**MONTHLY STATEMENT**

MARCH 2022

# Redwood

REDWOOD ASSET MANAGEMENT

***"Better slip with foot than tongue."***
***Benjamin Franklin - Founding Father of the United States***

It doesn't take a political scientist to recognize the calamity that besets us. After the "it's over, damn it!", we now have the "don't tell me to be goddamn calm!". Phrases coming from no less than our current Commander-in-Chief, in an act of absolute contempt and decorum, towards the office and the people. It would be more appropriate if society directed such eruptions towards the government, but the former is more dignified and compassionate. Yes, so much so and with such a short memory that it rewards, with first place in the electoral polls, the pre-candidate who, until the other day, made the headlines of the biggest corruption scandals in the country.

In case no one noticed, both abovementioned do star in the "democracy parade" and, to the surprise of absolutely no one, they will evoke victimization, social polarization, the trivialization of morals, ethics and democratic values, in addition to the empire of extremist ideologies . The main forerunners can only deliver more of what they have already proven themselves to be capable of. Both striving for the good of Brazil is like embracing all capital sins at their source. The abyss is right there and we are staring right at it!


On the other hand, just so we don't get ourselves stuck between a rock and a hard place, there is a huge share of the population that waits and yearns for a third way. However, this path did not actually pan out and is very late in its joint organization. The timing of politics is always quite different from the common citizen's perception, but the neophytes on duty and the amateurism of many of the third way, in constrast with the foxes best placed in the polls, is laughable and, taking advantage of this, they holler at and stifle any isolated initiative. The project, without a doubt, is the union of all those falling behind... but how to promote the union without a common leader that can be accepted by all?

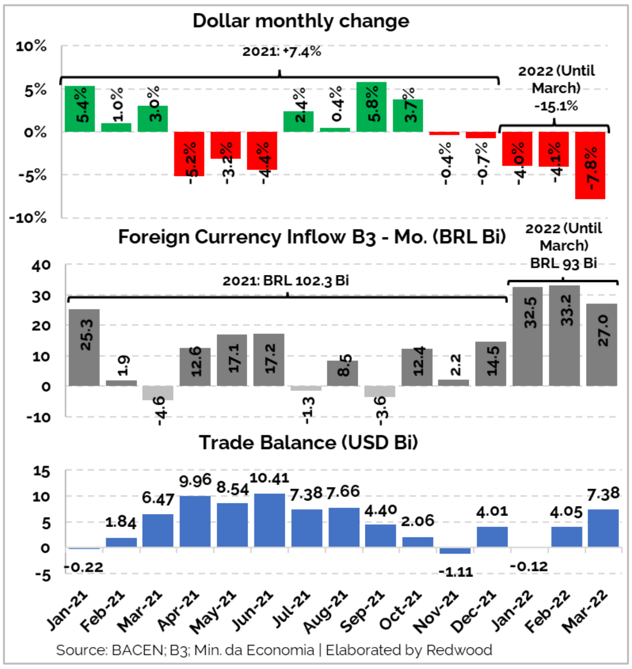
More than that, what is the tone and what issues should they pursue? To abide by the nonsense of the current president's arguments or embark on the left-wing onslaught? Or to stand firm and upright in the discussion of the real problems facing the government and the country? The right thing does seem to focus on what really matters in public debate in a democratic environment, which few have looked at so far: the weak state of the economy and its harmful effects.

With few good news (albeit important), such as the trade balance and the inflow of dollars into the country, both with less encouraging explanations, the country faces problems with no short-term solution on sight. Inflation remains strong (few believe it will be below 7% in 2022) and unemployment is still high (12 million people). Income falls and economic growth will be meager – in the government's view 1.5%, and the market around 0.5%. For 2023 the story is not much rosier, for now. At this pace, the government branches continue in outright "hostility" with each other, without any focus nor common agendas to solve the real problems of the population. On the contrary, reforms do not advance, movements of key positions in the government signal uncertainties and the environment of economic and social imbalance gains space in discussions.

The third way, or what is now dubbed the Democratic Center, does not have pre-candidates that are perfectly aligned, especially for the issues mentioned above. It covers supporters from the fateless New Macroeconomic Matrix of the PT era, to defenders of economic liberalism that we would like to have seen in the current administration. Aside from their personal vanities and interests, they are like oil and water: hardly an easy mix. However, they have something in common: they do not want this polarization and many do not want to "be part" of it. The "altruism" of giving up candidacies and more, of certain convictions in favor of a "greater good" (chasing extremists away from the Presidency), will be more convincing the shorter this presidency race becomes and the greater the polarization grows. The risk, of course, is not allowing time for this reversal.

In fact, we need to plagiarize the President, albeit in a more polished way: enough is enough, patience is over!

In financial markets, much of the stress experienced around the world has not affected us yet. This “bonanza” may be short-lived, as this interest of foreigners in Brazil is due to the high inflation in the world and a “race” for interest rate premiums lying around here, as well as the soaring prices of commodities in international markets, with the inflow of billions of dollars. Not least, we demonstrate what we call “[a one-in-a-million trajectory]” for the possible behavior of the exchange rate with the dollar. This moment may still last for a while, but it does not change the bleak prognosis we have for the economy and its effects on the markets. The favorable environment for emerging countries, given that international interest rates have not yet advanced and the terms-of-trade gains the war has brought us, will collide with political uncertainties, as soon as the (polarized) presidential race gains momentum. However, this flow can be perpetuated (and even increase!) if we manage to signal a consistent economic policy from 2023 onwards.



Source: BACEN; B3; Min. da Economia | Elaborated by Redwood

Along these lines, the Ibovespa closed the month with a sharp +6.06% increase, reaching 119,999 points; this is a relevant performance, even by standards of emerging markets more commensurate with Brazil. In the yield curve, except for DI 2023, which closed at 12.71% against 12.45% in the previous month, the other DIs with longer maturities, ranging from 2025 to 2031, dropped slightly and ended the month at 11.38% (compared to 11.42% in February) and 11.49% (compared to 11.59% in February), respectively. The BACEN signals for this market (end of the Selic hikes) do not seem to have had much effect, and thus everyone trusts with some “suspicion”.

The Brazil risk, priced by the 5-year CDS, in the same line, fell to 208.81 points: an important variation of 15.82 points, a reduction of nearly 7%. The Dollar, in similar fluctuation, retreated 7.81%, closing the month at BRL 4.7378 (with a minimum of BRL 4.7225) in the wake of events just mentioned. Thus, we remain with our medium-long term view, but we stress what we stated last month regarding the “particularities” of the moment and possible opportunities, namely: the “window of optimism” that we detailed for interest rates, exchange rates and the stock market. Once again, we emphasize the “size” of this window and the conditions listed.

As for the economy, despite the good winds of the foreign currency inflow and the better “competitiveness” of emerging countries, this one-off movement still has little impact on the real economy. The hardships of the pandemic that we are still recovering from, added to the Ukraine-Russia war, lead us to once again face supply bottlenecks. The eventual shortages of fertilizers will make a difference for agriculture and the price increase of raw materials will affect manufacturing, whose output declined in 18 of the 26 activities in FEB/22 compared to FEB/21, rising only 0.7% at the margin. All this without ruling out new supply shocks arising from the war or even from new variants of Covid, as recently identified in China.

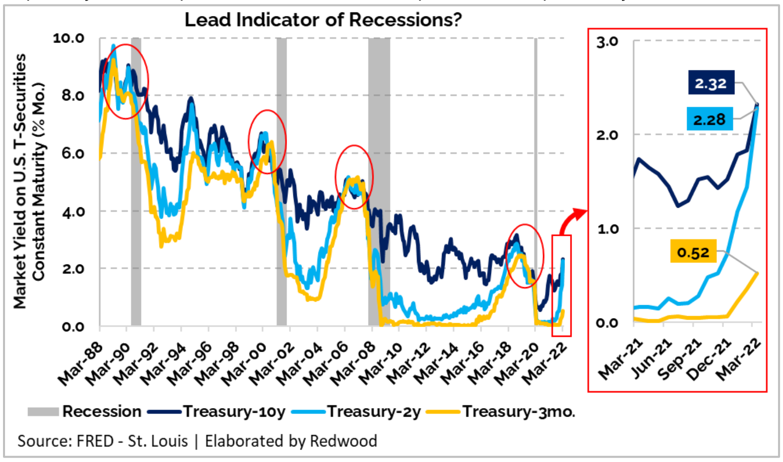
With only a small improvement in unemployment, the numbers are still terrifying – 12 million unemployed and under-occupation rate (unemployed, discouraged, underemployed, etc.) of 23.9% of the workforce, no less than 28 million people – and thus [scenarios] are far from cheerful. Therefore, unemployment coupled with the average income of workers falling by almost 10% in the last year, raises the alert for family spending. With household consumption facing potential risk, the production of services and manufactured goods will find it difficult to move forward. Breaking this vicious cycle will be the great challenge the next President will have to tackle.

In Monetary Policy, BACEN, which acted faster than the other Central Banks around the world (but still lost the timing!), “came up with” such an alternative scenario and follows its route spreading to the four corners that the Selic hike cycle will end soon at 12.75%. In its formal statement it leaves the "door open" for further increases should fundamentals deteriorate – will that only hold if the alternative scenario fails? And the longevity of the war and its deleterious effects yet to come? And the expected volatility of this particular year? What about spending pressures? And what if the accumulated inflation, which is expected to begin to decrease as of May, be slower than desired, with a consequent compromise of 2023 inflation on the way to hitting the target's upper bound? So much for "independence and courage"! As strong as interest rates, its main "tool" to contain inflation, its communication is more than a guide to the market, it amounts to its very credibility.

As for the exchange rate policy, the capital inflow turns a "blind eye" to the internal risks ahead – certainly because (how good!) entering and leaving the country with resources does not "meet" any resistance nor bureaucracy. The international scenario also has everything to disrupt such "festivities", be it due to the economic slowdown, new inflationary shocks or even to interest rate hikes and reduced liquidity by the FED. It is a fact that the Real was very undervalued, but this movement seems to escape BACEN's expectations... and it remains silent. It may very well be in search of a new level, but the return to fundamentals makes our perspective not to bet on further strengthening of the Real without some return, notably in the second half of this year.

On the fiscal side, after the changes in the 2021 Spending Cap, added to the "self-impositions" of an election year, we do not expect major fiscal improvements in 2022; with some luck and depending on the proposals of the presidential candidates, perhaps starting in 2023. For this reason, and in line with the market, our projections point to a growing Public Debt-to-GDP ratio for the next few years. Whatever fiscal proposal is to be implemented, it will need to deliver something like the Fiscal Responsibility Law (2000) did: it produced average annual surpluses of 3%! For this year, there is some hope that the "train does not go completely off track", given the tax waivers (exemptions) and increases in expenses (wage adjustments for public servants of all branches).

Overseas, the Russia-Ukraine war continues to leave a trail of desolation and a climate of profound instability and tension in the region. But if Putin devastates Ukraine, he will also destroy Russia, under the strains of the isolation imposed by economic, financial and trade sanctions against the country by the West. In addition to the two countries, the war is contributing to strong stagflationary pressures across the planet, especially after the negative supply shock (still recovering) from Covid-19. Central banks of the main economies are on alert, each with its own particularities and conjunctural situation, but all with an eye on the FED.



Source: FRED - St. Louis | Elaborated by Redwood

In this sense, the Fed faces the highest inflation in the last four decades and tries to juggle all plates with its "multiple mandate". Financial conditions are poor and our forecasts of higher interest rates and reduced liquidity are taking shape. However, it is common to assume that in order to reduce inflation, the Central Banks should raise the nominal interest rate above the inflation rate, and it does not seem that the Fed would be willing to do so. [John Cochrane has a possible explanation]. In any case, the markets continue to bet on the history and its effects on the economy, notably on the inverted yield curve between the 2 and 10-year T-notes, which anticipates recessions. This time this indicator is quite biased given recent interventions due to the pandemic and, therefore, it is even more necessary to evaluate the sharpest movement of the shorter maturities that has not yet occurred.

Say yes to attention and caution in the analysis. Say no to haste.

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