MONTHLY STATEMENT

MAY 2023

Redwood

REDWOOD ASSET MANAGEMENT

Quo Vadis?
"Where are you going?" (free translation)
Christian Bible, John 16:5.

Five months into the new administration, a legitimate question is: who is found more frustrated, Lula or his electorate? Anyone with eyes can see that, on the one hand, the President 3.0 “has found out” that he commands little (and hustles a lot to get any management done) and, on the other, the people who can’t see anything moving forward. The matrix of confusion established is so large and associated with petismo’s recalcitrant vices, that the sun refuses to shine at all for for the new government. Nothing works. The Commander-in-Chief's political verve is not the same, and in choosing his team to make up the so called *broad front of democracy*, the cognitive immunity of most of the members prevails. A disaster, most of his agenda in the National Congress (NC) prospers in the dark, with numerous important setbacks. Things are not going well, we need to brace for the impact.

With a sulky and ill-mannered President, we are headed towards a sequence of perverse and disfigured policies that the country really needs. The slouching agenda, oblique by all segments of the public policies covered, imposed counterproductive pressure on everything under construction. Insidious measures tend to annul technical and well-structured processes, drive away and demonize those who conceived them, and vandalize organizations and institutions. The Central Bank no longer has the “privilege” of being the preferred target, but a wide and extensive range of sectors, with foreign policy being a special highlight, with events and attitudes that deeply embarrass us, such as the attempt to mediate the Russia-Ukraine war and the reception and praise of Nicolás Maduro in Brazil.

The agony and the ecstasy live side by side in these early days of this new administration - which feels already quite old to us. It pays off to remember that a lie told a thousand times is still a lie, and it is not another “narrative” or a “counternarrative” that will change the fact, but our President seems to think so. It is an attempt to hijack our brains, but only the unattentive fall for that. This is why we endure enormous agony when outlandish ideas and statements in their defense appear, and a total ecstasy when common sense and rationality prevail. National Congress (NC) has done heavy-lifting in this respect, not least because of vested interests.

These flagrant defeats of the Executive in the NC, due to its disorganization and lacK of unity, also encounters ideological resistance and a some “esprit de corps” (especially from the so-called Centrão). The alternative route has been to find a “base” on the Judiciary branch, with greater approximation to some Supreme Court Justices that “sympathize” with the government, and the appointment of “comrades” for open job slots. Legitimate, and it does not deviate from what we have seen and will see more in appointments to CB’s board. This seems to be the main guideline wherever it is possible to change organizations and institutions – inside and outside the country (see Dilma Rousseff's nomination to chair the BRICS bank - NDB).

This *modus operandus* – notably the referred-to misguided agenda and “inappropriate” indications –, however, tends to come at a price - as a rule, very high. In this line, the country's image – so lacking in a strong recovery – is damaged. The consequences are far-reaching and range from legal uncertainty to distrust in the country's transparency and governance, increased risk and the perception of corruption. This is the perfect binge for a long, disastrous hangover. However, the Commander-in-Chief does not show major concerns, but instead delivers what he promised during the campaign – he is at least coherent with his voters and faithful to his government plan. This is commendable, an achievement of our democracy and pedagogical for all of us Brazilians. But is this the attitude that reality demands?

It doesn't seem to us that if asked "Where are you going?", our president would regain the “strength and courage” of yesteryear and face his true challenges, no. His paths are different, his purpose – the one he has always envisaged – is quite different from what we need.

In financial markets, the saying "sell in May and go away" was not the keynote this year. Far from wonderful, the good prospects now with the approval of the new fiscal framework and some evaluation of certain "calm" in the FED (both of which we diverge from) promoted a more "favorable" environment in the markets. Internal and external factors were, in May, reducing uncertainty, giving pace to local markets, especially in the evaluation of large players. The political blunders mentioned above cost little that month, notably because short-term actions (such as reducing fuel prices) brought about a reduction in inflation this year, with a consequent impact on the potential reduction of the Selic and the yield curve. The market always reacts and exaggerates in the short term, but little by little it signals and corrects the course of action.

In this line, the Ibovespa returned to the upside this month, and ended May with an important advance of 3.74%, reaching 108,335 points, thus reducing its weak performance in 2023 to mere -1.28%. A significant improvement, but one that will depend on an environment with increasingly low interest rates, which do not seem reasonable to us in the coming months. In this segment, the yield curve also corroborates the performance of stock markets and was adjusted with drops along the entire curve. Thus, the shorter DI fluctuated from 13.295% to 13.225%, the one maturing in 2025 fell from 12.070% to 11.520% and for 2031, a greater contraction (12.32% to 11.54 %). Larger cuts in the long term clearly signal greater confidence that the fiscal policy will not place public debt unmanageable and, in our opinion, only after a consistent decrease in interest rates in the long term will the CB be able to think about loosening its interest rate policy in the short term.

As for the Brazil risk, priced by the 5-year CDS, the market saw a new reduction, in line with what was said above, closing the month at 212.33 points – a near 4% drop within the month. On the contrary, however, the Dollar advanced to BRL 5.0959, with an increase of 1.9%, frustrating expectations of a greater appreciation of the Brazilian currency at around BRL 4.85 – which would be very much in line with the other identified movements of markets. Quite provocative! This is a sign of the observed "optimistic" movements.

In the economy, GDP numbers for the 1st QTR/23 were exceptional, much better than our forecasts. The data released, however, show exactly the sector that stood out: always Agriculture! With a resounding 18.8% change, a real source of pride for Brazil, it completely changed the outlook for this quarter. This result triggered, in the market, numerous revisions to the performance forecast in 2023, with several analysts revising the 2023 GDP to above 2%. Unfortunately, our first calculations do not point to such a revision, even though we may end up with 1.5% to 1.7% this year. It is significantly higher than our 1.21% and much higher than the big banks projected for 2023 at the beginning of the year. Our perspective is that there is a positive "contamination" of this Agro result, but a limited one due to this growth not being structural. On the Demand side, the numbers also do not endorse greater advances, in particular the gross investment figure – an indicator of "hiring" or not future activity. The news is, luckily, excellent, because we will be able to grow at potential or maybe a little more. The unemployment rate decline to 8.5% (PNAD - QTR mobile APR), which also helps the market to forecast better GDP numbers.

GDP GROWTH (QTR on QTR / YEAR)

	Agriculture - total	Manufacturing - total	Services - total		
1st QTR 23 - SUPPLY	18.80%	1.90%	2.90%		

	Household consumption	Government consumption	GFFC	Export	Import
1st QTR 23 - DEMAND	3.50%	1.20%	0.80%	7.00%	2.20%

	1st QTR./23		2nd QTR./23	3rd QTR./23	4th QTR./23	2023
	Observed	Projected	Projected	Projected	Projected	Projected
GDP (QTR on QTR / YEAR)	4.00%	2.35%	0.75%	0.50%	1.32%	1.21%

Source: IBGE; Redwood Proj. | Elaborated by Redwood

In Monetary Policy, it is possible that the CB takes into (greater) consideration the GDP results. There may be a disinflationary aspect (supply shock?) in the assessment that the Supply side advanced, especially in relative terms, much more than the Demand side – even though seasonality matters a lot here. In any case, we do not believe in a change in the direction of the monetary authority's policy stance, because the signs of reduction in inflation this year and the next ones are still well above the (unanchored) targets, and thus we maintain our expectations of Selic cuts only in the last two meetings of the 2023 COPOM. The chairman RCN has sent very harsh "messages" to his verbose executioners, who insist on the lowering-interest-rates-by-force rhetoric.

In the exchange rate policy, CB keeps one eye on the tighter financial conditions of the more developed economies, while the other rests on our domestic conditions that can promote capital outflows from the country and, with that, exchange rate devaluation (with inflationary hikes). Still far from any perspective of more significant external shocks, our reserves are a little smaller (net foreign exchange position of USD 226.4 billion), but still very comfortable to withstand any events ahead. Another positive point for CB is the progress in the new regulatory phase of the new 2021 foreign exchange law. Improving the mechanism by further simplifying access to data is the right path!

Source: Russian News Agency (Tass); Various Brazilian-based websites

On the fiscal side, what really matters are the fiscal framework (and how to carry it out as intended) and tax reform. Minister Haddad has been working hard as far as his (and his team's) (economic) prospects allow him to, but the government's clumsiness hinders any solid advance. The sole focus today is on optimizing resources, eliminating subsidies and revenue losses. Any truth to that? No! The government comes with the program "New popular car"… it takes away focus and resources and signals very badly what the true convictions are and the alignment to the other executive´s departments. The General Government Gross Debt reached BRL 7.5 trillion in April/23, a marginal increase of 0.2% compared to March/23, when it registered 73% of GDP. Our estimates indicate that we will reach the end of 2023 with a Debt-to-GDP ratio of 77.8%. This projection, although higher, does not deviate from the projections of the main market analysts and the FOCUS bulletin, while also reflecting the "extra-effort" of the government working on the edge.

Overseas, the possibility of a US debt default took center stage in global markets. As we commented earlier, this would never be feasible and any attempt at "arbitraging" or "negotiating" with this hard fact was a low-hanging fruit. There are so many consequences on all sides and for everyone that a default of this nature would be catastrophic, especially for the moment. After the "scare", markets will return to their "normal" status. Still in the US, all throughout the month people took for granted that the FED would pause its monetary tightening towards the end of the month. Our rationale goes as follows: the interest rate range is currently set between 5.0% and 5.25% and, as a rule, steps up and down in 0.25% shifts. We believe that we could see the FED hiking rates to 6%, with a floor at 5.5%, the likely figure at 5.75% and a ceiling at 6%. In sum: we will have at least two more 0.25% hikes. Even if interest rates remain unaltered at the next meeting, which seems unlikely to us, it will hardly mean the end of the monetary tightening cycle.

In Europe, the course of things will not be different, and we believe that the ECB will continue to raise interest rates, despite the annual CPI of the Euro Zone (EZ) having lost momentum to 6.1% (compared to 7% in April), while core measures are still under pressure. The unemployment rate in the EZ fell to 6.5% in April and economic contractions punish several places in the region. In China, PMIs point to economic recovery, but at a slower pace. Whether due to an eventual confrontation with Taiwan or the Russia-Ukraine War, China is preparing for the "worst-case scenario". As for the Russia-Ukraine War, the Kremlin placed conditions for a cease fire… it was sheer lip service. What a shame!

DISCLAIMER

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