

MAY - 2019

# MONTHLY STATEMENT

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PLANNER REDWOOD ASSET MANAGEMENT

## “TO GOVERN IS TO MAKE BELIEVE.”

Nicollò Macchiavelli – Florentine Philosopher

The effective and pragmatically lived dimensions of the State crisis are beginning to be felt, in all their rigor, by the new government and especially by the economic team. The highlight, of course, is the recognition of the enormous difficulty faced in passing the agenda of reforms proposed by Paulo Guedes's team of economists. Naiveté, ignorance and/or overconfidence can be a diagnostic for the team of economists, but they would not be for the Commander in Chief - at least, it should not be so.

So the result of these difficulties is that the recovery of the economy will be very slow. The expectation, therefore, is to overcome these obstacles by means of an ingenious negotiation and, of course, unlike anything we have seen in this field in recent years. The recent understanding and rapprochement of Presidents Bolsonaro and Maia is proof that it

can work. However, this event seems particular due to a previous major stress - it would not be long lasting, even though President Bolsonaro does not seem to gather the attributes to constantly play this role. Nor does federation-wide pact seem likely from a point of view of continuous effectiveness (though valid!). We need something that truly "grounds" our "governance and governability," strengthening our Federal Constitution and focusing on principles that guarantee this political, economic and social balance. Possibly a document as a Joint Statement of Intent by the three Branches of Government (albeit conversely to the initiative of the Executive), which could

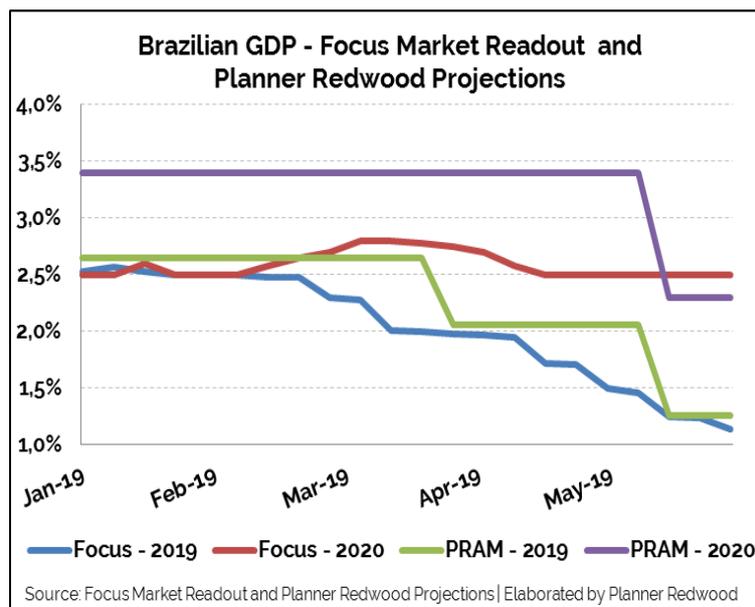
even be a landmark for bringing the country together. It is a Letter of Intent among powers that, in line with its specific constitutional functions, does not compromise democratic impartiality and accountability; that is, an instrument to provide solid foundations and to align independent and harmonic powers around essential values. In addition, and as it already happens in other countries, we need a well-organized center of government, with more defined attributions, assignments and responsibilities that do in fact coordinate and articulate intra-government and inter-powers as well as

governmental spheres.

Managing these "governance and governability" does not seem to fit the structures that are currently in place. We need to reorganize, optimize and empower structures that give dynamics, agility, transparency and efficiency in these actions. A new government, with new paradigms and a

differentiated approach, needs suitable and adequate structure and tools. The mindset and actions that the Bolsonaro government wants to implement are incompatible with the frame/structure in place. Adjustments and formulations like these would certainly be a nation-wide calling toward unification... after all, "to govern is to make believe".

Market performance accurately and predominantly reflected the effects of this policy agenda. The Ibovespa closed up 0.70% at 97,030 points in May, while the yield curve showed a significant shift in almost all vertices, closing the month at 6.49% (DI1F20) and 7.55% (DI1F23),



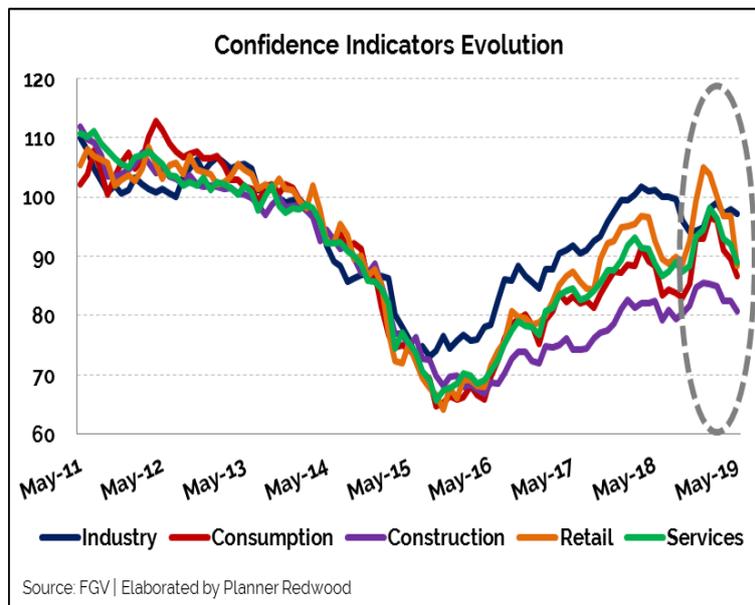
corresponding to  $-0.63pp.$  and  $-0.67p.p$  variations, respectively. The Brazil risk, measured by the 5-year CDS, with all risk-aversion-fueled volatility ended the month at 180 points. The Dollar (Ptax sell), in turn, closed at BRL 3.9407, although it mildly seems to retreat towards what would be a more compatible level with the other correlated variables, something of a reversal, as mentioned last month, which is expected in the medium term, when noises will have lagged behind and faded in projections.

In the economy, as seen in the revaluations of GDP in the chart above, there is no doubt that the year 2019 will be a low growth year – that is, if the pension system reform is approved with some fiscal power. In fact, the confidence indexes (leading indicators) show a drastic cooling and almost a frustration reflecting a generalized discouragement. The fundamental observation, however, is the sudden retraction that occurs, that is, in very few months we went from "heaven" to "hell", with special emphasis on the slowdown of retail sales. In this way, we will grow by around 1% this year, and the (albeit smaller) impacts already affect projections for 2020. Unemployment on the rise, consumption and investments in decline, stagnant income, lower growth, idle capacity in various sectors and no concrete prospects for the use of installed capacity, enthusiasm vanishes. Averting this vicious cycle depends essentially on the Social Security reform, but given its lengthy process, its innumerable setbacks and the non-negligible possibility of its results falling short of the desired and necessary outcome, perhaps it is a moment of "palliative measures", but at the same time shall not discourage and/or compromise the end result of the process.

The Central Bank (BACEN), in line with the "palliative measures" will certainly be one of the main targets for a cooling of its Monetary Policy. That is the moment when its independence must prevail, because it is precisely in this area that we should not falter, especially when it comes to interest rate policy and/or foreign reserves management. Bacen's *conservatism* is of utmost importance, and short-term measures (as already mentioned in the SELIC cuts) in monetary policy, as a rule, costs dearly for its fundamental mandate, namely, inflation control.

On the fiscal policy front, the public sector accumulated a primary deficit of BRL 95.6 billion in the 12

months through April. In fact, the central government, states, municipalities and state owned companies managed to achieve a primary surplus jointly during this period, but this effort was canceled out by social security (INSS) expenditures. The primary surplus of the federal government comes primarily from the Treasury accounts,



with essentially discretionary spending and some non-recurrent revenues... nothing of the magnitude required to cover the growing welfare deficit. We have reached a nominal deficit amounting to BRL 485 billion, equivalent to 6.98% of GDP, when we should be at the highest around 3%, an upper bound established by other countries. The worst news is that surpluses are, as a rule, seasonal effects, so there is not much to cheer about. Although it is hardly a sufficient condition, only the Social Security reform will begin to bring rising expenditures to a halt.

At any rate, the month of May did not live up to its fame on Brazilian shores of *Sell in May and Go Away*. The yield curve has provided excellent results for those operating in this market. In fact, the curve's responses,

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especially for Federal Public Securities (*TPF*), have offered exceptional returns, especially for medium- and long-term vision investors, with significant returns - even if adjusted to higher risks and properly marked to market. The premia, however, which had already waned from last year to the shorter vertices, also seem to end up for the longer *TPFs* - absolutely aligned with our prognoses.

The Ibovespa was much more "well-behaved", oscillating between 89,408 and 97,992 points. In dollars, it ended the month with 24,721 points, registering a net outflow of BRL 4.16 billion in foreign resources, an unmistakable sign of the moment in which we live. In the foreign exchange market, BACEN "needed" to act and made it "successful" in its biddings. Obviously the result at most is ephemeral, and in the sequence "dominated" by the players and drivers completely outside the monetary authority's range of control. Along the same lines, the level of country risk measured by the 5-year CDS, again showed a slight increase, ending the month at 180 points, without much noise.

Overseas, we witnessed the melancholy departure of Theresa May without completing her main purpose: BREXIT. Elections for the European parliament also showed advances by the liberal and green parties, although the center parties remain as the main forces. The highlight is the extreme right-wing groups and so-called Eurosceptics, who have triumphed in Italy and France. Both economically and financially, the month of May did not witness any significant movements or positioning by the European Central Bank (ECB). In Venezuela the population continues to suffer the horrors of Maduro's dictatorship, "awaiting a signal and alignment" of the US

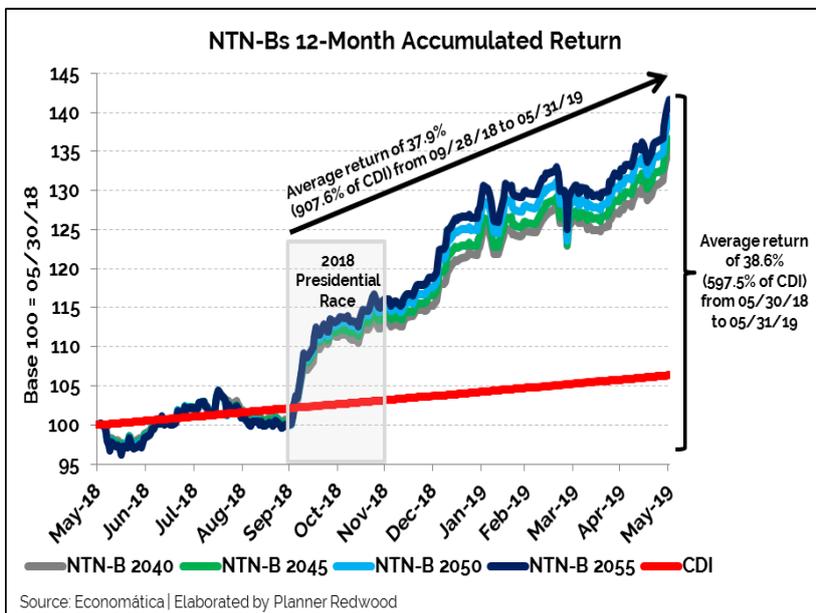
and Russian polarization on the situation.

In the US, the economy evolves as expected: economic activity growing at a rate of 3 percent, inflation under control, falling unemployment rate, and the Fed foreseeing problems ahead (a reversal of long- and short-term interest would be indicative of that), some of its board members "signal" a possible loosening of monetary policy. Donald Trump, meritoriously, takes his time and already insinuates himself as pre-candidate for re-election in 2020. Despite its innumerable moments of "excess" (or perhaps due to them), Trump doubles down on his style, and deepens its original campaign promises in a mix that irritates various groups not only in the US, but worldwide

as well. He does not seem to care.

In China, the trade war with the US begins to bother more than anticipated. Their interventions in the local market have returned and signs of economic activity are far from promising. Even the unthinkable appears more frequently in parallel conversations: the

significant use/sell-off of its reserves in American securities/bonds. We do not believe at all from such an inconsequential move (China would be greatly impaired, with global impacts), but simply speaking about it already raises serious risk. It would be the beginning of the end.



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