Planner Redwood Asset Management

MONTHLY COMMENTARY

JULY 2015

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"The emperor has no clothes!“

From the fairy, tale "The Emperor's New Clothes", by Danish writer
Hans Christian Andersen

Introduction

Error is inherent to human beings, but some of them must be avoided to the extreme. In the same way that an engineer cannot make mistakes in the calculation of the structural design of a bridge and a doctor cannot do any mistakes in a heart surgery, economists need to know how to do the math. This hard science side is essential for good management, although it does not altogether override the human/behavioral side of economic sciences, either. But an economist who is not akin to numbers simply is not a good economist, simple as that.

However, we must not forget that economics as we understand today was at one point called Political Economics, a vital component for the design and implementation of economic policies. Consider the recent revaluation of the fiscal surplus, was it a calculation error or a policy adjustment? Are we facing a blunderous assessment of indicators and measurements, or is there more between heaven and earth in spinning this 1.1% GDP surplus into 0.15%? In any case, Minister Levy has been knocked out...his recovery will be difficult. In a way we feel sorry for the Minister and his team, they are left politically hanging by their peers - especially from the economic area and Central Bank, with very few exceptions.

All those minimally involved with the country's figures knew and know that we have is not a short-term imbalance between revenues and expenditures, but rather a chronic, structural lack of control - we spend more than we are able to. In this sense, the arrival of Minister Levy and his staff filled us with hope, that "*The Inevitable Adjustment*" would be faced - as called by Mansueto Almeida Jr., Marcos Lisboa and Samuel Pessoa in their recent article. It was the beginning of a dream, the expectation was to reverse *a perfect dry storm* (yes, here as in California - where the phenomenon occurs - we have a water crisis) and eliminate the Brazilian state solvency risks - with the support of Congress, of course. Everything went terribly wrong in the primary surplus reduction surplus announcement: the "excitement", the content, the form. Even worse were the projections, which attempted to justify the "stability" of the Debt/GDP ratio, the reason for cutting the state and municipality targets (as of today, they deliver results), the non-contractionary effects of the current policy. The financial market understands the "disease", knows the "medicine" and knows the side effects, one cannot hide it. It priced the day after, and will continue to do so!

Worldwide, life was no less agitated. Greece reached a momentary agreement (until the next one) without serious impact and contagion in the Eurozone (but the case is not over yet) and the FED decided to take action (raise interest rates) only in September. The most worrisome ghost is China's hard landing. The government stimulus, sung in verse and prose, and support to the economy may be too much even for the Chinese State's unlimited and megalomaniac economic project. The China problem can be so large (not only for emerging countries) that some even believe that China's situation will impact the FED decisions.

In this environment, US Treasuries ended the month at 2.20%. S&P changed 1.97%, NIKKEI closed at 1.73%, DAX at 3.33% and FTSE at 4.80%. The Ibovespa ended the month at -4.17% and IBrX at -3.44%. Maximum DIF16 was 14.31%, DIF17, 14.01%. NTN-B 2050 ended the month at 6.47%, and the dollar (Ptax sale) at R$ 3.3940.

Economic Activity

In 2014 we had stagflation, in 2015 we will have recession. How about from 2016 on? Will we have a long recession or do we go straight into a depression?

Ok, let's slow down. The fact remains that our situation is much worse than we thought in the beginning of the year. The situation gets worse every week, and considering the direction of the economic policy - especially the fiscal failure - the bitter taste of the medicine (macroeconomic adjustment) which was supposed to be temporary, appears to be more challenging and long lasting. It's more than a shame, because apart from the failure that in itself can make a huge mess, this can also result in a vicious circle with very adverse consequences in the whole production chain of our economy.

The situation is indeed critical. We have the worst of all worlds (inflation, unemployment, recession) without the expected benefits (an economy on the right path and economic power), because there is a risk of entering into a downward spiral where people and economic agents do not see a perspective of growth. Pessimistic forecasts feedback (this is not entirely baseless) and become self-fulfilling prophecies. Credibility and growth go hand in hand...and we have neither. This perpetual motion must be stopped so that there is light at the end of the tunnel, and there is a reversal of the trend. This will only happen with clear and direct engagement from the one who caused this: the federal government itself. Is this simple? No. Is it a necessary and sufficient condition? No. But it is the first and most important step at this time...a formal recognition of mistakes done and an honest defense of the measures and their reasons...full transparency. All at once, bluntly, without pretense.

In this sense, as we see it, economic activity, which obviously responds to stimuli, rationality and efficiency of correct economic measures, at this point depends fundamentally on a "political" drive beyond Minister Levy and his team's good management. The breeching we would need to endure, discussed in the last report (then a GDP contraction forecast a little over 2%) is currently estimated by our peers at 3%. It is a lot, and very rarely have we seen in our time series two consecutive years of negative economic performance.

Anyway, Brazilians will "understand" if the tightening is momentary and convincing...if today's over-exertion can be seen as a prize ahead. Otherwise, we will have turmoil, demonstrations and concerns, which will translate into even greater socio-political and economic instability, which both drive away investors and puts all of society on stand-by. Following steps, a break with the model and the system is in order. Is this a naive deduction? Not really, there are plenty of examples.

Again we reach a borderline situation, and the catalysts of this problem were genuinely the country's wrong decisions in the recent past. However, the situation is still reversible - but the there is little time for adjustments, for now externalities will hit strongly… China's slowing down, the FED's raising interest rates, etc... It is time for Statesperson Dilma to come into action. God help us!

Fiscal Policy

We really we do not need enemies! We asked last month whether the glass was half-full or half-empty...it is 100% empty.

What a colossal disaster, in every way! We witnessed in disbelief and absolutely terrified the "explanation" offered by Ministers Levy and Barbosa (and their teams) concerning the reduction (or elimination?) of the fiscal surplus this year, 2016 and 2017. What a joke, a week before Levy would not even accept discussing this matter. We prefer to believe that he was beaten, that it was (and it is) possible to do more about the surplus... That the emperor (or rather the empress) is not naked. Better yet, if Minister Levy and staff assume this and stop (the Minister) saying that the reduction of the fiscal target from 1.13% of the GDP to 0.15%, should not be interpreted as a loosening of the fiscal adjustment, that "*this change of target was caused by exogenous reasons and it is not an indication of fiscal relaxation, quite the opposite. It would be an illusion considering the need to change the target due to a conjunctural situation to be construed as slackening of the fiscal adjustment"* It's getting ugly, very ugly, because nobody believes it (quite possibly, not even Levy himself) - who, by the way, enjoys extreme respectability among economists (those who really studied) and the financial market. However, if confidence is lost, it takes time to win it back.

Anyway, *alea jacta est*! In our opinion, we have just sealed and anticipated the loss of our Investment Grade and have began a phase of extreme distrust of everything and everyone. The problem is not a simple rejection of the reversal of numbers and outlook, but rather, trying to tell and convince us of the impossible, such as the Minister's statement, that the Gross Debt/GDP ratio (on whatever method!) will be stabilized and declining and that the effects of the measures are not contractionary. Dismissing other people's intelligence is rude, arrogant and, ultimately, unintelligent - something that cannot even remotely be attributed to someone of the Minister's stature and his team. Such a stand could be admissible only and if motivated by an exaggerated, momentary, generous public spirit, and extreme haughtiness of a person on the way out, who did not want an even greater turmoil for the country, mindful of the consequences.

Anyway, we completely refute that such a miscalculation has happened. The surplus was 0.9% and 0.2% for the Central Government and States and Municipalities, respectively. The States and Municipalities, on their own, had been delivering their "target" as set forth... the combined target was reduced to 0.15%. Surreal. It gets worse: this new 0.15% estimate includes extra revenue which, if is not accomplished, may even result in primary deficit. Do you know what is one of these important measures? Repatriate (or formalize) funds sent abroad illegally and therefore tax them...*gee*! Who will do this???

We all know the structural issue involving public spending, the non-cooperation of the National Congress and the different views of the Ministry of Planning and the President's agnostic views of austerity regimes (due to poor training and political antagonism), but the consistency of Minister Levy's attitude must continue...governments run their course, some sooner and faster than we imagine...Levy and staff can be helpful shortly after, for they are good technicians. Meanwhile, Tombini and staff better get ready, because more will be required of monetary policy.

International Environment

Economies around the world, whether emerging or developed countries, have not given a rest this past month.

Greece, which took over the international scene last month, finally reached an agreement, but the situation is far from a sustainable outcome and even less, some relief for the population. The recovery will be long and costly - that is, if there is no disruption of the agreement or another outburst by the party in power.

Russia, in turn, that since December last year was forced to significantly increase its interest rate to address the devaluation of the Ruble, promoted the sixth reduction in interest rates - now 11%, still above 10.5% (Dec/ 2014). The outlook for growth of the Russian economy is very bad and this has driven a higher rate of reduction of basic interest rates. The Russian Central Bank expects inflation will cool down this year, but convergence to target (4% per annum) will take place only in 2017.

In Europe, the disclosed economic indicators show that the European Central Bank - ECB should continue and even expand monetary accommodation - judging by the direction, understanding and attitudes taken by the ECB so far. Annual inflation in the EURO zone remained stable at 0.2% in July, but the number of unemployed grew, suggesting the recovery of the labor market will continue weak.

In the United States, the economy is expected to grow around 2.7%, the unemployment rate approaches the figure considered adequate and inflation (the only variable far from the expected figure) still remain at "unsatisfactory" levels on the "target". For all this, we remain adamant that the FED will raise interest rates in September of 2015. In fact, this view seems to have been widely accepted by the markets - both domestic and international.

However, the protagonist of the month was China. Besides the undisputed cooling of its economic activity, the question remains whether the Chinese government would be able to prevent a possible hard landing. All who are not strongly believers of market economy and free trade, reckon that China fits the American definition of *too big to fail*. The question is whether, if possible, anyone could help except for the Chinese Government itself...some believe that even the Fed has been considering this probability in assessing its interest raise decision.

As it turns out, the assumptions discussed here seem to happen, at a very precise horizon. Let us tighten the belt!

Interest Rates

The economic situation is stirred up...worsening of the political crisis, reduced fiscal target, new phases of the Lava Jato operation, revised forecast scenarios for the Brazilian economy. And as a result, it is no surprise to anyone following the market, that the Standard & Poor's rating agency has lowered Brazil's outlook from neutral to negative. Next step: loss of investment grade.

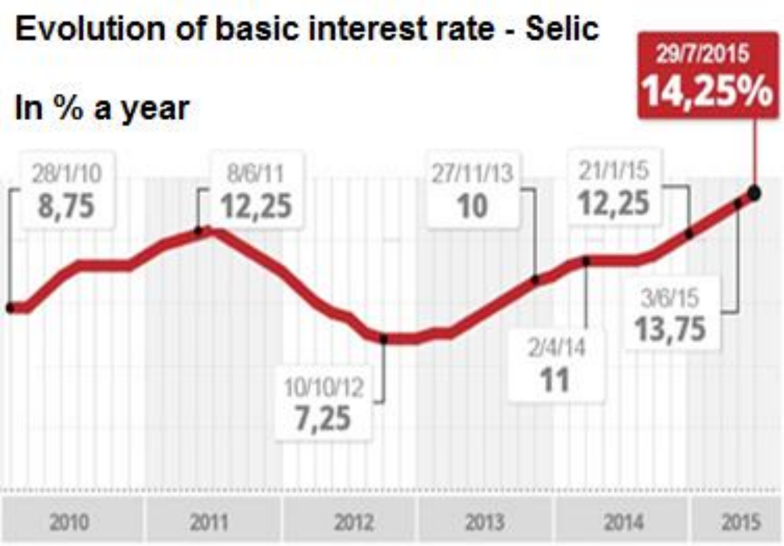
As a result, monetary policy should be used more strongly, that is, in the balance and synergy that must exist between fiscal and monetary policy for the smooth running of economic policy. Since fiscal policy will not meet the target, monetary policy must (again) do the "work" - even if lame and with consequences that will not result in the long lasting effects of fiscal adjustment.

So once again the Central Bank raised the Selic rate 0.5%, now at 14.25%. With a higher interest rate the Central Bank tries to control credit and consumption, thus acting to hold inflation (although the most important objective, in fact, is the equilibrium of savings and long term investment). On the other hand, in the short term and until the idiosyncrasies disappear, high interest rates hinder investment, employment and subsequently, the growth of the Brazilian economy and government revenues, by making credit and investment more expensive. We are in a vicious cycle! The cost of the macroeconomic imbalance with such a strong impact on inflation requires an absolutely rigid stance to anchor medium and long term expectations.

According to market analysts interpretation, the post Copom report indicates that the rate should remain at this level for a long period. Will it? We cannot forget that the economic situation has deteriorated, the fiscal target will not help fighting inflation and finally, the rise in US interest rates looms around the corner.

Volatility was high on the interest rate market in the month. The market reacted to every Central Bank Directors' statement, at times betting on a lower Selic increase, then the continuation of the intensity of increase. After the decision and communiqué that kept the pace of increase, but indicated that the tightening may be over, short interest rates ended the month with lower rates than the previous month, and the long-term interest rates began demanding more premium.

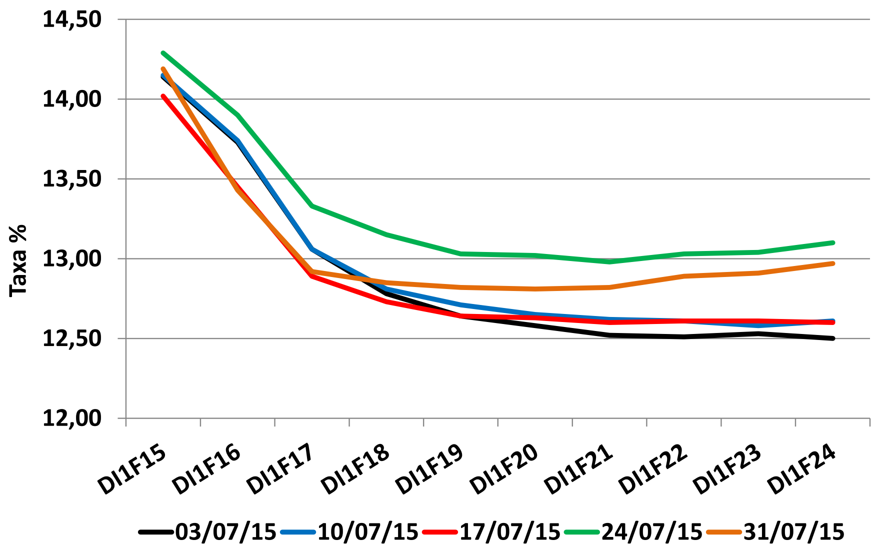
In a fairly objective analysis, with signals of more rate increases (SELIC) and as the market prices higher interest rates in the long term, there seems to be no definitive and consolidated convergence of low and anchored long-term inflation. The rational expectations of economic agents do not seem at all appeased.

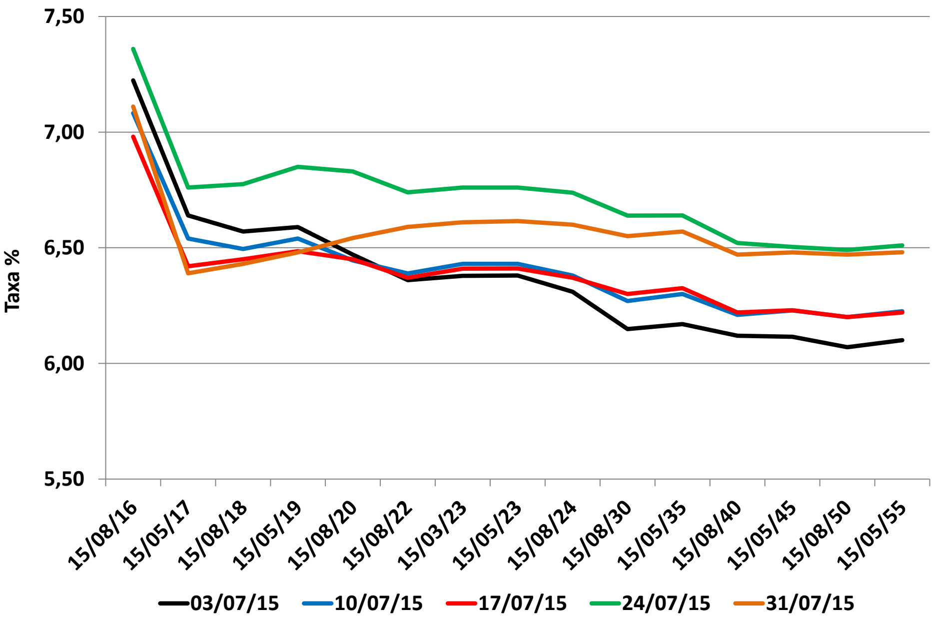


Source: Central Bank

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

The dollar rose almost 10% in the month! The currency reached the highest value in 12 years. Where will it stop? No one knows, but this is the cost of a floating currency (can we really say that when the Central Bank intervenes daily with currency swaps?), intended to be as "just" another price. It seems a liberal dream, but it is important to note that the Economic Policy (which includes exchange rate policy) requires this time and movement symbiosis, for any misalignment unsettles the whole. That is reason for our agreement with Director Tony Volpon, who does not believe in gradualism, in interest rate or foreign exchange. If it is supposed to free float, then float - but ensuring an implementation model as a whole, minimizing the misalignments of variables.

The pressure on the currency reflects concerns about the fiscal situation, political turmoil, uncertainty about the Central Bank intervention on foreign exchange rate (which was supposed to have ended) and the public sector primary deficit of R$ 9.32 billion, the worst of the series for the month of June. The Greece risk is on the background, China's stock market crash had less impact and even the US situation was not hard hitting. This month, the fault is all ours.

Losing investment grade is a matter of time. Brazil's economic and political crisis has definitely entered the radar of the international risk agencies. The political field now has a key role in the running of the country's economy.

What will happen to the Brazilian currency following the loss of investment grade? The bump will be strong, but possibly ephemeral. At first, one imagines, more devaluation, settling later. With the loss of investment grade, the rules of international pension funds impede investment in Brazilian assets, and large amounts will leave the country, additionally hindering and making more expensive private Brazilian company funding abroad.

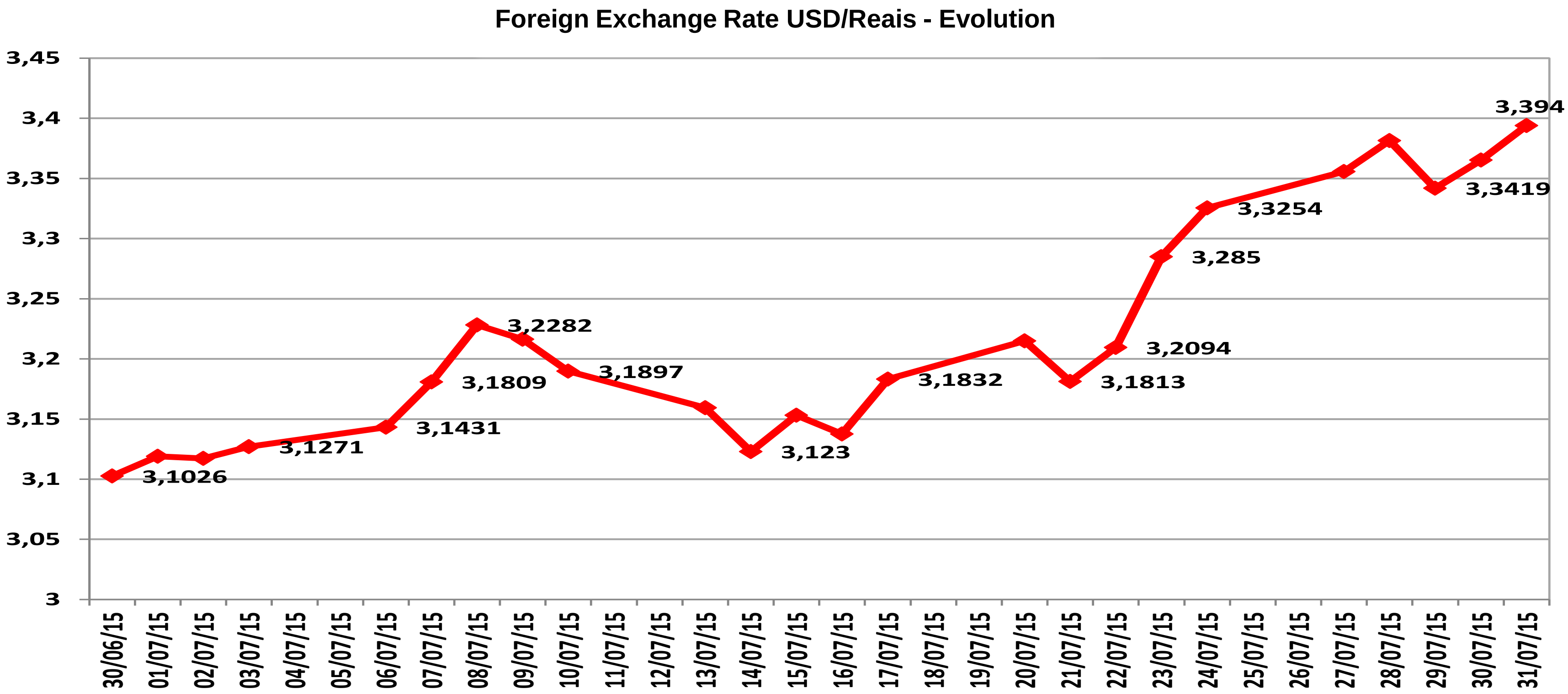
The graphics in the next two slides show (i) the evolution of the dollar in the last month and (ii) the Credit Default Swap behavior - CDS (country risk levels) tendency behavior for emerging countries with and without Investment Grade. The dollar's movement tends to be correlated with the country's CDS that, as a rule, overshoots upon imminence of actual loss of investment grade. Russia's recent experience can be a good indicator, but not necessarily a rule...the financial market can interpret and adjust prices in advance.

Hopefully the Central Bank team leaders as a whole, like its more illustrious current Director Tony Volpon, will have firm and clear positions and promote, ultimately and as soon as possible, a foreign exchange policy which is coherent with the rest of the Economic Policy. The swap reduction management "game" cost us in the first half no less than USD 33.13 billion!

At any rate, the loss of trust has a cost, and it is very high!

Foreign Exchange

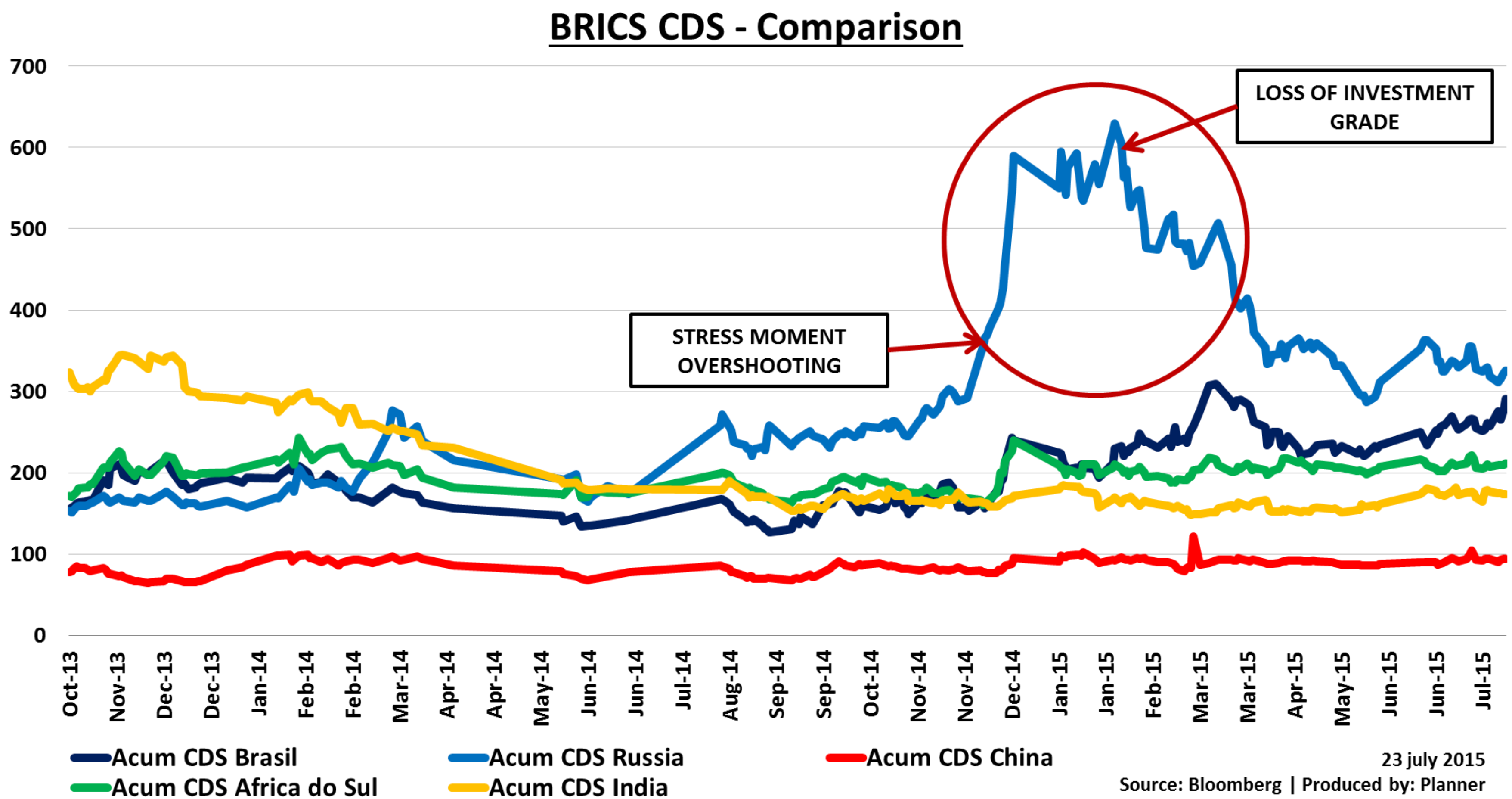
Foreign Exchange Rate - Evolution



Source: Economática

Foreign Exchange

CDS - Evolution



Stock Market

Another month of losses in the Ibovespa...contrary to international stock exchanges indices. In spite of the recovery in the last trading sessions of the month, Ibovespa closed down 4.17%. During the month, it accumulated negative return for the year, losing 50,000 points.

In the short term, there are no facts that justify an improvement in the Brazilian stock market. On China's side, the news remain negative: (i) growth below expectations, (ii) various government interventions in order to boost the economy and the capital markets do not seem to have had the desired effect in quality and quantity and (iii) fall in commodity prices, especially iron ore. On the domestic side, second quarter balance sheet disclosures are not encouraging.

For example, Brazilian industry has accumulated a 6.3% decrease in the first half, the worst result since 2009. Low level of business and consumer confidence, investment uncertainty, deteriorating labor market, lower consumption and an unfavorable international market explain the industry's behavior. Apparently, the country is heading towards years of recession (perhaps depression) - the GDP projections for 2016 have begun to show.

The country needs structural reforms to restore growth and generate income and productivity gains. The headlines concerning the country in the international press started to have a negative tone. Brazil has gone from life of the party to ugly duckling. The Financial Times called the country "the sick man of emerging markets". Do our politicians fail to understand the need for reforms? It is difficult to get gringo investment like that, and they always had an important role in the Brazilian stock exchange.

Just when the market expected Moody's position due to its visit to Brazil, Standard & Poor's forged ahead and changed the Brazil risk bias from neutral to negative. Unlike other markets, the stock exchange did not have a strong downward movement - the downgrade was already priced. In fact, the Ibovespa seems in a state of lethargy...the main Brazilian stock index trading range has been between 48 and 54 thousand points. This behavior may reflect a deliberately low trading by major local and international investors (the average daily volume in the year has been only R$ 6 billion) as a result of low prices and the expected reaction for a better exit option. It will not last long, either due to the choking opportunity cost, or the loss of investment grade, that will result in actual asset sales.

Are we doomed to failure, then? Not really, there may be one or another opportunity here and there. And on the whole, as structured and dynamic management of a portfolio? Yes. The only way out is the country's realignment (which is promoted with long-term policies that may have an impact on the real economy) or a political-institutional breakdown that effectively signals the country's realignment.

Blue chip stocks were largely responsible for Ibovespa's downward movement. First due to drop in commodity prices in the international market, and secondly, due to their liquidity, having been at the top of the list of investors' departure from equities. That is the way it goes. It will get worse, though.

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