MARCH - 2019

MONTHLY STATEMENT

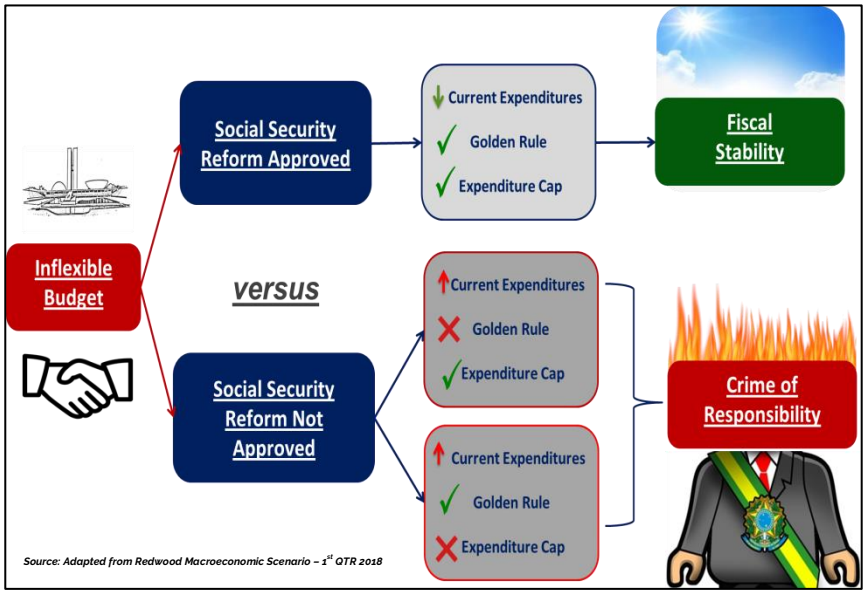
PLANNER REDWOOD ASSET MANAGEMENT

planner Redwood

"FOR WHOM THE BELL TOLLS."

American novel by Ernest Hemingway

We really need to fix the roof while the sun is shining. From this standpoint, we lost the timing for the adjustment of our public finances a while ago. In recent years, dark clouds have loomed on the horizon, and today the weather has stormed on us. With the recent, legitimate and at the same time overpowering decision of our legislators (including some PSL supporters), there is very little room for maneuver in budget management. We should not lose sight of the impacts the economy is bound to suffer, when we evaluate the extent and the eventual outcome of the Social Security Reform on the eve of its appreciation/voting. We cannot get lost in narratives and then feel helpless in the face of imminent "death." While optimistic about a yet-to-come substantial approval of the Pension Reform, it is undeniable that the likelihood of either its failure or dehydration has increased significantly. The analysis is objective and clear. We have destroyed our country's finances in the last decade, and if Minister Guedes's plan fails to move forward, he and probably a good part of his team will leave the government. This fact alone would be a disaster, but even if the team is reassembled, resources will still fall short of the necessary amount to properly manage Brazil. The government will have to submit itself once again to Congress to obtain additional credits (as it already attempts to do through PL 4/2019) to cover the essential expenses. If Congress does not approve the Reform, it will hardly make any sign toward extending further credit lines. The end result: either the government will default on the Golden Rule (impeachment), or will not provide fundamental services (low popularity and following consequences). The immediate interpretation will be that the Right-wing administration was incompetent and destroyed the country, and we will have the Left back on its feet. Is it sheer skepticism in the likes of Hemingway? No way! Against facts there are no arguments, and so we should reflect on this our walk. It is easy to understand "for whom the bell tolls": they do it for us!



So, unlike last month, markets that love the proposed pension reform have begun to factor in a greater likelihood of delay in their approval and even dehydration. The Ibovespa that reached the 100,000 points retreated to close at 91,000 points. The yield curve rose sharply in all vertices, but ended the month at 8.11%, near the beginning of the month. Both the Brazil-risk measured by the 5-year CDS and the Dollar

were in the spotlight: they rose to 179 points and to BRL 3.90, respectively. Thus political noises show their destructive potential, and can anticipate the end of the honeymoon between the administration and the market. A definite reversal of the picture, which looks just like an "armistice" today, imposes a strategy change with a "commander" (a Chief of Chief of Staff) and a structure fit for it – at variance with what we have today.

In the economy, the reflexes of this troubled beginning of the Bolsonaro government, are already felt in the first revisions of the country's growth forecasts. Although still less pessimistic than the market in general, we expect GDP in 2016 to advance 2.06%, but much higher and above its potential in 2020 (3.42%) as a result of the approval of the Pension Reform and its effects starting in the second half of 2019. In this sense, the improving employment figures will come more consistently in 2020.

PAULO GUEDES RESIGNS + CABINET DISSOLUTION

ASSUMPTIONS/ CONSEQUENCES:

- No Social Security Reform; no Tax Reform; no Political Reform; no Microecon. Reform and revision of Labor Reform;
- Expansionary Fiscal Policy;
- Interruption/Revision of Privatizations;
- Protectionist Policies.

REDWOOD PROJECTIONS - DISASTER SCENARIO*

ITEM	PROJECTION 2019	PROJECTION 2020
CDS	401 Pts	541 Pts
USD	R$ 5.10/USD	R$ 6.33/USD
Inflation IPCA	5.81%	6.37%
Interest Rate SELIC	8.80%	11.88%
GDP	0.43%	-0.67%
Unemployment Rate	13.2%	14.5%
FISCAL – Primary	193.714 MM	232.457 MM
FISCAL – Gross Debt/GDP	84.7%	93.2%

*Brazil will undergo further downgrading according to major Rating Agencies.

Assuming a favorable outcome for public finances, monetary policy will stay put for this year. Its main focus on inflation seems properly "anchored" within the foreseeable future. An adverse scenario (on the domestic front only, without major externalities), however, has the potential to reverse this "tranquility".

Thus, the fiscal realm hogs all attentions, as never before. To comply with the Golden Rule (albeit with some flexibility), we must stick to the limits of the Expenditure Cap, and deal with a budget that is almost completely earmarked, with no alternative but to follow the planned and proposed reforms (Social Security, Tax, Microeconomic ones and implement the plan for infrastructure concessions, etc.).

And once again, the fiscal question was to provide the transmission of the macroeconomic situation to the dynamics of the financial markets. Through the increasingly accelerated process of forming expectations, we are all at the mercy of the political turmoil that marked the third month of 2019. And given that the financial sector - among all sectors of the economy - enjoys incomparable liquidity, market volatility was instantaneously infected by events.

An important reflection in this sense was the dynamics of the yield curve. As the political noise gained terrain, the future interest contracts registered significant increases. Analyzing the distribution of these effects among the different vertices, there is clear evidence that the variations between the minimum of the month and the peak of stress were distributed with higher increases for longer maturities, as expected. However, when we filter by the market closing, we notice a normalization in a greater degree in the longer vertices, so that, at the end of March, there was a change in the slope of the yield curve, but leaving it less steep than the one verified to along the month.

In the currency markets, the country risk spike was reflected in a strong devaluation of the Real against the US Dollar at 4.23%. Among the 47 major international currencies, the Brazilian currency had the second worst performance in March, losing only to the Argentine Peso, a country currently enduring hardships of incomparable magnitude. As other times in our recent past, the Central Bank did not turned a blind eye on growing volatility. Now under a new president, the monetary authority has offered USD 1 billion in line auction with repurchase commitment in an attempt to

calm the markets. Although far from the ideal scenario of a truly fluctuating exchange rate, the abandonment of the currency swap instrument is in itself a good signal - especially given what was called for.

Last but not least, we had in this context the realization of profits in the long positions in the stock market, which in the first days of the year took the breath to look for new historical highs, approaching the 100,000-point mark in the first half of the month (99,993.93 points). By the end of the month, the Ibovespa reached 91,903.41 points. Between highs and lows, the plunge amounted to 8.09%. However, the highs of some of the main components of the Ibovespa managed to pull the index back up in the last days of the month, so that the monthly drop recorded rested at 0.81%. Among these highlights we can cite VALE3 (8.13%), BRAP4 (10.69%), PETR3 (4,325), CSNA3 (24.24%) and JBSS3 (18.54%). In moments like these, with historical highs, it becomes increasingly important to analyze and select with specific modeling an efficient portfolio allocation.

Overseas, the agony of the Venezuelan people lingers on, facing widespread shortages, anywhere from electricity to foodstuffs. However, far worse is the lack of hope; while it is true that the delay in overcoming the impasse does weaken Maduro, it also impacts Guaidó's ability to take over the country. In fact, time is all that Venezuela really lacks.

In China, signs of economic cooling seem obvious. In this sense and as we have seen repeatedly, the Chinese government's "visible hand" will come with more power. It will be quite possible to see misguided investments stimulating (leveraging) the economy, but in this case, finding further sources of financing for these debts sooner or later will be needed. The effect of the trade war with the United States continues, and has not yet been fully impacted, and yet no agreement has been reached. A recent IMF study shows the impact if "all tariffs for goods traded between the US and China were raised to 25%": US GDP could fall by 0.6% and China's GDP would decrease by up to 1.5%. Apart from being a lose-lose game, the asymmetry in this dispute is very clear, as well as who should bear the greater brunt of adjustment.

In the US, political clashes continue and President Trump threatens to resume the issue of the Mexican border. This time, the promise goes to the limit: the possible closure of the border. In the economic-financial realm, we see a inversion of 10-year and 3-month Treasury rates yield curves - a potential recession indicator, but not necessarily for this year, since other indicators do not endorse/follow this trend. Of course, the reversal of the FED monetary policy towards a more dovish stance is evident.

In Europe, a looming no-deal BREXIT promoted all sorts of proposals (including the promise of Theresa May's stepping down), all rejected by the British parliament. Worries about the performance of the Italian economy are coming back, and the yellow jackets resume their demonstrations in France - preventing a more effective advance in economic measures. Even the powerful German economy may kneel down: its PMI has fallen to the lowest level since July 2012. The truth is that several economies in the Euro Zone are not as resilient as we frequently asserted in this letter. For this reason, and in order to achieve an adequate balance between economic growth, sustainability of its BoPs and the pursuit of social objectives and reducing inequalities, the ECB will most likely abandon the prospect of monetary tightening. Fiscal adjustment and realignment of countries has been out of the agenda, especially now with gloomier outlook for global growth.

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