MONTHLY STATEMENT

MAY 2022

Redwood

REDWOOD ASSET MANAGEMENT

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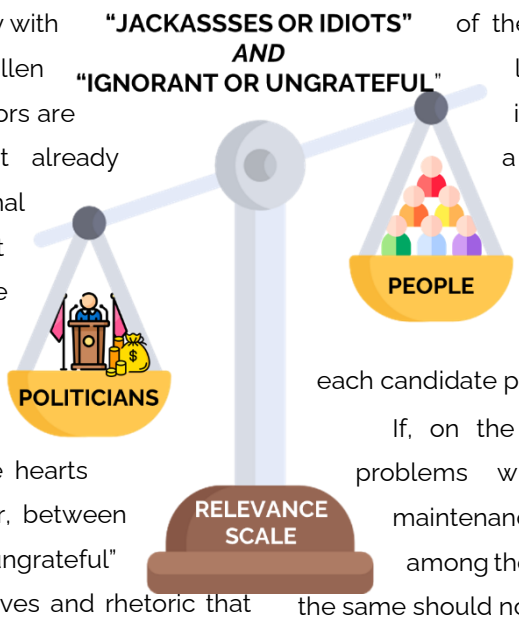
"Politics is not a game, but a serious business".
Winston Churchill – U.K. Former Prime Minister

Polarization is breeding hatred and fostering a growing social divide, amidst the deliberate weakening of the Third Way, while physiologism takes shape, dignity fades away and society, torn apart by numerous recent crises, suffers from inequality in the midst of an explicit institutional setback. The horizon of events that economists, political scientists, among others anticipate – in a realistic scenario – does not distance us from the general shortage, with low growth, inflation and unemployment. This vicious circle must be broken, for we cannot accept silently those who promised and did not deliver, or those who almost led the country to total ruin.

If the current President's lack of empathy for the people continues to surprise us, notably with regard to the tragedies that have befallen us, the statements by his closest advisors are a close match. In an environment already completely "taken over" by professional politics, the bases of the two best placed in the presidential race polls are tooth-and-nail dispute. What about the people and the politicians? Water and oil! All of the tears and sweat of the Brazilian people do not touch the hearts and minds of our politicians. However, between "jackasses or idiots" and "ignorant or ungrateful" we need to escape this war of narratives and rhetoric that lead us nowhere (better).



From the current administration's promises that we would have a more liberal economy, today we hear proposals such as freezing fuel prices for 100 days. The extra-effort we should have had to privatize *everything*, as Paulo Guedes said, led to almost nothing compared to what was promised and, now, for reasons of political contamination, even a further "slicing" or sale of Petrobras shares held by BNDESPar is suggested. It is so surreal that the market simply ignores these wild ideas. On the other hand, with the return of the PT people, the promise is to shake up the liberalism that never was. Lifting the Spending Cap and reversing the feeble progress made in the reformist agendas already initiated in the administration of former President Temer. This is not pessimism, it is straightforward analysis of the facts and promises that have been made. This is such a terrible perspective for the political road ahead!

In any case, according to the latest spontaneous polls, approximately 40% still haven't decided who to vote for. The deadline is short and there is still no consensus on a third name, but these "truths" need to be made public and foster debate – in fact, debates that don't even seem to happen, depending on the two front-runners in the polls. In summary, in this case, we will not have the discussions of our main problems, much less a healthy identification of the positions of the currently best placed candidates. The lack of this discussion at present impoverishes understanding and weakens a guarantee of the fulfillment of the promises of the future president, at the same time that it would at least bring light to the approaches to each problem, and a clearer vision for society of how each candidate proposes to face our ills.

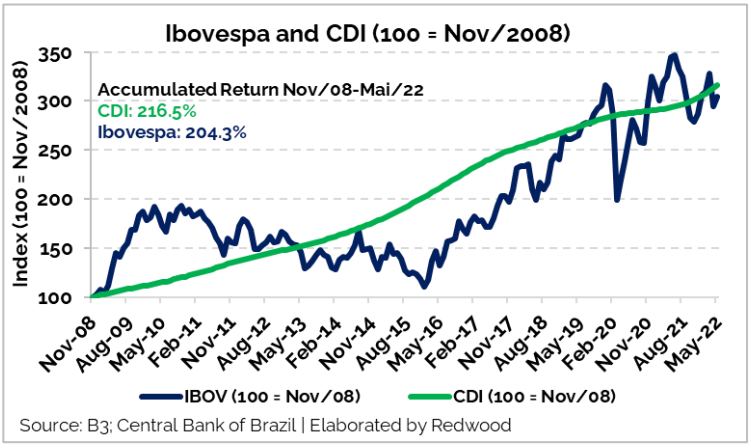
If, on the political side, the combination of our problems with the ongoing populism and its maintenance is catastrophic, whoever is chosen among the two front runners in the presidential race, the same should not happen with BACEN. Yes, the institution has lent itself, on several occasions, to provide enormous "help" to the Commander-in-Chief. The effect of the electoral cycle, especially in the last 6 or 8 months prior to the elections, we experienced conduct in monetary policy that was at least incompatible, either with what was required or with the stance taken until that moment. This year, with BACEN's autonomy in course, we hope that the agency's performance will be less "politically sensitive" for reasons unrelated to what is required of its monetary, exchange rate (policies), etc. and proper posture will be required.

Soon we will test the true autonomy of BACEN and its board of directors, taking into account that politics is not a game, but a serious "business" called Brazil.

In the financial market, after a very difficult month of April, May proved to be somewhat "milder". Although any relief falls short of permanent, the flavors of the possible reopening of Chinese cities (effect on commodities), a lower aversion to risk and the perception of a "less aggressive" FED in the monetary tightening, as well as our BACEN, guaranteed this brief timeout. For us, it is a momentary truce: the war in Ukraine continues with no end in sight, the FED and Janet Yellen herself are only now realizing the error in reading inflation (which affects large economies), and here we have simply ALL the relevant risks ahead – economic, social and political.

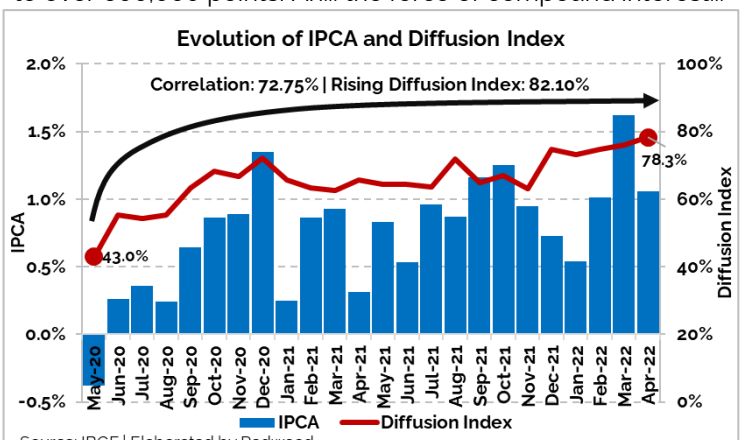
As a result, the Ibovespa closed the month climbing 3.22%, reaching 111,351 points: a small return compared to last month's fall, but one that served to "recompose" the annual variation near the 6.23% level. All the main maturities in the yield curve showed positive changes from April to May, leaving the DI 2023 from 13.03% to 13.385%, and the DIs 2025 and 2031, longer maturities, ranging from 12 .04% to 12.27% and from 12.09% to 12.28%, respectively. The Selic should continue to rise a little more and should remain at this level for longer than initially expected.

The Brazil risk, priced by the main indicator, the 5-year CDS, also cooled down to 223.29 points. Here the "recovery" was only 7 points, 1/3 of what it rose last month (21.21 points). The Dollar dropped 3.87%, in fluctuation equivalent to April (+3.83), closing the month at R$ 4.729 (with a minimum of R$ 4.696).



Source: B3; Central Bank of Brazil | Elaborated by Redwood

If our medium-long term vision remains the same, a curiosity for the passive investor profile presents itself. The previous Ibovespa x CDI chart entails this premise, but we admit here that the investment in the Ibovespa was made at the moment of the lowest monthly closing rate of 2008 (Nov/08 Ibov = 36,595 points), and we compare its evolution with the CDI so far. With a lower volatility (CDI), the two assets are practically equivalent in terms of yield, a true "absurdity" admitting that we should have a premium for the risk taken on with the Ibovespa. Ranges of analysis can be "adjusted", but the highlight is that in the last 13.5 years the performance was exactly as mentioned and, now, we do not know what the future performance of the Stock Exchange will be, but we know how much we can earn at pre-fixed rates in the next decade. The correction of the current stock exchange (111,351 points) by this index (average of 12.4% p.a.), "liquid and certain", takes us to an Ibovespa level of approximately 400,000 points! This is just to tie with the "risk-free rate", because if we take into account a yearly premium near 5%, the index jumps to over 600,000 points! Ah... the force of compound interest...



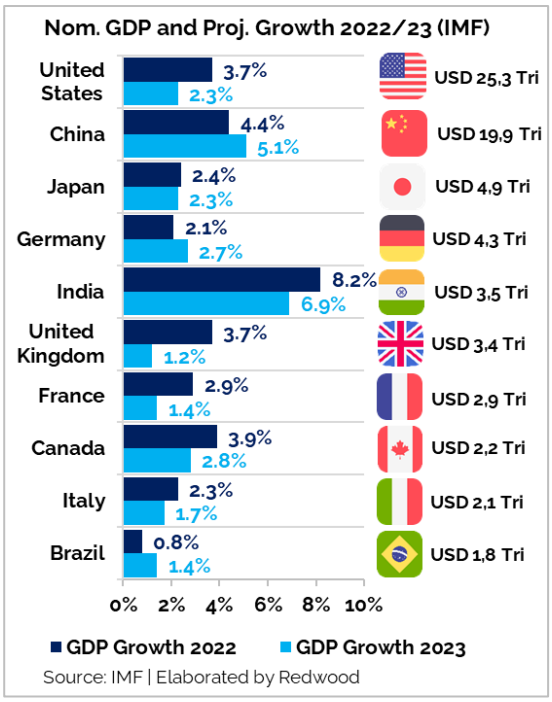
Source: IBGE | Elaborated by Redwood

In the economy, these possible effects of the financial market also have important impacts. The chances of us continuing to be the country of "rentiers" are enormous. Interest at this level may not kill the country once and for all with a one-time "shot", but possibly gradually as in several small "stabs". High interest rates are the real tool to curb inflation, but we are tired of knowing that monetary policy requires sound fiscal policy. Inflation projections are still not very optimistic and, therefore, we should expect Selic at higher levels, but little can be expected of additional relief from inflation this year – the relevant horizon is 2023 ahead. However, we also need to follow the chart above depicting the IPCA and the Diffusion Index, as there is an important correlation between the two, and it would be essential to see

the Diffusion Index return to its recent average 65% level of at least.

As for this year's GDP, our forecasts are reasonably in line with what has been observed, and therefore we will not strongly revise the country's growth, which should be between 0.5% and 1% in 2022, and certainly in an equal or lower figure in 2023. Unemployment rate did bring some positive "surprise", but it aligns with what we believe in the short-term Phillips Curve: more inflation and we have a little less unemployment.

In Monetary Policy, the deterioration of the global scenario due to the generalized inflation resulting from the stimulus package to fight Covid-19, the Russia x Ukraine conflict and its side effects, as well as our own problems, BACEN seems "confused" (perhaps "cautious") in its communications and some guidance on its stance regarding its interest rate policy. On a rhetorical level, Bacen is always committed to the inflation target (although the relevant horizon for monetary policy is always expanding: soon it will not be 2023 anymore!), but it signals the end of the cycle of Selic increases and little is said about how long rates will be kept at current levels.



In exchange rate policy, BACEN has once again been dealing with exchange rate dysfunctions in recent weeks, but according to its chairman RCN, it has acted less intensely in recent months. Why? Wouldn't the essence of the interventions be precisely this? Or is it because everyone knows the exchange rate is out of place and therefore all drops are welcome? But, as a whole, to be fair, BACEN in May held a public hearing on new rules related to the foreign currency market (90/2022)... although it will only be from 2023 on that we will actually see debates on topics such as the interbank market, compensation and payment in foreign currency of obligations enforceable domestically. Two other hearings are already on the agenda, both on the regulation of foreign capital in the country in the investment modality related to Law 14,286/21.

On the fiscal side, the public sector reaps important results. BACEN recorded the best result for the month of April, at BRL 38.9 billion, since its historical series started in 2001. The primary surplus for the year equals 4.74% of GDP, in the amount of BRL 148.5 billion. Gross public debt stood at 78.3% of GDP, much better than the consensus figure, although far from its best mark of 51.5% of GDP in Dec/2013. But if the current results make us any happy, the prognosis is bleak. ICMS rate cuts on fuel and energy, other tax exemptions, subsidies in mind, linear increases in civil servants and all sorts of benefits generated in an election year, there will also be no restraint on spending on legislative amendments. The fiscal effort of Paulo Guedes so far may then, in a "magic pass", see the wreckage of the construction of a new fiscal landscape, while we continue to pay high premiums for fiscal risk.

Around the world, inflation imposes significant punishment, with the consequences always looming harsher for poor countries, but also in scope for societies whose burdens indicate that they will last for some time. Both here and in the rest of the world, Central Banks will increase their interest rates to fight inflation and, with this, there is an impact on the growth of economic activities in countries. Possibilities of recessions appear in the radar, but with low to medium probability still. In any case, one can expect a troubled economic and financial environment, not only to fix the effects of policies implemented to fight Covid-19, but also the current geopolitical conflicts in course.

FED and ECB must be followed very closely, in that order. The US is running inflation above 4% (8.3% on an annual basis!) and unemployment below 4%: "as a rule", this leads to recession in the aftermath. Would this slowdown carry the rest of the world along?

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Redwood

Avenida Brigadeiro Faria Lima, 3900 – 10º andar
São Paulo – SP | CEP 04538-132
+55 (11) 2172.2600
planner.com.br