Planner Redwood Asset Management

MONTHLY COMMENTARY

NOVEMBER 2016

Monthly Commentary / NOVEMBER 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.

"Patriotism means to stand by the country. It does not mean to stand by the President."

Theodore Roosevelt – former President of the United States of America

Introduction

The Brazilian Congress has been pushing up meaningful legislation, but one is of utmost importance, albeit the early stages it is in, and will lead to many other of equal relevance, namely: Social Security Reform.

No one would disagree that President Michel Temer is Michael Jordan of politics and that his unpopularity (his greatest "asset" – as mentioned in previous reports) teams up beautifully with his clout on the National Congress, placing him at a privileged political position… but the recurring twists and turns of this lasting political crisis come at a high cost. This situation is accompanied by the belated formulation of the Social Security Reform and may anticipate the end of the honeymoon period with financial markets – which shows up in lowering confidence indicators and the subsequent recovery of investments in our economy.

As Pierre Trudeau would have it: "Timing is politics' essential ingredient" , and in this sense the present moment seems to indicate a more energetic and proactive stance by our Michel *Jordan* Temer. Losing out on the timing can lead to dire consequences, for all the recently set up administration may be put in jeopardy. The traverse to 2018 is fundamental, but there is no chance of doing so under half-hearted actions, because we need reforms of a restructuring nature and also feasible solutions for the short and medium terms.

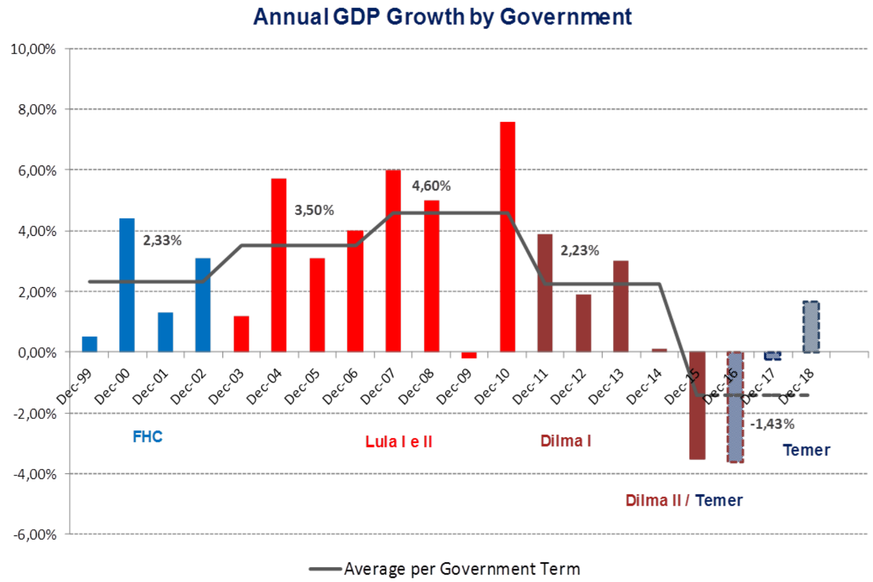
Once again, our bets are on President Temer's competence and skills, but as former US President Theodore Roosevelt once stated: *"Patriotism means to stand by the country. It does not mean to stand by the President."*

In the world at large, and especially for the crushing majority of the international media, Donald Trump's victory was a surprise. Furthermore, it raised uncertainties of all sorts which brought volatility to international financial markets. The days following his election to the White House, all that was "bad" happening to the world had one single cause: Donald Trump. In fact, a lot is about to change, after all *change* is what the American people have chosen! We at Redwood have always stood on the side of things improving for Brazil under an eventual Trump presidency, so that this market volatility (widely known and "cherished" by the markets) will phase out soon – particularly because President Trump will not be Candidate Trump, be it for the impractical measures ventilated in his campaign speeches, be it for the strong breaks built in American institutions.

However, the Trump effects are not constrained by US borders. Following the BREXIT, political adjustments are in motion in Italy and also with the elections in France, all tilting towards rightwing parties. Should this contagion, especially in Europe, affect Germany to the point of questioning the Eurozone's very existence, sharp changes are to be expected, beginning in 2017.

In this landscape, US Treasuries closed the month at 2.37%. S&P varied 3.42%, NIKKEI at 5.07%, while DAX at -0.23% and FTSE at -1.14%. Ibovespa ended the month at -4.65% and the IBrX at -5.00%. Highs for DIF17 at 13.72% and DIF21 at 12.39%. NTN-B 2050 closed the month at 6.0493% and the USD (PTAX) at BRL 3.3967.

Economic Activity



Source: IBGE | Elaboration: Planner Redwood

It seems as though our macroeconomic scenarios, developed throughout 2016, are pointing out to the right direction (unfortunately if compared to those released by the main market players in the last few months), particularly as regards economic activity (outlooks for 2016/2017/2018).

A negative – or near zero GDP - growth in 2017 is far from bad news in the current situation, for we are coming out of one the worst crises in the country's history with a negative per capita growth of near -10% in the last 3 years, with the economy shrinking -3.5% only in 2016! Additionally, we may embark on an upward spiral (however gradual) of growth on new and solid bases for the upcoming years – given the ongoing reforms, the return to fiscal accountability, a rational economic team and an intelligent macroeconomic policy setup.

Nonetheless, GDP is not the only macro variable that has yet to suffer. Unemployment will linger high at least until 1st quarter 2017, but with some improvement in the second half of the same year. Despite recovery of confidence indicators, there is large idle capacity in the economy so that firms will restore hiring workers once investments pick up effectively.

Quarterly Rate of GDP Growth (based on the same period of the previous year) (Percentage)									
Period	GDP growth Current market prices	Agricultural	Industry	Services	Private Household Consumption	Government Expenditure	Gross fixed capital formation	Export of goods and services	Imports of goods and services
Q1/2016	-5.4%	-8.3%	-7.0%	-3.5%	-5.8%	-0.8%	-17.3%	12.7%	-21.5%
Q2/2016	-3.6%	-6.1%	-2.9%	-2.7%	-4.8%	-0.5%	-8.6%	4.0%	-10.4%
Q3/2016	-2.9%	-6.0%	-2.9%	-2.2%	-3.4%	-0.8%	-8.4%	0.2%	-6.8%

The above chart leaves no doubt as to what we claim.

Fiscal Policy

This report has always laid great emphasis on public finances at the federal level, but a growing number of Brazilian states are losing control over their finances – being of particular concern the states of Rio de Janeiro (RJ) and Rio Grande do Sul (RS).

The troubled political scenario that engulfs Brazil has spilled over to state-level finances since these latter “are dependent” on the federal government’s support. It is borderline naïve to believe that political bumps will not affect any other level of the federation.

We believe Congressmen and Senators are conscious about how fundamental is the fiscal consolidation for the country, but political turmoil surely is bound to get in the way of both designing of and the pace adopted to pass legislation. An unstable environment breeds exposure to unlikely events whilst exciting the usual opposition – always under spurious pretenses, both undemocratic and unfavorable to Brazil.

The Expenditure Cap Constitutional Amendment does not cut expenses in the short run; quite the contrary, it raises them. Therefore, other measures must be urgently carried forth, such as the Social Security Reform (which is, all conspiring in favor of it, will be approved in the second half of 2017). First estimates project BRL 700 billion in savings for the next 10 years! These are resources that may be harnessed towards a host of services to the population, not to mention the positive effects on fiscal accounts and, subsequently, on monetary policy.

However, if policy, measures (such as expenditure efficiency, cutting back on costs to run the government and directing resources to oversight and counter-fraud actions) and reforms aiming at a systematic and structural realignment are taking place at the federal level, one should not overlook the need for states to fall in such line as well. Everyone needs to be committed to fiscal consolidation in the terms proposed by the federal government, without prejudice against auxiliary actions taken to accommodate each state’s singularity. This refers to the Fiscal Decentralization Theorem (FDT) proposed by Oates (1972), once it is admitted a variation in provision of public goods to different regions – the so-called geographic subsets. It is assumed that local governments maximize their welfare, that is, they are more efficient at providing services at Pareto-efficiency levels. Underlying this theory is the very heterogeneity among such subsets. It seems obvious that states will be bound by the same requirement of limiting the growth of expenses, be it in nominal terms, by way of partial indexation to inflation and/or by growth of net tax collection – or yet, through increasing tax rate on state-level social security contributions. It is very unfortunate situation, but it is a short blanket. In sum, the FDT is very alluring but the political and economic landscape led to a disaster in RJ, in RS and other states, which will now have to strive to catch up with the federal government’s intent… either that or federal intervention shortly.

The corrections must not be carried half-heartedly; they need to be far-reaching, general and unrestricted. Without palliatives, patches or temporary adjustments of the muddling-through type, which in reality has nowhere to go. Society cannot stand such a situation any longer and there is room for making the population understand the gravity of the situation, as has been the case of Congressmen and Senator of good faith.

In this and all senses, the time to act is now!

International Environment

The world is clearly tilting towards the right! However, even populism in certain places, but historically and paradoxically Latin America not necessarily.

Donald Trump's election as president of the United States has caused commotion worldwide. Doubts range shorter when it comes to the fiscal, trade and immigration policies to be enacted, but it is still too early to say how he intends to approach interest rate policy. In fact, the extent and intensity of his policies in this regard are unknowns to this day, however clear may be the direction he is likely to take. In this sense, despite the FED's structure and independence, there is a possibility that some "unease" comes in between the President and Janet Yellen, leading the latter to resign her post as FED Chairwoman, whose term ends in 2018. At any rate, it seems right to imagine that President Trump will not mimic Candidate Trump, but a clear-cut Republican Trump is ever more apparent, as indicated by the appointments he has made thus far to integrate his administration.

In the world at large, we now witness the Chinese government's interventions in the economy in irregular periodicity, moving from monthly to weekly. The pace of economic slowdown seems to be faster and irreversible. In Europe, rumors that the ECB would shut down its asset purchase program (Quantitative Easing) have no longer any basis in our analysis – situation in Europe is tied to ECB's board's mindset, thereby hindering, in our opinion, any move toward ending the program.

The landscape in Latin America and the Caribbean, we find Argentina with a plunging exposure in the media, the Peace Treaty in Colombia and the passing away of Fidel Castro. This latter had a major repercussion in the media for what he stood for as Commander-in-Chief of the Cuban Revolution, however meaningless for any attempt to reverse the *status quo* in the country, for his brother will continue as president. In truth, Donald Trump's election may indeed represent a sharp change in Cuba's fate after the conciliatory measures taken by President Obama pointing out to a re-approximation to the US.

In short, the planet is under sharp transformation and the peoples, especially in democratic countries, have eloquently called for changes. These latter have started out with the BREXIT, the election of Donald Trump, the inevitable (to greater or lesser extent) upcoming changes in Italy, the growing possibility of a rightwing party rise to the presidency in France and also the German elections projecting a likely scenario very different in a short timespan. Is globalization really under siege? Perhaps, but it is difficult… we have come a long way with this reality, and protectionism and "closing" the borders do not seem feasible anymore.

At any rate, we are about to live a different reality. The major problem in changing reality is in its transition and its inherent dangers, which have circumstantially began to be felt: the strains governments are under with treaties, commitments and deals of all sorts which are being questioned and revised. A slow down to tidy things up may be welcome, but it places stability at risk.

Interest Rates

The political crisis is back. The period of calm was short. In six months the Temer administration lost six ministers. Lawmakers went back to pass self-serving legislation with an anti-corruption bill withdrawing important clauses from the original proposal. Streets were vocal but fell on deaf ears or could it be that fear of future punishment following the plea deals by Odebrecht speak louder?

Beyond domestic problems, largely responsible for the current predicament the country is in, Donald Trump's victory brought volatility to markets. There was a strong Government bond movement sell-off accompanied by boosted demand for the Dollar, as foreign investors fled the country. It was but a speculative movement detached for economic fundamentals.

In the last meeting of the year, the BACEN's Monetary Policy Board lowered the basic interest rate (SELIC) in 25 b.p. from 14% to 13.75% yearly rate and, in its minute following the meeting, has signaled the possibility of intensifying further cuts, depending on the deflationary effects of the activity slowdown. Nonetheless, many variables are still uncertain: what will be of the international economy under Trump? How will reforms pull through the long process of approval, extension and implementation in Brazil? Will Michel Temer be able to keep himself in office until the end of 2018? Facing such a scenario the BACEN opted for caution, at least for the moment.

In the US expectations are that the FED will hike interest rates. Donald Trump's discourse speak of raising expenses, which can be inflationary. If inflation rises, the central bank will probably have to raise interest rates – especially if Janet Yellen is no longer chairing the board. Under higher US interest rates, investors opt out of riskier assets to earn a little more where it is safer. In this case, we may be facing the Flight to Quality phenomenon, but could that happen in Brazil? We at Redwood bet that, in relative terms, Brazil stands out among the BRICS, and in a world where investment is running at negative rates (see some European countries) resources seek security, but good returns as well. In this sense, an eventual capital flight in a higher-interest-rate environment is unlikely in Brazil – be it for our alluring high interest rates be it relatively lower capital withdrawals.

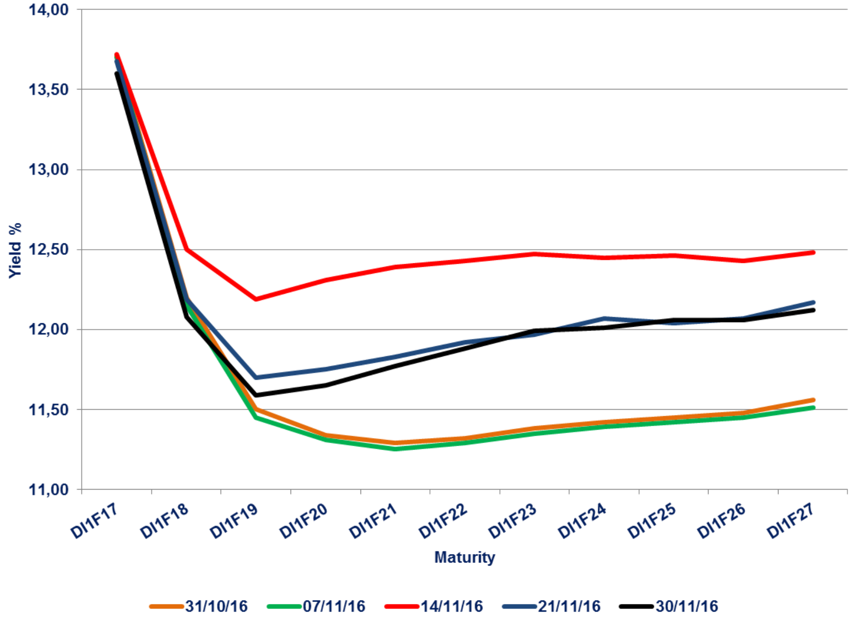
What is certain is that the yield curve volatility in November soared high, especially after the results of US elections. Fixed income markets has lived Stock Market moments with daily swings above 2%. Overall in the month, the curve has switched its slope with rates until January 2018 backing down and longer maturities being negotiated at higher rates when conflated with previous months' scores. For the short term, news are the SELIC rate cut and expectations of speedier further cuts by the BACEN to boost the economy. As for the long term, where foreign investors have larger stakes, capital withdrawals have dominated the scene under political uncertainties both domestic and external.

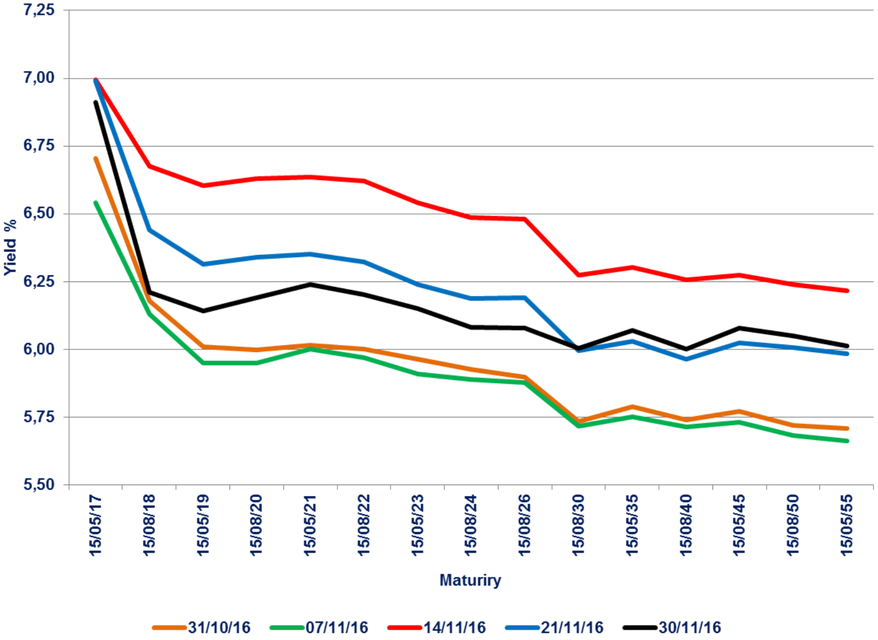
Deep down, truth is our problems (monetary policy included) depend fundamentally on our resolve, with efficiency, facing our troubles… we do not depend on anyone else so much.

Well, that is the problem!

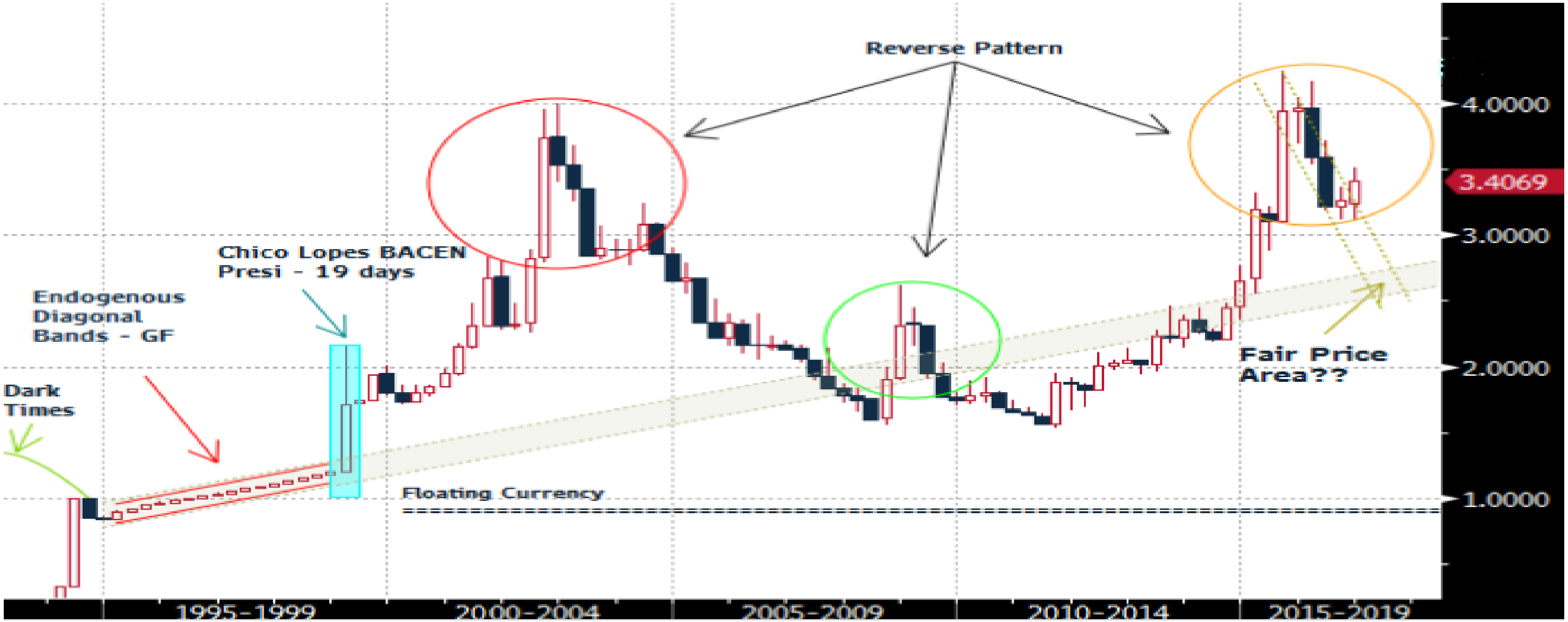
Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange



Source: Bloomberg | Elaboration: Planner Redwood

The USD was the best "investment" in November (6.78%) for those on the buy side. However, overall in the year, the USD is the worst "investment" with a 13.01% plunge.

The currency spike within the month reflected the surprise by the market with the American elections results – the victory of Donald Trump and the rise in risk aversion with the burst of one more domestic political crisis.

Despite Brazilian exchange rate policy be defined as "floating", the Central Bank has interfered with the exchange rate since 2013 by way of Dollar future market operations (currency *swaps*) with the goal of "reducing volatility". Since he rose to chair the institution, Ilan Goldfajn has dismantled the swap positions in a way to leave the USD quotes as just one more price. However, with the Trump victory, the BACEN has resorted to traditional currency swap auctions, not only rolling over maturities but offering new issues. The exit of foreign investors from the Brazilian market was loud, leading the BRL to a 5% devaluation in one single day.

Stock Market

Source: BMF&Bovespa | Elaboration: Planner Redwood

It was a month of profit accrual in Stock Markets. The index closed with a 4.65% drop. As mentioned in previous reports, the inflow of resources from foreign investors drives the movement in stock markets. In November, there was net withdrawal of resources.

The third quarter GDP in 2016 has shown that the country is still enthralled in a recession. Economic recovery after impeachment of former president Rousseff has not come to fruition as most market players expected. Advancements in reforms as anticipated were relegated to a “second tier” or, at least, put on hold until a more adequate timing arises, above all because de political crises has not come to a close with Rousseff’s stepping down. The Car Wash probe target politicians denounced by Odebrecht whilst private interests prevail over the public’s and state-level deficits build up to gigantic proportions. The passing of Expenditure Cap Constitutional Amendment by the lower house has contributed little to the scenario, at least for now and also because it does not deliver much mileage by itself: further reforms are required. Without a single concrete perspective of an economic improvement, the Stock Market will not price its assets adequately.

Economic recovery is farther than expected by the market, but falls in line with our prognostics throughout the year. In the face of this, the stock market will probably be at the mercy of investors’ flow, especially foreign ones, with some punctual movements for some stocks. For instance, iron ore appreciation, following declarations by President-elect Trump that he will invest strongly in American infrastructure, has contributed to the appreciation of Vale and other steel companies in the month. The chart above, however, displays the outlook of Ibovespa (in USD) for foreign investors.

Monthly Commentary

NOVEMBER 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