March 25, 2022

Bulltick Research and Strategy

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Market Strategy:

Investment Landscape After A Tumultuous First Quarter

With the conflict in Ukraine still far from resolved, markets characterized by well-above-trend volatility, and inflation nearing 8.0% on a y/y basis, investor uncertainty has risen drastically over the first quarter of the year.

On balance, we believe that the already-present risks to inflation, due mainly to wage pressures and supply shocks, are likely to be exacerbated by recent events, including energy costs and a massive COVID surge in China, still the 'factory to the world'.

Fed action will have little impact on these dynamics, but as Omicron passes through China just as it has much of the rest of the world, supply chain issues slowly resolve, and a new normal is established in Europe, we expect price growth to fall in the latter part of the year. We expect that Fed balance sheet reduction will be more aggressive than it was in 2017, and that it will incorporate a significant draw-down of Mortgage Backed Securities as a percentage of total assets. As a result, we expect rising yields but even faster-rising mortgage rates.

Asset	Spot	Chg In Past 2 Weeks	YTD Change	End- 2022 Target
USG10Y	2.48	+48bps	+96bps	2.25
USG30Y	2.58	+23bps	+68bps	3.00
JGB10Y	0.24	+5bps	+17bps	0.10
DXY	98.73	-0.40%	3.20%	95.00
EUR	1.10	0.73%	-3.32%	1.18
JPY	122.06	-3.90%	-5.71%	115.00
MXN	19.95	4.82%	2.89%	22.00
BRL	4.76	6.57%	17.00%	5.20
SPX	4533	7.81%	-4.90%	5100
IBOV	119155	6.66%	13.67%	120000
MEXBOL	55397	3.93%	3.99%	56000
Brazil 10Y	11.75	-58bps	+95bps	11.75
Mexico 10Y	8.57	+9bps	+102bps	7.90
MXEF	1137	4.72%	-7.72%	1450
Gold	1954	-1.71%	6.85%	1800
WTI Crude	112.7	3.08%	49.85%	70.0

As of 03/25/2022

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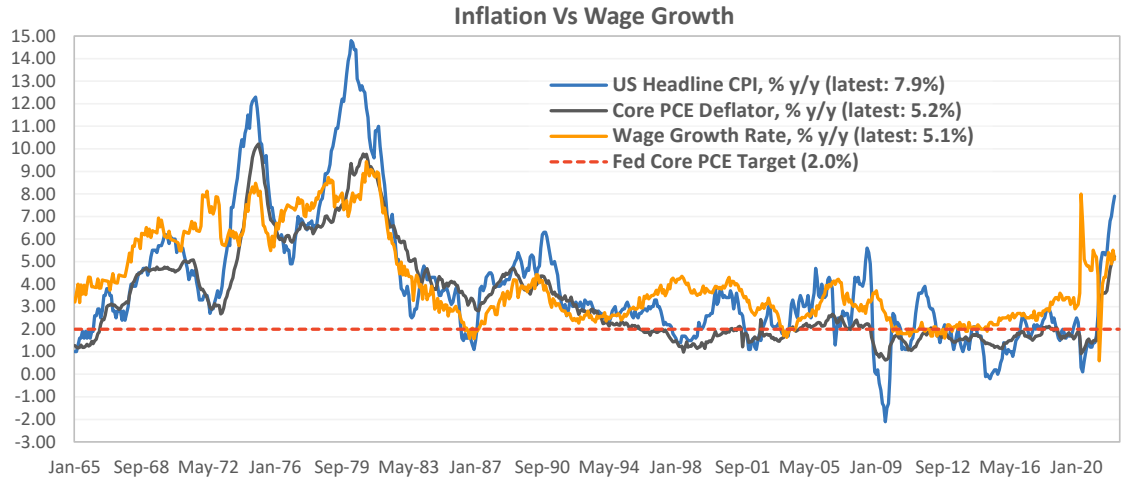
A Closer Look At Changing Landscape At The End of Q1 2022

What Has Stayed the Same

In many senses, the themes coming into 2022 have not changed. We highlighted the risk of high inflation, which – while a common topic of concern among investors – had still not been fully appreciated or priced into the markets. Wage growth was and continues to be a driving force behind inflationary forces, and the Fed was and continues to play catch-up to this reality.



Source: Bloomberg, FRED, Bulltick

We still expect that yields will rise as a result of both Fed action and market activity, and note that banks are a natural hedge and potential outperformer in this environment. We continue to expect that a recession will be avoided, although a slowdown in growth is likely.

What Has Changed

Nevertheless, against this backdrop, the investment landscape has also seen some important changes over the first quarter of the year. These changes have important implications for sentiment, but also direct impacts on fundamentals including growth, and most importantly in the present context, on inflation.

Conflict In Ukraine

Most obviously, a land war broke out in Europe for the first time in decades, which has changed the calculus of relative value substantially. While we preferred Europe to the US at the beginning of the year (owing to its valuation metrics and its higher concentration to sectors (such as banks) which we expected to outperform), we now believe risks outweigh the potential benefits, and prefer the US and markets without such direct

exposure to the conflict. Until the war is resolved, a sharp escalation is very much a possibility, with potentially devastating consequences.

Inflationary pressures have ramped up substantially due to the impact of the price of fuel. Although oil has come off its recent highs, Europe is still buying energy from Russia, and the possibility that this situation changes – European leaders are presently in talks to consider adding energy to the growing list of sanctions against Russia – presents enormous risks to the energy market. We expect continued volatility, and believe that the tail risks for a sharp spike upward to the price of oil are much 'fatter' than those of a similar magnitude to the downside.

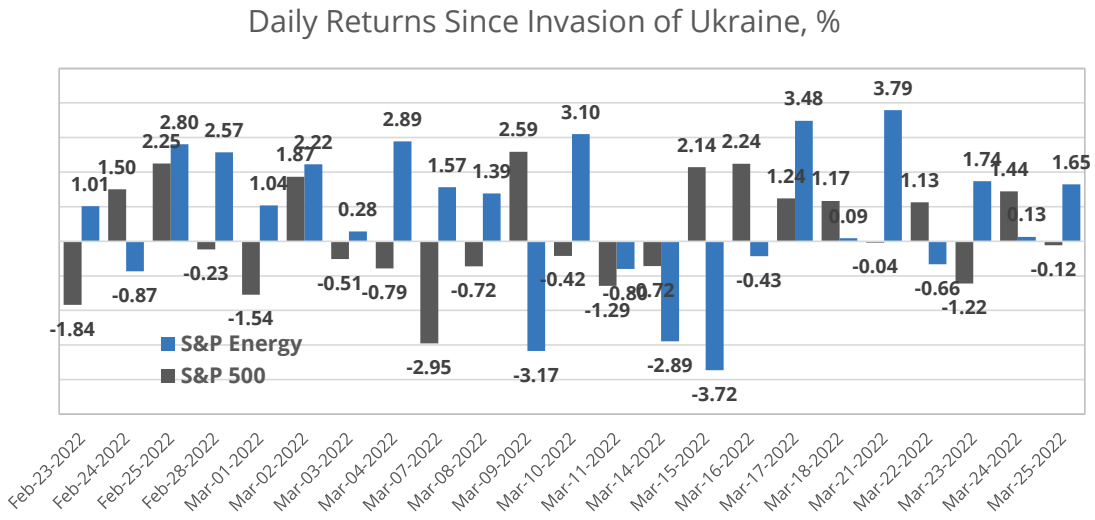
On the war itself, there are a few reasons for optimism

- The prospect of a rapid escalation including potential conflict with NATO territories hinges first on Russia's confidence in prevailing in such an endeavor. Whatever happens in the future, it is clear that this campaign has been much more costly, in terms of blood, treasure, and reputation, than President Vladimir Putin had anticipated, and it demonstrates the outdated military doctrines which would put Russia at a disadvantage in a wider conflict. This is likely clear on all sides, making a full-scale conflict with NATO less likely than just two weeks ago. Corridors on the west of the country funneling weapons from Europe into Ukraine are now well-established and have improved Ukraine's capabilities to withstand the onslaught. While we hasten to note that Russia is still vastly better equipped militarily and is likely to win and/or leave Ukraine in ruin, the experience is likely to have given Putin pause on potential escalation.

- Negotiations with Ukraine have gone on for several days, with representatives from Turkey saying that the parties are 'close to an agreement'. While it is impossible to know whether the Russian delegation is operating in good faith – an unprovoked invasion is hardly the basis for trust – the first step to a lasting negotiated settlement is the holding of any negotiations at all.

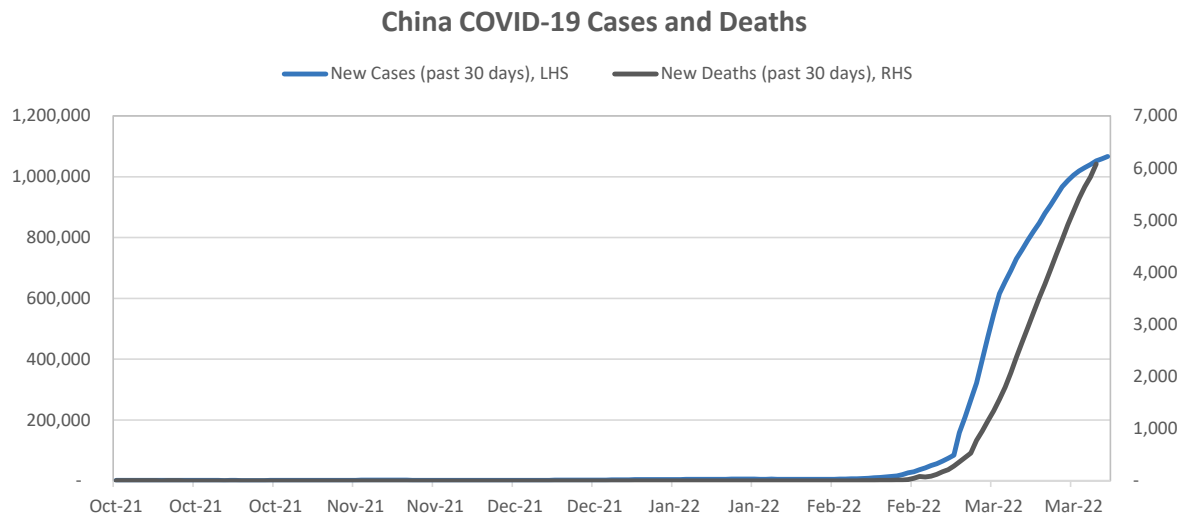
Oil Emerges As a Hedge

We have noted in our recent Cross Asset Strategies that as a result of the above dynamics, oil has become a hedge for those long the market. Essentially, a 'good day' for markets (due to a potential détente or normalization in Europe) is a 'bad day' for energy (as the prospect of major supply disruptions abate). Indeed, there have been 23 trading days since the invasion of Ukraine. Of those days, the broad S&P 500 index has moved in an opposite direction compared to the S&P Energy Index 16 times. We maintain our recommendation that **some outsized exposure to energy remains appropriate in the present context** to reduce overall portfolio volatility.



China Grapples With COVID

Also of note is the surge in COVID cases in China. Long-touted as an example of the brutal efficacy of autocratic governance given low case count, China now has some of the highest infection rates in the world. Over a rolling 30-day period, China's total new infections fell below 1,000 in October, versus over 1 million over the most recent 30 days.



The COVID re-emergence in China is significant from a supply-chain perspective, since Chinese authorities are much more likely, from a governing style standpoint, to impose harsh restrictions up to and including lockdowns. Ultimately, any decision the government takes is in the interest of the ruling Communist Party, and if it is determined that a major economic blow is necessary in order to show that officials have the pandemic under control, it will be a price they will be willing to pay. This would exacerbate supply

chain issues which have been blamed for inflation since the beginning of the pandemic, and prolong the disruptions to a host of industries.

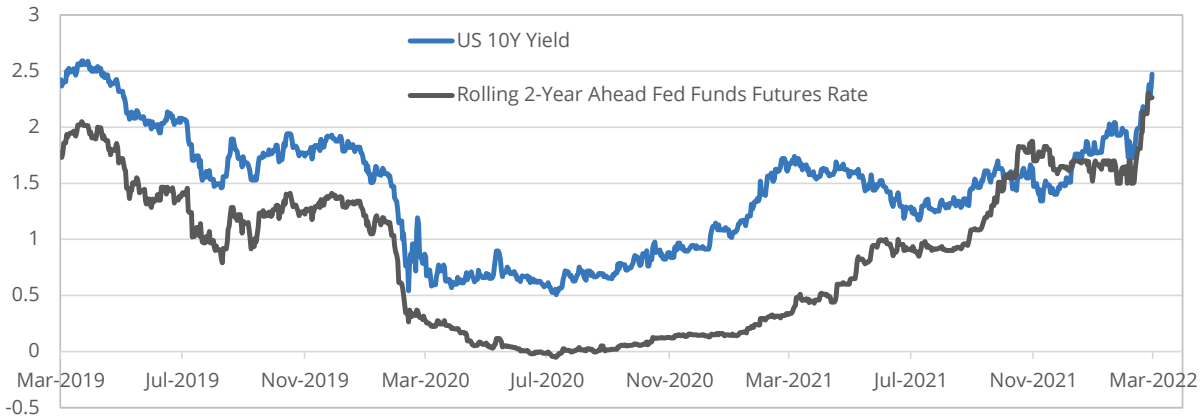
The Fed Steps Up to the Plate

The lesson from all the above is that energy prices, supply constraints, and high wages will conspire to keep inflation high, and the Fed, to its better-late-than-never credit, has begun to acknowledge that. Fed officials have broadly changed their tone and approach to monetary policy. Just over a year ago, Chair Jay Powell said that 'we welcome slightly higher inflation' to compensate for the years when price growth had fallen far short of the Fed's 2.0% goal. By June, Powell was noting a 'notable' increase in both inflation and uncertainty, but maintained an overall dovish posture. Subsequent meetings saw the infamous abuse of the word 'transitory', but by the November meeting he acknowledged that the situation was 'not at all consistent' with the goal of price stability.

Finally, last month, the Fed has acknowledged that its credibility and its raison d'etre were at stake, and Powell said that 'there's a real risk now, we believe, I believe, that inflation may be more persistent and that may be putting inflation expectations under pressure, and that the risk of higher inflation becoming entrenched has increased'. After Fed funds rate liftoff, the new 'dots plot' was published, showing a much more aggressive path of rate hikes than we expected. When asked what would derail a 50bps hike in the May meeting, Powell said 'nothing'.

It is clear that the Fed has acknowledged to a much greater extent its lateness to act, and is trying to make up for it. Interest rate futures are now pricing in nearly 100bps of additional hikes by the end of the year than they were at the beginning of March.

Futures Rates Vs 10Y Yield



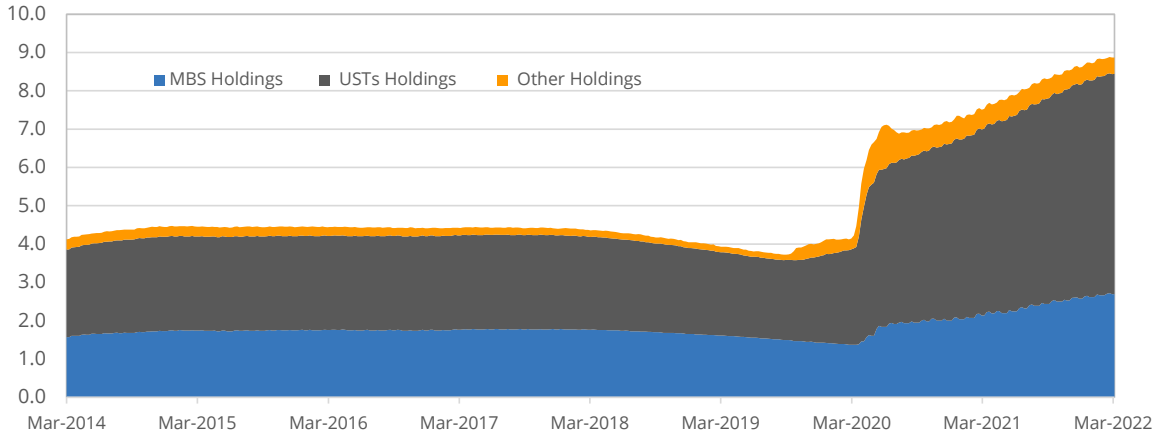
Source: Bloomberg, Bulltick

Apart from the path of rate hikes, another key question is what will happen to the balance sheet, which at around US$9trn, is about double what it was prior to the pandemic.

We expect that the Fed will:

- Reduce its balance sheet faster than in 2017, when it had a 50bn/month runoff. We expect the runoff will be at least double that pace. The maturity profile indicates that 1.2trn of treasuries will mature in a year, which would equate to 100bn/month.
- Sell mortgages in the open market, rather than wait for them to roll off, since otherwise the proportion of MBS will grow as a percentage of total assets, a situation the Fed has said it wants to avoid.

Fed Balance Sheet, USDtrn



Source: Bloomberg, Bulltick

Market Strategy:

As a result of Fed action, we expect that mortgage rates will likely rise faster than yields, and we are short Real Estate, and long banks. We are long Energy as a hedge against the broader market, given its negative correlation with the SPX in the present context. We like inflation hedges, as we expect that inflation still has room to surprise to the upside – this includes gold, real estate, and even some exposure to cryptocurrencies.

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