Planner Redwood Asset Management

# MONTHLY COMMENTARY

DECEMBER 2016

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## Agenda

- Introduction
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- Fiscal Policy
- International Environment
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- Foreign Exchange
- Stock Market

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## *Epigraph of the month... a propos of Brazil's current predicament.*

*"Optimism is the foundation of courage."*

*Nicholas M. Butler – American Philosopher*

# Introduction

2016 has finally come to an end!!!... and as the Portuguese saying goes, “there is no ever-lasting bliss nor an unyielding dismay...”

2016 was indeed a challenging year and has also brought disquiet to the human spirit: feeling of uncertainty. Our world was eclipsed – internally and externally - by this state of affairs added to the startling incompetence of PT which have unequivocally led the country a step closer to its “venezualization”. Brazil “has broken down” in many senses… our crisis is both wide-ranging and deep-seated. Brazil has treaded throughout 2016 at a fast pace toward discontinuity of its dearest foundations. But things have changed… and for the much better. We’ve exited the highway to hell. Dilma Rousseff’s replacement by Michel Temer (with all his remaining “accolades” from PT that came along) refreshed the cabinet with newly incoming Executive managers that dawned upon the Administration. Matters are still tough, but there is a new chance. Our assessment is that the glass is half full rather than half empty.

There are several reasons to be optimistic, despite our prognostics, especially carried out at the end of the year. If among our crisis the political is the seminal one, with impinging consequences on the Brazilian economy, uncertainty can linger on, but events such as the Car Wash probe and the general demeanor of our institutions seem imbued with the “duty to resolve”. One could add to the latter the countless measures/reforms in course and others made effective in the first six months of President Temer.  Demands from society are huge and urgent, but reconstructing the country will take some time and courage to persevere. By this reasoning nothing is more assertive than what Nicholas Butler reminds us of in the epigraph to this commentary: *“Optimism is the foundation of courage.”*

Worldwide, the year of 2016 was not too generous either, be it in politics or in the economy – with some promising events (as we see them) for each people, such as BREXIT and Trump’s election in the US, both with catalyzing effects of political changes, especially in Europe. Obviously, these two events are highly controversial, for they are positive in their own right, but, on the other hand, it is consensual that they will raise a new order for countries “relying” on the US and the UK.

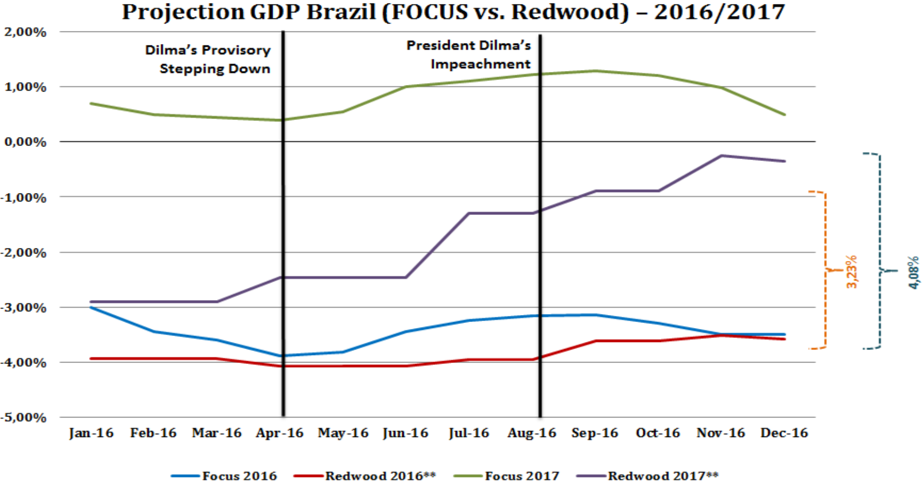
We enter 2017 under a new era, definitively. There is indeed the possibility of a polarization of ideas and imbalances (commercial, political etc.) among nations, but this seems to be the path (so chosen democratically by citizens of the US and the UK) toward a new, and perhaps dynamic, equilibrium level. The autonomous decision by both countries will affect the world. This new moment points to an opportunity for a collective adjustment, for the topic of inequality will be, as it never has before, brought to the fore, both politically and academically. 2017 ***will not be** business as usual.*

In this landscape, US Treasuries closed the month at 2.45%. S&P varied 1.82%, NIKKEI at 4.40%, while DAX at 7.90% and FTSE at 13.61%. Ibovespa ended the month at -2.71% and the IBrX at -2.55%. Highs for DIF17 at 13.63% and DIF21 at 12.36%. NTN-B 2050 closed the month at 5.7349% and the USD (PTAX) at BRL 3.2591.

# Economic Activity

The chart depicts the forecasts/revisions for growth of Brazil in 2016 and 2017 throughout the whole year of 2016 – this is a usual dynamic and its existence is but a natural aspect of data collection. As time goes by, the available information set increases and thus there is a natural convergence of projections toward the former. However, this explanation does not suffice our needs, for economic agents have to make decisions in real time and revisions are sometimes too large, which implies serious limitations for decision making.

The variables of GDP and output gap are of special interest, once they affect several decisions regarding investments, consumption, financial investments and even Monetary Policy (however through indirect channels, that is, whether we'll grow above or beyond potential). As regards this item specifically, forecasting models have not been too generous, be it for their volatility or the direction the variable was taking. *Ex-post facto* everything seems easy to explain, invoking whatever fits… that's what happens.

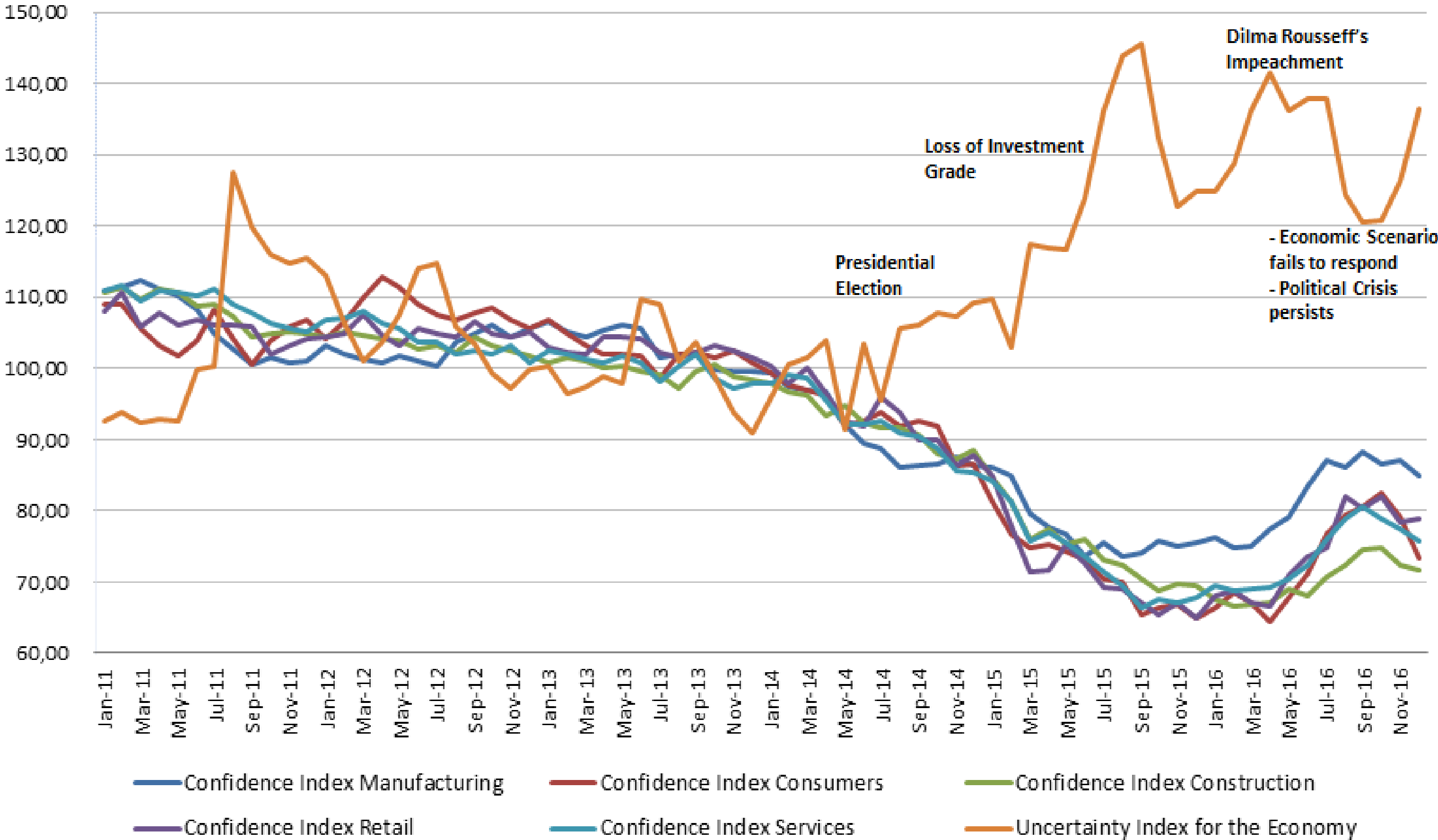



Source: Focus Bulletin – Central Bank of Brazil | Elaborated by Planner Redwood

Therefore, in the relevant front of analysis, our GDP projections for 2017 have always been on the negative side (albeit with important variations) – in stark contrast with forecasts run by the market, always much more strongly optimistic than our view, which were not only running on the positive side, but far above our understanding, running above 2% for GDP in 2017. Gross mistake? Maybe not; only imperfect and asymmetric information, expectations and seasonal factors applied incorrectly and inadequate methodologies for the "moment".

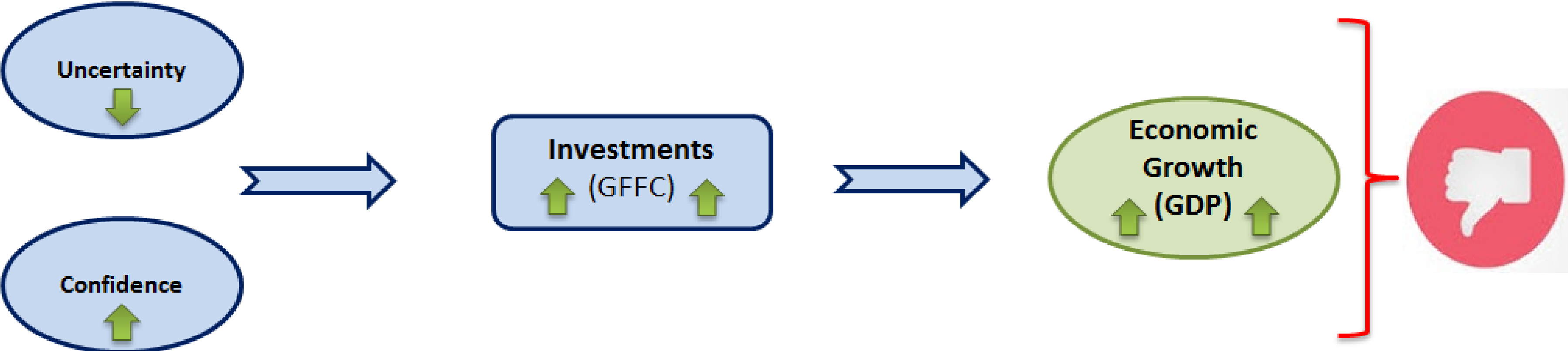
One of the most frequently heard hypotheses (as the market reviews its forecasts) is that improving confidence indexes and lower uncertainty scores would restore investments (Gross Formation of Fixed Capital – GFFC) and, in its turn, to enhanced activity. Confidence indices were understood to be lead indicators, but this transmission mechanism has not pulled through and, before any investment was realized, expectations were frustrated as regards a positive growth in 2017. Charts below illustrate this situation.

# Economic Activity




Source: FGV IBRE | Elaborated by Planner Redwood

# Economic Activity - *(Transmission Mechanism of Confidence and Uncertainty)*




The flowchart states an intuitive hypothesis, but does not fit well in our statistical simulations – possibly in other time windows… or perhaps the reversion in confidence indicators has been too early or of an insufficient magnitude, thereby hindering any investment materialization. In addition market predictions corroborate the idea that recovery would mimic 2010, in shape and form. Neither, firms and households are too far leveraged… in fact, all is different – in Brazil and in the world.

But (relative, at least) optimism prevails, for in the face of the Brazilian economy's meltdown in the last years, predictions see growth of +0.50% and -0.35%, according to the market and Redwood, respectively. It fall short of our needs, but far from negligible, for we are talking about a positive variation of +3.23% as per our projections and +4.08% for the market (Focus bulletin). Recovery will be slow.

If the above is true, at least it is constant and at a growing rate – a gradualism that steers clear of any hasty developmentalist raptures and calms the yearnings of our more adventurous and excited Keynesians. Recovery and, particularly, the traverse of a delicate political moment, both make the economy delay its reactions to "stimuli" of a new economic policy. Interest rate will fall, but its effects will take some 8 months to be felt… and on the fiscal side, as it is, the lag is much longer – however, structural reform (as the one being proposed) is likely to bring enormous benefits.

The risks for this more optimistic scenario are all there, highlights given to the political dimension. Nonetheless, expectations (now adjusted) point out we are on the right path! Estimates for December 2017 will be much better!

# Fiscal Policy

It is clear that Fiscal Policy in the last years accounts the complete destabilization of the Brazilian economy. Likewise, it is beyond any doubt that only a new and responsible fiscal policy is the only way out.

The strategy of fiscal consolidation and especially of structural reforms in due course will bring positive effects to deal with our debt sustainability. If we evaluate this latter according to the solvency index of a country (Debt-to-GDP ratio), sustainability must be controlled with transparency and credibility, in order to demonstrate its evolution on minimally credible and acceptable parameters.

In this line, the application of the Public Expenditure Cap (whose shape and effectiveness have been previously discussed here) in conjunction with the Social Security Reform (followed by Tax and Labor market reforms) will help cope with what the future has in store for us, namely: a long period of fiscal imbalances coupled with budget rigidity. If this comes to be realized, our solvency indicator will indeed rise to hazardous levels, but on a described trajectory, limits in place and perspectives of reversion and improvement – it will be a foreseeable path. It is not the best state of the world, but at least one where assessment and risk measurement and opportunities replace uncertainty – which translates, above all for investors, not in sufficient, but at least necessary condition to reactivate entrepreneurial appetite and animal spirits.

However, even with optimism regarding reforms and their positive long run impacts, the short term requires measures aiming at minimizing the agony we are currently enduring. A responsible government cannot be expected to provide miraculous solutions that compromise structuring reforms, but at the same time insensitivity to our current troubles may jeopardize the greater goal through political unfeasibility. Thus the Republic hangs by a thread, at times due to the political crisis, at others to the economic crisis – both feeding on each other.

This way, heeding this duality, President Temer and his team had (and still do) at least two things to do immediately, before it succumbs to possible tax raises: (i) propose growth-enhancing microeconomic measures (presented in December – see summary below) and (ii) reassess taxation/tax relief and intensify oversight/audits of revenues.

Tax increases will trigger several poor interpretations, be it on the political field, be it in society's acceptance and even lead to innocuous results depending on the shape/tax applied. According to Laffer Curve (tax collection limits – growing and decreasing) there still might be some room for increases in the aggregate, but who will bear the burden? Recent statistics point out that companies have hardly been able to make ends meet with basic items in their payables accounts.

At least but not last – after all, last month we dedicated most of this section to discuss the fiscal situation of state-level units – President Temer has approved (correctly) with vetoes the Complementary Law that sets the State Fiscal Relief Plan and measures of stimulus and fiscal consolidation. The veto hits the Fiscal Recovery Regime, which brought a set of tools that, coupled with debt relief and restructuring, would secure fiscal balance by the end of the regime's duration. The withdrawal of such dispositions has led to the end of counterparty measures by the States and the Federal District (*Brasília*). Indeed, this cannot be!

# Fiscal Policy - Growth-Enhancing Microeconomic Measures

## 1 – Tax Regularization

Civil or Legal persons will be able to refinance tax-related debts expired until November 30th 2016. Debts may be deferred in varying number of installments on a case-by-case basis. Any one interested must prove to expressly desist of pursuing further judicial measures against the debt under negotiation.

## 2 – Real State Credit Incentives

Regulations of the Warranted Real State Security (*Letra Imobiliária Garantida - LIG*) seeks to increase the supply of long run credit for the construction industry. Measures will be put under public discussion in January 2017 and submitted to the National Monetary Counsel (CMN) for posterior resolution.

## 3 – Reduction of *spread* / Positive Credit Survey Improvement

A platform will be created to register financial assets used as collateral in credit operations, which will centralize registries of commercial papers, credit card receivables and others. It will increase creditors' security in receivables discount operations, which will boost the supply of credit to small and medium-size firms and also cut interest rates for them. Government has also announced the improvement of the Positive Survey (list of well-performing debtors), whose adhesion is thereby automatic and exclusion from it to be made under request.

## 4 – Credit Cards

By way of Provisional Measures, the government will allow store owners to set prices according to form of payment (cash, deposit, bank debit or credit card). Such practice is to this day forbidden, impeding the buyer to access discounts that may prove advantageous. The government is also aiming at reducing the time gap between sales and the deposit of funds by the credit card operators, as well as cost of credit card interest rates. Another measure in this instance determines that card-reading machines be compatible with all credit card banners.

## 5 – De-burocratization

It foresees the simplification of the payment of labor market obligations related to social security and tax items. The government will unify the release of tax and accounting information and instate a municipal-level electronic invoice-issuing service.

## 6 – Management Improvement

The National System of Territorial Information Management (Sistema Nacional de Gestão de Informações Territoriais - Sinter) will integrate notaries and share information among the various departments of the administration. The goal is to reduce the information-obtaining cost about real state, securities and documents.

## 7 – Competitiveness and Foreign Trade

The government will expand the Foreign Trade Main Webpage to consolidate the processing of documents and data required for imports and exports. Measures are expected to cut 40% of processing time.

# Fiscal Policy - Growth-Enhancing Microeconomic Measures

## 8 – BNDES – Credit access and debt restructuring

The revenue limit of micro, small and medium-size firms will be extended from BRL 90 million to BRL 300 million. Also, measures touch on the increase of maximum participation for investment projects and acquisition of machinery and equipment. Refinancing and renegotiation of debt under the Long Term Interest Rate (TJLP) that already expired and to be expired in all credit lines of the BNDES.

## 9 – Gradual Extinction of the 10% Fine on FGTS/Distribution of Returns on the FGTS

Federal government will propose, in a complementary act project, the gradual extinction of the 10% fine on the FGTS obligations in cases of lay-offs under just cause. The reduction will follow the rate of one-percent discount per year until full extinction. Another measure aims at distributing 50% of the profits accrued by the FGTS to workers' accounts.

## 10 – Productive Microcredit

Incentive measures aim at increasing the limit to apply for productive microcredit from BRL 120 thousand to BRL 360 thousand in yearly revenues, followed by change of operational rules that facilitate access.

Congratulations! In fact, a nice initiative; however, two observations are in place: (i) various measures signal momentary relief and not properly growth-enhancing measures (in truth they at least avoid further folding by firms) and (ii) other measures (for non-residents it sound incredible) tackle the problems only half-heartedly (with the benefit that they at least confront them) – such as the Positive Survey, simplification of payment of labor-related tax and social security obligations and the FGTS question – and not the extinction of the 10% fine and/or the distribution of returns from FGTS, but the FGTS itself!

It doesn't matter; this is a welcome start!!!

# International Environment

A brief summary of what goes on around the world, particularly in Europe and in Asis, we have the following picture for the last month of 2016:

- ✓ PMI Composite of Germany has climbed to 55.2 in December – the greatest level in 5 months, whilst the country's Industrial PMI rose to 55.6 in December, highest in almost three years;
- ✓ Unemployment rate in Germany is stable at 6%;
- ✓ UK's Industrial PMI escalated to 56.1 in December – highest in a two-year streak;
- ✓ Eurozone:
  - PMI Composite reached 54.4 – highest in 67 months;
  - Industrial PMI climbed to 54.9 in December – highest since APR/11;
- ✓ Japan's Industrial PMI rose to 52.4 in December from a 51.3 in NOV;
- ✓ India's Services PMI reached 46.8 in DEC, but point to a contraction two months in a row;
- ✓ China :
  - Services PMI retreated to 54.5 in DEC from 54.7 in NOV;
  - Industrial PMI dropped to 51.4 in DEC from 51.7 in NOV;
  - PBOC injected 733 Bi Yuans in liquidity into the system in DEC.

Evaluating what lies ahead is not very challenging, but it requires a close follow-up of what happens in other regions. In Europe, it seems clear that ECB will resume its monetary easing measures in 2017 (perhaps a strategic reassessment in mid-year of the Quantitative Easing). Italian banks' situation and a new Greek crisis are not ruled out, quite the contrary. BREXIT made effective and elections in important countries under rightwing proclivities will quake the old continent. In China, things are far from well, indeed. Now, beyond the several difficulties within the economy, tensions are bound to rise under the Trump Presidency.

On this note, it will be important to follow up on Chinese reactions to international developments in foreign policy, notably in regard to Trump's agenda toward US-China relations – this fact itself is coupled with the potential of a slowing economy could amount to domestic social tensions (despite China's closed regime). Beyond Trump, there are issues with Taiwan and North Korea – both virtually "radioactive", and a problem of this sort to China will be a huge problem for the world.

# International Environment

In the US the election of Donald Trump with a majority in Congress makes his campaign promises yet more credible. Republican House Speaker Paul Ryan will be reelected to chair the a Republican-majority House with 241 seats against 194 held by Democrats, a situation of control of both Legislative and Executive branches unseen since 2007.

With a majority, House and Senate will be Republican-dominated, and the new Congress promises to dismantle much of Obama's legacy. For starters, a new agenda includes tax cuts, repeal of both new laws and healthcare program (Obamacare) enacted during Barack Obama's tenure in office. The promise of the Republic party, now that it moved on the misunderstandings bred during the presidential campaign, aims to empower "even further" the American government in the economy.

The pack of measures seems to be on the way and contemplates two important items: (i) corporate tax cuts from current 35% to 20% or 15% and (ii) a border adjusted-tax typical of VAT regimes, but uncommon as a corporate tax. The underlying idea seems to be that the VAT would provide differential treatment for domestic purchases and imports, and would incentivize exports. Companies would not be allowed to deduct costs with imported inputs from its taxable income, but in compensation its export revenues would not be taxed… much speculation, but the ultimate goal seems to be improving the US trade balance. The idea of implementing fiscal instruments as a way to "increase trade competitiveness" harks to Keynes' days… it did not sound good then, even less today, especially in the US and under a republican administration.

However, there are several measures to be applied in this new moment of American life and in various sectors of its society, and a good part of them seems to be aligned with the goal of "making America great again" and are in their majority at variance with the Democrats' agenda. Given the latter and that the US leaves these elections highly divided, the electoral period seems not to fade out easily on account of a significant share of the population not accepting that relevant changes are on the way. This posture spreads across the world with the whelp from the media… there will be no rest for Trump.

It is obvious that expected changes of this magnitude in the US will impact, at various levels, countries around the world. On this side, we are largely optimistic… *Republican* President Trump will prove to be good to Brazil.

# Interest Rates

2016 was intense: impeachment of former President Rousseff, fiscal crisis in the Brazilian states, highest historical unemployment rate, depositions of Odebrecht's executives in the Car Wash probe, municipal elections with outstanding results, former President Lula on the defendant's chair, Eduardo Cunha (former House Speaker) forced to step down and arrested, interventions by the main central banks in the world in the economy, terrorist attacks, BREXIT, Donald Trump's victory, just to list some of the events in 2016 that had a direct impact on asset prices – especially the ones analyzed in this section, namely interest rates.

Despite all the above, 2016 ended with a positive result for Brazilian assets. CDS for 5-year obligations in the country has registered a 40% drop in the period, reflecting the government change and the confirmation of a new economic team, followed by the passing of an Expenditure Cap on the government that established a lagged-inflation-linked limit to public expenses for the next 20 years. With direct or indirect correlations, with longer or shorter lags, interest rates faced the same movement. When we compare the closing result of 2016 with the one in 2015, DI contracts maturing in January 2021 dropped more than 5 percentage points. This performance reflected the start of a monetary easing cycle by the Central Bank and also the overturn of the investor's risk perception regarding Brazil after the provisory stepping down and definitive impeachment of Dilma Rousseff (illustration on slide 16).

With economic recession and ongoing disinflation, the Central Bank has resumed in December its interest rate cutting cycle. The Selic closed the year at 13.75%. Despite criticism (technical and formally unfounded), for many ascribe to the institution the responsibility for economic growth (in spite its sole mandate of guardian of the currency - according to the 4.595 Act of 31 December 1964), for the Bacen's chairman, Ilan Goldfajn, the cut down of the interest rate will be responsible and sustainable so as to avoid future increases. Inflation in 2016 surprised all, and particularly us at Redwood. In the beginning of the year, market projections indicated an IPCA at 7% (our own estimates pointed to 8%) in 2016; however, throughout the year, inflation decelerated indicating a closing value around the target's interval's upper bound, and for us the most recent projections signaled inflation not far below target. From a general and unfocused perspective, counter to the BACEN's own views, there is nothing to celebrate. There is, indeed, and not few reasons for those that advocate that "a little" inflation may bring "some" benefits in terms of growth and employment. The disinflation process is costly: deep recession and unemployment. It is the price we pay for the former administration's irresponsibility.

In the US the FED finally began raising its interest rate. In the first hike, in one year's time, interest rates have climbed to 0.5%-0.75% interval against 0.25%-0.5% band. In its release, the institution signaled a faster pace of hikes in 2017 citing Trump's intent on stimulating growth through tax cuts, increasing expenditures and deregulation. Since mid-year, the FED has been flirting with a new interest rate hike in the face of more positive numbers for the economy (especially employment and, not so much, inflation figures), but the decision was delayed due to uncertainty raised by the BREXIT, to the slow recovery of the world economy, to the low prices of oil and to the expectations regarding world economy's reaction to the American election. This new stand by the FED, as well as expectations on growth for the US economy under Trump brings back discussions on Flight to Quality around the world and its impacts on Brazil.

# Interest Rates

In this new landscape, domestic and international, one must evaluate what's to be expected of Monetary Policy, not only in terms of the size of interest rate adjustment, but also as regards the pace and intensity of such an adjustment. The analysis we set forth shortly and briefly, takes into account the situation of the economy as a whole, but it also focus on the mandate of the BACEN, its operational autonomy premise, non-interference of politics in the decision-making process and intellectual honesty of its board of directors.

That said, the first premise states that, under inflation targeting (IT), the possibility of cutting down interest rates is couched on properly anchored future inflation (expectations). More than that, they must be anchored at the *right level* (in our case, 4.5% yearly)! However, inflationary expectations years ahead do not suffice to identify whether inflation is on target, as many belief. More than that, it is necessary that inflation be less sensitive to shocks in the present – it must be duly anchored. This assessment is not easy to do, but serious central banks rely on it to work and guide themselves (beyond the set of other variables, such as the output gap abovementioned) as regards the size and pace of interest rate cuts.

Well, generically speaking, by any model (taking the Taylor rule as standard), Brazil seems to have today enormous room for cuts in its interest rate and BACEN's Reaction Function (including our own proprietary models) clearly points to such a situation in the relevant horizon of analysis; but at which pace? Is future inflation properly anchored so as to allow us faster cuts? Is there any inflationary persistence suggesting parsimony in dwelling with interest rates? These questions must be minimally addressed so there will be no need to recant measures in the process – a frustration now, be it for reducing rates in excess or losing the timing for cuts may jeopardized the BACEN's team's hard-won credibility.

Thus, in order to verify the future inflation anchorage, models attempt to test the sensitivity of certain vertices of the implicit inflation rate in relation to monthly variations of relevant macroeconomic indicators for the trajectory of the short-term inflation and monetary policy. Our simulations amount to some adjustments applied to traditional models: we simply evaluated the sensitivity of some vertices of implicit inflation rates (obtained with information of the Term Structure and the NTN-B for each vertex) with respect to the observed data throughout several windows of analysis, taking as benchmark the expected inflation for 2017 and comparing them to inflationary expectations for 2018/19/20/21.

With this innovative methodology, we aim at verifying whether there is loss of statistical significance in forward inflation rate sensitivity with respect to 2017. In other words, it doesn't matter if there is an external shock or a domestic one (as long as this affects the year 2017 and **does not** affect any other year ahead specifically), but whatever the impact, the question to be addressed is: if it affects 2017 does it promote significant alterations in the subsequent years of within the scope of analysis? We limit our scope to vertex of 2021 for obvious reasons related to asset liquidity (NTN-B's), to the term structure of interest rates and the horizon of interest. On the other hand, studies show that the coefficients of implicit inflation rate variations lose statistical significance as data move away from their origin and approach maturities related to the economy's steady state.

# Interest Rates

| Correlation (Baseline 2017) \| $\rho = \frac{Cov(X_t, X_{t+n})}{\sigma_t \sigma_{t+n}}$ | | | | |
|---|---|---|---|---|
| | 2018 | 2019 | 2020 | 2021 |
| 21 days | -0,4844 | -0,6086 | -0,3865 | -0,2228 |
| 63 days | 0,2928 | 0,0518 | -0,1323 | -0,1085 |
| 126 days | 0,5905 | 0,4883 | 0,4637 | 0,4291 |
| 252 days | 0,9426 | 0,8988 | 0,8814 | 0,8804 |

| Beta (Baseline 2017) \| $\beta = \frac{Cov(X_t, X_{t+n})}{Var\ X_{t+n}}$ | | | | |
|---|---|---|---|---|
| | 2018 | 2019 | 2020 | 2021 |
| 21 days | -1,3763 | -1,6774 | -1,0216 | -0,4900 |
| 63 days | 0,4519 | 0,1130 | -0,2873 | -0,1579 |
| 126 days | 0,5219 | 0,4028 | 0,4253 | 0,4444 |
| 252 days | 0,5288 | 0,4069 | 0,4056 | 0,4342 |

The tables present the results for two metrics well-known, of easy interpretation, and possibly representative of anchorage identification under our simplified and adjusted model.

Thus, information seems to indicate (dropping the ones tied to the shorter term) that the anchorage process is "under way". Note that the correlations of inflation expectations in 2017 throughout 2016 loses strength for 252 days, so as to gradually become less correlated within the last periods under observation.

Likewise, the Beta – or as it is understood here, as a "drag" or "persistence" - of implicit inflation in 2017 for the subsequent years under scrutiny diminishes significantly throughout the other windows of observation.

If that is true, one must find out if technically the board members of COPOM will be "comfortable" with the magnitude and trajectory of the data – obviously, with other relevant variables at hand for a broader analysis.

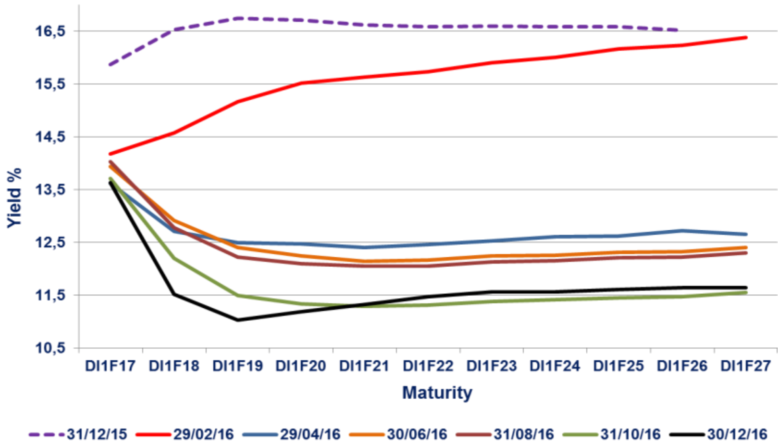
Our evaluation is that Monetary Policy takes some time to promote all of its effects, and that these are still yet to be passed through to observed indicators. It is clear that such effects may be on their way and that being more aggressive in pacing up the interest rate cuts may not prove "harmful". On the other hand, stepping up the pace of cut-downs only to be negatively surprised next would undermine credibility… and worse yet, for not waiting a little bit longer. Yes, what the data suggest is that shortly the degree of certainty will rise in the near future.

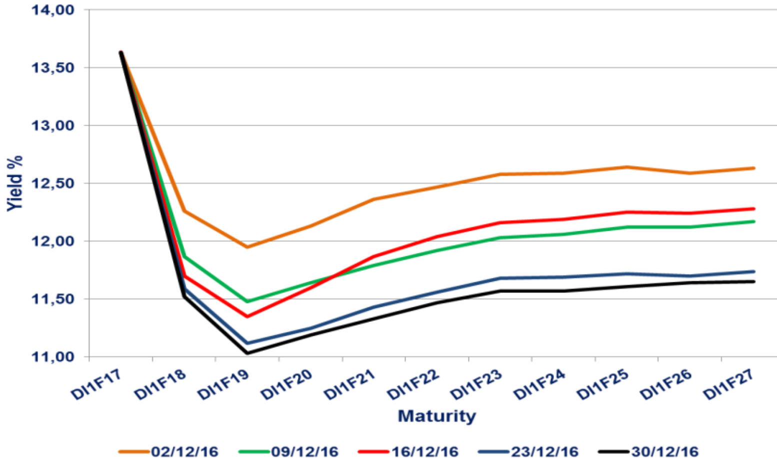
In the face of all the above, we believe that the BACEN's team will opt to be "conservative" (with a faster pace than the previous board, but still slower than 0.75%-1% per meeting); these are the bets waged by the market and "renowned" economists. At any rate, if the pace of cuts in the SELIC remain in the next meetings at the 0.5% and then (eventually) is reduced, even then it will reach the end of the year with a base interest rate significantly lower and in line with the needs of the economy at large.

Overall within the month the yield curve saw a fall in premia, reflecting the plummeting Dollar and the lower inflation expectations for this year and the following ones. The same movement has taken place of the yield curve of NTN-B. The path is set, but the government has little room for mistake!

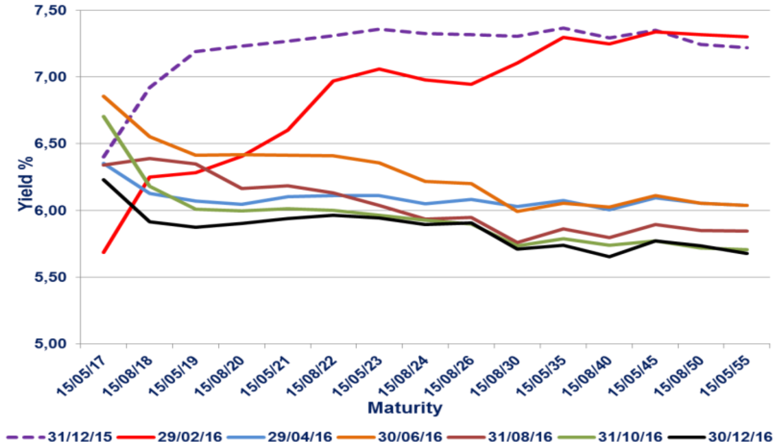
# Interest Rates – Yield and Coupons Curves (monthly and weekly)

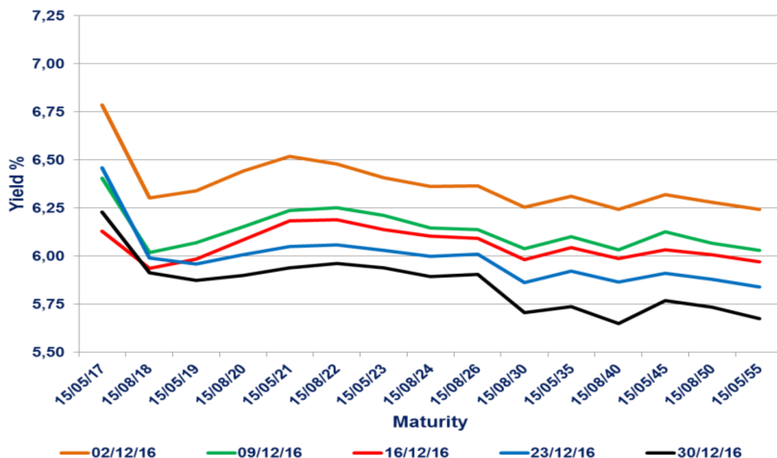
Yield Curves




Coupons Curves



# Foreign Exchange

The Dollar initiated the year under pressure. In January the currency came to be negotiated at BRL 4.16, highest level since the enactment of the Real Plan. The impeachment of President Rousseff and the recovery of commodities prices reverted the situation. The dollar closed 2016 in a downfall of 16.54% (Ptax), under the first devaluation of the US currency with respect to BRL since 2010. It was the greatest within-year drop since 2009. The Dollar ended the last day of business of the year quoted at BRL 3.2591. In December, the drop amounted to 4.05%.

Up to the conclusion of the impeachment process, Brazil has suffered severe credibility loss as regards its economy. The refusal by the government to admit the gravity of the political and economic crises was struck when Moody’s downgraded in two levels the Brazilian credit rating and classified Brazil as “junk bond”. The country lost its investment grade and with it its credibility, followed by a deterioration in asset prices and a strong capital outflow.

Amid this turmoil, the Central Bank acted sternly in currency markets throughout 2016, especially in the swap auctions, be they traditional or reverse – depending on the humor and assessment of the “attending analyst”. The last intervention by the BACEN was on December 13th, through the auction line – Dollar sales with a repurchase agreement. The total stock of swaps equals USD 26.6 billion, according to official data. Likewise, the institution’s goal with interventions is to dampen volatility and not establish any fair price to the currency – in other words, it’s dirty floating. Even with interventions, always questionable, one thing is for sure: credibility enjoyed by the BACEN was duly recovered with Ilan Goldfajn’s rise to chair a largely discredited institution on account of a list of past mistakes (on all sides) made by his predecessor. One point is above dispute: credibility will rise even more (for this is its most fragile flank so far) if he applies what he actually believes, that is, a free-floating exchange rate. Ilan Goldfajn and his team have conquered so wide a credibility that such “momentary misgiving” was overlooked.

For the next year, considering Temer’s permanence in power and the approval of essential reforms, one can work on the appreciation of the BRL. Expectations are of a reduction in country-risk levels with an eventual improvement in fundamental credit ratings to jumpstart investments. Notwithstanding geopolitical complications worldwide, our scenarios point to relative stability of the exchange rate, even in a new reality under Trump’s presidency with unforeseeable impacts in case some economies highly correlated with the US do not adjust to the new status quo. Donald Trump will be a positive externality to Brazil, especially for the exchange rate (no, we are not overlooking the hike of interest rates in US) – in relative terms and in front of BRICS, we’ll be in a position of distinction and advantage. With a more open economy and a bolder commerce, exchange rate policy might be much less interventionist.

Excuse us, but we are rooting for the “attending analyst” to lose his job.

# Stock Market

Brazil has begun the year under a bleak perspective of its fiscal situation, with investors questioning the country's very solvency. This doubt has lost power after the changing of the guard. The new team's economic agenda has focused on the limits to expenditures growth besides several measures to balance public accounts. The numbers of the so-called *Brazil Pack* (Stock buy-in, Dollar and Interest shorting) have demonstrated this. Ibovespa has closed 2016 with a 38.94% high, the first appreciation within-year since 2012 and the largest since 2009. In the month of December, however, the index dropped 2.71% with an outflow of resources by foreign investors. Is one thing linked to the other? It is hard to correlate, but some stocks seemed underpriced… and many of them did not look promising when adjusted for their risks.

Among the main influences on the stock markets this year, the political landscape featured along with uncertainties in the external front and the trend in commodities prices. The Stock Market is strongly influenced by the latter. Vale and Petrobras account for a significant share of the index and enjoyed upsurges this year, which helped push up the Ibovespa. Following Rousseff's exit, there was a change in State-owned companies' governance outlines, such as Eletrobras, Banco do Brasil and Petrobras itself, with technical criteria being adopted in search of higher efficiency and results, and lesser political criteria. This has had direct and positive impact on the value and, in rule, on the companies' shares prices.

Despite positive perspectives for 2017, strong highs are not expected. Uncertainties abound as to the external landscape, which may rise volatility in the stock market: from a full-blown reorganization of the world at a new normal under Donald Trump, going through the eventual demise of the European Union as we know it, to the simply "Unknown known", as former Defense Secretary Donald Rumsfeld's famous quote, meaning "*something we think we know but in fact we don't*". Deep down and much less confusing is our domestic scenario, in itself greatly challenging. On the positive side, inflation deceleration, possible enhanced pace in cutting down interest rates by the BACEN and the maintenance of stimulus measures studied by the Temer administration may boost shares prices.

At any rate, from a fundamentalist and value investing analysis for the companies' perspective at this moment, taking the Ibovespa as a representative "average" of firms, there is no upside when risk-adjusted prices are in place, especially for domestic investors. The same cannot be said, at this moment, for investors whose resources are tied to the Dollar.

At last but not least, 2017 will be a year in which a manager's expertise will prove crucial to those who believe in stock-picking models The ability to identify sectors, companies vs. economic cycles, intrinsic value and the bet and identification of market inefficiencies (notably through direct and indirect effects of crises), punctual or not, will be a most relevant differentiator.

# Monthly Commentary

## DECEMBER 2016

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