AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

05.07.21

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

US CPI — 13.07

Will the US inflation continue to increase as the base effect starts to fade away?

CHINA GDP — 15.07

In the second quarter of 2021 the Chinese economy is expected to growth only modestly, +5.2% on the quarter and +8.0% vs last year

US RETAIL SALES — 16.07

After the expiration of the one-off effects of the fiscal stimuli, will the US consumer continue to maintain a sustained level of spending?

UMCSENT — 16.07

After two months of higher than expected data, will the inflation expectations move upward or remain anchored?

FLUSH WITH CASH

- **Central banks and the US Government flooded the markets with liquidity in 2021**
- **Ample global liquidity helped to sustain the prices of all asset classes**
- **Equity inflows were extraordinarily strong this year**

Financial markets ended the second quarter with a substantial rally especially in the asset classes and market segments that lagged the most in previous months: the growth stocks in the US and the government bonds (rising prices, falling rates) in fixed income markets.

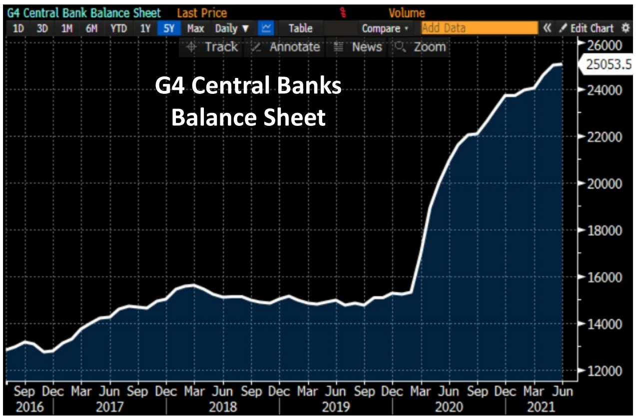
If falling risk-free rates can be explained with the assumption that market participants have bought the central bank narrative that GDP growth and inflation are both transitory, then the recovery in the equity indices might contradict with this belief.

This could be better explained by the abundant amount of liquidity unleashed into the markets starting from February. In our previous issue dated February 15th, we reported that the Treasury General Account (hereinafter “TGA”) “*is the general checking account that the Department of the Treasury uses and from which the U.S. government makes all of its official payments. […] When the TGA balance rises, the US Treasury drains reserves (liquidity) from the banking system; when money is spent and/or the maturing bonds and bills are not rolled over, the TGA balance contracts and the US Treasury provides liquidity (via the reimbursing of the bonds/bills) to the banking system that results in increased cash balance*”.

Even if the contraction of the TGA happened slower than expected (from 1.65 trillion to 750 billion), almost one trillion of liquidity has been injected in the markets since mid February.

(continued)

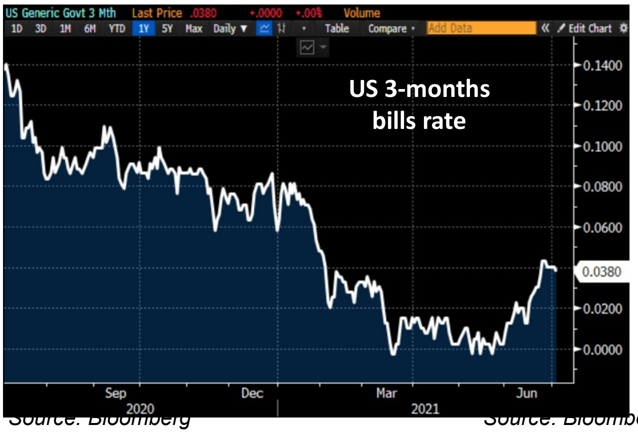
Source: Bloomberg



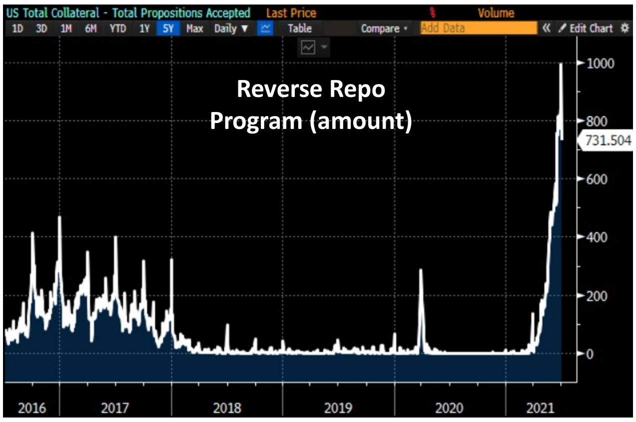
Source: Bloomberg

To this extraordinary liquidity injection, we should also add about over 1 trillion coming from the ongoing QEs of the major central banks and the stimulus checks paid to the US citizens twice this year.

This tsunami of liquidity flooded the markets, in particular the money market segment, where the US 3 month Treasury bills reached slightly negative rates, even below the lower bound of the Fed policy rates (currently at 0 - 0.25%). Market participants with too much excess cash on their balance sheets started to redeposit this excess cash back to the Fed, via the Reverse Repo Program (RRP). With RRPs, the Fed sells Treasury securities and removes cash from the financial system, hence RRPs have the opposite effect of QE. The amount of RRPs is not something governed by the Fed, and it is mainly driven by the private market players. An increase in RRPs is considered as a sign of ample (unused and undesired) liquidity in the financial system. Starting from March, the RRP increased steadily reaching almost 1 trillion at the end of the second quarter.



Source: Bloomberg



Source: Bloomberg

This huge amount of excess liquidity eventually spilled over the rest of the market causing a chain reaction.

While the long term rates staying contained in spite of the recent spike in inflation could certainly be rationalized by the multiple episodes of assertive reassurances by Central Banks that the inflation is only a transitionary phenomenon, we should also give credence to the argument that ample liquidity was the driving force behind rates staying under control.

In the next page, we provide a comparison between the YoY change in inflation (orange) vs the evolution of the 10 year US Government Bonds (white). Two metrics started diverging in March, and even if the inflation will prove to be transient, it's quite surprising that long term rates have fallen during such a major period of reflation.

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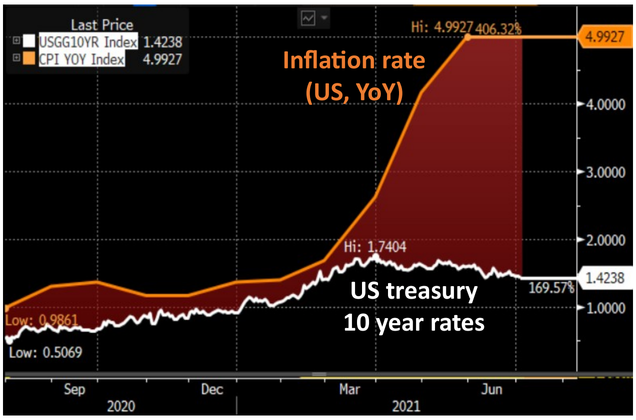
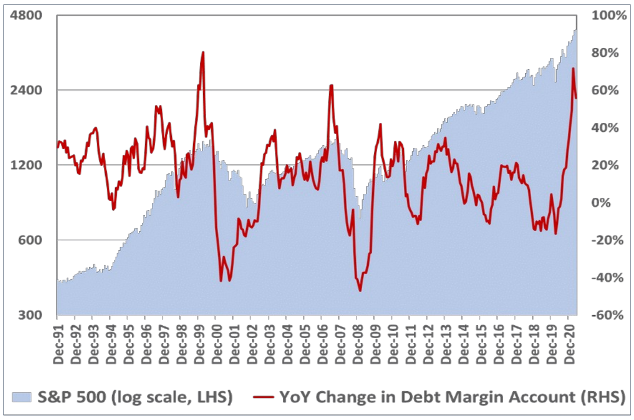


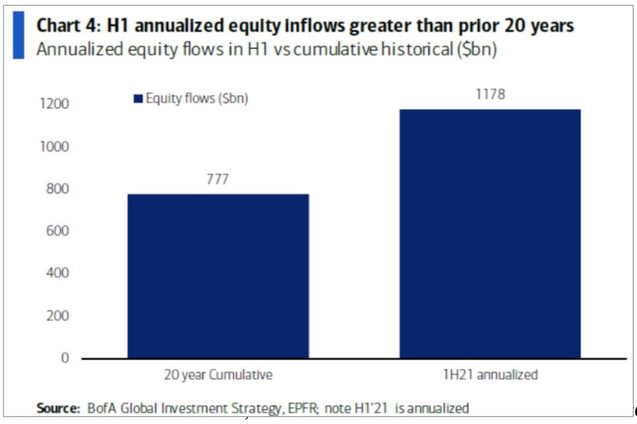


Source: Bloomberg

Source: Azimut proprietary research, FINRA, Bloomberg

Part of those liquidity injections also reached the equity markets. Above on the right the S&P 500 is compared to the YoY change in the debt balances in customers' securities margin accounts. The latter measure corresponds to the margins owed by investors for leveraged investments. Ample liquidity coupled with rising equity prices tends to encourage additional risk taking. This is exactly what happened over the past year: debt margins increased very fast, and the YoY change increased roughly to +70%. when this measure increased more than 60% in the two previous occasions, the market was about to enter a meaningful correction.

Not only leveraged but also cash investments increased sharply recently. Bank of America estimates that the first half annualized equity inflows is about 1.2 trillion. Without annualization, this correspond to about 600 billions of net equity inflows. This amount is almost as big as the cumulative equity inflows over the past 20 years (777 billion).



Similarly, the equity investors flooded with cash were also more than willing to invests in any new IPOs (including SPACs) to the point that the number and value of the equity offering has skyrocketed during the last quarters, well beyond any preceding period, including 2000.

In conclusion, even if the tapering is few months away and the Treasury General Account balance has some room to compress further, this period of exceptional liquidity injections is approaching to a material reduction. There will be no additional "one-time" payments related to fiscal stimulus programs, and the extraordinary unemployment benefits will run off during the summer. Additionally, most of the new equity investments were made this year, at valuations not considered as cheap (please refer to the previous issue for a detailed analysis on market valuations). As always given such backdrop, we remain cognizant of potential risks and recommend to maintain a cautious approach.

Asset Allocation View

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

− UNDER = NEUTRAL + OVER

Equity

Developed Markets

We maintained our recommendation on Developed Markets Equities to **Slightly Underweight**. The central banks projections of lower inflation and GDP growth, together with an earlier than expected tapering by the Fed and elevated valuations could make equity markets vulnerable to corrections over the medium term. Among regions, we still prefer Europe thanks to the lower valuations. In terms of styles, the Committee favors a more balanced approach as we are approaching the period of the year when we'll reach the peak of the growth rate, it is advisable to increase the weight of defensive stocks in the portfolio.

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

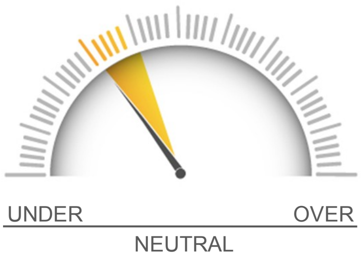
Emerging Markets

We lowered our recommendation on Emerging Markets Equities to **Slightly Underweight**. Developed Markets Central Banks' projection of lower GDP growth could weigh on Emerging Market equities, as well as any reversal to the upside of US long term rates. Among regions, we have a more negative stance on Asia ex-Japan, not only driven by the new flare ups of Covid-19 cases, but also due to the continuous repetition of unfriendly market behavior by the Chinese regulators (Didi, ride-hailing service, crackdown of recent).

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

Fixed Income

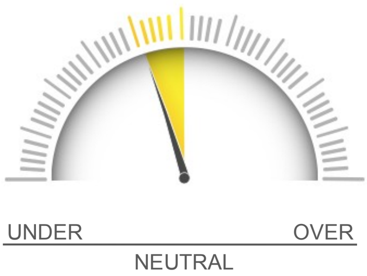
Developed Markets Sovereign



We maintained our overall **Underweight** recommendation on Developed Markets Sovereign Bonds. Over the medium-term, we continue to see higher rates, due to the expectation of a still robust growth rate and the eventual tapering by central banks. No change in terms of preference, EU Peripheries are still favored notwithstanding the recent compression in the BTP-Bund spread.

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

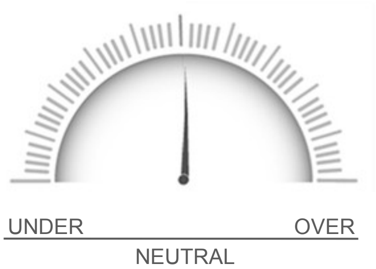
Developed Markets Corporate



We kept our **Negative** recommendation on Developed Markets Corporates. No further compression is expected in the corporate investment grade spreads. Since the performance of IG bonds will be sensitive to the evolution of risk-free rates, we should avoid them mainly because they are likely to deliver negative returns. 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 solutions also offering an attractive risk profile.

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

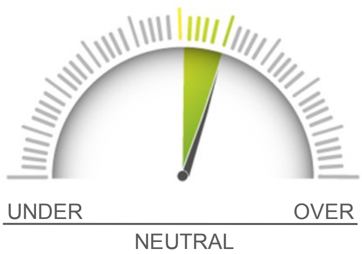
Emerging Markets



We kept our recommendation as **Neutral**. Emerging Market Bond spreads have compressed less than the developed market bonds with similar risk. Considering the reduction in the long-end US rates and the fact that the Fed will wait some time before tapering, further reduction in spreads is likely. For Emerging Hard Currency, we have a preference for low duration strategies.

Local Currency	Hard Currency IG	Hard Currency HY
=	=	=

Commodities



We still maintain our **Positive** view on the asset class. After the recent increase in oil prices, we are tactically reducing the relative preference on energy commodities. We are still positive on precious metals, considering the recent retracement and the fact that deeply negative real interest rates should be supportive for the asset class.

Precious	Energy	Industrial	Agricultural
+	=	=	=

Currencies

After the recent strengthening, the Committee's consensus view is that the US dollar may be vulnerable to some depreciation due to the negative real rates and the twin deficits, but few members are moderately positive on the greenback as it usually serves a hedge in case of increased risk aversion.

We maintain our neutral view on Euro and JPY, on which we see no particular catalyst for a movement in either direction that is specific to them. Against the USD, they can appreciate or depreciate moderately as a consequence of the reasons mentioned above and that could alter the demand for the greenback.

Emerging Market currencies are also expected to remain fairly stable, unless US risk-free rates start rising again, in which case they may be vulnerable to correction.

Euro	=	**USD**	=	**Yen**	=	**Emerging**	=