AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

15.05.23

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

18.05 — US LEI
The leading economic indicator is expected to fall another 0.6 percent, the 13th consecutive monthly decline

19.05 — JAPAN CORE CPI
Could the attainment of 4.2%, the highest level since 1981, potentially expedite a policy review under the tenure of the new Governor Ueda?

23.05 — GLOBAL PMI
How much will the combined effects of higher rates and tighter credit standards affect confidence indices?

25.05 — US JOBLESS CLAIMS
Will continuing claims keep rising from the September lows, foreshadowing a weaker labor market and possibly even a recession?

BUMPY ROAD AHEAD

- **The Fed has finally opened the door to the possibility that the fastest and sharpest rate hiking cycle in a decade may be over**
- **However, there are increasing signs that a slowdown or outright recession could materialize in the coming months**
- **Weighing on the outlook are the ongoing banking crisis, the softening of credit card spending, the increase in jobless claims, and the risk of a government shutdown**

As expected, the Federal Reserve altered its stance in the FOMC meeting earlier this month, removing the sentence from the statement that indicated the appropriateness of further policy tightening. As Powell stated during the press conference, "We're no longer stating our anticipation of additional rate hikes, so our decisions will be guided by the incoming data on a meeting-by-meeting basis."

Powell has strived to strike a delicate balance between warning that there could be further hikes if inflation does not align with expectations, leaving the door open for the possibility of maintaining the status quo or lowering rates. The latter option is the least likely, but by basing monetary policy on the evaluation of incoming data in each meeting, it cannot be categorically ruled out that a rate cut may eventually be possible.

However, the prevailing scenario remains that of maintaining rates at their current level for an extended period. Indeed, Powell said that a 500 basis point hike over 14 months, coupled with one-year inflation expectations remaining at 3 percent, implies that real rates stand at 2 percent, which is "meaningfully above what most people [...] would assess as the neutral rate. So policy is tight." He added that one must consider that the tightening of lending standards by banks and the ongoing QT are contributing to even tighter monetary conditions. Using Powell's words, "we're trying to reach -- and then stay at for an extended period -- a policy stance that is sufficiently restrictive to bring inflation into two percent over time."

(continued)

Source: Bloomberg, SLOOS

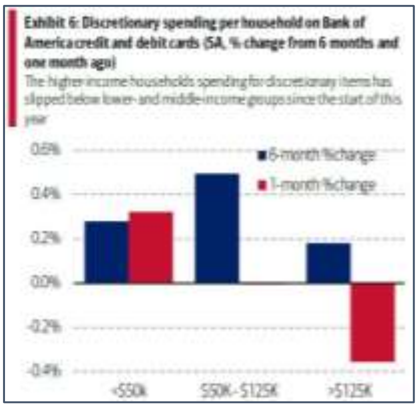
Source: Bloomberg, SLOOS

This tweak in Fed policy is more than appropriate, considering the increasingly concrete risk of incurring a recession in the coming months.

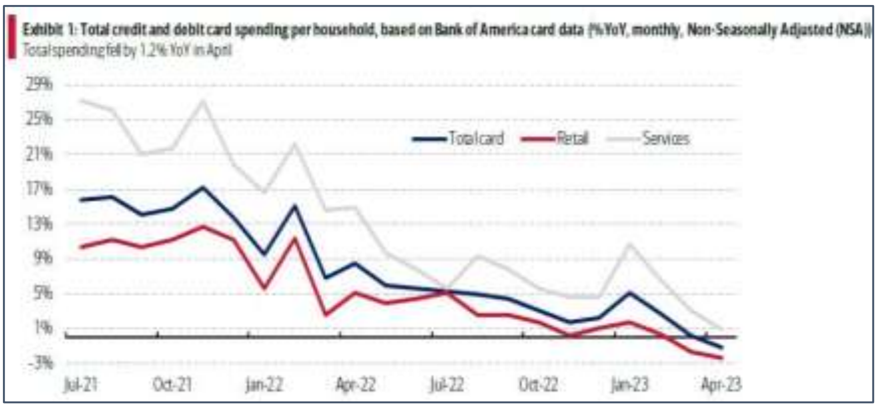
Starting with the factors cited by Powell himself, the Senior Loan Officer Opinion Survey (SLOOS) for the first quarter of 2023, which is only partially affected by the failures of Silvergate Bank and Silicon Valley Bank, confirms that both the tightening of credit standards for business and the collapse in demand for new loans from businesses were trends that had been in place already before the banking crisis hit in March. Whenever such dynamics have occurred in the past, a recession (indicated by the red area in the graph) has typically followed shortly afterward. Realistically, the ongoing banking crisis should lead to a further deterioration of both of these statistics in the coming months, thereby increasing the risk of a recession.

Another risk factor is the resilience of the consumer. We have previously discussed how excess savings due to the 2020-2021 fiscal stimulus are expected to run out by mid-2023, thus eroding the ability to spend. This phenomenon seems to be already underway at least for households with the highest incomes (>$125k), which are also those with the greatest elasticity in consumption, particularly discretionary consumption. The numerous layoffs announced by technology companies in recent months may be also contributing to this decline in spending for the highest income brackets, given that employees of technology companies tend to earn above-average salaries. On the other hand, consumption appears to be relatively more stable for low-income households, which is expected since the elasticity of spending tends to be lower as income decreases.

Similar indications can be obtained by looking at Bank of America's credit and debit card data, published by BofA itself. The annual change in spending slipped into negative territory in April 2023, despite the fact that this is nominal and not real (inflation-adjusted) data. The dynamics observed by BofA's cards may not necessarily reflect the average U.S. consumer. However, it is important to note that the GDP data are calculated on a real basis (net of inflation) rather than on a nominal basis. Taking this into account, these indications further strengthen the hypothesis that a slowdown or contraction in the economy cannot be ruled out for the months ahead.



Source: Bank of America



Source: Bank of America

(continued)

Source: Bloomberg Source: Bloomberg

Let's now have a look to the labor market. We usually read that employment data in the United States remains remarkably robust, despite the significant layoffs announced by tech companies as mentioned earlier. The unemployment rate at its lowest level since 1969. However, the unemployment rate is normally a lagging indicator of a recession, meaning it starts to rise when the recession is almost underway.

A more timely indicator for signaling the risk of a recession is the number of continuing jobless claims. As shown in above graph, continuing jobless claims tend to steadily decline from the end of one recession to the beginning of the next. It is evident from the graph that unemployment claims bottom out a few months earlier (usually 8-12 months earlier) than the unemployment rate. In this respect, therefore, continuing jobless claims are a leading indicator and the unemployment rate a lagging indicator.

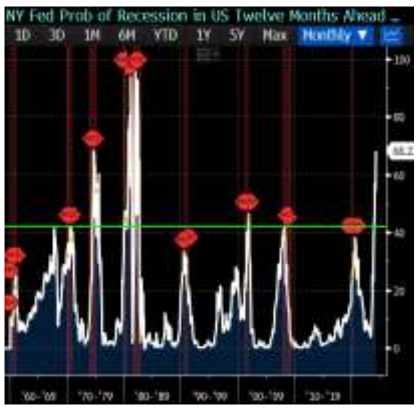
As is evident from previous experience (1987, 2006), the fact that continuing jobless claims bottom out is a necessary but not sufficient condition for a recession to materialize shortly thereafter. The beginning of a considerable rise from the low in continuing unemployment claims is the necessary condition for a recession to occur, as seems to be happening today. The unemployment rate, which is still falling, has not yet been able to capture this dynamic.

What has been discussed so far reinforces the indications of other metrics that in the past have always been able to accurately predict a recession with 100 percent reliability: the inversion of the curve between the 2- and 10-year (similar indications are also obtained from the inversion of the curve between 3 months and 10 years, which today stands at a record low of -181 bps), and a year-on-year change in the 10 leading economic indicators of less than -1 percent (today at -7.8 percent).

We also add to the list the probability of recession for the next 12 months, as calculated by the New York Federal Reserve. Every reading above 42 percent has actually always been followed by a recession.

Source: Bloomberg

Source: Bloomberg



Source: Bloomberg

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Further complicating matters is the issue of the debt ceiling. We will not dwell on what might happen in the very remote event of a U.S. sovereign default. We want to assume, at least for the moment, that the debt ceiling will be raised without triggering a default (even at the cost of Biden invoking the 14th Amendment).

What could happen with a much higher probability is that we would face another government shutdown. Recall that during a government shutdown, non-essential government operations remain closed and government employees are furloughed. During this period, state employees do not receive any pay. However, this is not a permanent loss, only a temporary deferral, since as soon as the debt ceiling is raised and the government funded again, wages are paid back in full. Nevertheless, it is reasonable to expect that if a government shutdown occurs, consumption will suffer, and this could become the classic straw that breaks the camel's back.

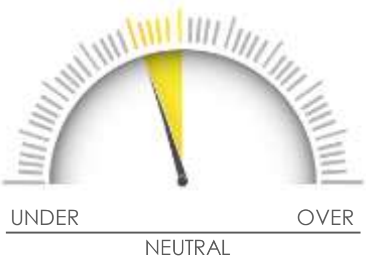
Asset Allocation View

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

− UNDER = NEUTRAL + OVER

Equity

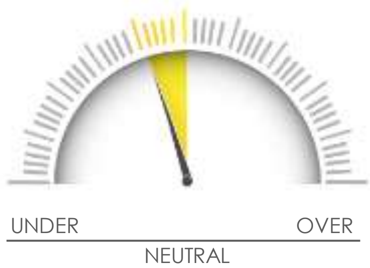
Developed Markets



We maintained our **Slightly Underweight** recommendation on Developed Markets Equities. On the one hand, after the Fed confirmed that the hiking cycle is likely over, there is room for a further modest surge in equity prices. On the other hand, as was mentioned in the prologue, valuations remain high and the probability of recession is increasing. We therefore continue to believe that a cautious approach should be maintained over the medium term.

US	=	**Europe**	=	**Japan**	+

Emerging Markets



We kept our recommendation on Emerging Markets Equities unchanged at **Slightly Underweight**. Emerging markets continue to trade at far lower multiples than developed countries and could benefit from the end of the Fed's rate hike cycle, but they are also more sensitive to a potential global slowdown or outright recession. We downgraded the Asia ex-Japan region to Neutral in view of the much weaker-than-expected economic numbers emerging from China, which signal that the long-awaited recovery after the end of the lockdown is not gaining traction.

Asia ex-Japan	=	**EEMEA**	−	**LATAM**	=

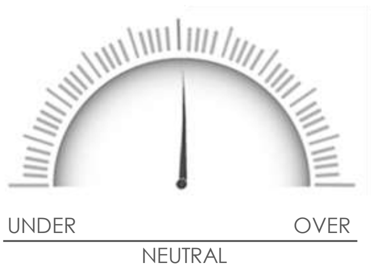
Fixed Income

Developed Markets Sovereign

We kept our **Slightly Overweight** recommendation on Developed Markets Sovereign Bonds. The Federal Reserve is no longer committed to raising rates further, taking time to assess the combined effects on the economy of higher rates and the continuing tightening of credit standards by commercial banks. As a result, monetary policy should no longer be a headwind for Treasury bonds, but there may still be some volatility if the U.S. debt ceiling impasse is not resolved in a timely manner. Only the ECB has committed to continue raising rates for at least a few more meetings, so there are still some dangers exposing EU bonds to downside risks.

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

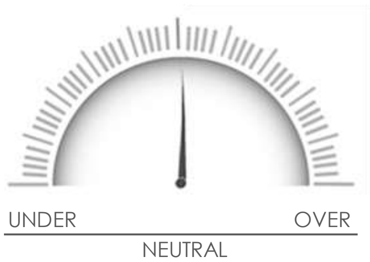
Developed Markets Corporate



We maintained our **Neutral** recommendation on Developed Markets Corporates, as the end of the US hiking cycle largely eliminates duration risk. We remain slightly more cautious on corporate bonds than sovereign bonds, owing to spreads that remain quite narrow in light of the mounting risks of a slowdown or recession, albeit we see some chances in subordinated or hybrid bonds. We continue to see high yield corporate bonds as having the poorest risk/return outlook.

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

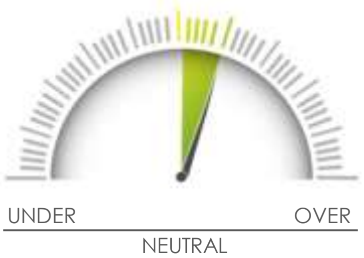
Emerging Markets



We maintained our **Neutral** recommendation on Emerging Market bonds. The likely end of the Fed's rate hiking cycle and the significant widening of spreads in recent months should offset the mounting recession risk globally.

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

Commodities



We maintained our **Slightly Overweight** recommendation on Commodities. In addition to being a safe-haven asset in times of heightened geopolitical tensions, precious metals could be supported by the debt ceiling issue, the ongoing banking crisis, and the end of the Fed's rate hike cycle. In contrast, we are more bearish on non-precious commodities, as the increased risk of a global slowdown or recession could weigh on commodity prices. Only energy commodities could benefit from potential new production cuts by OPEC, which seems to be aiming at keeping oil prices not far from $80 to $90 a barrel.

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

Currencies

The Committee confirmed its **Neutral** view on the US Dollar. The Federal Reserve meeting ended in line with market expectations. Only the Fed's apparent intention to debunk hopes of an impending series of rate cuts seems to have given the dollar the strength to make the modest comeback of the past few days, but our expectation is that the greenback may remain rangebound.

The view on the Euro is also **Neutral** as the ECB also didn't deviate from market expectation. The rally of the euro in the past months may leave the currency exposed to the risk of a short term retracement, like the one that has taken place in the past two weeks.

The view on the **Chinese Renminbi** is **Neutral with a bearish bias** in consideration of the much weaker-than-expected economic and inflation data in China, which suggest that some monetary easing may be needed to support the economy.

On most of **other emerging market currencies** the view is **Neutral**, but we are more constructive on Latin American currencies as they could benefit from some of the highest real rates in the world.

Euro	=	USD	=	CNY	=	Other EM	=