Quarterly Call
July 2021

English Version

Surfacing and Assessing the Mid-Year Landscape

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

insigneo

Transcribed from comments made during our Quarterly Call Q3 | 2021

July 8th, 2021.

"Hello, everyone, and welcome to our flagship event – Insigneo's Quarterly Call for Q3 2021. As always, it's truly a pleasure to be here virtually with all of you – our clients, partners, and friends from around the world – and for the first time in quite a while – in person – with some of you here at our headquarters in the United States. There is a sense of returning to normal for many, certainly in many parts of the developed world, less so in others, but one thing is clear – the light at the end of the pandemic tunnel is approaching quickly.

As many of you know, we are very fond of "big themes" here at Insigneo, drawing from the school of thought of the longue durée – a perspective on history that extends further into the distant past and attempts to extract the powerful super-cycles that, though imperceptible to those who experience them, slowly but inexorably drive us toward paradigm shifts.

Our research demonstrates that understanding and properly investing in these cycles is the best way that investors can extract value over the long-term, a better (and more profitable) approach than trying to time the daily gyrations and vagaries of the Market."

Ahmed Riesgo
Chief Investment Strategist
Insigneo Financial Group

"Surfacing" is a term where submarines ascend to approximately 60 feet below the surface, deploy their periscope, assess the field of view, and then quickly descend beyond the reach of surface vessels. They are not leaving the battlefield, seeking safe harbor. No, they remain in it, but their level of engagement diminishes as they surface to gather information for potential hazards ahead.

We are also very fond of metaphors. In an era where too much information is as much a problem as too little, they help us get at the heart of what is going on. In October of 2020, during the pandemic year's final Quarterly Call, we deployed one that particularly resonated with some of you, as our numerous subsequent conversations attested to.

We advised clients to **"stay in the game but change the players". The "game" was the market and risk-on assets. The "changing the players" bit referred to rotating the assets that you held in your portfolios**. Our poor attempt at high metaphors alluded to a soccer game where you substituted certain players in and out depending on the time left and the score. Specifically, we urged you to "sell the Covid winners and buy the Covid losers".
That meant incrementally rotating out of Growth and the mega cap US names that benefited from the lockdowns and other pandemic responses to Value and the more cyclical names that had been adversely affected by it. Since that date, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by almost 12% as of June 30th. It's not that the Growth style has done poorly; it is up over 24%. It's just that Value has done better, trading up 36%.

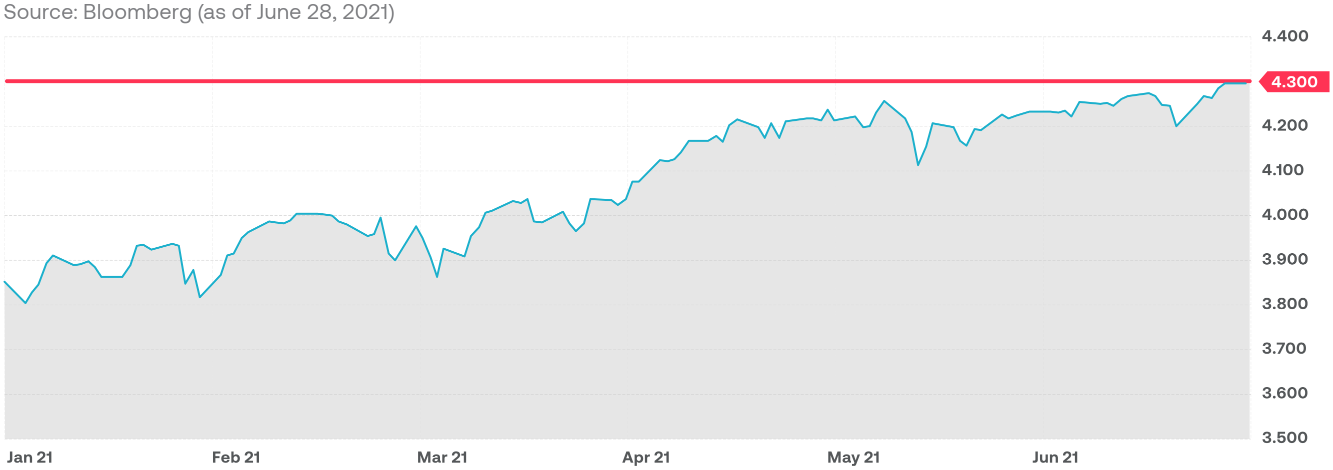
Both of those extraordinary performance figures underscore the broader underlying narrative that the economic recovery and bull market was in its early stages, with ample space to run thanks to the wholesome mix of exceptionally high fiscal and monetary policy stimulus around the world and the promise of highly efficacious vaccines.

This underlying thesis remains intact, but there are nuances and risks rearing themselves in a way that merits caution especially given the market's breakneck performance and our own investment recommendations. This cycle seems that it will run hotter than most, but my guess is that it will also be shorter. In other words, it makes sense here to surface and assess the mid-year landscape.

"Surfacing" is a term borrowed from naval warfare where submarines ascend to approximately 60 feet below the surface, deploy their periscope, assess the field of view, and then quickly descend beyond the reach of surface vessels. They are not leaving the battlefield, seeking safe harbor. No, **they remain in it, but their level of engagement diminishes as they surface to gather information for potential hazards ahead**.

S&P 500 is close to our 2021 price target

Source: Bloomberg (as of June 28, 2021)



In this case, we have already reached our target on the S&P 500 for year-end as this first chart demonstrates. As I write these words on June 30th, the S&P 500 is a mere 2.5 points away from it, closing the day at 4297.50. It will be interesting to see where it is today, as I speak these words back to you. For us and other investors who are very bullishly positioned in their portfolios, it would be prudent to pare back some risk on a tactical basis and wait to reassess the monetary policy framework and growth outlook in a few months. In other words, one should ascend to periscope depth for a look around, mindful that the 12-month view for global equities and other risk-on assets is still positive.

Is it time to recalibrate our S&P 500 target? The answer is probably "yes", but I need more information before doing it, so instead I will raise some cash in our portfolios until we get better market intelligence. Let me first tell you how I arrived at my target:

> **First**, I factored in robust US growth to start the year, much higher than market expectations at the time. We will get into more details on that in a minute.

> **Second**, I assumed that the US corporate tax rate would be increased to 25% by the passage of further fiscal legislation.

> **Finally**, I calculated that fair value on the US 10-year Treasury bond would be 2% by year-end.

Put together, this gave me a 21x multiple on the S&P 500 and USD 205 forward EPS estimates, and by the power of multiplication you get to 4305 on the index. Has anything changed for me to alter my target? Well, for one, the chance that there is no further US fiscal stimulus has increased, though my base case remains that we still get a reconciliation bill that raises the corporate tax rate from 21% to 25%, instead of the 28% wanted by the Biden Administration. If the corporate tax increase were not to occur, then my forward EPS estimate would rise to 215 and the new target on the index would be slightly higher than 4500 *ceteris paribus*.

But the markets and life are never all else being equal. We must consider the market multiple, which is affected by rates, the most important question that all market participants are grappling with. If the

10-year stays where it is as of June 30th at 1.46%, then that would argue for a multiple around 23x, which gets you all the way to 4700, ceteris paribus. If it were to increase all the way to 2.5% by year-end, say by another inflation scare like we did earlier in the year, then the multiple will contract down to 18x, and that would leave the index at around 3700, roughly 14% below today's levels. For now, we have not altered our view on the 10-year US Treasury and still believe that it ends the year around 2%, so the current market multiple of 21x seems appropriate.

Insigneo/Forefront US Recessionary Model

Probability of recession within the next two quarters

0.0%	Overall Macro Indicators
0.08%	Overall Macro Leading Indicators
0.0%	Conference Board US Leading Index Ten Economics Indicators YoY
12.3%	OECD Composite Leading Indicators
93.78%	3-month % Change of Manufacturer's New Orders, Consumer Goods And Mat.

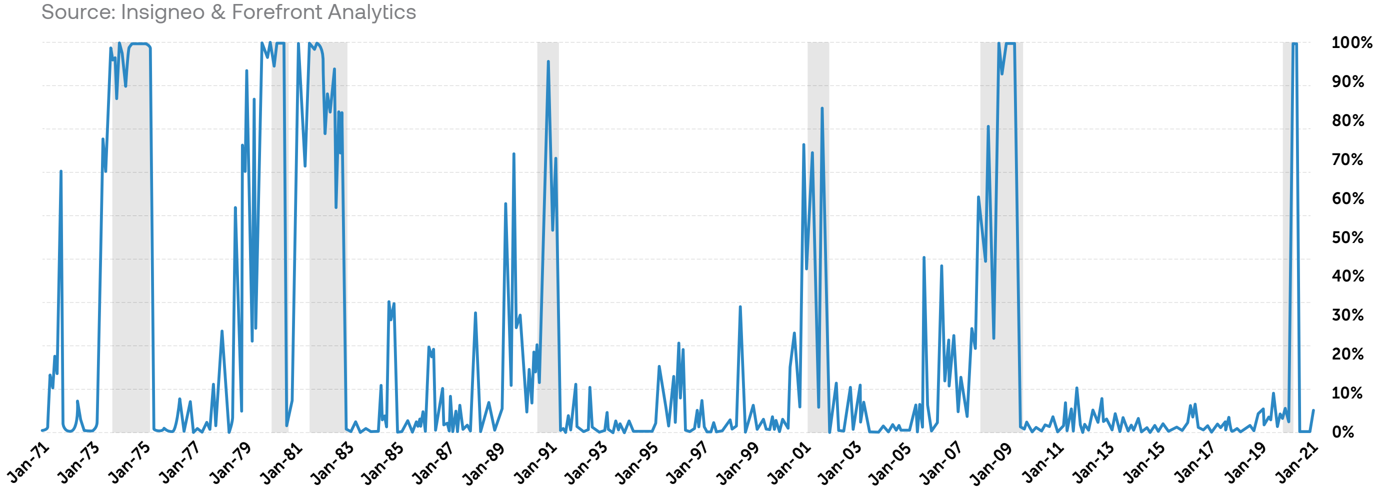
Source: Insigneo & Forefront Analytics

Within our multi-asset portfolios, we are closer to neutral on US equities than we have been in many years. Why are we not more downbeat given valuations and flows? This next chart largely tells the story: **the Insigneo-Forefront Recessionary Indicator is saying that there is practically no chance of a recession in the US within the next 6 months**. This is our proprietary model which forecasts the probability of a recession two quarters out. It aggregates various leading indicators as inputs and then gives a score as an output. While some gauges within the model, individually, are signaling heightened risk, such as the 3-month change in manufacturing new orders, consumers goods, and materials, in aggregate the signal is quite benign.

These are all the current gauges signaling some risk, but not enough in combination to move the main output variable. In fact, as this back test of the model going to 1971 suggests, **we are well below the threshold level of 40% that would trigger a change in our cyclical macroeconomic outlook**. When the model's dial is below 40%, we are risk-on and keep our portfolios either bullishly positioned or, at worst, neutrally positioned. When the reading is above 40%, the reverse is true. Risk-off and bearish or, at best, neutral.

Forecasted Recession Probability for 2-Quarter Forward Period using All Macro Leading Indicators

Source: Insigneo & Forefront Analytics



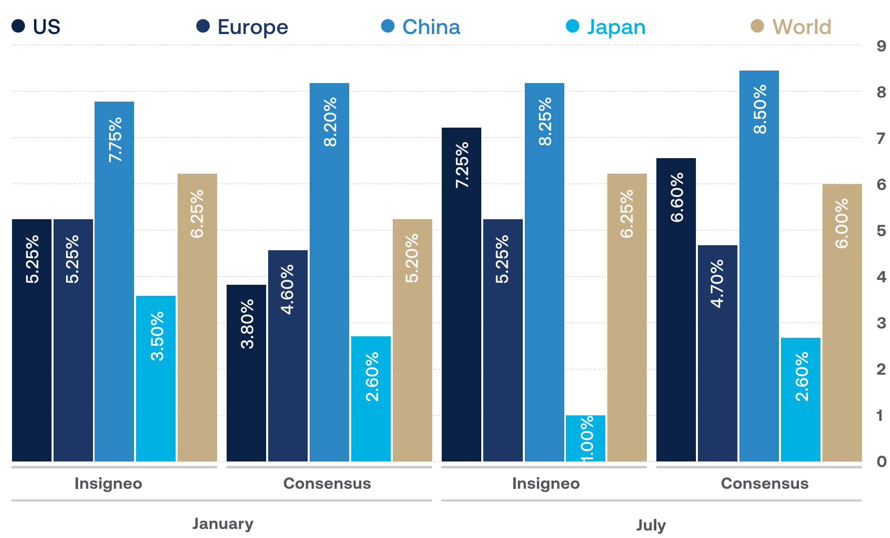
As a sidenote, we chose a 2-quarter forward looking probability because markets tend to peak 6 months before the onset of a recession. The model's major limitations are capturing quick-moving exogenous shocks to the global economy like the pandemic. Indeed, it did not predict the Covid-19 recession in time to miss the beginning of the short-lived bear market.

We are currently looking at ways to refine the model to capture these fast-moving downdrafts of economic activity by looking to incorporate more real-time, high-frequency data like credit card payments, open table reservations, shipping data, etc. We are confident of the model's ability to predict ordinary recessions, as most of them are not like the Covid one.

— "Not only are we not forecasting a recession any time soon, but global growth estimates have increased."

level and will remain well above trend levels. The housing market is cooling a bit, the effects from fiscal stimulus will fade, but US households still have very elevated levels of savings and generationally great household balance sheets. If the increase in inflation proves transitory, which is our base case, monetary policy will remain very accommodative.

Growth Estimates: Consensus forecasts are approaching Insigneo's



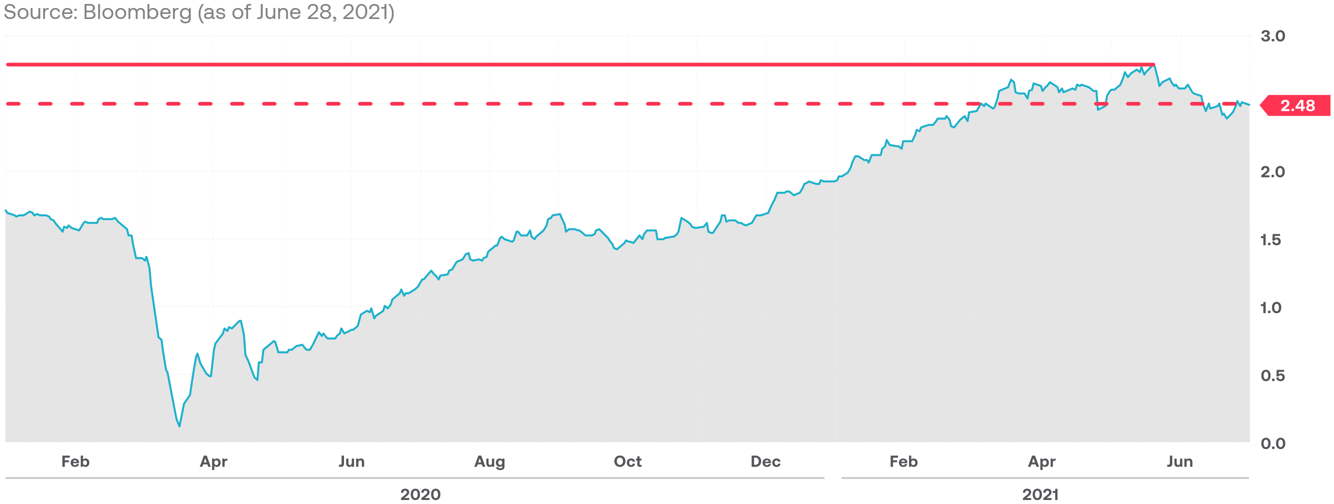
Source: Insigneo | Bloomberg | Consensus (as of June 28)

As this next table shows, not only are we not forecasting a recession any time soon, but global growth estimates have increased, bringing consensus figures closer to our already heightened expectations to start the year. In the US, **we have revised up our estimate of 2021 Real GDP growth YoY from 5.25% back in January to 7.25% today**. US growth peaked in Q2 and should decelerate into H2 albeit from an elevated

While consumer prices are increasing at a faster pace than most anticipated, the empirical evidence points toward supply-side constraints that should ameliorate in the next quarter or two. Given the Fed's new average inflation targeting regime, one would need to see a large and persistent spike in inflation expectations for the US central bank to pivot away from easy monetary policy.

5-year breakeven inflation remains subdued

Source: Bloomberg (as of June 28, 2021)



As this chart shows, that has not occurred yet. In fact, 5-year breakeven rates in the US have come down from the the May peaks and have settled around 2.5%. Going forward, the main driver of the Fed's reaction function will be when labor market conditions have reached its assessment of full employment. While I cannot completely rule out numerous, spectacular employment reports in the second half of the year bringing forward the first rate hike from current expectations in late 2022/early 2023, it is also not the most likely scenario. As April's disappointing jobs number reminded us, the damage to the labor market, especially in the low-income segments, was quite severe and could take some time to fully heal. More data is needed to reach that determination, and the summer and early fall will be crucial periods to watch. In sum, I am less worried about the near-term inflationary pressures than the current market narrative suggests.

Turning now to the European Union, the Continent is where the US was 3 months ago, and its steady progress suggests that it will get there.

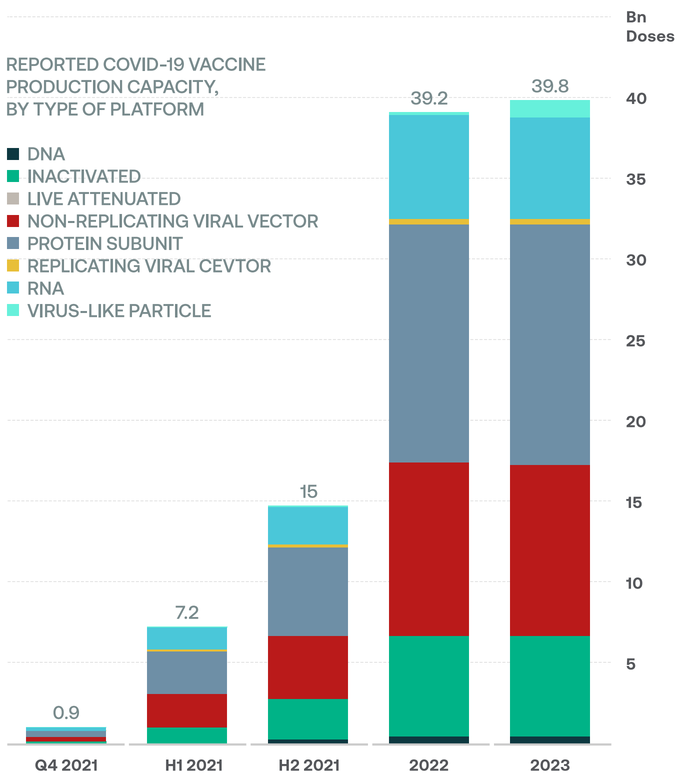
In China, growth is back above pre-pandemic levels, and the authorities are using the strength of the global recovery to reduce the credit impulse and tighten monetary policy. We expect Real GDP growth YoY of 8.25%, about 0.25% below consensus estimates. Though the credit impulse is declining, it is far from restrictive, and we are seeing signs that we may be nearing an inflection point. In other words, China has increasingly decoupled from the rest of the global growth cycle.

— "5-year breakeven inflation rates in the US have come down from the the May peaks and have settled around 2.5%."

In the rest of the developing world, the picture is more nuanced, and any fair assessment of the macroeconomic story must be addressed at the country level. Later in the presentation, we will present to you a closer look of the macro-landscape, particularly in Latin America.

Vaccine production will ramp up sharply

Source: BCA Research; UNICEF Covid-19 Market Dashboard



But as this chart demonstrates, vaccine production is set to ramp up sharply, and doses will begin to flood the rest of the world starting early next year. For now, there are three main risks to this overall sanguine view:

First, the appearance of **a new, vaccine-resistant strain of the coronavirus**. In my view, this is a potentially high impact but low probability event. So far, all the new variants of Covid-19 have been neutralized by the existing vaccines. Even the new Delta variant, an expected mutation that is more transmittable but less deadly than previous strains, can be dealt with very effectively by the mRNA vaccines from Pfizer and Moderna. And in places where the population is not inoculated, the Delta mutation is causing cases to rise but there has been no corresponding uptick in hospitalizations or deaths.

The second major risk is stemming from the impact of **higher taxes in the US on corporate earnings and long-term dividends**. Like I stated previously, I expect some legislation to emerge, even if it is very diluted from the original proposals. Interestingly, the biggest stumbling blocks come from the moderate voices within the Democratic caucus. Senator Joe Manchin of West Virginia, a deeply Red state, is perhaps now the most important person in Washington D.C. thanks to the political gridlock. In the end, **I expect the corporate tax rate to settle between 24 and 25% and the dividend tax rate**, in the unlikely event it even passes, to be under 30%. But the risk that the moderates fall in line with the progressives under the pressure of a floor vote on a reconciliation bill cannot be ignored altogether.

Finally, **there is the greatest risk of all – the aggressive withdrawal of stimulus in China, and sooner-than-expected tightening in other parts of the developed world**. It is our base case that neither of these risks will materialize enough to derail the global recovery. We do not think there will be a policy mistake. In our view, the Chinese credit impulse may have already bottomed, which would signal that we may be near the end of their purposeful managed slowdown. And in the US, at the risk of sounding repetitive, the US Employment Reports during the next few months will be key indicators to watch for the Fed because a consistent string of blockbuster reports may force its hand if inflation expectations rise as well. As far as the tapering of Fed asset purchases go, our expectations remain that it will begin between December 2021 & March 2022, with a formal announcement perhaps at the Jackson Hole conference in late August.

— "Vaccine production is set to ramp up sharply, and doses will begin to flood the rest of the world starting early next year"

A look back at 2013's taper tantrum

	6 MONTHS BEFORE TAPERING ANNOUNC.	TAPERING ANNOUNC. TO TAPERING START	6 MONTHS AFTER TAPERING START
S&P 500	19.0%	11.7%	6.8%
EuroStoxx50	11.8%	11.8%	-0.5%
FTSE100	18.1%	-0.3%	-1.6%
TOPIX	64.3%	1.4%	-1.6%
MSCI EM ($)	6.3%	-6.7%	9.1%
MSCI China ($)	4.3%	-1.1%	3.3%
MSCI EM ex Asia ($)	3.5%	-11.1%	8.3%

Source: JPMorgan | Datastream

And as this next chart shows, the last time the Fed began tapering asset purchases back in 2013, the emerging markets were disproportionately negatively affected during that window from the announcement of the program to the beginning. This means that emerging markets could suffer a period of weakness from September of this year to January 2022, if our expectations prove true. We tactically reduced some emerging market equity risk in our model portfolios, the I-maps, to account for this scenario.
It is worth remembering that the most important factor when it comes to monetary policy is not when tapering will begin, by how much, or even when the first rate hike will occur. It is expectations of the Fed's terminal rate. When that rate settles above r*, the neutral rate of interest, then monetary policy turns restrictive and risky assets fare poorly. So, while those maximally overweight risk should mildly reduce exposure on a tactical basis, none of the risks warrant paring back exposure over a cyclical one. A prudent approach might be to maintain slightly elevated levels of cash on hand to pursue any opportunities that arise after a market dislocation.

The following is **a summary of our market and asset class views on a cyclical or 12-month horizon**:

Remain overweight equities over bonds in multi-asset portfolios, although returns should be more muted than they were to start the year. Expect low single digit returns in global bourses in H2 2021.

Within equities, overweight global non-US stocks versus their US peers; overweight Europe versus emerging markets.

On a style basis, maintain overweight in Value versus Growth although dispersion and outperformance should be less going forward.

Within fixed income, moderately shorten duration on sovereign bond holdings; overweight high yield versus investment grade. Spreads should remain tight however, and we do not expect material widening.

Maintain cyclical overweight in commodities, especially industrial metals as a multi-year commodity super cycle likely began late last year.

After the current spate of US Dollar strength has ebbed, the Greenback should resume its bear market as the global growth epicenter will shift from the US to the rest of the world.

Maintain inflation hedges in multi-asset portfolios through commodities, US bank stocks, real estate, and farmland.

Before we end our portion of the presentation and commence our deep dive into Latin America, I want to leave you with two possible paradigm shifts occurring right now.

The first has to do with commodities. As you may well know, we have been recommending them this year as long-term inflation hedges. After the robust gains from the pandemic lows and China's moves to curb prices, we would be remiss to ask ourselves is the cycle over now? Our sense is that the answer is "no". Yes, the declining Chinese credit impulse could temporarily put a damper on the metals rally, as it did during the end of the previous super-cycle in commodity prices. But our thesis was never centered around China. It was about physical deficits in spot markets (scarcity) and a developed market-led (especially out of Europe and to a lesser extent the US) permanent increase in aggregate demand for industrial metals.

China is no longer the marginal buyer dictating pricing, as it once was during the previous super-cycle from 2009 to 2011. It is increasingly being crowded out by the Western consumer. In fact, China's release of strategic stockholdings to dampen prices now may exacerbate upward price movements in the future. Longer-term, the shift to clean energy will maintain robust demand for the industrial metals. And with mining capex half of what it was in 2012 (USD 40 billion vs. USD 80 billion), this should keep prices well buoyed. With respect to oil, the picture is certainly clouded in the longer-term as governments around the world are doing all that they can to reduce the market share of fossil fuels. But ironically, in the short-term, that will keep prices well bid as the market too remains in a physical deficit. In sum, with respect to industrial metals: short-term caution, but longer-term buying opportunity; for oil, it is the reverse: longer-term caution, but short-term price pressures likely to persist.

The second paradigm shift may be occurring in the developed sovereign bond market – where US Treasuries reign supreme as the carry instrument of the world's reserve currency, the US Dollar. But the Dollar's place atop the hierarchy of reserve currencies is not mandated by Divine Law. Just like its predecessor, the Pound Sterling, remained the world's reserve currency long after the British Empire ceased to be the global hegemon, so too may the USD's reign last longer than when the US must share power with others. In fact, it was not until after the devastation of World War II, where Europe's economies lay in ruins and the US represented over 40% of global GDP that the USD was firmly entrenched as the reserve currency. To be sure, I am not saying that the US Dollar is about to be displaced as the world's reserve currency. In fact, it probably will not happen in any of our lifetimes as there is no clear successor, neither from the Euro nor the Renminbi as they are plagued with numerous and more onerous structural problems of their own. What I am saying, however, is that there is an opportunity for another currency to gain a fair amount of market share among central bank balance sheets.

— "I am not saying that the US Dollar is about to be displaced as the world's reserve currency, however, there is an opportunity for another currency to gain a fair amount of market share among central bank balance sheets"

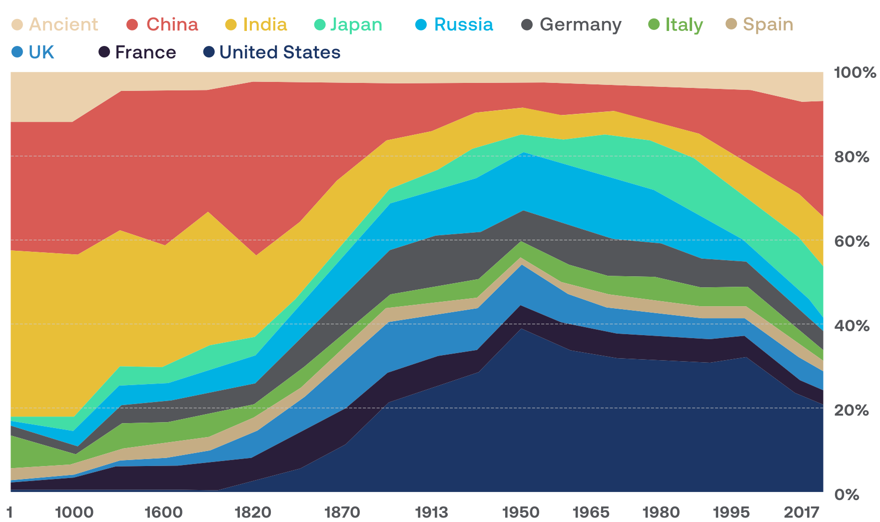
This splendid chart shows 2000 years of economic history in one graph. We are amid a multi-decade, paradigm shift in the global power structure. At the end of World War II, the US accounted for a far larger share of global GDP than would be warranted given its population. As it demonstrates, the US' share of global GDP reached a zenith of almost 40% in the early 1950s. To be sure, some of this was due to the US economy's unrivaled level of productivity and innovation. The US will always punch above its weight because of these factors.

But the overwhelming reason why the US was the geopolitical center of the world was that most major economies were in ashes after that devastating conflict. Since then, our share of global GDP has been steadily waning. To paraphrase Herbert Stein, that which can't go on won't.

Enter the Covid pandemic – a game accelerator not changer. While China was ground zero and grappled with the pandemic first, it too was the first to emerge from the crisis with the least number of fiscal scars. In fact, China did not need to pump as much fiscal stimulus as the West did because its draconian and rapid quarantines meant that only regions had to be locked down and not the entire country. While the US has run a fiscal deficit of more than 20% of GDP and will return to pre-pandemic growth later this year, China is already operating at its pre-pandemic output level while running only a 5% fiscal shortfall. Then in March of last year, I noticed a curious phenomenon during the worst of the pandemic. Chinese Renminbi-denominated sovereign bonds exhibited safe-haven characteristics.

2,000 years of economic history

China is returning to its historical norm in terms of share of global GDP



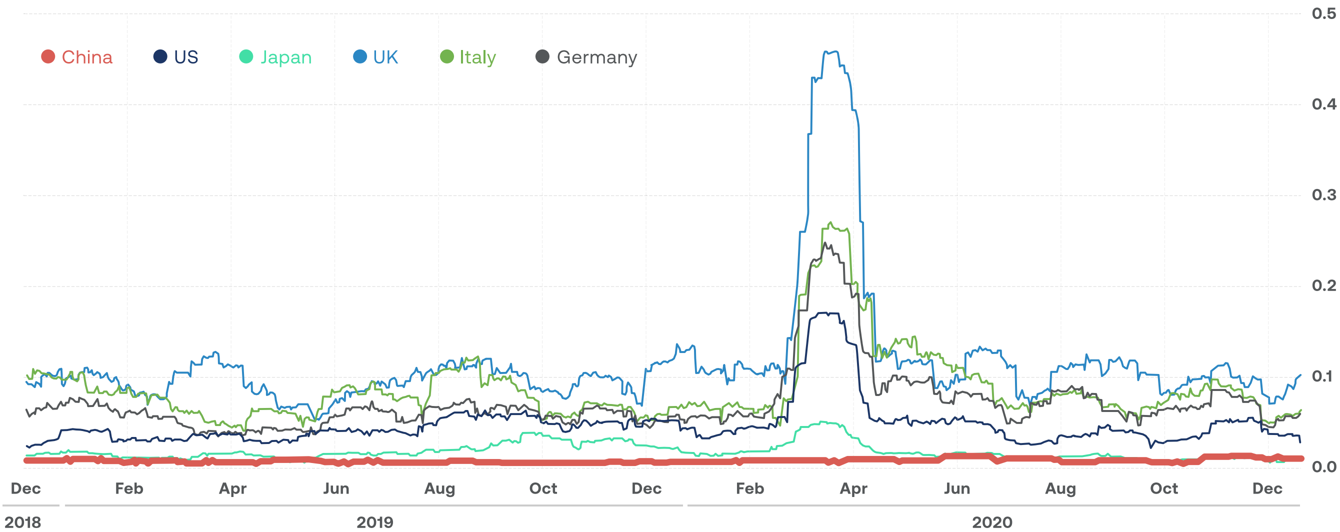
Source: "Statistics on World Population, GDP, and Per Capita GDP, 1-2008". Angus Maddison | IMF

The other component to this relative slide has been China's rising economic heft. For most of its history, the Mainland's share of global GDP has hovered between 30% and 35%. **In other words, China's rise is merely a return to its normal, baseline level of economic clout. The previous century was the anomaly. China's rise should and will continue**.

— "China's rise is merely a return to its normal. The previous century was the anomaly. China's rise should and will continue."

Observation: China proved to be a low-volatility alternative during pandemic

Source: Bloomberg | Aberdeen Standard Investments



This chart captures a very curious development: In the throes of possibly the most malign global crisis since World War II, when the world typically seeks the safety and certainty of the US and other western sovereign bonds, Chinese government bonds were less volatile than American Treasuries, Japanese JGBs, UK Gilts, and German Bunds.

At Insigneo, we started doing our own research on this issue. We wanted to know if Chinese sovereign bonds were truly acting as risk-off assets by studying their price movements and correlation to key indices like Treasuries, the S&P 500, and the MSCI All Country World index. The initial results showed that, indeed, they were exhibiting safe-haven characteristics especially after the pandemic while being lowly correlated to global equity risk and US Treasuries. During the pandemic-induced volatility, the correlation with US Treasuries considerably increased and the equity correlation remained stable. In other words, **they are starting to look more like Treasuries and less like risky emerging market assets**.

— "The initial results showed that, indeed, they were exhibiting safe-haven characteristics especially after the pandemic while being lowly correlated to global equity risk and US Treasuries."

There are two additional reasons that Chinese sovereign bonds are attractive. First, though China accounts for 18 to 20% of global GDP, central banks around the world only hold roughly 2% of their reserves in Renminbi. Of course, there are structural reasons for that. The Renminbi is not a freely traded currency. China's Capital Account is closed, and the People's Bank of China tightly manages the Renminbi within a trading band. But we except that gap to close, especially as China tries to purposely create a payments and trading system in Asia centered around the Renminbi, instead of the US Dollar, and using Chinese bonds as the risk-free rate instead of Treasury Bills. That means that the path for the currency is likely up even if the pace will be managed and purposely weighed down by the PBOC.

Finally, Chinese government bonds, because they are structurally under-owned by investors around the world have a very attractive carry *vis-à-vis* other developed market sovereigns. As of June 30th, for example, the 10-year Chinese bond yielded 3.18% vs. 1.47% for its American equivalent.

So, because of all these considerations, we have decided to make an investment in the Chinese sovereign, quasi-sovereign, and corporate market by reducing our exposure to High Grade corporate credit in our model portfolios, the I-maps. A unipolar world where the global hegemon, the US, had unmatched global capacity and influence is morphing into a balanced, multipolar world where various countries have an ever-increasing impact on global decision-making and action. We want to get ahead of that trend by making this investment.

> — "A unipolar world where the global hegemon had unmatched global capacity and influence is morphing into a balanced world where various countries have an ever-increasing impact on global decision-making and action."

And with that, I complete my prepared remarks for today. It is now my pleasure to introduce to you our new Investment Strategist, **Melissa Ochoa Cárdenas**, who will be giving you our latest views on the macroeconomic and political landscape in Latin America for the second half of the year.

Melissa Ochoa Cárdenas
Investment Strategist
Insigneo Financial Group

EM & LatAM Notes

After setting the baseline for our main assumptions around the world, it is now time to open the floor for our views on emerging markets, our expectations, and what we consider are the main risks.

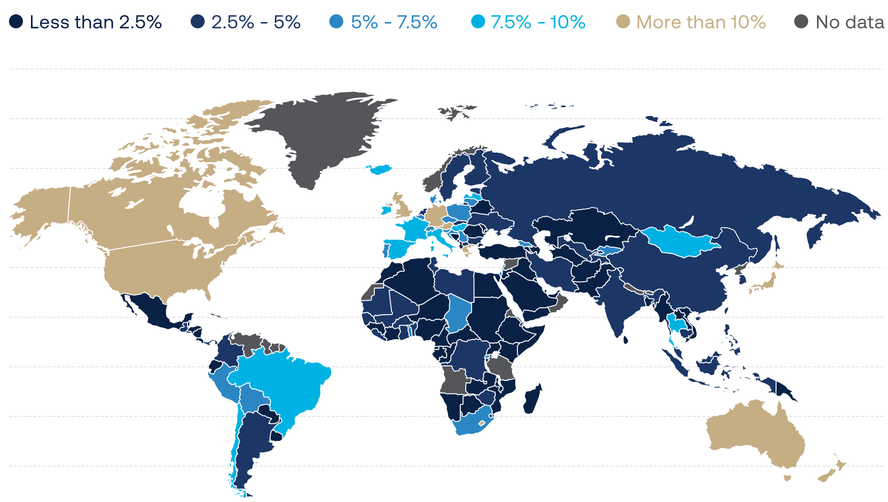
Just like we observed in the developed world, emerging markets are set for a brighter outlook in the second half of 2021 due to an ebbing of the COVID-19 pandemic effects. Nevertheless, we are still observing some setbacks in several economies mainly caused by supply chain bottlenecks that, together with a renewed COVID wave, have made reopening and revival of the economy a challenging task. This situation makes us consider that, for 2021, developed markets are going to outperform emerging markets in both absolute and relative terms.

Our motives for believing so circle back to the pandemic, considering the appearance of new variants of the virus, such as the Delta variant that, together with a slower vaccination rate observed across emerging markets, as well as a limited access to vaccines, could slow progress even further.

Meanwhile, we have witnessed monetary and fiscal stimulus across most economies of the globe during the first half of the year. As per this map from the IMF's April fiscal monitor, it is relevant to highlight the efforts made specifically by the US, Europe, and Australia in the developed world. Meanwhile, even if its appearance has been uneven across emerging

— "We have witnessed monetary and fiscal stimulus across most economies of the globe during the first half of the year."

Global growth will continue to pick up in a post-COVID world, propelled by robust fiscal stimulus



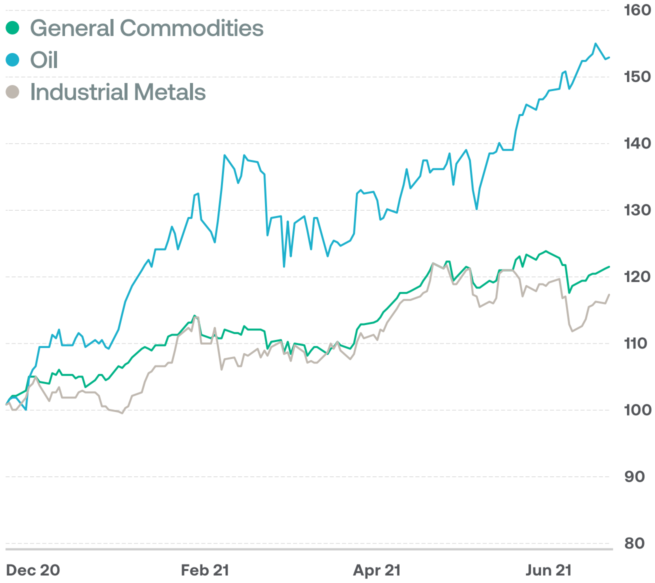
Source: IMF - Fiscal Monitor Report, April 2021

markets, a trend we identified is that most economies have leaned towards fiscal stimulus provided by the government, especially in Latin America. This has caused risk premia to be low, and in case of a removal of those stimuli, an eventual rate increase in the US, which is not our base-case, would pose a challenging environment for fixed income investments.

Another factor that we need to consider for our analysis is our bullish view on commodities, which will be sustained by a revival in aggregated demand both in developed and emerging markets. Considering the oil shortages that we are already witnessing, together with the tensions observed inside OPEC+ to control oil prices, this is a scenario that bodes well for oil to continue overperforming the other commodity types, as seen on this graph. Moreover, it is relevant to keep in mind that, for all economic cycles, they all tend to reflate at the beginning, but as the cycle matures returns start to differentiate amongst themselves. As mentioned before, we expect oil to strengthen further, with most of the gains in price coming during the Summer. Against this backdrop, it is worth keeping in mind that China is still one of the main drivers of commodity growth; therefore, if China happens to slow down its commodity consumption – considering that the current environment is favorable for China to try and de-lever into global strength, this could eventually imply a stagger growth. However, that risk is mitigated by the fact that we expect aggregate demand for commodities to remain robust in both the US and Europe, so China's relative importance is lower in this cycle than it has been before.

In 2021, the commodity cycle has been propelled by an overperformance of oil

Source: Bloomberg | Data rebased with December 29, 2020 = 100



Our bullish view on commodities is also supported by the recovery we have witnessed on both consumption and aggregated demand; however, this renewed activity might bring inflationary pressures with itself, just like the ones we have already seen in the developed world and that even have triggered changes in the monetary policy communications of some central banks – such as the Bank of Canada, the Fed, among others. Emerging markets have been no strangers to inflationary pressures that have come mostly due to transitory factors – such as food, energy, and transportation – together with a base effect from the low prints observed in 2020 that distort the current readings. Therefore, and even if the current pressures seem inevitable, we believe they will also be transitory across emerging markets. Nevertheless, some central banks inside Latin America have taken some monetary policy measures to control the increase in inflation by hiking their monetary policy rates, thus beginning a tightening cycle that most market participants penciled in to start later down the line.

This situation is the perfect segway for us to now focus on Latin America, and what our expectations for the region are. **We acknowledge that Latin America, just like the rest of the world, is faced with a brighter outlook in terms of growth for 2021**, as economies slowly find their way back to reopen and demand is stimulated with consumers willing to spend. This has been visible in the first quarter GDP readings that surprised the market to the upside and, in some cases, set the stage for upward forecast revisions. This, as mentioned before, comes hand in hand with a positive commodities cycle, that also bodes well for Latin American economies that are commodity exporters, such as Mexico, Colombia, Peru, Chile, Argentina, and Brazil.

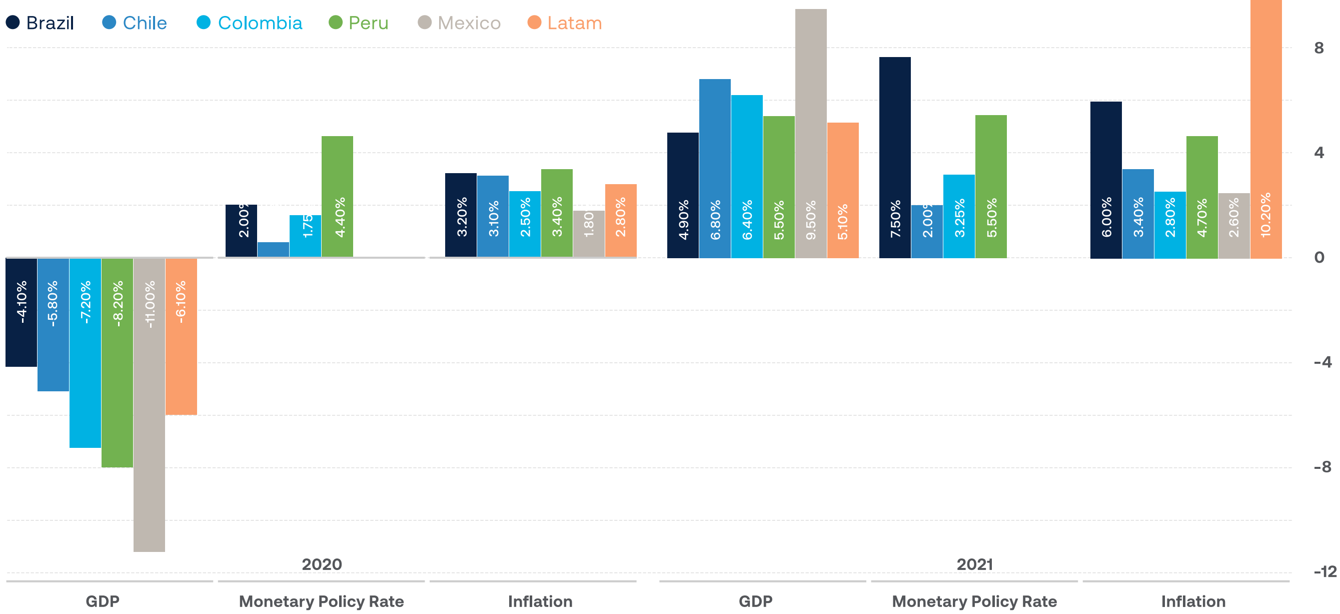
Despite the favorable external macroeconomic landscape, there are two challenges that cloud the outlook for country-specific assets. First, the tapering of Fed asset purchases. As we alluded to earlier, we expect an announcement towards the end of the Summer, and for the program to start between December and March. This risk urges caution in the near-term but has few – if any – long term consequences. Meanwhile, the other considerations are all political: here, the risks could potentially manifest themselves not only in the short term; rather, their implications could have medium- and long-term lasting effects.

> — "Despite the favorable external macroeconomic landscape, there are still some challenges for Latam."

The better growth perspectives, aside from the possible challenge that they face from the political front that we will address later, will also be combined with inflationary pressures that, as previously mentioned, have already triggered some tightening cycles across the region.

With the COVID-19 pandemic receding, an economic recovery seems plausible across the region

Source: Bloomberg | Data as of June 28 | *Inflation as measured by CPI YoY

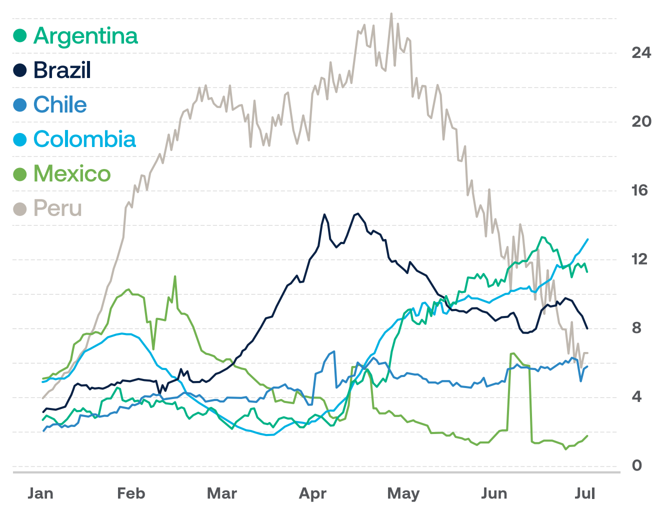


Market consensus currently prices several rate hikes across the region, with Peru being the sole exception. The countries with the most aggressive hikes priced in are also the ones experiencing the highest inflationary pressures and are also the ones that have already acted – namely Brazil and Mexico. Moreover, it is relevant to remember that monetary policy in Latin America is not as autonomous as in the US, considering that the region would be heavily affected once the Fed starts removing the accommodative monetary policy that has accompanied the US as a response to the COVID-19 pandemic. Once this stance starts to change and it is assimilated by investors, their response could be one of flight to quality, thus hurting international inflows into Latam. It is key here to keep our eye on the United States dollar. Our expectation is that it will resume weakening once this bout of temporary strength is past. If we are wrong, however, and the dollar's strength is a more permanent feature of the post-pandemic landscape, then emerging market assets will experience renewed downward price pressures.

Another factor that needs to be considered when analyzing Latin America is how the region has handled the COVID-19 pandemic, as portrayed by the following graph.

New Deaths Smoothed Per Millions

Source: Our world in data



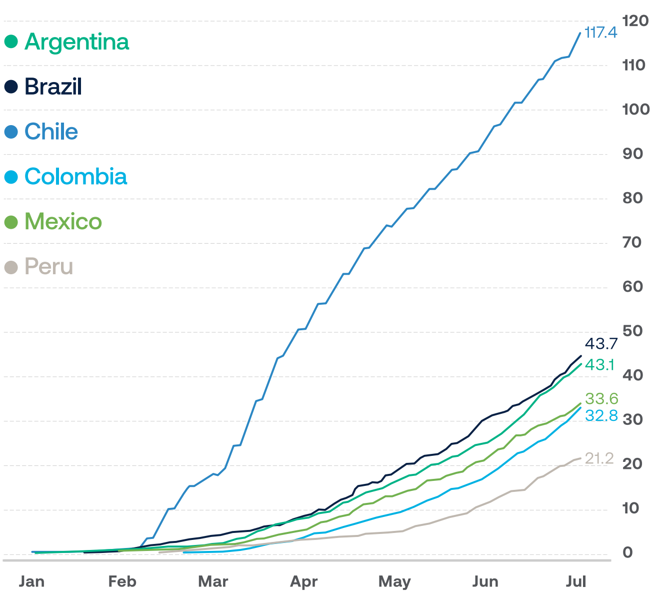
Even if new confirmed cases across the region are now adopting a downward trend, countries like Argentina and Colombia are still registering over 400 cases per million people daily. This situation, coupled with depressed vaccination rates, have presented a relevant challenge for the economic recovery, with countries like Chile and Colombia experiencing lockdowns during the first half of 2021. Nevertheless, it is worth highlighting that, because of initiatives like the G7 vaccine donation or individual efforts done by the United States, the tables may turn in Latin America.

Recently, we found a report where they highlighted the change in trend in vaccination across the region, and we also believe that an acceleration in vaccination programs should and would propel a more sustainable economic recovery.

Meanwhile, it is also worth highlighting that, counterintuitively, Mexico has not seen a meaningful spike in COVID cases as its economy reopens, in contrast to what was observed in Colombia, where vaccination remains lagged and the country seems to be entering its worst wave of the pandemic. Another surprising finding from the pandemic is that the Chilean economy remains with several mobility and travel restrictions, despite having the highest vaccination rate per hundred inhabitants. Even if it hasn't had the same effects as the ones implemented last year, these restrictions could still dent in future consumption figures, which in turn could slow the monetary policy normalization.

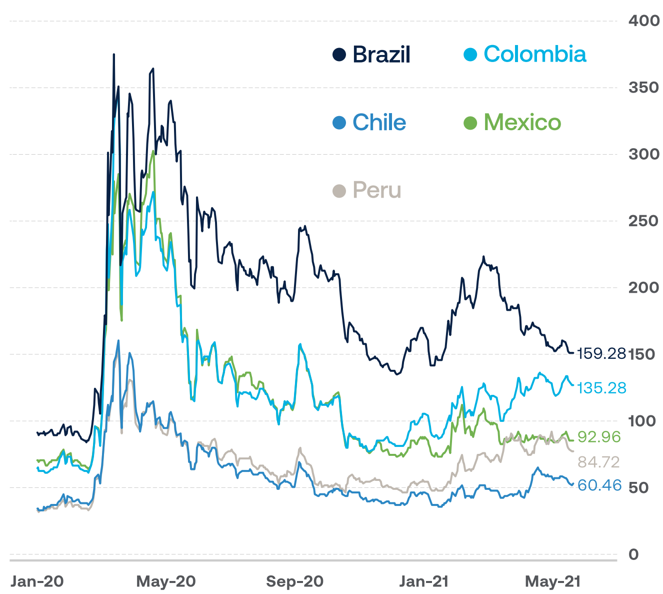
Total Vaccination Per Hundred

Source: Our world in data



Risk perception across Latam has ebbed in 2021 when measured through the 5-year CDS

Source: Bloomberg (as of June 28)



— "Nevertheless, it is worth highlighting that, because of initiatives like the G7 vaccine donation or individual efforts done by the United States, the tables may turn in Latin America."

When looking at the risk perception across the region, it is worth highlighting that, when measured through the 5-year CDS as seen in this graph, the countries comprising the region are perceived as less risky than at the beginning of the pandemic, with this situation boding well for international investment flows coming into the region. Nevertheless, our main concern stems out of the political uncertainty that is faced across Latam, and its yet-to-be determined consequences on the economic development of the different countries.

program, which could in turn lead to additional currency depreciation and capital outflows. The challenges on growth that the economy is facing, together with a lagged recovery within Latin America, could keep the central bank from hiking its monetary policy rate in 2021: analysts are not considering this possibility; however, what is being considered is that the central bank will continue to intervene the FX market, as a consequence of the expected capital outflows.

Political risks are increasing in the region

COUNTRY	CREDIT RATING (MOODY'S / STANDARD & POOR'S/FITCH)	TYPE OF ELECTION	DATE OF ELECTIONS
Peru	A3/BBB+/BBB+	Presidential elections	June 6, 2021
Mexico	Baa1/BBB/BBB-	Legislative elections	June 6, 2021
Argentina	Ca/CCC+/CCC	Primary elections Midterm elections	September 12, 2021 November 14, 2021
Chile	A1/A/A-	General elections Presidential runoff	November 21, 2021 December 19, 2021
Colombia	Baa2/BB+/BB+	Parliamentary elections Presidential elections	March 13, 2022 May 29, 2022
Brasil	Ba2/BB-/BB-	General elections	October 2, 2022

Source: Insigneo

For Peru, the question revolves around how the political environment will unwind, given that we have yet to get a full perception of what the new administration of Pedro Castillo is going to do. Will he walk down the path of AMLO or Lula, or will his choice be even more radical and tilted towards Hugo Chavez? President Castillo will be sworn in on July 28, and until then uncertainty will most probably dominate.

Against this murky backdrop, the Peruvian economy surprised with a first quarter growth that was above forecasts; however, a slow rollout of the vaccine program could jeopardize the economic recovery that we have witnessed until now. This challenging environment could prove worse if business confidence deteriorates because of Castillo's governing

This political instability, together with a possible deterioration of macroeconomic fundamentals, could lead rating agencies to consider lowering Peru's sovereign rating, just like they did with Colombia: both Moody's and Fitch already have a negative outlook on the country, with the former having changed that outlook in May.

When looking at Mexico, the country has been able to catch up in terms of reopenings and economic recovery, given that the COVID cases have not spiked in recent days. This situation has been beneficial for domestic demand, which also means that the recovery will be more balanced, while the cyclical momentum currently observed remains strong. Even if the country has also experienced inflationary pressures, those seem to be likely past. Analysts expect inflation to drop because of strong base effects; however, considering a possible increase in services inflation due to reopenings could also mean sustained pressures for price dynamics. Overall, inflation is expected to close 2021 above Banxico's target of 3%, and this scenario could imply a more hawkish rhetoric from the monetary policy committee – at least before the scheduled board change takes place. For now, expectations are that Banxico will be forced to change its monetary policy stance sooner rather than later, given that the higher-than-expected growth and higher inflation scene don't bode well for lower rates.

Meanwhile, **the political situation in Mexico seems to be more controlled than in the rest of the region**, when considering the outcome of the elections held in June of this year, that accounted for a more balanced power in the Lower House that also implies an improvement in sector confidence, as well as an increase in private investment.

deceleration of the inflation during the first part of the year, a positive commodity-exporting environment, and the government imposing currency controls and price freezes. The latter have accounted for a temporary lid on inflation; however, current expectations for future prints are at a record high, displaying distortions in relative prices and repressed inflation in the system. The rising inflation that was observed in the past months is also accounting for both an erosion of real incomes, as well as for an appreciation of the exchange rate.

According to private estimations from the IMF, a deal that would allow Argentina to reschedule payments on the 45 billion owed to the lender will be pushed into 2022, given that negotiations entailing fiscal austerity are not expected to make much progress before Argentina's mid-term elections in November. **These primary and midterm elections, to be held in September and November of this year, portray a challenging environment for the current government**, with its confidence close to the lowest levels since

— "The political situation in Mexico seems to be more controlled than in the rest of the region, when considering the outcome of the elections held in June of this year."

Regarding Argentina, it is worth noting that the country's main concern revolves around its capability to reach an agreement with both the IMF and the Paris Club in the following months, with negotiations being held with both parties, and the government trying to stick to a muddle through strategy, at least until elections are held. Concerns about the outcome of these deals have risen against a backdrop of some restrictions to mobility because of worsening pandemic dynamics. This situation developed amid a

Fernandez took office, while the opposition leaders are strengthening their position. Nevertheless, the picture could change a lot before elections, when considering the government's current plans to push for higher wage agreements, together with a projected increase in social spending. **This, in tandem with an acceleration in the vaccination program and a possible easing in mobility restrictions could shift the political picture, adding uncertainty to it.**

For Chile, the observed growth has been propelled by an important fiscal stimulus coming from the government. These programs have allowed people to access their pensions savings ahead of time, all aiming to impel consumption, thus reaching an economic recovery. However, there is uncertainty as of what the impact on consumption from the fiscal measures may be since an important portion of the money transfers could be saved. This savings pattern could enact a reduction in the observed inflationary pressures. On another note, if the consumption rhythm remains relatively subdued to pre-pandemic times, the central bank would be faced with an additional challenge when wanting to normalize its monetary policy; however, in its latest meeting the Banco de Chile displayed a more hawkish tone, together with a recalibration of monetary policy. This, after having an upward revision of its growth forecast, and with several analysts already starting to consider that an initial move towards monetary policy normalization could happen as soon as July.

Meanwhile, **some of the biggest risks in Chile are portrayed by the upcoming elections at the end of this year: the Constitutional Assembly**, which was elected in May amidst an electoral surprise, is currently displaying no clear majority, which makes it challenging to establish how its votes will interact with the existing political coalitions. On the other hand, the presidential race, with elections being held in November, will have its first challenge with the primary elections being held in July. This, considering that the communist candidate Daniel Jadue has seen his support increase since end of April. This heightened incertitude, together with a possible deterioration of public finances, could set the stage for Chile's sovereign rating possibly being revised lower.

For Colombia, the positive macroeconomic outlook was overshadowed with social unrest, and a governmental attempt to pass a tax reform that was removed afterwards. The government held consensus dialogues with different stakeholders from all sectors, aiming to pass a new version of the tax reform that will allow the government to redirect Colombia's public finance figures towards a narrowing of the fiscal deficit, as well as reducing public debt readings both observed and expected for future years. The publishing of the Medium-Term Fiscal Framework gave investors and the market some peace of mind when considering that the government remains committed to improve the country's public health, even if some of the baseline assumptions for that recovery are dependent on external factors. Furthermore, the publication of this document was key for Moody's to hold Colombia's rating unchanged, as they stated that they will wait until the new tax reform is presented before making any considerations to Colombia's rating. However, Fitch Ratings downgraded Colombia's ratings, on the back of deteriorating public finances and a reduced capacity of the government to gradually bring it to a downward path in the coming years.

In terms of monetary policy, after its last meeting BanRep remained relatively dovish by keeping its rates unchanged, even if the monetary policy committee recognized that some of the inflationary pressures currently present were persistent. This backdrop does not bode well for the anchoring of inflation expectations, which have been crucial for BanRep to remain on hold as much as it has. Even if there were no hints from the Committee in terms of normalization moves, the market is already pricing a rate increase as soon as December of this year.

Moreover, and even if considering the previous backdrop is already a challenging one, we need to keep into consideration that Colombia will have Congressional and Presidential elections next year, and with the country being as polarized as it is right now, the probability of a leftist candidate coming to power should not be underestimated.

When looking at Brazil, the fiscal instability that the country is facing – even if the scenario has improved in the short term – opens the door for necessary reforms to be approved and implemented in 2022, if the country is aiming to reduce its debt/GDP ratio, together with a decrease in its public debt figures. Moreover, as was noted by the COPOM in their last meeting, "further extensions of fiscal policy responses to the pandemic that increase aggregate demand and deteriorate the fiscal path may pressure the country's risk premium." These fiscal risks could tilt the balance to the upside, which would translate into a higher-than-expected path for inflation. This increase in variable, which was also highlighted by the Central Bank, is one of the main explanations for the aggressive rate hikes that we have seen in the country. It has even come together with a de-anchoring of the inflation expectations, which on itself could cause either a more hawkish central bank, or a loss of currency stability against a backdrop of accelerating inflation. Even if it comes further down the line, it is worth bearing in mind that Brazil will hold general elections in October of next year, and with Lula having the possibility to run again for political office, it opens the door for a return to a left-leaning government.

Therefore, **our main conclusions for the region are as follows**:

Mexico is, within Latin America, our safest bet. If Colombia manages to pass a tax reform that secures governmental revenue for years to come, it should remain as an attractive alternative for investors looking for yield.

Peru's political instability makes it challenging to consider an investment strategy, at least until we have more clarity on Castillo's governing program, and any political turmoil seems to be out of the picture.

Even if Chile's fundamentals seem solid from a macroeconomic point of view, the decisions made by the Constitutional Assembly, together with a yet-to-be decided presidential race, are set to become the main drivers to either direct or re-allocate flows to Chile.

Brazil's short-term success in reassessing its fiscal policy may be overshadowed by challenges still arising from the government directly, such as the delayed approval of 2021's budget, or the need for it to approve measures that account for the reduction of mandatory expenditure. Those challenges, while entering an electoral period, don't seem favorable for a structural investment in the country.

[End of Conference]

House Views Matrix

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