

Macro Commentary

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

Year 2020 is expected to be a turning point for several long term trends that have characterized the financial markets over the past decade.

The biggest one could be the switching role as herald of growth from central banks to governments. Many central banks worldwide, mostly in the zero or negative interest rates regions, stated quite clearly that monetary policy has been the only pillar for growth and stability over the past decade, but currently there are a few ammunitions left, and hence the governments should lead with fiscal spending and reforms.

Should this change effectively take place, then major changes to asset allocations might be needed to keep the portfolios performing. In fact, fiscal spending is usually associated with expanding budget deficits, GDP rebound and even potentially a pick-up in inflation.

All three likely consequences are not welcomed by the fixed income markets, at least for the safest bonds like government bonds and high grade corporate bonds. Central banks tend to react to such developments with less accommodative or outright restrictive monetary policies. Considering all the money that poured into fixed income over the past decade, combined with the all-time low interest rates, we have a potentially lethal combination for long duration risk-free bonds. Provided that many central banks have just started to implement more accommodative policies, it would be improbable to see some U-turn in the first half, but late in 2020 we could see some central banks starting more restrictive policies.

As oftentimes happens, markets will probably anticipate this shift in the monetary policy, so we can expect to see risk-free rates increasing already in 1H2020. This could happen even in the absence of fiscal spending, as there are several signs of bottoming and recovery of the economic cycle.

This is not something disconcerting. In an environment characterized by economic recovery with accommodative monetary policies, carry trading tends to be the best investment strategy to implement. In developed markets subordinated and hybrid bonds amongst corporate bonds are preferred, whereas inflation linked bonds could be a cheap protection against any unexpected rise in inflation. In order to maximize returns, investing in those bonds together with short positions on core sovereign bonds would be prudent. With this strategy, it is possible to benefit from the probable further compression in spreads, while avoiding adverse movements in duration.

The other segment of the credit market that could benefit from this environment is the emerging market bonds. They are generally quite compelling thanks to a combination of factors, such as the lack of QE from their central banks (and hence EM yields not decreased as much as DM) and the expected de-escalation of the trade war between US and China, that caused a massive outflow from emerging markets assets during the past two years.

There are several reasons to remain cautious about the high yield markets, both in US and EU. Spreads are quite low already, the increase in corporate leverage of the past few years has been substantial and refinancing maturing bonds could prove more difficult in a rising yield environment.

Macro Commentary (continued)

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On the Equities, if the governments will implement fiscal spending measures, this would be bullish for equities worldwide, as EPS could get a boost. The sectors that would be most favorable are cyclicals, i.e.: the sectors that have significantly underperformed in the past years, where only growth companies were the market favourite. The tentative recovery of value vs. growth stocks that started in September 2019 is probably due to these expectations.

But there could be a reversal in the relative performances on a geographical scale. Over the past decade, US indices greatly outperformed the rest of the world, amid healthier domestic economy. On the contrary, the GDP growth was capped in the EU because of the austerity measures, and in emerging markets because of the trade war.

Whilst in the US there won't be any short term fiscal loosening, Europe could be the area where the consensus is growing for more pro-growth fiscal policies. As the EU markets trade at a very wide discount versus the US due to the lower GDP growth, any concrete actions by the EU could ingenerate a sharp repricing of the European stocks. EU Indices are also those that currently present the widest risk premium worldwide.

Emerging markets equities are trading at low valuations, due to the large outflows following the US-China trade war. Since the Phase 1 of the trade deal is done, there are expectations that the two countries could find a common ground in settling their dispute. This could give a boost to EM stocks, that could also benefit from a potential recovery in Europe, as EU is one of the most important export markets for emerging countries.

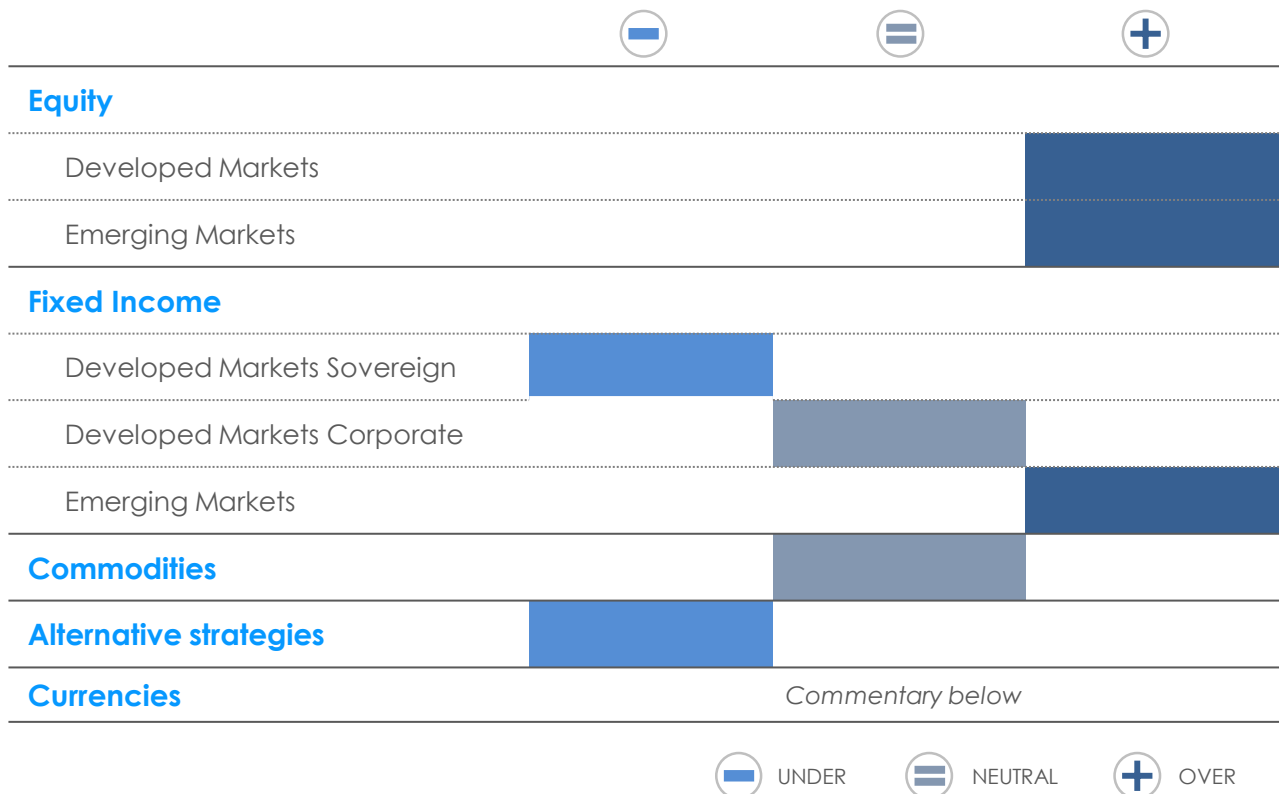
Irrespective of where fiscal spending will be enacted, it is expected that most of the government interventions will be focusing on infrastructure and environmental friendly projects, hence the only two "themes" that could continue to outperform in 2020 are effectively Infrastructure and ESG investing.

Concerning currencies, in a more risk prone environment the US dollar could lose some of its appeal, in favour of the euro (because of the expected fiscal spending), the Sterling (due to the diminished uncertainties related to Brexit) and most of all to emerging currencies (because of the carry they offer).

On the commodities side, if the fiscal spending will become a reality and global growth will start to recover, perhaps in association with a rise in inflation, commodities could be included again in a portfolios (to a limited extent as a mean to increase the diversification).

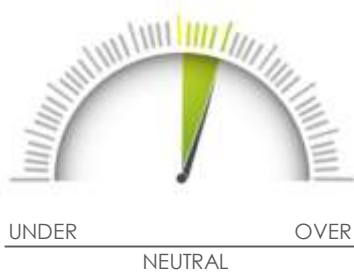
In light of all the above, the asset allocation advice for 2020 is to reduce the exposure to core government bonds, and to continue to gradually increase the equity exposure. The expected long term return of the former is too low or even negative, while the latter is poised to deliver still decent returns over an appropriate time horizon. Performances, however, will not follow a linear pattern. The rally experienced in all asset classes in 2019 has been remarkable, and some short term retracements could happen at any time. When presented, those occasions should be assessed as opportunities for adding sharply to the equity exposure, as the long term expected return will be much better then.

Asset Allocation View



Equity

Developed Markets



Long-term positive, mid-term slightly positive. The 2019 rebound in the main equity indices reduced the potential upside, and the strong inflows over the last quarter of the last year trimmed the underweight positions of the market participants. As recent performances have been driven entirely by multiple expansions, the market could be vulnerable to some profit taking in the short/medium term. European equity indices are seen as the best place to be in 2020, whilst US is cut to underweight.

United States ⊖	Europe ⊕	Japan =
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Emerging Markets



Long-term positive, mid-term positive. Emerging markets have the lowest valuations amongst equity indices. The diminished trade tensions together with the expectation of a pick-up in global growth and monetary policies still accommodative for quite some time and will favour an extension of the rebound of emerging market stocks. Any short term corrections should be used to add long positions.

Asia ex-Japan ⊕	EEMEA ⊕	LATAM ⊕
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Fixed Income

Developed Markets Sovereign



Long term negative, mid term negative. Central Banks' easing cycle is probably over, meaning that no further stimulus measures are expected. Short term rates could remain rangebound in Developed Markets, but there is a possibility that the long end of the curves could steepen. That would be a sign that the market is discounting that the economy is stabilizing, thanks to the monetary stimulus. Avoid particularly core EU government bonds, and long duration bonds. Inflation linked bonds and steeper strategies could be the best investment solutions within sovereign bonds.

EU Core



EU Periphery



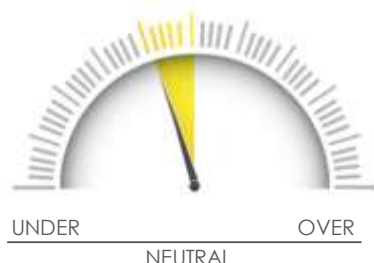
US Treasury



Japanese JGB



Developed Markets Corporate



Long term slightly negative, mid term slightly negative. Thanks to Central Banks' easing cycle the spreads are relatively narrow, but further compression is still possible if the global recovery will consolidate. Better value presents in Investment Grade compared to High Yield, mostly in Europe as the ECB is stepping up its purchases on EU IG corporate bonds. The preferred segments of the credit market are subordinated and hybrid bonds. It is advisable to reduce or remove the duration of the corporate bonds via short positions on sovereign bond futures (taking advantage the compression of the spread duration).

IG Europe

IG US



HY Europe



HY US



Emerging Markets



Long term slightly positive, short term positive. In the mid term, there is a quite perfect combination for emerging market bonds: global central banks are still accommodative, global recovery is underway, more risk prone environment, trade war receding, large outflows from the asset class in the past months, spreads not so compressed as emerging markets central banks did not engage in QEs on their bonds. Better value presents in Investment Grade compared to High Yield.

Local Currency



Hard Currency IG



Hard Currency HY



Commodities



We have a neutral stance with a positive bias both long term and mid term. The preference for precious metals continues due to the low yield environment and the safe haven status. Waiting for a confirmation that the global recovery is in place before adding to energy and industrial commodities.

Precious



Energy



Industrial



Alternative Strategies



We have a negative stance as alternative strategies continue to suffer in the current environment. Amongst alternative strategies, low volatility strategies more preferred rather than medium and high-volatility ones. Low volatility strategies could be considered to a limited extent as a substitute for the fixed income component of the portfolio. Mixed asset funds or pure equity funds are instead preferred to, respectively, mid volatility and high volatility strategies.

Low Volatility

Medium Volatility

High Volatility


Currencies

Euro: long term slightly positive, mid term slightly positive. The possibility of fiscal policies to be enacted in the EU, and the removal of Brexit uncertainties could lead to a re-rating of the single currency in 2020. Downside risks could come either from politics in countries with unstable majorities, or by unexpected moves from the new EU Chairman, Mrs. Lagarde.

US Dollar: long term neutral, mid term slightly negative. On one hand the more risk-prone environment could diminish the appeal of the greenback, but on the other hand the US has the strongest economy within developed markets, and probably it will be the first place where the monetary policy will switch to a less accommodative stance.

Japanese Yen: slightly negative both long and mid term. Upside potential seen only in the case of a sharp and unexpected increase in risk aversion on financial markets.

Emerging Market Currencies: Long term slightly positive, short term positive. Some emerging currencies appear undervalued and could offer an interesting entry point. DM CBs in easing mode and negative yields support the demand for higher yielding securities.

Euro

USD

Yen

Emerging


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