Planner Redwood Asset Management

MONTHLY COMMENTARY

DECEMBER 2017

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ANBIMA

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

"A bright future beckons. The onus is on us, through hard work, honesty and integrity, to reach for the stars."

Nelson Mandela – First President of South Africa and Peace Nobel Prize Laureate in 1993.

Introduction

2017 is over and, with it, goes a bleak past!

The economic policy pursued recently, beyond reason in Roussef's administration particularly to the minimally committed to economic rationality, seems to have passed. The herculean effort to drag us out of the worst recession in our history, finally shows some results in the last quarter of 2017. We closed the year with strong recovery perspectives, albeit slower than anticipated, and not least, due to the colossal PT wreckage – in all areas.

However, there still lingers a fragility that may compromise this expectation: the political-fiscal situation of the country. If the Temer administration has already achieved much in terms of reforms and of undoing a horrific past (of which it was itself a part!), the most important of all reforms, namely Social Security, has not yet been approved and coupled with an eventual discontinuity in current economic policy, the future ahead seems rather dark. Economics and politics do not stand apart, period. The current unpredictability of this year's presidential election is the main uncertainty factor, a crucial point for the continuity of recently reestablished policies with an upswing of both investments and growth, or we'll go back to the morbid dark ages imposed by the PT administrations. The suffering must end already! The domestic landscape is benign in many fronts such as low interest rates, idle capacity (which allows for inflation-less growth), anchored inflation and improving unemployment. The global scenario also (for now) helps, with growth and low interest rates and with a gradual pace of adjustments, particularly on the side of the FED. Thus, there is a highly favorable alignment of factors contributing to a significant improvement for Brazil in contrast to how we closed 2017. Without fear of incurring in excessive confidence, Nelson Mandela's quote in the epigraph fits our expectations: *"A bright future beckons. The onus is on us, through hard work, honesty and integrity, to reach for the stars."*

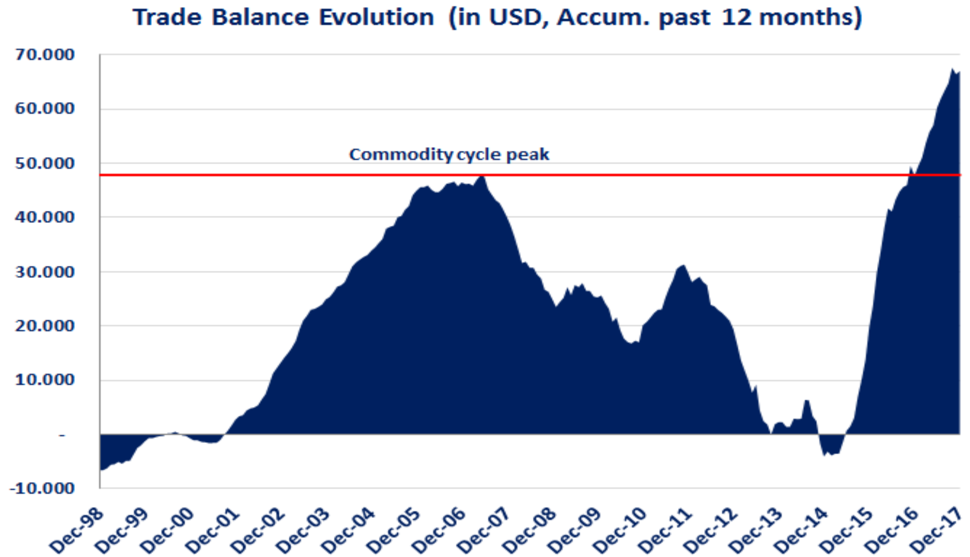
Worldwide, 2017 and especially December have been all but "more of the same". With Donald Trump leading the most important economy in the planet, many paradigms have shifted. However, the whole world (including a great share of the US population – or at least the leftwing media) has missed the point of the "new normal" of the "republican" Trump. It is not about simply undoing Obama's legacy, but a complete turnaround of rules, postulates and conducts, without missing the objective and hegemony of a global leader. Certainly it is a great challenge, for it will impact both allies and foes. Retaliations and reciprocities will come as 2018 will show.

In this landscape, the *US Treasuries* closed the month at 2.4054%. S&P varied 0.98%, NIKKEI closed at 0.18%, DAX at -0.82% and FTSE -2.30%. Ibovespa finished the month at 6.16% and the IBrX at 6.35%. Highs of DIF18 at 7.0% and DIF21 at 9.35%. NTN-B 2050 ended the month at 5.4533%, and the Dollar (Ptax) at BRL 3.3080.

Economic Activity

2017 appears to have been the comeback year for Brazil's economic activity.

After enduring the deepest recession of our history, winds seem to blow in our favor. In truth, figures in the end of 2017 circumstantially point to a much promising 2018, with both the economy and the market recovering, a monetary policy yet to present/reflect its effects and several other blunt signs of an economic upswing. Among these signs, we highlight the trade balance of 2017, with an impressive record: a USD 67 billion surplus. Of course a detailed analysis will show that this outcome is couched on facts we wish had not taken place (recession-restrained imports), and thus is unlikely to happen again in 2018. At any rate, it is an expressive figure and ratifies the heating up of activity, especially in December, when imports had the highest growth rate. Although the benchmark is low (2016), a 20.4% change of the index relies on 14.7% increase in capital goods and 16.5% in intermediate goods; an unequivocal sign that investments are coming back.



Source: MDIC | Elaborated by Planner Redwood

In this vein, agriculture bore the burden in 2017, but like the trade balance, its exuberant performance in unlikely to be repeated. This is not to say a poor outcome is on the way, but we'll hardly surpass this past year's record harvest. Automobile retail has also fared quite well: following four consecutive years of falls, it has grown 9.25% in 2017, with a 14.4% growth in December alone, based on daily average of car plate registrations. In fact, beyond data on trade balance, monthly figures in manufacturing also have reinforced the trend of improving investments. We expect growth of the FCGF in 2018… at last!

In sum, various sectors present good perspectives and one can only hope for no frustrations along the way. After all, we must "engage" definitively in a sustained growth pace, for from a long-term hindsight (40 years) the per capita income of Brazil has grown 30% (since 1980), measured in USD-PPP (IMF projection); in the same period US has grown 92% and Chile, 194%.

Enough with the lost decades!

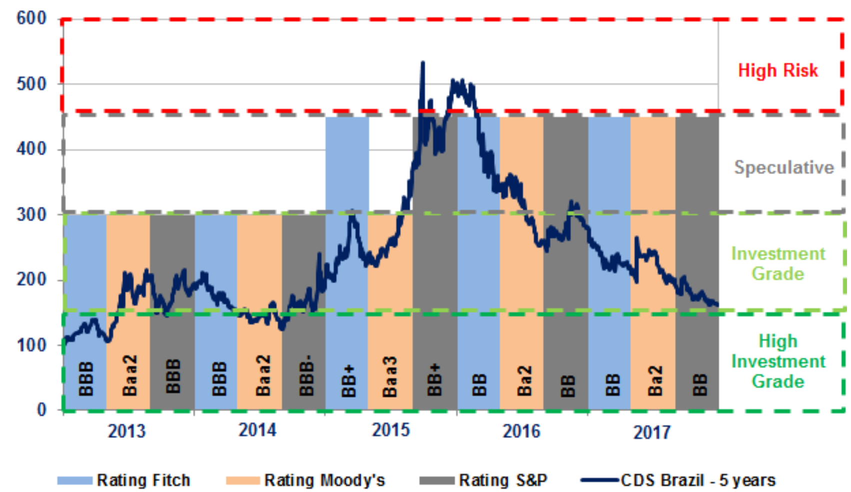
Fiscal Policy

Social Security Reform has not been approved in December.

Our congressmen's mindset displays a striking degree of either immaturity or irresponsibility when it comes to this topic. A brief assessment of recent events is enough to grasp where we are and to where we are headed in wide steps, that is, a future quite close to extreme difficulties. The moment is indeed of general alarm, so we can avert the current direction of things in the future, so Brazil won't become the federal equivalent of Rio de Janeiro. We repeat yet again the "mantra" that Social Security Reform must be approved – be it disfigured or not.

However, the tic-tac of this time bomb becomes increasingly scary, for time runs out around April when the presidential race will ossify any political movement that proves more emphatic and "compromising". Counting on the imponderable is hardly a good strategy, and in this case even less because we are on the verge of lacking control over budget, in a crucial moment for our economic recovery and a window of opportunity (in general) seldom seen. Yes, Social Security is a landmark that will guide the country, and if it is not set now, one cannot tell when it will be.

CDS Brazil 5 years vs. Main Rating Agencies (end of year)



Source: Fitch; Moody's; S&P; Bloomberg | Elaborated by Planner Redwood

On the other hand, the government finds itself in trouble trying to develop a Plan B should the reform not be approved. Truth is there aren't many alternatives at this time to raise revenues (increase taxes, extraordinary revenues etc.), decrease expenses (almost all compulsory), and improve tax collection efficiency (including collection of outstanding tax debts). An eventual Plan B also needs to be sustainable, even if only for a short while (such as the "temporary flexibility" of the Golden Rule - if that is possible, for it is a Constitutional matter), at the cost of not achieving any fiscal consolidation and, with it, the deterioration of investors' perception and the consequent re-pricing of Brazil. Invariably, this scenario awaits us with no alternative plan.

The solvency assessment of a country by its main and accepted indicators does not point to a comfortable situation, but the financial market may bet and give a vote of confidence in this regard. The 5-year-CDS, a relevant risk indicator, has closed December 2017 at 161, against 280 in December 2016; a significant additional cut-down of 42%... it was around 500 at the end of 2015 and early 2016!

Once more, an opportunity knocks on our door and we cannot waste it!

International Environment

The world is in fact in the hands of a few countries.

Like it or not, *four or five relevant countries* dictate the where the world goes. It does not mean that the remainder of nations are simply subjects, but not playing by the rules of these leading countries or fall in line with their strategies, turns the life of the “rebel” quite hard, especially in the short- and medium-terms.

However, every once in a while facts shake out this established order. Now is such a moment, when we acknowledge events that have taken place in many parts of the world in 2017, namely: Donald Trump’s actions, the evolving Brexit, the change of guard in Europe and the new stance by China. The axis is undergoing adjustment and this probable reordering will lead to a new and improved relative position by *peripheral countries*.

In the US, such “warning” has been signaled since the presidential campaign. If attacks are common between party lines during the presidential race, promises and measures are, as a rule, smoothed out once the presidency is secured – it hasn’t been so with Trump. His objective seems to be a total undoing or a great commitment to policies enacted by Obama. Moreover, the destruction of Obama’s legacy seems not to be transient, for Trump has nominated 12 judges to appeals courts, against 3 by Obama, all with a conservative profile and with a perspective of long court mandates. *Obamacare* apart (which still stands) and notwithstanding the many cherry-picked budget cuts and submission deadlines, many measures have taken place or are in due course in areas such as diplomacy, immigration, environmental and fiscal policies. Examples abound: withdrawal from the Paris Agreement on climate change, a reversion of the historic agreement with Cuba, the suspension of the nuclear deal with Iran, stepping out of the TPP, suspension of several federal regulations etc. However, the most important of all has been the approval of Tax Reform in December. The idea is, in its essence, the philosophy of the Republican Party and will entail repercussions of significance to public policy and to the world at large.

Given its context, there have been numerous changes in Europe, albeit quite localized. If Germany, Holland, France and the UK already face some turbulence and changing *status quo*, Spain has witnessed a new stance on the Catalonia plea. Greece also will not hold up one more year of restrictive measures and, to that effect, the rest of Europe will not accept additional bail-outs of the country by the ECB. French President, Emmanuel Macron, stated in his first New Year’s speech that 2018 will be “crucial” for France, for Europe e for the world, speaking directly to European citizens, calling them out to vocalize their views on the direction Europe should take. Italy will have general elections in 2018 and will also be a source and thermometer for the future of Europe.

In Asia, the main driver is China, which struggles at this moment with its falling economic growth, but also “seizes” such global adjustments to gain terrain in the political and economic fields, rising up to a likely new world leader. It is difficult to imagine that the *four or five relevant countries* will let that go easily.

Interest Rates

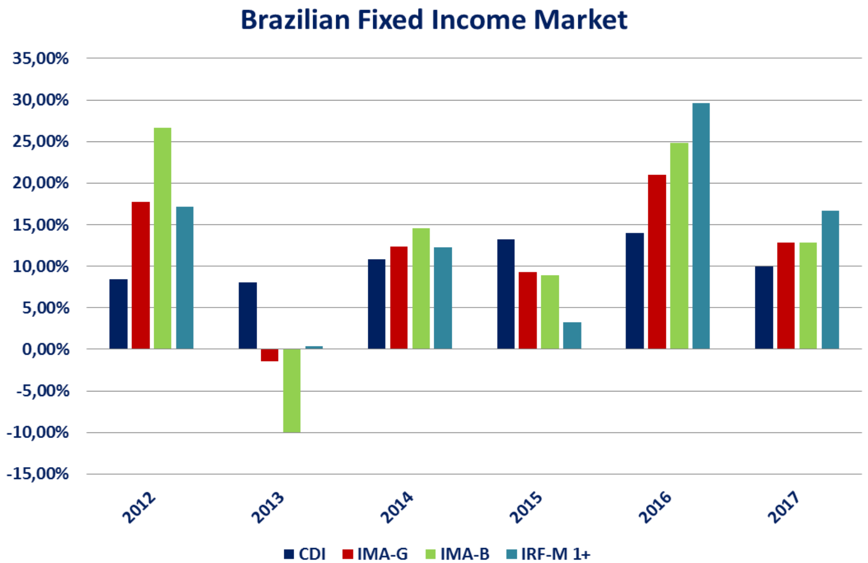
Possibly the event of greatest relevance in this process of revamping the Brazilian macroeconomic policy is the SELIC interest rate, the main guide to Brazilian interest rate market and which has registered its lowest level (7%) in history in December. The decision by the COPOM to cut down 5 basis points has fallen in line with the view that inflation is completely under control for both 2017 and for 2018, given the strong anchoring of expectations. In this line, gains strength in the market the understanding (shared by us at Redwood) that a new cut in February 2018 is quite reasonable, which would take the base interest rate to 6.75%.

Hence the yield curve inclination is pointing out that, even with possible risks tied to the upcoming elections, the shorter vertices are already well priced at levels similar to the estimate described for the SELIC, and with low volatility. However, it has become evident that risks related to not approving Social Security Reform are still on the fore, with vertices in medium- and long-terms closing the year substantially above minimums reached in the last 12 months. Such risk still exists. Nevertheless, should this scenario sets in in 2018, with the passing of the reform and the growing unlikelihood of a leftwing victory on the presidential race (in view of current poll leader and former president Lula's trial), this landscape is bound to change, with the narrowing down of spreads between different vertices.

Another effect of relevance adjacent to the interest rate cut will probably be observed in the fixed income market. At each new cut by the COPOM, passive positions indexed to the CDI endure lower returns. Thus, with the lowest SELIC in history, a more technically qualified management is required in order to generate relevant returns and to effectively protect capital. Strategies based on "feeling" will not be enough. Well-calibrated models and informed analyses aiming at finding the correct position will be a rule in the fixed income market in 2018. In truth, it is not about an exclusive defense of active management of arbitrages between vertices, but above all the identification of maturities that, adjusted for risk, will bear out relevant premiums.

Monetary policy has been magisterially conducted until now by Ilan Goldfajn and must remain vigilant in the face of political-fiscal fragility. But it is undeniable that 2018 kicks off with a much more comfortable situation for the Bacen team than the one in previous years and in the other areas of the administration.

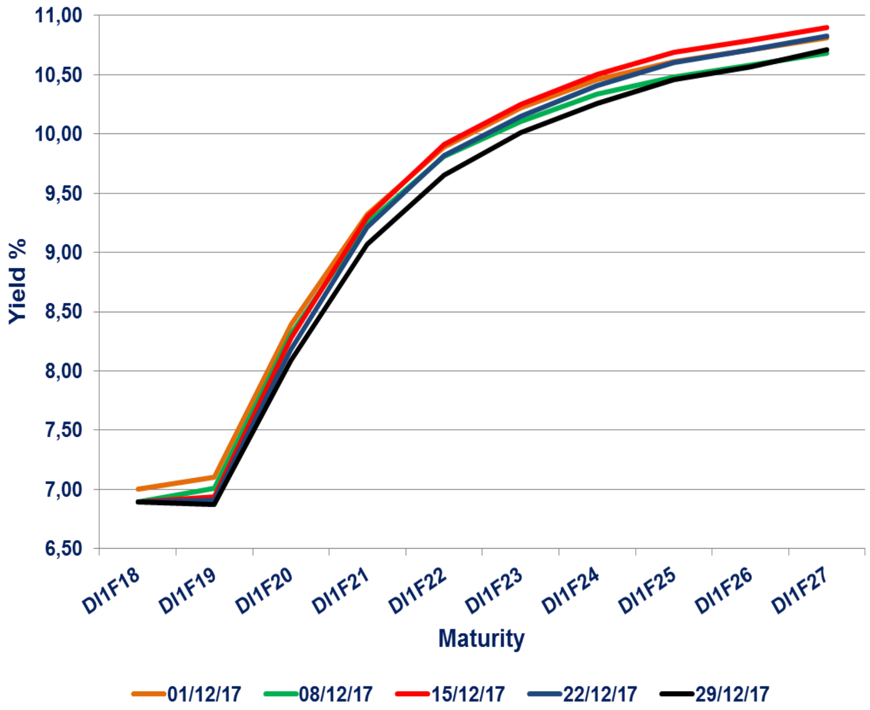
Congratulations! Job well done!

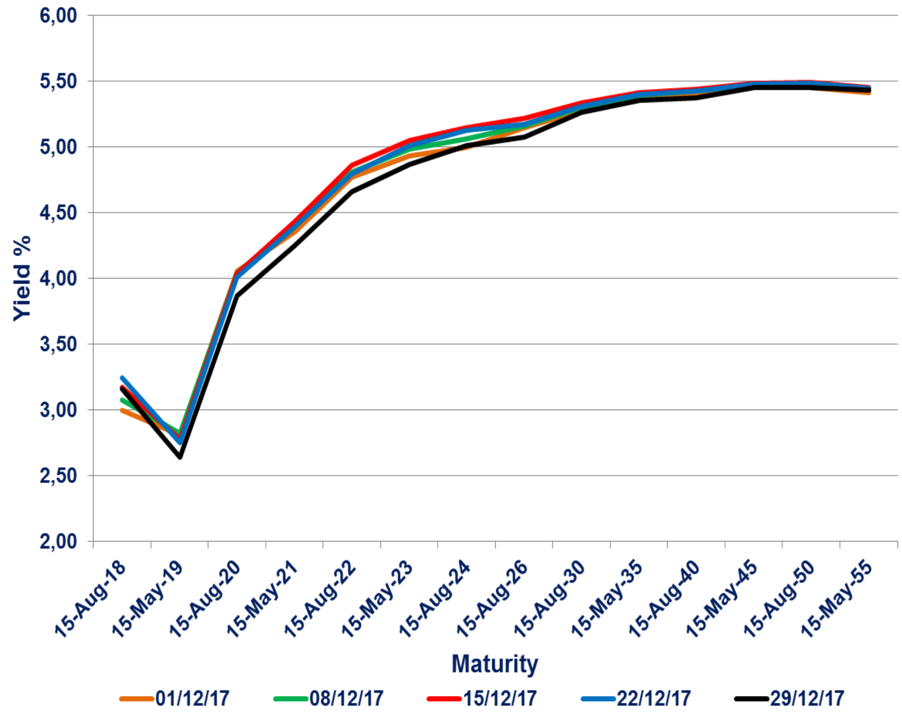


Source: Economatica; CETIP | Elaborated by Planner Redwood

Interest Rates

Yield and Coupons Weekly Curves (NTN-Bs)



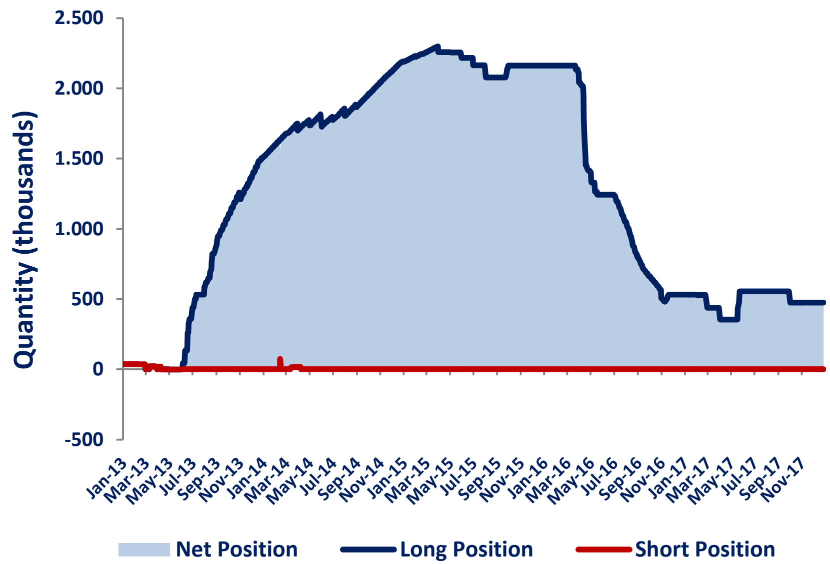


Foreign Exchange

We have singled out in this very space in November that the decision to vote for or against Social Security Reform in late 2017 would amount to a key factor guiding the behavior of the USD. We were right on point. With the postponing of the vote to February 2018, the currency has advanced and "consolidated" its quote above BRL 3.30, closing the month with a Ptax sale at BRL 3.308. Part of the important information in determining such level was the hypothesis winded by rating agencies of a negatively biased revision of Brazil's credit grade still in 2017, in light of observed difficulties in managing fiscal policy in the long term. The year is over and, as it looks, we've earned some more time before more drastic measures are deployed.

Apart some differences in directions pointed by the "vectors in the risk equation" for Brazil, we believe that early into 2018 the quote on the main currency of the world will fall "substantially" against the BRL, even with its current cycle of appreciation in regard of other currencies (considering the expected impacts arising from the approval of fiscal reform packs by president Trump). Meaningful events such as the very approval of the social security reform and the trial of former president Lula (scheduled for the end of January) must have dominant role in this sense. Besides, our models point out that, among the variables usually behind the fair price trajectory of the BRL/USD quote, under our estimates of the latter, there is no room for further advances in the BRL/USD quote as some market players project.

Traditional Swap – Stock held by the Central Bank of Brazil



Source: Bloomberg | Elaborated by Planner Redwood

As for the recurring interventions by the Central Bank in the currency market, there was a rollover of USD 9 billion in swap contracts. Within the year, the monetary authority in Brazil has registered gains of BRL 7.033 billion with operations of this nature, a far lower outcome than the BRL 75.562 billion registered in 2016. The official narrative continues to be that of providing hedge to the market, the containment of volatility and the formation of a "liquidity buffer". However, the market has grown more consensual, apart uncertainties relating to 2018, on the view that more interventions by the Bacen in the currency markets are uncalled for; the same even applies to the continuity of the gradual rollover process of the current stock of swaps. In this vein, our volume of foreign reserves at USD 380 billion is our stronghold, under various premises, including the containment of eventual speculations against the currency in the short- and medium-terms.

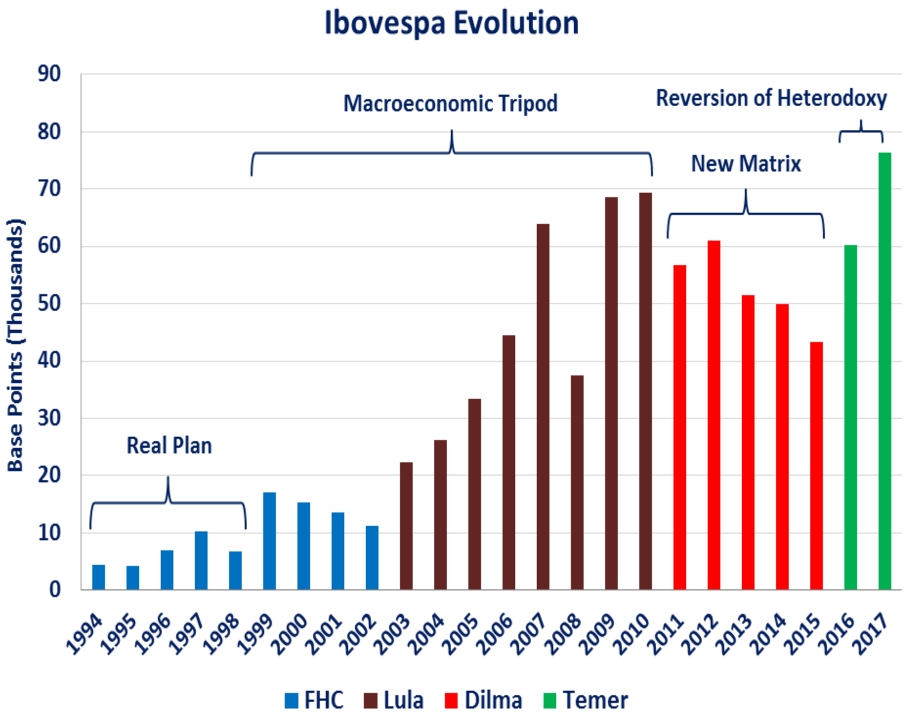
In other words, Exchange Rate Policy can and must abandon this interventionist practice.

Stock Market

The effect of uncertainties relating to the vote of the Social Security Reform is omnipresent in all markets!

It would be any different in the stock market, and this political fact that has guided completely the month of December has made the Brazilian stock exchange behave quite "timidly", recovering after the negative outcome in the previous month. The Ibovespa has closed 2017 at 76.402 points (high of 6.16% in the month and accumulated gains of 26.8% within the year!), much close to its historical maximum, reached in October this past year, when the index recorded 76.989 points. A key factor behind this success in the domestic stock market was the reform-promoting efforts by the federal government (given the already approved labor market reform and public expenditure cap) aiming at modernizing our economy and at building a more consistent and rational economic policy.

Even with no consensus on the social security issue – considered to be a "silver bullet" in the Brazilian public finances adjustment, the year was marked by the recovery in agents' optimism, which was expressed in the appreciation cycle that led the Ibovespa to its historical high. There were 9 IPOs in the B3, amongst which we highlight Carrefour, BR Distribuidora and Azul. As for the 59 companies composing the main index in the stock exchange in December 2017, 50 have registered gains. One must also recall that we've witnessed, in the past 12 months, the comeback of foreign investors to the stock market, with a net inflow of BRL 13.4 billion.



Source: Economatica | Elaborated by Planner Redwood

Thus we had the second year of strong recovery of stock markets after a continuous cycle of drops (2012-2015) that was interrupted by the radical change in the conduct of economic policy and consequently in the country's perspectives. For the decisive year of 2018, one is left with the choice for continuity of hard, honest and righteous work, as suggested by our epigraph in this report… because 2017 has already given us a sample of the bright future waving at us.

Monthly Commentary

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