MONTHLY STATEMENT

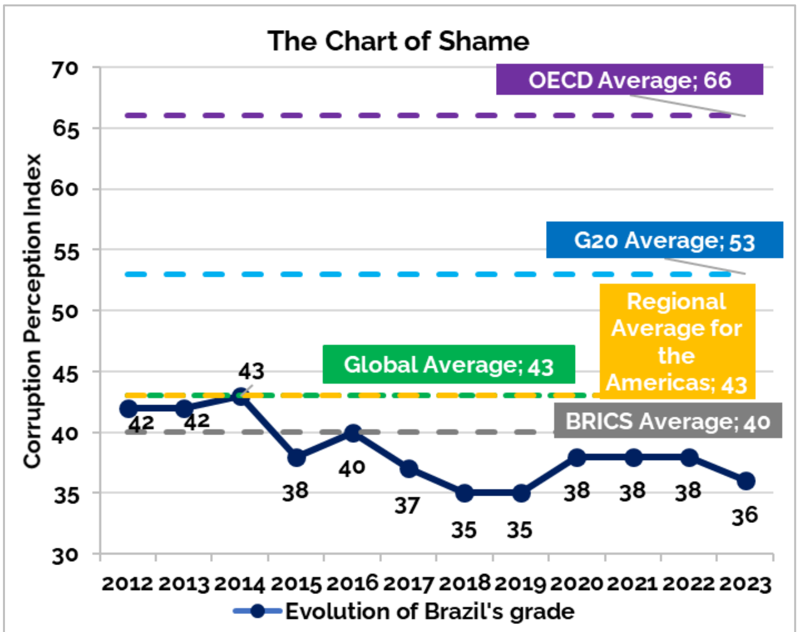
JANUARY 2024

Redwood

REDWOOD ASSET MANAGEMENT

"Fighting corruption is not just good governance. It's self-defense. It's patriotism."
Joe Biden – U.S. President

Corruption has deeply plagued Brazil, regardless of the administration in power. There is no moment in the country's recent history that one could experience some relief or true hope for some evolution. More than deliberate action, it seems to be in the nation's DNA, a catastrophe on all levels. In terms of government and institutions, we are experiencing a moral panic, a widespread cognitive disorder. Since 2023, however, we are witnessing an even darker arrangement, with an alignment of government branches and an absolute deterioration in what is required to get out of this ditch – after all, with 36 points in the Transparency International survey ranking, we are closer to Somalia with 11 points (last place), than Denmark with 90 points (first place). On top of that, we are paralyzed and defenseless!



Source: transparenciainternacional.org | Elaborated by Redwood

The situation of high institutional vulnerability, coupled with mutual submissiveness between branches, especially when common objectives are attacked – herein the "democratic" agendas of the ideology on duty – results, if not in a purposeful riot or a circus-like prank, until own interests prevail. This dire scenario has little risk of changing with the current administration, after all power was gained legitimately and will have to be endured over the next few years. However, incompetence and arrogance mixed with irresponsibility need monitoring and control. This is because the fanfare must have limits, and today's actions greatly compromise in the near future, not only the economy, but all segments of Brazilian society.

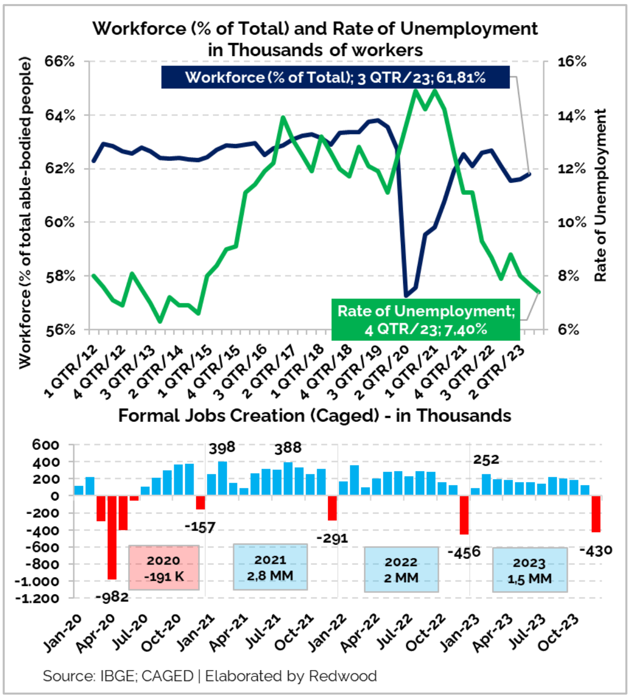
Signs are everywhere, whether through political nominations to "adjust friends and the management of companies", as recently seen for Vale or Banco do Brasil, as well as carrying out campaign promises that are inconsistent with our financial-economic situation, such as the income-tax exemption up to BRL5,000.00 and the real gains to the Minimum Wage. All of that is necessary, but what about the balancing actions and efforts to increase productivity? Nothing at all! Not enough? We also have the New Industrial Plan, which has an impact on public finances and an effect on monetary policy – nothing more than what we had already signaled: swelling of targeted loans, benefits for some (the winner-picking is back), and the potency of interest rate policy; subsidized credit, preference margin mechanisms, minimum local content policy, etc. On the micro side there is even more, with increases in import taxes, BNDES promoting mistaken policies of the past and other interventionism in companies with government participation.

What little good there is always comes from the side that "saves" this administration: the Central Bank. The initiative to pursue total independence requires an assessment by the National Congress, but the ferocity of the attack on this alternative, especially by the ruling party, is colossal. The objective of the measure? Simple: prioritize State policy over the caprice of those in power. We have already experienced all of this in past PT terms, but although "knowledge is transferable and communicable, wisdom is not". The administration has no interest in the first (information analysis), so it fails to achieve the second (use of learning). It lacks mental excellence.

The fact is that this administration is there, whether one likes it or not, republicanly elected by the people. However, this does not mean license to do whatever suits it, and we just need to take care so to avoid "too much" destruction of the economy and the country, in a way that it is still possible to recover it at the end of the next three years.

In the financial market and economy, the effects of corruption mentioned above are felt on a daily basis. Studies show that, for countries with greater perceived corruption (followed by less governance), the impacts range from less predictability in the markets, greater volatility, to more intense structural breakdown. In our case, where corruption seems absolutely institutionalized, despite the adverse situation, expectations are directly raised, leading to decreasing trust with the deterioration of the whole environment. The consequence, obviously, is that investment decisions, whether by Brazilians or foreigners, are profoundly affected, postponing or even canceling intended investments. This phenomenon, however, can have repressed and lasting impacts, especially because there are mechanisms through which the corrupt system is maintained, as well as the so-called agency problem (e.g. Petrobras) – here taken as a broad concept. What are the solutions from the get-go? Transparency and governance.

Along these lines, the Ibovespa had a major drop this month (4.79%), while the world's main stock markets rose (DAX 0.91%, S&P 1.59%, NIKKEI with a resounding 8.19%, and only FTSE fell 1.33 %,), and closed at 127,752 points. As for the yield curve, the market presented different changes, impacting the term structure. The shortest DI (DI-25) fluctuated from 10.03% to 9.985%, the one maturing in 2026 went from 9.61% to 9.66%, and for 2031, it rose from 10.26% to 10.47 %. Without many significant changes compared to last month, this month the variations recorded were -0.045, +0.05 and +0.21, for DI deadlines 2025, 2026 and 2031, respectively. Once the interest-rate-cut trend is confirmed, the trajectory of which does not yet seem to be fully priced in by the market, we reinforce the need to reevaluate the portfolio with some risk-adjusted rebalancing. There are, in fact, great possibilities of return and with immediate liquidity.

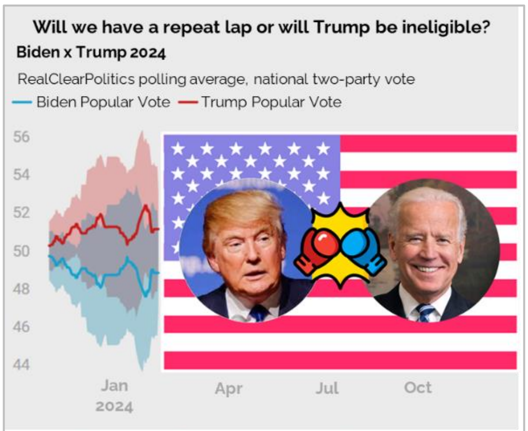


Source: IBGE; CAGED | Elaborated by Redwood

As for the Brazil risk, priced by the main indicator, the 5-year CDS, the performance here was "reasonably" in line, with a "slight" increase ending the month at 138.43 points, an increase of 5.9 points, or approximately 4.5%. The Dollar, in turn, also followed suit, but with a slightly narrower variation, closing the month at BRL4.9535 – which accounted for a +2.32% change in the month/year. These are numbers within the estimated possible ranges and, for the premises of an environment without major stress, within the Scenarios envisioned. If we could overcome by addressing, even for the long run, our domestic problems – economic, financial and institutional –, the market reaction could be much better than what we are seeing now.

In the economy, the numbers discussed above by the main players in the market for 2024 are not far from our Potential GDP, that is, something around 1.8%. Our projections are a little more pessimistic and we are at 1.21%, but moving towards 2.26% in 2025, a little more optimistic than the market in general. The projections arise from a set of variables and situations, but they have great weight in the lagged effect of the SELIC and a very important premise: no major stress on the horizon for public finances. In any case, we don't expect much coming from the confidence indices, the investment rate, etc., but we are cautiously betting on some progress in the reform agenda – if there is any discussion in H1 2024. On the employment side, no substantial advances are expected either for this year or for 2025 – rate of unemployment estimated at 8.36% and 8.28%, respectively. The labor market performance in 2023 was good with the creation of 1.5M formal jobs, but 25% lower than in 2022 and still below to the pre-pandemic situation. Unemployment has indeed decreased (noteworthy!), but not only because more people have found jobs, but also because there is a smaller workforce.

In Monetary Policy, the recent statement by COPOM leaves no doubt: maintaining the SELIC rate cuts at the same 0.5-pp pace in the next meetings. This is also what we think and have claimed, given our projections for inflation at 3.56% for 2024 and 3.30% for 2025. The highlight, always, is the public accounts that can alter this trajectory. At the last COPOM meeting, the four people newly nominated directors by the PR met for the first time: Gabriel Galípolo (Monetary Policy), Ailton de Aquino Santos (Inspection), Rodrigo Teixeira (Institutional Relations, Citizenship and Conduct Supervision) and Paulo Picchetti (International Affairs). There is serious doubt that this group, led by the Director of Monetary Policy, and under greater pressure from an economy growing as little as previously envisioned, can act in a less technical way, but so far the performance has been adequate. Our projections point to a SELIC of 9.25% at the end of this year and 9% in 2025.



Source: https://www.pollyvote.com/pollyvote-election-forecasting/polls/realclearpolitics-poll-average/ | Elaborated by Redwood

As for the Exchange Rate Policy, a strong conviction is that the price of the Dollar will not reach BRL 4.00, nor will it reach BRL 6.00. This is because the assumptions for the Basic Scenarios do not incorporate, for now, greater stress (Fiscal!). In fact, the landscape is quite "benign", whether from the outside – with cuts, albeit later, by the FED – as well as new trade surpluses to be repeated this year and next. This does not mean, however, that we should expect a less interventionist stance from BACEN... the group always likes to tinker! It is also important to monitor the preservation of our foreign reserves – once again the fear of the market and ours as well, regarding the new composition of BACEN's board of directors. The litmus test will certainly come when conditions become more challenging – at that moment we will truly know each person's commitment and responsibility.

On the fiscal side, the focal point will be when the Revenue and Expenditure Assessment Report is released at the end of march. By then, we will see what the fiscal target will look like, the additional spending freeze, and the entire discourse regarding the fiscal responsibility of the "expansionist" camps of the administration and Minister Haddad's wing that "insists" on a balanced budget this year. Dialogue with National Congress, of course, remains fundamental in this sense. Very few people in the market, including us, believe in a zero deficit this year, but at the same time, our projections do not place Brazil on an explosive debt trajectory. However, the uncertainty is far from negligible (just listen to the PR's speeches) and yes, a change in the country's fiscal framework will "mess up the room", with immediate repercussions on interest-rate policy. One absolutely cannot ignore the (terrible!) PR narrative, according to which "spending is life".

Overseas, at a time when BCs seem well "coordinated" in fighting inflation, geopolitical issues and wars are one important factor behind uncertainty, with direct consequences on the prices of commodities and the Dollar itself. This situation, by itself, would trigger a reversal in economic policies in several parts of the world.

In China, despite the gigantic size of its economy, its activity continues to decline, despite growing more than the USA and Europe. Its debt and the crisis in the real estate market, as well as the possible worsening of relations with Taiwan – with consequent retaliation and sanctions from the US and allies – have kept investors away. For the economy, what is expected is more of the same (fiscal expansion): government stimulus (with little effect so far on the real estate sector)... and Taiwan, an unknown. In the Euro Zone (EZ), the economy is expected to grow little this year, and we do not believe, as in the USA, in an interest-rate-cutting stance by the ECB in the short term. Inflation in the EZ slowed down in January, but was exceeded analysts' expectations, and the unemployment rate was at a record low of 6.4%. In the US, "strong" activity and job creation, combined with rising wages, do not guarantee a more confident and prosperous population. Why is that? Hours worked decrease, and the creation of jobs mainly for those born abroad, among other issues. Biden suffers and Donald Trump surfs the wave of the moment.

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