MONTHLY STATEMENT

NOVEMBER 2023

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REDWOOD ASSET MANAGEMENT

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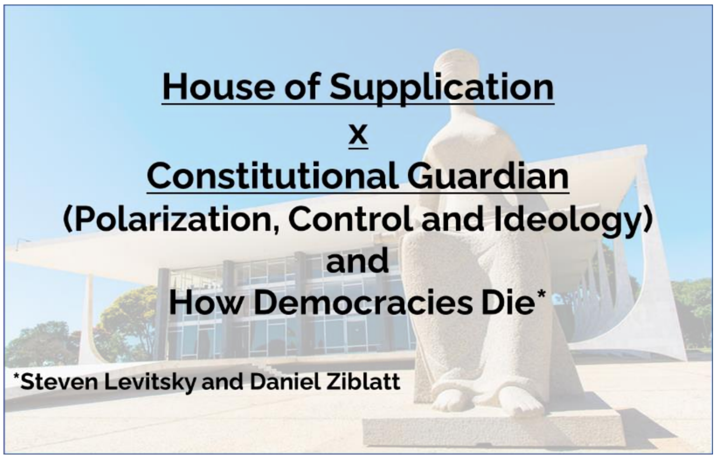
"The worst dictatorship is that of the Judiciary. There is no one to turn to against it."
Rui Barbosa – Brazilian Polymath

The Brazilian Federal Supreme Court (STF) has been the target of increasing and heavy criticism across society. No wonder, its excesses are notorious and widespread. Supreme "trolling", its Ministers seem to feel like demigods, quasi-crystals. As the nomination is a prerogative of the President of the Republic (and with the current political polarization), we have always seen names ranging from terribly evangelical names to private defenders. Merit and what is fundamentally required, notorious legal knowledge and an untarnished reputation, may even be present, but it certainly has not been the main characteristic for the nomination. In other words, notable legal knowledge has been systematically and savagely replaced by the influences of legal and political elites. And now, it's the turn of the communist "Avengers". From House of Supplication to Guardian of the Constitution, enthralled to politicization, control and ideology, our democracy is at risk.



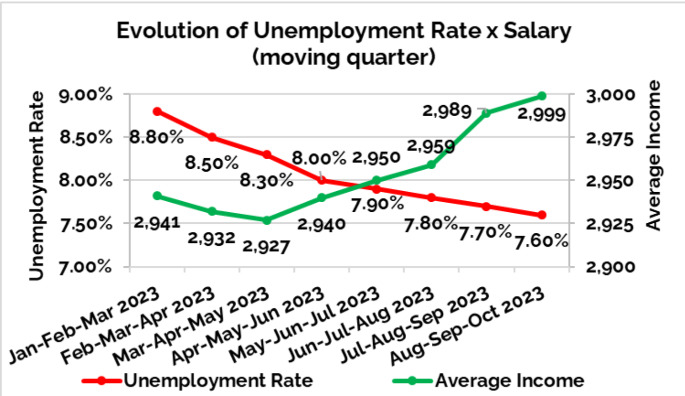
There is no doubt that the politicizing the Judiciary branch promotes legal uncertainty. It is also true that the choice of the future Minister will still go through a hearing in the Senate's Constitutional and Justice Committee (CCJ) and a vote in the plenary, but the hand-kissing "process" and secret meetings already predict its approval with more than the minimum necessary number of votes (41) . The reason? Simple, a man doesn't stray far from what he thinks and does, much less from his history – thus, being "the man" of the hour as well as the President's choice. In this way, will we really see a technical and impartial performance from the one who so vehemently defended his ideas for years? The doubt is not just for the current nomination, but in fact for almost everyone there. In fact, there are several appointed Ministers who are part of a conglomerate of cancer tumors and now we will only have one more to make up this metastasis that has become our Supreme Court. The country's major issues, including the necessary serenity and moderation in sensitive matters, do not seem to have a place with the current nomination.

However, perhaps there is a light at the end of the tunnel: it is a Constitutional Amendment (PEC) that restricts the monocratic decisions of the STF. Although far from truly changing the direction of how the Court has acted, the Legislative branch seems engaged in ending excesses, that is, if confirmed, for example, it will prohibit monocratic decisions by Ministers from suspending the effectiveness of laws. It would be a substantial change, but as everything is political and reaches various levels of the judiciary branch, the challenges are numerous and "smoothening" paths is already under way. It's a game of good cop and bad cop, of matching interests and where "concessions" rule. The risk is that this "offensive" comes too late, or the proper balance among branches is no longer achieved. This entire environment is very harmful to our society and also in the eyes of investors, notably foreign ones. A politicized, "apoplectic" Supreme Court that brings insecurity does not raise any appetite from foreign capital.

Our problems, however, go further. The project to tax exclusive and offshore funds went ahead and is now with the President – who obviously agrees, as the country desperately needs resources. It's truly a shot in the foot! It is not easy to find on the planet where measures of this nature have worked, even in the medium term – quite the contrary, there are countless cases of failure. In a country essentially dependent on savings, the effects of this measure simply accelerate decisions to leave the country. The immediate idea, especially identified by managers of large fortunes, is to change tax residence to non-resident. It is difficult to understand the reason: whether it is ideological, despair due to lack of fundraising or even ineptitude. Maybe a little of each, but with different weights.

The next 3 years will be quite long ones in Brazil.

In the financial market, heading towards the end of the year, several analysts are taking a short break to assess the government and project what to expect for the next 3 years. This diagnosis, not always easy, does not exactly seem like the most difficult task at this moment. This is because the Lula 3 government is increasingly looking like a mix of Lula 2 and Dilma, just look at how the little bit of common sense went from the first semester to the second. If even Minister Haddad managed to "help" at a certain point in defending the Fiscal, the rest of the entourage, always led by the Commander-in-Chief, plays against it. Thus, the net outcome is that populist speeches did more harm than good, an uncompromising defense of a growth-inducing State, and criticism against a market economy. If this continues, despite the "good" numbers based on other factors and lagged effects, the prospective view for the markets, economy and society as a whole is quite bleak.



Source: IBGE | Elaborated by Redwood

Along these lines, the Ibovespa advanced substantially this month (12.54%), along the lines of the main stock markets in the world, and closed at 127,331 points, which led to a cumulative annual rate of return at 16.04%. The market also did well in the yield curve, with drops across the entire interest structure. The shortest DI fluctuated from 12.052% to 11.886%, the one maturing in 2025 went from 11.08% to 10.32%, and for 2031, it also dropped from 11.77% to 10.77%. The highlights this month are the larger negative shifts for longer terms, an important adjustment that we expected a little further ahead with approval of the fiscal framework and maintenance of agreed-upon targets. After all, it is preferable to maintain the rules and make an extra effort to follow them than to make changes even before the game has started. In any case, interest rate cuts are in place and, despite the volatility, returns and capital gains are not negligible – it is worth reevaluating the portfolio.

As for the Brazil risk, priced by the 5-year CDS, this was an absolute positive surprise, even under the analysis of "external influences and interests". A significant 18.46% drop! It closed the month at 149.245 points, against 183.04 points last month. The asymmetry of this variation is enormous, if compared to the set of other variables analyzed. The Dollar, in turn, also retreated, but at "acceptable" levels, closing the month at BRL4.9355 – which represented -2.41% in the month and an accumulated result of -5.41% in the year. In any case, with there still being a month left until the end of the year, our projections seem quite on track, within the likelihood ranges, of what the Dec/23 numbers will be (Scenarios) and in the medium-term (difficult below BRL4.70 or above BRL5.15).

In the economy, it is common sense that this year's better results are a reflection of policies and some recovery from the recent past, but that will, unfortunately, be exhausted soon. There is always a doubt - a positive one, in fact -, that our forecasts – and like the rest of most of the big research houses on the market – are wrong, or poorly calibrated, as has been, in some way, in the latest projections. Explaining the fact in retrospect is always easier, while also irrelevant, if not "poor professionalism". Therefore, we cannot endorse the pattern seen in the graph alongside, as the rationale does not hold. GDP and confidence index (entrepreneurs) create jobs. Investments (GFCF) boost GDP, high average interest rates do not help us in this sense - despite serving their role at the moment, namely: controlling inflation. We will be glad if Brazil grows in 2024 at near its Potential GDP. Furthermore, the government knows that we need microeconomic reforms (in addition to macroeconomic ones) to improve productivity: some suggestions were made, but there was little progress. Therefore, we foresee difficulties ahead with *heterodox measures* aiming to contain them.

In Monetary Policy, the new Director has given "well-behaved" and reasonably aligned statements. He says that Central Bank (BACEN) does not have a target for interest rate differentials with the US, exchange rate and unemployment, and declares that it is not advisable to cut interest rates and change exchange rate policy at the same time. Congratulations!... but he seems to have some difficulty understanding the "independence" of fiscal and monetary policies. In any case, BACEN is on the right track and the signals always come from SELIC cuts of around 50 bps at each COPOM meeting, with a clear assessment of the balance of risks. Paying attention to our fiscal and externalities, we can have, *coeteris paribus*, inflation controlled and anchored in the coming years.

In Exchange Rate Policy, the falling-SELIC scenario currently does not seem to have many impacts on the exchange rate. However, this Brazil x US interest rate differential tends to decrease significantly, especially in the next 1.5 years. The crisis(s) we always refer to – both of fiscal and/or external origin – cannot be ruled out, but it is also a fact that the exchange rate flow has brought some relief. The highlight here is the speed of change in this area, with BACEN being required to quickly identify... but, what exactly to do? Well, what it does best in this context: intervene.

On the fiscal side, it is clear that the heart of the country's issue lies in public accounts. If revenue collection is frustrating, the impetus to spend marches on. The decision on the primary balance target will be fundamental, and the vote on the 2024 budget by the National Congress will seal the commitment to the fiscal adjustment plan. Therefore, the last 30 days of the year will be extremely important, and will truly dictate the direction of our possible scenarios. The expectation, however, is far from encouraging, especially given the declarations, stances and propositions. We return to the litany of the New Fiscal Framework: fiscal balance is necessary, but it is essential to have surpluses! Even more so, we need to repeat that the adjustment is made on the side of expenses, cost cuts (and here without sophistry and semantics of "cost and investments"), and not by revenue. The focus needs to lie on efficient cost management, with rationalization processes in all instances, collecting information for better planning and controls. The current bunch doesn't seem to believe much in this, but we will gauge the appetite for this and the result will be used in the formulation of our Scenarios published/updated at the beginning of the year.

Overseas, the Israel x Hamas war takes all the attention and puts the Russia x Ukraine war in the background. These are unspeakable horrors, but, like the last one, it seems that, economically and financially, it should be limited to those directly affected – at least momentarily. This conflict in the Middle East, obviously, has the potential to intensify and last for a long time. Still in the field of conflicts, we now have a potential "demand" from Venezuela against Guyana, which dates back to the end of the 19th century. A clearly political movement by those who seem to want to "unite" their people around this objective, especially due to the proximity of the elections there.

In China, despite the PMI rising to 50.7 in November - a much better mark than expected - the never-ending crisis in the real estate sector, deglobalization and reduced growth potential have placed the country in a very difficult situation. Not to mention the geopolitical problems involving Taiwan, which will soon escalate. Altogether, this important global player is less economically influential, and therefore has significant consequences for several economies and companies.

In the Euro Zone, the PMI also rose to 44.2 in November, reaching a six-month high, but still below 50 (defines activity expansion). According to the ECB's stance, interest rates will still remain high. In the US, there is much talk about interest-rate cuts, but we stand by our assessment that the FED does not want to make any other mistakes. In the short run, pay close attention to likely pressure on (Bond) yields.

Finally, Javier Milei's Argentina is preparing for much-vaunted measures such as dollarization. For those who turn up their noses at the proposal (ourselves included!), here is an excellent text by economist John Cochrane (and other references) in favor. Have a good read!

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