Main Events

BoE MEETING

Anticipated to implement a 25 bp hike, what are the indications that the BoE will provide regarding the future path of the rates?

US PAYROLLS

The U.S. economy should have created 200k more jobs in July, but there is room for an upward surprise given the strength of the labor market

CHINA NEW LOANS

After the previous month's sharp rise, will banks continue to provide abundant liquidity to Chinese enterprises?

US CPI

From this month, the favorable base effect begins to fade, so consumer prices are expected to rise again to 3.2% from 3.0% YoY

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

DATA DEPENDENT

- **The Bank of Japan raised the ceiling on Japan's 10-year rates to 1%, a move that could foreshadow a normalization of Japanese interest rates in the not-too-distant future**
- **The ECB and the Fed have both retained the option to raise or leave rates unchanged in September, stating that they will be data-dependent**
- **Although it is possible that the tightening cycle in Europe may already be over, the expected dynamics of U.S. inflation may instead suggest that further rate hikes by the Fed are still possible**

In the latest round of central bank meetings, it was the Bank of Japan that claimed the title of the one that surprised markets the most.

Contrary to market expectations, which predicted a move in September at the earliest, Japan's central bank lifted the 10-year rate ceiling from 0.5% to 1% for the second time since December 2022.

By widening the permitted fluctuation band to up to 1%, the BoJ's official policy target of keeping 10-year rates close to zero is effectively invalidated. The decision should be seen as the first necessary step before any true normalization of monetary policy can take place in Japan: it would not be possible to raise policy rates, as of today still at -0.1 percent, without first giving long-term interest rates the freedom to move away from zero.

The reason for this move probably lies in inflation dynamics, which seem to suggest that inflation in Japan has also been too lightly branded as transitory. Tokyo's core inflation, which is typically regarded as leading national inflation, reached 4.0 percent, the highest level in 40 years. Perhaps it was this dynamic that put pressure on new Governor Ueda, accelerating the steps needed to normalize rates in Japan.

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Source: Bloomberg

Source: Bloomberg

However, as is often the case, changes in Japan are implemented smoothly. To avoid an immediate rise in market rates toward the new ceiling of 1 percent, the BoJ announced that it would carry out open market operations should interest rates rise too quickly, which it did exactly the day after the last meeting.

But what might be the impact on markets of any normalization of monetary policy in Japan? Japan is one of the largest holders of U.S. government bonds in the world. Considering that the cost of hedging the yen against the dollar is about 5.5% (the differential between policy rates) and that the U.S. curve is inverted while the Japanese curve is currently the only positively sloped curve among developed markets, for a Japanese investor to buy a JPY-hedged U.S. Treasury "yields" about -1.6% (3.9% of the 10-year Treasury rate minus the 5.5% hedging cost).

This -1.6%, compared to the yield on the Japanese 10-year today at 0.6%, means that for a Japanese investor, buying JPY-hedged U.S. Treasuries yields 2.2% less than buying domestic government bonds. Therefore, it is increasingly expensive for a Japanese investor to hold JPY-hedged U.S. Treasuries, which should provide an incentive to sell U.S. government bonds and buy domestic ones.

The only way for a Japanese investor where it could still be convenient to hold U.S. Treasuries is to do so without currency hedging. However, this works as long as the yen depreciates, as it did this year (the dollar gained about 9 percent against the yen). But should the BoJ's decision to raise the ceiling on 10-year rates to 1% actually set the stage for an increase in policy rates from the current -0.10 percent, it is likely that the yen could rally against other major currencies. In that case, unhedged investment in U.S. government bonds would also turn into a considerable loss for a Japanese investor.

In short, in the event of interest rate normalization by the BoJ, investing in U.S. Treasuries could prove to be an inefficient solution for a Japanese investor, both hedged or unhedged. This would provide Japanese investors with an incentive to reduce exposure to U.S. Treasuries, which, in turn, would put upward pressure on US yields, particularly on the longer ends of the curves.

As for the ECB, nothing special emerged during the press conference. Ms. Lagarde repeated several times that the ECB wants to "break the back of inflation," but she also made it clear that another rate hike in September is far from a given, and that the ECB will be data-dependent for its future monetary policy decisions. This dovish turn can be explained both by the fact that some of the disinflationary push from falling energy prices in Europe has not yet been transmitted to consumer prices, and by the increasingly evident signs of an economic slowdown. To give one example, although confidence indicators have long been unreliable in signaling a slowdown that has so far failed to materialize, the decline in the German manufacturing confidence index, not that far from the lows of 2008 and March 2020, is of such magnitude that ignoring it would perhaps be hazardous.

Powell also made no precommitment about what the Fed will do in September, conditioning future actions of the U.S. central bank on the incoming data. During the conference, he put special emphasis on the job market and CPI data for July and August, which will be released before the next FOMC meeting.

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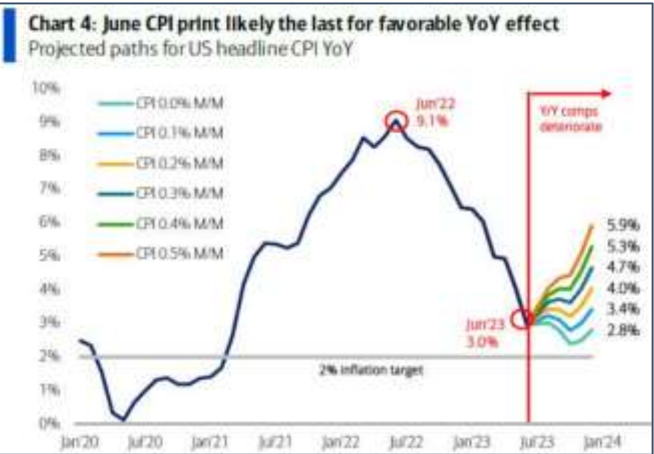
Source: Bloomberg



Source: BofA Research, BofA Global Investm. Strategy, Bloomberg

As for the labor market, unemployment claims have resumed their downward trend in recent weeks, suggesting that there are still no signs that the imbalances between labor supply and demand are easing. It, therefore, seems plausible that the payroll data to be released later this week may prove stronger than the expectations of 200k new jobs.

But the most important data will be those on inflation, as it is possible that the headline inflation figure could start to move up again between now and the end of the year. As mentioned in previous reports, the June YoY CPI reading benefited from the strongest disinflationary push from the energy component of the CPI, which peaked in June 2022. As shown in the chart above right, unless inflation remains unchanged in the next six months (CPI 0.0% MoM), the year-end inflation rate will be higher than the current 3.0%. Assuming a monthly increase of 0.2% MoM, consistent with 2.5% annualized inflation, we could again see headline inflation at 4.0% at the end of the year.

The surge in commodity prices in the past month, intensified after the announcement of stimulus measures in China, could lead to an even more pronounced pickup in inflation, although the core component of inflation is expected to decline in the coming months. Considering how much Powell has emphasized in the past how crucial is not to repeat the mistakes of the 1970s, when inflation was prematurely deemed defeated, if the CPI picks up again, it is very likely that the Fed may continue to raise rates in September.

Given how complacent financial markets have been so far, they could be exposed to the risk of a retracement if the Fed and BoJ continue to implement tighter monetary policies in September. Before then, the annual meeting of central banks in Jackson Hole in late August may already shed light on the likely future path of monetary policies.

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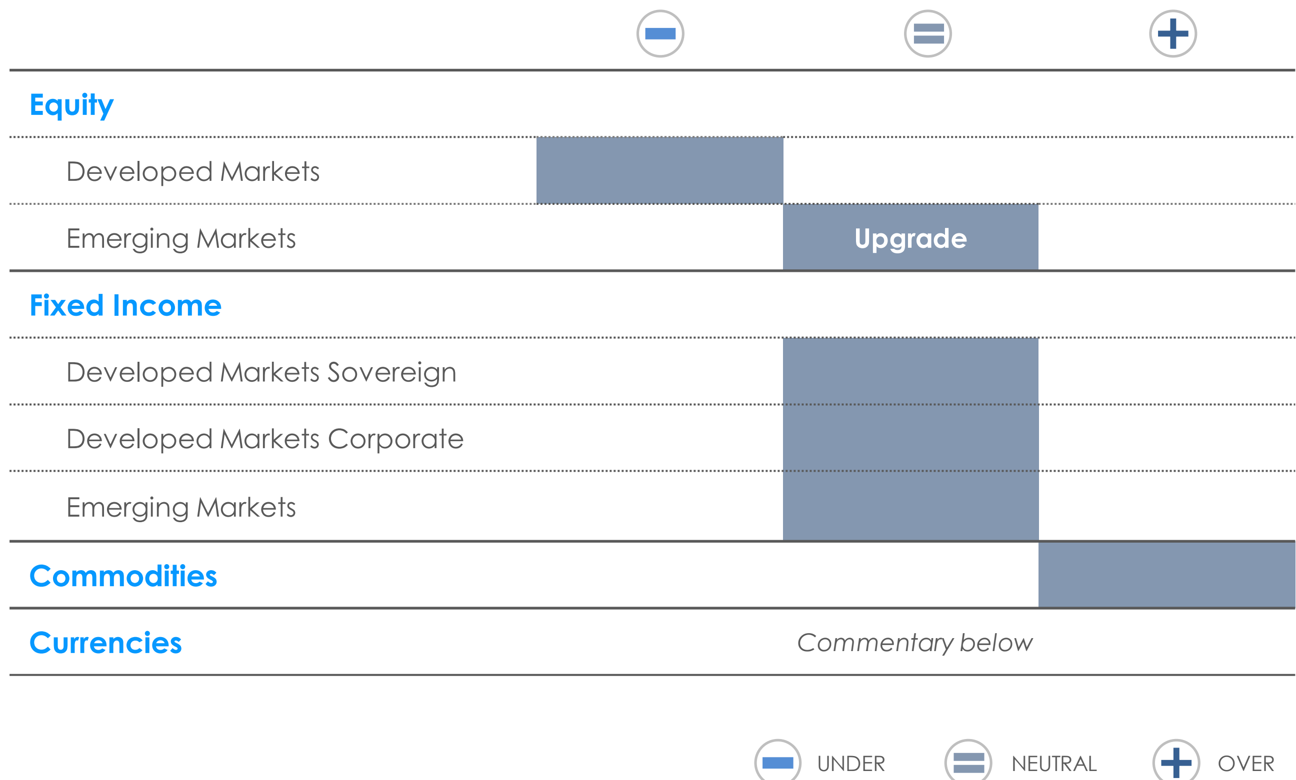
Asset Allocation View

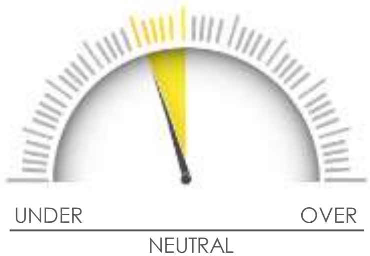


	− (Under)	= (Neutral)	+ (Over)
Equity			
Developed Markets	■		
Emerging Markets		Upgrade	
Fixed Income			
Developed Markets Sovereign		■	
Developed Markets Corporate		■	
Emerging Markets		■	
Commodities			■
Currencies		*Commentary below*	

− UNDER = NEUTRAL + OVER

Equity

Developed Markets



We maintained our **Slightly Underweight** recommendation on Developed Markets Equities. On the one hand, high valuations, an overbought condition, extreme bullishness, and the presence of vulnerabilities such as increasingly higher rates, tight monetary policies, and the dormant risk of a slowdown continue to suggest caution is needed. On the other hand, the strong positive momentum, a slightly better-than-expected reporting season (albeit on lowered expectations), and the resilience of the economies, especially in the U.S., could allow for a further extension of the current uptrend in the short term. Greater caution seems appropriate in the longer term.

US =	**Europe** −	**Japan** =

Emerging Markets

We upgraded our recommendation on Emerging Markets Equities to **Neutral**. After the announcement of more economy-friendly policies at last week's Politburo meeting and the release of more positive macroeconomic data, China's stock market has finally started to rebound. Given depressed valuations, extremely negative sentiment on the country, and positive developments on the geopolitical front after Blinken and Yellen's visits in recent weeks, there is room for the rally that has just begun to continue. Coupled with increased chances that the central bank tightening cycle is effectively coming to an end, this could lead emerging markets to outperform.

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

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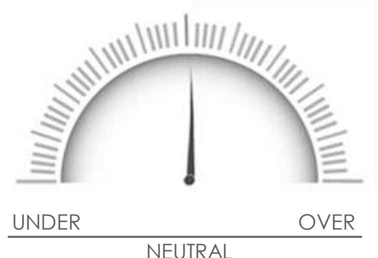
Fixed Income

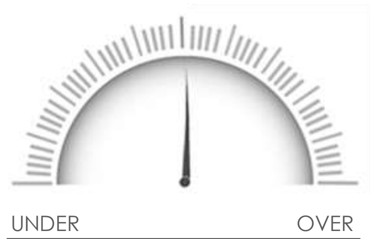
Developed Markets Sovereign



We kept our **Neutral** recommendation on Developed Markets Sovereign Bonds. In last week's meetings, the Fed and ECB conditioned future hikes on the evolution of inflation and the strength of the economy, as argued in the prologue. In the short run, this could make bond markets more volatile due to greater reactivity to macroeconomic data. The long ends of the curves could still be vulnerable to further increases in rates in case of stronger-than-expected macro data, the removal of the cap on 10-year rates by the BoJ, or the ongoing QT. The preference remains for the short ends of the curves.

EU Core		EU Periphery		US Treasury		Japanese JGB	

Developed Markets Corporate



We maintained our **Neutral** recommendation on Developed Markets Corporates. Since a few weeks, we highlighted that while the likelihood of further increase in risk-free rates 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 continued to unfold 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 persistence of tight monetary policies for an extended period of time, along with rising nominal and real rates, could diminish the short-term appeal of precious metals, despite their potential as a hedge against geopolitical risks or upside surprise in inflation. Regarding other commodities, we maintain a more cautious outlook, as some countries/regions begins to show signs of a slowdown, though not yet in the United States.

Precious		Energy		Industrial		Agricultural	

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Currencies

The Committee has upgraded its view on the US Dollar to **Neutral with a bullish bias**. The possibility that the Fed may continue to raise rates in September due to the resilience shown by the U.S. economy could lead to a widening of the interest rate differential in favor of the dollar.

The view on the Euro has been downgraded to **Neutral with a bearish bias**. Unlike the United States, clear signs of a possible slowdown are beginning to emerge in Europe, which may cause the ECB to remain on hold at its September meeting, thus halting the hiking cycle at lower levels of rates than in other major developed countries.

The view on the **Chinese Renminbi** remains **Neutral,** but no longer with a bearish bias, in view of the announcement of some economic stimulus after the latest Politburo meetings and the improvement in international relations after the visits of Blinken and Yellen, both of which may prompt some investors to increase exposure to Chinese assets.

Regarding **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.

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