First quarter 2019
Date of report: December 31st 2018

Quarterly Report

Our View on the Markets

INDEX

Rollercoasters

We are expecting a volatile year on the financial markets, but the current pessimism appears extreme.

One of the best investors of the last century once said, “do not trust those who claim to have found the truth, but those who continue to seek it”. Allow us, then, to try to understand our current context before speculating on what 2019 might bring us. So kindly accompany me back in time to half a century ago... 1971: Richard Nixon abandons the gold standard. In practice, this means clearing the path for the Federal Reserve, which until this time had to tread very carefully (because otherwise it risked emptying Fort Knox). Additionally, the dollar begins a long decent. For commodities producers that bill in dollars, this is not good news at all. This perhaps contributed, two years later, to OPEC’s decision to initiate an embargo on sales to the West in retaliation for the Yom Kippur war between Egypt and Israel, which caused the price of oil to skyrocket. It was not until the early 1980s that the high inflation caused by this situation was finally curbed, when Volcker increased interest rates to 20%.

The anecdote above serves to illustrate two critical points to stand us in good stead for 2019. The first is that since that time - now almost forty years ago - interest rates have only moved in one direction: downwards. In other words, it has been forty years since the prices of bonds and notes have gone up. To build a robust investment portfolio, capable of resisting complicated market environments, it is necessary to be very aware of the fact that one of the traditional diversifying tools - fixed income - is of little to no use. Secondly, it is helpful to put into perspective to what extent the financial markets have been affected by the influence of central banks, which have been hyperactive and omnipresent since the Lehman Brothers collapse ten years ago. Now that the central banks are taking a step back, albeit a very timid one, it is as though the car we are driving has suddenly had its shock absorbers removed. The slightest bump in the road causes a disproportionate jolt. Everything goes up and down at once. 2018 was a good example of this. Never, in the last 20 years, have so many assets closed in the red. In fact, if we had to settle on just one prediction for 2019, it would be that volatility is here to stay.

As for bumps in the road, there are many and more to come, but this is where we need to inject a little optimism. It appears quite unlikely that any of the scenarios currently terrifying investors will come to a bad end. It is far more likely than not that there will be no “quick and dirty” Brexit and that Trump will reach a trade agreement with China. Furthermore, although there is an economic slowdown, a recession is not in sight. Yet in spite of this, the markets have just about fallen from record highs to multi-year lows, which is what usually happens when there is a recession. There is no better opportunity to buy for patient investors than when pessimism reigns. The downside, unfortunately, is that we must come to terms with much volatility. It is invariably the case that the “smoothest” investments either only appear to be so or they simply offer no yield. In 2019, everything seems to suggest that the markets will continue their rollercoaster ride. There are to be ups and downs, and even occasional upside-downs, but in the end, we will always come back down to earth, safe and sound. It is impossible to know if there are more twists and turns to come, but what is certain is that it is much better to join in after a downturn.

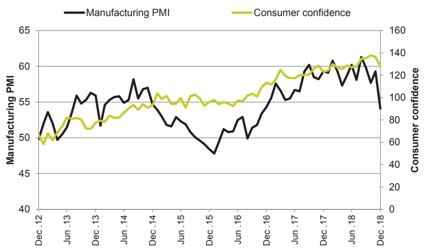
David Macià, CFA
Chief Investment Officer

Strategy

Asset allocation (2018 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

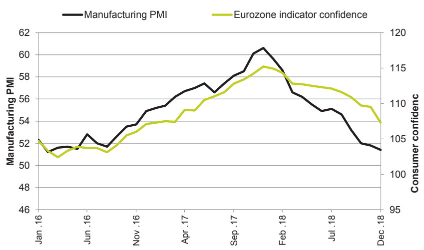
Manufacturing PMI and consumer confidence index for the US



Source: Bloomberg

The manufacturing PMI and consumer confidence index remain very high.

Manufacturing PMI and confidence index for the Eurozone



Source: Bloomberg

Although indicators have fallen away from the historical highs, they continue to suggest the continuation of the economic cycle.

Growth in the main countries and regions (%)

	2016	2017	2018	2019	2020
World	3.3	3.7	3.7	3.5	3.3
Regions					
Africa	0	1.6	2.8	3.4	3.7
Asia exc. Japan	6.1	6.2	6	5.7	5.6
Developed economies	1.7	2.4	2.3	2.1	1.8
Emerging countries	4.4	4.9	5	4.9	5
Eurozone	1.9	2.4	1.9	1.6	1.5
Countries					
US	1.6	2.2	2.9	2.6	1.9
Japan	0.6	1.9	0.9	0.9	0.6
Germany	2.2	2.2	1.6	1.6	1.5

Source: Bloomberg

Emerging countries will lead global growth in 2019 with expected growth of 4.9%.

The major challenges for 2019

Last year ended with a feeling of intense pessimism among investors. Uncertainty regarding trade between the US and China, political challenges in Europe and a more hawkish monetary policy from the central banks suggest lower economic growth on a global scale. So, what will 2019 bring us?

While we do not have a crystal ball to predict what will happen to the various financial assets in 2019, consensus expects global economic growth to be at 3.5%, compared with 3.7% in 2018.

To take a closer look at the data on a regional level, leading indicators and confidence indices in Europe continue to show deterioration from the historical highs reached at the beginning of 2018. However, they are still suggesting a continuation of the expansion cycle. Growth estimates for the Eurozone have been revised downwards and the region is expected to grow 1.6%, compared to the 2018 figure of 1.9%, even though there is still above-potential growth in the long-term. Political risks continue to generate uncertainty. Italy, the European Union's third economy, caused much instability in 2018 due to disputes with the European Commission. However, the country eventually lowered its target budget deficit for 2019 to 2.04% from the 2.4% initially proposed. In the coming days, the British Parliament will decide whether to approve or reject the deal reached between Theresa May and the European Union. Beyond Brexit, the European authorities will face other challenges in 2019, such as the decisive European Parliament elections in May and the European Commission elections in October. And let us not forget that Draghi's mandate ends in October and he has announced that the reinvestment of maturities will continue for some time following the first rate hike, which is expected after the summer. And finally, inflation remains below the ECB target at less than 2%.

In the US, it is unlikely that growth will remain at the level of 2018, but the pace of potential growth will stay high and it is expected to grow 2.6% in 2019. Private consumption, around 70% of US GDP, will continue to underpin the solid pace of growth, and leading (PMI) and consumer confidence indicators are still very high. The Fed is maintaining its positive outlook on the economy and monetary policy normalisation persists, with underlying inflation at 1.8%, in line with the long-term target. Regarding the trade war, the beginning of negotiations between the US and China is cause for some optimism and threats of further tariff increases have been called off until the end of the negotiation deadline, in March 2019.

Risk factors remain high, but arguments of an impending recession are weak

After being weakened by a stronger dollar and rate hikes from the Fed during a complicated year, emerging markets are expected to see higher growth rates than developed economies this year, as the IMF estimates 4.9% compared with 2.1%. The region's need for foreign financing, although still a reality, is more manageable than it once was. However, some countries, like Argentina and Turkey, are still in a delicate position and are suffering from structural difficulties. We must be selective when opting for these countries, as there are significant difference between them.

The risk of a recession appears to be low in 2019. In brief, global growth remains quite strong, financial conditions are broadly dovish - although we expect monetary policy to tighten somewhat - and inflation continues to be moderate. Furthermore, the cost of debt is very low thanks to the current interest rates. Nevertheless, we should get used to to more day-to-day volatility as the real economy will probably adjust to the new economic paradigm of lower growth and rising interest rates.

Sergi Casòliva
Macroeconomic analyst

Fixed Income

‘Signor Mario Draghi, arrivederci e grazie’

Economic slowdown and geopolitical risks with the confirmation of the end of QE by the ECB, meaning a lower overall injection of liquidity. Bond yields will track upwards and the spreads will show greater anxiety. Emerging markets will be more attractive with a weaker dollar. Draghi’s mandate ends on 1 November.

On a macro level, it seems that we are looking at an economic slowdown and we recognise that it is possible that the growth rate ceiling may have been left behind. Meanwhile, political uncertainty in Europe (Italy, Brexit and the European Parliament elections) and regarding global trade (negotiations between the US and China) will continue to be the focus of attention for investors. All of this comes alongside confirmation of the EBC’s monetary policy normalisation, which will cause a reduction in the aggregate balance sheet of the main central banks, resulting in less liquidity on the market.

What can we expect in 2019 for fixed income assets? Regarding government bonds, we expect bond yields to rise in the face of the changing scenario from quantitative easing to quantitative tightening. If we look at the financing needs for the new year, France, Italy and Spain are the countries who may feel the most pressure. The risk premium will also depend on whether the geopolitical risks die down. With the fall of the breakeven rate and although inflation figures continue to disappoint due to a possible rise resulting from wage pressures, inflation-linked bonds should offer us some protection. The likelihood that the gap between the US and the Eurozone will converge in the future is higher, with an increasingly likely pause by the Fed and the ECB beginning its normalisation process.

We must be alert to the liquidity risk that is present at times and to the credit “equitisation” process

In private fixed income, the fundamentals remain positive: leverage is still close to minimums, profit margins continue to be strong, although they are slowing down, and the default rate is low. In all probability, the spreads will continue to widen as there will be increased anxiety surrounding the debate about whether we are facing the end of the economic cycle and the absence of new purchases from the ECB will probably have an effect, as well. Nevertheless, with the latest widening of the spreads, levels are now closer to what we would call fair values and above the average for the last three to five years. At these levels, the negative impact of the widening spreads will be compensated by the carry offered by some securities. The financial sector will be the new protagonist, with a possible new round of bank financing (TLTRO) and the risk of an extension to the AT1 if the expected calls are not executed.

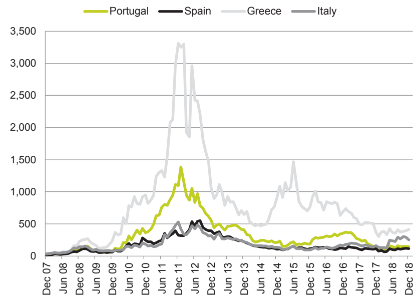
With respect to emerging markets, even with the forecast of a slowdown in world economic growth, emerging countries are expected to grow more than developed economies. In the event that rates in the US rise less than expected and the dollar fails to maintain as solid a position as it held in 2018, following the depreciation seen this year in the main emerging currencies, having exposure to local currencies will be a plus, provided we select the countries with the best fundamentals.

We must be alert to the liquidity risk that is present at times and to the credit “equitisation” process, so we would opt for more higher quality bonds through the search for higher alpha and lower beta and by giving a greater importance to the analysis and issuer selection processes.

On 1 November 2019, after 8 years, Mario Draghi’s mandate will end. He is the architect behind the monetary expansion programme that was put in place to tackle the financial crisis and over which the ECB exercises its role of sole supervisor. Draghi’s words “The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough” helped to reduce the risk premium for the peripheral countries. His departure may coincide with the announcement of the first rate hike since March 2016.

Josep Maria Pon, CIIA
Fixed Income portfolio manager

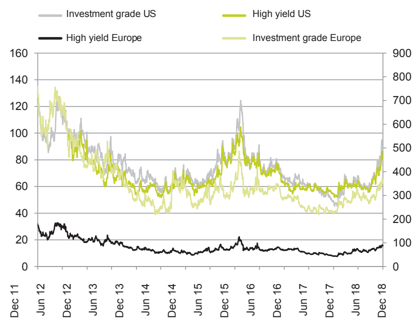
Risk premiums



Source: Bloomberg

The risk premiums of the peripheral countries have fallen after monetary expansion.

Credit spreads in Europe and the US (%)

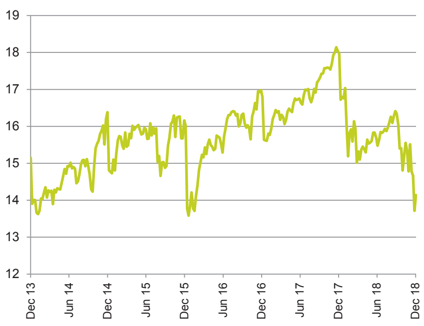


Source: Bloomberg

The credit spreads widened in both Europe and the US.

Equities

Forward P / E of the S & P 500



Source: Bloomberg

The multiple on the S&P 500 compressed significantly during the 4th quarter of 2018.

Probability of interest rate hikes by the Fed (%)

Next meetings	Probability of rate hikes
30/01/2019	0.5
20/03/2019	10.1
01/05/2019	13.8
19/06/2019	26.7
31/07/2019	26.4
18/09/2019	26.5
30/10/2019	26.0
11/12/2019	23.2

Source: Bloomberg

The market is reflecting very low probability of an interest rate hike in 2019.

US Equities: Walking in a minefield

In our last quarterly report, the US equity markets were at a historical high and we cautioned that the market was not factoring in much impact from the US/China trade war and, thus, it would be difficult to expect another good year for the market in 2019. During the 4th quarter, the market has come to the same conclusion.

In our last note, we should have spoken of the fourth quarter of 2018 instead of 2019 as our fears were realized by the markets earlier than we had predicted. To wit, Apple has stunned the market by lowering its revenue guidance. The shortfall was primarily caused by the slowdown in China's economy, which is under pressure from the trade war. Confirming Apple's warning was China's December PMI, which showed contraction in economic activity.

The news from Apple hit the market very hard at the start of 2019 until a strong Jobs Report placed the market on a better footing. Let us now acknowledge the other problems that the US equity markets face.

Volatility is only good if it's part of the trend and it's giving entry points within a trend

S. Druckenmiller

The Fed

There is widespread fear among investors that the Fed is going to keep raising rates as the economy slows and this could possibly push the economy into a recession. In December, the Fed signaled that they would like to raise rates twice in 2019, but the market is currently pricing in ZERO increases for 2019. Fed Chairman Jerome Powell's recent dovish commentary notwithstanding, there is a big difference between where the Fed and the market see the economy heading in 2019.

The market is not alone in disagreeing with the Fed, as President Trump has been actively tweeting against Fed Chairman Powell for months. Trump believes that Powell is to blame for the market's decline and has looked into whether or not he has the legal authority to fire Powell.

Shutdown highlights the dysfunction

As we write this, the US government has been partially shut down for a couple of weeks, which is not particularly harmful for the economy in the short term, but it does highlight the dysfunctional government the US is likely to be saddled with in 2019. With control of Congress now split between Republicans and Democrats, the government has been unable to agree on funding because of a measly $5 billion that President Trump wants to be applied to building a wall on the border with Mexico. This is just a taste of what is to come when the US Treasury inevitably has to ask Congress to increase the debt ceiling in a few months. Remember that in 2011 the credit rating of the US was downgraded after a prolonged fight in Congress that nearly caused the US to default on its debt. It does not take much to imagine a similar debt ceiling crisis (or worse) in 2019. Nor do we want to ignore the possibility of a severe disruption in the government if the Democrats attempt to impeach Trump. Mueller is expected to present his report on Russian intervention in February, and this could be the catalyst that starts the impeachment process.

Conclusion

Last quarter we were already feeling cautious towards the US market's prospects in 2019 and, following the sharp decline, we think the market has been de-risked. However, we expect to see a continuation of the elevated volatility that will test the resolve of every investor. Eventually, valuation will lend support to the market, but until the situation with the trade war improves and we can overcome the upcoming political hurdles, it would be best to look towards other equity markets including emerging markets like Brazil or other developed markets such as Japan and Europe.

Charlie Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Plummeting oil prices

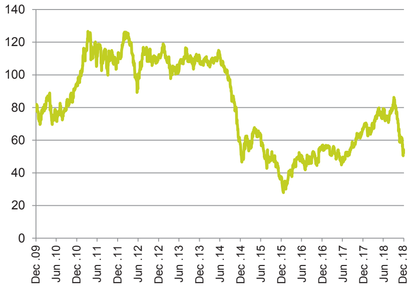
In the last quarter of 2018, the price of oil had fallen around 35%, due to fears of a supply surplus on the crude oil market. From the speed of the fall, it would seem that the situation is similar to what happened in 2014. However, the difference now is that the OPEC has rapidly taken measures to halt the decline. OPEC's experience during the collapse of 2014-2016 was too painful to contemplate a return to a phase of falling oil prices.

Also, today's context is rather different. In 2014, the OPEC drove the fall in the price in order to obstruct more costly production by the US and other producers. But this time it seems that the weak prices are due chiefly to growth in production in the US, which is at an all-time high. The events of 2014 showed that the OPEC could not curb production growth in the US. Having learnt from this experience, it is unlikely that the cartel would try to keep production levels high to conserve its market share.

Although in the last few months we have seen a temporary increase in crude oil production from Saudi Arabia and Russia (to compensate the supposed lower production from Iran), both countries have committed to decreasing production and the current volumes are not likely to remain stable without new investments. Furthermore, both countries will seek to sustain the highest prices in order to maintain the tax revenue, which reduces the downside risk.

Miguel Ángel Rico, CAIA
Portfolio Manager

Oil price performance



Source: Bloomberg

The increase in supply and slower global growth have caused a correction in the price oil.

CURRENCIES

The US dollar should weaken in 2019

We thought the dollar would weaken in 2018, but we had not foreseen the protracted trade war negotiations nor the outcome of the Italian election. 2018 has been a year of diverging economies, with a striving US on one side and the rest of the world on the other. We think this should change in 2019 as the fiscal stimulus fades in the US and the rest of the world recovers.

The slowdown in Europe was partly due to the normalisation of unsustainably high growth rates in 2017 and temporary factors. Nevertheless, Europe is still growing above trend. With respect to political risks, Italy cannot go too far in its fiscal deviation as the markets will push yields higher, going against Italy's own interests.

Regarding emerging markets, we think China will resort to fiscal stimulus policies should the growth rate drop below 6% and, even though the ride could still be rocky, a trade agreement between the US and China should be reached in the best interest of all parties.

Market sentiment towards all these risks is already very negative and a gloomy scenario seems to be priced in. A positive outcome for any one of these issues, therefore, would probably see a downward movement in the dollar. Ultimately, the most important factor for currency movements is the shift in interest rate differentials. The market is only pricing in 40 bp of hikes by the ECB over the next two years, whereas the Fed is nearing the end of its hiking cycle. Consequently, there is ample room for a hawkish surprise on behalf of the ECB.

The main risk to this view is that the political tensions may take time to resolve themselves and the European parliamentary elections in May could prove to be yet another hurdle.

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

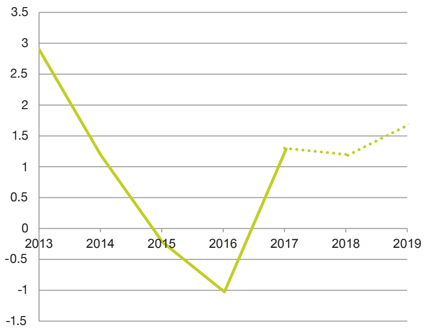
Exchange rate EUR/USD

Source: Bloomberg

We are seeing a weaker dollar as economic growth and monetary policies converge on both sides of Atlantic.

Latin America

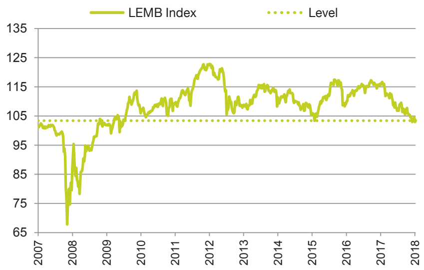
LatAm growth



Source: CEPAL

Latin American is expected to grow 1.7% in 2019, chiefly driven by Brazil.

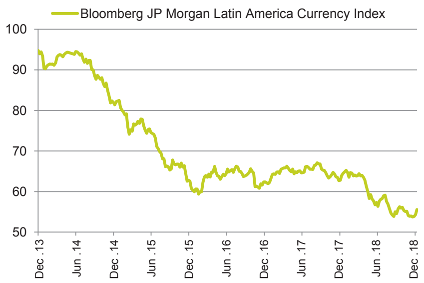
iShares JP Morgan USD Emerging Markets Bond



Source: Bloomberg

The bearish trend in emerging market bonds seen in 2018 could be coming to an end. JP Morgan's EMBI index is close to a historically significant level.

Bloomberg JP Morgan Latin America Currency Index



Source: Bloomberg

Trade tensions, the sudden rally in the dollar and monetary normalization in the US have brought Latin American currencies to levels not seen since the oil crisis in 2016.

A late recovery

Latin America (excluding Venezuela) is expected to grow 1.3% in 2018, a slower rate than the previous year (1.8%). It is advancing but slowly and it seems to be in the mood to stop. However, it is the only region among the emerging markets that is expected to grow in 2019, driven by its largest economy, Brazil.

Economically speaking, 2018 was not an easy year. The endless stream of political news, the US-China trade war, the Fed's rising interest rates and balance sheet reduction and the unexpectedly strong dollar have caused global economic growth, investor sentiment and asset prices to deteriorate. Of course, this has all affected the emerging countries the worst. Latin America clearly felt the blows, but it was also hampered by the electoral uncertainty in Brazil, Mexico and Colombia, although there were no great surprises in the results. Looking towards 2019, the path ahead is littered with uncertainty. But we need to put it into context because, as the saying goes, "the devil is in the detail".

To begin with, let us talk about Brazil, the beacon of hope. The region's largest economy by GDP is shining bright and more so with its new far-right president (Jair Bolsonaro), who has now taken power and who, in spite of his controversial statements, has been accepted by investors. His government plan has an emphasis on tackling corruption, shrinking the size of the government, intensifying privatisations, reducing the country's tax burden, as well as introducing tax and economic reforms, including a pensions reform, among other things. At the helm of these initiatives is Bolsonaro's finance minister, Paulo Guedes, a former investment banker. The Economic Commission for Latin America and the Caribbean (ECLAC) estimates that Brazil will grow 2% in 2019, 0.7% more than in 2018. This is thanks to an increase in investment and consumption, which will be partially compensated by lower government spending, tighter financial conditions across the globe and a tense trading environment.

The region's second largest economy, Mexico, depicts a bleak picture. The current president, Andrés Manuel López Obrador, has affected investor sentiment with his far from market-friendly policies. As a result, corporate investment, which was already low, could deteriorate further. Mexico is expected to grow 1.9% in 2019, thus completing three consecutive years of growth below its potential, estimated at 2.3%.

The Andean economies, on the other hand, look promising. Chile and Colombia will experience growth close to 3.3% in 2019, in line with ECLAC estimates. These two countries share political and economic stability and they characteristically depend on the price of copper and oil, respectively. However, Colombia faces more risks as it suffers from twin deficits. Peru, in contrast, maintains a strong external balance sheet and low levels of debt. The country's growth for 2019 is estimated at 3.6%.

> LatAm is the only region among the emerging markets that is expected to grow in 2019, driven by Brazil

And finally, there is Argentina. It tells an almost agonising tale, but one that now seems to be heading in the right direction. The economy will shrink almost 2.6% in 2018 but it will do so to a lesser extent (1.8%) in 2019 (ECLAC). The IMF's aid programme seems to be providing results and confidence for investors. One of the country's main risks relates to the elections, as Argentinians go to the polls in October and the current president, Mauricio Macri, is expected to be reelected.

Against this backdrop, fixed income, in both local currency and hard currency, is attractive since the Fed could halt the rising interest rates and show some flexibility in its balance sheet normalisation policy. In equities, we prefer countries like Brazil and the Andean region (Colombia, Chile and Peru). The most relevant risks are, firstly, a stronger dollar because emerging economies are free to dance around if the dollar is not at the party. And secondly, the credit ratings, due to the recent deterioration in the evaluation metrics and high maturities in the coming years. For now, the high levels of volatility will be the norm.

Diego Fernando Agudelo López
LatAm analyst

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