Planner Redwood Asset Management

MONTHLY COMMENTARY

MARCH 2015

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Agenda

"The remedy is worse than the disease."

Francis Bacon - Philosopher

Introduction

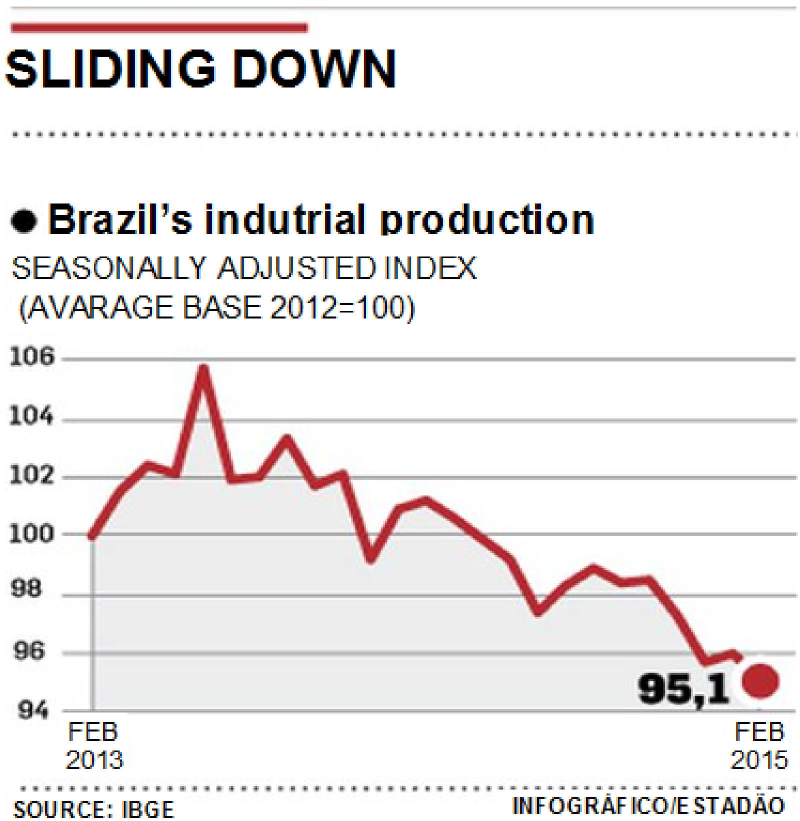
The first quarter of 2015 ended and Minister Levy's flight plan seems reasonably outlined. That is how we interpret it. The Minister holds non-stop meetings with politicians of all camps, at breakneck pace. He remains true to his mantra, and says to all who would listen to him that fiscal adjustment is imperative. Diametrically opposed to what was spread, encouraged and implemented in the last Administration, now all need to "profess the same faith"...and it seems that the Minister is succeeding in this endeavor... even the unorthodox Aloisio Mercadante amazingly seems to have "aligned" himself with this line of thought. However ephemeral and circumstantial are the *quasi*-true supports, this challenge is the first and most important at this time, and all help is needed and welcome. Only then can trust in the government be restored, as well as the growth possibilities of the country, additionally preventing loss of investment grade. Any downgrade of the sovereign credit rating would be a disaster in the plan to replace Brazil on a secure growth path.

In this crusade, Minister Levy has stressed the importance of the entire society's participation in the fiscal adjustment effort, and the President herself has asked for society's patience and understanding... however, she did not apologize and/or recognize the huge economic mistakes of the recent past. But not all is so well, for the second consecutive month the Minister has made statements (not to argue their merits) that has made the main government leaders uncomfortable... this time not as a criticism to the recent past economic model, but rather, against the posture of the President in the handling of problems. This is inadmissible for somebody holding this office, perhaps he should not be there... the rope always breaks on the weaker side and the Minister must realize what is his side. In the aftermath, adjustments are made to the statements, appeasement is made, and myriad explanations surface on this or other subjects, which end up serving as political "currency", irrespective of genuineness. Surprisingly for a Chicago Boy, Minister Levy seemingly does not consider Fundamental (at least for now) the actual independence of the Central Bank, a thorny issue, difficult to change under the PT and this President.

Internationally, the US Federal Reserve took the central stage and everything seems to revolve around the timing of raising interest rates in the USA. Every now and then speculations of all kinds emerge, thus providing an environment of great instability. The time indicators reinforced the perception that the US economy, after a good end of 2014, may be slowing down, and so the interest on the 10-year T-bills retreated... inflation is far from what were expected... none or at least almost anything. For the medium and long term scenario the decision to raise interest (and as soon as possible) is inexorable. On the emerging countries' side, Russia is suffering greatly from oil prices drop and, according to the World Bank, in its "lower limit" setting (barrel at USD 45) economic contraction in Russia will be quite strong.

In this environment, US Treasuries ended the month at 1.93%. S&P changed -1.74%, NIKKEI closed at 2.18%, DAX at 4.95% and FTSE at 3.67%. Ibovespa ended the month at -0.84% and IBrX at -0.51%. Maximum DIF16 was 13.92% and DIF17, 13.87%. NTN-B 2050 ended the month at 6.39%, and the dollar (Ptax sale) at R$ 3.2080.

Economic Activity



Manufacturing is only one of the sectors of the economy. From the supply or demand side, performance is poor and getting worse this year. It is noteworthy that manufacturing's results are consistently disappointing and no other sector was so celebrated, cajoled and encouraged with so many favors from the past Administration: tax cuts (vehicles, household appliances, building materials), subsidized interest rates, payroll tax relief, and some market reserve... all this with the support of the Treasury, via the kind BNDES. Notwithstanding, the sector has always complained (basing its arguments even on economics textbooks, among other things) that the exchange rate was over-valued... a weaker Real would help manufacturing sector, specially in the balance of trade. Well, this year alone the devaluation of the Real has been approximately 20%... and how about manufacturing? No reaction. Why not? The answer is: the problem is competitiveness! The Brazilian industry is uncompetitive not only because the infrastructure is expensive, bad and obsolete, but also because it lacks greater productivity - productivity that depends on better professional qualification of workers, improvement of industrial facilities (including import of raw materials), machinery and working capital as well as external provision of supplies… you see... the weaker Real had a negative impact on all of these!

Let us not be so shallow in our analysis. The economy is all messed up, specially in this sector, and a devalued Real or specific adjustments will not, alone, solve the problem in a structurally cohesive fashion. The industrial confidence index in the sector is a shambles and the outlook even worse. Again, public accounts adjustment will restore credibility, predictability and support for the economy. Fiscal equilibrium brings inflation down, and therefore, the interest rate. Add to that a more efficient taxation system, labor reforms and removal of other trade obstacles and there will an industrial revival at global competitiveness levels.

What is advocated for the industrial sector fully applies to all other sectors of the economy.

Fiscal Policy

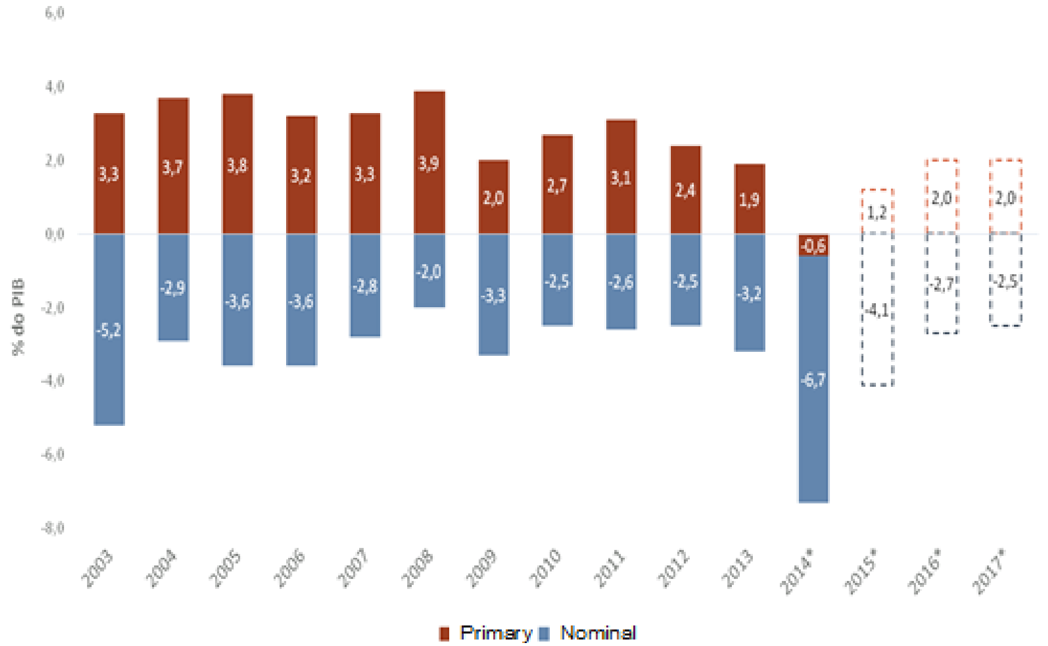
Minister Levy brings with him the following Fiscal Adjustment message wherever he goes:

- REVERSE THE FISCAL AND EXTERNAL ACCOUNTS DETERIORATION
- RESPOND TO THE DISCONTINUATION OF ANTI-CYCLIC POLICIES OF OUR MAIN PARTNERS
- ENDING THE COMMODITIES SUPER CYCLE, REORIENT THE ECONOMY
- ENSURE SAFETY AND COMPETITIVENESS CONDITIONS FOR OUR ECONOMY
- PROTECT SOCIAL GAINS
- STRENGTHEN THE NEW MIDDLE CLASS WITH "OPPORTUNITIES INCLUSION"

But, how much Fiscal Adjustment should be done?

There are quite a few segments of society who do not understand the reason for this Fiscal Adjustment. After all, everything was going so well... and so, the aversion of various segments is based on the fact that the fiscal adjustment is an end in itself, the perception that it is a necessary step but we do not really know why, and the potential implications that this adjustment can bring. Ideally, we should have more time to educate and explain in detail...

At this time, objectively, the number (surplus target) is important but it is not essential. The essence is the commitment to the adjustment, the need for consistent recovery of the primary surplus, combined with a truly vigilant Monetary Policy and floating exchange rate. This is a forceful economic transition, which must be quick and efficient, like a properly prescribed medicine - a dosage and length of treatment that will to heal, rather than kill the "patient."



Source: Central Bank and LDO (2015/17)
Produced by: Ministry of Finance

International Environment

Nothing seems to capture more world attention and monopolize discussions than the "normalization" of US monetary policy by the Fed.

The apparently friendly FED chairperson, Janet Yellen, a true disciple of her predecessor Ben Bernanke, does not appear to want to rush the raising of interest rates. In fact, although practically all the prerequisites for lifting have already been achieved (apart from inflation) the decision is not yet made, lest the attitude be considered premature... and so the saga continues, the institution is waiting for the achievement of an ideal point, or at least one in which the effects of possible errors' impact have been diminished. The great is enemy of the good. The vacillating and/or not unanimous position have led to two interpretations by the market, that monetary tightening will take place towards the end of this year, or that it may come sooner, but more parsimoniously. However, both have the same effect: caution and uncertainty for investors across the world and the immediate consequence of these phenomena: volatility. Repeating our mantra: we reckon the prospect of increased interest by the FED will take place at the end 1st Semester or early 2nd semester of 2015.

In Europe, finally some good news. The industrial PMIs (Purchasing Managers Index) of various countries rose: in Spain it rose from 54.2 to 54.3, in France from 47.6 to 48.8, in Germany from 51.1 to 52.8, in the United Kingdom from 54 to 54.4 and Italy it rose to 53, the highest level in 11 months. In the Euro Zone there has been progress: from 51 to 52.2. This data ensures the ECB that it has chosen the right path and the intensification of measures (monetary easing) is permanently on the agenda, because these numbers are interpreted as another sign that a regional economic recovery, albeit modest, is happening in the region. Some principles and paradigms have been broken, specially the low limit of interest rates... zero, right? No. In Europe, Central Banks are practicing negative interest rates... For instance, in Germany, investors in government bonds have to wait sometimes more than seven years to earn some return! In other words, investors in these cases must *pay for the privilege* of investing in government securities. It does not take much to realize this cannot go on forever... there are some limits to idiosyncrasies.

In China, after 2014's 7.4% GDP advance, a reduction of this expansion is expected to around 7%. Even so, if the Eurozone continues as above, the world economy is expected to grow more than last year: 3.6%. The main highlight, a real outlier of the sample, will be Russia, strongly pulling down the global growth rate.

In non-economic terms (but certainly there are some reflections in the economy) the US also grabs the headlines with Cuba, and more recently, Iran rapprochements. The head start of the US-Cuba rapprochement was the end of 2014, but the first *real* contact will happen at the Summit of Americas in Panama, where Presidents Barack Obama and Raul Castro will meet and will lay the foundation to end half a century of hostilities.

This will be an important and historic moment, especially for Cuba.

Interest Rates

Inflation, for countries that have already suffered so much from that evil like Brazil, should be demonized at any cost. This is the most perverse tax that exists and always impacts, mercilessly, the poorest. Brazil put an end to this evil with the advent of the Real Plan and the implementation (at the time very much questioned) of inflation targeting as an alternative to traditional inflation control measures. In good economic terminology, the Central Bank ceased to be a "monetarist" manager and became more "wicksellian" (Johan Gustaf Knut Wicksell was a Swedish economist), where the interest rate (or, to Wicksell, the natural rate of interest) has a key role in controlling demand for money and thus price control. By identifying a natural interest rate, key to monetarists, and the endogeneity of money, essential for some aspects of Keynesian thinking, Wicksell developed elements of his theory, that are closely related and aligned to our current reality. But is this the way our Central Bank really evaluates things? Does the operation of practiced monetary policy really consists of the manipulation of the money supply in order to influence the prime rate (and vice versa)? Is the Selic really used in this light?

In the market, January's interest relief did not last in the quarter. The fiscal adjustment package announced earlier this year in order to contain government spending and help control inflation has not yet been approved by Congress. The delayed approval of package compromises the achievement of the consolidated public sector fiscal target, of 1.2% of GDP, projected for 2015 and reduces the positive impact on inflation.

In this report, we have often advocated the joint action of Monetary and Fiscal Policies in order to enhance their effect on inflation. The 2015 inflation forecast already exceeds, by far, the 6.5% inflation target ceiling. There is no doubt that all areas of Government must make an effort, both in the expenditure and revenue side, in the context of fiscal adjustments and, not least, absolute Monetary Policy firmness.

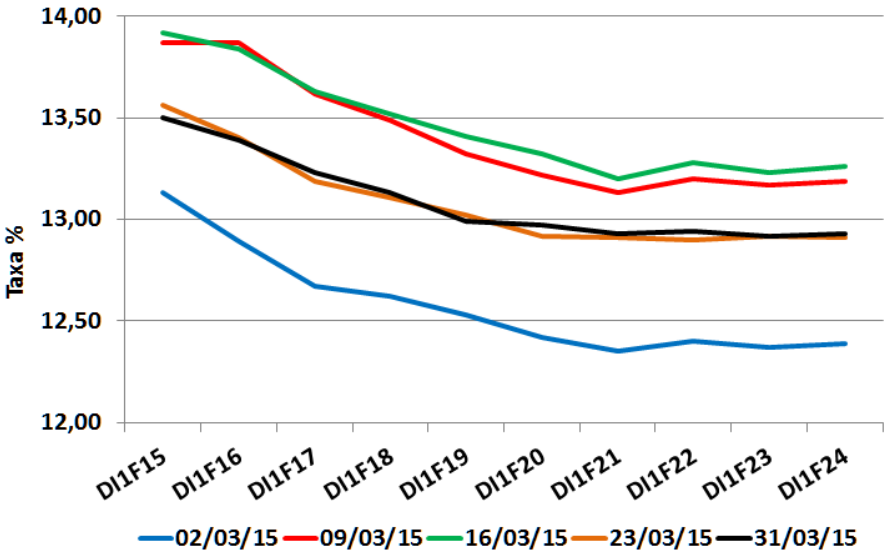
In regards to inflation, projection revisions during the quarter were always high. The target ceiling, set by the CMN, seems a distant, unattainable number. Apparently, this year, the president of the Central Bank will have to explain to Congress why inflation exceeded 6.5% a year, for inflation control is, in theory, its first and primary mandate. High inflation, low investor and producer confidence and the worsening political crisis raised the premiums of all maturities along the yield curve and NTN-B coupons, in the consolidated quarter and the month. The inflation pegged notes (IPCA) with maturities beyond 2024 were traded during the month of March with real interest in excess of 6.5%.

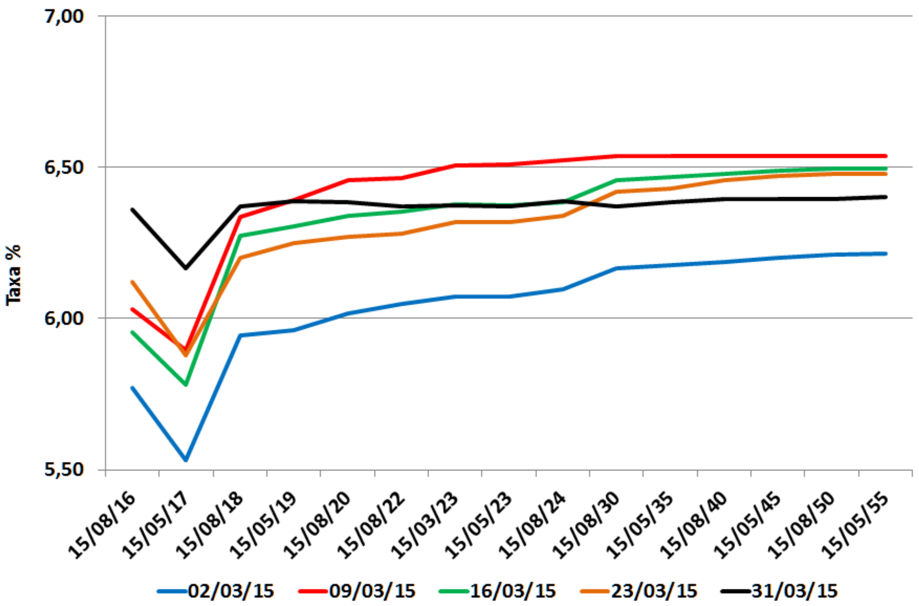
In this scenario, the COPOM rose the Selic rate another 0.5%, which is now 12.75% a year. After the COPOM minutes disclosure, which added no relevant information to the market, the shorter maturities of interest futures priced a Selic peak of over 0.75% for the next meeting.

The question is: to what extent will the medicine (combination of rigid Monetary and Fiscal Policy - if indeed adopted) be used in a dosage and timing that will cure our problems, without asphyxiating the economy? Francis Bacon's well known phrase cannot prevail.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

Just when you think things are bad, they can get worse. The Real continued to lose value against the dollar and exceeded R$ 3.30 in the spot market during the month of March, closing the month at R$ 3.2080. In the year the dollar is up 20.77% on the Brazilian currency. Dollar appreciation was widespread with greater impact in less developed countries.

External and internal factors, the latter with more weight, influence the currency market. Political crisis worsened and had a direct influence on the Real exchange rate. In addition to the rows between President Dilma and the Chairmen of the House and Senate, the economic *school* differences between the President and Minister Levy became explicit, given the statements made twice by the Minister concerning the management of the economy in the first term. The first happened during the announcement of the new payroll tax relief for companies when the Minister stated that the previous methodology was unthought and inefficient, and the second during a meeting with University of Chicago students, when he again questioned the efficiency of the measures adopted in the first term. Doubts concerning the permanence of the Minister after such statements generated volatility in the markets and devaluation of the real. However, due to the government's reliance on the success of the actions proposed by the Minister, nothing happened and the market followed its course.

Another internal factor that contributed towards the devaluation of the Real are the statements made by the president of the Central Bank, to the effect the institution will not interfere with foreign exchange. Foreign exchange will float and will follow the law of supply and demand. Unbelievable! First a sudden brake, and then a 180 degree turn! Under the same institution President and staff (or almost the same). We can only believe it because we are witnessing the fact! The Central Bank ended the daily foreign exchange swap auction program on April 1 (some thought it was an April fools joke) but kept the full rollover of outstanding lots. The program began in August 2013 and according to the Central Bank*, it has provided significant volume of foreign exchange hedging* for economic agents. They also say that, if necessary, the institution may carry out additional operations using foreign exchange instruments. Oh, well, we are back to normal!

This premise and philosophy that Foreign Exchange is just another price in the economy is a Chicago Boy thing, definitely. In this regard we are being assisted in numerous fronts, as this mini dollar overshooting (20% in 2015 and more than 40% since July/14) has not yet contaminated inflation... it is true, in spite of the dollar appreciation, the traditional foreign exchange appreciation pass-through did not happen (studies indicate the effects will be felt, in the medium-term, in 3-6 months). What are the reasons? There was little effect on the tradable price index, for the prices of the main commodities have dropped, and it is believed that the effects of foreign exchange depreciation may be limited by the conditions imposed by weakening economic activity, from a demand reduction perspective. However, there is the undeniable certainty that there will be an effect. Geee...

Stock Market

Quarter finally ends! The first three months of the year were marked by mass demonstrations, risk of blackouts and water rationing, increasing political tensions between Congress, President and Ministry of Finance, expectations about rising US interest rates and finally maintenance of Brazil's rating by Standard & Poor's. Even so, Ibovespa closed the quarter with a rise of 2.3%.

The risk of blackouts and water shortages were dissipated due to the surprising March rains, and the negative GDP expected by the market this year. As for the demonstrations that took nearly 2 million Brazilians to the streets in March in several cities of Brazil, they should continue and the government will have to be more agile in its decision process. The lack of political coordination between Congress and the President is hampering the adoption of the necessary fiscal measures, for achievement of the fiscal surplus and inflation control. Internationally, the FOMC meetings came to be on portfolio managers' radar, positive data from the US economy raised the expectation that interest rates will increase earlier than expected. However, during the March FOMC, the FED chairperson's statements indicated that interest rate increase will not take place in the very short-term.

To close the quarter, S&P gave Brazil a vote of confidence and retained the country's sovereign rating at BBB-. But, for how long? And how vulnerable is the Brazilian economy to Minister Joaquim Levy's action and presence? For the risk agency, the maintenance of the Brazilian note rating reflects the expectation that the ongoing fiscal adjustment will have the support of President Dilma and the National Congress, despite the challenging political and economic environment. The prospect of a stable rating seems to give time to the Minister Levy to deliver the announced fiscal adjustment, and, at the same time, strengthens his position in the Government.

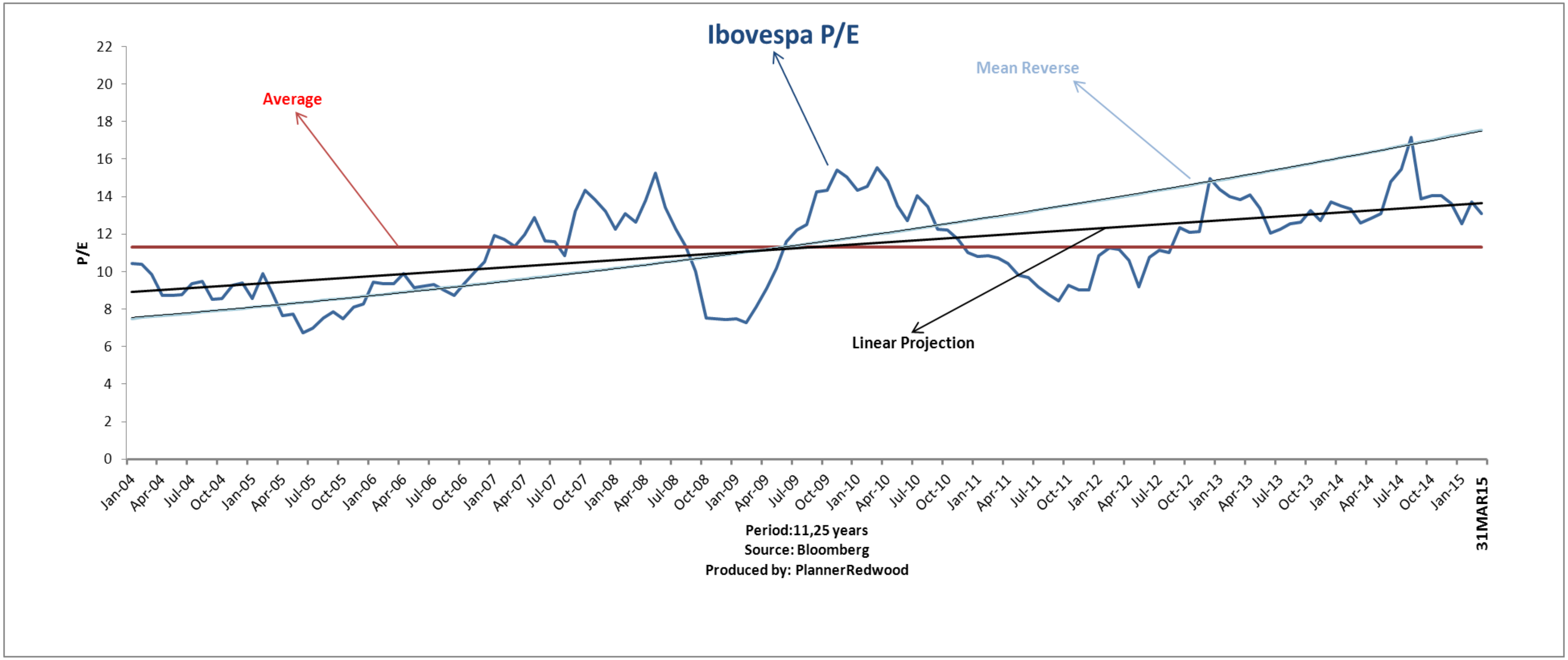
S&P's decision did not pump life into the Stock Exchange Index, however, in the short term, the maintenance of investment grade prevent the hasty flight of investment funds, which may only invest in investment grade countries.

After February's strong Stock Exchange peak, in March sell side was stronger and the Ibovespa index closed down 0.84%. Adds to that, falling oil and iron ore prices in the international market also reflected in stock prices in these sectors. Foreign investors supported much of the stock exchange trading, benefiting from the price of stocks in dollar terms.

Under this approach and analysis, the next two slides present a scenario in the least intriguing and thought-provoking for the Stock Exchange as a whole (Ibovespa). In the first, the Price/Earnings chart seems to indicate that the Stock Exchange is *well priced*, while the second, the dollar Ibovespa chart place is at unbelievable 2005 prices! The first and immediate interpretation is: for Brazilians (in Reais) the upsides at first sight are not exciting, but for the foreigners (in USD) there is a lot of joy in store. So why foreign investors have not yet come in droves? The answer may be that they look at these two charts... all they see is uncertainties on the horizon, not risk. However, as soon as the adjustment of the economy takes place, the Stock Exchange, as always, will anticipate the movement of the real economy and will appreciate a lot. So we hope!

Stock Market

Dollar Ibovespa Chart



Ibovespa Forecast		Up/Downside 31-Mar-15
Fair Price:	31-Mar-15	51.150
Linear Projection:	52,300	2.25%
Average Projection:	44,043	-13.89%
Mean Reverse:	68,521	34.0%

Stock Market

Bovespa Index in USD

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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