MAM

MONACO ASSET MANAGEMENT

Investment Outlook

Q3 2022

Executive Summary

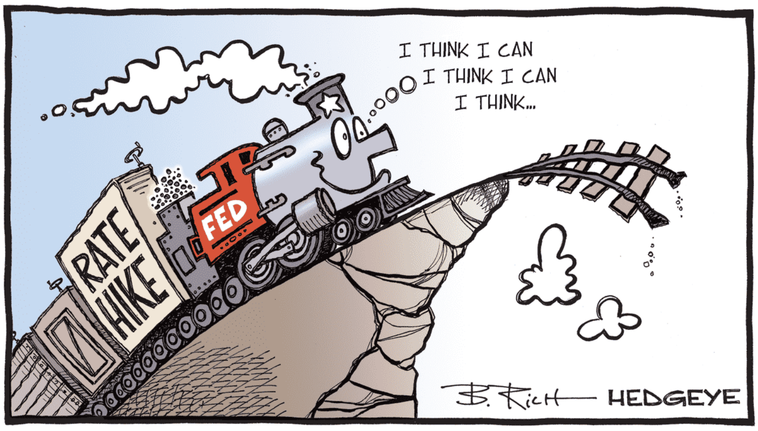
- **From stagflation to recession.** Consumer confidence dropped to all-time lows, revolving credit jumped to all-time highs, real earnings growth is negative and falling, credit card interest rates reached all-time highs, and real consumption turned negative. The consumer is not in good shape. A negative wealth effect is materializing. Decelerating growth is here, the recession is now after two quarters of negative growth (the definition of a technical recession). A Fed pivot is more likely in the next 2-3 months. Fed fund futures are already showing that.

- **Cheaper credit ≠ attractive.** Rates and spreads have gone up dramatically over the past few months. Fundamentals are bound to rollover from cycle peaks. Liquidity is evaporating. Investors' appetite for new issuance is drying up. Dispersion and distress ratios are rising. Refinancing risks are emerging, and overall confidence is eroding. Spreads in high yield have room to reach over 700bps in a recession scenario, a level where the risk-reward would make it more compelling to go long credit.

- **Rich dollar valuation.** Fed policy tightening, rates differential, and investor flight to safety were supportive to the dollar but left it more than +1.7SD expensive on a REER basis. Fed Fund Futures are in contango for the first time this year, which could be an early sign to the end of the dollar rally. As the ECB catches-up with other central banks and the Fed turns incrementally less hawkish, we would expect the Euro to find a floor near current levels.

- **Choppy times ahead in equities.** Multiples look cheaper on a forward basis, but denominators have yet to come down. Reverting back to the mean on valuations is one thing, but we could see an overshoot to the downside by up to one standard deviation. The recession picture is looming, markets will start to discount it back. It brings us closer to our S&P 500 target of 3,000 (-20%). Bottom picking is a dangerous game but we are ready to add growth and commodity-related equities as part of our barbell strategy for when the Fed pivots. Staying bearish Europe, long China.

- **Commodities taking a back seat, but the cycle is not over.** We are at the dawn of a secular bull market in commodities. Why secular rather than cyclical? The current bull run is a function of massive supply disruption, prolonged under-investment, and regulatory headwinds for new capacity to come online. We do not exclude some near-term weakness with demand destruction from the recession. However, the imbalance is such that prices could quickly find a floor. We remain long-term bulls.



Investment Stance Overview

Our investment philosophy, centered around the analysis of liquidity and economic cycles, prompted us to be proactive in assessing macroeconomic risks. Specifically, we were among the first in late 2020 to talk up the risks of non-transitory runway inflation. Our market narrative shifted months ago to elevated risks of a rising interest rates-induced recession. We argue the recession is here. As consensus catches up to our view, we are already exploring the shape of the next market paradigm. The depth of a recession and its impact on corporate earnings is complex to handicap. 2Q22 earnings results over the summer should be the catalyst for additional equity and credit market weakness. However, the combination of falling asset prices, rolling over inflation, and a rapidly weakening economy pushes us to expect the Fed to pivot in late 3Q22 to early 4Q22. This is progressively being reflected in sovereign markets. Interest rate expectations are down 50bps for 2022 and pricing a 50bps interest cut in 2023. Said pivot could occur ahead of the US November 8th mid-term elections. In our view, a barbell strategy is the best way to position for such an event. On the one hand, the combination of a weaker dollar and prospects of improving economic outlook can benefit commodities and related equities. A Fed pivot should propel precious metals higher. We will be buyers of commodities if prices dip throughout 3Q22. On the other hand, the stabilization of interest rates could bring back some market appetite for small cap growth-oriented companies which have suffered a material de-rating since 1Q21. Our area of focus remains renewable energy and software companies. Timing portfolio adjustments to a Fed pivot is complex. However, fortune rewards the prepared. This is the roadmap we will employ over the coming weeks.

	Investment Stance						Quarterly
	Very Bearish	Bearish	Neutral	Bullish	Very Bullish		Change*
SOVEREIGN BONDS						**BULLISH US/EM**	-
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							↗
China							-
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 Q3 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	1.04	-1.4%	-0.5%	-8.2%	Bullish	10.0%
USD	105.08	1.1%	0.4%	9.8%	Bearish	90.0%
Equities						**30.0%**
Developped Markets	**53.88**	**-1.7%**	**0.3%**	**-20.2%**	Bearish	**22.5%**
Europe	409.68	-1.3%	0.6%	-16.0%	Bearish	3.4%
North America	3,825.33	-2.2%	1.1%	-19.7%	Bearish	13.5%
Great Britain	7,243.37	-0.2%	1.0%	-1.9%	Bearish	2.3%
Asia Pacific	26,153.81	-2.7%	-0.9%	-9.2%	Bearish	3.4%
Emerging Markets	**992.84**	**-3.4%**	**-0.8%**	**-19.4%**	Bullish	**4.5%**
Asia Pacific	601.55	-2.7%	-0.7%	-13.4%	Bullish	3.0%
EMEA	193.26	-2.4%	-0.4%	-29.9%	Bullish	1.1%
South America	2,023.70	-3.4%	-0.9%	-5.0%	Bullish	0.5%
Thematic						**3.0%**
Asset Allocation	29.39	-0.9%	0.2%	-14.6%	Bullish	3.0%
Fixed Income						**15.0%**
Europe						**0.0%**
Sovereign	206.72	1.8%	1.0%	-6.2%	Bearish	0.0%
Investment Grade	219.77	1.9%	1.1%	-12.2%	Bearish	0.0%
High Yield	375.41	-1.7%	0.1%	-14.3%	Bearish	0.0%
North America						**5.0%**
Sovereign/Tips	2,455.56	1.1%	0.5%	-10.6%	Bullish	5.0%
Investment Grade	3,033.35	0.8%	0.6%	-13.9%	Bearish	0.0%
High Yield	2,116.06	-1.6%	0.2%	-14.0%	Bearish	0.0%
Emerging Markets						**7.0%**
Local Currency	333.19	-0.5%	0.9%	-19.4%	Bullish	7.0%
Hard Currency	1,055.81	-0.2%	0.6%	-16.7%	Neutral	0.0%
Others						**3.0%**
Convertible	864.26	-0.9%	-4.0%	-13.3%	Bearish	0.0%
Trade Finance	105.09	0.1%	-0.2%	-4.0%	Neutral	0.0%
Broad Funds	460.44	0.7%	0.5%	-13.5%	Bullish	3.0%
Commodities		**-3.4%**	**0.1%**	**18.1%**		**7.0%**
Agriculture	99.34	-3.9%	-2.5%	7.4%	Neutral	0.9%
Energy	50.52	-3.2%	3.7%	63.5%	Neutral	0.9%
Industrials	151.71	-3.9%	-2.6%	-12.2%	Neutral	0.9%
Precious Metals	206.65	-2.8%	-1.0%	-5.7%	Bullish	4.2%
Alternatives						**25.0%**
Hedge Funds	1,358.65	-0.2%	-1.8%	-5.1%	Bullish	15.0%
PE/Real Assets	1,920.21	-1.3%	0.7%	-11.2%	Bullish	5.0%
Pre-IPOs	599.08	-2.5%	0.4%	-20.6%	Bullish	5.0%
Cash						**23.0%**

Source. MAM Research, Bloomberg

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Pre-IPOs	599.08	-2.5%	0.4%	-20.6%	Bullish	5.0%
Cash						**28.0%**

Source. MAM Research, Bloomberg

Asset Class Returns

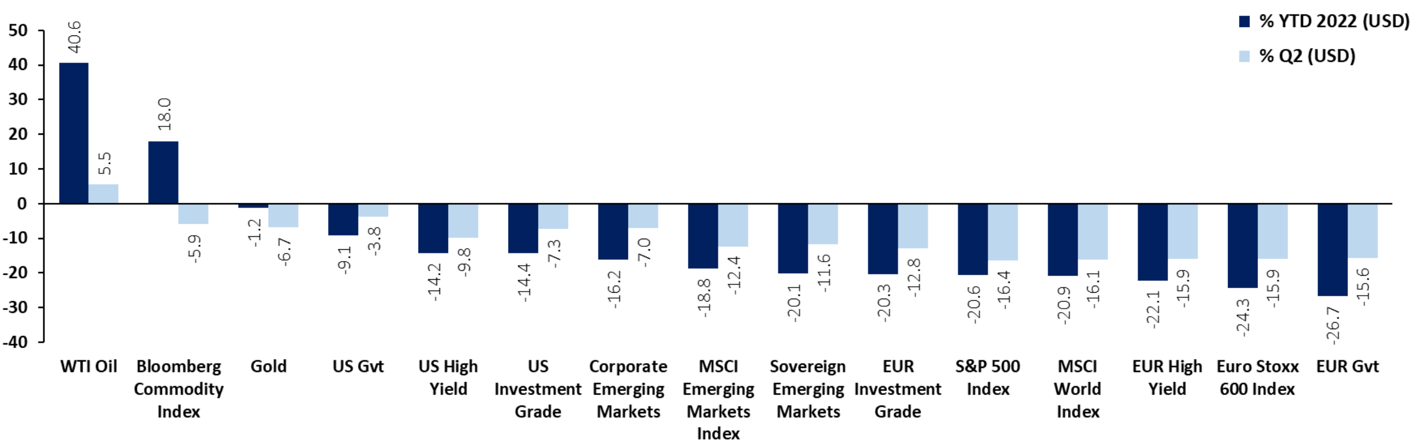
2Q22 displayed a global meltdown. Investors had nowhere to hide with all assets classes but energy posting negative returns both in USD and EUR terms. The S&P 500 officially entered a bear market, with the index down 16.4% in 2Q22 alone, down over 20% from its cycle peak in January 2022, and the worst start to a year since 1970. Emerging market losses were more contained with the index down 12.4% thanks to Chinese equities, one of the sole positive markets with the MSCI China up 2.3% on the back of accommodative policies and easing zero-Covid measures. European equities outperformed but remained negative, down 9.5%.

Fixed income assets continued to feel the pain of monetary policy normalization, higher interest rates, and wider credit spreads. The Fed lifted rates by 125bps throughout the quarter and kicked off its balance sheet reduction in June at an initial pace of $47.5bn per month and will accelerate to $95bn later this year. The BoE hiked by 50bps, through two 25bps hikes. The ECB left rates unchanged but cleared the path to start of the hiking cycle in July. US and EU sovereign bonds posted negative returns. US Sovereign bonds were down 3.8%, US Investment Grade down 7.3%, US High Yield down 9.8%. EU Sovereign bonds were down 10.4%, EU Investment Grade down 7.6%, and EU High Yield down 10.7%. Emerging Market credit also posted negative returns with sovereigns down 11.6% and corporates down 7.0%.

The hawkish rhetoric at the Fed continued to be a key support to the dollar amid global monetary policy divergence driving interest rates differentials and economic growth prospects outlooks decouple. The greenback was up 6.5%. EUR weakened by 5.3% with the ECB unable to raise rates in a timely manner due to the war in Ukraine. The Japanese Yen dropped 11.5% with the BoJ holding its interest rate and accommodative policy unchanged.

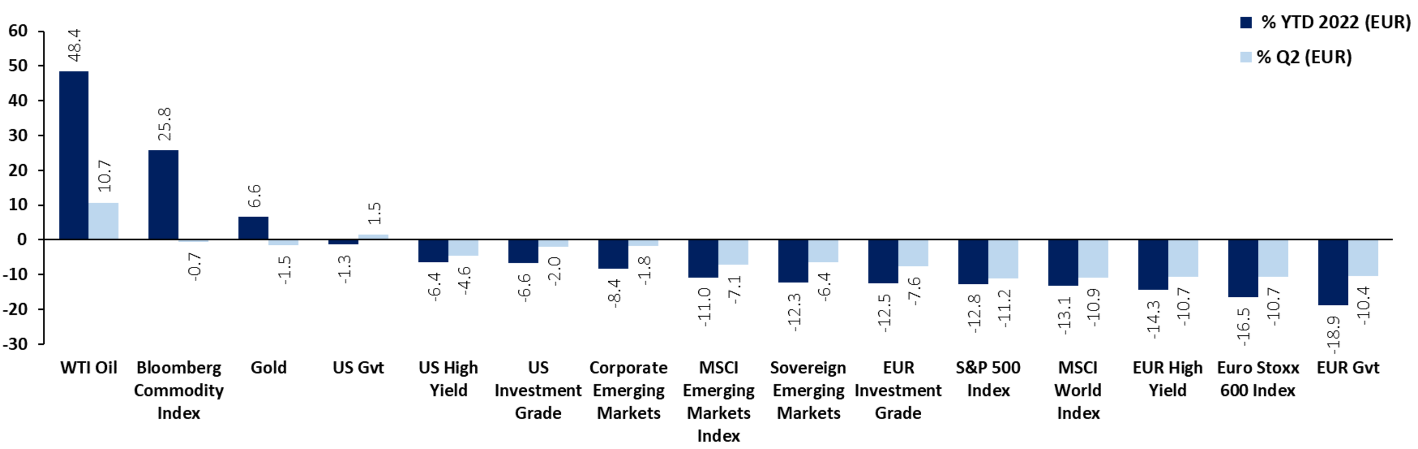
Commodities remain the only positive asset class year-to-date. Energy was the only sector posting positive returns, up 6.7% in 2Q22. The remainder of the commodity complex is down meaningfully from their cycle highs as economic growth scares put pressures on prices. The Bloomberg Commodity index was down 14% from its ATH. Industrial metals (i.e., Copper, Aluminium, Steel) were down more than 30% from their highs. With a strong dollar and positive real rates, precious metals lagged with gold down 6.7%.

Chart 1. Asset Class Returns YTD 2022 vs. Q2 2022 (USD Base)



Source. MAM Research, Bloomberg.

Chart 2. Asset Class Returns YTD 2022 vs. Q2 2022 (EUR Base)



Source. MAM Research, Bloomberg.

MAM Actions

Equities

What have we done?

2Q22 was an active period for equity trading. Bear markets are a succession of busts and bounces. We took advantage of the sell-off in April 2022 to cover some of the hedges from 4Q21. We closed deeply "in the money" put spreads on Nasdaq, closed long puts on the S&P 500, and covered some equity index futures short positions where applicable. Then, we used the short-term market trough and volatility spike to sell put options on the SPDR S&P Biotech ETF with a June 2022 maturity. We also took advantage of oversold market conditions to buy a tactical position in the KraneShares China Internet ETF. Later, we used the bounce to open put spreads on the Nasdaq and S&P 500 with a September 2022 maturity. We also used the relief rally to substantially reduce portfolio exposure to energy-related equities after a strong performance. Recessions fears impact value stocks, including commodities-related ones.

Our strategy going forward?

We keep a cautious view on equity markets in 3Q22. Our strategy of hedging in market rallies and tactically adding longs in market sell-offs will continue. More structurally, our view on equities will change from cautious to positive once prospects of a Fed "pivot" are clearer. We believe it can happen some time in late Q3 to early Q4. We would then employ a barbell strategy of long US mid-cap growth stocks, and long commodities and related stocks. Mid-cap growth stocks would benefit from stabilising US interest rates, leading a potential multiple re-rating. "Pivoting" in an environment of lower but elevated inflation would be negative to the USD and positive commodities. We would add exposure to small-cap growth, energy producers, base, uranium, and precious metals miners.

Fixed Income

What have we done?

We anticipated an upcoming US recession in early 2Q22. Based on this prospect and the relative value of US sovereign markets, we initiated long US long-term treasury futures positions in USD accounts.

Our strategy going forward?

Our view on fixed income is unlikely to change materially in 3Q22. Like equities, downside risk in credit markets remains high. US HY spreads should continue widening to previous crisis highs. We are unlikely to buy US or European credit until spreads fully reflect the recessionary environment. We continue to be positive on US long-term treasuries and would add exposure on pull-backs. Our exposure to EM debt markets is likely to remain constant in 3Q22.

Commodities

What have we done?

We have kept precious metals exposures constant in 2Q22.

Our strategy going forward?

We will use a significant drop in commodity prices to add exposure to commodities in 3Q22, buying the iPath Bloomberg Commodity ETF around $30 per share (or -27% from the highs of $41.1 in June 2022).

Currencies

What have we done?

Given our negative USD view, we reduced USD exposure in EUR-denominated portfolios to 10% when the EUR/USD dropped to 1.05.

Our strategy going forward?

Admittedly our negative USD view was ill-timed. We continue to believe prospects of a recession and a Fed "pivot" during periods of elevated inflation will impact the USD in the medium-term. We are likely to keep our FX exposures constant in 3Q22.

Alternatives

What have we done?

We didn't change portfolios' allocation to Alternatives in 2Q22.

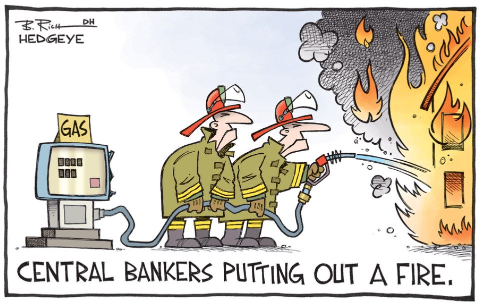
Our strategy going forward?

Our hedge funds' exposure is unlikely to change meaningfully over the course of 3Q22.

Events

Jam-Packed Central Bank Action

Liquidity drives asset prices. Market participants eager to determine the potential direction of financial markets need to assess the likely decisions of major central banks. 3Q22 will display a high number of central bank meetings: The Fed (July 27 & September 21), the ECB (July 21 & September 8) and the BoJ (July 16 & September 22) will all meet twice during this quarter. Such "jam-packed" central bank action is taking place during the summer months which are traditionally lower market volume months. Coupled with the release of Q2 corporate earnings (and Q3 guidance), central bank meetings have the ability to add fuel to the fire. While the central banks' decision for the first meeting are well anchored, surprises may happen at the September meetings. We anticipate the potential for a central bank "pivot" in the event financial markets continue to fall, the global economy continues to deteriorate and should inflation start rolling over due to annual effects.



US Mid-Term Elections in Preparation

US mid-term elections are taking place on November 8th. This is later than the horizon of our 3Q22 outlook. Yet, the outcome is so important that we wanted to discuss them. Historically, the midterm elections have served as a quasi-referendum on the presidential party. In 19 of the last 21 midterm elections, the presidential party has lost seats in the House. Republicans are considerable favourites at online sportsbooks to win the House of Representatives in this fall's midterm elections, but the U.S. Senate is shaping up to be a much bigger ask for the GOP, according to UK bookmakers. Popular British bookmaker Ladbrokes, installs the Republicans at -800 to clinch the House in November. The same sportsbook has the Democrats pegged as the +450 underdogs in this market. Whereas the betting frame for the rest of the midterm elections is mixed. While the Republicans are clear favourites at -400 to win more the 50 seats in the Senate, the Democrats are also favoured to win in key battleground states, New Hampshire and Pennsylvania. Political betting isn't legal in the United States but it is fair game with our neighbours across the pond. UK bookmakers regularly offer politics odds, also known as "specials," such as these on a number of American political events and elections, including the upcoming 2024 US Elections. As the market is fully aware of the risk of a split governing body between the White House and Congress, the real surprise could come from a retention of leadership from Democrats. What can drive this? The Roe vs Wade over-turn from the Supreme Court is pushing women and men in favour of abortion to come to vote in size and vote Democrat. This would be very positive for markets, and more specifically for the renewable energy sector as Biden may be in a better position to pass the long-expected related bills.

China's 20th Party Congress

At the end of 2022, the Chinese Communist Party will hold its 20th Party Congress. In all likelihood, Xi Jinping will be re-elected as General Secretary for another five years and, thus, be able to extend his political agenda indefinitely. Xi has discarded the decades-old succession mechanism at the top of the CCP and has concentrated more power on himself than any Chinese leader since the Mao era. This re-election happens at a crucial time when China's economic growth is faltering and fears of a potential conflict with Taiwan are rising. We believe that this re-election calls for unity and a common flight against the current economic slowdown. It will push China's leaders to pursue easing measures and put on the side any intention to increase tensions with Taiwan. In fact, China just announced a $200bn+ economic stimulus program centered around clean energy and infrastructure. We expect more announcements of stimulus ahead of Xi Jinping's re-election. This supports our bullish view on Chinese equities and bonds.

Economics & Rates

Conclusion. From Stagflation to Recession. Consumer confidence dropped to all-time lows, revolving credit jumped to all-time highs, real earnings growth is negative and falling, and credit card interest rates reached all-time highs. Nominal spending mostly held, but real consumption turned negative. The consumer is not in good shape. A wealth effect in reverse is materializing. The labour market remains imbalanced, but job openings are now in retreat. Small business employment trends are negative as sentiment on forward outlook dropped to an all-time low. Payroll trends will follow, with a lag. Labour trends define the trisect for (organic) consumption capacity. The recession is here. Bourgeoning disinflation and recession concerns are pushing break-even rates lower. Markets are challenging the Fed's terminal rate assumption and pulling forward rate cut expectations as early as 2023. Central banks (excl. PBOC) are hiking into an economic slowdown. Portfolios were proactively positioned for such an environment. Awaiting a Fed pivot, we will be incremental buyers of long-term treasuries and yield curve steepening trades in the coming months.

Although we may see a sequentially higher inflation print in July looking back at the month of June, the data is pointing towards disinflationary pressures for the coming quarters. Used vehicle inflation (Manheim) peaked in January 2022, -5.6% in 6 months. YoY Shipping costs (long-lead inflation contributors) have been slowing sequentially for the past year. Assuming 10bps per 15% increase in shipping rates, we see shipping contributing -1.8% to core inflation over the next 12 months, wiping out c.~17% from headline CPI by 2Q23 **(Chart 1)**. Owner Equivalent Rent (OER) lagged Case-Shiller National peaks and troughs by 12-15 months in the last 30 years **(Chart 2)**, meaning OER turns disinflationary towards 2H23 but keeps inflation elevated/supported till then.

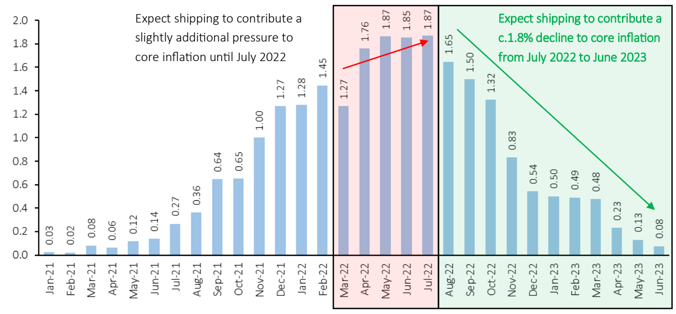
Inflation sees a K-Shaped distribution between income groups **(Chart 3)**. Food, energy, and shelter make up a 12% higher share of expenditures for the bottom income quintiles. These are the components with the largest price accelerations. Thus, essential spending captures an increasing wallet share relative to other discretionary items for lower income cohorts. It is only a matter of time until the pain is felt higher up on the income ladder and partly explains why consumer credit reached new all-time highs. Despite the above disinflationary components, inflation should remain elevated above 3-5% over the upcoming 12-18 months. As consumers feel the pain, spending will have to come down. Yet, consumption is critical to trend growth. The share of GDP growth attributed to it rose from 60% to 75% since 1960.

In Europe, the economic outlook is even more challenging. Euro area flash PMI for June came in well below expectations with manufacturing new orders falling into contractionary territory for the first time since the pandemic. Energy shortages hamper manufacturing. Russia is throttling natural gas exports. Germany activated phase 2 of a 3-stage emergency energy program, one step closer to rationing whereby it would prioritize "protected customers" like households and hospitals over industrial users.

We are in a recession. The risk is for the Fed and other central banks (i.e., BoE, ECB) to once again overshoot and overdo it on the policy normalization front. Nevertheless, we could start to see central banks slowing or even halting their accommodative policy pullback as the data gets reported. Investors must stand ready for 2-3 months of deteriorating job reports, which in turn will push the Fed to pivot.

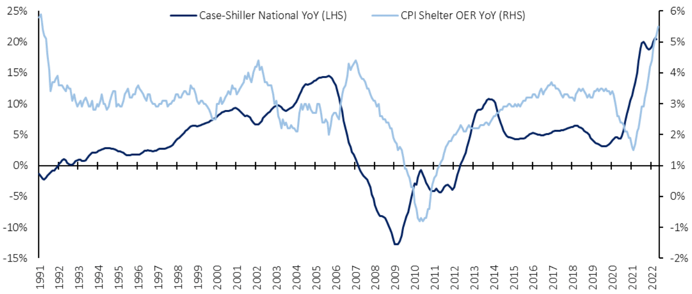
Global policy divergence is turning into a key theme. The PBOC plans to continue easing as the world tightens **(Chart 4)**, which is why we are more constructive on China while keeping an eye on Taiwan risks.

Chart 1. Shanghai Containerized Freight Contribution to CPI (%)



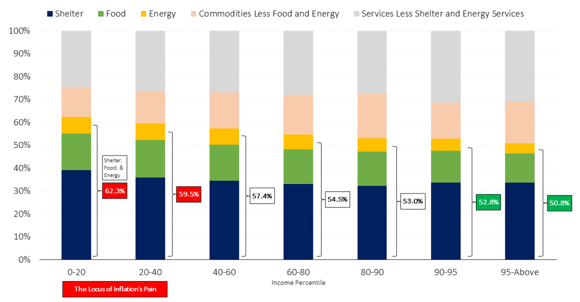
Source. MAM Research, Bloomberg

Chart 2. Case-Shiller National vs CPI Shelter OER YoY (1991-2022)



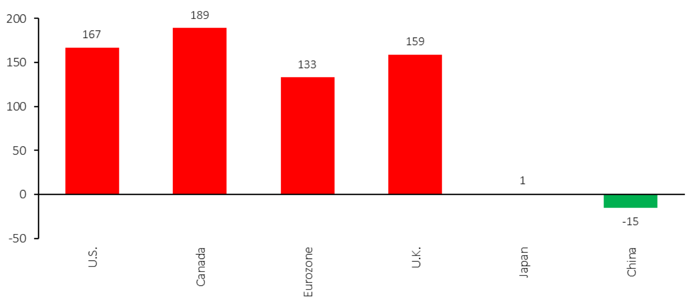
Source. MAM Research, Bloomberg

Chart 3. Expenditure Shares by Income Group (%-ile)



Source. Penn Wharton, BLS, Bloomberg

Chart 4. Δ Current vs. Year-End Expected Policy Rate (bps)



Source. MAM Research, Bloomberg

Credit

Conclusion. Cheaper ≠ Attractive. Rates and spreads have gone up dramatically over the past few months. The deteriorating outlook is feeding into expectations. Fundamentals are bound to rollover from their cycle peak. Liquidity is evaporating, investor appetite for new issuance is drying up. Dispersion and distress ratios are rising. Refinancing risks are emerging, and overall confidence is eroding. A stronger than expected, or longer than anticipated, recession would drive credit spreads wider and default rates higher. We have been arguing cheaper credit is not synonym to attractive over the past few months and will re-iterate this for the coming quarter, especially in the high yield market. The cyclical sector overrepresentation is a negative attribute in this environment. Credit spreads in high yield have room to reach >700bps in a recession scenario (in line with Covid highs), a level where the risk-reward would make it more compelling to go long credit. However, we will primarily look to re-enter credit via investment grade where risks are milder. Meanwhile, we are staying focused on EM credit where the risk-reward is more attractive notably in Asia and especially China.

Credit markets faced a number of challenges this year such as a sharp rise in yields, spreads, and inflation, a positive cross-asset correlation, and record drawdown to name a few. A silver lining for markets, however, was that most of these challenges were external in nature. Balance sheet fundamentals meant credit was resilient in the early innings of a rates induced correction. Wider spreads and loans outperformance kept with a mid-cycle correction narrative. The disconnect between the Fed's reaction to inflation and what markets were pricing then was one of our primary concerns. We expected lagging policy and uncertainty as sources of volatility and credit weakness. H1 2022 behind us, the macro stress points clearly pivoted from rates and inflation risk to growth and credit risk, and spreads reflect it **(Chart 5).**

Key credit metrics plateaued or deteriorated marginally in the last quarters. The share of issuers reporting negative quarterly EBITDA jumped to 9%. HY dispersion (see *MAM Insight No.20)* reached 72% in June. Softer earnings growth in 2Q22 will affect cycle low leverage and cycle peak coverage ratios **(Chart 6)**. Gross leverage for the median issuer trended higher for the first time in five quarters from weaker earnings growth and limited debt paydown after 1Q22 already. Even interest coverage ratios frayed, settling around 5x despite falling interest expenses. The median HY cash/debt fell to 13%, -4% from peak but +3% from pre-Covid level. FCF/debt declined for a 3rd consecutive quarter in 1Q22 and now tracking at 9%.

QT and rising rates are drying up liquidity. US HY new issuance dropped to a three year low. Distressed has jumped in a major way, with 11% of the HY index by par now above 1,000bps OAS. The share of issuers likely to refinance is back to GFC levels, and below pandemic levels **(Chart 7)**. The recession is here. 550bps should hold in the near-term on HY credit spreads. There needs to be more evidence (i.e., 2Q22 corporate earnings results) to send spreads above 700bps.

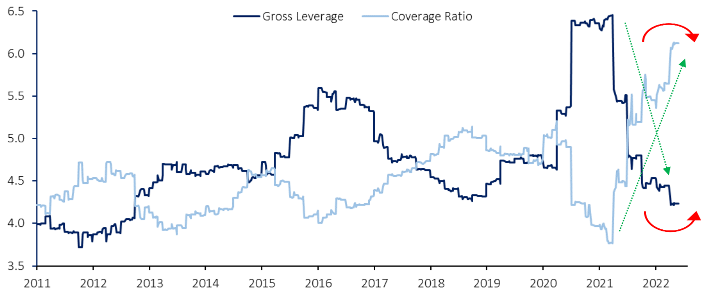
In Europe, the picture is broadly similar with spreads widening materially over the past few quarters. The Bloomberg EuroAgg Corporate Average OAS **(Chart 8)** is back to pandemic levels at 217bps and point to a continued slowdown in the Eurozone. In the meantime, European inflation is worse than it has ever been, the consumer has never been more bearish in Europe with the lowest consumer confidence print since 2012 (-23.6).

China is progressively relaxing its zero-Covid policy, the PBOC is one of the few accommodative central banks, and the economy has been showing signs of improvement on a sequential basis in the data. As the outlook improved, credit spreads contracted.

Chart 5. US High Yield Credit Spread (Monthly)

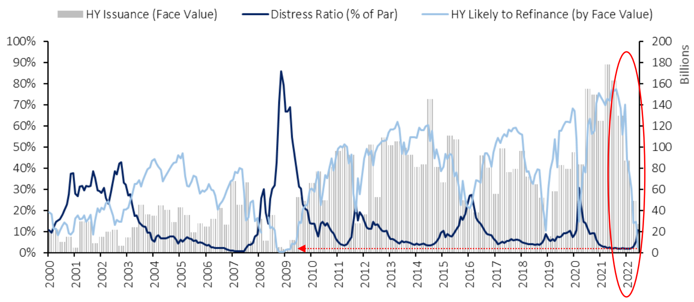
Source. MAM Research, Bloomberg

Chart 6. US High Yield Fundamentals (Leverage and Coverage)



Source. MAM Research, BofA Global Research

Chart 7. US High Yield Market (Issuance, Distress, Refinance)



Source. MAM Research, Bloomberg

Chart 8. European Investment Grade Credit Spreads (Weekly, %)

Source. MAM Research, Bloomberg

Currencies

Conclusion. Rich Dollar Valuation. Fed monetary policy tightening, rates differential, and investor flight to safety were supportive to the dollar but leaving it more than 13% overvalued against the Euro and 4% against the Pound on a PPP basis. News and data out of Europe are negative. However, despite the Fed's hawkish rhetoric, we are expecting central banks to end their tightening cycle sooner than anticipated amid a deteriorating economic outlook and fears of a prolonged recession. The Atlanta Fed GDP Nowcast has real growth contracting by more than 2.0% in 2022, thus implying the economy is in a recession. As a result, we could see the Fed pivoting as early as 4Q22. Yields on the December 2023 Fed Fund Futures contracts are now below December 2022 for the first time this year, which could be an early sign to the end of the dollar rally. As the ECB attempts to catch-up with other central banks and the Fed turns incrementally less hawkish, we would expect the Euro to find a floor near current levels. The asymmetry remains in favour of being long Euro in the longer term. Elsewhere, we see JPY and CNH weakening slowing down.

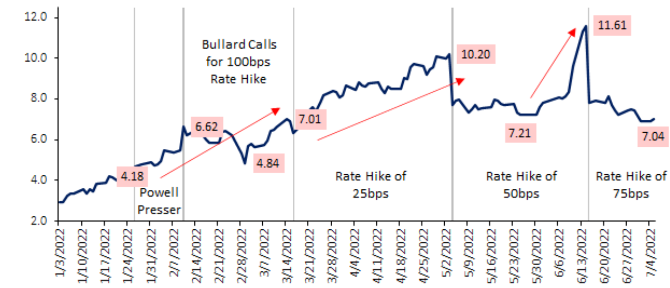
The dollar often acts as a counter cyclical currency, weakening when global growth accelerates and vice vera. The deteriorating outlook has been supportive to the dollar, but it does not stop there. The greenback benefited from favourable interest and growth differentials with the Fed aggressively hiking rates and a European economy on the edge of an energy crisis set to exert pressures on growth. However, tightening expectations started to moderate **(Chart 9)** with the number of expected rate hikes declining as the market discounts a recession. Ultimately, when the Fed pivots, we expect the dollar to quickly weaken on the back of rich valuation **(Chart 10)** and long positioning (+1.6SD).

With 50bps rate hikes the new norm, the ECB is left behind. The central bank is dealing with two opposing factors. On the one hand, aggressive rate hikes in July and September should reduce the rate differential and support the currency. On the other hand, inflation is diverging across the eurozone. The later makes it difficult for the ECB to use its policy tools as it impairs the German and France states to back aggressive rate hikes as credit spreads in Southern states are swiftly widening. Given the upcoming energy crisis, consumer confidence near its all-time low, and decelerating PMIs, the Euro should face some headwinds in the summer. We believe this is discounted. However, there is a rising probability for the EUR to start finding some support on the back of broad dollar weakness later in the year. Eurodollar future spreads are pricing Fed rate cuts in 2023 **(Chart 11)**, which would reduce the interest rate differential in favour of non-USD currencies.

USD reached a new multi-decade high against the JPY **(Chart 12)** last quarter at 137.0. The weakness primarily stems from wider interest rate differentials between Japan and the US. The BoJ is maintaining a highly accommodative monetary policy while the Fed is aggressively tightening and raising rates. The weakness in FX markets has caught the government's attention, which does not rule out an intervention to stabilize the currency. If global bond yields temporarily decline thanks to falling inflation, the spread in yields between Japan and the rest of the world will move in the yen's favour. In a recessionary scenario, the spread between Japanese yields and those abroad would narrow even more, causing the yen to potentially recover.

CNH should continue to depreciate throughout the summer as the PBOC and Fed policy divergence prevails. China remains on a path of accommodation to stimulate the economy, a source of headwind to the currency. However, we expect to see some stabilization by the end of the quarter as peak hawkishness is priced in the US and the PBOC fades the incremental easing.

Chart 9. Market Expected Number of Fed Hikes by Dec. 2022

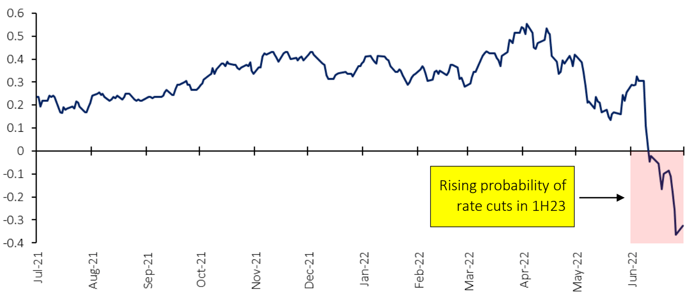


Source. MAM Research, Bloomberg

Chart 10. US Dollar Valuation - REER Basis (as of May 2022)

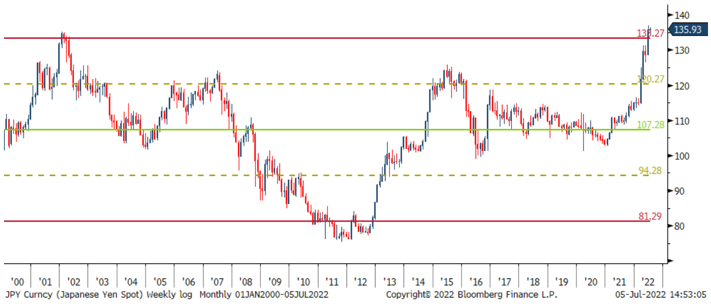
Source. MAM Research, Bloomberg

Chart 11. Eurodollar Futures Spread Dec. 2022 - Jun. 2023



Source. MAM Research, Bloomberg

Chart 12. Japanese Yen at Decade Highs (Weaker) against USD



Source. MAM Research, Bloomberg

Equities

Conclusion. Choppy Declines Ahead. Coming into the year, we had an out-of-consensus view valuations would drop substantially due to rising rates and tighter financial conditions. We believed earnings were at risk of a payback in demand, rising costs, and inventory. Corporate sales and earnings are starting to decelerate on a sequential basis (i.e., EPS growth down from +20% to +10%). Multiples need to adjust. With the S&P 500 NTM P/E multiple down 31% from its peak, the de-rating process is no longer much of a call nor is it out-of-consensus. Though multiples look cheaper on a forward basis, the denominators have yet to come down. Reverting back to the mean on valuations is one thing, but given the current macro we see rising probability of overshooting to the downside by up to one standard deviation. The recession is here, markets will soon need to discount it, bringing us closer to our S&P 500 target of 3,000 (-20%). Bottom picking is a dangerous game. Yet, we stand ready to add productivity enhancing businesses, small cap growth, and commodity-related miners as part of our barbell strategy for when the Fed pivots. We remain bearish Europe, and long China.

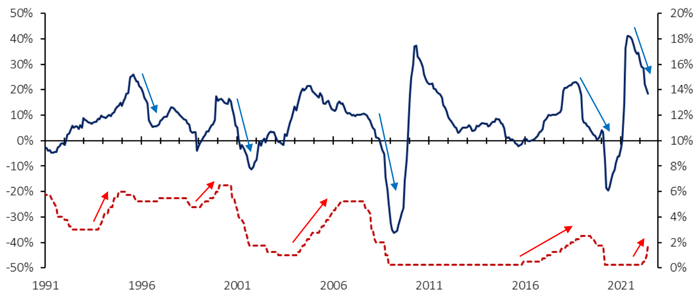
Cyclical equity bear markets are often defined by a two-stage adjustment via a multiple compression followed by an earnings contraction. Each time the Fed raised rates, P/E ratios declined. There have been no exceptions. An equity bear market usually, albeit not always, involves earnings contraction. Whenever the Fed launches a tightening cycle, EPS growth almost always turns negative **(Chart 13)**. Of course, there has been times of earnings deceleration (not contraction) during mid-cycle slowdowns but EPS always collapse during a recession.

Today's 20%+ decline on the S&P 500 has purely been driven by a multiple compression with earnings still projected to grow at a double-digit pace over the next 12 months **(Chart 14)**, an overly optimistic assumption. We see flat to negative earnings growth over the next 6-18 months. The mix of rising inventories, higher energy, borrowing, and labour costs, and lower demand will eat into corporate profits. These factors are nothing but headwinds to the continuation of all-time-high margin trends. Q2 earnings results will likely be the catalyst forcing analysts to revise their estimates lower and adjust to the current macro. A wave of EPS revisions (lower) lies ahead and could fuel the next down leg towards 3,000 on the S&P 500 (or 15x NTM EPS of $200).

A recession is not yet in the price for European equities with the current drawdown modest versus history. Equity markets tend to trough 2-3 weeks before earnings revision bottom, however the latter did not even turn negative yet **(Chart 15)**. The 30% drop in P/E (NTM) in the last year was only exceeded by the bear markets of 2000-2003 and 2008-2009. Though we may be in the valuation de-rating, it does not imply the bottom is near. In price terms, MSCI Europe is down 17% from its peak. Yet, in prior downturns, this figure often reached 25-30%. Downgrades on EPS should commence over the coming quarter. Persistent upgrades this year explain why its P/E decline is larger than the price decline. Index holdings continue to see positive earnings revisions. However, the EPS downgrade cycle should finally kick in over the next few of months as the data continues to worsen.

Despite our broadly negative outlook on equities for the coming months, we are not bearish everything. May and June marked a directional divergence between China and the rest of the world. The PBOC has an accommodative monetary policy **(Chart 16)**. China's money supply is expanding. PMIs and GDP growth are accelerating meanwhile covid lockdowns are coming to an end. The PMI comps setup is favourable (easier in 2H22/1H23) and its PPI continues to decelerate monthly. The CPI-PPI spread has been decelerating since November 2021 now on a -1.2 z-score. The conjuncture is highly supportive to equities. Long China.

Chart 13. Interest Rate and EPS (S&P 500) Cycles

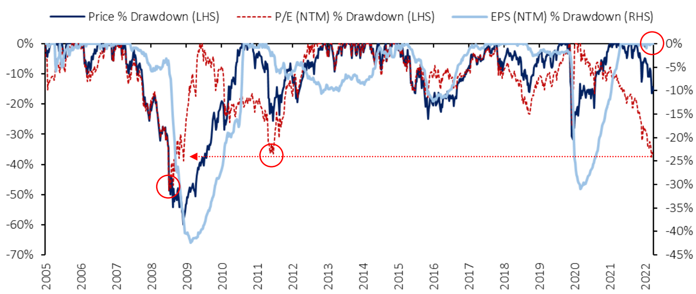


Source. MAM Research, Bloomberg

Chart 14. S&P 500 P/E Multiple vs. EPS Estimates NTM

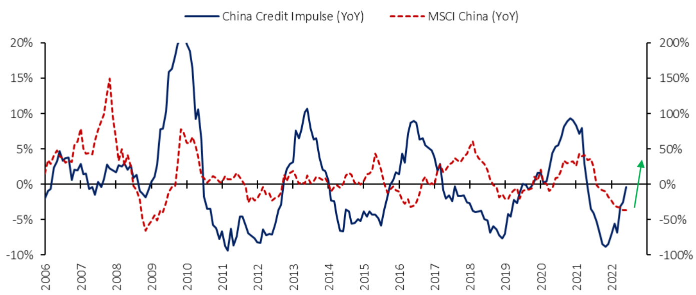
Source. MAM Research, Bloomberg

Chart 15. MSCI EU Price, P/E (NTM), and EPS (NTM) Drawdown



Source. MAM Research, Bloomberg

Chart 16. China Credit Impulse YoY vs. SHCOMP Index YoY



Source. MAM Research, Bloomberg

Commodities

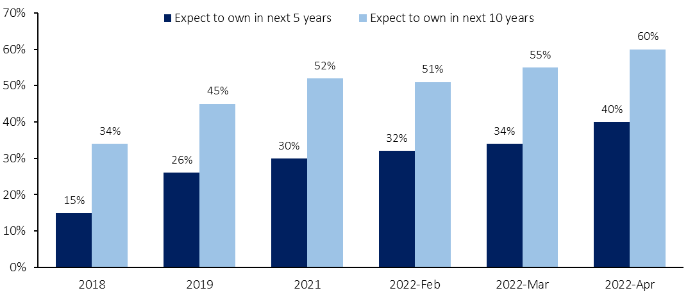
Conclusion. Taking a back seat, but the cycle is not over. We are at the dawn of a secular bull market in commodities. Why secular rather than cyclical? The current bull run is a function of massive supply disruption, prolonged under-investment, and regulatory headwinds for new capacity to come online. However, we do no discount some temporary weakness in the near-term. Base metals may struggle if the broader energy crisis persists resulting in curbed production and industrial capacity per lack of fuel. Germany is moving to level 2 on emergency gas planning may very well just be the first domino to drop. Anecdotally, fireplaces and wood stoves are becoming scarce. The market is "empty" according to the German Firewood Association as a "fear of freezing" emerges ahead of next winter. Bad weather and diseases are affecting soft commodities and livestock supply. The balance remains tight, supporting a higher for longer prices narrative. Though we may witness demand destruction heading into recession, the imbalance is such that prices would quickly find a floor. We remain long-term bulls on commodities and buyers on significant market dips.

Tight supply continues to buoy oil prices. As an old adage goes, "the cure for high oil prices is high oil prices". High oil prices are subject drive more investment in the energy sector. They will also supress oil demand both near-term as people drive less and long-term as more people elect to purchase an EV. Today, >40% of US households expect to buy an EV in the next 5 years, up from 15% in 2018 **(Chart 17)**. Transportation accounts for 60% of global oil demand. However, there is one caveat. Capital spending in the oil sector is still a fraction of what it was in 2014 as energy companies do not want to spend huge sums on capex given the uncertainty about the path of oil prices and demand. Risks to the downside over the next twelve months exist. Biden is set to visit the Middle East in a few weeks time. Conventional wisdom is he will come back empty-handed. However, this may be too pessimistic. Saudis are unlikely to want the US to lift the embargo on Iranian crude. Elsewhere, Venezuela is still under a US embargo. It is home to some of the world's largest reserves and US governmental officials have been traveling to the region recently. Lifted sanctions would be a headwind to oil prices.

Like coal, oil, and gas prices, Uranium prices have given some of their post-invasion gains, dropping back to $45/lb. Purchases by Sprott Physical Fund **(Chart 18)** was a key contributor to the price move over February-April, rather than any changes in the underlying supply-demand fundamentals. With investments in uranium having slowed, the spot market corrected to a level better reflecting the underlying market. Now, a geopolitical play is materializing. There are no sanctions on Russia's uranium in place, but US/European utilities (50% of global nuclear capacity) are looking to reduce their reliance on Russian uranium and starting to source alternative supplies. The US draws about 14% (6.3Mlbs of U3O8) of its Uranium from Russia, and Europe 20% (6.6Mlbs). Russia's mine supply is 7.6Mlbs/year (6^{th} largest mine supplier) but there is est.15Mlbs/year of secondary supply from stockpiles, tailings re-enrichment, and underfeeding. Idled and spare mine capacity from Cameco and Kazatomprom may need to be utilised to fill the gap opened up by this two-tier market. Against tight supply-demand fundamentals **(Chart 19)**, we still see more near-term price strength from a bifurcated market.

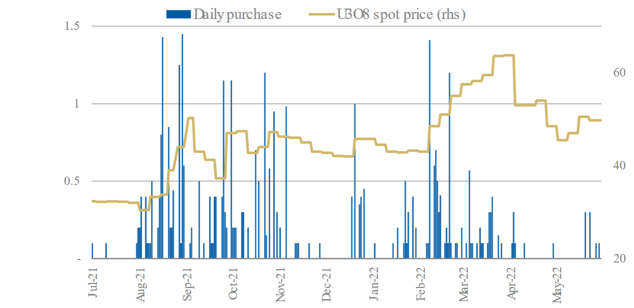
Gold. The yellow metal faces diverging drivers. In the 20 worst quarters for equities since 1980, its performance was positive in 14 of them, typically coinciding with falling interest rates. As we approach a peak in the dollar and US interest rates, Gold is set to start outperforming again. The key catalyst for the next leg higher for the commodity will be a Fed pivot **(Chart 20)**.

Chart 17. Consumer Sentiment Towards EVs



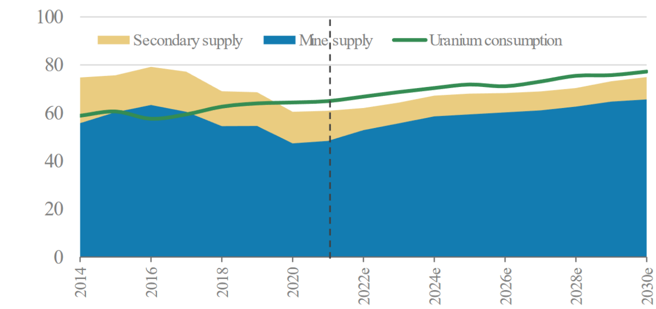
Source. MAM Research, Cargurus

Chart 18. Sprott's Daily Uranium Purchases vs. Spot Price



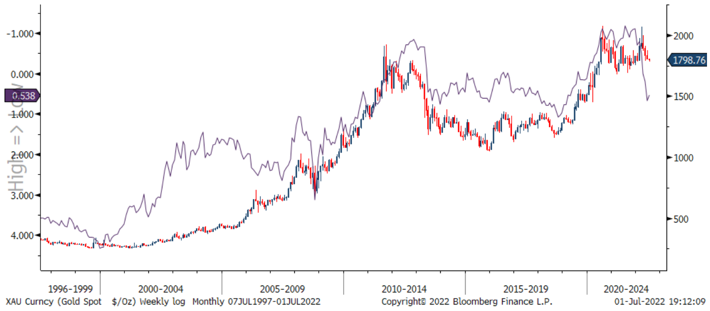
Source. Sprott Website, UxC, M S Research

Chart 19. Uranium Supply vs. Reactor Consumption (ktU)



Source. WNA, Company data, MS Research

Chart 20. Gold Held Up Strongly vs. Move in TIPS (Monthly)



Source. MAM Research, Bloomberg

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