PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - NOVEMBER 2018

planner Redwood

Agenda

- Introduction
- Economic Outlook
- Fiscal Policy
- International Outlook
- Interest Rates
- Foreign Exchange
- Stock Market

ANBIMA

This Institution has adhered to ANBIMA's Regulation and Best Practices Code for Investment Funds.

planner Redwood

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

"One of the great mistakes is to judge policies and programs by their intentions rather than theirs results"

Milton Friedman – American Economist.

Introduction

January 1st 2019 is coming, but the best part of the party is in waiting for it!

The transition team is in full-power mode, and the best definition we can give, especially for the economic side is: exiting Unicamp and entering the stage, the University of Chicago! The mindset is completely different, truthfully, from everything we have ever seen in Brazil. The dominance of conservative ideas, the reestablishment of order, the fight against the State hypertrophy and the incessant search to privilege merit and competence to the detriment of *quid pro quo*, has been the mark in these early days of transition and nominations of the cabinet.

This is our new normal. Moreover, the Super-cabinet begins to structure their teams with absolute autonomy and in tune with the whole. The importance of this form of action is fundamental for Brazil, as we will no longer have dependence, at least in the medium and long term, of one or another cabinet member. Obviously, the realignment of actions, policies and programs, depends a lot on the "mentors" of each department, but once the structure is reestablished, with a new direction and a cohesive team, the trajectory becomes easier to follow and our vulnerabilities to such direction and conduct of policies are toned down.

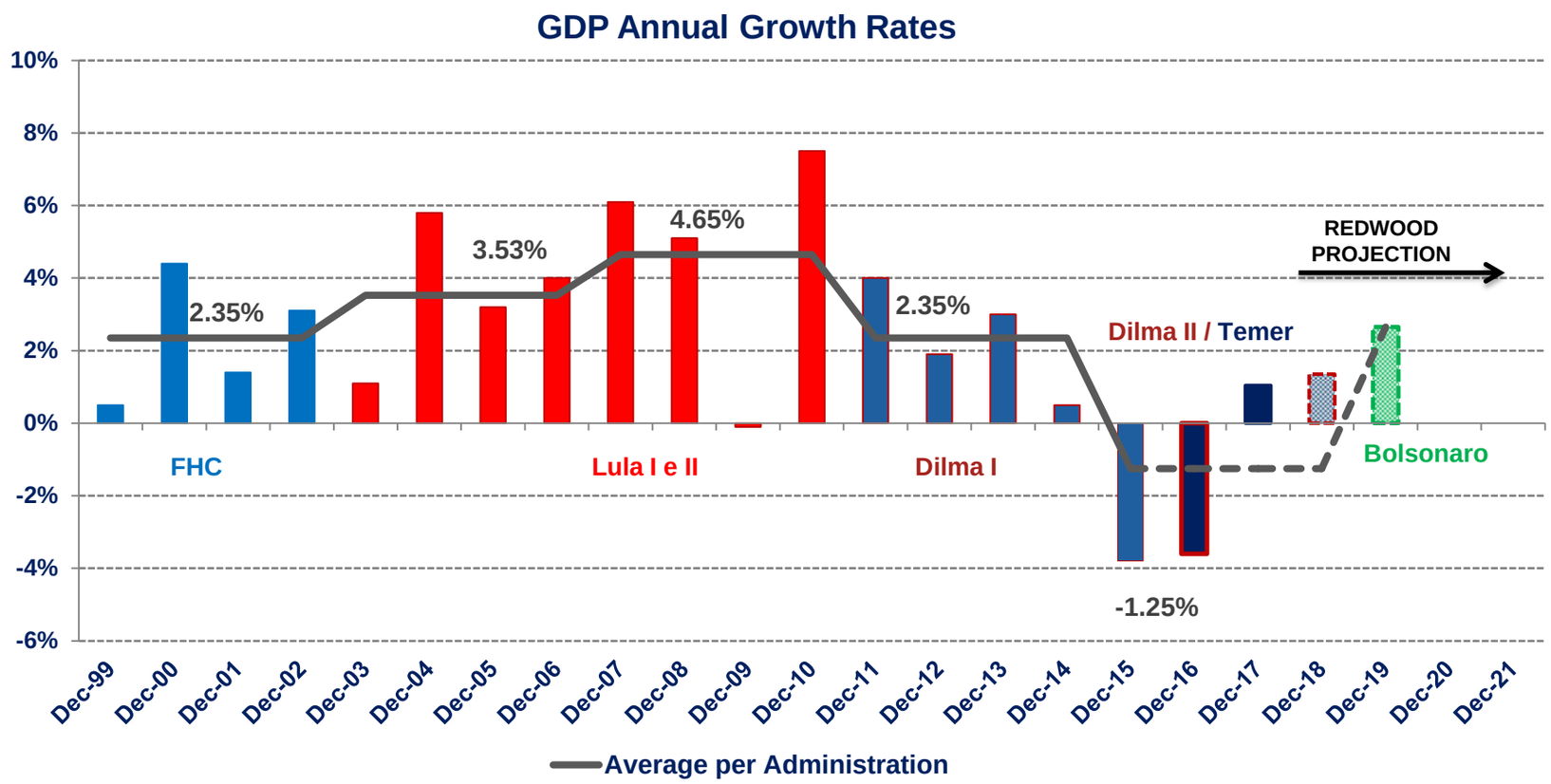
A significant risk mitigation tool can be translated into establishing, therefore, the ordering of ideas and campaign proposals with competent professionals that can follow the government program. Investors, risk rating agencies and markets as a whole look at and evaluate this. The moment requires recovering the confidence indexes, which are the basis for everything else. The return of confidence will, along with the first actions, be the driving force for economic recovery.

The formation of the new government has some peculiarities, and these are not subtle. Besides the reduction of the State size, which is not expected to be timid, the soon-to-be administration is composed of several members with military background. Military personnel of the highest technical abilities and adjusted to their future functions, but who, as a rule, carry in their curricula the characteristic of seriousness and incorruptibility. Nothing is fairer and more consistent with the promises of the campaign, and that will once again break paradigms that the military is authoritarian and less democratic. In this line, the much awaited "disruptiveness" on several dimensions within the country's life (we repeat, always within legal bounds), no one better than the military to compose this new team. If the economic field will face a strong right turn, in other segments society also believes in radical changes. Hope is back and, certain that we can not "erase" or disregard the actions taken and gains we have made in recent years, we expect a lot of seriousness and commitment from the new team not only during the short transition period to listen to respectable citizens but also over the next few years as contributors. We need effectiveness. Hence the quote that opens this Commentary by the economist Milton Friedman of the University of Chicago translates well the moment we live: *"One of the great mistakes is to judge policies and programs by their intentions rather than their results".*

Overseas, November saw as escalation of October difficulties and "opened" other fronts. International agencies have recanted their calculations and are now expecting smaller world growth than previously projected. The confusions in Europe are everywhere, namely Italy with its strained finances, France amid very strong demonstrations and the United Kingdom with its endless discussions about the BREXIT. Still on the old continent, the recent crisis between Russia and Ukraine could lead to an escalation with larger military interventions and ensuing significant impacts to the region. In China, concerns are focused on the growth of its economy and are trying to circumvent the "trade war" with the United States. In that line, hopes are falling on the G-20 meeting in Buenos Aires/Argentina, where all efforts will be launched in search for a "favorable" outcome. In the US, rumors of possible markets and a downturn in the US economy are growing. In this environment, this line of reasoning has encouraged a more dovish position by the Fed in relation to the recent expectations of monetary tightening for next year. All of this is very uncertain, for the indicators in fact do not yet support as much. The US Midterm Elections did not bring a bad result for the current government, but it did withhold much comfort for its future management.

In this environment, US Treasuries closed the month at 2.9879%. S&P varied 1.79%, NIKKEI closed at 1.96%, DAX at -1.66% and FTSE 100 UK -2.07%. The Ibovespa ended the month at 89,504 points (2.38%) and the IBrX at 36,968 points (2.66%). Monthly highs for DIF19 at 6.428% and DIF21 at 8.20%. The NTN-B 2050 ended the month at 5.0836%, and the Dollar (Ptax) at BRL 3.8633.

Economic Outlook



Source: IBGE and Redwood Projection | Elaborated by Planner Redwood

This is the performance of economic activity in Brazil in the last almost two decades. Painful. However, far worse than the observed low average growth is the stop-and-go that discourages entrepreneurs and drives us away from a solid and sustainable long-term growth.

Even if we were to grow around the average for the period, which was very close to our potential at around 3% per year, it would be better without the bumps encountered along the way because it would foster long-term planning and would have given us stability to promote growth-enhancing policies rather than super-packs and marginal adjustments. We must not rely on recovery spurts, much less localized ones, due to the exceptional growth of one sector or another, as verified during this period. It is true that at some times the external scenario hits us, at others climatic events do (as more sensitive to farming), and sometimes our internal factors are responsible for disturbances, as in manufacturing (except the extractive one) and services, the latter being widely responsible for employment.

Finally, the analysis of GDP figures suggests a recovery. The quality and consistency of this recovery is that we care more. With the new government of Captain Bolsonaro (with several military officers in his team) there are those who bet on reviving our economic miracle period of the 1970s, but this is definitely not the route to take, not even the current economic team seems to want it that way. Everything is different nowadays: our problems, needs and prospects, except for the exact notion that growth, albeit lower but constant and balanced, brings innumerable benefits.

One step at a time we will get very far!

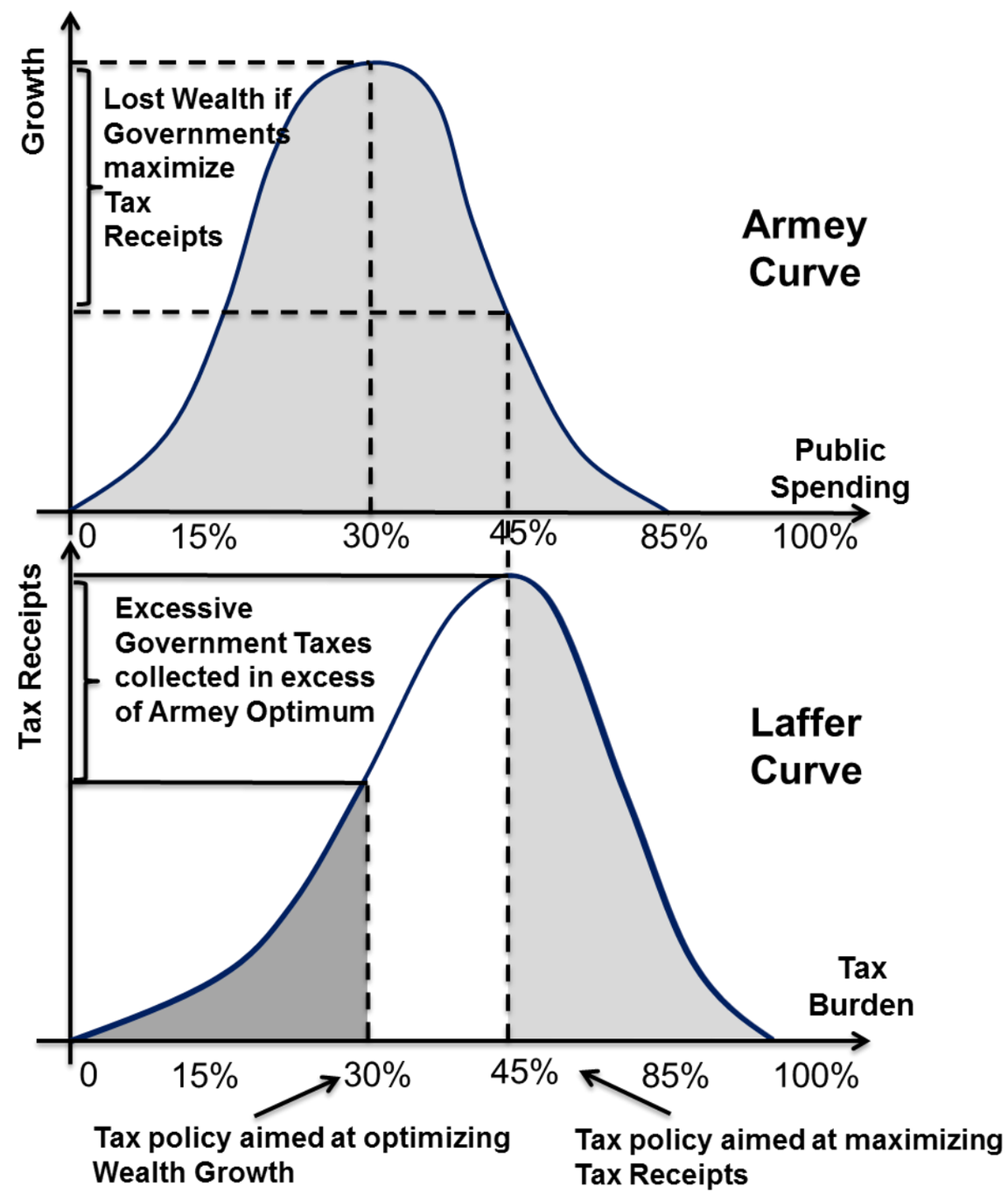
Fiscal Policy

As we approach the end of the year, and especially on the eve of a new government where hopes are renewed, we are faced with the inevitable predictions and expectations of every sort - government finances would be no different. Here, in this case, the news is not promising, especially if we move away from the so-called essential reforms. The National Treasury (STN) itself has admitted for some time that the sustainability of our public finances is, rather, precarious. It also admits that the route of growth of the public debt is uprising, surpassing the critical level of the 80% of GDP with a likely reversion only in 2022.

The prediction and honest observation above are part of no less than the current Secretary of the Treasury - Mansueto Almeida, who, faced with his technical quality and commitment to the truth, was invited to remain in the next government. His lucid and reasoned assessment can best be understood in the book[1] organized by Mansueto himself and Felipe Salto, where, with great objectivity, they teach the interactions of the components and the dynamics of debt. In other words, it demonstrates how the variables Real GDP growth, real interest rate, debt size as a share of GDP and the primary fiscal surplus will guide us on the path of debt or, more directly, on its sustainability or not. Although almost intuitive, they speak with authority ... so their projections are reliable, and for this very reason they must be taken very seriously, notably by our Congresspersons and society as a whole. Reforms are strictly unpopular and equally fundamental. Anything outside this script means an explosive trajectory to the public debt.

Contributing to this emergency framework of reforms and other complementary actions is a nefarious combination of possible more challenging external and internal scenarios, where the response to heightened revenue from economic activity may be delayed. In this context, we underline our analyzes that combine the Laffer curve with the Armey curve.

❖ ***The Armey curve postulates that there is a quadratic relationship between an area of government spending and its economic activity (growth).***



[1] Finanças Públicas – Da contabilidade criativa ao resgate da credibilidade. Introdução – páginas 15-25

International Outlook

Many important players are becoming increasingly pessimistic. There is a dark wave of expectations that the world will grow less and the US will suffer a sharp decline in the markets.

We are not (yet) buying this assessment, no. In fact, our forecasts of world output growth have always been less optimistic than the market, excluding the US. It is true that in many parts of the world markets have underperformed, economies are falling short of expectations (except the US) and economic policy obstacles prevail in many countries.

Thus, with some assurance that much can change in the coming months, this most pessimistic scenario, especially for the US, does not seem credible to us. The information available does not indicate, especially when compared to previous recessions, an impending turnaround. Notwithstanding the analysis and the importance of China in the likely downturn and the geopolitical conflicts in Europe, in addition to others, some variables stand out when the cycles' peaks are reached. One of them is aggregate consumption, which usually decelerates in these cases, and is not what the evidence says regarding the major developed markets. There is also stable employment growth (in the US, 250,000 jobs were created in November) and mild inflation.

A fairly widespread indicator, the P/E Forward, clarifies the situation a bit. With all the caveats that the case requires when it comes to projections and comparisons with historical data and their relevance, we envisage a 11x trading figure for emerging markets, when compared to their long-term average of 13x. For EURO Zone shares, something like 13x against an average of 14x and, although in the USA everything seems very expensive, the Projected P/E is at 16x, very close to its average of 15.6x. In other words, it is not anywhere near cheap.

In this line of reasoning, these figures corroborate the pessimistic analysis that the Federal Reserve - FED will have a posture of strong monetary tightening from 2019. Could it be so? If so, how strong? Will it be enough to shake up the economies around the planet? It may be, but it is rather hard to say. Our projections are aligned with estimates resulting from the famous Taylor Rule: the Fed rate will likely be at 3.75% by the end of 2019. It is much higher than the "near zero" interest rate seen in recent years, but far from their peaks reached when difficulties arose in the past. The US is far from it, quite the opposite. Therefore, the Fed's actions will be important in determining the future scenarios... but, as we know, the Fed is "always" lagged with respect to the market. Let's wait a little longer.

In Europe, the UK Prime Minister has not managed to reach a consensus on the BREXIT text and one more cabinet member leaves the government - now they amount to seven, and time is running out. The European Union divorce has a deadline of 29 March 2019, and a departure without agreement will cause a rupture with commercial consequences and even implications on transit of British citizens in continental Europe. In France, the movement called "revolt of the yellow vests" stirs up Macron's country and asks for his resignation. What was initially a single tariff, the rise in fuel prices, now evolves into a much larger scope. Bottom-line: it seems to be a repudiation of Emmanuel Macron's reform agenda... it is difficult for France to accept a right-leaning president. In the economic field, according to Eurostat, the Producers Price Index (PPI) for the EURO Zone rose by 0.8% in October and 4.9% year-on-year, above expectations. Unemployment and inflation do not seem to have changed much and ECB maintains its stance on policy and expectations anchored.

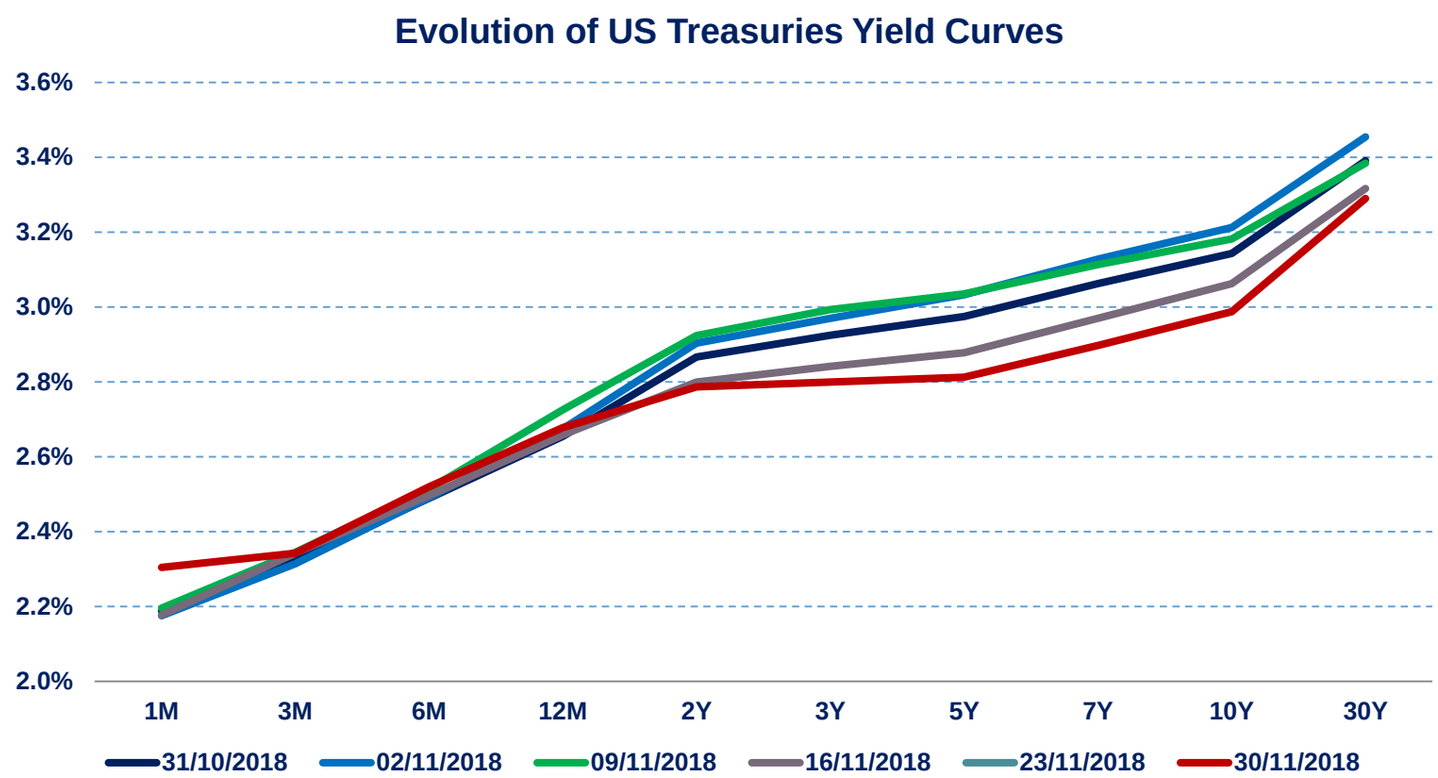
China, through its PBoC, went back to "trading" in the markets, injecting USD 58.4 billion into the financial system in November through a medium-term financial instrument to maintain liquidity in the banking sector. It also injected USD 2.1 billion more permanently through a short-term monetary loan and extended USD 3.69 billion of additional credit via loans. It is but a typical effort to get around their economic problems. There is no way this will end well.

Finally, the humanitarian crisis facing the Venezuelan people may have found some relief for 2019. The UN has an assistance plan aimed primarily at medical aid and food, as no quick solution to the problem is expected. The UN will now look to financial donors for the plan.

Interest Rates

Among players in developed markets, the hypothesis that a new crisis will fall on the US economy has gained more traction. The first symptoms for such a diagnosis would be some weakness in expected economic growth and the escalation ("taking to the next level", in colloquial language) of the Trade War with China. Correct or not, we could already observe its reflection in the fall by the treasuries of longer maturity and in the profit realization on the part of the investors before with position bought in the stock market. In the predictive line of an imminent setback in the American economy, markets and pundits expect an eventual narrowing of the long-short rate differential, which has not yet been verified, as shown in the chart on the side.

By reading such an external environment for financial markets, it is clear that the widespread uncertainty environment could and should directly affect liquidity in emerging markets where we are inexorably included. With regard to the interest rate market, we had a consistent month of decline along the yield curve. The DI 20 had a monthly decrease of 2.786%, closing at 6.98%. The DI 21 ended the month quoted at 7.92%, reflecting a decrease of 2.583%. At the long maturity, the DI 25 recorded a fall of 2.843% reaching a level of 9.57%.



Source: Bloomberg | Elaborated by Planner Redwood

Much of this movement is explained by new figures released, which confirm the take that monetary fundamentals continue to trend well, which reads, anchored inflation and lower prospects for interest increases for next year. Although there were some (few) oscillations, largely explained by the "buzz" that followed the assembly of the government team and its consequent focus, this market niche was highlighted by the resilience to the pressures during the month with the net outflow of direct investment.

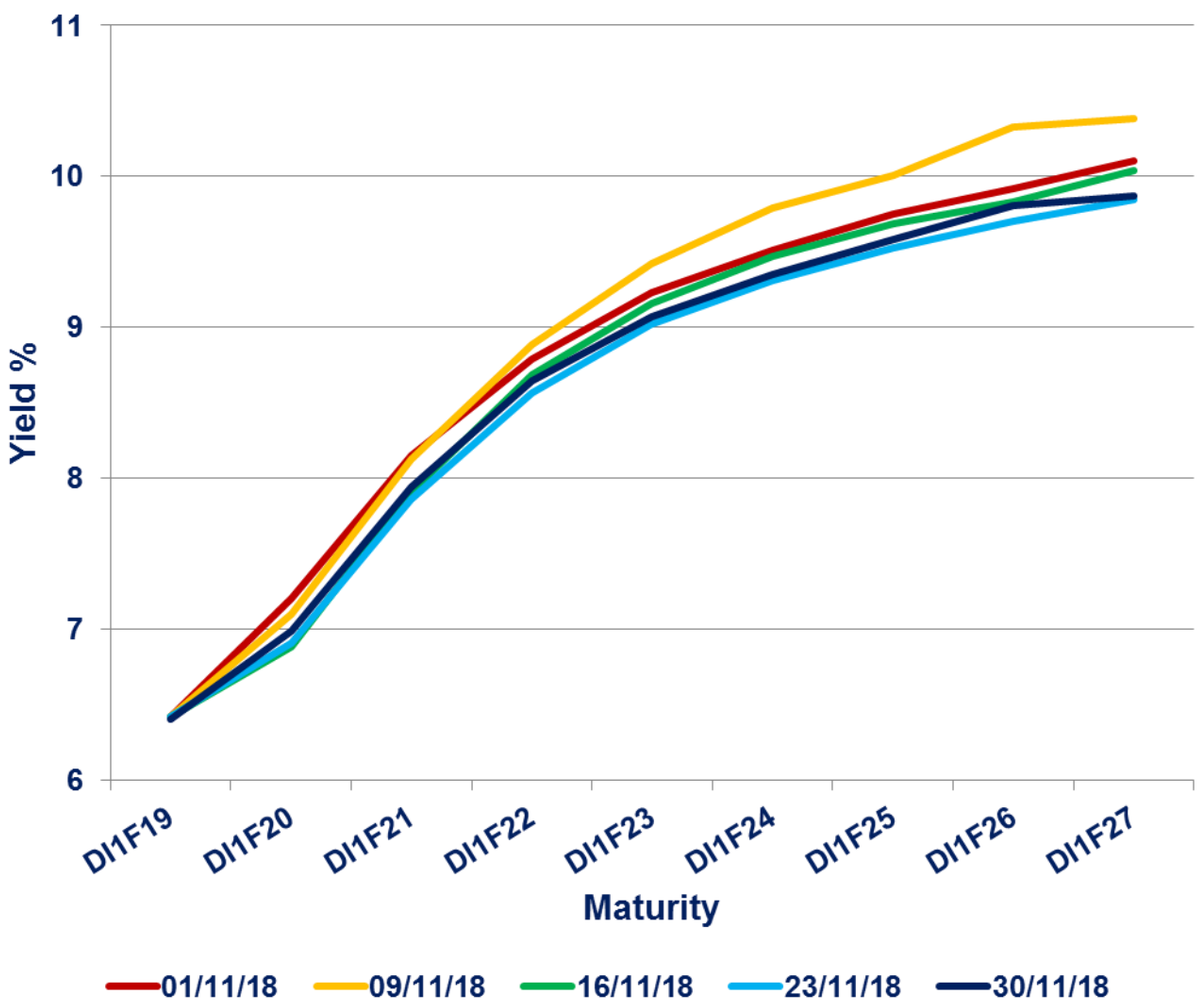
With the possible slowdown in US monetary policy (a special focus on the Fed's announcement to the market at this last meeting of the year), the positive outlook for Foreign Direct Investments (IDPs) in the coming period may gain momentum, since the agents (rational as they are in the face of sound monetary policy communication) are bound to anticipate portfolio rebalancing considering the weaker risk-free rate by the end of 2019.

We at Redwood are skeptical about the possibility of a US crisis in the short term, and so we stick to our expectation of four more increases in the Fed Funds in 2019. International interest rate parity will prevail, and one way or another, in higher or lower degree, we will have a convergence. Until then, capital flows will generate interesting short-term gain opportunities for those enjoying a correct reading of the new scenario we are facing.

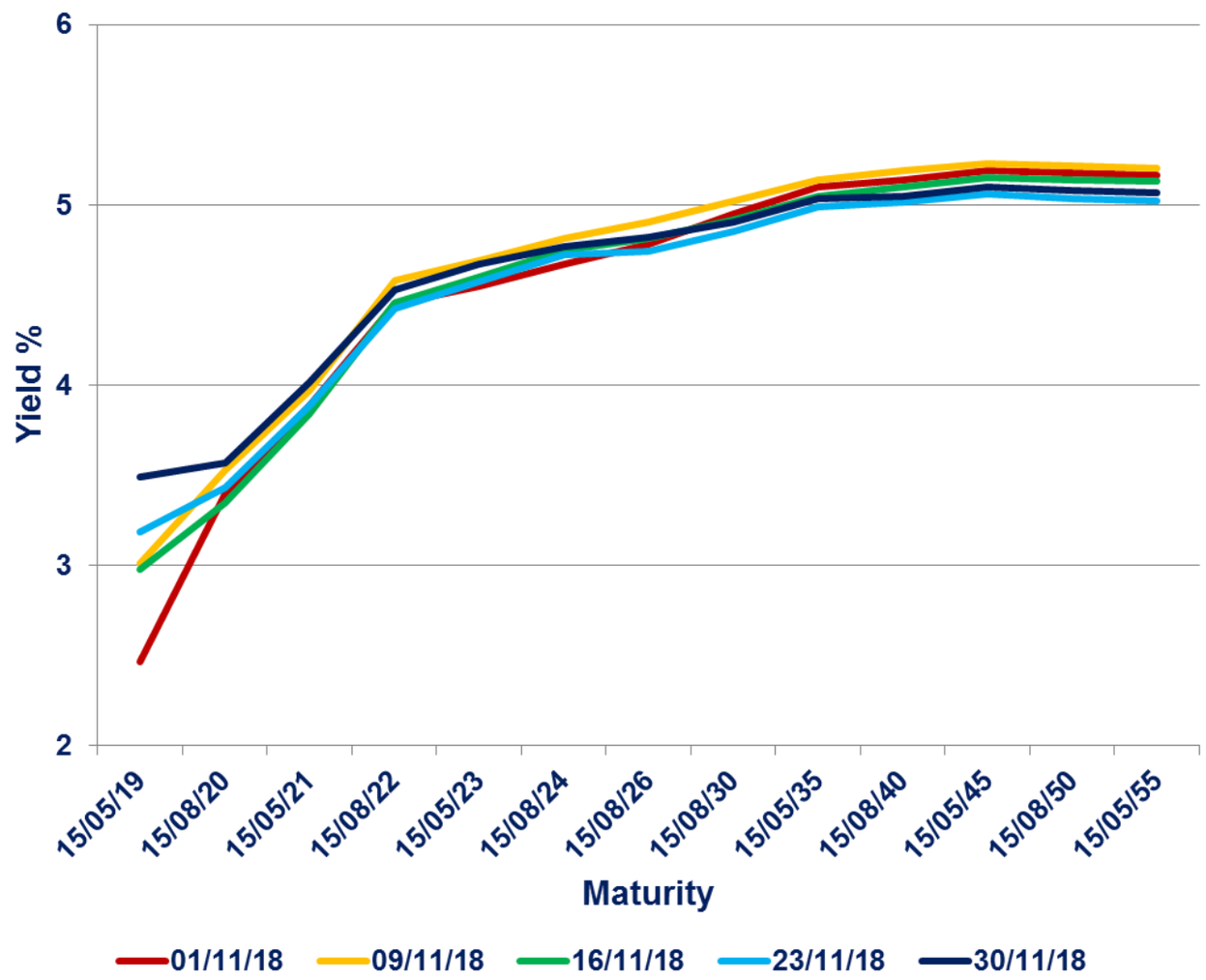
In addition, we cannot fail to praise, when due: Our Monetary Policy is doing very well!

Weekly Interest Rates

Yield Curve Diagram



NTN-B Diagram

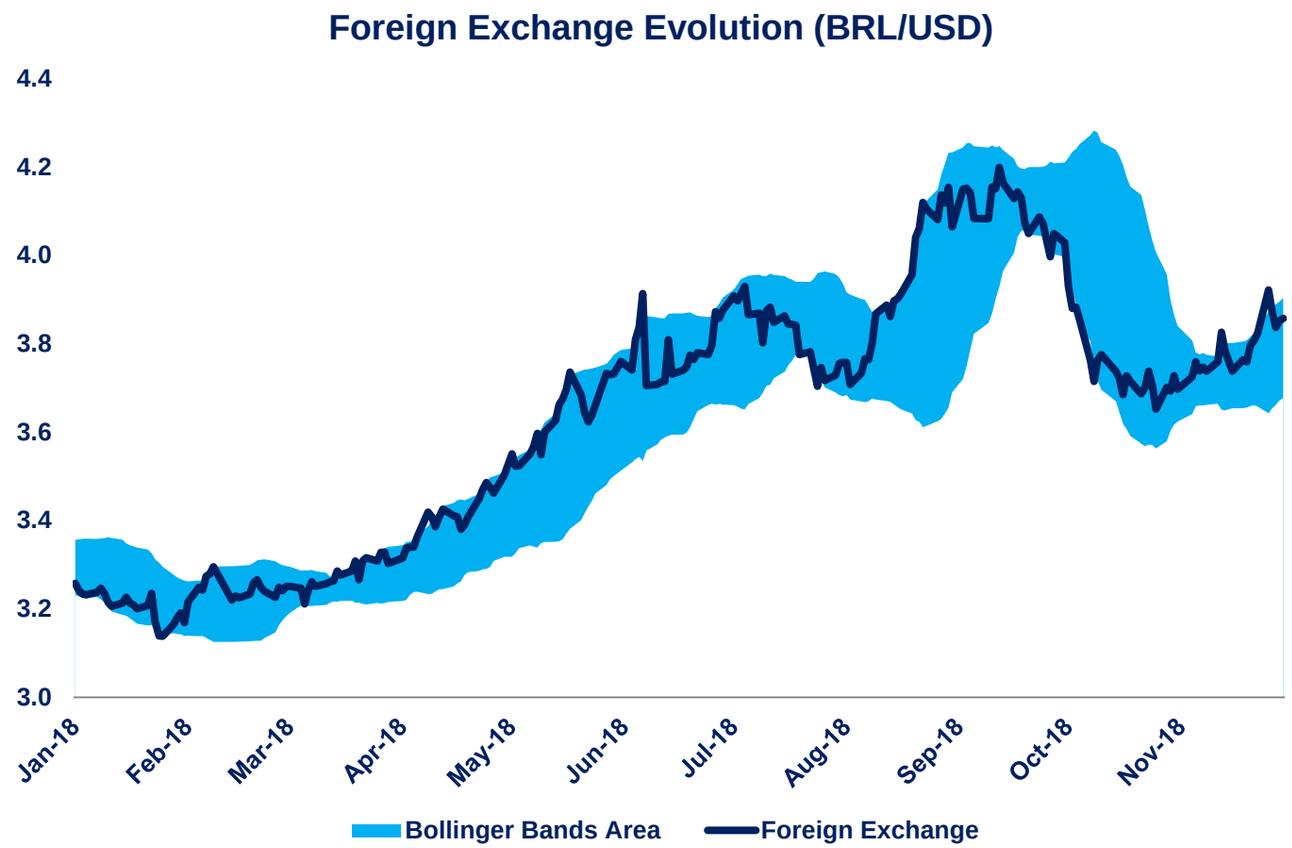


Source: Broadcast | Elaborated by Planner Redwood

Foreign Exchange

External pressures on the exchange rate in an international landscape that is increasingly approaching its turning points had a strong impact on the variation of the Real (and other emerging currencies) against the US Dollar throughout November. And this scenario of uncertainties is thickened when placed against the domestic backdrop. Although the electoral process ended last month, there is still some uncertainty over, among other factors, the way in which Brazil will assert itself in a world marked by an escalating Trade War, the upcoming conclusion of BREXIT, uncertainties in trade relations between EU and MERCOSUR, among others. We can only be sure that more heterodox lines of domestic and foreign economic policy were finally left behind. That certainly plays in our favor.

The exchange rate is always a challenge for economists, whether in assessing its trajectory or in the proper interpretation of their volatility and resulting impacts. Tracking the past (short or long) is easy, but basing on it one's inference of the future (short or long) is something to avoid. Thus, having registered at the closing of the last Ptax sale at BRL 3.8633 and, thus, accumulated devaluation of more than 3.92%, the Brazilian exchange rate has once again revealed that its determination is much more linked, at least at this time, to the dynamics of US interest rates than by sensitivity to changes in the domestic scenario, however beneficial they may be in terms of long-term expectation. With absolute intellectual honesty, this is the best explanation.



Source: Broadcast | Elaborated by Planner Redwood

However, not everything in the garden is rosy when we talk about changes. The Dollar's climb at the end of the month (when quotes went from BRL 3.738 on the 16th to BRL 3.922 on the 26th of November) has made our Central Bank, always so proactive in matters of exchange rate policy, strongly enter into line auctions with repurchase commitments amounting to USD 3 billion. The monetary authority also informed the market that he intends to roll over the traditional foreign exchange swap contracts that will mature in January 2019, adding up to around USD 10 billion. And it is in this sense that the phrase that opens our commentary fits so well. Controlling volatility and liquidity to provide stability in the business environment is a noble reason, one must agree. However, the great error of this strategy is precisely to guide its continuity based on its good intentions (of which hell itself is full of, as the popular saying teaches us), instead of its results, which until now are ineffective with its proposal at the expense of a significant fiscal impact.

As for the direction of the exchange rate by the end of 2018, we cannot ignore the natural pressure inherent in the remittances of profits and dividends abroad to balance the books. However, with the stabilization of the country risk and greater definitions regarding the political issues, we may have the quotes of the USD approaching somewhere around BRL 3.63 by the end of the year.

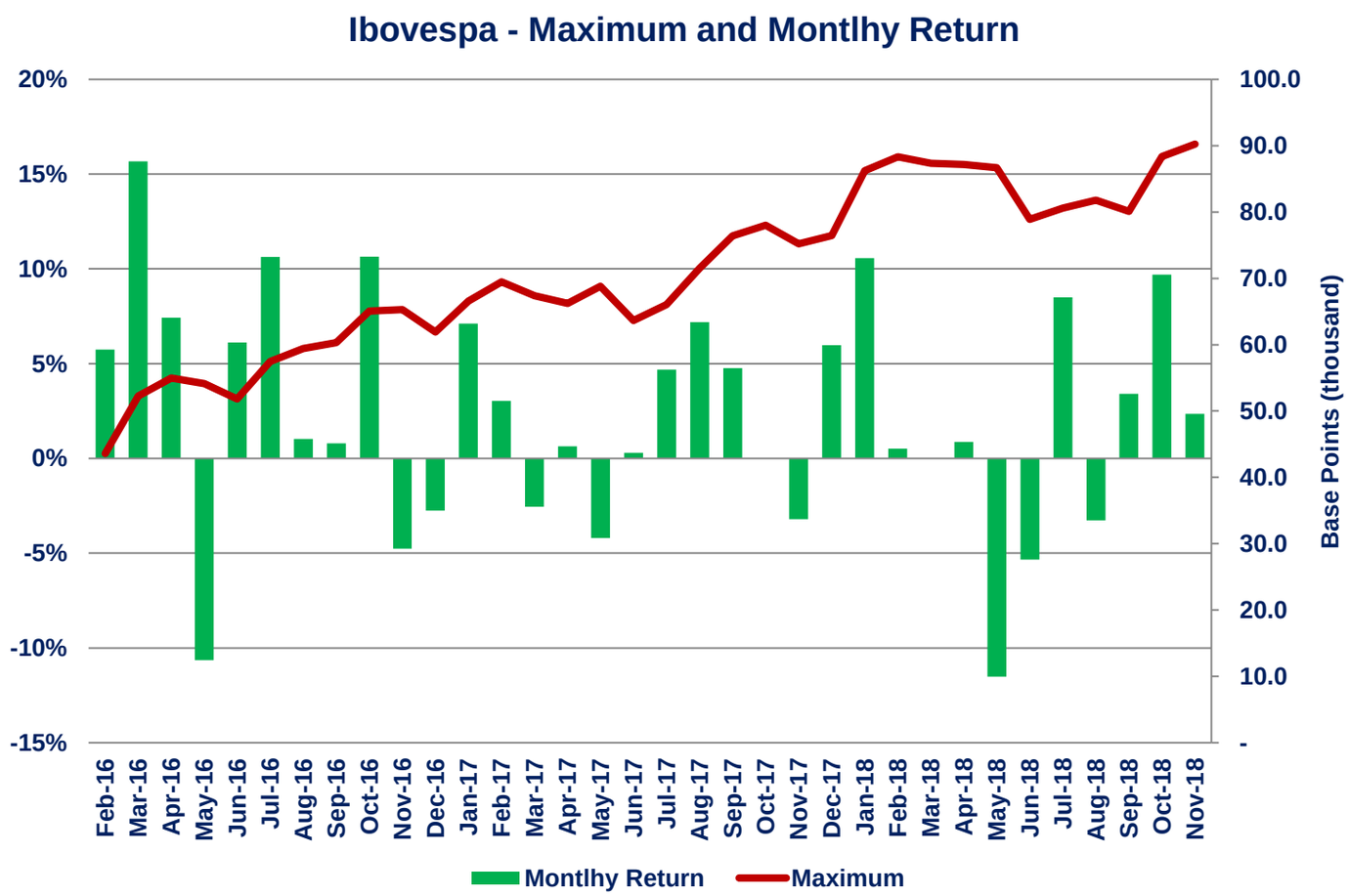
Acknowledging one's limitations and lack of dominance, in the face of absolute reality of facts, would be a great tool for the Foreign Exchange Policy.

Stock Market

The Ibovespa closed the month of November registering a rise of 2.38%, ending the month at 89,504 points raising the accumulated return within the year from 14.43% to 17.15%. The daily average traded financial volume was BRL 13.3 billion. Some outstanding shares in terms of profitability were NATU3 (25.53%), CPLE6 (23.90%), SMLS33 (18.66%), CCRO3 (18.41%) and GOLL4 (17.39%). The distinctive result of the cosmetics company's shares is based on the sound Q3 results, which reinforced the recovery movement of this industrial giant that has experienced turbulent years recently, but which is moving towards reestablishing its prominent role among the main Brazilian companies.

The negative surprise was due to Cielo (CIEL3 registered a 27.88% decrease in the month), which has been suffering from what is already known among specialists as the "war of the debit card terminals", which has weakened the company's revenues a company that has been among the investors' favorite blueships.

In its third consecutive monthly high, the Bovespa index witnessed a rise in the prices of 68.75% of the shares that make up its portfolio. Although B3's main stock index presents criteria of sectoral diversification that can be questioned, this is a good sign that the recovery of the real sector can begin in a reasonably disseminated way. Good for Brazil and for portfolio diversification! In the midst of this momentum of the Brazilian stock markets, the historical highs were renewed again, with quotes reaching 90,245 points.



Source: Broadcast | Elaborated by Planner Redwood

The potency behind this spurt came mainly from the local level, with domestic investors taking aggressive positions to greater extents than is necessary to contain the potential fall linked to net capital outflows throughout November. The climate of optimism disseminated widely with Bolsonaro's rise to the presidency. The Chicagoan reforms are expected to reduce Brazil's Country Risk, infuse greater dynamism into the bureaucracy and promote a more favorable business environment, which add up to the ideal mix for a consistent recovery of private investment.

If this positive scenario plays out, although the P/E ratio still points to an unfavorable relationship when we analyze from the risk-return perspective, good opportunities for investment will continue to surface, and we can see the Ibovespa rising toward the 100,000 point-mark within a short period. This is a very welcoming horizon to be born out of the transformation of good intentions into expressive results.

Additionally, and not least, if the Ibovespa has hit its all-time high this month, the same cannot be said about the USD-denominated Ibovespa... and with foreigners accounting for approximately 50% of the volume and under a more benign scenario here, it will not be surprising if the stock market significantly comes to improve.

DISCLAIMER

This material has been prepared by Planner Redwood Asset Management Administração de Recursos LTDA. (Redwood) and is for information purposes only and does not constitute a recommendation for investment, offer or solicitation of an offer to acquire securities or any financial instrument. The information, opinions, estimates and projections refer to the present date and may contain information about future events and these projections / estimates are subject to risks and uncertainties related to factors that exceed our ability to control or estimate accurately, such as market competitive environment, fluctuations of currency value and inflation, changes in regulatory and governmental entities, a well as other aspects that may differ materially from those projected without prior notice. The information herein contained is based on the best available information collected from public, official or credible sources, which we believe to be reliable and of good faith. However, they have not been independently verified and, neither express nor implied warrant is given as regards their accuracy. We are not responsible for any omissions or errors, and even as we have taken all precautions to ensure that the information contained herein is not false or misleading, Redwood is not responsible for its accuracy or completeness. The opinions expressed solely reflect our opinions at the moment. We reserve the right at any time to buy or sell such securities. These projections and estimates should not be construed as a guarantee of future performance. Redwood undertakes no obligation to publish any revisions or update such projections and estimates in light of events or circumstances that may occur after the date of this document. This material is provided for the exclusive use of its recipients and its contents may not be reproduced, redistributed, published or copied in any form, in whole or in part, without the express permission of Redwood.

planner Redwood

Avenida Brigadeiro Faria Lima, 3900 – 10º andar

São Paulo – SP. CEP 04538-132

+55 11 2172 2600

www.planner.com.br

redwood@planner.com.br