azimut

AZIMUT GLOBAL VIEW

26.
06.
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

JAPAN RETAIL SALES — 29.06
Retail sales in Japan are expected to increase 0.8 percent MoM, underscoring the strength of the economy

CHINA PMI — 30.06
Another weak reading could further worsen sentiment towards Chinese assets

EU CPI — 30.06
European inflation is expected to fall from 6.1% to 5.6% due to base effect, but core inflation is expected to increase from 5.3% to 5.5%

US NON-FARM PAYROLLS — 07.07
New jobs are expected to increase less than in previous months, indicating a softening of the labor market

NOT THERE YET

- **During the June meetings, all major central banks either resumed raising after a pause, or promised additional hikes in the coming months**
- **The Federal Reserve raised its forecast of where official rates will be at the end of 2023 and end of 2024 by 50 bps. Powell also stated that real interest rates will remain positive until at least the end of 2024**
- **The ECB pledged at least one more hike in July and confirmed the end of APP re-investments from July, while the Bank of Englans raised rates by 50 bps, 25 bps more than expected**

Back in May, central bank meetings had given the market hope that the rate hike cycle had come to an end (Fed) or was about to be (ECB). The Fed, in particular, had emphasized that after a very sustained pace of hikes, rates were at a level that could already be considered restrictive, and thus they were willing to take a pause to assess the effects of the monetary tightening already implemented.

Lately, these hopes seem to have faded. Even before the Fed and ECB meetings, the Reserve Bank of Australia and the Bank of Canada resumed raising interest rates after a pause due to stronger-than-expected inflation and economic growth. The BoE, last week, stepped up the pace of hikes again, with a 50-basis point increase (more than expected) after reducing the pace to 25 basis points at the previous two meetings.

But let us return to the most important central bank. After the eruption of the banking crisis in the U.S., which led the market to expect rate cuts of up to 150 bps in less than a year, for weeks Powell and the other governors had done everything they could to convince the market that such expectations were unfounded. Gradually, they succeeded in getting the desired outcome, as by the date of the last FOMC, the market was expecting Fed rates at 5.25 percent, exactly the current level of official rates.

(continued)

Source: Bloomberg

Source: Bloomberg

At the mid-June meeting, the Fed adopted a much more aggressive stance again. First, the DOTS showed that the Fed governors' projections of where official rates will be at the end of 2023 and the end of 2024 were raised by about 50 bps each. By the end of 2023, 16 dots are higher than the last indication in March, and Powell said during the press conference that "nearly all Committee participants expect that it will be appropriate to raise interest rates somewhat further by the end of the year."

Raising the DOTS by 50 bps by year-end, coupled with the comment above, is making a commitment that would be hard to renege on. Considering also that Powell said July is a "live" meeting (i.e., a change in monetary policy is not to be ruled out), the Fed is unlikely to not deliver a 25 bps hike in the next meeting. In addition, Powell insisted that the Fed's priorities and actions adapt to the context: just over a year ago, it was important to raise rates quickly to catch up with inflation; then the focus shifted to the appropriate level of interest rates, and at this stage, the speed of the hikes became secondary (we are at this stage); and finally, the focus will become on how long to keep rates at a restrictive level.

In his remarks during the conference, Powell pointed out that the Fed had first acted with hikes of 75 basis points, then 50 basis points, and concluded with three hikes of 25 basis points, and hinted that reaching the appropriate level of interest rates (phase two of the rate hike cycle) will take place by further reducing the pace of hikes to 12.5 basis points per meeting (i.e., one hike every two meetings, which reinforces the credibility of one hike in July and another one in October, resulting in official rates rising by 50 basis points, in line with the dots plot).

But the strongest signal conveyed by Powell concerns expectations about where rates will be. We have already mentioned that the Fed managed to dash market expectations of a cut in 2023. Nonetheless, earlier this month, the market was still predicting that official rates at the end of 2024 would fall to 3.5 percent (now, one week after the FOMC meeting, this has increased to 3.9 percent). By indicating that the average level of official rates expected by the end of 2024 is 4.75 percent, the Fed wanted to send a clear signal to the market that even for 2024, the market should not expect significant cuts, contrary to what is currently implied by market rates.

The main takeaway from the conference was an answer to a question about, why, according to the SEP, the Fed is expected to start cutting rates next year before inflation has reached 2 percent. Powell began his response by saying that he "wouldn't put too much weight on forecasts even one year out because they're, they're so highly uncertain," downplaying the reliability of the forecasts (with reference to the absolute values of inflation and rates). Conversely, what he said immediately afterwards is extremely important, and is not at all conditional (text under brackets **[ ]** and bold ours): "as inflation comes down in the forecast, if you don't lower interest rates, then real rates are actually going up **[...]** The nominal rate at that point—**two years out**, let's say—should come down just to maintain **[**stable**]** real rates. And **[...] we're having real rates that are going to have to be meaningfully positive and significantly**. So for us to get inflation down, that probably means— that, that certainly means that, that it will be appropriate to cut rates at such time as inflation is coming down really significantly. And again, we're talking about a couple

(continued)

of years out. I think, as, as anyone can see, **not a single person on the Committee wrote down a rate cut this year, nor do I think it is at all likely to be appropriate**, if you think about it. Inflation has not really moved down. It has—it has not so far reacted much to our—to our existing rate hikes. And so we're going have to keep at it." (source: https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230614.pdf).

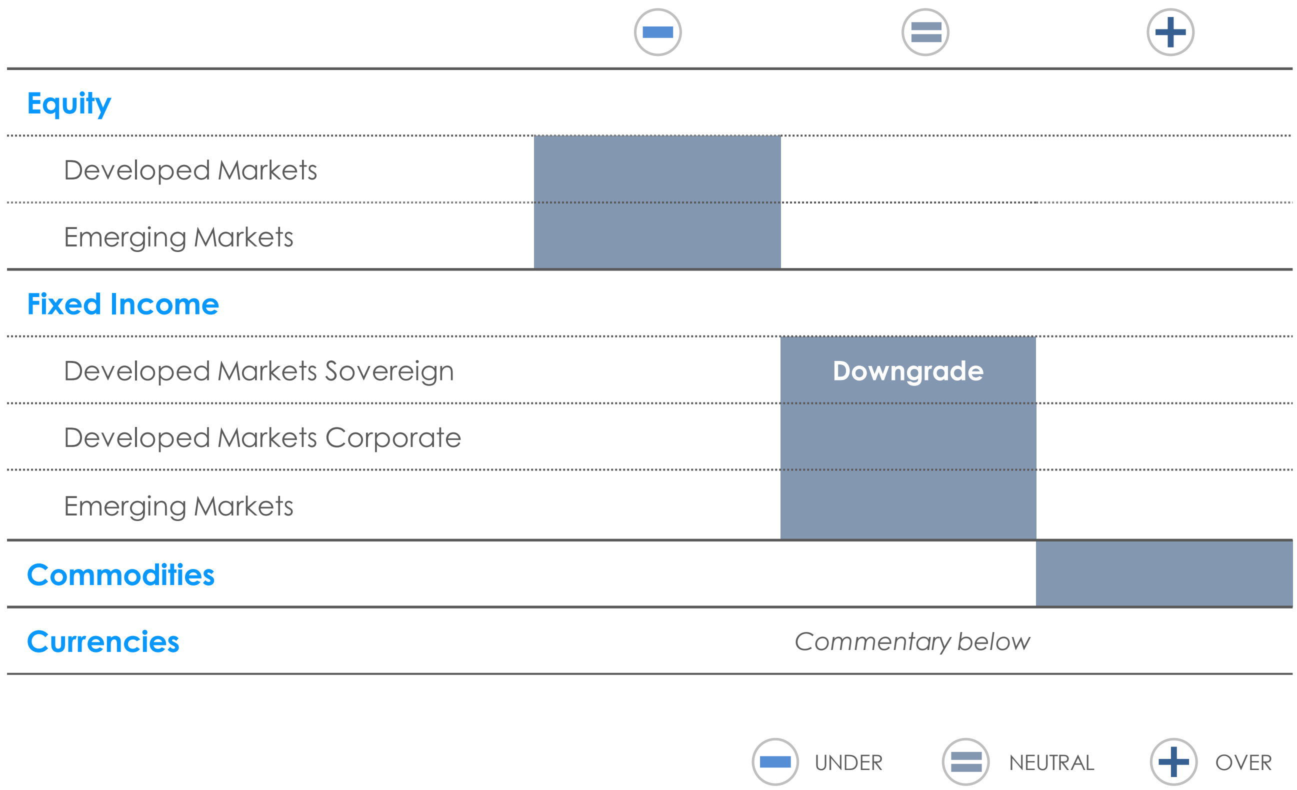
In other words, Powell has announced to the market that monetary policy will remain tight potentially for the next two years or, in the most optimistic interpretation, at least until the end of 2024. Considering that, according to the Fed's projections, inflation expectations are stable or declining, while rates will rise another 50 basis points, real interest rates are likely to climb further in the coming months. We can therefore assume that real rates will be held at or above their current level at least until the end of 2024, regardless of the evolution of inflation (as pointed out earlier, Powell explicitly stated that forecasts of the absolute level of inflation or rates do not matter; what seems to matter now is the real rate). This represents a dramatic rupture from the past 15 years in which real interest rates were almost always negative. And considering that for financial assets, it was the combination of nominal rates at zero and negative real rates that propelled the rally in all asset classes (expansion of multiples), the consequences of such a U-turn could be unpleasant for the markets.

No particular surprises came from the ECB. Nevertheless, Ms Lagarde was particularly assertive, almost promising another hike in July "barring a material change to our baseline." No promises were made for subsequent meetings, but considering that Lagarde also said that "we have ground to cover," another hike in September seems likely.

It should also be recalled that the ECB will discontinue the reinvestments under the Asset Purchase Program starting from July, a measure equivalent to a QT. The average amount of bonds coming to maturity is expected to be in the range of EUR 25-30 billion per month for the next 12 months. Moreover, the maturity of a TLTRO tranche this month will result in about 510 billion euros (477 billion euros mandatory, plus 30 billion euros voluntary) being repaid to the ECB by European banks.

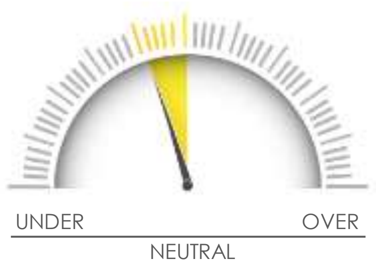
Therefore, the central bank meetings in June, with hikes or promises of further hikes in the months to come, threw cold water on the enthusiasm of investors who had been cheering for the end of the hiking cycles by central banks after the May meetings. Curiously, despite what central banks delivered or promised, market rates have done nothing, but fall, since the central bank meetings. This is probably because the market is assuming that if central banks follow through on such pledges, a recession would become increasingly likely (of course, this is the scenario priced in only by the bond market, while the stock market continues to discount that the economy remains strong). The tug-of-war between central banks and the market seems likely to continue for a while longer.

Asset Allocation View



Equity

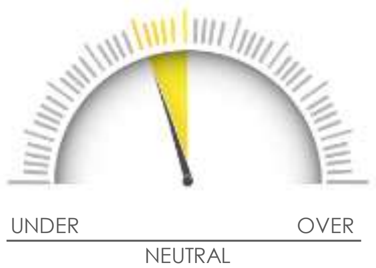
Developed Markets



We maintained our **Slightly Underweight** recommendation on Developed Markets Equities. The prologue's discussion of central banks' once-again restrictive stance adds to the other pre-existing vulnerability factors, including as high valuations, overbought conditions, and continued liquidity drain. Furthermore, sentiment indicators have moved into bullish territory, and most systematic/quantitative investors are close their maximum gross and net equity holdings (both of which are normally warning indications). Those who had been cautious in earlier months, on the other hand, appear to be capitulating. As a result, it appears likely that the available ammunition for the rally's continuation is limited, at least in the medium term, and a cautious approach seems to be required.

US **Europe** **Japan**

Emerging Markets

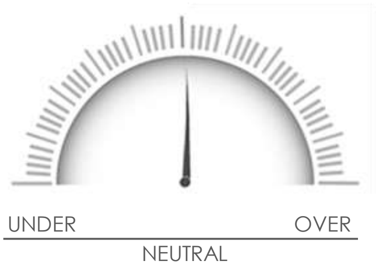


We kept our recommendation on Emerging Markets Equities unchanged at **Slightly Underweight**. Persistent weakness in Chinese economic data and the absence of adequate support measures from the Chinese government or the central bank continue to be a drag on emerging markets. On the other hand, despite the recent rally, we continue to maintain a relatively positive view of Latin America.

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

Fixed Income

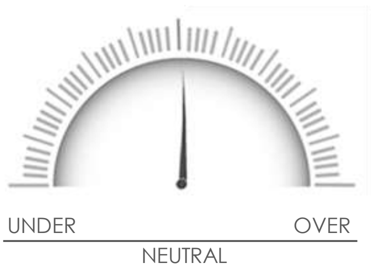
Developed Markets Sovereign



We downgraded our recommendation on Developed Markets Sovereign Bonds back to **Neutral**. The combination of commitments to continue the hiking cycle by most Western central banks, sharply inverted curves, and the overall decline in market rates since the central bank meetings suggests that there is a renewed risk that market rates may rise again from these levels. Within sovereign bonds, barring concrete evidence of an incoming recession, the preference has shifted back to the very short end of the curves (up to 6-9 months), waiting for a better entry point into the long-ends.

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

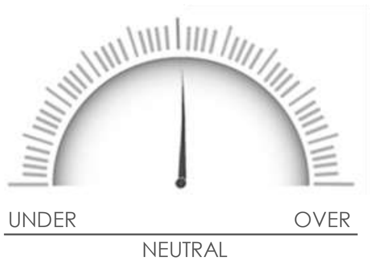
Developed Markets Corporate



We maintained our **Neutral** recommendation on Developed Markets Corporates, because, on the one hand, the likelihood of more central bank hikes might put downward pressure on the asset class, but on the other hand, the lack of signs of an oncoming recession could allow for a minor compression in spreads, which could offset any increase in risk-free rates. We continue to believe that high yield corporate bonds have the worst risk/return profile.

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

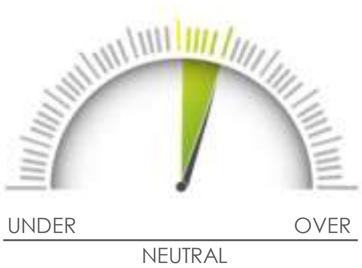
Emerging Markets



We maintained our **Neutral** recommendation on Emerging Market bonds. The reasons supporting the recommendation are the same as those reported for companies in developed markets.

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

Commodities



We maintained our **Slightly Overweight** recommendation on Commodities. The more hawkish attitude on the part of central banks could reduce the attractiveness of the precious metals in the short term, but we continue to maintain a positive bias in view of the geopolitical risks and the challenging situation faced by the U.S. banking system. We remain more cautious on the other commodities.

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

Currencies

The Committee has confirmed its **Neutral** view on the US Dollar. Even if the Federal Reserve has adopted a more hawkish than expected stance, the rate differential between the US Dollar and the Euro suggests that the two currencies are both fairly prices.

The view on the Euro is also **Neutral** or the same reason reported for the U.S. dollar, but evidence of a possible economic slowdown that is more pronounced than expected could be a drag on the common European currency.

The view on the **Chinese Renminbi** is **Neutral with a bearish bias** in consideration of the much weaker-than-expected economic data in China, and the lack of an adequate response by the Chinese government or central bank.

On most of **other emerging market currencies** the view is **Neutral**, but we remain 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	=