Vista Multiestrategia Fund and Vista Hedge Fund registered returns of 6.67% and 2.86% respectively in May and 46.81% and 17.48% respectively in 2022.

In May, positive contributions to the results came from commodities, the long position in local equities, and hedging, with a receiving rates position on developed markets and a short position in US equities.

In the last letter, we explained that our conviction in the reflation scenario, especially beneficial for finite and scarce assets, has come to an end over the past few months. Considering that there is a wide range of medium-term scenarios and that we have not yet attributed a dominant probability to any of them, the moment calls for a reduction in volatility and risk and an incessant search for hedging.

So we chose to share some questions and discussions that have emerged over the past month in our meetings and that may become the basis of a more complete scenario in the future.

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Why Brazilian inflation is so resilient and widespread? Can we see a better inflationary dynamics later?

Despite the electoral uncertainty embedded in the price of assets, we understand that the main medium-term risk factor for Brazilian markets will be the evolution of the inflationary process and its impacts on the interest curve.

In search to foresee the future, it is important to revisit and to understand the past. Certainly the "imported" inflation, the misconceptions of monetary policy and the successive adverse supply shocks are an important part of this equation, but they do not seem to explain the situation completely.

In the letter of Jan/21, we saw that inflationary risks seemed quite asymmetric, and we viewed the inadequate response of economic policy from 2020, with policies much more focused on demand than on supply, as an important source of inflationary risk.

" On the other hand, inflation still is a growing concern. The supply and demand imbalances resulting from breaks on some supply chains and the inefficient response to the pandemic, with excessive stimuli on the demand side and little attention on the supply side, have taken their toll.

The microeconomic disarray adds to the important incentive to exports with the devalued exchange rate, generating a shortage of products and inputs.

The result of this process has been not only an important relative price shock, natural in an environment of abrupt changes in the consumption basket, but also a more widespread process of rising prices. The recent strong valuation of commodities in

BRL helps exacerbate our concern. Although the supposedly contractionary fiscal policy in 2021 helps reduce some pressures, there is no longer a safety margin in inflation to accommodate a new shock and, without an adequate monetary policy response, inflation expectations can be contaminated."

The successive negative surprises of consumer inflation, despite the dissipation of some shocks, suggest that the government and the central bank have underestimated the persistent imbalances between supply and demand. The excessive calibration of stimuli to the demand side and the error in the lack of supply support, in our view, still put us in a certain "general imbalance".

Over the past few quarters, we have become notably more optimistic about economic activity versus the consensus. We believed that the progressive reopening of the economy, the recomposition of services supply, and the excess of family savings would have important effects on economic growth, which has been confirmed. This process, however, seems to be close to a depletion. In addition to the lagged effects of monetary tightening, we are closely aligned with current expectations of a modest GDP growth.

On the fiscal side, we are somehow disturbed by the containment of the readjustments of the civil service and with the sustainability of maintaining some discretionary spending at historically very low real levels. In other words, despite the strong improvement in the primary surplus, we think that an important part of this adjustment has to do with the inflationary tax and the postponement of some inevitable pressures for more spending, already evident in the demands of more organized categories of the civil service such as the Central Bank.

Finally, the end of the first semester historically marks the beginning of the electoral process in the asset prices. In the current cycle, we were unable to measure risk and project expected value correctly as in other elections. In addition to the normal uncertainty surrounding the winning odds of the top candidates, we have important (and abnormal) doubts surrounding the expected returns associated with the different election results.

That is, as much as we might see the dissipation of some important inflationary vectors, enhanced by the significant recent appreciation of the exchange rate, economic policy errors and their effects leave us with a low short-term appetite for relevant directional positions, which makes us focus mainly on relative value allocations.

How do commodities curves relate to interest rate yield curves?

Parallel to the discussion on inflation dynamics in Brazil and in the world, the commodities curve draws our attention. As a reference, 12-month forward prices of diesel and natural gas have implicit declines of 25% and 40%. Although we challenge the predictive power of future commodities curves, such divergence opens relevant hedging possibilities.

Our expectation, frequently discussed, is that future prices will be materially wrong in the oil and derivatives markets. The short-term inventory sale and the still below-normalized demand should bring a tighter market in the future than today, the inverse of current pricing.

However, if we are wrong and commodities suffer more than the large projected falls in the curve, inflationary pressures should be significantly lower, and the market will reevaluate part of the interest rate increases that are currently priced.

* * *

Does the zero-Covid policy in China mask more fundamental changes?

As we look closely at the speed of Shanghai's reopening and the promises of more forceful economic stimuli, we wonder if we are not anchored in a China that has remained in the past.

The explosion of growth based on Deng Xiaoping's “state capitalism” brought us here. The low cost of labor, the accelerated process of urbanization and, fundamentally, the incentive to entrepreneurship, and the generation of wealth because of individual effort, have pushed China's spectacular development in recent decades.

“The more striking example is his insistence on the need for real incentives and the delegation of authority in order to motivate individual efforts” [1]

Today, in contrast, we are discussing a zero-Covid policy more than two years after the outbreak of the pandemic, where China's resistance to using Western vaccines is evident. Why did the Chinese government choose the least economically efficient path? In other policy cycles, would we be discussing persistent *lockdowns* or the offer of a wide range of vaccines? Or should I say, does the color of the cat now matter?

This same pattern of less efficiency and more interventionism expands to other areas. Regulatory attacks on tech companies, the “quotas” for party members on the board of major companies, the “incentive” of donations by large companies, the attack on billionaires and, more recently, the “orientation” to curb excesses of wealth demonstration on social networks are part of the same ideological orientation.

Today we wonder if we have seen the best moment as a market economy in China, which is paradoxical considering that economic reforms have caused

[1] *NAUGHTON, Barry. Deng Xiaoping: An Assessment. The China Quarterly No. 135. Cambridge University Press. September, 1993*

China's GDP to multiply 36 times in the last three decades. What will be the effects on the Chinese entrepreneurial spirit of the “counter-reforms” of recent years? What comfort will external capital have to invest in China, in addition to an attractive consumer market?

We will not have immediate answers to these questions, especially in view of the fiscal and parafiscal stimuli that are coming and that should mask the probable drop in potential growth.

However, with the hangover generated by the end of the protracted real estate boom of recent decades, the worsening of the business environment, the accelerated aging of the population and the effects of Russian sanctions on the global investor, there are important doubts about the medium-term prospects for economic growth in China and for the evolution of its capital market.

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Does the drop in the margins of American consumer companies mean a worsening of activity ahead or just a microeconomic difficulty?

The recent heated debate around the risks of recession in the US, involving the Fed, market participants and the political class, shows us that we are not the only ones questioning the prospective scenario.

The drop in some companies' profit margins over the past month is part of this puzzle. An inflationary environment certainly has the capacity to squeeze margins in some sectors. The question that remains is whether we are only normalizing a greater difficulty in passing on price or whether we are at the beginning of a more relevant process of loss of pricing power of companies, either by the corrosion of real income of consumers or by the digestion of excesses of demand associated with the period of the pandemic.

In addition, considering the magnitudes of projection errors since 2020, we are especially skeptical about the ability of market consensus and economic policymakers to anticipate, with some precision, the inflation and activity scenarios of the coming years. The magnitude of demand and supply shocks was so powerful, causing economic surprises not seen for more than four decades, that the effects of the partial reversal of these shocks should not be underestimated.

We have also wondered if companies’ results are not a sign that the volatility of the economic cycle is here to stay. Projecting the profit of a single large company should be relatively trivial in a more stable economic environment, considering that part of the numbers is previously known, the contact with the management is frequent, the guidelines are renewed with some frequency. The size of the deviations of the projections in relation to the effective results and the adverse reaction of the market, among the largest of the last decades, shows us that the scenario remains extremely complex and subject to forecasting errors still potentially very representative.

In such unexpected environments, we are inclined to think in an even more probabilist way, running away from certainties and searching operations with good risk-return or *hedges* that would protect us efficiently from sharp turns.

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The fund's position in commodities has barely changed. The oil market remains particularly tight, and the reopening in China and the normalisation of flights is likely to contribute to the accentuation of what can already be called a global energy crisis.

On the hedging side, as usual, changes are more frequent. Currently, the fund is receiving global rates as a defense against adverse demand shocks, especially to keep a more neutral portfolio at this time of greater complexity.

Finally, it is worth highlighting the significant reduction in risk allocation in Brazil, mainly due to the divestment in Petrobras after a long investment period.

We remain at your service.

Vista Capital