AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

01.03.21

Main Events

Azimut Global Network

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

US PAYROLLS — 05.03
The strength of the labour market and the hourly earnings will be scrutinized

US CPI — 10.03
The last reading of inflation before the base effect starts to kick-in

ECB MEETING — 11.03
After the recent spike in rates and the v ocal interv ention by sev eral ECB members, the press conference will be followed v ery closely

FOMC MEETING — 17.03
The market participants will be focused on understanding if/how the recent rates rise would affect monetary policy

AUGMENTED REALITY

Everything is unfolding as expected. In our 2021 outlook as well as during Azimut annual convention, we had outlined two main risks for 2021 for financial markets: the inability to contain the pandemic due to the mutation of the virus or problems with vaccine rollouts, and expectations of a recovery that is too strong to the point of causing a sharp rise in rates which, in turn, generating a correction in risky assets. Fortunately, between the two, the robust economic recovery seems to be materializing, while on the virus front, vaccines are proving effective and should allow herd immunity to be achieved within a few months.

In such a scenario, it is more than rational for rates to go up because stronger economic growth requires higher real rates, even without a pick-up in inflation. A combination of additional factors contributed to a more brutal rally in the rates. Among these, we can mention Boris Johnson's announcement of the UK reopening plan, which gave hope for a similar fate to the rest of the world; the approval of the new single dose vaccine produced by Johnson & Johnson; the reassuring statements by central bankers that they are not worried about the recent move in market rates, and therefore a change in monetary policy should not be expected. But the biggest impact probably came from the progress in approving the Biden administration-backed 1.9 trillion fiscal stimulus plan, which was cleared by the House on February 27. Biden and Yellen do not want to repeat the mistake made in 2009, when the inability to approve a sufficiently large fiscal stimulus plan results in a much slower, and longer, recovery in the economy.

This stimulus bill has been contested by none other than Larry Summers, who served as the Treasury secretary under President Bill Clinton and as a senior economic adviser to Barack Obama; two former Democratic US Presidents. A Washington Post article argued that the stimulus plan is too big considering the output gap (An output gap indicates the difference between the actual output of an economy and the maximum potential output of an economy).

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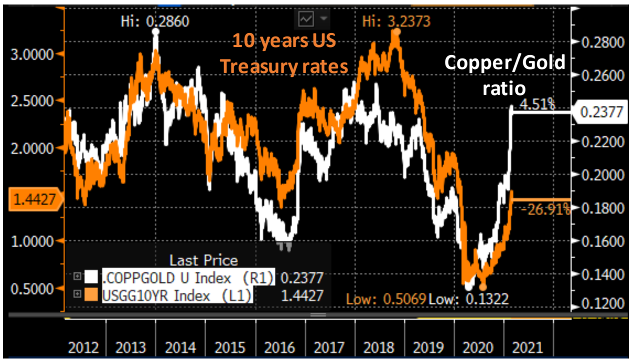
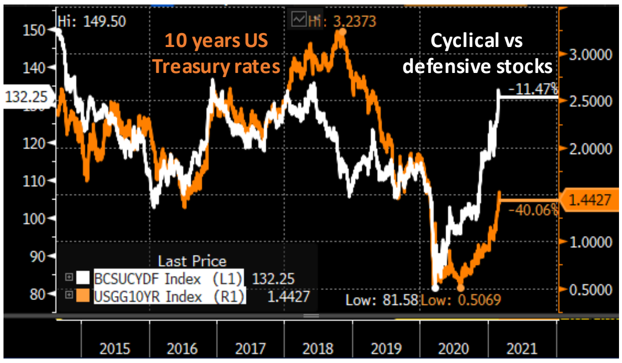
Quoting the Washington Post, "*In 2009, the gap between actual and estimated potential output was about $80 billion a month and increasing. The 2009 stimulus measures provided an incremental $30 billion to $40 billion a month during 2009 — an amount equal to about half the output shortfall. In contrast, recent Congressional Budget Office estimates suggest that with the already enacted $900 billion package — but without any new stimulus — the gap between actual and potential output will decline from about $50 billion a month at the beginning of the year to $20 billion a month at its end. The proposed stimulus will total in the neighborhood of $150 billion a month, even before consideration of any follow-on measures. That is at least three times the size of the output shortfall*".

Pushing aggregate demand through fiscal stimulus to the point of exceeding the maximum output capacity will likely results in overheating the economy and, probably, accelerating inflation. This is not welcomed considering that the market was already anticipating higher inflation and risk-free rates, as demonstrated in the charts below. The copper/gold ratio as well as the cyclical vs defensive stocks ratio (both in white) were already calling for US10 year rates of about 2.0%-2.5%.





Source: Bloomberg

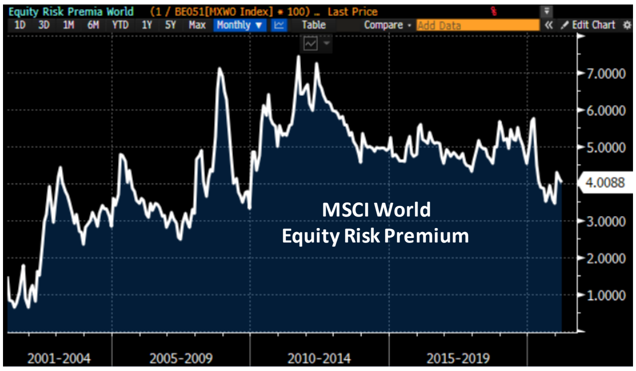
The increase in government bond rates led to the breakout of the long-term downward trend lines on interest rates in several major countries (except the US) which, if not negated, may trigger an additional selling pressure on sovereign bonds to hedge the portfolio duration.

Source: Bloomberg

(continued)

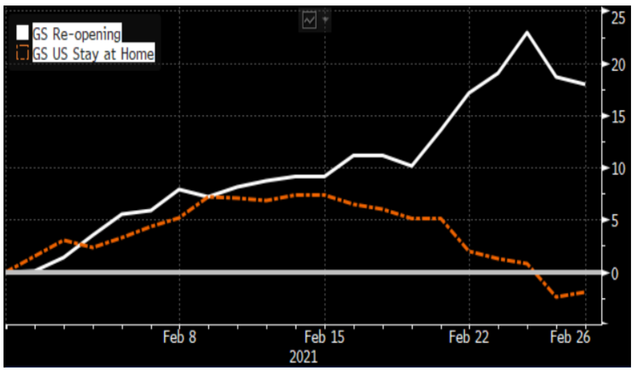
Equity markets, though, were not impacted by the rise in interest rates and ended the month at +2,4% (in both euro and US dollar) essentially for two reasons. The first one was that the rate increase that occurred so far is attributable to expectations of a stronger recovery in the second half of the year, which is normally associated with higher real rates. The second reason was strength of the reporting season where the earnings expectations have risen that in turn lifted up the expected returns for equities. Consequently, the equity risk premium remained substantially unchanged despite the rise in rates.

This apparent calm at the level of the main equity indices actually hides an intense rotation. Everything that has benefited from low rates and poor economic growth (growth, tech) has suffered very sharp declines, while everything that benefits from an increase in rates or a sustained economic growth (value, cyclicals) has gone up in sync with the rates. In the second half of February, the MSCI World Growth underperformed the MSCI World Value by almost 7%.



Source: Bloomberg

The rotation was more extreme if we look at specific themes that have performed very well or very poorly in the recent past. Two examples are given in this regard. The first graph below shows the "Non-Profitable Tech" index which, although composed of companies with very weak fundamentals, has risen dramatically over the last year. Following the recent spike in rates, the index suffered a correction of more than 20% in a few days. The second graph shows the absolute performance of the thematic indices “stay at home" (everything benefiting from the pandemic) and "re-opening" (everything benefiting from a return to normal life).



Source: Bloomberg

There are many takeaways that we can learn from the recent developments:

1. The recent increase in risk-free rates was induced by the expectations of stronger economic growth resulting from a progressive reopening of the economies. Expectations of higher inflation have yet to be priced in.

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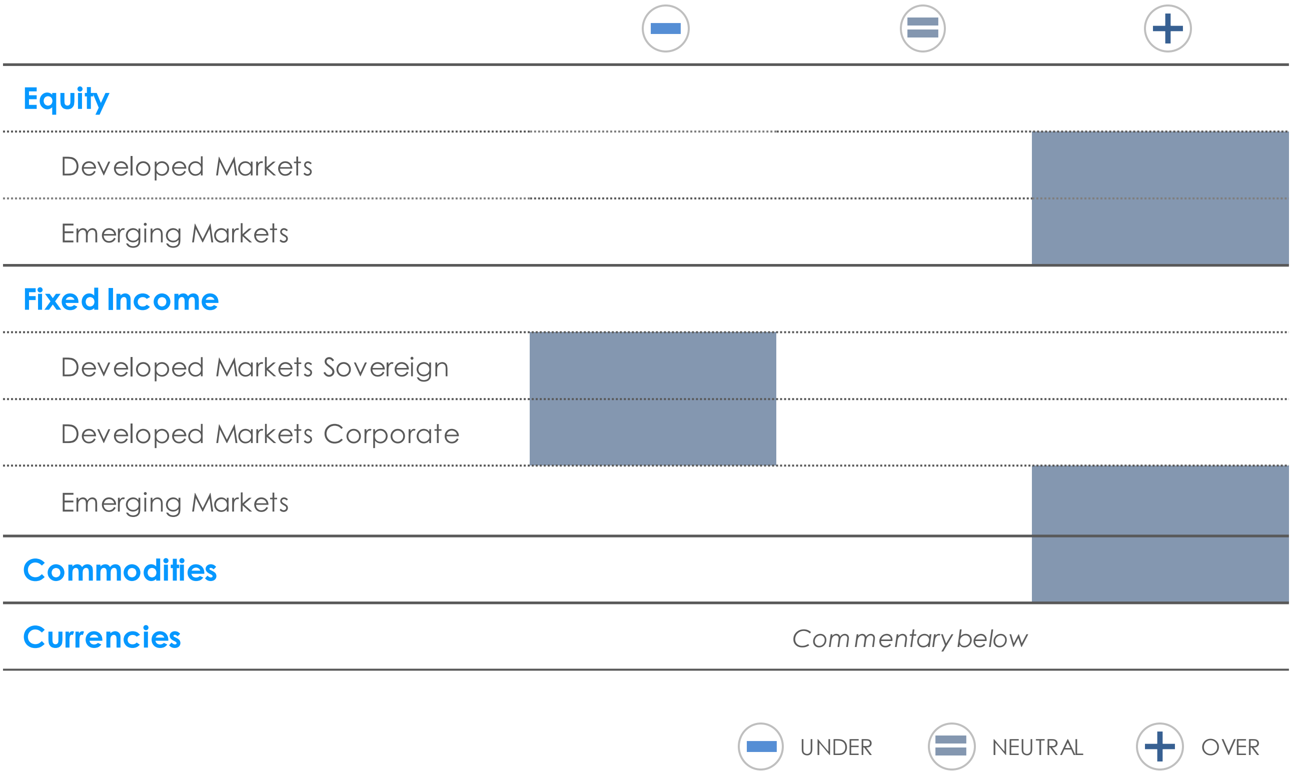
2. It is reasonable to expect that interest rates will not move significantly higher above the current levels unless concrete inflationary pressures begin to manifest. This could happen starting from the second half of April, when inflation is expected to rise above 2% due to the base effect.

3. As long as the increase in rates is driven by expectations of stronger economic growth and the maximum levels reached in February are not significantly exceeded, the expectation is that the equity markets, as a whole, will not experience significant drawdowns.

4. Considering that we are effectively moving towards a scenario of reopening and normalization, cyclical companies with reasonable valuations that could benefit from an increase in rates are increasingly favored. Typically, these stocks are mostly represented in European and Japanese equity markets, within small caps and/or funds with a value investment style. Conversely, the companies that could suffer the most in this scenario are the growth stocks with really high valuations, which are usually more represented in US indices. Emerging markets lies in the middle, as developing countries on the one hand benefit enormously from a strong and synchronized economic recovery, but on the other hand they are more negatively affected by rising rates in developed countries.

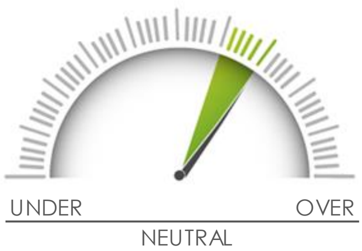
Taking into consideration above points, we are of the view that for at least a few weeks the financial markets could enjoy a quite benign environment and with correct positioning it is still possible to generate extra performance.

Asset Allocation View



Equity

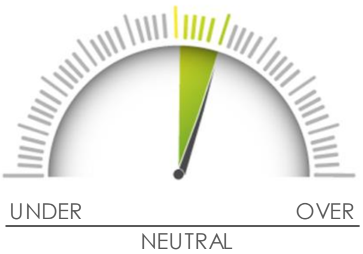
Developed Markets



We maintained our positive recommendation on Developed Markets Equities. The rate increase of the past two weeks has been mainly driven by the expectations of stronger economic growth, and rates are not expected to rise above their highs of last Thursday in the short term (*please see the main commentary in the prologue*). The modest retracement in the main equity indices must therefore be read as a buying opportunity. A preference remains for Europe and Japan, where cyclical stocks benefiting from a rise in rates are largely represented, while the US remains underweight because of the higher weight of technology and growth stocks that tend to be negatively affected by the increase in rates.

US	−	**Europe**	+	**Japan**	+

Emerging Markets

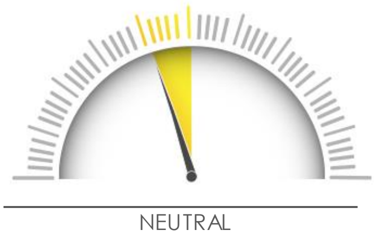


We decided to tactically reduce the recommendation on Emerging Markets Equities by one notch. The short-term sharp increase in risk-free rates may temper the very positive sentiment on Emerging Markets. Furthermore, over the past year the weight of growth stocks in Emerging Market indices has increased materially. Therefore, even if in the long term Emerging Markets should continue to grow faster than Developed Markets and the increase in rate has been driven by expectation of stronger growth, we prefer to maintain a more cautious approach in the short term.

Asia ex-Japan	+	**EEMEA**	=	**LATAM**	=

Fixed Income

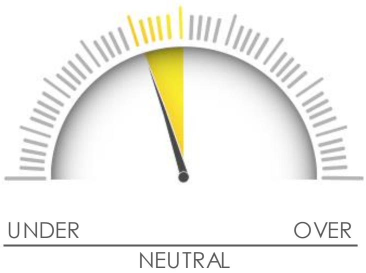
Developed Markets Sovereign



We reduced by one notch our negative stance on Developed Markets sovereign bonds after the sharp increase in rates of the past two weeks. Our view is that the rates may have temporarily peaked last Thursday (*please see the main commentary in the prologue*). The mid-to-long term view remains unchanged amid the expectation of further increases when global CPIs start to increase due to base effect. Considering that the ECB has been more vocal than other central banks against the spike in rates and that the PEPP envelope has not been fully used, it is possible that the ECB may intervene in the markets, and consequently we upgraded our stance on the EU core bonds to neutral.

EU Core	=	**EU Periphery**	=	**US Treasury**	−	**Japanese JGB**	−

Developed Markets Corporate



We kept our negative recommendation on Developed Markets corporates. The recent move in risk-free rates has not been extended enough to make investment grade bonds attractive again and in the high yield space spreads remained broadly unchanged. We stick to our view that further spread compressions could be possible in the segment between investment grade and high yield, in particular in subordinated bonds.

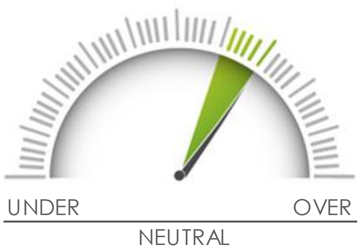
IG Europe	−	**IG US**	−	**HY Europe**	=	**HY US**	=

Emerging Markets

We kept our bullish recommendation on the asset class as the prospect of a strong recovery should be supportive for the asset class. Notwithstanding this, emerging markets bonds are usually negatively affected by increase in risk-free rates, and in particular on the US curve. The recent move in US rates was not yet extended enough to materially affect the asset class, but should rates continue to increase a more cautious approach to Emerging Market bonds should be warranted. Chinese Renminbi (RMB) denominated bonds are our preference within the local currency bonds.

Local Currency	+	**Hard Currency IG**	+	**Hard Currency HY**	=

Commodities



We maintain our bullish view on the asset class. In the short term precious metals could face headwinds due to the increase in risk-free rates, but the ample liquidity and the expectation for higher inflation later in the year should underpin precious metals. We tactically lowered the recommendation on industrial metals as they may be vulnerable to short term retracements after the strong increases of the recent past.

Precious	+	**Energy**	+	**Industrial**	=

Currencies

We maintain our neutral view on the euro mainly because on one hand the expectation for a stronger economic growth should sustain the demand for cyclical/value stocks that are more represented in EU vs. the US, and on the other the slower vaccine rollout may temper the expectation of the Eurozone recovery.
We maintain our negative view on the US Dollar because of 1) the expectation for lower short term yields in the US curve as extensively discussed in Feb 15 dated report, 2) the expectation for the approval in the short term of another stimulus plan, and 3) the possible underperformance of US equities which may be dragged by the rate sensitive growth stocks.
We kept the neutral view on the Japanese Yen as the country may attract foreign investments if the interest on value stocks, which are well represented in the main equity indices, continues in the near future.
On Emerging Markets currencies, we are still maintaining a slightly positive view but, as highlighted in the commentary for Emerging Markets bonds, if US rates will continue to rise this should be revised to neutral.

Euro	=	USD	−	Yen	=	Emerging	+