AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

12.09.22

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

US CPI — 13.09
Falling commodity prices should allow headline inflation to decrease, but core inflation is expected to rise further

CHINESE DATA — 16.09
After a recent slowdown, industrial production and retail sales are expected to recover

FED MEETING — 21.09
After the Jackson Hole statements, will the Fed deliver an interest rate hike consistent with the expectations created?

GLOBAL PMI — 23.09
S&P Global releases confidence indexes for the majority of developed countries. Will any of them be able to get back above the 50 threshold?

TAKING A BREATHER

- **Volatility in the main asset classes overshadowed the exceptional movements that occurred in the world's major currencies**
- **The Dollar has risen sharply against all major currencies, thanks to the Fed's responsiveness and determination in implementing tighter monetary policies**
- **After such large gains, the US Dollar may retrace, and could spur a rebound in non-US markets and more volatile asset classes**

If you ask investors what financial dynamics characterized 2022 the most, many will probably say the evolution of interest rates, commodity volatility, the joint decline of equities and bonds that made mixed asset funds unbalanced, or the stock market correction, particularly in growth stocks. Few, if any, would respond to the extraordinary dynamics affecting the world's major currencies.

It is undeniable that the movements in asset classes other than currencies have been of extraordinary magnitude. However, the visibility given to interest rates as a result of runaway inflation and loud central bank pronouncements, as well as that given to commodities as a result of the Ukraine war, has overshadowed the magnitude of currency movements and their impact on portfolio returns.

In theory, the long run exchange rate between two currencies is influenced by the evolution of inflation rate differential between the two countries: the nation with the higher inflation is likely to see its currency depreciate relative to the other since exchange rates should ensure (always in the long run) the parity of purchasing power of the two currencies.

However, in the short to medium run, exchange rates are more sensitive to the difference in short-term interest rates and the amount of monetary base injected into the system: the country with the higher short-term rates and the one with less monetary base should see its currency strengthen.

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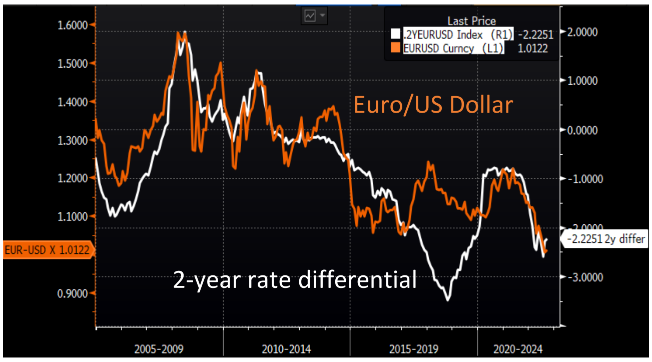
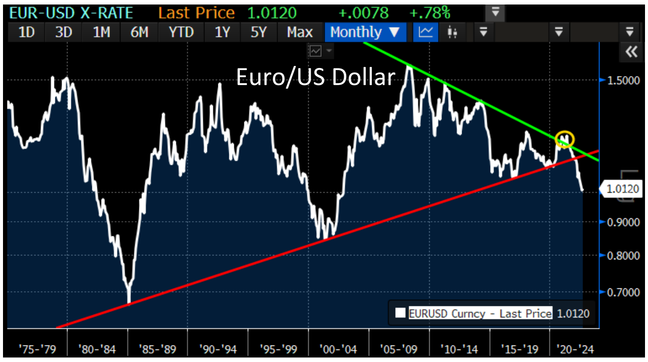


Source: Bloomberg



Source: Bloomberg

Due to very similar inflation levels between the two blocks, the rate differential has been the main driver of the Euro/Dollar exchange rate's evolution. Using the two-year rate differential as a guide, we can see that we are in substantial equilibrium at current levels, and the recent weakness of the Euro can be fully explained by the Federal Reserve's more rapid rate hikes compared to the ECB.

In the long run, we see that the Dollar is appreciating fast against the Euro, for two reasons. The first is that the ECB has increased its balance sheet (monetary base) to 70% of EU GDP through QE and PEPP. Despite significantly expanding its balance sheet, the Fed has not exceeded 38% of US GDP.

The second reason is purely technical. After failing to break the downward trendline (green) to the upside (yellow circle), the Euro quickly retraced and broke the long-term upward trendline (red). After the break of such an important long term trendline, a sharp acceleration was to be expected. The Euro/Dollar exchange rate has been reconstructed in the top left chart by extending the Euro exchange rate with the Dollar/German mark exchange rate.

The third reason is "mechanical" and applies not only to the Euro/Dollar exchange rate, but to all the exchange rates of the various currencies with the Dollar: during periods of increasing volatility and/or risk aversion, the greenback tends to strengthen. World financial market thinks in Dollar terms, so when volatility arises, margin calls are typically asked in Dollars, leading to an increase in demand for Dollars. Likewise, when market participants deleverage, they typically sell more volatile assets (often denominated in currencies other than the Dollar) and convert everything back into Dollars. As mentioned at the beginning of the paragraph, these are mechanical trends that do not necessarily impact the fundamentals. As an example, when the problems were centered in the U.S. in 2008 (subprime first, Bearn Stern and Lehman Brothers later), the Dollar had strengthened from almost 1.60 against the Euro to below 1.30, corresponding to an increase of about +20%.

The worst performing currency this year, however, has been the Yen, which has depreciated by nearly 25% against the Dollar since the beginning of the year. The main reason for this devaluation is the disparity between the Bank of Japan's monetary policies and the rest of the developed world.

Throughout the year, the Japanese Central Bank has reiterated that it does not intend to intervene in response to an increase in inflation, which, by the way, has remained very low (around 2%). Rather, the Bank of Japan has stated its intention to buy an unlimited amount of Japanese bonds in order to keep the yield curve under control throughout the first half of the year. The widening interest rate differential between Japan and the rest of the world, as well as an expansion of its balance sheet to more than 130% of GDP, contributed to the sharp decline in the exchange rate.

As if this were not enough, in line with what we have already seen for the Euro, the yen has exceeded two very long-term bearish trendlines, the breaking of which has fostered an acceleration of the Yen's devaluation.

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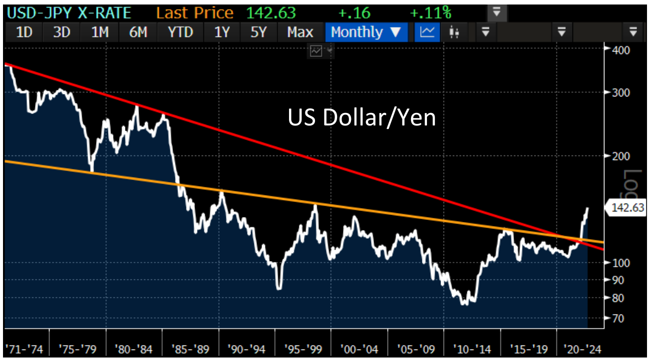


Source: Bloomberg

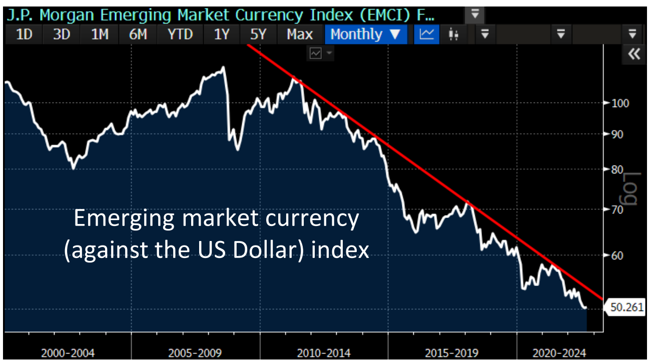
Source: Bloomberg

Turning to the Chinese Yuan, we can see that it, too, has been weakening against the dollar this year. The reason is, once again, diverging monetary policies. After remaining restrictive in the post-Covid period while the rest of the world implemented record monetary stimulus (which led to Yuan strengthening against all major currencies, including the dollar last year), Chinese monetary policy became more accommodative this year as Western central banks became more restrictive.

As a result, the Yuan has given back all of its gains made against the US Dollar, and is now approaching ominously the downward trendline starting in 2005. While the graphs for all other currencies have always shown the post-1971 period (since on August 15 of that year Nixon declared the end of the "Dollar standard" i.e., the possibility of converting the Dollar into gold), for China the period preceding the 1990s is considered not so meaningful. Prior to joining the WTO, China was a poor emerging country that played a minor role in the global economy and financial markets. Since late 1990s and even more since joining the WTO in 2001, its importance has grown exponentially to become the powerhouse it is today. Thus, the track record of the Yuan that is considered relevant is that since 2005, when modern China gradually allowed its currency to float freely, abandoning the peg with the Dollar.

But the Yuan exchange rate also seems to be impacted by the evolution of the Yen. In the 2012-2015 period, in the wake of Abe's economic policies (Abenomics), the Yen had depreciated dramatically against the Dollar (chart above left), but also against the Yuan (chart below left). This resulted in a loss of competitiveness against Japan, which China did not want because, at the time, China was no longer competing with other low-value-added emerging countries, but with high-value-added and technologically advanced nations like Japan.

It can be clearly seen that once the threshold of 20 Yen for a yuan was reached, China let the yuan weaken. Between 2015 and 2019, the Yuan was devalued to bring the exchange rate with the Yen back to more acceptable levels. As a consequence, the Yuan weakened as well against the USD during the same period. Today, the Yuan/Yen exchange rate is rising back above 20, indicating that China is following the same strategy as in 2015-2019 in order to maintain competitive advantages, allowing the Yuan to devalue against the Yen and the US dollar.



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We conclude with a quick overview of emerging currencies (chart on previous page), courtesy of the JPM Emerging Market Currency Index. It is clear that the last 10 years have been a lost decade for emerging currencies, which have suffered from an increasingly pronounced slowdown in global growth with negative repercussions on commodity prices, growing domestic instabilities and external geopolitical tensions, and structurally higher inflation rates than in developed countries.

Based on the above, the strengthening of the US Dollar against all major currencies this year is considerable. This acceleration can be explained, as elaborated in the beginning of this prologue, both by the Fed's increased resolve in raising rates and implementing QT, and by the fact that in times of increasing risk aversion, the Dollar continues to be seen as a safe haven.

Although in the medium-term these factors could still be supportive of the Dollar, in the short term a retracement of the greenback against all major currencies looks possible given the extent and linearity of the movement in recent months. The ECB's more hawkish stance, which could propel the Euro higher, could be a catalyst for a reversal.

If the US Dollar weakens significantly, ex-US markets and risky assets in general could enjoy a nice run for a while.

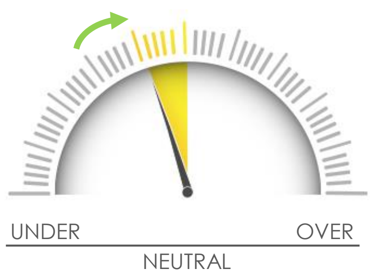
Asset Allocation View

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

− UNDER = NEUTRAL + OVER

Equity

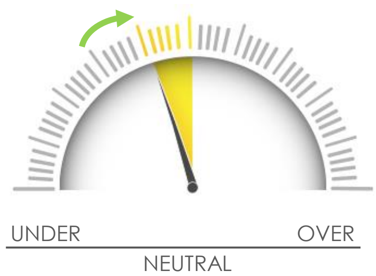
Developed Markets



We **upgraded** our recommendation on Developed Markets Equities by one notch to **Slightly Underweight**. Macroeconomic data continue to remain strong, reducing the likelihood of a near-terms slowdown. In addition, market sentiment remains decidedly bearish, an indication that should be read in a contrarian perspective. Europe and Japan among the major markets are preferred, not only because of their significantly lower valuations, but also because of the possibility of a rebound in their respective currencies against the Dollar, as mentioned in the prologue. The portfolio management team continues to advise caution in the medium to long term.

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

Emerging Markets

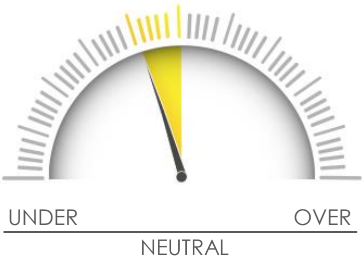


We **upgraded** our recommendation on Emerging Markets Equities to **Slightly Underweight.** On the one hand, the hawkish stance by Western central banks as well as domestic and geopolitical tensions continue to represent a drag for emerging markets. On the other hand, valuations significantly lower than developed countries and the possibility of a weakening of the Dollar could prompt a temporary rebound in emerging markets.

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

Fixed Income

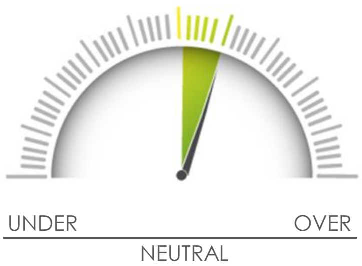
Developed Markets Sovereign



We maintained our Slightly Underweight rating on Developed Markets Sovereign Bonds. On the one hand, we continue to regard the very short end of the curve (maturity up to 6 months) as the most secure place to park savings. The clearly hawkish messages conveyed by the major central banks at Jackson Hole, on the other hand, 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. Because of the upcoming elections, European bonds are regarded as the most vulnerable, particularly the Italian BTP.

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

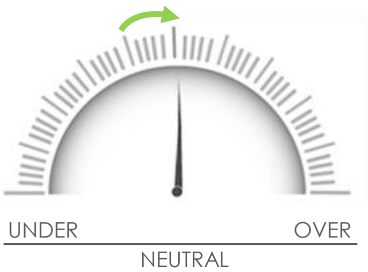
Developed Markets Corporate



We maintained our recommendation on Developed Markets Corporates as **Slightly Overweight**. Among corporate bonds, investment grade and particularly European hybrid bonds 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	−

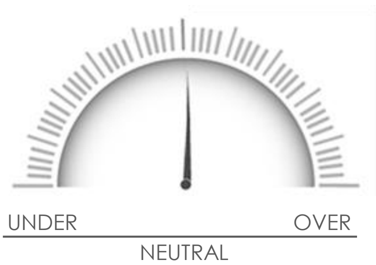
Emerging Markets



We **increased** our recommendation on Emerging Market bonds to **Neutral**. Although developing market bonds may remain under pressure as long as Western central banks continue to raise interest rates or in the event of a global economic slowdown, a short-term retracement of the US Dollar, combined with generous spreads, could lead to a rebound in emerging market bonds. We prefer local currency bonds because they are the best strategy for capitalizing on the anticipated rebound in emerging market currencies against the US dollar. Because of their sensitivity to interest rate movements, hard currency bonds may continue to be under pressure.

Local Currency	+	Hard Currency IG	−	Hard Currency HY	−

Commodities



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 shifting to a bearish bias** (from a bullish bias)**, on the US Dollar**. The ECB's switch to a much more aggressive stance challenged the expectation of a further widening of the EU-US rate differential. This could trigger a short-term repositioning of market participants that could lead to a temporary weakening of the Dollar against major currencies.

The view on the **Euro is Neutral, but with a bullish bias**. In addition to the reasons outlined above with reference to the Dollar, Ukraine's military breakthrough against the Russians could provide further support for the single currency.

The view on the **Chinese Renminbi** is confirmed to **Neutral, with a bearish bias**. The unpredictability of government decisions, the never-ending slump in the real estate sector, the provocative stance of the U.S. on Taiwan status and the rapid depreciation of the Yen that is eroding Chinese competitiveness should continue to weigh on the Renminbi.

On the **other emerging market currencies,** we maintain a **Neutral** stance, **but with a bullish bias** in view of a possible retracement of the US Dollar, which may prompt a rebound in EM currencies.

Euro	=	USD	=	CNY	=	Other EM	=