AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

04.07.22

Main Events

EU RETAIL SALES — 06.07
After suffering a sharp decline in April, will retail sales in Europe show signs of strength?

US PAYROLLS — 08.07
The labor market's strength will be crucial for determining the path of monetary tightening and determining how concrete the risks of an economic slowdown are

US CPI — 13.07
Headline inflation is expected to rise to 8.8%, a new 40-year high, while core inflation is expected to fall to 5.7%

CHINESE GDP — 15.07
Due to the zero Covid policy, the tech crackdown and real estate sectors, China's Q2 GDP is expected to increase only 0.8% vs a year ago

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

WISHFUL THINKING

- **Lower real disposable income and declining wealth may weaken consumption, resulting in a slowdown or outright recession, although there is no clear evidence of this risk as of yet**
- **Corporate margins, which are currently at record highs, would contract in the event of an economic slowdown, resulting in lower corporate earnings**
- **Instead, market consensus anticipates that earnings will continue to rise at the same rate as in previous quarters, exposing the market to the possibility of a rude awakening if those expectations are not met.**

In the previous report, we argued that rising inflation has forced central banks to halt monetary policies based on QE and zero or sub-zero interest rates. With rising interest rates and a lack of continuous liquidity injections (read: central bank purchases to support asset prices), the market has been forced to bring all asset classes' valuations back in line with historical averages.

In the stock market, it was a price correction ("P") that brought the P/E back to more normal levels. Now the question is whether the earnings assumptions ("E") used to calculate P/E are realistic.

There is a currently a heated debate about whether we are approaching an economic slowdown or a full-blown recession. Some, especially central banks, argue that a soft landing is possible, because the economy is strong enough to withstand higher rates. We will see in a few months whether this prediction by central banks is as reliable as the one about the transitory nature of inflation.

What we can do right now is to try to understand what drives consumption and how serious the risk of recession is. Macroeconomics teaches that consumption is derived from either income or wealth (more precisely, from the change in the level of wealth).

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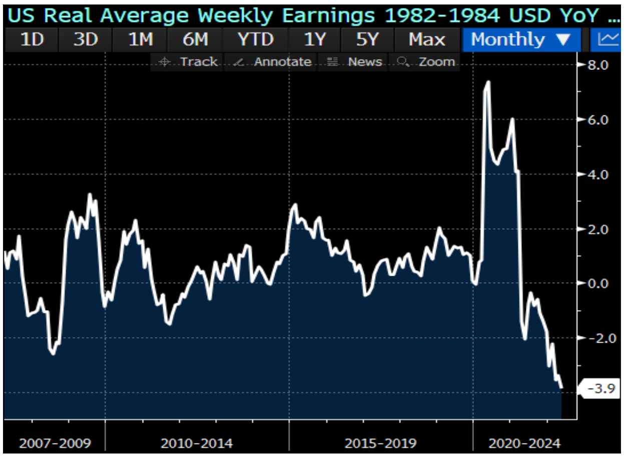
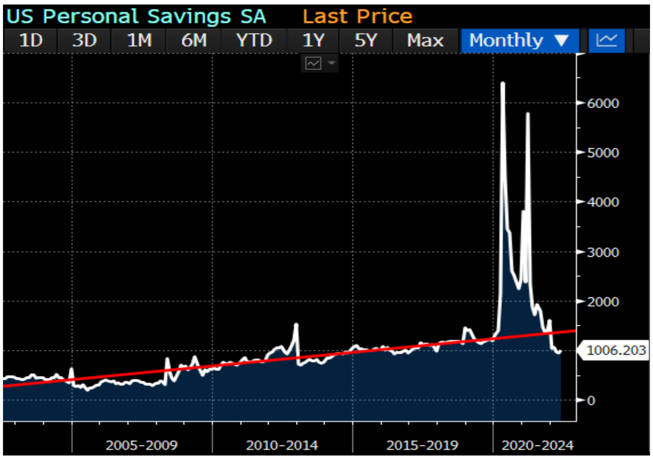


Source: Bloomberg

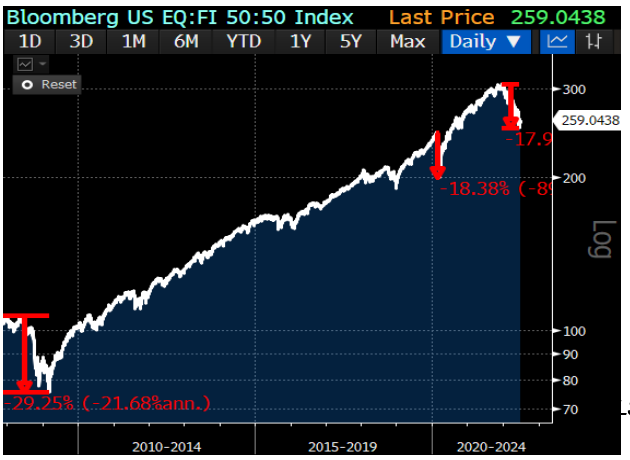


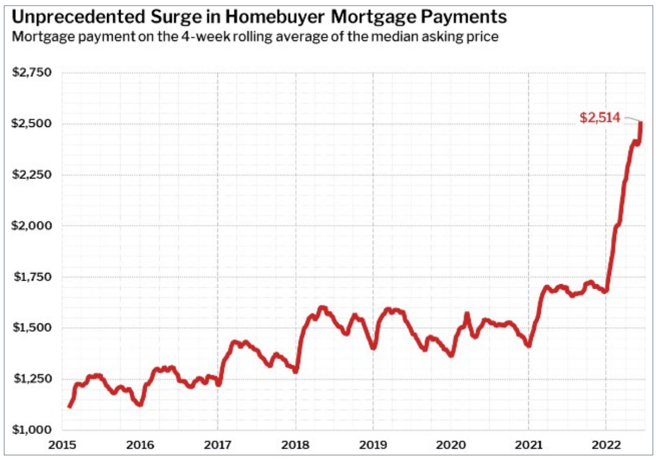
Source: Bloomberg

Wages and salaries are rising due to a tight labor market, but they cannot keep up with inflation and thus fall in real terms. Personal savings (what is saved each month) have fallen below the pre-pandemic trend, so the accumulation of new savings is small. It is also difficult to estimate how much of the savings accumulated during the period of extraordinary subsidies is still available or has already been spent.

The wealth effect on the other hand turned negative since December last year, when stocks and bonds began to correct in anticipation of more restrictive central banks. The simultaneous decline in stocks and bonds has resulted in significant losses for balanced portfolios. The decline since the beginning of the year for 50-50 strategies is two-thirds of what it was in 2008, when the equity market correction was much deeper. Retail investors have suffered even greater losses, as growth stocks and cryptocurrencies have fallen much more precipitously than the rest of the market.

The only component of personal wealth that is increasing is real estate. Year on year, the Case Shiller home price index is up 21.2 percent. While this increase is an all-time high, the real estate market is expected to slow in the coming months due to the increase in the average mortgage payment. Keeping the term and principal amount borrowed constant, the monthly payment has increased by nearly 50% since the start of the year due to higher long-term rates and wider spreads. For Americans, this increase will not have a direct impact on personal finances, as about 90 percent of mortgages are now fixed-rate. Nevertheless, the increase in the mortgage payment will make it more difficult for those who do not have one to buy a home, and this should eventually cause the housing market to cool down. So for a few more months, the real estate will continue to rise, but with the risk that it, too, may eventually slow.





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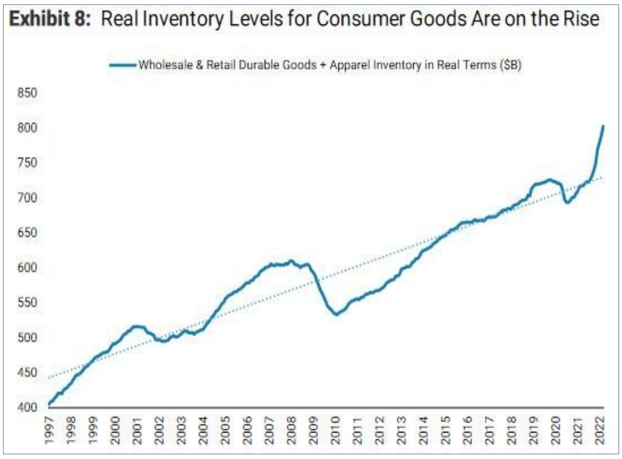
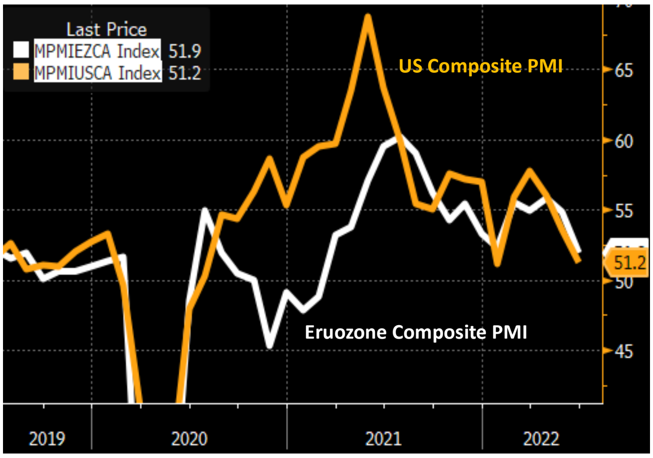


Exhibit 8: Real Inventory Levels for Consumer Goods Are on the Rise

Source: Haver Analytics, Morgan Stanley Research



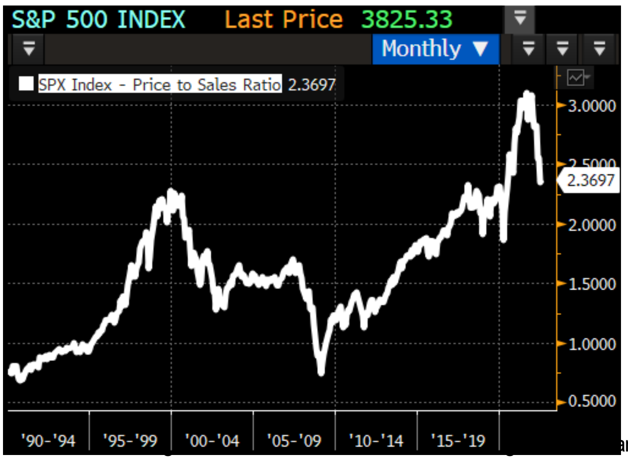
Source: Bloomberg

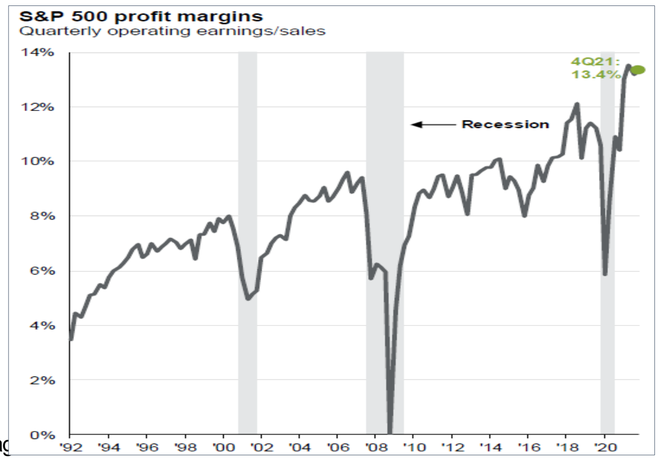
As a consequence of the above, it is questionable that consumption can remain as resilient as in the past. Although there is no clear evidence to date of a marked slowdown, let alone a recession, some signs of weakness are beginning to emerge. Inventories are rising faster than the long-term trend, and PMI indices of business confidence fell sharply in the last quarter, particularly in June, despite remaining at levels that indicate economic expansion.

Consumption, GDP and sales are closely related variables, as consumption accounts for more than two-thirds of GDP, and turnover is the other side of the consumption. If we look at the price to sales ratio (P/S), we have an idea of how expensive the market is per dollar of turnover. The higher the P/S, the higher the corporate margins must be in order for the P/E to remain at reasonable levels.

As a result of this year's correction, P/S fell from a record high above 3 down to 2000 levels. Despite the correction, however, P/S remains at historically high levels. If P/E has returned to its average long-term level, despite a high P/S, it is only because operating margins are also at all-time highs.

We all know that costs are not as elastic as revenues. In previous quarters, government handouts caused an artificial and unsustainable increase in consumption. Revenues increased more than costs because of the strong stimulus-driven consumption, allowing for unprecedented margins. However, if consumption begins to stagnate or contract, margins will begin to suffer. Margins contract in every recession for the same reason: costs are less elastic than revenues. Even if the central banks' anticipated soft landing materializes, it is reasonable to expect that margins could return toward 10-11 percent (and they would still be at levels never seen before 2018). The downside would be more pronounced in the event of a more severe recession.





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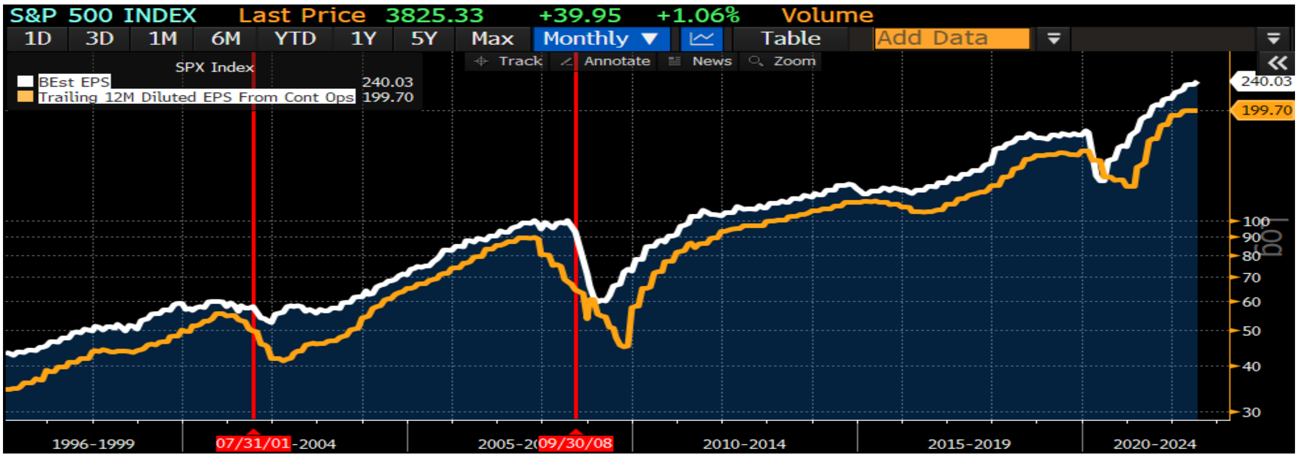


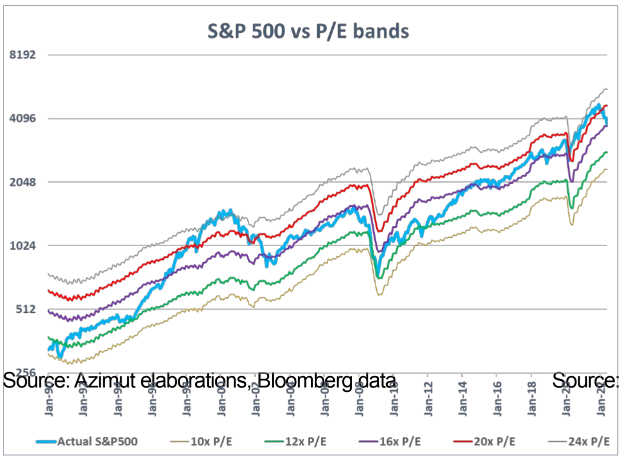
Source: Bloomberg

In the graph above, actual earnings of S&P500 companies (orange) are compared with analysts' estimated earnings for the next 12 months (white). It can be seen that in the two "normal" recessions of the past two decades (the one in 2020 is not relevant since it was not driven by normal macroeconomic dynamics) analysts either never predicted a decline in earnings (2000-2003) or only started lowering them since October 2008, when earnings had already been falling for a while and a few weeks after the Lehman Brothers bankruptcy.

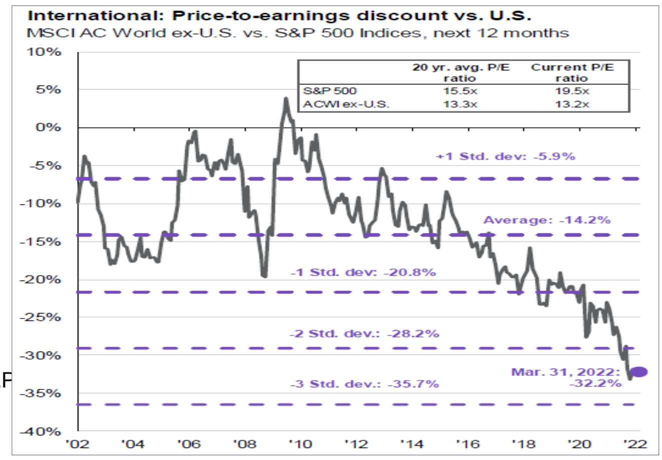
Currently, realized earnings have been flattening for some time, while analysts' estimates have been steadily rising. Consensus is that in 12 months earnings will be at $240, 20 percent higher than actual earnings. It's difficult to explain how this is possible given the current macroeconomic situation.

If history repeat itself, as it did in 2000 and 2008, earnings expectations will fall in the last months of the year. As of today, the market's P/E stands at about 16 (bottom left graph). But, if earnings ("E") were to fall materially because it became apparent that market expectations (the white line in the graph above) are unrealistic, then the market's P/E would revert to an overvalued level.

Furthermore, during downturns, not only earnings but also multiples falls. In the recessions of 1991, 2003, and 2009, P/E bottomed at 10x, 14x, and 12x earnings, respectively. If a recession occurs, we will be in a situation where margins, earnings expectations, and the P/E ratios are quite high, thus leaving the market vulnerable to further downside. The reporting season starting next week will be critical to see whether companies will confirm analysts' expectations, or begin lowering guidance.



Source: Azimut elaborations, Bloomberg data



Source: J.P

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It should be noted that what has been argued so far primarily applies to the US markets. As shown in the last chart on the previous page, the rest of the world trades at a record discount to the US, nearly 2.5 standard deviations below the average. This means that the downside seems more pronounced for the United States than for the world ex-US.

However, there are other reasons why the rest of the world trades at a discount to the US. In Europe, inflation is expected to climb further, the end of QE exposes government bonds to the risk of fragmentation, there is an energy supply risk and a war is just at its borders. In Japan, macroeconomic data have already deteriorated significantly, and the Bank of Japan is implementing difficult-to-understand monetary policies. Emerging countries may be vulnerable either if restrictive monetary policies continue, or if the global business cycle slows down, given that many countries are major commodity exporters; nevertheless, in terms of valuations and sentiment, they are the countries with lowest valuations, which may prove advantageous.

Therefore, for the medium term we still recommend maintaining a cautious approach and a well-diversified portfolio, preferring styles and sectors more resilient to the downside. In the short term, a rebound could happen at any time, but unless there is strong evidence that economic growth and consumption remain robust, those who are overexposed should trim exposures on any meaningful rally.

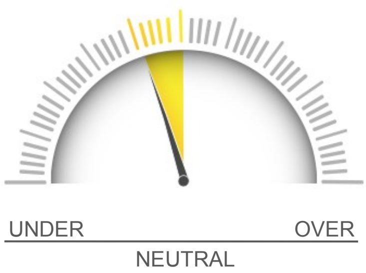
Asset Allocation View

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

– UNDER = NEUTRAL + OVER

Equity

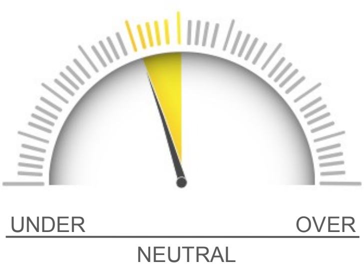
Developed Markets



We maintained our **Slightly Underweight** recommendation on Developed Markets Equities. As stated in the prologue of this report, optimism about the earnings outlook makes the market vulnerable to further downside in the medium term if these expectations end up being disappointing. The reporting season, which begins next week, will be critical in this regard. Given the oversold situation and the retracement of interest rates in the latter part of June, a short-term rebound remains possible, especially if the CPI comes in higher than expected.

US	=	**Europe**	–	**Japan**	=

Emerging Markets



We increased our recommendation on Emerging Markets Equities to **Slightly Underweight**. Emerging market stocks continue to outperform developed market stocks, owing to valuations that are significantly lower in comparison to developed markets as well as in absolute terms. However, emerging markets countries remain vulnerable if Western central banks continue to implement increasingly restrictive monetary policies in response to persistent inflation, as well as if the global economy slows.

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

Fixed Income

Developed Markets Sovereign

We decreased our recommendation on Developed Markets Sovereign Bonds to **Neutral**. The recent rate retracement of past two weeks has reabsorbed the oversold situation on government bonds. After this change, the entire curve, from the short to the long end, has returned to unappealing levels, so the positive recommendation was removed. Given the risk of an economic slowdown, an outright short position is also not considered appropriate. Only the very short segments of the curves (up to 6 months of maturity) can be used as a safe haven.

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

Developed Markets Corporate

We maintained our recommendation on Developed Markets Corporates as **Slightly Overweight.** Among corporate bonds, investment grade and particularly European hybrid bonds have reached level of spreads and YTM that are worth restarting to accumulate, even if an economic slowdown materializes. Conversely, caution is still advised on high yields, which may still have some downside in the event of a downturn in global growth.

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, as well as in case of a global economic slowdown.

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, with no ability to 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, but with a positive bias**. The dollar could benefit both should the economy remain strong and inflation sustained, as the Federal Reserve is proving to be the most aggressive central bank in tightening monetary policy, and in the event of a global economic slowdown given that the dollar tends to appreciate during increasing risk aversion and/or deleveraging.

The view on the **Euro is neutral.** After the depreciation in recent months, a rebound of the euro is possible given also the retracement of the BTP-Bund spread. Nevertheless, growing uncertainties regarding the reliability of energy supply and rising electricity prices could continue to weigh on the euro.

The view on the **Chinese Renminbi** is confirmed to **neutral.** On the one hand, the outperformance of the Chinese stock market could encourage a return of capital from abroad. On the other hand, the continued devaluation of the Japanese yen makes the yuan less competitive, which could induce Chinese authorities to avoid further strengthening of the yuan/yen exchange rate.

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

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