Planner Redwood Asset Management

MONTHLY COMMENTARY

JULY 2016

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- Economic Activity
- Fiscal Policy
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Epigraph of the month... a propos of Brazil´s current predicament.

“One of the greatest pieces of economic wisdom is to know what you do not know.”

John Kenneth Galbraith – American economist

Introduction

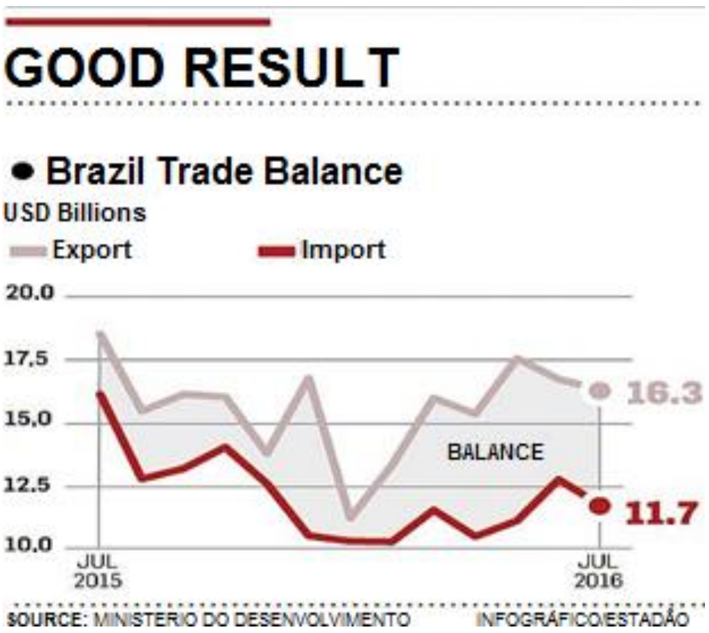
Finally the Olympic Games are in town and the eyes of the world are on Rio de Janeiro. Not surprisingly, it is an event of immense scale when the country is expected to be on world media for at least two weeks capitalizing to maximum this unique moment. Unfortunately, this will not follow suit. Obviously the planet will be watching everything, but there are other important events distracting the expected focus, as the elections of USA and rampant terrorism spreading across the world with an increasing frequency.

Apart from the legacy (questionable under innumerable views) of the Olympic Games, the eyes of the potential investors for Brazil will be accompanying a political, economic and social reality, which the bright of the games are not enough to cover-up, and less, to revert. The top wish was that Brazil would be in quite different shape at this moment. From an economic perspective, the Interim Government does not “start” until the exit of the ousted President Dilma, closing an incredible window of opportunity. Reality shows not only a situation of deep imbalances, and with it the enforceable recognition of economical knowledge which was referred by John Kenneth Galbraith (that opens this report). The good news is: the unknown is acknowledged, but there are both a team with competence and desire to win… it is not about a 100-meter dash, but about a Marathon in which we will be winners and everyone who bet on Brazil.

In the world at large, the reflexes (although momentarily smaller) of Brexit – the exit of the United Kingdom from the European Union -, begin to appear, China decides to inject almost USD 100 billion as a manner of intensify the efforts to stimulate the economic growth and Japan “hesitates” on which line of economic policy to adopt. In the USA, the FED (American Central Bank) anxiously waits for the Job Report to be disclosed on upcoming days and, with it (in case of being misaligned to the expectations), gather the “disappointing” performance of American economy on second quarter and justify eventual increases of interest rates only in 2017. Curiously, all of these facts are, directly or indirectly, beneficial to Brazil.

On this environment, the Treasuries of USA closed the month at 1.458%. S&P varied 3.56%, NIKKEI closed at 6.388%, DAX with 6.79% and FTSE 4.01%. The Ibovespa finished the month at 11.22% and the IBrX in 11.31%. Maximums to DIF17 at 13.985% and DIF21 at 12.30%. NTN-B 2050 finished the month at 5.79%, and the Dollar (Ptax) at R$ 3.2390.

Economic Activity

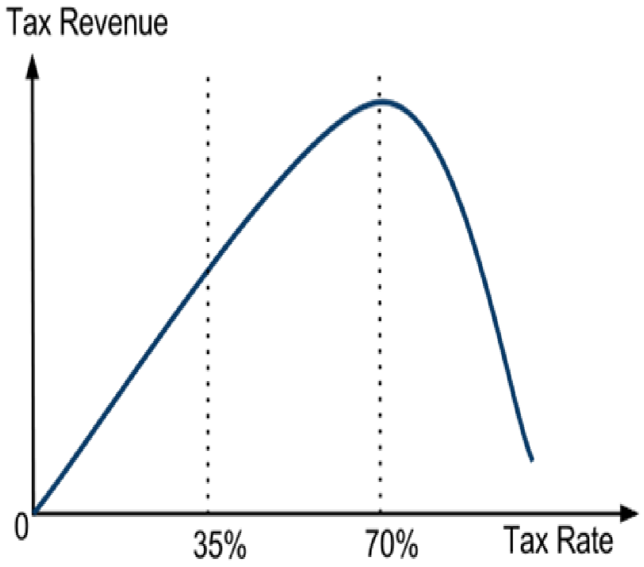


The eventual effects of a change of economic policy are defeated, especially when it is compared to the reflexes on financial market and on perception of the agents. Thus, before the fact comes the expectation that, on its turn, if attended, feeds back and begins a possible virtuous circle – it is how it works. The confidence index has improved on the last month, in special among micro and small entrepreneurs on services and retail sectors. It was not too much, but signalize a feeling of possible improvement, whereas the general conditions of economy and the impacts on this sector got worse on last semester.

The Trade Balance, according to what the chart shows, is still “great”. The Current Account balance is thankful, although one must not be deceived, this result arises fundamentally from plunging imports. A more detailed analysis shows that the current abrupt recession dropped income (recently, including the nominal) and consequently consumption too, and the immense exchange devaluation (notably in 2015) – this latter even by lagged effects -, have competed for this performance. Is there any problem? This situation might not persist, and the dynamic of the Trade Balance as sustainer for the adjustment of the economy and the restoration of economic activity will slow down. However, every cloud has a silver lining and makes up for this situation in medium-long terms. The reasons of this possible reversion will be (i) the definitive exit of the President Dilma and the confirmation of the current economic team of Interim Government bringing perception of a lower country-risk and with it more investment, and (ii) developed economies with negative interest rates foster appetite by risk. Here we are with our beautiful risk-return ratio! On that path, there are more two expected effects: the increase of gross fixed capital formation, and the reminder that competitiveness “gains” via exchange rates are but a fallacy.

Once again, lags are disturbing… the level of unemployment will take a long time to improve even with some alleviation of the crisis. But every journey starts with the first step, which has been taken. What is expected is that there is not an exaggerated frustration of expectations, since it is the only way to interlock a new cycle. In this sense, better projections of GDP 2016 and 2017 are being presented every now and them, but they do not seem very likely. In our opinion, it is too much to be done for that we could glimpse forecasts so beneficial as it has been plentiful published by Institutions of renown. Certainly history bears out that big reversions are possible (as of 2009 to 2010), and it is also true that the Brazilian economy has flexibility for it, although current reality differs starkly from that one of the past. Reconstructing the country will be like marathon-long hurdling, but with relay of (economic) teams of same quality.

Fiscal Policy



Repeatedly we have claimed here that the sustainability of the trajectory of the debt is central for Fiscal Policy, being certain that it can be achieved with the efficient management of revenues and expenses. However, the increasing of the ratio Debt/GDP, as well as its controlled velocity do not diminish the importance of the level where it sits. In this sense, the alternatives that are being presented does not seem to be enough (control of expenses with indexation – maybe possible at this moment) and on other hand a probable “non-event” with alleged second-order impacts (increase of taxes). Among the existing “plans”, everything points out that in the end we will have a single one as a mix of all of them, i.e., with reduction of expenses, increase of privatization and concessions, ***AND*** a tax increase.

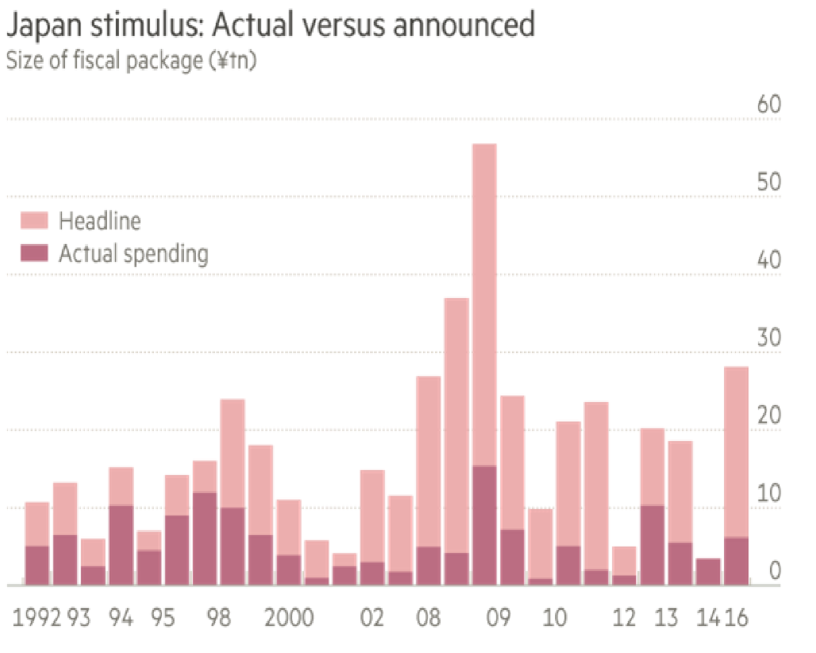
If expenses cannot be sustained on a nominal dimension (it means, without readjustments) for whatever the reason, we will have to keep in mind that this debt “ceiling” may not be appropriate in the face of the dynamic of readjustment of prices. Still, increases in privatizations and concessions are welcomed, but the timing for that is, and has always been, a great complication in Brazil. However, if the first and imperative action (expenses control) may not be enough and the second (privatization/concessions) excessively lengthy, the increase of taxes may be even worse.

Common sense was brilliant formalized in what is known as the Laffer Curve (named after the economist who developed the theory), that represents a relation between the amount collected with taxes of different rates – translates, in essence, the concept of “elasticity of the taxable income”. The geniality of the proposition is not on the evaluation that a rate of 0% or 100% does not generate a tax revenue (the first hypothesis for the application of the rate and the second by obvious reasons of disincentive to production or evasion), but in the fact that there might exist an rate between 0% and 100% that maximizes tax revenue. In other words, increasing incomes beyond a given threshold might harm tax collection. The chart depicts that relation.

The issue is controversial and differs greatly from one economy to another and also in an intertemporal way, and becomes even more interesting because the incidence of taxes reoccurs in distinct ways for suppliers and buyers. This more detailed evaluation considers the elasticity/inelasticity of demand and supply curves, under analysis of variation of prices and quantities. Finally, what matters is to reach the optimal tax revenue, and that is what the Government must consider. Have we arrived on the limit of the tax collection? If not yet, it will be worthwhile to increase taxes (even in a momentary way) and assume all of the others harmful effects?

Perhaps increasing taxes is like using anabolic substances to get stronger in order to excel at weightlifting… more than unfair (prohibited on sports), its effect on health (of the athlete and of economy) can be fatal.

International Environment



Source: Financial Times (www.ft.com)

A quick evaluation of the Industrial PMIs on main economies of the world shows retreating indexes in Germany, United Kingdom and on Eurozone, while rising in France. Japan and India also registered increases on their Industrial PMIs, and in China the information are conflicting with the same index ("it is justified" by the different methodology) What is our understanding? None. Regarding the world economy everything is too confusing, and the economies are trying to balance out the policies presented and, many times implemented, on their countries.

In Japan, once again a fiscal package aiming to revitalize the Japanese economy is announced, but the chart clearly shows the scale of the stimulus announced and what is in fact happening. This time it does not seem it will be any different, because the volume announced will have a negligible impact in the year of 2016. What does that mean? In the very short and short terms an amount of changes on financial market (especially Japanese), but on short and medium terms it may mean that the BOJ (Bank of Japan) will promote another round of stimulus (at least new announcements) or simply give up and accept that the desirable macro adjustments only will come with time and less heterodox and intrusive measures.

In China, on other hand, they do not waste time and seem more convicted of the policy to be implemented. The PBoC (People's Bank of China) injected a combined amount of 626.7 billion Yuans (USD 94.4 billion) of liquidity in the financial system, through its credit lines. For those who recognize that the levels of Chinese growth is most likely to to retreat for 3% to 4%, any measure to intensify the efforts to stimulate the economic growth seems appropriate. Honest mistake. The bill will come and the disaster in an economy as massive as the Chinese will impact everything and everybody.

In the USA, the behavior of the FED (American Central Bank) on last years (except recent and small increase) has been to postpone, meeting after meeting, the normalization of its Monetary Policy and, the "disappointing" performance of the economy of the second quarter of 2016 and an eventual bad Job Report on beginning of August will be the unequivocal signals of definitive suspension of any expectation of increasing interest rates… maybe in 2017… maybe later on. You know what else? Some serious people are taking back the "theory of the secular stagnation". Oops! Increase of interest rates only in 2117!

There is no parallel or similarity of the international landscape with any Olympic modality that would allow us to entertain some metaphor. The games follow rules and last only two weeks.

Interest Rates

Fiscal austerity is becoming more intimately linked to the Monetary Policy conducted by BACEN. However, the hard political moment has been imposing to the Interim President concessions that pull away the necessary fiscal equilibrium, and stifles the conduction of the monetary authority. With the reinstated office-focus pursue of the inflation target in 2017, the ambivalence recently seen by the decisions of the Interim President undermines the appropriate set effort Fiscal-Monetary and can anticipate the end of the market-government credibility game.

Therefore, aligned with market consensus, the first meeting of COPOM under the command of the Chairman Ilan Goldfajn maintained the SELIC rate in 14.25% p.a. The chairman of BACEN not only understands the reality and necessities of the country, but also knows how to conduct and optimize the Monetary Policy under regime of inflation targeting.

In this sense, the chairman of BACEN recognize the importance of the communication between central bankers and the society and because of that he has altered the format of the minutes released soon after the decision by the COPOM, making it similar, on size and matter, with the one disclosed by FED after decisions of Monetary Policy. The minute brought a more accessible Portuguese, simpler explanations and a shorter length. The market liked the new communication of BACEN. In the balance of risks that was presented, the BACEN gave a clear message: it will wait for the factual conversion of inflation to the target of 4.5% until the end of the next year. If the expected actions and purposes of fiscal adjustment happens soon (the limit would be the immediate moment following President Dilma’s stepping down) and the inflationary expectations recede further, Monetary Policy will have more room to cut down the SELIC in order to stimulate a quick recover by the sick Brazilian economy.

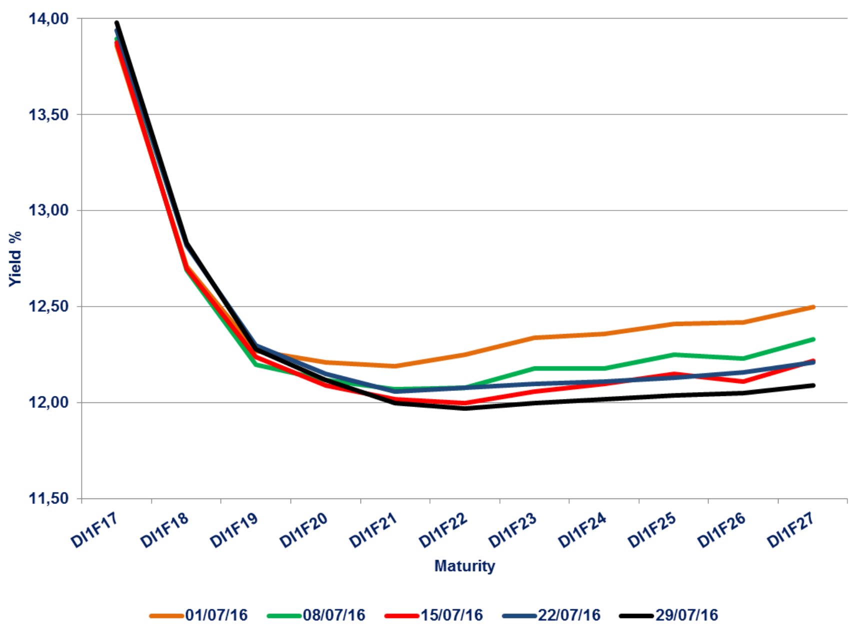
Upon maintaining the SELIC in 14.25% p.a., Brazil holds the highest nominal basic interest rates among the biggest emergent markets and a real rate more and more attractive for investors. In Russia, the basic interest rates are in 10.5%, while in Colombia and Turkey, the rate is in 7.5% and in South Africa in 7%. On the opposite side, further stimulus, via injection of resources or cut of interest rates, is expected to be adopted by the Central Banks of developed countries, in particular the one of England, Japan and the Eurozone. In general, an accommodative monetary behavior (negative or close to zero interest rates) by rich countries will endure longer, making the international investors migrate their resources seeking more rewarding taxes of return, benefiting countries with high interest rates. Brazil is, no doubt, one of these countries that may receive great flows of external capital, notably if the country risk falls… well, we came back to the “circle” problem … the Fiscal supporting the Monetary.

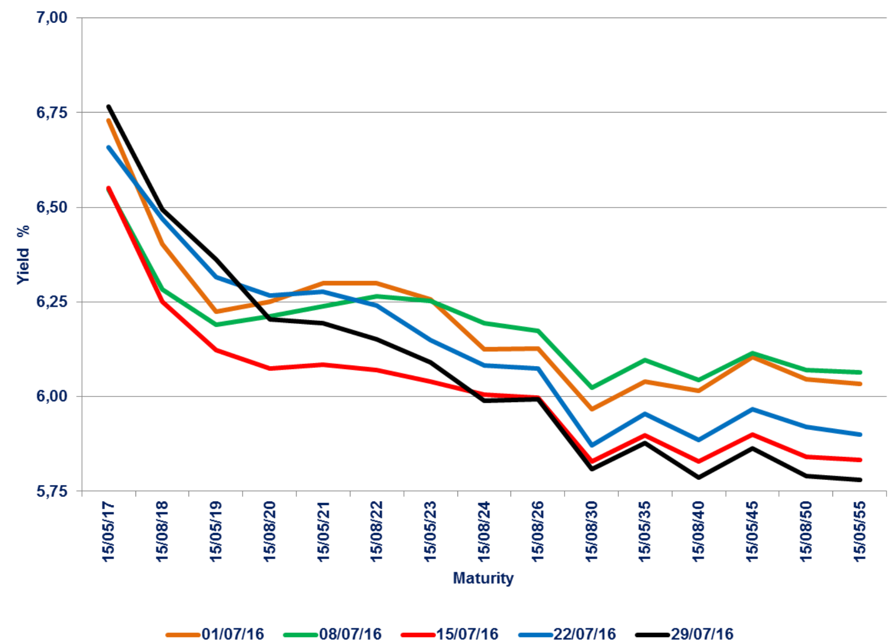
In the balance of the month, the curve of the future interest rate reflected the communication of BACEN in relation to SELIC rate. Interest rates in the very short term has increased, with a prospected postponement of the beginning of the fall of the basic rate, and premiums of the longer-maturity contracts have decreased. Similar movement happened on the IPCA-coupon curve.

The modality for BACEN with its Monetary Policy is target shooting with pistols of extreme precision… the team of the Fiscal Policy also likes target shooting, but unfortunately they have not changed its pistol yet and still using cartridge.

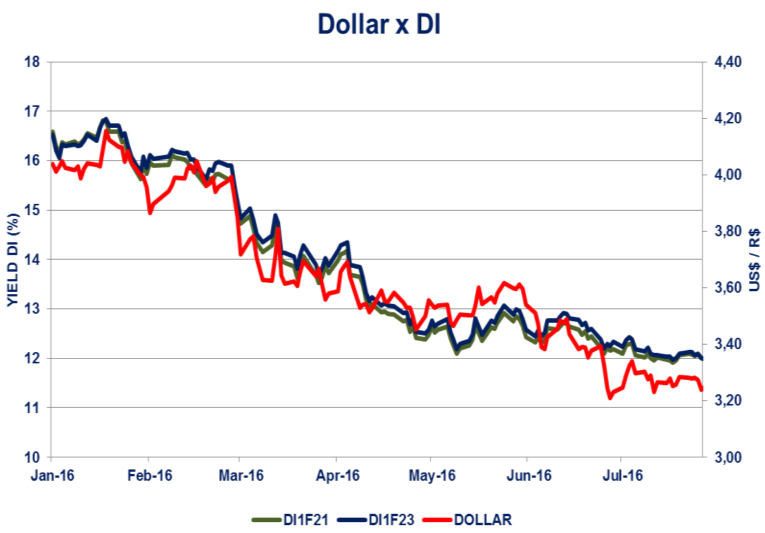
Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange



The slowdown of the Dollar in face to Real happened on the last session of the month, after the release of the first estimate of the US Gross Domestic Product (GDP) for the second quarter, was not sufficient to neutralize the movement of devaluation of the Real over the month. The "low" growth of GDP of USA, at variance with the expectation of economists, promoted a wide reassessment by the market in terms of the timing of interest rates hike by FED, seemingly to be further apart while contributing to the appreciation of emergent currencies.

In comparison with previous months, the currency oscillation was moderate, there was a decrease in volatility and a change in the level on Dollar dealing price. The historical volatility of 14 days decreased to around 21% p.a in the beginning of the month to something around 12% in the end of the month. The reduction of volatility made investors and companies search for more trading options to set up positions in currencies, be it for heading or direct position. The lower the volatility, the lower is the cost of the premium.

Some market players bet the Dollar will reach R$ 3.00 on next year, after the conclusion of the impeachment process and the approval of some reforms. This projection is aligned with the one held by Planner Redwood. The definition of the political scenario and the advance of the fiscal questions shall bring a greater flow of foreign investments for the country and, with a bigger supply of Dollars, additional impulse to the likely decrease in its quotes.

The Real being more appreciated contributes to the decrease of inflation, thus reducing the pressure over the price of imports, especially supplies. Anchored inflation, future interest rates falls and with them the related assets. The new projections for the Real, an outcome of the current Economic Policy and perception of country risk, added to the communication of BACEN, resulting in lower long-term interest rates in accordance with what is shown on the chart (strong relation between those assets).

The BACEN maintained *homeopathic doses* of auctions of reverse swap, removing from the market the equivalent to USD 9.5 billion in the month. Notwithstanding the competence of the BACEN'S teamwork, the question of Exchange Policy is a factor that "tarnishes" the team's profile, even though (justice be made) it was clearly stated that the interventions would be punctual and specific. In this way, it is both likely and expected that BACEN will maintain its regular pace on the operations of reverse swaps, aiming to reduce the stock of the traditional exchange rate swap. After that, no more interventions are to be carried out.

Let the game begin!

Stock Market

The great hike of the Ibovespa with nominal gains above 30% in this year makes the allocation in assets potentially riskier, especially when it is conflated, in a consist manner, with foundations of economy and impacts of real economy on financial world. Some analysts believe that there is more space for highs, pending the confirmation of the impeachment of the President Dilma Roussef. It is hard to predict! After all, by the criteria of the multiple price-earnings ratio (that indicates how long the investor can, in thesis, recover the capital invested) the Ibovespa hovers above the historical average.

The apparent external calmness (on financial Market, the same cannot be said in relation to the terrorist attacks) enabled an abundant flow of resources to assets of developing economies. Among negative interest rates in important markets as Europe, Japan and United Kingdom, the global investors became more likely to taking risk to get better returns. On external flow directed to Brazil prevail investors of short term, but is expected that with the confirmation of the impeachment the resources will have a profile of longer term.

The domestic figures show a slight movement of reversion. The confidence of the entrepreneurs seems to be in an upward trend, a possible indication that the sector is leaving rock bottom. The growth of 1.1% of industrial production in June is the best result for this month since 2013. Good enough, but far from the ideal. Despite of the improvement on the margin of the idle capacity according to the National Confederation of Industry, 40% of the machinery and equipment are inactive making production costs increase and contributing to unemployment. Finally, corporate delinquency and the requests of judicial recover are on the rise. The path of recover is long and lengthy – actually, it is about race-walking: long, exhausting, and requires much limberness! Maybe, expectation of lower long-term interest rates, which is reference to the financing of companies, can boost the recover. Anyway, everything is still far too obscure.

At any rate, it is characteristic of the movements of the stock market the overreaction in highs and lows, especially in moments of great changes. Thus, the so-called adjustments and technical corrections are common, with more or less frequency and amplitude, and this is definitely one of those moments for Ibovespa. However, knowing exactly the limit of the correction is what matters for the long-term investor and for those skeptical about market timing. On the other hand, the “professional” identification of undervalued companies associated with a recovering activity (with comparative advantages in the sector) might represent excellent opportunity for building positions.

For the time being (in the short-run) everything seems perfect, the Ibovespa advanced 11.02% in July, being the best investment on the month. However, surprises may arise and bring volatility to the market… in this case, it is better to be as Usain Bolt and run fast toward exiting positions.

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