Planner Redwood Asset Management

# MONTHLY COMMENTARY

NOVEMBER 2015

# Monthly Commentary / NOVEMBER 2015

## Agenda

- Introduction
- Political, Economic and Financial Scenarios
- Economic Activity
- Fiscal Policy
- International Environment
- Interest Rates
- Foreign Exchange
- Stock Market

*Epigraph of the month... a propos of Brazil´s current predicament.*

*“You must pursue this investigation of Watergate even if it leads to the president. I’m innocent. You’ve got to believe I’m innocent. If you don’t, take my job.”*

*Richard M. Nixon – Former U.S. President*

# Introduction

Our current situation is not good at all, but it will worsen before it can improve!

The statement above is valid despite the following political and economic outlook:

- ✓ The President is in a bad fix and facing an impeachment process;
- ✓ The House Speaker is about to be overthrown from office;
- ✓ The Senate Speaker is facing charges in the “Lava Jato” operation;
- ✓ A Senator and leader of the situation has been arrested;
- ✓ One of the greatest icons and entrepreneur/banker is also behind bars;
- ✓ Inflation is above two digits in 2015 and above target ceiling in 2016;
- ✓ Galloping unemployment and economic activity reaching depression levels;
- ✓ Hesitating fiscal policy, monetary policy under pressure and Exchange rate policy absolutely erratic…

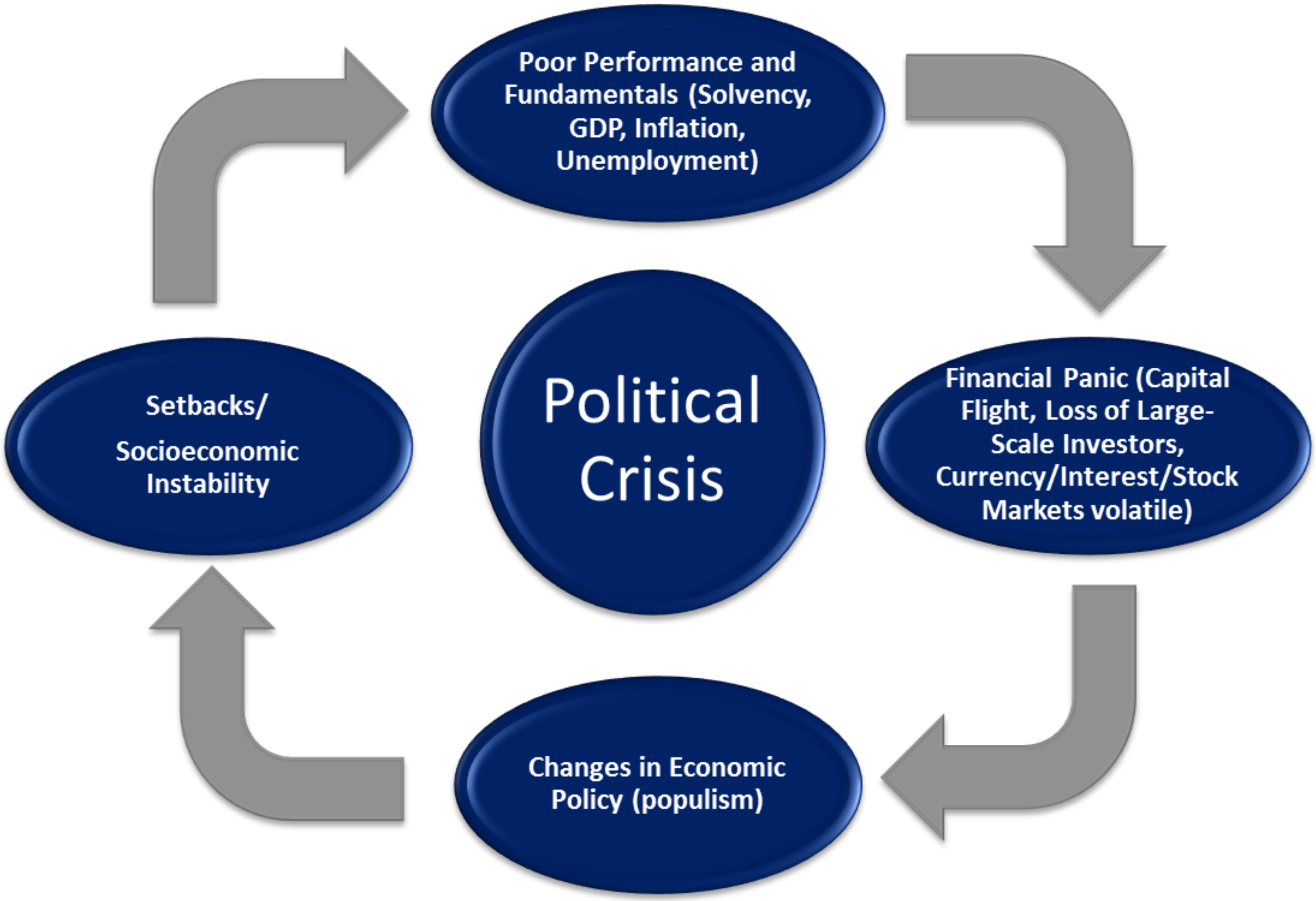
And is there still room for more bad news? Yes, definitely so! We have a perfect storm building up: interest rate hikes by the FED, credit downgrade by the two important remaining rating agencies, commodities prices with a dire outlook etc. Isn’t there any good news? There is: our institutions are well functioning (Supreme Court, Federal Police, among others) and it all points to a cleaning of the Country’s slate clean... a one-in-a-lifetime opportunity to come back and display the strength of our democracy, flexibility and resilience of our economy. But, in the meantime, as regards “illegal operations, corruption and knowledge of it all by the President”, the Watergate scandal finds no resemblance with our current crisis… you have to believe that! If you don’t…

In the international area, we will have another round of stimuli to economies of Europe and China, the US as the only country minimally organized to show off some growth, and with terrorism coming back as a ghost to scare everyone, and not only Europe. From Argentina we get the best news with Macri’s election, a great promise… but even here, we must proceed with caution and parsimony, for the country is still divided and, as in Brazil, it will face daunting difficulties in Congress, to pass and implement reforms at the required pace.

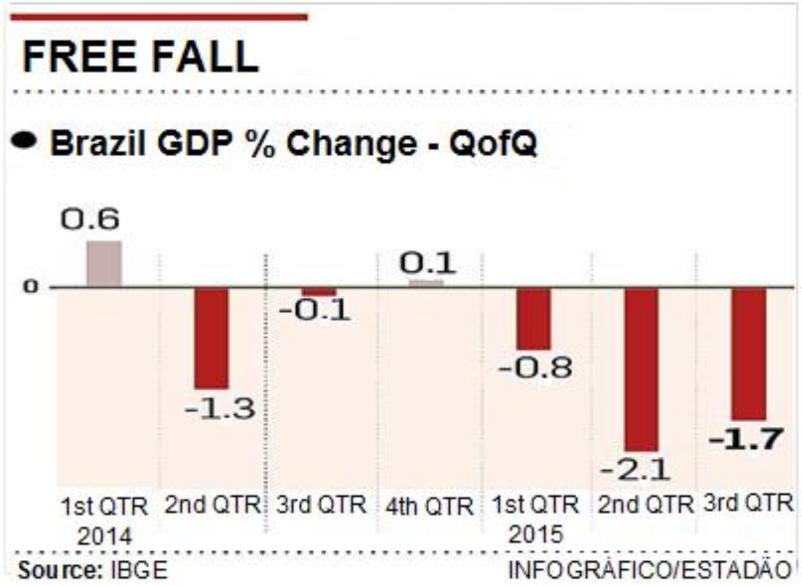
Against this backdrop, US Treasuries closed the month at 2.22%. S&P varied 0.05%, NIKKEI closed at 3.48%, DAX at 4.90% and the FTSE at 1.23%. Ibovespa has ended the month at -1.63% while the IBrX at -1.66%. Highs for DIF16 at 14.25% and DIF17 at 15.81%. NTN-B 2050 ended the month at 7.10%, and the Dollar (Ptax) a BRL 3.8506.

# Political, Economic and Financial Scenarios

**Vicious Circle of the Brazilian Economy (Contagion) – The unexpected may happen**



# Economic Activity


Both graphs above are unquestionable realities – present and future. The first addresses Gross Fixed Capital Formation, which translates into investments – which have plunged 4% in the quarter and 12.7% in the year. Future reality will already be compromised - should this outlook proceed -, for the lower investments are today, the more meager growth tomorrow. On the other hand, current situation shows a facet much more worrisome than expected… much more. The level of economic activity, measured by the GDP variation, dropped 1.7% in the third quarter of 2015, significantly more than we expected and also the market – it should be singled out that such variation took hold in all sectors, including the “always savior sector” of agriculture. What do they signify? Well, they mean that the current GDP (we can evaluate with some precision via a statistical effect) reflects, in certain measure, its drag upon the future and the few investments today confirm, ensure and influence negatively the future level of activity. As we have already mentioned in previous reports, we rule out the forecast of a stagflation (stagnation + inflation) in favor of a scenario of overt economic depression. Our current projections for GDP hover around -3% and -2%, for almost -4% and -3% for 2015 and 2016, respectively. And with a dwindling real economy, all additional macroeconomic variables tend to display worse performance. Tough times ahead.

# Fiscal Policy

Every year's end, as we approach now, is a moment for pause and reflection of what has happened and what the future brings. Well, Fiscal Policy has gone too far with a soaring debt and ensuing disarray in government accounts. Worse yet, we have accomplished too little throughout the year… in fact, much too little. Besides, we cannot say we have done what was possible, for this is not helpful and does not look real or whatsoever.

Our projections for fiscal policy are scary, and its reflections are ever more rapid and sharp. It is simply mind-boggling how such horrendous results do not strike policymakers, including urgent measures that do not rely upon Congressional approval. It is no secret to any economist (those educated, of course) that Fiscal Policy is pivotal to rebalancing, especially if it is aligned with Monetary Policy, for inflation, interest rates, current account deficits, as well as long term growth. And this is no theoretical talk, for we ourselves have seen this not long ago. The table below displays a short history and our projections made in the last quarter of this year:

| Public Finances | | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|
| Primary Deficit | % GDP | -2.9 | -2.2 | -1.8 | 0.6 | 2.21 | 1.12 | -0.07 | -1.30 |
| Nominal Deficit | % GDP | 2.5 | 2.3 | 3.1 | 6.2 | 9.10 | 8.20 | 7.19 | 6.23 |
| Net Debt Stock | % GDP | 34.5 | 32.9 | 31.5 | 34.1 | 38.30 | 43.43 | 45.10 | 44.60 |
| Gross Debt Stock | % GDP | 51.3 | 54.8 | 53.3 | 58.9 | 72.66 | 76.14 | 74.29 | 70.95 |

Produced by: Planner Redwood — Projections in red

In sum, what we can see is still reflexes of misgivings of a recent past, but the timid actions of the new economic team throughout the year needs rapid reversion. This undoing is necessary not only for the adjustment itself that must be carried out, but for a growing difficulty adding up at every worsening of public accounts – that is, the longer we wait to achieve the required adjustment, the harder it becomes to solve mounting problems. There is more: we must not look away from the imponderable… such as a sharp turn towards a more populist administration, externalities, a stirring up of the political crisis etc. In this line, when a structural reordering is of utmost importance, liable even to translate as a long-term solution, we need immediate relief… that much requires urgent actions in the short term as well.

Fiscal policy when well managed is a sacred remedy!... And we are in dire need of both: sacred and remedy!

# International Environment

International outlook does not present a favorable landscape, whatever the angle taken to assess from – be it in the economic realm or the political

In economics, the only country (with some highlight and real clout) “prepared” to grow consistently is the US, while all of the others are subject to hardships on the output performance (amongst which we depict the emerging Brazil and Russia), various countries in Europe endure low/moderate growth and those facing high growth (albeit some doubts can be raised as to the reality of their figures) or expectations on which are yet to be confirmed regarding the long run, such as China and India, respectively.

On the social-political front, we are witnessing great migration waves to Europe – with flagrant impacts in their economies – and the ghost of terrorism knocking the doors again. This is a latent problem whose effects are also generated by change in international policies for sectors that could never have been let off control, especially when it comes to ISIS. Therefore, two statements can be confirmed: (i) the jumpstart and control over these segments have become much harder, and (ii) attacks seem to target important countries, but the main goal seems to be the US. In this vein, these acts do not lead, as of now, to any economic impact at the global level of any significance – at most for a country directly affected (perhaps even positive, via the expansion of public spending due to war efforts). On the other hand, an eventual terrorist attack on the US would generate significant economic damages.

In this environment, despite the strength of US economy, the slowdown in China and India, the moderate growth in Europe, as well as a drastic downturn in Russia and Brazil – which besides its intensity is likely to protract beyond expectations – will probably result in lower global growth. This deceleration of global activity, albeit modest, has several conditioning factors, but the realignment of economic policies – at this time in Europe in particular -, is liable to avert these expectations. Emerging markets may benefit from such realignment, but there is considerable homework yet to be done domestically.

Therefore, at variance with what we once imagined, an adequate economic realignment, the chairman of the European Central Bank (ECB) Mario Draghi will resume the stimulus policy, acting as a tutor to all economies, and thereby pulling away indefinitely from a general and lasting solution as a definitive non-approach of the region’s real problems. In this vein, constant monetary stimuli are misleading for the gloss over real problems under the pretense of leading the economy, though at a modest pace, towards an orderly economic recovery. Honest mistake, the cost further ahead will be much higher.

In the US, it seems that the FED’s “apologies” for hiking interest rates are over. With that crowd running things and the biases of many policymakers, interest rate rises will be slow and gradual. The impacts of this evaluation do not seem relevant to the very American economy (the effect has been probably already anticipated by prices), but we cannot say the same for the rest of the world – especially emerging markets.

# Interest Rates

And there comes paralysis of government… When the political landscape seemed to improve, one more stage of the “Lava Jato” Operation storms Brasilia again.

The political context is still impacting the economy, market interest rates and the very conduct of monetary policy – by way of lack of independence and of “competence” of the Central Bank. The political situation reinforces the “decision” by the Central Bank to analyze the benefits of an eventual rise in interest rates to control inflation hovering at two-digit levels in 2015 and above 7% in 2016; in addition, with a worsening economic activity, hiking interest rates now may generate more costs than benefits, leaving out that fiscal indicators may continue to be disastrous. All reasons are invited to justify the institution’s “inaction” facing its main objective of inflation control.

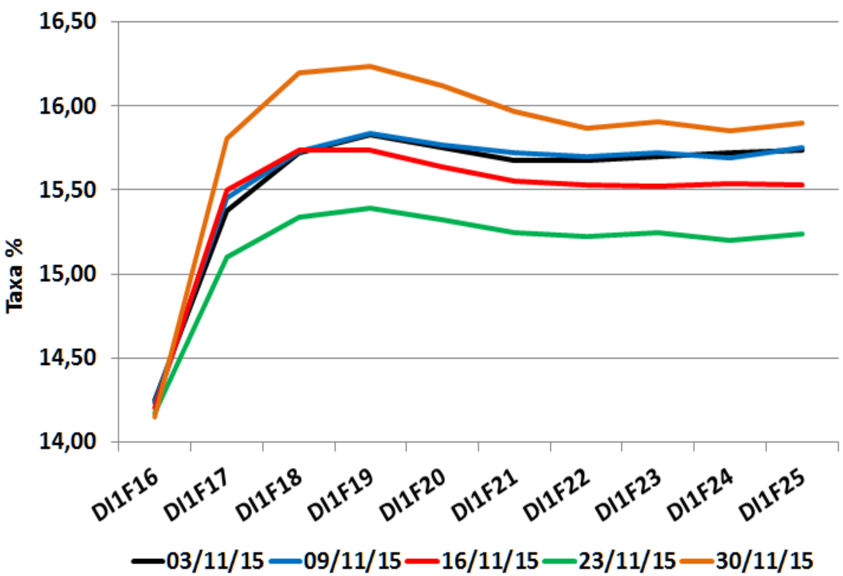
But all is not lost. With all political-economic stress (imprisonment of the CEO of BTG Pactual André Esteves and of Senator Delcidio Amaral, Government leader in the Senate), the Monetary Policy Committee (COPOM) ended up surprising all investors. Not so much for keeping the SELIC base-rate at 14.25%, what was already expected, but for the non-unanimity of the decision. Out of the 8 votes of the board, two were in favor of base rate hike. When we add the outcome of votes and the post-meeting communication we get the message that the monetary authority (at least part of the team, which is something to be cherished) is paying attention and will not be corrupted by following villains: recession, unemployment, fiscal and political crises. We wonder if it is high time the Central Bank exercise its role as the guardian of money, a role despised for the sixth year in a row. Let’s see!

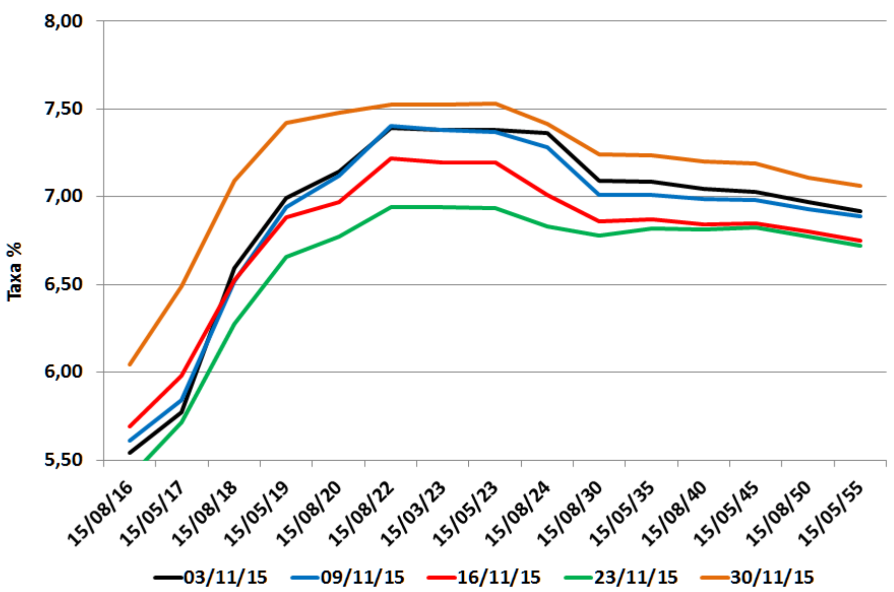
In this environment, we have seen future contracts rates retreat throughout the month with rumors of the replacement of Minister Levy by the former Central Bank president Henrique Meirelles, appointed/supported by former president Lula. For the market, this change could ease the approval of some fiscal stimulus policy and the economy could recover through a new process of credit loans. Here we disagree with the market in two points: (i) replacing Levy with Meirelles would not change the fiscal behavior and the latter’s better political transit would have limited effect in the general political landscape, and (ii) eventual credit extensions (even with the use of CAIXA and Banco do Brasil) will have extremely limited effects in the face of the greater compromise of households’ income, unemployment etc. Therefore, rationally, we reach the end of the month with Levy leading the Finance Ministry and even scoring some wins in his disputes with Congress. Interest rate had consistent falls until the last week of the month. Whereas forecasts about the FED’s interest rate hikes did not affect the interest curve in Brazil yet, for expected is a gradual rise, in such a way as to diminish its impacts – but that is still uncertain due to first and second order effects of an eventual risk-aversion movement and the ensuing flight to quality.

Closer to the end of the month (starting on the 25th) we observed a strong rise in interest rates on future contracts due in January 2017, and also on those expiring in 2021 and 2023. This short-run movement, as many of those, is hard to precisely identify, but it is likely that the market has begun anticipating a rise throughout 2016 or, more conservatively, the maintenance of the ongoing rate for a longer period. At this moment and in the face of the abovementioned context, we stress our claim that the Central Bank should raise interest rates, but that it won’t. Hence, our effort is to make investments feasible in the likely scenario, and not in the desirable ones.

# Interest Rates

## Yield and Cupons Curves (NTN-Bs)



# Foreign Exchange

So the Central Bank continued its policy of injecting liquidity into currency markets by way of its line auctions. Until when? And at what cost?

Throughout the month, bets waged in global markets were heightened in that US monetary tapering will begin in December. For us at Redwood, as mentioned in the last months, this normalization should have begun a long time ago. Consequently, as the market anticipates such a rise, the dollar rages up against the BRL and stop orders are issued in Brazilian futures market, elevating pressure. The commodities price plunge, in the case of Brazil – which is a relevant exporter of this asset to China – also contributed to volatility of the BRL within the month. China has shown an 18.8% contraction in its imports in October against the same month in 2014.

Other externalities such as the terrorist attempt in France did not impose, in fact, much damage in currency market prices, which were already pressed by domestic issues. These latter, accounted for by rumors about the possible replacement of the economic team ended up fueling appetite for risk. For investors, despite the likelihood of things becoming even worse, any signal sparks a flame of hope – even if only to display some form of reaction, after so much devaluation and volatility in recent times. However, being just rumors, volatility was enhanced, and the dollar hiked once more.

The fact is, however, that this government's Exchange rate policy (as with the rest of all those with interventionist proclivities) amounts to only conveying an image that its goal is keep foreign currency inflows and outflows in balance, so as to attenuate currency volatility and to find an equilibrium level for it. An equilibrium that guarantees predictability for investors, entrepreneurs etc. while also guaranteeing that the effective handle on these sharp twists works towards minimizing their impacts up on prices subject to such variations. None of this has happened, not even an unstable equilibrium. Once all and no model are adopted at the same time, the Central Bank has managed the worst of all possible worlds: the absolute unpredictability of economic agents and with it the discredit of its policy, which adheres neither to a floating, to a fixed or even hybrid regime – it is a veritable mess!

Amid all of these events and assuming all other domestic and external variables (which are barely influenced by the Central Bank) affecting the exchange rate, the Central Bank could transparently define and seek its goal with focus and determination. It is certainly easier said than done, but the constant and contradictory signals by the Central Bank only ensure the opposite to what was best whished for in the first place: less volatility.

Thus, as variables affect the exchange rate are too many, with distinct correlations varying in time with changing intensity, it becomes virtually impossible to grasp an effective and constant control of the exchange rate – our very experience supports this claim. Better yet is to let the currency float and take care of what we have effective power to manage and that, amongst all domestic features pressing upon the currency (public finances, for instance), may help our main goal in an exchange rate policy.

# Stock Market

Political uncertainty, public finances squeeze and new developments in the “Lava Jato” Operation have contributed to the closing of Ibovespa at low 1.6% in November.

The beginning of the month was a joyride, with foreign investors buying large alongside announcement of mergers and acquisitions between great companies, which raised volume and prices imbued in the index. It was but a whisper: poor output indicators brought us down again and quite quickly.

As already mentioned, GDP in the third quarter 2015 retreated 1.7% on the previous quarter, and the recession we are currently living reflects directly the price of Brazilian companies. So when will we see a reversion of these features? Our projections point to the second half of 2016, although the market may anticipate such movement.

The relevant fact of the month was the tragedy in Mariana, which weighted down on the Ibovespa a 24% plunge in VALE’s stock price up to the end of the month. Vale owns 50% of Samarco’s shares, the company responsible for the dam. The General Attorney’s Office (AGU) has charged a civil action suit demanding reparations for damages caused in the order of BRL 20 billion or more. This amount, the cuts in production in mines affected by the accident, plus a lowering in dividends received from Samarco will impact the company’s quarterly figures. Additionally and more importantly, the price of iron ore has dropped to USD 43.

Keeping in mind that the market is likely to anticipate the upward movement in the Stock Exchange (in our view, still months apart), the next two slides are quite intriguing (given our current predicament), and also intuitive (for the results they present). It is also suited to highlight that things that look cheap, can become either cheaper or, still, remain cheap for a long time (which by way of opportunity cost, ends up reducing its price).

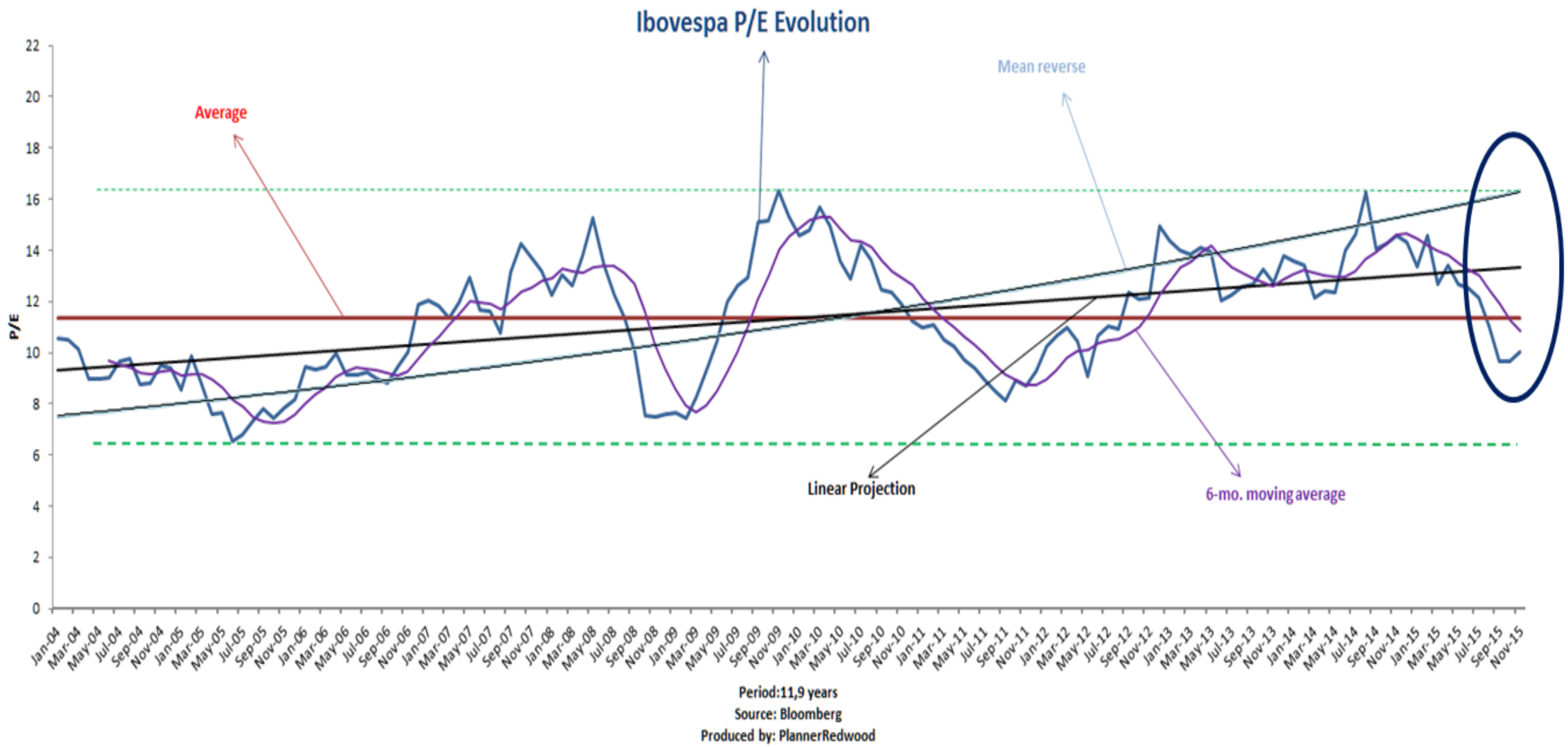
At any rate, if Ibovespa – being a weighted average of companies’ market value – reflects the following situation, it is not a stretch to assume that some companies are already in a more distant situation (for better or for worse) and, therefore, with greater or lesser attractiveness. The reversal of the political crisis and the ensuing tackling of macroeconomic issues will allow for economic recovery and, with it, finance will flourish. The charts that follow will be the first to indicate this with some consistency.

# Stock Market

## Ibovespa in USD terms

# Stock Market

## Ibovespa P/E Evolution



# Monthly Commentary

## NOVEMBER 2015

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