Planner Redwood Asset Management

MONTHLY COMMENTARY

JANUARY 2016

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Agenda

- Introduction
- Economic Activity
- Fiscal Policy
- International Environment
- Interest Rates
- Foreign Exchange
- Stock Market

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

“Irony strikes intelligence only. Useless it is to waste it on those out of its reach. Against these latter a weapon is yet to be invented. Stupidity is invincible.”

Mário Quintana – Brazilian poet

Introduction

The year has just begun and there is noise all around us.

Domestically we had given our Central Bank an exceptional leverage relative to what was spread and waved about raising interest rates. In the last hour, it reversed its position and kept the SELIC unchanged in 14.25%, with rumors about an “unscheduled meeting” between the Central Bank’s president and President Rousseff, where she “convinced” him to change his mind about raising the interest rates. It obliterated any credibility the Institution still enjoyed. It doesn’t matter, autonomy and independence don’t make part of the same prescription and therefore the exogeneity in the COPOM’s decision-making procedure is total – we have definitely become a drifting boat, and worse, with a captain and “minions” (except of two Directors) that submit themselves to the President’s orders. In this way, it seems to us, and by irony of fate, lots of Central Banks worldwide made the choice of (in this moment) reducing their basic interest rates (make no mistake, we were fast, certain and the first with a “new attitude”!) as if their ailments were the same as ours – and admitting the others Central Banks were right. To an economic policy that indicates returning to the practices of President’s Dilma first term with the so-called New Economic Matrix, the Central Bank was our last possible anchor… and we have lost it. However, the possible subservience of Central Bank isn't what ails us worst, not even the most usual; the worse of our ills is our stupidity. Theirs successive and conspicuous mistakes leave no doubt that Mario Quintana was spot on: stupidity is invincible.

In the international field, though far from our performance and expectations, the beginning of the year proved quite complicated with oil prices plunging, a yet-to-be-completed accommodation of China, poor performance of several economies and theirs policymakers sending contradictory signals of their intentions. The response of markets have been relentless with significant drops, volatility and growing anxiety of the investors in general to the point of questioning if we are at the end of a cycle of almost 7 years of “prosperity” for financial assets.

Thus, both here and there (after all, we are in a globalized world, right?!) investors will need to control anxiety and reinforce their patience, because we will be more volatile early this year, but it is not evident yet that the world as a whole will slide into recession and, with it, entail a change of posture in economic policies of these countries. Nonetheless it is unquestionable that the price of commodities, of the dollar, as well as those in markets overall need to stabilize. It is equally important watch for the positive signals coming from the real side of the economy. With such surveillance, certain markets’ dysfunctions and displacements will provide several opportunities…portfolios with a vision for rebalancing and strategic long term allocations are good options…but, for the time being, the economic environment requires great precaution.

In this very environment, the USA Treasures closed out the month at 1.93%. S&P varied -5.07%, NIKKEI closed out at -7.96%, DAX with –8.80% and FSTE -12.89%. The Ibovespa ended the month at -6.79% and o IBrX at -6.26%. Maximum for DIF17 at 15.76% and DIF21 at 16.81%. NTN-B 2050 ended the month at 7.36%, and the dollar (Ptax) at BRL 4.0428.

Economic Activity

There is no doubt that the international scenario is quite worrisome, particularly with lower figures for the Chinese economic activity compared to recent growth scores, 13% in 2013, 6,9% in 2015 and average projections going below 5% for the next decade.

Also, difficulties endured by developed countries (such as Japan, “Eurozone”, etc) add up to our framework. However, what is the real impact of meager growth of developed economies on Brazil’s performance? Hard to measure, but the fact is that our internal imbalances are the truest and most important aspects for our under-performance. In this way, we are, in part affected by the shortest economy growth cycle of the world, but we contribute (just as other "emerging countries” do) to a decrease in the economy's dynamism, even more so because, nowadays, emerging economies have relevant participation in the world GDP.

Thus, we must provide urgent care to our domestic troubles. Investment is what really matters, but in order to ensure its happening we have to meet all of the previous requirements presented here – the control of public accounts (at any cost!), credibility (clarity in actions and proposes) and the building up of savings. The order of actions pursued thus far is mistaken, and adding up to political crises and economic team’s convictions, the despair of government suggests recovery can last more than we anticipated in the past and is likely to be the source of ALL our problems: parafiscal policies, measures to fiscal slackening and leniency in monetary policy. It is a big and eminent risk.

The Country’s governability will be in check throughout this entire first semester, accompanied by the total paralysis of economic activity – there will be no real economic "life" at this moment. Besides that, we are optimistic (not really) once we get passed this political turbulence – with a clearer definition of our future and therefore a slowdown in the decline of economy's activity, especially in last quarter of the year. Some points toughen this view apart from the “cooling” of the political crisis: Dollar quotes have accommodated further, the external sector (consequently, also) with favorable results, and the beginning of concessions of exploratory rights on public utilities and privatizations in infrastructure, among others. All of this matched with a lucidity shock and (though small) spasms of intelligence or, even, divine help that disturb any plan to return to the notorious New Economic Matrix’s concepts.

We count on everything, even with the economic team’s inaction if they want to resort to practices and actions typical of the President’s first term in office with the stimulus package recently announced (anything is better than *that*!). The President’s misconceptions about the national and international economies are an important factor and need to be decreased, given the fact that she is the one calling the shots. The attraction the President enjoys to stimulating consumption and using the State as an economic inducing device (via increasing spending) is a danger.

Lastly, is the fact that the global economy influences our own, but it doesn’t compare to our main problems. Adding to this, if the world “disturbs” us (as the government often blame the international crisis), we had better reinvent ourselves because the international environment will not get any better. This reinvention isn’t about isolating ourselves from the global economy but, on the contrary, it is about opening our economy to new investors and markets and attracting financial flows. This dynamic is of utmost necessity.

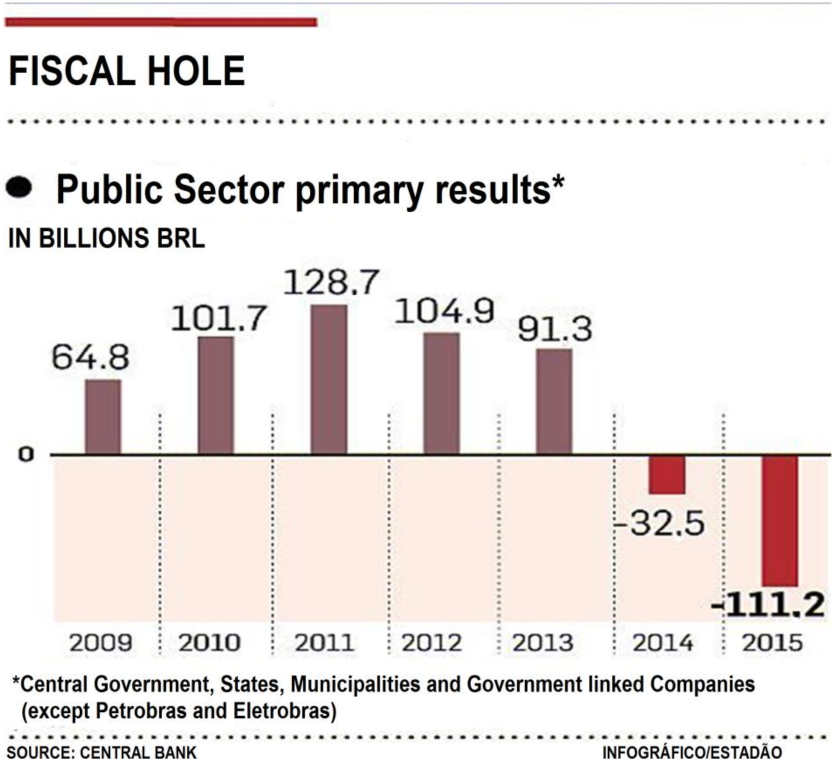
Fiscal Policy

More than simply looking back at our past, what matters in economics is looking into the future. But it is necessary to grasp the future in other ways, and not with the interpretive myopia about things that landed us in the hole that we are in now, as observed in the graph.

The outcome of fiscal policy thus far is so disastrous that we should dispense with any detailed comment and analysis. Time is everything we don't have to spare, and reality rubs on our faces that we need to cut costs most urgently. It doesn't mean cutting and reducing costs in linear fashion, without assessing and valuing their short and medium term impacts – but they must be large and unequivocally will affect all segments. There is no way around it, and the process will be less painful and enforceable as soon as the adjustment is promoted. The true challenge will be to pursue, democratically and firmly, the possible adjustments with or without the help from Congress.

Finance Minister Nelson Barbosa brings back the ideas he once proposed to his predecessor Minister Mantega about implementing fiscal bands – one which the latter rejected in favor of "creative accounting" practices. Although stipulating a tolerance range does "guarantee" greater fiscal responsibility than simply fulfilling empty promises, the idea of bands does not engender by itself the required credibility because what we really need are more than transcends bands and goals, we need floors – minimum floors arising from strong cuts. Bands, if results are tampered with, look like "licenses" to spend… and depending on the gap… oh boy!...not even balance the debt-to-GDP ratio. Better yet, it would be high and staggered minimum floors aiming at stabilizing and averting the trajectory of debt-to-GDP ratio within a 3-year period.

Anything different from that, our call is that Brazil will be downgraded again from the main rating agencies.



International Environment

Mirroring what happened in some countries as the figure on the side shows, Japan has changed its interest policies too. Negative interest rates convey a simple and direct message: it is about a punishment on banks that have money and don't want to lend it to their clients… really?... is there any truth to that? If there is anything that bankers HATE is idle cash balances. The principle is crushingly simple: the business is about lending what is in store and chase interests by lending it over again. Therefore, if this cycle doesn't happen, something really strange is taking place in this country's economy… and in many other economies as well! Concrete data: a share of almost 25% of the Global GDP comes out of economies with negative interest rates. They are running out of ammunition to stimulate their economies….

In China, the government continues to enlarge the fiscal spending in 2015, which went up by 15.8%, and its interventions are to continue in 2016. The landing of Chinese economy is increasingly clear and scares everyone, especially because of the actions that a "desperate" Chinese government will be able to adopt.

In Europe, Mr. Benoît Coeuré, member of European Central Bank, has claimed the accommodative monetary policy is working. Mario Draghi, president of the same institution, said in the last meeting that probably the monetary accommodation will be reinforced in the Eurozone next March. Humm…some data: the PMI for Germany, France and Italy decreased in January, whereas it increased in the UK and in Spain. In the Eurozone overall, it fell. I see…

In USA, we followed the FED not raise interest rates as it did in the last FOMC meeting. It will be like this anyway, gradually… but will continue increasing. Despite the dovish style of those in charge, the FED is highly zealous of its communication and tries to keep it coherent.

Ah! Still the chart bothering us when we compare ourselves to other countries? Unfortunately we deserve it, which is not to say that when someone becomes Central Bank's Director he or she becomes wicked, neither unpatriotic nor friend to bankers… this is the rate that, as a rule, translate our situation and needs… and at times we are far below what it should be!

Selected countries Interest rates	
Denmark	Deposit Rate: - 0.65%
European Central Bank	Deposit Rate: - 0.30% Refinancing Rate: + 0.05% Marginal Interest Rate on Loans: +0.30%
Switzerland	Deposit Rate: - 0.75% Libor - Interbank Rate of 3 months (band): -1.25% until – 0.25%
Sweden	Repurchase Rate: - 0.35%
Japan	Deposit Rate: -0.10%
Canada	Basic Interest Rate: +0.5%
Australia	Basic Interest Rate: + 2.0%
Norway	Basic Interest Rate: + 0.75%
United States of America	FED Funds Rates: +0.25% until +0.50% Rediscount Rate: +1.00%
Emerging countries	
Russia	Basic Interest Rate: 11%
South Africa	Basic Interest Rate: + 6.75%
Mexico	Basic Interest Rate: + 3.45%
Indonesia	Basic Interest Rate: + 7.25%
Turkey	Repurchase Basic Rate (one week) : +7.5 %
Colombia	Basic Interest Rate: + 6.0%
India	Basic Interest Rate: 6.75%
Brazil	Basic Interest Rate (Selic): 14.25%

Sources: Central Banks and Dow Jones Newswires

Interest Rates

Credibility has been entirely lost!

A decision, not unanimous, by the Central Bank at the last COPOM’s meeting on 01/20/2016, to keep the SELIC at 14.25% per year ratified the non-operational independence of the institution. After several speeches signaling concerns with current inflation and the goal of bringing it to target level in 2017, which required increasing the interest rate even in the midst of a recession, President Alexandre Tombini surprised the market with a total turnaround. The Reason for this change being? The Central Bank’s lack of independence from the Presidential Office. Alibi used: an IMF’s report illustrating Brazil’s non-growth economic reality. The report showed that Brazil might suffer a further slowdown of 3.5% in 2016 and register economic stagnation in 2017.

After COPOM’s minute was published, many economists changed SELIC’s projections from an increase in 2016 to either maintenance or decrease in interest rates. Such projections are likely to remain should we notice no change in the monetary policy guidelines. It is worth recalling that the Brazilian Central Bank’s directors change their minds in a heartbeat. The dovish tone of the minute has shown great concern with domestic and global economy’s slowdown risks apart from the uncertainties generated by plunging oil prices.

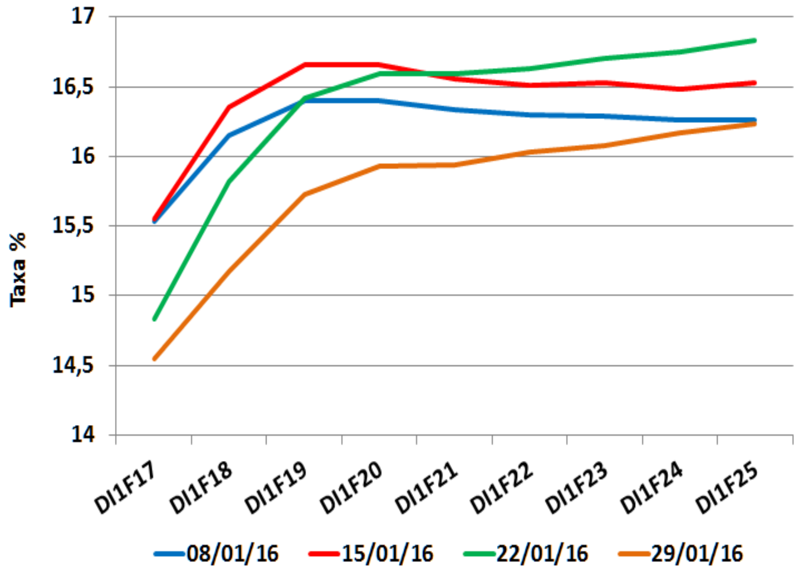
Markets’ interpretation of the Central Bank president’s speech and decision was about a sudden change in the future market interest rates movement. Contracts maturing in January 2017 have removed interest rates highs projected for the year. Prior to the meeting the increase was being priced up to 0.5% rise of the rate. Consequently, the long-term contracts had interest rate increased, resulting from the scenario’s deterioration.

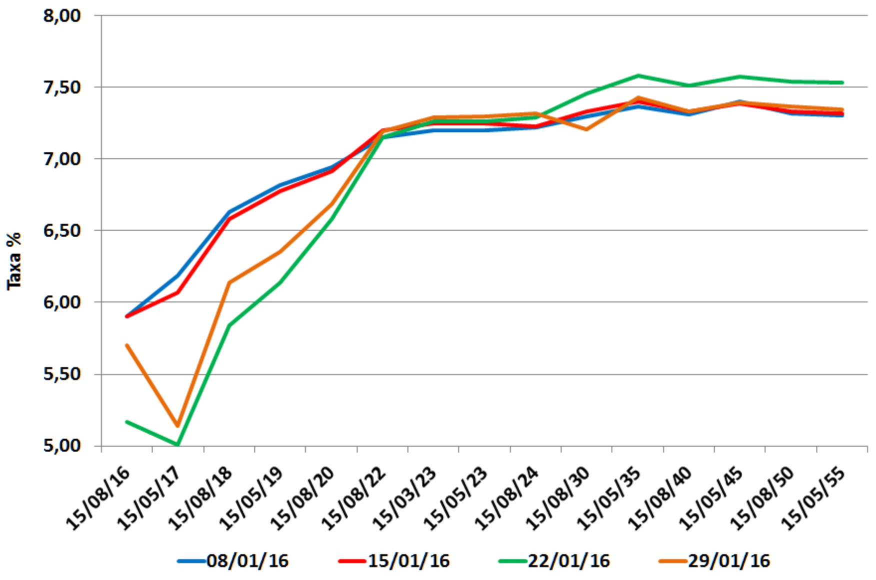
The façade of commitment with that necessary adjustment was unveiled with the Central Bank’s decline to increase the interest rate. Recovering the expected confidence and competence enjoyed by the Central Bank as to any of its attitudes does not seem to be in their plans. Monetary policy´s very efficacy has decreased significantly, following the unfortunate “interference” episode (tacit, at least). We can’t forget that one of the monetary authorities´ responsibilities, especially under the inflation targeting regime, is to “control” economics agents’ expectations by clear, real, objective, technical and independent reports. In the background, more than a “surprise turnabout” in the market, the Central Bank also brings now a “swirling moment” in which everyone starts to settle.

Actually, it is now easier to predict the Central Bank movements (or not!). The dissident board members can flounce all they want, even make the alternatives the most imaginatively distinct, that is, they can transform the COPOM into a stochastic simulation process, but whose results will eventually revert to the average. Does anyone know what the average is? It is the one that suits best the President and Commander-in-Chief. Brace yourselves for the worst!

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

The dollar has reached the mark of BRL 4.17 in January! The highest price since the Real Plan was launched.

This price was achieved in the day that followed the COPOM's meeting that frustrated the market's expectations. Several agents were positioned as to an increase in SELIC and needed to adjust the position by making the dollar achieve the maximum early in the trading session. However, the price was being adjusted throughout the day. In the month, the US currency closed up with a high of 3.5%, at BRL 4.04.

The deterioration in the political landscape, the revision of the fiscal target, capital flights and the possibility of using the international savings can lead the Country to a new downgrade. These facts will bring volatility to the exchange market. In addition, as was verified in 2015 (and others years) the exchange swaps issued by the Central Bank will not avoid the volatility in the currency's price. Unfortunately, the Central Bank isn't so smart nor even faster than the market. The fact is that the solution is much simpler: it would be enough if the Central Bank were to meddle less in the economy.

The exchange rate policy therefore, could be more transparent, less intrusive and more dependent of a solid situation on our Balance of Payments, especially in our current accounts. In other words, a real floating exchange rate, as the investors want and as the country's predicament requires. But, one could wonder: if the situation isn't good at this moment…shouldn´t we pursue a more active exchange rate policy? After all, it would be naïve to imagine that countries do not call on preventive measures to protect their currency, right? Yes and no. Yes, everybody has this kind of mechanism and has yet to use it in a moment of its history; and no, such attitude doesn't make sense, because all countries adjust themselves and, in the end, the balance will be given by other intrinsic factors of each one country – not forgetting the glorious term coined by former Finance Minister Mantega: Currency Wars, the analysis triggered the subject and what we came to verify thenceforth.

In both relative and absolute circumstantial terms, there are several externalities which may contribute positively to our exchange rate question, amongst which we find the quantitative easing policies around the world, the negative interest rates on deposits in several countries (which fuels "carry-trade", albeit of low magnitude and ephemeral), the Chinese government injecting more than US$ 15 billion on economy and the "People's Bank of China" (PBoC, the Chinese Central Bank) starting to charge compulsory requirements on yuan-denominated onshore deposits of foreigners banks, and even extreme measures of capital control (they made it before! 1998 – Asia's Crisis) and their currency devaluation.

Finally, any exchange rate policy - as we understand it (or how typically interventionist governments would have us believe) - is as complicated as it is innocuous. Getting it right would require pursuing the K.I.S.S method, namely: Keep It Simple, Stupid.

Stock Market

China isn't the only one to blame. The Brazilian recession owes primarily to internal factors: inflation rate of two digits, imbalance of public accounts, the corruption scandals fueling Petrobras' windfall losses amounting to billions, mainly because of mismanagement, the real estate credit/house loan shortages, industrial production slowdown, reduction in investments and lowering productivity, just to mention some of the factors that brought Brazil to its knees. There is no doubt: it is easier to blame it on China and the international markets.

Different retail indicators show that, in 2015, the segment endured its worse year since the cycle of expansion when Brazilian families boosted consumption, more than a decade ago. What is worse is that no one sees great possibilities of recovering in 2016, with hesitating entrepreneurs cutting costs and holding back on investments – the primary factor governing the return to growth. Such *a* framework is drawn through a myriad of problems that punish the country and result in a burden that scares investors and establishes our odds for a long time.

There is no package or credit incentives, as was announced by the government, that would revert the recession chart and therefore sensitize and materialize any significant and continued effect on the real economy. Eventual credit availability may help the companies in rolling over their commitments, thereby avoiding defaults and delinquencies from becoming rampant in the short run, but it is absolutely insufficient to restore growth and consequently shares' values.

The stock market went back in time, for in January the index was negotiated at the same levels as those of 2009. Without further calculation, it looks as though the Brazilian stock is cheap, even more so if we consider the devaluation of the real against the dollar. However, risks seem high. Companies relying on commodities' prices and shares of State companies weigh heavily on the index. Even if one can't foresee the extent of the effects arising from the "Operation Lava Jato", it is well known that, due to the involvement of the country's top companies, the return of growth and of long-term investors are indeterminately delayed.

Finally, safeguarding all the own characteristics of financial market momentary overeactions, the stock market reflects the economic outlook and today it is mostly affected by the political crisis. Therefore, the good news is: with the political crisis cooling down and the traditional early pricing of financial market, it will be possible to see quite a significant correction. This latter would be much better and much more lasting if we reach a political solution to the economic realignment. The gringos call it *wishful thinking*.

Meanwhile, the Bovespa index closed up with decrease of 6.79%.

And it wasn't any worse only because of the strong and punctual recovery of the month's last trading day.

Monthly Commentary

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