Market Letter

Third Quarter 2022

3rd Quarter 2022 Investment Letter:
Hike and Hold! Prices keep rising, although inflation pressures should eventually abate to a slower pace.

Long story short: risk aversion to continue for as long as inflation remains high. The cat-and-mouse game between the markets and the Fed - or rather, between the markets and the inflation data, continues to dominate the trading and investing ecosystem and those dynamics aren't changing anytime soon. The Fed can't afford to back down, the terminal rate continues to drift higher, and they should continue to hammer a message of higher-for-longer. However, the markets see the Fed lowering rates again in the second part of 2023 against the Fed's message.

- GDP growth in the second quarter, as well as inflation, both continued to surprise to the upside, even after strong 1Q readings. As recoveries have advanced, DM central banks are proceeding with plans to scale back their balance sheet policies (from QE to QT). Despite a string of adverse shocks through the first half of the year (from the Omicron wave in Europe, to the COVID-related collapse in China, to the Russian invasion of Ukraine and its impact on global commodities, to the tightening in financial conditions), the **global expansion has continued**.

- **Inflation** pressures are set to moderate as energy prices are cooling (outside of Europe) and as easing bottleneck pressures and slowing growth temper core goods inflation. By contrast, tight labor markets are expected to keep wage inflation elevated. At the same time, rising interest rates are adding to the debt service burden.

- The ongoing **hawkish tilt by DM central banks** (outside Japan) reached a **crescendo** as rate hikes were accompanied by guidance for further tightening ahead. This is a response to two closely related developments: i) they are shifting their views on slack in a manner that requires both larger and more front-loaded action; ii) their actions have yielded few results so far. Despite sub-par GDP growth this year, DM labor markets continue to tighten with employment gains running well above pre-pandemic norms. And despite their success in anchoring medium-term expectations through the inflation surge, pressures continue to broaden with core inflation remaining above a 5%ar this quarter. Central banks will see progress as job growth and core inflation step down (next quarter?). This progress should be realized as stances turn restrictive, allowing for policy pauses in 1H23.

- Headline inflation is projected to fall by half, but **central bankers** are clear that they will keep moving but **not providing strong guidance** on the rate level at which they will pause. This is understandable given uncertainty on how the size and persistence of current shocks will alter price- and wage-setting behavior, as labor markets remain tight. The August

US inflation print came in above expectations, keeping pressure on the Fed to keep tightening expeditiously.

- Annual headline consumer price inflation has either peaked or will peak before year-end in a large majority of EM countries. Cooling inflation momentum is generating a more **muted EM response**. Certain exceptions include Poland, Indonesia, and Argentina, where inflation should hit an inflection point by the first quarter of 2023. Brazil kept rates on hold and Turkey cut. EMs are still expected to lag the anticipated action by the Fed. Not surprisingly, the **dollar continues to appreciate**, and a number of EM central banks are resisting via currency market interventions. EM FX reserves are depleting at the fastest pace in two decades, with interventions most pronounced in Asia.

- The Bank of England moved to calm the Gilt market down by buying bonds. The UK government followed through on plans for a raft of tax cuts. But another large unfunded fiscal easing—without an independent review from the UK's fiscal watchdog and at a time when inflation is already running high—prompted an outsized sell-off in debt markets and a run on the currency. After the latest BoE's dovish 50bp hike this week, pressure is mounting to demonstrate commitment to its inflation target given fiscal policy is pulling in the opposite direction.

Global Drivers:

- **Global growth:** *Resilient growth momentum to run out of steam. The market has priced some measure of elevated recession risk throughout this year -- both across assets and in the form of an inverted policy curve.*

  The September DM flash PMIs pointed to broad-based sluggishness across countries and sectors. Although the DM all-industry PMI rose 2.0pts in September, the PMI level of 48.8 points to a 0.5%ar contraction in DM GDP. At the national level, the monthly momentum in the PMIs is consistent with US resilience and Europe sliding toward contraction. Global supply chain dislocations appear to be easing according to the latest PMI indicators of bottlenecks and high-frequency data on shipping costs. Global debt remained contained last quarter as inflation surged.

  Lower growth in **developed** economies, along with the ongoing monetary policy tightening cycles across many EM countries, and the loss in purchasing power from the inflation shock, will inevitably affect real GDP growth. **EM** real GDP growth should average 3%+ in 2023. However, excluding China it should average just 1%+ next year, down from 2.4% in 2022. This would be one of the weakest growth rates in recent times, better only than those posted in 2009 and 2020.

  China's current growth remains a concern; manufacturing surveys are sending mixed signals with the NBS and Caixin PMIs moving in opposite directions in September.

  Latin America has stood out in 2022 for posting robust real GDP growth. Economic activity was stronger than expected in the first half of the year across countries. Overall, it seems that the post-pandemic domestic recovery still had some room left, while strong external demand helped export-oriented economies. This benign context is unlikely to persist into 2023, given the projected global slowdown and higher interest rates globally.

- **Monetary policy outlook:** *Fed to increase the Funds rate to a restrictive level (4% in November, probably at 4.5% at the end of the year and 5% in March?) and then hold it for a long time. However, futures expect the FOMC to cut rates in the second quarter next year.*

  In terms of today's US data flow, the Federal Reserve's favored measure of inflation has come in higher than expected, which will keep the hawkish comments coming from Fed officials and reinforce expectations of a fourth consecutive 75bp interest rate hike on November 2nd. The FOMC meeting made clear that they are not backing down. Powell said: "Our responsibility to deliver price stability is unconditional. We will keep at it until we are confident the job is done." Brainerd said, "Monetary policy will need to be restrictive for some time to have confidence that inflation is moving back to target. For these reasons, we are committed to avoiding pulling back prematurely." A majority of FOMC members believes inflation will remain higher for longer, which will require a higher Federal

Funds rate for longer. The odds of the FOMC hitting the pause button or pivoting should develop when the 2-year yield drops below the Federal Funds rate, as the history since 1985 shows.

Dollar strength is effectively exporting inflation to every country whose currency has weakened against the Dollar. The strength in the Dollar has been magnified by more than the FOMC's Dot Plot and is hurting any country that needs to import oil or food, since commodities are priced in Dollars. The higher cost of these imports has lifted inflation for EM countries above the inflation rate in developed countries. The increase in inflation has forced EM central banks to increase their policy rates to fight domestic inflation. Higher inflation and weaker economic growth have led to more currency weakness, which EM central banks have attempted to offset by using their currency reserves to support their currency with purchases.

Risks to global financial stability are increasingly a known unknown for the growing risk that monetary tightening generates **financial stress**. Fading supply shocks should deliver a growth dividend, but the expected inflation drop will not likely calm central banks. Expectations of persistent elevated core inflation and strong job gains are prompting the Fed to guide policy rates to 4.5% by year-end, despite subpar GDP gains and sliding headline inflation. A rapid tightening in US monetary conditions has been conducive to building financial stress in the past, e.g., the 2013-15 EM credit crunch, the Asian financial crisis (1997-98), Orange County/Peso crisis (1995), and the 1980s US savings and loan crisis can all be linked to tighter US monetary conditions.

In terms of the monetary policy tightening cycles, inflation-targeting central banks in Latin America and in the CEE3 countries may end their hiking cycles in the fourth quarter of 2022. Meanwhile, the majority of EM Asian countries will end their monetary policy tightening cycles a bit later.

- **Commodities:** *commodity producers still have an edge*

Forecast for Brent oil price to average $100 with some upside if OPEC cuts production. Oil demand growth remains resilient, in large part due to the 30% move lower in oil product prices and surging use of oil in power generation. Historical evidence suggests that demand is well supported as long as global economic growth remains positive. Oil prices tend to fall in all recessions by 30% to 40%. Under a 1.5% global growth scenario, the global oil market is forecast to end in a 1.4 mbd surplus in 2023 with stocks normalizing back to 2015-2019 average levels by the end of 2023, flattening the forward curve and forcing Brent oil price well below $80/bbl. The single bullish risk remains the chance of a political miscalculation if the US-led plan to cap the price of Russian crude oil underestimates Russia's capacity to retaliate in response.

Europe has moved rapidly and effectively to reduce its reliance on Russian gas, and it could end its dependency by mid-2024. But this might not be possible until 2027 or even for as long as 7 to 10 years. However, Europe has realigned its partnerships and diversified its suppliers.

Investment Outlook: *Central banks will keep tightening financial conditions causing stress in risk markets. The real fed funds rate is still negative, which continues to suggest unfinished business on Fed tightening. A taper in the Fed's asset purchases would eventually lead to higher US yields. The stock of negative yielding debt continues to shrink as secular forces and structural drivers point to higher yields.*

Tighter financial conditions, a decline in purchasing power, and weaker growth in developed economies will likely affect real GDP growth prospects in many emerging market (EM) economies in 2023. The basic fundamental setup hasn't changed throughout 2022: The Fed has a serious inflation problem on their hands, and they need to drain liquidity into an economic slowdown. There has been no shortage of market-sensitive events in 2022. War, jumbo Fed hikes, oil, rates… all have led sentiment and positioning down to extreme lows, financial conditions to tighten and US equities to rapidly derate. But we are not out of the woods yet. Furthermore, market and macro conditions could worsen from here via bond market liquidity, credit conditions and long-duration real assets such as housing. Moreover, starting in September, the cap on Treasury run-offs rose from $30bn to $60bn per month,

representing a two-fold increase in Quantitative Tightening.

The recovery in corporate profits in the aftermath of the global pandemic has been remarkable. But the latest gains are concentrated in the commodity-related sectors, and profit growth has slowed broadly. While nominal revenue growth remains robust, margin expansion has stalled after rapid earlier gains. As pricing power eases, still-strong unit labor cost growth poses a challenge to the business cycle.

What is certain so far: higher US rates, a stronger dollar, and structurally higher commodities. The risk/reward setup for equities is not clearly skewed in either direction. Stocks are held hostage by the thrust of monetary policy. The bulls can argue that we are closer to the end of this tightening cycle than we are to the start of it or that hard landing fears are misplaced given an ongoing abundance of nominal growth. The bears can counter that the drainage of liquidity hasn't really taken place yet or that hopes for a tidy, soft landing are delusional.

One can envision an end point of lower core inflation, but the path from here to there is anyone's guess. The inflation narrative will keep us on our feet for a good while longer. Another possibility is that realized volatility is elevated because the market is pricing elevated recession tail risk. In this case, it is the risks to the economy from the tightening path -- not the rate volatility -- itself that may be pushing equity volatility higher.

Risks: *Growing risk that monetary tightening generates financial stress. Can inflation in the US be brought down without a sharp recession and a sharper increase in the unemployment rate? The Fed may not have the patience to await a slow-moving US supply-side recovery.*

- Rising risk that **Fed engineers a recession**, by intent or accident, as it prioritizes u-rate rise and displays limited patience. There is a growing tension between a Fed worrying about shifts in inflation psychology and the reality of a monetary policy transmission mechanism that works with long and variable lags. An impatient Fed, focused on results, is more likely to overshoot the appropriate level of tightening, which will take time to be reflected in labor markets and core inflation. As mentioned previously, rapid tightening in US monetary conditions has been conducive to building financial stress in the past, e.g., the 2013-15 EM credit crunch, the Asian financial crisis (1997-98), Orange County/Peso crisis (1995), and the 1980s US savings and loan crisis can all be linked to tighter US monetary conditions.

- **Corporate challenge lifts recession risk**: risks lean toward stickier and high inflation to offset stickier and high wage inflation. With cost pressures building, businesses will eventually turn to protecting their margins. This is the way of business cycles. Businesses will either begin cost-cutting or pass on rising costs to consumers. In the former case, reduced hiring becomes a catalyst for moderating aggregate demand and potentially sparking a recession. In the latter case, fear of a wage-price spiral as inflation becomes more salient will induce aggressive central banking tightening that would also spark a recession. Risks are skewed toward the latter as core inflation keeps surprising to the upside and CBs turn increasingly more hawkish.

- Destruction of the Nordstream pipelines: It seems Europe will have to weather **winter without much Russian gas**. Evidence is said to point to a violent act rather than technical issues after Swedish seismologists detected two explosions in the area, when leaks appeared in the Baltic Sea. Gas prices jumped.

- Russia has resisted declaring a draft to prevent **public backlash**. Greater discussion over the use of Russia's frozen assets, estimated at $300bn, to pay for Ukrainian reconstruction raises unprecedented legal concerns and will increasingly come to the forefront.

- The key lessons for China from the Russia-Ukraine war is the need to "sanction proof" its economy and strengthen its military capabilities. US House Speaker Nancy Pelosi's visit to Taiwan incited a robust response from China, but there is a greater risk that **China increases its gray zone coercion tactics rather than declare an outright act of war**. However, there are huge risks in grey zone tactics. Until relatively recently, China's leaders viewed the situation in the Taiwan Strait as unsatisfactory but

tolerable. When Taiwan was ruled by the traditionally China-friendly Kuomintang (KMT) party, China was able to pursue a gradual strategy of economic integration, diplomatic isolation, and military pressure—one that it believed would eventually make peaceful reunification Taiwan's only option. Though it is difficult to pinpoint precisely when the new status quo became intolerable to China, a key turning point probably came in January 2020, when Taiwanese President Tsai Ing-wen of the Democratic Progressive Party (DPP) easily won a second term in legislative elections. As the DPP solidified its political reach, the prospects for achieving peaceful reunification likely moved further out of reach. While China is unlikely to launch a deliberate attack on Taiwan and is not drawing a line in the sand, it is sending a strong message to the US that it will respond to US actions. Military exercises have become longer and closer to Taiwan but are usually in response to a political event especially relating to the US. The Taiwan Strait strain is likely more a reflection of US-China tensions, rather than a China-Taiwan confrontation.

- Emerging markets remain under pressure due to the rising cost of capital, the drainage of global liquidity, and multiple external headwinds, ranging from the adverse effects of the war in Ukraine to economic underperformance in China. Add persistent US-dollar strength to the equation, and it becomes difficult to see relief for EM asset prices in the near term.

Countries

China: *Lockdown disruptions and policy hesitation drag down China growth. PBoC is likely to slow the pace of CNY depreciation.*

In a couple of weeks Xi Jinping will likely be handed an unusual third five-year term running China's communist party. In effect he is taking over as the country's permanent leader. The mysterious Mr. Xi has grown ever more assertive abroad.

Policy hesitancy, lower marginal effects of infrastructure stimuli, and insufficient support to the real estate sector collectively have led to cut 2022 GDP growth forecasts. At the central government level, the authorities would provide immediate and direct fiscal support to a subset of non-SOE real estate developers in addition to quickly implementing the already announced infrastructure stimuli. Although policy action has been in this direction, the magnitude and breadth of the announced support measures have been less than expected. At the local government level, fiscal stimuli have not been rolled out in a timely fashion, likely a result of a combination of Covid disruptions and an estimated 2tn RMB shrinkage to local government revenue. Local authorities are and will likely remain hesitant to take on more debt and splurge on fiscal spending.

Looking into 2023, the key driver will be how quickly China can move away from the Covid disruptions, and the expectation is that China will do this in a very gradual fashion.

Brazil: *Elections: Lula has consistently kept an advantage against Bolsonaro, suggesting local assets prices will likely not be significantly impacted if such a scenario materializes*.

Lula wins the first round with much tighter than originally indicated by polls so Lula and Bolsonaro will face each other in a runoff election on 30 October. Bolsonarismo has staying power in Brazil regardless of runoff. President's allies won key congress, local government races. Bolsonaro to keep influential voice in politics for years.

Brazil's fiscal metrics, including gross debt and consolidated primary results have turned around dramatically over the past year, however these improvements came from one-off factors. Inflation is likely to continue to decline in the next few quarters as a result of lower commodity and industrial prices but there are risks for disinflation on both external and internal fronts. Current account deficit will remain low owing to the deceleration in domestic economic growth and still depreciated real exchange rate.

Argentina: *"muddle through" strategy until the 2023 elections*

Without FX reserves, policymakers will have to stabilize and reform the economy, likely post next year's elections.

Argentina's overall credit conditions are unlikely to improve materially while it lacks market access and

persistent macroeconomic imbalances continue to undermine its credit profile. Even though Argentina has signed an extended fund facility with the IMF, a lack of political consensus over the pace and direction of fiscal consolidation will likely hinder the government's ability to consistently meet targets over the span of the program. The Dec-2022 reserves accumulation target still looks challenging, despite the soybean-related inflows in September.

The government has supposedly embarked on a set of policy measures meant to tackle some of the prevailing economic distortions. Some of these include negative real interest rates, an overly appreciated currency, and the central bank financing of the deficit. Though many investors were of the view that the government would adjust some of the imbalances after the legislative elections, this has not happened. A standstill took hold, along with several changes in the Ministry of Economy. Nearly 10 months after the legislative elections, recently appointed Economy Minister Sergio Massa initial policy decisions do not suggest that imbalances will be forcefully tackled.

Mexico: *Fiscal risks loom… small, for now.*

Headline fiscal metrics screen healthy public accounts. Moreover, risks over the short term appear contained. Spending dynamics, however, pose medium-term risks. Low growth, sticky rising spending are key concerns.

Debt-to-GDP has been steady at around 50%, even throughout the pandemic, when it would have been unsurprising to see a big jump in spending that compounded weak activity. In the event, Mexico maintained a headline fiscal deficit roughly at 3%, consistent with a nearly balanced primary result. The government has thus honored its pledge to keep debt

Russia: *The next stage of the conflict does not change dramatically the economic backdrop*

Referenda were held in Donetsk, Luhansk, Kherson and Zaporizhzhia on being formally incorporated into Russian territory. The results came back 87%-99% in favor of integration. Meanwhile, the situation in Moscow has deteriorated, as the Kremlin attempts to maintain a "partial mobilization" of Russian citizens to fight in the campaign.

It is not clear the oil cap is going to be supported by major buyers of Russian energy in Asia and the Middle East. A drop in Russia’s energy exports as well as oil and gas revenues in the federal budget, would not be a major threat to the Russian economy, whose contraction so far has been much milder than generally expected. First, Russia cannot make use of its large current account surplus (more than 10% of GDP in 2022), as it cannot buy crucial technologies owing to sanctions. Second, it cannot efficiently accumulate extra energy revenues in FX reserves since traditional reserve currencies are no longer available. Therefore, a narrowing in the current account surplus would be of no harm. As for the budget, the widening of the deficit from lower energy revenues would be either offset by a weaker currency or financed through a combination of borrowing in the domestic market and fiscal reserves. In September, the Ministry of Finance resumed selling local bonds (OFZs) for the first time since February 2022. The central bank front-loaded as much policy easing as possible thanks to subdued inflation and normalized households’ inflation expectations.

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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