azimut

AZIMUT GLOBAL VIEW

22.01.24

Main Events

ECB MEETING
Will the ECB confirm several of its members' hawkish statements that interest rates are unlikely to be cut before the summer?
25.01

US GDP
Considering the strength of the latest data, it is possible that US GDP will grow faster than the 2% predicted by economists
25.01

FOMC
Will the Federal Reserve confirm or deny market expectations for a rate cut as early as March?
31.01

EU CPI
Will European inflation continue to fall as expected, or will there be setbacks similar to those experienced in the UK?
01.02

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

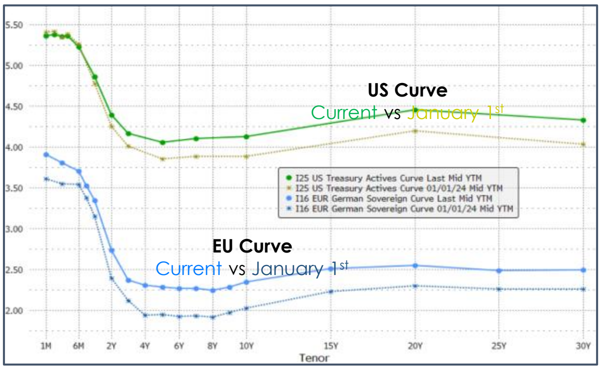
IS THAT FOR REAL?

- **Higher than expected inflation readings, strong macroeconomic data and renewed geopolitical tensions have led to a further increase in market rates**
- **This reaction seems disproportionate considering the true extent of the inflationary pressures, the abundance of liquidity, and the Federal Reserved signaling the possibility of tapering the QT**
- **Additionally, there was record demand for bonds in the primary market, with new issuances being subscribed twice as much as last year**

In the last few weeks, we came across some news that passed rather unnoticed but should have actually increased the focus on fixed income: liquidity and demand for bonds; the two areas capturing our attention.

But let's focus first on what is putting some renewed pressure on rates after the amazing, historical, returns in November and December last year: the apparent interruption of the deflationary path at levels still higher than the targets of central banks, both in US and Europe, with the path now more uncertain given a still strong job market, confidence rebounding with wage growing faster than inflation supporting future consumption, together with cumulated savings.

Without forgetting what is probably the major cause of renewed inflation fears: geopolitical frictions in the Middle-East, mostly in the Red Sea.



Source: *Bloomberg*

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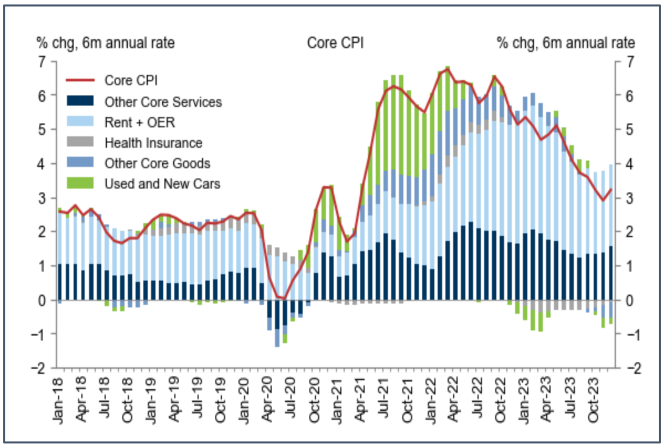
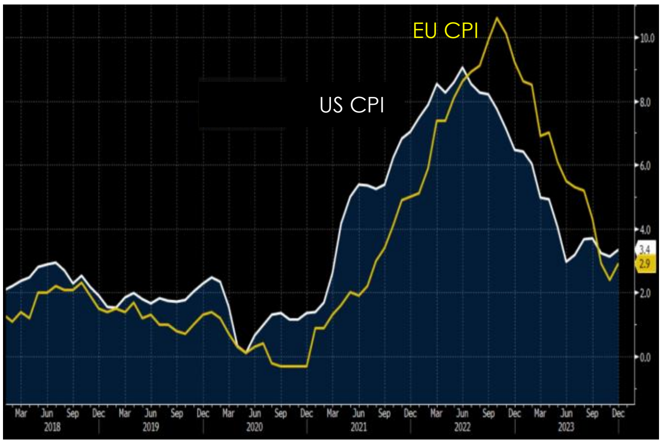


Source: *Department of Labor, Goldman Sachs*



Source: *Bloomberg*

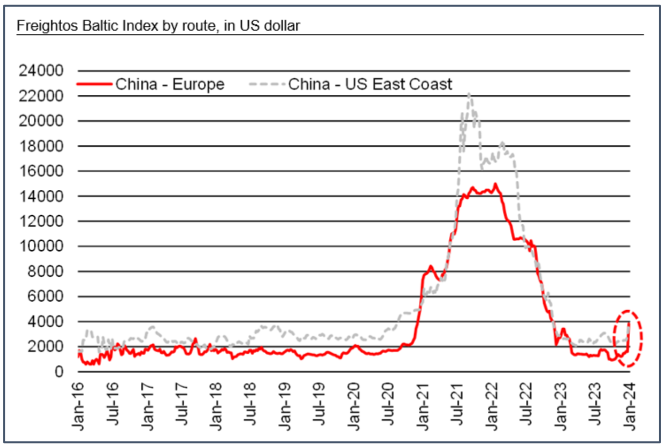
The Houtis terrorist actions in the Red Sea are putting renewed pressures on shipping companies, leading them to divert their routes to longer and more costly paths. However, a good comparison with previous experiences of "supply side issues" is worth mentioning: translating these dynamics in renewed inflationary pressures seems really too much from our point of view.

Let's focus now on what seems really supportive for fixed income markets in the long run.

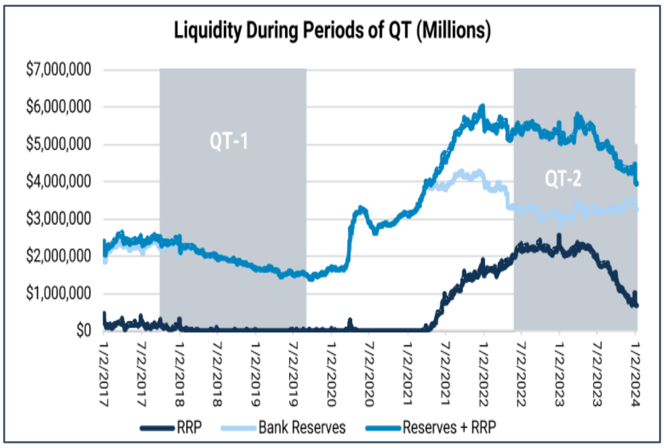
Liquidity:

A few days ago, Fed's Logan mentioned a drop in reserves as the factor they have on their radar, creating some disappointment. This drop is seen as a reflection of a potential beginning of difficulties among banks managing their liquidity, with a subsequent potential impact on repo markets. As a reminder (thanks to Jefferies): "In the prior attempt to reduce the balance sheet through QT (let's call it QT-1), the Fed tried to estimate the "lowest comfortable level of reserves" (or LCLoR) and manage the pace of rolloffs to try and get down to that level. In the end, this failed spectacularly as no one correctly estimated the LCLoR, whether inside the Fed or out."

What Jefferies refers to in the comment is the spike in repo rates occurred in September 2019: reaching as high as 10% intraday, with disruption beginning the day of Treasury settlement, coinciding with corporate tax deadlines. The combination of these two developments resulted in a large transfer of reserves from the financial market to the government, creating a mismatch in the demand for and the supply of repo that drove rates higher. This is the reason why Mrs. Logan signaled a potential reduction in the pace of QT, which could occur during this year.



Source: *Unicredit Research, Bloomberg*



Source: *Fed Board of Governors, Bloomberg*

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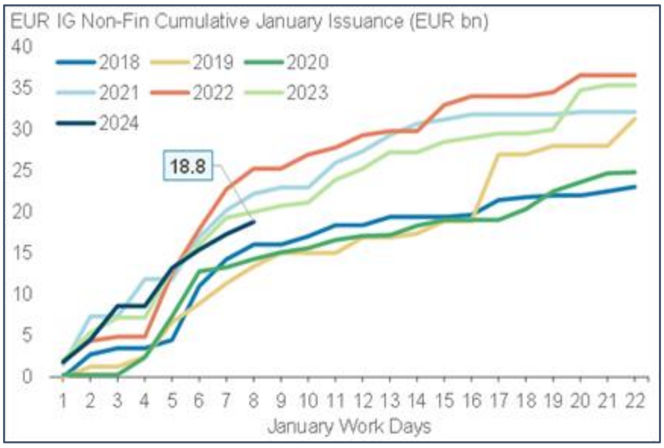
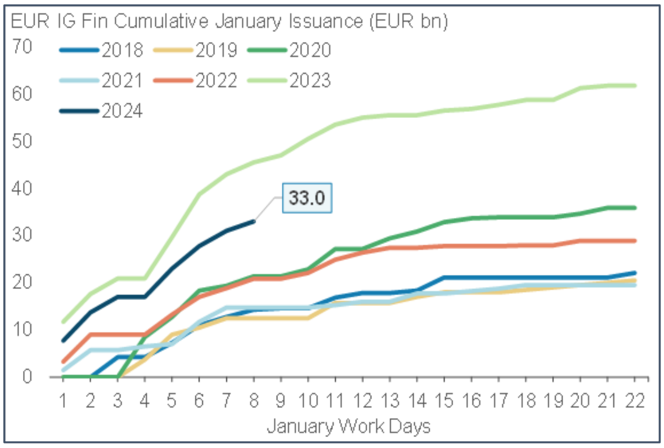


Source: *Morgan Stanley Research*



Source: *Morgan Stanley Research*

This should be treated as a major news: the extra boost of liquidity markets received after Covid, which, given the end of the pandemic was supposed to be withdrawn, will actually remain in circulation. Investors have complained for years about the distortions created by excess liquidity: flat curves, extremely low yields and booming equities with tight valuations. The withdrawal of liquidity should have removed part of those distortions, bringing steepness to yield curves on the back on investors asking risk premium again, and eventually moderating excesses on equities.

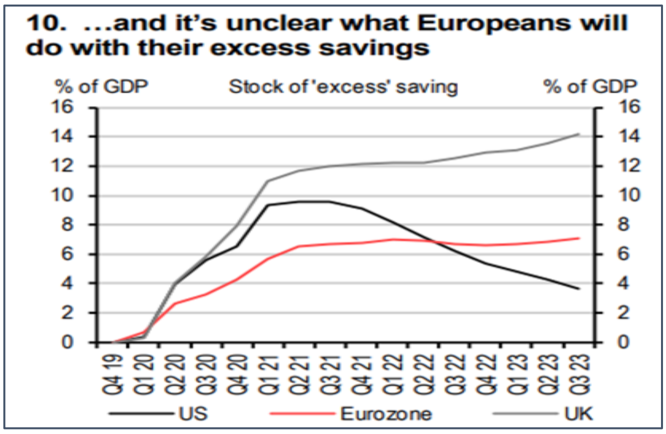
This flushness of liquidity could actually be part of the explanation why central banks hiked rates so much and with such a speed, and practically both global growth and employment practically unaffected. Now, if instead of seeing that liquidity persistently withdrawn, markets will be able to enjoy it for a longer period, the same excesses and distortions have the chance to persist supporting both the credit and equity markets.

Demand for bonds:

Fears of huge amount of issuance and of digestion of that issuance were widespread. However, it turned out to be quite manageable.

What should be really striking is the demand for that issuance: books on credit issuance have started going back to higher multiples, in some cases 5x-8x, compared to more modest 2x-4x in 2023. A comment from a credit sales at a major European bank: "But when you consider the size of the supply being absorbed (in Peripheral, which is ultimately Credit!), and the size of the order books coming in, you get a sense of how strong the market actually is: a quarter of a trillion euros in demand for BTP and SPGB – half a trillion if we add Belgium and the rest of the Credit Markets."

One thing is quite clear: if you wonder what consumers typically do with their excess savings, the answer may very well lie in the attractive yields offered by bonds.



Source: *BEA, ONS, Eurostat, Macrobond, NB*

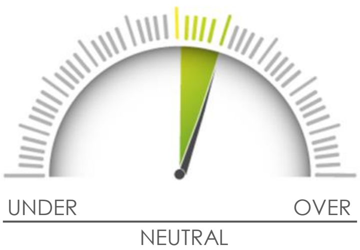
Asset Allocation View

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

− UNDER = NEUTRAL + OVER

Equity

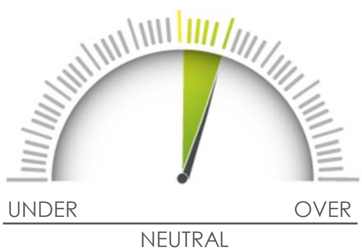
Developed Markets



We maintained our **Slightly Overweight** recommendation on Developed Markets Equities. The majority of the committee members have a constructive view on equities, at least on a tactical basis, as strong economic data, inflation under control and the breakout to new highs suggest that a continuation of the uptrend is possible in the short term. However, valuations remain rather high, and the possibility of adverse surprises from central banks or the upcoming reporting season suggest that caution is still warranted.

US	=	**Europe**	=	**Japan**	=

Emerging Markets

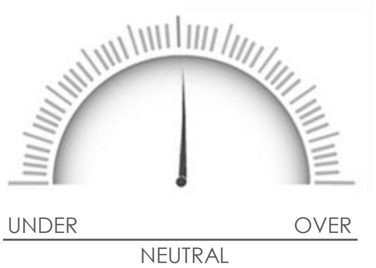


We kept our **Slightly Overweight** recommendation on Emerging Markets Equities. On the one hand, emerging country valuations continue to be attractive on both an absolute and relative basis, and on the other hand geopolitical tensions as well as negative sentiment are capping the potential upside. Any positive catalyst (economic stimulus, fading of some of the tensions) could allow emerging countries to rebound significantly.

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

Fixed Income

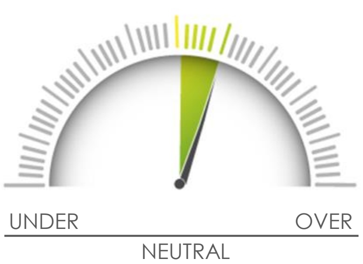
Developed Markets Sovereign



We keep the **Neutral** stance on Developed Markets Sovereign Bonds. After the increase in rates across all developed countries' curves, the committee believes that most of the bond retracement is now over, and consequently rates should not rise significantly from here. However, in the medium term the committee remains constructive on the expectation that interest rates will continue to fall from the current levels

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

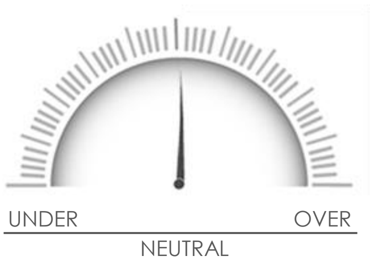
Developed Markets Corporate



We upgraded our recommendation on Developed Markets Corporates to **Slightly Overweight**. Considering that risk-free rates may have concluded the physiological retracement that began at the beginning of the year, that the Federal Reserve may slow the pace of QT, and that the economy remains robust, it is possible that investors will resume the hunt for yield. In that scenario, a further narrowing of corporate bond spreads is conceivable. We continue to favor investment-grade corporate bonds and recommend avoiding high-yield bonds.

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

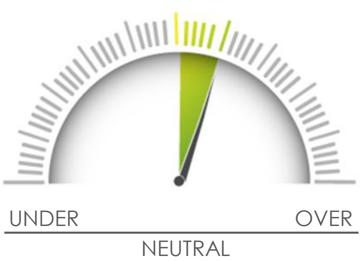
Emerging Markets



We also kept our **Neutral** recommendation on 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 may have room to extend their advance, thanks to the central banks' pivot and the fact that they tend to act as a portfolio hedge in the event of rising geopolitical tensions. The committee remains more cautious on other commodities, as they are linked to the evolution of the business cycle, and it is too early to be confident that a soft landing will actually occur.

Precious		Energy		Industrial		Agricultural	
	+		=		=		=

Currencies

The Committee kept the **Neutral** stance on the US Dollar. Barring unforeseen changes of stance by the central banks in their first meeting of the year, all major currencies seem fairly valued.

For the same reason, the view on the Euro is **Neutral** as well.

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.** The change in stance by Western central banks and lower rates are supportive for emerging currencies, while local bonds may also benefit from a reduction in rates by the central banks of emerging countries. We continue to remain relatively more optimistic about Latin American currencies.

Euro	**USD**	**CNY**	**Other EM**