AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

29.05.23

Main Events

CHINA PMI	EUROZONE CPI	US PAYROLLS	EU RETAIL SALES
A further drop in Chinese PMIs could exacerbate negative sentiment against the country	As in previous months, inflation is expected to decline due to the drop in gas prices, but core inflation may remain stable	A stronger-than-expected figure could prompt the Fed to consider another rate hike at its June meeting	Macroeconomic data in Europe have generally been worse than expected recently, pointing to a poor retail sales figure
31.05	01.06	02.06	06.06

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 DEBT CEILING

- **Apparently, a bipartisan agreement has been reached to raise the debt ceiling before June 5, the date when a U.S. technical default could have occurred**
- **The replenishment of the Treasury's general account, in conjunction with the Fed's QT, will lead to a significant drain of liquidity in the coming months**
- **This could have negative consequences for financial markets, as well as reignite the decline in bank deposits**

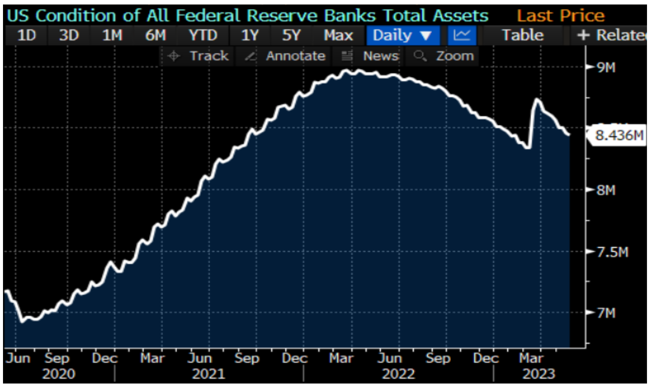
As usual, the debate over raising the debt ceiling in the United States seems to be ending favorably, exactly on the heels of the date on which a sovereign default is likely to occur. Neither party wants to take the risk of being associated with such an event, which could have catastrophic consequences for the country. This is even more true considering that we are a year and a half away from the next elections, and no member of Congress is willing to risk their seat.

Since the focus of this report is to analyze the consequences for the financial markets, we will not delve into the details of the agreement but simply summarize the most salient points. The agreement suspends the debt ceiling until January 1, 2025, immediately after next year's elections and just before the new president takes office.

The suspension of the debt ceiling means that until January 1, 2025, there is no debt ceiling in place. The debt ceiling will go back into effect on January 1, 2025, and will correspond to the value of the U.S. public debt on that same day. This means that Biden will no longer have to face a debt ceiling debate again as long as he is president and will pass the responsibility to the next administration. The new administration will have a few weeks or months before risking a sovereign default again, since the Treasury General Account (or "TGA") at the Fed will have a positive balance that can be used by the Treasury to meet its obligations.

(continued)

Source: Bloomberg



Source: Bloomberg

The compromise includes a number of spending cuts (mainly in military spending, food stamps, and funds for the IRS) that are smaller than Republicans had hoped for and less deep than Democrats had feared, allowing both sides to present the deal as a victory (preserving fiscal stability for Republicans and preserving spending for low-income workers for Democrats). The impact on the U.S. deficit is also discordant, with Republicans projecting savings of two trillion over the next ten years, while Democrats expect only half that amount.

Regardless of which estimate is correct, what matters is that the agreement will lead to a reduction in government spending. Since government spending is one of the components of GDP, this means that in the coming quarters, the government will have a recessionary impact on the economy: the reduction in government spending corresponds to lower demand, and since demand = supply = GDP, the impact on GDP will be negative. Considering the growing recession risks that are already emerging and that we discussed in the previous report, this is certainly not the best timing to implement a cut in government spending.

But let us now turn to the direct consequences for financial markets. As can be seen from the chart above, since the debt ceiling was reached, the TGA balance has steadily declined, from about $500 billion in February to almost $62 billion today. A drop in the TGA has the same effect as QE: liquidity in the system increases. Taking the period under review as an example, when a government bond came to maturity, the U.S. Treasury simply redeemed it since it could not issue new debt. In practice, the Treasury withdrew a government bond from the system and injected liquidity (the value of the principal).

At about the same time, the Federal Reserve also had to inject liquidity into the system because of the banking crisis that started in March. After the failure of Silicon Valley Bank, the Fed had to create a new program, the "Bank Term Funding Program" (BTFP), which allows U.S. banks to borrow unlimited amounts at favorable terms. As can be appreciated from the second chart, this program resulted in the Federal Reserve's balance sheet expanding by about $400 billion, temporarily reversing the downward trend due to the ongoing QT. As argued in previous reports, the increase in liquidity due to the BTFP does not have the same direct effects on the markets as a full-blown QE since financial assets are not being bought in the market, but rather distressed banks are being supported. Nevertheless, in the absence of the program, banks would somehow have had to raise liquidity in the market in equivalent amounts. Thus, it can be said that the BTFP also had, in some ways, an effect similar to a QE.

Overall, in just over three months, the market has benefited from unexpected liquidity injections of nearly $900 billion, which have more than offset the approximately $300 billion of QT ($95 billion per month) that the Fed has continued to implement in the meantime. In the past four months, therefore, the market has enjoyed net liquidity injections of about $600 billion.

But now that an agreement seems to have been reached on raising the debt ceiling, this trend will be reversed. In the last instances where the debt ceiling was increased, the government brought the TGA back to values between $500 billion and $1 trillion.

(continued)

Projections circulated by the government itself in early May (https://home.treasury.gov/news/press-releases/jy1453) regarding borrowing estimates for the quarters ending in June and September (implicitly assuming that the debt ceiling would be raised) indicate that the TGA balance at the end of those quarters should be about $550 billion and $600 billion, respectively. Taking into account the debt needed to cover the government's ongoing fiscal deficit, net issuances (government bonds issued minus government bonds redeemed) are expected to be $726 billion in the April-June quarter (all raised in June since the government cannot issue new debt until the debt ceiling bill is passed into law) and $733 billion during the July-September quarter.

Considering that the Federal Reserve will continue its QT at the pace of $95 billion per month, in the four months leading up to the end of September, the market will face a liquidity drain of about two trillion dollars: $1,550 billion due to net issuance by the government and nearly $400 billion due to the Fed's QT.

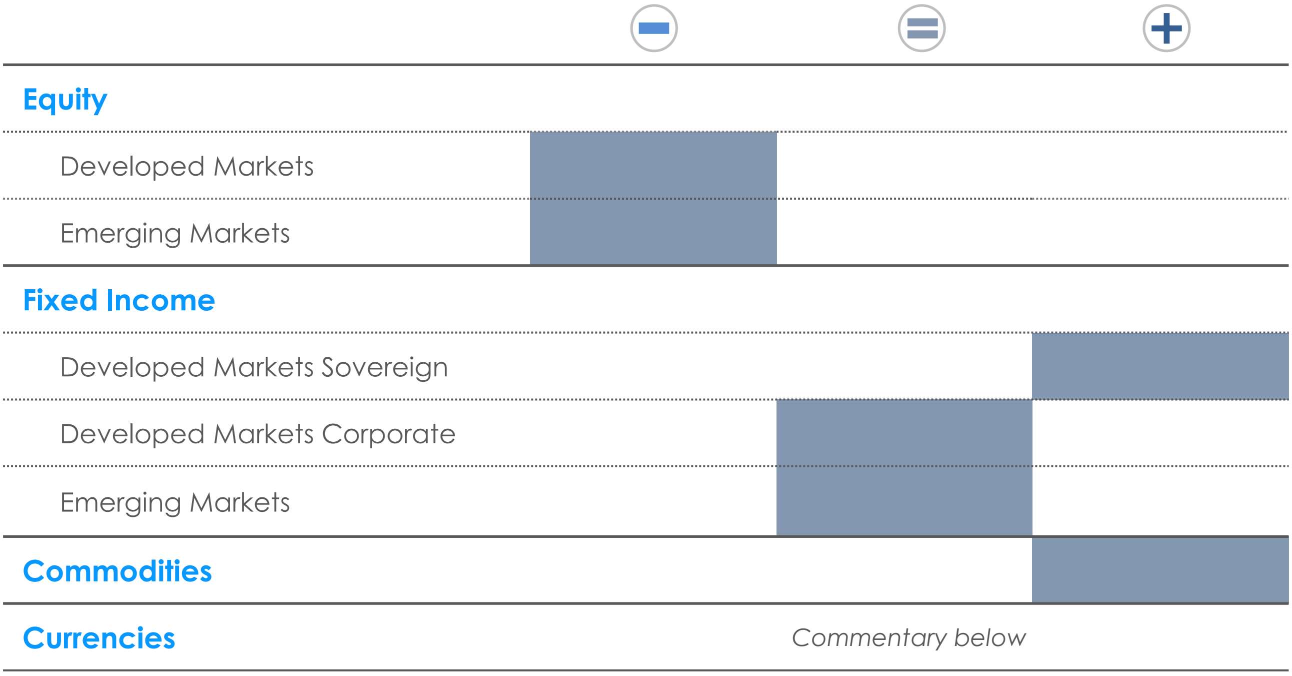
However, the consequences are not necessarily limited to financial markets alone. Such a liquidity drain could put the U.S. banking system under stress once again. As explained earlier, when the TGA falls, the government transfers liquidity to the system (through government bond repayments to individuals and businesses), which turns into deposits. The opposite happens when the TGA rises. The replenishment of the TGA will, therefore, add additional stress to the banking system, which already faces outflows from current accounts into money market funds. We are, hence, likely to see renewed pressure on the U.S. banking system in the coming months.

As for the net effect on available market liquidity, much will depend on the share of new issuance that will be absorbed by money market funds. Without going into complicated details, in recent months money market funds have increased their allocation to the Overnight Reverse Repo Facility (ON RRP) with the Fed, an alternative allocation to the purchase of Treasury bills. Considering that the replenishment of the TGA is expected to take place mainly through the issuance of bills and not bonds, it can be expected that the yields of short-term bills will increase their competitiveness against the rate offered by the ON RRP. Therefore, some of the increase in TGA (and the resulting liquidity drain) is expected to be absorbed by money market funds.

Out of the approximately two trillion in liquidity drain due to the reconstitution of the TGA and ongoing QT discussed above, it is estimated that the actual liquidity reduction for the market may be "only" $1-1.5 trillion if money market funds effectively take a share of the new issuances. However, this drop in liquidity will be about double the liquidity injection that has occurred in the past four months.

Therefore, reaching an agreement to raise the debt ceiling is certainly a positive development for markets, as it eliminates the risk of a technical default, which would have had dire consequences. However, for financial markets, the months ahead may prove more complicated than expected.

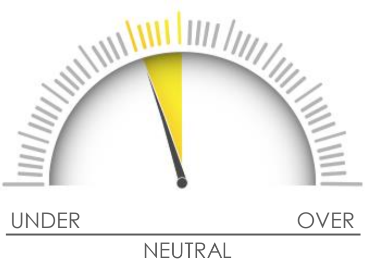
Asset Allocation View



UNDER NEUTRAL OVER

Equity

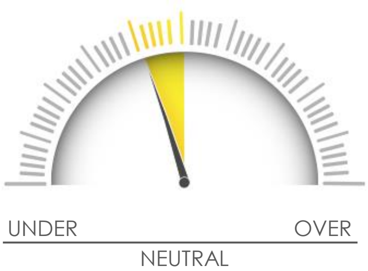
Developed Markets



We maintained our **Slightly Underweight** recommendation on Developed Markets Equities as valuations and the probability of a recession remain high. Additionally, since the increase in recent weeks has been driven mainly by a few stocks that are currently overbought, it seems unlikely that there is room for further upside, at least in the short term. Even the news (yet to be confirmed) of the agreement on the debt ceiling could turn out to be the classic "buy the rumors and sell the news." Moreover, as illustrated in the prologue, a deal is not necessarily a positive development for markets because of the expected liquidity drain in the coming weeks.

US **Europe** **Japan**

Emerging Markets

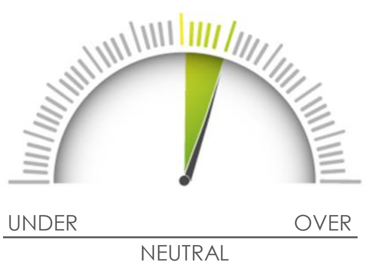


We kept our recommendation on Emerging Markets Equities unchanged at **Slightly Underweight**. In Asia, we are becoming more constructive on India, while becoming more cautious on China, where macroeconomic data and corporate reporting indicate a steeper than expected deterioration in the Chinese economy. We have also upgraded the Latin America region, because growth numbers in Mexico are quite robust, and Lula is currently implementing more moderate policies than in the past, which is a positive surprise.

Asia ex-Japan **EEMEA** **LATAM**

Fixed Income

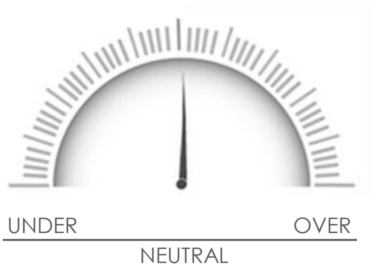
Developed Markets Sovereign



We kept our **Slightly Overweight** recommendation on Developed Markets Sovereign Bonds. The Fed's strategy of pushing the market to accept that interest rate cuts are unlikely before next year is starting to bear fruit. Coupled with macroeconomic data shows no apparent signals of an ongoing slowdown for the time being, curves globally have shifted upward by a few dozen basis points in recent weeks. Risk-free rates are thus returning to more attractive levels. In the event of further similar increases, rates would reach a level where an increase in portfolio duration would be appropriate.

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

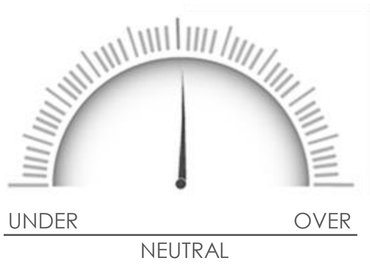
Developed Markets Corporate



We maintained our **Neutral** recommendation on Developed Markets Corporates, as the end of the US hiking cycle largely eliminates duration risk. We are slightly more cautious on corporate bonds than on government bonds, owing to spreads that are still relatively narrow in light of the rising dangers of a slowdown or recession, while we see some opportunities in subordinated or hybrid bonds. We continue to believe that high yield corporate bonds have the worst risk/return outlook.

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

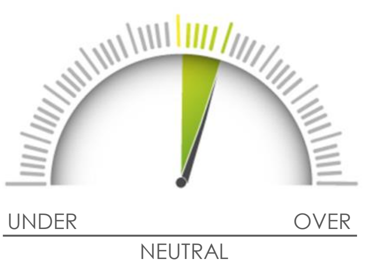
Emerging Markets



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. Precious metals continue to be a safe haven asset at times characterized by heightened geopolitical tensions, the ongoing banking crisis, and the unresolved (though improving) debt ceiling issue. We maintain a more cautious approach to non-precious commodities because of the risk of a global slowdown or recession.

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

Currencies

The Committee confirmed its **Neutral** view on the US Dollar. In the United States, better-than-expected macroeconomic data are pushing up short- and medium-term interest rates, with positive spillover effects on the dollar.

The view on the Euro is also **Neutral**. Unlike the U.S., macroeconomic data in Europe are coming out worse than expected, and the continued collapse in gas prices could encourage a somewhat faster decline in inflation. This could induce the ECB to end the rate hike cycle earlier and at a lower level than previously expected, which could have negative implications for the euro.

The view on the **Chinese Renminbi** is **Neutral with a bearish bias** in consideration of the much weaker-than-expected economic 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	=