MORABANC asset management

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MARKETS & STRATEGIES

Our vision

The Ellsberg paradox

In a bag there are 90 balls, 30 are red and 60 are yellow or black. We pull one out at random. What would you rather have: A) €100 if it's red but nothing if it's another colour, or B) €100 if it's black but nothing if it's another colour? People usually choose A. Let's start again: choose from C) €100 if the ball is red or yellow but nothing if it's another colour, or D) €100 if it's a black or yellow ball but nothing if it's another colour. In this case, people usually choose D, which is odd because choosing option A is clearly a contradiction to choosing D.

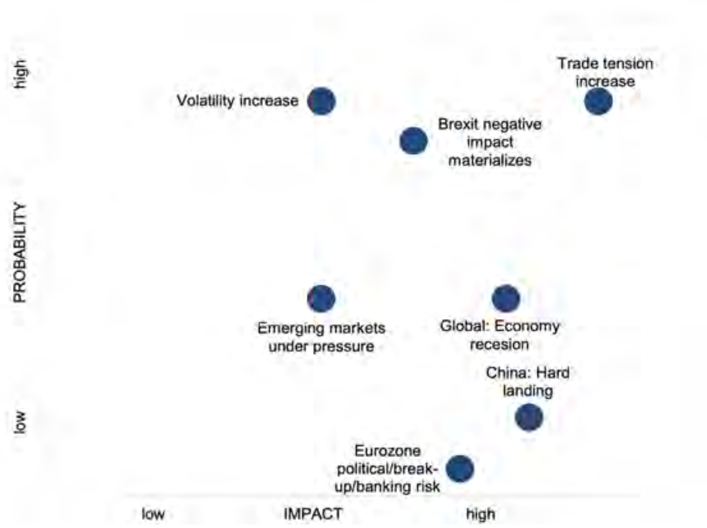
Let me explain. If you choose A, you believe that the bag contains more red balls than black. You'll prefer C if you think there are more red or yellow balls than black or yellow. If a red ball is more likely than a black ball, a red or yellow ball is also more likely than a black or yellow ball. If you prefer option A to B, you'll also prefer C to D!

This contradiction is known as the *Ellsberg paradox*. It proves a phenomenon known as the ambiguity aversion bias: we prefer a probability distribution we know to one we don't. In other words, better the devil you know.

Whereas accepting risk means investing in a known distribution, we accept uncertainty when the distribution is unknown. We investors usually hate uncertainty more than risk, but at this time in the market, uncertainty is at a high. On the one hand, macro indicators depict a slowdown. Our central context is still recovery but we cannot ignore the significant increase in the probability of a recession in the next twelve months. On the other hand, the shift in monetary policy should start to be felt in this last quarter, as shown by some advance indicators, and the economic surprise indexes have rebounded from the July lows.

So, we're sticking to the plan: we won't change our strategy, knowing that this last quarter will provide clues on how to position the portfolio for the future.

By asset type, variable income offers the most attractive risk-return potential. Despite some adjusted values, these are not extreme and sentiment is mixed. Also, the support from central banks should be a catalyst. Tactically, we see value in the Eurozone and Iberian market, considering the resistance of the economy and some attractive values.



In fixed income, the credit spreads seem adjusted and the risk-return potential lower. We prefer investments with more yield (emerging, high yield, etc.), respecting the risk limits imposed by our profile, and we underweight government debt.

We see value in adding small positions in real assets, such as listed real estate; we remain neutral towards the comings and goings of oil and currency, and continue to believe that the Euro will be revalued.

So, we accept the uncertainty while staying invested. But without turning our back on reality: we also adjust to the profile that we find most comfortable, construct hedges at times of increased positive sentiment and, above all, remain alert and ready to act if conditions change.

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Currency

Yearly lows

We start October with the Euro at yearly lows and many open fronts in the short term. Throw in the towel and join the momentum? As for fundamentals, while awaiting the publication of globally significant macro data, we can talk of better resistance in the US economy. Some countries in the Eurozone may have entered a technical recession and inflation rates seem to be slacker than expected in the Old Continent. If we add to that the refusal of the Federal Reserve chair to enter into a continual dynamic of lowering rates, the divergent panoramas should impel us to buy dollars without falter.

However, there is a series of technical and political factors that we are all awaiting and which have always taken their time to affect the market. As we indicated months back, prices are generated by forces of supply and demand. Leaving the latter to one side, in supply we don't know why a reactive Fed is hesitating to increase its balance, "providing more dollars to the market". It has said it outside, has approved it in its internal forum, but maybe needs more than one shock, such as the recent one in the monetary markets with the major increases in repo types. All of this is testing its calculations of the liquidity cushion needed by the economy and must lead to an increase in reserves. Avoiding further technicalities, the "supply helicopter" should be the main catalyst we see in the next few months. Especially with a head of Government who has just heard the worst Manufacturing ISM data in the last ten years and who won't take long to call the current course of action "pointless". This, as can be seen in graphs, would end up weakening the dollar which, according to the models, might be overvalued by more than 5%. Without disparaging the strength of demand, we also need to see how Brexit is resolved in the next quarter, the regulatory change in Japanese pension plans, the volatility in commodities and a series of catalysts which we think should be in the background.

Graph 1: Evolution of surplus reserves in the USA and USD

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Fixed income

The markets take a breather

This September, some of the summer declines were reversed. If we analyse the main markets, we can see that the rises were generalised. We would highlight Europe in general, with the EuroStoxx 50 at +4.2%, especially Spain with the IBEX 35 rebounding +4.9%, and Italy +3.7%. The US market was slower to rise, with the S&P 500 adding +1.7%. All this in a context of inverted curves, as in the case of the US, where the Treasury 10-year bond is below the 2-year bond. This theoretically forecasts a coming recession, and the fact is that many stocks are already discounting it in their values, specifically in the sectors most tied to the cycle. Yet the most significant destabiliser we have is still Brexit, generating confusion and indecision in the markets. To top it all, we still have no trade agreement between the USA and China, with one year to go until the next US elections and clear symptoms of an economic slowdown in both countries. Furthermore, the central banks' ultra-expansive policies are still distorting the behaviour of the markets. They seem endless, especially after the lowest advance indicator data for years. All these events have led us to a record gulf between value and growth. We think that the market will go back to looking at the value of businesses and revert to value. At a time when macro indicators are improving and stimuli are decreasing, being invested in businesses with low values is the best way to be protected against the return to normality.

Graph 2: Evolution of the IBEX 35 compared with its profits

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