

MARKETS AND STRATEGIES

> FEBRUARY 2018



¿Saved by the VIXplosion?

In the September M&E editorial, I wrote “shorting volatility right now is similar to charging (currently 15% a month due to the contango effect) for sitting on a time bomb: a 2-3% drop in the S&P500 could easily trigger the explosion (sharp jump in the VIX, say 30-40%) and the snowball effect (winter is coming!), triggering of stop losses, closing of positions (buying of the VIX), a contagion (the S&P has a negative correlation of -80% with the VIX) and a panic effect, further falls in equities...”

Selling the VIX became one of the most popular investments, providing returns way above those on equities.

On February 5, the bomb exploded: the VIX rose >100%, literally wiping out the assets under management (AuM) of short volatility products and damaging above all US pension funds hunting for yield in the historically low interest rate environment. As this caused a 10% slide in US stocks in just one week I believe it merits a closer look.

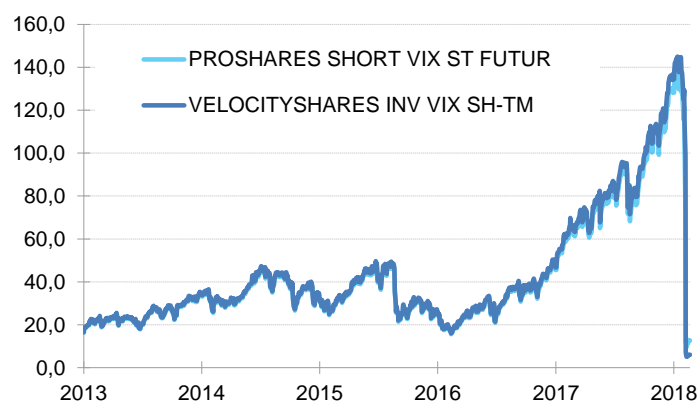
The enigmatic word, *volatility*, is simply the degree of movement in an asset or market (normally expressed as an annualised standard deviation) and it reflects the risk related to an investment. For markets/stocks that have options, the prices of these options can be used to estimate the implied volatility: the more expensive they are, the higher the risk they are discounting (the same as with insurance premiums). In the 90s, the CBOE (Chicago Board Options Exchange) introduced the CBOE Volatility Index, commonly known as the VIX, which aggregated the volatility implied by S&P 500 option prices in a single index (soon to be called the “fear index” because of its negative correlation with stock market indices; the explanation being simply that investors get nervous when markets fall). Futures and options on the VIX were created, and this is when volatility became directly invertible.

Over the last decade, the very slow recovery in macro data and central bank asset purchases contributed to a spectacular drop in volatility in virtually all financial markets and asset classes. Seasoned investors are accustomed to risk levels of 15-20%, but in 2017, when stock markets were barely registering daily movements of 1%, volatility was at half its historic average.

Selling the VIX became one of the most popular investments, providing returns way above those on equities. Multiple products were created that enabled investors to short volatility, and futures volumes soared. When, as a result of the tumble in US markets on February 2 and February 5, the VIX went through the roof, the shorting vehicles had to buy many more futures in order to rebalance, thereby driving prices even higher (essentially chasing their own tail), to the point where they needed to close positions in order to avoid negative NAV (one of them, curiously enough, is now trading again). Products that had produced an incredible 200% return in 2017 (average monthly rises of 10%) fell 90% overnight (chart 1).

While the drops across several markets wiped out the gains made in January, it is my belief that, for the medium-long term, what happened is actually positive (obviously not the case for those who were short VIX): firstly, because stock markets have finally taken pause for breath, and this, in my view, is a prerequisite for the bull market to continue; secondly, because the correction was clearly technical (no change to the extremely solid fundamentals, both micro and macro); and thirdly, because the bets on falling volatility have shrunk to such an extent that they are no longer an important factor for market stability. Put another way, the box is virtually empty of explosives.

Chart 1. Following a multi-year rally, vehicles used for shorting the VIX plummeted 90% in a day



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Risk analysis

When in January we included crowded trades in our risk list, we didn't expect such they would materialize so quickly; products shorting the VIX have closed after having plummeted 90% overnight, and the bitcoin has tumbled 45%. As a result, they are no longer crowded, and the panic/knock-on risk has fallen significantly.

This month, the biggest risk, according to our list, is also fast becoming a reality: wages (AHE), the CPI, and production costs (three inflation measures in the US) came in higher than expected, increasing the possibility of four rather than three rate hikes this year. More specifically, it appears to have been wage growth that

Strategy: finally a correction!

Macro backdrop. Even though ISM indices remain very strong (Manufacturing 59.1 and Services 59.9), investors are increasingly focused on inflation; US wages in January (AHE – average hourly earnings) registered their biggest rise since 2009. Europe, for the time being, is growing without inflation (latest PMI 59.6). It is also worth drawing attention to China's 2017 GDP, which was stronger than expected (6.9%), and also the overall macro recovery in Brazil.

Equity. We believe the sell-off in February was needed to enable markets to continue rising; complacency has diminished, money has flowed out of the crowded trades, valuations are more attractive. The correction was a technical one: there has been no change in the fundamentals, and the results season in the US is proving exceptional. This said, we are waiting to see a recovery in credit markets before we take on further risk. Those who are not into tactical trades, should maintain their equity exposure, in our view. We are highlighting the Energy and Telecoms sectors, which following the sell-off look particularly oversold.

Fixed income. We are buyers of corporate and emerging debt, although increasingly selectively. We maintain our exposure to short durations and we expect to see further rate rises. We continue to like inflation-linked bonds (ILBs); the latest inflation data in the US confirms that we need to be protected against rising prices. We believe there is still potential in peripheral debt, particularly Spanish debt.

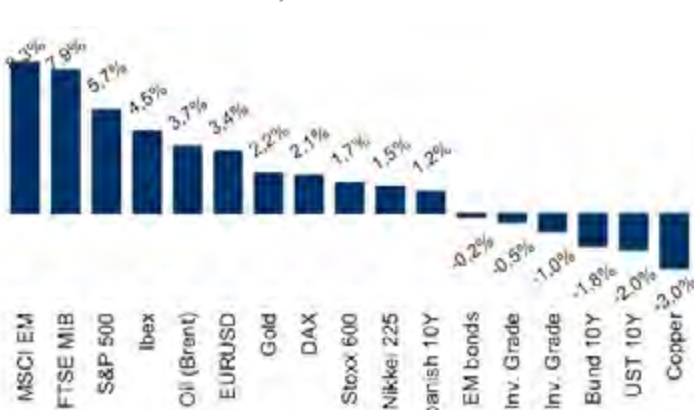
EURUSD. We are buyers of the dollar up to 1.10-1.15; the PPP valuation, the level of speculative positions, interest rate spreads, and the technical levels all point towards a change in the downward trend.

Commodities. We are buyers of gold, due to the increasing inflationary pressure, which ought to reduce real interest rates. We remain neutral on oil, but we are keeping a very close eye on the correction; at USD 60, it may well be very interesting again.

Chart 2. Main risks

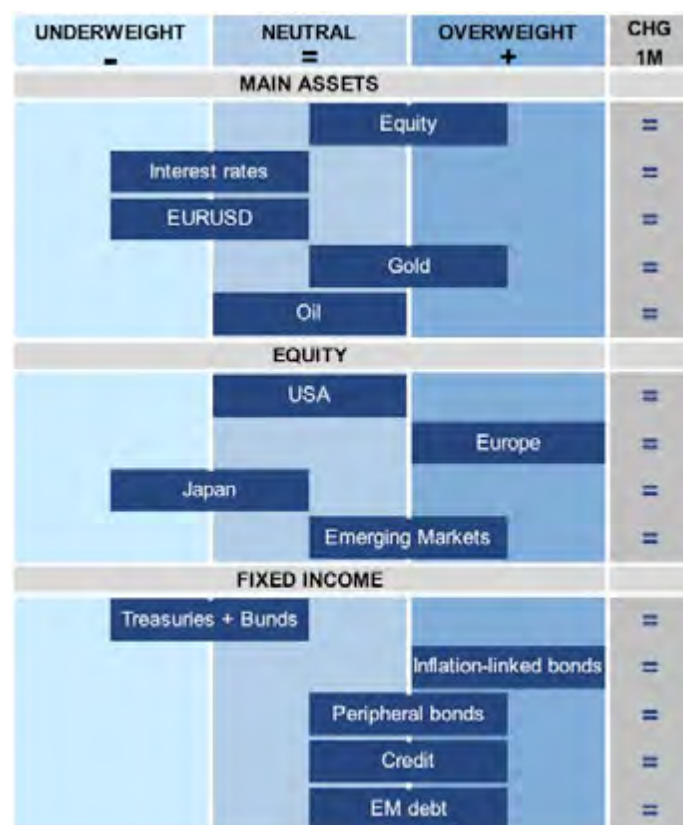


Chart 3. Total returns in January*



*Dollar denominated returns on the MSCI EM index

Chart 4. Positioning in the main asset classes



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Fish in troubled waters!

The last month has been a troubled one, to say the least. We have seen major corrections in several risk assets, which have led to significant bounces in volatility. Generally speaking, the macro indicators continue to improve in several regions. And wage data, along with the growth improvements, are beginning to accompany the rise in interest rates and inflationary expectations. With just under a month to go before the next Fed meeting, Fed Funds futures are still only discounting over 1.7 rate hikes for the rest of 2018: the next one in March is being allocated a probability of 88%. However, the upbeat corporate data suggest we should see more.

On the geopolitical front, the outlook remains turbulent short term. Talks in Germany appear to have moved towards a grand coalition and, as is so often the case, electoral support seems to be waning. In March, we have elections in Italy and Russia. So, it could well be a volatile month. And if to this busy calendar we add the February corrections on several risk assets and the bounce in volatilities, it seems perfectly reasonable to expect investors to find their risk appetite anew, depending of course on the result of these events. This said, it is certainly not a question of throwing caution to the wind.

R. Giménez

News	Events
Eurosceptic parties make the biggest gains in Italian opinion polls	04/MAR/18. Parliamentary elections in Italy
Social democrats and conservatives agree on terms of grand coalition in Germany	7-9/MAR/18. Next interest rate meetings in Canada, Eurozone, and Japan
European Parliament votes against transnational lists for 2019 European elections	18/MAR/18. Presidential elections in Russia
The VIX (S&P 500 volatility index) suffers the worst one-day absolute bounce since it began in 1990	21/MAR/18. Next interest rate meeting at the Fed/FOMC (USA)

Chart 5. Main macro data continues to exceed expectations



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fixed income

New year, new life

The ECB's debt purchases and the uncertainty surrounding the end of QE (expected for September) will be the main drivers for government debt and credit curves in Europe. Europe's core debt markets reacted hawkishly to Mario Draghi's speech on January 25, the German 10-year picking up to 0.80%, level not seen since September 2015. At the same time, peripheral risk premiums continue to perform well, in particular in Spain, where it has dropped below 70bp in February.

Credit indices underwent a massive rebound in January, even more so in the first weeks of February, in line with the movements we have seen in equity markets. The Itraxx Crossover has reached 280bp, similar level to March 2017.

In the US, Janet Yellen chaired her last meeting at the Fed on January 31, and on February 5 Jerome Powell took over. Implicit interest rates are currently discounting a 95% probability of a 25bp rise at the March 21 meeting.

As for emerging debt, following its upbeat performance in January the EMBI Global has bounced from 288bp to 322bp, in line with market volatility.

M. Soca

Chart 6. Risk premiums



Chart 7. Inflationary risks in Europe



The first fright

After a fabulous start to the year (one of the best I can remember), February brought the market its first fright. It seems, according to the experts, that what we have experienced is a market correction (-10%) triggered by purely technical factors. Apparently, it could even be deemed a flash crash; that is to say the market plummeted in a question of minutes. If we look at performances over the last month, we see the Nikkei 225 down the most (-10.6%) and the S&P 500 down 4.4%. In Europe, the EuroStoxx is down -6.9%, the sectors registering the biggest losses being Energy (-11.8%) and Materials (-6.6%).

So, in the drop Europe has once again underperformed the US. At the new lower levels, the US market is trading on a P/E of 16x, with EPS of USD 160 for this year, so far more attractive multiples, even more so if we bear in mind that following the last quarterly results 75% of companies have raised their full-year guidance for 2018. In Europe, the Stoxx Europe 600 is trading on a P/E 2018 of 14.5x, versus its historic average of 15x.

It is probably a good moment for buying the laggards, but providing we are properly prepared for the ride (both up and down).

X. Torres

Chart 8. S&P 500 versus its earnings

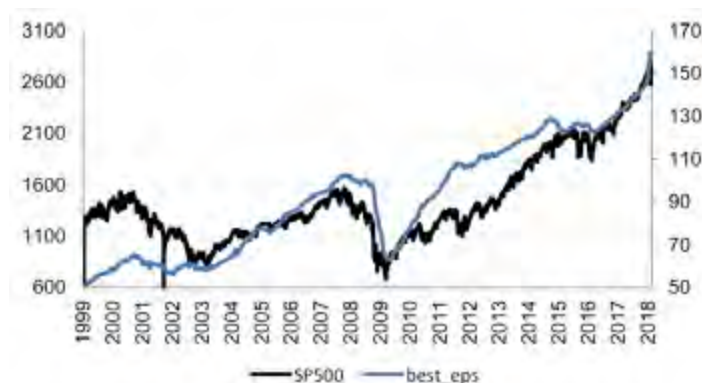


Chart 9. IBEX 35 versus its earnings



No pain, no gain

What a January that was! The first few weeks, full of complacency and continued festive spirit, gave rise to gains in equity markets around the globe; but this then gave way to a bout of global nerves and a dramatic increase in volatility that has made investors shake from top to bottom. However, and despite these violent movements, we remain positive on equities, both in Europe and the US. The starting points that we mentioned last week have not been broken and, even though the bull structure has taken some damage, it is too early to turn bearish. We are not expecting a V-shaped recovery like the one that followed Brexit, but rather a consolidation at current levels over the coming weeks. The Eurostoxx 50 chart shows how the support at 3,350 worked properly, and it also indicates a short-term target level of 3,535. Another market movement that we believe to be important but that has drawn little comment in the last few days is the EURUSD; the euro remains strong and actually hit a new high last week. We believe this movement could continue to 1.27, level at which we could well see a correction. We need to keep a close eye.

G. Apodaca

Chart 10. Eurostoxx future (daily) with 200-day moving average

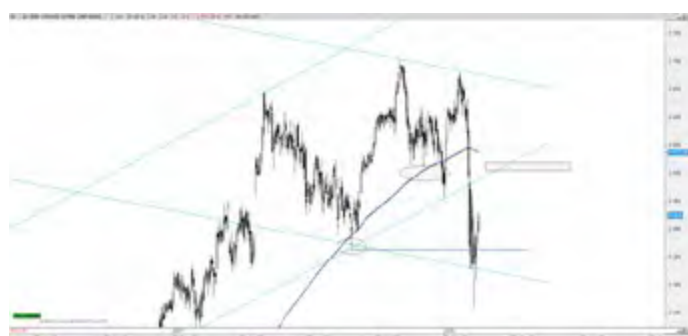
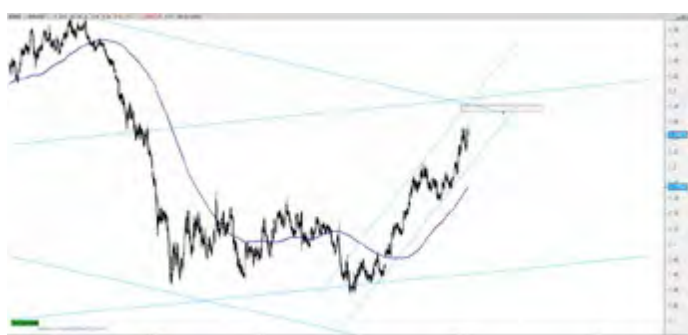


Chart 11. EURUSD future (daily) with 200-day moving average



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currencies

It's awake!

In December, we wrote that 2017 had been a year of low volatility but that it would be difficult for the situation to continue. Central banks globally are starting to introduce markets to the idea of monetary normalization, and history has shown us that when such pieces are moved volatility rises (see 2010, 2012, the end of 2015, or the start of 2016).

Since December, 30-day volatility on the dollar index (DXY) has doubled. The US currency remains weak across the board. We also highlight the rises of the JPY, NOK, and CHF (all up more than 5% YTD), interestingly the most undervalued currencies on PPP. Among the emerging currencies, the MXN stands out, also undervalued based on PPP.

The technical levels on the DXY are of utmost importance: 88 has been a key level since the 90s, and the market's collective memory has determined that this is where the double bottom should be formed, along with a bullish divergence in the RSI and all this coinciding with a 50% retracement of the rally since 2011. If it were to lose this level, the correction could be down to 80 or 72.5.

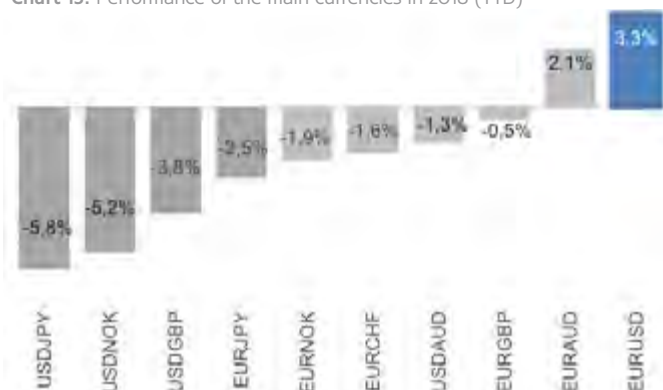
This means a double top for the EURUSD, with a bearish divergence in the RSI and all this not so far from the key level of 1.27-1.28 (bearish trend line from 2008). Here, the fundamentals (interest rate spread), extreme speculative positions, and bullish consensus on the EUR suggest that things should be moving in the dollar's favour, at least in the short term.

T. García-Purriños

Chart 12. Volatility on the Dollar Index (30d)



Chart 13. Performance of the main currencies in 2018 (YTD)



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commodities

Timid reaction from gold

We said in January that some of the factors influencing the price of Brent were short-term ones, and we suggested that the risk was more to the downside. However, this contradicted our 12-month bullish outlook, and it is why we maintained a neutral position. For the moment, we are not changing our view, but we do see the zone at USD 58 as important, and it is around this level that we may start to buy oil again.

For several months now, we have been defending the idea that the cycle has changed for the oil price, and it is our belief that we are looking at the beginning of a new bull phase. Demand is building, the economic backdrop is strong, production remains under control, and the demands on shale to balance out the market (output increases of more than 30%) are complicated to achieve.

There are risks. OPEC is not a monopoly, and shale's capacity to react has surprised often enough to be taken seriously. Even so, we still believe a change in the cycle is on the cards.

As for gold, as often happens when market volatility rises, the increase in correlation between assets has taken away some of the metal's shine as a safe-haven asset. But it has held up relatively well. It is also true that a gap has now opened up between real interest rates and gold, but we don't expect this to last and we are leaving our positive stance unchanged.

T. García-Purriños

Chart 14. Gold and VIX

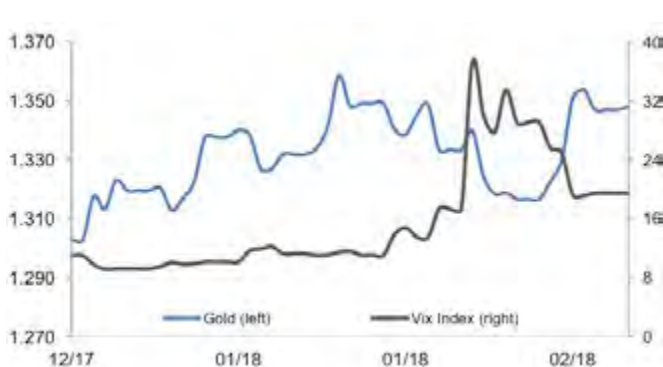
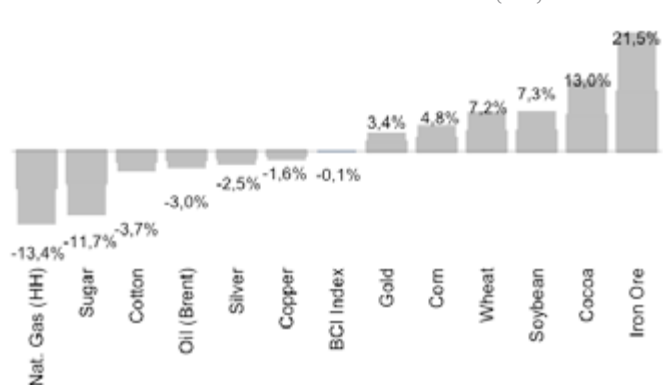


Chart 15. Performance of the main commodities in 2018 (YTD)



Socially responsible investing finds its niche

Socially Responsible Investing (SRI) is nothing new, although it has a much longer history in Nordic countries; and in others, such as France, it is gaining importance. One of the main references is the Norwegian sovereign fund, which manages the funds generated by the country's oil exploration, and it tends to be a trend setter.

There are several ways of setting about SRI. The most intuitive and the first to be used was an exclusionary approach: for example, not investing in tobacco companies, alcohol companies, arms manufacturers, or companies experimenting with animals. Countries were excluded based on human rights records, for example.

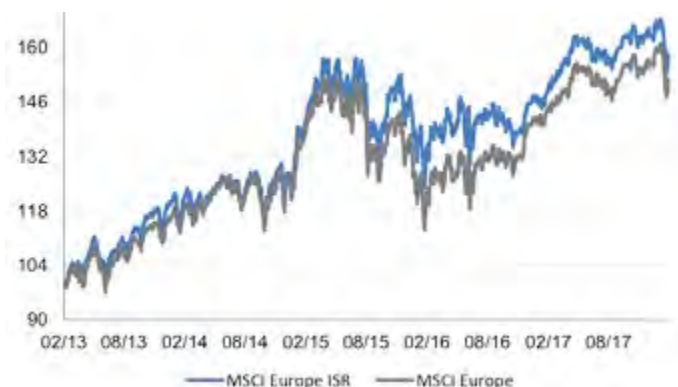
But the approach is increasingly thorough, the aim being to follow the best ESG (Environmental, Social And Governance) practices.

In developed markets (both Equity and Fixed Income), there is in-depth coverage by analysts and a growing concern among companies to meet with SRI criteria. However, in emerging countries it is very much a matter pending, and it is the same with small caps. It is a gap that ought to be filled over the next few years, but for now it presents fund managers with fewer options.

In terms of results, investing in this way does not need to be synonymous with sacrificing returns. There are studies that show how over the long-term companies with high ESG ratings obtain above-average returns, at less volatility. A look at some of the SRI indices corroborates this.

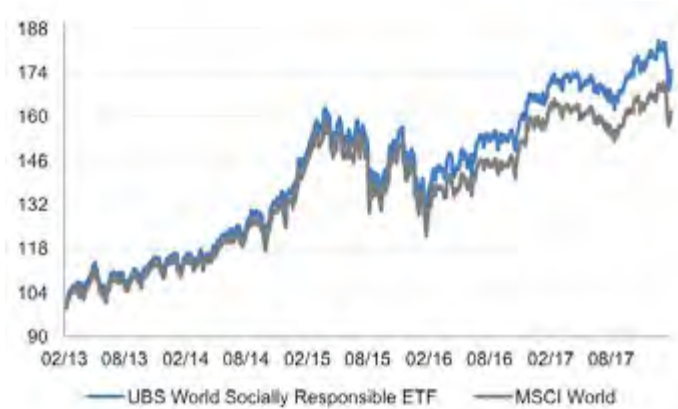
J. Hernando

Chart 16. MSCI Europe SRI vs MSCI Europe (5 years)



Resource: Bloomberg

Chart 17. ETF ISR Global vs MSCI World (5 years)



Resource: Bloomberg.

Powell's Black Monday

The recent sell-off in equity markets is a timely reminder of how inherently unstable the financial system is. The trigger, a larger than expected increase in Average Hourly Earnings in the US, cannot itself explain such a violent gyration.

In fact, US Treasury yields have been steadily raising since the summer, when macro data clearly evidenced a positive economic momentum globally. With all major economies running at or close to full potential, and little slack in the labor market, higher real interest rates were to be expected.

Overall, market observers have been circumscribing the problem of rising yields to the bond market, and have expected equities to continue performing positively on the back of earnings growth from a stronger economy. But you cannot have your cake and eat it too, and if rates rise faster than earnings, a compression in P/E multiples becomes unavoidable.

However, none of this can explain the violence of the recent sell-off. The explanation rather points towards a combination of technical factors (stop-losses, automated trades) behind the speed of the fall at the end of the trading session on Monday 5th.

As we do not see any fundamental reason that would support a crash, we recommend to stay calm and take some time to assess whether the "Goldilocks scenario" is dead and we are moving into reflationary territory, or if this is just a needed correction whilst the market digests how to price in a higher rate environment.

Shortly after Alan Greenspan took over the reins at the Fed, he was confronted with the Black Monday Crash, when the Dow – inexplicably – dropped by 22.6%. Just getting off a plane, he rushed to release the following statement:

"The Federal Reserve, consistent with its responsibilities as the Nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system"

This strong – though vague – message helped to assure markets and avoid an economic crisis. However, it gave birth to an era of investor dependency on central banks; an addiction that has only worsened over the years. Jerome Powell was sworn-in as the new Fed chairman the very day the correction began; so stay tuned for his first dose of sugar to the markets after his first Monday in office.



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Equity

16/02/2018	LAST	PRICE	CHANGE 1M	CHANGE YTD
INDEXES				
MSCI World		2.138	-3,2%	1,5%
MSCI Emerging Markets		1.200	-2,6%	3,7%
S&P 500		2.732	-3,0%	2,0%
Nikkei 225		19.910	-7,9%	-3,7%
EuroStoxx 50		3.427	-6,0%	-2,1%
FTSE 100		7.295	-6,4%	-5,9%
DAX		12.452	-7,2%	-3,5%
Ibex 35		9.832	-5,8%	-1,7%
CAC 40		5.282	-4,4%	-0,6%
FTSE MIB		22.798	-4,8%	3,4%
PSI 20		5.505	-4,3%	1,1%
Athex		846	-0,7%	4,9%
Hang Seng		31.115	-3,2%	3,2%
Bovespa		84.525	5,0%	11,7%
Micex		2.255	-0,7%	7,6%

SECTORS

16/02/2018	LAST	PRICE	CHANGE 1M	CHANGE YTD
Consumer Discretionary		251,9	-1,4%	5,1%
Consumer Staples		232,3	-4,3%	-2,7%
Energy		211,6	-9,7%	-5,5%
Financials		130,8	-2,8%	2,8%
Industry		266,2	-3,7%	1,8%
Materials		283,0	-4,5%	0,6%
Health Care		233,0	-3,1%	2,1%
Technology		232,5	-1,6%	5,4%
Telecommunication		68,7	-2,8%	-3,3%
Utilities		121,5	-2,6%	-4,6%

16/02/2018	LAST	PRICE	CHANGE 1M	CHANGE YTD
IBEX-35				
BBVA		7,1	-5,2%	-1,4%
Inditex		26,8	-4,4%	-6,0%
Repsol		13,9	-9,4%	-4,3%
Santander		5,6	-4,6%	3,2%
Telefónica		7,6	-7,7%	-6,2%
BLUE CHIPS EUROPE				
Siemens		111,2	-9,2%	-3,3%
Total		45,9	-1,5%	1,1%
Sanofi		64,5	-11,7%	-10,4%
SAP		84,3	-8,4%	-9,5%
Anheuser-Busch InBev		85,2	-9,8%	-8,6%
Daimler		72,5	-6,3%	-0,7%
BNP Paribas		64,7	-3,1%	4,2%
LVMH		248,5	1,7%	-0,2%
Deutsche Telekom		13,2	-8,3%	-10,5%
BLUE CHIPS US				
Apple		172,4	-2,6%	2,7%
Microsoft		92,0	2,7%	8,0%
Johnson & Johnson		133,2	-10,9%	-6,0%
Amazon		1.448,7	13,5%	25,6%
JPMorgan Chase		114,7	1,3%	7,0%
General Electric		15,1	-9,0%	-15,2%
AT&T		37,1	-1,0%	-5,3%
Pfizer		36,3	-1,8%	0,1%

FX

16/02/2018	LAST	PRICE	CHANGE 1M	CHANGE YTD
EURUSD		1,2406	0,8%	2,8%
EURCHF		1,1511	-2,2%	-1,4%
USDJPY		106,21	-3,5%	-4,9%
GBPEUR		1,1310	-0,5%	0,7%
AUDJPY		83,96	5,0%	-3,8%

Fixed Income

16/02/2018	LAST PRICE	CHANGE 1M	CHANGE YTD
GOVERNMENT BONDS			
	YTM	bp	bp
Treasury 2y USD	2,19%	15,4	33,6
Treasury 5y USD	2,63%	21,1	45,4
Treasury 10y USD	2,87%	24,0	49,3
Bund 2y EUR	-0,57%	9,6	12,0
Bund 5y EUR	0,07%	21,8	28,0
Bund 10y EUR	0,70%	16,0	30,2
CDS			
	Spread	bp	bp
ITRAX EUROPE 5Y	51,5	8,7	7,6
ITRAX EUROPE 10Y	92,4	12,2	10,4
ITRAX EUROPE SR FIN 5Y	51,4	11,7	10,1
ITRAX EUROPE SUB FIN 5Y	108,4	14,2	10,4
CDX USA 5Y	51,7	5,7	3,8
SOVEREIGN SPREADS			
	Spread	bp	bp
Spain / Germany 10y	75,1	-7,3	-33,8
France / Germany 10y	24,6	-0,9	-9,1
Italy / Germany 10y	121,7	-8,8	-25,1
Ireland / Germany 10y	-8,6	5,7	-5,1
Portugal / Germany 10y	130,2	-9,6	-20,2
BREAKEVENS			
	Rate	bp	bp
Germany Breakeven 10Y	1,32%	0,0	1,0
US Breakeven 10Y	2,10%	3,7	12,6
UK Breakeven 10Y	3,14%	0,8	8,8
HY & EM SPREADS			
	Spread	bp	bp
BarCap US Corp HY	341,0	20,0	-2,0
JPM EM Sovereign spread	308,8	11,0	-2,2
CS EM Corp Spread vs. DM	205,6	1,3	-4,6

16/02/2018	LAST PRICE	CHANGE 1M	CHANGE YTD
IBEX-35 CDS 5Y			
		bp	bp
BBVA	50,9	12,1	8,2
Iberdrola	42,8	4,6	0,7
Repsol	49,2	4,7	1,7
Santander	40,0	10,0	7,1
Telefónica	75,6	8,3	2,6
BLUE CHIPS EUROPE			
		bp	bp
Siemens	21,9	0,6	-1,2
Total	25,6	1,2	-0,8
Sanofi	25,1	3,1	-0,8
SAP	24,2	n.a.	n.a.
Anheuser-Busch InBev	n.a.	4,4	5,9
Daimler	42,5	8,2	5,8
BNP Paribas	27,2	4,5	4,6
LVMH	25,1	3,6	-0,1
Deutsche Telekom	33,7	3,8	0,6
BLUE CHIPS US			
		bp	bp
Apple	24,9	n.a.	n.a.
Microsoft	25,5	n.a.	n.a.
Johnson & Johnson	16,7	0,8	3,0
Chevron	97,1	-1,1	n.a.
JPMorgan Chase	44,0	6,7	6,7
General Electric	97,0	-1,4	-3,1
AT&T	67,7	2,3	3,1
Pfizer	25,3	5,2	6,8

Commodities

16/02/2018	LAST PRICE	CHANGE 1M	CHANGE YTD
Gold (USD/oz)	1.347,0	0,4%	2,6%
Copper (USD/t)	7.233,0	1,1%	-1,8%
Crude Brent (USD/bbl)	64,8	-4,6%	-2,0%
Corn (USD/bushel)	367,5	4,6%	5,1%
GSCI Commodity Index	443,6	-1,5%	0,3%



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