Planner Redwood Asset Management

MONTHLY COMMENTARY

MARCH 2016

Monthly Commentary / MARCH 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.

“There is no more dangerous menace to civilization than a government of incompetent, corrupt, or vile men.”

Ludwig von Mises – (Economist) leader of the Austrian School of economic thought.

Introduction

The level of tension in Brazil, in special because of the non-economic events, is on the way toward closure, where we will have an inflexion point or deepening of the unprecedented crisis.

The inflexion will happen with the current government leaving (and it doesn't matter how it will happen: impeachment, resignation, new elections, etc.), and along with the possibility of a new and more legitimate administration, who could realign political interests with an economic plan focused on achieving fiscal responsibility, and with an approach that pays homage to good practices of public administration.On the other hand, the intensifying crisis will probably come in the absence of any previous alternatives, because in this case, what is valued will be the rerun of populist macroeconomics and its medium- and long-term consequences. Here, we aren't talking about the political factor acting behind the scenes, only singling out the pragmatic analyses of its effects in economy. The beauty of democracy lies in alternating political parties in power, and we can't forget that *"Politicians and diapers must be changed often, and for the same reason."* (Mark Twain).

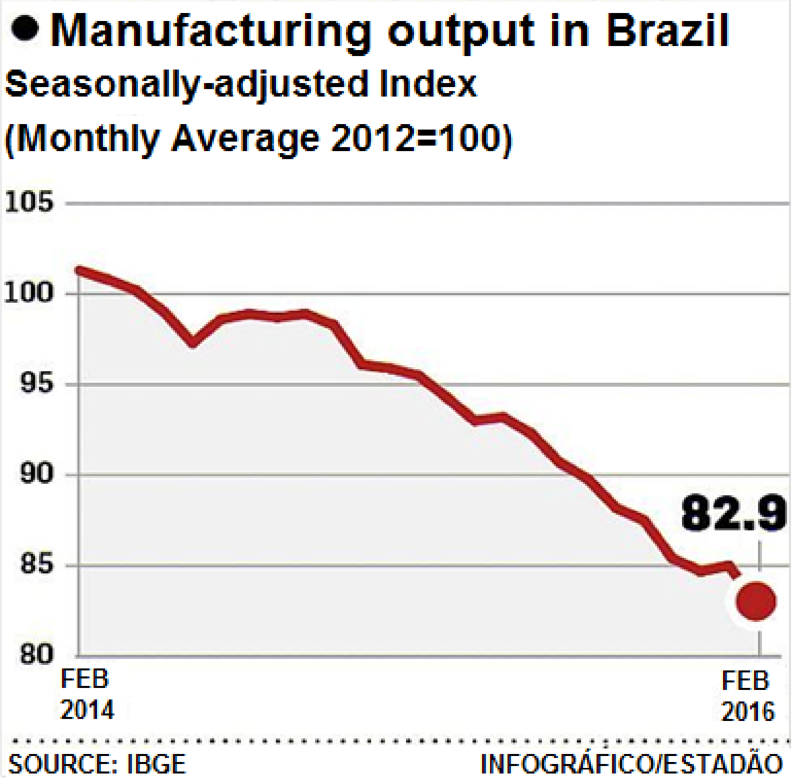
On the international front, the main economies did not present any significant changes in relation to last month. Now the FED is wondering if the level of 4.9% would be, in fact, of "full employment" and, aligned to the posture and the last declarations of its Chairwoman, Janet Yellen, it has confirmed a slowdown of the FED's interest rates hike. In Europe, the ECB (European Central Bank) may not change its monetary policy in this second quarter (has expanded the stimulus program twice in the last three months) and in China the results of the main banks show lower profits, which indicate, especially, that bad loans have been accumulated and become irrecoverable debts. For both the therapy to be applied has been stated: more government stimulus.

As for international politics, the American presidential race seems be definitely on spot. The Republican candidate Donald Trump, rejected by many voters, even within his own party, has gotten increasing exposure and his controversial opinions - a trademark of his - has become viral in several segments of American society. We are far from believing that an eventual Trump victory would bring his proposal to fruition (it looks more of a marketing strategy, as it is), but even so a small portion of his ideas, if applied, will promote significant changes in US as we see them today. Maybe his polemic opinions are a way to take the ones who don't want to see more of the same by Democrats with his opponent Hillary Clinton.

Finally, it is impossible not to mention the Belgium attacks and the threat to peace between nations, and the possible changes in international relations, that this situation (and its development and expansion) brings, with economic-financial impacts.

In this environment, the US *Treasuries* closed the month at 1.79%. S&P varied 6.60%, NIKKEI closed at 4.57%, DAX with a 4.95% rise and FTSE at 2.80%. Ibovespa ended the month at 16.97% and the IBrX at 15.47%. Maximums to DIF17 at 14.12% and DIF21 at 15.43%. NTN-B 2050 finished in 6.50%, and the dollar (Ptax sell) at R$ 3.5589.

Economic Activity



Economic activity in this year of 2016 will probably remain at 2015 levels. It means that we will have a slowdown around 8% in these two years combined (2015/2016).

Perspectives are far from exciting. Our projections of unemployment rates achieve to the previously unthinkable 12% at the end of the year, inflation hovering above 8% and a great political mess in the economic realm. All of this creates an environment where flimsy confidence in all indicators directly reflects in further hindrance to investments.

The solution at this moment invariably goes through the political adjustment that drives our projections in an elementarily binary fashion. Only two scenarios weigh in on probabilities: the negative and positive, and both are awful. On the positive side, a broad change of the economic team (Ministry of Finance, Planning, Central Bank and advisors) more technically committed and more deeply focused on structural adjustments, could put an end to the current poor economic performance. Only a change in this sense would provide decompression on financial markets, and with it expectations may change, modifying confidence indexes, etc. There is no magic to it, but some relief… even because only by way of a statistical effect we will have an ordinary performance in 2017. In this sense, we would end the three years (2015/1016/2017) in a slowdown amounting to around 10%. On the negative side, we can anticipate the continuity of this economic team (with the possible return of macro and microeconomic populism), along with the more imaginable harmful effects, by which we would see Brazil burst into a depression until the 2018 elections, with a GDP contraction that could easily double the results of the end of this two years (2015/2016).

From our standpoint, everything looks awful. Hopefully we will be proved wrong, but this chart below seems to support the analyses above, and worse yet, with almost no chance of reversion, because everybody waits for a political definition in order to rethink their investments.

We need to change the diapers, urgently!

Fiscal Policy

If the fiscal adjustment is the exit door from hell, our predicament shows that we are locking ourselves up in it and throwing the key away.

The recent figures leave no doubts about it. According to the Central Bank, the consolidated public sector (Central Government, States, municipalities and state-controlled companies, except Petrobras and Eletrobrás) presented a primary deficit of BRL 23.040 billion in February. It is the worst result on this very month in the historical series that began in December 2001. Besides that, the government requested the National Congress to register a new primary deficit of R$ 96.65 billion in this year in the Federal Government. This attitude is really unthinkable, especially because of tough resistance met in the National Congress due to the political moment we live… or not? This measure could represent an increased "budget" and resources allocated to lawmakers and with it some sympathy and probably success… better not think this way. We shall only remember that we doubled the goal!

Since last year, the Central Bank is saying that the fiscal efforts tend to converge toward neutrality in 2015, and could even present a contractionary character. It wasn't a few times that something of the sort was stated. However, now the Central Bank seems to be changing its mind. It is not surprising due to signs that the government has relaxed on the side of expenses in February, whereas we had a real increase of 8% in Central Government expenses when compared to the same month in 2015. On the other hand, the Central Government gross revenues in February kept decreasing in practically all across the tax board, with revenues collected out of real profit plunging (30.5%), those from companies' billing results (13.6%), from wages and salaries (4.4%), payroll (6.1%), financial operations (15.7%), taxes on production (9.7%) and on imports (17.9%). Wow! Strengthened on both sides.

All of it results in significant deterioration of our indicators. The Gross Debt-to-GDP ratio will achieve, at the end of 2016, 73.2%, while the net debt-to-GDP ration around 41.6%, according to the market scenario evaluated by Central Bank. We are at the peak levels of the 2008 crisis. Our projected figures are even worse for 2016: 77.33% and 44.64% for Gross and Net Public Debt as shares of GDP, respectively. The consequences of this situation are immediate and, unfortunately, long-lasting from the point of view of reverting perspectives. In special here we refer to new rounds of Brazil's credit downgrades by the risk-rating agencies – in the short run.

But, if the rating agencies' opinion doesn't matter to the government, the more incredible it seems, whereas the grades translate the payment capacity by a Country, the domestic effects of economic disorganization are huge. In this sense, the adjustment needed is of absolute emergency, because the mechanism of fiscal adjustment has its own gap between discussion and adoption of measures and its results. Therefore the faster the adjustment process, the more abrupt will be the reversion toward a favorable trajectory to the public debt and the restoration of the families' and companies' confidence. Finally, we need to start generating a primary surplus quickly in order to create a positive perception about the macroeconomic environment in medium and long runs, so as to decrease the cost of servicing the public debt. In the face of what we have been seeing, such an outcome seems unlikely. In COPOM's words, *"Furthermore, a limited fiscal policy will reflect favorably on the capital costs in a general way, which, in its turn, will stimulate the private investment on mid and long terms*". The Central Banks was a bit late, wasn't it? Is the Central Bank changing the diapers? With this team? We doubt it!

At any rate, fiscal matters are a "problem" Minister Barbosa must face.

International Environment

Nothing short of disappointing is the sensation of fragility, incapability of direct reaction and insecurity. It is what the world has endured in last months with the return of terrorism in Europe. Those events, for now, however non-economics, embed a great potential of political-social and economic disorganization in case of an expansion and increased frequency of its occurrence, or in case of success of an attack in another country of greater expression in the world economy. More than this, the Old Continent has its plates full of problems as it is, with raging unemployment, stagnated economies, refugees, etc., etc., and now the ubiquitous ghost of terrorism… It is too much for a society to support. The “landscape” is quite troublesome in Europe.

The index analyses of Europe, the Industrial PMI increased in Italy, UK, Germany and in the very Eurozone – this latter, however, with the first-quarter average as the lowest in a year. On the other hand, the PMI decreased in France and Spain. PPI and CPI (inflation, to the producer and to consumer, respectively) in Eurozone has decreased too – a terrible sign to their monetary authorities. As a relief, the unemployment rates in Eurozone decreased, although marginally, but to the lowest level since August 2011 – 10.3%.

In China, the Industrial PMI moved forward to 50.2 in March, but economists warn against seasonal factors. However, in the same line of expansion the Services PMI increased to 53.8 – here including retail, aviation and software, as the real state and construction segments. At any rate, the PBOC may persist with its measures of relaxing of monetary policy, now with expectations of that the called “total social funding”, a credit indicator that includes bank loans and non-bank loans, grows 13%.

In US, the spotlight is on Chicago’s ISM, that increased to 53.6 in March after 47.6 in February. Of the five indicators that compose the index, the surprise came of the employment sub index that surpassed the barrier of 50 and achieved the highest level since April/2015. This spotlight is important because signals the way that we will be seeing soon to the whole American territory, and with it, a reversion (though belated) of the leniency that FED has threated the return to normalization of American monetary policy. Of the five increases of interest rates imagined some time ago, today we will have perhaps only two, according to the speech of the FED’s Chairwoman, Janet Yellen. The transparency of what the FED will do is clear on its Chairwoman’s messages, but it doesn’t mean that we agree with it or that they are right – and more than this, that it is useful for us to evaluate the impacts and consequences of global economies, in special ours.

Turning to our hemisphere, the Golden Boy of this round, and with all its merits, is Argentina’s President, Mauricio Macri. His government gathered sufficient support to overturn Senate-sponsored laws that impeded the reaching of an agreement with creditors that hadn’t accepted the renegotiation of Argentina’s debt, thereby dubbed “Vultures” by Cristina Kirchner’s administration. The project got 54 of the 72 votes. He also obtained, enough support to issue USD 12.5 billion in new securities too, with which he intends to collect money to manage Argentina’s debt and re-enter the international credit market.

Ah! All these with minority in Congress and the American President dancing Tango. The envy is a @%#&. Congratulations, Argentina!

Interest Rates

Once again, political news dominate the markets. We ended the quarter without a conclusion about the continuity or not of Dilma's government, we proceed without a government, without direction, and in this segment, as in the rest, this fact has troubled the assets on the run.

As to the basic interest rates, the Central Bank's Chairman kept the same tone in his recent declarations and he pointed out that the risk balance to inflation keeps challenging, a chart that precludes any chance of the Central Bank working with the hypothesis of a lax monetary policy even with worsening GDP perspectives for this year. The institution's quarterly report admitted for the first time that the IPCA *(headline consumer price index)* is likely to break the top target bound in 2016, closing at 6.6%. The *"Boletim Focus",* published in the first week of April, ratifies Central Bank's increasing inflation projections. Despite estimating above-target inflation rate for this year, IPCA decreased at the margin.

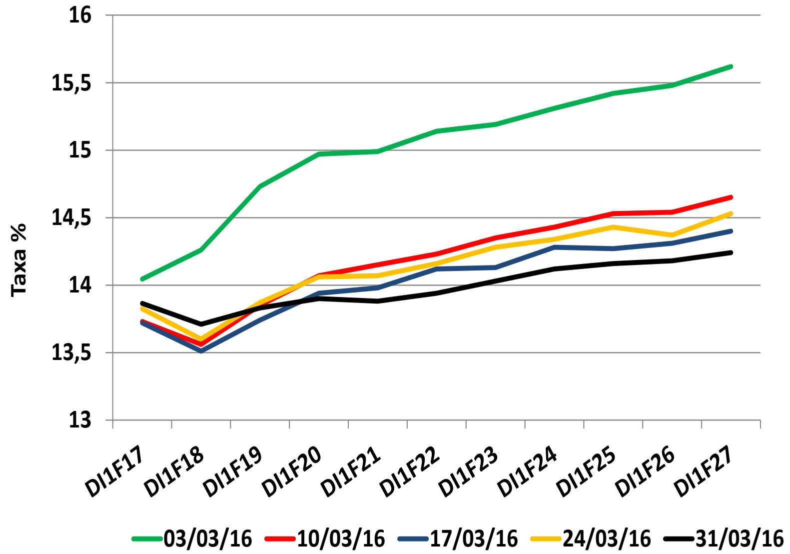
We, at Planner Redwood, are at variance with the Central Bank's Chairman's view and we project a reduction of the SELIC rate in the second semester of 2016 even with the IPCA closing the year above the target's top bound (8.4%). The main driver behind price reduction will be the economic recession and not monetary (and economic) policy as it is conducted to date. The Central Bank can't revert on its own the inflationary trend fomented by the Ministry of Finance and Treasury. With its conduction and results on recent years the Central Bank has entirely undermined its reputation as guardian of the currency – its "communication" tool, otherwise very important to Central Banks, is now worth too little and, therefore, has very low market impact. Additionally, the risks coming from the mismanagement of public accounts and political crisis can generate a boom of goods and services' prices. But, does it really matter? Of course not! Let us repeat ourselves here: Central Bank's leaders aren't in command; the President is the Commander-in-Chief. Period. It doesn't matter even if our projections point out or not to a reduction of the SELIC. It doesn't matter which is the best, the technique adopted by the market agents or the traditional and consecrated measures (as Taylor) in the world. What matters is what is going through the President's mind and her evaluation about what is best for the economy. Inflation? Prices control. Lack of consumption? Cheap interest rates. Economy can't grow? Entrepreneurial State. With high interest rates are we on the verge of Fiscal Dominance? We can fix it: SELIC reduced, we can use part of foreign reserves, create remunerated accounts to replace repo operations… whatever comes to mind, there are no bad ideas! And the Central Bank, how is it? It simply isn't.

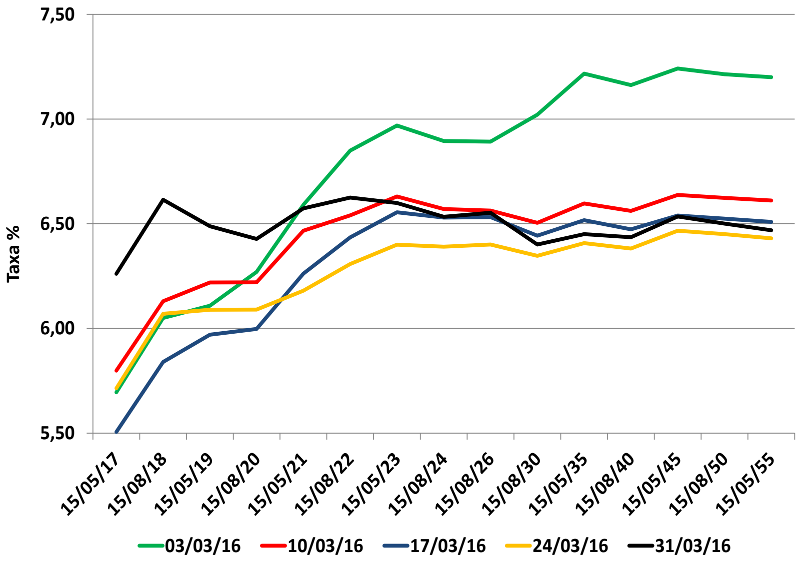
The conclusions above reflect the purest assessment of how things work. We have our models and we observe the market, but the distinction always falls between what the authority "should" do and what it "will" do – which often cannot be one and the same. Thus, formal models at times need to be exogenously calibrated with non-economic arguments, and we have a route of short term - and an unstable one – about how the variables will be conducted. All too pragmatic. In this sense, the yield curve in this month had a movement similar to the pre-elections period. The increasing probability of the country's change of command reflects directly into the reduction of premiums negotiated in the futures market for interest rates, with eventual spikes whenever the government could catch some breath to keep going. In the quarter overall, interest was displaced downwards more than 2% along the curve.

Within the relevant horizon where our perspectives are set upon, the assets' volatility will keep on running highs and Central Bank's reign at the same level as always.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

The US currency lost thrust facing the Brazilian Real since the beginning of the year, with greater intensity in March. The Real closed the month with a 10.57% appreciation, negotiated at R$ 3,5589. So it is what it is... who in its own estimates in the beginning of the year, in its most optimistic projection, would have foreseen the Dollar at this level (and at this moment)?

Since June 2013, the Central Bank has intervened in currency markets placing swap exchange operations (Dollar sell), in other words, in Brazil we don’t have a free-floating exchange rate. The objective, according to the Institution, is to protect the exposure to foreign currencies (exporters, banks and investors) and, specially, control the value (and the volatility!) of the Dollar, in a manner that the American currency would not overshoot, thereby passing through to inflation rates. Therefore, what the Central Bank interpret as Exchange Policy, as regards swap exchange operations, as in foreign reserves management, the autarchy doesn’t aim at profits, but to provide hedge to markets in times of volatility and maintain liquidity in crisis moments. We had already demonstrated that nothing of this is effectively proved by the conduction entailed by Central Bank’s team. Thus, in March, the Central Bank switched sides: moved on to make reverse exchange swaps (buying Dollars) and to reduce the exchange swap rollover – nowadays in a volume higher than USD 100 billion. The justification? Window of “opportunity”… really? For who? Or does the Central Bank work with a floor to the Dollar quotes? An intense Dollar decrease would generate damages to the trade balance (according to many economists, the solution to BP), but, in the other hand, the weakening of the American currency helps to reduce the inflation. Which will be the exchange rate equilibrium to Central Bank looking the two sides of the coin? And, actually, which currency the Central Bank looks to?

But when we believe that we have had enough, ridiculous news arrives. Discussions about the use of the foreign reserves to pay the government bills were boosted when Ms. Roussef named Lula as her Chief of Staff, despite refusals of Minister of Finance and the Central Bank – that deep down and in the limit, doesn’t matter too much. This government’s attitude, if carried forward, would be one more absurdity in the current context of Brazilian economy, a disagreement between the literate and the illiterate and unanimity among opportunists. The reserves were not built to finance the irresponsibility in government’s expenses, the reserves are, ultimately, our mainstay in domestic and international investors’ view facing the crisis we are going through. In case this threat becomes real, there won’t be a Central Bank intervention that could control the Real’s devaluation. From “maybe” net foreign reserves of USD 270 billion an attack on Brazil’s currency would pulverize these reserves in “two seconds” – what seems be large, turns into “zero or nothing” very quickly. Such an idea is tremendously serious.

Actually, we are already inside a catastrophe and, to this kind of situation, words elude us. Maybe the quote by the economist Ludwig von Mises that opens this monthly report could explain it.

Stock Market

The buying-in movement by foreigners sustained the Ibovespa at high levels, ending the month with a valuation of 16.97%. However, the future movements of the stock exchange are as uncertain as Brazil's political crisis. It is about, fundamentally, investors (foreign, in a general way) bet in a rupture of the current government and with it the verified valuation – a movement that has been called "impeachment's rally".

An example of the movement of the Ibovespa, not based on analysis of fundamentals is Petrobras and its shares. Owing to its great liquidity, the oscillation of the asset's prices, at times increasing, at others decreasing, is not related to the company's fundamentals (highly indebted, mismanaged and the protagonist of the largest corruption scandal), but engender changing expectations. The company's situation allows that the speculative capital bet in the two ends (buy and sell).

No one cares about the Brazilian private productive sector, there is no investment and no perspective of changes, in the short run, in case the current government doesn't ends, and/or another with the same mind set remains in power. The Brazilian State grew so much in the last years that it took space of many others within the private economy. While the government expenses grew 6% per year (average index), industry endured negative results. A "capitalist" country as large as Brazil is cannot sustain itself with a public sector larger than the private sector. Perhaps we aren't or don't want to be "capitalists".

The country faces a challenging situation. We will have a second consecutive year of activity slowdown, as we move on to the third year should abrupt changes not be made in economic policy. Measures of short-term stimulus, as those aired by the former-president Lula, are not enough to jump-start the economy for it will only be a "chicken flight" at best. Recovery will be short-lived or won't happen and will worsen the structural problems already at play. The great truth is that today we live a binary situation, here without any ideological ring and with only a attentive reading of markets: (I) relief with a possible recovery with changes in the status quo or (II) what "looks" cheap will remain "cheap" (in this case, the opportunity cost undermines the assets' attractiveness) or will fall even more. The return to stock exchanges may be just around the corner, but it has not happen yet.

Summing up, today Brazil lives an unprecedented situation: the political crisis reigns in all too much on the economy. Solving the macroeconomic puzzle requires, first, untangling the political crisis. Without credibility and governability, it isn't possible to resolve the economic troubles and restore growth. In this sense, Brazil went too far… solving the political crisis seems to face a one-way street from the standpoint of investors, whose evaluation is stated and in line with Mark Twain: we should change the diapers and the politicians every now and then.

Democracy wins.

Monthly Commentary

MARCH 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