FEBRUARY - 2019

MONTHLY STATEMENT

PLANNER REDWOOD ASSET MANAGEMENT

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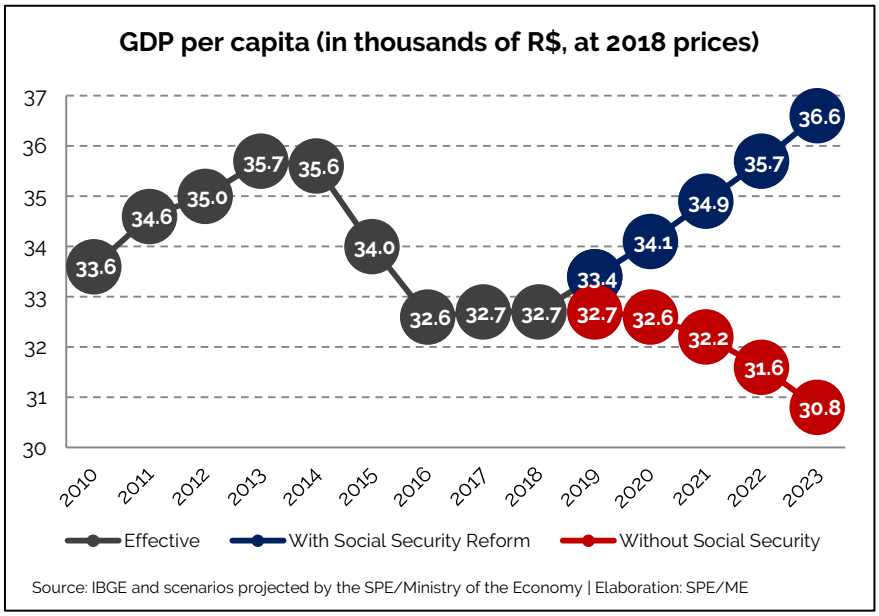
"IN THE BEGINNING THERE WAS CHAOS."

Book of Genesis – Christian Bible (popular interpretation)

In the beginning of almost all administrations confusion and disarray have free rein. The transition period, it is assumed, is the time to precisely build buffers to reduce impacts and greater compromises of the functioning of the Government. For the Bolsonaro administration, it could not be different, especially with the promises of radical changes. However, even in this moment of transition and accommodations, some "mistakes" should have actually been avoided, such as the episode involving Minister Bebianno's dismissal.

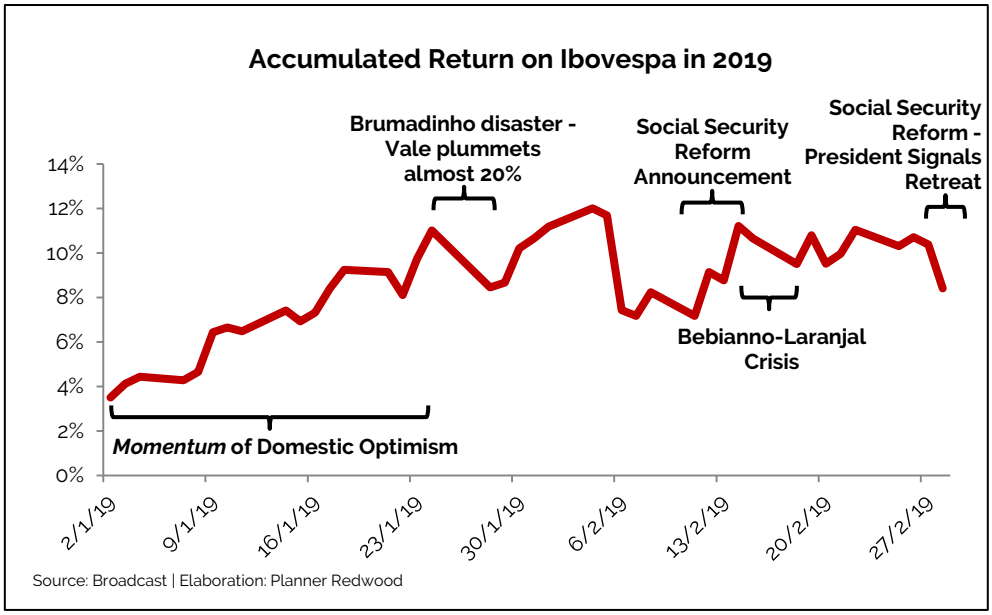
One can only expect, however, that a highly skilled government learns quickly, and more, to anticipate more compromising situations, especially those that may tarnish its major purposes from the outset. Among these purposes we can cite, clearly and unequivocally, its credibility and the build-up of its support basis in parliament. At this moment, the Bolsonaro administration bets all of its chips on the construction of a robust and fair Social Security reform that attacks the inequality of benefits and helps reorganize the public accounts.



Markets have thus reacted very well to the first presentation of what could be approved as a Social Security reform. The Ibovespa temporarily continued its upward movement, peaking at 98,588.63 points on FEB 4th, although it closed the month at -1.86%. The Brazil-risk measured by the 5-year CDS fell further throughout the month to 156.22 points, while the Dollar did not cool down as expected, closing the month at BRL 3.7738. Nominal interest rates up to 2027 were around 8.37%, and the longer NTN-Bs are paying interests as high as 3.99%. Therefore even amid the initial confusions, noises do not speak louder than the first rearrangements, but one cannot lower one's guard for a moment, for the future necessarily depends on overcoming these challenges.

As for the economy, GDP results for 2018 were even worse than we imagined. The 1.10% figure "repeats" 2017 (1.06%), and sheds a light on the need for an even more detailed reevaluation of each sector's behavior. However, we at Redwood have not yet raised any major skepticism as regards this year's growth, notably due to our expectation of approval of the aforementioned pension reform by the middle of 2019. Approval by the end of the first half of the year (signs will appear over the next months) will make room "for some stronger recovery in the second half, especially if the reform is not substantially dehydrated."

In fact, the general outlook for the country is binary, precisely because of this reform. Should it be approved with the expected economy of BRL 1.16 tri (herein included the pension system of the armed forces) in a ten-year stretch or so, our opinion is that all other conditions will be met. Brazil will embark on a virtuous cycle in a "timely" moment, including in terms of our emerging peers and the world situation itself. On the other hand, failure at approval will simply take us back to recession. Period. Not for least, unemployment will not take off; after all, this is the last variable to enjoy recovery. Entrepreneurs as a rule take their time when it comes to dismissing an employee, but they also only restart hiring when they are sufficiently sure that their projects, like the economy, will prosper.



On the Monetary Policy front, especially with Roberto Campos Neto's taking over, we do not see any major changes in the conduct of basic interest rates policy in the short and medium terms. In fact, the expected inflation for 2019 has cooled down several times in recent past, possibly due to labor market results and a sluggish aggregate demand. The healthy "boredom" Monetary Policy has conquered for itself could lead to a much more "active" policy, also due to the adjustments in the public finances.

In this line, the fiscal realm brings false good news: the positive public sector's fiscal balance of BRL 46.9 billion in January 2019. This is a seasonally positive result and practically the same as in 2018. In addition, finances remain chaotic. If we evaluate the Nominal result (with interest service on public debt), the value is reversed to a deficit BRL 26 billion (much worse than in January 2018) and the nominal deficit accumulated in 12 months reaches BRL 480 billion, or 6,9% of GDP. If we take an indicator more commensurable with other economies (despite some differences in methodology) such as the Gross Public Debt, ours reached 76.7% of GDP - a scandalous figure when compared to any emergent market in our category. Yes, we need structural reforms, (such as the Social Security one) to implement planned infrastructure projects and all the liberal agenda set forth by Jair Bolsonaro and Paulo Guedes.

The sum of factors such as the deceleration of GDP in Q4, the net outflow of foreign investors, the possible loss of space granted to the Brazilian market in the Emerging MSCI and the unfortunate and early declarations of the president on a possible dehydration of the social security reform proposal recently presented has led the Ibovespa to its first monthly drop in the year. Impacted by the outflow of foreign investors in the order of BRL 2,613 billion in net terms, the negative result was partly offset by some support derived from the increase in the positions of institutional investors and (to a lesser degree) individual investors. This support will be ratified in upcoming months only with a clear reversal

of the investment and growth trends of the Brazilian economy.

This net outflow of foreign investors, which in large part awaits clearer signals in the direction of the approval of the reforms to resume productive investment, exerted sharp pressure also on the exchange rate that, even in a scenario with declining country risk throughout the month, resisted dropping to lower levels. On the contrary, the Real depreciated against the Dollar in February. This result provides clear proof that promises will no longer suffice to attract the large surplus of international liquidity to our markets. Practical advances in the relationship with Congress and with society to pave the way for much-needed reforms is proving to be the only possible alternative and a challenge that lies ahead of this new government.

As far as the future interest rate market is concerned, indexes seem to accompany expectations of prices that, far more than anchored, already show signs of breaking down under a scenario so adverse for the recovery of employment. In CAGED, released in January, the net job creation neared 34 thousand jobs and fell short of half the median of market projections (of 82.5 thousand vacancies). Without any clear incentive to promote interest rate hikes by the BACEN, we are also stuck with the current SELIC rate, given the unsustainability of practicing lower real interest rates without a solid containment of the current fiscal disarray.

Overseas, we highlight Venezuela's endless political-social-economic-humanitarian crisis. Contrary to our recent expectations, the country unfortunately is fast approaching a tipping point, wherein there will be no escape without bloodshed. The resistance offered by Maduro and the exhaustion of diplomacy leads to either a civil war or a possible "coordinated and endorsed intervention" by foreign powers.

In China, Xinhua state agency released the economic growth target for 2019 between 6.0% and 6.5%, at variance with the difficulties highlighted by independent companies. Other targets set for 2019 include: Inflation (3%), fiscal budget deficit (2.8% of GDP), 11 million new jobs and unemployment cap in urban areas at 5.5%. Very "fancy", but the truth can hardly be "planned". Even with some relief, the trade war continues, and is reflected in injections of USD 10.74 billion in liquidity in the banking system (supplementary credit line) and USD 4 billion (permanent credit instrument) by the People's Bank of China (PBoC).

Although less optimistic, we are more confident with the US GDP than the overall market, which revised growth rate projections for 2019 to around 2%. Although the effects of last year's fiscal policy have dissipated, the four Fed Fund rate increases, and possibly lower global growth, we still believe in the prevalence of credit growth and declining unemployment. On the financial front, long-term Treasuries and credit spreads show improvement over the recent past.

In Europe, politics still dominates the agenda with the BREXIT stalemate. Exactly one month to the departure of the United Kingdom from the European Union, there is no plan to ensure greater trade continuity with several countries in the world. Supporters of British withdrawal and/or possibly other countries never really targeted an unplanned exit. It is therefore imperative to find alternatives able to prevent the interruption of global trade relations with the United Kingdom.

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