MONTHLY STATEMENT

MARCH 2023

Redwood

REDWOOD ASSET MANAGEMENT

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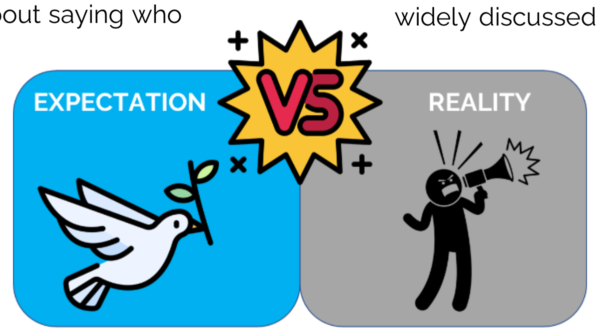
"Hate, emotionalism, and frustration are not policies."
Madeleine Albright – former US Secretary of State

In these early days of the administration we have experienced exactly what was described above, although in different moments, with varying intensities and sectors. It is a fact that theorizing is necessary, but it is insufficient and, sometimes, useless, depending on the audience, because in certain technical matters – which not everyone has the obligation to understand or agree to – one cannot overlook the reasons. Thus, we already have polls that show different reactions to the new administration's performance. For society as a whole, the assessment, although worse than previous terms of the current President, is still quite reasonable. On the other hand, for the financial market, which as a rule overreacts – for better or for worse – the performance is mediocre. It is not about saying who is right or wrong, but fundamentally who has greater sway over opinions and, in fact, over the direction of the country's paths - after all, there is only one reality, and it is not worth confronting it when it presents itself.



It is human nature to react to adversity, to a greater or lesser extent. The formation of expectations, in this sense, plays a great role and triggers varied emotions, which in turn stir the psyche of markets and society as a whole. The fundamentals are, as a rule, important inputs for the analysis and establishment of expectations, although parameters and short-term information influence the decision-making process, whether we are aware of their biases or not, much more than we realize. When reality presents itself and the deviations are large, the shocks and reactions are equally impactful.

The definition of the economic policy and its conduction has been the keynote in this first moment. There seems to be no doubt that politicians and pundits should have better economic education, since with the support of the Commander-in-Chief, it has been frequent to see his supporters scolding and belittling aspects and circumstances well addressed by consolidated policies, and few leaders have had the serenity to appease the inadequate tone of statements as well as attempts to manipulate facts. We need to face it upfront and say clearly what has not been said about the status of our economy, however frightening it may be. Roberto Campos Neto (RCN) declared that, if we had to reach the inflation target this year, the Selic rate should be at 26.5% p.a.! It is unthinkable, but it shows, nakedly and cruelly, our extremely difficult predicament.

Likewise, Minister Haddad faces reality when he presents a fiscal framework with primary result targets that are much better (albeit unrealistic and insufficient) than the expectations of the market and of his party comrades – and hence the positive initial reactions. After all, the numbers don't add up, and it is deplorable to hear ideas as if they were new, when the underlying rationale reflects concepts already widely discussed in the past. But even worse than that is resorting to old ideas with demonstrably bad results for analogous situations. Haddad basically does not deviate from the essence by not confronting the expenditure side (we now have a Spending Floor), but confronts several around him, and we also know that the text soon to be presented to Congress can "enter riding a horse and leave on a camel with horns". Thus, before losing his way, or even worse, becoming a political and economic prisoner, he'd better seek advice from those who think in terms of fundamentals and experience – approaching reality.

The truth is that, if one fails to structure oneself to propose and change several points now, affliction and anguish, guilt and insecurity will weigh in, when the proposals for the fiscal framework presented by the government start to produce their rotten outcomes. The insecure decisions taken now will be difficult to correct later on. It is bound to be a total disaster to simply watch an eventual dishonest and irresponsible economic policy and not react, thus tolerating such behavior. The President can help: *hate, emotionalism and frustration are not policies* and take us apart from reality. Brazil needs to know how to distinguish right from wrong. It cannot be admitted, once again, that we get played as test-tube for amateurs. Brazil will not stand it!

In financial markets, expectations for the release of the fiscal framework took their toll. The proposal presented was better than expected and, in particular, the day-to-day traders' class loved it. People who can do a little math and enjoy some serenity now push on the brakes. Thus, even though several details are still lacking regarding the framework, we do not see, at this moment, with the available information, reasons for major changes in the scenarios.

Therefore, the negative return of last month's Ibovespa (7.49%) pushed down even further, retreating an additional 2.91%, touching 101,882 points. In line with our scenarios for the segment, we continue to have poor expectations not only for the domestic landscape, but also for all the global stress that directly affects us. The yield curve continues without major shifts, but reflecting the "positive surprise" coming out of initial responses to the proposed fiscal framework, notably the longer maturities. The shortest DI fluctuated from 13.37% to 13.20%, while others, maturing in 2025 and 2031, from 12.685% to 12.035% and from 13.48% to 12.80%, respectively. A credible fiscal proposal would have enormous power to *consistently* reduce future rates and, along with them, later on, also short-term rates and the Selic rate.

Wishful Thinking

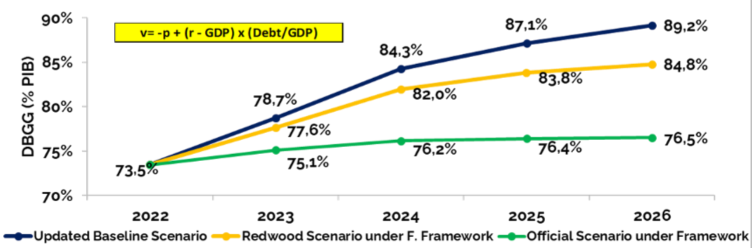
CHART I

Updated Baseline Scenario		2022	2023	2024	2025	2026
Debt Variation %	v		5.3%	5.5%	2.9%	2.0%
Primary Deficit (% GDP)	p		-1.60%	-1.10%	-0.50%	0.00%
Real interest rate %	r		6.17%	6.58%	4.83%	4.85%
Real GDP Growth %	GDP		1.10%	0.97%	2.00%	2.50%
Debt-to-GDP %	Debt/GDP	73.45%	78.73%	84.25%	87.13%	89.18%

CHART II

Redwood Scenario under Fiscal Framework		2022	2023	2024	2025	2026
Debt Variation %	v		4.2%	4.4%	1.8%	1.0%
Primary Deficit (% GDP)	p		-0.50%	0.00%	0.50%	1.00%
Real interest rate %	r		6.17%	6.58%	4.83%	4.85%
Real GDP Growth %	GDP		1.10%	0.97%	2.00%	2.50%
Debt-to-GDP %	Debt/GDP	73.45%	77.63%	81.99%	83.81%	84.78%
Official Scenario under Fiscal Framework			75.11%	76.17%	76.43%	7654%

General Government Gross Debt (DBGG) - % GDP



Source: Min. da Fazenda - Brasil; Redwood Forecast | Elaborated by Redwood

The Brazil risk, priced by the 5-year CDS, changed little and its level of 226.13 points against 230.82 points last month shows valuable stability, while the Dollar, in the opposite direction, fell to BRL 5.08 from 5.2078 in April, a -2.45% change. It closed practically near the month's bottom figure, at BRL 5.0711, after having reached a peak at BRL 5.3316.

The summary for interest rates, foreign exchange and the stock market – in our assessment – is that the former will remain running high, the US currency with some support and the stock market, greatly impacted by high interest rates.

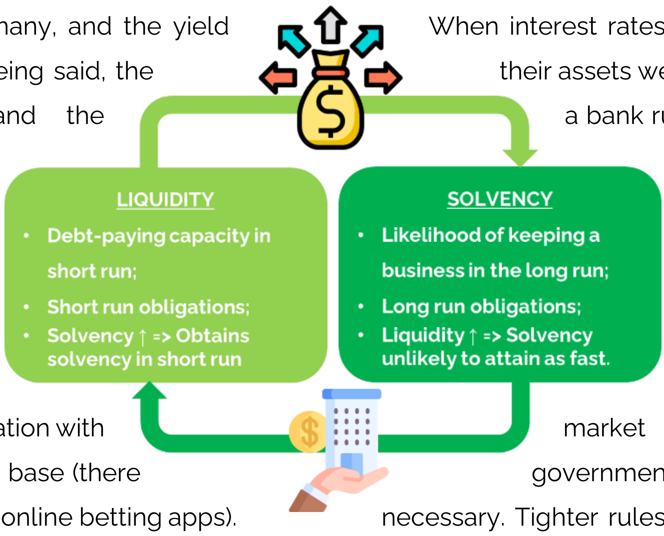
In the economy, this year's contraction is already being felt – however, nothing far from what was expected and, therefore, no surprises around here. Market-set credit operations fell sharply, as expected due to the tightening of interest rates and also the additional effects of the Americanas event and the collapse of US banks – all of which in some way impacted this segment. The cut in manufacturing output is also in line with the slowdown of activity, not to mention the fact that unemployment rose to 8.6%. The fact is that it is not about expensive credit, its scarcity, high interest rates or pressure on prices – all that matters, of course – but, originally, especially for this period of "honeymoon" at the outset of a new administration, it is about better performance in economic policy, with less shouting and frenzy, with unswerving focus and objectivity on problems and their solutions.

In Monetary Policy, RCN remains as the "scapegoat" – yes, the culprit has already been selected if everything goes wrong in the economy. But BACEN counters the criticism with professionalism, technicality and a lot of transparency in its decision-making process. It was like this recently in its March Quarterly Inflation Report (RTI). Thus, we believe that the Selic will remain at current levels for a long time, despite possibly lower inflation in the H2 2023. The presentation of the fiscal framework, as can be understood at this moment, has no chance of promoting any anticipated cuts of Selic, as mentioned above – the best hypothesis, in our opinion, will be some reduction in the last two COPOM meetings at the end of the year.

Regarding exchange rate policy, the BACEN seems not to change... and the praise stops here – everything else remains the same. With a net foreign exchange position at approximately USD 230 billion, the BACEN needs to protect this guarding wall that guarantees balance and resistance to external shocks – and they are likely to come, in the face of such troubled world nowadays. Depending on the new board members to be appointed by the Commander-in-Chief and the future replacement of RCN, these foreign reserves that brings us absolute security could be at risk.

On the fiscal side, the tables and graph above are intended to portray what has been presented to us thus far. Chart I reflects what we have projected in our macroeconomic scenario, while in Chart II we only replace our estimated primary balance with that described in the fiscal framework presented by the government. The other variables, GDP and Real Interest Rate, do not deviate from market estimates – which, of course, may undergo changes but let's be careful: the government can "induce" GDP growth, yes, but its "tools" are not that many, and the yield curve is out of its control. That being said, the comparisons seem honest, and the interpretations start from a few assumptions. The government says that there will be no increase in the tax burden or even new taxes, nor does it indicate sectors to be burdened and relieved – perhaps an optimization with a broadening of the tax collection base (there is talk of taxing apps like Uber and online betting apps). Revenues from privatizations? Forget about them. Spending cuts directly? No way, as proposed, we will always have an increase in expenses – in fact, now we will have a Spending Floor. Expenses always depend on revenue, and this, in turn, is a function of economic activity, which everyone knows is in a process of contraction. It remains, however, and properly so, to collect from those who do not pay, but this seems insufficient and faces enormous difficulties in the political arena. Thus, the primary balance proposals are good, but they do not hold up. The proposed structure is also not good, because it does not attack the variable that can be controlled: expenses. The numbers just don't add up and, with the information we have available today, the gap is huge! What's more, there is nothing countercyclical about the plan. Finally, and unsurprisingly, the Debt-to-GDP ratio does not stabilize, much less reverts its trajectory as desired; in sum: it is all "wishful thinking". The government's assumptions do not seem to be anchored in reality, but it is important to highlight that what the government delivered is rigorously in line with its campaign promised. It is a setback and potential disaster for the country, but historically consistent with the PT's proposals.

Overseas, we witnessed the failure of US banks and the rescue of another in Europe. Connected or not to each other (correlation is not causation), these events forced central banks to "join forces" to tackle the problem immediately and "nip it in the bud". The case of Silicon Valley Bank (SVB) is not difficult to understand, as many banks bought long-term assets, but did not mark them to market. When interest rates went up, and they went up fast, their assets were worth much less and there was a bank run. The Fed, absolutely terrified of any systemic contagion, faced a solvency problem as a liquidity problem. Was the SVB collapse due to bad management? Yes. Lack of greater Fed supervision? Perhaps. Is there need for greater market regulation? No. However, governments believe that regulation is necessary. Tighter rules, more controls to strengthen the financial system. That is their mindset.



In Europe, in the midst of the economic and financial turmoil, the debate on its relationship with China is gaining strength, notably in trade and investment relations. The background, of course, is Xi Jinping's relationship with Vladimir Putin in the context of greater interaction in Russia's war with Ukraine. Diplomatic skill, in this case a determining factor, would be better intermediated by the US, but there seems to be a lack of leadership, strength and political purpose at this moment.

In the US, former President Donald Trump was indicted by a New York grand jury led by District Attorney Alvin Bragg. It couldn't be better for his presidential run... Trump knows this and will make the most of it.

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