MORABANC
asset management

MARKETS AND STRATEGIES

> JANUARY 2019

Goodbye 2018

I don't think we investors are going to be very sad to see the back of 2018! At the close of the year, virtually all asset classes were down over the 12 months, meaning there was no safe haven. In equities, for example, October was once again the worst month of the year. And, instead of providing the much touted Christmas rally, December was the worst for 30 years. Almost all the MSCI World sectors registered negative returns (if it hadn't been for the bounce on the 31st, all of them). There were few exceptions among developed and emerging markets either (in terms of USD returns, there were no exceptions). In fixed income, credit spreads widened, particularly emerging and high yield spreads. Commodities too were down. And nearly all currencies lost ground versus the USD. Most alternative funds and hedge funds registered poor results too. This made for the perfect backdrop for one of the year's trending topics among investors, which was that chart that shows 90% of assets in the red, for the first time since the early 1900s.

> We cannot ignore the fact that bearish consensus, fear, and small positioning, in conjunction with attractive valuations and positive economic growth tend to coincide with market floors.

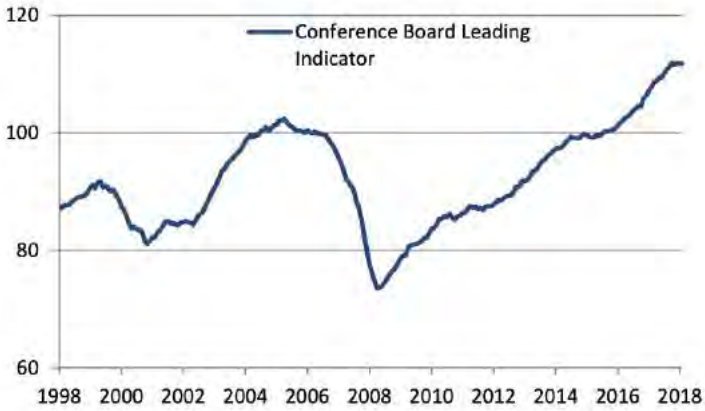
It is perfectly understandable that market players have begun 2019 with such small positions, with such negative sentiment, and without any real belief in the bounces we have seen since the beginning of the month. What is more, everyone's market outlook for 2019 follows the same line: be cautious! But it is also true in situations like the current one that in the investment world there are opportunities. We cannot ignore the fact that bearish consensus, fear, and small positioning, in conjunction with attractive valuations and positive economic growth tend to coincide with market floors.

Obviously, the reliability of this floor will depend on the economy and the companies. Regarding the economy, we are certainly seeing less activity, but by no means does this suggest a change in cycle. With job creation, consumer confidence, and leading indicators continuing to hit all-time highs, we need to be careful about predicting an imminent recession. It is true that other sentiment indicators have weakened, and so too has activity in China, especially that relating to international trade. But markets have priced this in and more, and in the end it has encouraged both the Fed to ease off with its monetary normalisation process (thereby reducing the risk of error in monetary policy that was so feared by the market) and governments to speed up their negotiations, thereby diminishing political risk.

As for companies, we have seen over the last month how both management and analysts have been lowering forecasts ahead of the forthcoming results presentations. The important thing to focus on in these will be management's outlook and how the geopolitical uncertainty is going to affect their guidance. This itself will provide an incentive to politicians to speed up talks and reach agreements sooner than expected.

In the same way that 2017 was exceptionally good, 2018 has been exceptionally bad. So we find ourselves repeating ourselves: never trust the extremes! That is to say, we shouldn't expect a year of clear blue skies; but at the same time, storms don't last forever, and they are always followed by calm.

Chart 1. Conference Board Leading Indicator



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Risk analysis

China and the US have speeded up their negotiations to such a point that Trump himself has tweeted what a "tremendous success" they are. But these comments also coincide with the first indications in the macro data that the trade dispute is taking its toll on the growth rates of both giants. As a result, the Chinese government is already preparing fiscal measures, and the Fed has shown itself to be more cautious about the speed of interest rate normalisation. As for the other geopolitical fronts (continued government shutdown, the possible investigation of Trump, Italy, the Greek government crisis, etc), these don't appear to worry the market. Even Brexit is unable to spook it, and this despite continuing to make all the headlines. In the end, the UK government may have gained some breathing space, if the rumours of a delay to the start date are confirmed.

Strategy: negative sentiment continues

Macro outlook. Despite the drop off in activity, the data is far from worrying and the worst would appear to be in the price. This, together with the fact that geopolitical risks have diminished, appear to be the first building blocks towards a sustainable floor under risk assets. Add to this the fact that investor sentiment remains cautious, hedge fund and institutional positions are still small, and the fact that valuations are more attractive than for several years, and we have enough arguments to justify sticking to our position.

Equity. The 4Q results season is now underway. After several weeks of management and analysts lowering forecasts, the worst may well be factored into prices. What is more, profits under pressure and, above all, guidances and managment comments that show concern about the political uncertainties are only likely to encourage governments to reach agreements.

Fixed income. While less dynamic, against a backdrop of economic growth and recovering wages, inflationary pressure is inevitable, and we remain long ILBs. We maintain our positions in credit and in emerging debt, albeit selectively. We remain bullish on Europe, and we are buyers of peripheral debt.

EURUSD. We are sticking to our bearish stance on the USD, basically due to the USA's twin deficits. Versus the EUR, our models point towards a target level of 1.20. We therefore stick to our target range of 1.15-1.20.

Commodities.Following the recent rebounds, gold has lost its attraction and we have unwound our positions for tactical reasons, even though we remain strategically OW. As for oil, we continue to believe in its recovery and we see a balanced market for the end of 1Q19, which should ensure a price back above USD70/bl.

Chart 2. Main risks

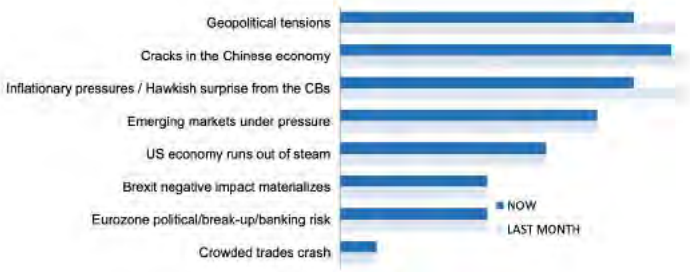
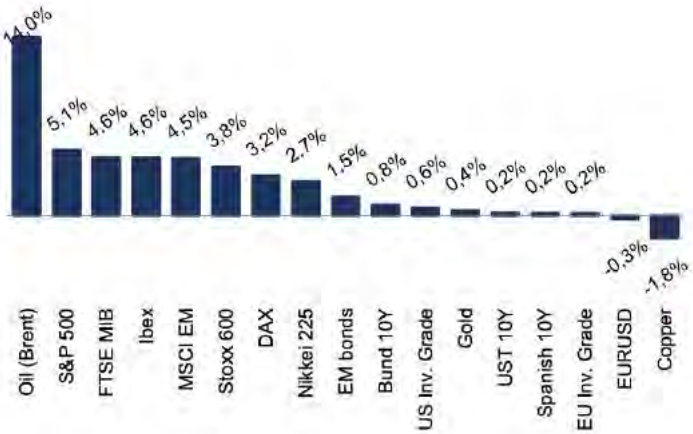
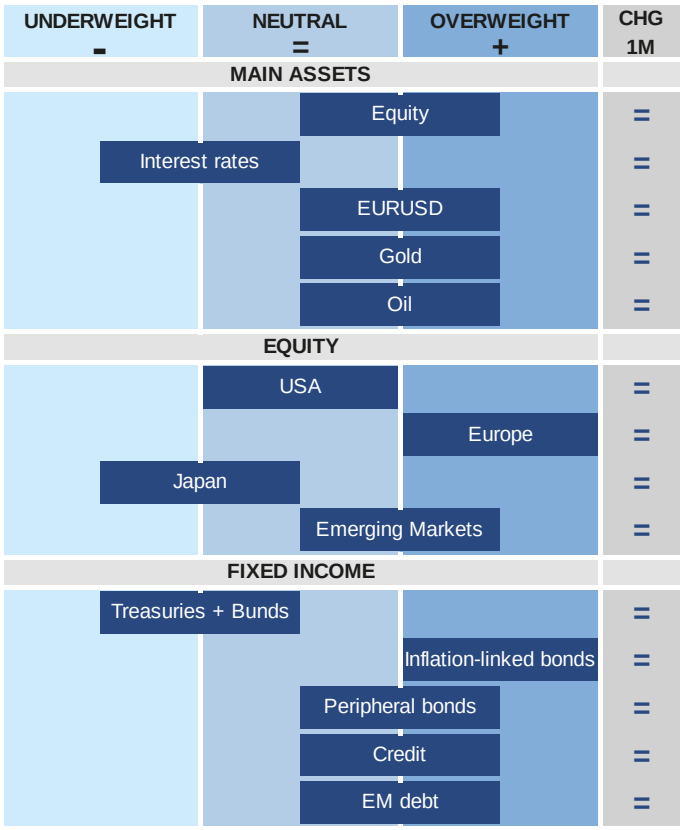


Chart 3. Total returns in december*



*Dollar denominated returns on the MSCI EM Index and emerging bonds

Chart 4. Asset allocation



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macroeconomy

A good start to 2019

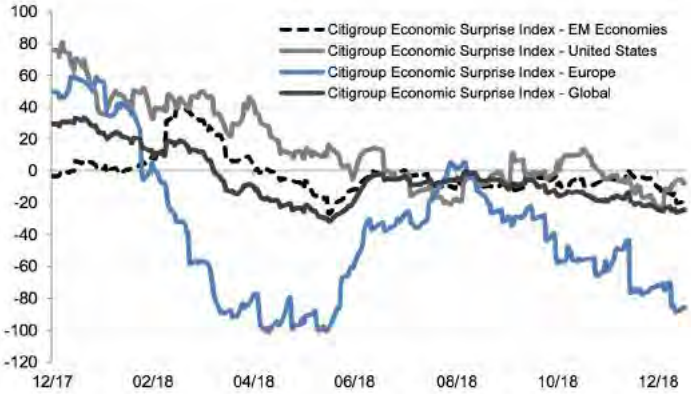
While in the last publication we were talking about an end to 2018 dominated by uncertainty and volatility in risk assets, the outlook at the beginning of 2019 is bright (many of the negative trends of 4Q18 having been reversed), even though the recent deterioration in several figures and global macroeconomic data would suggest we need to stay patient and cautious. Not only are there few global economic surprise indicators in positive territory, which suggests a period of macroeconomic weakness, but manufacturing output figures also continue to weaken, as well as inflation numbers and interest rates.

In terms of geopolitics, the new year has started with a bit of everything. On the one hand, the House of Commons has rejected by a significant majority (2 out of 3 members) the Brexit proposal that Theresa May had agreed with the EU; and on the other, even though progress between the US and China on the trade front appears good, the former is facing other uncertainties, such as the government shutdown and continued tension in domestic politics. And bearing in mind the seriousness of the issues pending, we should be prepared for unexpected movements during 1H19.

R. Giménez

News	Events
The Commons in the UK rejects the Brexit agreement with the EU by a significant majority	22/JAN/19. France and Germany sign and ratify extension to Élysée Treaty
The Yellow Vest movement goes viral at a rapid pace around the world	24/JAN/19. ECB interest rate decision
France and Germany continue to closen their ties	30/JAN/19. First estimate for 4Q18 GDP in the US
Rising tensions between the US and Turkey over the Kurdish conflict in Syria	20/FEB/19. Minutes from FED/FOMC interest rate meeting on Jan 30

Chart 5. Macro data continues to fall short of expectations



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fixed income

Debt markets in 2019

2019 has begun the way 2018 finished, with core rates falling and with credit appearing to have stabilised and likewise peripheral risk premiums. On January 3, the German 10-year was yielding less than 0.15%, lowest level since 2017. The turbulence in Europe and the rest of the world are going to remain key to the shifts between risk-on and risk-off in government and corporate debt markets and other financial assets. And Brexit, the Italian deficit, and Trump's continued trade war will remain the main risk factors for markets around the globe.

As for central banks, the ECB's stance was unequivocally dovish during the whole of 2018, despite the announced end to QE in December, and it looks likely to maintain this position at least for 1H19. While the Fed, following its hawkish 2018 (four rate rises of 25bp each and shrinking of its balance sheet) appears to be shifting a bit towards a more dovish stance for 2019.

And finally credit: the Itraxx Crossover is below 335bp, having reached 370bp on January 3, and the Investment Grade index in Europe is narrowing (currently close to 80bp). Emerging market debt underwent a turbulent final quarter to 2018, and the EMBI Global Spread index reached 440bp at the beginning of this month before falling back to its current 405bp.

M. Soca

Chart 6. Risk premiums

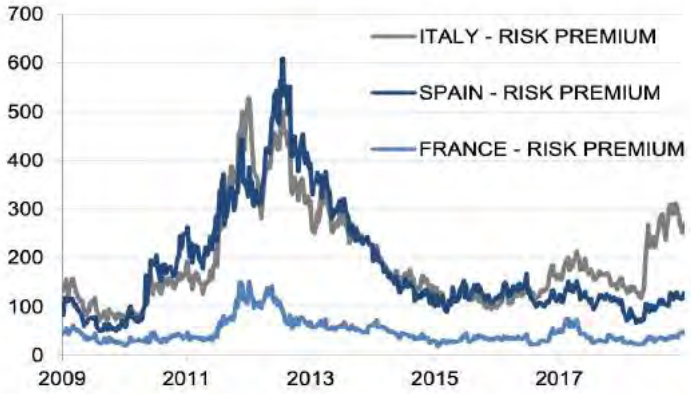

Chart 7. Inflation risks in Europe

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equity

Finally Brexit?

2019 is here and we are still talking about Brexit and its effects; but, after more than two years, we are finally going to be able to see how markets react ...when the real thing gets underway. And the most interesting of all will be to see whether the worst-case scenario is actually priced in, or not. This month, the 4Q19 results season kicks off and is likely to be the markets' main focus, despite the fact that analysts have been lowering their forecasts for months. For example, the consensus forecast for earnings growth on the S&P500 as slid from +18% back in September to its current level of +11%. So, expectations have been well adjusted, suggesting that actual earnings figures may come as a pleasant surprise. At the wider global level, earnings revisions have been almost as drastic as they were back in 2008 and significantly more aggressive than in 2015 and 2011; the end result being that the market is discounting an extremely negative scenario for the economy short-term. After their major corrections last year, equity markets are once again moving in synch with credit markets. This trend is likely to continue, and we need to track it carefully. Meanwhile, Emerging Markets have started 2019 well, the MSCI rising +3% and Brazil +7%. Sectors that have stood out since the beginning of the year: Utilities (-2.5%) and Consumer Staples (-2.5%), and Materials (+3%) and Consumer Discretionary (+2.4%).

Brexit permitting, let's see if we can start to build a positive trend after the horrendous last few months!

X. Torres

Chart 8. SP500 vs earnings

Chart 9. IBEX 35 vs earnings

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equity / technical analysis

Still hope for a good 2019?

The main global markets continued to take a beating right through to the end of the year. The bounces we have seen in January do offer some hope, but they don't change significantly what is still the start of a new bear cycle.

Updating the EuroStoxx 50 chart, we can see how the index has lost the middle section of the double bear channel and seems to be starting a pull-back, which has yet to be completed; and if the December lows are broken, the market could be going down to 2,600.

As for the US indices, despite having recovered more vigorously after the falls, we see how the S&P500 future appears to be approaching a significant resistance level; this forces us to be more defensive, at least until the resistance is broken.

On the EUR/USD, the floor that we highlighted at around 1.13 appears to have been consolidated, suggesting that we could see further EUR strength over the coming months.

G. Apodaca

Chart 10. Eurostoxx50 (daily) future

Gráfico 11. Futuro S&P 500

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currencies

To hedge or not to hedge?

The main arguments against hedging currencies in the asset allocation process focus on the complications involved in forecasting the hedge's performance, something that often exceeds the manager's scope. On top, if the focus is companies it is not easy to know the exact breakdown of their currency exposure: more important than the currency in which a company's shares trade are the currencies in which it pays its expenses and generates its income.

At the same time, from a risk perspective hedging can reduce a portfolio's volatility, particularly if the returns on the currency show a positive correlation with that on the portfolio's assets. Mathematically, the variance of a portfolio made up of two assets is the sum of the variances of these plus two times the product of its deviations and its correlation. Therefore, if there is a negative relationship between the currency and the other asset (e.g. JPY and the Nikkei) adding both to the portfolio will reduce its volatility. On the other hand, if this relationship is positive, the risk will increase.

Against this backdrop, the way currencies correlate with other asset classes means that it is worth viewing the currency as an asset in itself. Over the medium term, it may be worth hedging these currencies, especially those with higher risk and a higher correlation with other assets in the portfolio. And active management of the hedges can boost the portfolio's returns and reduce its volatility.

T. García-Purriños

Chart 12. Currency market volatility

Chart 13. Performance of the main currencies in 2019 (YTD).

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commodities

Truths and myths about commodities

In June 2004, Gary Gorton and K. Geert Rouwenhorst published a study that has become a must-read: "Facts and Fantasies about Commodity Futures". They studied between 1959 and 2004 the performance of an evenly-balanced portfolio of commodity futures (in June 2015, they published a revision through to 2014 with no significant changes to results).

In terms of returns, the portfolio showed a similar performance to that of equities and a higher performance than both inflation over the same period and also a portfolio made up of the assets underlying the futures. They thereby corroborated the theory that defends the premium that the hedgers pay to futures speculators for assuming the market risk (normal backwardation).

As far as risk is concerned, the portfolio of commodities futures registered a lower standard deviation (volatility) than equities (and therefore a higher Sharpe ratio), but a higher one than bonds. The breakdown of the portfolio's results was characterised by its positive symmetry (compared with the negative symmetry of the shares) and a higher curtosis. A breakdown with positive symmetry is a sign of lower tail risk.

All the above added to the fact that commodities and other asset classes register different performances, depending on the stage of the cycle we are at, which raises their attraction substantially when it comes to asset allocation.

T. García-Purriños

Chart 14. Equities vs 90% Equities / 10% Commodities

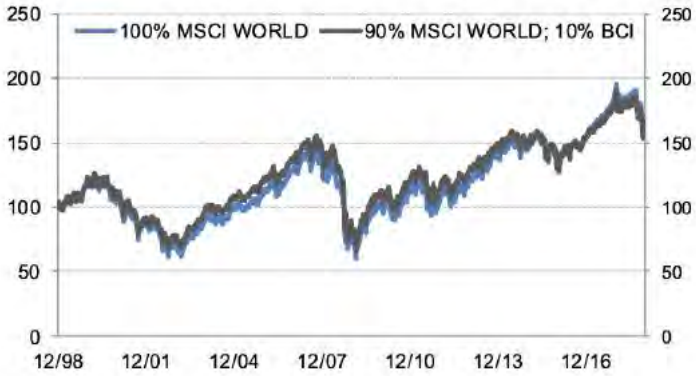
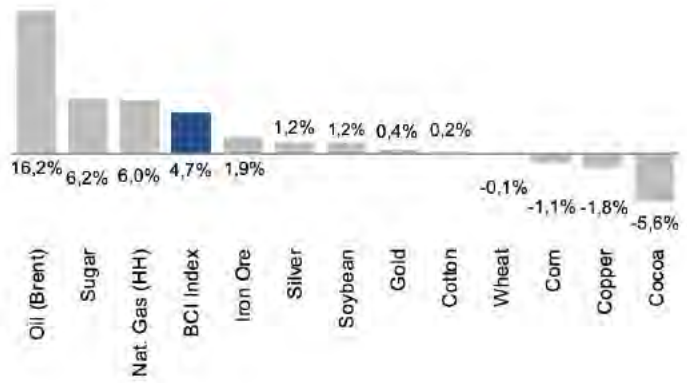


Chart 15. Performance of main commodities in 2019 (YTD)



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Applying big data to asset management

Big data or the use of data on a massive scale is one of the fastest-evolving themes of the last few years. It can be used in our daily lives, from the management of traffic flows to the mobility of cities, the setting of consumer patterns, or virtually any other aspect of our day-to-day. And of course, big advances are being made in this area in asset management too.

The general idea is that the use of big data enables the taking of better-informed decisions, where the weight of intuition or opinions taken as certain (and often without validation) is reduced and more importance is given to facts backed up by data complied on a massive scale. And the figures are stunning: according to IBM, 90% of the data has been generated in the last two years; and of this extraordinary figure, only 2% is being analysed- i.e. the margin for growth is spectacular.

In terms of asset management, this all comes into play at a more basic level, which is the way funds invest in the Big Data theme itself. At the end of the day, what they tend to do is focus on those companies most immersed in researching the trend from the technological angle, such as Google or IBM. While this is not a bad approach, it is incomplete if it is not complemented with companies that stand to benefit over the coming years in sectors such Finance, Healthcare, and Energy.

Another focus in our sector is the use of big data as a tool for taking decisions with a greater level of knowledge. There are some good examples, such as retail companies studying activity in their stores by analysing the traffic in the car parks, patterns that could be used for estimating sales; and then e-commerce changed the focus from the analysis of car park flows to website flows or payment method flows. In short, the potential is huge as a tool, and there will be positive applications within the asset management business.

J. Hernando

Chart 16. 3-year performance of big data tools fund

Source: Bloomberg

Chart 17. 3-year performance of big data theme fund

Source: Bloomberg

End-of-cycle anxiety

The current economic expansion in the US is only five months away from being the longest ever recorded. And with unemployment near historic lows, and consumer and business confidence showing great strength, it is difficult to foresee an imminent derailment of the US economy.

However, human minds function largely on the basis of anticipation, and investors have been worried lately about the possibility that the economy will go into recession in 2020; causing a sharp fall in the price of risk assets

There are a number of reasons behind such a grim outlook. The expected fading of the stimulus caused by the tax reform – and the burden generated by the resulting deficit – the end of an era marked by (brazen) support from central banks, concerns about a possible trade war, but also a certain "altitude sickness" caused by the longevity of this cycle.

All these factors indicate that the best is already behind us, and that we are entering a new phase with fewer positive stimuli, in which avoiding a recession will depend on economic agents managing the decline in a responsible manner.

Facing the end of a cycle requires psychological strength. As football fans know well, it's hard to see your team go from glory to mediocre performance. Decadence is not a linear process. After a good day, there is always the temptation to think that it is still possible to stay on top, only to fall into despair when the team stumbles again.

Consumers, investors and business leaders are experiencing a similar process, since macroeconomic data show mixed signals. Keeping up the economy is a social enterprise, and the temptation to "piggy-back" is large. If economic agents reduce consumption and investment as a result of worsening data, they can aggravate the slowdown and lead the economy into a recession, if on the contrary they remain calm, the current expansion will continue.

This type of end-of-cycle anxiety is aggravated by the fact that the previous two recessions coincided, or rather, were triggered, by the collapse of a stock market bubble, and a once-in-a-century financial crisis. These caused the S&P 500 to fall from its highs by -48% and -58% respectively; forging a generation of traumatized investors for life.

But not all recessions are equal and, for example, during the two "standard" recessions experienced in the 80s and 90s, the stock market fell by only -25%. Taking into account that since the peak of October last year, the S&P already corrected -20%, long-term investors should not be too worried.

Of course, the nature of the next crisis is still unknown; it can be a shallow recession followed by a rapid recovery, but it can also be a depression if, for example, China implodes. In addition, there is great concern about the room for maneuver that policy-makers will have when the next crisis finally hits, since fiscal and monetary tools have largely been exhausted.

Time will tell whether we will face a "relief recession," that helps dissipate accumulated anxiety, or a severe depression. What we do know is that timing recessions is extremely difficult and that sitting in cash waiting for the next one to come can have a large opportunity cost. Therefore, it is advisable to focus on identifying companies with business models that can withstand economic cycles well, instead of trying to guess the future by reading the tea leaves.

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Equity

18/01/2019	LAST PRICE	CHANGE 1M	CHANGE YTD
INDEXES			
MSCI World	2.001	9,0%	6,2%
MSCI Emerging Markets	1.018	6,3%	5,4%
S&P 500	2.671	10,5%	6,5%
Nikkei 225	20.666	2,7%	3,5%
EuroStoxx 50	3.135	4,2%	4,1%
FTSE 100	6.968	3,8%	3,7%
DAX	11.206	4,9%	5,7%
Ibex 35	9.069	5,8%	6,0%
CAC 40	4.876	3,7%	2,9%
FTSE MIB	19.708	6,4%	6,8%
PSI 20	5.068	9,6%	7,7%
Athex	617	1,4%	0,6%
Hang Seng	27.091	5,6%	5,2%
Bovespa	96.097	12,1%	9,3%
MOEX Index	2.474	5,5%	4,6%
SECTORS			
Consumer Discretionary	238,8	11,1%	7,0%
Consumer Staples	214,7	3,2%	2,8%
Energy	200,6	11,8%	9,8%
Financials	111,6	11,4%	8,3%
Industry	236,2	10,2%	7,4%
Materials	240,0	7,9%	5,4%
Health Care	240,2	7,9%	4,5%
Technology	224,8	10,2%	5,5%
Telecommunication	65,8	9,9%	6,7%
Utilities	128,9	1,1%	2,4%

18/01/2019	LAST PRICE	CHANGE 1M	CHANGE YTD
IBEX-5			
BBVA	5,2	12,0%	11,6%
Inditex	23,8	4,9%	6,8%
Repsol	15,0	4,0%	6,1%
Santander	4,4	10,0%	8,8%
Telefónica	7,7	2,5%	4,6%
BLUE CHIPS EUROPE			
Siemens	100,6	2,4%	3,3%
Total	47,8	2,9%	2,6%
Sanofi	72,9	-3,1%	-3,1%
SAP	93,1	7,0%	6,4%
Anheuser-Busch InBev	64,8	8,4%	11,9%
Daimler	50,9	8,5%	10,6%
BNP Paribas	42,5	7,0%	7,0%
LVMH	253,4	1,2%	-0,6%
Deutsche Telekom	14,9	-2,7%	-1,4%
BLUE CHIPS US			
Apple	156,8	4,0%	-0,6%
Microsoft	107,7	9,7%	6,0%
Johnson & Johnson	130,7	2,0%	1,3%
Amazon	1.696,2	23,1%	12,9%
JPMorgan Chase	104,6	11,1%	7,1%
General Electric	9,1	26,7%	19,7%
AT&T	31,0	9,4%	8,5%
Pfizer	42,5	1,4%	-2,6%

Fixed Income

18/01/2019	LAST PRICE	CHANGE 1M	CHANGE YTD
GOVERNMENT BONDS	YTM	bp	bp
Treasury 2y USD	2,61%	-2,5	12,6
Treasury 5y USD	2,62%	-1,6	11,2
Treasury 10y USD	2,78%	-0,6	10,0
Bund 2y EUR	-0,58%	1,9	2,7
Bund 5y EUR	-0,33%	-4,6	-3,1
Bund 10y EUR	0,26%	0,2	99,8
ITRAX EUROPE 5Y	76,6	-13,3	-12,5
ITRAX EUROPE 10Y	121,8	-11,2	-9,9
ITRAX EUROPE SR FIN 5Y	94,2	-17,8	-17,6
ITRAX EUROPE SUB FIN 5	192,0	-35,6	-38,2
CDX USA 5Y	72,6	-18,1	-15,3
SOVEREIGN SPREADS	Spread	bp	bp
Spain / Germany 10y	108,3	-4,7	-706,8
France / Germany 10y	39,8	-4,9	-688,6
Italy / Germany 10y	246,8	-5,7	217,6
Ireland / Germany 10y	6,2	-5,9	n.a
Portugal / Germany 10y	146,6	4,8	-98,3
BREAKEVENS	Rate	bp	bp
Germany Breakeven 10Y	0,98%	0,0	2,0
US Breakeven 10Y	1,82%	5,8	10,9
UK Breakeven 10Y	3,14%	-4,9	-1,4
HY & EM SPREADS	Spread	bp	bp
BarCap US Corp HY	422,0	-42,0	-104,0
JPM EM Sovereign spread	388,5	-29,7	-46,2
CS EM Corp Spread vs. BM	280,1	-15,5	-26,3

18/01/2019	LAST PRICE	CHANGE 1M	CHANGE YTD
IBEX-5 CDS 5Y		bp	bp
BBVA	79,5	-15,2	-15,8
Iberdrola	72,1	-8,3	-8,6
Repsol	76,1	-9,3	-10,4
Santander	65,9	-7,6	-10,2
Telefónica	97,2	-6,6	-7,1
BLUE CHIPS EUROPE		bp	bp
Siemens	26,1	1,9	1,1
Total	33,8	-11,4	-11,4
Sanofi	30,6	10,5	10,5
BASF	48,4	-7,2	-7,9
Anheuser-Busch InBev	73,3	21,5	21,5
Daimler	89,4	-6,3	-7,4
BNP Paribas	61,9	-10,8	-13,4
LVMH	295,3	13,2	13,2
Deutsche Telekom	48,0	-4,5	-6,5
BLUE CHIPS US		bp	bp
Apple	97,4	1,0	0,5
Microsoft	99,5	1,0	0,6
Johnson & Johnson	29,2	-6,2	-7,7
Chevron	100,3	0,8	n.a.
JPMorgan Chase	61,1	-7,6	-8,0
General Electric	93,7	2,0	1,7
AT&T	114,1	-23,5	-25,2
Pfizer	31,1	-4,6	-5,7

FX

18/01/2019	LAST PRICE	CHANGE 1M	CHANGE YTD
EURUSD	1,1363	0,0%	-0,9%
EURCHF	1,1310	-0,4%	-0,8%
USDJPY	109,78	1,5%	0,1%
GBPEUR	1,1330	-1,9%	-1,8%
AUDJPY	78,68	0,1%	-1,4%

Commodities

18/01/2019	LAST PRICE	CHANGE 1M	CHANGE YTD
Gold (USD/oz)	1.282,1	1,7%	-0,3%
Copper (USD/t)	6.052,0	1,4%	1,5%
Crude Brent (USD/bbl)	62,7	15,6%	16,3%
Corn (USD/bushel)	381,8	-1,0%	1,8%
GSCI Commodity Index	413,2	8,6%	10,4%

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