April 8th, 2024

FESC Asset Management

MACRO VIEW

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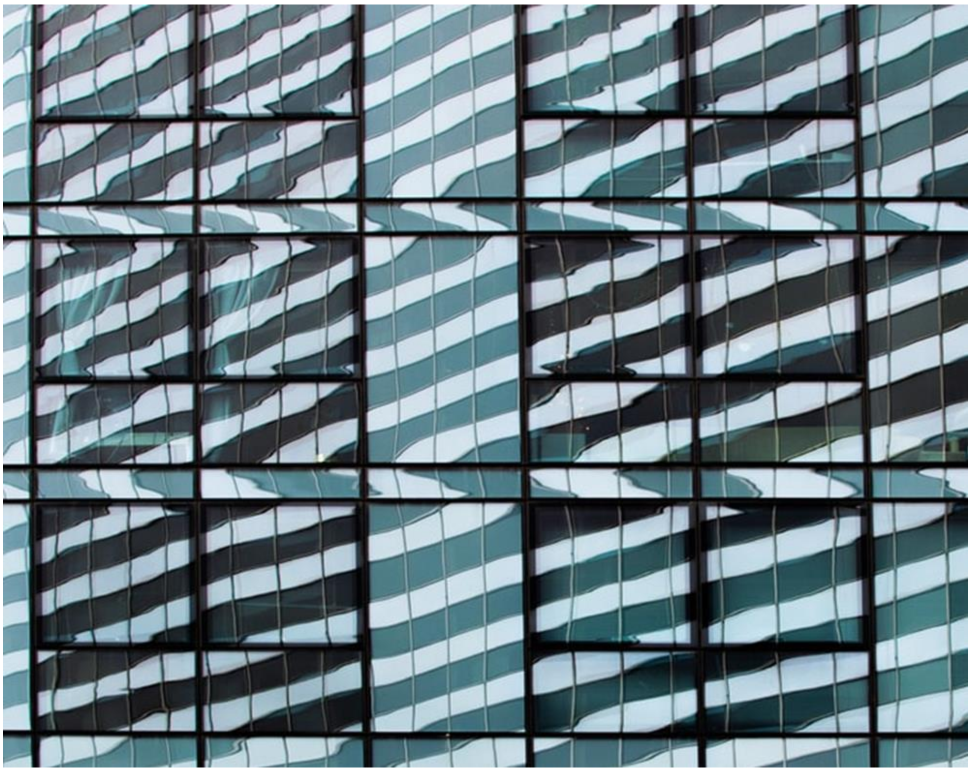

MacroView IN A NUTSHELL:

- The scenario outlined in our last MacroView has not changed. We expect a phase of consolidation in price growth above the Central Bank's target. Without a recession in sight, there are no strong arguments to believe inflation can dive below 3% this year or in the coming years.

- The longer it takes for inflation to move consistently below 3%, the more probable it is that structural dynamics such as higher wages will take hold and reinforce a scenario of inflation above the Central Bank's target. Looking at the latest inflation numbers, this seems likely.

- With this in mind, we believe there are only two possible outcomes for interest rates: either rates remain higher for longer (and probably rise again towards 2025); or the Central Bank gives up on its inflation goal of 2%, allowing for higher inflation levels, admitting defeat in the battle against rising prices.

- In that sense, volatility and continuous adjustments in asset prices are still to be expected this year, with the inflation debate at the forefront and prevailing risks of excessively optimistic market views for future financial conditions.

- Understanding divergence around the world is also crucial to navigate this landscape. While in the US no apparent signs of weakness in the economy propel the idea of "higher for longer", in the rest of the world things aren't quite the same.

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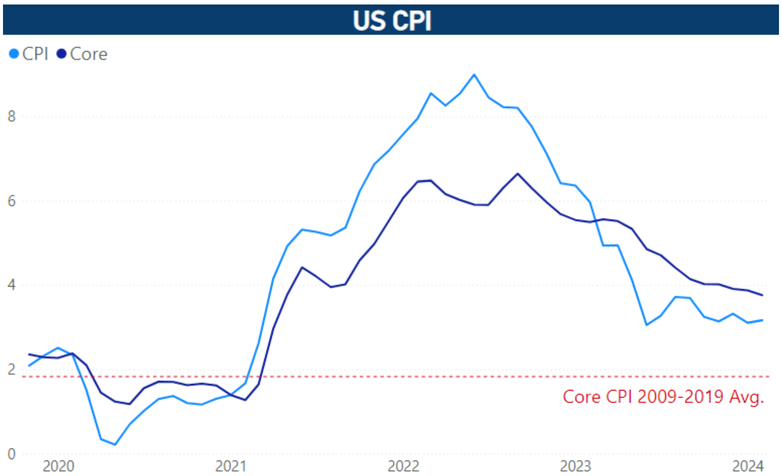
Adjusting to a new reality

Our base case scenario has not changed since August 2023. Although inflation has come down below the levels we expected, we have already entered a phase of consolidation in price growth that is above the Central Bank's target. Without a recession in sight, there are no strong arguments to believe inflation can dive below 3% this year or in the coming years.

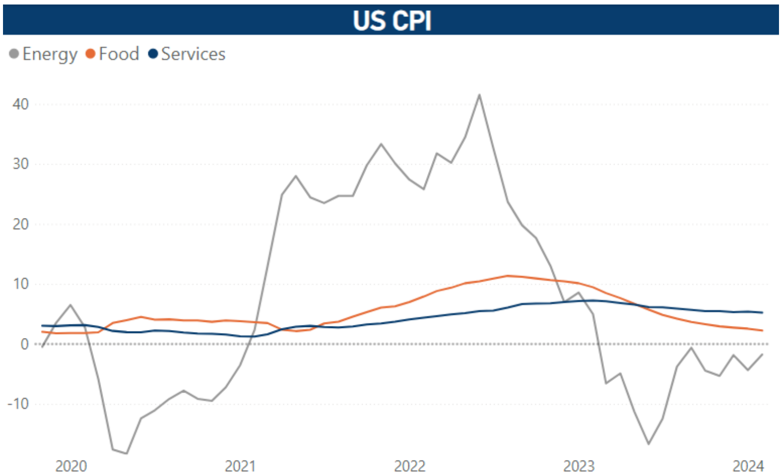
Under the current circumstances, the FED has stopped hiking rates and might not hike rates further in 2024. But things could begin to shift towards October or November 2024, when core inflation is expected to pick up pace and regain the 5% handle by mid-2025. Then, the conversation of a more restrictive monetary policy stance could take over. Specially if growth picks up after the soft patch it went through in 2023.

From a short-term perspective, it seems like the 'mirage' of a soft landing and falling inflation has materialized. But is it so? Can it last? For how long? Will the FED just admit inflation above 2% forever? We strongly continue to believe that expectations of low inflation and no recession are contradictory. As long as the labour market remains tight, there is no reason to believe price pressures could erode significantly. Maybe the height of inflation is behind us, but price growth is set to consolidate at a higher level; certainly, above the average we have seen in the past decade.



The longer it takes for inflation to move consistently below 3%, the more probable it is that structural dynamics such as higher wages will take hold and reinforce a scenario of inflation above the Central Bank's target. Looking at the latest inflation numbers, this seems likely. Disinflation is now mainly a dynamic driven by energy prices, and this could change fast given the geopolitical tensions in the Middle East and Ukraine. Moreover, IEA forecasts estimate an oil supply deficit for 2024, a dynamic that would at least put a floor in oil prices (perhapsthat mid $70s level reached last December). Food inflation, on the other hand, has stabilized at an average pace of 0.2% MoM growth since April 2023, (2.2% YoY) with no much more downside in the horizon. We think we already saw the low on food prices and we expect a strong leg up in the second half of 2024, as global commodity prices recover.

If we strip out food and energy prices, commodity prices logged their first positive growth rate in february, after 8 consecutive months of disinflation. While prices for services keep growing at a stubbornly high rate, with an average pace of 0.45% growth MoM in the last 8 months, after reaching a low in June 2023. That is almost double the average growth rate of the pre-pandemic era (0.25%). In sum, with goods inflation stalling and services inflation strong, there is no reson to believe the fight against inflation is over. A pick up in inflation is now more likely than a continuation of the downward trend; at least in Core inflation, which matters most. Inflation above 3% (or above 3.5% prehaps) is here to stay, for long.



With this in mind, we believe there are only two possible outcomes for interest rates: either rates remain higher for longer (and probably rise again towards 2025); or the Central Bank gives up on its inflation goal of 2%, allowing for higher inflation levels and admitting defeat in the battle against rising prices. We believe the former (higher rates for longer) is more probable, given the historical consequences Central Banks have faced when letting inflation run above target. The reasoning is simple: if the FED gives up on its inflation target and allows inflation above 2% permanently, confidence on the ability of the central bank to manage price inflation could be lost and risk the reinforcing of inflation pressures. If they decide to cut rates with core inflation still running high, things could get out of control quite easily; just as they did in the 1970s. And this is quite relevant for financial assets' pricing.

Markets keep trading on hope and are reluctant to accept change; they are still neglecting the possibility of a world with higher inflation and higher interest rates. Debt markets seem to be the most rational, adjusting to higher yields gradually and every time the FED pushes back on rate cuts and CPI numbers reinforce their cautious posture. But credit and equity markets seem to have been negligent of high interest rates in a world swimming on debt.

In that sense, volatility and continuous adjustments in asset prices are still to be expected this year, with the inflation debate at the forefront and prevailing risks of excessively optimistic market views for future financial conditions. Take for example rate futures, which have priced lower rates since the second half of 2023 but have seen no materialization of their expectations so far. For the last 12 months, markets have been continuously adjusting their expectations of rate cuts, pushing them further and further in time as the economy remains resilient and inflation shows no signs of structural weakness. The last adjustment was after March's jobs data, with the US economy still generating jobs at a higher rate than expected with no signs of the weakness in the labour market that would allow price pressures to abate. Lower rates are only consistent in a world of low inflation and moderate growth that is not showing in data. So, markets keep scaling back their bets on rate cuts and continuous price adjustments have become the norm.

Perhaps markets and market participants remain nostalgic of the old times, daydreaming that the conditions of the past decade will come back to dominate. **But for us that is improbable.** The most compelling argument for lower rates is that the FED will cut rates to "normalize" monetary policy, given that inflation is way below its peak and real interest rates are rising. But under our view, a 5.5% handle in nominal rates is still not restrictive enough. As we argued in August, we still estimate a neutral rate of interest around 2% (real) or slightly higher. With Core CPI expected to stabilize at 3.5%, a 5.5% nominal rate is barely enough. It risks falling short of what's needed to lower inflation. That is why we think it is prudent not to expect moves in interest rates for 2024 and look forward to possible hikes in 2025.

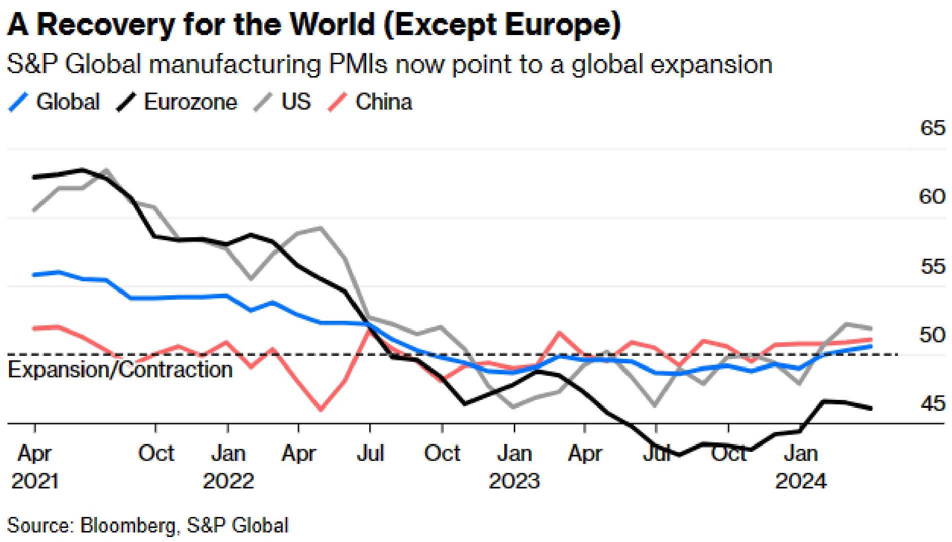
At most, in a very positive scenario, a cut of 50bp could happen and momentarily reinforce the rally in risky assets. But in the long run, the prudent way to invest is to expect higher rates for longer: look for opportunities in debt markets without taking too much duration and try to surf the waves of sentiment in equity markets. Expect the market to keep adjusting to the reality of no rate cuts, sticky inflation, and look forward to a comeback of conversations about the FED hiking rates.

CME FEDWATCH TOOL - MEETING PROBABILITIES									
MEETING DATE	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550
5/1/2024				0.0%	0.0%	0.0%	0.0%	4.8%	95.2%
6/12/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	2.4%	50.8%	46.8%
7/31/2024	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%	22.4%	49.1%	27.4%
9/18/2024	0.0%	0.0%	0.0%	0.0%	0.7%	15.1%	40.1%	34.8%	9.3%
11/7/2024	0.0%	0.0%	0.0%	0.2%	5.6%	23.7%	38.3%	26.0%	6.1%
12/18/2024	0.0%	0.0%	0.1%	3.8%	17.5%	33.2%	30.3%	13.0%	2.1%
1/29/2025	0.0%	0.1%	1.7%	9.5%	24.1%	32.0%	23.0%	8.4%	1.2%
3/19/2025	0.0%	0.9%	5.8%	17.2%	28.3%	27.2%	15.3%	4.6%	0.6%
4/30/2025	0.4%	2.7%	10.1%	21.3%	27.9%	22.8%	11.3%	3.1%	0.4%

Market rate cut expectations. As of April 6th, 2024.

Understanding divergence around the world is crucial to navigate this landscape. While in the US no apparent signs of weakness in the economy propel the idea of "higher for longer", in the rest of the world things aren't quite the same. A look into Europe puts in evidence that economic activity is still weak, and inflation could come down further in that region. The ECB has recently lowered growth and inflation expectations for the Eurozone and rate cut talks seem more convincing there than in America. Economic activity stagnated since late 2023 and the data points towards weakness in the near term. For example, industrial production in the Eurozone is at its lowest since 2020, a reason why the economy is struggling to grow in the first quarter of 2024.

This could be linked to the Chinese economy, which had been struggling for growth until very recently. There, retail sales lost ground after an initial rebound in December, and so did industrial production, with the country growing at a pace that won't see them reach the 5% growth goal for GDP in 2024. Authorities have preferred to directly support the financial markets via regulations, rather than to stimulate the economy via fiscal or monetary policy. News of fiscal stimulus are again circulating, but always accompanied by caution of authorities that do not wish to increase the fiscal deficit much more.



However, some positive signs are appearing in China and add some complexity to the mix. Travelling, for example, has regained levels not seen since the pandemic, and inflation has picked up to 0.7% YoY in February, its highest in 10 months. The latter suggests demand could be picking up, with 3 consecutive months of rising princes in a month-to-month basis. Some leading indicators are also improving and, once the debt issues and negative sentiment within consumers fade in China and the effects of the housing crisis recede, a more positive outlook for Chinese growth could ensure. This could have consequences in two aspects: global inflation pressures could be reinforced, and Chinese assets could see a rally.

This is crucial for global markets. Picture a scenario where the FED doesn't move and decides to ride the problem of sticky inflation by keeping interest rates high. Europe will certainly consider cutting rates by mid-2024, given their economic weakness. In China, rate cuts are expected, not at a fast pace but monetary policy easing is needed to overcome the growth problem. The combination of this factors (Restrictive FED, easing ECB and PBOC) could cause waves. The divergence in monetary policy around the world will cause movements in the FX markets and, perhaps, provide good opportunities in some EMs that are strongly linked to US growth. If China growth picks up, then also look for good opportunities there and the Asia-Pacific region.

Finally, in Japan things are starting to move and that will be crucial for global financial markets in the coming years. As we briefly exposed in our November 2022 and August 2023 MacroView, Japanese investors play a key role in global sovereign debt markets. Given the low yields of JGBs throughout the last decade, many Japanese pension funds and big investors have found better opportunities investing in foreign debt. Hedging against currency volatility, Japanese investors have been key drivers of demand for US Treasuries and European bonds. In March, the BoJ hiked its benchmark interest rate for the first time in 17 years, an important shift that we consider a confirmation of the end of the era of ultra-low interest rates worldwide. Moreover, with inflation growing above the central bank's target and finally suggesting the end of disinflation, the BoJ Governor, Kazuo Ueda, is signalling the gradual end of yield curve control in Japan. This is crucial, as it could gradually create incentives for Japanese investors to hold more domestic debt than before, and put persistent upward pressure on yields elsewhere.

In sum, our view has been reinforced by the latest economic developments: we are entering a new regime of higher interest rates and inflation. The hypothesis held in our las MV that the neutral interest rate (R-square) in the US could be much higher than thought by many, has not been proven wrong. There is still resilient growth and expectations of acceleration in 2024 despite higher nominal rates. Inflation remains sticky and we do not expect rates to come down below 5% anytime soon. Under our view, one should not expect rate cuts in the US. The FED might have paused, but they could be talking again about rising rates towards the end of the year. Specially if growth picks up in the second half of 2024, after barely reacting to monetary policy.

We expect disinflationary pressures to abate and structural inflation to be the norm. We still expect to see nominal interest rates in the US of around 6-7%, before we can see a sensible slowdown of economic activity that puts inflation back below 3%. That could happen in 2025. In the meantime, the market's adjustment to this reality will provide us some good investing opportunities.

Alternate Scenarios

Our base case scenario contemplates a process of stabilizing inflation above the central bank's target, with a moderate trend upwards as we get to the second half of 2024. We could not see higher rates in 2024, but we don't expect them to be much lower than they are now. We expect long term yields to keep adjusting up. Towards 2025, we see probabilities of new interest rate hikes, especially if growth picks up momentum in the second half of this year. However, it is always sensible to consider other possibilities:

1. **Inflation continues to moderate –** There is a possible scenario where inflation continues to cool down and eventually reaches the FED's target towards the end of 2024. This is only possible if growth underperforms and no pickup in economic activity ensures in the second half of 2024. If that happens, it could point to the resurgence of a characteristic that dominated in the past two decades: moderate-to-low growth that chokes any inflation pressure. This could prompt a scenario of lower interest rates (below 5% and moving towards 3%) and a renewed appetite in markets for risk taking.
2. **The FED blinks –** This is an alternate scenario we've held for a year now. It is still possible that the FED declares victory on inflation well in advance, despite not seeing inflation move persistently under its target. It is not a highly probable scenario, given the position and narrative held by FED lately, but if they gradually shift their narrative and become complacent with inflation and the market (be it by economic or political reasons), risks of a more entrenched inflation and unhinging inflation expectations could become acute. Eventually, the FED will be forced to hike rates again at a much higher economic cost.

Investment opportunities

Lately, with credit spreads tightening, recession risks have subsided substantially, and markets have become more prone to risk taking. It is possible to participate in the opportunities this has brought, adding risky assets to your investment portfolio. However, one should remain alert of several dynamics that pose risks and threaten to keep markets quite volatile. Keep an eye on core inflation and wages; if these two don't abate as expected by markets, continuous adjustments in risky assets are to be expected, as markets calibrate to less benign financial conditions than projected. Also, remain aware of inflation expectations and credit spreads, use them as your main market indicator when assessing to either take more risk in your portfolio or to move to safer assets.

Short US bonds — We still favour a scenario with a higher rate environment, specially at the long end of the curve; this is our conviction trade. We've added exposure in this regard, positioning short US 10y Treasuries. We will continue to add to that position if yields adjust back below 4%. It is also possible to play the very same idea but outside the US. Look for opportunities in European yields and even Japan.

Long Gold and Silver — We've held this position for a long time now and it's proven its worth. Both precious metals are strong alternatives for diversification, in a context of prevailing uncertainty. Silver has had a more volatile ride than Gold, but both have been favoured by market expectations of rate cuts. Platinum and Gold miners ETFs are also a very attractive alternative to be exposed to the moves in precious metals, as they both have a similar behaviour to Gold and Silver. They all seem to be reacting positively when its "risk on" mode in the market; and they will surely provide protection in case of a "risk off" event. These are good choices for a portion of a portfolio, looking for diversification and ways to weather the market volatility.

Long Chinese equities — We continue to hold Chinese equities, despite its disappointing performance in the last 18 months. We are still convinced there is a great opportunity in this space and, when looking at risk-reward metrics, there are not much more attractive opportunities elsewhere in the equities market. However, caution and active risk management is still recommended. We've begun to build more positions, but we've been very cautious and will bare very low tolerance to new signs of weakness. We've been also adding positions that indirectly benefit from a rebound in growth in China (or globally). We've added Asia-Pacific EMs equities in some of our strategies.

US Mid & Small-caps — With a pause in interest rate hikes and fears of recession fading, we've begun participating more actively in US equity markets. We consider the best opportunities to be found in the Mid and Small Cap space. However, it is also worth having a look at some names in the Technology sector, mainly looking to participate in a sector that has proven to historically outperform during equity rallies. We still hold defensive stocks with high dividend yields, although they have been losing attractiveness in a high interest rate environment (against short term debt, for example).

Long commodities — This one we've held also for long. It hasn't been performing as expected, but we remain of the idea that it is a great asset to have. We've kept small positions in Wheat and Coffee, with mixed results. But we expect commodities to rally with a pick-up in global growth; otherwise, they just might keep trading in a range. We like agricultural commodities in general, but Copper could also work as an indirect bet to an acceleration in growth in China and globally this year.

Credit spreads — Our bet on credit spreads widening didn't materialize, so we closed all positions. We'll keep an eye on them as an indicator of general financial conditions and market sentiment. For now, we don't recommend positioning on this space. If credit spreads do widen, it will be more nuanced than we thought last year, when a recession was on the cards. However, if recession fears reappear and talks of more interest rate hikes ensure, we will certainly jump back in.

Long USD/Short euro — We still favour holding USD and USD assets. A strong rebound of the dollar against other G10 currencies has taken place in 2024 and we expect it to continue, as we anticipate divergence in monetary policy worldwide. We particularly like the USD against the Euro, and consider parity a very likely scenario. In our view, given the economic weakness in the Eurozone, it is highly probable the ECB will cut rates before or deeper than the FED putting downward pressure on the Euro.

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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