MONTHLY STATEMENT

AUGUST 2022

Redwood

REDWOOD ASSET MANAGEMENT

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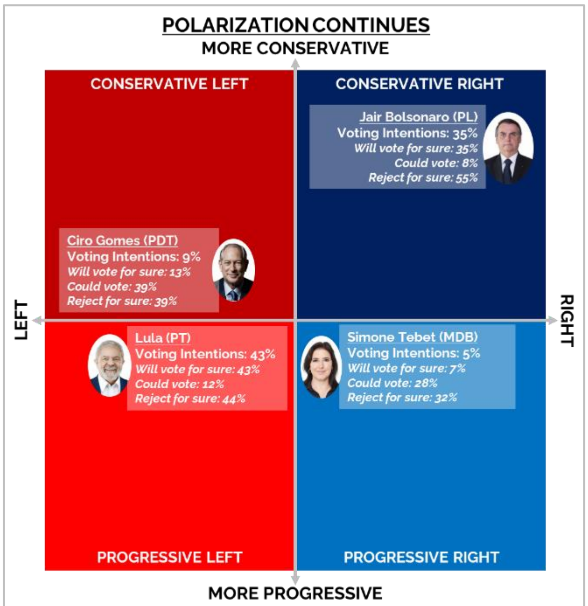
"Government is the great fiction, through which everybody endeavors to live at the expense of everybody else."
Frederic Bastiat – Economist and member of French liberal school of thought.

Our political reality is a massacre on us. In the final stretch of the presidential race, the two front-runners brutalize both our patience and intelligence with radical speeches that only please their most loyal voters. Their popularity mainly lies in their professed populism and, as such, they assault any logical reasoning by those who want to see and truly analyze proposals, while also criminalizing those who dare to think differently. Virtue, purpose and dignity for the presentation of ideas and alternatives in truthful debates in veritable democratic confrontation for the evaluation by the people is something as distant as it has always been. We haven't really evolved, unfortunately. As is many other instances in the case in Brazil, we remain tarnished as a Banana Republic.

These "other instances" interact with and foster the situation portrayed above. With the country's "governance" in shambles, we are witnessing truly disfunctional institutions, with advances and overlapping responsibilities. It is, as the specialists refer – on the one hand - a "judicial activism", where there is intrusion of the competence of other branches and, on the other hand, arousal with affronts and bravado. In this environment, there is no policy of consequence, just apeasement with ever growing evasive stances, tempered with quid pro quo with the federal budget as the main adjustment variable. A Scam? Marked cards? One way or another a "pork-barrelers' little lap dog" type of politics is thus established. The New York Times is not to blame for not finding a specific term to translate this "phenomenon", there are many concepts inserted into one, and it is shameful to try to explain.



Source: IPESPE Survey 08/31/22; STE Candidate Images | Elaborated by Redwood

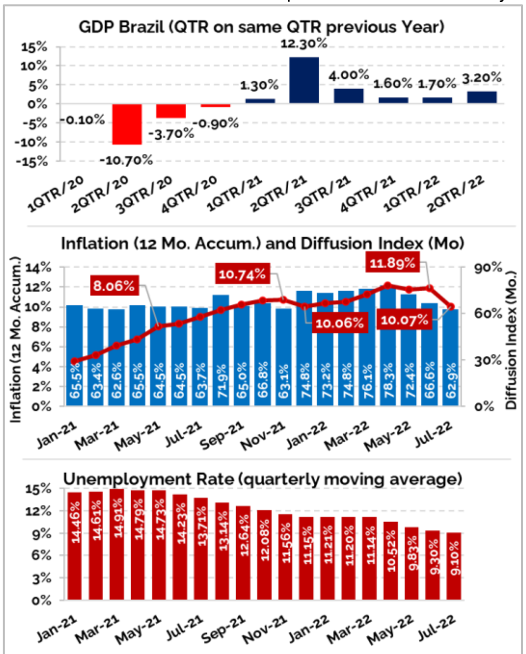
Thus, with a slow and complacent Senate in its attributions towards the actions of Supreme Court Justices - when they expose and demean the guarantee and construction of freedom of expression, doubling down of their blunders, we also see the President of the House of Representatives turn a blind eye to numerous impeachment requests towards the Commander in Chief. All this has a direct impact on what we are witnessing today in politics, with polarization – largely "validated" by those who wish to maintain the status quo (including the main candidates!), as they will be fine with any of them -, as well as in the management of economic variables and, above all, their expectations, with immediate consequences for investors' perception about Brazil.

Despite all this, Brazil remains resilient, but it is ill-advised to stretch our luck too far. The populist promises are piling up, although all of them (and most of them will be, it is hoped!) can be solemnly broken and not honored – it has been that way, for better or for worse. Some cases, such as the fair maintenance of the BRL 600-floor of Auxílio Brasil cash-transfer program (defended by both candidates best placed in the surveys), does not seem to be reversible, although the recently-sent Budget Bill does not contemplate it. However, given that the "blanket is short", these additional resources will have to be taken from other budget accounts, that is, one or more "public policies" will be affected.

Without being able to escape this reality and face it respecting our democratic pillars, identifying problems and feasible solutions, we have launched a series of articles in this sense (see Reflections on Economic Guidelines and Modeling of State Governance – Part I and Part II). In a context in which recent surveys point out, we will hardly avoid a second round with both current front-runners, thus perpetuating our reality wherein Frederic Bastiat is right. We need to make lemonade out of lemons; that's what our articles are for.

In the financial market, the easing continued this month for several asset classes, possibly due to the good numbers of the economy and the chilling of the tensions of the electoral process. In a presidential race in which the state of the economy matters most, this wave of "good news", even if ephemeral (since it is, in part, "manufactured"), has the power to help the incumbent President. Here, means matter less than the immediate end, let alone the expectations and possible consequences, whose scope is overshadowed by the narratives and by the "heat" of this electoral period. It is difficult to know how to decode whether society "captures" the reflections of what is being done today and/or the more progressive proposals in progress. However, financial markets "know" how to arbitrate at every moment the mood and the directions that present themselves, with absolutely no shame in reversing a position to a greater or lesser extent – a different reading and understanding is enough. That's it.

Reflecting the reasoning outlined above, the Ibovespa closed the month with a 6.16% rise, reaching 109,523 points, equivalent to a +4.48% annualized rate of change. The same shift was imposed on the yield curve, with a reduction in the main maturities, with the shortest DI 2023 varying from 13.795% to 13.73%, and the DIs 2025 and 2031, longer maturities, similar drops, ranging from 12.715% to 11.995% and from 12.79% to 12.07%, respectively. These movements, although combined with other (improved) domestic variables and the international scenario (worse), do not call for different perspectives for the SELIC trajectory from those we have projected - i.e., we remain with 13.75% or even a little higher.



Fonte: IBGE | Elaboração: Redwood

The Brazil risk, priced by the 5-year CDS, cooled off slightly and closed the month at 263.86 points, another drop of 3.4%, or, approximately, 9 points only. In line with the Brazil risk, although with a marginal reduction, the Dollar also retreated and closed at BRL 5.179 against BRL 5.1884, a decrease of BRL 0.0094. However, the fluctuations observed should not be disregarded, when prices registered a minimum at BRL 5.0169 and a maximum at BRL 5.3081 – a significant range that "tests" important limits.

The evolution of the variables in the financial market are within the parameters imagined for the period, although, at the moment, on the upside – that is, we expected a greater deterioration in the "normal" course. This course, obviously, has been altered by the government's imposing actions combined with a momentary better perception of international scenarios – in our opinion, rigorously wrong. This is why we remain with our same strategies, reflecting the potential volatility of domestic policy and the likely deterioration of the external scenario. So, we repeat: short-term protection and extreme attention and gradualism in risk allocations, while dynamically mapping the evolution of the markets and the consistency of our models. The focus should always lie on the medium-to-long term and on the opportunities that the various asset classes will present.

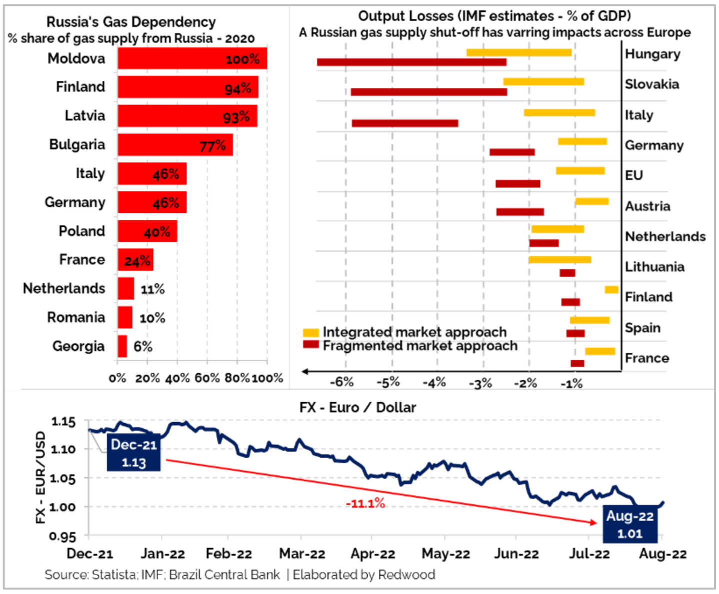
In the real economy, nothing more can be done for the remainder of this administration, but the benefits of the "return to normal" of the post-pandemic period have been reaped. Here it is also understood that the direction is correctly identified, as we have "improvement" in economic activity, inflation in clear downswing at a previously-identified timing and declining unemployment rate. It should be noted, however, that the intensity at which these oscillations are verified is better than the estimated ones, without unfortunately changing the medium-long term trajectory outlined.

With a closer look, economic activity of Q2 2022 compared to 2Q 2021 came within market expectations ranging from +0.2% to +3.7%, in line with our projections, with a median of +2.8%. The best news was the 1.5% increase in Gross Fixed Capital Formation, when the investment rate (GFCF/GDP) reached 18.7% in 2Q 2022. Inflation, although strongly impacted by the government's "actions", showed an inflection, as we have rigorously predicted, but its annual variation at the end of this year may be slightly below our projections (7.34%) and the market consensus (6.70 %). Again, nothing that changes the direction of either this year or the next, despite taking away some momentary pressure. In the same sense, the unemployment rate drops below expectations: 9.1%. More than that, the average income of employed workers (BRL 2,693.00) showed a real increase of 2.9% compared to the quarter up to April – BRL 75.00. Great!

In Monetary Policy, despite the behavior of inflation, no significant change in BACEN's policy stance is expected. It is worthy of praise and the realization of the reflexes of the monetary authority's independence, as a rule tested in periods of presidential elections: this time, so far, we do not see any weakening of its resolve, without, however, moving away from the assessment that it "missed" the timing and the magnitude of the increases in the SELIC rate.

In the exchange rate policy, BACEN continues to emphasize that its interventions in the market, whether through swap operations and/or the management of reserves, continue without seeking any profit, but a hedge for times of volatility and adequate liquidity in times of crisis, otherwise let's see: after the gain of BRL 7.47 billion in exchange rate swaps in July, the positive result is repeated in August, now with BRL 9.11 billion. In the overall result of 2022, until August 26, BRL 88.6 billion has been accounted for - always on a cash flow basis. The net foreign currency position is at USD 225.25 billion, against a position at the end of 2021 of USD 264.5 billion. With the *flight to quality* effect lurking, it would be better to rethink all of this "protection" available to the market. Less "help" will be welcome.

On the fiscal side, good current figures are at the expense of the future. Yes, promises and commitments made indicate strong challenges from 2023 onwards. However, with the accounts currently in the blue, the consolidated public sector balance showed a surplus in July (the best in the historical series) of BRL 20.44 billion - being BRL 19.96 billion from the central government (NT, CB and Social Secutiry) and BRL 1.76 billion from states and municipalities. State-owned companies had a primary deficit of BRL 1.28 billion. However, it does not stop there, as Minister Guedes says that the return of BRL 90 billion by the BNDES, later this year (?), will bring the public debt-to-GDP ratio back to 76.6%. The Minister not only does not recognize the potential "fiscal bomb" of nearly BRL 0.5 trillion, but also underestimates it and indicates that we will have fiscal surpluses... this is not what his own Budget Bill for 2023 shows.



Source: Statista; IMF; Brazil Central Bank | Elaborated by Redwood

Overseas, the forecasts are not positive at all. Here in Latin America, Argentina and Chile draw attention with their political situations, with the former already in chronic difficulties and the latter suffering from the first unease after Boric's election – both cases without major financial impacts on the region. In China, with more lockdowns due to Covid-19 and the prolonged drought, the government is closely monitoring the performance of the economy, and promises to act – in this case with immediate repercussions for the rest of the world. In the Euro Zone, the picture is even more difficult, as it is expected to enter a recession as the gas crisis deepens. The suspension of gas supplies by Russia to the European Union seems to be the final card (in winter) to end the war with Ukraine. In the US, the Fed (Powell) does not really signal that it has understood the gravity of the inflationary situation, judging by its recent speeches (Jackson Hole). "Hesitating again", it will lead the US to a hard landing with rippling consequences for everyone on the planet. The external environment corroborates the caution we advocate in investments.

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