Main Events

US CPI
Inflation is expected to remain unchanged. Any upside or downside surprise may cause large swings in market prices
13.10

US RETAIL SALES
How much retail sales have been impacted by the end of the extraordinary unemployment subsidies?
15.10

CHINESE DATA
Third quarter GDP, retail sales, industrial production and fixed assets investments will help assess the real extent of the Chinese slowdown
18.10

UK CPI, PPI
The BoE is the first central bank to start admitting that inflation may not be under control. Any further acceleration in CPI and PPI data will reinforce the view
20.10

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

CHESS GAME

- **Despite a last-minute agreement and an extension of a few weeks, the problem of the US debt ceiling remains an issue**
- **Democrats could be forced to use the "budget reconciliation" to approve both the increase of the debt ceiling and the $ 3.5 trillion infrastructure plan**
- **The personal transactions of some Fed members sparked public outcry and prompted Elizabeth Warren to ask the SEC to open an investigation**

The last few weeks have been characterized by a series of political events of some significance, which have quickly passed into oblivion despite their effects have yet to fully unfold.

The first was the open letter from Mitch McConnell, minority leader in the Senate, to President Biden in which it is reaffirmed that the Republicans would not help the Democrats by voting in favor of the increase of the debt ceiling (source: https://www.republicanleader.senate.gov/newsroom/press-releases/mcconnell-letter-to-president-biden-on-debt-limit
).

For those unfamiliar with the issue, the debt ceiling is the limit on how much money the federal government can borrow or, put differently, the maximum level of debt the US government can issue. It is a form of Congressional control over Government's decisions, so that it cannot undertake reckless spending. If the debt ceiling is reached and the government has no longer cash available to repay a maturing government bond, it can no longer resort to issuing new debt to repay the maturing one, and would therefore be forced to default. In the case of the United States it would only be a "technical" default, in the sense that once the political impasse is resolved the creditors will certainly be repaid in full, but a default of the US would be a traumatic event for the markets.

This possible outcome is to be considered as extremely remote, mainly because of the seriousness of the consequences, and everything will be done to prevent this from happening, but let's try to better understand what is effectively unfolding.

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Ever since the Biden administration took office, and the Democrats won a majority in both houses of the Congress, they have embarked on very expansive fiscal policies resulting in a large expansion of fiscal deficits. Republicans, typically more conservative and opponents of large fiscal deficits, have tried to resist such spending, but being a minority they were not able to succeed.

The spending spree embarked by the Democratic in the first part of the year has been possible because the debt ceiling was formally suspended until the end of July 2021, and therefore until that point in time the government had no limits on its spending capacity. Since the end of July, though, the debt ceiling has re-entered into force, settling at the exact value of the American debt at the end of the suspension. Since then, the Democratic administration faced the current expenses and repayment of maturing government bonds, thanks to its cash reserves, which are expected to run out in the coming weeks.

The problem is that the Democrats want to continue to run huge fiscal deficits. In particular, the approval of an infrastructure plan of 3.5 trillion dollars (in addition to the bipartisan one of 0.5 trillion dollars on which Democrats and Republicans had agreed during the summer) which would further jeopardize the long term sustainability of the US public debt. Given that all the measures approved by the Biden administration so far have never been discussed or agreed with the Republican minority, the Republicans demand that the approval of the debt ceiling increase be carried out with the votes of the Democrats alone. From McConnell letter to Biden, “The debt limit is often a partisan vote during times of unified government. In 2003, 2004, and 2006, Mr. President, you joined Senate Democrats in opposing debt limit increases and made Republicans do it ourselves. You explained on the Senate floor that your ‘no’ votes did not mean you wanted the majority to let the country default, but rather that the President’s party had to take responsibility for a policy agenda which you opposed. Your view then is our view now”. And also “Bipartisanship is not a light switch that Speaker Pelosi and Leader Schumer may flip on to borrow money and flip off to spend it. Republicans’ position is simple. We have no list of demands. For two and a half months, we have simply warned that since your party wishes to govern alone, it must handle the debt limit alone as well”.

A few days after this letter, the Republicans agreed to a partial increase in the debt ceiling until early December, but only for a maximum amount of 480 billion dollars. While this decision can be interpreted as if the Republicans had yielded on their position, another interpretation must be taken into account. Raising the debt ceiling to be able to repay maturing government bonds is something that is considered as a moral duty by both parties as it is linked to honoring past Federal debt, which has been accumulated by both parties.

If the Republicans had simply opposed raising the debt ceiling, the Democrats would have blamed them in case of default. By allowing for a limited/reasonable increase in the debt ceiling, Republicans have instead proven that they want to take responsibility for past debt, but not for the additional debt that Democrats would need to pursue their economic agenda. Therefore, Republicans have made it clear that it’s upon the Democrats to take the full responsibility of deliberating an additional and considerable increase in the US debt, which is functional only to their agenda.

In December, therefore, Democrats may have no other choice to raise the debt ceiling than to use the procedure called "budget reconciliation", which allows the Senate to pass by simple majority (50 votes) resolutions that would normally require a qualified majority (60 votes).

The problem is that the budget reconciliation can only be used once during a fiscal year. Given that the infrastructure plan also requires a qualified majority because of its significant impact on the public debt, Democrats would be forced to use the budget reconciliation for both the raising of the debt ceiling and the approval of the infrastructure plan. The problem, however, is that within the Democrats some moderate exponents are reluctant not only to approve such a large spending plan, but also to raise the debt ceiling only with partisan votes as the political responsibility for this act may be considerable, and could have negative repercussions in next year's mid-term elections.

(continued)

Since the favorable votes of all 50 Democratic senators are required to pass the budget reconciliation, if the Democrats fail to achieve absolute unanimity, things will get complicated. If the infrastructure deal is not reached due to the reticence of the more moderate Democrats for such a massive spending plan, then there would be no choice but to approve just the increase in the debt ceiling. In this case, however, the infrastructure plan could never see the light as for its approval in the ordinary way, the favorable votes of also at least 10 Republicans are required, which is completely unreasonable to expect. This would be a blow to the credibility of the Democrats, but also to the market expectation of additional stimulus down the road.

In politics, things often have to get more complicated before reaching a solution. Considering what is at stake, it is reasonable to expect that in one way or another a solution at least for the debt ceiling will be found, either by the Democrats alone or with a bipartisan accord. This is the base-case scenario. But it will be necessary to remain vigilant.

Another hot topic in recent days has been the scandals involving three Federal Reserve governors, Dallas Fed President Robert Kaplan, Boston's Eric Rosengren and Vice-President Richard Clarida. The first two resigned at the end of September. According to Bloomberg, "Kaplan disclosed multiple trades of over $1 million during 2020. Rosengren transacted in real estate investment trusts, including some that invested in mortgage-securities that the Fed started buying in 2020", while "Fed Vice Chair Richard Clarida's 2020 financial disclosures show he traded between $1 million and $5 million out of a bond fund into stock funds one day before Chair Jerome Powell issued a statement flagging possible policy action as the pandemic worsened". Bloomberg also reports that those trades "were a "pre-planned rebalancing to his accounts, similar to a rebalancing he [Clarida] did and reported in April 2019" and were "executed prior to his involvement in deliberations on Federal Reserve actions to respond to the emergence of the coronavirus and not during a blackout period".

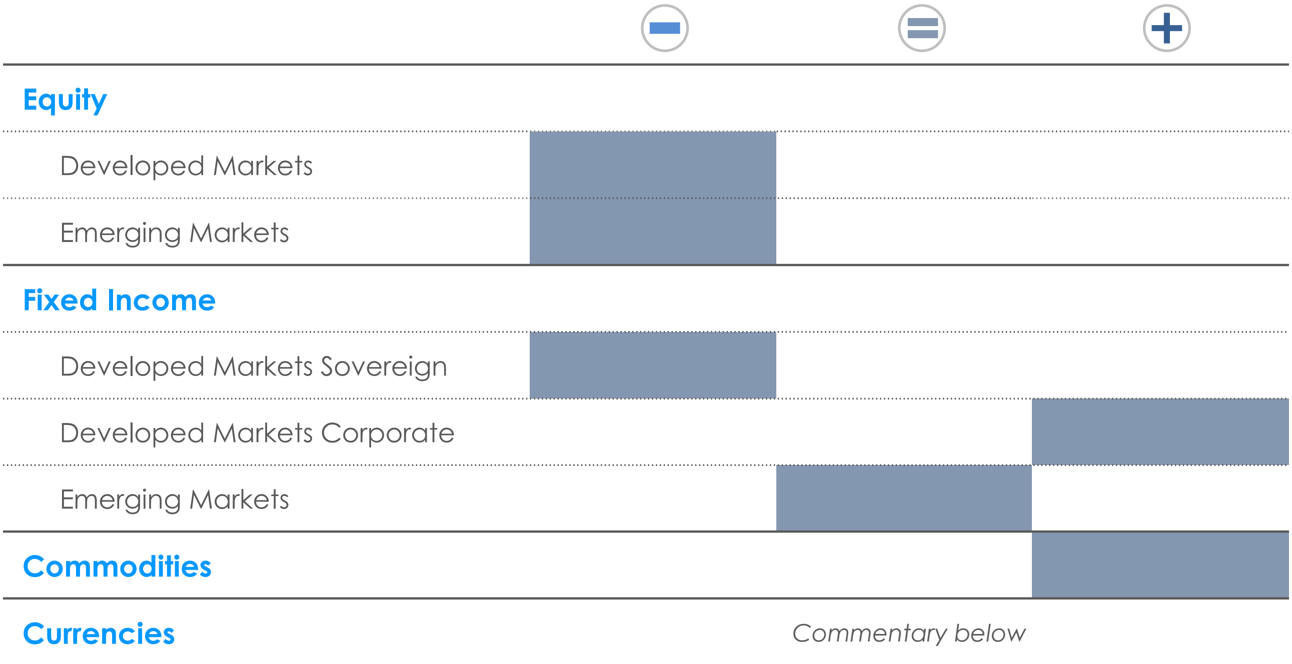
These trades questioned the moral integrity of the concerned Fed members, to the point that Senator Elizabeth Warren formally asked the SEC to open an investigation procedure against them to see if they violated insider trading rules or have acted in a situation of conflict of interest.

These developments, obviously, have not led to question the credibility of the Fed as an institution. However, the timing of these events is unfortunate, as never before have the Fed and central banks in general needed all their credibility to defend the view that inflation is transitory, despite growing evidence of spikes in prices, and persistent disruption in the global supply chains.

Finally, among the "discords" that have recently emerged between institutions, there is another one that is worth to be mentioned. At its latest meeting, the Bank of England opened the door to the possibility of a sooner-than-expected rate hike, even before the tapering ends, in consideration of inflation rising too fast (it is worth noting that CPI is "only" at 3.2% YoY in the UK). Over the past weekend, two of the more hawkish members of the BoE further stressed the view that inflation may not be transient, and that a lack of action could cause inflation expectations to stabilize at higher level, thereby making it more difficult to bring prices back under control afterwards.

Certainly, some of the inflation in the UK is also due to Brexit-related issues. Nonetheless, the fact that one of the world's leading central banks is starting to question the transience of inflation (and despite lower inflation rates than in other countries), could make it more difficult for other central banks continue to defend their narratives.

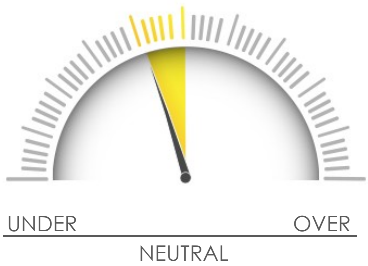
Asset Allocation View



UNDER NEUTRAL OVER

Equity

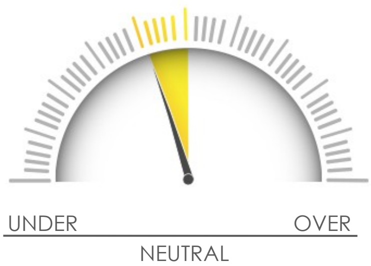
Developed Markets



We kept our **Slightly Underweight** recommendation on Developed Markets Equities. Less accommodative central banks, the end of fiscal stimuli, the political issue discussed in the prologue of this report, the spike in the energy and commodities prices, and valuation near historical highs suggest that a cautious approach is warranted in the short term. In terms of regions, we still maintain a preference for Europe, but to a lesser extent as the surge in electricity and energy prices could have a larger-than-expected repercussions on growth. In terms of styles, thanks to lower contagion rates and the new antiviral pill developed by Merck, Value may continue to outperform as well as the sectors positioned to benefit from higher commodity prices and/or interest rates.

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

Emerging Markets

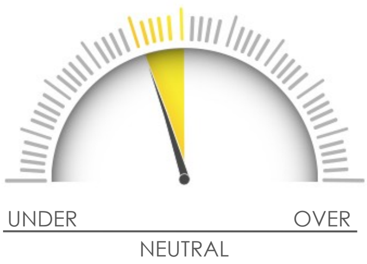


We maintained our **Slightly Underweight** recommendation on Emerging Markets Equities. After the strong year-to-date underperformance, the selling pressure on emerging markets and China seems to abate gradually: in the retracement of the last two weeks, developing nations did not underperform developed countries; even if during the increased risk aversion, riskier assets are supposed to correct more. Notwithstanding this, caution is still warranted as further crackdowns by the Chinese government are still possible, and a combination of stronger US dollar and higher risk-free rates in developed markets are usually associated with weak emerging markets performances.

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

Fixed Income

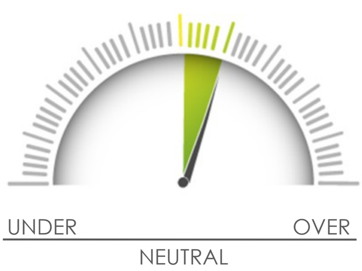
Developed Markets Sovereign



We maintained our **Slightly Underweight** recommendation on Developed Markets Sovereign Bonds. On one hand, the recent rebound in rates globally is becoming quite extended, with yields approaching the record highs for the year. Only in the US interest rates are still about 20 basis points below the maximum level of the year. On the other hand, the spike in energy and electricity prices and the persistent bottlenecks in global supply chains may cast doubt on the transitory narrative of inflation, which in turn may lead to higher rates.

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

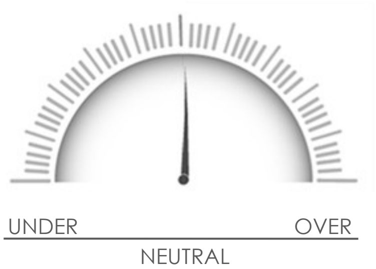
Developed Markets Corporate



We increased our recommendation on Developed Markets Corporates to **Slightly Positive**. The change in attitude from central banks to a less accommodative monetary policy may trigger a correction in risky assets and increase the attractiveness of less volatile assets. 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 actively managing duration and credit risks could prove to be an interesting investment solution. Within corporate bonds, we are growingly cautious on high yield bonds.

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

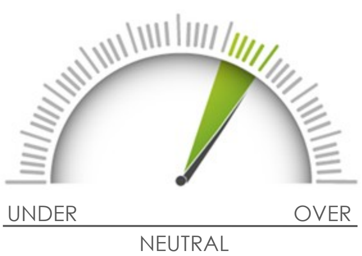
Emerging Markets



We kept our recommendation as **Neutral**. Emerging Markets bond spreads widened in response to the Evergrande crisis, with low grade corporate bonds suffering the most. The asset class, which has already lagged behind developed market bonds, seems to have already adjusted to this less favorable environment. Therefore, EM bonds look even more attractive now on a relative basis, and they can still count on the ample liquidity and the hunt for yield. Assuming US rates will not move significantly higher from here and no widespread increase in the risk aversion, 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 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 reduced risks related to the spread of the delta variant is balanced by a more favorable real rate differential against the USD and by the spike of the energy prices.

On the Chinese Renminbi the view is slightly negative. The increased risk aversion on the Chinese assets due to the ongoing financial crackdown may continue to keep investors away. 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. Some central banks are either starting or continuing to raise rates, which could help support their currencies.

Euro	=	**USD**	=	**CNY**	–	**Other EM**	=