

A low-angle, upward-looking photograph of several modern skyscrapers with glass facades. The buildings are set against a pale, overcast sky. A large, semi-transparent red rectangular area is overlaid on the right side of the image, partially covering the buildings. The text is positioned within this red area.

**MONTHLY STATEMENT**

OCTOBER 2022

*Redwood*

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REDWOOD ASSET MANAGEMENT

**"We are free to choose our actions, but we are slaves to their consequences."**

**Chico Xavier – Writer, spiritual leader and philanthropist**

The greatest presidential election of all time in Brazil crowned two great victors: the Brazilian people and democracy! Both stand at enormous contrast with the pettiness of the candidates' speeches, notably with respect to their administration plans and the healthy confrontation of ideas. Despite our freedom to choose being confronted with the sad need to select between the "least worst", the winner would come of this election with the potential of 156 MM voters with 60 MM votes in his favour, which means we have a Brazil immensely divided.

This true fact poses another challenge at this time, the serenity and maturity of both the President and President-Elect to assist in a peaceful and orderly transition. We did not start well, as the President-Elect himself, in his first two speeches on October 30<sup>th</sup>, presented antagonistic versions: the first was a written speech rendering an unifying and pacifying message; the second declaration was by "improvisation" and came with a bold attack and vehement criticism of the current president in office. A clear sign of the latent indisposition when, on the one hand, it tries to "formally"

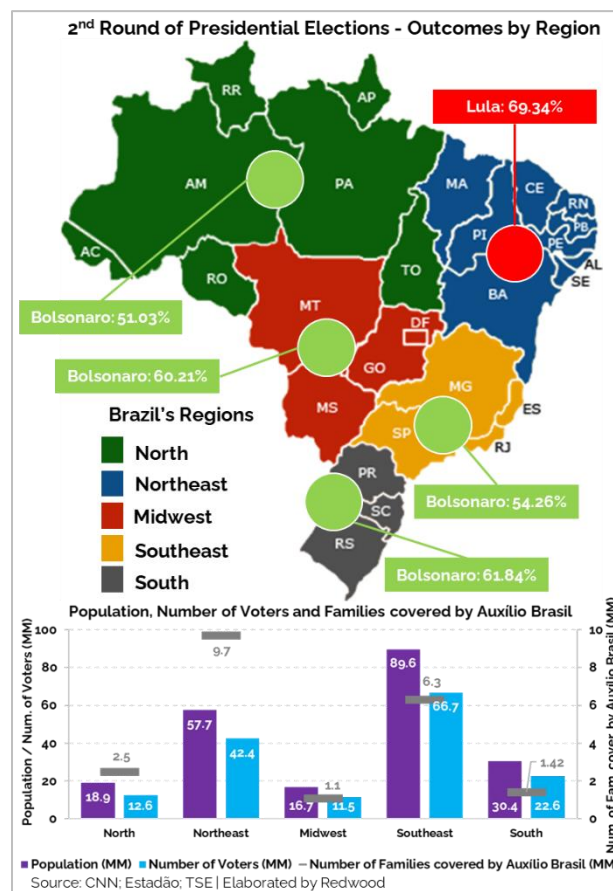
pass on the idea of equilibrium and, on the other hand, unleashes his rudest instincts. On the other hand, the current Commander-in-Chief, in his best style, brutish and crude, remained in solemn silence - he made no statement about the outcome of the elections for hours - despite several of his close supporters, politicians and heads of State of foreign Nations who promptly congratulated the President-Elect. All this in the midst of rising protests by truckers who blocked highways aiming to prevent the free movement of people and goods, with an evident coup agenda. What a shame!

Intelligence, determination, peace of mind, altruism, generosity and understanding are just some of the traits,

combined with a structured government plan, that we have been desperately in need of in recent years. Leader. Statesman. We have not had any luck... we have not even emulated nature, those irrational animals which as a rule do not "allow" the weak to lead their groups. We are not there yet. The Holy Bible has taught us that "we reap what we sow", and how hard has it been to harvest such fruits: hunger, social inequality, corruption and excesses. The current administration was a "detour" and a term aiming at better sowing, but the Head of the Nation, although "getting it right" in content, miserably erred in form. And the people, victorious in their confidence and determination, could not stand such "mistake" and voted for the past, when the present and the future are absolutely different.

In the economic field, the starting point for social improvements, the setback seems to be colossal - if the "improvised" version of the President-Elect comes to prevail. The current government has done an vast disservice to liberalism, the only way - hard but true - for advances in the quality of life for the population. After two Chicago Boys, with one even holding office in a PT government, the chances of a new and pure "liberal" are practically zero. Sad for us. We had a stillborn liberalism, and the responsibility falls heavily on those who lead us with the consent of the Ministry of the Economy.

However, if our democracy is consolidated and shown to be resilient, the alternation of those in power should be a guiding principle. The consequences of our choices, wrong or not, will soon appear. What matters is that awareness advances and that we make the appropriate course correction. Move forward, Brazil!



In the financial market, historically correlated with political tensions, this transition period should not pass unscathed or, at least, until the Ministers – in particular of the Economy – of the new Government are nominated. The study [Macroeconomic Scenarios](#) has recently been updated to show us that the likelihood of greater “moderation” by the future administration is an effective constraint, above all because of the political situation and extreme divisiveness of the country. If this hypothesis holds, we may have a decrease in the expected volatility in the markets, but we cannot rule out a radicalization of the progressive wing, which is in the DNA of the winning party in this past election. Thus, greater or lesser risk aversion (and therefore better market performance) will fundamentally depend on two crucial points: (i) admission of defeat by the current administration, without inciting rebellion and thus fostering an orderly and peaceful transition and (ii) the announcement of an economic team for the new government that minimally embraces fiscal responsibility and a further path of reforms, necessarily in that order.

Therefore, on the day-after of elections, the Ibovespa established this tone and expectation. It closed the month with a 5.45% rise, reaching 116,037 points, that is, a 10.70% increase this year. In the yield curve, the current analysis also holds. The shortest and longest observed DIs, 2023 and 2031, dropped from 13.70% to 13.672% and from 11.76% to 11.680%, respectively. The DI 2025, intermediate maturity, drove upwards from 11.60% to 11.705% - nothing significant. The size of changes for all analyzed maturities were also not expressive.

The Brazil risk, priced by the 5-year CDS, reversed the advance previously observed, when it closed the September at 312.28 points, and ended October at 277.04 points, namely: a 35.24-point drop, more than 10% in a single month! Following the same tune as the Brazil risk, but to a lesser extent, the Dollar closed at BRL 5.257 against BRL 5.4066, a

decrease of BRL 0.15. These directions observed in the markets do not deviate far off the field of perceived probabilities, but are in line with what we have repeatedly highlighted in this space: the greater the chances of staying on the less interventionist path of reforms and plans perceived by the market, the greater the positive advances will be.

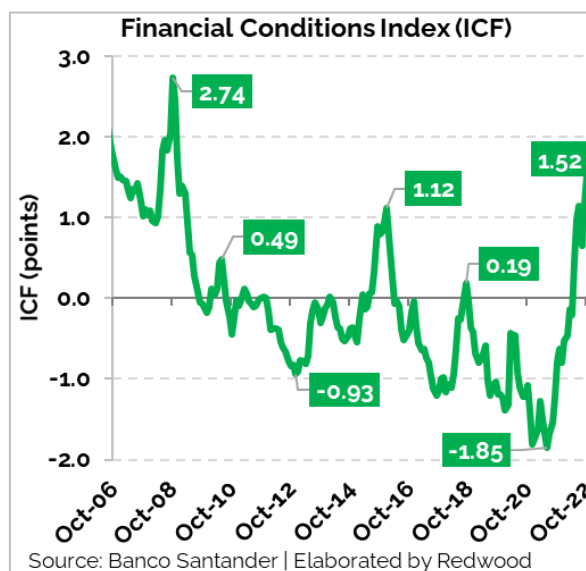
These advances, even if under the banner of a less heterodox economic team and aimed at “great moderation”, will not display grand signs of clear skies in the main leading indicators. Quite the opposite. The current good economic and financial news, of economic activity, unemployment rate, disinflation, and average real income and wage bill, etc., will hardly be perpetuated. The table on the side provides a good

overview of what we are talking about (greater than zero reflects a restrictive effect), although several others point in the same direction. (see [Macroeconomic Scenarios](#)).

The concerted action expected from the new administration aiming at political and economic “moderation” is just a necessary condition – and it is within our reach –, but far short of sufficient, given what is foreseen in turbulent international scenarios –

which stands beyond our control. In this way, given the negative externalities that lie ahead, all the better if we have adequate structure and organization to face them, otherwise our collapse will be speedier and more intense. There is no way to detach the world activity from its effects on our economy, and the adoption of countercyclical actions at this moment, especially in view of our fiscal situation, need to be carefully thought out, as they can further compromise our economic future.

With respect to Monetary Policy, inflation has cooled down more than expected for this year, but still falls outside the target-band ceiling for this year and next. BACEN itself recognizes this and more, admits to serious “unknowns” on the relevant horizon of monetary policy action, especially



regarding the new fiscal framework to be implemented as well as its consequences. Thus, in our view, this relevant horizon length is, definitively, postponed to 2024. The practical effects of this statement, embodied in the continued independence of the monetary authority, is that we will have very high interest rates (without neglecting further increases depending on the economic policy to be adopted by the new administration) throughout 2023. We stand by our assessment that we do not believe in a SELIC cut anytime soon (perhaps in the 2nd SEM/23). Prices that have a slower reaction to monetary policy, such as services, will continue to be under pressure, as we will see the regulated prices make their comeback after the forced "tax controls".

Regarding exchange rate policy, the diagnosis is that nothing will change, not now, not in the next term. First, because of BACEN's independence and second, because it would be extremely naive to imagine the new administration will show any motivation to promote a "freer" FX market. Institutional advances in this field have already been made, and it is expected to take them forward, but Bacen's trading desk's interventionist stance is likely to continue and with even greater intensity depending on the upcoming bumps along the road. Uncorrelated with any intervention by BACEN - which has come to even put in question its purpose of offering hedge to the market - the price of the Dollar follows its own and constantly shifting determinants, but which we believe will revert to what our short- and/or long-run PPP models predict.

On the fiscal side, despite this year's "good performance", there lies our biggest concern, namely: Is there really a "fiscal bomb" for next year? What will be the new tax framework to be adopted? How big of a fiscal "loosening" will we see from the new administration? Here lies our Achilles

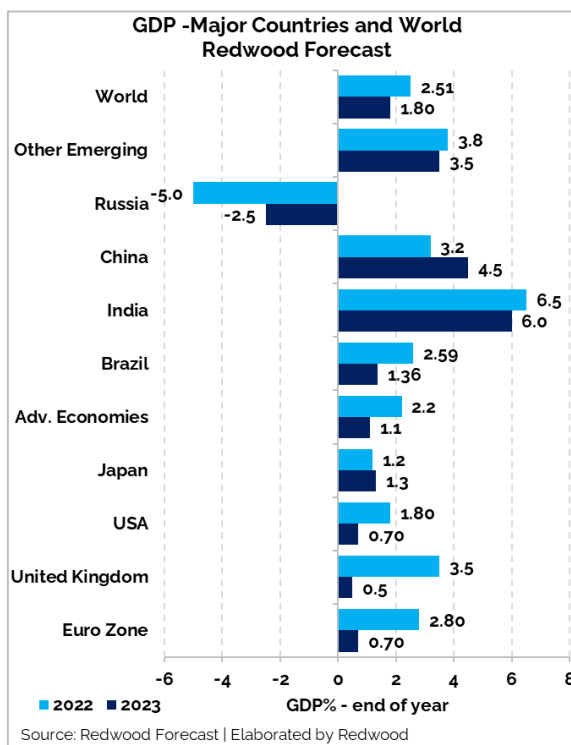
heel, and the source of all our problems to be faced first and foremost. In fact, no matter the mechanisms and "bells and whistles" of the new fiscal arrangement, the state of the economy will simply not tolerate more fiscal imbalances without being heavily impacted. This means that, one way or another, with greater or lesser propensity to sugarcoat reality, we urgently need to make fiscal surpluses. No wonder BACEN is so concerned. Monetary policy has its "limits", and fiscal policy matters a lot in that regard. Obviously, social programs are important, but the consequences of fiscal imbalances directly impact the exchange rate depreciation, inflation and interest (high!). Let us not forget that the source

of funds is always our own - namely, the citizen's - via our savings or tax collection. The PT's heterodox discourse never accepted this, and we are now, again, seeing how they will position themselves.

Overseas, the severity of the health crisis effects associated with the impacts of the war, coupled with the political-economic mismanagement in several developed countries, all of this projects that the compensatory measures carried out now take their toll, which, in turn, they demand contractionary policies that can have lasting effects. This finding

applies to Europe, Asia and, obviously, the USA, led by the Fed, which will not hesitate to raise its interest rates near 5% soon, with negative impacts on all markets on the planet. Thus, stagflation and recession are not ruled out.

Politically, the elections for the US Congress are taking the stage at this moment. All 435 House seats, 35 of the 100 seats for senators and 36 of the 50 states will be renewed. Republicans are favorites in regaining control of the Legislative branch and with it comes huge shift in US policymaking with repercussions across the world. It could be a signal for the 2024 presidential election. Democracy: peaceful transition of power. That's it!



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