Planner Redwood Asset Management

MONTHLY COMMENTARY

JULY 2017

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ANBIMA

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

"Corruption of leaders quite often begins with the corruption of their principles".

Charles-Louis de Secondat "Montesquieu" – French politician, philosopher and writer.

Introduction

We have repeatedly listened recently that the Brazilian economy has decoupled itself from politics.

The statement heeds the fact that the ongoing political confusion is far from mirroring the past, when markets overreacted to political conditions. Besides, the "phenomenon" is believed to transcend our shores – citing classical examples of Italy, or more recently, BREXIT and Donald Trump's election.

In fact, financial markets do not price our current political distress as they once have – yet. Offshore, BREXIT, Donald Trump and even Quantitative Easing – QE by the FED have not bred the expect "effects" exactly because they were already "priced" or, as in the case of QE, which was clear for some – but not to the mainstream media – it would be (as it was) a great Monetary Non-Effect. Ok, there are thus no great surprises or witchcraft – especially in the medium and long terms… it all makes sense.

We may perhaps not grasp the present, due to intuitive inefficiency or lack of more rigorous analysis. However, at last we came to better understand, ex post, when variables were more clearly explicated in their interrelations. So it goes today with respect to this detachment of the economy from policy – but it won't last for long. Not in a country essentially dependent upon its politicians to push fundamental reforms, without which the economy will falter – simple as that – monetary policy loses effectiveness, fiscal imbalances compromises the country's solvency etc. Markets work with a safety margin of time and intensity, but its dosage will not necessarily be gradual should this margin be compromised. This is the intelligence, perception and principles our politicians need to uphold in this exact and crucial moment of reforms in Congress. Nevertheless, we hear the echo of the words opening this comment, one which sums up this worry quite well: *"Corruption of leaders quite often begins with the corruption of their principles".*

In the world, China brings good news with the fact that its manufacturing recovery cycle may be longer than expected. Relations between US and Russia have deteriorated sensibly, with the American Senate approving financial sanctions against Moscow – measures which that inhibit any presidential measures without Congress concurring. In France, under the command of the new president Emmanuel Macron, the National Assembly has approved labor reform in the country – a very sensitive subject. However, the spotlight was placed on Venezuela with all the turmoil caused by President Maduro, which triggered sanctions from various nations, further injuring the already suffering Venezuelan people.

In this landscape, the *US Treasuries* closed the month at 2.2942%. S&P varied 1.93%, NIKKEI closed at -0.54%, DAX at -1.68% and FTSE 4.39%. Ibovespa finished the month at 4.80% and the IBrX at 4.91%. Highs of DIF18 at 8.85% and DIF21 at 10.02%. NTN-B 2050 ended the month at 5.3055%, and the Dollar (Ptax) at BRL 3.1307.

Economic Activity

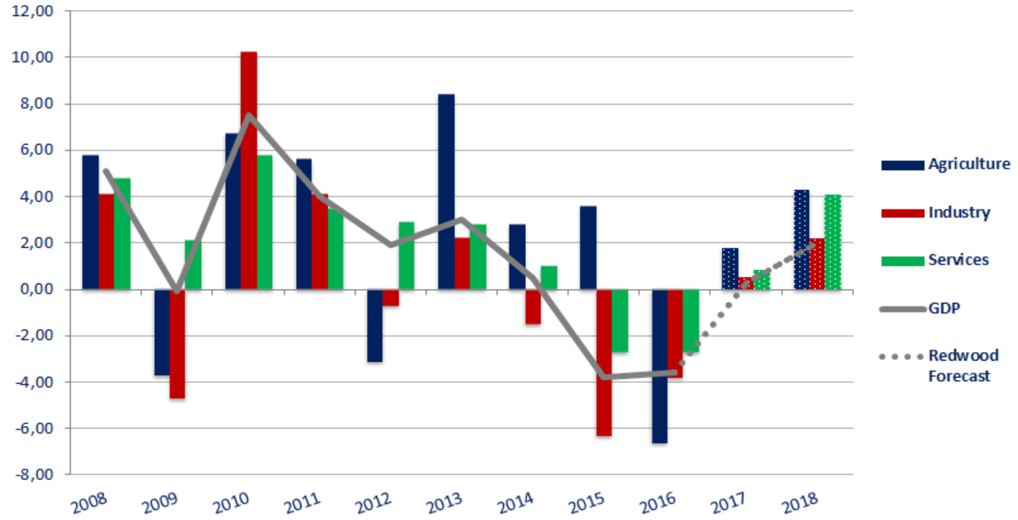
Unemployment indicators released are in line with our projections, as we also believe the credit market may be, cautiously, improving.

However, since the crisis on May 17, confidence indicators seem to have averted the expectation of a strong upward trend (lower impact and some recovery), and that has consequences for businesspersons and consumers. On the other hand, it helps that Trade Balance will present another expressive surplus this month.

Additionally on the pros and cons table, we reached recent conclusion, without many changes in levels: GDP this year will be close to zero and for 2018 close to 2%. Consequently, expectations are likely to settle and we can state that the output gap will continue on the negative side for a long while.

The chart below clearly depicts the statement above: a slow recovery – albeit gradual – with highlights to agriculture and some comeback by Services in 2018. Being the worst crisis ever endured by the country's economy, it is hard to be any different from this.

Evolution of GDP growth rates by sector (Redwood forecast 2017 and 2018)



Source: IBGE and Redwood Forecast | Elaboration: Planner Redwood

One shall not be fooled, the gigantic mishandling of economic policy in recent years by the PT government and the enormous political crisis that besets the country undermines any possibility of stronger and bolder advancement. Uncertainties "run" wild still, and the reversion of this setting requires, necessarily, the enactment of not only economic measures, but also and above all political realignment, reforms, adjustments and greater control over the public machinery, countering corruption and preventing its dissemination, and not the least, a new private sector.

Sensitivity to economic uncertainty levels goes through all of this, but above all and in this moment, through the loss of confidence owing to the political landscape and its capacity to realize changes the country needs, a feat both markets and the economic team are impotent to pursue. If the financial markets can not keep away from politics for too long, much less can the real economy also do so.

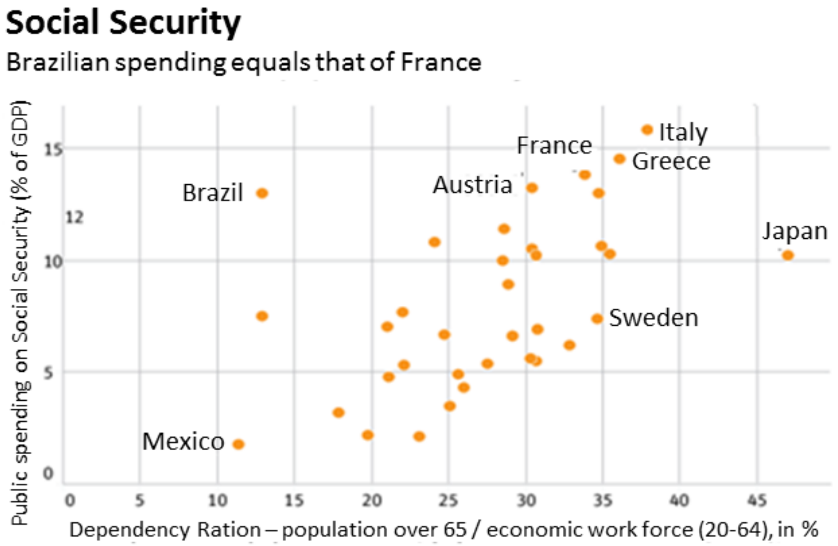
Fiscal Policy

Our prognoses were right: tax increases!

If the fiscal goal of a deficit amounting to BRL 139 billion was compromised without tax raises, now in place, one wonders if this raise will be enough, with everything moving at a very distinct pace from when the goal was set. Our math shows that it clearly won't be.

What to do, then? We need to reassess expenditures of all sorts – all of them. It will also require "unearthing" projects that envisage extraordinary revenues as fast as possible. Removal of tax reliefs to sectors done by Dilma's administration (postponed to 2018) need to be put back on the table.

At last, the State needs to shrink in all aspects! And we need to push forth this project of a leaner State in a consistent manner. The moment seems – as paradoxical as one may find, given the political unrest – adequate to ventilate new ideas and break loose from ages-long paradigms that reflexively weigh us down as a nation. A new vision in this sense will very much help improve our public finances.



Source: Samuel Pessoa, weekly column on "Folha de São Paulo", March 12 2017.

On the road to controlled spending and a country more in line with (evolved!) countries worldwide, Social Security reform needs to be seen through, because, aside from being outdated in terms of legislation, it accounts for the greatest expenditure – nearly 46% of primary expenses. This reform, practically abandoned in its original version, seems to gain strength and to be resubmitted on account of President Temer's hold of office. A president with very low levels of approval, but with a wide support in the House – essentially what is needed to push ahead the reforms. Even if the text ends with a more timid and dried up complexion, it will likely improve fiscal outcomes down the road, the perceptions of investors, country risk and the effectiveness of monetary policy.

Meanwhile, in short, the budget proposal for 2018 needs to be delivered to Congress by the end of August, and this could be an ideal moment – notably due to a more clear political landscape in which feasibility of reforms is secured – to eventually redefine the fiscal goal for 2017. It will be better to "chicke out" now while reviewing the current target, in place of "blushing" (shamefully!) and not achieving it. What needs to be done is very clear. No arguments can stand up to facts!

International Environment

Venezuela has hog all attention this month, and it all points to a dragging suffering by the Venezuelan people.

It is not news that Venezuela suffers, and it does so on account of its last two Presidents. The dismantling of its economic structure has long been widespread, but the levels of deterioration have advanced far recently. The escalating lack of respect to individual liberties reaches staggering levels, and the persecution of political oppositionists to current government has had no truce. The last drop was the idea to convene a Constitutional Assembly, whose goals are highly contested worldwide. With the political landscape absolutely troubled and a grinded economy, the solution should not go through this path, as has well pointed out the EU in mentioning that the new Assembly “must not be part of the solution” amid growing waves of violence and insecurity in the country. Brussels has also asked that President Maduro “work in such a urgent way as to adopt measures that build confidence in order to reduce tensions and boost improved conditions to restart efforts aiming at a pacific and negotiated solution”. Sanctions are well on their way, as seen by declarations coming from the US and the escalating tone of Europe stating that measures will not be confined to speeches of reproach. These are the “tools” the world has available… not always they have the intended impact or, as a rule, they take too long and the population continues to suffer. Depending on the Latin American history in situations such as this one, a likely aggravation of the situation lies before us unfortunately – including a coup. Besides the nefarious impacts to the Venezuelan people, it is worth mentioning that the country is a great producer of oil and that the US relies on its output… it is hard to believe the world will not get involved more bluntly, especially the economies to be more profoundly affected. It remains to be seen.

In Europe, the PMI Manufacturing in Germany dropped to 58.1 in July – lowest level in 5 months – while the UK has risen above the expected 54.9, reaching 55.1. In the Eurozone as a whole, the indicator retreated to 56.6 whilst the 56.8 was the expected figure. At any rate, the Eurozone GDP has grown 0.6% in the second quarter against the first quarter of 2017 and has shown an annual expansion shortly above 2%, but projections continue to point to 2017 still as quite a challenging year. In this line of reasoning, we will maintain our perspective of a quantitative slack by the ECB no sooner than late 2018, and much likely to be done in gradual fashion in 2019. China, in its turn, surprises with its economic resilience (caveats in place as to the credibility of its statistics). The Chinese PMI manufacturing has reached the highest level in four months in June, indicating that the recovery cycle might be longer – some projections already point to a 6.8% GDP growth. The Chinese government tries to push hard, with the PBoC injecting the equivalent to USD 53.5 billion through a medium-term credit line. Finally and still in Asia, PMI manufacturing in India retreated to 47.9, the greatest plunge in 9 months!... despite that, the country is still investors’ “sweetheart” emerging market. Japan, in its turn and in contrast with its performance in 2017, may grown less in 2018 on account of signaled less fiscal support.

In the US, rising friction with Russia (sanctions and diplomatic measures on both sides), and the endless “organization” of Donald Trump’s close advisors. All of this in the midst of attempts to deliver his campaign promises – right or wrong, his fulfilling his mandate. Contrary to what preaches the mainstream media, his term goes reasonably well – Uncle Sam appreciates.

Interest Rates

SELIC is once again at one-digit levels!

Current scenario is quite different from November 2013, when the basic interest rate had also one digit. At that time, the government obscured economic data and the direction of the economy was the opposite: inflation was pressed up, public expenditures accelerating and activity reasonably high due to ill-advised incentives by the government. Today the outlook is one of dragging activity, surprising plunge in inflation scores, and the effort (albeit constrained) by the government to shield its finances. The team at the Central Bank has also changed (to the better!) and the measures taken find more solid ground to stand on.

In its July meeting, the Central Bank determined a 1% cut in Selic to 9.25%. The minute released after the meeting struck the market for its “dovish” tone, signaling the pace of cuts on the basic rate to be maintained in the next meeting. Redwood projections indicate that the rate must close 2017 at 8%. Not even the recent rise in parafiscal tax rates (PIS/Cofins) on fuel and its multiplier effect is seen to be a threat to inflation control, which is still strikingly low. The IPCA-15 (leading indicator to official inflation) came -0.18% in July.

On the same day the COPOM cut down the Brazilian interest rate, the FED opted to maintain US rates within the 1-1.25% range. The institution adopted a moderate tone, leading analysts in the market to bet on a new hike in December this year – in line with our prognosis of only one more increase in 2017. The FED’s demeanor translates into an important externality and whose reflexes can (and should) affect our monetary policy.

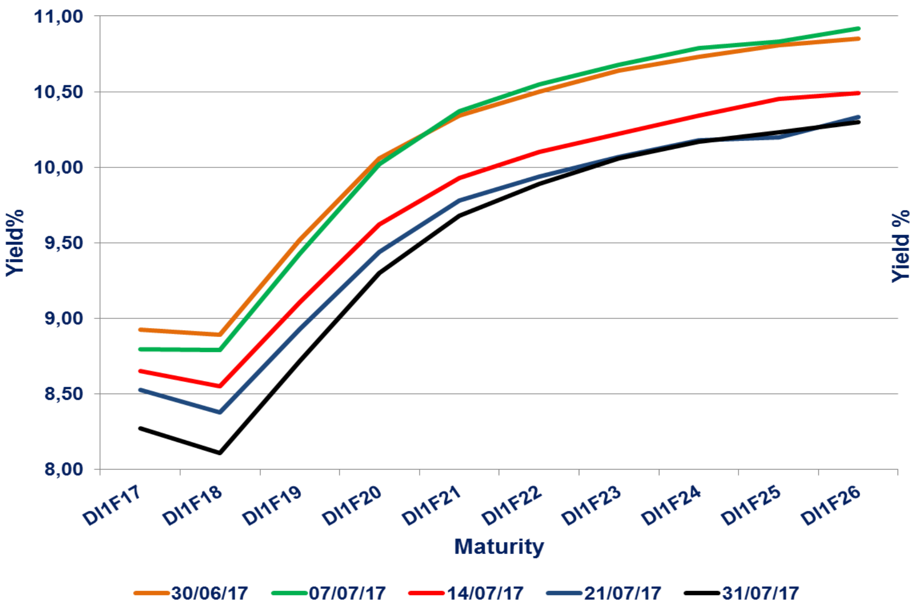
The yield curve has dropped premiums all month long. Short-, medium- and long-term contracts have had lowering rates with the parallel movement of the curve against the closing of the previous month. Contracts maturing in the short and medium terms have priced the cuts in SELIC and the lower inflation projections and, consequently, a lower basic interest rate. As for the longer maturities, efforts by the government to achieve its fiscal targets, as hard as it seems, and to pursue the reforms, have pleased investors.

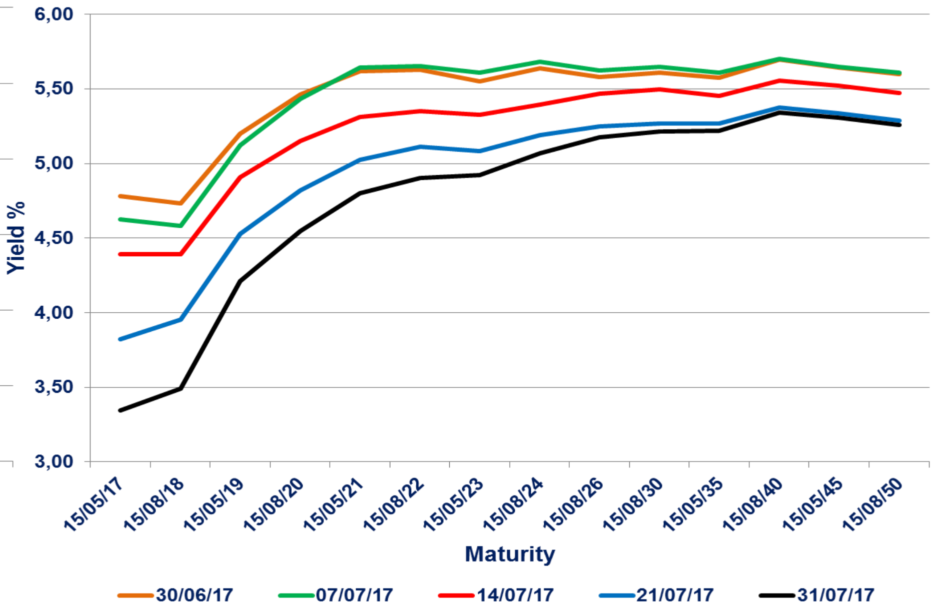
At this rate, the next months will witness more accurate pricing of interest rates for 2017 and 2018, and thus real interest, including under the concept of international parity of interest rates, tend towards lower spreads. This is the reason why the cycle of SELIC cut-downs can and should continue strongly in 2017, but the limit to competition in Brazil in terms of interest rates, which really matter to foreign investors, starts to show, and with it the fall in basic interest rates in the Brazilian economy will be much smaller in 2018.

This scenario, if confirmed, the movement of portfolio rebalancing and/or reallocation of resources are certain. Happy will be those with the know how to adequately position themselves to this upcoming reality.

Interest Rates

Yield and Coupons Curves (NTN-Bs)





Foreign Exchange

Back to pre-JBS-crisis levels! The USD has closed the month at BRL 3.1307, with a 5.37% devaluation.

The exchange rate, historically one of the greatest concerns of the Central Bank (one can fathom why!), has shown the market that does not play the villain anymore, and many have bought that, given that foreign reserves remain at high levels and the international pressure against the American currency is low, especially after the perception that the US monetary tapering is bound to be more gradual than anticipated. Besides, this fact is corroborated – as striking as it may sound – investments continue (to a certain extent) to find the country, raising the supply of dollars and weakening the possibilities of a strong devaluation of the BRL. This is true, but one cannot forget that a closed economy (hereby under scrutiny) as Brazil, with exchange rate policy still dependent on the monetary authority and an only slightly orthodox history in this issue, greater volatilities shall not be ruled out.

The inflow of foreign resources attracted by scheduled IPOs in July (it is quite true) and the integral rollover of currency swap contracts maturing in August (highly doubtful) have contributed to the general understanding by the market of an appreciation of the BRL. One way or another, the fact is that the tendency of a stronger BRL is couched on robust and serious studies – although we should keep in mind Edma Bacha's coined phrase that the exchange rate is a divine invention designed to humiliate economists. *Coeteris Paribus*, CDS plunging, nominal and real interest rates in similar trajectories and other variables correlated and with causality, the Dollar quotes are likely to cave even further, despite the BACEN and the situation of the Brazilian economy.

As in other segments, the political environment is a somewhat more positive and that helped. President Temer has been victorious in the Commission of Constitution and Justice that analyzed the Federal Prosecutor's accusations of malfeasance, and thus the Labor Reform was approved. This enhanced the working hypothesis in the financial market that the economic team will stay in place even in case of an impeachment of the current government – reflexes were immediate.

The simple fact of continuity of the current economic team, tied with the possibility – with or without President Temer – of success in approving Reforms (especially the Social Security), has already positioned us very favorably regarding exchange rate – that, obviously, with the help from BACEN in "regulating" the market. With the country in check with its accounts and pointed toward stabilization, and pulling away from risks of insolvency and downgrades, there are more than USD 17 trillion of liquidity sloshing around the world in search of returns… Dollars will pour down over here (Amen)!

Assuming in this issue holds the law of supply and demand, once the eventual supply surge is confirmed, we may not know the new equilibrium price, but we can infer in what direction it will shift. Simple as that!

Stock Market

The Ibovespa has closed the month with a 4.8% increase – about half of the total returns within 2017 until now. The international price of commodities was determinant for this outcome.

Once more Brazil stood out as a major producer of commodities, especially, soybeans, iron ore and oil. The slow recovery of global economy and the hike of foreign prices boosted Brazilian exports and, consequently, the shares of companies that negotiate in these markets. However, one shall take heed that the country cannot stand on commodities-trading companies alone, for their added value is low, and therefore do not contribute as much to gains in competitiveness and quality of domestic activity – thereby compromising the reflexes on the main Index which represents the main companies traded in the Stock Exchange.

In the political field, the possible undermining of a runner-up from a PT in the next presidential elections in 2018 has favored the stock markets. An eventual comeback by the party entails a perception of a step back on what has been built in the last year and the possibilities of advancing reforms with the new economic team and its current policy. To the foreign investors, a determinant player on the Ibovespa, the possibility of a minor political risk of this nature (catastrophic for Brazil) in 2018, strengthens the credibility of the country and consequently raises their bets.

Four companies have kicked-off in the Stock Exchange in July: Carrefour, Biotoscana, IRB Brasil and Omega Geração. With these operations, IPOs amounted to 7 in 2017, adding up to BRL 11 billion, the best year in capital markets in four years. These offerings demonstrate, albeit timidly, an increase in confidence levels by entrepreneurs and investors in the Brazilian economy.

In July corporate quarterly results started coming out. As compared with the previous quarter, in general, outcomes are positive and some sector, particularly banks, have outstripped market expectations. Within the month, real estate companies, once more, have been benefited by the interest rate cut-down. From this perspective and in short (one can only hope!) for all other sectors, the reduction in interest rates will have a very important effect for companies as to their “deleveraging” and revaluation of projects.

At any rate, although Ibovespa is still reasonably “cheap” in USD terms, other indicators such as Price/Earnings (P/E) its attractiveness falls short of desirable – figures lie above the historical average and not far over a linear projection, both within a 14-year period sample… the moving average of 6 months equals the current P/E. Notwithstanding the limited information these figures provide – given their aggregate nature, which may conceal differential performances by several companies –, they serve at the very least as indicators of eventual movements or shifting patterns.

In fact, assessments today are not as inviting, but although the Ibovespa is not up for grabs, in the balance of risk propensity and investor’s preference (and eventually his/her ability in portfolio selection), it is important to follow up on the segment.

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