



## Interest Rates and Capital Allocation

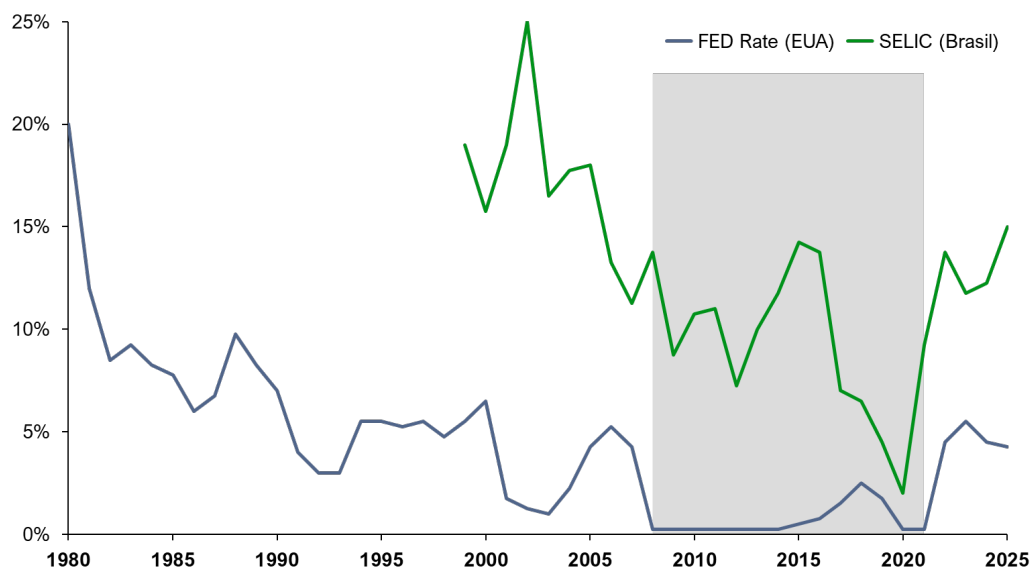
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**Dear investors,**

Between 2009 and 2021, the world experienced remarkably low interest rates. This decade of cheap money was fertile ground for “new businesses.” Venture capital funds multiplied and financed a multitude of startups of every kind. Mature companies embarked on expansion plans through internationalization, acquisition programs, and the construction of new factories. At the height of the search for alternatives to the dwindling returns of fixed income, even exotic asset classes emerged, such as the notorious NFTs—certificates of ownership of easily replicable digital images that moved an estimated USD 6 billion in January 2022.

Throughout 2022, central banks raised interest rates to combat the inflation generated by government aid programs created during the pandemic, and the era of low interest rates came to an end, taking with it the euphoria of the previous decade. In Brazil, the movement was more modest, but in the same direction.

### Evolution of Benchmark Interest Rates



*Note: rates at end of each year. SELIC was created in 1999.*

This phenomenon was not unprecedented. Capitalism is well known for generating economic cycles, and the benchmark interest rate plays an important role in shaping the behaviors that contribute to this cyclical movement. We will provide a brief summary of this dynamic and share our view on the current situation.

### **Interest Rates and Capital Allocation**

In theory, investors should always seek the best possible allocation for their capital, considering the relationship between potential return and risk for each opportunity. In practice, many operate somewhat differently. The typical investor defines a level of return they consider sufficient to achieve their financial goals and seeks opportunities that reach that threshold with the lowest possible level of risk. The difference between the approaches may seem subtle, but it has profound impacts on the economy.

The most convenient alternatives for capital allocation are government debt securities and low-risk private credit instruments. They require little analytical effort, have low volatility, and are accessible to virtually any investor. The return on these securities closely tracks the benchmark interest rate, and the market behaves quite differently depending on whether that rate is above or below the return threshold that most investors consider adequate.

In times of low interest rates, standard fixed income fails to satisfy, increasing appetite for alternative investments that offer the possibility of higher returns: risk assets, longer-maturation projects, leveraged companies, innovative business plans. There are always people and companies seeking financing for such initiatives, but truly good opportunities to deploy capital with high profitability in the real economy are rare. When there is too much money chasing opportunities, selection criteria loosen. Projects of questionable quality receive financing and come to life. Later, part of this crop of investments will turn into idle capacity, operating losses, and bankrupt companies—the hangover of an era when attention was more focused on potential returns than on the risks involved.

When the benchmark interest rate is high, the opposite phenomenon occurs. Fixed income satisfies a large portion of the market and absorbs a considerable share of all available capital. Most investors stop evaluating alternative opportunities and new projects struggle to secure financing. Beyond the scarcity of resources, few initiatives are capable of delivering a risk premium above the already high interest rates. Few investments in risk assets are made, the economy grows more slowly and generates unease in the market. However, investors who do not become complacent can take advantage of this period.

Faced with an abundance of opportunities and scarcity of competing capital, the active investor can raise the rigor of their selection process and allocate capital only to opportunities with genuinely above-average quality and return expectations—ones that should face less competition in the future, since few competing initiatives will be successfully financed at the same time.

### **The Impact of Interest Rates on Consumption**

Alongside the capital allocation dynamics described above, interest rates also have a direct effect on consumption levels. When rates are high, there is little incentive for

individuals to take on loans to consume more. There will always be those who do so out of necessity or imprudence in managing personal finances, but the overall level of consumption tends to stay closer to the population's true economic capacity and grow with greater difficulty. When interest rates are low, this dynamic changes.

Easy access to cheap credit encourages many people to raise their consumption beyond what they could pay in cash. The problem is that credit expansion does not increase the long-term consumption power of the population. It merely brings forward what would be future consumption, in exchange for interest that reduces the total purchasing power each individual would have over their lifetime. The resulting economic acceleration is temporary and destined to reverse itself later.

From a corporate perspective, this dynamic is difficult to see and interpret while it is unfolding. What executives see clearly is the evolution of sales in their businesses. When revenues grow, the natural interpretation is that the company is thriving in a promising business segment—not that part of the growth comes from credit expansion and is likely to disappear when the cycle turns.

This environment generates optimism and fosters the emergence of ideas for capacity expansion and new businesses to meet growing demand. In other words, low interest rates simultaneously create investors eager for risk-premium opportunities and executives with ideas built on optimistic assumptions. It is the recipe for capital misallocation.

These cycles repeat continuously even though they are well known to virtually all the investors and executives involved. In large part, this is due to psychological biases that are difficult to avoid, but also to the impossibility of predicting how long each phase of the cycle will last—combined with the ambition of some investors to do exactly that. Believing themselves capable of predicting the next turning point, many continue investing in risk assets until too late during upswings and delay new investments for too long during downturns. This behavior drives prices to excessively optimistic or pessimistic levels and ends up contributing to the pendulum-like movement characteristic of economic cycles.

### **How to Seek Opportunities in Capital Cycles**

Understanding the dynamics of capital cycles is not difficult. Explaining the evolution of a cycle in retrospect is not difficult either. The challenge is determining when it is time to act against market consensus, which tends to be right much of the time.

A starting point is to notice that the market pays far more attention to the evolution of demand in each sector—measurable by the revenues of companies operating in it—than to the evolution of supply capacity, which can be inferred from the volume of investments made. There are sectors where supply capacity is quite flexible and adapts quickly to demand fluctuations. However, capital-intensive sectors typically lack this agility. Building a new factory can take years. In these types of businesses, capital cycles are more relevant.

When demand is growing and a large volume of investment in capacity expansions is being made, it is a poor time to invest in the sector. The market mood at the time will be

optimistic, but it is likely that excess capacity is being created that will become idle when the cycle turns, intensifying competition among companies seeking to optimize the utilization of their assets and eroding the profitability of the entire sector.

The most favorable time to find good opportunities is when demand is weak, there is little investment in expansions, market sentiment is pessimistic, and assets become cheap. If there is no structural reason for demand not to recover, it is likely to do so in the future—at which point supply capacity becomes the limiting factor for sales volume. By the good old dynamics of supply and demand, prices rise and sector profitability improves.

The caveat is that this type of investment thesis requires patience. It may take years for the cycle to reverse and the expected scenario to materialize. Our investment in Marcopolo is a good example of this type of thesis. We purchased our first shares at the end of 2019 and waited more than 3 years for sector profitability to improve substantially. But the thesis has generated an average annual return of ~36% to date (we still hold part of the shares in our portfolio), so the wait was worth it.

### **What Phase of the Cycle Are We In**

There is no single capital cycle governing the entire economy. Each sector in each region has its own dynamics and goes through its highs and lows at different times, so the analysis must be done on a case-by-case basis. However, an entire country's economy operates under the same benchmark interest rate, and extended periods of high rates cause several segments to experience their downturns simultaneously.

Sometimes, sector dynamics are stronger than the influence of interest rates and prevail in determining the capital cycle. For example, massive investments in infrastructure construction for artificial intelligence are being made even under high interest rates. In 2025, USD 400–450 billion were invested by the hyperscalers (Microsoft, Amazon, Google, Meta, and Oracle), and a further USD 600–800 billion are expected for 2026. Perhaps the capital allocated is not excessive given the potential of the technology, but this sector is certainly not in a down cycle.

Meanwhile, several more traditional segments of the economy have not had such exciting developments recently and are feeling the weight of what is now the fifth year of high interest rates—a scenario common to both Brazil and the world's major economies. It is a good time to investigate where there is a scarcity of capital that could turn into a supply bottleneck in the future. In the past month, we purchased shares in a company that fits this opportunity model well. We expect to disclose the new position at our next investor meeting.