Second quarter 2018
Date of report: March 31st 2018

INDEX

Quarterly Report

Our View on the Markets

Dust cloud

During the first quarter of the year, complacency among investors was excessive and it looks like it will come to an end amidst an atmosphere of widespread distrust. Fortunately, fundamentals remain intact.

The markets had one of the best starts to the year in a long time. Investors had gotten used to an environment of zero volatility in financial assets, which were going up and up. Nobody warned of any dangers and this position was unanimous (several risk tolerance indicators set records not seen for decades). The excess optimism created the perfect breeding ground for what was to come. Sooner or later, everything falls back down to earth. Indeed, the subsequent two months have reversed the gains accumulated in January and we are once again seeing the volatility levels that we are used to (the previous ones were far from normal).

Rather than worrying about the investors' change in mood, we should be much more concerned with fundamentals. And thankfully, the diagnosis in that respect is very good. The economic environment is excellent across the world (the first synchronised recovery over almost the entire planet since 2010, with macro indicators that, in some cases, have not been seen in decades). Corporate earnings are solid. And even if there are warnings of a change in tone from central banks, it will be so very gradual that it does not pose an obstacle for the financial markets. This, combined with the downturns accumulated so far this year, means that we can buy these same fundamentals at better prices. Good news.

Of course, we need a touch of courage. Those who are selling are not usually in the practice of giving away money. They do so because they share a widespread concern, which we should only try to take advantage of if we have a different view. At the time of writing, there is a prevailing fear that a trade war will be unleashed between the US and China. Common sense dictates that we should assume that this would not happen because both sides would come out of it considerably worse for wear (there is no possible winner in such combat). Clearly, it is not easy to detect huge amounts of common sense among the verbal diarrhoea coming from the US president, but a more impartial analysis throws up some different conclusions. To begin with, Trump seems be in the habit of starting negotiations like a bull in a china shop, making lots of noise and throwing threats around, but then his tone softens significantly. By way of example, we have the exemption of his NAFTA partners from the tariffs (this is the same NAFTA he intends to break apart by force of tweets) or the fact that he will soon sit down to talk with his North Korean counterpart despite previous promises from both sides of mutually assured destruction. Let us add to this the fact that the tariffs, in many cases, would be applied to US products manufactured in China, which means domestic resistance to the measures is set to be tough. Yet, China has not fallen for it. This is probably because it knows that it will have to make a concession that Trump can then boast about to his electorate because, do not forget, we will have mid-term elections in the US in November, in which half the seats will be renewed. With a varying degree of fuss in the meantime, we believe the most likely scenario is as follows. When the dust kicked up by Trump settles, investors will see nothing more than solid corporate earnings and a good macro environment. What they will not see is the same prices we have now. Let us make the most of them.

David Macià, CFA
Chief Investment Officer

Strategy

Asset allocation (2018 Q2)

Monetary	↑
Fixed Income	↓
Equities	↑

Fixed Income

GOVERNMENT:	
USA	↓
Eurozone	↓
INVESTMENT GRADE:	
USA	↓
Eurozone	↓
HIGH YIELD:	
USA	↓
Eurozone	↓
EMERGING MARKETS	→

Equities

USA	↓
Eurozone	↑
Japan	↑
Emerging Markets	↑

Commodities

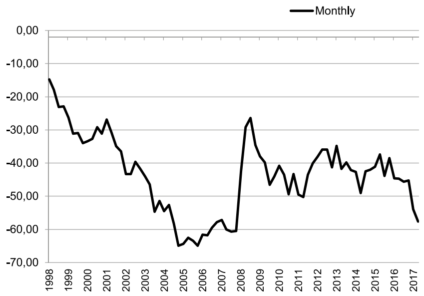
Oil	↓
Gold	↓

Currencies

EUR/USD	→
JPY/USD	↓

Macroeconomic View

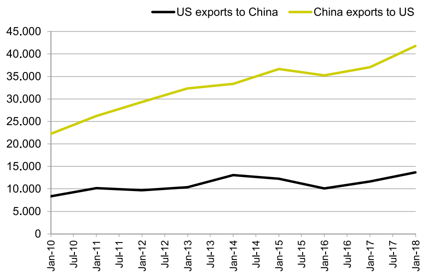
US Trade deficit



Source: Bloomberg

The US has a global trade deficit of $57 billion, and one of President Trump's campaign promises was to renegotiate trade deals to reduce the deficit.

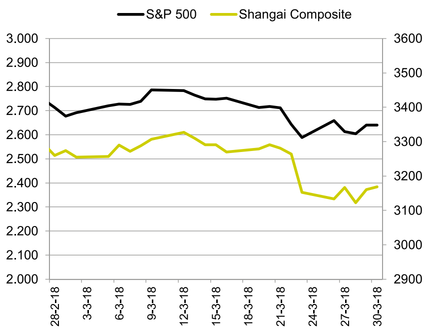
Trade volume



Source: Bloomberg

China's export economy relies very heavily on the US, and trade war would likely harm China more than the US.

Evolution of S&P 500 and Shangai Composite



Source: Bloomberg

Both the US and Chinese markets declined during the month of March as investors fear a looming trade war.

On Trump and Tariffs

In early March, despite objections from his advisers and many Congressional Republicans, President Trump announced tariffs on steel and aluminium. Fears of a global trade war hit the equity markets hard, but the US has already given a reprieve to many of its major trade partners. The exception is China...

Political Foreshadowing: *Death by China*. In late February, President Trump promoted trade adviser Peter Navarro to Assistant to the President. As a trade policy adviser, Mr Navarro reported directly to White House Economic Adviser Gary Cohn. It is well known that Mr Navarro (a Harvard-trained economist who wrote a book titled Death by China) has very protectionist ideals, while Mr Cohn (the former President of Goldman Sachs) is a proponent of free trade. Mr Cohn served as a buffer between Mr Navarro and the President, but once that buffer was removed we felt that some extreme trade policies were on the horizon.

In less than a month, Mr Navarro's influence on the President was plain for all to see as Mr Cohn resigned from his position after his futile attempt to convince the President not to implement tariffs on steel and aluminium. The equity markets suffered an immediate pullback on the news of Mr Cohn's resignation as investors feared that the US would become even more protectionist without the influence of his globalist views.

"We are not in a trade war with China, that war was lost many years ago..." -Presidente Trump

This has happened before. In 2002, the administration of George W. Bush placed tariffs on steel products ranging from 15 to 30% in an effort to save the US steel industry. Back then, several steel producers had declared bankruptcy amidst a surge in imports. The government decided it needed to protect the steel industry for a period of three years to give companies time to restructure. Just like now, Canada and Mexico (thanks to NAFTA) were excluded from the tariffs of 2002.

Almost immediately the European Union imposed retaliatory tariffs that targeted products in politically sensitive states. The EU and several other countries filed several successful cases against the US at the WTO. Following the international backlash and disappointing result for the economy, President Bush rescinded the tariffs only 18 months after their implementation.

China ups the ante, but there is still hope of an agreement. On 22 March, the Trump administration announced the findings of its Section 301 investigation into China's treatment of intellectual property. Not only did the US accuse China of forcing joint venture requirements that facilitate the transfer of technology to Chinese companies, but they also claimed that "in recent years, cyber theft has become one of China's preferred methods of collecting commercial information".

President Trump has announced the imposition of $50 billion in tariffs, which is in-line with the administration's estimate of the economic harm done by China's misappropriation of intellectual property. The US has already released a preliminary list of products to be considered for tariffs which includes everything from televisions and aerospace components to vaccines. The Chinese government has responded with its own plans to target $50 billion in US products for retaliatory tariffs. The goods mentioned include many agricultural products along with automobiles and some models of aeroplanes. Importantly, the Chinese have indicated they will not implement any tariffs unless the US does so first, giving negotiators from both countries time to strike a deal. To this end, US Treasury Secretary Steve Mnuchin has said that he is "cautiously hopeful" a deal can be reached.

Charlie Castillo
Senior Portfolio Manager

Fixed Income

Government bonds

The latest figure from the Institute of International Finance (IIF) showed global debt to be at a record €193.3 trillion. This represents 318% of the world's GDP. Of this amount, 26.95% belongs to governments.

Global debt has increased and there has been a growing trend over the last few years. The expansive monetary policies of the main central banks (that have brought interest rates down to zero or lower) has a lot to do with it. The policies have allowed for cheap financing, which has been exploited mainly by businesses. And investors, in the context of excess liquidity and a low default rate, have taken on these new issues, which have generally been very oversubscribed. **Government bonds, in particular, have been in more demand due to the various purchase programmes put in place by the main central banks.**

With this in mind, **what can we expect for the future evolution of this asset class?** Let us look at some fundamental points that are affecting the main economic areas:

Without a doubt, the end of quantitative easing (QE) will be a turning point. It looks like the extreme monetary measures adopted in the current environment are not necessary and central banks will be more active in reducing balance sheets. **In recent years, the ECB has been buying almost seven times the amount of net bond issues.** This is not the case for the Federal Reserve, which has always purchased below the level of net issues. This brings us to expect a greater impact on the increase in bond yields in the Eurozone.

> The future evolution of this asset class will be determined by the end of quantitative easing (QE).

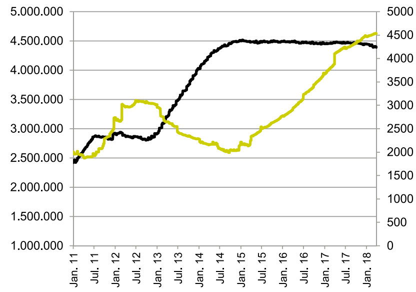
Geographically speaking, due to the search for yield and against the backdrop of a weak dollar with more restrained long-term US bond rates, inflows towards government bonds from **emerging countries** will continue. These bonds offer more interesting yields than those of developed countries and they continue to improve in line with the good macro data that we are seeing globally, alongside improvements in the current account balance and increased currency reserves.

The debt-to-GDP ratio is another factor to look at. In developed countries the percentage is higher. Here, it is important to consider just who holds the debt. For example, in countries like Japan (with a ratio of 223.8%) or Italy (131.2%), debt is mainly in domestic hands, which reduces the risk of contagion: Japanese or Italian investors are repurchasing the maturities continuously, which causes no particular concerns. Investors must be very aware of the indebtedness variable when selecting investments and demanding adequate return on the risk.

US debt serves as a good example. Currently, 38.1% of the total is in foreign hands. Of this percentage, China owns 18.66% and Japan 17.02%, distantly followed by Ireland, Brazil and Switzerland with 5.23%, 4.24% and 4.01% respectively. These figures become more important within the context of a trade war between the US and China as the latter holds $1.1682 trillion. **If China decides to start selling the US debt in its possession, it would push up the cost of US financing** at a time when the Fed has also started the process of normalising rates. Remember that at the beginning of the year there was some tension regarding the price of US bonds. A Chinese government official made a comment stating that the country planned to reduce its purchasing of these bonds, something which was later denied but which caused a rally in bond yields nonetheless. It is also true that China should assess whether it is ready for a drop in the price of the debt to affect the valuation of its own portfolio because, out of the foreign currencies it possesses, the dollar remains the dominant one.

Josep M Pon, CIIA
Head of Fixed Income

Fed and ECB Balance Sheet



Source: Bloomberg

With the end of QE, central banks will reduce their balance sheets, which has significantly increased due to purchase programmes.

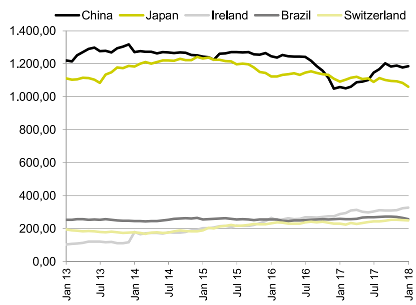
Debt and CDS by countries

Country	Debt (MM)	CDS 5 years
Greece	374.412	317.43
Italy	2.396.319	100.50
Portugal	259.908	63.21
Spain	1.254.590	37,81
Ireland	216.642	19.99
US	14.981.755	19.42
France	2.400.367	17.31
United Kingdom	2.168.909	16.31
Australia	402.538	14.48
Belgium	456.750	14.05

Source: Bloomberg

The debt-to-GDP ratio has increased, particularly in developed countries, with Japan out in front, although the debt is mainly held domestically.

US External debt by countries

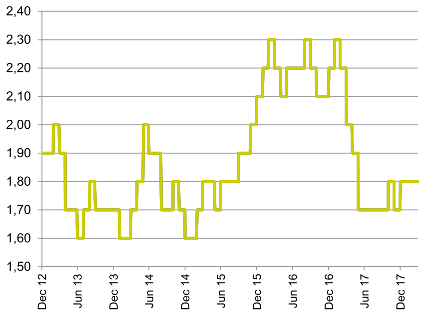


Source: Bloomberg

China holds $1.1682 trillion in US Treasury bonds. It is the country has the most and it represents 18.66% total debt in foreign hands.

Equities

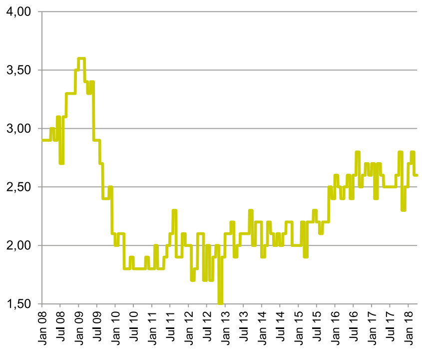
US Core CPI Inflation



Source: Bloomberg

Inflation is rebounding due to salary increases and the rise in commodities prices.

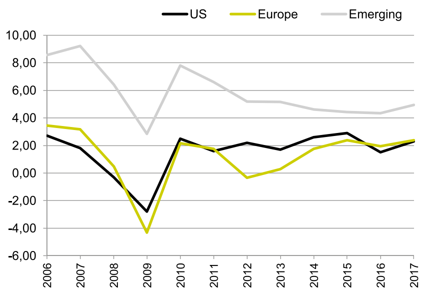
US Average Hourly wage



Source: Bloomberg

The average hourly wage in the US has been increasing progressively.

GDP Growth in US, Europe and Emerging Markets



Source: Bloomberg

The world's economy is experiencing its most synchronised expansion ever, reflecting the economic boom.

Volatility in equities: inflation

Volatility in equities has awakened. The trigger seems to have been inflation and the impact it has had on interest rates.

Since February we have seen a significant rally in volatility in equities markets, which appears to have been caused by a modest increase in inflation expectations in the US (underlying CPI at 1.8% in January up from 1.7% in December and CPI at 2.1% compared with an expected 1.9%). In turn, this generates upward pressure on long-term interest rates, the basis for all financial asset valuation models. An increase in interest rates causes increases in discount rates and downturns in the multiples to be applied to various income statement metrics.

Inflation is not a bad thing for equities, but rather quite the opposite.

There are two fundamental questions:

1. Are there really any **clues that inflation has entered the realms of sustained recovery?**

We believe that inflation is indeed moving upwards, mainly thanks to the so-far very modest salary increases and rises in commodity prices.

Considering the price of oil is 35% higher than in June 2017 and its heavy influence on the CPI, a rally in inflation should not come as a big surprise to the market.

Furthermore, and bearing in mind that inflation is a delayed indicator of economic cycles (in the US it is estimated that inflation trails real GDP growth by six quarters), we see the recent rally in inflation as an indication of the strong economic cycle which began some time ago.

The economic cycle is strong not only in the US, but also in Europe, where economic capacity utilisation is somewhat higher than the historical average (84% compared with an 81% average since 1985).

2. And secondly, the issue that should concern us more as we contextualise the falls of three weeks ago: **How should a possible recovery in inflation be interpreted from the perspective of equities investment?**

We believe that as long as this recovery goes ahead in a progressive manner, equities should not become too uneasy. Traditionally, equities have generated the best returns when inflation has been between 1% and 3%, although they often fall sharply at times of hyperinflation.

We also think that operational margins (particularly in Europe due to operational leverage) are more sensitive to expected sales - increasingly consistently - than to salaries (given the concern surrounding potential increases in salaries which will start to be seen in the corporate world).

However, we also believe the rise in salaries will be consistent with the momentum of economic strength and with the fact that growth is starting to become more sustainable again (because the major contributor to most developed countries' GDPs is nothing other than consumption).

Ultimately, we can conclude that inflation, in just the right measure, and its resulting impact on long-term bond yields, is not a negative factor for equities but rather quite the opposite. Inflation is a reflection of the economic boom and its transfer to business results.

Luis Buceta, CFA
Head of Equity

Commodities and Currencies

COMMODITIES

And Trump also left his mark on commodities

The US will implement a tariff of 25% on steel imports and 10% on aluminium imports. This is what the president announced and this is what will be done.

However, these taxes are only applicable to China. We all know that the president uses his rhetoric to negotiate in those areas that interest him. And this time is no different. It is the first move in stepping up the pressure in negotiations with China regarding reducing the huge trade deficit that the US holds with the country.

Mr Trump appears to be killing two birds with one stone with these measures.

On the one hand, he continues to fly the flag for "America First" as he goes into the mid-term elections this November. Interestingly, although the US consumes around 110 million metric tonnes of steel per year and it produces just 80 million metric tonnes, the utilisation capacity of its factories is only at 74%, demonstrating the inefficiency of the American steel industry. It is estimated that Trump's measures will increase capacity utilisation to 86%.

And on the other hand, he starts to apply pressure to reduce America's trade deficit with the country of the Great Wall by $100 billion. But it is here where we should quantify the impact, which is really what concerns us.

The US represents 16% of China's total aluminium exports and just 2% of its steel exports. The impact is immaterial and, therefore, the rules of the game will not change on the aluminium and steel markets: it should not affect their price nor the companies in our portfolio that produce these materials.

Miguel Ángel Rico, CAIA
Investment analyst

Steel price evolution High

Source: Bloomberg
High volatility in steel since Trump stated his intentions.

CURRENCIES

Too early to discount tapering!

The yen has been one of the best performing currencies this year and many believe it still has room to run. In the hope of boosting the economy and stoking inflation, the Bank of Japan has been the most innovative central bank in terms of monetary easing. It has not only purchased government and corporate bonds, but it has also implemented short-term negative interest rates and 10-year yield bond control and bought Japanese REITs, equity ETFs, loans and other assets. Total assets amount to 96% of Japanese GDP while the Fed's balance sheet amounts to just 23% of US GDP.

When earlier this year the monetary authority trimmed their bond purchases, some investors speculated that the Bank of Japan may scale back its ultra-easy policy and the yen strengthened. On March 2, "taper speculators" were comforted in their reasoning when the governor of the Bank of Japan dropped his first hint of an exit from monetary stimulus. However, Kuroda also said they will consider and debate an exit around fiscal year 2019, which ends in March 2020. That seems a long way off to start discounting any serious action! The governor also added that any exit will be dependent on attaining the 2% inflation target and Japan is still far from that mark: excluding volatile fresh food and energy, prices rose 0.5% in February compared with a year ago.

Finally, a strong yen would be counterproductive as it would not only hurt exports, but it would also dampen inflation via imported prices. We therefore think the market has got ahead of itself and would be selling the yen at present levels of 105 against the dollar. Only deteriorating risk sentiment or a rapid increase in inflation would put our view into question.

Jadwiga Kitovitz, CFA
Head of Multi-Asset Management
and Institutional Accounts

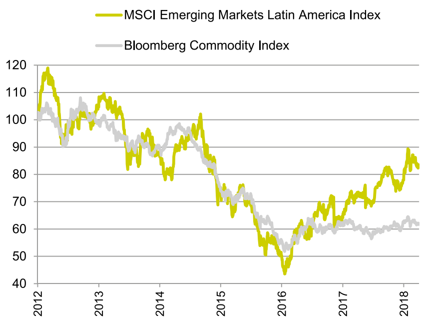
Exchange Rate USD/JPY

Source: Bloomberg

The yen has been one of the best performing currencies this year due to speculation over tapering.

Latin America

MSCI Emerging Markets Index vs Bloomberg Commodity



Source: Bloomberg

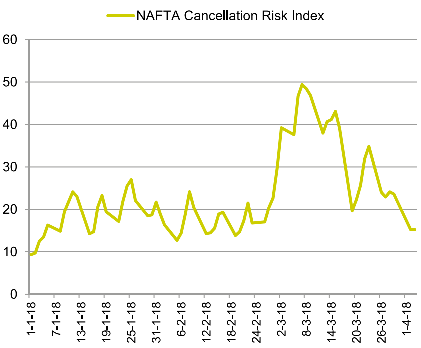
The commodities crisis seen between 2012 and 2016 affected Latin American equities to a great extent.

Exports and Imports in Latam

Source: Economic Commission for Latin America and the Caribbean (ECLAC)

2017 is expected to be a turning point for the region's exports and imports.

NAFTA Cancellation Risk Index



Source: Bloomberg

A preliminary agreement for the renegotiation of NAFTA may be reached in the coming days. A risk scenario is very unikely.

Short-lived calm

The recent rally in commodities offered some respite from the poor trade performance suffered in Latin America between 2012 and 2016. Now, however, concerns surrounding a possible trade war are generating further obstacles in the way of achieving a sustainable recovery.

Latin America has long been characterised as a region whose main export is commodities. Nowadays, around 44% of exports are primary goods with a focus on 15 products, including oil, metals and seeds. According to data expected from the Economic Commission for Latin America and the Caribbean, Latin America's exports and imports grew 10% and 6.1% respectively in 2017. After a period of economic contraction, we can see a light at the end of the tunnel. This turning point has come about thanks to external factors, such as the increase in the price of commodities, but still with timid growth in the amount of trade.

Dependency on commodities is the region's Achilles's heel, although the end of the crisis brought some temporary relief to Latin America. In addition, rumours of a possible reflation have put commodities on investors' radars, providing a natural hedge against the risk. Furthermore, greater global economic growth, particularly in the US (one of the most important trade partners with the region), will boost the commercial dynamic, thus benefitting Latin America's economic situation.

However, in the search for long-lasting and sustainable recovery, the region has found another fly in the ointment: **the rise in protectionist and populist policies, driven mainly by the US President Donald Trump, who claims unfair and unequal trade.** Trump has pounded the table in a cry for attention and thrown up obstacles to free trade in the form of tariffs on products imported from the US. And then he decides to sit down to negotiations and soothe the tensions by excluding some countries from the recent steel and aluminium tariffs. Such countries include Mexico and Brazil, which are strong commercial players in the region. As the well-known proverb goes, "confuse and conquer".

This behaviour has awoken fears of a possible worldwide trade war, as significant international trade regions, such as Europe and China, have threatened retaliation, challenging and casting doubt upon the importance of international trade. So far, the issue has been the stir created rather than the impact. However, **should the matter escalate, it could become a significant problem for the region and its economic growth and, to a greater extent, for smaller economies that rely on foreign trade for growth.**

The renegotiation of trade agreements like the NAFTA has served as another of Trump's weapons. The agreement was signed 24 years ago between Mexico, Canada and the US. Today, its renegotiation has centred on three main pillars: modernisation; market access and protection of intellectual properties rights; and "pending problems", such as the rules of origin (this refers to local content that goods exchanged between the countries must have in order to be exempt from tariffs). Recently, Trump agreed not to demand that traded products contain at least 50% US materials, a sensitive issue on the negotiation agenda, which has calmed concerns. The seventh round of official negotiations took place at the beginning of March. Six chapters and four annexes were agreed. There are still 30 chapters to go.

> We continue to see fair tailwinds for emerging markets, particularly Latin America.

Time is running short but everything seems to suggest an agreement will be made in the coming days.

These worries have made themselves apparent on the financial markets. Volatility has come to the fore and uncertainty is the catalyst for the dramatic swings we have seen in assets. For emerging markets, including (occasionally) Latin America, we continue to see fair tailwinds in the current macroeconomic environment. **As the famous investor Warren Buffett says, "only when the tide goes out can we see who is swimming naked".**

Diego Fernando Agudelo López
Analyst Latam

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Research

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