Second quarter 2022
Date of report: 31 March 2022

Quarterly Report

Our view on the markets

INDEX

2 Macroeconomic View
3 Fixed Income
4 Equities
5 Commodities and Currencies
6 Latin America

Inflation

Much volatility is in store for the financial markets, generated not so much by the conflict in Ukraine, but by the resurgence of inflation and central banks' attempt to curb it.

Strange times we are living in. Just when we seem to be emerging from a global pandemic, we watch in astonishment as Ukraine is invaded. Aside from the obvious condemnation of violence and deeply deploring the suffering to which the population is subjected, as regards the financial markets—our overall focus in these texts—the handbook tells us we should put the war's importance into perspective. Investors tend to turn the page swiftly when it comes to geopolitical events. It is hard to recall events of this nature in the past that have caused significant downturns, either in duration or quantity.

This time, however, we believe the turbulence will be more prolonged. This is not because the Russian aggression does not have long-term consequences—it does. We seem to be returning once again to the bloc economy, to soaring arms spending and to a further regression of globalisation, which has brought us so many benefits in recent decades. But this is not incompatible with good returns on financial assets, as evidenced by various periods between the end of the Second World War and the fall of the Berlin Wall. Nor should we forget that the starting point, at the macro level, was excellent, with unemployment rates at record lows and great eagerness to get out of the house and spend what we saved during the pandemic.

The problem lies in the fact that the invasion is adding fuel to an already raging inflationary fire, which central banks have sought to play down for too long. Both Ukraine and Russia are major producers of a long list of commodities, the most obvious being wheat and oil. Triple-digit crude oil along with the Old Continent's dependence on Russian gas have emerged just as inflation practically the world over reached levels not seen in decades. To top it all off, China is tackling Omicron outbreaks with severe lockdowns, which disrupt (yet further) the damaged global supply chains. More inflation.

Central banks now face a difficult mission: withdraw clearly excessive stimulus without slowing the economy too much. History does not give us much cause for optimism. They have only managed it three times since 1945, and on none of those three occasions were they battling high inflation. They cannot put their faith in the end of the war or the end of the pandemic in China. Both will happen, but restoring normality will be slow and sanctions against Russia will remain. Moreover, the economy may prove to be less robust, as price increases are broad-based and eat into people's disposable income.

Given all that, the most likely outcome is that the withdrawal of central bank liquidity will lead to increased market volatility. There is nothing wrong with that, especially for long-term investors with portfolios that can take advantage of better prices. Volatility, with patience, is opportunity. Whatever the immediate course of events, better times will come. And we must not forget that inflation is a destroyer of savings, so not investing does not seem like a smart solution at all.

David Macià, CFA
CAAM Investment Director

Strategy

Asset allocation (2022 Q2)

Monetary	↑
Fixed Income	→
Equities	↓

Fixed Income

GOVERNMENT	
USA	↓
Eurozone	→
INVESTMENT GRADE	
USA	→
Eurozone	→
HIGH YIELD	
USA	→
Eurozone	→
EMERGING MARKETS	→

Equities

USA	→
Eurozone	→
Japan	↑
Emerging Markets	→

Commodities

Oil	→
Gold	→

Currencies

EUR/USD	→
JPY/USD	↑

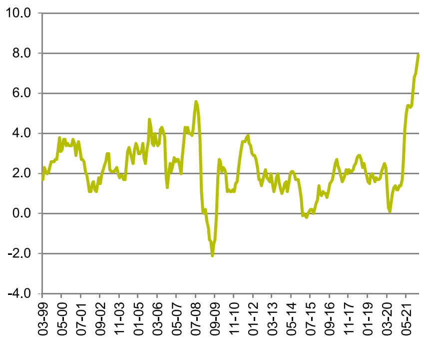
Macroeconomic View

Euro zone CPI

Source: Bloomberg

March consumer prices surged to 7.5% from a year ago.

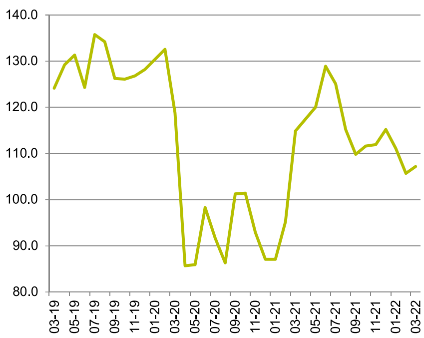
CPI in the US



Source: Bloomberg

In march, headline CPI rose 7.9% from a year earlier in the US.

US Consumer Confidence



Source: Bloomberg

In March, US consumer confidence slumped to its lowest level since the early months of the pandemic.

War in Ukraine hits global growth

At the start of this year, we were expecting above-trend growth and decelerating inflation as economies around the world dropped COVID restrictions and temporary price pressures due to the pandemic eased. However, the Russian invasion of Ukraine and consequent sanctions on Russia have dramatically altered this outlook.

The short-term economic consequences of the war are evident. As well as being the dominant supplier of gas to Europe, Russia is one of the world's largest oil producers and a key supplier of industrial metals such as nickel, aluminium and palladium. Both Russia and Ukraine are major wheat exporters, while Russia and Belarus are also important exporters of potash, a fertiliser input. The prices of these commodities have skyrocketed, exacerbating already high inflation rates. During 2021, the pandemic was at the heart of rising inflation due to pent-up demand, supply disruptions and labour shortages but before the conflict started, most economists expected prices to come down during 2022 as some of the temporary pressures were reversed. However, the Russian invasion of Ukraine has deeply changed the game. Euro-zone inflation rose to a new all-time high in March as the conflict roiled global supply chains and drove already soring energy costs even higher. March consumer prices surged to 7.5% from a year ago, up from 5.9% in February and more than the 6.7% median estimate. The core gauge excluding volatile components, such as energy and food inflation, also hit a new record showing the increasingly broad nature of the advance. EU countries depend on Russia for 40% of their natural gas, 35% of crude oil and 47% of coal. Germany is by far the biggest EU spender on Russian oil, gas and coal; it gets 55% of its natural gas, 52% of its hard coal and 34% of its oil from Russia.

An abrupt cut-off would cause an industrial shutdown and recession in Germany, Italy and much of Central Europe

The conflict has highlighted Europe's vulnerability and puts into question the transition to clean energies as natural gas was a big part of the solution. With inflation rates hitting 8-9% in the coming months, European consumers are set for a significant erosion of disposable income. In March, Euro-area consumer confidence slumped to its lowest level since the early months of the pandemic. Although European governments could soften the burden with a targeted fiscal response, growth for the region will have to be revised down.

The US, on the other hand, is self-sufficient in energy and a major producer of many of the commodities that are surging. Even so, the impact on inflation is being felt and headline CPI rose 7.9% from a year earlier, while the core index rose 6.4%. Households have $2.6 trillion in excess savings built up during the pandemic that will help mitigate the negative impact of higher prices on consumer sentiment and spending in 2022. The distribution is uneven, with lower-income households and the unemployed having already dipped into their savings, while high-earners—where services make up a larger share of the consumption basket—have experienced an increase in wealth. In the coming quarters, they will likely increase their spending after two years of COVID restrictions despite the pressures from higher inflation.

Future growth and inflation rates will greatly depend on how the conflict and sanctions on Russia evolve from here. However, it is evident that the war will have long-lasting consequences on the global economy, accentuating the deglobalisation trend already initiated by the pandemic.

Jadwiga Kitovitz, CFA
Head of Multi-Asset Management and Institutional Accounts

Fixed Income

Towards a new normal

We started the year with Federal Reserve Chair Jerome Powell and his colleagues convinced of ending the ultra-loose monetary policy and having accommodative financial conditions at more normal levels. The conflict in Ukraine, in addition to the tragedy it entails. has put the supply of raw materials at risk, further exacerbating the inflationary spiral.

The great challenge for the market will be how to react as rates rise after years of being anaesthetised by excess liquidity, and the main issue is where the neutral rate—which neither restricts nor stimulates growth—is set. This is the difficult and primary job of central banks. Getting it right will be crucial to ensuring economic growth is not derailed. There is much talk about rate hikes, but we will also have to watch the pace of balance sheet reduction, as this will also affect bond prices.

We are seeing two main blocks in terms of central banks. On the one hand, the group led by the Federal Reserve, the Bank of England and the ECB with the first two having already started hiking rates and the ECB showing this intention in its actions. And on the other, the PBOC, which is continuing with QE, and the Bank of Japan, which is continuing with its curve control policy, increasing bond purchases. This suggests that excess liquidity will continue globally, although clearly not at the levels of previous years. That is the new normal.

The great challenge for the market will be how to react as rates rise and the main issue is where the neutral rate is set

Interest rates have been rising this year and this variable has been the main detractor in fixed income. The prospect of aggressive Fed action in the face of rising global inflation and tightening labour markets has pushed the benchmark 10-year Treasury note to 2.6%, levels not seen since 2018. The 2-year is already discounting up to almost 10x hikes by the Fed and stands at 2.55%. This is where discussion of the curve of concern comes in: the 10-2-year spread. An inverted curve may indicate economic recession in the near future, as has happened in the past. Is this time different? Normally the inverted curve is accompanied by a negative term spread. How is that term spread calculated? The Fed suggests the "near-term forward spread", which looks at the difference in yield between the current 3-month Treasury bill and its expected yield six quarters from now. When the current yield is higher than implicit future yield, a recession may be imminent, and this is not the case currently.

In terms of credit spreads, the widening we have seen has been mainly due to the conflict in Ukraine and the tone of assets in the short term will depend on how events unfold. As soon as the market sensed slight progress in the resolution of the conflict, it compressed spreads again. We think that corporate bonds have become more attractive after the widening of the spreads and, unlike other periods, years of low financing rates, fiscal stimuli and rebounding economies have strengthened corporate balance sheets and companies are better prepared to face the current environment.

All in all, during the first quarter bonds continued to sell off on the rising inflation data and government bond yields reached the levels that were expected by the end of the year, the run being made in just one quarter. This largely explains the fall in bond prices in the first quarter of the year.

Higher bond yields allow us to buy bonds at more attractive levels and increase the positive carry of the portfolio as a whole. This variable is increasingly important in return attribution, after years of negative yields, and acts as a buffer against market fluctuations. Further interest rate increases will depend largely on inflation developments and, in order for inflation to fade, the conflict in Ukraine, the evolution of commodities prices and distribution channel problems need to improve. This will lead to greater stability in fixed income.

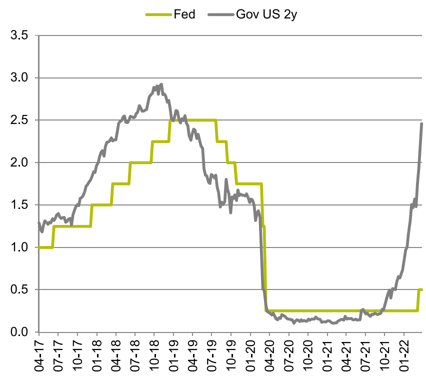
Josep Maria Pon, CIIA
Head of Fixed Income and Monetary Assets

10-2 year Treasury

Source: Bloomberg

Evolution of the 10-2 year Treasury yield spread.

Fed vs 2-year Treasury

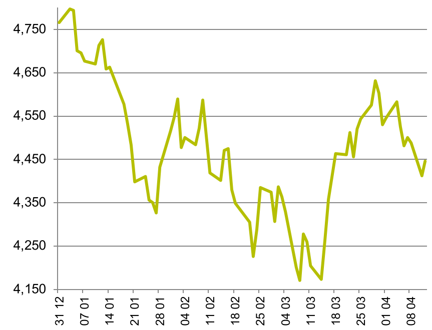


Source: Bloomberg

The Federal Reserve has increased rates by just 25 bp this year, but the 2-year Treasury has already discounted a complete tightening cycle.

Equities

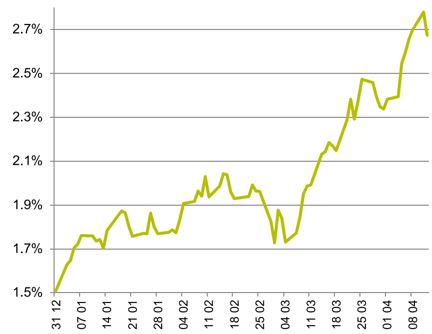
S&P 500 2022 YTD



Source: Bloomberg

Several headwinds have made it a choppy year for the S&P 500.

Yield of US 10 year Treasury



Source: Bloomberg

The increase in rates have shocked many investors.

The Fed, energy prices and Russia

In case you haven't been following the market lately, interest rates are much higher, consumer confidence is weak, energy and food prices have spiked, and there is a war on the European continent.

In my last report, I mused that the writing was on the wall for a tougher market environment in 2022 vis a vis 2021 due to a more hawkish Fed and decelerating earnings growth. I also highlighted the surprisingly rapid rise in long term rates as the yield of the US 10-year Treasury went from 1.51% to 1.80%. If only what we were seeing in January were the extent of the market's problems. Of course, that was before Russia invaded Ukraine, WTI crude oil reached $130 per barrel and the yield on the 10 year Treasury surpassed 2.75% while the curve inverted!

Regarding the invasion of Ukraine in late February, the conflict has driven up costs for food, fertilizer, energy, industrial metals and created a refugee crisis in Europe. Ukraine produces 13% of the world's calories and it is uncertain that they will be able to have a spring planting season anywhere near previous levels. It is already being estimated that 70% of Ukraine's wheat production could be at risk. Meanwhile, Russia is the largest provider of energy to Europe and this heavy reliance has come under enormous scrutiny as many European nations look toward alternative sources.

> "People really don't believe in words."
> Volodymyr Zelensky, president of Ukraine

Aside from the invasion, Covid stubbornly refuses to go away. This has lead to a series of draconian lock-downs among major Chinese cities which has further stressed already problematic supply chains.

Consumer confidence is slumping in the face of 40 year high inflation rates. In fact, the most recent 12 month readout of the PPI (Producer Price Index) hit 10.0% while the CPI (Consumer Price Index) came in at 7.9%. The Fed has been forced to take notice of the rather dire situation and has doubled down on its recently acquired hawkishness. Just last week, Fed Governor Lael Brainard indicated that the Fed is looking to shrink its balance sheet considerably more rapidly than in the previous recovery. This was confirmed by the latest FOMC minutes which talked about reducing the balance sheet by $95 billion per month ($60 billion for Treasury securities and about $35 billion for agency mortgage backed securities). Not surprisingly, the rise in rates has already begun to impact the consumer as can be seen in mortgage rates. After spending most of the last 2 years below 3%, mortgage rates in the US are now at 5.25% for the first time since 2011. This is further affecting the affordability of housing.

Granted there could be a significant rally in the market if the Russian invasion of Ukraine comes to negotiated ending. The consumer will see some instant relief in the form of lower energy prices and maybe total inflation will be a bit less pressured. Even if we were to get the best-case scenario, the road ahead for the stock market this year still won't be an easy one.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Empty shelves and commodities

What the pandemic did not manage, the conflict in Ukraine certainly can: empty supermarket shelves as the latest consequence of the soaring price of some commodities.

Much has been said of Russia's role as the world's supplier of oil and gas, but its status as a key agricultural producer also means there is a real risk of food shortages in the future.

Russia is a major exporter of energy in the form of oil. To replace Russian production and stabilise the oil market, Iran, OPEC, Venezuela or US shale oil would need to supply an additional 3 to 4 million barrels a day. The first three look difficult due to the negotiations that would be needed, and the latter would take over 6 months to solve the problem due to the current lack of investment. Thus, oil prices are likely to remain under pressure.

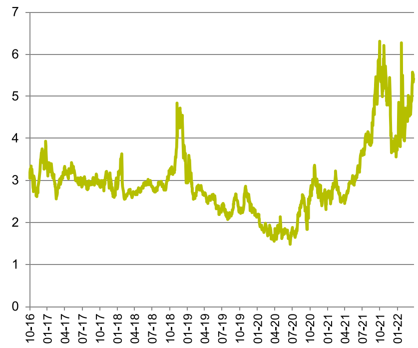
So far this year, commodities prices are up an average of more than 25%, on top of the 27% rise in 2021 when supply shortages were already widespread. The price shock caused by the invasion of Ukraine is pushing governments against the ropes as popular outcry is already beginning to emerge.

In this context, a solid supply chain is critical, something that has been temporarily complicated by new outbreaks of COVID in China and the powerful earthquake that struck Japan.

In terms of global trade, Ukraine accounts for around 15% of corn exports and 10% of wheat exports, and if we include Russia, that is over 30%. The longer the war goes on, the greater the risk of wider sanctions, higher commodities prices, higher inflation and greater social unrest.

Miguel Ángel Rico, CAIA
Investment analyst

Natural Gas



Source: Bloomberg

High volatility in natural gas due to Russia - Ukraine conflict.

CURRENCIES

Questioning the dollar's dominance

In view of the historic economic sanctions imposed by the US and allies on Russia, we learnt last month that Saudi Arabia was considering accepting payments denominated in renminbi instead of US dollars (USD) for its oil exports to China. This event puts into question the greenback's dominance in trade invoicing.

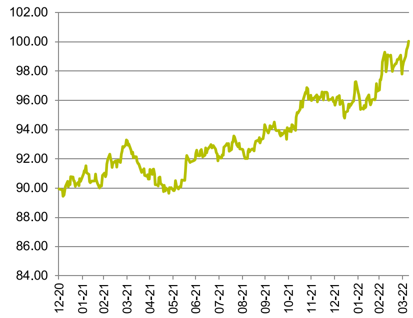
Discussions on the possibility of the US dollar losing ground as the global reserve currency come up periodically, but finding a substitute is not that easy. The US dollar clearly dominates international trade. According to the IMF in 2020, over half of non-American and non-EU exports are in dollars. This share rises to 75% in Asian emerging markets and 100% in Latin America. These figures have changed little in the past two decades.

Moreover, as of September 2021, eurodollar deposits (bank deposit liabilities denominated in USD held outside the US) amounted to $17 trillion, double the equivalent for all other global currencies combined. While the percentage of central banks' reserves in USD has fallen, from 71% in 1999 to just 59% in 2021, the beneficiaries are mainly Western currencies that have established links with the dollar. The yuan—often cited as a possible future substitute to the USD—only represents just over 9% of these reserves. China's unwillingness to loosen its control over offshore renminbi trading, lack of open capital accounts and its authoritarian political model all hinder its appeal as a global reserve currency.

The dollar's reliability, flexibility and liquidity also explain why the US dollar index is up 3.5% YTD during these times of high uncertainty. Let's not forget that US Treasuries are still the safe asset of choice when markets turn south!

Jadwiga Kitovitz, CFA
Head of Multi-Asset Management
and Institutional Accounts

The US Dollar Index

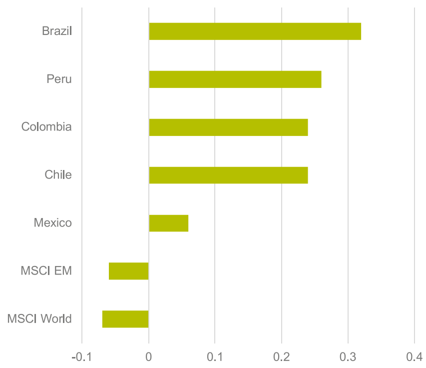


Source: Bloomberg

The dollar's reliability, flexibility and liquidity explain why the US dollar Index is up 3.5% year to date.

Latin America

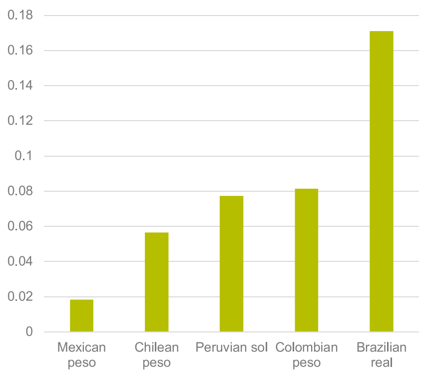
Latin American stock exchanges - YTD return



Source: Bloomberg

The Latin American equity market is the global leader in terms of YTD return in 2022.

Latin American local currencies vs. USD



Source: Bloomberg

The region's major local currencies have appreciated against the US dollar in the first quarter of 2022.

Costs and benefits

Latin America witnesses Russia's aggression against Ukraine from a distance, both geographically and politically. However, it is not immune to the global consequences of the conflict and it also plays an important indirect role.

Latin America witnesses Russia's aggression against Ukraine from a distance, both geographically and politically. However, it is not immune to the global consequences of the conflict and it also plays an important indirect role.

The sharp rise in commodities prices has a major effect on the economy of a region that is highly dependent on raw materials. On the one hand, the increase in hydrocarbon prices is benefiting producing countries like Brazil, Colombia, Mexico and Venezuela, and penalising non-producing countries like those of Central America and Chile. On the other, Latin America is a leading global producer of metals and agricultural inputs that are seeing the same trend caused by the supply crisis. Chile is the leading producer of copper worldwide, Mexico is the world's leading producer of silver and Brazil is the world's third largest producer of iron ore. Peru has all three of these raw materials as well as others like lead, while Cuba and Brazil are also important players in the production of nickel. In addition, Argentina and Brazil will have the possibility to boost exports of wheat and maize as the breadbasket of Europe and part of the world, Ukraine, is at a low.

Latin America leads the global equity market in terms of YTD return in 2022

The market has not overlooked this situation, making the Latin American equity market the global leader in terms of YTD return in 2022. Brazil's Bovespa index was up 32% at the time of writing, Mexico's Mexbol was up 6% and benchmark indices in Chile and Colombia are up 24% respectively, to name the region's largest stock exchanges. Local currencies also appreciated against the dollar, notably the Brazilian real (+18%), the Colombian peso (+9%) and the Peruvian sol (+8%).

However, not all the implications are positive. The global inflationary environment will deteriorate global growth estimates and Latin America is no exception. Significant upward pressures are being seen in the prices of petrol, food and fertilisers, considerably eroding the population's disposable income, which in turn does not directly reap the benefits we mentioned above. Social tensions are rising. The protests in Peru are likely a harbinger of what is to come and the political spectrum is increasingly polarised in an election year for Brazil and Colombia. Latin American central banks were the first to take measures to combat inflation by hiking rates, but that of course comes at a price, jeopardising the post-COVID recovery and making financing more expensive.

With all these components, we believe there are interesting opportunities in the region, but we need to be very selective. There are several factors that support the case for exposure to Latin American corporate fixed income: recent events have reduced the investment universe in emerging markets; the significant weight of the energy and materials sectors; default rates are below the average for this asset class (estimated at 2.5% this year); Latin American corporate debt has a better risk-adjusted return than its emerging peers; and finally, corporate balance sheets are generally in good health, with notable deleveraging in recent years. Geographically, we favour Mexico and Brazil, underweighting Chile (the likely sovereign credit downgrade could spill over to corporate ratings) and Argentina. In terms of sectors, we like utilities, commodities exporters and protein producers.

Juan Gestoso Ruiz
Investment analyst

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