Research
Crèdit Andorrà Financial Group

Second quarter 2019
Date of report: 29 March 2019

INDEX

Quarterly Report

Our view on the markets

Sing!

Last year's downturns have engulfed investors who have not shared in this year's recoveries in pessimism. We believe that the current expectations of economic growth and corporate earnings will be exceeded and the valuations have room to improve, now even more so as the central banks take a breath.

In one of my son's favourite films, one character tells another "what's great about hitting rock bottom, there's only one way left to go. And that's up!". Unintentionally (I assume, because Sing! is about animals entering a singing competition... worth a watch, by the way), this character is giving some of the best advice an investor can hear. The bleaker the outlook and the more your instincts scream sell, the nearer the end of the storm and the more we must use these instincts to buy.

Last year, the record was set for the most assets closing in the red and in December, sentiment indicators were signalling extreme pessimism. At that time, we advised aggressive buying. An objective situation analysis told us that things were far from as dramatic as they seemed. 2019 began very well and, at the end of the quarter, there is a temptation to take profits. The economy seems unable to pick up its previous pace, when it is not in a sharp slowdown, as is the case in Europe. And the factors worrying investors, such as Brexit or Trump's trade wars, are yet to be resolved.

But we believe that we must stay invested and have a bit more patience. While there is nothing wrong with taking profits —we have, albeit only partially—, to do so there must be profits to take in the first place. Most investors have missed the rally. In fact, there have been net outflows of equities throughout the whole beginning of the year. It is something we follow very closely: investors who sold in the downturns will be tempted to return to the market if the rise looks set to continue. And it probably will. We think that a hard Brexit will be ruled out and Trump and Xi Jinping will sign a trade agreement in this second quarter. With the Fed at the helm, central banks have set aside any intentions of implementing more hawkish monetary policy, which is usually very beneficial to risk assets, and more so now as they still have relatively sluggish valuations that do not reflect the most likely scenario for the coming months. The US —the world's leading economy— continues to be exceptionally healthy. With no further rate hikes, unemployment below 4%, the lowest salaries finally growing and tax cuts providing the tailwind, a recession seems highly unlikely in the months to come (also remember the election in 2020 and Trump will probably not want to run in a poor macro environment). The slowdowns in the rest of the world seem more than priced in, particularly in Europe where we have contraction to such a degree that it is hard to believe anything could get worse. Analysts have downgraded corporate earnings growth forecasts so much that a surprise on the upside should not be difficult. Therefore, we believe that, unlike fixed income, where the credit spreads have already shrunk a lot and they do not seem to have much room to run, equities and emerging assets are still enjoying a good outlook. We think investors are looking at everything too negatively. And, when it looks like something has hit rock bottom... sing!

David Macià, CFA
Chief Investment Officer

Strategy

Asset allocation (2019 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

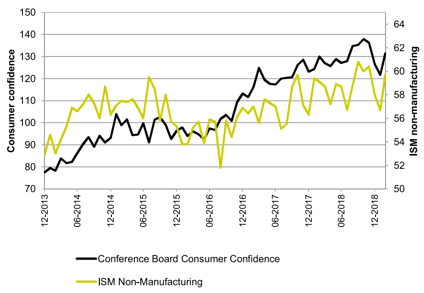
Oil	→
Gold	↑

Currencies

EUR/USD	↑
JPY/USD	↑

Macroeconomic View

Conference Board Consumer Confidence, ISM Non-Manufacturing



Source: Bloomberg

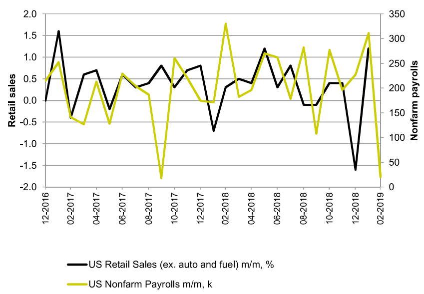
According to the main leading indicators, US data is stabilizing.

US Unemployment

Source: Bloomberg

There has been a steady improvement in US economic data over the current cycle.

US Retail Sales (ex. automobiles and fuel) and Nonfarm Payrolls



Source: Bloomberg

Although recent readings of retail sales and nonfarm payrolls have been quite volatile.

So, do the markets know better?

Just as last year's economic slowdown was preceded by a sell-off only comparable to the one that took place in 2011 (S&P 500 -18,3%), the first quarter's rally was one of the strongest on record and it does indeed look like the economic data has at least stabilized.

A bunch of leading indicators from the US are hinting at this stabilization: The Conference Board Consumer Confidence Index; the ISM Non-Manufacturing Index; and the University of Michigan Consumer Sentiment Index, to name a few. There are also some green shots in Europe and the emerging markets, such as the recovery of the European Consumer Confidence Index and the Chinese Caixin PMI moving back towards 50 again. It is too early to say that the rest of the world is following suit, but this is what the markets seem to be telling us. If they are right, we should soon see the ISM Manufacturing Index pick up and the European PMI break above 50.

Still, we are far from the highs of 2018 in terms of macro indicators and analyst estimates as all of the main economic surprise indices are in the red even though consensus forecasts have been revised sharply downwards. The fears of a trade war have clearly taken their toll on the global economy, the collapse in German industrial production being perhaps the best proof of this. It may be no exaggeration to say that the future of ongoing economic expansion depends on the handshake between Donald Trump and Xi Jinping. Assuming there will be a ceasefire, we believe the global economy has room to grow, given the low/ negative output gaps and a persistent lack of inflation pressure. While the current business cycle has been one of the longest on record, it has also been one of the most sluggish.

We are also seeing an emerging pattern of increased data volatility. Those of you who follow market commentary have surely noticed that the term "volatility" is now used very frequently, a typical phrase being "our stance is positive, but we should expect more volatility ahead". What this essentially means is that as investors become more nervous towards the end of the cycle and, thus, sensitive to any bad news, the markets tend to correct more frequently.

However, it is also true that volatility --that is to say the magnitude of market movements-- has been particularly low in recent years, in part thanks to little variability in economic data. By way of example, let us look at US unemployment: since 2010, it has essentially been declining in a straight line! This might be about to change as the latest retail sales smashed the consensus after coming in well behind in the previous reading. The opposite was the case for the nonfarm payrolls, one of the key US indicators, which reversed as of February (up just 20,000) after surging as much as 311,000 back in January. Chinese exports have also been particularly shaky. After a very strong January there was an unexpected 21% plunge in February, supposedly due to Lunar New Year holiday distortions. However, it is hard to believe the analysts did not factor this in. Either way, with less visibility in economic data, volatility can be explained by more than just the psychology of profit taking. But once again, having become so volatile back in 2018, the markets already seemed to know about it.

The future of ongoing economic expansion might depend on the handshake between Donald Trump and Xi Jinping

Aleksandra Tomala, CFA, CAd
Senior Multi-Asset and Institutional Accounts Portfolio Manager

Fixed Income

Is there life beyond central banks?

At the start of 2019, we saw a rally in risk assets thanks to the fact that investors have been focused on the more dovish signals coming from the central banks rather than on the weakening growth trend.

At the ECB's last meeting, Draghi referred to a weak environment fraught with uncertainty: rise in protectionism causing a slowdown in trade and global production; political risk, emphasising Brexit; and vulnerable emerging markets, particularly China. He also announced new measures: 1) leaving rates unchanged until at least the end of 2019 (as it is, Draghi will be the first ECB president not to increase rates, as his mandate ends in October) and 2) a new series of targeted longer-term refinancing operations (TLTRO-III) in September 2019, to keep credit flowing.

The margin available to the central banks is smaller than when they first began the quantitative easing measures

The extraordinary measures implemented by the main central banks to overcome the financial crisis are set to take hold. The Fed, which had begun monetary normalisation, put a stop to the expected rate hikes and intends to end its balance sheet reduction sooner than planned. The Bank of Japan is continuing with QE and has kept rates around 0% for the last 10 years. And the ECB is implementing new measures in the hope of making the euro zone economy more resilient.

While central banks remain dovish in sticking to monetary normalisation, everything suggests that the available margin is smaller than when they began. Note the evolution of Draghi's words, from his proclamation in 2012: "I will do whatever it takes to preserve the euro, and believe me, it will be enough", to his metaphor at the ECB meeting in March 2019 about the economic context: "In a dark room you move with tiny steps. You don't run, but you do move". See the difference? It was possible to run at the start, but now we can only walk.

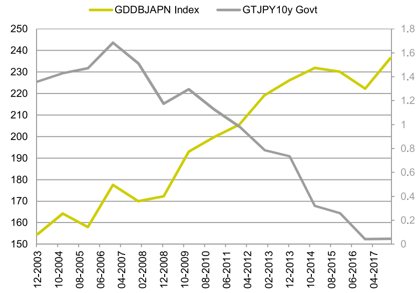
Better coordination between fiscal and monetary policy would help the economy in a slowdown. In the US, Trump has already implemented an expansionary fiscal policy following years of growth. In Europe, depending on the May election results, there may be more pressure to adopt those fiscal incentives despite the mechanisms agreed by European countries to contain the deficit and control debt.

Today, the debate in the US focuses on the so-called Modern Monetary Theory, the greatest defenders of which come from within the Democratic Party (Bernie Sanders, who tops the polls for the presidency, and Alexandria Ocasio-Cortez, activist and bright new star in Congress). They essentially propose printing money (or nowadays simply pressing a button) and, instead of buying bonds like during QE, using it to finance social, environmental and infrastructure projects etc. Proponents of MMT argue that, provided they borrow in their own currency and they can print money to cover their obligations, they cannot fail and the limit would depend on rising inflation.

In a scenario in which fiscal spending would be injected directly into the real economy instead of using a more indirect QE route, inflation should rise. But, everything we know about macroeconomics is being called into question because, so far, the deficits have not caused runaway inflation or a flight from the bond markets. Even so, it seems reasonable that implementing these measures would mean higher debt, which would affect countries' creditworthiness. And more debt would push rates upwards and affect bonds. The assets that would do better unsurprisingly would be real estate and investments in infrastructure or commodities like gold.

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

% Japanese government debt-to-GDP (GDDBJAPN) vs 10-year Japanese government bond (GTJPY10Y)

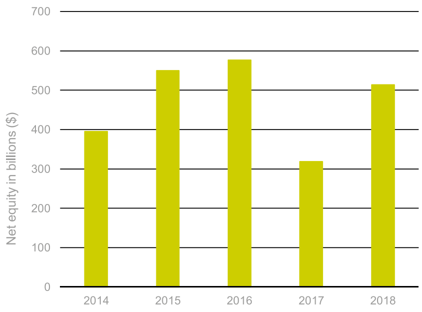


Source: Bloomberg

Comparison between performance of Japanese debt and 10-year government bond interest rate

Equities

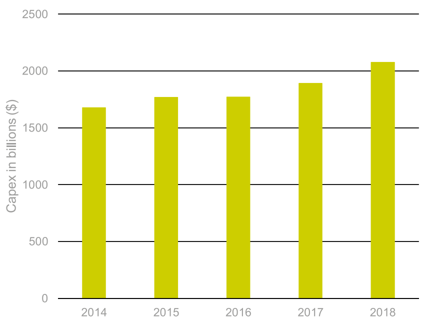
Decline in net equity



Source: Federal Reserve

Net decreases in equity are equivalent to net buybacks. The level in 2018 was actually below the level achieved in 2016.

Capital expenditure (Capex)



Source: Federal Reserve

Capital expenditure (capex) has continued to climb.

Blaming buybacks

During 2018, US corporations announced more than $1 trillion in buybacks. Several liberal politicians are targeting buybacks as a mechanism for management and shareholders to enrich themselves at the expense of reinvesting into the business.

One of President Trump's central campaign promises was to reform and reduce the corporate tax structure. Trump kept his promise with the passing of the 2017 Tax Cuts and Jobs Act. It was sold to the American people as a way to make US corporations more competitive in the global market. This would, in turn, lead to companies making greater investments into their businesses (increasing capex) and, ultimately, create more jobs.

Now that we stand 16 months from the 2020 presidential election, several prominent Democrats have begun campaigning in earnest. A key tenet in their rhetoric is that the corporate tax cuts passed by Trump and the Republican Congress are harmful because they create further wealth inequality due to companies using the windfall on share buybacks. A buyback is when management believes the company is undervalued relative to its investment opportunities and then deploys its excess capital to repurchase outstanding shares either on the open market or through a special offer. The buyback reduces the company's share count, lowering the base over which profits are spread, thus increasing earnings per share (EPS).

Why have share buybacks become a political target?

In the US, share buybacks have surpassed dividends as the preferred method for companies to return cash to shareholders. This is in stark contrast to Europe, where dividends remain king. Share buybacks have some distinct advantages over dividend payments as they can increase EPS, usually have a more direct impact on share price, and when the economy sours, it is much less painful for a company to curtail its buybacks than to reduce its dividend. Finally, in a study carried out by Goldman Sachs, it was found that companies that do buybacks tend to outperform the broader stock market.

Presidential candidate Senator Bernie Sanders and Senate Minority Leader Chuck Schumer have together proposed legislation that would force companies to provide retirement benefits, health coverage, a minimum wage of $15/hour, and 7 days of paid sick leave as a precondition for buybacks. The two senators wrote that "the goal is to curtail the over reliance on buybacks while also incentivizing the productive investment of corporate capital." It seems that they believe companies face an either-or proposition on buybacks vs capex.

However, is that even true? A 2018 study by MSCI stated that they "did not find evidence that companies might be diverting resources to buybacks instead of reinvesting in their companies." Furthermore, net buybacks in 2018 were below the level achieved in 2016 while capex has continued to climb (see charts 1&2).

Another presidential candidate, Senator Elizabeth Warren, believes the US should follow the German example whereby workers elect 40% of the board members. In her view, this would produce fewer self-serving buybacks while increasing capex and worker pay. Unfortunately for Warren, over the last couple of decades, German companies invested less than their American peers while American workers have received higher pay increases.

Finally, cash that is spent on buybacks does not simply disappear. It is typically spent on goods or services that flow back to corporations, fueling the economy, or it gets reinvested back into the financial markets.

Charlie Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

2016 as a point of reference?

What happened at the start of 2016? Are there any similarities with today? In early 2016, there were fears of a hard landing in China. The worry was that the country (which represents almost half of world economic growth) would experience a significant slowdown and see growth drop from 7% to 6.5%. As a result, commodities suffered sharp downturns due to concerns about lower demand.

And what about today? The dispute between the US and China has brought trade to a standstill. We are now seeing the effect of this situation in the demand indicators. China's manufacturing PMI was poor again in February and figures for new orders are signalling the lowest level ever seen for this time of year. Some argue that China's GDP will soon fall below 6% from today's 6.5%. Thus, in the last quarter of 2018, commodity indices fell more than 30%.

What happened back then and what will happen now? In 2016, the Central Bank of China, which seems to be the most flexible of all central banks, applied expansionary monetary policies, which refloated the Chinese economy. Thanks to these policies, we saw commodities rebound strongly. Today, the Chinese authorities have already begun to implement a stimulus package which resembles the one three years ago. So far this year, we have already seen how credit data has recovered following many months of declines. Considering just how sensitive commodities are to what we have described here, it is likely that this year's rally will continue and the record levels of 2018 may be reached again in a relatively short period of time (for some industrial metals in particular).

Miguel Ángel Rico, CAIA
Investment analyst

Oil price performance

Source: Bloomberg

Stimulus measures from the Chinese authorities drove the price of commodities in the past. It could happen again.

CURRENCIES

Still expecting a weaker dollar

We thought the prospect of convergence in global growth and interest rates and abating political risks would bring an end to dollar strength. Although these events have occurred to some extent, the dollar has been range-bound. So what did we miss?

In January, the Fed made a U-turn and adopted a much more dovish stance. Consequently, markets are now discounting only one hike in 2019, down from four. However, in the face of poor macro data, other central banks followed in the Fed's footsteps and some market participants even think the ECB will never be able to hike rates this cycle. So, even though the differential between US and German 2-year yields has effectively compressed by 40 bp over the last 3 months, it has had no impact on the exchange rate. Suffice to say, the move has come entirely from lower US rates and we will need to see European interest rates moving higher to underpin an unwinding of the long positioning in dollars.

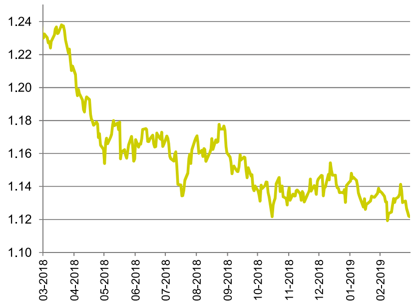
Similarly, although macro data in the US has weakened, poor data in the euro zone has kept the brakes on the euro strengthening. But forecasts for the region have come down so much that, going forward, a positive surprise seems very easy and should support the euro.

With respect to political risks, China and the USA seem close to reaching a deal, Italy has aligned itself more to the wishes of the European Commission and the possibility of a "no-deal Brexit" has shrunk. However, lingering uncertainties have probably held back support for the euro.

Our call was obviously made too early, but we are sticking to it and hopefully time will prove us right. Nevertheless, an improvement in macro data in the euro zone and, hence, higher interest rates will be key.

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

Exchange rate EUR/USD

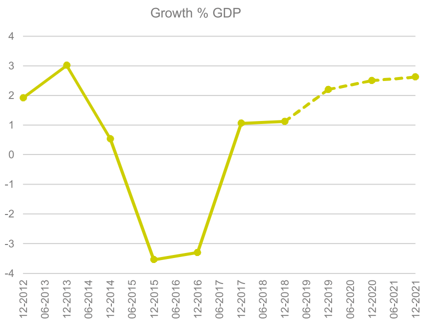


Source: Bloomberg

Despite the Fed's much more dovish stance, the dollar has remained range-bound.

Latin America

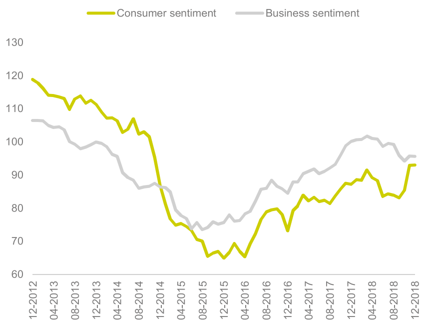
Economic growth forecast for Brazil



Source: Bloomberg

Brazil is expected to be the region's economic driver, with growth of 2.3% and 2.5% in the years to come.

Brazil economic sentiment



Source: Bloomberg

Economic sentiment in Brazil has rebounded sharply, driven by greater trade openness.

Evolution of financial conditions in Brazil

Source: Bloomberg

From the lows of 2016, financial conditions have notably improved in Brazil. If progress is made on the pension reform this improvement could continue.

Uncertainty about pension reform

There is a theory that if Brazil's pension reform passes, it will lead to a decline in country risk, higher growth and foreign capital inflows. This, combined with easier monetary policy, would put the country back on the path to investment grade.

For decades, Latin America has been making global headlines, although often for negative reasons such as divisive election campaigns in Brazil and Mexico, worries over Argentinean debt and the news coverage of the Central American migrant crisis. For many, it has been the least attractive region in the world in which to conduct business. While western Europe, the United States, Canada, Japan and other developed countries continue to benefit from mutual trade, the Spanish and Portuguese speaking parts of the western hemisphere have lagged behind, often because of the hyperinflation and political instability characteristic of the region. Nonetheless, although the investing climates vary widely by country, many Latin American countries are catching up and presenting attractive investment opportunities.

With prospects of a US-China trade truce on the horizon and the Fed shifting to a dovish stance, the external macroeconomic scenario seems to have faded into the background, leaving domestic narratives in the spotlight. It is expected that a tepid growth recovery in the region will be led by Brazil.

It is impossible to talk about Latin America without focusing on Brazil, the giant of the region. With its new far-right president (Jair Bolsonaro) in power, economic sentiment has been very positive due to the political initiatives he is looking to implement. These initiatives consolidate 1) social security reforms (pension reform), 2) asset divestments (privatizations/concessions), 3) tax reform and 4) trade openness. This is all in an effort to balance the social security deficit and, therefore, give stability to Brazil's public accounts.

For many, the most important pillar of Bolsonaro's policy is the bold social security reform proposal, which was presented to Congress in mid-February. According to government officials, this new proposal forecasts savings of 1.167 trillion reals in 10 years. This amount is significantly higher than the former President's (Michel Temer) original proposal of 780.8 trillion reals. In the new proposal, the bulk of the savings will come from changes to the rules for the retirement of private and public workers, as the minimum age is increased to 62 for women and 65 for men. The proposal also includes a plan to make pension contribution amounts more progressive, raising the contribution rates for households with higher income, while lowering rates for workers with lower income.

> Most fund managers are not fully invested in the region, awaiting better visibility on the pension reform

Passing this reform in Congress will be tough and the markets have started to have some doubts about the timing and government capacity to implement the reforms, given the fragmentation of Congress and political polarization. Also, the recent detention of former President Temer has added uncertainty to the outlook of key economic reforms.

While President Bolsonaro appears to be making the right economic decisions, any setback in the implementation of the pension reform may change the economic sentiment.

Despite the current turmoil, Brazil remains a world-class performer. The economy is expected to grow at a rate of 2.3% this year and 2.5% next year, supported by looser financial conditions, intensifying privatizations of state-owned companies and the rhetoric of an expansionary monetary policy.

Eduardo A. González Ciccarelli
Investment analyst

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Research

Crèdit Andorrà Financial Group

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