Planner Redwood Asset Management

MONTHLY COMMENTARY

AUGUST 2017

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

"In a time of universal deceit, telling the truth is a revolutionary act".

Eric Arthur Blair "George Orwell" – British writer and journalist.

Introduction

It has been a year since Dilma Roussef and the Labour Party (PT) stepped down!

This date must be remembered and celebrated – it does not mean we are in paradise, but at least we are not on a downright and speedy highway to hell. Truth be told, many measures set forth by the PT administrations since 2003 – in the political, economic and social spheres – have their effects only now brought to bear with more intensity. However, under President Rousseff the real PT agenda was implemented and conducted with utmost ideological rigor – especially the New Macroeconomic Matrix, an earthquake for the Brazilian economy… with the ensuing the social unrest, as shows the Social Vulnerability Atlas (SVA) by IPEA (Institute of Applied Economics Research). The SVA combines 16 indicators covering 3 dimensions (urban infrastructure, human capital and income/labor), and it shows a slowdown in the process of diminishing social vulnerability in Brazil in the Roussef years in the Presidency.

But, afterall, Roussef was elected by the people, right? Of course! Nevertheless, her discourse was a flagrant attack on truthfulness and what was about to emerge. Economic and social outlooks already displayed distress, but dissimulations and simulations fed and sheltered untrue assertions… it was a coup! Manipulations and omissions, we saw everything done to hold on to power. The impeachment was our salvation facing the imminent final debacle. In this sense, one should celebrate! However, there is much still to be done… President Temer may end up with a fame of leading a reformist government (should he manage to push reforms forth), but he will never escape the stain of the alliance with PT and all its unscrupulous actions for all these years. To this date the government counts on, even at the highest posts, with officials much aligned with PT agenda – with the trust the chicken helps out the fox in the barn. With no major political ambitions ahead, low popular approval and a reasonable work pace by Congress, Temer should make a difference at once! As goes the quote on the epigraph: *“In a time of universal deceit, telling the truth is a revolutionary act”.*

In the world, tensions with North Korea have swiftly intensified. What seemed to be sole bravado to be tamed diplomatically, is reaching heights of nuclear confrontation. The consequences of such a war, particularly if it leads to the polarization of superpowers (China, Japan, USA etc.) will impose suffering and pain that were believed to be buried after Hiroshima and Nagasaki. Pain and suffering is also endured by the Venezuelan people… although France looks to a negotiated exit for the political and economic crisis that sweeps the country, President Emmanuel Macron has described Venezuela as a “dictatorship aiming to survive at the cost of a humanitarian anguish without precedent”. True!

In this landscape, the *US Treasuries* closed the month at 2.1170%. S&P varied 0.05%, NIKKEI closed at -1.40%, DAX at -0.52% and FTSE 0.85%. Ibovespa finished the month at 7.46% and the IBrX at 7.35%. Highs of DIF18 at 8.23% and DIF21 at 9.52%. NTN-B 2050 ended the month at 5.29%, and the Dollar (Ptax) at BRL 3.1471.

Economic Activity

To speak of economic improvement in the current bleak Brazilian situation *means* exclusively job creation. This is the only variable with some *relevance* lately.

Well, according to the National Survey by Household Sampling (PNAD) released by the IBGE (Brazilian Bureau of Geography and Statistics), unemployment in July dropped to 12.8%. 721 thousand people have left unemployment status in the last quarter. Manufacturing, commerce, transportation and other services have created jobs, whilst sectors such as construction, agriculture, domestic services and financial activities have dismissed workers. The net outcome was positive, above all on account of the seeming economic recovery in course that reflects on the labor market. However, such advance is couched on informal job posts (2/3 of all new jobs). Therefore, the quality of the new jobs is highly questionable.

One piece of good news is that workers' average real income stayed at BRL 2,106 in the second quarter. The result represents a 3% hike with respect to the same period in the previous year. In this line, the consumer confidence index has ascended in August, after three months on the negative range. Nonetheless, the index is still quite low, and this does not allow us to foresee any highs for consumption in the nearby future.

With the release of GDP data for the second quarter, many economists were quick to present their new perspectives and to assert that we are technically out of recession – we have gone over this concept of how many quarters are necessary to signify a reversion of trend… we prefer to be cautious at this moment. The GDP of the second quarter with respect to the first quarter has climbed for the second consecutive time (0.2%), the agricultural output remained stable while services advanced 0.6%. Household consumption has grown 1.4% and government consumption fell by 0.9%. All reasonable up to this point, but the savings rate has remained at 15.8% and investment parked at 15.5% - this was the lowest figure for the second quarter within the series starting in 1996. Furthermore, Gross Formation of Fixed Capital (GFFC) dropped by 0.7%! It is the fourth consecutive quarter witnessing drops on a quarterly basis… and this should be kept in mind: GFFC **invites** future growth! The table below depicts the comparison between the second quarters of 2017 and 2016 respectively:

Quarterly GDP Growth Rate (with respect to same quarter in the previous year)									
Period	GDP at Market Prices	Agriculture	Manufacturing	Services	Household Consumption	Government Consumption	Gross Formation of Fixed Capital	Exports	Imports
Q2/2016	-3.6	-6.1	-2.9	-2.7	-4.8	-0.5	-8.6	4	-10.4
Q3/2016	-2.9	-6	-2.9	-2.2	-3.4	-0.8	-8.4	0.2	-6.8
Q4/2016	-2.5	-5	-2.4	-2.4	-2.9	-0.1	-5.4	-7.6	-1.1
Q1/2017	-0.4	15.2	-1.1	-1.7	-1.9	-1.3	-3.7	1.9	9.8
Q2/2017	0.3	14.9	-2.1	-0.3	0.7	-2.4	-6.5	2.5	-3.3

Source: IBGE | Elaborated by: Planner Redwood

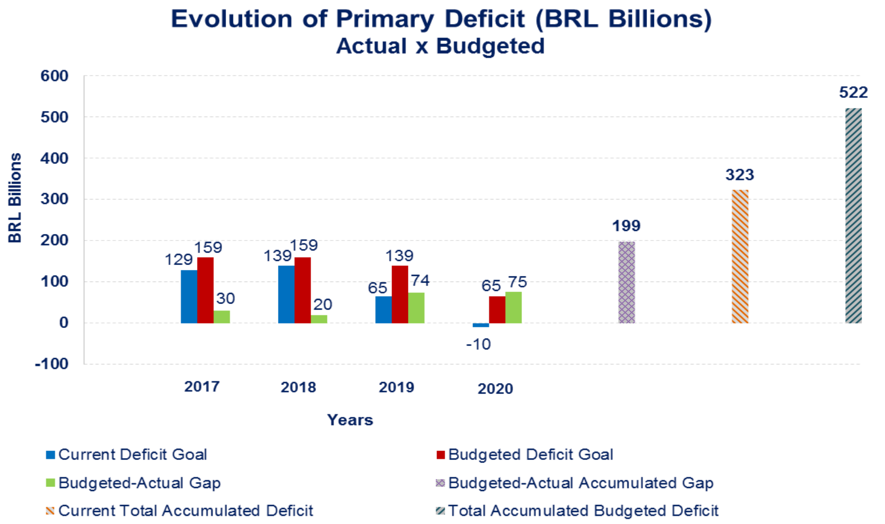
Data shows an actual improvement, consistent with our projections, that is, low growth in 2017 and some recovery starting in 2018. Oh! The unemployed population is currently at 13.33 million people – a still scary figure!

Fiscal Policy

The Central Government had a primary deficit of BRL 20.15 billion in July!

The result covers Treasury, Social Security and Central Bank and is the worst score for the month within the series, initiated in 1997. Between January and July of this year alone, the gap was BRL 76.2 billion, also a record negative number. In 12 months, the Central Government presents a BRL 183.7 billion deficit – equivalent to nothing less than 2.84% of GDP. We needed a +2.84%, not a -2.84%... truth be told.

The goal for 2017 is a deficit of BRL 139 billion, but the administration has proposed to increase this number to BRL 159 billion, which will fall short by our calculations – unless we have other tax increases and adjustments currently not on the table. However, the bad news goes on. The next three years will be of extreme difficulty in achieving goals originally set, and the government, in anticipation, has signaled new figures.



Source: National Treasure | Elaborated by: Planner Redwood

Realigning goals for 2017 and following years can be seen in two ways: (i) transparency with figures and possibilities and/or, (ii) absolute "rejection" of further cuts in discretionary and non-discretionary expenses. For 2017, as mentioned last month, it is somewhat prudent to do so for we crossed the half-year line and the original budget is not executable… thus "chicken out" was already priced and markets see the managing effort by the government to adapt. Now, substantial changes in the likes of those being currently proposed… jeez!... it won't be cheap. The chart above depicts the magnitude of the forecast error: BRL 200 billion!

On the non-discretionary expenses (mandatory), the focus must be set on the Social Security Reform – the bill must be sent in **any shape of form**. It is a fact that the longer it takes to present the bill the more flexible will become the fundamental features, and worse it will be thus leading to soon being revised and readdressed. However, we are on the edge: it is better to approve something now and bring some relief than to gamble with time and the chance of a better opportunity for approval by Congress. Enough! Better something than 100% of nothing.

International Environment

If Venezuela stole the scene last month, North Korea hogged all attention this month – dictators are on fire!

No, it is not true that things have gotten better in Venezuela, of course not! The fact is that North Korea has escalated towards nuclear confrontation that may end in a veritable catastrophe of literally continental proportions.

The conflict seems imminent, should diplomatic action prove ineffectual. US awaits a firm stand by China, which is longing to come. International organizations are articulating amongst themselves, while South Korea and Japan are preparing for the worst. In Europe (many countries) and even the BRICS in a recent meeting in China, have taken a stand against preventive military action, but the US certainly will not be able to manage the situation for long.

Amid all this turmoil, markets seem to behave without stress in the face of this potential and overwhelming event. Quite the contrary, the world's locomotive (the US) has advanced at an annualized rate (seasonally adjusted) of 3% in the second quarter of 2017, shortly above what economists expected and in line with our prognosis – it was the strongest figure since QI 2015, and shows the consumers' confidence is growing bolder in Uncle Sam's land. Despite good winds in the American economy, President Trump is bleeding politically – above all when it comes to honoring his campaign promises.

In Europe, as US turns to Asia and as the Chinese presence in the world stage grows more relevant, as well as the BREXIT potentially destabilizing the region, the German Foreign Relation Minister, Sigmar Gabriel, has come out in defense of a more vigorous European role in the world. He is right, because if Europe does not adjust politically and economically its future is not very promising – the UK has seen it. In the economy, despite (and not because of) measures taken by the ECB, we finally see annual consumer inflation in the Eurozone near 1.5% - closer to the 2% goal set by the ECB. Unemployment rate has remained stable at 9.1% in July, lowest level since February 2009.

In China, there is a date for the beginning of the 18th National Congress of the Communist Party: October 18th. The event has at least two important issues: (i) the beginning of the second mandate of five years with Chinese President Xi Jinping (party leader) and (ii) election of the new members of the Permanent Politburo Committee. President Xi Jinping has proven a powerful leader dominating the party, the government, the military and the state-driven economy for years in a row.

Definitely, dictatorship is the new black!

Interest Rates

No variable other than the interest rate is so symbolic of the changes observed in the last year.

In August 2016, we were reporting a totally different market than the one we see today. Galloping inflation did not give any room for the Central Bank to tweak the SELIC, while our country endured the effects of a recession that soon would become the longest in the country's history. One year later, this landscape has changed entirely. Despite the contractionary impacts on activity, it has been proved that monetary policy *still* works (no fiscal dominance!), with an expressive price disinflation of the Brazilian economy. In August 2016, the Headline Consumer Price Index (IPCA) accumulated 8.97% in 12 months, whilst the same indicator for 2017 scores 2.71%, a figure below the lower bound of the inflation target range. Once expectations were anchored (something correctly anticipated by Redwood in our reports), there emerged some room for consistent cutting downs of the Selic. Departing from 14.25%, we embarked on a downward cycle ever more robust, reaching 9.25%. The Yield Curve has followed suit along the period. The DI 2018, quoted at 12.78 one year ago, closed the month at 7.80. A visible improvement that signals a transition process observed in this period, which reinforces our claim that a responsible monetary policy is fundamental to consolidate a stable economy and markets on a sustainable basis.

The current scenario, however, bears a new arrangement for the near future. Different from the not so distant past when the Selic *artificially* hovered around 7% in November 2012, at this moment the "low" levels of interest rates are more consistent. The reason is simple: economic management is much more responsible and intelligent, and the reflexes of this new profile feeds into positive and coherent expectations – despite the negative feedback coming from the public finances and the political crisis.

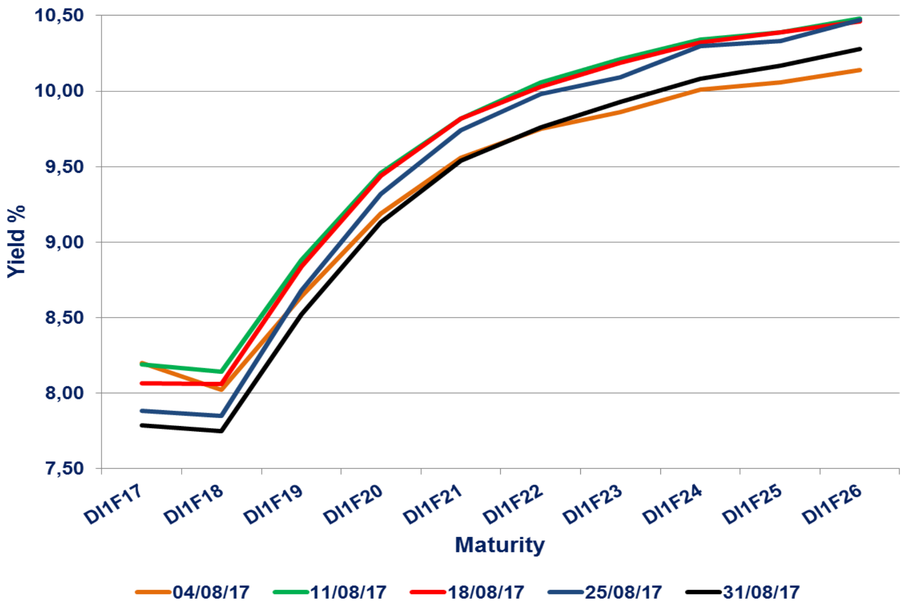
In this sense, our models and the market itself reflect this analysis in practice, indicating, unequivocally, that premiums in the short vertices of the yield curve are practically exhausted. We are left with premiums in long maturities. A reflex of this was the shift of the yield curve within the month. The market expects now the approval of the Long Term Interest Rate (TLP) in the Senate and the decision by the Copom in early September, although the 100-bp cut has been already priced. Redwood projects a 75-bp cut. If approved, the new rate for the BNDES loans may entail further drops in long term interest rates, given that this measure can lead to positive effects on the efficacy of monetary policy as well as on the fiscal framework (once it does away with the implicit subsidy with the Treasury), and subsequently for the perception of future risk.

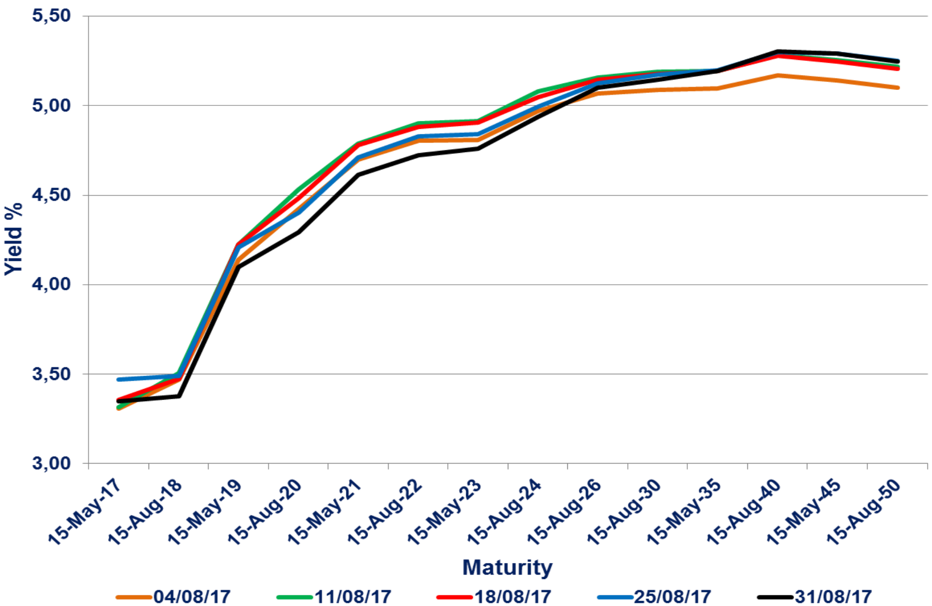
On all else, Redwood maintains its revised projections for the Selic at 7.5% at the end of 2018, although many in the market bet on a scenario of Selic below 7%. Even with positive signals coming from economic policy and from a lowering inflation, we do not think it is viable for an emerging economy, such as ours, to practice a real interest rate below 3%, despite the current landscape of global liquidity.

The naked truth is that, with premiums running ever lower, it will be much more difficult to attain good returns in this market. It will be necessary to proceed to a skillful and professional management… easy returns are over!

Interest Rates

Yield and Coupons Curves (NTN-Bs)

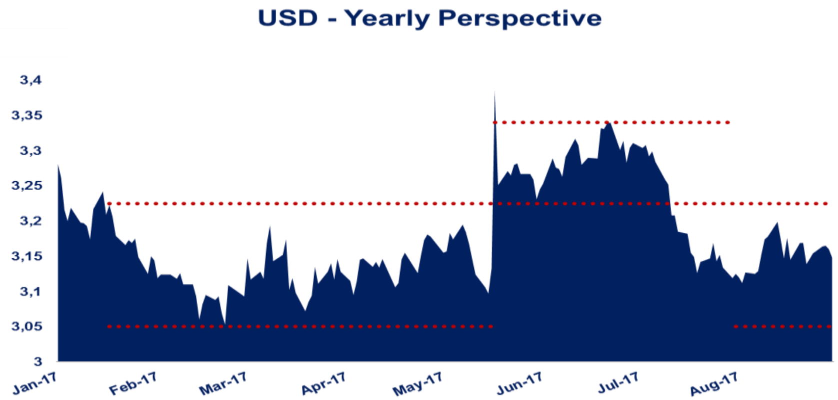




Foreign Exchange

In the current international scenario the USD has been affected by the growing geopolitical tension triggered by the missile tests promoted by the North Korean government, involving a missile launch over Japanese territory. Under the strains of a possible conflict between North Korea and the US (plus allied forces in the region) agents adopted protective strategies, swapping dollars for currencies such as the Swiss Franc or commodities such as gold. Nonetheless, the caution adopted by the US government up to date has outstripped such strategies quite rapidly.

In the domestic arena, the exchange rate had as its main test the announcement of possible new fiscal budgets which, besides downgrading the forecast for 2017/18, already "promptly" admits to primary deficits until 2020. Whether or not these factors would be enough to raise the risk of a further credit downgrading… it didn't happen.



Source: Broadcast | Elaborated by: Planner Redwood

Soon after the announcement by the government the rating agencies informed that Brazil would be placed under observation, with a downward bias, but for the time being the grade would remain unaltered. A vote of "confidence" comes at a good moment! Still in the domestic realm, the market has gone through August unscathed by Central Bank interventions… but one should not be overly glad. The absence of swap contracts maturing in September was determinant for the free floating of the American currency, which is not likely to repeat itself in the upcoming month, given that October-maturing contract add up to USD 9.975 billion. The perception among BACEN's officials is that the current stock of swaps (something near USD 28 billion) is "comfortable", which reinforces the continuity of the strategy and the likely integral rollover of the maturing amount still within September. Opportunities come and go, this was the chance to make a decisive adjustment…

In this troubled environment the American currency closed the month at 0.94%, at BRL 3.1471. In the year, it accumulates -3.15%. Should the current political and economic landscape linger on (continuity of the economic team and its strategy) and the external outlook of abundant liquidity, we reinforce our projection of USD at BR 3.05 at the end of 2017. At any rate, one should keep in mind that our current moment stand in stark contrast with the past, when fiscal crisis was tied to a crisis in external accounts, with a contagion mechanism linking the crunch in external liquidity and the consequent capital outflow, leading to currency depreciation and further fiscal imbalances… in the end a default on the public debt. In this segment, as in all others, in case fundamental reforms fail, the future hangs by a thread.

The tone of the last report continues: the detachment of economics from politics (as a way to pass Reforms) will not last long.

Stock Market

The Ibovespa closed the month with a 7.46% increase – the highest monthly hike in 10 months. The daily financial volume averaged BRL 8.6 million.

Among the determinants of this outcome, the international price of commodities was once again instrumental, especially the highs in iron ore and oil, which overcame uncertainties in the tense international environment, tagging along the unexpected acceleration of manufacturing activity in China. Adding to this was the last release of corporate results for the second quarter bringing, among other “good news”, indication of falling levels of leverage of public companies. Information compiled from corporate balance sheets (*Economatica* database), there was a 1.4% drop in net corporate debt (with respect to previous year) after six years of consecutive growth. Counted out of this analysis was Petrobras, which faced a 11% reduction in its debt in the same period.

However, the main factor for the stock markets in August was the privatization pack and the concessions announced by the government within the PPI. Among the highlights of this package are the privatization of the Brazilian Mint, the Lotex (public lottery tied to Caixa Econômica Federal) and, particularly, the privatization of Eletrobras (on the day following the announcement, the company’s share shot up 50%). The idea first proposed is similar to the process applied on Vale do Rio Doce and Embraer back in the 1990s. The State holds a stake and veto power in the company’s board, and will not involve in this process important issues such as Itaipu plant and thermonuclear plants. The intention is that newly entering shareholders speed up capital restructuring and lowering debt levels, beyond the positive effect on public accounts, particularly for 2018. In truth, privatizations should never be seen as means to embolden the government cash position, but as a way to affect the long run and to withdraw the government from companies – leave it to the private sector. It doesn't matter, all it does is that we are pushing privatizations ahead… be it for “opportunism” or not, we are having the cake and eating it too!

These factors added up allowed the Ibovespa to climb back to 71.000 points, something that last happened in January 2011. With continuity of reforms, the gradual recovery of activity, and if the improvement on the corporate financial soundness, new opportunities are likely to arise on the long-term investment front in the stock market.

Caution here is, obviously, most required, for the reflexes of an economy consistently recovering are still fragile. In this sense and similar to our comment of the interest rate segment, it is of utmost importance to proceed to a professional and focused management. If Ibovespa strides to its historical highs in BRL, the same cannot be said of the dollar-denominated scores… and under this light we have the main investor (foreign) with their eyes wide open for opportunities. They hold the power to shake up the stock market!

Monthly Commentary

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