AZIMUT
DEFINING INVESTMENT DIRECTION

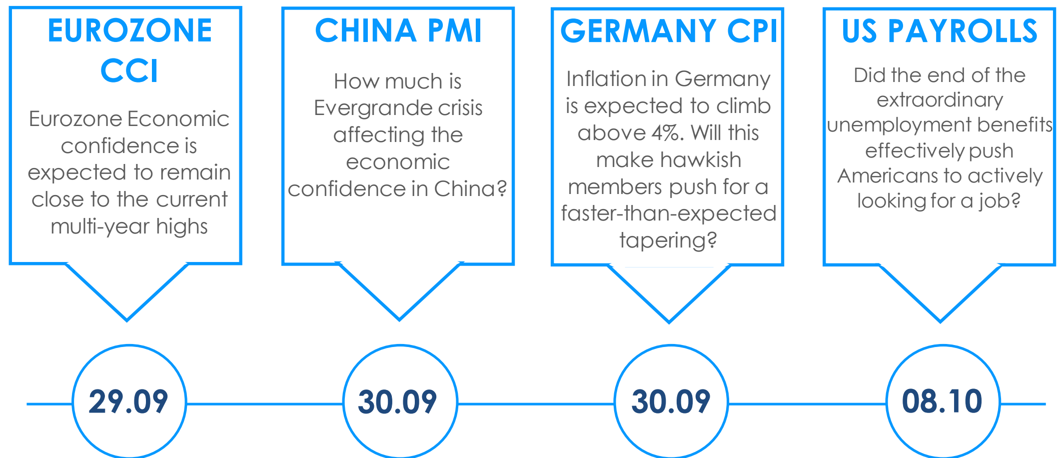
AZIMUT GLOBAL VIEW

27.09.21

Main Events

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



A TALE OF DR JEKYLL AND MR HYDE

- **Emerging markets hugely underperformed over the past decade leading to a deep discount versus Developed markets**
- **Less accommodative monetary and fiscal policies together with the increased political risks explain much of the recent weakness**
- **Aforementioned policies in Developed markets may create further volatility into year end, which could represent a good entry point**

Emerging markets' economies are those characterized by transitioning from a low income and less developed environment towards a modern, industrialized economy with a higher standard of living. The five largest countries by market capitalization weight in the MSCI EM Index are China (34%), South Korea & Taiwan (each approx. 15%), India (approx. 10%) and Brazil (5%). South Korea, Taiwan and China are still considered as emerging markets countries even though they have an income per capita above the World Bank's definition of Emerging Countries.

If we make a comparison in terms of performance between MSCI Emerging and MSCI World Indices (only developed countries) we can see that in the last 10 years, the MSCI EM index showed a stark underperformance of more than 170%.

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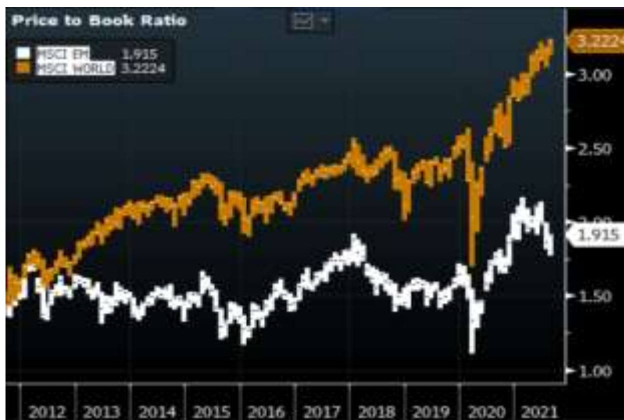


Source: Bloomberg

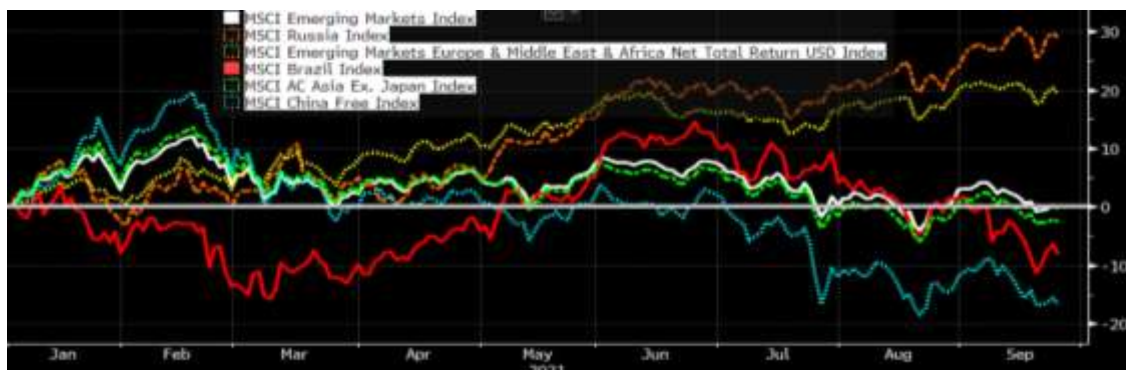
Source: Bloomberg

This has reset relative valuations to attractive levels (see chart above on P/B and next 12 months expected P/E valuation metrics in the last 10 years). However, even though a theoretical allocation of 13% (based on the MSCI ACWI) or around 37% (based on gross domestic product), Emerging Markets still remain largely underweight in the global institutional investors' allocations.

As the COVID-19 pandemic spread in 2020, investors initially withdrew their capital from emerging markets at record speed, threatening a financial crisis. But after the initial shock, the situation returned to normal. Global financial institutions like the International Monetary Fund and the World Bank have provided financial assistance and debt service relief playing an important role in stabilizing the markets. The pace of recovery has varied widely. China, Korea, and Taiwan all responded quickly to control the initial outbreak. But, China has recently instituted lockdowns again to control outbreaks. However, countries like India and Brazil suffered a brutal second wave that overwhelmed the countries' healthcare systems. The rollout vaccination in the first half of the year was slower than that of the western countries mainly due to little vaccine manufacturing in emerging markets.

The global recovery happening now since the beginning of 2021 is giving confidence that pent-up demand could persist until Q2 2022. However, strong rise in the commodities price combined with the dramatic surge in shipping costs, and bottlenecks in the supply chain is causing a sharp rise in inflation all over the world. Countries like Russia and Brazil are particularly sensitive to rising inflation and they immediately raised interest rates in different occasions. In other countries like Turkey and Poland, governments are openly driving for growth and prices are rising fast: in Poland they run a strong expansionary budget whilst in Turkey central bank surprised the market recently by cutting interest rates.

Rising commodity prices, buoyed by the global economic recovery, represent an advantage for some exporting countries like Russia and the Middle East. Brazil is an exception due to increasing political instability and the increase in rates to fight inflation. Conversely, commodity importing countries like China and Emerging Asia in general were at a disadvantage.



Source: Bloomberg, data in USD

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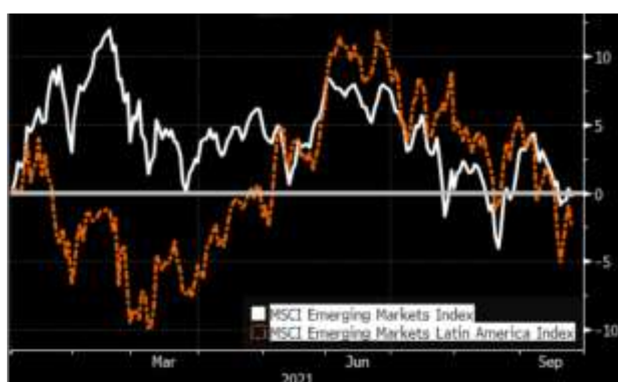
However, fear is once again on the rise. As inflation increases in the United States, the Federal Reserve could raise its interest rates in the foreseeable future. Meanwhile, it seems likely that the path of QE will be gradually reduced in the next 9 to 12 months. This might put emerging markets at a risk of a rise in the cost of capital and a flight of capital.

If inflation will prove not to be transitory due to strong demand and bottlenecks in the supply chain, it would be a negative for global equities including emerging markets equities. Reflation can lead to derating equity valuation multiples for companies in certain rate sensitive sectors. In this respect, it is worth noting that over the past few years the weight of "growth" stocks in the MSCI Emerging Markets and particularly in Asia has grown significantly. Growth stocks with extremely elevated valuation multiples are often more vulnerable to this kind of negative market reaction, particularly those in the healthcare, communication services, consumer discretionary, and information technology sectors. That's because much of their earnings potential is priced in the future, and higher interest rates reduce the current value of those earnings.

A rise in interest rates in developed countries, driven by expectations of a more hawkish central bank actions, can harm emerging market economies. We already witnessed it several times in the years following the great financial crisis in 2008, for example in 2012-13 or 2015-16 situations where the capital is withdrawn from emerging markets causing their currencies to depreciate. We should be aware that in the past decade, with constant intervention from central banks that forced trillions of developed markets government issuance to negative yield, many institutional investors were forced to look for higher returns financing emerging markets bond issuance either in local currency and hard currency; this apparently positive environment gave those countries the chance to dramatically increase their debt exposure from 30% of the economic output before the GFC in 2008 to a percentage well above 60% today.

Another aspect to take into consideration for emerging markets is the political turbulence that can take place any time. Amongst the major emerging markets regions, Latin America suffered several important political changes in the last 12 months. For example, few months ago, mass protests took place in Colombia over a proposed tax increase, but even though the proposal was scrapped, fueled by anger over economic inequality, the demonstrations lasted for about two month. Meanwhile, surprise election results in Peru and Mexico have reshaped the political landscape. Even in Brazil, the President Bolsonaro, fearing a loss in next year elections, clearly said that he wouldn't accept a defeat that led to rising worries of a potential military coup. We ended up with a situation where even though Latin American economies are deeply linked to export in raw materials (i.e. İron/ore, copper, oil, soy, sugar cane, etc.) political risk was a drag on the performance of Latin America whose YTD slightly underperformed the global emerging index.



Source: Bloomberg, data in USD

Source: Bloomberg

As we mentioned above, about one third of the MSCI EM Index is represented by China alone and more than 75% is represented by Asian countries. Chinese equities have been under stress in the past months, due to tighter regulation and deleveraging efforts by the Chinese government.

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In the last year, China has revealed several new regulations that reaffirms the ruling Chinese Communist Party's authority over citizens' digital life. A recent legislation reduced the amount of time that children and teens can spend playing video games to just three hours per week and banned online celebrity fan clubs. The new rules are part of a broader crackdown by Beijing's efforts to tackle supposedly monopolistic practices by the internet technology giants like Alibaba and Tencent.

By late July, the education sector was clearly Beijing's next target. Regulators ordered tutoring companies to restructure as non-profits, cut operating hours and remove foreign investment. Shares of industry leaders such as Tal Education, New Oriental Education & Technology were deeply hammered.
Moreover, China is showing absolute and relative restraint on monetary policy stimulus since credit impulse indicator has turned sharply downwards (see chart in the previous page).

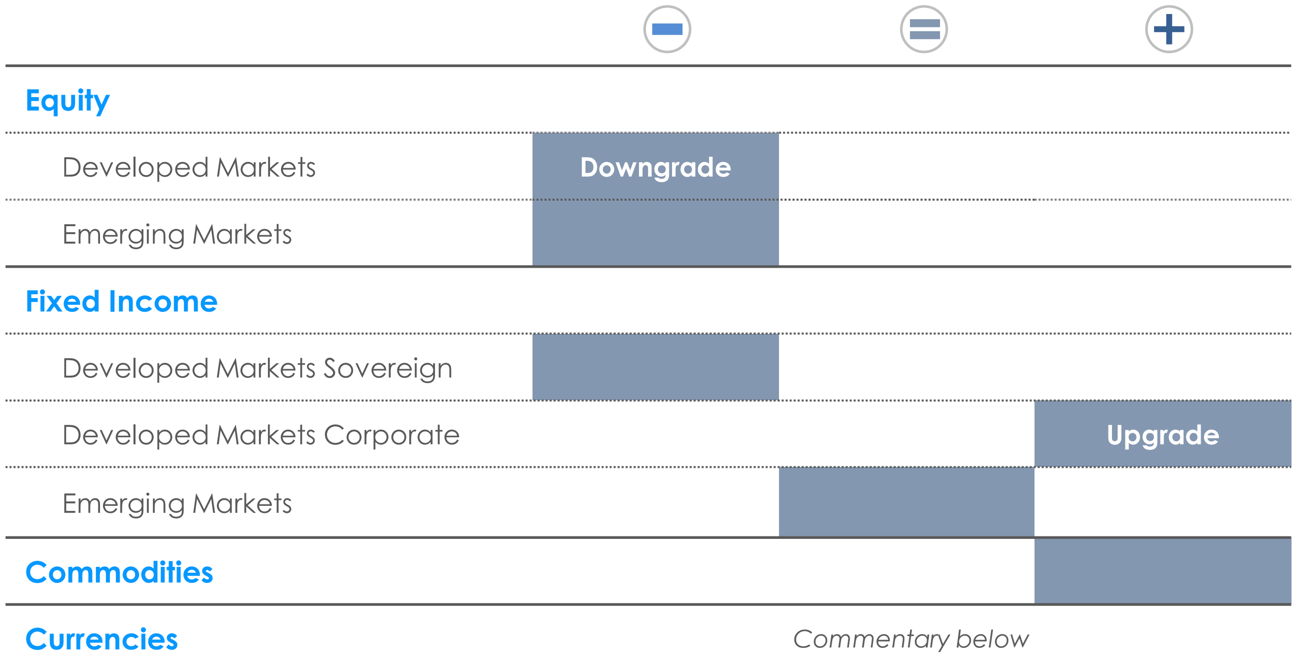
However, globally coordinated fiscal and monetary stimulus effort to combat the risk of a global depression induced by Covid-19 has helped to avoid spillover on the global economy due to Chinese moderation on its monetary policies. Of course, the scenario may change if the rest of the world shifts to less supportive monetary and fiscal policies.

In terms of flows this year, some investors clearly looked at ways to lower their investments in EMs through reducing China exposure and trying to be more focused on other emerging areas that are more commodity driven such as Russia and Middle East and favoring markets like India and Taiwan within Asia.

This process of window-dressing (reducing exposure to assets that underperformed during the year)mainly driven by professional investors could continue into year end. Furthermore, the possibility of less accommodative monetary policies by western central banks in the coming months and increased political risk in some EM countries are likely to add further pressure on Emerging markets equities.

On the positive side tough, Emerging markets show long term attractive valuation compared to developed countries; the sentiment in the region is already quite negative as investors incorporated the increased political risks in their expectations, while the rise in commodities price was a boost for more countries export oriented countries. Therefore, even if the next few months could still prove to be a bumpy road, there might be good entry points to accumulate.

Asset Allocation View

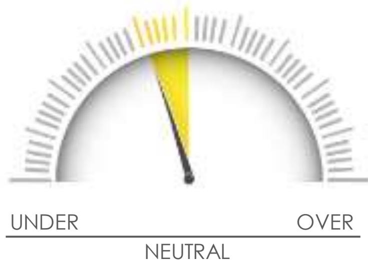


	UNDER (−)	NEUTRAL (=)	OVER (+)
Equity			
Developed Markets	■ Downgrade		
Emerging Markets	■		
Fixed Income			
Developed Markets Sovereign	■		
Developed Markets Corporate			■ Upgrade
Emerging Markets		■	
Commodities			■
Currencies	*Commentary below*		

UNDER NEUTRAL OVER

Equity

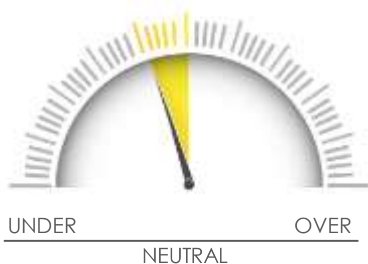
Developed Markets



We reduced our recommendation on Developed Markets Equities to **Slightly Underweight**. Central banks, especially the Fed and the Bank of England, began to announce that the monetary policy will be less accommodative going forward. Together with the waning fiscal stimulus, historically elevated valuations and the financial crackdown in China, a short term retracement is growingly imminent. While there is no clear preference for any particular style within equities, there is a stronger inclination for European stocks.

US **Europe** **Japan**

Emerging Markets

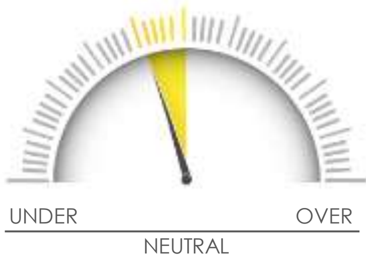


We maintained our recommendation on Emerging Markets Equities as **Slightly Underweight**. Even if Emerging markets are trading at a substantial discount vs. Developed Markets and in relative terms it could be reasonable to start increasing the exposure to EM equities, in the short term the switch to a more hawkish stance from the Fed and BoE coupled with the financial crackdown in China could still cause Emerging Markets to suffer in both relative and absolute terms.

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

Fixed Income

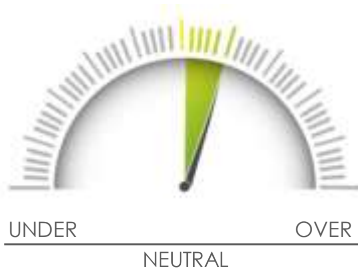
Developed Markets Sovereign



We reduced our conviction on Developed Markets Sovereign Bonds from Underweight to **Slightly Underweight**. Risk-free rates increased over the past weeks due to the anticipation of a less accommodative monetary policy from central banks, expectations that have been confirmed by the Fed and the Bank of England. The movement in risk-free rates may have already reached the halfway point. However, should risky assets begin a short term retracement amid the waning fiscal and monetary stimulus, the demand for safe-haven government bonds may increase in a risk-off scenario while limiting the upside in risk-free rates.

EU Core	EU Periphery	US Treasury	Japanese JGB

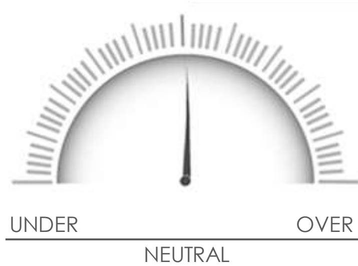
Developed Markets Corporate



We increased our recommendation on Developed Markets Corporates to **Slightly Positive**. As stipulated above, the change in attitude from central banks may trigger a correction in risky assets, increasing the attractiveness of less volatile assets. As emphasized in the previous report, solid balance sheets, low default rates and expectations for a continuation of the recovery/reopening of the economies should prevent spreads from widening significantly, even in a moderate risk-off scenario. Therefore, funds which actively manage the duration and credit risks could prove to be an interesting investment solution.

IG Europe	IG US	HY Europe	HY US

Emerging Markets



We kept our recommendation as **Neutral**. Emerging Markets Bonds spreads have compressed less than the developed market bonds with similar risk. This happened as most EM central banks adopted more conservative monetary policies than developed markets, and also because of the increased policy and political risks. Therefore, on one hand the EM bonds look attractive on a relative basis and they still enjoy from the ample liquidity in the markets driven by the hunt for yield. On the other hand, the approaching tapering by the Fed may lead to short term underperformance. Assuming that US rates will not move significantly higher from here, the view on the asset class is still balanced with risks tilted to the downside.

Local Currency	Hard Currency IG	Hard Currency HY

Commodities

We maintained our **Positive** view on the asset class. We continue to be positive precious metals specifically as they should benefit from very low real rates and rising inflation, and also they could serve as an hedge in case of increased risk aversion. Additionally, we maintain our bullish stance on energy and industrial metals due to the strength of the demand, supply constraints and shipping bottlenecks.

Precious	Energy	Industrial	Agricultural

Currencies

On the US dollar, the Committee still maintains a neutral stance. The announcement of the incoming tapering may be balanced by worries about the debt ceiling and the potential approval of the infrastructure bill.

The view on the Euro is also neutral. The moderate reduction in sentiment indicators due fear related to the spread of the delta variant is balanced by a more favorable real rate differential against the USD

On the Chinese Renminbi the view is slightly negative. The increased risk aversion on the Chinese assets due to the ongoing financial crackdown by the local government may prompt investors to further trim their exposure to Chinese assets. Additionally, the central bank may turn more dovish and inject liquidity in the system in order to avoid a slowdown.

The other Emerging Market currencies are expected to remain fairly stable, assuming that US risk-free rates won't increase materially above the current levels. If not, EM currencies may be vulnerable to corrections.

Euro	=	USD	=	CNY	–	Other EM	=

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