AZIMUT GLOBAL VIEW

20.12.21

Main Events

US CONS. CONF. — How strong is the US consumer going into the Christmas spending season? — **22.12**

JAPAN INDP — The industrial production in Japan is expected to rebound strongly — **28.12**

GERMANY RETAIL SALES — How strong has the impact of the mobility restrictions been on retail sales in Germany? — **28.12**

CHINA PMI — Looking for bright spots in the Chinese manufacturing and non-manufacturing PMI — **31.12**

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

CLOSING THE TAPS

- **Central banks around the world are adopting a more aggressive monetary policy stance**
- **The Fed and the ECB have both announced that they'll complete their tapering by the first quarter of 2022**
- **As the ample liquidity has been one of the factors underpinning the recent bull market, the end of the QEs may lead to increased volatility in financial assets**

Dozens of central banks have had their meetings in the past 10 days.

The main concern of all central banks, both in developed or emerging countries, has been finding the right balance between fighting against the inflationary pressures that have been building up in almost all countries worldwide and the downside risks that may be induced by the fast-spreading Omicron variant, for which the level of severity and whether vaccines can provide durable protection are still unclear.

Most central banks have resorted to more stringent monetary policies. Generally, the emerging market countries have either started or continued to increase their policy rates, as these countries are usually more vulnerable than developed markets to inflation flare-ups, which then tend to become entrenched.

The rate hike cycle is already well advanced in some emerging countries, who acted preemptively on rates in order to prevent inflation from going out of control. For example, among the biggest emerging markets, Brazil and Russia both increased their reference rates seven times in 2021, from 2.00% to 9.25% and from 4.25% to 8.50%, respectively. Majority of the rest of the EM had already started to increase their rates, demonstrated in the graph next page.

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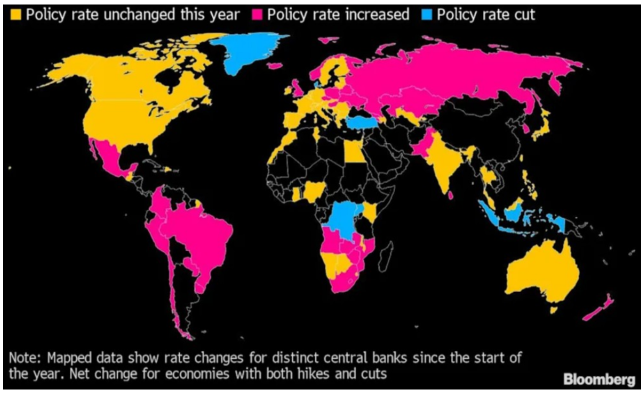
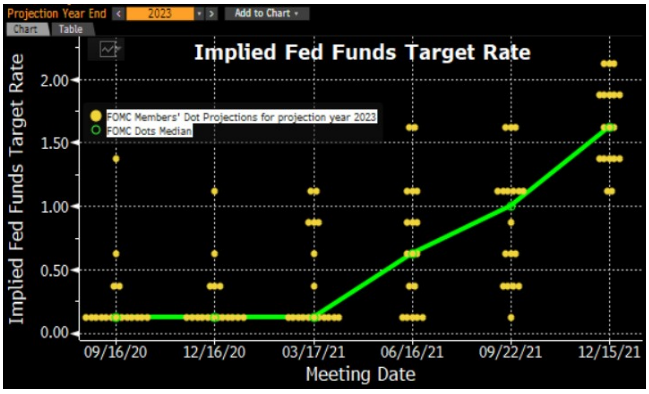


Source: Bloomberg



Source: Bloomberg

Central banks of developed markets, instead, have not yet acted on rates, except for Bank of England that became the first central bank among the world's leading economies to raise rates since the pandemic began, although the increase was minimal, from 0.10% to 0.25%.

As expected, the Federal Reserve and the ECB didn't move on rates. The ECB confirmed that the Pandemic Emergency Purchase Program (PEPP) would expire as expected in March, with the tapering occurring progressively during the first quarter. The word on the street was that in order to avoid an abrupt end to purchases, the ECB could have unveiled a new program or substantially boosted the existing Asset Purchase Program (APP), which currently runs at a pace of €20 billion of bond purchases on a monthly basis. Instead, the ECB just expanded the APP by €20 billion for three months, and by €10 billion in the following three months.

The Federal Reserve continued to be the most disciplined central bank, confirming during FOMC meetings what the Chairman or other members had already disclosed to the market prior to their meeting. As anticipated by Powell during his semi-annual testimony to the US Congress, the tapering will be implemented at twice the pace originally announced, with the purchases ending as well in March 2022, as for the ECB.

The decision to shorten the QE allows the Fed to begin its rate hike process already in the second quarter of 2022, earlier than originally expected. This could be seen as a sign that the Fed feels the need to accelerate the unwinding of its ultra loose monetary policies. Such hypothesis seems to be confirmed by the analysis of the dots plot, which summarizes the views of the FOMC governors about where the Fed's policy rate should be at any point in time: during the last meeting there was the sharpest increase on record in the dots median estimate. The graph above shows exactly how governors' expectations of where the Fed's official rate will be at the end of 2023 have substantially increased from previous FOMC meetings.

While the decision to accelerate tapering was expected, the same cannot be said for the interest rate projections. Nonetheless, market rates seem to have remained quite indifferent to the change in the dots plots, dismissing it either as a policy error or as something that would not have an immediate impact on markets.

The reduction in the amount of liquidity injected into the markets via QEs is likely to be the key focus of the markets in the short term. In just over three months, both the Fed and the ECB will have wrapped up their taperings. Until November, the Fed was buying $120 billion and the ECB about €70 billion (about $80 billion) a month. In total, there will be $200 billion/month of additional liquidity missing as from the second quarter of 2022.

And that's not all. The recent approval of the debt ceiling increase will allow the government to replenish its cash balance on the Treasury General Account (TGA), which is the general checking account that the Department of the Treasury uses, and from which the U.S. government makes all of its official payments.

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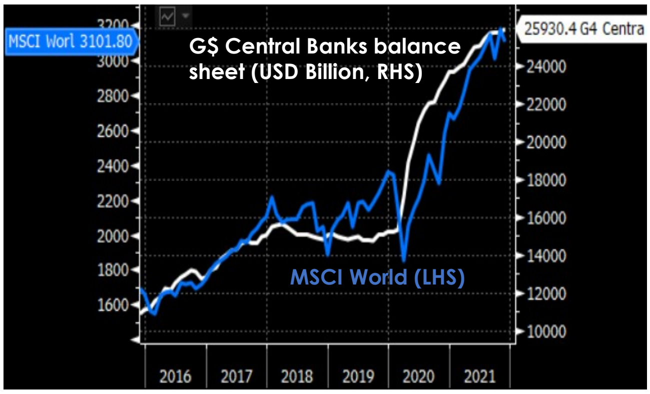
Source: Bloomberg



Source: Bloomberg

As we explained in February 15 dated Azimut Global View report, when the TGA decreases, the US Treasury Department injects liquidity in the financial markets, and vice versa. It is reasonable to expect now that the debt ceiling has been raised and that the US Treasury is again allowed to issue new debt, the TGA account will be replenished draining liquidity from the market exactly when central banks are closing their taps.

The historical evidence is that whenever liquidity stops flowing, financial markets and risky assets in particular tend to face periods of increased volatility and/or retracements (graph above on the right). Therefore, it is reasonable to expect that some hiccups may occur in the next few months. But in times of rising inflation and deeply negative real rates, equities are still the best asset class in town.

Asset Allocation View

	Under	Neutral	Over
Equity			
Developed Markets		■	
Emerging Markets		■	
Fixed Income			
Developed Markets Sovereign	■		
Developed Markets Corporate		■	
Emerging Markets			■
Commodities			■
Currencies	*Commentary below*		

UNDER NEUTRAL OVER

Equity

Developed Markets

UNDER OVER
NEUTRAL

We maintained our **Neutral** recommendation on Developed Markets Equities. Over the past two weeks, equity indices remained mostly unchanged, suggesting that both the spread of the Omicron variant and the more hawkish stance of central banks worldwide are already priced in. Stocks may face short-term headwinds amid the faster than expected tapering and the probabillity of the Build Back Better plan not being approved as is. In the medium run, equities are viewed as the asset class with the highest return expectations and should benefit from the more inflationary environment. Due to the uncertainty about the severity of the Omicron variant, we prefer to remain well diversified across all regions.

US	Neutral	**Europe**	Neutral	**Japan**	Neutral

Emerging Markets

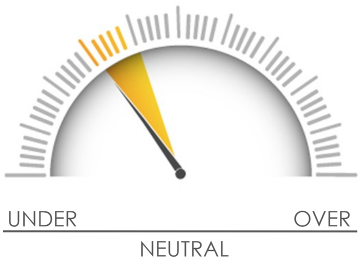
UNDER OVER
NEUTRAL

We kept our **Neutral** recommendation unchanged on Emerging Markets Equities. Considering the faster tapering and the possibility of an early start of the rate hike cycle by western central banks, there is still room for some volatility in these markets. That's why we are still neutral, even though, after the massive underperformance during 2021, emerging markets are now trading at a significant discount to developed markets and could potentially represent one of the most interesting opportunities in 2022. Within the EM space, we specifically prefer Asian region and China.

Asia ex-Japan	Over	**EEMEA**	Neutral	**LATAM**	Neutral

Fixed Income

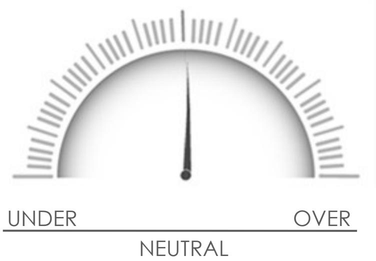
Developed Markets Sovereign



We downgraded our recommendation on Developed Markets Sovereign Bonds by one notch. The synchronized adoption of a more hawkish stance by the major central banks means less support for the bond markets. Due to the faster than expected tapering, the monthly liquidity injections will decrease by at least $200 billion, a considerable amount. Additionally, inflation continues to increase and is perceived as less and less transient, which should also lead to higher rates. Within Treasuries, we turned neutral on EU Periphery bonds as the approaching end of the PEPP program could lead to a widening of the BTP/Bund spread.

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

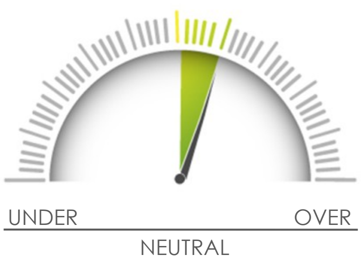
Developed Markets Corporate



We maintained our **Neutral** recommendation on Developed Markets Corporates. A faster than expected tapering together with the growing concern about the new Covid-19 variant outbreak may increase the possibility of the widening of corporate spreads, albeit not dramatically. As spreads are at very low levels, a worsening of the overall liquidity suggests that a more cautious approach to the asset class might be warranted. Within corporate bonds, we are turning bearish specifically on high yield bonds, the segment that could be most impacted by the end of the QEs.

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

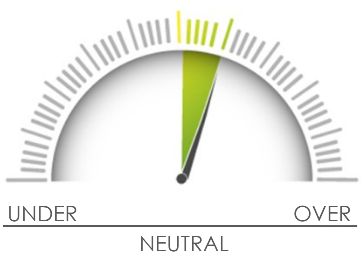
Emerging Markets



We confirmed our **Slightly Overweight** recommendation on emerging market bonds. Over the past year, the asset class has been underperforming Developed Market bonds and trading at decent spreads overall. We are turning more bullish on high yield bonds, in particular Asian high yields, considering that their spreads are close to the highest level of the past decades due to the crackdown of the Chinese government and of the Evergrande crisis. Instead, we are growingly cautious on investment grade bonds. As they have fared better so far, their spreads have not widened significantly and are therefore perceived as less attractive than high yields.

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

Commodities



We maintained our **Slightly Positive** view on the Commodities. We continue to prefer precious metals, considering that the real rates are still deeply in negative territory and lagged other commodities this year. Additionally, precious metals are one of the few asset classes that may serve as a hedge in case of a market turbulence. We have maintained a more cautious view on other commodities due to concerns over the spread of the Omicron variant that could weigh on the prices of energy and industrial metals.

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

Currencies

On the US dollar, the Committee still maintains a neutral stance. Central banks have turned more hawkish in a coordinated fashion, therefore major currencies may remain stable among them and the US Dollar is no exception.

The view on the Euro is also neutral. After the underperformance in the last few months, the Euro FX rate seems to have fully discounted the new wave of covid-19 infections that is affecting the Old Continent.

On the Chinese Renminbi the view is slightly negative. The strength of the renminbi this year combined with weakness of other emerging market currencies is denting China's competitiveness compared to other EM, and this could prompt some actions from the Chinese government and/or PBOC, in line with what has already been done two weeks ago.

The other Emerging Market currencies are expected to have room for a rebound after the correction caused by the new wave of covid-19 infection, the possibility of a faster tapering by the Fed, and the idiosyncratic issues that are affecting some countries.

Euro	=	USD	=	CNY	−	Other EM	+