Planner Redwood Asset Management

MONTHLY COMMENTARY

AUGUST 2016

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Agenda

- Introduction
- Economic Activity
- Fiscal Policy
- International Environment
- Interest Rates
- Foreign Exchange
- Stock Market

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

“With the new day comes new strength and new thoughts.”

Eleanor Roosevelt – Activist and First Lady of the United States of America

Introduction

It is time for renewed hope! With the impeachment of the President Dilma Roussef the political stress seems to tone down substantially and, with it, comes the possibility of a calmer social-economic-financial environment. We have a not so long period of truce ahead of us, in especial on the side of investors and financial market in general, because on the temporariness of the President Michel Temer his attitudes on the economic and financial realms have had repercussion, in its majority, good, but he also seemed to take actions at variance with a more orthodox policy.

However, unquestionably the environment has already improved and markets, somehow, have translated this movement into confidence indexes, in expectations of economic activity performance and in assets prices. And yet largely short, it is true, of Brazil's full potential. But, in this sense, the President must discern conflicting signals with a more energetic management on the fiscal side, thereby reinforcing his commitment to the economic-financial stability of the Country… these attitudes must be taken with urgency and an unequivocal tone.

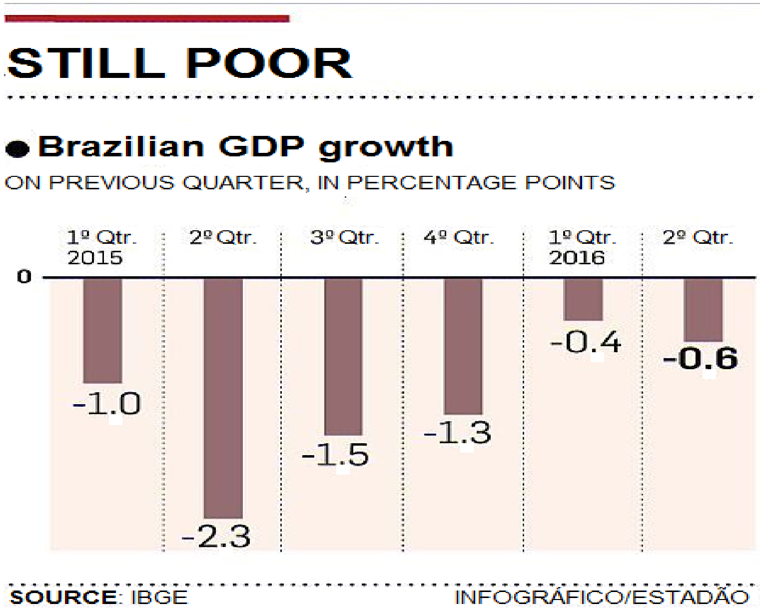
Under the pretext of temporariness several actions were taken, sometimes in sense of "guarantee" his effectiveness in power, sometimes to signal his compromise with the change of the *status quo*: Now Temer is effectively President and, as Mrs. Eleonor Roosevelt said, in the opening this Commentary: *"With the new day comes new strength and new thoughts."*. We all are anxiously waiting.

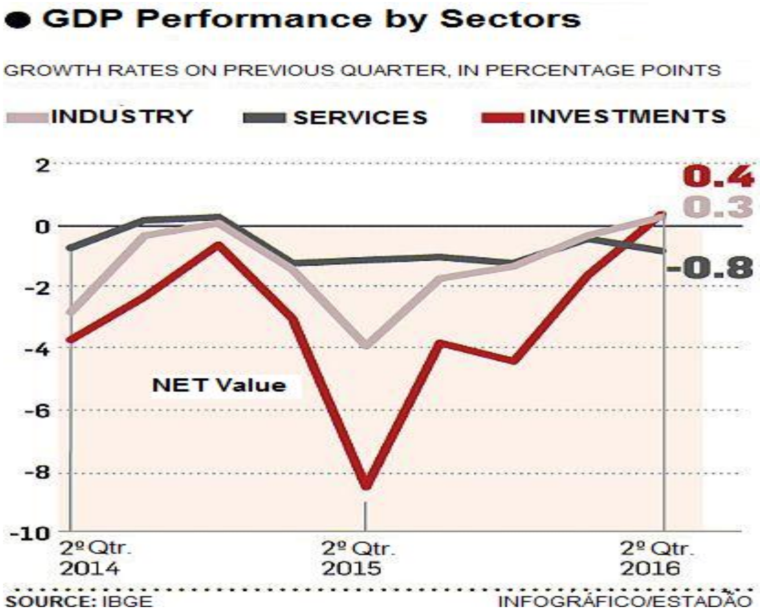
The Olympic Games of Rio de Janeiro, despite all problems, was a good event and also fairly praised around the world. The world thus interpreted and talked about Brazil during the games. It ended, now let's focus on honoring the "parrots".

In the world at large, great expectations hover around the G20 meeting, especially due to the fact it will be the last meeting with the presence of the American president, who possibly will attempt to express his legacy and the expectation of next steps. The posture of the FED (American Central Bank) contributed greatly on the volatility of international markets, notably in monetary quotation.

In this environment. the Treasuries of USA closed the month at 1.57%. S&P varied -0.12%, NIKKEI closed at 1.92%, DAX with 2.47% and FTSE 0.57%. The Ibovespa finished the month at 1.03% and the IBrX at 1.12%. Maximums to DIF17 at 14.025% and DIF21 at 12.15%. NTN-B 2050 finished the month at 5.8496%, and the Dollar (Ptax) at R$ 3.2403.

Economic Activity





Images "say" a lot. The situation is still quite worrisome, but the evaluation (by markets and Redwood, this latter much more measured) is that the signals of possible improvement are unequivocal, but tenuous. Only a really strong posture and concrete actions of a new course of economic policy will in fact consolidate these expectations.

It is easily seen that the major component of aggregate output, the GDP of Services, still bears the brunt of recession, but the GFCF (Gross Fixed Capital Formation) seems to rehearse some reaction... however "marginal". The unemployment rate has not caved in, even because it will be possibly one of the last features to display some reaction, given the components of adjustment on the real side of the economy. The financial market, in its turn, sees everything and turns it into price adjustment...

Fiscal Policy

President Temer has repeated the speech of '" *the most urgent economic challenge is of fiscal order… and that the primary objective is to promote a structural adjustment of the public expenses in a horizon of 20 years".* Great, that is right! However, we need to move beyond speeches and show what we came for, urgently. Moreover, we need not more rules and/or further hindrances.

Actually, the onslaught divided between targets of results or targets of spending seems somewhat misplaced – for the time being at least. The Fiscal Responsibility Act (FRA), the most important of the laws of recent times, maybe needs some "repair", although nothing implying changes in its substance and its core principles. Therefore, clearly put, it is not about, at this time, restricting indexation, differentiated ways of control or any other approach. Obviously, all of that can and will be greatly welcome, especially to medium and long terms. However, this speech requires a secondary connotation, absolutely secondary, because the fact is that focus is on cutting expenditures. Period. We are enthralled with an estimated *deficit* of more than R$ 170 billion – which makes the Country absolutely stranded, when in reality we need a *surplus* of more than 3% of the GDP.

Keynesian principles have long informed part of the budget formulation of the Government, wherein revenues are estimated and expenses are fixed (which reminds us that the budget is a authoritative mechanism not a normative one). Thus, claiming that the target of primary result increases the volatility of the economy by its pro-cyclical nature (when revenue increases, expenses rise along, and when it decreases, expenses are reduced), in contrast with the target of spending (where the expenses are fixed and, if the economy will improve, revenues increase, the result enhances and the Fiscal Policy becomes anti-cyclical, and - otherwise, if the economy fares poorly, revenues drop, spending is maintained and Fiscal Policy acts as a buffer) it does not seem plausible, and much less useful to what in fact we need at this time. We need less lip service and more action, there is no time to lose.

The naked truth is that fiscal figures do not leave doubts about the horrific legacy of the previous administrations – with or without crazy ideas. Keynesians or whatever they are: we spent much more than we could, and worse, we spent tremendously badly. Now the bill has been issued and we have to pay for it. And this payment cannot be made through more taxes, but by eliminating erroneously conceded tax relief and other perks bestowed upon specific sectors considered to be "vital".

Only with this control on spending in place will we be able to have a more solid economy, and with it some room opens up for lower interest rates (note the cyclical virtuous effect!) – main item of expenditures, and thus with more economic predictability, confidence, volatility… finally, an investment-friendly environment. Everything is necessarily tied to fiscal adjustment… economically speaking, forget the rest!

International Environment

The Composite PMIs of the most important economies in the world, the Eurozone and Germany, retreated while in India it moved forward, with highlights to the PMI of Services. On other hand, in Japan the PMI of Services has contracted, signaling a resuming contraction. In China, the Composite PMI has slightly retreated, but as a counterpart the PMI of Services advanced, according to research disclosed by the Caixin Media in partnership with Markit Economics, pointing out that the Chinese services sector has expanded in a slightly stronger pace in comparison with the previous month, thus eliminating part of the contradictions of the figures shown in July.

The FED also had its highlight moment in the month, since all of the world expects for an eventual normalization of the Monetary Policy, one that *never* comes. This time expectations were leaning more strongly toward the increase of interest rates later this year, but with “bad figures” of the report of employment, such a conviction has lost power and the interest rates (especially in Brazil) and exchange rates (in the world at large) did some re-accommodation.

On the other hand, expectations within the month focused the preparation for the meeting of the G20 in China – in Brazil, spotlight shed on the President Temer’s traveling soon after the impeachment of his predecessor only to be in his first photo at the meeting, while on the American side President Obama will have his last take on the event and, obviously, he wants to leave a mark.

The G20 started originally as G7 with the objective of coordinating global programs of economic policy, and this time it was convened to attempt, among other things, to define policies destined to encourage the economic growth and the employment and, especially, to suppress the mounting wave of anti-globalization sentiments. What is more curious about it? It will be held in China, exactly the country sponsoring heavily criticized practices and policies – movements against globalization, protectionism, etc. Although it is not only China, the Brexit is an unequivocal turn toward ‘isolation”, the increasing movement of the ultra-nationalist parties, hostilities to immigrants and even the expansion of the ISIS add up to the event’s agenda.

Where is the way out? Scrounge for resources to foment programs of development, promote global movements of inclusion and of economic openness … what is the ever-present problem? There is lack of resources… today more than ever… and the most important? Part of this movement is genuinely popular, and requires their politics (domestically) to run against what the G20 will debate.

Interest Rates

Former President Getúlio Vargas' suicide, the resignation by President Jânio Quadros, the fatal accident on the *via Dutra* with the president Juscelino Kubitschek, the plane crash with presidency runner-up Eduardo Campos and the Impeachment of the President Dilma Roussef. What all of those facts have in common? Every one of them happened in the month of August. It is certainly an odd month for Brazilian politics.

Political events, coupled with economic ones, have influenced the movement of the future interest rates curve. Throughout the month, markets worked under anticipation of the impeachment and in full-attention mode to the attitudes by the interim President Michel Temer. Each "goodness package" given led the market to accumulate premiums, in a rerun of the beginning of the month. After some days of low volatility, the market reacted to declarations by the vice-chairman of the FED, Stanley Fischer, that the American interest rates may be raised twice yet this year. More premiums. And as some investors preferred insurance against any risks, on the eve of the impeachment, they sought after hedging operations with interest rates contracts, thereby pushing up rates. Once the impeachment was officially announced, even with the maintenance of the political rights of the former president, interest rates gave in, but not to such an extent as to make up for the consecutive highs of the month, especially on longer term vertices. We need to wait a little longer.

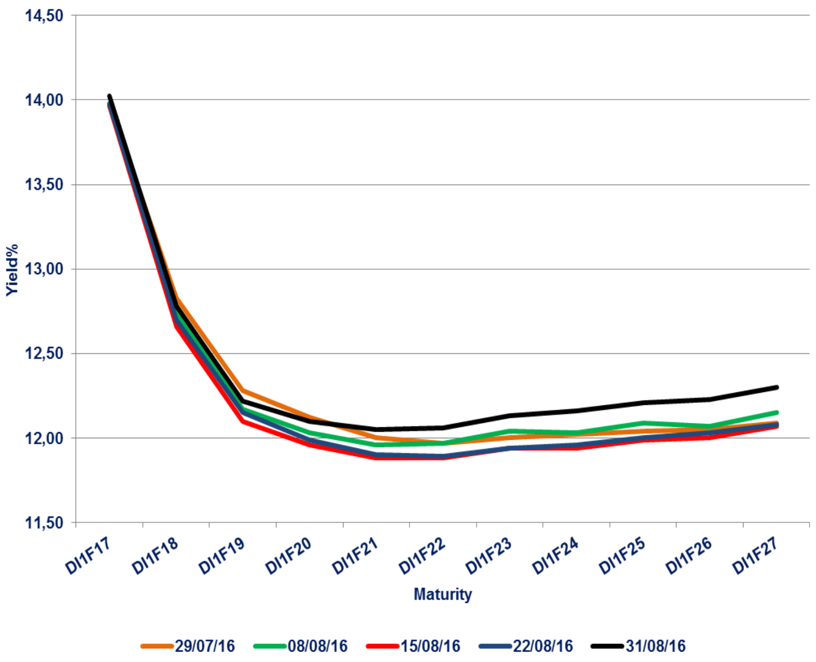
As for the FED, economists have leaned toward the expectation of an interest rate hike – in accordance with what was noted previously. However, the faltering posture of the American Central Bank hinges on some data as, for example, the poor GDP on second quarter. The market convulsions caused by the decision of the United Kingdom to leave the European Union raises the concerns that the American economy might be sliding back into a slowdown… jokes apart, this one was real news aired on the market place… Brace yourselves!

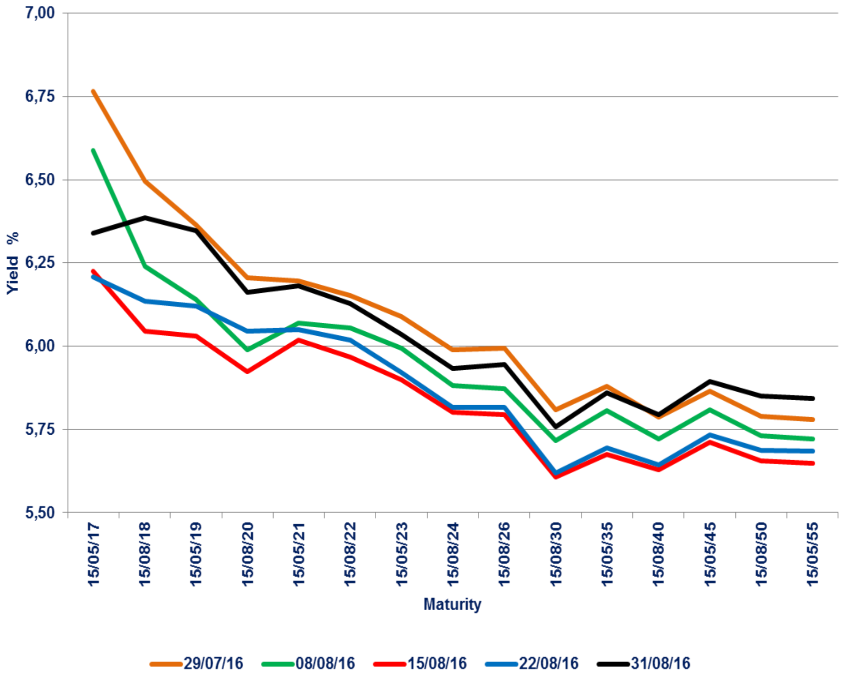
The Central Bank of Brazil for the ninth consecutive time maintained the Selic rate following the COPOM meeting, held at the end the month. The majority of the economists of the financial market, including us at Redwood, duly anticipated the decision. Although the release has shown a "dovish" mood making way, according to some market players, for a cut of the Selic in October meeting – not for us, the only possibility would be of a one-time reduction at the last or penultimate meeting of the year. To the Central Bank the Brazilian economy has stabilized and begins to give signs of recovery, an understandable position, but far from the reality we envisage. On the inflation side, it is still pressured due to food prices and, anyhow, the maintenance of the Selic ratifies the understanding of the institution that, despite more optimistic "convictions", the sense of responsibility of the new team representing the COPOM is straightforwardly admits that the inflationary control (short and medium-terms) is still far from the ideal.

It is good to see a BACEN more honestly committed to the reality of the facts and the dynamics of the economy. Yes, the higher interest rates will anchor future inflation and, as an effect, will shift downwards the term-structure, especially the longer vertices. It is really the right path!

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

The chairman of the Central Bank, Ilan Goldfajn has repeated not to follow any targets for the exchange rate, he is not looking to stablish a floor for the Dollar quotes and aims at reducing the volume of the stock of exchange rate swaps. If the Central Bank wanted to signal the intention to establish a floor to the Dollar, the intervention would have been even sharper, including the spot market – this latter being of greater impact and without the idiosyncrasies of the future markets for the Dollar, as we have had discussions on this matter in previous reports. The appreciation of the Real clears the way for the BACEN to speed up interventions on exchange markets, via contracts of reverse swaps and thereby reducing the stock. The daily auctions of US$ 500 million became US$ 750 million. However, at the end of the month, with the possibility of a hike in American short-term interest rates the dollar picked up and the BACEN reinstated the pace of US$ 500 million/day. Bottom line, it doesn’t matter much… by the end of the year (sooner or later) the slate will be wiped clean, from then on we will see - God help us! - a more freely “floating” market. Overall within the month the dollar appreciated 0.04%.

On the other hand, actions taken by central banks in developed countries, from cutting down interest rates (some to negative values) to injecting further monetary stimulus (via asset purchases), all led to a highly liquid international marketplace which boosted expectations of greater capital inflows heading toward Brazil. Foreign investors’ enhanced confidence in the announced macroeconomic adjustment makes way for more durable inflows beyond speculative capital. And we must not forget that Brazil currently has one of the highest interest rates (14.25% p.y.) and investors do take advantage of the interest rate differential, borrowing resources at low rates only to revert them onto a higher one (carry trade). In this sense, this reinforces our vision of an unequivocal tendency of a strengthening Real.

Throughout the month the American currency got to be negotiated at BRL 3.115 (intraday on the spot market), the lowest level since July 2015. This movement begged the question: will the dollar undershoot against the Real in the short or medium-terms? We at Planner Redwood believe that it will: there is space and plausible justification for a Dollar dropping to BRL 3.00, in the short term. Simple equilibrium models show it, the relation among interest rates, inflation and also the perception of risks (via CDS) supports this analysis… although one shall not overlook the eternal imponderable, always sneaking up to ruin everything. After all, we are talking about the price of the Dollar…

Anyway, the landscape has improved handsomely; the Exchange Rate Policy seems to get on track… or so we wish!

Stock Market

The Ibovespa closed the month at a 1.03% high supporting the movement of the previous months. The first fortnight was more positive with the valuation of the main commodities and the advancing process of impeachment. The main pillar of the Brazilian Stock Market still is the inflow by foreign investors. The Brexit generated great uncertainty in one of the most stable economies of the world. Amid uncertainty, portfolio diversification becomes even more important and, in comparison to other markets, Brazil has a robust, extensive and well-structured marketplace. Foreign reserves are high and there is no external credit constraint. With it comes a great possibility of foreign funds raising their exposure to Brazil, depending on the government's efficiency and effectiveness in achieve a long due fiscal adjustment. Reforms are essential for the country to get credibility and trace the path of growth – this is the only way for the revamping of companies and recovery on the real side of the economy, which unfortunately answers to a much slower dynamic than it is desired.

However, despite the claim above, the stupendous performance of Ibovespa until now is not expected to take place with the same intensity in next months until the end of the year. A great part of this movement was due to the expectation of impeachment (now consummated) and an international market slightly improved, although expectations about companies (the real side of economy) are still to be ratified with some recovery of activity, increasing profits, etc., and therefore a possible new round of increase of the Brazilian Stock Market main index.

In short, there are yet many uncertainties about the efficiency of the Government in passing and implementing much needed measures of adjustment and, therefore, therein lies a factor of high volatility. For an index that evolved almost 34% up to now, in general terms, the asymmetry seems quite reasonable for the short run. For a sight extending farther into the long term and with rigorous selectivity, it is possible to find some good premiums, depending on the investor's appetite for risk.

Finally, we can also see the extreme importance of the new economic policy guidelines that we hope be made effective henceforth. And as the expected, things are absolutely interconnected, and a successful new economic policy will come in medium and long terms – unfortunately the damages promoted in recent years were very deep and of enormous magnitude. Picking up and fixing things, as well as restoring good practices, will take some time. However, undoubtedly the positive effects of such measures will reflect on the valuation of Ibovespa.

Otherwise, on the hypothesis of frustration of measures and/or perception of the Market – be it a deficient will of resolution in practice or a dragging implementation of measures… as it said in the market: the assets will be on the price, or will adjust to the new level of normalcy.

Very simple…just like that.

Monthly Commentary

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