Research
Crèdit Andorrà Financial Group

Fourth quarter 2021
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INDEX

Quarterly Report

Our view on the markets

When the sun shines

Being cautious when everything is endlessly rising is not pleasant, but we think it is a good approach in times of euphoria. Winning less does not hurt the same as losing.

Corporate earnings have surprised all and sundry, beating even the most optimistic of analysts. This is perhaps the point that lends the most solidity to a rise that, especially in the midst of the pandemic, seemed more fragile than it is proving to be. The market downturns, when they happen, last hours. The liquidity injected by central banks, the economic recovery and the lack of attractive alternatives for conservative investors have led to massive inflows to equities, which are amassing double-digit returns.

But the skies are not clear enough for so many investors in their swimwear. Perhaps the biggest storm cloud is the uptick in inflation, which the central banks promise will be temporary. There are not enough semiconductors for everyone (it is estimated that 210 billion sales have been lost due to the failure to satisfy demand for tablets, consoles and cars, among many other things). Container ships are queueing up to load or unload goods at ports that cannot cope, trains are unable to deliver everything required of them on time and the lorry driver shortage is greatly hampering over land transport. The United Kingdom is the greatest example of this, with empty supermarket shelves and refuelling becoming an ordeal for its citizens, to the extent that the army was drafted in to deliver fuel. Meanwhile, commodities are in chaos. Partly due to the push for environmental policies (which we welcome), partly due to myriad of factors all at once. The price of gas has soared, taking the price of electricity with it, even causing severe power outages in China. Coal and oil have followed in the wake of gas. No rain here, no wind there, difficulties to ship certain goods or a factory burns down somewhere, all affecting many other commodities. In addition, labour is very scarce. If wages start to rise, we will see if central banks can keep up with inflation, now at levels not seen for decades in many parts of the world. Norway and New Zealand were the first to give in. The Bank of England will not be far behind. The excess liquidity was one of the supporting pillars of the markets. And the valuations leave no room for surprises.

Being cautious has not been the best business this year. It does not tend to be in times of euphoria. But euphoria is often a poor companion to a good investment. With sufficient hindsight, prices are never the best when buyers have money to spare. Swim and keep your clothes on. Invest – surgically, carefully, selectively. There are always opportunities. Having full current accounts is not the best idea, especially if inflation picks up. Do not believe the doomsayers foretelling Judgment Day. But do not believe those promising eternally sunny skies either. Sometimes it rains. Just as in the middle of a storm we know that sooner or later the sun will shine again, the opposite is also true. It has been too long since a drop has fallen. It is worth taking an umbrella, just in case.

David Macià, CFA
CAAM Investment Director

Strategy

Asset allocation (2021 Q4)

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

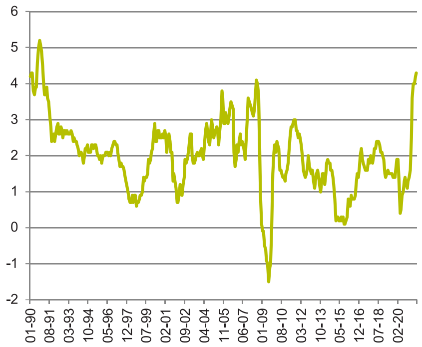
Oil	→
Gold	↑

Currencies

EUR/USD	→
JPY/USD	↑

Macroeconomic View

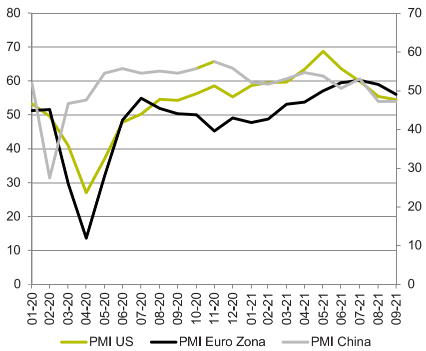
US PCE DEFLATOR YOY



Source: Bloomberg

The personal consumption expenditures price gauge, which the Fed uses for its inflation target, rose 4.3% from a year earlier, the largest annual increase since 1991.

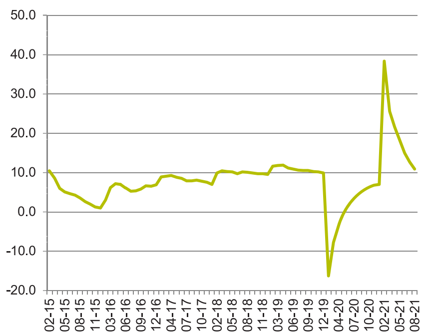
PMI (Purchasing Managers Index)



Source: Bloomberg

PMIs of major developed and emerging countries fell in September, indicating a slowdown in economic activity.

China Completed Investmenet in Real Estate



Source: Bloomberg

China's investment in real estate continued to fall in August

Has global economic growth peaked?

Several indicators show that global economic growth probably peaked during the summer. With the delta variant under control, countries are lifting the remaining restrictions and fully reopening their economies, allowing demand to rebound. However, other clouds seem to be forming on the horizon that could hamper this growth.

September PMIs dropped and fell short of expectations for developed and emerging economies, indicating that we might have seen the peak in activity. The Chinese economy was already slowing due to the modest wave of Covid cases during summer, which resulted in widespread –albeit temporary– mobility restrictions. The country is also constantly in the headlines due to its quest to orchestrate more sustainable growth, address social inequality and control financial and social risks. This new regulatory footprint that it is adopting has taken its toll, especially in the property sector, a key growth driver for China's economy. Construction has slowed partly as a result of policies seeking to limit leverage among developers, curb speculative housing purchases and contain property price inflation. We will see if the People's Bank of China adopts more easing measures, but whatever the case, a slowing China is not good news for the rest of the world.

Inflation is reaching new highs, but central banks and most investors still believe it to be transitory. They do however admit that it will probably stay higher for longer and are closely monitoring its evolution. Indeed, during the last few months, we have seen more examples of supply chain disruptions and the recent rise in electricity, natural gas and coal have added to the pressure. Not forgetting crude oil, which continues to creep higher after its big rise in the first half of the year. The steep rise in energy prices has been driven by a combination of factors: increased demand as economies reopen, a drive towards reduced carbon emissions, less wind in Europe, a drought in Brazil, coupled with Russia turning off the gas taps. Bear in mind that this is happening before the northern hemisphere moves into its winter months of peak demand! As the world transitions to cleaner energy, it becomes more dependent on climate, which probably suggests more volatile and higher energy costs in the future.

Government budgets for 2022 have yet to be submitted, but we must expect some form of fiscal consolidation next year as countries bring pandemic support to an end and seek to bring their growing debts under control. We do believe countries have learnt their lessons and that we should not see a repeat of the 2011/2012 eurozone recession caused by too much fiscal austerity, but that does not counter the fact that fiscal stimulus will be subtracting from aggregate demand growth by next year. Also, major central banks have already announced their intention to begin reducing asset purchases by the end of this year or the next. Although this does not mean that they will no longer be injecting liquidity into the system, it does mean that it will happen at a slower pace.

> We will see what impact the doubling or tripling of consumer fuel bills has on demand during the following months

Hopefully, governments and monetary authorities will be able to manage the future withdrawal of stimuli in the best interest of all parties. Central banks will be walking a tightrope trying to find a balance between keeping inflation under control and not choking off the economic recovery. So, we still expect solid growth going forward as consumers recover a more normal way of life, but we believe we are in the latter part of the cycle.

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

Fixed Income

The gradual withdrawal of the central banks

We are entering a new situation on the market in which one of the main drivers that has underpinned it —the coordinated implementation of an ultra-expansionary monetary policy by the major central banks— is going to be gradually withdrawn.

One of the words having most impact on the markets is “tapering”. What is it about? It is the gradual withdrawal of the economic stimulus measures implemented by the major central banks to respond in times of crisis, such as the 2008 financial crisis, or the more recent COVID-19 pandemic in 2020. However, this does not mean that they will stop purchasing assets in their programmes intended for exactly that. Instead, they will just do so at a slower pace and their balance sheets will continue to grow. This will happen more gradually and depend on the evolution of inflation and confirmation of the economic recovery.

Some recent examples of how the main central banks are moving towards this tapering include the Federal Reserve’s last meeting, at which it acknowledged that the economy was advancing towards the inflation targets and full employment. The Fed pointed to a gradual tapering starting in November and lasting a little over a year. It is also expected that it will raise benchmark rates at some point in 2022.

Greater preference for credit vs duration, for alpha vs beta and for investment decisions based on ESG

We also saw the Bank of England downplay the significance of upturns in inflation and attribute the negative surprises in the latest growth data to global supply problems. We recently learnt that the Bank of Norway hiked its deposit rate to 0.25%, making it the first central bank in the G10 to do so since the start of the pandemic.

Clues to the speed of tapering can be found in the evolution of real interest rates, which are still clearly in negative territory, and inflation, which, with the rise in energy prices, poses a new challenge. Investors seem to share the view of the central banks and analysts that price pressures will be temporary and, in the absence of wage increases, as a second-round effect, inflation should ease off.

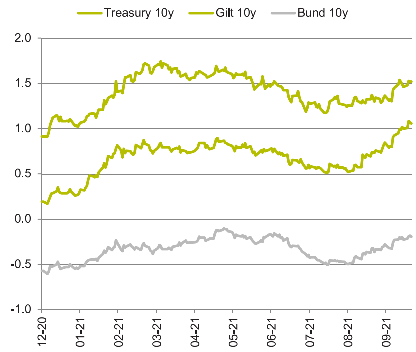
How will this new situation affect the fixed income markets? It must be said that the central banks have been preparing the market with its messages for some time, and the fact that it will be gradual will reduce the impact. In terms of rates, they will most likely rebound to pre-pandemic levels. We would not be surprised to see the 10-year Treasury at around 2% and the Bund close to 0%. The flow effect, with government net issues already positive, is a technical factor that should push them higher.

In the private fixed income segment, the corporate earnings being published and an improvement in credit ratios (with greater increases than decreases), with lower leverage and taking advantage of refinancing at lower rates, continue to be its best assets.

In this context, we would highlight a greater preference for credit vs duration. Episodes like that of Evergrande are a wake-up call, a reminder that credit risk exists and, therefore, the alpha (understood as the fund management team’s skill in selecting investments) should be of greater importance than the beta (defined as the sensitivity of the fund to market movements). The appetite for green bonds continues. The sale of bonds under environmental, social and governance (ESG) labels in 2021 exceeds 25% of total bonds issued, thanks to the push from the public sector. This percentage is expected to increase with the forthcoming new green bond issues from the European Union. ESG investment is being incorporated into the investment process and is expected to outperform conventional bonds. In fact, the “greenium” —as the premium on the ESG vs. conventional bond curve is known— which started out positive, is now negative.

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

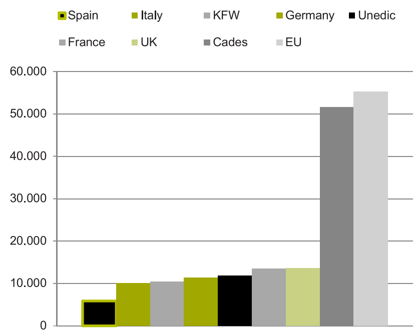
Bond yield



Source: Bloomberg

Government bonds rebound on the back of some central banks committing to gradual tapering.

Main issues of ESG bonds 2021

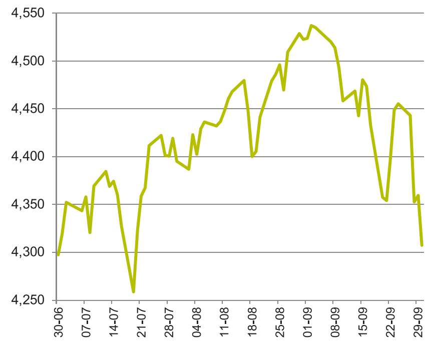


Source: Bloomberg

The appetite for green bonds continues: main ESG bonds sold this year.

Equities

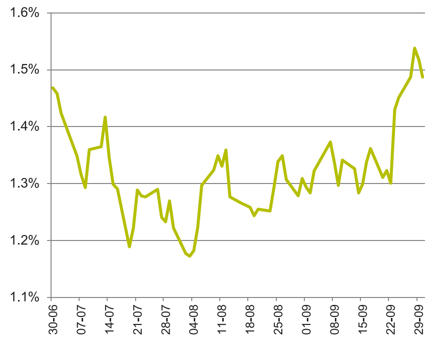
S&P 500 3Q 2021



Source: Bloomberg

The losses in September left the S&P relatively flat for the quarter.

Yield of US 10 year Treasury



Source: Bloomberg

Rates spiked up at the end of the quarter.

Climbing the Wall of Worry

Standing on the cusp of third quarter earnings season, we expect to see plenty of good news concerning demand, but also much talk of problems in China, interest rates, supply constraints, and rising costs. Can investors climb the wall of worry and push the market higher?

September was the worst month for the S&P 500 since March 2020 or basically since Covid brought the global economy to a halt. Since last March, the S&P had soared from a low of 2,237 to a record high of 4,537 in early September before slipping 5% by the end of the month. This left the S&P relatively flat for the third quarter. Now that September is in the rearview mirror, we can focus on third quarter earnings and ignore chatter of the great stock market crashes that occurred in October (1929 & 1987). It should be an exciting earnings season as analysts are projecting S&P 500 companies to report revenue growth of 14.9% and earnings growth of 27.6%. These numbers are well above the historic trend as have the last two quarters also have been. The third quarter numbers have also been on the rise, increasing from where they stood at the end of the second quarter (12.6% and 24.2% respectively).

> "My view is that the substantial further progress test has been met for inflation." -Fed Chair Jerome Powell

The eye-popping growth is a byproduct of a relatively easy comparison against a Covid impacted 2020, but it does also reflect broad economic strength in the US. Ten of the 11 sectors of the S&P 500 are expected to report earnings growth with the lone exception being utilities. Analysts anticipate the energy, materials and industrials sectors to report the strongest growth which speaks to the strength of the economic recovery.

This should be a good set up for the market, but investors do not currently seem to be overly optimistic. The nervousness many investors are experiencing do not seem to be in-line with the potentially earnings season we are approaching. Why is this? Well, a few things come to mind. First is some lingering concern regarding China's regulatory crackdown, potential systemic risk from Evergrande's default and sluggish Chinese economy that could weigh on global economic growth. More importantly is investor expectations that monetary policy is going to be increasingly less dovish and there is a possibility that the Fed may be behind the curve when it comes to inflation (Powell's statements to the contrary notwithstanding). This leads to fear that interest rates could push up abruptly and have an outsized impact on long duration equities. This can particularly affect the broadly popular mega cap technology stocks which had already been particularly punished during September. There remains little faith that the US Congress can reach any bipartisan compromise and advance either of the proposed infrastructure bills. Finally, there are concerns that profit margins will be pressured by the supply chain constraints.

If companies can point to a continuation of strong demand and an ability to pass on higher costs to their customers, investors should be appeased and most of the aforementioned issues will be forgiven, although likely not completely forgotten.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Fifty years ago

We have said time and time again in these pages that the price of commodities is a faithful reflection of the law of supply and demand. It is true that we are flooded with headlines about factors that could impact commodities prices, but in reality, what ultimately matters is the available supply and demand for commodities.

This explains why the price of gas is rising in a straight line (reduced supply), or why oil prices went negative —yes, negative!— last year when half the world was on lockdown (no demand).

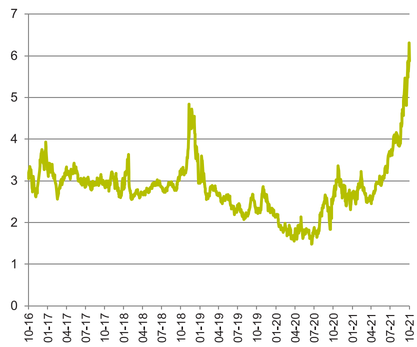
In addition, on these markets, price sensitivity to small fluctuations in supply and demand is huge.

The reduction in investment in fossil fuel provision, partly as a result of policies to mitigate climate change, has acted as a drag on supply. At the same time, demand has increased as economies are reopening following the pandemic. Therefore, global energy markets are believed to be operating with limited reserves.

So, could we see a repeat of an episode in the 1970s when energy prices quadrupled, leading to runaway inflation? The situation is likely to ease in the coming weeks. Granted, in the medium term, some markets globally will be tighter compared to recent years. But the current situation is nothing like it was fifty years ago. Developed countries are about one third as energy intensive as they were in the early 1970s. Plus, there are now alternative sources of energy, including nuclear power and renewables, and producing countries can increase supply more easily nowadays. However, in this process, there is always room for a scare along the way that makes the front page.

Miguel Ángel Rico, CAIA
Investment analyst

Natural Gas



Source: Bloomberg

Vertical rise in natural gas.

CURRENCIES

Conviction still lacking

The Eurodollar has been trading in a tight range since the beginning of the year. During the summer, the dollar appreciated towards the lower band as investors trimmed bets against the currency, expecting a hawkish surprise from the Fed. Going forward, the pros and cons for a stronger dollar seem to be more balanced.

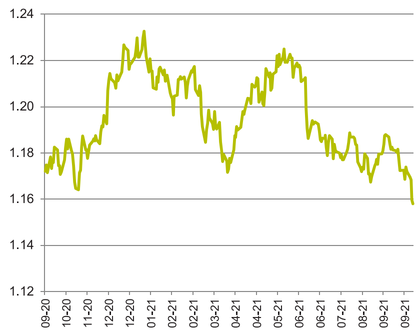
As expected, the Fed announced that if economic data continued to show good progress, it would start to cut back on asset purchases at the end of this year and half of the central bank's members forecasted a rise in official rates by the end of 2022. The Fed has not been the front-runner in this change of stance. Many other central banks have turned hawkish, such as the Royal Bank of New Zealand, the Royal Bank of Canada or the Bank of England, and Norway has already hiked interest rates. This all puts the dollar's strength into perspective. Although monetary authorities insist that the sharp rise in inflation is temporary, they will be closely monitoring its evolution. From this perspective, the ECB seems to have more leeway to stay dovish. Although inflation has increased in the eurozone, it is still at far lower levels. But this differential in policy stance seems to be already priced in.

In favour of the greenback is the confirmation that global growth is losing momentum, but it remains at high levels, and Europe continues to attract investor flows. In this sense, although they probably have peaked, the high level of the US twin deficits also continues to point to a weaker dollar.

To see a higher dollar, you would have to believe the Fed needs to do more –if inflation becomes more structural– or that global growth is slowing faster than expected. We are not there yet!

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

Exchange rate EUR/USD

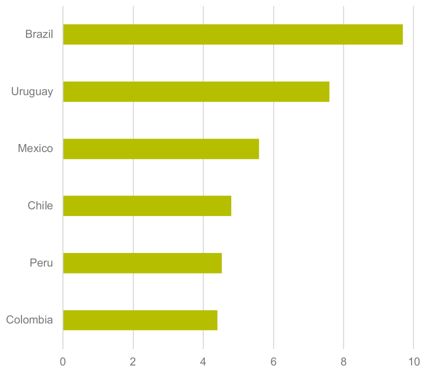


Source: Bloomberg

The dollar has appreciated towards the lower band of its trading range as investors trimmed bets against the currency.

Latin America

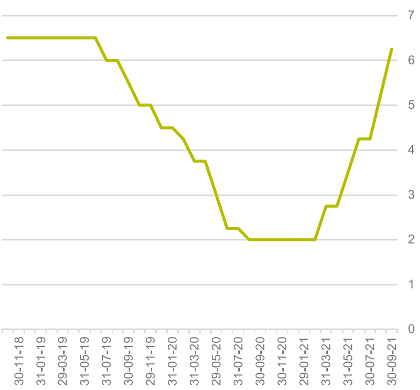
Year-on-year inflation rates, August 2021



Source: Bloomberg

The main countries in the region are seeing inflation rates above their target ranges.

Brazil benchmark interest rate



Source: Bloomberg

The Central Bank of Brazil has increased the benchmark rate to 6.25%, just 25 basis points below its pre-pandemic level.

Monetary dilemma

The central banks have hardened their monetary policy to combat rising inflation in the region

Inflation continues to rise in Latin America. The most obvious cause is the increase in the price of commodities. The reopening of economies, combined with expansionary monetary and fiscal policies from central banks and governments, have led to an environment of sharply growing demand, to the extent that supply —more inflexible and neglected for months— is now unable to keep up. Sporadic lockdowns in much of Latin America have dealt a blow to an already ailing supply chain.

> The central banks are occasionally forced to take hasty decisions to calm the social unrest

The more volatile elements in the inflation calculation are often excluded in order to gain a more stable picture of inflation. We are talking about energy and food, components that are more difficult to separate in the emerging countries, where the cost of raw materials in terms of the added value of goods and services is much higher than in developed countries. Rising oil prices do not only hit the consumers' pockets at the petrol pumps, but also indirectly by increasing the production costs of countless products. Meanwhile, the weight of foodstuffs in countries such as Brazil accounts for around 25% of the consumer price basket. As if all this were not enough, a number of countries in the region, such as Mexico and Brazil, have suffered droughts this year, impacting agricultural and livestock production and putting upward pressure on food prices.

Most countries are seeing inflation levels above their target ranges. In Mexico, the year-on-year inflation rate reached 5.59% in August. Peru saw how prices rose 4.53% in the last 12 months. Colombia also exceeded the Bank of the Republic's target range of 4%, seeing an increase of 4.4%, while Chile's rate was 4.8% in the eighth month of the year. Brazil, the region's leading economy, saw price increases of 9.68% in August.

The central banks of the region raced to lower interest rates to combat the effects of the pandemic on economies, but the recent inflation levels have forced them to at least straighten out the monetary steering wheel. In Mexico, the official rate has risen to 4.75% from 4%. Peru has also seen a cumulative increase of 75 basis points, leaving the rate at 1% in September. Readers will not be surprised that the Central Bank of Brazil has been the most aggressive in recent months, taking the benchmark rate to 6.25% from a low of 2% during the pandemic and almost reaching pre-pandemic levels of 6.50%. Chile raised the rate by 100 basis points and Colombia's Bank of the Republic was the last to act, finally adding 25 basis points to reach 2%.

However, the central banks are facing some obstacles in the way of moderating inflation beyond the rate hikes. The size of the informal economy, with low levels of lending and where much population do not even have a bank account is an example of a situation not easily addressed by the monetary authorities. Furthermore, the central banks are occasionally forced to take hasty decisions to calm the social unrest caused by rising prices. These countries are therefore facing a significant monetary dilemma (once again), considering that the economies still have a long way to go to recover pre-pandemic GDP levels.

Juan Gestoso Ruiz
Investment analyst

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Research

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