



Market Commentary
October 2022

English Version

How this time may be different

Quarterly Call Q4 | 2022

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 | 2022

October 6th, 2022.



Hello and welcome to our quarterly conference call, the final one for 2022. To say that this year has been a difficult one for investors, professionals, and everyone else involved with financial assets would be a lexiconic case of understatement. As we write this during the final days of September, most major asset classes, with the lone exception of the US Dollar, are sitting near their lows for the year; global equity and bond indices stand below 20%, the traditional demarcation for a bear market.



Ahmed Riesgo
Chief Investment Officer
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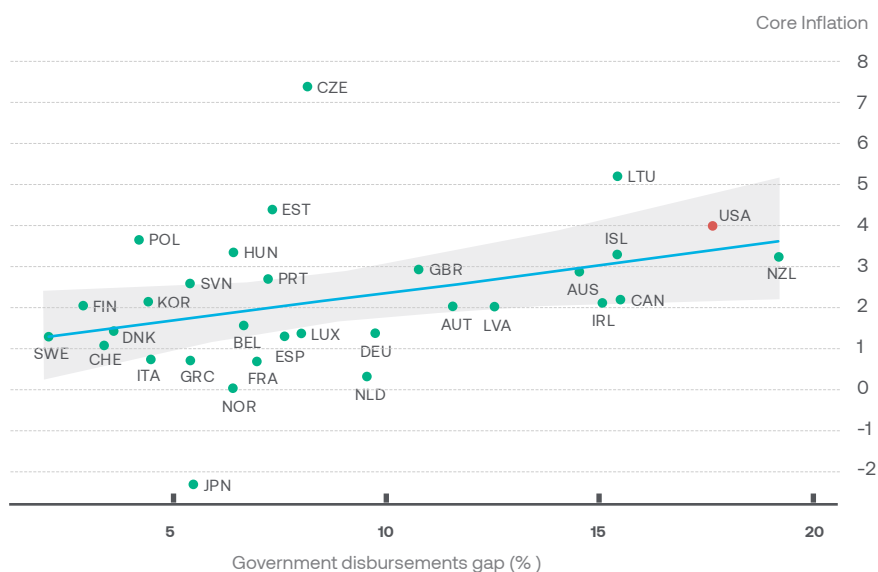
Our two major predictions from the previous quarterly conference call came to fruition. We have had no recession materialize in the US, and there has been no rebound rally in financial assets. **We expected volatility to continue in Q3, but to dissipate in the fourth quarter. That is no longer the case. What has changed our view? Quite simply, the persistence of inflationary pressures in most parts of the world, outside of Japan and China.** The simple truth is that the standard inflationary models we use to predict CPI and other inflation data are not working well in this environment. These are the same ones that the Fed employs, major research houses, academic economists...everyone. Why are they failing to pick up the correct trend in prices? It is tough to give an answer at this point, but intuition tells us that there is no historical precedent for what the global economy has endured over the past two years. Think about this for a moment: we shut down the US economy as never before, the Trump and Biden Administrations and the Fed pumped trillions of dollars into that same economy as if it were going to be shut down for an extended period of time, and then rapidly reopened the economy. This same pattern of concerted action

could be applied elsewhere, as well. It should not be surprising that the countries currently grappling with the most severe bouts of inflation are the ones that stimulated the most, as this correlation study suggests. This study from the Chicago Fed shows that larger fiscal stimulus packages and tighter labor markets are associated with greater inflation acceleration across countries. The stimulus packages we saw from the West during the pandemic were equivalent to the ones enacted during World War II, yet the latter saw the destruction or repurpose of most of the capital stock of Europe and the US. That inflation rose sharply is not the surprise, but its persistence has been. Needless to say, we and the Fed expected these

— “The simple truth is that the **standard inflationary models** we use to predict CPI and other inflation data are **not working well** in this environment.”

Larger fiscal stimulus packages and tighter labor markets are associated greater inflation acceleration across countries.

Source: Hobijn, B., Miles, R., Royal, J., Zhang, J., (2022) “What is Driving US inflation amid a Global Inflation Surge?” Chigago Fed Letter, NO. 470, August 2022, p. 6.



inflation prints to fall faster than they have so far. Indeed, core inflation actually ticked up in August to 6.3%, up from July's 5.9% reading and above consensus expectations. The composition of the report was strong, with broad increases in cyclical and wage-sensitive services categories including shelter (+0.7%), medical care (+0.7%), education (+0.5%), and personal care. The shelter component is especially worrisome because it comprises 30% of the CPI basket. At +0.7% MoM, it is the highest it has been since January 1991.

This is the key to bringing CPI inflation down now. Once shelter costs decrease, a distinct disinflationary trend could appear. The Case Shiller Home Price Index has lost all of its momentum, and we are already hearing reports of price cuts in certain markets like Seattle and Miami. But rents are “stickier” than other prices since they are usually enshrined in lease agreements. At a recent investment conference in New York City, the key phrase we heard from former Fed Vice Chair Richard Clarida was “failure is not an option.” It is curious as these same policymakers, who committed the policy error of keeping rates too low for too long, are now trying to ensure that they are remembered as Paul Volker, instead of Arthur Burns, the infamous Fed Chair who failed to contain the inflationary excesses of the 1970s. However, our current price environment is quite different from that period. Both realized and longer-term inflation expectations were north of 12% back then, whereas they sit at 8% (realized) and 2.25 to 2.5% (long-term expectations) today. While these longer-dated inflation expectations currently remain anchored, the threat that they become unmoored is prevalent among policymakers' minds, so we understand their propensity to “talk a big game” lest consumer psychology exacerbates the problem. As expected, the Fed delivered a 75-bps rate hike at the September meeting, bringing the Fed Funds rate to a range of 3% to 3.25%. The Fed's forecasts show downwards revisions to economic growth estimates and upwards revisions to the unemployment rate and inflation forecasts. Real GDP growth is now expected to be 1.2% in Q4 2023, while unemployment is projected to increase to 4.4%.

Notably, FOMC members shifted up their projected policy path quite significantly. The Fed Funds rate is now expected to peak at 4.6% in 2023 (up from 3.8% back at the June meeting) before moving down to 3.9% in 2024 (which is 0.5% higher than the June estimate). However, no change was made to the longer run Fed Funds rate projection, which remains at 2.5%. This is the Fed's determination of the neutral rate of interest, which though a bit higher than they previously

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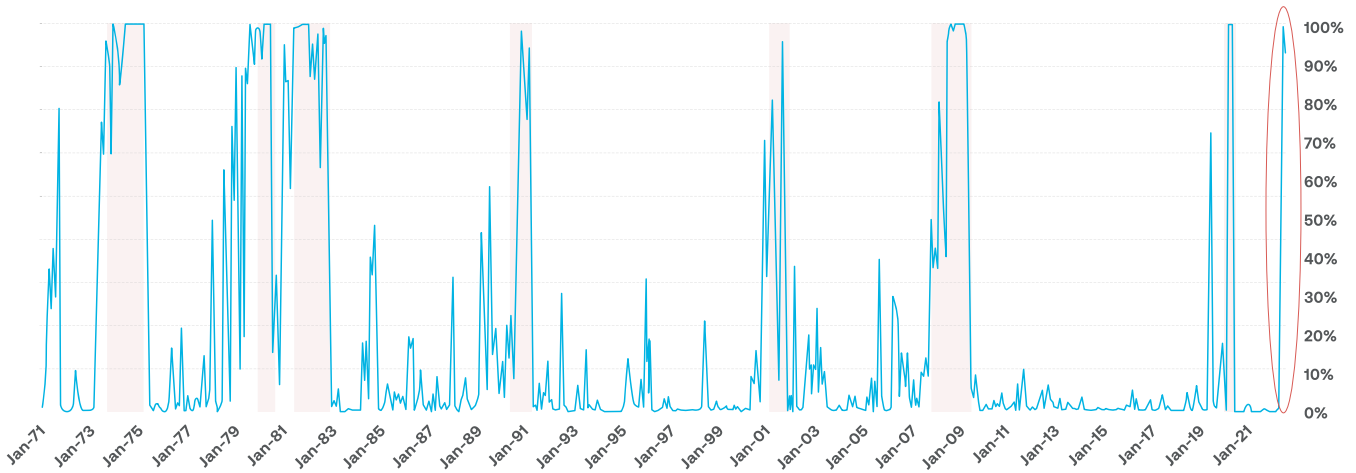
thought, is still too low in our view. During the press conference, Chair Powell had his “whatever it takes moment” with their new slogan “keep at it.” In sum, the Fed intends to bring the policy rate to restrictive territory rapidly. Indeed, we now think there is an **elevated probability that the Fed hikes us into a recession over the next two quarters.**

Economic Growth Outlook: Once Bitten, Twice Shy

Our proprietary recessionary indicator is now signaling over a 90% chance of a recession in the United States over the next six months, materially above the 40% threshold that would trigger, at best, neutral positioning in risk assets, but certainly precludes any bullish positioning. However, we are subjectively deemphasizing, though certainly not ignoring, the signal from the model as we believe the pandemic has lowered its predictability, just as in the inflation-

US Recessionary Indicator Flashing Red: Forecast Recession Probability for 2-Quarter Forward Period using All Macro Leading Indicators.

Source: Insigneo, Forefront Analytics (data as of 9/14/22, time lag summary ranges from T-1 Day to T-2 Month)



ary models we mentioned earlier. As one can observe, the pseudo-R-squared has fallen from 82% previously down to 56% as of September 14th, which is the last time we ran the model with new data, showing that the statistical variables are matching the intuition. As George Box, the famed British Statistician, once quipped, “All models are wrong, but some are useful.” In these unprecedented times, we are heeding his

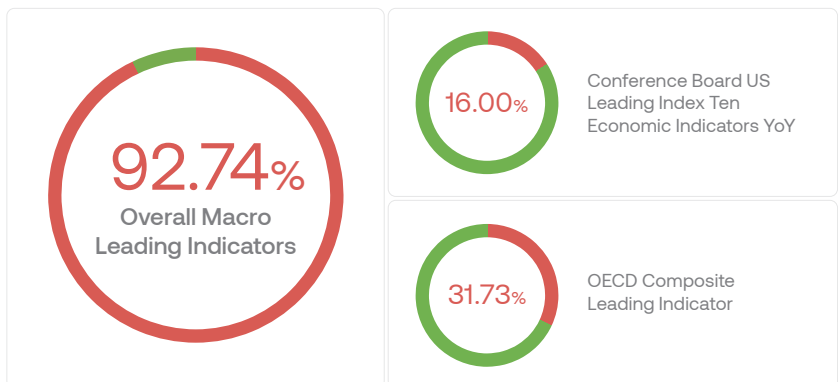
advice: our view is that US recessionary risks are very elevated and rising, but may not be as high as our model suggests.

Before we reveal our revised estimates for the growth outlook, let us address some of the thinking behind our qualitative assessment. The US central bank is not holding back in the fight against inflation, choosing

Indicator’s Predictive Capacity Has Fallen But Too Strong to Ignore: Heightened uncertainty reflected in increased variability.

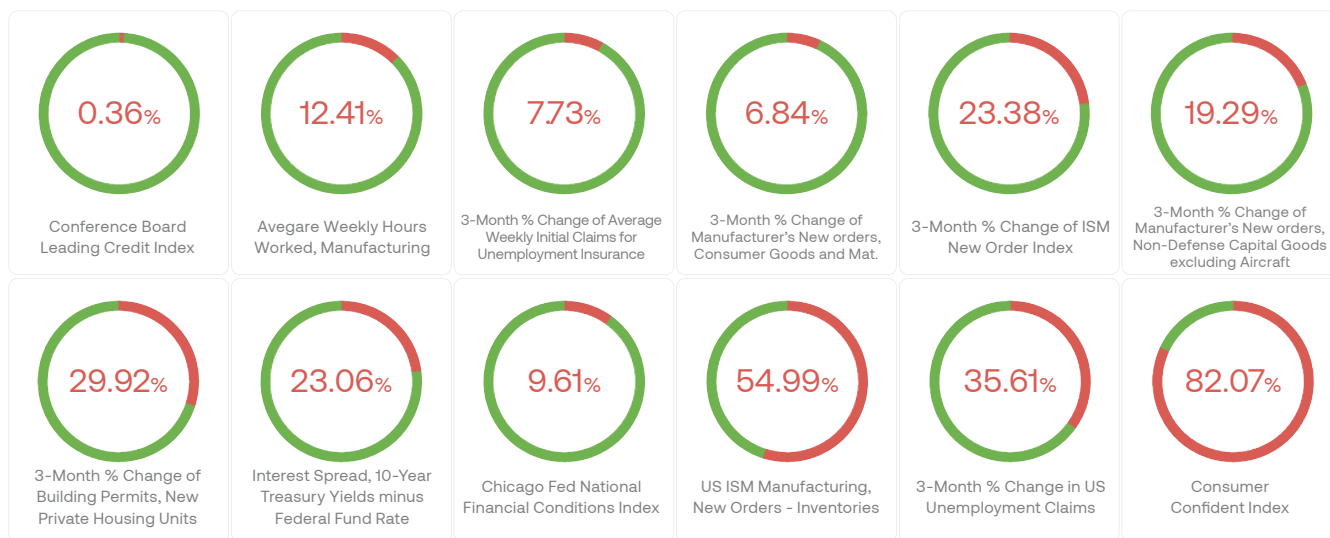
(Pseudo R-squared = 55.78% at 2 quarters)

Source: Insigneo, Forefront Analytics (data as of 9/14/22, time lag summary ranges from T-1 Day to T-2 Month).



Probability of a US Recession in 6 months at 93%, in 12 months at 77%

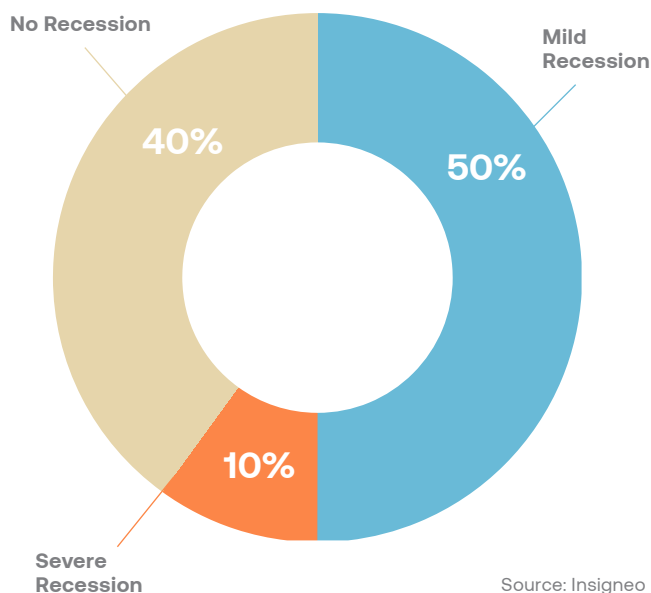
(Pseudo R-squared = 55.78% at 2 quarters; Pseudo R-squared = 57.66% at 4 quarters) | Source: Insigneo-Forefront Recessionary Indicator, updated as of 04/30 and 05/31 for various inputs



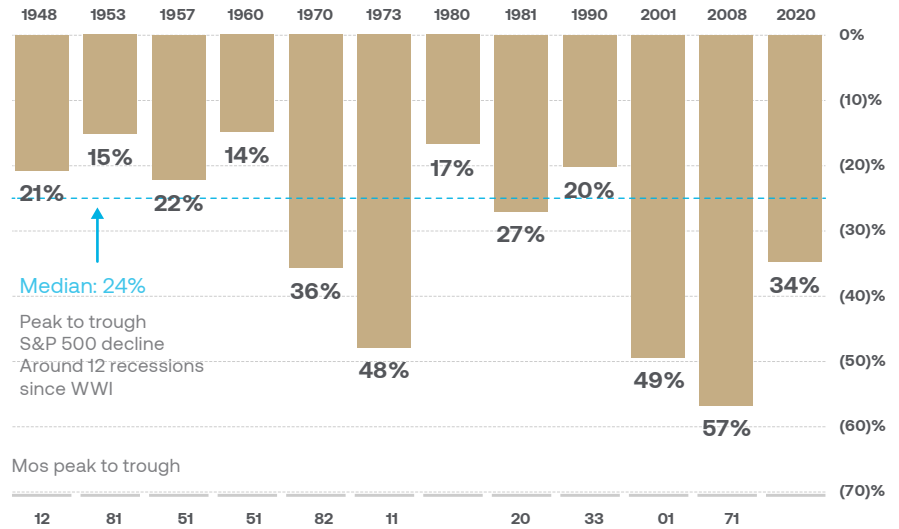
to deemphasize the employment part of its mandate at the expense of price stability. Under Powell, the current Fed is definitely talking a big game, suggesting that they are prepared to tolerate economic pain to bring inflation down to target. However, there is considerable uncertainty about the evolution of inflation as we discussed previously. In fact, future inflation prints could come down rapidly, as our traditional models suggest it will. But according to the Fed's own statements, it will need to see those inflation prints first, rather than anticipate them falling. Because they are lagging indicators, this means that it will significantly increase the chance that it overtightens monetary conditions and draws us unnecessarily into a recession. The Fed knows it committed an egregious policy mistake by keeping monetary policy too accommodative. Rates were too low for too long. The pendulum may now be shifting in the opposite direction: tightening too fast and not letting the lagged effects of monetary policy decisions work their way through the economy. Today, it is withdrawing liquidity just as quickly as it provided it during the initial months of the Covid pandemic in March 2020. **Why is the Fed**

behaving in this "once bitten, twice shy" manner? In our view, after having committed the mistake of keeping policy too loose, they would rather gain

Insigneo's Subjective Recessionary Probabilities



S&P 500 During Recessions Going Back to World War II



Source: Goldman Sachs

some credibility back than risk unanchoring inflation expectations even at the risk of causing a recession.

They have been able to do this because the US labor market has remained so strong; there are still 2 jobs for every unemployed worker in this country. Once the labor market begins deteriorating (and history tells us that once it begins, it’s tough to contain), the Fed will come under immense political pressure to not cast aside its employment mandate with the US November Midterm elections looming. Notably, after the September meeting, many US politicians publicly condemned the Fed’s actions. Of its own making, the Fed has a very dubious balancing act ahead of it. We are less confident that it will be able to navigate a “soft landing” of the US economy than we were a quarter ago.

Currently, we assign the following subjective probabilities of a recession in the US over the next several months: 50% chance of a mild recession, 40% chance of no recession or “soft landing” engineered by the Fed, and, finally, 10% probability

of a severe recession. Each of these outcomes has different implications for asset prices. We will now turn to these scenarios.

Market Outlook: Fed Dependent

Markets should remain volatile with heightened degrees of uncertainty due to the forward path of Fed monetary policy and the ongoing war in Ukraine. **Until we get a sustained downtick in inflation figures, it is difficult to envision a Fed pause, much less a pivot. A rapid weakening in the labor market would likely also trigger a Fed shift.** If economic data continues to deteriorate and the market falls, the Fed will respond, especially in an election year. It is worth noting that most major equity and bond markets are already down over 20%, investor pessimism is historically high, and positioning is very bearish as well. This will provide some support to markets, which have largely already priced in a recession. As we noted during our call last quarter, the median drop in the S&P 500 during recessions dating back seven decades is -24%. That

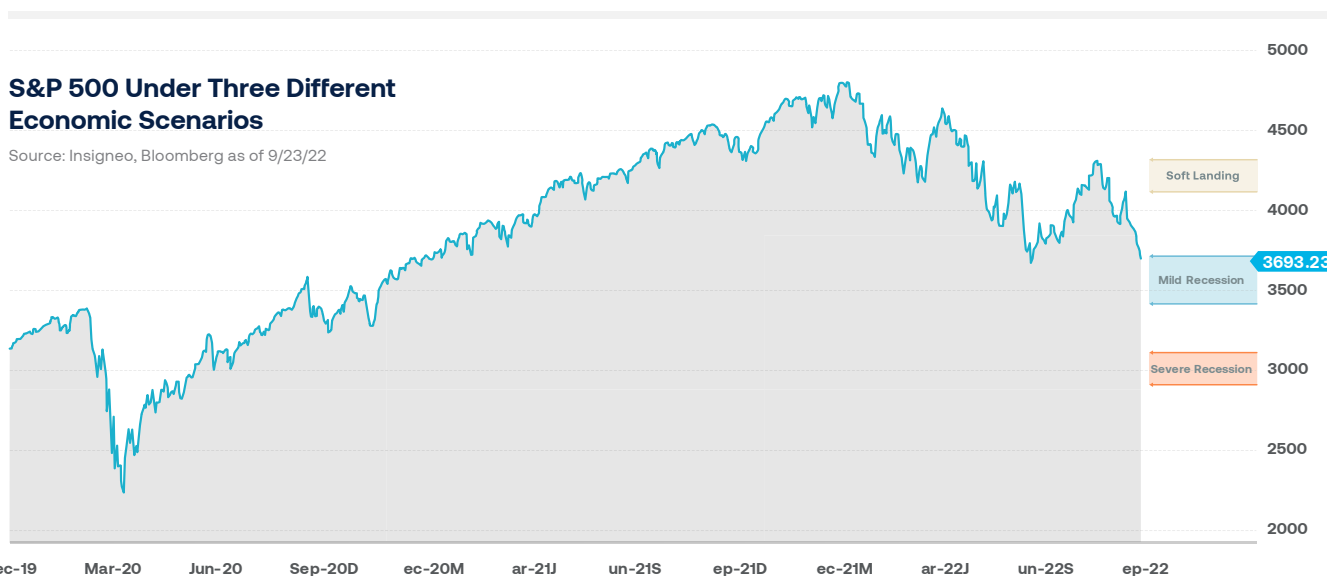
means that markets have largely priced in the median market drop for a recession back in June and now as we approach the final quarter of the year.

First, let us begin by defining a “mild” vs “severe” recession. A mild recession would be an increase in the unemployment rate to around 5%; a severe one would necessitate an unemployment rate of 6% or higher. Each of these labor market moves implies a certain degree of contraction in earnings per share estimates. If we avoid a recession altogether it means that this will just be a typical mid-cycle slowdown and soft landing induced by a Fed deftly raising rates just enough to cool the economy while not causing outright, sustained contractions in economic activity. However, it will keep the specter of the Fed overhanging markets for fear that it may not be able to back off rates any time soon.

In this benign scenario (40% chance in our view), the S&P 500 could rally into the year-end with a target range of 4100 to 4300. The 10-year bond would likely trade between 3.6% and 3.9% and the unemployment rate would remain relatively stable, perhaps creeping up by 20 to 30 bps. In the mild recession

scenario (50% chance in our rubric), the market will just muddle along its current trajectory with a target range of 3400 to 3700; the 10-year Treasury’s yield will also moderate, and we could expect a range of 3.2% to 3.6%. Under the more nefarious potential outcome, a severe recession (10% probability, in our view), the S&P 500 would likely trade in a range of 2900 to 3100 and the 10-year bond’s yield would fall to below 3.2% as the market would quickly reprice Fed rate cuts in 2023.

All of our scenarios leave the market negative for the year, and well below the January 3rd peak of 4796. Under a soft landing, the US equity market will end the year around 12% below the high; under a mild recession, it would be around 26% below, remarkably close to the median drop for recessions in the post-world war era. In the case of a severe recession, the market would end the year roughly 37% below the peak, and near the average drop for markets during such periods. There are two tail risks we need to consider, one on the left and one on the right. Left-tail risk largely stems from the Ukrainian war which is still unresolved and further from an outcome than ever. Our view is that Putin will seek to escalate the war



before contemplating a negotiated settlement as military defeat on the battlefield is simply not congruent with his regime's survival. Any escalation that involves tactical or strategic nuclear weapons and/or fighting beyond the borders of Ukraine could invite a NATO response. This outcome would likely only see gold, agricultural and energy commodities, and the US Dollar rally. Every other financial asset would suffer. On the other hand, right-tail risk stems from a precipitous fall in inflation outside of a recession. Markets could rally sharply in this instance and possibly even break above the 4300 ceiling that proved to be strong resistance back in August.

Putting it all together, and given current levels as of end of September, we remain neutral duration after the recent repricing in yields but will look to extend duration if and when the Fed pivots. On the equity side, continued caution is warranted with emphasis on Value, Quality, and High-dividend payers given the market environment. On the credit side, risk will remain contained even under a mild recessionary scenario. Only a severe downturn, should cause spreads to widen significantly from here. On the currency side, US interest rate differentials and lingering vulnerabilities in Europe should keep the US Dollar supported, but a word of caution here.

The Greenback is particularly expensive and over-bought. The only scenario where we see the US Dollar higher from here in 6 to 12 months is in a severe global recession and/or a global world war. On the other hand, the Euro is unbelievably cheap, and we expect it to be higher over that timeframe as well. Continue owning large swaths of the commodity complex as hedges – agricultural and energy ones for geopolitical risk and industrial metals on supply side concerns.

On the bright side for longer-term investors, the terrible market performance this year has significantly improved future returns. For one, bond markets are

no longer in negative territory in most places around the world as they were to start the year. US fixed income now look poised to return between 4 and 5% per annum over the next ten years and the S&P 500 between 6% and 7% per year over the decade. That means that a classic, balanced 60/40 portfolio should return between 5% to 5.5% per year; that is 2% to 2.5% more per year than we projected back in December 2021.

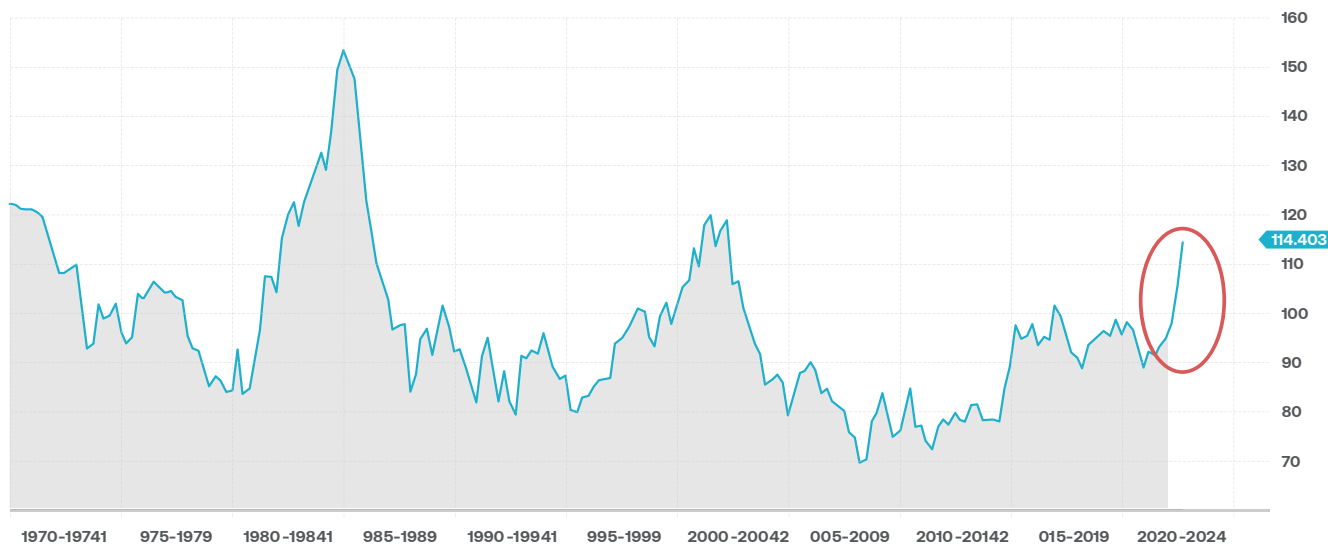
— “The only scenario where we see the **US Dollar higher** from here in 6 to 12 months is in a severe **global recession and/or a global world war.**”

We would also favor global equities over US equities given stretched US outperformance year-to-date and a stretched US Dollar. Our view on the structural bull market in commodities has not changed. In fact, commodities remain our preferred way to hedge for inflation and global conflict, two trends that we believe show no signs of abating any time soon.

How High Can the Dollar Go?

The best performing major asset over the past year has been, undoubtedly, the US Dollar. The US Dollar Index, the DXY, indicates the general international value of the US Dollar by averaging the exchange rates against major world currencies using rates supplied by almost 500 banks around the world. In the past year, it is up 20%. As one can see in this chart, the Dollar has gone parabolic. The only points on the graph with a higher slope (i.e., a faster ramp up) in the currency

US dollar Index: Two standard deviation move in the Dollar

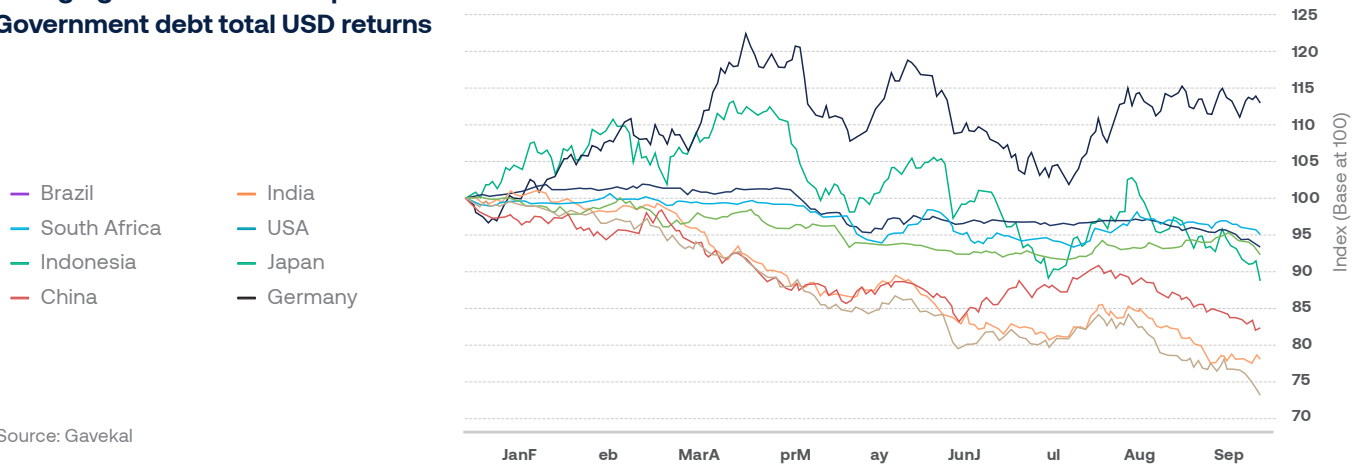


Source: Bloomberg as of 9/27/22

occurred right before the 1985 Plaza accords where the French, West Germans, Japanese, British, and Americans decided collectively to depreciate the US Dollar versus the Franc, Deutsche Mark, Yen, and Sterling by intervening in currency markets. The Dollar’s appreciation today is a factor of the rapid tightening of financial conditions engineered by the Fed, but it is also caused by the phenomenon known as TINA (“There is no other alternative”). Europe is in shambles due to energy rationing, China is still suffering from partial lockdowns under its “zero tolerance” Covid policy, the British are trying their best to inspire as little confidence as possible in their fiscal responsibilities, and the Japanese are still engaged in a policy of yield curve control. For all its missteps, the US Dollar is still the “cleanest dirty shirt” around, so people are getting their hands on as many as they can. Regrettably, a stronger US dollar is the last thing the world needs right now as many nations are grappling with higher energy and food costs. Although it has fared better than other major currencies, even the Chinese Renminbi has fallen by more than -5% against the Dollar since

mid-August, an unusual move by a managed currency. After having gone parabolic, the Dollar’s valuation now looks stretched, much as it did the last few times it made these types of moves. However, the drivers of this strength are not yet exhausted, and we expect it to become even more expensive over the coming quarter. The hawkish US central bank has now made it the highest yielding reserve currency, which means that demand for Dollars will stay strong. It is true that Russia and China are forming a substantial anti-Dollar bloc, but that process is a long one and its consequences are more likely to be pro-Renminbi than anti-Dollar, as the latter is in no imminent danger of losing its reserve currency status. **As the Dollar continues to rise, the best trade is to remain on the sidelines in cash or ultra-short US Treasury bills. However, the Dollar’s reckoning is likely to come when inflation finally rolls over.** If the US enters a recession within the next 6 to 12 months as we are currently predicting, that will surely bring inflation down, causing the Fed to pivot, US bond yields to drop, and the Dollar should fall alongside. Inflation always falls during a recession

**Emerging Market Bond Outperformance:
Government debt total USD returns**



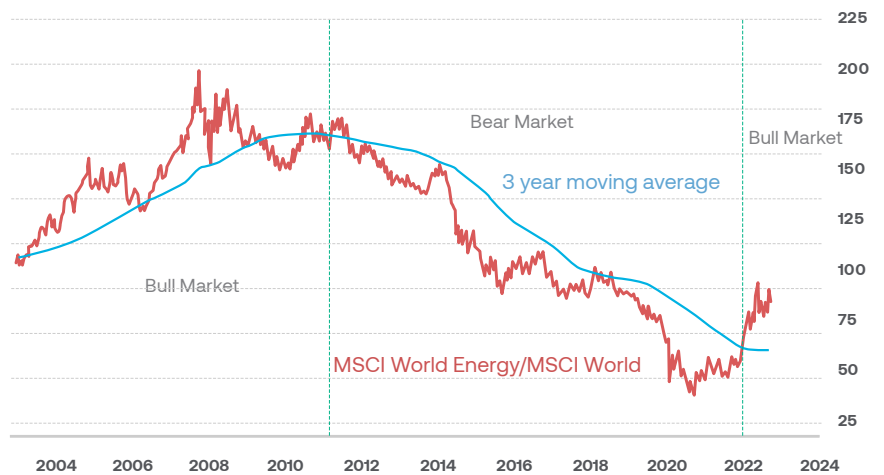
Source: Gavekal

– that was true even in the stagflation era of the late 1970s/early 1980s. So, which asset classes would be the biggest beneficiaries of a Fed-led Dollar fall? In our view, the biggest beneficiaries would be emerging market equities, emerging market local currency debt, energy, and other commodities. These assets have held up really well despite the Dollar’s strength. [Graph #9] This graph shows the outperformance of emerging market USD-denominated debt versus many developed market counterparts despite the 20% YoY appreciation of the Dollar. How much better will they

perform in an environment where the US Dollar is falling? The recent weakness in gold and energy is partly due to Dollar strength as they are priced in the currency. The bullish trend in energy, for example, should reassert itself once the Dollar cools as the structural case for supply-deficient energy markets reasserts itself. We expect oil to retest and eventually breakthrough the \$100 level again by early next year, if not sooner.

As this next chart shows, the 3-year moving average

**New Bull Market in Energy?
Energy equities vs. global equities**



Source: Gavekal

of global energy stocks versus global stocks finally turned positive this year, implying the beginning of a new bull market in energy stocks after a 12-year bear market. Energy stocks are still cheap and still under-owned by investors worldwide.

Scarcity & Innovation: Europe’s Answer to a Crisis

What Insigneo Quarterly would be complete without a thousand-year chart that we believe is relevant today? Well, it is coming, but first I want to highlight a few rules deeply embedded in our collective human history. One of the most repeated lessons from this history is that scarcity leads to innovation. Incidentally, the corollary to this principle is that hubris leads to downfall – just ask Putin how his ill-advised and ill-planned invasion of Ukraine is going. Another important teaching is that political and macroeconomic systems are very complex. And people tend to focus only on the first

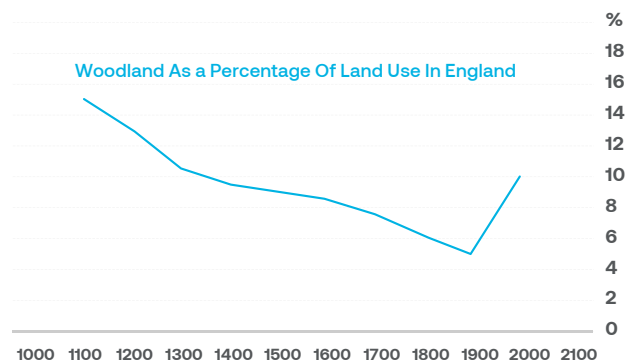
— “the English went from a state of a permanent energy crisis to one of energy abundance much sooner than any other place.”

order effects of policy and decision-making. But it is usually the second, and even third, order effects that are most important and least accounted for, the ones least priced-in by markets.

With these ideas in tow, let us take a closer look at the Industrial Revolution, one of the seminal transformative events in history. It is accurate to assert that this period was as important to humanity as the adoption of agriculture in terms of progress. So, we all know very well that the Industrial Revolution began in England

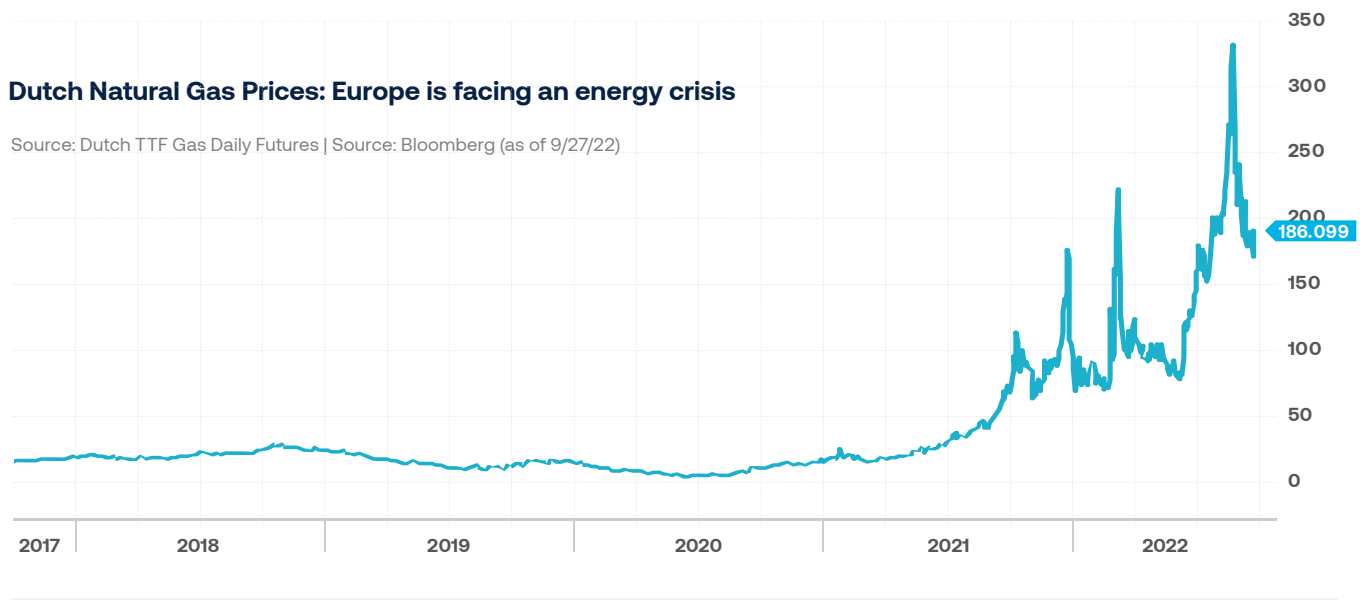
during the late 18th and early 19th century. But why did it begin there and not, say, in Spain or France that had similar technological advancement? And why during that time period? Well, as promised, this thousand-year chart offers some clues. As it shows us, woodland as a percentage of land use fell continuously in England from about 1100 AD to right before the commencement of the Industrial Revolution. By deforesting their own island, the English were running

Scarcity in England: England’s timber was disappearing before the onset of the Industrial Revolution



Source: Forestry Commission, 2001. National Inventory of Woodland and Trees. National Forest Inventory (2011); Clocktower

out trees. And trees were very important back then because they were the main source of fuel. England, we have a problem. In response, the English began importing trees from the Baltic regions, where there was a surplus of timber. But this trade was regularly interrupted by the Danes and the Swedes. This meant that the English were constantly dealing with a major problem for any economy – fuel scarcity. Well, this energy crisis – scarcity – led to innovation: the English were the first to experiment with coal as a source of energy. Necessity is the mother of invention. It turns out that coal is a more efficient as a source of energy than timber – 26K BTUs per ton for coal versus 14K



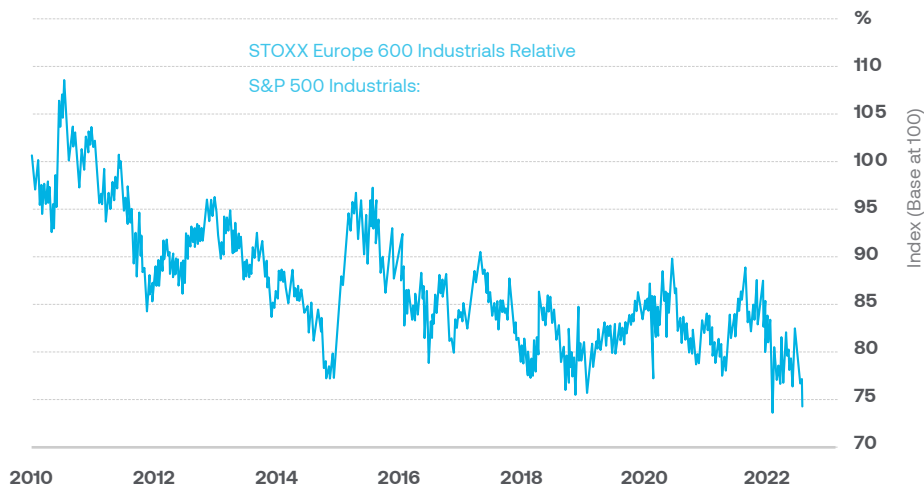
BTUs per ton for wood. Because of innovation born out of necessity, the English went from a state of a permanent energy crisis to one of energy abundance much sooner than any other place. One other feature of coal is that it is much heavier than timber. This means that the English also had to develop canals and other transportation systems that could move the coal from where it was dug up to where it could be transformed into usable fuel. Scarcity led to innovation which led to the Industrial Revolution which led to the British Empire dominating the world for over a century. So, let us return to the present and long-term forecasting. Who could be the big winner of the next decade? No one today would say Europe. Everyone is short the Euro, short European Industrial Stocks, etc. If you have a six-month time horizon, if you are a trader, a short-term investor, then that is the probably the appropriate risk stance. This chart shows Dutch natural gas from the generic futures contract prices. Since 2021, they have skyrocketed, punctuated with dramatic upward shifts every time Russia makes a major move or threatens another escalation. Europe is in the throes of a major energy crisis – largely of its own making, by the way. But if you are long-term investor, is that the appropriate stance? I would say no. Let me explain why. Despite the fact that over the past decade European

industrial companies pay a 30% to 50% premium for electricity use over their American counterparts (that cost premium today is close to 100%), their export share of global exports has remained largely in line over that same time period. That means that over the past decade, American companies have wasted their electricity cost advantage versus their European competitors by not

– “English also had to develop canals and other transportation systems that could move the coal from where it was dug up to where it could be transformed into usable fuel.”

taking market share from them. Another way to state is that higher European energy input costs have not decreased their competitiveness. Moreover, as the US exports more liquified natural gas to Europe and uses less for domestic consumption due to higher prices abroad, European and American liquified natural

European Industrials vs. American Industrials



Source: Macrobond, rebased to 100 at 1/1/10

gas prices will converge – European gas prices will fall, and US prices will rise. This should reduce the energy advantage that US companies currently enjoy over their European counterparts. Finally, Europe leads the world in renewable energy use. 30% of European energy consumption comes from renewables versus 19% for the US and 18% for the world. It will probably continue to innovate on renewable energy precisely because of its energy scarcity problem. It has to, it's a matter of survival. Think about it, where is the next big breakthrough in energy likely to come from? A place where energy is abundant and cheap like the US or the Middle East? Or a place where it is scarce and expensive like Europe? Again, necessity is the mother of invention.

My bet would be that it is in Europe where that breakthrough will materialize. Remember the medieval English and their problem of energy security.

As a long-term investor, how do you deploy this trade? You buy the European Industrial sector. This graph shows you the performance of European industrial companies versus their American counterparts. As you can observe, American industrial stocks have greatly

— “30% of European energy consumption comes from renewables versus 19% for the US and 18% for the world. It will probably continue to innovate on renewable energy precisely because of its energy scarcity problem. It has to, it's a matter of survival.”

outperformed over the past 12 years. The smart bet is that this trend will not continue. Either because European electricity costs will come down as the US exports more natural gas to Europe, or because Europe innovates faster and better, or both that trend should reverse. The only way this trend does not reverse is if Europe does not innovate its way out of its scarcity problem. That is a bet that goes against the grain of human history. It is not one anyone should make. For long-term investors, European industrial companies are a good bet.



Melissa Ochoa Cárdenas
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Insigneo Financial Group

The light at the end of the tunnel – investing outlook for Latam

As we have said several times, 2022 has been a daunting year across markets and regions for investors and market professionals alike. Amid an unexpected conflict between Russia and Ukraine, supply chain shocks that have placed additional inflation pressures worldwide, and the removal of monetary policy stimulus on the back of growing global recession fears, investors’ preference in terms of asset allocation has been tilted towards less risky, safe haven kind of assets. Latin America has not been immune from global de-risking despite some pockets of outperformance scattered through the region. For the rest, the question becomes, “are we approaching the proverbial light at the end of the tunnel?” Or are attractive investment entry points still far off?

First, let us set the macroeconomic groundwork. Part of the daunting environment that Latam is facing right now is tightly correlated with the unrelenting increase in both observed and expected inflation measures across the region, which in turn has forced Central Banks to implement an earlier, more aggressive tightening in their monetary policy than what other authorities have done throughout the year. At the time of this writing, this is the case for Chile (675bps), Colombia (700bps), and Brazil (450bps), which have displayed a more aggressive stance than Peru (425bps) or Mexico (375bps), all on the back of fears of unmooring inflation expectations and while trying to channel inflation back to its desired course. Nonetheless, some analysts are starting to pencil in the possibility of the tightening cycle being close to ending in countries like Brazil and Peru. On the contrary, inflation is expected to continue to climb in Mexico, Colombia, and Chile, where the need for additional monetary policy increases will be urgent. Central Banks will most likely wait for signals that inflation expectations have stabilized to cut rates.

— “Forced Central Banks to implement an earlier, more aggressive tightening in their monetary policy”

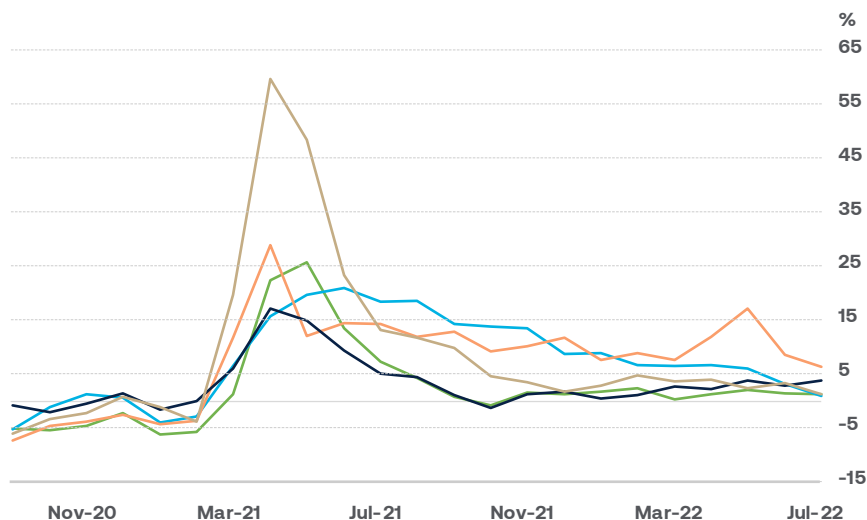
Moreover, while economic growth has remained relatively benign this year, there is some uncertainty as to whether that resiliency will persist next year. In fact, 2023 is a year where Latin America may be feeling the delayed effects of higher inflation and tighter monetary policy more acutely. Even if some countries should continue to have an outperformance vs. their peers, the deceleration of some Latin American economies is starting to appear: As this chart shows, Mexico started slowing down in June while Peru’s growth

Activity in Latam has been losing steam

— Brazil
— Chile
— Colombia
— Peru
— Mexico

Depicted are Mexico's IGAE, Chile's IMACEC, Colombia's ISE, Brazil's IBC - Br, and Peru's National Production Index

Source: Bloomberg. Data as of July 2022



decreased in July, as did Colombia’s and Chile’s. However, Brazil is an outlier here. Its Brazil’s figures continue to point toward stronger growth throughout the year, with support coming from an influx of social transfers and a recovery of consumer purchasing power.

Activity in Latam has been losing steam

Meanwhile, current account deficits remain weak in some countries. This challenging environment again stresses the importance of FDI flows and the interest of international investors in the local debt market of Latam.

There are some cases, like the Mexican one, where the country has seen record levels of FDI flows during 1H22. These flows reflect the effects of two significant operations of specific companies, as well as the dynamism of the manufacturing sector. Nonetheless, the Economist Intelligence Unit – EIU – expects these FDI flows to find constraints in the upcoming months,

“mainly owing to creeping concerns about contract rights under the government led by Andrés Manuel López Obrador.”. Meanwhile, Mexico has lingering political uncertainty stemming from the congressional approval of its 2023 budget; this proposal is still being discussed by the Congress, and it includes a relevant increase for social expenditure equivalent to 3.6% of GDP. These new resources are expected to be allocated to investment-related spending, such as the “Tren Maya” and the Dos Bocas Refinery.

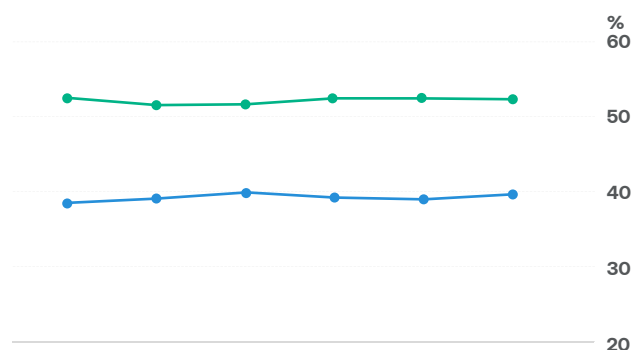
Another positive example of FDI inflows is Colombia, where FDI recovered to reach USD 4.77bn in Q2 22, after displaying a relevant outflow between 2019 and 2020, according to BanRep figures. Moreover, in the Colombian case, it is relevant to stress that international investors continue to be protagonists of the local debt market, where they have bought COP 20.43tn of local debt YTD.

Turning to the political climate in the region, even if it is more left-leaning now than it was a year before, 2022 has brought clarity to the political landscape in Latin America. As the year closes in, the only uncertainty that remains is Brazil and its presidential elections. In this regard, and at the time of this writing, leftist candidate

Lula continues to lead in the polls, even if his margin has narrowed slightly in the past weeks, according to the latest polls compiled by the EIU.

Both investors and analysts will be monitoring how each of the remaining candidates will address the challenging fiscal backdrop that Brazil currently faces. Specifically, whether they would implement chang-

Voting intentions for president in a runoff election



Source: Datafolha

es to the existing spending cap and whether either candidate would maintain the tax cuts expected to be reversed in 2023. The fiscal uncertainty was even mentioned in the Copom’s last meeting, where the Committee decided to implement the first pause to its hiking cycle while recognizing that the uncertainty about the country’s fiscal framework and potential additional fiscal stimuli as inflationary risks.

Elsewhere, Chile rejected the draft of its new Constitution, and now the country is embarking on a long, tortuous process to present a new alternative. The market took the plebiscite results as a positive development, and most analysts expect the new Constitutional Convention to include a more consensual approach with less left-leaning representation. This,

in turn, could potentially open the door for a more moderated version of the text voted on September 4 to be implemented as the new Constitution, which many believe would benefit both market participants and some parts of the corporate sector. Additionally, some analysts consider that the government may try to implement a more moderate and gradual agenda, which could help ease the negotiations between the Executive and the Legislative when considering that the government coalition does not hold congressional majorities.

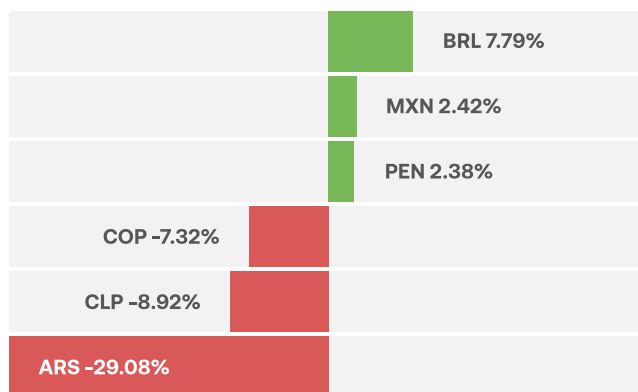
Meanwhile, Argentina is next in line regarding presidential elections, which will take place on October 2023, and where the current government would likely have to hand over power to the opposition. Moreover, talks with the IMF continue to outline the country’s future, more so after the IMF announced a staff agreement under the extended fund facility. This agreement would grant Argentina access to ~USD 3.9bn which the government will probably use to repay the debt that Argentina already has with the IMF. However, this decision does not mean that the macroeconomic backdrop looks less daunting for the country, considering that inflation remains uncontrolled, even if the government and the central bank continue to carry out measures to tame it, which in turn has undermined governability and makes the implementation of a tighter monetary policy a challenging task.

Moreover, Peru continues to experience political instability. On that note, the EIU expects that Congress will remove President Castillo from office and that the next general election will occur before its scheduled time in April 2026. This uncertainty bodes ill for future and current investment in the country, a fact that is visible through investors exiting their positions in PEN-denominated debt: according to the latest quarterly inflation report by the Peruvian Central Bank, international investors reduced their local debt stock in PEN 1.3bn during the quarter, and now hold 45% of the amount outstanding. This is compared to a year

earlier, when international investors accounted for 51% of the debt holdings. Now that we have surveyed the macro landscape, let us consider the accompanying market environment.

From the currency side, so far, those countries with political changes have been most affected in terms of currency depreciation. The exception here is Peru, where the PEN, instead of depreciating, has appreciated amid a challenging backdrop. This FX devaluation bodes ill for the current account deficits, making their funding more challenging.

Politics and a strong USD take a toll on Latam currencies



Source: Bloomberg. Data as of September 29, 2022

In the fixed income realm, it is worth highlighting that, according to the Bloomberg Barclays USD fixed income indices, Latam has been one of the best performers YTD. Even if some pain is expected due to the monetary policy normalization process currently underway across the world, the attractive rates that Latam fixed income is offering could tilt the balance towards additional investment flows coming to the region.

In sum, we believe that the investment outlook is relatively mixed. The grim outlook for inflation will

continue to force the hand of several Latam central banks in terms of tightening which, combined with a more hawkish stance from the developed world, will most probably imply that monetary policy rates will remain in restrictive territory for longer than what was initially expected. Furthermore, central banks have increased their data-dependent stance, highlighting the possibility of continuing with their rate hikes if inflation does not fall as quickly as expected.

This more restrictive environment in terms of monetary policy will dent growth for 2023, with several analysts having reduced their GDP forecasts for the upcoming year. Thus, the probability that Latam central banks will start easing their monetary policy before other regions do is relatively high, which would benefit government and corporate bonds from the shorter end of the local curves. Furthermore, if the USD remains high for the remainder of 2022, the rates that international investors would be able to secure in local fixed income markets in Latam seem more attractive than its peers in international markets. This is highly contingent on the US not experiencing a hard landing, making investors more risk-averse, and the interest for safe havens would spike again. Additionally, the risk perception in the region is another factor to consider, given that the 5-year CDS of the region have increased constantly during the year and that rating downgrades, like the Chilean one, could follow suit.

Even if we recognize that Latam assets are looking cheap, our final word would be one of caution. We have seen too many unprecedented events develop throughout 2022 that have been unkind to the region. Will next year do the same? Perhaps, but this does not mean that investors with the appropriate level of risk tolerance should not be exposed to the region. Latam has always been able to get back on its feet after previous crises, relying on strong macroeconomic fundamentals and its capacity to see the light at the end of the tunnel – even if reaching it requires additional effort. ■

House Views Matrix

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

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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