Planner Redwood Asset Management

MONTHLY COMMENTARY

DECEMBER 2014

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Introduction

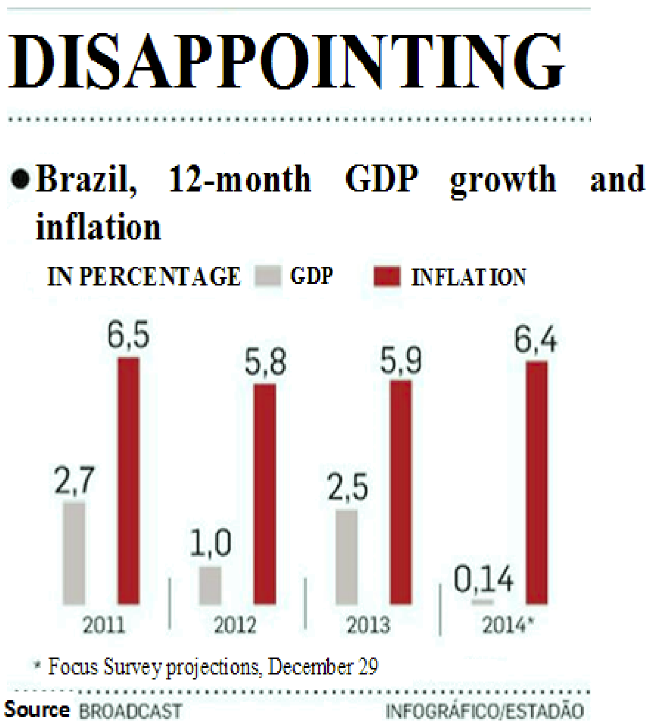
2014 is over, and so is the suffering caused by standing a large part of the country's leadership. 2015 will be even more challenging, especially due to international economy and impacts thereof. Notwithstanding, the new economic team and what it represents give us some energy and a renewed breath of life.

In retrospective, 2014 was a bad year, in short, due to three characteristics, which are a reflection of the change in the economic policy that occurred in the Dilma Administration: (i) slow growth, (ii) increase – external account imbalance and, (iii) inflationary pressures at the top (upperband) of official inflation target. However, 2014 ghosts may continue haunting us in 2015 (and maybe later) because of the corruption at Petrobras and its contagion, especially in the financial market which has always been a reference for funding and indicator of timing (for raising money) and risk levels. Petrobras' correlation and effect on other Brazilian companies is significant and this situation causes an increase of Brazil's risk premium, with impacts on all assets, including the long-term future interest, which, aligned to risk movement, will still be more magnified given the higher than normal level amidst the monetary and fiscal adjustment to be implemented. Thus, not only are economic and financial correction needs extrapolated, but also (and not only) those with immediate impact in this segment, such as adjustments to company governance control (especially state-owned) greater transparency and corruption control. 2014 and recent years have done great damage, with long lasting consequences, but the technical part is reasonably "easy to correct". Simply apply the teachings of the University of Chicago and other related thinking... whether the President will assume the political cost of this necessary adjustment remains to be seen. Hopefully she will.

On the world stage we observe the huge impact of the oil price drop and the political situation in Greece, which again contaminates the Euro region and the decisions of possible adoption of quantitative easing measures by the European Central Bank (depending on the elections of January 25, the country could leave the Euro Zone). Russia suffered a severe deterioration of its currency (exchange rate) and its Central Bank acted with vertiginous increase of its benchmark interest rate (17% per year) and become an additional and huge source of concern - especially for emerging countries. The big fear is the possible replay of the 1998 crisis and its spread around the world...at that time there was debt default...the Russians do not "fear" implementing extreme measures and panic can be generalized. China's growth reduction appears permanent and its impacts are reflected not only in the region (Asia), but also around the world - particularly in the other BRIC countries. Some relief on the world stage, is the US economy's performance, for it ended the year with good prospects. As a result of this fact and the international scenario, the country already experiences a run on its government bonds (flight to quality).

US Treasuries ended the month at 2.17%. S&P changed -0.42%, NIKKEI closed at -0.05%, DAX at -1.76% and FTSE at -5.01%. Ibovespa ended the month at -8.52% and IBrX at -8.17%. Maxima for DIF15 is 11.64% and for DIF17, 13.05%. NTN-B 2050 ended the month at 6.17%, and the dollar (Ptax sale) at R$ 2.6562.

Economic Activity

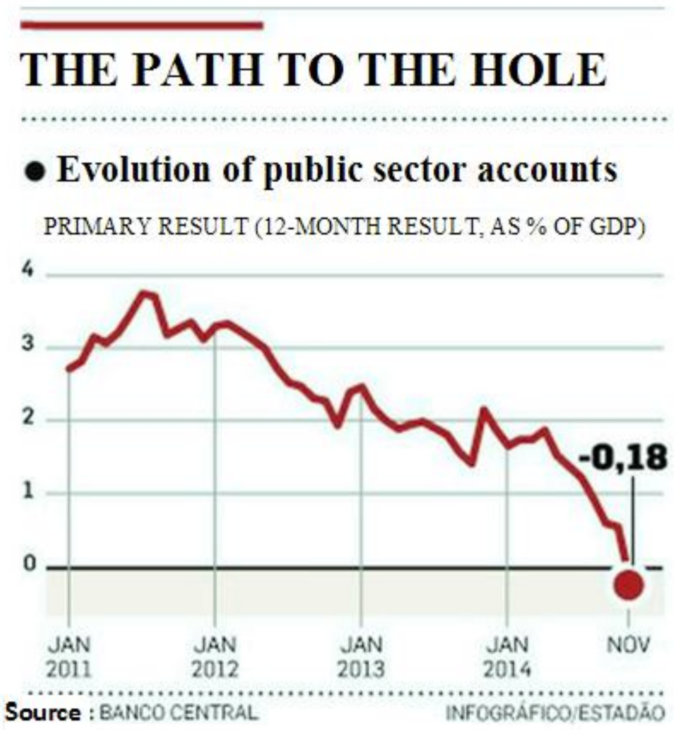


The figure speaks for itself, and it does not refer only to 2014, but to all other recent years: high inflation and disappointing economic performance. However, we have confidence on the new economic team, the upcoming adjustments and, above all, the shift in economic policy in the short term. The challenge is huge and the harmony between the economic area ministers needs to be fine-tuned as the political cost and confrontation will be very difficult...they cannot falter or have a relapse during difficult times, that will come. There should be total focus on public spending and, in addition to fiscal and monetary balance measures, implement policies toward investment and economic productivity increase. All this should be done carefully, in calculated fashion, one thing at a time...starting with regaining confidence. The new Minister of Planning, responsible for the Multi-Year Plan (PPA) that defines the direction of the country's development over the medium term needs to understand and align with this trajectory. In fact, more than a trajectory, we mean a mind set and the clear idea of what should be done, without daydreams or flirtations when adversities come. Thus, statements from Minister Nelson Barbosa, such as the one transcribed below, do not help to achieve the goal, and bring to mind some "uncertainty" concerning the administration's full unity and focus:

"The country was prepared to face the international crisis of 2008. The chosen path was the opposite to that used in previous crises. The government invested in emergency, structural, growth and employment incentive actions. These actions prevented the contamination of our financial system by the international crisis and enabled a rapid recovery of the economy, after the initial 2008 shock"... and continues to justify the performance, considering the numerous internal and external shocks faced..." We managed to preserve the priority on social benefits and programs and advance actions that improved the quality of life of the population. Fiscal policy played an important role in this process, absorbing economic shocks via temporary reduction of our primary result."

Hopefully this is only rhetoric, because it was precisely this attitude that got us where we are now.

Fiscal Policy



Another picture that says it all by itself.

That is the cursed legacy that Dilma receives from herself. Why? Because as much as we want to hold Secretary of Treasury Arno Augustin responsible, he was supported by Minister Guido Mantega and also by the Central Bank (BCB) and, ultimately, by the President herself. In this regard, looms another issue, similar to our questioning of Minister Nelson Barbosa's statements, only this time it concerns the attitude of the Central Bank. The institution, which will continue to be led by Alexandre Tombini, has said in its documents since August 2013 that... *"the public sector balance tends to move towards the neutral zone."* Has the thinking of the institution changed? The reality is here for all to see, for months...has the picture changed? The Brazilian Central Bank staff (for now) are the same ...will their attitudes be different? For how long? How strongly?

The objective reality is that the probability of having a public accounts hole, the first since 2001, when Central Bank's historical series began, is huge. Until a few weeks ago Minister Mantega declared he would deliver a surplus of more than US$ 10 billion, but the November results indicate a yearly deficit result of approximately R$ 20 billion, that is, in order to reach the desired figure, far from what was at first stated, it would be necessary to generate a surplus of tens of billions ...for how long will we try to kid ourselves?

There should exist team solidarity and unity of thought, but also discernment, intelligence and technical sense, for there are no arguments against facts. Enough of yes men...the time or reckoning has come! Never before in the history of this country have we been in such situation, it's time to change...to go back to what has been proven to work.

By the way, go back to what works together (as an economic team), with consistency in attitudes, statements and postures. Technical and professional independence, without parallel, venal and/or misaligned propositions.

International Environment

The US economy is expected to grow 3% in 2014 and also in 2015. In fact, our assessment is also now grounded on the perceptions of the chairman of the Cleveland Federal Reserve, Loretta Mester, that economic activity has recovered "very strongly" and posts very good data in terms of expansion, especially the progress in the labor market. In November, the unemployment rate in the US stood at 5.8% of the workforce. As a result, if the inflation heads towards the 2% target the Fed will interpret this as increased demand from consumers, and that would be another sign of "consistent" recovery of the economy, that is, sustainable growth. So the economist believes (and so do us!) the Fed may initiate a change of its monetary policy...in other words, start the monetary tightening, through an increase of interest rates in the first half of 2015.

In the Euro Zone, the European Central Bank (ECB) is in a difficult situation, now as a matter of timing, as well. That is right, it has been expecting some reflection of its measures before eventually implementing new ones. Its next meeting will take place on January 22, 2015, and the elections in Greece (the result of which can greatly influence the new measures, according to the result of the election and the subsequent Greek exit from the Euro zone) will take place on January 25...terrible circumstance...very hard to arbitrate. The President of the ECB, Mario Draghi, makes constant appeals to the Euro Zone countries to carry out structural reforms, because, as he said *"We have to create conditions for all block countries to prosper independently. All members must be able to explore comparative market advantages, attracting capital and creating jobs"*...and furthermore, *"... countries need the flexibility to respond quickly to short-term shocks."* In fact, this structural reform seems more linked to the field of Fiscal Policy of member countries, for while such "misalignments" last there will be differences in the levels of prosperity.

In China the slowdown is already unquestionable. It might grow 7.3% this year, and the target for 2015 and upcoming years is 7% (if confirmed, the lowest in 25 years!). The government, which is usually a great leverager for Chinese industry, with high investments in infrastructure, should reduce its spending in 2015. Investments are projected to be 6% of the GDP for 2015, half of the rate set for 2014, 12%, and less than one third of the 19% level posted in 2013. In other words, the party is over!

Finally, in addition to the specific problems of each country around the world and the correlations that affect each other, there are two important ingredients: (i) the steady appreciation of the US dollar against virtually all currencies, and (ii) the substantial decrease of oil prices. How will these variables affect each country and to what extent? Will someone benefit from it? How? How can one prevent and/or mitigate its effects? How will the economies come out of the low growth trap? Where will this macroeconomic orgy lead us? Answers in the following chapters...

Interest Rates

Since the beginning of the increasing Selic rate movement in April, 2013 and especially in 2014, the Central Bank's stance was absolutely hesitant at first and (possibly for political reasons) complacent in recent months. Timid increases failed to attain the main objective, which is the control of inflation. This was obvious, because the combination of (i) the increase of Selic in weak doses, (ii) unbalanced fiscal policy, and (iii) credit incentives could only result in a well above central target inflation. There is no magic! Unless there is (as promised) a new posture next year, the initial numbers are also not encouraging in the category inflation. The new Finance Minister, Joaquim Levy, has stated the need for realignment of prices and fiscal adjustment. It is indeed the first step. The year 2015 will start with higher prices for consumers of energy, public transport, water (in Sao Paulo due to scarcity, those who use more, will pay more), food, just to name a few. However, the counterpart to this realignment of prices and its limitation of their impacts in inflation are supported by a more contractionary Fiscal Policy and stronger monetary policy - this means interest rate increases.

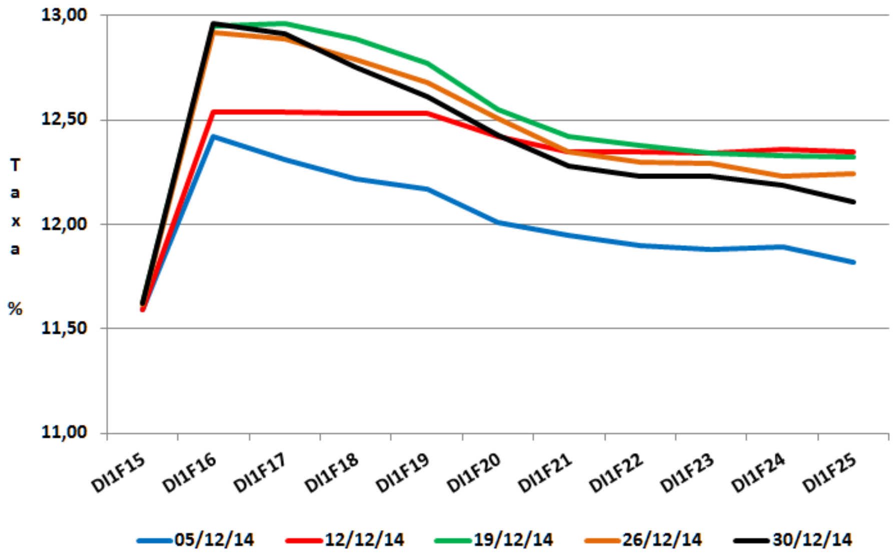
There are adversities from all sides, and we are not the only ones facing a challenging scenario. Russia raised its interest rate from 10.5% per year to 17% per year in an emergency meeting, after the Ruble posted the highest devaluation in 16 years. The purpose of the decision was to limit the depreciation of the local currency and inflation risks. The country's economy suffers from the sanctions imposed by the US and its allies and oil price collapse. Despite the economic situation and the fact that the Brazilian policy is different from Russia's, some investors see Brazil as parallel to Russia, thus the fixed income market reacted immediately with the sharp rise in futures interest rate contracts. Although investors asked for higher premiums in short-term interest rate contracts, we do not believe that the Central Bank will boost the intensity of Selic's interest rate as done in Russia. But rest assured, it will increase!

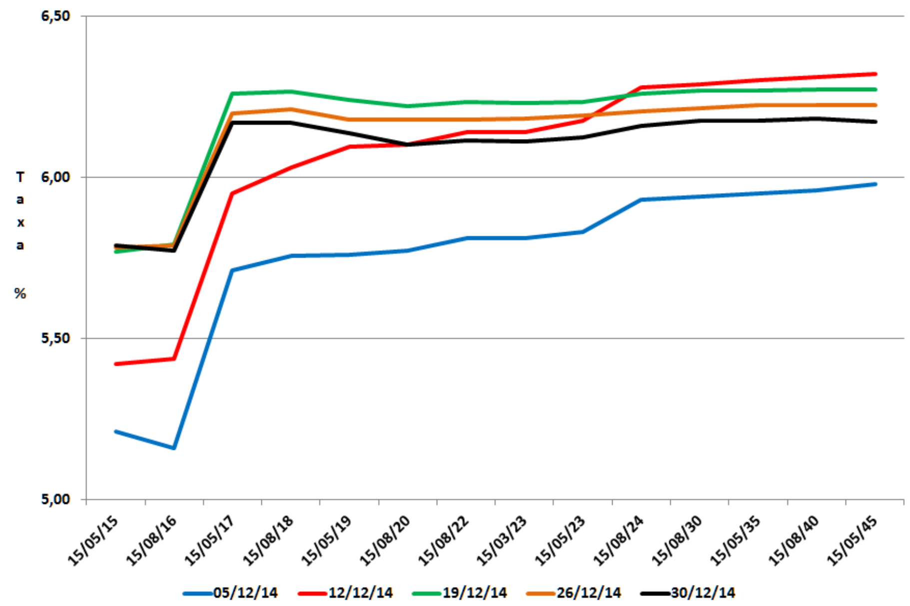
There were no surprises in the COPOM meeting held at the beginning of the month, unlike the previous one. The Central Bank raised the Selic rate by 0.5%, to 11.75% per year, the 2014 closing rate, as opposed to the 2013 closing rate of 10% per year. The increase of 1.75% in the Brazilian economy's base rate, as mentioned, did not bring relief to inflation, but the postponement of adjustment of several prices could (artificially) keep inflation at the upper band of the target of 4.5% per year. Given the limited autonomy of the Central Bank, in an election year and the strong influence of the President on monetary policy, nothing different could be expected...we expect a different attitude and stance in 2015.

Short-term contracts (DI1F16) closed the year traded near 13% per year pricing the "greater independence" of the Central Bank in the conduct of monetary policy and the orthodox education of the new Minister of Finance. The full year's futures interest rate curve had a strong gradient, with short-term contracts being traded at higher rates (perspective of the need to control inflation) at the beginning of the year and longer with lower premiums. A similar movement occurred in the NTN-B coupon curve. The market is sending signals, is anybody listening?

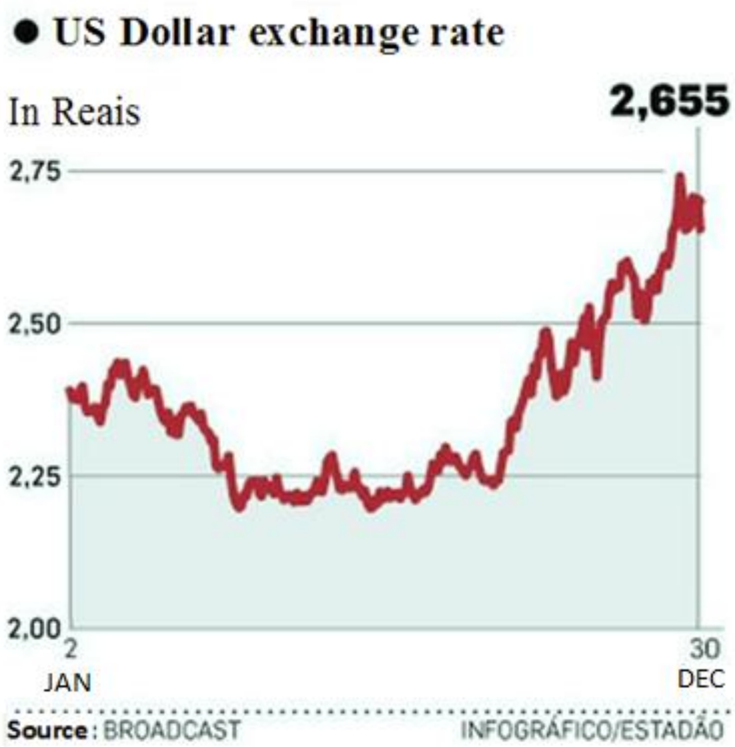
Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange



Let's not argue about definitions - doesn't the chart on the left show a dollar overshooting? Whether due to the size of the recovery, or the combination of this with intensity and time, the fact is that, according to the information available, the Central Bank worked on its economic and econometric models with a reference dollar at R$ 2.25...this variable, plus others, were used to drive the monetary policy. Prices were "balanced"...and now, will we adjust by increasing interest rates? Or leave them as they are?

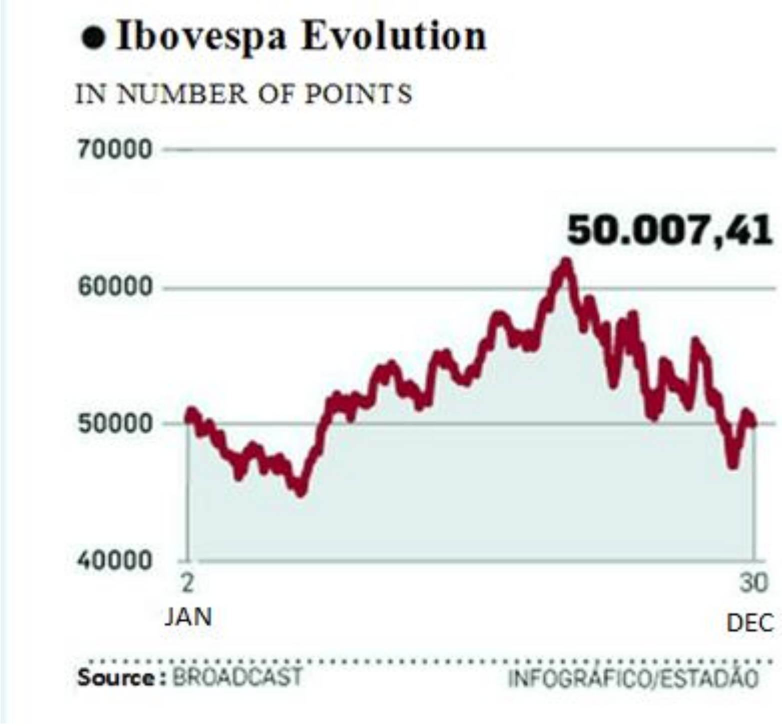
Not even the sharp devaluation of the dollar in the last trading session of the year was sufficient to reverse the devaluation of the real in December (down 3.49%) and 13.39% in the year. For the fourth consecutive year the Brazilian currency lost value against the dollar...but even more important is the recent volatility (17.2%).

In addition to this challenging scenario, massively commented in these reports, one expects, in 2015, the rise in US interest rates and a minimum intervention from the Brazilian Central Bank in the foreign exchange (currency) market, given the convictions of the new Minister of Finance. The Central Bank has said it will reduce by 50% the number of swap contracts offered daily and that the program should end in April. On the other hand, and as some relief to the current situation, monetary policy loosening measures in the Euro Zone and Japan, in addition to increased credibility for investors in Brazil, as a result of the new economic team, could mitigate the increase of the dollar and perhaps a possible return towards late 2015, depending on domestic and international issues. Don't we advocate "floating prices"? So, let us have them!

However, what is the real cause driving this movement? Did Brazil simply follow the worldwide market, especially in emerging countries? Why isn't the Central Bank intensifying its measures via customary instruments? Would it be spending ammunition for a purely speculative short-term movement or has the thinking changed? Has the President stopped listening to her advisor and professor Yoshiaki Nakano, who is credited with saying that a floating dollar is good as long as it does not float?

These are hard times. Internationally, uncertainties concerning the conduct of economic and political policies in the Euro Zone contributed towards the volatility of the currency. However, it will not stop there...especially in the short-term. Nouriel Roubini may be right...currency war!

Stock Market



Objectively and in general terms, the Ibovespa was stagnant in 2014, but a more detailed review per sector and future expectations paint a potentially much worse picture than the one presented here.

Along these lines, the December rally (always expected) did not happen! The fall of the Bovespa index in the year was 2.91%, narrowly closing below 50,000 points. The index did not fall further due to a change in the theoretical portfolio methodology, which as of 2014 now concentrates more on bank sector than commodities shares. The Stock Exchange fell in 3 of 4 years of the first Dilma administration, totaling a 27.84% drop in the period.

Volatility was the word most used in the Brazilian stock exchange in 2014, especially in the second half, with the proximity of the presidential elections. The index surfed the wave of polls, with peaks when they suggested the possible victory of Aecio Neves, and intense falls when the incumbent appeared to be the winner.

The international market also played a role on the behavior of prices of domestic assets: (i) the decline in commodity prices, (ii) slowdown in emerging markets, (iii) uncertainties in developed economies and, (iv) geopolitical conflicts influenced the price of shares traded on the stock exchange.

The later scenario is also quite nebulous. The rise in US interest rates is certain, in our opinion it will take place on the first semester of 2015, the Euro Zone begins another year without recovering from the 2008 crisis, China's growth will be reduced and Japan suffers from stagflation. Phew! Our hopes lie on the new team's management of economic policy, the question is whether they will be empowered to make all necessary measures for the resumption of growth and the maintenance of our Investment Grade. It will be a year of adjustments, in the end, and the Ibovespa, as a whole, tends to suffer.

However, even with all the uncertainties about the Brazilian market and the allegations of corruption at Petrobras (with potential contagion), foreign investor investments closed 2014 with a positive net balance on the BM&FBovespa, but negative signs in December. Comparing Brazil with Latin America countries, investors still see advantages in maintaining positions in Brazilian stocks. There are opportunities for (long-term) Value Investing.

Monthly Commentary

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