Planner Redwood Asset Management

MONTHLY COMMENTARY

NOVEMBER 2014

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Introduction

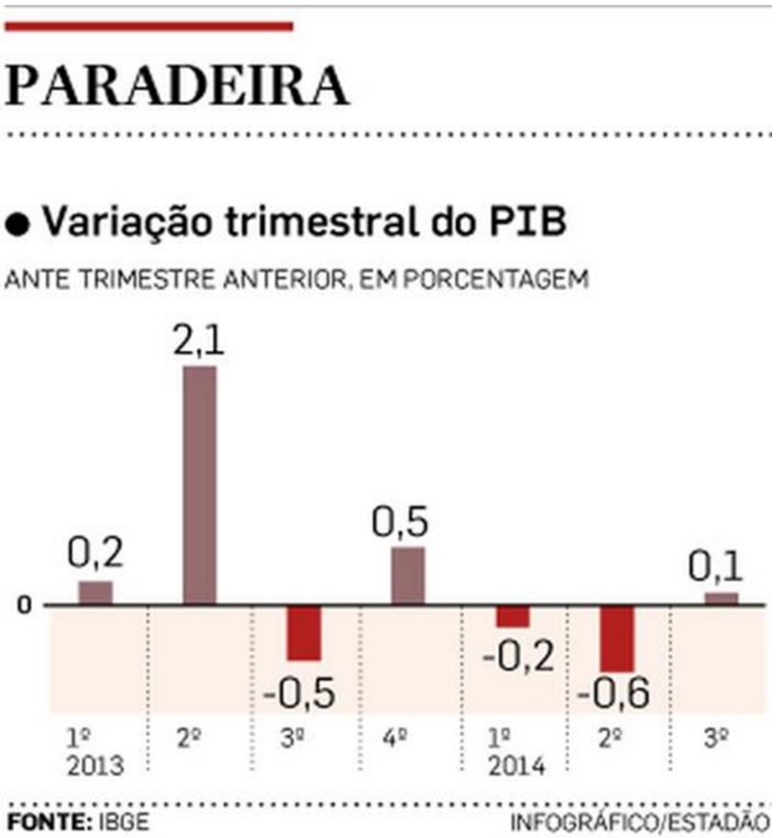
Joaquim Levy will be the Minister of Finance! Things couldn't be better, you nailed it, Ms. President ... congratulations! Really?

This report essentially addresses economic and financial considerations, but politics invariably "intrudes" given its importance and impact on the direction of economic policy itself. This is why we question the choice ... we tend to judge the rationality of ideas and practices. So after the recent elections and the onslaught against a possible return to orthodoxy by the winning party, the choice of Levy seems like real electoral embezzlement. But, for the good of the nation, this decision shows absolute economic rationality. That is not what some economists think, especially those who have signed at least two manifestos and, ultimately, all those who voted on the President trusting her economic speech. You know what? Based on Levy's academic training and his history (especially in the Federal Government), these "rebels" are 100% correct. In fact, the President (for consistency purposes) could have chosen an economist who graduated in any University in the world (Princeton, Yale, Harvard, MIT, Unicamp), but Chicago. Chicago is the synthesis of unbelief in all of PT's plans and economic ideas. However, this is "the guy" who will restore the credibility of economic management, which will put the economy on track, possibly prevent the loss of investment grade and get rid of our shame and sadness, given the numerous abuses and "misunderstandings" in the recently adopted economic policies - truly an insult to our intelligence, and a crime against our future. Levy may choose his closest associates: the Secretaries of the Treasury, Revenue Service, Economic Policy, etc. and others may align with him and his ideas (Minister of Planning, Central Bank President, and others). Finally and most importantly, the President may bypass any coming political differences and attacks (and surely, they will come!), to prevent the Finance Minister's tenure to be ephemeral, a buffer term in office. One of the greatest virtues is to recognize our mistakes and change. Politically we know how difficult it is to verbalize this ... it’s not necessary (indeed) just act and put into practice is enough. Congratulations, President Dilma!

Worldwide, Japan's rating was downgraded (Aa3 to A1), China seems expect GDP numbers settling around 7.0% and in the EURO zone, the ECB keeps expecting some reflection of its current policies. The USA continues to enjoy exuberant growth: 3.9%. This pace only reinforces our expectation of FED "action" in the 2nd quarter of 2015.

US Treasuries ended the month at 2.19%. The S&P changed 2.45%, NIKKEI closed at 6.37%, DAX at 7.01% and FTSE at 1.17%. The Ibovespa ended the month at 0.07% and the IBrX, 0.21%. The DIF15 and DIF17 maxima were 11.48% and 12.83%, respectively. NTN-B 2050 ended the month at 5.77%, and the dollar (Ptax) at R$ 2.5601.

Economic Activity



The release of third quarter GDP, virtually nil, demonstrates the complete failure of the so-called New Macroeconomic Matrix. Not even the 1.7% advance of the industrial GDP brings any joy. The Gross Fixed Capital Formation (GFCF - the account that measures the total investments in the GDP) increased only 1.3% and, compared to the same period in 2013, decreased 8.5% - this reflects low business confidence and uncertainty about the scenario ahead. However, even more important, the most significant reported GDP is the cooling of household consumption, which seems to be connected to credit, labor market and the real volume of income conditions which, in the long run, show declining trends (despite the recent decline in the unemployment rate). In the past, the reduction in unemployment was accompanied by strong work generation, causing real wages growth at a much higher pace. The overall picture is very bad in all respects and analysis, and unfortunately (despite the new economic team) the 2015 horizon is not much prettier... it will take time to repair the damage done in recent years.

A reflection of this thing called New Macroeconomic Matrix (a mixture of countercyclical fiscal policy, low interest rates, high dollar and myriad dirty tricks), the economic horizon looms with bad indicators, with public accounts deficit, a hole in the external accounts, manufacturing in crisis, infrastructure investment bottlenecks, frozen credit, unreal prices and high and absolutely resistant inflation. All this now, hopefully, has come to an end. But the cost of recovery will not be low, or even fast. We will have higher interest rates, need for high surpluses, and other very unpopular measures with direct and almost immediate consequences on the level of employment, wages and thus the economy as a whole. An absolutely necessary "evil", which will strengthen us and create a more solid foundation for a long-term sustainable growth.

Fiscal Policy

Fiscal adjustment will constitute a full and immediate priority for the new appointed Ministers Levy and Barbosa. The Age of Disorder will end.

As we have discussed in previous reports, the public accounts are a clear symptom of our financial governance and a definite signal to the rating agencies, whether or not our Investment Grade should be maintained. So the immediate action of the new economic area Ministers will be to avoid the risk of losing the investment grade - they will, therefore, need to rearrange the 2015 budget, giving it credibility and transparency.

Understandably, the tone of the first and few manifestations of the appointed Ministers indicate caution and gradualism... this seems adequate, and certainly appropriate. The public sector savings (primary surplus) anticipated for 2015 is relatively low, only 1.2% of GDP (about US$ 70 billion) ... reasonably justifiable given that GDP will not be thriving next year. However, it will increase (based on our knowledge of the future Minister Levy) to above 2% of GDP in subsequent years. This is simply essential, especially the balancing the famous Debt/GDP ratio. In fact, Arminio Fraga had already indicated that an adjustment would not take less than two years, and this view is now shared with the new economic team - the question is whether this gradualism does not compromise a desired effect: the recovery of confidence severely shaken by the economic policy experiments of the past four years. The last juggling, a grand finale with the support of Congress, is the attempt to eliminate the surplus target this year. This is an unimaginable attitude! Possibly not even Levy's "stature" will hold our rating in place.

No more cheap Keynesianism, in particular the identification that the problem is always weak demand, that can be solved by increased public spending and expenses without due consideration to increased supply and productivity. There is growing criticism that these adjustments will cause a recession in the country. It is possible, but it can be avoided ... it will depend on various circumstances. It is a cost we must face, as a result of the mismanagement of recent times. Deep down, as the late Roberto Campos used to say: *"you cannot make an omelet without breaking eggs."*

As a result of the lack of public spending control in 2014, Brazil reached in 12 months to October, a nominal deficit of 5% in relation to the Gross Domestic Product (GDP), which had not happened in 11 years. I hope we do not need to break a lot of eggs!

International Environment

The US economy continues to surprise, posting annualized growth of 3.9% in the last quarter. This is really significant growth compared to the performances of recent years ... well, since 2008, with so many FED (Federal Reserve) interferences, the economy seems to unravel and despite the FED, resume its pace. The obvious conclusion is, the rising interest rates horizon will shorten, bringing consequences for the rest of the world.

As a result of the low inflation and a mild recovery in the Euro Zone, the European Central Bank (ECB) is ready to implement new, additional stimulus for the region. In November, only the PMI (purchasing managers activity index) of Spain and the United Kingdom rose to 54.7 and 53.5, respectively, among the main industrial countries. Italy's was stable and the PMIs of France, Germany and the Eurozone as a whole dropped. The ECB may even momentarily, wait a little longer to check the resonance of its recently implemented policies, but benefit-cost, moral risk, legal and political considerations will make it act according to its price stability mandate. After all, in crisis *"we are all Keynesians"* and the situation implemented in the US seems ideal. That's right: after years of penury, the best alternative that macroeconomists see is the US's. Such a display of ignorance, Batman!

In Asia, China's Industrial PMI also fell to 50 in November. Perhaps because of this and a host of mostly poor indicators, the People's Bank of China (PBoC) announced an unexpected rate cut, the first since July 2012: the one-year lending rate was reduced by 0.4 percentage points to 5.6%, and the one year deposit rate by 0.25 point, reaching 2.75%. All this reinforces the expectation of slowdown of the country's economy which results, according to many analysts, to decline in the growth rate of economic activity to something like 7.0% in 2015. This is bad news for the Chinese, terrible for the Brazilians. In Japan, in addition to the downgrading of its sovereign note, the Central Bank also increases the scope of its quantitative easing program. More of the same, everywhere!

Dr. Doom(Nouriel Roubini)'s argument seems convincing: we may be on the verge of the Currency War - a return to it, that is. With the attitude of the Central Bank of Japan, the Central Banks of China, South Korea, Taiwan, Singapore and Thailand will also go into a looser monetary policy, in order not to lose competitiveness relative to Japan. Additionally, the ECB will join in ... a contagion effect, but it would be no surprise if other unconventional policies are put into practice. It is a true MMA to prevent the appreciation of their currencies. In an environment of (public and private) deleveraging (high debt), monetary policy becomes the only tool (known/available) to boost demand and growth. We (all) have a lot to learn from economics.

Interest Rates

If the broader change did not come as the financial market expected, at least the composition of the new economic team pleased the market, especially the appointment of Levy as the Minister of Finance. The Economic Policy will change, although the President of the Central Bank will remain! It took a long time! The folks who are leaving caused a lot of damage. Okay, better late than never ... poet Mario Quintana used to say: *"All of these... who stand on my way, ... they will pass, I am a bird!"*

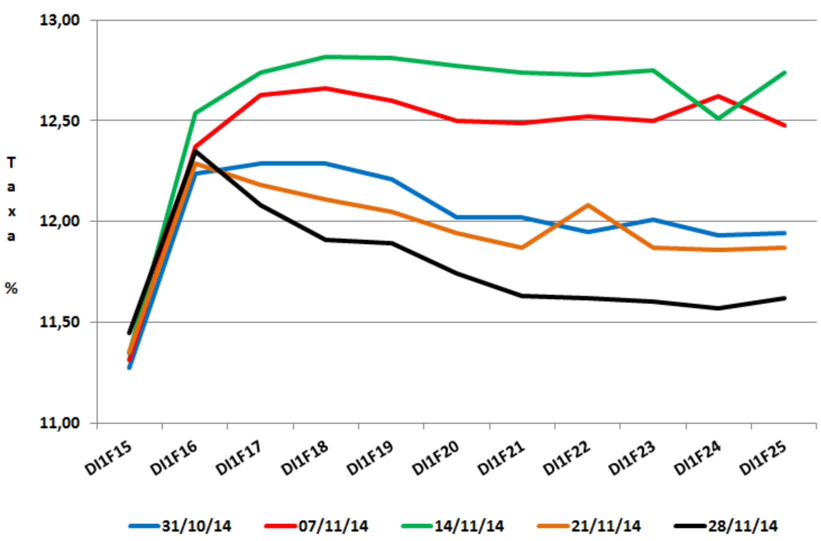
More than eight years were not enough - the wait in the last month was absolutely excruciating... until the penultimate trading day of the month, when President Dilma confirmed the name of Joaquim Levy as the future Minister of Finance, Nelson Barbosa for the Ministry of Planning and Alexandre Tombini remaining as President of the Central Bank. The chosen names are well regarded by the financial market. The delayed official announcement, for there were rumors about this team a few days prior, made the market anticipate the yield curve pricing. Unlike the economic policy adopted in the first Dilma administration, under Minister of Finance Mantega, which prioritized credit expansion policy and rampant subsidies, the chosen team should prioritize the control of public spending, inflation and transparency in the disclosure of data. This is the end of creative accounting! However, the confirmation of the new ministers is not set, for Budget Guidelines Law approval and the overthrow of 2014 fiscal surplus target are still pending in Congress.

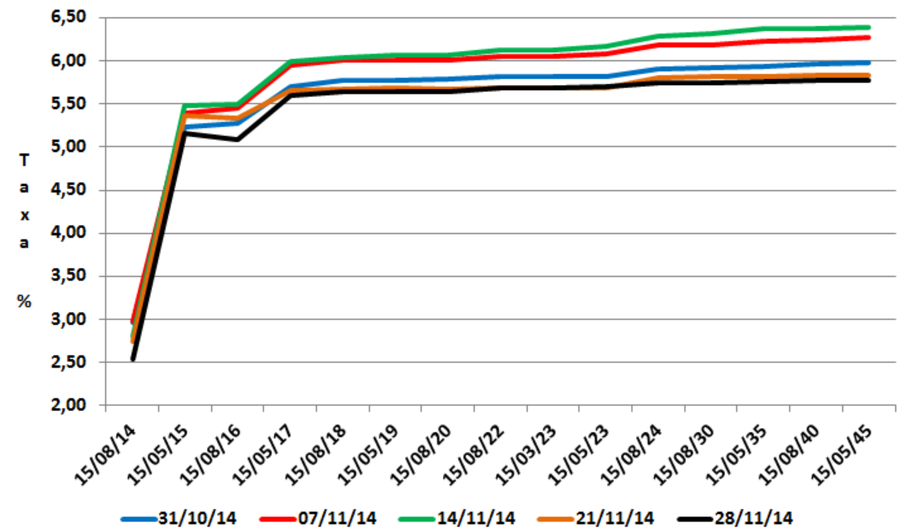
The yield curve had two moments, almost antagonistic, throughout the month: the accumulation of premiums and low liquidity, until the definition of the economic team, with contracts maturing beyond January 2016, trading at rates higher than 12.50% and the reversal of this movement, with increasing investor confidence based on signs that the government would choose a team with focus on fiscal adjustment and inflation control. Thus, the yield curve ended the month with short-term contracts (up to 2016) at higher rates than the previous month's closing (expected increasing intensity of Selic increase) and long-term contracts at reduced premiums.

The economic activity figures released during the month were not so important in the movement of the yield curve as the choice of the new team. But make no mistake, one swallow does not a summer make! A good and well oiled economic team is necessary, but not sufficient. Everything else must be in line. Let us wait for the first actions, to make a better evaluation. Trust and credibility are given - with an expiration date. The expected new policies are diametrically opposed to what we have seen so far - they are even "enemies". And as the saying goes, the enemy of my enemy is my friend.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

In addition to a global US currency appreciation trend, the strengthening of the US economy, an obvious and next change of its monetary policy (tightening) and the consequent and inevitable Flight to Quality (migration of resources to US bonds), with direct impacts in our economy, will cause what kind of Exchange Rate Policy from now on? Add to this the premise that the Central Bank reference scenarios the dollar is quoted at R$ 2.25 that, ultimately, was certainly part of the General Dynamic Equilibrium Model, which, among its goals, provided a convergence of inflation to 4.5% per annum.

Well, the level of the exchange rate seems to have changed. Projections of R$ 2.40 are farther ... is it? Will the Central Bank let it? The power of "misadjustment" of relative prices to a high dollar and a lot of volatility are huge ... it is hard to accept this.

Be that as it may, uncertainties regarding the economic policy of the second Dilma administration made the dollar be traded at over R$ 2.60 during the month. After defining the new economic team, the leading ministers, and the general lines in which they would work, the currency relented, but statements by the president of the Central Bank and the Ptax closing market movements made the dollar close the month trading at R$ 2.5601, an appreciation of 4.74%. This was the third consecutive monthly increase. Nothing like uncertainty!

In the first speech after the confirmation of continuity leading the Central Bank, Alexandre Tombini stated that the current swap stock meets the demand for currency hedges, the currency hedge offer program ends late December and that the contracts will be rolled according to the demand conditions. As a result of this statement, the market interpreted that there may be a suspension of the daily swaps, with the return of pressure on the US currency. Investors are worried about the future of the Central Bank's exchange rate intervention program, and which concrete actions the economic team will take to address this and other variables that have a strong impact on inflation. More specifically, the market may be "demanding" interventions on spot trading. Firmness of purpose and clarity of the Central Bank's Foreign Exchange Policy at the moment are simply fundamental, there is no room for half-terms. Floating exchange now!

Foreign currency balance closed on November at a negative USD 3.507 billion, the worst performance since December of 2013. This time, both the trade and the financial account closed in red. At any rate, the YTD is still positive at USD 4.763 billion. Is help needed? Shall we use our reserves? Or would it be better to adjust the economy as a whole and accept the dollar as just another economy price? Is this an utopia? Maybe not.

Stock Market

The long-term stock market index is considered a good indicator of development of a country. In this light and in this regard, we are doing very badly. In fact, in all analyzes (fundamentalist and/or graphic) we are going from bad to worse.

In the short-term, however, the random movement prevails - particularly in the current scenario. At any rate, the need for explanation always brings "discoveries" of "noises", but also some indisputable identifications/confirmations. Thus, the stock market went through a period of pessimism after the elections in the first half of the month. In the second half, the possibility that an economic team more aligned with orthodoxy would be chosen and the subsequent confirmation animated the market. The Ibovespa changed its trajectory and closed the month with a slight increase of 0.07%. YTD, the index has gained 6.13% by the end of November, near savings account rate (6.44%). A pity.

And Petrobras stands in the midst of these indisputable identifications/confirmations! Many doubted, but it happened. Petrobras, one of the largest Brazilian companies, with strong influence on the Bovespa index, did not disclose the audited balance sheet for the third quarter of 2014. As a result of the Federal Police operation involving the company, PricewaterhouseCoopers - PwC decided not to sign any financial statements of the company until the internal investigations to determine the corruption allegations are completed. This fact, coupled with OPEC's decision not to cut oil production directly impacted the price of the company shares (down 16%, preferred shares). Our investors are lucky, because we do not carry this share in our Investment Funds ... but there is still an indirect impact, by "contagion", or the impact it has on the Index and therefore the eventual hedge of the portfolio.

As the price of oil barrel plummeted during the month, iron ore was at one point traded below US$ 70 a ton, as a result of the commented Chinese economy slowdown. Not even the cut in interest rates in order to foster the advancement of the Chinese economy was able to consistently maintain/increase commodities exporters prices.

As written in previous reports, we do not see structural changes that indicate the recovery of the stock market as a whole in 2015. It is up to managers to identify the specific opportunities in this market. Crisis generates opportunities, particularly for value investors. However, the reorganization of the economy will bring greater predictability and confidence to the investor/entrepreneur, fundamental characteristics for the new cycle of investments in companies and general recovery. Amen!

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