



Quarterly Call
October 2021

English Version

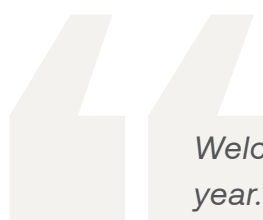
Quarterly Call Q4 | 2021

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

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Transcribed from comments made during our Quarterly Call Q4 | 2021

October 7th, 2021.



Welcome everyone to our final quarterly call of the calendar year. In many ways, it has been a more difficult one to invest in than last year, especially after the initial pandemic lockdowns. Essentially, almost anything you purchased after April of 2020, most likely went up as the reflationary trade spread throughout the world on the heels of massive monetary stimulus and historically high fiscal support. So far this year, and likely for the foreseeable future, a more tactical approach is warranted. This is one that considers valuations, the cost of money, and geopolitical and social considerations that were heretofore forgotten. Public policy will be addressed later as looming political shifts in the US will have real world market implications. This will be the subject of our Big Theme today: the coming regulatory onslaught on US Megacap companies. But first, let us begin as we usually do with the near-term global macroeconomic landscape and our tactical asset allocation shifts for Q4.



Ahmed Riesgo
 Chief Investment Officer
 Insigneo Financial Group

General Market Commentary & Expectations

As you know, the first question we always ask ourselves is **“where are we in the economic cycle?”** The answer to this question is important because the business cycle drives the equity market over an annual horizon.

Well, as this first graphic shows, our proprietary Insigneo-Forefront Recessionary Indicator, which predicts the probability of a contraction in US economic activity over the next 2 quarters is practically zero. In other words, there is almost no chance of a US recession in the next 6 months.

Insigneo/Forefront US Recessionary Model

Probability of recession within the next two quarters

0.0%	Overall Macro Indicators
39.00%	3-month % Change of Manufacturer’s New Orders, Consumer Goods And Mat.
20.08%	3-month % Change of ISM New Order Index
12.21%	OECD Composite Leading Indicator
27.28%	3-month % Change of Buildings Permits, New Private Housing Units

Source: Insigneo & Forefront Analytics

While some subcomponents of the Indicator, like the change in ISM new orders, consumer confidence, and building permits, are signaling higher risk, none of them have broken the 40% threshold required to signal heightened risk individually. Collectively, the message is even stronger: 2-quarter forward period recession probabilities stand at 0%. Certainly, US

growth passed its peak back in Q2, but real GDP growth will likely end the year at 6% to 6.5%, about 3 times the trend rate of growth despite the Delta wave-induced slowdown.

But what about the picture outside the US? Here the numbers tell basically the same narrative: slowing from elevated levels but remaining well above trend growth rates. Our global real GDP estimates currently stand at 5% to 5.5%, again well above trend. In fact, the only major economic block that will be a disappointment from a growth perspective will be China which has been hampered by a plethora of macro headwinds, most of them self-induced as the country pushes forward with its deleveraging and now “common prosperity” campaign. As you will probably recall from last quarter’s call, China was the only region in the world where we were expecting growth to come in below market expectations. It was one of the reasons why we cut our emerging market equity exposure then. At this point, however, we think that growth projections in China have gone too far in the opposite direction, and you will soon see how we plan to take advantage of that tactically. For us, Chinese real GDP growth should be within the range of 7.5 to 8.0%, roughly 50 bps lower than our previous estimates due to self-inflicted wounds.

Overall, though, we remain sanguine on global growth, and continue to argue that we are likely in the middle to late stages of a business cycle expansion begun in 2009 after the Global Financial Crisis that was momentarily interrupted by the global pandemic last year. Despite the Delta variant hiccup this summer, still-easy monetary policy, pent-up excess savings, and strong revenue growth should continue to prop up economic activity and financial markets even if some are showing signs of froth from heightened expectations. However, fiscal policy will turn from a tailwind in 2021 into a headwind throughout 2022, if no new fiscal initiatives are passed in the US or Europe (which is not our base

case, but a risk we are monitoring). Right now, we are penciling in about a -0.50% fiscal drag globally.

The downside risks to our view are as follows:

- | Potentially hawkish central banks tightening policy too far and/or too quickly,
- | A Chinese policy mistake during the Evergrande restructuring like failing to support the economy enough during this important phase,
- | The US debt ceiling debate becoming politically weaponized as in 2011,
- | Retail investors stepping away from the market, and
- | Autumnal Delta waves leading to further weakness in growth.

For rates, remember that the pace is often more important than the direction. This is what occurred back in March, and we saw a glimmer of this again last week.

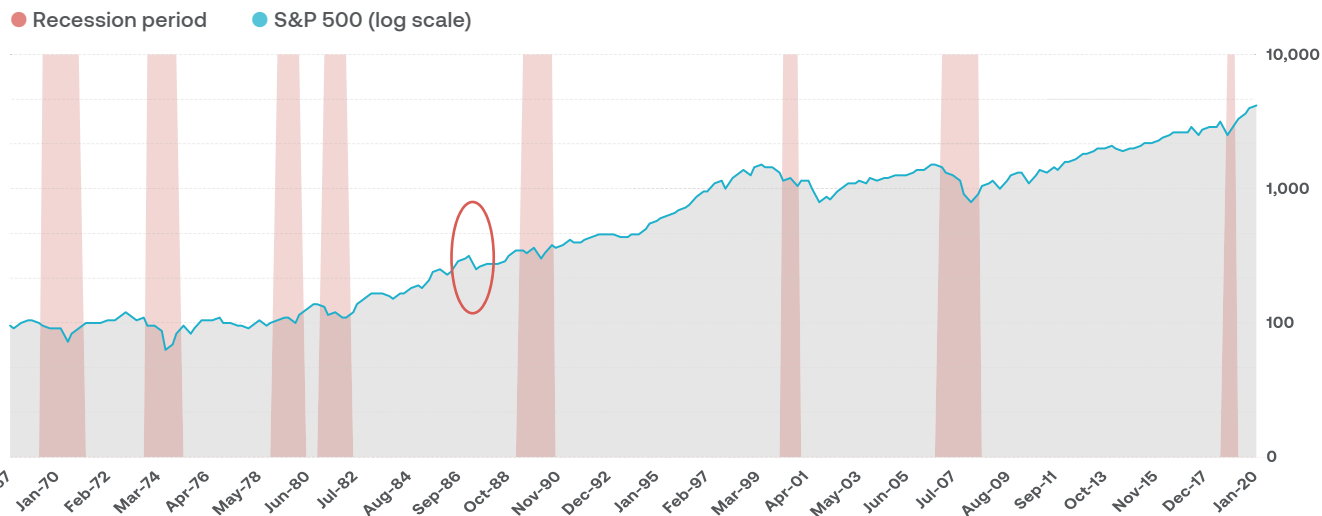
We are already seeing signs that inflation pressures are abating, but they may be staying more elevated due to rising expectations, higher energy costs, persistent supply disruptions, and shifting power

dynamics for labor vs. capital as worker demand has never been higher. If the full USD 3.5 trillion fiscal bill makes it into law, which is not what we expect, then we will get more worried. Chairman Powell has clearly stated that tapering is separate from a hiking cycle, and we do not see the Fed increasing rates until late 2022 at the earliest.

This next chart is one of my favorites. It succinctly explains why we remain bullish and continue to favor equities and other risk-on assets over sovereign bonds and other risk-off assets over the coming year. Bear markets and recessions tend to overlap. Over the last half-century, there has only been one instances of a bear market, a 20% or more contraction in asset prices, outside of a recession: the 1987 stock market crash.

And if you follow my logic that the Covid pandemic was not a technical recession (which it was not if you use the NBER definition of a 2-quarter contraction), then there really have only been two instances: 1987 and 2020. In both cases, however, you would have been better off if you did nothing to change the overall risk balance of your portfolios once the drawdown occurred as it was so short-lived.

Birds of a Feather: Recessions & Bear Markets | Source: Bloomberg, Insigneo (as of September 27, 2021)

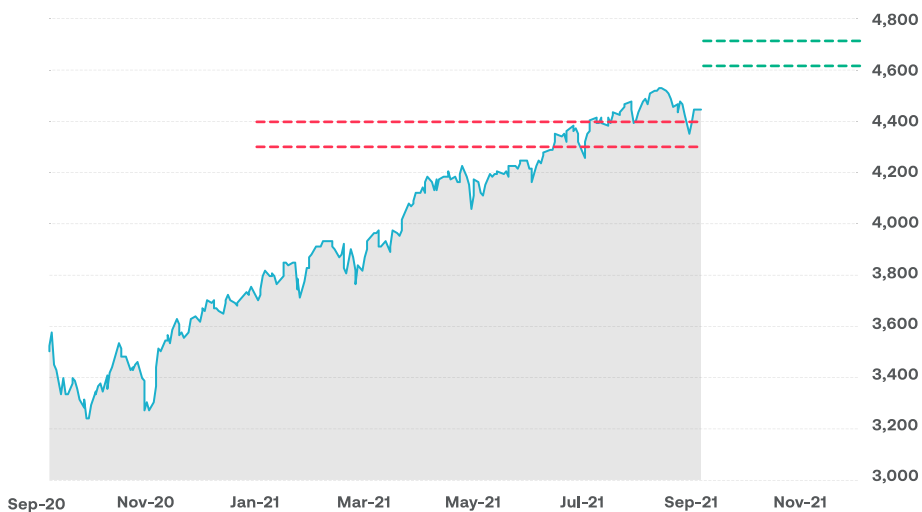


Because of this, we adhere to the foundational principle that, unless a recession is imminent, meaning 6 months away according to our Indicator, then our overall allocation should be bullish, or at least neutral. A corollary to this, of course, is that in the lead up to a recession and during one, our asset allocation should be bearish, or at most neutral. Notwithstanding the above, it is likely that **the best gains of the year are past us, and that investors should expect single digit returns on developed market equity courses** for the remainder of the year.

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Projected Path for the S&P 500

- S&P 500
- Previous Target
- Next Target



Source: Bloomberg, Insigneo (as of September 27, 2021)

Last quarter, I decided not to adjust my year-end price target on the S&P 500 of 4300 to 4400 until we had further clarity on the US fiscal picture with major legislation pending in Congress. Instead, we urged investors to surface and assess the mid-year landscape. Well, as you can see in this chart, the pause was warranted, and we are basically right where we began. Today, although the clarity on US fiscal policy is no clearer, I do have more visibility on earnings growth and the path of rates. Because of this, I would target a year-end level between 4600 and 4700 on the S&P 500.

On the US 10-year bond, we have reduced our year-end target range of 1.90% to 2.0% down to a range of 1.7% to 1.8%. But beneath the surface, we are making some tactical shifts to the portfolio.

Our global asset allocation views can be summarized as follows:

- Recommend maintaining an overweight exposure to risk assets, while moderately dialing back US equity exposure by positioning more defensively.
- Our relatively balanced, barbell-style approach is

evenly divided between Value and Growth. We want to have exposure in sectors that benefit from higher rates as bond yields likely bottomed last month (Value) as well as those that outperform amid an endemic Covid environment (Growth but ex-Mega-cap US tech stocks).

Maintain above average exposure to developed markets outside of the US, such as Japan and Europe due to their structural tilts to Cyclical and Value.

Increase exposure to emerging market equities given their recent underperformance and anticipated fiscal boost from Japan and policy easing in China.

Adjust for the “common prosperity” regulatory shift in China by favoring A-shares, smaller companies, and avoiding to the extent possible Big Tech and “common prosperity” targets like education, consumer internet, and housing.

Slightly increase exposure to Chinese sovereign and high-grade corporate credit as this space has performed as we posited as an effective risk-off

are a more defensive positioning in US equities, moving further up in the capital structure in China, and increasing our overall emerging market equity exposure. Let us address these in turn.

First, the increased defensive positioning of our US equity sleeves makes sense when we are so close to our year-end target on the S&P 500, earnings growth estimates are elevated, and US bourses have not seen a significant equity correction since the new bull market began in April of last year. This could be done through various strategies that lower the beta versus the broader market, such as covered calls. In our I-maps, for example, we decided to take part of our broad S&P 500 index allocation and rebalance it into a Shiller CAPE strategy. We did not become more defensive because investor sentiment has already turned quite bearish. As of September 15th, the American Association of Individual Investors’ latest sentiment survey revealed that

— “There are only 3 important differences from last quarter’s asset allocation. These are a more defensive positioning in US equities, moving further up in the capital structure in China, and increasing our overall emerging market equity exposure.”

asset class after our Q3 entry into the space; these also would benefit from further policy easing from the Mainland.

Global yields should continue to drift higher, and a retest of the March US Treasury highs is likely as massive Treasury issuance commences just as Fed tapering begins.

Maintain our preferred inflation hedge through commodities, favoring energy and the base metals.

As you can see, **there are only 3 important differences from last quarter’s asset allocation**. These

bullish sentiment collapsed as bears exceeded bulls by almost 17 points, one of the largest historical margins ever recorded. Therefore, our contrarian sensibilities inform us that any drawdown in US equities would likely prove quite fleeting, will be quickly reversed, or might not even occur given stretched negative sentiment.

Second, we purchased more Chinese sovereign and high-grade corporate credit. After initiating this position in Q3, the position has performed as expected – it is a diversified, carry-rich, uncorrelated

safe-haven asset. Since July 1st, our Chinese bond holdings have outperformed both our Treasury holdings and our Investment Grade corporate bonds. As of September 27th, this sleeve returned 1.3% versus 1% for investment grade corporate bonds and no change for Treasuries. And the Renminbi has strengthened during the crisis. This outperformance is remarkable given that global markets have been roiled by various risk sell-off episodes emanating out of China. These included draconian lockdowns, an economic slow-down, punitive regulatory and industry-killing reforms, and the default of the world’s most heavily indebted property developer, Evergrande. If these assets acted as a safe-haven during this period, then it is fair to say that they are a safe-haven asset.

This next chart shows the behavior of Chinese investment grade credit spreads versus their high yield counterparts. It shows that during the Evergrande default, when high yield spreads materially widened, Investment Grade spreads instead narrowed as investors sought refuge. As we have stated previously, a rational investor may correctly surmise that the only way to play the China growth story is through invest-

ments higher up in the capital structure where the regulatory sickle is unlikely to reap.

Finally, and perhaps most controversially, **we marginally increased our emerging market equity allocation as a tactical trade for the final quarter of the year.** If you recall, we reduced our emerging market equity exposure for Q3 in anticipation of Fed tapering policy signaling, the declining Chinese credit impulse, increasing regulatory uncertainty, and lower vaccination rates vis-à-vis the developed world. That trade worked in our favor, but now it is time to reverse course for at least a quarter.

There are several pillars underpinning this investment thesis. For one, emerging market equities have underperformed developed market ones by a wide margin

— “During the Evergrande default, when high yield spreads materially widened, investment grade spreads instead narrowed as investors sought refuge.”

Chinese IG Spreads Decouple from HY | Source: Bloomberg, Insigneo (as of September 27, 2021)



and there is some scope for mean reversion. The last two instances where emerging equities have underperformed developed markets by 20% (in the second half of 2015 and in the middle of 2018) were followed by a period where emerging markets subsequently outperformed by 10% to 15%.

Next, we anticipate that the inoculation rate in the emerging markets will ramp up considerably in the near-term. Over the last 3 months, **the vaccination rate in Asia, for example, has jumped from 21% to 63% of the adult population. At this pace, an overwhelming majority of APAC nations will have more than 80% of their adult population vaccinated by the end of the year.**

This will remove a major growth drag on these economies. Growth momentum in Asia slowed in the last two quarters due to continued stringent measures to contain Covid outbreaks in several large economies, a “zero tolerance” Covid policy. China, for example, imposed a lockdown in a city after only one confirmed case. They did this because so few people were vaccinated.

APAC consumption growth, specifically, is the only GDP component that remains below its pre-pandemic path. If our projections prove true, however, APAC should modify their Covid management strategies from “zero tolerance” to the Western-style acceptance of Covid as an endemic problem. If so, we would expect a robust recovery in consumption starting in Q1 2022, paralleling the recovery in the West earlier this year. An investor would want to position for that recovery in Q4 when it has yet to be priced in.

We are also seeing signs that inflationary pressures in the emerging world are starting to ease, especially in food prices which traditionally have been a strong driver of inflation in the region. There are also signs that the PBOC is embarking on a stimulative path: the reserve requirement ratio was cut in July, new bank

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loans have risen by 13% in August, fiscal spending is up with increased local government bond issuance, and an additional RMB 300 billion in credit support was provided to small and medium sized businesses in September. Lately, the central bank has provided the market liquidity injections for several consecutive days. The trend is clear.

Lastly, emerging market equity valuations are very cheap. They trade at a Shiller P/E ratio of only 14.7x, compared to 22.2x for Europe, 24.1x for Japan, and 36.8x for the US. We have not seen this discount since the late 1990s. If you think that they are cheaper because they have weaker earnings, then consider this – Since mid-2019, US earnings have outpaced emerging market earnings by only 6%, but emerging market equities have underperformed US equities by 29% during this same period.

The biggest risk to our view here is that Chinese policymakers make a mistake – either by not curtailing secondary and tertiary effects of the Evergrande default resulting in a broader slowdown, and/or that they do not stimulate the economy as much as we expect. The latter is more probable than the former as there was a previous bias to promulgate only “common prosperity” themes and deleverage the economy. Overall, though, we like the trade over a tactical horizon in Q4.

— “For Megacap Tech companies, names like **Amazon, Facebook, and Google**, the pandemic was manna from Heaven. Forced to remain inside their homes, consumers were forced online as real-world activity ground to a halt. This resulted in unprecedented revenue and, as rates moved to new lows, soaring P/E multiples for these Growth stocks.”

US Megacap Tech at Risk

Now, let us turn our attention to US Megacap names, those ubiquitously owned stocks, that we think have very poor long-term prospects. In the Biblical book of Exodus, God delivers “manna” to the Israelites during their 40-year journey from Egypt until they reach Canaan. It was the sustenance they needed for their arduous journey of purification before they could enter the Promised Land.

For Megacap Tech companies, names like **Amazon, Facebook, and Google**, the pandemic was manna from Heaven. Forced to remain inside their homes, consumers were forced online as real-world activity ground to a halt. Moreover, these people were flushed with cash thanks to historic fiscal stimulus. This resulted in unprecedented revenue and, as rates moved to new lows, soaring P/E multiples for these Growth stocks.

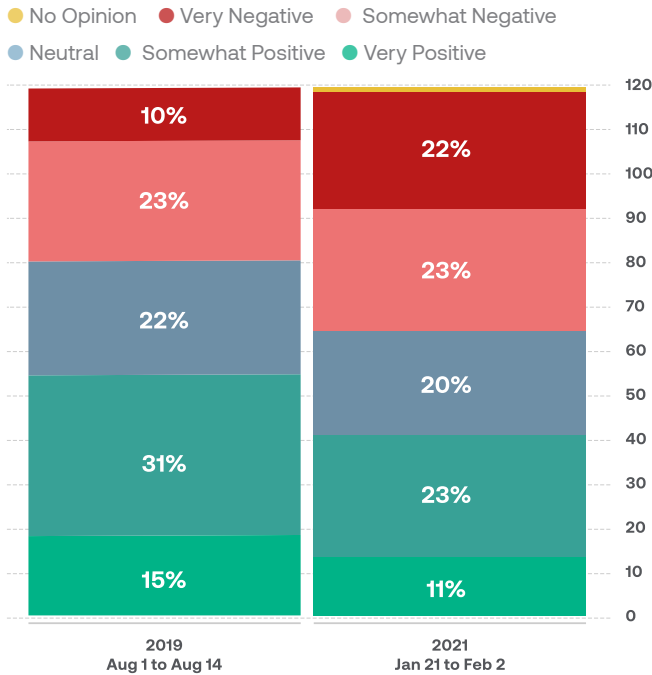
As we return to “normal”, all these tailwinds will turn to headwinds: consumers will spend less on goods and more on services, and higher rates will greatly impact their discounted future cash flows thus compressing multiples. Positioning is still very crowded (who does not own Amazon stock), so who is left to buy? Unwinding here could also be painful. But these are all relatively short to medium-term considerations.

The biggest worry, as always, should be the long-term trend. The most compelling argument for exiting these US Megacap names is that they will be subjected to an onerous regulatory onslaught over the next several years. What does this long-term risk look like?

First, they are likely to come under intense scrutiny for monopolistic corporate practices. So far, this has been hard to prove because these companies tend to drive prices down, rather than up. After all, they are not setting prices above marginal costs as monopolies usually do, and many give away their services for free. But regulators will not be focusing so much on pricing policies here. Instead, they will be more attuned to how they use data, especially user data in the case of Facebook and Google. Remember, data is the new currency of the realm, and no government – not the US, not China – will allow private companies to dominate this space.

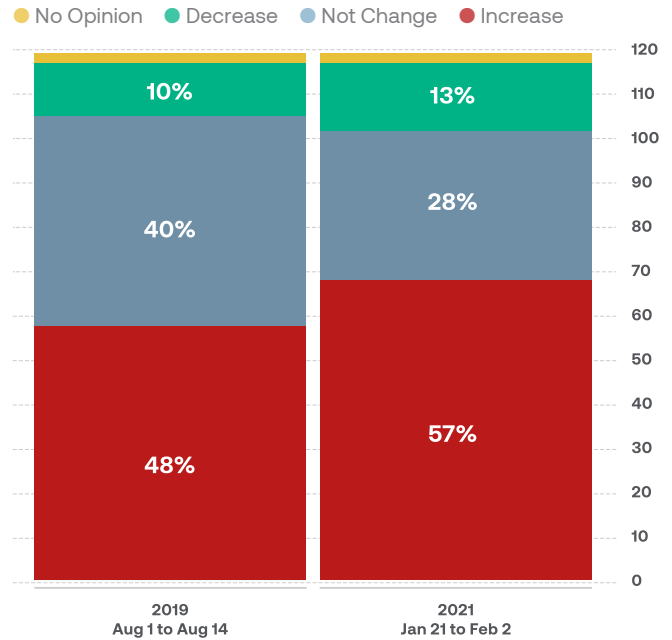
Second, and perhaps most importantly, US public opinion has turned harshly against them. As these tables show, according to a recent Gallup poll, 55% of Americans have a negative overall view of technology companies like Amazon, Facebook, and Google. This is up from only 33% two years ago; that is a two-thirds increase in just 17 months. Importantly for investors, 57% believe that the government should increase regulation of these tech companies, from 48% in 2019. The social media companies (e.g., Facebook, Snap, and Twitter) have especially drawn the heightened ire of the public.

Say whether your overall view of technology companies is | Source: Gallup Poll (as of February 18, 2021)



Do you think the government should change its regulation of technology companies?

Source: Gallup Poll (as of February 18, 2021)

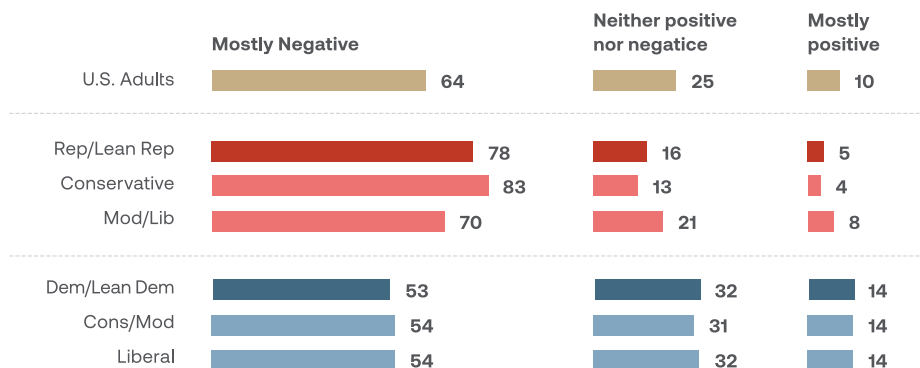


The next table from a Pew Research Center survey from July 2020 shows that 64% of American adults believe that social media has a mostly negative effect on the country, while only 10% think it has a mostly positive effect. That is more than 6 to 1. The dislike is particularly acute among Republicans, who believe that Facebook and Twitter suppress conservative viewpoints and speech.

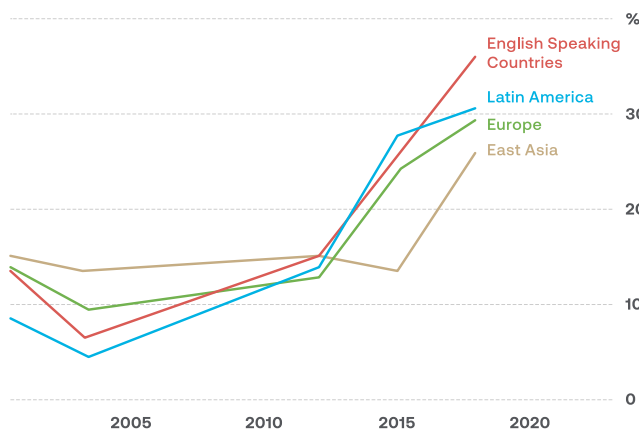
Why has the American public turned so harshly against Megacap Tech, generally, and social media companies in particular? Well, there is growing evidence that social media use is highly detrimental to the mental health of young persons. A study published in the Journal of Adolescence in July of 2021 titled, “Worldwide Increases in Adolescent Loneliness”, concluded that the pervasive use of social media

Majority of Americans say social media negatively affect the way things are going in the country today

Source: Pew Research Center, US Adults surveyed July 13 – 19, 2020



The share of students reporting high levels of loneliness at school has increased sharply since the early 2010s | Source: BCA Research

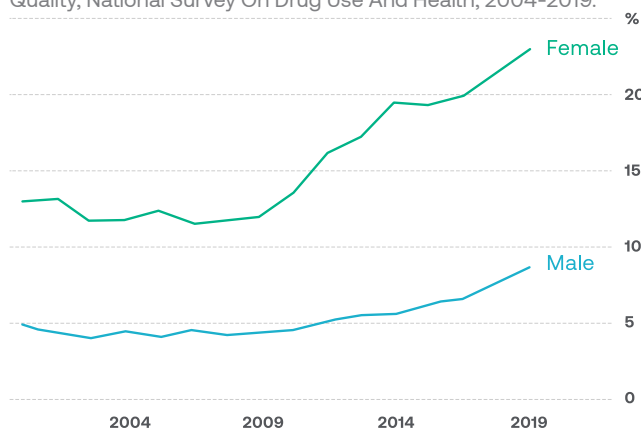


leads to increased feelings of loneliness and isolation in young people. Moreover, as this chart shows, the problem is a worldwide one, with sharp increases occurring in the Anglosphere, Europe, Latin America, and East Asia from 2010 to the present. Basically, these are all the regions of the planet where social media use is widespread. But the problem goes beyond just feelings of loneliness and isolation. In fact, it seems to now be morphing into significant mental health problems, particularly in young girls, and it is cutting across genders, age groups, and racial/ethnic groups.

As this chart shows, in 2009, just over 10% of girls from the ages of 12 to 17 reported a major depressive episode over the previous year. Ten years later in 2019 when this particular study concluded, 23% of girls in the sample reported such an episode. This will not go unnoticed by regulators and the government. How long before these companies are regulated the same way tobacco, drugs, and alcohol ones are? In fact, I would argue that, in many ways, the Chinese government is ahead of the curve, and that the same regulatory crackdowns we observed this year on Alibaba, Tencent, and gaming are preludes to US measures on their own companies.

Major Depressive Episode Rate: Young Girls Are At High Risk From Social Media Uses

Source: Samhsa, Center For Behavioral Health Statistics And Quality, National Survey On Drug Use And Health, 2004-2019.



Of course, the American answer to Megacap Tech’s growing ubiquity must come from consensus-making and the democratic process, a sometimes long and laborious process as opposed to China’s authoritarian, unilateral phone call from a bureaucrat. But as we have seen, the consensus on greater regulation is already there. Now, we must wait for the democratic process to catch up. In our opinion, it is only a matter of time before it manifests itself in concrete public policy and enhanced regulatory scrutiny. With towering valuations among the US Megacaps (e.g., forward P/E multiples of these companies are still north of 80x, while the S&P 500 is only 22x), these will be hard pressed to justify these multiples. In fact, they would have to grow earnings approximately 30% per year over the next 5 years to simply meet analysts’ heightened expectations. Remember, every decade has its own bubble. Unequivocally, the 2010s belonged to Megacap Tech. My bet is that the 2020s will belong to something else. Therefore, I would use rallies in this group as points of exit.

And with that I conclude my presentation for today. Now unto our Investment Strategist, Melissa Ochoa Cárdenas, who will be giving us an overview of Latin America.



Melissa Ochoa Cárdenas

Investment Strategist
Insigneo Financial Group

Latam Views

Picking up where we left off last quarter, it seems odd to say that not much has changed on some fronts, but at the same time a lot has changed for the region. Our expected path towards economic recovery has materialized in most of the countries, together with some upward revisions in terms of growth forecasts, but there has simultaneously been a dangerous increase in inflation pressures that are tilting central banks to tighten monetary policy. Moreover, the US seems poised to finally announce the beginning of the tapering in November, and oil has remained relatively bullish for the last months – even if it has registered some blips in its price. The Summer months also brought additional volatility from China and, even if more contained, renewed fears from COVID-19.

In general terms, and **just like the rest of the world, Latam continued its economic recovery from the pandemic** setback with growth for the region as of 2Q21 exhibiting a variation of 16.77% YoY, amid an improvement in COVID-19 vaccination rates, where it is worth highlighting that across Latam, all countries already exhibit over 40% of their population being vaccinated. This trend, together with a more visible reopening of the economies has ramped up consumption across the region, as well as setting the stage for sustained inflationary pressures that seem to be a bit more permanent than previously expected. The latter has also pressured some of the central banks to either be more aggressive with their monetary policy tightening, or to preemptively raise rates as is the case in Peru.

However, and even if the macroeconomic backdrop could be deemed as benign, the political environment keeps taking center stage, with upcoming elections in the last quarter of the year that will roll until October 2022. Even if some of these pieces start falling into place, the puzzle is likely to remain far from complete. Now, let's dive into a more specific country-vision of what has happened since we last reconvened.

Brazil

In its latest monetary policy meeting, the COPOM fulfilled the market's expectations and hiked the Selic rate 100bp to 6.25%, amid sustained inflationary pressures – both from the headline and the core readings –, together with heightened risks coming from the fiscal side that could also add additional pressure into current and future inflation readings. On another note, the COPOM considered that growth for 2Q21 continued to show a positive evolution and didn't modify its forecasts for this year. Furthermore, their latest press release highlighted COPOM's stance where they consider continued tightening to be appropriate, further moving policy into restrictive territory while also acknowledging an additional adjustment of the same magnitude for the next meeting.

Turning back to the fiscal front, the COPOM emphasized **on the need of implementing reforms and adjustments that could cement a sustainable recovery of the economy, while recognizing that any changes to the fiscal consolidation process, which could result in an increase in the structural interest rate.** In addition to the latter, COPOM is also aware of the risk that extending fiscal policy responses to the pandemic represents in terms of fiscal deterioration. This is no small matter, considering that time is running out for President Bolsonaro to present any reforms or budget modifications given that Brazilian law does not permit the creation of new programs in election years. Against this backdrop, the continuity of Bolsonaro's "Bolsa Familia" is hanging by a thread as well as that of the emergency benefits that were paid during the pandemic that will expire in October. This, considering the necessary adjustments of the spending cap that such continuities would comprise, could jeopardize the country's fiscal credibility. Furthermore, the 2022 budget that was presented to Congress last August is under pressure from the "precatório" payments, since their inclusion in the budget implies that the government could be able to pay for the amount indebted in "precatórios" of BRL 89.1bn while accounting for additional mandatory expenditures. However, this would impair the government's ability to increase discretionary spending in 2022, an election year, and would force the budget allocated to "Bolsa Familia" to remain unchanged from 2021 levels to comply with the spending cap. It is also worth highlighting that any modifications that could allow for spending to happen outside of the cap ultimately would dent the power of Brazil's only fiscal anchor, thus increasing volatility and uncertainty ahead of the October 2022 elections.

— "Brazil is surrounded by noise generated by the ongoing collision between President Bolsonaro and members of the Supreme Court."

The backdrop is all but favorable when considering that the political landscape in Brazil is surrounded by noise generated by the ongoing collision between President Bolsonaro and members of the Supreme Court. In addition, Bolsonaro currently faces four separate investigations, which he has summarily dismissed by attacking several institutions. These responses appear to have dented his approval rating.

The political challenges keep building up when we take into consideration that increased political tension makes any sort of cooperation between government branches more difficult, while slowing the pace of progress regarding reform approval and implementation. If the current government were to feel any mounting pressure from the left – maybe led by former President Lula – it is highly likely that it will do all it can to increase stimulus, and therefore its popularity amongst the people, even if this only brings additional pressure to an already entangled budget.

Colombia

In Colombia, growth forecasts have been positively revised by analysts, and this thesis seems to be materializing with the observed increase in consumer confidence and a recovery in the PMI, that even if it decreased in its last print, still shows a positive trend year-to-date. Furthermore, high-frequency activity data also confirmed this trend, with both manufacturing production and retail sales posting yearly variations of double-digit growth when compared to pre-pandemic levels.

Moreover, this positive trend in growth was also confirmed by the latest GDP reading, even if below the market's expectations. Growth for 2Q21 exhibited a YoY variation of 17.6%, with household consumption exhibiting a 25% YoY growth. Against this backdrop of increased consumption and a slow return to normalcy, inflation has not remained as tamed as it previously was, while surpassing BanRep's upper limit for the

— “In 2Q21, Colombia recorded historical maximums in its current account deficit, despite higher oil prices for the quarter, and experienced higher external spending needs. Nevertheless, the future may seem bright in terms of a feasible recovery in both oil production and exports.”

first time since 2017 in August. The increased inflation pressures that have also dented inflation expectations made BanRep pull the trigger in its latest monetary policy meeting by increasing the monetary policy rate by 25bps. This is a situation that the market already penciled in, displaying an implied monetary policy rate of ~2.75% for the next three months. Those expectations are also being supported by BanRep’s latest survey, in which inflation expectations for December increased 48bps and reached 4.70%, implying that the variable would end the year above its target for the first time since 2017. In terms of monetary policy, most analysts expect a more gradual approach, forecasting that the monetary policy rate would experience two 25bp hikes at the time of this writing, thus closing 2021 at 2.5%. It is relevant to state that, for Colombia, the pace of monetary policy normalization would follow a more gradual path, given that the country still displays a negative output gap – even if it is less negative than previously expected. However, and even if this was not the ultimate solution to the challenging fiscal environment that Colombia currently faces, **it is worth highlighting that Congress approved the renewed tax reform after several sessions of discussion and consensus-seeking spearheaded by Finance Minister Restrepo.** This reform positions Colombia as a trailblazer in terms of implementing tighter fiscal spending, while showing a commitment to tackle social demands. It is also intended to preserve the country’s fiscal stability. This reform is expected to grant the Colombian government average savings in the 2022–2032 period of 0.1% of

GDP, while also generating additional revenues of around 1% of GDP in net permanent revenues.

Nevertheless, it is worth noting that most of the measures will only commence in 2023, and it has already been stated that additional and more structural efforts would be needed from the upcoming administration scheduled to take office in 2022.

Regarding the approval and content of the approved tax reform, the rating agencies have already issued their opinions: Fitch Ratings stated that, even if they recognize Colombia’s effort by approving such a reform, it would not be sufficient for the country to recover its investment grade rating. Additionally, the rating agency is also aligned with the government in terms of deeming necessary that another, more structural tax reform, should be presented by the incoming administration.

Meanwhile, Colombia faces a challenge coming from its external sector. In 2Q21, Colombia recorded historical maximums in its current account deficit, despite higher oil prices for the quarter, and experienced higher external spending needs. Nevertheless, the future may seem bright in terms of a feasible recovery in both oil production and exports. Portfolio investments have also proven to be a stable source of financing throughout 2021.

Colombia is about to enter an electoral cycle that could bring additional volatility to the market. As of

the time of this writing, official presidential candidates have not been declared and more than 30 names are emerging as potential standard-bearers from both traditional and newly formed parties. Uncertainty will linger until we get more clarity on the definitive candidates, and subsequently until the results from internal consultations from the parties take place.

Peru

The last quarter was full of different challenges for Peru. The country found it difficult to navigate a new course upon President Castillo assuming office, and the markets may have priced in a worst-case scenario. The negative news began in the form of a rating downgrade by Moody's, basing that decision on Peru's current polarized and fractured political environment that has both increased political risk and weakened any policymaking capacity. Nevertheless, Peru's outlook was upgraded to stable, thus reflecting the country's capability to retain a high degree of fiscal strength and economic resilience when compared to its peers.

The news of the rating downgrade came amid a political turmoil that involved the Congress' decision to grant former Prime Minister Bellido's cabinet confidence instead of walking the path of a confidence denial. However, uncertainty surrounding policy development and implementation for the government remains high, especially if one considers that the agenda initially presented by President Castillo, and what Finance Minister Francke has revealed in the Multiyear Macroeconomic Program, has shown little signs of moderation from his heterodox campaign proposals. Whereas Francke has advocated to reinstate the fiscal rule while aiming for fiscal consolidation progress. This, amid a projected reduction of the fiscal deficit to 1.0% of GDP in 2025 by Francke, that strongly contrasts with announced expenses by President Castillo that could represent an expense of at least 2.0% of GDP. Furthermore, and even if the government has announced

its intention to use the increase in mining tax collection to account for additional revenue to subsidize these expenses, the amount of revenue that the government can collect stemming from this source could be smaller than the cost of the projects, thus risking an increase in fiscal deficits above what is being forecasted.

Moreover, the macroeconomic picture for Peru is a mixed one: the latest real GDP measured by INEI's monthly indicator came below expectations by portraying a 12.94% YoY variation in July, being propelled mainly by the sectors that benefit from the economic reopening and having only 5 of the 12 sectors expanding. Even if this indicator showed that the economy has not lost momentum, and most analysts have revised their growth expectations to the upside, business confidence has taken a hit from the previously mentioned political uncertainty. This does not bode well for sustained growth and economic development going forward, especially if the government plans to keep its expansionary fiscal policy going. In addition to waning business confidence, Peru is also facing unexpected inflationary pressures that have caused the BCRP to, surprisingly, pull the trigger in the implementation of a more contractionary monetary policy, after having increased its monetary policy rate by a total of 125bp in the last three meetings. Nonetheless, the BCRP has emphasized that the previous rate hikes do not imply the beginning of a hiking cycle, and that monetary policy is still expansionary – especially when considering the current levels of the real reference rate. Still, consensus views point towards additional rate increases to come that should be targeted towards controlling inflation, while trying to keep inflation expectations anchored, amid a more data-dependent tone from the Central Bank.

On the inflationary front, Peru has had three upside inflation surprises, with its latest print surpassing BCRP's upper limit in ~200bp, with the latest upward move principally explained by increases in food prices and a worrisome increase from its core measure. Further-

more, inflation expectations, per the latest inflation report published by the BCRP, increased 64 bps to 3.07%, amid a deterioration of the inflation risk balance. However, the BCRP showed little signs of worry in terms of inflation increases by stating that they expect inflation to return to its target within the next 12 months, and that it will remain there for the following year, given the transitory nature of the observed increase.

Chile

For Chile, the economic recovery seems to be well underway, propelled by strong domestic consumption on the back of still present fiscal stimulus, that has come together with inflation increases and tighter monetary policy from the BCCh. This tighter monetary policy came into effect when the BCCh, in a surprising move, hiked 75bp in its latest monetary policy meeting, while trying to control higher than expected consumption and inflation prints. It is also relevant to highlight that the Committee displayed a more hawkish tone, specifically when assessing the current overheating of the economy, together with a visible deterioration of the inflation outlook, as well as the risk balance for that variable. Furthermore, the latest Minutes from the BCCh showed that the Committee believes there is need for faster normalization of monetary policy, admitting the need for additional rate increases from either 50 to 75 bps for subsequent meetings. This stance seems to be penciled in by the markets, with Chilean implied monetary policy rate for end of the year being close to 2.75%, equivalent to a 125bp hike.

Economic recovery seems to be well under way in Chile, with the output gap already closed and now being positive, which contrasts with a deterioration from the external accounts, despite positive commodity prices that usually bode well for Chilean exports. The buoyancy of growth was visible in the last GDP print, which portrayed a YoY expansion of 18.1%. This, on the back of economic activity that proved more

— “Economic recovery seems to be well under way in Chile, with the output gap already closed and now being positive, which contrasts with a deterioration from the external accounts, despite positive commodity prices that usually bode well for Chilean exports.”

resilient to restrictions imposed due to the pandemic, and the news coming from the government that the IFE cash transfers that were supposed to end in September, were going to remain in place for two additional months. This is the latest proof that fiscal stimulus is still present, while also being a support for consumption for the coming months. However, the fact that the stimulus will remain for additional months seems to contradict the view expressed by the Committee in its latest Minutes where all members admitted that the worst of the pandemic was over, which made maintaining measures to contain its economic and social impact a source of problems and imbalances.

As was mentioned before, this increase in consumption, together with the extended cash transfer program, have set the stage for a relevant increase in both current and inflation expectations. In its latest print, CPI recorded a YoY variation of 4.78%, with the services group being the main driver of the increase, together with other sectors that particularly benefitted from the reopening of the economy. Additionally, core inflation also replicated the upward trend seen in the headline print by displaying a yearly variation of 3.76% and heading further north of the BCCh's target. The observed increase in inflation has also represented a transmission to inflation expectations that has been so strong that, according to the latest Minutes, inflation expectations two years ahead were already settling above the 3% target.

As previously mentioned, the Chilean government has not hesitated in providing people with additional stimulus that, in turn, have provided an ongoing support for consumption. Together with lower-than-expected tax collections, this further widened the fiscal deficit, with the government revising its forecast to include a wider deficit for this year.

Moreover, political risk continues to be one of the main risks for Chile, with the November Presidential elections getting closer by the day. According to the latest polls, leftist candidate Gabriel Boric is leading the race, ahead of the center-right representative Sebastián Sichel. This is relevant when considering that the popularity of President Piñera continues to deteriorate, and a shift towards a left-leaning government seems more probable. Nonetheless, it is relevant to highlight that Boric's stance is less radical than what the Communist party would have proposed, even if his agenda is left leaning.

Meanwhile, the crafting of the new Chilean Constitution is still underway, and even if the Assembly has held sessions for more than two months, little progress has been made. It is worth highlighting that the deadline for the new Constitution to be ready is July 4, 2022. If this completion date cannot be reached, then it could further increase an already high political uncertainty.

Argentina

Argentina is facing a plethora of issues for the remainder of 2021 and the quarters ahead. If we consider that the already challenging economic environment must now take into account the governmental defeat in the primary elections, it is improbable that they will retain control of the Lower House in November, further denting governability.

In the recent primary elections, Argentinians went to the polls and expressed their dissatisfaction with the current administration, which led to the government

being defeated in 17 of the 24 jurisdictions. This result is very unlikely to be reversed in the upcoming November elections, leaving the Fernandez administration in a weaker position and with several internal clashes that should not be resolved anytime soon. Specifically, those between the more traditional Kirchnerism and the economic team of the government. According to different analysts, this situation could also accelerate the fiscal spending rhythm until the November elections to try to turn the primary results around.

Moreover, President Fernandez recently announced a cabinet reshuffle due to internal pressure, where most of the replaced ministries are now occupied by former members of Cristina Kirchner's government. However, it is worth highlighting that Finance Minister Guzman retained his position, which diminishes uncertainty around the resolution of the IMF negotiations and was received by the markets as positive news.

Still, the fiscal consolidation that was achieved during the first half of 2021 could be at risk because of the possible interest of the government to accelerate fiscal spending, considering that this spending trend already started last July, when several social expenses – such as higher subsidies, social security spending, and higher capital spending – were implemented. Furthermore, the government announced its intentions to increase the minimum wage, and a couple of weeks ago, the Ministry of the Treasury issued a decree that permits the usage of the SDRs to both pay part of the IMF amortizations and increase the legal amount of allowable monetary financing from the Central Bank to the Treasury. The previously mentioned backdrop implies that the financing needs of the government will remain high and fiscal deterioration may occur. Furthermore, if the government wants to comply with the IMF's targets, it will face the obligation to cut back spending in the upcoming months, contradicting its previously stated objectives ahead of the November elections.

The challenging political situation comes into play in a country that has been seeing elevated inflation levels which seem to portray a stickier trend, even if its July reading was the lowest one for the year. Moreover, it is worth bearing in mind that inflation has benefitted from higher commodity prices – which in turn helped avoid a nominal exchange rate devaluation – and from the freeze instated on public utility prices. If these phenomena were to revert next year, the inflation outlook looks even less promising. In terms of growth, the Argentinian economy surprised the market to the upside in 2Q21 by displaying a YoY variation of 17.9%, even if mobility and economic activity restrictions were in place during the quarter. This upward surprise was also in part due to a favorable base effect.

However, it is relevant to highlight the expansion portrayed by both public and private consumption, even if it was milder than the one seen in 1Q21. Going forward, given that the percentage of the population that is fully vaccinated has increased substantially in the last few months, reopening activities should continue to propel growth for the remainder of 2021, together with the forecasted fiscal support coming from the government.

Mexico

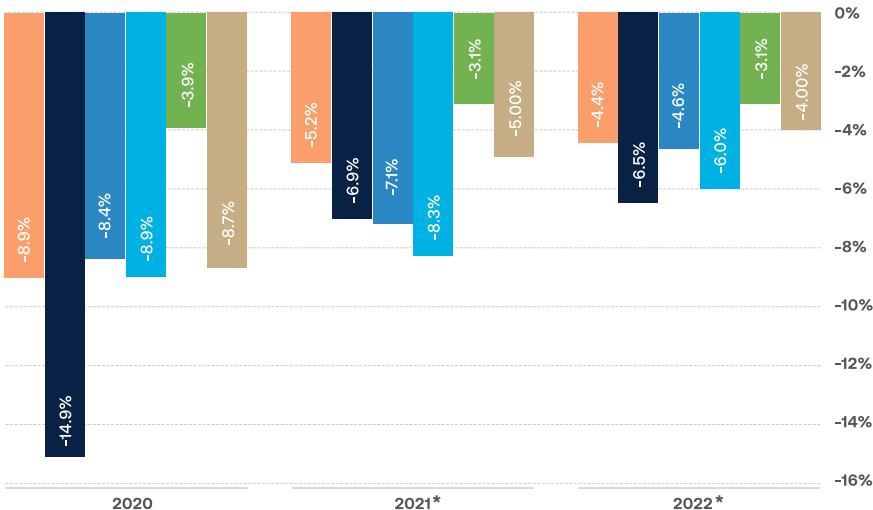
In our previous quarterly call, Mexico seemed to be the safest bet across Latam – a relatively stable political environment after the June elections, a bright picture in terms of economic recovery after a strong 1Q21 GDP reading, and a central bank that was starting to react to mounting inflation pressures, but with a gradual approach.

Inflationary pressures in Mexico seemed to be confirmed by the bi-weekly inflation print for the first half of September, which recorded upward surprises both in its headline and core reading. In the case of headline inflation, the increase was mainly explained by the price pressures observed in core goods, food, and energy. It is worth remembering that, for August, inflation displayed a yearly variation of 5.59%, leaving the print 259bp above Banxico’s inflation target. Furthermore, core inflation is 192bp above target, accelerating significantly from last year’s closing levels, and seem to confirm the belief that inflation, at least in Mexico, is less transitory than what was previously believed, especially when considering that current core inflation marked a new cyclical high after reaching levels not seen since the end of 2017.

Fiscal deficits continue to loom in Latam

- Argentina
- Brazil
- Chile
- Colombia
- Mexico
- Peru

Source: Bloomberg
(as of September 29, 2021)



This change in inflation has had its effects on Banxico's stance and decisions, with the Central Bank accumulating 75 bps in rate hikes year-to-date. Nevertheless, the Central Bank may have to act more carefully in terms of implementing a more contractive monetary policy, while considering that activity prints seem to be losing steam – a trend that was confirmed in both the latest industrial production reading as well as the latest print for retail sales for July, where both figures portrayed a setback. The latter was surprising, considering that vaccination rates have increased across the country, which should help those sectors most embattled by the pandemic lockdowns. Additionally, after its latest monetary policy meeting in which Banxico decided to increase 25 bps its monetary policy rate, it is worth highlighting its worries regarding how the observed increase in inflation could endanger future inflation expectations, thus making a further tightening of monetary policy a necessity.

Turning to the political front, President Lopez Obrador is entering the second half of his tenure after having lost his qualified majority in the lower house, which leaves the government party in a weak position to fulfil negotiations that would allow Lopez to carry on with his suggested constitutional reforms in terms of strengthening the state-owned electric power utility and modifying the electoral system as the two main ones. Moreover, another political point that is on the horizon is the expected recall referendum that would take place in March of next year. Even if current popularity levels of AMLO are relatively high (~60%), analysts believe he will undergo the exercise of putting his tenure under scrutiny which, in the end, could cause some volatility around that time.

Furthermore, it is worth remembering that the 2022 budget was presented a couple of weeks ago, in which the government is proposing to run a primary deficit close to 0.3% of GDP, a first when seeing previous years' trend of surpluses recorded in the period between 2017-2020. This piece of news came with

optimistic forecasts from the government in terms of future growth that seem to depend on higher tax collections, securing a reduction of the profit-sharing tax rate on Pemex, and leaving the door open for further support measures for the company. This budget is still under discussion in the Congress and should be approved before the October 20 deadline, considering that the approval requires only a simple majority. Even if the allowance of a primary deficit would be a first, the fact that the budget is approved would bring fiscal stability, amid already stated commitments from the government to keeping public debt levels around 50% of GDP.

In sum, our conclusions for the quarter are as follows:

Volatility across most of the region will continue to be the name of the game, especially in those countries approaching elections. It is highly likely that currencies may already be pricing this increase in uncertainty.

In terms of investments, Mexico seems to be an attractive bet, considering that volatility has not been present – or at least not to the same degree as its peers. Fiscal and political stability seem to favor investments in the country, as well as a hiking cycle that seems to be coming to an end. Additionally, and even if structural fiscal challenges may lay ahead, the history of strong fundamentals and a more gradual approach to monetary policy than its peers in the region also make us consider Colombia as an attractive investment opportunity for the quarter.

Political and fiscal risks continue to be the biggest worry across Latam, especially when taking into account the high projected fiscal deficits for most of the countries.

Focusing more on the political front, we continue to consider that the best way to play Latam is to have reduced exposure to both Peru and Brazil, given their current uncertainty in terms of government agenda execution. Furthermore, the fact that the

government may not be able to carry out most of its proposals in both countries makes us believe that political risk is too high to execute profitable trade ideas.

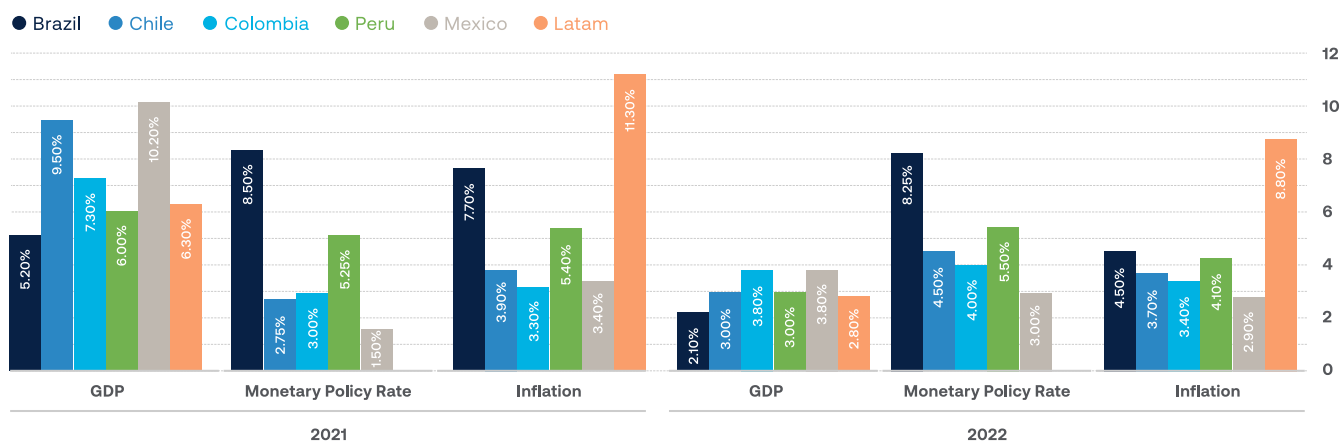
Despite the buoyant growth in Chile, it is not sufficient for us to prefer that country as an attractive investment opportunity. We need more political clarity to make that call. The future president

needs to shed some light on how to reduce existing fiscal stimulus that has been a double-edge sword for the Chilean backdrop.

Argentinian credit could be an attractive play for those investors willing to tolerate high volatility until the November elections are past, or at least until more clarity comes in terms of an IMF program before the March amortization.

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

Source: Bloomberg (as of September 29, 2021)



Appendix: Bitcoin and El Salvador – worth the effort?

El Salvador recently made history after being the first country in the world to implement bitcoin as a legal tender; however, the situation doesn't seem as flattering as initially thought by president Bukele. It is relevant to remember the initial motives that drove Bukele towards the implementation of bitcoin as a legal tender: firstly, El Salvador's great dependency of remittances, accounting for almost one quarter of the country's GDP. Secondly, this project is Bukele's attempt to bring Salvadoreans closer to financial inclusion, given that most of the population doesn't have a bank account.

During the implementation day, several inhabitants were unable to download "Chivo", the e-wallet developed by the government through which Salvadoreans were supposed to be able to perform payments, to the point that it had to be taken down from service after experiencing technical glitches.

Some weeks after the implementation, the road ahead still looks bumpy. On the one hand, the volatility of the cryptocurrency – which sometimes seems to be its trademark – has remained, while the slack implementation of bitcoin has been met with protests that grow by the day: some businesses are refusing to accept bitcoin as a means of payment – even some government offices are not taking the cryptocurrency –, shielding themselves in their lack of technological support to implement it. Furthermore, the means through which the population has access to bitcoin are getting more challenging, given that the bitcoin ATMs installed around the country have either been vandalized by the protestors, or do not work properly.

Moreover, the Central American country is incurring additional costs to deploy bitcoin implementation, and the population does not seem too

happy about that. According to several statements from those who took to the streets to protest, the resources utilized by the government for this project are coming from taxes. In a highly indebted country like El Salvador, where inequality abounds, both implementation and adoption, especially from those least favored who don't have access to a stable internet connection, remain challenging. Moreover, it is important to remember that supranational institutions like the IMF and the World Bank opposed President Bukele's plan to implement bitcoin, even if he considered it a means of bringing investment into El Salvador.

Meanwhile, the main argument against bitcoin implementation stems from those who argue that it may fuel illicit transactions and financial instability. The fact that the IMF did not approve the adoption does not help the country's cause considering it has open USD 1 billion Article IV discussions with the organization. Similarly, the World Bank also stated that it would not be able to help El Salvador in its bitcoin adoption process, citing environmental and transparency shortcomings.

— “This is still a developing story, and there is much on the table in terms of future learnings and developments. The full world will be watching.”

This is still a developing story, and there is much on the table in terms of future learnings and developments. The full world will be watching – specially those countries whose economies are also dollarized, such as Ecuador and Argentina. If the experiment goes well, it would not be surprising to see other economies adopting the same path, despite the recommendations against it.

House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
US Equities¹	OVERWEIGHT	OVERWEIGHT
European Equities	OVERWEIGHT	OVERWEIGHT
Japanese Equities	OVERWEIGHT	NEUTRAL
Emerging Market Equities	OVERWEIGHT	NEUTRAL
Chinese Equities	OVERWEIGHT	UNDERWEIGHT
US Treasuries²	UNDERWEIGHT	UNDERWEIGHT
Investment Grade Fixed Income	NEUTRAL	NEUTRAL
High Yield Fixed Income	NEUTRAL	NEUTRAL
Emerging Market Sovereign	NEUTRAL	OVERWEIGHT
US Dollar	NEUTRAL	UNDERWEIGHT
Energy³	OVERWEIGHT	OVERWEIGHT
Precious Metals	NEUTRAL	NEUTRAL
Cash	NEUTRAL	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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