Planner Redwood Asset Management

MONTHLY COMMENTARY

SEPTEMBER 2015

Monthly Commentary / SEPTEMBER 2015

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.

“There are two problems in my life. The political ones are insoluble and the economic ones are incomprehensible.”

by *Alexander Frederick Douglas-Home – Ex-United Kingdon Prime Minister*

Introduction

Little by little the Federal Government has succumbed entirely to the rising pressure. And it is not all!

The Ministerial Reform and the nomination of the new ministers have entailed the final act of capitulation of government lost beyond hope amid its political and economic troubles. Its extreme fragility and desperation has rendered the governmental decision-making process a big trading desk, wherein the currency used in exchange for political nominations seeks to avert all obstacles, especially those linked to the necessary stabilization of government finances. Silly mistake, the simple-minded political view held by the Government and its supporting party seems to have irreparably doomed them both … there are so many clumsy moves with nefarious economic and political implications, up to a point the recovering the main managing tool seems beyond reach: confidence has faded away!

However, as traditionally believed in Brazil, *all* is possible in the realm of politics and hope is the one to die last, this “surrender” seems to have been the (only) possible way out in order to adjust what only politics can help us to achieve (with this government) in the current economic landscape. The main issue with political fractioning is that the President, in practice, will no longer be in charge, which therefore puts an upward check on its already debilitated credibility, thereby turning the orthodox economic adjustment yet more costly. Indeed, economic policy implemented (it reads Minister Levy´s mindset) has been crumbling down for the last three months “aided” by the other members of the economic team; besides, it does not reflect the true DNA and the “logical structure” of the Roussef’s first term agenda. In truth, it is practically a rape in the eyes of the beholder. At last, just like with Sir Alec Douglas, there seems to be no solution for the situation looks politically insoluble and economically, incomprehensible. There seems to be no way out.

On the international front, China is still the most potentially dangerous aspect, to the point of being mentioned in the FED´s minute. That makes us rethink through not only the direct impacts of a Chinese slowdown upon emerging markets, but above all reconsider the extent of its relevance to the American economy – perhaps a greater relevance than those estimated by the available models that take the FED´s understanding into account. In the political arena, the escalation of tensions and bombings in Syria (which create a chasm between the US and Russia – both desire the end of ISIS, but Russia supports Assad and the US don´t) may become spread beyond the limits of an isolated issue, albeit not for now.

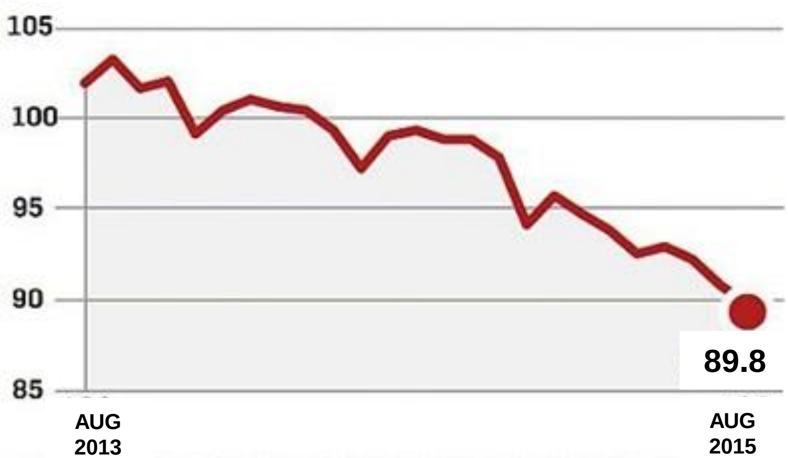
In this vein, whilst facing our domestic troubles and counting on the “good fortune” of still “restrained” external pressures (the FED interest rate hike has not taken hold yet), the Government believes it has bought itself some time, some relief. Unfortunately, it seems the calm that precedes the storm, a perfect one to which we have already made mention in previous reports. The first signs of the end of tranquility will be an eventual replacement of Minister Levy and with the latter will go what remains from an economic policy that can save us from the disaster of the ill-fated New Macroeconomic Agenda upheld in Roussef´s first term.

In this environment, the US Treasuries have closed the month at 2.06%. S&P varied -2,64%, NIKKEI closed at -7,95%, DAX at -5,84% e FTSE at -2,95%. The Ibovespa has ended the month with a -3,36% variation while the IBrX suffered a -3,11% drop. Highs for DIF16 at 14,86% e DIF17 at 16,55%. NTN-B 2050 closed the month at 7,33%, and USD (Ptax) at BRL 3,9729.

Economic Activity

PLUNGING FURTHER

- **Manufacturing Production in Brazil (Average 2012 = 100)**



SOURCE: IBGE

Economic activity is running low and postpones the beginning of a more consistent recovery to 2017. For 2015 market forecasts hover around -3% and ours do not fall far from it, -2.91%.

The ongoing recession has spread to various sectors of the economy, but the chart, on the left, seems a lot more troubling – Brazilian manufacturing produce has plunged between August 2013 and August 2015. Additionally, September data has pointed to no reversion of this trend. In truth, industrial production in August has dropped 1.2% with respect to July and 9% in comparison to August 2014. In a twelve-month stretch, it receded 5.7%. It is not a small drop, especially for a sector that has earned so much “attention” from the government in Roussef´s first term.

The fact is that any initiative is blocked by a self-defeating strategy composed by the combination of a lacking confidence among entrepreneurs, the hole in fiscal accounts, the disconcerting policies for the private sector and for the economic environment at large. It is not a question of what comes first: whether it is the chicken or the egg. Not indeed. Our only solution is the restoration of economic growth via adjustment of fiscal accounts – and that is not to say we are under fiscal dominance. Both monetary and exchange rate policies are still active and fulfill important roles. Fiscal balance reinstates the belief in the country´s solvency and, with it, agents´ confidence and investment recovery. This is how growth resumes and with the latter the government´s revenues, a process in which manufacturing is of utmost importance.

All we need is to beware of proposals and alternatives (ideologically opportunistic and populist) that accompany the amounting political fragility of the Government and which induce us toward the type of macroeconomic policies of Roussef´s first term, the source of all our ongoing problems. One of such proposals is the so-called “Toward a Fair and Democratic Brazil – Change is the way out of the Crisis” (free translation) recently put forth by the Perseu Abramo Foundation (a think-tank that supports the Labor Party – PT) among others. We cannot pull back now!

Fiscal Policy

From time to time the press choses some word or expression and turns it viral it to the point it becomes a fad. It is not hard to find someone to dress it up in some technical argument or associate with studies that provide some sense to the diagnosis: the term of the moment is Fiscal Dominance. It is important indeed and renowned economists have carefully grappled with it (however feeble may be the general agreement around it) with several papers published – including studies on the Brazilian case. Unfortunately, as with almost anything in this realm, the subject has been brought to the fore with haste and rushed statements have already targeted the "phenomenon" – the problem is: let us take a step back and look into it in more detail:

The economic literature has framed the debate between the concepts of "Fiscal Dominance (FD) vs. Monetary Dominance (MD)", which is clearly explicated by Gadelha & Divino (2008), who outline three points of view:

I – The traditional view is presented by Sargent & Wallace (1981) in which the monetary dominance is depicted by a passive fiscal authority aiming at a primary surplus that is compatible with a stable debt-to-GDP ratio; this exempts the monetary authority from forcefully monetizing the public debt, keeping prices under the control by the interplay of supply of and demand for money. Alternatively, the fiscal dominance regime breaks the link between the primary surplus the fiscal authority seeks and a stable debt-to-GDP ratio; as a result, the ensuing passive monetary authority loses control over the price level once it is forced to generate the seignior age revenues required to meet the solvency of government accounts. Inflation is still understood to be a monetary phenomenon, however motivated by fiscal imbalances.

II – The second line is couched on the contributions by Cochrane (2001), Sims (1994) and Woodford (1994, 1995, 2001), by which the Fiscal Theory of the Price Level (FTPL) postulates the role of fiscal policy in determining the price level. In the Ricardian fiscal regime (or Monetary Dominance Regime), primary surpluses are generated to ensure fiscal solvency for any given price level trajectory, which are determined according to the traditional view. On the other hand, the non-Ricardian fiscal regime (the Fiscal Dominance Regime), primary surpluses are randomly sought after, without a strict concern with keeping stable trajectory for the public debt. The price level adjusts to satisfy the present value of the budget constraint.

III – The third view comes from Blanchard (2004) who proposed a structural model supported by empirical evidence on Brazil between 2002 and 2003 wherein a restrictive monetary policy triggers an explosive path to the public debt under a inflation targeting regime. He claims that a rise in the nominal interest rate in response to an inflation hike above the targeted rate had led to an increase not only of the stock of public debt beyond a sustainable level, through the impact of debt servicing, but also a growing probability of default and bloated risk premiums, triggered a capital flight and a depreciation of the BRL, instead of an appreciation.

Therefore, as we can see, statements we read in the news media addressing the subject should not be so incisive and objective as they have been, for each rests on many assumptions, variables and circumstances. In spite of this, what can be made of declarations is that the Central Bank's measures have no longer the desired effect. In other words, under FD regime the Central Bank would be forced to tag along the fiscal authority – Congress, Ministers, etc. It should not go this way!

International Environment

China has gone to the international center stage.

In truth, opinions have been grabbed by the Chinese economy's evolution and FED's monetary policy. On these two matters, several analysis were spawned regarding the possible impacts on economies around the globe.

Measures already ongoing as to the easing of monetary and fiscal policies have not shown to this day to able to revert the deteriorating outlook for the Chinese economy. The last two months have witnessed a contraction of manufacturing, slowing down to 6.4% growth rate in the third quarter with a projected not higher than 6.8% growth in 2015. For next year we forecast a 6.3% - clearly a significant decrease when compared to 2014 (7.3%), although much far from the bleak scenarios in the 3-4% range put forth by various specialized consulting firms, which amounts not to a hard landing prospect but to a downright free fall. Whereas it is not part of our base scenario, it is taken into account in our probabilistic scenario as a plausible yet pessimistic outlook (owing much to considerations by the FED on China in particular). In this sense, consequences are much sharper for emerging markets and for those economies with close commercial ties with China.

There, on the other side of the planet, we have an up-moving American economy with an estimated growth of 2.8% and close to full employment (5% rate of unemployment). The Chairman of the San Francisco FED, John William has reiterated his belief that the FED will raise the interest rate this year, considering the situation in the labor market. He said: "I hope we reach full employment in the near future and inflation will gradually move toward the 2% target"… and amended… "In this context, it will make sense to abandon gradually the extraordinary stimulus we have in place". Yet the low inflation scores is only a transitory situation. In fact, as we have repeatedly claimed here, the only variable (among those "selected" since Ben Bernanke) which has not signaled a consistent move toward its "target" until the end of the year is inflation. Still, some argument can be made when the targeted indicator is a core measure of inflation (energy prices excluded) while headline CPI has moved from 0.2% to 1.8% in the last 12 months.

At any rate, the FED has run out of "excuses" to postpone tapering its monetary policy – and so could be construed from the Janet Yellen speech on the 24th September at the University of Massachussets. We at Redwood continue to believe the FED will begin raising the interest rate at every new meeting. In line with our vision is that of Harvard Economics Professor Martin Feldstein, who claims that the FED sought after an explanation that relied on conditions other than the domestic one in the US: they then "found" China. This argument has been worrying us, but Feldstein presents solid arguments in his most recent piece (The Chinese Economy and FED Policy) where he mentions that in US external balance imports from China add up to only 8%, and American exports to China represent less than 1% of its GDP.

Quite curious! Why then FED? Could it be that the FED is seeing something we are not? It doesn't matter, we go on looking and monitoring.

Interest Rates

We will miss 2008…

It was in that year that Brazil achieved investment grade and was repositioned within the group of emerging economies. However, joy was short-lived. We did not do our homework at the time of the commodity *bonanza* and now we had our image scathed with the downgrade by Standard & Poor's (S&P) in the follow-up of the political crisis we are living in. The triggering event for this outcome was the 2016 budget proposal with a forecast BRL 30-billion primary deficit the Government presented to Congress, something unprecedented and unimaginable until then. We are thus waiting for the next downgrading so we can witness a massive withdrawal of resources from the country. Unfortunately, it will be virtually inevitable, with an immediate and lasting consequence: higher premiums, shorter contract lengths and volatility.

Stop loss orders and circuit breakers - which are common in stock markets - have taken hold in interest and exchange rate markets in September. In interest rate markets volatility was so high that trades were halted due to intense highs and lows. The panic was countered by the joint intervention by the Central Bank and the National Treasury.

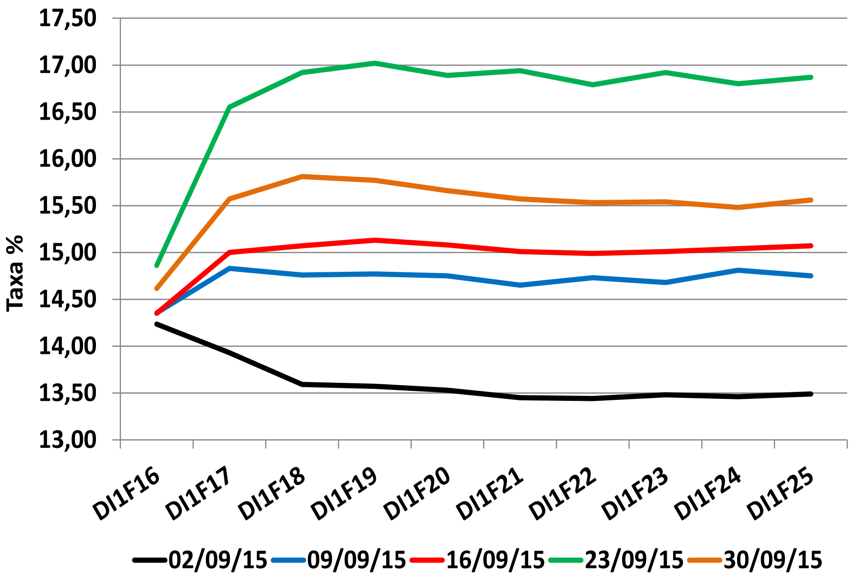
The Central Bank intervened in the exchange rate determination and the Treasury took an active role in fixed-price bond auctions, thus raising the share of the debt stock allotted to adjustable-rate bonds, and even acting as a "market maker" in buying and selling the NTN-F. Fixed-rate bonds were traded at 17% annual rates while the basic interest rate is at 14.25% annual.

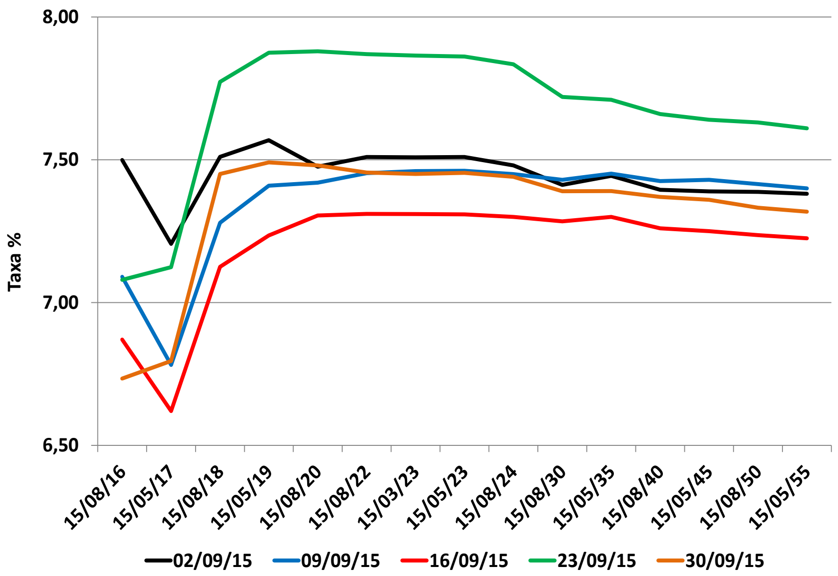
The negative slope of the interest rate curve (noted in the first week of the month) can be construed as inkling of trust in the country's economy, but it ceased to be so, revealing a sharp deterioration of perceptions regarding Brazil. The inverted curve took shape right after the meeting of the Monetary Policy Committee (COPOM) which kept the interest rate at 14.25%. Besides, the successive signs of crumbling economy and the impact of the dollar appreciation on domestic inflation have compromised, even further, the strategy of the Central Bank to keep inflation tamed in 2016 and thenceforth. For an institution skeptic about fiscal dominance, with a time path for anchoring inflationary expectations ahead that does not follow the calendar-year, it would perhaps be more suitable to send a clear-cut signal that it is willing to deploy all of its available tools for monetary containment. If it does not bluff or hesitate when push comes to shove, the market "follows its lead". The Central Bank communication is a powerful "weapon" held by the monetary authority; however, it does not sit well with any indecisive or contradictory behavior.

Selling moments in the month came along the attempts by the Government to avert the fiscal and political crisis. Halfway through the month the government announced a new set of fiscal adjustment measures. Recall that an estimate of 0.7% primary surplus to GDP was proposed for 2016? Well, the government has recanted and recalculated his way to this target. However, it won´t be easy, given that most revenues originate in CPMF which depends on approval by Congress. One more battle between the Executive and Legislative branches is bound to erect, for congressmen and senators have shown to be against the recreation of this contribution. Intentions are good but the execution is hard, above all after the debacle of the deficit-laden budget proposal. What does the Central Bank have to do with it? Isn´t the Central Bank independent? Not so much, and since the fiscal policy seems to move toward the neutrality band (as once claimed the institution´s president Tombini) and there seems to be no fiscal impulse (at least not the expected one), the interest rate policy become overburdened… does it? Rumor has it that monetary policy has lost its thrust, expectations are immune to the institution´s communications and the servicing of public debt is on the rise. As you can see, there is much yet to tackle. Much appreciated, saint Tombini!

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

And the dollar has broken the psychological barrier of the BRL 4.00... appreciation of over 9% in the month, 28% in the quarter and almost 50% in 2015! Is it a maxi-devaluation or what?!

The mouth started with the market players closing their positions, uncertainties about the Minister Levy´s presence in the government and the hike in risk aversion, culminated in the downgrading of Brazil by the S&P. Took them long enough! More on this is yet to come; it is but a matter of time – and a short one at that.

On one hand the news forced the Government, Ministers and Congressmen into speaking the same language; on the other, it has bred greater volatility within the market – of course, the pace, trend and level of deterioration have sped up consistently. In order to counter the overvaluation of the dollar, the Central Bank has begun injecting dollar into the market via auction lines: over 10 interventions were carried out following the downgrading to speculative investment level and, in spite of the bolder foreign currency inflows they were not able to contain the devaluation of the Real. Nor could they, for the "attack" was not solely speculative, but a combination of the latter with confirmation of worsened fundamentals. Such interventions were put forth via exchange rate swap contracts, that is, operations that mimic the sale of dollars in the futures market, and of auction lines, contracts of currency sales (dollar) with a repurchase agreement in a future date. Despite the relief it has brought - momentarily for the market – these operations have been a step back in the gradual process of dismantling of the swap-driven policy the Central Bank has been pushing forward. In fact, the idea of a floating currency demands the whole corpus of the economic policy be in unison and aligned with the original mindset of any Chicago Boy… and this, we do not have. One thing is for sure: this is proving to be an expensive game to the Central Bank!

Foreign reserves that amount to USD 370 million should not be used in situations like these? Perhaps, given that our homework is far from done as a whole (despite the Central Bank best efforts) and that we lack consistency in the exchange rate management… in truth, the answer would be affirmative if our crisis were not of a dominant political nature and confidence-related (with its origins referring to the macroeconomic policies carried out in the last two years).

A myriad of suggestions abound amid this troubling environment, including abandoning the inflation targeting policy and adopting, in its place, a currency floating band – albeit temporarily (see http://blogs.piie.com/realtime/?p=5172). What if both fail? It doesn´t matter, we would resort to capital controls. Really? The Labor Party´s president and President Roussef´s campaign manager must be rejoicing on such idea, for he has stated last year that "*We must contain purely speculative investment, which is done by applying appropriate capital controls*". Again, the vulnerability we got ourselves in subjects us to listen to aberrations of this nature.

Although the American currency has been negotiated above BRL 4.20 throughout the month, it has reached BRL 3.97 at the closing of the quarter. As one can easily note, should the market actually demand dollars, we will need more than USD 370 billion – we will require the help from the FED and the Bundesbank altogether.

Stock Market

One more ill-fated month... the Ibovespa has closed September with a 3.36% drop.

The word of the month in all markets was volatility. Uncertainties regarding politics and the Brazilian economy, expectations of a US interest rate hike and anxiety with the slowdown of China have dominated the market – with direct impacts in the Brazilian stock exchange.

The level of confidence in the country is falling fast. How can one invest in a country with uncontrolled government finances, recession, growing unemployment, an inflation rate barely scraping off the two-digit mark, shaken confidence, amongst several other negative features. What about the capital markets? How long has it been since the last IPO in Bovespa? The most recent one announced (offering by Caixa Seguros) has been postponed due to unsuitable market conditions.

More specifically, in the last trading day of the month, Petrobras was relieved from part of the pressure over its assets and the company´s stock had a great hike with the announcement of price rises of gasoline and diesel. This measure enhances the company´s cash holdings and reduces the chances of it having the government bail it out further down the road. On the other hand, the company´s dollar-denominated debt-stock – as well as other companies in the same situation – will affect the results for the third quarter.

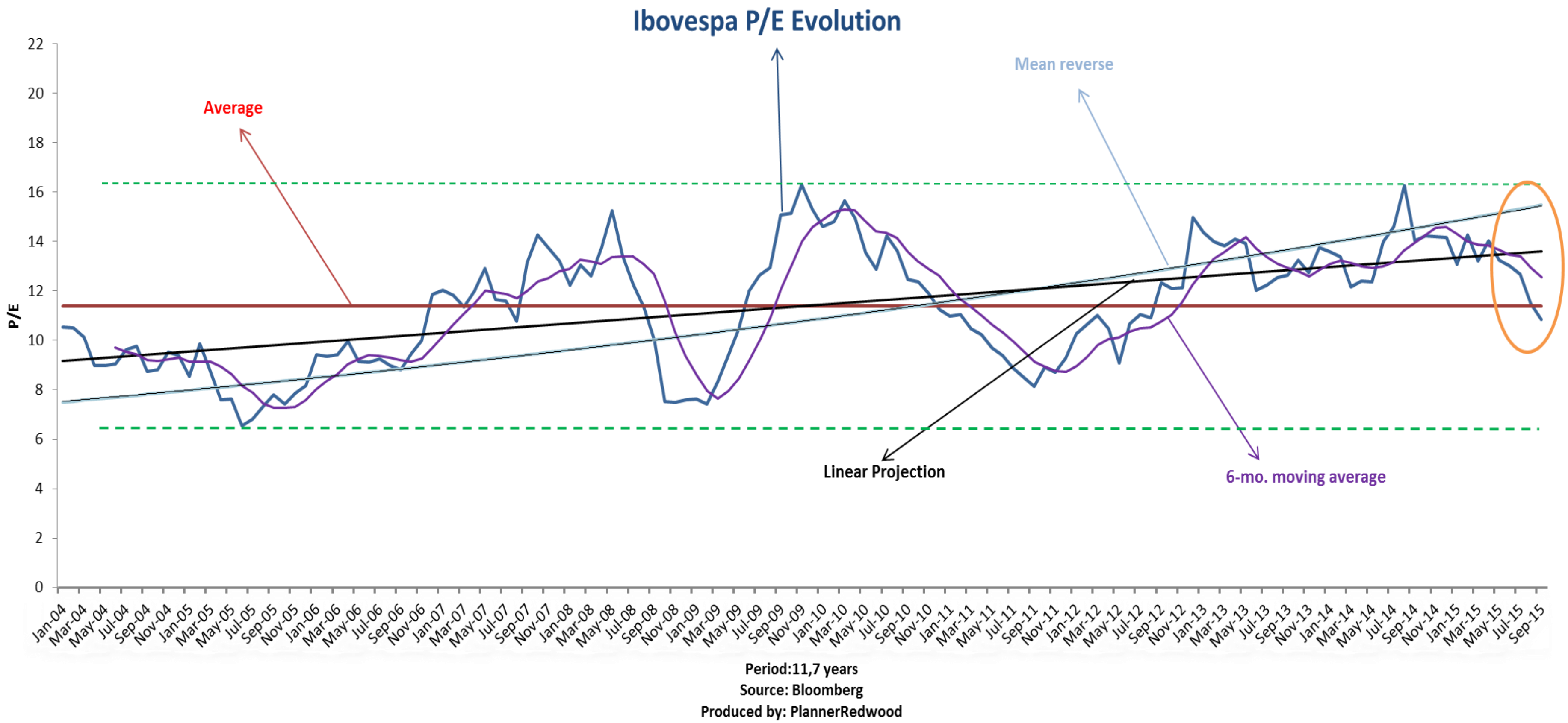
In the external front, as we have already mentioned, China is back in the news and, with it, comes volatility. Weaker indicators of activity show a slowdown of the Chinese economy, which was reflected on prices of iron ore and metallurgy products. The IMF itself has warned that a sharper deceleration of the Asian giant represents a “potential shock” to the worldwide economy and is likely to lead to international contagion. On the positive news side, the FED has signaled that interest rates will probably rise at the end of the year, muddling through the worries of the market… but is it real?

The next two slides below reveal, respectively, two conclusions that can come in very handy in assessing the current situation and the timing for investment decisions. As commonly stated, these charts demand further studies that encompass a greater set of economic variables, both domestic and international, namely:

I – Evolution of the Price/Earnings (P/E) Ratio of Ibovespa: the index reveal the time for investment returns through interest payments. Normally, a lower P/E indicates good opportunities while higher P/E usually means high prices.

II – *Investment Clock* – it depicts generally (normally), which investments would be more suitable in each identifiable economic moment.

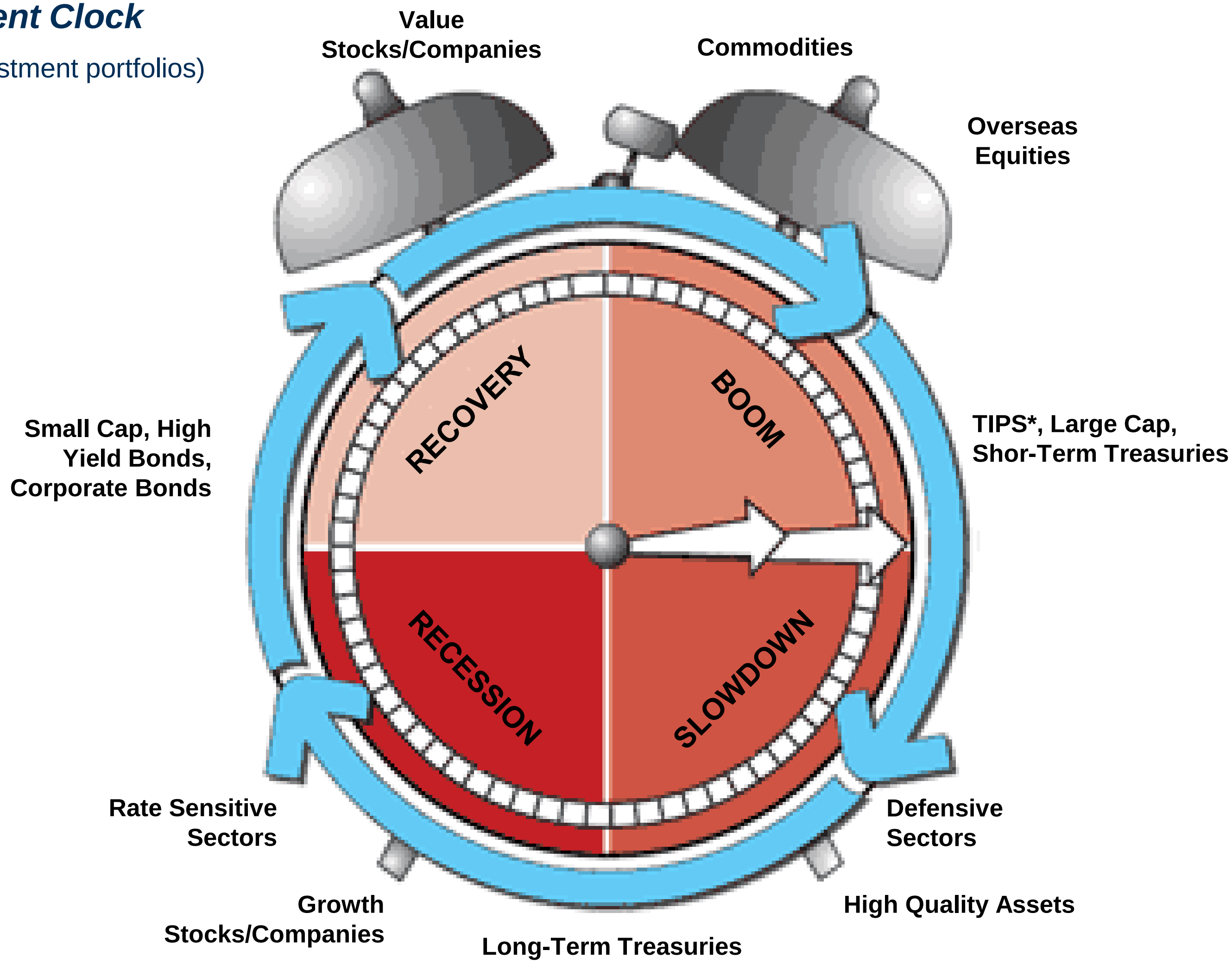
Stock Market



Stock Market

Investment Clock

(global investment portfolios)



***Inflation protected bonds**

OBS: Produced by Planner Redwood, Source Merryl Lynch

Monthly Commentary

SEPTEMBER 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