MONTHLY STATEMENT

JANUARY 2023

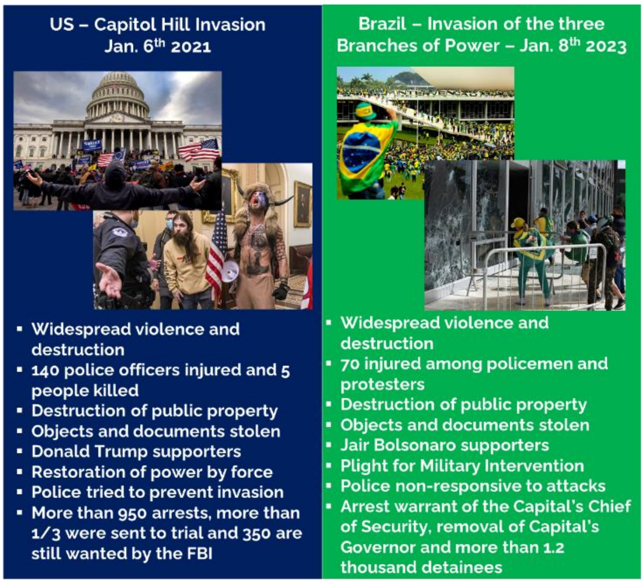
Redwood

REDWOOD ASSET MANAGEMENT

"Patriotism is the last refuge of a scoundrel."
Samuel Johnson – English poet and playwright

The anti-democratic riots of January 8, 2023 reveal a lot about the evolution and political understanding of a large share of the Brazilian people. Once seen as peaceful and immune to extremism, part of our society, fostered years ago by growing political antagonism ("us vs them"), and more recently by a false patriotism that emerges from atrocious political immaturity, buries us in a condition as idiotic as that which invaded Capitol Hill on January 6, 2021. A colossal shame now tarnishes our history, as a symbol of savagery and medieval predicament in which some have put us.

As a matter of fact, the attacks that took place were not at all unthinkable – quite the contrary. With the growing political-ideological divide, the inflammatory statements and the country's institutional disarray, the ground was set. In truth, for the intended purposes, it is a vast intellectual deficiency, but one cannot believe that what happened did not have the concurrence of several people and that, unfortunately, other uprisings may occur later on – the atavistic rancor remais.



For the current administration, it was the second best post-election "gift" it could have received. After his predecessor, possibly his greatest electoral supporter, paved the way by extinguishing the Car Wash probe, annihilating the debate on corruption, fumbling terribly in relations with the Legislative and the Judiciary branches, the current President "surfed the wave" by giving immediate and institutional answers. Nothing could be more surreal given his history and the positions taken by several members of his party over the years. Our scourge seems endless. The discursive promiscuity of the demagogue on duty is now a statesman posture, while the other grumbles beside Goofy in Orlando (FL) without the courage to return home. In fact, two sides of the same coin where cowardice is a fundamental part of the personality of political demagogues, who grant themselves "medals and privileges", praising themselves with personal grandeur and purism. Pure theatrics. The cheering crowd applauds.

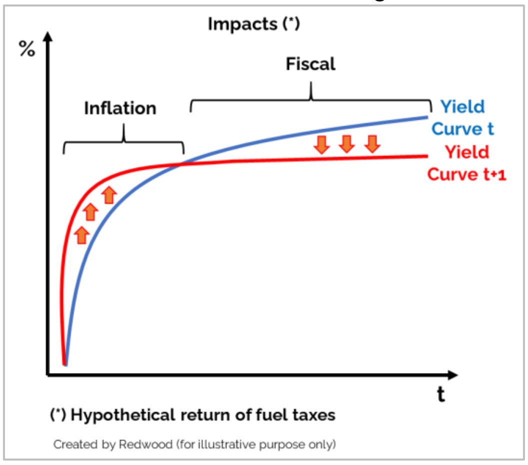
But despite the second "gift" received, the news about it were not able to offset the flood of far-fetched ideas from a number of ministers, always led by the President's disconcerting rhetoric. Perhaps due to political constraints and lower popularity rates than those achieved during his other terms, the Commander-in-Chief still needs to make speeches that please his audience. Thus, we witnessed things like the attack on the Central Bank's autonomy, changes in the Law of State-Owned Companies and even the creation of a common currency between Brazil and Argentina, clearly conceived for ideological reasons, but presented as a solution to promote bilateral trade. Are they demagoguery or simply bad ideas? We have both!

Thirty out of the first hundred days of his term, so important in defining what the government's main agenda will be, have already passed. The first indications, especially in the economic field, were terrible. With a team full of supporters of the so-called Modern Monetary Theory (MMT), attacks on the current monetary policy, signs of changes in the established inflation targets, an Expenditure Cap without a substitute, reforms without a whisper of clarity, BNDES with "subsidized" interest rates, " anti-reform" of Social Security, etc., it all sets the market on a defensive mood. All this in the midst of a minister who confuses CVM (SEC) with CMN (Monetary Counsel)! Shall we take this in as beginner's anxiety and give it a chance?...humm, no. The market does not forgive and prices it all in.

Thus, we are under in this demagogic hypnotism, now permeated by revenge and witch hunts, while a "can-do-anything judge" still curtails civil rights and freedom of speech. What will be our last refuge? Disneyworld?

In the financial market, distrust is showing signs that it could take hold. Statements misaligned with a good understanding of the country's finances, inconsistent statements and a jaw-dropping disorientation – as if there wasn't a structured plan and the transition hadn't given him a minimum foothold on where we stand – it all brings the feeling of a long and flat learning curve for the incoming administration. All we don't have is time, either for learning or failed experiments in other countries. Once again, our belief in a non-disruption, at least momentarily, remains, but the ongoing noise has begun to undermine this conviction. Without any commitment to error, if our perspectives change, we will not hesitate to recalibrate our political-economic-financial scenarios – which, as a rule, we do at the end of each quarter. In this way, no movement seems opportune to us at this moment, with caution and liquidity prevailing as the main guideline.

Thus, the Ibovespa experienced some progress this month (3.37%) reaching 113,431 points. For 2023, taking into account the current risk-return menu, the equity market will once again be the environment for very specific choices, until the scenarios, especially interest rates, show signs of settling down. As for the yield curve, the start-of-government puzzles begin to be priced in, at least in part. The shortest DI rose from 13.45% to 13.545%, and the other maturities for 2025 and 2031, rose from 12.695% to 12.84% and from 12.65% to 13.08%, respectively. These movements, along the curve, should be adjusted (via economic/monetary policy) very soon. For now, with rising inflation and fiscal risk on the horizon, the positive shift along the yield curve is expected to continue.

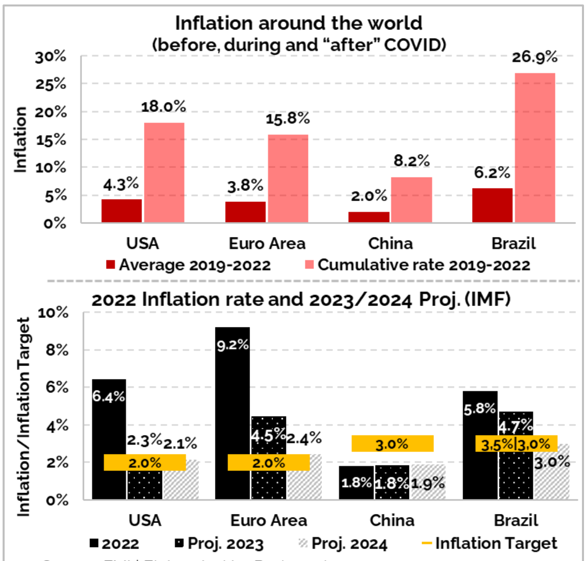


The Brazil risk, priced by the 5-year CDS, retreated by around 9%, ending the month at 231.39 points against 254.16 points last month, paradoxically reflecting more the international situation – Covid-spread stabilization and some "relief" in global monetary tightening – than domestic fundamentals. The Dollar, an asset that also reacts promptly to uncertainties about the country's economy, as well as the Brazil risk, ended the month at BRL 5.0993, with a -2.27% change against BRL 5.2177 last month. The reasons for this movement seem to be in line with those presented for the Brazil risk, and do not deviate from our general understanding of no disruption for the moment, with continuous and extreme attention to assessing and monitoring market behavior.

In the economy, although information on what will be done is scant, so far what has been presented is not good. In a short time, even the most outspoken critics of Paulo Guedes' policies will miss them. The results left, even from a static viewpoint, will be difficult to sustain. To name a few items: economic growth, inflation, fiscal outcomes, job creation, trade balance, etc., all of these important research firms signal worse results this year and in the following. It is clear that the good frame turned into sequential footage, with the actions of the past government, has a strong influence on these projections. The problem here is how much more aggravated these forecasts will be under a more heterodox stance. For the incoming administration, the "cursed legacy" is in the trajectory and for the outgoing administration, it will always show the December 2022 photograph. If the new economic plan does not work out, the excuse will always resort to consequences left by the actions of the predecessor and, for the outgoing administration, to the changes in its policy that had been working "properly". We need to wait for a while to envision where the ongoing changes are headed.

In Monetary Policy, last month we said that *"in 'theory' we have the protection of BACEN's (Central Bank - CB) independence"*, and here lies one of the points of the weakening of our conviction commented above. Attacks on the Institution, its monetary policy and even its members, signal that this independence is bound to be short-lived. However, it is expected that at least it will be preserved, as it stands, until the end of the terms of its board of directors. In this way, for the time being, we are betting on the continuity of sane technical and strong responses to what will come from the new economic policy. The return of inflationary pressures, for various ongoing reasons, demands direct and objective action by the CB, with maintenance of the Selic at current levels, for a longer period, or even additional increases. The reflexes can be like the illustrative figure on the previous page, with a shift of the yield curve in its short range (greater effects of inflation), with the subsequent and possible "re-anchoring" of future inflation and, therefore, an ensuing reduction in longer maturity rates. A responsible fiscal policy will be fundamental for this to happen. The general dynamic is: with stable/lower long rates, short-term interest rates "might" be lower.

In the exchange rate policy, CB sees itself grappling with the "more favorable" external landscape and its impacts on the price of the Dollar. Like a bystander, it keeps watching "passively", as it should be as a rule. Were it not for the aforementioned misplaced statements and the growing risk of a bad fiscal outcome - compared with other currencies, such as the Chilean or Mexican peso, for example - the Real should be around BRL 4.85 – a value that is situated at the most optimistic quadrant of our probabilistic scenario. Brazil has managed to forego even positive externalities, but we maintain our projections.



Source: FMI | Elaborated by Redwood

On the fiscal side, the new Minister of Finance believes that we may have approved the tax reform and a new fiscal framework in the House of Representatives by April this year. One can only hope, for in these three months we would have debates and assessments on the matter with enough time to revert the wave of currently poor expectations that contaminate the entire economic spectrum. Despite being a rigorously technical matter, it would be utopian to imagine that the President himself will not be involved. By the end of 2022 with a Public Debt-to-GDP ratio of 73.45%, it will be virtually impossible to maintain this mark and, according to our projections presented in the December 2022 statement, this ratio is likely to advance approximately 6 p.p. throughout 2023. If this is confirmed, pricing by the market will already be practically given. The market seems to understand that the time frame of fiscal recovery can and should be seen in the short- to medium-term – but here the trajectory is identified with commitments assumed and the debt-stabilization trajectory defined.

Around the world, markets made important advances this month, as shown by the DAX (8.65%), S&P (6.18%), NIKKEI (4.72%) and FTSE 100 (4.29%) stock exchange indices. Based on expectations of cooling inflation, some improvement in economic activity and notably a change in Covid-fighting policy and China's subsequent reopening, they brought relief and a greater probability of the main world economies having a smaller contraction than previously imagined. Is this movement in any way consistent? In our opinion, it is too early to claim victory, and even promote any more significant adjustment in investments in the face of the present volatility and wide-ranging uncertainties. The chart on the side shows that the fight against inflation is starting to deliver results, but CBs need to maintain their policies steady until the trajectory towards that goal is guaranteed.

In the Euro Zone (ZE), despite the energy crisis, the bloc's economy grew at 3.5% in 2022 (faster than China and the US! Anti-Covid-19 policy effects), but registered marginal progress in the Q4 2022 on Q3 2022. The ECB's tighter monetary policy slows down activity, so a contraction is expected for the H1 2023. The annual inflation rate, however, cooled down (Jan/23 at 8.5%), but the unemployment rate remains at 6.6%, reflecting the ECB policy stance. In China, as the economy reopens, its PMIs (Industrial rose from 47 to 50.1 points and Services, from 41.6 to 54.4 points) show a rapid recovery of activity.

In the US, the FED raised its target rate to 4.5%-to-4.75% range, a 25-bp increase. However, Powell points out that inflation is still far above target. Despite being a clear slowdown of monetary tightening, it is not over yet!

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