AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

26.09.22

Main Events

Azimut Global Network

- Milan
- Abu Dhabi
- Austin
- Cairo
- Dubai
- Dublin
- Hong Kong
- Estoril
- Istanbul
- Lugano
- Luxembourg
- Mexico City
- Miami
- Monaco
- New York
- Santiago
- São Paulo
- Shanghai
- Singapore
- Sydney
- Taipei

27.09 – US HOME PRICES
Rising mortgage rates are causing home sales to tumble. As a result, there is a growing risk that real estate prices will slow down and eventually decline

30.09 – EUROZONE CPI
Due to the soaring energy prices, European inflation may reach 10%

04.10 – TOKYO CPI
Could a further acceleration of inflation in Japan cause the BoJ to revise its monetary policy stance?

07.10 – US PAYROLLS
A strong reading may lead to further spikes in rates, as the Fed's goal now is to orchestrate an economic slowdown and a softening of the labor market

NOT THERE YET

- **The Federal Reserve made it clear once again that it will continue to raise rates, and a recession is necessary to stop inflation**
- **Markets have reacted to higher rates and the growing risk of recession with widespread corrections, but the move may not be over yet**
- **The extreme volatility experienced by UK assets after the Truss government's budget announcement may cause additional stress on markets and could lead to margin calls and forced deleveraging**

After the stronger-than-expected 75 basis points hike and the hint that additional super-sized hikes might follow in upcoming meetings, the market had thought for a few days that the torch of the most hawkish central banker had passed to Lagarde.

The handover did not even last a week, because 10 days ago Powell returned to the throne as the central banker most determined to fight inflation.

During the post-FOMC meeting press conference, Powell began by stating that nothing has changed from what he said in Jackson Hole. He than reaffirmed that “restoring price stability will likely require maintaining a restrictive policy stance for some time” and that “the historical record cautions strongly against prematurely loosening policy”. But later on, with reference to the appropriate level of rates to fight inflation, he added that "we're not at that level. Clearly today, we're probably into the very lowest level of what might be restrictive. And certainly in my view and in the view of the committee, there's a ways to go".

The above does not outright contradict the statement he himself made in July when the rates were at 2.25%-2.50% and he’d said that Fed's "monetary policy is now in neutral territory," but it makes it clear that it is not enough to be in neutral territory or even to be at the low end of the restrictive range. The Fed has to go higher.

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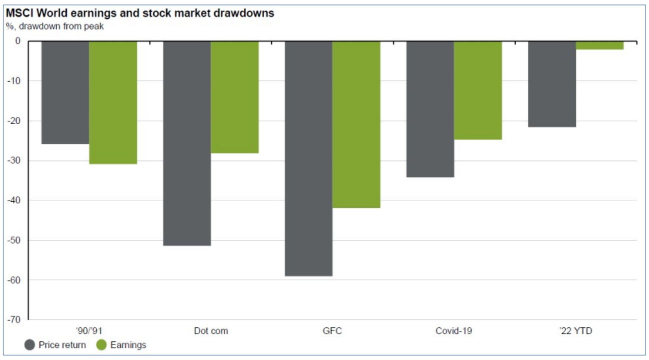

Source: J.P. Morgan, as of June 2022 *Source: Bloomberg*

Probably with the goal of making it clear to the market that its rate expectations are completely off-target, the Fed's dots have been revised firmly upward: the median expectation is for Fed Funds rates to be at 4.4 percent at the end of this year (implying a 75 bps and a 50 bps hike in the next two meetings), to remain at 4.6 percent at the end of 2023 before gradually declining to 2.9 percent in 2025.

Rates this high are way above what was expected pre-meeting. It is no coincidence that from the FOMC onward, the nominal and real interest rates have continued to rise steadily, exceeding the highs touched in June, as predicted in the August 29 report.

However, comments made about the current monetary policy goals have had the biggest effects on markets. Although by statute the Fed has the dual mandate to pursue price stability and full employment, Powell made it clear that, at least temporarily, the mandate has been reduced to just price stability, even at the cost of sacrificing full employment and, by extension, economic growth. Powell stated that “we'll need to do two things in particular - to achieve a period of growth below trend, and also, some softening in labor market conditions to foster a better balance between demand and supply in the labor market”, and especially that “we have got to get inflation behind us. I wish there were a painless way to do that. There isn't”.

A central bank cannot publicly declare that it wants to bring about a recession and an increase in the unemployment rate. However, in plain English, it means exactly that: the Fed wants to cause a recession and a rise in the unemployment rate because there is no other alternative to allow inflation to subside.

If the world's leading central bank is covertly pursuing the goal of causing a recession, and the other major central banks seem to be lining up, then the risk of a recession in near future is material. If we look at previous occurrences, we see that earnings fall on average by about 25 percent during a recession. The MSCI World index has dropped by 15% in dollar terms since Powell first suggested a recession was inevitable in Jackson Hole in mid-August, despite analysts only recently starting to cautiously lower earnings growth estimates (down about 2% to date). Earnings have not decreased as much as they might have, but some of the recession risk has already been factored into prices.

The market multiples are an area of vulnerability still. We have repeatedly argued that the higher the real rates, the lower the multiple on earnings the market can sustain (top right graph). Since Jackson Hole there has been a record increase in real interest rates, +120 bps in one month. However the Nasdaq multiple, one of the indices that should be most sensitive to changes in interest rates, has seen only a marginal contraction. Even without focusing on the correlation between multiples and real rates, if the Nasdaq trades at 20 times forward earnings, it means that its implied yield is 5% (100/20). The Nasdaq's 5% return is not alluring when compared to the two-year Treasury's annualized, risk-free return of 4.3%, even before we consider that central banks want to engineer a recession.

If stocks seem unwilling yet to surrender to the need to offer higher returns or to the evidence that a recession may now be inevitable, perhaps an external catalyst, a sudden deleveraging or an increase in risk aversion could be the tipping point for such an adjustment to take place.

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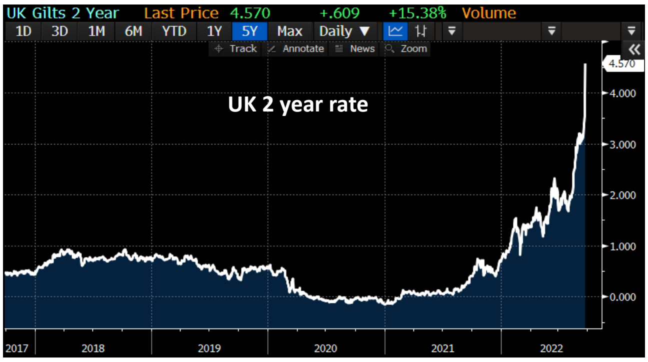


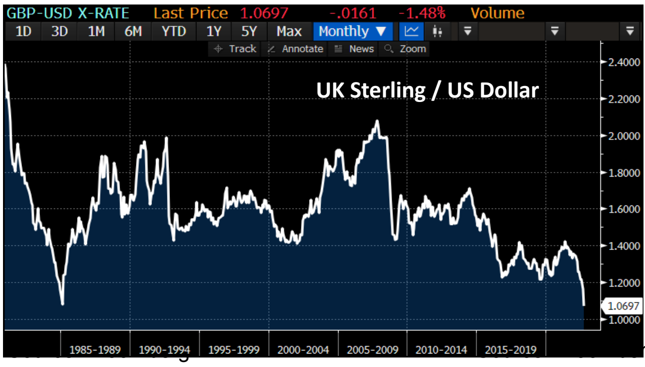
Source: Bloomberg   *Source: Bloomberg*

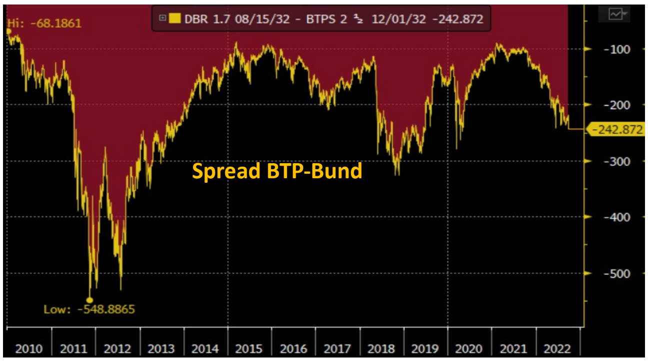
In this regard, some asset classes have recently experienced unusual movements. The Japanese treasury made its first intervention after the BoJ meeting in decades to support the yen, which immediately rose by 4% before gradually erasing its gains over the next few days. The Swiss franc lost 2.5 percent in just a few minutes on the same day following the Swiss central bank meeting.

But these two movements were nothing compared to the earthquake caused by the fiscal plan announced by the incoming British government, which was a sea of red ink rather than a balanced budget. The market reacted by selling off British assets in a panic mode.

The rate on the UK two-year bond rose more than 1 percent in two days, and 150 bps in a week. The 30-year Gilt lost 50 basis points on Monday 26 alone. Its price literally imploded, going from 60 to 47 (more than -20%) in one week. Record declines also for the pound, which lost up to 8 percent against the dollar since the new fiscal package was announced, and broke through its all-time lows of 1985 against the dollar.

Such brutal responses signal that the market is starting to severely penalize anyone who implements questionable policies after years in which any monetary or fiscal excess has always been tolerated. This response serves as a warning to the new Italian government that it risked being severely penalized if it abandoned fiscal restraint. Since the vote count has not even been finished and it is far too early to make any assessments on the situation, we won't go into further detail on this.





Exceptional movements such as those mentioned above usually lead to widespread stop losses, margin calls, deleveraging, and forced liquidations. If the number of investors involved is limited, and/or the asset classes affected are only marginal, the risks of a vicious cycle being triggered are limited. However, considering that the events reported above involved major currencies and countries, and that they occurred at a time when markets seem willing to ignore the clouds hanging on the horizon, then it cannot be ruled out that such movements could lead to an extension of the corrective movement that started in August.

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On the other hand, if the major indices managed to hold their June lows and the S&P500 managed to stay above its 200-week moving average, we might witness another short-term uptick. If offered, the rebound should be taken advantage of to reduce exposures by those who were overweight equities or to rotate portfolios toward funds with more defensive characteristics given that recession risk is now much more tangible than it was in June.

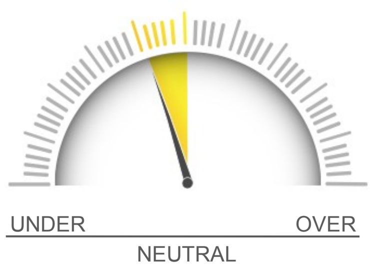
Asset Allocation View

	UNDER	NEUTRAL	OVER
Equity			
Developed Markets	■		
Emerging Markets	■		
Fixed Income			
Developed Markets Sovereign	■		
Developed Markets Corporate			■
Emerging Markets		■	
Commodities	Downgrade		
Currencies		*Commentary below*	

UNDER NEUTRAL OVER

Equity

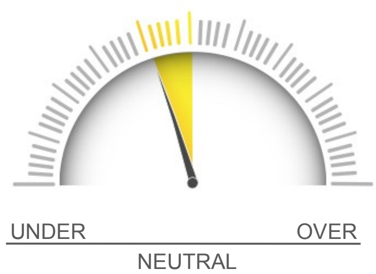
Developed Markets



We kept our **Slightly Underweight** recommendation on Developed Markets Equities. As detailed in the Prologue of this report, the Fed's intention to provoke a slowdown or recession is increasingly manifest. The market moved accordingly, with a rapid decline that took the indices back to their June lows. A bounce off the double low is possible, and if offered will have to be used to offload equities for those who were overweight. In the medium term, should we actually end up in recession, stocks have further downside. The Fed uber-hawkish stance also imply that the dollar will continue to remain strong, and thus the preference for European and Japanese markets have been removed.

US	NEUTRAL	**Europe**	NEUTRAL	**Japan**	NEUTRAL

Emerging Markets

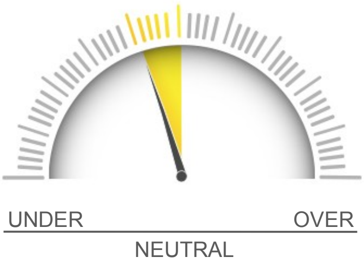


We maintained our **Slightly Underweight** recommendation on Emerging Markets Equities. The outlook for emerging stock markets does not differ from that reported above for developed countries. Developing countries' valuations are much cheaper, but geopolitical risks and increasingly tightening monetary policies in Western countries continue to weigh on the indices.

Asia ex-Japan	NEUTRAL	**EEMEA**	UNDER	**LATAM**	NEUTRAL

Fixed Income

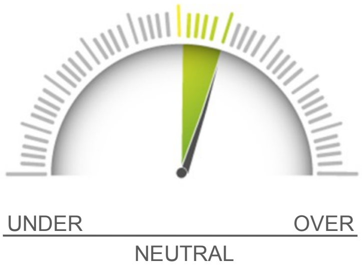
Developed Markets Sovereign



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. Although it is believed that there is room for a further increase in rates from these levels, given the hawkish stance by central banks, the extent of the movement since late August is such that the downside on bonds (upside on rates) is narrowing. In terms of countries, U.S. Treasuries at current levels may be appealing again to provide a hedge should equity markets correct significantly. Europe is the region that is lagging the most in the rate normalization process, so we continue to take a cautious approach there.

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

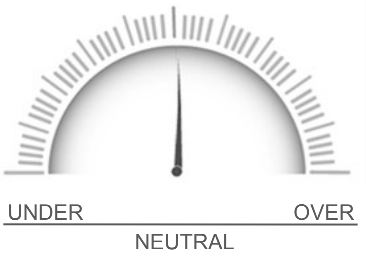
Developed Markets Corporate



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 yield bonds, that could still have downside as the probabilities of a global recession increase considering the increasingly restrictive monetary policies.

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

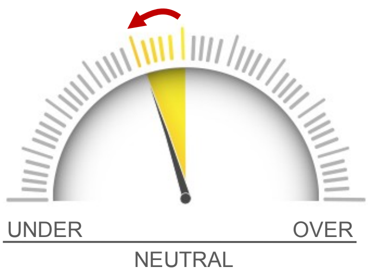
Emerging Markets



We maintained our **Neutral** recommendation on Emerging Market bonds. Although developing market bonds could remain under pressure due to continued interest rate hikes by Western central banks or in the increasingly-likely event of a global economic slowdown, the huge correction that affected the asset class over the past few months should ensure a more limited downside than developed market bonds. We continue to prefer local currency bonds.

Local Currency	+	**Hard Currency IG**	–	**Hard Currency HY**	–

Commodities



We reduced our recommendation to **Slightly Underweight** on Commodities. With no ability to generate cash flow, precious metals face increasing competition from government bonds, especially as official interest rates rise. Due to the Fed's stated intentions to create a slowdown to curb inflation, it is likely to expect that the price of industrial and energy commodities may fall in anticipation of a reduction in global demand.

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

Currencies

The Committee confirmed its **Neutral View, but shifting again its tilt to a bullish bias** (from a bearish bias)**, on the US Dollar**. The aggressive tone used by Powell following the last Fed meeting has put the U.S. central bank back in first place among the world's central banks in terms of resolve in tightening financial conditions. As a result, expectations for a retracement of the greenback have faded.

The view on the **Euro is Neutral, but with a bearish bias**. The more aggressive than expected rate hike by the ECB was unable to support the euro, considering that the Fed surprised in an even more aggressively, as just argued above. In addition, uncertainties related to the energy crisis and how the newly elected center-right coalition in Italy will behave continue to weigh on Europe.

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 bearish bias** in view of a possible global slowdown due to restrictive monetary policies implemented by Western central banks.

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