Planner Redwood Asset Management

MONTHLY COMMENTARY

JANUARY 2015

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"The confiscatory brutality of taxes is a serious economic retardation factor. It is frankly outrageous to see the official bureaucracy declaring that paying taxes is akin to "citizenship". Citizenship is exactly the opposite: controlling government spending." (free translation)

Roberto Campos – Economist

Introduction

They say bad news never comes alone, but accompanied by several others. In this context, it seems that Brazil's misfortune is full-fledged - a real perfect storm. Among other things: economic activity, which stagnated last year, is projected to decrease further this year, inflation is well above the upper band of the target (6.5%), unemployment is on the rise (despite the lower number, a result of recent comparative analysis perspectives), tight credit, stagnated productivity, water and electricity crisis, corruption at unimaginable levels and a political scenario which is challenging, to say the least. Are we going to miss 2014? I honestly do not think so. In fact, the year 2015 will be far more difficult than 2014, but it will be the year when adjustments begin, the year in which we will get on the right course ... so we hope. But let us not be naive; an analysis of the first 100 days of Government is done in several parts of the world. That is when one analyzes the purposes of the new government, its guidelines and broad directions. At least on the economic side, we have started well ... much more remains to be done, but we still have 60 days.

The main domestic concern is the history of this government and the President. There is a cliché that politicians dislike unpopular measures, for obvious reasons (loss of votes), but the fact is that the social theme this government has always aligned with and embraced is diametrically opposite to the direction it has now taken. This is a very strong change from what has been done in the past and defended in her recent presidential campaign. Nobody likes uncertainty, let alone markets. Will this "new guideline" based on solid economy fundamentals be the product of the slogan "new government, new ideas" or just a momentary concession to win business and consumer confidence, only to return to old ways soon after? It does not matter, because the actions of the past will reflect today and for a long time an important dose of mistrust which, in the markets, translate into higher prices (spreads) for all! Patience is necessary, but the sooner the better.

Internationally, there is a saying that when the US catches a cold, all other countries get sick. The reverse does not seem to apply. There is an ongoing real US decoupling compared to other countries in the world. The American economic activity (with possible short-term deviations) grows consistently and at a strong pace. On the other hand, Japan, ECB, China and other countries join the monetary easing train. Additionally, there are the absurdities of the Central Bank of Russia (of course, a "political" movement) that has recently sharply reduced higher interest rates. In fact, if there are changes in Brazil, the international environment also promises multiple readjustments that, ultimately, may have important impacts on Brazil.

US Treasuries ended the month at 1.67%. S&P changed -3.10%, NIKKEI closed at 1.28%, DAX at 9.06% and FTSE at 7.84%. Ibovespa ended the month at -6.20% and IBrX at -5.88%. Maximum DIF16 was 12.90% and DIF17, 12.87%. NTN-B 2050 ended the month at 5.99%, and the dollar (Ptax sale) at R $ 2.6623.

Economic Activity

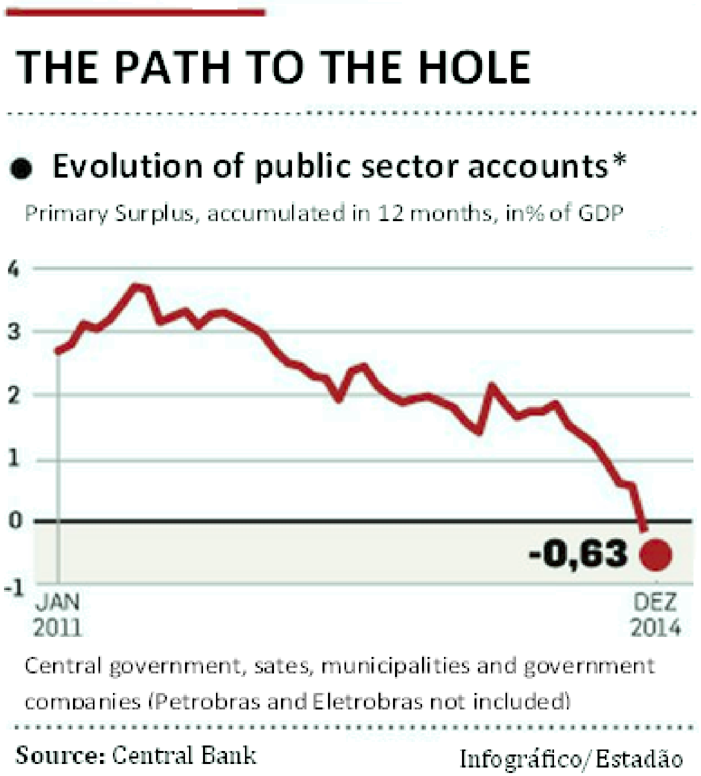
The failure of economic policy, translated into very low GDP growth in recent years, is bound to have another mediocre year. However, in this case this will be for the better. We need to have a strong commitment that 2015 (at least) must be the year of the beginning of adjustments, and once the house is back in order, we have fertile ground for sustainable growth.

The watchword here is restoration of confidence and dramatic increase of total savings - understood (amply discussed here) as Government Savings + Private Savings + Foreign Savings. On the whole, this involves increasing revenue and reducing expenditure. This seems simple enough, but when one analyzes in details where, how and when to make cuts and increase taxes, things get rough. In that regard, sensitivity, dexterous evaluation of social programs, people's achievements and attaining minimum applicable legal regimes must all be involved in the equation. This is a balance that a good economist must have, because, after all, economics is not a hard science. This all very nice and dandy, but we still face a cruel reality, although the lessons of previous crises show us a highly predictable way. Professors Nouriel Roubini and Stephen Mihm clarify with great detail, in the book "Crisis Economics: A Crash Course in the Future of Finance", the shape of the future international financial system and therefore, the economies of each country. We cannot forget the past, watch the uncontrolled surge of current account deficits and the emergence of fiscal deficits (the latter is not all bad, after all, it may be financing investments in infrastructure, for example), because we know the end of the story. However, Brazilians believe God is also Brazilian and things will be resolved. Notice, for example, the extreme complacency of rating agencies that have not downgraded the Brazil from Investment Grade ... additionally, not even the FED has signaled the rise of its interest rate.

Anyway, one should not abuse Divine goodness ... everything has a limit. In this year of adjustment Brazil will have negative growth, according to our projections, but the light already appears at the end of the tunnel in 2016. That's the good news. We will regain lost ground and realign the country economically, avoiding the clear consequences we faced under the previous economic policy.

At any rate, we should pray a little, especially for Mrs. Dilma Rousseff not having a relapse, for many people alongside her are unhappy and do not agree with this turn around…as goes the saying: *Show me your friends and I will tell you who you are*.

Fiscal Policy



Well, the disaster was huge!

The year began with a expected surplus of 2.1% of GDP, ending wistfully with a final promise of US$ 10 billion in the end of 2014. Now one finds a deficit of R$ 32.5 billion. It is the first primary public sector deficit since 2001!

The way the matter was handled, the scorn of the plunderers was more absurd than the result itself. Still, this was endorsed by superiors and peers (like the Central Bank's stance on several occasions). Anyway, it is all past us. There is a new life ahead, let's turn the chart on the following page upside down. It will be the beginning of our salvation.

However, it will not be easy to reverse this situation, especially with economic activity quite depressed. At any rate, we are all rooting, and the resumption of confidence will help in the process, but the target of 1.2% of GDP will not be easy to achieve. Preliminary savings figures indicate something like R$ 66 billion, totally inadequate for any macroeconomic purpose, but essential to try to prove our "rehabilitation", mainly before rating agencies, so that our country (Government Sovereign Bonds) is not downgraded to Speculative Grade. It would be a new disaster and a great irony of fate: the team that contributed so much to achieve the dream of a Investment Grade status would be the same facing downgrading. Hopefully it will not happen.

In fact there are actions already underway and the Chicago Boy (Minister Levy) started on the revenue side (via tax increases), but he is also expected to approach them on the expenditure side, not only in rationalization, but also the actual reduction and optimization of costs. This is a painful but essential healing process. There is a famous phrase… *austerity cripples, but lacking kills*, so true in a case like ours. Austerity also includes reform projects to give more rationality to the economy: tax, labor and administrative reform!

International Environment

The situation in Greece, with the inauguration of the new elected government and its campaign promises (fundamentally opposed to austerity) places the country in a very difficult situation. In fact, this is leading the country to a corner, a binary decision: whether or not to leave the EURO Zone - it seems that the risk of Greece leaving the Euro Zone is now much higher than in 2012. The demands of the new Government are not supported by other countries, because what they want in essence (term increase and/or debt reduction) can open a dangerous precedent for countries like Portugal, Spain and Italy, which could also make the same requests. Anyway, this imbroglio (existing since the start of the EURO - lack of fiscal and political unity) has the potential to create much trouble in Europe, to be reflected all over the world.

The confusion in Europe does not stop there. The downgrade of Russia from Investment Grade and the huge mess caused by its Central Bank, which reduced the recently increased basic interest rate (from 17% to 15%) ultimately sealed the perception of negative credibility of this monetary authority. This "gap" and lack of direction translates into lack of consistency of the actions of the Russian Central Bank, with complete unpredictability of inflation, foreign exchange and even increasing risk of capital controls. Russia is also involved in a conflict with Ukraine, with increasing possibility of escalating into a war.

In the midst of so many problems, the economy in the Eurozone is not improving and the European Central Bank (ECB) launched a giant, a trillion Euro "goodness package" - a Quantitative Easing (QE) no one will ever forget. Essentially the same remedy applied in the US, that's right, the same one that led the US economy to grow robustly seven years after its first QE. What's more, misdiagnosis and inappropriate prescription. Will this bring momentary relief? Maybe. Is this a final solution? No way. The EURO problem comes from birth (actually, it might be stillborn - consider England's decision at the time): there is no fiscal and political union, and the idea that the financial union would "drag" the others has not happened so far. Worse yet, no one talks about it ... Maybe because it's really impractical. What a mess! Maybe the Keynesians of this world will have a solution ...they should be invited for a round table for discussion ... I think the rich cousin (Germany, who did its homework and has economy in order) will not accept very heterodox solutions.

In Asia, especially in China, the government is also considering additional stimulus to allow its economy to grow at least 7% per year, but paradoxically, nothing close to what has been done by the ECB. In the US, despite a shift in growth expectations in the last quarter (from 3% to 2.6%), in general, all other indicators point to strong growth in 2015, minimum unemployment, real wage rising, consistent ISMs PMIs. The only indicator which is "not aligned" to expectations is inflation. Practical result: we continue to expect the Fed will promote monetary tightening until the end of the 1st Semester or beginning of the 2nd Semester of 2015. We have discussed the consequences often, and will adjust accordingly.

Interest Rates

Another year of Fixed Income? Apparently yes! The basic average interest rate above 12% per year and real long-term interest near 6% per year, this is the scenario for 2015. Thus, seeking investments in infrastructure, equity and/or real estate becomes not only less attractive comparatively, but also asymmetrical in terms of risk-return ratio.

The new economic policy discourse leaves no doubt there will be monetary tightening in 2015, but monetary policy, however efficacious, is ultimately on the background. Fiscal policy definitely came to stay, in line with the return to a responsible macroeconomic matrix. The combination of aligned fiscal and monetary policies is that it will solidify the foundation for resumption of sustainable growth.

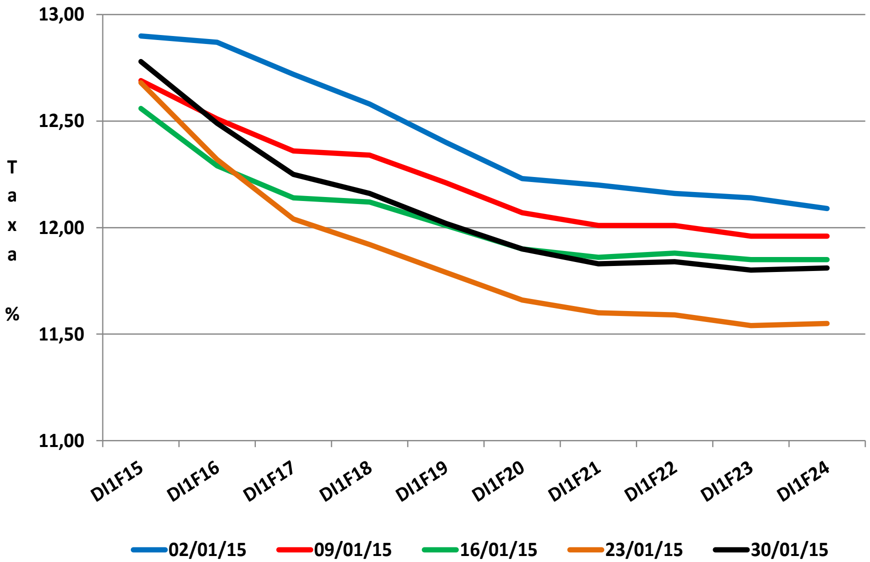
In this connection, the Selic rate increased again in January, to 12.25% per year, and according to the inflation figures and statements by the president of the Central Bank, new increases should occur this year. The Central Bank maintains its speech that inflation will converge to the central target (4.5%) in 2016. However, we saw, in January an avalanche of consumer price increases: energy, fuel, education, water, among others, making it difficult to reach the 2016 target, and almost hopelessly compromising the target ceiling (upper band 6.5%) in 2015. Our inflation forecasts for 2015, as the rest of the market as a whole, exceed 7% per year. The news is not all bad, we need to realign relative prices, and the sooner the better, because then all “fall into place”, and the objectives will be attained more quickly and easily. Obviously, fiscal and monetary policies are like medicines, the difference to poison is in the dose, intensity ... reactions and side effects are necessarily felt (unemployment, falling real wages, recession, etc.), this is the cost of radiotherapy and chemotherapy for the patient. The excesses and mistakes of the recent past economic policy will cost us dearly, imposing an ocean of political challenges in these difficult times.

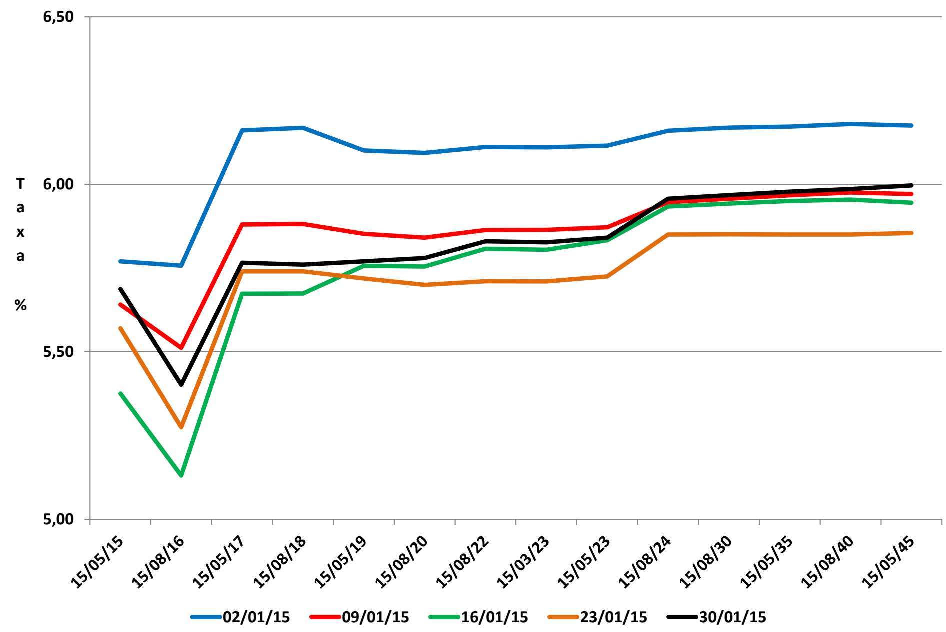
In the financial market, we experience the consequences of all of the above, for example, the term structure of interest rates, which in the month, had reduced premiums compared to the curve in the beginning of the month. Reduction in spending decisions by the Executive as well as the approval of the 2015 Budget, Finance Minister statements that fiscal policy will help monetary policy to fight inflation, tax increases and even the ECB's decisions to keep interest rates and to increase liquidity, influenced the reduction of local premiums. However, in the last week of the month there was strong pressure on rates, reflected by the rise of the dollar, the global wave of risk aversion and the consolidated public sector primary deficit in 2014 that, in line with the international scenario (especially Europe), led investors to seek developed country sovereign bonds.

There is no doubt that the National Treasury team will work on stretching the public debt and, in that connection, it has launched a new NTN-B maturity date - 2055 (only one auction). It would be far better if these were fixed-rate securities, but possible fear of premiums that would be demanded prevented such initiative. The IPCA coupon curve followed the movement of the yield curve, as shown in the following charts.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

Living with the ideas of a Chicago Boy will not be easy, especially for Latin Americans (like us) used to anything but liberalism, especially in the latter years of economic policy. Deciphering and discerning the Chicago mainstream is very simple, but very difficult to accept... The market adjusts (competition and all relevant information available to the markets), rejection of Keynesianism, adept of monetarism, non-rigid prices, rational expectations and of course, less government interference on the economy. Thus, it is not difficult to understand the words of Minister Levy, concerning Foreign Exchange Policy. The Minister has recently said that "the (Brazilian) economy has worked better on its own than with government support", "the exchange rate is a variable that cannot be controlled easily" and also said he "does not intend to keep the exchange `artificially valued`" and that "we will not make major foreign exchange operations." A more clear position than that is impossible! Foreign exchange will be just another price in the economy. Entrepreneurs (manufacturing, FIESP!) beware, because the improvement in competitiveness (exporters, for example) will be through investment rather than through foreign exchange interventions. This is our understanding of the possible philosophy of the Minister: he does not advocate a more or less valued Real... just a "more" floating foreign exchange... Is this an utopia? It could be, but it seems to be right, the Minister scores again!

So, everything was going well until the last trading day of the month when the dollar rose 2.99% in a single day, as a result of those statements and the actual understanding of what they mean. This is not easy to digest, and we are adjusting to the new reality. In truth there are members of the team (the Central Bank officers) who were part of another reality until recently. Distrust still prevails. The dollar closed the month at R$ 2.6889, an appreciation of 1.10%.

The questioning of utopia of the "new philosophy" draws upon the fact that the "exchange (FX) price" suffers from domestic and external influences, in the latter case, uncontrollable. Recently, the increasing dollar was a reflection of concerns with the local market and the worsening of the international scenario. Domestically the downgrading of Petrobras' rating by Moody's (others shall come), primary public sector deficit, PTAX dispute and the aforementioned statements by the Minister Levy pressured the last trading day of the month. Abroad, risk aversion, unexpected cut of the benchmark interest rate in Russia and greater political intervention in Turkey contributed towards the devaluation of the currencies of emerging countries. Absorbing shocks of all kinds and at all times requires muscle and well structured compensation mechanisms ... the cost is not low (particularly for some sectors), but the overall result is positive.

Thus, like the interest rates, the Real actually appreciated during the month with the fiscal tightening measures, greater transparency of government decisions, maintenance of basic interest rates by the ECB and increased liquidity in the EURO Zone. However, the increase in risk aversion later this month added to the internal infrastructure problems, such as the imminent energy and water rationing, have pressured the Real. In practice, this is a floating exchange rate.

Stock Market

New year, new hopes, new moves ... However, this is not what we experienced in the Brazilian Stock Exchange early this year. The 2014 mood remains, and the Ibovespa closed the first month of the year with a devaluation of 6.20%.

Downgrade of ratings of Vale and Petrobras, and Russia (the country lost the S&P investment grade), reduced global and Brazilian growth forecast by the World Bank and a significant part of private banks and fund managers research departments, falling commodity prices, blackout, spread of the water crisis, terrorist event in France, opposition party's victory in Greece, endangering their stay in the EU block, U.S. GDP below expectations, liquidity injection in the EURO Zone and new Chinese economy growth level were some of the month's events that influenced directly and indirectly our stock market. January was definitely not a quiet month... but nothing is excessively out of the parameters we projected for the stock market as a whole (certainly some was expected and anticipated).

The Petrobras case and its possible Contagion: The "Lava Jato" police operation remains in the news headlines. The numbers involved are still unknown. Due to the difficulty of identifying such figures, the company did not include in its 3rd quarter of 2014 results statement, not yet audited, the corruption numbers in the balance sheet, with immediate impact on the share price (PN fell 18.4% in the month) and the company's rating downgrade by Moody's. What worries investors the most is the impact on the supply chain (stakeholders) and the contamination of other industries and markets. The dollar, long-term interest rates and country risk are directly affected as the company's largest shareholder is the Federal Government. In this regard, the Federal Government also urgently needs a Plan B, given the importance of the company (it is certainly under the too big to fail assumption) and the possible need to "aid" without taking the country down the drain. If the company does not comply with certain debt covenants, creditors can accelerate their debt and that would have a devastating effect and needs to be eliminated (renegotiation, guarantees, etc.). No less important is recognizing the current management's poor image (even if not related to corruption) and the inertia and distrust of the Board of Directors. The change of directors is mandatory, and the hiring of professional management with autonomy and independence from the Federal Government, are the first steps towards a long-term solution for the company. Additionally, privatization should be definitely announced. Investors are harmed, and the answer is always the same: lack of interest and/or demand higher returns due to the risk involved. The EMBI +, which measures the Brazil risk premium jumped from 250 points to more than 320 points (since 12/13/14), a movement which is fully aligned to the deterioration of Petrobras shares.

The electricity sector has also been rather penalized on the stock exchange, in light of the increasing risk of power rationing and the end of National Treasury contributions to the industry. The low level of rainfall in Brazil, impacts not only the supply of water as well as an energy source, since the power generation in the country is mostly hydroelectric. This problem is not new, and is the result, among other things, of lack of planning. What is the solution? Revolving use? Rationing? Once more, governments work in the short term, without thinking of a long-term solution.

Anyway, we hope that Minister Joaquim Levy, despite being a lone voice in this government, can keep the Brazil as investment grade, in order to avoid a mass exodus of foreign investors. It will not be an easy task.

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