

Quarterly Report

Our view on the markets

Barbecues

The case for risk assets has never been stronger, but too much is already priced in.

Sir John Templeton famously stated that “bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria”. If he was right, there can be little doubt about which phase we are currently in.

Certainly, parallel readings to the one prevailing among investors are difficult to make. The economy is improving by leaps and bounds. Citizens want to, and they can, spend (they have been cooped up at home for a year, and in the US, savings have even increased thanks to the subsidies received). As restrictions are lifted, they are stampeding out. At the same time, authorities are not even considering withdrawing the stimulus measures. For the markets, this is like pouring gasoline on a fire: the flare-up is tremendous. It will be the barbecue of the century; how could you not put all the meat on the grill? Add in zero rates, the argument continues, and you are left with little to choose from. And if the fire dies down, do not worry. The central banks will come to the rescue (this has happened since Paul Volcker, we have not seen any different for three decades). Not even the global pandemic caused market downturns lasting more than a few weeks. The central banks are the markets’ superhero. They are invincible, and there is no villain that can resist them.

Although this author’s tone is one of deep scepticism, there is no denying the reality. In the short term, things are not what they are on financial markets; they are what they appear to be. Investors are convinced that nothing can go wrong. Bad macro data is good because it allows central banks to keep turning the crank. Good macro data is the proof that everything is fine. To rise or to rise, that is the question. Nor should we

forget that bullish markets often last much longer than bearish markets. However, markets end up yielding to the unassailable law of gravity. Like a plane flying without fuel, inertia sooner or later gives way, and it plunges into the void.

For equities, the runway is cleared by corporate earnings. We believe the valuations have moved too far away, but if earnings accelerate further, perhaps the landing will be more of less soft. Inflation may be kryptonite for the central banks. With almost no inventories of anything (and some will take a long time to be replenished, as with semiconductors), with factories at full capacity, workers highly sought after, rising real estate prices and fiscal policies in step with monetary policies (that did not happen in Europe in 2008), it may resurface and give Superman and his friends a rude awakening.

In short, do not rule out the possibility that the party will continue. But always be wary when you see that everyone, without exception, is defending a single theory (be it the advent of the end of the world or a bright future, it does not matter). Stay invested (all or nothing is almost always a mistake), but perhaps it is better to forgo part of any remaining gains and mitigate potential disappointments.

David Macià, CFA
CAAM Investment Director

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Strategy

Asset allocation (2021 Q3)

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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 CPI YOY



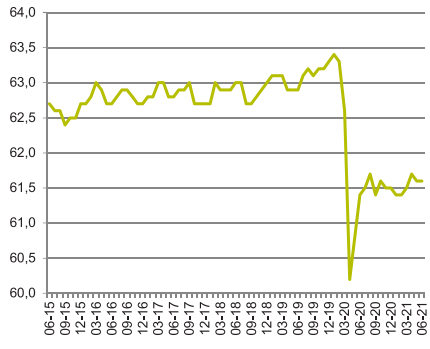
Source: Bloomberg
The year-on-year change in consumer prices surged 5% in May, higher than consensus expectations.

FED'S Balance sheet as a % of GDP



Source: Bloomberg
The Fed has doubled its balance sheet to \$8trn in response to the covid crisis.

US Labor Force Participation rate



Source: Bloomberg
The low participation rate distorts the unemployment rate to the downside.

US inflation: higher for longer?

Last quarter, we said inflation would be the focal point to watch this year. The year-on-year change in consumer prices surged 5% in May, higher than consensus expectations. However, travel related services explained most of the jump in the number, backing the theory that the rise in inflation is due to temporary factors.

Elevated price indexes, evidence of rising expectations as well as labour and material shortages have focused our attention on the risk of higher inflation for longer. Most financial market participants think that the spike in prices will be transitory due to base line effects, one-offs and temporary supply shortages in sectors that were very much affected by the pandemic. The fact that we have been living in a low inflation environment for over a decade has undoubtedly also influenced opinions. However, today's situation contrasts sharply with the post-Great Financial Crisis (GFC) period. Fiscal austerity, low investment, a deleveraging consumer and central banks acting pre-emptively defined the post-2008 crisis. The risk always seemed to be tilted towards the downside where growth and inflation were concerned and the worry was always about what central banks could do next if growth failed or deflation set in. In the aftermath of the 2008 crisis, stimulus was insufficient, and, consequently, the recovery too slow. Conscious of past mistakes, policy makers this time round have been on a frantic spending spree. So far, the US fiscal stimulus of above \$5 Tn significantly dwarfs the relief packages of \$1,5 Tn passed during the 2008 financial crisis. As for monetary stimulus, today the Fed has doubled its balance sheet to \$8 Tn in response to the COVID crisis. In 2008, it increased it by \$1 Tn, and then by another \$2 Tn in the 6 years that followed. The Fed's new average inflation targeting means that the monetary authority will no longer act pre-emptively, but that it will need to see actual data in order to adapt the monetary policy.

So far, this enormous growth in money supply has not been a large driver of inflation pressures, basically because cash is being held by banks as deposits. As companies and consumers draw on their deposits and boost spending, demand can grow at a faster pace than economic output, pushing prices higher, and once inflationary expectations start to get embedded in the system, they become a self-fulfilling prophecy.

One of the main pushbacks to a long-lasting trend in inflation is the labour market. Although we have seen some anecdotal evidence of lack of labour supply, such as companies reporting vacancies they cannot fill, job creation numbers have disappointed due to extended unemployment benefits acting as a disincentive to work. Despite the sharp recovery in the unemployment rate, employment is still 7,63 million below the pre-pandemic levels. Moreover, the low participation rate –the proportion of the working-age population that engages actively in the labour market– distorts the unemployment rate to the downside. As unemployment benefits dry up, the labour market should normalise, preventing a price-wage spiral.

Once inflationary expectations start to get embedded in the system, they become a self-fulfilling prophecy

The pandemic has driven stimulus to levels not seen since World War II, but neither governments, central banks nor investors are showing much concern for inflation. This complacency worries us, and although it is not our base case scenario, we will closely monitor data for signs of a more structural inflation setting in. With the Fed's new framework, the central bank is more likely to react too late to rein in inflation pressures, thereby having to hike rates more sharply with the risk of causing a sharp recession.

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

Fixed Income

Between tapering and inflation

The debate rages on about when the central banks will start to wind back the stimulus measures, with an eye on inflation. We think the tapering will be smooth, allowing for an inflation “overshoot”, following over 10 years below the target in the eurozone.

In the first half of the year, the fixed income products that performed the best were those with higher beta, with high yield indices in Europe and the US rising around 3,5%, and subordinate financial bonds (CoCos) globally up around +3%. On the negative side, US and EU government bonds yielded -2,4%, negatively affected by the rise in interest rates in the period (-55 bp in the case of the 10-year Treasury and +36 bp in the case of the Bund).

As for central banks, although the Federal Reserve struck a more “hawkish” tone, which could suggest that it would wind back the stimulus measures sooner rather than later (tapering), it was short-lived with subsequent qualifications by Powell, who said, for example: “inflation has come in higher than expected, but particularly for categories directly affected by the reopening of the economy” and “the Fed will not increase rates pre-emptively because we fear inflation; we will wait for actual inflation data”. In any case, inflation divergences (higher in the US than in Europe) could lead to a desynchronisation in the withdrawal of stimuli. This would be a departure from what we have so far seen as coordinated action from the central banks in the implementation of expansionary monetary policy.

We need to be more cautious about the duration of the portfolio, which should be actively managed

In terms of the curves, the combination of the economic recovery driven by the progress in vaccinations, an expansionary fiscal policy and smooth tapering should encourage a rise in long-term interest rates and a steepening of the curve. The issue of the potential infrastructure deal in the US and an increase in debt should play a role in this. In the eurozone, we remain more positive on the periphery than the core area, as it will benefit the most from the Next Generation EU programme, the funds of which will start reaching the countries once the placement of the bonds that will finance

it in the primary market begins. We should also leverage inflation-linked bonds in the case of changes in inflation that may prove to be not as temporary as the central banks believe.

Good corporate earnings continue to provide support for credit. These assets benefit from an increase in rating upgrades, a default rate that is expected to be lower than the initial projections after the onset of the pandemic, and a corporate strategy to conserve liquidity and adjust expenses which improve risk metrics. The PMI figures released suggest a strong global recovery, which should also support private fixed income. The segments that performed the best were those related to the “reopening trade”, such as airlines, cyclical sectors and issuers linked to commodities, financial subordinated bonds and high yield bonds. The latter posted record sales in the first half of the year, while their yield fell to a record low of 3,75% in the US.

The conclusion would be that, from the point of view of the risk-reward trade-off for rates, risk is asymmetrical and, in this environment of global economic recovery and corporate earnings that are beating analysts’ expectations, we are more concerned about the variable duration —which should be actively managed in the portfolios— and less so about the development of the credit spreads. We still see room to run in a selective list of corporate issuers until they reach pre-pandemic levels.

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

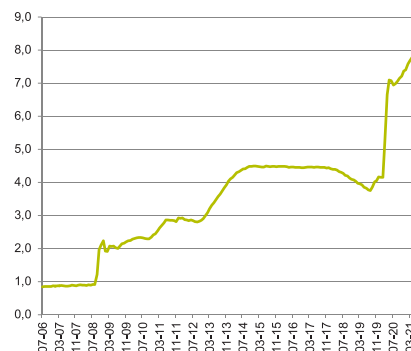
US bond yield



Source: Bloomberg

Corporate High Yield set an all time low of 3,75% at the end of the first half of 2021.

US Federal Reserve balance (millions)

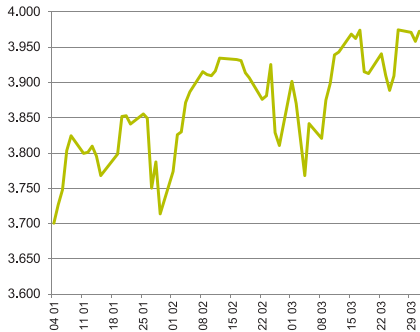


Source: Bloomberg

The US Federal Reserve continues to expand its balance sheet. It represents 36,6% of GDP vs the European Central Bank's 79,1% and the Bank of Japan's 133%.

Equities

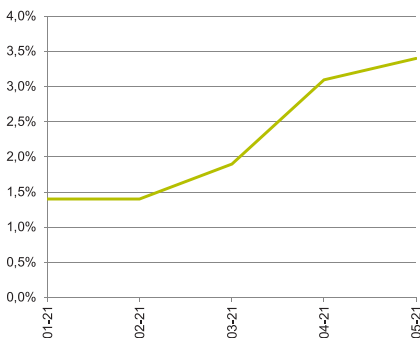
S&P 500 2Q 2021



Source: Bloomberg

The market did not seem to be concerned about a peak in growth.

US Core PCE



Source: Bloomberg

Has inflation peaked?

Enjoying the view on the way down

Investors spent the last quarter fretting over whether we have arrived at a peak. Which peak is that? That could be peak growth, peak earnings, peak inflation, or peak policy. Only one of those peaks is good for the stock market.

The June meeting of the FOMC was deemed by the market to be a hawkish shift or at least a downshift in dovishness. Investors had become complacent in the belief that the Fed would be on hold until 2024 which meant they were blindsided when the latest median forecast projects 2 rate increases in 2023. To add insult to injury, seven members of the Fed are projecting a rate hike in 2022. Finally, the Fed also removed the already lampooned projection of 2,4% for the PCE (measure of inflation) and raised it with a more worrisome 3,4%.

“These one-time increases in prices are likely to only have transitory effects on inflation”, Jerome Powell

The market reacted negatively with the S&P 500 falling 1,9% and the Russell 2000 plummeting 4,2% that week. The more cyclical sectors were hit especially hard with both financials and materials down more than 6%. Investors flooded out of the cyclical sectors as well as the overall market because they began to believe that we have reached peak Fed policy. There was palpable fear that the August or September FOMC meeting could result in the dreaded tapering announcement. From there it is a short path towards fearing peak growth and peak earnings because if the Fed is no longer going to be so accommodative then surely it is only downhill from here. Of course, the Fed is likely to give plenty of warning before the tapering actually begins, so even if the Fed makes the announcement in August, the tapering may not begin until 2022. Assuming the Fed takes a gradual approach to tapering and steps down initially from the current level of \$120 billion in Treasuries and mortgage-backed securities to \$100 billion or even \$80 billion, that will still represent a whole lot of monetary support throughout 2022. In the same manner, let's assume that the Fed starts hiking rates gradually in 2023 by

raising the target rate from 0,00-0,25% to 0,25-0,50%, it will be hard to argue that the Fed isn't still being accommodating.

To be certain, the Fed is forecasting 7% growth in 2021, but expecting it to slow to just 3,3% in 2023. On the surface, that seems like a massive deceleration, but 3,3% is still well above the Fed's long range economic growth projection of 1,8%. Seen in that light, the path down from the “peak” doesn't seem so bad. Similarly, if we look at earnings growth, it is pegged to peak at 62,8% in the second quarter and then decelerate to “just” 23,2% in the third quarter. Again, that is still impressive growth.

Finally we come to peak inflation. Fed Chair Jerome Powell has said time and again that he believes the current spike in inflation is “transitory.” If the stock market's performance in any indication, investors do believe Powell.

All of the above are reasons why investors bought the dip following the FOMC's less than dovish announcement. Recently, both value and growth stocks, small-cap and mega-cap, and quality and meme stocks have found favor. The stock market is continuing to make new highs as investors are still liking the view on the way down from the peak.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Protection against inflation

Which came first, the chicken or the egg? Does investing in commodities work as a hedge against rising inflation or do rising commodity prices themselves cause higher inflation?

The chicken or the egg we do not know, but as for the second question, both things are true, albeit with some caveats. There is a very important nuance: investing in commodities does protect against inflation, yes, but against unexpected inflation. That is, inflation that is already known or expected to occur does not have a strong positive correlation with commodity prices. However, there is a very significant strong positive correlation between the price of commodities and rising inflation expectations. In other words, if inflation today is expected to be higher than that expected yesterday, commodities today will rise. The greater the upside inflationary surprises, the higher the rise in commodity prices.

Therefore, it is very important for those who want to invest in commodities not to

invest at a time of peak inflation. At the present time, it would be very important to know whether inflation will be temporary or permanent, as has been discussed lately.

Federal Reserve Chair Powell stated in a recent press conference that the inflation was temporary. He used the price of timber used for construction as an example to show that there had been a bottleneck that had led to a rise in the price of timber, which was now beginning to be reversed.

Although it may take a few months for supply to meet demand in some commodities, once this occurs, the peak in inflation is usually over and the imbalances caused by the pandemic will gradually adjust; Powell may be on to something.

*Miguel Ángel Rico, CAIA
Investment analyst*

CURRENCIES

Dollar stays range-bound

Last quarter we thought the dollar would appreciate in the short term. The US was far ahead of the old continent in their vaccination programme, its economy had already started to recover and some feared accelerating inflation would force the Fed to tighten monetary policy earlier than what was being telegraphed. Three months later, and the dollar is at the same level as it closed the first quarter even though we have seen some ups and downs. Inflation is at a 10-year high, having surged to 5% in May, and the US economy is roaring ahead. The estimated growth rate for the second quarter is 13% for the US, while it is 1.4% for the Eurozone. So, why did our thesis not play out? Well, despite the accelerating inflation and strong economy, the Fed has stuck to its guns and has maintained a very accommodative rhetoric, thereby managing to temper any run up in the Treasury or in the dollar. During the next months, the dollar will probably stay rangebound. Europe is catching up with the US and will be able to reduce the growth differential. After a difficult start, the vaccination programme has gained steam and we can expect the economy to fully reopen during the following

months. EU leaders have agreed on the €750 billion recovery programme, Next Generation EU, to help the region tackle the crisis caused by the pandemic. The Fed has already shown that it is determined to maintain its accommodative stance until the labour market shows several months of successive improvement, allowing for further high prints in inflation. Until the Fed adopts a more hawkish tone, we probably will not see a much stronger greenback, although bouts of volatility during the summer months cannot be discarded.

*Jadwiga Kitovitz, CFA
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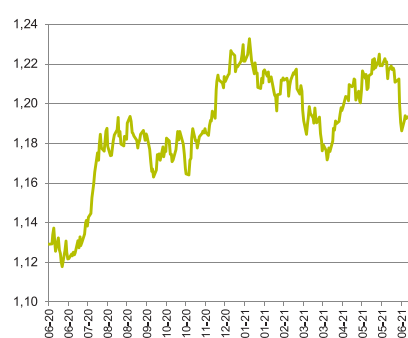
Inflation



Source: Bloomberg

US Inflation.

Exchange rate EUR/USD

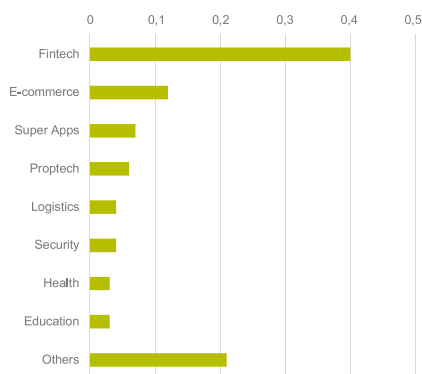


Source: Bloomberg

The dollar is at the same level it closed the first quarter even though we have seen some ups and downs.

Latin America

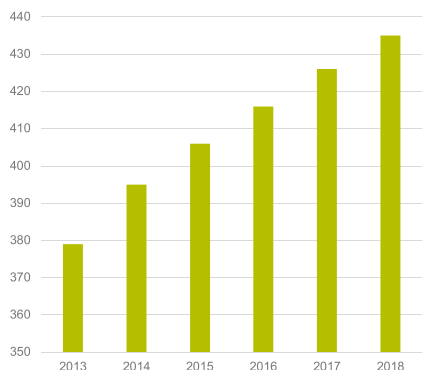
Notable sectors in 2020



Source: LAVCA

Fintech was the favourite sector for private investors in 2020, and it remains so in 2021.

Smartphone users in Latin America (millions)



Source: Bloomberg

The penetration of the internet and the use of smartphones is increasing, with still plenty of room for growth.

Private equity touches down in Latin America

In recent months, Latin American has been in the midst of a private equity boom, in Fintech in particular.

Since the 2008 crisis, the Latin American markets have found it especially difficult to attract capital. Other factors such as political instability, weak local currencies, regulatory issues and insufficient legal certainty have added to the traditional preference of local investors for fixed income.

Investors like Softbank, Microsoft, Sequoia Capital and Tencent are leading investments in Fintechs in the region

This situation is in contrast to the strong trend of attracting private capital at startups in the region. Numerous funds and institutional investors have set their sights on Latin America, aware of the enormous potential offered by a market of 650 million inhabitants. With innovation as a focal point, several sectors are receiving interest. Loft, a Brazilian PropTech company, has captured 600 million dollars in just one year, in two rounds led by investors such as Tiger Global, Soros and Andreessen Horowitz. The Colombian brokerage company Rappi received an investment of 300 million dollars from T. Rowe Price, while the Brazilian logistics enterprise Loggi obtained 250 million dollars from Microsoft and Softbank, among others.

However, one sector stands out above all the rest: Fintech, or technology applied to finance. Its growth is exceptional, and it is expected to continue. What makes us say this? Firstly, cash transactions clearly dominate in the region's economies. In Mexico, they represent 90% of transactions, while they amount for almost 70% in Brazil. Secondly, a significant portion of the population does not have access to traditional financial services. According to the World Bank, in Mexico, more than half of the population does not have a bank account, while in Brazil and Colombia these figures are around 33% and 32% respectively. Furthermore, the Latin American banking sector, with high margins compared to the rest of the world,

shows a high concentration of market share by the major institutions, which gives them little incentive to improve tech platforms and provide a superior service.

There are reasons to believe that this situation, which has remained static for decades, is now beginning to change. In Latin America, the population is younger than the global average; these citizens use smartphones for any day-to-day activity and they are not willing to go to a bank branch to request a service. In addition, the governments are willing to facilitate people's immersion in the financial system, so they are making efforts to positively regulate these activities. For example, in 2018, Mexico approved the "Fintech Law", intended to create a legal framework through which these companies could operate under the same requirements as traditional financial institutions. Other countries are going down that same path, although not without difficulties.

The numerous private financing transactions seen in recent months demonstrate that this is a solid trend. Nubank, the Brazilian neobank, has received 1 billion dollars in the last three years from investors like Invesco, Tencent and Sequoia Capital, and the company was valued at 25 billion dollars in the last round. To put this into context, this figure is almost half the market capitalisation of Itau, Brazil's largest bank. Neon Pagamentos and Credits, also Brazilian, rose 300 and 255 million dollars respectively in 2020 alone, from investors such as PayPal and Blackrock in the case Neon, and Wellington Management and Softbank in the case of Credits.

It is likely we will soon see the first IPOs of such companies, and even more likely that they will be listed on foreign markets, such as the New York Stock Exchange, where they have the security and liquidity that investors demand.

Juan Gestoso Ruiz
Investment analyst

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