JULY - 2019

MONTHLY STATEMENT

PLANNER REDWOOD ASSET MANAGEMENT

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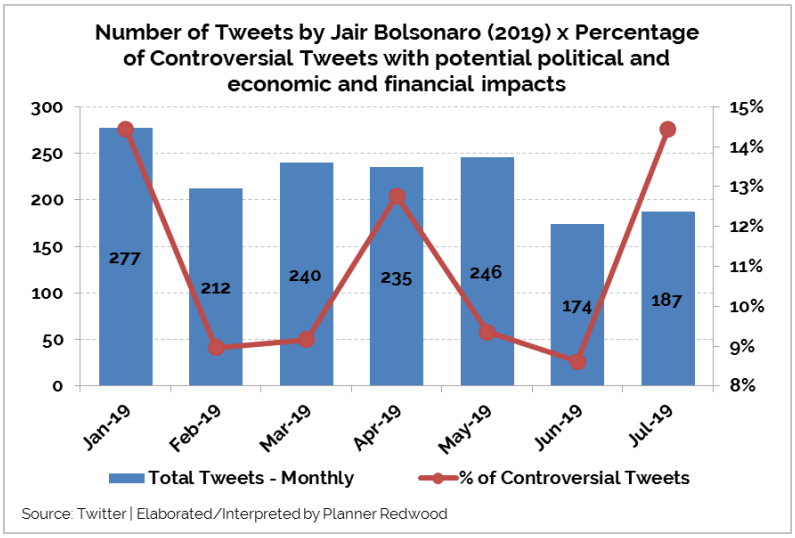
"I speak my mind and pay no mind to what I speak."

Author Unknown

We all know that the "good" is the enemy of the "great", and that is why we cannot lose perspective when we compare the Bolsonaro administration with what we have had over the past decade. Our sad reality reflects an almost indescribable legacy in every area, and the *Bolsonarian* "new normal" seems to be here to stay, but without losing sight of what in fact made him president of Brazil.

Hard-won freedom of expression is the largest representation of the Democratic Rule of Law, but we should not confuse it with permissiveness of communication. More than that, it is not only what is spoken, but also how it is spoken and, in the case of the president, which translates, influences and alters the course of thought of the whole administration – it sets the tone. It is not about blocking the president's ideas and manifestations, no. However, his most controversial comments are already hurting and have the power to generate major political, economic and financial instability.



What's worse is that many of the often out-of-context, over-the-top, and absolutely unnecessary prodigies and nudges at this post-election and effective government moment, more than demonstrating immaturity and sloppiness, this rhetoric has a double opposite effect: it takes energy and focus, and offers a platform for the opposition. It could not be worse, especially at a time when nothing can go wrong in the country's realignment process. Although the suggestion is absurd, the president needs to focus and reflect more on his statements and opinions. He needs to control his language. Apologizing for a mistake or a poor choice of words is a noble act, but it will only have effective meaning if an actual change in behavior follows suit. Courage is not expressed in mere words, but clear action.

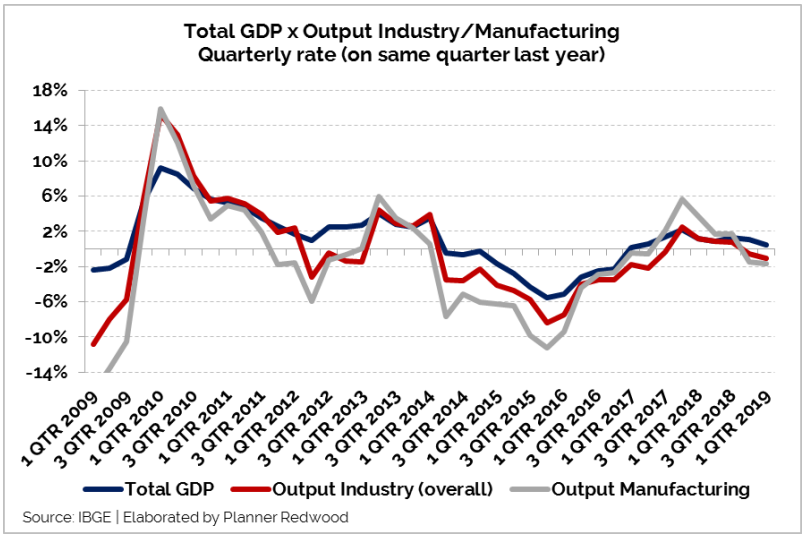
Correcting this behavior seems urgent. Recent data show that the potential for controversial statements from the president has increased again and, even if subjectively analyzed, the wordy arsenal has atomic impacts. Until recently, with the trio intact (Paulo Guedes, Sergio Moro and Gen. Santos Cruz) there seemed to be some "brake" on the presidential statements (each assisting in their own camp), but with the definitive removal of the General and the others for various reasons, those left around him either do not have the "strength" to influence him or keep him away from unwelcome statements, or are in essence passive men of the "yes, sir" kind.

In fact, as in an addiction, the president needs help. However, the president himself needs grasp this truth first, otherwise his aid will not come nor have any effect. Speaking your mind, but minding not what you speak, even if you're in a "new normal" doesn't seem like a promising attitude. The administration has riches of good technicians and we have a real chance to change the course of our history - we need to focus on that, especially on that!

In markets, the performance of key indicators has evolved positively this month. The Ibovespa closed up 0.84% at 101,812 points in July, while interest rates DI1F20 and DI1F21 were highlights of the short-term yield curve downward shift, closing the month at 5.59% and 5.48%, respectively. The Brazil risk, measured by the 5-year CDS,

yielded 24 points in further downward movement and ended the month at 126 points. The Dollar (Ptax), in turn, ended the month at BRL 3.7649, dropping its price slightly and adjusting its main correlated variables, which still point to some asymmetry.

While structural reforms are underway, the real economy still does not benefit from this movement, which will actually take some time to work. Not least, the announced palliative measures (redemption of PIS/Pasep and active/inactive FGTS accounts, MCMV-real estate rentals, compulsory reserves, etc.) arrive in good time, but are really unable to make major improvements. Overall, they are expected to add something like 0.25% to our 2019 GDP performance, leading it toward a near 1% growth. However, if aggregate GDP is already low, the manufacturing sector is even worse. The crisis in this sector started in the second half of 2014 and lasted until 2016, and in 2017 there seemed to have been a resumption of beginning but intensified again in 2018. This is a long and deep crisis. While Brazilian GDP fell by 4.2% between 2014 and 2018, manufacturing output shrank by 14.4%. In this line of evidence, the fall in the confidence index in manufacturing is justified, which decreased by 0.9 points in July compared to June - the lowest level since October 2018. Confidence indicators fell in 11 out of 19 surveyed industry segments in July.

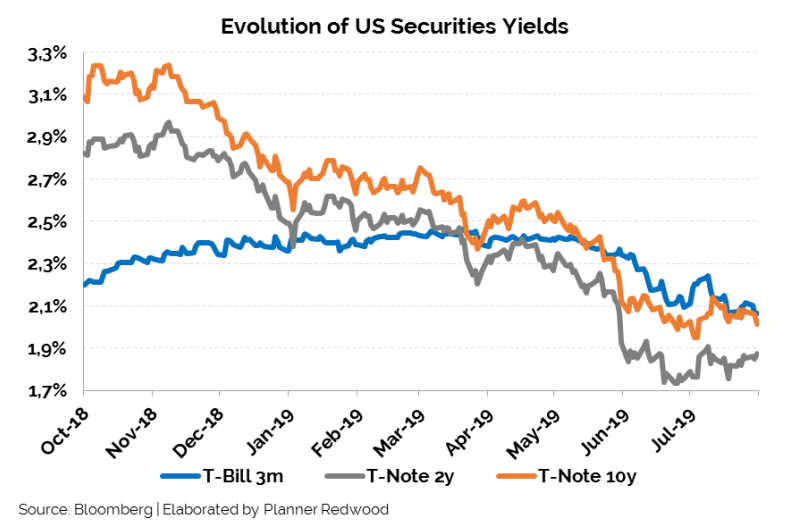


Interestingly, two important phenomena were detected in this environment of low economic activity: higher tax revenues and lower unemployment rate. The Brazilian tax burden reached its historical peak of 35.07% of GDP, equivalent to BRL 2.4 tri – meaning that each Brazilian worked 4.27 months to pay their share of taxes: BRL 11.5 thousand. The explanation may lie in a combination of localized recovery with some increased collection efficiency and enforcement, and increased tax rates. Still in the field of "contradictions" in the face of economic weakness, the unemployment rate fell from 12.7% to 12% in the quarter ended in July. These good news are however justified by a seasonal moment, and we have a poor comparison base, high unemployment and high informality. Thus, even if small hiring breakthroughs happen, their reflexes are positive. Finally, there was improvement, and should continue at this rate and quality until the end of the year.

Monetary policy, especially the recent COPOM decision, came as a surprise to us at Redwood, both for its attitude and intensity. Although inflation is comfortably far below its target and also appears to be properly anchored, ongoing reforms and other variables that "endorse" basic interest guidelines such as activity and unemployment, we recall that Brazil is keen on surprising us. The 0.5% cut in the SELIC rate (unanimously!) was a bold move. This is because nothing guarantees us a turnaround in the next stages of pension reform, or even significant dehydration. Also the external environment, although better, is no guarantee of further tranquility - and even the Fed's stance is far from what markets have priced in. For us at Redwood, this COPOM stance should have been postponed until next meeting, when the scenarios will definitely be clearer. What emerges from this attitude is clearly an anticipation of a loosening, and possibly shorter, cycle. The risks are not negligible, but BACEN can get it right - not least because the effects of monetary policy do take a few months to run their full effects, and therefore (the COPOM scenarios being certain) the sooner the better.

Regarding public finances, there was an improvement in the results in this first semester; nothing that can be celebrated yet, because we don't even have a surplus yet, but we can see a possible progress in the path of the primary deficit. The primary deficit at BRL 5.7 billion in this first half is the best result for the period since 2015, when the government enjoyed a BRL 16.2 billion surplus. Thus, while net and gross debt may grow at marginally decreasing rates, as we do not run surpluses, the trajectories of both definitions of debt do not change. The hopes are, as always, for the combination of structural reforms, optimization and rationalization of spending, privatization and concessions programs and, of course, the resumption of economic activity.

The Brazilian financial market has surfed all this wave of "optimism" recently and thus reflected in the yield curve movement that continued its downward trend, especially for shorter vertices, pricing short-term real interest rates well below 2%, due to expectations of a Selic close to 5% at the end of the year. On the other hand, longer maturities remained far more stable, a reality that seems to point to reaching the floor in front of our situation. For us at Redwood, the opportunities for eventual arbitrage are enormous given the volatility of the scenarios ahead, whether domestic or external.



Source: Bloomberg | Elaborated by Planner Redwood

The stock market, more specifically the Ibovespa, timidly evolved 0.84% this month (in BRL) and approximately 1.39% in USD. Still fundamentally fostered by domestic forces, it reached its all-time high on July 10th at 106,650 points, accounting for a 6,577-point spread on its monthly floor. This volatility without greater participation of foreigners seems to reflect, within our scenarios, each investor's appetite, evaluation and caution.

The foreign exchange market, in turn, reflects everything we can imagine and a little more, each with different intensities depending on the internal and external environments. At this pace, the behavior of the exchange rate did not go in the opposite direction to what we imagined, but at the same time we have absolute conviction of the impracticability to forecast it, especially relying on variables that dynamically change their effects and correlations. External bumps are not ruled out and they can promote currency swings while dragging other variables along.

Overseas, markets are all about recession and the need for Central Banks to act as soon as possible. In the United States, it is not enough that activity is growing above expectations, inflation is near target, unemployment rate is hanging low and, on top of it all, a more aggressive stand by the Fed than expected. Markets are betting on the economic slowdown by assessing performance of indices such as service sector activity (ISM), as well as the "belief" in inverted US short- and long-term yield curves as a good sign of recession ahead. Confirmation of the need for lower interest rates would be on the curve of the 2-year Notes, identified as predictors of US monetary policy. Add to that the instability of US-China trade relations, the political conflicts in Asia (uninterrupted protests in Hong Kong), an increasingly likely no-deal BREXIT and Germany as the economy that can lose most with this European imbroglio. The consequences of it all can spread like brushfire around the world, completely reversing the expectations on emerging countries – amongst which Brazil. Are we facing a self-fulfilling prophecy?

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