Quarterly Report

Our View on the Markets

INDEX

Nanakorobi yaoki

***"Fall seven times, stand up eight"* says the ancient Japanese proverb chosen as our title. After two decades of economic stagnation and battered by chronic deflation, Japan may finally climb out of the pit.**

Eighteen years of zero interest rates didn't prevent the Japanese economy from suffering two back-to-back lost decades (nominal GDP is currently at the same level as in 1991). QE (quantitative easing) wasn't invented by Bernanke, but rather it was tried out previously – without any luck – between 2001 and 2006 in Japan. Fiscal stimuli are not new either – Japan has registered a permanent public deficit since 1992. Again and again investors thought they could see the light at the end of the tunnel and, thereby, spurred spectacular stock market rebounds which always ended up puttering out. Are we now dancing to a different tune?

In Japan the gigantic real estate bubble hit maximums in 1989, bursting shortly after, leaving the private sector with epic debt loads. Its central bank (BoJ) took more than four years to realize that zero percent interest rates were necessary and ten before it attempted to take more daring action. Meanwhile, deleveraging under way only served to entrench deflation further, leaving an indelible imprint on the Japanese psyche. This latter factor is what, in our view, explains why all attempts to turn around the situation have unfortunately been unsuccessful. The economic performance doesn't depend so much on what's happening, as on what economic agents expect to occur. If they foresee lower prices, they abstain from consuming and investing and, effectively, prices will fall. Companies won't raise salaries and banks, with collateral values falling, won't lend money. Moreover, they all were simultaneously trying to pay down enormous accumulated debt loads. It was very difficult to break vicious circle (does this story ring a bell? "Peripheral" Europe looks much more like it than we would like).

Twenty years of crisis have allowed debt excesses to be digested. Deflationary expectations, deeply entrenched among the population, look like the main obstacle to overcome at this time. In our view, this is what is truly different this time around. The BoJ announced a massive intervention (double the size in half the time vs. that of the Fed), under orders of a new government – with an ample majority – which has stated that it will do whatever is necessary. Once he has won the upcoming upper house elections, Abe should also be able to move forward with structural reforms. All of the above seems to have finally convinced investors and, more importantly, Japanese citizens. Consumer and corporate confidence are on the rise, salary hikes not seen since 1990 are in the wind, and acquisitions of land and homes are increasing. Timid signs of inflation have even been glimpsed (in Tokyo, for the first time in four years).

Needless to say there are risks. The accumulated public debt load is enormous (237% of GDP) and would be toxic if combined with a loss of control of the interest rate curve. Managing a change in expectations is not a piece of cake and a loss of confidence in the central bank could trigger very unpleasant consequences. Given its inverted demographic pyramid and an economy plagued with inefficiencies, very unpopular structural reforms are also necessary. Yet the most onerous task of all –breaking away from expectations – may already be under way. The above advises fleeing from Japanese fixed income, but makes Japanese equities very interesting indeed. We aim to continue to enjoy the uptrends, as we have done since the beginning of this year, taking advantage of corrections to buy – gradually – and always hedging currency risks. Eighth time lucky!

David Macià, CFA
Head of Research and Strategy

Strategy

Asset Allocation (3-month view)

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

Fixed Income

Hara-kiri or shinto wisdom?

GOVERNMENT:

U.S.	↓
Eurozone	↓

CORPORATE:

U.S.	↓
Eurozone ("Core")	↓
Periphery	↑

Equities

In the land of the rising Nikkei

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

Commodities

Japan by itself isn't enough

Oil	↓
Gold	→
Metals	↓

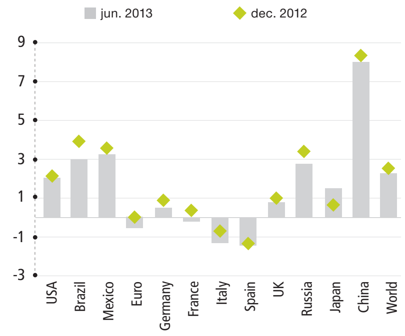
Currencies

Yen-dependence

EUR/USD	→

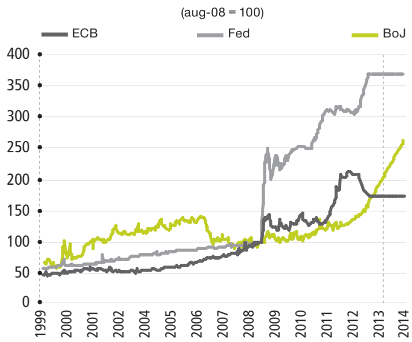
Macroeconomic View

Change in global growth expectations for 2013



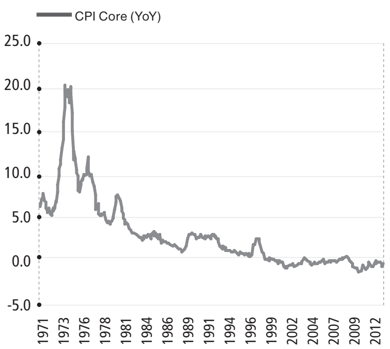
Among the major economies, only Japan has benefited from upward revisions. For many of the major economies, growth rate expectations have been reduced.

The race for balance sheet expansion



The Bank of Japan, which had been more active than other central banks in the early 2000s, will recover ground rapidly with the announced balance sheet expansion. *(Note: the chart assumes that the balance sheets of the Fed and the ECB are stable from now on).*

Japanese CPI



Prices are showing a trend of "secular" moderation in Japan, aggravating the situation of almost continuous deflation since the late 90s.

"Abenomics": great expectations

Within a scenario of downwards revisions to global growth expectations, Japan's upwards revisions set it apart.

In recent months analysts have adjusted downwards growth forecasts for a significant number of global economies, particularly certain emerging economies. Forecasts for the US (around +2%) however could lend support to global growth. We would highlight a particularly bright star: Japan. It is the only major economy which has enjoyed upwards revisions: expected 2013e GDP growth has been lifted from +0.7% in December 2012 to a level of +1.7%. What has changed since YE 2012? We'd chalk it up mainly to "Abenomics", the slew of economic policies spearheaded by the new Japanese Prime Minister, Shinzo Abe, who took office in December 2012.

> **The Japanese Central Bank is set to implement an unprecedented expansionary monetary policy: doubling its monetary base in 2 years.**

These policies are divvied up into three main categories. The first one focuses on fiscal policy. Aiming to stimulate the economy over the short term, in January the government announced a package of fiscal stimuli equivalent to 2% of GDP (spread out over the next 2/3 years). However, we would bear in mind that the Japanese fiscal situation is certainly dire (i.e. its runaway public debt). The government is also planning to implement measures to get back on a sustainable fiscal road. As a result, it plans to double the VAT from 5% to 10% in two phases (in 2014 and 2015, although the first phase might be delayed). The second category of new policies consists of structural reforms, mainly to deal with problems affecting growth stemming from very adverse demographic dynamics. Thus far, little progress has been made on this front and we will not analyse this category this time round.

The third category – the most important thus far – is the country's monetary policy. The new government asked the Bank of Japan (BoJ), headed by a new Governor (Haruhiko Kuroda), to implement a more aggressive policy aimed at escaping the claws of deflation (for once and for all) and bidding farewell to the country's "lost decades". The BoJ didn't disappoint and lifted its inflation target to 2%, which it aims to reach in approximately 2 years. In order to do so, the BoJ is set to implement an unprecedented expansionary monetary policy: doubling the country's monetary base in just 2 years mainly by purchasing Japanese government bonds (but also buying ETFs and RE-ITs) and noticeably lengthening the duration of bonds acquired.

Japan's new policies have been given a stamp of approval by analysts, who've raised growth estimates. What's indeed certain is that, initial signs of improvement of some indicators are already apparent. First quarter GDP growth was a surprisingly robust +3.5% (annualised). Moreover, the recovery of certain sentiment indicators is clearly visible: e.g. the manufacturing PMI and the consumer confidence indicator. The latter has registered a substantial accumulated increase since December and is at maximum levels since the summer of 2007. Yet, it is too soon to cry victory. Deflation is still firmly entrenched in the economy and we believe timid upwards pressures seen thus far are temporary and may have been spurred by import prices (due to the Yen's weakness).

David Rojas Pecero
Macroeconomy Analyst

Hara-kiri or shinto wisdom?

Before committing *hara-kiri Samurai* warriors would drink sake and write a farewell poem. Is there any parallelism between this ritual and the Bank of Japan's strategy of flooding the market with liquidity? Although venturing into unknown territory, we believe these measures will indeed prove helpful: finally reviving the Japanese economy, albeit only partially. However, the country's fixed income doesn't look attractive.

"Aggressive" and "unprecedented" are the most common adjectives for describing the groundbreaking Japanese monetary policy announced this year. It is one of three arrows – according to a Japanese proverb, one arrow alone can be easily broken but three arrows are indestructible – which make up the measures of the so-called "Abenomics". The BoJ aims to double the country's money supply through 2015e, buying – to this end – a huge amount of public debt and printing as much money as necessary. Do these adjectives really capture the essence of announced measures? Let's put them into context: the US Federal Reserve has raised its current account balance by 233% since 2007, implying a jump in its monetary base by the equivalent 2.0Bn. This figure is quite similar to Japan's current target, albeit the difference is that the US economy trebles that of Japan and that the former's policy was implemented in five years vs. the two-year period established by Japanese authorities. Therefore, our answer is yes, Japan's policy entails an avalanche of astronomical amounts of liquidity and there are few precedents – or perhaps none – of such an aggressive monetary policy during such a short timeframe.

The aim of this program is to stimulate economic growth and raise prices and, thereby, put an end to 15 years of deflation (an explicit two-year inflation target of 2% has been established). Since inflationary expectations tend to drive interest rates upwards, this target clearly conflicts with the premise that they should remain low in order to avoid putting a damper on growth. This explains the announced massive purchase of bonds and other assets which should drive rates down all along the Japanese sovereign interest rate curve. Yet, the key lies not so much in the level of nominal rates as in the level of real rates. In other words, in order to stimulate the economy, real rates (discounting inflation) of close to zero or even in negative territory are necessary. Moreover, attention must also be paid to relative rather than absolute rates. It is important for nominal GDP growth to outpace long-term rates in order for the primary fiscal balance to improve (once interest expenses generated by the public debt load are discounted).

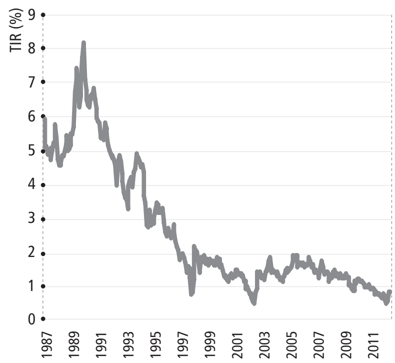
> "We don't think the Japanese government is about to commit *hara-kiri*"

How might Japan achieve this desired effect? Over the short term, such low interest rates spur a shift of risk-free asset holdings toward equities – wealth effect – and other more attractive investments. Simultaneously, domestic investors seeking higher returns must invest overseas – since the central bank is crowding out the fixed income market and driving everybody else out –, weakening the Yen and encouraging Japanese exports. Over the longer term, inflationary expectations also encourage greater private investment and consumption. Moreover, we mustn't forget that this should allow for a decrease in the real burden of the public debt load, which is crucial in a country like Japan with the highest public debt in the developed world (gross debt/GDP: 237%).

Clearly, Japan has ventured into unknown territory with a very ambitious set of measures. Yet, we don't think the Japanese government is about to commit *hara-kiri*. However, the Japanese government must indeed implement the third arrow of its plan – structural reforms – rapidly, in order to achieve sustainable long-term economic growth. Therefore, if our expectations are confirmed and inflation is generated, fixed income assets are likely to suffer – sooner or later – in spite of the extraordinary aid of the central bank's purchases.

Meritxell Pons, CAIA
Fixed Income Director

10 year Japanese sovereign interest rates



Despite the aggressive asset purchase policy of the Bank of Japan, we do not think the 10-year rate can go down much further.

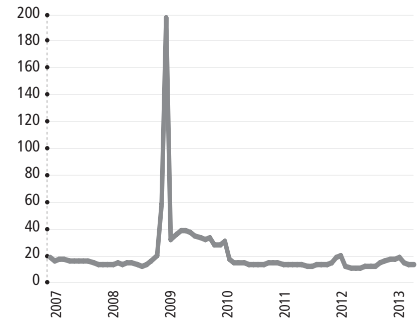
Official Rates: Consensus Forecasts

	28/03/13	Q3 '13	Q4 '13	Q2 '14
Euro-Zone	0.75%	0.50%	0.50%	0.50%
U.S.	0.25%	0.25%	0.25%	0.25%
United Kingdom	0.50%	0.50%	0.50%	0.50%

Interest Rates: Changes

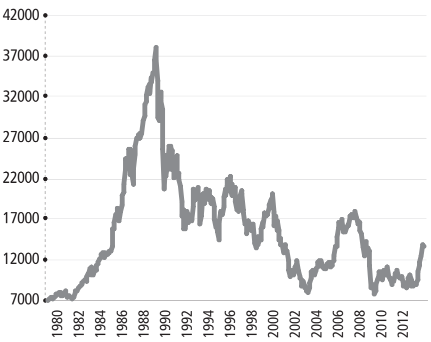
	28/03/13	Last 3 months	Last Year
Euro-Zone			
3-month Euribor	0.22%	-0.007	-0.435
10-year Bund	1.73%	0.439	0.145
U.S.			
3-month U.S. Euribor	0.27%	-0.010	-0.188
10-year U.S.	2.49%	0.637	0.841
United Kingdom			
3-month GBP Libor	0.51%	0.003	-0.385
10-year Gilt	2.44%	0.675	0.709

Japanese stock market PE



The Japanese stock market multiples are not high, relative to those reached since the global crisis began in 2008 (on the chart, 12-month forward PE of the Topix).

Nikkei



Despite the strong rebound in the Nikkei, the index was very near historic lows and is still far from the maximum reached at the end of the 80s.

			Q2 %	YTD %
USA	S&P 500	1,606	2.36%	12.63%
	DJ Indus. Avg	14,910	2.27%	13.78%
	NASDAQ 100	2,910	3.23%	9.35%
EUROPE	DJ Euro STOXX 50€ Pr	2,603	-0.82%	-1.26%
	France (CAC 40)	3,739	0.20%	2.69%
	Spain (Ibex 35)	7,763	-1.99%	-4.96%
	UK (FTSE 100)	6,215	-3.06%	5.39%
	Germany (DAX)	7,959	2.10%	4.56%
	Switzerland (SWISS)	7,683	-1.67%	12.61%
	Italy (FTSE MIB 30)	15,239	-0.65%	-6.35%
	Netherlands (AEX)	345	-1.01%	0.55%
JAPAN	TOPIX	1,134	9.58%	31.87%
	NIKKEI 225	13,677	10.32%	31.57%
Emerging markets	Mexico	40,623	-7.84%	-7.05%
	Brazil	47,457	-15.78%	-22.14%
	Argentina	2,976	-11.96%	4.27%
	China	1,979	-11.51%	-12.78%
	India	19,396	2.97%	-0.16%
	Korea	1,863	-7.06%	-6.70%
	Russia	1,330	-7.52%	-9.78%

In the land of the rising Nikkei

Japanese equities should continue to benefit from the gigantic monetary and fiscal intervention implemented by authorities, still reasonable valuations, and – most importantly – the change in expectations which is probably under way.

The Land of the Rising Sun is an object of desire once more. The lion's share of its stock market upturn was a reflection of expectations. We got into the game early, mainly because we foresaw that a very appetising cocktail that investors would not be able to resist drinking was in the blender: a new government with a strong message and a sufficient majority for executing its plans was to be followed by – in just a few months – a change in the Central Bank Governor. Said and done. Last November Japanese stock markets were just barely in the black versus the beginning of the year. Six months later the Nikkei had rebounded by 80%. It isn't such an extraordinary situation. In fact, it was the fifth time since the bubble burst that jumps of over 50% were registered; they never proved lasting (prior to the previous rebound, the stock market was quite close to historic minimums, 77% below the maximum hit in 1989).

The situation has evolved from the above-mentioned reflection of expectations to their confirmation. As we put forth on our cover page, we believe Japan is moving in the right direction towards achievement of "the" needed change: the breaking of deflationary expectations. Even if this doesn't finally pan out, the magnitude of the BoJ's intervention is so huge that we believe that at least the other type of inflation – financial – should be achieved. Whilst this process is under way, Japanese equities should continue to appreciate. We see the 20% correction since end-May as merely an excellent opportunity to enter the market.

For those prone to vertigo, it is also comforting to bear in mind that in spite of upturns, the Japanese stock market's valuation is still very reasonable. The estimated analyst consensus P/E ratio currently amounts to 13.6x, well below the 20x which was paid quite recently (please refer to attached graph). The Japanese corporate earnings growth rate is expected to treble the global average this year (+57% vs. +19%). This largely reflects the drop in the Yen (exporters benefit greatly), which also lends a hand to importation of much-coveted inflation (which, as it is confirmed, should also be a magnificent catalyst for stock markets). On top of all this, the economy is improving (the latest published GDP rate was over 4%). Moreover, companies appear to be accelerating their investment plans, which should finally put the enormous cash piles that they have been hoarding to use, lifting ROEs and long-term earnings.

We must insist that risks are not trivial. Any sharp setbacks registered by the Yen or drastic movements of the interest rate curve would scare investors. Moreover, the country's fiscal health is delicate, to say the least: worldwide, only the US has issued more public debt (yet Japan's GDP is half that of the US) and its deficit level (nearly 10%) would surely be the cause of panic in the Eurozone. We also mustn't forget that getting rid of chronic deflation is a mammoth undertaking (the GDP deflator has fallen by 17% since 1997) and no matter how confident we are that Japan is set to achieve this goal it is certainly possible that they end up failing once more. We must keep in mind that "easy" winnings are probably behind us. Further gains must probably be accompanied by tangible results. Company earnings must rise, macroeconomic data must remain on track, and structural reforms are needed. We believe that Japanese indices should rise, but not at the pace seen during the early months of this year. Yet, in our opinion, upside potential is sufficient for the Japanese stock market to continue to enjoy one of the best medium-term outlooks.

David Macià, CFA
Head of Research and Strategy

Commodities and Currencies

COMMODITIES

Japan by itself isn't enough

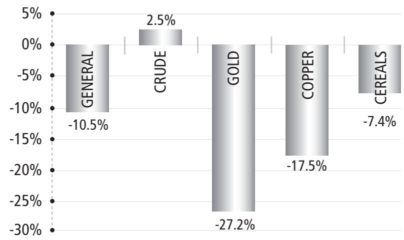
Gold benefitted for a long time from a chain of positive news that, bit by bit, led investors to include it in their portfolios. More novice investors even considered the precious metal an ideal instrument to add to portfolios, anxious to achieve returns and thinking they weren't taking on risks inherent to equities.

The launch of Japan's expansionary monetary policy appeared to be gold investors' second-to-last shot. However, these measures didn't manage to turn around gold's recent situation either – turbulent since the beginning of the year –and since then it has suffered a sharp correction: over -20% thus far in 2013 and, presently, with there is no clear forecast of where the bottom lies. If investors turned to gold for diversification and protection from possible inflation or fears of financial turbulence, what can they do now that they own it? In recent years, a lot of myths have been debunked. Gold together with government issues and the Yen (to give just a few examples) have ceased to be assets which always ensure security during the most complicated times (de-correlation in technical terms).

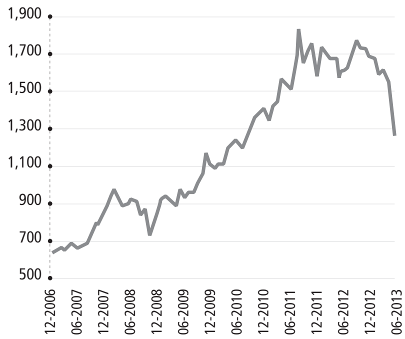
At any rate, everything has a price and gold is still underpinned by emerging markets' needs for diversification of currency reserves: China is at the head of the pack, but probably has more pressing issues at hand right now. Regarding inflation, the risk that all these expansionary monetary measures end up creating inflation over the medium term is not minor. Finally, we would bear in mind that mining companies have cut-off price levels for mineral extraction (it isn't profitable to mine when prices fall below them): some analysts estimate an average cut-off price of around USD1,080/ounce.

David Rabella
Head of External Funds and Alternative Investments

Performance DJ UBS TR commodities Year to Date



Gold



CURRENCIES

Yen-dependence

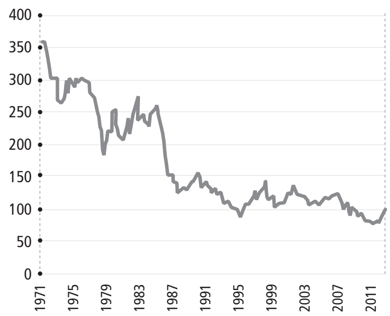
The performance of the Yen plays a crucial role in the Japanese economic recovery. The Japanese currency was at the verge of hitting historic maximums just before investors began to discount the upcoming changes and they were not let down. The new Bank of Japan (BoJ) Governor rushed to announce a humongous intervention, entailing the most aggressive expansion of its balance sheet to date, even overshadowing the Fed itself.

Authorities argue that that the Yen's weakness is a "consequence" and not an end itself, yet clearly it is of inestimable assistance, driving up exports – and therefore, company earnings –, which should lead to salary improvements. Yet, a second and even more important effect is perhaps going more unnoticed: imports are also becoming more expensive, helping to generate long-awaited inflation. The latter is crucial, as we explain on the cover sheet, to finally break away from deflationary expectations which are a roadblock to recovery. The Yen's weakness also stimulates the optimism of investors – who are aware of all of the factors set forth previously – who anticipate events and help the cause: uptrends in the stock and/or real estate markets create a "wealth effect" which stimulates private spending. Moreover, as the Yen loses value, domestic investors are increasingly interested in making foreign investments, thereby spurring greater sales of the Japanese currency.

One of the key factors for ensuring that this virtuous circle isn't broken lies in not restarting up nuclear energy plants (greater nuclear energy production implies that the country wouldn't have to import so much energy, which would increase the current account surplus and, therefore, the demand for yens). Yet, whatever happens, the important thing is that very positive dynamics have been triggered. As long as movements are gradual – abrupt drops might frighten investors – the Yen's weakness will keep being one of the main drivers of the Japanese economy's recovery.

David Macià, CFA
Head of Research and Strategy

Yen vs dollar



The yen is correcting from all time highs versus the dollar.

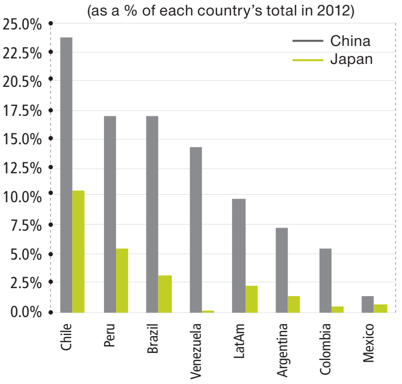
Exchange rate € vs $

% change:	1 month	3 months	1 year
	0.26%	1.45%	2.80%

Consensus Forecast:	Q3	2013	Q1 '14
	1.28	1.27	1.26

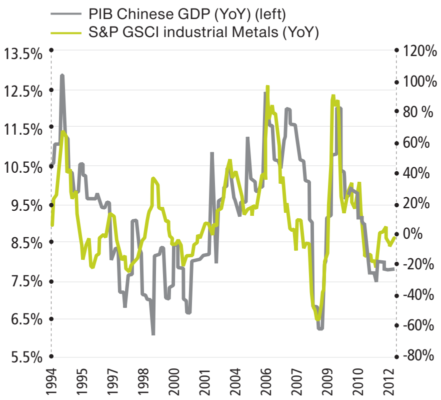
Latin America

LatAm area exports to China and Japan



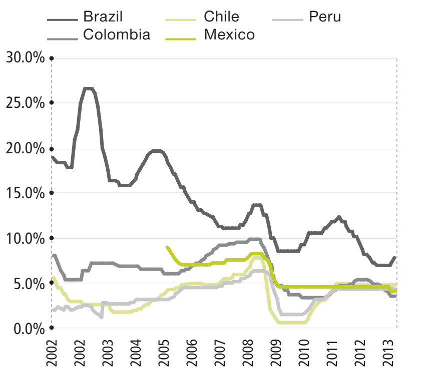
China is a much more important trading partner than Japan. Additionally, exports from much of the area have a clear bias towards commodities, which means they would not compete with Japanese exports *(Note: the LatAm area refers to the group of countries shown above).*

Chinese economic growth and commodity prices



The increase in demand for commodities in recent years has been dominated by Chinese demand. Therefore, the prices of raw materials such as industrial metals have been heavily influenced by Chinese growth.

Official interest rates



Due to fears over inflation, the Central Bank of Brazil has entered a new phase of monetary tightening. In other economies such as Chile, where prices are under control, there is scope for monetary policy if the economy weakens.

The key is China, not the Yen

The lack of re-acceleration in China is a much greater obstacle for this region than depreciation of the Yen. The US economy's health should lend support in coming quarters, but fears that the Fed might withdraw stimuli are likely to overshadow this effect over the short term.

With Prime Minister Abe's new government in place and a new boss at the Japanese central bank, much more aggressive monetary policies have led to a sharp depreciation of the Yen. Although this trend is expected to continue, the Japanese currency shouldn't make it onto the list of the most pressing concerns of LatAm economies. Although Japan might steal market share from other nations in the global export markets, it is not a natural competitor for this region, where exports are more biased towards raw materials. An acceleration of the Japanese economy isn't of vital importance for LatAm economies either, since Japan's importance as a trading partner for the region is minimal (accounting for only slightly over 2% of the region's exports).

On the other hand, China is a key trading partner of the region. A source of growth for LatAm exports in recent years, China already absorbs nearly 10% (of LatAm exports). Moreover, the Asian giant's growth, due to the importance of its demand, clearly shapes the fate of the prices of some of the main raw materials. As a result, the cooling off of Chinese growth which has been registered for quite some time is one of the main roadblocks for LatAm economies. The most recent indicators still don't point to re-acceleration of Chinese growth, which is putting downward pressure on raw materials prices and is already spurring an additional deterioration of the region's current account balances.

Moreover, some of the main economies in the region are still facing additional problems. In Brazil, following a hugely disappointing 2012 growth, economic re-acceleration remains weaker than expected and we see no reason for a "major celebration" in 2013e. Its growth model seems to be petering out, with consumers appearing to be running out of gas. The credit cycle is quite mature, with household debt holding back growth at levels well below those registered over the past few years. Investment in the economy remains insufficient – deepening supply-side problems – and, combined with a limited labour market, is putting pressure on price trends; at least the impact of the drop in raw materials on the region's economies is positive in part, as it alleviates inflationary pressures.

In addition to the Brazilian economy's difficulties, we would also highlight the sharp halt observed in Mexico (although it is expected to be temporary). As the US economy picks up pace from the second half of the year, we would expect to see a recovery of more dynamic growth. However, the health of the US economy should lend support to the region as a whole (we would bear in mind that it is also the main trading partner of Colombia and Venezuela). Nevertheless, over the short term the US economic recovery mightn't be so positive for LatAm since the debate regarding the Fed's possible withdraw of stimuli measures is likely to be revived (negatively impacting investors' appetites for risk and emerging market assets). Currency markets clearly reflect these concerns, as demonstrated by sharp corrections suffered recently by the region's currencies.

David Rojas,
Macroeconomy Analyst

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