MONTHLY STATEMENT

DECEMBER 2023

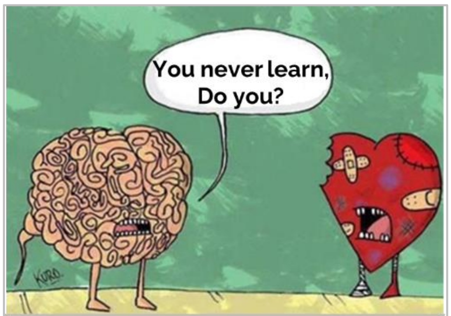
Redwood

REDWOOD ASSET MANAGEMENT

"You never make the same mistake twice. The second time you make it, it is no longer a mistake. It's a choice."
Lauren Conrad – TV/Cinema Actress

Human knowledge is limited and therefore keeps us from grasping the meaning of many mysteries and phenomena; despite that, it is true that some seem to challenge even the simplest of minds. Recent research shows that nine out of ten Brazilians do not regret their vote for President in 2022. This conviction reinforces Simon's theory of bounded rationality and will cost a burdensome sacrifice, some sweat and a lot of tears. People lent themselves to the ignominy of re-electing whom had been convicted, galvanizing such different specters that throws the country, once again, into a deep darkness of uncertain fates.

This reappointment of the reprobate should not surprise us. After all, it is not the first, not even the second - which already took place amidst the Mensalão scandals - but the third time, leaving aside the dark period between January 1st 2011 and August 31st 2016. All of that was the outcome of our exclusive choice, even though administrative incapacity and the wrong option led to the dissection of our political problems on the table. The result is quite predictable, as Brazil, with the current policy direction, will have the same outcome as the underground area affected by the Braskem mine in Maceió: it will crumble down; it is but a matter of time. It is hollow inside and essentially and structurally condemned, which not even palliative actions will be able to sustain for long.



ARE THERE ARGUMENTS AGAINST FACTS?	
EXPECTATIONS - 01/01/23	REALITY (*) - 12/31/23
GDP: 0.77%	GDP: 2.92%
UNEMP. RATE: 9.8%	UNEMP. RATE: 7.7%
INFLATION: 5.39%	INFLATION: 4.72%
GROSS DEBT-TO-GDP: 79.4%	GROSS DEBT-TO-GDP: 75.8%
ECONOMY AND ITS LAGGED EFFECTS	

Source: Focus Survey, Markets and Redwood | Internet image (*) Preview

Although intelligence is a polysemic concept, it has been difficult to assimilate the choices of "the people". The alternation in power is truly the essence of democracy, but pedagogically we should have already learned from our past mistakes. After all, from 2024 onwards, once the lagged effects of the previous government have passed, we will see the predicted challenges come to fruition and, it has been established how to address these problems and how to face them. These are the same past "solutions", the results of which we also know. Is there any chance for some "novelty"? None! Furthermore, we saw in the presidential campaign and throughout 2023, how the mainstream media encouraged and supported countless spokespeople for disinformation, instrumentalizing ways to solidify the power and influence of the status quo. All is right, the press must be free and can take "sides", each person choosing and analyzing what they should and want to see and hear – always.

But if the direction of politics has been getting in the way and directing us towards a challenging future, especially by an administration led by someone (with countless supporters) absolutely averse to fiscal responsibility, Minister Haddad (essentially the same DNA!) managed it – by force of reality, some responsibility and skill in negotiating with the National Congress – staying away from friendly fire and the wild ideas of his supporters. He accomplished a lot under terrible technical and political conditions, given the structuring of the New Fiscal Framework (NFF) and the countless measures and political suggestions contrary to the rebalancing of public finances. What's more, progress was made in the Reforms and reaping good results, as shown in the table on the side. However, with no offense to his effort and the recognition by the market – after all, he did much better than expected -, he is enjoying the results from past actions. His biggest challenge will now come in 2024 when its actions and policies will actually come into effect, notably with a rigid budget and enormous interference by parliamentarians in public spending – the conflicts between State branches are identified here.

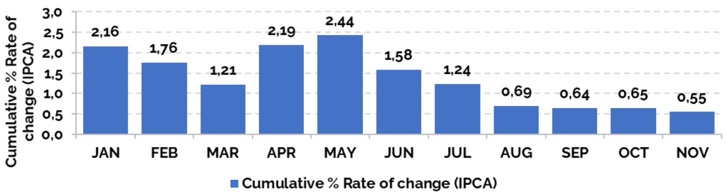
Fortunately, the economy managed, with its own dynamics, to advance on the trail of the achievements we have had in recent years, namely the agribusiness performance which was responsible for a large part of this year's economic growth, the independent BACEN (Central Bank) overcoming inflation with low rates of unemployment. Many of these achievements are threatened by a low investment rate, confidence, high household indebtedness, etc. It will be necessary to focus more on the cognitive process and escape the political trap we are in.

Financial markets and the economy both ended 2023 "much better" than forecasted at the beginning of the year. Interest and exchange rates, stock market, inflation, GDP, unemployment rate, Brazil risk, among others, had poor expectations and suggested constant deterioration, not least due to the expected poor economic growth, high interest and household indebtedness, as well as a expansionary fiscal policy. Several factors "explain" these deviations from projections, but some have more weight than others, such as the performance of agriculture at the beginning of the year, the continued expansion of labour force and the real wage bill, as well as various government stimuli (which are difficult to anticipate). The foreign sector was also better than expected. However, this does not exempt errors in modeling and how we calibrate estimates – including lags, correlations and the timing of the transmission mechanisms of various policies.

Along these lines, the Ibovespa advanced this month (5.38%), more than the main stock exchanges in the world (DAX, FTSE, S&P, NIKKEI), and closed at its highest at 134,185 points, leading to a cumulative annual return of 22. 28%. As for the yield curve, the market continued to perform well, with drops across the entire interest rate forward structure. The shortest DI fluctuated from 11.886% to 11.654%, the one maturing in 2025 fell from 10.32% to 10.03%, and for 2031, it also dropped from 10.77% to 10.26%. Following last month's shift, this month had higher negative variations for longer maturities, recording negative variations of 0.2332, 0.29 and 0.51, for the 2024, 2025 and 2031 DI maturities, respectively. We must stress, as we have already done, the need to reevaluate the portfolio with some risk-adjusted rebalancing, given the trajectory of interest rate cuts for the coming months beyond what is "priced" in the market.

As for the Brazil risk, priced by the 5-year CDS, it also repeated its good performance and brought a new positive surprise: it ended the month/year at 132.53 points. The annual drop amounts to -47.86% and sets us, in an isolated analysis, near a BBB- rating. The Dollar, in turn, also fell in December, but with an even smaller change, closing the month at BRL 4.8413 – which represented -1.91% in the month and a cumulative change of -7.21% within the year. These are numbers that, despite being within the estimated ranges, are near the most optimistic of our Probabilistic Scenarios. The challenge now, as always, will be to calibrate the models (parameters) in order to better reflect reality, but above all avoiding to be "contaminated by recent optimism or perpetuating intrinsic pessimism".

Revenue collection administered by the Federal Revenue Service (Jan to Nov - 2023/2022)



MÊS	REVENUE COLLECTION (CURRENT PRICES) JAN-NOV/23 [A]	JAN-NOV/22 [B]	CHANGE (%) NOMINAL [A]/[B] MONTH	ACCUM.	REAL (IPCA) [A]/[B] MONTH	ACCUM.
JAN	235	217	8.05	8.05	2.16	2.16
FEB	153	143	6.81	7.56	1.14	1.76
MAR	166	159	4.58	6.65	-0.07	1.21
APR	189	172	9.63	7.39	5.22	2.19
MAY	171	159	7.61	7.43	3.54	2.44
JUN	175	174	0.38	6.23	-2.7	1.58
JUL	187	181	3.23	5.78	-0.74	1.24
AUG	167	165	1.12	5.22	-3.33	0.69
SEP	168	160	5.39	5.24	0.19	0.64
OCT	196	185	5.56	5.27	0.71	0.65
NOV	173	166	4.14	5.17	-0.52	0.55
ACCUM.	1,979	1,882	-	5.17	-	0.55

Source: Receita Federal | Elaborated by Redwood

In the economy, ending the year 2023 with a GDP growth near 2.9% is a resounding "success", and it goes back to past actions that the performances of the last two quarters outline our near future. The signs are everywhere, as shown in the table on the side, the slowdown in the labor market, confidence indices, volume of investments, among others – all in unfavorable territory. Surprises can, of course, come from abroad, with the FED launching interest cuts in March/24 (we don't believe in that!), or even (it wouldn't be anything new!) typical actions by populist governments, using whatever tools at their disposal, such as CAIXA, Banco do Brasil, BNDES and others to "heat up" the economy, using the FGTS, earmarked loans, special credit lines for certain segments, etc. In short, all of this is treated as immediate and short-side while, to the contrary, the bill will have to be paid in the future. With all possible forecasting adjustments, we will be happy if Brazil's economy grows in 2024 at the levels of its Potential GDP: near 1.7%. Anything beyond that will require, as it did this year, "extraordinary" events.

In Monetary Policy, a lot of speculation has tried to put "pressure" on BACEN to speed up the SELIC cuts, but even with the current board composition, we do not believe in this hypothesis and maintain our estimate for the interest rate trajectory. Aside from this, in our view, the internal and external situation, especially in the USA, does not technically support a change in direction and intensity. A consolidation of both environments is a *sine qua non* condition for any adjustment, and the COPOM minutes themselves seem to indicate this – although there is some identification of improvements, these are short-term and do not alter the current balance of risks. In this way, we stand by our pace forecast of 50 bp-cuts in the next meetings, until uncertainties phase out, the labor market has some slack and the dynamics of disinflation can be assessed in the future.

In Exchange Rate Policy, in line with some perception (by the market agents) of improvement as described above, notably the external sector (interest cut by the FED), combined with the exceptional strength of the trade balance, led the Dollar price to float below BRL 5 in recent months. It also allowed, with some normalization, BACEN to restore the cap to sales volume of the US currency to pre-pandemic levels. Thus, the Monetary Policy Director (also responsible for Exchange Rate Policy) now has "only" 2.5% (half of what is allowed) of international reserves for interventions without approval from the other board members. Two points that unfortunately neutralize any "joy" for those who do not agree with interventions in this area: (i) the current percentage still corresponds to something like USD 9 billion, and (ii) the change comes from an Internal Audit, which can be changed as well. In the event of non-compliance (exceeding this volume in five working days), a simple notification must be made to the Chairman, who will call an extraordinary Board meeting... and everything will be fine. That's what they call governance! Everything is irrelevant, economically speaking: BACEN is incapable of changing the course of the Dollar in the medium-long term, not even its volatility – no matter the size of our reserves for this purpose – is defined by the market. Nonetheless, it is extremely important to preserve our reserves above their "optimal level" in order to buffer adverse shocks, such as abrupt reversals in capital flow.

MOST IMPORTANT CHALLENGES IN THE WORLD IN 2024 WITH ECONOMIC CONSEQUENCES

1. Political instability;
2. Financial risks (asset bubbles);
3. Inflationary pressures
4. Geopolitical tensions;
5. Social inequality;
6. Technological transformation (automation and A.I.);
7. Energy transition;
8. Demographic changes;
9. Measures against climate change impacts;
10. Economic uncertainty.

On the fiscal side, the improvement in Brazil's risk rating by S&P appears to be, in the eyes of the unwary, a certificate of great achievement for the country in this aspect. This is an outright wrong. Although undoubtedly good news, it was surprising in terms of timing, however consistent with the positive outlook set forth some time ago. It certainly reacts to the Tax Reform, and a clear signal to the country that reforms are fundamental. With the performance of the rating agencies in 2008 and the huge damage to their credibility, it is necessary to properly read the reasons and the market's reaction. Furthermore, it is necessary to return to spending control (general cleaning), but this reality (the PR only thinks about spending!) will only have resonance when the first Report on Revenues and Expenditures is published in March 2024. Recalling the late Robert Solow, *"the fact that there is no such thing as a perfect anti-sepsis does not mean that one might as well do brain surgery in a sewer"*. Our politicians need to perform a broad disinfection of spending, while the NFF relies on revenues (hence a strong GDP).

Around the world, the wave of "optimism" seen in recent weeks in the markets contrasts sharply with the political horizon for 2024. Both the Israel-Hamas and Russia-Ukraine wars do not seem to be losing momentum, not to mention the presidential elections in Ukraine and the USA – which can have monstrous impacts on the outcome of these conflicts, and also have all sorts of consequences across the planet.

Just like the FED, the ECB and the BoE have been bombarded by markets to start a new cycle of monetary easing in 2024, but the IMF has given out "valuable tips for current policymakers" in a recent study. Kristalina Georgieva summarizes: *"fighting inflation is a marathon, not a sprint"*. In China there is only one way out for Beijing: to open the coffers forcefully (before Trump arrives) to "save" its economy. Anyway, the uncertainties that currently loom abroad are very relevant, and there are many challenges that have direct impacts on the countries' economies. Faith and courage!

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