First quarter 2020
Date of report: December 31st 2019

INDEX

Quarterly Report

Our view on the markets

Stories

Much of what takes place on the markets will depend on the story we tell ourselves as investors. The one that has driven us during the last decade seems to have come to an end.

Humans are probably the dominant species on the planet thanks to our ability to tell ourselves (and believe) stories. Because of this, we are the only animal capable of collaborating with each other the way we do. Ants and bees work together by the thousands but on very limited tasks, while chimpanzees and wolves are capable of great flexibility but in very small groups. Thanks to rather intangible concepts like religion and money, we coordinate ourselves in extraordinarily complex ways. The idea (from one of the most illustrious thinkers in history, in my opinion, Yuval Noah Harari) that something we imagine together defines us as a species can also be applied to the financial markets.

As investors, we tend to tell ourselves stories frequently, and to believe them even when they elude common sense. We are social beings and, as such, we seek acceptance from our peers. If everyone is paying astronomical multiples for technology companies, it doesn't occur to us to do otherwise. The few that do so are vilified by the pack. For instance, Warren Buffet was written off as an investor for refusing to participate in the tech bubble of the late 90s.

We must embrace this in order to invest well. It is just as important to correctly diagnose reality as the market's perception of that reality. We must try to understand what story the market is telling itself and when it becomes unsustainable and mutates into something new. We think something like this might be happening now. Over the last decade, we have become used to central banks' endless interventions, low inflation and profoundly low rates. The market seems convinced that the effects of this potion will last until the end of time, and this can only lead to more increases in financial assets. We believe that the start of the new decade will force us to rethink the current narrative. If history serves as a precedent (believe me, this is always the case sooner or later), we should note that every time excessive debt has combined with fiat money, i.e. money not backed by any real asset, inflation rears its head. Zero or negative rates are neither natural nor sustainable, and the central banks have exhausted most of the tricks up their sleeves for grabbing the attention of the markets. When we have a new crisis, the solution must be a fiscal one. This tendency to spend what one does not have is also accentuated by the growth of populism across the world. These fiscal excesses must be monetised, as well; there is no other politically acceptable solution.

In this environment, real assets are the best way to protect our savings. Allow me to make two special mentions here. Equities may suffer in the mid-term when the economy falters or another temporary crisis arises, but it should then be bought intensively because it is the asset that protects our savings from inflation the best. Nor should we forget to have gold in our portfolios. Firstly, this is because it is one of the few assets that will truly serve to diversify the portfolios when curves come – this role used to be held by fixed income and we find it hard to understand that it may continue to be useful with the current levels. And above all, because in most scenarios that we are able to imagine, it ends up working very well.

David Macià, CFA
Chief Investment Officer

Strategy

Asset allocation (2020 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

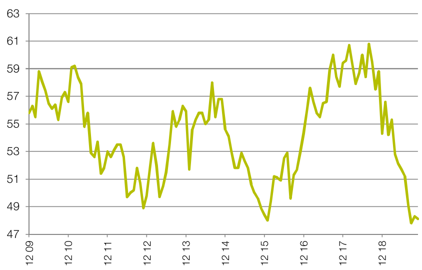
Oil	→
Gold	↑

Currencies

EUR/USD	↑
JPY/USD	↑

Macroeconomic View

ISM Manufacturing



Source: Bloomberg

The manufacturing sector in the US seems to have bottomed out with the ISM manufacturing having reached the 2016 lows.

US Unemployment rate

Source: Bloomberg

The US CPI rate remains muted at 2.1% in November.

Eurozone Composite PMI

Source: Bloomberg

The eurozone composite PMI holds above 50, still indicating expansion.

Global growth should recover in 2020

In 2019, the global trade war led to a massive uncertainty shock, which took its toll on growth and brought on a massive dovish shift in monetary policies. The outlook seems brighter now that the US and China are set to sign a preliminary trade agreement and we believe global growth will accelerate in 2020.

Beyond the direct negative impact of tariffs, the global trade war weighed on business confidence and caused a sharp contraction in the manufacturing sector. The slowdown was exacerbated by a downcycle in the auto industry as demand in China was affected by an increase in taxes and a change in regulation and a ban on diesel took its toll on German production. However, fears of a recession were overdone. Countries most exposed to trade and the manufacturing sector, such as Germany, were the hardest hit but those more reliant on domestic demand, such as the US, ended 2019 with only a modest decline in their GDP growth rate. In most countries, the spillover into the service sector was minimal as domestic consumption remained strong.

Recent economic indicators confirm that the manufacturing sector is bottoming out and that the slowdown is easing

For most, fears of a recession have completely dissipated but the sheer longevity of the present cycle continues to worry some bears. Indeed, the current cycle is just shy of becoming the longest uninterrupted expansion since 1860. Long cycles can lead to excesses followed by a crash. Asset valuations are usually at extreme levels when this happens, and the consequent market corrections further tighten financial conditions and create a negative feedback loop between the economy and markets. We do not deny that there are risks; debt levels are high and central banks' leeway is reduced, but these factors by themselves are not enough to set off a recession. Typically, recessions will occur following a period of restrictive monetary policy, which is implemented in response to the economy overheating and inflation pressures rising. For the moment, inflation continues to be muted even though the preconditions for a pick-up are in place given the strength in the labor market. In the US, inflation stood at 2.1% at its last reading. Finally, at worst, central banks will be on hold in 2020.

The initial trade agreement between China and the US restores some level of confidence, which should help lift investment activity. The lagged effect of synchronized monetary easing should also offset some of the weakness. That recent economic indicators suggest the global slowdown is easing supports this view. PMIs in Japan, the euro area and the US confirm that global manufacturing is bottoming out. Nevertheless, growth indicators in the eurozone will probably only improve moderately during the following months as stronger growth may require additional stimulus. As mentioned above, developed central banks are near the limits of their policy space, which is why there has been a great push for fiscal policy to take the lead in trying to boost the economy. However, concrete signs of fiscal aid have been modest to say the least. Countries that have the most leeway are reluctant to use it, as is the case in Germany, and we would probably need to see a worsening of the economic situation before seeing any sizeable fiscal stimulus.

Our base case scenario, therefore, points only to a modest economic recovery in 2020 and it is conditional on an agreement being reached between China and the US. The trade war will probably continue to be a lingering concern as a full-blown agreement will undoubtedly have its ups and downs, especially as we approach the November elections. If tensions were to reemerge, business confidence would take another blow and activity would be damaged yet again.

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

Fixed Income

The Year of Monetary Non-Normalisation

2019 was the year of monetary normalisation by the central banks. Political uncertainty (US-China trade war and Brexit) made them change course with the application of new expansionary monetary policies intended to support growth.

At the end of last year, central banks were preparing to begin the process of monetary normalisation in 2019, but political uncertainty with the US-China trade war caused concern about growth and forced the main central banks to take a step back and consider more expansionary monetary policies. As a result, the world's largest central banks (US, China, Japan and the Euro Zone) have increased their balance sheets. The Federal Reserve lowered its interest rate from 2.5% to 1.75% and it increased its balance sheet to manage the liquidity problems it faced on the repo market. In September, the European Central Bank announced a 10-basis point reduction to the deposit rate and the restart of QE for as long as it deemed necessary, with 20 billion euros per month of net asset purchases.

A scenario in which central banks inject liquidity coincides with the easing of trade uncertainties

Everything suggests 2020 will be a year marked by the continuation of the economic slowdown in the main economies, although it seems unlikely that we will fall into a global recession. For the first time in many quarters, a scenario in which the central banks will continue injecting liquidity into the market will coincide with an easing of the trade uncertainties that have plagued the year, following the approval of the phase-one trade agreement between the US and China and Boris Johnson's clear victory in the UK election, which points to an ordered Brexit.

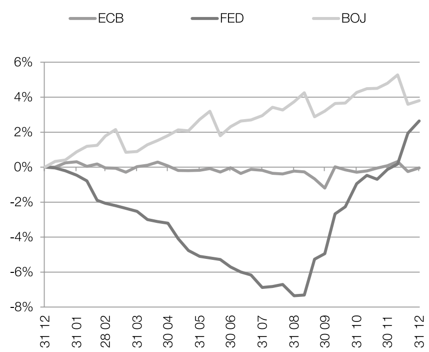
Thus, the main central banks have already announced that they will continue to run on automatic pilot during 2020. Without a doubt, this offers the best news and support to fixed income. However, in order to adapt our strategies if necessary, we must remain alert to the potential risks:

- New protectionist threats that may arise, particularly in Europe, and we will have to see what the phase-two negotiation between the US and China brings as it concerns the bulk of the issue with key points to be agreed such as intellectual property.
- The central banks have demonstrated the speed with which they can change course and a shift in stance would have a significant impact because of their great influence on the markets.
- Europe may take longer than expected to offer the fiscal stimulus demanded by the new ECB President, Christine Lagarde.
- Risk that there may be signs of inflation, which would cause long-term interest rates to rise even if the central banks did not increase their reference rates.
- The credit spreads are low, bolstered by a "low forever" scenario, which means investors are investing in lower investment grade bonds in their search for yield. The risk is increasingly asymmetrical as the high prices of fixed income assets mean there is less room to run on the upside and greater potential downside.
- The emerging markets tend to benefit from greater liquidity, low rates in the US and a weak dollar. If, in the end, we do not see the expected weakness in the dollar, this type of assets would be affected.
- US presidential election.

We are optimistic about the beginning of 2020 given the prospect of support from the central banks that continue to inject liquidity and the easing of the uncertainties that have defined 2019. The analysis and selection of issuers, diversification and active adaptation to the potential risks that are always on the horizon will be our best companions along the road in 2020.

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

Balance sheets of the main central banks

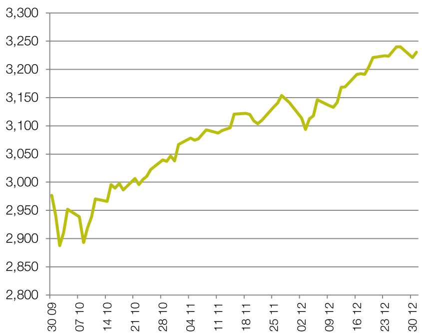


Source: Bloomberg

The balance sheet of the main central banks has continued to increase

Equities

S&P 500



Source: Bloomberg

After a robust 4Q19, can a favourable monetary policy sustain equities in 2020?

Yield of the US 10-year Treasury

Source: University of Michigan

The US consumer represents 70% of the economy and feels quite confident about 2020.

Easy $$$ to keep equities afloat

The equity markets collapsed at the end of 2018 driven by fear that the Fed was pushing the US economy into a recession. The market rallied strongly in 2019 as fear of the Fed proved to be unfounded. We still face many potential pitfalls in 2020, but accommodative monetary policy remains a potent elixir for the market.

It was a spectacular year for the equity markets with the S&P 500 advancing to historic highs in 2019. This happened in spite of numerous bearish narratives, including the US/Chinese trade war, an inverted yield curve, a corporate earnings recession, the impeachment of President Trump, and heightened political noise from leftist US Presidential candidates.

These same bearish concerns are expected to continue into 2020 and let's not forget that President Trump kicked off the year with a major provocative move against Iran that is escalating tensions across the Middle East. Yet the same factor that helped drive the markets higher in 2019, is also expected to persist in 2020. Monetary policy is expected to remain accommodative with the Fed likely on hold with its key interest rate while it aggressively expands its balance sheet. If we include the Bank of Japan and the ECB together with the Fed, these 3 central banks are growing their balance sheets by a combined $100 billion per month! Needless to say, the markets are awash in cash looking for a home and with interest rates this low, equities continue to look attractive relative to bonds.

These 3 central banks (FED, ECB, BOJ) are growing their balance sheets by a combined $100 billion per month!

The consensus amongst economists is that the US economy will slow in 2020. While we are not disputing that, the outlook is not as bleak as the headlines would imply. It is worth remembering that monetary stimulus acts with a lag of several months, boding well for 2020. The US consumer, the true heart of the economy, remains strong. Unemployment is a meager 3.5% and hourly wages showed some positive momentum in the second half of 2019. Meanwhile, inflation remains tame, giving the Fed the fig leaf it needs to keep supporting economic expansion.

That is not to say 2020 will be an easy year with low volatility for the equity markets. Right now, corporate confidence is likely starting to rebound as the US and China have agreed to a 'phase one' trade deal. However, negotiations over the much more problematic issues were postponed until the two sides begin talks over a 'phase two' deal. It would be naive to expect the two sides can easily come to terms over issues such as IP theft and structural reforms in China. Additionally, the 2020 US Presidential election promises to deliver plenty of heart burn to investors. A White House and Congress united under the banner of the Democrat Party would not only repeal Trump's tax cuts, but likely implements new ones (such as a wealth tax). In that nightmare of a scenario, it would not be surprising to see the market pull back 20% or even 30%. Fortunately, we see that outcome as a low probability, but one that will have investors nervously looking at polling data from now until November. Another less than optimal scenario would be the Democrats taking the White House with a far left candidate, but Republicans holding on to the Senate. Although the tax cuts would be safe, the President would likely disrupt the energy and health sectors, over-regulate the banks and attempt to break up some of the mega cap tech companies (Facebook, Alphabet, Apple). Luckily, our base case is that Trump or a moderate Democrat is the winner.

Although, it will likely be a bumpy ride, we see a supportive Fed helping the US equity market move moderately higher in 2020.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Batteries and Minerals

Whenever a trend is disruptive, it brings about radical changes. In the blink of an eye, the outlook and the expectations we once had can change completely.

The world of batteries is adapting quickly to global needs. Electric cars are being billed as the greener future of transport.

IBM has announced that it has created a battery that does not use cobalt or lithium, but that is instead based on new materials extracted from seawater. Thanks to this change in design, IBM's battery could be lighter, less flammable and much cheaper to manufacture. The battery's commercial development is backed by Daimler.

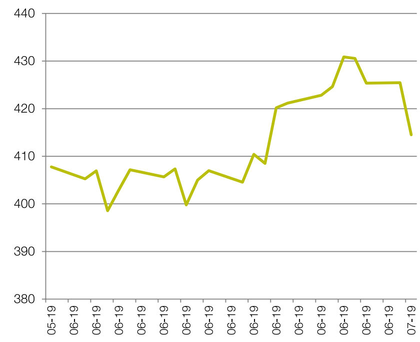
Cobalt, found mainly in the Democratic Republic of the Congo, is now starting to be in short supply. But, you see, such discoveries can eliminate problems like this in one fell swoop.

It might be tempting to speculate about the price of the various materials used for vehicle batteries, but the reality is that in such a changeable environment, it may be a very risky investment to bet on any of these materials or the companies that produce them.

On the other hand, we will always have gold. Rather than speculating on whether it will be used in any industrial processes, we can rest assured that, thanks to an age-old cultural tradition, demand for gold is guaranteed. This demand will grow more or less depending on the moment, but it is safe.

Miguel Ángel Rico, CAIA
Investment analyst

Oil price



Source: Bloomberg

The largest daily increase in oil in the last 30 years.

CURRENCIES

The euro should gain as growth recovers

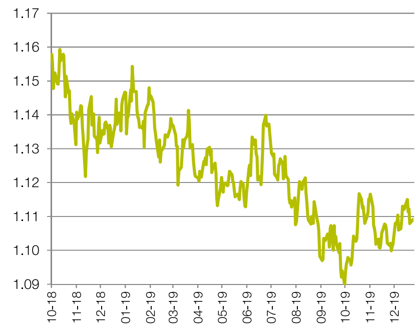
In 2019, the dollar continued to strengthen as trade tensions weighed more on export-oriented economies and less on consumer-led economies such as the United States, which was also benefitting from the lagged effects of the fiscal stimulus. The greenback also benefitted from the higher interest rate. If we are correct in our assessment of a global economic rebound, the euro should strengthen in 2020 as the trade war fades, an orderly Brexit is carried out and monetary policies continue to be supportive. This more benign backdrop should reassure investors and flows should return to the eurozone, further supporting the currency.

That is not to say that this call is without risks. Recovery in 2020 remains a delicate balancing act and it is very much dependent on the dissipation of trade tensions. We are not expecting a significant move in the exchange rate, as this would require a V-shaped recovery, and the euro's upside may also be dampened by its use as a funding currency due to its low yields. Indeed, investors can borrow in euros and then invest the proceeds in higher-yielding assets denominated in other currencies. The cross rate will also be impacted by the news flow on the US elections, depending on who the candidates are, their policies and their ability to implement them.

In the context of these uncertainties, we continue to believe that it is important to balance your portfolio and incorporate hedges that can help protect the global return of your portfolio. The yen is one of the few assets that serves as a hedge when things turn south. Therefore, we would take advantage of any weakness, should the risk-on mode continue in the beginning of 2020, to build positions in the Nippon currency.

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

Exchange rate EUR/USD

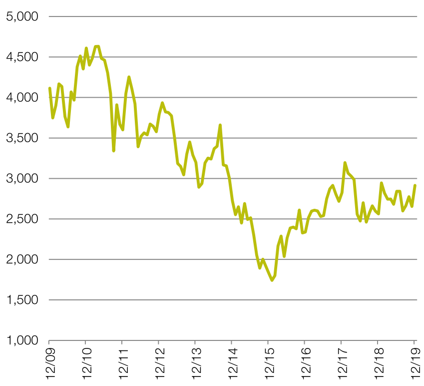


Source: Bloomberg

In 2019 the euro seems to have bottomed and should appreciate as growth recovers in 2020.

Latin America

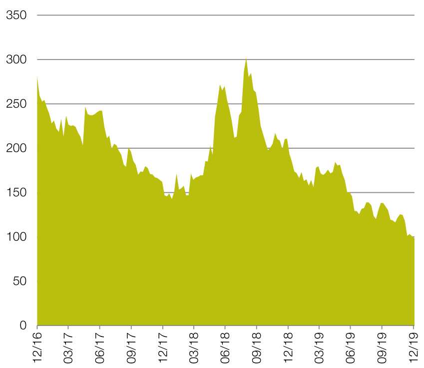
Latin America MSCI Index



Source: Bloomberg

The Latin America MSCI index has had a total negative return in the last 10 years, below the rest of the emerging markets.

Brazil 5-year CDS



Source: Bloomberg

Brazil's 5-year CDS (credit default swap) has dropped below 100 bp for the first time since 2010.

Low growth and social instability

Latin America has seen growth expectations for 2020 revised downwards, amid a climate of discontent reflected in major protests up and down the region.

In 2011, the president of the Inter-American Development Bank, Luis Alberto Moreno, published "The Decade of Latin America and the Caribbean: A Real Opportunity". This well-meaning report presented a number of reasons why the ten years that have just ended would mark the definitive breakthrough of the region on an economic, social and institutional level. The region got off to an encouraging start with 5.9% growth in 2010. But the joy was short-lived. From 2013, average growth barely reached 0.8%, although there were significant differences between the countries. One common denominator is the fact that social inequality has hardly declined, with a disappointing increase in the middle class and a poverty rate of 31% according to the UN, very close to the 2010 level. The social unrest has manifested itself in recent months in the form of serious protests in many of the countries in the region, including Ecuador, Colombia, Argentina, Nicaragua and Chile. Indeed, Chile is the most striking case, if we consider that the Andean country has been the continent's leader in terms of economic growth and it has acted as a mirror through which many countries have examined themselves in recent years. While this is not another "lost decade" like the 1980s, Mr Moreno was too optimistic.

Our outlooks for the main countries in the region are varied for the year to come. Starting with Brazil, the region's giant is our favourite. Following the pension reforms, the fiscal and institutional reforms are showing progress and they are stimulating investor appetite. The measures taken by the government have reduced the fiscal deficit to 5.7% of GDP. The central bank cut the Selic rate by 50 bp to 4.5%. All this has served to revitalise and stimulate an economy that had stagnated. Brazil's CDS (credit default swap) fell below 100 bp, demonstrating the confidence of investors in the progress of the country's economy.

In Mexico, despite the less combative tone from President López Obrador, the doubts surrounding his mandate still outnumber the certainties. The IMF forecasts growth for the country of 1.3% in 2020, inflation has slowed and economic activity remains weak. This has led the Bank of Mexico to continue with its expansionary policy which translates into greater cuts to the reference rate, currently at 7.25% with a total reduction of 100 bp in 2019.

Central banks have joined the global trend of monetary expansion

In Chile, although the economy is underpinned by solid institutions, the protests have made a dent in all areas: the Chilean peso is heavily devalued and the economic activity index fell by 3.4% year-on-year in October while the November index is expected to have fallen between 6% and 7%. Both industrial production and consumption are being strongly affected and, as a result, we are underweight in Chile.

Similarly, we do not find Colombia attractive with its current social and institutional instability. The currency rallied in December after reaching all-time lows of 3,500 pesos to the dollar. We maintain a neutral position in Peru, awaiting the general elections that will take place on 26 January, while the negative outlook on Argentina remains unchanged, with almost all economic indicators showing contraction.

Latin America faces substantial challenges in the years to come. Not only is there the need to transform the production model towards greater openness, diversification and innovation in order to enhance productivity, but this must take place with the support of an increasingly impatient society with a political class that has failed to live up to the task on many occasions.

Juan Gestoso Ruiz
Investment analyst

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Research

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