MORABANC
asset management

MARKETS AND STRATEGIES

> JULY-AUGUST 2016

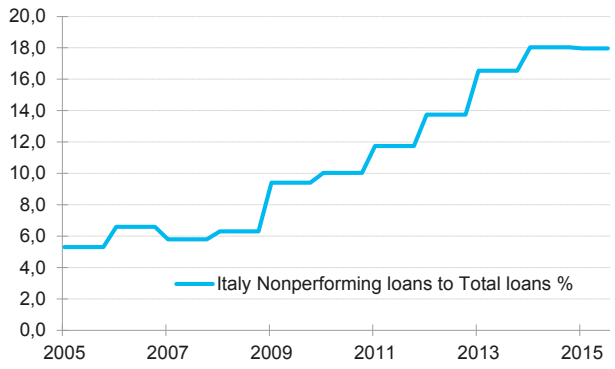
COVER PICTURE: RDC

Europe Ultra Trail

Last weekend, hundreds of people tested their stamina in the various mountain races known as the Andorra Ultra Trail (congratulations to all the finishers!) As well as being a fantastic event, sporting celebration, and great publicity for the country, it also explains well the current market situation. Personally, I thought that after last year's adventures (Greek negotiations, Chinese stock market "reform", recession and political scandal in Brazil, deliberate OPEC pressure on the oil price, tumbling commodity prices), 2016 would be an easier year (like the Solidaritrail: 10km with a 0.7km ascent). However, following a dreadful start by stock markets, and with European banks back at 2011-12 levels, 2016 has quickly taken on the appearance of the marathon (42.5km with a 3km rise). And now, with Brexit having triggered the biggest one-day drop in the Stoxx600 since the Lehman Brothers bankruptcy, the year is increasingly looking like the Ronda dels Cims (the lap of the Principality that takes in all the highest peaks: 170 km with a 13.5 km ascent). It is not clear when the UK wants to activate Article 50 of the Treaty of Lisbon, so we don't know exactly when it's exit from the EU will come into force (two years after the activation of this article). What we do know is that: 1) the UK economy could fall into a (minor) recession as of 2017; 2) banks will be hit by the combination of macro slowdown, a flatter yield curve, and additional costs; 3) the focus of attention is shifting to the US, with the presidential elections on November 8. The slowdown in the UK is certainly not helping, but it may not do too much damage to global sentiment. It is a similar story in Brazil; in 2013, it had a bigger economy than the UK, and it is currently contracting at 5.5% y/y. As for banks, those with a European passport could benefit, picking up clients off their UK peers. I believe however that the best move would be to use this shock as an opportunity to recapitalise Italian banks once and for all, given that they have proved incapable of improving the quality of their balance sheets (chart 1). In fact, the market is asking for exactly this, having watched the dreadful performance of the Italian financial sector; it is becoming increasingly clear that half measures (like the Atlante fund, which is too small to make any effective recapitalisation) just do not work, and that in order to prevent the collapse of the European project a strengthening of the core is what is needed, a core that Italy forms part of, even more so now following Brexit (Italy is now the third largest economy in the EU). I expect to see a more decisive resolution concerning Italian banks over the coming weeks. And finally, I believe that after June 23 nothing will ever really surprise us again, probably not even the result of the US election. Drifting out of the limelight should give European markets a chance to breathe, like the runners in the Ronda del Cims once they have reached Comapedrosa (Andorra's highest peak at 2,943m).

> Italy, post-Brexit, becomes the EU's third largest economy.

Chart 1. Bad debt in Italy, on the rise



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Risk Map

We have decided to exclude Brexit from the risk map, on the assumption that the UK government will respect the decision of its citizens. The most obvious implication is the increased risk of a European crisis. Following the attempted coup in Turkey and the attack in Nice (yet another attack for which the Islamic State has supposedly claimed responsibility), we also see an increase in geopolitical tension. And finally, both of these events appear to support Donald Trump's candidacy in the US presidential elections, which, if successful, could be negative for markets.

Strategy: monetary policy to remain expansionary

Macro environment. The most important figure last month was non-farm payrolls in the US (+287,000 vs. the +180,000 forecast), which amply offsets the terrible figure the previous month. The manufacturing ISM also confirms the recovery, holding above the 50 level (53.2) for the fourth month in a row and with some extremely solid sub-indices. However, because of Brexit the forecast calendar for rate rises in the US has been pushed back. The UK's decision will almost certainly push it towards recession. But Europe too will be affected (economists estimate to the tune of -0.5% of GDP), which means that the latest figures, which have been extremely solid, are worth their weight in gold (the PMI at 52.8 and unemployment at 10.1%). Meanwhile, the Chinese economy continues to meet expectations, with 2Q16 GDP at 6.7% y/y. It is important to highlight the change in role of the central banks, which, with Brexit now on the horizon, are going to have to continue with their lax monetary policies or perhaps soften them even more.

Equity. Equities, despite being the most fragile asset, have withstood the earthquake (S&P at its highs and Europe almost at Brexit levels), which could be a good sign for the second half, shaping up to be calmer on the European risk map. Valuations are attractive and the macro data is promising. We still need to see just how good company results are going to be, the 2Q16 reporting season having just got underway. We are maintaining our exposure to the Eurozone and the US. We are underweighting Japan and Emerging Markets. As for sectors, we are lowering our weighting in banks and increasing those in energy and utilities.

Fixed Income. We continue to play inflation (the y/y effect on oil prices should start to lift price indicators as of the summer), meaning that we are holding short durations and inflation linked bonds. We are overweight credit and the periphery, which are both benefiting from ECB purchases.

EURUSD. We are leaving our forecast range unchanged at 1.05-1.10. Not only the monetary policy, but also the safe-haven effect post Brexit ought to help the dollar as well.

Commodities. Oil: US production continues to fall and there are supply risks in some emerging economies (Venezuela, Nigeria). We remain OW. We are taking profit on gold at these prices.

Chart 2. Risk Map

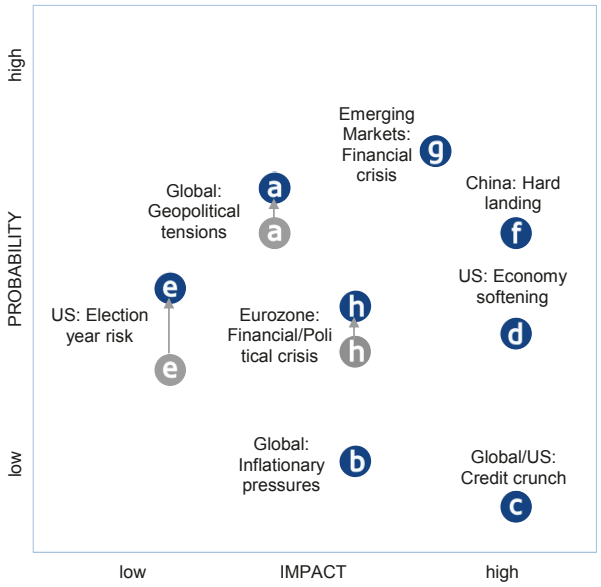


Chart 3. Total returns in June 2016*

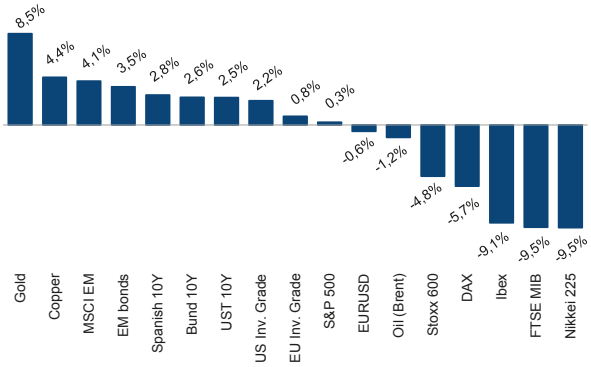
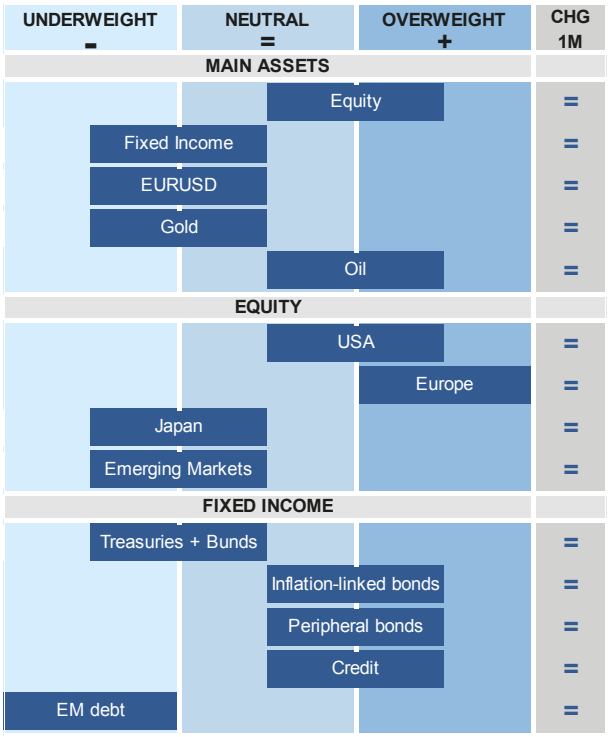


Chart 4. Positioning on the main asset classes



*USD returns on MSCI and emerging bond indices

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macro

It never rains but it pours

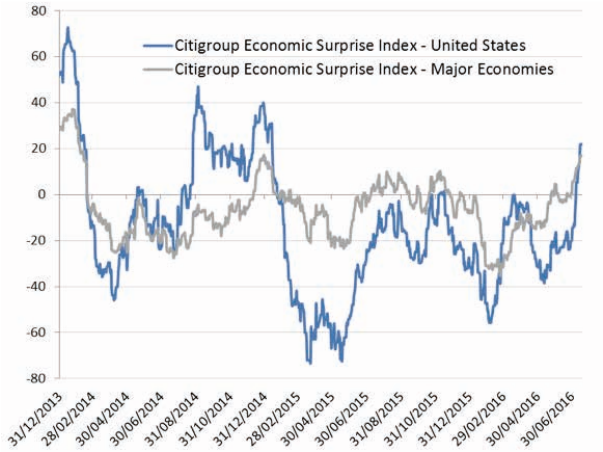
From the UK NO to the EU, through the political polarisation in the US, to the terrible attack in Nice, and the failed military coup in Turkey, I remain dumbfounded by the current unpredictable geopolitical situation and stunned by the ups and downs of financial markets all over the world. At the macroeconomic level, the latest raft of figures shows a significant improvement versus consensus forecasts (chart 5). However, the continuous drip of unexpected political, social, military events, etc. should serve as a warning about the discord that exists between the real and financial economies. Stock markets have recovered strongly from the unexpected sell-off following the Brexit vote (particularly in the US), and are now at their highs. However, the flight to quality triggered by the uncertainty has left many assets, especially core debt, with extremely low yields.

While the macro data appears to contain some cause for celebration, it has also been accompanied by cuts to growth forecasts by the main international institutions (World Bank, IMF, BPI). Against this backdrop of lower growth expectations and large amounts of uncertainty and black swans, I am sticking to my cautious stance...It never rains but it pours!

R. Giménez

News	Events
Government reshuffle in UK following the vote to leave the EU	27/JUL/16. FOMC meeting in the US
Failed military coup in Turkey	29/JULIO/16. First estimates for 2Q16 GDP in the US and the Eurozone
World Bank cuts growth forecasts from 2.9% to 2.4%	17/AUGUST/16. Publication of FED/ FOMC minutes
IMF cuts growth forecasts for US and Europe	4-5/SEPTEMBER/16. G20 meeting in Hangzhou (China)

Chart 5. The latest bunch of data beats forecasts



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fixed income

Corporate debt purchase programme and market volatility

June and July have been busy months in the fixed income market in terms of events. Since the middle of last month, volatility levels started to rise as the UK referendum date got closer. Markets were discounting a "remain" victory by a small margin, but the final result was in favour of Brexit. The consequences we can expect to see are a weaker UK economy, weaker sterling, and increased doubts about the EU's cohesion.

Markets' first reaction following the Brexit result was a clear shift to risk-off, which triggered corrections in equities and in credit spreads, as well as a rally in core fixed income (French and German debt). The correction has barely lasted two weeks. Following publication of the upbeat employment figure in the US, markets reacted positively. And the iTraxx Main and Xover indices are now below their levels the day before the Brexit vote.

We highlight the sharp movement at the long end: during the first week of July, we saw a dramatic flattening of both European and American curves, with yields hitting new all-time lows. More specifically, the German 10-year made a new all-time low at -0.20%. But then during the second week there was a sharp steepening of European curves, with the German 10-year yield at 0% soon after the BoE, contrary to expectations, left its intervention rate unchanged at 0.50%.

M. Soca

Chart 6. Ideas for 2016

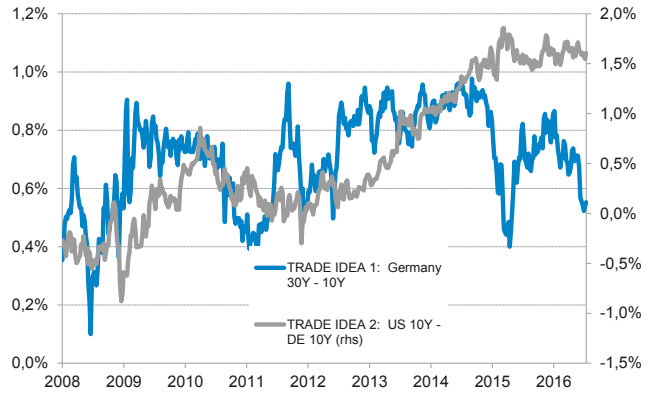
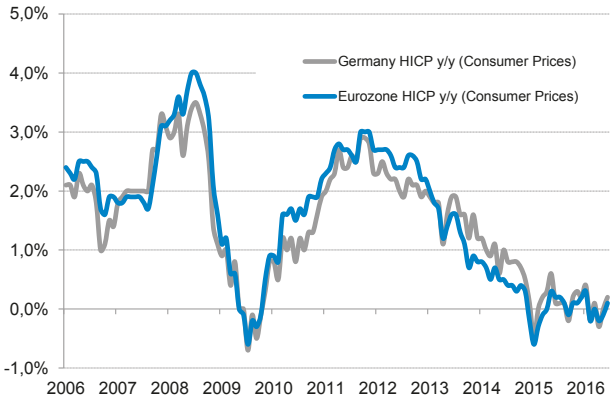


Chart 7. Deflationary risks in Europe



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equity

Post brexit, we are focusing on italian banks

June 24, Saint John's Day: The UK voted YES to Brexit and in the following days equity markets around the world went into meltdown (Ibex: -15%, Stoxx600: -11%, FTSE100: -6%, SP500: -5%, MSCI World: -7%). But once the flames were put out, share prices bounced strongly, recovering their pre-referendum level, both in the UK and the US, in the case of the latter breaking through to new all-time highs. As for the other European markets, they are well on their way to recouping all their losses too (Ibex: +12%, Stoxx600: +6%, MSCI World: +7%), although they are still suffering as a result of the financial sector, which is being weighed down by Italian banks. It is not clear whether the solution in Italy is a bail-in (i.e. charging the losses to shareholders and creditors) ahead of a potential bail-out (i.e. charging the losses to public funds). Whatever the final solution, we are guaranteed volatility in the sector, and then there are the results of the EBA's stress tests, which take place this month and which, so it is rumoured, an Italian bank or two may fail. And finally, we must not forget that the 2Q16 results season has already kicked off; in which we expect companies to dispel some of the doubts regarding the year so far and the impact that Brexit may have on their results.

X. Torres

Chart 8. P/BV: Stoxx600 vs. SP500

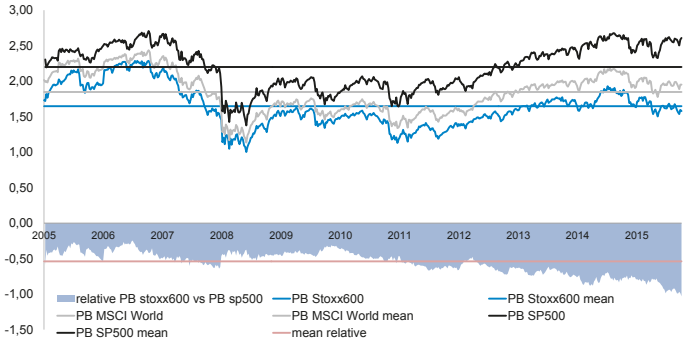
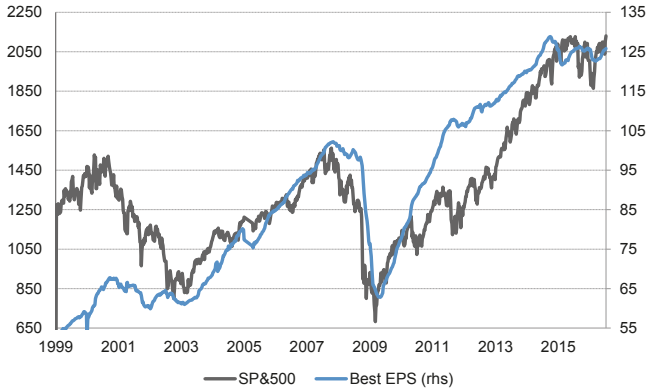


Chart 9. SP500 vs. earnings



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equity / technical analysis

Directionless

We are living in a financial environment in which analysts' expectations and predictions have little to do with real market movements. Initially, Brexit was almost totally ruled out, and a major and significant correction was predicted in the event that this were not the case; yet here we are with the UK preparing to pack its bags and with European markets at the same levels as they were before the vote! The market is extremely lost, and nobody seems able to get an accurate reading that shows us the way. The only option appears to be waiting for the market's next move and then trying to take advantage of that trend. We said last month that the EuroStoxx and the Ibex could test their year lows, and this is exactly what they did. But since then both have recovered virtually all the ground lost since June 24, and both are once again facing resistance levels. It may be an idea to trim equity positions in the short term in order to look for new buying levels.

G. Apodaca

Chart 10. Eurostoxx future (daily chart)

Chart 11. Ibex future (daily chart)

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fx

GBPJPY: the fashionable crossrate

Despite having diminished a bit over the last few sessions, volatility in the currency markets is still high. Against this backdrop, there are two currencies that stand out: GBP and JPY. The former because it is virtually impossible to find a currency against which it has not lost ground since the referendum; and the latter, just the opposite.

GBP took a breather following the BoE's decision to leave interest rates unchanged. The central bank has gained time and avoided any sensation of panic. Its decision is a effectively an intervention against a backdrop of de facto monetary easing, due to its depreciation.

The decision is justifiable on the basis that there is still not enough information to be able to evaluate the effects that Brexit will have on the economy.

In the case of the JPY, we believe it is significantly overbought. Buying interest from speculators, as indicated by the percentage of open interest in the futures, is currently at 1.4x the historic average, level that has normally been followed by depreciation.

As for the EURUSD, we are not changing our scenario. Our 2-year interest rate spread model suggests a fair level for the EURUSD of 1.05-1.10. As for the technical angle, we are leaving our tactical stop-loss at 1.162 and our strategical stop loss at 1.18.

T. García-Purriños

Chart 12. JPY: Speculators' position as a percentage of total open interest

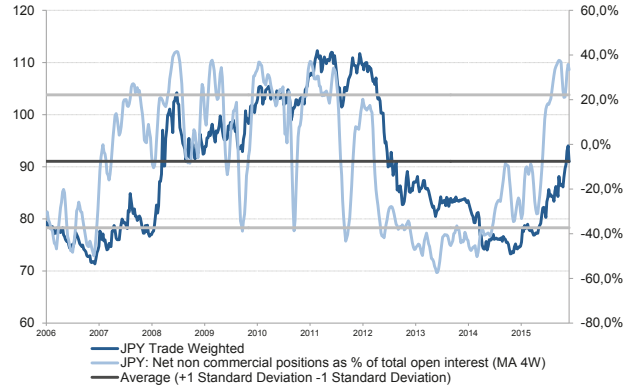
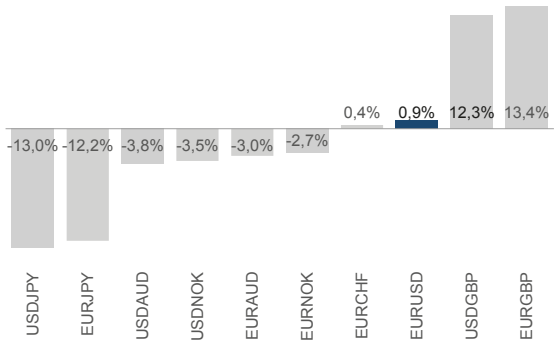


Chart 13. Performances of main currencies in 2016 (YTD)



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commodities

No change to the outlook

Commodities continue to consolidate, as part of a change in trend and with a degree of support from the fundamentals. This is all helped by China, where there appears to be less risk of a hard landing, according to our macro scenario. From the technical angle, the levels to watch on the Bloomberg Commodities Index are the same as those in May.

In terms of the oil price, based on our outlook for demand (in line with that of the IEA), if non-OPEC supply is unchanged, the market reached a state of equilibrium at the end of the last quarter. In this context, we see the risk on the upside. A large part of the downside risk is already discounted, and in the current situation any disruption to supply could have a positive impact on prices. We maintain our target price at USD55 (Brent).

We are also leaving our technical outlook unchanged. If it were to lose 46.8, we could see a correction down to 43.0, which remains the stop in our tactical strategy. Even so, unless there are closes below 37, we will be maintaining our positive stance long-term.

Turning to gold, we continue with our technical underweighting, with a target price of around USD 1,000/oz. This outlook is coherent with both our dollar and interest rate scenarios. In such a scenario, we would expect to see other precious metals, such as silver, outperforming gold.

T. García-Purriños

Chart 14. Oil: rising inventories and growing supply/demand spread

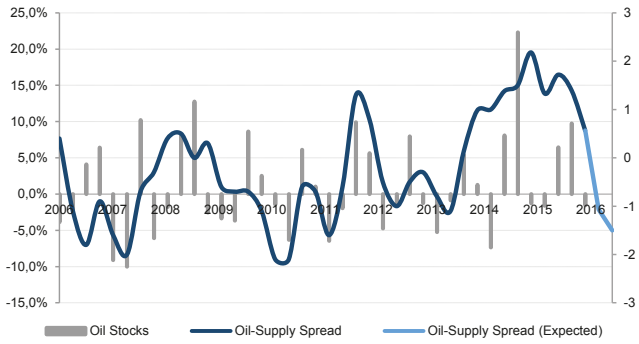
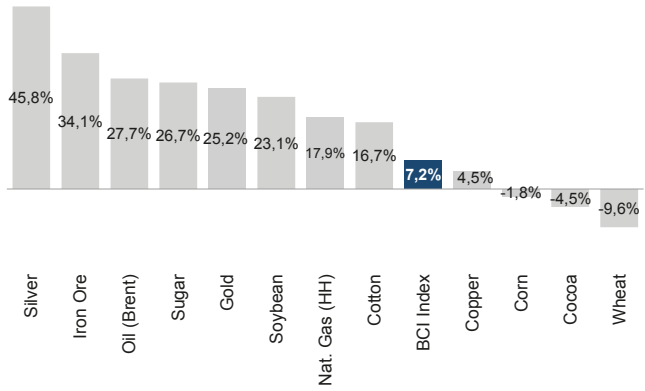


Chart 15. Performance of main commodities in 2016 (YTD)



Deflation: An inconvenient truth?

After fiercely fighting inflation over decades, central banks are now trying to revive it by all means, be it quantitative easing, negative interest rates or currency depreciation. This poses an intriguing question apt for fans of conspiracy theories: do central bankers know something that the rest of us don't?

The policy twist followed the financial crisis, when the Fed decided to embark on "quantitative easing" in order to avoid that a slump in aggregated demand could be worsened by an excessively tight monetary policy, as had previously happened during the Great Depression. However, the downward trend in inflation had not started then. In fact, Ben Bernanke himself had advanced the "Great Moderation" paradigm, whereby advances in central bank "technology" were relegating macroeconomic volatility – including inflation – to the history books.

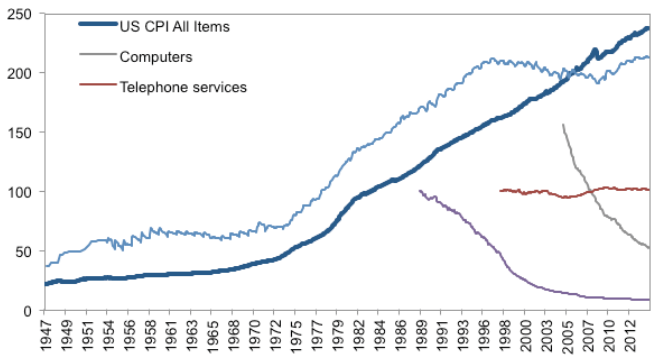
Bernanke's technocratic complacency omitted the fact that inflation had already been long decreasing due to other factors not influenced by central bank "magic". Two politico-economic forces can be identified beneath the deflationary tide. The first is globalization, which combined with technological advances and improved managerial skills, has enabled companies to make huge strides in optimizing production and distribution costs. To mention a few, the use of outsourcing, off-shoring, robotics, inventory management and on-line marketing is surely behind the sharp decrease in prices of goods and services. Moreover, during this process, workers' bargaining power evaporated, severing the traditional link between corporate profits, wage pressure and inflation. The second force was the formation of currency blocs around the US dollar and the newly created Euro, which meant bringing many inflation-prone countries under monetary discipline.

The deflationary trend would be more acute if, as economists have long suspected, real inflation rates are significantly lower than those reflected in official statistics. Broadly speaking, the reasons for the mismeasurement are the late accounting for newly introduced products that exhibit a rapid decline in price (see graph), as well the failure to capture quality improvements. Moreover, the Internet revolution has brought a whole range of new services that are either offered for free (Google, Facebook, YouTube, etc.) or below economic cost (Airbnb, Uber, etc.), and which are barely included in the official price statistics.

This debate is not new and reached its zenith in the late 90's when the proponents of the "New Economy" paradigm commanded by Alan Greenspan argued that large productivity gains – particularly in the growing service sector – were being understated by an inaccurate measurement of inflation. In fact, the so-called "Boskin commission", appointed by the US Senate in 1995 to study possible bias in the computation of the CPI, found that the CPI was overstating inflation by more than +1%. At the time, with the CPI hovering north of 3%, this was not a reason for concern. However at current levels, it would mean that we are currently experiencing deflation.

If this is true, the economy would not be in bad shape when thinking in terms of productivity and real economic growth. The danger however is that once a deflationary trend is in motion, corporate profits and rents sooner or later start to decline, which in turn deflate asset prices and increase the value of liabilities. This threatens the very foundation of the financial system and would thus explain the mystery behind central bank's unorthodox behavior.

Chart 16. Deflation in innovative products not yet reflected in the CPI?



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Equity

20/07/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
INDEXES			
MSCI World	1.701	2,1%	2,2%
MSCI Emerging Markets	868,1	5,7%	9,3%
S&P 500	2.161	3,9%	5,9%
Nikkei 225	16.682	4,5%	-12,4%
EuroStoxx 50	2.964	0,7%	-9,3%
FTSE 100	6.716	8,3%	7,6%
DAX	10.122	1,6%	-5,8%
Ibex 35	8.566	-0,9%	-10,2%
CAC 40	4.380	0,9%	-5,5%
FTSE MIB	16.775	-3,3%	-21,7%
PSI 20	4.618	-1,0%	-13,1%
Athex	571	-2,7%	-9,6%
Hang Seng	21.882,5	6,7%	-0,1%
Bovespa	56.698	12,7%	30,8%
Micex	1.905	0,1%	8,2%
SECTORS			
Consumer Discretionary	190,0	0,9%	-1,8%
Consumer Staples	224,9	2,4%	7,4%
Energy	207,1	2,3%	15,3%
Financials	90,3	-0,3%	-7,0%
Industry	204,4	2,0%	6,5%
Materials	209,4	2,7%	12,4%
Health Care	209,9	4,3%	-0,4%
Technology	149,0	4,2%	2,7%
Telecommunication	73,7	1,2%	7,1%
Utilities	124,2	1,9%	11,2%

20/07/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
IBEX-5			
BBVA	5,2	-5,2%	-22,5%
Inditex	31,0	4,4%	-2,2%
Repsol	11,9	9,7%	17,3%
Santander	3,8	-1,6%	-16,8%
Telefónica	8,7	2,2%	-13,8%
BLUE CHIPS EUROPE			
BASF	71,7	5,6%	1,4%
Daimler	58,2	4,1%	-24,3%
E.ON	9,5	11,6%	6,4%
HSBC	495,3	11,9%	-7,6%
Nestle	78,1	12,0%	4,7%
Roche	251,6	4,7%	-8,6%
Royal Dutch Shell	25,0	6,6%	18,4%
Siemens	94,7	1,5%	5,3%
Vodafone	226,0	7,0%	2,3%
BLUE CHIPS US			
Apple	99,2	4,0%	-5,1%
Bank Of America	13,9	3,5%	-15,3%
Coca-Cola	45,6	1,7%	6,2%
Exxon Mobil	94,5	4,4%	21,2%
Mc Donald's	126,5	1,1%	7,1%
Microsoft	53,1	7,5%	-4,3%
Procter & Gamble	86,2	3,3%	8,5%
Walt Disney	99,5	1,0%	-5,3%

Fixed Income

20/07/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
GOVERNMENT BONDS	YTM	bp	bp
Treasury 2y USD	0,70%	-4,7	-35,0
Treasury 5y USD	1,13%	-5,4	-63,2
Treasury 10y USD	1,57%	-12,1	-70,1
Bund 2y EUR	-0,63%	-4,7	-28,6
Bund 5y EUR	-0,50%	-2,9	-45,5
Bund 10y EUR	-0,03%	-8,1	-65,8
CDS	Spread	bp	bp
ITRAX EUROPE 5Y	70,9	-7,9	-6,4
ITRAX EUROPE 10Y	106,7	-6,0	-7,0
ITRAX EUROPE SR FIN 5Y	96,4	-7,3	19,6
ITRAX EUROPE SUB FIN 5	219,1	2,1	65,6
CDX USA 5Y	71,3	-8,4	-17,1
SOVEREIGN SPREADS	Spread	bp	bp
Spain / Germany 10y	118,2	-24,3	4,4
France / Germany 10y	23,5	-13,6	-12,4
Italy / Germany 10y	126,0	-12,0	29,5
Ireland / Germany 10y	43,6	-23,5	-8,1
Portugal / Germany 10y	311,4	0,8	122,7
BREAKEVENS	Rate	bp	bp
Germany Breakeven 10Y	0,80%	-5,0	-22,0
US Breakeven 10Y	1,48%	0,6	-9,6
UK Breakeven 10Y	2,38%	6,7	2,0
HY & EM SPREADS	Spread	bp	bp
BarCap US Corp HY	525,0	-65,0	-135,0
JPM EM Sovereign spread	378,6	-50,3	-67,0
CS EM Corp Spread vs. BM	327,9	-71,8	-83,5

20/07/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
IBEX-5 CDS 5Y		bp	bp
BBVA	135,5	-10,5	6,2
Iberdrola	71,3	-12,1	-11,4
Repsol	159,9	-27,5	-100,7
Santander	144,4	-9,7	8,6
Telefónica	109,7	-11,2	-9,8
BLUE CHIPS EUROPE		bp	bp
BASF	45,7	-2,4	5,6
Daimler	59,3	-13,9	-3,0
E.ON	71,0	-21,2	-26,9
HSBC	82,2	-10,5	11,4
Nestle	26,1	-0,2	-5,0
Roche	33,0	-0,5	2,0
Royal Dutch Shell	n.a.	n.a.	-10,2
Siemens	39,7	-1,3	-0,5
Vodafone	92,1	-2,6	-2,6
BLUE CHIPS US		bp	bp
General Electric	38,5	1,3	0,4
Bank Of America	77,3	-11,3	5,0
Coca-Cola	27,6	2,1	2,1
Chevron	85,0	-15,0	16,7
Mc Donald's	30,8	-3,8	-6,3
Microsoft	34,4	0,1	2,2
Pfizer	20,5	-6,5	1,9
Walt Disney	17,9	-6,8	1,6

FX

20/07/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
EURUSD	1,1011	-2,7%	1,7%
EURCHF	1,0870	-0,1%	0,1%
USDJPY	106,5500	2,2%	-11,4%
GBPEUR	1,1964	-7,8%	-11,8%
AUDJPY	79,8650	-2,6%	-8,9%

Commodities

20/07/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
Gold (USD/oz)	1.325,6	2,9%	24,8%
Copper (USD/t)	4.984,0	9,5%	5,9%
Crude Brent (USD/bbl)	46,9	-8,6%	10,3%
Corn (USD/bushel)	342,3	-18,8%	-4,6%
GSCI Commodity Index	355,3	-7,2%	14,0%

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