JANUARY - 2019

MONTHLY STATEMENT

PLANNER REDWOOD ASSET MANAGEMENT

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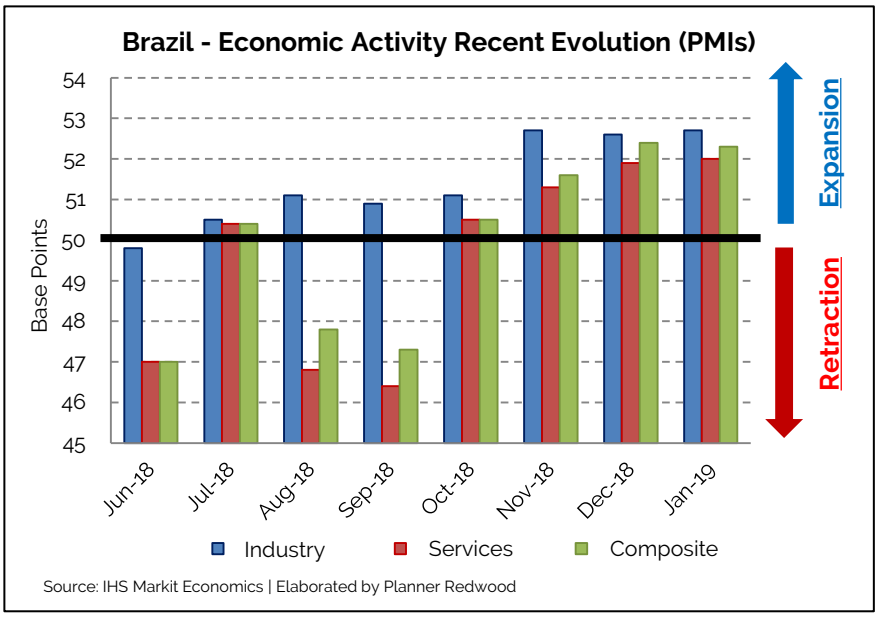
"ONE SMALL STEP FOR MAN, ONE GIANT LEAP FOR MANKIND."

Neil Armstrong – American astronaut, first man to step on the moon

The first month of Bolsonaro's administration seems to translate well how it will all play out from now on: on the one hand, a radical positive change abandoning the logic of coalition presidentialism - where government posts were allotted to political allies – in favor of technically qualified names and, on the other hand, the confrontation of the tailings dams built in the last years, whose political and ideological practices and wastes are embedded in Brazilian daily life.

However, the momentum of this renovation movement was sparked by the demonstrations of June 2013 and has materialized in the last elections where 243 of the 513 seats of the Chamber of Deputies now belong to new lawmakers. In the Senate the change was even greater: of the 54 seats, 46 went to newcomers. The election of Bolsonaro allied to these two landscape changes in the House and the Senate amount to an unmistakable message by the Brazilian people that enough is enough. This cry for change, however, needs to be closely monitored, especially due to a built-in bias toward "old politics" that somehow still reins in several outcasts in Congress.

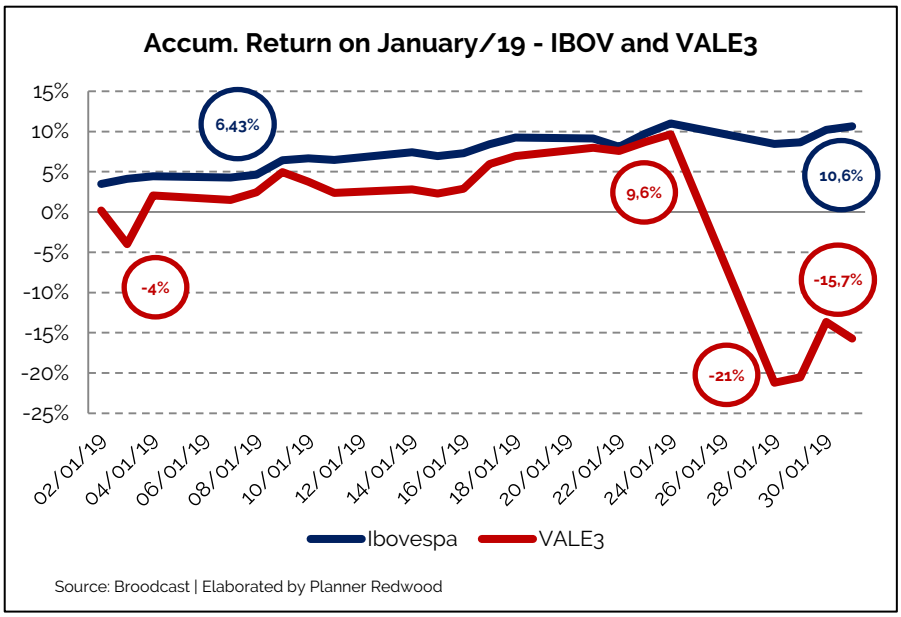


Anyhow the markets has understood and reacted quite well to all of this as the first steps of the "new policy" were taken. The Ibovespa rose more than 10% in January and the Dollar fell almost 6%. The Brazil risk, as measured by the 5-year CDS, closed the month at 165.73 points, while the returns to the most liquid interest rate contracts up to 2027 ranged below 9% and the longer NTN-Bs paid real interest rates short of 4.5%. What a feat! Thus, to paraphrase Neil Armstrong, last elections may have been a small step for us at this time, but a giant leap into the future of the next generations in Brazil.

The economy has thus far only timidly reflected this change, but the outlook is promising. If economic activity in 2018 will not actually surpass 1.3% this year, doubling this number (albeit low) will not be exactly troublesome. This statement takes into account, obviously, the approval by Congress of the emergency reforms – especially social security. Actually, achieving the reforms' maximum effect hinges basically on two variables, namely: the intensity

of changes in social security rules (expected savings), and the timing of their approval. Little will come out of a fast track approval of a project with superficial results, or a more robust reform but with long belated ratification by Congress.

Investors are waiting for social security reform. Period. Everything else seems to rely on this fact. Although inflation is controlled, "well behaved" interest rates and the consensus around economic activity projections is near 2.5% for this year, the specter of unemployment still frightens. It still adds up to more than 12 million unemployed people, whose only chance of relief will come with the confidence effectively restored and investments in due course.



Obviously, once the very first measures have passed, other important ones will pave the way for veritable economic recovery. One of them is the reform of the tax system, which, in the limit, aims to tackle two fundamental points: (i) the high tax burden (33% of GDP) and (ii) the complexity of the tax rules. Perhaps this is the main item conditioning the improvement of business environment in Brazil. Finally, finding an optimal point between the Laffer and Armey[1] Curves has been a tonic of our analyses.

Finally, still on the fiscal aspect, a great cut and optimization of costs is expected, through privatizations, State-owned companies closure and process simplification and rationalization. On the side of Monetary and Foreign Exchange Policies, even with the BACEN Chairman Ilan Goldfajn's programmed stepping down, no major changes are expected - which for the market translates into predictability and operational transparency.

In this sense, markets love this type of behavior, as they give legitimacy to their plans and perspectives. Not least, the volatility has cooled down substantially. Despite the constant and innocuous intrusions by the BACEN in the foreign exchange market, spot currency volatility (30 days) is currently around 14.22%, while dollar options futures contracts reduced their average volatility in the last quarter of 2018 for monthly closing in JAN/19, from 14.68% to 13.35%, respectively, a decrease of near 9%. The US currency has also weakened, and a bearish trend is admitted by key players in the market – well in line with our projections since the last quarter of 2018.

Therefore, Ptax closed January at BRL 3.6519, lowest closing figure since October 2018, when the electoral process was already in progress toward Bolsonaro's victory. Once again, 5.75% appreciation of the Real was only made possible by the steps taken last month fulfilling the promises at the dawn of this new era for the Brazilian economy. In addition to these factors, the American monetary tapering movement seems to lose ever more traction, thus reducing eventual anticipations of capital outflows.

As a reflex of anchored expectations and a controlled IPCA (as was evident in the monthly change

of December 2018, significantly below its historical average), interest rate futures already point to further cuts - at least in the short term. A significant fact, however fundamentally linked to the lower demand of investors for a time-related premium, and which can only be reached consistently and not circumstantially with the generalized perception that better days are spotted in the near horizon.

But the strong emotions were really reserved for the stock market, especially at the end of the month. Renewing its historical peaks (98,586) and with the monthly high of 10.8%, the (negative) highlight definitely goes to Vale (VALE3), which accounts alone for just over 10% of Ibovespa Index. With the painful tragedy of Brumadinho-MG, the company's stock plunged 10.78%, and remains under observation, since legal developments can heavily affect the company's cashflow and financial results, in the event of further liability for the company in the form of new fines and penalties. The market, as always, sharply and immediately priced its quotation, but the output cuts in the area does not seem to be a very representative share of total production. With possibly high costs as a consequence of the depletion and/or reduction of ore concentration of the region's mines, it is premature to predict the company's lower profitability. Moreover, although still expensive from the perspective of its P/E ratio, the stock market prices begins to factor in the greatest optimism with the increasingly possible resumption of economic activity.

Overseas, politics in the month of January did not fare well, especially under the potential economic impacts. The trade war between the US and China does not seem to evolve significantly. Some believe[2] that the Chinese economy may take severe hits in the upcoming years – quite a different angle from the one hitherto envisaged - where China should, in fact, fill in the "blanks" left by the US with the "new normal" launched by Donald Trump. Among the emerging markets, the Brazilian economy would be the one that could benefit most from such scenario.

Still in politics, there is BREXIT and its immediate repercussions for the region's economy and its wider impacts worldwide. As soon as the lights go out, Theresa May can handle all sorts of problems, and everything indicates that a hard BREXIT is on the way. Europe, not just the UK, will suffer greatly. If this is the way, we should brace for significant bumps. Not least, Germany and Japan are making arrangements to minimize the global impact of the United Kingdom's unrestricted exit from the bloc ... after all, Japan and the EU are today the largest economic union in the world.

In the USA Trump will make the most relevant speeches: the "State of the Union", where one hopes the main points of American politics will be outlined - with so many reflexes, even on the global economy. Last but not least, Venezuela is on the verge of a resolution of its economic-humanitarian crisis. Although President Nicolás Maduro still controls the government, opposition leader Juan Guaidó has been increasingly recognized as interim President of the country.

The world awaits a peaceful solution, with the eventual interim government conducting democratic elections with international observers.

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[1] See Planner Redwood's Monthly Commentary of November 2018.

[2] Finacial Times, Martin Wolf's Article on Jan 1st 2019 *"The future might not belong to China".*

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