Quarterly Report

Our View on the Markets

INDEX

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Both Trump's trade wars and the Italian populist government have eclipsed what should be a good environment for the financial markets. The global economy remains solid, as do corporate earnings, while the central banks are shyly winding down stimulus programmes.

One thousand, three hundred and seventy-nine. This is the number of tweets posted by Trump this year. He is now more popular than Shakira (ranked 18th). This should be nothing more than a fun fact, but as the US president has decided to start a trade war with half the planet, the financial markets have been dancing to the beat of his tweets. We continue to believe that there is a need to contextualise Trump's provocations. On the one hand we have the November mid-term elections and, on the other, a very unique negotiation style. With regards to the former, we need to remember that a large part of the electorate that carried Trump to the White House is an indirect victim of globalisation. These voters like to believe that the offshoring of industry can be reversed by force of tariffs. However, these very same people do not like to see how the prices rise for many of the imported goods that they regularly use. A rise in prices is very difficult to avoid when adding tariffs on top of those already on the table, albeit of token value. Trump breaks the mould in terms of the old negotiation methods. First, he threatens, then he aims to obtain some kind of concession that he can boast of as a personal success. But he always seeks to benefit himself, this time in the form of votes in November. We do not believe that he will allow the markets to become overly nervous, nor that his trade battles will end up significantly affecting the good economic environment or the consumers' wallets. Nor do we believe that he would be so naive as to think that he could emerge the victor of a trade war. The devaluation of the yuan alone, which he himself caused and which clearly worsens the US-China trade balance, suggests his tariffs are a mere paper tiger.

Trump is just one of the consequences of the disappearing middle class in developed countries, a phenomenon that is mutating into an increasingly ferocious populism. Italians have also been seduced by the siren calls of those who promise impossible solutions and they are now governed by an improbable coalition of the extreme right and left. But do not be fooled by the headlines. Under no circumstances do Italians want to leave the euro and both the Northern League and the 5SM know it and they never campaigned around this promise. We can see provocations towards Brussels in the form of overly generous budgets, but Italian debt, however massive it may be, has long maturities and low average rates. Therefore, it is bearable for longer than the current government is likely to last (usually not longer than a year and a half in Italy), and so no major effects are expected. The fact that the two-year Italian bond reached 2.5% a few weeks after trading at negative yields is a rare opportunity which must be taken advantage of to add to the portfolios, which we have done with due moderation.

While the global macroeconomic situation remains robust (exceptionally solid in the US, without us having yet seen the effects of the tax cuts), corporate earnings maintain their current strength and central banks do not go overboard in withdrawing stimuli (it does not look like it), Trump's tweets should not confuse investors. Use them to add new positions to your portfolios.

David Macià, CFA
Chief Investment Officer

Strategy

Asset allocation (2018 Q3)

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

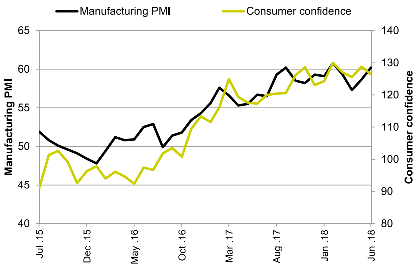
Oil	↓
Gold	↑

Currencies

EUR/USD	↑
JPY/USD	↑

Macroeconomic View

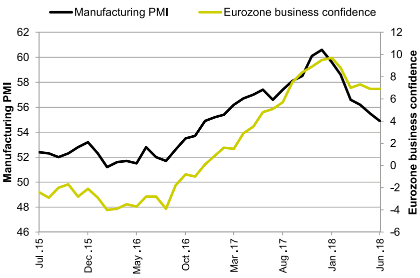
Manufacturing PMI and consumer confidence index for the US



Source: Bloomberg

The Manufacturing PMI and consumer confidence index are close to all-time highs.

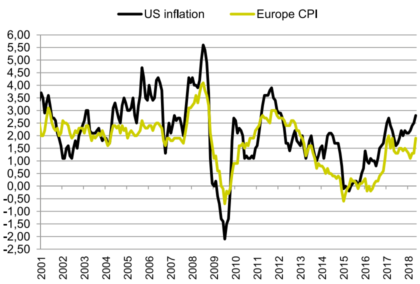
Manufacturing PMI and business confidence index for the Eurozone



Source: Bloomberg

The PMIs and consumer confidence index are moving away from the all-time highs achieved in January, but they remain solid.

US and Europe inflation



Source: Bloomberg

Inflation in Europe is close to the ECB target, while in the US, it appears to have an upward trend.

No dark clouds on the horizon

The positive outlook persists for global economic growth. On the one hand, the US continues leading the economic growth of the main developed countries. And on the other, although it has lost some of its strength, Europe's solid fundamentals continue to develop favourably.

When we think about the GDP growth of a country, it is important to separate the variables that comprise it. When we breakdown GDP, we are usually talking about the total sum of consumption, investment, public spending and trade balance (exports minus imports).

Analysing US growth, consumption, the main driver of the American economy with 70% of the weighting, grew 0.9% in the last quarter, underpinned by the tax cuts and wage growth. Also, the economy is at almost full employment, with an unemployment rate of below 4% and headline inflation at 2.8% in May. And this rising trend will continue in the coming months. In terms of investment, the tax cuts have had little impact so far on company investments, although the recent increase in oil prices is benefitting investments in the energy sector. Public spending is not lagging and the tax reform, including tax savings, is expected to contribute 0.7% additional growth for 2018. As for the balance of trade, the deficit continues at 4.45%. For 2018, GDP growth is expected to be around 3%, with a significant increase in the second quarter of around +4%.

With all of this, leading and confidence indicators rallied in May and they are still at very high levels, close to all-time highs. This is the case for the ISM Manufacturing and consumer confidence indices. The main storm cloud we can see and what is causing most uncertainty is the trade war. We continue to think that it will not go beyond causing instability in the short term, as a trade war is good for nobody.

> Although we have seen a bit of a slowdown, growth in Europe remains robust.

Even though we cannot ignore the fact that the US economy has experienced growth for nine consecutive years, the outlook for the coming months is positive, suggesting the good economic path will continue.

In terms of Europe, macroeconomic fundamentals, consumption, investment and public spending are developing nicely. The labour market is still the cornerstone of growth, having fallen from 9% to 8.4%, although large differences remain in the unemployment rate among EU member countries. For example, Spain has an unemployment rate of 16%, while in Germany it is 3.4%. Inflation, currently at +1.9%, is close to the ECB's target and significant inflationary pressures are not discernible. And finally, exports continue improving (2.7% since the beginning of the year), helped by the depreciation of the euro.

Although the most recent activity data shows signs of fatigue and the PMIs are down from the all-time highs achieved at the beginning of the year, they remain in the expansion zone. On the whole, the deterioration of business confidence indices reflects concern regarding the rise of populism in Italy and protectionism. We believe that the geopolitical risk in Italy will continue to be a source of upheaval for the markets. It is expected that the new leader will present the budget in September, in which the government will probably try to raise the public deficit in order to fulfil some of its electoral promises, which could result in a confrontation with the EU. That said, Minister of Finance Giovanni Tria has made several statements ruling out Italy's intention to leave the currency union and confirming the country's commitment to a growth-friendly fiscal strategy that would not jeopardise debt sustainability.

Due to all of the above, we believe that there are no significant storm clouds on the horizon for the European economy and the outlook remains favourable as GDP for 2018 is expected to grow around 2.1%.

Sergi Casòliva
Macroeconomic analyst

Fixed Income

Volatility returns to sovereign debt

We have seen sharp falls in the peripheral debt markets due to the rising political uncertainty caused by the new government formed in Italy.

Italy has caught the world's attention thanks to the political instability generated following the elections. In the end, the formation of a coalition government (5 Star Movement and the Northern League) has set alarm bells ringing, provoking some concern among investors. These worries multiplied after a leaked draft of a document suggested a possible exit from the Eurozone. Among other measures, the government asked the ECB to forgive €250 billion in debt. This would mean freezing and cancelling a portion of the bonds held by the ECB. It is something that is expressly prohibited in the statutes of the institution presided over by Mario Draghi and that Greece once attempted without success.

This situation has set Italian bond yields on a roller coaster ride, as the risk premium reached 290 bp up from 116 bp. Although the variation has been relatively modest compared with recent figures, what has indeed been notable is the sharp rally in the short-term yields. When these episodes occur, liquidity often disappears and volatility in prices intensifies. For example, it is worth looking at the 2-year bond, which closed the quarter with a yield of 1% (increase of 125 basis points YTD), sometimes reaching 2.8%.

The declines caused by purely political reasons are often windows of opportunity to buy solid securities.

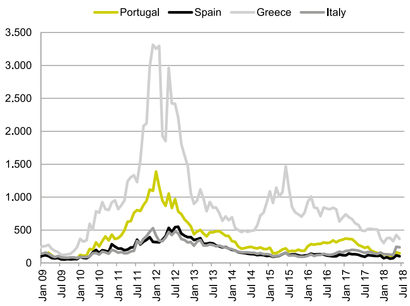
Could the situation in Italy spread? At least so far, the situation seems to be contained. Although the yield spreads for the 10-year government bonds of other peripheral countries with the German Bund have increased, their movements have been much lower than the Italian bonds. Also, the spreads are not particularly wide in terms of historical standards. In fact, they were all higher just a year ago. This suggests that the investors are rather confident that the Eurozone as a whole can resist the current political uncertainty in Italy, in spite of the widening of the spreads we saw halfway through this year. If the uncertainties caused by the trade war, Brexit and the political situation in Germany and Italy start to temper, we will most likely see a contraction in the peripheral country bond spreads. For its part, Greece has agreed with the Eurogroup to bring an end to the eight-year bailout programme in August. In addition, the S&P has improved the country's rating to B+ and it is soon expected to issue bonds on the capital market as normal once again.

It is not all about political uncertainty, as concern from investors has also focused on the high level of indebtedness. The debt-to-GDP ratio for Italy is 132% and it has remained stable since the record high of 2013. This is far from the Eurozone average of 87% and the target of 60% set by the Stability and Growth Pact. It is normal that investors demand higher yield, although they have remained positive on the asset. This is due to expected accelerated growth driven by improved domestic demand, the current account surplus seen since 2012, the reduction of the interest costs because of the accommodative monetary policy and the relative stability due to the fact that two-thirds of the debt is in domestic hands.

We expect that the geopolitical tension in Europe will de-escalate and that tranquility will be restored, although we need to keep a close eye on the main challenge up ahead: the end of QE. We should be wary of how this situation will affect this type of asset, although the ECB is expected to continue with the reinvestments for a time before reducing the balance sheet, something that would limit the initial impact.

Sergio Villadangos, FRM
Fixed Income portfolio manager

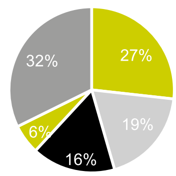
Risk premiums



Source: Bloomberg

We saw another rally in the risk premiums of peripheral countries, although they remain low when compared with previous figures.

Italian bondholders

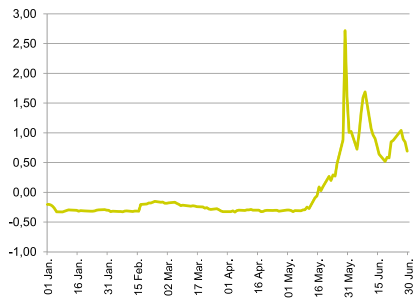


- National banks
- National pension funds and insurance companies
- Italian banks
- Domestic households and companies
- Non-residents

Source: Bloomberg

Only one third of Italy's total debt is held by non-residents.

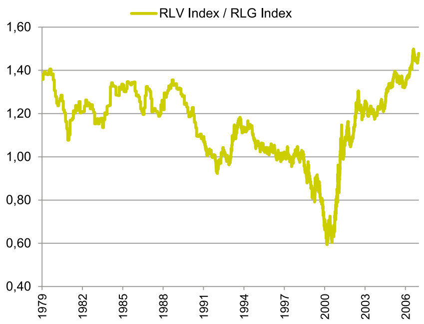
2-year Italian bond yield (%)



Source: Bloomberg

Following the political instability caused by the elections, the 2-yearbond yield rose to 2.8%.

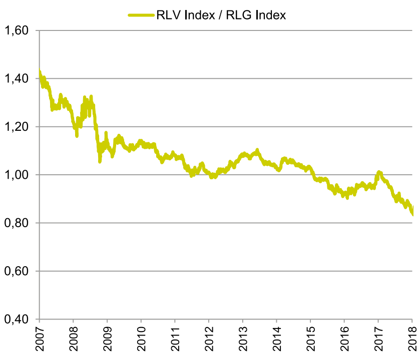
Russell Growth vs Russell Value (1979-2006)



Source: Bloomberg

From 1979 through 2006, Value had slightly outperformed growth and had done with much lower volatility.

Russell Growth vs Russell Value (2007-2018)



Source: Bloomberg

Over the last 11 years, the Russell 1000 Growth Index has greatly out performed the Russell 1000 Value Index. This has shaken the confidence of value investors.

Is value investing dead?

Historically, value has outperformed growth, but the last 11 years have been quite a different story as growth has far outpaced value. Does this mean that value investing is dead and Benjamin Graham was ultimately wrong?

Nobel Laureate Eugene Fama, who is commonly known as the father of modern finance, and fellow professor Kenneth French collaborated to better measure market returns. In 1992, they published the Three-Factor Model in which one of the three main 'factors' is that value outperforms growth. (Don't worry, this will not be a technical article). Unfortunately for value investors, the last 11 years has shaken their faith.

"Sometimes growth is cheap and value expensive." Bill Miller his value fund beat the S&P 500 15 years in a row

Where can we place some of the blame for this? Well, if we look back over the last decade we can start with the Great Recession and the Federal Reserve's actions during the recovery. First, the Fed lowered rates to near zero which effectively neutered one of the tenets of value investing: look for companies with a strong balance sheet! Why do companies need a strong balance sheet if debt is virtually free and they can invest in growth opportunities for their business? The same thing can be said for investing in companies with a solid cash flow profile. The second problem was the Fed's quantitative easing (i.e. flooding the market with cash), which caused investors to be much less discerning with their money. These problems are temporary (although 11 years is quite long) because they are both currently being unwound as the Fed is raising rates and is no longer growing its balance sheet. Let's not forget to mention that since 1928, value has outperformed growth every time rates have risen.

Related to this extended interest rate cycle is the fact that financials has been the worst performing sector over the last decade. And guess what? It is the sector with the largest weight in value indexes. Look at the top holdings of any large cap value fund and you will see some combination of JP Morgan, Wells Fargo, Citibank, and Bank of America. Take a guess at what the third largest sector is? It is energy and it has been the biggest dog of the last five years. Financials and energy combine for a stunning 43% of the Russell 1000 Value Index. Technology, on the other hand, only accounts for 9% of the value index but it is a third of the growth index.

Perhaps value investing just needs to be redefined. One of the key ratios used by Fama and French to discriminate between value and growth stocks is the Price-to-Book ratio (P/B). In this ratio, 'price' is simply the market value of the company, while 'book' is the assets minus liabilities. A low P/B ratio has historically been treated as an indicator of an undervalued company, but is that still true? The methodology used to select the constituents of the Russell 1000 Value Index is heavily weighted towards low P/B ratios. This is why the index is stuffed with financial companies and why it also overweights old economy industrial companies that own many physical assets. Conversely, technology companies mostly get ignored as they typically do not have many assets. A great example of this problem is Apple. The maker of the iPhone appears to be a value stock based on profitability, cash flow and balance sheet, etc, but because of its relatively high P/B, it falls into the growth index. Warren Buffett would seem to agree that Apple is a value stock since he recently made it the largest holding at Berkshire Hathaway.

So maybe we do not have to wait until rates go higher for value to make a comeback.

Charlie Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Oil. The OPEC is back on the scene

For the first time in a decade, the cost curve for oil production projects has risen. The sharp increase in the number of shale oil deposits that we saw in the past with the current crude oil prices will come to a halt in the future ($76/ barrel for Brent at the time of writing). Higher costs, lower yield and less eagerness to increase supply.

Furthermore, the estimated duration of large production projects fell to less than 40 years. Technological progress means resources are being exhausted ever faster and so the average project life span is dropping. As the volume of shale increases, the more difficult it becomes for it to continue to grow. In fact, a slowdown is expected from 2020, even if there is an increase in global activity.

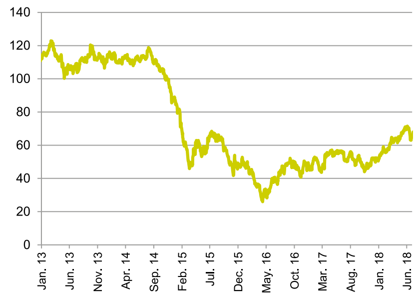
In 2020, the OPEC will need to increase its supply. This was the subject raised at the OPEC's meeting in June, its most important meeting of the last two years. The price of oil fell in the build up, influenced by the prospects of a potential turning point and an increase in supply following the cuts of recent years.

However, the crude oil market is at risk of being under-supplied if the continual declines in Venezuela persist and if the same thing happens in Iran. In part, this is what has pushed the price from $45 to $80 in just one year. Even if the OPEC does decide to increase production, it will require further increases and investments will need to be made in order to supply the world with oil over the next five years.

The OPEC is back on the scene and this time with good reason. We are now seeing a turning point that will increase production.

Miguel Ángel Rico, CAIA
Investment analyst

Brent price evolution



Source: Bloomberg

Geopolitical tensions pushed the price upwards.

CURRENCIES

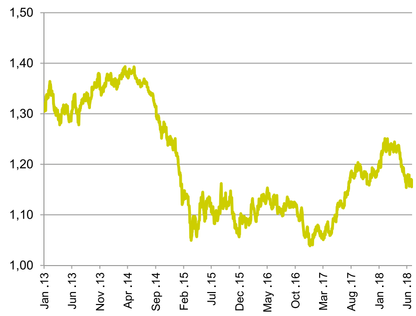
Headwinds slowly dissipate

At the end of last year, when the euro was at 1.20, we thought it still had room to run and it did, hitting 1.25 by the end of January, where it hovered until mid-April. At that point, we did not expect it to rise much further as all positive factors seemed to be priced in already and literally everyone was long the common currency. Since then, the exchange rate has dropped and it is currently quoted at 1.16. Several negative elements underpinned the correction. For instance, economic data was disappointing, indicating a slowdown in growth while inflation remained muted. Furthermore, fears of a global trade war and the political upheavals in Italy, Germany and Spain also helped to pull the euro down further. The final blow came from the June ECB meeting, in which Draghi confirmed that the asset buying programme would effectively end in December but that the first interest rate hike would only happen during the summer of 2019. Meanwhile, due to still compellingly strong data and higher inflation the Fed has upped its hawkish bias giving support to the greenback.

Even though politics may continue to hit the headlines and cause volatility, the macro data in the Eurozone is more likely to surprise on the upside, thereby allowing the ECB to readopt a less accommodative rhetoric. Furthermore, the market is already pricing in future interest rate hikes in the US so the dollar is unlikely to receive an extra boost from the Fed. Finally, the euro area's current account surplus and shrinking fiscal deficit contrast with the deteriorating current account and fiscal deficits of the US. It may take some time and the euro could drift down further in the short term, but we envisage it grinding back up again in the mid-term.

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

Exchange Rate EUR/USD

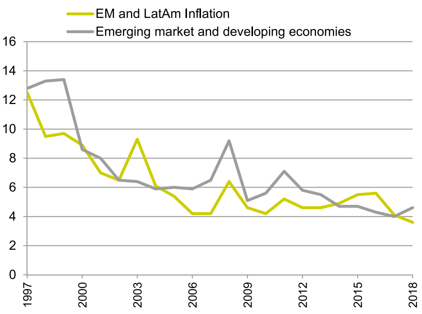


Source: Bloomberg

It may take some time and the euro could drift down further in the short term, but we envisage it grinding back up again in the mid-term.

Latin America

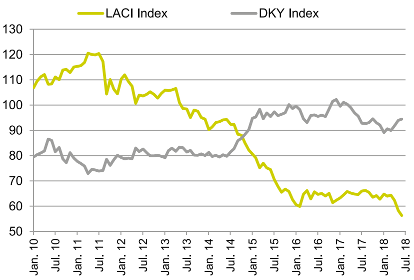
Latam and Caribean inflation vs EM EMEA Inflation



Source: International Monetary Fund (IMF)

Inflation on emerging markets is historically low, particularly in Latin America, where it has never been so low.

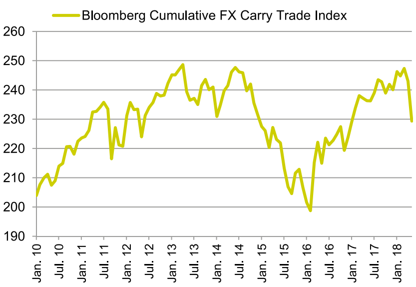
Bloomberg JP Morgan LACI vs DXY Index



Source: Bloomberg

The strength of the dollar is the great est enemy of the emerging markets.The liquidity-weighted LACI Index for LatAm currencies has fallen around 10% YTD.

Bloomberg Cumulative FX Carry Trade Inde



Source: Bloomberg

The reduction in the rate spread between the US and LatAm has made the carry trade less attractive.

Latin America: Navigating uncertain waters

The second quarter of 2018 has left a bad taste in our mouth. Emerging markets remain fragile, mainly due to a suddenly strong dollar, and Latin America has not been spared. Perhaps being selective and evaluating the fundamentals will guide us through these high tides and put us on the right course.

Emerging markets got off on the wrong foot in 2Q18. A sudden rise in the dollar wreaked havoc on the various economies. However, this damage varied in severity. The countries that suffered the most were those with more fragile fundamentals, greater imbalances and political and economic uncertainties. The equities market, which can be considered to be a leading indicator, reflected this theme and some countries have found themselves with what is theoretically a bear market. Such is the case for Brazil, Turkey, China and the Philippines, which have fallen around 20% or more from their recent maximum levels. On the other hand, some equities indices in emerging markets have shown resilience to the circumstances. Colombia, Peru, India, Russia and Taiwan are some such examples, which have fallen around 6% from their recent maximums. A very striking phenomenon.

Looking at Latin America, something similar has happened, but it was the exchange rates that were affected the most abruptly. The Brazilian real and the Mexican and Argentine peso suffered sharp falls, while the Colombian, Peruvian and Chilean peso dropped as well, although to a lesser extent. The most striking case was that of Argentina, which experienced an attack on the currency, causing the Central Bank to increase the Repo rate to 40% and President Macri to request a line of credit from the IMF for a value of $50 billion. Upon learning of the agreement, the authorities announced a $5 billion offer at 25 ARS/USD. However, the exchange rate dropped again to 28 ARS/USD and it is still under pressure. The floating exchange rate will continue to do its job and it will possibly reduce the imbalances through depreciation. However, the so-called carry trade has returned to the fore due to the country's high interest rates. Now is the time to evaluate the risk-return dynamic and put Argentina on the radar.

We are also seeing historically low inflation. In emerging markets, inflation for 2018, according to the IMF, is expected to be 4,6% and 3,6% in Latin America. These are some of the lowest levels ever seen. As a result, the central banks have implemented a more accommodative monetary policy, lowering interest rates and reducing the carry trade that helped to shore up the region somewhat (with some exceptions, such as Argentina). A more restrictive policy in the US casts a further shadow on the strategy. We are possibly very close to a turning point in monetary policy in Latin America as the pass-through of the depreciation alongside higher oil prices will weigh on the prices. However, the search for yield still plays an important role and the strategy should not be disregarded.

In Latin America, we prefer countries like Colombia, Peru and Chile for both equities and fixed income.

The good news is that we have tools at our disposal to identify the most attractive economies. Firstly, we must avoid countries suffering hefty twin deficits and/or imbalances. Secondly, commodities bottomed out and have recently strengthened, which should benefit the economies that export these goods. And finally, we must seek economies subject to fiscal discipline and that are en route to carrying out necessary economic adjustments. To conclude, in Latin America, we prefer countries like Colombia, Peru and Chile for both equities and fixed income, and a close eye should be kept on Mexico, Brazil and Argentina.

The second half of the year may take us on a long and dizzying journey because, with the continued rise of anti-globalisation policies, trade wars, more restrictive monetary policy and a stronger dollar, a more pronounced risk-off scenario will be created.

Diego Fernando Agudelo López
Latam Analyst

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