MONTHLY STATEMENT

OCTOBER 2023

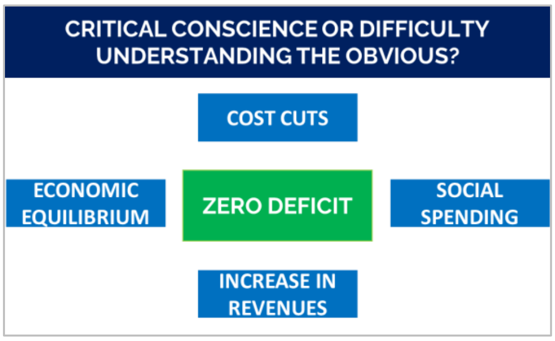
Redwood

REDWOOD ASSET MANAGEMENT

"We'll hardly achieve the zero public deficit goal in 2024."
Lula – President of Brazil

The President (PR) is faithful, concise and objective. Faithful to his promises, concise in his words and objective in his purposes. The direction and organization of things matter little, as the horde footmen disguised as advisors embrace a new directive and defend it with tooth and nail. The anatomy of the public-finance-control assassination was already set up and is called the New Fiscal Framework. We clearly went from having a ceiling to having a spending floor, but the Minister of Finance welcomed the difficult, but necessary, target of zero fiscal deficit. The PR, in the balance of his powers, aborted the strategy, annihilated the premises and buried the organization, albeit fragile, of Minister Haddad's leadership. The goal now is zero… credibility. Congratulations!

The PR's irresponsible stance and the Minister's shameful submission sealed the expectations that we have to deal with in the next three years. But this attitude is not far from what we saw with Paulo Guedes, who was "forced" to swallow many decisions made by his boss, causing him to lose a good part of his shiny team in the face of excesses and outrageous statements. Like his predecessor, now, for Haddad, humiliated by the current Commander-in-Chief, he lacked the moral strength to resign. Disgraced, he loses his dignity, expenditures will be "unleashed" and what Haddad says will not be taken at face value. It couldn't be any worse!



In addition to the shot in his own foot by the Chief Executive, making his main Minister absolutely weakened, the political relationship between the Executive and the Legislative does not deviate from this context either. With decreasing popularity and under siege by the National Congress, the PR finds itself in bad shape. Irrelevant or with little power, the "compromises" impose themselves and thus the eschatological management of public finances is established. We have already seen this film in the past, in the best style and with the consequences reaped in the years 2014 – 2016. In ten months of government, the signs are everywhere. The actions of this government are similar to the Hamas' skyborn crusaders, annihilating everything in their way and destroying dreams and chances for a better country. The government needs a Law-and-order-guarantee task force (GLO) on itself.

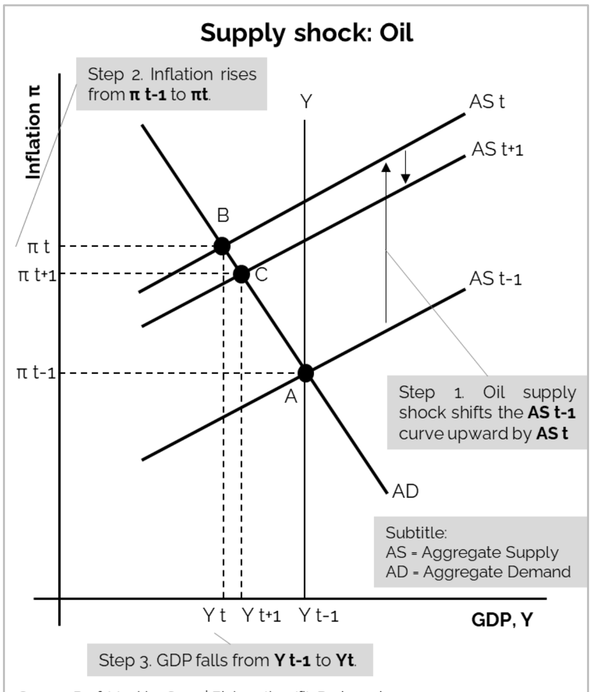
One should not, however, drift too far from the sovereign will of the people who elected them and their government program. The *woke bona fides* crowd must be happy, but the insanity of the *modus operandi* remains. More than that, even within the government, following the example of Minister Haddad – which does not necessarily have an in-depth knowledge of the economy – he understood the need for zero deficit and fought until the end when his boss said that he will not "...establish a fiscal target that forces me to start the year by cutting billions..." and that considers..."the market is too greedy...". Why did you let your Minister follow that line then? Is that a course correction from whom understands more and better, such as reflection and critical awareness or simply a difficulty in understanding the obvious? Maybe none of that, but just politics(king). Survival! Paths for his support in a coalition presidentialism, after all, out of the three branches of government, it is increasingly clear to the PR who is truly in charge... and that he has limited resources to change this reality, at least not in the short term.

Although divergent in the essence of their arguments, Nobel laureate in economics Joseph E. Stiglitz recalls a quote in a chapter of his book *The Great Divide* stating that "Low growth and inequality are political choices. We can choose otherwise." (Washington Monthly). Nothing could be more correct, but here we believe that economic and social balances are dissociated – or that one has priority over the other. Ultimately, a one-to-one correspondence is established. This is the current mindset, which will invariably result in low growth and high inequality – everything that people say they don't want.

The trap in which Brazil has fallen should come as no surprise to anyone. Its conduct is as illogical as it gets and is rooted in a DNA that is widely known and never hidden.

In the financial market, the month of October confirmed the predicted skepticism. However, of all the forecasts, such as the uncertainty regarding the cycle of Selic cuts, the Central government's deficit and the doubts regarding the accounting of Court-mandated debt (Precatório) and the revenue losses, the horizon became bleaker, and still without any impact for two additional reasons: the possible new primary fiscal balance goal and the terrorist attacks by Hamas in Israel. Both highly impactful to our economy... both together then, potentially a perfect storm.

Accordingly, the Ibovespa fell this month (2.94%), following the example of the main stock markets in the world, and closed at 113,144 points, which led to a meager 3.11% within-year accumulated return. As for the yield curve, in this difficult but once again predictable environment, our perspectives have been consecutively confirmed. The shortest DI fluctuated from 12.24% to 12.052%, the one maturing in 2025 went from 10.84% to 11.08%, and for 2031, it also rose from 11.57% to 11.77%. In sum: short contracts with negative variation and positive shifts for the longer segment of the curve, reflecting inflation (lower) and fiscal (more difficult) for the short and long stretches of the yield curve, respectively. It is quite possible, however, as has already occurred for the 2025 maturity this month, some stress on the shorter part of the curve given the new challenges mentioned above.



Source: Prof. Mankiw; Suno | Elaboration/fit: Redwood

As for the Brazil risk, priced by the 5-year CDS, there was reasonable stability compared to the other correlated variables, closing the month at 183.04 points, on top of the 187.81-point mark last month. The US Dollar, in turn, rose 1.00%, possibly for reasons related to global shifts. It closed the month at BRL5.0575, still registering an annual decline of 3.07%. For this and other projections of possible trajectories of the main economic-financial variables for the end of 2023 and 2024, updated, the study [Scenarios Q4 23] may be of reference.

In the economy, in line with a better GDP for this year, the unemployment rate also follows suit. According to PNAD, in the quarter ending in September, the unemployment rate was 7.7%, compared to 8.7% recorded in the same period last year. Average real income and usual real income rose by 4.2% and 5%, respectively. It is important to highlight the good performance, as it was the best unemployment rate for the quarters up to September, since 2014. This result points to two things: a very tight labor market and that we may be at the low limit. Yes, because applying the appropriate seasonal adjustments, the rate shows an inflection, going from 7.8 in the quarter up to August and going to 7.9% in September. Without question, this positive performance of the labor market is necessarily linked to better dynamics in economic activity. From this angle, as we project a lower GDP from now on, it reinforces our thesis that the job market is possibly tightened to its limit.

In Monetary Policy, attention turns to the fiscal and the complicated external geopolitical scenario and its possible and probable consequences. Regarding the escalation of the Hamas-Israel war, if so realized, the first and most immediate impact is shown on the table to the side. With strictly limited effects so far, notably due to prospects of lower global economic performance, this scenario could change quickly – although something like the crisis of the 1970s is not expected, as we are in a much better situation today. In any case, a possible oil shock will have impacts like those described in the graph and monetary policy will be urged to react. Much of what we expect today may have its perspectives changed and, with them, repercussions on the economy and investment portfolios. Total caution is advised!

Regarding exchange rate policy, the crisis scenario comes with successive shocks, but in this case we have enough reserves to face any bump ahead. Hopefully. For now, BACEN records (as of October 27th) a positive flow of approximately USD 2.0 billion, in a movement strongly influenced by the commercial channel (through the financial channel there was a net outflow). In truth, the crisis we are referring to has yet to set in (and hopefully will not come true), – both of fiscal and external origins –, but it is also a fact that the total currency inflow of the year could have affected the exchange rate with a Real more appreciated. In short, the current view is practically neutral, as the currency flows bring relief, but the drop in the Brazil-USA interest rate differential (carry-trade), the fiscal uncertain and the new war, could represent alerts for the BACEN (and, therefore, for investors), but nothing that takes it away from such never-ending "tactical interventions".

Fed funds rate vs Fed funds futures at different points in time

Source: John Cochrane – Blog: The Grumpy Economist

On the fiscal side, the change in the zero-deficit target, after the PR's positioning, is certain and has become a tug of war within the administration - with the Chief of Staff, Planning and Management ministries in clear opposition to the Treasury. With a gigantic gap in just ten months of government and prospects that are far from optimistic, we have said that even the stones knew the goal was unfeasible – but it was essential that helmsman Haddad always had it as his flag and purpose, for obvious reasons. Therefore, no more striking impacts are expected in the short term, although the deterioration of expectations will depend greatly on the damage control from this self-imposed imbroglio. Furthermore, Minister Haddad's political efforts in the National Congress to find ways to improve revenue collection will certainly suffer credibility setbacks. More expenses and frustration in fundraising and we have the perfect recipe for highlights in BACEN's risk balance. Any consequence? Higher inflation, higher interest rates and lower GDP. It will not be very easy, in this environment, for Brazil to continue financing itself at real rates (NTN-B) nearing 5% (attention investors!). It is clear that the episode worsened the perception of fiscal risk, and the Minister's discomfort with the PR – if he really remains in office – a workaround situation will have to be "orchestrated".

Around the world, all attention is focused on the Israel-Hamas war and, above all, on the (unfortunately) escalation of the conflict with the possible entry of other Arab countries from the region. The slowdown (in the future) of the main economies in the world is a fact, notably due to the monetary tightening to which they are subject (today), but this conflict in the Middle East has the potential to intensify this trend, if it spreads and/or intensifies and lasts for longer than expected. For now, the impact seems limited, but the assessment is that the commodity market (especially Oil) will change if the conflict spreads. It cannot be forgotten that the Russia-Ukraine war has demanded too much from the USA and its allies – and it seems impossible, economically, to "sustain" two wars of this magnitude simultaneously.

In China, news are not very encouraging and, once again, government aid to the economy is certain. The Industrial PMI fell to 49.5 and the Services PMI (although still above 50 points) fell from 51.7 to 50.6, both in October. Still in Asia, Japan appears to be increasingly abandoning the interest rate curve control policy, as BoJ statements now indicate the 1% JGB interest-rate ceiling as a "reference point".

In the Euro Zone, GDP was reasonably stable in Q3 23 compared to the previous quarter and the same quarter last year, -0.1% and +0.1%, respectively. Inflation slowed to 2.9% in October, but the core CPI rose – therefore, the ECB should only start its monetary easing from the Q2 24.

In the US, the political situation intensifies as the party primaries and presidential election year approach. For the economy, the most recent signals "all" point to interest-rate cuts by the FED, but the emphasis is on the end-rate of the cycle – higher for longer. This has an impact on the whole world. Hard times.

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