MONTHLY STATEMENT

SEPTEMBER 2021

Redwood

REDWOOD ASSET MANAGEMENT

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"Cowardice is submissive surrender to circumstances!"
Martin Luther King – American Baptist minister and civil rights leader.

This month of September is likely have been the apex of daydreams, nonsense, stupidities and surrender in the 1,000 days of the federal government. Victims of stupidity, machine-gun political rhetoric and the country's leader's empty brain, who avoids learning anything, a fair share of his voters is awakening. Other more tribal supporters, such as radicals from different spectrums, only momentarily join the group of disappointed by the President. Resilient, like those of the PT era, they quickly regroup and renew their strength to assuredly continue as those Saramago well describes in his "Essay on Blindness".

This is democracy in action, and if that is the way, lessons must be learnt. Hope lies, however, in the "silent" majority engulfed by the current polarization. We need a natural alternative to countervail extremes, especially a fair and not weak one that heeds the country's wants and needs. No more disrespectful and amateur management, we are no longer silently taking the middle finger!

Health Minister Marcelo Queiroga shows his middle finger to protesters in New York - UN General Assembly

This political temperature directly reflects on the disarrangements of the markets, notably in expectations formation. The electoral demands of the Commander-in-Chief with direct and indirect responsibilities are evident, such as increasing the Bolsa Família – fair enough – and the budget amendments by the bill's rapporteur – unwarranted. The problem is that the math doesn't add up! And how nice! Were it not for the expenditure cap the budget would retread long-trodden trails (and in a way it already is), namely: a piece of fiction. A more far-fetched fiction than the market already prices in, like the distant conservative agenda and the what is unthinkable to a Chicago-Boy, but nonetheless incoming: tax hikes!

The price dynamics of the economy are another crucial point at the moment, and we shouldn't be scared if political actors start with their "inputs". With the political weakness of the Minister of Economy and, according to him, our deficiency (Brazilian economists) in understanding General Equilibrium models, as well as the plunging popularity of the President, little separates us from more heterodox measures. All of this is duly "justified" to meet the people and their basic needs. Can we expect some sketch of an eventual reaction from economic policymakers? We should not. Those who could have left the government and the remnants are not vertebrated enough to do so. And if any still does exist, by a spasm of courage and intellectual coherence, one such will surely be replaced.

Populism is "always" the end result of combining rising inflation with high interest rates, anemic economic activity (especially from 2022), high unemployment and low presidential popularity in an electoral race. In addition, the President has surrendered to the Centrão (with a wide domain in Congress and harsh thirst for money), truly non-liberal and with a developmentalist bias, we have a very high probability of populist measures whose outcomes are, as already experienced, disastrous. Once again, cowardice lies in the space between an excuse and a motive. The financial market does not distinguish between one thing and another, it just corrects its course to adjust to risk-return ratios.

The population, however, always bears the brunt. The President's bravado and intimidation escalated to the peak level, with his subsequent surrender, thus signing a letter dictated by former President Temer... damage went beyond containment. Disrespect and betrayal reigned in; the remaining trust is fast fading away, and the little admiration rapidly disappears. There is still dismay, but with it goes the certainty of turning this page soon!

In the financial market, the bed of roses was turned over. Despite the good economic news, such as Caged's job creation and the lower public debt-to-GDP ratio, these indicators were not enough to reverse the gigantic pessimism besetting the markets. Political rhetoric is predatory and head-banging around the country's finances with electoral needs undermines confidence and shatters expectations. As the "vessels are intercommunicating", any reversal must be quick and forceful to avert further "contagion", which seems unlikely.

Reflecting this mood, the Ibovespa fell sharply this month, once again, varying -6.57% down to 110,979 points – good news remained only in the H1 2021. Replaying last month's outcomes, the entire yield curve shifted upwards. The final analysis points to hikes across the board due to risks associated with the lack of control over inflation and fiscal stability under constant "stress test". The DI1F22 ended the month rising in relation to August (6.735%), at 7.185%; and the DI1F25 closed at 10.25%, 7.56% above last month's mark (9.53%). The price oscillations between the highs and lows showed important variations this month, with emphasis, once again, on the DI1F25 with 1.13 pp, and the shorter maturity DI1F22 went higher this month, at 0.75 pp. The same variations for DI1F22 and DI1F25, in August were 0.575 pp and 1.57 pp, respectively. BACEN is absolutely aware of the facts and their "causes", but prefers to be more "cautious" on adjustments regarding the short range of the yield curve, while "washing its hands" (of course) on fiscal matters.

The Brazil risk, priced in by its main indicator, the 5-year CDS, also showed its face, and reacted with a upswing of 17%, rising to a level of 206 points – waking up to an undisputed perception of country risk. The Dollar, in turn, "nervously" ended the month at BRL 5.4394 (Ptax), with a +5.76% change – a new and important devaluation of the BRL, for the third month. Other assets in the financial markets also exhibited strong volatility, and do not escape the general tone of pessimism and distrust of the future.

Economic indicators that had been giving good signs lately, improved even more, despite being "ignored" by the market. The Brazilian Balance of Payments remains "firm and strong". Trade Balance, despite some cooling down, will close 2021 with a balance above USD 70 billion, and Current Transactions also display good performance. In the same line, the Debt-to-GDP ratio reached 82.7% in August, far better than expected a few months ago. Caged's numbers are surprising every month, and the projection for the year now exceeds the generation of jobs above 2.5 million – a real relief, even if the PNAD "still" does not capture this performance. The unemployment rate, at this pace, will be reduced, although a slowdown is almost certain. The economic activity, however, adjusts to reality and signals a strong brake for 2022. Good numbers for 2021 (far from market expectations), with no detriment to any effort, are due to a stronger tax collection - very sensitive to higher inflation – and the activity comeback on top of a very depressed base, due to the Covid-19 crisis. We may witness, again, a "chicken flight".

NON-OPTIMISTIC FORECASTS

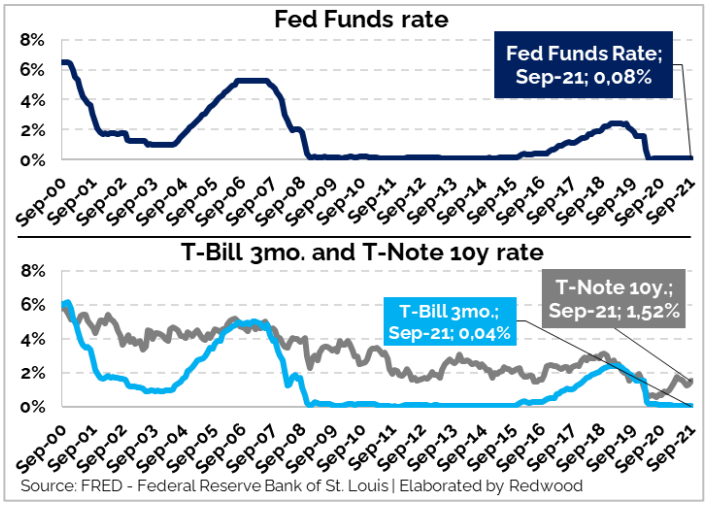
YEAR	INFLATION TARGET			INFLATION PROJECTION		SELIC PROJECTION	
	BAND FLOOR	TARGET CENTER	BAND CEILING	BACEN[2] *FOCUS 09/24*	REDWOOD	BACEN[2] *FOCUS 09/24*	REDWOOD
2021	2.25%	3.75%	5.25%	8.45%	8.13%	8.25%	9.00%
2022[1]	2.00%	3.50%	5.00%	4.12%	4.33%	8.50%	9.00%
2023	1.75%	3.25%	4.75%	3.25%	3.75%	6.75%	6.75%

[1] Relevant time-horizon
[2] Basic exchange rate BACEN BRL projection 5.25 and evolution by PPP
Source: Central Bank of Brazil - BACEN/Focus; Redwood Projection | Elaborated by Redwood

In Monetary Policy, the picture above is quite revealing. It is necessary to remember that BACEN, today, is "independent". It is important to note that its communication has left no doubt about its commitment to strict inflation control. All the same? But what about the attitude? Which time range is really relevant? Maybe flexible? What is the adjustment variable for this period? Economywide performance? Political stress or structural reforms? The hard fact comes down to the usual dilemma between what BACEN should do and what it will do. It's like the tightrope walker in a circus juggling several spinning cymbals, trying to keep all of them in balance, and he's going to lose control of them all. If the timing of interest rate hikes was not correct - ok, but flirting with transitory rise in prices is no longer

acceptable - monetary policy takes time to run its full course, and the intensity of the Selic hikes seems wrong. This "calibration" of hikes can be doubly harmful: delaying the taming of inflation and even prolonging the "suffering" of economic activity.

The exchange rate policy follows routine interventions by BACEN (its favorite sport), which now seem to have other "justifications", namely: inflation. With the Selic up, it was to be expected a more appreciated Real, but the different conditions and risks make our equilibrium exchange rate almost BRL 1.00 higher. However, there is still additional distrust: the "use" of such interventions (extraordinary swap auctions) to "aid" in the fight against inflation, promoting adjustments of "only" 1% in the Selic. Could it be? BACEN's net foreign exchange position is USD 273 billion against USD 299 billion in Dec/20, that is, this is the stock readily available in case of emergency. The arsenal is vast, but not infinite. *The market sees what doesn't exist, and suddenly... wow!*



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

On the fiscal side, the number came out good! The public sector had a primary surplus of BRL 16.73 billion in August, the best for the month in the series, starting in Dec/01. The 12-month accumulated primary deficit through August totals R$130.3 billion – equivalent to 1.57% of GDP. They are expressive and important figures, but the rest of the story that could perpetuate this performance and improve expectations, is not convincing at all. Containing the evolution of public debt should be the main objective of fiscal policy, which is why surpluses need to be recurrent, in order to reduce the debt. This debt is remunerated at very high and increasing interest rates. The preservation of fiscal discipline and the maintenance of the Expenditure Cap are fundamental, but they clash with electoral needs and the budget.

Around the world, as the health crisis tones down and the beginning of the return to "normality" in several countries, its damages and challenges are beginning to disturb several economies on the planet. Problems in the post-pandemic supply chain affect the supply side too much, and the expected rapid recovery is confronted, in several places, facing similar problems. Signs of economic slowdown ahead and inflation are common, and attention is also turned to the problems specific to each country arising from the way in which they faced the Coronavirus crisis.

In the US, in addition to the aspects mentioned above (inflation will overshoot the "target" before falling), the country faces problems such as the ceiling for financing its debt, the beginning of tapering (reduction in asset purchases - on a monthly basis, the Fed buys USD 80 billion in Treasuries, US debt securities, and USD 40 billion in bonds linked to mortgages) and the interest rate hike itself – if not in this year, perhaps early 2022. In addition to these problems, recent crises such as the clumsy exit from Afghanistan, the border issue with Mexico and the refusal of part of the population to be vaccinated against Covid-19, are all mixed with the bad communication of the current government and its intentions to carry out its agenda. The point is: problems in the US are never US-only-circumscribed. The planet suffers.

In Europe, The ECB seems to be a step behind. They recognize the potential for inflation and understand that the bloc's economy is back, but not out of danger. Like other places, threats to growth resumption are frightening.

In China, the slowdown in economic activity is a certainty, especially after the Evergrande case. The injection of USD 15 billion into the financial system was just the beginning. China's eventual downfall will also drag many.

The world scenario does not help emerging countries, especially Brazil. Important deep reassessment of investments at this time is advisable.

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