Planner Redwood Asset Management

MONTHLY COMMENTARY

FEBRUARY 2015

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Agenda

"There's no such thing as a free lunch."

Milton Friedman – Economist

Introduction

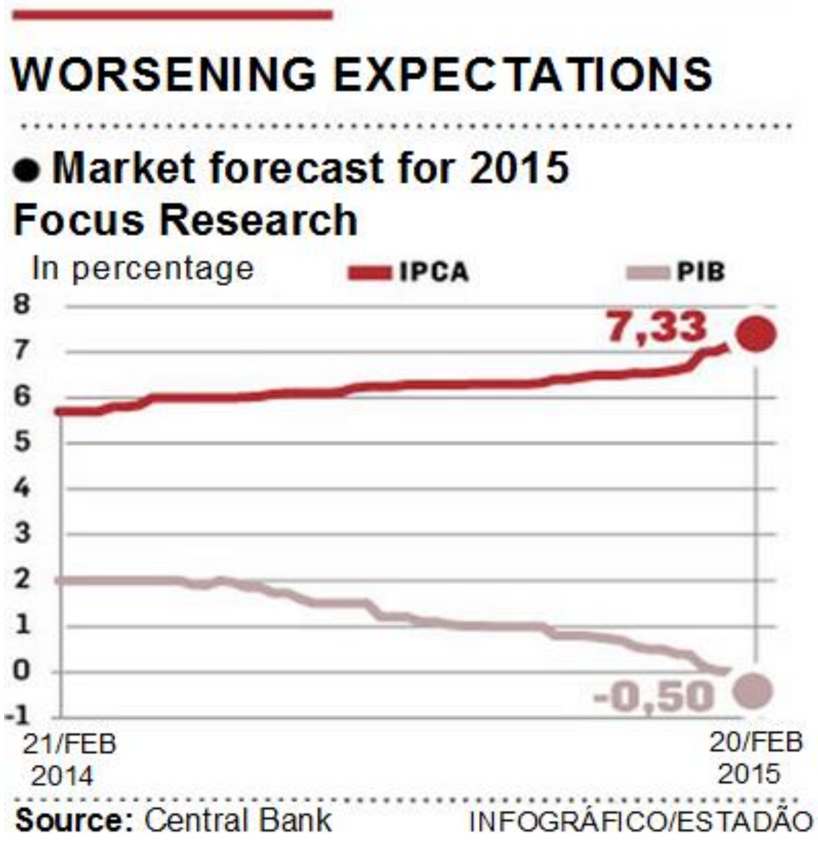
We are in the second month of the new government with Minister Levy at the helm of one of the greatest challenges in recent years. In fact, we are almost 2/3 through the traditional 100 day-period for the initial evaluation of the new direction of a government. The truth that emerges is much worse than anticipated, not only due to the excesses and damages of the recent past, but also the impacts of implemented actions that endure over time. In the backdrop, a crusade to reduce costs and increase revenues has began, and it promises to be ruthless, that is, if Minister Levy does remain. Because the ideology that supported the failed macroeconomic matrix, put in place by former Minister Guido Mantega and former Treasury Secretary Arno Augustin, with endorsement of President Dilma, is still supported by many members of the Federal Government and to some extent rightly, by those who voted for the President based on her political discourse. There is some friction in the statements and concern displayed by the President, in her public comments to Minister Levy's more than colloquial statements concerning the tax relief policy conducted by former Minister Mantega and his team. In truth Minister Levy was "politically incorrect", but in his defense (albeit a fragile one, considering his post) anyone who does not have cold blood, has minimal knowledge of economic efficiency, does not suffer from extreme mental rigidity and/or is a patriot, would have had the same reaction. No one will change the past, it is there all the time to remind us of the evils done. The Minister and President need to take a deep breath.

The adjustment process initiated now is not at all ideological, it is simply a resumption of course, especially in regards to the public accounts, basic prerequisite for any rational economic policy. Thus, the decision of a "change" of the President was essential or unavoidable for some ... because the deterioration of the entire economic and financial framework would be inexorable. However, the President does not seem very convinced and convincing in her statements... in fact, the discomfort with the new economic measures seem colossal. Anyway, *"it is not enough for Caesar's wife be honest, she should appear honest"*... Brazil has created too many problems for itself, complex ones, and the painful solution will affect the needy population. Oneness of attitude and thinking now!

On the world stage, there are more monetary easing measures in China, always in order to help the country implement its promised structural reforms, that is, return Government to the traditional economic model. On the European side of the announcement of the trillionaire package by the ECB last month, sparked even more sharply monetary easing in other economies of the world. Given this movement, the Fed adopts a posture that is interpreted on the market as faltering in terms of the timing of its monetary tightening, given the potential divergence between the domestic and international monetary policies, whose reflexes are directly found on the appreciation of the US Dollar compared basically to all currencies.

In this environment, US Treasuries ended the month at 2%. The S&P changed 5.49%, NIKKEI closed at 6.36%, DAX at 6.61% and FTSE, 8.95%. The Ibovespa ended the month at 9.97% and IBrX, at 9.33%. Maximum DIF16 was 13.24% and DIF17, 13.21%. NTN-B 2050 ended the month at 6.12%, and the dollar (Ptax sale) at R$ 2.8782.

Economic Activity



The chart indicates market expectations at this time, absolutely in line with the scenario we presented in the beginning of this year, which formal revaluation occurs on a quarterly basis ... we will soon analyze the alignment or non alignment of the variables trajectories. Anyway, there really is no free lunch... we are paying (and will pay, during the entire year at least) a high price for the failure of economic policy in the last four years - the so-called new macroeconomic matrix ...

But the adjustment of the economy is already underway, an orthodox procedure where austerity (much is still missing in terms of spending cuts) aims to tackle both the economic side (practical numerical results) and credibility. Paradoxical as it may seem in the short-term, the current policy in the medium/long term will strengthen what matters most now: savings! Only with savings there will be investments, that is the seminal identity of economy: equality between savings and investments.

It is a fact that the recent economic policy caused imbalances, was unable of producing economic growth, emptied manufacturing, produced mediocre GDP results, brought back the specter of high inflation (now above the target ceiling), created a hole (nominal deficit) in public accounts and deficit in external accounts (current account) and, finally, the reduction of jobs as a result of all this. That will change. However, no serious economist will deny that the path will be very difficult (higher interest rates, high unemployment, weak economic activity, etc.), the *free lunch* of the past will cost us a feast in the short-term, but pragmatism and determination are essential at this time. Unequivocally, the entire economic policy should face the relentless and priority fighting against inflation.

Anyway, there are several concerns for a better economy: more and better jobs, business, quality of life, social welfare, etc. On the other hand, there aren't several available economic policy alternatives to achieve that many... we need to pay for each lunch we eat.

Fiscal Policy

The tax relief policy, orchestrated and implemented by the duo Mantega-Augustin, was part of the so-called counter-cyclical approach to economic policy and the results were terrible. The discontinuation of this policy, the success of which depends on the National Congress, among others, will be an important step in this initial adjustment process. Seeing the President and her group of supporters defend this thesis and, on the whole, the Levy program, will be a hallmark (the first of many, one expects).

A good indicator is that as the President gave a slap on the wrist of Minister Levy due to the "improprieties" uttered concerning the tax relief policy, at least she did not force him to retract his statements and measures (difficult to believe he would do so, at any rate), as happened with the Minister of Planning, Nelson Barbosa, who had to retract his initial statements concerning the change of the minimum wage adjustment policy. What is the practical result? The market captured this and gives the benefit of doubt to the President, as to her willingness to follow through with the adjustment.

After all, why is the Fiscal Policy so trendy among economists? What are the real functions and what is actually expected of this "tool"? A paper published by the IMF in 2006 called Fiscal Adjustment for Stability and Growth answers fundamental questions such as (i) when the fiscal adjustment is necessary, (ii) how the tax position should be evaluated, (iii) what makes fiscal adjustment successful, (iv) how the fiscal adjustment should be conducted and, (v) which institutions can help to achieve fiscal adjustment. Moreover, the paper focuses on broader topics rather than more technical and/or theoretical ones, and although much of the analysis may be relevant to more advanced economies, its focus is the emerging and low-income economies. Briefly, the responses are suggested in the title of the paper itself, fiscal adjustment for stability and growth. Fundamentally, governments seek to promote social welfare through sustainable economic growth and constant poverty reduction and a sound fiscal policy is essential to achieve macroeconomic stability, in turn a *sine qua non* condition for all other policies. A well-run and high quality fiscal adjustment and focus may "induce" the increased savings, improve the efficiency of resource allocation and therefore, assist in developing the country.

Finally, it should be noted that Fiscal Policy (implementation, adjustments, reviews and corrections) is not incipient, or a matter of little study and research! In fact it is much studied in the world and in Brazil. Thus, all adjustments can be evaluated *ex-ante* and *ex-post* (of course), with expected results with a reasonable margin of accuracy. The calculation of fiscal impulse, an indicator that provides relevant subsidies to monitor the impact of government activities in the economy, highlights the discretionary actions of the government to adapt, for example, the fiscal stance to economic cycles and the strategy to maintain the Debt/GDP ratio at acceptable levels. Simple math, it does not hurt much.

Once more, one can calculate this beforehand. Former Minister Mantega knew (we would like to believe that) where this would lead us, current Minister Levy knows where it will take us.

International Environment

Consistent to our expectations, the Chairman of the Dallas FED (Central Bank), Richard Fisher said the US Central Bank should raise interest sooner than later, but he would not want the tightening done quickly or too frequently. Fisher said the Federal Open Market Committee (FOMC) should act gradually on the rise of interest and avoid reactive investor movements, which could adversely affect the markets and the economy while the FED "normalizes" the policy. When FOMC starts raising interest rates, it should not necessarily implement tightening measures at each meeting and it should refine its communication in order to clarify the information to the financial markets. In other words, the economy is a big ocean liner, it is better to reduce speed gradually to make a "turn" rather than having to take more drastic and severe measures - of course, we are referring to increase in interest rates and other monetary tightening measures. It is better doing this now rather than risk undesirable economic slowdown ahead. Our scenarios continue with the prospect of increased interest by the FED late in 1st semester, or early 2nd semester of 2015.

In Europe, uncertainty about the future of the Eurozone is total. After the elections in Greece, the country's new rulers entered into lengthy negotiations with international creditors concerning the country's bailout package, which resulted in a partial solution, with an extension of the aid program for another four months, in other words, they kicked the can down the road postponing the issue. The consumer price index in the Euro zone fell less in February/15 in relation to February/14, but despite a slower pace, inflation in the block remains far below the target of the European Central Bank (ECB), which is slightly lower than 2.0%. The unemployment rate has not changed much, it went from 11.3% to 11.2% - a decrease of 140,000 in the number of unemployed people in the block. These are the motives and the reasons for the size of the package implemented by the ECB... at least the continent's economists think so.

In China, the People's Bank of China (PBOC, the Chinese Central Bank) announced the reduction in 1-year lending interest rate by 0.25 percentage point, to 5.35%, from 5.60% previously. The one-year deposit rate was reduced by 0.25 percentage point, to 2.50% from 2.75%. These measures take place on the eve of the National People's Congress, the Communist Party event that defines the goals and economic projections for the year. As we have already discussed in these reports, we expect a more timid growth target: 7.0% instead of last year's 7.5%. The measures are an attempt by the Central Bank to stimulate aggregate demand and combat deflationary risk, and encourage the real estate market. However, just like Brazil, there also seems to be a great need for fiscal adjustment in China.

Considering the particularities of each country, once proper diagnosis is made, formulas and economic models can be used in any country, at any time and (almost) any circumstances... And the results are strictly foreseeable, for Americans, Europeans, Chinese or Brazilian.

Simple? Not really, but this is an indisputable truth.

Interest Rates

Tranquility, predictability, low volatility. Forget it! Doesn't fixed income rule anymore?

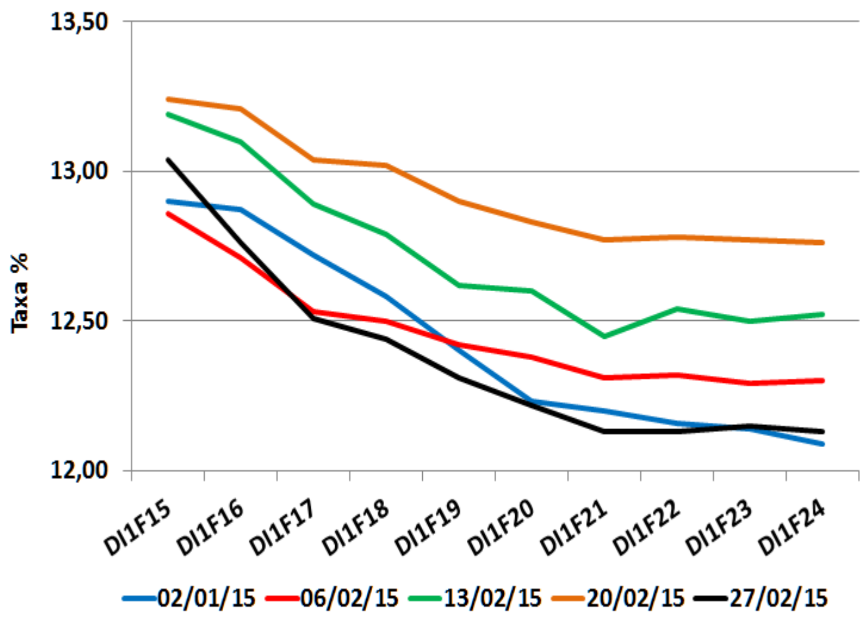
The economic situation deteriorated in February. It was a month of review of macroeconomic projections for much of the market. For instance, the Focus Bulletin released by the Central Bank in the first week of the month (02/02/15) showed the 2015 IPCA inflation (CPI) above 7% for the first time, and the following research indicates successive increases. In the last Bulletin of the month (02/23/15) the IPCA was 7.33%. The same happened with the other Brazilian economy indicators. The GDP, that started the month positive, ended with a projection of -0.5% (down). Selic projections for the end of 2015 increased from 12.50% to 12.75%. With these new numbers, market expectations start to become more in line with Redwood's.

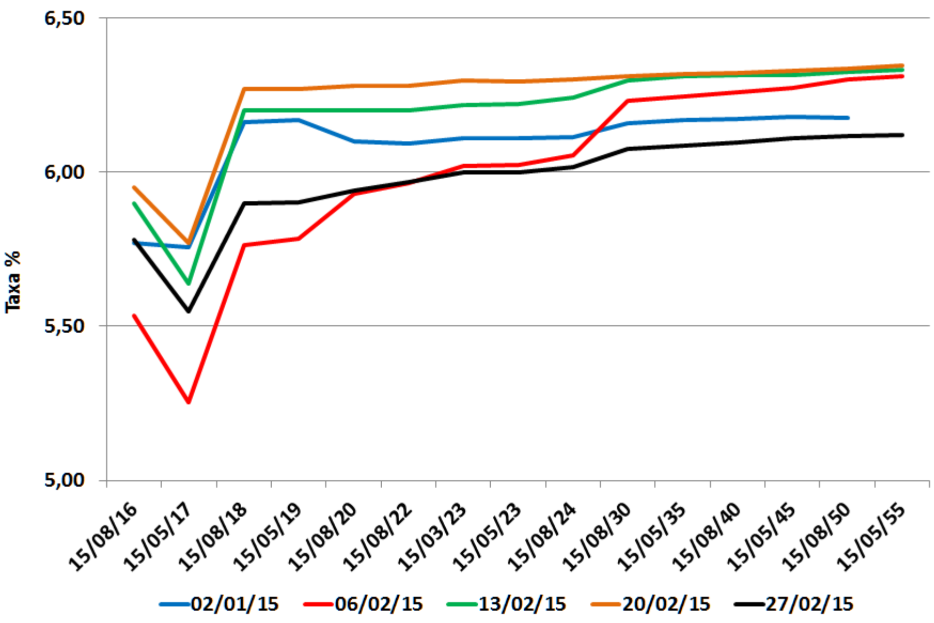
Concerns about domestic economic fundamentals, the agreement between Greece and its international creditors and the eternal question as to when will US interest rates increase brought great volatility for the interest rate market. Internally the market is concerned with the Congress' approval of the tax package proposed by Minister Levy, given the communication difficulties between Government and Congress. At any rate, the new fiscal measures disclosed in the closing of the month (spending limits of executive power, increase of sales tax rates and lower returns to exporters via Reintegra), added to the primary surplus of R$ 21.063 billion in January, made the futures rates retreat consistently, especially in the long end. On the other hand, the inflationary pressure scenario contributed towards the movement of the yield curve over the month. Short-term futures contracts increased strongly with much of the market pricing the Selic increase of 0.50% at the March meeting, especially after a statement from the new director of monetary policy of the Central Bank, Luiz Awazu, that the institution focused on bringing inflation down to the target of 4.5% in December 2016. Is this a midsummer night’s dream?

The question is not cynical or biased criticism. Monetary policy must be firm, clear and objective. Regardless of the adopted inflation control system, the formation of expectations is a crucial factor and the Central Bank communication is ultimately extremely important. The Central Bank must be very careful how it communicates with the market - in fact, if properly used, communication is a very useful tool. Last December the message was the interest rate policy would be conducted "sparingly" and the new economic team "will do whatever is necessary to combat inflation" ... truly sounds crazy. Why the sudden change of direction? The realignment of prices that "no one" knew would come? How will the Central Bank make inflation converge to 4.5% in 2016? There are many doubts whether the Central Bank staff, constantly surprised by "adversity", is capable and competent to deliver its promises. There is more to it. In 2014 it said that Fiscal Policy would stop producing inflation, in 2015 it says in its documents, that now it can rely more on Fiscal Policy in controlling inflation. As for economic activity, will the Central Bank be the true guardian of the currency or flirt with the necessary interest rate increases in an arbitration of "Inflation x Economic Growth"? It really seems like a dream, let us hope it does not become a nightmare.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

Change of baseline: the dollar hovers around R$ 2.90. The currency soared and reached levels not seen for over 10 years. Is this circumstantial or a new trading level?

We believe it is circumstantial, uncertainties related to the domestic scene and the beginning of the rise in US interest rates. In our Probabilistic Scenario (likely) we work with a perspective of Real devaluation in the first half, considering the above mentioned factors and subsequent reversal to appreciation of the real until the end of the year. That is it. However an “inconsistency” remains: the upward movement was advanced by a few months ... What does this mean? A simple recalibration of the projections model or the probabilities of Probable and Pessimistic Scenarios have changed?

The Real began the month pressured by Minister Levy's statements that he will not interfere with the exchange rate and an artificial appreciation should be avoided and that the Central Bank will reduce the rollover of foreign exchange swap maturing in April after a full rollover of maturing swaps in January and February. He said that "the economy has to work by itself." Definitely a very strong statement, typical of his training, miles away from what we have seen (in practice) in the country and a real challenge for the economic team as a whole and the Brazilian financial market itself, not used to this "free price" philosophy.

But the appreciation of the US currency occurs in virtually every part of the globe. The distrust concerning the continuation of Greece in the Eurozone, the slowdown of the Chinese economy and the possibility of increased interest in the US in mid 2015 drove up the dollar against most other currencies. The risk aversion movement controlled the markets even after the signing of the 4-month extension of aid agreement to Greece. Anyway, externalities also influence what happens in Brazil, quite a lot. More than that, countries around the world adopt an active defense of their currencies and economies, a game whose imbalances (for open economies) occurs only in the short-term, but the market ALWAYS adjusts itself in the short-term, and, as a rule of thumb, for this case, through interest rates.

So what is expected of the Foreign Exchange Policy if the price of the dollar represents a "general price level"? Is any exchange rate good, adequate or fair? Furthermore, will the price spikes and troughs be gigantic, causing such volatility as to impede the stabilization of contracts and planning? How about national sovereignty, the adverse impacts on the economy and the pride of the authorities? Will we be eternal hostages of exchange hedging? The real economy could not stand this, and the source is not inexhaustible. Is there a solution?

Yes. The economy has to work by itself. Is this an utopia? We shall soon see!

Stock Market

Where is the rationality of the market?

The month of February was full of negative news, and yet, the Bovespa index rose 9.97%, after a sharp drop in January. The problems involving the Lava Jato operation, culminating in Moody's downgrading Petrobras to speculative grade, rising fuel, successive increases in electricity prices, the ghost of water crisis and the strikes and demonstrations that began popping around the country ... it seems that investors were not much concerned with this, and only considered that stocks were cheap, especially in US dollars terms, so they went shopping! We remain very pessimistic ... only a portfolio that is really able to generate alpha is justified in our stock exchange.

Petrobras continued to be prominent in the stock market. The month began with the expected change of the company's management and the Board of Directors, by renowned market executives. The replacement of the president and five directors soon occurred, earlier this month. Aldemir Bendine was appointed president of the company, until then president of Banco do Brasil. The market expected an independent executive without government relations, however, once again the wishes of President Dilma prevailed. Although the names are not those preferred by the market, the change was, overall, well

regarded, as a means to reduce the risk of default of the company. As for the company's Board of Directors, some names have been changed. It is relevant that Minister Levy, unlike his predecessor, will not be a Board member, in order to avoid political interference in the company.

Even with the change of executives and Minister Levy's efforts to provide a "letter of comfort", that is, a guarantee of aid to Petrobras, if necessary, Moody's downgraded the company's rating to speculative grade. The downgrade makes it difficult to raise funds and makes the company's financing costly. Additionally, it affects the pricing curve and issuance of bonds by other companies. According to the risk rating agency, the downgrade reflects greater concern with investigations of corruption, liquidity pressures stemming from the delayed release of the balance sheet, and the lack of concrete assurance that the audited balance sheet will be released at a specific date. The downgrade of Petrobras raised fears in the market that the ratings of other state-owned companies can be downgraded, as well as Brazil's note, which would lose investment grade rating. This is the so-called Petrobras contagion effect that goes far beyond the effects on the financial market (which interests us greatly, given our Portfolio Value) and strikes the real economy.

Analyzing the whole scenario (interest rates, risks, opportunity costs, dollar, company leveraging, P/E, etc.), is the Stock Market cheap? Apparently not! But Mr. Market (Warren Buffet loves to mention the term coined by Ben Graham) bought. How come? Pure short-term market dyslexia.

Where is the market's rationality? Nowhere. In fact, trying to find (short-term) market rationality is an irrationality itself!

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