Planner Redwood Asset Management

MONTHLY COMMENTARY

AUGUST 2015

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Agenda

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

“Cheer up, the worst is yet to come!”

by Mark Twain American writer

Introduction

The Brazilian government reveals time and again an endless reservoir of surprises.

It has submitted to Congress a budget (PLOA) with a projected fiscal deficit of BRL 30 billion. That's right! It is the first time in the history of Brazilian Republic that PLOA is submitted to Congress with a deficit of BRL 30 billion. This is absurd, a challenging situation for other power involved and flies straight in the face of basic budgetary principles and a clear non-compliance with the Fiscal Responsibility Act. All of this under the President´s command, but also under the fiscal adjustment´s greatest proponent: Finance Minister Joaquim Levy. It is a shame indeed. Far beyond a disaster in macroeconomic terms, it infuses great political uncertainty… not to mention that it jeopardizes the minister Levy´s credibility while reinforcing the markets´ perception that the Government has lost its handle on the economy.

The end result, it is understood, is a combination of ideological divide, the unorthodox elements that constitute (and influence) the economic team and the blatant managerial incompetence. Furthermore, we must add the populist tone of measures and partisan allotting of government posts. There you have it. Nothing more combustible than power coupled with incompetence. We stride fast toward a closed alley. The country´s predicament requires swift action. Michel Temer, the vice-president and in charge of political negotiations, has jumped ship and Joaquim Levy is hanging by a thread. All sirens are going off!

At the international level, it seems the only economy thriving at the moment is the US. All indicators since Ben Bernanker's term have fallen in line, with the exception of inflation which still is falling short of the 2% "target" rate. On the other hand, now everyone seems to believe that China will grow, in fact, below 6% and not as official forecasts have insinuated. Shockwaves stemming from this acknowledgement have wreaked havoc in world financial markets and there is yet more to come. This first and still mild Chinese blip has shown the world how far-reaching can be the international consequences of the country´s hard landing, encompassing both developed and emerging economies.

Therefore, the perfect storm is gaining momentum – in both domestic and external fronts. In an economic climate such as this one, with a credibility-challenged Government (politically and economically), anything can happen… the worst is yet to come, unfortunately.

It is against this backdrop that US Treasuries have closed the month with a 2.2% higher yield. S&P has dropped 6.26%, while NIKKEI faced an 8.23% plunge, the same outcome reaching both DAX (-9.28%) and FTSE (-6.78%). Ibovespa had the same fate (-8.33%) as IBrX (-8.25%) for the month. Top returns for DIF16 (+14.46%) and DIF17(+14.36%). NTN-B 2050 has ended the month on 7.05%, whereas the Dollar (Ptax) reached BRL 3.6467.

Economic Activity

The chart shown was elaborated by Austing Rating and conflates the Brazilian economy´s activity with the track record of 35 countries. We are running ahead of Russia and Ukraine only.

We are clearly in recession – the slowdown reached -1.9% compared to the first quarter 2015 and a -2.6% on the second quarter 2014 – which is much in line with our projections up to now. Differences with respect to the chart below increase when our projections overestimate the downswing for this year to -2.37 and -1.09% for the next.

China stars with an amazing 7% growth – a highly unlikely rate that affects the relative analysis, albeit neither the ranking nor, one must say, our harsh predicament: should our projections for 2015/2016 be realized, they will match those suffered in 1930/1931, when Brazil faced a downturn of -2.1% and -3.3%, respectively. At that time the world was enthralled in the aftermath of the 1929 Wall Street Crash and Brazil endured the uncertainties revolving around the 1930 Revolution.

Our present outlook must be seen not only as outcomes of recent wrong and inadequate measures, but also as a moment in which we must take action, right away. The deficit in fiscal responsibility that has taken hold of part of the economic team and Congress reflects directly on activity and must be undone quickly. But, how? Among many necessary political actions one stands out: a firm and definitive stand by the finance minister Joaquim Levy regarding spending cuts. Personality and assertiveness.

GDP RATE GROWTH – 2nd QTR. 2015					
RANKING	COUNTRY	2nd QTR.15 / 2nd QTR.14	2nd QTR.15 / 1st QTR.15 (*)	2015 Proj.	2016 Proj.
1º	China	7.0%	7.0%	*6.8%*	*6.5%*
2º	Philippines	5.6%	7.4%	*6.6%*	*6.4%*
3º	Malaysia	4.9%	n.a.	*5.5%*	*5.6%*
4º	Indonesia	4.7%	n.a.	*4.9%*	*5.5%*
5º	USA	3.7%	0.9%	*2.5%*	*2.7%*
6º	Slovakia	3.2%	3.1%	*2.7%*	*2.8%*
7º	Spain	3.1%	4.1%	*3.0%*	*2.5%*
8º	Peru	3.0%	2.5%	*4.0%*	*4.9%*
9º	Sweden	2.9%	4.0%	*2.5%*	*2.8%*
10º	Hong Kong	2.8%	1.6%	*2.3%*	*2.1%*
11º	Latvia	2.7%	6.0%	*2.7%*	*3.5%*
12º	Hungary	2.7%	2.0%	*3.0%*	*2.8%*
13º	Great Britain	2.6%	2.8%	*2.5%*	*2.3%*
14º	Mexico	2.2%	2.0%	*2.5%*	*3.1%*
15º	South Korea	2.2%	1.2%	*2.8%*	*3.3%*
16º	Norway	2.2%	-0.4%	*0.7%*	*1.6%*
17º	Chile	1.9%	n.a.	*2.9%*	*3.8%*
18º	Estonia	1.9%	3.2%	*2.3%*	*3.2%*
19º	Israel	1.9%	0.3%	*3.4%*	*4.0%*
20º	Singapore	1.8%	-4.0%	*3.1%*	*3.2%*
21º	Germany	1.6%	1.8%	*1.6%*	*2.0%*
22º	Holland	1.6%	0.3%	*2.0%*	*1.9%*
23º	Greece	1.5%	3.1%	*0.5%*	*2.2%*
24º	Portugal	1.4%	1.6%	*1.3%*	*1.6%*
25º	Lithuania	1.3%	2.3%	*2.7%*	*3.1%*
26º	Belgium	1.3%	1.8%	*1.3%*	*1.6%*
27º	South Africa	1.2%	-1.3%	*2.0%*	*2.2%*
28º	France	1.0%	n.a.	*1.2%*	*1.5%*
29º	Japan	0.7%	-1.6%	*0.9%*	*1.5%*
30º	Italy	0.5%	0.7%	*0.7%*	*1.2%*
31º	Taiwan	0.5%	-6.6%	*3.4%*	*2.7%*
32º	Austria	0.4%	-2.9%	*0.6%*	*1.5%*
33º	BRAZIL (**)	-2.6%	-7.4% (*)	*-2.06%*	*-0.24%*
34º	Russia	-4.6%	n.a.	*-3.5%*	*0.3%*
35º	Ukraine	-14.7%	-4.4%	*-6.4%*	*1.9%*

The Ranking by Austin Rating compares the economic performance of 35 countries and considers seasonally-adjusted data when comparing with 1st quarter figures.

Fiscal Policy

Shall we repeat that we don't need enemies? Of course not! Our enemies are constrained by our own boldness in self destruction;

The Finance Minister Joaquim Levy has been spreading the word that the Brazilian present situation compares to those endured in the 1980s: "I´d venture to say that we are in a situation that looks similar to those of the beginning of the 1980s, when we enjoyed a period of expansion and industrialization". It may very well be, perhaps the closing of a favorable cycle. Levy recalls that there was at that time a sharp drop in commodity prices, like the one we see today, but has pointed out that "the main difference is that now we have over USD 300 billion in foreign reserves". He further maintained that the current shock is large and it makes no sense to seek an inflationary solution to it. "The magnitude and persistence of the current shock are almost as large as those of the 1980s". Fine. He failed to mention though that in 1982 Delfim Netto, then head of the Ministry of Finance (and a close interlocutor with the current administration of the Labor Party) had promoted a 30% maxi-devaluation of the currency with an interest rate control. He seemingly followed this reasoning, as journalist Luis Nassif recollected back in 2013:

1. a maxi-depreciation of 30% to boost exports;
2. the end of mini devaluation and the freezing of the Treasuries bonds yields (OTN), which served as benchmark for other financial assets' returns, to avoid the pass-through of exchange rate to prices.

As a result, the economy entailed an ill-fated march with successive inflation hikes. As Treasuries' real returns fell behind, companies started to fiercely alter their portfolios onto inventories and other real assets, which fueled the inflation spurts. Soon enough, any real devaluation was quickly eroded by price rises.

To check the external accounts' escalating deficits, Delfim Netto relied on State-owned companies to increase borrowing, including leasing operations for fictitious exports by Petrobras. Any resemblance of fiscal controls and stability soon faded away. Banco do Brasil – at that time – a monetary authority, had its accounting control impaired.

Back to Levy, he claims "the tide has shifted" and the idea of a fiscal adjustment "has to sink in". The first measure consists of preparing the country for a major shock with persistent effects. His strategy underlines the need for unbending cooperation between the Legislative and Executive branches to pass a profound tax reform. "We have to improve on some taxes, such as the ICMS (Sales tax) to tame "fiscal war" among state-level governments, and the PIS/COFINS, to simplify bureaucratic requirements on private companies". That is all fine, but should the specter of the 1980s hovers over our heads, we should at least learn from past mistakes.

Truth be told, the government has signaled a complete disorientation as regards the solution to the fiscal crisis. The budget deficit proposal for 2016 submitted to Congress is exhibit A in favor of this hypothesis. Odds are that fiscal balance will only be achieved in 2017, or even in 2018, thereby reinforcing the trend towards a hike in the debt-to-GDP ratio, with all the grim consequences that come along with it.

International Environment

US excluded, the rest of the world seems to be in economic bad sheets.

In a recent article title *The Great Emerging-Market Bubble*, Bill Emmot (former Chief-editor of the Economist) underscores that "there is something very wrong with emerging markets". Finding the culprit is the task of the day: price of commodities, expectations of FED interest rate hike, China, currency wars etc. All of the above have their share of guilt, but Emmot breaks it down to a simpler and more traditional answer: politics. He is right, at least in part. We must add managerial incompetence to his analysis. The belief held up until very recently was that emerging markets could grow faster than developed economies by increasing technological transfers and management techniques, while exporting goods and services, thereby enjoying the fruitful combination of low wages and productivity increases. Things worked quite differently and we agree with the author in that, although countries are bound to benefit *from waves of growth and cycles of commodities prices – despite having highly dysfunctional political institutions – the real test appears when the scenarios turn less favorable and the country is required to change its course. This maxim applies to all emerging economies.*

In this vein, the landscape has grown much less encouraging in all senses – being China the most "dangerous" of all problems, not only by its massively "destructive" potential (particularly due to the risk of unprecedented contagion) but above all because of the unpredictability that involves the timing and longevity of the country's landing. But Bill Emmot sums up the problems of emerging markets without much impact (although considered), from the international environment. The author states*: "The democracies of Brazil, Indonesia, Turkey, and South Africa are all currently failing to perform what is a basic task for any political system: to mediate smoothly between competing interest groups and power blocs in order to permit a broader public interest to prevail. By that is meant essentially a public interest in allowing the economy to evolve flexibly, so that resources move from uses that have become unprofitable to ones that have a higher potential. A clogged up economy, one that does not permit such creative destruction and adaptation to new circumstances, is one that will not grow sustainably. (…) The bottom line is that unless emerging economies can ensure that they remain flexible and adaptable, they will not continue to "emerge." And the determinant of that flexibility and ability to adapt lies in political institutions and their willingness to challenge interest groups, mediate social conflicts, and maintain the rule of law".*

Therefore, the perfect storm approaching is being rapidly catalyzed under the pressure of problems yet to be resolved in Europe (unemployment, deflation etc.), currency wars ranging on (especially in Asia), the imminent monetary tapering by the FED, the downturn of the Chinese economy (with or without hard landing) etc. One would hope, at least, not to be part of a context as Bill Emmot so accurately describes. Such a relief is to no avail, for we are entirely contemplated by his analysis.

Interest Rates

August began with the illusion that, in spite of being in the third quarter, volatility would recede with the breaking news of an agreement between the President of the Senate Renan Calheiros and the Executive branch, sending out the message of a favorable exit to the political crisis. Honest mistake!

Throughout the month, two of the biggest rating agencies, S&P and Moody's, published their analysis on Brazil. S&P ascribed the negative bias to Brazilian sovereign risk and kept the grade, while Moody's downgraded long-term foreign currency debt ratings for the country from Baa2 to Baa3, leaving out the country just above a speculative level perception of its debt, albeit with no bias towards revisions. In the latter case, the reasons range from low growth and fiscal deterioration to lack of political consensus. They were of no surprise, whereas the maintenance of an investment-grade rating was quite striking. Not even the imminence of being downgraded was enough to infuse into Congress the required sense of urgency as regards the fiscal adjustment and the need to tame the representatives' ill-advised compulsion to increase spending in these uncertain times. Adding harm to foul, we suddenly thought former Minister Mantega was back in office, for the automobile industry was granted subsidized loans amounting to over BRL 8 billion in order to avoid further lay-offs. This subsidies-led growth begs the question of whether the economic team has learned from its very recent past mistakes.

Finally, the month of August witnessed the announcement of a BRL 30,5 billion budget deficit proposal submitted to Congress. Did we get this right? Yes, we did! According to the Minister of Planning and Budget this is a realistic measure, for the Fiscal Responsibility Act requires the set-up of a target, be it positive or negative. Surreal!

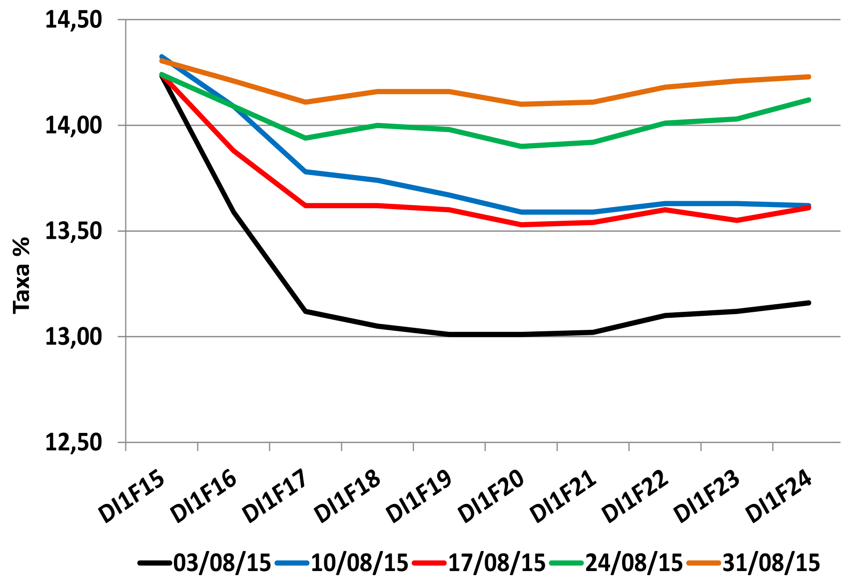
Resistance to this aforementioned proposal brought back on the table the discussion over the CPMF, a tax on financial transactions, an idea whose life hangs by a thread. However, due to the lack of political support and the resistance from society in general, the Government gave up the idea. The restoration of this tax will not do away with the problem of balancing the books for next year, but may mask the problem temporarily. Not only is the CPMF a regressive tax (bad for economic activity and creates a heavier burden for lower income classes), its renewal emboldens society's tax burden and stymies both consumption and investment. To avoid further friction, President Rousseff has evaded Levy's recommendations for reforms in social security and spending cuts on social programs. Government has lost its mind! Hence our solid expectation that the full downgrade of Brazil's rating is but a matter of time, whilst Levy's hold of office is much less certain. The solution goes through cutting spending, not increasing tax collection. The country requires structural reforms right away!

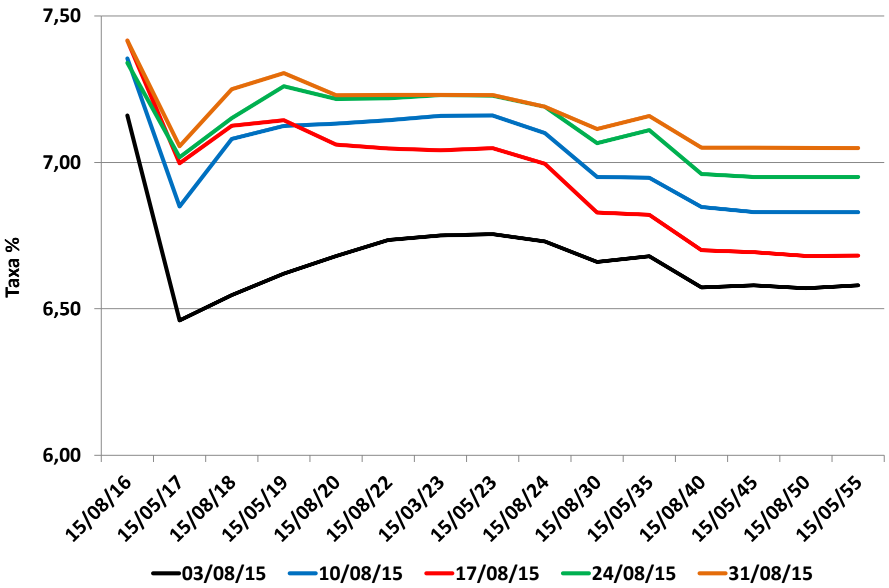
All the above points inevitably to an unequivocal conclusion: it is once again up to Monetary Policy to do the "dirty work" of stabilizing the economy via interest rates. However, we all know of the side effects that come along the correction of the magnitude required: weak output and employment performances. Yet, there is more. The big question is whether the Central Bank will really make a stand as the guardian of the Brazilian currency or whether it will accommodate other variables within its scope of action (away from its original "mission") and resolve; even worse, if it will succumb to the Commander-in-Chief's ill-fated macroeconomic reasoning.

Furthermore, the uncertainties at the domestic level coupled with the worldwide risk aversion has caused the flattening out of the term structure of the Brazilian interest rate in August 2015, a distortion not witnessed for a long while. The curve has not anticipated an interest rate cut for next year. Along with the troubled landscape, investors are demanding now greater returns to invest in the country. That is how it works!

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

On a stable scenario, exchange-rate forecasting is deemed the greatest challenge within macroeconomics calculations. In Brazil these days, this task has evolved to downright guesswork for most of the financial markets analysts: early this year expectations for end-of-year prices were quoted at BRL 2.80 while the Central Bank's weekly report points out to BRL 3.50. In August, the BRL/US$ closed at 3.6467, almost 6% rise!

As the economic crisis is protracted, both political risks and country-risks increase. It is hard to measure how much of the deterioration in the outlook owes to economic and political factors and how they influence the currency.

Central Bank's interventions in the exchange markets were insufficient to avoid a strong devaluation, even with the full re-issuance of exchange-rate swaps (future contracts on dollar sales) due in October and the sales of up to BRL 2.4 billion with repurchase clause in November and December 2015.The idea of ending Central Bank's interventions seens to have been abandoned. Needless to say, these measures have fallen short of their intended results, for the real causes lie in the foundations of the economy.

In truth, the country has no Exchange rate policy. The rate is neither fixed nor floating, nor has is explicitly defined ranges of variation… there is nothing! It is a veritable disaster! It is worth recalling Mario Henrique Simonsen, who used to claim that **"inflation cripples, but the exchange rate is fatal!"** Once again, there seems to be no macroeconomic alignment guidelines among the economic team and putting the blame on the "independence" of the Central Bank cuts through common sense and insults our intelligence.

One should not celebrate the overshooting we are now enduring, not even with the apparent "improvement" of our trade balance. It will be a short-lived measure and it is naïve to believe the exchange rate alone will, in the long run, enhance our competitiveness. The exchange rate, as the price level, will stir imbalances in the economy, infused uncertainty in entrepreneurs' prospects and, via a pass-through on to prices, increase our inflation rates.

Yet, with the awaited FED interest rate hike and the rating downgrade there will be a massive flight of resources from our country, which will first raise the price of the Dollar before a downward accommodation becomes feasible (one can only hope). An elusive question nowadays is the new equilibrium exchange rate and whether the Central Bank agrees to it. Countries like Brazil tend to be out of favor, given their high inflations and unbalanced budgets. It is a fact, however, that the dollar x real exchange rate has surpassed other emerging markets' currencies under the strains of an expected Chinese slowdown, when the PBoC triggered several measures to devalue the Yuan as well as to boost local markets.

All these factors weigh in on the behavior of our exchange rate but do not remove our absolute lack of assertiveness on the matter. Beware: the exchange rate is fatal!

Stock Market

Brazil is technically in a recession! Domestic manufacturing industry is fast losing competitiveness! The stock markets in the country will soon reflect this situation.

The perception that emerging countries were the hallmark of robust growth has fallen out of fashion. Brazilian GDP for the second quarter, as mentioned before, revealed a downswing which inevitably influences the financial markets – in this case, it reflects on the performance of companies' stocks. Worse than that, recession will not be short-lived, for the number indicate a negative growth for 2016 – which is inkling of an adverse scenario for companies and, consequently, for the Ibovespa as a central indicator for the performance of the main companies in the country. Truth be told, consumption-led style of growth is rigorously worn-off; combine the latter with the ripple effects on the economy and politics coming from the corruption scandals (Operation Lava-Jato) and the explanation for the slowdown becomes quite clear-cut, with unavoidable effects on investors' mood behavior and, therefore, on the stock markets. We will have to wait until the end of 2016 or even 2017 to envisage positive numbers for our economy – and, who knows?, in this case, the financial markets (as always) will anticipate and price in this development.

Externalities are also of importance here. Contagion and correlations apply. Take once again China as an example: one of the central engines of the world economy has overcome Greece as a top concern. The PBoC has cut its interest rates and, at the same time, has slackened Compulsory Deposits rules for the second time in two months, strengthening support to the economy and the stock market, whose fast-pace dive – especially the Shanghai stock exchange – has affected markets worldwide.

The current outlook is one of risk aversion, with doubts over future developments and lack of concrete information of all sorts: hard landing in China, interest rate hike by the FED and the Brazilian rating downgrade… all of these are just the beginning of the story, albeit their overwhelming impact on our domestic stock markets.

Therefore, after a positive first semester with an inflow of foreign investors in the Brazilian stock Exchange, the month of August – as in July – has witnessed an outflow of interested investors. Worries over China and the FED rate hike account for the main factors behind this movement in emerging markets. In Brazil, the political standoff enhances the intensity of this flight from risk in comparison to other countries. Ibovespa has ended the month with losses of 8.33% in August and total variation of -6.76% in 2015. The financial sector has endured its worst outcomes with the proposal to increase taxation on net profits (CSLL), the negative budget for 2016 and the pressing news on inflation and overall activity.

In the final analysis, full realization of all potential forces is not yet complete. The true sell-off in the stock markets will come when the abovementioned worries become reality (surely with some anticipation captured by prices). At this moment, there is rapidly closing window of opportunity to exit the country exactly when everyone wants to leave (some foreign investors will only jump ship following the rating downgrade)… a sell-off will be in place.

Is there any good news? Yes, the debacle in prices is likely to offer excellent investment opportunities for value companies and for those with true investment possibilities in the long run. We should all wait for a more suitable moment. Finding such companies won't be an easy task.

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