Planner Redwood Asset Management

MONTHLY COMMENTARY

MAY 2016

Monthly Commentary / MAY 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.

“Order and Progress.”

Sayings of National Brazilian Flag.

Introduction

Order and Progress! It is all what we need at this moment.

After years of disorder and general clatter, especially on Brazilian politics and economy, the last month seems had been the peak of this trouble that torment the Country. The exit (even temporary of President Dilma Roussef) and the Mandatory command exchange brought relief and hope by new ideas and a professional direction to a situation once fated to the Brazilian society collapse.

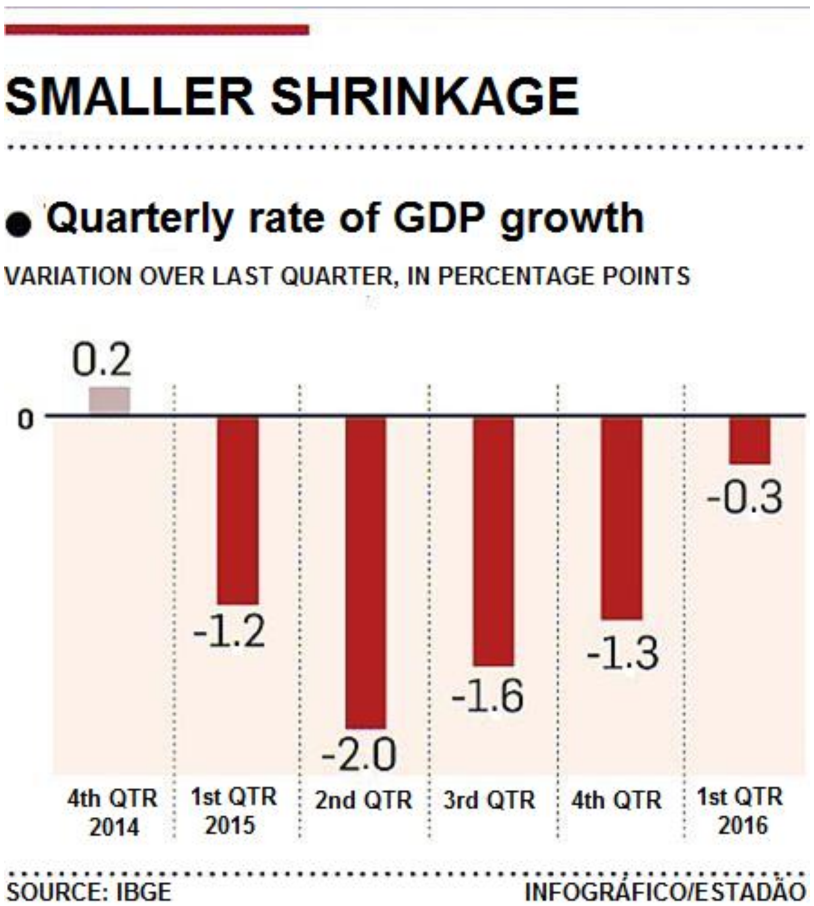
Also, it is a fact that the possible “solution” comes a bit too late, and the brunt of the legacy of recent years reinforces great costs and adjustments to us, with important consequences stemming of the new politics to be implemented. Following it, if the new Ministers chosen are not “beyond any doubt” (two have already stepped down), the good news comes out of its abilities and policy compositions to pass the necessary measures by the National Congress and the team of second rank that (in fact does happen), in its Marjory notably on economic area, join professionals of extreme quality and renowned competence.

We need some cleaning up, so progress can ensue.

The main drivers of the world’s situation and its reflexes on emergent economies have yet to be defined. In China, the inevitable economy landing is being softened each time by State intervention; in Europe maybe some cooling of the Quantitative Easing politics on second semester; and in the US, the FED will have to bow down to evidences from reality and start the monetary tapering. Also, an eventual change of the whole world’s political and economic scenario is likely to entail should the Republican candidate Donald Trump win the American presidential elections – a new order may arise from this scenario.

On this environment, the Treasuries of USA closed the month in 1.83%. S&P varied 1.53%, NIKKEI closed at 3.41%, DAX with 2.23% and FTSE -3.09%. Ibovespa finished the month at -10.09% and the IBrX in -9.41. Highs of DIF17 at 13.70% and DIF21 at 12.92%. NTN-B 2050 finished the month in 6.2739%, and the Dollar (Ptax) at BRL 3.5951.

Economic Activity



The chart below shows, unequivocally, the situation of misfortune we are currently enduring.

However, it shows also that the situation is "not as bad" – which is not to say that such an incredibly awful predicament is anywhere near its end. Unfortunately, for us at Redwood, this daunting scenario is still dominating the scene despite the good winds of change brought by the economic team and its new mindset.

Let's turn to the evidence. The GDP figures show a retreat of 5.4% when compared to the same quarter last year. The worst of all indicators, as we always highlight here, is aggregate investment. The Gross Fixed Capital Formation – GFCF, responsible for future growth - has fallen by 17.5% and as share of GDP it has plunged below 17%, and we needed it to be above 25% so as to have a sustainable growth path. In emerging countries, rates higher than 30% of GDP are very frequently verified. But it does not stop there: manufacturing output has decline 10.5%, retail sales by 10.7%, and even the once and again "hero of the day", namely agriculture, has dropped by 3.7%. Commerce and service sector were sensibly impacted by the waning household consumption (- 6.3%).

Thus, the situation nowadays is even worse for the real economy, which can be noticed if we add to the diminishing GFCF two other important variables coupled with a third one that is crucial to future performance: (i) the unemployment rate hiking up and (ii) the credit level on economy. The crucial one is the Fiscal Sector of the country.

The good News is that the new government recognizes the urgent necessity of dismantling the fiscal arrangement set up in recent years and of implementing a new order. This is what we hope for.

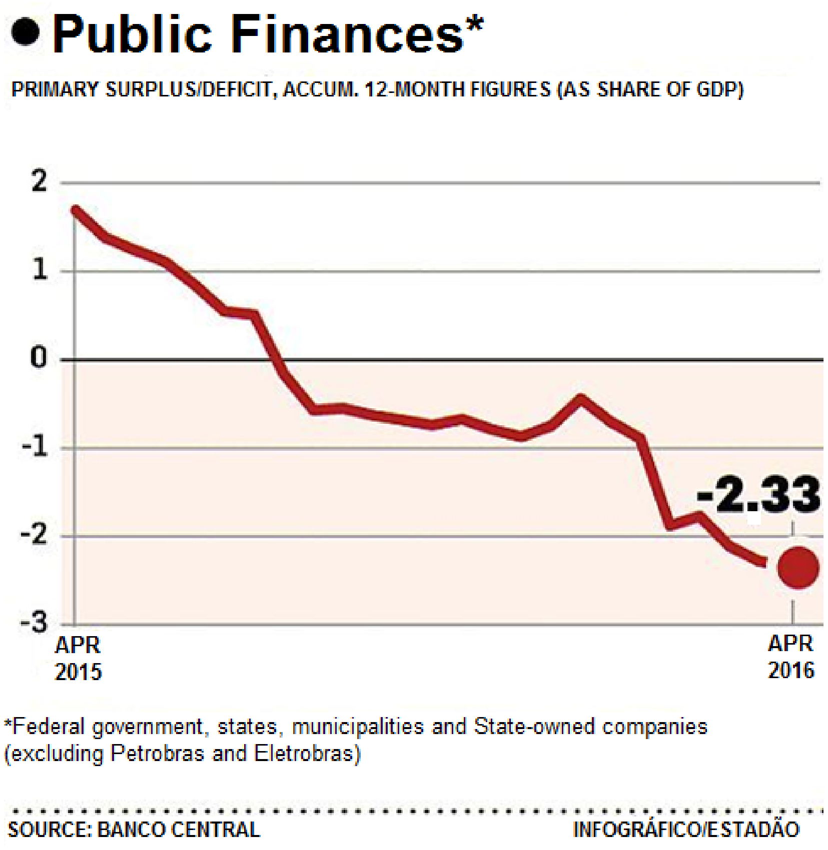
Ah! We must be thorough and mention that the Trade Balance is also going well, with improved outcomes in external accounts. This so-called "competitiveness" is based on an overvalued dollar, but let's do not spoil the good news.

Fiscal Policy

A new economic team that is mature and competent, as the one assembled, is the first and fundamental question, but is not in any way sufficient. It is up to Congress to approve the full reversion to good practices, efficient mechanisms of administration and restauration of a coherent macroeconomic framework.

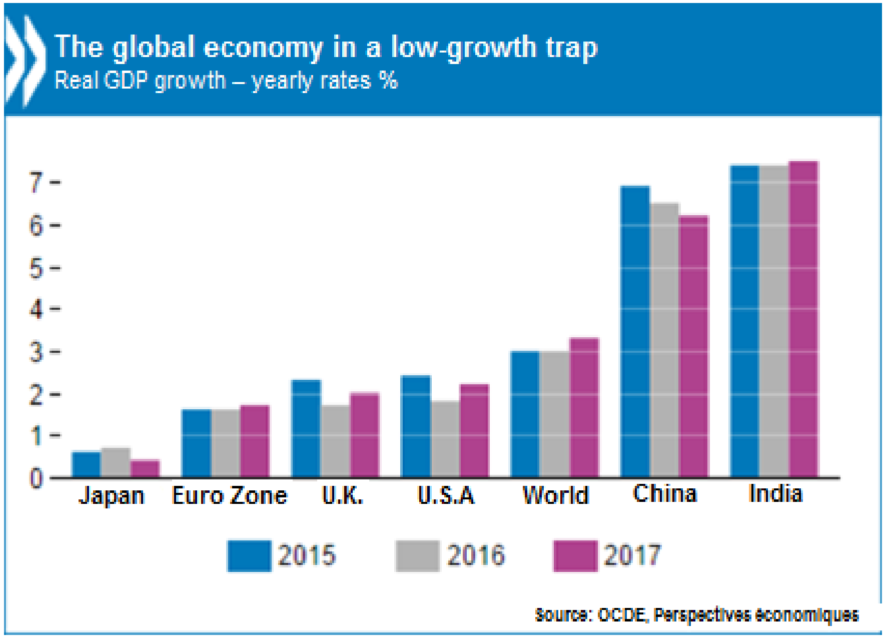
The revised fiscal figures are terrifying: a primary deficit of R$ 170.5 billion. Not even the most pessimistic analyst would dare to mention these numbers six months ago. Worse than the figure itself, is the transparency and the evolution of this deficit over the last months – it would be comic if was not a dreadful tragedy to the Nation. We are the pot calling the kettle black (as regards our neighboring countries) when it comes to the credibility of economic statistics. Investors like risk (some of them), not uncertainty (all of them). Credit-Rating agencies assessed our situation by studying (mainly) our official numbers. How to expect any relief if we do not follow (in various cases) accepted and consolidated standards and if our own classification system presents completely different results at each moment? Some planning here (not only expense control, but its clear identification) is also a *sine qua non* condition to restore confidence, a condition that precedes the recovery of investments.

In a broader sense of the Brazilian reality, and to begin with public finances, the statement of the American judge Louis Brandeis fits perfectly in our historical moment: “Sunlight makes the best of all disinfectants”. We need to reveal everything that was done and evaluate, grounded on data, the extension of damage and the possible solutions.



International Environment

Next chart displays forecasts held by Organization to Cooperation and Economic Development – OECD which stand not too far from our analysis – excluding USA economic activity.



The world economy is expected to grow around 3% this year and a little above that in 2017. The most developed economies, except US in relative terms, have presented stable growth and the emerging ones – especially Brazil and Russia – have a great negative weight in these accounts. Actually, since the 2008 crisis, the emergent economies have been a support to World GDP, but since a great part of BRIC's faced difficulties the situation have deteriorated.

The Chinese economy, that for some people can have more influence on emerging markets than that of the US, will have an enormous challenge to grow at 6.5%. Despite countless attempts by the government to boost crucial areas and blitz the weak points of its economy, like the recent injection of capital by the PBOC of 290 billion Yuan by credit line, the mechanism seems to amount to no more than a patch – the adjustment will come further down the road

In Europe, signals are still mixed (PMIs, Industries, mainly) and the ECB is likely to maintain its interventionist and expansionist monetary policy this year, but speculation about its reduction in 2017 are already on the rise.

In the US things are a bit different… with the economy reacting, unemployment running low and inflation on its way toward the targeted rate, the FED will speed up interest rate hikes. This will not change the tone adopted by the current board of directors… everything too soft, with much parsimony and gradualism. IMF, at this moment, supports what seems to be the "predilection" of this FED: it suggests the latter wait for more "concrete" information.

On the international political front the new Argentine government keeps on surprising positively, to the point that after high demand for the sovereign bonus, new room opening up for debt issuance by provinces and companies. In the US, the presidential race gets closer to the nominating the candidates of the main parties. Everything indicates that the finalists will be Donald Trump and Hilary Clinton, although California still inspires some hope to the Democrat Bernie Sanders.

Interest Rates

The honeymoon between markets and the interim president Michel Temer seems not to have begun and maybe it will not come to that...

The nomination of renowned professionals on strategical positions of the economic team was not enough to calm the investors. Uncertainty over the feasibility of the proposals announced has generated volatility in markets. The economic matrix of floating exchange rate, fiscal control and inflation target will be restored, although some measures need legislative approval and it is not known what is the government strength to succeed when facing Congress.

In the first interview with the Finance Minister, Henrique Meireles have defended the Central Bank independence (a measure criticized by PT - Labor Party – during the last presidential elections), a system of floating exchange rate (with interventions to avoid “volatility events” – we know what that means) and the maintenance of the international reserves at a “level that minimizes the risks of conversion” (whatever that means). And as fundamental measure, the application of an expenditure control system that prevents the increase of inflation-adjusted expenses (it means a lot). The theory is almost perfect, but how these measures will work in practice remains to be seen.

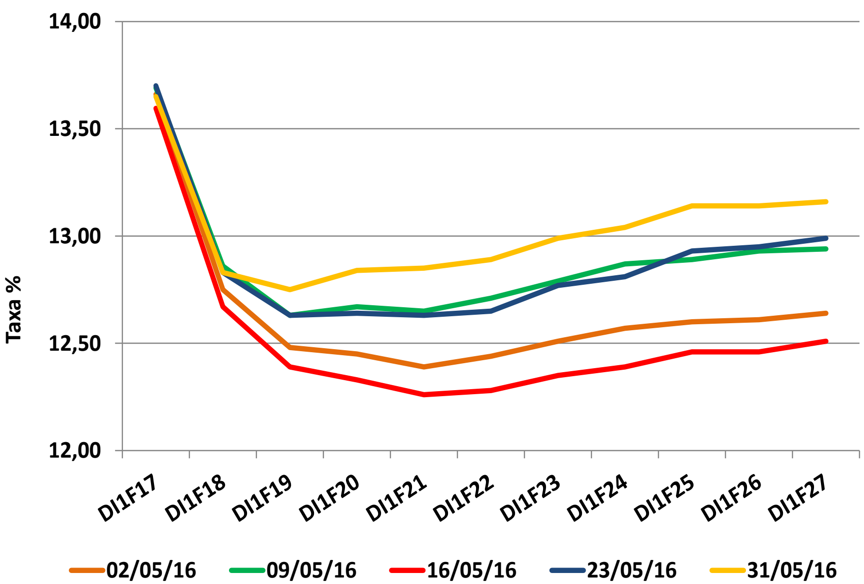
In a yet foggy scenario, worsened by the endless reports of involvement by high-ranking politicians of the interim government in the “Lava Jato” (Carwash) probe, the investors of long term demanded greater premiums to buy Brazilian fixed-income bonds. Short-term derivatives contracts, maturing up to 2018, have remained somewhat stable. It is practically certain that the BACEN, even with a change in command, will trigger cuts off the SELIC cuts in the second half of this year. The accumulated inflation in 12 months is already cooling down: the market predicts inflation around 7% and we at Redwood anticipate a 8% rate in 2016. Following this line, we predict a reduction of the basic interest rates, closing the year at 13.5% p.a.

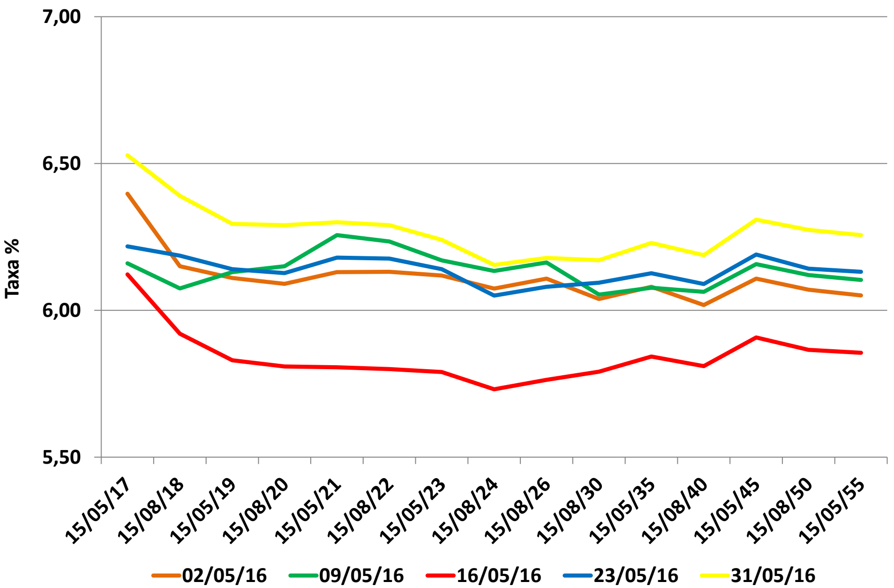
Ilan Goldfajn takes up the Central Bank’s chair with two immediate challenges: recovering the credibility of the monetary authority and restoring the efficiency of BACEN’s instruments to control inflation. It is all about bridging the gap with the economic policy by the Finance Minister. It seems that the latter’s systemic interference with BACEN’s policies will be left behind, as Dilma’s government stuff that contributed to the loss of credibility by Chairman Tombini and by the BACEN.

A new team, specially this one, that seems more competent and tuned with the reality always bring us hope. Hope of see a Monetary Policy aligned to BACEN’s greater mandate (the inflation control) and the so-expected synergy with the Fiscal Policy. The market patience is not very elastic, but since the “wedding” has only recently taken place, let’s wait for the honeymoon… it has to consummate the union, the one that translates the efficiency and the transparency and as a result the dynamic equilibrium between the public and the private spheres.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

The new government has yet to make clear how it will conduct the exchange policy. The few references made to it signal that the exchange rate will have wider floating space, with less interventions. It is far from ideal, though much better than what we have nowadays.

Dilma´s administration, via Central Bank, has had an active administration of the market, intervening systematically on future markets through swap contracts. When the dollar was forced to hike some three years ago - stimulated by the international movement and by a worsening of domestic crisis -, BACEN engaged in market operations that amounted to more than US$ 100 billion. These interventions have intensified in 2015 with the objective (frustrated) of containing volatility and the dollar quotes, in order to provide a more stable environment and to avoid the rise of inflation.

In early may, with the approaching removal of President Dilma (occurred on May, 12th), falling country risk and the devaluing dollar in the international market, the BACEN started intervening on the other end to avoid the strengthening of BRL and, consequently, the curbing of exports. The reverse swap auctions were not enough to control the dollar quotes and, in its final act Dilma administration has changed tax rates on financial operations of spot exchange rate from 0.38% to 1.1%. It is beyond words. A greater disaster would be practically impossible!

What about the new BACEN? What will be its attitude regarding the exchange rate? Will it let the exchange rate float and adjust the prices even if it staves of the country's trade competitiveness? Or will it hold the currency's fall so as to maintain some momentum to exports in the short run, under the controversial proposal of an Exchange Rate Policy Committee (COPOC)? Taken from the speeches of the new team, the focus must be the structural fiscal consolidation and long-term planning. It is still unknown what will be viable in the current scenario. The Exchange Rate Policy Council seems to be out of the agenda for the next months, at least until the definitive removal of Dilma Roussef. The best case scenario would be to do each time less, encroach less, and thus use the KISS method - *Keep It Simple Stupid*.

In May, the BRL lost value in relation to the Dollar (4.18%), basically, due to external questions. The Brazilian currency is aligned, to a certain extent, to the worldwide movement of exchange rates. All currencies lost strength facing the Dollar, with the exception of the Sterling, whose appreciation is associated to the possible exit of European Union. Everything points to the FED launching a gradual process of successive interest rate hikes, starting on the July 27th meeting. As an effect of this trend, the currency flow within the month registered net withdrawals of US$ 4.07 billion, resulting out of a US$ 11.38 billion deficit on the financial flow of the exchange market. The effective normalization of the FED's monetary policy might enhance the depreciation of the Real as well as of others currencies.

Running against the abovementioned tendency, we have a foreign currency inflow caused by the surplus in current dealings/transactions that, in May, registered incomings of US$ 7 billion. Furthermore, acting in favor of appreciation of the BRL there is the approval of assertive measures on the fiscal front, as the indexation of the growth of public expenses to one-year-lagged inflation rate and the social security reform, which will instill optimism on foreign investors. That is why we maintain our exchange rate forecast of BRL 3.50 to the end of the year. The dollar closed the month with a price of BRL 3.61.

Stock Market

Profit taking: after a high of 7.7% in April, Ibovespa closed the month of May with a decrease of 10.09%.

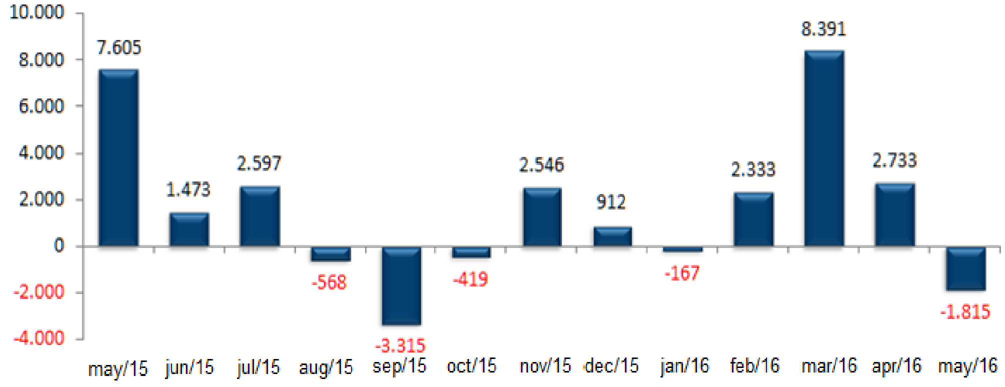
The commodities prices' volatility, plus the expectation of change of federal administration, confirmed on 12th with the removal of the president Dilma and the start of the interim government by the vice-president Michel Temer have reflected on the stock market causing the month´s profit taking. The market welcomed with open arms the new economic team, although the economic crisis is so deep that the investors preferred to stay away from the stock market, thereby decreasing the average volume negotiated within the month.

The feeble numbers of economic activity in China and in Europe emboldened the probability of an interest rate increase in the US, next July, also contributing to a withdrawal of foreign resources from Bovespa. In the short run, there is no expectation of improvement on this investment segment, for domestically speaking, the scenario is still undefined and the international economies´ behavior is also worrisome. The Brazilian macroeconomic indicators are scary: high unemployment rate of 11.2% in April, increase of credit defaults, waning economic activity and high inflation. Not to mention the new stage of Carwash (*Lava Jato*) and of Zelotes probes. All of this agitation scares investors away.

Confidence! That is the most important variable to avert the deep economic recession. While consumers, investors and producers do not restore confidence in the country, no decision will have positive impacts on the economy. But until then, the road will be a winding one: repairing what was done during Dilma´s administration as well as combating corruption will demand courage and efforts by the new leaders.

In this sense, the Stock Exchange is an excellent thermometer of the appetite arising from this change of perception. It remains to be seen whether the movement is lasting and consistent, or whether it is but sheer speculation.

Monthly Foreign Capital Flow to Bovespa (BRL millions)



Source: Ibovespa, forecast until May, 31st 2016

Monthly Commentary

MAY 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