azimut

AZIMUT GLOBAL VIEW

10.07.23

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

10.07 — US CPI
Headline inflation is expected to fall to 3.1%, the lowest level in two years, but core inflation at 5.0% could prompt the Fed to continue hiking rates

17.07 — CHINA GDP
China's second-quarter GDP is expected to come out at +0.6% QoQ (+2.4% annualized), sharply decelerating from +2.2% QoQ in the first quarter

18.07 — US RETAIL SALES
Retail sales are expected to increase by 0.5% in June, underscoring the strength of the US consumer

21.07 — JAPAN CPI
If inflation shows no signs of moderating, there may be additional pressure on Japanese rates, which have nearly reached the BoJ's limit

EQUITIES DEFY BONDS

- **The increase in interest rates intensified further after central banks pledged tighter monetary policies at their June meetings**
- **In recent days, long-term rates have experienced the most significant rise, causing the yield curves to move away from the near-record inversion level.**
- **Despite the widespread rise in market rates, equity markets have shown little concern, creating a situation where equities appear relatively less attractive in the medium term**

After announcing their intention to pursue increasingly restrictive monetary policies at their June meetings (as discussed in the previous report), central banks reinforced their stance during the symposium in Sintra, Portugal, which is considered the second most important gathering after the central banks meeting in Jackson Hole, scheduled for August.

During this event, Powell even hinted at the possibility of implementing the projected 50 bps increase, indicated by the dots for the end of 2023, through two consecutive hikes in July and September.

The credibility of this threat was further supported by resilient macroeconomic data in the U.S. Despite some interpreting last Friday's payroll data as relatively soft due to lower-than-expected new employee numbers, average hourly wages rose more than expected and the unemployment rate fell 0.1 percent. Three Fed governors emphasized the necessity of continuing to raise interest rates.

In response, the market had no choice but to take notice. Market expectations for interest rates one year from now (June 2024) have surged approximately 180 bps in just two months, completely reversing the drop observed after the SVB bankruptcy in March and reaching new highs slightly above 5 percent.

(continued)

Source: Bloomberg

Source: Bloomberg

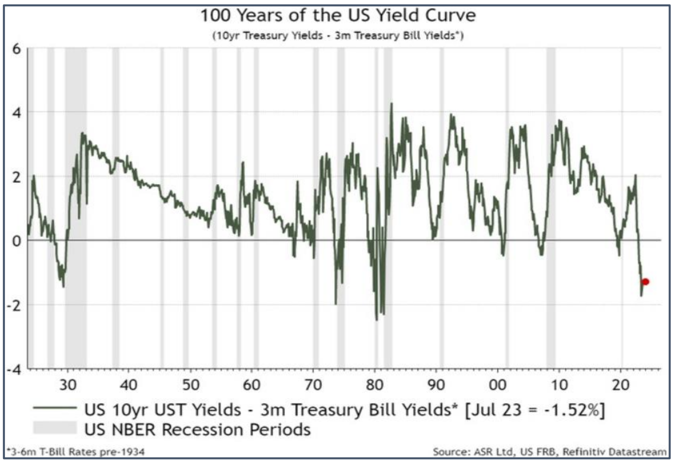
However, this time the longer ends of the yield curves also experienced an upward shift. The U.S. 10-year yield has climbed back above 4 percent, marking its first time since March and breaking the downward trendline that had been in place since October 2022. It has accelerated further in an upward trajectory.

As a result of the increase in long-term rates, the U.S. yield curve is slightly less inverted compared to previous weeks, where the inversion approached record levels. In this particular instance, the steepening of the curve is not happening, at least for now, due to the typical reasons that lead to curves moving away from their maximum inversion point.

Normally, the curve steepens in anticipation of an impending recession, as central banks tend to cut rates in such situations. This results in a decline in the short ends, which are more sensitive to official rates, and an increase in the long ends, which start to reflect the expectation of economic recovery and a potential rise in inflation.

Currently, we are not witnessing these typical conditions. On the contrary, central banks are committed to further rate hikes. Given the already existing near-record inversion, the announcement of additional rate increases and the prospect of elevated rates being maintained for a prolonged period have forced long-term rates to rise. This situation raises concerns for risky asset classes, as theoretically, the higher the risk-free rate, the more other risky assets should correct. However, it is also true that long-term rates are increasing because there are no concrete signs of a slowdown yet, indicating reduced concerns about economic growth.

Moreover, despite inflation expectations (measured by breakeven rates) remaining essentially unchanged over the past two months, the increase in nominal rates has pushed real rates (measured as the difference between nominal and breakeven rates) to their highest level in a decade.



Source: ASR Ltd, US FRB, Refinitive Datastream

Source: Bloomberg

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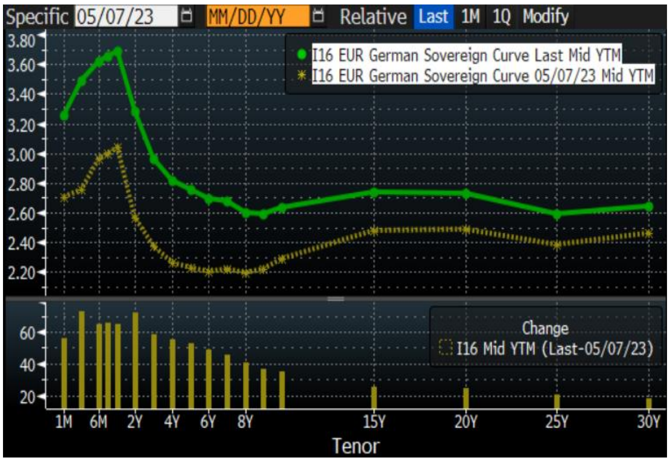
Source: Bloomberg



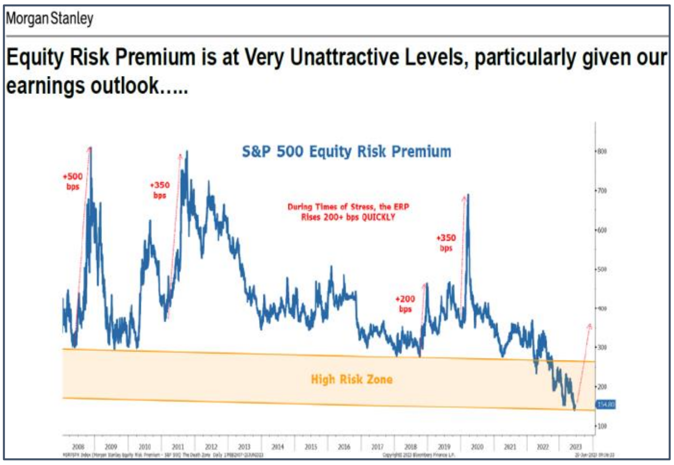
Source: Bloomberg

Over the past two months, yield curves have experienced upward movements not only in the United States but also in other developed countries. The most significant movement has been observed in the United Kingdom, where inflation has proven to be more resilient and higher compared to other countries, possibly due to the ongoing effects of Brexit.

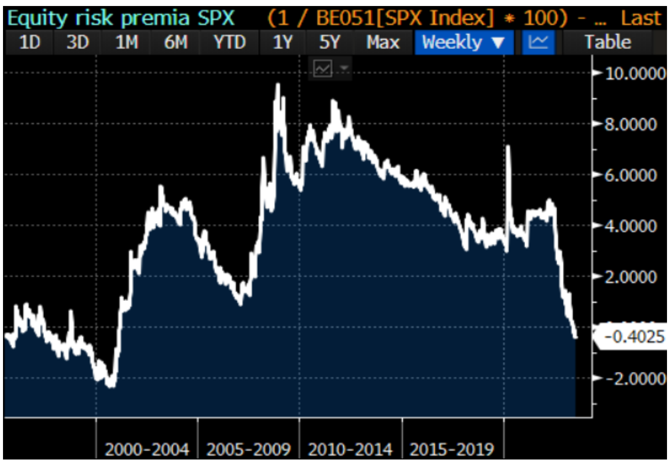
In the European Union (EU), the increase has been less pronounced, primarily because the European Central Bank (ECB) is the only central bank that has not recently announced a more restrictive stance. It's worth noting that the ECB began raising rates later than other central banks and had already committed to continue doing so until the summer as of the end of last year. Consequently, while other central banks have set themselves with a more restrictive stance, either by promising or already implementing rate hikes, the ECB's commitment to raising rates until the summer is not new. Additionally, weaker-than-expected macroeconomic data also contributed to the limited increase in the yield curve within the Eurozone.

Despite these developments in risk-free rates, what is surprising is the complete disregard shown by the equity market. In theory, as observed in 2022, 2018, and during the 1970s and 1980s, a sustained increase in interest rates typically leads to a decline in the stock market to maintain the equity risk premium at an appropriate level (on average estimated between 3 percent and 4 percent). Utilizing Morgan Stanley's proprietary model (bottom left chart) or the differential between the expected earnings yield of the S&P 500 and the 3-month T-Bills (bottom right chart), the indications appear similar: at current levels, equities do not seem particularly attractive.

Even more striking, however, is the behavior within the stock market itself. It is widely known that so-called growth stocks are typically the most sensitive (and inversely correlated) to interest rate movements, while so-called value stocks are often more resilient or may even benefit in a rising rate environment.



Source: Morgan Stanley



Source: Bloomberg

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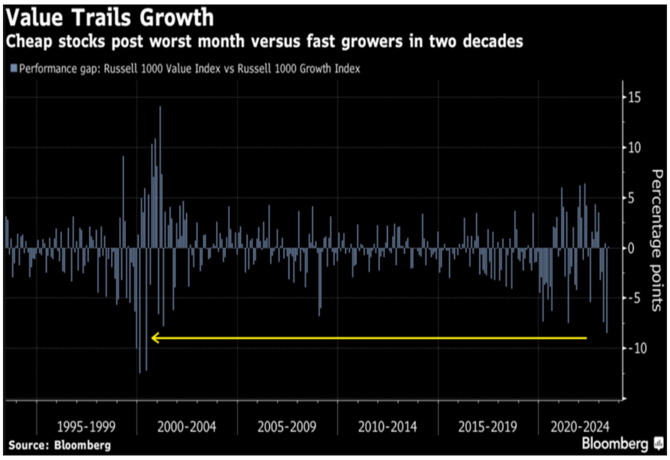
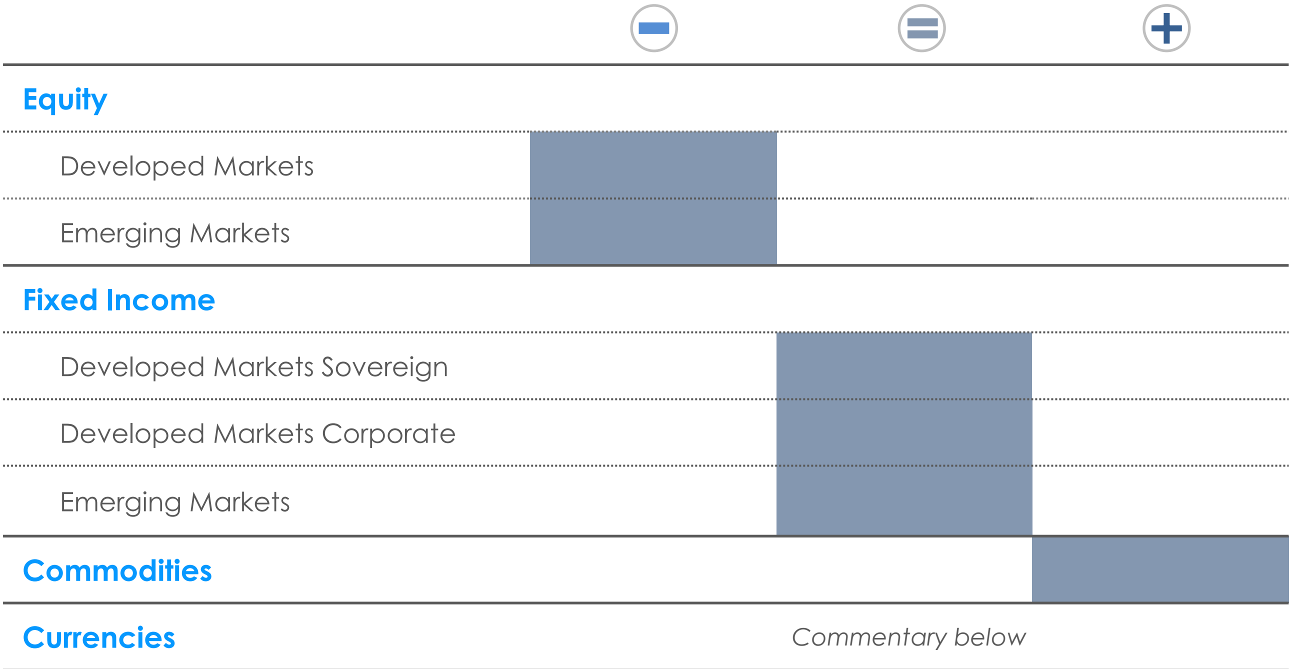


Source: Bloomberg

Since the beginning of the year, the opposite trend has been unfolding. The gap between the Nasdaq P/E (calculated based on the expected earnings over the next 12 months, forecasted to increase by more than 20 percent from their current value) and real interest rates (depicted in white on the inverted scale in the graph above, left) has been consistently widening. It appears as if the correlation between growth and interest rates has suddenly ceased to exist. Additionally, contrary to expectations, we have witnessed the strongest outperformance of growth stocks over value stocks in recent months, reminiscent of the internet bubble of 2000.

Given that growth stocks hold the highest weighting in global equity indices, the recent dynamics of interest rates and increasingly high valuations imply that exercising caution from a medium-term perspective would be prudent. However, certain factors may still provide short-term support. Positive momentum, sustained inflows primarily from retail investors, and the potential for a positive stock market reaction if U.S. inflation turns out lower than anticipated, rather than due to positive earnings surprises in the upcoming reporting season.

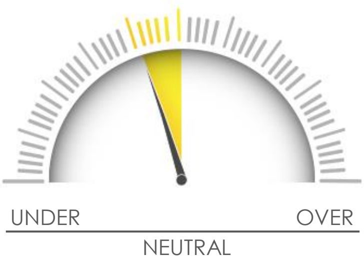
Asset Allocation View



UNDER NEUTRAL OVER

Equity

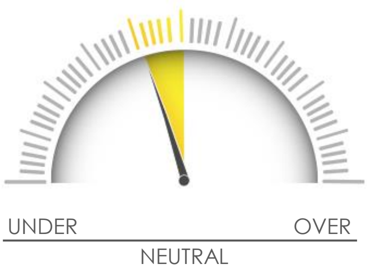
Developed Markets



We maintained our **Slightly Underweight** recommendation on Developed Markets Equities. Increasingly high valuations coupled with rising nominal and real interest rates, liquidity drain and hawkish central banks make the outlook for equities progressively less favorable. Among the supportive factors, analysts' expectations for the upcoming reporting season are notably subdued, with a projected 7% YoY decline in earnings, which could potentially be surpassed. In terms of geographies, we maintain a preference for Japan while exercising caution regarding Europe due to multiple signs of an ongoing slowdown

US **Europe** **Japan**

Emerging Markets



We kept our recommendation on Emerging Markets Equities unchanged at **Slightly Underweight**. Unlike the past two years, where changes in geopolitical tensions between China and the United States resulted in phases of underperformance or outperformance by China, the recent visits by Blinken and Yellen aimed at repairing relations between the two superpowers failed to generate a rebound in Chinese markets. Even the conclusion of the investigation on Chinese tech giants, which resulted in acceptable fines, did not succeed in triggering a recovery in those stocks, despite the potential for a brighter future for these companies. As a result, we maintain a cautious stance on China, while favoring LatAm and India.

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

Fixed Income

Developed Markets Sovereign

We kept our **Neutral** recommendation on Developed Markets Sovereign Bonds. Central banks, particularly the Fed, have continued to emphasize the need for further monetary tightening to bring inflation under control. As a result, most developed market curves have shifted upward over the past two weeks, with the long ends rising more than the short ends, thus somewhat reducing the sharp inversion of the curves that we highlighted as a potential risk in our previous report. Within sovereign bonds, we continue to prefer the very short end of the curves (up to 6-9 months) while 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. Last week, we highlighted that while the likelihood of further central bank rate hikes could exert downward pressure on the asset class, the absence of recessionary indicators might lead to a slight narrowing of spreads, potentially offsetting any rise in risk-free rates. This scenario has indeed materialized and may persist in the short term. Our view remains that high yield corporate bonds possess a relatively unfavorable 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 the developed markets.

Local Currency	+	Hard Currency IG	−	Hard Currency HY	−

Commodities

We maintained our **Slightly Overweight** recommendation on Commodities. The increasingly hawkish stance of central banks, coupled with the rise in nominal and real rates to new highs, may diminish the short-term appeal of precious metals, despite their potential as a hedge against geopolitical risks. Regarding other commodities, we maintain a more cautious outlook, as signs of a slowdown are becoming evident outside of the United States.

Precious	+	Energy	=	Industrial	=	Agricultural	=

Currencies

The Committee has confirmed its **Neutral** view on the US Dollar. Waiting for the CPI number later this week, the rate differential between the US Dollar and the Euro suggests that the two currencies are currently 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	=