Quarterly Report

Our View on the Markets

INDEX

2014: Lights and shadows

The consensus amongst analysts and strategists for the present year is overwhelming: "Buy equities and rush into the few remaining pockets of fixed income offering attractive returns. What about the risks? Don't worry, everything is under control". The first phrase might end up being good advice to follow, but believing the latter is an act of folly.

Upon returning home in the middle of the night, one man runs into another who is searching the ground around a lamppost. The latter explains that he has been looking for his keys for hours. "Are you sure that you lost them here?" asks the former. "No, but this is where the light is". Something similar is happening in the financial markets. Investors look where the light is pointing, until the spotlight shifts to another place, leaving the previous one in the darkness. Right now there are no possible doubts regarding where the lights are pointing, with an almost blinding intensity: there isn't a single research team which hasn't pinpointed equities as their favourite asset class for 2014. Fixed income has been left in the penumbra, also reflecting an overwhelming consensus. The "plundering" of the last remaining spreads can only plough forward, they tell us, and high yield and peripheral debt again look like the best alternatives. An increase in 10-year US (mainly) and German (to a lesser extent and influenced by the former) yields shouldn't be excessively disturbing, since the rise should be gradual, according to the main sages on this subject. Since global growth can only go so far and inflation neither exists nor is expected, the previously-described scenario shouldn't spur substantial turbulence. To wrap up, we can't forget to mention gold – which has completely lost its lustre – and the Dollar – an object of everyone's desires – although the Euro is stubbornly proving everybody wrong.

Only in the blackest darkness can risks be found this time around. The level of complacency in the investor and analyst communities is truly disturbing, as they don't see how the foreseen scenario might turn sour. It is true that the agreement with Syria and Iran has lessened geopolitical risks, that Europe has metamorphosed from the greatest threat into an apparent haven of peace, and that the US despite the bitter disputes between Democrats and Republicans which are now left behind continued to show a robust recovery). In fact, we believe the US recovery might even accelerate: the impact of fiscal consolidation has declined, excess private debt levels have eased, job creation continues at a healthy clip, US consumer wealth has again hit highs, and corporate investment is likely to reactivate. Yet, in our view, it is precisely in the US economy where one of the risks most underestimated by the markets is lurking. A moderate acceleration of inflation might come along much sooner than expected, since - among other factors - the decline in the active population might be largely structural (stemming from an increase in the long-term unemployed and the gradual retirement of the "baby boomers").

We prefer not to align ourselves with the consensus, but this time we think the expected scenario has every chance of prevailing, at least during the earlier part of the year. Nevertheless, we are increasingly uncomfortable with such a unanimous view. We do believe that there are some major risks: the more complacent the pervading viewpoint ,the less they are reflected in prices (given current volatilities, clearly they currently aren't), the greater the risks. Keeping this very much in mind, we plan to participate in the collective enthusiasm for equities and to continue to bet on peripheral names which have thus far given us such good results. Yet, we will continue to opt for low durations and adjust our stock market exposure in accordance with the circumstances. 2014 may be a year of lights, but also of shadows.

David Macià, CFA
Head of Research and Strategy

Strategy

Asset Allocation 2014

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

Fixed Income

Uncomfortable unanimity

GOVERNMENT:	
U.S.	↓
Eurozone	↓
CORPORATE:	
U.S.	↓
Eurozone ("Core")	↓
Periphery	↑

Equities

The pendulum

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

Commodities

Excessive harmony

Oil	→
Gold	→
Metals	→

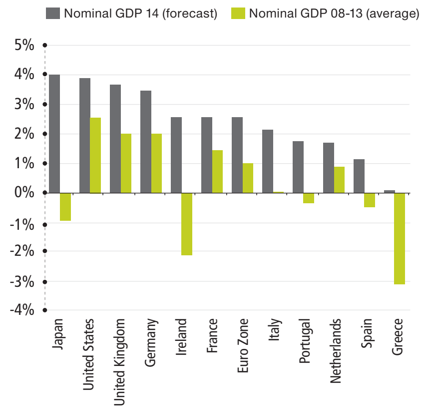
Currencies

Asymmetry

EUR/USD	↓

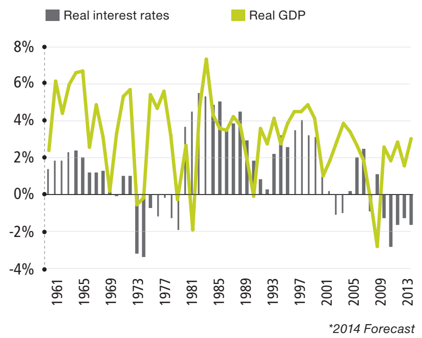
Macroeconomic View

Nominal GDP



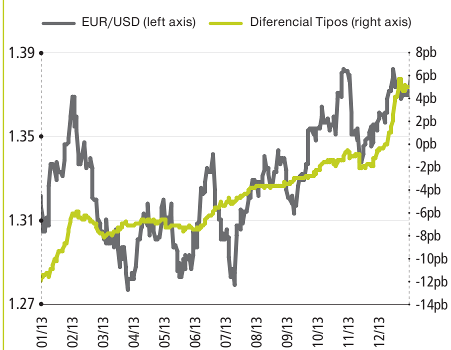
According to forecasts by the European Commission in 2014 nominal GDP will grow much more than the average in recent years, helping the deleveraging process.

Real GDP & real interest rates



Since 2010 we have entered in a period of low real interest rates. In 2014 economic growth is forecasted to accelerate, which may not justify low nominal interest rates.

EUR/USD & 3 month interest rate spread (EUR-USD)



The Euro has appreciated in the last part of the year. One possible explanation is the increase in the spread of short-term rates (EUR-USD). In the medium term, there is reason to believe that this differential becomes negative helping the Euro to depreciate, which theoretically strengthen exports.

The economic recovery takes hold

The economic outlook for developed countries for this year is looking good, especially in the US. Both real GDP and inflation are expected to rise, alleviating the burden debt plays on the economic activity. Among possible risks, we would highlight tapering, an unexpected hike in US inflation, and a starveling European recovery.

Our forecasts coincide with those of the main agencies and we are somewhat optimistic regarding 2014. The expected increase in real GDP is moderate, particularly in the European case. However, in nominal terms, forecasts point to significantly higher growth than in the previous period. Although real GDP is the measure that most accurately indicates the economic welfare of a country, nominal GDP growth is particularly relevant given high-debt situations (while the value of the debt is fixed, assets and income are affected by price trends). Therefore, the probable increase in nominal GDP in 2014 should help to reduce the negative impact of debt repayments on economic activity.

In the US, 2014 has all the ingredients necessary for a year of strong growth. Thus, factors that dampened the economy in 2013 should cease to do so. Fiscal consolidation has largely finalised and, most importantly, politicians appear to have adopted more conciliatory negotiating positions, reducing the probability of another partial government shutdown. Another argument allowing us to view 2014 in a more optimistic light is the rise in the wealth of families thanks to the re-rating of the stock market (S&P 500 +30%) and rise in housing prices (+9%). As for monetary policy, this year tapering will take place: i.e. a reduction of direct monetary stimuli. In January, the Fed will start to reduce them after having injected around USD3Tn since 2008. It is crucial that this exit strategy is carried out successfully in order to ensure financial stability and economic growth. In addition to tapering, another risk that worries us is an unexpected rebound in inflation, which would cause the Fed to bring forward interest rate hikes, which the market is currently expecting during the second half of 2015. An additional argument which might propel the Fed to raise interest rates early is a situation of negative real interest rates and accelerating growth, which is quite unusual historically.

In the Eurozone, peripheral countries are beginning to show signs of an economic recovery while some core countries, especially France, are bringing down consolidated figures. In any case, growth forecast for this year is moderate and based on external sector, with employment normally the last indicator to reflect the economic recovery. A factor which could aid growth is the depreciation of the Euro, which theoretically should drive up exports. In fact, exactly the opposite occurred during the latter part of last year when the Euro appreciated. One of the possible explanations is the increase in the short-term interest rate spread (EUR-USD). Thus, if the ECB again cuts interest rates or if US economic growth drives up market rates, the Euro could depreciate, improving the competitiveness of its foreign trade sector. Moreover, it looks like we will see advances in the Banking Union directives during 2014. Its three cornerstones are in different phases: I) the Single Supervisor Mechanism should begin to function in November 2014; II) the Single Resolution Mechanism is still under negotiation with targeted implementation in January 2016; and finally III) progress towards approval of a Single Deposit Guarantee Fund has halted and there are unlikely to be any new developments achieved on this front during 2014.

In short, we foresee a year with solid economic fundamentals in the US with progress towards both economic recovery and structural reforms in Europe. Furthermore, growth of nominal GDP in developed countries should ease debt burdens, which could be a major catalyst for economic activity. The main negative risks? A poorly executed tapering and a Europe which is unable to get its economic recovery to take off. However, we believe that this year will finally be a good year for global growth.

Pablo Manzano,
Macroeconomic Analyst

Fixed Income

Uncomfortable unanimity

The era of reaping positive returns without taking risks has come to an end. Rising long-term interest rates over the past few months have created a great challenge for fixed income investors, especially in the US. For 2014 the maxim linking risk with rewards makes more sense than ever: those who are unwilling to accept exposure to risk are expected to receive returns of close to zero.

The much-predicated end of the fixed income asset bonanza appears to be at hand. This is most visible in the US: 10-year rates increased by nearly 125bp during the last year. More specifically, an investor with a portfolio comprised of 10-year bonds issued by the US Treasury at the beginning of the year would have registered negative returns of around -8% in 2013. Following losses suffered in recent months by buyers of bonds with longer durations, we believe that the quest for returns will no longer focus on longer-term instruments but rather on lowering credit quality of investments. Seeking returns via duration risks is currently an overly risky move.

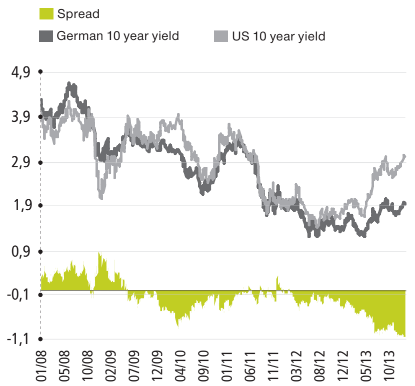
The economic recovery is already a reality in the US and is on the way in Europe: improving macroeconomic indicators, tightening of peripheral spreads (who would have imagined this scenario back in mid-2012 when the EU looked like a sinking ship and the famous risk premium hit record highs of over 500bp?!), recovering labour markets, healthy financial institutions (for the most part), etc. All of these arguments are among those used by the majority of analysts in order to recommend assets with lower credit quality in an attempt to achieve positive returns. We do not strive to always go against the trend, but we find agreement with such an overwhelming consensus among analysts to be worrisome. Nevertheless, this time around we think the arguments are sufficiently solid.

One year ago in this report we spoke about the “World according to ZIRP” (Zero Interest Rate Policy). Stimuli are already beginning to be unwound in the US, but are still in force in Europe. The European economy’s conditions still aren’t adequate to allow for monetary policy tightening. Weak Eurozone growth implies that the ECB will continue to focus on stimulating growth via low interest rates and excess liquidity. This policy of nil interest rates encourages investors to seek greater returns through higher risk assets, whilst creating a favourable climate for companies to refinance loans, and should keep the ratio of potential bankruptcies stable or even trending downwards. Moreover, Europe’s slow-motion recovery doesn’t encourage companies to carry out large investments or acquisitions either, which is positive from the point of view of credit spreads of issuers (which should remain stable). As a result, we think that European company fundamentals are likely to remain robust throughout 2014. US companies, in our view, are already at a more advanced stage where M&A and investment risks are indeed higher although the economy’s greater growth potential should partially offset these negative effects. At any rate, the outlook for traditional fixed income is much worse in the US than in Europe: we can rule out neither the appearance of inflationary tensions in the US economy over the medium term nor an acceleration of the rebound in long-term rates which is already under way.

Aren’t there any risks inherent in the scenario which we set forth for 2014? Yes, there are quite a few... Yet, for the time being they remain hidden and it is difficult to see them materialising over the short term. The “uncomfortable unanimity” which we discussed earlier makes us feel like we are watching a scene out of a classic suspense movie: all is peaceful and there is no sign that the assassin might appear, until he shows up right at the least expected moment; we must be prepared just in case he appears. We must take greater risks if we want to achieve positive returns on fixed income portfolios, but not duration risks. Let’s be picky about which companies we invest in, avoid government debt of countries such as the US and Germany, hedge the risk of interest rate hikes, avoid holding a static bond portfolio – we should buy and sell with agility – and seek non-traditional fixed income assets, with low correlations with traditional ones.

Meritxell Pons, CAIA
Fixed Income Director

Yield spread between both sides of the Atlantic



The different performance in recent months of the German and US 10 year yields reflects the diverging views of investors on the economies on both sides of the Atlantic and the potential moves in opposite directions of the central banks.

Official Rates: Consensus Forecasts

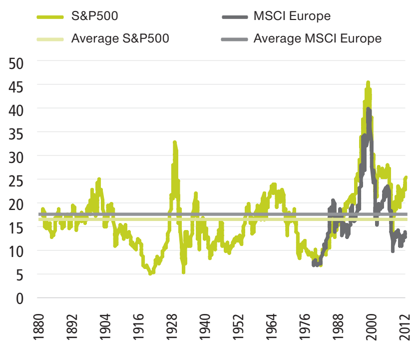
	31/12/13	Q1’ 14	Q2’ 14	Q4’ 14
Euro-Zone	0.25%	0.25%	0.25%	0.25%
U.S.	0.25%	0.25%	0.25%	0.25%
United Kingdom	0.50%	0.50%	0.50%	0.50%

Interest Rates: Changes

	31/12/13	Last 3 months	Last year
Euro-Zone			
3-month Euribor	0.29%	0.062	0.100
10-year Bund	1.93%	0.150	0.613
U.S.			
3-month U.S. Libor	0.25%	-0.003	-0.060
10-year U.S.	3.03%	0.418	1.271
United Kingdom			
3-month GBP Libor	0.53%	0.008	0.010
10-year Gilt	3.02%	0.301	1.194

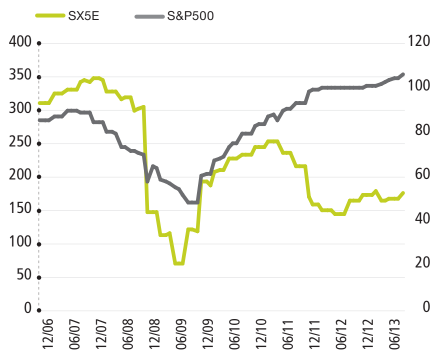
Equities

Shiller Price to Earnings



The long-term valuation (PE adjusted for cycle -10 year average- and for inflation cf graph) is clearly above the historical average in the U.S., well below in Europe.

EPS S&P500 vs EuroStoxx50



While U.S. earnings (trailing 12 months) have been setting new highs for some time, in Europe they still have a long way to go.

			Q4 %	YTD %
USA	S&P500	1,848	9.92%	29.60%
	DJ Indus. Avg	16,577	9.56%	26.50%
	NASDAQ 100	3,592	11.62%	34.99%
EUROPE	DJ Euro STOXX 50€ Pr	3,109	7.46%	17.95%
	France (CAC 40)	4,296	3.68%	17.99%
	Spain (Ibex 35)	9,917	7.95%	21.42%
	UK (FTSE 100)	6,749	4.44%	14.43%
	Germany (DAX)	9,552	11.14%	25.48%
	Switzerland (SWISS)	8,203	2.25%	20.24%
	Italy (FTSE MIB 30)	18,968	8.79%	16.56%
	Netherlands (AEX)	402	7.17%	17.24%
JAPAN	TOPIX	1,302	9.06%	51.46%
	NIKKEI 225	16,291	12.70%	56.72%
EMERGING MARKETS	Mexico	42,727	6.33%	-2.24%
	Brazil	51,507	-1.59%	-15.50%
	Argentina	5,391	12.69%	88.87%
	China	2,116	-2.70%	-6.75%
	India	21,171	9.24%	8.98%
	Korea	2,011	0.72%	0.72%
	Russia	1,504	2.82%	1.99%

The pendulum

Equities are still the best alternative in 2014. Yet, expectations are already high and the level of consensus is frightening. Moreover, we must watch out for any further widening of the gap between prices and fundamentals.

One of the fund managers for whom the writer has a particular fondness, Howard Marks, compared the behaviour of financial markets with that of a pendulum in one of his books. Like a pendulum, markets move unceasingly from one extreme to another and only pass through the balance point during a few moments on their way to the other extreme. Investors tend to behave against their interests,often getting trapped in losing positions at the worst time: the more prices fall the more they sell and the more prices rise the more they buy. Rare is the forecast in which one can have more faith than that this pattern will continue. This is no coincidence: human beings, in spite of being the most rational species, often let their emotions get in the way when it comes to investing. Fear, greed, or envy often prevail over objectivity, particularly in times of extreme panic or euphoria.

We believe that right now stock markets are in the strange – unusual and fleeting – balance point described previously. They are discounting the most probable, in our view, scenarios: A macroeconomic acceleration in the US accompanied by a modest additional increase in earnings (average analysts estimates: +5%); In Europe, where earnings are still very depressed and operating leverage is high, any consolidation at all of the still weak economic improvement under way should spur a more than proportional rebound. Even more so, if – as we expect – the global economy improves (thanks mainly to the Americans), the Euro should finally depreciate and the ECB end up implementing additional measures (which are quite likely to be necessary).

Yet, all of the above may already be reflected in current prices after an exceptional 2013. The S&P500 rose 30%, but EPS only advanced by an estimated 7.7%. It doesn't look like a splendid 2014 is being discounted either, judging by the 5% growth expected in profits. In fact, one digit gains might be justifiable (merely taking into account dividends and share buybacks we already come up with returns of 5%). However, not much more can be justified, at least not by fundamentals. Margins are at historic maximums and earnings – in proportion with GDP – are at levels unheard of since WWII. Further improvement implies that multiples would need to continue to expand, which would be quite difficult to justify (adjusting for the cycle and inflation, the US stock market currently trades at 25 times earnings,well above the historic average). The problem in Europe is that the level of optimism is very high and analysts are already forecasting double digit earnings growth, a combination leaving little room for positive surprises. Given this panorama, we still believe that Japanese equities are the best play – although certainly not a bump-free ride – in spite of their already spectacular performance. We reckon either things will improve or the authorities will redouble efforts (thereby weakening the Yen). Either way the impact on equities would be positive.

To excess complacency described on the cover page we would thus also add rather tight valuations and high expectations. Nevertheless, we believe that – at least at the beginning of the year – the situation may continue to be favourable for investors eager for equities, taking into account the low interest rates, an improving global macroeconomic scenario, and still extremely lax monetary policies (which should remain the norm, although American, English, and some emerging markets – the latter involuntarily – might begin to be the exceptions). Like a pendulum, we have come from a zone of clear undervaluation, have taken a run up, and are probably going to enter territories which could be harder and harder to justify. Although overvaluations, still nonexistent – at least in Europe –, sometimes last for years (this was the case of the last two bubbles), we will have to pay close attention.

David Macià, CFA
Head of Research and Strategy

Commodities and Currencies

COMMODITIES

Excessive harmony

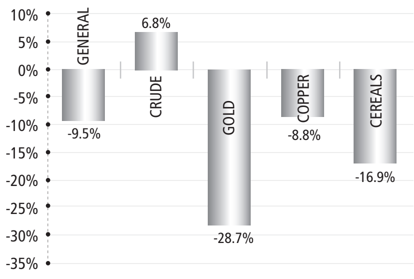
Oil is a perfect example of balance. Given an improving economic outlook, with many nuances but mainly focused in developed countries and with the US leading the pack, we are very likely to see demand rise. Yet, on the supply side, lower tensions in Libya, agreements with Iran, and greater US production thanks to shale oil should pour more barrels into the market which should be offset by either the above-mentioned higher demand or the OPEC's possible easing of production, which was boosted during the past several years. As a result, we believe it will be difficult to see major price movements unless new tensions arise in the Middle East or should the anxiously awaited economic recovery finally not end up materialising.

Regarding industrial metals, strong dependence on Chinese imports continues. Although the Asian giant's performance certainly does raise serious doubts, it is also just as true that worst case scenarios appear to already be discounted by prices. Moreover, in these cases declines of the past few years have left production costs and prices at similar levels – or even lower as in the case of zinc – so we think any additional drops would trigger fears regarding supply constraints.

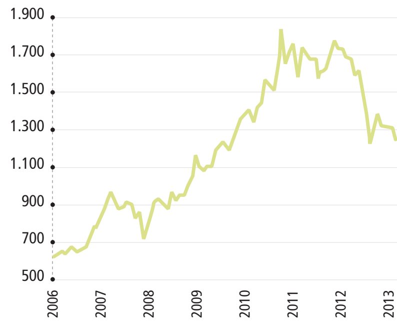
We see gold having the most room for possible surprises. After suffering an "annus horribilis" the consensus view is that its price could continue to trend downwards particularly if the technical support of 1,200 is broken. Yet, we also think that the fact that China – after registering record imports in October – is now the largest global importer of gold and that nobody is currently talking about inflationary fears – and therefore any rebound would be a surprise – could cause sentiment to change at some point during the year and, thereby, spur prices to recover some lost ground.

David Rabella
Head of External Funds and Alternative Investments

Performance DJ UBS TR commodities YTD 2013



Gold



CURRENCIES

Asymmetry

In Europe, in spite of noticeable improvement – at least we have exited from what appeared to be a never-ending recession – the economy is languishing and the ECB was even compelled to cut interest rates last November to 0.25%. Meanwhile, in the US 200,000 jobs are still being created each month, the real estate sector is rebounding, consumer spending is bringing positive surprises, budgetary and private debt excesses have been left behind, and the economy's competitiveness has improved thanks – among other things – to the weak USD, particularly against the Euro. The latter doesn't tally up.

Until a few quarters ago we remained sceptical because we figured that while the Fed continued to experiment with expansionary balance sheet measures the USD's weakness would continue. When the Fed announced its intension of beginning to reduce its balance sheet last May, it looked like the right time to bet on a stronger Dollar. Moreover, the Yen appears to be the best instrument for financing carry trades at this time, given the Japanese central bank's endeavours to flood its economy with liquidity.

But the Euro not only resists, but has even flirted with additional appreciation. A range of factors can explain this. The sudden international interest in European assets has spurred the massive purchase of Euros while the bulk of peripheral economies have successfully raised exports, thereby lending a hand to growing foreign trade surpluses. As if this were not enough, the ECB was one of just a handful of central banks with de facto balance sheet shrinkage since European banks have rushed to repay loans granted by the monetary authority (LTROs), partially due to lower needs and partially reflecting fears of upcoming stress tests – which in fact might, ironically, be undermining the ECB itself: in spite of the cut in official rates, the shortest segment of the curve later rebounded.

At the end of the day, however, we believe that logic will prevail, reflecting on-going divergence of economies and monetary policies. However, if this isn't the case, a stronger Euro would partially dampen long-awaited European growth – given high dependence on exports – forcing the ECB to intervene. At current levels, we believe betting on the Euro's weakness is an asymmetrical move... with a lot to gain and little to lose.

David Macià, CFA
Head of Research and Strategy

Euro vs dollar

The Euro not only resists against odds, versus the dollar, even after the start of tapering, but ends the year appreciating.

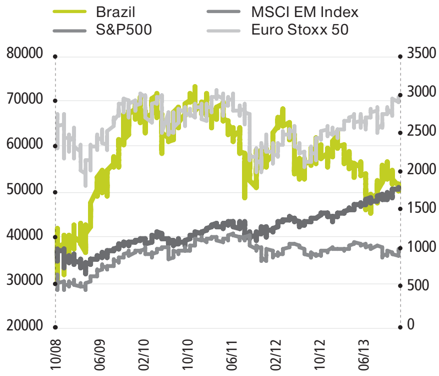
Exchange rate $/€

% change:	1 month	3 months	1 year
	1.49%	1.91%	4.49%

Consensus Forecast:	2014	Q1' 14	Q2' 14
	1.28	1.33	1.31

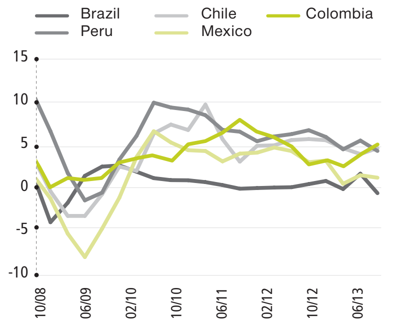
Latin America

Stock Exchange's Evolution



Even though 2013 was a good year for risky assets like the European and US equity markets, it was not been the case for Emerging Markets which against all odds suffered strong outflows of capital from foreign investments.

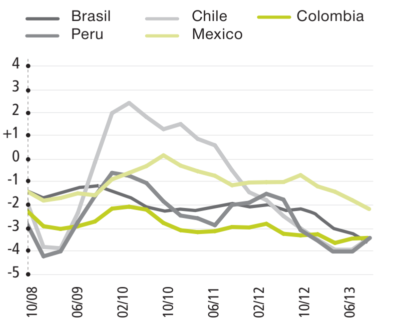
GDP



The slowing trend in GDP could continue into 2014 in countries like Brazil, which might continue to have corrections in its currency, increasing inflationary risks and the probability of an increase in interest rates, which could put pressure on domestic demand.

Current Account

(% del GDP)



Countries with the largest current account deficitis have suffered the biggest corrections in their currencies, increasing even more their external debt, entering a vicious circle difficult to break.

The moment of truth: living with tapering

With an outlook of greater economic growth at the global level, all Latin American countries are not equally positioned to take advantage of the situation. In 2014, some of the region's countries must face the challenge of an economic slowdown together with the expected impact of the Fed's withdrawal of stimuli on their economies.

Ample liquidity in the markets, largely underpinned by monetary programmes of large central banks, and a lack of attractive alternative investments led to expectations that 2013 would be a great year for risk assets and, therefore, for emerging market assets. This was not the case for the latter and the LatAm region's assets were penalised by the macroeconomic deterioration suffered by some of its countries and massive capital outflows due to the threat of the beginning of the already famous tapering. Indeed, the gradual winding down of the Fed's monetary stimuli programme revealed some imbalances in the main LatAm countries. Those with the greatest current account deficits suffered sharp corrections of their currencies: e.g. Brazil. The flow of capital funds from emerging countries towards developed countries, mainly European – thanks to their macroeconomic improvements – put the frosting on the cake. Although these corrections made the region's assets more attractive, we believe that these negative dynamics could continue in 2014 and that other regions – such as Europe – are likely to register better relative performances.

We expect the macroeconomic situation to tend to normalise, with greater growth in developed countries and stabilisation of growth in China. Latin American countries should also benefit via exports, but we believe that not all countries' situations are similar. Mexico stands out as our star regional pick. Deep reforms – that have already been launched and will continue during 2014 in that country and which should attract foreign investment – together with the correlation of its growth with that of the US should foster Mexican economic growth, revalue its currency, and improve the earnings outlook of its companies. Cyclical and industrial sectors look the best positioned to benefit from this scenario and we would avoid defensive domestic sectors with higher valuations. The other side of the coin is set to be Brazil, which has the greatest tail risks due to the possible weakness of its currency – although we expect it to be kept in line by possible interventions by its central bank, current account deficits could continue to rise – as well as weaker growth and high levels of inflation. Low visibility of corporate earnings and political uncertainties – elections are scheduled to take place in October – are also factors which may take a toll on the performance of Brazilian assets. Moreover, the country's debt ratings may be cut during 2014. Nevertheless, we do see some opportunities among cyclical stocks with a global presence which should benefit from the recovery of developed countries and China and from downtrends in the Brazilian Real. We would avoid sectors with high exposure to domestic markets with higher relative valuations as well as greater exposure to local growth. As a result, we think that bottom up research will be crucial in 2014 when deciding where to invest within this region.

Noelia Povedano, CFA
Vice-President of LatAm
Markets and Strategy

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