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
- St Louis
- Sydney
- Taipei

US EXISTING HOME SALES
The housing market is collapsing because of the Fed's hikes. Existing home sales are projected to fall by another 5%
21.12

US LEADING ECONOMIC INDICATOR
The LEI is expected to decrease by 0.5%, bringing the YoY change to -4%
22.12

JAPANESE CPI
Japanese inflation is expected to reach 3.9% in the headline and 3.7% in the core figure, putting further pressure on the BoJ to revise its zero-interest rate policy
23.12

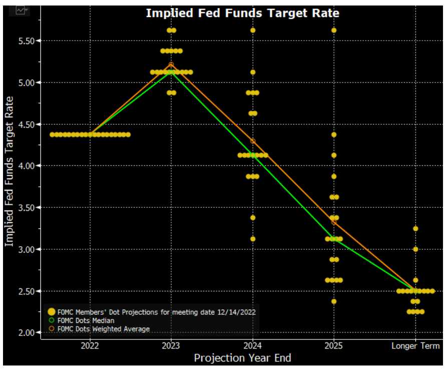
US PERSONAL SPENDING
In November, despite Thanksgiving, personal spending is expected to increase by only 0.2% MoM in nominal terms
23.12

ADAMANT

- **The Federal Reserve has confirmed its resolve to continue to raise rates and keep them at a restrictive level for as long as necessary**
- **For the first time, though, Powell seemed less hawkish than usual during the press conference. Is the Fed worried about the housing market or a recession?**
- **In contrast, the ECB surprised the market by announcing much tighter monetary policies than expected, spurring widespread corrections in both equities and bonds**

With last week's meetings, central banks ended a year that saw a record number of rate hikes around the world. As Bloomberg reports, "Bank of America Corp. has spotted around 275 rate hikes this year, enough for one every trading day, with just 13 cuts" and "more than 50 central banks have executed once-rare 75 basis-point increases, some joining the Fed in doing so repeatedly".

We begin by analyzing the Federal Reserve meeting. Before Powell's press conference, the new Summary of Economic Projections was released. Based on them, the projected GDP for 2023 was revised downward to 0.5%, which was 0.7% lower than in September, and a level close to stagnation. The median projection for unemployment shows that it is expected to reach 4.6% at the end of next year, almost 1% higher than the current level. Although Fed members continue to believe that risks to inflation are weighted to the upside, PCE is forecasted to fall to 3.1% in 2023, 2.5% in 2024 and 2.1% in 2025. Despite the economy is expected to slow, unemployment to rise and inflation to return toward 3% in 12 months, the Fed has raised the dots considerably since its last projection just three months ago. The FOMC median dots now project that Fed Funds will be at 5.1% (previously 4.625%), 4.1% (previously 3.875%), and 3.1% (previously 2.875%) at the end of 2023, 2024, and 2025, respectively.



Source: Bloomberg

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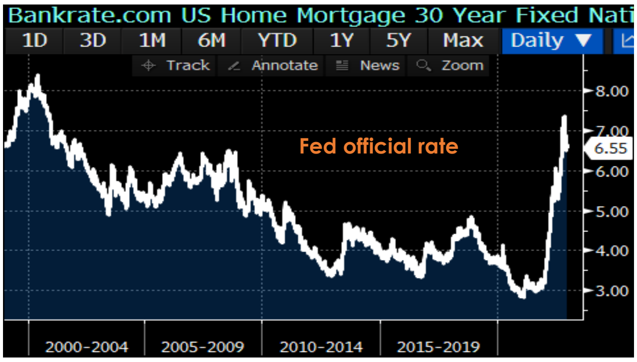
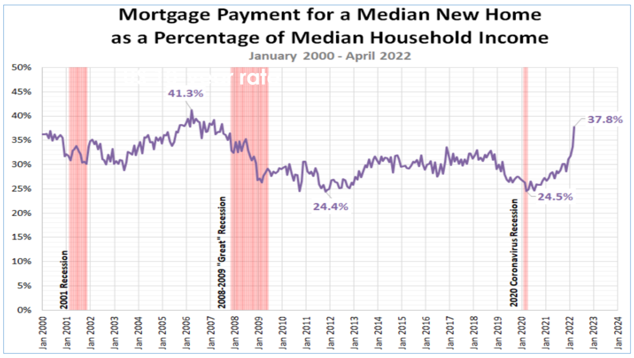




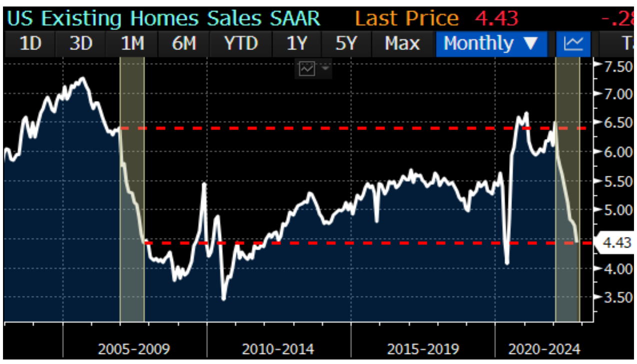
Source: Bloomberg

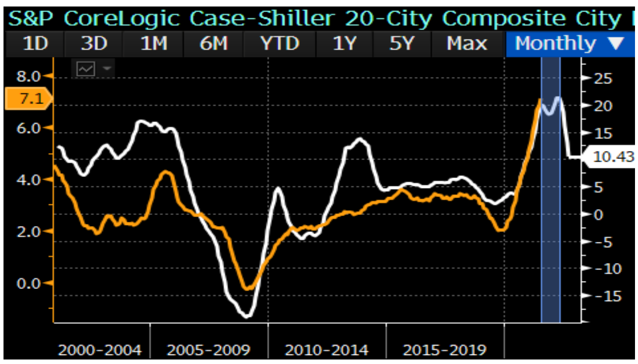
Although the dots, the projections, and the statement were decidedly hawkish, Powell used a slightly more conciliatory tone in the conference call. Yes, he reiterated the need to keep raising rates until they were in restrictive territory (read: above core inflation) and that this level would have to be maintained for some time. But he also emphasized several times how inflation in the last couple of months was falling, that this descent was what the FOMC had repeatedly hoped for, and that this made them more confident that they were better able to predict the evolution of the economy. The conclusion was always to reaffirm that by the end of 2023 inflation would be around 3%, almost as if to reassure the market that a pivot would occur next year.

For about a year, during the post-FOMC meeting conference calls, Powell always used much more hawkish words than expected, and than the FOMC minutes themselves, always taking the market by surprise. What is going on beneath the surface that for the first time, Powell seemed more dovish than the FOMC statement?

The development of the housing market offers the first explanation. Due to the Fed's restrictive policy, rates on 30-year mortgages have doubled since the end of 2021. This has driven the cost of mortgages as a percentage of disposable income close to the record of 2006. The unaffordability of homes was the tipping point that kicked off the housing crisis of the following years: sales of existing homes began to decline in 2006 then plummeted in 2007, but the repercussions on bank creditworthiness and stock markets were not fully felt until 2008.

As in 2006-2008, after peaking in early 2021, home sales began to collapse a year later. Both the magnitude of this year's decline and the time frame in which it occurred (just under a year) are equal to those of 2007. House prices, after rising on an annual basis by more than 20% (more than the previous record in 2005), have begun to fall in absolute terms since June, even though prices continued to rise by 10% YoY. In the graph below right, the year-on-year change in house prices (white) is compared with the change in rents ("owner equivalent rent", orange line, which accounts for about 1/3 of core inflation). Rents follow the dynamics of house prices, but with a delay, so the change in rents is reported with a lag of 16 months compared to the change in home prices. Based on this correlation, the peak in rents (and thus probably also in core inflation) should occur no later than nine months from now, thus allowing the Fed to start acting openly dovish in the second half of 2023.





Source: Bloomberg Source: Bloomberg

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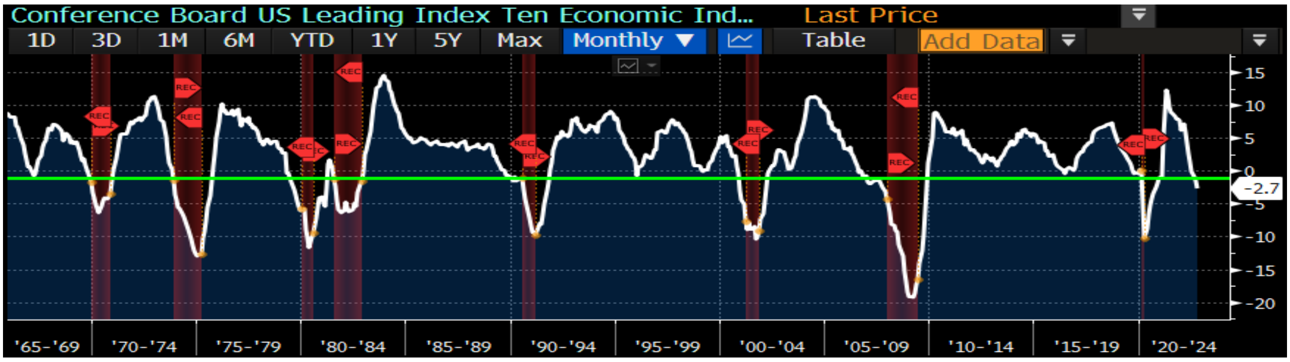

Source: Bloomberg

A second explanation may be the growing signs of an impending recession. However, the market consensus is that a recession will almost certainly occur, and if it does, it wont happen until the second half of the year. This is because data on consumption, employment, investment and orders continue to be strong. However, there are two different indicators that have always predicted any recession. One is the inversion of the yield curves in the 2-year vs. 10-year segment rather than 3-month and 10-year segments. Both are largely inverted today.

But while curve inversion is often mentioned, there is another indicator that has never been wrong in predicting a recession: the year-on-year change in the 10 leading economic indicators. Simply falling on a year-on-year basis is not enough: there are several instances in which this has happened and not been followed by a recession. Whenever the year-on-year descents below -1%, a recession has always begun with a lag of between 1 and 12 months. The indicator fell below -1% in September, and in the figure to be released this week it could approach -4% (from the current -2.7%).

Let us now turn to Europe, where we can say without hesitation that the latest press conference was by far the most hawkish in ECB history. As usual, immediately after the press conference "rumors" come out providing further insight into what happened at the meeting. Apparently, there was a clash between those who wanted a 75 bps increase and those who wanted a 50 bps increase. Probably the former included all the northern European countries, which on the one hand are the most prone to monetary austerity and on the other hand are also suffering the highest inflation (Lithuania 22.9%, Latvia 21.8%, Estonia 21.3%, Slovakia 15.4%, Austria 10.6%, Germany 10.0%, the Netherlands 9.9%, and Finland 9.1%), as they are most dependent on Russian gas.

Apparently the compromise was that in exchange for a hike of only 50 bps, it would be made clear in the press conference that rates must increase "significantly further" at a "steady" pace, meaning that a series of 50 bps hikes would follow, implying that ECB needs to do more on rates than market expects and that "we're not wavering, we're not pivoting". Lagarde also announced that QT would begin in March at a rate of 15 billion euros per month, catching the market by surprise as the announcement was not expected until March, with implementation beginning a few weeks or months later. The hawkish stance was also warranted by the ECB staff's macroeconomic projections, which now sees a sharp increase in inflation to 6.3% at the end of 2023 (from the previous 5.5%), and 3.4% in 2024 (from 2.3%) and to 2.3% in 2025. This means that inflation expectations are at risk of no longer remaining anchored, if the CPI needs 3 years to return to the ECB's target.

On the economy, the ECB expects the GDP to grow only 0.5% in 2023, about half of what was previously expected, and Lagarde added that there is a risk that Europe will enter recession as early as this quarter. Nevertheless, to bring inflation back under control, Lagarde said it is necessary to make rates sufficiently restrictive to dampen demand.

Such unexpectedly aggressive attitude has forced the market to reposition itself. Interest rates have risen across the entire curves, albeit more pronouncedly on the short end, and peripheral bonds have experienced a violent widening of spreads (about 30 bps).

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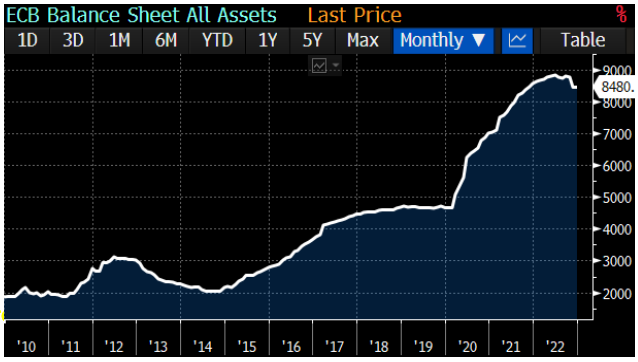


Source: Bloomberg

It is highly likely that the widening will continue, considering that if the ECB really wants to reduce its balance sheet (which is now 65% of European GDP, nearly twice the Fed's 34%), its firepower would be very large.

The European stock market is also likely to be at risk of a correction. In addition to coming from a major outperformance relative to the rest of the world, it faces a central bank that is very determined to raise rates and Europe is likely to face an imminent recession. Only Euro seems poised to benefit from this policy shift.

Central banks' 2022 thus closes without giving investors much reason to hope for a less restrictive stance, at least in the very short term.

Asset Allocation View

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

− UNDER = NEUTRAL + OVER

Equity

Developed Markets

We maintained our **Slightly Underweight** recommendation on Developed Markets Equities. As discussed in the prologue, the expectation of a pivot, which was the foundation of the stock market rally continues to be disproven, at least for the moment. Moreover, central banks have revised growth expectations downward, noting the growing risk of recession. We, therefore, continue to advise a cautious stance on equities, and especially European stocks, which may give back some of the recent outperformance because of the ECB's surprisingly aggressive stance.

US	=	Europe	−	Japan	=

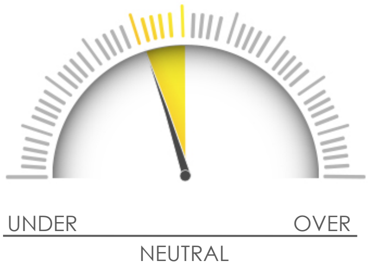
Emerging Markets

We maintained our recommendation on Emerging Markets Equities as **Neutral**. Despite the substantial rebound achieved by emerging countries over the past month, growing evidence that China is effectively abandoning its zero-Covid policies and implementing measures to support the real estate sector may allow emerging markets to continue to outperform.

Asia ex-Japan	=	EEMEA	−	LATAM	=

Fixed Income

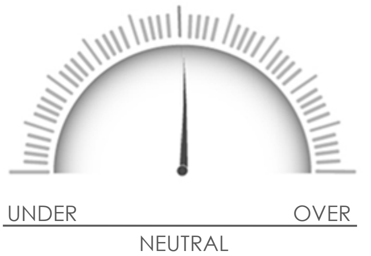
Developed Markets Sovereign



We maintained our recommendation on Developed Markets Sovereign Bonds to **Slightly Underweight** after the two-notch downgrade of the last report. The Fed and the ECB have both confirmed that rates have yet to rise substantially from the current levels, and then stay there for an extended period of time. Given the rally in prices (decline in rates) over the past two months, the downside risk for bonds is once again relevant. We remain particularly negative on European bonds, considering that the ECB has clearly caught the market by surprise with a very aggressive stance and the still ample gap between inflation and benchmark rates.

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

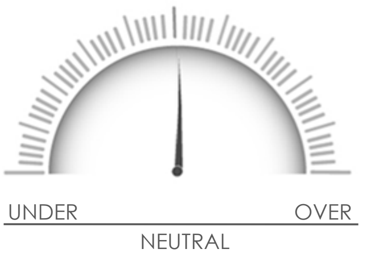
Developed Markets Corporate



We have further reduced our recommendation on Developed Markets Corporates to **Neutral**. The downgrade is a result of the significant spread compression that has occurred over the last two months, as well as the decline in risk-free rates and the central banks' affirmation of their hawkish stance. In terms of corporate bonds, we still continue to favor investment grade bonds over high yields because the latter's spreads are perceived to be too low.

IG Europe	IG US	HY Europe	HY US
+	+	−	−

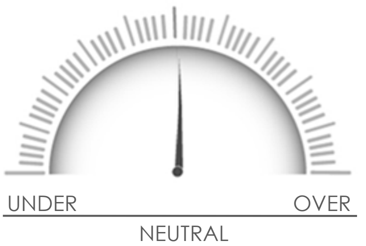
Emerging Markets



We maintained our **Neutral** recommendation on Emerging Market bonds. While emerging market bonds could benefit from a dovish pivot by central banks (which continues to be missing for the time being), they would also be exposed to downside risk in the event of a global slowdown or recession. Within the asset class, local currency bonds continue to be preferred.

Local Currency	Hard Currency IG	Hard Currency HY
+	−	−

Commodities



We increased our recommendation on Commodities to **Neutral**. Energy and industrial commodities should benefit from the increasingly tangible easing of Covid-related restrictions in China as well as from measures to support the Chinese economy. Precious metals could benefit from a further weakening of the dollar, and they can serve as portfolio hedges in case of unexpected troubles.

Precious	Energy	Industrial	Agricultural
=	=	=	=

Currencies

The Committee downgraded its view on the US Dollar to **Neutral with a bearish bias**. Although the Federal Reserve has confirmed its hawkish stance, it is expected to be the first central bank to slow the pace of rate hikes in 2023, which could lead to further weakness for the greenback.

The view on the Euro has been upgraded to **Neutral with a bullish bias**. The particularly aggressive stance of the ECB regarding rate hikes and QT could enable Euro to regain further ground against the dollar and other major currencies.

The view on the **Chinese Renminbi** has also been increased to **Neutral with a bullish bias**. The easing of Covid measures, the approval of measures to support the real estate sector, and the inflows of foreign investors repositioning themselves on China will likely keep the Renminbi strong.

On the **other emerging market currencies,** we maintain a **Neutral** stance taking into account both the risk of a potential global slowdown and the potential weakness of the US dollar.

Euro =	USD =	CNY =	Other EM =