Quarterly Call
January 2022

English Version

Catch-22 in 2022

Quarterly Call Q1 | 2022

Get guidance on investments, and the major structural factors behind your clients' portfolios.

insigneo

Transcribed from comments made during our Quarterly Call Q1 | 2022

January 11th, 2022.

As we begin the new year, it is difficult not to believe that not much has changed. Afterall, we are still dealing the pandemic as a new variant, Omicron, spreads throughout the globe begging the question, "When will it end?" The answer to that is "never". As we have been saying for quite some time now, Covid is not going away and we expect it to become a normal and endemic part of the infectious disease landscape, much like influenzas and the common cold. But the good news is that people, nations, and economies have adapted surprisingly well and quickly to "living with Covid" thanks to highly efficacious vaccines, better treatments, and behavior modifications. Since the virus is mutating in a predictable way in terms of becoming more contagious but less virulent, this latest wave of the virus should cause the least economic damage of all. For example, for 2022 we are only estimating a 0.40% dent to US Real GDP and a 0.50% hit to global GDP. Overall, we are now entering the balanced, mid-cycle expansion of the economic recovery that will be driven by greater demand-supply equilibrium, and a resurgence of the services sector. When you compare this to the economic carnage wrought by the first wave of the virus back in 2020 due to the lockdowns, one can say that the pandemic has gone from a wrecking ball to a headwind to growth.

Ahmed Riesgo
Chief Investment Officer
Insigneo Financial Group

Of Viruses and Inflation

I do not want to say that the virus has become immaterial to our projections. Because it has not. One area that concerns us with the new variant is the price outlook because it points to higher inflation. Supply chains were already stretched, even if those strains were easing on the margin before the new variant rolled on the scene. But a virus-related surge in goods spending (versus services spending), transportation hub closures, or labor shortages could halt the progress made thus far. This could worsen the inflation narrative in the short-term and complicate the policy response. And that is why our theme for the year is the Catch-22 in 2022. As some of you may know, “Catch-22” is a satirical war novel first published in 1961 by the American author, Joseph Heller. Without getting into too much detail about the plot of the novel, suffice it to say that the namesake, a Catch-22, refers to a problematic situation for which the only solution is denied by a circumstance inherent in the problem itself. In other words, it is a situation presenting two equally undesirable alternatives. That is precisely the place where the US central bank finds itself. If inflation takes another tick up due to this new strain, will the Fed and other central banks continue tightening in the face of a resurgent pandemic? That could lead to slower growth and higher rates. Remember that the central banks of the developed world do not want to raise rates. Their governments have issued so much debt, that they want to maintain rates artificially low for as long as possible to lessen the interest payments on that debt. I authored an article in April of 2020 titled, “All Roads Lead to Inflation” where I argued that debt sustainability is not an issue if the government’s effective borrowing costs are below its long-term growth potential. In this scenario, a nation will be able to outgrow its debt burden. This occurred in the UK after the Napoleonic Wars, and in the US after the Second World War. The key will be for governments to credibly maintain borrowing costs artificially low through financial repression mechanisms like quantitative easing. When the output gap is wide, as it is now but rapidly closing, you can have your cake and eat it too. But when it closes, if the government wants to spend more, it must convince the private sector to spend less. This is achieved by raising interest rates. In the end, bondholders must believe that the central bank is independent and not an arm of the Treasury or the Finance Ministry undertaking stealth debt monetization. Here, history offers us many examples of market forces evading the most adept bureaucrat’s grip. Are we in such an environment now? **I am not as concerned over the next 12 months, because I do think that inflation has peaked in the near-term. Beyond 2022, though, I am more worried and because of this I anticipate that we will begin pairing back risk aggressively towards the end of the year**. This cycle has been a sharp one, but I fear it may be a lot shorter than what we have been accustomed to over the last few bull markets.

Insigneo/Forefront US Recessionary Model

Probability of recession within the next two quarters

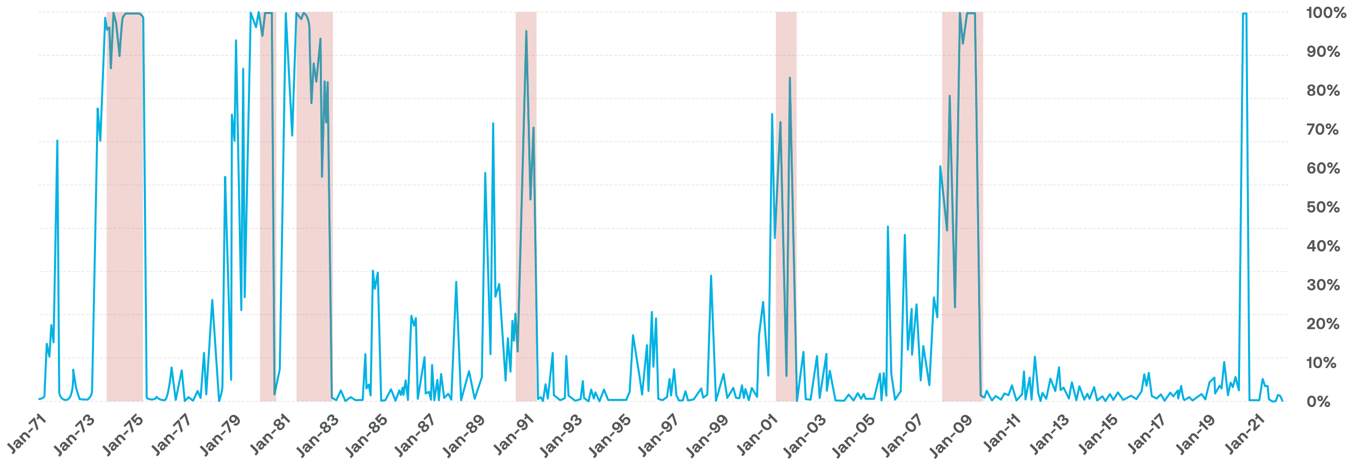
0.0%	Overall Macro Indicators
0.01%	Overall Macro Leading Indicators
0.33%	OECD Composite Leading Indicator
15.27%	Conference Board US Leading Index Ten Economic Indicators YOY

Source: Insigneo & Forefront Analytics

We will get into what that may look like from a portfolio management perspective shortly, but first let us begin where we always do… the 6 to 12-month economic outlook. For now, we remain sanguine on the overall economic outlook both in the US and globally. As this first graph shows, our proprietary Insigneo-Forefront recessionary probit model which gives the probability

Forecasted Rexession Probability for 2-Quarter Forward Period using All Macro Leading Indicators

Source: Bloomberg, Insigneo, Forefront Analytics



of a recession in the US over the next 6 months is still hovering close to zero, near the levels it has consistently been since the early summer of 2020. In terms of Real GDP growth, one can see in this graph that our forecasts last year were pretty accurate. Please note that our growth projections for this year already account for the Omicron variant. In the US, they also include two projected rate hikes from the Federal Reserve and the passage of a slimmed down version of President Biden's Build Back Better Program of USD 1.25 trillion.

Real GDP Predictions & Estimates

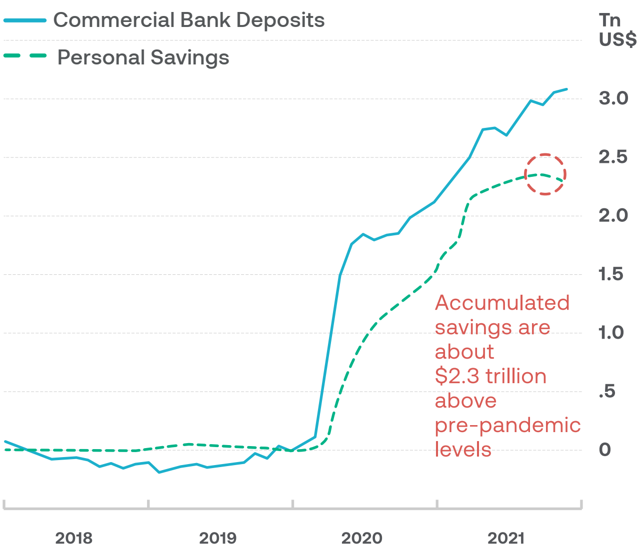
	INSIGNEO 2021 ESTIMATE	ACTUAL AS OF 12/31/21	INSIGNEO 2022 ESTIMATE
US	7.25%	6.50%	3.25%
China	8.25%	8.00%	5.00%
EU	5.25%	5.25%	4.25%
Japan	1.00%	1.50%	3.50%
World	6.25%	6.00%	4.25%

Source: Insigneo & Bloomberg

There are two main takeaways from our projections. First, **global economic growth will slow, but remain strong**. Second, the US will no longer be the primary driver of global growth as it was in 2020 and 2021. We expect European growth to remain robust and exceed the US figures for the first time in a while. Yes, the European economy faces some near-term growth pressures. In addition to Covid-related lockdowns, high energy costs will take their toll. But the combination of increased energy supplies, easing supply-chain bottlenecks, and lockdown fatigue in Europe, should all point toward better-than-expected growth across the Continent. European bank balance sheets are in much better shape than they have been in over a decade, and consumer confidence is even stronger in Europe than it is in the US. The European Central bank will also not begin a tightening cycle in 2022, unlike its US counterpart. Finally, we predict that Japan will have a particularly robust year, well above trend levels on the back of further stimulus and a very accommodative Bank of Japan. Following the election on October 31, the new government led by Prime Minister Fumio Kishida announced a stimulus package worth 5.6% of GDP. Despite this, the Bank of Japan will likely maintain loose monetary policy as core inflation remains close to zero, while long-term inflation expectations remain far below the 2% target. Over the coming three months, the odds are high that Omicron will disrupt economic activity in advanced economies, but the magnitude of the disruption will be minor compared to past variants. As previously stated, we only expect a 40 bps and 50 bps hit to US and global GDP, respectively. The demand for goods will moderate in 2022, but, in contrast, the demand for services will continue to rebound. Since the pandemic began, US households have accumulated USD 2.3 trillion in excess savings. At least some of this money will be spent this year, with or without a new fiscal stimulus bill. In fact, the rebound from Covid has had the opposite effect of the GFC. Household net worth has risen to almost 130% of GDP since the start of the pandemic, as opposed to falling to 50% of GDP during the Global Financial Crisis. By some estimates, the wealth effect alone could boost annual consumer spending by 4% of GDP.

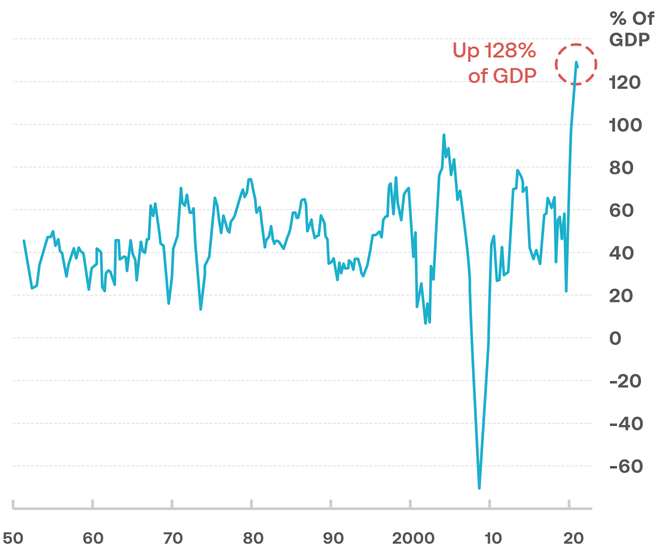
— "Household net worth has risen to almost 130% of GDP since the start of the pandemic, **as opposed to falling to 50% of GDP during the Global Financial Crisis**."

US change versus Pre-Pandemic Trend (2018-2019)



Source: BCA Research

US 7-Quarter Change In Household Net Worth

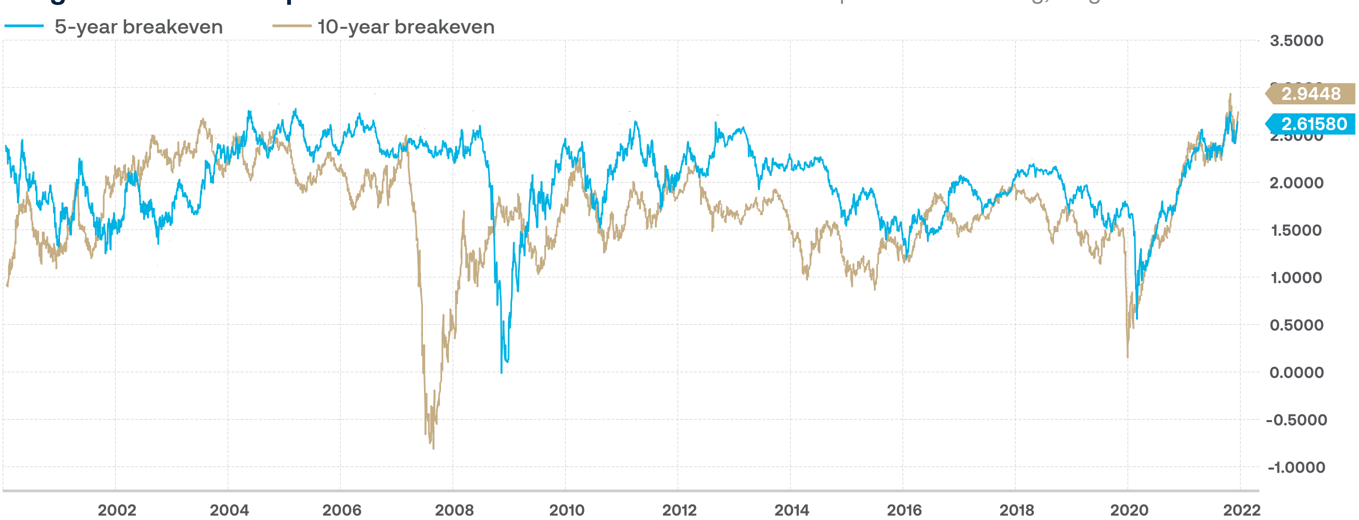


Source: BCA Research

Emerging markets face a more uncertain outlook. The Chinese economy stands at an important crossroad. On the positive side, the energy crisis seems to be abating as the country has now reopened 170 coal mines and will be resuming Australian coal imports. The US and China may be on the verge of a geopolitical *détente* as tariffs may be rolled back and the ADR listing dispute reaches a finale. Finally, China is the only major economic block in the world that is in a full easing cycle with both fiscal and monetary levers being pulled. On the negative side, however, the property market remains under duress as housing starts, sales, and land purchases are down 34%, 21%, and 24%, respectively, on a yearly basis. Moreover, the proportion of households planning to buy a home has fallen drastically, and loan growth to real estate developers has fallen to a historical low. Sure, the authorities have taken some steps to stabilize the property market, such as relaxing restrictions on mortgage lending and land sales, cutting the mortgage rates in some cities, and allowing some developers to issue asset backed securities to repay outstanding debt. But China's inescapable long-term problem is that it simply builds too many homes given its demographic trends. As was the case with Japan in the early 1990s before its own property bubble burst, China's working-age population has already peaked, and according to UN estimates, it will decline by over 400 million people by the end of the century. Although I suspect that the Chinese authorities will do a better job than Japan did and provide more fiscal stimulus to fill in the gap to aggregate demand from the property implosion, the sector will still be a drag to growth for many years. It is one of the reasons why my Real GDP estimate for China is the lowest it has been in quite some time at only 5% for 2022. The government has already suggested that it will increase infrastructure spending on clean energy, and that it will boost social spending quite dramatically. This is the opposite of what Japan did in the early 1990s. So, in sum, the Chinese property market is weakening and should remain weak for some time as demographics do not bode well for it, and the recent collapse of the Turkish lira highlights some of the structural problems that many countries face. Nevertheless, the combination of elevated commodity prices, the ramping up of Chinese stimulus, and the resumption of the US dollar bear market this year should support emerging market growth. Relative to consensus, we think the risks to growth in both developed and emerging markets are tilted to the upside in 2022.

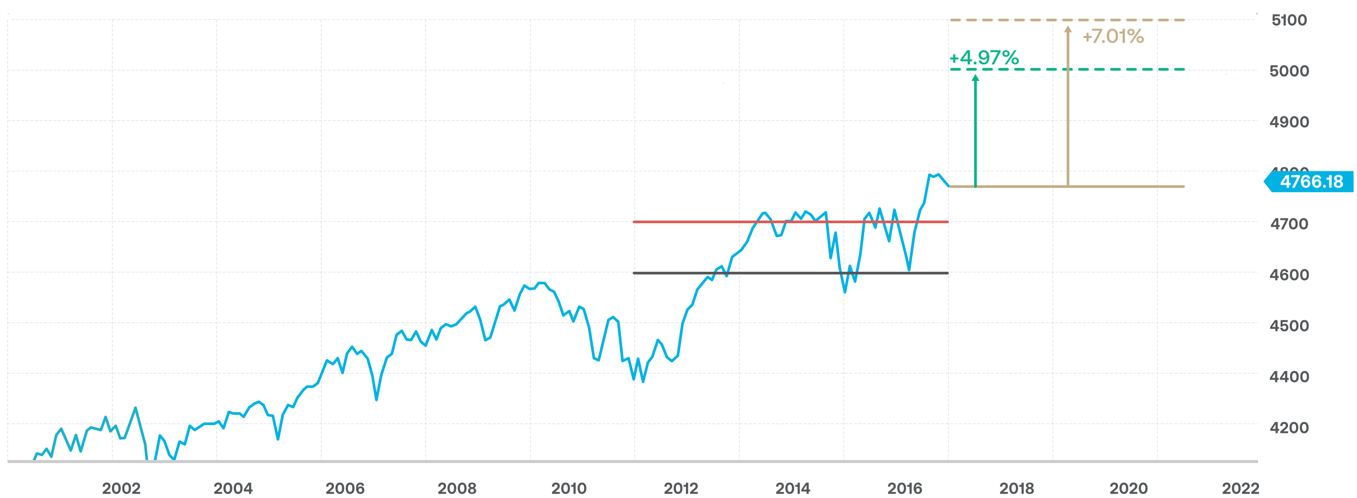
Equally, the inflationary risks have increased as well, so the most likely scenario for 2022 is above-trend growth and above-target inflation. The Fed's position is unenviable and why we call it a Catch-22. There is a risk that Fed tightening causes investors to become fearful of a recession. But the true risk of a policy-induced recession over the coming 12-18 months where the Fed hikes us into one will only materialize if long-dated inflation expectations break above the range that prevailed prior to the Global Financial Crisis. As this graph demonstrates, that has not happened yet as both 5-year and 10-year US Breakeven Inflation rates remain below the peaks that existed before and after

Long-term Inflation Expectations Must Remain Below GFC Levels | Source: Bloomberg, Insigneo



the GFC. However, the next phase of the inflation environment should be to the downside, even if the long-term trend for inflation is to the upside. This near-term pause should give the Fed some room not to engage in a major tightening campaign until the middle of next year even though we do expect two rate hikes this year, as we previously mentioned. Beyond 2022, the main risk to financial markets is that long-term interest rate expectations increase closer to the trend rate of economic growth. Although this would not necessarily be horrible news for real world economic activity, it could be unwelcome news for financial markets because it would imply materially 4700. We also told you that if we were wrong, it was probably going to be to the upside. As this graph shows the index ended the year at 4766, +1.4% above our target range. If one were to ask, most people would probably say that the US stock market had a momentous year. Indeed, it looks and feels that way, as the S&P 500 had an astonishing total return of 29% including dividends. However, paradoxically, this statistic is inaccurate or at least incomplete. **It is more appropriate and accurate to say that a few stocks had a spectacular year, while most stocks had a terrible one**. In fact, the median US stock was in sharply negative territory for the year. Because the S&P 500 is

S&P 500 in 2022: 5000 to 5100 (5 to 7% gain) | Source: Insigneo, Bloomberg



lower prices for financial assets that have benefited from extremely low interest rates. In other words, **one could see a reversal of the scenario observed since Covid when non-experts were asking themselves "How could the market do so well even though the economy is doing so poorly?"** But that is a matter likely only relevant beyond this year.

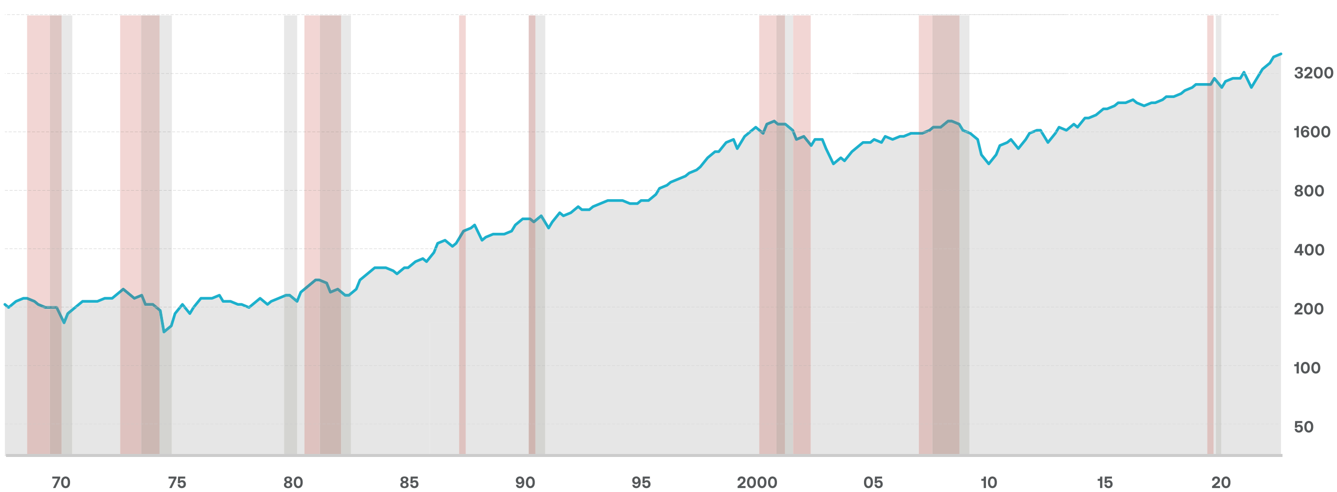
For 2022, we still expect positive, but more muted single digit returns in the US. Early last year, we had a target range on the S&P 500 of between 4600 and so top-heavy with the few largest companies accounting for a third of the index by market-cap weight, their stellar performance surged the broader market to new highs. But the vast majority of stocks that comprise the index by name and not weight, the smaller, typically value and cyclical names, did very poorly. Beyond the internal market statistics, the proof is in the proverbial pudding: active managers had one of their worst years on record. In fact, 85% of growth and 80% of core managers underperformed their benchmarks for the year. For this year, we expect the S&P 500 index to produce much lower returns. We think an appropriate multiple on the index is around 20x (lower than in previous years but correct given that we think rates are moving higher). With consensus forward 2023 EPS estimates at $250, that gives you an S&P 500 level of 5000. Thus, **our target range for the index is 5000 to 5100, a +5% to +7% gain from 2021**. While the Tech sector still has robust fundamentals, it is a long duration sector that could face multiple compression from higher rates. In other words, we expect Tech to be flat to market-perform for the year with most of the gains emanating from the cyclicals.

Broad asset allocation guidance and investment recommendations

Equities

Since recessions and bear markets tend to overlap as this favorite chart of ours demonstrates, one should stay overweight equities in multi-asset portfolios for the time being since we do not think a recession is in the offering over the next 6 months.
However, **we would favor equities outside of the US, especially Europe and emerging markets, and would overweight cyclicals and value stocks and mid to small caps**. Although we see further market upside in the US, we do believe that gains will be more muted than they have been over the last few years. **Within emerging markets, we think that China will be the stellar performer**. Outside of China, there is scope for Russia, Brazil, and Indonesia to outperform as well.
By sectors, we prefer energy, financials, consumer

Since Recessions & Bear Markets Tend to Overlap, Stay Bullish | Source: BCA research



— "Since recessions and bear markets tend to overlap, one should stay overweight equities in multi-asset portfolios for the time being since we do not think a recession is in the offering over the next 6 months."

services, and healthcare. In fact, travel & leisure looks particularly attractive on a risk/reward basis. We would underweight consumer staples, utilities, and consumer goods.

Fixed income

We would continue to maintain low interest rate duration exposure within sovereign bond portfolios. **Our target range for the US 10-year government bond is 2 to 2.25%**; we also expect further yield curve steepening into the middle of this year. On a country basis, we would underweight the US, UK Gilts, Canada, and New Zealand. Within corporate credit, we would also continue to favor high yield over Investment Grade.

Currencies

Although the USD could continue to strengthen over the near-term as it is a momentum currency, we would expect it to weaken on a trade-weighted basis over the course of the year. Within the G10, the Loonie (CAD) could be the best performer.

Commodities

Oil prices should continue to rise after the Omicron wave passes and could average USD 80 to 85 per barrel this year. The base metals should also remain buoyant given clean energy infrastructure demand, tight supply and unresolved physical deficits, and Chinese stimulus. Maintain gold exposure as an inflation hedge as well.

Two main risks to our view

The first stems from a greater-than-expected hawkish shift, especially by the US Federal Reserve; if the Fed's Catch-22 becomes insurmountable, in other words. The second major risk is geopolitical: war in Ukraine, a preemptive strike against Iran, and/or a mistake in the Chinese littoral regions to name a few. While these risks always exist, they are heightened in my view due to the breakdown of the unipolar world dominated by the US into a more fragmented multipolar one. Historically, shifts like this in the global landscape have increased volatility and depressed returns.

Declining Democracy & Other Factors Pointing to Lower Future Market Returns

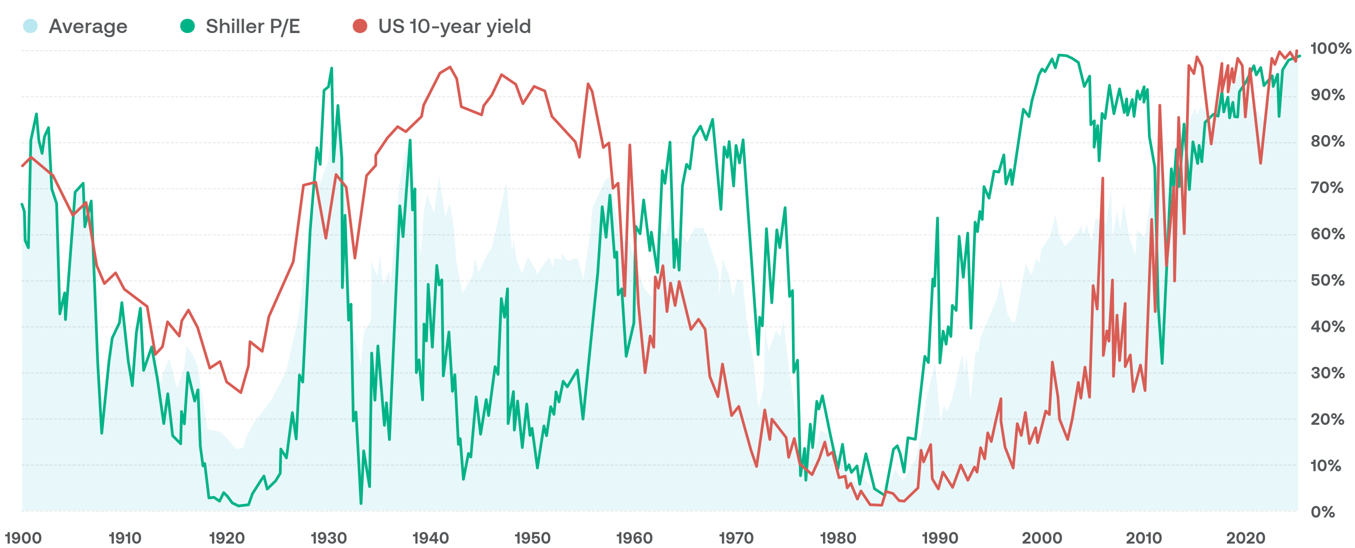
In the latest Freedom House's Freedom of the World report, many countries have been downgraded in terms of their democracy rating. As this chart demonstrates, the median 10-year return for stock markets that experience a downgrade of this sort are lower than if there was no rating change or an upgrade. In fact, after such a downgrade, equity market returns are approximately -5% lower annualized over this period

Annualized Median 10-year Returns (1972 – 2020)

Source: Freedom House, MSCI, JP Morgan (LCU = local currency unit) versus countries who were upgraded, and approximately -2.5% lower annualized over countries with no change. This is due to weaker earnings growth and currency depreciation. What are some of the drivers of this underperformance? Although we do not know for sure, we could hypothesize that democracies provide more effective governance, and greater true competition. In the few empirical studies on the subject, the weight of the evidence indicates that democratic improvements are supportive of both economic growth and stock market returns. Since the US was downgraded, this does not bode well for long-term equity market returns. When you also factor in the fact that traditional balanced portfolios, such as the ubiquitous 60/40 model, might be less attractive in a post-pandemic world, things start to look a little bleak over

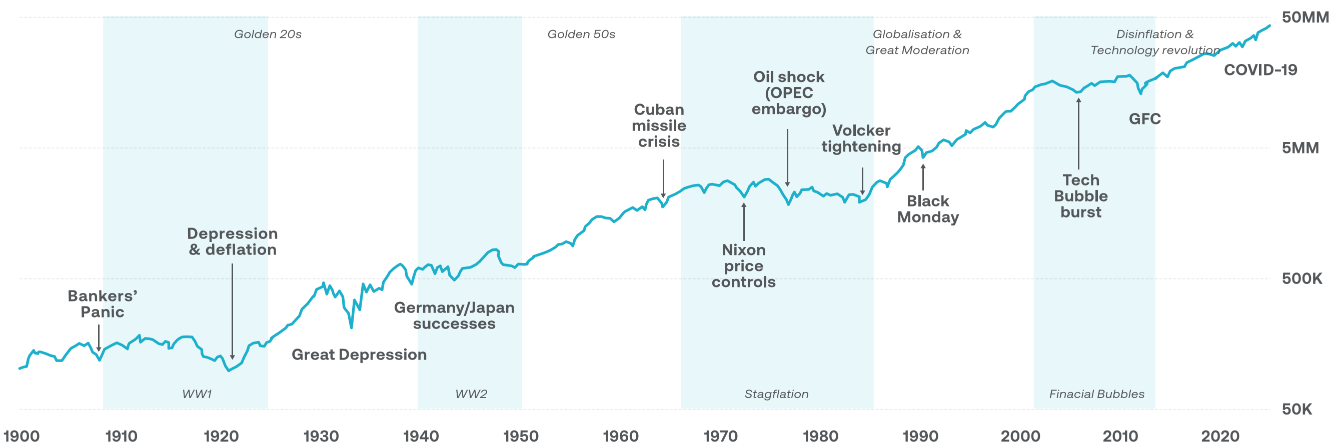
— "A lost decade is a prolonged period of inferior buy and hold returns. In fact, as this graph shows, valuations right now are as expensive as they were in the Roaring '20s and the Golden '50s, above the 90th percentile dating back to 1871."

Valuation Percentiles since 1871 | Source: Robert Shiller. Datastream, Goldman Sachs



time. There is a ton of precedent for this, as well. Since 1900, there have been several 'lost decades' for balanced portfolios with almost zero real returns. A lost decade is a prolonged period of inferior buy and hold returns. In fact, as this graph shows, valuations right now are as expensive as they were in the Roaring '20s and the Golden '50s, above the 90th percentile dating back to 1871. And these periods of subpar performance are common. Since 1900, we have had four of them. The first was a period that lasted for nearly 15 years. It began after the Banker's Panic of 1907 and ended roughly in 1924. Then, we had the Roaring '20s, an age where balanced portfolios did very well, even during the Great Depression. The

Lost Decades for Balanced Portfolios Follow Bull Markets | Source: Robert Shiller. Datastream, Goldman Sachs



second "Lost Decade" roughly coincide with World War II and its aftermath. It lasted about 10 years and gave way to the Golden '50s era that lasted until the mid-1960s. The third one was one of the longest periods and it generally coincided with the stagflationary environment of the late '60s, '70s, and early '80s. The final one, from 2000 to 2010, was one of financial bubbles – emerging markets, tech, and finally real estate. Since then, we have been in one of the better environments ever for balanced portfolios largely due to a happy cocktail of supportive growth and disinflation.

Meanwhile, US equities have outperformed the rest of the world by almost 7% annually over the last 13 years. As an illustration, if one would have invested USD 100 in the US at the end of 2007, that would now be worth USD 385. If you had invested that same USD 100 only outside of the US, then it would only be worth USD 165 today. So, why did I just tell you all to continue shifting money outside the US this year? A trend that I think will continue for many years. Because over the past 50 years, whenever the US has outperformed the rest of the world over a 10-year period, that trend was reversed 75% of the time. As this graph shows, since the early 1970s, US multiples are now at all-time highs against the rest of the world and margins are high.

Obviously, a major factor has been stellar US earnings growth versus the rest of the world, but that could be due to the rise of Megacap Tech and pseudo-monopolies. Thus, enhanced US antitrust regulation and enforcement that would focus almost exclusively on

US P/Es minus the rest of the world

Source: Refinitv Datastream, JP Morgan

Megacap Tech (something I predicted in the last quarterly call), could unwind those earnings growth drivers. Another factor has been the accretive impact of share buybacks on the EPS of US growth stocks, and an outsized expansion in equity multiples.

There are significant secular risks to these sources of US equity outperformance over the past 14 years. Mean-reversion on valuations points to poor real returns, even with similar growth to the last cycle. Even if valuations remain at elevated levels, supported by continued low and negative real yields, we expect less than half the real 60/40 returns of the last cycle and likely below the long-run average of 5%. **In absolute terms, we estimate that US equites would generate annualized nominal total returns of between 4.5% to 5% over the next 10 years. The bottom line is that investors should expect diminished returns in their portfolios given the same asset class mix**. To maintain those returns, investors are going to need to either:

- increase their risk tolerance and add assets with greater risk, and/or
- start investing in private markets.

Melissa Ochoa Cárdenas
Investment Strategist
Insigneo Financial Group

Sustainable and ESG investing: Still a long way to go

Even if it has been around longer than what investors believe, sustainable and ESG investing have increasingly won over center stage for investors across the world, with a large amount of asset classes becoming more and more available for those investors who aside from getting a return on investment, are looking to generate an impact beyond financial gains. Nonetheless, investors are increasingly concerned about the quality of such 'sustainable' or 'green' investments, with terms like 'greenwashing' or 'social-washing' starting to become more common.

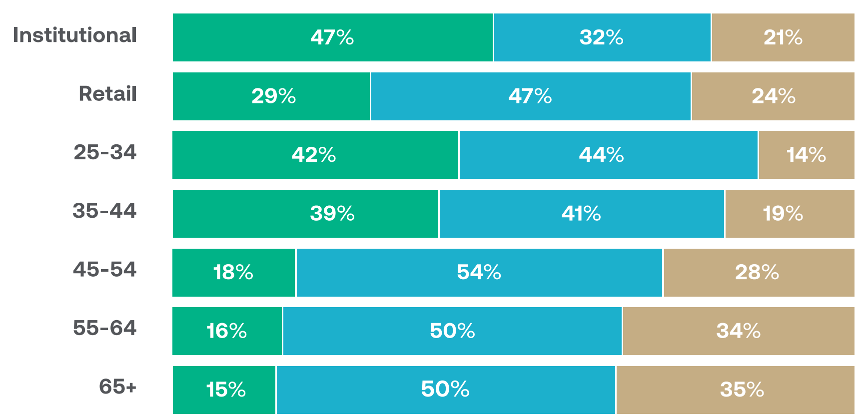
Today, our goal is to get a general understanding of what sustainable and ESG investing means, how that can be achieved in your portfolios, and what pitfalls may lie ahead.

Let's start by stating what sustainable investing means. Per a Harvard Business School article, "Sustainable investing, also called socially responsible investing or ESG investing, is a means of investing in which an investor strongly considers environmental, social, and corporate governance (ESG) factors before contributing money and resources to a particular company or venture. The goal is to, whenever possible, use investment dollars to promote positive societal impact, corporate responsibility, and long-term financial return." It is worth highlighting the CFA Institute's addendum to this definition. It further clarifies that "sustainable investing has broader connotations and is more like an investment philosophy, whereas ESG investing works at a practical level to describe investment mechanics.".

of the COVID-19 pandemic accelerated the adoption of sustainable investing, with a specific focus on social responsibility. This increased interest was also captured by a CFA Institute survey, in which 67% of the participants chose 'social' as the ESG area they take into account in their investment analysis or decisions; in 2017, this figure was a much lower 54%. Moreover, the share of respondents that do not consider ESG factors for their investment analysis or decisions decreased from 2017 to 2020 from 27% to 15%, again highlighting the importance of the topic in today's markets. Furthermore, according to an analysis performed by the International Capital Market Association of the Environmental Finance database, social bond issuance in 2020 was more than USD 11.5bn through mid-May, an 86% increase from the same period the previous year.

Which best describes your interest in ESG investing?

- Higher risk-adjusted returns
- Personal values or invest in companies w/positive impact on society/environ.
- Both



(Source: CFA Institute, 2020)

Despite its current popularity, it should be pointed out that sustainable investing began in the 1970s, when the first sustainable mutual fund was launched. From then on, additional milestones have paved the way for sustainable investing to become more and more popular, such as the launch of the Dow Jones Sustainability Index in 1999, the development of the UN Principles for Responsible Investing (PRI) in 2006, or the launching of the Global Impact Investing Network (GIIN) in 2009. In more recent history, the appearance

The interest in ESG investing was also tangible in the CFA Institute survey that I mentioned, in which 47% of institutional investors stated that they were interested in ESG investing to generate higher risk-adjusted returns, whereas the desire to advocate personal or social values came in lower at 32%. This same trend was apparent in younger investors (i.e., ages 25 to 34), while other age brackets, as well as the retail investors, seemed more interested in prioritizing their values when performing an investment.

Before we move on, it would be relevant to outline a couple of points that investors should consider before they enter the ESG investing sphere. First, investors need to define what ESG comprises specifically for them. This can be determined through a suitability questionnaire, or simply by establishing which of the three letters of the acronym – be that the E, the S, or the G – are most relevant to them. This is important to determine which focus they would prefer to have within their investment universe. **Moreover, if the investor decides to enter the ESG sphere through an ETF or a fund, they need to perform a thorough due diligence on the fund per se and see whether its interests, its mandate, and the companies it is supporting are aligned with the investor's principles and beliefs**. This part should also help investors avoid 'greenwashing', a topic we will discuss later today. Furthermore, a fundamental element to identify the interests and principles of both companies and funds relies on their capacity to do ESG reporting, and whether those reports are aligned with industry ESG standards.

On its face, sustainable and ESG investing sound appealing and, according to a KPMG –CAIA–AIMA–CREATE Survey from 2020, is being propelled mainly by institutional investors who believe that the traditional modus operandi of investing, which only considers risk and return, needs to be rewritten to address ESG factors. In his 2020 annual letter to shareholders, BlackRock's Larry Fink emphasized the effects that climate change could have on the reallocation of capital, and not coincidentally, the term has never been more popular since, according to data from Google Trends compiled by the CFA Institute.

Nevertheless, there have been issues around sustainable and ESG investing that make its implementation more challenging – starting by its target users and potential clients. According to the previously mentioned CFA Institute survey, a lack of client demand remains the top reason that firms do not consider ESG issues. Another point that should raise signs of worry across market participants is that, for 33% of investors, there is insufficient knowledge of how to consider ESG issues, as can be seen in the following graph.

Even if one highlights the increase observed in the materiality of ESG issues when investing – considering the decrease of 17 percentage points portrayed by this survey – there is still a long way to go if we want ESG and sustainable investing to be a primary factor for portfolio managers, asset allocators, and clients.

Why do you or your organization not take any ESG issues into consideration in your investment analysis decisions? | Source: CFA Institue, 2020

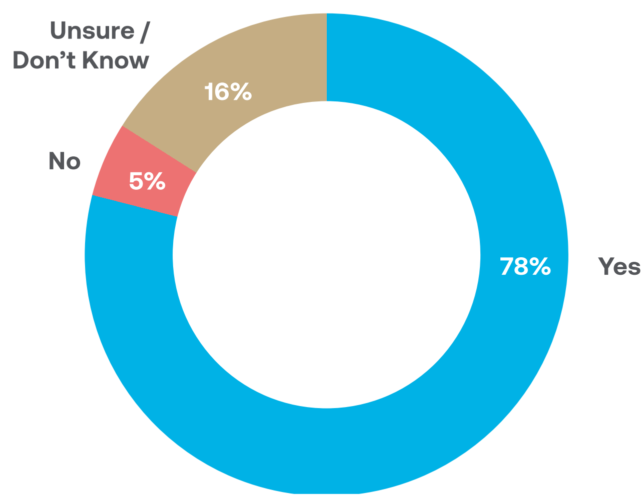
		Change vs 2017	Region where highest
Lack of demand from clients/investors	52%	+5	Americas
Insufficient knowledge of how to consider these issues	33%	+16	Asia Pacific EMEA
Lack of information/data	26%	+7	Asia Pacific
These issues are not material - no added value	26%	-17	Asia Pacific
Inhability to integrate ESG information into my quantitative models	21%	+6	EMEA
Market practices require me to focus on short-term performance	12%	+7	Asia Pacific
Other	19%	+6	Americas and EMEA

— "Investors have revealed elevated concerns that proceeds stemming from sustainability-linked instruments may be funding projects without a clear beneficial impact."

This same trend may be gleamed from the aforementioned KPMG survey as well, where 31% of the surveyed sample affirmed to be in the "awareness-raising" phase of impact investing implementation, whereas 10% still had no implementation. One possible explanation for this shortfall is the lack of quality and consistent data on ESG factors. This was noted by S&P in a report where they highlighted those two factors as the key challenge in addressing confusion in the ESG space. Additionally, the rating agency highlighted that "the quality and consistency of post-issuance use of proceeds and impact reporting is still highly unstandardized and fragmented across issuer types and regions making it difficult to compare and aggregate performance.".

Furthermore, another challenge that investors are facing within the reporting realm is the one where they must identify whether the claims from the issuers are trustworthy and reliable, or if those have been 'greenwashed'. Here we need to take a brief pause and define what the industry means when it uses the term 'greenwashing'. According to Investopedia, "greenwashing is the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound. It is considered an unsubstantiated claim to deceive consumers into believing that a company's products are environmentally friendly." The greenwashing concern is of high importance for investors: a Quilter Investors survey conducted in May 2021 showed that this specific challenge was the biggest

Do you think there is a need for improved standards around ESG products to diminish "greenwashing"?



Source: CFA Institute, 2020

concern for almost 44% of investors, who have become "increasingly sensitive" to the effects of companies that could have potentially exaggerated their green credentials. These concerns were also visible in the previously mentioned CFA Institute report, where 78% of the participants of the survey considered that there is a need for improved standards around ESG products to diminish 'greenwashing'.

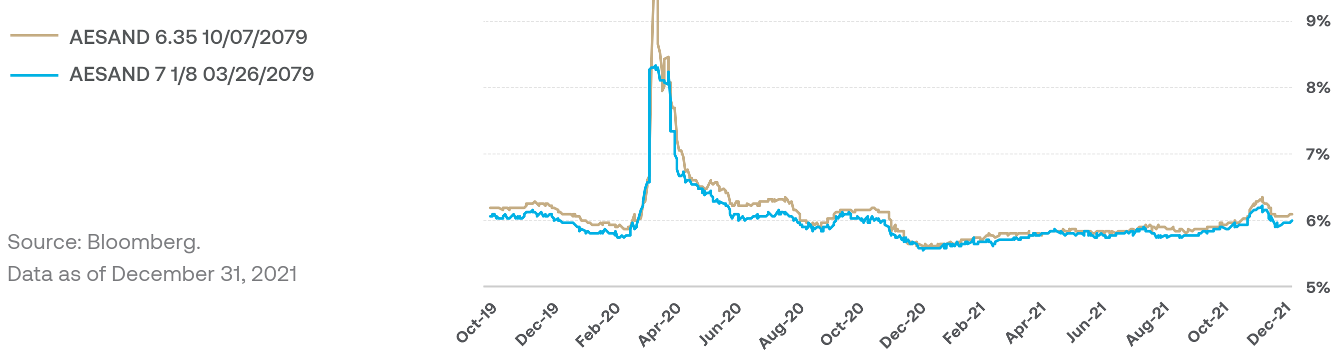
Meanwhile, additional concerns have started to arise in the ESG industry around "sustainability-washing". Given the importance that new types of sustainable financing tools – such as social, transition, and sustainability-linked instruments – have started to attract, this has become even more relevant considering that investors have revealed elevated concerns that proceeds stemming from sustainability-linked instruments may be funding projects without a clear beneficial impact. Moreover, an additional concern that comes from the sustainability-linked instruments is that those issuers could be tempted to set performance targets that are not ambitious enough, meaning that the issuer would not have to demonstrate a significant improvement over its business-as-usual strategy, or it would not require a significant investment to achieve those targets.

Another obstacle that ESG investors are facing is the heterogeneity of ESG reporting that the industry currently has available. According to data from KPMG, 57% of surveyed hedge fund managers admitted that they do not currently report on ESG performance at all. Of those who do, 11% use customized metrics and 23% use PRI. **Nonetheless, expectations here are more optimistic than other ESG facets, given that ESG reporting has gone from 'nice to have' to a 'must have'**.

On another note, investors have debated around the possible existence of a 'greenium', defined as the difference in yield between a traditional fixed income instrument and one that has ESG objectives, more specifically green bonds. The presence of this 'greenium' has been discussed across investors, and its existence is dependent on different factors. First and foremost, 'greeniums' should be seen as an issuer-by-issuer case and should not be determined in a general analysis, while also taking into account that not all green bonds have a conventional peer against which they can be compared. Secondly, the expected increase in green bond supply may help ease any signs of premium that green assets could have exhibited, due to being scarcer than its traditional peers. Now, let's consider a specific case: AES Andes, the Chilean electricity producer and distributor company, tapped the markets in 2019 by issuing a 60-year green bond, the first for the company. Luckily for us, AES Andes also has a traditional bond that matures in 2079, which allows for an initial analysis in terms of 'greenium' existence. When comparing the historical yield of the two bonds since the green bond was issued, one can highlight that the average spread between the green and the traditional bond is 11bps, as can be seen in the following graph.

Nonetheless, one can observe that the yield of the green bond was largely superior (almost 200bps more)

The market is letting go of the 'greenium'



Source: Bloomberg.
Data as of December 31, 2021

than its traditional peer only in March 2020, when the company reported a capital increase of USD 500mn to finance its renewable energy investment plan. The market reacted sharply to this announcement, considering that the company was not capable of funding part of its green strategy, which in the end made the green bond perform worse than its traditional peer. As stated before, this is an isolated case and each bond should be evaluated within its own context, but i**t seems that the market is casting aside the 'greenium' that could have been charged to green bonds before**.

Yet another challenge that ESG investors have voiced is the need to create an infrastructure with data, professional knowledge and skills, and technology that can support the proper development of the industry. If we go back to the second graph, we can highlight that the three main factors that undermine ESG investing are, unsurprisingly, these same stated missing ones. In terms of upskilling, a couple of alternatives, such as the Certificate in ESG Investing backed by the PRI and launched by the CFA Society United Kingdom, have emerged in the last years, and most of the investment professionals that participated in the surveys I have quoted stated their interest in building up their ESG knowledge, while being aware that ESG should be a fundamental pillar in the security selection process, instead of just one element at the end of it.

In addition to the latter, and as a means to combat both 'greenwashing' and 'sustainability-washing', the industry needs to focus on the quality of information available, thereby allowing investors to compare and have access to different sustainability metrics, while understanding the most material considerations from a financial and ESG perspective. **According to Standard and Poor's, the increased demand for more detailed and consistent ESG disclosure will drive improvements in the field, while simultaneously adding momentum to the development of ESG-focused regulatory disclosure and reporting frameworks**.

Finally, the industry shift towards heightened interest in ESG and sustainable investing would also benefit from an improvement in leadership. Leaders need to set the tone and lead by example, while being aware that institutional investors are the biggest fish in this pond, thus their influence – and their leadership example – is crucial for the success of this shift.

We cannot deny that progress has been made, and that interest in ESG investing has increased dramatically over the years. Nations and companies have issued green bonds, preferrable to traditional investment alternatives in some cases. Nevertheless, the need for a more standardized, homogeneous investing sphere, where everyone can compare and draw conclusions from an equitable starting point, is something that the industry is still lacking. This opens the door for fraud and/or negligent behavior from bad actors. But it is moments like this that we should remember the words of historian, philosopher, and playwright Howard Zinn, **"We don't have to engage in grand, heroic actions to participate in change. Small acts, when multiplied by millions of people, can transform the world."**

— "According to Standard and Poor's, the increased demand for more detailed and consistent ESG disclosure will drive improvements in the field, while simultaneously adding momentum to the development of ESG-focused regulatory disclosure and reporting frameworks."

Latam Outlook: a challenging road ahead

> Latin America continues to face several challenges for the year we are currently starting, even if some clarity seems to be stemming from previous sources of uncertainty.
> On the growth front, most of the region's economies have already recovered most of their pre-pandemic levels. However, the gains may have already been reaped, and the activity forecasts for this year do not look as promising. This outlook is occurring in conjunction with tighter monetary policy and diminished fiscal capacity from governments.
> Political risk remains a concern for the region, with presidential elections happening in Colombia and Brazil, the Constitutional process in Chile, and Argentina's negotiations with the IMF.

Latin America continues to face several challenges for the year we are currently starting, even if some clarity seems to be stemming from previous sources of uncertainty. Nonetheless, there are some maladies that may continue to haunt the continent in 2022. How governments and monetary authorities respond to these uncertainties will be crucial for future development and economic growth.

While we enter our third year of the COVID-19 pandemic, it is relevant to highlight that Latam, as a region, was able to recover some of the growth that it sacrificed in 2020, even if it did so in a heterogeneous fashion. However, this recovery was propelled in some regions by a stronger than expected comeback from household consumption and spending which, in the end, also ignited an inflationary cycle. As 2021 came to a close, practically all central banks in the region had tilted their monetary policies towards a more hawkish stance, amid fears that inflation was not as transitory as previously believed and recalibrating their reaction function to a similarly more hawkish US Fed.

On the growth front, it is worth highlighting that, by 3Q21, most of the region's economies had already seen their activity levels retrace most of their pre-pandemic levels. However, the gains may have already been reaped, and the activity forecasts for this year do not look as promising. This outlook is occurring in conjunction with tighter monetary policy and diminished fiscal capacity from governments.

Additionally, political risk remains a salient concern. **With the region having taken a notable shift to the left, observers will be closely monitoring presidential elections in two key countries in 2022: Colombia and Brazil**. Moreover, they will also be watching the developments around the new Chilean Constitution as Convention members expect an initial draft by July 2022. Finally, Argentina's negotiations with the IMF remain ongoing and, with numerous internal political challenges, the country is struggling to present a plan that can convince the monetary authorities to sign a deal by the end of the first quarter.

Nevertheless, the best way to address the region is by using a country-specific approach, and then reaching general conclusions for the quarter – and the year – ahead.

— "Latin America continues to face several challenges for the year we are currently starting, even if some clarity seems to be stemming from previous sources of uncertainty.
How governments and monetary authorities respond to these uncertainties will be crucial for future development and economic growth."

Argentina

Argentina's fate will depend on its capacity to seal a deal with the IMF and whether this deal is approved by the government. Nevertheless, in macroeconomic terms the country is facing a challenging scenario, with persistently increasing inflationary pressures, lower growth, decreasing FX reserves, and additional macro and fiscal imbalances that make the implementation of any program a daunting task.

In terms of growth, Bloomberg consensus estimates a very mild 2.2% GDP for 2022, on the back of a declining physical stock, lack of growth-enhancing reforms, and weak policy credibility. Even if we are expecting higher commodity prices that would bode well for Argentinian exports, this situation also entails a headwind: an economic recovery may also imply higher imports that the country cannot face with its FX reserves declining by the hour. Furthermore, inflation is also expected to continue accelerating, given the extensive set of established price controls. Additionally, it is worth bearing in mind that the Argentinian economy currently has maintained tariffs practically unchanged as an attempt to contain inflation; however, these efforts have not been enough, and **the government may be forced to perform a devaluation of the ARS to tame inflation, together with a possible re-setting of price controls and tariffs**. This increase in tariffs may imply a reduction on the welfare subsidies that have been granted to the community, and this could represent an additional struggle for the government.

On another note, with fiscal policy expected to remain loose for the upcoming years, with the balance widening for 2022 after having displayed an adjustment in 2021 because of the IMF SDR allocation, and the profits obtained from the wealth tax. A means to achieve fiscal adjustment would then be the commission of a deal between the IMF and the Argentinian government; however, the current political backdrop that entails a weakened current administration that lacks credibility, and the existing tensions between them and the ruling coalition, leaves a very limited range for any type of fiscal adjustments. Moreover, it should be highlighted that **the negotiations between the IMF and the government could get tense, considering that the IMF is looking to implement an adjustment that goes beyond previous efforts, while the government seems to continue to want to implement a muddle-through strategy**.

> — "Argentina is facing a challenging scenario with persistently increasing inflationary pressures, lower growth, decreasing FX reserves, and additional macro and fiscal imbalances."

Going forward, the market will continue to monitor the developments of the negotiations between the government and the IMF, while also taking into account that the deadline to strike a deal (March of this year) is looming closer. If the deal is struck, then the market will be eyeing its passage through the Congress, and if the more orthodox measures that the IMF most probably will suggest will outlive the opposition, and even the government's stance to do the bare minimum.

Brazil

Brazil's outlook for 2022 is challenging, to say the least. The country faces a continuous increase in inflation that has led to an unmooring of inflation expectations, even if the November inflation reading surprised the market to the downside, mainly due to lower-than-expected food prices. This situation has also forced the hand of the Central Bank which, in turn, started tightening its monetary policy stance earlier than other Latam Central Banks and has hiked a a total of 725bps throughout 2021. In addition to the challenging monetary backdrop, Brazil has also seen its latest growth

> — "Brazil is entering an election year, with Presidential elections taking place in October. Markets will continue to monitor the electoral race, in hopes to get a more defined picture of voters' intentions; however, volatility will continue to surround markets until election day."

prints experience a setback, with the country entering a technical recession after the release of its 3Q21 quarterly GDP print.

Furthermore, the biggest challenge that Brazil will face comes from the fiscal front: even if there was a visible improvement last year in the fiscal balance and the public debt dynamics, the fact that the government is postponing the payment of precatórios to liberate space within the spending cap for President Bolsonaro's welfare programs jeopardizes the country's fiscal stability. It is worth bearing in mind that, after the Brazilian Congress approved the "Precatórios PEC" in December, it allowed for the spending cap to have an additional space of close to BRL 69bn, while it also freed up BRL 44bn in budget resources for 2022 after deferring the payment of precatórios. This is equivalent to having freed an amount of almost BRL 113bn in the 2022 budget, with the biggest part of this allocation being directed to finance the new welfare program Auxílio Brasil. Against this backdrop, analysts expect a widening of the fiscal deficit for 2022, which contrasts starkly with the projected surplus that was forecast for 2021.

On another note, the Central Bank has been one of the most aggressive entities across the continent, having to face an inflation that is practically out of control, thus having to implement a hawkish monetary policy earlier than its peers. On its latest meeting, the COPOM hiked the Selic rate 150bps to 9.25%, levels not seen since 2017 when the COPOM was implementing an accommodative monetary policy. However, the hawkish stance of the committee was visible on its latest minutes, where the Committee acknowledged that the fiscal shift that the country is experiencing sets the stage for a higher neutral interest rate, especially when considering that, even for the committee members, inflation expectations for the next two years are above the Central Bank's target.

Lastly, Brazil is entering an election year, with Presidential elections taking place in October, as well as congressional, local gubernatorial, and legislative elections. For the presidential election, voting is scheduled for October 2, with the tentative run-off date set for October 30. It is worth noting that the candidates that have gained the most support among voters represent the two extremes: current president Jair Bolsonaro, and former president Luiz Inácio Lula da Silva. This polarization seems to be leaving very limited space for a center candidate to emerge, even if the race is still too open to call. Markets will continue to monitor the electoral race, in hopes to get a more defined picture of voters' intentions; however, volatility will continue to surround markets until election day.

Chile

For 2022, and almost as if it were a constant for all countries Latam, Chile is facing a challenging environment stemming from an overheated economy that now must deal with increasing inflation, and a governmental transition between the Piñera and the Boric administration, who will be sworn in March. The latter, amid the continuous process of rewriting the Chilean Constitution, and the presentation of the initial draft before the document is presented to a popular plebiscite in August this year.

The Chilean economy continued to outperform in the last months of 2021, mainly driven by a strong domestic demand and a positive behavior from the commerce sector. This trend is also explained by the large fiscal transfers that were performed during 2021 that implied an important setback on savings. However, this trend is not expected to remain for 2022, on the back of higher inflation, the implementation of tighter monetary policy, and the uncertainty element coming from the political front that still exhibits some unsolved mysteries.

In terms of monetary policy, the Chilean Central Bank has been tightening its monetary policy rate since June, with the last moves being the most aggressive ones in terms of magnitude. This stance is supported by the sustained increase in inflation that Chile has witnessed, and as an attempt of the BCCh to tame it down, while trying to re-anchor inflation expectations within the monetary policy horizon. Therefore, the market expects the Central Bank to maintain its tightening pace beyond the restrictive territory which, eventually, would hurt economic growth.

Moreover, inflation could begin to recede in 2022, given that a more restrictive monetary policy should bear fruit. Nonetheless, it is worth keeping in mind that, in the case of Chile, the country has experienced considerable price pressures stemming from both food and energy prices, which in turn makes the receding of inflation more challenging. In addition to the latter, and even if the fourth pension withdrawal bill was rejected by the Congress in December, spending in services – as well as services inflation – have accelerated considerably, thus keeping that variable way above the Central Bank's target, while being an additional drag to inflation convergence.

Going forward, and as was mentioned before, **the political factor will continue to weigh in the Chilean landscape: the new president, Gabriel Boric, will assume his mandate after having won the presidential elections by a wider margin than expected**, and after having moderated both his proposals and his political views. However, the president elect will face a divided Congress, and a Constitutional Assembly that is more left leaning than the Congress per se. Furthermore, uncertainty remains around Boric's ministerial cabinet, and whoever he chooses to surround himself with will also play an important role in the stabilization of the incoming administration.

> — "Colombia, just like Brazil, will have to deal with the political uncertainty that usually brings an election year, while trying to balance an increasing inflation with a wider current account deficit."

Colombia

Colombia, just like Brazil, will have to deal with the political uncertainty that usually brings an election year, while trying to balance an increasing inflation with a wider current account deficit, and a deceleration in a growth trend that reached pre-pandemic levels in 2021.

In the monetary policy front BanRep, like the other Central Banks in the region, started its normalization process by hiking the monetary policy rate by 125bps in 2021, on the back of a continuous rise in inflation, and as an effort from BanRep to keep inflation expectations from unmooring. This tightening stance should continue in 2022, considering that the output gap has been closing faster than previously expected, and the last inflation print of 2021 continues to challenge how anchored inflation expectations truly are. Inflation will continue to be pressured to the upside due to higher food prices, as well as by the nominal increase in the minimum wage that is effective starting January; however, BanRep could maintain its current hiking rhythm of 50bps per meeting if the core inflation measure remains relatively anchored and close to its target. Furthermore, the existing current account deficit has widened to levels not seen since 2014, and the observed weakness of the exchange rate would account for its closing process to be more challenging, even if the expected positive behavior of commodity prices should help alleviate a deeper widening.

Economic activity has remained strong throughout 2021, propelled by the recovery of retail and construction sectors, while also being spurred by a strong internal demand. The positive news in the activity front have also come from the soft data, with PMI releases that have remained in expansionary territory for the last six months, and an observed recovery in consumer confidence for the same period. Even if the economy has solid fundamentals for its activity to remain on positive ground in 2022, the strong recovery observed last year will not be sustained at the same level in 2022, considering the higher inflation and the tighter monetary conditions that should pare down domestic demand, together with a high base effect from 2021.

Even if the economic fundamentals seem relatively stable, Colombia will face an electoral cycle, with legislative elections in March, and presidential elections in May, with a possible run-off in June. Even if left leaning presidential candidate Gustavo Petro has been leading in recent polls, uncertainty will continue to surround the presidential race until candidates are not fully defined after the internal consultations from the parties take place in March. Additionally, once candidates are defined, alliances and possible endorsements may also shape the electoral race differently, hence investors should keep a monitoring eye on these political developments.

Mexico

After a sharp contraction due to the pandemic in 2020, and a recovery that was still finding its feet in 2021, the main two issues that Mexico will face in 2022 are AMLO's referendum on his mandate, and his electricity reform proposal that prioritizes the state's electricity company over private ones, while dissolving autonomous regulatory bodies.

In terms of economic growth, Mexico experienced a sharp contraction in 2020, and 2021 the expected recovery is milder, especially after observing bottlenecks that sharply affected the manufacturing sector in the auto and electrical fronts that translated to a contraction in 3Q21. Nonetheless, the market could expect a better performance from domestic demand going forward, considering that in 4Q21 there were fewer COVID-related lockdowns, and consumption started to take flight amid an observed recovery in the services sector.

On the inflationary front, Mexico also endured a sustained increase in the variable throughout 2021, mainly due to stronger-than-expected increases in food prices, as well as supply chain disruptions. Furthermore, inflation of energy prices remained high in 2021, thus being an additional drag for the headline inflation figure. This backdrop made inflation finish 2021 over 400bps above its target, while also propelling an increase in inflation expectations for the short term, while long-term expectations remain anchored, as per information reported by Banxico. Going forward, inflation should recede in 2022 due to high base effects, but it would remain above Banxico's target for the year. Furthermore, it is relevant to highlight that Banxico expects inflation to start receding in 1Q22, after having reached its peak in the end of 2021.

Regarding monetary policy, and after having increased its monetary policy rate by 150bps in 2021, Banxico is expected to continue to tighten the monetary policy, in an effort to maintain long-term inflation expectations anchored, and on the back of risks that jeopardize the convergence of inflation to its target, such as the normalization process by the Fed that should start in 2022.

As stated before, president AMLO will try to get his electricity reform proposal approved after it got delayed until April this year. It should be stated that the market expects the proposal to be watered down for it to be approved. On another note, AMLO's referendum on his mandate would take place on April 10, 2022. Nonetheless, the president continues to have a high approval rate, which makes the market pencil in that he would not be removed from office; moreover, the result of the referendum is not binding.

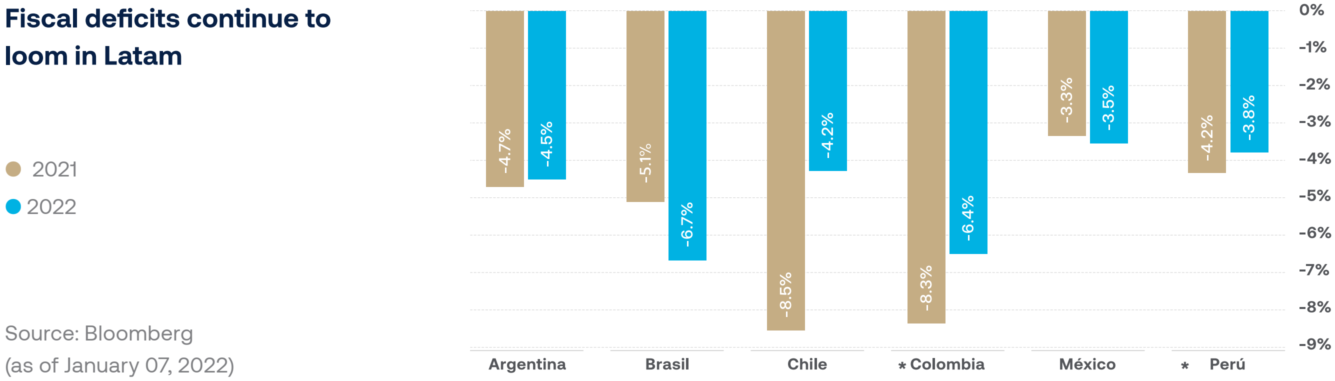
Peru

In terms of political stability, Peru has the most challenging backdrop of the region. President Castillo has not been able to maintain a high governability, given that his current period in office has been surrounded by, among others, cabinet reshuffles and attempts from the Congress to impeach him. This, in turn, has made the implementation of a political agenda more challenging Thus, political uncertainty and volatility have remained as common elements of the Peruvian outlook. This challenging political situation has developed amid an economy that portrayed a strong recovery from the effects of the COVID-19 pandemic, and that strong trend should allow the Peruvian economy to reach a double-digit expansion in 2021; however, and even if momentum should continue in 2022, it will do so at a milder rate. On the positive side, Peru will reap the benefits from the continued COVID reopening and the recovery of the services sector, together with higher vaccination rates, as well as a positive backdrop for copper prices.

Regarding monetary policy, the Central Bank fulfilled the market's expectations by hiking its monetary policy rate by 50bps to 3.0%, in an attempt to contain inflation expectations, while removing the accommodative stimulus that was present during the pandemic. Nonetheless, the Central Bank displayed a more hawkish tone in its latest meeting, by considering the need to continue normalizing the monetary policy stance in the coming months, instead of maintaining an expansionary stance.

On the inflation front, and as was highlighted in the latest communique from the Central Bank, the latest print exhibited an increase to 6.43%, over 300bps above the upper limit of the target range. This behavior was explained mainly by the observed increase in food prices, and by the devaluation of the PEN. It is worth highlighting that the depreciation observed in the PEN has stemmed from the political instability that has been present in the country since President Castillo took office in June and would remain as long as there is no clear agenda or government plan.

Fiscal deficits continue to loom in Latam



Source: Bloomberg
(as of January 07, 2022)

As we have previously stated, Peru's political picture continues to dent on business confidence, and might trigger additional capital outflows from what the country has already experienced to date. Moreover, it is worth remembering that the political instability already triggered two rating agencies to downgrade Peru's sovereign rating and, if the situation does not show signs of stabilizing, the downgrades could continue.

In sum, our conclusions for the region are:

Milder growth and higher inflation will characterize the region in 2022, with the Central Banks forced to implement tighter monetary policy rates that account for unanchored inflation expectations. The contractionary cycles will have a bigger magnitude in Brazil, followed by Chile and Colombia.

The political landscape will continue to have center stage in Latin America, with most of the nations in the continent having switched to a more left leaning government. It will be crucial to see the outcome of the congressional elections in Colombia, while also monitoring the discussions of the Constitutional Assembly in Chile, and any unexpected political development in Peru during this first quarter of the year.

Considering our positive outlook on oil, we also maintain our recommendation to keep exposure to this sector through corporate debt. Nonetheless, this recommendation has its nuances:

Given the heightened uncertainty and volatility that currently surrounds Brazil, we would be cautious on Petrobras's corporate debt.

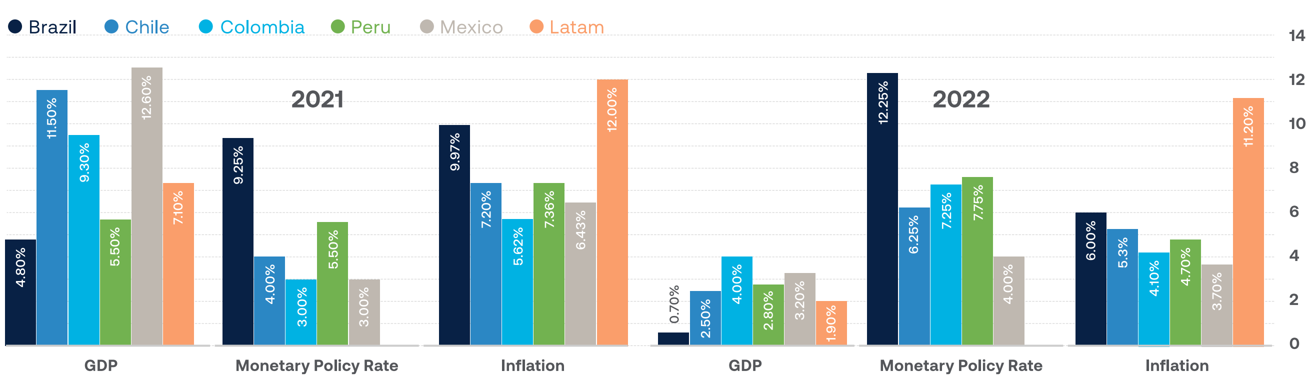
Depending on the risk profile of the investor, Pemex could be an attractive bet. However, one needs to take into account the company's latest decisions, in tandem with Mexico, of being 'self-sufficient' and not exporting oil anymore. The consequences of that decision remain unclear, and it could bring volatility to the name.

Ecopetrol continues to announce discoveries and to give steps towards a greener business model, all while maintaining a positive free cash flow. Therefore, the bonds from the mid-end of the curve continue to exhibit value.

Regarding utilities, specifically in Chile, the shift towards a 'greener' business model is underway, and it is disrupting this sector. Therefore, we maintain our bullish bet on those Chilean issuers, such as Colbun and AES Andes, that have made commitments towards greener energy generation, and that have taken the first steps to adapt to this new normal. More specifically, we favor the green bonds issued by these companies. Nonetheless, it is worth noting that the political backdrop could still play a relevant role in the definition of the coal transition in Chile, which could affect the issuers and bring additional volatility.

Latam is coming back strong from the pandemic setback, but challenges still remain

Source: Bloomberg (as of January 7, 2022)



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House Views Matrix

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

[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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Important Legal disclaimer