MONTHLY STATEMENT

JULY 2022

Redwood

REDWOOD ASSET MANAGEMENT

"A good rest is half the work."
Yugoslavian Proverb.

Brazil looks much like a victim of its own actions. The tragedy of the past, with the corrosive legacy of the PT administration, whose catastrophe we have not yet fully recovered from, does not resonate with our people today – not if we look at the frontrunners in the presidential race. On the other hand, the association of the current Commander-in-Chief with the worst in politics brings the usual radioactivity, while vandalizing previous promises to fight and prevent quid pro quo; hence the domino effect of country's self-destruction. One way or another, the "implosion" of the country is but a matter of time. Pessimism? No, just an assessment of the past and the present, no victimization, the unvarnished truth.

Until recently, we thought that we could be living in the twilight of populism, but that was a big mistake. The normalization of stupidity in recent years, in various segments and in all powers, made room for a moral and decision-making complexity that is difficult to decipher. The vandalism besetting our institutions, the demonization of the rule of law and the lack of proposals and solid arguments, have bred the polarization that we are witnessing today. It all implies dehumanizing the way we deal with our social and economic problems. It is the confrontation of facts with narrative, respect with disrespect, values with opportunism, scientific methodology with polls, good governance with disorder and, why not say, oppression with free thinking.

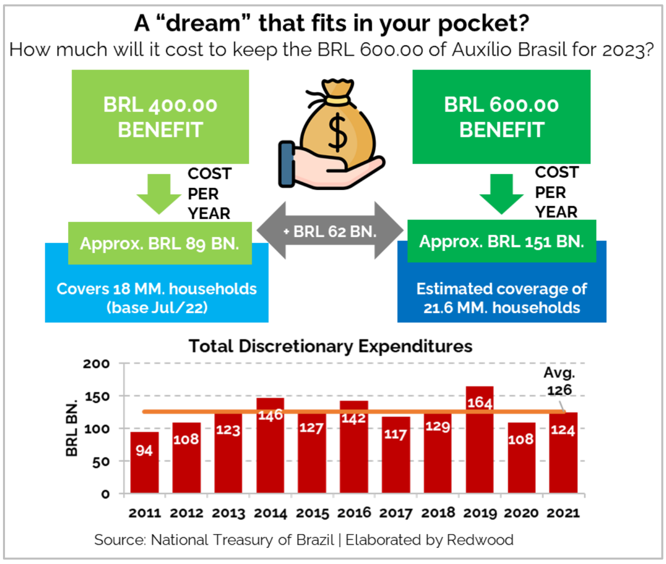
The vision, understanding and execution of what the two frontrunning presidential candidates think, did and do for the country, do not align with Brazil's needs. In fact, although paradoxically, they have similar stances on some topics: the approximation with Centrão, the destruction of the Car Wash probe and the "reformulation" of the Spending Cap are very similar ideas and actions. The irrational formulation and management of the Union's budget in the last PT administration shattered confidence in Government and sealed the disarray in public finances, promoting the worst recession in the country. Today, the excessive optimism of Minister Paulo Guedes endorses the populism of his boss. The extra fiscal effort is gone... now? No, it's simply looting the future. Current tax juggling, and the numerous electoral measures recently adopted, threaten the country's future solvency. Whoever is elected will have to deal with it.

The sums of these expenditures reach unimaginable figures, due to maintaining the BRL 600 transfer floor (defended by both best frontrunners) of Auxílio Brasil, to keeping States' and Municipalities' finances in the red ("permanent" exemption from ICMS and IPI rate cut), to the readjustment o federal public servants' salaries, etc.,. So, enjoying a lower inflation today (than expected, from 9% to 7.5%) implies enduring a higher one next year (from 3.5% to 5.5%). From a continuously decreasing unemployment rate, with higher basic interest rates, we will see a slowdown in economic activity in the coming years, with the number and quality of jobs tagging along. All of this is fraught (but not only!) with conditional suspensions of spending in education and health, but also with financing from state-owned companies' dividends.

But since hope dies last, we must have confidence all the way to the end. It is important to believe that if the eyes mirrors the soul, they must also be a reflection of the heart and, with that, we expect gestures of grandeur from human beings. Giving up might be the best attitude for the greater good – both frontrunners could rest. Naiveté or madness? Perhaps, but we cannot admit that the cry of dellusion contaminate even further the raw reality wherein nothing is expected.

Faith and trust!

In financial markets, the political aspects affecting financial asset classes are considered daily, so that their impacts can be identified and promote better resource allocation for the benefit of investors. In this way, this symbiosis between politics and what the (aspiring) leaders think and propose and economic data, as in an eternal feedback loop, motivates the elaboration and monitoring of specific models to predict the outcome of the presidential elections. These simulations serve as comparisons with those carried out by political analysts and election polls, but are based, as a rule, on historical economic-financial data and their correlations with the final results of the election. Therefore, they do not escape the evaluation of economic performance, inflation, income and unemployment. Aware of this, the current administration is solely running for the sake of improving these indicators at all costs, even if only for the short term and to the detriment of the future.



Thus, reflecting these perceptions, the Ibovespa closed the month with a 4.69% rise, returning to levels above 100 thousand points, registering 103,165, equivalent to an year-on-year -1.58% change. The yield curve displayed the same "calm" movement, with the shortest DI in 2023 showing a small variation, going from 13.755% to 13.795%, and the DIs 2025 and 2031, the longest maturities, enduring some reduction, ranging from 12.75% to 12.715% and from 12.86% to 12.79%, respectively. These shifts, however, do not change the perspectives described here for the SELIC trajectory, which, in the limit, may even advance a little further than expected (13.75%).

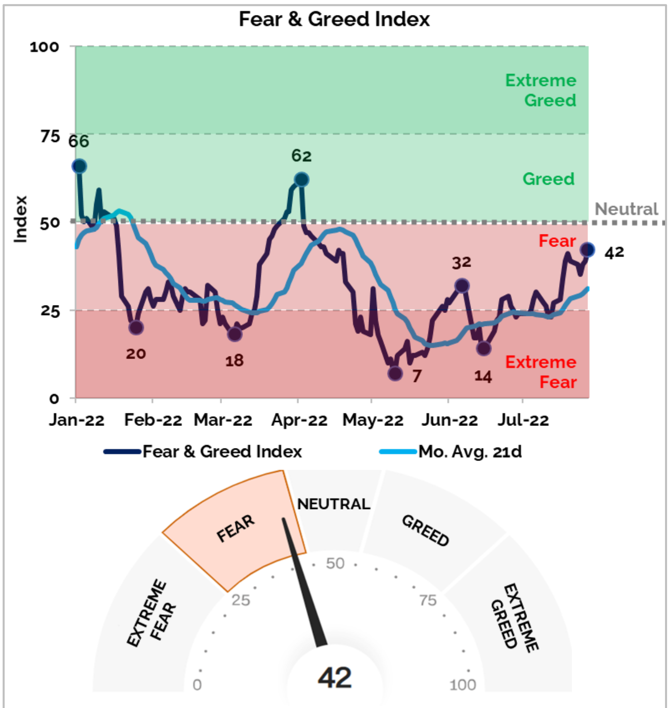
The Brazil risk, priced by the 5-year CDS, "corrected its excess" from last month and dropped to 273.21 points, a significant 7% change, or approximately 22 points. In line with the Brazil risk, but with less intensity, the Dollar also cooled down and closed at BRL 5.1884, a decrease of BRL0.05. This is the most sensitive and rapidly contaminated variable, being therefore an important "thermometer" of the economic-financial environment.

All these movements are, in fact, not only expected, but also characteristic of the course and the current moment we live in – the ups and downs are normal. However, the short-and-medium-term meaning for each variable remains the same in our forecasts. This is because although our models point, with no major changes, to the same envisaged political outcome, we cannot guarantee that campaign speeches will come to full fruition after the election – Paulo Guedes was (and the Brazilian people are!) the most recent "victim" of that statement. One way or another, Brazil will need to be pacified after the elections in order to be governed. As a rule, this happens at least for the first year of government, with full support from Congress and a "carte blanche" from various segments of society. Thus, our strategies always follow this line of approach, that is, short-term protection and extreme attention and gradualism in risk allocation, dynamically mapping the evolution of markets and the consistency of our models. We always think about the medium-to-long term and the uncontested opportunities.

In the economy, the delay in promised reforms - combined with the final stretch of the current administration and its desperate attempt to attract votes - means that last minute measures are taken. The little progress made in modernizing labor rules and administrative reform gives rise to "quick fix work". Likewise, without a comprehensive and structured tax reform, multiple tax reductions follow – always very welcome, as long as they are in a responsible and organized manner. The public utilities concessions and privatizations, which would be in the order of R$ 1 trillion, are still on hold, as is the case with Correios (post office) and Petrobras. Last but not least, we witnessed the launching of "goodness pack" that, despite serving the population's needs, lacked the above adjustments for a proper equalization of finances in the long term and for Brazil to tread a new path.

This year's economic activity, however, will be higher than estimated for obvious reasons of measures not "envisioned" *ex-ante*, such as the additional release of the FGTS and other "kindnesses", but still without even reaching our long-term potential growth. Likewise, the (important) advances identified in tax revenue collection and job creation also seem to be short-lived – both strongly fueled by inflation, and in the case of the unemployment rate, with emphasis on informality and lower wage jobs. Does the shoe fit the administration, for which the election is now of sole interest and "we'll see the economy later"?

In Monetary Policy, the policy actions taken recently have their short-term effects. Annual inflation cools down with probable deflation in July and August, but it does not seem to be perceived in a general and persistent way – on the contrary, the (expected) trend is upward for 2023. This is the reason why that the market and the Brazilian monetary authority itself did not change their forecasts for the SELIC rate.



Source: CNN | Elaborated by Redwood

When it comes to exchange rate policy, BACEN continues as a "candy in the mouth of a toothless kid", sometimes on one side, sometimes on the other. With the world about to experience one of the biggest interest rate shocks in decades, the *flight to quality effect* will soon be increasingly present. This could imply massive outflows of Dollars from emerging markets and, combined with our peculiar political moment, a strong impact for us. In this vein, BACEN will always be convinced of its "responsibility" to control the dysfunctionalities of the foreign currency market – it remains to be seen the limits of its action.

On the fiscal side, irrespective of the partisan or ideological nature, whether for questionable reasons or not, the current numbers do not lie: we have better fiscal indicators. However, more careful and responsible assessments, intellectually honest and with credible and relevant models and assumptions, point to a deterioration of the current situation. In addition to the current spending packages that can definitively impact public finances, the long-awaited fiscal consolidation is at even greater risk depending on the next government official, especially if he is the one who rejects limits such as the one established by the Spending Cap. There is much uncertainty about what the fiscal rule will be next year – which implies a direct impact on our allocative preferences, especially with respect to the yield curve.

Around the world, the graph on the side reasonably reflects, although restricted and specific to measuring stock market movements, what has taken hold of the planet: Fear. As if the Ukraine-Russia War and the consequences of the health crisis were not enough, the US government decides to pay a "visit" to Taiwan, and triggers the wrath of the Chinese. These are ingredients that intensify geopolitical disputes, with global impacts.

In the US, the Fed raised interest rates by 75 basis points (range from 2.25% to 2.5% - in theory neutral interest), which signaled being a little more cautious as the signs of recession in the country gain momentum. However, to contain a 9.1% inflation in the last 12 months, we do not imagine that the pace and intensity of interest rate increases will decrease if there is a true drive to bring inflation down to the 2% target. In Europe, the diagnosis is not very different, as high inflation and weakening economic growth are expected. Emerging countries will suffer a lot from the reality imposed on the US and Europe. China could be a counterweight to the global slowdown, but much less so than before. Hard times.

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