MONACO ASSET MANAGEMENT

Investment Outlook

Q2 2022

Executive Summary

- **Stubbornly high inflation.** The Fed is cornered between fighting inflation and sustaining economic growth. Markets price 9 rate hikes in 2022. This is happening at a time when economic growth is softening. A policy mistake can very well represent a black swan event. Historical precedents such as the 1970s provide some guidance.

- **Credit spreads to widen a whole lot more**. The cocktail of softening economic growth and rising long-term interest rates is a clear headwind for credit markets. Credit spreads have widened but are still more than distance away from offering compelling "value" given the macro headwinds. 2018 could be a conservative proxy, however a 2008 like credit spreads widening scenario is not out of the question, especially for high yield. Emerging markets credit is the only area left providing real value, especially after the weakness in China driven by the property sector.

- **The USD rally has run its course.** Structurally, the environment is increasingly more bearish for the U.S. Dollar. While a consolidation around 1.08-1.10 may take some time, our medium-term target of 1.18 suggests the risk-reward is more skewed to being long the Euro. However, we are mindful of tail risks in the Euro associated with the French Presidential election over the next couple of weeks.

- **Downgrading Equities to Very Bearish.** We have been more cautious on equities since Q3 2021. A stagflation environment has historically been a challenge for equities, especially when trading close to record high valuations. We remain positive on certain pockets of equity markets such as value, Emerging Markets and de-rated mid-cap growth stocks geared to the new green economy. That said, we keep a relatively low exposure to equities relative to benchmarks and history.

- **The Commodities super-cycle remains intact**. Commodities managed exceptional outperformance in Q1 2022 despite a rising USD. As the USD enters a potential weakening phase, we strongly believe the Commodities bull market will carry on. Our over-arching positive view on inflation makes us structurally positive on precious metals. We believe the environment is ripe for a renewed outperformance of gold and silver. We do turn more neutral on the energy commodity complex as prospects of demand destructions may balance some of the medium-term supply constrain.

Investment Stance Overview

Based on our assessment of global liquidity and asset price cycles, we downgraded equities to Neutral with a strong Underweight in “long-duration” assets such as technology in Q1 2022. It was timely as risk assets experienced a significant draw-down last quarter. Fast forward to today, our fundamental view has not changed. Nine US rate hikes are priced in for the year; up from three rate hikes a few months ago. Overly tight financial conditions and stubbornly high inflation can exert serious pressure on the global economy with a non-trivial risk of recession in H2 2022 in Europe and possibly in the US. The inversion of the yield curve is testimony to this risk. Equity valuations have contracted. Corporate bond spreads have risen. Yet, they still fail to fully reflect the economic hardship ahead. As a result of our cautious outlook, we further downgrade European and US equities to “Very Bearish”. We also downgrade U.S. and European high yield ahead of an economic deceleration and large refinancing risk. Market tops are a process during which draw-downs are accompanied with swift and strong rallies as seen at the end of Q1 2022. Navigating this environment is a challenging endeavour. Short-term trading can lead to losses. As such, we are focusing our investment strategy over a 12-month horizon. We are turning bearish on the USD and remain broadly bullish commodities. We continue to favour outsized exposure to Alternatives in an effort to offset some of the potential weakness in traditional risk assets. Overall, we are extremely cautious in the construction of portfolios. This approach is unlikely to change until something “breaks”; the economy or markets (or both).

	Investment Stance						Quarterly
	Very Bearish	Bearish	Neutral	Bullish	Very Bullish		Change*
SOVEREIGN BONDS						BEARISH DM	-
US		■					-
Europe (Core)		■					-
Europe (Periphery)		■					-
Emerging Markets				■			-
CORPORATE BONDS						BEARISH DM	-
US High Yield	■						↘
US Investment Grade		■					-
EUR High Yield	■						↘
EUR Investment Grade		■					-
Emerging Markets				■			-
CURRENCY						BEARISH USD	-
USD		■					↘
EUR			■				-
EM				■			↗
CNH		■					-
EQUITIES						BEARISH DM	-
US	■						↘↘
Europe	■						↘↘
Japan			■				-
Emerging Markets				■			-
COMMODITIES						BULLISH	-
Energy			■				↘
Precious Metals				■			-
Metals & Agriculture				■			-
ALTERNATIVES						BULLISH	-
Hedge Funds				■			-
Real Estate				■			-
Private Equity			■				↘

** Change compared with previous months. One arrow means the stance has moved one place to the left or the right, two arrows means a move of two places, etc.*

Model Portfolios

The following model portfolios are based on current positioning at the start of Q2 2022. Considering the volatile nature of financials markets and our outlook, their compositions is likely to change throughout the quarter.

USD Based Portfolios

Asset Class	Last Price	Perf. 5D	Perf. MTD	Perf. YTD	MAM Outlook	Asset Allocation
Currencies						
Portfolio Bases						**100.0%**
EUR	1.09	-1.4%	-1.4%	-4.0%	Bullish	10.0%
USD	99.53	1.2%	1.2%	4.0%	Bearish	90.0%
Equities						**30.0%**
Developped Markets	**62.88**	**-2.7%**	**-1.2%**	**-6.9%**	Bearish	**22.5%**
Europe	458.12	0.5%	0.5%	-6.1%	Bearish	6.8%
North America	4,481.15	-2.6%	-1.1%	-6.0%	Bearish	12.4%
Great Britain	7,582.44	0.9%	0.9%	2.7%	Bearish	1.1%
Asia Pacific	26,888.57	-3.4%	-3.4%	-6.6%	Bearish	2.3%
Emerging Markets	**1,142.50**	**0.1%**	**0.1%**	**-7.3%**	Bullish	**4.5%**
Asia Pacific	657.99	0.3%	0.3%	-5.3%	Bullish	3.0%
EMEA	235.45	-0.2%	-0.2%	-14.6%	Bullish	1.1%
South America	2,663.22	-0.6%	-0.9%	25.0%	Bullish	0.5%
Thematic						**3.0%**
Asset Allocation	31.81	-1.9%	-1.1%	-7.6%	Bullish	3.0%
Fixed Income						**10.0%**
Europe						**0.0%**
Sovereign	211.15	-0.8%	-0.8%	-4.2%	Bearish	0.0%
Investment Grade	232.76	-0.8%	-0.8%	-7.0%	Bearish	0.0%
High Yield	419.76	0.0%	0.0%	-4.1%	Bearish	0.0%
North America						**0.0%**
Sovereign/Tips	2,535.75	-1.4%	-1.4%	-7.6%	Neutral	0.0%
Investment Grade	3,203.87	-1.5%	-1.5%	-9.1%	Bearish	0.0%
High Yield	2,321.70	-0.9%	-0.9%	-5.7%	Bearish	0.0%
Emerging Markets						**7.0%**
Local Currency	369.08	-1.3%	-1.3%	-10.8%	Bullish	7.0%
Hard Currency	1,141.37	-0.7%	-0.7%	-9.9%	Neutral	0.0%
Others						**3.0%**
Convertible	957.11	0.2%	0.2%	-4.0%	Bearish	0.0%
Trade Finance	105.64	-0.9%	-0.9%	-3.5%	Neutral	0.0%
Broad Funds	491.08	-1.7%	-1.7%	-7.8%	Bullish	3.0%
Commodities		**0.8%**	**0.8%**	**26.4%**		**10.0%**
Agriculture	109.39	0.6%	0.6%	18.2%	Bullish	1.3%
Energy	46.78	2.4%	2.4%	51.4%	Bullish	1.3%
Industrials	211.96	0.0%	0.0%	22.6%	Bullish	1.3%
Precious Metals	231.21	-1.2%	-1.2%	5.5%	Bullish	6.0%
Alternatives						**25.0%**
Hedge Funds	1,416.79	0.4%	0.4%	-1.0%	Bullish	15.0%
PE/Real Assets	2,235.79	0.9%	1.7%	3.4%	Bullish	5.0%
Pre-IPOs	703.14	-1.2%	-1.2%	-6.8%	Bullish	5.0%
Cash						**25.0%**

Source. MAM Research, Bloomberg

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Source. MAM Research, Bloomberg

Asset Class Returns

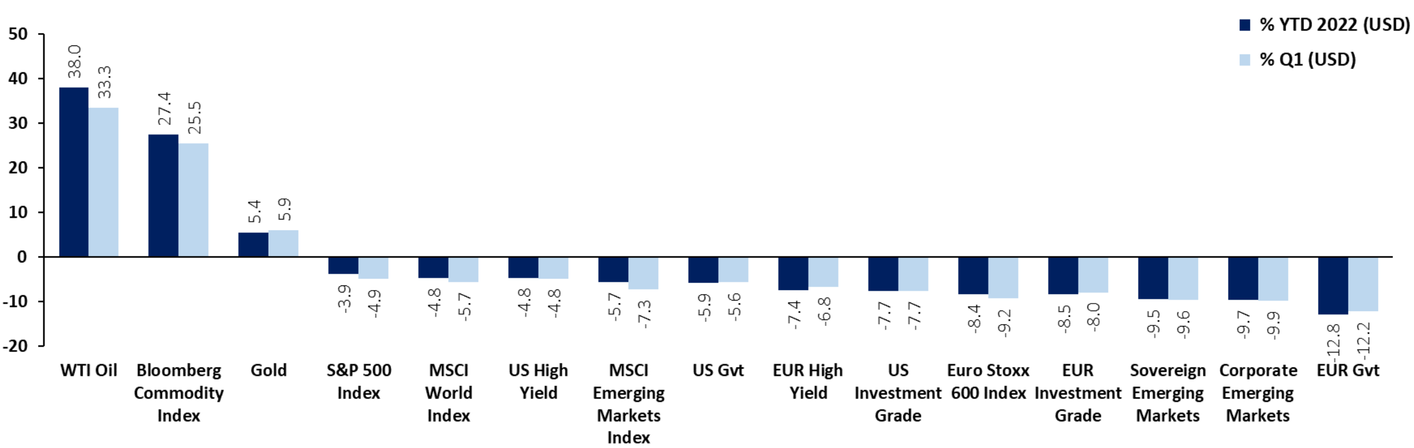
The first quarter has been challenging for markets. In many ways, it has been the worst start to a year in decades for both equities and bonds. Concerns over the economic implications of the Russian invasion of Ukraine, slowing economic growth, sustained inflation, and central banks pushing for a faster-paced interest rate hiking cycle weighted on both equities and fixed income. While acknowledging uncertainties related to the geopolitical situation and its economic implications, central banks view inflation as the most pressing problem to tackle unless the growth outlook markedly deteriorates.

Equity bear market rallies can be violent with the one we experienced in March being a prime example of that. Global equities were up 10.6% from their lows, but remain down 5.2% YTD. After closing in bear market territory, the Nasdaq 100 violently bounced back by over 17% led by mega-caps like Tesla and Apple, gamma squeezes into options expiries, and month/quarter-end rebalancing where institutional investors had to buy equities and sell fixed income. Europe being a massive importer of oil and natural gas from Russia was relatively more vulnerable to the conflict, beyond the obvious geographic proximity. European equities trailed global risk assets, down 8.4% through the quarter.

A year ago, central banks across the globe were keen to describe inflation as transitory. Fast forward to a year later and not only have they dropped the word "transitory" from their language but they are pushing one of the fastest rate hiking cycle in modern history to combat a supply and energy driven inflation at a time when fiscal stimulus is fading and economic growth is decelerating. All in all, that meant being long duration was the pain trade in the first quarter. No area in the fixed income space was spared. US sovereign bonds were down 5.6%, investment grade was down 7.7%, and high yield (supported by an overweight to energy) was not as negative on a relative basis, closing the quarter down 4.8%. The picture was identical for European credit markets.

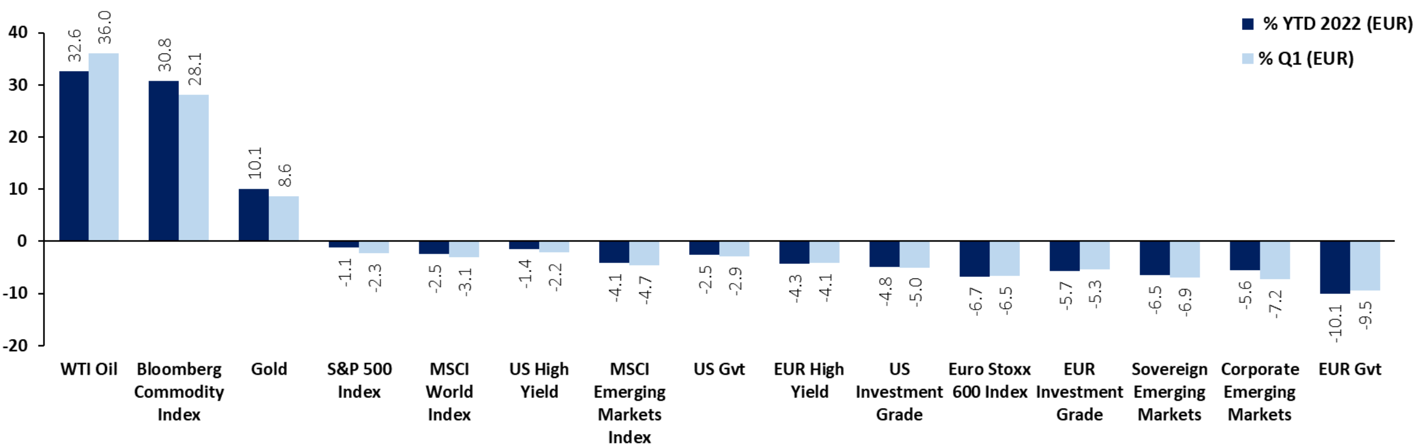
Commodities were once again the major outperformer throughout the quarter with the broad commodity index up 25.5%. They also were the only assets posting positive returns. Energy was the best performing sector with WTI Crude Oil up 33% in Q1, topping $130/bbl. at its peak in March. Industrial metals fared relatively well with copper up 6.4%. Precious metals found support near their most recent technical resistance levels with Gold closing the quarter up 5.9% at $1,937.44/oz. and Silver up 6.4% at $24.79/oz.

Chart 1. Asset Class Returns Q1 2022 vs. YTD 2022 (USD Base)



Source. MAM Research, Bloomberg.

Chart 2. Asset Class Returns Q1 2022 vs. YTD 2022 (EUR Base)



Source. MAM Research, Bloomberg.

MAM Actions

Equities

What have we done?

We started Q1 2022 with 50% of portfolios' equity exposure hedged. We strategically used intermediary market bottoms and peaks in volatility at the end of February to sell put options on indices (Euro Stoxx 50 Index and Nasdaq Index) and on the Biotech sector. We covered these strategies promptly. We also used relief rallies to add to our hedging strategy. We implemented Put Spreads on the S&P 500 Index and on the Nasdaq Index with a June 2022 maturity. Finally, we switched some of our energy equities exposure out of integrated companies into oil equipment manufacturers which display a higher beta to oil prices.

Our strategy going forward?

Equity markets have not seen tighter financial conditions since 2018. While the first rate hike is not necessarily synonym of market crash, we have to remain cognisant of the risks embedded in an equity market which has printed double-digit performances for the last 3 years. Our strategy remains to be relatively more exposed to "value" regions and sectors while keeping a relatively low outright exposure to equities. As we near the end of Q2 2022, our focus will be on rolling our equity market protection into H2 2022.

Fixed Income

What have we done?

Our allocation to credit has not changed throughout the quarter. We initiated a Put Spread strategy on the US High Yield ETF in order to take advantage of widening credit spreads.

Our strategy going forward?

We are likely to keep our underweight credit exposures constant in portfolios throughout the quarter. The combination of rising Fed fund rates and stubbornly high inflation does not bode well for this asset class. We conserve our exposure to EM credit at this stage as a relative area of value.

Commodities

What have we done?

We used the rally in commodities induced by the Russia-Ukraine conflict to sell holdings in the Broad Commodities ETF. Admittedly we were a bit early on this profit taking.

Our strategy going forward?

We are likely to use any commodity price sell-offs due to optimism on the Russia-Ukraine conflict as a moment to add back our exposure to the Broad Commodities ETF.

Currencies

What have we done?

We kept FX exposures constant throughout Q1 2022.

Our strategy going forward?

We are likely to keep FX exposures constant in portfolios throughout the second quarter.

Hedge Funds

What have we done?

We kept Alternatives exposures constant throughout Q1 2022.

Our strategy going forward?

Our hedge funds' exposure is unlikely to change meaningfully over the course of Q2 2022.

Events

Russia/Ukraine

The Russian attacks on Ukrainian civilians are stalling peace talk efforts as Kiev ramps up efforts to obtain heavier weaponry from the West. The developments on the ground and pictures coming out make it all the more difficult for negotiations to continue as before.

EU members are in the meantime working on a ban on Russian coal imports as part of a new package of sanctions. The U.S. looks to impose sanctions preventing new investments in Russia as it adds sanctions its financial institutions, SOEs, and government officials.

The global geopolitical risk runs high, very high. Arguably, we are in or at the onset of a new cold war where sanctions will remain in effect for an extended period of time in our view, especially given the most recent developments and discoveries. We believe other ramifications will also remain in place. Energy independence, insourcing, weapons purchases, and a lot more deglobalization are just a few of the many consequence that will stick post-war. We think we are still far from the end.

In the coming months, though we hope for a conflict resolution, we expect further sanctions to put additional pressures on Moscow.

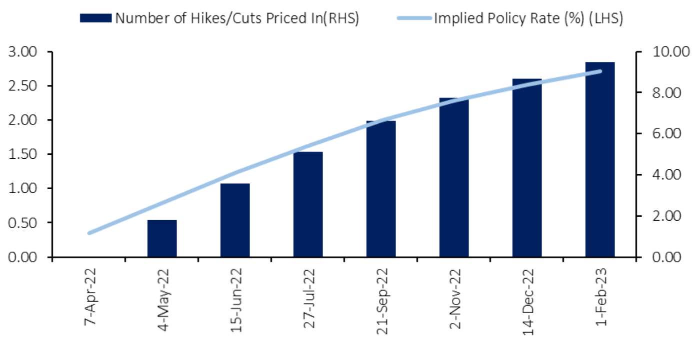
FOMC Meetings

The 25bps rate hike announced at last month's FOMC meeting did not come as a surprise, but the hawkish comments from all FOMC members since then did.

In essence, the Fed has convinced the market of two things: (1) the rate raises will be higher than formerly believed **(Chart 3)**,(2) these will do little to cure inflation, at least in the near-term.

The March FOMC meeting minutes amplified the hawkishness assumptions. "Many" participants going into the meeting were apparently favouring a 50bps hike but reverting to a 25bps hike decision in light of uncertainty stemming from the geopolitical situation. Though there was no commitment to timing for when the balance sheet runoff would begin, the FOMC consolidated a plan with an announcement and details to be expected at the May 4th meeting. Q2 is likely to see the start of a balance sheet runoff with aggregate reinvestment caps set at $95bn/month.

Chart 3. Implied Fed Overnight Rate & Number of Hikes/Cuts



Source. MAM Research, Bloomberg

French Presidential Elections

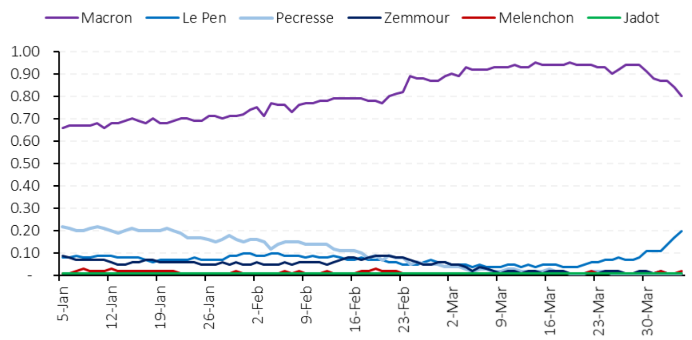
The results of the French presidential election will be watched closely by investors. The first round on April 10 is followed by a runoff of the top two candidates on April 24 if no candidate receive an outright majority (which seems highly likely).

Macron, the incumbent President, is viewed as the favourite, especially since the geopolitical tensions picked up. However, in recent weeks, the "McKinsey case" has been playing against him in the polls **(Chart 4)** as Le Pen progressively wins ground. Nevertheless, online prediction markets continue to imply there is an 80% chance the incumbent president will win the election.

Looking at volatility markets for the Euro, it is clear markets are not pricing too much risk around the event therefore suggesting an unexpected defeat from Macron would be a negative shock to the Euro, a tail risk to keep in mind heading into this event.

If political events such as Brexit and Trumps' election taught us anything, be careful and prepare for the negative outcome.

Chart 4. Odds: Who will be elected president of France in 2022?



Source. MAM Research, Bloomberg

Economics & Rates

Conclusion. "Volker Moment" Ahead. The U.S. economy is set to slow down this year. While there are a few factors that could change the degree of deceleration such as (1) the Fed tightening as much as markets currently expect, (2) the Russian-Ukraine war coming to an end, and (3) supply chain constraints abating in a meaningful way, no matter what happens, the underlying math stays the same. The domestic economy faces almost impossible stimulus-fueled growth comps starting this quarter. In other words, investors should prepare for a growth slowdown towards the end of 2022. Brainard, one of the most dovish FOMC members, is quoting Volcker. We can only but speculate to the idea of Powell looking back at the Volker moment of 1979 as a template to "kill" inflation, the number one concern among Americans, by raising rates quickly and sending the U.S. economy into a technically recession. Our base case sees the U.S. and most developed nations entering a recession in the next 9-18 months. It has been supported by the inversion of yield curves, which more often than not acted as a leading indicator to economic recessions.

The U.S. Federal Government spent money hand-over-fist in the pandemic support and stimulus package. Mathematically, it will drop Federal spending by $1.3 Trillion in 2022 (YoY) from $6.8tn to $5.6tn. This spending drop represents ~6% of GDP. As overall GDP faces a 4-5% headwind from the drop in spending, most of the stimulus comps are in Q2. With US leadership likely divided post-midterms, the picture is unlikely to change any time soon.

For Q1, our expectations of a hawkish Fed as inflation lingered and U.S. 10-Year yields above 2.2% proved correct. Fast forward 3-month, the economic landscape has shifted. Markets have now priced in 9 hikes for the year (from 3 in December 2021) **(Chart 5)**. If markets remain stable, a risk is for the Fed to push for more. A 2.5% Fed fund rate by year-end would see interest rates at Q4 2018 levels, point where rates were too restrictive for economic growth. Add a Fed balance sheet normalization to the equation and risks of overly restrictive financial conditions by the year-end rises substantially. Expectations and shadow rates added to the hike done in March imply 19 hikes this year!

Many investors continue to believe the U.S. economy is strong, the Fed is optimistic about growth, and therefore the risk of an economic recession is low. Forgotten, though, is the Fed often tightens at the top of a business cycle, meanwhile its prognosis for the economy is always bullish and optimistic at the start of a tightening campaign. None of this changes the fact that each tightening cycle almost always ends up with a financial calamity and an economy recession or slump. A supply push inflation is a much more troublesome problem than a demand pull inflation since the former does not respond to higher rates and tighter monetary policies, but consumer and business spending does. The asymmetry means monetary policy tightening in response to supply push inflation could hurt the underlying economy without curbing inflation quickly enough.

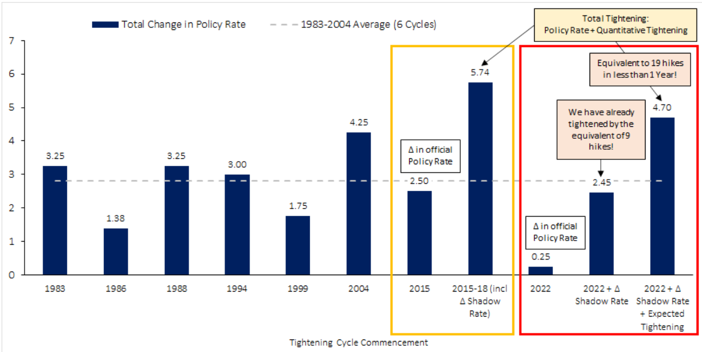
We see long-term U.S. treasury yields peaking >3.5% **(Chart 6)**. A recession could bring down both commodity prices and goods inflation (e.g., disinflation). But we are not there yet.

Leading indicators are already pointing to a significant growth deceleration in Europe **(Chart 7)**. The elevated inflation, energy crisis, and tighter financial conditions are likely to push Europe into a technical recession ahead of the U.S. this year.

China is unlikely to be able to single-handedly save the global economic growth as the country deals with its own domestic set of issues and a global push for "re-shoring" supply chains.

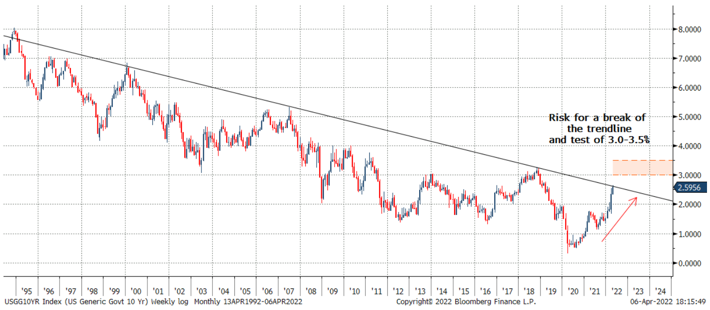
Outside of the developed market world, we continue to believe emerging market economies will stay resilient given, in part, the net commodity exports and a significant room to lower interest rates to spur economic growth. This should all be supportive of emerging market sovereign bonds and the local currencies.

Chart 5. Fed Tightening Cycles



Source. MAM Research, Hedgeye Risk Management, Bloomberg

Chart 6. US 10-Year Bond Yields (Monthly)



Source. MAM Research, Bloomberg

Chart 7. German IFO vs. GDP YoY

Source. MAM Research, Bloomberg

Credit

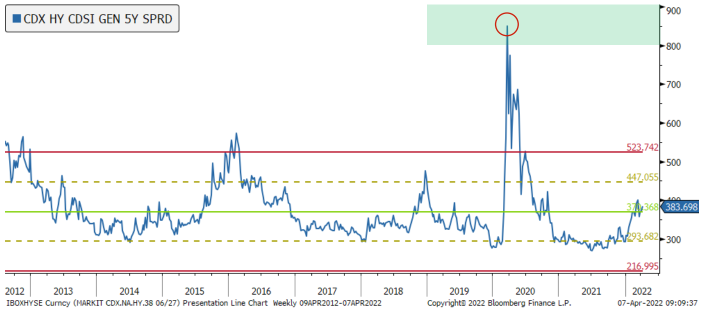
Conclusion. Much Wider Spreads Ahead . Elevated uncertainties are unlikely to abate any time soon and weaker fundamentals ahead mean credit spreads should continue to trade wider, despite the recent reversion to the mean on High Yield credit spreads **(Chart 8),** as the Fed progresses on its monetary policy normalization agenda. The first leg of credit sell-offs is usually about higher volatility and a general repricing of credit risk premium, which affects investment grade credit more. The second leg of the sell-offs is more about defaults which impacts high yield credit more as investors observe actual credit deterioration, funding stress, and defaults. Credit markets are suffering one of the sharpest drawdowns in modern history. With that said, however, we believe the worst has yet to come. The new issuance volumes came down significantly, particularly in the high yield space (-70%) **(Chart 9)**. We continue to recommend an underweight allocation to the broader credit asset class in developed markets while favouring emerging markets credit, especially China, as the government sets course on a series of policy accommodations to support the economic recovery.

Credit spreads are back to pre-Ukraine invasion levels with their sharpest two-week compression (excl. recession/recoveries) on peace talk hopes. However, in this post-covid world and energy crisis environment, fundamentals remain gloom. The economy is set to slow down which ultimately will have an impact on the fundamentals of credit issuers. We believe the Fed is on a path to force the U.S. economy into a technical recession within the next 9-18 months. Ultimately, this will result in lower industrial growth and lower consumption at a time when margins will be suffering the consequence from elevated cost inflation and high wage growth. In turn, it implies a diminished ability to service debt, which would ultimately send spreads higher as the risk of defaults from credit issuers rises. At the very least, we should expect spreads reaching the Q4 2018 levels around 475bps. In a more constructive fashion, we believe spreads have the ability to go to 600-800bps within 12-24 months vs 383bps today. The 2008 crisis saw HY spreads widening towards 1000bps.

In the meantime, given the strength in commodity markets, EM credit continues to offer attractive value with a more measured level of risk. Central banks in the regions are already nearing the end of their rates hiking cycles to contain inflation as economic growth differential prove supportive to local currencies, a plus for the local currency bonds. Performance within the emerging markets fixed income space remains mixed as local markets are outperformers on a YTD basis and continue to trade well from a technical perspective. Part of this story has also been associated with commodity inflation narratives lending solid terms-of-trade boosts to certain FX pairs (i.e., BRL, MXN). From a spreads view, EM credit remains historically cheap **(Chart 10)**.

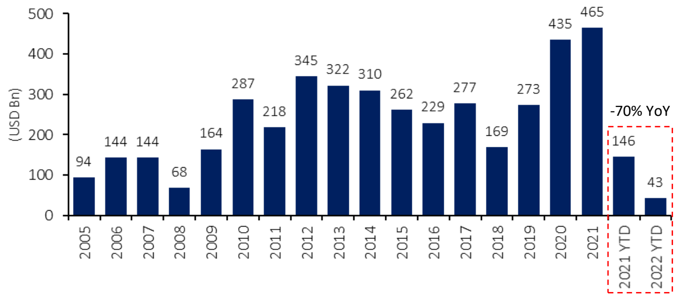
China remains one of the few economies around the world that is still largely applying a zero-Covid policy. Questions and doubts around China's growth increased over the past couple weeks in light of the recent lockdowns. Investors are very much focused on how long such policy could last. Arguably, some wonder why the PBOC has not cut rates yet. A couple of reasons justified it. (1) February data had been relatively strong though questions around data quality remained. (2) China's State Council said the PBOC could proactively use monetary policy by increasing credit lending. (3) A rate cut itself might not have a significant impact on the economy given less effective transmission mechanisms. However, the most recent PMI print fell to its lowest point since February 2020. We are increasingly convinced the government will turn more accommodative in the coming months which will be supportive to the Asian credit markets **(Chart 11)**. We view buying Asian credit at or below March 2020 levels as attractive.

Chart 8. U.S. High Yields Credit Spreads (Weekly)



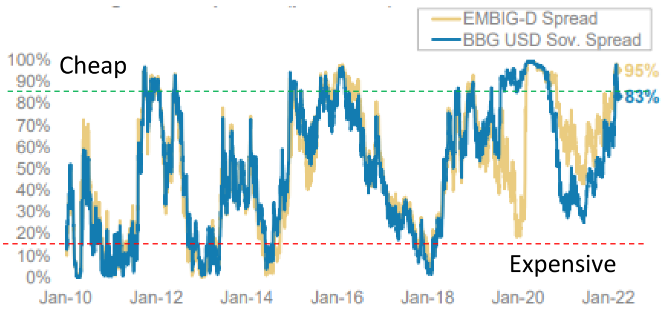
Source. MAM Research, Bloomberg

Chart 9. US High Yield New Issuance



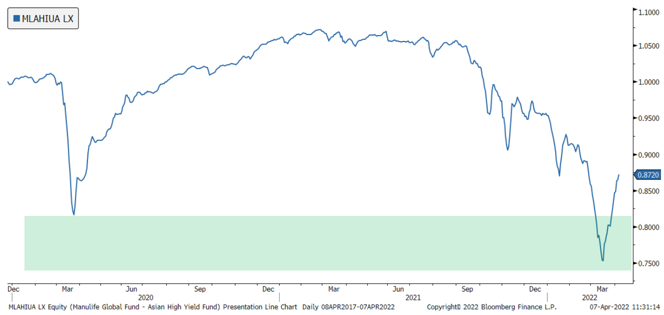
Source. MAM Research, S&P LCD

Chart 10. EM Credit Spreads (Percentile)



Source. MAM Research, Bloomberg

Chart 11. Manulife Asia High Yield Fund (Daily)



Source. MAM Research, Bloomberg

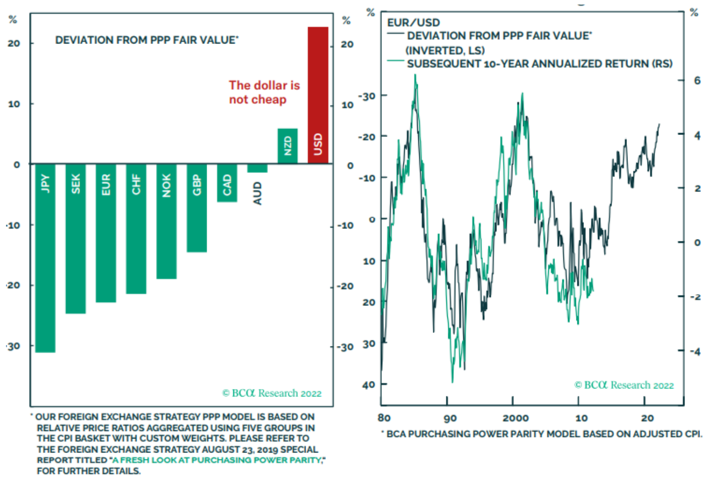
Currencies

Conclusion. Dollar Peak. We expected a peak in the USD in Q1 2022 with a potential target of 1.10 against the EUR. Our timing and target was slightly off, due in part to the lingering war in Ukraine and its secondary effect on economic growth in the European Union. However, our fundamental view remains unchanged for now. Rates, monetary policy, and growth divergence will remain the main drivers of FX markets over the next few months. Overly tight monetary policy is first and foremost a US phenomenon. US growth is likely to undershoot expectations in the next couple of months. The dollar tends to be particularly vulnerable when growth expectations are rising more outside the US than in the US. The dollar's ascent has left it overvalued by more than 20% on a Purchasing Power Parity (PPP) basis. Dollar positioning remains stretched on the long side. While both arguments are not sufficient for short-term trading, they point to potential longer-term weakness for the USD. We remain bullish emerging market currencies based on valuations, with the exception of the Chinese Renminbi.

The dollar has benefited from a divergence in real yields in favour of the US, and from investors searching "safe havens" during the financial market route following the Russia-Ukraine conflict. Some of these factors have now dissipated. The dollar rally has left it overvalued by more than 20% on a Purchasing Power Parity (PPP) basis **(Chart 12.LHS)**. While valuation is not a short-term trading signal, it has been a fair predictor of long-term performance. The EUR cheapness suggest a potential for long-term appreciation against the USD **(Chart 12.RHS)**. Dollar positioning remains stretched on the long side. That is not necessarily an obstacle in the short run, given that the dollar tends to be a momentum currency, but it does suggest that the greenback could weaken over a 12-month horizon as positioning normalises. Technically, the USD Index **(Chart 14)** is approaching key resistance at 100. We believe that the EUR/USD exchange rate will find a floor at current levels of 1.08-1.10. We then expect a rally in the EUR over the coming months towards 1.18 (+8%).

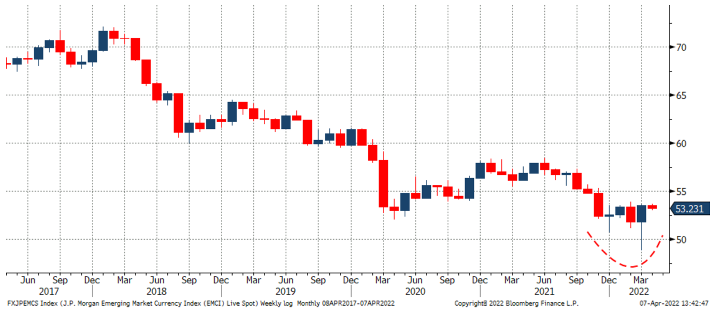
We remain relatively bullish on EM FX **(Chart 13)** on the back of cheap valuations (excl. CNH). In the first part of the last US rates hike cycle (2015-2016), emerging market currencies rallied by more than 12% against the dollar so a tightening in the US can be supportive. The only area of risk in our view is the Chinese Renminbi. It is 2-standard deviation expensive on a REER basis. The risk of a devaluation similar to 2015 is rising.

Chart 12. USD Remain Expensive. It Matters Long-Term



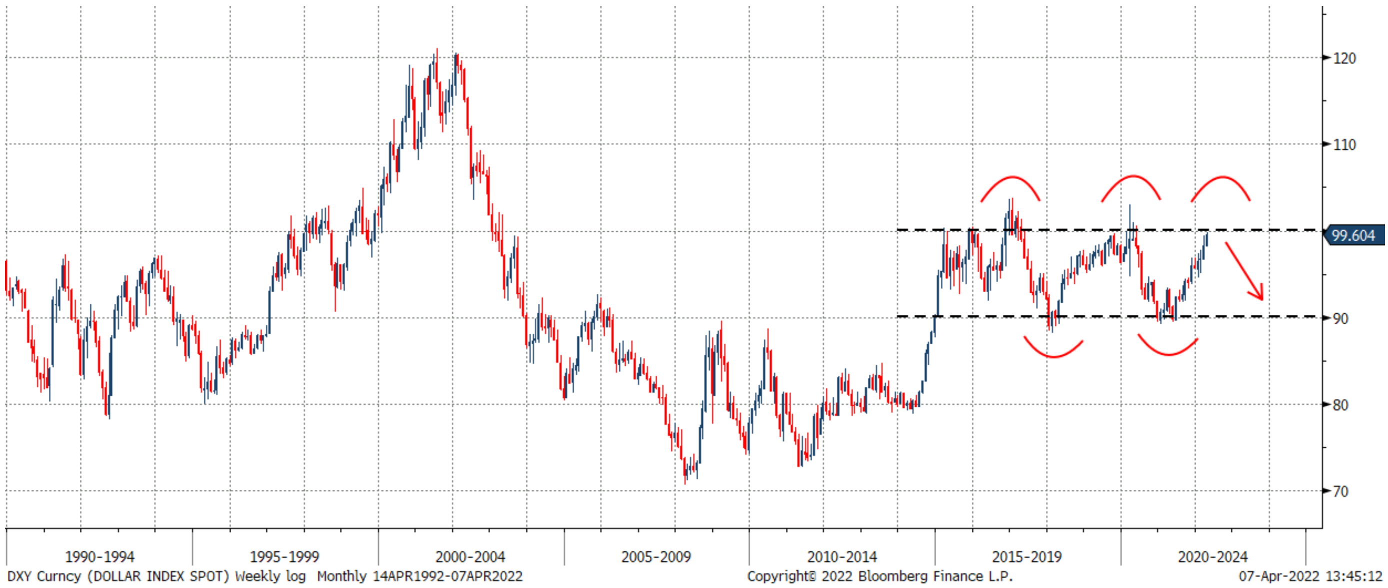
Source. BCA Research

Chart 13. EM FX Spot (Weekly)



Source. MAM Research, Bloomberg

Chart 14. USD Index (Monthly)



Source. MAM Research, Bloomberg

Equities

Conclusion. Downgrading to Sell. Our cautious approach to equities heading into the new year proved correct. We did not anticipate the Russia-Ukraine conflict, but found the risk-reward in risk assets unappealing at record high valuations ahead of tighter monetary policies. Fast forward a couple months and this view has not changed. Our perspective on equity markets has actually deteriorated, which is why we are now downgrading them to sell or underweight ahead of Q2 2022. Valuations remain elevated. The prospect for a deep economic growth deceleration has yet to be reflected in multiples and estimates. Market tops are a process. More often than not, they can be frustrating. Bear market rallies can be violent as it was apparent heading at the end of Q1. Yet, fundamentals do not change. We are exiting European value assets given late cycle headwinds. Our year-end target for the S&P 500 is 3,750, or -16.3% from spot. Small cap growth stocks will be a key area of focus for us in H2 2022 as valuations in this pocket of the market dropped substantially already. In the meantime, staying defensive.

Q1 was one of the worst quarters on record for the collective performance of stocks and bonds with the latter worse than the former. It makes sense given investor concern focused more on the inflation and Fed than the growth slowdown. The last ISM Manufacturing survey shows the orders component fell below inventories for the first time since the expansion began. This book-to-bill proxy for the manufacturing sector suggests a meaningful downside to headline ISM **(Chart 15)** over the next few months which does not bode well for equities.

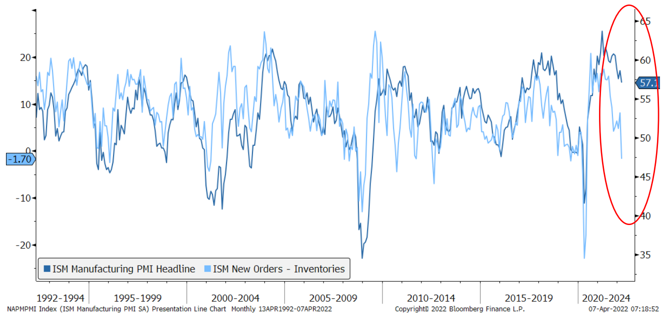
Companies have reported record sales and earnings growth last year, benefitting from pent-up demand, above trend consumer spending fuelled by government support (e.g., stimulus checks) **(Chart 16)**, lower costs, and easy comps. However, the numbers are bound to roll over. On a sequential basis, the U.S. corporate profits have already turned negative. The S&P 500 EPS are down from +87% YoY in Q2 2021 to +38% YoY in Q4 2021, and could easily go lower towards 0% YoY in Q2 2022. Would it simply be a Russia-Ukraine story? We think not.

Equity Risk Premium (ERP) is a good measure for the expected return of stocks above the risk free rate. In our view, it makes little sense for the ERP to be at decade lows **(Chart 17)** given headwinds to earnings growth from rising risks of recession in the next 9-18 months, cost pressures, un-comp-able comps, and a war structurally increasing the prices of food and energy.

The market must be pricing it in, no? If you look at headline P/E multiples, sure. Valuations do look a whole lot cheaper than as of a couple months ago. However, the numbers are biased and driven by two factors (1) a compressed numerator (price) as the market adjusted for Fed policy and inflation and (2) an inflated denominator (earnings) given sustainedly high earnings growth expectations. Analysts on the street are still factoring in 20% EPS growth for 2022. The upcoming earnings season starts a week from now and should mark the begging of a new wave of earnings revisions and down guidance driving that EPS growth number down to the 0-10% range, which will have a material impact on both valuations and indices. To achieve our year-end 3,750 target (-16.3%) on the S&P 500, we used 5% EPS growth and an 18.4x P/E multiple (pre-Covid level) **(Table 1)**.

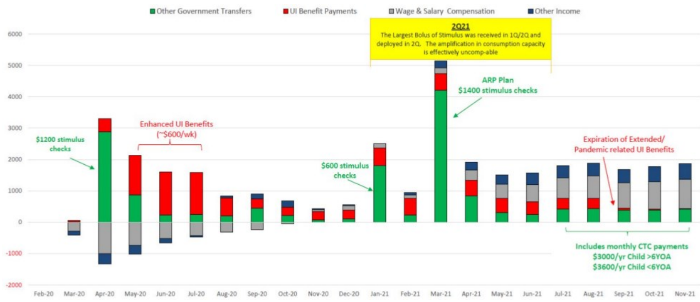
In this late cycle environment, we recommend staying defensive in our factor and sector allocation. We are reducing exposure to European value. Focusing on the utility, energy, and healthcare over industrial, discretionary, financial, and tech sectors. Small cap growth will be a key area of focus heading into the second half of 2022 as valuations have already reset meaningfully.

Chart 15. ISM Manuf. Headline vs. New Orders - Inventories



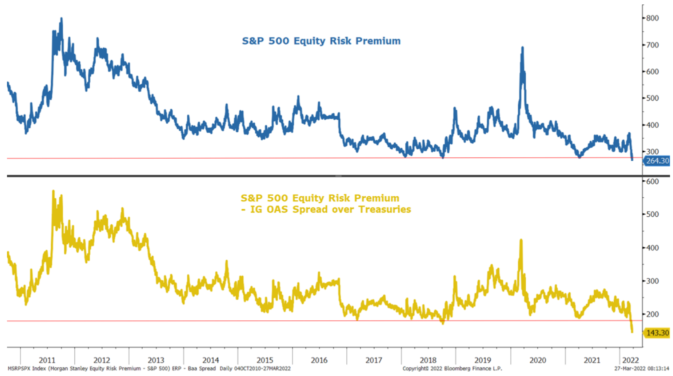
Source. MAM Research, Bloomberg

Chart 16. Household Income Relative to February 2020



Source. BEA, Bloomberg, Hedgeye Risk Management

Chart 17. S&P 500 Equity Risk Premium



Source. MAM Research, Bloomberg

Table 1. S&P 500 Return Sensitivity - EPS YoY % & P/E Multiple

		EPS Growth						
		-24.8%	-9.8%	5.2%	20.2%	25.2%	30.2%	35.2%
EPS Multiple	13.2x	-57%	-48%	-40%	-31%	-28%	-25%	-23%
	15.2x	-50%	-41%	-31%	-21%	-17%	-14%	-11%
	17.2x	-44%	-33%	-21%	-10%	-7%	-3%	1%
	19.2x	-37%	-25%	-12%	0%	4%	8%	13%
	21.2x	-31%	-17%	-3%	11%	15%	20%	24%
	23.2x	-24%	-9%	6%	21%	26%	31%	36%
	25.2x	-18%	-1%	15%	31%	37%	42%	48%

Source. MAM Research, Bloomberg

Commodities

Conclusion. Supportive Fundamentals. Under-investments and ongoing energy transition needs imply supply and demand dynamics did not change from last year. In fact, supply dynamics deteriorated quite substantially in the first quarter. Russia exports huge amounts of materials the world uses to build cars, transport people and goods, make bread, and keep the lights on. Its invasion of Ukraine is threatening those crucial supplies as it becomes increasingly isolated from the global economy, driving up prices in the process. Agriculture commodity prices will rise or remain elevated on the back of elevated energy (input) prices and so will industrial metals. A weaker dollar in H2 2022 alongside a Chinese growth comeback, post-covid lockdowns, should push commodity prices higher. Strong market dynamics are supporting higher uranium prices onward while precious metals should continue to perform. Within our bullish commodities view, we are turning neutral on the energy complex; primarily because the prospects of a recession in Europe and the U.S. could relief some of the current supply constraints. We see oil range-bound within $90-100/bbl.

Russia's invasion of Ukraine is constraining the world's supply of natural resources. The country is a commodity powerhouse. It is the second-biggest crude oil exporter after the U.S. (>1m B/D), the biggest exporter of gasoil and diesel (198m cu m), the largest exporter of natural gas (c.16% of global export volumes), and the third largest exporter in coal shipment (173mt). Energy prices are bound to stay elevated. However, we do not call for substantially higher prices, rather for more of range bound price fluctuations. For instance, despite record prices last year, major thermal coal suppliers struggled to boost output due to a litany of issues including weather events, rail disruptions, covid outbreaks, and equipment shortages. Then, for most of January, Indonesia (#1 Exporter) banned exports to fight a low domestic stockpile **(Chart 18)**. Post-implementation of the most stringent sanctions (so far excluding energy exports) Russia ever faced, things will get worse. Adding to supply woes, Russia is over c.25% of the global high calorific value coal exports. While an increase in Indonesian exports may help offset lost tonnage from Russia, it will not make up for the quality difference.

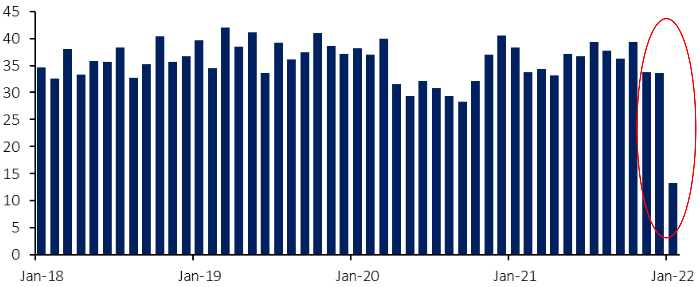
On the soft commodity front, the picture is just as worrisome. Russia and Ukraine are crucial to global flows, Africa and Asia are the largest buyers of cheap Black Sea wheat **(Chart 19)**. Seeking alternative supply could be good news for sales from the EU, Australia, and North America. Costlier wheat and risks of shortages will raise bread costs at a time when food has never been so expensive, exacerbating a global hunger crisis.

The fertilizer market was already constrained before the war due to plants shutdowns, trade tariffs, and sanctions on Belarus. Now, it is on the bring of chaos. Russia, which accounts for 20% of combined exports **(Chart 20)** of the three main nutrient types (nitrogen, phosphate, potash), has urged its producers to halt shipments thus making it much harder for agriculture giants like the U.S. and Brazil to source fertilizers. Farmers will likely pass on the extra costs, feeding into prices, and drive food inflation. In itself, food crises do not affect short-term financial markets but they create long-term societal instability.

Overall, we remain positive commodities in Q2 2022 and look to add exposure in any correction. That said, we need to keep an open mind over the risk of lower demand emanating from a potential recession. We are just not there yet.

We are puzzled by the performance, or lack thereof, of precious metals. Prospects of stagflation are usually very bullish for gold **(Chart 21)** and silver. However, we believe it is only a matter of time before we start seeing precious metals resuming their rally. As such, we maintain a large exposure to the asset class.

Chart 18. Indonesia Coal Exports (Monthly)

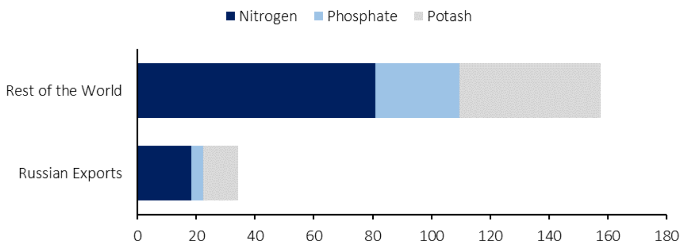


Source. MAM Research, Bloomberg

Chart 19. Russian Wheat is Consumed Around the Globe

Source. UN Food and Agriculture Organization, Bloomberg

Chart 20. Russia Accounted for a Fifth of 2021 Fertilizer Exports



Source. MAM Research, Bloomberg

Chart 21. Gold Spot (Weekly)

Source. Bloomberg, MAM Research

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MONACO ASSET
MANAGEMENT

Monaco Asset Management
Villa Les Fleurs
27, Boulevard Princesse Charlotte
98000 Monaco

Tel. + 377 97 97 64 00
Fax. + 377 97 97 64 01