First quarter 2021
Date of report: December 31st 2020

INDEX

Quarterly Report

Our view on the markets

Burnt forests

The markets are celebrating the arrival of the vaccine, pricing in a strong economic recovery. We share that assessment, although we have more doubts about whether it is being exaggerated in terms of valuations.

Imagine you were told to choose between two assets. One is a lush forest, replete with tall trees and spanning hundreds of hectares. The other is a forest identical in size to the first, but which has been ravaged by fire. However, the authorities are all-hands-on-deck, and they have brought in gardeners to plant seeds all over, as well as helicopters to dump water from overhead to keep the land well-watered. The first thing an investor would want to know, of course, is how much is each one selling for. One is 16% more expensive than the other. Guess which.

A year ago, the situation was clearly better than what we have today, but investors have decided to pay more for the current situation. This is despite the fact we are on the cusp of the third wave of the pandemic that has resulted in the shutdown of economies across almost the entire world. By the way, this is something that is unheard of, as we have never inflicted such economic destruction on ourselves without a war being involved. This will not be the end of it, if we consider the string of forecasts from strategists who anticipate a 2021 with double-digit gains on the stock markets. Their argument is that 12 months ago, central banks could have considered raising rates at some point, which now seems impossible. This economic recovery will be so with zero rates and with the printers running at full speed. They come and tell us something along the lines of whether you like the forest or not, it is much better than the alternative, the barren lands. How can it not be worth more than before the fire?

That could be a good metaphor for the dilemma we are facing in terms of the markets in 2021. Perhaps, at least for a time (and it is impossible to know for how long), the latter group might be right. As a self-fulfilling prophecy, if all investors are convinced of something, that something will indeed happen, since the prices of things are nothing more than the result of the interplay between supply and demand. Valuation remains secondary, but, like the markets' law of gravity, it exerts a constant force. A plane remains airborne until it runs out of kerosene. The fuel keeping the markets in the air is the shared belief that there is no alternative to equities. It is true that few come to mind. But is a half-charred forest really worth more than before the fire?

In 2021, it is time to swim, but while keeping our clothes dry. We have to invest (the plane might have a lot of kerosene to burn through yet), but with a great deal of care, distinguishing very clearly among the opportunities available. We will keep our fingers crossed that we will leave the virus behind and that the best forecasts will be realised. At the current valuation levels, that is not incompatible with corrections, which we will do our best to take advantage of to accumulate value for our clients in the long term.

David Macià, CFA
CAAM Investment Director

Strategy

Asset allocation (2021 Q1)

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

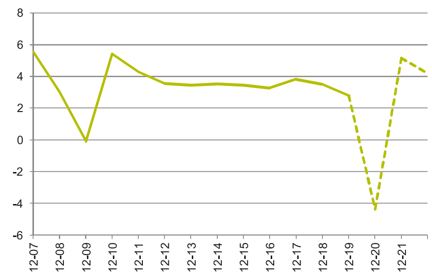
Oil	→
Gold	↑

Currencies

EUR/USD	→
JPY/USD	↑

Macroeconomic View

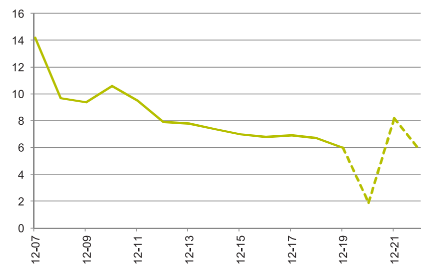
World GDP growth



Source: Bloomberg/IMF

The IMF projects world growth at 5.2% in 2021 following an estimated -4.4% contraction in 2020.

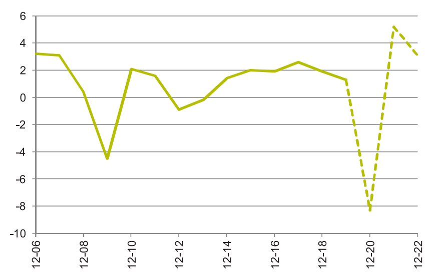
China'S GDP growth



Source: Bloomberg/IMF

China's GDP is already above pre-COVID levels.

Euro zone's GDP growth



Source: Bloomberg/IMF

Euro zone's GDP is expected to reach pre-COVID levels only in 2022.

Light at the end of the tunnel

Consensus is expecting a global synchronous recovery in 2021 with growth in both developed and emerging countries accelerating. The positive vaccine developments have led economists to raise their growth outlook for 2021 and most see a sharp recovery starting in the 2Q21 as the massive vaccination programmes are deployed.

As countries around the world start to vaccinate people against Covid-19, economists have raised their growth forecasts for 2021, predicting a strong rebound from this year's record post-war recession. In the northern hemisphere, the most vulnerable to the coronavirus will be vaccinated by the first quarter which should be enough to restore most economic activity and herd immunity should be achieved by around the middle of the year allowing the economy to fully reopen. The IMF projects world growth at 5.2% in 2021 following an estimated -4.4% contraction in 2020 and the level of global GDP in 2021 is expected to be a modest 0.6% above that of 2019. The recovery is uneven amongst regions: China, for example, has fared far better as its GDP is already above pre-covid levels; in the US it will take until 2021 whereas Europe is expected to reach the previous level in 2022.

> There is a lot of pent up demand and it would not be surprising to see consumer spending snap back

After a year of restrictions, there is a lot of pent-up demand, so it would not be surprising to see consumer spending snap back to its fundamental level. Central banks have played a central role in ensuring very easy financing conditions through their various programmes and they have repeatedly expressed their intention to remain very supportive for as long as it takes to re-establish sustainable growth. The fiscal response has seen a big shift compared to the 2008 crisis when fiscal austerity was deemed the correct path, especially in Europe. The €750bn pandemic recovery fund will allow transfers to pandemic-stricken member states starting in 2021. In the US, Trump finally signed the bill to release the Covid-19 $900bn stimulus package and the $2.3tn federal government budget at the end of December. As the economy reopens all these levers should give support to the expected strong pick-up. Moreover, most economists are not forecasting any inflation in the short term due to large slack in the economy. With the pandemic causing unemployment to surge, it may be some time before workers can push for wage increases. Even once labour markets heal, the long-running demographic and technological shifts that have depressed inflation over the past decade remain in place. Consensus is therefore predicting the economy to enter a sweet spot whereby we will have strong growth, sustained policy stimulus and no inflation.

Our outlook is more moderate than that as it seems rather naïve to think that everything will roll out as planned. Consensus' forecasts are heavily dependent on a successful vaccine deployment which is not without challenges. Logistical difficulties and potential production shortfalls could delay the mass vaccination programme. Vaccine hesitancy and potential mutations of the virus are also key issues. Both the European recovery plan and the US stimulus package have been delayed several times and their implementation could face further hiccups. Lastly, a pick-up in inflation cannot be ruled out and will probably be the biggest threat to growth as it would push interest rates up, consequently choking recovery. Meanwhile, the present economic picture is not so bright. The economy contracted again in the last quarter of the year due to the renewed spike in the virus count and the resulting imposition of mobility restrictions which will probably continue to weigh during the first quarter 2021.

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

Fixed Income

Towards a 2021 with continued support

In the euro zone, support from the Central European Central Bank and the European Union will continue to be the main drivers for the credit spreads and the stability of interest rates. Fundamental and technical elements will also continue to benefit fixed income assets.

In 2020, we have seen two distinct periods: the first with the confirmation of the pandemic by the WHO, which impacted the fixed income markets with a rapid widening of credit spreads. And the second, with intervention of central banks, increasing the volume of the purchasing programme --in terms of both public and corporate debt-- and fiscal stimulus from countries, which allowed bond prices to recover.

In 2021, we expect the fixed income markets, even those with high beta, to maintain this good momentum thanks to the progress made with the vaccine and the monetary and fiscal support that will continue into next year. In December, the ECB agreed to increase the Pandemic Emergency Purchase Programme (PEPP) by 500 billion euros and extend it for 9 months until March 2022. The European Union also approved the Next Generation EU programme, the temporary instrument intended to boost the recovery with 750 million euros.

The central banks' strategy is altering the perception of risk and the ultra-low interest rates are generating large deficits

Fundamental and technical elements will also continue to benefit fixed income assets: 1) The central banks' strategy has altered the perception of risk and investors continue to seek yield (US high yield bonds hit an all-time low); 2) new debt issues: following a record-breaking 2020 on the primary market, the volume is expected to decrease and, in the case of government bonds, the volume of purchases expected by the ECB will mean net issues are negative, which should keep the risk premiums under control; 3) inflows remain solid (the volume of negative yield bonds is increasing); 4) if there was a greater number of rating downgrades in 2020, we now expect to see a reversal of this trend; 5) the default rate is increasing slightly in Europe (higher in the US), but not as much as could be expected in the first quarter of 2020; and 6) mergers and acquisitions and expectations of improved corporate earnings are acting as catalysts.

In an environment in which the vaccine should reduce the number of infections and help reactivate the economy, the main risks are: the increase in global debt, which continues to hit new highs with ultra-low interest rates, giving the impression that huge deficits could be generated and any attempt to talk about austerity is rejected. Another risk is "reflation trade". Although the prospect of an increase in inflation is not seen in the latest data published (-0.3% in Germany) or in future forecasts (the ECB still sees inflation below its target for the coming years), there is a risk that the large quantity of liquidity injected could push it up. This is something inflation-linked bonds are pricing in with an increasingly high breakeven. A rise in interest rates that the central banks are unable to control would be negative for the evolution of fixed income.

We could see a rise in interest rates and an increase slope of the curve, but watched over by the central banks. Investors' search for yield supports further tightening of spreads, particularly on higher risk assets, as we are seeing in the high yield world and also in emerging market bonds, with potential for further reductions in spreads if credit metrics are improved. The risk selection in higher risk products will be fundamental. In the euro zone, we could see a repetition of what worked in 2020 with eligible investment grade bonds (the ECB will control 40% of the total) and the ESG bonds (green, social and sustainable bonds), with the green transition gaining prominence.

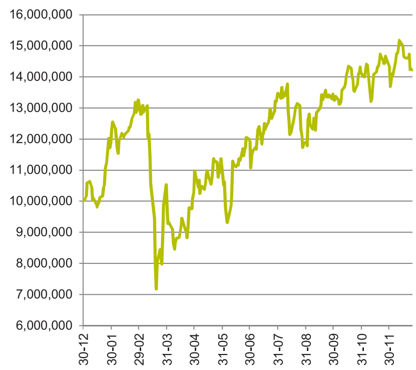
Josep Maria Pon, CIIA
Head of Fixed Income and Monetary Assets

Evolution of investment grade credit spreads

Source: Bloomberg

The EU's planned issue as part of the Recovery Plan could provide a major boost to the global green bond market.

The volume of negative yield bonds has increased with the expansionary monetary and fiscal policies

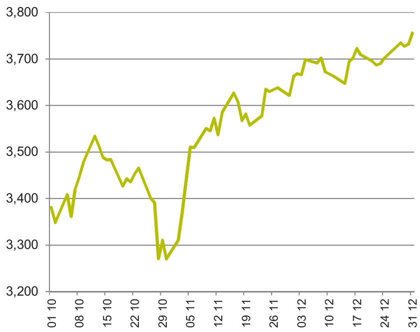


Source: Bloomberg

Until now, ESG bond and traditional bond yields have been similar. The chart shows the example of the US market.

Equities

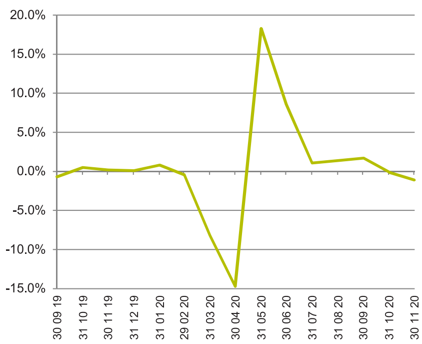
S&P 500 4Q 2020



Source: Bloomberg

The market continued its upward trajectory fueled by news of effective COVID vaccines and the US elections.

US Retail Sales 09/2019-11/2020



Source: Bloomberg

The stimulus payments sent to Americans during the pandemic propelled a quick recovery in retail sales.

Spending trumps higher taxes

The recent US elections have resulted in Democrats controlling both the Presidency and Congress for the first time in a decade. Although, investors fear the potential of higher taxes, they are excited by the prospect of massive government spending.

Most investors claim they prefer a split US government as the two sides can rarely agree to any significant changes, providing a stable environment for the market. Accordingly, some of the market gains in November and December can be attributed to the US elections ending in what appeared to be a split result. However, two Senate races were pushed into a second round and the results ended with a Democrat controlled government two months after the initial elections. This should have scared the market as Democrats favor higher taxes and more regulation, but investors are ready to feast on fiscal stimulus!

Investors fear that a Democrat controlled government would undo the Trump administration's corporate tax cuts. However, it seems investors also believe that the Democrats spending plans will give a big enough boost to the economy to overwhelm the negative impact of tax increases. While this is likely to be true in the short run, the positive effects of a heavy dose of fiscal stimulus will eventually wear off, possibly in as little as a couple of quarters. Higher taxes on the other hand, have a more lasting effect. Furthermore, there are several other potential long-term problems that can be caused by this liberal application of fiscal stimulus. Inflation could finally become a problem causing interest rates to rise faster than expected, downward pressure on the US dollar, or possibly a loss of confidence in US economic policy.

"Anyone can hold the helm when the sea is calm", Publilius Syrus

The most notable piece of any new fiscal stimulus bill will be increasing the direct payment to most Americans from the $600 approved in December to $2,000. This means that a family of 5 could possibly receive a $10,000 check. Last April, most Americans received $1,200 per adult and $500 per child. This stimulus was given much credit for the lightning fast rebound in US Retail Sales (see chart). However, there is more on the Democrat wish list. It is likely the Democrats will attempt to push through additional funding to support vaccine distribution and direct aid to state governments. Together with the stimulus checks this could be $2 to 3 trillion in additional spending on top of the $900 billion stimulus package passed in December. The spending does not end there as Democrats will likely target a major expansion of the Affordable Care Act, as well as significant infrastructure spending.

Another aspect of this evolving bull case is that the Democrats will only control the government by the narrowest of margins. The Democrats will have the smallest majority in the House of Representatives in over 20 years and the Democrats have the smallest majority even possible in the Senate. To pass unilateral legislation, the Democrats will not be able to have a single Senator from their party in disagreement. President Joe Biden has promised to roll back the corporate tax cuts Republicans passed in 2017 and raise taxes on the wealthiest Americans. However, moderate members of the party are unlikely to want to raise taxes while we are still feeling the economic impact of the pandemic. Even looking past COVID-19, they may not agree with raising taxes as high as party leadership prefers.

All of this is a recipe for a bullish sentiment to take hold that not even a rowdy mob taking control of the US Capitol can shake.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Consequences of stimulus & sustainability

Much has been said about the stimulus being injected from all sides, both monetary and fiscal. And also associated with a more sustainable world. But what are the implications of this in the world of commodities?

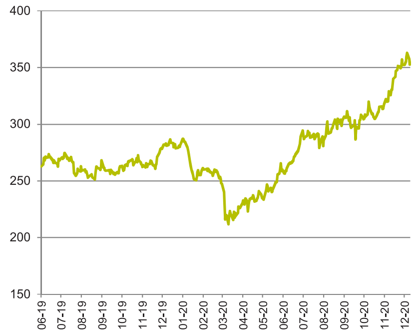
a) Stimulus. One consequence being seen is that wage inflation in the US has started to rally after many years. This is significant for commodities as changes in wages tend to influence commodities prices more “rigidly”. I know what you are thinking, but a high level of unemployment and inflation can co-exist, and this has historically been the case, provided that unemployment is addressed and a lower level of unemployment is sought (as is the case today).

b) Sustainability. China has committed to being carbon neutral by 2060. President Xi Jinping recently revealed his renewable energy plan for the next 10 years. Copper is the metal most likely to benefit from the transition to renewables, such as wind and solar energy, as they are twice as copper-intensive as traditional power generation. Electric vehicles also continue to be a positive factor for copper. This all helps maintain the current growth in demand for copper.

These are just two examples, from the two major world powers, but they could also apply the other way around, with China in point a) because, despite coming out of the pandemic as the great winner, it is increasing its money supply like never before in the last five years. And the US in point b), because although Biden’s mandate has not yet begun, he has proposed carbon neutrality by 2050, the same as in Europe.

Miguel Ángel Rico, CAIA
Investment analyst

Copper price



Source: Bloomberg

Copper price recovery

CURRENCIES

Turning neutral on the dollar

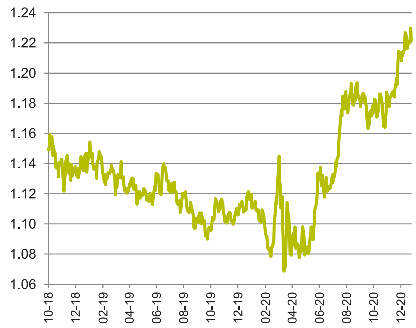
In 2020, the dollar dropped 10% against the euro. The currency had become overvalued after having benefitted from its exclusive proposition of a high-yielding, safe-haven asset and we started 2020 thinking the Fed’s expansionary monetary policy shift would push the dollar down. Today, however, the spread between US and German interest rates has largely converged and we now have adopted a more neutral view.

Most market players expect the dollar’s depreciation to continue, but it is precisely when the consensus is on one side that there is the greatest risk of prices moving in the opposite direction. They think that with the roll-out of vaccines, the worst of Covid-related uncertainty is behind us and demand for the safe haven aspect of the dollar should diminish. The dollar is considered a barometer of global economic health, falling when growth is buoyant and rising at times of slowdowns. However, we do not think the future is without risks and we also believe the US could very well outgrow its counterparties during the recovery. Dollar bears also believe that the US budget and current account deficits justify a weaker dollar as they must be financed by importing capital from abroad. As the dollar depreciates, US assets become more attractive for foreigners, but the US has been in this situation for years and it has never caused the dollar to fall. Last of all, the dollar’s reserve currency aspect has also been called into question. Although this might have some funding in the long run, we do not see it happening in the short or medium term.

Forecasting exchange rates is a very difficult task, but for all these reasons we would rather not bet on the dollar’s continued decline.

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

Exchange rate EUR/USD



Source: Bloomberg

In 2020, the dollar dropped 10% against the euro.

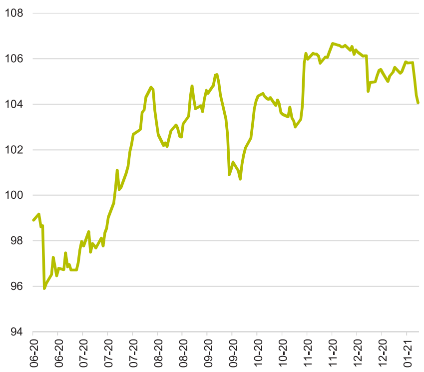
Latin America

iShares MSCI Brazil ETF

Source: Bloomberg

With losses of over 50% between February and March, the Brazilian market recovered a good amount of the ground lost over the year.

The Brazilian 10-year sovereign bond. YTM



Source: Bloomberg

The Brazilian sovereign bonds have continued to rise since March, offering all-time low yields in USD.

Double-edged loans

Fiscal and monetary expansion in Latin American countries to combat the economic crisis will bring with it a rise in foreign debt, with China playing an increasingly important role.

Latin America is one of the regions being worst affected by COVID-19. In terms of the health situation, several countries in this region are among those with the highest number of cases and deaths per million inhabitants globally. And in terms of the economy, it is also suffering badly. In its latest update, the Economic Commission for Latin America and the Caribbean (CEPAL) estimated that GDP in the region will shrink 9.1% in 2020, with Peru and Argentina seeing double-digit downturns, and Mexico and Brazil at levels close to 10%. Government responses have been varied: Chile is the country to have implemented the most fiscal stimuli with 11.5% of GDP, followed by Peru with 10% and Brazil with 7.4%. For its part, Mexico is the country to have allocated the fewest fiscal resources, with just 0.6% of GDP. From the monetary perspective, Chile, Brazil and Peru are have also implemented more expansionary decisions.

The rise in the deficits will be defrayed by the increase in the countries' foreign debt, in both the public and private markets. In terms of the latter, one country in particular is becoming a big player in the region: China. Through state-owned enterprises like the China Development Bank or the Export-Import Bank of China, the Asian giant has become the banker of Latin America in recent years. Direct loans amount to over $150 billion. The most well-known case is Venezuela, engulfed in an enormous social and economic crisis and without many alternatives for financing on the international market. However, other nations like Brazil, Ecuador, Argentina and Bolivia are receiving financial support from China through this route, and on an ever-increasing scale.

But what is China looking to get out of these investments in Latin America? The answer is obvious: greater economic and political influence. In the economic arena, in exchange for these loans, countries are often required to buy Chinese machinery and manufacturing products, or to have Chinese companies carry out certain infrastructure projects. In Brazil, for instance, Chinese companies have been awarded the contracts for over 20 roads and bridges projects since 2013. Another formula, already in practice in Venezuela, are loans-for-oil deals, whereby China receives oil as payment in the event the country becomes insolvent. This solution could potentially be applied to other commodities, of which Latin America has an abundance and in which China has great interest.

The Economic Commission for Latin America and the Caribbean estimates that the region's GDP will shrink 9.1% in 2020

With the increase in foreign debt, it inevitably brings to mind Latin America's "lost decade" of the 1980s, when several countries were unable to meet their loan obligations following a global economic crisis and the fall in commodities prices. While it is true that this situation is different —as interest rate hikes are not expected in developed countries causing the capital flight that happened back then— those who do not remember their past are condemned to repeat it.

In the political arena, China also has great interest in Latin America, at a key time in the rivalry with the US, which has historically viewed the region as a natural area of influence. And not only in those countries with governments with which it is more ideologically aligned; China has also been able to establish close diplomatic ties with nations with which it has had no relationship in the past, like Panama and the Dominican Republic.

Juan Gestoso Ruiz
Investment analyst

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