AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

25.
05.
21

Main Events

Azimut Global Network

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

28.05	US PERSONAL SPENDING	How much will the US consumer scale back his spending after the consumption boom following the two fiscal stimuli of 2021?
31.05	EU CPI	Germany and Italy will publish their preliminary CPI data for May. Will they signal a heightened inflationary pressure also for the Eurozone?
01.06	WORLD PMI	Markit will publish PMI indices for most of the countries. Is the synchronized global recovery effectively taking place?
04.06	US PAYROLLS	A strong labor market data may stoke fear of earlier than anticipated tapering by the FED

HERE TO STAY

- **The latest US inflation figures were markedly above expectations**
- **Commodity boom, bottlenecks, labor shortages and fiscal stimuli can have lasting effects**
- **Central banks are still convinced that those effects will be transitory, and so far financial markets are not questioning these assumptions**

Several important inflation figures have been released in the past couple of weeks, but all of them were quickly branded by the Fed as transitory and/or due to the base effect, and markets quietly followed suit. Let's carefully and objectively review those data.

As everyone knows, the US generic CPI came out at +4.2%, and the core at +3.0%, much higher than expected, even considering the well known “base effect”. As a reminder, CPI fell 1.1% last year due to the pandemic and the ensuing lockdowns. This “abnormal” decline constitutes the famous "base effect", or how much the CPI reading should have been distorted to the upside. Assuming stable inflation around 2%, the CPI should have risen only up to 3.1% because of the base effect, but not significantly higher. The April figure, instead, came in above 4% and, as can be seen from the evolution of the CPI index in the next page, inflation has been actually accelerating to the upside.

A few days later the PPI gave similar indications. It is worth noting that the PPI figure used recently is the "final demand", created at the end of 2009, and no longer the "old" "Finished Goods" index that has existed since after the WWII. The key difference between the two is that the "final demand" is much more stable over time than the "finished goods" and the adoption of the new metric helps to demonstrate price stability. In April, the PPI final demand rose "only" by 6.2%, while the finished good by 9.5%, one of the highest readings of the post-war period and only experienced during previous inflationary outbursts.

(continued)

Source: Bloomberg

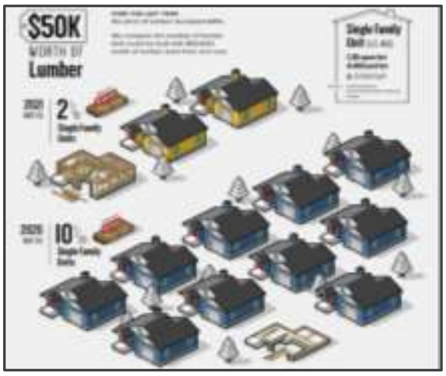
Source: Bloomberg

Even the increase of 0.9% in the MoM core CPI (highest reading since 1981) has been blamed upon transitory effects such as the increases in used car and airline fares, which explained half of the increase. Funnily enough, now even within the "core" indices, designed specifically to filter out transitory effects, it is apparently possible to find volatile components.

How plausible is that these increases are indeed transitory? The rising demand for new and used cars stems from the factors that may not be so transitory. On the one hand there is the lack of supply of chips which is causing bottlenecks in the car manufacturing and reducing the availability of new cars, especially the EVs that require more chips to run. On the other hand, the possible structural changes in life habits we are witnessing due to Covid-19 are causing a massive relocation out of large urban centers to less densely populated areas. Relocation to suburns results in increase of the private-car-usage (rather than the subway or public transports) to go to work or take children to school. As a result of the pandemic, people, even those who stay in the big cities, may be less inclined to use the public transportation.

The relocation is supporting the demand for single-family homes too, with existing single-family home median prices rising to 20.3% YoY in April, the highest on record. Real estate prices are pushed up also by the increase in raw materials, lumber in particular (today only two houses could be built with the same worth of lumber compared to ten of last year). Since real estate is considered as an investment, it is not included in the CPI - only rents are included. Rents make up about one fifth of the CPI basket, and are currently estimated to grow at an annual pace of 2%. It is reasonable to expect that rents would follow the increase in the real estate in the coming months, adding to the inflationary pressures.

Source: Bloomberg



Source: Visual Capitalist

If the lumber has been particularly hot recently and the commodity prices in general are well above the pre-pandemic level, this just cannot be explained by the base effect (graph on the next page). Years of weak global growth has led to structural underinvestment in installed commodity-extraction capacity. The constrained supply faces growing demand due to fiscal-backed infrastructure spending, the development of green technologies (electric batteries, electric grids improvement, etc.) and the need to replenish the inventories which dropped to record-low levels even before the reopenings reach full speed.

(continued)

Source: Bloomberg

Source: Bloomberg

The unemployment insurance is another factor contributing to inflationary pressures because of its side effects on the labor market. These subsidies have been raised to such levels that they actually act as a disincentive to go back to work, especially for those workers in the lower income brackets. The graph below on the left shows how the unemployment benefits compare to minimum wage and the numbers between 105% and 269% indicate that you receive up to almost three times your salary for not working. In many states, unemployment benefits represent 70% or more of the average wage (graph on the right). People who choose not to work can save up on commuting, eating out, babysitting or kindergartens, clothing, etc. All in all, net of those savings plus the unemployment benefits are a very competitive alternative to not going to work for the a big part of the population.

Source: www.businessinsider.com

Source: www.businessinsider.com

As a result, businesses, especially small and medium-sized ones, are increasingly struggling to find people willing to work. The NFIB small business report showed that the job openings are hard to fill and soared to the highest level ever. Seven percent of owners cited labor costs as their top business problem and 24% said that labor quality was their top business problem. After the latest disappointing payroll report, the Chamber of Commerce called for ending $300 weekly supplemental unemployment benefits to address labor shortages (www.uschamber.com).

Additionally, Biden's proposal to increase the minimum wage to $15/hour is putting pressure on the companies to increase their salaries. Chipotle has already increased its minimum wage to $15. McDonald's is looking to hire 10,000 workers and forced to raise its average salary by 10% to $13; but some of the restaurants owned by franchisees are hinting the possibility of passing these higher costs to clients.

As everybody knows, wage increases by their very nature are not transitory.

Source: Bloomberg

(continued)

Source: Macrobond and Nordea

Source: Bloomberg

All the evidence presented so far seems to suggest that inflationary pressures may be more persistent than expected. Macrobond and Nordea (left graph above) have developed a proprietary model that has exactly predicted the evolution of the CPI so far, and suggests that in a few months we may see the inflation reaching a high single-digit figure. Additionally, it must be taken into account that we have not yet seen the effects on prices from the consumption boom that is expected to occur as a result of the normalization and full reopening of the economies, in addition to the increase in demand induced by government-backed infrastructure spending plans.

In the past, it was widely accepted that PPI was a leading indicator for the CPI, and that monetary policy needs at least a few months (conventionally at least six) to start having effects on the real economy. Central bankers are currently challenging those old paradigms and claiming that they will only react ex-post and no longer ex-ante. As a consequence (right graph above), they are letting real rates to fall to such negative levels that were only reached during the previous two inflationary booms of the 70s and 80s. They are growing confident of their ability to keep inflation in check after years of monetary easing that have not translated into higher inflation. This may prove very risky, as there is a quite big difference between monetary and fiscal easing.

Monetary easing (QE) did not translate into (real world) inflation essentially because the incremental liquidity remained confined to financial markets. Its only effect has been an increase in the value of financial assets (asset inflation), but since assets are usually owned by already wealthy people who typically have a low propensity to consume, the real economy did not benefit from the QEs. In more technical words, the amount of money (M2) has grown, while the GDP remained substantially unaffected. As a result, the velocity of money decreased, favoring lower inflation.

To the contrary, fiscal easing is putting money directly into the wallets of people, and particularly those with the lowest income who are also the ones with the highest propensity to consume. Driven by these consumptions, GDP, velocity of money and inflation all may increase more rapidly than expected.

In conclusion, the main risk going forward is that if the Fed and other central banks continue to underestimate the magnitude and persistency of the current inflationary spike they may be forced to react forcefully ex-post.

We all hope that they will be right.

From: Hedgeye

Asset Allocation View

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

− UNDER = NEUTRAL + OVER

Equity

Developed Markets

UNDER OVER
NEUTRAL

We kept our recommendation on Developed Market equities to neutral. The biggest threat for equities valuation, a spike of inflation which in turn could cause an increase in rates, did not have any effects on the markets as several central banks members downplayed the inflation risk. In terms of geographical allocation, we continue to prefer Europe and Italy in particular, as they are more "value" than US, and trade at multiples lower than the historical averages for MSCI World. In terms of styles, we have a preference for the value investment style.

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

Emerging Markets

UNDER OVER
NEUTRAL

We maintained our underweight recommendation on Emerging Markets Equities. The threats of higher inflation and tapering in the second half of the year could continue to weigh on investor sentiment towards emerging markets assets. Within EM space, we are keeping our cautious view on Asia ex-Japan, not only because Asia is the biggest importer of commodities, but also due to new outburst of Covid-19 infections in some countries.

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

Fixed Income

Developed Markets Sovereign

UNDER OVER
NEUTRAL

We maintained our overall underweight recommendation on Developed Markets sovereign bonds. Even if the recent CPI data has been well digested by the markets, our expectation is that rates will continue to increase over the next months for the reasons explained in the preface of this report. Considering the recent underperformance of Italian BTPs, we reaffirm our (relative) positive view on European Periphery bonds, in expectation of a narrowing of the Bund-BTP spread. Additionally, should the 10-year Bund reach zero before the ECB, we could tactically upgrade our recommendation also on EU core bonds.

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

Developed Markets Corporate

UNDER OVER
NEUTRAL

We kept our negative recommendation on Developed Markets Corporates. There is no expectation of further compression in corporate investment grade spreads. As the performance of investment grade bonds will therefore be primarily affected by the evolution of risk-free rates, these bonds are likely to deliver negative returns and we prefer to avoid them. In the crossover/high yield segments, there is still room for some spread compression, but the bulk of the tightening has already happened, and a more cautious approach should be warranted. *Considering the above, for those looking to lock in higher yields over a longer time horizon, private debt strategies are a suitable solution also posing an attractive risk profile.*

IG Europe	−	**IG US**	−	**HY Europe**	=	**HY US**	=

Emerging Markets

UNDER OVER
NEUTRAL

We kept our recommendation as neutral. In addition to the risk of further increases in US risk-free rates, some emerging markets are experiencing a new wave of Covid-19 cases. This could derail or delay the expectations of a sustained GDP growth and prevent central banks from increasing rates to defend the currencies and/or restrain inflation pressures.

Local Currency	=	**Hard Currency IG**	=	**Hard Currency HY**	=

Commodities

UNDER OVER
NEUTRAL

We maintain our positive view on the asset class, as we think commodities may have started another bullish super cycle. The bull case on precious metals is still supported by the ample liquidity and the surge in fiscal deficits, even if an increase in long term rates is increasingly plausible. As for agricultural, industrial and energy commodities; a combination of years of underinvestment, surging demand and shipping bottlenecks are all driving commodity prices to new highs.

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

Currencies

We maintain our neutral view on Euro, USD and Yen, in line with the recommendation for all other currencies. The view of the asset allocation committee is that in the short term, all major currencies will remain rangebound within their recent trading range.

On Emerging Markets currencies, we maintained our neutral view. In case of further increase in US rates, emerging market currencies may have room to weaken.

Euro	=	USD	=	Yen	=	Emerging	=