MONTHLY STATEMENT

AUGUST 2024

Redwood

REDWOOD ASSET MANAGEMENT

"Be careful who you trust, the devil was once an angel".
– Origin Unknown

Brazil, surname chaos, marches firmly towards a crossroads where any route suggests difficulties beyond the acceptable. The poor leadership of the country results in a moral illiquidity whose markers are scandalously dictated by the Chief Mandate-holder. This moral squeeze spills over into other sectors. The wisest and the most foolish today carry the same weight in economic and social discussions. This is the "flattening" of knowledge, the linearization of ideas, and the "leveling down" of debates. The anything-goes game is astonishing. The malleability of character and personality in the Commander-in-Chief surprises and humiliates even the most experienced in politics, yet presents itself as an angel. The cynicism shocks, causes indignation, and enrages all those minimally committed to truth and justice. We live in a state of inner disharmony, whose social disarray is but a step away from the already existing divorce between reason and hope. Where have we ended up, Brazil?

The behavior of opinion leaders fuels the rhythm and intensity of the deterioration of our scenario. In politics, as in economics, we witness one improvisation after another in attempts to circumvent the unavoidable. Politicians want to spend in any way possible, they do not "accept" the reality of the country, and the Executive Branch (except for a few technicians of the Ministry of Finance), in turn, insists on anchoring the balance of public accounts on increased revenue, not on cutting expenses. The apex: Haddad believes that the Fiscal Framework is consolidated. It is no wonder that tail risk is growing absurdly, and the more sensitive indicators are already pricing it in. The Minister also believes that Brazil will receive an upgrade from credit rating agencies. Are we victims of misinformation and other manipulations that cloud our judgment? More tax hikes (CSLL and JCP)? And the House loosening the Fiscal Responsibility Law (LRF) for personnel expenses? Are we getting exasperated for nothing?

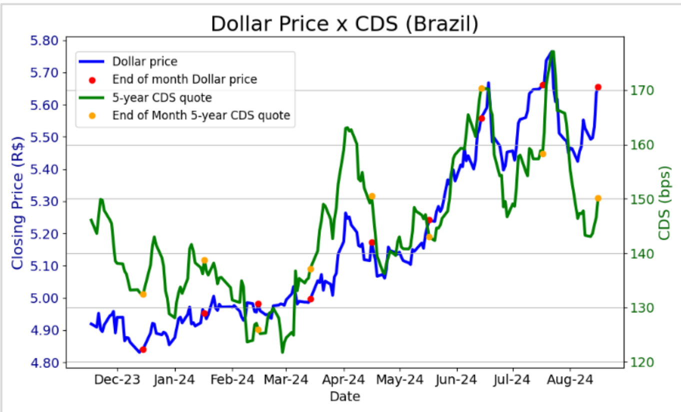
On the BACEN (Brazil Central Bank) side, the confirmation finally comes of the heterodox Galípolo replacing RCN as president. No surprise there, but enormous doubts about his recent behavior. Suddenly, the Director of Monetary Policy has become the most hawkish of the BACEN Directors. Is this a learning curve or sheer momentary convenience? He has the President's support, who has already "authorized" him to raise interest rates (as long as he provides the rationale for it), believe it or not! Is the game "fixed," or do the title and cover image of Galípolo's 2017 book with Beluzzo say it all? The market will not believe it until it finds out, in fact, whether this is a wolf in sheep's clothing. Either way, we expect the transition to go smoothly, but the future president desperately needs to consolidate his credibility as a technician and, on top of that, "perfect" the decorum of the position, sometimes neglected by RCN. These and other answers will only come in the 1st QTR 2025, and until then, it will be a construction under strong suspicion and volatility.

As if political and economic problems weren't enough, we are now also advancing strongly into legal uncertainty in the country. There is no doubt that court decisions must be followed, period. If you disagree, you appeal. However, under the mantra of "protecting democracy," we have seen abuses of all kinds, and the recent suspensions of the social network X and the asset freeze of Starlink (same shareholder Elon Musk) pose enormous risks to legal security and investments in Brazil. Worse still, it's not just one Minister in this case – although Alexandre de Moraes is the precursor and promoter of several "biased" processes, but the entire Court (1st Chamber).

With all due respect to Minister Haddad, it makes no sense to maintain or raise the country's credit rating. Adding up the stances of the Executive Branch (PR), the National Congress (NC), and the Supreme Court (STF), Brazil is fast forming a horrendous environment, whose inconsistencies and the failure of Institutions to function normally are the foundation of our downfall. Without changes, we will see an exodus of investors and capital flight. Brazil's rating should be downgraded. The game goes on, hedge your investments.

In the financial market, the STF's rhetorical contortions to justify its decisions, the shamelessness of the NC's projects completely out of touch with the economic and financial reality of the country, and the constant insults to our intelligence perpetrated by the Executive, led by the chief mandate-holder, have not yet priced in, but truth will come due. In fact, the market "always" reacts (up or down) without a very explicit rationale and, at times, with some delays. However, subject to course corrections, it generally aligns with the reality of the facts.

In this sense, the Ibovespa rose once again by an impressive 6.54%, closing at 136,004 points this month, reversing its negative result to a positive 1.36% for the year. In the interest rate segment (ETTJ), the vertices under analysis advanced and remained aligned with the shift when comparing the maturities. The shorter DI (DI-25) went from 10.71% to 10.995%, the 2026 maturity moved from 11.62% to 11.88%, and the 2031 maturity rose from 11.96% to 12.17%. This month, therefore, the adjustments represent variations of +0.285, +0.260, and +0.210 points for the 2025, 2026, and 2031 DIs, respectively. For other arguments we will discuss below, this positioning rules out any technical possibility of a Selic cut and likely endorses an increase according to market perception – a move we now accept – albeit in "measured" doses. The risk balance in the domestic situation has consolidated, and the speeches of the future BACEN President, in his eagerness to signal his technical stance to the financial market, have "confirmed" the Selic increase.



As for Brazil's risk, priced by the main indicator, the 5-year CDS, there was another contraction this month, closing at 150.193 points or -5.10%, erasing much of the nearly 20% gain recorded in June. The Dollar, much more subdued, remained practically stable: it closed the month at R$ 5.6562 – representing a 0.10% drop for the month and +16.83% for the year. In line with our constant re-evaluations, with absolute adherence to medium-long-term models and in line with our commitment to good technique, we have been revising our projections for the USD by Dec/24. It is increasingly clear that the Dollar's level is changing, with domestic inflation and our fiscal situation being the main drivers of this analysis, which seems to be taking more evident shape by September. In effect, it is not the Dollar that is high, but the Real that is weak, and with additional disappointments (on the drivers), we will certainly miss the Dollar at R$ 5.65.

Na In the economy, the 2nd QTR 24 GDP surprised, and it is difficult to find anyone in the market projecting economic activity running below 2.7%, as we do. In our models, at this level, the economy is operating well above its potential, with a gap around 1%. It does not seem reasonable to accept, with other indicators deteriorating, the continuation of this trend. For example, the monthly drop in PIM (Industrial Survey), the unemployment level easing, prospects of higher interest rates, and unchecked spending stand out as indicators of a slowdown in economic activity. On the other hand, Gross Fixed Capital Formation (GFCF) provided some relief and pointed to a possible improvement, but it will be necessary to check the consolidation of this indicator. The labor market also presented a new drop in the unemployment rate (PNAD – 6.8% in the quarter ending in July), but it is worth noting that the decline in unemployment may have been caused by the drop in the participation rate rather than an increase in job creation. In any case, although we foresee numerous uncertainties that could compromise the future performance of the Brazilian economy, the engine of this growth has been government spending and, thus, of poor "quality." A study by FGV-IBRE Nordeste points to the increased share of social programs in family income, while the share of labor income decreases, with impacts on job search. Savings and investments are also down (16% and 16.8%), not guaranteeing sustainable growth. The summary of the opera: likely another "flash in the pan".

In Monetary Policy, the above scenario “haunts” COPOM, as well as uncontrolled spending and the international situation. Unanchored inflation and the market pricing in 150 basis points of a Selic increase by the end of 2025, combined with Galípolo’s stance and the need to “show” himself as a technician and “restore” BACEN’s credibility, without guidance but with a lot of chatter, seem to seal COPOM's decision (which ***must*** be unanimous!) for at least a 0.25 raise now in September. Thus, from what we had bet on for the maintenance of the Selic (with economists analyzing that there might still be some chance of holding it – obviously for a longer period), we can’t disregard what our financial models point to, because it’s not about what BACEN should do, but what it will do (our BACEN Reaction Function).

In Foreign Exchange Policy, BACEN has returned to its roots (it was too good to be true!). We do not withdraw the praise for the lack of intervention—it was good while it lasted and may have been an opportunity to reevaluate its overly interventionist stance. In any case, the sale of USD 1.5 billion on the spot market (excluding *swap* transactions) barely calmed the market's momentum (as is usually the case). The last time this occurred was in April 2022, setting a clear threshold that anything above R$5.65 would not be "tolerated." In fact, this is the number that really bothers, in every sense. Last month, we concluded this segment by saying, "It won’t take long for us to know" the level of acceptance of the Dollar’s rise, and now we know. Our projections for the dollar at the end of December 2024, around R$5.30, now suggest this as the floor. COPOM's moves with interest rate hikes will certainly adjust the ETTJ (forward interest rates) and possibly the Dollar as well. To be verified.

On the fiscal side, expecting significant cuts from this administration is truly unlikely. They simply don’t believe in it and instead bet on an ever more buoyant economy to improve revenue collection. This is an inefficient tactic that ignores the order of events. That’s why the answers to more structural measures are always evasive and generally rely on the failed Fiscal Framework and its disconnected metrics. Patches and surprises appear all the time, such as the recent "fiscal maneuver" embedded in the bill that boosts the old Gas Aid program and the bill (House) that removes expenses with outsourcing and civil society organizations from personnel expenditure limits. In this vein, the consolidated public sector recorded a cumulative deficit over the last 12 months (ending in July) of R$257.74 billion, or 2.29% of GDP. With mandatory expenses exceeding the limit set by the Fiscal Framework, there is no clear path to convergence of primary results. Uncertainty will persist, and with it, all the consequences priced in by the market.

Around the world, markets are once again worried about a possible recession in the US, and major fluctuations are shaking the stock markets. We do not believe in this. Previously, the inversion of short- and long-term interest rate curves signaled this possibility. It didn’t materialize, and after such a long time, we have seen the return of the 2- and 10-year T-Notes testing a "disinversion." Now, the Sahm Rule, which is also a good recession predictor, is gaining attention, but we cannot overlook, once again, the other indicators that counter this forecast. A tight labor market, reasonably stabilized inflation, government spending, and the likely beginning of monetary easing by the FED are just a few important variables in the analysis.

In Europe, despite greater risks, the ECB seems to be working toward a "soft landing," and "progress" in combating inflation consolidates the market's expectation of a rate cut. In Asia, the Chinese PMI fell again, definitively signaling an economic slowdown. Closer to home, but without any direct economic impact, there’s the mess in Venezuela, which, in addition to Brazil's stance on the Ukraine-Russia and Israel-Hamas wars, now supporting Maduro, has earned us the title of humanity's shame. This does not help the country’s image with investors.

DISCLAIMER

Redwood

Avenida Brigadeiro Faria Lima, 3900 – 10º andar
São Paulo – SP | CEP 04538-132
+55 (11) 2172.2600
planner.com.br