Dynamism in markets and good macro data

Monthly Strategy Report March 2017

Equipo de Estrategia de Mercados de Banca March:
Alejandro Vidal, Unit Director, Market Strategies
Rose Marie Boudeguer, Service Director, Research Services
Pedro Sastre, Service Director, Market Strategies
Sebastián Larraza, Director, Discretionary Management Services
Paulo Gonçalves, Specialist Technician, Research Services
Miriam Ordinas Sanjuán, Specialist Technician, Market Strategies
Joseba Granero, Specialist Technician, Research Services
Dynamism in markets and good macro data

Financial markets progressed favourably on good macro data and corporate results. Financial markets progressed favourably throughout the month of February, driven by the publication of good corporate results, as well as positive macroeconomic data and leading indicators, which, in most cases, exceeded expectations, showing signs of strength and dynamism.

In the US, uncertainty about Trumps' fiscal policy persists…

In the US, Donald Trump remains unclear about the fiscal measures he intends to implement, though he will not include these measures in the budgets to be presented to Congress in March, until an in-depth cost analysis of the healthcare system is conducted. The market still awaits new clues about the infrastructure investment plan, as well as tax breaks for households and companies that the US president plans to implement.

…but he announced a 9.3% increase in defence spending and began deregulating the financial sector.

Meanwhile, Trump has already announced that he will increase defence spending by USD 54 billion, up 9% from 2016, by slashing funding to other departments considered less relevant. He also warned NATO member countries that the US would reduce its commitment to the organisation unless all members increase military spending to 2% of GDP. Also noteworthy is the signing of two executive orders by Trump, beginning the process of repealing Dodd-Frank, an Act passed in an effort to avoid new financial crises, which signifies the first step toward rolling back sector regulation.

In Europe, political uncertainty persists and Greece’s creditors will assess its commitments.

In Europe, France’s presidential polls are becoming increasingly significant. Macron’s candidacy has been buoyed by support from the centrist Bayrou, and he would win a second-round vote against the National Front candidate, Marine Le Pen, with 61% of the votes, according to Odoxa-Consulting polls. Meanwhile, in Italy, the former Prime Minister, Matteo Renzi, resigned as Democratic Party secretary, causing a rift in the party’s far left. In Greece, however, it is crucial that the next aid tranches are unlocked by creditors, who will send analysts to Athens to assess the commitments made by the Greek government. According to estimates, the country should have enough funds, without the need for new injections, to last until June, when a large portion of its debt is due.

In the United Kingdom, the House of Lords will vote on May’s bill.

In the United Kingdom, the House of Commons granted Theresa May the authority to trigger the Brexit with 498 votes in favour and 114 opposed, with no amendments submitted. Now the bill will head to the House of Lords, where an article related to the rights of European citizens residing in the country may be added. The date on which May will trigger article 50 of the Lisbon Treaty will depend on any amendments from the House of Lords, which could delay the Brexit’s intended activation in March.

The Fed could accelerate rate hikes in light of a robust economy.

With regard to economic activity, the macroeconomic data published remains largely positive. As such, Fed Chair, Janet Yellen alluded to further rate hikes to normalise monetary policy through gradual increases. The US economy continues to expand at a moderate pace, while the labour market shows signs of strength, with the creation of 227,000 new jobs in January, and inflation...
accelerating to 2.5% y-o-y (2.3% for the core rate). The probability of a rate hike in March is roughly 88%.

**ECB stimulus will continue.**

For its part, the ECB will continue its economic stimulus given the uncertainty of the political calendar in Europe and new protectionist measures that may be implemented by the Trump administration. However, it is worth noting the rebound in inflation, though on a temporary basis in this instance due to the rise in energy prices.

**The Bank of England improves 2017 growth prospects.**

The Bank of England kept interest rates at 0.25% and continues its £435 billion quantitative easing programme, although it issued an upward revision of UK growth expectations, from the 1.4% forecast for 2017 to 2%, despite the uncertainty surrounding the process of exiting the EU.

**The US confirms greater economic dynamism supported by private spending and the labour market.**

In the US, the macroeconomic data published remains positive and the uptrend in confidence continues. GDP grew +1.9% (annualised quarterly) in the last quarter of 2016, the main contributor being private spending, which advanced 3%. Likewise, retail sales rose 5.6% y-o-y in February. The labour market also remained robust, having added 227,000 new jobs in January. The PMIs are still in expansive territory, with marginal declines relative to January: the manufacturing PMI stands at 54.3 (-0.7 points), the services PMI at 53.9 (-1.7 points) and the composite PMI at 54.3 points (-1.5 points). On the downside, orders for durable goods fell 0.4% monthly, after deductions for defence and transport.

**The eurozone experiences moderate growth and the CPI rebounds on energy prices.**

The eurozone also experienced moderate economic growth in the last quarter of 2016. GDP grew 1.7% y-o-y, while the CPI rebounded 1.9% relative to the same period one year prior, albeit with a significant seasonal factor given that the core rate repeated at 0.9%. The labour market also progressed favourably and the unemployment rate shrank to 9.6%. In February, leading indicators reflected signs of acceleration, with a manufacturing PMI of 55.5 (+0.2 points), a services PMI of 55.6 (+1.9 points), and a composite PMI of 56 (+1.6 points).

**Spain continues to grow at a good pace and create jobs...**

In Spain, the data published was equally positive, though activity, and subsequently job creation, eased. In the fourth quarter of 2016, GDP grew 3% y-o-y, while the unemployment rate closed the year at 18.6% and job creation eased to 2.3% y-o-y. In February, CPI slowed its progress and repeated at 3% y-o-y, the highest level since 2012.

**...while the United Kingdom has begun to feel the effects of Brexit.**

In contrast, the United Kingdom will begin to feel the effects of Brexit in the coming weeks. Consequently, the manufacturing PMI dipped to 54.6 points in February (55.9 previously), and consumer spending slumped, with retail sales down to 1.5% y-o-y in January (from 4.1% previously). The unemployment rate remained at 4.8% while inflation stood at 1.8% y-o-y in January.

**In China the foreign sector remains buoyant with inflation rebounding to 2.5%.**

With regard to emerging economies, business confidence also improved in China and in February the manufacturing PMI rose three-tenths to 54.6 points, while the non-manufacturing PMI stood at 54.2 points (vs. 54.6 in January). The buoyancy of the foreign sector continued in January, with a year-on-year advance in exports of 7.9% and in imports of 16.7%. Inflation, meanwhile, rebounded
four-tenths to 2.5%, with prices for industrial production rising 6.9%, the highest level since 2011.

The Central Bank of Brazil cut rates.

In Brazil, because inflation eased to 5% in February, the Central Bank accelerated interest rate cuts, this time slashing the benchmark SELIC rate 75 b.p. to 12.25%, the lowest level since early 2015, given the context of lower inflation and economic crisis.

The European Commission situates eurozone GDP growth at 1.6% in 2017 with a 2.3% increase in Spain.

The European Commission's forecasts situate the eurozone's GDP growth at 1.6% for the current year, and 1.8% in 2018. For the EU as a whole, growth would be 1.8% for both years. Regarding inflation forecasts, eurozone CPI would reach 1.7% by the end of the year, easing to 1.4% in 2019. For Spain in particular, growth is expected to reach 2.3% in 2017, while inflation temporarily rebounded in January to 3% on energy prices. Nevertheless, the Commission expects a CPI of 1.9% in Spain by year-end, once the temporary effect recedes.

Sovereign bonds with higher credit quality fared well while peripheral bonds failed to rally in light of political uncertainty.

Sovereign bonds closed the month with rate declines, especially in those countries with higher credit quality, supported by waning political tension in France and ECB purchases. German 10-year yields are situated at 0.21%, down 23 b.p. In Spain, however, the uncertainty of Europe's political calendar in the coming months has had more impact and the curve rallied at different maturities, with the 10-year bond at 1.66%. On the other side of the Atlantic, the US curve performed unevenly, with shorter maturities under pressure from the increased likelihood of interest rate hikes, and in the long section, the 10-year bond fell 6 b.p., for a required yield of 2.39%.

Credit spreads narrow.

Credit performed well overall, with investment-grade appreciating 1.21%, and high-yield closing the month with gains of 1.42% due to the ongoing tightening of spreads.

Overall increase in the main indices on both sides of the Atlantic.

In general, equities performed positively on the main stock exchanges. In the US, the S&P gained 3.72% in February, on a 6% increase in corporate profits, with 96% of the companies on the index having reported their Q4 2016 results and 72% of companies exceeding expectations. In Europe, the Eurostoxx 50 rose 2.75%, while the IBEX 35 closed February with gains of 2.58%, in line with Europe's other primary indices. Emerging stock markets also closed the month in positive territory and the MSCI Emerging Market Index climbed 2.99%, though performance varied according to region.

The dollar appreciates in the run-up to a potential rate hike which affects the price of gold.

The dollar continues to appreciate on expectations of further rate hikes by the Fed, and is currently situated at 1.058 EUR/USD. In the past week, the pound sterling depreciated 1.1% against the euro due to the publication of macroeconomic data that reflects a less dynamic economy, limiting its monthly appreciation to 0.5%. The yen, meanwhile appreciated 2.1% against the euro to 119.27 EUR/JPY.

Oil appreciates 1.46% to $56.50/barrel.

Oil prices closed February with an appreciation of 1.46%; the price of a barrel of Brent stood at $56.50. Gold, meanwhile, depreciated 0.34% to $1,248/ounce, on the increased likelihood of a Fed rate hike and the appreciation of the greenback against the euro.
Our expectation of higher global growth and rebounding inflation—which will ease in the second half of the year—is reaffirmed.

The activity data of recent months has been positive, reaffirming our expectations earlier in the year that the global economy would shift toward a scenario of higher growth and rebounding inflation in 2017.

It is worth noting that this improvement in the economic cycle has spread, and in nearly 90% of core economies, business confidence indicators are in expansion range.

We will continue to see new spikes in inflation: as long as oil prices remain in the current range ($55-60 for Brent), the effect of rising energy costs will remain high relative to last year, when Brent reached $30 in February. However, in the second half of the year, inflation should slow its climb as this effect recedes. Structural factors remain at play, such as rapid technological progress and, above all, the existence of idle capacity in the main economies that will serve to curb inflation.

Monetary policy will be less expansionary, especially in the US.

This positive scenario will entail a less expansionary monetary policy, a trend that will be more evident in the United States, where the Fed will raise the federal funds rate to 1.25%-1.5% by the end of the year. These expectations are not entirely reflected in prices, since the market only assigns a probability slightly higher than 55% that the Fed will reach or exceed these rate levels by year-end.

In the eurozone, the ECB will reduce its purchases but the programme will remain in effect until year-end.

In Europe, although the ECB will reduce its asset purchases from April, the programme will remain in effect until the end of the year. While it is true that eurozone growth has delivered an upside surprise, risks still persist and the ECB will cautiously withdraw from the current ultra-expansionary measures. As such, no changes in interest rates are expected until next year.

A complex environment for fixed income with negligible value in higher-credit-quality sovereign bonds.

It will be a complex economic climate for bond investments, and with conventional haven assets (German and US government bonds) at such high valuation levels, they may conceal elevated risks. Within sovereign bonds, there is still value in European peripheral debt, which has been
subject to increases in risk premia due to political factors, but which will continue to be supported by the ECB and the prospect of improved fundamentals for these economies.

**We recommend investing in short durations and pursuing returns by selectively increasing credit risk.**

Faced with the threat of rising interest rates, the primary recommendation for bond investment focuses on maintaining short durations and pursuing returns in this asset class by selectively increasing credit risk. Despite the narrowing of spreads, high-yield corporate debt still offers attractive returns. Likewise, at the same credit rating, bonds from emerging countries offer higher returns than their developed counterparts, so some exposure to emerging debt in dollars is recommended, at low durations to obtain this higher rate.

**Equities will be supported by profit growth and better economic prospects.**

Among assets, equities have the best risk-return ratio. Improved activity will translate into higher corporate profit growth, which will be the true driver of stock markets. The Q4 corporate earning season represented a turning point and analysts are revising their earnings-growth expectations upward to the fastest pace in the last five years. Although at current levels, stocks are no longer cheap (in terms of P/E ratio, for example, the MSCI World is above the historic average), this improvement in earnings is precisely what prevents the markets from reaching excessively pricey valuation levels while maintaining potential.

**We advise a slightly higher weight in cyclical sectors…**

Sector exposure will be more important than regional exposure because the protagonism of the central banks should begin to decline as improvements in the economic cycle become more apparent. Therefore, we will focus our portfolio exposure on more cyclical sectors, like industry, technology, and finance, though without neglecting risks, in pursuit of a balance with the existing opportunities in more defensive securities with high profit visibility and, above all, with pricing capacity, like consumer goods.

…without neglecting risks, considering stocks will remain exposed to today’s uncertain political climate.

On the downside, stock markets will remain exposed to the current economic policy risks and March may be a reflection of that, with general elections in the Netherlands, the British government awaiting the start of Brexit negotiations, the new US President’s budget presentation, and the annual meeting of the Communist Party in China. Elections in France are not far off, which could usher in more populist candidates. In addition to all these events of uncertain outcome are the meetings of the central banks, particularly the Fed, which could implement a new rate hike as early as this month.

**Liquidity will serve as protection and an important means to capitalise on opportunities.**

All of the foregoing implies we will see periodic spikes of volatility in financial markets, and therefore we recommend allocating some weight in portfolios to liquid assets which, despite its “non-existent” profitability, will protect us from volatility and, more importantly, will enable us to take advantage of any potential purchase opportunities arising throughout the year.

**The dollar will remain bullish, though with diminished potential.**

As for currencies, the dollar will continue to be buoyed by higher US economic growth and foreseeable rate hikes. However, its appreciation against the euro is steadily declining. Therefore, we maintain some portfolio exposure for diversification purposes and as a means of minimising risk in light of uncertain political scenarios in Europe.
Equities are the most attractive asset and we remain cautious on bonds, where diversification is essential.

In short, in the medium term, we will see the acceleration of global growth confirmed as last year’s deflationary risks recede and as certain central banks grow less expansionary. Given this climate, we recommend overexposure to equities in portfolios and a neutral position for monetary assets. We also advise lower exposure to bonds, specifically higher credit quality bonds (both sovereign and corporate), as they will be pressured to comply with monetary policy normalisation and/or by further spikes in inflation.
Equity Indices

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Data: Bloomberg
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