AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

06.03.23

Main Events

GERMANY RETAIL SALES
Retail sales are expected to rise 2.2% MoM, but despite this they would still be down 5% from a year earlier

US PAYROLLS
Another strong employment data could prompt the Federal Reserve to raise 50 bps at its next meeting

US CPI
In addition to the employment data, the CPI is the other data that could influence the Fed's decisions later this month

ECB MEETING
The ECB staff's macroeconomic projections will be updated, which should shed light on the trajectory of future rate hikes in Europe.

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

ON THE RISE!

- **Consumer price indexes and measures of inflation expectations have increased all over the world in the last month**
- **Hopes of an imminent end to the rate hike cycle by central banks have been dashed, and expectations about where official rates will be a year from now have risen by one percentage point**
- **Stock markets continue to remain stable, hoping that China's strong recovery will counterbalance the ever higher level of interest rates**

Financial markets started 2023 on a frothy note thanks to expectations of a rapid comeback of inflation. Such hopes had been fueled by data on European inflation (released right at the beginning of January) and then U.S. inflation, both of which had fallen more than expected.

In the past month, almost all of the data on consumer prices and inflation expectations from around the world have instead given the opposite signal, suggesting that the decline in inflation may not prove to be such a swift and straight path.

In the previous report, in addition to discussing how strongly the U.S. economy was still growing, we had already discussed how the latest CPI in the U.S. had shown a reduction in the headline version, but the core version was more resilient, mainly due to the "owner equivalent rent" item (one-third of the core CPI basket), which continued to increase and touched 8% YoY.

Staying in the U.S., PCE (the Fed's preferred measure of inflation) climbed to 5.4 percent, up from the previous 5.3 percent and well above the expected 5.0 percent. The month-on-month reading was up 0.6%, much higher than the roughly 0.2% that would be needed for inflation to return toward 2% year-on-year. Even more remarkable was the core PCE, which also rose by 0.6% MoM, bringing the year-on-year figure up from 4.3% to 4.6%

(continued)

Source: Bloomberg

Source: Bloomberg

At the beginning of March, the ISM manufacturing "prices paid" sub-index inched back above the 50 mark, which means that the perception (this is a sentiment indicator, not statistical data) of manufacturing professionals is that prices are beginning to rise moderately again (a reading above 50 indicates an increase), whilst the PMI Services price paid sub-index stayed as high as 65.6.

Finally, last Thursday, unit labor costs rose 3.2 percent last quarter, much more than the 1.1 percent of the previous projection. As a result, productivity only rose by 1.7 percent QoQ, less than the 3.0 percent expected. On a YoY basis, productivity in the United States fell 1.8 percent, making 2022 the worst year on record for this metric.

Let us now turn our attention to Europe. Consumer prices in Germany increased 9.2 percent to 9.3 percent year-on-year in February. The most significant figure was the month-on-month change, which increased 1.0% in February after increasing by 0.5% in January. If inflation rose 1.5 percent in the first two months of the year, it is unrealistic to expect inflation to reach the levels desired by the ECB and financial markets before 2024 (when these two months will be excluded from the year-on-year reading). In France, the CPI increased 0.2 percent to 7.2 percent, while the cumulative increase in the first two months of the year was 1.4 percent.

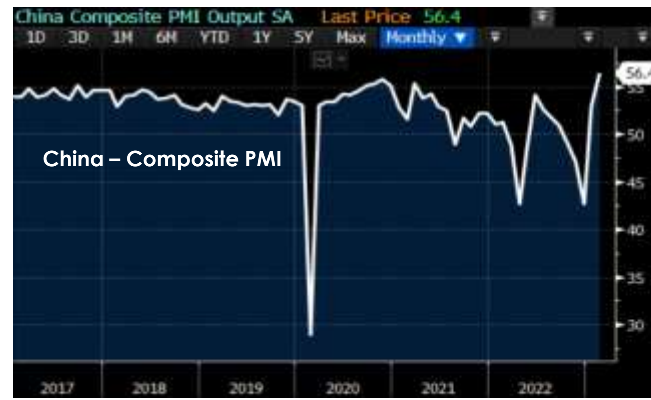
As for the Eurozone as a whole, headline inflation data were more muted. Overall inflation fell from 9.2 percent in January (after a massive upward revision from the first estimate of +8.5 percent) to 8.6 percent in February. February's monthly increase was +0.8%, after -0.4% in January. Thus, for the whole of Europe, inflation appears to be much more "subdued" than for its two major economies (unless the statistics are revised upward next month, as they were this month). But the real surprise was the EU core inflation rate, the most relevant for the ECB, which continued to rise undaunted from 5.3 percent to 5.6 percent, a new all-time high. So right now the United States and the European Union have exactly the same core inflation rate (5.6 percent), but while in the United States it has been stable or trending down for almost a year, in Europe it is still rising steadily, as can be appreciated from the graph above.

In the United Kingdom, average regular pay (i.e., weekly earnings ex-bonuses, the "sticky" component of labor costs) increased at an annual rate of 6.7 percent, approaching the highs of the post-lockdown period and well above the level of the past 20 years. In addition, although the U.K. CPI (which does not take into account housing costs) fell from 10.5 percent to 10.1 percent and the core CPI from 6.3 percent to 5.8 percent, the Retail Price Index (which includes housing costs such as rents and mortgage payments) remained stable at 13.4 percent.

Source: Bloomberg

(continued)

Source: Bloomberg



Source: Bloomberg

Finally, core inflation in Japan is also rising, reaching 4.2 percent year on year, the highest level since the early 1980s, while labor costs (labor cash earnings) are rising 4.8 percent year on year, the highest level in nearly 30 years.

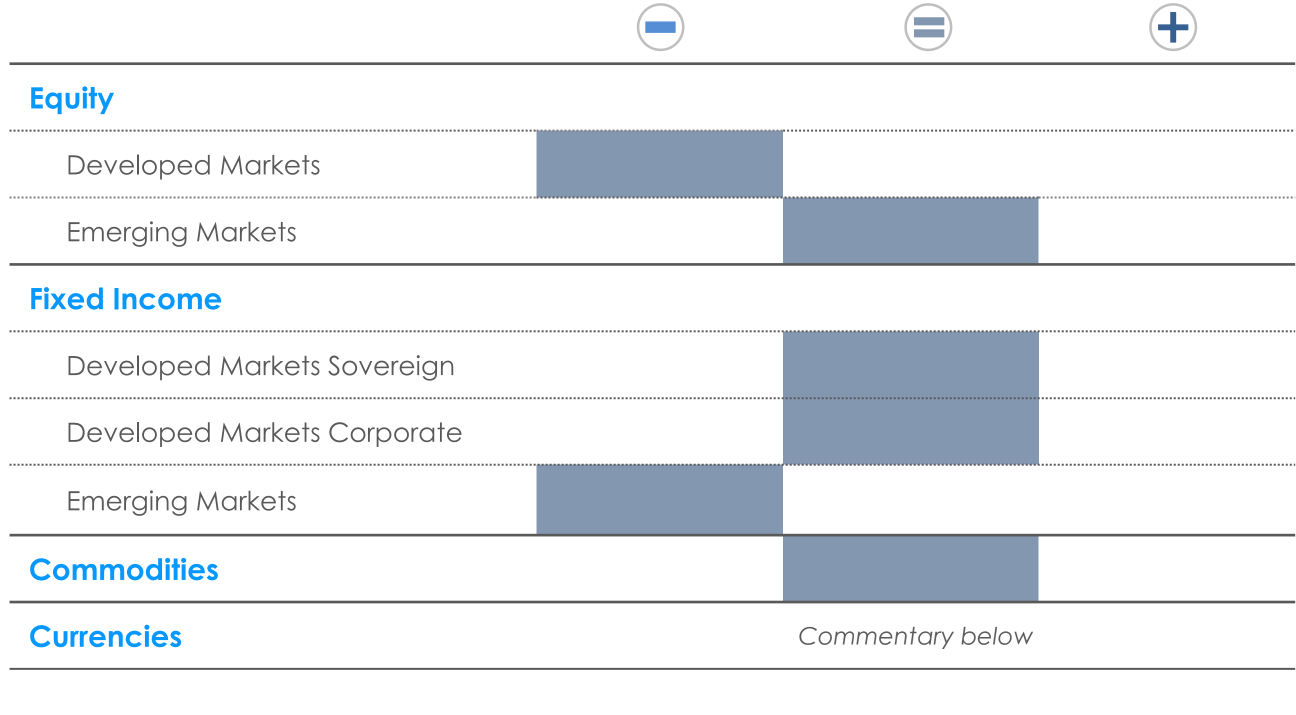
All of this evidence that inflation is falling less than expected or rising again (even if these are normal hiccups in the disinflationary process) has forced markets to revise their rosy expectations for a rapid drop in interest rates in the coming months.

As if that were not enough, further complicating the picture for central banks will also be China's recovery. As predicted last year, the lifting of the COVID-Zero restrictions was first followed by a surge in contagions that caused a temporary slowdown in production as a major part of the population was unable to work. The spike in infections, which occurred just before the Chinese New Year, allowed China to achieve herd immunity.

The sudden availability of its entire workforce, the consumption boom that followed the end of the restrictions (similarly to what happened in Western countries), and the approval of monetary and fiscal stimulus (including to the real estate sector) resulted in a vibrant growth of the economy, so much so that China's PMI index rose to 56.4, the highest level since the inception of the time series.

Therefore, the global economy may not slow down as much as would be necessary to bring down inflation, leading to higher commodity prices. The likely consequence is that central banks may have to raise rates even higher than previously assumed. The fixed income market has already adjusted to the new scenario, as in the last month alone the implied market rates for January 2024 have already risen by a full percentage point in the United States and a little less in Europe. Equity markets, on the other hand, have remained unfazed, probably assuming that the negative news of higher rates can be counterbalanced by higher earnings due to the strength of the economy.

Asset Allocation View



	Under (−)	Neutral (=)	Over (+)
Equity			
Developed Markets	■		
Emerging Markets		■	
Fixed Income			
Developed Markets Sovereign		■	
Developed Markets Corporate		■	
Emerging Markets	■		
Commodities		■	
Currencies		*Commentary below*	

UNDER NEUTRAL OVER

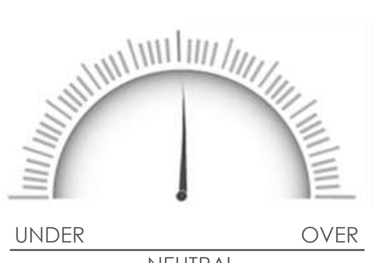
Equity

Developed Markets

We kept our **Slightly Underweight** recommendation on Developed Markets Equities. We confirm our view that equity markets are expected to remain range-bound in the near future, and are currently trading in the upper end of the trading range. On the one hand, macroeconomic data show that global economies remain fairly strong, which is positive for equities; but on the other hand, growing evidence that a more resilient inflation will require higher rates is a headwind. In light of the above, the Committee maintains a preference for cyclical stocks over defensive stocks, as there are still no signs of an economic slowdown.

US	Europe	Japan
Neutral (=)	Neutral (=)	Neutral (=)

Emerging Markets

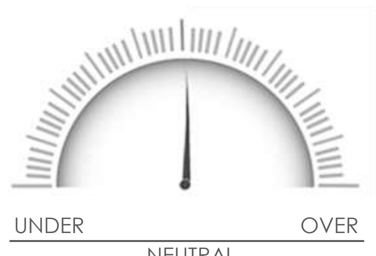


We maintained our **Neutral** recommendation on Emerging Markets Equities. Record-breaking Chinese PMI data suggests that China is recovering strongly after the end of the Covid-related restrictions, although the 5 percent GDP growth target set for 2023 has somewhat cooled enthusiasm. Overall, we continue to view China and emerging markets as the place with the best valuations and perspectives. Therefore, we recommend continuing to accumulate emerging markets gradually.

Asia ex-Japan	EEMEA	LATAM
Neutral (=)	Under (−)	Neutral (=)

Fixed Income

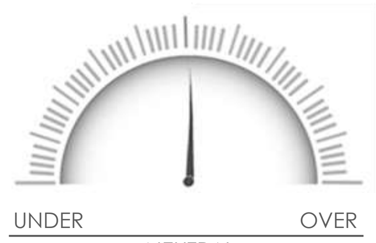
Developed Markets Sovereign



We maintained our **Neutral** recommendation on Developed Markets Sovereign Bonds. Expectations about the terminal rate have reached new highs, above 5.5 percent in the U.S. and just above 4 percent in Europe. As a result, market rates have rebounded and returned to attractive levels. However, given that there is still room for yields to rise due to the upward surprises in inflation data discussed in the prologue, we maintain our neutral recommendation for the time being. We will likely turn positive at slightly higher levels than now, and/or if central banks pivot in March meetings.

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

Developed Markets Corporate



We have kept our **Neutral** recommendation on Developed Markets Corporates. Spreads are at acceptable levels for investment grade bonds, whilst too narrow for high yield bonds, especially in the event of a marked slowdown or outright recession should materialize. Furthermore, unless global inflation data continues to surprise to the downside, the potential for further reductions in the risk-free rate is quite limited.

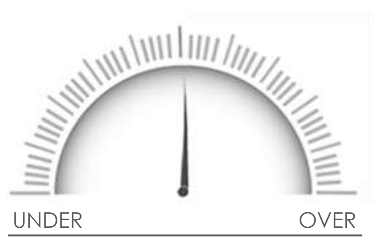
IG Europe	+	IG US	+	HY Europe	−	HY US	−

Emerging Markets

We kept our recommendation on Emerging Market bonds as **Slightly Underweight**. The recent spread compression, as well as the possibility that central banks in Western countries will raise interest rates to even higher levels than previously anticipated, suggest that the asset class should be approached with caution.

Local Currency	+	Hard Currency IG	−	Hard Currency HY	−

Commodities



We maintained our **Neutral** recommendation on Commodities. Precious metals could rebound when central banks will finally halt their hiking cycle, and they can serve as portfolio hedges in case of unexpected issues, especially those that could arise from geopolitical tensions.

Precious	+	Energy	=	Industrial	=	Agricultural	=

Currencies

The Committee confirmed its **Neutral** view on the US Dollar pending the March Fed meeting, where updated dot plot projections and Powell's remarks after the FOMC will determine the direction of the greenback.

The view on the Euro remains **Neutral**. Upward surprises in the EU CPI data could trigger a more aggressive stance by the ECB at its next meeting, where updated economic and inflation projections will be released as well. As the ECB has been rather unpredictable in its communications and decisions in recent months, we prefer to wait for the meeting to reassess our stance on the EU common currency.

The view on the **Chinese Renminbi** is also confirmed **Neutral**. Data indicating a stronger-than-expected economic recovery may offset fears about geopolitical tensions experienced in recent weeks.

On the **other emerging market currencies,** we maintain a **Neutral** stance.

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