burden/HDI), we are in 30th place[1]. Although this study is not recent and the retrieval of information has proven difficult - and as a rule need to be adjusted for both variables (tax burden and HDI) - it leads us to believe that, despite a static analysis, the dynamics of variables fail to disprove the conclusions of the study. In other words, any spurious correlations, filters, and "questionable" classification criteria are not enough to reverse the original situation.

PLOA 2019 – Main Tax Expenditures (BRL Million)



Source: Brazilian Federal Revenue Office | Elaborated by Planner Redwood

Thus, we have the urgency of two reforms: the social security and the tax; necessarily, in that order. The first is that expenditures need to be contained, either for reasons of social justice or adequacy to economic and productivity patterns; secondly, because of imbalances of the underlying tax base and/or the need for simplification. We need to insert ourselves in the list of countries that actually promote social welfare, and reverse the huge tax burden on quality public services and improve the quality of spending. The chart above PLOA 2019 refers to the Annual Budget Law and it says it all. There is no need to think about raising taxes or even rationalizing them in order to continue and/or to promote spending as it is today. It would be insane - society will not accept it any more.

This is the reason why Social Security Reform submitted by the Temer administration should be used. Time is not on our side, neither on balancing the books, nor on the likely period of ephemeral "peace & love" that the government will enjoy with the National Congress. It is very likely that social security reform will have to be seen as a "process" whose initial step is taken with fundamental changes and is open to progressively evolve to the required level. Perhaps this provisory nature of the bill is better than starting a whole new approval process of a Constitutional Amendment Proposal (PEC), wasting precious time that could be used to consolidate changes and ongoing good expectations.

We should always keep in mind: we are already broken, without Social Security Reform we will face total collapse!

[1] https://www.ospcontabilidade.com.br/blog/a-carga-tributaria-no-brasil-e-no-mundo-comparativo-e-necessidade-de-mudancas/

International Outlook

The United States will face the so-called Midterm Elections in early November. This is the renewal of the House, a third of the Senate and 75% of State Governors. For many, more than a major election, this has been assessed as a referendum (or not) of President Donald Trump.

In fact, the results of this election will bring, if the Republicans lose majority in the House and the Senate, not only a hindrance to Donald Trump's actions, but also possible reversal of what has already been done. For those largely against Trump's moves, they even imagine the possibility of impeaching him. On the other hand, maintaining majority for the Republicans will represent, in addition to continuing the current policy, the "approval" of Donald Trump's re-election for his second term... truly a wishful thinking for Republicans.

The importance of these elections is so great that the prospect of the above becoming true is so real that even the hidden Barack Obama has come out publicly to reinforce the Democrats' campaign. And in this fierce "struggle" on both sides, we see more unreasonable arguments than is imaginable. Moreover, because one alternative or the other has the power to effect change far beyond US domestic affairs, including a good share of the inhabitants of the planet, opinions and manifestations from all over the globe appear at all times. The “celebration of democracy” in US impacts all of us, and even a subject like the Latino Migrant Caravan - a true humanitarian crisis - has become a target of criticism on both sides. Obviously, the implications go way beyond that... but it looks like we'll have the House with the Democrats and the Senate with the Republicans. A middle ground does not seem like a good result. That’s how Democracy works.

The geopolitical issues in Latin America have never really been very calm, with frequent economic and institutional crises that, one way or another, have caught the attention of the superpowers for decades. More recently, the Venezuelan people have suffered too much with their poor economic performance, to the point of raising rumors of international intervention in the country. That is why, through the declarations of the US authorities or even the new Brazilian stance, or simply because of the proximity and ties of friendship with Russia, a delegation was sent to that country to help develop strategies to manage the economy in the current crisis. The Russian team will offer technical assistance with the development of economic measures, as well as the rescheduling of a debt up to USD 3.15 billion. It is always good to remember that interests cement relations between countries - nothing comes for free.

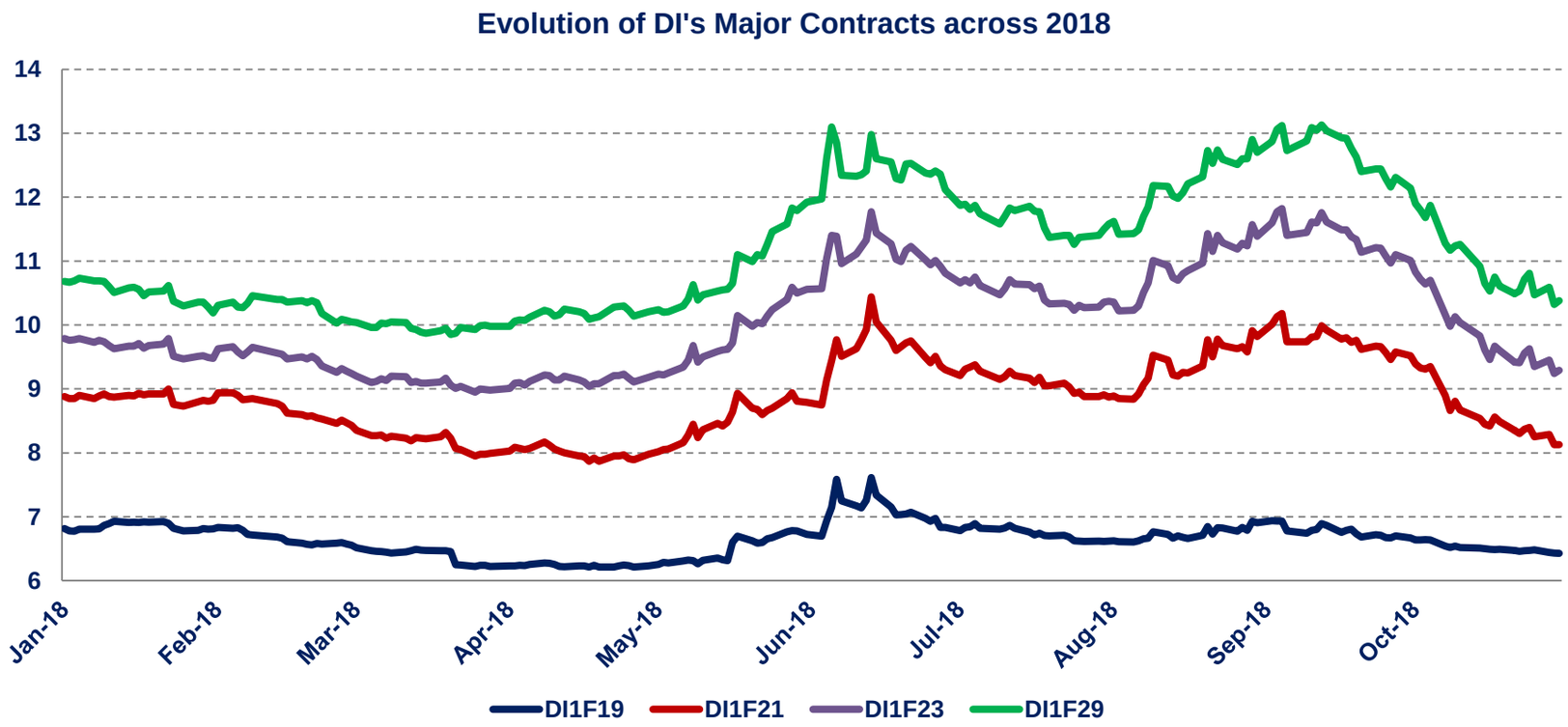
In Asia, North Korea threatens to harden their position in the ongoing nuclear talks with the US, bringing back its two-pronged policy, with a simultaneous focus on its nuclear strength and economic development. The complaint is based on the fact that, for North Koreans, Washington would be impairing the fulfillment of commitments made by Donald Trump and Kim Jong Un. Apparently, North Koreans find the US behavior to be one-sided and thus to promote asymmetry... meaning: (effective) nuclear program suspension versus withdrawal of US economic sanctions (pending). In China, the PBoC continues with its policy of intervening in the markets, each time with alternating measures or a combination of them. This month, there were increased net loans through the supplementary credit line, reduction of compulsory deposits and injection of 29.2 billion yuan in the banking system through its permanent credit line. On the other hand, the good news is that trade relations with the US may have a new chance of reaching an agreement, since their representatives will be meeting in Buenos Aires at the G20 summit on November 30th and December 1st. The same cannot be said of Iran, as the South East Asian country "caught the eye" of Trump with its trade sanctions.

In Europe, negotiations for the BREXIT seem increasingly distant, but paradoxically markets do not react accordingly. In fact, although the BoE itself has kept its interest rates, it has signaled that, depending on the expected performance of the economy, monetary policy should tighten. Nothing could be more straightforward. Clearly a scenario without agreement on the BREXIT is underestimated because the BoE has not pointed otherwise at low interest rates in order to stimulate the British economy. These Englishmen are quite far-sighted...

Interest Rates

Financial markets marked October with the end of the electoral process and a newly elected president. With the victory of Jair Bolsonaro agents have renewed their expectations of a near future carrying reformism and economic policies with a conservative bias. This movement, which gained momentum throughout the month (with the polls already indicating the actual result), led to a gradual movement of adjustments and repositioning in risky assets that culminated, already at the final moment, with expressive rates of return for the three points of the "Brazil Package".

In the interest market, we had a nonlinear shift of the ETTJ with more expressive variations from the mid-term vertices. The DI 19 had a monthly fall of 4.05%, registering a closing value at 6,428. The DI 21 ended the month quoted at 8.13%, reflecting a 15.14% drop. For lengthier maturities, the DI 25 recorded a drop of 16.17% reaching a level of 9.85%.



Source: Economática | Elaborated by Planner Redwood

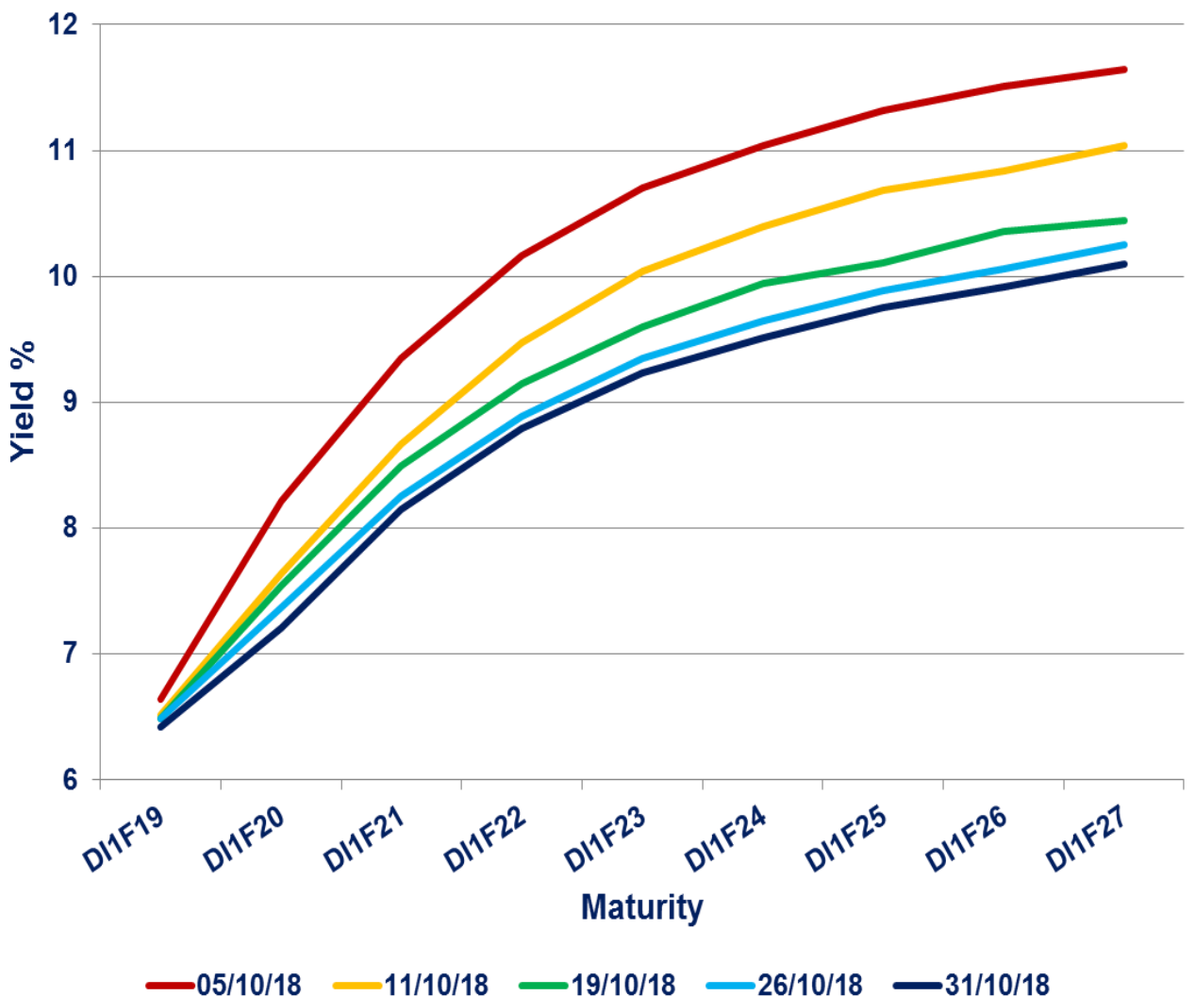
Some of the reasons for making sense of this movement in interest (described in the chart above) can be abstracted from the COPOM's reading of its decision to keep the SELIC rate at 6.5% per year. While it seems to be consensual (including much of the market), inflation for the next 14 months seems to be satisfactorily anchored around the center of its target range. Although the pressure from the pass-through effect on prices within a reasonable period with high exchange rates is emphasized, the effect of the persistently high number of unemployed people on the already contracted aggregate demand is undeniable. Thus, while speculations as to the magnitude of the interest rate for next year run high, the SELIC should not close 2019 outside the range 7.25-8.00%, ceteris paribus. In this line, and with the internal environment more expectations-friendly, BACEN should not touch SELIC this year, and even for the upward trend of interest rates for 2019, it is possible that there is a "delay" in this increase.

At the longer vertices of the yield curve (discounting the expected effects of time on volatility), the uncertainties are linked to the country's fiscal sustainability, a point that necessarily pervades the need for reforms such as social security. In this sense, the victory of the "reformist platform" - or pro-market - has imprinted on the future interest rate the perspective of a strong fiscal adjustment, with focus on social security reform already in 2019. However, in line with the quote that opens this Report, the BACEN warned that in the case of "a frustration of expectations... may affect risk premiums and raise the inflation trajectory in the relevant time horizon that informs monetary policy."

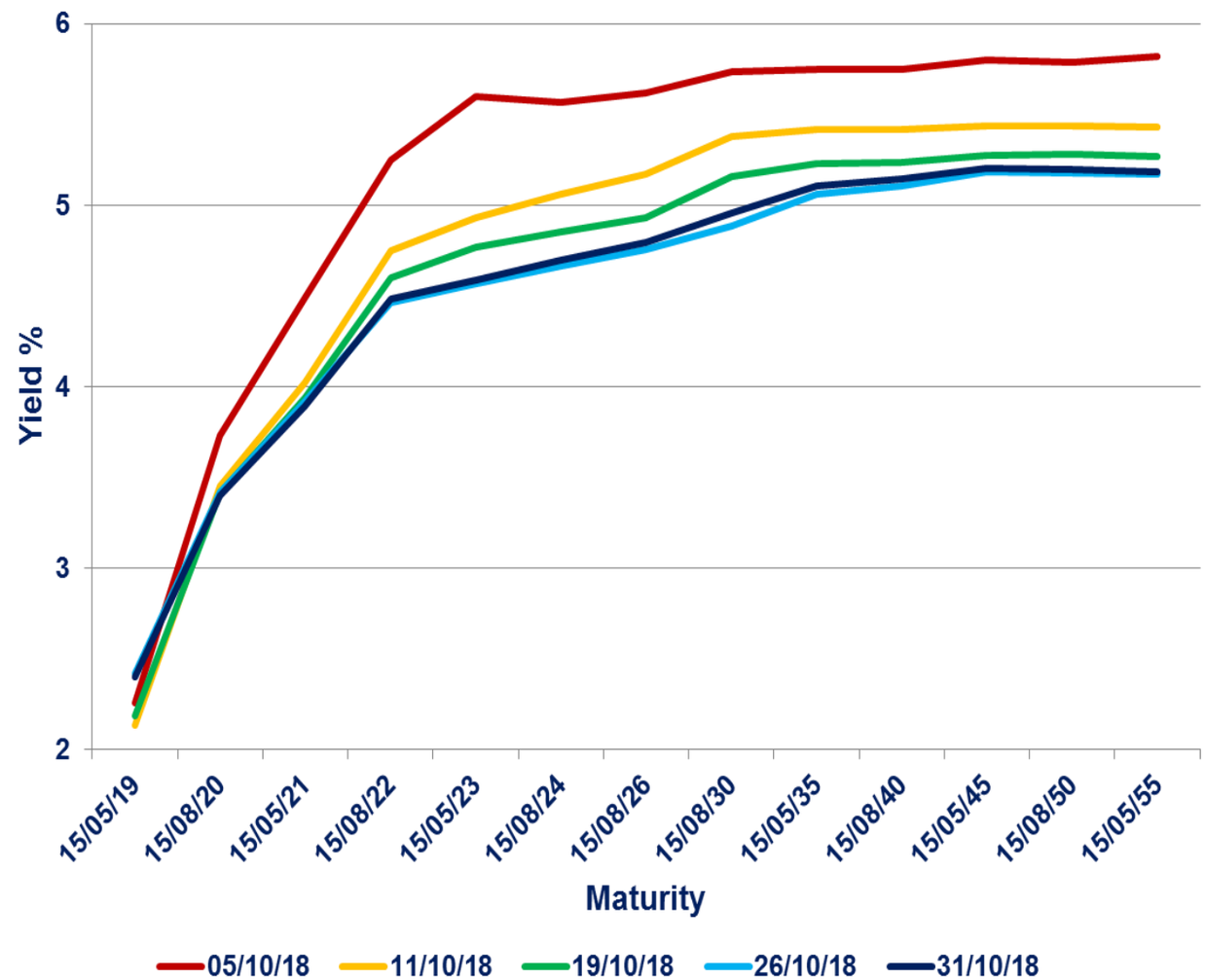
There is a positive bias in expectations these days. However, it does not take much for economists to share the skepticism of the political class. There is really no time for learning curves.

Weekly Interest Rates

Yield Curve Diagram

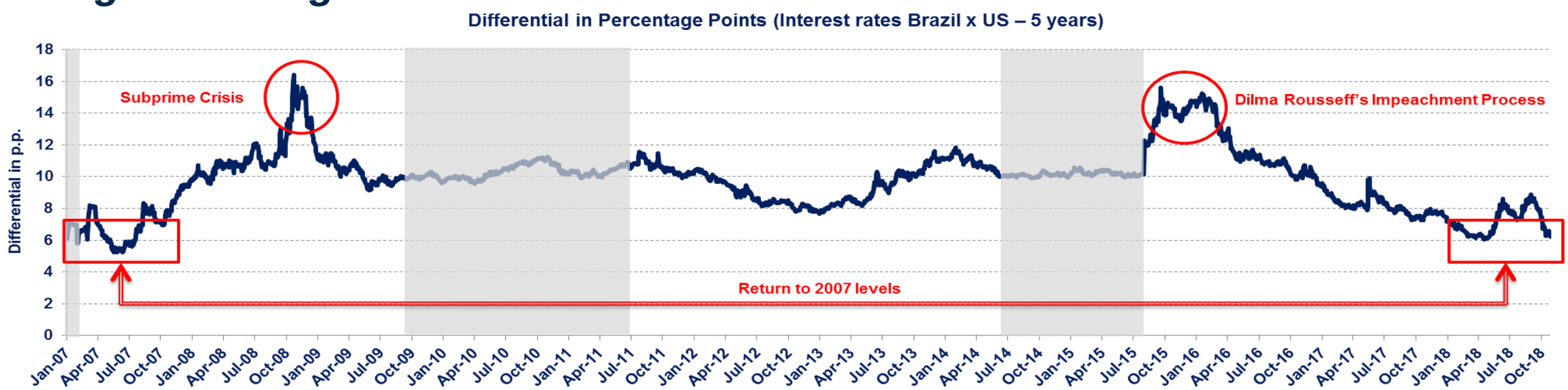


NTN-B Diagram



Source: Broadcast | Elaborated by Planner Redwood

Foreign Exchange



Source: Blooomberg | Elaborated by Planner Redwood / OBS: Periods (cross-hatching) with data interpolation

Contrary to normal behavior in local currency markets, external pressures had less influence on the dynamics observed in October. Not surprising, since the definition of the next president is an outstanding fact, with both conjunctural and structural impacts. While some of the major emerging currencies have depreciated against the US currency, the Real has had its most significant appreciation in the last 28 months.

Having registered at the closing of the last Ptax a BRL 3.7177 quote and, thus, an accumulated appreciation of more than 7%, the movement indicates the positive outlook, partly due to the hope of a conservative agenda in Brazil. With guidelines such as the country's greater insertion in international trade and a robust privatization agenda, the inflow of foreign capital and the demand for Real are the prelude of a new appreciation cycle of the Brazilian currency (in the medium term) – i.e., the risk appetite for Brazil signals an expressive improvement.

The horizon seems clear and benign heretofore. However, there is a wide gap between the present and this desired future, and it is rather possible that deviations along the way may surprise us. However diffused, the information provided by the future economic team to reduce the current level of international reserves under the guise of controlling the fiscal costs raises warnings. Is it more of the same? High interest rate differentials? The above graphic says it all! In addition, IMF studies show that we have 60%[1] excess reserves. Could this be true? We better not risk it; at least not before we address the necessary reforms. Although we have experienced a significant reduction in the interest rate differential with the United States, we should not lose sight of even underestimating less favorable scenarios.

With strong US growth, the Federal Reserve's monetary tapering movement gains momentum and speed, with four more interest rate raises expected for next year. Thus, although the country will launch throughout 2019 the bases for a new cycle of sustainable growth, the movement of global capital may experience some *flight to quality* phenomenon. As has already been proven in the experiences of our emerging peers throughout 2018 (Turkey and Argentina), maintaining international reserves is an important firewall against speculative attacks or shocks of abrupt devaluation against the local currency.

The market may be naïve about politics, but it will not be lenient with the conduct of exchange rate policy. We cannot lower our guard. The main fiscal costs of rolling this foreign currency stock have already been absorbed by the fiscal accounts over the last cycle of the Selic rate. Come up with something else, because that story does not stick anymore!

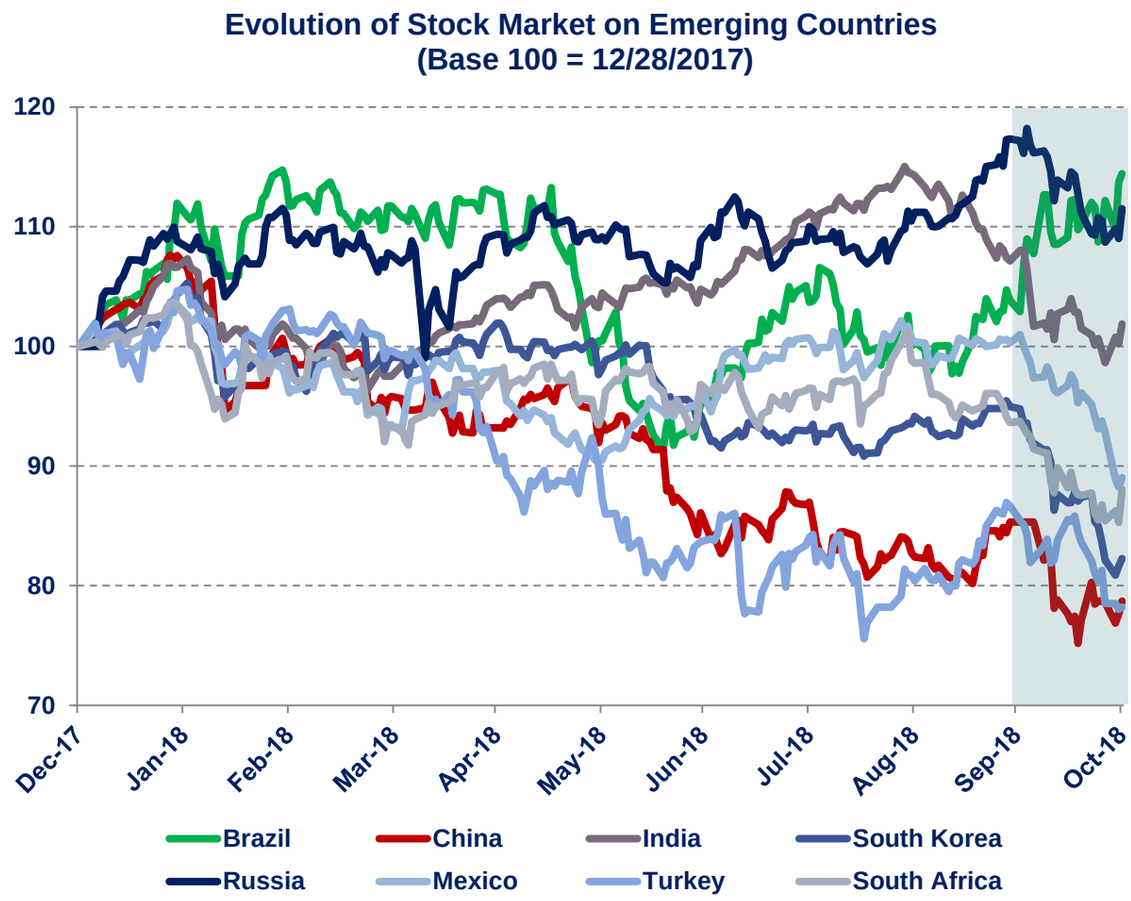
[1] The IMF considers reserves between 100% and 150% of the Assessing Reserve Adequacy (ARA) methodology as adequate for precautionary purposes.

Stock Market

The stock exchange seized excellent results by the end of October. Apart from some below-expected results, the prospect that the victory of a pro-reform and reformist platform will take place over the next four years improves both macroeconomic stability and a good business environment. Guidelines such as de-bureaucratization, commercial opening and simplification of the tax process will be important for the recovery of the real economy, the reflexes of which are already felt, somehow and to some extent, in the Brazilian stock market.

In October, the Ibovespa recorded a 10.19% increase, closing the month at 87,424 points, thus boosting the accumulated gain throughout 2018 to 14.43%. Some outstanding performances were GOLL4 (66.7%), CMIG4 (54.19%), ELET3 (50.74%), BBAS3 (44.31%) and PETR4 (30.96%). The role played by the airline company Gol is justified by the Smiles merger announcements (focused on loyalty programs and responsible for the company's airline rewards program) and migration to the “Novo Mercado” top-tier segment.

Regarding most of the highlights listed above, there are some of the main Brazilian state-owned companies, which somehow are on the radar when it comes to the composition of the privatization agenda. While the president-elect himself has already stated that it is feasible to privatize some companies and operations of Petrobras (although he does not admit a privatization of the company's core business), the future minister of the economy openly discusses a model for the privatization of Eletrobras. Facing further resistance by the "military wing" of the future Bolsonaro government, the viability of the Golden Share model is on the fore. Still, the market looks favorably to the increasing chance of a downsizing of the State through the privatization of these companies, which often feature as “champions” in the B3.



Source: Bloomberg | Elaborated by Planner Redwood

At any rate, the net outcome is an improvement of investors’ expectations, now positioned under the possible formation of new momentum that allows for breaking historical records. This is a completely different perspective from that observed in the stock markets of our emerging peers, still very much sensitive to the uncertainties inherent in the process of monetary normalization in developed countries (the US, already underway, and the expectation of an end to Europe’s quantitative easing) and which in some cases reflect their sluggish economic recovery.

As Brazil risk falls and economic growth is picked up by the expected monetary and fiscal stability, we can observe the (increasingly smaller, but still relevant) excess of global liquidity headed toward Brazilian markets, either aiming at auctions and privatizations or at the potential appreciation of Brazilian stocks and Ibovespa in general. In other words, even in an adverse external scenario, it is quite possible to be a stand out among emerging markets in relative terms.

At the risk of flirting with naïveté, we are not blind to the investment opportunities that are likely to arise with the dawn of a new era for the Brazilian economy. We are not alone in our optimism.

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