INDEX

Quarterly Report

Our view on the markets

Extra-terrestrial

The economy will remain robust and the pandemic may come to an end, but the financial markets are at very demanding valuations with little margin to cope with the shift in global monetary policy, especially if this accelerates because of inflation.

Let's imagine an alien lands on Earth and we show him the prices of the planet's main markets and economic metrics, with high inflation and economies growing strongly. "Mr Alien, what kind of interest rate do you think would apply in this situation?". "I know this", he says. "Above inflation, to be able to get a grip on it, according to the textbooks of classical intergalactic economics". That is wrong. The right answer is zero or negative in half the planet, with the major central banks printing yet more money to buy financial assets. Next look at stock market performance, with the main US index setting record after record following three straight years of double-digit returns. "Mr Alien, would you say that a) we are emerging from a global pandemic that has not yet ended, or b) something else?". "B?", ventures the extra-terrestrial. "Incorrect, Mr Alien. You have failed Earth macroeconomics and financial markets."

The truth is that the alien is lacking some information. The markets may be at all-time highs, but so are corporate earnings. Moreover, financial markets anticipate the future, and the future looks solid. The pandemic is probably almost over – Omicron, one of the most transmissible viruses in history, coupled with mass vaccination, may finally result in the necessary herd immunity. At the very least, we know how to live with it much better, and we have new antiviral treatments and the ability to adapt vaccines quickly to new variants. Labour markets are strong, savings and disposable income are high and there will be no shortage of appetite for consumption, especially in services, as leisure activities stifled by the pandemic can resume as normal. As for companies, they are investing heavily in digitalising their production processes to meet latent demand. And liquidity, however much central banks may be thinking about shifting their monetary policy, remains very abundant.

Two major obstacles stand in the way of financial markets once again performing as well as their fundamentals. The first is that current inflation is extremely uncomfortable for central banks, and their laxity has been a major support for markets. A change in monetary policy could cause the odd hiccup, to say the least. The second obstacle, and perhaps the biggest, is that the starting valuations are high and leave little margin for adverse surprises.

This does not apply to anyone investing in the short term (which is an oxymoron: short-term investors do not really invest, they speculate), but it does apply to everyone else. The best asset at the wrong price is not usually a good investment. Maybe 2022 will again bring excellent returns. But we are not being properly rewarded for the risk we are taking, so caution is advised. Opportunities are out there, and we need to make the most of them. But, as they say, "handle with care".

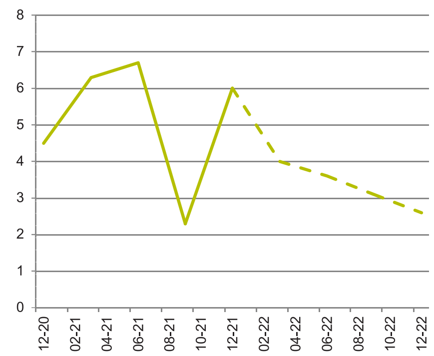
David Macià, CFA
CAAM Investment Director

Strategy

Asset allocation (2022 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

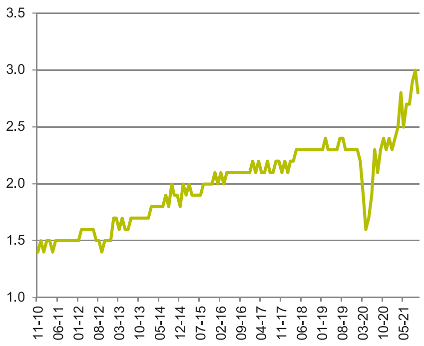
US Real GDP (QoQ%)



Source: Bloomberg

The median forecast sees US GDP growing 3.9% in 2022 down from 5.6% in 2021.

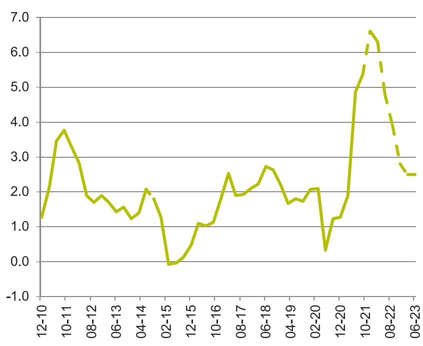
US Quits Rate



Source: Bloomberg

The quits ratio at 2.8% shows workers are confident they can find another job.

US Consumer Price Index (YoY%)



Source: Bloomberg

Consensus sees US inflation peaking at the end of 2021 and then declining.

Growth slows but remains above trend

As is customary for the first report of the new year, we will try to outline how we see the economy unfolding in 2022. After the worst recession since World War II in 2020 and the fastest post-recession recovery in 80 years in 2021, we are expecting a more normalised situation in 2022, but that does not go without risks.

Most economists predict that global growth will slow in 2022 but remain above trend. The median forecast sees US GDP growing 3.9% in 2022, down from 5.6% in 2021. Recovery from the sharpest contraction since World War II along with unprecedented fiscal and monetary support resulted in extraordinarily high growth in 2021, which —be it just because of base effects— will be hard to repeat. However, there are many factors that allow us to remain bullish on growth. During 2021, supply was unable to fully satisfy the surge in demand for goods. Disruptions in supply chains, capacity problems at ports and the lack of qualified workers were all a drag on supply and, therefore, on growth. As these problems get resolved in 2022, growth will be sustained by latent demand, the rebuilding of depleted inventories and the recovery in services as COVID restrictions are lifted. Much of the fiscal support in the form of direct payments to consumers will be replaced by income as more people find jobs, thereby avoiding the usual fiscal cliff after a year of significant stimulus. Moreover, the economy has yet to reap the benefits of the infrastructure plan, the Build Back Better social plan —still on the negotiating table in the US—and the Recovery Plan in Europe.

Growth will be sustained by latent demand, the rebuilding of depleted inventories and the recovery in services

Inflation pressures have continued to build during the 4th quarter of 2021. Consensus sees US inflation peaking at the end of this year and then declining, but it should remain well above 4% with service price inflation, wage growth and rents offsetting slower goods inflation as supply disruptions begin to ease. Indeed, the labour market is showing signs of tightening, especially in the US with record-high job openings and quits. The number of people who voluntarily left work fell to a still lofty 4.2 million and the quits ratio at 2.8% shows workers are confident they can find another job.

Even though there continues to be a lot of noise around the Omicron variant, we do not believe that it represents a serious threat to growth in 2022. While far more transmissible than previous strains, the symptoms are milder, vaccines and COVID pills are effective against hospitalisations and morbidity, and the truth is we have learnt to live with the virus. Although some countries have declared a temporary full lockdown, such as the Netherlands and, previously, Austria, it does not seem this will be the preferred path adopted around the world. Prolonged restrictions could however cause more supply constraints, holding back growth and leading to higher inflation, and a more virulent variant cannot be ruled out.

The pandemic aside, there are other risks to this base case scenario. In the last quarter of 2021, we saw central banks across the world begin to shift their monetary policies. After two years of the most aggressive quantitative easing ever recorded, central banks have started to pull back on their buying programmes and some have already begun to hike interest rates. We expect this shift to accelerate in 2022 in the face of rising inflation. The biggest risk in our eyes would be if inflation does not ease as much as expected should supply problems persist or due to second round effects and wage inflation. If this were to happen, central banks would be obliged to tighten more aggressively with the risk of choking the recovery.

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

Fixed Income

Beginning of the end for high liquidity

Monetary policy is tightening with the start of tapering after years in which the main central banks coordinated in implementing ultra-expansionary policies to support the economic recovery. The impact of new coronavirus variants on growth and inflation will be the main variables to bear in mind.

With tapering, central banks triggered the beginning of the end of the era of huge liquidity. At the Fed's last meeting, it trusted in the economic strength, doubled the pace of tapering, and it expects to raise rates once QE ends in March: three hikes in 2022, another three in 2023 and two in 2024, taking us above pre-pandemic levels (1.75% at year-end 2019). For its part, the ECB confirmed the end of the PEPP in March 2022 and pointed to QE conditions returning to pre-pandemic levels by the end of the year. A first consequence of this reduced support is that it will go from buying 130% of the government's net issues, as it did in 2021, to 70% in 2022.

Increased preference for credit with low default risk and sound fundamentals, ESG bonds will gain visibility

The policy shift carries risks: tightening and discovering that inflation is temporary could derail the economic recovery. Waiting and seeing that price pressures are permanent may require a more aggressive adjustment. The "policy mistake", the risk of central bank policy being wrong is the number one risk that investors see in 2022, according to a Bloomberg poll. With this new paradigm, what can we expect in the new year?

Inflation and the development of the coronavirus will determine the evolution of interest rates. The new variants (Omicron) are more contagious but less severe, and boosted vaccines and new pill-based treatment options will increase the effectiveness of the fight against the pandemic. Inflation could be the most significant positive surprise towards the middle of the year as the effects of the reopening fade with the normalisation of demand, bottlenecks and the expected fall in commodity prices. The evolution of the real rates will be the most important variable to track in interpreting the dynamic of the markets. Currently at record lows, we need to not lose sight of the risks of corrections. We can remember hikes of +60 bp in 2013 during Bernanke's Taper Tantrum or +60 bp in 2018 when Quantitative Tightening was initiated and resulted in huge market crashes. In this scenario, a longer duration in the fixed income portfolio is not attractive.

In the world of credit, the focus is on fundamentals in the face of less monetary support. Fundamentals are improving, so the upward spread adjustment process should be moderate. The companies that needed to issue debt have benefited from cheap financing and an average maturity of almost 11 years, with a reduction in financial leveraging, expectations of rating upgrades and a record low default rate (12-month European default rate of around 2% for high yield according to Moody's).

Emerging market bonds were expected to suffer this year as central banks moved towards withdrawing stimulus. However, the global debt that performed the best was all from developing countries, with South Africa, China, Indonesia, India and Croatia topping the rankings. This should give investors some confidence that the Fed can reduce asset purchases and start to raise interest rates without triggering an increase in global volatility. The key will be in how the dollar evolves and in the de-correlation that the emerging world has shown.

ESG bonds will continue to gain visibility in 2022 and to register strong growth rates, driven by regulatory developments that favour standardisation, transparency and lower risks of "greenwashing" by issuers. During 2021, they have achieved higher oversubscription rates in the primary market and with a lower issuance premium than their non-ESG equivalents. Sustainability-linked bonds (SLBs) are gaining the largest market share.

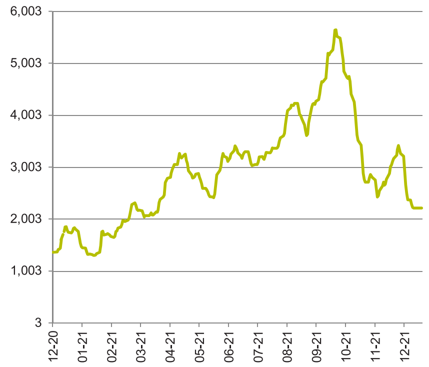
Josep Maria Pon, CIIA
Head of Fixed Income and Monetary Assets

U.S. Real Yields

Source: Bloomberg

The evolution of real rates, currently at record lows, will be the most important variable to track in interpreting the dynamic of the markets (10- year US rate adjusted for breakeven inflation rate).

Baltic Dry Index

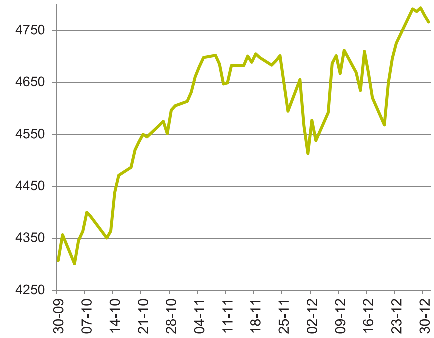


Source: Bloomberg

The Baltic Dry Index (cost of dry bulk shipping) is on a downward trend, suggesting supply problems are being resolved.

Equities

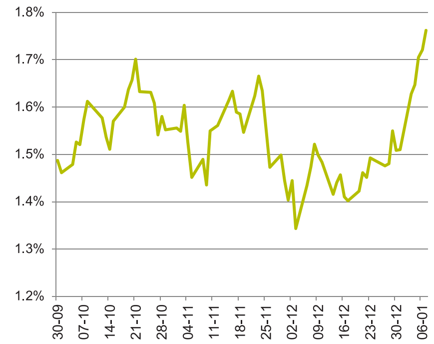
S&P 500 4Q 2021



Source: Bloomberg

2021 ended with an impressive run in the S&P 500.

Yield of US 10 year Treasury



Source: Bloomberg

Rates spiked up at the start of the new year.

2022: The year of the hawk

2021 started off with a contested US election, increasing deficit, and the world mired in a pandemic. Still, the S&P gained 26.9% fueled by low rates, fiscal stimulus, and strong earnings growth. What will 2022 bring, now that the Fed has turned hawkish, there is no new fiscal stimulus, and decelerating earnings growth?

The market faced some setbacks every now and then in 2021 as a new Covid variant would strike, or a statement from an increasingly more hawkish Fed would rattle investors. None of that really mattered as the S&P gained an impressive 26.9% for the year, while the Nasdaq lagged behind a bit at 21.4%, marking the first time the Nasdaq has lagged the S&P since 2016. Although the indices gained over 20%, it was not a particularly easy year for investors as the market continually rotated between growth and value, cyclicals and non-cyclicals. The constant rotations caught many investors leaning the wrong way at various points during the course of the year. According to the Wall Street Journal, last year roughly 85% of US equity funds underperformed the S&P 500. The market was led by a very narrow group of stocks that includes some old mega-cap favorites such as Apple, Alphabet, and Microsoft, however, Tesla and NVIDIA joined that group. This is while other long time investor favorites such as Amazon and Walmart underperformed, pandemic favorites (Zoom Video and Peloton) were disastrous, many Chinese stocks collapsed, and the SPAC/meme craze faded. There were plenty of ways for investors to misstep in 2021.

> “It’s a probably a good time to retire that word (transitory).”
> -Jerome Powell

The low interest rate environment, a very dovish fed, fiscal stimulus, and the promise of more to come had created an insatiable appetite for stocks. The economy did claw itself out of the Covid induced slump and Americans returned to work in droves, but there was a problem. In the 18 months following the outbreak of the Covid pandemic, the Fed had repeatedly said that above trendline inflation was acceptable and that it was likely to be “transitory.” However, the Fed drastically underestimated how strong consumer demand for goods would climb, how housing demand would remind us of 2005-06, and how a global supply chain still facing Covid disruptions would fall short.

The Fed would eventually come to regret having used the word transitory as consumer inflation hit its highest levels since 1982. The Fed’s newfound perspective on inflation would cause it to pivot its approach dramatically. Their approach now incorporates a plan to speed up the taper, the possibility that a reduction of the Fed’s balance sheet could follow right behind the completion of the tapering, and signaling that we could have three rate hikes in 2022. The Fed was the gift that kept on giving during 2020 and 2021, but it looks poised to be a Grinch in 2022.

This has led to some eye-opening moves in the first week of 2022 as the yield on the 10 yr US Treasury surged from 1.51% to as high as 1.80%, the Nasdaq plummeted 4.5%, and the market is now discounting a 75.7% probability of a rate hike in March. The writing had been on the wall for a while now, but investors had been willing to ignore it during the late December Santa rally. Now that we have stumbled at the start of the year, the reality becomes more in focus. Rates are likely to rise, long duration stocks are falling out of favor and investors are piling into high cash flow stocks. Still, consensus is centered around modest gains for 2022, but volatility will be high, rotation will happen often, and it will be an unfavorable time for speculative stocks.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Turning point

The more inefficient a market is, the more opportunities it offers.

Commodities are becoming increasingly prevalent in the global investment community. However, the fact that many of them are heavily dependent on demand from a single country (China) makes their prices more inefficient in some ways. This is especially true with a country like China, where the market is highly regulated, which creates even more inefficiencies.

Iron ore's performance in recent months is a clear example of how Chinese governmental regulation can affect the price of a commodity. It makes no sense that it has fallen and its price has gone almost to the lows of 2015 when we saw a commodity crisis, no matter how much trouble the Chinese real estate market is in.

The expected recovery in China's steel production by the second quarter of 2022 (+25%), thanks to the easing of environmental regulations that had caused the reduction in production until now, will favour iron ore. Demand for steel should improve given the expected turning point in China (growth, stimulus and support for the property market).

The controls that the government have put in place to curb pollution will be eased once the Winter Olympics in Beijing are over.

Iron ore may have bottomed out, the combination of political support to push GDP growth above 5.5% and reduced pollution controls after the Winter Olympics could allow a sequential recovery in steel production and thereby support demand for iron ore.

As nothing comes for free, of course, we will have to keep an eye on developments in the Chinese property market.

Miguel Ángel Rico, CAIA
Investment analyst

Iron Ore

Source: Bloomberg

Iron Ore crashing by chinese regulators.

CURRENCIES

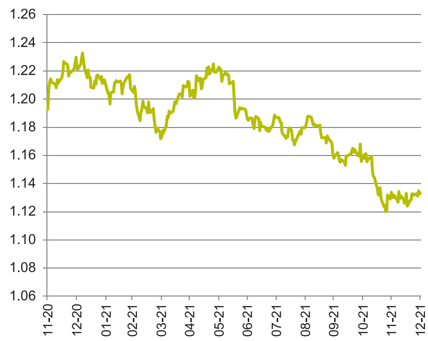
Can the rally continue?

During the fourth quarter, the dollar continued its upward march against the euro, appreciating 2.2% and closing the year with a gain of 7.2%. A sharp increase in COVID cases in Europe, stronger economic data in the US and a more aggressive Fed are behind the move. In the short term, the dollar should remain strong as we see continued support from these tailwinds. We expect divergence in monetary policy to continue to drive currency dispersion with the "hawks" —in the process of withdrawing stimuli more rapidly or hiking rates—, such as the US, the UK, Canada, Norway and New Zealand, and the "doves" —favouring a more accommodative policy and low rates for longer—, such as Switzerland, the Eurozone, Japan and Sweden. Indeed, more persistent and higher inflation in the US calls for an earlier tightening cycle as hiking too late would mean having to be more aggressive and running the risk of choking the economic recovery. The ECB, on the contrary, seems to have a bit more leeway where inflation is concerned and is unlikely to hike in 2022.

At some point, however, we do believe that this trend should reverse. The new year should see an improvement in economic data outside the US as the supply chain disruptions are resolved, COVID restrictions are lifted and demand for services recovers. With that, flows toward safe haven assets should reverse. Moreover, markets have already priced in a more hawkish Fed cycle, leaving little room for the unexpected, whereas ECB policy adjustments could prove to be much more of a surprise and support the euro. Finally, we are approaching levels where we believe that the dollar, from a fundamental standpoint, seems expensive.

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

Exchange rate EUR/USD

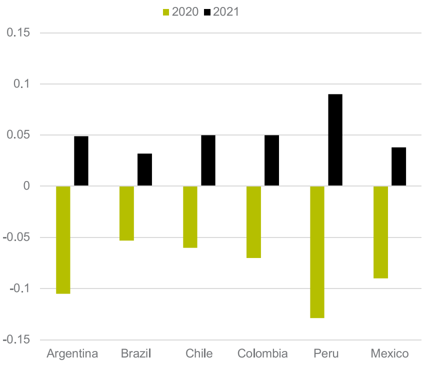


Source: Bloomberg

During the fourth quarter, the dollar continued its upward march against the euro, appreciating 2.2% and closing the year with a gain of 7.2%.

Latin America

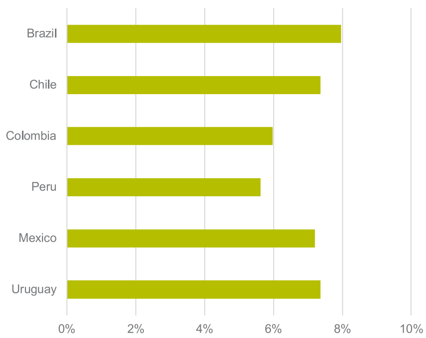
Gross Domestic Product growth



Source: CEPAL

At the end of 2021, none of the region's large economies will have recovered the product levels reached prior to the pandemic.

Year-on-year inflation, December 2021



Source: Bloomberg

Normalisation and past challenges

The region's central banks have continued to take steps to combat prolonged and rising inflation, amid political instability and an economy that has not yet recovered to pre-pandemic levels of activity.

Earlier we discussed the monetary and fiscal measures taken by central banks and governments respectively to deal with the economic crisis resulting from the pandemic. In recent months, monetary institutions have had no choice but to start raising, to a greater or lesser extent, interest rates to combat rising inflation which Latin America has historically suffered greatly, although this problem is not unique to the region.

> After a GDP contraction of 6.8% in 2020, this will be followed by an expansion of over 6% in 2021 and close to 3% in 2022

The rise in rates in Latin America has come earlier than in many of its emerging peers and, of course, developed countries. But what will happen when the latter actually start monetary normalisation? Looking back to 2013, we witness how restrictive policies generated capital outflows from emerging bond markets to developed ones, leading to depreciations of local currencies, in turn raising financing costs and making it difficult for countries to manage their external debt. It is true that this situation is different from the current one, not least because the US Federal Reserve has sufficiently prepared the ground. In any case, central banks in the region will undoubtedly keep a close eye on the movements of developed countries, while ensuring that monetary normalisation does not undermine the still fragile health of domestic economies.

Following a contraction of the region's Gross Domestic Product of 6.8% in 2020, it will be followed by an expansion of over 6% in 2021 and the forecast for 2022 is for a slowdown in growth below 3%. To date, less than half of the countries managed to recover to pre-pandemic levels of activity, although most will do so by 2022.

However, the region had pending tasks before the pandemic that should not be ignored by institutions. Low levels of investment, savings and productivity, coupled with high labour force burdens in growth and the informal economy, make the challenges of recovery and development considerable.

In addition, the region has not been spared political instability in several of its major countries. In Chile, Gabriel Boric has been proclaimed the winner of the elections, beating José Antonio Kast, the market favourite. In Peru, President Castillo, despite avoiding an early motion of censure, is failing to bring balance to an increasingly divided society. Brazil and Colombia face presidential elections in 2022. In the first case, former President Lula da Silva, who is still facing legal proceedings, is comfortably ahead in the polls of the current President, Jair Bolsonaro, whose popularity is at an all-time low. In the case of the coffee-growing country, which has recently lost its investment grade rating, former Mayor Gustavo Petro is leading the polls, but he does not enjoy the market's favour either.

Government leaders will have to face the final stage of the economic recovery and also continue efforts to modernise economies that are still far from their potential, which is good news. External private investment is coming in, and levels of domestic entrepreneurship have risen sharply, highlighting that the potential in the region is significant.

Juan Gestoso Ruiz
Investment analyst

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