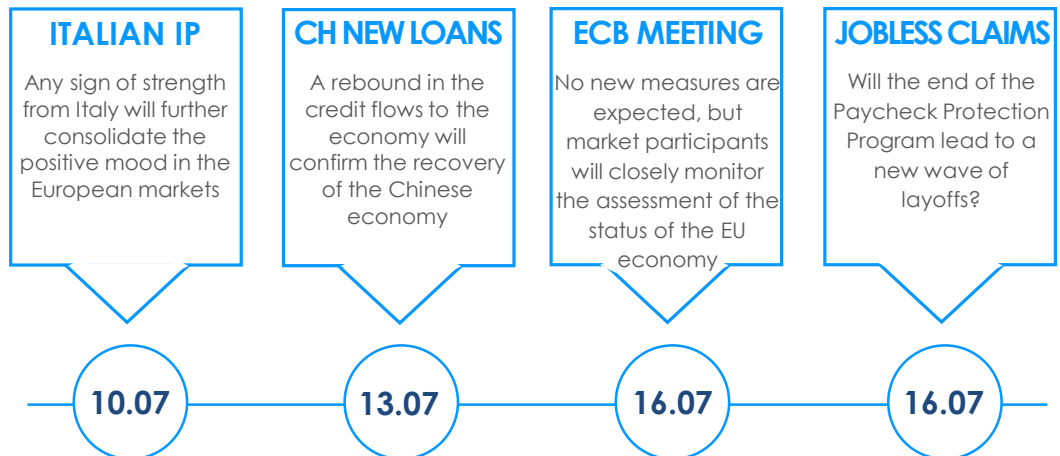


Main Events

Azimut Global Network

- * **Milan**
- * Abu Dhabi
- * Cairo
- * Dubai
- * Dublin
- * Hong Kong
- * Istanbul
- * Lugano
- * Luxembourg
- * Mexico City
- * Miami
- * Monaco
- * Santiago
- * São Paulo
- * Shanghai
- * Singapore
- * Sydney
- * Taipei



Anatomy of a strange recession

The covid-19-induced recession is a very unusual one, not only because of how it started (a very rare instance of supply-demand shock), but also for the response to this crisis by policymakers. In a normal recession, consumptions start to decrease for whatever reason, and then corporations progressively adjust downward in production and employment until a new balance between supply and demand is reached. In a supply-demand shock, spending and production fall suddenly in tandem. After the initial shock, the economy must adjust to the new, lower, level of activity, further depressing GDP.

It should be reminded that the GDP could be either calculated as the sum of expenditure, the sum of income or the sum of value added.

In the expenditure approach, $GDP = C + G + I + NX$, where C stands for private consumption, G for government consumption, I for investments (including inventories) and NX for net exports. In the income approach, $GDP = \pi + W + rK$, where π stands for corporate profits, W stands for wages and rK for return on capital. In the value added approach $GDP = (\text{Final value of all goods and services}) - (\text{intermediate costs})$.

In a supply-demand shock as the one induced by the covid-19, GDP is jointly impacted downwards by 1) the lower demand (C in the expenditure approach as people at home not consuming), by 2) the lower supply ("final value of all goods and services" in the value added approach as the production was interrupted), and by 3) the lower income (π and W in the income approach).

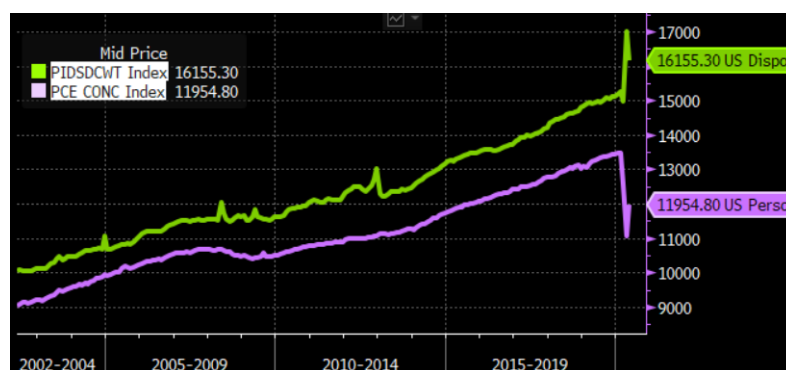
Contrary to a normal recession where GDP contraction is an orderly and somehow linear/predictable process, in a supply-demand shock the GDP has a first leg down because of the unforeseeable cause of the shock, and then a second phase which starts once the supply-demand shock fades. The economy needs to smoothly adjust downwards due to the loss of income experienced by those who permanently lost their jobs, and to the lower level of profits as some of the corporations go out of business. The loss of income then ripple through the economy in a second stage, thus lowering overall demand and further creating a vicious circle.

(continued)

In a supply-demand shock, after the initial impact it's really difficult to predict the magnitude of the "second round effects", i.e.: how severe and lasting is the loss of wealth and the subsequent drop in consumptions. The risk is to overestimate the speed and breadth of the recovery, and underestimate the second round effect. History shows that predictions by governments and international organizations have always failed to be accurate when it comes to predict recessions in particular.

To further complicate things, the impressive amount of monetary and fiscal stimulus altered the normal reaction chain. Focusing only on the fiscal stimulus and their impact on GDP, the support packages impacted positively G in the expenditure approach (i.e. increase in the deficit spending), W in the income approach (unemployment benefit) and the value added as Governments took over some of corporates' costs (mostly, but not only, costs related to the personnel) or provided some grants.

To give you an idea of how powerful (and distortive) the stimulus were, the following graph, compares the US disposable income (green line) and personal spending (purple line). The difference between the two lines represents the personal saving.



Source: Bloomberg

Whilst the two lines usually tend to move in sync, recently there has been a massive drop in consumption and an impressive increase in personal income. The former is completely understandable, but the latter is justified only by the grants and unemployment benefits provided by the governments as people that were fired or furloughed would have received much less or no income at all.

Within the Cares Act (Coronavirus Aid, Relief and Economic Security), the USD 2 trillion stimulus package approved by the US government at the end of March, two programs are triggering this abnormal behavior, the Pandemic Additional Compensation (PAC) and the Paycheck Protection Program (PPP).

The former program allows for payments of \$600 per week (more than \$2,500 per month) for anybody who is enrolled in unemployment assistance. It is scheduled to expire on July 25. This extraordinary payment is irrespective of the salary received by the worker, and is paid on top of the standard unemployment benefit. It should be reminded that in the US the minimum wage is \$7.50/hour, which corresponds to less than \$1,500 per month. This means that a lot of people, who have been furloughed due to the pandemic, received much higher income (even double, considering standard and exceptional benefits) for being home and doing nothing rather than going to work. As a result many of those in the lower income brackets were much better off after the pandemic than before. Considering that the low-income families' propensity to consume is higher, it could be expected that on a temporary basis consumptions could even increase as a result of the spike in the unemployment rate. The big question is how those people will react (adapt their spending) once the measure ends.

(continued)

The Paycheck Protection Program (PPP) is a program that provides loans to small and medium enterprises. These loans could be used for payroll, rent or mortgage interest. The loans will be forgiven and should not be returned only if all employees are kept on the payroll for at least eight weeks. After eight weeks there is no longer any obligation to keep employees. The measure expired at the end of June.

Non-farm payrolls data are published in the first week of each month, but refer to the situation in the first 10 days of the preceding calendar month. This means that the first reading taking into account the number of people laid off following the expiration on the PPP will be known in early September.

Therefore, even if the non-farm payroll data published last week showed another back-to-back beating expectations (4.8 mln vs 3.2 mln), it would not be reasonable to get much excited over it.

On the left graph below, the number of people temporarily laid off (which includes those who expect to be re-hired as far as the US economy reopens) is coming down from 18 mln two months ago to about 10.6 mln. The long term average of this measure (the horizontal red line) is about 1.1 mln, which means that there are 9.5 mln people that are probably not working due to the coronavirus. The right graph shows the number of people currently employed, 142 mln. If we assume that the 9.5 mln temporary unemployed people will be reintegrated as the US economy reopens, then the number of people employed will rise to about 152.5 mln. Therefore in the best case scenario the US economy will face a permanent loss of 7.1 mln jobs, almost the same drop (-8.6 mln) during the Great Financial Crisis through 2008-2009. In fact, considering that more layoffs are expected upon the expiry of the PPP, the impact on the job market could be even bigger than in 2008.



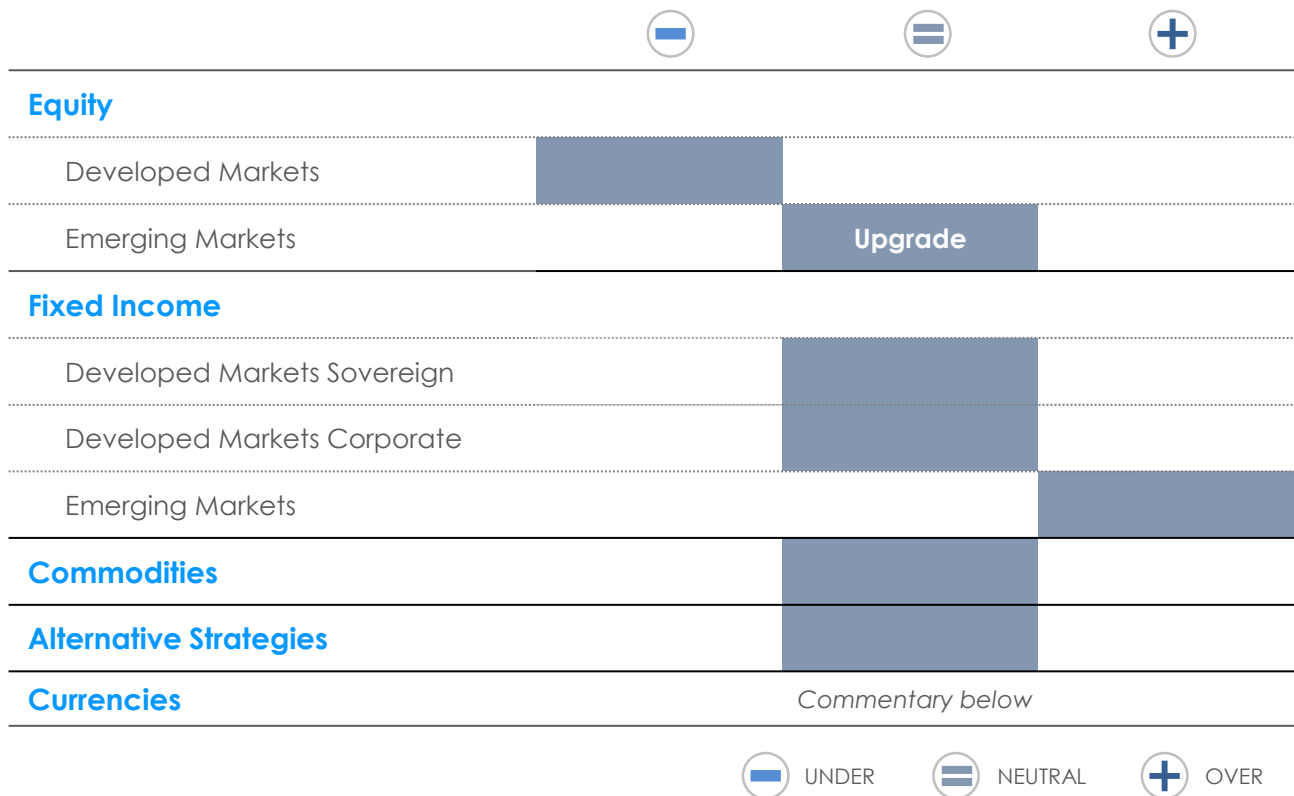
Source: Bloomberg



Source: Bloomberg

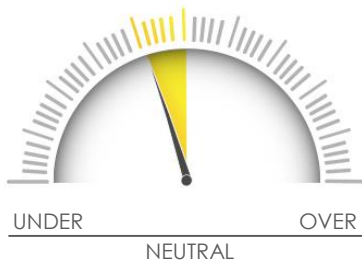
In conclusion, we are of the view that the next two/three months personal income could be affected by the double - whammy of the expiry of the two federal programs (PAC and PPP), thus resulting in lower consumptions, GDP and profits. The good data of the past few months could prove to be mermaids better not to be listened to, as the awakening could prove rude.

Asset Allocation View



Equity

Developed Markets



We reduced the underweight recommendation by one notch in light of the series of upbeat macro data (vs expectation). Even if the positive data could be reversed in the medium term, as discussed in the general commentary, in the short term they could further sustain the equity markets. In terms of the markets, we reduced the recommendation to the US equity markets, as the country is facing a second wave of contagion and because of the fear of a possible capital income tax hikes should Biden win the elections, which is becoming the base case scenario. Within developed markets, we reiterate the unanimous positive view on Europe.

US



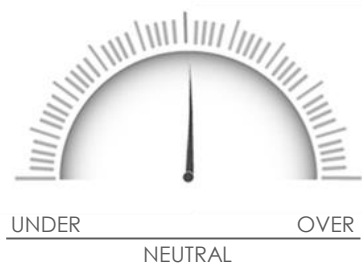
Europe



Japan



Emerging Markets



We increased our recommendation on Emerging Markets to Neutral, with a strong preference for the Asia ex-Japan region, and China in particular. The main catalyst is the recent spike in polls by Joe Biden. If elected, he is expected to halt and possibly even reverse the policy of Trump vs China. This could lead to a sharp rerating of Chinese stocks, that have been sharply sold off over the past few years. Valuations of Chinese stocks are currently about half the US markets, and technology companies trade at much more reasonable multiples. Unchanged the view on the other regions.

Asia ex-Japan



EEMEA

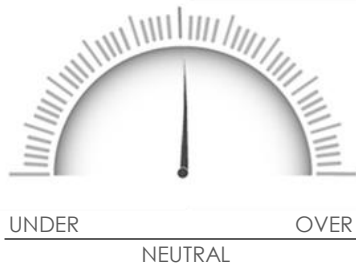


LATAM



Fixed Income

Developed Markets Sovereign



No change in the neutral view on sovereign bond of developed markets. The Fed is apparently applying a yield curve control, even if not officially declared, as long term rates remain within a very narrow range since several weeks now. In general, we reiterate the view that the ongoing QEs by all the major central banks should keep rates close to the current levels for all markets. There is little value to be found now, but this does not imply that there is downside risk either, at least in the short term.

EU Core



EU Periphery



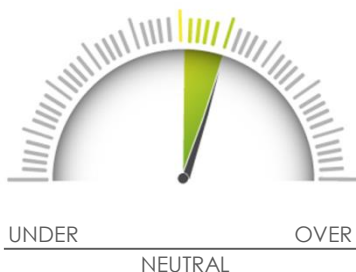
US Treasury



Japanese JGB



Developed Markets Corporate



We keep our overweight stance. Unfortunately as in many other asset classes, the levels reached by the spreads are not particularly attractive anymore. Notwithstanding this, because of the various QEs, investment grade corporates are as protected as sovereign bonds, but offer a slightly higher yield. In the Fixed Income space, investment grade bonds appear to be the best place in terms of risk/reward. We reinforced our underweight stance on EU and US high yields as their spreads contracted too much, also considering the expected increase in the default rate.

IG Europe



IG US



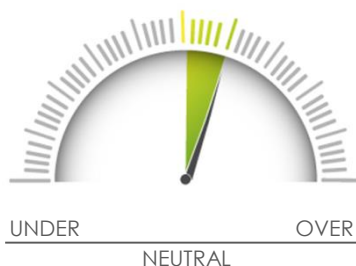
HY Europe



HY US



Emerging Markets



We maintained the recommendation on EM bonds to slightly overweight as these bonds did not enjoy the same fast recovery of other segments of the credit markets. They were left behind because EM central banks are not doing QE on their bonds, therefore investors have been more cautious in buying those. Considering the low levels of the risk-free rates, the compression of the spreads in developed market corporates and the rebound of commodities, there is room now for a catch up of emerging bonds. Among them, we have a strong preference for local currency bonds.

Local Currency



Hard Currency IG



Hard Currency HY



Commodities



We have a neutral stance with a positive bias. We continue to prefer precious metals because of the low yield environment, and as a hedge against unexpected turbulence. Because of the possibility that the Euro will continue to be quite strong in the short term for the reason explained in the currency section, for Euro-based investors precious metals could be a less attractive investment solution as any strength in the Euro will dent on performances.

Precious



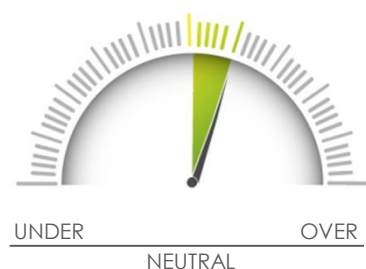
Energy



Industrial



Alternative Strategies



We keep our recommendation to neutral on liquid alternative strategies, because of the diminished expected returns on other asset classes. This implies that other asset classes have now higher downside risk and could be vulnerable to volatility as well. Therefore alternative/decorrelated strategies are more attractive on a relative basis.

Low Volatility		Medium Volatility		High Volatility	
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Currencies

We maintain a slightly positive view on the euro, as there have been positive developments for the region in the recent past, like the progress on the European Recovery fund and the better management of the coronavirus crisis. Europe was the biggest underweight position in investor portfolios, therefore there is room for the Euro to remain strong in the short and mid term, thanks to the flows of purchases.

We have a slightly negative view on the US dollar because of 1) the expected strength in the euro, 2) the spike in the new cases in US after the reopening, and 3) the rise of Joe Biden in the polls, as he is expected to implement policies which could be less market-friendly than those of Trump.

We maintain our slightly negative view on the Japanese yen, as there are no positive catalysts in sight for the currency.

On emerging markets currencies, we have a constructive view as most of them appear to be undervalued and the yields offered by those currencies are more and more attractive as YTM continues to fall in developed markets.

Euro		USD		Yen		Emerging	
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