MONTHLY STATEMENT

JULY 2023

Redwood

REDWOOD ASSET MANAGEMENT

"I hate manure".

Biff Tannen – Back to the future (movie trilogy)

One who wishes to relive the past and ignores the present is bound to miss the future. However, this is what we have seen from the federal government, especially led by the the Commander-in-Chief 's short-sighted view of the current world. There are countless projects resurrected in anodyne actions whose reflexes demand an environment that is no longer there. Such an unparalleled folly could only come from those who want to enjoy at the expense of what once was, using wordplay, glittering generalities and momentous (d)effects against what has been achieved in the last four years. Faced with a man who demonstrates low *oxytocin*, the admnistration's hard core follows principle and sets the tone.

If the country looks like it is in political shambles, where in the combinatorial space of "coalition management" they agree in the abstract and diverge in the concrete, all sorts of decisions, violations and excesses tend to prevail. For a number of reasons, the focus is on exorcising any plans or ideas that are unrelated or unconnected to the prevailing ideology. It is a fight against the "dictatorship of ideas", to abhor the convergent, and to impose what is considered more democratic. To this end, we intend to rescue names (in outright reverie, it would be important not to even remember!) such as Marcio Pochmann and Guido Mantega, whose performances in previous terms in government speak for themselves. Thus, the country continues in a frank fraying and a bleak political future, mainly due to the polarization that the opposition itself foments and is unable to extricate itself. In this sense, we have a long way to go and chaos will rage on.

All projects and actions will be back

- ***New PAC: Check***
- ***More Doctors: Check***
- ***Industry incentive: Check***
- ***Subsidized loans: Check***
- ***Minha Casa Minha Vida: Check***
- ***FGTS Release: Check***
- ***Infrastructure investments: Check***
- ***Debt Relief: Check***
- ***Higher indebtedness: Check***
- ***New state-owned enterprises/reversal of privatizations: Check***
- ***Quid pro quo: Check***
- ***Use of State-owned Banks: Check***
- ***Media Control: Check***
- ***Witch hunt: Check***
- ***Environmental agenda: Check***
- ***Public sector job creation: Check***
- ***Support for LATAM dictatorships: Check***

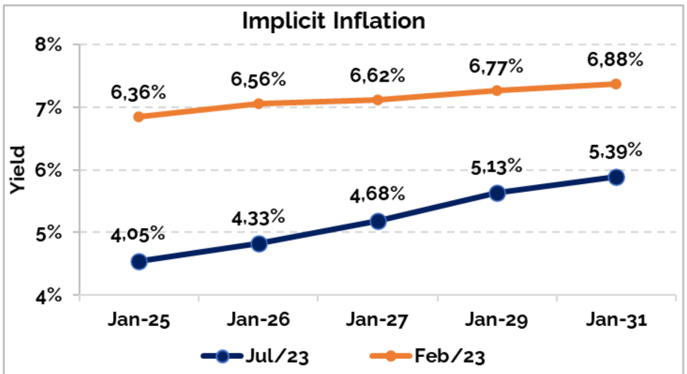
The scenario outlined above is not consistent with good and lasting prospects for the real economy, quite the contrary. In fact, markets can decouple from the country's factual reality, and even take time for one and the other to adjust – but they adjust. Furthermore, wanting to relive past actions (notably without adjustments) brings the various possibilities of arbitration, which market players are grateful for, but the people, as a rule, always after the fact, are not. It is evil dressed up as a good narrative. The table below lists several projects and actions that were good, bad and irreparably bad, but all, without exception, require adjustments, if not be thrown in the trash. This does not mean that, in order to judge the "morality" of one or another action, one must relive them – which is nonsense. But that's how we go, and in addition to the projects and actions "back to the future", we move forward with criticism and outrage aimed at the obvious, in an anomaly that not only stalls the country, but also subjects it to ever-lasting risks of institutional setbacks.

As a reflection of politics, the economic playing field will also suffer despite CB's policy. Yes, it is necessary to recognize that the high interest rate policy – launched by the last administration -, with a transmission mechanism ranging from 12 to 18 months, will be "responsible" for bringing inflation to the target (without considering greater fuss in the fiscal front) , but will also account for the country's economic downturn. Along these lines, a more "plural" COPOM is already under way, whose new, more heterodox members will soon form a majority. Politically, that is to say: lower basic interest rates to start growth, and with that, government-controlled banks will immediately be able to encourage credit. In fact, the model is also the same one pursued in the past, that is, increase consumption with the aid of state-owned banks and increase government spending. It is the entrepreneurial State, nothing new. However, in an environment that does not resemble the Lula government 1.0 or 2.0, the price of recklessness here can be fatal. For the gang, it's worth the risk!

The attempt to speed up the "Brazil automobile" to "rebuild" the Brazilian State capacities with inappropriate measures from the past, at the same time that it slows down by pursuing institutional advances, will lead to a collision (as happened with the character Biff Tannen) against a truck full of manure. It is poor-quality policy that makes Brazil what it is, eternally skidding in a limbo that does not fit the country's history.

In financial markets, volatility stole the scene this month. Expectations, especially in relation to CB's decision to cut the Selic more incisively (with consequences for the Ibovespa), the good performance of stock exchanges around the world, the rise in Brazil's credit rating (and its effects on the Dollar and the CDS), scored on the positive side. On the other hand, politics continues to get in the way and raise doubts, whether due to the probable reform of cabinet, of departments and companies under government influence, or due to the relationship with the National Congress and progress in important agendas to be approved. In any case, pricing was still favorable for assets in general.

Along these lines, the Ibovespa presented another positive performance, although falling short of that of June. It ended the month at 121,943 points, accounting for a 3.27% change in the month and 11.13% within the year 2023. In the yield curve, the scenario was no different. The shortest DI fluctuated from 12.85% to 12.585, the one maturing 2025 came down from 10.745% to 10.615, and for 2031, it rose from 10.59% to 10.75%. Our highlights for a sharper drop in the shorter part of the curve were confirmed, for the reasons presented in this space and also in our last *Macroeconomic Scenarios*.



Source: B3; Selic | Elaborated by Redwood

The reflections do not stop there, as the Brazil risk, priced by the 5-year CDS, also recorded a further drop, closing the month at 165.15 points, that is, approximately -6% or almost 11 points. Likewise, the Dollar, which had already "aligned" itself last month, this time followed the expected route and also depreciated 1.61% in the month, reaching the BRL 4.7415 mark at closure, but with an intra-month peak at BRL 4.9183. The Real gained more than 9% within the year so far.

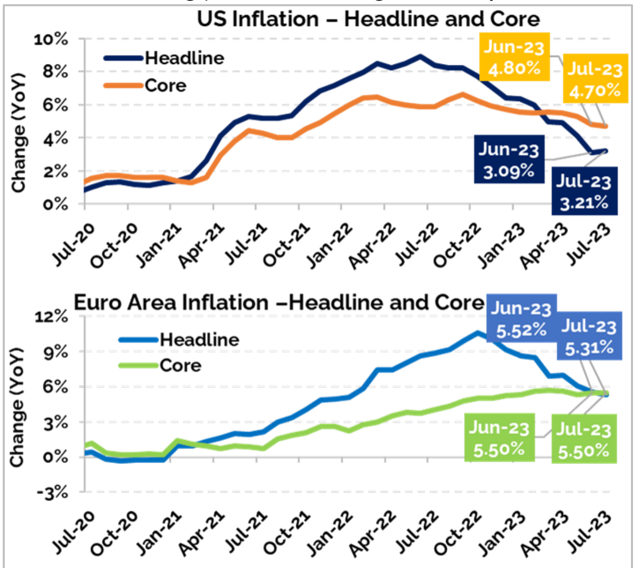
The summary for the financial market does not differ from our position, expressed last month, and the time has come for portfolio reassessment and eventual repositioning in view of each one's risk appetite. However, we (still!) want to encourage a very cautious optimism here, with careful allocations, liquidity in mind and flexibility for adjustments for those who need it.

In the economy, unfortunately, optimism is waning. Although several important analysts have recently increased their estimates for the Brazilian GDP, we maintain our expectations for economic activity, that is, Brazil will grow near its potential GDP this year, and short of that in 2024. Despite the beginning of the cycle interest rate cuts, even with all the government-led stimulus, we do not estimate large credit growth this year. Progress is also still very timid in Gross Formation of Fixed Capital (*GFFC*), the true economic performance lead indicator. On the other hand, the labor market shows reasonable resilience. According to the Continuous PNAD, the unemployment rate in the country dropped to 8% in the quarter ending in JUN/23, the lowest rate since 2014, when it reached 6.9%. Unfortunately, the growth of informality stands out as the end result.

In Monetary Policy, the beginning of the interest rate cut cycle was not the issue (contrary to our assessment), but the size of the cut and the future pace of others. Cutting 0.25% would not be a problem, but anything above that would be considered daring and an affront to the majority market expectations. The chart on the side clearly shows the reduction in implicit inflation in the year, but it also firmly points out that we are not completely "safe". CB cannot "flirt" now, and whatever its decision going forward, despite the current more heterodox composition of the COPOM, it will need a very blunt explanation. With an inflation target of 3% and its projections of 3.4% for 2024 and 3% for 2025, it is possible that its "implicit target" is slightly higher than defined. The anchoring of inflation is not "guaranteed", and the deadline for the good work to be carried out may expire with most of the replacements of CB Directors – nothing guarantees us that COPOM's technical profile will continue; nothing at all.

In exchange rate policy, the new Monetary Policy director (the most important department), Gabriel Galípolo, will also coordinate this area, where CB, in our assessment, is an eternal interventionist. Galípolo will manage exchange rate policy instruments, including FX and interest rate dealer desks, with operations of bond auctions and exchange rate swaps regulating the markets. Expectations are high here, and we hope our constant criticism doesn't turn into a "we were happy and took it for granted". Once again, our expectations for the exchange rate can be better understood in our study *Macroeconomic Scenarios*.

On the fiscal front, the definitive approvals of the fiscal framework and the tax reform are highly expected. The 2024 budget, under new perspectives, will require significant cuts to meet the actions and programs of the presidential cabinet. With ever-shrinking fiscal space, and ever-increasing political demands, the budget (which has always been a "fictional piece"!) will need constant adjustment. With the tone and posture of both the executive and legislative branches, under the auspices of the goals set by the fiscal framework (in terms of audacious goals), the government will have to raise more than BRL 100 billion to neutralize the deficit in 2024, that is, nearly +1% of GDP. This figure corresponds to the additional revenue value already expected for this year (to be repeated in 2024). Another point of extreme distrust is that the GDP growth forecasts for 2024 by the government are at 2.3%, at least 1 percentage point above our projections, which results in a significantly higher revenue collection and, for us, absolutely unrealistic. For 2023, the story seems to have already been "told" and we know the future, as the target of deficit at -0.5% of GDP expects a fiscal gap at least twice as large. Now or in the future, the challenge of balancing the books is gigantic and, for that, several revenue raising projects will need to "pass" in the National Congress, such as: change in the taxation of exclusive funds and Allowance for Corporate Equity (ACE), taxing offshore funds, etc. In other words, a joint effort will be necessary, contrary to what is seen today, that is, a sincere effort by the government combined with the National Congress to curb expenses and advance in sponsoring increases in the tax burden. It seems easier to call Marty McFly a "chicken" and get around his reactions.



Source: Fred St. Louis; Trading Economics; Investing.com
Elaborated by Redwood. (Proj. Jul/23 - Trading economics / Investing.com)

Overseas, markets in several developed countries reacted well, economic signs improved slightly, but the general picture still remains quite worrying. In Europe, after months of stagnation, the economy grew modestly at 0.3% Q2 on Q1 2023, although Ireland has pushed upwards, masking the result which, without it, would have been much smaller. In Russia, politically Putin "controlled" the Wagner Group episode, but he continues to be increasingly isolated and fragile. In any case, he tries to get closer to some heads of State, and he agreed to visit Turkey amid tensions over the stalling Black Sea grain agreement. In China, its economic stimulus policy is intensified and the pressure on local governments to accelerate infrastructure spending is high. Structural changes in the real estate market negatively impact GDP, and this is related to demographics and slower rural-to-urban migration. Also, the Chinese ministry of foreign affairs said that it will protect its companies in the Xinjiang region, after the US accusation of forced labor – a stress that can be harmful to trade rules and the stability of the supply chain, which is under tests of normalization. Definitely a bad fix.

In the field of economic policy, the picture above leaves no doubt as to how (very) far we are from starting monetary easing. Also, we had the US credit rate downgrade by Fitch... it would be comical if it weren't bizarre. The 2008 crisis indelibly marked the quality of credit-rating agencies. This one, in particular, is the same one declaring that the yield curve control policy (more flexible) does not harm Japan's rating and will be positive for its banks. Go figure. Better not comment.

DISCLAIMER

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