azimut

AZIMUT GLOBAL VIEW

06.07.26

Main Events

Azimut Global Network

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

US INFLATION (14.07)
The CPI is expected to decline 0.1% MoM, in what could be the first of a series of negative prints following the drop in energy prices

CHINESE DATA (15.07)
GDP, investments and industrial production are expected to deteriorate further, underscoring the need for an urgent shift in China's economic policy

US RETAIL SALES (16.07)
Growth in retail sales is expected to moderate, following a strong second quarter

ECB MEETING (23.07)
Will the ECB reconsider its stance, in light of falling inflation and the risk that they might have just made another monetary policy mistake?

CHECKS-WRITERS vs CHECKS-CASHERS AND THE IMPACT OF LEVERAGED ETFs

- **The recent stock rally was heavily concentrated in semiconductors, benefiting from the huge capex commitment from hyperscalers, and supply bottlenecks in memories**
- **The boom in the use of leveraged ETFs—most of which focus on semiconductors—has further fueled the bull market, but is also the root cause of the recent heightened volatility in those very same stocks**
- **While it is possible that the recent volatility will subside thanks to a healthy rotation, it is of paramount importance monitoring whether or not hyperscalers will reaffirms their commitments to AI investments, as this could be a source of renewed volatility**

After a few months of frenzied gains, stock markets have entered a consolidation phase, taking a breather following the sizeable gains posted by a few stocks and subsectors.

The second-quarter rally was indeed extremely concentrated: while the MSCI All Country World Index rose 14.5% in U.S. dollar terms, the technology sector posted a return of 38.9%—more than triple the second-best-performing sector, industrials. Even within the technology sector, performance was anything but uniform. The MSCI Semiconductor and Semiconductor Equipment sub-index closed the quarter with a gain of 58.4%, largely outpacing the other subsectors. In the US market, the Philadelphia Semiconductor Index (SOX) ended the quarter with an impressive +87.7%. Elsewhere in the world, the MSCI Korea Index posted a similar return (+85.6% in US dollar terms) thanks to the performance of SK Hynix and Samsung, which now account for one-third of the index each.

Two main factors are behind these stellar results, as well as the concentration of returns.

The first factor is certainly nothing new. It has been the most hotly debated topic in the financial markets in the past several years: the exponential growth in the investments required for the race to AI.

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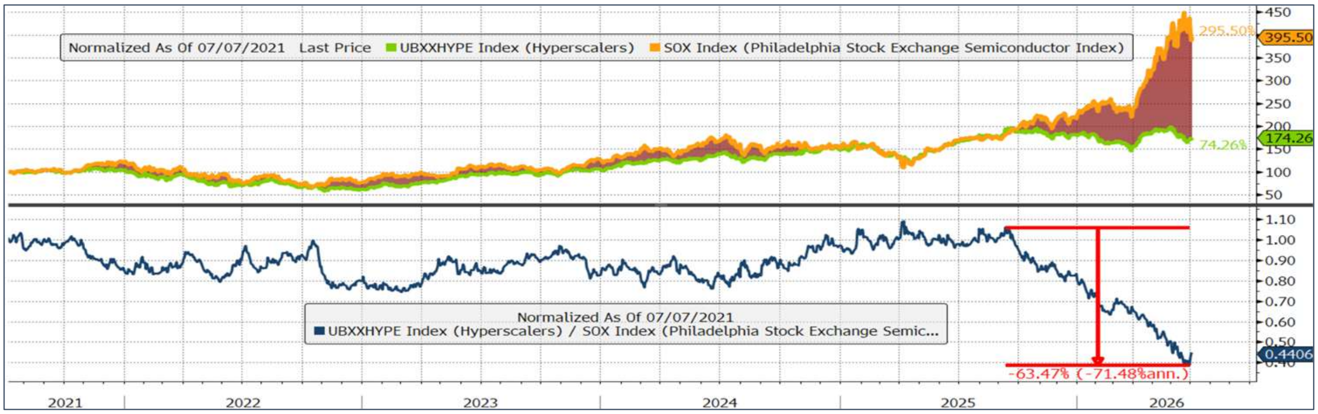


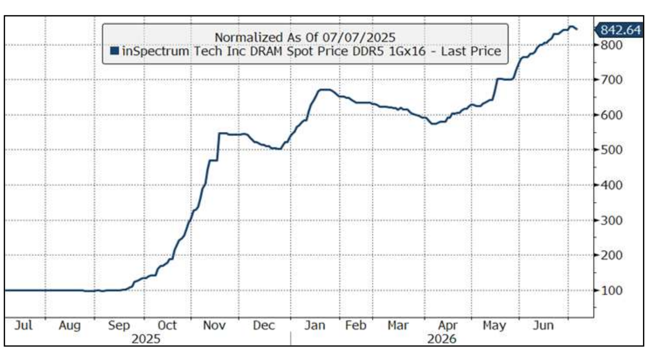
Source: Bloomberg

For years, the market has viewed the realm of companies involved in the development of AI as a homogeneous group, coining the acronym “Mag-7” and buying them all in bunches. And for many years, their performance was indeed closely aligned.

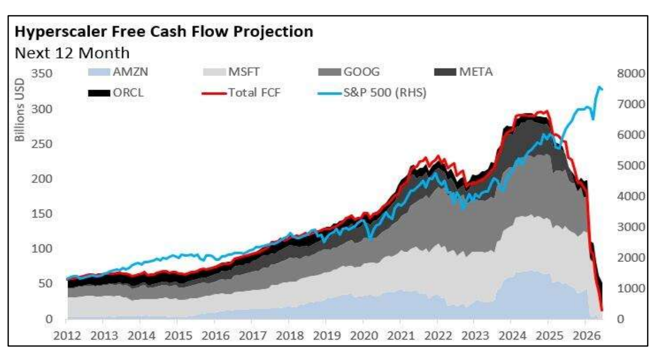
However, the Mag-7 group is not homogeneous, as it includes "checks-writing" companies and “checks-cashing” companies. The first group includes the hyperscalers, while the second includes semiconductor and memory manufacturers. In the chart above, we compare the performance of these two groups, using the UBS Hyperscalers Index (comprising Microsoft, Amazon, Meta, Alphabet, and Oracle) and the Philadelphia Semiconductor Index, respectively. Even when grouping the big tech companies this way, one can still clearly see that their behaviour was virtually identical through September of last year. Thereafter, however, the performance of the two groups has diverged dramatically. The underperformance of hyperscalers relative to semiconductors was over -60% during the period.

It was precisely the escalating competition among hyperscalers—all vying to win the race for artificial intelligence—that triggered this disconnect: capex commitments became so large that it became clear there was a significant bottleneck at the level of semiconductor manufacturers—particularly memory producers—with demand set to far outstrip their capacity for years to come. This allowed them to leverage their position to raise prices. Memory prices, which had remained fairly stable until September of last year, began to rise exponentially. The chart at the bottom left shows the price of one type of memory, indexed to 100 a year ago; other types of memory followed similar trends.

The hyperscalers' projected capex increase this year is only partially due to higher demand (intended as volume) for chips and computing capacity. The other portion is simply a mere reflection of the higher costs that hyperscalers will (ultimately) have to bear to pay for the memories needed for the chips employed in data centers. Put another way, the fierce competition among hyperscalers is leading to a significant shift in their business model: they are transitioning from capital-light to capital-intensive, the free cash flow they have always generated is drying up, and their margins could come under pressure. The exact opposite is true for semiconductors: their free cash flow and margins are skyrocketing, reaching unprecedented levels. The diverging trends observed in financial markets between hyperscalers and semiconductors are therefore perfectly rational—as long as the merry-go-round keeps turning.



Source: Bloomberg



Source: Nomura

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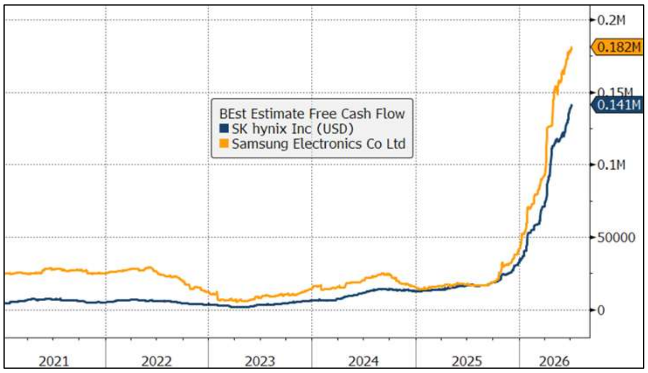
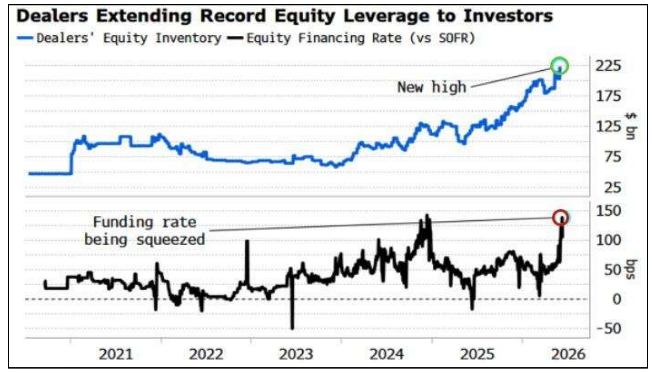


Source: Bloomberg



Source: Bloomberg

This situation where memory makers pocket massive margins, while hyperscalers swallow the higher infrastructure costs can indeed continue only as long as those same hyperscalers keep allocating ever-larger amounts of capex for the AI buildup. The profits expected to be reaped from being the ultimate winner in the race to AI are so enormous that, so far, no hyperscaler has even remotely considered announcing a slowdown—let alone a scale-back—in capex.

However, on Wall Street, some are beginning to wonder whether the current divergence in performance—with some hyperscalers even posting declines in absolute terms since the start of the year—could prove to be a tipping point. By penalizing the stock prices of hyperscalers that are allocating an ever-increasing share of their free cash flow and profits to artificial intelligence, financial markets could sooner or later prompt some of their CEOs to reconsider their spending plans, given that recent growth in capital expenditures has been nothing more than a transfer of cash and profitability to the benefit of semiconductor manufacturers. And if one of the hyperscalers were to actually start curbing its capital expenditures, the others will likely follow suit.

If that were to happen—even though memory production bottlenecks are currently expected to persist through 2027—the semiconductor sector could suffer a setback, as the market will likely begin to price in the end of this period of bonanza, with memory prices falling back to normal levels. However, in such a scenario, it is also likely that hyperscalers will experience a significant rebound, as their cash flow and profitability are inversely correlated with those of the semiconductors. As a result, the market might simply undergo a rotation, without experiencing a significant correction. Or, at least, not for this reason alone.

The other factor that materially influenced performance in the last quarter, besides the one just mentioned, was the growing speculative attitude of investors, particularly retail investors. The link between the two factors stems from the fact that retail investors' focus has been precisely on semiconductor and memory stocks.

Two major trends have been observed recently in this respect. The first is the increase in the leverage extended by dealers to investors for the purchase of stocks via futures contracts and total-return swaps, which has reached an all-time high of over $200 billion.

The second factor is the boom in the use of leveraged ETFs. Recently, the issuance of new ETFs with 2x or 3x leverage has grown exponentially. A significant portion of these consists of single-name ETFs (such as the Direxion Daily Micron Bull 2X ETF, with AuM of $6 billion, or the CSOP SK Hynix Daily 2x Leveraged Product, with a current AuM of $10 billion, though it peaked at $17 billion), rather than those focused on subindustries (such as the Direxion Daily Semiconductor Bull 3X ETF, with AuM of $24 billion, or the Roundhill Memory ETF, with AuM of $25 billion, and launched less than three months ago) or on the hottest countries of the moment (such as the Direxion Daily MSCI South Korea Bull 3X ETF, with AuM of $2 billion).

The total assets under management of these leveraged ETFs recently surpassed $200 billion, but they command an effective exposure (due to the leverage embedded) of over half a trillion dollars. According to Citadel's calculations, about 30% of the AuM of leveraged ETFs is linked to semiconductor ETFs, while another 37% is tied to technology ETFs not focused (exclusively) on semiconductors.

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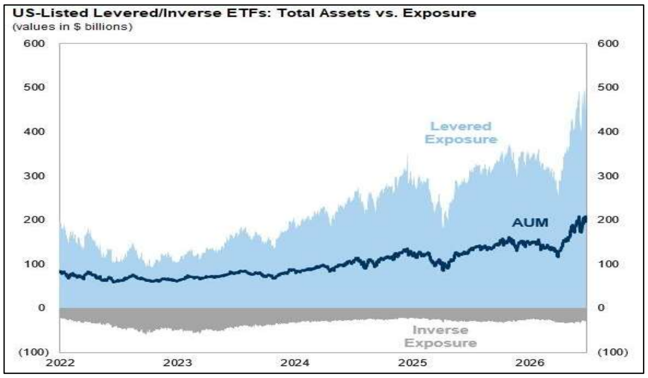
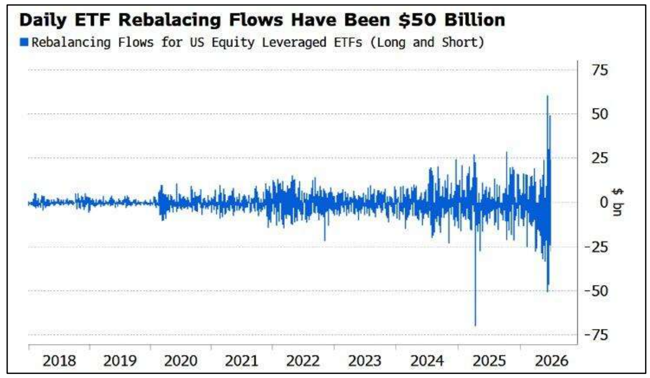


Source: Goldman Sachs



Source: Bloomberg

Due to their gigantic size, these leveraged ETFs are causing extreme volatility in the underlying stocks and indices. A leveraged ETF, precisely because of its leveraged nature, is forced to rebalance its exposure every day based on daily market movements: if the market rises, a leveraged ETF must increase its long exposure at market close to avoid becoming underleveraged the following day (relative to its target leverage level). If the market falls, a leveraged ETF must sell (increase its short positions) at market close to avoid becoming overleveraged the following day. This mechanism amplifies the volatility of the underlying stock or index. Furthermore, since other market participants are fully aware of these mandatory end-of-day rebalancing flows, when the market begins to move significantly in one direction, speculators front-run the leveraged ETFs' expected rebalancing flows. This, too, contributes to exacerbating volatility.

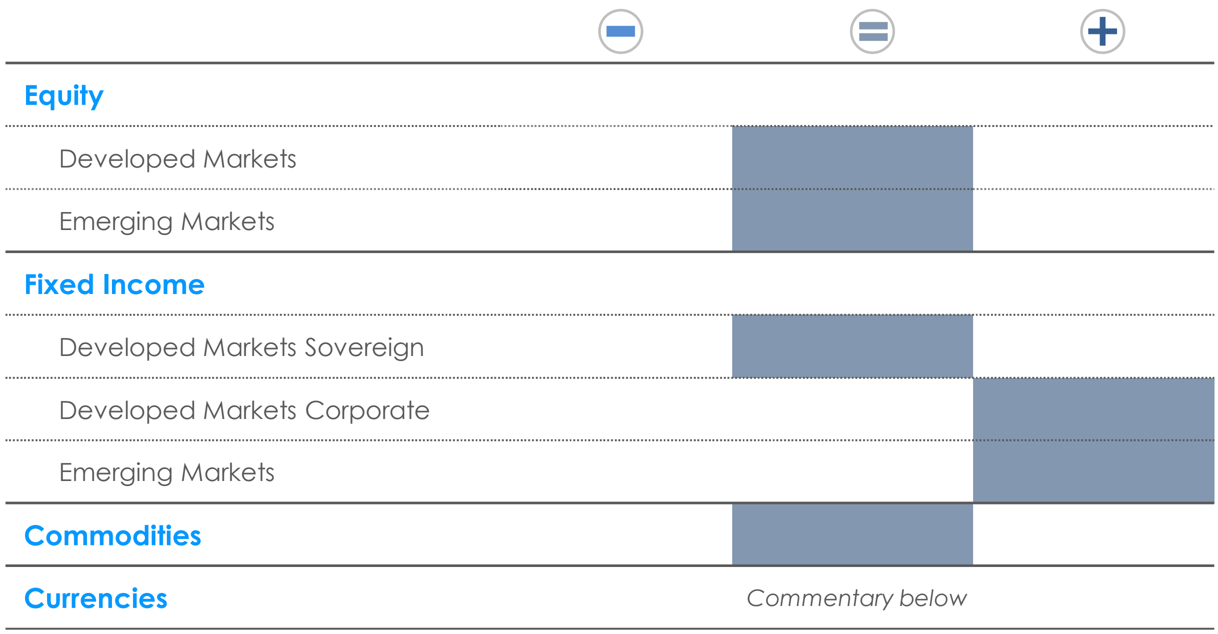
It is not surprising that, over the past month, there have been several instances of extreme volatility in the semiconductor sector and in Korea, given the significant weight (65%) that Samsung and SK Hynix have on the Korean index. Daily price swings exceeding 5% are now commonplace. As a result of these extreme fluctuations, leveraged ETFs have generated rebalancing flows of up to $50 billion per day—an exceptionally high amount considering the daily trading volumes of the underlying assets.

So far, steep declines on one day have been followed by sharp gains the next day, thereby limiting the pain for investors. However, if semiconductors were to experience a prolonged series of significant declines, the risk of panic selling and forced selling by leveraged ETFs could cause a downward spiral in these stocks. Given the heavy weighting that semiconductors currently have on major indices and the substantial rebalancing flows that could be expected from leveraged ETFs, what has so far remained an idiosyncratic risk has the potential to spread to the rest of the market, turning into a systemic risk.

To wrap things up, the developments discussed in this report suggest that one should carefully monitor the developments in financial markets over the next few weeks. There is a possibility that recent market excesses will be absorbed smoothly thanks to a healthy rotation between stocks that have outperformed and those that have lagged behind in recent months. The upcoming earnings season, which should prove to be strong once again, could facilitate this orderly transition.

Nevertheless, the possibility of disorderly market movements remains. These could be triggered by a further increase in the daily volatility of semiconductor stocks, although such a scenario remains quite unlikely. A more concrete catalyst would be what the hyperscalers say during the upcoming earnings season, because any material change in their capex commitments could have significant effects on market stability due to the direct impact on the semiconductor sector.

Asset Allocation View



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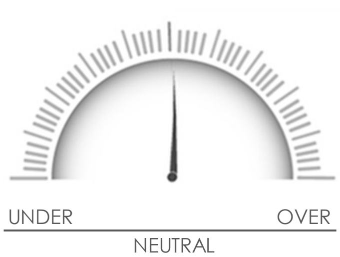
Equity

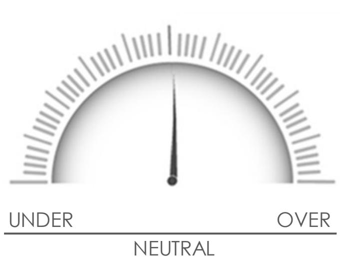
Developed Markets



We maintained the **Neutral** recommendation on Developed Market equities. The huge concentration of the rally in a limited number of stocks, lofty valuations and the heightened volatility affecting the retail' favorite stocks currently represent the main sources of vulnerability, as discussed in the prologue of this report. Nevertheless, the upcoming earnings season is expected to prove favorable once again, as are the latest positive inflation readings, which should allay fears of tighter monetary policy by central banks.

US	Europe	Japan

Emerging Markets

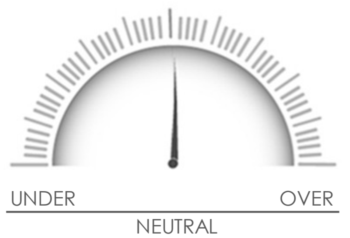


We kept our **Neutral** stance on Emerging Market equities. The growing weight of technology (45%) in the emerging markets index—and particularly the three largest semiconductor manufacturers (Taiwan Semiconductor, Samsung, and SK Hynix, which collectively account for 30%)—is altering the characteristics historically associated with this index, which used to be more value-oriented and closely tied to the domestic economic developments of individual countries. The growing use of leveraged instruments, such as ETFs, is leading to extreme volatility in some markets, which calls for caution. The long-term outlook remains positive, but it is advisable to wait for volatility to normalize, at least with regard to additional investments.

Asia ex-Japan	EEMEA	LATAM

Fixed Income

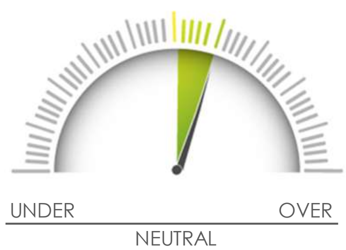
Developed Markets Sovereign



We have kept our **Neutral** recommendation on Developed Market sovereign bonds. The decline in oil and other commodity prices following the reopening of the Strait of Hormuz should allow inflation to fall in upcoming readings, thereby enabling central banks to shift away from the tightening bias they adopted after the conflict in Iran began. Among the main yield curves, the European ones could stand to benefit the most, given that core inflation has already returned to 2.4% and the domestic economy is showing increasing signs of weakness.

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

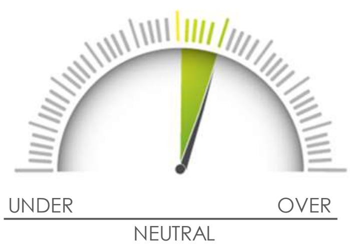
Developed Markets Corporate



We kept our **Slightly Overweight** recommendation on Developed Market corporate bonds. The hunt for yield continues, fueled by ample liquidity, with spreads nearing all-time lows. If global growth continues to hold up relatively well, there is no reason to be overly cautious and exit the market prematurely. Within credit, we continue to prefer investment-grade bonds over high-yield.

IG Europe	+	IG US	+	HY Europe	−	HY US	−

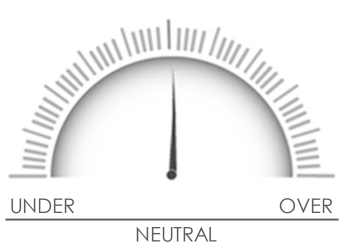
Emerging Markets



We left our recommendation on Emerging Markets Debt unchanged at **Slightly Overweight**. The reasons are the same as those just outlined for developed countries' corporate bonds.

Local Currency	=	Hard Currency IG	=	Hard Currency HY	=

Commodities



Our recommendation for commodities remains **Neutral**. We maintain a cautious stance on precious metals, given headwinds from central bank selling and the higher-yield environment. Over the medium to long term, however, our view remains positive. On industrial metals, we are more bullish, driven by growing competition for essential raw materials.

Precious	=	Energy	=	Industrial	=	Agricultural	=

Currencies

We have reaffirmed our recommendation on the US Dollar to **Slightly Overweight** in light of the more restrictive stance adopted by the Fed under Warsh's leadership, the stronger economy and the fact that the greenback continue to serve as a portfolio hedge in times of market stress.

The view on the Euro has been downgraded to **Neutral with a bearish bias**, due to the relative weakness of the economy and the possibility that the ECB will soon rule out further rate hikes.

We have maintained our recommendation on the **Chinese Renminbi** to **Neutral**, but no longer with a bullish bias.

The outlook for other **emerging markets currencies** has been confirmed as **Neutral with a bullish bias**, with a preference for currencies of countries that are net exporters of commodities.

Euro	=	**USD**	+	**CNY**	=	**Other EM**	=