AZIMUT
DEFINING INVESTMENT DIRECTION

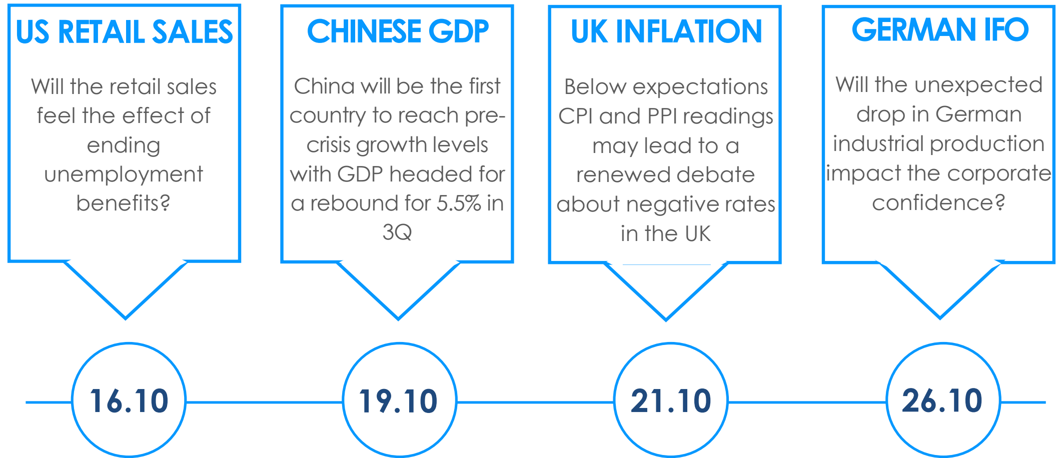
AZIMUT GLOBAL VIEW

12.10.20

Main Events

Azimut Global Network

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

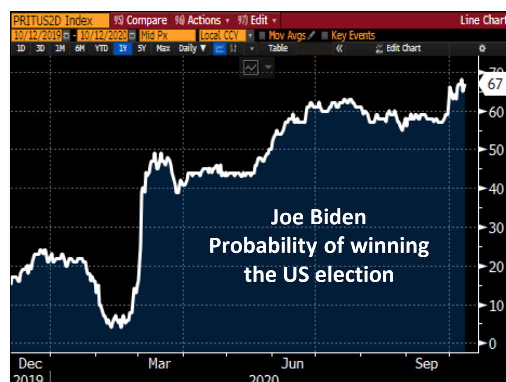


THE RISE OF CHINESE ASSETS

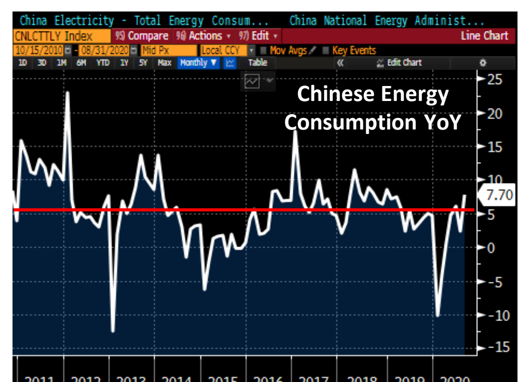
After the impressive rally from mid-March lows, all asset classes continued to trade at quite expensive levels, at least using the standard valuation metrics, when the global economy is still fragile and needs further fiscal stimulus in order to avoid a new downturn. In such a challenging environment, identifying areas of relative undervaluation and/or with stronger growth potential is particularly important.

One area would be China where our Global Team has been bullish for several months. After the Golden Week holiday, Chinese assets continued their relentless advance, and the constructive view is far from over.

Two of the bullish cases are widely known. The first one is the expected triumph of Joe Biden in the upcoming US elections, as suggested by the polls (graph below left). If this will be the case, then the relationship between China and the US could improve substantially boosting confidence in Chinese's economy and its financial markets. As demonstrated by data, China is well on its way to recover from coronavirus and the first country expected to go back to pre-covid-19 activity levels. For illustration purposes, we picked the total energy consumption that was up by 7.7% YoY in August, above the 10-year average growth rate (graph below right).



Source: Bloomberg, data as of October 12th, 2020



Source: Bloomberg, data as of August 2020

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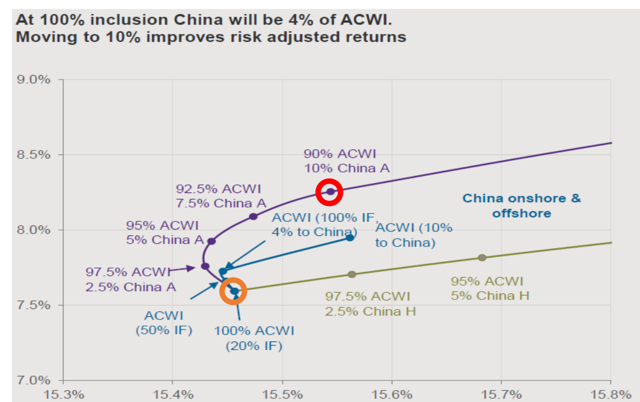
Given the solid ground presented by the Chinese equities investment thesis from an economic standpoint, we can say the same scenario from a financial standpoint holds true. Currently Chinese A-Shares are only partially included in the MSCI global indices. MSCI included Chinese A-shares for the first time in February 2019 with a 5% inclusion factor, which was increased to 20% at the end of 2019. The "inclusion factor" is the portion of the market cap that is considered by MSCI when it determines the weightings of its indices. For example if the inclusion factor is 10%, only one tenth of the market cap of a stock is considered. It is expected that over time this ratio will reach 100% (full inclusion), which corresponds to a Chinese equity weighting of 4% in the MSCI All Country World Index (hereinafter "MSCI ACWI"). As passive instruments represent an always larger share of total investment funds, this change in weightings will lead to large inflows into Chinese A-Shares.

Chinese A-Shares currently trade at about 16.5 expected P/E, compared to 26.4 for the S&P 500, as shown in the upper part of the graph below left. In the lower part of the chart the discount (spread) between the two metrics is shown, which is at record levels (almost -10 points). Putting in other words, the S&P 500 is 60% more expensive than the Chinese shares.

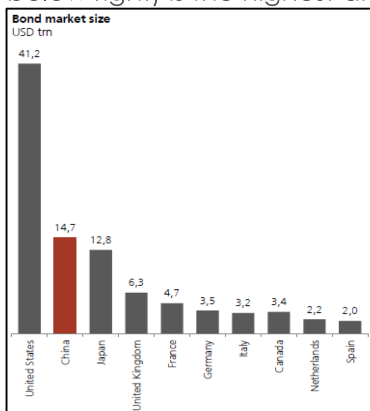
As can be seen on the graph below right, adding Chinese equities to a global equity portfolio could be an efficient strategy: a portfolio made up entirely of the MSCI ACWI (orange circle) has a volatility of about 15.45% and an expected return of about 7.6%. Another portfolio comprised of 90% of the MSCI ACWI and10% of Chinese A shares (red circle) has a 15.55% volatility(less than1% higher) with a 8.3% expected return(~10% higher).

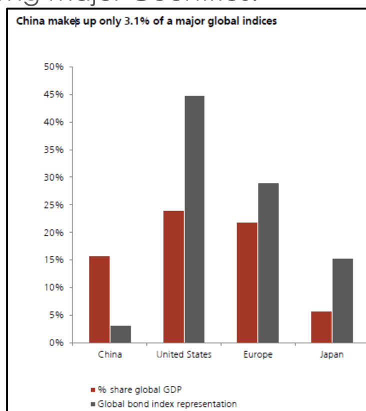
Source: Bloomberg, data as of October 12th, 2020

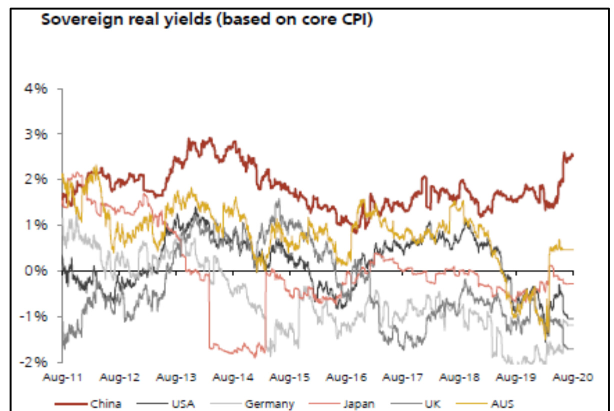


Source: J.P. Morgan Asset Management

In the bond markets we observe a scenario akin to equity markets. The size of the Chinese bond markets is nearly15 trillion USD, second only to the US (graph below left), but its weight in the global bond indices is only about 3% (grey bar in the center graph), well below US, EU and Japan. Also in this case it is expected that over time the bond market indices will allocate higher weighting to Chinese bonds. Likewise equity, fundamentals are in favor of China as the real rate offered by Chinese bonds (red thick line in the chart below right) is the highest among major Countries.







Source (all charts): UBS Asset Management

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On the basis of all the aforementioned evidence, it could be expected that Chinese assets (equity, bonds and currency) could remain strong in both the short and long term. The only possible negative catalyst would be the surprise victory of Donald Trump, but even in this case the long term positive developments for China that have been discussed could not be derailed or stopped, and any correction must be considered as an attractive opportunity to add onto the existing positions.

Asset Allocation View

Equity

Developed Markets

Emerging Markets

Fixed Income

Developed Markets Sovereign

Developed Markets Corporate

Emerging Markets

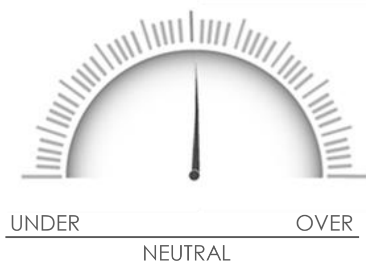
Commodities

Alternative Strategies

Currencies *Commentary below*

Equity

Developed Markets



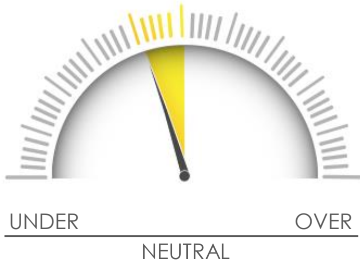
We maintained our neutral recommendation on developed markets equity after the upgrade done two weeks ago; looking for a short term rebound. Valuations remain expensive and the recent move seems to be driven mostly by the expectation of additional fiscal stimulus approval in the short term. In terms of regions, Europe and US continue to be seen equally attractive, but some portfolio managers are considering again favoring US Equities given the sharp rise in covid-19 cases across Europe and the expectation for slower EPS growth in the EU.

Emerging Markets

We keep our slightly positive recommendation on Emerging Markets with a strong long term preference for the Asia ex-Japan region, China in particular. The reasons for our positive stance on Chinese assets has been elaborated in the initial market commentary. The increased probability of Biden winning the Presidency should continue to sustain the uptrend in the Chinese markets. Unchanged the view on the other regions. A weaker dollar, a continued consensus of the committee, constitutes strength for the EM equities in general.

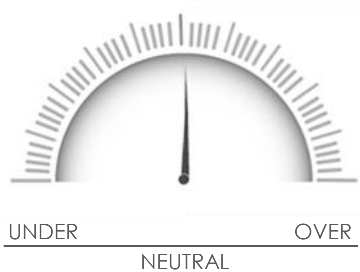
Fixed Income

Developed Markets Sovereign



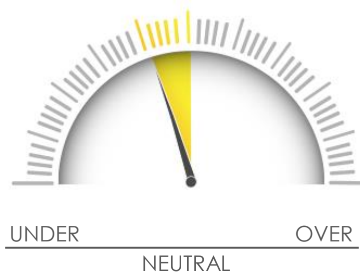
We kept our slightly underweight recommendation for developed markets sovereign bonds. After the recent increase in the US 10Y Treasury rates (albeit moderate, just +10bps) we are turning positive again on the US treasury bonds. In Europe the recent drop in the CPI readings is putting off, at least in the short/medium term, the possibility of an increase in the EU sovereign rates, but we are seeing no further upside either. We continue to prefer EU peripheral bonds compared to other core European bonds.

Developed Markets Corporate



We maintained our neutral recommendation on developed markets corporate bonds. The QEs implemented by all major central banks on their sovereign and corporate bonds are compressing both risk-free rates and spreads. Monetary policies will remain accommodative for an extended period of time supporting the corporate bonds prices amid the hunt for positive yield. In the corporate bond space our preference remains in the investment grade. The slowdown in the real economy is weakening the fundamentals of some corporates, especially in the high yield space, where we keep the negative stance.

Emerging Markets

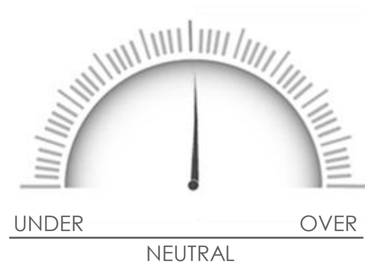


We keep our slightly underweight recommendation. Even if emerging markets bonds trade at richer yields than developed market bonds, the central banks of emerging markets are not implementing QEs on their local bonds, and therefore emerging market bonds are more vulnerable than the corresponding developed market bonds. We are keeping a positive stance only on Chinese debt, as the Renminbi is expected to continue to strengthen over time on the back of the increased inclusion in international portfolios, as explained at length in the initial market commentary.

Commodities

After the recent correction in precious metals, we are increasing our recommendation by one notch on the asset class. Among the commodities we mostly prefer gold because of the low yield environment, and as it could serve 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 reasons explained in the currency section, for Euro-based investors precious metals could be a less attractive investment solution as any strength in the Euro might detract from the performance.

Alternative Strategies



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

Currencies

We maintained the positive view on the Euro in the short term. The fall in the EU inflation rate over the past few months made the real rates much less negative in the Eurozone, de facto making the Euro more attractive in relative returns in the EU. The only weak spot for the Euro is the increase in covid-19 cases, which could put a drag on the currency if new lockdowns are imposed.
We kept our negative view on the US dollar due to the expected strength of the Euro and the uncertainty relating to upcoming US election results.
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 turned bearish on two developments. Turkey and Hungary have increased interest rates and their currencies depreciated afterwards. This is a risk that could spill over to other countries.

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