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

Main Events

UK CPI

The consumer price index (CPI) and retail price index (RPI) are expected to reach 9.1% and 11.4%, respectively

22.06

MICH 5-10 YEAR INFLATION

The Federal Reserve will be forced to continue with its outsized rate hikes if inflation expectations rise

24.06

US PERSONAL SPENDING

Did American consumers keep on spending, despite the loss of purchasing power from inflation and declines in financial assets?

30.06

EUROZONE CPI

Eurozone inflation may not peak until late summer, increasing pressure on the ECB to make bolder moves on rates

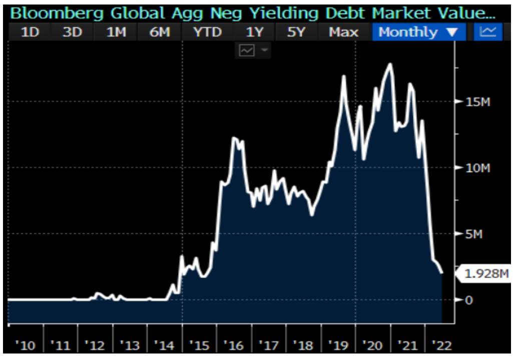
01.07

THE WORLD WE KNEW

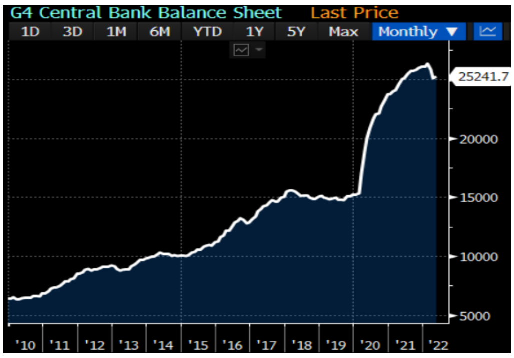
- **Negative interest rates and QE have led to a general increase in average valuations among all asset classes**
- **These overvaluations are being unwinded as a result of corrections that started at the beginning of the year**
- **Notwithstanding the above, the risk of further corrections is still possible**

The era of zero or sub-zero rates is finally coming to an end after nearly a decade of implementation. The official announcement by the ECB that rates in September will be at or above zero, as well as the SNB's surprise move to raise Swiss official rates by 50 basis points (from -75bps to -25bps), has caused the stock of negative-yielding debt to contract from a peak of $ 18 trillion to less than $ 2 trillion, with the bulk of the reduction occurring since the beginning of the year.

Although the ECB, SNB, BoJ and a few other central banks have not lowered rates further below zero in recent years, the negative-yielding debt has continued to rise undeterred from 2014 until 2021. This is due to the impact of QEs implemented recently by most central banks.



Source: Bloomberg



Source: Bloomberg

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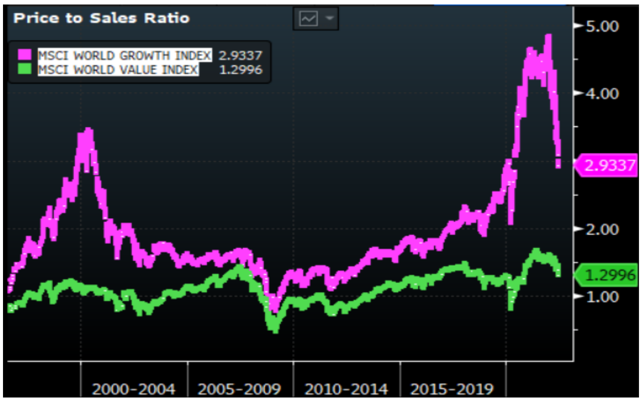
These bonds with unattractive returns have been held primarily by central banks and financial institutions as part of their regulatory capital. However, the inability to get decent returns from the safest assets has led investors to increasingly invest into assets with higher risk and/or worse liquidity so as to maintain an acceptable level of portfolio return. Cornered by zero or negative returns and increasingly large liquidity injections (QE) that compressed expected returns, investors were forced to rotate their portfolios toward more speculative asset classes. In this way, even though central banks were (normally) buying only bonds, they were able to drive a huge compression of expected returns (i.e., higher valuation) across all asset classes. TINA (there is no alternative) is the acronym coined to describe this dynamic.

Investors who embraced TINA during the years of subzero rates and QE by increasing portfolio risk were handsomely rewarded by ever higher prices in any asset class (equities, fixed income, real estate, cryptocurrencies, commodities, ...). Investors who were more cautious or more reluctant to increase portfolio risk, eventually capitulated because of the fear of missing out ("FOMO," the other acronym that along with TINA has determined investment decisions in recent years). These dynamics have become parabolic in the last two years, owing to disproportionately larger stimulus than in the past as a result of extraordinary fiscal and monetary measures enacted in reaction to the pandemic. Demographic factors have also contributed to such developments taking hold.

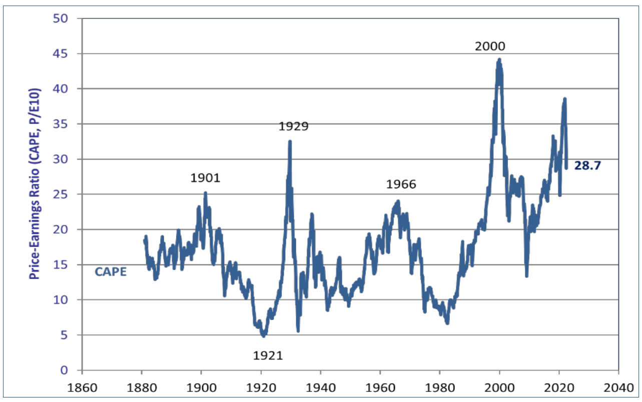
The 2008-2009 bear market was not driven by unsustainable valuations, but by a collapse in the value of a portion of the banks' balance sheet assets, which they sought to sell, creating a vicious circle that resulted in the failures of Bear Stearns and Lehman Brothers, as well as a credit crunch that brought economies to a halt.

The last bubble with characteristics similar to the recent one (overvaluation) happened in 2000. We see in the below graphs that the valuations touched in the past months are not dissimilar to those reached 20 years ago. Twenty years after that crash, there are relatively few investors who have experienced it and are still on the market, while there is a large majority of people who have entered the financial markets in the last two decades and have known nothing but central banks always ready to support the markets at the slightest setback (the famous "Fed Put" discussed in the April 11 report). Hardly any investors who have started in the last two decades, much less retail investors, have any idea how thinking that valuations do not matter can be a fatal mistake. As John Hussman very effectively reports (source: www.hussmanfunds.com/, emphasis ours):

"Among the 15 largest stocks in the Nasdaq 100 index at the 2000 peak, only four of them remain in the index: Microsoft, Cisco, Intel, and Qualcomm. The others either became defunct or were bought out after they collapsed. Of these four survivors, each of them had lost between 60% and 88% by the October 2002 market low. By March 2009, all were still down between 52% and 83% on a total return basis. It took until October 2015 for Microsoft to finally outperform Treasury bills from its March 2000 peak. It took until April 2019 for Qualcomm to do so. The others are still behind T-bills. ***All of these were great companies, but for over 15 years, they were extremely disappointing investments, because investors imagined that their growth made their valuations irrelevant****."*



Source: Bloomberg



Source: Robert J. Shiller (www.econ.yale.edu/~shiller/data.htm)

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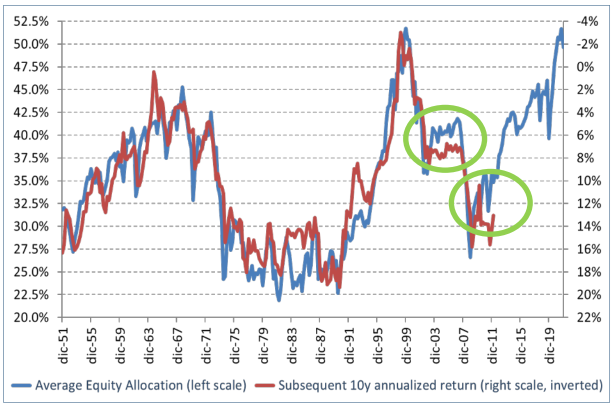
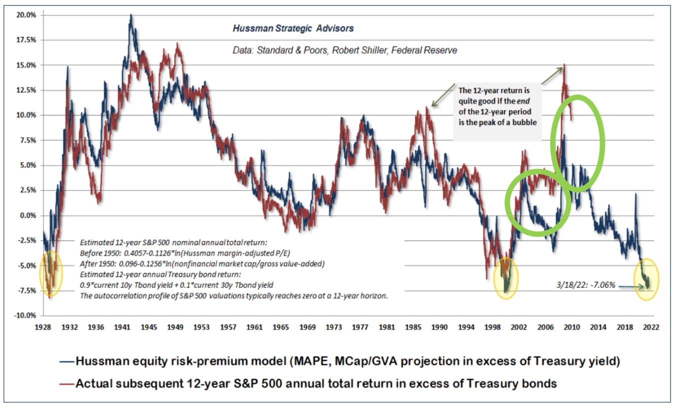
So, what about the current market situation? Using two predictive models of future returns that have consistently demonstrated very high predictive capability in the past, we can estimate the amount of overvaluation relative to fundamentals created by TINA and FOMO. Not surprisingly, the predictive capability of these models has declined over the past 20 years, coinciding with the implementation of unconventional monetary policies that were not guided by objective macroeconomic variables (first keeping US interest rate close to zero for several years after 2000, then the multiple QEs and zero or below zero interest rate policies implemented after 2008).

The first of these models (graph on the left) relates the average equity exposure of US investors (left scale) to the total return of the S&P500 over the subsequent ten years (right scale, inverted). The basic concepts is that in order for bull markets to continue to extend, more people and money must be drawn into the market. Performances and inflows drive the average equity allocation up until there are no more investors willing to put fresh money into the stock markets. The trend then reverses, and a bear market ensues until there are no new marginal sellers.

The second model (graph on the right) is a proprietary indicator on the equity risk premium constructed by John P. Hussman, which is used to predict (given the market capitalization to corporate gross-value added and the margin-adjusted P/E) the total return that the market will achieve over the next 12 years.





Source: fred.stlouisfed.org/graph/?g=qis, Bloomberg, Azimut Source: www.hussmanfunds.com

The green circles highlight the gaps between the performance predicted by the models and the performance actually achieved by the markets in the years characterized by TINA and FOMO, for which complete data are already available. These differences are typically between 2% and 5%, depending on the models and the time period under consideration. Given the high predictive capability of these models, and the fact that recent performance has been around 3.5 percent (the median point of these gaps), we can assume that market overvaluation relative to fair value corresponds precisely to this "extra return" that was not to be achieved.

Based on this, we can calculate what a fair level of the markets would be if we did not have the distortions caused by zero or subzero rates and QEs. Just take the 3.5 percent and capitalize it for 11 years (let's use the average time horizon used by the two models), and we find that markets would have to correct 31.5 percent (mathematically: (1 / 1.035^11) - 1)) from the peak to clean up the market from the overvaluation caused by central banks.

With neither contained nor transitory inflation, keeping rates at zero and doing QE was no longer politically and socially acceptable, given the dramatic loss of purchasing power for households. When the market realized in the beginning of the year that central banks were no longer free to support the market and keep spreads contained, the repricing of various asset classes began. If we look at the US, the market where the effects of TINA and FOMO were most pronounced, we see that from peak to trough the S&P500 corrected by 24 percent and the Nasdaq by 34 percent, so we can say that the bulk of the distorting effect of central banks has now passed.

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So nothing but blue skies ahead? Unfortunately, no.

Many of you may have noticed that the predictive models presented on the previous page suggested that starting from the 2021 high, U.S. markets traded at levels implying future returns of -3.5 percent (absolute) annualized, or 7 percent lower than treasury bonds (considering that treasury bonds currently yield 3.5 percent, the indications of the two models are extremely, and not surprisingly, aligned).

In the next issue of Azimut Global View report, we will discuss the factors that may lead to further downside (hint: economic slowdown + unsustainable margins).

For the time being, we will just remind how Azimut has always stood out during periods when active management has been rewarding, and one of the most favorable periods was precisely that of 2000-2003, when significant alpha was created despite falling markets. With our fingers crossed, we hope this trend continues today.

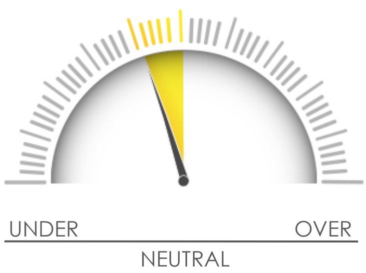
Asset Allocation View

	−	=	+
Equity			
Developed Markets	■		
Emerging Markets	Upgrade		
Fixed Income			
Developed Markets Sovereign			■
Developed Markets Corporate			■
Emerging Markets	■		
Commodities		■	
Currencies		*Commentary below*	

− UNDER = NEUTRAL + OVER

Equity

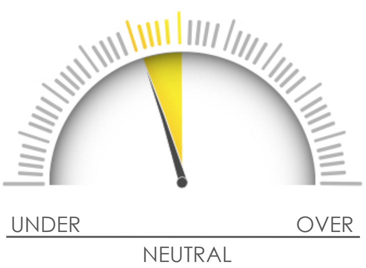
Developed Markets



We maintained our **Slightly Underweight** recommendation on Developed Markets Equities. After another leg down, and given that much of the overvaluation has been cleared from the markets following the correction that started at the beginning of the year (as elaborated in the prologue of this report), we believe a short term rebound and/or a consolidation phase could begin at any time. The medium/long-term view remains cautious, thus we continue to advise those who are overexposed to equities to scale back their exposure if a significant rebound is offered.

US	=	**Europe**	−	**Japan**	=

Emerging Markets

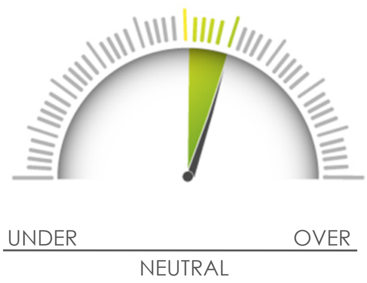


We increased our recommendation on Emerging Markets Equities to **Slightly Underweight**. During the recent correction, emerging market stocks showed signs of relative strength against developed countries for the first time in months. This could suggest that investors are beginning to focus more on extremely attractive EM valuations rather than potential problems related to Western countries' tightening monetary policies, the conflict in Ukraine, and domestic issues in some emerging countries.

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

Fixed Income

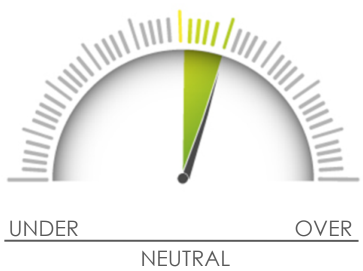
Developed Markets Sovereign



We maintained our **Slightly Overweight** view on Developed Markets Sovereign Bonds. The moderately positive outlook on the asset class is limited exclusively to the very short end of the sovereign curves (6 months to maximum 12 months) which will be used as a safe haven to park money during the period of interest rate normalization and fight against inflation. Inflation is not showing signs of slowing down, and central banks are continuing to maintain or strengthen their restrictive policies, thus the outlook for the short, medium, and long parts of the curves is still negative. In terms of regions, we are starting to prefer US bonds over European's.

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

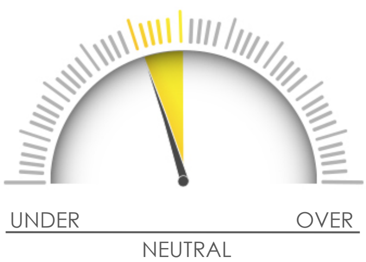
Developed Markets Corporate



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 now facing (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**

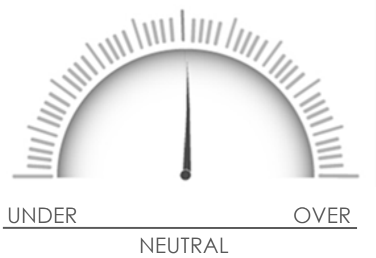
Emerging Markets



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. We are more cautious on precious metals in light of Western central banks' increasingly restrictive monetary policies. Precious metals, which generate no cash flow, are facing increasing competition from US government bonds. The possibility of a significant economic slowdown in the second half of the year suggests that energy and industrial commodities should be avoided. For the time being, the positive outlook is limited to agricultural 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 likely that the US dollar could extend the short term retracement it started few weeks ago.

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 last ECB meeting seems to have had no significant effect on the euro, considering that the possibility of bolder rate hikes was offset by Lagarde's overemphasis on fragmentation risk.

The view on the **Chinese Renminbi** is confirmed to **neutral**. Chinese monetary authorities have recently implemented some measures to support the markets, and the possibility of a reopening after the drop in covid-19 cases may lead to an extension of the rebound of the Renminbi.

We maintain our Neutral recommendation for other emerging market currencies, but with a relative preference for LATAM.

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