Research
Crèdit Andorrà Financial Group

Third quarter 2020
Date of report: 30th June 2020

INDEX



# Quarterly Report

## Our view on the markets

## Weightlessness

**The markets have rebounded sharply and they seem disconnected from fundamentals, which warrants protecting profits, even though the trend could continue due to the lack of alternatives to risk assets.**

The pure virulence of the recovery in risk assets has been truly remarkable. How long can it last? To answer this question, it might be useful to look at the reasons behind and the obstacles in the way of the rebound. In terms of the former, the faster than expected economic recovery has certainly helped. Being cooped up at home for several months with the kids has caused many to downplay the risks in going out for dinner again, going on holiday or, let's be honest, just going anywhere. Sectors that looked condemned to abandonment -those related to leisure and tourism, for example- are set to emerge better off than previously assumed. Although they may remain in a precarious position, the important thing -as far as the markets are concerned- is simply whether they can continue to beat expectations. This seems increasingly difficult, particularly because those expectations have continued to rise. The extreme pessimism we were previously seeing also served as fertile ground for investments. This is no longer the case as the negative outlooks have faded. Moreover, the monetary and fiscal stimuli are of such calibre that we believe it unlikely they will continue to boost the markets (although they will sustain them in the event of corrections). New obstacles may also appear along the way, chiefly in the form of unresolved geopolitical tensions. It is surprising to see how the markets have ignored the war of words waged by the US on China. Democrats take an even tougher stance, and the mood will not get any better the closer we come to the US election this November. Especially if the gap of support for Democrats in the polls continues to widen, as a Democrat victory would not be received well by the markets initially (whatever it looks like, the markets certainly prefer Trump, who is much more inclined to deregulate and lower taxes). We might also see a second wave of infections. However, we believe that if this happens, much more localised measures would be taken, which would be less damaging for the economy than the lockdown from which we have emerged.

All of the above calls for caution, especially after such a rebound. Our portfolios were underinvested before events unfolded, not because we had anticipated the outbreak of a virus, but simply because we believed the valuations to be very demanding and we were struggling to identify catalysts. We were completely unafraid to take advantage of the market meltdown in March to buy, accumulating positive returns for the year in the mixed portfolios, meaning we are much more concerned with protecting profits than giving some of them up, if they continue. We do not want to give the impression that we think sharp corrections are inevitable. Investors have few alternatives and they will probably buy quickly on any pullback. Official interest rates are close to zero across 60% of the planet, leaving little alternative to real assets.

Fortunately, we can, and we must, give the portfolios the necessary flexibility to take advantage of possible opportunities that arise in the short term. In any case, remember the disdain this author has for any and all fortune tellers. In my opinion, prediction is a very poor investment policy. We devote our efforts to understanding the most likely scenarios, positioning our portfolios to maximise return, but always in a robust manner (i.e., we must be able to withstand all those scenarios with dignity). In the long term, the best investor is not usually the one who gains the most, but rather the one who never loses more than necessary.

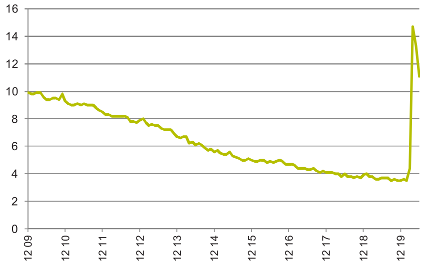
*David Macià, CFA*
*CIO*

## Strategy

| | |
|---|---|
| **Asset allocation (2020 Q3)** | |
| 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

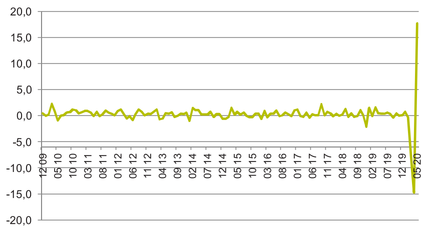
## US unemployment rate




Source: Bloomberg

US May unemployment improved from 14.7% to 13.3%, well below the expected 19%.

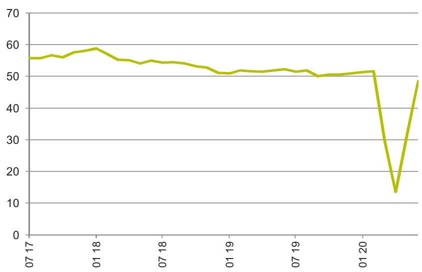
## Adjusted Retail & Food Services Sales




Source: Bloomberg

US retail sales doubled expectations growing 17,4% in May.

## Markit Eurozone Composite PMI




Source: Bloomberg

PMIs bounced off their lows indicating a sharp improvement in both the manufacturing and the services sectors.

## What kind of recovery can we expect?

**Since developed countries eased lockdown restrictions, economic data has rebounded strongly. However, it is difficult to assess how the recovery will unfold. Opinions are divided and the truth of the matter is that there is a high degree of uncertainty with respect to the pandemic's evolution and governments' responses.**

Policy reaction to the economic slump has been swift and decisive, and it will be maintained for a long time to come. The timing, scale and coordination has been far greater than in the previous crisis. The G4 central banks will expand their balance sheets collectively by 28% of GDP in this cycle, compared to 7.1% during the global financial crisis. Headline fiscal deficits across the US, eurozone, Japan, UK and China will also widen to a historical high of 16.9% of GDP in 2020, from 5.6% in 2019. More importantly, in the US, fiscal stimulus is flowing directly to households, and about two thirds of the unemployed are receiving benefits that are more than their regular wage income!

### After months of confinement, released pent-up demand gave way to a sharp improvement in economic data

Providing there is no major second wave of infection, April marked the bottom of the recession. After having spent months in confinement, released pent-up demand gave way to a sharp improvement in data, exceeding all expectations. US May unemployment improved from 14.7% to 13.3%, well below the expected 19% as 2.5 million jobs were created, compared to the forecasted loss of 7.5 million jobs. US retail sales doubled expectations, growing 17.4% and, in Europe, PMIs bounced off their lows, indicating a sharp improvement in both the manufacturing and services sectors.

However, once base effects normalise and as some of the current pent-up demand is exhausted, the risk is that the labour market is likely to remain weak, constraining consumer demand. Many sectors that have been hardest hit, such as leisure, gaming and retail, will take a long time to recover due to the safety measures still in place. The International Monetary Fund expects global growth to shrink 4.9% this year, more than the 3% it predicted in April. For 2021, the organisation sees growth of 5.4%, down from 5.8%. The IMF's increased pessimism reflects the larger than anticipated supply shock at the beginning of the lockdown period and the continued hit to demand from social distancing and other safety measures as some countries continue to struggle to control the spread of the virus.

On the positive side, many megatrends that were in place pre-COVID have since gained momentum. Consumers who were forced to stay at home embraced e-commerce, electronic payments, streaming, video games and more video calls. Employees who worked from home helped companies realise the cost cutting potential of teleworking, virtual meetings and reduced office space. Meanwhile, governments made wide use of big data to track the pandemic's evolution. It appears that although several industries have been severely hit, others such as technology, media and e-commerce should come out of the crisis as clear winners. Indeed, many companies have already said that they will increase capital expenditures on tech-driven spaces.

We find it difficult to make projections on the growth trajectory at this stage. A bull case scenario would need a vaccine to be found rapidly, whereas a bear case scenario would be the consequence of a major second wave of infections. However, widespread testing, selective lockdowns and better-equipped hospitals should enable us to avoid a repetition of a global shutdown. Nevertheless, we do believe that the most recent data is somewhat misleading, and we expect a more gradual recovery than this initial phase to prevail.

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

# Fixed Income

## The virtuous circle of fixed income

**The reactivation of the economy has generated a sense of euphoria judging from the recovery of the main leading indicators at the macro level. Without a doubt, the measures being implemented by the central banks and the global economic stimuli are opening the way for a recovery in the fixed income markets.**

The main central banks have come to the rescue like never before, and they are flooding the market with liquidity. Countries are also implementing expansionary fiscal policies to help to mitigate the economic slowdown caused by COVID-19. Furthermore, some macro data have emerged that, driven by the euphoria generated by the reactivation of the economy, are surprisingly positive. This was the case for US unemployment, retail sales in the US and UK and confidence indices. Both manufacturing and services PMIs are recovering quickly, and some countries are even seeing figures above 50, indicating economic expansion. Another example is the financial soundness index, as both the US and Europe are moving away from the area considered to be under stress.

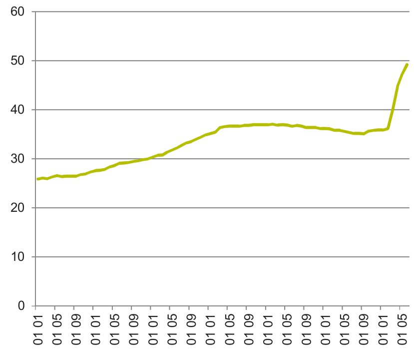
### Expansionary monetary and fiscal policy has had the desired effect: the reduction of the spreads

We are going to contextualise some data that, while extraordinary, will help us to understand why we have seen a recovery on the fixed income market in the second quarter based on low interest rates and a narrowing of the credit spreads. The Federal Reserve will start to buy individual bonds, with a corporate debt purchasing programme amounting to $750 billion. Suppose the volume of the iBoxx USD Domestic Non Financials 1-5y index, which would be the bonds targeted by the programme, reaches $900 billion. Based on the data we have to date, the balance sheet of the G4 central banks is expected to expand to up to 68% of GDP, almost double the percentage shown at 31/12/19. Other catalysts: companies are issuing more bonds than ever, diversifying their sources of funding and with the aim of increasing their cash flow. In both the US and Europe, the figure of 1 trillion has already been reached, marking a new record in this half of the year. In other words, more bonds have been issued in the first six months of this year than in previous full years. The default rate should decrease from the initial March forecasts with the aid that corporations are receiving and the reduction in spreads. In terms of cash flows, we see strong in-flows in credit funds in the US and Europe, with weekly records being set. And it is speculated that, coinciding with the mid-point of the year, the main asset allocators could take profits in equities and move this liquidity towards fixed income. Wells Fargo estimates that the rebalancing could be the largest seen for 6 years.

All these measures are lending support to fixed income and demonstrating the effect known as the virtuous circle: the in-flow of cash makes it possible to reduce interest rates, despite the greater increase in debt, and allows the financial cost to be more bearable, the reduction in spreads reduces the probability of default, volatility falls and the introduction of fixed income assets into investment portfolios reduces the overall risk of those portfolios. Of course, it will not all be one-way and we must be on the look out for potential second-round effects, which the huge liquidity entering the market can cause. For example, inflation could make a violent comeback and erode the value of investment, or so-called zombie companies might emerge that, with expansionary fiscal and monetary policies, could extend their life cycle just through access to easy financing but, with their profits, they would not even cover the financial costs. The way to avoid this, as always, is to achieve effective diversification, efficiently cover the risks and be selective with the names we acquire in our portfolio.

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

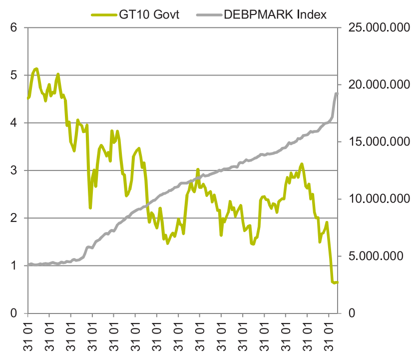
### Evolution balance sheet G4



Source: Bloomberg

The chart shows the evolution in the size of the balance sheet of the 4 main central banks (Fed, ECB, BoJ and BoE), in % of GDP approaching 50%.

### Volume and Yield (Treasury)

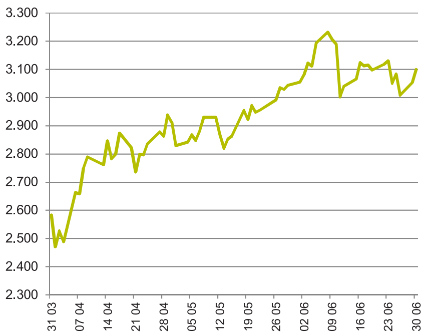



Source: Bloomberg

In the US, the volume of debt issued rose sharply, but the Treasury yield is dropping.

# Equities

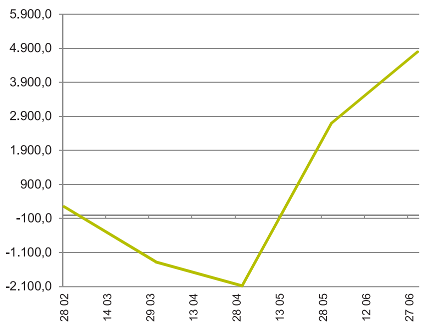
## S&P 500




Source: Bloomberg

It was a a very volatile quarter but the S&P 500 rallied strongly.

## Monthly U.S. Nonfarm Payroll Additions (thousands)




Source: Bloomberg

With the reopening of the US economy, millions of people have been able to return to work.

## The recovery is under threat

**Can the US economic recovery continue at the current pace? The rapid increase in new COVID-19 cases in the US threatens to stifle the recent improvements in the US economy. How this develops will be the key to the equity market over the medium term.**

As of June 30th, US stocks have just posted their best 100-day period in more than 80 years. In March, the economic shutdown caused by the pandemic rocked the equity markets. Since then, completely unprecedented fiscal and monetary stimulus have supported a sharp economic recovery and catalyzed a 21% gain in the S&P 500 during the second quarter. In fact, the S&P 500 managed to claw back most of its losses for the year, ending the second quarter only down 3%.

Of course, the recovery in the S&P 500 wasn't even across all stocks or. The mega cap tech stocks (Alphabet, Amazon, Apple, Facebook, and Microsoft) gained an impressive 35% during the quarter while the rest of the index was up 17%. Across sectors, it's not surprising to see technology and consumer discretionary gain over 30% while the more defensive sectors (consumer staples +9% and utilities +3%) lagged far behind. A positive turn in the economy led investors to shun the more defensive stocks.

> "We are not even thinking about thinking about raising rates", Jerome Powell

Manufacturing PMI, Retail Sales and Employment have all shown remarkable improvements in May and June. Most impressive have been the 7.5 million jobs the economy has added over the prior two months, while unemployment has fallen from 14.7% in April to 11.1% in June.

However, a sharp resurgence in new COVID-19 cases is threatening the economic recovery and may possibly derail the equity market. In early July, the US is now reporting over 50,000 new cases per day as 40 out of 50 states are trending in the wrong direction. This spike is triggering new curfews, stay-at-home-orders, travel restrictions and business closures. Should this continue to intensify, we could see some deterioration in July's economic data points.

Logic would dictate that worsening economic data could shaken the market. Investors would naturally look again to both the Fed and the government to provide further stimulus. Fed Chairman Jerome Powell has made it clear that the Fed stands ready to provide further monetary. He famously said that the Fed is "not even thinking about thinking about raising rates." The Fed has already injected a large dose of QE into the system with its asset purchase program supporting more than $700 billion in Treasuries and mortgage-backed securities. The massive amount of QE has played its part in supporting asset prices and it seems reasonable to assume that the Powell led Fed will continue to do so. What is much less certain is the size and scope of any further fiscal stimulus. The Democrat controlled House and President Trump support another round of direct payments to the people, possibly even exceeding the $1,200 per adult that was distributed amidst the crisis. Unfortunately, the Republican controlled Senate is much less sanguine about it.

If investors cannot count on fiscal support to pull the economy through a resurgence in infections, the market suddenly becomes increasingly vulnerable to any disappointing developments. For the market to move higher from here, potential catalysts could be positive developments for a vaccine, a deceleration in new infections or at least that mortality rates remain low. At a minimum, the market could benefit from signs that the current wave of infections is manageable and the economy does not need to shut down again.

*Charles Castillo*
*Senior Portfolio Manager*

# Commodities and Currencies

COMMODITIES

## Bringing home the copper

Chile and Peru represent 40% of the world's total copper production. As coronavirus has spread, it has hit emerging countries harder, and these two countries are now among the worst affected. The lockdown and halt in production in these two countries has disrupted the copper supply chain (currently more so in Peru than Chile). It may take some time for them to get back to normal as it is difficult to comply with health and safety measures in the production process, and workers are not allowed to return to the mine so they cannot "bring home the copper".

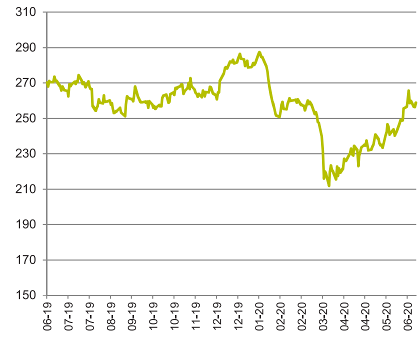
China is the country with the highest demand for copper in the world. In May, metal demand from China for construction and infrastructure exceeded even the most optimistic projections, as the country's demand for copper and steel increased 29% and 7% respectively, compared with the previous year. The Chinese government's stimulus policy was key to this surge. They are facilitating credit, which is encouraging the purchase of property and cars, and the May data were very good for both markets.

The combination of this higher demand and disruptions in the supply chain associated with COVID-19 has caused the copper market to be left with relatively low inventories. In fact, it is estimated that there will be a deficit during the year 2020 and therefore the level of inventories will remain very low.

Since March, the price of copper has risen over 20%, in part reflecting the shortage of this material. If, in the coming months, Chile experiences a similar problem with supply as Peru, and other developed regions like the US and Europe join in with the recovery in demand, the price of coper will inevitably be pushed higher in line with this dynamic.

*Miguel Ángel Rico, CAIA*
*Investment analyst*

### Copper price




Source: Bloomberg

Copper price recovery

CURRENCIES

## Can the dollar ease more from here?

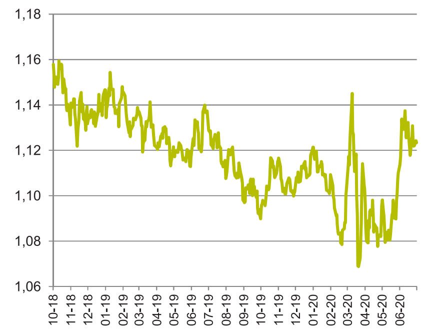
Selling pressure on the dollar gained momentum during the second half of May, reflecting a global rebound in cyclical assets. As economies have reopened, data has recovered from its lows, indicating that the worst is behind us. This broader risk-on mode has pushed the greenback down almost 6% from its March highs.

We have long argued that the dollar is expensive and with official interest rates close to 0%, it no longer finds support from a higher yield. Indeed, its popularity for carry traders who borrow a currency with low interest rates to bet on the higher yielding dollar assets may languish further. There is a strong consensus behind the bearish trend for the dollar as one looks for European assets to outperform given that the region has been more successful in reigning in the virus spread and in reopening its economy. Moreover, the ECB is not considering further rate cuts, which were partly responsible for the weak euro. Instead, it has extended its asset purchase programme.

Nevertheless, the market recovery has been spectacular, and much of the good news is already priced in, leaving little room for setbacks. In the short term, we would not be surprised to see a pause in the dollar's downward trend as markets have got ahead of themselves. During the volatile summer months, the dollar could resume some of its safe-haven status. The proposal for an EU recovery fund boosted the euro by alleviating fiscal concerns across Europe, but is yet to be approved and there is room for disappointment. The Citi economic surprise index has reached historical highs, indicating a possible reversal in the data trend from here. Finally, earnings reports could also give a bit more perspective.

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

### Exchange rate EUR/USD

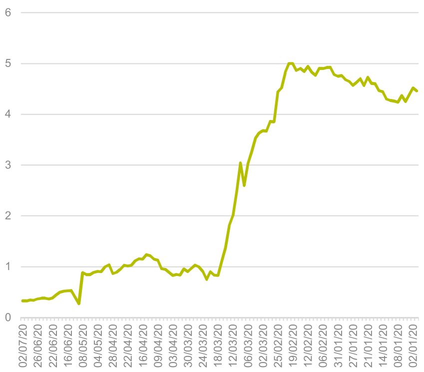



Source: Bloomberg

The dollar has weakened almost 6% since its March highs.

# Latin America

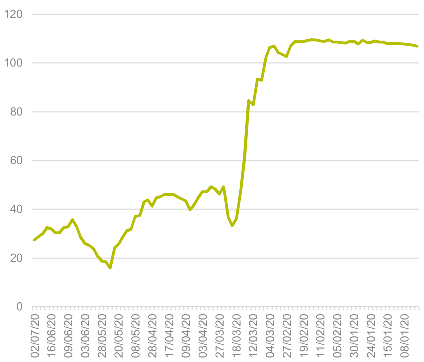
## Avianca share price




Source: Bloomberg

Avianca shares on the US stock exchange (AVHOQ US) have lost 94% of their value since February.

## LATAM Airlines bond with 2024 maturity




Source: Bloomberg

The first maturity of LATAM debt in USD has gone into default, trading at levels below 30 cents on the dollar.

# Getting off the ground again

**Latin American airlines are facing an unprecedented crisis, forcing some of them to file for Chapter 11 of the United States Bankruptcy Code. Unlike in other regions, governments here are providing very little financial support to the airlines.**

Aeroméxico was the latest Latin American airline to initiate the voluntary reorganisation process under Chapter 11 of the United States Bankruptcy Code. While it negotiates with creditors and restructures its capital, the process will allow the company to continue operating.

Avianca did the same thing. The world's second oldest airline and second largest in the region in terms of revenue filed for Chapter 11 in May, a foreseeable development considering the financial difficulties that were already plaguing the company prior to the pandemic. That LATAM Airlines also took this route was more unsettling, as it is the region's largest airline in terms of both passengers and revenue. The company, which was born of the 2015 merger between the Chilean LAN and the Brazilian TAM, closed 2019 with \$1.1 billion in cash and cash equivalents. However, it is true that some solvency ratios, such as a net debt/ EBITDAR of 4x –although better than the airlines mentioned above– were a long way from other companies such as the Panamanian Copa Airlines, with 2x. Burning through cash at the rate of 200 million per month and with virtually no government support, it seems that Chapter 11 was the only alternative available for the survival of the company in the immediate future. This is bearing in mind that airports remain closed across a large part of the south of the continent and, in many cases, governments will not hesitate to indefinitely postpone reopening them if the health situation does not improve. As part of the reorganisation process, some core institutional and private shareholders of LATAM have already committed \$900 million to help the company, which is seeking even greater support in the senior tranches. In the case of LATAM, it will overcome this crisis and continue operating, but the damage to its bondholders has already been done, and it will take some years to recreate value for the shareholder.

The Latin American market has piqued the interest of North American airlines in recent years, due to its enormous growth potential. Delta Airlines acquired 20% of LATAM last year, United Airlines became a shareholder of the Brazilian company Azul as well as planning global deals with Avianca and Copa before the pandemic, and it is speculated that American Airlines was interested in Gol, another Brazilian company. US airlines, meanwhile, have their own problems. However, they will very likely continue to conquer the southern skies as soon as they can.

## The scarce and deficient infrastructure and geographical obstacles mean that flying is the only option in many cases

Intra-regional air traffic in Latin America is even more important than in other regions. The scarce and deficient road and rail infrastructure and geographical obstacles mean that flying is the only option in many cases. It is not possible to drive from Bogota to Cali, or from Rio de Janeiro to the capital Brasilia, if you do not want to lose an entire day or put your safety at risk. With the entry onto the market of the low-cost companies, first in Mexico and then in countries further south, prices finally became affordable for a new middle class that began to contribute heavily to the economy. Incomprehensibly, the high taxes applied to the tickets were holding back this growth, in a service that is no longer strictly luxury.

The aviation crisis has been dealt with in very different ways across the globe. In the US, government aid amounted to almost 25% of the annual operating revenue of the airlines, 15% in Europe and 10% in Asia-Pacific, while in Latin America, it amounted to barely 1%. Latin American governments have other important priorities, such as combating the growing poverty caused by the crisis. Yet, the region needs its airlines more than ever, it needs the competition between them and it needs better fiscal conditions so the industry can fly high once more.

*Juan Gestoso Ruiz*
*Investment analyst*

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