AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

23.05.22

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

S&P GLOBAL PMI — 24.05
The PMI movements will reveal whether or not fears of an impending economic slowdown are justified

FED MINUTES — 25.05
Minutes from the latest FED meeting may provide more clarity on the future of US monetary policy

EU CPI — 31.05
European inflation is expected to accelerate further, putting pressure on the ECB to act

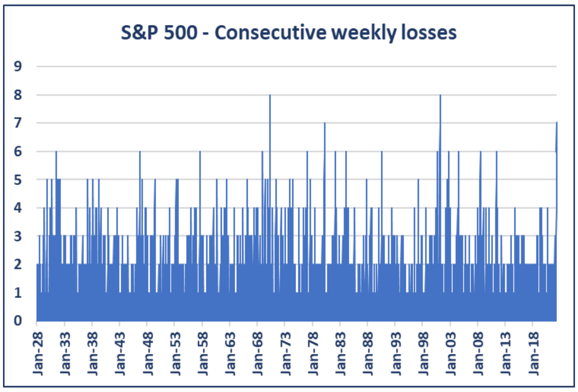
US PAYROLLS — 03.06
A US labor market slowdown would make the Fed's task much more difficult

FED-ACHE

- **Despite the streak of near-record weekly losses and oversold conditions, Fed and other central bank officials have maintained their hawkish stance**
- **Not only have interest rates weighed on equities, but so has the cryptocurrency rout and the increased perceived risk of a significant slowdown - even recession fears**
- **Although the correction has been severe, there are no clear signs of capitulation, but given the strongly oversold situation, a short term rebound is possible**

In the almost prophetic report a month ago ("Don't fight the Central Banks" dated April 11) we had discussed extensively the potential ramifications of Central Banks' suddenly becoming more hawkish on the markets. This change of stance has been particularly evident in the US where not only current Fed members, but also former governors (freer to speak up openly) have stated explicitly that tighter financial conditions in the US were necessary, and that the markets would have to correct to achieve this.

Fast forward to today, the market has suffered its seventh weekly decline, the longest losing streak in more than two decades. The other three instances when the market corrected for seven or more consecutive weeks occurred after the Internet bubble or during periods of sharply rising interest rates in the 1970s and 1980s. These are similar to today's conditions (high valuations, particularly for growth stocks, and rising rates).



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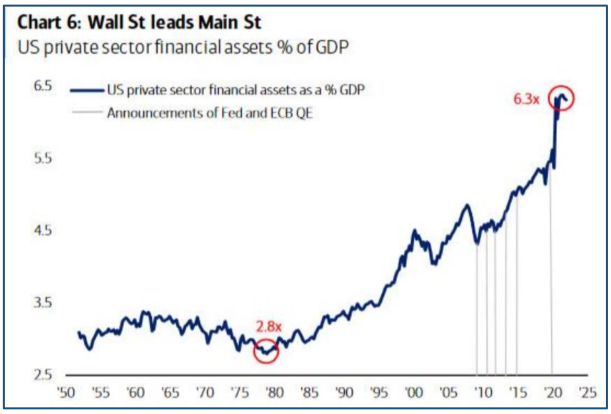
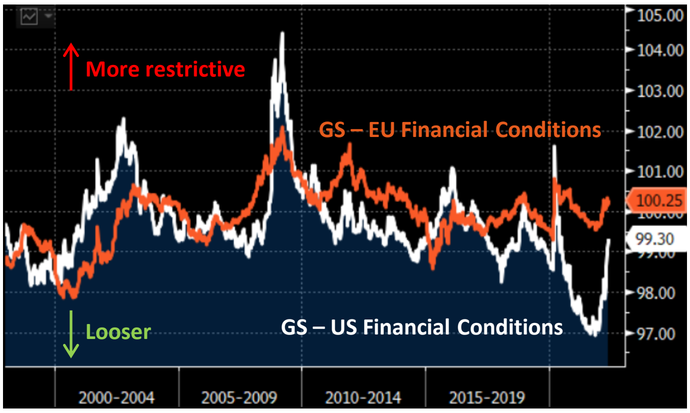


Source: BofA Global Investment Strategy, Harver

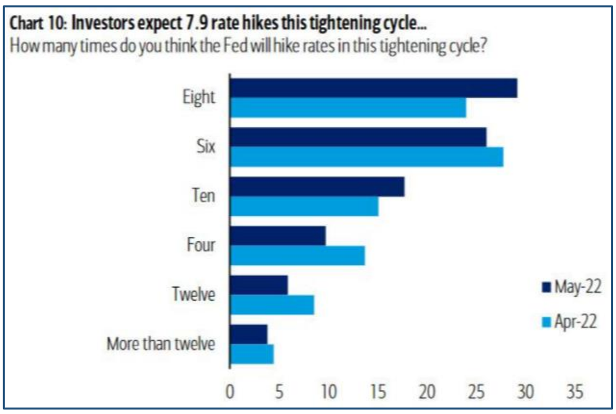


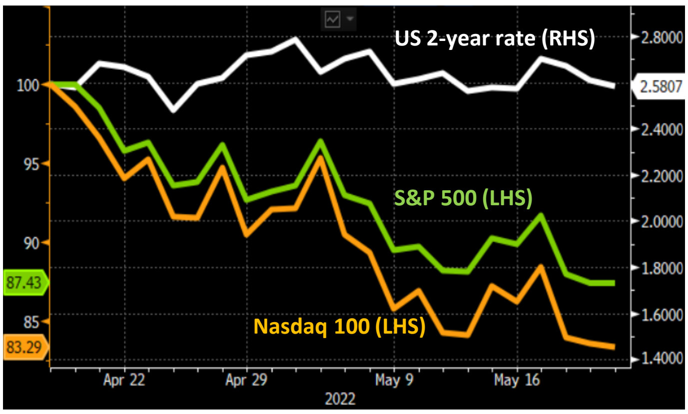
Source: Bloomberg

If the Fed really wants to be effective in containing inflation, it has no choice but to tighten financial conditions, considering that in recent years the ratio of financial assets to GDP has risen sharply mainly as a result of the monetary policies implemented by the main central banks (zero or below-zero interest rate policies plus several trillions of liquidity injected via QEs).

Despite the dramatic correction of the markets in recent weeks, financial conditions in the US and Europe are still at neutral / accommodative levels. This explains why the Fed and ECB governors are continuing to float increasingly restrictive monetary policies, irrespective of what is happening in the markets. Last week, Powell reiterated his commitment to fight inflation, saying he won't stop until there's "clear and convincing" evidence that it's slowing down, and that he will not hesitate to raise rates above the neutral level (estimated around 2.5%) if necessary. He also stated that "the process of getting inflation down to 2% will cause some pain, but the most painful thing would be if we failed to deal with it and inflation became entrenched in the economy at high levels." Powell also reintroduced the possibility of raising rates by up to 75 basis points per meeting, saying "If things go better than expected, we're willing to do less. If they arrive later than expected, we are prepared to do more ". Similarly, in Europe, some ECB members hinted at the possibility of raising rates as early as June, not ruling out hikes of 50 basis points per meeting.

Despite the Fed's efforts to convince the market that this rate hike cycle will be significant, roughly two-thirds of investors believe the US central bank will only make 4 to 8 25-bps hikes (corresponding to total hikes between 1 percent and 2 percent). However, interest rates are unlikely to be the only reason for the recent corrections. Two-year interest rates are unchanged from a month ago, while the S&P 500 is down 12.5 percent and the NASDAQ 100 is down nearly 17 percent.





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Source: Bloomberg

Source: Bloomberg

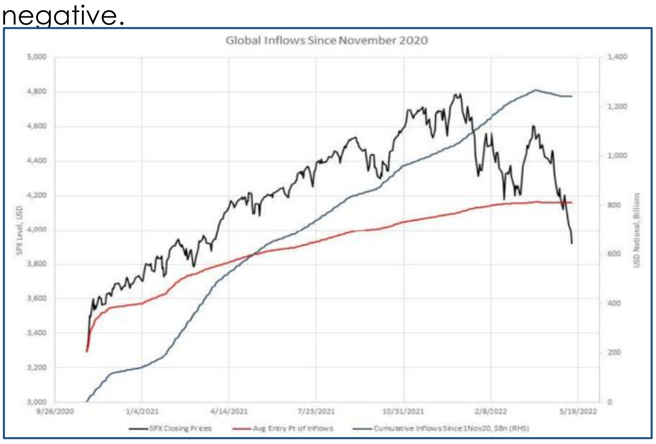
The cryptocurrency crash had a negative impact as well. The meltdown of digital coins began after the Fed meeting in early May and the coup de grace came the following week causing depegging of the stablecoin TerraUSD, or "Terra“ from the Dollar. The linked coin Luna, that was supposed to hold 1:1 parity of the TerraUSD with the dollar, collapsed to virtually zero in a few days. The TerraUSD coin is trading at about 6 percent, compared to its theoretical value of 1$.

Before the meltdown, the Terra-Luna pair had a combined market cap of around US$60 billion. These are already significant sums, and the effects were felt on other major cryptocurrencies, with Bitcoin and Ethereum losing roughly a third of their value in May.

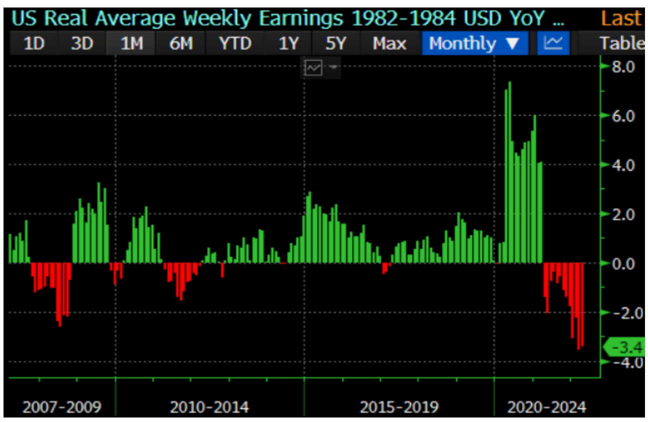
Additionally, considering that cryptocurrencies are primarily held (but no longer exclusively) by retail investors, this violent correction in digital currencies has intensified the correction in retail traders' favorite stocks, many of which have fallen by at least 50 percent since the beginning of the year. More broadly, these events are likely to have resulted in stop-losses and margin calls, contributing to the market’s downward spiral.

Finally, markets have priced in a growing risk that the economy will slow more than expected in the second half of the year. The destruction of wealth caused by widespread corrections over the last month and a half may further limit the spending ability of consumers, who are already facing a significant contraction in their purchasing power.

In fact, the average price of the flows that went into the stock market since November 2020 is estimated to be slightly below 4200 on the S&P 500 level. As of Friday's close at 3900, those who have invested over the past year and a half now (on average) facing a loss on their investments. In terms of the purchasing power, while the wages are rising at the fastest rate in years, they are failing to keep pace with inflation, resulting in a year-on-year change in real wages that is becoming increasingly negative.



Source: Goldman Sachs



Source: Bloomberg

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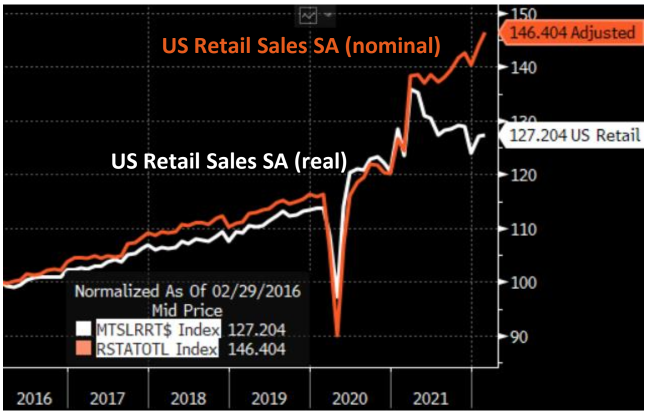


Source: Bloomberg


Exhibit 1: Performance of cyclicals vs. defensives consistent with a dramatic growth slowdown
as of May 16, 2022

Source: Factset, Goldman Sachs Global Investment Research

Unsurprisingly, while retail sales continue to rise at a rapid pace in nominal terms, they have been trending downward in real terms since the approval of the two massive fiscal stimulus packages in December 2020 and March 2021. This divergence demonstrates that consumers are falling further behind in their living standards, and the longer inflation persists, the greater the risk of an economic contraction. As a result, Walmart, Target, and other retailers reported declining comparable-store sales last week, as inflationary pressures reduced profit forecasts in their most recent quarterly reports.

In recent weeks, the market began to take notice of these gloomier scenarios, with cyclical stocks significantly underperforming defensive stocks. Historically, PMI indices have been strongly correlated with the cyclical vs defensive stock ratio. At current levels, PMI indices should soon fall below the 50-point threshold that typically forms the watershed between expansion and recession.

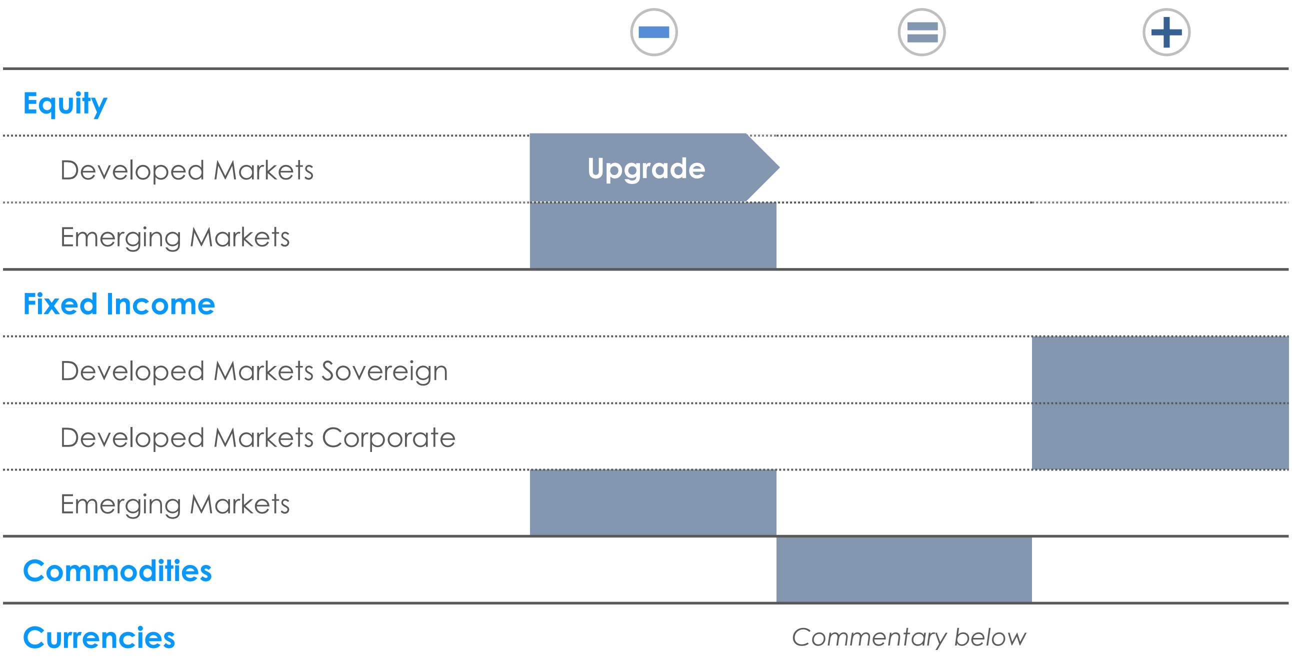
According to a CNN poll, the risk of a more or less pronounced economic slowdown is increasingly perceived as real "A staggering 68 percent of CEOs polled by The Conference Board believe the Fed's inflation war will eventually lead to a recession. [..] The good news is that only 11% of CEOs expect a so-called hard landing, which would result in a deep recession. The remainder anticipate a "very short, mild" recession ".

All of the aforementioned factors have contributed to the recent downturn. What is more important is to try to predict what will happen in the short to medium term.

On the one hand, stress indicators suggest that while the decline has been severe, situations of extreme stress that are normally associated with market capitulations have never been reached. Analysis of fund flows would also suggest that we are far from a capitulation, at least as far as equities are concerned. As BofA reports, for every $100 of inflow to investment grade/high yield/emerging market debt since April 2020, $27 has been redeemed; for every $100 of inflow to global equities since January 2021, only $4 has been redeemed.

The deeply oversold situation, on the other hand, and the near-record weekly losing streak suggest that a short-term rebound is possible. Goldman Sachs also provides some encouraging data, stating that the "S&P500 is down -16.05 percent through the first 89 trading days of 2022." Only the year 1932 (-25.99 percent) had a worse start to the trading year on record in the last 90 years. The median return for the remaining year of the top ten worst starts to the year is +8.20 percent. Through the first 89 trading days of 2022, Bloomberg US Aggregate is down 9.89 percent. This is the worst start to a year since 1989. To put this into context, the second worst year on record was (-4.98%) in 1994, roughly double. The median return of the top 10 worst starts to the year for the remainder year is +5.61% (+9/10)".
Forecasting has become much more difficult than in the past due to the exceptional nature of events in recent years, ranging from the pandemic to extraordinary fiscal and monetary measures. Caution is still warranted, and a lightening of positions might be appropriate for those who are overexposed to equities, if the stock market rebounds handsomely.

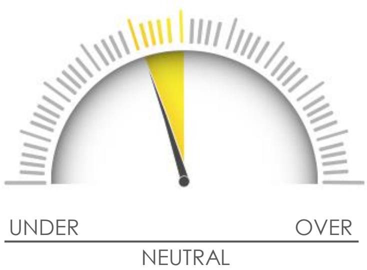
Asset Allocation View



− UNDER = NEUTRAL + OVER

Equity

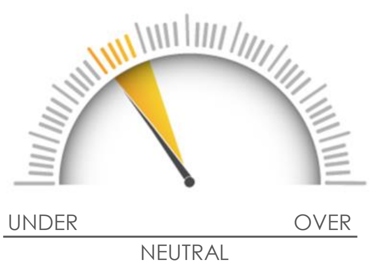
Developed Markets



We have become **Slightly Underweight** on Developed Markets Equities. Financial markets were hammered down by the combined effect of increasingly restrictive central banks, cryptocurrency troubles, and the growing fears of an economic slowdown, as extensively elaborated in the introduction. Following such extended declines, we think a short-term rebound is possible, prompting the need to tactically reduce the underweight recommendation in order to take advantage of any rally to reduce equity exposure even further. In terms of geography, the Committee became more negative on Europe.

US	=	**Europe**	−	**Japan**	=

Emerging Markets



We kept our **Underweight** recommendation on Emerging Markets Equities. Hawkish central banks, increases in nominal rates in developed countries and geopolitical tensions warrant a cautious stance on Emerging Markets. We remain wary of China among emerging markets, not just because the zero-Covid policy appears too aggressive given the scope of the contagion, but also because the monetary and fiscal actions announced thus far are not yet considered large enough to be truly effective.

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

Fixed Income

Developed Markets Sovereign

We maintained our **Slightly Overweight** view on Developed Markets Sovereign Bonds. Interest rates have risen significantly in recent weeks around the world, reaching levels from which a short-term retracement is possible, so we are still temporarily positive. However, we expect the yield curve to continue to rise in the medium to long term as a result of runaway inflation and increasingly hawkish central banks. We continue to favor short-term government bonds as a safe haven, because they offer limited downside. We are turning negative on European core bonds in terms of yield curves.

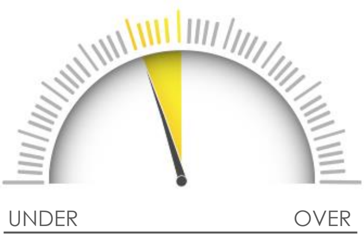
EU Core **EU Periphery** **US Treasury** **Japanese JGB**

Developed Markets Corporate

We maintained our recommendation on Developed Markets Corporates as **Slightly Overweight**. The decision to keep the recommendation is primarily motivated by the fact that spreads have not yet reached sufficiently appealing levels in light of the numerous concerns we are currently confronted with (potential economic slowdown, hawkish central banks, and geopolitical risks). We prefer short-dated, high-grade corporate bonds within corporates because they are less vulnerable to duration and/or spread risks. We remain cautious on high yield bonds.

IG Europe **IG US** **HY Europe** **HY US**

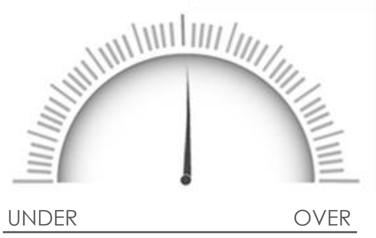
Emerging Markets



We maintained our **Slightly Underweight** recommendation on Emerging Market bonds. Despite spreads reaching high levels, it is reasonable to expect developing market bonds to remain under stress as long as Western central banks continue to release progressively hawkish statements.

Local Currency **Hard Currency IG** **Hard Currency HY**

Commodities



We maintained our Neutral view on Commodities. Given the central bank's willingness to fight inflation and China's continued lockdowns, the risks of a second-half slowdown have been brewing. We continue to prefer precious metals over commodities, owing to their safe haven status in light of the current events in Ukraine. We have a relatively constructive view on agricultural commodities, which we believe can remain strong in the face of supply disruptions. We remain cautious about the other commodities.

Precious **Energy** **Industrial** **Agricultural**

Currencies

The Committee confirmed its **neutral view on the US dollar**. After strong outperformance against the major currencies, supported by widening rate differentials and growing concerns in the rest of the world, it is increasingly likely that the US dollar could experience a short term retracement.

The view on the **Euro is neutral** as well. In addition to a physiological rebound against the dollar after the steep decline of the past three months, the Euro could benefit from a possible acceleration of European inflation. In such a case, the market would be forced to price in bolder actions by the ECB, thereby reducing the rate differential with the dollar.

The view on the **Chinese Renminbi** has been tactically upgraded to **neutral**. Chinese monetary authorities have recently implemented some measures to support the markets, and they may remain on hold for some time. As a result, the Renminbi may stabilize in the short term.

We maintain our Neutral recommendation for other emerging market currencies.

Euro	=	USD	=	CNY	=	Other EM	=