Market outlook 2020.

Sustainable returns in a low interest rate world

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Sustainable returns in a low interest rate world

Dear client,

The 2019 financial year is set to conclude on a positive note, having largely made up for the previous year's setbacks. When reviewing the investment performance of our clients' portfolios we were pleased to see that, despite significant differences across markets, they generally have benefitted from the favourable market dynamics.

It is important to note, however, that these good returns were not accompanied by an improvement in fundamentals. Unfortunately, economic growth and earnings for both this financial year and the next are lower than we predicted twelve months ago. This shift in market optimism was largely caused **by the major central banks cutting interest rates, which resulted in positive effects on bonds and shares.** These monetary policy measures have left interest rates at historic lows in some countries and present significant management difficulties, even for the most conservative portfolios. We are in uncharted territories and it is our responsibility as managers to warn our clients that **the financial environment has fundamentally changed and that certain traditional investment rules have changed.**

Managing this changing environment is highly complex, as we are faced with the dilemma that while fixed-income assets generally offer minimum interest rates, some stock exchanges (mainly those in the US) continue to break records. With equity markets at a peak and interest rates at all-time lows, it is difficult to build efficient portfolios with a good risk reward ratio. Our baseline scenario for the next twelve months depicts a **low-growth (but non-recessionary) environment potentially favourable for moderate risk positions.** This is a context in which geopolitical risks may decrease and where a lack of profitable options in most fixed-income assets will continue to drive investors to seek for alternatives in equities and other growth assets.

We have identified **four key factors that are likely to determine the future of the market during the next twelve months.** Our moderately positive base case for investment depends on these factors not taking a negative turn. We are paying close attention to the upcoming elections in the US, corporate earnings growth, a possible trade agreement between the US and China and the confidence of investors in the monetary policy measures taken by central banks.

We feel that, now **more than ever, we need to be disciplined in adhering to some investment guidelines that have demonstrated their value over the long term:**

- Avoid excess cash (for now). There may be a significant opportunity cost of holding too much liquidity, given that low-interest-rate environment may last for longer.
- Do not chase returns and keep your investments at a suitable risk level. However, take advantage of volatile events to strengthen positions in assets with higher potential.
- Increase portfolio diversification to reduce risk. Complement positions in traditional assets with alternative strategies that provide different returns and risk profiles.
- Include sustainability criteria (ESG) when selecting investment strategies and asset classes. Investments with a high ESG rating are likely to provide competitive advantages in the medium term.

We feel that, although a combination of low growth, low interest rates, high valuations and geopolitical risks does not make for an ideal investment scenario, it is reasonable to expect some risk-taking to continue to bring rewards. We also see specific opportunities in bonds (emerging fixed income and USD yield curve), equities (including Germany, United Kingdom, Brazil and India), alternatives (infrastructure, private debt, private equity), currency (GBP, NOK), some styles (value, ESG), and some commodities (gold). Our teams of advisors and portfolio managers are at your disposal to explain, and to implement, these and other strategies in line with our highest standards of prudence and diversification, and in accordance with the risk level of your investment profile.

Thank you very much for your trust.

Víctor Matarranz
Global Head of Santander Wealth Management & Insurance division

1

Executive summary.

Macroeconomic and market context

1

Historically-low interest rates.

An abnormal situation which, due to its low nominal and real profitability, does not allow for above-inflation returns in most countries.

2

Low economic growth but without recession in the very short term.

Our central macroeconomic scenario envisages global growth of 3% in a mature stage of the cycle.

3

Little room for manoeuvre for central banks: the normalisation of interest rates has been delayed.

The context of low inflation and growth means interest rates that are lower for longer.

4

Complex investment environment (especially for conservative investors), although not without opportunities.

In this scenario, risk assets may offer some opportunities to generate above-inflation returns.

Key factors 2020

1

Credibility and capacity of central banks.

The market continues to rely on the support of expansive monetary policy, along with fiscal policy.

2

Temporary resolution of geo-strategic conflicts.

It is critical to clear up the uncertainty resulting from Brexit and the trade war between the US and China, as a driver of business confidence.

3

Worldwide political stability.

Investors are keeping a close eye on events in Hong Kong, as well as on the electoral process and domestic political affairs in the US. Political strategists point towards Trump being re-elected because of the good economic momentum.

4

Positive growth for company earnings in a non-recessionary macro environment.

However, we expect current consensus forecasts to be revised down to around 4%, due to margin compression.

Asset classes overview

1
Expected low levels of future returns for liquidity and fixed income.
There is little upside potential for eurozone sovereign and corporate bonds. There is a higher value in USD and emerging markets (with a higher risk).

2
Attractive equity markets as long as profit growth remains positive.
The stock exchange is attractive in relative terms (but not in absolute terms). We see opportunities in Germany, the UK, certain sectors in the US and in selected emerging markets.

3
Diversification in commodities and currencies.
Gold and some currencies (mainly USD) may continue to function as safe-haven assets. We see additional value in sterling if Brexit is resolved positively.

4
Non-liquid assets in portfolios.
Investment in unlisted markets through private debt, infrastructure or private equity could be an excellent complement to traditional investment for sophisticated clients.

Investment conclusions

1
Avoid excess cash (for now).
There may be a significant real and opportunity cost, given that the low interest rate environment may last for some time.

2
Do not chase returns and keep investments at a suitable risk level.
However, take advantage of volatile events to strengthen positions in assets with a higher potential yield.

3
Increase portfolio diversification to reduce risk.
Complement positions in traditional assets with alternative strategies and assets that provide sources of returns with different risk profiles.

4
Include sustainability criteria (ESG) when selecting investment strategies and instruments.
Investments with a high ESG rating are likely to provide competitive advantages in the medium term.

2 Global overview.

2019: Interest rates fall and stock markets rise

In 2019, the market saw a recovery in profitability, practically across the board (among the main types of assets, only liquidity in euros had negative returns). **Returns have been very high, in contrast to the negative outcomes suffered by investors, almost without exception, in both fixed income and equities in 2018.** As you can see in the table on the following page, returns both in USD and EUR profiles were close to double-digit in November 2019, notably exceeding the average for the last 10 years (around 4% on fixed income and 9% on equities).

Central banks come to the rescue

The cause of these different trends between the two financial years cannot be explained by the performance of market fundamentals, since both economic growth and profits were lower in 2019 than they were the previous year. The main catalyst for this improved market sentiment has been the change in tack of the monetary policies of central banks. The fall in risk asset prices during the final quarter of 2018 was initially caused by investors fearing the effects of monetary policy tightening (mainly because of the Federal Reserve's rate rises). The growing anxiety among economic agents, arising from the US-China trade dispute, forced a large number of central banks to change the direction of their monetary policies and almost all of them reduced interest rates at practically the same time.

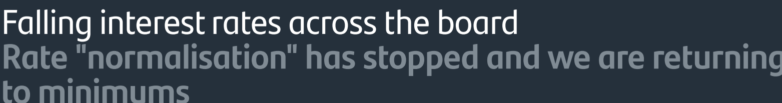
The opportunity cost of risk assets is significantly reduced in the current interest rate environment

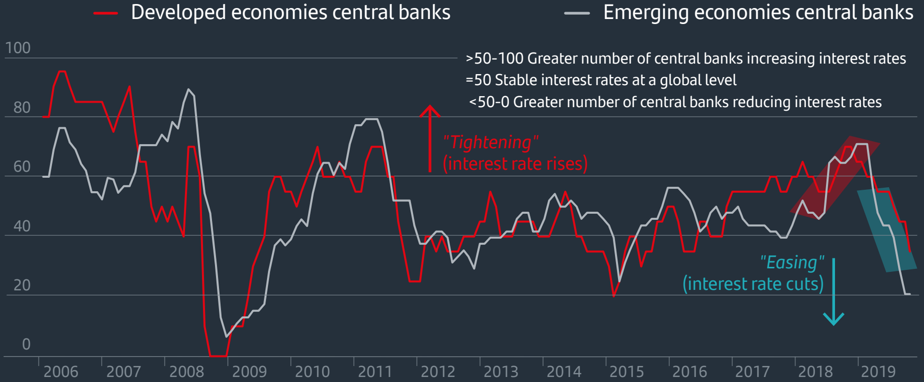
The resulting monetary calm triggered a positive reaction in all risk assets but raised a number of questions with regard to the yields we can expect in the immediate future. The first question concerns whether it is sustainable for short-term interest rates to remain at these levels, and how to manage liquidity positions and mandates where the priority is capital protection. The second question concerns the search for additional sources of return in this environment of low yields on risk-free assets. Given the low (even negative) starting levels of return on these assets, there is greater incentive than ever to assume risks in other assets. However, developments in the economic cycle need to be watched closely in order to try and avoid major price corrections. This leads us to a third point of consideration, which focusses on the analysis of key factors that we think may determine the market's risk appetite; four aspects of which we will analyse in the next section.

The change in direction of monetary policy has helped markets to rally

Source: Refinitiv Datastream and in-house

interest rate cuts have been widespread in both developed and emerging economies





Main asset returns in the last 10 years

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Annualised returns 3 years	5 years	10 years
Liquidity (USD) 1)	**0.2%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.4%**	**1.0%**	**1.9%**	**2.0%**	**1.7%.**	**1.1%**	**0.6%**
Liquidity (EUR) 2)	**0.4%**	**0.9%**	**0.2%**	**0.1%**	**0.1%**	**-0.1%**	**-0.3%**	**-0.4%**	**-0.4%**	**-0.3%**	**-0.4%**	**-0.3%**	**0.0%**
Global fixed income 3)	**5.5%**	**5.6%**	**4.3%**	**-2.6%**	**0.6%**	**-3.7%**	**2.1%**	**7.4%**	**-1.2%**	**6.2%**	**3.9%**	**2.0%**	**2.1%**
Fixed income USD 4)	**6.5%**	**7.8%**	**4.2%**	**-2.0%**	**6.0%**	**0.9%**	**2.6%**	**3.5%**	**0.0%**	**8.6%**	**4.1%**	**3.1%**	**3.6%**
Government FI (USD) 5)	5.3%	6.6%	1.7%	-1.3%	2.6%	1.4%	1.1%	1.1%	1.4%	5.2%	2.6%	2.0%	2.3%
Corporate FI (USD) 6)	9.0%	8.1%	9.8%	-1.5%	7.5%	0.1%	6.1%	6.4%	-2.5%	13.7%	6.0%	4.5%	5.4%
High Yield FI (USD) 7)	15.1%	5.0%	15.8%	7.4%	2.5%	-2.0%	17.1%	7.5%	-2.1%	11.6%	6.3%	5.3%	7.6%
Fixed income EUR 8)	**2.2%**	**3.2%**	**11.2%**	**2.2%**	**11.1%**	**1.9%**	**3.3%**	**0.7%**	**0.4%**	**6.8%**	**2.8%**	**2.6%**	**4.1%**
Government FI (EUR) 9)	**1.1%**	**3.4%**	**11.0%**	**2.2%**	**13.1%**	**2.7%**	**3.2%**	**0.2%**	**1.0%**	**7.9%**	**3.3%**	**3.1%**	**4.3%**
Corporate FI (EUR) 10)	6.6%	3.2%	14.6%	1.5%	11.0%	3.3%	2.9%	1.9%	-1.5%	6.2%	2.6%	2.4%	4.1%
High Yield FI (Europe) 11)	16.2%	-2.4%	28.5%	9.9%	7.0%	5.6%	6.5%	6.2%	-3.6%	10.1%	4.8%	4.4%	8.1%
Global emerging FI (USD) 12)	**12.8%**	**7.0%**	**17.9%**	**-4.1%**	**4.8%**	**2.7%**	**9.9%**	**8.2%**	**-2.5%**	**11.2%**	**5.9%**	**5.0%**	**6.4%**
Latam emerging FI (USD) 13)	13.1%	10.7%	16.9%	-6.0%	4.2%	-2.2%	16.3%	10.6%	-4.9%	8.5%	5.4%	4.1%	6.0%
Global Equities 14)	**11.8%**	**-5.5%**	**15.8%**	**26.7%**	**4.9%**	**0.9%**	**7.5%**	**22.4%**	**-8.7%**	**22.9%**	**11.9%**	**7.5%**	**9.3%**
US equities 15)	15.1%	2.1%	16.0%	32.4%	13.7%	3.0%	12.0%	21.8%	-4.4%	26.3%	14.3%	10.8%	13.4%
European equities 16)	11.6%	-8.6%	18.2%	20.8%	7.2%	15.4%	1.7%	10.6%	-10.8%	23.9%	8.9%	6.2%	8.3%
Spanish equities 17)	-12.9%	-7.7%	2.8%	27.8%	8.6%	4.7%	2.6%	11.3%	-11.5%	13.0%	6.4%	1.3%	2.5%
Japanese equities 18)	1.0%	-17.0%	20.9%	54.4%	10.3%	14.3%	0.3%	22.2%	-16.0%	15.9%	7.3%	6.0%	9.9%
Emerging market equities 19)	18.9%	-18.4%	18.2%	-2.6%	-2.2%	-13.0%	11.2%	37.3%	-14.6%	11.1%	9.6%	3.1%	3.6%
Alternatives 20)	5.2%	-8.9%	3.5%	6.7%	-0.6%	-2.3%	2.5%	6.0%	-6.7%	6.6%	2.1%	0.7%	1.0%
Commodities 21)	16.7%	-13.4%	-1.1%	-9.6%	-17.0%	-22.3%	11.4%	0.7%	-13.0%	2.5%	-2.6%	-7.7%	-5.3%

1) Barclays Benchmark Overnight USD Cash Index. 2) Barclays Benchmark 3mEUR Cash Index. 3) Bloomberg Barclays Global Aggregate Total Return Index Value Un. 4) Bloomberg Barclays US Agg Total Return Value Unhedged USD. 5) Bloomberg Barclays US Intermediate Treasury TR Index Value Unhedged U. 6) Bloomberg Barclays US Corporate Total Return Value Unhedged USD. 7) Bloomberg Barclays US Corporate High Yield Total Return Value Unhedged USD. 8) Bloomberg Barclays Euro Agg Total Return Index Value Unhedged EUR. 9) Bloomberg Barclays Euro Agg Treasury Total Return Index Value Unhedged EUR. 10) Bloomberg Barclays Euro Aggregate Corporate Total Return Index Value Unhedged EU. 11) Bloomberg Barclays Pan-European Aggregate High Yield TR Index Value Unhedged. 12) Bloomberg Barclays EM USD Aggregate Total Return Value Unhedged. 13) Bloomberg Barclays Emerging Markets Latam Total Return Value Unhedged USD. 14) MSCI World Index Total Return. 15) S&P 500 Total Return Index. 16) Stoxx600 Net Total Return Index. 17) Ibex 35 Total Return Index. 18) Topix Total Return. 19) MSCI Emerging Markets Net Total Return Index. 20) Hedge Fund Research HFRX Global Hedge Fund Index. 21) Bloomberg Commodity Index. NB: data as of 22 November 2019.

Data as of 22 November 2019

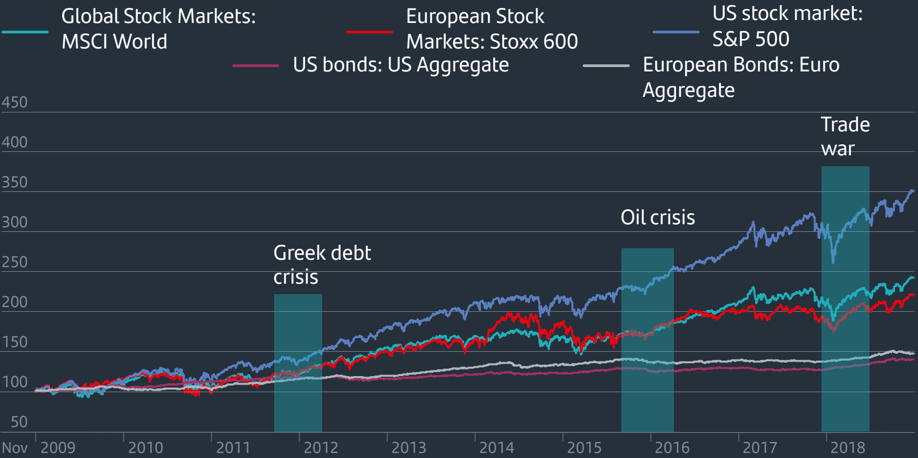
Main asset returns in the last 10 years

Source: Bloomberg and in-house

This expansion has occurred alongside three episodes of considerable uncertainty, but those investors taking a long-term view have obtained excellent results

A decade with excellent investment performance

Markets have efficiently rewarded risk exposure



Rates with no interest: no prospect of normalization in sight

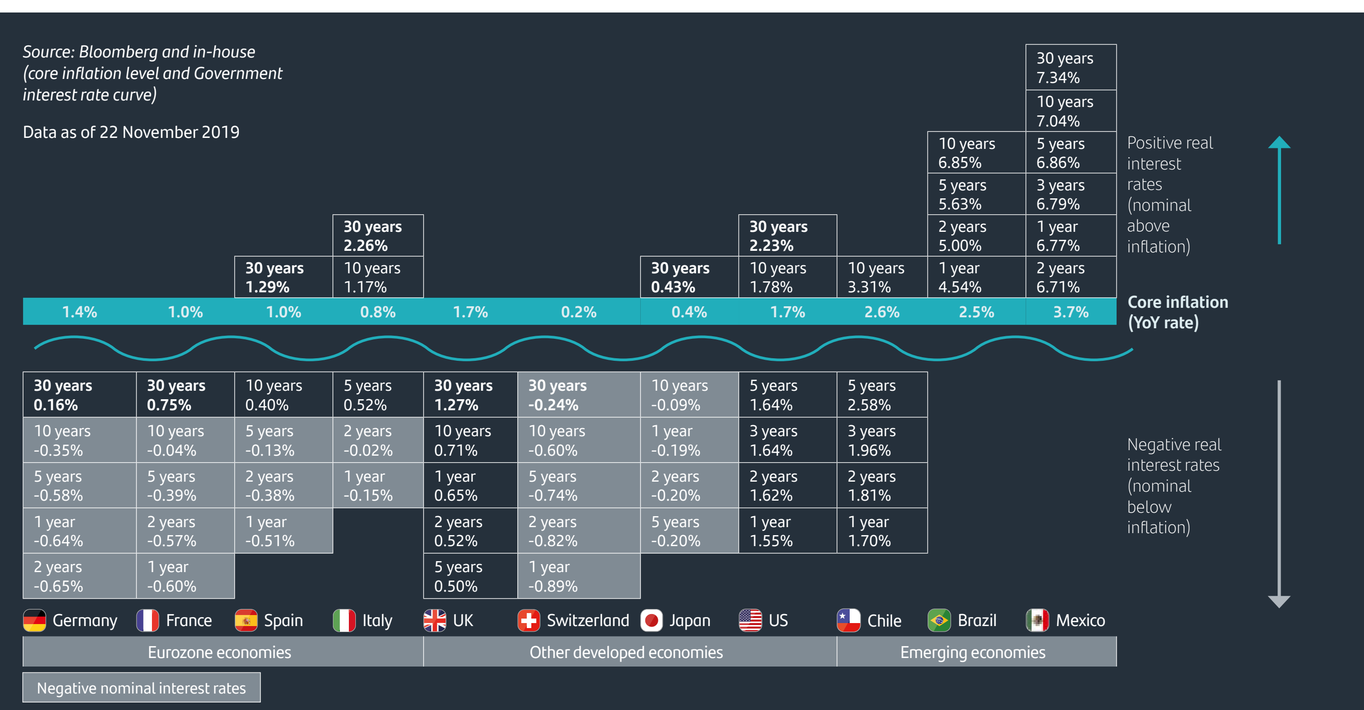
Conservative investors will be the main victims of monetary easing

The immediate consequence of the major central banks introducing expansive monetary policies is the **problem that it presents for investors seeking returns on conservative mandates.** Global interest rates are at historic lows, and more than USD 13,000 million of nominal capital held in bonds globally have a negative return on maturity. The objective of these monetary policies is to boost corporate investment and economic growth by reducing funding costs, but this is offset by the lack of return for savers, a situation which has become known as "financial repression".

Savers and investors lack historical experience when it comes to having to pay for the security of being invested in liquid assets, which causes a dilemma when transferring their investments towards more profitable assets (but also with higher risk). In the chart below, our aim is to illustrate available yields in the main geographies, by investing in liquidity or government bonds (better credit quality at a local level), and how this yield compares with inflation or the loss of purchasing power. We can see how in many developed countries, such as in Germany and Japan, almost all the available options in risk-free assets involve negative yields in nominal and real terms (net of inflation).

The low interest rate scenario will continue for longer than analysts expected

These ultra-expansive monetary policies are penalising savers (and benefitting economic agents with debts), and **market expectations are that this situation will not undergo any significant change over the next few years.** In the eurozone, analysis of the Euribor curve suggests negative yields until at least 2025. So far, banks have resisted the temptation to pass liquidity costs on to individuals, but they have started to do so with institutions and corporations. The first conclusion we reach in this report is to warn investors that global returns on liquid and highly rated interest-rate assets are at all-time lows. Economic analysts have coined the phrase "lower for longer" when referring to this resistance of global interest rates to "normalisation" in the current cycle, and recent yield reductions corroborate this outlook for investment in risk-free assets.



The search for yield: the only alternatives to be found are in risk assets

We believe investors should not resign themselves to negative yields and should seek alternatives

Insofar as the base case for the economic environment continues to be that of reasonable growth at a global level and where liquidity continues to be penalised in yield terms, **there will always be incentives to look for alternatives in higher-risk assets, as we have seen in recent quarters.** Investors are not prepared to settle for negative yields, net of inflation, or for safe-haven assets, and **the demand for risk assets with a higher return is greater than ever.**

Our role as advisors and managers is to analyse which assets offer the best risk-reward ratio, taking historical experience and changes in current market factors into account. Thanks to the central banks' actions, **it has never been easier to outperform government bonds.** Our central scenario is somewhat more conservative than the market consensus, but it is still based on economic growth far away from recession and a slight increase in company profits. In this scenario, **the search for sustainable returns with a high degree of diversification and attractive risk premiums, compared to lower-risk assets, should continue to drive yields over the next 12 months.**

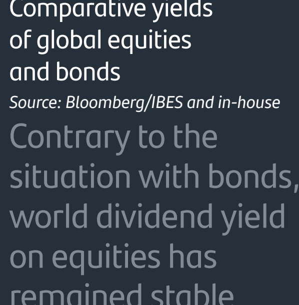
There are no easy, volatility-free solutions when it comes to obtaining positive real returns

In the chart below, we compare the yield on bonds and assets at a global level in order to assess whether it still makes financial sense to keep investing in risk assets. Here you can see the fall in yield on maturity of the global bonds index as a result of the actions taken by central banks. We measure the performance of shares based on their dividend yield, and have observed a greater stability in this metric in comparison with the worsening performance seen in bonds. Growth in profits and dividends has been the factor that has helped avoid decline in share yields. Equity markets have defended their profitability metrics better than bonds and are still good value in relative terms.

Data as of 22 November 2019

Relative yields of bonds and shares

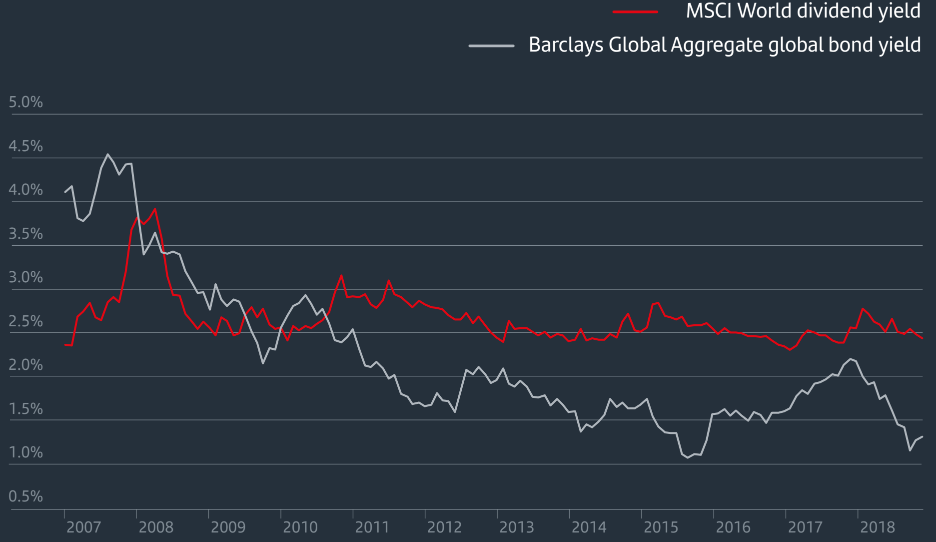
Equities compare positively with fixed income



Comparative yields of global equities and bonds

Source: Bloomberg/IBES and in-house

Contrary to the situation with bonds, world dividend yield on equities has remained stable



A completely new investment environment

There is uncertainty about the side effects of ultra-expansive monetary policies

When it comes to designing optimum investment strategies for the new investment environment, it is worth noting that **we have no historical references for many of the market's current metrics**. The last decade has been very positive for investors, but they have had the tailwind of expansive economic policies (basically monetary) in their favour to an extent never seen before. The secondary effects of these policies, and their extraordinary character (there is little capacity to re-implement them on the same scale), involve a certain amount of additional uncertainty when it comes to estimate the future performance of assets.

International economic bodies, company executives and financial advisors are warning us that the central growth scenario they have in mind is threatened by a rising level of risk. Investors should bear in mind that along with **the need to take positions in risk assets, they must also have defence strategies in place that diversify their investment portfolios.** The world economy is breaking records for longevity in this expansion, but **this degree of maturity in the cycle could make it more sensitive to potentially negative events.**

The maturity of the cycle increases the risk of negative geopolitical and economic surprises

Among the most negative of these is geopolitical risk, and specifically the possibility of there being major regulatory changes which may have a significant impact on the expectations and decisions of economic agents. The chart below was developed in an attempt to measure the level of economic uncertainty arising from political changes and, as you can see, the current **perception of risk is very high.** This insecurity emerges from the high-profile impact of the US-China trade war, the uncertainty of Brexit negotiations, internal tensions within the European Union and concerns over high levels of public debt. In the following section, we will analyse the **four key factors that we feel will determine the outlook for the market in 2020,** which we understand to be: tariff tensions, the US presidential election, the credibility of central banks and the business profits cycle. Successful investment management over the next 12 months will rely on a well-balanced structure between risk assets and defensive strategies, together with a correct evaluation and anticipation of these key factors which we will now look at in greater detail.

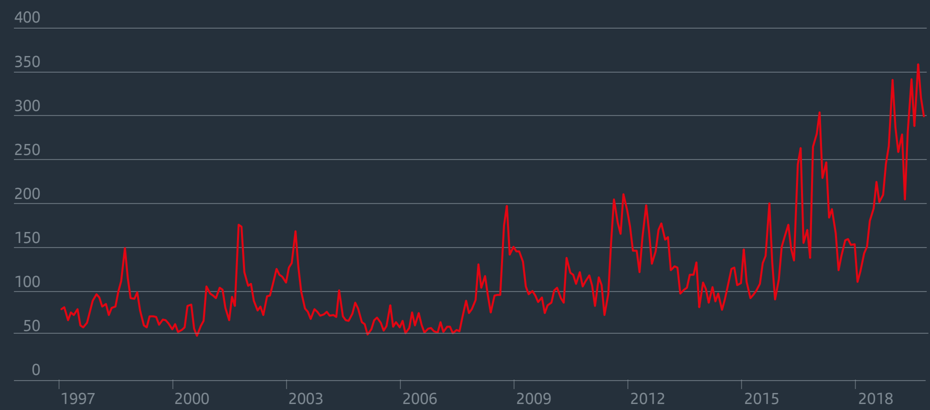
Data as of 22 November 2019

Complex geopolitical environment

High level of uncertainty in the global outlook

Global Economic Policy Uncertainty Index

Source: Baker, Bloom & Davis (Global Economic Policy Uncertainty Index) and in-house



Many of the fundamentals on which the economic policies of recent decades have been based are being questioned

3 Key factors to consider.

3.1 Credibility of central banks: monetary policy reaching its limits

The current economic cycle has had an unquestionable ally in the central banks, which have put extreme measures into practice, initially with the aim of finding a way out of the financial crisis, and then to ensure the sustainability of economic recovery. A weak market, resulting from monetary and financial tightening at the end of 2018, led to monetary authorities **making a 180º turn, and once again implementing extreme stimulus measures.**

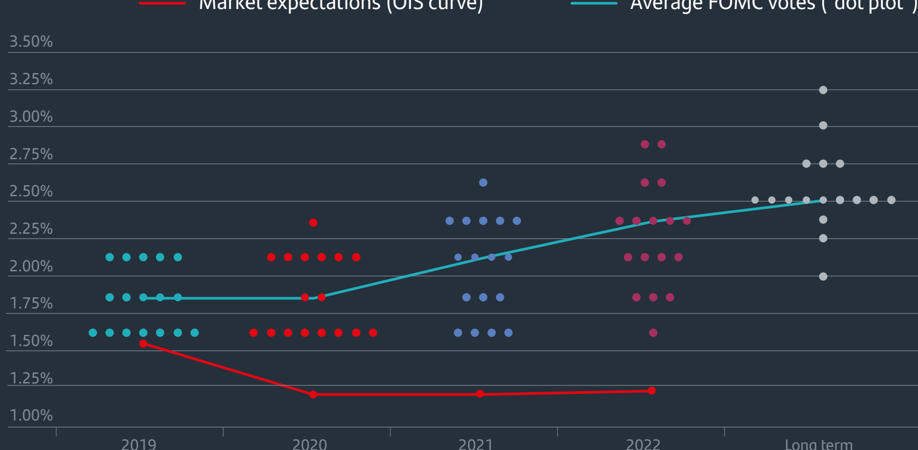
The timing and scope of these measures was questioned by economic experts, who argued that given central banks had little room for manoeuvre, these measures should have been postponed until a time when the economic slowdown was seen to be more widespread. A significant example of this **lack of consensus** was the **opposition by certain members of the European Central Bank (ECB) governing council to the monetary measures implemented by Mario Draghi** before the end of his mandate.

An additional factor of this uncertainty lies in the recent **change of leadership at the ECB,** and in how much **room for manoeuvre Christine Lagarde will have.** We are also beginning to see a broad consensus saying that the effectiveness of lowering interest rates and buying-back assets is very limited, when practically all the eurozone interest rate curves are in negative territory. In his final press conference, Draghi stressed the need for fiscal policies to take over, and pressure is now being put on Germany to turn on the public spending tap.

As for the **Federal Reserve (Fed),** after having made three rate cuts to reduce interest rate to 1.75% (the higher range of the target level for the federal funds rate), Jerome Powell hinted that they had now **brought this round of preventive measures to an end (*"insurance cuts"*).** The market has moderated its expectations for further reductions, but still differs from the Fed's guidance and expects the interest rate to stand at around 1.50% by the end of 2020. Just like the ECB, the Fed is facing **a difficult credibility exercise, since it needs to demonstrate it is interpreting the economic outlook correctly** and at the same time convince the markets of its capacity to act where necessary. The monetary authorities are reaching the end of this economic cycle with high levels of credibility, but with a feeling that their **ability to act is becoming somewhat limited.**

Data as of 22 November 2019

Differences of opinion between the Fed and the market
The market sees further cuts and the Fed indicates a pause



Gap between market and Federal Reserve expectations
Source: Federal Reserve and in-house

The market will continue to pressure the Fed with further interest rate cuts in 2020

3.2 Trade wars: impact of tariffs on business investment

The greatest cause of uncertainty for economic agents lies in the trade conflict which began in February 2018. This has led to numerous announcements and the implementation of tariffs by the US, with corresponding counter-measures by China and Europe.

We feel that the most probable scenario will be the signing of a Phase One agreement between the US and China in the first quarter of 2020

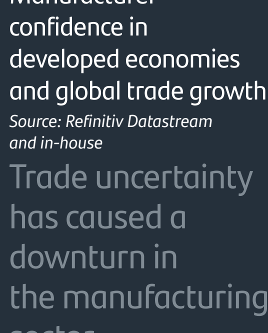
With the passage of time, these tariffs have impacted on various global value chains, causing uncertainty, price increases for imported goods, a fall in the volume of trade and a decline in business and consumer confidence. As you can see in the chart below, this uncertainty from businesses viewpoint has led to a decrease in export volumes, with the corresponding impact on growth worldwide. This has led to growth standing at around 3% for the first time in this economic cycle since the European crisis of 2012.

CEOs of the large US multinationals are urging the White House to reduce this climate of uncertainty, warning that this trade dispute is affecting **decisions regarding investment, procurement and household expenditure.** This pressure, combined with weak business investment indicators and the proximity of the presidential elections, has been instrumental in the Trump Administration becoming less aggressive in its tariff rhetoric. Our base case involves an improved perception of this risk in the coming months and the signing of an initial agreement between the US and China in the first quarter of 2020.

In short, **it is essential for agreements to be reached in the coming months (even if they are preliminary) that resolve the two current major trade and geopolitical conflicts: negotiations between the US and China and a negotiated settlement for the United Kingdom to leave the European Union.** Given the importance of these negotiations for the global economy (since they affect the world's three largest economies), we face a binary scenario, where the outlook for the market and the economy in 2020 will largely depend on the outcome of these months of negotiation.

Data as of 22 November 2019

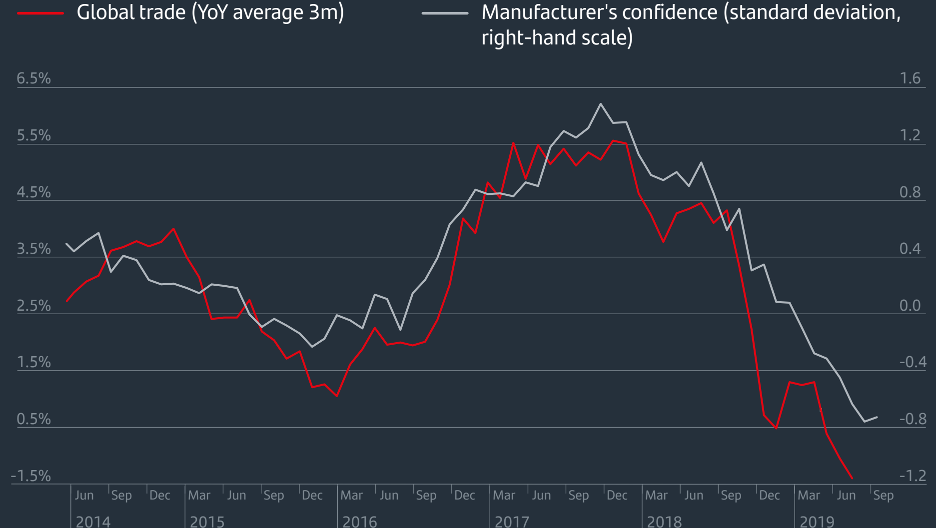
The announcement of tariffs had a negative impact on world trade
Manufacturer confidence is affected by trade uncertainty



Manufacturer confidence in developed economies and global trade growth

Source: Refinitiv Datastream and in-house

Trade uncertainty has caused a downturn in the manufacturing sector



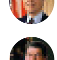
3.3 Presidential elections in the US: *"The Economy, Stupid"*

There is very little chance of the impeachment process succeeding because of the Republican party's control of the Senate

2020 is an electoral year in the US and Wall Street will pay close attention to surveys and the electoral process for the Democratic Party candidate. It is highly likely that Donald Trump will be the Republican Party candidate, unless the impeachment process, which was recently initiated by Congress, succeeds. In the Democratic Party, however, the candidacy is still very open (polls show a tight race among candidates). For the time being, political experts feel it is **highly unlikely that impeachment will be successful** for two reasons: the first is the strong control that the Republican Party has over the Senate (the Democrats only have 45 senators and 67 are required to approve impeachment), and the second is Trump's high approval rating amongst Republican voters (nearly 90%), which would make it difficult for a Republican senator to vote against Trump.

US - Conference Board Consumer Confidence Index

Source: Refinitiv Datastream and in-house


Jimmy Carter

Ronald Reagan

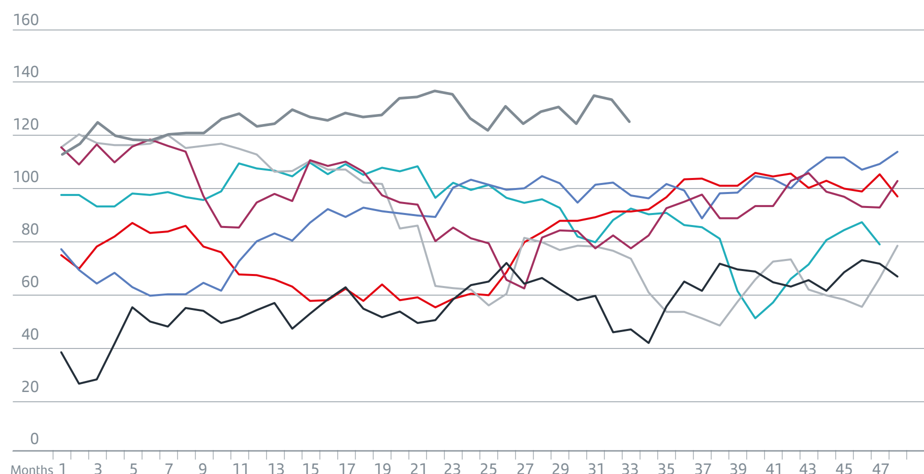
George H. W. Bush

Bill Clinton

George W. Bush

Barak Obama

Donald Trump



Trump should focus his agenda on ensuring the health of his greatest electoral asset: economic growth

The **economic situation usually has a crucial impact on the elections** when the current president is a candidate for re-election. The expression *"The Economy, Stupid"* became famous in US politics during Bill Clinton's campaign, used by one of his strategists (James Carville) to attack George H. W. Bush, by focussing on the economic downturn during the year of the elections in 1992. The worsening of the economic outlook had a big impact on the election and led to the downfall of a president who just one year earlier, before the Gulf War, had enjoyed close to 90% acceptance. In the following table, we analyse the **three US elections in which the incumbent president stood as a candidate and was not re-elected, and can see how, in each of these three cases, the campaign developed against a backdrop of high unemployment and/or economic downturn.**

President as candidate	President's party	Candidate elected	Election year	Change in unemployment*	Unemployment rate	Change in GDP
Gerald Ford	Republican	Jimmy Carter	1976	-0.8	7.6%	2.2%
Jimmy Carter	Democrat	Ronald Reagan	1980	1.8	7.5%	-0.5%
George H. W. Bush	Republican	Bill Clinton	1992	0.7	7.6%	4.0%

*Difference in unemployment rate for the third quarter in which the presidential election took place and that for the third quarter of the previous year.

Presidential advisors are well aware of these factors, and this should mean that in the coming months **Donald Trump is likely to concentrate his efforts on resolving those aspects of his agenda that may have a negative economic impact in the short term (the trade conflict, for example).** He will also highlight those aspects which may be seen to have a positive effect on consumer and business confidence. We feel that the market will take a positive view of Trump's potential focus on the economic agenda and this will increase his chances of re-election.

Private Banking

3.4 Corporate earnings growth

We estimate that, on the whole, companies listed on global stock exchanges (MSCI World) will maintain their capacity for profit growth, although it is highly probable that current estimates will be downgraded to around 4%

Another key factor which will underpin growth and extend the current economic cycle lies in **the capacity of companies to continue investing and employing more workers.** This capacity is very closely linked to business confidence in the outlook for the economy, and also in the ability of companies to generate profits. So, regardless of what happens in the trade war, we feel that the macro environment in 2020 (especially in the second half of the year) will most likely depend on the maturity of the profits cycle, and the capacity to continue to finance growth in investment and employment.

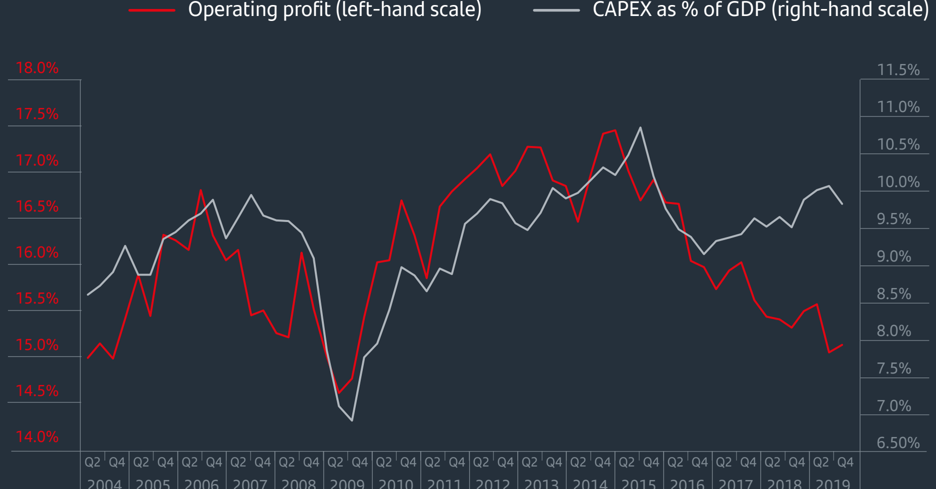
In this regard, it should be noted that **profits as a percentage of GDP have been falling in recent years** (see chart below), to the extent that they are currently below the historic average. This decrease is due to lower margins as a result of increased salaries, in turn resulting from **tightness in the labour market,** reflected in an extremely low unemployment rate.

Since the trend in the labour market remains the same, **it appears unlikely that the upward trend in salaries will be reversed in 2020.** In fact, the trend is likely to become more acute and cause a further downturn in company profits. Although the latter are not yet at the critical levels that caused a recession in the past, we do think they will prevent high growth rates in business investment (even if the trade war dies down).

Recent figures for US corporate earnings show a very low growth trend (negative in the third quarter and practically nil for the whole of 2019) when faced with the combined effect of economic downturn and the pressure of increased labour costs. Analyst expectations for the 2020 financial year are more optimistic, when double-digit growth - or thereabouts – is expected. **We think it is highly probable that these expectations will be revised down to levels of about +4%. Our main assumption for there being some potential stock market upside is based on the fact that profit growth figures remain in positive territory.** The rally phase, based on the expansion of multiples, has been going on for too long and the momentum for profit growth needs to be maintained.

Correlation between profit and investment

Businesses cut back on investment when profit strength disappears



Non-financial corporations' operating profits and capital expenditure (% of GDP)

Source: Refinitiv Datastream and in-house

Declining operating profit margins is a bad sign for the future growth of business investment

4 Macro-economic perspective.

Macroeconomic context

Assuming that we avoid the worst-case scenarios in the US-China trade conflict and Brexit, world economic growth in 2020 will be below its trend rate of 3.5%, but above levels which indicate a recession (GDP growth below 2.5%). We consider the chances of a recession scenario crystallising in the next 12 months to remain low.

The orderly downturn in OECD economies would be offset by the greater traction of emerging markets

The assumptions envisaged by our base case for 2020, summarised as a **moderate downturn in global GDP growth** (from 3.2% estimated for 2019 **down to 3.0%),** are as follows: (i) although **geopolitical uncertainty** still exists, **it will be reduced** as a result of an agreed resolution to Brexit, and the softening of the trade conflict between the US and China (although it will, nonetheless, remain latent); (ii) the **monetary easing** undertaken in 2019 and the **solidity of the services sector** (consumption) are two essential **levers** (and probably sufficient if the trade conflict does not prevent it) to avoid a greater downturn in global activity, (iii) the **central banks will reduce the intensity of their stimulus** packages over the next few quarters as a result of increased certainty from a geostrategic viewpoint, and there will be a subsequent moderate recovery of inflation expectations; and (iv) **company profits** growth will once again be below consensus forecasts, but will **remain positive.**

However, **it would not be at all unrealistic to see an increase in world economic growth** if, firstly, there was enough clarity over trade to generate a considerable boost to corporate investment together with a recovery in global trade and secondly, if the world's main economies were to introduce more far-reaching fiscal stimulus packages. In any case, it will be difficult for both variables to occur: in the case of investment, because of the structural support factor of the replacement of obsolete capital; and in the case of fiscal policy, because pressure by economic agents is enough to dissuade it from returning to a contractionary status.

Alternatively, if there were to be a deepening of political uncertainty and the contraction in the manufacturing sector were to spread to the service sector, **a recession scenario would come to the fore, but with a qualified severity and impact on the market:** it would be a technical recession (barely two consecutive quarters of negative growth due to more moderate imbalances compared with more severe previous recessions) with the ability to generate major corrections in the prices of assets with more limited risk.

Macro scenario 2020 - Growth and central bank interest rate forecasts

	Economic growth (GDP)*					Central bank interest rates as of December			
	2017	2018	2019e	2020e		2017	2018	2019e	2020e
US	2.4%	2.9%	2.4%	2.0%	1)	1.50%	2.50%	1.75%	1.75%
Eurozone	2.5%	1.9%	1.1%	1.1%	2)	-0.40%	-0.40%	-0.50%	-0.50%
UK	1.8%	1.4%	1.0%	0.9%	3)	0.50%	0.75%	0.75%	0.25%
Brazil	1.1%	1.1%	1.2%	2.0%	4)	7.00%	6.50%	4.50%	4.50%
Mexico	2.1%	2.0%	0.1%	1.0%	5)	7.25%	8.25%	7.25%	6.50%
World	3.8%	3.6%	3.2%	3.0%					

*Average annual rate
1) Fed Funds: Federal Reserve's federal funds target rate (upper part of the range)
2) The interest rate set by the ECB on the Eurosystem's overnight deposit facility
3) Bank of England *base rate*
4) Banco Central do Brasil (Brazilian central bank) Selic rate
5) Banxico (Mexican central bank) target rate

Macro US.

The US consumer will continue to be the "guarantor" of economic growth in line with the trend for 2020. Assuming there will be some degree of trade truce and tariff stabilisation, export confidence and business investment should recover after the weak trend of recent quarters.

The **US economy is on course to complete its eleventh year of uninterrupted growth,** prolonging what has been, since midway through 2019, the longest expansionary cycle in its history.

Households enjoy extremely benign economic and financial conditions, providing strong support for consumption

This remarkable statistic makes us wonder how much longer the current cycle can continue. The answer to this will be provided, as always, **by private consumption,** a determining factor for the US economy as a whole, which is consistent with its significant weight in GDP (70%).

Consumer **fundamentals continue to show considerable strength:** (i) confidence is high; (ii) unemployment is at its lowest for half a century; households are in a solid financial position due to the accumulated wealth effect since 2009, a reduction of debt as a percentage of disposable income (it has gone down from 129% in 2007 to 93% currently), relief in servicing debt (the aggregate debt/income service coverage ratio is close to being the lowest in four decades) and a high rate of savings (8% of disposable income when in 2006, just before the last recession, it was negative).

The determining factors (salaries - they are still growing more than one percentage point below what would be normal in this mature phase of the cycle - **and wealth** - it does not usually decrease in a year with presidential elections) **suggest that household spending will once again be the growth engine in 2020,** although at a somewhat lower rate than in 2019 which is consistent with the extraordinary longevity enjoyed by the current expansion.

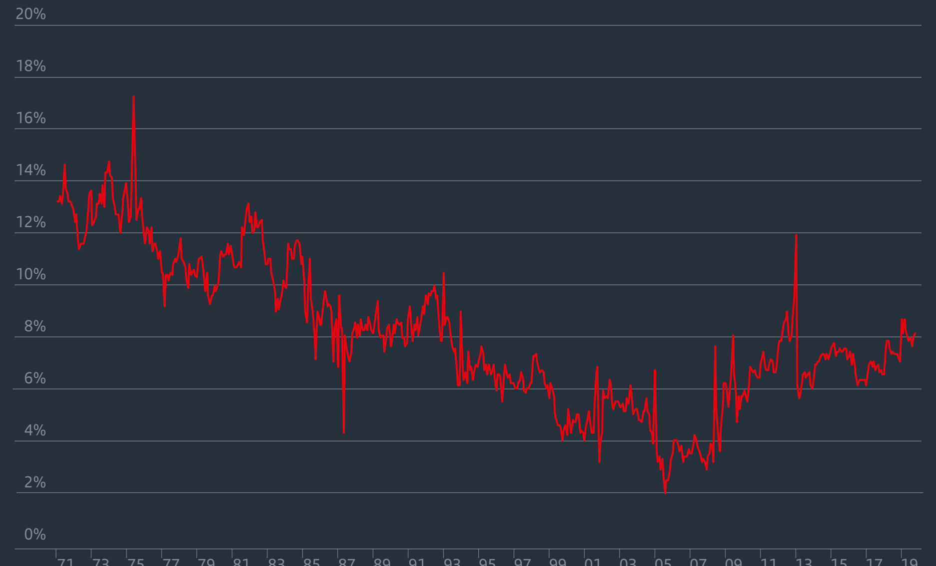
The domestic saving muscle has been strengthened

Consumers facing the mature phase of this cycle are better protected than in the previous cycle

US - Household savings rate (% gross disposable income)

Source: Refinitiv Datastream and in-house

Unlike what ocurred in previous cases of fiscal stimulus, households took advantage of the 2018 fiscal stimulus to strengthen their financial position



Barring any unexpected surprises, we feel that conditions are right to drive growth in the sectors most affected by trade uncertainty

As for business investment, under our central assumption of no additional trade tensions, **we foresee a return to modest growth.** The expected export and manufacturing recovery will put an end to the slow-down in investment. Boeing's problems may cease to have a negative impact, as will investment in the energy sector. But there will still be a significant level of uncertainty, not just because of the ongoing trade conflict but also because of the elections. Lofty corporate profit margins have been a hallmark of this ongoing business cycle, but it will be hard for companies to maintain the current level of profitability over the coming decade. However, **we do not foresee sufficient cost pressure for a fall in profits to occur in the coming quarters.** There would need to be an increase of total unit cost in excess of 2% for the margins to be at greater pressure. **The margins for listed companies remain high, so any slight correction would not be a concern for the stability of companies and their valuation.**

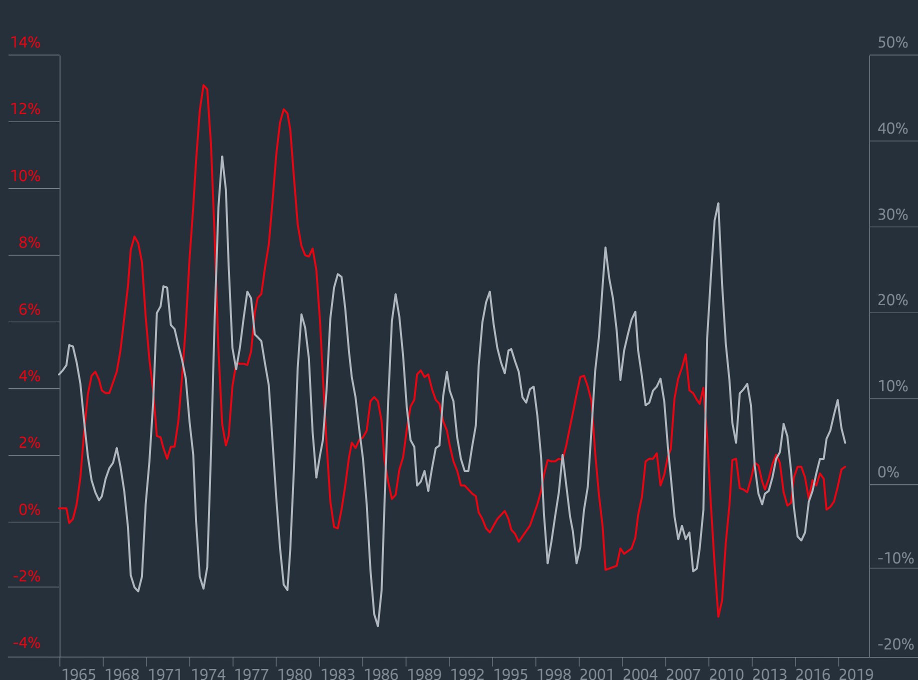
Finally, reductions in mortgage rates this year have already had an effect on the demand for housing, so **we expect residential investment to make a positive contribution** to economic growth in 2020.

To conclude, **we estimate that GDP growth in the US will vary only slightly in 2020, in line with its potential** (slightly over 2%), **but far from the figures which would suggest a recession** (we anticipate the probability of recession one year from now as being lower than 25%). **Further cuts to interest rates by the Federal Reserve in 2020 are now more difficult to justify.** For this to happen, there would need to be a combination of negative data (including the labour market), a rise in geopolitical tension and a very negative impact on financial markets.

We need to keep an eye on corporate margins...
...but we do not foresee sufficient cost pressure to cause a significant fall in earnings

US - YoY growth in Total Unit Cost (TUC) and company profits (non-financial companies)

Source: US Bureau of Labour Statistics and in-house



Labour costs, more so than financial or energy costs, will be the main pressure factor for the remainder of the cycle

Macro Europe.

Activity in the Eurozone will stabilise in 2020 as global trade uncertainty decreases and the Brexit situation is clarified. There will be a more balanced composition of growth. Risk for the region resides in the lack of financial instruments (or the decision to use them) to counteract a possible further worsening of the geopolitical situation.

Eurozone growth should remain at similar levels in 2020, within a context of improved global trade that will enable this growth to be more balanced

The **Eurozone economy** will end 2019, with an increase in GDP slightly above its 1% yearly average, **a clear downward trend from the high of 2.5% reached in 2017,** mainly affected by increased trade uncertainty and the inconclusive exit of the UK from the European Union.

Given the importance of the external sector to the GDP of the Eurozone (50% weight), it should be noted that it is the region most affected by hostilities between the US and China, which has led to a significant decrease in global trade. There has also been added uncertainty created by Brexit, as well as the specific problems affecting certain European industries, such as the automobile sector.

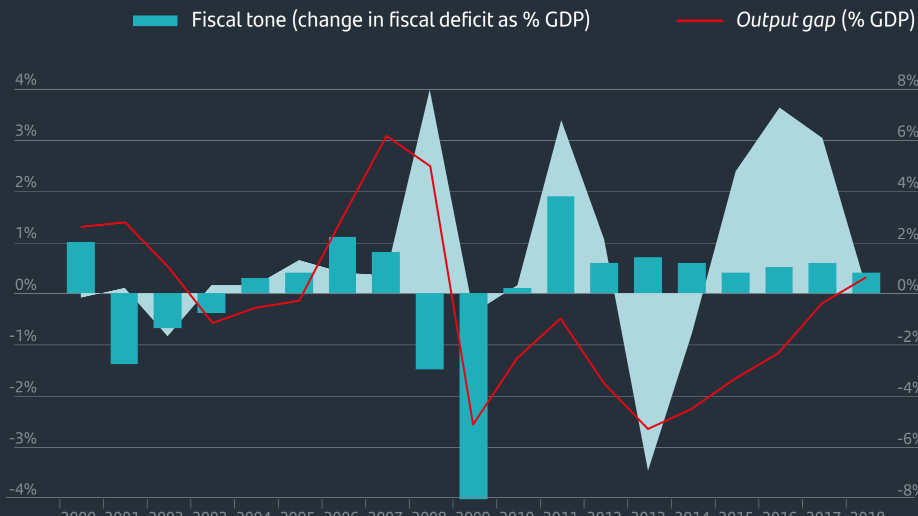
We expect these factors to remain for a good part of the coming financial year, although less pronounced in aggregate terms; this would result in **GDP growth** in the eurozone **of 1.1% in 2020.** Although the region would see a quasi-repeat of the rate of expansion experienced in 2019, **activity would no longer** be based exclusively on private consumption. **Rather, it is set to become much more balanced,** with the export sector and company investment once again contributing to GDP.

We will also see certain differences **by country** compared to the results for 2019. Driven by improvements in the external sector and the corresponding rise in investment, we expect the **German economy -the most dependent on foreign trade- to grow 4 tenths more in 2020 (from an annual average of 0.5% up to 0.9%).**

Monologue of monetary policy in the Eurozone...
... but it is already showing clear signs of exhaustion

Eurozone - Position of fiscal and monetary policy versus output gap

Source: Refinitiv Datastream and in-house



The region is in a privileged position for fiscal policy to be more effective. But there is still a lack of consensus and political appetite

Meanwhile, **the Spanish economy,** which is one of the most dependent on the external sector in the region, has been the least affected by the slow-down in global trade over the last two years, and hence will reap fewer benefits from its recovery. We expect Spanish GDP growth to slow down in 2020 and reach an annual average of around 1.7% (down from the 2% with which it will close 2020). In any case, this slowdown will be steady and not particularly sharp.

The scant room for manoeuvre in monetary policy and the lack of interest in fiscal expansion will leave the Eurozone at the mercy of the international agenda

Our forecasts describe a scenario for the European economy that is highly dependent on external factors which, have not yet crystallised, and will need to be monitored closely as 2020 progresses. Faced with a scenario in which activity is highly dependent on what happens abroad, the question we should be asking is: **does the eurozone have the instruments to autonomously boost its growth rate?**

From the monetary policy perspective, there is little left to do. As Mario Draghi pointed out in his farewell speech, the margin for this type of intervention is virtually exhausted, and even if it were possible to expand the asset purchase programme or reduce the marginal deposit facility even more, the impact of these measures would be extremely limited. In any case, it should also be pointed out that we do not expect the European Central Bank, under Christine Lagarde's leadership, tighten its monetary policy during 2020.

We do see a greater margin for action in the fiscal arena. Although not all countries have sufficient capacity to increase public expenditure, there are notable exceptions, like Germany and The Netherlands. These countries do have margin. Unfortunately, and especially in the case of Germany, there is very little political will for these increases. Nevertheless, even if these countries were to initiate a fiscal expansion programme, its impact on activity (via multipliers - the elasticity of GDP to government spending - and indirect effects) would never be as significant as a co-ordinated programme across the region. **Our conclusion is that the instruments are limited and, therefore, the Eurozone is highly affected by the resolution of external factors.**

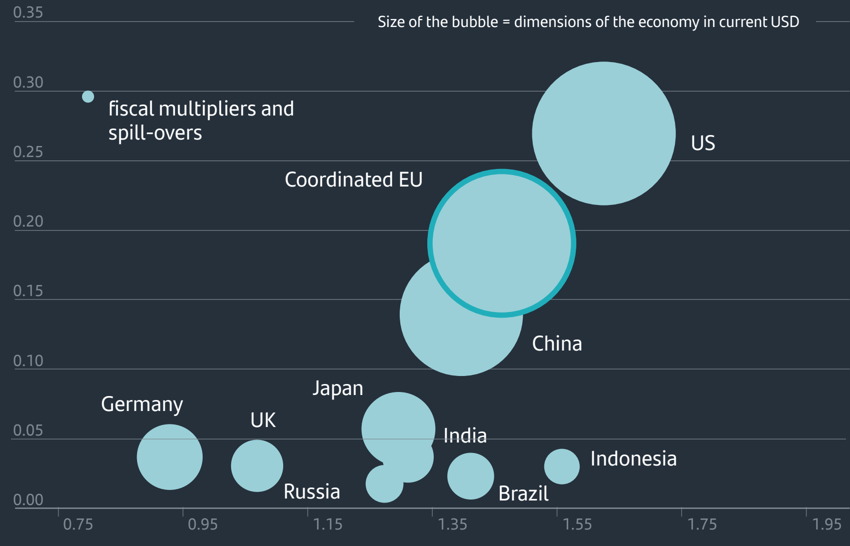
A historic opportunity not to be missed

The European fiscal multiplier is one of the most effective

Fiscal multipliers and indirect effects

Source: Oxford Economics and in-house

Fiscal expansion will be effective and good for everyone if it is undertaken in a coordinated manner



Macro Emerging.

We do not expect the slowdown in activity in emerging economies observed in 2019 to continue next year. We expect the relaxed financial conditions present last year to have a stabilising effect on growth throughout the coming year. Nevertheless, there will be differences by region.

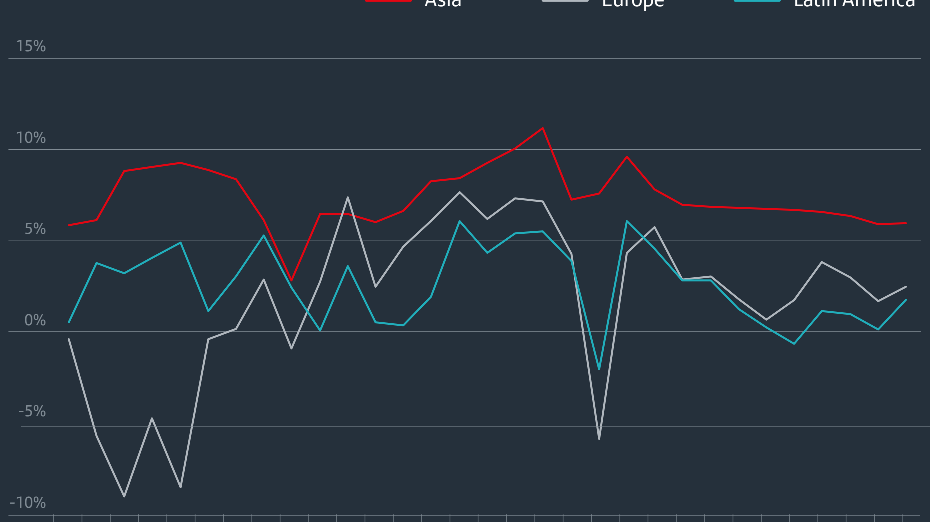
Asia will continue to be the region with the highest economic growth rate, but its growth rate will be accelerating at the slowest rate of the emerging regions. Acceleration in growth is expected in India, where it could reach 7% as a result of the declining effect of the credit restrictions applied in 2019. In China on the other hand, the stimuli may not be enough to compensate for either the impact of the US trade conflict (if tariffs are not reduced) or a slowdown caused by a change in the production model that has been seen in recent years. Growth in China is expected to continue slowing to levels below 6%.

India and Latin America are the main drivers for accelerating growth in emerging markets in 2020

Latin America is one region where growth could be faster among emerging economies, with average GDP increases in excess of 2%. Generalised monetary stimuli and the diminishing effect of events that occurred in 2019 (e.g. change of government in **Mexico** and public protests), will be key. In the same way, the reforms already undertaken by the Bolsonaro Government (pension reform has been especially significant), and those that may be introduced next year, will continue to improve the prospects for growth in **Brazil.** Commodity performance is the variable most likely to cause deviations away from our central growth scenario for Latin America.

Is there **structural imbalance** in the main Latin American economies which presents a significant risk of a downward turn for our base case ? **With the exception of Argentina,** we think the answer is **no.** In the remaining countries, neither current account deficit (also not in Argentina), nor public deficit (except in Brazil), nor inflation are at sufficiently high levels to trigger a severe adjustment to activity.

Asia, at the head of growth levels in 2020...
... but Latin America will lead in acceleration



Emerging regions - GDP growth (average annual %; 2019 and estimate for 2020)

Source: Refinitiv Datastream and in-house

India will be the growth capital, recovering GDP growth rates of around 7%

In principle, trade and the Fed's monetary policy are the main global focus points for these economies

The **uncertainty regarding Argentina** will depend on maintaining the financial support of the IMF, and **may cause controlled volatility** in the region. It is not expected for this volatility to spread to other countries on the continent, as Argentina is not only economically small, but also not very open externally. **Bolivia,** which also has political uncertainty, is another economy with **little capacity to infect others.**

The midpoint in terms of growth rates for 2020 will be found in Emerging Europe, with hardly any imbalance, but affected by moderate activity in its main area of influence, the Eurozone. If trade tension relaxes, the delocalisation decisions may benefit investment in these countries.

To summarise, a close watch will need to be kept on two key factors next year:

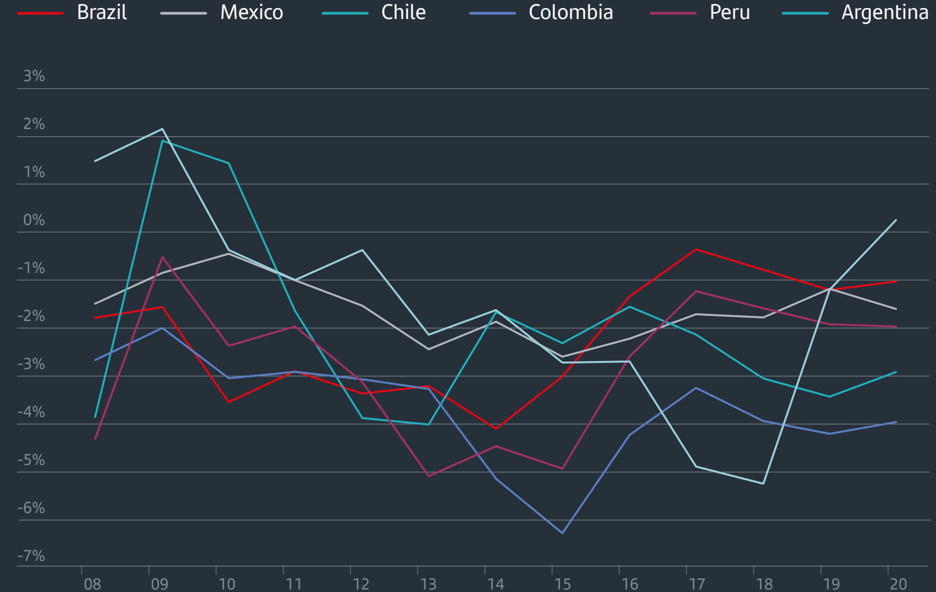
- **Trade war.** Given the fact that Trump is up for reelection, the most probable scenario is that the conflict will ease. He has a strong incentive to try and reach an agreement and present this as a victory to voters. This scenario would not only relieve pressure on China, but also on the remaining emerging economies, which are strongly linked to growth in international trade.
- **Federal Reserve.** The market still expects interest rates to be cut next year. However, if the expected growth rates are maintained, the Fed may no longer find justification to do so, as would happen if the US and China reach a trade agreement. In short, in this environment the risk for emerging economies (which we see as remote) would be a considerable increase in interest rates, like in 2018, which would result in a heavy withdrawal of investment flows. This risk scenario is especially sensitive for countries like Argentina, Turkey and South Africa, with economies that have a high level of external debt and/or current account deficit.

How we have changed

Less external vulnerability for Latin American economies

LatAm economies - Current account balance (% GDP; 2019 and estimate for 2020)

Source: International Monetary Fund and in-house



The gap between savings and investment has narrowed considerably. We are far from the fears that triggered Bernanke's *taper tantrum* in 2013

5 Fixed Income.

Today's increased geopolitical and economic uncertainty means that it is now more important than ever for investors to balance their portfolios with defensive positioning in bonds from good credit quality issuers. However, it is advisable that this positioning is made with a high level of diversification in terms of duration, issuer, sectors and geographies/currencies given the low returns offered by debt after the 2019 rally.

There were very positive surprises during 2019 in the fixed income market, owing to higher than those expected returns than were anticipated at the start of the financial year. These increased returns were particularly unexpected in regions such as Europe where bond yields started the financial year at very low, or even negative, levels. The strong overall performance is the result of lower yields insovereign bonds and a reduction in the credit spreads of corporate bonds.

Based on historical levels, yields on bonds priced in USD and in emerging currencies compare less favourably to those listed in EUR

The following table explains how current yields for different segments in the US and European debt markets are close to the historic lows of the last ten years. This is especially pronounced in the case of European fixed income, where government and corporate bonds, as a whole, yield 0.4% until maturity. US fixed income yield is less of an issue, however, with interest rates that compare well to the historical average. Fixed income in emerging economies offer better yields comparedwith other high credit risk options (High Yield credit USD and EUR).

The situation is complex. According to historical benchmarks, investment in countries with lower credit quality (Italy, for example in the Eurozone), over longer periods, or in corporations with a lower credit rating and even emerging economies, no longer offers an acceptable risk-reward ratiocompared. **When it comes to obtaining yields in fixed income which exceed current levels of inflation, the investor will be obliged to accept higher risks than those historically assumed,** which will need to be done in a tactical and diversified way.

Fixed Income USD yield range

	Current	Minimum	Range	Maximum
Aggregate US Fixed Income Index	**2.3%**	**1.6%**		**3.7%**
US Treasury bonds	1.8%	0.8%		3.1%
Corporate Investment Grade	2.9%	2.6%		4.4%
Corporate Speculative Grade *(High Yield)*	5.8%	4.8%		10.2%
Emerging Fixed Income USD Index	**5.1%**	**4.0%**		**6.8%**

Fixed Income EUR yield range

	Current	Minimum	Range	Maximum
Aggregate Fixed Income EUR Index	**0.4%**	**0.1%**		**3.9%**
Eurozone governments	0.3%	0.0%		3.7%
High rating (GER, NL, FRA, etc.)	-0.4%	-0.7%		3.1%
Low rating (POR, GR, ITA, ESP, etc.)	0.3%	0.0%		5.9%
Corporate Investment Grade	0.8%	0.5%		5.3%
Corporate Speculative Grade *(High Yield)*	3.9%	3.0%		12.7%

(Date range: Dec. 2010 - Nov. 2019)

US Fixed Income.

In developed countries, the yield on bonds in USD is still attractive in relative terms, despite the Fed's rate cuts. We recommend moderate positioning, both in investment duration and in credit quality, while paying close attention to movements in yields to increase the risk tactically in portfolio.

1.45%
Historic low for US Treasury 10-year bond yield

Fundamentals and valuation

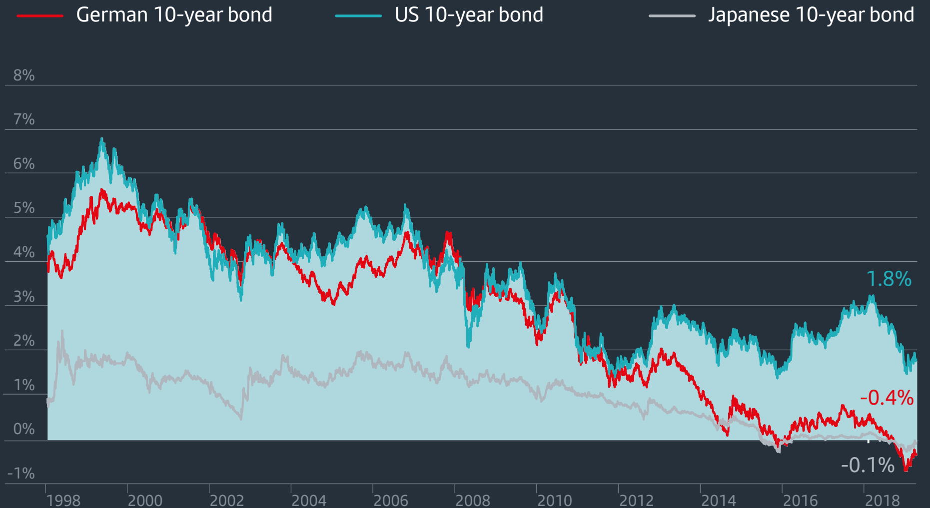
Monetary markets: the short-term sections of the US Treasury curve enable yields to be obtained at levels closely in line with inflation indicators. Liquidity **positions in USD involve a loss of purchasing power that is** not as pronounced as in other currencies in the developed world.

Government: the US Treasury yield curve is very flat, and was inverted in 2019 during moments of particularly high tension withinin financial markets. The current economic environment favours "bear steepening" strategies (an increase in long-term, rates due to a perception of a lower level of economic uncertainty), in which, and in accordance with our base case , the short-term sections of the curve would perform better during a period of Fed rate stability. Nevertheless, **the return on US bonds still compares favourably with its counterparts in Europe and Japan** (see chart below), which would act as a possible support for potential increases in long-term yields.

Credit: the reduction in interest rate spreads (that reward the investor for assuming a greater probability of default in interest and principal payments) makes the purchase of corporate bonds less attractive. The financial position of US issuers is, in general, healthy (above all because of the meagre cost of debt), but more discretion is required in the BBB segment given the increased debt in issuers with this rating profile. It is also **necessary to be selective and to avoid industries and issuers that are negatively affected by digital disruption (primarily in the retail distribution sector and audio-visual media)** that may be susceptible to margin compression.

Data as of 22 November 2019

Relative higher yields from US Treasury bonds
The rates for US 10-year bonds are low in absolute but not in relative terms



"Japanisation" of European rates

Source: Bloomberg and in-house

Historic maximum yield spreads between the US and Europe

Strategy and positioning

8.6%
Return obtained in 2019 on Fixed Income USD issues as a whole

There is no doubt that the scenario is complex for both long-term strategies (bonds with long-term maturity offer very little spread to compensate for the risk of rises in the yield curve with a corresponding drop in prices, i.e. convexity) **and for aggressive positioning in credit risk** (the market is offering low risk premium to offset a possible lower rating downgrade or non-payment if there were to be a slowdown in economic activity).

Strategic positioning will require strong tactics in order to switch between assuming interest rate sensitivity risk (duration) and credit risk. Even though both risks were excellently rewarded in 2019, we feel **that over the next 12 months there will be fluctuations in circumstances that will favour one type of risk or the other.** The key variable for rotating between these two types of risk will be in the perception of the moment for economic growth and geopolitical risk. **We think the "safest" bet will be in the corporate bond segment, with short-term and medium-term maturity.**

2.3%
Yield on maturity available for Fixed Income USD issues as a whole

We remain cautious regarding issuers **with a lower credit rating** (speculative or high-yield bonds), as we feel that the risk-reward ratio is not sufficiently favourable. Furthermore, the rating agencies are starting to detect a deterioration in the fundamentals of these kinds of companies and, as can be seen in the chart below, an increasing number of companies are suffering credit rating downgrades. This trend is usually the precursor for potential increases in the credit spreads demanded by the market for these types of bonds, with a corresponding fall in the prices of these assets.

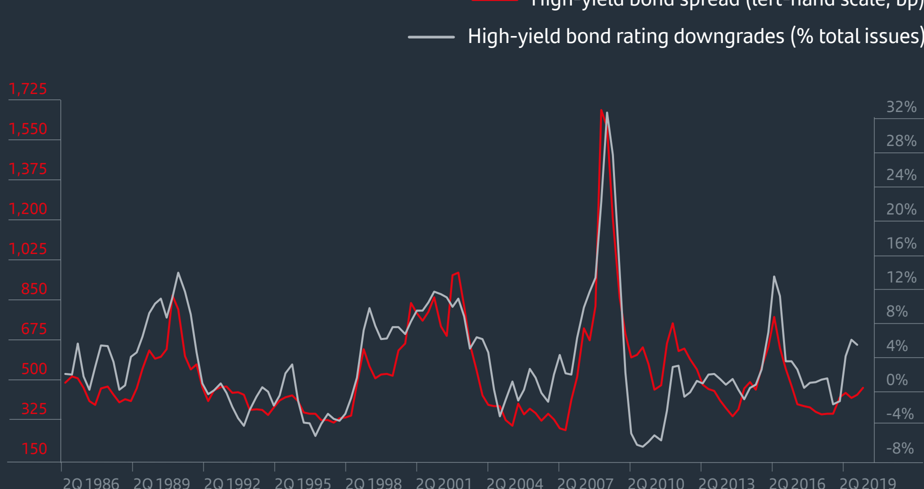
Insofar as the slowdown in the manufacturing sector does not affect the other sectors in the economy, positions in corporate bonds may continue to provide extra yield. However, **we do not recommend taking an aggressive approach towards credit risks.**

Moderate downgrading of credit ratings...
... but the agencies are starting to take note of deteriorating balance sheets

US Speculative Grade (high-yield) bonds - Increasing trend towards ratings downgrades

Source: Moody's and in-house

Companies with the poorest credit ratings are starting to show signs of a deterioration in health of their balance sheets



European Fixed Income

Investment in the interest rate curve in EUR provides few alternatives to escape from the negative interest rate trap. The most common source of profitability in recent years has been positioning in bonds from non-core countries, but the upside is now very restricted. Corporate bonds still offer more value since their leverage indicators are considered reasonable.

1.4%
10-year Greek government bonds are trading with a lower yield than the same term bond issued by the US Treasury.

Fundamentals and valuation

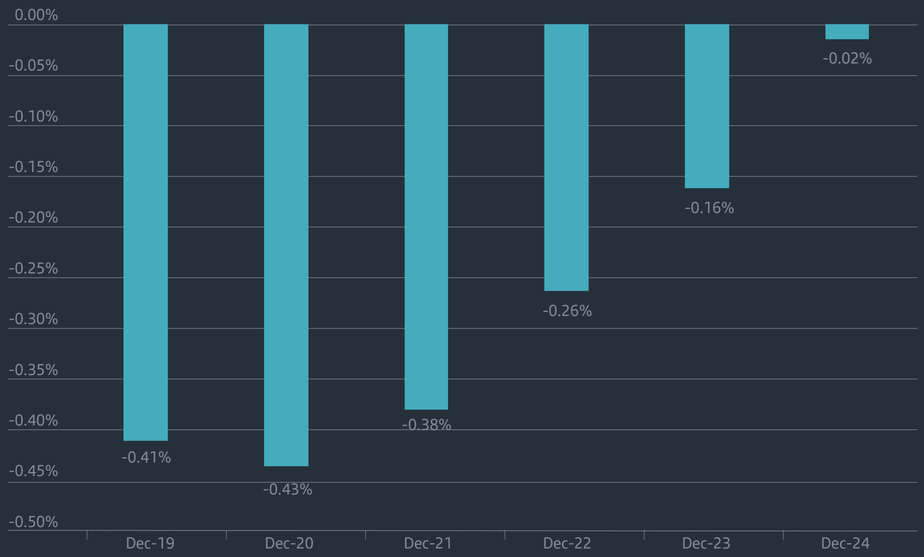
Monetary markets: the European Central Bank (ECB) lowered interest rates again in September 2019 (10 basis points on its deposit rate) and announced an asset purchase programme, also known as "quantitative easing" (QE), for EUR 20,000 million per month. However, **when it comes to additional monetary easing, the ECB has more limited margin than the Federal Reserve** because of the current negative interest rate situation and internal divisions within its governing bodies. Even though we do not expect further cuts in the deposit rate, **liquidity will continue to be penalised and this is not expected to change for quite some time** (see chart below with future market forecasts for 3-month rates).

Government bonds: German sovereign bonds are trading at negative interest rates throughout the curve whilst **Spanish 10-year bonds are at levels close to zero.** The overriding message is that there will be low rates for a long time and an attempt to pass the baton to fiscal policy. This process will also favour a reduction in core vs non-core spreads, supported by an apparently more collaborative relationship between Italy and Brussels.

Credit: a decelerating economy would have a negative effect on credit spreads and the hunt for yield. In addition, the ECB's monthly purchases would create a strong demand for assets. The credit market continues to accumulate investment flows, which explains the enormous amount of debt with negative yield at the global level.

Data as of 22 November 2019

Five years with a liquidity trap
The penalisation of liquidity is expected to last until 2025



Negative interest rates (3M Euribor)
Source: Bloomberg

According to the market, the ECB's latest measures have delayed a return to a positive interest rate scenario by two years

Strategy and positioning

-0.4%
Average yield on government bonds issued by countries with a higher credit rating (Germany, France...)

Draghi's legacy brings with it highly complex decision-making, not only for Lagarde, but also for European fixed-income managers. **The purchase of bonds with a negative yield is a new paradigm for any investor** as this involves coming to terms with settling for loss of capital and purchasing power (inflation is below the ECB target but it is still positive) or maintaining liquidity levels with penalisations that are even higher.

Company financing is occurring at historically low interest rates due to investor appetite for corporate bonds and robust company fundamentals. Our growth scenario considers that company fundamentals will be maintained as a result we expect default levels to remain low. Furthermore, **negative interest rates on sovereign bonds favour a "carry" strategy for non-core sovereign and corporate debt.** However, future economic developments will play a key role in exposure to corporate credit risk, and low interest rates in the eurozone will cause a significant reduction in the potential return for European fixed income.

We envisage a **more volatile environment in interest rate curves,** with possible stress episodes in risk premiums that will enable investors to take positions in more profitable conditions. It will be especially important to monitor any possible disagreements over budgetary discipline between the Economic and Monetary Union and one or more of the Member States.

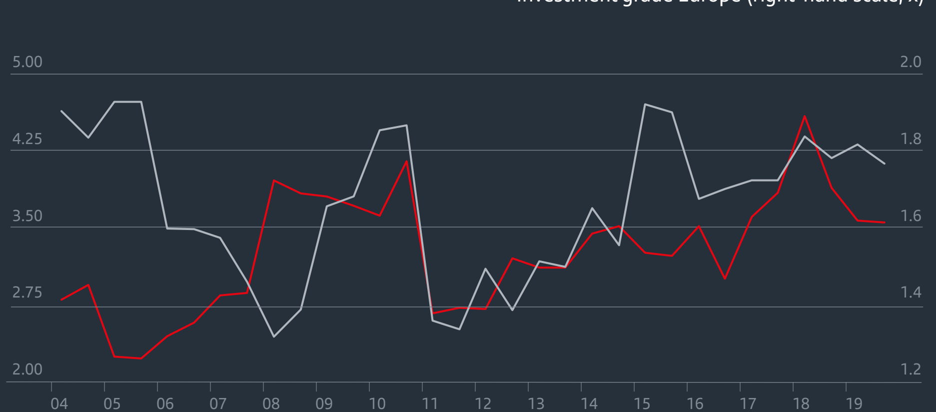
+0.3%
Average yields on bonds issued by European non-core governments (Spain, Italy, Portugal, etc.)

Unlike in the US, we perceive value in bonds with a lower credit rating (speculative or high-yield bonds) as there has been no increase in their leverage ratio throughout the present cycle. The European banking and financial system has been more cautious in lending standards than the US and we feel that there is less probability of an increase in spreads on European speculative bonds.

Balance sheet quality in the European business sector
Leverage levels have remained stable

Leverage for corporate debt issuers in Europe
Source: Bloomberg and in-house

European companies have committed fewer excesses than their US counterparts with regard to debt



Fixed Income Emerging countries.

5.0%
Annualised returns over the last 5 years

For the last five years, emerging debt has been one of the main sources of returns for fixed income investors who can accept the higher levels of volatility involved. We feel that, in an environment of controlled geopolitical risk, investment in emerging bonds still offers good value given the yield spread they continue to offer.

Fundamentals and valuation

Yields currently offered by emerging markets bonds are moderately attractive when compared with their range over the last ten years, with an average return of 5%. However, this yield varies significantly between countries with an investment grade rating and those with a speculative grade rating, as can be seen in the following table.

Yield Ranges for Emerging Markets Bonds

	Current	Minimum	Range	Maximum
Emerging Fixed Income USD Index	**5.06%**	4.0%		6.8%
Investment Grade countries (Russia, Mexico, etc.)	3.24%	3.0%		5.3%
Speculative Grade Countries (BRA, ARG, TUR, VEN, etc.)	8.39%	5.7%		10.7%
Mexico *(S&P Rating* BBB+)	**4.51%**	3.4%		6.3%
Brazil *(S&P Rating* BB-)	**4.23%**	3.7%		10.7%
Turkey *(S&P Rating* B+)	**5.76%**	3.3%		11.5%
Russia *(S&P Rating)* BBB-)	**3.31%**	3.3%		11.4%
Asia	**3.74%**	3.0%		6.3%

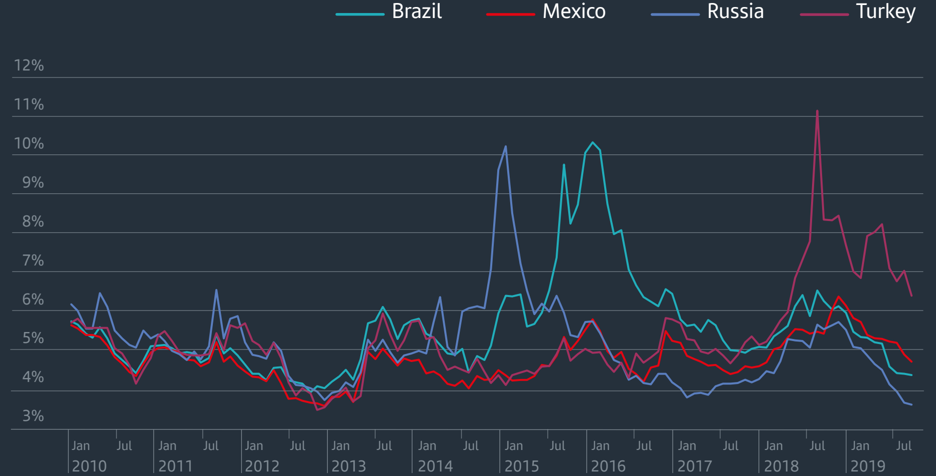
(Date range: Dec. 2010 - Nov. 2019)

This situation is a result of worsening liquidity and credit conditions in countries such as Turkey and Argentina, which have not received the market's backing in the last year. As demonstrated by the following chart, Brazil and Russia have experienced a significant reduction in their funding costs in USD. The market has valued positively the progress in Social Security reforms by the Bolsonaro administration and the healthy financial position of the Russian economy.

Yield spreads for emerging market bonds
Breakdown by country of interest rate yields

Growth of Emerging Market Fixed Income spreads
Source: Bloomberg and in-house

Emerging market bonds have attracted significant investment flows, the cost of their debt has reduced considerably



Strategy and positioning

Emerging market bonds provide real, positive yields both in USD and in the local currency

Our forecast for debt assets in emerging markets (especially in Latin America) is relatively constructive. Moderate growth and, as a result, generally loose global monetary policies mean that real interest rates will remain historically low, which usually intensifies the search for yield. Debt in emerging markets still offers very attractive returns, especially in relative terms.

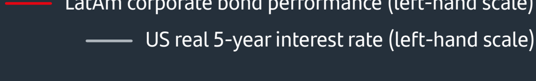
The search for yield will also have a positive effect on corporate bonds where spreads are currently not very demanding, slightly above the historic average. Most companies will generally present healthier balance sheets than their counterparts in developed countries. The financial conditions are also very favourable for a reduction in company financial costs, with the exception of those companies with a high percentage of financing in USD.

The possibility of interest rate cuts in Mexico and Brazil and the low levels of debt are factors that favour investment in Latin American corporate bonds

From a microeconomic point of view, the slowdown in global growth means that companies will continue to postpone their expansion plans, maintaining very high liquidity levels and very low leverage. In Brazil, for example, low interest rates and a strong appetite for domestic debt will mean that external debt repurchases will continue, financed with domestic placements at very attractive interest rates and spreads.

The main risk for this scenario would be a greater downturn in international trade, with the threat of a global recession. In this case, we would see a different response from the developed world, with more expansive fiscal policies financed with higher levels of debt. Moreover, emerging countries would drastically cut interest rates to record lows, forcing currency devaluations depending on each country's ability to control the effects on internal prices.

There is value in Latin American corporate bonds
They offer attractive nominal and real yields



Real interest rate performance US vs LatAm corporate bonds

Source: Bloomberg and in-house

We recommend issuers that have solid balance sheet structures with financing in local currency and low income cyclicality

6 Equities.

Global equities have benefited from a cycle of economic expansion which has already lasted over a decade. We feel that future returns on shares will tend to decrease compared to historic averages. Despite the balance of risks in the medium-term being higher, we feel that there is still upside potential in equities and, in relative terms, this asset presents the best risk-reward ratio.

Equities worldwide have been directly impacted by developments in the "trade war" over the last 18 months. The market has recently assimilated and overcome the noise about geopolitical disputes and has achieved new record highs. In our opinion, **there is still upside potential in stock markets as long as a basic trade agreement is reached, the economic and profit slowdown is stabilized, interest rates continue to be low and there is good geopolitical visibility.**

9.3%
Annual returns of global stock markets in the last decade

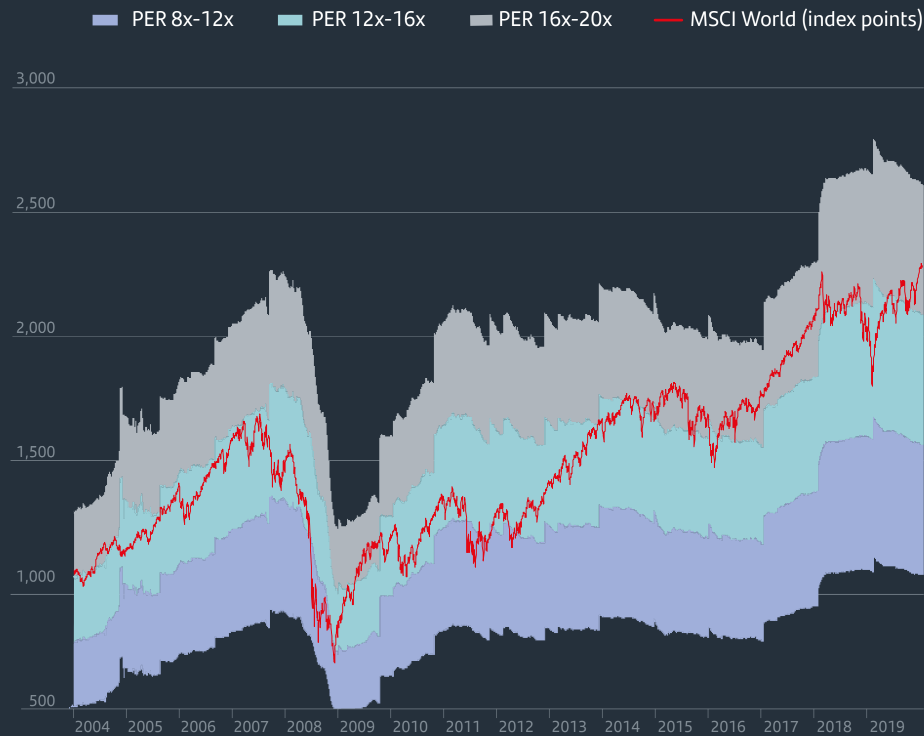
The chart below shows how an increase in the global equities index (MSCI World) led stock markets around the world to set new record highs at the end of 2019. This re-valuation was not accompanied with the same intensity by profit growth, **so valuation ratios are no longer at the attractive levels of early 2019.**

It is **essential that expected profits for 2020 maintain positive growth,** business margins are established and the rise in labour costs is offset by increased revenue.

Data as of 22 November 2019

Valuation multiples at highs for the decade

Stock markets are in the demanding valuation zone if viewed in absolute terms



MSCI World - Index and valuation areas by PER

Source: Bloomberg/IBES and in-house

The rise in share prices has exceeded the rate of profit growth, with a corresponding rise in valuation ratios

US equities.

14.1%
Annual returns for US stock markets in the last three years

The US stock market continues to lead the global market's expansionary cycle, with its technology giants playing the leading role. Performance over the next 12 months will be key, and our attention will be on the capacity to meet profit growth expectations. The most important qualitative factor domestically will be the result of the presidential elections and the impeachment process, as well as the trade war with China in the international arena.

Fundamentals and valuation

Earnings: given the maturity of the economic cycle and low unemployment levels in the US, companies are beginning to note an increase in their operating expenses. Combined with a decline in company margins and a slowdown in sales revenues, these factors are hindering the growth of corporate profits to such an extent that the **expected increase in profits for 2019 is practically nil.**

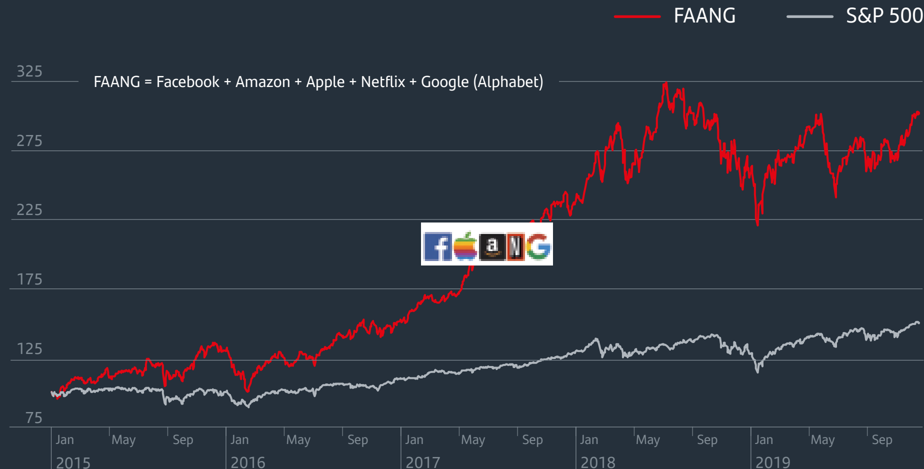
One of the key players in this expansionary cycle for the US stock market is the technology sector, and in particular, the so-called **"FAANG" (Facebook, Amazon, Apple, Netflix and Google).** These digital giants have enjoyed spectacular growth in market share and revenues, and are the **main drivers of the rise in the S&P 500** and more favourable behaviour compared with other stock markets. However, in 2019 the technology sector's capacity for generating profits has shown signs of running out of steam, with a 10% fall in earnings per-share (EPS) at the close of the third quarter.

Analyst consensus expects double-digit growth for S&P 500 profits next year but given the context of a downward revision in growth forecasts, the negative effects of trade tensions on the manufacturing sector, and the squeeze on company margins, we anticipate more modest profit growth estimates of around 5%. This outlook involves a valuation ratio of 17x profits (PER), which would be slightly above the historic average for the S&P 500 index.

Data as of 22 November 2019

"FAANGtastic" returns
The main driver of revaluation in the US stock market has been the technology sector

FAANG revaluation *versus* S&P 500 index (base 100=1 for January 2015)
Source: Bloomberg and in-house



The global success of these technology giants has placed the US at the top of the global rankings for market performance

Valuation and positioning

Using traditional valuation metrics and retrospectives, like the CAPE* ratio, US equities are still more expensive than those of other regions and **are trading at historically high multiples.**

The US stock market trades at a premium over other regions, but this has been so far justified by superior earnings growth

However, it is important to remember that demanding valuations do not necessarily imply lower future returns; for example, US shares have been more expensive than those in any other region for the majority of the last decade and despite this, have consistently offered a relatively higher return.

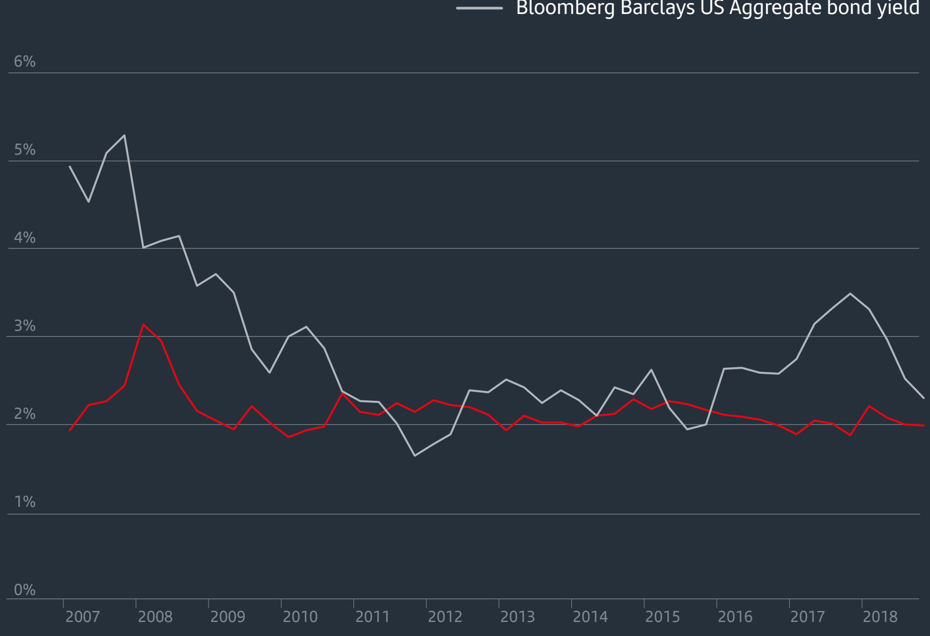
The macroeconomic context for the medium term should also continue to be moderately favourable. US equities have been leaders in delivering strong returns for a decade compared with the stock markets in other developed countries. This outperformance is justified by US companies' capacity to generate higher margins and profit growth (especially through their technology platforms). Even so, investors are overexposed to US equities, making them susceptible to negative surprises. One of the greatest concerns for investors is the implementation of anti-monopoly measures against the technology platforms (FAANG).

We recommend maintaining positions but rotating towards sectors that are more defensive and have a "value" bias

This makes us lean towards a rotation to more defensive and domestic sectors, which would theoretically benefit from a higher fiscal stimulus and would be better protected against any possible additional downturn in international trade. The passing of new regulations governing certain areas like health, banking and technology platforms would also pose a significant threat. **We recommend maintaining positions in US equities but rotating towards sectors that are more defensive and have a "value" bias** until the ongoing geopolitical uncertainty and trends for margins and company profits become more clear.

(*) *Cyclically Adjusted PE* (PER by profit cycle).

Returns comparison for US equities and fixed income
Yield for both assets has been similar in this cycle



Comparative US equity and bond yields

Source: Bloomberg and in-house

Historically, yield from dividends on the US stock market has been lower than the yield from fixed income indexes, but that discount has practically disappeared

European equities.

European shares are significantly behind US shares when it comes to market performance and profit growth. We could see European stock markets perform better in a context of less uncertainty about the outlook of several key industries (automobiles, banking...) and regarding Brexit.

The European stock market is still trading 17% below its high of the previous cycle

Fundamentals and valuation

Current market data shows a high aversion to risk as a result of macroeconomic and geopolitical uncertainties. **Investor exposure to European equities is at historically low levels and low compared to other geographies.** In 2019, there were significant withdrawals from equity funds, in contrast to strong deposits in fixed income. In terms of sectors, investor surveys show a clear preference for defensive and "growth/momentum" bias sectors compared to cyclical companies with "value" bias.

Corporate earnings growth among European **companies has been declining** in line with the downturn in industrial production. Current expectations are that general growth for 2019 will be practically nil.

5%
Weighting of the technology sector in the European stock exchange (vs 21% in the S&P 500)

In this context, the European stock market has enjoyed more than appreciable revaluation given the incentive for investors to transfer unremunerated positions in fixed income to shares with a dividend. However, European stock markets are still behind those in the US. This is a result of three factors: (i) higher economic growth and less uncertainty in the US, (ii) higher growth of company profits in the US, (iii) less prominence of higher growth sectors in Europe (mainly technology and health). The outperformance of the European stock markets by the US can also be explained by the difference between the revaluation of the banking sector in Europe and the technology sector in the US. **The prominence of the financial services sector in Europe (combined with problems in the automotive sector) and the absence of digital and technological platforms with a global dimension to compete with those in the US and China, has been an impediment for European stock markets.**

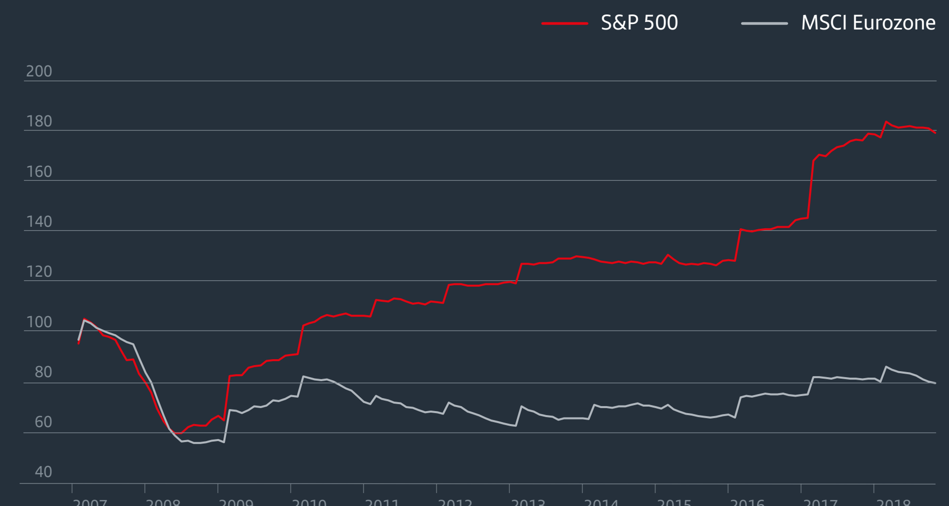
Data as of 22 November 2019

Decoupling in profit growth

The US stock market's outperformance is based on more buoyant profit growth

Comparative growth of earnings per share (base 100=2007)

Source: Bloomberg and in-house



The spread between the appreciation in US stock market valuations and those of the European market has never been so wide, but it can all be explained by the "lost decade" of European profits

Strategy and positioning

The relative valuation of European equities compared to fixed income provides the strongest support argument for the stock exchange if we take into account that the comparison has historically never been so favourable. All stock market indexes have experienced an increase in multiples in recent years as a result of excess liquidity arising from the central banks' ultra-loose monetary policies. In the chart below you can see how the gap has widened between the dividend yield of European shares and the yield to maturity on bonds, reaching maximum historic levels.

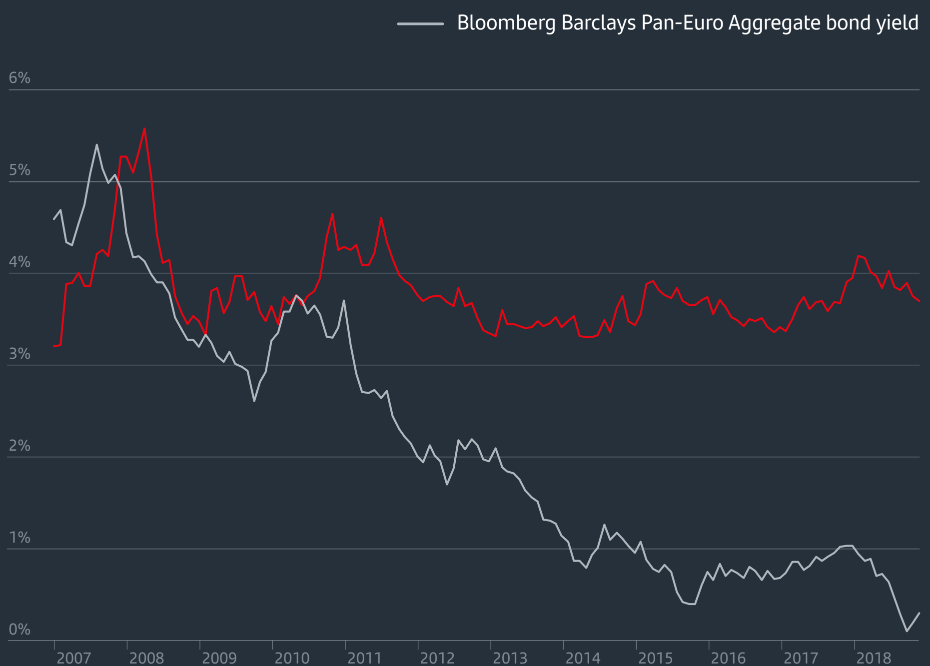
The European stock exchange generates almost 4% more yield from dividends than the bonds of European issuers

Although 2020 appears to be a year of economic and geopolitical uncertainty, we feel that European equities are more attractive in terms of valuation, even assuming that there may be a downturn in profits. The opportunity for **arbitrage towards equity by the debt markets and the low positioning of investors is a bolster for European stock markets.** From a sector and a style perspective, we recommend a certain neutrality. Regarding cyclical/defensive or value/growth stocks, a scenario involving a major macroeconomic downturn can be discounted.

Uncertainty regarding Brexit is another factor that has undermined the performance of the European indexes. Over the next twelve months, risk premium will probably decline, and this will breathe more life into European shares, especially British shares (financial services, aviation and real estate would be the sectors that would benefit most in the United Kingdom). Our base case considers an **agreement between the European Union and the United Kingdom** that could prove to be a **catalyst for a significant recovery of both Sterling and the UK equity market.**

Data as of 22 November 2019

Maximum yield spreads between equities and bonds
Yield from dividends are significantly higher than fixed income



Comparative European equity and bond yields

Source: Bloomberg and in-house

Dividends yields have continued to grow while those of bonds have continued to decline as a result of the ECB's ultra-loose monetary policy

Equities Emerging Countries.

Although stock markets in emerging countries offered returns approaching 10% in 2019, this was lower than in developed countries and considerably less than that of the S&P 500. Even though emerging economies are enjoying higher economic growth than developed countries, the uncertainties they face need to be mitigated in order for their stock markets to realise their potential for appreciation.

Fundamentals and valuation

31%
China's weighting in global emerging market equity indexes

Our opinion on **emerging market equities is determined to a large extent by our outlook for China,** since it represents almost 30% of the weighting for the index and is the main trade partner for most of the emerging countries.

Taking this into account, at least in the short term, we believe that fundamentals will have less weight than market confidence and sentiment, the probability of internal stimuli and the implementation of the new *"Belt and Road"* initiative. Although it is clear that China's macroeconomic variables are stabilising, we continue to keep a close eye on events involving public protests in Hong Kong.

In terms of valuation multiples, **the stock markets in emerging countries are trading at record highs,** as illustrated by the following table. The only countries trading with reasonable multiples compared to their historic averages are Mexico, Turkey and Russia.

Emerging Stock Market Valuation Bands (PER)

	Weighting in Emerging Market MSCI	Current	Minimum	Range	Maximum
Emerging Market MSCI		**13.7x**	**9.0x**		**14.3x**
China	31.4%	12.3x	7.6x		15.9x
India	8.9%	21.7x	12.1x		22.5x
Mexico	2.5%	15.4x	12.5x		23.3x
Brazil	7.7%	15.2x	7.7x		16.1x
Turkey	0.5%	8.3x	5.9x		12.4x
Russia	4.1%	6.3x	3.9x		8.0x
Poland	1.2%	11.8x	7.4x		15.0x

(Date range: Dec. 2010 - Nov. 2019)

Our selection of markets for 2020 **highlights China, India, Brazil and Russia.**

In the case of **China,** we see a market that, despite the considerable returns generated in 2019, it is still trading at undemanding valuation multiples. A certain reversal of trade tensions would highlight the fiscal stimuli introduced by the Chinese administration during this year.

We still think of **India** as a preferential market, and our overweight rating on this country is the result of a combination of two factors. This year's reduction in company tax will be positive in the medium-term. This, combined with the excellent data for economic and financial risk that it provides, means that India is still at the top of our rankings for stock markets in emerging countries.

In **Brazil,** the recent growth in multiples could drive more accelerated growth in returns as a result of (i) more robust economic growth, (ii) more favourable financial conditions as a result of the efforts of the central bank, (iii) an easing of the "trade war" which will put an end to the

freeze on global investment and boost commodities prices (of which Brazil is a net exporter) to a certain extent. It is also the result of (iv) progress in the reform agenda which will act as a magnet for direct foreign investment and represent a turning point in the confidence of local economic agents. The materialisation of the above factors would provide a margin for revaluation that would be considerable even for the Brazilian stock market, in which we feel investment should continue.

Finally, **Russia,** apart from being one of the emerging markets presenting the least expensive valuation metrics, is a country in which we still observe robust fundamentals from a fiscal perspective, and which has a wide margin for reducing interest rates.

Strategy and positioning

Investment positioning in equities in emerging markets is still low, given the modest performance over the last 18 months —in line with the appearance of risks due to the "trade war" —which could mean that it will continue in the short-term, precisely because this type of asset is undervalued by global managers.

Falling interest rates in Latin America are increasing the attractiveness of stock markets in the region. This potential can only be materialised insofar as investors perceive the economic policy scenario, in general terms, as favourable for company investment and profit growth.

For our part, we still consider **India as our preferred market in the long term,** given the favourable demography, its development status and valuations that a greater profit drive could make more inexpensive.

We cannot overlook the impact that the different **focal points of geopolitical instability** could have on how some of these markets progress. We will be paying close attention to public protests, especially to what is happening in larger countries like Hong Kong (China) and Kashmir (India).

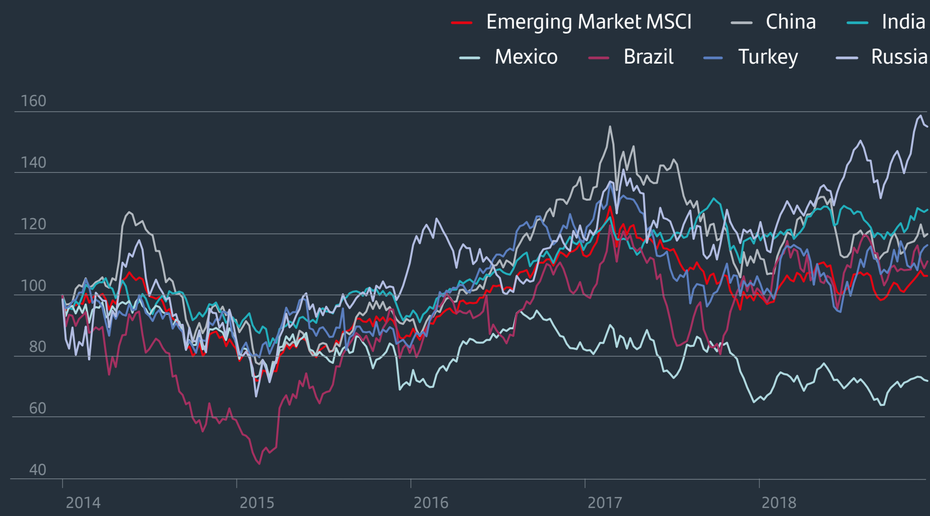
Data as of 22 November 2019

As always, monitoring risks in emerging market equities is key

High sensitivity towards political and economic instability

Geographical selection is critical for this asset (base 100=2014)

Source: Bloomberg and in-house



The volatility of emerging country stock markets is very high, with a wide spread of returns between the different geographies

7 Currencies.

The high volatility that has historically affected the foreign exchange market has not been as intense in 2019, with certain logical exceptions such as sterling. However, investors should not be complacent and always take into account that investment in this asset is highly complex, due to its volatility and liquidity.

The **euro** (EUR) **to US dollar** (USD) exchange rate will certainly continue to be **one of the main variables that markets will be watching throughout 2020.** Following the USD's gains against the EUR over the last two years, we should ask ourselves what prospects remain for any additional appreciation of the USD against the EUR in the current primary cycle (long term), which dates back to 2008 and an exchange rate close to 1.60 EUR/USD.

Investors desperate search for yield will continue to reward currencies with more attractive interest rates

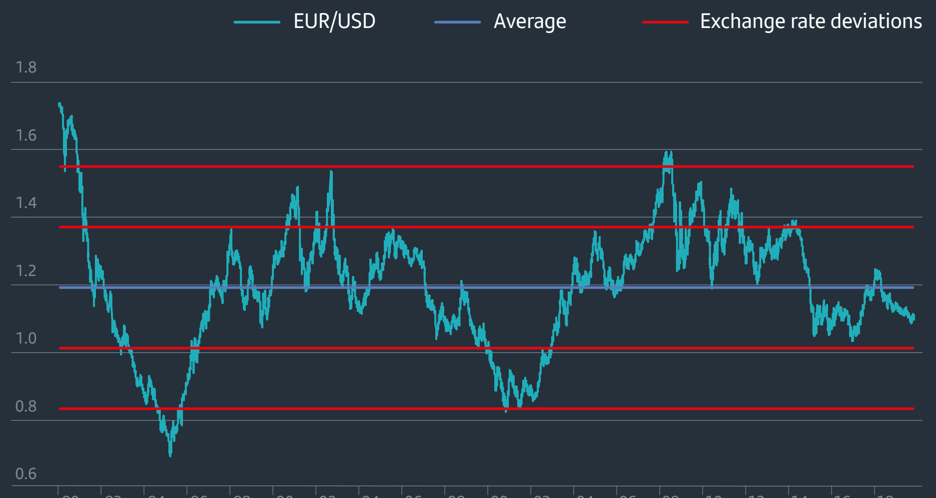
There are two factors which lead us to foresee the continued appreciation of the USD vs EUR, at least during the first half of 2020. Firstly, the interest rate spread between the two economies. After narrowing in recent months, this could widen in favour of the USD, ahead of others in the shorter sections of the curve, if the market ends up making a clear correction of current expectations for Federal Reserve interest rate cuts for next year. Secondly, valuation. Notwithstanding that equilibrium PPP stands close to the 1.30 reference point, history tells us that primary trends typically revolve between one or two typical deviations below, or above, the average currency cross trading level over the very long term. That area is located close to parity.

During the second half of 2020, the EUR/USD exchange rate could return to the path of more consistent appreciation, moving slowly towards equilibrium, although we think that this will not be reached next year. The factors that could bring about this movement are firstly a firm Brexit agreement (which we expect in January), which would have a positive effect on growth in the eurozone from the mid-point in the financial year. Secondly, the stabilisation of growth in China (the current stimuli applied by the authorities may have a greater impact from the Spring), which could also have favourable ramifications for Germany.

In the very long term, everything gravitates towards the average...
... but first we have to cross the "finishing line"

EUR/USD - current vs average exchange rate

Source: Refinitiv Datastream and in-house



Before recovering the road to appreciation with greater consistency, history tells us that EUR/USD needs to depreciate somewhat more

Although the outlook for variation in currencies in the short term predominately depends on growth and interest rate spreads between countries, it is also important to analyse their basic valuation in terms of the deviation away from the PPP equilibrium

With regard to other currencies, **GBP has a considerable potential for appreciation** against USD and EUR, as it is trading well below its PPP equilibrium, and this potential appreciation would result in gains if, as expected in our base case , a Brexit agreement ultimately becomes a reality on 31 January.

Investment in **Norwegian krone (NOK) is an alternative to the limited attraction of the euro,** which is being supported by its central bank, with four increases of 25 bp in its reference rate since September 2018 and stable oil prices.

As for the **yen (JPY), the attraction of its valuation against the USD and EUR would justify a moderate further appreciation over the medium term.** However, JPY has been moving "like a fish in a pond" during the geopolitical turbulence of recent years, and it will be difficult for significant appreciation in 2020. We should also take into account future actions that are likely to be taken by the Bank of Japan (BoJ), as it will probably not wish to be left behind by the Fed and the ECB when it comes to turning the screw on monetary stimulus, as occurred in 2019. The Governor of the BoJ, Kuroda, has also spoken of the potential for greater coordination between monetary and fiscal policy. Any downturn in growth resulting from the recent increase in sales tax in Japan could coincide with a tax stimulus at the beginning of 2020, which would also be a factor for the depreciation of the yen as a result of the decline in fiscal balance. To summarise, the yen itself appears to be balanced between upward and downward catalysts, and movement which should not be very sharp in either direction. We should not forget that the yen could perform well in the future, by playing its traditional role as a safe-haven asset during periods of global economic anxiety, which should certainly not be dismissed over the 12-month investment horizon.

The **context** of an acceleration in economic activity envisaged for **LatAm,** in spite of certain idiosyncratic risks, could be **moderately positive for its currencies.** Stabilisation of the "trade war" could also boost the price of commodities.

Interest rates could "win the day" in the short term...
... but in the future they will be a more neutral variable

Expectations for US-eurozone rates and changes in exchange rates

Source: Refinitiv Datastream and in-house

The EUR/USD rate has yet to price in what we expect to be less generous cuts by the Fed than those already discounted by the market

8

Commodities and alternatives.

Commodities

The opportunity cost for investing in commodities has lowered significantly due to the major central banks' ultra-loose monetary policies, and could allow the favourable environment for precious metals (especially gold) to continue.

In the high maturity phases of the economic cycle, there is an increase in investor appetite for assets that perform strongly during periods involving a downturn in economic activity. The investor concern over the long-term effects of ultra-loose monetary policies on the valuation of fixed income assets is encouraging the search for such alternatives. **We think the price of gold will continue to perform well, supported by the central banks' change in structural reserves and hedging demand during scenarios with rising inflation and/or geostrategic uncertainty.** The attraction of investment in components that are more cyclical (oil and precious metals) is more restricted given the point we are at in the cycle and the downturn in China's demand for commodities. However, we see more support for the price of crude oil because of the geopolitical situation.

Alternatives

The nucleus of an investment portfolios should have a purely directional character with direct exposure to basic assets (fixed income and equities). However, in the current environment with stock markets at maximum levels and fixed income yields at a minimum, we highlight the added value of complementing and diversifying portfolios with less directional strategies.

Investing in alternative assets requires the investor to have extra sophistication and experience, but the current environment offers diversification and potential returns

2019 has been a productive year for alternative strategies. Specifically, we have been able to confirm their ability to diversify away from traditional assets in infrastructures, real estate assets, managed futures and event-driven strategies, since they have been able to protect capital against downfalls and have shown an extraordinary capacity for recovery throughout the financial year. We foresee greater uncertainty for 2020, with risk premiums at a minimum, lower liquidity and a possible strong increase in volatility. Suitable portfolio diversification is therefore required to **broaden traditional assets with alternative strategies, and protect capital in difficult conditions.**

Against this **backdrop, it may be favourable to employ unrelated strategies with little directionality or flexibility in their investment strategy, and to invest in assets other than bonds or shares.** These include commodities, flexible fixed income, "long/short" credit, global macro, real estate listed infrastructures and inflation.

The alternative investments that have generated the highest returns have been those in private markets (OTC), which are strategies with lower liquidity. Prominent amongst these investment types is **private equity,** which **has generated an annualised return in excess of 12% over the last 20 years.** Given the rise in private equity in the financial market and its historical profitability, we think that, along with real estate investments, it is one of the most interesting diversification alternatives for sophisticated investors.

9 Conclusions.

Investment guidelines in an environment of uninteresting interest rates

There are no easy or simple recipes during such a complex investment environment, as that we have no historical references for many of the variables that are currently on the table. Now, **more than ever, we need to remember the basic rules that have historically worked for investors. The first of these is that we obtain better yields and returns if we stay invested and avoid liquidity in portfolio with a long term horizon.** Liquidity has rarely generated returns above the inflation rate, and over the last ten years has brought practically zero returns both in USD and in EUR. Trying to use market timing to create liquidity positions which should be structurally invested (looking to purchase at a potentially better price), usually means lower returns than those obtained by more disciplined investors. The **"stay invested"** rule of keeping your money at work in the markets, is one of the "golden rules" for the more successful investor. Be consistent and focus on time in the market, not on timing the market.

1) Avoid excess cash (for now)

The first recommendation then is not to increase liquidity levels extraordinarily, for two reasons: firstly because of low returns on short-term money market investments (with certain exceptions, like Mexico) and, secondly, because of the perception that there are still opportunities in some assets (providing tail risks at an economic and geopolitical level are avoided). **Our base case involves weaker growth in the world economy, but enough for risk assets to still have a role to play.** About a quarter of the global bond market, or about $13 trillion worth of bonds, offer negative interest rates. **The search for alternatives to these positions will continue to be the engine driving the increase in risk assets while the economic cycle remains on positive ground.**

Minimum interest rates are the driving force behind continued investment in risk assets

While the economic cycle maintains a minimum growth rate there is no alternative for generating returns above the inflation rate

Balanced and diversified positioning

An economic and market cycle that demands highly active and sophisticated management

Investment recommendations

1) **Avoid excess cash (for now).** There may be a high real and opportunity cost of this positioning, given that the low-interest-rate environment may last for some time.

2) **Do not chase returns and keep investments at a suitable risk level.** Take advantage of volatile events to strengthen positions in assets with a higher potential yield.

3) **Increase portfolio diversification to reduce risk.** Complement positions in traditional assets with alternative strategies and assets that provide sources of returns with different risk profiles.

4) **Include sustainability criteria (ESG)** when choosing investment strategies and instruments. Investments with a high ESG rating are likely to provide competitive advantages in the medium term.

Specific investment opportunities with upside potential

Fixed Income: Emerging market bonds. Greater potential for interest rate cuts and higher yields compared to the historical average.

Equities: Germany and United Kingdom. Agreements regarding tariffs and Brexit could increase potential for high returns in both of these markets.

Currencies and Commodities: sterling and gold. There is still potential for sterling to recover and gold can still be a safe-haven asset.

Alternative assets: private debt, infrastructures and *private equity*.

2) Do not chase returns and keep investments at a suitable risk level

The **second recommendation** is related to avoiding the temptation to try to compensate lower asset yield with investments that are too volatile for your risk profile. The most successful investors know that **you need to resist the temptation of chasing returns by following the trail of excessive optimism.** It is much more effective and profitable **to take advantage of periodic episodes of pessimism to strengthen positions in risk assets *("Buy the dips")*** and purchase when the price falls. The global economy is currently in a mature phase where the remaining potential for non-inflationary growth is quite restricted. This means that the possibility of an increase in risk assets is less than at other points in the cycle, and the risk-reward ratio is leaning towards a higher probability of market correction. We feel that it is not a time when it makes economic sense to increase the level of assumed risk in investment portfolios.

We think it is highly probable that returns at a global level will be lower than those achieved in 2019. This has been an extraordinary financial year, and one in which both fixed income assets and equities have provided very high returns. **It is foreseeable that volatility will increase and there will be corrections in some of these assets** (as we have seen recently in the bond market), **which could present an opportunity to restructure portfolios.** The current scenario of an upward trajectory in assets demands greater tactical discipline and flexibility when taking decisions. The market is showing mixed signs, and this should generate a certain amount of caution in positioning. **There will be opportunities to build up positions over the next twelve months, so we recommend you remain invested, but at moderate risk levels.**

If tension arises in the fixed income market and yields increase in the interest rate curves, we would take advantage by increasing positions in long-term bonds, especially in the USD curve. We could also take advantage by diversifying into emerging market bonds, if there is turbulence in those markets. There will be significant potential for recovery in both the UK and the German stock markets should there be reduced political risk relating Brexit or the trade conflicts.

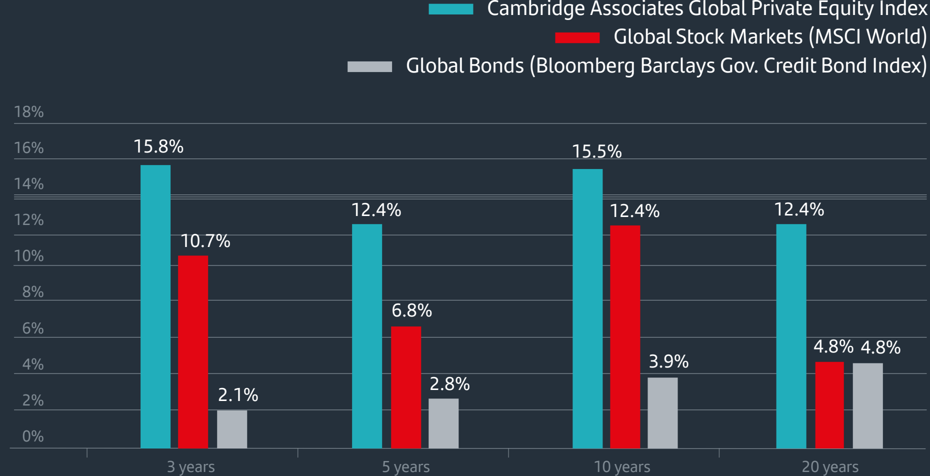
The illiquidity premium has generated a significant extra yield

Source: Cambridge Associates and in-house

Temporarily abandoning liquidity and investing in private equity has enabled access to very interesting investment opportunities and the generation of an extra level of return

The added value of investing in private markets

Investment in private equity has generated returns exceeding those for listed markets



3) Increase portfolio diversification to reduce risk

The **third recommendation is to increase diversification by seeking to optimise risk levels with both assets and fund managers.** In a scenario of lower returns and volatility, and increased risk, it will be more necessary than ever to reinforce portfolio structures and to optimise the risk level through the detailed analysis of the opportunities for diversification. As Harry Markowitz (winner of the Nobel prize for Economics) said, diversification is the only free option ("free lunch") in the market, as it enables the maintenance of risk levels in portfolios, while reducing the potential for suffering losses.

For sophisticated investors who have the capacity o assume illiquidity premiums, it is also **advisable to analyse investments in unlisted markets via private equity or private debt.** In the following chart, we can see how, depending on the measurement period, investment in private equity has generated average returns of between 12% and 15% annually. These returns significantly exceeded those achieved in listed fixed income and equities markets. There are a series of structural factors that could explain this return differential (a decrease in the number of listed companies, delays in the public listing of companies with higher growth, illiquidity premium, etc.). If we take into account that the problems arising from an environment of low interest rates will not be solved in the short term, **new alternatives for management and investment will need to be found**.

4) Include sustainability criteria (ESG) when choosing investment strategies and instruments

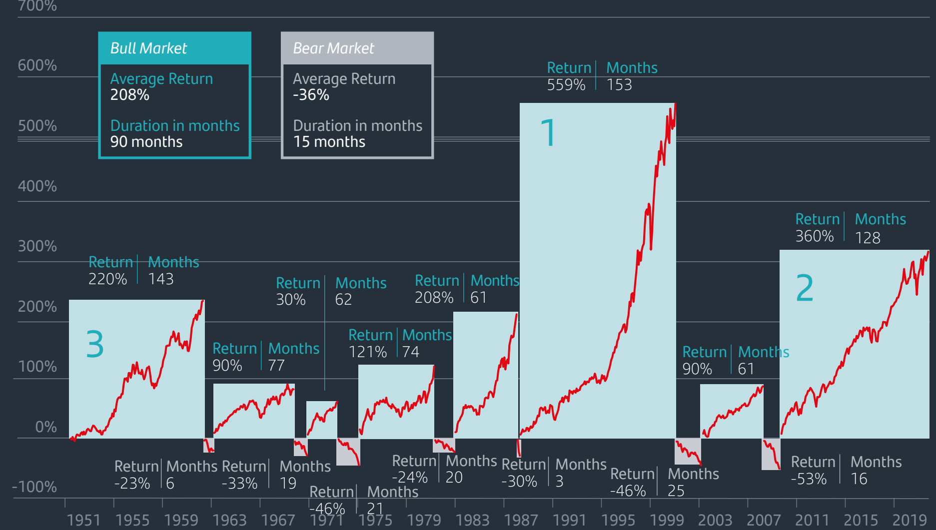
Our recommendation for investment is also to consider the **growing importance attached to sustainability as a new factor within portfolios.** Investment mandates under ESG (Environmental, Social and Corporate Governance) criteria represent the sector with the highest growth among all the markets in which we invest. Focussing sustainability is investing in clean energy, climate change, waste recycling, efficient energy, etc. It is also investing in the problem of ageing or the "Silver Economy", in healthy and organic food, efficient town planning and in new technologies applied to artificial intelligence. In a word, it is investing in the future, knowing full well that we are also investing in businesses with a high probability of leading the economy in the coming years.

In 2020, we are facing a complex context which nevertheless has the potential to drive the market upward, if geopolitical risks recede (a reasonable Brexit agreement, fiscal policy measures, trade agreements, elections...). **We reinforce our commitment to giving you the best personalized advice on these and other important matters.**

Data as of 22 November 2019

The second-highest stock market rally in history

Recovery since the 2008 financial crisis has already lasted over ten years



350% accumulated yield

Source: Bloomberg, NBER and in-house

The S&P 500 index for the US stock exchange is enjoying the second-highest rally in its history

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"Periodic table" for asset returns.

References		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US Equities	S&P 500 TR	**18.88** Emerging Market Equities	**38.3%** Eurozone Government	**28.1%** Eurozone Government	**54.4%** Japan Equities	**71.3%** Eurozone Government	**12.1%** Japan Equities	**14.8%** Global High Yield	**37.3%** Emerging Market Equities	**3.3%** Spain Government	**26.3%** US Equities
Japan Equities	Topix TR	**17.6%** Commodities	**7.6%** Spain Government	**20.9%** Japan Equities	**32.4%** US Equities	**61.3%** Spain Government	**6.4%** Europe Equities	**12.0%** US Equities	**22.4%** Global Equities	**0.1%** Eurozone Government	**26.1%** Europe Equities
Spain Equities	Ibex35 TR	**15.1%** US Equities	**2.6%** Global High Yield	**19.3%** Global High Yield	**27.8%** Spain Equities	**13.7%** US Equities	**1.4%** US Equities	**11.2%** Emerging Market Equities	**22.2%** Japan Equities	**-0.4%** Liquidity	**22.9%** Global Equities
Emerging Markets Equities	MSCI EM TR	**13.9%** Global High Yield	**2.1%** US Equities	**18.2%** Emerging Market Equities	**26.7%** Global Equities	**10.3%** Japan Equities	**-0.1%** Liquidity	**9.7%** Commodities	**21.8%** US Equities	**-1.2%** Global IG	**15.9%** Japan Equities
Europe Equities	Eurostoxx50 TR	**12.5%** Eurozone Government	**2.02** Global IG	**18.1%** Europe Equities	**21.5%** Europe Equities	**8.6%** Spain Equities	**-0.5%** Global IG	**7.5%** Global Equities	**11.3%** Spain Equities	**-3.3%** Global High Yield	**12.3%** Spain Equities
Commodities	Commodity RB TR	**11.8%** Global Equities	**0.9%** Liquidity	**16.0%** US Equities	**21.1%** Spain Government	**8.3%** Global IG	**-0.8%** Global Equities	**6.6%** Eurozone Government	**10.2%** Global High Yield	**-4.4%** US Equities	**11.1%** Emerging Market Equities
Global Equities	MSCI World TR	**4.8%** Global IG	**-5.5%** Global Equities	**15.8%** Global Equities	**8.0%** Global High Yield	**4.9%** Global Equities	**-3.6%** Spain Equities	**5.7%** Spain Government	**9.2%** Europe Equities	**-8.7%** Global Equities	**10.8%** Global High Yield
Europe IG	ERL0 TR	**1.0%** Japan Equities	**-7.8%** Spain Equities	**13.2%** Global IG	**2.4%** Global IG	**4.0%** Europe Equities	**-4.2%** Global High Yield	**4.8%** Global IG	**2.5%** Global IG	**-10.7%** Commodities	**10.5%** Spain Government
Liquidity	Eonia TR	**0.4%** Liquidity	**-8.2%** Commodities	**0.2%** Liquidity	**0.1%** Liquidity	**0.1%** Liquidity	**-10.5%** Spain Government	**3.7%** Europe Equities	**1.7%** Spain Government	**-11.5%** Spain Equities	**10.4%** Eurozone Government
Global High Yield	HW00 TR	**-2.8%** Europe Equities	**-14.1%** Europe Equities	**2.8%** Spain Equities	**-2.6%** Emerging Market Equities	**-0.1%** Global High Yield	**-16.3%** Eurozone Government	**2.6%** Spain Equities	**1.7%** Commodities	**-12.0%** Europe Equities	**8.3%** Commodities
Spain Government	SPAIN 10 YR	**-12.9%** Spain Equities	**-17.0%** Japan Equities	**-3.3%** Commodities	**-5.0%** Commodities	**-2.2%** Emerging Market Equities	**-14.9%** Emerging Market Equities	**0.6%** Japan Equities	**-0.2%** Eurozone Government	**-14.6%** Emerging Market Equities	**6.2%** Global IG
Eurozone Government	GERMANY 10 YR	**-37.1%** Spain Government	**-18.4%** Emerging Market Equities	**-3.8%** Spain Government	**-46.6%** Eurozone Government	**-17.9%** Commodities	**-23.4%** Commodities	**-0.3%** Liquidity	**-0.4%** Liquidity	**-16.0%** Japan Equities	**-0.3%** Liquidity

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