azimut

AZIMUT GLOBAL VIEW

28.08.23

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 — 31.08

Retail sales are projected to rise 0.8% month-on-month, underscoring the current strength of the Japanese economy

EU CPI — 31.08

Because of the favorable base effect, both headline and core inflation are expected to fall by 0.2% to 5.1% and 5.3%, respectively.

US PERSONAL SPENDING — 31.08

Consumption may have risen 0.7% in July alone, strengthening the case for another Fed hike in September

US PAYROLLS — 01.09

New jobs are projected to decline to 150k in August, but the unemployment rate should remain at the rock-bottom level of 3.5%

LONG-TERM IMPLICATIONS OF HIGHER RATES

- **At the Jackson Hole meeting, central banks did not offer any guidance about the evolution of monetary policy in the coming months**
- **The need to maintain a restrictive monetary policy for an extended period of time is the only message that has been emphasized by all central banks**
- **Higher rates will affect everyone - individuals, corporations and governments - but the most impacted could be the latter due to the deterioration of public finances that occurred since the Great Financial Crisis**

Unlike last year, the annual central bank meeting in Jackson Hole was uneventful. Market participants' expectations were centered on getting enlightenment about the future of the Fed's monetary policy path.

Before the meeting there were speculations that Powell might indicate that the "neutral rate" (the theoretical rate that should neither stimulate nor restrain economic growth) may have risen as a consequence of the recent pandemic and inflationary episodes. In that case, the implication would have been that interest rates should be raised more, because the higher the neutral rate, the higher the official rate must be.

Instead, Powell stated that estimating the real level of the neutral rate, even for a central bank, is extremely difficult. However, he made a statement with virtually similar implications, namely that the central bank's goal is to return inflation to 2%. Given the recent inflation rise, many expected the Fed to tolerate a somewhat higher inflation target of approximately 3% for a period, without explicitly aiming a return to 2%.

The fact that Powell reiterated that the target is 2 percent entails that monetary policy will have to remain restrictive for a long time, and that no easing should be expected in the short or medium term.

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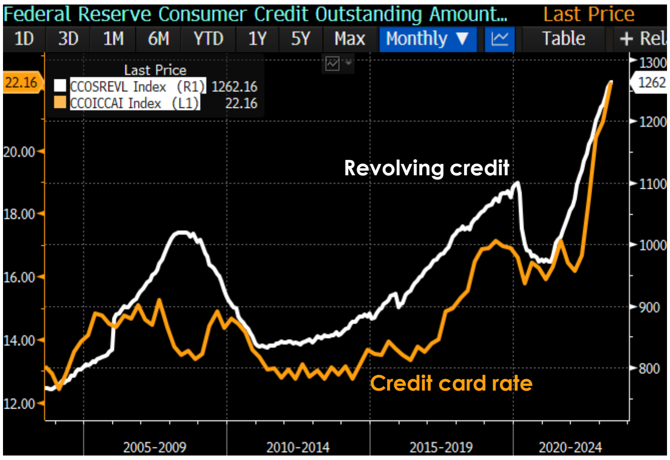
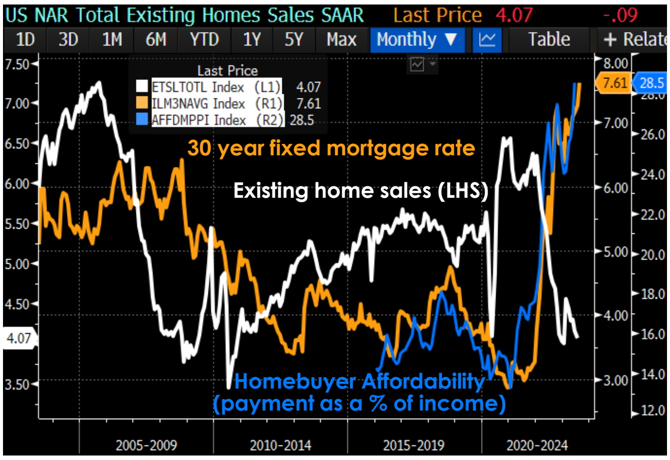


Source: Bloomberg



Source: Bloomberg

Powell then warned that "additional evidence of persistently above-trend growth could put further progress on inflation at risk and warrant further tightening of monetary policy", but that they will "proceed cautiously" in deciding whether to raise rates again. The Bank of England is the only central bank that has committed to continuing raising rates, whereas Ms. Lagarde has made no such pledge, leaving the door open to a pause in September, which seems increasingly plausible considering the ongoing slowdown in Europe. The BoJ, on the other hand, stated that Japan still needs rates to remain at the current low level.

While the Jackson Hole meeting did not eliminate uncertainties about what central banks will do at their next meetings, it was unanimously stated that rates will have to remain at the current or higher level for a considerable period of time in order to completely combat inflation.

However, high rates for a prolonged period of time risk having a negative impact on economic growth and financial stability. It should be noted that the debt outstanding has climbed sharply over the past decade, largely due to the perception that, with rates at zero, debt was neither expensive nor burdensome.

Individuals face a decline in disposable income for consumption as the cost of debt rises. Looking at revolving credit, which includes credit cards, it has risen to new highs as the fiscal stimulus of 2020-2021 progressively dwindled away. In the previous two years, the credit card rate has risen by 5% (in line with official rates) to 22%, much beyond the 13%-15% level that prevailed while official rates in the US were at zero.

As for real estate, 30-year mortgage rates have more than doubled from their lows, reaching the highest level since 2000. Although the vast majority of mortgages in the US are fixed-rate, the impact on disposable income (in aggregate) is rather limited for the time being, buying a home is becoming increasingly expensive. Homebuyer affordability is at an all-time low, as soaring real estate prices and mortgage rates, monthly payments have reached almost 30% of income, nearly doubling the level of two years ago. Not surprisingly, existing home sales, which account for 90% of US real estate transactions, have dropped precipitously, at a pace not unlike that of 2007.

The elimination of student loan reduction initiatives will also have an impact on consumers' disposable income. Since March 2020, student debts totaling more than USD 1.3 trillion have been frozen, with interest rates set at zero. Borrowers will be required to restart payments, which average a few hundred dollars each month, beginning in October.

Instead, corporations gained the most from the post-pandemic era's ultra-loose monetary policies, locking in rock-bottom returns for several years. After March 2020, corporations issued significant quantities of debt to take advantage of massive liquidity injections by central banks and investors' desperate need to deploy that money. As a result, by 2025, just approximately a fifth of existing corporate debt will have matured. However, it is still feasible that these cash reserves will be spent sooner than projected, particularly if an unexpected and stronger-than-expected slowdown occurs.

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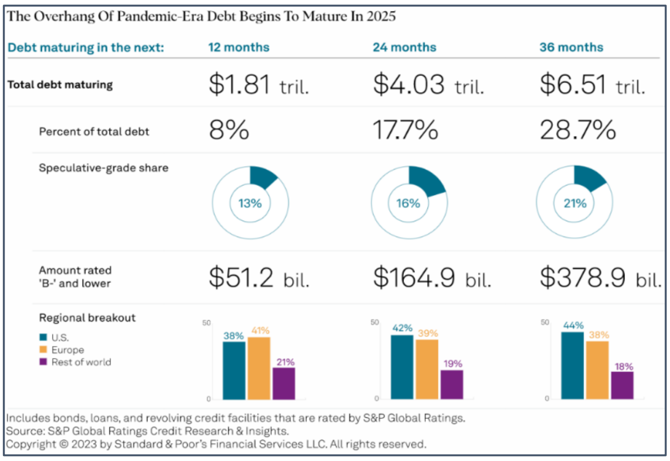
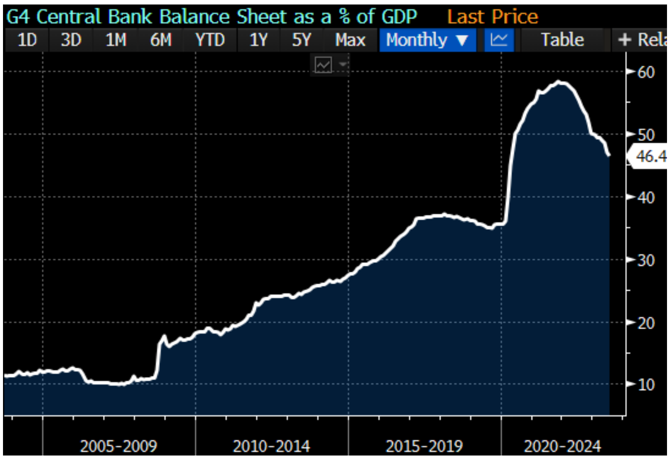


Source: Speculators Anonymous, S&P Global. Data as of April 2023



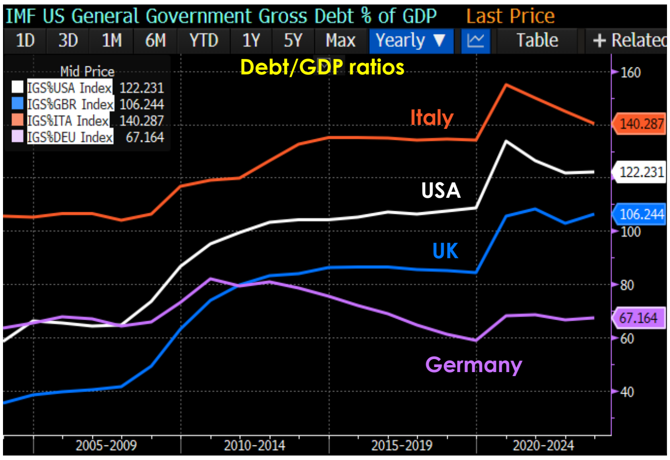
Source: Bloomberg

Furthermore, several issuers currently rated BBB- or comparable may be downgraded to sub-investment grade if interest rates remain unchanged, as they may be unable to meet the higher interest payments. In general, however, corporations appear to be the least vulnerable player (in aggregate) in the current phase of rising rates.

In contrast, the governments, on the other hand, appear to be in a worse condition. Central banks' use of unorthodox measures after 2008 gave governments the impression that they could increase debt without limit and at no cost. Despite ballooning debt-to-GDP ratios, zero or negative interest rates have allowed them to benefit from a reduction in interest expenditure, and QEs have absorbed much of governments' net issuance: the balance sheet of the top four central banks as a ratio of GDP rose from 10 percent (stable) in the pre-GFC period to 60 percent before the recent spike in inflation, which allowed that ratio to decline somewhat due to the expansion of nominal GDPs.

Over the past 15 years, the Debt/GDP ratios in all major countries have risen sharply, with the sole exception of Germany, the only major country to have the same Debt/GDP ratio today as pre-GFC. In contrast, the least virtuous countries have been the UK and the US, whose Debt/GDP ratios have risen by about 60 percent since 2008.

The U.S. Debt/GDP ratio today is at the same level as that of Italy in 2011 (after being 15% higher), when Italy and all the EU Mediterranean countries came under attack precisely because it was said then that those levels of public debt were unsustainable. It is intriguing to observe how radically the market's perception can shift... or, rather, how complacent the market has become with respect to this topic. But complacency could wane at any time and abruptly, as shown by Lisa Truss's "mini-budget" episode last year.



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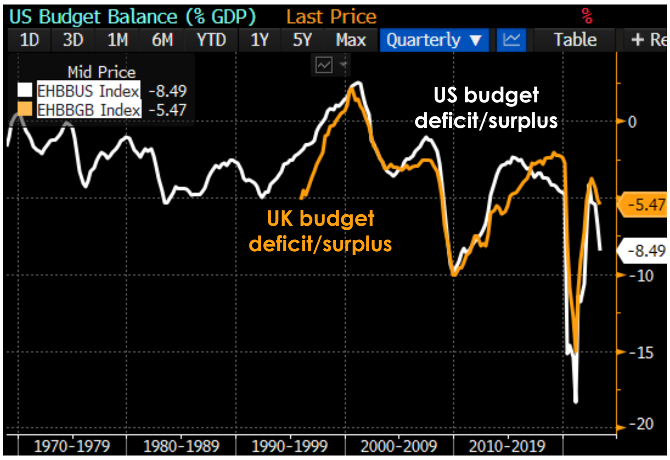

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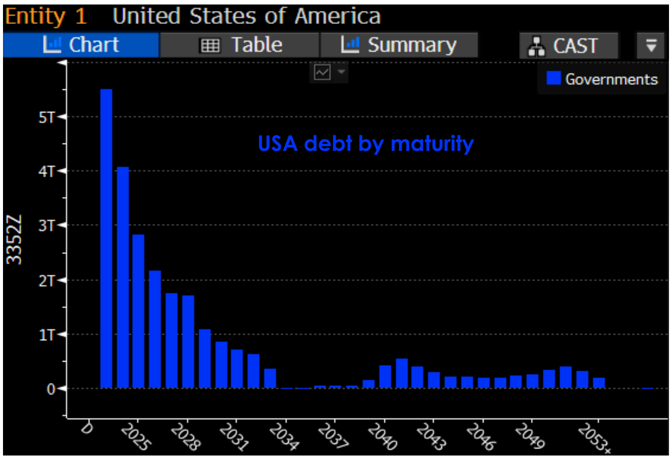

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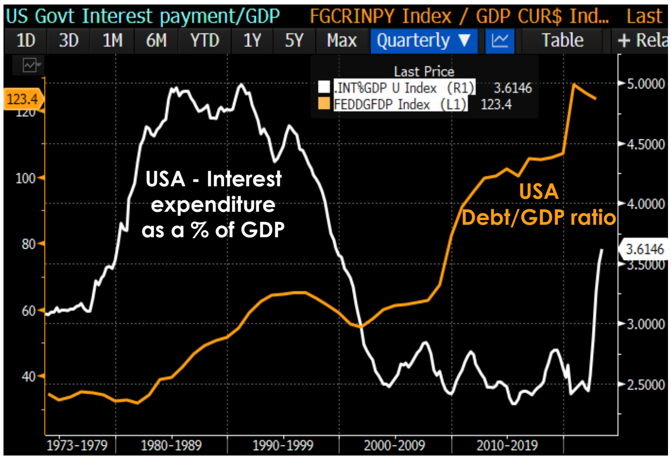


Source: Bloomberg

The United Kingdom and the United States, in addition to having the worst decline in the Debt/GDP ratio, also have the largest budget deficits. The United States, in instance, currently has a deficit of 8.5 percent of GDP, which is similar to the level achieved in 2008 during the height of the financial crisis. In addition to being the worst post-war budget deficit, excluding the GFC and the pandemic, it should be noted that the deficit exploded in response to the deepest recessions in decades on the other two occasions, whereas today's near-record deficit occurs with a booming economy that even the Fed's rate hikes have failed to slow, at least for the time being.

Furthermore, the United States faces enormous refinancing risk. By the end of 2024, the United States' debt will be worth little under $10 trillion. This indicates that around 35%-40% of outstanding US debt must be refinanced by that date, in addition to the new debt to be issued to pay the budget deficit. If Powell follows his commitment to keep rates high until 2024, this means that refinancing will take place at substantially greater rates than in the past.

Even without this large refinancing, the United States' interest expense has already risen to well above 3.5 percent of GDP. It is not so impossible that interest expenditure as a proportion of GDP will soon surpass 1980s highs, when interest rates were much higher but the outstanding debt was just one-third of what it is today.

As a result, the issue of public debt sustainability could be the next big theme in the not-too-distant future, especially if inflation actually returns to 2%, given that the recent spike in inflation was the main driver of the decline in debt/GDP ratios over the last 18 months.

However, given that the United States has the world's largest economy, the largest and most liquid Treasury bond market, and the dollar is the world's reserve currency with no viable alternative, the issue of public debt sustainability is unlikely to explode. Even if the issue arises in the United States, it is not improbable that the US Dollar and Treasuries will strengthen as a result of margin calls and a "flight to quality." A more likely trigger would be the approval of substantial budget deficits in other nations (as was the case with Lisa Truss' mini-budget) or the advent of a global downturn or recession, which would result in a decline in tax collections and the need to expand the economy, resulting in worsening budged deficits and Debt/GDP ratios.

The dynamics and risks described so far are an additional factor that is expected to cause interest rates to remain at a structurally higher level than in the past, as investors are likely to demand higher rates to compensate for the risk of holding government bonds (the so-called "risk-free"...) due to deteriorating public finances.

Nonetheless, in the short term a new extended decline in interest rates remains possible should a slowdown materialize, as the market would first focus on the fact that in a recession inflation collapses and central banks will respond with monetary easing. But this potential decline in risk-free rates may not last that long.

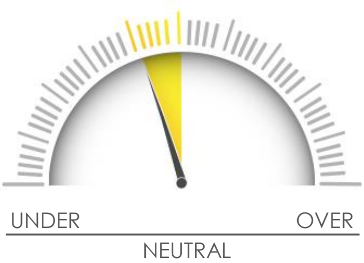
Asset Allocation View

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

− UNDER = NEUTRAL + OVER

Equity

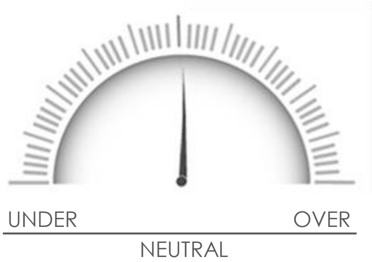
Developed Markets



We maintained our **Slightly Underweight** recommendation on Developed Markets Equities. The August correction was insufficient to return valuations to more reasonable levels, especially given the general rise in market rates and mounting concerns about a global economic slowdown. Furthermore, September is historically the least favorable month for stock markets, so the committee prefers to be cautious for the time being.

US	=	**Europe**	−	**Japan**	=

Emerging Markets



We kept our **Neutral** recommendation on Emerging Markets Equities. Despite the Politburo's pledges in late July, the Chinese government did not take any meaningful steps to bolster the domestic economy in August, disappointing investors, who responded with a new wave of selling. Despite the Chinese economy's numerous challenges, sentiment is currently so negative that a rebound might begin at any time, particularly if bolstered by favorable data or more substantial stimulus. Latin America is our preferred emerging market.

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

Fixed Income

Developed Markets Sovereign

We kept our **Neutral** recommendation on Developed Markets Sovereign Bonds. At the Jackson Hole meeting, all major central banks reiterated the need to maintain tight monetary policy for a long period of time. Markets are slowly taking note of this reality, so it cannot be ruled out that rate curves will continue to move upward a bit. On the other hand, at the current levels, sovereign bonds may prove to be an effective portfolio hedge in the event of an economic slowdown, which cannot be ruled out. Therefore, we recommend maintaining a neutral allocation to the asset class.

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

Developed Markets Corporate

We downgraded our recommendation on Developed Markets Corporates to **Slightly Underweight**. The committee considers that spreads in both investment grade and high yield bonds have tightened too much and are now too narrow, particularly if a slowdown or recession occurs. We continue to favor investment grade corporate bonds over high yields.

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

Emerging Markets

We maintained our **Neutral** recommendation on Emerging Market bonds. Given the macroeconomic environment, emerging market debt spreads are also not extremely wide. However, inflation has already fallen significantly in some countries, some central banks may decide to begin cutting interest rates, which will have a positive effect on the prices of bonds.

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. In terms of other commodities, we remain cautious, as some countries/regions begin to show symptoms of slowing, though not yet in the United States.

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

Currencies

The Committee has removed the bullish bias on the US Dollar, bringing the view back to **Neutral**. Following its rise in August, the dollar is anticipated to stabilize around current levels, pending additional clarity on the trajectory of inflation and what the Fed will do in September.

The view on the Euro has been upgraded to **Neutral**, removing the bearish bias. The Euro weakened in August on the expectation that the ECB may not raise rates in September amid weak macro data. Considering that this seems already priced in by the market, the downside from these levels is currently believed to be modest, with a chance for a rebound in the event of more favorable macro data.

The view on the **Chinese Renminbi** remains **Neutral,** with a bearish bias, in view of the lack of significant economic stimulus despite the pledges of the last Politburo meetings. This lead to a renewed wave of selling by international investors, resulting in pressure on the Renminbi.

The outlook for other **emerging market currencies** remains **Neutral,** although we remain more optimistic about Latin American currencies, which might benefit from some of the world's highest real rates.

Euro	=	USD	=	CNY	=	Other EM	=