Second quarter 2015
Date of Report: 27th March 2015

INDEX

Quarterly Report

Our View on the Markets

Oil

In just a few months crude oil prices have suffered a collapse that we think will not revert in the medium term. In this quarterly report we focus on explaining its impact on the global macro economy and different financial assets.

The frequency of radical shifts in majority views in financial markets never ceases to amaze us. Situations that slightly earlier were perceived to be impossible are considered inevitable in a blink of the eyes. There are numerous recent examples: For example, just a short while ago the possibility that the ECB launch a QE programme sounded like science fiction to many. In addition, a quarter of all European sovereign debt issues currently trade at negative yields (yes, you have to pay to lend your money?). It seems unbelievable, but this situation is expected to continue, as if nothing else were possible… What about the Euro/Dollar? Among analysts and strategists, try to find someone who was brave enough to predict a Euro nearing parity with the USD last summer.

In some cases we believed it was the starting point which didn't make sense (i.e. the strength of the Euro or the conviction that the ECB could avoid launching a QE programme) while at other times the "new paradigm" astonishes us (negative rates). In our opinion, the rapid collapse of oil prices – Brent at twice the current level last June – fits into the former case.

In fact, what was surprising is that oil prices managed to remain above USD100/barrel. We have seen US production take off thanks to improved extraction technologies (the so-called "shale oil"), which have added nearly 5Mn barrels per day and propelled that country into the top world producer. Meanwhile, economies of half of the planet are suffering a slowdown, with the Chinese case (still under way in our view) one of most relevant.

The key to any forecast is the current excess supply situation, which amounts to an estimated 2Mn barrels per day. We believe it will be extremely difficult to eliminate.

In spite of quotas imposed on members – non-compliance is pretty much the norm – the OPEC produces more than demanded and Saudi Arabia refuses to cut production as it fears losing market share. In fact, the drop in prices encourages oil-dependent countries to raise production in an attempt to balance their budgets. In the US, although new extraction investment plans have dried up, production levels have not suffered much: in March, accumulated stocks were at the highest levels registered in 80 years of history, which surely helps to explain the gap between traded Brent vs. West Texas prices. Looking ahead, the drop in prices stimulates technology investments which are rapidly advancing driving down extraction costs. In short, we foresee neither a substantial jump in global demand nor a noteworthy downtrend in supply this year. In fact, the International Energy Agency is forecasting an increase in 2015 production by 800,000 barrels.

Given our belief that what we are seeing is a "permanent shock", the situation can be considered good news for consumers and companies: it is like being handed a check thanks to lower manufacturing, distribution, gasoline, and heating costs. Thus, it is also good news for the global macro economy. However, it is much less positive for producers (companies and countries, many which are emerging), which sometimes have a sufficient weight in fixed income and equities indices to ruin bullish forecasts. This edition of our quarterly report is dedicated to "black gold" and to explaining in detail the expected effects of the collapse of its price on different types of financial assets.

David Macià, CFA
Chief Investment Officer

Strategy

Asset Allocation (2015 Q2)

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

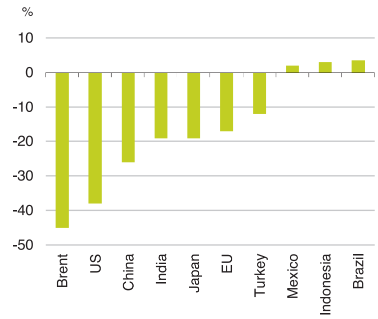
Oil →
Gold ↓

Currences

EUR/USD →

Macroeconomic View

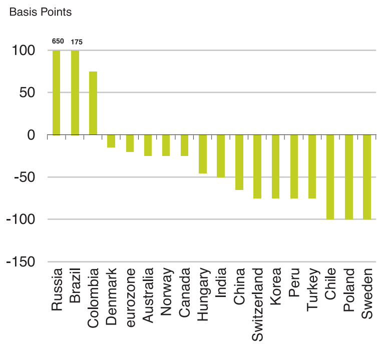
Change in gasoline prices since June 2014



Source: IIF, Barclays

The price of gasoline has not fallen as much as oil. Among the reasons are the depreciation of currencies against the dollar and changes in taxes and subsidies.

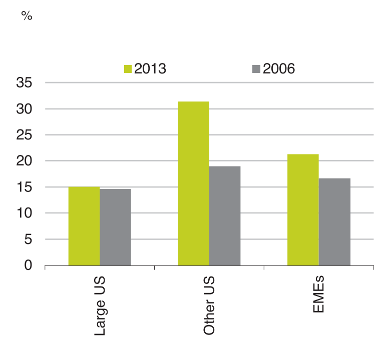
Change in official interest rate



Source: Bloomberg

Since June 2014 many central banks have provided further stimulus.

Oil and gas producers: total debt to assets



Source: BIS

The high leverage of oil companies affects the macroeconomic consequences of the fall in oil prices.

The dark side of the drop

The -50% drop in oil prices has positive consequences for global growth. However, it's not all good news. Momentum may be weaker than on previous occasions, the probability of bubbles is greater, and certain sectors may be destabilised.

The value of oil production has fallen from USD3.5Tn in 2013 or slightly less than the German GDP to – maintaining prices – USD1.6Tn in 2015. This entails redistribution of wealth from producers to buyers, with noteworthy economic consequences. That said, effects may be different than those registered on previous occasions. In our view, the three most relevant implications are as follows:

1) Impact on economic activity: According to economic theory, the nearly USD2Tn transferred to buyers should drive up global growth. What is the classic rationale underpinning this theory? Money is put into the hands of those economic agents with greater propensity to spend. However, we are observing that the downtrend in oil prices is not totally feeding down to consumers and companies. This is due to two factors: i) Many governments have taken advantage of these circumstances to raise taxes and/or cut gasoline subsidies; and ii) Weak crude oil prices have been accompanied by sharp appreciation of the US Dollar. As a result, the price drop in local currencies has been smaller. Thus, since June, prices have even increased in some markets such as Brazil, Mexico and Indonesia, the 7th, 16th and 17th largest global economies. Therefore, a portion of the above-mentioned USD2Tn have remained in the hands of governments and/or vanished due to volatility of currency markets. Moreover, it is possible that producers' tendency to cut costs – through investments – is greater than on past occasions. This can be explained by oil groups' high financial gearing, currently at historic peaks, which requires them to aggressively reduce investment projects which, in turn, negatively affects economic growth.

2) Monetary policy and financial bubbles: While the transfer of the drop in crude oil prices to final prices hasn't been complete, it has been sufficient for many developed countries to register negative inflation rates. Thus, the oil price downtrend has spurred the implementation of over 30 measures by central banks since December 2014: in many cases, such as the ECB's QE programme, extremely expansionary.

As a result, this situation has allowed additional global monetary measures, which have been extraordinarily lax for more than eight years. Under a scenario of central banks getting carried away when implementing measures, the situation could trigger the creation or expansion of financial bubbles (currently 25% of Eurozone sovereign bonds at negative interest rates).

3) Destabilisation: The sharp drop in oil prices has led to deterioration of global financial stability through three main channels. Firstly, high levels of dependence on crude oil of some economies, in general emerging countries, have generated uncertainties which have been reflected by depreciation of their currencies. Secondly, oil companies in emerging countries have issued large quantities of USD-denominated debt and the loss of revenues is spurring substantial balance sheet imbalances. Finally, since 2008 a slew of highly geared oil companies have appeared in the US. Currently, the possibility that we might see some defaults of these companies is not negligible. For the time being, in spite of this deterioration, there hasn't been – with a few exceptions – any major financial turbulence. Nevertheless, should the downtrend deepen or be drawn out excessively risks might be generated which could jeopardise the financial stability of certain regions.

In short, the -50% drop in oil prices has positive implications for global growth, especially in the US. Yet, we believe effects should end up being less than the earlier-indicated figure for three reasons. Firstly, a portion of this sum has ended up in the hands of governments and evaporated in currency markets. Secondly, this situation has allowed for a new round of expansionary monetary measures, thereby raising the probability of financial bubbles. Finally, the financial stability of emerging countries and key sectors has been negatively affected.

Pablo Manzano
Macroeconomic Analyst

Fixed Income

The end (start?) of a time of plenty

Although net positive effects on the global economy are quite apparent, there are some hidden victims: sector-related companies. Fixed income investors should consider both sides of the coin.

It makes sense to assume that a decrease in oil prices is good for the global economy. Particularly if we believe it is due to a supply-side shock, as is the case of the collapse of approximately -50% registered since mid-2014. As economists, we tend to consider this situation similar to a tax cut: consumers' purchasing power increases, profits of companies in sectors with intensive usage of energy rise, and the trade balance of countries that import crude oil improves. Furthermore, even after taking into account the dark side of the drop (see page 2), it should stimulate economic growth whilst simultaneously easing short-term inflationary pressures. These two consequences represent opposing forces for the outlook of long-term interest rates: on the one hand, greater economic growth should drive them upwards, particularly at the longer end of the curve and; on the other hand, the lack of inflationary expectations is delaying increases in official rates by monetary authorities. When we compare these two factors we think that, particularly in the US, the former outweighs the latter. In addition, interest curves on both sides of the Atlantic are currently so low that we believe it will be difficult for traditional fixed income investors to generate positive medium-term returns.

Declining profits, lower capital investments and even risk of non-survival... This is the situation faced by companies related to the oil sector, which are set to be negatively affected the most by the decline in oil prices. On the back of high crude oil prices a slew of independent oil-related companies popped up: not only in the exploration sector but also dedicated to providing services to large oil groups. These companies have high capital spending and employ expensive and sophisticated technologies and, therefore, their profitability is jeopardised by declining energy prices. These highly-leveraged companies, which are negatively affected by the drop in oil prices, are members of the universe of high yield debt issuers.

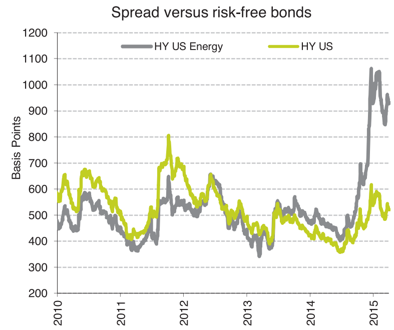
Particularly in the US, where there is greater access to capital markets than in the "highly banked" European market, credit spreads of bonds tightened thanks to high crude oil prices and – even more importantly – investors' search for yield under a scenario of historically low interest rates. Moreover, the fall from grace of these issuers has been pretty much across-the-board: many investors haven't differentiated between companies and their flight has triggered widening credit spreads which has made it extremely difficult for these issuers to access capital markets.

Geopolitical variables could lead to volatility of oil prices this year, but we believe that supply-side factors should have a greater weight in holding them in check over the medium term. As a result, we don't expect to see a sharp rebound of oil prices over the medium term and foresee a positive impact in the US to allow the Fed to normalise its monetary policy. Therefore, in our view, fixed income investors should adjust their portfolios in accordance with this new situation: we recommend maintaining very low durations, particularly for USD-denominated issues.

Moreover, should all "high yield" issues be avoided? Our answer is clearly "No". In fact, we believe that the earlier-mentioned across-the-board sell-off has created opportunities to invest in certain issuers with good prospects which have been overly punished by the markets. Nevertheless, we continue to believe that – more than ever – the careful selection of individual companies and the proper matching of investments in accordance with customer risk profiles are essential success factors.

Meritxell Pons Torres, CAIA
Director of Asset Management Americas

High-yield credit spreads



Source: Bloomberg

The fall in oil prices has led to a widening of credit spreads in High Yield, considerably higher in issuers from the energy sector.

Official Rates: Consensus Forecasts

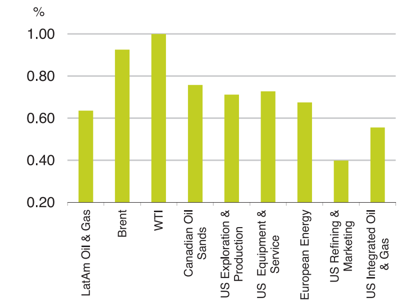
	31/03/15	2nd Q	3th Q	4th Q
Eurozone	0.05%	0.05%	0.05%	0.05%
US	0.25%	0.35%	0.55%	0.80%
United Kingdom	0.50%	0.50%	0.55%	0.65%

Interest Rates: Changes

	31/03/15	Last 3 months	Last year
Eurozone			
3-month Euribor	0.02%	-0.06	-0.29
10-year Bund	0.18%	-0.15	-1.39
US			
3-month US Libor	0.27%	0.02	0.04
10-year US	1.92%	-0.07	-0.79
United Kingdom			
3-month GBP Libor	0.57%	0.01	0.05
10-year Gilt	1.58%	-0.18	-1.16

Equities

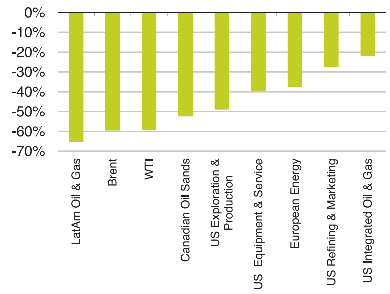
Correlation with WTI



Source: Bloomberg

The effect of lower oil prices varies in different sectors related to this raw material.

1Y Drawdown



Source: Bloomberg

LatAm oil companies have been those that have experienced major falls, with almost 70% wiped off the price in the last year.

			1Q	2015 %
USA	S&P 500	2,068	0.44%	0.44%
	DJ Indus. Avg	17,776	-0.26%	-0.26%
	NASDAQ 100	4,334	2.30%	2.30%
EUROPE	DJ Euro STOXX 50€ Pr	3,697	17.51%	17.51%
	France (CAC 40)	5,034	17.81%	17.81%
	Spain (Ibex 35)	11,521	12.08%	12.08%
	UK (FTSE 100)	6,773	3.15%	3.15%
	Germany (DAX)	11,966	22.03%	22.03%
	Switzerland (SWISS)	9,129	1.62%	1.62%
	Italy (FTSE MIB 30)	23,157	21.80%	21.80%
	Netherlands (AEX)	489	15.30%	15.30%
JAPAN	TOPIX	1,543	9.63%	9.63%
	NIKKEI 225	19,207	10.06%	10.06%
EMERGING MARKETS	Mexico	43,725	1.34%	1.34%
	Brazil	51,150	2.29%	2.29%
	Argentina	10,837	26.32%	26.32%
	China	3,748	15.87%	15.87%
	India	27,957	1.67%	1.67%
	Korea	2,041	6.55%	6.55%
	Russia	1,626	16.44%	16.44%

Energy stocks: Back to quality

In the energy sector, in the last years, all eyes were on new growth areas, such as pre-salt, oil sands, shale and other nonconventional resources. In the future, quality, cost discipline and profitability will come to the fore again.

It is no surprise that the fall in oil prices has weighed heavily on the energy sector, which has been the worst performing global sector in the last 12 months. But obviously there have been big differences between subsectors, regions and individual stocks. Some highly-leveraged, high-cost producers are facing severe pressures. Examples are relatively small players in the shale areas of Texas and North Dakota, as well as Canadian oil sands. If oil prices stay low for longer, these pressures might even intensify. It is clear that a rebound in oil prices and/or M&A activity could lead to a temporary rebound in these names, but the risk/reward profile remains unattractive, in our view. Even if oil prices rebound, the cost of financing is likely to rise in the future, which negatively impacts the economics of higher-cost projects.

On the other hand, the US oil & gas refining & marketing sector has reached a new all time-high. The sector has benefitted from strong refining fundamentals. Refining margins have expanded thanks to lower crude oil prices in the US (WTI) compared to international oil prices (Brent), which can be explained by a crude oil oversupply in the US and temporary refining outages. But the current spreads are unlikely to be sustainable, especially as some of the capacity constrains diminish. Therefore, we would not chase refining companies at this stage.

We believe that the big, integrated European and US oil companies are the ones that can cope best with the new oil price environment.

They generally benefit from their strong balance sheets, new cost cutting initiatives and eventually from interesting M&A opportunities from distressed companies. In addition, their refining & marketing operations help to partly offset pressures in the exploration & production segments. However, the announced reductions in capital expenditures (of around 20-30% in 2015) translate in lower medium term growth prospects and the upside potential (after a rather shallow correction) is likely to be limited. Instead of focusing purely on growth prospects, investors should focus on high-quality companies with strong profitability and stable dividends.

The energy equipment and service subsector is most vulnerable to lower capital expenditures, but further consolidation activity appears likely, which enables further cost cutting potential. In emerging markets, there are specific factors adding to the pressures, such as corruption scandals (Brazil), international sanctions (Russia) and the risk of shareholder rights violations and dilutions. Generally, state-controlled energy companies in emerging markets are badly governed and there cash flows are used for the financing of government deficits, instead of what is best for minority shareholders. This makes them highly unattractive as long-term investments, regardless of the oil price environment.

Pascal Rohner, CFA
Director of Latam Equities

Commodities and Currences

COMMODITIES

The shale assault

We have witnessed a sharp correction in oil prices and, in our view, one of the main underlying causes is that "Father OPEC" is no longer willing to hold up prices. In addition, this is clearly a dramatic paradigm shift in the OPEC's 55 years of existence.

At current levels, predicting the equilibrium price is a pipedream. However, it is easier to try to get a handle on causes which might drive up oil prices, although we largely rule out this scenario for the time being (as indicated previously): Demand might rise on the back of the global economic recovery; Supplies of non-OPEC countries might fall more sharply; OPEC supplies might suffer some type of shock due to exogenous factors: e.g. geopolitical risks.

On the supply side, we see three key uncertainties regarding US Shale Oil: Firstly, what are the true levels of production costs of these producers? Different research reports point to average costs of around USD60/barrel but with highs of over USD80/barrel and lows of under USD30/barrel.

Yet, we think another two major uncertainties should determine the future of crude oil prices: Possible payment problems faced by extracting companies and future financing costs of their new oil wells; and the speed of development of technologies aimed at reducing extraction costs.

Although production adaptation capabilities are greater using Shale technology, the majority of US producers are likely to continue operations, in the short term, primarily since – in many cases – they must meet debt payments. Yet, we would also bear in mind that fixed costs are largely "sunken".

Everything seems to indicate that the greatest excesses are likely to be seen during the second quarter of 2015. Additionally, this phenomenon may trigger new sharp drops in oil prices once US storage capacity runs out. This also occurred in the 1998 and 2008 (in those cases, due to declining demand) but this time around the OPEC's refusal to cut production could end up aggravating the situation.

David Rabella, CAIA
Head of Selection of Third Party Funds and Alternative Assets

CURRENCIES

Currencies & Oil

Since summer of 2014 oil prices have nosedived by nearly -50%. Regarding currencies, during this period depreciations vs. the US Dollar ranged from -40% to -5%. In our view, the drop in oil prices has directly and indirectly affected currency trends.

Direct effects: Firstly, the market has sharply penalised currencies of those countries where the oil revenues are highly relevant. The explication is simple. The collapse of revenues has driven some economic sectors of these countries into a risk situation and, in certain cases, jeopardised the health of governments. Thus, uncertainties regarding economies and currencies have arisen.

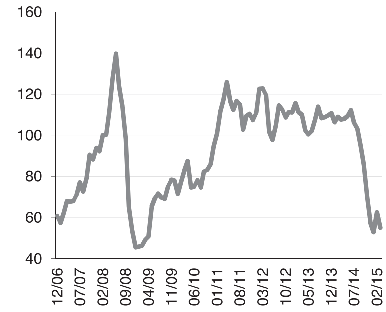
This situation was observed during the second half of 2014, when the greatest downtrends in oil prices were registered. The three largest depreciations during that period were those suffered by currencies of **Russia (-41%), Colombia (-21%), and Norway (-18%)**. In all three of these countries, oil prices are extremely important. In Russia, the weakness of the Ruble can also be chalked up to instability due to the conflict in the Ukraine and the impact of sanctions imposed by the EU and the US.

Indirect effects: Secondly, since the beginning of 2015 a second, indirect, set of effects has become more visible. The drop in oil prices reduced inflationary pressures thereby underpinning new expansionary monetary policy measures which, in most cases, led to the depreciation of currencies. Moreover, the ECB's aggressive move (i.e. its QE programme) inspired many European countries outside of the Eurozone to implement similar measures. Due to this second set of effects (spurred by central banks' monetary policy measures) thus far this year we have seen noteworthy downtrends in currencies of the **Eurozone, Denmark and Turkey** (by approximately **-10%** in all three cases).

Looking forward and taking into account our expectations of stable oil prices at around current levels, we believe that these effects should become less relevant. Therefore, in our view, the next major protagonist of currency markets is likely to be interest rate hikes in the US.

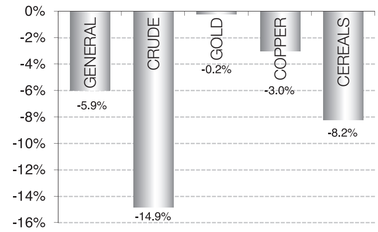
Pablo Manzano,
Macroeconomic Analyst

Oil (Brent reference)



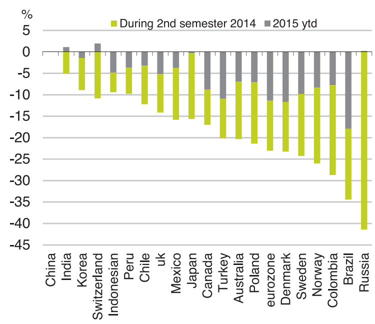
Source: Bloomberg

YTD performance of DJ UBS TR commodities



Source: Bloomberg

FX movements vs US dollar



Source: Bloomberg

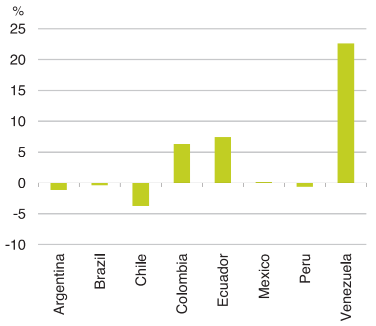
In many cases, the depreciation of currencies in the first period is directly related to the drop in oil prices; the second period is more influenced by the new wave of expansionary policies in many countries.

Exchange rate $/€

% Variación:	1 mes	3 months	1 year
	-4.15%	-11.30%	-22.06%
Consensus forecast:	2nd Q 15	2015	2016
	1.05	1.05	1.08

Latin America

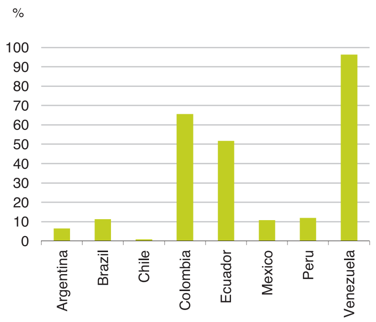
Oil Net Exports (% GDP)



Source: IIF 2013

Venezuela is the country where oil is most important to its economy, by some considerable distance.

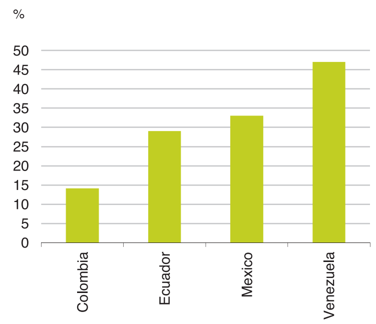
Oil related exports (% total exports)



Source: IIF 2013

In addition, diversification of exports in the case of Venezuela is zero, virtually 100% is oil. Diversification of Colombia and Ecuador is also low.

Fiscal revenues from oil (% total exports)



Source: IIF 2013

Many governments in the region are funded largely by oil revenues.

Good, bad and terrible oil

The drop in oil prices benefits some and harms others. In general, the new panorama doesn't jeopardise the macroeconomic stability of Latam countries with the exception of Venezuela.

In just a few months, oil prices dropped from USD106/barrel to approximately USD55/barrel (the downtrend in local currencies is less dramatic since currencies have depreciated sharply against the USD). The impact on the region's countries is heterogeneous: i) positive on crude oil importers; ii) negative on net exporters; and iii) very negative on Venezuela due to both its poor starting situation and huge economic dependence on this product.

Good oil: Of the main Latam economies, the following are net importers of oil: Brazil (net imports account for 0.4% of GDP), Peru (0.6%), Argentina (1.2%) and Chile (3.8%). However, benefits are quite different for these countries. In Brazil, consumers have hardly benefitted at all as the government has taken advantage of the situation to cut subsidies. In fact, inflation – highly affected by gasoline prices – has jumped from 6.5% in June to 7.7% in February. Moreover, state oil group Petrobras' situation – which is already complicated due to recently arising corruption cases – is set to worsen as revenues decline. In Argentina, the government is also set to benefit the most, as its delicate financial situation should be alleviated slightly. Since consumer prices are state controlled, in January government-owned YPF announced that it only plans to cut prices by -5% after hiking them by +55% in 2014. To the contrary, in Chile and Peru final prices are reacting to the current scenario and benefitting consumers. Thus, in terms of economic growth we think these two countries should end up taking advantage of lower crude oil prices the most. Moreover, this advantageous factor has arrived on the scene at a critical time for both economies which are suffering negative consequences of the Chinese slowdown.

Bad oil: It is another story in Ecuador (7.4% of GDP), Colombia (6.3%) and Mexico (0.1%) which are net exporters of oil. In these countries, the state generates a major portion of its financing via state-owned oil companies.

More concretely, nearly 30% and 15% of public revenues in Ecuador and Mexico, respectively, are raised by oil companies. The drop in revenues has driven Colombia and Mexico to carry out public spending policy cuts. However, the strong exposure of these economies to the US should allow them to successfully confront this problem, particularly in Mexico's case. However, Ecuador's policy of strong public spending does not look sustainable over the medium term. Moreover, if foreign financing conditions worsen on the back of US interest rate hikes - which is likely in our view - whilst there is a loss of USD revenues generated by oil, Ecuador's financial system may be at risk since it uses the USD as its legal currency.

Terrible oil: With the drop in oil prices the situation in Venezuela has become truly chaotic. Clearly, this economy is set to suffer the most. Firstly, the negative oil price shock has come at a very complicated time, with inflation of over 60% and the economy shrinking by nearly -3.5% in 2014. Secondly, the economic weight of oil is huge: net exports of oil amount to 22% of GDP and 97% of total exports. In addition, the government receives 50% of its revenues thanks to crude oil. In fact, we can already see some consequences. Recently, government bodies announced the implementation of a new exchange rate (SIMADI) which currently amounts to 200 Bolivars per US Dollar or a depreciation of the country's currency by -75% since 2014. Therefore, analysts foresee a -7.5% drop in the GDP in 2015e with inflation of over 100%. If to this cocktail we add the complicated political situation and high default probability of this country, we believe that the most likely scenario is that consensus forecasts finally prove to be too optimistic.

Raúl Ponte
Head of LATAM Fixed Income

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