MONTHLY STATEMENT

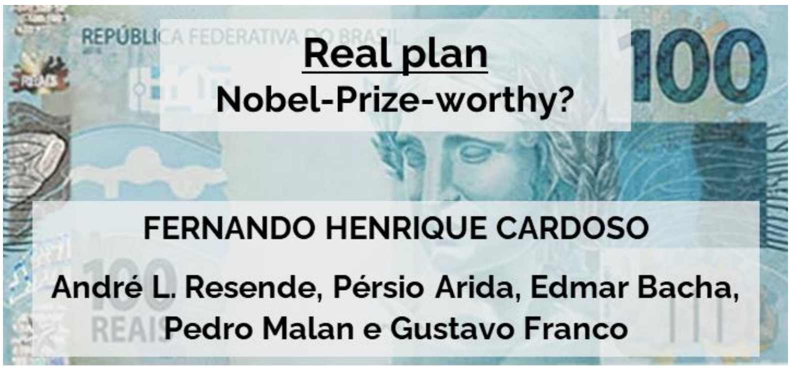
FEBRUARY 2024

Redwood

REDWOOD ASSET MANAGEMENT

"A smooth sea never made a skilled sailor."
Franklin D Roosevelt – Former American President

We are celebrating the 30-year anniversary of the launch of the Real Plan. In the economy and finances, at the time, Brazil was sailing through turbulent seas and with disconnected measures and attitudes – there were six other previous failed attempts. We lived in a true economic madhouse and the country was a laboratory open to all kinds of lunatic economic plans. Until the Real Plan came along, with a team of notables, but which did not have the support of PT and its sympathetic economists. Maria Conceição Tavares, always very vocal and somewhat rude, predicted the following at the time, with respect to the team formulating the plan: "If it works, you will win the Nobel Prize and, if it goes wrong, you will go to Harvard and stop bothering us, because making a mistake on two stabilization plans is too much." In particular, it is possible that the Plano Real has not yet received its due recognition, nor have the economists resposible for it received a worthy award. History will correct for this.



More than keeping hyperinflation at bay, the Real Plan put the economic house in order and, as expected, it also helped to organize and strengthen our institutions. Of course, since then it has become increasingly evident that we need a structured plan for public finances. Over the years we even had some "flashes" and determination for such a discipline, such as the Fiscal Responsibility Act (LRF), the Golden Rule, Spending Cap, etc. The definition and dogmatism towards constant fiscal austerity has always been fragmented for various reasons and, subsequently, lost or replaced by something more "convenient".

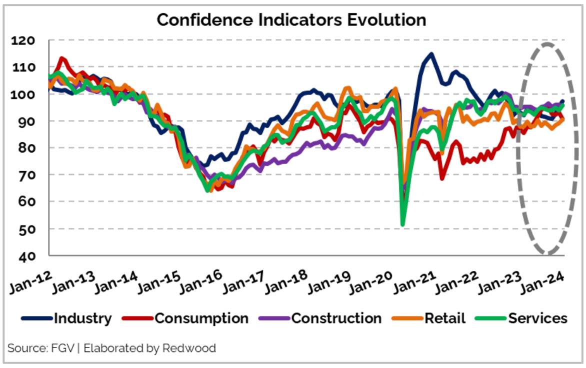
It seems obvious that if in the past we had any chance of greater control over the country's fiscal authorities, today the reality could not be further away. Worse, politics, polarization, and the ideological storm weakening cognitive capacity, devastate any spark that could ignite economic judgment. Accounting for and evaluating the country's balance is not very typical of politicians, but it should be a priority. Our political commanders lack, as we have claimed in this space, introductory courses in micro and macroeconomics or at least the elementary knowledge of mathematical operations: adding and multiplying, because they only know how to reduce and divide taxpayer money. The truth is that the sequence of stabilization, growth and distribution was never "bought" by the left. They think it should be all together and at the same time... not least we have a dysfunctional government... they claim: if you don't care about social justice, there's no point.

The fact is that we missed the timing to expunge economic charlatanism (e.g. the New Macroeconomic Matrix), and we now have iconic figures in BNDES, IBGE, etc.. Flat-earth economics (and especially fiscal) seems to be returning with full force - despite the lone voice of Haddad - and with a PR that does not align with fiscal responsibility. We need a radical metamorphosis in political-economic management, in order to avoid social unrest and get back on the track to prosperity. This tyranny of dissent, with slogans like *Spending is Life!*, contaminates the entire landscape and leads us to a situation of lawlessness, thus undermining institutions and the (little) established governance, with simultaneous failures. Total disaster sustained by the enablers in PT and its acolytes regarding the absurd statements of the PR.

Just as Gustavo Franco often reminds us, that *the problem of inflation is not the generalized increase in prices, but rather a disease of the currency, it is the loss of the currency's purchasing power*, perhaps the fiscal problem is not actually spending – it may just as well be the consequence. The Reforms, the regulatory frameworks, the indicators (Debt-to-GDP) to be monitored and the limits (on Spending) are the attitudes to be followed in this turbulent sea with the entire crew in a reverie and without a good captain. The vessel Brasil is drifting off.

In financial markets, the obscenities that we have experienced from Brazilian politics have not yet taken a toll on its potential. This epic story of excesses, as expected, has primarily affected foreigners, with the perplexity that does not seem to frighten so many natives – at least contact with investors points to this situation. Is that so? The evolution of confidence indicators does not raise good news. Be that as it may, the market is, without a doubt, very apprehensive, cautious, but also carries a loaded hope that – despite the creeping vulgarity of the policy and its consequences – whatever little appetite there is for investment in the country is not destroyed.

Along these lines, the Ibovespa advanced 0.99% this month, softening last month's drop of almost 5%, closing at 129,020 points. The interest rate market showed small fluctuations, "marginally" impacting the term structure. The shortest DI (DI-25) went from 9.985% to 9.955%, the one maturing at 2026 moved from 9.66% to 9.78%, and for 2031, it rose from 10.47% to 10.65%. Thus, similar to last month, this month had no significant changes, with recorded changes at -0.03, +0.12 and +0.18, for the DI maturities for 2025, 2026 and 2031, respectively. We remain firm in our assessment of the trend of interest rate cuts, always very cautious, but whose trajectory still does not seem to us to be fully priced in by the market. As we have insisted, this fact deserves attention and, possibly, for those who can take on more risk, the need to reevaluate the portfolio and rebalance appropriately. Despite the volatility, there are, in fact, great possibilities of return and with immediate liquidity.



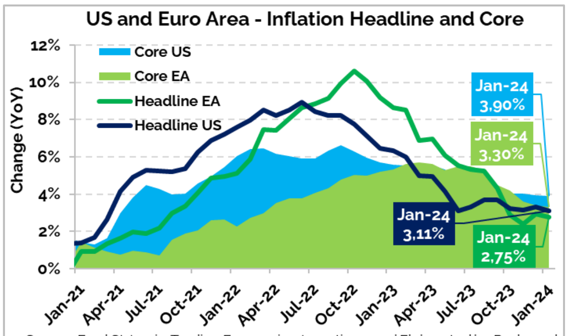
Source: FGV | Elaborated by Redwood

As for the Brazil risk, priced by the 5-year CDS, the performance here contrasted much with the behavior of the other assets mentioned, with "some" reduction, ending the month at 125.90 points, a 12.53-point decline, or approximately 9%. The Dollar, in turn, showed a small change, closing the month at BRL4.9833 – which represented +0.60% in the month and +2.93 in the year. Overall, these are "lukewarm" numbers, without major stress and within the scenarios envisioned for the period. In many cases there is a waiting game, even though the evaluation and appetite of the foreigners have dried up. The general financial hemorrhaging (substantial loss of resources, money or value), however - it is expected - will not come (or be worked out) by ceasing the disastrous political onslaught, thus impacting the markets (e.g., speeches by PR and Prates about Vale and Petrobras, amongst many).

In the economy, the external scenario remains the main risk to our economic and financial stability. Confirmed GDP for 2023 (2.9%, totaling BRL10.9Tri), strictly in line with our latest projections, reinforces, as presented in the Q4 2023, the poor growth estimates for 2024. The strong slowdown in the last quarter of 2023 points to a downswing, but our projections show growth slightly below potential GDP – as Agribusiness steps down as the big "star" in 2024, as well as the lagged effects of Monetary Policy. Leading indicators – such as the graph to the side -, and setting the tone is the volume of investment, which is not taking off (it fell by 3% in 2023!). The Investment rate in 2023 was 16.5%, the lowest since 2019 (15.5%). Family consumption, although it grew during the year, showed a slowdown in the last quarter of 2023, which is why we believe in the government's action on "new ideas" for income transfers and the like. The unemployment rate was surprising and stood at 7.6% in the quarter ended January 2024, which indicated that the market remains strong, with data supporting the expectation of a gradual slowdown. Our assessment is that the effects of the labor market reform may have changed the level of the estimated neutral unemployment rate (9.5%). There is no shortage of reasons to move forward with reforms.

In Monetary Policy, a more resilient economy last year does not interfere, in our opinion, with the cycle of interest rate cuts throughout this year, precisely because activity in 2024 will move at a much slower pace. It is clear that "low unemployment and rising wages" imply a warning about inflation, especially in services. Not surprisingly, important houses are already signaling the Selic terminal rate in December 2024 to be 10%, something that BACEN rightly refuses to do at the moment. Also important, as mentioned, is what happens overseas, and here the actions of the FED and its interest rate cuts can change the direction taken by our BACEN. Unlike much of the market, we continually anticipate fewer FED Funds rate cuts, and even so, our scenarios point to a Selic in the range of 9.25% and 9%, based on our projections for inflation at 3.56% and 3.30% for 2024 and 2025, respectively.

As regards exchange rate policy, the FED's time path can also have an impact on the exchange rate. In fact, falling US interest rates couched on geopolitical concerns tends to impact commodities prices and, as a rule, generates pressure on the exchange rate. At this point, we still consider it too early to make further predictions on exchange rate policy beyond what is in fact already the BACEN's playbook. Furthermore, it is important to remember that the director of the area himself declares that it is reckless to make significant changes to exchange rate policy in the middle of an interest rate cut cycle. Correct, as it could bring "the risk of generating more noise", making it difficult to properly parse out the effect of monetary policy from those stemming from the exchange rate. In any case, the same director says that he sees no need to change the current stock of swaps... currently around USD 100 billion... because the stress on the exchange rate coupon is within normal limits and the market tends to adjust by itself. Who would have guessed!... but he added: "It doesn't mean that we won't act, but that we will also be 'data dependent' in this regard." BACEN is consistent with its philosophy!



Source: Fred St. Louis; Trading Economics; Investing.com | Elaborated by Redwood.

On the fiscal side, the Revenues and Spending Assessment Report (scheduled for the end of March) appears to be the focal point and deadline for evaluating the fiscal target for the year. However, there are many who believe that the government will be able to postpone this decision. Tough! Supporting the zero deficit rhetoric needs to be accompanied by arguments and practical solutions, which do not seem to exist. Without sufficient revenues (forget a temporary improvement in revenue), without contingencies (a bad word for politicians) and without any additional control over expenses (no one in the Executive endorses this), expectations for the primary deficit and debt growth will undoubtedly deteriorate. "Making up" the government's accounting assessment report – with revenues that will not be sustained – would not actually be a surprise, it would please many and "buy" the economic team some time. If this happens, however, the entire rationale of the probabilistic scenarios for the country collapses. The ideal is, in turn: credible goals, extra effort towards fiscal stabilization and primary surpluses. Confronting spending control? Almost utopia.

Overseas, three subjects dominate the news: the Wars (Russia x Ukraine and Israel x Hamas), the behavior of CBs and the presidential election in the USA.

This past month, Russian president accused the West of "provoking a nuclear war" by suggesting sending NATO troops to Ukraine. It was a direct response to the French president in a speech to the Russian Federal Assembly: *"(The West) must realize that we also have weapons that can hit targets on its territory. All of this really escalates conflict to the use of nuclear weapons and the destruction of civilization."* It doesn't get any more serious than that. Without positive progress, the Israel x Hamas conflict has not even reached a momentary ceasefire – all attempts have been frustrated, and the US has grossly failed as a mediator.

As for the Central Banks, the focus is always on the FED, but the ECB doesn't stray too far from the script. Everyone has been very cautious in carrying out their policies, but the convergence is not to anticipate any movement before there is greater assurance in the fight against inflation. Therefore, we reiterate, we are more skeptical about the start of cuts, but also about their intensity, with the necessary impacts on investments.

Last but not least, everything indicates, despite the numerous lawsuits and attempts to derail Trump's candidacy, that we will have a Trump x Biden rematch. At this moment Trump leads with a 5% advantage.

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