Planner Redwood Asset Management

MONTHLY COMMENTARY

JUNE 2016

Monthly Commentary / JUNE 2016

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.

“The time to repair the roof is when the sun is shining.”

State of the Union Address – 11th January 1962

John F. Kennedy – former United States President

Introduction

The immense difficulties in dealing with the economic and political moment in Brazil, which impacts the whole society and can be more lasting than it looks, have come to face a momentary “truce” as a result of a “benefit of the doubt” granted – albeit tacitly – by good people who want what is the best for the Country. However, this support is bound in time and by the constant evaluation of attitudes and emitted signals – each one feeding back onto the other – for better or for worse.

Until now, the Government of the Interim President Michel Temer succeeded in nominating an economic team of renown, but which has not shown any work in fact. Understandable, but we could have already had a more overwhelming action with more factual measures – considering this team enjoys a low or null cost as to embarking on a “learning curve”. However, the fact is that the Michel Temer, as an interim president, is far from being at a political comfort zone, as regards the legislative field, which would allow him to launch any kind of transition or even effective actions. Thus, changing the status of substitute president to that of an empowered successor offers the best timing for Temer to start acting... the society and pundits might think otherwise. At any rate, the evaluation by the former President of United States John F. Kennedy fits this juncture perfectly when saying that *“the time to repair the roof is when the sun is shining”*… for the time being, the sun still shining on Michel Temer.

As to the rest of the world, the “insanity” of terrorist attacks and the atrocity of how they are committed has been widely overwhelming. The escalation of those acts points up, and even the most seasoned governments have been taken by “surprise", and the consequences are unimaginable in all segments where that movement manages to prosper. More than a coordinated action of governments, a radical change of their behavior and attitude as to available intelligence service and others agencies is needed. And it is a responsibility of the democratic superpowers to trigger this change.

On the international front: there is the Brexit – the exit of the United Kingdom from the European Union. Was it good or bad? For who? Are the effects transitory? Are the commotion and hysteria justified? The answers can be as complex as we want them to be, but for the British people the answer lies in more straight and simpler terms: we've had enough! This cry for “independence” and the need for change are resonating in other countries and it is already happening in others – it is impossible to turn a blind eye on this movement, because the relation between countries and peoples will be deeply disturbed. In the USA the presidential race becomes more credible and may be a watershed, also in this sense.

Amid this environment, the USA Treasuries closed the month at 1.49%. S&P varied 0.09%, NIKKEY closed at -9.63%, DAX at -5.68% and FTSE, -10.14%. The Ibovespa ended the month at 6.30% and the IBrX at 6.48%. Maximums to DIF17 at 13.94% and DIF21 at 12.80%. NTN-B 2050 closed the month at 6.0549%, and the Dollar (Ptax) at BRL 3.2098.

Economic Activity

The Brazilian economy, stuck and sunk in the worst recession in decades, is physically degrading itself and losing its operating capacity. The statement draws upon now not only the worn out (commented many times on this report) investment key – the Gross Fixed Capital Formation – GFCF, but also in the net figures. The investment in machines, equipment and buildings has been insufficient to cover the depreciation of the physical capital. In a recent study of IPEA (Institute of Applied Economic Research), net investment – obtained by discounting the depreciation of equipment, roads and others buildings – retreated some 40% last year. This is the main point, we will not be certain about the recovery to a consistent growth before this deterioration ceases and revert its downward trend.

In this sense, investments in the productive sector will take time, in other words, the real economy will not jumpstart so promptly. The fact that we have more than 1/3 of idle productive capacity corroborates the previous statement. It means that companies are able to meet any temporary increase in demand… a demand that is extremely weak. On the side of Industry, companies operate with 64% of total installed capacity – this is the lowest number within historical data. Therefore, in an eventual recovery of economic activity (and we, at Planner Redwood, believe that it can happen), the agents would, firstly, use the available capacity and only then, with the economic improvement and the reversal of expectations confirmed by stronger confidence indicators, investments could be restored.

Therefore, forecasts are, to a certain extent, optimistic, but do not allow setting off fireworks (not yet). New calculations point to an improvement of economy's performance this year, although nothing more than -4%. On the other hand, the performance level for 2017 points, once more with not so much fanfare, to relatively much better number if compared to this year: -1%. It is about an expressive relative improvement, but far away from what is needed and from the potential of the Brazilian economy.

What follows from this situation are the reflexes that truly impact the Brazilian society: the employment level, inflation under control, the resumption of projects and investments, and, consequently, the improvement of social welfare. Unfortunately, none of the latter will come in short run. Nonetheless, the tendency and the positive trajectory are what really matters, not to mention how essential is the ability by authorities to conduct the economic policy in order to avoid setbacks, be they motivated by political issues or by crazy ideas of recent economic teams.

The government of the interim president Temer seems willing to create this new environment, the traits of which are indispensable for economic recovery. However, Brazilians must have a critical and constructive thinking and evaluate, constantly, the way things are headed. It is a part of Democracy that everyone gets to participate. The economic model has changed, the differences in relation to the last economic policy are immense and they point to improvements in all senses – but none of it implies full and unconditional acceptance of the upcoming measures. We must remain vigilant!

Fiscal Policy

Few are those who, by their quality of painless reflection, do not attribute the dismantling of our economy to the irresponsible handling of public accounts in recent years. Even fewer are those who, immune to elementary logical economic reasoning, do not bet that the master key that will unlock economic growth and bridge the salvation gap towards ***every*** cure of our ills are concentrated on efficiency of public expenditure.

Michel Temer and his economic team have started with full commitment to control the expenditures and to fiscal consolidation. However, the political question imposes restrictions on the form as well as the content of actions to be taken. Some points, therefore, are limiting, however temporary, as to the extent of overly due advance of the fiscal adjustment. The first of them is the stability, adhesion and guarantee of coalition of an interim Government. The second, the low popularity (by obvious reasons) of Michel Temer and the natural intolerance of the society to measures of austerity – both of which, as a rule, result in a protracted recession and heightened unemployment. Some of the announced measures thus far may be (and are!) necessary measures, although insufficient to achieve the necessary fiscal consolidation and stabilization of public spending. Others, as the “kindness package” imbued in, among other measures, wage rises conceded to public servants (even though it was already contemplated in the budget), indicate the opposite of what was expected, but reduces the adverse effects of the limiting factors mentioned above. Finally, after all, the truth is that the dynamics of the debt needs to signal at least the stabilization of the Debt/GDP ratio – anything other than that would lead us into trouble.

In this sense, the sustainability of the debt trajectory is the most important and can be achieved, obviously, with the effective management of revenues and expenses. On the side of revenues, kind of optimization is welcomed, but it is unimaginable to assume any tax increase before a strong, drastic and deep spending cuts. It will be a loss and a colossal waste of energy (as well as a political suicide – from the standpoint of governability and not of future personal interests held by the interim president) a proposal to elevate taxes ***before*** the proper and reassured attempt of reduce the expenses.

We must not to leave out the particular nature of the fact that several Federal Government expenditures have their own increasing dynamics, such as the expenses on social security and assistance programs indexed to the minimum wage. Thus, for these and other reasons, it is known that the room for maneuver is too narrowed when compared to what is possible to cut out. There is hence the fundamental need of structural reforms. However, it must not mean that is not possible to manage the budget in a more bluntly way. The adjustment will come (via inflation and others) in one way or another, sooner or later, and try to circumvent this situation via political arena, as the art of the desirable and possible, may not be the best way – but maybe the more acceptable for Temer.

In this case, microeconomics lends us its *Theory of Revealed Preferences* … soon enough we will see Temer, by his actions, maximizing his *Utility Function* and then his preferences will be uncovered. What is the holdup then? Perhaps the indifference curve of Temer, that whose variation enables explaining the behavior that results out of the options to increase his satisfaction, is not the same as the one of the Brazilian society.

International Environment

The exit of the United Kingdom (Brexit) was, definitely, the most impacting economic subject this month. Surprise for some, not so much for others, however the margin of victory (although undeniable) did not amount to a landslide. The result, therefore, leaves hope for an eventual reversal – this is so true that until now, several alternatives have been shown to a different outcome for when the European Union makes the official communication. Honest mistake, it will not have any way back – moreover, the more time goes by, the more irreversible will be the decision made. There is no doubt that the cost of the exit (to the United Kingdom) is clearer each day, but the feeling of return to the national identity seems to gain space.

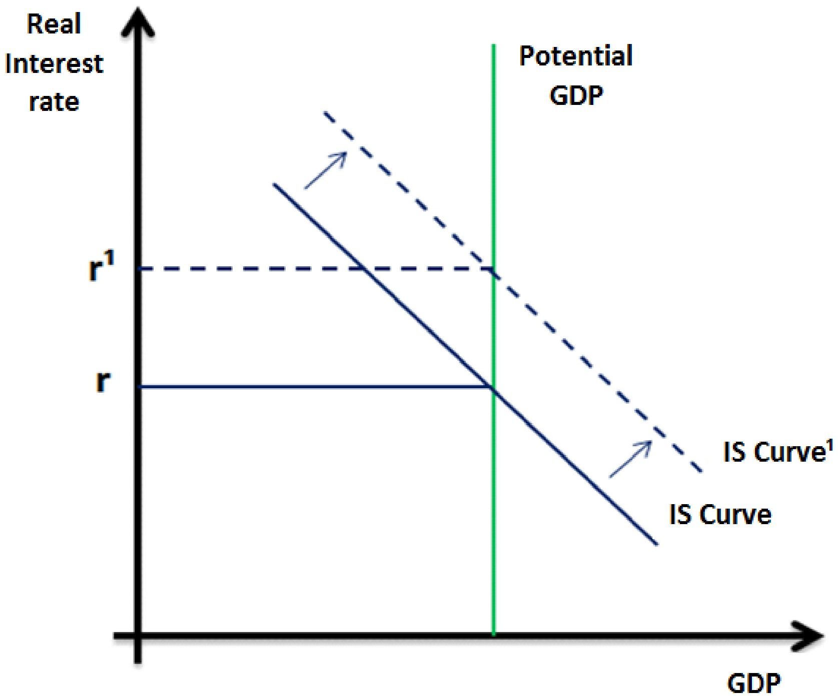
The same feeling emerges also in other countries on last years, and the United Kingdom decision must foster the neo-populist speeches of some parties conquering the adhesion of public opinion segments in many important countries of the block.

The reflexes and main impacts are still diffuse, but certainly the current projections result in much lower values than the ones originally presented. What then to expect from the Bank of England – BoE and from the European Central Bank – ECB? Every kind of accommodative policies – which is clear, obvious and beyond any doubt

In the USA, the Brexit does not seem to point to any immediate repercussion in the economy, but is yet early to talk about concrete impacts. The fact is that the American economy has solid foundations, the economy grows slightly above its long-term trend (for a while, in relative global terms, has a good performance), unemployment under 5% and inflation gradually in direction to the target. Nevertheless, the Brexit is the trending excuse for he FED to postpone tapering of its monetary policy.

In China, in its turn, thinking twice before taking action is out of the picture. The China State Council has oriented the local governments to boost private investments through measures which will reduce the bureaucracy, expand the access to markets and support investors' confidence. The private investments are losing thrust this year, compromising the general level of investments, once they find difficulties in obtain financing and access to markets. The order there is for the Ministry of Finance to relieve the operational costs of private companies through to the reduction of taxes and fiscal exemptions. But what is the cost of this? It does not matter.

Interest Rates



The fundamental question to economic policy makers and also to financial market players is: where is the interest rates going? In the long run, economists believe that interest rates will converge to equilibrium, which Wicksell defined as the “natural” rate. Unfortunately, this natural (real) interest rate is not “observable" and so it needs to be estimated and calibrated dynamically. For monetary authorities it is important because a higher or lower rate has the power to foment or to inhibit economic growth, control or not the inflation, and for financial markets, understanding the formation of the interest rates enables it to make better predictions of investment returns.

In a broader sense, several definitions of “natural” interest rate are applicable and economists struggle, using many statistical techniques, to infer the true natural interest rate, none of which however have been resoundingly successful on the identification. Hence the recurrent conclusion that it is but a trial and error methodology trying to keep up with the disequilibrium verified. But what are those disequilibria? A well-accepted definition for the natural interest rate is the one consistent with the real GDP matchings its potential, in an environment of stable inflation and without supply and demand shocks.

For us at Planner Redwood, roughly and in compass with the humility limited by the short horizon of the knowledge of the subject matter, this equilibrium is the fundamental equality between the SELIC (Brazilian basic interest rate) and that rate that matches aggregate savings to investments (S≡I). Several implications of a higher or lower SELIC in other macro variables are not discarded, however, if the tautology S≡I is true it is kind of easy to know if we are below or above of our natural interest rate. Moreover, studies show that budget deficits are related to higher real interest rates of long term and increases of budget deficits projected year after year represent a displacement of the IS Curve to the right, as the charge bellow… Does it sound familiar?

Interest Rates (Cont.)

In practice, beyond the expected above, a “higher” SELIC anchors the future inflationary expectations, which in their turn will promote the decrease of future interest rates. With it, the investor’s confidence is retaken and the economy moves up again. Obviously it is a simplified view (however objective) and there are others determinants variants in this process.

The fact, although, is that we closed the first half of the year with the new president (and his team) in the Central Bank (BACEN), with a very distinct profile from the previous one, and it brings us hope of a more adherent and friendly team to what is learned in the university classrooms. In the opening speech, Ilan Goldfajn, stated the following message: he will be the guardian of currency stability. Let’s root for that! The alignment of the new economic policy seems adequate, although it is better to tread lightly and carefully, because the synchrony of monetary and fiscal policy is what will determinate the successful trajectory.

A relevant point was the speech of the new chairman of BACEN during the release of the Quarterly Report of Inflation (QRI) of the second quarter of this year, which motivates many analysts, including the Planner Redwood, to review the beginning of the monetary loosening cycle. Ilan declared that inflation in 2017 at 4.5% is ambitious and credible, however, as the fiscal chart is not yet in a restrictive field, the SELIC must be maintained at its current level for a longer time. Presumably, the communication of BACEN henceforth will be clear and uncomplicated in the search of the recovery of the institution lost credibility. For those who follow inflation targeting regimes, credibility is everything!

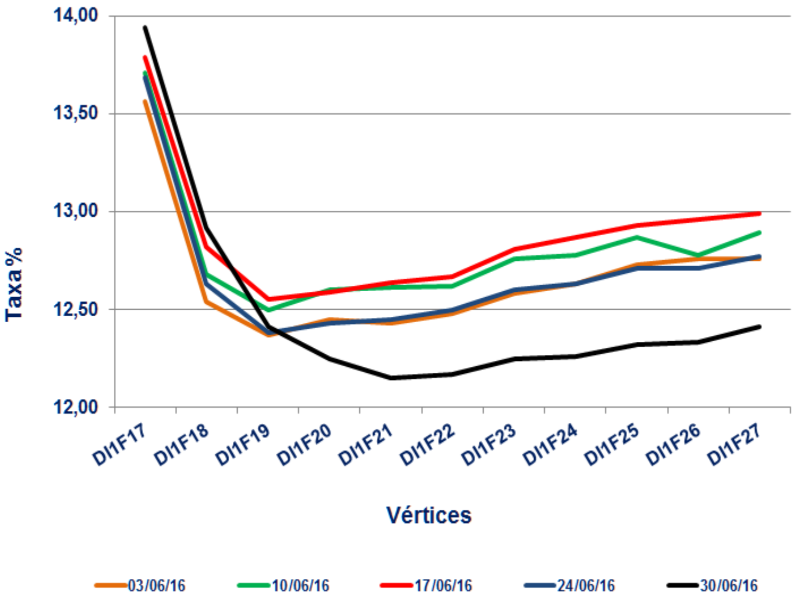
In the opposite side, the perception held by investors is that the main central banks in the world are likely to extend their measures of liquidity stimulus after the referendum in the United Kingdom (Brexit) – a reflex of the total incapability (especially ideological) of taking any other attitude. In a non-analogous reasoning, but by internal “convenience”, the bets are on a belated interest rate increase in the United States, not to mention that the low global growth has become once more a point of warning. In any way, a good part of the developed world is navigating on negative rates, which makes the Brazilian bonds more attractive. In Brazil, price-indexed papers pay real interest rates above 6% p.a. And it is believed that the great inflection and trigger point to the heavy inflow of foreign investors in the local market will be the definition of the impeachment of the President Dilma – second half of August.

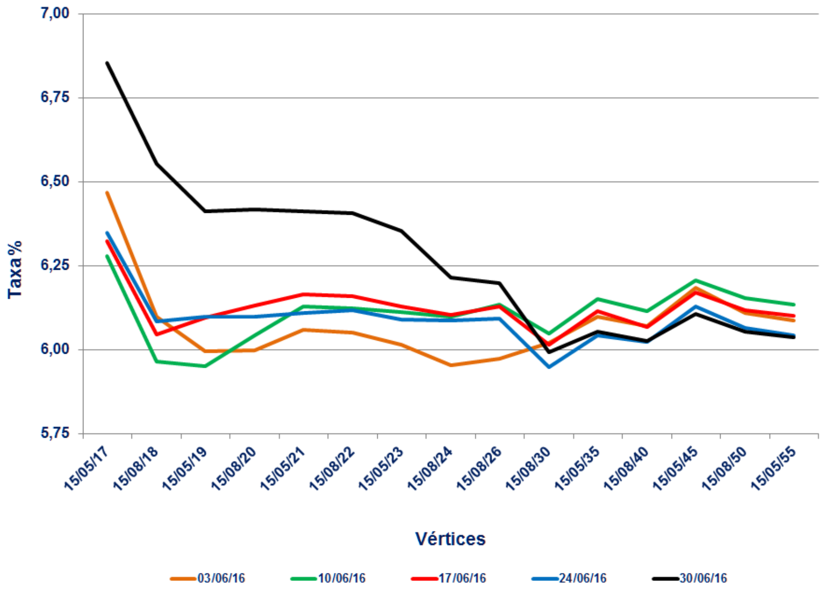
The inflation target for 2018 remains at 4.5% with bands of 1.5% above or downward. The decision was disclosed by the National Monetary Council (NMC) in the last day of the month, after the closing of the market. Until the NMC decision, the market speculate about a possible reduction of this target to 4%, which was reflected in the movement of the future interest rates curve: higher of the interest rates in short run and fall at the long end of the curve. To the market, the reduction of the target would lead BACEN to maintain the SELIC in 14.25% for a longer period than predicted. Coherent to our view.

In the consolidated balance for the month, there was a great change in the slope of the future interest rates curve, which was a result of the facts exposed above. The interest rates for the short run closed with a high, while the long term ones ended in a decrease. A similar movement happened with the coupons of the NTB-B, however with lower intensity in the maturities of long terms, resulting in an expectation of a lower inflation for the medium and long terms. In the year, the DI contract maturing in January of 2017 has decreased more than 4%, an outcome of the changing local scenario and of the possible postponement of the lifting of the interest rates in the United States.

Interest Rates

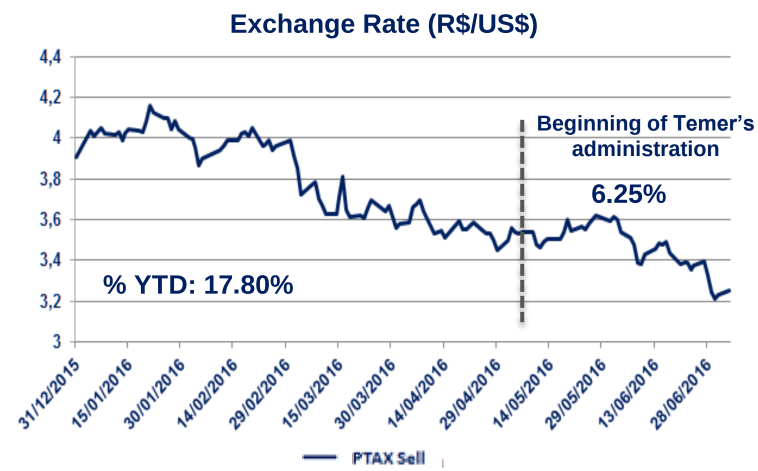
Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

Under the promise that the interventions in exchange rate market are to become “more parsimonious”, we have come to even celebrate the end of intrusions by the BACEN on the market… unfortunate deception. This impression started to be undone with the announcement of the return to auctions of reverse swap - happiness did not last long. The exchange rate might float, but great appreciations probably will be avoided – it means that the exchange rate will float, but not so much... more or less... depending on the volatility... and also of the enlightened person who decides to intervene. Our floating exchange rate is more or less as a “half pregnancy”, it does not really exist. Are there excuses for this? Obviously there are... every one of them well founded and sustained in practices of several Central Banks around the world.



In this sense, the month spotlight was the strengthening of the Real. The purchase power of the Real in face of the Dollar increased 10.72% in the month, and it has increased by 17.80% in the year.

The main factors contributing to the appreciation of the Real in June was: (i) domestically, the speech of the BACEN’s chairman, Ilan Goldfajn, highlighting the “floating exchange rate” and defending a lower intervention of the authority in the market and (ii) externally, the FED’s “caution” on increase the interest rates at the United States and the recent increase of prices of the agricultural commodities, which led to a recovery of previous terms of trade, the robust trade balances and the continuity of the strong external accounts adjustment. The Brexit has caused a hike of the Dollar in the first days after the impact with the British people's choice, but there was no lingering effect.

While BACEN talks about a *regime of floating exchange rate*, at what level might be the new American currency price floor? In June, there were no auctions of reverse swap by the BACEN even with the currency being negotiated at R$ 3.20. The traditional swap stock was reduced, before the government changed, to something around US$ 62 billion, half of what it was in March. Some market professionals started to bet on a new level of R$3.00 which would be beneficial to inflation control, a priority of BACEN. However, soon after the Real closed the month with the appreciation cited above, the BACEN resorted to intervention in the market with more of the reverse swap operations. In Brazil, we can redefine everything: the exchange rate is floating until certain point. It is bigotry altogether, but perhaps the essence lies in the anomaly of the current institutional mechanism in Brazilian market, where idiosyncrasies in the spot market and the ones in futures markets are glaring and disparate from the rest of the world... those characteristics render ineffective an authentic regime of floating exchange rate... **maybe**. It can be due, also, to a much simpler reason: we do not believe in free-floating exchange rates. Period. This approach reflects much of the express thinking of the others directors of BACEN: they do advocate the regime of floating exchange rates, just not in a *clean and free manner*.

Ok, “half pregnancy” it is!

Stock Market

Believe! In the consolidated balance of 2016 the Ibovespa has been the asset enjoying the greatest returns comparing to the fixed income (CDI, IRF-M and IMA-B) and exchange rate markets. Almost everything is right in the ratio risk-return, were it not for the moment of crisis that the country currently endures and the lower expectation of growth for this and the next year. The Ibovespa closed the month with a high of 6.30% and in the year accumulates returns of 18.86%.

A great part of the rising return trend was caused by the foreign investors. Even with multiple companies in bad financial shape, the foreign investors saw opportunities in the Brazilian market. Could this be a selective movement, an anticipation or a relative improvement Brazil's rank in face of others emerging markets? Adding to this, is the Brazilian stock exchange cheap to foreigners holding dollars? Perhaps it is but a speculative movement? Hard to know, but for us, at Planner Redwood, the indicators are still far from favorable especially from the comparison between the risk-adjusted return of the segment and the opportunity costs. At any rate, for foreign investors, notably, a more well-founded reversion is to be expected once the impeachment of president Dilma is made official. Foreign investors could care less for the interim government, they want a definitive president in office – not a replacement, but a sitting successor. They are absolutely right!

In line with a more optimistic view, some indicators show an improvement and a possible recovery. Businessmen' and consumers' confidence indexes have halted their drops and now begin to show a slight recovery. Those indexes are important, because they do predict the future behavior of the economy. However, there is no guarantee of growth being quickly restored and the domestic economic situation is still bleak. It will be necessary to wait some more months to confirm the much desired change of trajectory.

Despite the confidence deposited in the new government, it is still under evaluation. The investor is alert, especially after the kindness package with government funds and the declaration that the deficit in 2017 will be greater than R$ 100 billion. It is hard to organize the economy with positive reflexes in short term in companies – including those listed in stock exchange. It is not discarded, given the moment, that “necessities” will impose an “evil package”: increase in and/or creation of taxes. It might be the end point for entrepreneurs.

The exit of the United Kingdom from the European Union brings doubts and uncertainties, although with lesser effects for emerging countries. It is not identified, until now, greater negative impacts of this decision on the Brazilian stock exchange, but the range of this referendum will be completely shown in the future. How will these agreements unravel from now on? Will the countries involved become more protectionist? Will we have more trade barriers? Will we see a new crisis in European countries impacting Brazil, or will this event represent an opportunity? Maybe we will have our competitive advantages underscored, especially by the improvement of foreign trade by domestic companies (the listed ones).

This is an exercise that momentarily transcends the more elaborate economic-financial techniques and requires an effort of a more subliminally esoteric kind. We have not come to this (not yet), but the fact remains that those who use such types of model and accrues handsomely consistent returns is thus faced with a splendid opportunity.

Monthly Commentary

JUNE 2016

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