Dear customers, we would like to inform you that Persio Arida will be an adviser of Vista Capital, starting on August, 2020.

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Vista Hedge FIM and Vista Multiestrategia FIM returned 1.16% and 3.21% in July 2020, and had cumulative returns of 6.22% and 15.55% in the year, respectively.

*   *   *

The result of the month was concentrated in the long position in gold and silver, in addition to gains with the pound and Turkish lira.

The macroeconomic outlook has been explained as follows: a major economic shock resulting from the crisis caused by the coronavirus is counterbalanced by traditional fiscal and monetary stimuli.

We understand that this view is potentially simplistic and we believe that a deeper paradigm shift in economic policy is unfolding around the world, especially in developed economies.

Monetary

The revolution started before the pandemic and its effects on liquidity and interest rates levels have been the subjects of our discussions for more than two years.

Using the same lenses to analyze the current macroeconomic scene, we retake a stretch of the *2019 March Monthly Letter*:

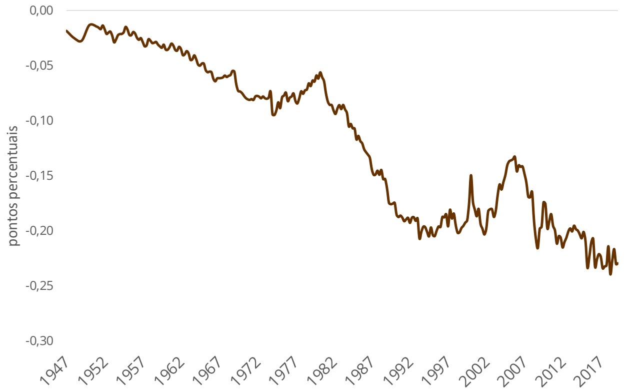
> *"(...) Certain of the difficulty of making an estimate, it seems that the neutral interest rate is significantly lower than previous forecast.*
>
> *To this perception, we add the FED's initiative on changing the monetary policy framework. The discussion about average inflation targeting gained momentum in the academic world and reached the speech of Jerome Powell. The matter will be discussed in June at a conference held in the Federal Reserve of Chicago, and its likely to be implemented.*
>
> *The conclusion about the initiative is similar: if the FED will seek higher inflation in normal periods, the real interest rate will be lower.*
>
> *Theory and practice seem to lead to the same place. The world works, and will probably work, with lower real interest rates. And the important thing here is not just the level - which, yes, it was even lower in some moments -, but the change in perception and the market narrative. Long-term interest rates are relevant factors in asset pricing and structural changes are rare. If the event observed in 2018 is the maximum monetary tightening that the world can handle, it is possible that the time for a new review has arrived. Whether this is the case or not, traditional normalization seems increasingly distant and the Japanese scenario closer and closer.*
>
> *(...)*
>
> *What are the direct conclusions about these changes? In a very simplistic way, higher asset prices."*

Just over a year later, our conclusions about the scenario are still the same.

Even with all the parsimony adopted in the tightening process, the economy and the market had difficulties in dealing with positive real interest rates, a sign that the neutral interest rate is potentially lower than imagined. The pandemic was just the shovel.

The traditional central bank's operational model was affected by the resentment of the way out approach for the long period of easing. As an example, the effect that 1% of interest rate variation has on American companies performance (graph on the right). The same effect also occurs with liabilities denominated in dollars globally, though in different degrees.

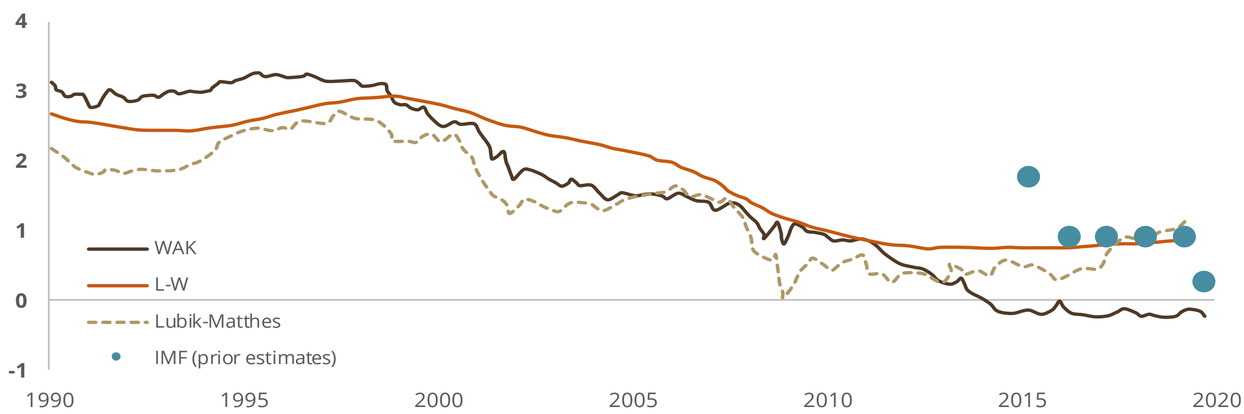
Impact on RoE of American companies after a shock of + 1pp in interest on their debts



Source: BEA, FED and Vista Capital

Therefore it seems very likely that the movement to reverse monetary accommodation will be postponed. Even more important than the postponement is the consensus around "making mistakes the other way" in this cycle, after more than 10 years without reaching the economic potential and generating inflation.

Estimate of long term neutral real interest



Source: IMF WORKING PAPERS; Reading the Stars Author/Editor: Peter D. Williams; Yasser Abdih; Emanuel Kopp; Jul/2020

Then the new FED framework adopts, *ex-ante*, a greater tolerance for inflation higher than the 2% target, which has direct implications on financial conditions.

The market's perception is that the neutral interest rate is lower and the new FED framework has a relevant practical effect on the interest curve. Today, the FED declares that it will not raise interest rates for a long period, which is consistent with its dual mandate and the framework adjustments, and the market does not challenge the statement.

Fiscal

The pandemic increased an already existing discussion in monetary policy and in the fiscal policy the effects were outstanding. Topics such as the European fiscal union and the universal minimum income have thrived and gained preference on the debate.

In the United States, the effectiveness of income transfer programs and increased public spending to face the sudden economic activity paralyzation reinforces the thesis that such instruments will be used in an attempt to lengthen economic cycles. The theme will certainly be present in the American election. Brazil is following the same path.

If implemented, we can watch fiscal policy take the baton of monetary policy in managing economic cycles. To place politicians in the chair that today belong to central bankers officers will certainly raise the disruption risks of the last decades low inflation environment.

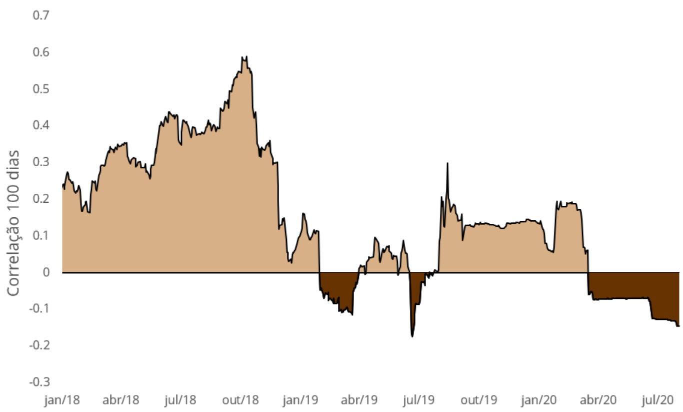
Notwithstanding the medium-term considerations, what we see is monetary and fiscal policies gaining momentum around the world, a rare situation in recent decades and very positive for asset prices.

Practical effects

In the last monthly letter, we dealt with the inversion of the correlation between real interest rate and implicit inflation, resulting from a “fixed” nominal interest rate.

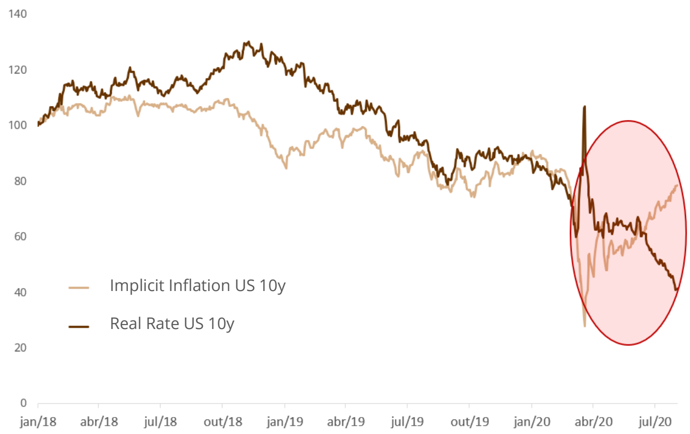
2018 is a good example to explain the thesis. During that time, economic recovery confidence raised inflation expectations and, in parallel, real interest rates: the stronger the economy the greater the expectation of high interest rates.

Correlation 100 days: US real interest rate 10y x US implicit inflation 10y



Source: Bloomberg

Normalized chart: implicit inflation US 10y x US real interest rate 10y



Source: Bloomberg

The correlation was growing until the end of the year, when a correction in prices showed that the market would not stand the highest level of interest rates that was already priced at the time.

In 2020, it is expected again an economic recovery in the after-pandemic. The effects on monetary policy, however, are quite different.

In the light of the new FED framework, the correlation between economic activity and interest rates has not only been reversed but has deepened every day. Marginally, it is a surprising movement.

The inversion is part of what we call a macroeconomic revolution.

In previous *modus operandi*, the economic recovery generated an increase in real interest rates, given the closer proximity to the Fed's mandate. Two antagonistic forces operated on asset prices. On one side, the increase of expected inflation led to profits nominal growth. On the other side, the discount rate increase reduced assets present value.

In the current environment, in which the structural change in the Fed's reaction function anchors nominal market rates, the increase in expected inflation will lead to a reduction in real interest rates, and not the other way around. Both forces start to operate in the same direction: the increase in profits anticipation is leveraged by the discount rate fall.

In addition to the effects on prices, it also affects the economy, since the greater the recovery, the more stimulus is being offered to the activity. However absurd it may seem, a faster reopening and a successful vaccine could lead to more inflation, real interest rate will be lower, and the economic stimulus will be greater.

In summary, we are moving towards a world where the economic stimulaton of the FED in normal times will be substantially bigger than it was in the height of the pandemic.

The old correlation had never been reversed to the current magnitude precisely because of this issue. If the more the economy recovers, the greater the stimulus, how far will we go?

Assets

The funds remain focused on real assets, discussed at length in recent months, exposed to the main effects of the new framework.

In this sense, the funds' main positions are long positions in (**i**) gold and silver; (**ii**) oil and Petrobras; and (**iii**) international equities.

International equities have been part of the portfolio a few times this year and have been gaining relevance recently.

In the context of the projected scenario for global interest rates, the predominant factor in our thesis for international equities is the expectation regarding the high level of the equity risk premium - especially for the American stock exchange, in which flows are less uncertain and durations are longer.

The concept of premium is simple: how much of a return above the risk-free interest rate the investor will gain to hold stocks and be exposed to the risk of business activity.

In addition to the compression towards the levels observed in recent years, it is possible that the movement is even more relevant. It should be noted that the equity risk premium have been running at higher levels after the 2008 crisis, probably due to a greater uncertainty about the maintenance of low interest level that prevailed at the time.

As stated in the aforementioned letter, the agents' bet on high interest rates indicated the perception that zero interest rates were out of place. There is nothing more natural than to price stocks using interest rates other than those indicated by the current curve.

After the failed attempt to raise interest rates in 2018, it is possible that agents understand that zero interest rates will be perennial and we will return to working with even lower levels of equity premium.

Portfolio

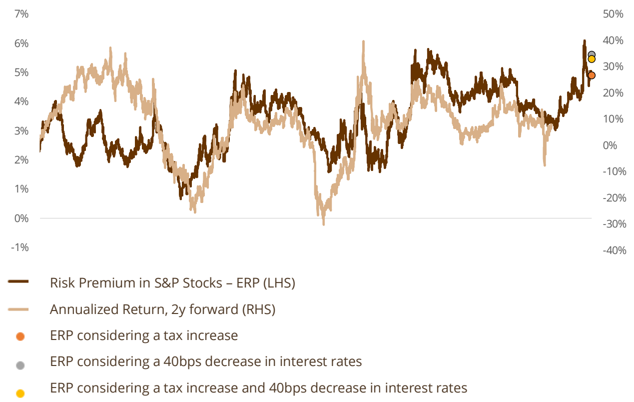
Our biggest current questions are about choosing hedging, something that has been easier other times in recent years.

Purchase of bonds to protect the equities position, a type of hedging widely used by the market, becomes practically unfeasible in an environment of financial repression, with interest rates close to zero.

Even if it were not the case, there is a question about which the biggest risk is: deflation or inflation?

In principle, a portfolio sought protection from deflation scenarios. The new macroeconomic framework has made it important to protect against inflation.

Equities Risk Premium and S&P Total Return



Source: Bloomberg and Vista Capital

In our portfolio, we see gold as a protection for currency debasement; oil offers protection against inflation and interest rate increases; and international equities have a good safety margin.

This allocation is complemented by a long position in sterling pound, a short position in the Turkish lira and the purchase of implicit inflation in Brazil.

Even so, we believe that a deflationary shock is the main risk to which the portfolio is exposed today.

The position in domestic stocks today is concentrated in Petrobras and specific investments in which we see a good asymmetry. With macroeconomic lenses and considering the stock index basket, other geographies are currently more favorable for investments.

Other thoughts

In the midst of the portfolio construction discussions, some issues arise. Part of them are shared below:

Theme 1.

The scenario described above requires someone to pay the bill. We believe that that someone will be “the money” and, consequently, its owner.

The current situation is as follows: thinking about the savings account for his newborn son, an Englishman who acquires a 18-years redeemable government bond, will give it to his heir when he reaches the majority age, one in real terms.

There are two worse news:

i. Financial repression shows signs that it will be deepened. In other words, babies who are born from now on will see their bond heritage drop further over the 18-year period.

ii. The real interest rate is the result of the nominal interest rate less the actual and measured inflation. Is the measurement being done correctly? Or yet, for whom is it measured? In recent years, official US inflation has hovered below the 2% target, but the inflation of unallocated capital holders has probably been much higher. We live in a world of asset price inflation.

The more the prices of gold, silver, stock and real estate will rise, the lower your purchasing power. For example, in the past 10 years, the official inflation was 18.4%, while the average price of American homes rose 49% and the stock exchange rose 197%. That is, whoever carried money and not assets in the period suffered a huge loss of purchasing power.

In summary, the decision of any person who has increased its net worth is not how much to invest, but when to invest. Doing nothing is not an alternative anymore, as its net worth will be drained over time to pay for increased public spending and financial repression by central banks.

Theme 2.

It seems that a Selic rate close to 2% and negative real interest rates will put Brazil in a similar situation to that described in the previous theme. It is a totally new scenario for Brazilians.

The biggest symptom of Tupiniquim's originality is the allocation in equities in multimarket funds (hedge funds). In Brazil, the question that is asked is "what percentage of the fund's portfolio is invested in equities?". In the USA, the question is diametrically reversed: "what percentage of the fund is in cash?".

Even ourselves, raised in a high interest rates environment, we also deploy this framework in the way of thinking about asset management, though in an implicitly manner. Over the past few years, we have grown tired of discussing our hedging and ways to protect assets from falls. We repeated: "if there is no great conviction, the best choice is to do nothing."

If before it was obvious that "doing nothing consisted of keeping resources in cash, we now wonder if the meaning of the expression needs to be changed.

Questions like this are part of the team debates we invite our clients to join.

Theme 3.

The new framework and the effects on the interest differential, the increase in the double deficit, the worsening of the oil trade balance with the reduction in shale production, the deficit in net external liabilities and, above all, the election risks favor the dollar devaluation.

Today we avoid increasing exposure for a number of reasons: (i) the long position in sterling has a similar basis, since it is a currency considered to be a store of value and, therefore, an excellent destination; (**ii**) gold works like a currency, and is also an option; and (**iii**) US dollar devaluations are usually accompanied by commodities appreciation, the fund's main position.

Theme 4.

Petrobras' result surprised us positively and brought important confirmations to the thesis.

The cost of production fell again, approaching the lowest levels in the sector. Cash generation was positive even with a US$ 24 oil price, which proves the company's resilience at extreme prices. The divestment, deleveraging and cost reduction process continues to accelerate. The company's shares continue to trade at a considerable discount compared to its global peers, offering a good safety margin.

Theme 5.

The COVID cloud makes it difficult to fully price the scenario discussed above. The fear of a new wave, of a repetition of a relevant fall in the market and of sharp losses generate a dispute with the fundamentals. These factors, added to the unavailability of hedging, increase the level of market volatility.

Yet fears are very present in decisions, the level of stimulus and valuations show us a more protected market than before, with less risk of permanent capital loss.

We remain at your service.

Vista Capital