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

02.02 – EU CPI
The harmonized inflation rate in the EU is expected to fall from 5.0% to 4.4% YoY. Any upside surprise will put greater pressure on the ECB

03.02 – ECB, BoE
While no surprises are expected by the BoE, which should continue its hiking cycle, there are doubts that the ECB may also hint to less dovish policies in the future

04.02 – US PAYROLLS
Expectations are for a very low print. Any significant improvement in data will put additional pressure on the Fed to raise rates

10.02 – US CPI
Both headline and core inflation are expected to increase further, reaching 7.3% and 5.9% YoY respectively

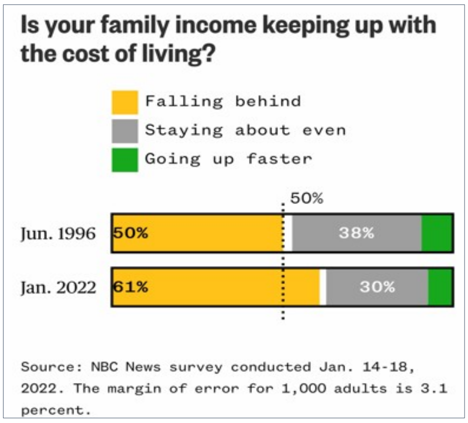
BEHIND THE CURVE!

- **Rising inflation and mounting political pressures lead to a more aggressive-than-expected stance by the Federal Reserve**
- **The Fed is now in between a rock and a hard place as it may be forced to hike rates even if the economy may be on the verge of cooling down**
- **The market, on the other hand, remains skeptical that the Federal Reserve will actually implement all the restrictive measures it has hinted at**

Mr. Powell and his colleagues only a few months ago predicted that inflation would be temporary and would subside quickly. Fast forward to last Wednesday, and the Fed's assessment of inflationary risks has shifted dramatically.

Growing political pressures to keep inflation under control most likely played a role in such a remarkable shift in course. The issue of inflation was brought up to Powell during the most recent congressional hearings, as well as by President Biden, who recently told the press that the Fed has the mandate and responsibility of maintaining price stability.

The introductory sentence in the official statement that said "the Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time" has been removed, implying that we are no longer in a "challenging time." Rates were expected to remain unchanged in December "until labour market conditions have reached levels consistent with the Committee's assessments of maximum employment," while there was a "strong labour market" in January.



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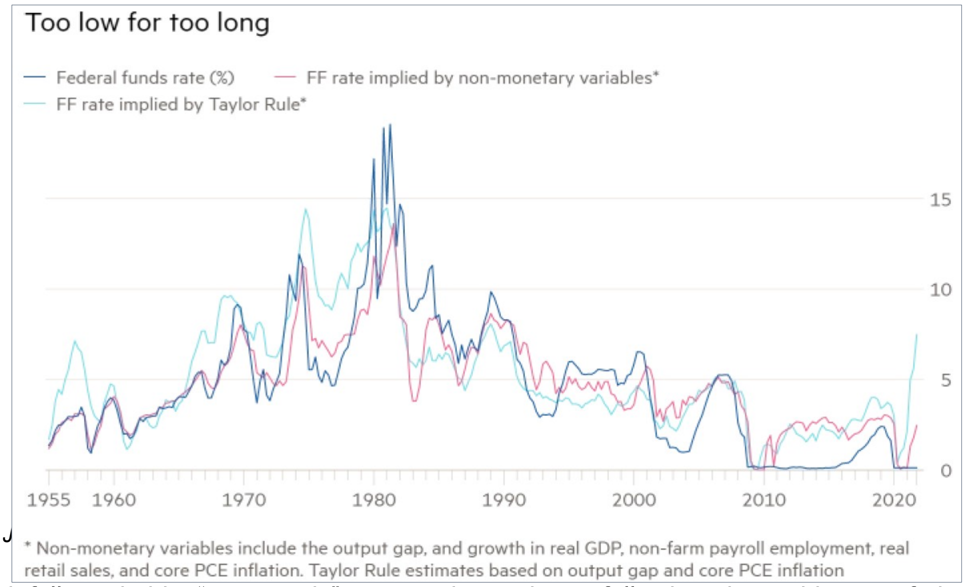
The sentence from December “With inflation having exceeded 2 percent for some time” has been replaced by “With inflation well above 2 percent”. During the press conference, while affirming that he “expects inflation to decline over the course of the year”, Mr. Powell also said that “Inflation risks are still to the upside” and committed that “Fed will use tools to prevent higher inflation from becoming entrenched” and that he doesn’t “rule out rising rates at every FOMC meeting” and as soon as March. He also added that the Fed has a lot of room to raise interest rates without damaging labor market, and that the best way to promote growth and a strong labour market is to keep inflation under control. Finally, while acknowledging that “the Fed balance sheet is much larger than it needs to be”, Powell stated that the FOMC members have not yet decided how and when the balance sheet will be reduced, but added that the pace of the reduction may be faster than in previous occasions and that they will likely do it via the run-off of maturing debt.

Speaking about the future path of interest rake hikes and balance sheet reduction, Powell reaffirmed that the Fed will be data-dependent. Unfortunately this has not been the case over the past few years, including the post pandemic period, as if the Fed had followed a “systematic” approach to settings rates, it should have already hiked several times. As John P. Hussmann correctly wrote in an FT article, “’Systematic’, in this context, means a framework where policy tools such as the level of the fed funds rate maintain a reasonably stable and predictable relationship with observable economic data such as inflation, employment, and the ‘output gap’ between real gross domestic product and its estimated full-employment potential. Systematic policy allows individuals and financial markets to anticipate the general stance of monetary policy based on observable data.”



Source: J

If the Fed had followed this “systematic” approach, such as following the guidance of the non-monetary variables or the Taylor rule (which some economists believe is no longer a reliable indicator), interest rates would have already been higher. That could have have prevented inflation from soaring that much, and allowed rates to rise when the economy was stronger. The risk for the Fed right now is that it will be forced to increase rates anyway to fight inflation, regardless of the strength of the economy and the economic fallouts of such actions.

The equity markets, which were trying to recover from the January 24 low, were caught by surprise by the Fed’s hawkish stance, but after the immediate negative reaction, equity indices began to recover. This could be explained by the fact that while market participants acknowledged the Fed’s resolve to rise rates (market based measures suggest that 5 hikes are now priced-in for 2022), the long-term rates which have the greates impact on equity valuations, have been stable because the market’s view is that the Fed’s hike will cause a slowdown or recession which in turn will force the Fed to reverse course again.

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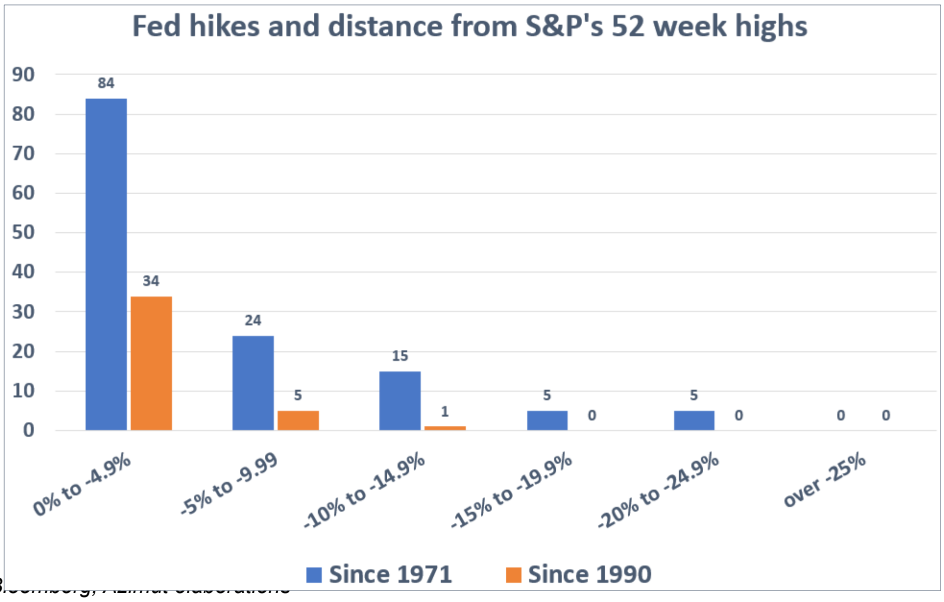
The market is also viewing an extended rate hike as unrealistic as the Federal Reserve rarely raised rates when the equity market was more than 10% off the 52-weeks highs, as shown by the graph below.



Source: Bloomberg, Azimut elaborations

It is worth noting that that since 1990 the Fed only hiked rates once when the S&P500 was more than 10% below its 52-week highs. With the S&P500 already close to -10% at the end of January, market participants were skeptical of the possibility of an extended series of rate hikes. The picture is somewhat different if the observation period is extended to include also the 1970s, which were characterized by a rising inflation from already elevated levels. Furthermore, in the years preceding 1990, the notion of the "Fed put" was not yet established, as the common expectation that the Fed will step in and support equity markets whenever a correction starts to unfold began with Greenspan after 1987 and more evidently during the early 1990s.

Stock market performance in the medium term will thus be determined by who is correct about the future path of interest rates. If the Fed is correct and delivers all of the short-term interest rate hikes it has hinted at while also significantly reducing its balance sheet, then new corrections may occur throughout the rest of the year. If, on the other hand, the market is correct and inflation falls quickly and the economy slows enough to force the Fed to pause, the outlook becomes much brighter, especially given that the reporting season has been very good thus far.

Asset Allocation View

	UNDER (−)	NEUTRAL (=)	OVER (+)
Equity			
Developed Markets			Upgrade
Emerging Markets		■	
Fixed Income			
Developed Markets Sovereign	■		
Developed Markets Corporate		■	
Emerging Markets			■
Commodities			■
Currencies		*Commentary below*	

UNDER NEUTRAL OVER

Equity

Developed Markets

UNDER OVER

NEUTRAL

We upgraded our recommendation on Developed Markets Equities to **Slightly Overweight** owing to the fact that the worst-case scenario targets of the 2022 Equity Outlook were nearly met during the January correction. This upgrade should be read as a short term recommendation, meaning that a bounce from the lows is possible, mainly from US and growth stocks that suffered the most recently. In the medium term the view become more cautious now, given Powell's surprisingly hawkish tone, as we argued in this report's prologue. In addition, due to the prospect of higher rates and reduced fiscal stimulus in the medium term, we prefer value and defensive stocks, Nonetheless, thanks to the dispersion in valuations and YTD returns, we are confident that it will be possible to find good investment opportunities in all markets, sectors and styles.

US	Europe	Japan
=	+	=

Emerging Markets

UNDER OVER

NEUTRAL

We kept our **Neutral** recommendation unchanged on Emerging Markets Equities. Emerging markets showed sign of resilience during the correction that primarly affected the US in January, thanks to the much lower valuation of developing Nations versus the developed ones. Offshore China was especially resilient finishing the month in positive territory. This is encouraging and reinforces the view that emerging markets could represent one of the most interesting opportunities in 2022. As a result, we continue to recommend gradually accumulating them. Within the EM space, our preference remains for the Asian region, and China in particular.

Asia ex-Japan	EEMEA	LATAM
+	=	=

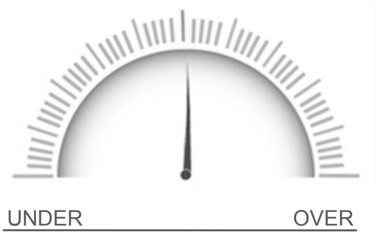
Fixed Income

Developed Markets Sovereign

We maintained our **slightly underweight** recommendation on Developed Markets Sovereign Bonds unchanged. Following the Federal Reserve's hawkish turn, short term rates will likely continue to rise further, while increases in the long-end of the curves may be more contained as the market will likely price in a higher probability of recession. In Europe, CPI data continue to surprise to the upside, which could prompt ECB to use less accommodative language this Thursday as well, even if no change in the monetary policy is expected. As a result, we are turning more bearish on EU core bonds. On the contrary, the confirmation of Mattarella as President of the Republic and Draghi as Prime Minister could lead to a compression of the BTP-Bund spread.

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

Developed Markets Corporate



We maintained our **Neutral** recommendation on Developed Markets Corporates. The recent widening of both investment grade and high yield bonds spreads is not considered extended enough to warrant an upgrade for the asset class. A faster than expected tapering and a more sustained pace of rate hikes are likely to continue to weight on developed markets corporate bonds. We continue to recommend taking a cautious stance on the asset class and favoring strategies that actively manage the duration and/or are focused on short maturities.

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

Emerging Markets

We confirmed our **Sligthly Overweight** recommendation on emerging market bonds. During the second half of January emerging market bonds began to shows signs of strength, exactly when developed market corporate bonds spreads began to widen. We maintained our more bullish view on high yield bonds, and particularly Asian high yields which are trading at spreads that are close to the highest levels in decades as a result of Chinese government crackdown and of the Evergrande crisis. Additionally, the fact that EM central banks are much further along in their hiking cycle than their DM peers, there is little downside left on EM bonds, at least in terms of duration risk.

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

Commodities

We kept our **Slightly Positive** view on the Commodities. We continue to prefer precious metals, given that the real rates are still deeply negative and have lagged other commodities. Additionally, precious metals are one of the few asset classes that may serve as a hedge in the event of a market turbulence or geopolitical crisis, or as an inflation hedge if inflation is not temporary. We have maintained a more cautious view on the other commodities.

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

Currencies

The committee's view on the US dollar is becoming more positive following the Federal Reserve's hawkish turn. However, should the ECB also express a less accommodative stance during its meeting on Thursday, the view on the US dollar would be downgraded to neutral again.

The Euro is viewed as potentially slightly weaker. However, considering that inflation data continue to surprise to the upside, it may be possible that the ECB will hint to the possibility of adjusting its wording about future monetary policy decisions, even if no concrete changes are expected in the short term.

The outlook for the Chinese Renminbi is slightly negative. The current slowdown in China induced by the crackdown on some technology and real estate companies may force the People's Bank of China to cut interest rates more, and to provide additional liquidity to support the economy.

Other emerging market currencies are expected to have room for a rebound as interest rates continue to rise, which should prove effective in containing inflation and supporting local emerging market currencies.

Euro	
USD	
CNY	
Other EM	