Planner Redwood Asset Management

MONTHLY COMMENTARY

OCTOBER 2016

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Epigraph of the month... a propos of Brazil’s current predicament.

“At times unpopular measures are needed in order to change behavior.”

Lucy Powell – British Politician

Introduction

Brazil has recently endured a truly political perfect storm, one which is ameliorated at the moment, but which still carries the potential to hinder much needed reforms. Uncertainty has diminished, confidence indicators have improved and the level of risk has plunged in the last quarter. President Rousseff's stepping down was highly beneficial to a realignment of political forces around the structural reforms the country needs.

In this vein, President in Office Michel Temer has shown great ability in conducting political dwellings (specially in National Congress) and will face several challenges ahead with no time to lose. However, beyond his political prowess, he's got a card up in his sleeve: unpopularity. Let us explain: both these traits act in favor of reforms, difficult decisions and changes that need be done now, whilst also purging away any shortsighted interest (such as reelection in two years), albeit momentarily, that may come in between further pretenses in the future. Truth is there will be no room for any political agenda if Temer does not "adjust" the economy. This is the only way possible. Not that this reality shall not nor will not take place, especially if measures yield good outcomes.

The key point is, however, that unpopularity is by rule a short-term deal, for it has the power to compromise the current political environment. After years of unruly interventions and mistakes in economic policy, we need change. And these changes will be highly unpopular, but as Lucy Powell stated in the epigraph to this Report, they are necessary in order to change behavior.

In the world at large, the Syrian crises seems to reach its climax, with bombings decimating everything and everyone, while refugees (particularly in France) reveal the cruelty of warfare, unimaginable in our time, and the absolute incompetence of Nations in reaching a satisfactory humanitarian solution for the current situation. In Europe the banking crisis seems imminent and the dominant mindset behind the block's economic policies seems to fall short of desired outcomes. In the US, the presidential elections "thrilled" the planet with expected impacts of each candidate's electoral performance. The Fed seems immune to all this and its reluctance to pursue the so-called monetary tapering lingers… more room is open for innuendo that the Fed is sensitive to politics. In China, the PBOC has flooded the market with liquidity yet once again – business as usual.

In this landscape, US Treasuries closed the month at 1.834%. S&P varied -1.94%, NIKKEI, at 5.93%, DAX at 1.47% and FTSE 4.41%. Ibovespa ended the month at 11.23% and the IBrX at 10.75%. Highs for DIF17 at 13.74% and DIF21 at 11.49%. NTN-B 2050 closed the month at 5.72% while the Ptax sale at BRL 3.1811.

Economic Activity

Following the impeachment of President Rousseff, the main banks and consulting firms have issued reports on the economic performance of Brazil that are, say, far too optimistic. In truth, these outlooks consider scenarios of a strong jumpstart of activity, duly hinged on the sharp improvement of several indicators. These projections have reached, in the last weeks, a 2% growth for 2017 and over 4% for 2018 – thereby generating an extremely positive contagion among several other research departments and institutes (possibly due to the credibility enjoyed by the institutions behind it). At last, it all adds up to a favorable cycle developing a positive *momentum*, a conclusion from which only a few analysts have distanced themselves.

We at Redwood are far more pessimistic than the abovementioned purview. This does not mean that we do not project improvement for the upcoming years, but we stand far apart in terms of indicators. We agree that our economy is much flexible and ***could*** deliver a high variation in activity, say, a 2% increase in 2017 after a -3.5% drop in 2016 – as happened in 2009 with a -0.2% figure followed by a 7.6% growth in 2010. It could happen, but the ongoing situation and the circumstances surrounding us do not emulate, not even from afar, those at that period.

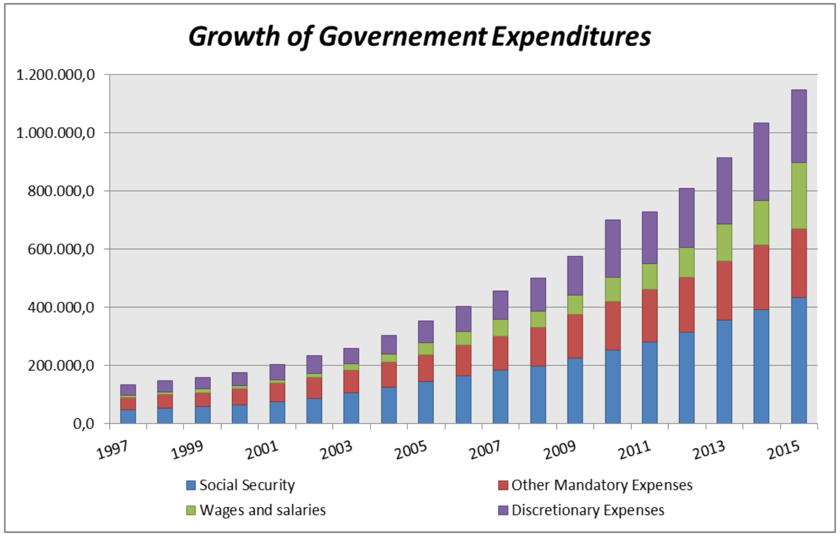
For us at Redwood, growth “will soar” – we may enjoy a positive variation of 4% from this year to 2017. It is not a meager outcome, but far from what the market had “anticipated”. In fact, in the last days and especially after the release of information on the labor market and the IBC-BR (Central Bank’s monthly leading indicator of activity), these banks and consulting firms have downgraded their projections significantly, but still far from our current estimates.

Our insistence on lower projections relies on the outcomes of our models when we simulate them with all the premises and variables altogether. It is evident that Brazil risk (measured by the CDS) has diminished sharply and that confidence indicators have substantially improved. But this is not enough, and moreover, it doesn’t match with recently released data.

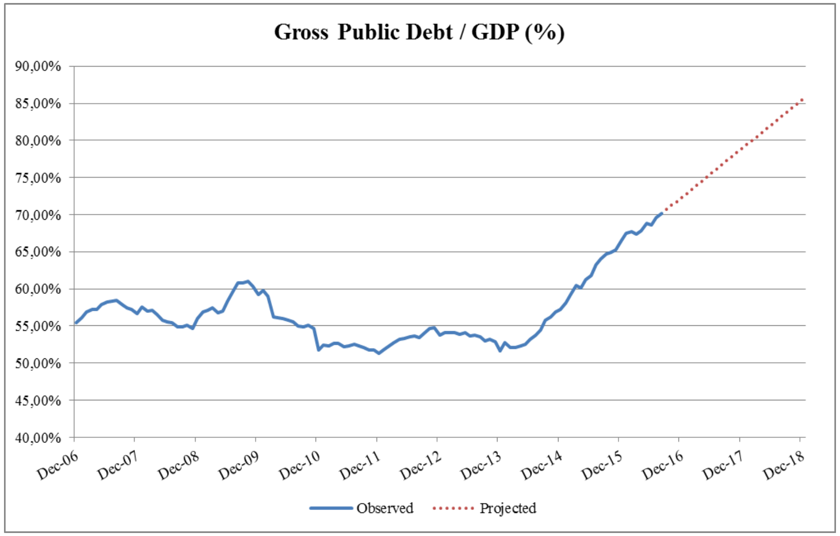
Truth is that companies are still highly leveraged (and will remain so for a while), and the labor market disappoints those with more rosy projections. Our models forecast deteriorated unemployment for the first quarter of 2017, while inflation misses the target in 2017 (which somewhat hinders a speedier reduction of the SELIC rate) and the recovery of credit will be extremely gradual. In other words, all of this does not strengthen the channels of transmission to activity, and therefore we foresee a more meager GDP than the one we’d wish for (and need), but still one shall not be disheartened… we are on the right path, but the recovery trajectory is likely to be morose.

At the risk of sounding redundant: Brazil has been trashed, recovery cannot be as fast… step by step we’ll get back on a high growth track and, with some evolution, with enhanced productivity and efficiency allowing for stronger and more sustained advances.

Fiscal Policy



Source: National Treasury | Elaboration by: Planner Redwood



Source: Central Bank of Brazil| Elaboration by: Planner Redwood

Both charts above leave little doubt as to how important is the cap on government expenditures in Brazil.

On the side of current expenses, we observe a gigantic ascent (in real average terms, they have grown, in the last 19 years, at 12.04% yearly rates, while revenues have grown at 11.35% annually, leading up to an accumulated expenses-revenues spread of 14% in this stretch). If we break the period (starting at the revamping of statistical procedures by the National Treasury in 1997) down to administrations by FHC and PT, we find revenues growing at 12.03% and 10.07% and expenditures at 9.95% and 12.16%, respectively. In this line, Gross Debt-GDP ratio (main solvency indicator of a country) has soared toward troubling heights. And this is not all, for although the Project of Constitutional Amendment 241 (PEC 241) may lead to plunging expenses in the long run, in the short term the situation will be unchanged and, given our projections of a dragging activity, this ratio tends to deteriorate significantly further – surpassing the 80% level. So the Cap on Expenditures is bad? No, it falls short of optimal, but it seems to be what's possible at the moment. Tackling the social security reforms is what matters now, given its dominating share among government expenses.

At last, although there is no nominal cut at sight, the time has come to openly discuss the budgeting priorities in Congress. Perhaps now Budgetary Law will stop being a piece of legal fiction.

International Environment

The international outlook has been overridden by geopolitical events, Syria, refugee crisis in Europe and so forth, but nothing compares to the attention devoted to the new President of the United States. While markets expect greater foreseeability for the US economy (and the rest of the world) with Hillary Clinton's election, an eventual "surprise" by Donald Trump's becoming the *Commander in Chief* has the power to strongly shake markets. In our view, should this "surprise" take hold, we would most likely see some bumps, but it would be short lived. Let us explain: (i) Donald Trump (as any other president) is bound by Congress and does not do as he wishes, (ii) he is a businessman and has developed his endeavors knowing how to pick his advisors (one can only imagine he will do so in office, surrounding himself with competent professionals), and (iii) emerging markets (perhaps the most "fragile") are today in a situation of low vulnerability (at the main ones). Thus, the fear of a sudden change in US *status quo* seems not to be large – once again the market tends to overreact. In the final analysis, it is up to the American people to decide whether it wants more of the same (Clinton/Obama) or a change of the guard. The rest of the world waits in anticipation.

On the side of PMI, several economies displayed growth:

- ✓ Japan (best reading in 9 months – 54.1)
- ✓ China – up to 51.2 in October, outperforming expectations of 50.3
- ✓ India rose to 54.4
- ✓ Russia up to 52.4 in October (peak value in 4 years)
- ✓ EUA rose to 53.4
- ✓ Eurozone escalated to 53.5

Remark: the UK was an outlier, with PMI Manufacturing dropping to 54.3 (however with a lower fall with respect to expected value of 54, and above the 50-level line).

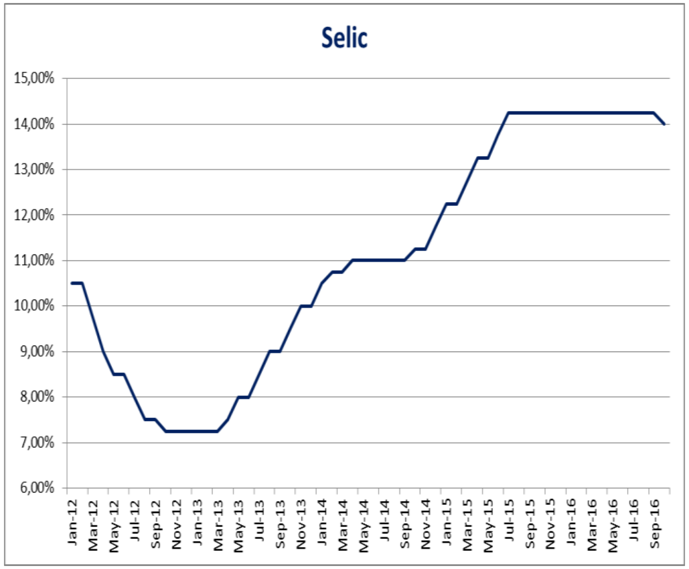
The UK government, yet in the spotlight, will possibly have to consult the Parliament on Brexit – no impact is expected (economic or financial) of this requirement, for a change in the outcome of referendum seems to be unlikely.

Another event worthy of note was the BoJ's decision to maintain its policy. Nonetheless, it has revised down its inflation forecast, in line with various bad economic indicators. In other words, the BoJ will continue annually buying around USD 767 billion of its 10-year Bonds (JGBs). Following this decision, there comes the postponement of the 2% inflation target until March 2018 instead of March 2017. In fact, an endless story for Japan.

Interest Rates

The Committee of Monetary Policy (COPOM) has reduced the SELIC rate in 25 b.p. A decision expected by market analysts, considering the transparent communication by the new economic team at the Central Bank. Dissension in the market regarded the magnitude of the cut, some worked with a stronger cut (50 b.p.), while we, at Redwood, did not foresee a cut at this past meeting. However, the Central Bank opted for more caution with respect to "optimists" by cutting the SELIC to 14% yearly rates.

For this decision, the Central Bank has underscored that figures for inflation in the short run are simmering down and that advances of fiscal reforms are helpful. Before the COPOM meeting, the House of Representatives passed, in first round, the cap on government expenditures (PEC 241). It was a victory for the government, but the struggle is long and much more needs to be done in order to fully adjust public finances and to put Brazil back on growth track. Besides that, the COPOM singled out that "the prolonged period with high inflation and with above-target inflationary expectations may enhance inertial mechanisms and retard the process of disinflation". By this and other declarations by the Central bank, which point to a moderate and gradual loosening, sectors of the market and Redwood project a further 25 b.p. cut at the November meeting, leading to a 13.75% SELIC at the end on 2016.



Source: Central Bank of Brazil | Elaboration by: Planner Redwood

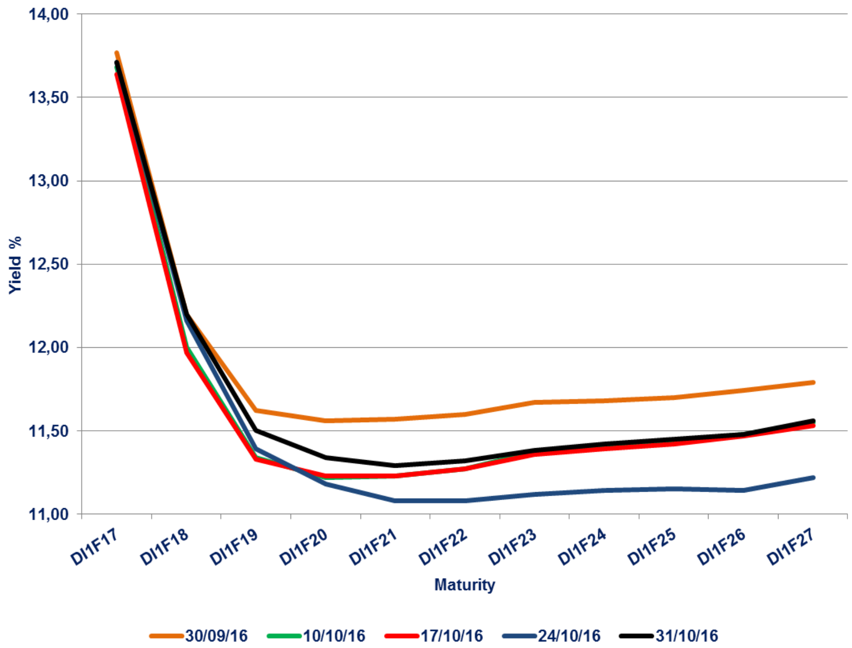
The speed of SELIC cuts in 2017 hinge on further progress in reforms: (i) approval of expenditures cap in Congress and (ii) social security reform. Once the government achieves its intended results in both fronts, country risk is likely to retreat, the currency to strengthen and inflation expectations to cave. All of these events, should they happen, open up room for further cuts in the basic interest rate, but keeping in mind the achievement of a 4.5% inflation, according to the headline consumer price index, as declared by the Central Bank.

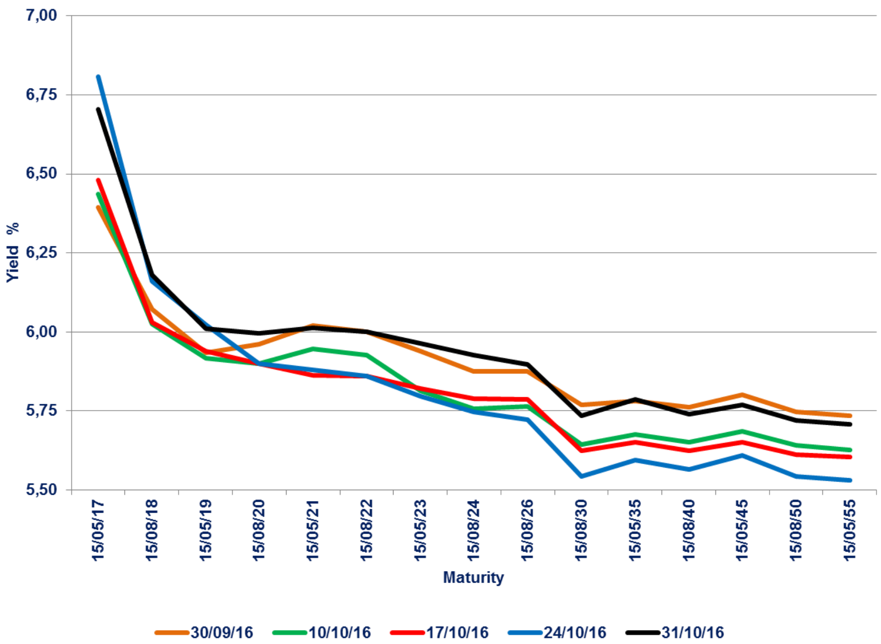
The yield curve faced a downward trend throughout the month, which was reversed in the last week of the month after the COPOM decision to be more "conservative", especially the contracts maturing in January 2017, since part of the market betted on a 50 b.p. cut. Even with last week's great volatility, overall in the month, there was a reduction in the yield curve premiums. No oscillation was seen in the coupons for NTN-B, when compared to the previous month's closing value.

The Central Bank is going well, it is part of the solution to the "Brazil problem".

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

A month of volatility. The Dollar started out the month at a high BRL 3.26 (10/03/2016) and reached its lowest at BRL 3.10 (10/25/2016), closing October with a 2.01% devaluation facing the BRL.

Among the factors collaborating with the depreciation of the Dollar throughout the month, we can cite: (i) maintenance of the project of legislation to repatriate illegally remitted resources abroad; (ii) approval by the House of Representatives, in two rounds, of the expenditures cap constitutional amendment; (iii) increase in commodities prices, especially when it comes to oil (the possibility of limiting production) and finally; (iv) investors' appetite for the country due to the interest rate differential that is still high even with a beginning of lowering process of SELIC. On the opposite side, positive data for the American economy led up to bets on rising interest rate in the US and therefore to the BRL devaluation.

A punctual fact of the month was the inflow of repatriated resources kept abroad illegally which contributed to bring USD spot price down. According the Federal Revenue, the formalization of assets totaled BRL 169.9 billion, thereby guaranteeing the government revenues of BRL 50.9 billion in Income Tax and other fines. Taxpayers rushed to meet the deadline ending in 31st October 2016 and bring in their money prior to a high valuation of the BRL. Since these are extraordinary revenues (very welcome at that), there is some perspective of a new round of the same nature for next year, but with higher rates. These are but speculations.

Facing the possibility of atypical capital inflow or sharp volatility of exchange rates, due to the abovementioned process of repatriation of funds by Brazilian citizens abroad, the Central Bank has not rolled over its exchange rate swaps maturing in November 1st 2016.

The Central bank has registered a positive outcome of BRL 3.8 billion in October until de 28th with exchange rate swaps. Despite this result, the Central Bank faced losses amounting to BRL 33.4 billion with returns on foreign reserves. These figures take heed of earnings and losses with currency variation, mark-to-market updating and interest rates. The net result of reserves (earnings minus borrowing costs) has become negative in BRL 39.3 billion, also by October 28th. The outcome of currency operations in the period was negative in BRL 36.9 billion.

Currently, foreign reserves add up to approximately USD 375 billion. The Central Bank always reminds that it is not profit-oriented, be it through swap operations or foreign reserves management, but providing hedge to the market in times of enhanced volatility and keeping a robust set of reserves.

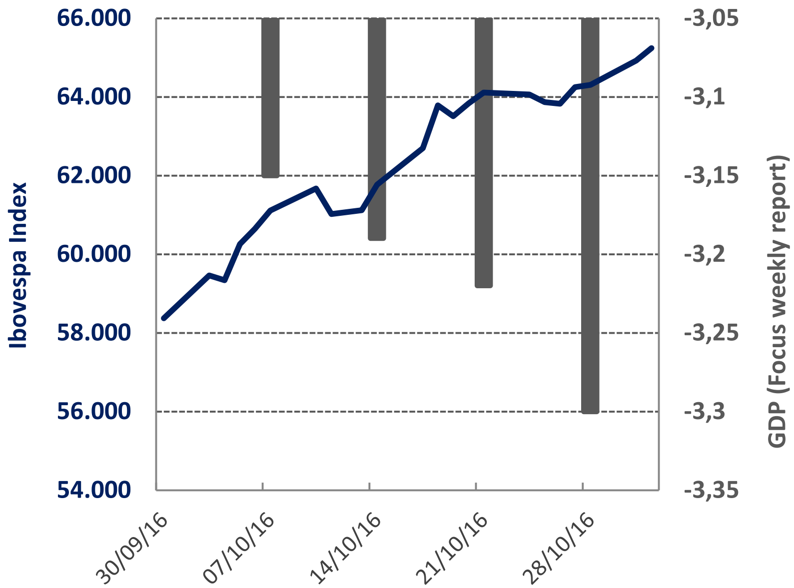
It is a typical case of ends justifying the means. In this topic, the Central Bank has much to improve!

Stock Market

Brazilian GDP Projections by economists in 2016 were in a downward trend throughout the weeks in October. In contrast the Ibovespa has jumped 11.23% in the month and accumulates highs at 49.77% within the year. How to make sense of these figures?

Simple, the local Stock Exchange has risen with investors' inflow. With the change of government and the advancement of measures dealing with the fiscal deficit, Brazil is back in the investors' interest list, especially foreign investors. There was some truce on the fronts of the inflation indices and the first SELIC cuts after a long period.

As GDP figures show, corporate finances referring the third quarter 2016 just released display the effects of recession. Labor market weakened and retreating lending figures contribute to meager economic activity. According to CAGED (employment statistics), 39.3 thousand jobs were closed in September, a figure much worse than most pessimistic market projections – however in line with our projections. According to Central Bank, the total credit created dropped 1.7% in the last 12 months up to September, the lowest rate registered in the times series.



Source: Central Bank of Brazil and BM&FBovespa | Elaboration by: Planner Redwood

However, and intuitively for the medium and long-term, the correlation between an economy-wide representative stock index and the GDP should be positive and strong. But the financial markets are fraught with such things, especially for the short and very short terms: there is some anticipation of movements which, as a rule, are expected to be confirmed. It is the complex simplicity of the phenomenon, one which although is subject to speculative readings (how nice!) must keep some rationale with investors. The continuing flow of investors and their permanence will confirm such tendency. Causality is also very simple: an improvement in confidence indicators (unpressured markets) lead to investments (stocks react first, long-term investments soon after), which in its turn will take the economy forward. It becomes a virtuous cycle, wherein expectations tweak "prices" and these have the power to move *quantum* (physical production)… but it has to be *for real*… one must do the homework or else transmission channels to activity will be impaired.

These are the times we face, when the benefit of the doubt is ahead of us and we must deliver (especially to foreign investors – because they bring inflow) what is expected of us. Unpopular measures will be taken, but of structural character and the permanent outcome – that is, long-term. That way we can all witness, perhaps sooner than expected, the convergence between stocks and the GDP.

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