Planner Redwood Asset Management

MONTHLY COMMENTARY

APRIL 2017

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- Fiscal Policy
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Epigraph of the month... a propos of Brazil's current predicament.

"The worst kind of blind is the one unwilling to see"

Brazilian Popular Saying

Introduction

“Guesswork” has broken Brazil.

We have spent much time “guessing” this or that could work. In the limit, the Brazilian “little way” (or “Gerson’s Law, meaning to trying taking advantage of every single opportunity) and the “whatever works” mindset end up concealing the “guesswork”, for after all we guessed it could work at the end. It won’t, period!

Unfortunately, it all points to us not having learned from our own history. It challenges reason to imagine that a Nation may comprehend that things can be conducted as in an iterative process or trial-error approach, which are highly costly as we can see from several examples. We are in no way also not defending here that we were free from “guesswork” by the Government. There is nothing like confuse irresponsible conduct – be it for evil, corruption and/or incompetence – with “unknown” and “guesswork”. In truth, we have had much of that in the recent past.

What really matters is that we are facing an unsustainable situation, which must be resolved: Social Security Reform. More than patchwork solution (which has been the basic M.O.), we are taking it to the limits of what is possible, dodging what really needs to be done. We are about to find another “little way”, since all sectors wish to “reap some advantage” and, at the end, “it is as good as it gets” for now and we will correct it farther down the road. But why go through all the trouble? In the end “we guess” it will all work out. We “guess” (part of society, at least) that social security may not have a deficit. End result? A crushing majority of people is against the reform proposed. It will be very expensive if we think we can simply let go of a serious reform. And as the saying goes, which opened this comment: *“The worst kind of blind is the one unwilling to see”*. Open your eyes, Brazil! We have a huge and bright future to build, but we can not go on “guessing” things will go back on their feet easily after years of folly.

The month of April in the world was a troubled one, both politically and economically. PMI Manufacturing in China has dropped, but was compensated by a rising indicator in the Eurozone (highest in six years) and has surprised in the UK (highest in three years), remaining stable in India. The Eurozone GDP has grown 0.5% in the first quarter of 2017, with a 1.7% within the year, while unemployment has remained stable. In the US, Trump promises enormous tax cuts for corporations while signaling great enthusiasm toward infrastructure investments, however meager is his “power” to crowd Congress in his plans – despite Republican congressional majority. The FED seems to be adamant about only two more hikes of interest rates in 2017. Politically, back to Europe, we have seen (lately) the movement of absolute rejection of political, economic and social agendas – both candidate to the French presidency leave no doubt about it. The Left seems to have lost all terrain over there, and pending the final outcome of elections, more properly in being Marine Le Pen, the “nationalist” contagion effect in neighboring countries seems inevitable.

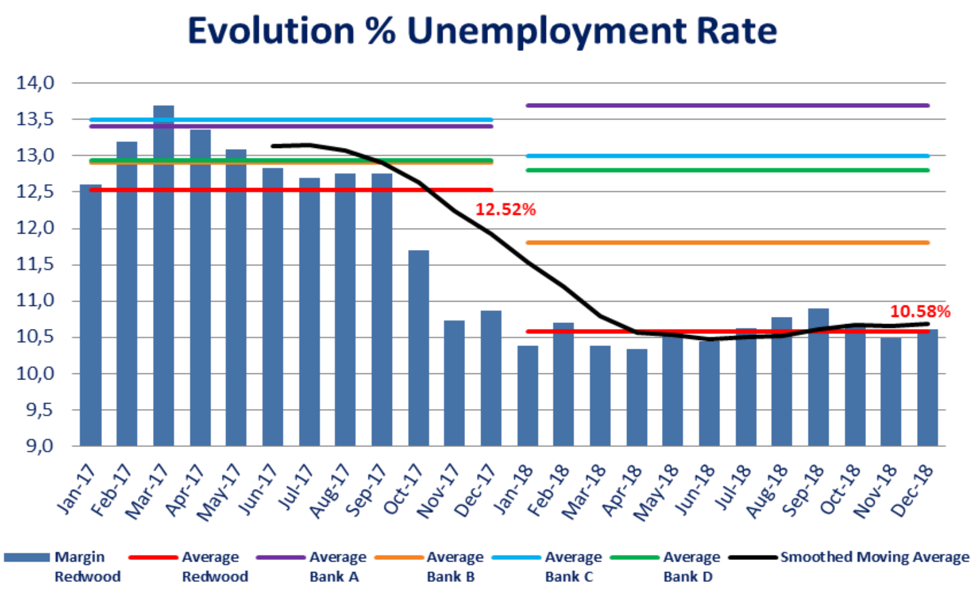
In this landscape, the US Treasuries closed the month at 2.28%. S&P varied 0.91%, NIKKEI closed at 1.52%, DAX at 1.02% and FTSE 0.57%. Ibovespa finished the month at 0.65% and the IBrX at 0.88%. Highs of DIF18 at 9.82% and DIF21 at 10.12%. NTN-B 2050 ended the month at 5.33%, and the Dollar (Ptax-sell) at BRL 3.1984.

Economic Activity

In a recession, unemployment is the last variable affected and, in the upswing too – but some surprise is likely to happen here.

Brazilian GDP will not bloom this year. Manufacturing was the first to embark on the downswing and could very well be the first to show stronger signs of recovery, but it won't stick to it; besides it exhibits some volatility. Manufacturing output has climbed 0.7% in the Q.I 2017 against Q.IV 2016, but has retreated in the last month – the statistical carry over effect accounted for much of positive result of the first quarter of 2017.

The challenge of balancing the books every day leaves little time to plan and strategize for the long term, especially in Manufacturing. We need a policy unhinged by fiscal incentives, tax reliefs and the infamous protection of domestic output. We need actions that guarantee more competitiveness, innovation and technological development, with impacts on efficiency, with spillover and multiplier effects across sectors, thereby infusing benefits to all society via more jobs and income. We do not stand by here in favor of a growth-feeding State, but of a provider of market-friendly environment for sustained development to boost the economy.



Source: PNAD Continua (IBGE) and Redwood Projections | Elaboration: Planner Redwood

Still on the supply side, other sectors have not shown any significant improvement. However, one cannot leave aside the excellent result of the trade balance in the first quarter 2017: surplus of USD 21.4 billion. This number bears good news as to growing exports and imports.

Back to unemployment, the chart above depicts our perspectives. To sum up, our projections point to figures much more favorable than projected by the market (in this case, we compare our numbers to the main private banks in the country), even with a Smooth Moving Average. In truth, the effects (still preliminary and with favorable scenarios) are likely to appear in the last quarter of 2017 and first quarter of 2018… adjustments and accommodations are soon to come in the face of reality and reforms, but we highlight the comparative difference (level and timing)… Government set apart (an eternal optimist and for obvious reasons), someone is far off mark in premises and projections.

Fiscal Policy

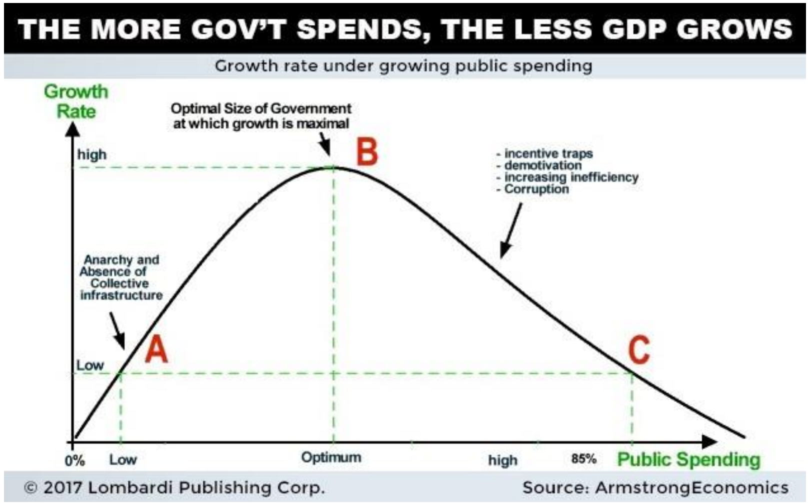
Despite efforts by the Administration, fiscal figures are horrendous.

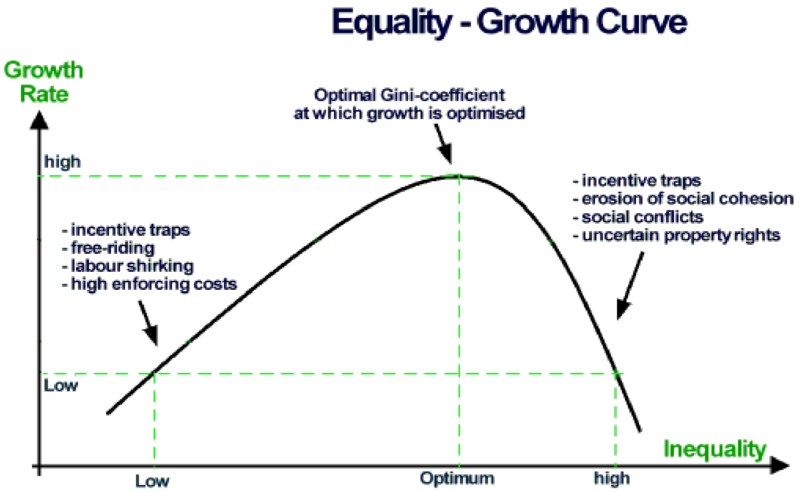
Here as in other problems affecting our economy, the "profligate" State, especially when social security numbers are factored in, does away with several initiatives. It is necessary and fundamental to continue with these lines of attack, but if we do not resolve the numbers in Social Security, we'll enjoy a pyrrhic victory. Social security reform, without prejudice to other measures of fiscal containment, is a *sine qua non* condition for sparing resources to fund public investments. It is necessary to understand that "spending cuts" is not an end in itself, but a "mean" to it. It is only with such an effort that the books will not (shortly) collapse. Yet more important, under such realignment and assessment of public finances sustainability, we can change the perception of economic agents, thereby inducing drops in country-risk, improving confidence indicators and, as a consequence, retrieving investors, boosting the economy and therefore reducing unemployment.

But, what if all of this fails? Yes, more than 70% (research poll) of people interviewed are against social security reform… is the Government willing to let the State "break down"? They (financial minister and economic team) have said before, "it won't"… and what will they do? Raise taxes! It is a disastrous exit… put simply: raising taxes will obliterate economic incentives and consequently job creation.

The Laffer Curve (already mentioned in this report) has clearly shown the tax-collection effects of increasing tax rates; it has also led the way to further studies as the one shown aside (https://www.lombardiletter.com - graphs).It is clear that the Government spends too much and poorly… and the reflexes are those presented in the analysis.

Unfortunately, or perhaps fortunately, we have currently only one point to deal with in order to achieve sustained growth (private investment!), employment, income and lowering inequality: control of public finances… with the most central of all reforms that is Social Security!





International Environment

Three subjects have grasped the world's attention in April: (i) rising tensions between US and North Korea, (ii) early elections in the UK and (iii) French elections.

The US relations with North Korea have never been exactly "healthy", but especially after Donald Trump's rise to office nerves have grown hotter. In this board game, even China has become a possible ally, after being a punching bag during the presidential campaign, for the US is now pressing China to use its clout on North Korea to put a check on its nuclear program and ballistic missiles drills. The American government does not seem to take these matters "lightly", and is already preparing further sanctions on North Korea in case provocations continue, by way of realizing missile tests. The US might also impose sanctions on North Korea's allied countries in order to demotivate them from collaborating with the continuity of the country's nuclear program.

In single master stroke, as in the times of Margaret Thatcher, the Prime Minister Theresa May has called for anticipated elections – a clear movement to strengthen her own position. Sheer astuteness and intelligence. It is clear to the PM how hard BREXIT will be to pull off. Threats come from all sides, but the narrative laid out by some leaders of the European Union shows that negotiations for the exit will not be "facilitated". For Theresa May the UK need a strong and stable leadership, for the consequences may be of great gravity should negotiations fail – and it is possible that this act may have aimed at this point.

In France news could not be better! The Left no longer has any chances over there, at least for now. Both candidates going for the second round of presidential elections, Marine Le Pen and Emmanuel Macron, stand far from any socialist lineage. Research polls show Macron leads, but who knows…

Somewhat overshadowed for not having the same "*glamour*" or the "unheard-of-ness" of the above issues and also for having been already priced in, the world has had little trouble in the economic-financial aspect of it. BoJ authorities have released a statement claiming it is premature to revert its expansionary monetary policy, citing the close-to-zero inflation and the modest economic recovery. The BCE has, in its turn, indicated that monetary policymakers are yet to consider cutting back of monetary stimuli put in place since mid-2014. As a counterpart to this policy, the Finance Minister of Germany Wolfgang Schäuble has, once again, claimed that low interest rates in many regions of the world are likely to increase risks and the Central Banks must envision a strategy to gradually exit this policy. In line with our thinking, this policy feeds complacency in countries instead of underscoring the need for economic reforms. At last, the FED does not seem willing to speed its pace in raising interest rates – we still foresee two more 25-b.p. hikes in 2017.

Interest Rates

Monetary policy seems to be back on track.

By any model, method or analysis of dependent variables, a swift and bold monetary easing is the direction. Thus, be it by our proprietary model of the Reaction Function of the Central Bank, the DSGE models, the traditional Taylor rule and even by future comparative analysis domestic vs. foreign interest, all point to a strong interest cut.

All of these methodologies, directly or indirectly, take into consideration some underlying variables and the BACEN, guardian of the currency, also heeds (as it reflexively reminds us) other elements apart from inflation. But, what about prices? Well, these are quite well behaved – today and for the coming years. Tied to price variation, we have an enormous recession, with meager aggregate demand, 13.7% unemployment and a slack in production that makes room for a major interest cut without setting off inflation. But, would that be enough for a wider and stronger cycle of interest rate cuts? Models state so, but models do not capture everything and need to be dynamically adjusted. Politics and the reflexes of the much awaited reforms have the power to alter to a significant extent the trajectory thus far drawn – to say the least.

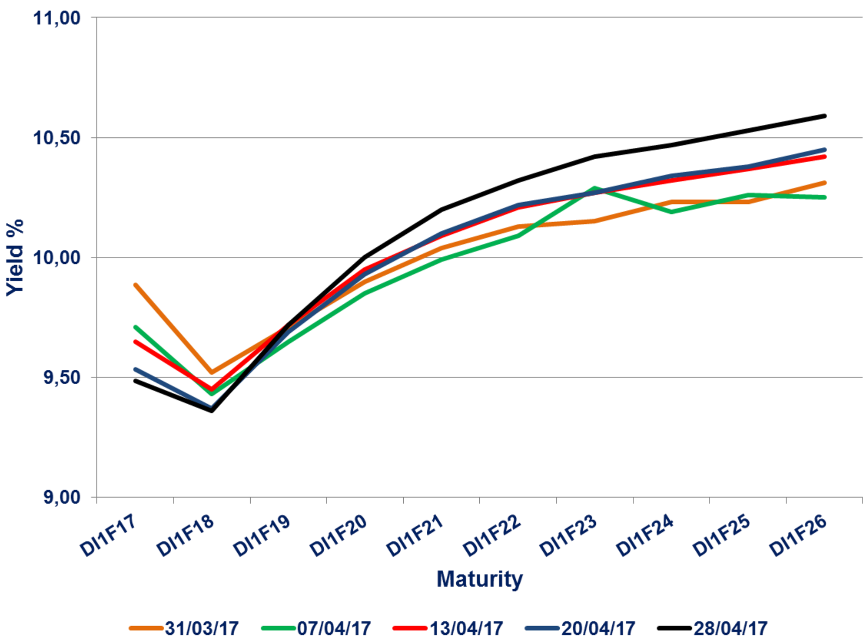
Moreover, in our opinion, monetary policy must be constrained by the unswerving Wicksellian principles ($S \equiv I$) and in this matter the analysis of “adjusted interest rate” parity suggests we are adequately “managing” and the country is soon to be competitive. In this line, investors are much likely to come back. If that is true, we may have SELIC at 8.5% in 2017 and 8% in 2018, with inflation on the target (or below it!), investments flowing and the recovery of sustained growth.

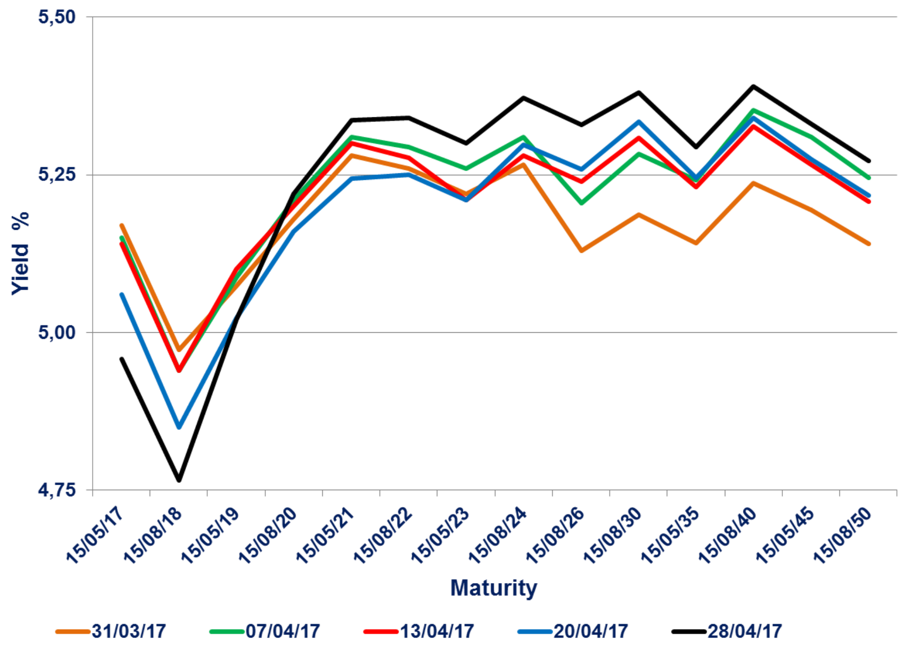
Beyond wishful thinking and in order to see this analysis prosper, it will be necessary more than monetary policy. It will require a general rearrangement that unshackles free initiative, especially foreign capital, from restrictions in place and thereby infuse oxygen in productive activity with competition and openness to trade.

In the marketplace, the unraveling discussions on reforms and the partial loss in Government support in Congress have brought, in the short term, the feeling that increasing fiscal risks reflected in the price of Brazilian assets in April. For short interest rates, the trend points downwards. The Copom has cut down the SELIC in 100 bp to 11.25% yearly rate, as expected by the market. The release of the minute reaffirmed the Central Bank’s view that the a faster pace of cuts is adequate, in the moment, although the current situation in the economy would justify speeding up cuts. On the long vertex of the yield curve the movement reflected a higher risk aversion with increasing rates and the return of future contracts negotiation starting in January 2021 with rates above 10%.

Interest Rates

Yield and Coupons Curves (NTN-Bs)

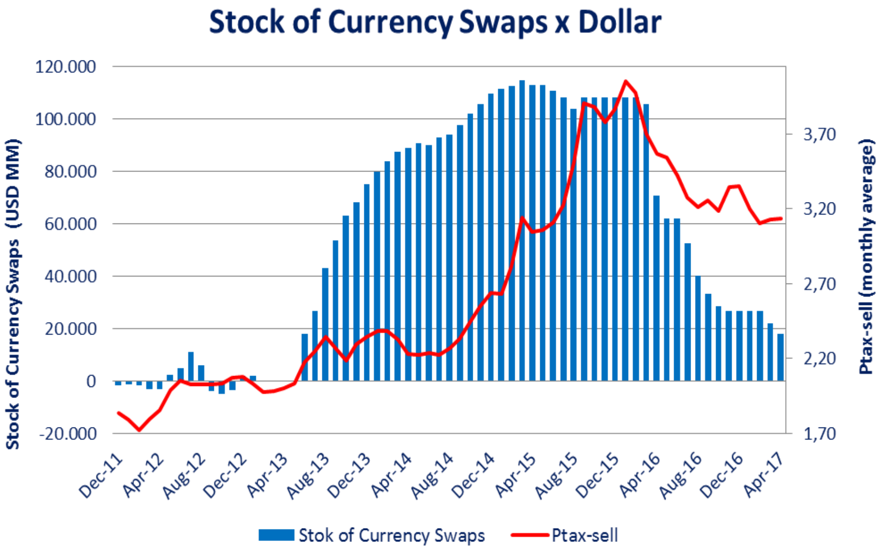




Foreign Exchange

April was marked by volatility in currency markets throughout the month and in the intraday market. Investors paid close attention to the voting scores on social security reforms, as the required minimum to approve the Constitutional Amendment proposed by the Government is 308 votes out of 513 congresspersons. However, the Government has lost support in the house by its own coalition, which raises uncertainties as to the easy passing of reforms. Beyond domestic issues, there was a defensive movement by a share of the market on account of possible ramifications of international conflicts involving Syria and the rising tensions between US and North Korea. The BRL devalued 0.95% (PTAX).

After two months of partial rollovers, the Central Bank has renewed, entirely, the stock of 127.785 contracts of Currency Swaps maturing in May, amounting to USD 6.389 billion. The strategy change was announced after the Dollar reached BRL 3.15. Even with the Central Bank intervention the American currency continued to appreciate in face of higher foreign risk aversion and also due to domestic issues regarding the approval of social security reform amid releases of plea bargains of former corporate executives of Odebrecht.



Source: Bloomberg and Central Bank of Brazil | Elaboration: Planner Redwood

In April, the Central Bank registered a loss of BRL 558 million with currency swaps operations. In the year, the outcome is still positive in BRL 5.419 billion. On the side of foreign reserves if converted to BRL, the gains amount to BRL 5.917 billion in April. Within the year, the net result has been BRL 46.766 billion.

According to the Central Bank, the Dollar inflow to Brazil was higher than the outflow by USD 9.066 billion in the fourth month of 2017. This position is the net result of incoming USD 52.729 billion and a total withdrawal of BRL 43.663 billion throughout 18 business days in the month. The positive currency flow of USD 9.066 billion registered in Brazil in the fourth month of 2017 was 39.16% higher than the one registered in April 2016.

Stock Market

April was a month of volatility in the stock markets. Considering only within-month figures there was little change with respect to Ibovespa closing the month at 0.64%. In graphical analysis, the month has formed possibly the second “section” of a “W” pattern, pointing to a reversal in movement.

Doubts on the approval of labor market and social security reforms still in the first semester of this year, the release of plea bargains by former executives of Odebrecht, the volatility of commodities prices in foreign markets were some of the factors impinging on trades at the Brazilian stock exchange. On the external front, the geopolitical scenario was highly troubled, as described in the previous section on International Outlook, also impacting prices and trade volumes of Ibovespa.

On the other hand, the drop of domestic interest rates and some signs of improvement on the real side favor the stock market. The perception by Brazilians regarding the economy has improved. Although companies are in various stages of financial deleveraging in relation to households, the tendency is that companies continue with this extra effort and with it promote the rebalancing of their books. It’s not only a few companies that, in the face of difficulties in deleveraging and operating administrative revamping, have tried to lengthen their financial obligations aiming at smoothing some of the cash flow impact in the short run and, therefore, “buying” some time until the economy recovers. Market analysts and investors do not miss such “details” of companies, and these tend to be highlights of quality of management and of investment.

Source: Broadcast | Elaboration: Planner Redwood

Moreover, the Stock Exchange tends to tag along a recovery in case Brazil does its homework. With the approval of reforms and the more intense drop of interest rates, consumption and investments are likely to accelerate until the end of the year, boosting recovery and reflecting on the prices of shares. It is obvious that, under this hypothesis, selectivity must be accurate, for the quality of companies associated with sectors that will in fact recover will be determined by a risk-adjusted return.

Therefore, we have the Ibovespa closely tied to the rest of Brazil – despite the fact that the thermometer here reacts quite fast: if Brazil follows through on its reforms and if we have a next President engaged in continuing these reforms and that deepens the balancing of public finances, we will see investors (notably foreign) with much appetite, on the contrary… turn out the lights.

Monthly Commentary

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