Quarterly Call
July 2022

English Version

The “R” Word: Recession or Rebound?

Quarterly Call Q3 | 2022

Get guidance on investments, and the major structural factors behind your clients’ portfolios.

insigneo

Transcribed from comments made during our Quarterly Call Q3 | 2022

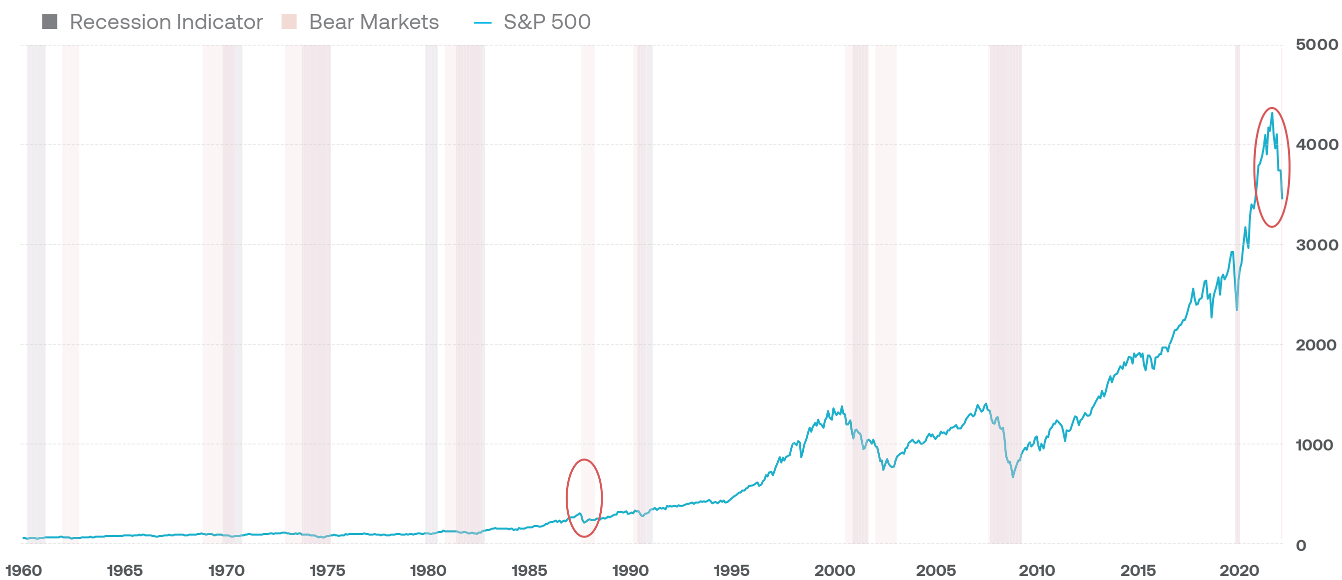
July 7th, 2022.

As markets grappled with the ongoing war in Ukraine and increasingly hawkish global central banks, the second quarter of the year proved no less volatile and nerve-wracking for investors as the first. Two of the most universally watched global equity indices, the MSCI All Country World Index and the S&P 500, briefly fell into bear market territory, posting losses of -22.5% and -23% in the middle of June before staging mini rallies in the second half of the month.

Ahmed Riesgo
Chief Investment Officer
Insigneo Financial Group

Bear Markets & Recessions Tend to Overlap

Source: Bloomberg (as of 06/29/22)



— "As our regular readers and listeners know, one of our fundamental, though certainly fallible, principle of investing is that **bear markets and recessions tend to overlap.** It is exceedingly rare to get one without the other as this chart attests to."

As our regular readers and listeners know, one of our fundamental, though certainly fallible, principle of investing is that bear markets and recessions tend to overlap. It is exceedingly rare to get one without the other as this chart attests to. Since the 1960s, we have only had one instance of a US bear market outside of a US recession – the 1987 October crash. Since we technically entered a bear market in mid-June, this chart tells us that the US should already be in a recession, if one goes by the historical average lag time between the markets and the economy of approximately six months, or on the cusp of one. Not surprisingly, market strategists and media pundits who but six months ago were predicting exceedingly high above-trend growth levels are now tripping over themselves revising economic forecasts and index targets sharply lower. Yes, the war in Ukraine caught most observers, us included, by surprise, and the effects from the conflict are certainly exacerbating these issues. But we should also remember that, again just six months ago, markets were forecasting that the Fed would not raise rates until late 2024. At that time and without the war imminent, we found that view too out of touch with the global inflationary environment. In our view, the market was too sanguine on the outlook then, but it has become too pessimistic about it now. The pendulum has swung too far in the opposite direction.

In our experience, markets rarely do what everyone expects them to do. When market consensus becomes too extreme in any direction, the projected moves rarely materialize. Surely, growth is slowing, but it is not contracting and surely not collapsing. Another curious development is the dichotomy between sentiment and activity. Almost all the sentiment and survey-based measures are falling rapidly, but the activity indicators and real-time data are holding up fairly well or slowing modestly. In other words, there is a massive divergence between how people feel and what they are doing. In fact, it is our view that it was precisely these survey-based measures of longer-term inflation expectations and not the latest CPI prints that scared the Fed into becoming more hawkish at its latest meeting. Investors worried, perhaps rightfully so based off the Fed's own statements, that the only way the central bank would be able to reduce inflation is through the deflationary impulse of a recession. The Fed might have been worried that people's perceptions of longer-term inflation expectations might become self-fulfilling and wished to cut them off as quickly as possible.

In economics, an adaptive expectation is a process by which agents form their expectations of the future based on past experience. And recency bias is a cognitive bias that favors recent events over historic ones. Both are prevalent and powerful forces that the Fed must account for when formulating policy. Over the course of this quarterly, we will address our views on the economy and markets and attempt to give a roadmap for the third quarter of the year. Is a recession or rebound more likely? Perhaps, there is a third option – neither. We will address these scenarios and how investors should position themselves over this quarter and into the end of the year. As always, we will also consider longer-dated structural forces at work in the world.

We will revisit our commodity supercycle thesis which has served us well since last year but lately has encountered some weakness. Is the cycle over, or is it simply a buying opportunity? Finally, we will end with some important trends in global demographics that may have momentous investment implications over the next few decades.

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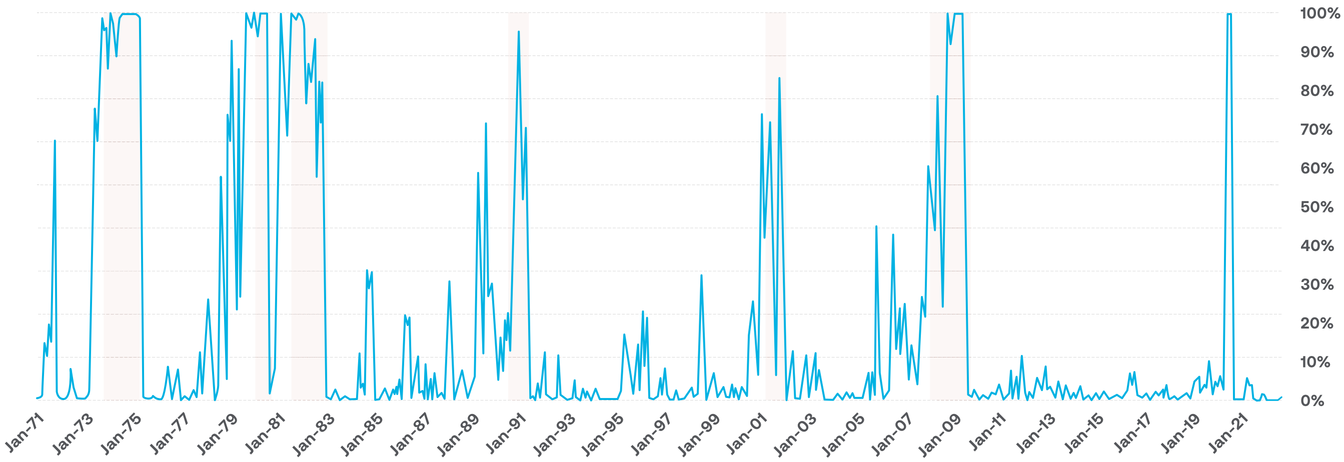
Macroeconomic Views

Importantly, we do not anticipate a recession in the US over the next six months given where our forecasted US recession probabilities currently stand. As long-term investors, we construct our asset allocation firmly rooted on macroeconomic and market fundamentals. For that, we rely heavily on our proprietary Insigneo-Forefront recessionary indicator that gives us the probability of a US recession over the next two quarters.

As this graph demonstrates, it is telling us that the probability of one is still low hovering below 10%. US growth is definitely slowing (purposefully, due to Fed tightening) and it is showing some signs of late-stage dynamics of the economic cycle, such as inventory buildup. If this trend continues, this means that recessionary risks could become significant around mid to late 2023. For now, there are plenty of reasons to be optimistic, and that we are simply in the midst of a midcycle slowdown. Household debt is much lower now than it has been in recent decades, real personal consumption has been quite robust (largely due to

Economic Update – Dashboard Using Macro Indicators

Source: Insigneo-Forefront Recessionary Indicator, updated as of 04/30 and 05/31 for various inputs



falling savings), excess savings still stand above USD 2.5 trillion, and the labor market remains firm. Though there has been some weakening as of late, the US consumer remains buoyant thanks to incredibly robust private balance sheets that are offsetting the squeeze in real income caused by higher inflation.

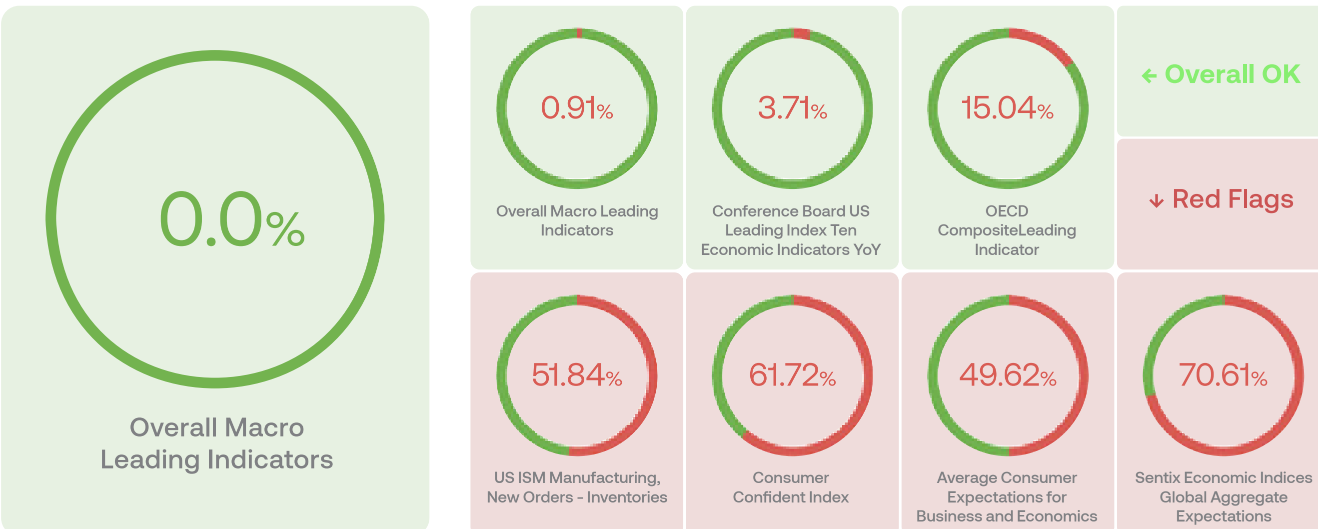
On the corporate side, capex should be buttressed by elevated levels of cash and a still generous (but rapidly closing) spread between the real return on invested capital and the real weighted average cost of capital. However, there are also plenty of reasons to be concerned. The US housing market looks particularly vulnerable right now and activity is falling rapidly as housing costs soar, making the average monthly cost of the median US home 50% more expensive than it was just a year ago. We expect flat price action in the US housing sector after several years of strong gains, as well as outright price declines in more vulnerable real estate sectors like Canada, Australia, Japan, and New Zealand.

It is worth nothing though that our recessionary indicator incorporates over 50 input series that capture all facets of the US economy. The statistical confidence of our model 2-quarters out based on past data is 81%. This means that it has successfully captured upcoming US recessions roughly 80% of the time going back to 1971. It is not perfect, but the correlation is high enough that it would not make sense for us to claim that the next recession, whenever it arrives, will be in the 19% distribution not captured by the indicator.

Though the indicator is still far away from the 40% threshold that would force us to turn “bearish” from our current positioning of “neutral”, many inputs, particularly sentiment-based and market variables, are flashing red. One of the most astonishing aspects of the current market environment is the wide gulf between sentiment and activity. Like I mentioned before, the latter is holding up quite well while the former is near historic nadirs. The power of the indicator though lies in aggregating the fifty input variables, significantly improving the degree of statistical confidence based on past data instead of

Insigneo – Forefront Recessionary Indicator: some worrisome confidence-related numbers appear

Source: Insigneo-Forefront Recessionary Indicator, updated as of 04/30 and 05/31 for various inputs



relying on individual signals which have much lower predictive capabilities. The indicator allows us to block the noise, and to generate a meaningful signal that is actionable. In this environment, the Fed is deliberately dampening demand in order to reduce price pressures. Frustratingly, the Fed's problem is that this is both a demand and supply-driven inflation shock, so the chance of a Fed policy mistake is remarkably high. There is clearly a risk that it goes too far and tips the economy into a recession, unnecessarily, as we do expect inflation to come down on its own rather quickly. Nevertheless, the chance of the Fed overtightening financial conditions is now high. So, while our proprietary model's reading tells us that a recession is not imminent, we have subjectively raised the odds of one over a twelve-to-eighteen-month horizon to around 40% given this heightened risk of an error in central bank policy. To be clear, our base case remains no recession in the US over the remainder of the year. We should observe slowing but not contracting growth, a trend reflected in our updated global economic growth forecasts.

Europe concerns us as recessionary risk is elevated in Germany and Italy, two nations that depend heavily on Russian natural gas imports to power their economies. Russia has already begun to curb shipments to the Continent as part of the economic war it is fighting against NATO and the West. For example, Gazprom,

Changes in Economic Growth Forecasts*

REGION	PREVIOUS ESTIMATE	CURRENT ESTIMATE
US	2.9%	1.8%
China	4.4%	1.9%
EU	3.1%	1.7%
Japan	2.8%	2.0%
World	3.7%	3.1%

Source: Insigneo | **Assumptions: Military conflict remains within Ukrainian territory; Russian oil and gas flows continue to Europe.*

Russia's state-owned gas company, cut its exports to Germany through its Nord Stream pipeline by 60% in June. If gas inventory levels fall far enough, the country will be forced to enter a state of emergency whereby supplies to industrial consumers would not be protected, thus causing a severe recession in Germany.

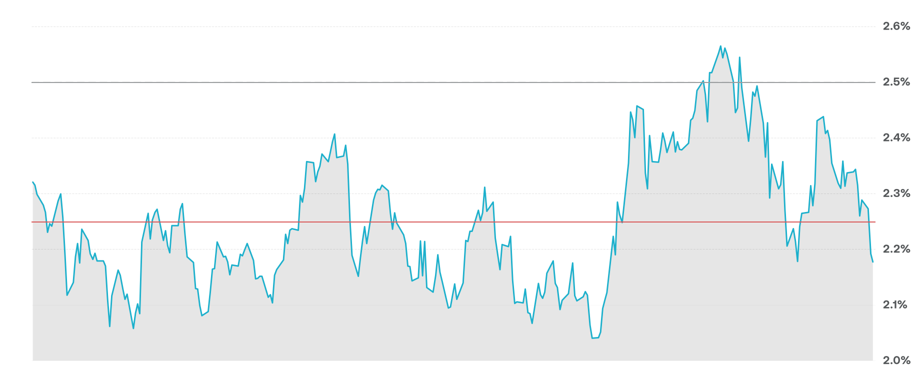
China, on the other hand, is on its own economic and market cycle. The economy is accelerating, not decelerating as elsewhere, and monetary and fiscal policy is loosening. The Chinese economic rebound in the second half of the year is one of the reasons that we remain so sanguine on global GDP growth over the second half of the year. As we mentioned in last quarter's commentary, we still believe that Chinese equities will be the best performing major market bourse in the world this year. We stick with that view and, indeed, China's recent strong outperformance versus global equities reinforces our thesis.

On the inflation front, we see the global annualized rate falling by more than half by the end of the year, much faster than current market expectations, partly because global financial conditions have already tightened significantly. In fact, outside of the two seismic shocks of the 2008 Global Financial Crisis and the 2020 Covid-19 pandemic, global financial conditions have not tightened this much since the 2011/12 European debt crisis where the survivability of the Euro and the EU were in serious doubt. We also assume that the Ukrainian war will ultimately result in a ceasefire sooner rather than later as two realties converge: Russia consolidates territorial gains in the Donbas region in the face of mounting casualties and a disappointing war effort, and Ukraine realizes that it cannot win back lost territory without escalated outside help, which it will not receive. Thus, both sides will leave the conflict not getting everything that they want, but with enough to save face domestically.

Global Financial Conditions Index: Back to 2011/12 Euro-crisis Levels

Source: Capital Economics

US 5YR/5YR Forward Breakeven Rate is below the Fed's 2.25% to 2.50% comfort range



Source: Bloomberg (as of 6/29/22)

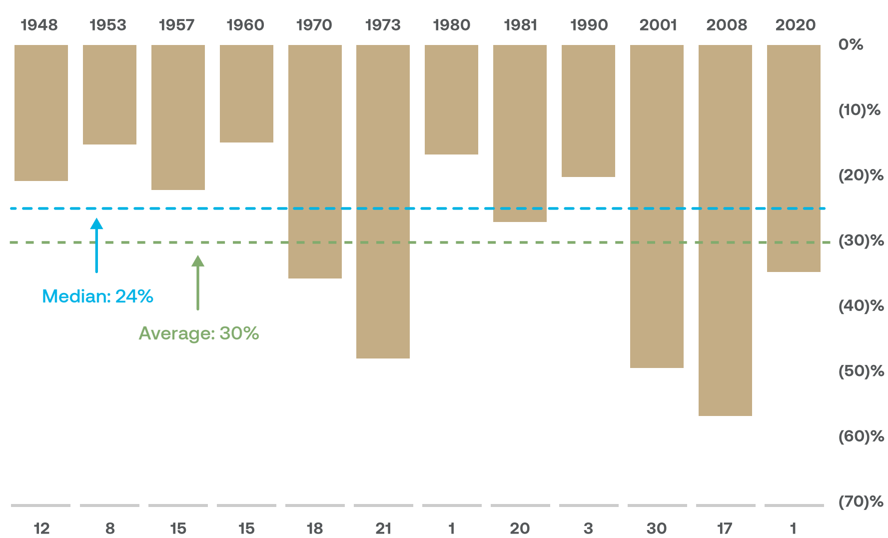
Lastly, the market already expects the Fed Funds rate to reach 3.5% by the end of the year. Putting it all together, it is our view that the Fed will not tighten more quickly than what is already priced into forward rates and the yield curve.
Market-based inflation expectations, such as US 5-year/5-year breakeven rates, have come down significantly and they should give the Fed the breathing room it is looking for.

Market Views

If our base case holds, then financial assets could rally by the end of the year though we expect that to materialize in the final quarter rather than the current one. If so, then markets may not do much in the third quarter other than trade within the range they have done so since early June; the rebound will likely have to wait until the fourth quarter. So, the answer to the question we posed at the beginning – recession or rebound? – is more likely "neither" at least over the next three months. Investors should refrain from adding to equity positions until more clarity emerges about the trajectory for inflation and growth. However, with markets down so sharply since the start of the year and investor sentiment and positioning at multi-decade lows, the time to de-risk portfolios has passed even if a US recession is imminent.

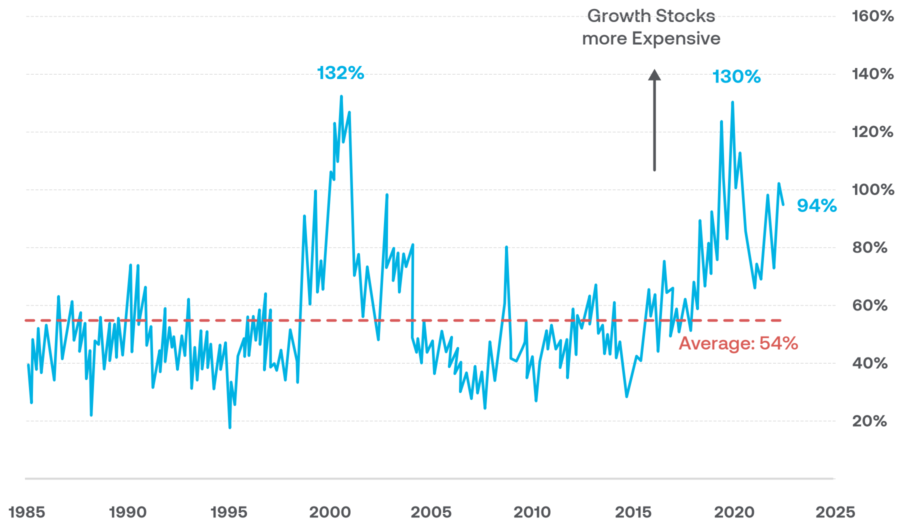
If we are wrong in our assessment that inflationary pressures will ease enough during the second half of the year as pandemic dislocations subside and services consumption normalizes, then a Fed-induced recession is more likely than not to materialize in the US. At that point, the Fed may decide that the only way to bring inflation back under control is to cause a contraction in US economic growth.
If a recession does occur, it should be a fairly mild one as a) there are no large financial imbalances out there and b) it will be caused by purposeful Fed tightening. In other words, it is not likely to look like the sharp contractions caused by exogenous shocks like the pandemic and financial crisis, our two most recent recessionary experiences. If that is the case, then it does not make sense to reduce volatility in your portfolios after the market has fallen so much already. Since World War II, we observed twelve US recessions coinciding with bear markets. During such markets, the S&P 500 has contracted, peak-to-trough, by a median of 24% and an average of 30%. On June 17th, the S&P 500 was down -23.39%.

S&P 500 During Recessions Going Back Over Seven Decades



Source: Goldman Sachs

Growth Still Expensive Versus Value Despite Selloff



Source: Goldman Sachs

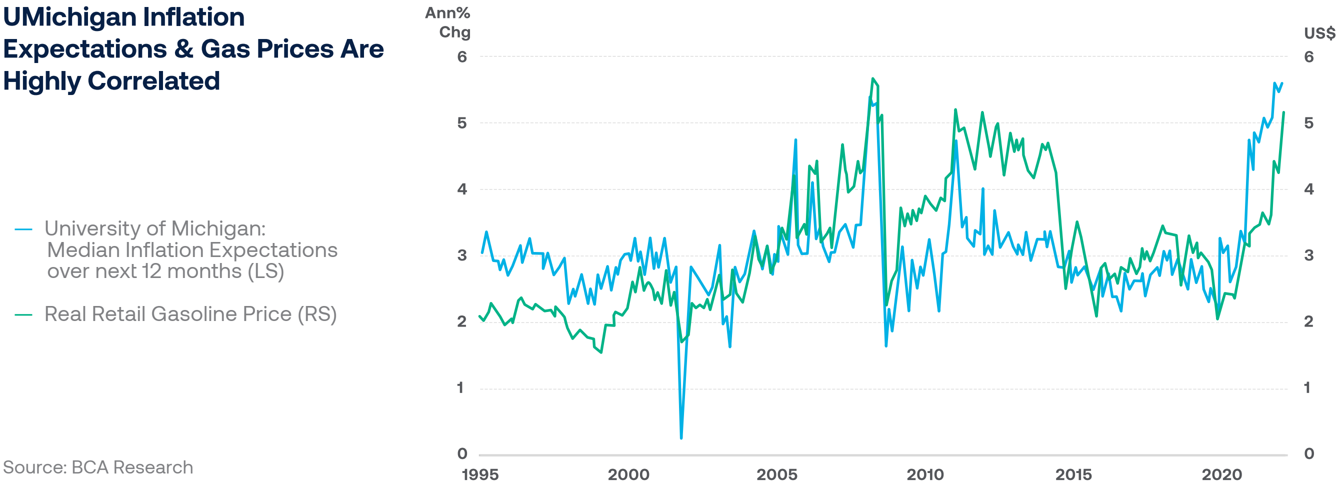
That means that investors have absorbed 97% of the median losses they can expect and 78% of the average losses. Furthermore, a mild recession, by definition, will likely be below the median and average. So, the time to reduce volatility (i.e., to raise cash) has passed. Now, we would advise conservative investors to stay the course throughout the third quarter, or until we get further clarity on the inflation/growth mix. For aggressive clients (i.e., those with higher volatility tolerance), now would be the time to start buying attractive markets or assets.

— "As a firm, **we are maintaining our neutral risk allocations for now**, as this is as bearishly positioned as we can be given where our recessionary indicator is."

As a firm, we are maintaining our neutral risk allocations for now, as this is as bearishly positioned as we can be given where our recessionary indicator is. However, we will look to increase risk exposure once there is clear evidence (from the Fed's perspective) that inflation has peaked and/or there is a ceasefire announced in Ukraine. Our year-end target ranges for the S&P 500 and the US 10-year yield currently are 4200 to 4400 and 3 to 3.5%, respectively. On a style basis, Growth is still expensive versus Value despite the underperformance year-to-date. Historically, Growth trades at an average forward P/E premium of 54% versus Value. The Growth sell-off has reduced the premium from 130% down to 94%, so it is still too expensive in relative valuation terms and may have further room to underperform. We see two significant left- and right-tail risks to our investment stance. On the downside, a major geopolitical energy shock could drive oil prices well beyond $130 per barrel, exacerbating headline inflation data. Retail gasoline prices are highly correlated to consumer-based inflation expectations surveys. It was the breakout in these survey-based measures that alarmed the Fed and triggered the 75-bps hike last month.

The Fed is worried that if consumers believe this trend will continue (remember, adaptive expecta-

UMichigan Inflation Expectations & Gas Prices Are Highly Correlated



Source: BCA Research

tions), then they could become further entrenched and require a disinflationary recession to dislodge. So, a negative oil shock now represents a major downside risk. On the other hand, there is also a right-tail scenario where CPI and PCE inflation fall much faster than the Fed and markets currently expect. This could trigger a Fed dovish pivot that could lead to renewed multiple expansion if rates fall significantly. We view this as unlikely before the fourth quarter, since the Fed has already stated that it needs to see "several" (i.e., at least three months) of falling price prints. However, this upside risk increases into year-end, and it is why our S&P 500 target range is 14% to 20% higher from the June 16th low.

The Commodity Complex: The Supercycle Thesis Still Holds

In our view, the recent weakness in the commodity complex has been driven by elevated recession/growth fears. It has been focused on the demand side as market participants expect central banks to curb enough demand for oil, metals, and other commodities by enough that prices will fall. But our core thesis underpinning our long-term, bullish supercycle view on the commodity complex was never predicated on demand. It rested on the supply side. It was due to the decade-long underinvestment in production capacity by commodity-producing companies. Basically, there is a chronic lack of supply after a decade (pre-2020) of falling prices. In our view, the recent weakness in the commodity complex has been driven by elevated recession/growth fears.

There is simply not enough global commodity productive capacity at current levels to meet the world's demands. Only higher prices, perhaps much higher prices, will shift the supply curves upward and eventually cause prices to fall. But we are years away from this occurring, and the structural uptrend in commodity prices is only just beginning. We view the recent weakness as working off the potential excesses caused by the war rather than the end of the cycle. Of course, if a recession does materialize, prices will fall – temporarily. When the economy is in a recession for long enough, demand for commodities will decrease and prices will eventually fall.

Eventually, however, a recession will only worsen the underlying supply issues plaguing the complex. So, it just means that the supercycle will lengthen. In the end, we continue to view commodities and commodity-related assets both as a return-generating component within portfolios, and as an effective and valuable hedge for inflation and geopolitical risks. We particularly still like the industrial metals (supply and demand story here with renewables) and project that Brent oil should trade between $115 and $120 per barrel by the end of the year.

Separately, gold functions well as a hedge against inflation and geopolitical risk, but it is not as compelling of a directional play right now as the rest of the commodity complex. In other words, it does not have the same structural supply side concerns as copper or oil. Gold prices are approximately flat for the year, so it has done quite well amidst all the global market turbulence. If an investor believes that inflation is non-transitory, that inflation data will not come down this year, and/or that we are heading into a stagflation environment, then they should certainly be overweight the precious metal in their portfolios as a core holding.

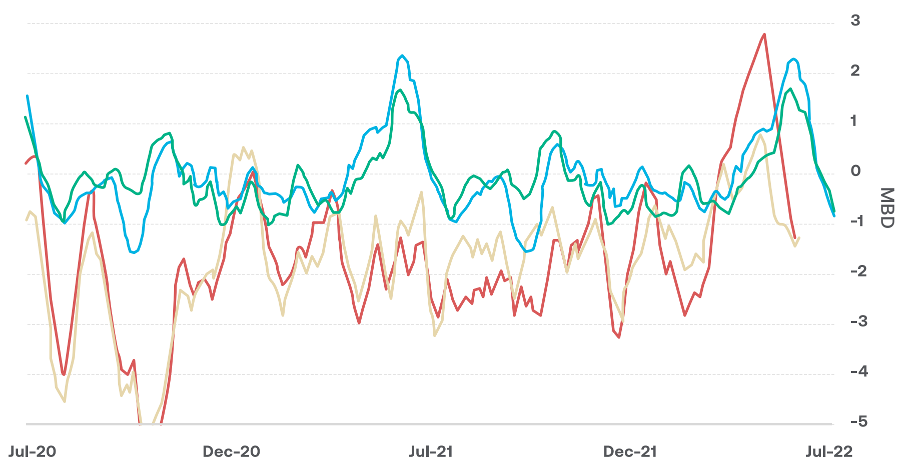
Our view is that gold is currently trading near to fair value, so we are maintaining our neutral positions as an inflationary/geopolitical risk hedge. If our base case is right and inflation will peak shortly, then gold should underperform other commodity prices. In the long-run, however, we still like gold quite a bit as we think that central banks will want to hold more gold than they currently do in their reserves as the demand for US Dollars decreases, and that an increasing amount of trade especially between China/Russia and the West will be settled in gold rather than Dollars, Euros, or Sterling.

What if Birth Rates Skyrocket Instead of Collapse?

It is a well-known fact that the pandemic caused births globally to collapse and that they remain below levels necessary to stabilize population growth. We also know that aging populations place a major strain on pension and health care systems as fewer workers have to support more consumers and retirees. This graph demonstrates that after rising steadily since the 1980s, the global support ratio, or the ratio of workers to consumers, peaked a few years ago and is projected to collapse to levels

Rolling 4-week Global Oil Inventory is Back in Deficit With China Out of Lockdown

- Total
- Seasonal (17-19)
- Ex China
- Seasonality Ex China

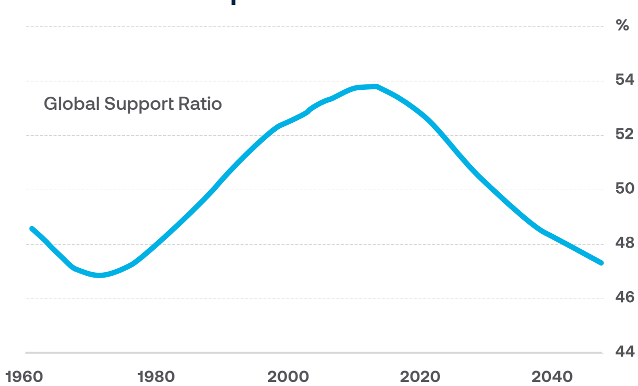


Source: Goldman Sachs

last seen during the 1970s. The news is filled with alarmist predictions of the "greying" of European, North Asian, and North American populations, coupled with their dire repercussions. After many years of failed government policy to boost fertility rates (e.g., China lifting its one-child policy), there is a sense among policymakers that there is not much that they can do to encourage people to have more children. Studies show us that as people retire, they save less and spend more.

As the pool of global savings decreases, it places upward pressure on equilibrium real interest rates and bond yields. Faced with these prospects, governments are likely to further increase spending to encourage more childbearing. Permanent and/or larger fiscal budget deficits will similarly deplete national savings and push rates higher. These demographic considerations have underpinned one of our most recent fundamental investment calls, the end of the 40-year bond bull market. A major corollary of that thesis is that interest rates have begun a structural uptrend with successively higher highs and higher lows, although they will temporarily fall during recessionary periods.

Global Support Ratio (Workers/Consumers) is Predicted to Collapse



Source: BCA Research

But what if birth rates will eventually increase on their own despite government policy? What if global fertility rates, instead of further declining, may be bottoming and poised to rise sharply?

A 2019 study in the journal of Evolution and Human Behavior by Jason Collins and Lionel Page suggests that our population modeling is incorrect because they use assumptions of constant long-term fertility rates. In their place, the authors introduce a dynamic model incorporating inheritable fertility based on evolutionary biology. Rather than stabilizing around a long-term level for developed nations, fertility rates tend to increase as children from larger families represent a larger share of the population and partly share their parents' trait of having more offspring. In other words, both cultural and genetic evolution will select for families that wish to have more children. To further clarify, the desire to have more children is as inheritable as height or IQ. As cultural forces have suppressed fertility over the last few hundred years (really since the Industrial Revolution), an ever-growing proportion of people with a higher propensity to have more children will have children. When the environment changes so quickly (since the early 1800s, for example) that existing reproductivity strategies become suboptimal, natural selection responds quickly. Their results suggest that the global population will

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> — "The effects are most pronounced in the two areas you would least expect: **Europe and North America.**"

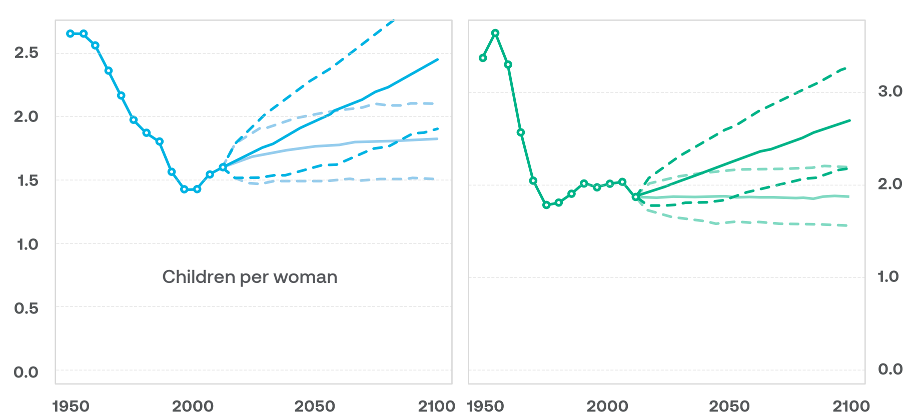
grow much faster than currently anticipated. In their model, without the inheritability effect, the global fertility rate declines to 1.82 by the end of this century, which is below the human replacement threshold. But once heritability effects are factored in, that rate increases to 2.21, well above the threshold. If true, this would have massive global policy implications from climate change to migration patterns to global conflict and even extraplanetary human settlement. And as this chart demonstrates, the effects are most pronounced in the two areas you would least expect: Europe and North America. Their model projects the European and North American fertility rates to rise to 2.46 and 2.67, respectively, above the global averages and against all conventional wisdom given current population modeling and projections.

At a recent event, Elon Musk said, "if people don't have more children, civilization is going to crumble." He is right. Progress, technology, and network effects work better with higher "n" variables: the more people the better. But we might not have to do anything about it from a policy perspective as natural selection pressures might already be breeding out those of us less inclined to have children. As Dr. Ian Malcolm in Jurassic Park reminded us, "life finds a way".

Now, I pass it along to my colleague, Melissa Ochoa Cardenas, who will be addressing impact investing in Latin America, after giving us an executive summary on the region's outlook.

Natural Selection Pressures Could Increase Birth Rates if Fertility is Heritable

Source: Collins, J., Page, L., "The heritability of fertility makes world population stabilization unlikely in the foreseeable future," Evolution and Human Behavior (2019)



EUROPE NORTHERN AMERICA

Melissa Ochoa Cárdenas
Investment Strategist
Insigneo Financial Group

The Latam Chapter

The region continues to face a challenging outlook amid slowing growth and sustained inflation pressures. Political uncertainty will remain a relevant variable for several countries during the second half of the year.

> Argentina is faced with a daunting outlook. The country is at the cusp of an inflationary crisis, while tensions between the government and the opposition linger. Any changes in the fiscal policy's implementation that steer away from orthodox management would be detrimental to the country.

> Brazil's economy remained solid despite high inflation and a tighter monetary policy stance. The political front will remain a source of uncertainty until the presidential elections take place in October.

> Chile saw its economy contract in the last quarter, as higher inflation and higher rates dent consumption. The uncertainty surrounding the fate of the new Chilean Constitution and any developments related to it will remain a central issue for the quarter.

> Colombia displayed robust growth last quarter; however, inflation still does not recede, and BanRep could be forced to hike into more restrictive territory. Moreover, the political outlook remains uncertain, with markets awaiting clarity from Petro's tax reform and his initial steps once he is sworn in.

> Mexico seems to be the most stable country in political terms in the region; however, its economic recovery is still below pre-pandemic levels, amid high inflation and a constant tightening from Banxico.

> Peru's growth is also losing steam against mounting inflation prints and an unstable political backdrop. The Central Bank stated it would remain data-dependent on its future decisions, but growing inflation pressures could force its hand into a more hawkish territory.

Argentina

Argentina continues to face a challenging environment for the second half of the year. Even if the government met all quantitative targets from the IMF EFF program in 1Q22 and got access to a USD 4.03bn tranche, the objectives for year-end remain unchanged. The latter adds a layer of complexity for 2023, a year that will host presidential elections, and the possibility of an inflation backdrop that deteriorates further. Moreover, uncertainty could remain during the following months when considering the recent resignation of Minister Guzman, who was replaced by Silvina Batakis – known as an acolyte of Kirchnerism. The confirmation of Batakis as the new Minister of Economy could tilt the power balance away from the current government party while undermining the fiscal consolidation that former Minister Guzman sought

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The economy continued to grow compared to last year's figures but showed a quarterly deceleration. Argentina's GDP for 1Q22 displayed a 0.9% QoQ variation, equivalent to a 6.0% YoY growth. The print was propelled by private consumption, whereas exports fell. The positive trend in growth has strengthened fiscal revenues, at least in nominal terms. Going forward, some analysts expect the economy to remain flat in Q2 22 and even contract in Q3 22 on lower exports after the harvest season.

On the external sector front, the latest current account print displayed a continuation in the balance deterioration explained by the services deficit, while import payments hit new record levels that could prompt the central bank to tighten import controls further. Nevertheless, this restrictive strategy could dent growth and reduce tax revenues, which would bode ill for Argentina.

Meanwhile, inflation remains a challenge, with the variable reaching a new high in May and the market penciling in a sustained increase for the remainder of 2022. The latter, on the back of higher gasoline prices, as well as an increase in the hotels and restaurants subgroup. According to some analysts, the observed increase in inflation could be explained by the lack of market access that is needed to finance the upcoming maturities in 2024. That backdrop and the lack of a credible fiscal consolidation trajectory make a potential disinflation path unlikely.

Brazil

Aside from the region's challenging macroeconomic environment, Brazil will have additional political uncertainty towards the end of the year since the presidential elections will take place on October 2, with a possible runoff on October 23. According to the latest Datafolha poll, Lula continues to garner most of the votes with 37% of the projected vote, whereas current president Bolsonaro accounts for 25%. In the case of a runoff, an IPESPE poll shows Lula would claim victory with 53% of the votes versus 35% for Bolsonaro.

On the growth front, the economy continued to show momentum after growing 1.0% QoQ, on the back of a faster Omicron rebound, the effects of new rounds of government stimulus, strong job creation, and an improvement in confidence indicators. Nonetheless, analysts are penciling in a deceleration during the second half of the year on the back of a tighter monetary policy implemented by the Copom.

Switching now to monetary policy, the Copom, like other Central Banks in the region, has seen its monetary policy rate increase by over 1,000bps since the tightening cycle began in March of last year. The Copom continued to signal an additional tightening move in its upcoming August meeting against rising inflation expectations and fiscal uncertainty stemming from possible tax changes. However, some analysts are penciling in a pause in the monetary policy rate path sooner rather than later, expecting rates to remain higher for longer, while the pass-through of monetary policy starts working on the macroeconomic picture.

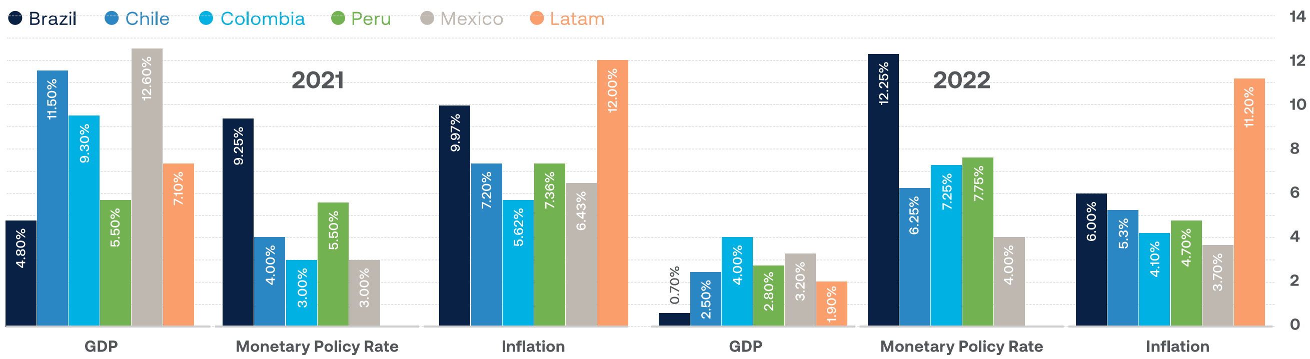
> — "Brazil will have additional political uncertainty towards the end of the year since the presidential elections will take place on October 2, with a possible runoff on October 23."

Moreover, even if it remains high, headline inflation is expected to have peaked in April, after the May print saw the variable recede to 11.73% YoY. On the core front, inflation is proving to be stickier, with the annual figure reaching a new high of 9.69%. Furthermore, it should be noted that going forward, the inflation outlook will remain dependent on the potential fiscal discussions that are currently underway, as well as on the behavior of fuel prices. Analysts now expect inflation to remain high in 2022, with a projected decrease next year.

On the fiscal front, by end-June, the Senate approved

Latam is coming back strong from the pandemic setback, but challenges still remain

Source: Bloomberg (as of January 7, 2022)



a constitutional amendment for a state of emergency that allows for additional spending until year-end. This bill, among other things, is expected to increase the cash-transfer program to low-income families, better known as “Auxílio Brasil”, to BRL 600 per family per month through December, create a diesel stipend of BRL 1,000 per month for independent truckers until year-end, and expand the cooking gas voucher program for low-income families. The bill still has to go through the voting process in the Lower House, where a swift approval is expected, probably before the mid-year recess scheduled to start on July 18. According to analysts, the fact that this is the third modification of the spending cap since March 2021, and this one was done through a state of emergency during an election year, undermines the credibility of Brazil’s fiscal anchors.

Chile

The upcoming quarter seems daunting for Chile. Aside from facing a cooling economy amid mounting inflation pressures, the uncertainty surrounding the fate of the new constitution will remain until the plebiscite vote on September 4. With the rejection vote gaining traction, the situation looks murkier for President Boric.

The Chilean economy displayed a contraction in 1Q22 on quarterly terms, but when comparing the economic activity with the previous year, the Chilean economy grew 7.2% YoY. Nonetheless, the market does not expect growth to continue in the austral country, considering the observed reduction in gross fixed investment during the first quarter of the year and the fact that for investment to recover, political certainty is necessary. Even if household consumption has remained solid due to the previous pension fund withdrawals and going forward could imply higher inflation, some data are showing fewer brighter spots, like the latest print of retail sales falling 5.6% YoY.

Inflation has increased incessantly since March of last year, reaching its highest level in almost 30 years in May. Furthermore, core inflation reached its highest reading since the ‘90s with the May print. Some market analysts are starting to believe that the variable may end the year close to the 10% handle, with the headline number being pressured by higher food and energy prices and by the minimum wage increase, which was the most significant in 25 years.

Against this backdrop of above-potential growth and high inflation, the Central Bank is expected to continue hiking its monetary policy rate. In its latest policy meeting, the BCCh unanimously decided to hike the rate by 75bps while announcing that additional adjustments would be needed, even if those would be milder. The Committee stated they would remain data-dependent and would continue to monitor the development of inflation.

Perhaps the most pressing problem that remains unanswered in Chile is the fate of the new constitution. The last draft prepared by the Constitutional Convention was presented to the government on July 5, while the rejection voting option has been gaining steam in the previous weekly surveys. This situation only adds up to an already polarized environment that will remain volatile until the plebiscite vote on September 4 since investors have no certainty on what could happen if the new constitution is rejected in the plebiscite.

Colombia

Like the rest of the Latin American region, Colombia is similarly facing a challenging outlook for the second half of the year. Even if the country was one of the highest growing ones in 2021, things for the current year look somewhat more nuanced.

In its previous readings, inflation has reached highs from the last two decades, being pushed upwards in June by food and energy prices and by an unfavorable base effect from last year. Moreover, core inflation remains firm, and risks for the headline figure remain tilted to the upside in the short-term due to a possible upward revision of fuel prices in the coming months, as was stated in the Medium Term Fiscal Framework.

For 1Q22, Colombia registered a YoY GDP variation of 8.5%, surprising the market to the upside and with the figure underpinned mainly by solid household consumption. It is worth noting that household spending is above pre-pandemic levels, whereas gross fixed capital formation is still recovering. Going forward, growth is expected to moderate on the back of higher inflation, which will account for a more contractive monetary policy. In terms of monetary policy, BanRep increased the magnitude of its latest move by unanimously deciding to hike the monetary policy rate by 150bps, on the back of strong economic growth and worries that inflation expectations may be unmoored in the medium term. Moreover, the Monetary Policy Committee highlighted that the observed increase in inflation expectations reduced the real policy rate, thus easing the monetary policy stance. Against this backdrop, while also considering a widening current account deficit and a currency that has been reaching all-time lows against the dollar, the market expects BanRep to continue tightening to re-anchor inflation expectations and implement a more restrictive monetary policy.

> — “Perhaps the most pressing problem that remains unanswered in Chile is the fate of the new constitution.”

Colombia’s political landscape will remain volatile at the beginning of the quarter, amid the new Congress being sworn in on July 20 and newly elected President Gustavo Petro assuming office on August 7. Since his election, Petro has shown a more moderate view, trying to build alliances with different parties that should ease Congress’s approval of his proposals. He has also held conversations with various political sectors. Going forward, investors will continue to monitor the tax reform proposal that Petro has announced he will present to Congress the same day he takes office since several of his campaign proposals have been considered ambitious and lacking funding.

Mexico

The Mexican economy continued to grow in 1Q22 by 1.8% YoY, relatively in line with market consensus. Like in several other Latin American economies, Mexico’s growth was mainly explained by solid consumption, and by strong remittances and government transfers. Looking forward, growth perspectives for Mexico could be dampened by expected high inflation, which could dent consumption, thus keeping activity below its pre-pandemic levels and potential.

Regarding inflation, June's print reaffirmed the trend that it still faces substantial mounting pressures in its headline reading after a print of 7.99% YoY. Even if the core measure receded slightly in June to 7.49% YoY, the headline figure reached a new high in annual terms, with analysts expecting the upward trend to continue for a couple of months.

In terms of monetary policy, Banxico has been relatively gradual when implementing a tighter monetary policy; however, the market continues to pencil in a more hawkish stance from the bank on the back of higher inflation expectations and, like most of its peers, in an attempt to tame those. Furthermore, Banxico has always been closely monitoring the Fed's actions in monetary policy terms and given the more hawkish stance of the latter, Banxico could face upside risks in the short term.

On the political front, Mexico recently held gubernatorial elections on June 5 in six states. The results show that, as expected, Morena won in four of those six, whereas the opposition took the remaining two. Now, all eyes will focus on the 2024 presidential election, for which current President Lopez Obrador still has to announce a candidate to succeed him. Meanwhile, analysts have stated that the opposition seems weak, with no potential candidates to enter the race in 2024. Still, it is worth highlighting that, for the near future, Mexico appears to be one of the most politically stable countries in the region, if not the most.

Peru

In Peru, the political situation also remains in the headlines while the government struggles with a weakening macroeconomic landscape.

Economic activity has been losing steam in the last few quarters, with some analysts even starting to predict the possibility of an imminent recession. The economy's deceleration has been partially contained by an additional pension fund withdrawal that propels consumption. Still, confidence and supply disruptions are not allowing the economy to take advantage of the commodity boom that the world has experienced through 2022. Here one should consider that the previously mentioned pension fund withdrawal was approved against the advice of several technical entities such as the BCRP, the Ministry of Economy, and the Banking Superintendency.

In terms of inflation, the June reading surprised markets to the upside after coming in at 8.8% YoY. Inflation was mainly propelled by food and transportation prices; core inflation continued to increase with a yearly variation of 4.9%. This reading has analysts suggesting that inflation will be more persistent than they initially believed, which sets the stage for the BCRP to continue implementing a tighter monetary policy. Shifting to monetary policy, the BCRP has kept a constant pace of monetary policy rate increases since August of last year. Current market expectations are that the Peruvian Central Bank will continue to tighten while remaining data-dependent and vigilant of future changes in inflation and inflation expectations. In its latest monetary policy decision, the BCRP hiked its monetary policy rate to 6.00%, in line with market expectations, insisting that inflation would start easing in July.

On the political front, Peru has faced continuous turmoil since President Castillo was sworn in last July. The country has undergone four cabinet reshuffles, and multiple key government officials have been replaced every month. This political instability has dented Capex spending as well as the capacity of the government to execute projects. Furthermore, the government faced protests in April that could reignite at any time since the protestors' demands have not been fulfilled.

Impact investing in Latam

— "Impact investments, are made with the **intention to generate positive, measurable social and environmental impact** alongside a financial return."

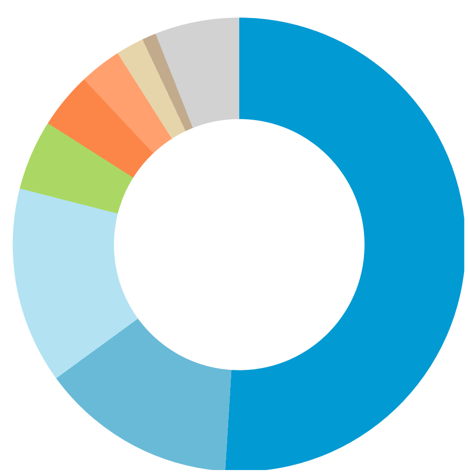
Much has been spoken about impact investing in the last few years, making it another buzzword in the investing industry. As was stated by Rockefeller Philanthropy Advisors, "delivering a financial return while doing good—struck most philanthropists and investors as far-fetched.". However, this is not a new type of investing, nor is it the desire of human kind to achieve something beyond just financial returns with its capital investments. Today, we will dive deeper into impact investing, how the perspectives are looking for Latam specifically, and what we as investors can do to benefit from it.

Let's start with the definition. Impact investments, as defined by the Global Impact Investing Network – GIIN – are "made with the intention to generate positive, measurable social and environmental impact along-side a financial return." Furthermore, even if all investments make an impact on society -be it good or bad – impact investments are expected to focus solely on pursuing those that lead to measured positive social impact.

In addition, as stated by the GIIN, "impact investing challenges the long-held views that social and environmental issues should be addressed only by philanthropic donations, and that market investments should focus exclusively on achieving financial returns." This approach still seems far off the usual modus operandi of the financial sector; however, the latest GIIN Annual Impact Investor Survey from 2020 proves this to be false. Amongst the respondents of the survey, 51% were equivalent to asset managers of for-profit institutions, whereas only 14% were fund managers of not-for-profit organizations, ranking second in the list.

Organization Type

- 51% Asset Managers: for-profit
- 14% Fund managers: not-for-profit
- 14% Foundations
- 5% DFIs
- 4% Family Offices
- 3% Diversified Financial Institutions
- 2% Pension Funds
- 1% Insurance Companies
- 6% Others



Note: Other organizations include community development finance institutions (CDFIs), NGOs, nonprofits, permanent investment companies, real estate developers, sovereign wealth funds, and independent federal government agencies.
Source: GIIN, 2020 Annual Impact Investor Survey

In addition, it should be highlighted that 52% of the respondents began making impact investments within the last decade. Moreover, with respect to the different nationalities from the impact investors involved in this survey, North America and Europe are the industry leaders, accounting for 45% and 26% of the respondents, respectively.

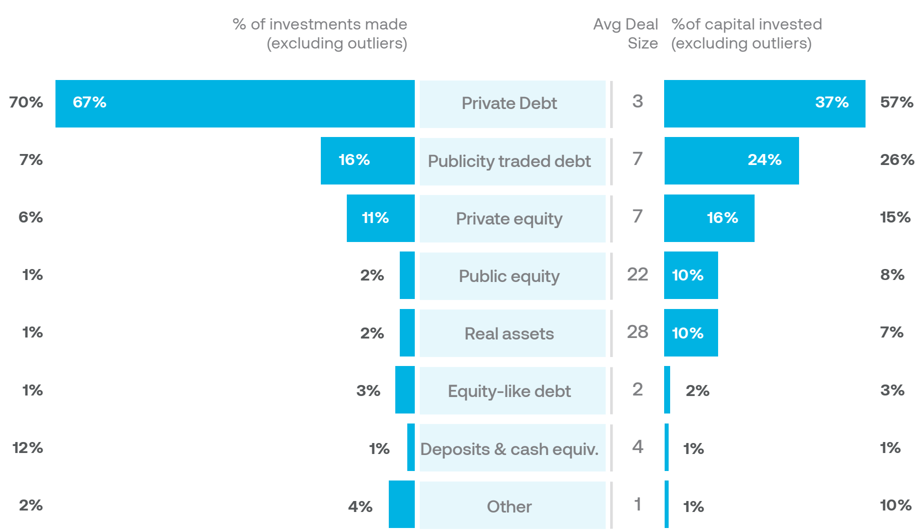
Zooming in into the types of investments that comprise the impact investing industry, private debt stands out as the asset class that gets the highest percentage of both investments and capital invested, followed by publicly traded debt and private equity as can be seen in the following graph.

— "North America and Europe are the industry leaders, accounting for 45% and 26% of the respondents,"

Nonetheless, the situation I just portrayed is not focused on any region. So let us drill down on Latin America. The first thing that I would like to highlight is the growth that impact investing has had in the region: according to the latest GIIN Annual Impact Investor Survey, impact investing allocation in Latin America and the Caribbean in 2019 stood at USD 13.17bn, equivalent to a CAGR of 21% for the period between 2015 – 2019.

Furthermore, the latest Latam Impact Investing Survey states that 60% of its respondents are based in the continent, with the greatest representation coming from Brazil and Mexico. This survey also stresses that the impact investing market in the region is becoming more attractive since the capital deployed by local investors has increased in the five years before 2019, with the initial investments made by locals more than doubling that of investors based outside of Latam. In this regard, it is worth pointing out the perspective gleamed from Acumen Latam Impact Ventures (ALIVE). The organization stated in this survey that 30% of its fundraising stemmed from local institutions. The latter is a trend they had not

Capital Invested and number of investments made in 2019, by asset class



Note: Excludes six outliers and nine respondents that did not report 2019 investment activity. 'Other' includes guarantees, alternatives, mezzanine, New Market Tax Credits, and revenue-based financing.

Source: GIIN, 2020 Annual Impact Investor Survey.

seen in other regions where Acumen, a non-profit focused on changing how the world tackles poverty, had participated in different fundraisings.

Moreover, impact investing has also been present in Latin America through venture capital investing, with big names like SoftBank launching Latam-exclusive funds in 2019 and 2020 that helped turn venture investing in the region into a bigger, faster, and more sophisticated process.

Another example of Impact investment in Latam is New Ventures, a Mexican company that is, in its own words, disrupting business as usual. It is trying to incorporate intentionality across all its projects by, among others, launching funds from its venture investing arm, where the first one will be a women-focused health tech fund.

In a recent interview, New Ventures' founder Rodrigo Villar highlighted that Latam recently had its first social unicorn: the Chilean company Betterfly. It is a B Corp whose aim is to provide insurance and wellness to companies and their employees. Here it is relevant to address what being a B Corp means. B Corporations are companies that "voluntarily meet the highest standards for social and environmental performance. They go through a rigorous certification process, completing a comprehensive assessment of their company's impacts on all stakeholders, and having their assessment verified by B Lab, the nonprofit behind the B Corp certification."

The next point I would like to address is how investors can access this space that is starting to evolve from a niche to a more developed way of obtaining both social and financial returns. Firstly, the GIIN states in its latest listed equities report from 2020 that there are different strategies to address impact. Those can range from funds with a broad vision that seeks to invest in companies that broadly promote an equitable and sustainable world to funds with a more specific approach and target a defined impact problem or sustainable development goal – SDG.

When allocating resources into their different portfolios, and according to the GIIN report I just mentioned, there are three separate profiles of investments:

> Diversified funds with a broad thematic focus (100+ stocks across the entire set of SDGs).
> Diversified funds with a narrow thematic focus (100+ stocks clustered around a specific set of SDGs).
> Concentrated, high conviction funds (~50 stocks).
> These different profiles also depend on individual investors' considerations, such as big multinationals that could impact other sectors or even have both positive and negative impacts depending on the part of the business being considered.

— "Impact investments, are made with the **intention to generate positive, measurable social and environmental impact** alongside a financial return."

Zooming in to some fund investments that are a common alternative for investors to access the space, there are fund managers such as Amundi that offer different sleeves so that investors can choose the type of impact investment they would like to perform. Others, like Acumen, created a specific investment arm – Acumen Capital Partners – to structure and manage funds that will fill a critical gap that currently exists for social enterprises. One of these funds that I previously mentioned, whose focus is solely on Latam, is ALIVE.

Both managers and investors will need to have tools to quantify impact to determine the social return they were able to achieve. Thus, it is relevant to highlight the existence of the IRIS+ system developed by the GIIN, which is defined as the generally accepted system for measuring, managing, and optimizing impact. One of its key features is that it includes a thematic taxonomy that offers generally accepted definitions of Impact Categories and Impact Themes. The IRIS+ also identifies common goals and core metric sets by theme, thus providing a common language for describing, assessing, and comparing impact performance.

In sum, impact investing is helping to close the gap that existed previously between societal benefits and financial returns in a way that other investment alternatives had not been able to attain. If the GIIN survey proves to be correct, and the growth of this market continues with the trend it has been displaying throughout the last five years, the term impact investing, first coined in 2007, could transition from being a buzzword to something crucial within the financial services industry.

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House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
US Equities[1]	NEUTRAL	OVERWEIGHT
European Equities	UNDERWEIGHT	NEUTRAL
Japanese Equities	NEUTRAL	OVERWEIGHT
Emerging Market Equities	NEUTRAL	OVERWEIGHT
Chinese Equities	OVERWEIGHT	NEUTRAL
US Treasuries[2]	NEUTRAL	UNDERWEIGHT
Investment Grade Fixed Income	NEUTRAL	UNDERWEIGHT
High Yield Fixed Income	NEUTRAL	NEUTRAL
Emerging Market Sovereign	NEUTRAL	NEUTRAL
US Dollar	NEUTRAL	UNDERWEIGHT
Energy[3]	NEUTRAL	OVERWEIGHT
Precious Metals	NEUTRAL	OVERWEIGHT
Cash	OVERWEIGHT	NEUTRAL

[1] Relative to global equities in USD
[2] Relative to aggregate fixed income markets in USD
[3] Relative to an overall commodity allocation

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