FEBRUARY - 2021

MONTHLY STATEMENT

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"If anyone convinces me that I got it all wrong, I will leave."

Paulo Guedes – Brazilian Minister of the Economy

Web-Interview to Primo Rico on FEB 26th 2021.

Bolsonaro appears to be quite decisive in leaving his indelible mark in Brazil. At a time when the pandemic is worsening with an increasing number of cases and deaths, he acts beyond his negativism and omission, goes out in public to promote agglomerations, neglecting the use of masks, and demoralizing certain vaccines. Such irresponsible and belligerent behavior is not limited to the health crisis, no. Demoralization and humiliation also reached who was once his main Minister: Paulo Guedes.

In a spree of tantrums and tirades, with a typical blockbuster behavior, he dethroned the President of Petrobras in an episode as organized and delicate as an elephant in a room full of crystal glasses. It was not an isolated case, nor was it just another foolishness of the Commander-in-Chief. It was clearly a turning point when any remnant of what voters once imagined could be a government with a liberal economic agenda was shamelessly left behind.

Minister Paulo Guedes, in turn, imbued with a spirit to leave his mark as someone who has recovered and aligned Brazil in the right direction, supports his boss in such folly. He overlooks how Bolsonaro can make mistakes, and in doing so he is wrong to accept and implement unsound ideas. Guedes becomes an accomplice in Bolsonaro's impostures. Nothing is more compelling than the exodus of his team and the unrestrained vituperations by some as the President's absurdities advance. Paulo Guedes is not as relevant as before; his expected liberal agenda was dead on arrival.

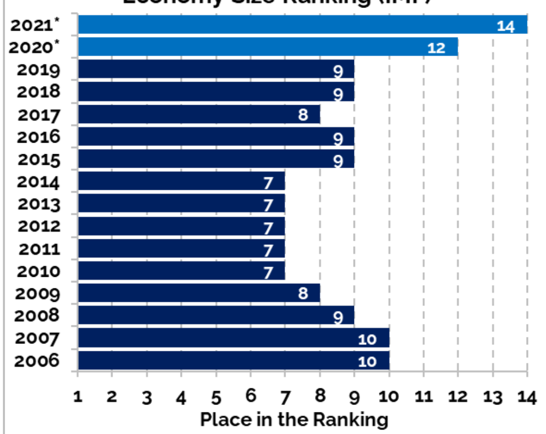
The direct and/or indirect interference in SOEs, especially the most recent ones at *Banco do Brasil* and *Petrobras*, seem to repeat the film that we have seen countless times in the past, making them an instrument of government policy. The end result is disastrous, to be sure, but now the potential to perpetuate the damage is enormous, with amounting difficulties to recovery. In this line, the management of public finances, with a "hand" by the National Congress and a certain subservience of the Executive, will complete the bridge to chaos. Paulo Guedes has lucidly reiterated this forcefully, by signaling our "argentination" and "venezuelization" scenarios within very short deadlines. He seems to be doing sterile lip service; it does one no good to listen.

The financial market, albeit timidly, has played its role in anticipating "pricing" these events. The real economy also begins to show some of its reflexes: our heyday of the 7th largest economy in the world is behind us and we have moved to 12th place. Furthermore, our economic recovery will be slower than the growth prospects of the planet and also less than the recovery of emerging countries. At this point, our best Minister sees everything, correctly evaluates everything, alerts us to all problems and ***accepts everything***. The "subliminal" message is clear: Bolsonaro no longer gives a damn about Guedes, that the Minister can't see it! Curious, he talks about everything and can't see what is right in front of him.

For precisely this reason, our scenarios for Brazil are growing less and less optimistic. The original purposes of Paulo Guede's liberal agenda are worthy of praise, as are some important "achievements" such as the independent BACEN and the Currency Bill 5,387/2019, as well as, now, Guedes's detachment and flexibility in conceding in some points to save the bigger picture. Perhaps he did not understand the structural and non-punctual turn of the President's actions, interests and final objective at the beginning of the year. The purposes are given, and throwing Paulo Guedes and his agenda under the bus is no longer an obstacle nor does it cause any embarrassment. Poor Brazil.

The financial market, which started the year under stress, "consolidates" its bad mood in the face of inconsistencies in fighting the pandemic and its reflexes on the economy and society. Investors have been, it is true, quite condescending until now, but the scenario has become increasingly clear and expectations have been more adjusted. Thus, the IBOV closed the month at -4.37%, with emphasis, for obvious reasons, on Petrobras. Yield curve moved sharply upward, pricing in the risk at increasingly higher premiums. DI1F22 ended the month under renewed upward pressure in relation to January (3.305%), at 3.74%; and DI1F25 closed at 7.23%, with an increase of 0.89 points compared to last month - or, 1.58 points in just two months. The oscillations recorded between the highs and lows were also significant, with DI1F22 going from 0.645 points in January to 0.50 points in February. DI1F25 fluctuated 1.21 points in February. In both cases it turned on the red light for BACEN and its policies. As expected, uncertainties transcend the realm of interest rates, since the Brazil risk, measured by the 5-year CDS, advanced to 195.77 points, an expressive variation of 21, 45 points, in line with the above movements. In this vein, the final dollar exchange rate (Ptax) ended the month at BRL 5.5302 - a new devaluation of the Real, which deviates from the initial projections for 2021, reflecting previous analyzes.

Evolution of Brazilian Economy
Economy Size Ranking (IMF)



Source: IMF | Elaborated by Redwood *IMF Forecast

The additional instability in February is due, above all, to the interventionist attitudes by the President, in the tone of the “new” policy arising from the new composition of the House and the Senate, and, of course, in the alternative choice by both branches of government of spending beyond the limit imposed by the Expenditure Cap. As the situation worsens, economically and sanitarily, “Emergency Constitutional Amendment Bills” will appear with the risk of becoming an instrument to make the spending cap more flexible, undermining the country's confidence and sustainability. The consequences will be more of the same as described above in the financial market.

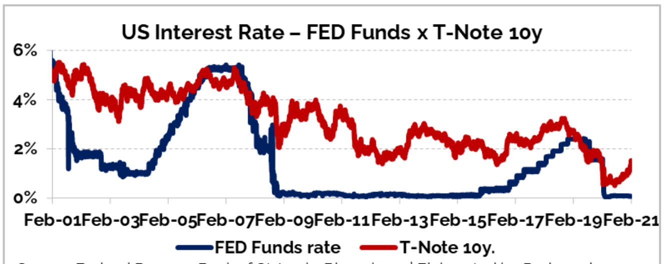
Despite being in rear view, the economy's performance in the 4Q/20 surprised. This could be a boost if this reality continues, which does not seem to be the case. Economic performance exceeded expectations, but the administration's actions, especially those of aid to the most vulnerable, reversed the situation. This reversal, however, should not be celebrated, as, for example, an investment that cannot be evaluated without the risk involved, we cannot boast that we performed better without properly assessing the risks in front of us. Regardless of whether our fiscal situation, in relative terms, was worse than that of others emerging countries before the crisis, aid was (and is) needed in such extreme conditions, but in coverage (population), term (time) and adjusted values. We were effective but not efficient. Our situation is now much worse than before, with daunting impediments to the economic recovery.

Thus, combining increased spending with no counterpart to reducing expenses, possible tax hikes, disbelief in the definitive advance of reforms, Minister Paulo Guedes increasingly “close to resignation” and the unequivocal posture of the President to “stick his nose” in state-owned companies: all of the above moves us away from a more optimistic base scenario. In fact, in our probabilistic scenario, we expect deterioration in the main macroeconomic variables, with striking stresses in financial markets. This understanding put us in line with the IMF forecast, which presents Brazil out of the 10 largest world economies, devolving back to 2006 levels. In this way, we will not even be able to grow in 2021 beyond the statistical load of the observed 4Q/20, we will be around the 2.5% mark. A far cry from a government-proclaimed V-shaped recovery, as we had the worst recession on record since 1990 at -4.1% in 2020.

In Monetary Policy, the winds blow stronger for an earlier and more vigorous (tightening) monetary cycle to begin. Several important market players are already betting on Selic increases in March (between 0.25% and 0.5%) with the basic interest rate at 4% in December this year. Our models and perspectives continue to point to a Selic rate of 3.75 at the end of the year, with an effective and constant beginning of the cycle of increases in May, despite some deterioration in the inflation projections. In any case, the monetary authority is much more attentive to possible inflationary shocks and notably the fiscal issue. The unemployment rate is expected to cool somewhat given the new emergency aid, which, for BACEN's "new" mandate, could be a mitigating factor in its interest rate policy. In the exchange rate policy, BACEN will be "required" to participate even more intensely, since the horizon seems to change significantly, be it for various domestic reasons, or for international issues, specifically the American bond market. In fact, the whole environment favors this possible "reversal", or at least a decrease in the original projections for the year 2021. BACEN will not lack interest, ammunition and a willingness to intervene, whether to "control" volatility or price level. Exchange rate intervention seems to be the favorite sport.

On the fiscal side, Guedes' team seems to be 100% committed, but the same cannot be said of the other branches and several members of the Executive. Under the guise of helping the population, all sorts of initiatives at this time and further ahead, we will see alternatives for pushing through and/or circumventing the Expenditure Cap. This premise, increasingly present in our scenarios, reduces the trajectory of greater hits in the economy, and opens room for all kinds of speculations and bets contrary to what is desired, especially (but not only) for long-term projects. If we really want fiscal consolidation and return to the path of adjustment and prosperity, respect the Expenditure Cap, have an adjusted budget, guarantee the Golden Rule, comply with the Fiscal Accountability Law, at all levels of the federation, these will be topics to be permanently under vigilance. But what is the real chance of this happening at this moment, with such diffuse interests, a Minister of Economy torpedoed almost daily and a new partner (*Centrão*) with such a different stance? In addition, everything that can be done should, in our opinion, take place by next October, since after that date all attention will be focused on the elections in 2022. Although the resumption of a trajectory of controlling public spending is under threat, we don't see it being totally abandoned, only that Guedes' initial fiscal rigor will be progressively impossible, either due to the President's DNA or due to the inadequate measures in fighting the pandemic on account of electoral motivations.

Thus, not all reforms, privatizations, concessions, etc., are envisaged, but only a few (those already in "progress") and all of them tend to be dehydrated and/or embezzled. It was all very lukewarm, dubious in the eyes of investors, and therefore without any more forceful effect. In addition, with Guedes "thrown to the wolves", even if he remains in office, everything will come out "half-assed" and thus we will drag ourselves to the elections.



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

Overseas, in contrast with our situation in Brazil, the Coronavirus crisis seems to be resolved, although with several setbacks and challenges. The full commitment with and serious planning of vaccination has had enormous effects in many countries. With this, several locations boast very positive projections for economic recovery in this year already. In the USA, we expect a 4.5% recovery, but renowned institutions estimate 7%. In Europe, despite some distinction among countries, we project an average advance of approximately 5%. It remains to be seen how sustainable it will be.

Obviously, these advances are, as a rule, a coordinated action of monetary and fiscal policies associated with health-related goals and other policies. Therefore, like a short blanket, it is necessary to dynamically adjust the variables and their undesired effects. One of them, due to the injection of liquidity, is already reflected in the T-Note 10 years. Is inflation rising ahead? Is protection needed? Will Flight to Quality divert resources from emerging markets? The Fed will signal the times to come in March.

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