Crèdit Andorrà Asset Management

Second quarter 2014

Date of Report: 28th March 2014

Quarterly Report

Our View on the Markets

INDEX

Submerging?

Emerging markets have taken up the baton from Europe as the geographic region most hated by investors. Such moments tend to be precisely the right time to begin to selectively buy. However, we would take structural positions gradually since several factors are likely to continue to plague this group.

In 1994, developing economies accounted for 18% of the total global GDP; today they currently verge on 40%. These countries will undoubtedly continue to gain weight and influence: the urbanisation process is still a work in process (in India only 30% of the population lives in large cities, less than half the percentage in Germany); people continue to join the ranks of the middle class (two-thirds of which should reside in Asia by 2030e or double the current level); and, therefore, consumption should continue to be pushed upwards (again Asia wins: in 15 years, it is expected to amount to 59% of total global spending or almost treble the current level). Moreover, demographic trends are clearly better in the majority of emerging markets (although China is a major negative exception) than in developed ones (in this case, the US is the main positive exception). Furthermore, they are currently much better prepared to combat crises than in the past, with flexible exchange rates, credible central banks, and large foreign currency reserves (equivalent, on average, to over 25% of GDP). As a result, excluding emerging market assets from our portfolios, over the long term, would undoubtedly be a serious error.

Unfortunately, investors' disaffection is not fortuitous and may very well continue for quite some time. As explained in greater detail later in this document, "easy" economic growth has been left behind and in many cases structural reforms are urgent. The Chinese case must be addressed separately since we believe a slowdown of the second largest global economy is inevitable, as it shifts towards a consumer-based model from one based mainly on investment (which currently accounts for half its GDP, which we consider completely unsustainable). This scenario, at least initially, will be difficult for many emerging countries to digest since they have deepened their economic and trade links with the Asian giant (e.g. trade between the African continent and China has multiplied by 20 thus far in this century). This is particularly the case for raw material producers since the Chinese have been voracious consumers of these products. The change in the Fed's tone – tapering at full speed –, with interest rate hike, in our view, likely to occur sooner than the market is discounting, is not expected to help emerging markets either if the vast quantities of capital poured into them in recent years continue to be repatriated. In order to halt the bloodletting and combat inflation imported due to weak local currencies, many central banks have no alternative but to raise interest rates at the worst time.

However, the investor sell-off which began last May has left a lot of assets with very attractive valuations and one should take advantage of the prevailing extremely negative sentiment. With emerging market currencies close to lows of the last decade, there may already be some good opportunities in both equities and fixed income, mainly on the corporate side (which is less risky than it might appear given that over 60% of the components of indices are companies with investment grade ratings). We would bear very much in mind that this is a strategic rather than tactical buying opportunity: i.e. a structural addition to portfolios. We believe we are likely to see more and better opportunities, but it is precisely during full "immersion" that it makes sense to buy assets which, undoubtedly, will end up emerging.

David Macià, CFA
Head of Research and Strategy

Strategy

Asset Allocation 2014 (3-month view)

Monetary	→
Government Fixed Income	↓
Corporate Fixed Income	→
Equities	→

Fixed Income

Too attractive to ignore, too uncertain to fall in love

GOVERNMENT:

U.S.	↓
Eurozone	↓

CORPORATE:

U.S.	↓
Eurozone (Core)	↓
Periphery	↑

Equities

Against the tide

U.S.	→
Eurozone	→
Spain	→
Emerging Markets	→

Commodities

"Copper" test

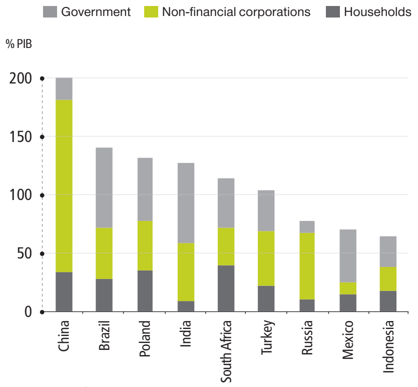
Oil	→
Gold	↓

Currencies

Side effects

EUR/USD	↓

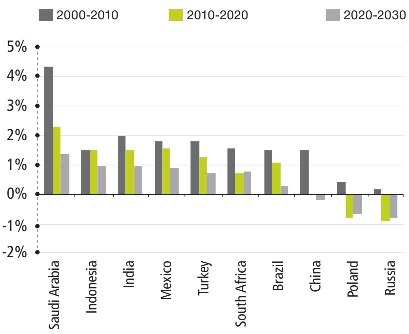
Debt of emerging economies



Font: BIS & IMF

The level of debt in emerging countries is becoming high. In China, non-financial corporations have accumulated levels of comparable debt equal to, or higher than those of developed economies.

Average annual growth of the working age population



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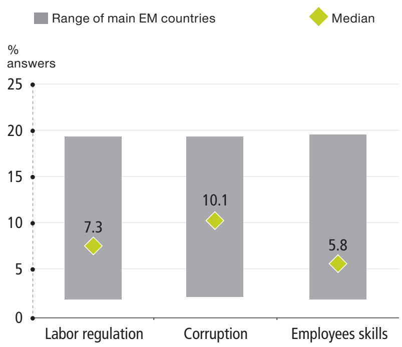
The growth of the working-age population is expected to slow in the coming decades. Moreover, in some countries, like China, this segment of the population is expected to decline.

Most problematic factor for doing business (16 causes)



Font: The Global Competitiveness Report 2013-2014

In the list of priorities are the reforms to combat corruption, improve the training of workers and labor market flexibility, as in shown in the Global Competitiveness Report 2013-2014.

Reform and prosper

Emerging countries are facing the most complicated stage of their metamorphosis into developed economies. The global scenario is certainly not ideal but the potential benefits of approving ambitious reforms are high both in economic and financial terms.

Emerging countries are facing the most complicated stage of their metamorphosis into developed economies. The global scenario is certainly not ideal but the potential benefits of approving ambitious reforms are high both in economic and financial terms.

Since mid-2013 emerging markets have experienced several episodes of strong turbulence. We have identified two main causes: 1) the increase in treasury yields, reflecting investors' anticipation of future interest rate hikes in the US; and 2) downward revisions of growth forecasts for emerging economies. During this period, emerging markets suffered some major corrections, particularly in those countries with large current account deficits, high inflation and excessive loan growth. Increases in official interest rates in some of these economies as well as interventions in currency markets by their central banks have managed, for the time being, to calm investors' nerves. While it is true that emerging countries cannot halt interest rate hikes in developed economies, they can improve their own growth outlooks by implementing structural reforms.

According to the IMF, in 1992 the GDP of emerging economies accounted for 16% of global production vs. 39% in 2014. We would highlight three main factors which have influenced the growth of emerging economies during these years: Firstly, exports have been an extraordinary driver of growth. In China, this component jumped from 20% of GDP in 1992 to 40% in 2006. For some countries – such as Russia, Indonesia, and Brazil – it is noteworthy that exports largely consisted of raw materials, reflecting increases in prices and demand in recent years. The second growth driver has been the rapid increase in private debt, especially of non-financial companies. Finally, demographic dynamics have also underpinned the growth of these economies given a substantial rise in the working-age population. However, convergence is not complete. GDP per capita in terms of purchasing power parity (PPP) in India (one of the four main emerging economies) amounted to only 7.5% of the US level. At the other end of the spectrum, the PPP in Poland was 40% of that of the US. Therefore, there is clearly still quite a long road ahead. In this journey towards convergence of emerging countries with their more developed peers, we see two stages: In the first stage, capital is provided (factories, machinery) to workers, allowing the weight of manufacturing and exports to rise. In the second stage, investments in innovation and human capital must be carried out in order to develop economies capable of applying more advanced and competitive productive technologies. Moving beyond the latter stage is more complicated, as seen in the 1980's when many LatAm countries were unable to successfully do so.

As a result, once growth drivers of the first stage peter out, emerging countries must implement structural reforms in order to move towards convergence with developed economies. The highest priority reforms include: flexibilisation of labour markets; a reduction of corruption; and improvement in the level of education of the population. During this year, presidential elections are scheduled to take place in 11 of the main 22 emerging countries. This should give citizens the opportunity to select leaders committed to ensuring the future success of their economies, which should stimulate reforms. The consequences for real economies should be apparent over the long term since the productive models of these countries will be modified slowly. However, if reforms lead to more positive outlooks for the performance of these economies, the impact on financial markets should be seen much sooner. Thus, when investing in these economies we believe it is crucial to differentiate between those countries that implement reforms and those opting to sit back and rely on growth drivers which we expect to gradually putter out.

Pablo Manzano
Macroeconomic Analyst

Fixed Income

Too attractive to ignore, too uncertain to fall in love

The current search for yield, plus low interest rates and high liquidity, may lead investors to undervalue risk. In the case of emerging markets debt, we see some very attractive medium-term opportunities but think potential short-term risks must not be ignored.

During the 1980's and 1990's investors suffered several bouts of crises in Latin American countries. At the end of the 1990's it was Asia's turn. Last summer when the Fed announced plans to reduce its injection of monetary stimuli into the economy, investors fled from emerging market debt in order to seek refuge in assets considered more attractive given the onset of a potential period of increasing US interest rates. During the last few weeks, investors' concerns have been aggravated by fears regarding the health of the Chinese economy and consequences for the growth of emerging countries – which are highly dependent on exports to the number two global economy –. Thus, are we about to witness another bout of systemic crisis in emerging countries? In our view, the answer is "not by a long shot"!

According to IMF estimates, half a trillion US dollars of foreign investment went into emerging market government debt from 2010 through 2012. The main investors weren't banks, but rather large institutional investors, hedge funds, and sovereign funds. One of the top reasons cited to explain this interest was the improved management of public debt by emerging countries: average debt maturities have been extended; the weight of floating rate issues has declined in favour of those with fixed rates; and debt in foreign currencies has declined. As a result, public balance sheets of these countries are currently more resistant to exchange and interest rate shocks. Moreover, the increasing importance of emerging economies and markets from a global point of view implies that allocated weightings in fixed income portfolios of international investors should structurally be higher.

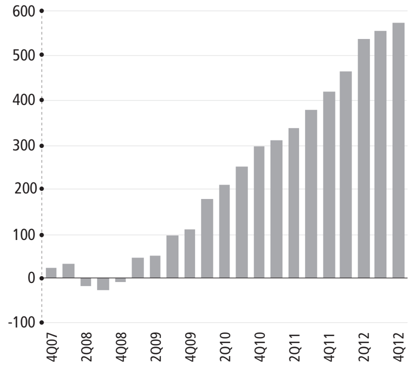
These and other arguments validate a medium/long-term investment strategy that considers it imperative to include emerging country fixed income issues in a globally diversified portfolio. Yet, in the short-term we cannot ignore the risks associated with these investments: although there are technical factors that should encourage continued inflows of fixed income investments into emerging countries, they cannot be totally immune to the consequences of the decrease of US monetary stimuli and the consequent increase in interest rates – which potentially might also spur increases in emerging countries' interest rates in order to prevent depreciation of currencies –, the loss of competitiveness of some of these countries as a result of not completing necessary structural reforms, implications of a slowdown in Chinese growth, etc.

Nevertheless, while we believe that – from the point of view of a fixed income investor – it is advisable to avoid sovereign debt of most emerging countries over the short term, we cannot say the same thing about private corporate issuers. A deeper analysis allows us to pinpoint companies in these countries that have taken advantage of the bonanza of the past few years in these regions in order to de-leverage, restructure their debt, create more solid businesses with recurrent cash flows, and improve financial ratios. We aim to cherry pick the issues of exactly these kinds of emerging market companies and include them in our fixed income portfolios in order to begin to build up positions allowing us to achieve the geographic diversification which, in our view, is absolutely necessary over the long term.

Meritxell Pons, CAIA
Fixed Income Director

Cumulative foreign flows into emerging market government debt securities

(bilions of US dollars)



Source: Arslanalp & Tsuda, IMF Working Paper 14/39.

Half a trillion of US dollars in foreign investement poured into emerging market government bonds from 2010 until 2012.

Official Rates: Consensus Forecasts

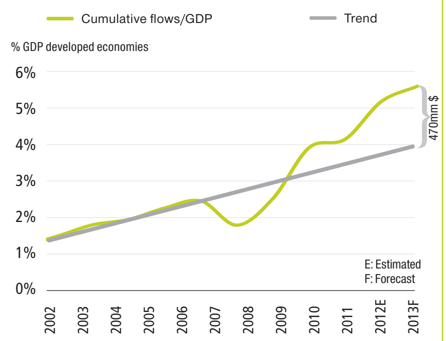
	31/03/14	Q2'14	Q3'14	Q1'15
Euro-Zone	0,.25%	0.25%	0.25%	0.25%
U.S.	0.25%	0.25%	0.25%	0.25%
United Kingdom	0.50%	0.50%	0.50%	0.63%

Interest Rates: Changes

	31/03/14	Last 3 months	Last year
Euro-Zone			
3-month Euribor	0.31%	0.03	0.10
10-year Bund	1.57%	-0.36	0.28
U.S.			
3-month U.S. Libor	0.23%	-0.02	-0.05
10-year U.S.	2.72%	-0.31	0.87
United Kingdom			
3-month GBP Libor	0.52%	0.00	0.02
10-year Gilt	2.74%	-0.29	0.97

Equities

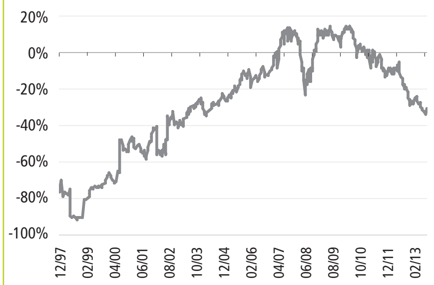
Flows to emerging economies



Font: IMF

Inflows to emerging markets have been very high, above what could be considered as a reasonable upward trend.

Premium/discount emerging vs developed markets



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The discount of emerging markets with respect to developed markets was far greater in the past (*Price to Book MSCI Emergentes vs MSCI World*).

			Q1 %	YTD %
USA	S&P500	1,872	1.30%	1.30%
	DJ Indus. Avg	16,458	-0.72%	-0.72%
	NASDAQ 100	3,596	0.10%	0.10%
EUROPE	DJ Euro STOXX 50€ Pr	3,162	1.69%	1.69%
	France (CAC 40)	4,392	2.22%	2.22%
	Spain (Ibex 35)	10,341	4.27%	4.27%
	UK (FTSE 100)	6,598	-2.23%	-2.23%
	Germany (DAX)	9,556	0.04%	0.04%
	Switzerland (SWISS)	8,454	3.06%	3.06%
	Italy (FTSE MIB 30)	21,692	14.36%	14.36%
	Netherlands (AEX)	403	0.35%	0.35%
JAPAN	TOPIX	1,203	-7.63%	-7.63%
	NIKKEI 225	14,828	-8.98%	-8.98%
EMERGING MARKETS	Mexico	40,462	-5.30%	-5.30%
	Brazil	50,415	-2.12%	-2.12%
	Argentina	6,374	18.23%	18.23%
	China	2,033	-3.91%	-3.91%
	India	22,386	5.74%	5.74%
	Korea	1,986	-1.28%	-1.28%
	Russia	1,369	-8.96%	-8.96%

Against the tide

We believe the time is ripe to begin to build up structural positions in emerging market equities, albeit very selectively and equipped with a large dose of patience.

If a holder of emerging market assets did not get the message last May, when the Fed signalled a change in direction of its monetary policy, this year it has been impossible to look the other way. First Argentina then Ukraine – with Venezuela, Turkey and Thailand lurking in the background – suffering from major political problems, kicked off a new round of sales. Elections in up to 11 emerging countries in the upcoming months are sure to continue to make headlines. Moreover, we mustn't forget that China is moving towards a new economic model whilst attempting to dismantle excess private debt – certainly not an easy combination to tackle – which (besides ensuring an economic slowdown) means we are likely to see some rather recurrent bouts of turbulence. This is just the type of scenario where the most interesting long-term investment opportunities can begin to arise. Yet, although we think extremely negative sentiment towards emerging markets might already act as a catalyst, when we analyse flows and valuations the picture is foggier and implies that an additional dose of patience is necessary.

Fund inflows into emerging market assets have been enormous over the past few years. While this is to some extent logical – reflecting these economies' greater weight vs. global figures – inflows clearly outpace any reasonable bull trend (refer to attached graph). The sell-off is likely to take a breather over the short term (outflows from ETFs of this category have been registered for 16 consecutive weeks). Yet, putting the situation into perspective, there may still be a lot of positions to be unwound, specially, if we take into account that many of these investors were forced out of their natural habitat driven by domestic zero interest rate policies. These "non-structural" investors are much more volatile and might sell positions to a much greater extent than advisable based on fundamentals. This absence of discrimination is one of the greatest risks threatening emerging equities markets. The tapestry of countries sharing the same label is too large. Under the same umbrella hide countries with serious problems – justifying additional sales – and others with much better outlooks than those discounted by markets. However, if massive indiscriminate sales are triggered, no matter what the catalyst, a lack of liquidity might spur previously nonexistent problems.

Regarding valuations, unarguably the emerging markets universe trades at a discount to the main indices of developed countries (MSCI Emerging Markets has an estimated P/E for this year of 10.41x the S&P 500's 15.9x and the EuroStoxx50's 13.56x). However, the attached graph illustrates that this discount was much greater in the past and that, in fact, not too long ago the premium at which they traded was theoretically unjustifiable in the author's view: particularly since the profitability of emerging market companies has been deteriorating steadily for the past 10 years (the ROE of non-financial companies was 8% greater than the average of developed market companies in 2003 and is currently lower). Capital mobility thanks to ever greater globalisation may be responsible for this convergence, while – simultaneously – the major crisis that affected developed markets markedly compressed the gap in competitiveness. We believe that both effects are structural which, combined with the fact that everything seems to point to a clear slowdown vs. growth of recent years (neither the Fed's withdraw of liquidity nor the Chinese slowdown are likely to lend a hand to the opposite scenario), implies that some level of discount of emerging markets equities to their US or European peers is probably quite reasonable.

To summarize, we think it is a good time to begin to add, very selectively, emerging markets equities to our portfolios. We should take advantage of investors' current aversion to include assets which we consider to be very attractive on a long-term view for both diversification purposes and due to their upside potential. Yet, the aim is to build, very gradually, a structural position. We must leave room to take advantage of better opportunities. We are likely to be swimming against the tide for quite some time.

David Macià, CFA
Head of Research and Strategy

Commodities and Currencies

COMMODITIES

"Copper" test

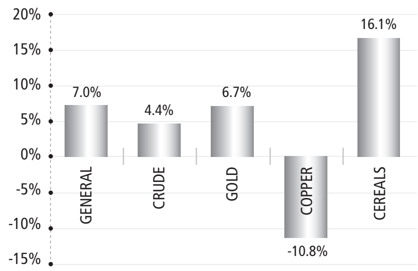
China is immersed in its own long-distance race to become the number one global economy. In this race, the government – at its last convention last November – drafted a different roadmap from the one announced in previous years. While in 2008 stimuli were underpinned by a very aggressive infrastructure plan which promoted, among other measures, imports of copper, the 2013 plan did not focus so heavily on new infrastructures.

We would bear in mind that during the past decade China has become the main global consumer of many raw materials. For example, during 2013 China consumed over 40% of total global consumption of copper – the main reference industrial metal – or four times more than the US. Yet we would also bear in mind that its production accounts for 30% of the total global figure or double the next in line, which is Chile.

Thus, it is clear that any negative data regarding this economy would, logically, affect the price of copper. Recently, some macro figures have raised doubts regarding its future growth. Moreover, for the first time some financial products went bust, spurring the exit of investors in certain products linked to copper. Nevertheless, we believe that we are in the midst of a "Cooper test," the par excellence physical fitness test consisting of running as far as possible in 12 minutes. Looking beyond complicated moments like the current one, it is undeniable that emerging markets' growth greatly outpaces that of more developed countries. In spite of keeping in mind possible short-term downturns, we believe that current copper prices are already low enough to be considered attractive. Furthermore, the latest declines have left current prices even closer to production prices. Therefore, the risk of further drops is minimal since if prices drop below current levels most mines won't be able to continue normalised operations.

David Rabella
Head of External Funds and Alternative Investments

Performance DJ UBS TR commodities YTD



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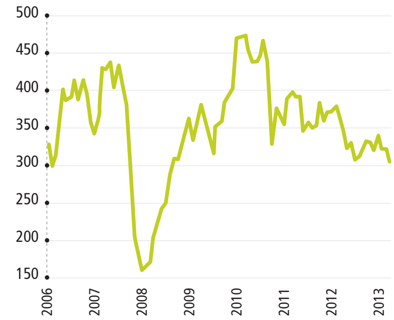
Copper



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CURRENCIES

Side effects

Sales of emerging market currencies were unleashed when Bernanke added, in May of last year, the term "tapering" to the already extensive financial glossary. The end of zero interest rates should reinforce the attractiveness of US assets as the US dollar is re-rated and the interest rate curve shifts upwards. Simultaneously, once the previous situation is confirmed, US dollar financed positions (the so-called "carry trade") could be rapidly closed, underpinning by additional sell-offs of emerging markets currencies in a self-reinforcing process.

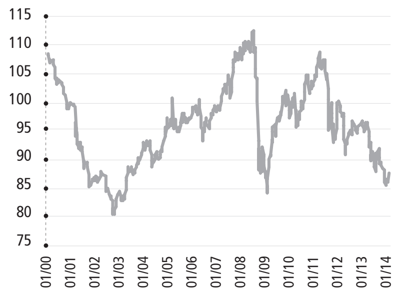
The above-described situation has given a double headache to emerging market central banks, which are under pressure to raise interest rates in order to defend their currencies both in an attempt to hold back the outflow of foreign capital and to fight inflation spurred by their weakness. The prescription, however, has some side effects: ironically, higher interest rates have arrived at the worst time, slowing down economic growth necessary to avoid discouraging the foreign investment they would like to retain…a very difficult lattice of factors to keep in balance.

Yet, there is a second, even more dangerous, contraindication. Public debt levels are clearly lower than in developed countries (34% vs. 109%, respectively, according to IMF calculations of yearend figures). However, often this is only an appearance if economic growth dries up (we mustn't forget that Spain's debt load amounted to 40% in 2008). Yet, private debt might in fact be the most imminent threat for the emerging market universe. This isn't so much due to absolute levels (without considering China), since they are similar to those of developed peers, but rather to the pace of expansion registered in recent years (average annual rate of 15%). If interest rate hikes are too rapid, and accompanied by an economic slowdown, non-performing loan ratios can be driven to levels above those that can be absorbed by financial systems creating huge problems of both solvency and liquidity. Such problems often have a contagion effect from private to public sector and shatter the medium-term growth outlook (again, Spain is a good recent example).

Yes, emerging market currencies have corrected substantially and are getting near to lows of the past few years (refer to attached graph) and this could be an excellent medium-term opportunity. However, we must keep a close eye on the patients, since they are under shock treatment.

David Macià, CFA
Head of Research and Strategy

JPM Emerging currencies index



The sell-off in emerging currencies has been one of the worst in the last decade.

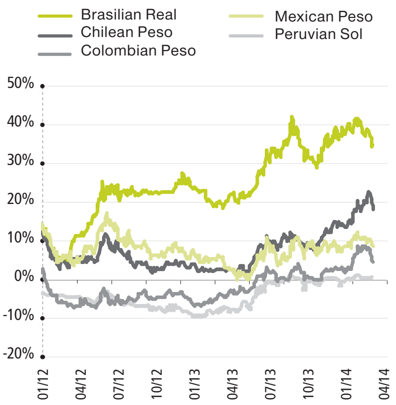
Exchange rate $/€

	1 month	3 months	1 year
% change:	-0.26%	-0.12%	7.43%

	2014	Q2'14	Q3'14
Consensus Forecast:	1.30	1.35	1.33

Latin America

Cummulative Return



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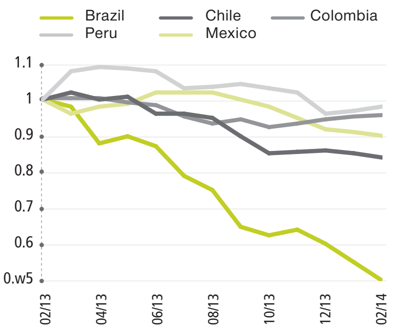
The countries with the largest current account deficitis such as Brazil, Chilie and Colombia have suffered the biggest corrections in their currencies, further increasing their external debt issued in dollars.

GDP Forecast



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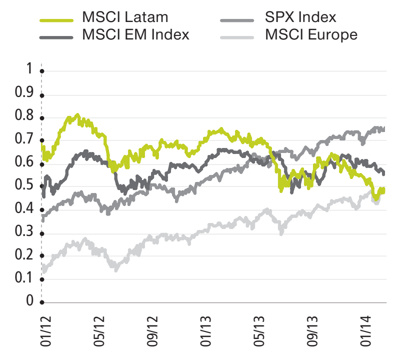
The 2014 real GDP growth expectations continue to fall accross the board in Latam. However the situation should stabilise some time during the year.

Stock Indexes Cummulative Return



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MSCI Latam is one of the worst performing indexes in the equity emerging markets spectrum (-5% vs -4.4% for the MSCI Emerging markets). In Addition to this disappointing performance, the region has suffered from largest amount of outflows worldwide.

Can love come back?

Volatility has returned to Latam markets. The Ukraine crisis has worsened an already difficult situation with the start of tapering and mixed Latam GDP growth data. The macroeconomic situation should normalize throughout 2014 and investors' appetite should revert.

Emerging markets have suffered from a painful mix of bad news that led to a strong sell-off in equities and currencies, especially during the second half of January. Political risk in Ukraine, Venezuela, Turkey and Thailand, combined with a more hawkish FED stance and weak data in China, led to strong pressure on EM currencies, higher sovereign spreads and weaker equities. In 2013, growth in Latin America reached its lowest level since the global financial crisis. For 2014, we believe low growth will persist, but risks are tilted to the downside. Yet, despite lower growth, average inflation in the region has not come down, thus limiting the ability of some central banks to lower rates. This inflationary backdrop highlights structural imperfections and government misteps in many Latam countries, such as inconsistencies in policies, indexation to past inflation rates and government controlled pricing.

In this context, it is no surprise to see that the MSCI Latam has been the worst performing region in the emerging equity spectrum since the beginning of the year (-5.0% vs. -4.4% for the MSCI Emerging Markets Index and flat for the MSCI World Index). In addition to disappointing performance, the region has suffered from the largest amount of outflows worldwide.

On the bright side, valuations are becoming cheaper at a consensus forward P/E of 11.3x, in line with the 10-year average of 10.9x. Because of the very low conviction and extreme caution among investors about Latam in particular, in the short term, the risk reward offered does not seem attractive enough. However, the situation should normalize throughout the year, especially for the Pacific Alliance countries (Mexico, Colombia, Peru and Chile).

We are seeing an increasing divergence within Latam; Pacific Alliance economies are expected to grow at an average of 3.8% this year, more than double the expected growth of Mercosur. This has resulted in heterogeneous monetary policies in the region: tightening in Brazil and Uruguay due to inflationary pressures, status quos in Mexico and Colombia, and an easing policy in Peru and Chile, in line with their current cyclical positions. The external deficit (negative current account) should start to decline, especially in those countries with a bigger foreign trade gap (Peru and Uruguay) as the outlook for exports improves with the recovery of global growth and depreciation of their currencies.

In the meantime, before we start seeing normalization in macroeconomic indicators that helps to change investor behavior towards Latam, we maintain our bottom up and relative value approach, and would avoid any strong directional commitment to the region.

Stephane Prigent, CFA
Analyst LatAm

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