MONTHLY STATEMENT

FEBRUARY 2023

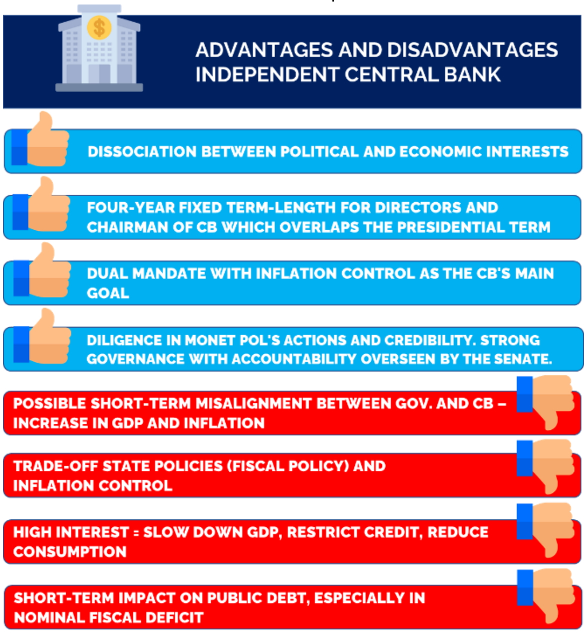
Redwood

REDWOOD ASSET MANAGEMENT

"Speak softly and carry a big stick; you will go far."
Theodore Roosevelt – Former US President

The new administration's first sixty days reveal a colossal lack of preparation and the absence of any basic planning and implementation of the election-winning government plan. We have seen all sorts of discussions, always shallow, superficial and usually about people. Misunderstandings and initial setbacks are permissible, especially for newbies, not old goats and at currently ongoing levels. The established standard borders on resentment, hatred and revenge – incompatible with the intelligence and political experience of many. The direction of the attacks and the posture adopted so far are frightening, in addition to the reflexes that are already stemming from these attitudes.

If they are frighteningly unprepared and inept for the numerous functions that speak for their departments, no less important are the cultural war and the indoctrination and psychological repression of new ideas and the confrontation of the dawning liberalism in Brazil. The leftwing postmodern ideology does not even seem to admit the discussion of established ideas, facing common sense and ridiculing factual realities around the world.



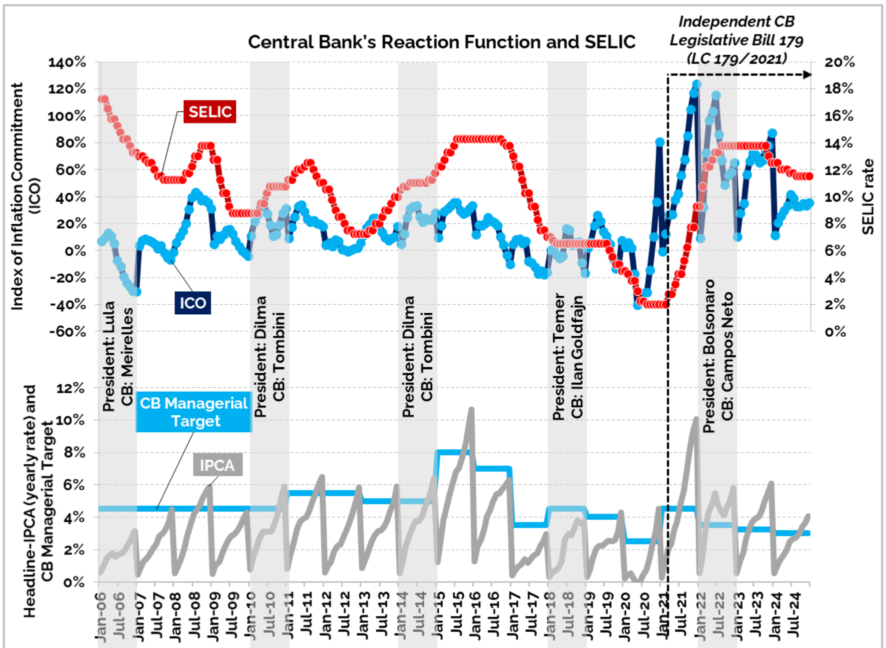
The Commander-in-Chief himself took the lead in these acts. He assumed a posture of rabid attack against Roberto Campos Neto (RCN), the Central Bank's (CB) chairman, with criticism far beyond reason. Nothing could be more out of bounds, since in the past the President would delegate this role to those close to him, as was the famous and constant posture of his then Vice-President José de Alencar, routinely criticizing the high interest rates throughout Lula's first terms in office. This time he took the lead and, acting shamelessly, as if he were still campaigning, he created more than ludicrous situations, unnecessary ones. The episode of shifting inflation targets (as a "consequence", interest rates shot up) was not only a non-event, but also a mistake and a lack of practical knowledge on the matter – possibly justified by a certain cognitive limitation. The National Monetary Council (CMN) is responsible for setting inflation targets a few years forward, composed of three voting members: Ministers of Finance, of Planning and the chairman of BACEN. Thus, there was no need for any fuss; it would have sufficed to simply adding this item to the agenda at the last meeting of the CMN and its two Ministers would vote accordingly and all would have been resolved smoothly. The chairman of CB would be outvoted. Everything would be laid out as they wanted... but no, it had to be a flashing spectacle. It is astonishing that his advisers let this posture go so far (although the case was not taken to the CMN meeting), for the consequences are already being felt.

Expectations matter. Decades ago this topic was studied and widely proven. All this tough talk by the Commander-in-Chief and his followers, notably in the case of CB, has direct impacts and can be sharply anticipated. One of the main tools available to CB is precisely its credibility and, with it, its communications. When this credibility is undermined, threatening and boasting that it will change its staff, its policy, etc., in order to reverse the current monetary policy, expectations change and, as has happened in the past, the market no longer believes in statements and attitudes by the monetary authority, even ignoring what was expected of its policies. Why? Because they know that the current arrangement will not last and that the new members will set new direction and guidelines. And could a new policy such as reduced interest rates compared to everything else that influences inflation be any better? Come on President, try!... but know that the costs will be enormous; infact: Huge!

The new posture of the current President is truly impressive. He'd better look to his past or Theodore Roosevelt's. Love did not win in the end!

In the financial market, this discussion about the level of interest rates – as it was entailed – sent cyclopean shock waves and contaminated the environment, scaring everyone away. The perception is that there is a lack of adults in charge, and the issues being treated as "unimportant" (which are appropriate for the realignment of the country's economy), seem to point to the need to divert attention away from what really matters at this time. Foreign investors are absolutely wary, with zero appetite for Brazil while this "tidying up" is not effectively concluded and the new course for the country is clearly set.

Therefore, last month's positive advance of the Ibovespa was fully returned and then some, with one of the worst returns for the month (7.49%) touching 104,932 points. Our scenarios for the segment remain poor, given that only a few very specific sectors, and with very well-chosen companies, can the risk-return ratio justify investments. From an asset macro-allocation viewpoint for this year, the stock market seems to indicate a significant slowdown (or some *hedge*) – even for bolder investor's profiles. The yield curve continues to be pressured in the face of created complications adding to the problems themselves. The shortest DI, went from 13.545% to 13.37%, and the others, with vertices for 2025 and 2031, from 12.84% to 12.685% and from 13.08% to 13.48%, respectively. These high interest rate levels, which until recently were expected to cool down throughout the year, now face "suspended" hope, given all the noise created by the government. The power of monetary policy may be in check, especially with the politicization of the established rules of inflation control, and an economic policy that still does not know exactly what direction to take. With unabated inflation and fiscal risk on the horizon – fiscal framework still promising – positive shifts of the yield curve are not ruled out… quite the contrary.



Sources: IBGE; CB Brazil | Elaborated by Redwood (projections Redwood starting Feb/23)

The Brazil risk, priced by the 5-year CDS, remained put at 230.89 points against 231.39 points last month, while the Dollar reacted and rose slightly to BRL 5.2078, against BRL 5.0993, changing +2.13%. An important highlight was that in addition to an oscillation of almost BRL 0.30, the foreign currency price broke the BRL 5.00 floor, being quoted at BRL 4.9706, triggering great interest in sending funds abroad. This is indeed a relevant signal. Attention!

The economy's performance of almost 3% of 2022 will not be repeated this year. The Q4 2022 already demonstrated this, with some early cooling down, which makes a bad start to 2023 amid so many uncertainties. For this year growth will be near 1% - a long way from our "potential GDP", although the dispersion of projections on a small basis can result in significant relative values.

In Monetary Policy, all guns are drawn. The emblematic figure thus chosen, obviously, is RCN. However, the range of attacks is not restricted to high interest rates only. They put in question the costly and long battle to win an independent CB. We could not be facing a greater setback, not only due to the comparison of its advantages and disadvantages, but also due to the undeniable reality of its benefits in practice. The Reaction Function above, the model we used to identify *what the CB will do and not what it should do*, clearly shows its "differentiated" conduct when it had "only" *de facto* autonomy and when it became effectively independent. Highlights go to the pre-presidential election periods, when interest rate management suffered from changes in relation to expectations – clearly political influence, whose intrusion hindered the conduct of monetary policy. As of the effective independence of CB, this no longer happened – a very important advance in favor of technique and good practices. We believe that the saboteurs on duty will intensify the attacks, but its independence was conceded precisely to shield itself from political attacks as it is now, and that the Board of Directors will remain firm in their posts and in their policies. Thus, the Selic will remain at current levels for a long time due to current and future inflation until accountability for economic policy sets in.

In exchange rate policy, CB needs to be aware... not of its fateful movements, but of what potentially emerges after the political attacks on "high" interest rates. Make no mistake, if the pillars of CB's independence are in any way in jeopardy, exchange rate policy will also be a target, as in revising the level of reserves, forcefully cutting interest rates, devaluations pressing upon price levels... why hold reserves of USD 230 billion? In any case, for the time being (short- and very short-term) we have evaluated the Real's price subject to waves of devaluation of the US currency abroad, indicating some reduction, but the tendency is for the Real to end 2023 more devalued than today.

Sources: FMI; Revista Veja; G1; Infomoney | Elaborated by Redwood

On the fiscal front, eyes turn to the new fiscal framework that the economic team intends to present in March/23. We're definitely not hopeful that something really "hard" regarding spending is coming our way. We have also gone through various forms of control, and it does not seem to us that the current team, far from fiscalists and seasoned on MMT theory (we finance ourselves in Real!), has any interest or motivation (technical and political) for something along the lines of a strong public debt reduction. Today debt level is at 73% of GDP, on the way to 80% this year, while we should have a trajectory towards 60% like the other emerging countries. The truth is that Administrative Reform should precede everything at this point; sadly, it will not happen. Only a credible and sustainable debt trajectory will restore credibility. Without that, defeat is certain – we should know by now.

Overseas, the impacts of the Russia-Ukraine war ripple through the world after a year of countless atrocities. Regardless of these findings, the conflict continues with no end in sight, but there is no accommodation or feelings of impassivity, especially due to the potential of a nuclear escalation and/or a closer relationship between China and Russia.

In Europe, the ECB raised interest rates by 0.5% and signaled a new hike of the same magnitude for its next meeting. The Eurozone economy is better than imagined, and the fear of a deeper recession is reduced. Inflation eased somewhat, but its core remains stable. Inflation is projected at around 6% by mid-year.

In China, the lower-than-expected growth in 2022 did not hold back government impulses to set, once again, a 5% growth target for this year. Without the limitations imposed by the Covid-Zero policy (lockdowns), the recovery of the real estate sector and various aids from the PBoC, etc., an advance of this size in Chinese GDP is not unlikely. It runs counter to the slowdown of the global economy, with direct effects upon the demand for Chinese products.

In the US, betting against the market, we continue to envisage several interest rate increases. Inflation subsides, but persists at a high level. The tight job market fuels inflation. Treasuries support our vision!

DISCLAIMER

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