AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

29.08.22

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

EUROZONE CPI — 31.08
Despite soaring energy prices, the market expects an increase from 8.9% to 9.0% . The risk of an upside surprise is material

US PAYROLLS — 02.09
The U.S. labor market is expected to remain strong, showing no indications of slowing down

EU RETAIL SALES — 05.09
Will European consumers be able to maintain their consumption levels despite the loss of purchasing power due to inflation?

ECB — 08.09
Will Lagarde be able to unite the ECB board and deliver a bolder rate hike, as hinted at in Jackson Hole?

HIGHER FOR LONGER

- **The Jackson Hole meeting of central banks concluded with an unambiguous and coordinated message: interest rates will continue to rise and will remain elevated for some time**
- **The hopes for a dovish pivot by Central Banks have thus been dashed.**
- **The bear market rally that was fueled by these hopes is at risk of being reversed, as central banks reaffirmed their hawkish stance**

As the title of the previous report suggested, expectations of a dovish pivot by central banks turned out to be just a fairy tale.

The heads of the major central banks delivered two messages at Jackson Hole in a coordinated and unequivocal manner: rates still need to rise significantly from current levels to tackle inflation, and they will remain at those levels for an extended period of time. In short, higher for longer.

Powell, opening the Jackson Hole symposium, stated that "the Federal Open Market Committee's (FOMC) overarching focus right now is to bring inflation back down to our 2 percent goal", and "our responsibility to deliver price stability is unconditional" as "a failure to restore price stability would mean far greater pain".

The Fed is willing to do anything to bring down inflation, even at the cost of inducing a recession as "reducing inflation is likely to require a sustained period of below-trend growth. […] While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation".

Continuing to raise rates despite an economic slowdown or outright recession is exactly the opposite scenario of what the market has been speculating in recent weeks.

(continued)

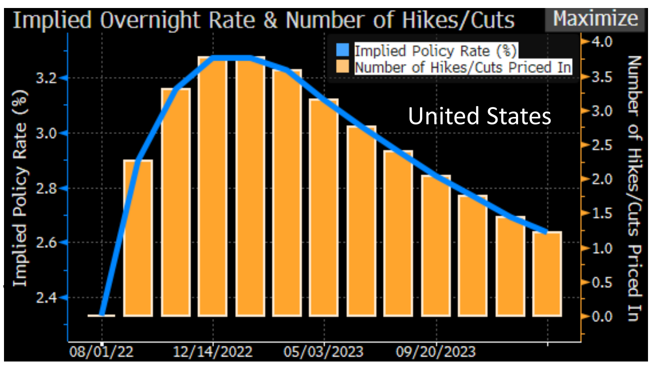
As for expectations on medium-term monetary policy decisions, Powell brushed off any hope of rate cuts as soon as the early part of 2023, saying that "restoring price stability will likely require maintaining a restrictive policy stance for some time", and he warned that "the historical record cautions strongly against prematurely loosening policy", downplaying the relevance of the first decrease of the CPI by saying that "while the lower inflation readings for July are welcome, a single month's improvement falls far short of what the Committee will need to see before we are confident that inflation is moving down".

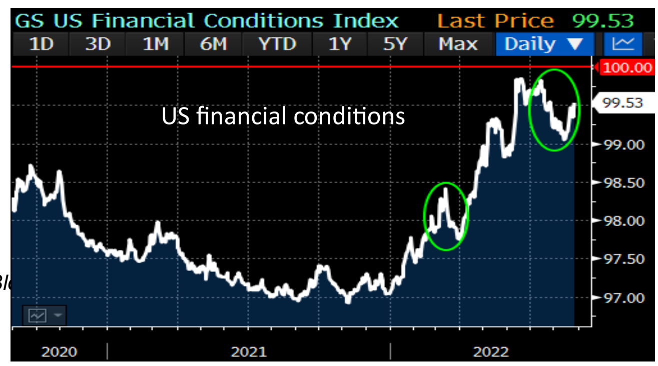
To further strengthen his message, he cited the experiences of the 1970s and 1980s and recalled the actions Volker took to defeat inflation: "our monetary policy deliberations and decisions build on what we have learned about inflation dynamics both from the high and volatile inflation of the 1970s and 1980s" and "history shows that the employment costs of bringing down inflation are likely to increase with delay, as high inflation becomes more entrenched in wage and price setting. The successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years. A lengthy period of very restrictive monetary policy was ultimately needed to stem the high inflation".

The other Fed members who spoke during the symposium all expressed guidance consistent with the Fed chairman's remarks. Atlanta Fed President Raphael Bostic, the most dovish of all, said rates should rise at least another 100-125 basis points and remain at that level for a while. Cleveland Fed President Loretta Mester cautioned that she needs "to see several more months of better inflation data to be able to even say that it's peaked," and that interest rates will have to be raised above 4 percent remaining there for some time. Minneapolis Fed President Neel Kashkari, during a discussion with International Monetary Fund First Deputy Managing Director Gita Gopinath, said the current situation "is not what we had in mind when we talked about running the economy hot. This is a raging inferno. And so, I think a raging inferno entails significant risks." The comment was referring to the Fed's willingness not to raise rates immediately after the reopening, and to let the economy run unrestrained for some time.

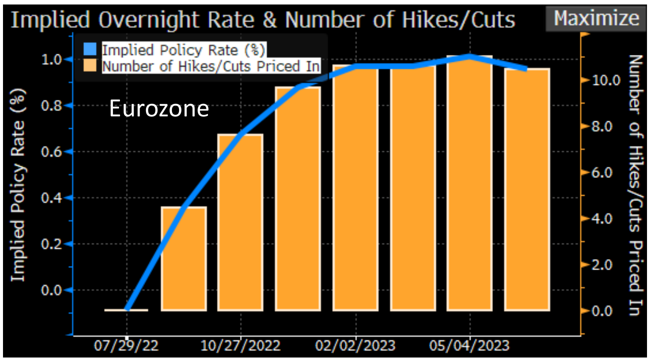
Such an aggressive stance by the Fed is likely due to how the market has reacted in recent weeks. As eloborated in the previous report, after the last ECB and Fed meetings, the financial markets have been willing to believe that the central banks were close to a pivot, meaning that they were almost about to end raising rates and start cutting them soon after. In early August (bottom left chart), the market was assuming that official rates would rise to a maximum of 3.25 percent by December, and then be cut gradually through 2023 to 2.6 percent. The decline in interest rates has thus been a tailwind for stock markets, and in particular the U.S. indices and the Nasdaq. The combined rise in stocks and bonds thus caused a considerable easing of financial conditions, exactly the opposite of Fed's intended goal.

A similar situation had already occurred in March and, then as now, it was necessary for several Fed members to begin openly warning the market that the U.S. central bank would have to inflict heavy losses on the markets in order to achieve its goal of tightening financial conditions (see the April 11 "Don't fight the central banks" report). And that was exactly what happened immediately after.

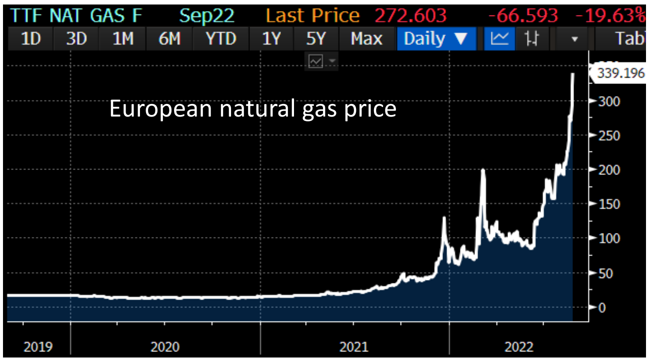




(continued)



Source: Bloomberg, data as of July 31st, 2022



Source: Bloomberg

After such strong commitments, it is likely to expect the Fed to raise rates by 75 basis points again at its next meeting in September in order not to lose its credibility. Arguably, in the absence of such a strong market rally, a 50 basis point increase would have been more plausible.

As for the ECB, the first thing to note is that the delegation selected to attend the Jackson Hole meeting was composed exclusively of moderately or resolutely hawkish members. This could be a sign that within the ECB those who would like more austerity in monetary policy amid record inflation are succeeding in having a greater say. If so, the rate hike in Europe could be faster and more extended.

European Central Bank Executive Board member Isabel Schnabel said that "both the likelihood and the cost of current high inflation becoming entrenched in expectations are uncomfortably high" and that "in this environment, central banks need to act forcefully". Joachim Nagel, the head of the German Bundesbank, added that "the story is pretty clear. Inflation is much too high. And so the answer in a situation like this is also obvious. This is what central banks have to do in a situation like that. We have to raise rates ". Governing Council member Francois Villeroy de Galhau stressed how the risk of inaction is that of being forced to act more brutally later on, warning that "we can be gradual, but we should not be slow and delay normalization until higher inflation expectations force us into aggressive interest-rate hikes ". Olli Rehn, another ECB Governing Council member, anticipated that "the next step will be a significant move in September, depending on the incoming data and the inflation outlook". An unspecified ECB member would have even argued that it would soon be time to discuss when to start QT in Europe.

Although not identical because the rate hike cycle is at different stages, the ECB's message was consistent with that of the Fed. The ECB has also made it clear that monetary policy will have to become much tighter, forcing market participants to revise their expectations. As of July 31, the market was still discounting that European interest rates would never exceed 1 percent, and this despite an 11-fold increase in electricity prices year-on-year, and a 4-fold increase since early June.

In light of the messages conveyed by central banks in Jackson Hole, investors should carefully analyze the composition of their portfolios. In fact, the recent rebound in equity markets and the fall in interest rates was driven by the expectation of a dovish pivot by central banks and a cycle of rate cuts starting immediately after the end of the rate hikes. Now that those expectations have been strongly denied, it is possible to assist to a full retracement of the entire bear market rally. After all, any bear market rally is always founded on unrealistic expectations.

Worse yet, given that it is now clear that rate hikes will continue even in the event of a recession, and that the likelihood of a recession is significantly increased if the announced monetary policies are implemented, financial markets may reach lower lows. Better to be prepared for a potentially turbulent autumn.

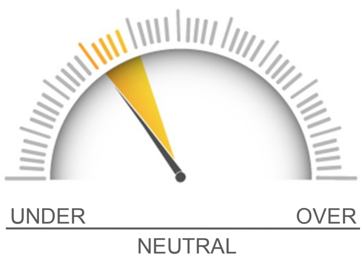
Asset Allocation View

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

− UNDER = NEUTRAL + OVER

Equity

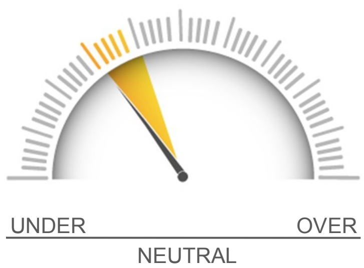
Developed Markets



We reduced our recommendation for Developed Markets Equities by two notches to Underweight. In our previous commentary in early August, we advised those who were overexposed to equities to take advantage of the bear market rally to reduce exposure in case of further strength, fearful that central banks' dovish pivot would not materialize. As expressed in the prologue, this is exactly what happened, with the market rising until mid-August and then accelerating lower on evidence that central banks will maintain their hawkish stance. The risk is that the bear market rally will be reversed in part, hence the underweight recommendation.

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

Emerging Markets



We further reduced our recommendation on Emerging Markets Equities to **Underweight**. Although the valuations of emerging countries are definitely at a discount to those of developed countries, the adoption by Western central banks of a markedly restrictive monetary policy is expected to lead to an increase in risk aversion with a consequent reduction in exposures to risk asset classes. Therefore, and although emerging markets ex-China have performed in line with developed countries in the past months, a more cautious approach is advised for the months ahead.

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

Fixed Income

Developed Markets Sovereign

UNDER OVER
NEUTRAL

We reduced our recommendation for Developed Markets Sovereign Bonds by one notch to Slightly Underweight. On the one hand, we continue to see the very short end of the curves (maturity up to 6 months) as the safest place to park savings. On the other hand, the clearly hawkish messages conveyed by the major central banks at Jackson Hole suggest that the curves from the short end (2 years) to the long end (30 years) are vulnerable to revisiting and even exceeding recent highs in rates. European bonds are regarded as the most vulnerable, particularly the Italian BTP also for political reasons.

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

Developed Markets Corporate

UNDER OVER
NEUTRAL

We maintained our recommendation on Developed Markets Corporates as **Slightly Overweight.** Among corporate bonds, investment grade and particularly European hybrid bonds continue to offer the best opportunities, even if an economic slowdown occurs and/or central banks implement more restrictive monetary policies. In contrast, caution is still advised on high yields, which may still have some downside in the event of a global growth slowdown.

IG Europe	=	**IG US**	=	**HY Europe**	–	**HY US**	–

Emerging Markets

UNDER OVER
NEUTRAL

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 raise rates, as well as in the event of a global economic slowdown.

Local Currency	=	**Hard Currency IG**	–	**Hard Currency HY**	–

Commodities

UNDER OVER
NEUTRAL

We maintained our **Neutral view** on Commodities. With no ability to generate cash flow, precious metals face increasing competition from government bonds, especially as official interest rates rise. We are becoming bullish on oil, owing to the end of the Strategic Petroleum Reserve release in October and rising European energy prices, which make it economically viable to generate electricity from oil.

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

Currencies

The Committee confirmed its **Neutral View, but with a bullish bias, on the US dollar**. The dollar should continue to remain strong as the Federal Reserve has shown the most resolve in implementing more restrictive fiscal policies among the central banks represented in Jackson Hole, and as the greenback tends to strengthen during periods of increased risk aversion.

The view on the **Euro is Neutral**. On the one hand the energy crisis should continue to weigh on the currency, on the other hand the possibility that the ECB will surprise with bolder action at its next meeting following the ECB governors' remarks in Jackson Hole may spur a rebound in the Euro.

The view on the **Chinese Renminbi** is confirmed to **Neutral, but with a bearish bias**. The unpredictability of government decisions, the never-ending slump in the real estate sector, and China's dubious stance regarding the conflict in Ukraine are weighing on investors' willingness to invest in Mainland China.

Similarly, on **other emerging market currencies** we maintain a **Neutral** stance, **but with a bearish bias** in view of more stringent monetary policies by Western central banks, and the possibility of a more pronounced economic slowdown.

Euro	=	USD	=	CNY	=	Other EM	=