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Quarterly Report

Our View on the Markets

Political risk

With macroeconomics in "pause" mode, investors have a very intense political calendar - with which to entertain themselves – going forward. When evaluating them one by one, we do not think any of the risks on the table look like they could end up spurring truly adverse scenarios for markets. But looking at them all together, makes one cautious.

There is no lack of upcoming events with the political factor as the common denominator: US elections with Trump rearing his head, an Italian referendum that could end up with the resignation of Renzi, Spain deciding whether or not to hold a third round of elections, and a 2017 with elections in the Netherlands, France and Germany. That is nothing to be sniffed at. We would also bear in mind the noise that will be generated as the UK's roadmap out of the EU is hashed out. We could continue to add to the list (Greece, Portugal, Austria, Hungary, Syria, Putin, Iran, North Korea, etc.), but just the former should be more than enough to dishearten even the greatest optimists.

However, analysed one by one, the risks which we face are not such a big deal. Starting with the most talked about, a Trump victory would clearly unleash high volatility due to his inconsistent proposals and unpredictable melodramatic behaviour. However, after an initial surprise, we believe that investors would reconsider selling. With an almost secured Republican majority in the House of Representatives, Trump could cut taxes and reduce regulation, which should spur a short-term rebound in economic growth, albeit at the cost of a jump in the public debt load. His migratory and anti-globalisation policies would be difficult to implement and find reason in being only to attract attention (there would certainly be no lack of words and symbolic acts, but surely millions of people cannot be deported and Mexico will not pay to build a wall). That is if Trump wins, which does not seem likely. Don't forget that the winner of each state gets all seats. Based on voting intentions measured thus far, Clinton has a 70% probability of becoming President at the time of writting.

Perhaps Trump is the main risk, but European events dominate the preceding list. We do not think they are cause for panic either. An eventual "no" vote in Italy's referendum (surveys are currently at 50%) could lead to the resignation of Renzi, but not necessarily to new elections.

An interim government attempting to change the electoral system is more likely. Without a reform of the Senate, and with the appealed law granting a majority to the winning party in the other house, Italy has a totally proportional bicameral system which – in practice – means it is nearly impossible to govern. Even if elections are held, nobody will achieve a sufficient majority. A referendum regarding membership in the Euro (as promoted by Beppe Grillo, which is what really worries investors) is even less likely and is unconstitutional by international agreements. Even if it were held, surveys continue to point to majority support for the Euro. Moreover, and unfortunately, markets are used to Italy's ungovernability. It is also worrisome that the 2017 French elections might put Le Pen in the Presidency. However, although that party is quite likely to win the first round, it is just as unlikely to manage to win the second one. In Germany the rise of the anti-European AfD is also of concern, but its possibilities have been exaggerated: voting intentions do not surpass 14%. We commented Brexit in our previous report and would only reiterate that we do not think there will finally be an unfriendly exit and, in any case, it is mainly the UK that is set to be negatively affected rather than Continental Europe.

In short, we believe that it is time to prepare portfolios for the volatility that is lurking around the corner. Yet, we would also keep our buy list at hand: a priori, we do not think that political risks are going to trigger bearish trends in risk assets.

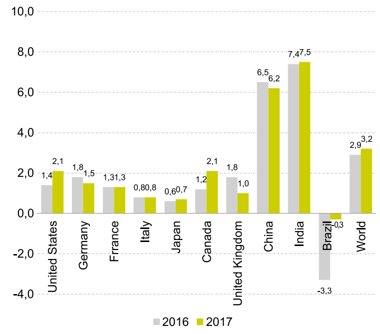
David Macià, CFA
Chief Investment Officer

Strategy

Asset allocation (2016 Q4)	
Monetary	↑
Fixed Income	→
Equities	→
Fixed Income	
GOVERNMENT:	
USA	↑
Eurozone	↓
INVESTMENT GRADE:	
USA	↑
Eurozone	→
HIGH YIELD:	
USA	↓
Eurozone	→
EMERGING MARKETS:	↓
Equities	
USA	→
Eurozone	→
Japan	↑
Emerging Markets	↓
Commodities	
Oil	→
Gold	↑
Currencies	
EUR/USD	→

Macroeconomic View

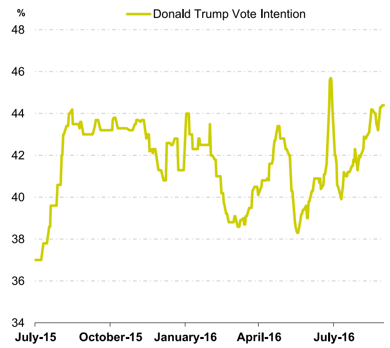
OCDE: Real GDP Growth Estimates 2016 - 2017



Source: OECD

Worldwide economy continues growing below its potential, burdened by high debt levels, which makes it more vulnerable against any unexpected event.

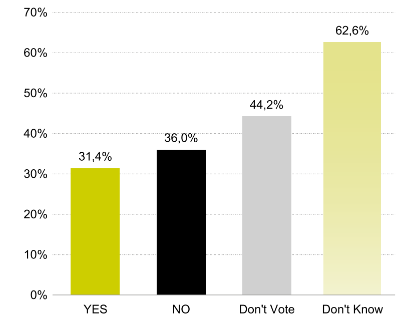
Donald Trump Vote Intention



Source: Bloomberg

The vote percentage in favour of Donald Trump has been growing as the US elections of 8th November come closer.

Italy Referendum Vote Intention



Source: EMG Acqua, Bloomberg

Last polls on the Italian referendum show a slight advantage for "no", albeit we must highlight the high percentage of undecided voters shown by latest published data; which makes it difficult to foresee a result.

Consequences of political instability

Political uncertainties affect economic agents, who delay their investments until there is a clearer horizon or find those investments already carried out at risk due to regulatory or fiscal changes.

One of the traditional mantras of financial markets is that they detest uncertainty. This tends to be linked to a sentiment of greater risk aversion when faced with an unknown panorama, but fundamental factors are key. Political risk, following the UK referendum, has risen and become the **main concern of investors** on a 12-month view.

Within the political risks, there are two fundamental risks for the economy. First, doubts of economic agents arising from an uncertain political scenario when investing in a country. Second, potential (regulatory, fiscal, financial) consequences that may arise depending on the final outcome. Moreover, we would bear in mind that the OECD forecasts global economic growth of +2.9% in 2016 and has revised downwards its 2017 forecast to the lowest growth rate since the 2008 financial crisis. **The global economy has limited ammunition for dealing with any potential negative consequences** of a period of political uncertainty.

> The global economy has limited ammunition for dealing with the potential negative consequences of a period of political uncertainty.

Regarding the first risk, we can quantify the effects with a well-known example. Political uncertainty in Spain has already begun to take a toll: in the first semester of 2016, **foreign investment in Spain dropped by nearly -29%** to €9.42Bn from €6.72Bn. It is true that the most recent indicators do not show these effects and the economy continues to grow at a healthy pace. However, it is not farfetched to think that this **slowdown in investment may end up affecting future economic growth.**

Regarding the second risk, possible consequences stemming from these political events span a very broad spectrum (regulatory changes, new tax rates, impact on public and corporate financing, etc.) that should be contextualised in accordance with each particular political event.

The first political events coming up around the corner are the US elections and the Italian referendum. We think that the defeat of Prime Minister Renzi would surely generate high volatility as occurred in the UK. However, **we believe it is highly unlikely that we will see a divorce from the Euro** since substantial political and administrative red tape would be required to carry this out and the current situation of the Italian banking sector would discourage this move.

Regarding the US case, the range of potential consequences is greater but we would focus on two: Firstly, **expenditure growth** plans that both candidates include in their programmes in order to bolster economic growth. Hillary Clinton plans to raise taxes in order to offset this spending whilst Donald Trump plans to cut them. To a greater or lesser extent, what is clear is that in both cases US debt – which is already over 100% of its GDP – will increase, putting pressure on interest rates and corporate financing. Yet, undoubtedly, the greatest risk is the hypothetical **political protectionism** of the Republican candidate. According to the OCDE, the main cause of the slowdown in global growth is protectionism, which is at highs since 2009. Political protectionism in the US would **put a brake on growth of the global economy,** which remains weak on the back of imbalances inherited from the 2008 crisis, and would bring about a new market scenario. Hillary Clinton continues to lead the race towards the White House but, after Brexit, we would not rule out any possible outcome.

Alfredo Álvarez-Pickman
Macro and Research Team
Crèdit Andorrà Financial Group

Fixed Income

"It's politics, stupid."

Following the round of meetings of the main central banks where a breather in decisions to implement monetary policies until December was taken, political risks have become the main concern of investors over the next few months.

The title imitates the non-official slogan of the 1992 Clinton campaign ("It's the economy, stupid.") that made a fortune and was decisive in his victory against George Bush (Senior). Moreover, **nowadays political risks have moved to centre stage,** (temporarily) replacing the key market catalyst of recent years: implementation of non-conventional expansionary monetary policies by the main central banks. Bond investors, who are more accustomed to studying fundamentals, should include - preferentially - this variable in their decision making processes.

In Europe the moment of truth is approaching for the political parties in Spain given the challenge of establishing the new government. In Italy a Constitutional Referendum is scheduled to be held on 4th December. The UK Prime Minister, Theresa May, has confirmed the date of implementation of Article 50, before the end of March 2017, in order to launch negotiations of its exit from the European Union. The US Presidential election will take place in November. These are some of the upcoming political events.

We will witness a paradigm shift if fiscal stimulus measures finally take over from monetary policy.

Political risks, when they have the support of central banks, rarely have a prolonged negative impact on the price of assets. However, **if these risks materialised they would quite likely drive down markets given a combination of some exhaustion of monetary policies as well as underlying vulnerabilities of the financial sector and weak economic growth.** We now summarise some of the factors that we would follow closely in the upcoming months:

- Rating agency DBRS is expected to review its rating of Portugal and a downgrade could freeze ECB purchases of its debt.
- Trends in German banks, particularly Deutsche Bank, might affect the re-election of Merkel and, thus, the EU.
- It appears that the probability of a scenario entailing stiffer Brexit negotiations is increasing.
- **In the US presidential elections could trigger a shift towards fiscal easing and/or greater protectionism.**

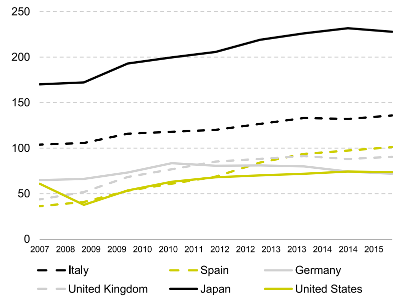
Until now, the protection of central banks has driven asset prices upwards with corrections seen this year spurred by investors' disappointment given expectations of further non-conventional quantitative measures. ECB President Mario Draghi has repeatedly insisted that governments carry out structural reforms and implement expansionary fiscal policies (in the case of those countries with margin to do so) in order to complement monetary policies and lend support to growth. The intrinsic relationship between economic growth, politics and banks has been demonstrated and they are mutually dependent.

Fiscal policies should take over from monetary policies as the main tool for reversing global imbalances and attempting to lift inflationary and growth expectations. Under the opposite scenario, the danger would be greater public debt loads which would drive risk premiums upwards.

The market is optimistic regarding the possibility of successfully dealing with the political risks that we face over the next several months. Yet, we would bear in mind that we have already seen some episodes such as Brexit. Thus, we should not ignore these sources of uncertainty which may end up having a negative impact.

Josep M Pon, CIIA
Head of Fixed Income and Money Markets

Debt to GDP



Source: Bloomberg

Fiscal policy is expected to take over monetary policy in order to reverse worldwide unbalances, thus lifting growth and inflation expectations, andreducing worldwide debt.

Official Rates: Consensus Forecasts (%)

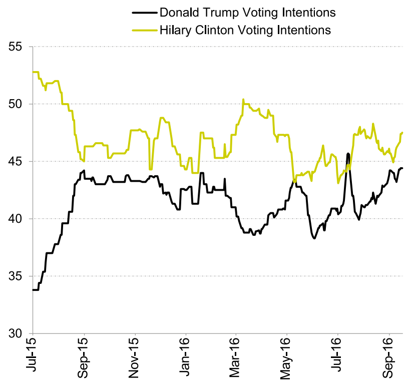
	30/09/16	4Q'16	1Q'17	2Q'17
Eurozone	0.00	0.00	0.00	0.00
US	0.50	0.70	0.75	0.90
United Kingdom	0.25	0.15	0.15	0.15

Interest Rates: Changes (%)

	30/09/16	Last 3 months	Last year
Eurozone			
3-month Euribor	-0.30	-0.01	-0.26
10-year Bund	-0.12	0.01	-0.71
US			
3-month US Libor	0.85	0.20	0.53
10-year US	1.59	0.15	-0.44
United Kingdom			
3-month GBP Libor	0.38	-0.14	-0.20
10-year Gilt	0.75	-0.12	-1.02

Equities

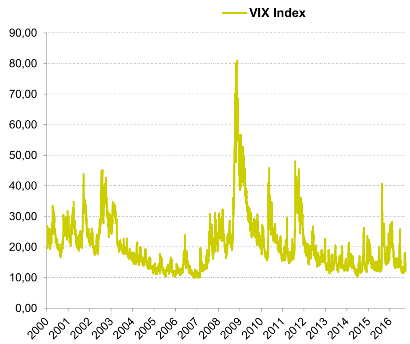
Hilary Clinton vs Donald Trump Voting Intentions



Source: Bloomberg

Brexit has had a significant impacton European stock markets.The effects have been especially intense on the banking sub-index.

US Volatility Index



Source: Bloomberg

The US volatility index VIX is at levels close to historical lows, showing a great condescension on the part of US investors regarding political risks in the US.

			Q3 %	2016 %
USA	S&P 500	2,168	3.31%	6.08%
	DJ Indus. Avg	18,308	2.11%	5.07%
	NASDAQ 100	4,876	10.37%	6.15%
EUROPE	DJ Euro STOXX 50 € Pr	3,002	4.80%	-8.12%
	France (CAC 40)	4,448	4.97%	-4.07%
	Spain (Ibex 35)	8,779	7.55%	-8.01%
	UK (FTSE 100)	6,899	6.07%	10.53%
	Germany (DAX)	10,511	8.58%	-2.16%
	Switzerland (SWISS)	8,139	1.48%	-7.70%
	Italy (FTSE MIB 30)	16,401	1.25%	-23.43%
	Netherlands (AEX)	452	3.77%	2.38%
JAPAN	TOPIX	1,323	6.18%	-14.51%
	NIKKEI 225	16,450	5.61%	-13.58%
EMERGING MARKETS	Mexico	47,246	2.78%	9.93%
	Brazil	58,367	13.27%	34.64%
	Argentina	16,676	13.57%	42.83%
	China	3,005	2.56%	-15.10%
	India	27,866	3.21%	6.69%
	Korea	2,044	3.72%	4.20%
	Russia	1,978	4.60%	12.30%

“Make America great again”

The quote above is the main slogan for Donald Trump’s presidential campaign. Although the sentiment is nice, we care more about what the impact of the election will be on our portfolios. The market, which thrives on certainty, is unlikely to be “great” if it gets surprised by the election of Trump.

As we approach the US Presidential election on 8th November, **market participants will focus on the potential repercussions of the results and position themselves accordingly.** We believe the market is currently factoring in a win by Democratic candidate Hillary Clinton, who represents the least risky option. Clinton is expected to broadly continue the policies of Barack Obama, providing a certain level of stability favored by the markets. Additionally, we expect the House of Representatives to remain under control of the Republican Party (the outcome in the Senate is a toss-up at this point). **Historically, a divided government has been favorable to the markets** with the best combination being a Democratic president with a Republican Congress. As we previously stated, the market craves stability, and a divided government tends to fall into a grid-lock situation where neither side can push through its agenda leading to a status quo situation.

Could we be headed for a Brexit-style surprise when legions of Trump supporters enter the confines of a private voting booth?

In stark contrast to the above-mentioned scenario, a win by Donald Trump could combine a Republican presidency and Congress. This would allow Trump to aggressively push through his agenda and potentially cause significant disruption to multiple sectors.

National polls may show a close race, but a state by state analysis of the Electoral College shows a different picture. The US presidential election is not a true popular election; instead, the elections are a winner-take-all format on a state-by-state basis. When votes are counted in this manner, **Clinton has a much stronger position than reflected in the national polls.**

Could we be headed for a Brexit-style surprise when legions of Trump supporters enter the confines of a private voting booth?

The answer is a possible yes. There have been a pair of recent surprise outcomes in both the UK and Colombia that give credence to this thesis. The vote in favor of Brexit caught many by surprise, as it was not the politically correct choice (anti-immigration, anti-Europe), and many supporters likely kept this political view to themselves. More recently, in Colombia, the people surprisingly voted against a peace accord with the FARC. Once voters were alone in the voting booth with only their conscience, their anger against the FARC and desire to punish them took over.

We believe there is a chance (albeit a modest one) that we could face a similar situation in the US. In many social circles it is unpopular to be a Trump supporter due to his extremely harsh anti-immigration policy (including his promise to deport 11 million illegal aliens and build a wall on the US border with Mexico). It is possible that many Americans claim to support Clinton when asked in polls, but again in the secrecy of the voter’s booth they are punching the ticket in favor of Trump. Assuming Trump is the winner, we could see significant dislocations in the equity markets. The healthcare sector could be volatile, as the market sorts out the winners and losers of a cancellation of ObamaCare. The energy service companies could see a renaissance as Trump opens up more drilling on Federal land. Retail companies that source products from China or Mexico could see a disruption in merchandise shipments. Industrial Technology companies that depend on sales to Chinese factories could face retaliatory tariffs. The list of potential impacts goes on and on, so it is easy to see how the market gets spooked each time Trump gains ground in the Polls.

Charlie Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Deglobalisation? …and its effects

The end of globalisation has not arrived, but some backtracking can certainly be observed. During the next 18 months numerous elections/referendums with risk of a substantial rise of "anti-parties" (political parties that are against specific segments of the society) are scheduled to take place. **This could have negative economic implications over the long term, including commodities.**

Yet, what can we expect over the very near term? Leaving Brexit behind us, we think the most important event that could have a major impact on financial assets is the US presidential elections on 8th November.

According to research by Moody´s, **if Donald Trump were elected President,** his proposals of massive tax cuts and an increase in public spending could lead to inflation of +5.4% in 2018. This would cause the Fed to lift interest rates aggressively and, also, would strengthen the US Dollar and negatively affect commodity prices. Moody´s forecasts also contemplate that this series of factors would end up triggering a recession in the US in 2018/19.

Even if there are no immediate political changes, the trend is that there is clearly an increase in the possibilities of change.

Given the victory of any "anti-party," except for the case of gold we would not expect any major changes in commodity prices over the short term. Gold, however, would benefit from nervousness that might appear in the market (it is already up +20% thus far this year as it is discounting a scenario of greater instability). At the end of the day, globalisation on the back of the collapse of the Iron Curtain and the opening up of China and India have been a process of over 30 years. Thus, an uptrend in **trade protectionism naturally implemented by "anti-parties" would not be a question of days.**

Therefore, we must wait for confirmation of a "deglobalisation" movement during a longer period of time in order to foresee whether to expect lower global trade which would affect demand and, therefore, commodity prices over the long term.

Miguel Ángel Rico, CAIA
Crèdit Andorrà Asset Management

CURRENCIES

FX and political uncertainty

According to recent surveys carried out by major US marketing research groups, political uncertainty has become the **main concern of investors** over the next 12 months. The Italian referendum and the US, German and French elections, among others, are the most noteworthy events on the calendar for markets for the rest of 2016 and 2017.

Yet, how should we position ourselves in FX markets given these events? The recent UK referendum regarding that country's exit from the European Union demonstrates the **risks of confiding in surveys and bet on events with such extreme results.** Current disillusionment with "traditional" politicians increases even further the potential for unexpected surprises.

Currencies, even though over the medium to long term tend to adjust reflecting the fundamentals of their economies, over the short term, act like a thermometer measuring the confidence in a country. Therefore, results that might put into question the current "status quo" may trigger **drastic swings in prices.** In addition, markets tend to overreact to unexpected events in the short term, complicating our investment outlook even more.

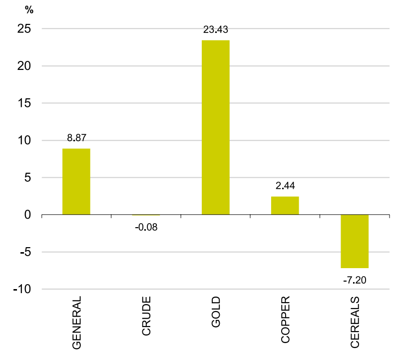
Taking positions prior to political events can be a source of substantial gains, but **the risk-reward binomial should be on our side** (potential gains should be much greater than possible losses). In the case of upcoming major political events which could have a substantial impact on the main currencies, we think that gains and losses could be quite similar.

High uncertainty of possible outcomes, the potential for extreme market reactions and the fact that potential gains and losses look similar lead us to remain **cautious when taking positions before these events.** However, we would take advantage of any bouts of volatility that might take place, as we think that these risks should end up being diluted over time.

Finally, if our aim is to seek refuge, where should we invest? In the US, elections might move the US Dollar; the GBP is affected by Brexit; the Swiss Franc is subject to its central bank's actions; etc. **Thus, there is only one "currency" to which we might turn: gold.**

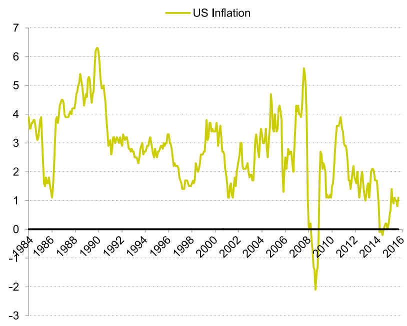
Alfredo Álvarez-Pickman
Macro and Research Team
Crèdit Andorrà Financial Group

YTD performance of DJ UBS TR commodities



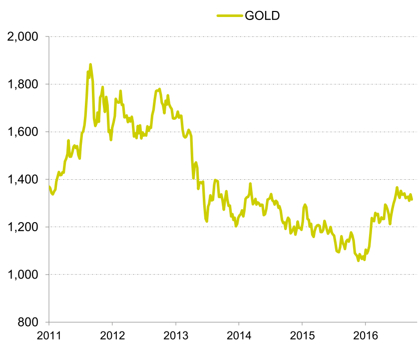
Source: Bloomberg

US Inflation



Source: Bloomberg

GOLD



Source: Bloomberg

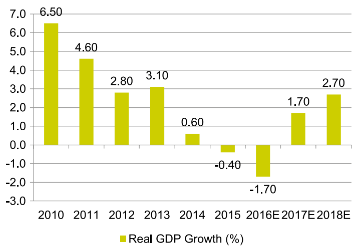
Doubts regarding the success of the central banks' expansive policies have boosted gold prices since the beginning of the year. Investors seem to search for safe havens amidst uncertainties that threaten the political and economic scenario.

Exchange rate $/€

% change:	1 month	3 months	1 year
	0.34%	0.89%	0.36%
Consensus forecast	4Q 2016	2016	2017
	1.10	1.10	1.10

Latin America

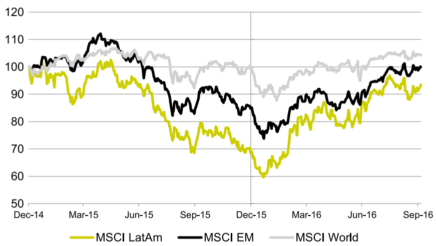
Latin America Real GDP Growth



Source: Bloomberg

Latin America should finally exit the recession in 2017.

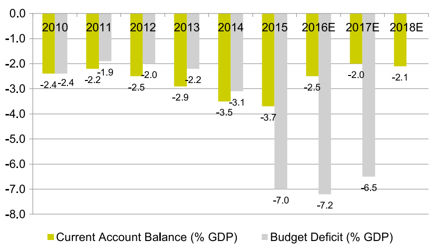
Index Returns



Source: Bloomberg

Emerging Market Equities rebounded sharply in 2016.

Budget Deficit and Current Account Balance



Source: Bloomberg

Current account dificits have started to improve.

LatAm: Too fast too furious?

Latin American assets have delivered extraordinary returns this year. The strong momentum might well last, but the high hopes for market-friendly reforms are not easy to fulfill.

There are encouraging signs in emerging markets. In contrast to developed markets, economic growth is accelerating and the performance of the different asset classes has been notably strong across the board: the MSCI Emerging Market Equity Index and the JP Morgan Emerging Bond Index are both up more than 15% this year, outperforming most other asset classes. Looking at the different regions, the performance of Latin America has been particularly strong with equities up more than 30% this year.

Readers might struggle to share the euphoria amongst emerging market investors, given the recent political headlines: Brazil continues to suffer from one of the worst economic recession in its history paralyzed by corruption scandals, Venezuela is on the brink of a default, Colombians expressed their discontent with the current government by rejecting the FARC peace deal, and the popularity of Mexico's president has taken another hit after Trump's humiliating visit.

So what are the reasons for the recent optimism? First, the Federal Reserve has moved much slower than expected in raising their interest rates. Emerging market assets offer attractive yields for yield-hungry investors that lack alternatives given the bond bubbles in developed economies. Second, China managed to postpone an economic slowdown by introducing new fiscal stimulus at the beginning of the year, supporting sentiment towards emerging markets. Third, the trade deficits in many countries have improved significantly, removing the pressures on their currencies.

Finally, the rally in some markets has been fueled by hope for political change to the better. The best example is Brazil, where the impeachment of Dilma Rousseff raised hopes that the new government could implement the necessary reforms to revive the economy and to get the structural inflationary pressures under control (which is far from being an easy task).

Latin America desires to rejoin the world.

The good news is that – despite some negative headlines – several Latin American governments are actually opening up their economies and trying to implement market-friendly reforms. This is best illustrated by the recent political changes in Argentina, Brazil and Peru. However, only time will tell if they are successful in boosting economic growth in the next years. **It might well be that too much good news is already priced in after the recent rally.**

Interestingly, while Latin America desires to rejoin the world, it appears that the world is moving into the opposite direction. There is a new wave of protectionist tendencies in the "first world", best illustrated by Brexit-voting Britons or the surprising nomination of Donald Trump as a presidential candidate. There is a concern that a Trump victory could lead to anti-American sentiment and push Latin America back to the left.

Pascal Rohner, CFA
Director of Latam Equities

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