November 18th, 2022

FESC Asset Management

MACRO VIEW

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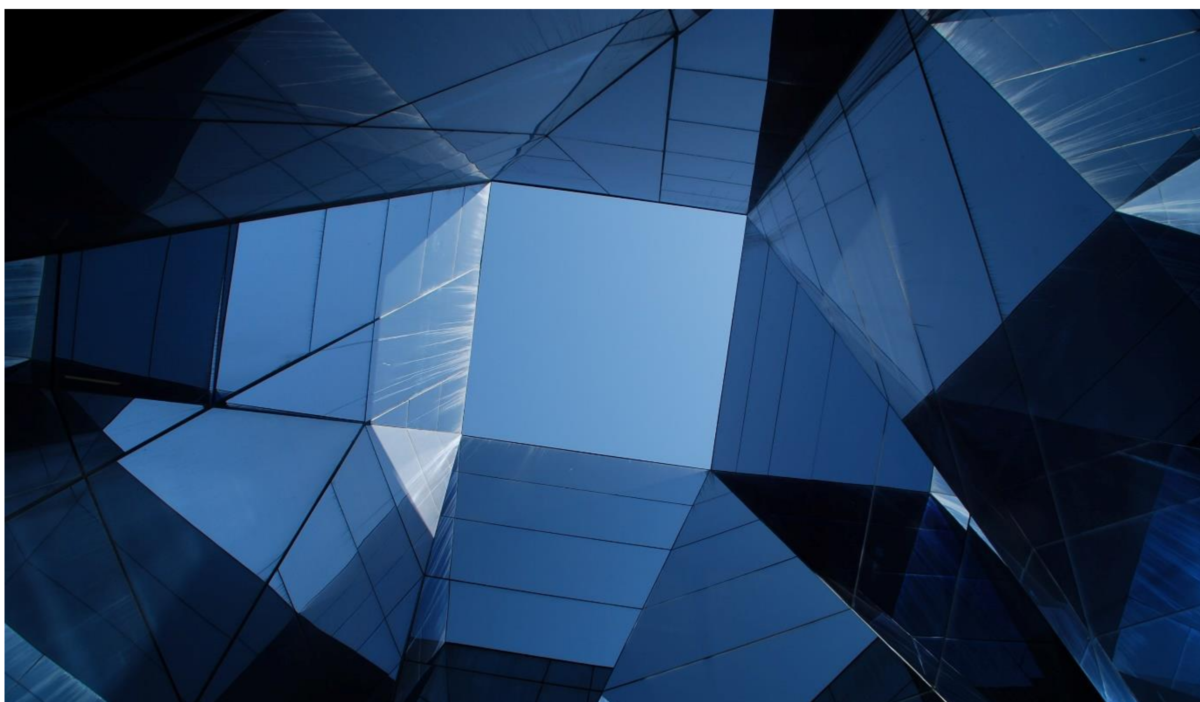


MacroView IN A NUTSHELL:

- Headline Inflation has peaked, but core inflation is still high. Inflation is becoming more structural than cyclical, as we envisioned in our last MacroView.

- We see a high probability scenario where Federal fund rates in the US reach 6%, with core inflation stubbornly high until 2023.

- We expect an economic slowdown in the US for the coming months that might become a recession in mid-2023.

- We expect the U.S. to outperform relative to other economies and we expect USD to resume its upward trend in 2023. This could mean tighter financial conditions worldwide and higher risks of a financial accident outside the US.

- In the medium and long term, we still believe we won't go back to a regime of low growth and low interest rates. Our base case scenario remains the same: a more entrenched and structural inflation problem that could last for years, and an environment of higher interest rates.

- Positioning and investment ideas: Long commodities, Long USD, exposure to Credit spreads widening, tactically Long China, Long defensive sectors and income generating stocks on those sectors.

Where will inflation stabilize?

Four months ago, we exposed our views on inflation being at or near a peak. Inflation is now on its way down and inflation fears have receded. However, despite headline inflation peaking, core inflation is still quite high and won't fade away easily, while risks to the upside (new shocks) in energy and agricultural commodity prices remain. A persistently high inflation could prompt a scenario where policy interest rates in the US reach 6%-7% in 2023, with more stringent financial conditions worldwide and a higher potential of financial instability. The low liquidity in the Treasury and Eurodollar markets, or the volatility in the UK and European sovereign debt markets, are early signs of financial instability and stress worldwide. In our last edition, we might have underestimated the FEDs resolve to fight inflation and the strength of the US economy. But by now, it seems more probable that the FED will not stop tightening financial conditions until inflation begins to show a clear downward trend, something that might take longer than expected, as inflation dynamics are showing signs of being more structural than cyclical. Under these circumstances, we expect no pause in interest rate hikes, at least until mid-2023, and a higher terminal rate than the one priced so far by the market.

The US economy remains resilient, but a recession is still the most probable scenario by mid-2023. Overall consumer spending keeps expanding, albeit at a more moderate rate. Consumer spending has not budged, and consumers are increasingly relying on credit, with savings at its lowest level in several years (3.5% of disposable income). However, it is difficult to think that, with lower savings, high inflation and a higher reliance on credit, spending will keep its actual pace. We still think It will decelerate further and perhaps begin contracting at the end of 2022 or early 2023. The housing sector has also started to show some weakness, with falling demand and prices that could affect consumers' confidence moving forward. Job growth has moderated, but overall, the labour market remains strong. We don't expect unemployment to rise substantially until early 2023, as the impact of interest rates on the labour market tends to be slow and operates with a lag of at least 12 months. Thus, a sharper deceleration in the US, in response to tighter financial conditions and lower spending, we think can be expected to be

more evident until mid-2023. By then, the US economy should decelerate markedly, given the aggressiveness of monetary policy tightening, which has no equal in recent history. The Federal Funds Target Rate has risen 1,500% from its low at 0%-0.25% in early 2020, to 3.75%-4% to date; while the Federal Funds Effective Rate — the rate at which banks lend money to each other— rose from 0.05% in March 2020 to 3.08% in October 2022, a staggering 6,060% (Figure 1). Monetary policy tends to operate with a lag of 6-12 months, and, by March 2023, the full force of rate hikes should be felt in the real economy. The 3M-10y yield curve has already inverted, signalling an arguably high probability of a recession within the next 12 months.

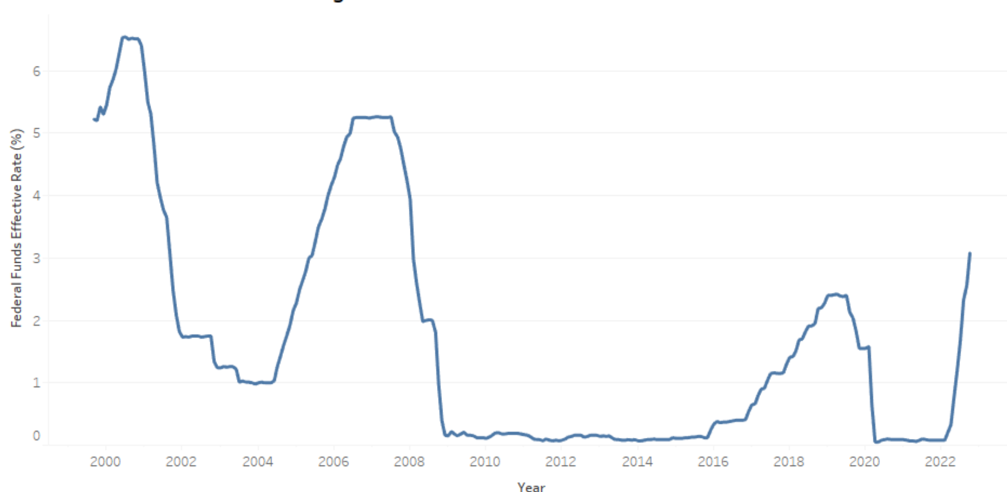


Figure 1 - FederalFunds Effective Rate

Despite the weak outlook for growth in the US, its performance relative to the rest of the world is strong. China is still going through a patch of low growth, with a housing crisis, persistent COVID waves that keep domestic demand weak, and a

global slowdown that has taken away any dynamism from exports. This could change soon if the Chinese government shifts to pro-growth policies, something that might be starting to happen after a recent easing of COVID restrictions and the announcement of a plan to save the housing market. But the effects of those initial policies are still to be seen. Inflation is not a problem in China and that has allowed them to keep a relatively accommodative monetary policy stance, something that has not been enough to revive economic activity, with the housing crisis being more protracted. However, given that savings in China have reached historically high levels[1], we believe that when all these problems are overcome or circumstances improve, the economy might go through a strong rebound. But no clear economic rebound is in sight yet.

In Europe, things are much worse. The geopolitical conflict in Ukraine is set to last for much longer and that entails a long-term energy crisis that might keep upward pressures on energy prices. Moreover, Europe is headed for a recession by the end of 2022, and monetary policy is still expected to tighten given the record inflation levels in the region (10.6% annual, oct.'22). The ECB has been slow in reacting to stop inflation, and it might result in high economic costs for the region, with an almost certain scenario of stagflation for 2023 and 2024. With this context, it is no surprise the US dollar kept an upward trend against all G-10 currencies during the past several months, a rise that found resistance only recently. We are expecting the pullback on the USD to continue until 1Q23, taking the DXY Index to somewhere around 105-100, but we think there is a high probability of seeing it resume its upward trend after testing those levels. The dollar strength is and will not only be a result of the strong relative performance of the US in terms of growth versus its peers, but also, of course, a consequence of higher rates in the US.

The FED has given no signals of stopping rate hikes until "they get the job done" and control inflation. If they keep their promise, **we believe policy interest rates could reach 6%-7% by the end of 2023.** Core inflation is still high, and we think it won't fall much further than 4.3% by the end of 2023 (Figure 2). If that is the case and the FED keeps its promise to fight inflation at all costs, the focus of monetary policy will soon center around setting a restrictive real rate of interest. That is, a nominal interest rate minus inflation which we estimate should be above 2% to undermine core inflation pressures. So, if our 12-month inflation projections put core inflation at 4.3%, that means rates should end 2023 at or above 6.3% to really generate a downward pressure on aggregate demand and cool core inflation (markets expect 5%-5.5% to be the terminal rate). If core and headline inflation

[1] According to the think tank China Finance 40 Forum.

stabilize around 5% towards the end of 2023, then the policy rate could reach 7%. That suggests rates still have a long way to go before the hiking cycle stops.

Figure 2 - US Inflation w/ Forecast

We could be wrong, and it is fair to remind everyone that calculations on neutral and restrictive interest rates are always uncertain. Even the FED is acting blindfolded. That's why their policy decisions have become data dependent as of late. It is almost impossible for them to know with any degree of certainty what level of interest rates should suffice to stop inflation and, at the same time, avoid a recession. They can make informed guesses, but they have no certainty at all. Moreover, we have already heard from Chair Powell and other FED members that they are aware of the high price to be paid to cool inflation down, meaning a recession won't deter them from fulfilling their mandate. This raises the risk of them doing too much to contain inflation. If they do too much, a financial accident and/or a recession is the most probable result; and if they decide to stop before inflation shows clear signs of moderating, they might just lose control of inflation altogether. Central banks, and especially the FED, are in a tough position. And, because the FED was the main driver of financial markets' conditions during the last decade, **we think now the whole market is in a tough, fragile, and changing environment.** That means uncertainty and volatility are here to stay. Something which could offer some good investment opportunities.

A recession in our view is the most probable scenario under current conditions. The only way to avoid it would be if, in the coming quarters, inflation

pressures ease and show to have been driven mainly by temporal post pandemic dynamics, a cyclical distortion more than a structural force[2]. Markets seem to be positioned in favour of the lower inflation scenario for the future and a victorious FED. But we see that more as 'hope trading' than a probable outcome. Nevertheless, our experience tells us that everything is possible, so we must be open to this possibility, despite it having a really low probability, according to our understanding. One asset class that could be signalling that this might be already happening is the equity market, which in the US has already made a 25-30% correction and has begun to bounce with a strong price action. This may be an early signal that the correction is over and that a brighter inflation outlook lies ahead, but again, we see this development more as **a 'denial' of actual conditions, or mere 'hope' from markets.** No available data signals an end of inflation pressures so far.

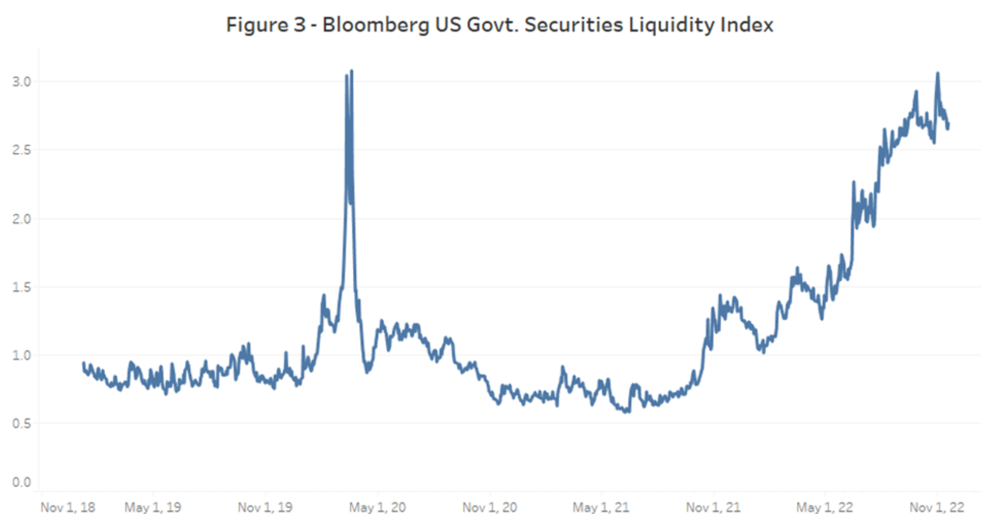
A look at inflation and its components suggests that there are still high probabilities of upward movements in 12-month inflation expectations, which would imply the need of higher rates. Despite the last inflation data showing a broader deceleration in prices, core inflation remains stubbornly high and, according to our models, only persistently low inflation readings (<= 0.2% monthly percentage rate) for the next 13 months can bring core inflation back to 3% at the end of 2023. Moreover, in 2023 salary pressures, tight food supplies and persistent geopolitical conflicts still pose upward risks to prices. Perhaps inventory levels, that have still been rising, could pose some downward pressure on prices in the short run (Q422, Q123), but overall risks remain tilted to the upside. We don't believe the FED has enough space to pause the rate-hiking cycle yet.

One of our main concerns –apart from inflation— is that, **even if the US economy is strong enough to avoid a deep recession under a high interest rate environment, outside of the US things are already flimsy**. The USD has continued its impressive rise and pressure keeps building in the global financial system. Turbulence in the European and UK sovereign debt markets during recent months bespeak of the fragility, despite EMs surprising sturdiness. Dwindling liquidity in key markets – the US Treasury market and the Eurodollar market (Figure 3) – also create vulnerabilities and produce the sensation that something will break. We think something will break; it is a matter of time. Given the historically high debt levels around the world and the increasing costs of refinancing, credit markets are set to undergo turbulent times. That is not to say we will see a sudden and

[2] We argue in our last MacroView that inflation is driven by structural forces: low CAPEX, Deglobalization of supply chains, money printing frenzy in the last decade, etc.

catastrophic debt crisis, the deleveraging of the world economy might be slow and painful (low growth, high unemployment, and still high prices).

Figure 3 - Bloomberg US Govt. Securities Liquidity Index



How central banks respond to this scenario will be interesting. We expect them to fully take responsibility of keeping market liquidity and orderly operations in financial markets; but we are not sure they could lower rates given the inflation outlook. We have even floated the idea amongst us of the possibility of seeing yield curve control in the US, something that could be implemented to manage orderly rate adjustments upwards in the market, especially in the long end of the curve.

Other points of concern are the BoJ and the JGBs market. Yield Curve Control in Japan is under threat by strong market forces that are putting pressure not only on the Yen to depreciate, but also on the 10y JGB's yields to rise. If the Japanese authorities lose control of this market, waves could hit the rest of the global sovereign debt market, including Europe and the US. Rising yields in JGBs could cause a renewed rally in US Treasury yields and European yields.

In sum, we are still on a path towards recession. What is unclear is the circumstances under which it will arrive. Despite the recent relaxation of market angst and inflation fears, circumstances seem to be pointing more and more towards a scenario of financial instability or deleveraging, a result of tighter financial conditions and persistent inflation worldwide. Given the resilience of the US economy and the ample liquidity buffers in the American financial system, it seems more probable things will break outside the US. Whether this will prompt a deep recession worldwide is still to be seen. It might just happen that we get into a

long-lasting recession, without many fireworks. Who knows, at this point, the best one can do is just make a well-informed guess and remain open to changing conditions to assess probabilities.

In the medium and long term, we still think we won't go back to a regime of low growth and low interest rates. Our base case scenario remains the same: a more entrenched and structural inflation problem that could last for years, and an environment of higher interest rates.

Alternate Scenario

A highly uncertain environment makes it very difficult to assess probabilities or foresee what might happen. We outline at least two alternate and probable scenarios, different from our base case.

1. **The FED blinks –** In this scenario, the FED could stop hiking rates in early 2023, either because a more pronounced deceleration of growth takes place or because of financial instability. Whichever the case, this poses a high risk for a more entrenched inflation and the unhinging of inflation expectations. This could prove costly. As we outlined in our previous MacroView, this could prompt a scenario where the FED would have to restart rate hikes sooner than later (a "stop-and-go scenario") and reinforce stagflation.
2. **Inflation comes down –** Although inflation pressures remain strong, a scenario where inflation comes down fast is not out of the cards. But we think this would have to come in the form of a deep and protracted recession that wipes out any inflationary and salary pressures. So far, there are no signs of such a deep recession (dares us say depression). But in a fast-evolving environment, conditions must be constantly evaluated. A deep recession is still a distinct possibility, given the steep increase of interest rates and the high levels of debt around the world.

Investment opportunities

Long commodities — The pullback we talked about in our las Macro View has ended or is about to end. We expect the upward trend in commodity prices to resume, from industrial materials and energy to agricultural commodities. Even with a strong USD in 2022, commodities haven't collapsed as they do when the USD rises, which gives us more confidence on this view.

Long oil — One of the commodities we favour the most for the coming years is oil. The low levels of investment during the last few years, the limited capacity of production worldwide, and a still rising demand for fossil fuels should keep upward pressures on oil international prices. Using WTI as a reference, we expect oil to reach between $85dpb and $70dpb before rallying back above $100-120dpb.

Long USD — We think the latest correction in the USD is a great opportunity to build or grow long positions in the currency or USD denominated assets (we favour T-bills in the actual environment; fixed-income assets in general are attractive, especially short-term). We expect a strong dollar for 2023, after it completes its ongoing correction, which we expect to be a short one. Taking the DXY Index as reference, the 105-100 levels could be tested in the short term, before the dollar resumes its upward trend.

Credit spreads widening — Due to the pace of rate hikes and inflationary forces that erode margins and growth, we expect a violent move in the next quarters on credit spreads. We are now on a different playfield in terms of the cost of financing, and debt levels are high enough to lead to some corporate and maybe sovereign debt bonds to implode.

Defensive stocks — We favour stocks of businesses that have a strong cash flow generation, a 'floor' in the demand for the products they produce (demand inelasticity) and a healthy balance sheet. There are some opportunities in the utilities, basic consumption, and energy sectors. There are a few names that are paying a healthy dividend yield in those sectors.

Gold and Silver — As we wrote in our latest MacroView, precious metals made a pullback to great entry levels in the past few months that, in our view, represent really attractive asymmetrical risk/reward opportunities. We see a

strong performance potential in all the probable scenarios described above: a long-lasting inflationary environment with risks of unhinging inflationary expectations, low growth, or in a scenario where the FED stops rising rates and real rates compress.

Long China —
The rebound in Chinese assets has apparently just started. They have taken off from a significantly lower level than we thought would be its floor. Chinese assets reached new lows since our last MacroView publication, and we had to reduce our exposure in September and October. However, we remain positioned in favour of a strong rebound, once the Chinese economy overcomes its problems. We will add more exposure as the rebound takes shape. Otherwise, we might cut all exposure in case no signs of a strong rebound appear in early 2023. As we previously noted, this must be a closely and carefully watched investment idea, because of its high-risk nature. But it is a great opportunity in terms of asymmetric risk/reward.

Update on previous investment ideas:

Long US Bonds —
This tactical investment idea, presented in the previous MacroView, didn't play as we thought. Bonds kept falling until early November. We are out of this position since September, although it is still possible yields will head lower (and bonds higher) in a recessionary environment. However, risks are too high, and we prefer to wait for a correction in yields before increasing our long-term strategic position, that is net short US bonds. We are betting on a probable unhinging of inflation expectations.

For any questions or any further information in the outlook, please feel free to Contact us at: info@fesc-am.com . We will be glad to be in contact with you and discuss.

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