Research

Crèdit Andorrà Financial Group

Fourth quarter 2018
Date of report: September 28th 2018

INDEX

Quarterly Report

Our View on the Markets

Emerging markets

This year, emerging country assets are suffering downturns that, in some cases, have more to do with contagion than real problems. We think we need to make the most of this scenario very selectively.

Sometimes, the tendency to generalise gives rise to serious misperceptions, something very common in financial markets that often produces fantastic investment opportunities. This year, emerging markets are suffering badly but the term *emerging* is being applied to countries that are very different from one another. Venezuela, Brazil, Turkey and Argentina are grabbing the headlines but they are not representative of the rest. Venezuela is an absurd case, for example. Despite having huge oil reserves, it has no way to exploit them (it does not even have a way to supply the supermarkets so that people can eat). The country's atrocious economic management (it has taken the easy road to finance the deficit, which exceeds 30% of GDP, by printing currency, among other unwise measures) has brought inflation to excessive levels and the IMF estimates that it will reach above one million per cent this year. A quiz show had to be cancelled because the prize, which was worth $100,000 in January, was not worth even ten cents in August. Brazil is suffering one of the worst recessions in its history and, this October, it must decide if it is to be governed by the far right (Bolsonaro makes Trump look like a little angel, at least in terms of controversial statements) or by leftist populism, led by a representative of Lula (jailed for corruption). In Turkey, Erdogan has threatened the country's central bank and appointed his son-in-law as the finance minister, while inflation surges and the Turkish lira collapses. And in Argentina, Macri is trying to follow the script dictated by the IMF (he has increased taxes and rates have risen to 60% in an attempt to contain inflation), but he has inherited Kirschner's economic debauchery that is of such a scale that he will have to move mountains to fix it.

These cases, which are diverse in themselves, are extreme and they do not represent the group. The thing that countries, emerging or otherwise, do have in common is that they compete among themselves for capital to finance their projects, both public and private. As the US interest rates rise and/or the dollar strengthens, the country becomes a huge capital vacuum (tempting investors to move investments to the US from elsewhere in the world). The capital, therefore, is *sucked up* and the miseries of some are laid bare, while a spotlight shines on the strengths of others. Unlike previous crises, many emerging countries now have independent central banks and vast reserves in foreign currencies and they maintain very healthy levels of debt. This debt is chiefly denominated in the countries' own currencies, which are also allowed to float freely (in the past a lot of debt was issued in dollars and emerging countries tied their currencies to the dollar, resulting in economic suicide when things went south). The Fed is running out of rate hikes (we do not think it will exceed 3%, from the current level of 2.25%) and we believe the dollar is already discounting the best scenario and it should not rise much further. We are of the opinion that Trump's trade war is an exercise in propaganda in the run up to the elections in November and it should fizzle out afterwards, calming investors' nerves.

Everything seems to suggest that the factors harming emerging assets the most now will cease to be a burden in the coming months. This means that they will no longer present the same opportunities as today. Patiently, separating the wheat from the chaff and, as ever, very gradually, we must not allow these opportunities to pass us by.

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

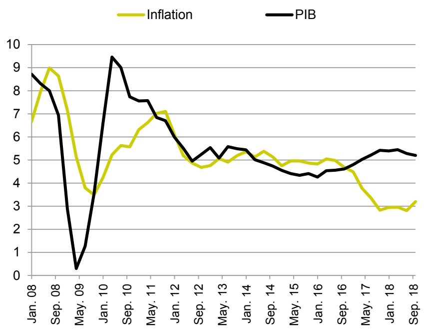
Oil	→
Gold	↑

Currencies

EUR/USD	↑
JPY/USD	↑

Macroeconomic View

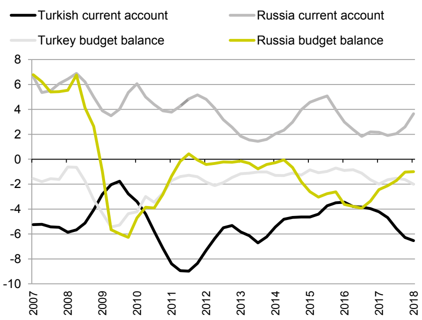
Evolution of GDP and inflation in emerging markets (%)



Source: Bloomberg

Although some countries are seeing high inflation, on average, emerging countries have inflation at minimum levels.

Budget and current account balance of Turkey and Russia (% GDP)



Source: Bloomberg

Turkey has twin deficits (current account balance and budget balance), while Russia has a current account surplus and its budget balance is improving.

Not all emerging countries are alike

In recent months, emerging countries have been the focus of investors and they have suffered episodes of great volatility. The increase in interest rates by the Fed, the appreciation of the dollar and the trade disputes have cast doubt on the economic stability of some emerging countries, among which Turkey, Argentina, Mexico, South Africa and Brazil stand out.

History is repeating itself for some emerging countries. When the dollar rises and the American bond yields increase, we see inflow to the US and outflow from emerging countries, which causes the depreciation of local currencies. American assets are more attractive for investors as they achieve interesting returns at lower risk. The loss in value of a currency has two opposing effects, one for the domestic market and one for the international market. On the one hand, the general level of prices increases within the country as the prices of imported products rise (once converted into the local currency) and, on the other, products exported elsewhere simultaneously become cheaper. Also, as many emerging countries have fiscal or current account deficits and they depend to a large extent on external financing, when the dollar appreciates, the debt owed increases and emerging countries suffer peaks in volatility and cash outflows from the country. When this happens, the central banks raise rates to avoid capital flight.

Emerging countries with a solid fiscal balance are better prepared for moments of strength in the dollar

A study by the Federal Reserve carried out by Scott Davis and Andrei Zlate looked at the performance of emerging economies in the global financial cycle. The report concluded that the countries with a solid fiscal balance had healthier economies, both when the dollar was strong and when emerging countries were strong. For example, during the *taper tantrum*, when the Fed announced the end to the stimulus programme, the countries with higher current account deficits (Brazil, India, Indonesia, South Africa and Turkey) experienced significant depreciations in their currencies compared with those that had a current account surplus. Countries with a current account deficit were forced to seek external financing in order to pay the interest on their debts and they became the countries that were most vulnerable to changes in the financial cycle.

Let us look at Turkey and South Africa, with significant twin deficits, which means they have deficits in their trade balance and fiscal balance. The sanctions imposed by the US on Turkey, related to the detention of an American pastor held since 2016, triggered an outflow of capital and a sharp fall in the latter's currency. This in turn caused inflation to surge (from 10% at the beginning of the year to over 17.75% in June) and it forced the central bank to increase interest rates to 24%. Turkish businesses had taken advantage of the abundant and cheap financing environment of recent years, to the extent that foreign debt increased to 53% of GDP, compared to 36% in 2011. In the case of South Africa, after the change in government following accusations of corruption and poor economic management, the country found itself in a recession, falling 0.7% in the second quarter after a drop of 2.6% in the first. The unemployment rate is above 26%, the highest in the world.

The good news is that in other emerging countries, the financial situation is more positive, even if they have been punished by the market. In Russia, for example, the fiscal surplus is 0.6% of GDP, thanks in part to the sharp rise in oil and the control on public spending. Mexico, for its part, has a roadmap to achieving a 2.5% fiscal deficit and reducing government debt as a percentage of GDP to 45.4% from 47%.

Even though the market has punished all emerging countries equally simply for being emerging countries, we must distinguish between the two groups explained above and differentiate their macroeconomic contexts. In general, most of these countries are in a better situation than on previous occasions, with more controlled inflation and more sustainable economic growth.

Sergi Casòliva
Macroeconomic analyst

Fixed Income

The end of quantitative easing

After a decade of central banks applying ultra-expansive and unconventional monetary policies based on asset purchase programmes (quantitative easing) and maintaining rates close to zero, now they are preparing for monetary normalisation and balance sheet reductions (quantitative tightening).

This September marked the tenth anniversary of the fall of Lehman Brothers, which signalled the beginning of the worst global financial crisis of recent decades. The hyper-debt could no longer support the existing economic model so the central banks, in a coordinated effort, came to the rescue with unconventional policies (known as quantitative easing), based on asset purchase programmes, which facilitated the injection of liquidity into the market. The objective was to reactivate the flow of credit in the economy, keeping interest rates low artificially.

Now, when it looks like the last financial crisis and subsequent economic depression are coming to an end and as the global economy is expanding (in its last edition of *World Economic Outlook*, the FMI estimates global growth of 3.9% for both 2018 and 2019), the main central banks are preparing to reduce their balance sheets and they are taking their first steps along the path towards normalising monetary policy. This is what is called quantitative tightening, the opposite of quantitative easing. The Federal Reserve began this process in November 2017 and it has so far reduced its balance sheet by $237.9 billion. The European Central Bank will reduce its monthly net asset purchasing to €15 billion by the end of December 2018 and it is expected to cease altogether from then onwards.

The increase in rates in the US and the appreciation of the dollar have influenced the price of emerging market bonds

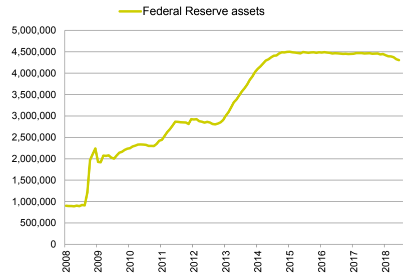
In the 10-year period between 2008 and 2017, according to data from Bloomberg, all central banks have trebled their balance sheets, resulting in a cash injection of $14.245 trillion. This expansionist policy, which has flooded the market with liquidity, without a doubt helped to raise the price of assets and also led to the so-called portfolio effect, by which the central banks' purchases of lower risk assets (government bonds, IG credit, covered bonds) have encouraged investors to purchase higher risk bonds, whether due to the lack of bonds in this segment or due to the search for higher yield. It is natural for investors to be concerned about what will happen when all of this liquidity runs dry and interest rates begin to rise, as there is a risk that this reversion process will cause a drop in the price of assets.

At this time, there is a particular need for central banks to correctly evaluate the various risk factors at play at the macroeconomic level (especially inflation forecasts), as well as in the financial and geopolitical contexts so that monetary normalisation can take place while avoiding as many hiccups as possible. In fact, the markets are also more volatile this year than in 2017. The price war and the crisis in Turkey played a significant role, but QT should not be ruled out as a contributing factor as the increase in US government bond yields and the appreciation of the dollar have influenced the price of emerging market bonds, for example.

In this context, who might be the big winners? The money market investors, who will be able to invest at better rates. For instance, the three-month US treasury bonds have gone from offering a yield of less than 1% just a year ago to 2.13% today. And what are the major pension funds doing to protect against the increase in rates or higher volatility? They are incorporating real assets that generate recurring revenues, such as real estate, or investing in infrastructure. Many already consider these real assets to be the new bonds, which help to improve return and reduce the global risk of the portfolios.

Josep Maria Pon, CIIA
Fixed Income portfolio manager

Evolution of the Fed balance sheet



Source: Bloomberg

After reinvesting the coupons and the maturing securities in the portfolio for several years, during 2018 it is possible to see the reduction in the Federal Reserve's balance sheet.

Evolution of the balance sheets of the main central banks (billion USD)

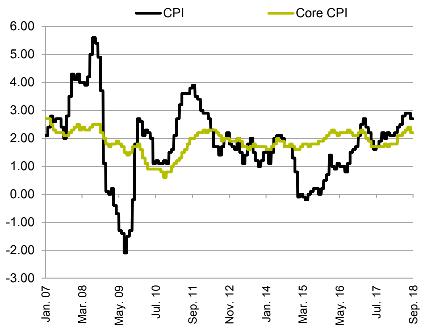
				Difference	
	2018	2017	2007	2017-2007	2018-2017
FED	4,210.80	4,448.70	891.20	3,557.50	- 237.90
BCE	5,398.70	5,375.70	2,223.30	3,152.40	23.00
BoJ	4,964.50	4,631.50	995.50	3,636.00	333.00
PBoC	5,302.40	5,577.80	2,317.90	3,259.90	- 275.40
Others	924.20	954.30	314.50	639.80	- 30.10
TOTAL	20,800.6[illegible]	20,988.00	6,742.40	14,245.60	- 187.40

Source: Bloomberg

In the period between 2007 and 2017, the main central banks increased their balance sheets by more than 14 trillion dollars. Compared with last year, asset purchases have dropped this year. This will probably be more notable in the coming years when the central banks that are still immersed in QE bring it to and end.

Equities

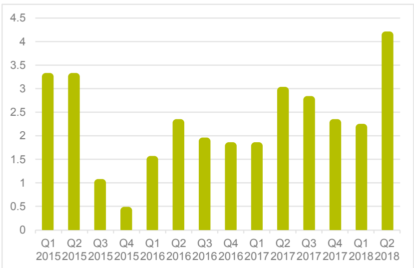
Consumer Price Inflation Yr/Yr (%)



Source: Bloomberg

Core CPI has hardly changed over the last few years.

Real GDP Growth, annualised (%)



Source: Bloomberg

Second quarter GDP growth was an impressive 4.2%.

US equities at new all-time highs

The US equity market is at an all-time high due to the combination of strong earnings growth, modest inflation and little visible economic impact from tariffs.

After the blow-off top we experienced in January, where the S&P 500 declined by over 10% in just 2 weeks, it has taken the market 6 months to claw its way back to new record highs, but here we are! It is not only the S&P 500 that is up, but the Dow, NASDAQ, Russell 2000, and the Dow Transports are all at or near their record highs. The last 6 months have seen a reset of expectations, and a reset of the sentiment that helped the market recover from the blow-off top. To be honest, the market in 2018 has already performed better than what most Wall Street analysts believed was possible at the end of 2017, and definitely better than anyone would have thought when we were sitting at the lows in February.

“I have talked to hundreds of CEOs [...] and all of them are investing more because of the tax breaks”

Marc Benioff

Of course, there are several tangible data points that helped the market get back on its feet. The most important (in our opinion) is that first quarter 2018 S&P 500 earnings growth came in at 25%, followed by another 25% in the second quarter. The strength in earnings growth is a strong elixir that has offset concerns regarding trade wars.

Speaking of trade wars, there has been little hard evidence that tariffs have made any significant impact to the economy. The market is also not assigning much future economic impact from the trade war as most investors remain convinced that the trade disputes will eventually be settled. To be sure, there have been a couple of companies, such as Micron, that have blamed disappointing earnings guidance on the effect of tariffs, but they remain the exception rather than the rule. Simply put, the economic impact of tariffs has not shown up in a discernible way, but the benefit of lower taxes has. Let us also not forget the mountain of buybacks that companies are executing thanks to tax reform. In the first quarter of 2018, companies repurchased $189 billion of their own shares, which absolutely dwarfs the $137 billion purchased in the six quarters before tax reform combined. Buybacks for the second quarter look to be even larger than $189 billion.

All the talk of trade wars and the Trump administration’s obsession with reducing trade deficits with tariffs has stirred up fear over rising inflation that will choke off growth. This ties in with our second data point, which is while CPI (consumer price inflation) has picked up a bit, core CPI (excludes food and fuel) has hardly budged (see graph).

Our third data point is real GDP growth. Of course, we started off 2018 at a rather pedestrian 2.2%, but then accelerated to a gaudy 4.2% in the second quarter, bringing to fruition President Trump’s campaign promise of 4% GDP growth (only for one quarter, but who is counting?). Although the aftermath of Hurricane *Florence* might dent third quarter GDP growth, the Atlanta Fed is estimating robust growth of 4.4% (see graph).

So far, 2018 has been good to investors and it is hard to ask much more of the stock market (except to selfishly ask it to keep setting new highs). However, expecting another good year in 2019 could be a tall order considering that interest rates should be moving higher, earnings comparisons will get much tougher, there is no end in sight to the trade war and, oh yeah, Donald Trump will still be President!

Charlie Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Tariffs, emerging markets & Trump's Twitter

Following a relatively solid start to the year for commodities (and raw material producers), some weaker than expected macroeconomic data in China and a deterioration in sentiment affected commodities prices as the trade war rhetoric escalated. Volatility rose as the to-and-fro of news and tweets alternately suggested that the trade war was either heating up or cooling down.

This has been particularly evident in the price of metals, but what do these prices tell us about future expected growth? The price of metals seems to indicate much lower global economic growth than a year ago. Doctor Copper, in particular, has been an easy target for speculators who have wanted to make the most of the stress on emerging currencies. Turkey, a country with serious structural problems, caused a contagion effect on the other emerging currencies this summer. The copper futures market, which is larger, more developed and more liquid than the others, was used as a proxy for the stress on emerging markets. It suffered a correction that is difficult to justify based purely on its fundamentals.

Of course, China continues to be critical to the evolution of commodities, as it represents over 50% of demand for the main industrial commodities. The Chinese government is being clearly proactive in its commitment to growth, bringing in tax stimulus measures and a more accommodative monetary policy if necessary. Looking beyond the headlines about the trade war and the stress on emerging currencies, let us make the most of the downturns when they are exaggerated. Now may be a good time to buy metals as proxies for emerging markets, but with good fundamentals, like copper.

Miguel Ángel Rico, CAIA
Portfolio Manager

Copper price performance

Source: Bloomberg

Copper was pressured by emerging markets.

CURRENCIES

Downward pressures on the yuan

China's aggressive stimulus package during the financial crisis helped to avoid an economic slump but left the country with a ballooning debt pile. Beijing has since engaged in rebalancing its economy, reducing excessive reliance on inefficient investments while increasing dependence on consumer demand. It has been a struggle to reduce debt growth without slowing the economy too quickly, but the debt-to-GDP was projected to stabilise this year at 260%. However, trade tensions have now put extra pressure on the economy, forcing authorities to postpone their deleveraging objectives and reinstall stimulus measures such as liquidity injections, fiscal policies and infrastructure spending.

A weaker yuan would seem an obvious tool to help compensate the negative effects of US tariffs on exports as it would cheapen the price of Chinese products once converted into dollars. Nevertheless, a significant correction of the currency would probably do more harm than good. During 2015-2016, the yuan depreciation triggered large capital outflows and pressures on FX reserves. Between August and December 2015, capital flows out of China reached an annualised rate of $1 trillion, causing ripple effects in global markets. Since then, China has promised a more market-orientated exchange rate regime in order to maintain foreign investors' confidence and avoid financial instability. Chinese officials have repeatedly denied Trump's accusations of currency manipulation and recent measures making it more expensive to bet against the yuan also underscore China's will to stabilise its currency.

Even though the accommodative policies of China and trade frictions put downward pressures on the yuan, we expect a very controlled depreciation. The main risk to this forecast would be a significant escalation of trade tensions heightening investors' concerns. 7 USD/CNH is a critical psychological level and should the exchange rate rapidly and forcefully break above this level, markets would probably suffer.

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

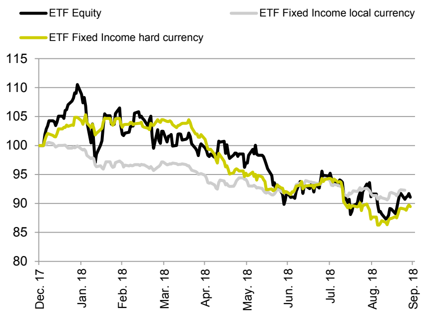
Exchange rate USD/CNH

Source: Bloomberg

China does not want the yuan to depreciate much further. 7 USD/CNH is the key psychological level to watch.

Latin America

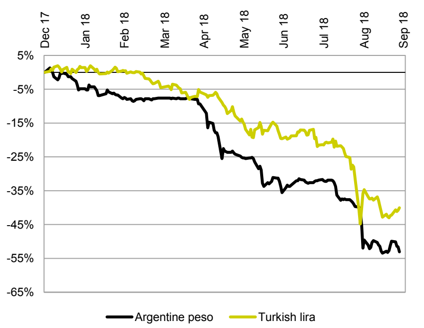
Equities and fixed income of emerging markets



Source: Bloomberg

Both equities and fixed income in hard currency and local currency accumulated YTD losses of 10%, 6% and 13% respectively.

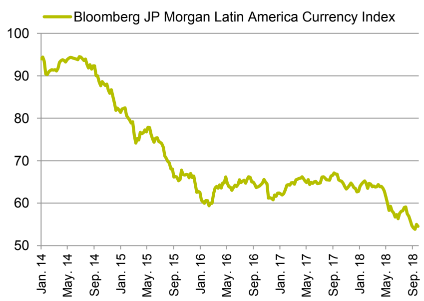
Evolution of the Argentine peso and the Turkish lira



Source: Bloomberg

During a currency and confidence crisis, the Argentine pesa and Turkish lira haven fallen 52% and 38% respectively againts the dollar so far this year.

Bloomberg JP Morgan Latin America Currency Index



Source: Bloomberg

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

Latin America: The anguish goes on

The year 2018 has been quite a challenge. Trade tensions, a sudden rally in the dollar and monetary normalisation have all caught up with the emerging markets. The pressure will continue in the short term, but a mean reversion is likely, particularly when the political uncertainty dissipates.

2018 has not been a good year for those of a nervous disposition. The sharp ups and downs on the markets and the heightened uncertainty have jangled nerves and still the storm clouds linger. The synchronised environment seen at the beginning of the year became disjointed and a divergence formed. The big returns have been concentrated in just one country, the US, thanks to its favourable macroeconomic environment. Other regions have shrugged their shoulders while emerging markets have suffered the most from the escalating trade tensions, monetary normalisation and the strength of the dollar seen since April. So far this year, there has been a downturn in EQ and FI, both in hard currencies and local currencies, of 20%, 8% and 12% respectively.

The current situation began to develop in 2015, when the US federal fund rates were within the range of 0% and 0.25% and, in December of that year, the central bank took its first steps to normalise its monetary policy. Rates have since increased by 25 basis points eight times. Furthermore, the reduction of the Fed's balance sheet since the end of 2017, thanks to reinvesting in fewer maturities, has affected liquidity across the globe. This situation, alongside the other catalysts mentioned above (trade tensions and the strong dollar), has forced the more fragile economies against the ropes. In the words of Warren Buffett, "only when the tide goes out do you discover who has been swimming naked" and Turkey and Argentina, each suffering a currency crisis, clearly illustrate this maxim.

Argentina and Turkey share several significant weaknesses, including twin deficits, relatively low international reserves, high inflation and indebtedness. However, an important difference lies in how each of the countries has dealt with the crisis. In Argentina, the support of the IMF and following textbook suggestions with orthodox policies (such as the central bank increasing rates, adjustments and tax reforms), could bode well for the future in spite of the continual bad news, like the recent resignation of the President of Argentina's central bank, Luis Caputo, a heavyweight in the economic field. In Turkey, on the other hand, the central bank appears apathetic, the President intervenes in decision-making and irrelevant and insufficient adjustments have been announced. As a result, the outcome will probably not be very positive. Although Turkey's central bank has recently increased its reference rate by 600 basis points, providing some relief, it is hard to believe that it will become a transparent bank overnight.

Complacency seems a long way off and as we look towards Latin America, great challenges and risks loom large. In the case of Brazil, the risk is obviously a political one, but following the elections in October the outlook will be clearer and the chance of a surprise on the upside is not off the table. In Mexico, the good news is already mostly discounted by the market. After the political turmoil died down, it was one of the most resilient countries, meaning that in a risk on scenario, its peers (Chile, Brazil and, to a lesser extent, Peru and Colombia) could have much more room for improvement. Monetary policy will also be an important factor.

> Although navigating the emerging markets in 2018 has been far from easy, sooner or later a mean reversion will occur

Although navigating the emerging markets in 2018 has been far from easy, sooner or later a general mean reversion will occur, driven by an economic or political catalyst. Volatility and the deterioration we have been seeing may continue in the short term, so it is important to be selective. The main issues to scrutinise are possible changes to monetary policy, the performance of the US dollar, trade dispute negotiations, elections and economic indicators compared with the consensus.

Diego Fernando Agudelo López
LatAm analyst

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Research

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