



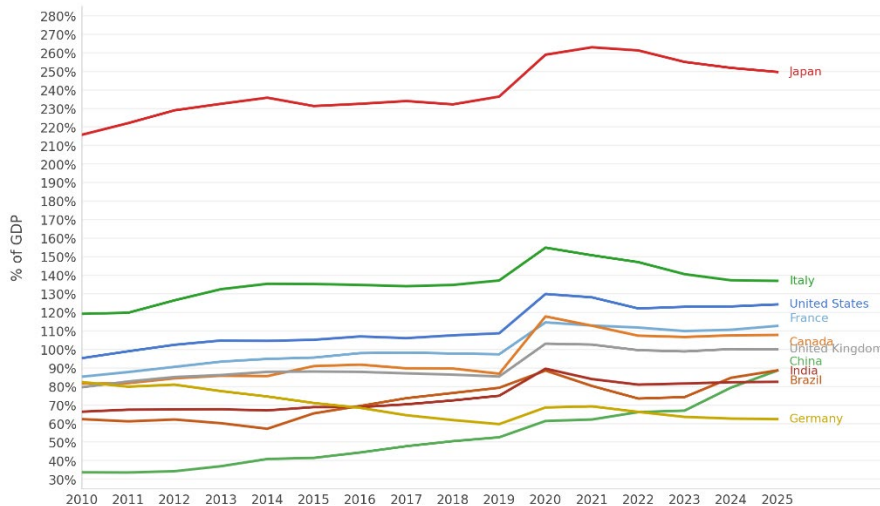
The Future of Indebted Countries

May 2026

Dear investors,

Brazil's public debt problem is well known and has worsened significantly in recent times. Between 2010 and 2025, our public debt rose from 62.4% to 88.7% of GDP. But Brazil is not an isolated case. Over the same period, several other nations have been expanding their debts. Among the world's 10 largest economies, only Germany is moving in the opposite direction.

Public debt of the 10 largest economies



Source: IMF Data – April 2026 WEO

This widespread leveraging of governments cannot continue increasing indefinitely. The key questions are: how long will this trend last, what could cause it to reverse, and what would the effects be on investments.

How We Got Here

Each country has its own story of how its debt grew so large, but there are two common factors that explain much of the trend: crises cushioned by government spending and political resistance to fiscal adjustments.

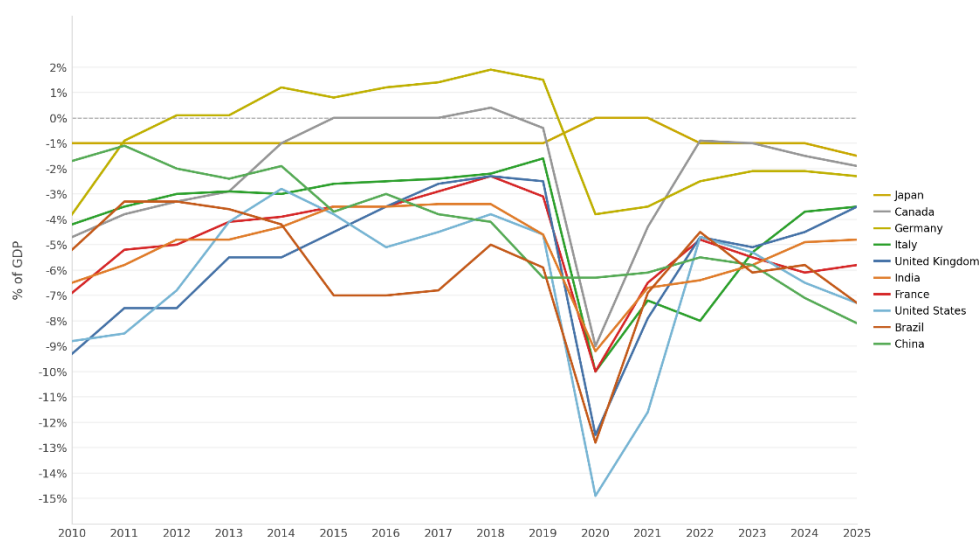
In recent decades, governments have adopted measures to deal with economic shocks based on the Keynesian concept that the state should act as a counterweight to private markets during crises — increasing public spending when private spending falls too sharply. Through this direct intervention in the economy, economic recessions would be avoided or, at least, mitigated.

In the face of the COVID-19 pandemic, this was done on a large scale. Several countries launched economic stimulus programs to offset the income reduction caused by lockdowns, financed by increases in public debt. In a milder and more recent example, some governments are adopting measures to cushion the impact of rising oil prices caused by the closure of the Strait of Hormuz. Brazil recently announced diesel subsidies.

In theory, public spending should be reduced after crises to offset the economic stimuli granted and replenish government coffers. Since it is easier to make concessions than to cut spending, this recovery does not happen in most cases. Of the world's 10 largest economies, 6 have still not returned to their pre-COVID debt levels.

The political reality of most countries encourages the trend of increasing government spending, since the population applauds the expansion of benefits while rejecting tax increases. Where would the resources for distribution come from? This inconsistency is ignored in campaign speeches, but not in fiscal accounting. Growing benefits generate fiscal deficits that are usually financed by more debt.

Fiscal deficit (nominal) of the 10 largest economies



Source: IMF Data – April 2026 WEO

In an environment where economic growth is greater than the interest rate on public debt, some fiscal deficit would be sustainable (in the simplified case where debt is 100% of GDP, it would be stable when the deficit and nominal GDP growth are equal). Under this

logic, the typical political desire to push to the limit of what is fiscally defensible — combined with the low interest rate period we experienced between 2010 and 2021 — allowed maintaining deficits and increasing debt to be argued as sustainable. The problem became more evident from 2022 onward, when the illusion of permanently low interest rates faded and the cost of indebtedness began to weigh on fiscal results again.

This is the situation that Brazil and much of the developed world face today: high public debt, high interest rates, and popular pressure against public spending cuts. Let us now analyze what may happen from here.

What Are the Alternatives for the Future

The most desirable solution to this problem would be to accelerate economic growth. With GDP growing rapidly, debt would be diluted without the need for spending cuts. This is how the United States reduced its indebtedness in the period following World War II. American debt reached 121% of GDP in 1946 and was subsequently reduced to less than 40% in the following decades. Today, it stands at 124% of GDP — without any world wars.

It is difficult to replicate that achievement, especially in the face of demographic and geopolitical trends that bring headwinds. Instead of the post-war baby boom, most countries today deal with aging populations, which implies fewer people of working age and more pension-related spending. Instead of globalization and the growth impulse linked to the intensification of international trade, several countries are now placing independence and national security as priority goals (we discussed this further in our March letter: “The New Cold War”).

The only remaining avenue would be productivity growth linked to technological advances or government measures that optimize the economy through better rules, without fiscal stimulus. Perhaps the advances in artificial intelligence offer some hope — though we have not seen much progress in governmental intelligence. On the whole, it seems unlikely that economic growth alone will be sufficient to resolve the problem.

Another way out is the old-fashioned fiscal austerity: spending less than the government collects and using the surplus to reduce debt. It is a measure eternally advocated by economists and ignored by politicians. Obvious for any individual or business with financial problems, but delicate for leaders who depend on an electorate that is poorly versed in economics and sensitive to benefit cuts. Historically, it has been implemented only rarely.

An extreme option would be simply not paying the debts or forcibly postponing payments (moratorium), since there are no supranational institutions that can compel a state to honor its obligations. The problem is what comes next: access to new debt would be restricted due to a loss of credibility; the financial system would enter a crisis due to the sudden loss of value of securities previously considered safe and widely used as collateral; the exchange rate would depreciate due to the flight of foreign investors. Given the severity of the consequences, we only see countries with no other options resorting to this.

The most likely scenario is that governments will resort to less explicit but historically well-known methods: inflation and/or financial repression. For this, debt must be denominated in the national currency — and that is the case for virtually all economically relevant countries. The world's 10 largest economies have more than 95% of their public debts in their own currencies.

On the inflation path, governments increase the issuance of their own currency and use this artificially created capital to honor the nominal values of their debts. Since no real economic value is created from nothing, the arbitrary issuance of currency generates inflation and causes all assets denominated in that currency to lose real value. The practical effect is a transfer of value from the owners of these assets to the government — as if they were compelled to pay an extra tax, in a veiled manner.

Financial repression is the use of more sophisticated mechanisms to force financing of the government at rates below what the market would normally require. For example, a government could issue a class of public bonds with low yields and require all pension funds in the country to invest a portion of their assets in that class. Several of the Asian Tigers practiced financial repression during their economic miracle periods. On a smaller scale, Brazil does this through mandatory investments in the FGTS (Severance Indemnity Fund). All formally employed workers are required to invest at rates just slightly above inflation, with real returns close to zero, and the invested capital is used to finance public projects.

In summary, economic acceleration is unlikely and fiscal austerity is politically difficult. Among the remaining options — outright default or inflation and financial repression — it is almost certain that governments will choose the latter.

How This Impacts Investments

The scenario we are pointing to as most likely will not necessarily trigger major economic crises. Governments are expected to address the debt problem as gradually as possible. What happens slowly causes less disruption and reduces the chance of major upheaval. The concern is not that we will face some catastrophic economic event causing sudden losses, but rather how we should position ourselves to navigate a prolonged period of inflation and financial repression without the value of our investments being slowly eroded.

The typical Brazilian investor's instinct is to move into fixed income and real estate at any sign of a bad scenario. In the current case, real estate is among the acceptable alternatives — but fixed income may be a dangerous path. The other asset classes to consider are commodities and equities.

Fixed income is the asset class most impacted by measures aimed at reducing public debt, especially bonds issued by the government itself — in Brazil, Tesouro Direto. Pre-fixed bonds are the most exposed to inflation, which erodes their agreed nominal return. Post-fixed bonds may suffer through monetary policies that compress the base interest rate. Inflation-linked bonds with pre-fixed real returns (in Brazil, Tesouro IPCA+ / NTN-B) are the safest within the sovereign fixed income class, but not entirely immune — they can still be subject to direct interventions, such as changes to the inflation index used,

imposition of special tax regimes, or liquidity restrictions. There are countless possibilities for creative legislators.

More broadly, all assets whose value is based on cash flows fixed in nominal terms are exposed — even those unrelated to public debt. Private credit instruments suffer in a manner analogous to public bonds under inflation and compressed interest rates. They are only spared from direct interventions that may specifically target sovereign bonds.

The other asset classes are better alternatives because they do not depend directly on the value of the currency — they are merely priced through it. If the currency loses half its value, the price of real assets doubles. This logic applies equally to consumer goods in general, commodities, real estate, and equities — but each class deserves some additional considerations.

Commodities offer excellent protection against inflation, but suffer in other ways. Their prices fluctuate due to various unpredictable factors and, since they are not assets that produce cash flow, their long-term returns tend to be quite low. This is not the asset class we would choose in search of safety.

Real estate is a traditionally safe alternative, but one that tends to offer modest real returns. Except in well-executed theses about specific properties (appreciation due to location or some particular reason), long-term returns tend to be close to the real base interest rate.

Equities are assets with more nuance. In principle, they do not suffer from inflation in the sense that a company's assets do not depreciate along with the currency — and they offer more attractive return potential than real estate and commodities. However, the intrinsic value of a share depends on the future results of the issuing company, and the monetary policies we are discussing can affect the performance of each business in different ways. Each case must be evaluated individually.

The equities that offer the greatest safety are those of companies with pricing power. This is what will allow them to pass on price increases to compensate for inflation and any other effects of imposed monetary policies. For a company to have this capacity, it must serve demand that is not price-sensitive (low elasticity) and face limited competition, owing to sustainable competitive advantages or other barriers that prevent the capture of its customers.

Not coincidentally, this business profile overlaps greatly with what we seek in any economic environment. The most profitable companies over the long run tend to be the same ones that best withstand various adverse scenarios.

In difficult times, the tactical adjustment we consider appropriate to the traditional philosophy of value investing is to prioritize high-quality companies and exercise greater caution with bargains: ordinary companies that are significantly undervalued. There are moments when preserving value is more important than taking risks in pursuit of high returns.