MONTHLY STATEMENT

APRIL 2024

Redwood

REDWOOD ASSET MANAGEMENT

"But principles matter more than profit." Elon Musk, owner of X (former Twitter)

A catch-phrase in the financial market is that "*cash flow solves everything*". As abject as such a statement may seem – given the scope and circumstances to which it applies – it well reflects rampant behavior in various segments of society, including the government. Of course, everyone can have "a price", yes, not necessarily monetary, but here, in this recent episode involving Elon Musk, the subject is money. In this case, the entrepreneur made several threats and said he could shut down operations in Brazil. It brought to light a possible rupture that raised "spirits and hopes" that someone would finally face, with courage and resignation of their own business, decisions that border on curtailing freedom of expression. Well, honest mistake!

Yes, at least so far, Musk's promises to challenge Alexandre de Moraes' decisions will not be fulfilled, and X's legal team has warned the STF and TSE. If it were just another specific case of the Brazilian business personality, it would be "fine", but it is not. With what is understood to be necessary to combat the *criminal exploitation of social networks*, we have sunk into the arbitrariness of the STF, which represents the true curse of limitations on freedoms and censorship on all of us.

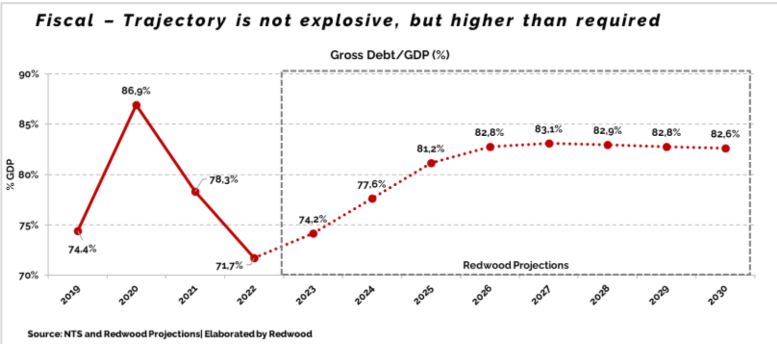
Therefore, it is worth wondering: is the STF above the laws? And has the National Congress really been an echo chamber for the Brazilian society? And the Executive branch, with its lame posture, speaks nonsense and savage attacks that, when they are not mockery, treats serious issues with demagoguery? We need to see things in depth, get out of this absolute vacuum and veritable institutional insanity. We are already paying a very high price for this harmful aspect that has overwhelmingly taken over the country in recent times... and the prognoses are far from good, just look at the socioeconomic indicators. We are on the path to the "deterioration" of institutional capital. The polarized, and largely clueless, constituency does not seem to see that the democratic rupture has already happened. Collective blindness, eclipsed by short-term populist movements, does not reach uselessness and futility as the maximum specialties of this administration. Anything goes. And as we claimed in last month's Letter about our political status, it pays off to remember that absolute immunity can lead to absolute tyranny.

The perfidy actions of our current political establishment must not go unchallenged. Not long ago we experienced stellar scandals, corruption and deep economic recession. We've already seen this horror movie. The trajectory, this time, unfortunately, has even more compelling potential and demarcations. In addition to the growing legal uncertainty amid everything we are witnessing, the international landscape, as we anticipated, does not help, but we managed to go down even further. Our main stock exchange has lost 6% this year alone, while the S&P and DAX fall, respectively, 4% and 3%. Our currency depreciates by almost 7% year-to-date, and our interest rate spreads widens on several maturities, in the short and long term, indicating inflation and fiscal challenges. It's no small feat, the perception of Brazil's risk increases – even if we look beyond the CDS - as conversations with international investors corroborate this assessment.

Since every story has at least three sides (one, the other and the real one – which is always revealed in the aftermath), we have the credit-rating agency Moody's (we cannot forget the behavior of the risk agencies in 2008!) which not only confirmed Brazil's risk level, but also place the country's medium- and long-term sovereign debt outlook as positive. In this case, we echo the statement by economist Alex Agostini from Austin Rating: "*I honestly don't know what Moody's saw to take the stance it did.*"

One way or another, reality imposes itself, and we are here to evaluate all scenarios (political and macroeconomic) and offer the best take to investors... and we do this by defending principles and profits. Necessarily in this order!

In financial markets, the repricing of Brazil is underway. It doesn't seem to be a one-off thing, and the hints are sinking in ever more, especially on the fiscal front. It is difficult to believe only in the domestic "bad mood" and the external environment, which does matter, but truly in the troubled political dynamics, the dissociation from reality and the terrible agendas and tackling "solutions" to our structural problems. Nothing reacts faster to all of this than financial markets, and not even "improvements" in our rating or even information such as the "largest" Foreign Direct Investment (FDI) flow since 2012 raise awareness of the great photo and film we are watching. The government "abandons" the narrative and effectively starts direct meddling in State-owned and private companies – next steps could involve "designs, incentives and regulations" of sectors. This affects expectations and induce likely portfolio rebalancing, which, at the very least, suggests increasing caution and avoiding greater risks.



Fiscal – Trajectory is not explosive, but higher than required

Source: NTS and Redwood Projections| Elaborated by Redwood

Along these lines, the Ibovespa fell once again this month by 1.70%, closing at 125,924 points, or -6.16% year-to-date. In the interest rate segment, various maturities have shifted upwards, in a clear movement of deteriorating expectations. The shortest DI (DI-25) went from 9.92% to 10.315%, the one maturing in 2026 moved from 9.80% to 10.65%, and for 2031, it rose from 10.92% to 11.78 %. It is no trivial movement: the changes this month amount to +0.395, +0.75 and +0.86 points, for the DI maturing in 2025, 2026 and 2031, respectively. At this moment, numerous important research firms are no longer betting on a single-digit Selic in 2024. We remain firm in assessing the interest-rate cut trend, but possibly no longer at the same magnitudes predicted in our last Scenarios (SELIC terminal rate at 9. 25%), but still below 10%. Thus, we increased the perceived level of risks and, therefore, even more caution is due when rebalancing portfolios. The opportunity to reevaluate and eventually adjust the portfolio (with more risks) takes on more dramatic tones.

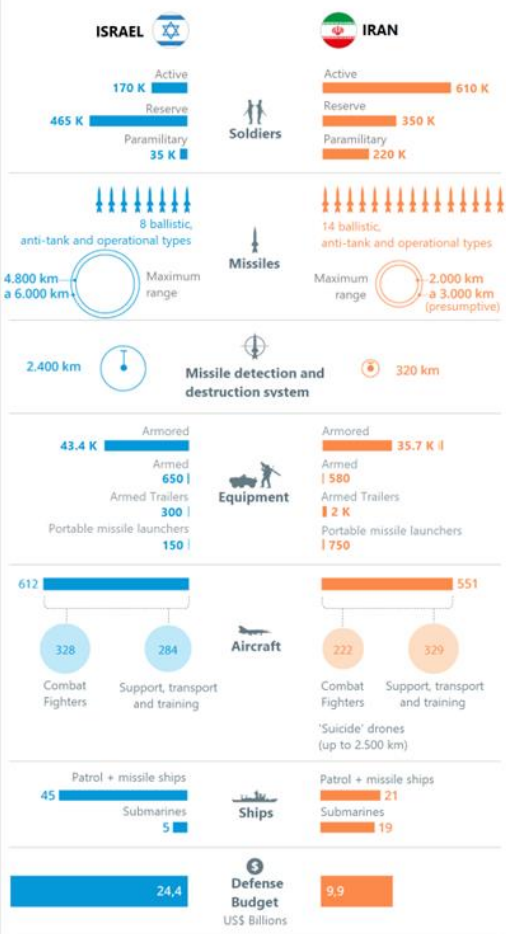
As for the Brazil risk, priced by the 5-year CDS, a new "hike" took place, with a significant 150.51-point advance. This is a variation of approximately 10%, or 13.8 points. The Dollar, in turn, also rose, closing the month at BRL 5.1718, or a +3.51% change in the month and a +6.83%. in the year to date. We are facing a "unison" picture of deterioration in "all" variables, but the medium- to long-term probability distribution of our Scenarios have not changed significantly... but yes, the warning sign is on. Although the DNA of all members of the highest government positions is strictly the same, the institutional capital has diminished and the intense "friendly fire" set on Minister Haddad, a dip in this trend sems unlikely without some relief, albeit momentary; such will be the opportunity to reevaluate the Scenarios.

In the economy, the government's wide-ranging presence will make a difference: increased spending and a lot of credit: these are the usual "tools" and carry no surprises. Macroeconomic risks, however, abound and, although the country's growth is already, for most market economists, around 2% (that is, above our potential GDP estimates), the quality of such growth is not based on sound fundamentals. Low investment, high and growing debt level, rising unemployment and a confidence index (leading indicator) that does not advance consistently. Aside from our domestic problems, the external environment remains a major risk to our already very challenging reality. Thus, internal and external issues can abbreviate this expansion, making it just another "chicken flight" (if we ever reach beyond Potential GDP at that), without freeing us from this terrible low-growth trap.

In Monetary Policy, the combination of the effects of political pressures, misallocations and the stillborn Fiscal Framework certainly sealed a smaller pace of reductions in the Selic rate. We maintain our opinion regarding interest rate cuts for this year – at the same pace, but possibly at a lower intensity. Although we see some "unanchoring" of inflation, this magnitude has not yet accelerated and, added to growing unemployment and an economy (in our opinion) that does not exceed Potential GDP, the pace of Selic cuts will remain the same at perhaps 25bp or 50bp, with fewer cuts than previously predicted. This is conditional on the current board composition at BACEN; with the new board chairman in 2025, we do not rule out political interference.

In exchange rate policy, fiscal issues also tend to affect exchange rate dynamics. In this case, without any conditions, in the medium-to-long term, despite the huge reserve holdings of BACEN control. Here the situation is even worse, because in addition to not having a truly floating exchange rate mechanism, we also do not have "any guarantee" of the level of interventions (with the board's approval, a lot can be done!). Therefore, in this segment the future remains extremely uncertain, but we believe that BACEN, with or without RCN, will make as many interventions as necessary to control exchange rate volatility and its level. The exchange rate directly affects the lives of every citizen, being it a fundamental price.

THE MILITARY STRENGTH OF NATIONS



Source: The Military Balance (The International Institute for Strategic Studies), Global Firepower and Missile Threat (Center for Strategic and International Studies) O Globo (reproduced, and freely translated and adapted by Redwood)

On the fiscal side, things turned "sour" and contaminated everything else. The administration's narratives and actions reveal the lack of commitment to fiscal soundness. On April 15th, the great doubt as to whether the government would try to surprise (by maintaining the original target) or frustrate (by changing the target) – which would be the best decision and enjoy acceptance by the market – came to an end, with the change in the fiscal balance target. This decision represents an important consolidation of the factual reality, ideology and mechanisms that they believe to be best for the country. From a fiscal point of view, the situation, in our opinion, has only gotten worse. We do not, in fact, understand the "interpretive key" that led Moody´s to upgrade the outlook for our sovereign debt – it was supposed to be downgraded!

The fiscal framework is definitely not working, it has no credibility and it remains to be seen how long it will take to be abandoned and to come up with something more "manageable" – perhaps an indicative interval of change for the Debt-to-GDP ratio, or any other indicator hinging on the key variable at stake that is withtin government's scope of action, namely: spending. More than a stabilization of debt trajectory, we need surpluses to begin a downward trend towards 60% of GDP; only then, and in the face of additional reforms, can we contemplate achieving Investment Grade again. As it stands, it looks like sheer utopia.

Overseas, wars (Russia x Ukraine and Israel x Hamas) tend to escalate and take on new and more worrying dynamics. After NATO military exercises, Russia simulates the use of tactical nuclear weapons in its military movements. On the other hand, the Israel x Hamas war is progressing and could actually become a regional conflict, especially with Iran. The consequences of this escalation could affect not only local economies, but also the entire planet.

In Europe, the ECB claims inflation in the Eurozone could be on the way to 2% on an annual basis. with mitigated risks, reaching the target by mid-2025. This is a scenario absolutely in line with our expectations, corroborated with statements by Philip Lane, that interest rates will remain high, so as to take the disinflation process further. In China, rumors of a major currency devaluation are looming. Speculation was sparked by recent PBoC moves in setting the Yuan price above 7.10 per Dollar.

In the US, politics dominates the news, making any topic (Israel, border control, economy, etc.) a reason for contrasts between Trump and Biden. Tensions are running high!

DISCLAIMER

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