Planner Redwood Asset Management

MONTHLY COMMENTARY

OCTOBER 2015

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Planner Securities: 150 East 52nd St.. 7th Floor - New York. NY 10022

Phone: 646-381-7011 / Fax: 646-381-7010

Monthly Commentary / OCTOBER 2015

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- International Environment
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Epigraph of the month... a propos of Brazil´s current predicament.

“The whole problem with the world is that fools and fanatics are always so certain of themselves, and wiser people so full of doubts.”

by *Bertrand Russell – Mathematician and British Philosopher*

Introduction

Brazil´s economic outlook is far more challenging than one can expect, and the political side of it – which can avert current hardships – becomes ever more complicated, dressed up with contours that take to the opposite of a political nirvana, a type of multiple sclerosis likely to condemn us, under the glorified certainty of “idiots and fanatics”, to a trap of backwardness and loss of the hard-to-achieve social progress.

In a month marked by the substantial deterioration in macroeconomic indicators, political forces in the domestic arena seem to transform Minister Levy into the “Court´s Joker”, at times making him responsible for our current troubles with his austerity measures, at times as a useful innocent bystander… incomprehensibly, he takes it all silently. It is hard to know if this is well- or ill-advised for Brazil… perhaps this is his *real* doubt, and in it goes fiercer patriotic sentiments and an unswerving sense of duty… and possibly some remorse in case things turn sour should he resign. The hesitation that bedevils the wiser, as Bertrand Russel would have it. Or simply, albeit in less “romantic” a version, a kind of opportunism suitable to the original aims behind his nomination.

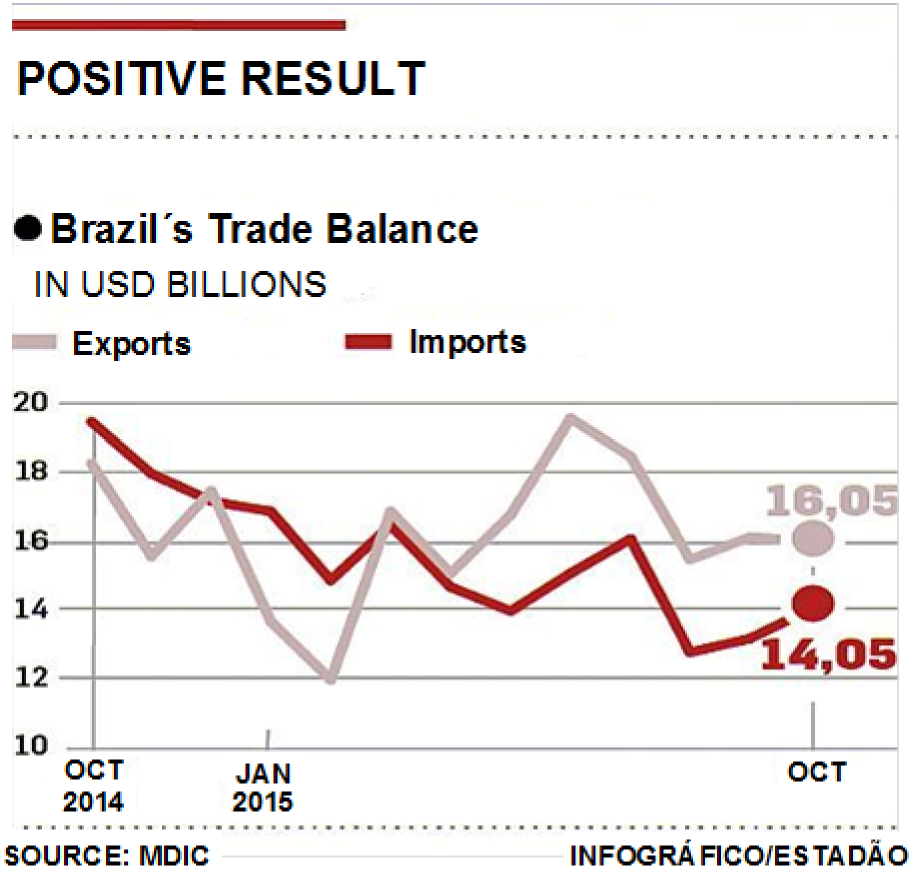
One way or another, his eventual leaving office does not seem (as of yet) dully priced in by the market. However, given the limited reach of his ideas, execution of his proposals has no resounding influence, let alone receptiveness, in Congress. Hence, like someone caught in quicksand, we go under slowly… recession, inflation, unemployment and so on, both for 2015 and, as it seems to be consensus now, for 2016 as well. Back and forth, the importance of Minister Levy becomes ever more relativized, as the ghosts (worsening of indicators) slowly set in while the relevance of his mere presence vanishes.

The Eurozone has witnessed the lowest unemployment rate since 2012 (10.8%), but that did not allow for any celebration (levels are still high in comparison with other developed markets) and the ECB´s president has called for new studies to evaluate the need for additional stimuli to the economy, to be scrutinized in the December 2015 meeting. Along the same lines, the Chinese government envisages another high-impact stimulus package, more encompassing and lasting, for the next five-year term. In the US, the FED´s hesitation in normalizing its monetary policy is couched on the need for further information (*data-dependent*) has transformed the FED´s communication strategy an instrument of confusion and, thus, of pure uncertainty.

Therefore, while waiting for the belated decision by the FED – be it successive piecemeal interest rate rises, or a realignment of its policy guidelines -, and for the unraveling of domestic politics, we thrust forth toward the end of the year that, at last, we hope meets a finer endpoint. Probability of such conclusion is not significant and, in truth, we are filled with doubts.

In this landscape, US Treasuries have closed the month at 2.15%. S&P varied 8.30%, NIKKEI closed at 9.75%, DAX at 12.32% and FTSE at 5.39%. Ibovespa has ended the month at 1.8% and the IBrX at 1.36%. Highs for DIF16 at 14.67% and DIF17 at 15.83%. NTN-B 2050 closed the period at 7.14% and the dollar (Ptax) at BRL 3.8589.

Economic Activity



Amid many troubling news if anything is liable – in some sense - to find a “positive” interpretation, the external sector can be seen as “safe”. Trade balance presents a USD 12 billion surplus in 2015, generating a positive net balance in October amounting to USD 2 billion. The terms “positive” and “safe” go in between quotations because such outcome owes much to the severe fragility of the economy, wherein consumption and imports were profoundly hit. Hence, there isn´t much to celebrate…

In truth, a keener eye with a qualitative twist might see in this reduction in capital goods imports (machines and equipment) a signal hard to miss: the retraction of investments, that is, entrepreneurs´ lack of confidence reflected in their practical (in)actions with immediate effects today and in the future, with perspectives of lower output. Hence, it is ephemeral the “good” effects of an undervalued Brazilian currency, for in the long run positive results of exports do not translate into continued productivity gains. The advantages of a maxi devaluation do not last long and end up concealing the situation whilst complicating matters in other sectors.

In this vein, other sectors in the economy perform poorer and poorer, with the exception of agriculture. With the sharp downturn in activity – new projections hover around -3% this year – Brazilian industries go on laying off workers and increasing idle capacity, with negative effects already expected for 2016. Unemployment is growing as a central variable for the ongoing adjustment, the wage bill has gradually deteriorated and the average labor compensation, however stable in the cumulative figures for the year, has pointed down in the last months.

In this environment, a host of proposals to jumpstart the economy tends to flourish and, as a rule, all of them have a tendency for developmentalist and immediate results. As such, in line with good old state interventionism, there prevail ideas of economic stimulus via more of the same that has been seen in the last years, which has brought to the current predicament.

It will be tough to activate macroeconomic orthodoxy!

Fiscal Policy

Minister Levy has stated that the Brazilian economy should seek a “fiscal ballast” that brings tranquility to long-term-related discussions. Nothing to add to that! However, how can everyone be convinced to join forces around a structural framework if in 10 months we have had 3 different prospects for fiscal surpluses, the last one being – with creative accounting measures in 2014 -, the gigantic deficit of BRL 120 billion? This number, if confirmed, leads to a deficit (and not a surplus) of -2.16% against the original (surplus) of +1.1% as a percentage of GDP proposed in the beginning of the year. Where is the big problem? Is it lack of transparency and tweaking of numbers? Is it incompetence in identifying and measuring accounts, or deliberate action in circumventing and amending the situation?

Deep down it doesn´t really matter, for now, which owes to the benefit of a doubt, on the part of the market, *still* enjoyed by the Minister and his team, although reality is unchanged: Debt-to-GDP ratio will surpass the 70% mark and move upwards in 2016 – despite down-trending GDP projections for next year. It is the last move before Investment Rating Downgrade by the two remaining rating agencies, Fitch and Moody´s. In the limit, what is expected of the Brazilian government and its economic team is coherence and assertiveness in its propositions, with clear messages of its commitments with a stable public debt.

The essential component that agents need to pass on to society is the goal of restoring trust and, if the political realm does not aid us in such direction – and Congress is mired in conflict while hindering the passing of necessary measures -, at least the economic team must project credibility while conducting its business, especially prospects and assessments of public accounts. This attitude, however insufficient in its own, is but a first and necessary condition for a credible fiscal adjustment, that is, a positive agenda for Brazil and the effective way out of the vicious circle will only open itself if fundamental technical conditions are reunited to set forth the adequate management of a long-term process of public finances realignment.

Finally, while mentioning long term, the actual current situation requires to be made fully explicit. There is no way to objectively “simulate” the future if we are unsure of actual fiscal figures. The fiscal non-definition brings in noise and perturbations to the economy, especially and directly on the execution of Monetary Policy. Acting upon this very direction with greater intensity are the level and the parameters of the fiscal economy: the higher the figures the more speedy the deterioration and, subsequently, the closer becomes the deadline for solutions, with higher costs to the country.

Summing up, the current outlook suggests that if political dependency is exogenous to the technical possibilities open to the economic team, albeit central to the reversion of the current fiscal framework, competence in mapping out the real situation and, from the latter, trace out a new and sustainable plan is a *sine qua non* condition for any proposal to the short, medium and long terms. The successive revisions of fiscal goals are undermining the economic policy´s credibility, thereby wasting the instrumental “political capital” upheld by the economic team.

Guaranteeing the sustainability of debt must be the main goal Fiscal Policy, and this objective should not be altered at every instant.

International Environment

This year has been background to a binary relay in the international arena: at times it is up to China, at others the FED steps in the spotlight – they are the big bad Wolf!

In the last days the situation has changed a bit and both actors have starred. China is in the midst of preparations of a new grand stimulus plan to its economy, under the threats of a diminished growth prospect for the years to come. On the US side, the FED grapples with the virtual impossibility of postponing the monetary tapering with interest rates hikes, forcing the effective normalization of its monetary policy in December 2015.

Emerging markets, especially China and to a certain extent Brazil too, are seen as a source of escalating risk to global growth. This perception relies on the downswing of primary commodities´ prices and policy-generated shocks that signal a deep and lasting slowdown. More than that, they are seen as a source of contagion for other emerging economies. The Chinese foresee the scenario and wave with two measures, quite intriguing in the limit, under economic assessment: on one side the government prepares a stimulus package, while on the other, it indicates that interest rates shall become ever more governed by market forces.

The FED in its turn seems to communicate, by way of its current technical team, that were it anyhow possible interest rates would remain as low as they are. Besides, the upcoming elections in 2016 turns the Market more sensitive to each and every move the FED makes and, should any signal be misinterpreted, all setbacks reflecting on the economy will coincide with the electoral calendar. But this is not the worst yet, for even if the FED raises interest rates (from the current 0.13% to 0.25%), its *modus operandi* is unlikely to change routes and/or strategy and will resume leaving the market clueless – with the accompanying volatility. The FED´s communication has been a sheer disaster.

In Europe, the ECB´s president Mario Draghi has underlined the risks of slowdowns in growth and inflation, stressing that it should take longer than expected to bring inflation up to its 2% target. In our opinion such a statement reflects the pessimism and, with it, the therapy always at hand: new measures to fuel the economy. The results expected are too the same as always: punishment to savers and unnecessary risk generation... better yet would be to follow Schumpeter in his “creative destruction” advice. In Europe? It is hard to buy it!

At last, international landscape does not bear on us any further burden beyond the ones felt in the last months, but the potential for impact in our economy should not to be dismissed. In fact, the later is likely to be greater if the abovementioned triggers are jointly set off, that is, an eventual uncontained downturn of the Chinese economy and the possible systematic rise in US interest rates.

While the big bad Wolf does not arrive, we should not waste time and proceed to a swift adjustment.

Interest Rates

Out Levy, stay Levy!

Clamor for resignation of Minister Levy by the Labor Party´s allies and even by the former President Lula was countered by President Roussef´s statement that Levy shall remain in office! We believe this is not due to the President´s conviction as it is of necessity. Reactions by financial markets were immediate. Levy enjoys credibility in front of markets. We bought ourselves some time. Until when? It is hard to predict.

If on one side the permanence of Levy on board calms markets down and sustains the minimum orthodox bias in economic policy, in one of its banners, on the side of Monetary Policy, the Monetary Policy Committee (COPOM) has kept interest rates at 14.25%. However, it has made clear that "in case it proves necessary" interest rates will rise. Thus, the members of COPOM have stressed, in its last minute issued, that without fiscal adjustment it will be hard to achieve the inflation target at 4.5%, even in the stretched-out scenario in which inflation meets the target only in 2017. Markets are quite skeptical as regards the Central Bank´s ability to anchor inflationary expectations and we, at Redwood, have not envisaged such possibility for some time now. A shift is worthy of note in the implicit inflation curve, as well as various other indicators overseen by our scenario-building systems.

So as not to state that the government has made peace with the movement in interest rates, the Treasury has informed that it will not be held "hostage by the Market" and will not ratify the high interest rates in long-term contracts. Therefore, technical personnel at that institution has decided that (i) supply of NTN-B will be made with bonds maturing in 2023, (ii) sales of pre-fixed bonds for longer terms will be provided in small batches and (iii) the supply of LFT will continue.

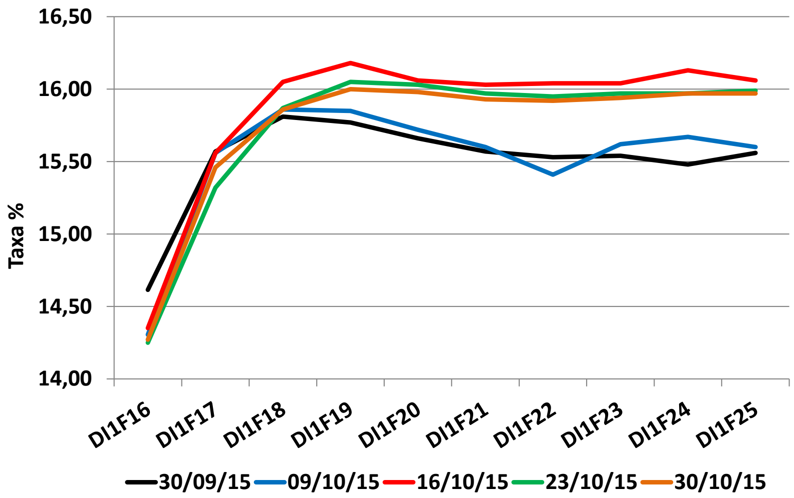
After months of sharp oscillations in the interest rate futures markets, a lateral movement characterized October. The farther maturity dates closed with a slight rise, whereas inflation-indexed bonds faced opposite outcomes, with closing yields and rises in implicit inflation. The situation does not allow for the prediction of improvement under current attitude by the Treasury.

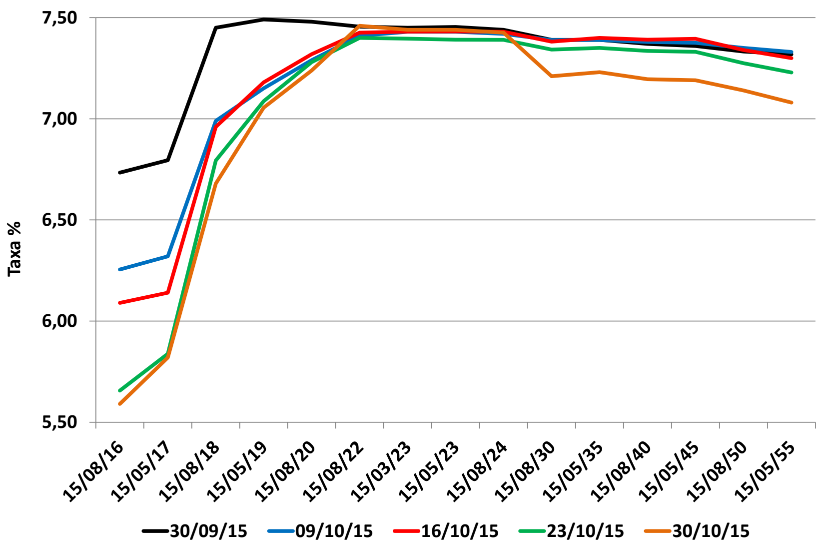
Amid this scenario, above all when the Fiscal stance affects so much of macroeconomic management, how should one interpret declarations by the Central Bank that "in case it proves necessary" it will raise interest rates and that the Treasury will not be "held hostage by the Market" in ratifying the rates demanded by the later? In the first case, inflation approaches 10% level this year and it hovers above the target´s tolerance band´s upper limit in 2016, with the slightest chance of convergence (at this moment) with the target in 2017 – for an institution held up to be, hypothetically, the currency´s guardian, there seems to be no additional nor stronger reasons for immediate action. In the second case, it is perhaps worthwhile reminding the Treasury as regards the composition of total savings (Government, External and Private) and its only channel still available. Ranting and venting of grievances regarding markets´ sovereignty, coupled with the fragility of Government's actions and the whole institutional-political framework in which we find ourselves involved, do not seem to be a policy mix liable to generate much-needed success in that front.

Paul Volcker, one of the greatest Central Bankers, in the midst of the 1980s crisis in the US and under strong austerity policy, did not hesitate in fulfilling its role, and hiked interest rates (from 11% in 1979 up to 20% in June 1981 – when inflation plunged from 14.8% in March 1980 to 3% in 1983) putting the house in order and preparing the economy for the upturn in economic activity in the following years of the decade. Courage, competence and determination with firm goals; that is what is expected of our Central Bank.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

After four months of rising the Dollar, it has finally given us some relief.

Foreign investors have been turning to Brazil once again; Brazilian assets have become cheaper with the rise of the Dollar and the plunge in the local stock exchange. However, as it seems, this is not a long-term solution but a speculative one, the highly attractive interest rates seduces investors to reap quick gains from Brazilian assets and leave after making a generous buck. We are at the mercy of international markets, given the domestic appearance of total paralysis. The political crisis dominates the landscape and feeds into the economic crisis.

The halfhearted fiscal adjustment and the growing disarray in government finances are reflected in asset prices, including the Dollar. The Exchange rate policy, from the beginning of this government has always been out of balance with the rest of Economic Policy guidelines and it seems to have lost direction once and for all. The country is enthralled in a vicious circle. It is completely beyond hope to think that the Dollar will float freely and thus become just another price in the economy. Interventions in the currency markets are back, aiming to contain the rise of the US Dollar (either its quotes or its volatility) and the increasing services of the exchange rate swaps. All right, we are not depleting our foreign reserves (yet) but shouldn't one account for the cost of such swap-based interventions? The net service of these swaps taken up by the Central Bank has amounted to BRL 131,9 billion, or 2.3% of GDP, in the last twelve-month stretch. The crux of the matter is as follows: what is the true efficacy of these measures? How much do they actually reduce volatility and alleviate upward pressure on the dollar? We at Redwood have no doubt that should Economic Policy move closer to a clear-cut austere, orthodox and liberal inclination, the Exchange rate would prove extremely beneficial. Much more so than the cost itself, the potential for disarray entailed by the current policy mix, lacking transparency (it would sound like a joke to mention how many swap batches will be offered), with no direction and facing setbacks at every instant, instills a risk component absolutely unecessary amid all this confusion we are living.

Fitch has sent its message this month by downgrading the credit assessment of the country. We still hold the investment grade status though. The next step is the downgrading itself. The motivation behind the decision was the increasing level of debt in the country – which is in some way affected by the current exchange rate policy. It is worth mentioning that the decision was made before authorities released the negative fiscal figures and the total payments outstanding due to the creative accounting.

Not less important, however, are the externalities affecting the domestic currency. The FED, for instance, has been the main responsible for the great volatility of the dollar in recent times and also throughout the month – but, this effect, albeit not homogeneous, affects all countries in the globe, some more than others, depending on the robustness of each economy. For us, and for obvious reasons, impacts are even more intense. Thus, by way of its communication, the market has interpreted, in the first fortnight, that interest rates would not rise anymore this year, forcing the investors to take on more risk in other to achieve greater returns. The Dollar came to be negotiated below BRL 3.80. Nonetheless, in its statement following the FOMC meeting in the end of the month the FED brought some news and the market shifted towards anticipating a rise in interest rates in the committee's December meeting. Now, think about our central bank (only one more player in the world market) with magnanimous power to interpret the timing, the size of volatility, and acceleration of quotes and, above all, with sole discretion to decide what is best for the country. It is just too much!

The current exchange rate policy is in the way of all the rest of economic policy setup.

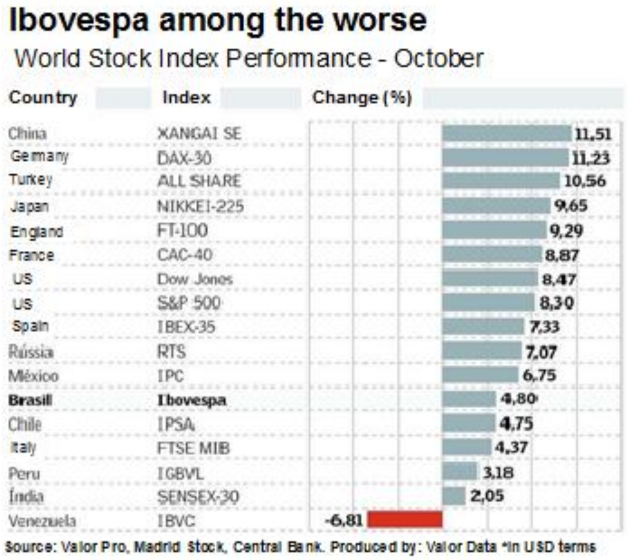
Stock Market

2015 has been a gloomy year, but 2016 sees no improvement in perspective.

The Brazilian Stock Exchange has not been able to keep up with the wave of recovery in global markets in October, following successive drops. Domestic problems resume in the economy and in politics. Worse yet, there are no perspectives of improvement in the short run. Pushing forth with the fiscal adjustment, along with all the additional measures proposed by the economic team, is necessary to exert positive effects on the Brazilian stock market.

Economic stimulus in Europe and in China has contributed to increase liquidity available for emerging countries, although resources were shared with other emerging markets due to the uncertainties as to the timeframe for the solution of our political struggles and to overcome growth-hindering problems. It was but a speculative flow, under the notion that stocks and currencies were cheap. Fundamentally, nothing has changed.

The Stock Exchange had some relief in the beginning of the month: it almost hit 50.000 points. However, negative data spawning from China and Germany (which triggered more stimulus packages) were coupled with domestic political confusion, which made the index close the month at 45.868 points. Even so, over the period it faced a 1.8% increase. At last, as mentioned, the FED has changed investors' perception: in its post-meeting statement, the market interpreted that there is room for a hike in the December meeting.



Preliminary third quarter 2015 results released by Brazilian public capital companies suggests that the worst is yet to come. In order to survive they will have to adapt to this critical environment. Consumption-goods-producing companies have prepared for tough times. Shutdowns of stores and lay-offs have taken place in this third quarter so as to adjust to a landscape of a persisting downturn in sales revenues. For instance, Via Varejo and GPA have laid off nine thousand workers, Usiminas foresees four thousand jobs terminated and Marisa has shutdown stores with lower-than-expected returns and also terminated direct sales operations (trading goods outside physical stores, solely by direct relationship between salesperson and buyer).

The real economy is already feeling, intensely, the impacts of the crisis. And if this is so, what is to expect in the financial markets from firms that do not grow and see no profits?

The climate of uncertainty prevails. It is high time we seek to preserve capital.

Monthly Commentary

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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