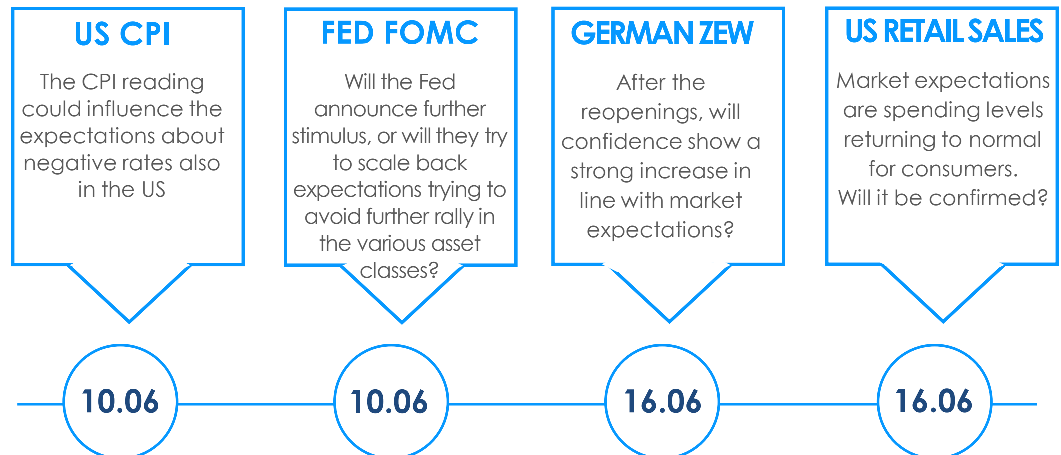
Main Events

Azimut Global Network

- Milan
- Abu Dhabi
- Cairo
- Dubai
- Dublin
- Hong Kong
- Istanbul
- Lugano
- Luxembourg
- Mexico City
- Miami
- Monaco
- Santiago
- São Paulo
- Shanghai
- Singapore
- Sydney
- Taipei



RED LINES

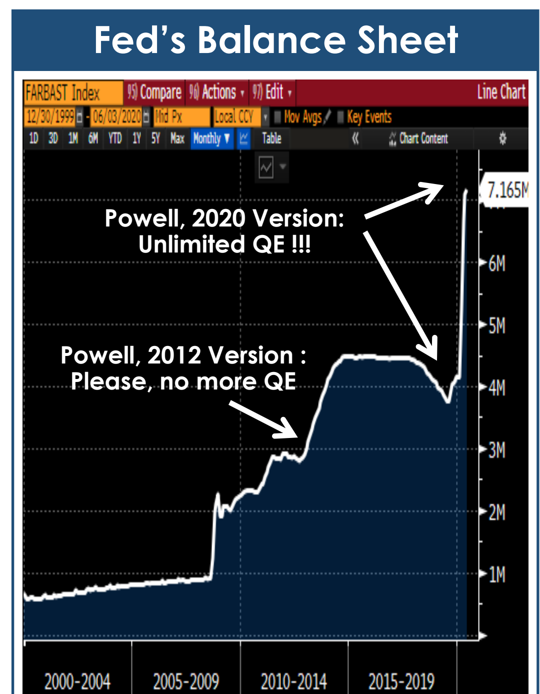
Unchanged. Looking at just YTD performances, 2020 seems a very boring year, with all major indices and asset classes at, or just below, the closing levels of 2019. Covid-19 seems now a problem of the past without any lasting effects, at least from financial markets' perspective.

This has been possible only because of the coordinated actions of central banks worldwide, especially the Fed which under Mr. Powell embarked in the biggest monetary Stimulus in history. Ironically, it's the same Powell who in 2012, during an FOMC debate about the opportunity to implement QE3, argued against it (www.federalreserve.gov/monetarypolicy/files/FOMC20121024meeting.pdf; pages 192-193) :

"First, the question, why stop at $4 trillion? The market in most cases will cheer us for doing more. **It will never be enough for the market. Our models will always tell us that we are helping the economy, and I will probably always feel that those benefits are overestimated**.

[…] Second, I think **we are actually at a point of encouraging risk-taking**, and that should give us pause. **Investors really do understand now that we will be there to prevent serious losses**. It is not that it is easy for them to make money but that **they have every incentive to take more risk, and they are doing so**.

[…] My third concern - and others have touched on it as well - is the **problems of exiting from a near $4 trillion balance sheet**."



Source: Bloomberg

(continued)

What an about-face 8 years later! Over the last 3 month the Fed expanded its balance sheet by almost 3,5 trillion (and counting), an amount which equals the cumulative balance sheet expansion of the previous decade.

Unfortunately, the side effects Powell warned about 8 years ago are more actual than ever. The rebound of all the asset classes has been by any measure without any precedent and we are reaching levels that are no longer in touch with the economic reality.

Let's start from equity markets. The price/earnings (P/E) measured on the basis of 2020's expected earnings (green lines in the graphs below) are skyrocketing like never before. Only if measured on 2022's expected earnings (red lines in the graphs below) valuations seems to remain within historical boundaries, even if at their top end.

Source: Bloomberg

Based on 2020 expected earnings (green lines) the S&P500 is reaching the same valuations of the dot.com bubble of 2000. The same for the Nasdaq 100, whose data starts only from 2001. US small caps, which are more linked to the real economy and that will benefit less from the QE (they are not large enough to be in the main indices and ETFs) have seen their valuation exploding near 45 (S&P600 index). In Germany P/E reached 21.

It is worth noting under which assumptions the 2022's expected P/E is apparently still within historical ranges. Let's take a look at the values in the cyan boxes. The implied EPS growth assumptions are the following:

- S&P500: from 2020 EPS of 125 to 2022 EPS of 188. Market's expected EPS growth: +50%
- Nasdaq 100: from 2020 EPS of 330 to 2022 EPS of 478. Market's expected EPS growth: +45%
- S&P600: from 2020 EPS of 20 to 2022 EPS of 52. Market's expected EPS growth: +135%
- DAX: from 2020 EPS of 610 to 2022 EPS of 1040. Market's expected EPS growth: +70%

(continued)

For DAX, it should be highlighted that reported EPS for 2019 was 560. Since market expectations this year were impacted by the covid-19, EPS will be at 510, or 10% above last year's level. Put it in other words, markets expect that German companies will benefit from the lockdown and will earn more than before of the outbreak of the virus.

Currently, the market participants are trying to justify current valuations saying that 2020 and 2021 earnings should be disregarded as they are not representative of the true earnings potential of the companies, which will be attained again only in 2022. The irrational thing is that companies are so uncertain about their own future that most have withdrawn their guidance, but analysts instead seem convinced that they will be able to fully recover any losses incurred by the coronavirus and its aftermath. If the history repeats itself, or at least it rhymes, when markets are obliged to find a creative explanation to justify valuations, it's because we're entering in a bubble territory.

Let's now switch to fixed income, and let's focus on the high yield, which is considered the segment of the credit market with the weakest fundamentals. Below, it is shown the YTW (Yield to Worst, the correct measure of the "YTM" for high yields).

Source: Bloomberg

Yields reached about 12% in both US and EU in the midst of the covid-crisis, but have since recovered the vast majority of the movement. Currently YTW are at 6.1% in US (they were at 5% earlier in 2020) and at 5.4% in EU (from a 2020 low of 3.2%).

If we assume that the economic damages of the coronavirus are at least somehow similar to those of 2008-2009, than current YTW are ridiculously low. Eleven years ago yields reached 23% in US and 30% in EU. Now we are trading at about one quarter and one sixth of those levels, respectively.

There are countless of other evidences that currently financial markets are no longer considering fundamentals, and that market participants have given up any prudent approach in evaluating the risk/reward of their investments. As Powell correctly pointed out, moral hazard seems to be the only game in town now.

The risk, though, is to cross the tiny red line where financial markets could stop from being the most efficient allocators of financial resources. If they start following blindly what governments and/or central banks say, then we're entering in a completely different system, the one of centralized planification. Asset prices tend to converge towards the desired levels of the central planner, active managers are forced to leave the markets, liquidity progressively dries up. De facto, financial markets slowly cease to exist.

(continued)

There are unfortunately some signs that could suggest that this process may have already started. Let's have a look at the 10-year treasury futures, one of the most liquid instrument in financial markets.

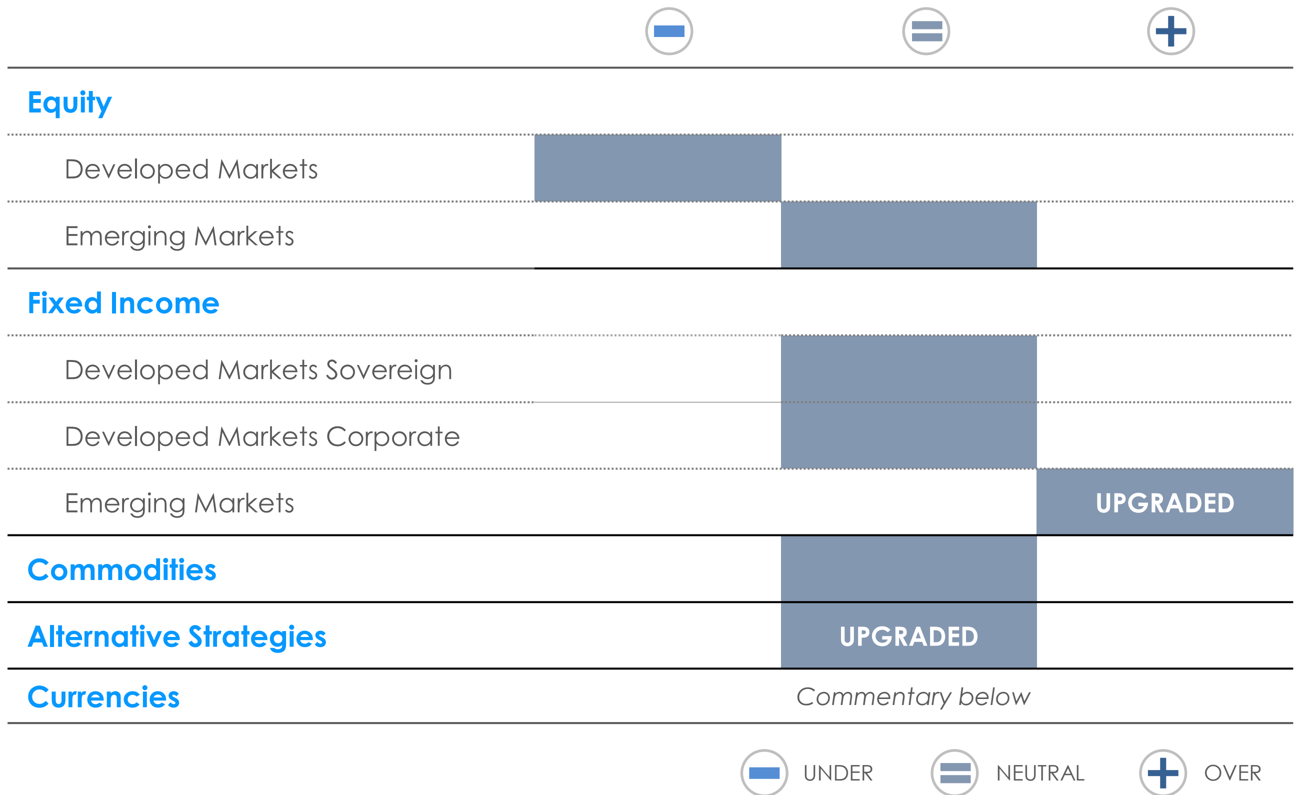
The graph on the left shows the YTD move of the price of the futures contract. During the panic, US treasury futures prices increased sharply. Starting from the second half of March, when the FED started to intervene, prices suddenly stopped moving. In the past two and a half month, the contract remained in a range of just 1,3%. Even if the S&P500 rebounded by more than 40% from its March low, the treasury barley budged instead of reversing the upward move of the first part of 2020.

In the right graph, it is shown the same treasury bond futures, on a three year horizon. It could be appreciated again the unnatural behavior of the price movement of the past months, but the most important thing to look at is the volumes (the cyan bars in the lower part of the graph). The orange line crossing the bars is the 3 months (62 trading days) moving average of the volumes. As expected, volumes picked up in the first part of the year, but then suddenly they started decreasing once the prices become rangebound. This reduction in volumes is not normal, considering the explosion of the treasury bond issuance from the treasury department, the FED purchases and the needed portfolio adjustments of market participants during such a volatile period.

Source: Bloomberg

The next weeks and months will be crucial to understanding where we're headed and how much this policymaker-induced bubble may still grow. Assuming that the red line won't be crossed and that free markets will continue to prevail as they ever did, then current valuations on all risky assets suggest a bit of a caution is now appropriated.

Asset Allocation View

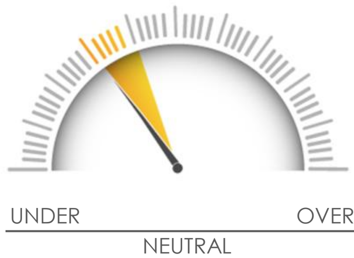


	Under	Neutral	Over
Equity			
Developed Markets	■		
Emerging Markets		■	
Fixed Income			
Developed Markets Sovereign		■	
Developed Markets Corporate		■	
Emerging Markets			UPGRADED
Commodities		■	
Alternative Strategies		UPGRADED	
Currencies	Commentary below		

UNDER NEUTRAL OVER

Equity

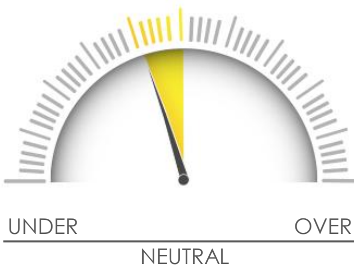
Developed Markets



We maintain the overall cautious recommendation. Valuations are at stretched levels measured in terms of fundamentals. The risk/reward profile is currently suboptimal, as the only supportive factors are central banks and governments interventions. A correction may start at any time, considering the overbought condition. One possible trigger could be a steepening of the yield curve. Even if equities are unattractive on absolute basis , there are still some relative value that could be found. Last time we increased our recommendation on European equities because of the approval of the European Recovery fund, and we think that the recent strength could persist for some time.

US **Europe** **Japan**

Emerging Markets

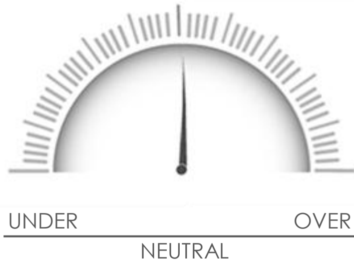


We keep emerging markets in a slightly underweight position after the recent rebound. We maintain a moderate preference for emerging markets as their multiples are well below of those main developed markets. In terms of the geographical area, we are no longer preferring Asia versus Eastern Europe and Latin America, as the rebound in commodities could lead to a recovery in highly cyclical stocks that represent the majority of Russia and Latin American indices.

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

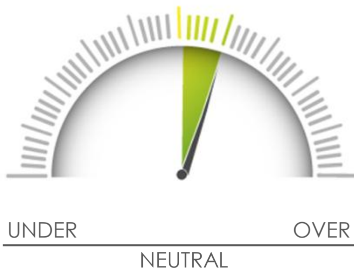
Fixed Income

Developed Markets Sovereign



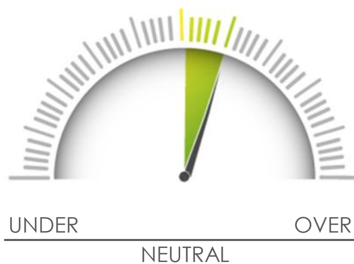
We maintain a neutral view as the ongoing QEs by all the major central banks should keep rates close to the current levels for all markets. In Europe the ECB just announced the additional purchase of €600 billions of bonds, and the extension of the duration of the PEPP. Due to the current levels of sovereign yield, there is little value to be found now, but this does not imply that there is downside risk either, at least in the short term. In this environment, a profitable investment strategy could be implementing some steepener in the portfolio. The risk-on attitude in the equity markets could lead to the perception that a recovery is effectively underway and therefore the long-end of the curves could start to move to the upside.

Developed Markets Corporate



We keep our overweight stance. Unfortunately as in many other asset classes, the levels reached by the spreads are not particularly attractive anymore. Notwithstanding this, because of the various QEs, investment grade corporates are as protected as sovereign, but offers a slightly higher yield. In the Fixed Income space, investment grade bonds appear to be the best place in terms of risk/reward. We downgraded EU and US high yields to underweight again as their spreads contracted too much, also considering the expected increase in the default rate.

Emerging Markets



We increased the recommendation on EM bonds to slightly overweight as these bonds did not enjoy the same fast recovery of other segments of the credit markets. They were left behind because EM central banks are not doing QE on their bonds, therefore investors have been more cautious in buying those. Considering the low levels of the risk-free, the compression of the spreads in developed market corporates and the rebound of commodities, there is room now for a catch up of emerging bond. Among them, we have a strong preference for local currency bonds.

Commodities

We have a neutral stance with a positive bias. We continue to prefer precious metals because of the low yield environment, and as a hedge against unexpected turbulence. Because of the possibility that the Euro will continue to be quite strong in the short term for the reason explained in the currency section, for Euro-based investors precious metals could be a less attractive investment solution as any strength in the Euro will dent on performances. We are neutral on energy commodities after the big rebound of oil, and are still moderately cautious on industrial metals, waiting for a more clear sign that a recovery is underway.

Alternative Strategies

We upgraded our recommendation to neutral on liquid alternative strategies, because of the diminished expected returns on other asset classes. This implies that other asset classes have now higher downside risk and could be vulnerable to volatility as well. Therefore alternative/decorrelated strategies are more attractive on a relative basis.

Currencies

We have a slightly positive view on the euro, as the approval of the European recovery fund is not just a sign of more cohesion within EU members, but could be interpreted as the first concrete step towards more integration and stability of the EU. Europe was the biggest underweight position in investor portfolios, therefore there is room for the Euro to remain strong in the short and mid term thanks to the flows of purchases.

We have a slightly negative view on the US dollar, not only because of the expected strength in the euro, but also as policymakers (government, FED) seems to be willing to embark on even more deficit spending and monetary easing. The riots in the US did not help the sentiment either.

We maintain our slightly negative view on the Japanese yen, as there are no positive catalysts in sight for the currency.

On emerging markets currencies, we have a constructive view as most of them appear to be undervalued and the yields offered by those currencies are more and more attractive as YTM continues to fall in developed markets.

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