AZIMUT GLOBAL VIEW

10.10.22

Main Events

US INFLATION — 13.10
Despite a further decline in commodities, US inflation is expected to remain above 8% YoY

US RETAIL SALES — 14.10
Will the American consumer keep spending, despite the shrinking purchasing power of wages?

EUROZONE ZEW — 18.10
Europe's energy crisis could push ZEW confidence index to break all-time lows

UK INFLATION — 19.10
A higher-than-expected reading could force the BoE to announce a jumbo rate hike, taking into account the new government's tax plan

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

GOOD NEWS: TIME BOMBS ARE TICKING

- **The Bank of England had to intervene with a QE to prevent the collapse of British pension funds after the turmoil created by the Truss government's tax plan**
- **Credit Suisse entered the list of systemic risks, with CDS rising to levels higher than in 2008, sparking fears about its effective financial health**
- **Central banks could be finally forced to make the infamous pivot should current vulnerabilities threaten the stability of financial institutions and markets**

In the previous report we had extensively argued about 1) how the risk of recession had risen significantly considering that the Fed reiterated its stance to induce one in order to bring down inflation, 2) how market multiples (particularly the Nasdaq) had not fallen enough in light of the surge in real rates and the increased risk of recession, and most importantly 3) how the new Truss government's tax plan had caused profound shocks in the markets.

Vulnerabilities and disorderly movements of outsized magnitude usually spread like shock waves and fully manifest their effects in the weeks and months that follow their occurrence. One of the time bombs mentioned above has nearly exploded, and others have appeared since our last report.

Let us begin with the averted disaster. Apart from being unfunded (as far as is currently known), the UK fiscal plan is highly expansionary and thus inflationary. Given that inflation in the UK is already at its highest level in 40 years, it was like throwing gasoline on the fire.

As a result, investors kept selling British Gilts, particularly inflation-linked bonds and those with the longest maturities, sparking unprecedented declines. UK pension funds have been the hardest hit, as they buy the longest maturities, including through instruments that can trigger margin calls (so-called liability-driven investment funds, which are largely leveraged and often use gilts as collateral).

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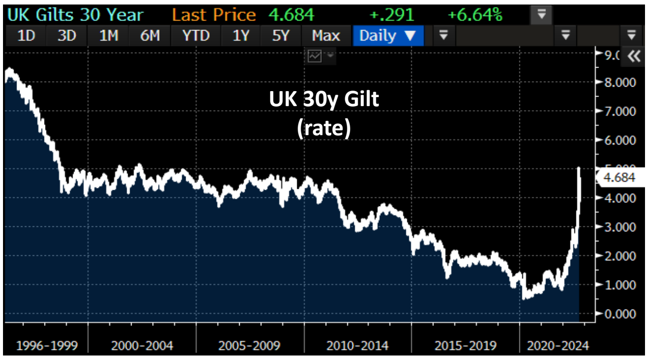


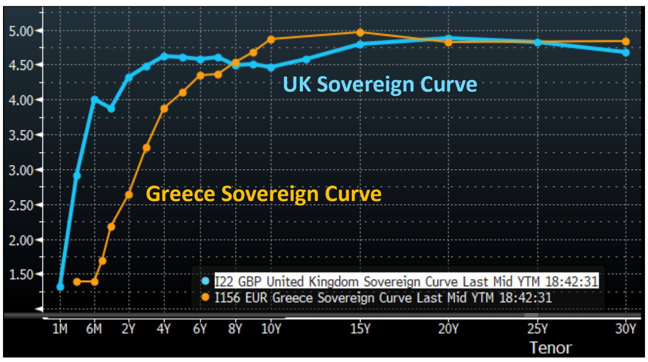
Source: Bloomberg *Source: Bloomberg*

As the price of gilts collapsed, pension funds began to receive margin calls and in order to meet them they raised cash by selling gilts and other securities, causing prices to spiral. On Sept. 29, the BoE intervened unleashing a £65bn bond-buying program to support the prices of long-dated gilts in order to prevent a bankruptcy of the pension funds, which, it is estimated, would have faced margin calls of up to 100 Billion Pounds.

The program was successful in causing a brief reversal in long bonds, but there are many unknowns about what will happen once the BoE stops purchases this Friday. 30-year rates, which had fallen from 5.1 percent to 3.6 percent had already risen back to 4.7 percent at the time of writing. Furthermore, across much of the curve today, the UK is paying higher rates than Greece, and Chancellor of the Exchequer Kwasi Kwarteng has gone to reassure the IMF, as this is more common in emerging countries. Let's see what happens after the program ends next week.

If the British pension funds were in danger of collapse, the rest of the pension funds in the world are not in great shape this year, not only because of the combined decline in equities and bonds, but also and most importantly because of the heavy losses they have suffered in the very long ends of the curves. Starved by several years of zero or sub-zero rates, pension funds have either increased their credit risk by enlarging the share of high yield and emerging debt (where permitted by investment policy restrictions) or invested in increasingly longer durations. Debtors, and particularly governments, have capitalized on this desire for long maturities by offering 50-year and 100-year bonds. The issue is that, starting with extremely low rates, such long maturities result in exorbitant losses when rates rises. Consider the 100-year Austrian bond maturing in 2120, whose price has dropped from a record 140 at the end of 2020 to 40 today. Losing one hundred cents on the dollar is equivalent to losing the principal. The previously mentioned 50-year inflation-linked UK one has lost 90% in just over a year.

These are, of course, extreme cases, and the fixed-income portfolio of pension funds is in aggregate losing much less than the two examples cited above show. As of today the situation is sustainable, but it should also be kept in mind that long-term interest rates are still well below historical average levels, with central banks fully committed to stem inflation. Should long-term rates normalize further, then the situation for pension funds could become more complicated.



Source: Bloomberg *Source: Bloomberg*

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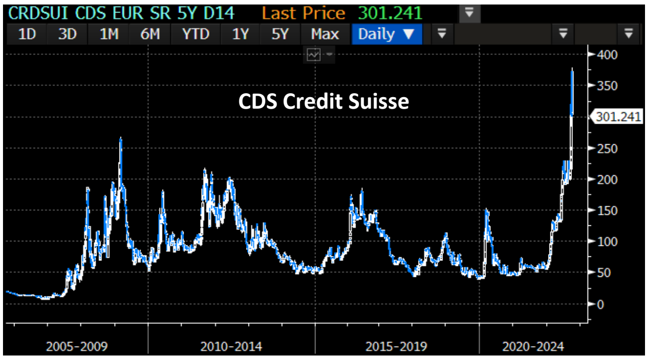


Source: Bloomberg

Source: Bloomberg

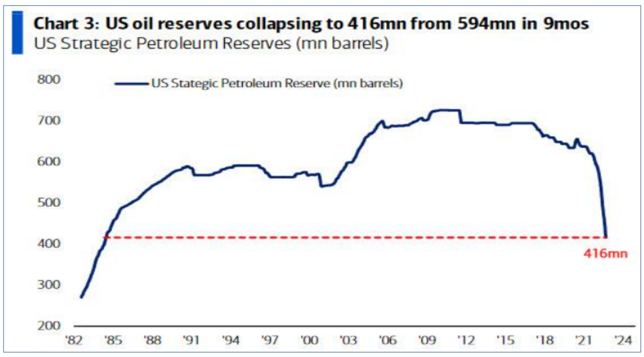
Another issue began to emerge at the end of the quarter, something not seen since the Great Financial Crisis of 2008. Following the sharp rise in the CDS, Credit Suisse's new CEO wrote a letter to employees for the second time in as many weeks to assuage their concerns about the bank's health. Unfortunately, this reminded investors of the numerous assurances provided by management at Bear Stern and Lehman Brothers prior to the two banks' failures.

The intention, while good, backfired and Credit Suisse's CDS spiked from 250 to nearly 380, smashing the 2009 record of 267. Back then the whole financial sector was under stress, and CDS of all financial institutions traded at record levels because of systemic risk. Today, there is no systemic risk, thus the spike of the CDS to levels much higher than in 2009 frightened investors.

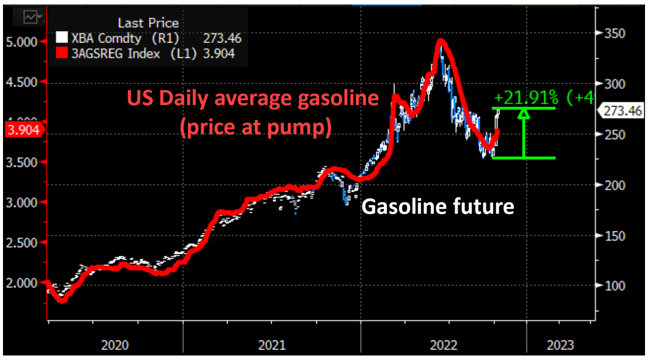
This resulted in an unexpected occurrence. Multiple news outlets reported that the rally in the first two days of October was led by the most shorted stocks, with the Goldman Sachs Most Short index rising +10%. Later, it was revealed that in the first few days of the month, many institutions that relied on Credit Suisse for securities lending activity abruptly requested the recall of the stocks on loan in order to avoid the risk of maintaining a credit balance with CS. Given the size of CS, the number of securities recalled was sufficient to explain at least a portion of last week's massive rebound. Indeed, once the stock recall was completed, the market resumed its decline, retracing the entire rebound.

Another threat appearing on the horizon is the rebound in commodity prices. Except for oil, many commodities have recently fallen below pre-war levels, reaching prices that were prevalent 3-5 years ago in some cases. In an inflationary environment with rising extraction and labor costs, it is difficult to imagine commodities falling significantly from recent lows.

This is especially true for oil, considering that the world's second largest producer, Russia, is under sanctions. In addition, during the previous six months the Biden administration released 1 million barrels per day of oil from its strategic reserves until the end of September. Coupled with this, OPEC's decision to cut production by 2 million barrels/day led to a reduction in aggregate supply of 3 million barrels per day in a matter of days, contributing to a spike in oil prices of more than 20 percent from summer lows.



Source: BofA Global Research



Source: Bloomberg

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This has also been reflected in gasoline prices, with futures prices rebounding more than 20% and normally leading to pump prices. The price of gasoline at the pump has already risen about 6% since the mid-September lows, but it is expected to rise further in the future given the move.

While the September inflation rate will continue to benefit from the recent commodity price correction, the recent rebound in oil and gasoline prices will be reflected in the October CPI number, which will be released in November.

As a result, following a CPI print that could be quite benign (around or slightly below 8%) this Thursday, November inflation could accelerate upward again, driven by both the core and volatile food and energy components. If this occurs, the market may react negatively, fearing that the Fed will become even more hawkish.

But if there are all these threats, why be optimistic as the title suggests?

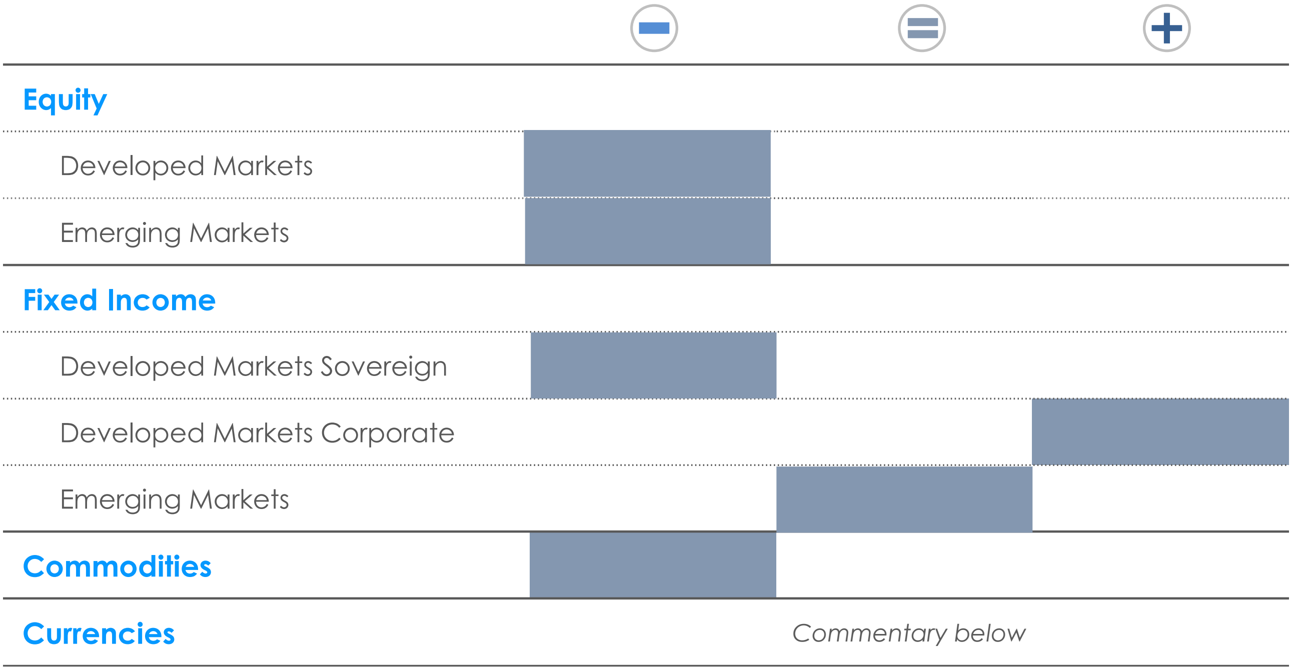
Central banks have learned a key lesson from 2008, that the safeguarding of the financial institutions' solvency, the proper functioning of markets, and the market's ability to continue making prices, transcends any other mandate in the central banks' own constitutive acts. When a market is not functioning properly or a financial system is on the verge of collapsing, it is no longer possible to pursue any of the other goals, such as price stability and/or full employment. Above all, the economic cost of undermining financial stability is massive.

We've seen two clear examples of this recently, in 2020 and just a few days ago. In 2020, central banks reacted vehemently, injecting an unprecedented amount of liquidity during the early days of the pandemic, remembering 2008. The Bank of England did the same a few days ago: despite the fact that the UK was experiencing double-digit inflation, in order to avoid the collapse of its pension system (which would, in turn, lead to the collapse of the rest of the British and potentially the global financial system as well), the Bank of England implemented what is de facto emergency QE, despite knowing that QE is an inflationary measure, and thus contrary to the central bank's price stability objective.

It is therefore possible that if one or more of the dangers listed in this report or the previous one actually materializes, then we could experience a further acceleration in the market correction. However, should such a correction threaten the stability of the financial system, central banks and the Fed first of all will not hesitate to implement emergency measures. In such a situation, central banks will make the infamous pivot that the market has been anticipating for so long, regardless of whether inflation has been overcome or not.

Starting from lower levels (without further corrections, a systemic event is unlikely), the pivot could mark either the ultimate low of this bear market or a major low from which a violent rebound could be unleashed and last several weeks or months.

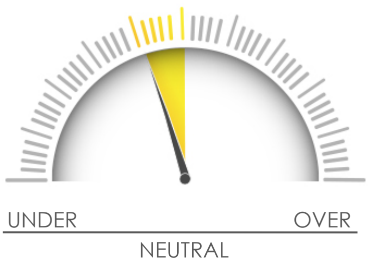
Asset Allocation View



UNDER NEUTRAL OVER

Equity

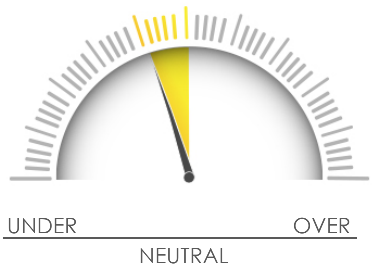
Developed Markets



We kept our **Slightly Underweight** recommendation on Developed Markets Equities. On the one hand, there are several catalysts that can have a negative impact on equity markets in the short term, as elaborated in the Prologue, but on the other hand, these same catalysts and the ensuing market correction can prompt central banks to intervene to preserve the financial market stability, thus pivoting on their hawkish stance. Furthermore, market participants' bearishness is increasing significantly, which is typically a contrarian indicator. The upcoming reporting season should also shed light on how credible earnings growth expectations are.

US **Europe** **Japan**

Emerging Markets

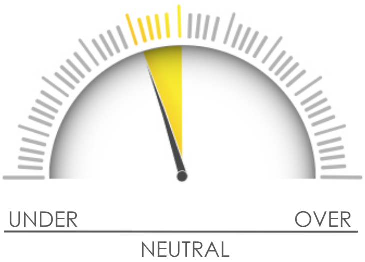


We maintained our **Slightly Underweight** recommendation on Emerging Markets Equities. The outlook for emerging stock markets is the same as for developed countries. The valuations of developing countries are much lower, but geopolitical risks and tightening monetary policies in Western countries continue to weigh on the indices. In Brazil, Lula's lead in the elections was much smaller than expected. A Lula victory would almost certainly result in a retracement, whereas Bolsonaro confirmation would almost certainly result in a continuation of the current bullish phase.

Asia ex-Japan **EEMEA** **LATAM**

Fixed Income

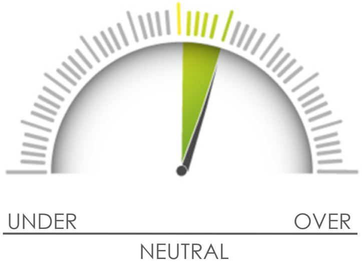
Developed Markets Sovereign



We maintained our **Slightly Underweight** view 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 there is room for a further increase in rates from these levels, we believe that central banks' peak hawkishness will be reached within few weeks (or months, at worst). In terms of securities, U.S. Treasuries at current levels may be appealing again to provide a hedge if 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**	=

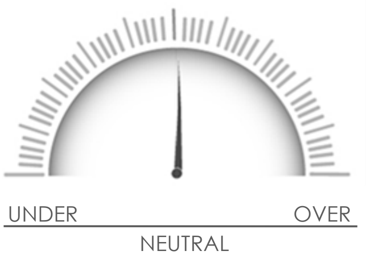
Developed Markets Corporate



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**	−

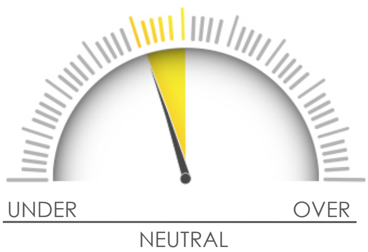
Emerging Markets



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. Although the Fed's stated intentions are to create a slowdown in order to reduce inflation, it is possible that energy commodities will remain relatively stronger than others, given the end of the United States' release of strategic oil reserves and OPEC+'s higher-than-expected production cut.

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

Currencies

The Committee confirmed its **Neutral View, but with a bullish bias, on the US Dollar**. The different threats to financial stability discussed in the Prologue may cause increases in risk aversion, demand for safe havens assets and margin calls. In such an environment, the dollar should continue to remain strong.

The view on the **Euro is Neutral, but with a bearish bias**. Europe continues to remain the place most affected by the energy crisis, whose impacts on the real economy are still difficult to estimate. Waiting for more clarity, it is possible that appetite for the single currency will remain subdued.

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 fresh ban on shipment of advanced chip equipment to China 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	=