PLANNER REDWOOD ASSET MANAGEMENT

MONTHLY COMMENTARY - DECEMBER 2018

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- Economic Outlook
- Fiscal Policy
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Epigraph of the month... a propos of Brazil's current predicament.

"Independence or Death!"

D. Pedro I, while proclaiming the independence of Brazil, on September 7, 1822.

Introduction

The time has come for tidying up the house, for a sharp overhaul in the Brazilian public administration!

After years of turmoil and uproar in all segments of our society that resulted in the greatest crisis ever experienced by Brazil - economic, moral and ethical - we are now facing a unique opportunity to reverse this evil domain that has taken over the country, especially in the last 14 years. Yes, Brazilian society has clearly stated “enough!” by electing Jair Bolsonaro to untie Brazil from the backwardness and ideological domination of the executive-legislative coalition model, which has perpetuated deep-seated problems that must be summarily tackled.

It is in this sense that Jair Bolsonaro as Chief of Executive Power, in a presidential regime like ours, is the faithful custodian of the hopes of the Brazilian people. The role of the President at this time is of fundamental importance given his ability to reformulate the national agenda. The support of the other branches of government, acting in harmony with Executive, will lead to optimal results, should the Executive break the inertia and propose new directions.

In this sense, even in the first acts of his administration, "disruptive" measures, paradigm breaks, and strong signs of change are expected. Only in this way will the new Commander-in-Chief make a remarkable administration, implementing fundamental measures to rebuild Brazil with courage and public spirit, with the effective collaboration of the other branches and support of public opinion. Apart from confronting the economic disaster that beset us with colossal unemployment, eroded public finances and deteriorated exterior image, it is still necessary to contain the uninhibited action of organized crime and to show an unswerving commitment to democratic values.

It is not an easy task. As the Americans say, "freedom is not free," and the rigging of the state was something very strong and well structured. Our "freedom" will not easily be retrieved, and those who have led the country to this point - and taken great advantage of the situation - are always on the lookout. However, the window of opportunity to make happen hardly lasts long, and in the first 100 days the new administration must have shown what it is all about. Jair Bolsonaro seems to understand this well, since his cabinet formation reduced the number of departments and the indications were not politically-driven in exchange for each party’s future support in the Congress: a clear measure of disruption to the status quo, of independence. In fact, this is all we need and at any cost... so nothing more pertinent than the phrase of D. Pedro I that opens this Commentary for this moment: *"Independence or Death!"*.

Overseas, the month of December was not marked by any improvement, quite the contrary. In fact, there is a growing perception in markets that global growth is actually slowing and financial conditions are tight. This perception seems to be driven by the assessment that the Chinese economy presents increasing difficulties. CEOs have seen China's growing weakness, which relies heavily on trade amid fights with the US, and now an important signposting of its Manufacturing PMI retreating more than expected and losing support by 50 points (the limit that separates expansion of activity and contraction). In Europe, the year 2018 ends without a final word on BREXIT, which adds uncertainty to the possible contamination of this event in the rest of the Old Continent. In the US, the Trump government will enter the second week of shutdown with no plan to reverse the situation so far - Donald Trump does not shy away from the desire to have the USD 5.6bn to build the border wall with Mexico. In fact, this is just another emblematic problem challenging the American president, among many others inside and outside the US during 2018. Not surprisingly, especially for someone who promised a "new normal" and who has a demeanor so "peculiar" and sometimes incomprehensible. However, facts trump arguments: the US economy is doing very well with very low rates of unemployment, inflation duly on target and robust growth, since the effects of the fiscal stimulus should last for a long time to come. Lesson to be learnt.

In this environment, US Treasuries closed the month at 2.6842%. S&P varied -9.18%, NIKKEI closed at -10.45%, DAX at -6.20% and FTSE 100 UK -3.61%. The Ibovespa ended the month at 87,887 points (-1.81%) and the IBrX at 36,491 points (-1.29%). Monthly highs for DIF19 at 6.41% and DIF21 at 7.99%. The NTN-B 2050 ended the month at 4.97%, and the Dollar (Ptax) at BRL 3.8748.

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Economic Outlook

GDP	QTR rate of growth (on previous years's equivalent quarter)			Quarterly rate of growth (on previous quarter)			Accumulated within-year growth rate		
	1 QTR 2018	2 QTR 2018	3 QTR 2018	1 QTR 2018	2 QTR 2018	3 QTR 2018	1 QTR 2018	2 QTR 2018	3 QTR 2018
GDP	1.20	0.90	1.30	0.10	0.20	0.80	1.20	1.10	1.10
Agriculture	-3.00	0.30	2.50	1.30	0.00	0.70	-3.00	-1.40	-0.30
Manufacturing	1.20	0.80	0.80	0.10	-0.60	0.40	1.20	1.00	0.90
Construction	-4.20	-2.70	-1.00	-0.40	-0.80	0.70	-4.20	-3.50	-2.60
Services	1.80	1.10	1.20	0.10	0.30	0.50	1.80	1.40	1.40
Retail	4.80	2.00	1.60	0.10	-0.30	1.10	4.80	3.40	2.80
Real Estate	2.80	3.00	3.20	0.40	1.20	1.00	2.80	2.90	3.00
Household Consumption	2.90	1.80	1.40	0.40	0.10	0.60	2.90	2.40	2.00
Government Consumption	0.70	-0.30	0.30	-0.30	0.50	0.30	0.70	0.20	0.30
GFCF	2.60	3.00	7.80	0.30	-1.80	6.60	2.60	2.80	4.50
Exports	5.30	-2.90	2.60	1.80	-5.50	6.70	5.30	1.00	1.50
Imports	7.80	6.50	13.50	0.80	-2.10	10.20	7.80	7.10	9.40

Projection	
3 QTR 2018	Redwood
1.30	1.34

Source: IBGE | Elaborated by Planner Redwood

The year 2018 comes to an end and economic activity in Brazil will be very different from the one we projected at the beginning of the year - performance will be around 1.34%. Several factors have led to this frustration, such as the truckers' strike, the structural imbalance in public finances, and the failure to advance the measures required to remove restrictions on investment and increase overall productivity of the economy. However, some advances were important, such as the microeconomic agenda, the strategy of restricting the real growth of total government spending, maintaining the Expenditure Cap in place, etc.

Job creation, which has fallen short of the projected figure, is also a great disappointment. With more than 12 million unemployed, we have seen some recovery, but especially in those low-paid, informal jobs. There is no escaping the rule, since employment is always the last variable to react, especially consistently. The burden of PT's legacy has been indeed a heavy one.

However, following the presidential election, the confidence indexes seem to show some recovery. Hope is back! With higher levels of confidence, everything else can get in the way. Investments will return, the economy will take a breath and the virtuous cycle will arrive at the scene. With a product gap above 2.0%, there is also no major upward pressure on interest rates due to possible inflation and, combined with an external environment in which the Fed will be softer than it is also imagined in the normalization of its monetary policy, the sky is clear and bright to the Brazilian economy - without any pun intended to the government full of military.

Obviously, the picture is not so rosy. In truth, the failure in approving Social Security Reform can put everything to waste. A number of infra-constitutional measures can and should be taken, rationalization of expenditures and optimization of the administrative structure are also mandatory, tax reform needs to be pushed, and opening up the country is a key part of essential advances for our sustainable growth. However, none of this will truly have significant weight if we fail in passing Social Security Reform. So, one way or another, sliced up or whole, we must urgently address this reform. Silver lining is, unfortunately, very tenuous and the agents are absolutely aware of the steps the administration must take in this matter. Any hesitation, the reversal of expectations will be instantaneous.

The good news is: we know what to do, the administration counts on popular and congressional support at this time and has an excellent team. Get to work!

Fiscal Policy

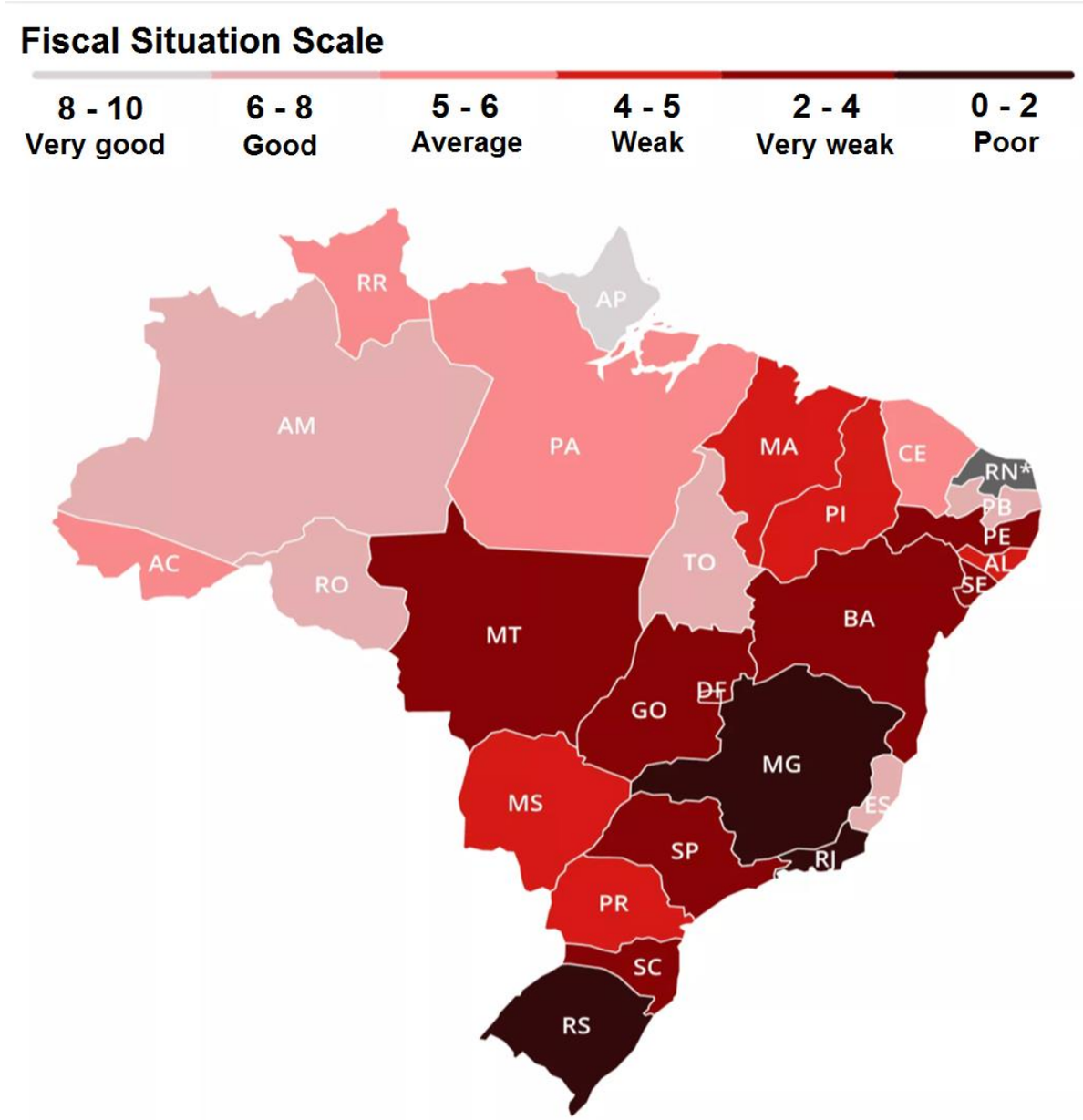
We often address in this space the overriding need to control overall public expenditure, but the truth is that for some States of the Federation the situation is unsustainable.

The script runs always the same for most of them, but the fact does not sugarcoat the rampant personnel expenses by successive increases granted to servers, and high expenses with inactive. Not less, only 1/5 of the Federative Units will start 2019 in a good fiscal situation. States such as Espírito Santo, Amapá, Amazonas, Rondônia, Tocantins and Paraíba stand out. Espírito Santo - ES is notably an example. In 2015, a strong government program towards fiscal balance was implemented with strong impacts contrary to the era, but determination carried them out toward a strong cost reduction without tax increases. The improvement was in no way slow, for in the last two years the Espírito Santo has invested nearly BRL 1 billion of its own resources.

On the other hand, the situation is troublesome in States like Rio de Janeiro, Minas Gerais and Rio Grande do Sul. Quality of life is getting poorer and poorer in these states, as essential public services such as health, education and security are already compromised. The example of ES, with the appropriate adjustments and particularities of each Federation Unit, should be followed.

Thus the roadmap going forward in the eventual adjustment seems obvious, but their implementation requires political determination, courage, will and support. On December 5, even though it is only valid for municipalities, the House of Representatives passed legislation making Fiscal Responsibility Act (LRF) more flexible, allowing for advances in the limit of personnel expenses... in the extreme, contrary to what should be done. Hopefully this measure will not trickle down to the States.

As for the fiscal crisis of the federal government much has been done in terms of transparency and disclosure, something to be replicated at the State level. Reality needs to be made explicit repeatedly, so that it is understood and accepted by society and the other powers. The Legislative and the Judiciary branches must join forces as parts of the solution to the problem.



Source:https://g1.globo.com/economia/noticia/2018/12/14/seis-governadores-devem-comecar-mandato-com-situacao-fiscal-confortavel-aponta-estudo.ghtml

At the Federal level, with the entry of the new administration, Jair Bolsonaro and his team are expected to present and carry out the Social Security Reform in its first 100 days. Besides this, numerous other actions in this space presented, as well as several infra-constitutional measures need to be put in place. The window of opportunity is there and we need to take advantage of it. Oh! The 27 new State Governors too!!!

International Outlook

From time to time we have witnessed the so-called "Government Shutdown" in the US, paralyzing some areas of government. It is strictly a political dispute that in this case seems to involve Donald Trump's claim to have resources to build the US Wall with Mexico and, on the other hand, (in)direct actions to undermine the re-election of the American President in 2020.

Fact of the matter is that the mainstream media and much of American society (and why not say the whole planet) simply do not accept Donald Trump's demeanor. They are somewhat right about that, but the delivery of results has been exceptional in many segments of American life. Especially at the end of 2018, with two years in office, the US economy is growing, unemployment is on record, inflation is on target, and so on.

Thus, the tug-of-war will not be easy, notably because Nancy Pelosi of the Democratic Party takes over the Chair of the House to lead abrasive opposition to Trump. Pelosi will have the responsibility to command the agenda of Congress, oversee investigations against Trump, and coordinate Democrats' strategies.

In China, where most analysts have absolute skepticism about their economic performance, interventions continue to be strong. The Chinese government now takes steps to stabilize trade. A process is under way to expedite the domestic sales of manufactured goods in free trade zones, as well as to facilitate imports of products for research and development. It is also expected, in the logistics field, that companies transporting some goods within these zones will be free from customs scrutiny. It was also announced foreign trade stimulus, making it easier for some banks to make payments in foreign currency. In the investment segment reality does not change. A two-year "effort" to reduce debt levels has put pressure on more indebted local governments, but the weaker investment in infrastructure has led authorities to relax these controls. Thus, the National Development and Reform Commission of China has approved total investments in the rail sector in the order of US $ 33.8 billion, These actions, already customary, may intensify in 2019 as the signs are not encouraging. China's industrial PMI signals that foreign demand has worsened in recent months. It is possible that not even a trade agreement between the US and China at this time will be enough to reverse the situation.

In Europe, the political balance in Emmanuel Macron's France is not good, especially after the demonstrations of the Yellow Vests movement started last November, entering December. The origins and foundations of the movement, greatly enlarged in sequence, have cooled, but it seems far from settled. The protests were identified as part of the poor result of the French Manufacturing PMI, which came below the 50-point line (49.7 in December), signaling contraction in sector's activity. Also nothing is yet settled with the UK exit negotiations (BREXIT) until the last minute of 2018. Paradoxically, the UK PMI accelerated from 53.6 in November to 54.2 in December, peaking within a six-month stretch - a possible effect of the increase in inventories of companies, precisely anticipating a tumultuous exit. Other European countries, such as Germany and elsewhere in the Eurozone, presented modest PMI readings.

In Latin America, Venezuela continues to be highlighted by the growing humanitarian crisis, but now with additional pressures, given that several countries indicate that they will not recognize President Maduro's second term as legitimate. If confirmed, it will be a serious blow that combined with an opposition-driven parliament will increase the chances of rising conflicts. Several countries in the region, including Brazil, should be part of this group not to recognize Maduro as legitimate president.

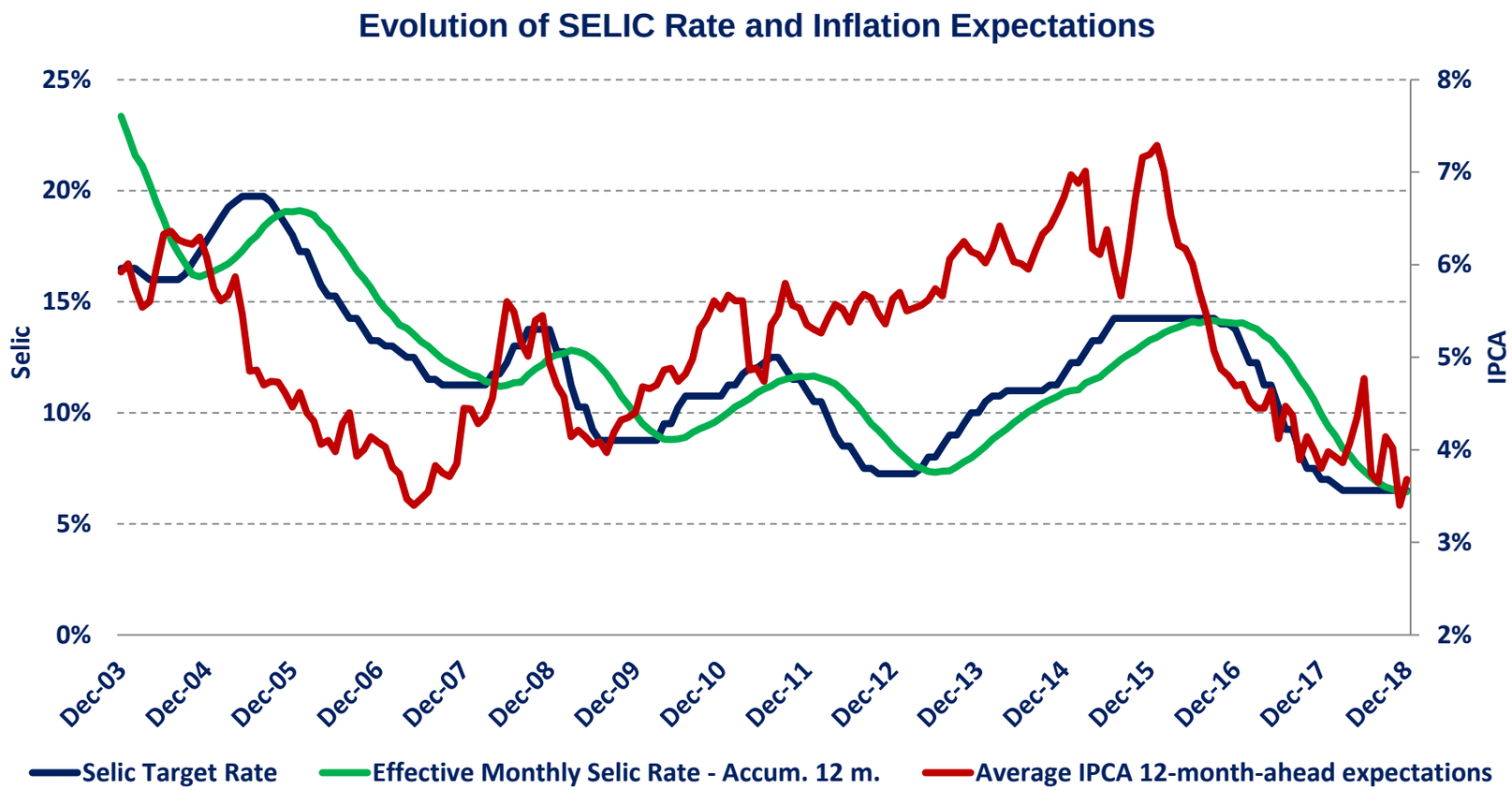
Last but not least, the world economy signals a slowdown, which is unlikely to be over-stimulated by a more aggressive position on interest rate policy by the FED. Perhaps for this very reason, of an expectation not so far from a monetary policy normalization in the USA with up to four 25 b.p. hikes, several analysts have already envisaged a maximum of 2 increases, and others, even more convinced, do not believe in any increase at all.

We at Redwood closely follow these expectations and market movements, but we also look at Taylor's traditional formula, which still points to a rate at the end of 2019 at 3.75%.

Interest Rates

We have seen over the year of 2018 an important achievement in the conduct of monetary policy, especially if our history is heeded. After the closing of the Selic low cycle in February, we experienced a sequence of months with the basic interest rate set at its historical low, without such condition being forcefully enabled by the Central Bank (BACEN). On the contrary, credibility was built on the commitment by the monetary authority to the inflation targeting regime, which, despite the May price shock, managed to keep expectations anchored.

And in a year of "muddling through" the continuity of structural reforms, marked by the long wait until the end of the electoral process in mid-November, the Central Bank's masterly conduct of Brazilian monetary stability set the tone for the forward interest rate markets throughout the year. Reflecting these aspects, DI contracts closed 2018 near their historic lows. The DI 20 had a monthly decline of 6.15%, ending the year quoted at 6.56%. The DI 21 ended the month quoted at 7.37%, reflecting a drop of 7.18%. At the long vertex, the DI 25 recorded a drop of 5.11% reaching a level of 9.09%.



Source: Central Bank of Brazil | Elaborated by Planner Redwood

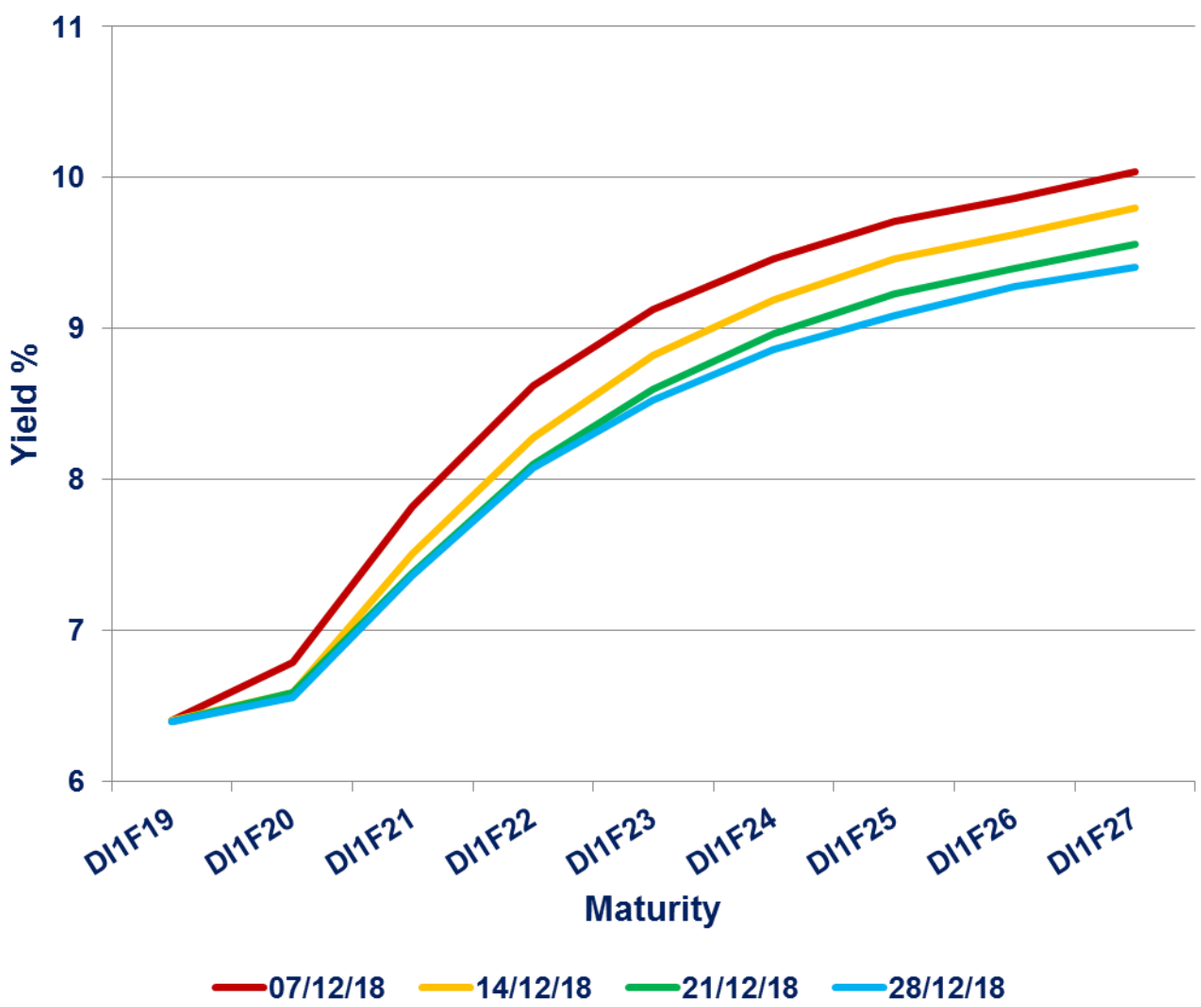
The projections for 2019, however, point to some adjustment in the Selic rate, especially to the continuation of the cycle of US interest rate increases and the subsequent need for higher real interest rates (risk premium). We at Redwood envision for 2019 a closing nominal interest at 7.25%. Of course this is a previous scenario, highly sensitive to the first steps to be announced by the incoming team starting in January. With a strong reform agenda focused on a fiscal adjustment of the magnitude promised by Paulo Guedes (zeroing of the primary deficit already in the first year of government) the external perceptions of country risk can and should drop several levels, thus cooling the need for adjustments in the real interest rates premiums.

With good expectations of Goldfajn's continued good monetary policy in the coming Campos Neto's guidance, the future of interest rates in Brazil for 2019 will once again be constrained by success in carrying out reforms and fiscal restructuring. The time is ripe to rewrite the course of our economy history, and it is up to those who have received the blank check to assert the collective will for a better future. If we fulfill this prognosis, we can have the confirmation throughout the year of the stability of the interest rate and thus enable the beginning of a new cycle of sustainable growth.

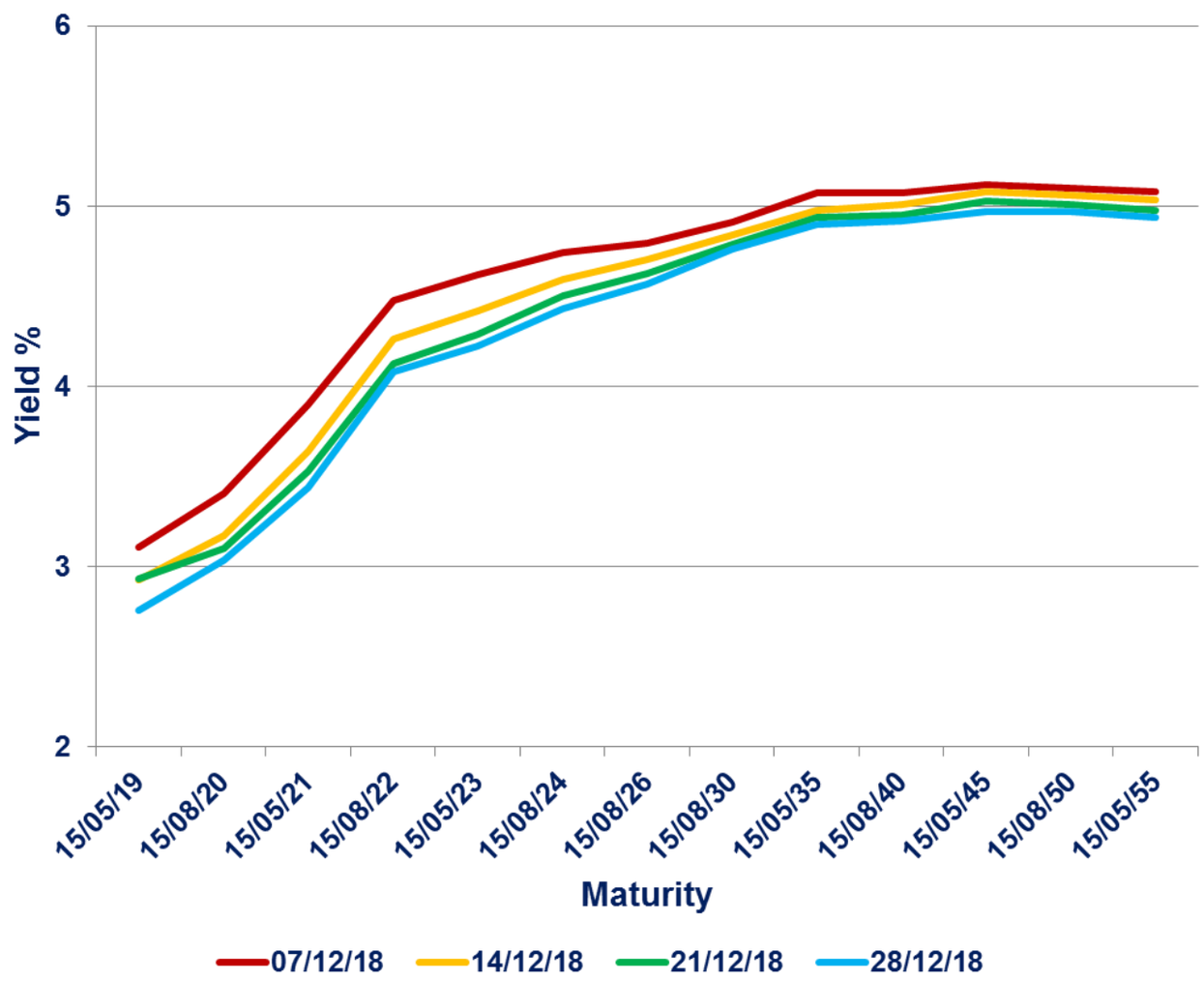
This singular moment begins in January 2019, raising hopes that BACEN will also enjoy the good winds of change blowing on the economy as a whole and finally have its independence formalized. More than preserving the current technical and adequate environment in the BACEN under the Bolsonaro administration, formal independence will give the necessary continuity and foster credibility with important positive effects in markets and pundits.

Weekly Interest Rates

Yield Curve Diagram



NTN-B Diagram

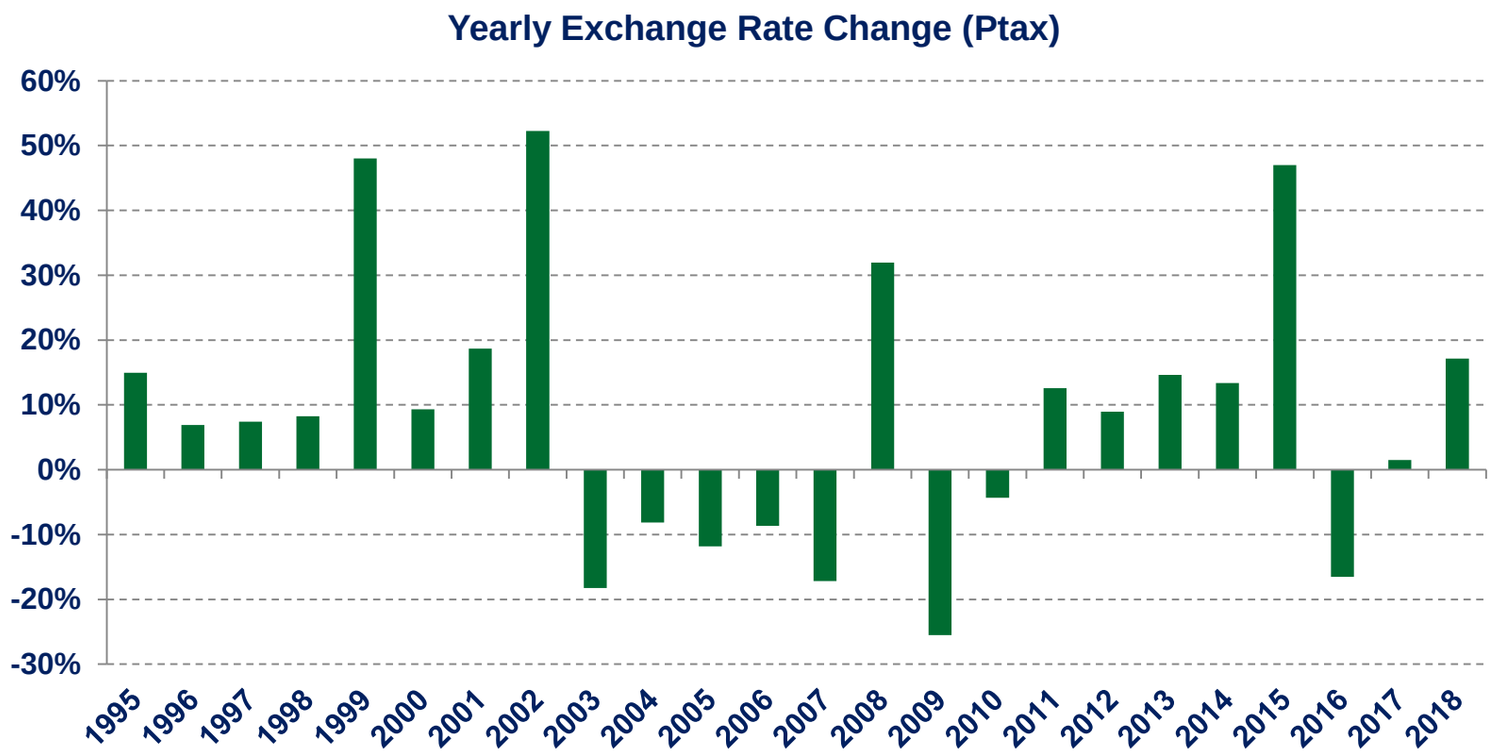


Source: Broadcast | Elaborated by Planner Redwood

Foreign Exchange

In a year marked by a scenario of widespread uncertainty both domestically and abroad, the Brazilian exchange rate registered an annual increase of 17.13% in 2018, the second consecutive and 7th of such events out of the eight years since the beginning of the decade. With a 0.30% devaluation in the final month of the year, the US currency price ended its last trading session at BRL 3.8748 (Ptax). Among the daily closings, we had the minimum quote at BRL 3.138 and maximum at BRL 4.199, which was also the highest closing figure in the history of the Real.

It is reasonably easy to see that the expressive volatility observed throughout the period was partly a direct reflection of the troubled internal scenario, boosted by the political process that culminated in the election of Jair Bolsonaro to the presidency. However, the main driver of the Brazilian exchange rate devaluation was external. The global instability resulting from the advance of the so-called "Trade War" especially between the two major global trading powers exerted a direct negative trend on emerging currencies (to a greater or lesser degree), and Brazil was not an exception to the rule.



Source: Central Bank of Brazil | Elaborated by Planner Redwood

The widespread perception of increased systemic risk by large global investors has led to portfolio rebalancing and less exposure to risky assets, the group to which we belong. If instability alone already provides incentives for flight to quality, this movement has been enhanced by the monetary normalization conducted by the Federal Reserve (FED) and is still in progress.

However, the path to a trend reversal consistent with a less volatile environment is once again paved in front of us, and naturally runs through the advance of already discussed structural reforms. We can cite some aspects of the Brazilian economy, which are determinant in the perception of external vulnerability of capital flows, which are at a very favorable level: stable and anchored inflation, balanced external accounts, a high level of international reserves, and a inviting legal environment as regards respect to contracts. The Achilles heel we have left exposed, one that is crucial to infer considerable risk, is our gross public debt. Both because of its level, which is close to 80%, and because of its speed, the high Brazilian public indebtedness fueled by fiscal disarray is a key point. In sum, if we want to witness an increase in investments drawn by external flows, we must do our homework!

As for the BACEN exchange rate policy, we had another year marked by the rollover of swap contracts plus the use of line auctions with a repurchase clause in a frustrated attempt to control volatility, quotes, liquidity... in short, nothing new... it still appears to us as wishful thinking to fathom a regime effectively compatible with floating exchange rate for 2019.

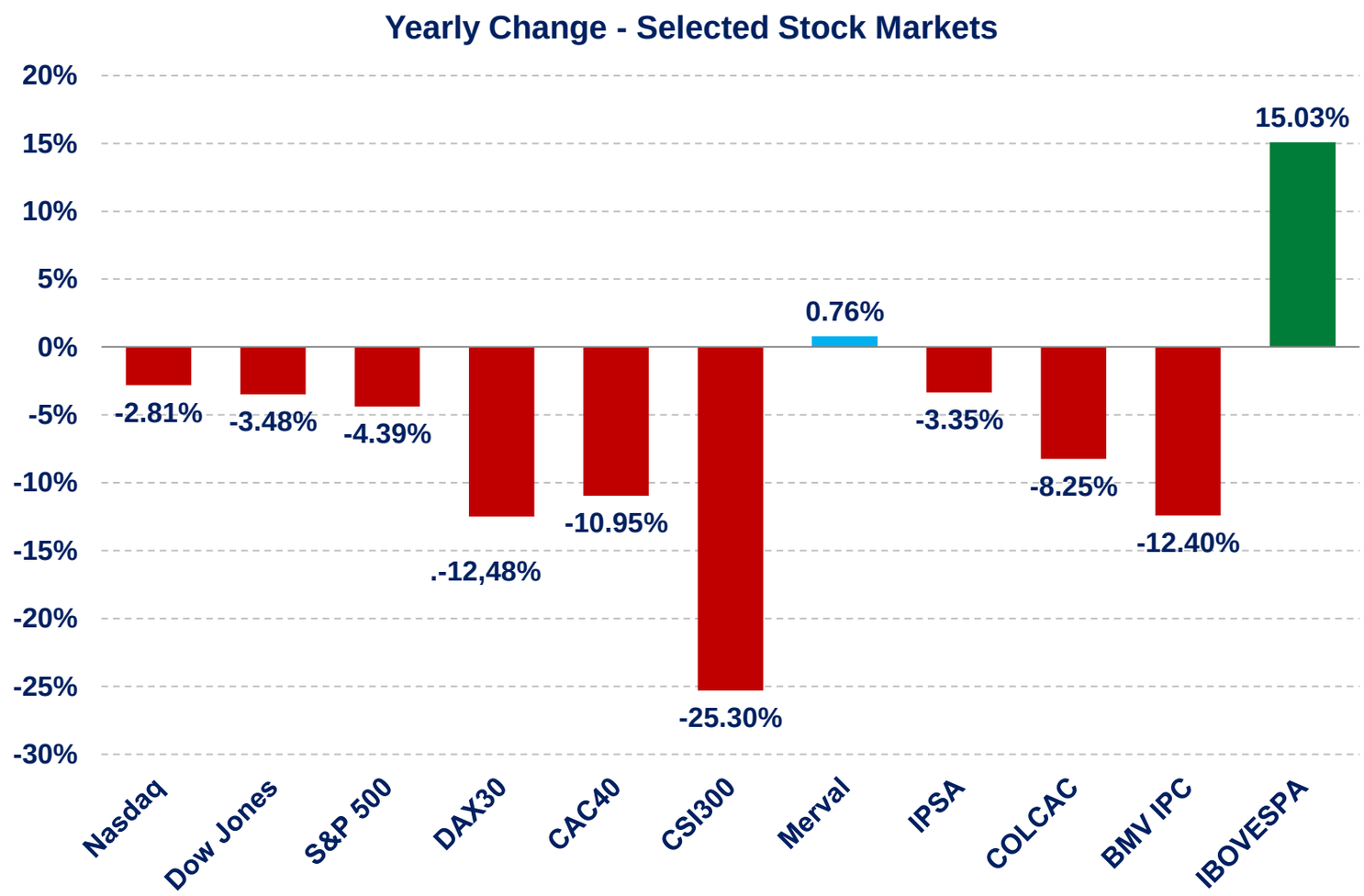
Rome was not built in one day!

Stock Market

In contrast with the intuition of many, the Ibovespa had a significant increase within the year despite its high exposure to the tensions of global markets. And it stands out even further when we find out that the good year of the Brazilian stock exchange was not a rule among the other major stock markets around the world. The downturn hit both developed markets (Dow Jones, Nasdaq, CAC40, FTSE-100, DAX30) and emerging markets (CSI300, BMV IPC, IPSA, COLCAC) for example.

This cycle of valuation is understood by many as a process of adjustment of some companies that since 2014 have suffered with the consequences of the great Brazilian crisis and deviated from their "fundamental value". True or false, the Brazilian stock market P/E indicator still signals a potential downside greater than the upside that complements it, which does not prevent (as we have always pointed out) the emergence of punctual opportunities capable of providing significant appreciation.

Specifically in December, even with the 1.81% devaluation, the Ibovespa closed the year quoted at 87,887 points, accumulating a 15.03% gain throughout 2018. Some outstanding shares within the year were MGLU3 (126 %), CMIG4 (116.76%), and PETR4 (30.96%). The merger between Fibria and Suzano Papel e Celulose, resulting in the largest company in the sector globally, and delivering returns of 104.73% for the SUZB3, was a very relevant event even at the macroeconomic level.



Source: Bloomberg | Elaborated by Planner Redwood

As for the outlook for 2019, this latter is aligned with the promotion of a business environment that favors the recovery of both economic growth and the level of employment. This microeconomic restructuring covers also an agenda of de-bureaucratization and rising productivity, coupled with State downsizing through privatization of the equity owned by companies that are often among the B3 champions. In this scenario, with the GDP converging toward its potential, we can see the Ibovespa consistently beating its historical highs towards its mean-reverting tendency, with a plateau at nearly 130,000 points.

Thus, even with potential external risks, such as the tightening of financial conditions, eventual greater volatility of commodities and the slowdown of the global economy, other expected developments such as an improvement in the business climate, de-bureaucratization, privatization and return of investments (notably foreign) will make the difference in our favor. We will be better off in absolute and relative terms, especially when compared to Emerging Markets.

Therefore, meeting the expectations set on our new economic team's management skills, we can have another brilliant year for our stock market!

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