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Market Letter

First Quarter 2022

1st Quarter 2022 Investment Letter:
Stagflation or Soft-landing? EM and Commodities, a Safe Haven

- The ongoing war in Ukraine has endangered the **growth outlook** for the global economy, as activity was rebounding following the easing of Omicron waves. Potentially far-reaching longer-term implications: effects on commodity prices could reshape commodity markets for years to come.

- Swings in commodity prices and financial markets suggest **volatility** is set to be a feature of the outlook for the foreseeable future. The challenges facing the major central banks grow ever harder.
- Commodity producers across the Gulf and parts of Latin America stand to benefit from the **surge in raw materials prices**.
- Global **inflation** is the highest in nearly 40 years. While the rise in core is perhaps the most alarming, commodity price surge lifts goods and energy.
- Investors' faith on the prospect of a **soft landing**, or of FOMC's capability to deliver one (Chair Powell cited 3 episodes of soft landings), is likely to be tested in coming months as the economy decelerates, the FOMC hikes rates, and begins to shrink its balance sheet in 2H22. A scenario of stagflation akin to the 1970s should be avoided: strong balance sheets, recovering service sector activity, and robust labor markets should help prevent a global recession this time around.
- **Hawkish FOMC** meeting: The Fed is now signaling a materially more hawkish reaction function. Chair Powell reiterated the Fed's willingness to tighten financial conditions to address inflation. Front-loading monetary tightening looks forthcoming.
- **Yields are rising**: Global yields are pushing higher, and yield curves are flatter as recession concerns intensified: the 10-year US Treasury yield dipped below the 5-year yield. A higher near-term range for the 10-year US Treasury yield poses potential pressure on risk assets. The tightening cycle looks set to be synchronized across developed market economies, which should result in rises in bond yields across countries but, in turn, could limit any further flattening of the US yield curve.
- The well-signaled increases in US interest rates would not have caught EM economies off guard: **EM central banks** had started their

hiking cycles much ahead of core central banks, creating real-rates buffers.

- The armed conflict, combined with official sanctions, has disrupted commodity exports from **Russia and Ukraine**, affecting not only oil and gas, but also many metals, fertilizers, and grains, especially wheat, where Russia and Ukraine play a crucial role in global supply. Surging commodity prices are felt across all regions, while physical disruptions of Russian/Ukrainian export routes expose certain regions, eg, gas pipelines to Europe or wheat shipments to the Middle East. The consequence is a **large stagflationary shock**, driving inflation even higher, while lowering growth through soaring energy input costs and negative real-income effects for consumers. This shock is not evenly distributed, however. Among advanced economies, Europe will feel the burden more than the more energy-independent US, and China should also be more shielded.

- The EU will struggle to quit **Russian gas**. For any large decline in imports of Russian gas, much of the shortfall will need to be covered by LNG shipped to the region. The European Commission has suggested a two-thirds reduction in purchases of Russian gas in 2022. But the LNG imports needed to meet this goal would still require natural gas prices about €200/MWh or higher—a tenfold increase from the norm just a year ago. That said, the scale of the targeted reduction in Russian supply remains unclear. The full two-thirds cutback could require breaking current contracts, so one alternative is to allow contracts to expire without renewal. Estimates suggest such a proposal would temper the drawdown to one-third this year.

Global Drivers:

- **Global growth:** *resilient growth in the face of the shocks*

Global growth will clearly be weaker than it would have been, and inflation will be higher. However, underlying global growth is still running at potential as the Omicron drag fades, boosting service-sector activity, and as global goods demand rotates toward business. Wealth gains and excess savings built up during the pandemic should keep DM consumers resilient in the face of large income shocks; and fiscal policies will ramp up to offset income loss. The US economy is going to slow progressively as the drag from higher mortgage rates and the Prime Rate slow demand. A review of the labor market suggests the odds of a recession beginning in the next 12 months is low.

- **Monetary policy outlook:** *Chair Powell noted the labor market is at or very close to maximum employment, but inflation is way too high. The case for going 50bp in May has grown. The inversion of the 10y-2y Treasury yield spread led to speculation that the Fed's interest rate hikes would quickly push the US economy into recession.*

The Fed hiked by 25bp, the first rate rise since December 2018, and made a decisive shift higher in its "dots" ´ rate projections. Quantitative Tightening is likely to start in May or June. The Committee's new "dots'' now signal a "restrictive" federal funds rate by the end of 2023. With inflation likely to remain elevated well into next year, FOMC is to press ahead with additional rate hikes, unless there is an unexpected severe slump in economic momentum. Risks may still be tilted to the upside, as some hawkish FOMC members demand the Fed policy rate reach at least 3% by year end and Chairman Powell has not ruled out moving in 50bp increments. In response, the US yield curve has risen and flattened sharply.

Core central banks have taken a decisively more hawkish stance recently. Ever-rising inflation prints, faster-than-expected labor market recoveries and deteriorating inflation expectations have forced them to abandon the 'transitory' narrative. Russia-Ukraine headlines will still cause gyrations in EM FX over the near term. But beyond that, rising inflation, deteriorating external balances, and rapid rate hikes by the Fed should matter more. Only those supported by prudent monetary and FX policies can weather these seismic shifts.

- **Commodities**: *the primary channel of transmission to inflation and growth. The risk of further price increases remains*

Russia is a large producer of various commodities, while Ukraine is significant mostly for cereals and sunflower seed and oil. Both countries are also large producers of fertilizers. Disruptions to various metals and, particularly, agricultural products imply risk of a global increase in prices.

The news that the US closed off energy imports from Russia, and the European Commission's proposed sharp cutback of natural gas imports from Russia, increase the risk of a larger shock.

The prices across commodities remain highly volatile as the market struggles to define the contours of the damage to supply, both immediate and in the more distant future. The risk is quite binary, particularly for commodities that are currently seeing very large price increases but no material disruption to supply. An actual significant shortage could be massively bullish while there is potential for a severe correction in areas where export flows continue largely undisrupted or were the conflict to de-escalate meaningfully. EU aspirations for energy independence seem too optimistic over a short horizon.

EM Investment Outlook: *hedge & hold until the dust settles*

Strategic OWs: **Commodities and Energy**: supercycle thesis and geopolitical risk. **OW EM**: reopening and relative insulation from current geopolitical flashpoints. **UW Europe**: geopolitical escalation, conflict overhang, even in case of a de-escalation.

Some EM's collateral benefit: Some EMs are seen as a safe harbor in a global risk-off environment, especially as two of them–Russia and Ukraine–are at the epicenter of the turmoil. A case in point is South Africa, where the sustained increase in prices for coal, platinum, and gold has allowed the government to slow fiscal consolidation. In Latin America, the improved terms of trade will brighten the outlook amid aggressive policy normalization. High commodity prices caused by the war in Ukraine are causing exports to surge. Trade figures from Brazil and Chile show that exports were up by 25-40% y/y. The higher terms of trade will not last forever but for now it offers some respite from the still-incomplete pandemic recovery.

The seismic shifts in commodity prices, terms of trade, inflation expectations and central banks' reaction to them are likely to drive differentiation in EM assets. The Russia-Ukraine war has led to broad-based losses across EM assets, as asset managers had to digest large outflows, coupled with the need to rebalance portfolios and to divest from Russian assets as a consequence of sanctions, index exclusions or changing attitudes towards Russian assets in a broader sense. However, in EM sovereign credit, there is a clear correlation between recent returns and commodity exposure: oil exporters outside the CIS region, such as Angola, Ecuador, and Gabon, have been among the best performers over the past three months, while many importers of energy and/or grains (including North Africa countries, Kenya and countries in the CAC region) have underperformed. CIS countries have generally underperformed, likely on account of their close economic ties to the faltering Russian economy, even though commodity exports should provide a partially offsetting factor (eg, Azerbaijan or Kazakhstan).

While yield curves have inverted in a number of emerging markets (and look likely to do so in several others in the coming months), they do not have a good track record in predicting recessions in the emerging world. Growth in most EMs will be softer this year than last, but outright contractions in GDP are unlikely.

RISKS: *the risks to growth from COVID-19 are fading, new headwinds are emerging.*

- The **war in Ukraine** and the **surge in energy prices** drag on the purchasing power of consumers, while a slowdown in the global recovery will weigh on the

exports. The duration of the shock from the war remains highly uncertain.

- **COVID-19**: Although there are some genuine reasons for optimism that the global pandemic is evolving into something more endemic, the resurgence of cases in parts of North Asia and the regional lockdowns in critically important manufacturing hubs and international ports like Shenzhen and Shanghai in mainland China, pose a risk of renewed temporary supply chain disruptions. More broadly, the risk that dangerous **new mutations** could still emerge.

- Rising interest rates and commodity prices generate **financial stresses**. Inflation is set to rise across the board, primarily through energy prices, and external balances will deteriorate. The simultaneous weakening of external demand and acceleration in inflation threatens economic recoveries. An aggressive Fed trying to catch up with inflation is, in principle, not good news for EM economies. However, EM markets are prepared. EM central banks had already accelerated their rate increases ahead of the Fed's recent hawkish tilt. With inflation high, but still likely to moderate in the second half of the year, rising real rates in many EMs should help to buffer the Fed increases.

- **US yield curve inversion**: The US economy has indeed slipped into a recession after the 10-year minus 2-year yield curve inverted over the last 60 years. The weakness in using this indicator is the amount of time between when an inversion takes place, and a recession begins. In the seven recessions since 1960, a recession began on average 19 months after the yield curve inverted.

- Idiosyncratic risks remain, particularly with upcoming **elections** in Colombia and Brazil.

- Funding the widening current account deficits and external debt obligations has become markedly harder for Egypt, Ghana, and Tunisia. Pakistan and Sri Lanka face pressure along with Costa Rica, the Dominican Republic, and El Salvador in Central America. Some of these economies have responded with monetary tightening and more flexible exchange rate management. However, policy action is unlikely to be sufficient and many of these economies will need to seek funding from the IMF and other multilaterals, as well as debt relief from bilateral official creditors. In some cases, **private debt restructuring** is necessary.

Countries

China: *more policy stimulus.*

Should growth falter, policy will need to react. So far, the government has stuck to the easing measures, such as an acceleration in major infrastructure projects and quick implementation of tax and fee reductions. Housing policy is already being relaxed. The Politburo meeting in late April will lay out the roadmap of COVID policy going forward and whether supplementary policy stimulus will be needed. If growth deteriorates too much, additional policy support may come from more rate cuts, further efforts to stabilize the housing market, and outright fiscal transfers to targeted households.

'Zero-tolerance' policy towards COVID seems in transition and thus far, the fallout from newly imposed lockdowns on supply chains has been limited. If China does manage to contain the situation with limited disruption to activity, its economy could re-accelerate.

Russia: *Coordinated global sanctions imposed on Russia. Chances of default increase. Credit ratings agencies downgrade debt*

The new sanctions introduce restrictions on secondary trading of RUB and non-RUB denominated debt issued after March 1, expanding the set of prohibitions from April 2021, which banned US entities' participation in primary local currency sovereign debt. Russia has shown it is willing to service its foreign debts despite sweeping

international sanctions. The Finance Ministry is allegedly offering to buy back some of the debt and pay with rubles. The country may have been able to meet most of its obligations on FX debt so far, but that is mostly a result of a grace period operated by the US Treasury on the use of Russian central bank reserves held abroad. Things should change when this disappears in May. Meanwhile, not all bond holders got their money. As time goes on and the ability to process Russian foreign debt payments will get harder, the chance of a major default increases.

The Bank of Russia acted quickly to shield the nation from sweeping sanctions that hit key banks, pushed the ruble to a record low and left President Vladimir Putin unable to access much of his war chest of more than $640 billion. The bank more than doubled its key interest rate to 20%, the highest in almost two decades, and imposed some controls on the flow of capital. A barrage of announcements that eventually restored some calm. One example: “The Bank of Russia will be very flexible in using all necessary instruments,” Governor Elvira Nabiullina said in brief televised remarks in Moscow. Facing the risk of a bank run, a rapid sell-off in assets and the steepest depreciation in the ruble since 1998, policy makers banned brokers from selling securities held by foreigners on the Moscow Exchange. Exporters were ordered to start mandatory hard-currency revenue sales and stock trading was temporarily suspended in Moscow. While there is some room to use gold reserves and divert trade to China, Russia’s financial system is set to come under stress as it will not be able to meet its financing obligations despite running a CA surplus. The immediate issue is whether the Western allies can effectively carve out exemptions for energy payments within the framework of SWIFT sanctions. Energy payments will be difficult to identify and carve out without changing SWIFT’s existing transaction tracking system. The sanctions will therefore likely be designed so that banks that are not under the ban can carry out such transactions. In addition, the sanctions could be widened if tensions are not resolved to include all Russian banks and exports. There is the option to cut off energy exports as a retaliatory measure, a cut off of natural gas could be particularly damaging for Europe.

About USD250bn worth of Russian corporate and sovereign bonds in foreign currencies are outstanding, with roughly USD40bn of that owed by the government. Conversion into foreign currency will be allowed only with permission from the Russian authorities. Foreign investors may have the option to apply for conversion into the original bond currency. It remains unclear if the payment in rubles will apply only to Russian sovereign debt or includes corporate bonds. There is also a debate if payments in rubles will trigger an event of default. A number of Russian sovereign bonds include clauses in their documentation that address the issue of making payments in a different currency (e.g. ruble) if changes in law make it difficult to repay in the original foreign currency amount. A number of Russian entities continue to service their Eurobonds in foreign currencies. The new payment mechanism needs to be tested. It is early to conclude whether Russian companies will continue to service their Eurobonds going forward. Russia’s prime minister said that the government plans to take over the operations of companies closed by foreign investors who are leaving Russia, effectively nationalizing these entities. President Putin stated that Russia will continue to fulfill its energy-supply obligations to Europe and other foreign clients in full. As of now Russian pipeline gas flows to Europe continue uninterrupted.

Brazil: *more flows into FX and equities. strong BRL is back. Local sentiment is positive. Surge in commodity prices benefiting agriculture. Elections may be a non-event.*

Foreign investors turned positive on Brazil earlier and now locals are following the trend. Locals are positive on short-term growth and see room for more BRL strengthening and equity valuations as attractive.

The gap between Lula and Bolsonaro has narrowed in recent opinion polls. Third in the polls, Sérgio Moro changed parties and announced he has abandoned his candidacy for now. The presidential election is still more than six months away. Geraldo Alckmin's appointment as Lula's running mate could lead to more moderate economic policies.

The unemployment rate started to decline. IP is partially recovering but remains below pre pandemic levels. Fiscal concerns dormant: higher revenues (on higher inflation/commodity prices) should compensate for additional spending. Fiscal discussions to return after elections. The next administration could face a benign scenario as interest rates are set to fall and inflation decelerates.

Argentina: *IMF deal reached. Grain prices, supportive. Economic growth to continue in 2022*

The 2022 fiscal consolidation strategy in the IMF program relies on an expansion of real revenues driven by economic growth and positive real spending growth (after excluding extraordinary COVID spending). The main spending cut measure is a reduction in economic subsidies. However, with the recent increase in energy prices the strategy is already falling short of the target, even if there are no more tariff adjustments. Complying with the IMF reserves accumulation target is what matters.

Trade surplus boosted towards USD20b, alleviating pressure on the external accounts and the parallel exchange rate and thus avoiding a further pickup in underlying inflation.

EMERGING ASIA:

Omicron hit expected to be smaller than first thought. Recoveries continue across the region, excluding China. That is despite the fact that almost all countries set fresh records for daily new virus cases, with some experiencing full-scale outbreaks for the first time.

Vietnam: *vulnerable to problems in China.*

Vietnam has increased its participation in the regional supply chain over the past decade, and the foreign value-added content of its exports, accordingly, has risen over time. Most of the foreign contribution came from China, Korea, and Japan, which is predictable from their dominance in FDI in Vietnam. This trend will continue in the medium term, based on continuing FDI attracted by its merits, including a large working-age population, relatively low labor costs, and high skill levels. In addition, US-China trade tensions may accelerate the ongoing reallocation of production capacity from China to Vietnam due to rising production costs in China. Also, Vietnam has been active in signing free trade agreements in recent years, including CPTPP (effective from January 2019) and bilateral deals with the EU (effective from August 2020) and the UK (effective from May 2021), which should help it further integrate into global supply chains.

India: *one of the largest net energy importers in the world*

Downside risks to growth from the negative terms of trade shock are rising, complicating macroeconomic management. India was already running a record large trade deficit even before the recent spike in oil prices.

The INR has depreciated since oil prices surged, challenged by wider twin deficits, lower real yields, and dimmer prospects of capital inflows.

Indonesia: *current account surplus*

Rise in coal and crude palm oil prices delivering a positive terms of trade shock. Subsequently, the rise in net savings should be evident in the banking system's excess liquidity and in the fiscal balances, given the positive revenue impact of the shock. Moreover, with fiscal buffers rising, the terms of trade improvement would also provide room for domestic retail fuel prices to remain stable beyond 2H22. Nonetheless, fiscal prudence would prompt some energy price normalization.

With the crude oil price assumed at US$63/bbl in the 2022 budget, a US$104 price would imply an IDR16.3 trillion (0.1% of GDP) boost to the overall fiscal position. This fiscal benefit from higher oil prices contrasts with prior periods when energy subsidy costs would have overwhelmed the revenue increase and reflects fiscal reforms to reduce energy subsidies.

Recent trends in the manufactured goods balance also are worth noting. Although mobility restrictions have stymied the consumption recovery, the capital spending recovery has continued relatively uninterrupted, as evident in the sharp rise in capital goods imports, which are now back above pre-COVID 19 levels. However, despite the vigorous

recovery in capital goods spending, net imports of manufactured goods, which in the past couple cycles had moved with the capital import cycle, has lagged in the past year.

Sri Lanka: *Restructuring and IMF.*

Sri Lanka's cabinet tendered its resignation amid growing public anger against soaring inflation and a foreign exchange crisis. Central Bank Governor Cabraal submitted his resignation too.

Fuel imports are putting pressure on the trade balance and the balance of payments position is fragile, with slower remittances and tourism only gradually picking up. This combination of negative factors is fueling concerns about the country's ability to repay its foreign debts.

Foreign reserves are at a critical level of USD2.31bn at the end of February while the country faces debt payments of USD4bn during the rest of the year, including a USD1bn bond maturing in July. The public debt load at 120% of GDP is probably too high to let Sri Lanka beat 3% annual growth. IMF, World Bank and Asian Development Bank funding, which is being sought, would be extremely helpful.

A restructuring seems likely over the next 12 months as financing needs are persistently large. The outcome for SRILAN bonds and IMF involvement will depend on Sri Lanka's ability to secure government-to-government loans. Difficult muddling through this year.

Sub-Saharan Africa: *more geared to commodity prices than to global interest rates*

Global shocks have implications for balance of payments dynamics: 1) a rise in commodity prices: improvement in terms of trade on average for Sub-Saharan Africa, supporting current account balances. 2) an increase in global interest rates and tightening of financial conditions associated with inflationary pressures as well as Fed and other global central bank tightening: EM capital outflows and upward pressure on domestic interest rates. However, a) most economies in the region have domestic financial markets with limited global integration and foreign participation; b) the read-through from global interest rates to debt service costs is limited given a large share of concessional debt from the IMF and World Bank on average; and c) the upcoming debt redemption schedule is light (except in Angola) and, in some instances, IMF programs are in place that act as a backstop (e.g., Kenya).

Regional variation in commodity and interest rate exposure is nonetheless significant. Net oil-importing countries such as Kenya have seen a deterioration in their terms of trade, while the benefit from higher commodity prices to large oil producers such as Nigeria and Angola are partly offset by a significant decline in their crude export volumes. Meanwhile, Ghana stands out as having relatively high global interest rate sensitivity, owing to a) more integration with global financial markets and sizeable foreign participation in the domestic debt market (hence, risk of further outflows); b) a smaller share of concessional debt; and c) more acute fiscal pressures (the highest debt service burden in SSA).

Market implications are straightforward: external balances are on average supported by commodity prices and exhibit limited exposure to global financial conditions, implying exchange rate support in most places. Oil exporters (e.g., Nigeria) are now running a large current account surplus (c. 5% of GDP), implying FX appreciation pressures, while net importers such as Kenya may see some limited depreciation pressure. Ghana's sensitivity to global rates and financial conditions leaves it vulnerable to further FX depreciation pressure.

Large oil producers such as Nigeria and Angola are benefitting from the surge in global oil prices but, a cause for concern for countries already running large CA deficits, such as Kenya, particularly given that external financing conditions have tightened at the same time. The Ghanaian cedi has been a notable casualty among African currencies. Higher commodity prices adding to inflation pressures and the Fed turning more hawkish, central banks may tighten monetary policy more quickly.

Egypt*: The buildup of FX pressures has pushed the CBE to floating the pound.*

External deficit remains wide; CBE FX reserves are vulnerable but now the exchange rate acts as a shock absorber. IMF funding seems a key catalyst

in favor higher rates and currency flexibility. As the EGP now floats, buffers are low and inflation is elevated, the CBE is to further hike the policy rate and rather rapidly.

The Russia-Ukraine war has dragged on Egypt's tourism, trade balance, and inflation. Egypt is the biggest wheat importer in the world, with roughly 85% of that from Russia and Ukraine. The wheat price surge combined with a likely slowdown in the tourism recovery raises CAD forecast to 3.6% of GDP from 3.0%. Funding the CA deficit still is the main concern. Funding a 3.6%-of-GDP CAD likely would require new FPI or at least no outflows. Although external amortizations appear high, the bulk are non-bonded with a high probability of being rolled over, particularly debt owed to the GCC. The strong supportive oil price environment is expected to bring more inflows of deposits, loans, and/or investments from GCC countries.

We thank you for your continued support.

The RVX Team
RVX Asset Management LLC
20900 NW 30th Avenue, Suite 401
Aventura, FL 33180
www.RVX-AM.com | Phone: +1-305-363-6847
Fax: +1-305-675-0394

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