MONTHLY STATEMENT

JULY 2021

Redwood

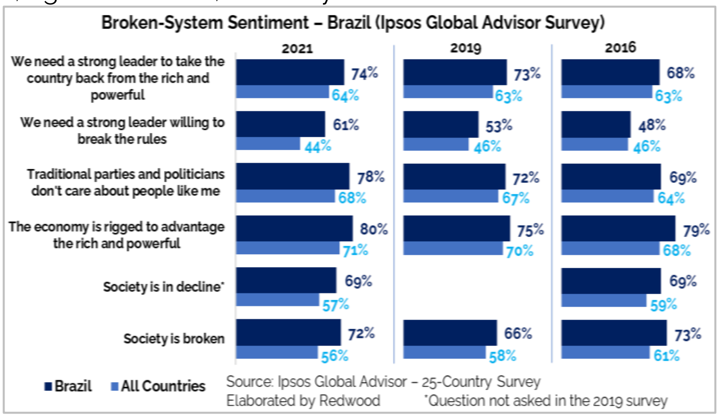
REDWOOD ASSET MANAGEMENT

"We are not Banana Republic!"

General Hamilton Mourão – Vice-President of Brazil

Are we not, really? Our political situation can be spelled out as follows: the more you pray, the more ghosts appear. With the total and definitive surrender to the Centrão, a political surrender capable of blushing the most loyal of his voters, the President justifies his act as a way of giving him greater control over government, while "preserving" his mandate and strengthening his interests for 2022 In his daily statements and in his grotesque "livestreams", with countless boasting, fanfare and conspiracy theories, "his" Brazil is revealed.

Elseways, the opposition, especially the one more to the left, is just as dreadful. They gloat in every way and abuse the people who, astonished by the various atrocities experienced since the beginning of the pandemic, forget about what was the recent past of the PT era. Furthermore, the Institutions, daily threatened, fight at random, and they attack as a defense strategy. On all sides, the ethics of the scoundrel rules. Tyranny dressed up as patriotism flourishes, undermining the democratic homeland as we built it. These are very distressing times.



The system is broken. Brazilians watch their country go down in steep decline, where there is no social cohesion to change the course of this reality. Social unrest comes, above all, from the feeling of frustration and non-representativeness of political parties and governments. The political polarization presented today further encourages this situation, whose exponents in their populist and ideological way, permeate the real problems of the country. Speeches about attacks and outlandish narratives reinforce the extremists' positions, and disgust those who still breathe and think about the country.

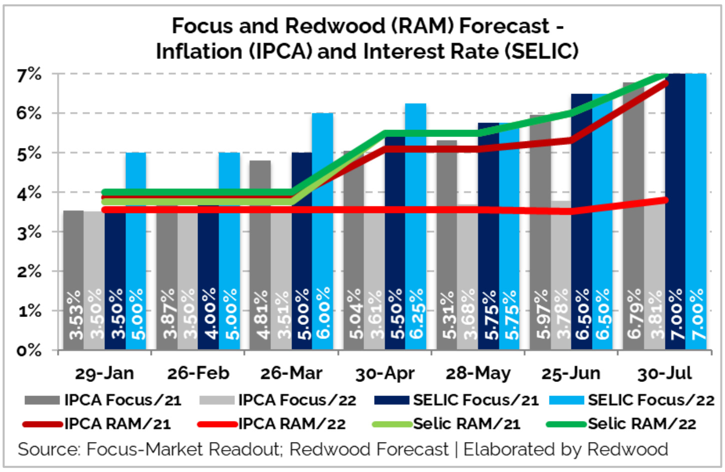
The background to this political assessment, as always and notably, identifies its effects on Brazil's economy and finances. Thus, we can find no relief in this environment, especially as the country's main leader avoids being helpful at all; quite the contrary. His constant clashes, regarding the printed vote, with the Judiciary branch escalate every day, even invoking the failure to hold next election. Bolsonaro's Ministers, with a recent highlight for the military, adopt a posture of which the corporation itself is strongly disapproving. His economic oracle, the formerly Super-minister Paulo Guedes, in addition to being "left" by most of his team and breaking up of his department, has by now dropped the liberal agenda and is far from being "the man" shielding the Expenditure Cap or actually structuring reforms, and is currently flirting with the possible default on court-ordered public debt. In the midst of all this, the Congressional Inquiry returns with an "all or nothing" push, which, for law-abiding Brazilians, is very difficult to understand outside the limits of political interests.

The result of all this confusion could not be far from what we have seen: the economy grows much less than it could, unemployment does not retreat, and inflation soars. Obviously, the Commander-in-Chief is already aware that this trajectory does not bode well for his electoral purposes. Thus, his troops (including the new Chief of Staff) have already been reviewed. A "goodness pack" needs to be formulated and put into practice, for reversing this trend is not easy and takes time, even with the support of the Centrão. The measures will necessarily be economic: increase in the Bolsa-Família, BIP, exemption and inflation-adjustment of personal income tax brackets and exemption of corporate tax, readjustment of civil servants' salaries, etc., not to mention a "bloated" budget for possible amendments by congressmen - in theory, his allies.

This is the "rule of the game", but one that the financial market is already pricing in and the population as a whole sees it in their daily lives. We can only wait for the so-called Third Way!

The financial market, which in recent months has underestimated the Brazilian political risk and paid attention to other factors, notably external, grew even more cautious in July/21. It is no wonder that the rampant political confusion in the country scares away even the most audacious investors. The tension comes above all from the federal government's systematic statements, which cloud the interpretation of public policies, blur the understanding of economic policy and confuse the signals aiming to realign expectations.

As a result, the Ibovespa retreated this month, varying -3.94%, down to 121,801 points. Last month's yield curve shifted upward, with higher rates in the short and long terms, in significant shifts to several longer maturities, with a clear "contamination" of inflation and fiscal risks along the curve. The DI1F22 ended the month up in relation to June (5.68%), at 6.31%; and the DI1F25 closed at 8.70%, well above last month's mark (8.06%). The oscillations between high and low prices presented important variations this month, both DI1F22 and DI1F25 at 0.68 p.p. in July, against changes of 0.735 and 0.75 p.p. in June, respectively. BACEN technicians could not have been more attentive, since the movements have become sharp and consistent in their trajectory, which requires extreme care in properly adjusting their policy. The Brazil risk, signaled by the 5-year CDS, more than offsetting the small 6-point drop last month, has advanced to 176.71 points in July. The Dollar, in the same direction, rose to BRL 5.1216 (Ptax), with a positive +2.39% change – a devaluation of the Real, breaking a sequence of three consecutive months of decline.

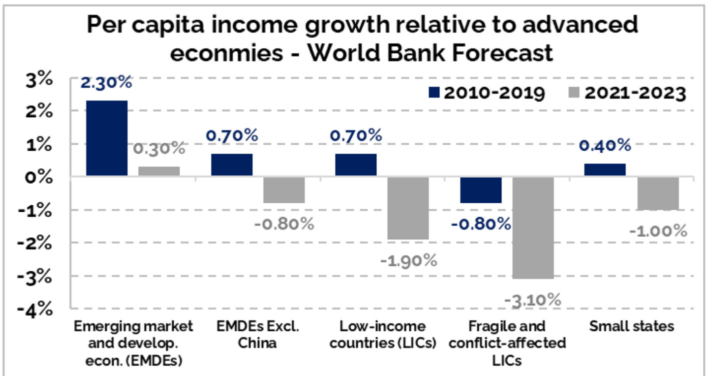


Source: Focus-Market Readout; Redwood Forecast | Elaborated by Redwood

With the financial market running with utmost caution, especially due to ghosts that restart their round with new Ministers and Departments, with a more political than technical stance, prices reflect rumors of the "goodness pack" that, if ever implemented, have the potential to circumvent fiscal rules, particularly the Expenditure Cap. It's a shame, because even with the stumbles along the road, with all the caveats and statistical justifications, some indicators have not worsened. Public debt/GDP ratio fell another 0.5 p.p. to 84%, whilst formal employment continues to grow and the balance of payments itself has not worsened. Obviously, the scenario remains very bleak, but given the numerous crises, even these indicators could have suffered more.

If good news as a rule is short lived in this environment, Paulo Guedes strives to confirm the saying. With his usual political awkwardness, disconnected and careless tone, he pointed out that "meteors" may be about to hit us – in this case, the federal budget. However, worse than the "meteor" hitting us is the "missile" he is intent on firing to protect us. What's the meteor? Court-ordered debt. What missile? Therein lies a default! Everyone knows which one has the greatest destructive power, broad and lasting. It is just unbelievable that something of this nature has the slightest support from a Chicago-boy. If confirmed, the economic and financial effects will be difficult to measure.

In Monetary Policy, current and future inflation clearly set the tone. The "cooling down" seen in some prices was less than expected and, thus, undermines the prospect of transitory and, associated with increases in electricity, household gas, car fuel and others, consolidates inflationary pressures. The chart above clearly shows this deterioration over the first half of this year, and the corresponding expectation of adjustment in the Selic. There is no alternative path to BACEN except to continue with its policy of strong Selic increases towards "interest above neutral rate", within the relevant horizon for Monetary Policy. In the Exchange Rate Policy front, the expected increase in the Selic rate, a "better" fiscal outcome and no major adjustments in the international landscape at the moment, we stand by our scenario of a likely weakening of the Dollar against the Real for the end of the year. However, playing against our projections are the political environment and the various crises, together with the always interventionist and "confrontational" stand by the BACEN on this issue. On the fiscal side, the Minister's communication remains terrible. However, the resistance and the fiscal defense have their last bunker in the technicians of the Ministry of Economy, but it could be hanging by a thread. This is because, once again, the political overrides the technical with the populist measures in course. It is an inglorious struggle for those who still carry the flag of decency in the rigor of public finances. Central government accounts registered a primary deficit in June: BRL 73.55 billion. The result was the second worst performance for the month in the historical series started in 1997. These expenses are still a reflex of the expenses necessary for the pandemic, but, according to government officials, the other ordinary expenses remain under control and on a declining trajectory for the last 12 months. In other words: the compliance with the Fiscal Accountability Act (LRF) and the Expenditure Cap, which preserve the sustainability of public finances and maintain the confidence of economic agents. That's what is at risk!



Relative per capita income growth is computed as a difference in per capita GDP growth between respective EMDE groups and advanced economies. Source: World Bank - *The Global Economy: on Track for Strong but Uneven Growth as COVID-19 Still Weighs*

Overseas, economic recovery continues to be strong while mass vaccinations takes place, albeit with a slight slowdown. This is a widespread advance, though quite uneven. The US and China "stand out", while several countries, notably those without major advances in vaccination, suffer significantly. This mismatch is reflected in different and profound ways, to a greater or lesser degree, depending on the country. In any case, it is common to see this impact also on the recovery of per capita GDP, but above all in the economic sectors. The economic recovery of countries, almost as a rule, is based on strong fiscal policy support – a back-up that will soon be withdrawn by most governments. Unfortunately, with economies growing unevenly and with regional disparities within countries, the vulnerabilities and risks are evident. So much so that global growth forecast for 2022 is much lower than for this year. In other words, many uncertainties lie in the way of recovery, in addition to inter- and intra-economy disarray, such as business failures, market distress and social crises. The legacy of the pandemic will take time to dissipate.

The Euro Zone (EZ) registered growth in its economic activity in the 2Q'21 compared to the 1Q' 21 above the forecast of 1.5%, advanced 2%. With the same positive signal, unemployment in the EZ in June dropped to 7.7%, compared to a 7.9% forecast. As for inflation, analysts were forecasting 2% for July, and the result was surprisingly above ECB expectations: 2.2%. Last but not least, EZ's manufacturing PMI slipped, but less than expected, with the help of Germany. From the latter also comes retail sales well above the 1.8% expected: a 4.2% advance in June.

In China, at a meeting chaired by Xi Jinping, the president recognized that the economic recovery is "unstable and uneven", and the need for policies that guarantee "reasonable and sufficient liquidity for small- and medium-size companies". China's Industrial PMI plunged to its lowest level in 16 months, possibly influenced by adverse factors such as recent floods, new Coronavirus infections, and power outages in some cities.

In the US, its economic policy will dictate the course of other countries on the planet. The vast majority of the market did not believe in tapering this year until recently, let alone interest rate hikes. We have claimed that the slowdown in asset purchases will start this year, followed by an increase in interest rates. Should the unemployment rate fall enough, and not as disproportional as today, the conditions will be set to start adjustments!

DISCLAIMER

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