Planner Redwood Asset Management

MONTHLY COMMENTARY

MAY 2015

Monthly Commentary / MAY 2015

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"The only thing greater than the power of the mind is courage of the heart."

John Nash - Mathematician, Nobel Prize in Economics 1994

Introduction

The world has lost one of its brightest minds: the mathematician and Nobel Prize in Economics in 1994 for his contributions in Game Theory - widely used in various segments of our lives. A man who spent much of his life battling schizophrenia, who found solace in mathematics, logic and numbers. However, he never failed to recognize the importance of courage of the heart.

Here in Brazil, we have a President who is known as "brave heart". First of all, we do not intend to make a detailed comparison, for different reasons and realities. Maybe she is a brave heart, but she does not have a minimally brilliant mind of her own, neither do a good part of those around her, people who influence her politically and ideologically. If there is any possible intersection with "courage of the heart," no doubt, the political-social-ideological schizophrenia and the ensuing conflict with the need for actions contrary to those recently implemented in Brazil form a union set. The immeasurable efforts of Minister Levy and his team's brilliant minds are either not well supported by the President's party, or deeply attacked by the opposition - sometimes for pure political opportunism, or blindness and contrary political-economic conviction. However, as John Nash understood, managed and overcame the "voices" that persecuted him and got on his way for much of his life, around here we will gradually overcome these "voices" that sometimes are not representative of healthy opposition and promotion of democratic discussions.

Along this line, little by little we eliminate the mad absurdities implemented in the recent past: misplaced tax relief, lack of account control... promoting the realignment of relative prices, tuning Monetary to the Fiscal policy. But it all comes at a price ... and a very high price. A price that now emerges without any modesty, with an ugly face. An ugliness that will be faced by all Brazilians, via unemployment, inflation, sluggish economy, etc... A real shock treatment, a veritable reality check... but it must be done now or the madness will never end.

In the world, we continue to wait for the FED's position and the eventual monetary tightening, frequently discussed. Russia confirms a very strong contraction of its economy and China is also solidifying the concept of "controlled convertibility" for its currency, that is, actual control. In Europe, rumors of Greece's exit from the Euro Zone persist. And now, there are rumors that England will leave the European Union.

In this environment, US Treasuries ended the month at 2.10%. S&P changed 1.05%, NIKKEI closed at 5.34%, DAX -0.35% and FTSE at 1.95%. The Ibovespa ended the month at -6.17% and IBrX, at -5.47%. Maximum DIF16 was 13.85%, DIF17, 13.62%. NTN-B 2050 ended the month at 5.87%, and the dollar exchange rate (Ptax sale) at R$ 3.1788.

Economic Activity

The First Quarter of 2015 GDP has been released. Was it a surprise? Yes, it was better than the market expected and much better than our projections. Are these good and decisive news? Not so, before improving, it will worsen a bit more. The effects of ongoing Government accounts adjustment measures will be felt most, if properly implemented and on time, in the 2nd and 3rd quarters of 2015 - according to our projections.

The table below is self-explanatory, but the 1.6% fall of the Brazilian GDP in the first quarter 2015 compared to the same period in 2014 was the fourth straight and the highest since the second quarter of 2009, when it decreased 2.3%. The main highlights were Manufacturing and Services, with decreases of -3.0 and -1.2%, respectively. The industrial GDP has fallen for the fourth consecutive quarter, the largest drop since the second quarter of 2014, when it reached -3.6%. On the other hand, Services had the highest drop in the Quarterly National Accounts series initiated in 1996.

Agriculture's GDP, which always saves the day, grew 4.0% in the first quarter of 2015 compared to the first three months of last year, the best result since the second quarter of 2013, when the increase was 9.7%.

The Brazilian Institute of Geography and Statistics (IBGE) also informed that drops in household and government consumption were the highest in this comparison (quarter to previous quarter) since the fourth quarter of 2008, at the height of the international crisis. Gross fixed capital formation (GFCF) dropped for the seventh consecutive time on margin, in the first quarter of 2015, falling 1.3% in the first three months of the year compared to the fourth quarter 2014.

Anyway, the dynamics still indicates a very adverse scenario for the Brazilian economy, especially on the demand side. The only effectively resilient sector and a real "damper" is the Agriculture, however seasonally impacted. Real improvements will happen only as of the 4th quarter of 2015. Let us hope so!

Comparison period	GDP	Agriculture	Manufacturing	Services	GFCF	Household consumption	Government consumption
1st QTR 2015/4th QTR 2014 (%)	-0.2	4.7	-0.3	-0.7	-1.3	-1.5	-1.3
1st QTR 2015/1st QTR 2014 (%)	-1.6	4.0	-3.0	-1.2	-7.8	-0.9	-1.5
Accrued 4 quarters	-0.9	0.6	-2.5	-0.2	-6.9	0.2	0.4
Current amounts, 1st Qtr (R$)	1.4 trillion	79.6 billion	267.9 billion	851.5 billion	276.7 billion	887.8 billion	272.6 billion

Investment rate (GFCF/GDP) in the 1st qtr of 2015 = 19.7%
Savings rate (Savings/GDP) in the 1st qtr of 2015 = 16.0%

Source: IBGE

Fiscal Policy

Some improvement is already observed in the public accounts results. Public sector accounts accumulate a primary surplus of R$ 32.45 billion from January to April of 2015, equivalent to 1.73% of the Gross Domestic Product (GDP). In the same period last year, the result had been negative R$ 32.54 billion. Thus, about 50% of the fiscal target was achieved in the first quarter. The fiscal results from January to April were as follows: (i) central government surplus of R$ 15.52 billion (0.83% of GDP), (ii) the regional governments (States and Municipalities) had a surplus of R$ 17.20 billion (0.92% of GDP), and the States posted a surplus of R$ 14.50 billion and the Municipalities achieved a positive balance of R$ 2.70 billion, and (iii) on the other hand, State owned companies, posted a loss of R$ 27 million in the period.

Does that mean that a disappointment suddenly became a "bed of roses"? No way! Let us not become overly enthusiastic. At the margin, we may be more aligned with the expected trajectory, but there is some seasonality in public accounts that favors results in the first half of the year. April numbers, as a rule, tend to be among the best of the year because of income tax paid to the Government. In the second half, the government has increased spending, with the payment of the year-end bonuses, etc. Therefore, to reach 1.2% of GDP (now adjusted to 1.1%) will not be easy, especially as the recession worsens. Do not rule out measures to promote extraordinary revenues.

Quite a few alternatives are being recalled or even presented (new ones), for reduction of cuts and thus mitigate their effects on economic activity, such as structural surpluses (adjusted to economic cycles), targets beyond the calendar year, by mean (trimmed), etc. Unfortunately none of this will be effective. The surplus is not an end in itself, but a pressing need for adjustment in such a way that we have recovered credibility - especially by risk rating agencies. We cannot just ignore them, claiming our "Brazilian sovereignty" and "people's interests." In fact, the people's interests are the reorganization of public finances and its immediate impact on lower perception of country risk and consequent attractiveness of investments. Fortunately the current economic team is aware of this.

The goal is ambitious, but absolutely necessary. What's more, the targets for the coming years cannot be smaller than the current 1.1% of GDP (in fact 2% adjusted, if we consider the postponement of expenses (0.3%) and an additional 0.6% from last year) ... in fact it should be above 2%, so that the surplus represents not only the stabilization of debt/GDP ratio, but even its reduction. An eternal tightening is not being advocated. It is expected, however, that any increase of the surplus target in the coming years will have less of an impact, because with the reheated economic activity (restored confidence levels and resumption of investments) the economic cycle itself will be virtuous.

The big question is always how much tightening should be applied in the short term, all costs considered. Remember: the difference between medicine and poison is the dose!

International Environment

Since the 2008 crisis, unconventional monetary policies (different from heterodox) that emerged around the world, starting with the US with their QEs (monetary easing measures), have soaked global liquidity markets. A recent article published by Dr. Doom (Professor Nouriel Roubini) entitled "The Liquidity Time Bomb" points out, however, that the macro liquidity has been linked to a severe market illiquidity. This is very curious, since interest rates in most advanced economies are very low, not least as a consequence of a "massive expansion" of the monetary base (the concept here cannot be misunderstood, and raise questions as to why the inflation has not increased – as this has been previously discussed in our reports) that fostered (i) low interest rates in the short, medium and long terms, (ii) decreased bond market volatility and (iii) turbocharging of the stock market, the housing market, etc... (specially in the US).

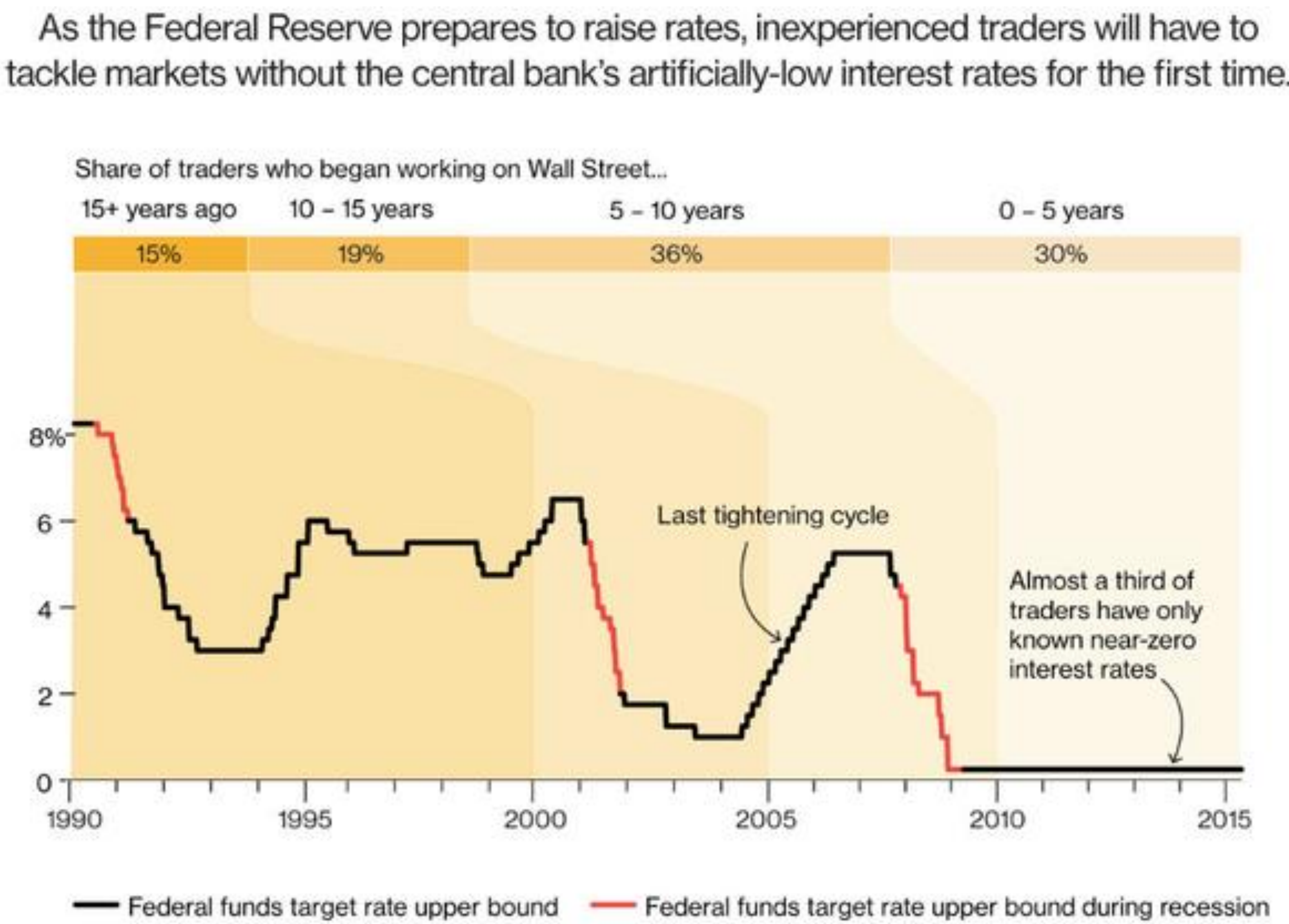
Dr. Doom's point is that markets may not be liquid enough! In short (so thinks Dr. Doom), the macro liquidity creation actions of central banks, maintaining low rates and volatilities has also created a "herding behavior" in many managers and even more investments in illiquid funds (bonds). Add to that more market regulation and you have banks (formerly market makers) out of the negotiations and therefore without fulfilling their role as "stabilizer" (speculator, yes! manipulator, no!). What is the result? When the FED (and in the future all other countries that are now following its prescriptions) indicates possible interest rate increases, as it is doing now, everyone wants to get out (reverse their positions) at the same time, and we know what happens, then, to prices and volatilities.

And then, is Dr. Doom right that the combination of macro liquidity and market illiquidity is truly a time-bomb? It may be so, it does make some sense. What makes no sense is to see other huge economies following the FED policy: seven years for a "recovery" which is ending with the most paradoxical result imagined, in response to the financial crisis. The Liquidity Trap is here! The skill and expertise of the policy handlers will be much required, but we cannot count much on the traders ... after all, 30% of them (in the US) have never experienced anything other than zero rate, as shown in the chart on next slide.

In other parts of the world things are not too good as well. Russia's economy should contract at least 3% in 2015 and the official inflation is near 12%. China continues to consider how to promote its economy, avoiding growth falling too far below 7%. In Europe, private sector loans data in the Euro Zone suggest that the recovery of Europe's economy still has enormous weaknesses (except for economies that did their homework).

Last but not least, Greece was once again very close to leaving the Euro zone. The escalating crisis seems inevitable and outcomes for the Block, gigantic.

International Environment



Source: http://krugman.blogs.nytimes.com/2015/05/29/sex-and-drugs-and-zero-rates/

Interest Rates

Who would guess that Monetary Policy, after so many years, ceased to be the most talked about economic subject? That's good! But, as inflation, and its disastrous consequences on the whole economic chain is purely a monetary phenomenon, one way or the other (via contractionary Monetary Policy or increase in basic interest rates, or via Fiscal Policy with decreased spending and investments) the reduction of liquidity affects the price of the currency.

The phrase *"Brazilians leave everything to the last minute"* was the maxim of the month. The interest rate market oscillated during the month, waiting for the approval of the provisional fiscal adjustment measures (664, 665 and 668) which finally occurred in the last week of the month, the deadline for vote on the proposals in Congress.

The month was busy in politics. First, the slow approval of the fiscal adjustment package and finally the manifestations of disagreement between the Ministers of Finance and Planning in relation to budget cutbacks, which culminated in demands, by some political allies of the government, for removal of the Chicago Boy (expression used to call the Minister Levy, making reference to the school where he studied, known for neo-liberal economic theories). This time President Dilma came out in Levy's defense, but the Workers Party (PT) is divided. Many believe that the fiscal adjustment model will inhibit growth and drive away the party from the social base. Therefore, they are in favor of Minister Nelson Barbosa, who is seen to have a developmental approach (a term used for fans of economic theory based on strong State intervention in the economy). And what will happen to the Brazilian economy if Minister Levy does leave? Surely we will lose investment grade, the country risk will rise and the yield curve's threshold will change. In other words, the catastrophic scenario.

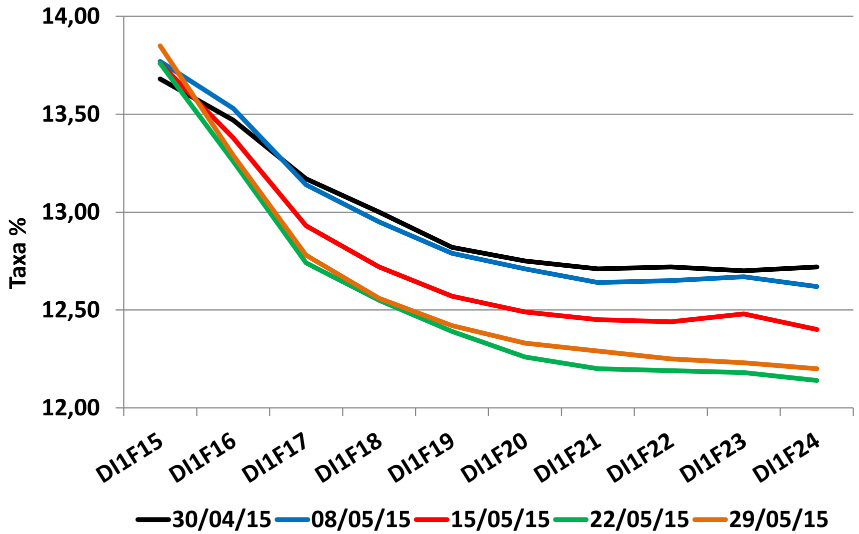
For now, we will continue working on the assumption of continuity of the economic team. Levy in the Finance Ministry promoting the adjustment of public accounts and Tombini in the Central Bank. The Central Bank kept its hawkish rhetoric during the month, reaffirming its commitment to an inflation target of 4.5% at the end of 2016. The objective of the monetary authority is to regain lost credibility. Based on this statements, the market has priced the increase of SELIC in another 0.5% in the COPOM meeting (Monetary Policy Committee) in the first week of June. And, according to the interest rates future curve, the increases will continue. There are some market projections that the SELIC will reach 14.25% per year ... for the time being, our scenario is not far from it.

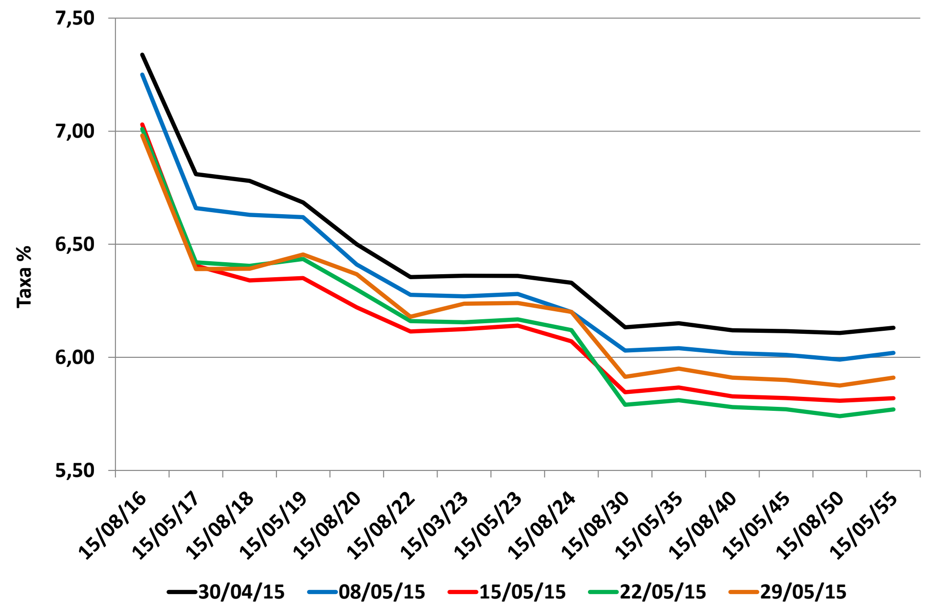
The higher short-term interest rates movement can be seen in the interest rates term structure weekly curves shown in the following slide. Not even the 1st quarter 2015 GDP with a decrease of 0.2% and a decrease of 1.6% compared to the same period 2014 were able to change the upward short-term interest rates trend - in fact, it may even have helped. The reason? The decline was smaller than expected and therefore makes room for new interest rate spikes and thus help control inflation without major economic activity penalties.

The figures show that the achievement of the inflation target, if it occurs, will involve other forces (or will be caused by them) in addition to the Fiscal and Monetary Policies. Unemployment will play an important role in this. As it turns out, the PT has reason to be divided. The adjustment costs will be huge misfits to their core beliefs and goals ... even if this momentary effort takes us to recapturing everything we all want, with or without Chicago Boys: **Economic Development**.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

Is the exchange rate really free? *Si, pero no mucho*. The talk that gradually the exchange rate will become looser is going too far. It seems that people in power seem to like the control and setting levels (they do not want to let go – like a bulldog with a bone)... a real danger, in the face of adjustments and price realignment policies (mind set) – which also includes foreign exchange rate.

What will be the next level for the US/Real exchange rate? Difficult to answer. In the first 20 days in the month the exchange rate was R$ 3.00. However, doubts about the timing of rising US interest rates, uncertainty about Greece's ability to pay its debt and Congress's delayed vote on fiscal adjustment measures caused the currency to close the month at R$ 3.18. The devaluation of the Real was 5.8% in May and 19.67%, year to date.

In relation to US interest rate, the disclosed economic activity, inflation and unemployment data leave some doubt about the timing of monetary tightening in the US. Private sector job creation data disappointed, but, on the other hand, the unemployment insurance numbers were positive. Retail numbers for April and the first quarter GDP revision generated speculation about the weakness of the economy. Producer inflation and the April industrial production were lower than expected and core consumer inflation exceeded expectations. The construction sector numbers were positive. With this data, it is certain that FED movements have not yet been defined, bringing volatility to the market, caused by the fight between short and long position holders. Notwithstanding, the FED chairperson, Janet Yellen, said that the institution continues on the road to raise interest rates at some point in 2015, and that the economic slowdown in the first quarter of the year was due to transitory factors (climate). The chairman of the San Francisco Federal Reserve, John Williams, reinforced this opinion, saying that the institution should rise interest "sometime this year". In our scenarios, at Redwood, we remain convinced the US monetary tightening will take place at the end of the 1st semester and/or beginning of the 2nd semester 2015, with direct impacts on the price of various currencies (especially in emerging markets) via *Flight to Quality* effect.

Internally, the fear that the government's fiscal adjustment measures would be rejected by Congress and rumors of Minister Levy's departure from the Government contributed to the departure of foreign investors - also promoting increase of the US Dollar/Real exchange rate. However, the approval of the fiscal package and the support of President Dilma to Minister Levy were not enough to reverse the dollar trajectory, and the foreign market movement prevailed.

As in May, in June the Central Bank announced that it will keep rolling over US/Real future contracts swap at 80%. According to Central Bank statements, the institution does not seem to be interested on a weaker dollar. And it should use the reduction of rollover and foreign exchange swap stock in case there is a possible inflow of funds in the country, as a result of rising interest rates – supposing that everything else remains constant, of course.

We would not be amazed if we soon hear that the Exchange Rate Policy (maintain foreign exchange flow balance) is one thing and dollar quotation (consequence?), another! Well, one thing is one thing, another thing is another thing. This is tough to swallow!

Stock Market

The Stock Exchange has some (long term) definitions that routinely defy common sense, traders and scholars, including PhDs: (i) that invested capital is remunerated to offset the risk incurred, (ii) it is a reasonable parameter of health of the economy (as a whole) and (iii) it anticipates movements (including recovery of the real economy) ... these are just a few, apart from other unimaginably correlated, whether for short or long term. At any rate, the following maxim is still valid: "finding rationality in stock market short-term movements, is an irrationality".

Chicken flight… The Stock Market tried, but the peak seen in the previous month and in early May did not last. The Ibovespa ended May down 6.17%, as a result of the deterioration of the national scene. Near zero interest rates in the US, monetary easing in Japan and Europe and incentives in the Chinese economy remained in the background. YTD, the Ibovespa is still up 5.5%.

The Brazilian economy indicators are not encouraging. OK, we all knew that the year 2015 would be difficult, but the intensity gained momentum and challenges for resumption of growth have increased. The inflation projections deviate more and more from the target, the short term interest rate speeds up, the labor market tightens, credit is more limited and, making matters worse, there are disagreements within the government, again. There is a punching bag for all of these: the stock exchange.

The poor Brazilian GDP results released for the 1st quarter of 2015, plus a second reading of the US GDP in the first quarter, 0.7% down, had an effect on the stock market, which in a single day retreated 2.25%. With regard to Brazil, unlike the US, which believes the GDP result was specifically due to climate issues, the scenario is not encouraging for the next quarter. The cost of capital will remain high discouraging investment by the industry, unemployment tends to increase with the retracted demand, income and confidence will decrease and thus consumption will fall further. Brazil's recovery will be slow, and much needs to be done. But as they say, every crisis generates opportunities and some sectors can benefit from this recession and come out of the crisis faster. This is life in the stock market, when one identifies value companies at bargain prices.

Among the sectors listed on the stock exchange, the financial sector was the negative highlight in May: the rating agency Moody's downgraded the credit score of five major Brazilian banks (Itaú Unibanco, Bradesco, Itaú BBA, HSBC Brazil, Banco Votorantim) and internally, the Government increased the social contribution paid by banks from 15% to 20%. The goal is to improve fiscal accounts and show that the tightening will not be directed only to individuals. One way or another, Government decisions impact the performance of businesses and thus their stock prices (for listed companies).

Alongside unimaginable correlations and mysticism, what we would really like to see is the government cutting its own current expenses. The revenue in the government's budget does not reflect the economic reality of the country...will investors somehow see any causal relationship? Causality is the causal influence of one factor or variable on another. However, as defined by A. Giddens: *"Causality cannot be directly inferred from correlation. Correlation means there is a regular relationship between two sets of events or variables [...]. It may seem that, when two variables are related to each other, one has to be the cause of the other, but this is often not true. There are many correlations without any causal relationship between the variables."* That's Sociology explaining the Stock Exchange. Everything goes!

Monthly Commentary

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