AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

21.06.21

Main Events

MARKIT EU
The EU confidence data has to confirm that the recovery is gaining momentum
23.06

US PERSONAL SPENDING
Any weakness in US consumption data may confirm the hypothesis of slower growth ahead
25.06

EUROZONE CPI
The inflation in the EU is expected to remain subdued as the reopening process is still in its early stage
30.06

US PAYROLLS
Nothing significant, but a small improvement is expected as unemployment benefits still prevent people from actively looking for a job
02.07

Azimut Global Network

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

NUMBER CRUNCHING

- **The ECB and the Fed confirmed their views that both inflation and GDP growth are transitory**
- **If they're correct, equity markets may be vulnerable, the US in particular. If not, then bond yields (at least in the US) have to move upwards**
- **Ex-US equity markets and Europe in particular, continue to be preferred**

Over the past two weeks the ECB and the Fed held their periodic meetings and they both reaffirmed that inflation is transitory, while economic growth may be more disappointing than expected.

Specifically, ECB now estimates that inflation will drop to 1.5% in 2022 and 1.4% in 2023, while the Fed projects the inflation at 3.4% in 2021 (up from earlier 2.4% estimate), the 2022 the estimate drops to 2.1%. As for GDP growth, Fed officials expect the economy to grow by 7% this year (highest since 1984), then to decrease sharply to 3.3% in 2022 and to 2.4% in 2023. The ECB, despite having raised GDP growth for 2022 to 4.7%, kept the estimate for 2023 unchanged at 2.1%.

The only element that took the markets off guard was the Fed's "dots", which came out at much higher levels than previous projections, especially for 2023. This, together with Powell's confirmation that they are starting thinking about thinking about tapering, has led the markets to a drastic repositioning. "Value" as well as Europe was heavily sold, while Nasdaq and Growth were heavily bid. For bonds there has been a prodigious flattening of the curves, especially in the USA: short-term rates have increased, while the long-term ones declined to the lowest level since February, well before the spike in inflation was known.

So, even if nothing has changed from the previous week, hard data raises legitimate doubts that central bank expectations might be proven wrong and it would take months before any change in monetary policy produces effects on the real economy, the market bowed to the words of the central banks.

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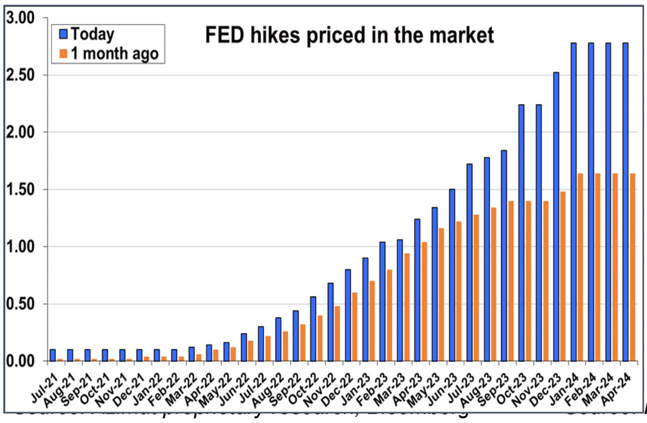
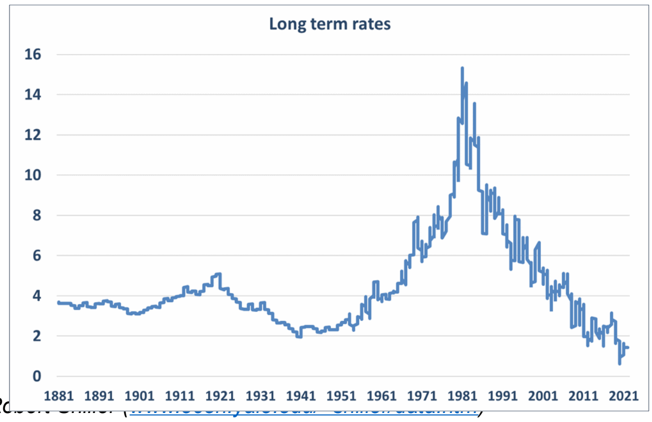
How reasonable was the reaction? If we look at the expectations about the future Fed hikes, we can see that as soon as early 2023 Fed's policy rates may be higher than the current level of the 10-year rates (1.4% as of last Friday). If rates normalize on the short-end of the curve, the long end rates should increase concurrently, otherwise we'll end up with a flat or negative yield curve that normally happens only during recessions.

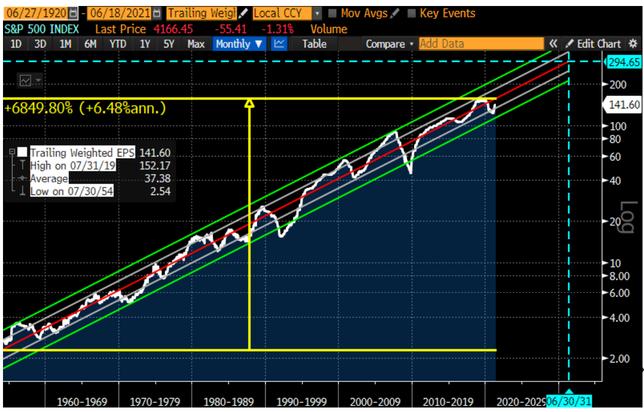


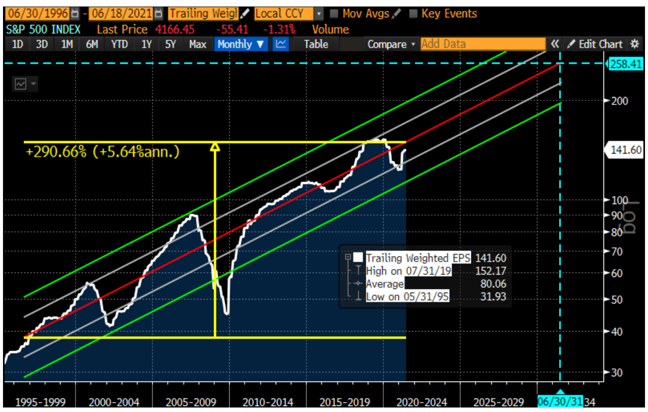


If we exclude the pandemic period, the 10-year rate is currently at the lowest level in history. How reasonable is that this level is perceived as elevated to the point that the central banks are doing everything they can to prevent an increase in rates? Difficult to explain.

If we assume that the Fed is right about the transience of growth and inflation, and that the bond market reaction is correct, then we need to question stock market valuations and the credibility of the earnings growth estimates.

Below is the reported the EPS for S&P500. The average growth rate since the data is available is 6.5%, while over the past 25 years it has fallen to 5.6%. Since these numbers are long term averages, spanning years of economic expansions and recessions, we can assume that they can be used to extrapolate a plausible level of EPS in the future. If we project these growth rates 10 years forward from now, we end up with 295 and 258, respectively.





Once we have the EPS estimate in 10 years from now, we can calculate the S&P500 value in 10 years by applying to it the P/E multiple we want. In the same way we estimated the EPS value, we can rely on the long term historical averages to determine the most appropriate level. In the next page, the red line is the average P/E since data are available on Bloomberg (16.8), and the yellow line is the average since the 90s (20).

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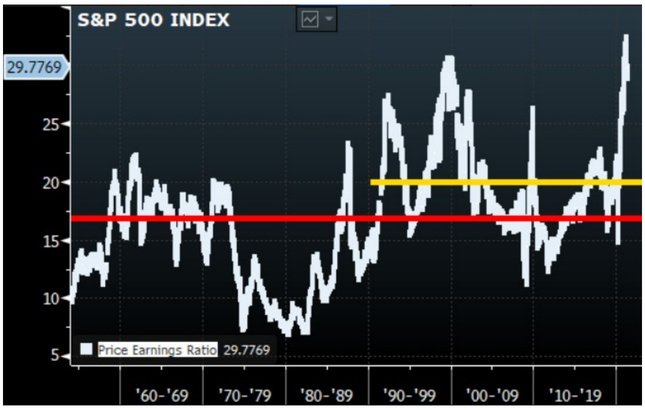


Source: Bloomberg

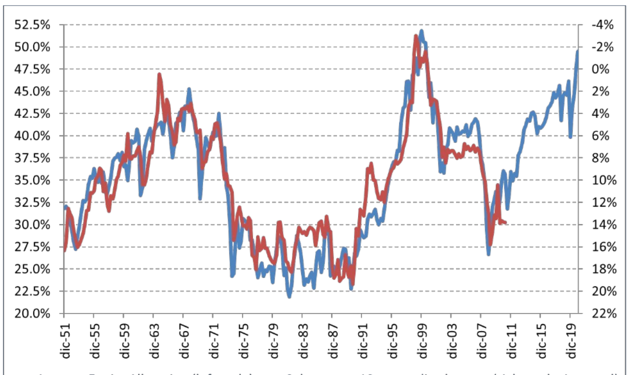
	Terminal level of price/earning ratio										
Terminal level of EPS	10	12	14	16	16.8	18	20	21	22	24	28
120	1,200	1,440	1,680	1,920	2,016	2,160	2,400	2,520	2,640	2,880	3,360
140	1,400	1,680	1,960	2,240	2,352	2,520	2,800	2,940	3,080	3,360	3,920
160	1,600	1,920	2,240	2,560	2,688	2,880	3,200	3,360	3,520	3,840	4,480
180	1,800	2,160	2,520	2,880	3,024	3,240	3,600	3,780	3,960	4,320	5,040
200	2,000	2,400	2,800	3,200	3,360	3,600	4,000	4,200	4,400	4,800	5,600
220	2,200	2,640	3,080	3,520	3,696	3,960	4,400	4,620	4,840	5,280	6,160
240	2,400	2,880	3,360	3,840	4,032	4,320	4,800	5,040	5,280	5,760	6,720
260	**2,600**	**3,120**	**3,640**	**4,160**	**4,368**	**4,680**	**5,200**	**5,460**	**5,720**	**6,240**	**7,280**
280	2,800	3,360	3,920	4,480	4,704	5,040	5,600	5,880	6,160	6,720	7,840
300	**3,000**	**3,600**	**4,200**	**4,800**	**5,040**	**5,400**	**6,000**	**6,300**	**6,600**	**7,200**	**8,400**
320	3,200	3,840	4,480	5,120	5,376	5,760	6,400	6,720	7,040	7,680	8,960
340	3,400	4,080	4,760	5,440	5,712	6,120	6,800	7,140	7,480	8,160	9,520
360	3,600	4,320	5,040	5,760	6,048	6,480	7,200	7,560	7,920	8,640	10,080
380	3,800	4,560	5,320	6,080	6,384	6,840	7,600	7,980	8,360	9,120	10,640
400	4,000	4,800	5,600	6,400	6,720	7,200	8,000	8,400	8,800	9,600	11,200

Source: Azimut proprietary research, Bloomberg

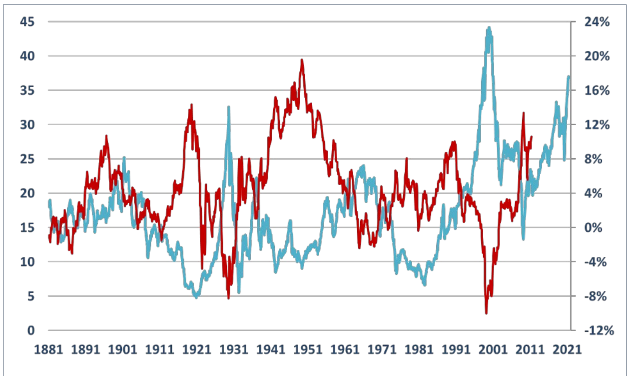
Above table on the right shows the theoretical values of the S&P500 based on the terminal level assumptions (in 10 years from now) of EPS and P/E. Currently the S&P500 trades at about 4,200, or 21 times the next 12 months expected EPS of 200. If we assume the long term P/E average of 16.8 and the last 25 years average EPS growth, the S&P will be mostly unchanged from today's level. If we use the other two averages (EPS of 300 and P/E of 20), the terminal value of the S&P will be 6,000, which corresponds to an annualized growth rate of 3.6%.

Let's now have a look at what other metrics suggest about the S&P's expected return over the next 10 years. The average investor equity allocation (available at https://fred.stlouisfed.org/graph/?g=qis) is considered as one of the most reliable predictors of the future stock markets return. The basic idea is that in order for bull markets to continue to go up, more people and money need to be attracted. Market performances and stock inflows drive the average equity allocation up. The opposite happens in bear markets.

The average investor allocation (blue) is compared with the total return of the stock markets for the next 10 years (red, inverted scale on the right). The higher the equity allocations, the lower the subsequent 10 year returns and vice versa. The blue line currently ends at the end of 2020 , due to the time it takes to collect all the information. Considering the phenomenon of meme-stocks, the stimulus checks paid in 2021 that at least partially ended in stock investments, and the increase in the equity market YTD, we can assume that currently the average equity allocation may be close to the record of 2000, when the subsequent 10 year returns were -3% annualized.



Source: Federal Reserve, Bloomberg, Azimut elaborations



Source: Robert Shiller (www.econ.yale.edu/~shiller/data.htm)

In the same manner, if we compare the Cyclically adjusted P/E (or "CAPE" or "Shiller P/E") with the subsequent 10 year annualized excess return of equities over bonds, we can appreciate that each time the CAPE was over 30, equities underperformed the Treasuries. Considering the current level of 10 year bonds yield (1.4%) this indicator also suggests that negative S&P500 returns over the next decade are possible.

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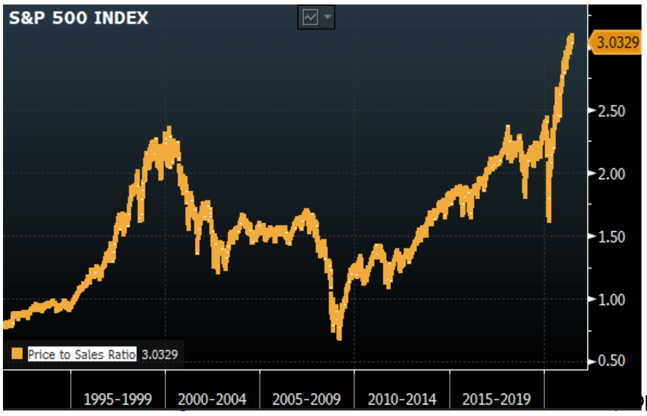
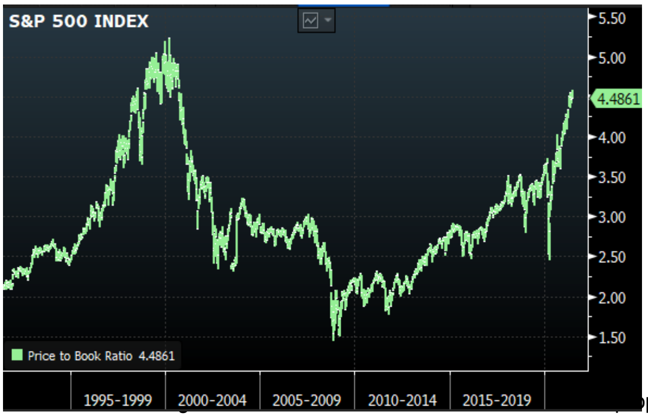
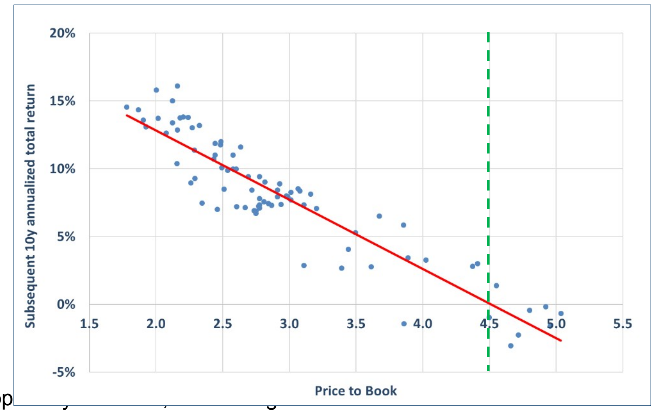
Finally, since last and this year's earnings have been materially distorted (the former by the pandemic and the latter by the stimulus measures) we can rely on two other less volatile and therefore more reliable metrics: price to sales and price to book. Below the two metrics are demonstrated for the available data set. On the right, there is the scatterplot showing the starting value of each metric at each quarter-end, and the subsequent 10 year total return of the S&P500. The dashed green line shows the current value for the price-to-book. For the price-to-sales ratio, instead of the current value (3.03) which is based on last year sales, we use 2.7 which is the ratio using the expected sales level over the next 12 months.







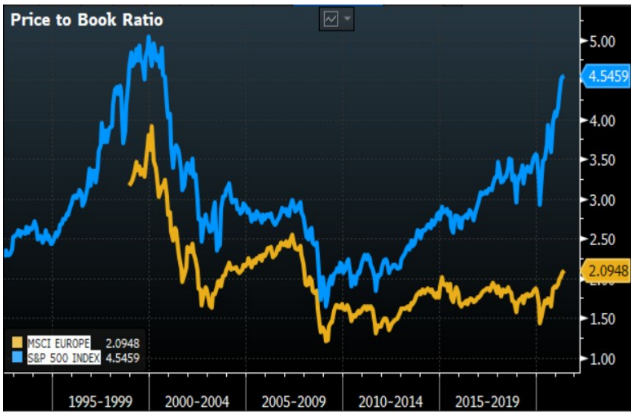
All the evidences proposed so far suggest that S&P500 returns over the next decade could be lackluster or even outright negative. If the central banks are right, and in fact we will soon enter a period of low growth and inflation, then earnings and sales will be negatively affected as they are functions of GDP growth and the price level.

In this sense, the reaction of the markets in the aftermath of Fed statement was not that rational. We are either about to enter such a low growth/low inflation environment, or will continue with strong GDP numbers and above-average inflation. In the former scenario, bonds behave correctly, but equity markets are far too optimistic, in the latter, equity markets are right, but bond yields need to rise dramatically. Currently, each market is choosing the scenario that best suits them, but unfortunately we cannot have two different realities at the same time. One of the two must concede.

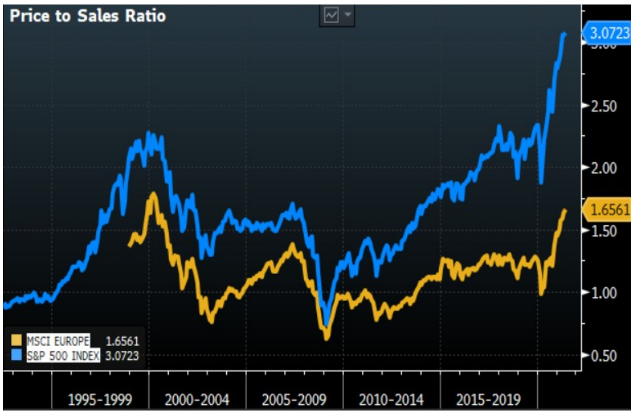
Throughout this document we have only talked about US stocks. We stress that the US equities trade at much higher multiples than the rest of the world, and therefore the prospects for other markets are better or much better, as already argued in previous reports.

(continued)

Source: Bloomberg



Source: Bloomberg



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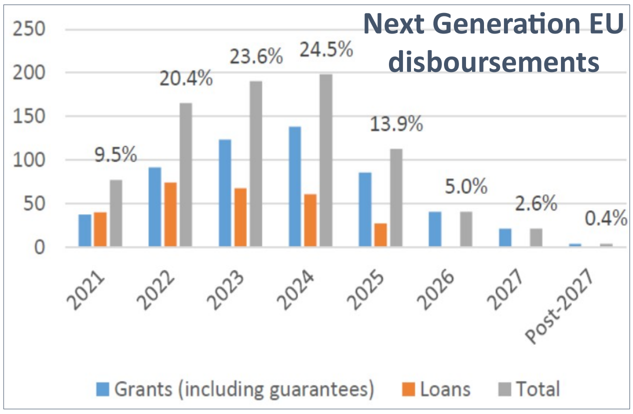


Source: EPRS

In the first three charts above, the S&P500 (blue) is compared to the MSCI Europe index (orange). It can be easily seen that European equities are not only trading at a considerable discount compared to the US (-23%, -53% and -46% respectively for the 12-months forward P/E, the price-to-book and the price-to-sales ratio), but this gap has been widening over the past years.

Furthermore, whilst the US is about to lose the tailwind of the extraordinary fiscal stimulus of the past year, in Europe we will soon start to benefit from the deployment of the Next Generation EU package. The overall fiscal stimulus will be lower than those implemented in the US, but it will contribute to sustain the EU GDP growth in a stable way for the next years.

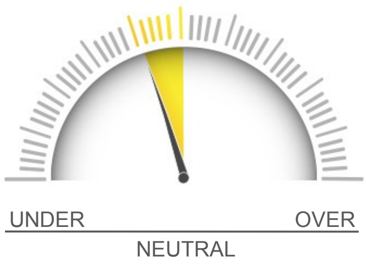
Asset Allocation View

	−	=	+
Equity			
Developed Markets	Downgrade		
Emerging Markets		X	
Fixed Income			
Developed Markets Sovereign	X		
Developed Markets Corporate	X		
Emerging Markets		X	
Commodities			X
Currencies		*Commentary below*	

− UNDER   = NEUTRAL   + OVER

Equity

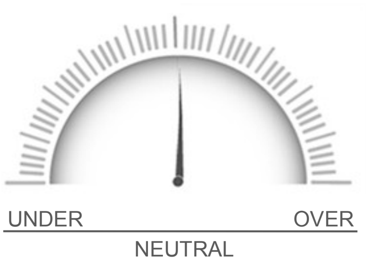
Developed Markets



We reduced our recommendation on Developed Markets Equities to **Slightly Underweight**. The central banks projections of lower inflation and GDP growth, together with an earlier than expected tapering by the Fed could make equity markets vulnerable to corrections over the medium term. Among regions, we still prefer Europe thanks to the lower valuations, as explained in the prologue of this report. In terms of styles, the Committee members now favor a more balanced approach.

US	=	**Europe**	+	**Japan**	=

Emerging Markets



We confirmed our recommendation on Emerging Markets Equities to **Neutral**. On one hand, the Developed Markets Central Banks' projection of lower GDP growth could weigh on Emerging Market equities, but on the other the sharp decrease in long term US rates could be supportive. Also considering the reaction of the commodities after the Fed meeting, we are moving to a neutral recommendation across the geographies.

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

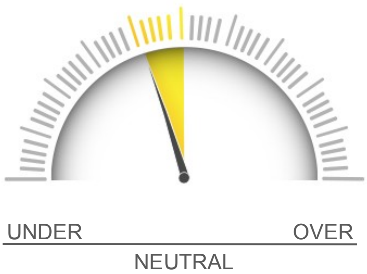
Fixed Income

Developed Markets Sovereign

We maintained our overall **Underweight** recommendation on Developed Markets Sovereign Bonds. The post-Fed meeting reaction is believed to be exaggerated due to short term repositioning. Over the medium-term, we continue to see higher rates. No change in terms of preference, EU Peripheries are still favored notwithstanding the recent compression in the BTP-Bund spread.

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

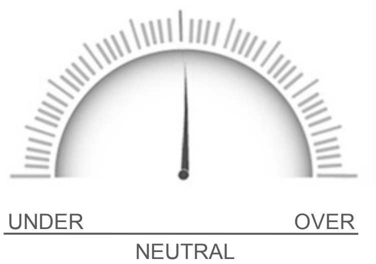
Developed Markets Corporate



We kept our **Negative** recommendation on Developed Markets Corporates. No further compression is expected in the corporate investment grade spreads. Since the performance of IG bonds will be sensitive to the evolution of risk-free rates, we should avoid them mainly because they are likely to deliver negative returns. In the crossover/ high yield segments, there is still room for some spread compression, but the bulk of the tightening has already happened, and a more cautious approach should be warranted. Considering the above, for those looking to lock in higher yields over a longer time horizon, private debt strategies are a suitable solutions also offering an attractive risk profile.

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

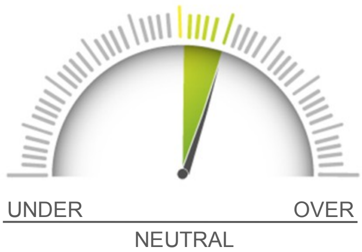
Emerging Markets



We kept our recommendation as **Neutral**. Emerging Market Bond spreads have compressed less than the developed market bonds with similar risk. Considering the reduction in the long-end US rates and the fact that the Fed will wait some time before tapering, further reduction in spreads are likely. For Emerging Hard Currency, we have a preference for low duration strategies.

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

Commodities



We still maintain our **Positive** view on the asset class, but we reduced the overweight recommendation by one notch. Powell's comments about excess in some of the commodities could potentially make the asset class vulnerable to short term retracement. We continue to have a preference for precious metals as an hedge against inflation and thanks to the lower US long term rates and for energy.

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

Currencies

We maintain our **Neutral** view on Euro, USD, Yen and Emerging Markets currencies. The view of the Asset Allocation Committee is that in the short term, all major currencies will remain rangebound within their recent trading range. The only exception is the USD, on which there is a few diverging views. Some expect that the greenback may weaken considering the twin deficits and the fact that the tapering is still months away, others believe that it may strengthen if short term rate differential continues to widen in favor of the USD, or in case of market corrections as the USD usually tend to strengthen in such occasion.

Euro	=	**US D**	=	**Yen**	=	**Emerging**	=