Planner Redwood Asset Management

MONTHLY COMMENTARY

APRIL 2016

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Agenda

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- Economic Activity
- Fiscal Policy
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- Interest Rates
- Foreign Exchange
- Stock Market

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

“Democracy is a device that ensures we shall be governed no better than we deserve.”

George Bernard Shaw – Co-founder of the London School of Economics, was an Irish playwright and journalist .

Introduction

As the political crisis reaches its peak (President Dilma Rousseff's impeachment), the Government debacle is deepening, a general paralysis has been settled, the social-economic environment is troubled by the senselessness of desperate measures by those who "recognize without accepting" the end, but the relief and the depressurization of markets are unequivocal and pave the way for a new reality. But how? By changing expectations!

Markets, as always, anticipate and price everything they see (sometimes even what they cannot see!) and it is the first indicator of the possibly reverting expectations. In this context, the time for change has arrived and markets yearn for it. Then the great anticipation about the possible new government configuration, and especially of a government that abandons populism and holds the administration of a less present and less inducing State, with a more open and more transparent behavior, of more liberal contours, and less protectionist and biased toward a few elected sectors. It is also necessary to have a social understanding of the moment in which we are living and how and why we are in this situation... with a broken economy, and who, after all, is responsible for it. Bernard Shaw's phrase that opens this monthly report is a beautiful indicator, but the inaugural speech of John F. Kennedy to the American people is complementary, regenerating and suitable to all Brazilians who want a better country: "*Ask not what your country can do for you – ask what you can do for your country*".

In the central economies, the scenario in Europe shows a slow recover and the threat (never taken seriously) of a *Grexit* (United Kingdom exit of European Union). In China, the Government has gradually increased its stimulus, and Japan faces a stagnated economy. Across the Americas the spotlight is on Argentina, with President Macri doing the "minimum", but reaping benefits by simply "changing and indicating" the new route of things in his country. In the USA, the economy signals an increase in pace, as was predicted (around 2.5%), which cannot be considered "moderate" anymore if one compares it with other economies' growth indexes. The FED, in turn, seems to be willing to take risk in this sense and is uneasy about increasing interest rates in this environment, that is, by overlooking an upward-thrusting inflation path that is aligned with expectations (2%), interest rates won't increase in expected pace nor intensity.

On the international political front, the presidential race will be the event of greatest repercussion and potentially most "disturbing", especially if Donald Trump wins. Possibly we will have a "new order" independently of Trump as "Statesman" or as "businessman" takes office. Change is good, and often, necessary.

In this environment, USA Treasuries closed the month in 1.82%. S&P varied 0.27%, NIKKEI closed at -0.55%, DAX with 0.74% and FTSE 2.67%. Ibovespa finished the month at 7.70% and the IBrX in 7.13%. Maximums to DIF17 at 13.88% and DIF21 at 14,18%. NTN-B 2050 finished the moth at 6.05%, and dollar (Ptax sell) at BRL 3.4508.

Economic Activity

The Continuous National Survey By Household Samples *(PNAD- Pesquisa Nacional por Amostra de Domicílio)* revealed the share of economically active population that cannot find a job: 10.9%! In absolute numbers, we are talking about 11.9 million people looking for a job. It is awful, but not so far away from what we expected at Redwood, unfortunately. It is so serious and this number is so high, that even if we compare with European Union we are already, in relative terms, 0.7% worse off.

However, bad news just keep coming. The economy's breakdown was so extraordinarily intense, with impacts, simply, across ALL indexes and economic fundamentals, that getting out of this quagmire will be costly and will take a long time. And this outcome lies in the best scenario wherein a rising new economic team that manages to place the economy on track again. Economic activity is very weak, not only on the supply side, but also on the demand side.

Therefore, once the current political deadlock of impeachment is solved, Brazil seems to have a new chance. Nevertheless, this new chance does not imply a benign scenario, but a less tragic situation if compared with the current one and with where it is taking us. Our simulations point to an unemployment around 12% to next year, also with a negative GDP growth in this period – even with a new government. The counterargument goes as follows: with a new government things tend to stop getting worse. The current scenario is one of widespread havoc, and keeping what we have today would (or will) lead us into collapse.

A new Government obviously cannot be more of the same – and does not seem to be so. The composition of the new team will give the tone and intensity of things. Yet, more importantly, it will give us a "north" towards which the economy will be conducted – the most important signal. A signal that has the power, at least in the short term, to revert expectations (markets and society) and, with it, to create an environment amiable to changes - especially those which depend on Congress. In this sense, it seems that the possible new Government has more conditions to push forth the necessary measures given the political capital in the moment, and thus will require a highly qualified and technical team – of Ministers, Secretaries and Advisors - to elaborate and put into practice the new economic model of the administration and its philosophy.

Like in any other situation, the benefit of a doubt will be bestowed upon the new administration, but with an expiration date. Which date? The traditional 100 days. On the 100 first days the possible new Government needs to show "it means business", otherwise it will lose its greater trump card: provisory "credibility". They cannot fail! And failing here does not mean only deviations or mistakes in defining and executing emergency actions, it means notably to communicate we don't have a "new" one. We need to exorcize the former economic *"*mindset*"* by overcoming any remnant of the New Macroeconomic Matrix and its embedded populism, and definitely get into the world of those who think rationally.

It is the only way to get it right. We are confident, and always wondering what we can do for our country!

Fiscal Policy

If the Government's fiscal (lack of) responsibility, with all its limitations, checks and balances that (in theory) it is subject to, was foully ignored, thereby vilifying and striking everything without minor decency or worry about its consequences, here is the result (impeachment), what could "ensure" greater inconsequences along the final straight of its exit? Nothing. Impossible? No. The power of damage ranges up to the last second.

The "goodness" package that we had news of in the latest days of the month to be granted by occasion of Labor Day, would be comic if it was not tragic. Not that the beneficiaries do not deserve it, but Brazil does not have conditions (at this moment) of taking such measures – it would in the romantic version, because on the coldest and cruelest version it is about leaving a legacy to be undone. Why? Because the Treasury itself claims there is no possibility of granting readjustment to beneficiaries of Conditional Cash Transfers Programs ("Bolsa Família", for instance) without further castigating public finances. Technically speaking, the Government expects Congress to approve of the new fiscal target (Government aims at a deficit of nearly BRL 100 billion). Without the latter and with current meager tax revenues, not only any "goodness" is out of the question but, also, postponing several expenses will be inevitable.

The deterioration of public accounts keeps going. In March, the primary deficit remained at BRL10.6bi, and it did not revert the trajectory of the Gross Debt/GDP ratio, that in 2012 was in 53.8% and in this year will exceed 70%. What is the reason for the vertiginous increase? The law of fiscal responsibility is not being followed… personnel and debt-servicing costs exceed the desirable limits to maintain accounts in order.

What can we do? We have various measures (already mentioned in this report and soon to be consolidated in an article) of greater and smaller impacts and of a technically chained and systematized implementation of measures to be shown and approved in a timely fashion (short term). The topics include from changing the minimum age to retirement, breaking the link between pensions and the minimum wage to a limit to be set to the Public Debt of Federal Government as a share of the GDP and compulsory zero-deficit budget guidelines are secured. All of this (as well as other measures) aim at achieving greater primary fiscal results, up to the point we can stabilize the Debt/GDP ratio and initiate its downward trajectory.

If we could cast three priorities for the possible new Government, we would have: (i) the fiscal adjustment, (ii) the fiscal adjustment and (iii) the fiscal adjustment. The fiscal adjustment motivates everything at this moment. If we fail at this task now it will be too late for any recovery and exponentially greater costs will await us in sequence.

One commonly hears that 50% of the problem is solved when you understand the "wording" of a problem. Let us not be deceived, the fiscal adjustment (if it is done as it has to be) will be long and painful, but the economists' abilities and the politicians' determination will form, as a whole, the appropriate and necessary tools for the traverse.

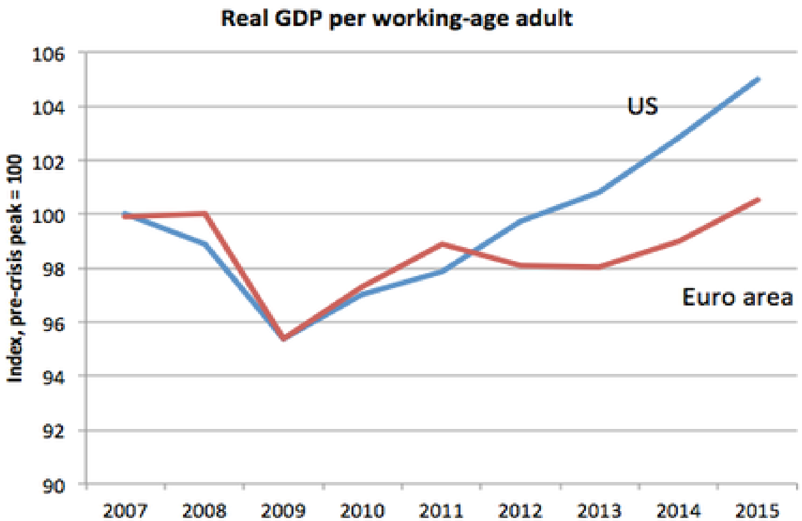
International Environment

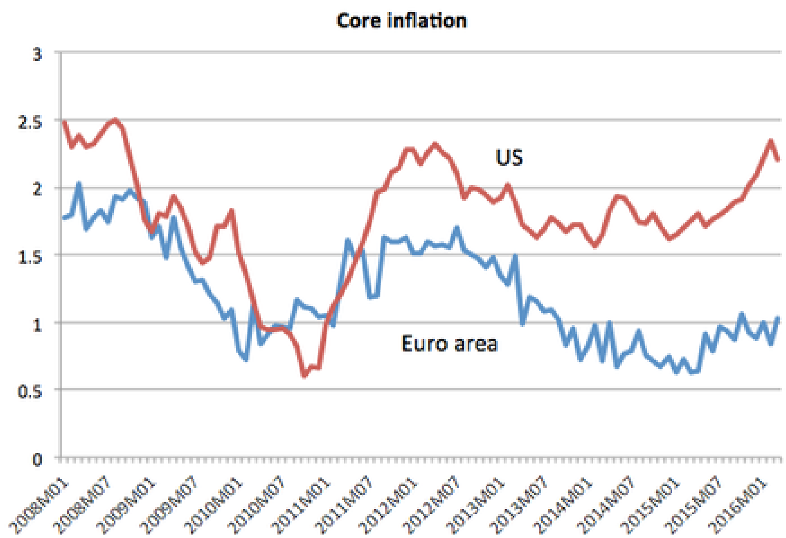
Both charts next indicate a great deal of things, but a detailed analysis can reveal upsetting surprises. There is no doubt that in relative terms the USA is in better shape than the Eurozone, but it does not mean that they are doing well, especially because the benchmark is in tatters. Also, it does not mean that they could not be better… in our opinion they could. In spite of it, and with the obvious limitation of this analysis and purpose, what comes to our attention is the performance since 2011. Independently of the realities faced by each one and the policies implemented, the lines referring to the Eurozone are blatantly worse than those of the USA, and so it remains. What is the matter? The ECB keeps applying with the same policy until its "remedy" makes effect. Hard to believe it will do the job.

In Asia, Japan keeps disappointing and it would have a growth rate next to zero in 2016 – the economists' crew that support the American Quantitative Easings and the current ECB measures, certainly point to a leak or insufficient Japanese Government stimulus as responsible for the situation. On the other hand, in China it does not happen and the inducing State holds increasing power, but for some reason the Chinese GDP might not exceed 6.5% this year and might decrease in 2017! Perhaps aligned with the inevitable change of the growth model (from export-led to domestic-consumption-led).

On the international political field the American presidential race is taking center stage. Donald Trump makes a surprise every day… the man is a runaway train, and a considerable part of American people seems to be loving it.

Other non-Americans throughout the world, too.





Source: http://krugman.blogs.nytimes.com/2016/04/30/when-europe-stumbled/

Interest Rates

It was politics that guided the interest rate market in April.

Rodrigo Janot's (Attorney General of the Republic) statement recommending that the Federal Supreme Court rejects the appointment of Lula to the President's Chief Advisor was the trigger to the downward movement of interest rates in this month. In addition to this fact, we have the Government's defeat on the impeachment process voting at the lower house of Congress and the ever clearer prospect of the President's removal from office for a 180-day period and, then, the current administration final exit. The interest rates market is strongly influenced by changes of the command of Central Bank – BACEN and in Ministry of Finance and Planning, which is likely to take hold in an eventual vice-president Temer's Administration. In case the new Minister of Finance holds a stance of fiscal austerity and inflation keeps slowing down - because of the deepening recession and increasing unemployment -, the Central Bank will find room to cut the SELIC interest rate.

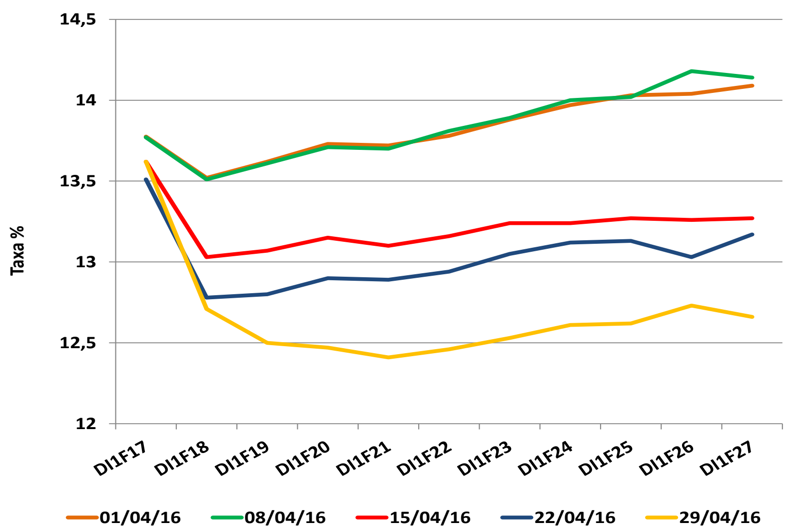
In April's meeting, the Central Bank maintained the Selic rate at 14.25%, aligned with the expected rate by Planner Redwood and by the market. The decision to maintain the SELIC unchanged was unanimous, after three meetings with dissent by two board members (Sidney Corrêa Marques and Tony Volpon) in favor of an increase by 50 basis points. On the release disclosed shortly after the decision, BACEN highlighted the advances made in the anti-inflation policy, but considered that the high level of the price index in twelve months and the inflation expectations do not offer space for a monetary policy softening. Communication, the main tool under inflation targeting regime, should breed greater effects – but not after so many abuses and incoherencies. In this way, only a few market participants give credibility to what was said or not said – water under the bridge, now we have to wait for the new team under the eventual new administration. All news points to chairman Tombini's removal from his position before the Selic is cut down… it is what we expect, the nightmare has to end.

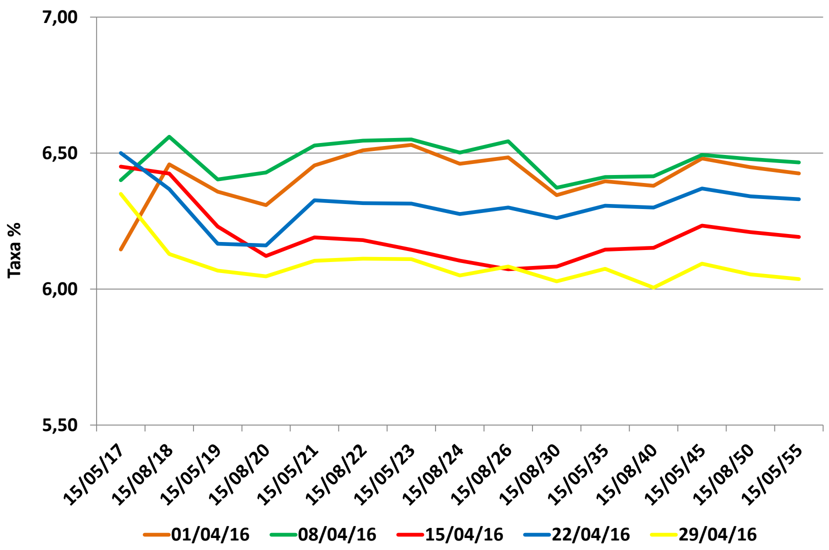
In this sense, optimism rules once we see the names considered to chair the BACEN. They are all, with no exception, light-years more appropriate to the position – at least it is what their records suggest. Also, it is anxiously expected that finally the Central Bank would be endowed with effective formal independence and that its directors would have their mandates set in unsynchronized terms with that of the country's President; remunerated quarantine, etc., etc., points that were often commented in this report. The examples of Central Banks in the world with those characteristics, in general, deliver the expected results. And finally, the alignment of new minds on BACEN will be harmonized with the purposes of those conducting the fiscal adjustment… yes, once more, the much warranted tuning between the Monetary and the Fiscal Policy. We won't have to hear that (whatever Fiscal Policy) in the relevant horizon was aligned to the Monetary Policy… enough with (an unsuccessful) Central Bank intervening on the exchange rate. Finally, changes are coming!

Should changes effectively arrive, prices are already capturing them… the change of the curve's inclination with an intense reduction of premiums on maturities from January of 2021 onwards is result of a decreasing perception of risk… in relation to which one? First, as regards Brazilian politics and, then, its second-order effects!

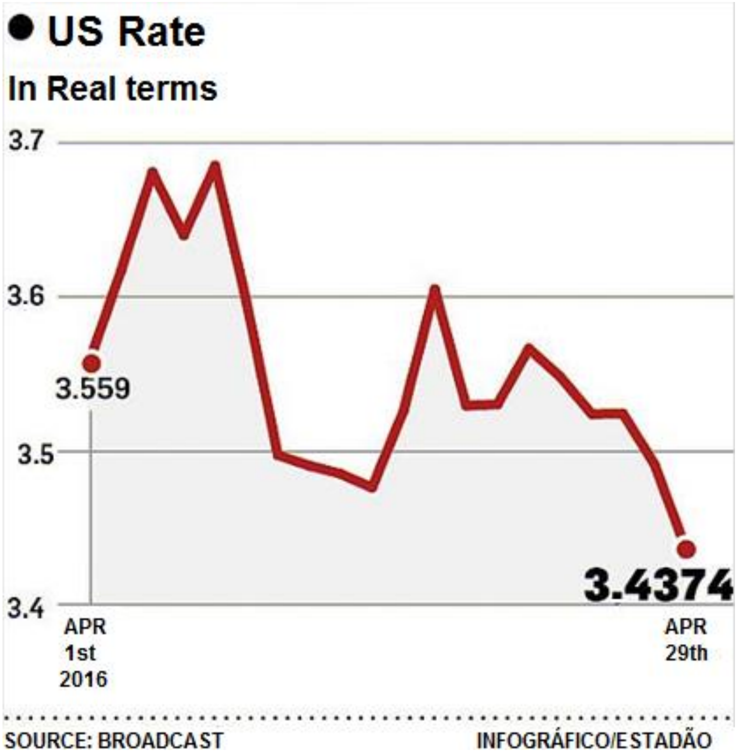
Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange



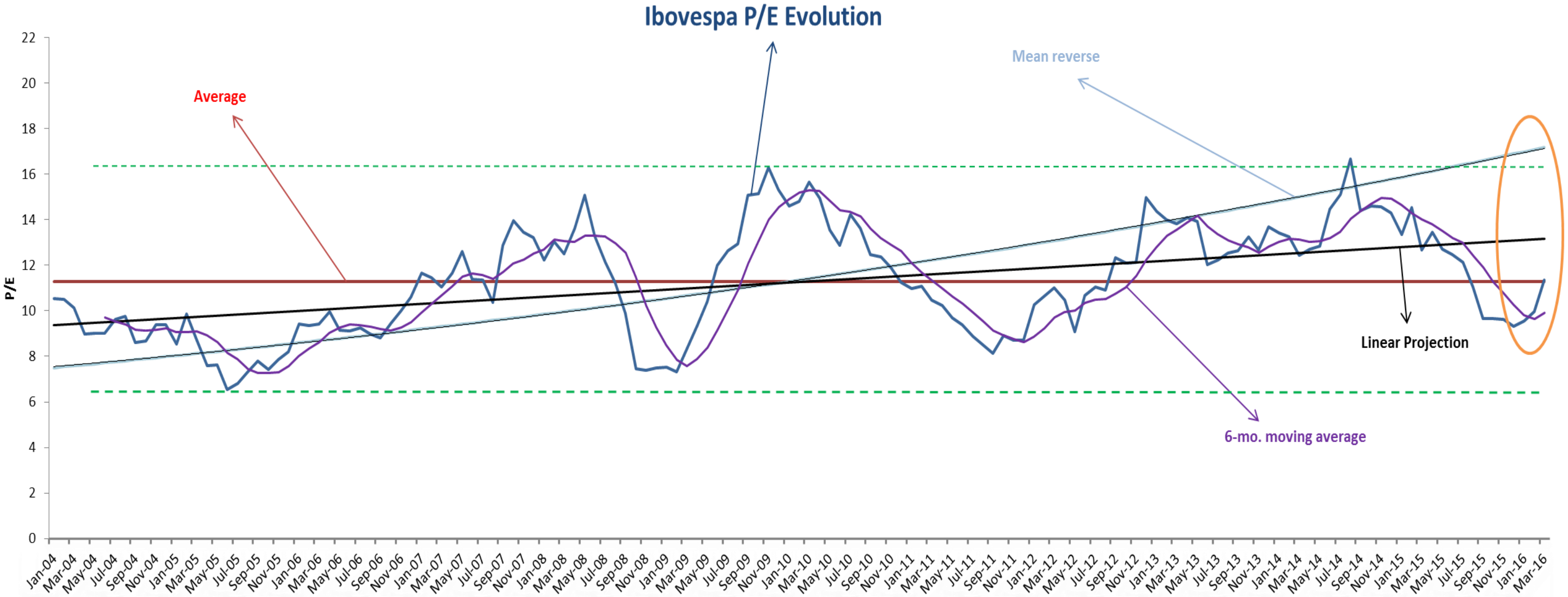
The financial assets negotiated in Brazilian market appreciated in the face of the worsening of President Dilma governability peaked on impeachment process approval by the lower house. The American currency melted and was negotiated under of the barrier of R$ 3.50, closing the month at R$3.45. And now, what will the trend be? Should it rise or fall? By how much? The Dollar is always too hard to understand; thus, it all depends.

If the impeachment succeeds and the future president creates a team able to restore the country's credibility and that engages in the fiscal adjustment, an intense foreign currency flow might come to Brazil looking for high interest rates and, along with it, the Real tends to appreciate even further. However, if the impeachment does not succeed or if the government approves the project of new elections in October, the dollar tends to gain value, and a great value. May will certainly be a month of great definitions!

With its interventionist bias, moving away from its original mandate and assuming to know the ideal exchange rate (and its volatility) for the country, in a fashion that would contain the Real overvaluation, the Central Bank entered with intensity the exchange rate market with reverse swap auctions. The BACEN's intervention showed more effective when the foreign currency decrease was linked to internal factors as the impeachment voting and the hope of a new government. Thus, it seems that BACEN can foresee the imminent changes… or does it want to take advantage and reduce its swaps' stock? Or perhaps it aims to defend the trade balance positive outcomes? Or does it keep thinking that it is the best market player? Maybe of all the above… is there any doubt? In the month of May we will have an rise of IOF's (financial transaction tax) rate to operations with foreign currency, from 0.38% to 1.10%, with chances of reaching 3%. One more government intervention in the exchange rate which tries to control the currency and increase fiscal revenues. It seems to never end.

In global terms, observing the markets, it seems that the Dollar appreciation movement is coming to an end. The global currencies' prices already incorporate a stronger US economy and the subsequently gradual increasing of its interest rates.

Stock Market



Period:12,25 years
Source: Bloomberg
Produced by: PlannerRedwood

Differently of the exchange and interest rate markets, the appreciation movement of the Ibovespa was not only related to the political scenario. The recovering price of commodities and the positive foreign capital inflow had a relevant part in the index result, that had the third month of gains, closing April with a high of 7.7%. The index concentration on assets of commodity producing companies was positive to the monthly result. The intense bounce back of oil and iron ore prices was favorable to Petrobras, Vale and steel mills based assets. The financial sector assets also had contributed positively, given that they suffer less with the current country’s turmoil. On the negative edge of Ibovespa we find the export companies’ stocks, which were harmed by the dollar plunge during this month. The chart above shows, in terms of the P/E ratio, the signals that Ibovespa presents.

However, as we always highlight, the fundamentals have not changed and the structural reforms are inevitable to change the course of the Brazilian economy. The companies’ realities, to a large extent, are influenced by poor fundamentals, thereby hindering strong improvements of the stock market in the short run. For the mid and long terms, the proposals of privatization of the infrastructure sector as a vector to restoring growth rates, the consistent increase of commodities prices in international market, the decrease of long term interest rates and the expectation of a lower inflation in 2016 and 2017 can all boost the stock market.

Monthly Commentary

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