Quarterly Report

Our view on the markets

INDEX

Party Time

Risk assets continue to rebound, in anticipation of the consolidation of a strong economic recovery, underpinned by the imminent vaccination of the entire population and fuelled by monetary and fiscal stimulus. There are many reasons to be optimistic, but there are too many optimists in the market.

The first quarter has been characterised by two major themes. On the one hand, restrictions are expected to be lifted as more and more people receive vaccinations. This will no doubt happen, but unevenly. Indeed, in certain countries like the US and the UK, around half of the population has received at least one injection, while other countries are experiencing shortages. In Europe, just 15% of the population has received the jab, pressure on hospitals is increasing and lockdowns are intensifying. In the US, hotel bookings are now at pre-pandemic levels, and the number of flights is on the rise, as well. In Europe, there are fears about the summer and there is talk of vaccine passports.

The other great influencing factor on the markets is an upswing in the long end of the curves. Central banks claim that they will be much more patient than in the past, and governments are showing much less fiscal discipline than before. This combination usually results in higher inflation, and markets are anticipating this, among other things in the increase in the long end of the curves. This has profound implications for many assets. Higher rates imply greater discount rates and, in theory, a contraction in multiples of stock with stronger or more stable earnings. They also alleviate banks' margins and disadvantage those paying higher dividends, who face competition.

The convergence of these two major themes largely explains the performance of most assets so far this year. Both things seem to be irrefutable. A large part of the population will ultimately be vaccinated, and the economic recovery is likely to be one of the strongest in decades. Official interest rates will remain low, but the long end of the curves will experience upward pressure. There is no alternative to risk. The problem is that this argument works with any level of assets. If the S&P 500 was at 8000, instead of close to 4000, would it make you think twice? The fact that it has almost doubled in the last year certainly does not appear to frighten anybody.

It is difficult to know where to draw the line, but valuations do matter in the end. Also, do not confuse irrefutable arguments with irreversible realities. The future, by definition, is uncertain. When optimism abounds (and it is difficult, very difficult, to find anyone who is not optimistic these days), tread carefully. Invest at half throttle. You will earn less –but you will earn, if everything stays up– in exchange for losing less, and being able to take better advantage of unexpected corrections. Don't have high durations just for the sake of maximising coupons – a rise in inflation seems irreversible, sooner or later. Don't bet against the dollar – a better vaccination roll-out and more stimulus will ensure a stronger recovery for the Americans. And make hay while the sun shines. With moderation.

David Macià, CFA
CAAM Investment Director

Strategy

Asset allocation (2021 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	↑

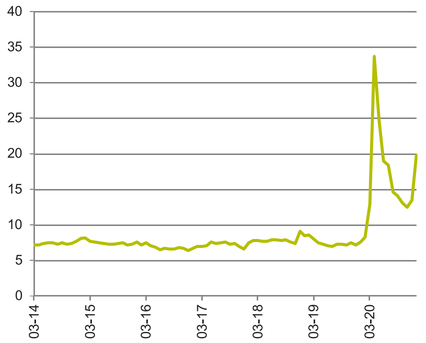
Macroeconomic View

US Real GDP

Source: Bloomberg

The OECD now predicts American Domestic Growth this year at 6.5% from a previous forecast of 3.2%

US Personal Saving as a % of Disposable Income



Source: Bloomberg

The household saving rate currently sits near 20%.

US Personal Consumption Expenditure Core Price Index

Source: Bloomberg

The Fed's preferred measure of inflation has risen from a low of 0.92% in March 2020 to above 1.50%

On the road to recovery

The pandemic is not over yet, but the global economy is on its way to a full-blown recovery during the following quarters as vaccine production and distribution are picking up steam. Pent-up demand, significant fiscal stimulus and very lax financial conditions promise to support strong economic growth this year.

Economists have significantly upgraded their 2021 growth estimates, especially for the US since the $1.9tn American fiscal stimulus package was approved. Including the two previous programmes, stimulus measures are almost three times those enacted in the aftermath of the financial crisis. The OECD now predicts the surge in government spending will boost American domestic growth this year from a previous forecast of 3.2% to 6.5%, noting that it will benefit other economies as a result of increased American demand and trade. Global GDP growth is now expected at 5.6% this year, more than a percentage point above the Organisation's December forecast. The recovery will be led by consumer spending, as capacity for American consumers to spend is massive and growing. Individuals making under $75,000 and married couples making under $150,000 will receive direct payments of $1,400 per person, and unemployment programmes have been extended through early September. Finally, the household saving rate currently sits near 20% and households have accumulated around $1.6tn in excess savings since the pandemic hit.

If inflation overshoots and is more structural in nature, the consequences could be somewhat more challenging

Europe's recovery will lag in time and magnitude due to lingering restrictions, a less optimal vaccination rollout and a less robust fiscal stimulus programme. Although the contraction in GDP was less than feared in the fourth quarter of last year at -0.60%, the slowdown in the first quarter is likely to be worse than previously expected, as the third wave of COVID infections has proved more tenacious, causing prolonged restrictions. Services have suffered the most while manufacturing has held up relatively well. Nevertheless, these setbacks should be temporary, and Europe should follow suit albeit with a delay.

Inflation will be the key data to watch this year. If it remains subdued, monetary authorities will be able to delay tapering and the goldilocks economic situation can continue. If, however, inflation overshoots and is more structural in nature, the consequences could be somewhat more challenging. For the moment, central banks see the acceleration as transitory, and the Fed has vowed to keep official rates near zero until the economy reaches maximum employment and annual inflation tops the 2% target "for some time." The Fed's preferred measure of inflation has risen from a low of 0.92% in March 2020 to above 1.50%, but it will probably increase sharply in the coming months due to base effects as we had historically low prints last year. Certain sectors particularly hit by the pandemic will face a sharp recovery in demand, whereas there could be a shortage in supply causing pricing pressure. Oil and commodity prices in general have had a very sharp uprun, and they will take their toll on inflation. However, all these factors should be transitory, and just as the base effect this year plays in favour of higher inflation readings, next year's base effect will have the opposite effect. The big question is whether the massive fiscal stimulus and expansionary monetary policy could cause a more structural shift in the inflationary trajectory. If that were to be the case, the Fed would find itself behind the curve, under the obligation to raise rates rapidly, which could choke the recovery and tip the economy into a recession due to the enormous debt burden.

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

Fixed Income

Yield scenario improves

Reflecting a better economic outlook, we can expect Treasury and Bund yields to rise, but not because of a withdrawal of central bank stimulus, which, judging by comments from the central banks themselves, will not happen this year.

The protagonist during the beginning of the year has been the US government bond (Treasury), and that is because there is a risk that the enormous economic stimulus packages that governments are implementing will awaken inflation and cause a spike in rates that will destabilise the financial markets. Generally speaking, the factors that affect interest rates are: economic growth expectations, market volatility, inflation and central bank policy.

In the first quarter of the year, government bond yields have improved. The yield of the German Bund rose from -0.57% to -0.29% (+28 bp), and the 10-year Treasury bond yield increased from 0.92% to 1.74% (+82 bp). Progress in the vaccination roll-out, although uneven, and a sustained economic recovery could be enough for the US 10-year bond yield to close the year above 2%.

Precisely because of these movements in yield, we have seen higher volatility in bonds (MOVE index) than in equities (VIX), which has remained at record lows.

There is a risk that a rise in rates will destabilise the financial markets

Investors expect inflation to rise because of the economic stimuli that will drive the economic recovery, so-called "Reflation Trade". However, while experts expect inflation to rise in the short term, they say that it will fall again after the upturn. If we look at how the US inflation breakevens are trading, we can see that they are stabilising around the Federal Reserve's target of 2%. To appreciate the pressure on inflation, one of the key things to watch is if the cheques that the Biden administration will hand out to the American people will be spent or saved. In fact, in a recent survey, respondents were asked how they planned to spend this income and, on average, respondents said they would spend 40% and save the remaining 60%.

The central banks continue to play a key role with quantitative easing policies, including asset purchases, which have helped to generate negative real yields. When the central banks decide to revert this policy, we should expect a return to positive real yields and levels similar to 2013.

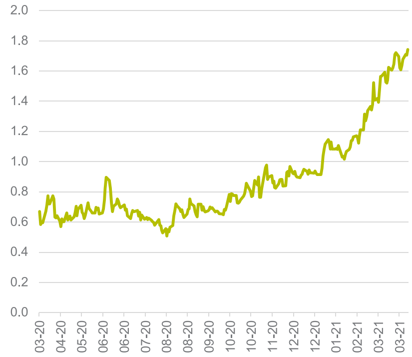
What happened in 2013? It was dubbed the "Taper Tantrum": the withdrawal of stimulus by the Fed caused a rise in bond yields. We are currently halfway to those levels, which, let us not forget, rose to 3% yields on the 10-year Treasury.

We have become used to the central banks coming to the rescue when the financial markets are in trouble, even though we know that this is not necessarily a good thing. We are not yet in that scenario, but it would be logical to think that investors may lose confidence if this backstop support were to disappear.

In any case, this time the central banks have surely learnt their lesson and they will not withdraw support as abruptly as they did in 2013: they will prepare to reduce liquidity on the market and, unlike in the past when they relied on the outlook, they will wait for the economy to make real progress. The baseline scenario is not that the Fed will act early. We can expect a reduction in asset purchases in 2022, then monitor if inflation remains above 2%, and the first hike in the benchmark rate could come in 2023.

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

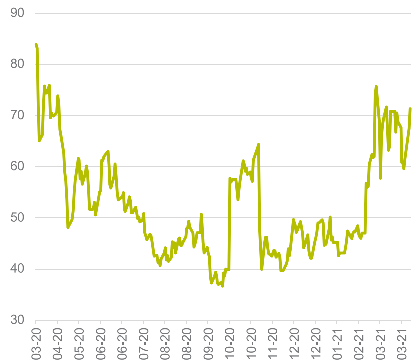
Yield Treasury 10 years (GT10 Govt)



Source: Bloomberg

The 10-year US government bond yield has increased 82 bp in the first quarter to 1.742%.

Evolution of the MOVE volatility index

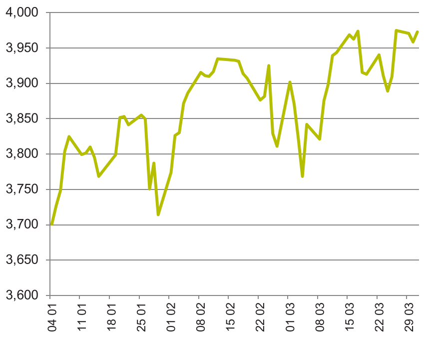


Source: Bloomberg

The ICE BofA MOVE Index measures bond volatility, and we can see how it has increased in the first quarter of 2021.

Equities

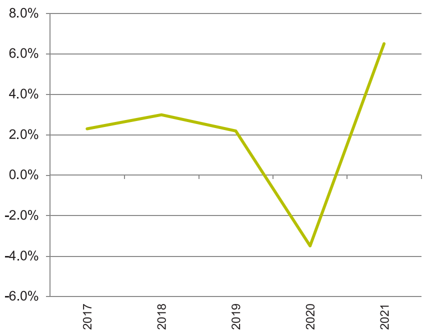
S&P 500 1Q 2021



Source: Bloomberg

The market continued to move higher but there was some volatility due to sector rotation.

US GDP



Source: Bloomberg

Thanks to trillions in stimulus, the US economy is expected to grow sharply in 2021.

When will a tax hike be priced in?

Could this be the start of the 21st century's version of the roaring 20's? An unprecedented economic boom fueled by trillions in fiscal stimulus, a shrinking viral threat, interest rates that are still low on a historic basis and pent-up consumer demand. Or will this be tempered by tax hikes?

The S&P 500 has set a new record high with its move above 4,000. The market seems to be intent on pricing on the economic benefit of fiscal stimulus, but what about higher taxes?

To offset the impact of the Covid-19 pandemic, the US government has attempted to spark the economy with trillions in fiscal stimulus. The results have been generally positive with a broad economic recovery leading to an estimated 6.5% growth in GDP for 2021. The US government is now preparing an additional $2.25 trillion of stimulus in the form of an infrastructure bill. This could further juice the economy with long ranging impacts. However, this will not be as purely additive to the economy as the debt-financed rounds of stimulus were.

> "Taxes are what we pay for a civilized society", Oliver Wendell Holmes

The Biden administration has proposed an ambitious plan to rebuild both the nation's physical and social infrastructure. Unlike the Covid related stimulus bills, the administration does not want to solely fund this with debt. Their idea is to fund the bulk of this spending with a corporate tax increase.

Biden has proposed to partially roll back the Trump era tax cuts that brought the corporate rate all the way from 35% down to 21%. The new proposed rate is 28%, but that is not all as the administration also wants to increase taxes on income earned outside of the US. They want to impose a global minimum tax for multinational corporations and ensure the pay a tax rate of at least 21% in any country they operate in. Furthermore, corporations will be discouraged from domiciling in tax havens and writing off expenses related to offshoring.

Assuming these changed take effect in 2022, these changes could reduce S&P 500 earnings by 9%. If we take a look back at the Trump tax cuts of 2017, we might be able to apply some of those lessons to the current situation. Trump campaigned in 2016 with the promise of corporate tax cuts and once in office, negotiations were begun in earnest. Throughout months of exhaustive negotiations, the market did not begin discounting the lower rates. It was only once passage of the bill looked inevitable did rotation into stocks benefitting from tax reform begin, and this rotation continued for several months.

Considering that the tax increase is not likely to pass until late summer or possibly fall and assuming that history repeats itself, the market may not price in this change for 3 months or more. Sectors that may be most negatively impacted by the proposed increase to the statutory rate are ones that are full taxpayers which includes many financial companies, industrials, and consumer products. In addition, companies likely to be most impacted by an international minimum tax include most of the large cap technology and communication services companies, semiconductors, and the major pharmaceutical companies. While it is impossible to predict the market with any certainty, it is difficult to imagine that it will not begin to discount the impact of higher rates when passage of the bill looks to be inevitable.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Commodity “supercycle”?

Such has been the rise in commodities over the last year that strategists and analysts have been forced to wonder whether we are in a commodity “supercycle”. A “supercycle” can be defined as an extensive period of booming demand for a wide range of commodities leading to a rally in prices, followed by a collapse in demand and, eventually, in prices.

It is said that four commodity “supercycles” occurred last century, and the last one began in the late 1990s when China became the world’s factory. “Supercycles” tend to coincide with rapid industrialisation of the global economy.

The closest thing to this process that we can find today is the green revolution, as many governments are supporting investments towards a more sustainable economy. It is true that some materials such as aluminium, lithium or cobalt will clearly see their demand increase thanks to this phenomenon.

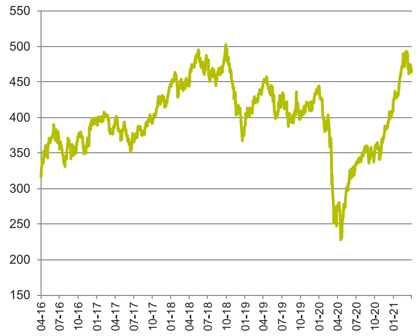
However, it is too soon to make such an assertion. In fact, what we have seen in recent months can more likely be attributed to the boost to demand in China due to expansionary policies, which are beginning to be reversed.

Inflation could arise from bottlenecks that have been seen in some production chains, but it should only be temporary. Investors tend to include commodities in their portfolios to hedge against inflationary risks. This may also have happened in recent months.

Therefore, rather than venturing to say that a “supercycle” is coming, we may in fact be seeing something more like the peak in the cycle.

Miguel Ángel Rico, CAIA
Investment analyst

S&P GSCI Index



Source: Bloomberg

Commodities main index.

CURRENCIES

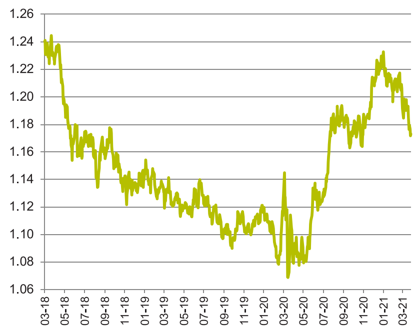
More positive on the dollar

Many still expect the dollar to weaken this year as global economic growth rebounds, pushing investors to leave the safety of US assets and seek higher returns in riskier ones elsewhere in the world. Pent-up consumer demand will mean a widening of the US current account deficit as consumers spend more on foreign goods, and the stimulus measures will signify an increase in the fiscal deficit. A rising twin deficit in turn implies more dollars being printed and flowing abroad, thereby weakening the dollar.

However, in our last quarterly report, we adopted a more neutral view on the dollar, and the events of the past few months have bolstered our opinion, at least in the short term. Economic growth is going to be far stronger in the US than in Europe. The Euro Area composite PMI has been below 50 for four successive months, whereas the US composite PMI rose to 59.5 in February, its highest level since August 2014. Not only is the vaccination rollout in the US much more advanced, but the $1.9tn fiscal package is enormous, doubling the growth outlook for 2021 alone, and a second round of stimulus checks are already being sent out in the US. The euro zone, in contrast, passed an $857 billion stimulus package in 2020, but most national governments will not receive the money until much later this year. We believe this divergence could widen further over the coming weeks, and we think that the US growth exceptionalism will be the determining factor allowing the dollar to strengthen further. At the same time, rising yields as investors discount a rebound in the economy and an acceleration in inflation are making US assets more attractive and will also support the greenback.

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

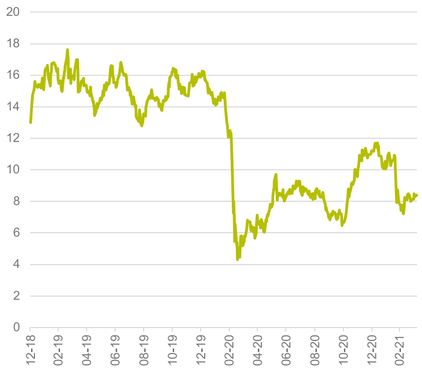
Exchange rate EUR/USD



Source: Bloomberg

The US growth exceptionalism will be the determining factor allowing the dollar to strengthen further.

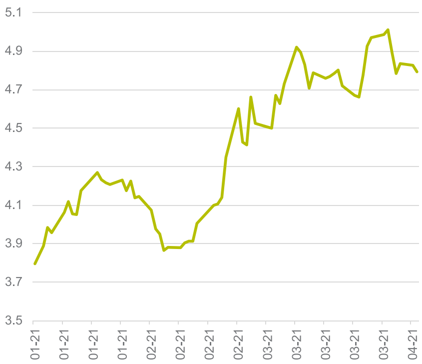
iShares MSCI Brazil ETF



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.

Bolsonaro and Petrobras

Despite Bolsonaro's pre-market sentiment, the ousting of the Petrobras CEO by the president was punished by the market, which is unwilling to assume the risk of further interventionism in state-owned companies.

Brazil remains in the spotlight. With the world's highest infection and death rate per capita at the time of writing, many are wondering whether the strategy of its controversial president, Jair Bolsonaro, is the right one. Since the beginning of the pandemic, the president has advocated minimal intervention in mobility restrictions and business and industry closures, arguing that the economic crisis resulting from closures would cause greater harm. His popularity has fallen sharply — from 41% to 33% — coinciding with the overturning of two corruption convictions against former president Lula da Silva, who has been tipped as a candidate in the next elections, leaving a deeply divided social landscape.

Bolsonaro is putting the economy first, as he had been doing before the pandemic, launching ambitious reforms that are the opposite of those implemented over the years. An energetic advocate of liberal economic policies, more than a few investors saw this change in course as an opportunity to enter the Brazilian market. The Bovespa index has risen by nearly 40% since he took office, and foreign investment levels were the highest in years before the pandemic hit.

This is why the market will not overlook the president's decision to sack the CEO of Petrobras, Roberto Castello, after disagreements with the executive over decisions on fuel prices, which rose by 35%, underpinned by a generalised increase in commodities and the depreciation of the real. The government controls 50.5% of the oil company's shares and seven of its 11 directors, which facilitated the ousting of the CEO, who defended the independence of the company to the very end. The market's negative reaction was not long in coming, and Petrobras's ADP dropped more than 25% on the US market, and the bonds followed suit as credit spreads on all issues widened sharply. The downturns dragged down the Brazilian market as a whole, highlighting the fear of further interventions by the government. This was not the deal, and investors certainly made that clear.

Despite the political noise and downturns, Petrobras's fundamentals remain reasonably sound.

In spite of everything, the company's financial position is reasonably sound, particularly if we compare it with previous years. Patrobras's debt has decreased from 132 billion dollars in 2015 to approximately 80 billion at the end of 2020. Leverage, including only net financial debt, is estimated at 1.5x compared to 4x in 2014. Its CapEx is also much lower, down to 10 billion today from 45 billion in 2013. Currently, 60% of its oil production comes from oil rigs, where the breakeven is below $30 per barrel. With the oil price at $60 per barrel, the company is expected to post an EBITDA of over 35 billion dollars, enough to meet its tax, interest, principal, lease and CapEx obligations. We think the market is penalising poor corporate governance stemming from the intervention risk mentioned, but the fundamentals have not deteriorated, at least for now. In the specific case of bonds, we consider Petrobras debt as quasi-sovereign bonds, and the yields they offer at the moment could be interesting.

In any case, the decisions that Bolsonaro's government may take with respect to Petrobras and other investee companies must be monitored. Although we do not expect large-scale intervention policies, certain actions could put the nail in the coffin of an already somewhat eroded market confidence.

Juan Gestoso Ruiz
Investment analyst

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