MONTHLY STATEMENT

SEPTEMBER 2023

Redwood

REDWOOD ASSET MANAGEMENT

"Your Honors are the most hated people in this country."
Sebastião Coelho – retired Superior Court justice addressing the Supreme Court (STF)

It is challenging to make sense so many strange things happening in the country, but some people have not only the courage, but also the detachment to state loud and clear what is going on in Brazil. Despite the indifference of many, the return of *Magdalenian* period type of thinking combined with a toxic moral anesthesia, confuses, disorients and discourages. Reason is nowhere to be found and questioning the reigning ideology is taken as insult and fake news. In just nine months, the administration's true identity was born, parading vices, hypocrisy and ingratitude. Love did not win; long before, hate – a poisonous feeling – brings harmful disorder of all kinds. Although democratically chosen, leaders act as if taken by the blindness epidemic of Saramago's essay: sick and wrong-headed. This administration should have an ICD (International Classification of Diseases).

The crawling legitimacy of Lula 3 is obvious and real; we are celebrating mediocrities in several areas, as the focus is to impose itself and oppose everything that preceded it. The intention of the warriors of the Brazilian people is not only to look like champions of honesty and fairness, but rather to annihilate the ideas and perspectives of their adversaries, or rather, enemies. Anyone who is not together must be cancelled. Mensalão, Petrolão and other anti-republican schemes are just inventions of a reactionary and oppressive right. What is left is the scathing sagacity of not sparing anyone to, at most, speak thinly in the face of whistleblowing about wrongdoings during his tenure.

"Wrong!"

Photo posted on social media by Minister Paulo Pimenta

Separatists from the truth, this legion that governs us must feel exhausted for being so morally superior. But, ironically, the effects of this intolerable policy of witch hunts and persecution do not hide the infinite shades of red of a pre-announced tragedy. Intoxicated by an amount of power that falls short of what they had in the past, they lack intellectual sobriety to compete with the other branches of the republic. The road taken is one of confrontation, collision and chaos. The PT seems to hate Brazil, but the good news is that the psychotropic effects that lull the cabinet will not prosper in the population.

But what is a diabolical business, if unaccompanied by good statements and longevity combined with the wrong way of doing it? "*Our priorities are to fight hunger, create jobs and keep the economy in balance*." (Rep. Zeca Dirceu) and "*... there is already a complaint that we will need five Lula terms to complete the agrarian reform process.*" (National Coordinator of the MST, João Paulo Rodrigues). Those who believe that the few positive reactions of the economy are due to this short period of government are deluded, no. We need to look ahead, at expectations, and see what today's actions promise us for the future. The decoupling of politics from the economy is not effective, and in the medium-to-long term they are quite correlated. In our case, the political and economic conduct is wrong. However, our "scary" agendas are not just under the Executive. In fact, as we always comment, our Institutions do not function properly – and we cannot blame it on being a "young democracy". There is a conflict over who should lead certain issues, such as new oil reserves, indigenous reserves and abortion. Legislative or Judiciary? The truth is that Brazil has increasingly weaker institutional capital.

The entire project slows Brazil down, but the economic conduct stands out and, in this particular, the issue of the fiscal framework is quite troubling. Even the stones know that the goal of zero deficit in 2024 is nonsense and, because of this, wild ideas return to the negotiation table. The theme chosen now was Court-mandated debts. In the last administration we had a "default" (a BRL 200 billion ride), and now they want a "embezzelment" - to segregate the main interest and principal, classified as financial and primary expenses, respectively. All because we need fiscal space.

Ultimately, we cannot continue lying to ourselves and perhaps Judge Sebastião Coelho's assessment should be broader, not restricted to the STF. It's wrong all around! The way out is through reaction and indignation in civic demonstrations. Other than that, we will be raising the Pinocchio Trophy.

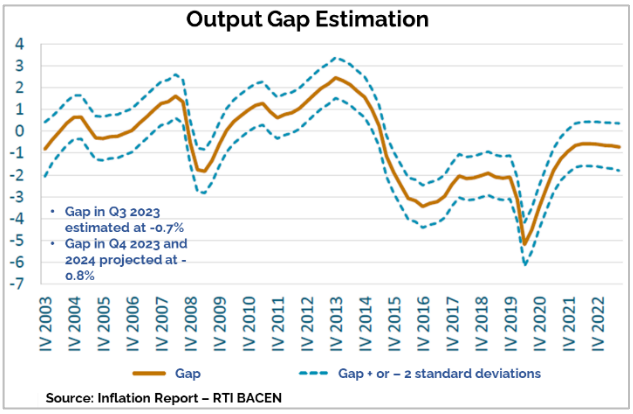
In the financial market, the month of September brought up more reasons for skepticism. There were several highlights that, together, at least alienated the most eager crowd, such as the uncertainty regarding the cycle of Selic cuts, the Central government's deficit and doubts regarding the accounting of Court-mandated debts and the loss of revenue. Bad winds from abroad come from the situation in China, whose government now promises a strong expansion of macroeconomic control to boost the economy, and the FED signaling high rates for longer (perhaps new increases, as we believe!), harming markets around the world. Amid all this, scaring away investors, our political-institutional situation (discussed above) once and for all undermines any trace of interest in taking risks in the country.

Along these lines, the Ibovespa made little progress this month (+0.71%), and closed at 116,565 points, which led to an annual cumulative return of 6.22%. In the yield curve, with the difficult but somewhat more predictable scenario, our perspectives have been confirmed. The shortest DI fluctuated from 12.395% to 12.24%, the one maturing in 2025 went from 10.545% to 10.84%, and for 2031, it rose from 11.12% to 11.57%. More of the same: downward shift for shorter lengths and positive variation in the longer contracts, thus reinforcing inflation (lower) and fiscal (more difficult) assessments for the short and long segments of the curve, respectively.

As for the Brazil risk, priced by the 5-year CDS, a significant advance was observed, closing the month at 187.81 points, at approximately 11% or 18.70 points. In the same vein, the Dollar hiked 1.74%, but strong here (also) possibly due to global movements. It closed the month at BRL 5.0076, but still with an annualized drop near 4.03% – our latest estimates pointed to a Dollar being worth around BRL 5.00 at the end of 2023, in scenarios without any additional stress, locally or internationally – quite the contrary.

The Brazilian financial market, therefore, continues to be under extreme attention, not only due to the lack of soundness and mastery of a structured economic plan – which could point to a favorable economic cycle –, but also due to the more difficult international landscape. The window of opportunities, notably in the variable income segment with companies that can benefit from lower interest rates (more sensitive), is still an asymmetric risk profile. Despite this, for those with an appetite for risk and necessarily aware of the possible long waiting period (two to three years, e.g.), it is advisable to reevaluate portfolio positions – always adjusted to the risk profile, the need and the possibility of these allocations.

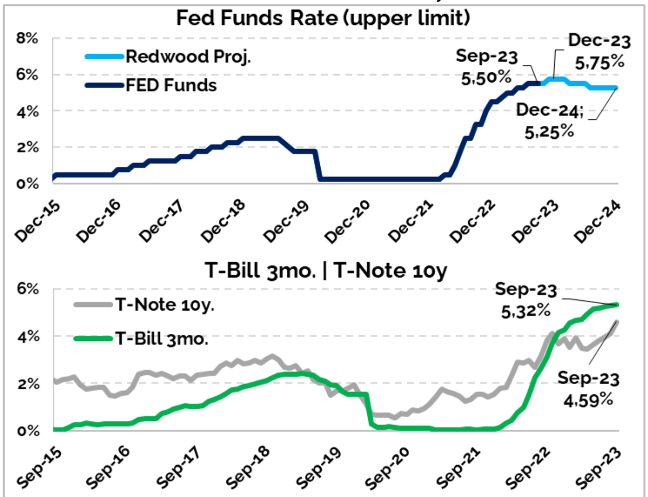
In the economy, the market's repeated reassessments of GDP projections have drawn attention. More than that, in the table on the side provided by RTI BACEN this month, data was expected to show a much narrower gap, like the one we have as well as several important houses. While this may explain systematic advances, these estimates do not seem to hold up. With the history and its adjustments, stagnant productivity, growing real wages, unemployment rates at current levels and the advancement of activity with a "stable" Potential GDP growth, the gap should necessarily be smaller. In fact, BACEN reduced its estimate of the output gap, but for us, it has already closed. From these perspectives, growing more with less inflation – even in the medium term – requires reevaluations of unobservable variables (neutral interest rate, NAIRU, etc.) ... or we will soon adjust to re-enter a "scientifically" acceptable route.



Source: Inflation Report – RTI BACEN

In Monetary Policy, with the easing cycle having begun (defined rhythm and intensity: at each meeting a 0.5 p.p- Selic cut), chairman RCN makes a point by repeating that "*the Selic rate needs to remain at a still contractionary level to achieve the inflation target*". This is because for the relevant monetary policy horizon, 2024 (more) and 2025 (less), inflation falls outside the target's central band. Thus, the market expects a Selic rate of 11.75% in 2023 and 9% in 2024 to continue fighting inflation, and this de-anchoring is also based on the prospect of primary deficits and higher spending in the coming years.

As for Exchange Rate Policy, BACEN follows its convictions and *modus operandi*. The transparency for its endless interventions, for obvious reasons, does not follow a standard or has explicit limits and intervals – one fears, at the very least, of some arbitrage taking place. There are controversies. What we can see is that for BACEN it is necessary to have a floating range for foreign reserves, in order to smooth market movements (and possible attacks) – but this is not specified today and at any time we can have different views of this policy and driving. Therefore, the best thing would be – even while BACEN is independent and without the possible "ideological" shifts with the replacement of its Directors – to establish a path on which current informal practice is "mixed" with a more "free regime" of foreign exchange trading. This is because it is necessary for us to move forward in this segment, as the exchange rate plays a very important role in the formation of expectations and there are no few variables that influence it (FED rates, our fiscal stance, Brazil x USA interest differential, etc.), and still have BACEN's interference does not in fact help to clearly identify changes in levels (structural or cyclical?) and thus promote a healthier environment for investors.



Source: Fred St. Louis | Elaborated by Redwood

On the fiscal side, Brazil has already made a lot of mistakes in the past by not giving adequate fiscal treatment to its finances. It was like this in practically all past economic plans, including Real, which, with an elegant conception, missed this point at the start and then had no way to readjust it. Paulo Guedes in the first years "fixed" this issue and advanced very well, but then "succumbed" to political appetites. Now, the liberal-democratic vision has been swept away from this government, and the new "methodology", widely criticized here, does not seem to hold and the obvious is increasingly difficult to hide. Controlling expenses is not an option, but raising taxes is. Several projects that promise increased revenues are about to be approved by the National Congress, but so far not much is being done, notably because it hurts the interests of numerous congressmen. This all means that frustrating Fiscal's expectations - with worsening beyond what is priced in the market (we do not believe that BACEN's premises will work with a zero-deficit target for 2024) - will end up impacting (not yet anchored) inflation expectations and, consequently, in Monetary Policy. This is where we think this should be the *beginning* of understanding the chances of success of an economic plan. It is that simple!

Overseas, the highlights are looming concerns about the energy crisis in Europe, notably triggered by the Russia-Ukraine War. Unlike last year's winter, this time the "support" and supplies from allied countries were cut down, and this situation may have repercussions across the planet, but certainly more acute in Europe. The shock waves of this likely scenario will impact several segments, and Russia will know how to take advantage by exacerbating these weaknesses to its own advantage. In any case, some relief came with the annual CPI slowing down in the Eurozone, overwhelming expectations. Thus, with an unemployment rate at a historic low of 6.4% (AUG), estimates that the ECB will cut its rates in Sep/24 are "confirmed", this is because leaders are not convinced of the sustained inflation rate trajectory towards the 2% target.

In China, the PMIs suggest that the growth stabilization is not yet widespread, and calculations sometimes made with large companies, sometimes with small ones, bring difficulties in interpretation amid "doubtful" information. In the USA, politics "throws the country into chaos" with the intensifying polarization of the Democratic and Republican parties and, as elsewhere, directly influences the economic-financial environment. The picture above leaves no doubt as to the political stress in markets, which contaminates the rest of the world. We reiterate, of course: FED will raise its interest rate. If they get the flu, we will catch pneumonia.

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Redwood

Avenida Brigadeiro Faria Lima, 3900 – 10° andar
São Paulo – SP | CEP 04538-132
+55 (11) 2172.2600
planner.com.br