MONTHLY STATEMENT

JUNE 2022

Redwood

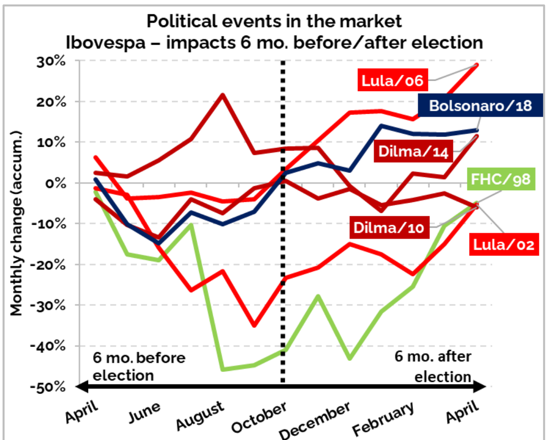
REDWOOD ASSET MANAGEMENT

"Hasta la vista, baby."

Famous quote by actor Arnold Schwarzenegger in the movie The Terminator.

The two front-runners in the polls for the presidential race are fiercely vying for the Terminator title. Following the results presented, the former president also seems to be taking the lead here, as he has already proved what he is capable of and now reinforces his attitudes. However, the incumbent at the *Palácio do Planalto* is also not far behind and shows himself to be a true fighter worthy of such (dis)"honor". Secret budget, constitutional amendments (*PECs*) with electoral objectives and governance meddling in SOEs are just recent attempts to jeopardize the future of the nation – Executive and Legislative branches fully aligned, unbeatable "duet".

With no "Sarah Connor" in sight to avert this trend - namely: a third way - we are doomed to swift and complete destruction or a slow and painful death. In the limit, "gaining" time can be a strategy, because something different has a chance to happen and change the course of things. This is unlikely, given that Brazil shows itself as it is, mirroring its people: gullible, good and poorly educated. We have reaped what we deserve from our politicians, and now we will have another chance. Our martyrdom may end next October, so whether we are wrong or right is up to us, and the past (or present!) can be a good predictor of the future in this case.



Source: Broadcast | Elaborated by Redwood

Fiscal rigor has gone hand in hand with a package of "kindnesses" and an unparalleled "generosity and condescension" from the Minister of the Economy. Paulo Guedes is no longer the boring cranky guy and becomes a total ally on the road to reelection. In addition to the "duet", the "endorsement" of the *goodwill pack* – with an increase in *Auxílio Brasil* and other benefits – Paulo Guedes seems to "forget" that the *Automobile Fuel Amendment* (PEC dos Combustíveis), nearing R$ 40 billion, undermines the already fragile credibility of the Spending Cap. Permanently losing this fiscal anchor is bad news, because the country desperately needs to generate strong and continuous fiscal surpluses again. "Romantically", one could accept that the Minister of Economy gives in "politically" in some instances so as to advance in others, but going down a step now to "assist" in reelection and then trying to climb the entire ladder of the economy in a second term, is a huge risk: a colossal irresponsibility in fact.

All of this, of course, comes at a cost. This cost essentially translates into what market agents interpret through the most "sensitive" variables: interest rates, exchange rates, stock exchanges and Brazil risk. At the moment, these variables show some negative reaction – although not always all synchronized, but in one way or another they reflect this dynamic. The Brazil risk (5-year CDS), for example, "exploded" this month – an overwhelming hike! Interest rates have been "pressured" for some time, and Federal Public Securities offerings at high rates are once again a nuisance. However, all this reflection is not only rooted in the "misadventures" of the moment, but is also based (in addition to externalities and other aspects) on the perspectives and ideas of those who are more likely to lead Brazil in the coming years. These ideas and proposals, not always carried out, are well characterized in the volatility of the Stock Exchange, as shown in the graph on the side.

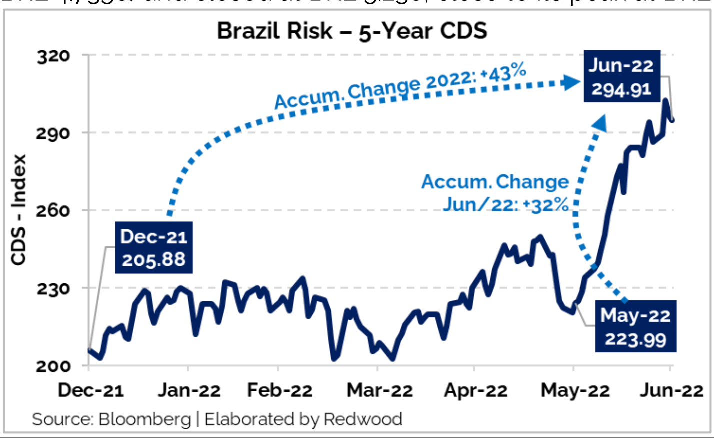
Thus, the economic team's extra fiscal effort, moving from a limit on the gross public debt-to-GDP of almost 90% to 78%, may be going down the drain, as the noise and fiscal uncertainties with the daily news of attacks on public finances - whether from the current administration and/or the proposals of the front-running candidates – will increasingly raise awareness of the variables mentioned with immediate consequences for the population. The responsibility is inexorably on their shoulders.

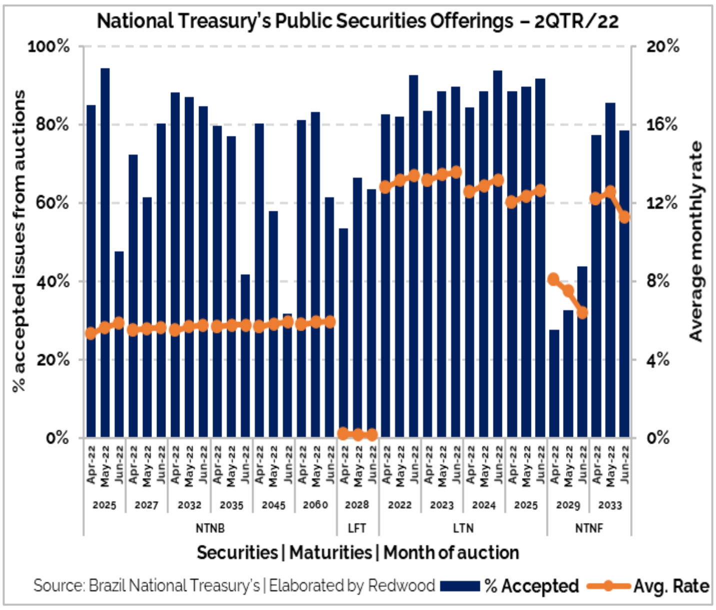
Whether we are close to the final judgment or not, with the political course for Brazil today, it's *hasta la vista, baby!*

In financial markets, in line with what was outlined last month, truce was short-lived. However, if in June the "going gets tough", this trajectory should not stop permeated by high volatility and contamination of several assets. Obviously, some "hiccups" can happen, but the internal and external environments provide a very bad second semester. Here, once again, we simply have ALL the relevant risks ahead – economic, social and political, but the expectation is that after the elections a pattern of lower volatility and a certain stress reduction will soon settle in. The new President will need to pacify Brazil and, as a rule, we will have the support of the National Congress in the first year of administration. Hopefully.

Thus, the Ibovespa closed the month with a sharp 11.5% drop, reaching 98,542 points. We now record a -5.99% change within the year. Once again, in this month all the main maturities in the yield curve showed positive variations from May to June, with DI 2023 moving from 13.385% to 13.755%, and the DIs 2025 and 2031, longer maturities, shifting from 12.27% to 12.75% and from 12.28% to 12.86%, respectively. As predicted in recent months, the Selic rate should continue to rise and perhaps move up little further than expected (should inflation persist in in the next two months), and remain there for a long time – by the way: until at least the Q2 2023.

The Brazil risk (5-year CDS), which had previously remained "well-behaved", exploded this month: it reached 294.91 points. A whopping 32% hike! Or, in points, a variation of 70.92 points. This is the sign of times toward which in fact we seem to be moving, an "unquestionable" pricing of what is to come. The Dollar, also under pressure, but to a lesser extent, advanced 10.77%, with a sharp change (from a low at BRL 4.7356) and closed at BRL 5.238, close to its peak at BRL





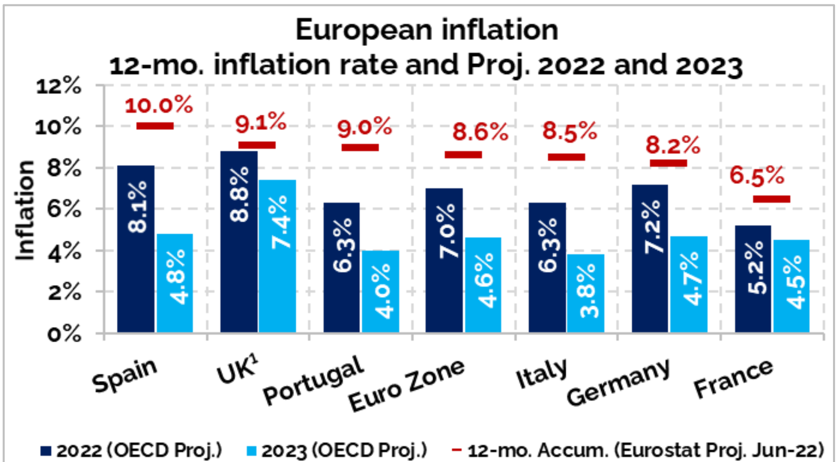
5.2539. Being one of the most important variables and at the same time one of the most difficult to estimate, its trajectory does not seem different from others – however, we estimate it will cool down in the post-election period.

The Ibovespa, already on the red in Reais, is even more bitter when measured in Dollars. With a R$ 430 million foreign inflow to B3. in June, the index dropped 20% and, since its recent 26,382-point high recorded in April 2022, it has dropped 28.6%! One can suspect that we may be facing more than a "simple technical correction". In addition to our analysis for the "conservative" (passive investor) profile from last month (*Monthly Statement – May/22*), more aggressive portfolio allocations cannot disregard Ibovespa drawdowns around 40% - analytical support during these episodes with thorough selections resulted in exceptional returns. Nothing that changes the interpretations offered last month, but they fit and adjust properly to those with greater risk acceptance and opportunity management.

In the economy, the effects of financial markets already cause some discomfort. The chart above shows various Federal Government Securities offerings and, although difficulties in rolling over the debt are not yet considered, clearly the market has not accepted the terms proposed for all securities. The signals here are clear to those with a low tolerance: they want higher yields! Once again, we are the country of "rentiers", and everything indicates that high basic interest rates are still behind the curve of market-pricing... which tends to advance in the next 90 pre-election days, following the vicious cycle of generalized contamination of other assets.

As for this year's economic activity, our forecasts have not changed, but there is a slight upward bias given an improvement in the unemployment rate and in the various ongoing benefits, the latter (the goodwill pack) unimaginable until recently. If for 2022 there is this positive bias, for 2023 the bias (also small) is negative. Lower unemployment is a welcome relief, but we believe that this performance is due to a short-term Phillips Curve effect that we have been highlighting: with more inflation there is a little less unemployment.

In Monetary Policy, in view of the numerous actions recently launched, especially the cap on state-level sales tax (ICMS) on fuel and electricity, it will be possible for some small reduction in inflation projections for 2022. Small indeed, given all the stress mentioned above (especially how the exchange rate impacts fuel prices) and, not least, BACEN itself did not incorporate the fuel tax cut into its projection - possibly like us, considering it temporary and above all "offset" by the other variables that make up the various fuels' pricing methodology. On the other hand, for 2023, as the tax cap is lifted, we may see the possible relief of this year disappear, boosting inflation once again. The deterioration of the global scenario is also another factor, no less important for us in this regard, as financial issues are increasingly tight, with high inflation impacting us. All this leads us to believe that our BACEN may not even raise the Selic much more, but the relevant horizon for the beginning of interest rate cuts is increasingly moving away.



Source: Eurostat; OECD | Elaborayted by Redwood
[1]United Kingdom: 12-month inflation rate up to May/22 – observed data

In exchange rate policy, BACEN will soon find itself "in trouble" once again. With the deterioration of the scenarios and in particular the Brazil Risk, customary interventions will no longer be enough to guarantee normality and avoid what they call the dysfunctionalities of this market. The Dollar's trajectory "seems to be a given", but not before the all-powerful BACEN trade desk rolls up its sleeves and takes action. It will not surprise us very strong interventions in the spot market and other more "energetic" attitudes. This is the rational and most likely view of the monetary authority.

On the fiscal side, if the recent past shows some good outcomes, the expectations currently in formation are terrible. Take note of the following: it is possible and reasonable to admit the control of the fiscal situation this year, but the approval of the goodness pack (*PEC de Bondades*) renders the Spending Cap moot. The more challenging fiscal framework leads to the consequences that we know quite well, and whose main motto of this administration was to face it consistently, leaving a "healthier" country. Is it gone?

Overseas, the Ukraine-Russia War continues to impact markets, especially Russia's commodity supply. Regarding the energy supply to Europe, some countries in the continent are already warning their populations about shortages, notably for the coming winter. As for oil, with broader reflexes involving other countries and variables, a reduction in supply leads experts to estimate a price spike in this 2H 2022, while others, anticipating a global activity slowdown, thus projecting a strong decrease in prices per barrel. One way or another, the fact is that inflation is strong in Europe and the ECB still speaks about gradualism in its monetary policy. However, a likely deceleration of the Chinese economy and the likewise signal for the US may induce a global disinflationary impulse. BCs seem to rely on this expectation.

What is certain for the 2H 2022 is that we will face all sorts of difficulties. A lot of political and economic turmoil on the planet supports this view.

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