Crèdit Andorrà Financial Group

**Third quarter 2015**
Date of Report: 23th June 2015

# Quarterly Report

## Our View on the Markets

INDEX



## Turn up the music, China's hosting

**Ironically, the economic slowdown in China may be the next major catalyst of financial markets once the PBoC is added to the never-ending list of central banks drawn to a lax monetary policy. We analyse the Asian giant from a financial markets point of view.**

Central banks not cutting interest rates (nearly 400 cuts since the crisis began) and/or implementing various monetary experiments (with negative rates and the QE programme heading up the list) are a rare breed. The Fed is one of just a few attempting to avoid zero interest rates, but markets – which never believed them – continue to prove to be right (the Fed certainly isn't too good at predicting its own decisions!). With the ECB and the BoJ already earnestly expanding balance sheets, investors seek new doses of liquidity to extend the *fiesta*.

Thus, it makes sense to try to guess the dose that will be injected and everything indicates that it is going to be massive. This looks doable as inflation is at lows (nearly 1%), and official interest rates are far from the level of zero that predominates in the main economies around the world. Yet, the top reason is that this is what it should do. The slowdown does not reflect temporary factors. China has enjoyed exceptional growth rates for decades (an average of +9.8% since 1980), a streak that is looking less and less sustainable. First the country made use of its abundant cheap labour force in order to become the world's factory, but this competitive advantage has gradually puttered out and is no longer the panacea of yesteryear. It came away unscathed from the last crisis as investment rose to unprecedented levels which must eventually be reversed. Finally, accumulating debt was – perhaps – the most important growth driver, but it has clearly run its course.

Although still manageable, debt ratios already surpass German or US levels on an absolute basis. The speed at which credit is expanding is much more worrisome (the indicator that best predicts future crises). Debt has quadrupled in seven years (surpassed only by Ireland, Singapore, Greece and Portugal). Less significant hikes triggered subprime and Japanese (1990's) crises. It is not at all helpful that nearly half of all loans are related to the real estate market, which many suspect is already facing a bubble. Signals are not lacking and some are rather odd: China consumed more cement in 2011/13 than the US during the entire 20th century (although the public works fever – e.g. the humongous Three Gorges Dam – largely explains this). However, we would not say that the situation is looking dramatic: prices have begun to decline, albeit moderately (-6% nationwide) and unsold housing stocks are increasing (from a low of 10/16 months) but are still a far cry from becoming nightmarish.

We firmly believe that the Chinese economy is slowing down irreversibly but we do not share the abundant views of doomsayers. Since it is a command economy (i.e. a euphemism for a lack of democracy), authorities enjoy not inconsequential privileges such as instant implementation of decisions and window dressing of data that markets should (and want to) believe. The government also has ample foreign currency reserves and, as previously mentioned, plenty of margin to manoeuvre on the monetary policy side. Directing the economic slowdown under the previously described scenario – aiming to simultaneously internationalise its markets and currency – is a major challenge for China. However, it is also an amazing opportunity to achieve a more sustainable growth model, much more beneficial for the planet than the previous one: characterised by boundless consumption of commodities. All of the factors addressed earlier have medium and long-term consequences for nearly all financial assets around the globe which we review in the following sections of this report.


*David Macià, CFA*
*Chief Investment Officer*


## Strategy

**Asset Allocation (2015 Q3)**

| | |
|---|---|
| Monetary | ↑ |
| Government Fixed Income | ↓ |
| Corporate Fixed Income | ↓ |
| Equities | ↑ |

**Fixed Income**

| | |
|---|---|
| GOVERNMENT: | |
| US | ↓ |
| Eurozone | ↓ |
| CORPORATE: | |
| US | ↓ |
| Eurozone ("Core") | ↓ |
| Periphery | ↓ |

**Equities**

| | |
|---|---|
| US | → |
| Eurozone | ↑ |
| Spain | ↑ |
| Emerging Markets | → |

**Commodities**

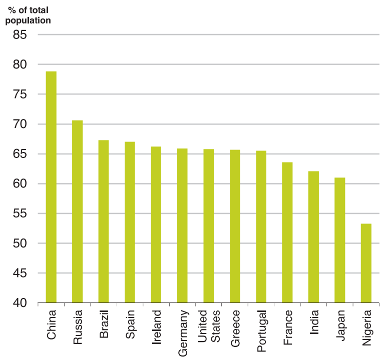
| | |
|---|---|
| Oil | → |
| Gold | ↓ |

**Currencies**

| | |
|---|---|
| EUR/USD | → |

# Macroeconomic View

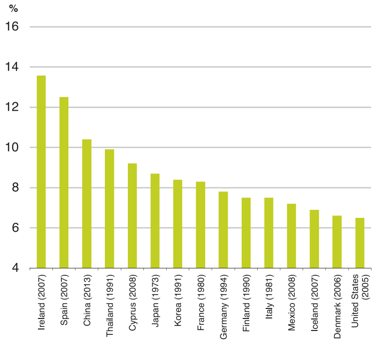
### Working age population




Source: Bloomberg

The population dynamics of China make it the country, amoung the main economies, with the highest proportion of people at working age. This situation is currently driving the economy forward, but it will turn against the country in the coming decades.

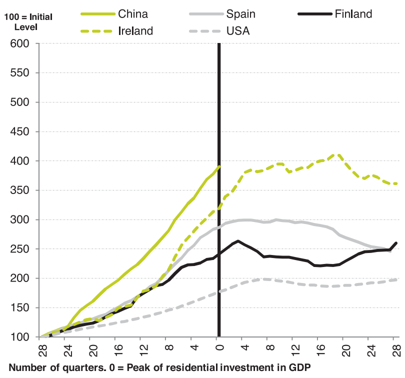
### Peak residential construction invesment (% GDP)




Source: Bloomberg

The weight of the residential sector in China's GDP is at levels similar to what other countries recorded before experiencing a real estate crisis.

### Credit growth (private sector)




Source: BIS

Another element of concern is the evolution of credit in recent years. The rate in China is higher than in other countries that experienced significant credit growth.

## China: Long and short-term excesses

**Following decades of economic expansion, China has generated imbalances that create major short and long-term challenges. Experience tells us that these problems are difficult to solve. We will see if, once more, China comes up with adequate measures to overcome them.**

The economic progress of China over the past few decades has been an impressive success story. While in 1980 China was the 9th largest economy in the world, with a GDP similar to that of Spain, it is currently the 2nd ranked country in the world, behind only the US. Moreover, its economy is approximately 10 times larger than that of Spain. However, along the way, China has accumulated some excesses that it must overcome in the long and short-term and which arose at different times.

**The main excess with long-term consequences** traces back to 1980. At that time, China was liberalising its economy and growth was underpinned by an explosive surge in exports. Also during this phase the government implemented the **demographic policy** that substantially reduced the country's birth rate and will have **future consequences for the Chinese economy**. While in 1980 the working age population amounted to 60% of people living in China, it currently totals 80%, the highest level among the world's main countries (vs. 65% in the US and 61% in Japan).

> "The residential sector is showing all the symptoms of a real estate crisis"

The demographic breakdown implies that, presently, the majority of China's population generates wealth. Moreover, savings in social spending on children and retirees is spent in other ways which generate greater economic momentum such as investment. Yet, over the medium term, as current workers retire and given a minimal birth rate, spending on social benefits should take off at a breakneck speed. While this problem is quite recurrent worldwide, its magnitude in China is exceptional.

**The second excess**, which will have immediate consequences, arose following the latest global crisis. In 2008 international trade suffered a substantial slowdown. As a result, among other reasons, Chinese authorities looked for a way to further propel investment - particularly in the **residential real estate sector** - in order to maintain growth trends. The Chinese government achieved this target but in exchange generated some major imbalances. The sector has all the symptoms of a future real estate crisis; in fact, short-term data is already pointing to a slowdown. Residential investment jumped from 2% of GDP in 1997 to 10.5% in 2013 (the 2005 US peak was 6.5%). Employment in this sector amounts to close to 15% of the total or similar to that of Spain in 2008 (which has dropped to a current level of 6% since then). Prices have suffered substantial hikes since 2008, with uptrends in different regions ranging from 50% to 90%. Finally, patterns of credit are also repeated. Since 2008 the debt/GDP ratio has jumped from 158% to 282% and more than half of the credit load is related to the residential sector.

History leads us to believe that the economic problems that China is facing will be difficult to solve. Therefore, if we analyse what happened to other countries that had to deal with similar situations, we observe that their economies ended up suffering sharp slowdowns. However, China has the tools and political will to confront these challenges. The government should, and has the time to, tackle China's demographic imbalances with structural reforms. Moreover, it has adequate tools to fight the economic effects of the slowdown of the real estate sector (e.g. fiscal and monetary stimulus packages and financial system reforms). We will see if, once more, China manages to find the right measures in order to successfully deal with these problems.

*Pablo Manzano*
*Macroeconomic Analyst*

# Fixed Income

## Panda & Dim Sum bonds

**China wants to convert its currency into a reference for global trade and, as a result, needs a deep and solid bond market. Moreover, the Chinese government will thus encourage its companies to diversify their financing sources and cut costs.**

In recent years the Chinese bond market has expanded to nearly CNY 36Bn and is already the third largest bond market in the world after the US and Japan. Nevertheless, it is still a great unknown. Why? It is a market dominated by the public sector. Of the total volume, 2/3 corresponds to issues of the government or state companies and only 1/3 to Chinese corporate issues. However, according to ratings agency Fitch, the corporate bond market will continue to register substantial growth as the Chinese government liberalises it and the weight of state companies steadily declines. The access to the "on-shore" market of bonds denominated in CNY is limited to domestic institutions and some foreign investors qualified as RQFII (RMB Qualified Foreign Institutional Investors), which are assigned investment quotas. Finally, a lack of information and transparency continues to hold back investors: There are discrepancies between ratings assigned by domestic and international agencies; barriers to obtaining financial statements remain; it is also still difficult to evaluate company debt levels; and default legislation remains precarious in terms of investor protection. While these are hefty reasons for avoiding this market, we would still certainly keep an eye on it given its size, pace of growth, and promising outlook.

"The Chinese market offers yields, exposure to a reference currency, and diversification."

Under the current low interest rate scenario, the Chinese bond market offers **attractive yields** (the Chinese 5-year government bond yield of 3.25% is nearly double that of the US government), **diversification** (these bonds demonstrate low correlation with other asset classes and relatively low volatility: 2.6% annualised), **exposure to a currency with great upside potential** over the long term, and **structural demand for these types of assets** given an aging population.

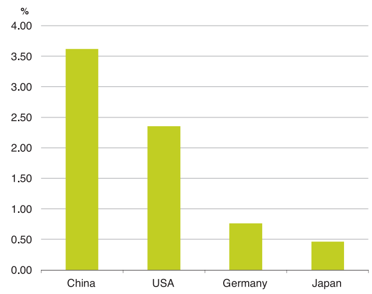
The default rate is quite low compared with other developed and emerging countries – at end-2014 amounting to a rate for the past 12 months of 1.9% according to Moody's – although we would bear in mind that the track record is still short. In fact, over the past three months we have seen three defaults underpinned by the economic slowdown. Furthermore, issuers are aiming to again tap the market given expectations that the Chinese Central Bank will implement new expansionary monetary policy measures allowing for a decline in returns required by investors.

We may access this market directly through "on-shore" bonds by purchasing shares in specialised funds with access to these issues. We would also point out that there are two types of bonds: "Panda" and "Dim Sum". Panda bonds are bonds of non-Chinese issuers denominated in Renminbi (Yuans) and issued in China. Dim Sum bonds – just like the delicious Chinese appetisers served with tea for which they are named – might be a first taste for investors: they are bonds issued in Renminbi outside of China and, since the first such issue in 2007, have been used as an asset for investing in the Chinese currency.

In short, the Chinese corporate bond market is a new emerging asset class of global importance. It is a growth market with increasing participation in primary markets and is sure to offer new private fixed income opportunities for investors.

*Josep Ma Pon and Susanna Torrent*
*CAAM Fixed Income and Money Market Assets*

### Interest rates (10 years)




Source: Bloomberg

The interest rate differential is a positive incentive to invest in Chinese fixed income assets.

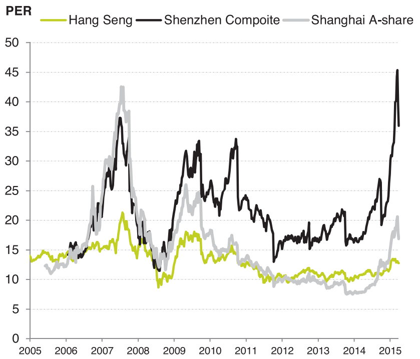
### Official Rates: Consensus Forecasts (%)

| | 30/06/15 | 3th Q | 4th Q | 1st Q '16 |
|---|---|---|---|---|
| Eurozone | 0.05 | 0.05 | 0.05 | 0.05 |
| US | 0.25 | 0.45 | 0.70 | 0.95 |
| United Kingdom | 0.50 | 0.50 | 0.60 | 0.75 |

### Interest Rates: Changes (%)

| | 30/06/15 | Last 3 months | Last year |
|---|---|---|---|
| Eurozone | | | |
| 3-month Euribor | 0.01 | -0.03 | -0.09 |
| 10-year Bund | 0.76 | -0.60 | 0.22 |
| US | | | |
| 3-month US Libor | 0.28 | 0.01 | 0.03 |
| 10-year US | 2.35 | 0.50 | 0.18 |
| United Kingdom | | | |
| 3-month GBP Libor | 0.58 | 0.01 | 0.01 |
| 10-year Gilt | 2.02 | 0.48 | 0.27 |

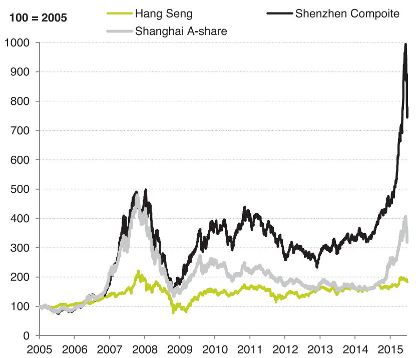
## China Stock Markets (PER)




Source: Bloomberg

The Chinese economy is cooling down. Yet, Chinese stocks have risen by over 100% since mid-2014.

## China Stock Markets




Source: Bloomberg

In recent months, China's stock market has seen a spectacular rise. The possibility that we are facing a bubble is high.

| | | | Q2 % | 2015 % |
|---|---|---|---|---|
| USA | S&P 500 | 2,063 | -0.23% | 0.20% |
| | DJ Indus. Avg | 17,620 | -0.88% | -1.14% |
| | NASDAQ 100 | 4,397 | 1.46% | 3.79% |
| EUROPE | DJ Euro STOXX 50€ | 3,424 | -7.39% | 8.83% |
| | France (CAC 40) | 4,790 | -4.84% | 12.11% |
| | Spain (Ibex 35) | 10,770 | -6.52% | 4.77% |
| | UK (FTSE 100) | 6,521 | -3.72% | -0.69% |
| | Germany (DAX) | 10,945 | -8.53% | 11.62% |
| | Switzerland (SWISS) | 8,781 | -3.81% | -2.25% |
| | Italy (FTSE MIB 30) | 22,461 | -3.01% | 18.14% |
| | Netherlands (AEX) | 473 | -3.44% | 11.33% |
| JAPAN | TOPIX | 1,630 | 5.66% | 15.84% |
| | NIKKEI 225 | 20,236 | 5.36% | 15.96% |
| EMERGING MARKETS | Mexico | 45,054 | 3.04% | 4.42% |
| | Brazil | 53,081 | 3.77% | 6.15% |
| | Argentina | 11,657 | 7.56% | 35.88% |
| | China | 4,277 | 14.12% | 32.23% |
| | India | 27,781 | -0.63% | 1.02% |
| | Korea | 2,074 | 1.63% | 8.28% |
| | Russia | 1,655 | 1.74% | 18.47% |

# Chinese stocks: A bubble?

**The Chinese economy is cooling down. Yet, Chinese stocks jumped over +100% since mid-2014. Is this a bubble that is about to burst?**

Chinese domestic stock markets have decoupled completely from the country's underlying economic trends. The two most closely followed domestic indices, the Shanghai A-Share and the Shenzhen Composite Index, more than doubled in the past 12 months. It is important to understand that A-shares are generally only available for purchase by mainland citizens; foreign investment is only allowed through tightly-regulated structures. Foreign ownership of A-shares represents less than 2% and, consequently, performance is driven by domestic investment flows. These flows are highly volatile, because of domestic policies and the fact that Chinese investors have proven to be valuation insensitive, aiming to obtain short-term trading gains.

Main drivers of the recent rally include liquidity injections by the People's Bank of China - through interest rate cuts and reductions in reserve requirement ratios for banks - and other economic stimuli by Chinese authorities. In addition, the cooling of the Chinese property market has redirected flows from housing to equities. The massive rally obviously raises the question of whether we are already in a bubble which eventually may burst, repeating the 2008 experience when the market crashed by -70%. There are actually several warning signs: New brokerage accounts reached 30 million (in April and May) and exceeded the record set during the last bull market. Recent IPOs have been oversubscribed by over 300 times. Moreover, trading volumes are rising rapidly and margin balances of brokerage accounts which now make up about 7% of the free float market cap (vs. 2% in the US) have reached record highs.

Finally, valuations have become excessive, especially in the tech-dominated Shenzhen Index. Yet, A-shares listed in Shanghai currently trade at a forward P/E of 18, which - though significantly below the last bubble's high - is expensive compared to other emerging markets, especially taking into account that China's corporate debt has gone from around 70% of GDP in 2007 to 125% of GDP. Bubble talk has intensified after the recently observed first serious correction of the current bull market, triggered by: government interventions to reduce margin lending; a surge in IPOs; and the MSCI's decision to postpone the inclusion of A-shares in their indices, citing ongoing concerns around capital mobility and capital allocations.

Risks have certainly increased and domestic flows and policies are difficult to predict. Nevertheless, as long as the Chinese economy is still cooling down, further monetary stimuli should continue to drive Chinese stocks. Moreover, China's economic transformation from exports and investment towards private consumption offers huge long-term potential for consumer, financial and technology companies. However, international long-term investors are better served to buy Chinese stocks via their Hong Kong listings (H-shares), where they currently trade at a discount of more than 20%. As China opens its capital account, we expect this discount to disappear.

*Pascal Rohner, CFA*
*Director of Latam Equities*

# Commodities and Currencies

COMMODITIES

## New consumption habits

China's role in the global economy has certainly been evident in innumerable areas, but its effect on raw materials markets is particularly noteworthy. However, huge Chinese demand for industrial metals became especially significant from 2009, underpinned by the country's very well-known infrastructure plan which coincided with a period of stagnant consumption of these metals by the Western world.

In order to put things into perspective, we would point out that in 2014 China accounted for 10% of global consumption of oil and 30% of gold. Yet, undoubtedly, Chinese demand has had the greatest impact on industrial metals with 2014 consumption amounting to 45% of global demand vs. a level of just 10% in the year 2000. Yet, the most important thing is not to understand what has happened but rather to predict what is down the road since China is expected to grow at a slower pace and, most importantly, its economic model is certain to experience major changes. The Chinese economy should become less dependent on construction of infrastructures, export sectors and the real estate market. Meanwhile, the weight of domestic consumption should rise.

As a result, the country's shrinking need for infrastructures should ensure that the pace of growth of demand for industrial metals – although maintaining its global pre-eminence – will lose steam.

In the energy sector, the shift towards cleaner energy (including gas), a larger national grid, and improved efficiency lead us to foresee an annual increase in consumption of not much more than 3%. However, since the vehicle fleet in China is expected to double in five years, gasoline demand will surely rise sharply. The increase in cars should also impact the consumption of palladium, which is used by diesel motors.

Thus, in the upcoming years we believe that China should continue to have a fundamental weight in the raw materials market. That said, its consumption habits should gradually change: reducing the quantity of raw materials linked with construction and increasing that related with private consumption.

*David Rabella, CAIA*
*Head of Selection of Funds and Alternative Assets*

CURRENCIES

## In search of its own orbit

Within the foreign exchange universe, we see two major classes: those currencies that "orbit" freely to the tune of the markets; and those with exchange rates pegged to the currency of a large economy with which its home country has trade relations. The Chinese currency – the Yuan– belongs, with some nuances, to the second set. Its value is pegged to the US Dollar, which has contributed to the economic success of China over the past few decades.

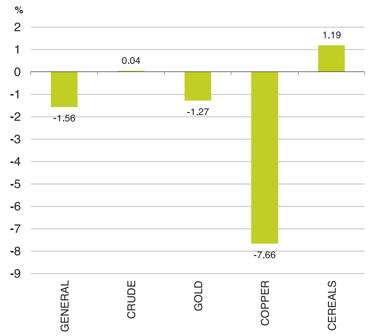
As a result, China has managed to safeguard the **stability** of its economy. The Yuan's low volatility - the average monthly fluctuation of the yuan vs. the USD since 2005 was 0.5% vs. the Euro's 3.1% and the Brazilian Real's 5% - has facilitated economic activity. Another reason why this monetary scheme has been positive has to do with the country's **competitiveness**. Over the past several decades, the export sector has enjoyed a competitive advantage vs. the rest of the world as the fixed exchange rate has been considered, by the vast majority of the economic community, to be too low (although this year the IMF considers, for the first time ever, that the currency is trading at a reasonable level).

Yet, the fact that the Chinese currency should be gradually unpegged from the USD should allow several **objectives** to be met. Firstly, as artificial competitiveness disappears, Chinese companies will fight for domestic market share, thereby allowing the economy to focus on **personal spending**. Another target is the **internalisation of the Yuan**, which accounts for 1.5% of total global transactions vs. the US Dollar's 45%. Thus, Chinese authorities should allow access to the Asian giant's currency, which should entail unpegging it from the USD. Moreover, the current regime causes **monetary policy measures** implemented in the US to directly affect China. Given their different economic cycles, the two countries should implement different measures.

Years ago there were factors making it understandable that the Yuan orbit around the USD. However, this now holds back its ability to meet its objectives and implement appropriate economic measures. **It is time for the Yuan to find its own orbit**.

*Pablo Manzano*
*Macroeconomic Analyst*

### YTD performance of DJ UBS TR commodities

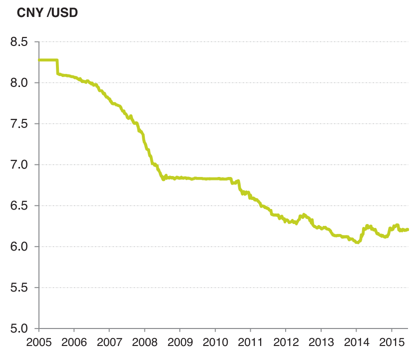



Source: Bloomberg

### Copper


Source: Bloomberg

### Yuan




Source: Bloomberg

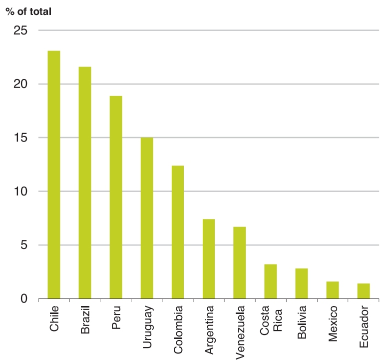
The movement of the Chinese currency has been controlled by its central bank in recent decades. At present, its currency is linked to the dollar, which limits the effectiveness of its monetary policy tools.

### Exchange rate $/€

| | | | |
|---|---|---|---|
| % change: | 1 month | 3 months | 1 year |
| | 2.01% | 3.57% | -18.59% |
| Consensus forecast: | 3Q 2015 | 2015 | 2016 |
| | 1.07 | 1.05 | 1.08 |

# Latin America

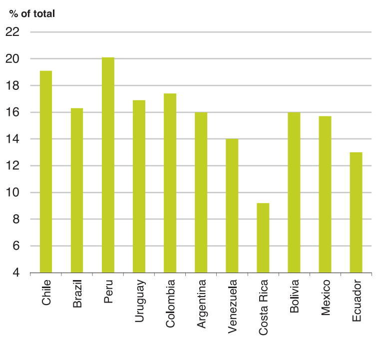
## Exports to China




Source: Bloomberg

The importance of the Chinese market for some countries is very significant.

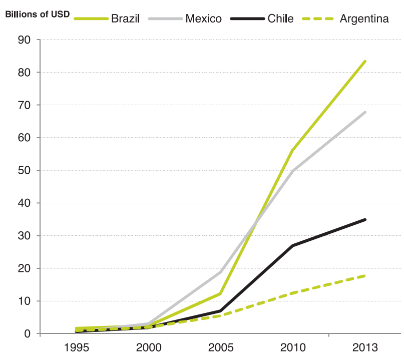
## Imports from China




Source: Bloomberg

The vast majority of Latin American countries import a large quantity of goods from China.

## Trade growth with China




Source: Bloomberg

Trade relations between China and Latam have grown very significantly in recent decades.

## China & Latam: A journey begins with a step

**Some of the main reasons underpinning China's interest in Latin American are: spectacular Chinese growth in recent years; a resultant rising interest in raw materials and intermediate goods; and also an on-going search for new markets to place its production surpluses.**

Growth achieved in recent years did not arise spontaneously, but rather was the result of increasing – albeit pre-existent – needs for certain products. Moreover, it reflected planned measures implemented by a strongly centralised state. This implies that decisions regarding the manner, methods, places and pace of this expansion have not been made solely by economic players. To the contrary, China's economic situation is the product of a highly planned political strategy which simultaneously juggles very different variables. The Asian giant is the main trade partner of Brazil, Chile and Peru and the second ranked partner of countries such as Mexico, Argentina and Venezuela. Forecasts indicate that in 15 years it should surpass the US as the region's main trade partner. 70% of Latin America's trade deficit with the Asian country can be explained by growth of Mexico's negative balance (USD60bn), which is due to the fact that less than 2% of Mexican exports to the rest of the world are absorbed by China while 17% of its imports are from that country. There are trade deficits with China (USD88bn for the entire region) in nearly all Latam countries although of different sizes. Only three countries are registering surpluses: Chile, Brazil and Bolivia.

China purchases as much soy as it can from Argentina (USD5bn) and Brazil (USD16bn). Chile, the largest producer of copper in the world, exports one-third of its production of this metal to the Chinese market (USD14bn); it also exports paper pulp (USD1.1bn), wine (it's the second largest supplier to China), and grapes and cherries (it's the largest supplier in this case) to the Asian Giant. Venezuela exports large quantities of oil to China. Peru supplies it with copper (USD4bn) as well as fishmeal and agricultural products (USD3bn); in this case, the two countries have signed a free trade agreement. Moreover, Peru is home to the second largest population of ethnic Chinese people in the region. In Brazil's case, in 2014 it sold over USD40bn of products to China: at the top of the list was soy, followed by iron ore (USD12bn), oil (USD3bn) and paper pulp (USD1.4bn).

We would also mention that an agreement has been signed entailing the purchase of 22 Embraer airplanes by two Chinese airlines.

Even though the bulk of investments are focused on the search for commodities, the trend is changing. China aims to invest in public infrastructure works via private agreements between governments with financing and exclusive participation of companies of the Asian country. Thus, it is financing a new port in Cuba, developing an interoceanic railway corridor in Brazil and Peru, and building an interoceanic canal in Nicaragua, two hydroelectric plants in Argentina, and a refinery in Costa Rica. China is becoming a lender of last resort to these countries, with some facilities financed in RMB (Yuans) in order to favour its own industry. Loans are granted, but only to purchase Chinese equipment, machinery, parts, and even labour. In many cases transparent public information regarding agreements signed is not available.

Latam is receiving more money from China than from the World Bank and IDB (Inter-American Development Bank) together with loans to the region jumping by +71% in 2014 to USD22bn. 70% of loans were in exchange for oil. Bilateral debt of Venezuela and Ecuador amount to around USD44bn and USD7bn, respectively. These countries have agreed to supply China with a set quantity of oil and, thus, will not benefit from any future price increases.

Some countries – such as Venezuela, Ecuador and Argentina – have many complementary interests with the Asian giant which are not merely trade-related: e.g. in some cases, they even encompass military interests.

*Raúl Ponte*
*Head of LATAM Fixed Income*

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