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Redwood

REDWOOD ASSET MANAGEMENT

"The right combination is between a free economy and social policy that addresses the needs of society and creates equal opportunity."

Benjamin Netanyahu – Israeli Politician

In the thirty days following the presidential elections Brazil seems to have gone into a trance. On the one hand, the incumbent "went into isolation" and has thus far not addressed the population about the unfavorable outcome to him (is that his right?), nor has he "gotten involved" with the anti-democratic protests launched by his supporters. On the other hand, the President-Elect makes utterly inappropriate statements and, "on purpose" (is that his right?), pulls the strings without naming his main advisors (future Minister of Economy, for example). This tactic, harmful to the country, raises doubts about the future economic policy, with rippling effects on all markets: interest rates, the exchange rate and the stock market suffer. Brazil is in pain.

The main and most daunting challenge, obviously, is public finances. Campaign pledges, generally speaking, on both sides, went far beyond our current possibilities. Thus, the so-called "fiscal bomb" is bound to be triggered precisely if all the promises are carried out. With no previously identified source of revenue and amid the dismantling of the Spending Cap rule without a credible alternative fiscal anchor, the general apprehension is justified. However, it should be noted that if the expected unraveling scene is bad, the current picture is far from the same prognosis. The current administration pierced and "circumvented" the spending cap several times in sky-high figures, ending the year with an estimated 74.3% Debt-to-GDP ratio, precisely because disbursements were temporary and/or relied on increased revenues. But this will not hold up any longer. The list of promises goes far beyond the figures on the table on the right, with equally important costs such as the income tax exemption of monthly earnings up to BRL 5,000, the need to clear the repressed demand on the public health system and vaccination schedules, in addition to other factors with a direct impact on the primary fiscal result.

Main Electoral Promises
A blanket too short.

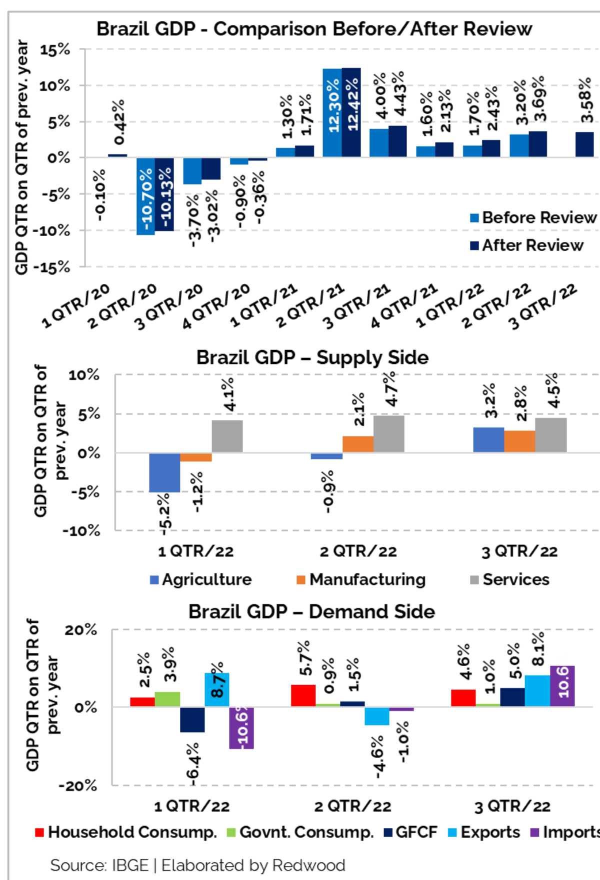
Promise	Cost to Public Finances	Observation
I. Cash transfers a. Aux. Brasil (additional BRL 200) b. Transfer for each child up to 6 years of age (BRL 150)	a. BRL 52 bi b. BRL 18 bi.	Impact on First year of Term and Remainder? Total BRL 70 bi
II. Adjustments a. Federal Servants' Wages: 5% b. Real Minimum Wage: 1.4%	a. BRL 17 bi b. BRL 12.2 bi.	Permanent impact. Total BRL 29.2 bi
III. Federal Tax Cuts (Pis/Cofins) a. Gasoline, Ethanol and Natural Gas b. Diesel and cooking gas	a. BRL 34.3 bi b. BRL 18.6 bi.	Rates zeroed down. Impact at 100%. Total BRL 59.2 bi
TOTAL	BRL 152.1 bi	Transitory or permanent impact requires sources of revenues.

Source: various websites | Elaboration and calculations: Redwood

It is clear that the promises have, at their core, a strong populist nature, but they are still defensible above all for their social aspect. This is how the dichotomy is set up: the economy and the social. There is no effort to discuss (in the limit) any list of priorities, but we cannot forget our profound economic limitations and how the consequences of a responsible economic policy have direct and extremely positive effects on society. For this year we expect a fiscal surplus (the first since 2013) and, even with the addition of BRL 200 in cash transfers (Aux. Brazil) and the addition of BRL 150 to households for each child up to 6 years old. All that totals BRL 70 billion (possibly offset by taxation of profits and dividends – a proposal pushed by the current administration), next year we would still have a deficit, yes, but much smaller than what is currently projected. With an extra expense (PEC da Transição) of BRL 200 billion for four years, it "does away" with all the savings amassed with the 2019 ten-year Social Security Reform; furthermore, not only does it not stabilize Debt-to-GDP ratio but, in fact, accelerates it. It is a social disaster waiting to happen.

The working group focused on economic issues structured by the President-Elect is of largely "diverse", which, as a rule, can bring benefits due to its different points of view. However, in some issues, as we understand the present state of things, such heterogeneity brings together names with a more "liberal" stance, like Pérsio Arida and André L. Resende, and Guilherme Mello and Nelson Barbosa, more prone to leftwing stances – the first being truly "a fish out of the water" in this environment and the last one, a "non-starter". We hope that the bygone of the "least worst" choice for President will be partly amended when it comes to economic policy.

In the financial market, ongoing volatility translates the impasse and the political trance described above. The belated nomination of future cabinet members imposes additional uncertainty because the established polarization indicates sharp changes in policy guidelines and, until these changes materialize, which will greatly affect the team's profile, the market "awaits" before taking its course. The greatest probability, however, in our opinion, will not be of a momentary rupture, but of a certain continuity for at least the first months or even the entire year of 2023. This is because the President-Elect needs to increasingly pacify the country, at the cost of facing immediate non-governability. After that, with his political skills and more effective "control" of political forces in Congress, Judiciary and other important Institutions, he will be able to impose his fundamental ideas and campaign promises. In any case, investors, in this case, will have time to assess the direction of the economy, opportunities and, consequently, their investments – enough time to reinforce their convictions and thus remain or not with their investments, with no need for hasty action, for there will be plenty of time for eventually reverse their operations.



Source: IBGE | Elaborated by Redwood

In this way, the Ibovespa returns a good part of the 5.45% increase seen last month, dropping 3.06% to 112,486 points – and these ups and downs will be the rule until the new team is defined, in particular the economic agenda. Yield curve shifts follow the same pattern. Except for the shortest DI, which remained practically stable at closing – going from 13.672% to 13.684% - other maturities for 2025 and 2031, fluctuated positively from 11.705% to 13.035% and from 11.68% to 12.63%, respectively, while others also showed similar changes.

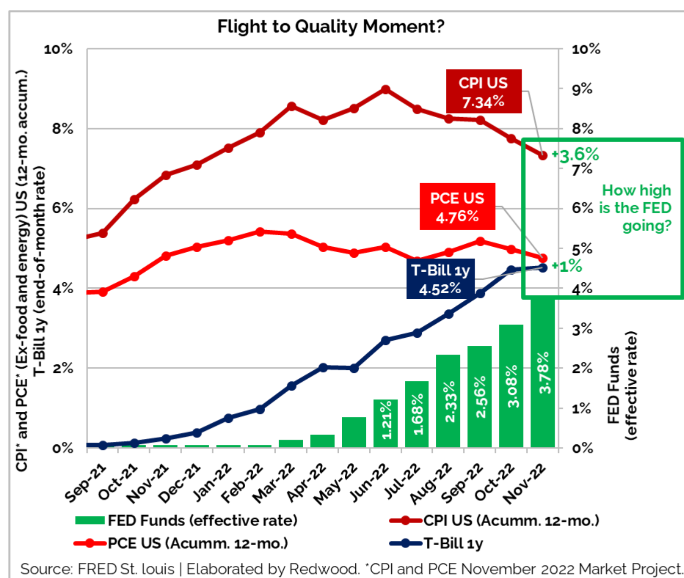
The Brazil risk main indicator, the 5-year CDS, continued last month's movement, dropping approximately 30 points to 247.75 points, equivalent to a new decrease of more than 10%. Unlike the Brazil risk, the Dollar ended the month not far from the closing quote of last month (BRL 5.257) and stayed at BRL 5.294 – a 0.71% increase or BRL 0.037. These movements reinforce perceived uncertainties and expectations, which are left at the mercy of inaccurate information that sometimes provoke enthusiasm, sometimes concerns. The end result: a lot of volatility.

The economy's photo shot, as commented, reveals a "positive picture". With a scheduled official revision of economic performance, GDP has improved in every quarter since 2020 and, for this year, from both the perspective of supply and demand, the results are better than expected for every quarter. Inflation follows the same line and is falling this year, although still hovering above target and with tweaks and "manipulations" whose bill is already being charged. The unemployment rate drops to 8.3% in the Q3 against 12.1% in the same period of 2021 – a beautiful feat! The real wage bill and real average labor compensation, in the same period, also rose by 11.5% and 4.7%, respectively, with shiny performances. However, the dynamic does not inspire any joy; quite the contrary. The GDP slowdown over Q3 2022 (1.3%, 1%, 0.4%) shows that contraction is, unfortunately, on the way. With the restrictive monetary policy and the still high household indebtedness, combined with the drop in the Business Confidence Index - ICE (which dropped 6.7 points in November compared to October, and 3 points in the quarterly average), we expect more timid movements for these indicators. Measures taken by the government to fight the pandemic and to ride the electoral cycle are largely responsible for the results.

In Monetary Policy, also due to the uncertainties of the new economic policy (especially the fiscal stance) to be implemented by the new administration, speculations of Selic increases begin to appear. As we do not believe in disruption in the short and medium terms, we maintain our forecast for the Selic (13.75%), obviously counting on the BACEN's independence and its technical management, as well as, if necessary, few adjustments, mainly due to the current effectiveness of the monetary policy in the face of tighter global liquidity ("an advantage"). Far from a benign scenario, this year's inflation, outside the target, is likely to stay around 6% and, in 2023, will depend mainly on the first signals at the beginning of the year, but the monetary policy's relevant horizon has definitely stretched towards 2024, which means high Selic for most of next year.

No change is expected in the BACEN's exchange rate policy, which will maintain its *modus operandi* under the new administration, at least not until institution's current chairman steps down in 2024. Not unlike the other segments, a decrease in fiscal uncertainty could benefit our exchange rate with a significant appreciation, in the direction that the parity models indicate. The opposite and more intense fiscal shift points to an eventual overshooting, with ensuing reactions of interest rates. In the regulatory field, advances in the rules on foreign capital in the country (new Exchange Law) should be prepared by December/22, coming into force at the end of this year. In 2023, a review of the regulation of foreign investments in the financial and capital markets will be carried out, with an increase in efficiency and access of investments to the country. It was about time!

On the fiscal side, all eyes are on the policy framework to be adopted. Convergence to this point is justified because although we will have a surplus this year (at huge costs), it is agreed that the result will be the opposite next year and perhaps in the years to come. The questions are basically: by how much will the annual spending cap be exceeded and for how long. The numbers for the "cap rule exemption" amount to a minimum of BRL 70 billion for the 2023 alone (best scenario), up to BRL 200 billion for the next four years (worst scenario, as proposed by the amendment bill). The lack of fiscal sustainability is thus set up, but it remains to be seen how it will play out intertemporally and, obviously, how to structure alternative fiscal frameworks. Spending with no corresponding revenue sources is a recipe for disaster, in the short term. The immediate consequences, of course, are the increase in Brazil risk and with it comes the Dollar, interest rates, etc. If we don't have the right mechanisms to fund this expansion, we will have an increase in debt, taxes and inflation, not necessarily in that order. This foretold tragedy – which politicians aligned with the new administration dare to flirt with on a daily basis – is unlikely to succeed; or so we believe... herein lies, in essence, the non-disruption we are talking about.



Source: FRED St. louis | Elaborated by Redwood. ¹CPI and PCE November 2022 Market Project.

Overseas, prognostics go from bad to worse. In China, the "Covid-Zero" policy is becoming a set of failures: in terms of economic, health and political outcomes. A potential mix for total chaos that could foment social upheaval or a harsh response by the government with escalating repression. Any alternative will have strong impacts on the rest of the world. In the Euro Zone, inflation ceased its rise. Resilient inflation and a poor economic outlook place monetary policy in an "uncertainty" field as the fiscal policies of some governments induce greater aggregate demand.

In the US, the locomotive and great lead indicator/influencer of the planet's economic directions, everyone follows inflation and all of the FED moves. It seems very likely that its policy rates will climb higher than 5%, but it is also disturbing to think that it will surpass the full CPI level. The reason is one: the attempt at a soft landing of the economy. One can only hope!

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