Market Letter

Second Quarter 2021

Growth versus rising rates. Inflation: temporary or permanent?

Economy Expanding: Economic growth estimates for 2021 and 2022 continue to rise. World economy is experiencing a strong but uneven recovery. US GDP growth likely peaked in 2Q. Economic activity should continue expanding in the second half which should give the Fed enough confidence to announce tapering in December. Actual tapering could start in January while balance sheet growth should stop by August 2022.

Macroeconomic Developments

- Despite facing a second wave of the pandemic, which was worse, than the first one a year ago, **global GDP** posted a robust 4.6%yoy gain in 1H21, 2%-pts above its potential growth rate. At the same time, global inflation staged an unprecedented early-expansion spike. Macro indicators show the US is close to maximum growth, but mixed activity data over the summer could result in a more patient Fed tapering timeline than expected. Positioning has also become less exuberant. FOMC to formally announce tapering this December. There is a potential to experience more mixed activity data surprises in H2, particularly in the US.

- For the first half of 2021, the financial markets were characterized by a solid upturn in global GDP growth- a view broadly held by investors. This was led by the US and China and reflected the lifting of COVID-19 restrictions, which resulted in a reflationary impact of astounding and unprecedented monetary and fiscal loosening." Equity markets moved to new highs in the major economies, the US dollar was in a downward trend and inflation expectations increased, abetted by a large rise in the price of oil. The S&P500 index increased 14% in the first half of this year, while the 10-year US Treasury yield increased to 1.47% from 0.91% at the end of last year. Brent rose to USD 75 from USD 51 over the same period. The Fed and the other major central banks were expected to maintain accommodative policies and any tapering of the Fed's balance sheet and lifting of benchmark interest rates were items for late 2022 and early 2023.

- Most countries moved further from balanced trade, increasing the global **flow of savings** to deficit countries, even larger than they were at the peak preceding the 2008 financial crisis.

However, the drivers of these dynamics are set to start reversing. In dollar terms, trade positions deteriorated most in the US and the euro area. Developed economies supported household income so much that consumer goods spending surged as social distancing constrained services spending thus temporarily increasing the import intensity of consumption.

- ***Inflation** to remain elevated in 2H21:* Global core CPI rising at its fastest pace in over 25 years. Supply constraints related to the pandemic and the normalization of depressed services prices lie behind the unprecedented spike in global core inflation. Breaking the link between the virus and mobility should relieve some supply constraints in restoring labor, but the immediate impact will actually exacerbate the pressures. Fading pandemic drags will likely continue to boost demand straining producers' ability to keep pace even as supply constraints ease. While both goods and services price inflation are set to rise rapidly in the coming months, the pressures will be strongest for services. The OECD's Economic Outlook underlined the message that inflation pressures are transitory given what the OECD considers to be excess unemployment in the US and evidence of spare capacity in the global economy.

- President Biden has recently published budget proposals for fiscal year 2022 and the subsequent decade. The Administration estimates that federal debt would grow to 117% of US GDP by the end of fiscal year 2031, while **US budget deficits** would total USD 14.5tn (5.1% of GDP) over the next decade. The San Francisco Fed in its latest economic report notes that the "Scale and scope of US fiscal policy measures since the onset of the COVID recession are unprecedented in recent history." The USD 1.9tn American Rescue Plan became law on 11 March 2021, and this was followed by the USD 2.2tn CARES Act and the USD 900bn funding bill last December. The big question is whether the scale of US fiscal stimulus is such that it will trigger inflation pressures that prove difficult to contain. Much will depend on how investors react to the notion that the Fed is financing an increasing quantity of deficit financed government spending. QE in its previous forms was not inflationary as it was just an asset swap (QE simply changed the mix of government liabilities held by the public as the Fed bought interest-bearing securities and replaced it with zero-interest base money).

- In recent months, initial jobless claims have been falling as the **US economic recovery** takes hold, though the FOMC thinks that positive progress is not yet complete. In the meantime, there is widespread survey evidence of labor market shortages, which can prompt a lift in wage inflation. Emergency unemployment benefit programs are scheduled to fully expire by September, and this might result in an increase in labor participation, which has been on a declining trend. Bearish economists worry about soft retail sales data and the withdrawal of unemployment benefits, as well as fading fiscal stimulus. In addition, the lifting of this year's inflation forecast to 3.4% was inevitable in the light of higher-than-expected inflation data. It might be that the inflation out-turn for this year exceeds the FOMC's forecast. Beyond that, the FOMC expects the US economy to revert to long-term trends. In the interim, the forecasts contain an element of what you might call "transitory persistence", but the FOMC thinks that **2021 is the peak year for**

both GDP growth and inflation and that in the longer term, US real GDP growth will return to 1.8% with inflation at 2%.

- In the next few months many factors are going to combine to make it look like a serious bout of inflation is beginning. The current surge in prices is stronger than at any time in more than a decade. Companies have the need and opportunity to raise prices into the post pandemic demand funded by government stimulus and they will. Headline and core inflation rates are likely to reach uncomfortable levels for a **FOMC** that will continue to insist this bout of inflation is transitory. This scenario could increase concerns that the FOMC may be forced to move more aggressively through balance sheet tapering and earlier rate hikes in 2022 as it tries to play catch up.

- The FOMC's penchant for keeping the real federal funds rate below zero percent for much of the past 20 years has pushed the valuations of stocks and real estate into what some may see as bubble territory. The massive increase in asset prices has contributed to income and wealth inequality. The FOMC believes that Average Inflation Targeting will address income inequality as Chair Powell noted in his Jackson Hole speech last August. "This change reflects our appreciation for the benefits of a strong labor market, particularly for many in low and moderate income communities. This change may appear subtle, but it reflects our view that a robust job market can be sustained without causing an outbreak of inflation."

- Investors believe that the Fed will remain dovish and highlight low labor participation rates, as it is important to note overall employment is still some distance from pre-COVID levels. It is also possible that, once the emergency unemployment relief programs end, actual unemployment goes up. Again, an argument for the Fed to remain cautious. Dollar bears point to the increase in the Fed's balance sheet, record setting trade deficit, negative real interest rates, and the trend in the Dollar since it topped in March 2020. All of these are reasonable and may contribute to the Dollar losing its reserve status at some point, but that's not going to happen anytime soon. But then, investors realized that tapering was coming and potentially a rate hike before the end of 2022, which together with extreme negative positioning and short covering caused a strengthening of the USD.

Global Drivers

- **Global growth:** *Vaccinations and pent-up demand are the key catalysts for the next leg of the global recovery. Slower growth and sharp price increases related to supply constraints increase the probability of a stagflation scenario.*

For the advanced economies, the upturn in activity is attributed to the lifting of COVID-19 restrictions, which has helped improve business sentiment. Survey data also shows that new orders rose even faster than output for the fourth consecutive month in June, indicating that demand over the past two months is running ahead of production.

Vaccinations: The large majority of EM countries can reach critical levels of protection during H2 2021, allowing safe reopening of most sectors. This will support global growth notably in coming quarters, with positive implications for EM economic performance and global risk assets. Studies continue to suggest that full vaccination provides strong protection against new variants, especially for hospitalizations and fatalities. EM

Virus Trends: path to herd immunity remains uneven across EM. Virus spread declined in India, Turkey, and Poland; moderated in Taiwan, Malaysia, Thailand, and Argentina; and increased in South Africa.

While 1H21 global growth has been strong, the gains have been uneven across regions owing to variations in policy support and vaccination programs. Growth leadership has shifted from China to the US, which is booming on the back of monetary and fiscal stimulus. In China, fiscal and credit tightening have slowed growth below trend. Early progress on vaccinations has boosted US performance. The second wave of the pandemic pulled Europe into two quarters of contraction, but the region is now bouncing back strongly as effective restrictions and a pickup in vaccination rates are unleashing pent-up demand.

The World Bank, in its just-published Global Economic Prospects, expects the global economy to expand 5.6% in 2021, which is the fastest post-recession pace in 80 years. EM economies are predicted to expand 6.0% this year followed by 4.7% next year. The US and China are each to contribute over one-quarter of global growth in 2021.

- **Monetary policy outlook:** *The FOMC is likely to 'wait and see' for the time being, and Fed Chair Jerome Powell shows little sign of deviating from this in promoting employment. The Fed's main intention is to tolerate near-term inflation pressures but focus on lifting employment back to pre-pandemic levels. Fed risk assessment shift pushed dots toward earlier rate move. The next six months could be tough for the FOMC as it tries to balance its messaging and the need to become less accommodative.*

The FOMC left the funds rate target range unchanged at 0–0.25% at the June meeting. The median projected path for the policy rate in the Summary of Economic Projections was increased to show two hikes by 2023, despite almost no change in the individual 2023 core inflation projections. Then, the FOMC sees the 2021 inflation overshoot, which will bring the average inflation rate since the recession began above 2%, as largely sufficient to accomplish its averaging goal, which lowers the inflation bar for eventual rate hikes. It might not be plain sailing for the Fed, though, especially with regard to developments in wages. There are indications that wage growth is picking up, reflecting strong demand for labor and high vacancy rates. Again, the Fed will not want to deviate from its view that any price/wage pressures are 'transitory', even if there is growing evidence of widespread price increases. It has decided to ignore a low unemployment rate and will instead wait for inflation to materialize. Higher wages will help lower income workers and are allegedly worth the risk of a broader wave of inflation. Chair Powell has assured investors that the Fed has the tools to deal with higher inflation if they are wrong. Headline inflation should trend lower in coming months as Base Effects unwind and investors conclude that the surge in inflation will be transitory. If core inflation (excluding food and energy) holds above 3.0% through the end of 2021, investors may wonder if inflation will prove more of a problem and force the FOMC to react sooner than currently expected. At last year's Jackson Hole Symposium Chair Powell announced the FOMC had adopted Average Inflation Targeting, so an announcement regarding the timing of tapering would not be a surprise. The key is whether the FOMC uses its July 28 meeting and speeches in July and early August to prepare markets for the 'taper'. The majority of members of the FOMC will resist announcing the timing of tapering until they see more job growth and a lower unemployment rate. But there are a number of Fed presidents that are concerned about the $40 billion a month in Mortgage-Backed Securities (MBS) given the record surge in home prices.

The era of low inflation and low growth in the major economies might be over, though the

evidence to support this thesis is not yet decisive. However, there has been a substantive change in the monetary and fiscal positions in the major economies. In the US, there has been an epic and unprecedented monetary and fiscal expansion. QE has changed in substance so that it now looks like QE+MMT. The Fed's balance sheet stands at USD 8tn and the Fed has been a significant purchaser of US debt from the US Treasury. Other central banks like the ECB and BoJ are also blurring the distinctions between monetary and fiscal policy. Fed Chair Jerome Powell played down the importance of the 'dots' and tried to also defuse 'taper talk'. The challenge for policymakers in the major economies is to convince investors that inflation pressures merely reflect price-adjustments in response to the recovery from the COVID-19 recession. Currently, the debate over the longer-term inflation outlook remains unsettled, and the US 10-year Treasury yield has been remarkably stable. LIBOR rates are at lows given excess liquidity in the US money markets. The Fed is in the curious position of having to drain liquidity through QT at the short end while still implementing QE to the tune of USD 120bn/month for longer-date maturities-in essence, the Fed is controlling the yield curve. The Federal Reserve continued its monthly purchases of Treasury paper at $80 billion, which it has been doing since March 2020. As a proportion of Treasury issuance the amount of Fed purchases was far less last summer than it has been in recent months as issuance declined. By the end of May, the Fed's monthly purchases covered all of the issuance. This has likely played a role in lowering Treasury yields since the yield peaks in March. In the next few months, the Treasury's balance at the Fed will be down to where it was before the Pandemic and will necessitate an increase in issuance As issuance exceeds the amount of Fed purchases, the tailwind Treasury yields have had in the last few months will be replaced by a headwind, which reinforces the expectation of higher yields in the second half of 2021. According to the IMF, "Fairly high inflation readings will continue for a few months", but it shares the view that this will be 'transitory'. Inflation pressures, in the IMF's view, are largely a product of relative price movements that are occurring as the economy rebounds from the impact of the pandemic. The IMF estimates that core US inflation could get close to 4% by the end of the year, then return to 2.5% by end-2022.

The PBoC has reacted to the strength of its currency by raising its FX reserve requirements for the first time since 2007, to 7% from 5%. This makes it more expensive for banks to hold dollars and other foreign currencies. After a period of strength in the Chinese currency, the next phase looks like being some degree of CNY depreciation (perhaps reflected in Asian currency appreciation and stabilization in the US dollar, which has been in a downward trend over the past year or so). Stabilization in the US dollar might look odd at a time of massive US fiscal expansion and deterioration in America's net investment position as a percentage of GDP. Despite the speculation that the Fed might taper its asset purchase program soon, it is unclear that this necessarily sets the stage for a sustained dollar recovery. US economic indicators will certainly be positive in the months ahead, but US balance of payments indicators are a long-term negative.

- **Commodities:** *the rise in commodity prices reflects the recovery from last year's pandemic, as well as supply-demand imbalances in certain commodities. The squeeze in global supply chains is creating shortages in many commodities.*

Global demand has moved past its peak growth phase. Lagging oil prices rose strongly as economic re-opening, particularly in the US, has driven strong demand. We expect commodity prices to moderate in 2H21 as prices for a majority of the commodities corrected some overshooting, led by weaker metals and grain prices. Moderation in energy price inflation and continued slowing in EM food inflation should

temper the drag on household purchasing power from core price pressures during 2H21. Commodity prices (excluding oil) potentially have peaked to stabilize in 2H21.

At the start of June, the notable feature of the markets was the persistent upward pressure on commodity prices – whether industrial metals, foodstuffs or energy prices. Brent at USD70/bbl will add to short-term CPI inflation pressures. However, even allowing for the increase in the oil price, underlying inflation pressures are mounting- in part due to reflecting supply-chain disruptions and the release of pent-up demand as COVID-19 restrictions in many countries are lax." Brent crude is seen averaging US$74 a barrel during 2H21. Increasing travel activity should boost oil demand. Oil prices have fully recovered from their pandemic slump, but the share of oil in global imports remains comfortably below 2019 levels and near the bottom of its twenty-year range.

In China, the rhetoric from authorities on over-inflated commodity prices is being backed up by actions. The strong momentum from export-related demand has slowed since May and major developed economies have also likely reached their peak recovery growth in 2Q. On the production side, supply-chain disruptions and logistical bottlenecks seem to be easing.

Latest Chinese monthly economic data featured signs of a gradual economic slowdown, which will likely prompt further Chinese currency slippage and steady interest rate policy. China's state planner says it is having some success in curbing commodity price increases and that they have released some state reserves of copper and aluminum. Commodity prices look as though they might be making an interim top, which would be helpful for the "transitory" inflation view.

EM INVESTMENT OUTLOOK: *Stronger economic growth in a 'Goldilocks' scenario of 'transitory' inflation and what seems to be a cautious Fed, despite taper talk, underpins new highs in US equity markets. But ... for how long?*

Above-trend growth and ample liquidity. The environment and backdrop for equities remains bullish. Outperformance of Value, inflation-linked assets and Cyclicals versus Defensives, as inflation surprises likely to persist. The US Treasury market is taking a different, less benign, view of the macro-outlook than the equity market, which seems to be more driven by earnings expectations and a belief that the equity market will always have the support of the Fed. The fundamental conditions for a rise in both bond yields and equity prices are in place. At an asset class level, the inflation theme favors an <u>OW in commodities and equities</u>.

- The outlook remains positive for risky asset classes as growth momentum has not yet peaked and pent-up demand should contribute to global growth surging above potential in 2H21.

- A more synchronized global growth cycle should materialize alongside a quicker tapering of Fed asset purchases and an eventual Fed liftoff in 2023.

- It is too early to position for mid-cycle dynamics as the Fed's reaction function remains significantly more dovish than other easing cycles with a geographic broadening of the global business cycle taking hold as vaccination rates ramp up and reopening accelerates.

- Higher nominal yields are in store for US Treasuries, reversing the outsized flattening of the yield curve since the June FOMC meeting.

- While global inflation is still rising into 2H21 as supply constraints related to the pandemic and the normalization of depressed services prices lie behind the unprecedented spike in global core inflation, longer-run measures of

inflation expectations have not yet broken out of their long-run ranges.

We are in an environment that looks friendly to equities. Economic growth will remain strong for quarters to come, earnings estimates will continue to rise, inflation expectations are in the sweet spot with 10 year break-evens at 2.25%, the consumer is in one of their best shapes in decades, Fed funds rate is pinned at 0 and will be for at least another year, money will continue to flood the system with the fed continuing to buy assets which will likely add another $1 trillion over the next year, and there is still massive amounts of cash in money market funds and checking accounts earning a very negative real yield that will likely move into riskier assets including equities. Value has sharply underperformed growth over the past two weeks including post the fed meeting-this presents an opportunity to enter. The combination of capital spending cycle by corporates, continued fiscal investments in infrastructure, the inventory/order imbalance, and the current strength of the consumer is a backdrop that should lead to fundamental cyclical strength for an extended period. This will benefit the value trade with particular support for materials and industrials.

In the run-up to the Jun FOMC meeting, the market backdrop featured record highs in US equities, which on conventional metrics looked historically overvalued. US household net wealth as a percentage of GDP is at a new high, but US corporate debt-GDP is also at a new peak. Indications of excessive leverage and debt are evident in bubble-type behavior in many asset classes. The culprit for all of this is the Fed's ultra-easy monetary policy and excessively loose financial conditions. The Fed refuses to acknowledge that its monetary policy could be a contributing factor towards potential financial instability or reckless investor exuberance

EM outlook: better tone in 2H. What should change in 2H for EM is that growth fundamentals look set to improve as vaccinations advance, which along with higher commodity prices, should provide a more positive tone. Three drivers to make the relative case of EM/DM equities into 2H21: (1) the phase-out of US exceptional strength; (2) higher commodity price tailwind for EM exporters; and (3) favorable positioning, a reversion to historical average allocation of global investors to EM.

Higher interest rates in the US, spurred by inflation fears and soaring spending, will be a headwind to LatAm and EM assets in general, although higher commodities should be modestly supportive. The effect of COVID in Latin America's real economy last year was a 6.6% contraction (-8.5% in Mexico, -11% in Peru), which the tremendous surge in poverty and inequality reflected." LatAm markets are among the cheapest markets in EM. EM Asian markets are trading on the most elevated premiums.

Risks: *The scenario sets the stage for Treasury yields to exceed their March 30th high and a correction in the stock market. The biggest threat to risky assets is that the Fed moves too early and aggressively, cutting the recovery short.*

- The financial markets believe Chair Powell is right and that inflation will prove transitory. Inflation could continue to surge in coming months and Treasury bond prices may sink lifting the 10-year Treasury yield towards 2% or more. **Inflation surprises** are likely to persist into the second half of the year: inflation risk seems underappreciated by both economists and markets at the moment. The increase in the correlation suggests the S&P 500 may decline as Treasury yields go up, with the S&P500 correcting towards 3800 level before the end of 2021. Recent Fed research focuses on the impact of Fed monetary tightening on emerging markets, where equities have had a good run in recent

months. Some central EM banks response to higher inflation is to tighten their monetary policies, a response which would imply they do not believe inflation is 'transitory '. If they are right, then the EM central banks that act pre-emptively will be rewarded by increased credibility, reflected in firmer currencies. Financial spillovers to EM economies from US monetary policy depend on whether an increase in US interest rates is driven by favorable growth prospects, likely to have a relatively benign effect, or if higher rates are driven by concerns about inflation, then likely be disruptive. The second factor is whether there are macroeconomic vulnerabilities. There are limited spillovers so far this year on emerging markets, but this might change if inflation starts to accelerate. Perhaps the real risk is a scenario in which US GDP growth prospects actually disappoint, and rather than inflation being transitory, it is US GDP growth above trend that proves to be 'transitory'.

- The possibility remains that **additional COVID-19 waves** or further **vaccination delays** deliver setbacks. Spread of the Delta variant remains an immediate threat, but the evidence thus far suggests the economic consequences will remain limited. The UK experience shows its spread has been associated with only a mild increase in hospitalizations. Countries with low levels of vaccinations are the most susceptible to virus-related downside risks.

- While external financing has improved, nearly half of the countries are now projected to post **wider budget deficits** than those expected heading into the year. These include countries with notable external financing improvements such as: Iraq, Pakistan, Oman and Azerbaijan. This reinforces the longer-term concern that the debt legacy in EM has been exacerbated by the pandemic, and wider deficits are in part, due to greater-than-anticipated fiscal expenditures to address the ongoing health and economic crises. While debt-to-GDP levels should be more stable this year, as some countries can deliver strong enough growth, the starting point was not low to begin with, so financing these deficits will still likely rely on external sources in the absence of domestic financing. Still, the improvement in liquidity means that imminent default risks are pushed out further, a near-term positive for EM spreads.

Country Updates

Asian economies: *Successfully limited viral contagion. A deterioration in global supply chains and supplier delivery times is adversely affecting some EM economies, especially in Asia.*

Factories were able to meet surging overseas orders, particularly for electronic goods. Asian export volumes shot up, quickly exceeding pre pandemic levels, but lately PMI data for many Asian economies, including China, has turned lower, and EM output growth has come close to stalling to its lowest level since June 2020.

High-saving Asian economies continue to finance the US trade deficit through their official institutions. Their conservative reserve

managers appeared to have accumulated safe liquid US securities over the past year. As global demand rotates toward services and away from tradable goods, these flows may be reduced.

China: *Policymakers cautious on reflationary policies and CNY. Factory output growing at the slowest rate since March last year.*

Against the backdrop of CNY appreciation since April, the PBOC announced on May 31 to increase the reserve requirement for FX deposits from 5% to 7%, effective June 15, mainly to prevent a formation of a one-sided appreciation trend of CNY.

Growth in China remains solid but has moderated as authorities have shifted their focus from buttressing activity to reducing financial stability risks. The key drivers for the post COVID-19 growth recovery, such as industrial productions and property investments, are slowly losing steam . While the rebalancing of the recovery towards retail sales and manufacturing investments has thus far been slow and can only partly offset the slowing momentum in IP and property investment.

There is still continued pressure faced by SMEs as seen in the PMI data with small enterprises falling below the 50 threshold in May. As private SMEs account for over 85% of urban employment, a broader recovery is still needed. In all, this likely points to Beijing staying on hold with "no sharp turns" in its policy stance.

Inflation is running at its fastest rate in 13 years, i.e. since the Great Financial Crisis. Producer price inflation is now galloping along at 9% and has compelled China’s Economic Planning Agency to launch price controls for corn, wheat and pork prices.

LatAm: *Amid firmer growth and lingering inflation risks, regional central bank stances are tilting hawkish.*

The Latam rebound is showing surprising resilience in the face of the virus and other headwinds as May activity and June surveys point to a firmer upswing in domestic demand. In Chile, GDP bounced more strongly than expected in May. In Brazil, additional upside risks to 2Q growth, supported by a stronger-than-expected May IP report.

Brazil: *the strongest earnings momentum in EM.*

Economic growth expectations are rising. With the global economy entering a new commodity cycle, the level of economic activity will rise. President Bolsonaro’s popularity has been declining ever since the government assistance program ran out in December. Popularity was 24% in May, down from 54% in March. Herd immunity and the arrival of new shipments of vaccines are already registering their effects against COVID-19. The rate of infections will decline, and mobility restrictions will be lifted on the eve of the election- which in turn will boost President Bolsonaro's chance for re-election.

BCB reinforced the signal of “whatever it takes” to bring inflation back to the target in 2022. The COPOM raised SELIC to 4.25%. April's fiscal results reinforced the better-than-expected scenario seen so far on public accounts this year. On the revenue side, robust economic growth and higher inflation readings helped to boost tax collection.

Colombia: *S&P and Fitch downgrade to BB+.*

The downgrade reflects the deterioration of the public finances with large fiscal deficits in 2020-2022, a rising government debt level, and reduced confidence around the capacity of the government to credibly place debt on a downward path in the coming years. Colombia's gross general government debt to GDP is forecast to reach 60.8% in 2021, more than double the 30% level when Fitch upgraded Colombia back to the 'BBB' category in 2011. Fitch expects debt to continue to rise through 2022 and does not expect significant debt reduction over the medium term.

Colombia was rocked by violent protests against the proposed tax reforms. Although the reforms were shelved, protests continued. New demands were made for: a standard minimum nationwide, an end to the privatization programs, reduction in education costs, and the demilitarization of the cities. There is no indication of how the demands will impact the fiscal accounts, but with the deficit projected at 9.2% of GDP, prior to the onset of the protests, the shortfall will probably crest into the double digits. Fitch expects the government to reintroduce a revised tax reform package in July 2021 when the new session of Congress commences. Upcoming elections, congressional and presidential, scheduled for March 2022 and May 2022 respectively.

Mexico: *PRI-PAN alliance succeeded.*

Midterm elections took place on June 6th, with the results now fully out, there seems to be some implications for the reform and policy agenda during the second half of the current administration's term. Also, the new political composition in several states of the country may prove relevant ahead of the 2024 presidential election. The president's Morena coalition lost its 2/3s supermajority in congress, decidedly weakening AMLO's legislative abilities in his remaining three years in office. The strong performance in gubernatorial and local congressional elections should help Morena broaden its influence at all levels of the government. Commitment to fiscal prudence to continue.

The Peso and Mexican equities soared while bonds also got a lift. Banxico unexpectedly hiked 25bp to 4.25%, towards 5% by year-end.

Peru: *to keep BCRP´s president Velarde.*

Driving the markets right now is fear of Castillo and his economic program. While uncertainty about the economic and financial agenda prevails, his program team has been active in conveying a moderate message. The message is aligned with the Bicentennial Program published before the runoff, committing to maintain the BCRP's autonomy, its inflation targeting regime, and the 2% inflation target. The message has also emphasized that no expropriations, nationalizations, or confiscations are envisioned.

Russia: *In reflation mode.*

Over-performance in non-oil revenues implies a larger space for additional spending, which will be filled by higher investment-related spending as the government's focus shifts from crisis management back to development.

Moscow is on a firm course to de-dollarize and setting precedence and an example that others may well follow over time. Russia's foreign reserves at 606 billion dollars hit an all-time high in May. Moscow almost doubled its reserves since the economy had been hard hit by the first set of US sanctions in 2015. Although, it has recently announced that all dollar-denominated assets will be removed from the central bank and wealth fund portfolios Reportedly, the future composition of foreign reserves is to include 40% Euros, 30% Renminbi, 5% each in Sterling and Yen, and around the 20% mark in gold. This year's national budget is based on 44 dollars per barrel of Brent oil. The current market price is 75% higher than this measure, and it looks like we have not seen the end of that crude rally yet. To be sure, Russia clocked up a budget deficit of -3.80% in 2020 due to the fight against the pandemic, but in the previous two years' surpluses were generated, to the magnitude of +2.9% and +1.8% respectively.

Turkey: *Current Account Waiting for Tourists.*

The economic mix, particularly in monetary policy, continues to lead in the devaluation of the lira. GDP growth has been better than expected, but a full recovery depends on how soon the tourism sector will reopen- which will also affect the unemployment rate. There is a risk that the Biden Administration and EU will force new sanctions on Turkey if it does not make changes in foreign policy and human rights.

International reserves have been on a steady decline due to: the loss of confidence in the monetary authorities, capital repatriation due to COVID-19, the large current account deficit and financial obligations of the Turkish private sector. Turkey has the lowest net reserves to debt ratio of the emerging markets (30%). The recent IMF Article IV Report found that net international reserves were negative once foreign exchange swaps were subtracted.

South Africa: *Surging metal prices have boosted terms of trade, exports and tax receipts, providing relief for the macro-outlook. A substantially improved fiscal outlook and steeper GDP recovery improve near-term debt dynamics.*

It is now projected a bigger external surplus and faster near-term fiscal consolidation. There are some welcome signs. These include the president's announcements on energy sector reform and liberalization, the sale of a majority stake in state-owned South African Airways, resolve for spending restraint from the National Treasury (despite the recent tax windfall), and signs of greater political accountability. All of this conjunctively, could result in strengthened business confidence and improve longer term growth and fiscal properties

Rapid rise in debt since 2008 only partly due to a swing in primary balance. The estimated break-even primary balance should be achieved by FY28 with debt at 90% of GDP. Recent increase in reform momentum signals a more constructive scenario, but steadfast consolidation is still needed. Treasury's budget presentation envisaged debt stabilization at 89% of GDP in 2025. Is fiscal sustainability within reach?

We thank you for your continued support.

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