AZIMUT GLOBAL VIEW

24.10.22

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

ECB MEETING
The European Central Bank is expected to deliver another 75 bps increase, but the focus will be on the future path of policy rate

US GDP
GDP expected to grow by 2.3% after contracting in previous quarter, but there may be surprises if the GDP deflator doesn't decline as anticipated (from 9.0% to 5.3%)

EUROZONE CPI
After the sharp fall of energy prices in the last two months, will the EU inflation show signs of abating?

FOMC MEETING
There are growing expectations that the Fed will hint at a possible slowdown in the pace of rate hikes. Will the market be disappointed?

IT'S ALL ABOUT THE POLITICS

- **Truss's resignation has helped calm financial markets, particularly British gilts, whose yields are returning to more normal levels.**
- **Giorgia Meloni's first steps as premier and the composition of her government are not spooking markets, allowing a narrowing of the BTP-Bund spread**
- **In contrast, Xi's winning of a third term and the stacking of the Chinese Communist Party's governing bodies with Xi's loyalists raise fears of an authoritarian drift in China**

Political events have continued to be the driver of financial markets in recent weeks.

After causing major market turmoil and forcing Britain's central bank to bailout Britain's pension funds, Liz Truss tried to keep afloat her government by firing her loyal Chancellor of the Exchequer Kwasi Kwarteng and replacing him with Jeremy Hunt, who was quick to make it clear that he would restore fiscal discipline, calming financial markets.

However, the damage caused was of such magnitude that Truss herself was eventually forced to resign, going down in history as the British Prime Minister with the shortest tenure. Consultations are underway among the Tories to appoint a new prime minister who is likely to be Rishi Sunak who had warned that Liz Truss's proposals would cause troubles in financial markets and is in favor of more orthodox economic policies.

Thanks to these developments, UK Gilt rates quickly fell, retracing much of the spike that occurred immediately after Liz Truss' tax plan.

The recovery in British government bonds also had a beneficial effect on Italian BTPs, which had previously been heavily sold off due to fears that the new Meloni administration might follow in the footsteps of the Truss government. In fact, apart from a brief quarrel with former Prime Minister Berlusconi that is now overcome, Italy's new prime minister announced the members of the new government at the end of last week, and none of the appointments raised fears that the new administration wants to be at odds with Europe.

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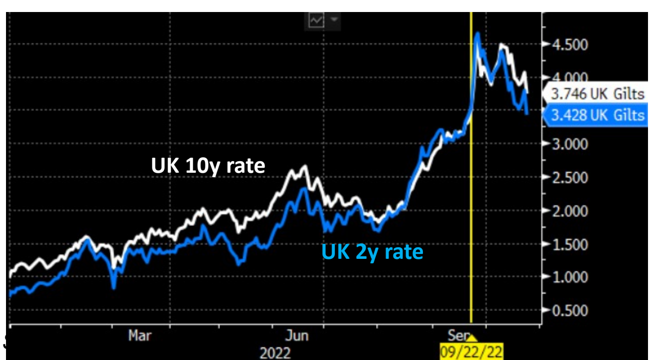

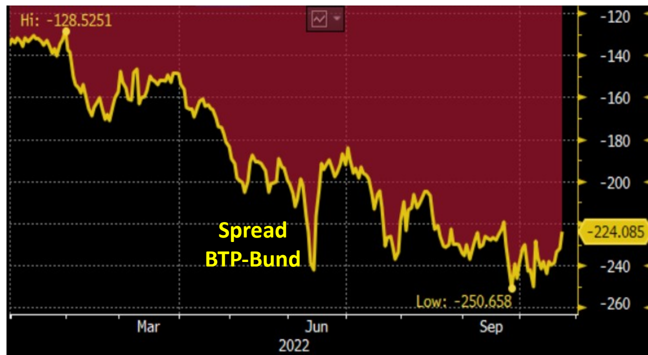

The BTP-Bund spread, which was already timidly recovering from the fall of the Truss government, compressed further, and it is likely that it may continue to narrow in the coming weeks.

The most important political event, however, was the 20th National Congress of the Chinese Communist Party, which took place last weekend. This is a quintessential gathering at which the Party's general secretary is appointed and the compositions of the Politburo and Politburo Standing Committee (PSC) are reviewed.

After the controversial reign of Mao Zedong, the founder of the People's Republic of China, whose leadership he maintained from its founding in 1949 until Mao's own death in 1976, the Party had stipulated in its constitution that no person could rule for more than two terms (10 years total) along with other mechanisms to prevent anyone from assuming dominant power. These safeguard mechanisms were eliminated in 2018 when Xi Jinping, the general secretary of the CCP since 2012 and whose term to lapse in 2022, had the maximum two-term limit removed from the constitution. This opened the way for him serve in the office indefinitely, possibly for the rest of his life.

Since being appointed as Party Secretary in 2012, Xi has gradually purged the party of anyone who might run against him or be in opposition to him. Unsurprisingly, during this congress Xi was confirmed for a third term and was able to completely overhaul the composition of the Politburo and Politburo Standing Committee, stacking them with his loyalists. Regarding the more significant out of the two, the PSC (the PSC is the highest level in the Chinese Communist Party's hierarchy, followed by the Politburo; the members of the PSC are also members of the Politburo) continues to be made up of seven members. Six of these are close Xi allies who will enable Xi to maintain total control of the country. Additionally, a record-high number of the 24 Politburo members—more than half—were replaced during this Congress.

Xi was also keen to make it clear that his power must remain unchallenged. Although it was clear from the footage (censored in China) that Hu Jintao had no apparent health issues, he was escorted from Congress for official health reasons. Two previous PSC members, Premier Li Keqiang and Wang Yang, were not reappointed although their age would have allowed them to serve another five-year term. In order to advance to the party leadership and the presidency in 2012, Xi had to compete with Li, a Hu Jintao supporter.

Li Kequiang's removal from the PSC also implies that he will not be reappointed as premier in March of next year. His role will likely be taken over by Shanghai party chief Li Qiang, who was the first PSC member to walk behind Xi on Sunday, making clear his rank as second-in-command in the country's leadership, despite never having served as vice premier, as it was always the case. Li Qiang is the Shanghai party chief, and has also gained notoriety for implementing one of the most controversial and longest (two-month) lockdowns in the country's biggest city.

Without delving too much into further details, the weekend's developments demonstrate that China is embarking on a path towards a significantly more authoritarian leadership, where there are no check-and-balance mechanisms or people of standing to oppose Xi, should he wish to implement questionable domestic or foreign policy decisions.

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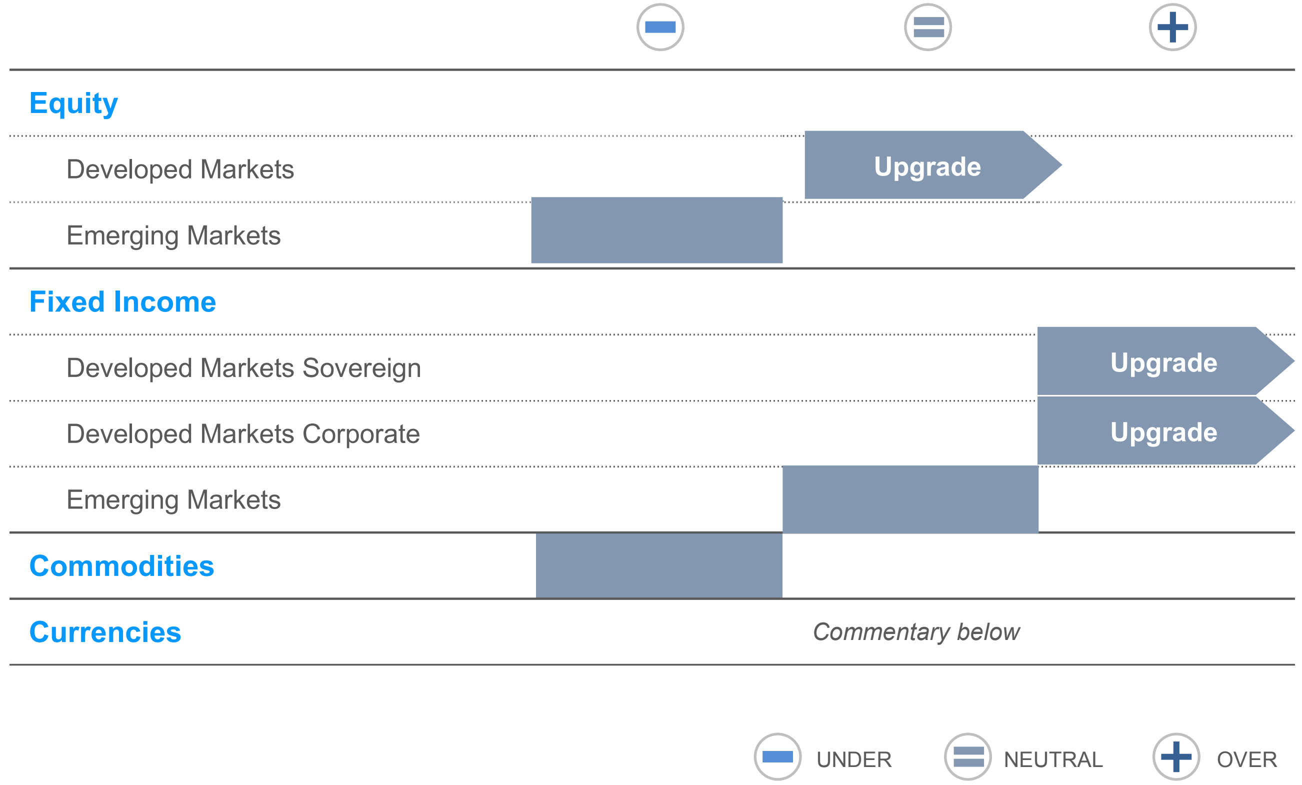
Source: Bloomberg *Source: Bloomberg*

For example, Li Qiang's promotion might imply that the relaxation of lockdown measures might be further postponed; the pursuit of "common prosperity" goals might require additional market-unfriendly measures; having reiterated that it is a priority for China to protect its security and national interests (with clear reference to Taiwan's status as an integral part of China) might lead to a worsening of the conflict with the United States.

Unsurprisingly, on Monday the Hang Seng China Enterprises Index of Hong Kong-listed Chinese stocks, fell by 7.3%, posting its worst performance after a CCP congress since its inception in 1994, while the Nasdaq Golden Dragon China Index of Chinese stocks, posted its biggest drop ever, tumbling 14% and wiping out more than $90 billion in market value. In the currency market, the onshore yuan fell approaching the 2% trading band around the fixing.

Despite these strong reactions from Chinese markets, Western markets have remained resilient so far, concentrating more on encouraging developments in the UK and Italy. In the medium term, it will be easier to understand whether the reaction of Chinese markets was purely emotional and there was no good reason to worry, or whether developments in China may have spillovers on the global economy and financial markets.

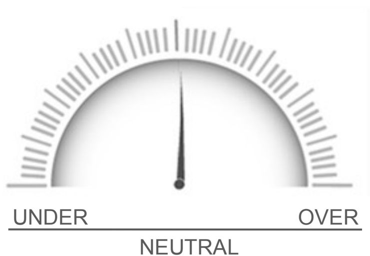
Asset Allocation View



UNDER NEUTRAL OVER

Equity

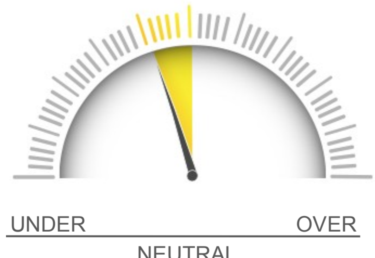
Developed Markets



We increased our recommendation on Developed Markets Equities to **Neutral**. The reporting season is about to end, and earnings have so far shown resilience. The buyback freeze is also over or about to end for the majority of the companies, which should be positive for stocks. Additionally, while the sentiment is extremely bearish, we are entering a period that is statistically most positive for equities. Markets might therefore enjoy another bear market rally. However, the upgrade is only tactical in nature as the possibility of an economic slowdown and the increased competition from risk-free rates may still weigh on equities.

US	Neutral	Europe	Neutral	Japan	Neutral

Emerging Markets



We maintained our **Slightly Underweight** recommendation on Emerging Markets Equities. It appears that China may be transitioning into a more authoritarian phase under the leadership of Xi thanks to the changes in the composition of the Politburo and the Standing Committee that were announced over the weekend. This has frightened investors, as the policies implemented by Xi over the past two years have not been market-friendly. Therefore, despite the enormous discount compared to developed markets, it's possible that investors will continue to avoid Chinese stocks for a while.

Asia ex-Japan	Neutral	EEMEA	Under	LATAM	Neutral

Fixed Income

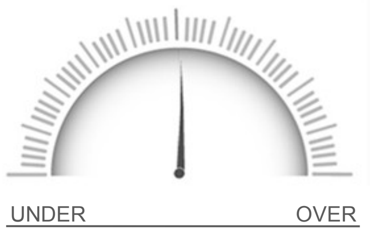
Developed Markets Sovereign

We have increased our recommendation on Developed Markets Sovereign Bonds by two notches to **Slightly Overweight**. Interest rates have reached a level where there is little chance of further increases, particularly for the US curve. Therefore, maintaining short-term positions may no longer be needed. While the long end of the curves may once again act as portfolio hedges in the event of spikes in risk aversion, the short end of the curves, particularly in the US, already offers high returns. British Gilts and Italian BTPs could keep outperforming, given the political developments covered in the prologue. Given that rate normalization is still ongoing in Europe, caution is still required on the German curve.

Developed Markets Corporate

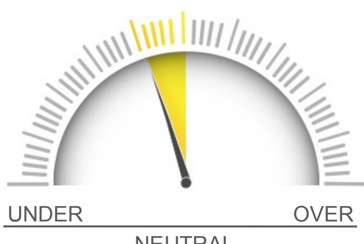
We upgraded our recommendation on Developed Markets Corporates to **Overweight**. Considering that the risk of further rises in the risk-free is now seen as limited, investment grade corporate bonds and hybrid bonds in particular are now an investment option to be seriously considered given the high level also reached by spreads as well as the risk-free. We remain cautious on high yields.

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.

Commodities



We maintain our **Slightly Underweight** recommendation 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 on the US Dollar. The Federal Reserve may shortly start to hint to a possible slowdown in the pace of rate hikes, and the demand for safe havens assets may be lower after the positive development in UK and Italy discussed in the prologue. Therefore, the US dollar may lose some of its appeal in the short term.

The view on the Euro is also **Neutral**. The fast retracement of gas prices and the positive political development in UK and Italy may lead to a rebound in the common currency.

With a bearish bias, the view on the **Chinese Renminbi** is confirmed as **Neutral**. Xi's authoritarian push, along with his focus on common prosperity, implementation of Covid containment measures, and his resolute affirmation on the defense of the national interest with a clear reference to Taiwan, 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
=	=	=	=

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