MONTHLY STATEMENT

DECEMBER 2022

Redwood

REDWOOD ASSET MANAGEMENT

"Bye-bye Brasil".
Song written by Chico Buarque

The twilight of Brazil takes place under the command of the one who, in 2018, made us believe that we could be different. It hurts our soul, if not because of the excesses and erratic posture, above all because it fostered and brought back what is most astonishing in Brazilian politics. Our light fades as the former president's attitudes degenerate into a sneaky exit from the country. So much disappointment and sorrow! Will you see that a son of yours doesn't run away from the honorable fight? Nothing of the sort; he fled!

Like Tite, Brazil's national soccer team, Bolsonaro lost and left without a word, not even a public "thank you" to his closest collaborators. Nothing could be more inglorious, a contempt worthy of deserters, leaving us to the hangman's noose and to our own fate. His last act, or lack thereof, is towering cowardness, under the eloquence that he made us see so much - and we refused to believe! - in the four years of his dismal term.

The best view of Brazil (according to some)

Source: internet

We left a weak, feeble and incapable politician to carry out his good intentions, to another who is astute, cunning and audacious in his intentions, purposes and objectives. In the coming weeks, we will find out about the pace and intensity of the course now already mapped out for Brazil over the next four years, and hope for its reversibility in the next election. Yes, Brazil suffered a lot, but it "did not succumb" to the previous terms of the same political agents who are now returning to the "scene" and, pedagogically, via the democratic process, we will once again have the chance to learn. More than that, we will help in everything we deem correct for the country to move forward.

If politics has such power and affects markets and society so strongly, the correct assessment of scenarios becomes fundamental. However, at this moment, the premises for an adequate study of Scenarios are still fragile in the face of campaign promises and the "pragmatism" verified in the first two mandates of the man who now returns to power. There is a total incompatibility between the discourse adopted in the electoral period - which extends to the present - and the reality in front of us. This conflict has been reinforced above all by the names that have been nominated to lead the Ministries, especially in the economic area.

There is no doubt that the way in which the new members of the government interpret macroeconomics is quite different from what we have seen in the last four years. For this group, consumerism generates economic growth, instead of production preceding consumption. The "law of markets" is not enough in itself, the State needs to intervene, coordinate and aid by way of policies and affirmative actions of all sorts need to come with full support from the government. Therefore, extreme caution is required in making investments until horizons clear up and we have some foothold on what is actually to come.

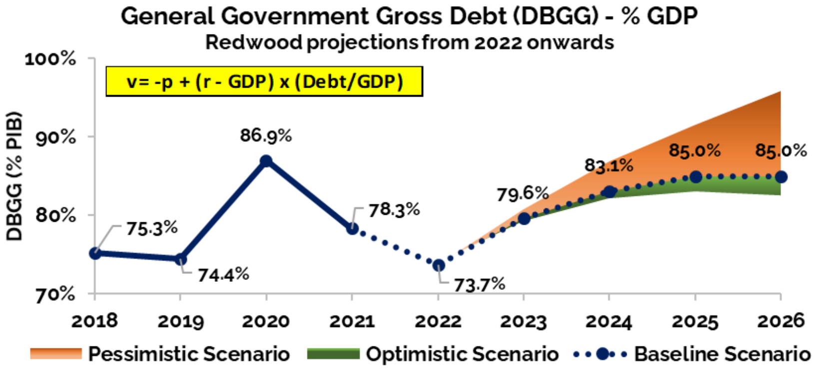
That being said, this does not mean that current uncertainties will be dissipated as if by magic, but only how much interference will we have from the political wing in economic agendas. Some dismantling and reversal of some measures are expected, but not a 180° bootleg turn – rhetoric seems not to prevail over the serious situation. The first 100 days of administration, as a rule, indicate what they propose to do. It's worth to watch!

Finally, beyond our Brazilianness, the visceral disgust and restlessness of a large part of society, based on what was seen as the greatest corruption scandal in our history, we need to be vigilant. This indecent approval, "incompatible" with the institutional order, does not allow us to neglect history and ignore reality: this time the choice between the bad and the worst is set up. However, if Brazil remains unimportant to the world, we will not lose faith and hope, because when we lose them, we lose our morals and values. You can't put your tail between your legs and run, let's face it!

In financial markets, few dare to act differently from the analysis above and, when they do, they are on the defensive side, avoiding to open new positions and favoring liquidity. The "belated" nomination of Ministers frustrated those who expected more conservative names in the economic area. This fact does not change our general understanding of a non-disruptive stance at the outset, but by adding noise, makes it difficult to interpret what the true information will be. Time "plays" in favor of investors, and the entering administration, if it plays it smart, will soon address its guidelines properly. This is a solution system that is impossible to ignore in the financial market, but the moment of implementation of the new model is key here. In this case, the message needs to be conveyed well, as agents are not, as a rule, deceived, and distrust can be the lighting fuse in such an unstable environment amid a world in serious trouble.

Thus, the Ibovespa dropped this month (-2.45%) and closed the year with a +4.69% change, at 109,735 points. With all the variables that influence the stock market, current forecasts are not the most promising for 2023. The yield curve faced no expressive variations this month. The shortest DI rose from 13.684% to 13.67%, and maturities for 2025 and 2031 also fluctuated marginally from 13.035% to 12.695% and from 12.63% to 12.65%, respectively. The prospects for 2023 have deteriorated a little, but this is also the result of uncertainties regarding the economic policy to be implemented.

Brazil risk, priced by the 5-year CDS, along the same lines, maintained reasonable stability, ending the month at 254.16 points against 247.75 points last month, a slight increase of 6.41 points. The Dollar, the asset that most quickly adjusts to market conditions – and, therefore, hogs all attention -, ended the month at BRL 5.2177, varying -1.44% in the month and closing the year with a 6.5% drop. Markets closed the month of DEC/22 pointing to a certain "calmness", but this is not, by far, in our opinion, a basis for investment guidance.



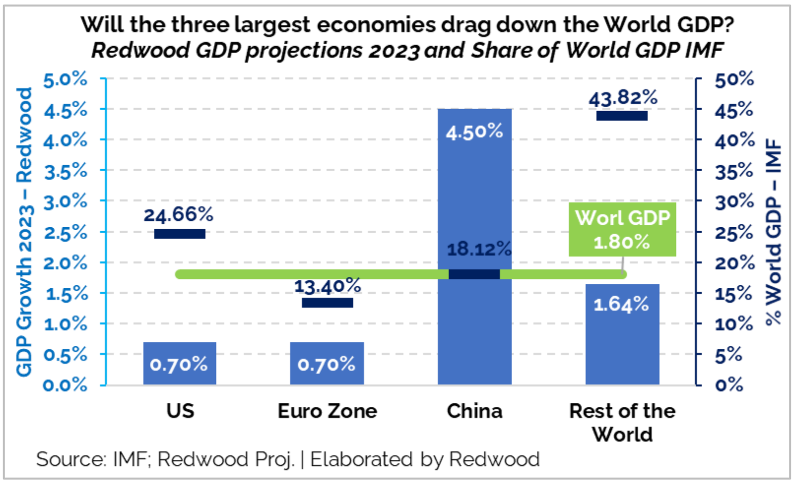
BASELINE SCENARIO	VARIABLE	2022	2023	2024	2025	2026
Debt Variation %	v		5.9%	3.5%	1.8%	0.0%
Primary Deficit (% GDP)	p		-2.25%	-1.5%	-1.0%	0.0%
Real interest rate %	r		6.0%	4.5%	3.5%	3.0%
Real GDP Growth %	GDP		1.0%	2.0%	2.5%	3.0%
Debt-to-GDP %	Debt/GDP	73.7%	79.6%	83.1%	85.0%	85.0%

Source: National Treasury of Brazil | Elaboration and Projections: Redwood

The economy ends 2022 better than initially imagined. However, the party ends here. GDP, inflation, unemployment, interest rates, and even the Balance of Payments itself, have shown constant deterioration in recent weeks. 2023 will be a very difficult year, and even greater if the far-fetched ideas aired by the transition team made up of economists and a former Minister, albeit "brief" but of sad memory, flourish. These ideas include, but are not limited to, the unfounded hypotheses of yield curve "control", and those that underlie the fiscal and monetary policies advocated by the so-called Modern Monetary Theory (MMT). One must be clear where to begin what the new administration disseminates as "combination of environmental and social responsibilities with fiscal responsibility". The health of public finances has already proven to be the core, so the first priority must be transparency and how the country's finances will be dealt with.

In Monetary Policy, in theory we have the protection of BACEN's independence, and the fact that its board of directors does not signal any early exits. Under this cover and with current indications, here we have a reasonable predictability that "good technique" will prevail, at least for the time being. In this way, we will see the monetary authority attentive to the daydreams mentioned above and in particular to the issue of fiscal responsibility to be addressed. Special attention needs to be dedicated to BACEN's relationship with the National Treasury. BACEN does not look favorably on projected inflation for the coming years, and this is a clear sign of maintenance or even hikes of the Selic rate this year.

In terms of exchange rate policy, BACEN did not escape the rule this year and will not do so in 2023 either. Why? Because intervention is in its DNA. Period. Furthermore, the variation range projected for the Dollar in 2023 is colossal: between BRL 4.80 and BRL 6.50. The reasons are equally broad: the new fiscal framework, tax reform and the very complicated world (high interest rates, recession, Covid-19 and its consequences for China), are just a few items of concern. Thus, our current projections, lacking more consistent information, do not deviate much from the average market rate of BRL 5.27, and the bands that record greater optimism and pessimism are rigorously within market forecasts. An important highlight, however, is that although the probabilities of a more optimistic or pessimistic scenario depend on the outcome of the above reasons, there is an important asymmetry for each side in relation to the base scenario of BRL 5.27. The projected fall nears 10% in an optimistic scenario, while in an eventual pessimistic path the Real weakens by more than 20%... and as we have seen so many times, the BACEN intervenes, but does not fully contain all price movements!



On the fiscal side, the graph on the previous page clearly shows our bleak situation (dynamically speaking) for those who believe in the Public Debt-to-GDP indicator as a country's true solvency index. Yes, solvency in a broad sense and not narrowly like those who advocate (MMT defenders) that the State, as the sovereign issuer of its own currency, can "run the printing press at will" and never go bankrupt. With the campaign promises and the fiscal package recently approved by the National Congress, we estimate a deficit at 2% of GDP in 2023, in the base hypothesis, and constant improvement in the other variables over the years with some fiscal effort. In this case, the debt stabilizes at 85% at the end of the new administration. Is that any good? No, but perhaps it is possible given what is in front of us. The ideal would be to stabilize, from now on, the Debt-to-GDP ratio as the leaving administration hands us over (Debt-to-GDP projected at 73.8%). However, in order to keep the other variables as they are set in our base scenario, we would need multiple extra-efforts with a needed surplus of 3.70%, 1.85% and 0.7% in 2023, 2024 and 2025, respectively, and only in 2026 would not a surplus be required to balance the debt trajectory. There is no chance of that happening! So, objectively, given the "dead moose on the table" we might have with the implementation of theories claiming that "deficits don't matter", our baseline scenario seems exceptional to us.

Overseas, developed economies continue to be under severe pressure and dominated by fears of recession. In China, the new waves of Covid impose restrictive economic activity, taking its effects to the entire planet. In the words of former Premier Wen Jiabao, it is an "unstable, unbalanced, uncoordinated and unsustainable" economy. Japan, in turn, surprised with a change in the control of the yield curve... it did not abdicate control of it, but it expanded the 10-year JGB interest rate variation band to double the current one (while we were here thinking in the opposite direction!). In Europe, signs of contraction are not few either, with PMIs still at contractionary levels. The hope is that, after the winter, turned especially more difficult due to the war, demand may reappear (albeit slowly), with production heating up and supply chain normalization.

In the US, the idea is fixed on making a soft landing of the economy, but the inevitable need to hike interest rates (priority of controlling inflation), does not strongly corroborate this scenario. Treasuries ended 2022 with the highest annual gains in the time series, and it looks like the movement isn't over yet. We agree with the IMF, because in 2023 we will see the economic slowdown in the US, EZ and China. As for the world, will it ride the wave or will the emerging markets be the rescue buoy?

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