Planner Redwood Asset Management

MONTHLY COMMENTARY

APRIL 2015

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- Fiscal Policy
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"On the road from the City of Skepticism, I had to pass through the Valley of Ambiguity."

Adam Smith - Economist

Introduction

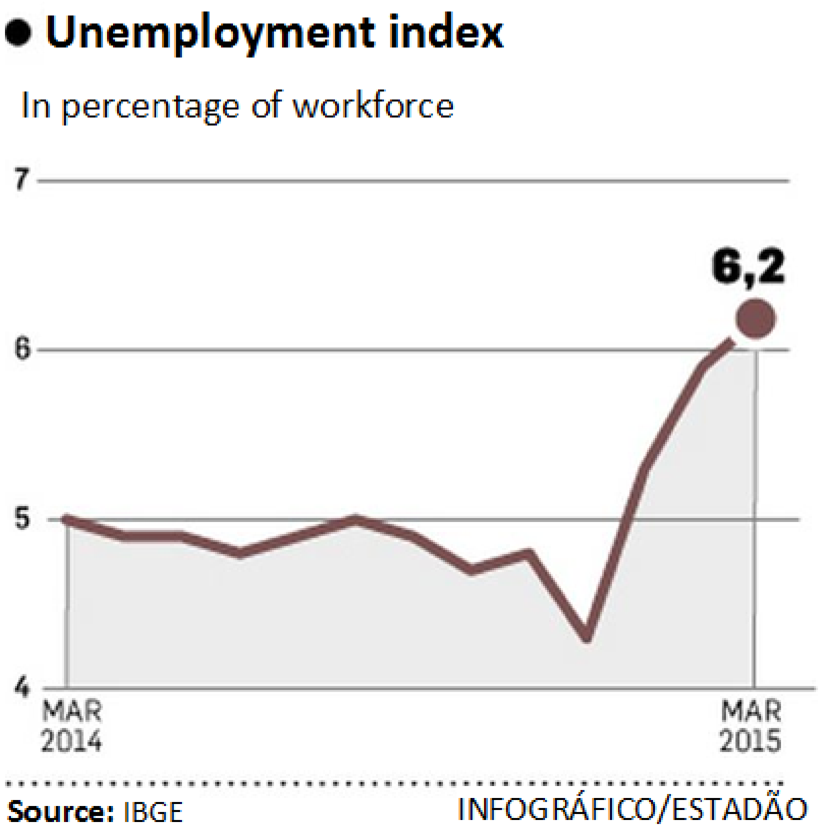
In the field of economic ideas to be implemented, pace is intense, surefooted and courageous, but the other no less important side of the equation, politics, does not seem to facilitate the process. In fact, if the problem is economic, the political solution is no less important... by the way, in a democracy nothing will be forced "down the throat." It seems that President Dilma recognized, by forceps (a measly 13% approval rate), that she does not have the political ability to conduct this critical moment. Actually, she delegated political handling to her Vice-President, as she did to economic policy, which has been delegated to Minister Levy. President Dilma is cornered, and there are plenty of parties who want to knock her out once and for all, with an impeachment.

In this battlefield, the ground becomes fertile for doubts and political exploitation, in addition to questioning and adequate and constructive discussions. Skepticism becomes a constantly used weapon, undermining the morale and instilling fear and mistrust. Debate and extensive knowledge are part of democracy, legitimizing actions and providing the path to be followed, but instability is not. It also does no good to segregate "poor from rich", "us and them" ... we are a single Nation. The Brazilian nation must undergo various adjustments (particularly of the economic and financial kind) given the very serious blunders in the recent past ... all of us, some to a greater extent, others to a lesser extent, everyone will go through these adjustments. Thus, if the President is driven aside, and if this is better for the country, so be it, for as long as necessary. We must overcome skepticism and ambiguities, that this same President got us in to; enforce and comply with the economic plan and revive the Brazilian economy. 2015 is a year of adjustments, beginning with Fiscal adjustments that will cut down the excesses. It is time to reinforce our beliefs, intentions and determinations. This is no time to falter.

Worldwide, the ECB's bond-buying program may actually strengthen, in the short-term, growth in the Eurozone and avoid the risk of deflation and thus "please" the market. Along these lines, China also signals a possible QE (Quantitative Easing) and the "circus" is set. Those who have the *Ricardian* comparative advantages and *Friedmanian* price flexibilities will prevail in the global economic balance. The FED, which holds the helm of the most dynamic economy in the world, will be the main character in this drama. The next chapters or meetings of the US Monetary Policy Committee reserve the possible outcomes and ensuing impacts on all economies of the world. Again, our homework as soon as it is done, will help us face future challenges, triggered in particular by the FED. Unfortunately, the most likely attitudes from a rise in American interest rates will be much more than a small wave, in the short term.

Thus, US Treasuries ended the month at 2.05%, S&P changed 0.85%, NIKKEI closed at 1.63%, DAX at -4.28% and FTSE at -0.48%. The Ibovespa ended the month at 9.93% and IBrX, at 9.12%. DIF16 maximum 13.68% and DIF17, 13.47%. NTN-B in 2050 ended the month at 6.10%, and the dollar (Ptax sale) at R$ 2.9936.

Economic Activity



We have good and bad news, and confirmation of both depend on the continuity of the objectives outlined by Minister Levy and his team: adjust the economy, realigning it to the only macroeconomic matrix that actually works - the one implemented since the advent the Real Plan. The bad news is that the economy's performance in 2015 will be indeed very poor, and the good news is that this belt tightening, if taken seriously, will put us on track to a quick turnaround and resumption of sustained growth.

Still on the negative side, we observe an expected deterioration, but at a much faster pace. The graph opposite shows a hard-hitting increase in unemployment, after having reached historic levels worthy of "full employment". In March it has already reached the 6.2% mark. This is unequivocally a reflection of the contraction of economic activity... perhaps greater than the market bets (between 1% and 1.5%) and our forecast (from 1.5% to 2%). In the wake of bad news, there is also a surprising reduction in real average worker income (adjusted for inflation), which fell 2.8% compared to February and 3.0% compared to March 2014. It is understandable that an adjustment as proposed and necessary will have reflections in various sectors, especially when assumptions and dogmas are breached, for instance, that prices and other macroeconomic variables will adjust in their own time, intensity and relative position. The improvement (or maintenance) of social welfare at the lowest possible cost is part of transience to the desired balance. In a model where there is no single adjustment variable or anchor, turbulence can be great: borderline of the ideal economic policy and required political economy.

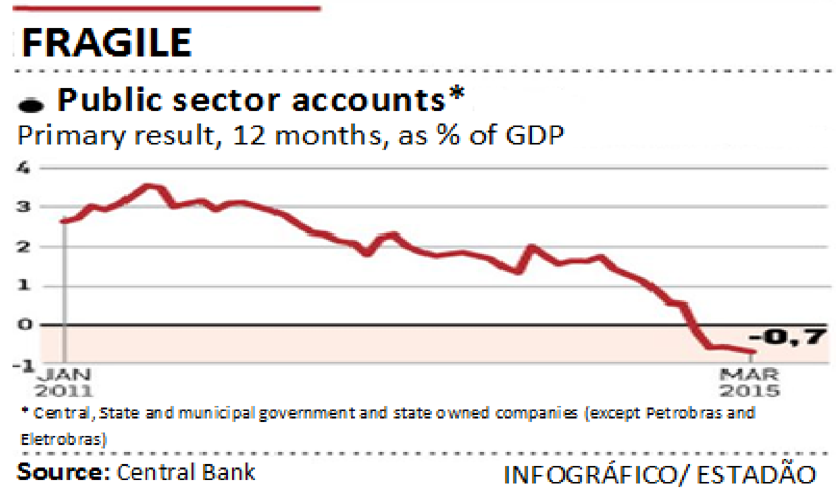
On the positive side, it is expected that in the coming months pessimism will stabilize or perhaps, even reduction of pessimism, and therefore, of worsening of macroeconomic indicators. Yes, even a "timid recovery" by consumers as well as industry and trade can happen. Is it too early? Maybe so, but there is some improvement in the perception of economic performance, if adjustments are carried out. The trade balance shows some recovery, there are signals that concession auctions will take place (extraordinary revenues!)...In other words, bad expectations will soon dissipate.

Fiscal Policy

Public accounts are again disappointing! The expected primary surplus of R$ 3 billion, the actual result, a ridiculous R$ 239 million. To achieve the much vaunted 1.2% of GDP surplus will not be easy, because, with the economy in recession, there is naturally less consumption, sales, production and so lower tax collection. Result: increased efforts to meet the fiscal target.

In the first three months of 2015, the public accounts result was a primary surplus of R$ 19.0 billion, while in 12 months, it totals R$ 39.2 billion, that is 0.7% of GDP, somewhat below 2014's. Fortunately Minister Levy is paying attention to this poor performance and warned the distinguished members of the House of Representatives and its effects on the country risk rating...to tell the truth, if Brazil continues at this pace, it is closer to a debt rating downgrade to Speculative Grade than maintenance of Investment Grade. There is no more time to lose, Congress must approve the adjustments outlined and we must fulfill the fiscal target - the only path for economic recovery and resumption of employment. There is no choice but to further reduce expenses and resort to extraordinary revenues. Privatizations and concessions have to be stepped up, without fear and without ideological restrictions: there must be focus on decisions that have proven correct, acceptance of the actual Government obligations and intelligence and humility to acknowledge its limitations.

The chart below, on the right, does not lie. It shows the "drag coefficient" caused by the recent ill advised economic experiment. It shows the leap of tax revenues the government failed to collect due to its incentive policy. Is this a joke or what?



Tax Relief and waivers

Taxes and contributions (in billions of reais)	2012	2015*
Payroll	3.7	22.4
CIDE - Fuel	8.5	5.8
IPI (manufactured products)	9.5	7.2
Basic staples	1.0	10.3
Simple and MEI	5.7	11.0
Financial operation tax	2.3	0.4
Naphtha and ethanol	-	3.9
Expansion of estimated profit	-	2.1
Expansion of estimated profit	-	1.6
Telecommunications and smartphones	-	1.1
Others	16.2	47.7
Total	**46.9**	**113.5**

* Projections Annual Budget Law

Sources: Federal Revenue Service/Ministry of Finance

International Environment

Anyone who thinks that former Minister Guido Mantega left his mark only in the lands of *tupiniquim/indians* is dead wrong. In 2010, the former Minister coined an expression that is used by everyone, to this day, for the opposite reason that originally motivated him to establish that "thought" - Mantega coined the term Currency War. At the time, the American QE deeply bothered the former Minister because the Real was appreciating, and according to him, this made our products less competitive. Well, now the term is also being used, because emerging countries currencies are depreciating too much, because the American QE ended and there will be monetary tightening soon. What a man of vision! How eclectic, intertemporal and self adaptable! Bravo, Guido Mantega!!!

After all, are these monetary easing programs that are expanding in Europe, Japan and possibly China healthy strategies? Or is it a zero sum game? Clearly the central banks of Europe and Japan want to see their currencies undervalued, lower interest rates to stimulate aggregate demand, improvements in the trade balance as well as in investments ... but obviously, not all currencies can depreciate at the same time...so what we see, as an immediate reaction, until a new general dynamic balance is established, is volatility! For a small portion of financial market operators who thrive on volatility, this seems good news, but for the rest of the real economy, it is a disaster. Companies need hedging because of exchange rate volatility (more costs, monitoring and plans), taking focus and assertiveness away from company export programs, and decreasing the appetite for direct and foreign investments. The result is, economic growth suffers. But unfortunately the international situation today, particularly the major economies in the world, follows this trend: Gerson Law (everyone wants to take advantage of everybody else all the time) ... which is not sustainable ... and what really matters is fighting the crisis at the source, because in the long term, exchange will always be just a price...a price which, in an increasingly globalized economy, will translate the general price level. It this utopian? Certainly not!

In Europe, the Industrial PMI (Purchasing Managers Index) of the Euro Zone was 52 (down). The highlights were: Spain 54.2 (fell), Italy 53.8 (rose), France 48 (fell) Germany 52.1 (fell) and the United Kingdom, which fell to 51.9 - the lowest result in seven months, disappointing those who expected an index of 54.5. In China, the Official Industrial PMI remained stable at 50.1, while in Japan it fell to 49.9, compared to 50.3 in March.

In the US, the April Industrial PMI was below preliminary expectations and touched the lowest level in three months: 54.1. Additionally, investments in construction fell 0.6% (March compared to February), but the Industrial Activity Index (ISM) remained stable in April. Still on the positive side, the Consumer Sentiment Index (Michigan) rose this month. Well: economic activity, inflation and unemployment ... expectations have not changed very recently, and as a result the FED maintained the same position as at the last meeting, not specifically stating when the expected monetary tightening will occur. Anyway, they call the shots and we (the rest of the world, especially those who have not done their homework when they could and should have done), just have to hold our breath...

It is true that we need not invent a new catchphrase, but it would be nice to invent one to translate our attitude when the international situation was in our favor, particularly in exchange terms, and we simple ignored it solemnly.

Interest Rates

Economic downturn, inflation above the target ceiling, deterioration of public accounts and rising unemployment rate. Indeed! This is the 2015 scenario.

For the purposes of monetary policy, our Central Bank (BACEN), observes all these variables. The main one, however, the widespread and constant price increases, aka inflation, seems to be more linked to adjustments and realignment of prices (especially managed prices and their related effects), than increased consumption per se.

Well, it does not matter! In a fit of "lucidity" the Central Bank now "sees" increases in interest rates as appropriate ... even to remain vigilant and fight secondary effects. Great! Secondary effects on prices, but how about its posture towards third order effects on economic activity and unemployment? Have the Directors forgotten that the Central Bank is not independent? What are the political hints? More so, the Central Bank, eager to appear technically free and politically untouchable and to "please" the "market", maintains the rhetoric that inflation will converge to the center of the target in 2016. However, there are no arguments against facts (and history). The Central Bank's posture and actions do not back this statement and intent, and given its customary use of monetary instruments and coherence, we have our doubts.

Tony Volpon and Otavio Damaso were appointed by Dilma to the board of the Central Bank and participated for the first time in the Copom meeting on 28 and 29 of April. The new executives, along with other members of the Committee have unanimously decided to increase the Selic an additional 0.5%, without bias. As for the statement issued after the meeting, the Central Bank left open the magnitude of its next moves. Maybe with these two new members reality will change. Really?

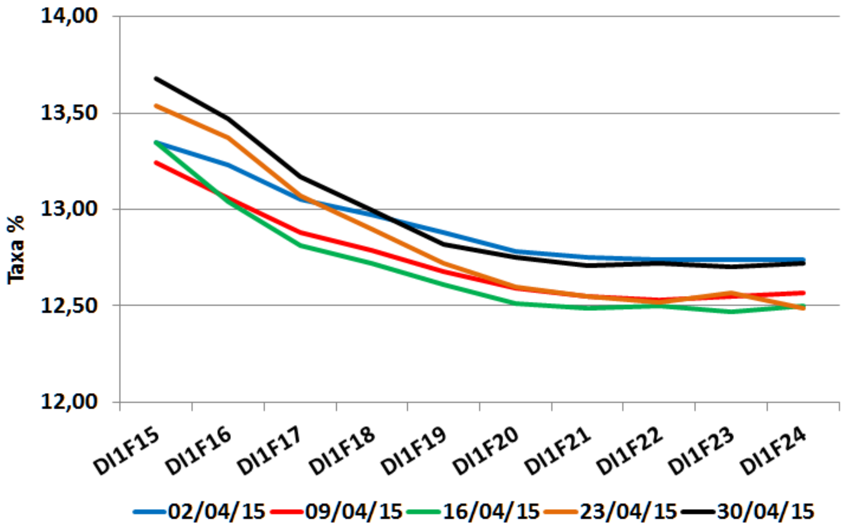
At any rate, if we cannot count on a Central Bank that is 100% independent and credible in its statements, at least there seems to be (currently) a reduction of political interference. This, however, did not diminish the difficulty in approving the fiscal package ... a priority that needs to align with the monetary policy, in order to fight inflation more efficiently. The status quo undermines the government accounts and brings uncertainties to the financial market. This situation is mainly reflected on short-term interest rate bringing volatility to the market.

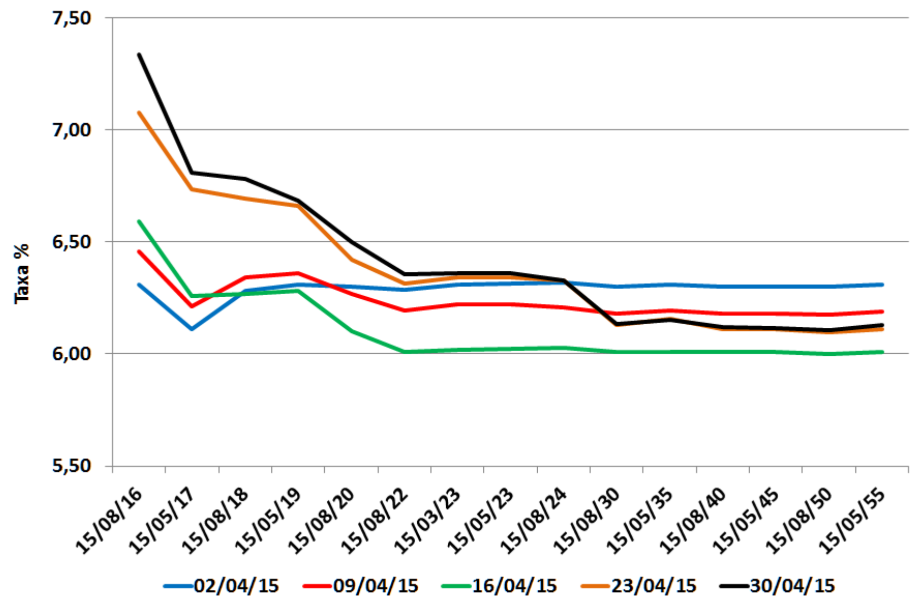
In the consolidated month figures, future interest rates have reduced the premiums in the long part of the yield curve. As for the short end of the yield curve, in several trading sessions it worked detached from the exchange rate movement, the market weighing more heavily the COPOM decision to maintain the pace of Selic increase. As for the long-term interest rates, investors are beginning to look more forward (2016), as it is a given that in 2015 inflation will remain above the target. As in the yield curve, the slope of the NTN-B curve has changed: rising of short coupons and reduction of premium, for long-term notes.

Transparency in attitudes, understanding the actual operation and objectives of monetary policy is, above all, an "ally" tool in the handling of the Central Bank policy ... the results of surprise effects, mysteries and "tricks up the sleeve" generally are not good. How much will inflation be in 2016?

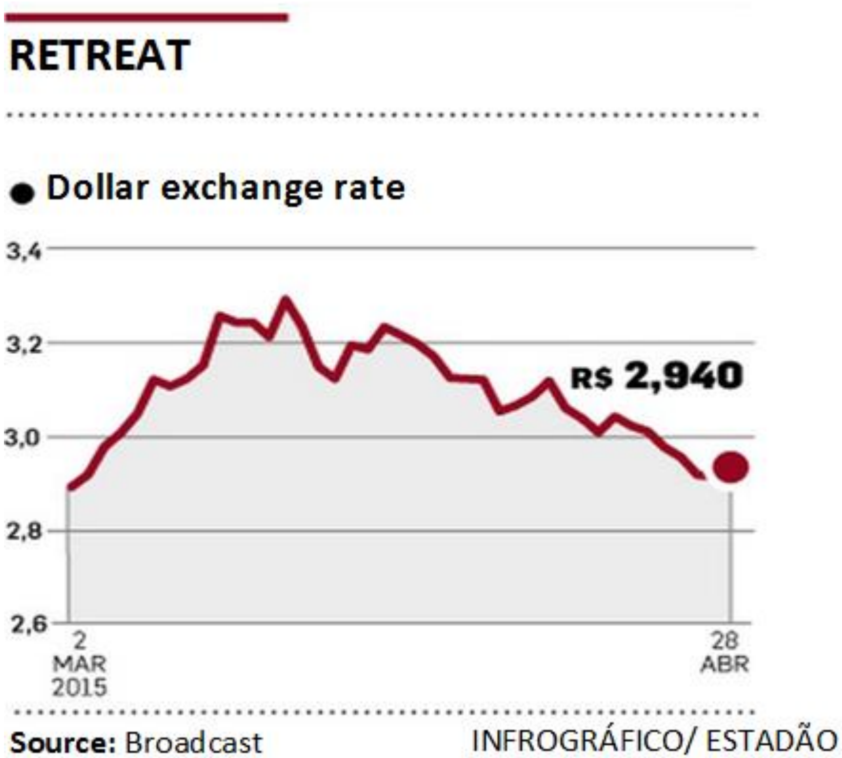
Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange



Understanding the exchange rate policy is getting more and more difficult ... after all, does the dollar float freely, or not? Will the Central Bank continue to intervene? Have swap auctions ended?

In the very recent past (as shown in the graph) the price of USD has risen and fallen again, and the Central Bank is unsure of what it considers to be "adequate" (in principle, in free trade the rate is *always* adequate). After reaching R$ 3.31 (at this point Brazil would be the “new” Argentina), prices decreased systematically (we begin to look like real people, again) and we understand the market reaction (and therefore this phenomenon) for three basic reasons: (i) the FED would not raise its interest rate at the moment (implying high liquidity in the world), (ii) our higher domestic interest rates attract dollars (possible resumption of carry trade) and (iii) a certain recovery in domestic confidence.

Well, this month it seemed the dollar would close the month well below US$ 3.00. But in the last trading day of the month the dollar appreciated strongly, due to Ptax disputes, market doubts concerning the rollover of swaps maturing in June and the worsening of the Brazil's fundamentals (amazingly, just three days after reaching the lowest price!) after the weak consolidated public sector primary surplus in March. In the month, the dollar retreated -6.68% and closed trading at R$ 2.99 (Ptax sale).

The fact is that the dollar ended the month below R$ 3.00 for 5 sessions because of an improvement in the perception of Brazil, due to fiscal adjustment measures status in Congress, the publication of Petrobras' balance sheet (despite a loss of more than R$ 21 billion reported by the state company in 2014) and the positive foreign capital flow. But investors are still watchful, and if the government fails to approve the fiscal adjustment program, new pressures on the Real will appear, as has occurred in the last trading day of the month.

In the international scenario, specially the beginning of monetary tightening in the US (our scenario), local fundamentals show a new rapid appreciation movement (and ephemeral, at current levels) of the American currency against the Real. The scenario that could lead to new dollar peaks would be further deterioration of the macroeconomic variables and consequently, reduce investor confidence and foreign capital outflow (via Flight to Quality effect). And the Central Bank wants nothing, and it can or will not do anything about it. Right?

Stock Market

The recovery of foreign investors' confidence in the Brazilian economy, the disclosure of Petrobras' 2014 balance sheet and the strong appreciation of iron ore prices made Ibovespa rise 9.97% in the month. Can we celebrate just yet? We believe not!

Based on disclosed company results, it is difficult to justify current Ibovespa levels. April's movement is due primarily to positive foreign investor flow, rather than the fundamentals of Brazilian companies. Foreigners see what we do not see ... isn't that right?

Minister Levy has established a good relationship with Congress, on behalf of the Presidency. President Dilma has stated that the government will make a large cut in the 2015 budget, despite the approval of funds for parties, and she will do anything to reach the established fiscal target. The choice of vice president Michel Temer to head government policy articulation was well received by investors. However, the fiscal adjustment package is still pending approval in Congress and the consolidated public sector March was disappointing, jeopardizing the reaching of fiscal surplus target of 1.2% of GDP in 2015. In a way or another, all these factors influenced the performance of Ibovespa.

Finally! On April 22, Petrobras announced the 4th quarter balance sheet of 2014 with operating earnings but huge book losses. The result was positive, as the government will not need to use its cash to save the company in the short-term. The biggest risk to the financial health of the oil company has been resolved. With the release of the results, there doesn't seem to be a possibility that lenders will accelerate the debt, as covenants have been met. The issue is important because, given the size of the company and its significance for the country, in every way (confidence, investments, etc.) it has the power, to some extent, to impact and form positive or negative expectations.

Even with the poor result, Vale's shares had a strong appreciation during the month. This performance is due to the appreciation of iron ore prices, which rose in the international market after growth stimulus measures in China, reduction of production by higher-cost mining companies and changes in the expansion plan of BHP Billiton, the world's largest mining company.

Anyway, two of the leading companies in the Ibovespa did well ... and so the index did well. Isn't this good? Not really! Ibovespa includes few shares and it is still fairly concentrated, but especially due to its liquidity, it is the most "popular" and "seen" index here and worldwide. However, it is far from a truly representative index.

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