MORABANC
asset management

MARKETS AND STRATEGIES

> DECEMBER 2016

WTI ↑ BRENT ↑

Happy Holidays!

Thanks for following us this 2016

COVER IMAGES BY: RDC

Banks: the new materials?

Last Christmas, I gave you my heart / But the very next day you gave it away / This year, to save me from tears / I'll give it to someone special... Apart from being the most annoying Christmas song (*Last Christmas*, by Wham!), it has a hidden meaning for those who bought into European banks a year ago, when they already seemed a bargain. Yet they dropped 30% between January and mid-February: nothing has caused more tears this year than an investment in European banks. And for those who remained faithful throughout, their patience was tested further when, following Brexit, banks plummeted 20% in a day, extending the loss to -40% YTD. It looked as though the banks had been attacked by a black swan, as analysts set about lowering their forecasts (for the umpteenth time). But, as so often happens, this was the moment to have bought ("retroactive analysis always works" is an old Polish saying widely used by professional investors); the EuroStoxx 50 Financials index is up 50% since Brexit, despite still being down on the year. Brokers, when they talk about their outlooks, tend to divide a year into two halves: one good and one bad. On this occasion, for European banks, it has worked to a tee.

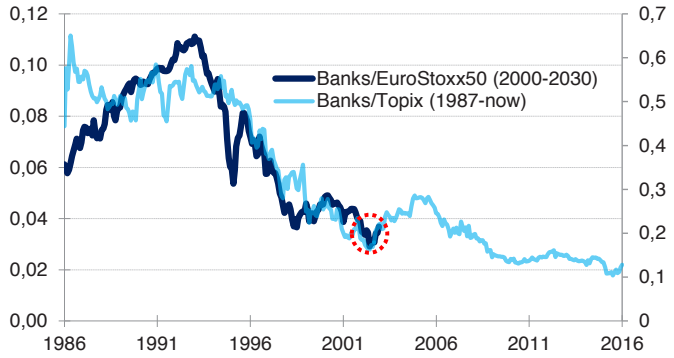
There is a series on Netflix called Orange Is the New Black, and for me banks are showing all the signs of becoming the new black; that is to say, the new materials sector.

What has worked all year (the "someone special" in the Wham song) is the materials sector, in particular the mining and steel stocks, with raw material prices doubling in several cases (coal, iron ore) and with the sector as a whole up 60% YTD. Yet investors in the sector no doubt feel let down over the last five years (-35% in 2015), and it became the most unloved sector I believe during the second half of 2015, just before it hit a low in January 2016.

There is a series on Netflix called *Orange Is the New Black*, and for me banks are showing all the symptoms of becoming the new black; that is to say, the new materials sector: underweighted by managers, hated, downtrodden, and... with huge potential looking ahead a few years.

Sceptics argue that Japan's banks have been in the doldrums for three decades, whereas Europe's banks lost their way only 10 years ago. And it is true. But it is also true that within this dark age Japanese banks have enjoyed some glimmers of light. Interestingly, the performance of the European financial sector looks very similar in many ways to that of the Japanese sector twelve years ago (chart 1); and, if the pattern is confirmed, the next three years could be golden ones for continental banks, with the potential to outperform the broad index by 70%, albeit most probably falling behind again later. So, we are waiting, and not giving our hearts away just yet. From all the team, we wish you a very Merry Christmas and, of course, a good seasonal tune!

Chart 1. The performance of Japanese banks bodes well for the sector in Europe



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Risk map

Ever since Trump's victory, the defence sector has been under the spotlight; the president-elect's stance on the status of Taiwan is not clear, and neither is the future of the recent nuclear deal with Iran. The new heads of international policy are likely to bring about significant changes. As a result, we are raising geopolitical risk. At the same time, plans to increase public spending and cut taxes are likely to result in inflationary pressures. And following the agreement by both OPEC and non-OPEC countries on crude production cuts, this pressure is likely to increase even more. We are raising the inflation risk.

Strategy: Changes in stance on EURUSD and oil

Macro environment. No surprise from the FOMC meeting: a 25bp increase, the second of this cycle, with an outlook of stronger economic growth and rising inflation. The unemployment rate is now at 4.6%, the ISM indexes are clearly bouncing, and some sentiment indicators are at their highest levels for 10 years. In Europe, we are seeing a significant improvement in the macro data, with the PMI at 54.9 (highest since 2011) and the unemployment rate below 10% (9.8%). China's economy continues to reap the benefits of the fiscal stimulus launched a year ago, with most indicators on the rise. In Japan, figures point towards a very modest recovery. However, it is still a question of waiting and seeing if the Brazilian economy grows in 2017.

Equity. Value is gathering momentum: this is the best way of summarising stock market performance since the US elections. We are seeing cyclicals outperform. And, given that value stocks have underperformed growth and quality stocks for the last five years, we believe this recently-initiated trend may well gain traction in 2017. We are buyers of banks, industrials, consumer discretionary, and energy. We are reducing positions in utilities and consumer staples. We see a lot of value in European equities and still some potential in the US.

Fixed income. Better macro data, increased likelihood of inflation, and the German 10-year at 0.30%: we continue to see a major risk of losses on core debt ; we prefer credit, inflation, and peripheral debt.

EURUSD. We are leaving our forecast range for the EURUSD at 1.05-1.10, meaning that at the current level of 1.05 we see no further upside for the dollar. **We are taking profit and changing our stance to neutral.**

Commodities. The oil price benefited from the agreement reached by exporting countries on production cuts, and it **has reached our target level of USD55 (Brent)**. We believe the 1.8 mmbpd cut and the potential pick up in demand should lead to a higher price. **We remain buyers and we are lifting our target price to USD60**. We remain bearish on gold, in keeping with our more bullish stance on risk assets.

Chart 2. Risk map

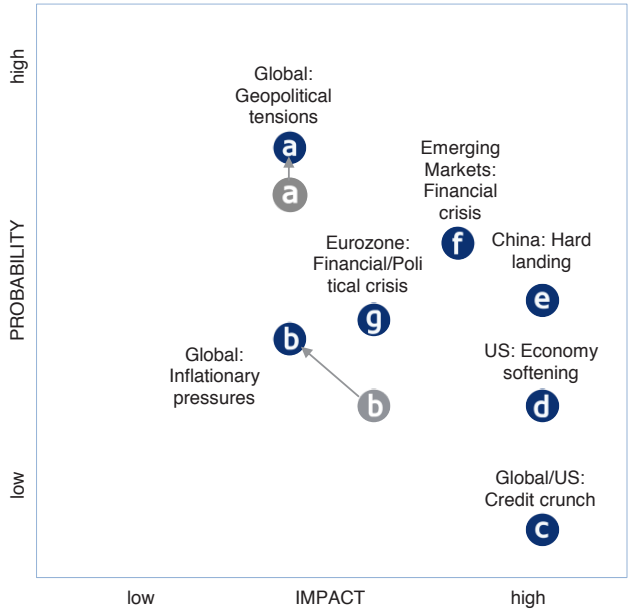


Chart 3. Total returns in November 2016*

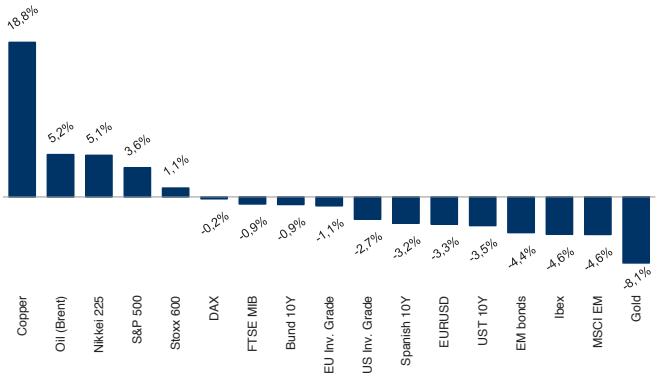
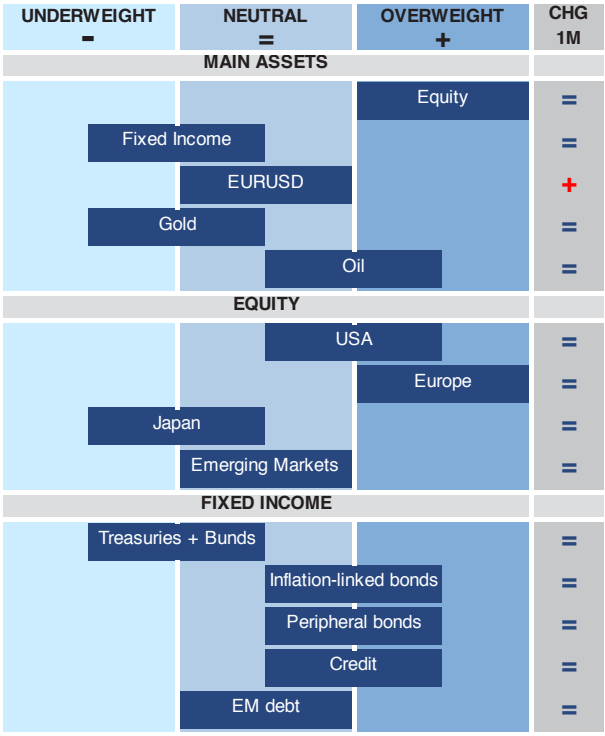


Chart 4. Positioning on the main asset classes



*USD returns on MSCI EM index and EM bonds

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macroeconomy

Brexit, US elections, and now Italy

Consistent with what I wrote last month: "an extremely unusual 2016; especially on the political front", the Italian referendum resulted in a decisive 60/40 "no" vote, triggering the resignation of prime minister, Matteo Renzi. And once again, many people have been caught out by the market's subsequent rise.

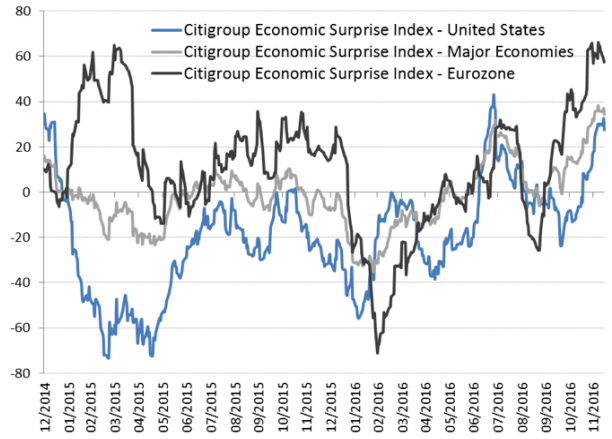
As for the interest rate decision in the US, the Fed confirmed market expectations, tightening by 25bp. And on this side of the Atlantic, the ECB has extended its bond repurchasing programme through to the end of 2017.

At the macro level, the figures continue to come in above expectations, with several economic surprise indicators hitting year's highs (see chart). Several inflation indicators in the US are at their highest level since 2014, adding to the pressure on core debt around the world and pushing the US 10-year above its 2015 high of 2.50%. The risk of global recession is receding. Right now, 2017 looks likely to get off on an extremely optimistic foot. But, the outlook is not exempt of risk: namely the implications of overly-vigorous rate increases or an excessively strong US dollar. Patience and Happy 2017!

R. Giménez

News	Events
The Federal Reserve increases US rates by 25bp	22/December/16. Last revision of 3Q16 GDP in the US
"No" vote in the Italian referendum, and resignation of the PM.	4/January/17. Publication of minutes from December FOMC Meeting
Finally, OPEC agrees on the first production cut in 8 years, triggering a new high for crude at USD 54.5	17-20/JANUARY/17. Annual meeting of the World Economic Forum in Davos (Switzerland)
	19/JANUARY/17. Next ECB meeting on interest rates

Chart 5. Bonds post-shock: interest rates still depressed, despite everything



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fixed income

Elections and volatility in debt markets

December continues to be a month of extreme volatility in debt markets on both sides of the Atlantic. On the one hand, the US debt market is pricing in the pick-up in inflation with a steepening of the government curve, in the face of a more expansive fiscal policy. As expected, the Fed lifted rates by 25bp at its December 14 meeting, at the same time painting a more hawkish picture for 2017. The market immediately pushed the US 10-year above 2.55%. It is worth highlighting the abrupt narrowing that has taken place in US credit markets (both investment grade and high yield).

Meanwhile, the ECB surprised the market at its last meeting on December 8, not so much with the decision to extend the purchase programme through to the end of 2017 (already very much discounted), but rather with its reduction in the monthly purchase target from the current EUR80Bn/month to EUR60Bn/month. This led to major movements across the different sections of European government curves in the following days, and a significant steepening of the core curves.

European credit indices have held up extremely well this month. The ITRAXX Xover has narrowed 40bp to 300bp, and the ITRAXX Europe has eased 9bp to 71bp. As for emerging debt, the EMBI Global index has narrowed to 370bp.

M. Soca

Chart 6. Ideas 2016

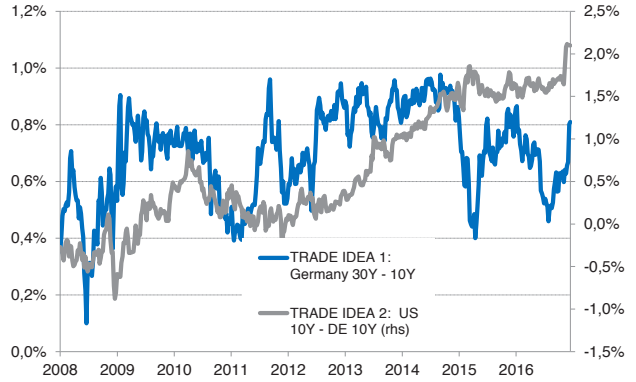
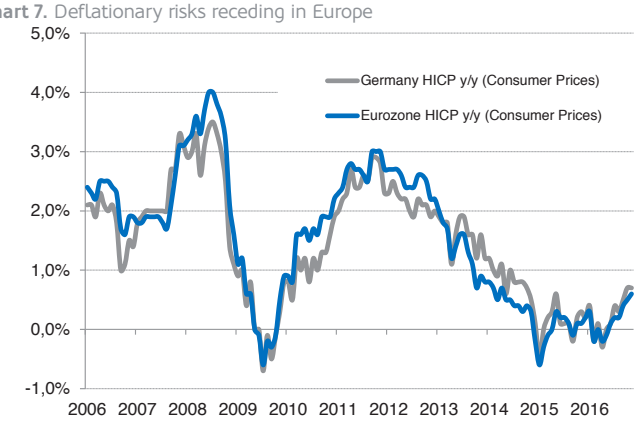


Chart 7. Deflationary risks receding in Europe



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equity

And the rally continues...

Last month, we spoke of the Christmas rally, which continues, thanks to the famous reflation trade and improved investor sentiment. In fact, in Europe the main bottlenecks (referendum and bank recapitalisation in Italy) are now likely behind us, so we expect the upbeat tone in European equity markets to continue. Meanwhile, the positive momentum unleased by the Trump victory also continues, and with it the honeymoon for markets.

What we have seen over the course of the month is a shift in sector rotation: defensive stocks are no longer the winners, be it utilities or consumer staples; investors are turning their focus to more cyclical sectors, such as banks and materials. What is more, the multiples on these sectors are way below their historic averages. In addition, the positive earnings revisions continue in both sectors.

As a result, we are expecting peripheral markets to outperform.

X. Torres

Chart 8. SP500 vs. earnings

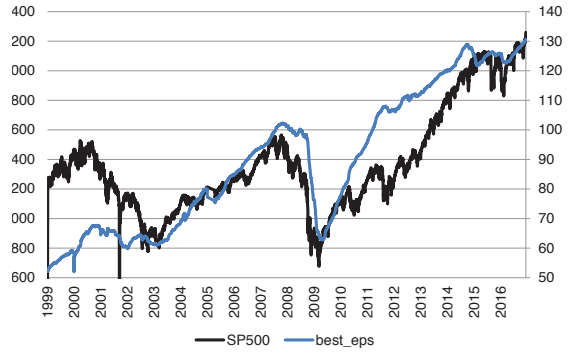
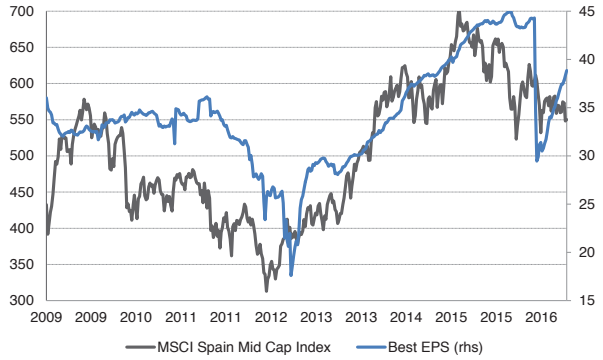


Chart 9. Performance of the MSCI Spain Mid Cap and its earnings



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Outlook for 2017

The last month of a year has arrived, the one that has provided us with plenty of ups and downs. I am not going to list them all or summarise the year; it's all water under the bridge. The important thing now is to look to the year ahead. So, what to expect from 2017? Well, a more encouraging outlook finally appears to be taking shape in equity markets; the latest rallies in European markets mean that we are optimistic about the new year. Last week, we talked about the false breakout during the US election period, which gave us a clue as to the market's potential trend. We could now see a consolidation short term, before the recent bull trend continues. In the case of the Eurostoxx 50, 3,500 seems to be a realistic target for the coming months. As for the Ibex 35, we have seen how a sideways bullish movement has been put in place; this could involve some small corrections short term, before a move up to 9,600. We also need to keep an eye on the US market, which continues to register new highs: the Dow Jones may find it difficult to break the psychological barrier at the 20,000 level, and the SP 500 could reach 2,400 over the next few sessions. This said, we prefer to maintain our exposure to European and US indices going into 2017. Happy Christmas to all!

G. Apodaca

Chart 10. EuroStoxx Future daily chart

Chart 11. Ibex future daily chart

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FX

Green, how I desire you, green

Last month, we spoke of *Trumpflation*, and the idea has lost no momentum as far as the USD is concerned. On a trade-weighted basis, it has rallied more than 6% since the elections and it is now close to its all-time high.

The Fed's rate rise and Yellen's more dovish tone (talking of three further rises in 2017, describing expansion as "moderate" instead of "modest", and highlighting the reduction in unemployment and stronger prices) have helped the dollar's rise.

It is now time to let the market breathe. Our short and medium-term indicators suggest that the US currency is overbought. And the long-term indicators are showing extreme deviations. In the same way that we stuck to our range earlier this year when the dollar got close to 1.15, because that is what our models were telling us, we cannot chase it now that it is at 1.04. We are taking a neutral stance (forecast range of 1.05-1.10) ahead of fresh clues. We know what the market can be like when it becomes pig-headed: it is not worth chasing it; and it is certainly not worth going against it!

Technically, the next level below 1,047 is 0,985. But the movement is not that clear. And, while it appears counterintuitive, since Volcker the dollar has normally fallen immediately after rate rises (see chart).

So, "tis the season to be jolly"....and patient!

T. García-Purriños

Chart 12. Fed Funds (left) and DXY (right.)

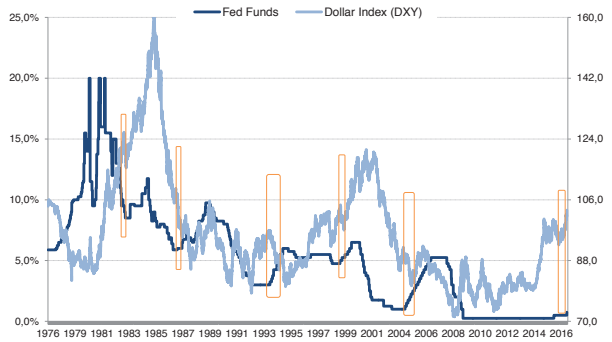
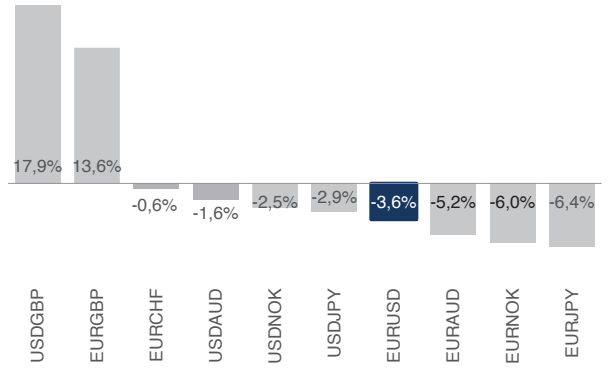


Chart 13. Performances of main currencies in 2016 (YTD



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commodities

Oil: not without the USD

We said last month that we thought an OPEC agreement was on the cards. Now, with an agreement reached, and in fact improved by the addition of several non-OPEC member states, it is time to go back to fundamentals. Assuming the production targets are met only partially (1.0 mmbpd reduction instead of 1.8) and demand growth in line with its 10-year average, the oil market looks set to register a deficit of 0.5 mmbpd in 1Q17. This should drive Brent above USD60 which makes it our new target level.

But not without help from the USD. Dollar strength is weighing on prices. And if it remains at these levels, our model suggests that the oil price won't go any higher. It is not the first time we have had seen such a long decoupling between the oil price and the dollar; but it is unusual.

What is more, technically speaking we do not like the fact that WTI has failed to confirm the upward trend by breaking out the diagonal support line formed by the lows since February. And as long as it does not manage this, we cannot assume that the second phase of the rally is yet under way; which means that we may well see a consolidation. So, for our bullish stance to remain intact, it is important that Brent does not lose the significant level at USD51.20.

As for gold, it continues its downward path, in line with the performance of real interest rates. We are sticking with our bearish stance, down to around USD1,000/oz.

T. García-Purriños

Chart 14. Brent and Dollar Index (DXY)

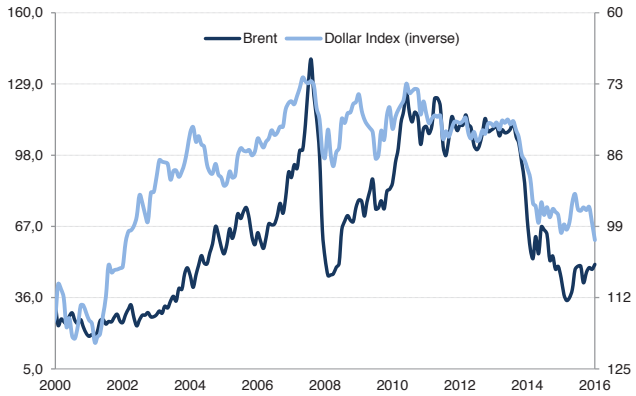
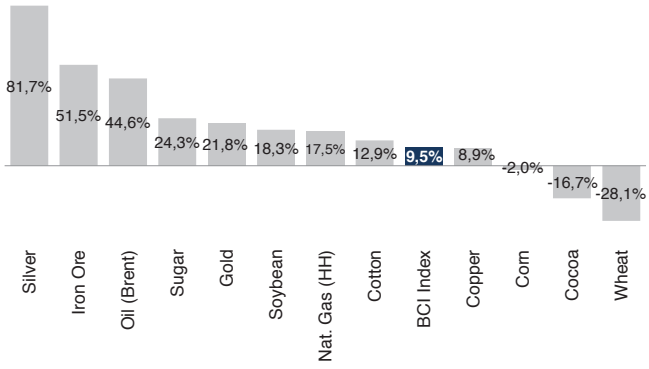


Chart 15. Performance of the main commodities in 2016 (YTD)



Behavioural finances and the biotech anomaly

In the low-growth environment we are currently living in, one should expect that fast-growing sectors command a premium. However, what we have recently observed is a rush to low-growth, high-dividend stocks (so-called "bond proxies") in a capitulation by investors crowded out of the bond market by central banks.

These yield-starved investors have reluctantly bought the narrative that in the current low interest rate environment "stocks are the new bonds". Therefore, they have no other choice than to accept higher volatility in return for a dividend. At the same time, equity investors have largely shied away from high-growth stocks and concentrated on high-quality stocks instead.

This reflux of investor flow has created a number of investment opportunities in the riskier end of the investment spectrum, with Biotech being the outstanding candidate.

Along with the S&P, the Nasdaq Biotechnology Index reached its peak in 2015, and started to correct in tandem with the US market, falling by almost 40%. However, whilst we saw a rebound in the broad equity market to new highs, biotech stocks have not managed this. While it is true that the index had had an incredible run (with a threefold increase since 2012), it was largely a consequence of the sector delivering up to its promises. New treatments hit the market and this enabled companies to make profits, subsequently triggering successive waves of IPOs and M&A deals, a result of Big-Pharma companies realizing that it is a smarter strategy to handsomely pay for successful biotech companies instead of funding risky R&D ventures.

The main trigger behind the sector's reversal was a tweet from Hillary Clinton promising to tackle the high cost of prescription drugs, following several scandals of price excesses in the industry. Now that Clinton is out of the equation, uncertainty has decreased, although it has not completely disappeared. A key element of Trump's program is to scale back government intervention. However, during his campaign, he also mumbled some "me-too" drug price controls.

This aside, current valuations still offer a good entry point for investors who have a long-term investment horizon as the sector's fundamentals remain very strong. The industry is not in a maturing but rather a reacceleration phase, akin to the web 2.0, but with less hype. Growth is driven by an expanding array of scientific discoveries (DNA sequencing, immunotherapy, stem-cell and gene therapies) powered by a convergence between biochemistry and the digital revolution. This enables both a reduction in costs (DNA sequencing costs are expected to drop from $100m in the year 2000 to $1k) and new ways for delivering treatments (personalized medicine, nano-robots). Moreover, some of the most wide-spread diseases without a definitive cure (cancer, alzheimer) are partially age-related. Coupled with an aging population, this translates into a huge market size.

If, despite the above, biotechnology still looks uninteresting compared with technology, for example, then the explanation lies in behavioural finance. We, as individuals prefer stories to analysis, and the biotech world is not easy and requires a high level of scientific knowledge to be understood; while it is easy to get excited about the design and potential of an iPhone without having any idea about engineering.

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Equity

16/12/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
INDEXES			
MSCI World	1.755	3,3%	5,5%
MSCI Emerging Markets	858,7	1,4%	8,1%
S&P 500	2.264	4,0%	10,7%
Nikkei 225	19.401	8,6%	1,9%
EuroStoxx 50	3.264	7,9%	-0,1%
FTSE 100	7.017	4,0%	12,4%
DAX	11.413	7,0%	6,2%
Ibex 35	9.370	8,5%	-1,8%
CAC 40	4.840	7,5%	4,4%
FTSE MIB	18.995	14,7%	-11,3%
PSI 20	4.624	5,2%	-13,0%
Athex	637	7,6%	0,9%
Hang Seng	22.020,8	-1,2%	0,5%
Bovespa	58.699	-3,4%	35,4%
Micex	2.243	10,6%	27,4%
SECTORS			
Consumer Discretionary	198,2	3,7%	2,4%
Consumer Staples	205,8	1,6%	-1,3%
Energy	218,3	7,1%	22,4%
Financials	107,4	6,5%	10,7%
Industry	212,5	2,0%	10,8%
Materials	221,2	2,6%	19,8%
Health Care	192,5	-0,9%	-8,4%
Technology	163,4	3,2%	11,6%
Telecommunication	68,2	5,7%	0,4%
Utilities	113,2	3,5%	1,4%

16/12/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
IBEX-5			
BBVA	6,6	10,0%	-2,6%
Inditex	32,1	3,3%	1,7%
Repsol	13,7	11,1%	35,4%
Santander	5,0	15,9%	9,9%
Telefónica	8,7	8,5%	-15,0%
BLUE CHIPS EUROPE			
BASF	87,1	7,5%	23,2%
Daimler	70,7	9,0%	-8,9%
E.ON	6,5	4,0%	-16,9%
HSBC	668,3	6,3%	24,6%
Nestle	72,0	4,2%	-3,5%
Roche	233,9	0,7%	-15,4%
Royal Dutch Shell	25,8	12,0%	22,5%
Siemens	116,6	8,0%	29,7%
Vodafone	201,0	-1,0%	-9,0%
BLUE CHIPS US			
Apple	116,1	5,6%	10,3%
Bank Of America	23,1	16,7%	37,0%
Coca-Cola	41,6	0,7%	-3,3%
Exxon Mobil	91,4	6,6%	17,3%
Mc Donald's	123,4	3,5%	4,4%
Microsoft	62,4	4,5%	12,4%
Procter & Gamble	84,7	1,8%	6,7%
Walt Disney	104,2	5,1%	-0,8%

Fixed Income

16/12/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
GOVERNMENT BONDS	YTM	bp	bp
Treasury 2y USD	1,25%	24,7	20,5
Treasury 5y USD	2,07%	40,0	31,1
Treasury 10y USD	2,58%	36,2	31,5
Bund 2y EUR	-0,79%	-16,0	-44,7
Bund 5y EUR	-0,47%	-13,9	-42,5
Bund 10y EUR	0,31%	1,3	-31,9
CDS	Spread	bp	bp
ITRAX EUROPE 5Y	72,0	-6,7	-5,3
ITRAX EUROPE 10Y	110,9	-5,7	-2,9
ITRAX EUROPE SR FIN 5Y	93,6	-8,4	16,8
ITRAX EUROPE SUB FIN 5	220,4	-14,0	66,8
CDX USA 5Y	68,3	-7,0	-20,1
SOVEREIGN SPREADS	Spread	bp	bp
Spain / Germany 10y	112,8	-11,8	-1,1
France / Germany 10y	44,8	0,5	9,0
Italy / Germany 10y	157,7	-15,9	61,2
Ireland / Germany 10y	34,6	-9,6	-17,1
Portugal / Germany 10y	351,2	13,4	162,3
BREAKEVENS	Rate	bp	bp
Germany Breakeven 10Y	1,17%	11,0	15,0
US Breakeven 10Y	1,90%	2,2	32,1
UK Breakeven 10Y	3,00%	-4,7	63,8
HY & EM SPREADS	Spread	bp	bp
BarCap US Corp HY	403,0	-81,0	-257,0
JPM EM Sovereign spread	368,8	-17,9	-76,8
CS EM Corp Spread vs. BM	277,4	-19,2	-134,0

16/12/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
IBEX-5 CDS 5Y		bp	bp
BBVA	126,0	-14,6	-3,3
Iberdrola	74,6	-2,2	-8,1
Repsol	126,0	-23,8	-134,6
Santander	126,1	-12,0	-9,7
Telefónica	122,0	-7,7	2,5
BLUE CHIPS EUROPE		bp	bp
BASF	40,5	-1,4	0,3
Daimler	56,7	-3,6	-5,6
E.ON	74,0	-3,1	-24,0
HSBC	69,2	-4,5	-1,6
Nestle	30,0	-1,0	-1,1
Roche	33,0	-0,5	2,0
Royal Dutch Shell	n.a.	n.a.	-3,9
Siemens	39,0	-3,0	-1,1
Vodafone	86,9	-2,5	-7,8
BLUE CHIPS US		bp	bp
General Electric	38,5	1,3	0,4
Bank Of America	76,3	3,0	4,0
Coca-Cola	27,6	2,1	2,1
Chevron	85,0	-15,0	16,7
Mc Donald's	34,3	-1,1	-2,9
Microsoft	34,4	0,1	2,2
Pfizer	42,3	5,7	23,6
Walt Disney	29,2	0,2	12,8

FX

16/12/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
EURUSD	1,0427	-2,5%	-4,0%
EURCHF	1,0731	0,2%	-1,2%
USDJPY	118,1400	8,2%	-1,7%
GBPEUR	1,1909	2,3%	-12,2%
AUDJPY	86,4210	-5,4%	-1,4%

Commodities

16/12/2016	LAST PRICE	CHANGE 1M	CHANGE YTD
Gold (USD/oz)	1.131,9	-7,7%	6,6%
Copper (USD/t)	5.732,0	3,7%	21,8%
Crude Brent (USD/bbl)	54,7	14,9%	20,3%
Corn (USD/bushel)	356,5	5,3%	-0,6%
GSCI Commodity Index	389,2	8,9%	24,9%

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