Vista Multiestrategia Fund and Vista Hedge Fund registered returns of 5.97% and 2.05% respectively in January and 30.24% and 10.72% respectively in 2020.

The positive result in the month is mainly explained by the gains in long *core* positions in oil and gold. Short positions in dollar against the Brazilian real and the Australian dollar, and in international equities also contributed positively.

The result for the year was quite diverse, with positive contributions in all lines. The international segment was responsible for most of the fund's results, especially in commodities and equities.

First of all, we would like to thank our clients and friends' partnership and trust in 2020, our most sincere votes of health and prosperity in 2021.

2020 was an excellent resilience test for our management model, focused on long-term positions and on the search for efficient hedging, since we entered the year bought in oil, an asset extremely affected by the pandemic and yet a *core* position in our portfolio. April 20th, the day when the first oil futures contract went negative, is still fresh in our memories. OPEC's decision to breach the agreement in March was definitely our black swan.

On the business side, it was also a year of significant advances at Vista Capital. Important partners joined the team - Alexandre Maia, Arthur Braga, Miguel Galvão and Persio Arida - and assets under management more than doubled during this year. Once again, we thank our clients for their confidence in this journey.

In this letter we avoid looking back to 2020, a year that was lived intensely by all, but instead we seek to look to the future, which is as promising as challenging for the asset management business.

Much is said about the changes that the pandemic has brought to the working environment and people's consumption pattern, with the acceleration of e-commerce and dissemination of working from home as trends. However, our greatest interest lays in the most perennial changes in economic policy environment, much of which started earlier and was enhanced by the pandemic.

An important part of what we will analyze below has been shared over the past months and years in our letters, with thoughts of a probabilistic and non-deterministic nature. In other words, our scenario is still under construction, with some open ramifications, but today we undeniably live in interesting and challenging times.

*   *   *

"We are a long way from neutral" Powell (2018)

"We thought carefully about how to normalize policy and came to the view that we would effectively have the balance sheet run off on automatic pilot." Powell (2018)

These two quotes above had marked the thwarted attempt of monetary policy normalization in the U.S.A. in 2018. Ten years of economic growth, unemployment below 4% and the fiscal expansion of the Trump administration indicated the need for continued monetary tightening, at least in the parameters then in force at the FED. Estimates that the neutral real interest rate was positive and not far from 1% also gave comfort to the FED to seek a less accommodative stance.

The strong squeeze of the financial conditions at the end of 2018 showed monetary policies limitations. In some letters back in 2018 and 2019, we talked about the change of the R* (neutral interest rate) and the greater sensitivity of a leveraged system to shifts in the monetary policy, points that had restricted the scope of FED's strategy in course until then.

As the 2018 monetary tightening was reversed as early as 2019, the FED immersed itself in discussions on a new monetary policy framework, having presented the new guidelines for this framework only in September this year. We discussed extensively in previous letters the consequences on asset prices of the new FED's reaction function, explicitly more likely to explore the limits of full employment and to tolerate inflation above 2% for an extended period.

Anyway, despite almost two years of debate over this new regime, we understand that the market consensus partly disagrees with our scenario. The recurring debate about when the FED should start normalizing the monetary policy is all the more evident than we imagined. Considering the long history of the US central bank of not delivering 2% inflation and the possible temporal inconsistencies in the forward guidance instrument, we understand part of the market's skepticism. Some recent messages of members of the FED alone reinforced this concern.

The taper tantrum also looks fresh in investors' minds. After all, in September 2012 the FED implemented what was known as the QE infinity, real interest rates reached historic lows in the first quarter of 2013 and, soon after, the FED announced its intent to reduce the pace of asset purchases.

The repercussions of the tantrum on the interest rate curve were very meaningful and, in our view, provide important lessons for today's FED and the consolidation of its new regime, which go through a very cautious management of the current quantitative easing program:

"What we've done is, we've laid out a path whereby we're going to keep monetary policy highly accommodative for a long time, really until—really until we reach very close to our goals, which is not, you know, not really the way it's been done in the past. So that's, that's providing significant support for the economy now"

(Jerome Powell, 2020)

As we discussed in previous letter, the great robustness test of the new FED framework will happen when metrics of full employment and inflation indicate the need for monetary tightening, at least from the perspective of previous cycles, and the US central bank does not sanction this expectation, which is our base scenario.

We therefore believe that, even with the inevitable pressure in the opposite direction, the FED will be firm with the new framework and signs of overheating of the economy are welcome. Even if reductions in the pace of purchase of assets happen, unlike the past, they will be reactive and not proactive, that is, conditional on an important improvement in the scenario.

Thus, we will consolidate the scenario widely discussed on 2020 letters, where the environment of persistently negative real interest rates, helped by the gradual increase in inflation expectations, produces relevant effects on asset prices.

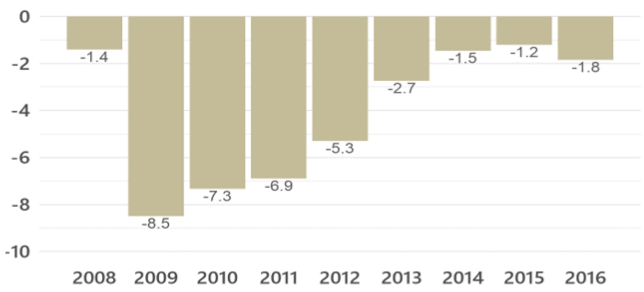
* * *

If in the monetary policy the pandemic accelerated an already existing discussion, the effects were more remarkable in the fiscal policy. In the USA, the effectiveness of cash transfer programs, implemented also in several countries throughout 2020, reinforces the thesis that such instruments will be used to lengthen economic cycles.

If we take a step back and go back to what was the mainstream economic policy of the 1990s and the first decade of the 21st century, some concepts were deeply rooted in the understanding of fiscal and monetary policies, especially in developed countries - central banks would be independent and they would pursue low and stable inflation still under the shadow of the inflationary sock of the 1970s; fiscal policy should be consistent with a declining or stable trajectory of debt/GDP ratio. Throughout the Clinton administration, for example, the years of strong growth and fiscal austerity brought the debate over to when the US public debt would end.

Still in the US, although fiscal policy was accommodative in the quarters following the outbreak of the 2008 financial crisis, the debate quickly shifted to the need for fiscal consolidation. Therefore, the Obama era was largely marked by contractionary fiscal policy, which overburdened monetary policy.

Primary Results – USA, GDP %



Source: Congressional Budget Office and Vista Capital

The fiscal tightening in the first half of the last decade, in the United States and in several other advanced economies, is now perceived as an economic policy mistake that helped to perpetuate the slow recovery of post-2008:

"The mistake came later in 2010, 2011 and so on, and that was true on both sides of the Atlantic. The first lesson is to make sure governments are not tightening in the one to two years following the trough of GDP."

(Laurence Boone, chief economist at OECD, 2021)

In the same way that we understand that 2018 was the moment where the FED and other central banks had accepted that the neutral interest rate age were well lower, 2020 was the year where the limits perceived of the fiscal policy had been extended, particularly in advanced economies.

In 2019, some of the leading western economists were already rehearsing a new approach to fiscal policy:

"Aggregate demand may remain chronically low, implying sustained low neutral rates. The zero lower bound may be fiscal policy help, and a more dramatic redistribution of roles from monetary to fiscal policy."

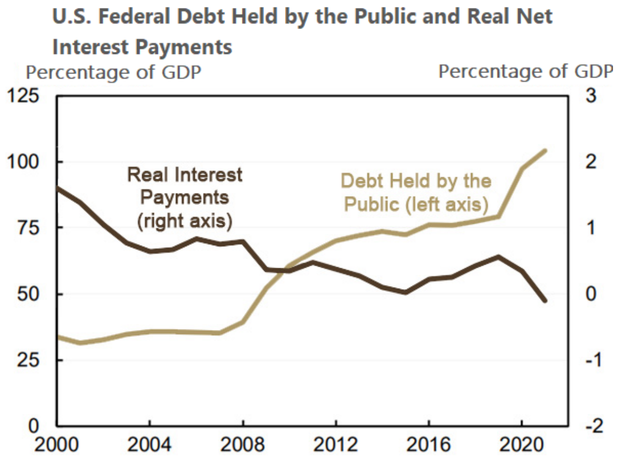
(Summers & Blanchard, 2019)

More recently, a debate between the leading economists at two American think tanks has gone in the same direction:

"Low interest rates also create numerous opportunities. They expand the scope for expansionary fiscal policy, make the debt more sustainable and increase the scope of public investments that will pay for themselves over time. Whether the era of low interest rates becomes a time of more prolonged and severe recessions and greater financial market bubbles or instead becomes an opportunity for public investment and stronger economic growth depends on macroeconomic policy decisions."

(Summers & Furman, 2020)

The new mainstream also examines the concept of debt/GDP ratio; after all why compare supply with a flow? The ability to roll over debt, measured by the cost of real interest payments load, would end up being the best measure of debt sustainability (see graph below - Summers & Furman, 2020).



Fonte: Office of Management and Budget; Congressional Budget Office; cálculo dos autores (Summers & Furman 2020)

Somehow, we are back to the post-war scenario, where there was a greater symbiosis between central banks and treasures and financial repression made it possible to carry higher debts.

In the same vein, it has increased the FED's debate on having a more lasting presence in public debt market, keeping a better balance than imagined some years ago:

"The sheer size of the treasury market may have outpaced the private market's ability to absorb any stress. Open question if the treasury market so large FED support mandatory"

(Randal Quarles, 2020)

This path still generates many debates and the medium-term inflationary implications of this new economic policy mix should not be underestimated.

The Democratic victory in Georgia puts us at the forefront of a possible more permanent turn in the fiscal regime, in addition to a greater focus on policies to reduce inequalities and the demands of so-called minorities, themes that we will address next.

* * *

"It's the economy, stupid" (Carville 1992)

The quote above reverberated on most of the last decades' political campaigns. After all, the economy should define elections, be it on the right or left sides. Still under the shadow of the Cold War, much of the political antagonism was under the mantra of dispute between capital and labor.

Margaret Thatcher, the British iron lady, despite being a conservative, had huge conflicts with striking movements, defending private property and minimal state. In Brazil, the Workers' Party (PT), born in the entrails of trade unions, was an explicitly example of class struggle. After years of empirical evidence of the failure of socialism model, along with one of the biggest economic expansions in history, the traditional left lost space.

The growth of the services sector over the industrial sector, the stimulation of entrepreneurship and even the trend towards work from home help to reduce the boundaries between capital and labor. The new left, concentrated in huge urban centers, partly accepts the capitalist agenda and has a higher-than-average income. In Brazil, this phenomenon is clear with the rise of PSOL (Socialism and Liberty Party) in São Paulo over PT.

Themes such as social inequality, social, racial or gender discrimination, environment protection, among others, are gaining space and there is no reason to imagine a setback. In this field, there is a coincidence between speeches of the center and left forces:

"Perhaps the biggest problem in the country is inequality. A relation between economic prosperity and general well-being exists, but it is tricky to believe that the economy growth is enough to solve social matters."

(Fernando Henrique Cardoso, former Brazilian President, 2021)

The privatization agenda in Brazil, for example, continues to face difficulties in Brasilia, but there is no longer a strong popular pressure on the other way. Where are those who protested on the streets in the 90s? They appear to have been replaced by protests associated with the minority agenda.

On the political board in Brazil, the situation is even more complex. The northeast countryside, for example, an old PT stronghold, is today a political force of the President in the wake of the emergency aid. The disarray, not yet widely discussed, is such that we can have an election in 2022 where the poorest might vote for the right and the richest might vote for the center or left forces.

In this new framework, we believe that Joe Biden's election was the redemption of economic and social centrism. Similar results had been seen in the Brazilian municipal elections and seem to happen again in the dispute for the control of the House of Representatives between the center and the left against the right and center-right parties.

The possible repetition of this dispute in 2022 might have an excellent effect on market prices. More important than the political actors in question, it is possible that the most populist speeches on the economic front do not attract the spotlight of the electoral dispute. Despite the profound political changes observed, doubts still surpass certainties for 2022 and it is not our goal to anticipate such a discussion.

In contrast, we cannot forget that important changes in the society influence public politics and its policymakers in an excellent way. If the social guideline of the moment is the reduction of inequality, would it not be the monetary politics and fiscal contemporaries of the countries' richest, argued previously, important consequences of these demands?

"A tight job market is probably the best single thing that the FED can do to support gains by all low- and moderate-income communities, and particularly for minority communities that are heavily representative in those groups."

(Jerome Powell, 2020)

Therefore, the FED seems to implicitly believe that an overheated labor market will lead to a successful redistribution of income from capital to work.

The inequality reduction flag is also quite evident on the president-elected Joe Biden's platform.

In addition to the convenience in maintaining high fiscal deficits, there is an emphasis on progressive taxes and increased union membership.

*   *   *

Therefore, we know that there is no free lunch. On the fiscal side, the most conventional way of reducing inequality would be a progressive taxation, including financing income transfer programs. The chosen way, mainly, is to finance such programs with the increase of the public debt.

Economics textbooks would say this would be harmless. A sequential increase in debt would trigger an inflationary process, punishing the poorest, and that could end in a worse situation than the previous one. Lyndon Johnson's *Great Society*, which aimed to eliminate poverty and racial injustice, culminated years later in Paul Volcker's interest shock.

Current times are different and strange. Inflation of goods and services, once more directly affected by exaggerated fiscal expansions, remains strongly under control. The reasons, beyond the scope of this letter, include technological and demographic changes and the long period of independence of central banks.

In contrast, asset inflation continues its march in an insistent way. Property, equities, and commodities continue to significantly increase in value during the pandemic. More recently, we have seen the bitcoin phenomenon entering this list. Finite and scarce assets continue to gain value.

To put it another way, if continuous fiscal expansions are slow to generate inflation, why not double the bet? After all, that is exactly what the MMT framework preaches: the only constraint for fiscal expansion in economies like the US economy would be the full usage of productive factors and the resulting inflationary pressures.

However, there is no free lunch. If the limits of the expansion of public debt are extended, whoever pays the bill is the holder of the money or, more precisely, who finances governments with a real negative return.

"I keep being asked: You say we may not need to increase taxes to pay for the additional debt. How can this be? Who will pay? The answer: Investors, who are willing to accept a negative rate."

(Blanchard, 2020)

Let us come back to the beginning. We will not directly tax the holder of capital to finance the debt, but the real value of that capital will be reduced, over the years, by some version of financial repression. Therefore, it is a tax in disguise.

The *rentier* is the big loser of this new framework.

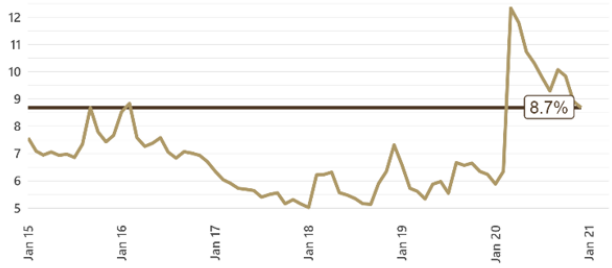
In the light of theory, we could say that this tax will not work. Agents will realize that cash is being taxed and will run for financial and real assets. Reality is harder than theory.

First of all, it is necessary to consider risk profiles. It seems very unlikely that, on average, agents will seek to allocate all wealth into assets.

Furthermore, hedging has become more expensive in this environment of financial repression. If buying bonds is no longer a protection at the current rate levels, options are the only hedging available. And just as insurance and reinsurance companies increase premiums after major claims, we see the same phenomenon in the financial insurance market. Investors, in the absence of viable alternatives, are forced to pay high premiums in pursuit of optimal risk management.

As an evidence of the above phenomenon, the chart below illustrates the cost of hedging for stocks listed on American stock exchanges, where there is a systematic demand for protection. It is noted that the cost of this protection is at high levels, approximately 9% per year in the S&P 500 or 30% more expensive than the average of previous years.

Cost of Hedging the S&P 500
Put options in %



Source: Vista Capital

It is also worth noting that, by traditional metrics, it would be the right moment to reduce the allocation. And here we reinforce our priority of guiding risk control by stress and not by metrics like VaR. Given the increase in market volatility, for the same variance in the portfolio, the position should be lower than before.

On one hand, the current environment encourages investors to maintain a very high-risk allocation. On the other hand, the limited hedging availability and high volatility encourage a greater cash position.

The investor has three options left: ***(i)*** to be highly allocated with little or no *hedging* ***(ii)*** be highly allocated and with some expensive hedging and ***(iii)*** not being sufficiently allocated and having cash being remunerated at a negative rate. No solution seems excellent.

Considering this difficulty, we invite our clients to participate in the discussion of what we consider to be the management paradox.

Is adequate protection being under-allocated or over-allocated?

* * *

We noted, then, an extremely benign scenario for asset allocation for the reasons we discussed throughout the letter. However, the allocation need to face the taxes on the *rentier*, in a more volatile environment, poses challenges to portfolio management.

The funds continue with a high exposure, although with less direct hedging than in other times.

The biggest risk of this benign scenario for the markets is a more than expected increase in inflation. In this case, our directional long position in *oil*, an asset that tends to present a good performance in inflationary environments, is perceived as a hedging. A rationale that also applies to the gold risk. Hence the current vulnerability of the portfolio is a deflationary shock.

In the short term, we will be carefully watching the struggle between the speed of vaccination and its greater transmission, explained both by relaxation of control measures and by new strains or variations of the virus.

2021 will be a year filled with many opportunities, but certainly with new challenges in this global adventure, where principles of economic policy management rooted for decades are set aside and strong convictions are tested. In our assessment, active portfolio management will be extremely important to successfully face a new volatility regime in the markets.

In any case, we are available for further clarification and again we thank you for the partnership and trust.

We wish you all a great and healthy year.

Vista Capital