# AZIMUT GLOBAL VIEW

21.11.22

## Main Events

| 23.11 | 25.11 | 30.11 | 02.12 |
|---|---|---|---|
| **GLOBAL PMI** S&P Global releases November data, which is expected to remain below the 50 level that separates expansion from contraction | **TOKYO CPI** Tokyo CPI data usually lead the country's inflation data. Additional increases may put extra pressure on BOJ to change its stance | **EUROZONE CPI** If Eurozone inflation rises further into double digits, expectations of a slowing in ECB rate hikes would be jeopardized | **US NON-FARM PAYROLLS** Expectations point to a softer, but still strong reading on the U.S. labor market |

Azimut Global Network

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

# A QUESTION OF STYLE

- **China and Europe have largely outperformed the United States in recent weeks, thanks to the dovish turn of some central banks and China's shift to more market-friendly policies.**
- **Europe's strength, however, seems to be mainly due to an outperformance of Value (more represented in the EU) over Growth and a recovery of the Euro.**
- **Growth stocks are underperforming because of downward earnings revisions from excessively high expectations and the fading of the unreasonably high premiums they enjoyed until recently.**

Since mid-October, a mighty rotation has taken place in financial markets, bringing a reversal (or perhaps just a temporary retracement?) of many of the major trends that have characterized the year so far.

Expectations that central banks were getting closer to the long-awaited "pivot" triggered the movement, which was later confirmed by almost all major Western central banks (except the Fed), as elaborated in the previous report.

Rumors of a shift in Chinese policymakers' stance on COVID containment policies, as well as expectations of measures to support the beleaguered real estate sector, have since taken shape, particularly in the latter. Finally, the U.S. inflation figure coming in lower-than-expected and showing an appreciable decline was the icing on the cake.

On the back of the aforementioned events, interest rates fell substantially (especially in the U.S.), the dollar lost against all the major currencies (the Dollar Index dropped about 7% from its recent highs), and equity markets rebounded strongly with the rally led by the worst performers YTD, China and especially Europe. European equity markets have completely erased the underperformance accumulated since the beginning of the year against the MSCI World, aided by the strengthening of the Euro.

# (continued)



Source: Bloomberg Source: Bloomberg

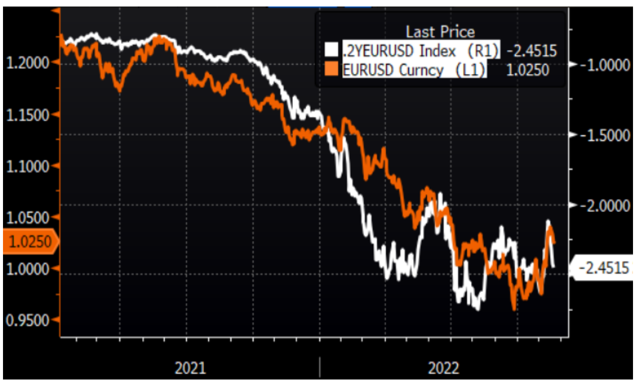
But let's dig a little deeper to see if we can get some useful insights from recent movements.

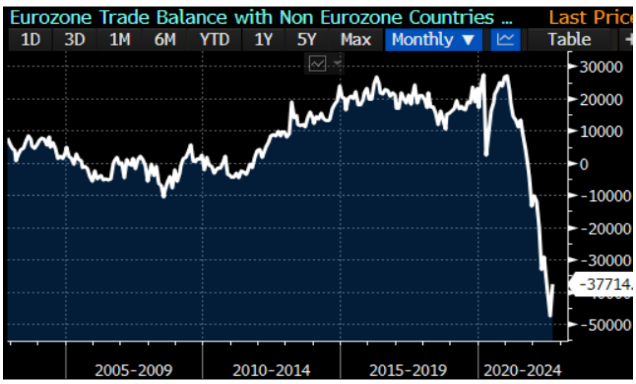
The change of attitude by the Chinese government on Covid and real estate is definitely a positive for global economic growth. In the medium term, it can be expected that if the Chinese economy restarts sustainably, inflation could prove more resilient, but this is not something that markets would take into account now. Given how low local asset valuations are, if China follows through on its new policy, there is ample room for the uptrend to continue.

Europe has clearly benefited from these developments in China, as economic ties between the two blocs are very strong. Part of Europe's recovery can certainly be attributed to the expectation of a recovery in Chinese demand. Two other elements that have played in Europe's favor are the lowest valuations among developed countries (we will return to this topic later) and the diminished focus on developments in the war in Ukraine, which has probably caused a reduction in the risk premium for holding European assets.

There are two other elements that, instead, downplay the significance of Europe's recent outperformance. The first one is currency related. The rally of the Euro versus Dollar, which was driven by the evolution of the two-year rate differential, which, as we have pointed out repeatedly, is the main factor driving the Euro/Dollar cross. When expectations of a pivot began, US rates fell the hardest because they had also been raised the most. As a result, the differential contracted (white line rising in bottom right chart), causing Dollar to weaken. Given that the Fed later maintained its stance on monetary policy, we can see that the differential is gradually shifting back in favor of the Dollar, casting doubt on the possibility of further Euro strengthening.

Even when expressed in terms of real rates, the conclusions are no different. European inflation is significantly higher than that in the U.S. (10.7% versus 7.7%), despite lower official rates in Europe (1.5% versus 4.0%), bringing the difference between inflation and rates to -3.7% in the U.S. States and -9.2% in Europe. With these disparities in real rates and the Fed confirming its restrictive stance while the ECB is already opening the door to a decelerated pace of rate hikes, it is difficult to see the dollar falling much further from here.




*Source: Bloomberg* *Source: Bloomberg*

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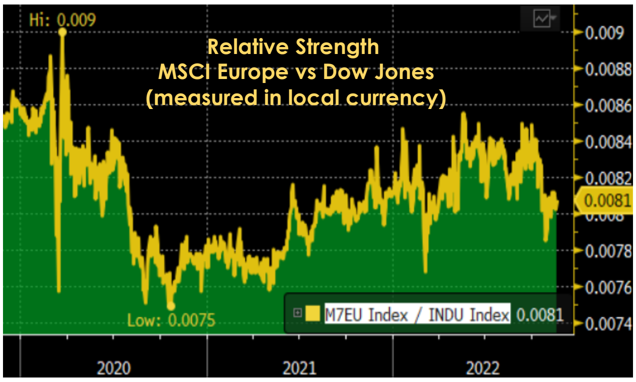
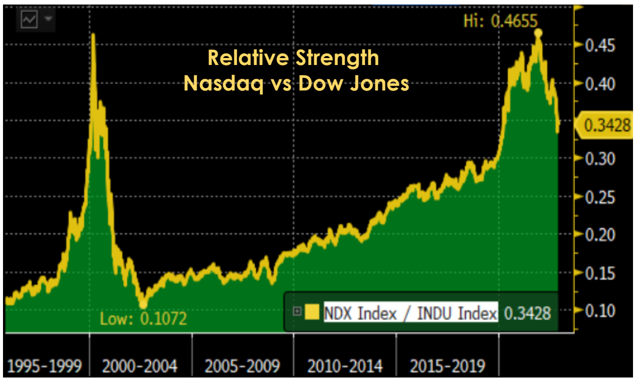



Source: Bloomberg




Source: Bloomberg

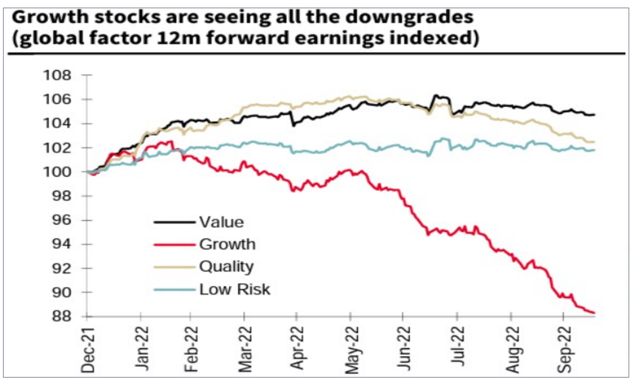
Moreover, it should be considered that mainly due to the energy crisis and hence the need to import energy commodities at higher prices, the EU trade balance (graph on the previous page) has suffered a massive deterioration. If the Euro continues to strengthen, we will pay less (in euros) for energy commodities, but the EU's competitiveness, which has already been weakened by rising production costs, will deteriorate further.

The second factor to consider in assessing the outperformance of Europe is related to the composition of the indices. For European equity indices, the weight of the Value component is significantly higher than the Growth. The opposite is true for the S&P500. If we compare the MSCI Europe to the Dow Jones index, which is also more exposed to Value than to Growth, the European outperformance is much smaller.

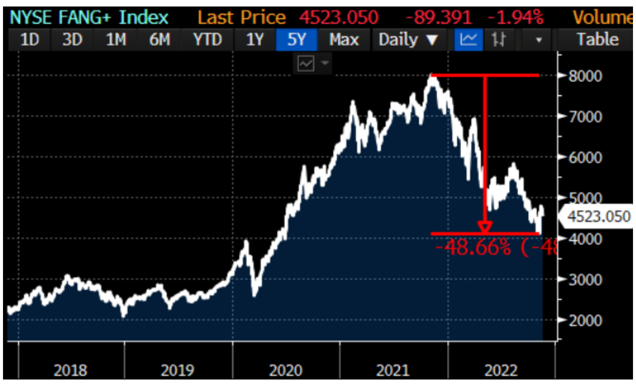
When we remove the effect of currency movements (because, as previously stated, the euro's strengthening was most likely due to transitory factors) and compare the Dow Jones in USD to the MSCI Europe in Euro (top left chart), we can clearly see that the ratio has barely moved. In other words, it appears that, when currency effects and different composition by style are removed, Europe's outperformance is much less indicative of the old continent's renewed intrinsic strength.

Indeed, if we compare the ratio between the Nasdaq as a proxy for Growth and the Dow Jones as a proxy for Value (thus comparing two indexes from the same country - subject to the same economic dynamics and without currency distortions), we clearly see that Growth is continuing to lose relative to the Value, leading to a deflation (probably not yet completed) of the bubble formed in recent years. The Nasdaq recovered 5% to the Dow Jones on the better-than-expected U.S. CPI data, but in the following days it has already lost half of it.

The underperformance of the Nasdaq and the Growth stocks, however, is not due to excessive pessimism. Fundamentals clearly show that earnings expectations for Growth stocks were excessively high since the beginning of the year and have been heavily revised downward. Earnings expectations for Value and low risk (i.e., minimum volatility) were, on the other hand, overly conservative.




Source: SG Cross Asset Research, Factset, Refinitive




Source: Bloomberg

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| | Equity | | | | |
|---|---|---|---|---|---|
| | S&P 500 | Stoxx 600 | MXAPJ | Topix | MSCI EM |
| Valuation metric | | 12m forward P/E ratio | | | |
| Current: | 17.5x | 11.8x | 12.6x | 12.4x | 11.3x |
| *Expensiveness (last 10y percentile):* | *66%* | *6%* | *43%* | *13%* | *40%* |
| 3M change: | -0.8x | -0.4x | 0.1x | -0.2x | 0.1x |
| Average: | 17.3x | 14.4x | 13.1x | 13.9x | 11.8x |
| 95th: | 22.1x | 17.4x | 16.2x | 17.3x | 14.8x |
| 5th: | 13.8x | 11.7x | 11.4x | 12.0x | 10.1x |

*Source: Goldman Sachs, Datastream, I/B/E/S, iBoxx*

| | Equity | | | | |
|---|---|---|---|---|---|
| | S&P 500 | Stoxx 600 | MXAPJ ($) | Topix | MSCI EM ($) |
| Valuation metric | | Dividend Yield (NTM) | | | |
| Current: | 1.7% | 3.7% | 3.2% | 2.6% | 3.4% |
| *Percentile (-10y):* | *19%* | *52%* | *48%* | *88%* | *91%* |
| Average: | 2.0% | 3.6% | 3.1% | 2.3% | 3.0% |
| 95th: | 2.3% | 4.1% | 3.6% | 2.7% | 3.4% |
| 5th: | 1.5% | 3.0% | 2.4% | 1.9% | 2.5% |

*Source: Goldman Sachs, Datastream, iBoxx*

What is happening is the fading of the excessively high premium enjoyed by some companies exposed to "secular growth." And we're not just talking about the now infamous non-profitable techs, which have fallen by nearly 80% from their highs. Even some of the most popular stocks among retail investors (the FANG+) have fallen nearly 50% from their highs.

However, despite this year's correction, multiples of Growth stocks continue to remain largely higher than those of other markets. As a result, because of its large exposure to growth stocks, the U.S. market continues to be by far the most expensive one. At 17.5 times projected earnings for the next 12 months, the S&P500 trades at a premium of about 50% to other markets that are trading at about 12 times earnings. If we look at the dividend yield, it is only 1.7% for the S&P500, about half the dividend yield offered by other markets.

In summary, given how remarkable the move has been, Europe may have limited room to continue its recent trend of outperformance in the short term. Nonetheless, valuations are largely supportive, allowing Europe to outperform the U.S. over the medium to long term. Emerging markets also have the potential to outperform the U.S. in the years ahead. However, it is equally reasonable to argue that if the rest of the world outperforms the U.S., it will be primarily due to a return to more reasonable valuations for Growth stocks.

# Asset Allocation View

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

UNDER NEUTRAL OVER

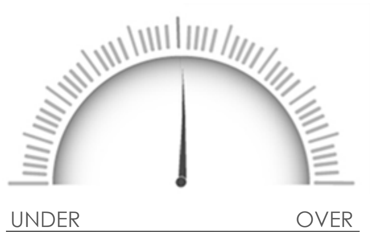
## Equity

### Developed Markets


We downgraded our recommendation back to **Slightly Underweight** on Developed Markets Equities. With the rebound of the past few weeks, equity markets seem to have fully discounted the better-than-expected U.S. inflation reading, the hoped change of stance by central banks and the Chinese government's long-awaited change of course on Covid-19 restrictions as well as on the real estate sector. The "Santa Claus rally" may have already occurred in November and further substantial increases may be difficult to achieve from here.

| US | Europe | Japan |
|---|---|---|
| NEUTRAL | NEUTRAL | NEUTRAL |

### Emerging Markets

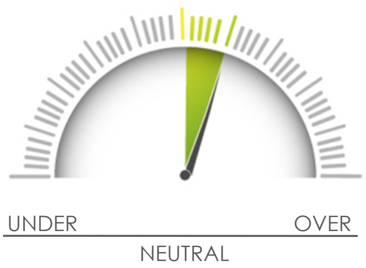



We maintained our recommendation on Emerging Markets Equities as **Neutral**. The expectation that the dovish pivot of the major central banks may actually materialize in the near future, and that the measures undertaken by China to support the real estate sector as well as the first signs of an easing of Covid-related restrictions may allow emerging markets to continue the rebound that started a few weeks ago.

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

# Fixed Income

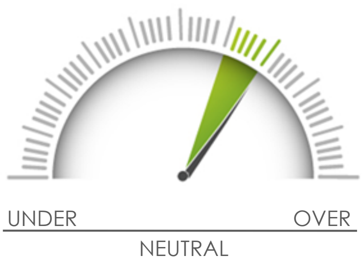
## Developed Markets Sovereign




We maintained our **Slightly Overweight** recommendation on Developed Markets Sovereign Bonds. The recent decline in rates, due to expectations of a dovish turn by central banks and positive U.S. inflation data, has made government bonds somewhat less attractive in absolute terms. However, considering that equity markets have also risen, government bonds continue to be considered relatively attractive, so the existing recommendation is maintained.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **EU Core** | = | **EU Periphery** | = | **US Treasury** | = | **Japanese JGB** | = |

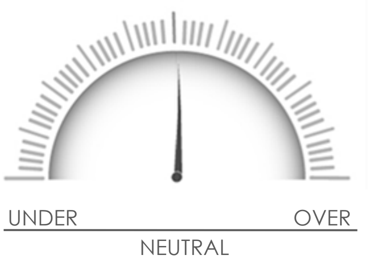
## Developed Markets Corporate




We reiterated our **Overweight** recommendation on Developed Markets Corporates. Given the high level of spreads, as well as the global economy that continues to remain resillient, the Iinvestment grade corporate bonds and Hhybrid bonds in particular are now an investment option to be seriously considered. We remain cautious on high yields due to their narrow spreads.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **IG Europe** | + | **IG US** | + | **HY Europe** | − | **HY US** | − |

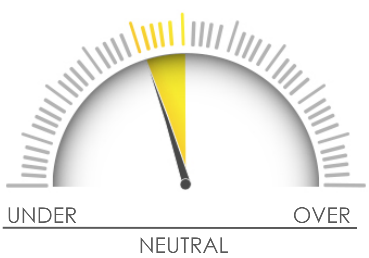
## Emerging Markets




We maintained our **Neutral** recommendation on Emerging Market bonds. Although developing market bonds may benefit from the dovish turn of some central banks, some caution is still warranted, because the Federal Reserve, the most important central bank for emerging markets, has reaffirmed its commitment to bring inflation under control. However, the asset class' significantly higher spread should reduce the risk of further declines. We continue to prefer emerging market bonds denominated in local currency.

| | | | | | |
|---|---|---|---|---|---|
| **Local Currency** | + | **Hard Currency IG** | − | **Hard Currency HY** | − |

# 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. Considering the first step towards a relaxation of the Covid-containment measures in China and the supportive measures for the Chinese real estate sector, it is possible that Energy and Industrial metals sectors may extend the rebound from the recent lows.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Precious** | = | **Energy** | + | **Industrial** | + | **Agricultural** | = |

# Currencies

The Committee confirmed its **Neutral** View on the US Dollar. The release of the CPI figures in the US, better than expected, has been the trigger for the long-awaited correction of the US Dollar. After a 7% retracement of the Dollar index, the greenback is unlikely to have much room to weaken further.

The view on the Euro is also **Neutral**. The recent rebound of the euro against the dollar has been significant, about 8 percent. Considering that Lagarde at the last press conference opened the door to a decrease in the pace of rate hikes as early as the next meeting despite double-digit (and rising) inflation, it is unlikely that the euro could appreciate much further.

The view on the **Chinese Renminbi** has been confirmed as **Neutral**. The first signs of an easing of anti-Covid measures in China and the approval of supportive measure for the real estate sector could prompt a return of interest of international investors for Chinese assets, whose valuations are at a deep discount compared to other developed or emerging countries.

On the **other emerging market currencies,** we maintain a **Neutral** stance considering on the one hand the risk of a possible global slowdown, and on the other hand the dovish turn by some Western central banks.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Euro** | = | **USD** | = | **CNY** | = | **Other EM** | = |