Planner Redwood Asset Management

MONTHLY COMMENTARY

DECEMBER 2015

Monthly Commentary / DECEMBER 2015

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

“Why does a public discussion of economic policy so often show the abysmal ignorance of the participants?”

Robert Solow – American Economist

Introduction

The year has finally come to an end and, along with it, came significant changes. Among these we can cite Minister Levy's resignation, which was, in fact, already long past due. For almost one year as chair of the Finance Ministry, we were fervent supporters of his nomination and complimented a most welcomed shift in economic policy – he was the savior of the day. However, the past four months witnessed a change in opinions with us actively criticizing his measures, not concerning his ideas and proposals, but for a feeble posture when push came to shove, which made him the "court's clown". The most awaited shift in policy never held up, President Dilma has never in fact genuinely supported him and the Labour Party and its allies – including members of the economic team – alwaysly "sabotaged" his efforts towards greater austerity. He was at error when trying to hold on to his job and has thus made a great disservice to all of us, let alone smearing orthodoxy's name as the required salvation approach. He was the best, no doubt about it – above all for a position that **MUST** be filled with eminently technical personnel and **NOT** political. Once he noted the unfeasibility of his economic policy, he should have jumped ship as soon as possible so we could face the hard alternative that seems to be rising and pointing to its last consequences. Many things hinge on timing… he made a grave mistake… Brazil has lost much, notably because his ideas never came to fruition, and more, were wrongly understood – by many of those who are constantly heard upon the country's economic paths – as the "culprit" of our current troubles.

Nevertheless, as the saying goes: "*when it rains it pours*". The new Finance Minister is the former Minister of Planning Nelson Barbosa. He is much more aligned with the President mode of thought, for his past, and has taken over with a "continuity" speech, albeit at a slower pace and with milder dosages. Hardly convincing. Nelson Barbosa has already been part of the government, took part in the ill-advised New Macroeconomic Matrix, was responsible for submitting to Congress a deficited planned budget (which bestowed upon us the investment downgrade), confronted his predecessor in his almost every move, aimed to "justify" the creative accounting approach while also proposing the fiscal adjustment by setting up tolerance bands instead of precise goals. No, we won't have what Levy sought after. At any rate, let us give the new Minister the benefit of the doubt and wait for the traditional first hundred days and then reassess. Expectations are high, but the "educated public" evaluating economic policy is diverse and heard. Robert Solow was right in his doubts.

Levy's great legacy, yet to be acknowledged – which, it is hoped, will occur shortly – will be to signal to the educated opinion-makers that there is no alternative to the country's predicament other than effective effort (i) in controlling and reducing current expenditures of Government, (ii) in reducing the size of the State in the economy, (iii) in withholding undue meddling by the Government in the economy, and (iv) the upfront tackling of the imbalances created – especially that of the Social Security, by way of reforms and the resumption of public utilities concessions on less ideological and more solid grounds.

At the international level, we finally watched the FED trickle its monetary "tapering", the ECB ratify its policy, China's continued promise to stimulate its dwindling economy, and the other emerging economies prepare for the challenges coming along with the year 2016. Exception must be made to India, which is prospering and has reason to celebrate.

In this environment, US Treasuries closed the month at 2.27%. S&P varied -1.75%, NIKKEI closed at -3.61%, DAX at -5.62%. Ibovespa ended the month with a -3.92% loss whereas the IBrX face -3.79%. Highs for the DIF16 at 14.16% and DIF17 at 14.135%. NTN-B 2050 closed at 7.24% and the Dollar (Ptax) at BRL 3.9048.

Economic Activity

Economic policy in recent years has ended in catastrophe: GDP growth in 2015 will be close to -4%. Beyond that, in 2016 a new contraction around -3% or even less is expected. It is truly a hecatomb without precedent in the last 80 years with all its reflections in every segment of the economy. Everything could have been avoided if it weren't for the policy implemented up until 2014, that is, the origins of the current crisis has a name and a date of birth. Its origins are fiscal in essence, but its unraveling and patching-up adjustment measures - and most times with extraordinary incompetence – were coupled with corruption scandals, turning this crisis into a political one.

The search for the culprits and their motives cannot be interpreted as a counterproductive exercise. We have lived other moments in history where developmentalism and populism has cost us a great deal. We have also experienced what is the proper homework to be done, and we must face our misgivings and identify our mistakes so as not run the same path once again. We are lying in the bed we have made ourselves. Bottom line: there is no easy way out and, yes, we will have to make costly adjustments for having acquired more than we could afford. We had every chance of adjusting when tailwinds (terms of trade, especially) were available – we opted not to do it. Any attempt at smoothing this transition with milder dosages of the New Macroeconomic Matrix – or the so-called twist to the Left – will drive us down to final debacle, endlessly postponing the solution to the country's problems.

The stubborn and exaggerated interventionism has led us to where we stand, and the pressure now to present immediate alternatives to restore growth suggest the opposite of what we need. Here comes the yet-to-be-acknowledged legacy Levy has left, but which may inflame the crisis further and force us – surely under much harsher conditions – to implement the truly needed measures. Let there be no doubt: it is not about glossing over the people's suffering - especially the poor – but quite the contrary. The rebalancing of accounts, inflation control and revamping of economic policy will serve the essential goal of restoring confidence and, as a consequence, growth of saving and investments. This is not a matter of which came first, like the chicken or the egg, here we have to act in the proper sequence.

Keeping our institutions solid and sovereign, and the on-going fight against corruption will prove extremely important to economic recovery. Just as an example of the impact on current GDP, out of the 23% the drop in Gross Fixed Capital Formation – GFCF (21.6% average over 2012-2014 to roughly 16% in 2015) 10% are due to recoiled investments by Petrobras as a side effect of the corruption scandal scathing the company. A lower GFCF today means meager economic activity in the future.

Deterioration was swift, deep and apparently will be a long-lasting one – above all because we lost the main flag post that led the right way. In the end, we know we are far from a consensus of how to leave this crisis, but may God help us in avoiding the prevalence of the notion of restoring activity by way of easy credit, selective sectoral stimulus, countering Central Bank's actions (or the continuity of current platitudes sought after by same of the institutions board members) and statist expansionism.

Fiscal Policy

On the fiscal front, it is an extraordinary mess we are in at the end of 2015.

The negative result of public accounts, apart from being a record for the month of November, when added to the cost of the creative accounting procedures (approximately BRL 60 billion) will amount in December to an annual deficit around BRL 120 billion. The diagnosis for the poor number is yet to be known, but the drop in revenues (around 7%) has been pointed out and is couched, above all else, on the recession. We have mentioned in previous reports that management, analysis, control and forecast of revenues seem far from optimum, but expenditures have been cut to meager 3.4%, which is an asymmetry hard to miss.

There is no doubt this Administration's DNA is expansionist, by definition and observation. It could care less for fiscal discipline and relies on the excuse of growth promotion to justify such posture - always. This is the reason why little or almost nothing has been pursued in the current situation and everything indicates matters will remain so: for 2016 the Federal Government's budget stipulates a BRL 30 billion surplus (0.5% of GDP – an outcome of the former Minister Levy's effort, for the current Minister Barbosa had proposed a target based on tolerance bands, under the premises of "realism" and "feasibility" for the moment). The cumulative long-term effects arising from this schizophrenic lavish spending will cost us yet more, and the first and foremost sign of trouble is the upward-spurring Debt-to-GDP ratio. Figures for 2015 are disastrous and will go much further, with new credit downgrading by rating agencies as reflexes of those numbers.

Whereas the seminal source of the crisis is fiscal and has unraveled, among other things, to the political arena, we are living today two simultaneous crisis under a two-sided causality puzzle, that is, the costs entailed by the fiscal adjustment fuel the political crisis and *vice-versa*. The fact is that up until recently fiscal targets were met and there was endogenous growth of revenues (with some positive response on the side of revenue tax collection efficiency) by way of increased registered employment, extraordinary revenues and fundamentally the strong positive externalities engendering significant tax flows on imports. So much for that; the reality now is difficulty in raising revenues and the rejection of any spending control.

In this vein, if the Brazilian fiscal dynamics relied upon the abovementioned aspects and was, still, vulnerable to the economic cycle – notably reliant on sales taxes – we must underscore the downward rigidity of government expenses. As this issue is not subject to swift solutions, especially amid a continuous economic contraction, one must assess the possibility of raising the tax burden, despite widespread opposition by society in general.

All of this has a purpose: improving on the debt-to-GDP ratio leads to better evaluation on the country's solvency, which in its turn restores investors' confidence and their resources. The path to follow will be exigent, for mistrust invited by the current administration's actions will require extra effort to admit its mistakes and assure the option for the right way forward. Any further reluctance will drown us definitively… otherwise, only a newly appointed administration will do.

International Environment

The international outlook was overtaken by the threat coming from poor indicators and new policy announcements of the Chinese economy, and from the monetary tapering by the FED, particularly for the emerging markets.

According to official data, the PMI Manufacturing for China has risen from 49.6 to 49.7 in December/2015, which signals a mild thrust up by the second largest economy in the world, albeit having fallen short of average projections by analysts. In general, PMI data reflect poor performance in other sectors of the economy. Therefore, for instance, in November, Chinese foreign currency reserves dropped more than expected and exports have decreased for the fifth consecutive month. Expectations point to China cutting off its interest rates starting in January 2016, reducing its reserve requirements on the banking system and raising spending on infrastructure in an attempt to remedy high financial leverage of households and firms and the economy's resilient weakness. Such "desperation" should not come as a surprise, for studies have reiterated the trajectory towards a lower average growth rate around 4% for the next decade!

In Europe, especially the Eurozone, the PMI Composite (manufacturing and services) rose from 54.2 in November 2015 to 54.3 in December 2015, reaching the highest level in four months and for several months above 50 points (a bar separating expansion from contraction). The rise can find two immediate interpretations: (i) expanding activity in the Eurozone at a faster pace and (ii) ECB's policy is on the right track. Could it really be any of these? At any rate, one of the ECB's council members , Peter Praet, states that there is no plan B, that he sees no alternative to the monetary stimulus program, although the latter has not accomplished boosting inflation in the region. In this line, the ECB has informed the continuity of EUR 60 billion monthly purchases worth of assets – mostly sovereign bonds – until no earlier than March 2017, hence six months beyond previously foreseen, and that this program can be extended if necessary. His mindset goes as follows: "If the ECB had not taken such measures, we would be in a depression by now", said Praet. "The ECB did what it had to do, but monetary policy cannot solve all sorts of problems". He is right: complementary policies do help much. But we all know where this "help" will lead to, but how hard it is to follow a different route. It is a re-run of FED's policy under Bernanke and his *Courage to Act* making disciples, despite outstanding differences between economies and, in the limit, the 7 years required to restore US growth.

As for emerging markets, India seems to indicate faster growth than the one recorded in 2015, despite possibility of a mild slowdown. That is not all, for the country still gathers the best performance perspectives and seasoned economists have demonstrated that the country may enjoy 7% yearly growth until 2024. Should that ever materialize, India is likely to overcome China… they did their homework!

In US, time for the truth has arrived – interest rate hike came trickling as expected, and gradualism seems to be the selected approach. Everything seems unanimous around there. Stanley Fisher, vice-chairman of the FED, believes measures to be adequate, and in Williams's view (chairman of San Francisco FED) interest rates can rise 3 to 5 times in 2016 if the economy resumes its current pace and expected escalating inflation. We at Redwood, also believe that this are the measures the FED will put in place.

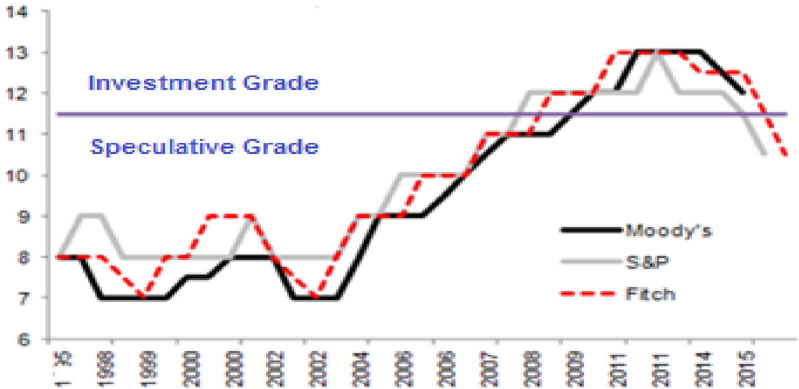
Interest Rates

We started out 2015 with some hope. A tough year lay ahead of us but we could anticipate some recovery by the end of the year. Honest mistake. The steepness of the crisis and the sharp deterioration of Brazilian figures were striking.

We close the year with a second credit downgrade. Fair enough! Fitch Ratings demoted Brazilian bonds to junk status (from BBB+ to BB-). Additionally, Fitch announced a negative bias, indicating a new downgrade should the country eschew necessary reforms in economic and political institutions. Fitch's decision came as no surprise to the market and now we await Moody's revised assessment. Therefore, 2016 kicks off with little uncertainty (or distractions) regarding credit rating matters.

Investment downgrade by two consecutive financial watchdogs cuts off access to foreign investments, especially from financial institutions, constrained to acquire only "investment grade" bonds by companies or governments. We are left with short-term and speculative investors seeking for high returns and willing to face greater risks.

On the fiscal front, as detailed above, market pessimism towards Brazil has worsened after the fiscal target for 2016 was reset, particularly due to the "homemade" solution of appointing Nelson Barbosa to lead the Finance Ministry, raising still further uncertainties on the grounds of his academic and professional and historical profile, when conflated with his predecessor.



Source: Globo/G1

In December, these events shifted upwards the term structure of the interest rate in response to greater premium requirements. Within the year, the interest curve increased premiums in all vertices. Contracts with short maturities reflected successive inflation countering rises in the SELIC rate. The effort was in vain, for rises had to be far greater to keep inflation close to target. Longer maturities in their turn hiked in response to political and economic unrest and higher country-risk. Bottom line, there is hardly any way for future interest rates to drop before our problems are solved. And doing so requires anchoring expectations of future inflation prior to any tampering with interest rates.

Interest Rates

On this note, we find ourselves mired in an announced conflict… in reality, more of the same: the imperative coordination of fiscal and monetary policies. On one side, we have made clear how the spending control will play out and, on the other, the Central Bank's mandate to control inflation requires (always!), under inflation targeting regime, a rising interest rate. In practice, the latter has the further aim of balancing the dynamics of S≡I, but also of acting upon three distinct but complementary transmission mechanisms of monetary policy, in short:

- ✓ Credit
  - More expensive credit curtails demand, thus raising idle capacity in the economy.
- ✓ Exchange rate
  - External/domestic interest rate differential attracts foreign investments, leading to BRL appreciation and falling prices of tradables.
- ✓ Expectations
  - Most important of all, demonstrates commitment to bring inflation closer to targeted rate (anchoring).

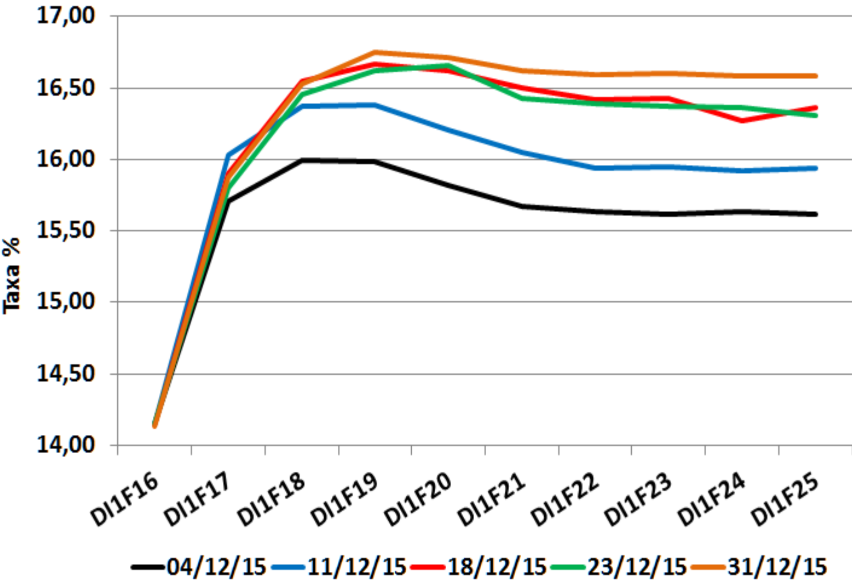
Credit and exchange rate may have different reasons and relative priorities to be tweaked due to other variables (i.e., international landscape and economic performance), but Expectations do not. This latter forms, in conjunction with confidence and credibility, forms the essence of the Inflation Targeting Regime adopted by the Central Bank. Credibility which this latter has thrown in the trash, be it for its "autonomy" or for its "flexibility of intentions" and resilience to the politically necessary.

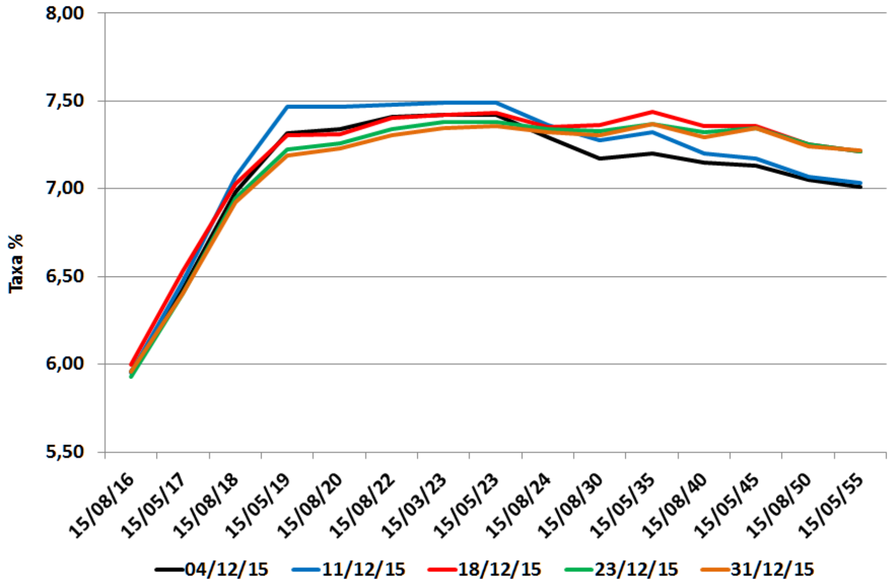
One way or another, the Central Bank knows it is not fulfilling its role and will have to justify the reasons behind its inefficacy in controlling inflation. As a response to this, the institution has made renewed communication efforts that it is committed with achieving the target and that it will raise interest rates even in the face of conflict with the Finance Minister Nelson Barbosa. Poor guy, his chances of raising interest rates are feeble, especially with a low GDP, growing unemployment and the diminished of President Dilma in an election year.

To alleviate the situation, the commander-in-chief - the President of the Republic- will step forward and play the rules In this fashion, with intellectual and professional servitude and crowned with the administrative and operational limitations upheld by the Central Bank, there is zero change of any such conflict. And if this is so, odds are everything will go wrong. Again.

Interest Rates

Yield and Cupons Curves (NTN-Bs)

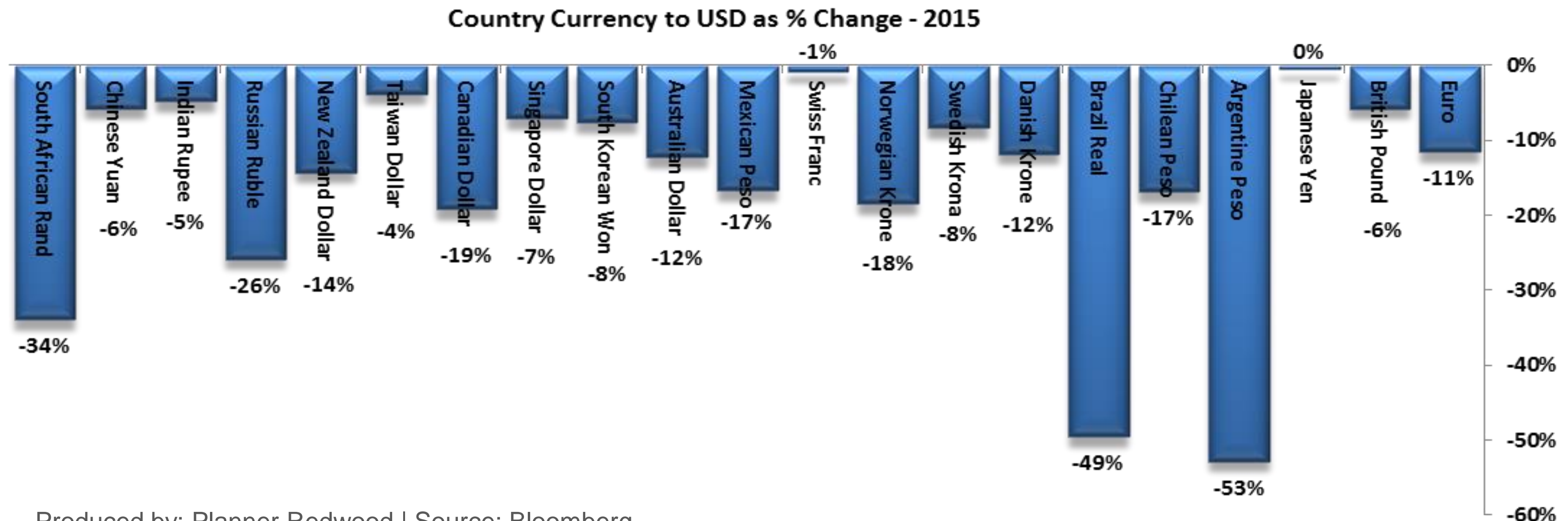




Foreign Exchange

The unstoppable forces of supply and demand as determinant of equilibrium prices of a good has occasionally defied our intuition and lead us into looking in more detail other variables that may be disturbing this relationship in the short run. The foreign currency flow of the country in 2015 has a net positive result of USD 9.4 billion, the greatest result since 2012, when the incoming amount of dollars overcame that of outflows in USD 16.7 billion. In the last two years, outflow run ahead of inflows, leading the BRL to a almost 50% devaluation this past year alone. However, let us seek into some of the details provided by the Central Bank: the financial accounts can be seen as the downside of this story, for within the year 2015 there were net outflows of USD 16.1 billion through the direct and portfolio foreign investments, profit remittances and foreign debt servicing, among other operations. In these latter, inflows added up to USD 522.7 billion and outflows USD 538.8 billion in the same period. Therefore, the outflow of currency by the financial channel was 20% greater than the one observed last year, despite the accumulated result within the year having ended on the positive side – due to external trade that ended the year with a trade surplus of almost USD 20 billion. Is it good news? It is hard to say. Controversy runs high, above all because this outcome is a direct consequence from the new level of the exchange rate.

Therefore, no economist in their right mind could anticipate, in the beginning of the year, a devaluation of the BRL of almost 50% in 2015. The so-called carry trade was negative, which is rare. Forecasts considered the Minister Levy could improve the economy's figures and that the currency would suffer some loss due to external issues. However, our ability to self-destruct fueled an avalanche of negative news in Brazil that steered the BRL towards rock bottom. The year has ended with sovereign risk above 500 points and with the USD quoted at BRL 3.96. Worldwide currency variation can be found in the chart below:



Produced by: Planner Redwood | Source: Bloomberg

Foreign Exchange

But the worst was yet to come. If the BRL was liable to all sorts of domestic and external shocks, the exchange rate policy run by the Central Bank aimed at controlling currency volatility. That is right, the idea was to provide agents with enhanced foreseeability. Volatility for the years 2012, 2013, 2014 and 2015 were, respectively, 9.93%, 10.96%, 12.26% and 19.09%, with volatility add factors of magnitudes of 10% in 2013, 11.9% in 2014 and 55.7% in 2015.

Results are humiliating, and against facts there are no arguments to be made. At any rate, what the Central Bank did was but trying to (and it did!) intervene in the market with the exchange rate swap operations (sales of currency in futures markets) and the line auctions. What a disaster!!! Losses with such operations have amounted to record levels: BRL 89.66 billion. This sum further aggravates the nominal deficit of the federal government, particularly for they are added to the service on the public debt. Once again: the result of such atrocities does not remain in the Central Bank's balance sheet, it goes to the Treasury! It is worth reminding that the deterioration in figures related to public finances was one of the triggers for the investment downgrade. Even so, the government seems to brag about the untapped foreign reserves. There must be a limit to everything and a detailed explanation of the net effect of these actions is yet wanted – for they have not begun in 2015 but have been there for some time. The Central Bank's autonomy is a desired feature, but controls, accountability of its actions and the results of its operations must be set in place.

The exchange rate swap contract is a financial bond between the Central Bank and the commercial banks, where the former faces wins if ever the interest rate in BRL outpace currency depreciation, whereas it loses when the currency devaluation overcomes interest rates denominated in BRL. Simple as this. In its defense, Central Bank reafirms that the losses with such operations are more than compensated by gains with the appreciation of the value of foreign reserves – which amount to three times the current stock of swaps. But the story shall not end there, for as mentioned before this impacts the debt servicing account, thereby fueling the federal nominal deficit. Professor Edmar Bacha has once taught us that *“the paradox has to do in part with the concept of public debt adopted by the government. By mixing the accounts run by the Central Bank with those of the Treasury, the government defines public debt only as the share of Treasury bonds out in the market. The Treasury bonds held by the Central Bank do not count as public debt unless they are supporting the operations with a repurchase clause (repos). These operations consist in selling bonds by the Central Bank to the market with the commitment of a future repurchase”*. However, one more of these Brazilian idiosyncrasies can be easily adjusted, sufficing to adopt an international standard definition for gross debt, that is, to account within this concept for the Treasury debt as whole, both that in the hands of the Central bank as that in the hands of the market, or yet, to treat exchange rate swaps as a deduction for foreign reserves. Certainly, there must be something more between heaven and earth…

In any way, if we let go of the accounting procedures, what is left are the adequacy of using such an instrument (when, how and in which intensity) and the effective capacity by the Institution to operate it. We have several other costs involved, but the principal one would be for the Central Bank to dare to imagine, if not for an instant, it is less efficient than the market; that its intrusions should be kept to a minimum and that the Dollar is but another price in the economy.

Stock Market

Three years running low… no investor can take it! In 2015, the Ibovespa retreated some 13.31%.

The Brazilian economy has lost its capacity to produce with quality, efficiency, wise cost and competitive price. It is a myth to believe that external demand will boost growth. The country needs urgently the following: (i) structural reforms, (ii) reduced interventions by the state, (iii) improved relation with the private sector, (iv) to cut down subsidies for selected sectors, (v) the end of subsidized credit, among other measures, to become truly competitive. It is not up to the BRL devaluation to solve our low productivity problems. Brazilian GDP has stagnated in 2014, will fall almost by 4% in 2015 and the projections for 2016 are 3% on the negative side.

A look at the stocks composing the Ibovespa, few have ended the year on the positive side, with highlights going to some exporting companies that managed to benefit from currency devaluation and from increase foreign demand. As a counterpart, commodities-producing companies such as iron ore and oil were doubly harmed by the drop in prices and in demand for these assets in the domestic and international markets. And what can we say of the infrastructure companies, many of which are involved in the operation ”Lava-Jato”? We’d better wait for developments on this story. To make the financial situation of these companies even worse, it was not only Brazil that lost its investment grade, but many companies were also labeled as (junk) speculative investments. Brazil has ended 2015 with only 14 companies classified as investment grade. The raging economic crisis was amplified by political difficulties discouraging companies from actively engaging in new investment projects in the country. Both investment downgrade and the change of guard in the Finance Ministry remove incentives for foreign resources to seek productive applications. With all that, what will be of the Brazilian labor market? In short: rising unemployment.

The new Finance leadership and the apparent change in economic policy will only instill further insecurity to investors and entrepreneurs. On the political side, President Dilma seems to have gained some room to catch her breath and the support from many leftist groups reduces the odds in favor of an impeachment. By every indication, the worst is yet to come. In this environment, it should be hard to find an entrepreneur willing to invest.

At any rate, if the real economy is in free fall with all the consequences it brings to Brazil, including the Brazilian Stock Market, it is convenient, however, to take a close look at some companies so that, with an eventual political resolution (this is the only adjustment able to bring some relief in the short run) expectations can be radically reverted, and with them a new environment. A landscape that would certainly take time to settle in as benign, but we also know how the financial markets would anticipate such event.

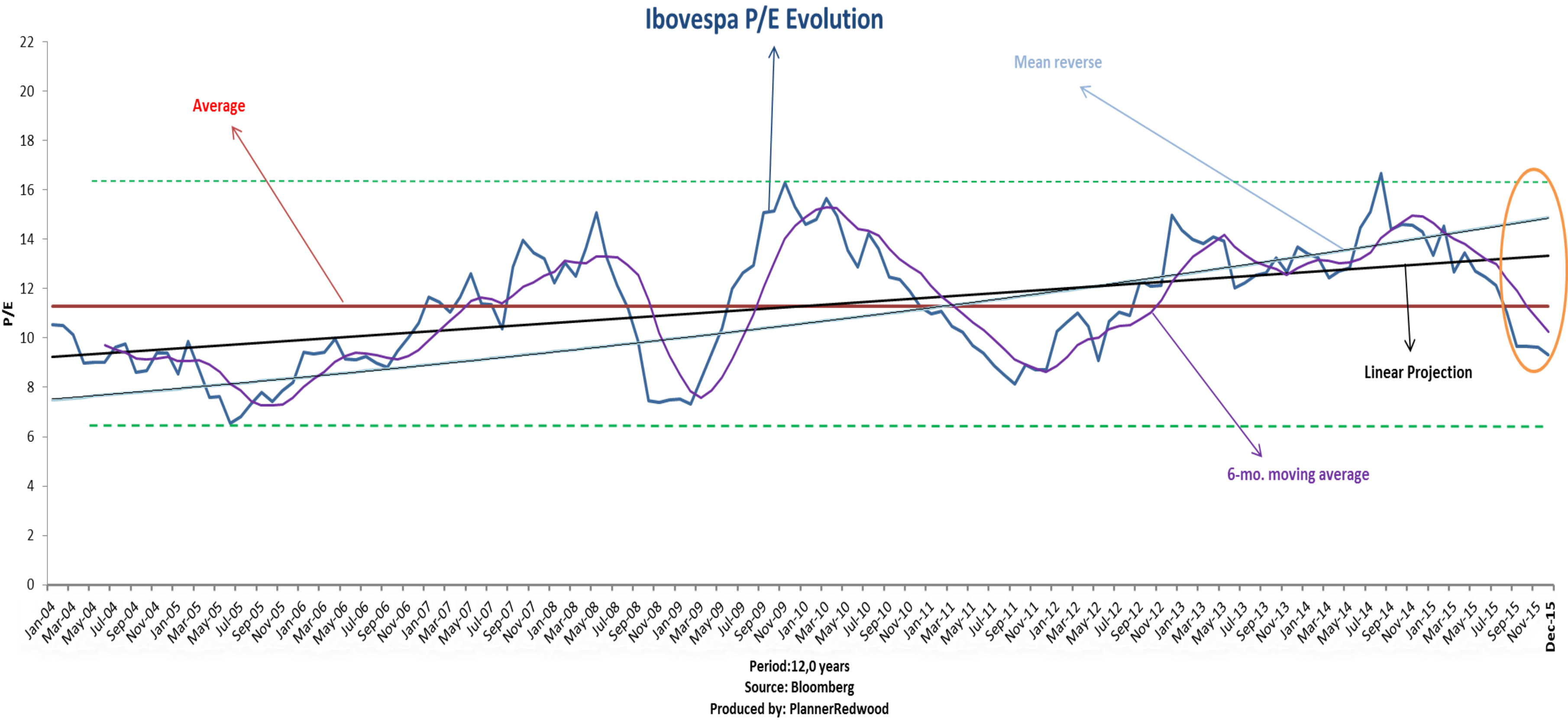
The next two slides reiterate our statement above in terms of an overall price for the IBOVESPA, but only in case a reversion of expectations take hold… otherwise, it will remain “cheap” or drop even further.

Stock Market

Ibovespa in USD terms

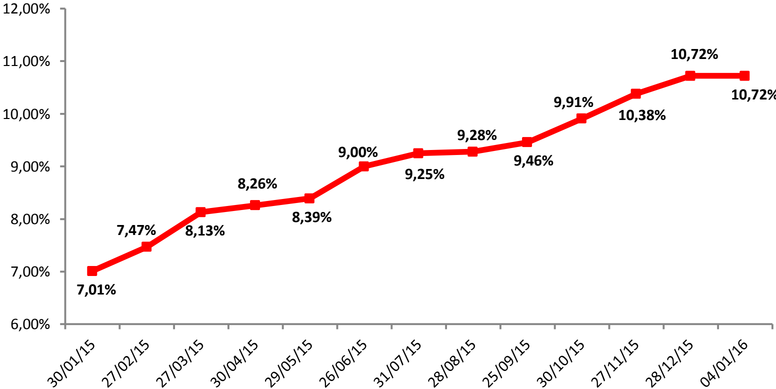
Stock Market

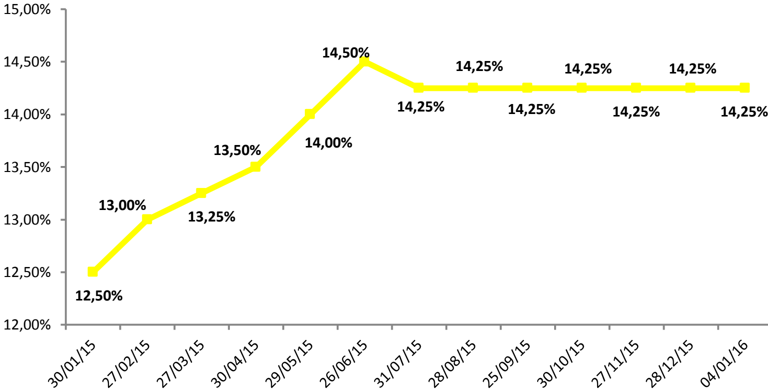
Ibovespa P/E Evolution

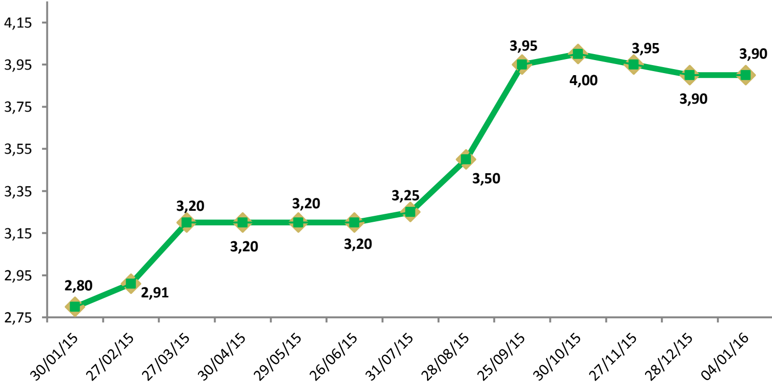


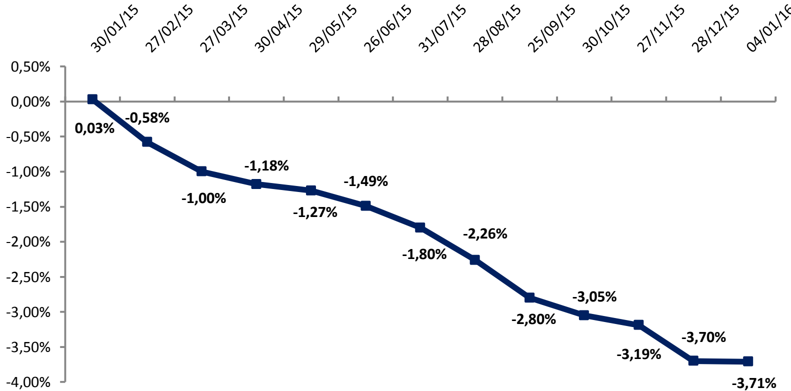
Overall Analysis

2015...Deterioration (Source FOCUS)









Monthly Commentary

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