azimut

AZIMUT GLOBAL VIEW

20.01.25

Main Events

DAVOS — 23.01
At the World Economic Forum in Davos, Trump may offer further insights into his foreign policy agenda

JAPAN CPI — 24.01
Japan's headline inflation is expected to rise back above 3%, increasing pressure on the BoJ to raise rates later in the same day

FOMC — 29.01
How will the Federal Reserve respond to early indications of Trump's policy implementations?

ECB — 30.01
Will the ECB follow the Federal Reserve as customary, signaling fewer cuts by 2025, or will it maintain its prior course to support the struggling EU economy?

IT'S ALL ABOUT LIQUIDITY

- **After peaking due to strong labor market data, interest rates began a physiological pullback following the CPI data which, however, was not so benign**
- **Investors should focus on the imminent liquidity reabsorption process that is only now about to effectively begin, considering that so far the Fed's QT has been offset by a similar reduction in the Fed's Overnight Reverse Repo facility**
- **If the U.S. Treasury were to start issuing more Treasuries than Bills, as was customary in the past, pressures on long-term yields could increase further**

In the first part of the month, U.S. interest rates edged close to the highs reached at the end of 2023.

While the rise over the past two months is largely due to expectations that the Republican sweep will allow Trump to fully implement his economic agenda, leading to stronger growth, but also potentially another pickup in inflation, the latest upward leg is due to the upbeat U.S. employment data.

The establishment survey (better known as non-farm payrolls) and the household survey, which in the recent past have usually provided mixed indications, this time both showed strong job creation, +256k and +478k, respectively. Also, the unemployment rate edged down, from 4.2% to 4.1%.

Post-election, a weakening labor market was the only scenario for the Fed to deliver a series of rate cuts in 2025. After such a strong labor data, market expectations had to adjust, suddenly dropping to a single cut for 2025, with 10- and 30-year yields reaching 4.8% and 5%, respectively.

A few days after, "apparently" better-than-expected inflation data once again bolstered investors' hopes for steeper cuts. "Apparently" since headline inflation picked up pace, increasing by 0.4% month-on-month, and from 2.7% to 2.9% year-on-year. 3- and 6-month annualized inflation increased even faster.

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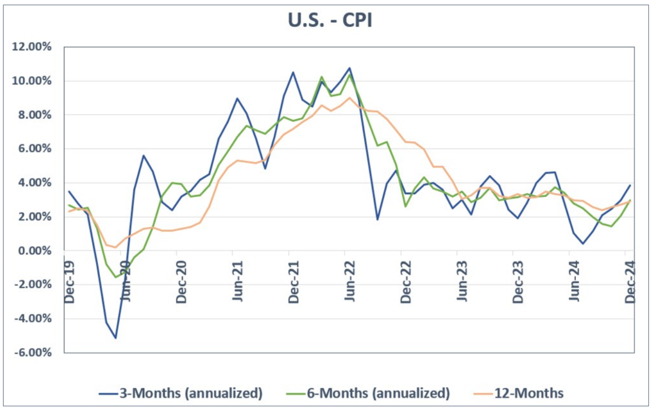
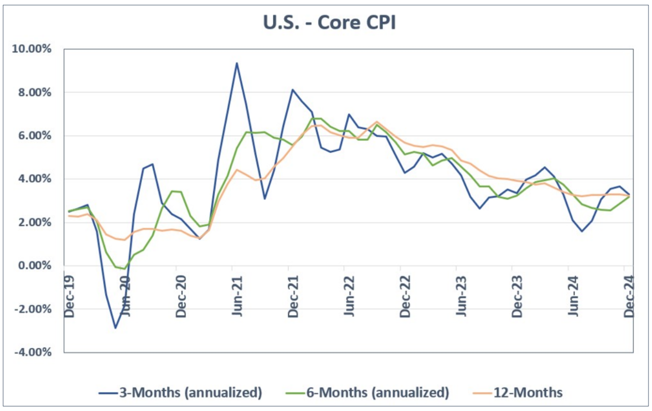


Source: Bloomberg, Azimut elaborations



Source: Bloomberg, Azimut elaborations

Investors instead focused only on the core inflation data, which, after 4 consecutive months of readings at +0.3% month-on-month, settled at +0.2%. Year-on-year core inflation fell from +3.3% to +3.2%. A “beat of 0.1%“ is actually not a big deal when one looks at the data. Annual and short-term core inflation remain at 3.3%, diverging from the Fed's desired downward trajectory.

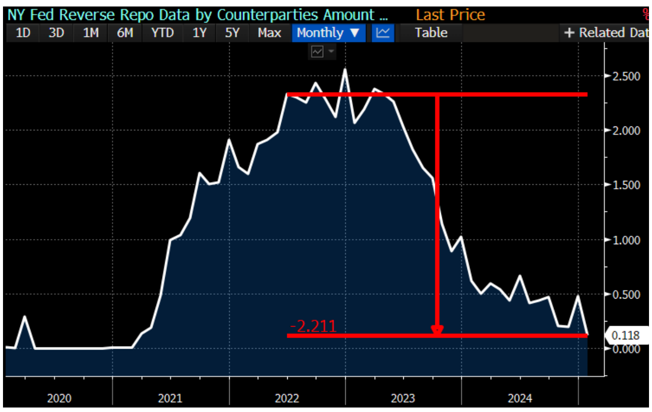
Looking ahead, commodities have experienced a significant and broad-based rally since mid-December. This is likely to reverberate in the coming months on overall inflation, which, by the way, has the most worrisome path. Furthermore, if Trump partially fulfills his campaign pledges to impose tariffs, the optimism surrounding the latest CPI figure may lack a solid foundation.

Instead, where investors should focus their attention to understand the direction of rates, particularly at the long end of the curve, is to assess the liquidity available in the market. This is because the process of reabsorption of liquidity is actually only just beginning.

For years, investors' attention has focused exclusively on the Federal Reserve's balance sheet. The QT, amounting to $90 billion per month and implemented progressively from mid-2022, has so far resulted in a reduction in liquidity of about $2.1 trillion.

However, the overlooked factor is the impact of liquidity deposited on the Overnight Reverse Repo facility (ON RRP). The ON RRP facility is used by banks and money market funds to park cash overnight directly at the Fed. The cash deposited on the ON RRP therefore is cash that is withdrawn from the market. An increase in the ON RRP balance acts like QT, while a decrease resembles QE. As shown in the charts below, the $2.2 trillion reduction in the ON RRP balance from mid-2022 is roughly equivalent to the reduction in the Fed's balance sheet over the same time frame. Since the former mirrors QE and the latter represents QT, market liquidity levels have remained essentially unchanged over the past two and a half years.

Source: Bloomberg



Source: Bloomberg

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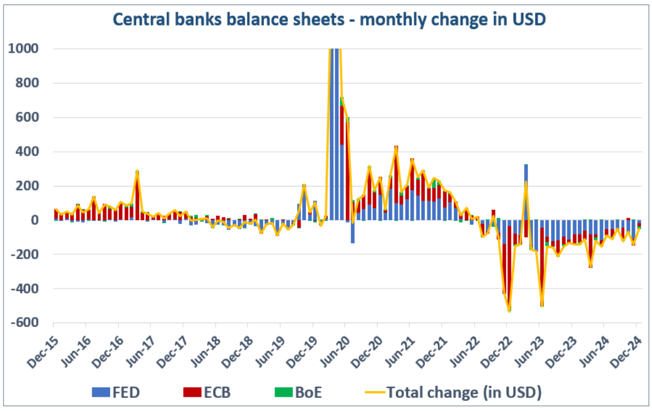
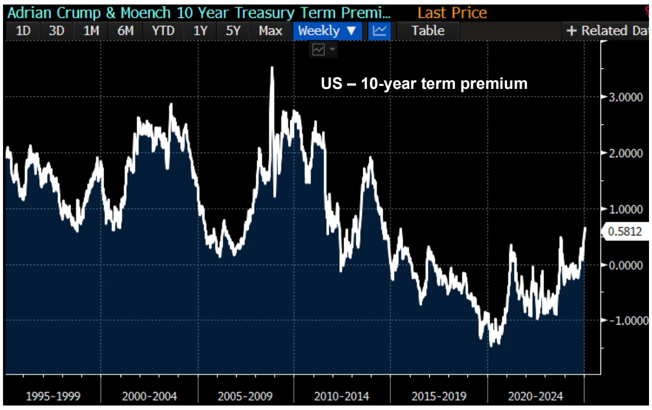




Source: Bloomberg, Azimut elaborations *Source: Bloomberg*

With the ON RRP balance now effectively at zero, there is no longer a mechanism to offset the ongoing QT by the Federal Reserve. As a result, the market will increasingly feel the impact of monetary tightening driven by the combined QT efforts of the Fed, ECB, and BoJ, amounting to approximately $120 billion per month.

Adding to this pressure is the potential shift in debt issuance by the new administration. Under Janet Yellen's leadership, the U.S. Treasury issued a higher proportion of Bills. If the new Treasury Secretary, Bessent, reverts to the prior approach of issuing only 15%-20% Bills and 80%-85% Treasuries, the market would face not only central bank QT but also a significant influx of long-dated Treasuries to absorb.

These dynamics are already reflected in rising market rates, especially at the long end of the curve. Additionally, the term premium—the extra compensation investors demand for holding volatile, long-dated bonds—is gradually returning to pre-QE levels. Nevertheless, there are compelling reasons to believe this adjustment process is far from complete

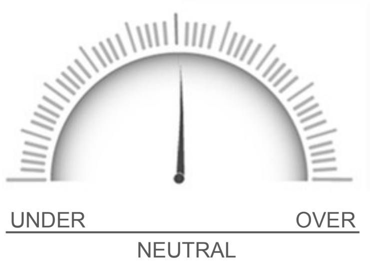
Asset Allocation View

	Under (–)	Neutral (=)	Over (+)
Equity			
Developed Markets		=	
Emerging Markets		=	
Fixed Income			
Developed Markets Sovereign		=	
Developed Markets Corporate			+
Emerging Markets		=	
Commodities		=	
Currencies		*Commentary below*	

– UNDER = NEUTRAL + OVER

Equity

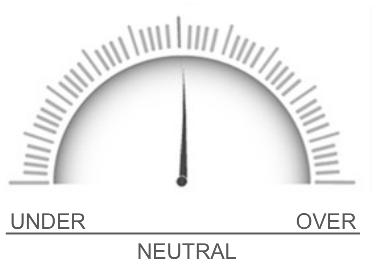
Developed Markets



We have kept our **Neutral** recommendation on Developed Market Equities. Better-than-expected employment and inflation data, coupled with a robust start to the reporting season, could support an extended uptrend in U.S. equity markets. Similarly, speculation about a milder implementation of tariffs may sustain the ongoing recovery in other developed markets. However, caution remains warranted as investors await greater clarity on the policies to be introduced by Trump, who sworn in this Monday as the 47th president of the United States.

US	=	**Europe**	=	**Japan**	–

Emerging Markets



We have maintained our **Neutral** recommendation on Emerging Markets Equities, owing to the uncertainties still surrounding the policies that Trump will implement. However, Trump's recent phone call with Xi and his announcement that TikTok will not be immediately closed suggest that an immediate escalation in U.S.-China relations is less likely. This development could enable a short-term rebound in Chinese and other emerging markets, particularly given the strong underweight positions held by international investors

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

Fixed Income

Developed Markets Sovereign

We have maintained our **Neutral** recommendation on Developed Markets Sovereign Bonds. After sharp increases over the past two months, rates have stabilized in response to slightly better-than-expected CPI data. While bonds may recover in the short term, we remain increasingly cautious about the medium- to long-term outlook, particularly at the long ends of the curves, due to the coordinated withdrawal of liquidity by central banks and the mounting funding needs of governments.

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

Developed Markets Corporate

We have kept our **Slightly Overweight** recommendation on Developed Markets Corporates. The search for yield in the fixed income market will continue to favor corporate bonds. Within corporates, we maintain a preference for investment-grade bonds over high-yield bonds that are hovering around all-time lows.

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

Emerging Markets

We have kept our **Neutral** recommendation for Emerging Market Bonds. The potential risks posed by tariff impositions from the Trump administration are mitigated by the relatively higher spreads that emerging market bonds currently offer compared to similarly rated corporate bonds in developed markets.

Local Currency	=	Hard Currency IG	=	Hard Currency HY	=

Commodities

We maintained our **Neutral** recommendation on Commodities. Among these, we have become more positive on precious metals, which could benefit both in the event of lower-than-expected tariffs resulting in a weaker dollar and/or fears of further fiscal slippage.

Precious	+	Energy	=	Industrial	=	Agricultural	=

Currencies

The Committee kept the **Neutral** stance on the US Dollar, **but with a bearish bias**. In the past two months, the dollar has strengthened against all currencies as a result of the "America first" policy advocated by Trump. Any announcement of milder implementation of electoral promises could result in a weakening of the dollar and a consequent recovery of other currencies.

The view on the Euro remains **Neutral** but **with a bullish bias** for the same reasons, in reverse, as those mentioned for the US Dollar. In addition, as EU rates catch up with US rates as of late, the rate differential also allows for a rebound in the euro.

The view on the **Chinese Renminbi** remains **Neutral with a bearish bias**. The Chinese currency will continue to remain under pressure until the Chinese government effectively implements long-awaited fiscal measures to support the domestic economy, even if the United States will not impose such high levies as previously speculated.

The outlook for other **emerging market currencies** remains **Neutral**, in view of softer tariffs by the U.S. government.

Euro	USD	CNY	Other EM
=	=	=	=