

Vista Multiestrategia Fund and Vista Hedge Fund registered returns of -8.69% and -2.63% respectively in October and 27.12% and 10.17% respectively in 2021.

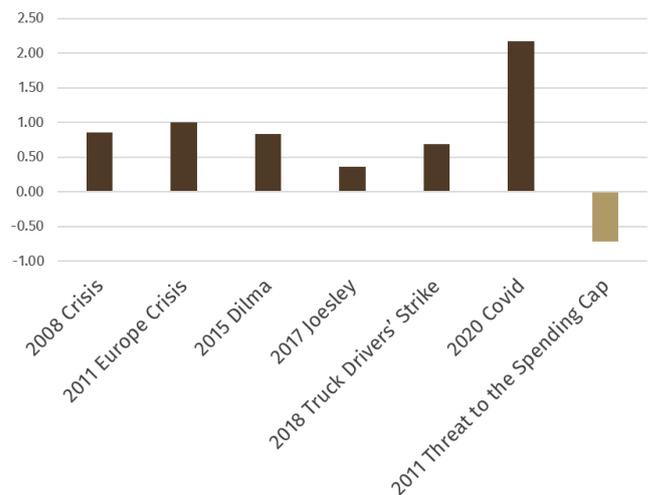
October was an especially challenging month. As mentioned in previous communications, the loss of correlation between assets is typically a greater risk to funds than directional worsening. Furthermore, the last two months show the importance and effects of hedging on the portfolio.

In September, hedges focused on the iron ore complex helped the fund reach the best month in its seven-year history. In the last month, the hedge on Brazil's interest curve slope not only failed to protect the portfolio but was the main detractor.

In October, the fund was structured as follows:

- Currency and credit hedges, aimed at isolating global demand shocks, covered uranium and oil positions. The result was not out of the expected historical pattern.
- Long on Brazilian stocks, growing in recent weeks and focused on Petrobras, was hedged by an interest curve steepening. We understood that the country's greatest risks were in the electoral process and in the sustainability of the long-term debt. More still, the signaling of the Brazilian Central Bank (BCB) to anchor the rhythm of 100 bps hikes would play the risk for the long part of the curve. All together, the above assumptions proved wrong.

Stress Scenarios: Steepening Yield Curve*



*Historical steepening of fixed interest rate yields (DI) from January 2024 and 2027

In historical correlation studies, we always look for a series of events with similar characteristics to what we want to protect. In the case of the yield curve, the track record was favorable (see chart above). However, the spending cap breaching and the global movement of flattening of yield curves had a significant impact on our hedging, both due to the revaluation of the expected path of monetary policy in the short-term and due to more technical issues.

Once the first defense position failed, the next step in risk control is the mandatory reduction of positions. Today the fund is limited to half of its risk budget.

The practical effect in the positions are:

- i) we no longer hold oil producing companies positions in several geographies, only exposure to long-term oil futures. The uranium position was

reduced and we zeroed out the gold and iron ore exposures.

ii) we no longer hold positions in currencies, credit, and international fixed income.

iii) in relation to the Brazil portfolio, few changes were made in the long directional exposure on the stock market. In turn, the position in the steepening of the yield curve slope was significantly reduced.

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Over the past two years, we have described our greatest skepticism towards the scenario in Brazil. At the end of 2019, when the government gave up on moving forward with the administrative reform, we reassessed our optimistic view and started working, most of the time, with a short or neutral position in Brazil. Valuations, our most faithful compass, were aligned with a country that would deepen the economic recovery with privatizations and reforms, which did not seem to us to be in line with the government's interest or capacity.

During this long period, apart from Petrobras, we used most of the fund's risk on international positions, both on the international equities and commodities, fixed income and currencies.

Especially in 2021, we disagreed with the current government's reelection expectation given the good GDP growth in the calendar year. The deterioration in the purchasing power of families seemed to us to

be a more faithful indicator of the political difficulties that lay ahead. Furthermore, the fiscal improvement resulting from the inflation tax would precede an understandable pressure for more social spending. After all, Brazil, which has a regressive tax burden, is facing inflation, the most regressive of all taxes. The K-shaped recovery, a global and local phenomenon, further accentuates this social tension, described in our July letter:

"The recent noises surrounding court issued registered warrants ("precatórios") and how to accommodate a new income transfer program reflect, in our opinion, the contradiction between the spending ceiling and the electoral cycle. The end of the emergency aid program and a slightly larger new Family Allowance Programme ("Bolsa Família") do not match the livelihood needs of the poorest population and therefore do not seem consistent with the upcoming election year."

"Anyway, the food insecurity of part of the population will be a central point of the electoral process. We will monitor closely the developments on this front, maintaining a bias towards more spending, with direct consequences for asset prices."

Although the review of subsidies, sectorial exemptions and the excess of parliamentary amendments should be considered alternatives to breaking the ceiling, the electoral cycle ends up becoming an important impediment.

With the worsening of local asset prices and the social picture in recent months, we understood that, in a way, the continuation of off-the-ceiling emergency aid was gradually being priced. With the strong reaction of the markets following the break of the ceiling, we underestimated the effect of the event.

It is clear that the recent developments are bad for our fiscal governance, but they do not seem surprising to us. The real new fiscal framework will start in 2023 and the duration of this new arrangement will only have a temporary effect.

That focus on the future should become even clearer with the Congressional recess. The noises tend to decrease and the current government's policies should lose relevance. With this chapter on the new cash transfer program and spending ceiling changes closed, we are probably looking at the latest relevant actions between the Executive and the Legislative leading up to the elections.

Faced with these uncertainties, for what reasons are we once again taking a relevant position in Brazilian assets?

First and foremost, the *valuation* of a large part of the assets seems to us to be quite discounted. Remember, for example, that Petrobras can return something close to 40% of its value to shareholders in dividends before the first election term. Other

stocks embed relevant risk premiums, although not of the same magnitude.

The exchange rate remains persistently undervalued, despite the gain in terms of trade throughout the year and the widening of the real interest differential against the US. The real interest curve, in turn, fully reversed the improvement that has taken place since the Temer government, with some vertices showing a real interest rate not far from 6%.

The second reason is the current snapshot. When trying to locate ourselves from where we are to use our compass, we discussed whether the current moment is similar to the Dilma government, given that we observe some similarity in specific valuations.

The fiscal scenario, despite the rupture of the previous regime, does not fit into a narrative of lack of control. States and municipalities (E&M), for example, were facing bankruptcy a few years ago and are expected to show a primary surplus of around 1.5% of GDP in 2021. The adjustment on the expenditure side after the 2016 Fiscal Adjustment and Restructuring Program, which allowed the federal government to refinance E&M debt, is an important part of this improvement. Furthermore, the strong improvement in ICMS (value-added tax on sales and services), transfers from the Union and the revenue gain from concessions or privatizations also explain this fiscal turn. In the case of the State

of Rio de Janeiro, for example, primary deficits between the years 2012 and 2017 were significant, reaching 15% of the current net income (RCL) in the fiscal year of 2014. Between 2018 and 2020, the result turned to a primary surplus of almost 4% of RCL.¹ In 2021 and 2022, with the resources from the CEDAE concession auction and the increase in oil royalties, the fiscal results will be even more expressive.

Also, in comparison with the Dilma government, in 2015 the country was experiencing a long cycle of unbalanced economic growth, which was also evident in the worsening of its external accounts. The government's disastrous policies, in the fiscal and parafiscal fields, added to the end of the commodities cycle, brought the end we all know.

As much as we remain pessimistic about the government's ability to deliver and there are contracted effects of the monetary tightening still in progress, it is an important momentum for activity that should not be underestimated. In addition to the fiscal space for investments in E&M, it is expected that in 2022, a strong growth in agricultural production, the continuation of the reopening of some sectors severely affected by the pandemic and the gradual normalization of the

automobile production, and several federal and state concessions will take place.

In companies, the differences are huge compared to the Dilma years. While in the previous crisis the leverage of companies such as Petrobras and Vale was a reflection of the wrong strategic positioning in the economic cycle, today's good publicly traded companies are not only unleveraged but also significantly capitalized.

Anyway, we don't want to underestimate the complexity of the economic scenario. The BCB continues to struggle to anchor inflationary expectations and has made moves that are, at least, delayed and questionable. Furthermore, fiscal risks on the horizon still seem to be focused on greater demands for spending and salary adjustments.

Considering the factors described above, we are against the consensus that in 2022 the country will suffer another recession. Since the Dilma government, political and fiscal noises have taken on great relevance, but we see some positive cyclical vectors for 2022.

If this is the case, it seems to us that stagflation or moderate growth scenarios are more likely than a recession, which has distinct effects on assets.

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¹Diagnosis of the Fiscal Situation of the State of Rio de Janeiro. Secretary of State for Finance of the State Government of Rio de Janeiro. July 2021.

Finally, the political part. As always, we do not try here to forecast any scenario or great conclusions,

but to argue some comments and only to discuss the scenarios in a probabilistic form.

If the presidential election is open, we can draw some lessons from history. The PT, even at the height of its popularity during the Lula government, always went to the second round, which did not happen in the successful elections of the PSDB in 1994 and 1998. In some ways, this suggests a more conservative bias in the electorate. In the current scenario, where the extremes are taken and consolidated, the electorate more to the center must be the tip of the balance. Pushing him away is certainly not a path to victory.

In Congress, this “conservatism” should become even more evident. The last election for members of the house of representatives showed a more center-right composition, what also was confirmed in the last municipal elections. The clauses resulting from the political reform promoted by the Temer Government will make this legislative election probably one of the most important in recent decades.

Barrier clauses should prompt parties to focus on the legislature dispute, which could prevent the fragmentation of a possible third way in the presidential election. The significant amounts of electoral funds in the hands of center-right parties bring weight to the deepening of the composition of

Congress.² In the case of the victory of former president Lula, the need for a composition with other parties will be even more latent.

Leaving the federal dispute, we see the states with compositions and politicians more in line with good economic practices than the other way around. In addition to the fiscally responsible governments of large states in the South and Southeast, we also have good fiscal governance in the Northeast, where there are many leftist governments. These improvements are even more relevant when we see that Brazil's GDP has barely grown for a decade, which makes any fiscal adjustment difficult.

It is also worth noting that there is a new generation in Congress, more in the center-left field, committed to fiscal responsibility and the reform agenda.

“The PEC on Writs of Payments (PEC dos Precatórios) is a workaround by the government to try to guarantee reelection. There is a lack of decency to face the super salaries and put an end to the change of amendments in exchange for support, to open fiscal space for the urgent expansion of social programs.”³ Tabata Amaral

We understand the government difficulties to approve the PEC on Writs of Payments, that is a

²44% of the Party Fund's total endowment in 2021 is in the hands of the following parties: PSL, PSD, PP, MDB, PRB, PR and DEM.

³ Amaral, T. [@tabataamaralsp]. 4 nov. 2021.

"shot in the foot" in the solidity of our fiscal governance, as a symptom of the winds of Brasilia. If it weren't for the clumsy leadership of the Executive, we probably would not have moved towards a scenario of constitutional changes in the spending ceiling regime.

The scenario of Brazil, therefore, seems more of the same. We are not exponents of ruptures, but of compositions. The same forces that prevent increased productivity and prosperity are the forces that prevent our leap into the abyss.

*"If you stay a week away from Brazil, everything changes. If you stay away for seven years, nothing changes."*⁴ *Gustavo Franco*

In our assessment, market prices no longer reflected a country that would have an extremely austere tax rule for many years to come. The path of fiscal lack of control, in turn, also seems unlikely to us, even as challenging as the dynamics of our public debt may be.

We therefore remain faithful to our investment process, the same one in place for the last 7 years, where the fund was long or short in domestic assets without any bias, with a focus on seeking its intrinsic value.

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⁴ Pesquisa Empiricus. Bitter Lessons: A Provisional History of Current Affairs with Gustavo Franco. Episode 22. 22 set. 2021.

Anyway, huge doubts still remain. Are we going to have a solid tax bridge by 2023? Will the current government try all the arrangements to be re-elected? Will the pressures for spending be limited to the legitimate demands of those most in need? Even more, the next government will flirt with the trapdoor before being led back to the center?

Therefore, Brazil's portfolio is concentrated in shares of companies that will arrive on the other side of the tunnel and, especially, are able to pass on prices. The focus is in unleveraged companies, with real assets, which are dividend payers and with a good competitive position.

In a country where the cost of capital rises, limiting access to credit for small and medium-sized companies, the complex tax system is not reviewed and the lobby strength hinders the review of subsidies, we wonder if a moderate crisis is not more beneficial rather than harmful to large and incumbent companies. Brazil's long stagnation tends to consolidate oligopolies and they are largely listed on the stock exchange.

We remain at your service.

Vista Capital