Planner Redwood Asset Management

MONTHLY COMMENTARY

FEBRUARY 2016

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

“If you’re going through hell, keep going.”

Winston Churchill – former Primer Minister of the United Kingdom

Introduction

Brazil is going through hell; unfortunately in almost all senses.

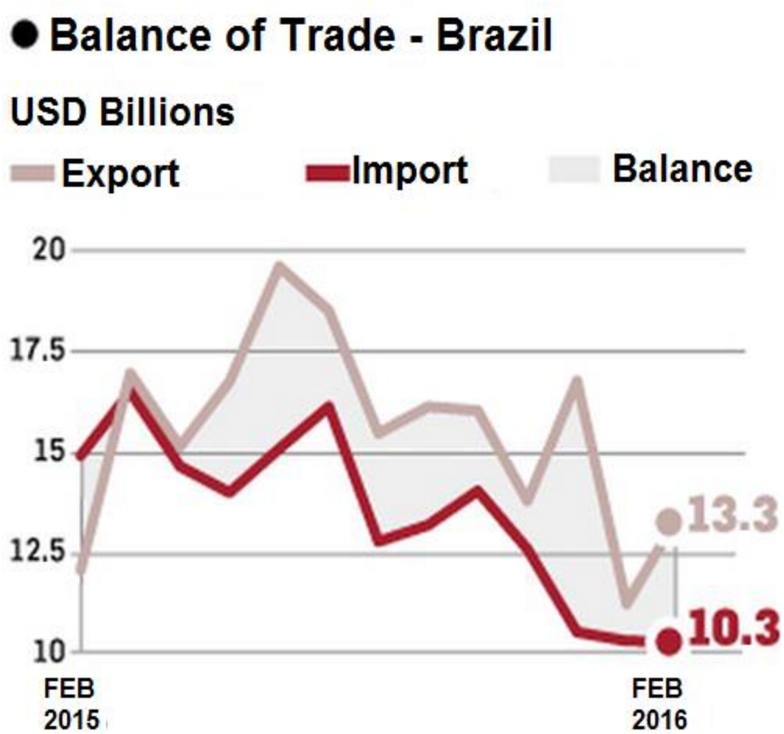
It doesn't look plausible being optimistic in moments like this, but we tend to always look for something good, however difficult it proves. However, the current "beating" is so intense that movements need to be extraordinarily well evaluated. Fronts are the most diverse: Disastrous fiscal policies; metastatic corruption; monetary policies submitted to President's orders; foreign exchange policies (those without an adjective that can qualify adequately); investment downgrade; general lack of credibility; country "closed" to external trade; the enormous hole of the welfare system accounts; anachronic labor laws; tax reform that never comes, increasing the State's interference at economy; a President lost failing to gather support from her own party; and now, finally, we have a dismissive Minister of Justice (in rule, the most important Minister in a democratic country). Discouragement? No way! Is the Government lost? Completely! Will this remain for 3 more years? Definitely not. So let's follow Winston Churchill's advice: let's keep going while in hell. It will pass. Nevertheless, always remember, especially for teaching purposes: We shall not complain about the hell we are going through, considering who we have chosen as our commander-in-chief.

In line with the chairman of the San Francisco FED, John Williams, it doesn't look like the cooling down of US domestic demand is in place, unemployment is on the way to 4.5% and inflation will revert to its tendency on 2% as the FED's goal. In Europe, ECB (European Central Bank) is ready to infuse new stimulus and in China this movement of economy's aid has just started in strong fashion. Therefore, in the international scope of the main economies, we have more of the same, and precaution is still the best game in town.

Finally, almost 100 years ago, Albert Einstein presented his relativity's theory and, according to general relativity, any asymmetric acceleration in a mass produce "gravitational waves" that spread at lightning speed. Good for the physicists, good for humanity. For those who analyze charts and follow up on the political-economic-financial worlds, it has been easy to grasp the effect of gravity in their analysis. This distortion of space-time fabric seems similar to political and economic financial distortions translated into an imminent collision of those truly black holes. At any rate, one should not expect authorities to abandon their efforts to impact markets (domestically and internationally) in case crises should aggravate and\or more instabilities on markets should arise. But the question is: is it as a reversion of "gravitational waves" or a deepening and speeding up of them? Forget the policymakers and call the physicists and astronomers!

In this environment, USA's Treasures closed the month in 1.74%. S&P varied -0.41% NKKEI closed in -8.51%, DAX with -3.9% and FTSE -5.54%. Ibovespa ends the month in 5.91% and the IBrX in 5.3%. Maximums to DIF17 in 14.54% and DIF21 in 16.12%. NTN-B 2050 finished in 7.316% and the dollar (Ptax sell) in R$ 3.9796.

Economic Activity



SOURCE: MINISTÉRIO DO DESENVOLVIMENTO

If tone is to classify, given the rough patch we are going through, we have an all-special hell: industrial sector performance.

The Brazilian economy is already showing signs of weakness from the second semester of 2014 onwards, and now the figures for 2015 have revealed a slowdown of 3.8% (our projections pointed to -3.93%), but with industrial sector GPD on spot: fall of 6.2%! A more detailed evaluation becomes even worse: deceleration stayed in 1.4% in last quarter of 2015 on the previous one and, on traditional measure of fourth quarter of 2015 on fourth quarter of 2014 we can depict a brutal decrease of nothing less than 8%!

The services sector, which has the largest weight in GDP final composition, decreased 2.7%, and the savior, as always, was Agriculture GDP presented positive values of 1.4%. But this is not all and it can be even worse, because Gross Fixed Capital Formation (GFCF) points, unfortunately, in the direction of our projections and therefore greater concerns: the Gross Fixed Capital Formation decreased 14.1% in 2015 onward 2014. In the same style of comparisons between lasts fourth quarters, of 2015 on 2014, the decrease reached 18.5%. Investment rates (GFCF/GDP) in 2015, therefore, remained at 18.2%. Truly, a disaster. We need more, much more than this and, as we always claim in this space, such a weak indicator signals bad economic performance in future.

Is there anything “better”? Maybe, depending on the perspective adopted: Exports increased by 6.1% in 2015. On the other hand, imports decreased 14.3% in the same period. Besides a different methodology to elaborate the Balance of Trade and the accounting method of exports and imports on GDP, which in the former, goods and services registered according to their values (price effect) are included, and in the latter, goods and services and percentage change in relations to volumes, the chart shows reasonably the performance of the Balance of Trade.

Economic Activity

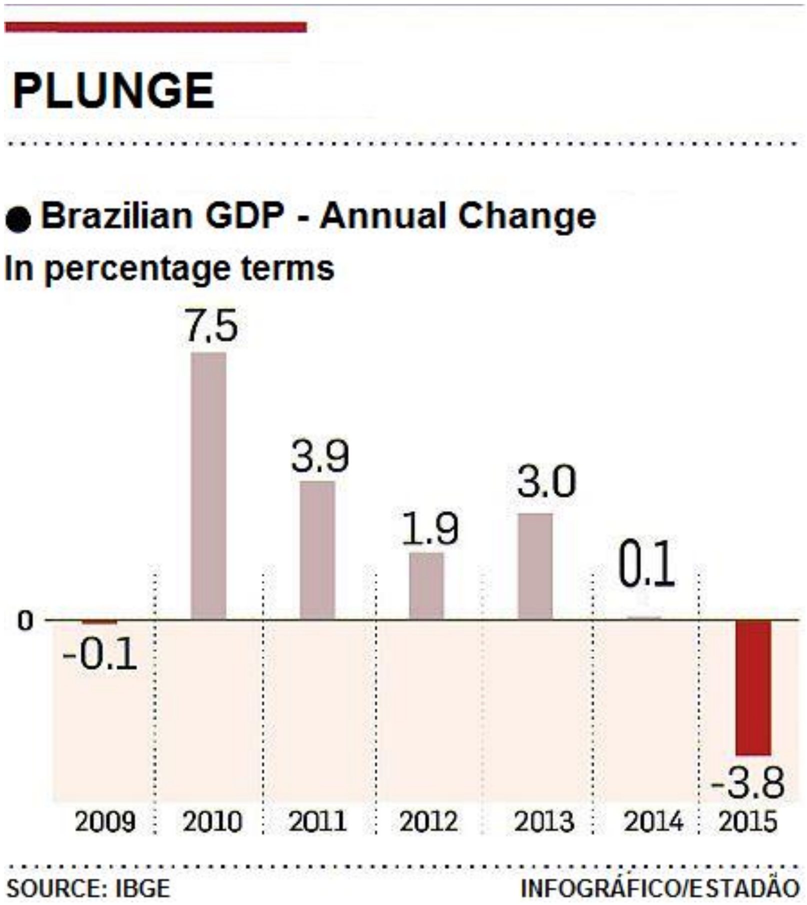
But looking ahead, the biggest chart's problem it is how the Government evaluate this result. The insistence in saying that our economic activity plunge is originated from external crises is almost an insult to our intelligence. Only countries as Russia and Venezuela (oil exportation dependents) will have a performance similar to ours.

These disaster that we constate in the outlook, is furthermore accompanied by a higher inflation and unemployment. In this context, it's verified that average income per capita is decreasing and as always, affect the less fortunate people.

The solution goes, as we have always claimed here, through wide-ranging macroeconomic reorganization. Grappling with the fundamental issues that afflict us, which were listed on the Introductory *slide,* is the essential complement set of measures. The Brazilian economy can even be flexible and give a quick answer, but as problems become more entrenched and are not faced swiftly, it will be harder to recover. In addition, here, it isn't about a "chicken flight" recover, but a solid and consistent recovery, that results from implementing the required measures and the restoration of credibility.

However, considering recent developments and the ratification of 2015 figures, our projections for 2016 are not inconsistent and we are expecting one more year of poor outcomes – maybe a replay of 2015 in 2016. Do you know what that means? A slowdown of 8% and a depression settling down.

Hell is hot.



Fiscal Policy

Fiscal adjustment: the exit door from hell.

The statement above fails to reach wide agreement, especially for the President's party and their representative economists. It is not news that this people think like that and, despite the potential that accompanies this segment (for better or for worse), they are coherent in their own historical stance. But at this moment even the Government seems to bend to the urgency of reforms, besides being rigorously indispensable. It's right in that this Government "general agreement" is "half-hearted", after all they parted with Minister Levy to bring Nelson Barbosa, but even his insufficient proposals (when compared to "A Bridge to Future" Programme of PMDB) are still colliding head-on with what PT "thinks" and the "National Emergency Programme". This distance between what is the best way to get the Country out of crisis is too bad, because the lack of political support to go ahead with the reforms is what destroyed the viability of Levy's plans and the same could happen with Barbosa.

At this pace, we follow the Government´s declarations and movements that signal a surplus of R$ 24 billion, but at the same time proposes a flexible goal that can take us to a deficit of R$ 60 billion. Questionable proposal, departing from the worst scenario, especially if we consider the figures of the government´s projections for GDP, inflation, exchange rate and expectations of extraordinary revenues. In this way, we believe in even worse projections for this year, but we don't bet in an explosive path of the relation Debt/GPD (say, about 90%), because, for us, it is unimaginable to let "it" happen. The moment of an "agreement" about the subject or a definitive breakdown and the isolate confront will come. Irresponsibility has limits.

On the other side, rumors and analyses at variance with those above are growing louder notably those that consider the imminent risk of insolvency of Brazil. The reasoning is simple (and crazy): the political crisis blocks the attainment of a fiscal solution. In this line, could the Government be more tolerant with higher inflation in order to alleviate the effects on the public debt, some interference on bonds markets (drastic way to reduce SELIC), or even some interference on the rights of these public securities holders. None of these survive on ours probability scenarios.

It's a fact that we are aware about suggestions and alternatives coming from all camps, albeit with certain filters and pragmatic evaluations. The crisis environment is favorable to speculation and crazy ideas. Everything seems plausible amid such turmoil, but it is not.

Therefore, we have to be careful… Ooops! We are in hell, but even hell need rules… we can't be the Demon (do whatever it takes).

International Environment

Despite the turbulence in markets and in developed economies, the international outlook presents, additionally, a situation that United Nations Organization (UN) called of “humanitarian imminent crisis”. It is a circumstance to which every refugee is submitted. The number of refugees arriving in Greece, especially from Syria and Iraq, increase each day, for more than one reason (but fundamentally due to war and lack of opportunities in their country). Estimates of the refugee flow within Europe point to doubling figures in 2016 in relation to 2015, which will lead to political, economic, and social immediate consequences in the region. An event such as this one can cause attitudes of high relevance, because the containment of this contingent won’t be limited to Greek frontiers for too long. All social-economic ordering will have to be reconsidered so as to “accommodate” this situation.

Still in Europe, even with fragile indicators, some relief can be seen, however ephemeral is this effect, given the general economy’s conditions and sensibilities to external factors. Therefore, in relation to the PMI, Germany had a decrease, as Spain, United Kingdom and Italy, and an increase in France. However, in all cases, figures above the 50-mark indicate that the industry activity is still expanding. In the Eurozone as a whole, the index fell, but remained at 51.2. Another encouragement in the Eurozone is that the unemployment rate reached the lowest level since August of 2011, close to10.3%. Better than expectations, but weak if compared with international standards of the most stables economies. From this perspective, not so robust as expected, the Europe Central Bank, will continue, at least, with their current measures. Is that for sure? Hardly so…for it is not typical of them. In the face of increasing risk scenario, uncertainty about growth in emergent economies and markets, increasing volatility in financial markets and markets of commodities, and geopolitical risks, the ECB will be called upon to take responsibility. If the ECB decides to act, in words of their President, Mario Draghi, there is “a variety of available tools” and that *“there is no length we are not willing to go, using our tools within our mandate to achieve our objective”*. There is no limit for them… we might go to heaven or hell…

China and Russia agreed in opening a bilateral exchange rate swap line, to boost commerce and investments cooperation. The measure seems wrapped on the intention of wider cooperation and on the attempt to diversify foreign loans and to rely less on western markets – especially for Russia. The idea points to a “de-dollarization” of commerce between countries and so as to expand the importance and the global role of their currencies. Sincerely, looking from the outside, it doesn’t seem to be sustainable on long term… Is the effort worthwhile?

In the US, the economy grew at 2.4% in 2015, a result fit to its dimension and to global economy situation, nowhere despicable. Unemployment remained at 4.9%, it means that maybe the FED may not proceed to all increases originally planned, but it will keep on increasing its interest rates. However, what is more hotly debated in the Yankees arena is the presidential election – that depending on the result will have potentially enormous effects on the US economy and on the rest of the world. The favorite republican candidate in their primaries, Donald Trump, is considered a “lunatic” (displeasing even his own party), and has everything to lose for the favorite democrat candidate, Hillary Clinton, in case a dispute between them takes place. However, for the majority share of the Republican voters, the message is clear and uncontested: they are done with Democrats and want someone a bit more “radical”.

Interest Rates

There is not only a single guilty factor for the market's mess! Furthermore, a completely satisfactory explanation is to no avail. That's the way it goes; we can't make one only and static evaluation. The composition of variables, in any attempt to set a explanatory and dynamic model, is always too hard, influenced by heteroscedasticity whilst multicollinearity is never a rule.

With it, investors, in general, are trying to explain markets' behavior with less "formal" arguments, which depict the past by events observations frequently isolated, and are of little help for the formulations and perceptions about future. Nonetheless, the empirical evaluation of facts and its structural associative model leave undoubted what happened with cause and effect and, through them, it's possible to study the future effects.

A recent emblematic case was the downgrade of Brazilian credit by rating *agencies*. The S&P has downgraded Brazilian sovereign debt, from BB+ to BB, while also maintaining a negative bias. The downgrade was expected, as mentioned in our report last month, but the timing was a surprise. Now we are two grades away from the investment level, taken in September of 2015. A little too late in relation to the other agencies, Moody's have downgraded Brazilian credit ratings in two levels, passing the country to speculative level. The main justification for the downgrade by those agencies are the still considerable political and economic challenges faced by Brazil, and because of them, they expect a longer adjustment process, a slower correction of fiscal imbalances and a another year of economic recession. What is the practical effect of this observation/event? The evaluation of interest market behavior and projections of models with this new information, of course. Curiously, the market responded quickly, in the moment the reports were released, but then returned to the previous premiums, possibly because of an anticipated adjustment of its portfolios. In the end, the short-term maturities would reduce the premiums and, as per our projections, market would start to project cuts of Selic in second half of this year – not necessarily for the same reasons. The long-term maturities closed the month with increased rates comparing to the last month.

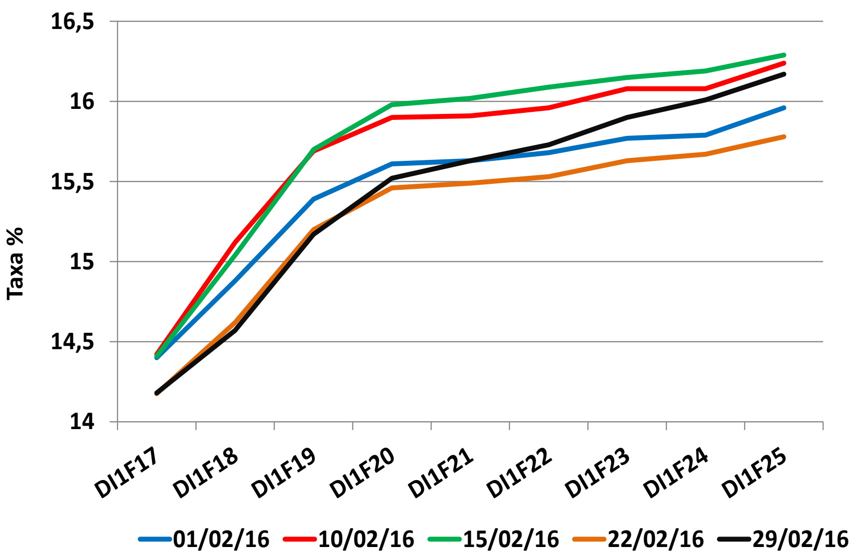
The Monetary Policy guidance (forgetting about the President´s interference in the last COPOM which humiliated and mischaracterized the reason for its very existence and its intellectually honest members), couldn't be worse under what was once understood as the "Inflation Targeting Regime" and the effective BACEN's mandate as guardian of the national currency. Its mandate is, in reality, two- or three-fold, namely: the control of inflation, of the level of activity and of unemployment. It does not deliver any of them, and it would be cruel to demand as much, amid the great confusion that blurs the definition and supervision of its assignments. Increasing inflation and unemployment plus a collapsing GDP amount to the perfect combination to socio-political instability and, without independence and following the ineptitude of the majority of COPOM's members, the interest rate will be decreased anyhow. In other words, BACEN has run out of mandates.

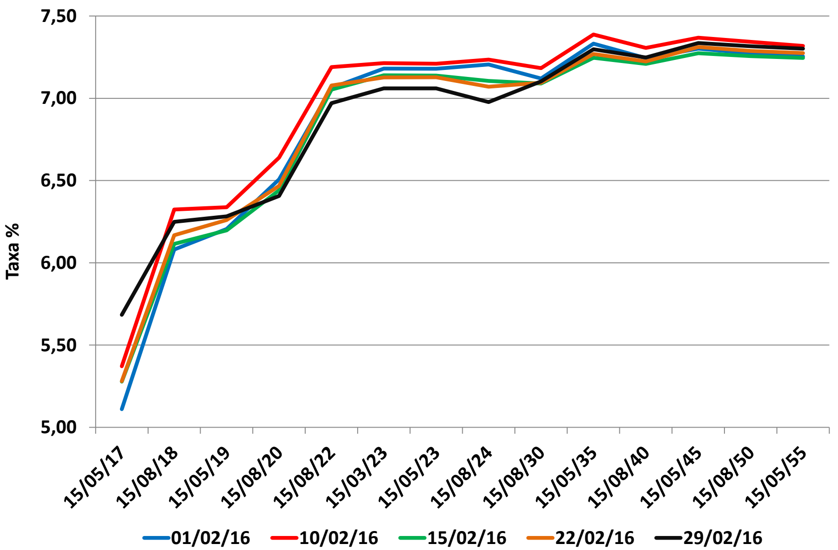
That is why markets become a mess in these times, and we don't have an explanation 100% satisfactory too… at least not ex-ante, which is of great interest in order to maximize our clients´ resources.

Maybe our economic models could be optimized using "Chaos Theory"… thinking again, forget it! Would not be applicable with these people in charge at BACEN, nor would it be with the person who tell them what to do.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

Except for punctual movements, after Brazil's downgrade by S&P and Moody's, the BRL quotes were guided by international markets.

Debates among country-members of OPEC (Organization of the Petroleum Exporting Countries) to restrict and/or freeze the production to contain the plunge of oil prices had strong influence in the dollar price in relation to countries that export commodities. However, the Dollar quotes with respect to BRL will be, among other things, but mainly, a reflex of the performance of the US currency as a whole, depending on conduction of monetary policy by FED and the health of the US and Chinese economies.

Now, the dollar is the big unknown here. If on one hand, a BRL depreciated will stimulate positive results on Balance of Trade, the exchange rate volatility brings uncertainties to markets and to the real side of economy, and will eventually stoke up the dollar, which is "fuel" to accelerate inflation. What makes the BACEN's exchange rate policy? What is the exchange rate equilibrium and, actually, of which equilibrium are we talking about?

According to our reassessment, the FED will continue increasing its interest rates in 2016 (but at a slower pace), and with it the dollar probably will not appreciate too much and the exchange rate pressure could alleviate – that is what our models are showing with others variables observed. The perception of the increase of China´s and Europe's risk also make part of the revaluation, as well as the high liquidity in international markets. The probability distribution of each event and the determination of their impacts draw out the critical values, but the variance is just too large.

In a study, published in January of 2011 entitled "Why Is It So Difficult To Beat The Random Walk Forecast Of Exchange Rates?", written by Lutz Killian e Mark P. Taylor, of University of Michigan and Warnick, respectively, the authors describe that *after almost two decades of researches since the pioneer work of Meese e Rogoff in the predictability of the exchange rate, the objective of exploring economic models of exchange rate's determination to overcome the naïve forecasts based on random walk processes is still as evasive as it has always been*. If this is so for academics and market practitioners, shouldn't it be the same, especially for the members of COPOM which, by rule, are not one thing nor the other?

How much time (and mainly wasted money) will be necessary for the BACEN to understand that less interference on markets, the better the results will be? And how much time will be necessary for us to understand that stable and dynamic equilibrium is possible and relies much more on markets then on the monetary authority's "intelligence"?

This should not be seen as utopia… it is possible… we just need courage to dare try at least once.

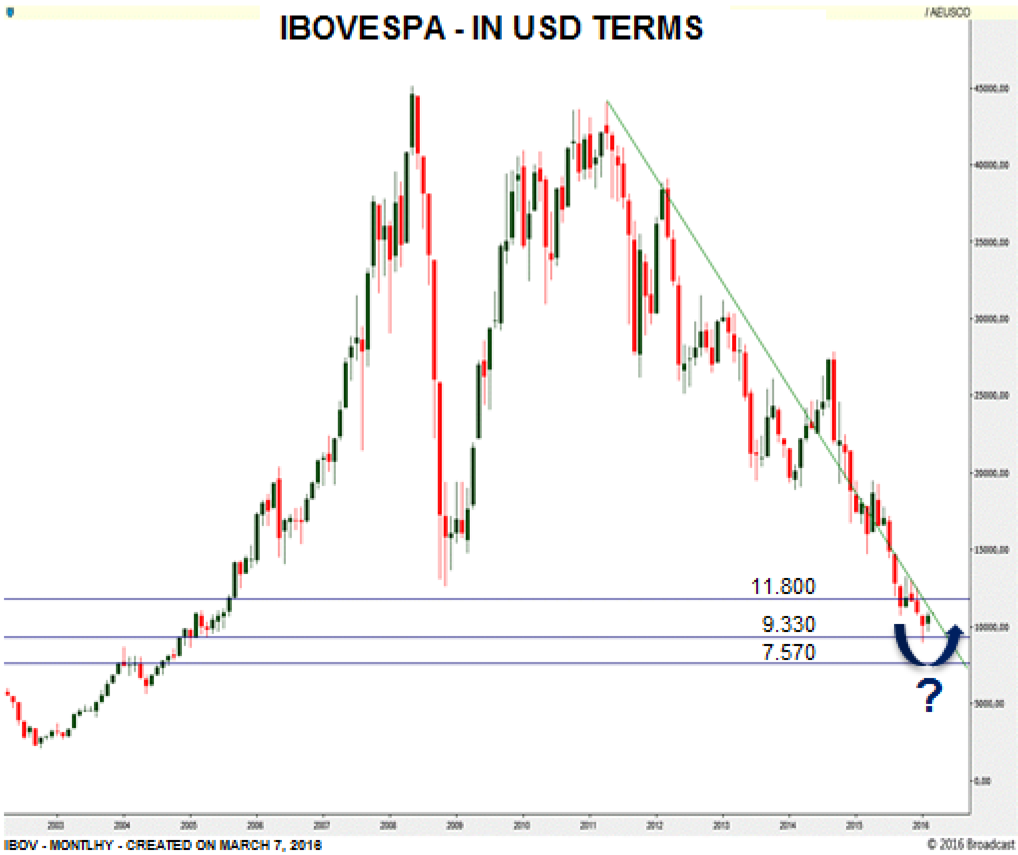
Stock Market

After every cloud there is a silver lining… In the case of Brazilian Stock Exchange it is hard to believe that it would last for long.

After the plunge taken by the Ibovespa in January, February closed with the index at highs of 5.91%. Is there a change on domestic scenario? No. Just flow. We remain under the pressure of the same hindrances: political crisis, economic crisis, credibility crisis, and all other just commented.

As usual, the downgrade was not exclusive to the Country for, in the same way, lots of companies highly represented on Ibovespa had credit downgrades, increasing their borrowing costs. Furthermore, the release of results for the fourth quarter of 2015 started, the figures, in general, are disappointing. We are left with the positive foreign capital inflow to justify the Stock Market´s rise this month.

But, why would we have positive foreign capital inflow if the scenario is so troublesome? What makes foreign investors think in a different way? Don't they have information about our current predicament? Or, are they more intelligent and more perceptive? None of this, possibly only a long-term vision, a favorable convertibility and a reduction, in the case of some assets, much too excessive. The evolution of Ibovespa index in dollars can be a great indicator (as we have shown in recent reports) and a great opportunity. A protracted calm? The effect of the crisis´ alleviation? Let us monitor changes in routes and fundamentals.



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