Planner Redwood Asset Management

MONTHLY COMMENTARY

JUNE 2015

Monthly Commentary / JUNE 2015

Agenda

"The character of the public deficit is not budgetary. The public deficit simply does not have character."

Mario Henrique Simonsen - Engineer, Specialist in Economics, Professor and Banker

Introduction

Even stones knew that 2015 would be a very difficult year - regardless of who had won the elections. In practice, when the time comes to make the necessary decisions in economics, left or right wing ideologies are not applicable, for there is a single solution - lest we become another Argentina or Greece. This is why there are only two types of economists: those who know and those who do not know economics.

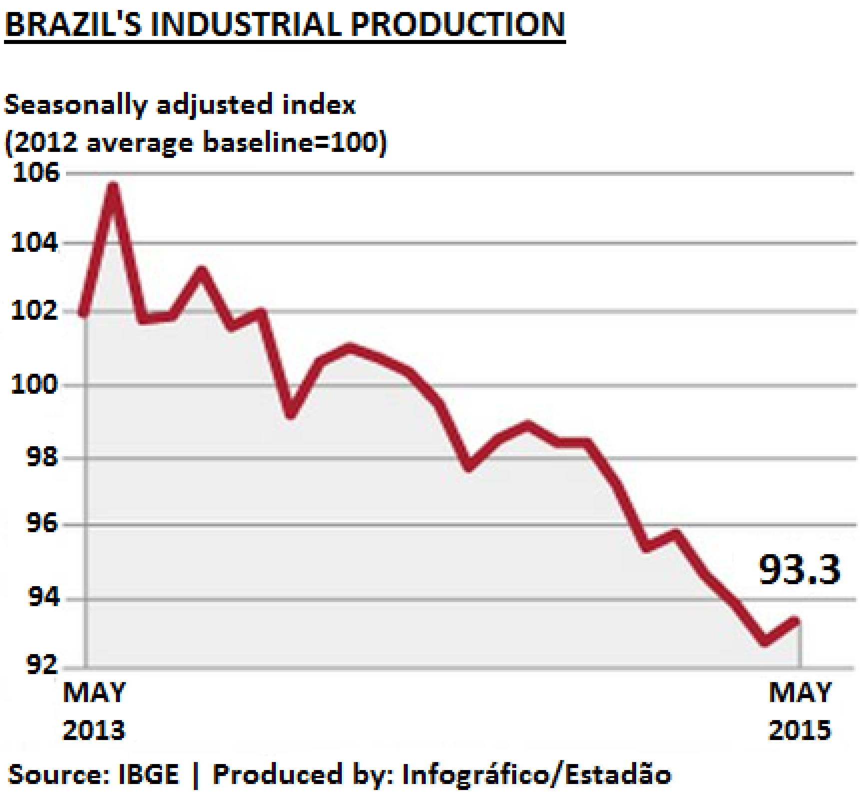
However, the assessment cannot and should not be so shallow. Necessity and appropriateness are not always possible, in terms of timing, and the art of actually making things happen sometimes requires politics. In a democratic regime, politics often creates obstacles that inhibit speed and the pressing need for adjustments - all this is good, it is good when the various forces "discuss" matters, focusing on a greater purpose, for the betterment of the country. The problem lies when Politics becomes Politicking... when the sum of forces work towards differing purposes, not aiming the *greater good* of the country. Is this a value judgment? All those opposing the proposal will say "yes", of course... but there is only one truth, no matter your angle.

Half of 2015 is over, and a good measure of "homework" has been done (particularly the fiscal adjustment), but less than expected, far from the proper timing, deviating from the expectations (original estimates). Additionally, some absolutely unfavorable surprises have emerged. All of these are domestic issues, incidentally...by the way, considering externalities, they are mostly *positive* (for instance, the most important of all, the Fed has not raised interest rates *yet*). The Brazilian Congress does not seem to be in tune with Brazil's reality and worse yet, with the urgency of economic measures. But this does not happen by chance. It is fruit of the political ineptitude of the President, the endless scandals the party is involved in, and, not least, the extremely cursed legacy she bequeathed herself - now translated into the worst of all worlds: inflation, low growth and unemployment. Pure political-economic autophagy. The result: 9% popularity! How can one remain in power for three more years like this? Impossible! History shows us that the next chapter in situations like this is bad.

In the global scenario, the Fed for the time being is not the eternal protagonist of the possible monetary tightening, and the Greek tragedy that has lasted for years and seems to be coming to an end, now takes center stage. A melancholy end that will bring more suffering and humiliation for the population. Attention now turns to the contagion effect of this outcome, and alternatives are being elaborated - to tell the truth, not for Greece but for the Eurozone and even the EU. In China, the People's Bank of China (POBC) continues the implementation of the announced stimulus and promotes credit with injection of billions for housing renovations in the country - more of the same, always.

In this environment, US Treasuries ended the month at 2.34%, S&P changed -2.10%, the NIKKEI closed at -1.59%, DAX -4.11% and FTSE -4.40%. The Ibovespa ended the month at 0.61% and IBrX, 0.76%. DIF16 maximum was 14.32%, DIF17, 14.08%. NTN-B 2050 ended the month at 6.06%, and the dollar (Ptax sale), R$ 3.1026.

Economic Activity



The first six months of the year are over, and in line with the IBGE's GDP figures of the 1st Quarter of 2015, managerial data of the 2nd Quarter of 2015 and the evolution of Economic Policy (particularly fiscal adjustment), the calculations have been redone, and a stronger reaction of the economy expected for the next year is still possible, but no longer largely probable. There are several reasons for this, but specially the delayed approval of ongoing measures to adjust the government accounts, tax collection forecast mistakes, unpredicted surprise spending increases and the difficult political environment that hinders all other actions.

The chart shows a very slight "recovery", nothing that guarantees a turn around, notably because the capital goods sector has dropped strongly, implying that investment is declining - investment which is the main variable for the economic recovery. The good news is that investment depends on a better macroeconomic environment, with better confidence indices and appropriate decisions and target focus.

In this sense, things are going well. Hard to believe? Certainly, but measures are underway, slowly but surely. The effects of the new and coherent Economic Policy will be felt in the medium and long term, and some (few) important results already appear in the positive trade balance result.

Finally, the summary of this drama is that if the timing of a bad political moment (understood as a non-reversal of economic policy in progress) is compatible with this additional time required for the effects of the implemented and future adjustments to take hold in the coming months, the economic activity recovery will come - certainly later, but it will come.

The cost of the recent past mismanagement is too high, and we need, in fact, to withstand it.

Fiscal Policy

We are at the point where we have to consider whether the glass is half-full or half-empty.

Since the established contingency, which limited the approved budget, we have observed in addition to the reduction of economic activity expectations, additional tax collection reductions than originally forecast. Gross revenues of the Central Government (National Treasury, Social Security and Central Bank) until May fell 3.5% in real terms, compared to the same period last year, which resulted in a surplus of R$ 6.7 billion...also far short from the nearly R$ 20 billion savings over the same period. On the other hand, the regional governments (states and municipalities) must fulfill their "target" delivering a surplus target - as it has done so far. All in all, there is a consolidated public sector (central government, states and municipalities and state owned companies - excluding Petrobras and Eletrobras) R$ 6.9 billion deficit in May - negative, but much better than last year's R$ 11 billion deficit.

So the problem remains the Central Government, which watches its revenues plummet due to the weaker economic activity at the same time its expenses are unbending, to wit, pensions and social spending. Despite the new benefits granting rules dictated by Provisional Measures 664 and 665, unemployment insurance and social security benefit spending, for example, have not slowed down...on the contrary, the weakening of the labor market has intensified the situation.

On the one hand, important taxes that make up a large part of collections at the beginning of the year, such as property and vehicle taxes, will not be repeated in the rest of the year, others such as sales tax, particularly on the electric bill and gasoline (due to adjustments made and probably another future adjustment) may increase results. Additionally, the new rate of social contribution on net profit applicable to banks and the increase in PIS and COFINS on financial income - all still pending, shall have a significant impact on revenues in the 2nd semester of 2015.

In this environment there are rumors that the surplus target will not be achieved. That may be so, but the numbers that are now being estimated (0.5% or 0.6%, compared to 1.1% of the current target) appear to exacerbate the pessimism and disregard the alternatives in place (concessions/privatization). Be that as it may, what really matters is the direction, the goals set and the structural reforms being implemented, that is, effectively there is a substantial change in how the public accounts are being managed. There's more: even the stones know (at least stones that have studied a bit) that a country in a situation such as ours should have lost the investment grade by now. And why has it not lost it? Are we cuter? Of course not! Like everything else in economics and finance, it is a matter of expectations. Yes, the risk rating agencies have been patronizing us for the simple fact that they have expectations that the ongoing changes will remain in place and will be further improved...but we are walking on a tightrope...we use and abuse... A downgrade and/or lost of investment grade would not be surprising. It would not be in any way an injustice. For this reason we believe that the economic team will not let a 0.5% surplus happen (benefit of the doubt has been given)... the main indicator for the rating agencies, the debt/GDP ratio, does not stabilize this way...this would be suicide!

International Environment

Greece took over the international scene this month. They say a picture is worth a thousand words...so here it goes! What will happen now?

Not to say that Greek monopolized on the news. The World Bank fears possible contagion in smaller Eastern Europe economies, the Chinese government continues its interventions in order to boost its economy, while the Fed is running out of “excuses” to postpone interest rate increase...

Interest Rates

What a contradiction... What will prevail, the commitment to fiscal adjustment and inflation control or the irresponsibility of Congress? While the Central Bank keeps the monetary tightening discourse and indicates it will continue rising interest rates to lower inflation, the National Congress approves spending increase measures such as linking all pensions to the minimum wage adjustment policy, while approving the adjustment of the Judiciary employee salaries up to 78%. Congress is not committed to economic sustainability and fiscal balance - added to this, government revenue is decreasing, as we mentioned above. Will the accounts settle this way? Simply, they will not. Monetary policy needs to be aligned with Fiscal Policy, and this depends largely on the will, understanding, acceptance and action of our Congressmen. It's like beach tennis, one helps the other.

The message from the Quarterly Inflation Report published by the Central Bank was clear: interest rates will rise higher and should be above 14% per year at the next meeting of the Monetary Policy Committee (COPOM). The Central Bank assumes a weak economy, high and rising inflation and growing unemployment. The worst of all worlds! With this discourse, the Central Bank tries with all its might to regain credibility, control expectations and lower the IPCA to the central target of 4.5% at the end of 2016. Is this possible? Yes. Likely? No. However, not all is lost, inflation convergence towards the target as of 2017 is considered a likelihood.

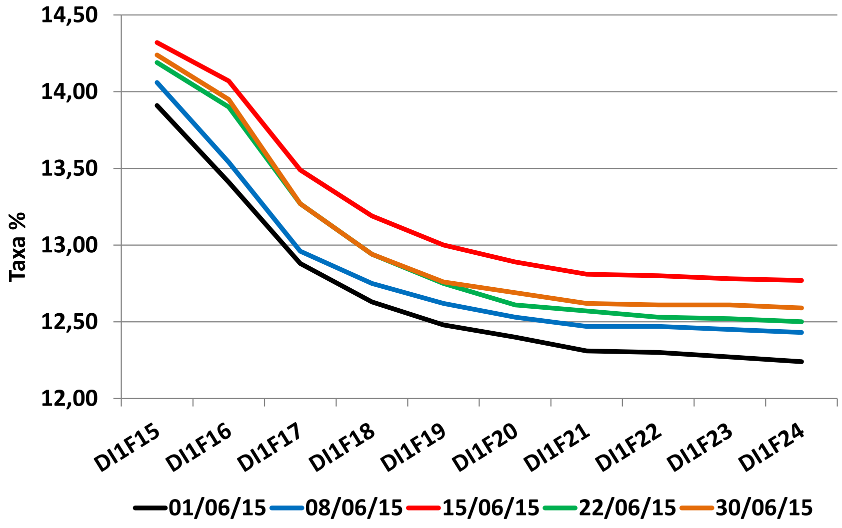
However, the scenario is pessimistic. The expected actual improvement in the Brazilian economy was delayed 12 months. We believed there would be an improvement starting on the second half of this year, but the worsening of the economic situation does not cease: (i) the GDP forecast calculated by the Central Bank, the IBC-Br, was down 0.84%, (ii) the June IPCA-15 hit a high of 0.99% - the forecast was 0.70% and (iii) the creation of formal jobs dropped 115,000 jobs in May - the closing of 57,000 jobs was expected. The figures show a deteriorating scenario, and should this continue, we will have even greater effects on the reduction of real and available income, increased delinquencies, reduced consumption and increased inflation. This is all a reflection of the rampant "bonanza" in the recent past, the received economic heritage that now must be fixed.

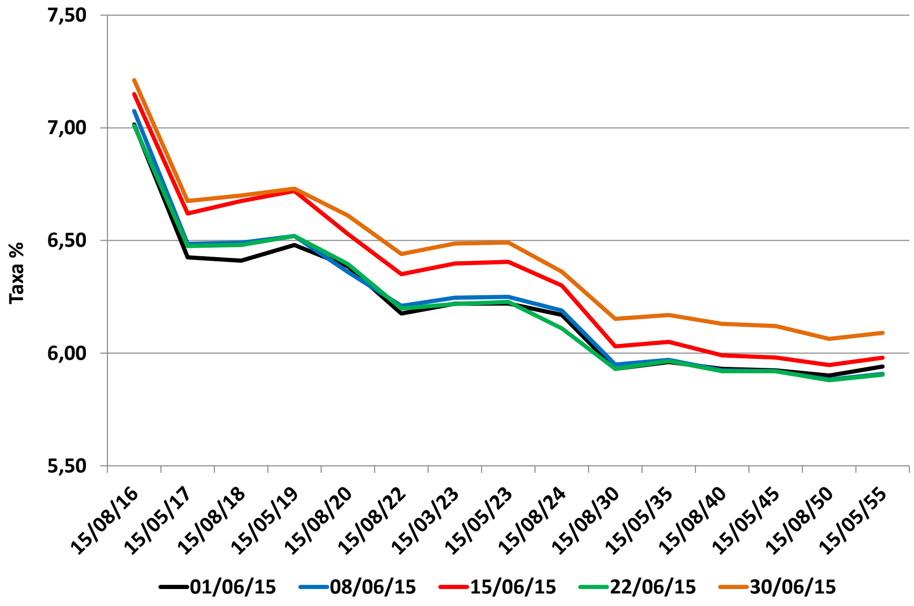
Note that the Monetary Policy took a rather Wickselian positive bias, for the time being (interest rate as the main inflation adjustment variable) - specially due to the impeccable technical posture of two Central Bank directors: Tony Volpon and Awazu. Their positions have been consistent, grounded in practical terms and in the economic literature. Another sign that the economic team is effectively committed to reducing inflation was the decision of the CMN to maintain the inflation target at 4.5% for 2017, reducing the tolerance gap from two percentage points to 1.5%, as of 2016. A home run!

All this movement helps solving the domestic problems of our own making, and will facilitate a smoother transition to the turbulence to be caused by normalization of the US monetary policy. We will be less vulnerable...so we hope.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

Greek tragedy? What will be the consequences, to non-developed countries, for the non-payment of 1.6 billion Euros of Greek debt to the International Monetary Fund?

We believe that the impact on Brazil is limited, we already have our own problems, but of course, some of it will affect us. The volatility in international markets and risk aversion may cause turbulences in Brazil. The country risk compared to the previous month increased about 10% and the Flight to Quality movement is a rule in stress scenarios. However, the high Brazilian interest rates tends to contain this movement, favoring the Real. The consequence of a possible Greek exit from the Eurozone is much lower today than three years ago, because the risk of contagion to other European Union countries, though not eliminated, has been reduced. The impasse of the Greek situation on the Eurozone is in its final chapters, but one cannot say the same about the crisis outcome...this, to be sure, will take a long time to sort out. In an act of absolute transfer of responsibility, disguised as democracy and participatory action, the Greek government called a referendum for July 5, 2015, in which the population was to decide whether or not to accept the restrictive measures imposed by the European Community or whether they prefer to leave or stay in the Eurozone. There are those who believe that the situation in Greece may postpone the interest rate increase in the United States by the FED, which would thus help not increasing the international market volatility - highly unlikely. At any rate, the postponement of the rate increase contributes towards the Real appreciation in the short-term. Which is good for us.

However, another problem is now becoming an annoyance, six months after the implementation of a “new Foreign Exchange Policy”. Foreign exchange was to be, ultimately, just another price - offering transparency, reference to a general price level and helping the current realignment of prices. It was also understood and accepted that this "transition" would be gradual, shockless, but never thought it would take so much time. "Noises" in the original message were not expected along the way as well. Now and then, the Central Bank had to set a clear and definitive program for this transition, with transparency (which at the end of the day should be used as a managerial tool) - a true *reverse Quantitative Easing*. Otherwise, we will be subject to "good management" from Central Bank technicians - at times waiting for a window of opportunity to reduce swap rollover, at others, with contradictions in their statements. That is bad, does not provide clarity of purpose and appears to all in a desire to "arbitrate"...financial markets do not like these actions and prices them. It becomes a lose-lose game, not in line with the rest of the current economic policy mindset. We hope that the institution will stop its "random interference" on the foreign exchange market, and that, as other assets, demand and supply will determine its price. Just an example, in May/15 alone these interventions cost R$ 22 billion. You don't think that is a lot? Use as a reference the entire surplus (which we might not attain) for 2015: R$ 66 billion.

Anyway, besides not working, this is a costly exercise! There will always be those who passionately defend a never ending list of controls. These are out of place, at least for the time being. Even with all turbulence in the international market and the camouflaged interventionism, the Brazilian currency ended the month with a 2.4% gain. For the year, however, it accumulates a devaluation of 16.81%. The country is better-off letting the thought that prevails in the rest of the Economic Policy apply to foreign exchange as well.

Stock Market

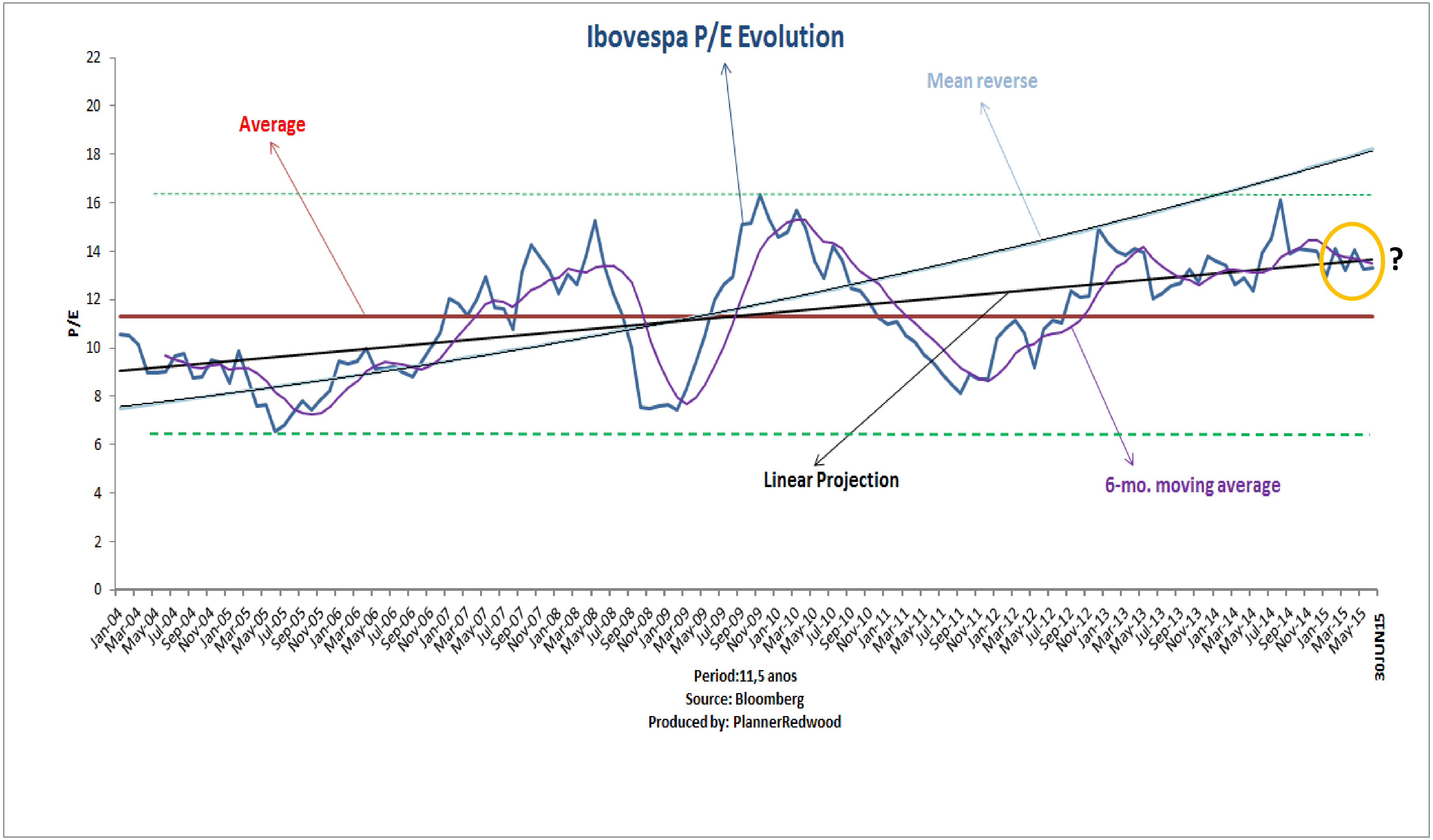
One half of the year is gone... We believed that the resumption of growth would begin in the second half of this year, however, as mentioned, under the current situation it seems we will have to wait a tad longer. The cumulative return for the Ibovespa in the year, 6.15%, does not seem to justify the risk involved in the stock market compared to high domestic interest rates. This finding is nothing new to those who follow the Brazilian Stock Exchange and the economy as a whole, but in recent months, this has been unsustainable even for those with a long-term vision - a fundamental premise, especially for investors who believe in the value investing strategy.

Under a Value Investing viewpoint, there are still some value companies, but very few are still good investment - that is, they are good companies, with low return outlook for a minimum one-year horizon - in fact little time, but with a huge asymmetry when compared to the risk-return and the local opportunity costs. At this time, one would expect Warren Buffet's master phrase about markets should apply, "Be fearful when everyone is greedy and greedy when everyone is fearful", but is simply does not sell! Combine this statement with another very common statement concerning Value, that *macroeconomic scenarios should not influence the analysis value* and one reaches the conclusion that investor appetite and mood (and the very Value management methodology) in less developed markets need to be customized. Specially the macro environment's contagion in the micro environment; in the short and medium-term, it is very strong...only Value companies survive. News about companies freezing or reducing investments is widespread. Layoffs, shutdowns and reduced work hours are a constant, with a consequent reduction in income. Under this scenario, how can one envision a thriving stock exchange in a virtually closed economy, with declining domestic consumption and incipient exports? It is not without reason that the industry confidence index fell 4.9% MoM in June - the lowest in the series since this index is being disclosed.

The R$ 90 billion reduction of Petrobras's new business plan also made the headlines, in addition to the sale of assets to reduce the company's leverage. Vale, in a meeting with analysts, reaffirmed it will be cutting costs, selling assets, reducing investments and increasing dividends. Usiminas already announced a reduction in working hours for administrative areas from five days to four days a week, with proportional salary reduction. These are just some of the reduction of investments in industry and future consequence of lower productivity and growth in the country.

The hope for some sectors of the economy, not in the short term, is the infrastructure concessions plan announced by the Federal Government. Ports, airports, railways and highways are for sale. This is great news, as long as the rules are clear and fair to investors. In the first term President Dilma imposed limits on profits and return on investment, driving away investors. It is now up to the Government to reverse the situation and regain credibility proposing plans and projects at appropriate pricing and perennial rules, with no risk of changes along the way. Also let us not forget that the financial market prices events in advance - for better or worse. Thus, the close monitoring of companies and the economy will bring the corresponding signals. The following chart, with cyclical analysis, sets the tone of the moment.

Stock Market



Monthly Commentary

JUNE 2015

3900, Brigadeiro Faria Lima Avenue, 10º floor
CEP 04538-132 São Paulo – SP
Tel. +55-11-2172.2600
Fax. +55-11- 3078.7264
redwood@planner.com.br
www.planner.com.br