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AZIMUT GLOBAL VIEW

22.01.24

Azimut Global Network

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Main Events

CHINA CPI
Deflation in China is expected to worsen to -0.5% YoY, making it increasingly urgent to approve supportive measures

US CPI
Stabilization of inflation around the level of the past six months is the condition set by Powell for the start of the rate cut

JAPAN GDP
After the sharp drop in the third quarter, GDP is expected to recover about half of the prior contraction

US RETAIL SALES
After December's exceptionally strong data, will U.S. consumers continue to spend at a frenetic pace in early 2024?

THE HARE AND THE TORTOISE

- **Powell pushed back against rate cut expectations as early as March, but he made it clear that fighting inflation is no longer the Fed's exclusive focus**
- **Pending confirmation that inflation is stabilizing at the levels of the past six months, the Fed will start cutting rates and might also consider tapering QT, even with a strong economy**
- **The U.S. labor market continues to be exceptionally strong, but this will not derail the expectation of lower rates, at worst, it will only delay the process by a few months**

The long-awaited, perhaps over-anticipated, start of the rate-lowering cycle will be longed for a while yet, at least in the United States. If nothing else, for good reasons.

Let's proceed in chronological order.

The first positive news for financial markets is that the reference to "any additional policy firming" was removed from the FOMC statement, cementing the view that further rate hikes are definitely off the table. Additionally, it was reported that the "Committee judges that the risks to achieving its employment and inflation goals are moving into better balance", meaning that fighting inflation is no longer the Fed's sole focus, as it has been for the past two years. Recall that in the past, the Fed had openly stated that in order to achieve the goal of price stability, it was prepared to accept causing some harm to the economy. This did not happen, but in the end inflation fell anyway. What the Fed is now saying is that it is no longer in "crisis mode" and can make more balanced decisions. Definitely a positive development.

During the conference call, Powell stressed that the Fed's "strong actions have moved our policy rate well into restrictive territory." If we're now "well into restrictive territory" we should expect that any further decline in inflation may lead to a similar reduction in rates.

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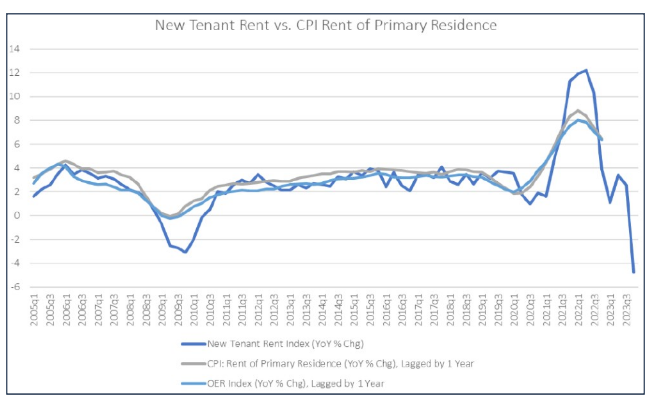
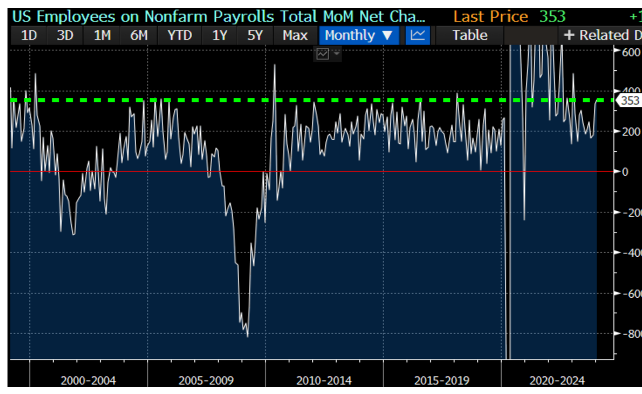


Source: Azimut elaborations on BLS data.



Source: Bloomberg

Later in the conference call, it was repeatedly emphasized that average inflation over the past 6 months (+1.9% annualized for PCE inflation, the Fed's preferred measure) has reached the desired level and that, in Powell's words, "it's just a question of can we take that with confidence that we're moving sustainably down to 2 percent." The logical deduction here is again that the Fed is not opposed to lowering interest rates if inflation remained at current levels; it just wants more evidence.

The housing component, which accounts for more than a third of core inflation, could help in this regard. We know that housing price data are reflected in the official inflation indexes with a lag, usually about a year. And we also know that rental prices have been falling in recent months. Once this decline is fully incorporated into the PCE, which is expected to happen in the coming months, core inflation will have room to fall further.

But, perhaps the most important statement of the whole conference call was the following one: "we look at stronger growth -- we don't look at it as a problem. I think at this point we want to see strong growth. We want to see a strong labor market. We're not looking for a weaker labor market. We're looking for inflation to continue to come down, as it has been coming down for the last six months." This reinforces what is reported in the FOMC statement, and commented on earlier: the Fed is switching to a more balanced approach. Feeling close to achieving its goal of bringing inflation under control, the Fed is changing its mindset and giving more weight to the other of its two mandates: full employment. This will result in a more accommodative monetary policy going forward.

Finally, Powell gave a final, unexpected gift to the market. He said QT tapering will be discussed as early as the next meeting in March. It is unthinkable that they will reduce QT starting in March. However, this means that in March, they will give the market guidance on when and at what pace QT tapering will begin. Realistically, it could coincide with or be close to the first interest rate cut.

Among so much good news, only one was contrary to the market's wishes: Powell pushed back on the expectation that the first interest rate cut could occur as early as March, albeit only in part, calling this hypothesis "unlikely." It is therefore necessary to be more patient. The market, which tends to err on the side of excessive optimism, has been running faster than the Fed is willing to concede, expecting a series of rate cuts right away. The Fed, which is more cautious, wants to go down the same path, just a little slower. Eventually, the two will end up in the same place.

Unfortunately, soon after, nonfarm payroll data made the rate path a bit more bumpy.

The 353k jobs created in January is one of the highest readings ever, excluding the volatile period tied to the pandemic. As if that were not enough, the revision of the previous two months indicated additional 126k new jobs, leading to an overall employment change of nearly +500k from the previous month, against market expectations of +185k. However, the Fed is no longer concerned about labor market strength; in fact, the opposite is true. The Fed was most likely disappointed by the change in wages, which was +0.6% MoM, more than double what was expected and far above the level consistent with 2% inflation. This also explains Powell's hesitancy on rates.

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The market reacted to the exceptionally strong employment data with an equally remarkable rise in market rates, particularly in the short-end of the curve, re-pricing expectations for the beginning of the rate cuts.

It is possible that there will still be jitters about the U.S. curve in the near future, especially if stronger-than-expected data emerges. However, if Powell's message is carefully considered, any increase in market rates should be viewed as an opportunity to accumulate bonds, given that rates appear to be on a downward trend.

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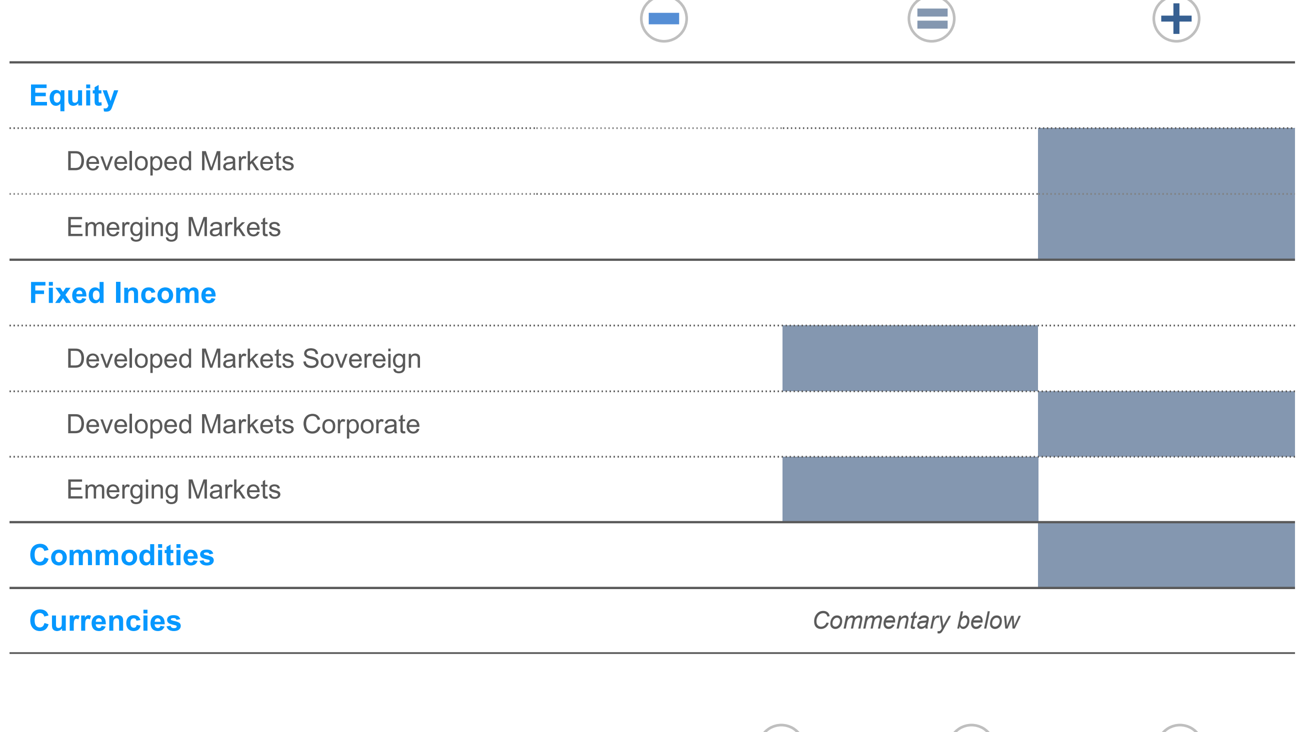
Asset Allocation View

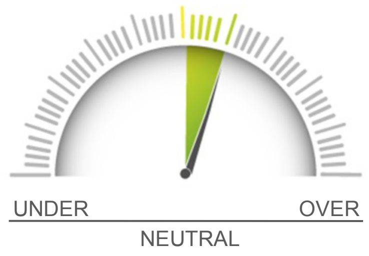


	− (Under)	= (Neutral)	+ (Over)
Equity			
Developed Markets			■
Emerging Markets			■
Fixed Income			
Developed Markets Sovereign		■	
Developed Markets Corporate			■
Emerging Markets		■	
Commodities			■
Currencies		*Commentary below*	

− UNDER = NEUTRAL + OVER

Equity

Developed Markets



We maintained our **Slightly Overweight** recommendation on Developed Markets Equities. The Federal Reserve meeting and US labor market data did not change the scenario from previous weeks. The US economy continues to remain strong, but with a disinflationary trend that should allow the Fed to lower rates even with robust growth. Given the overbought situation, a physiological retracement is possible at any time, and should be considered as an opportunity to increase exposure. Geographically, after the latest economic data and reporting season, the United States has room to continue to outperform.

US	+	Europe	−	Japan	=

Emerging Markets

We kept our **Slightly Overweight** recommendation on Emerging Markets Equities. On the one hand, emerging country valuations continue to be attractive on both an absolute and relative basis, and on the other hand geopolitical tensions as well as negative sentiment are capping the potential upside. Any positive catalyst (economic stimulus, easing of tensions) has the potential to significantly boost emerging economies. However, Trump's intention to impose 60% tariffs on Chinese imports (if elected) has weighed on sentiment toward China.

Asia ex-Japan	=	EEMEA	−	LATAM	=

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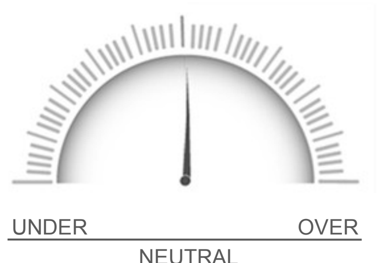
Fixed Income

Developed Markets Sovereign



We keep the **Neutral** stance on Developed Markets Sovereign Bonds. As elaborated in the prologue, the Federal Reserve's interest rate cut is only postponed and not ruled out, while in Europe it may start earlier than expected. Therefore, the bulk of the physiological rebound in rates after the rally in the last months of 2023 is believed to be over. However, further adjustments may be possible in the short term, so we prefer to maintain a neutral stance for the time being.

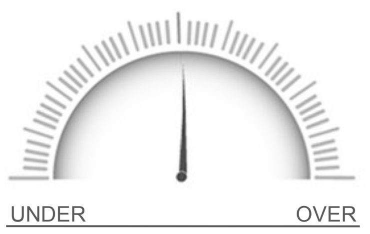
EU Core	=	EU Periphery	=	US Treasury	=	Japanese JGB	=

Developed Markets Corporate

We kept our **Slightly Overweight** recommendation on Developed Markets Corporates. Given that risk-free rates may have completed the physiological retracement that began at the beginning of the year, that the Federal Reserve has confirmed that it will discuss QT tapering at its March meeting, and that the economy remains strong, it is possible that investors will resume their hunt for yield. In that scenario, corporate bond spreads could narrow even further. We continue to favor investment-grade corporate bonds and advise against high-yielding bonds.

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

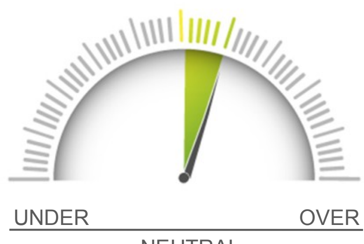
Emerging Markets



We also maintained our **Neutral** recommendation for Emerging Market bonds. On the one hand, the expectation of more accommodative monetary policies from Western central banks could foster a return of interest towards the asset class from international investors, especially should the dollar weaken from current levels. On the other hand, rising geopolitical tensions and rather negative sentiment towards emerging countries suggest that some caution is still needed.

Local Currency	=	Hard Currency IG	−	Hard Currency HY	−

Commodities



We kept our **Slightly Overweight** recommendation on Commodities. Precious metals continue to be the preferred commodities as they serve as a portfolio hedge in the event of escalating geopolitical tensions and are the ones that should benefit the most when the interest rate cut cycle begins. The committee remains more cautious on other commodities, as they are linked to the evolution of the business cycle.

Precious	+	Energy	=	Industrial	=	Agricultural	=

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Currencies

The Committee kept the **Neutral** stance on the US Dollar. Confirmation that the Fed will start discussing about tapering QT in March and eventually start cutting rates this year is bearish for the US Dollar, while the strong labor data is bullish. On balance, the greenback may remain stable around current levels.

For the same reason, the view on the Euro is **Neutral** as well. Weaker economic data and the possibility of the ECB starting to cut rates before the Fed have already been discounted by the market, meaning the euro could remain range-bound against the world's major currencies.

The view on the **Chinese Renminbi** remains **Neutral,** with a bearish bias. In the absence of adequate stimulus measures, and with persisting geopolitical tensions, the renminbi can have further downside.

The outlook for other **emerging market currencies** is **Neutral.** We continue to remain relatively more optimistic about Latin American currencies.

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