Planner Redwood Asset Management

MONTHLY COMMENTARY

FEBRUARY 2017

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Monthly Commentary / FEBRUARY 2017

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Epigraph of the month... a propos the moment we are living.

“Life requires pauses.”

and still...

“What now? The party is over, lights are out, people are gone, the night has gone cold, so what now?”

Carlos Drummond de Andrade – Brazilian poet and writer

Introduction

Carnaval is on in February! The "greatest spectacle on Earth" is held in Rio de Janeiro and "the people's festival" goes on for four days of revelry.

Although *Carnaval* is spread out and long-lived tradition, including Ancient Rome with King Momo and all, the Brazilian Holiday has worldwide renown. It is so highly important that it is commonly said that it is only after *Carnaval* that "the year only actually begins" in the country... and here is also where problems arise.

In truth, we can list positive and negative points for *Carnaval*, after all there are those who like it and other who don't. It is controversial whether the country "is off work" during the four days of folly, for several sectors of the economy are "triggered" in this period, but the same time it is not conceivable the excessive involvement of public resources in a moment of particular hardship for the country. In the end, the net result may prove positive, for the year "longs" to start out in this interregnum up to *Carnaval* and with it come all the nefarious consequences that follow; at the same time it is a period of reflection and adjustments across the entire fabric of society, formatting and shaping the foundations for a year full of victories!... Ok, it wasn't as eloquent... oh, well, but that's the way it is. At any rate, as the great poet Drummond used to say in the epigraph to this Report: *"Life requires pauses"*… and *Carnaval* boils down to this: a joyous moment of pause amid all the stressful day-to-day events, a moment to forget all of the problems for a while, but above all focusing (or at least it should be) on "recharging the batteries". But playing during *Carnaval* has such meaning, for in four days reality comes back in… and, on the contrary, we are back to Drummond: "*What now? The party is over, lights are out, people are gone, the night has gone cold, so what now?"*

In the rest of the world, without the healthy distraction of *Carnaval*, busy times have marked the month of February in Europe, Asia and especially in US. Europe prepares to face important challenges on the political and economic fields. In Asia, notably in China, changing economic policies in US reopen discussions about its role in the world while, at the same time, its fragilities are exposed – at a particularly sensitive moment. In its turn, in US those vehemently against Donald Trump's election seem to begin to "accept" the new style in power, but without however succumbing to the excesses of the new Commander-in-Chief. The American people and its institutions show why they are what they are.

In this landscape, the *Treasuries* of USA closed the month at 2.358%. S&P varied 3.88%, NIKKEI closed at 1.27%, DAX at 2.33% and FTSE 0.03%. Ibovespa finished the month at -3.08% and the IBrX at 3.30. Highs of DIF18 at 10.89% and DIF21 at 10.66%. NTN-B 2050 finished the month at 5.17%, and the Dollar (Ptax) at BRL 3.0993.

Economic Activity

With festivities coming to a ending, Temer's administration needs to step back on the road. Yes, there is no time to lose, for while debates over the projects for Social Security, Tax and Labor reforms take some time – and still need to avoid sensitive tweaking by Congress of the original proposal -, others must be addressed which can be presented and approved and focus on the restarting of economic engines.

An example of this is the project that deals with outsourcing of all activities – which can be a meaningful signal to productive sectors, as well as a modernization instrument for labor relations in the country, with more clear cut rules and judicial security to corporations. Politically speaking it is a mature project, for it has been discussed in Congress since 1998 and can be voted swiftly with a joint effort by the chairmen of both lower (Rodrigo Maia) and higher (Eunício Oliveira) congressional houses.

In other words, the government need to stress and speed up the passing of projects of this nature. And with President Temer's political know-how and the "right moment", it is time to act!

Coincident Indicators of Manufacturing Production
(variation %)

	Month/Previous Month (seasonally adjusted)[1]			Month/Same Month Previous Year			Accumulate	
Products	**Nov16**	**Dec16**	**Jan17**	**Nov16**	**Dec16**	**Jan17**	**Within year**	**In 12 months**
Heavy Automobiles	3.4	4.8	-2.3	-5.7	-3.5	-2.3	-2.3	-5.4
Cardboard Sales	3.8	2.7	0.5	-1.8	-2.7	5.5	5.5	-1.5
Vehicles	27.1	12.5	-14.4	23.5	39.9	17.1	17.1	-8.1
Intermediate Goods Imports	3.8	6.9	-0.2	6.4	28.5	40.2	40.2	-1.8
Steel	0.7	-6.5	11.5	3.1	-3.8	13.3	13.3	-4.8
Confidence Index – Manufacturing	0.2	-1.9	5.1	15.2	11.6	14.1	14.1	7.9
Capacity Utilization Level	0.0	-0.8	1.7	-0.6	-2.4	0.8	0.8	-2.0
Inventories	2.9	-1.0	-1.7	-11.4	-9.4	-7.8	-7.8	-9.0
IPEA indicator of Manufacturing Production	**0.4**	**2.3**	**0.0**	**-1.3**	**0.0**	**2.1**	**2.1**	**-5.4**

[1]seasonally adjusted by X-12 ARIMA method

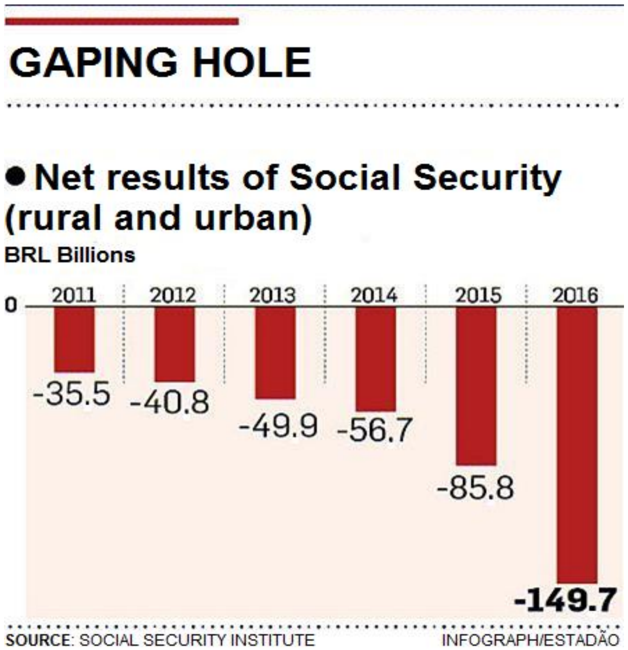
Sources: IBS, ABCR, ABPO, Anfavea, NOS e IBGE. Elaborated by IPEA/Dimac

http://www.ipea.gov.br/cartadeconjuntura/index.php/2017/02/

The table above was released by the Institute of Applied Economic Research (IPEA) and leaves no doubt as to the slowly improving situation, especially on the side of manufacturing (2.1%) in January 2017. However, the parade of indicators on the seasonally adjusted series between January and December was no pretty picture: automobile production plunged 14.4% and the cargo traffic volume in tolled roads dropped 2.3%. On the positive side, steel output has climbed 11.5%, confidence in industry 5.1% and the sales of cardboard 0.5%. But the lead feature on this parade (albeit timid) was the level of capacity utilization with 1.7%.

At last, it is not about a presentation on the main league of *Carnaval*'s contest, but we have leads that not only will we not be demoted to lower leagues, but also that next year promises a much better parade!

Fiscal Policy



From the *Carnaval* parade cars that enter the avenue of reforms in Brazil, notably the rebalancing of the budget, certainly the most important one is Social Security. More than the passing itself, it matters how the text will come out, in the face of all interventions and maneuvers aiming at altering it. Adds up to this the timing of this vote and the political-risk component involved in case an interruption of President Temer's term comes to be realized. These facts may well postpone the processing of the project or even push it back (many wish to do so), thereby compromising the entire economic policy in course.

It seems rather unequivocal the interpretation that reforms leading to public finances rebalancing will allow a wider, more general and continuous sustainability of projects for the jumpstart of economic growth of Brazil. Reflections are likely to be immediate and long lasting, both in what relates to investment increases and productivity in the country.

If the moment demand absolute dedication by the government to the social security, labor and tax reforms, this does not mean that approval will be smooth or that the desired time path and content will be respected. Well, this situation seems incompatible with the "cash" situation the government has to face. As in any company, what interrupts its adequate functioning is lack of cash, which needs to be reverted by a combination of measures, such as increasing receipts, cutting back on expenses, improving efficiency and/or borrowing money. With the new economic team, almost everything has been thought through and in some measure put to work, but it is a slow-moving and long maturation process (approvals depend on Congress).

What is missing are the "unthinkable" tax increases, compulsory deposits and loans… once it was not considered "adequate" a different proposal to be implemented or, in a politically incorrect form, there are not enough votes (in Congress), courage (withdrawal of sectional privileges, albeit momentary) and or competence (that's it here!) to promote larger spending cuts – under the "excuse" of budgetary rigidity.

One way or another, if the rope tightens and there is no other way for the government besides "increasing its own revenues" (beyond suggestions hereby presented last month), may the government proceed as in the case of a tax on financial operations to be reimbursed as the income tax. It would solve the negative cash flow effect until economic recovery and subsequent tax collection, and restituted to taxpayers. We can take this opportunity to adjust several things, as amplify and formalize the taxpayer base, adjust tables, etc. – of all evils, this is a lesser one.

The table above shows that the drumming section of our "Samba School" is skillful at playing *rock'n'roll*.

International Environment

Besides *Carnaval*, several countries in the world have deployed their own parades in February. The United Kingdom has started to face with decisiveness its resolve to leave the European Union (BREXIT), in the US President Trump shakes the tambourine with his Executive Orders to fulfill campaign promises and France makes way for the candidate Marie Le Pen (a sort of energized “Trump” in skirts) to the presidency.

We have previously covered on this space that this new “wave” (BREXIT, Trump, Le Pen, etc.) is not yet widespread, but punctual, may be the start of something that has come to stay. There seems to be some legit frustration of some peoples that find themselves less benefitted by globalization. Be it because they suffer with the lack of growth and welfare, be it because they see a “transfer” of its piece of the pie to other economies, with a reflex of impatience and rejection to everything that’s been made in the last years in terms of institutional arrangements (global). Examples of such rejection are not lacking, now led by president Trump, such as attacks on the UN, NATO and NAFTA and even the dead-born TPP. The point here is much simples than it looks: this sentiment is genuine and, therefore, it is more suitable to find an alternative so we don’t “lose” all that’s been made so far (taking heed of the weight of discontents). Free trade is “better” than protectionism, multilateralism is “preferred” to bilateralism, institutions and rules are “preferred” to isolated and proper regulations… but if all of this has been made and we still witness this phenomenon, it is because it is not well done and therefore needs to be revised… as soon as possible.

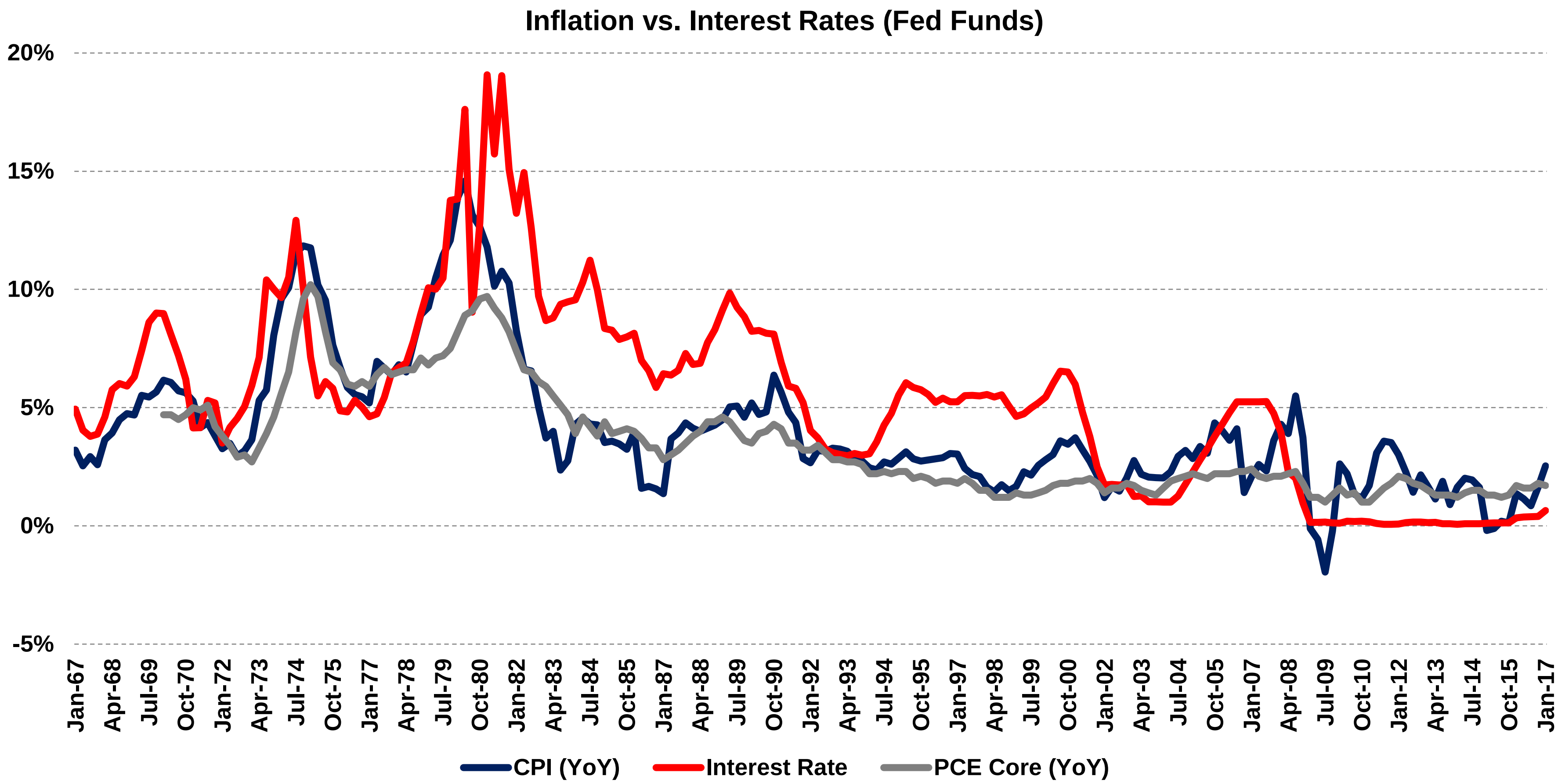
Amid all this agitation, the world at large has given some good news too. The Bank of Japan (BoJ) will release from now on the dates on which it intends to pursue its bond purchases, in an attempt to curtail volatility and improve communication with the market. In line with good news, the report by the OECD points to India growing at yearly rates above 7% (doing its homework with several reforms in course) – stronger growth among G-20 countries, thereby reflecting on its PMI Manufacturing at 50,7 and with indications of a yet stronger expansion. In China, PMI Manufacturing has increased in February, but PMI Services has pointed to a drop, however small.

In Europe, the PMI Manufacturing in Germany climbed to 56.8, while unemployment remained at 5.9%. In this way, the Eurozone has registered the highest level of its PMI Manufacturing in 70 months, reaching 55.4 in February, with an unemployment rate of 9.6% - lowest level since May 2009. As for inflation (2%), this has overshot the BCE’s target, generating blunt criticism to the policy implemented by the institution. On the opposite side to this performance, the PMI Manufacturing of the UK has plunged to 54.6 in this month… *BREXIT* critics will blame it.

As for the US, the FED seems to be out of alternatives and excuses to increase interest rates. At variance with our domestic situation, where we are (theoretically) focused exclusively on inflation, over there they study formally hiking interest rates based on indicators of economic activity such as unemployment and, of course, inflation. The charts elaborated and released in what follows leave no doubt that this movement should have started long ago.

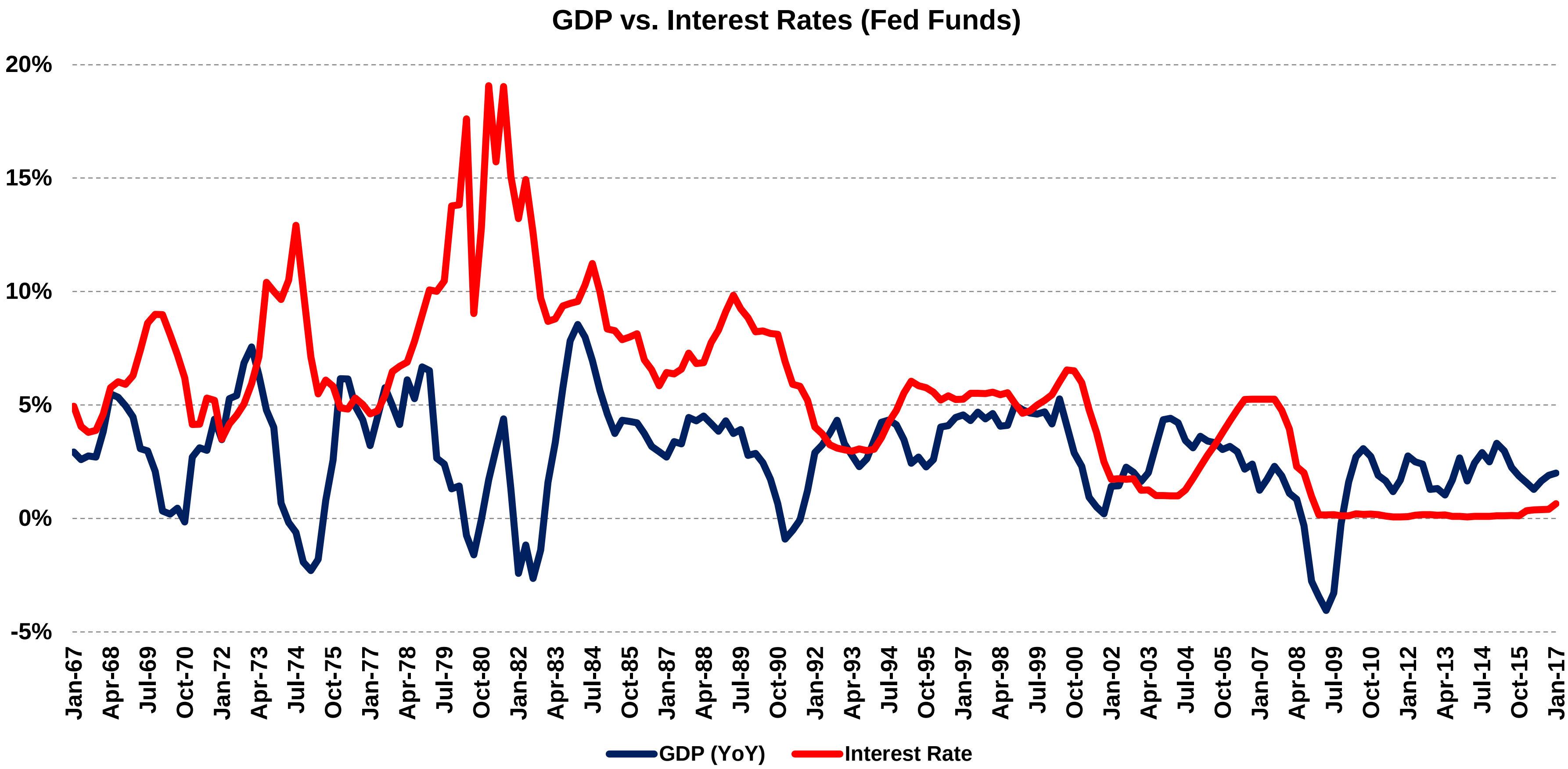
At last, in a world largely without *Carnaval*, February was truly a cheerful month.

International Environment – Chart 1



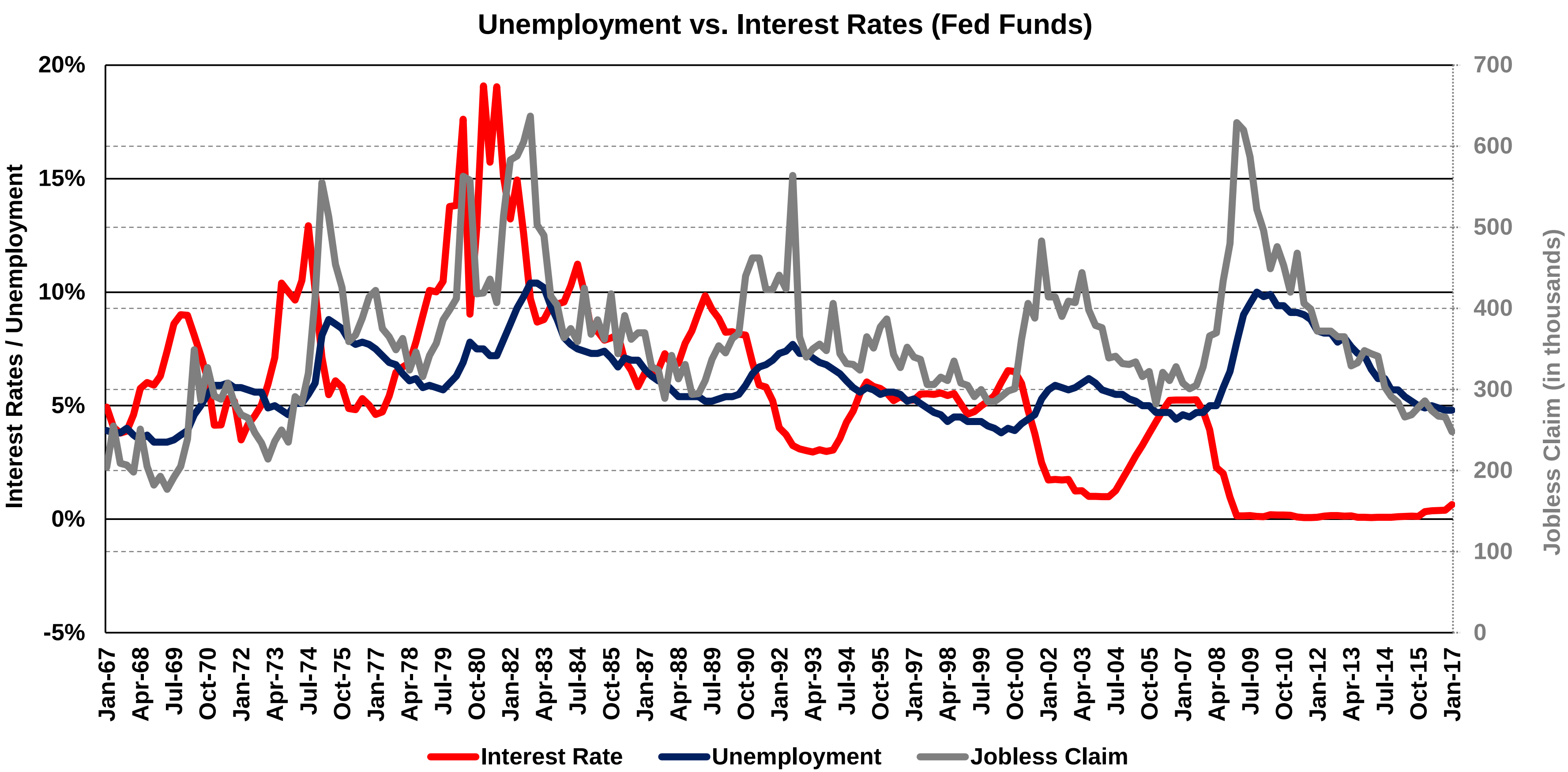
Source: Federal Reserve Bank of St. Louis | Elaborated by Planner Redwood

International Environment – Chart 2



Source: Federal Reserve Bank of St. Louis | Elaborated by Planner Redwood

International Environment – Chart 3



Source: Federal Reserve Bank of St. Louis | Elaborated by Planner Redwood

Interest Rates

If the drums section of a samba school is a fundamental feature for its performance, so is monetary policy to the economic management of a country. We are fare quite well on this topic. However, drums alone do not win over *Carnaval*'s contest, and also when it comes to the economy several other policies need to be in place, besides the monetary one, so that goals may be achieved.

Beyond the demand that all other aspects need to go well, all have in a way to evolve with the required pace. In other words, harmony amongst the various policies is all the more required the "messier" the economy finds itself – and in our case, the economy is down and out. Therefore, when we analyze both households' and companies' financial leverage, the level of investment and aggregate demand, we arrive at an understanding – albeit partial – of the performance of activity and the general evolution of prices. As an immediate consequence, all attentions are directed at the BACEN and its "responsibility" to be aggressive in its monetary policy as if it were the "Lead Dancer" that makes the way for the parade. In truth, monetary policy needs to go along with fiscal policy, in an evolution and harmony as the "Banner-holder and the Lead Dancer" of a High League Samba School. Of course, under the host of assessments, basic interest rates should be lowered (see the examples above and the Taylor rule, etc.), but they have not yet reached this level on their own or due to a malign sentiment of our central bankers, no. Cut-downs are now necessary, but won't mean a thing if fiscal policy (reforms under way) are not approved… and unfortunately their approval is not secured, and therefore, nor is any assessment of the whole. This, in fact, is the reason for the "parsimony" in cutting down interest rates and all the consequences that tag along it.

But, again, the month has ended with thousands of people taking the streets… and this time it was not to protest against the government but to celebrate *Carnaval*, which had relegated, for a few days, the economic and political crises to a second tier in the main news media. Thus, February was relatively tranquil on the economic and political fields, translating the maxim that claims the year only begins in Brazil after *Carnaval*. Therefore, happy New Year! March is ahead of us and claims for caution, as the Temer administration will have to display its political clout, even with both legislative houses under the control of his party, the PMDB. While the battle between Congress and the Executive power is yet to start, local financial markets are euphoric.

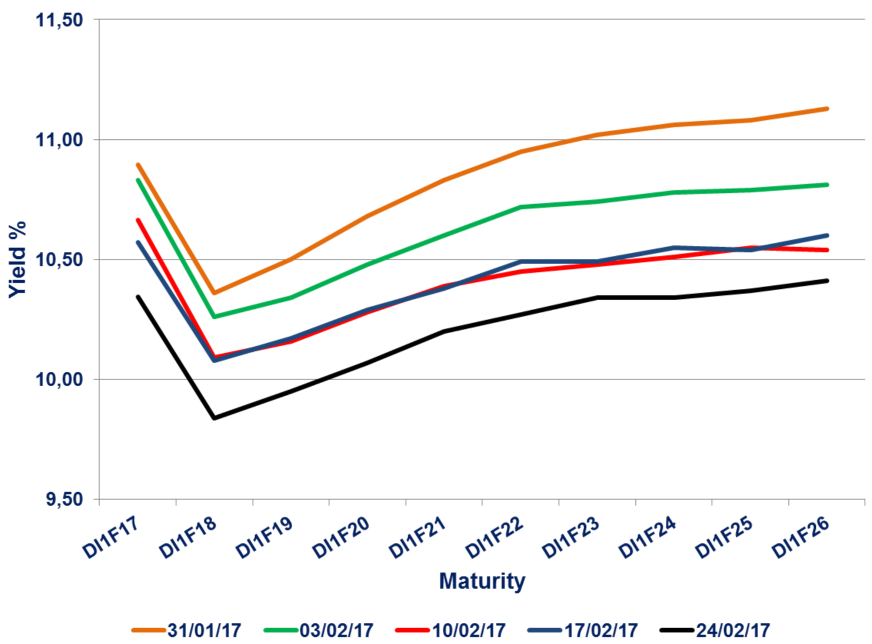
The release of the headline CPI (IPCA) was a surprise. The month closed with a 0.38% inflation rate (against 1.24% for the same period last year). If this pace carries through, the CPI in 2017 is likely to undershoot the 4,5% target. The Central Bank adopts a benchmark of 3.8% in 2017. A figure that was unimaginable one year ago. The inflation build-up of previous years is being eliminated by the acute ongoing recession and by the explosion of unemployment, which opens up room for monetary expansion. With a project drop of inflation for this and the next years, there comes a widening window of opportunity for the National Monetary Committee (CMN) to discuss a lower inflation target in Brazil for 2019, one that is closer to the emerging economies' average target.

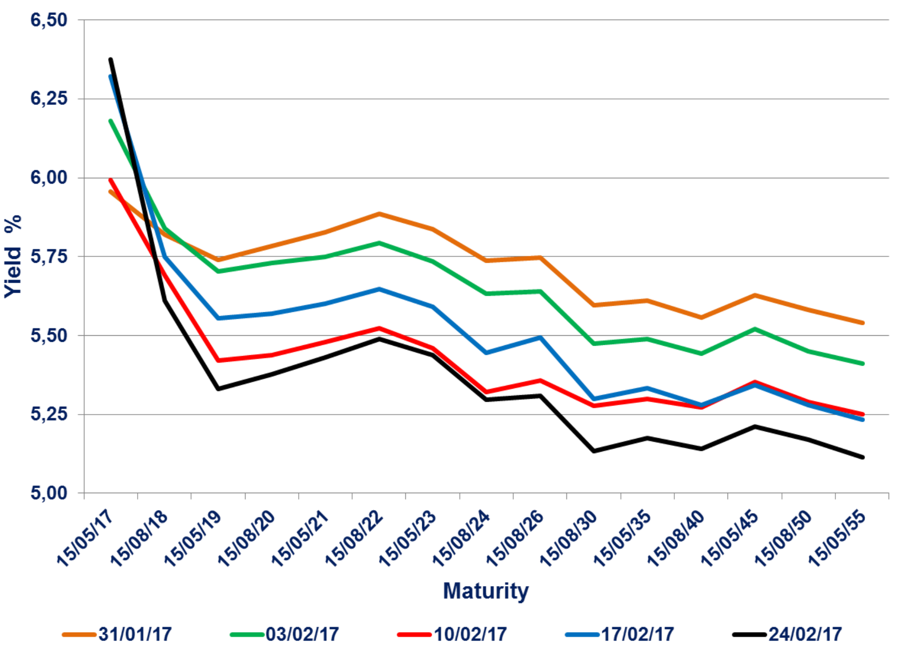
What should we expect from the Central Bank in this scenario? We believe that there are chances of speeding up cut-downs in the next meeting, thereby shortening and intensifying the cycle, the reasons for which subsist within the necessary lag for the transmission of monetary policy effects. However, all of this hinges on the approval and enactment of fiscal reforms… still, we believe the BACEN should and will keep the cut-down pace at 75 bp, despite assessment that disinflation is favorable and disseminated.

In the month the yield curve and inflation coupon had a significant reduction across all vertices. This is truly a fine "Opening Section" of a Samba School!

Interest Rates

Yield and Coupons Curves (NTN-Bs)





Foreign Exchange

Our exchange rate policy was until recently more like a dirty and out-of-tune parade than a true samba school. In fact, seeing it was as weird as a Japanese dancing Samba – you can choose: laugh or cry; we take the latter. But the fact is that for some, it was ♫*so much laughter, so much joy*♫… and also ♫*more than a thousand clowns in the court*♫… today we are, also on this matter, much better… but with the feeling that the mask has not dropped yet.

The important thing is that the mask will only fall when the independence of the BACEN is made effective, and with it the definitive and balanced relation between the BACEN and the National Treasury (TN). Although improvements should not be overlooked, there are still daunting challenges in this regard, to mention only the question of an eventual coverage of the fiscal costs arising from the exchange rate variation. Despite judicial interpretations, economically speaking this BACEN-TN relationship is endless (granted that the exchange rate is NOT freely floating!... and therefore *it should be adjustable (?)* in the balance sheets of both BACEN and TN… yes, we need to revise the so truly celebrated "exchange rate equalization and the volatility curtailment of the BACEN's results"), for given the "expertise" of the Exchange Rate policymakers and the market's own volatility (which these policymakers insist on trying to "defeat") we live in a eternal roller-coaster under these operations between BACEN and TN.

Since we have an economic team with much less flair for the ideological in its studies and assessments, there seems to hold a strong possibility of echoes and resonance if we raise the question and, at last, give a definitive step toward solving this matter. This new measure calls for urgency, while we have space, will and readiness… as it stands, it is *quite easygoing*. With the significant increase of our foreign reserves, the mechanism aiming at cutting down on volatility fared well, but has brought consequences and, worse, seems to have given "greater liberty" for the BACEN to act on the currency markets (always with the best of intentions, of course!).

Keeping ourselves bounded by the negative balance sheet results and the exchange rate equalization, the final responsibility for the fulfillment of such obligations is up to the TN, by way of its budgetary allowances as found in the Fiscal Accountability Act. Wow! Is it really? Yes, and it does not seem (in the big picture) irrational. But should there be limits to it? Any definition of risks? Any control or parameters that is more effective? The answer seems obvious… ♫*don't get me wrong, today is Carnaval!*♫

Oh, well, there is more if we look closer. Covering the balance sheet results and exchange rate variations, the TN issues bonds to the BACEN… really? Yes… a credit operation? Technically, so goes the argument… Geez… but wouldn't this be a sort of financing operation forbidden by our Constitution? Darn… institutionalized wrongdoing? Better not even mention it… let's have the guts and change it already!

Foreign Exchange (cont’d)

Granted all the above (surely, “some outsider” will have to shake things up), the Central Bank has kept its swap operations in February with the partial rolling over of contracts due within the month. The stock has been greater then USD 100 billion, and has closed the month at USD 22 billion. In March, USD 9.7 billion-worth of bonds expires, but BACEN has yet to signal which strategy it will follow (hum, a surprise to lower volatility!). One more month in which these operations were a “win” to the BACEN, earnings amounted to BRL 2.102 billion with swap operations (a nice feat for whom has a knowledge of the “whole”). But it is worth mentioning (as it is stressed) that the institution’s goal is not to obtain gains or losses but, instead, to offer exchange rate protection to the market and provide liquidity in moments of instability… whatever happens, the TN bears the brunt… that is, it is *Carnaval* and there are no rules, including and above all to fantasize.

The more hawkish tone of the FED board elevate the chances of a interest rate hike in US, although this movement should not have a significant effect over emerging markets’ currencies. Markets have already priced it and, also, countries are less exposed to dollar-denominated debt, the current account deficit is coming down and economic indicators of several emerging economies and even in Brazil have been improving. In the latter case, reforms in Congress (with some setbacks), plea deals in the Car Wash probe (with some delay) and the exchange rate policy by the BACEN (unnecessary by rule) are the factors mostly impacting the currency in the short run.

The financial market, which always anticipates cycles, works with a more positive scenario for Brazil, reflecting Dollar and the country-risk quotes which have improved sensitively since January. Despite country-risk in free fall, Brazil is far from recovering investment grade, as S&P had us believe by maintaining a negative perspective for the country’s economy. A signal not much aligned with the vision held by “Mister Market” and the projections of economic improvement (albeit slow) seen by economists – including us at Redwood. At any rate, pragmatically speaking, if this is so, incoming foreign resources may well be directed at short-term applications in the financial markets. Lacking investment status or at least any signaling toward re-acquiring it by credit-risk agencies (the same ones that displayed questionable behavior that led us to the 2008 crisis), may hinder the inflow of long-term-oriented resources, especially from more conservative investors, such as pension funds and insurance companies, for they are blocked by their local statutes from investing in less-than-investment-grade assets.

The Dollar accumulated losses of 0.89% (PTAX). This year alone, devaluation facing the BRL has reached so far 4.90%. If the BACEN allows, it is possible that more of that will come… just let the mask fall; after all *Carnaval* is over!

But wait, next year brings more… and hopefully with many Japanese, for these are quite fast learners!

Stock Market

An analogy of the stock market in Brazil with *Carnaval,* under a fundamentalist and/or value-investing view lately, is much likened to that of huge parade cars. Beautiful, sumptuous, but a crisis as the one we find ourselves in (parade cars and companies not always very “safe”) always holds surprises at times unpleasant: they break down and people get hurt. But if you know how to choose a right parade car and a comfortable position, it is likely that you will go follow through the parade with great joy.

This is what happened this month in the stock market, and it has been usual – especially for those following it in terms of USD – in recent times, a magnified effect for the US currency. The Ibovespa climbed 3.10% and accumulates high of 10.68% in 2017. In terms of USD, 16.39%.

The maintenance of US interest rates and the tendency of interest cuts in the local markets both contributed to the positive outcomes in the stock exchange. Companies with improved performance were those in sectors of utilities, retail, construction and finance, sectors which have negative correlation with the interest rate, while commodities-producing companies compose the asset class that had highs in foreign markets. On the other hand, export companies faced losses with the drop of the USD facing the BRL. Among companies listed in Bovespa, we highlight strong positive results for Vale in the month on account of iron ore price hikes and the end of a long process of negotiation among stakeholders that decided to prioritize governance and thus pulverize control of the company. As for Petrobras, it had its risk upgraded by S&P from B+ to BB-, with a stable perspective. After a long period with no IPOs, Movida went public in Bovespa in February.

Throughout the month the Ibovespa has reached 69.000 points, but did not sustain it. Due to *Carnaval* many investors opted to realize profits and lower their exposition since negotiations were normal in foreign markets. In the last two days of the month. ADRs for Brazilian companies continue to be negotiated and are susceptible to general news and to commodities prices oscillations. In the US, NYSE has also had record-breaking scores with Trump’s indications of tax cuts beyond other measures to boost companies and job creation in the country.

Despite all this stock market improvement, the landscape is still cloudy in the short term. One cannot underestimate domestic political risks and the veracity of growth data coming out of the international realm. For a sustained appreciation of equities the country needs to move on its structural reforms. Sustaining growth requires going beyond simple patch-measures, such as the cap on credit card interest charges and the release of workers’ security funds (FGTS) inactive accounts… these are commendable measures, but absolutely insufficient.

At last, February has ended with a less explosive Donald Trump, with a toning down of previous campaign tirades while moving on, at least in formal venues, to a more Republican demeanor (in the sense of his party). During his speech at the lower house, he adopted a more restrained and less combative tone, more “presidential and statesmanlike” (at least according to “traditional” standards). Investors approved of it very much! The party is great, with pomp and circumstance! We only need to find out if we are at the beginning or the end of the parade.

Monthly Commentary

FEBRUARY 2017

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