Planner Redwood Asset Management

MONTHLY COMMENTARY

SEPTEMBER 2016

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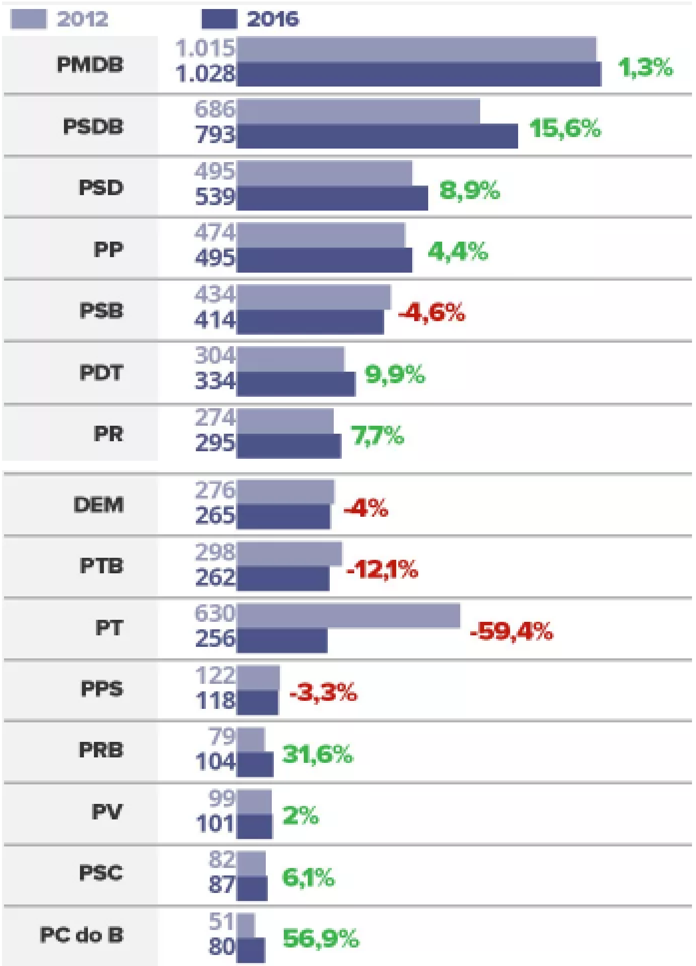
Epigraph of the month... a propos of Brazil’s current predicament.

“Some cause happiness wherever they go; others whenever they go.”

Oscar Wilde – British writer, poet and playwright

Introduction

Party performance at the municipal elections
PMDB won most of cities; PT has shrunk



Source: G1/TSE | Compilation: Planner Redwood

Brazil does not wish more of the same!

Brazil attended to the ballots to elect its mayors and city counselors, and the indisputable outcome (without prejudice, for many cities are yet to face a second round of voting) carries the message that changes made at the federal level mean an outright refusal of the previous *mode* of government. The voice arising from the ballots seems to point to something new, different and far better. The Labour Party (PT) has suffered a sharp loss of clout within the political map in Brazil, much of it due to the impeachment of Rousseff's administration. The causes behind it are numerous, but our focus must lie in its effects and assess what is brings in terms of opportunities.

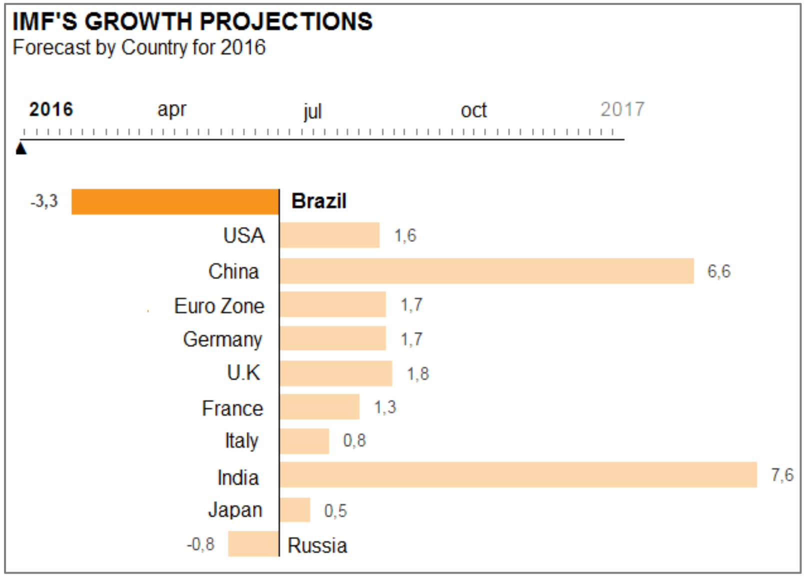
There seems to be no doubt that the ongoing crisis reflected in the voting results: rejection to traditional politicians and, beyond any doubt, the high level of abstentions and nullified votes (25%). Political *status quo* shows evident signs of strain. Beyond the resounding failure of PT, the population is stating out loud: "enough"!

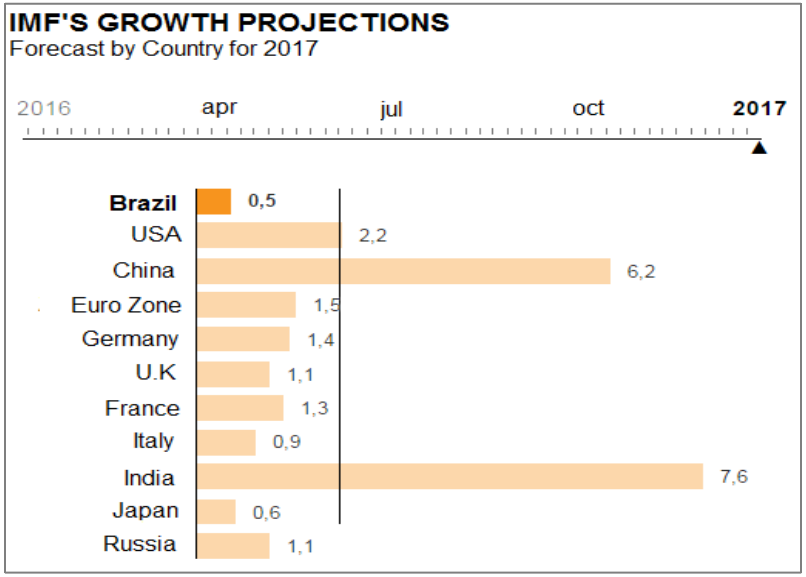
Therefore, the straightforward election of the Mayor in São Paulo in its first round (a non-politician, successful entrepreneur) is a classic example of rejection of traditional politics and a change towards those who know what to do. Roughly comparing, as are the elections in the US and the Trump candidacy. At any rate, Oscar Wilde was spot on: "*Some cause happiness wherever they go; others whenever they go.*" Brazil is already in a new moment and will find a way to adjust so as to seize upcoming opportunities.

In the world at large, center stage is taken by the Syrian crisis, the instability (especially in the banking sector) in Europe and the presidential elections in the US. Not least important, the FED seems to gather information and conviction to deploy, *de facto*, the so-called normalization of its monetary policy… lest it has become its new and true normal.

Against this background, US Treasuries closed the month at 1.608%. S&P varied -0.12%, NIKKEI at -2,59%, DAX at -0.77% and FSTE -3.20%. Ibovespa has closed at 0.80% and the IBrX at 0.60%. Highs of DIF17 at 14.01% and for DIF21 at 12.25%. NTN-B 2050 ended the month in 5.7471% and PTAX (sale) at BRL 3.2462.

Economic Activity





Source: http://www.folha.uol.com.br

The charts above depict the IMF's assessment for the Brazilian GDP and other countries in 2016 and 2017. Despite not having changed its vision significantly as to the country since its last report, the Fund sits apart from the "optimism" in the market and is closer to our scenarios – despite a reversion in trend foreseen by all. For us at Redwood, the economy is still contracting, albeit more slowly. Unemployment will still run high (in 2017 also) and inflation will likely stay above targeted levels in the next year, however clear is its convergence trajectory in a few years. Courage and competence are the requirements at this moment of change, the time has come!

The outlook is as follows: we must keep on improving confidence indicators and, to achieve that, a fiscal adjustment is in order for a relaxation of monetary policy – thereby feeding, dynamically and timely, new investment and therefore the effective restart of economic activity. That under *Coeteris Paribus* condition, obviously.

Fiscal Policy

Congress has been overtaken by debates around the new fiscal regime as stated in the Proposal Constitutional Amendment (PCA) 241/2016 (expenditure cap). And it is called for; the situation has become unbearable.

The proposal sets an upper bound to public expenses, freezing them in real terms, for at least the next 10 years. An alternative to this could have been put in place – such as some control in nominal terms for a shorter length – instating stronger “organizing breaks” in the short run (possibly a hastier adjustment) and a greater flexibility for the medium and longer terms, thereby turning the control guidelines more permanent and feasible. The technical reputation of the new economic team allows for the benefit of the doubt that in its simulations any alternatives would be unfit for the moment. We so believe and hope.

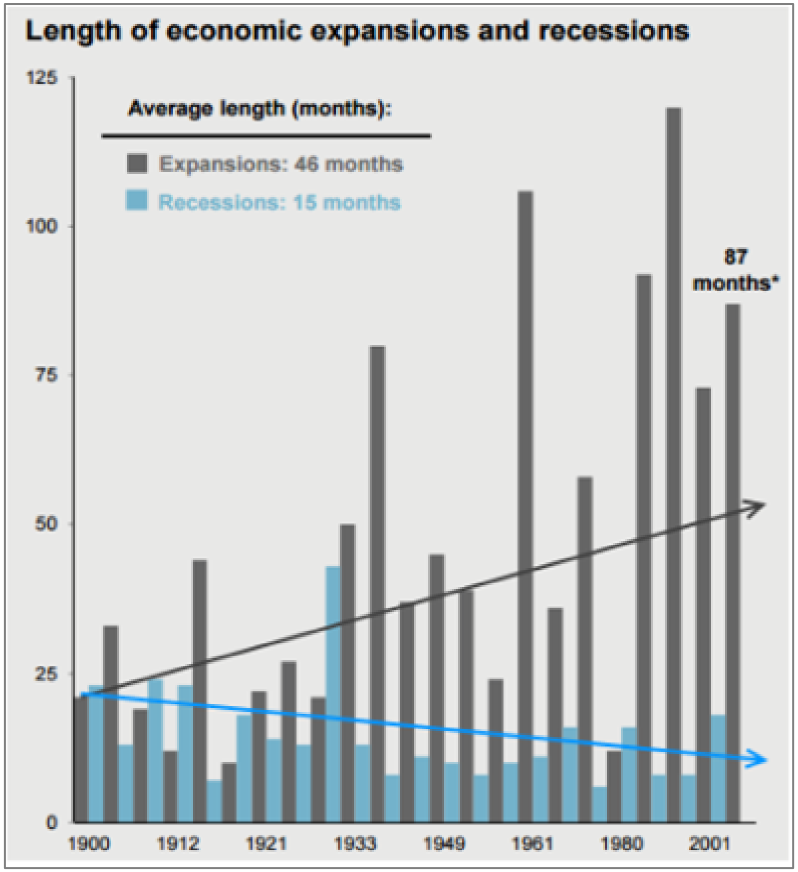
However, neither the government nor the market (more precisely those economists following up on recent developments) are naïve to deem anywhere near sufficient this upper bound to public expenses, for it isn’t. It is but a necessary stage, but nowhere enough to achieve balanced public finances and the stability of debt-to-GDP ratio. Auxiliary measures, as a matter of urgency, must be carried out, such as Social Security, which accounts for an expressive share of primary government outlays. The truth is, as we have reflexively pointed out here, that Brazil should find a way to muster a budget surplus around 3% of GDP, when in fact we have a 2.5% deficit.

Therefore, achieving a fiscal balance and contain a growing debt, we must restore revenues. The components of this equations are as follows: expense cut-downs (PCA 241 and other reforms) and the revival of economic activity. This latter, fundamentally, free of “keynesian” artifices. It is not expected either that the government resorts to (“the easy way out of”) raising taxes, under the premises and intuitive perspective of the Laffer Curve.

One can only hope for, in truth, for a reversion of the trajectory displayed by the Public Debt to cast aside the specter of insolvency of the Brazilian state. An austere fiscal policy is the departing point to any lasting solution to Brazil’s economic troubles. It is but a starting point to tackle and rebuild – many other unpopular measures (in the short run, at least) shall be taken as well.

This context of deep economic mess requires understanding and engagement by all: Government, civil society and especially a consensus among partisan leaderships in Congress, so as to pass strategic legislation. It is not about unmaking “social conquests”, quite the contrary, it is about trying to maintain and improve conditions for the medium and long terms.

International Environment



Source: www.pragcap.com

The theory of "secular stagnation" is gaining terrain among economist worldwide and, thereby feeding debates and informing policy decision, especially in developed countries. For obvious reasons, such as dwindling growth and its consequences and the wish to avert this tendency, many measures have been taken under the assumption that this theory holds.

However, the chart displays a different and challenging perspective, in a lengthier and somewhat distinct scope. However frustrating, the data show that expansions have been more lasting than periods of recessions. In other words, we have been through more good than bad times. Of course, we must check whether the net accumulated results lean in favor of expansions. The study subscribes to the latter, but trends indicate some reversion toward the long run average growth rate (2% annually since 1700s) in contrast with 3% or 4% annually (end of 1800s and 1900s)… under this secular take we are under an ongoing "*secular boom*"! Besides, with expansion periods outlasting those of contractions, analysis seems to suggest that the economy is becoming ever more stable, that is, with less volatility. Thus, adjusting for risk, it is possible to conceive of a better situation… hard to see, huh?! We let out of our analysis any count of inequality, "arbitrage" among countries, "asymmetric" globalization, etc.

It is a most interesting theory, however thin when it comes to portray the international outlook. Meanwhile, the FED is about to raise interest rates (is it?), the ECB is ever more out of policy alternatives (beyond BREXIT, now an imminent banking crisis), the Chinese government with its unending interventions and Japan recycling (in varying intensities) its economic measures.

As one can easily see, we live in a time of intellectual stagnation!

Interest Rates

The political component invariably (at least in the short run) sensitizes the interest curve dominated this past month. Those who expected a more tranquil month with the instatement of the new administration had to review its expectations, for politics remained under the spotlight, featuring as one of the uncertainties hindering the restoration of the Brazilian economy. It was a busy month due to the investigations on the Lava Jato probe: (i) the launching of the Greenfield operation looking into gigantic mismanagement of State-owned pension funds, (ii) the operation X Files involving the former finance minister Guido Mantega and the OSX company, (iii) acceptance by Judge Sergio Moro (in charge of the probe) of charges brought up by the General Attorney's Office that turned former president Lula a defendant and, at last, (iv) the Omertà operation which indicted former finance minister Palocci as suspect of having received bribes from Odebrecht. As it sits, the closing of this operation is far from sight and there is no way to mitigate the risk that the probe will touch members of the new administration, thereby hurting the necessary reforms – and with it the reflexes in macroeconomic variables.

On the economic side itself, inflation (IPCA) has decelerated 0.44% as to the previous month, however accumulating 8.97% in 12 months against 8.74% in the previous measurement. Despite this, the Quarterly Inflation Report (RTI) released at the end of the month has brought more positive projections to the IPCA in 2017 and 2018, thus triggering alert sirens in the market as to the possibilities of interest rate cuts (SELIC) already in the October meeting. Figures are still far from targets (4.5%), but nowadays, the Central Bank enjoys more credibility to initiate cut-downs due to its commitment and ability to deliver an inflation rate closer to target in 2017 – at least this is how the market has understood and so has the interest curve. We at Redwood also believe this to a certain extent, but for us cuts should only come in November and December. This begs the question: will the Central Bank consider *the whole picture* or only the part covered by its mandate?

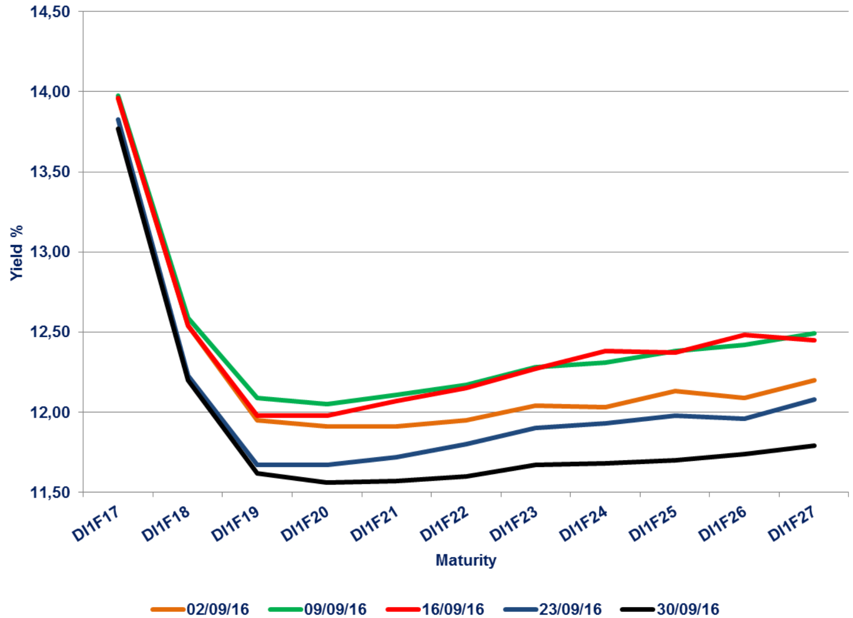
On the external front, the FED was the great villain responsible for the domestic interest rate curve volatility. The divergence of opinions among its board members as to the timing of hikes reflected on the local curve. At each statement backing the hike in the next meeting the local premiums would rise, following the opposite whenever statements had a more dovish tone. At the September meeting, the dovish line won over and US interest rates remained locked at the same levels.

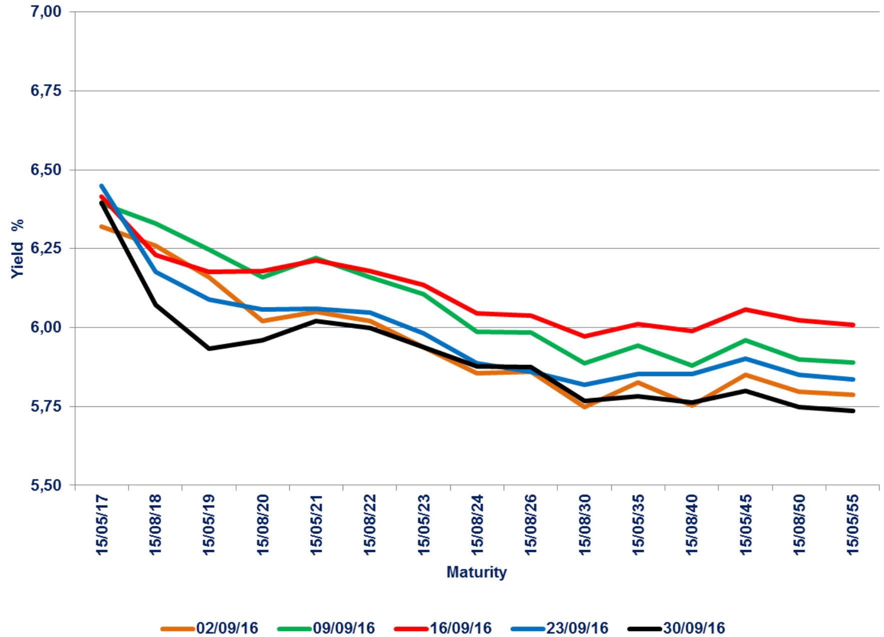
Overall in the month, there was lower risk premium in the forward interest curve along all vertices. A phenomenon possibly explained by the correction of excessive pessimism that infected investors in previous months, adding to the maintenance of both the US interest rate and government-sponsored stimulus around the world and, on the inside, once more, the Inflation Report has given great impulse to lowering the interest rate.

The Central Bank has recovered much of its credibility. The effects of Monetary Policy take some months to reach full course, so that it may be more prudent to postpone the reduction of interest rate until a full inspection of the *whole* picture is at hand, which will allow for a more robust, even if more gradual, time path of further cuts. It is not worth to jeopardize its greatest asset.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

The relief of tension with the FED, after the decision to maintain interest rates at the September meeting, has allowed for a lower volatility in the exchange markets. The USD has closed the month being quoted at BRL 3.2462, with a 0.18% increase.

Throughout the month, the American currency reached BRL 3.36 with the possibility of lower domestic interest rates and higher ones in the US, that is, a less attractive interest rate differential for the currency inflow to the country. The reaction by the Central Bank was to shorten the supply of reverse exchange rate swaps from 10 thousand to 5 thousand daily contracts, thus keeping this volume throughout the month, aiming to avoid further pressure on the dollar. Another factor pressuring the latter was the recurring worry about political risk in Brazil, much owing to State-level financial troubles leading to state governors demanding further financial support from the Federal Government.

In this line, the Central Bank has indicated that conditions to its interventions in the currency markets are “undergoing changes”. According to the institution’s chairman, Ilan Goldfajn, the room for reducing the stock of exchange rate swaps is narrowing, notably if the FED decides to raise interest rates. The board intends to lower this stock, but without infusing further pressure on the currency… this is how we have read their attitudes, although in our opinion it would be much better (and still is!) to move forward with the reverse exchange rate swaps and do way as soon as possible with the remaining stock of it.

The Central Bank’s parsimony regarding exchange rate policy is understandable at this moment, but it is always fruitful to keep in mind the necessity of realignment and the definitive interruption of this yearning mixed with a pretense of knowledge (and ability) to control the level and volatility of exchange rates without its disastrous consequences. The major guideline of the new team at the Central Bank is that of a floating rate, and they should not succumb to temptation, even under greater distress, to reinstate greater “control” (however provisory). As far as the Central Bank’s ability goes, we must indeed structure, maintain and enhance a final regime of a free-floating currency.

A volatile currency does not encourage investors, but its volatility should not be corrected by interventions (inconsistent and misaligned) in the marketplace or, yet, by capital controls – even in its indirect format. Before that, rules must be set clearly for whatever may come, so we can have a more “open” economy with more comfortable reserves (as we have today) so as to protect ourselves from attacks by opportunists and conmen. A clearly defined regime. Obviously, an exchange rate policy is part of a whole, of an internally coherent economic policy, one which is being reestablished at this moment.

Let’s stay alert!

Stock Market

Even under a heightened risk aversion, at the end of the month, which characterized the main stock markets around the globe following abrasive news on Deustche Bank's predicament, the Ibovespa has closed September with a 0.80% high. Throughout the month, the market had twice closed above 60.000 points, but realized profits and closed the month around 58.000 points.

The untouched US interest rate added to higher chances of a cut in the SELIC in October, as seen by the market, which boosted the local exchange. The movement toward lower rates could amount to important signaling by the Central Bank so that foreign investors reconsider opportunities in Brazil, and the credit markets are back to normal and so entrepreneurs rethink their plans regarding lay-offs, production and investments. An extra impulse toward enhancing trust, an essential ingredient for restoring activity and, as a consequence, inspire some reaction by the real side of the economy.

Just like in other markets, the contradictory statements by the FED board members fomented volatility in the stock markets. The price of oil barrels also influenced stock markets around the globe. Early in the month, an apparent deceleration of demand for the commodity led plunging prices. As a response, the members of the OPEC came to an agreement to cut back production for the first time in eight years. The deal however will only be effective in the next meeting, scheduled for the end of November. Despite the drop in oil prices, Petrobras has closed the month with a positive return on its shares, as a result of a business plan for the 2017-2021 period, with an investment cut and a plan to lower its leverage levels.

As much expected by the market, the government has announced a package of infrastructure consortiums with the public sector, however vague as regards the projects themselves. The announcement did not detail the financing structure, the system of warranties, nor minutia of each project. This information is available in the documents setting the rules for submission, which will be open to foreign companies. Good start. Nonetheless, one shall not forget: investors know their math and always consider price, cost and risk in their analyses.

However, the country accumulates, up to June, six semesters of falling GDP and the third quarter shall not be any different. The cycle of adjustment in the real sector has yet to be completed and there is also the restrictive effect of a tight monetary policy, whilst the world economy slows down, which takes a toll at the country's economic dynamics.

In the absence of direct and positive impact on the real economy, all of the above has negative effects on companies and therefore on the Ibovespa which can not provide improved perspectives for companies and their share prices; all of this leads to a fairly priced Ibovespa at around 60.000 points, at least so far.

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