AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

28.03.22

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

CHINESE PMI — 31.03
Manufacturing and non-manufacturing PMIs are likely to dip below 50, a level that indicates stagnation

EUROZONE CPI — 30.03
The first inflation reading following the Ukraine invasion is expected to come at 6.7% YoY, and by 1.9% MoM

US PAYROLLS — 01.04
The US labor market is expected to remain strong, as suggested by the lowest level of weekly jobless claims in decades

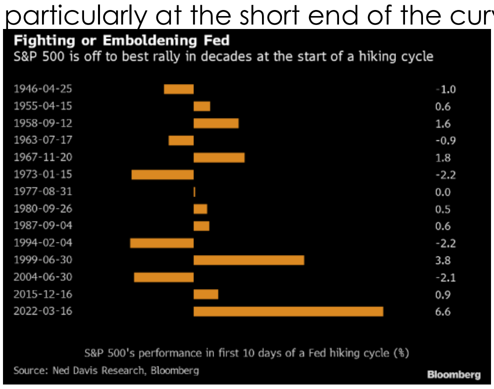
US SERVICES PMI — 05.04
The services sector, which accounts for more than two-thirds of the US economy, is predicted to grow faster than before the invasion

STRENGTH OR DENIAL?

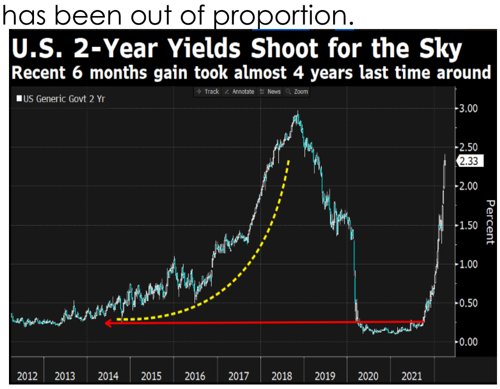
- **Over the last two weeks, equity markets, particularly growth companies and the US market, rebounded strongly**
- **Given the simultaneous rise in rates and the substantially more aggressive stance of central banks, particularly the Fed, the rally seems puzzling**
- **For investors who are overexposed to equities, the rebound above pre-war levels provides an opportunity to trim positions, but stocks remain as the preferred asset class**

Here we go again. From mid-March through the second half of 2021, financial markets have snubbed all the headwinds and continued to rise unafraid. Neither the first major war in nearly 80 years, nor the raging inflation or a hawkish Fed were able to convince investors to be more cautious.

Since Fed's March 16th meeting, US equity markets have rebounded strongly, with the S&P 500 up more than 9% and the Nasdaq 100 about 14%, the strongest performance of equities markets at the start of a hiking cycle. This contrasts with increases of 50, 35, and 15 basis points in the US 2, 10, and 30-year rates over the same time period. In recent decades, the magnitude and pace of the increase, particularly at the short end of the curve, has been out of proportion.



Source: Bloomberg



Source: Bloomberg

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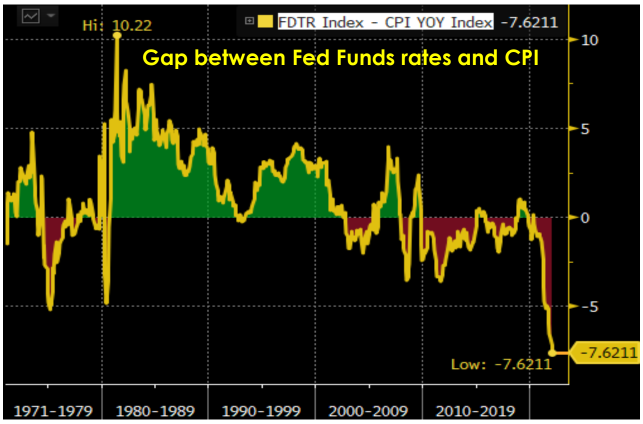

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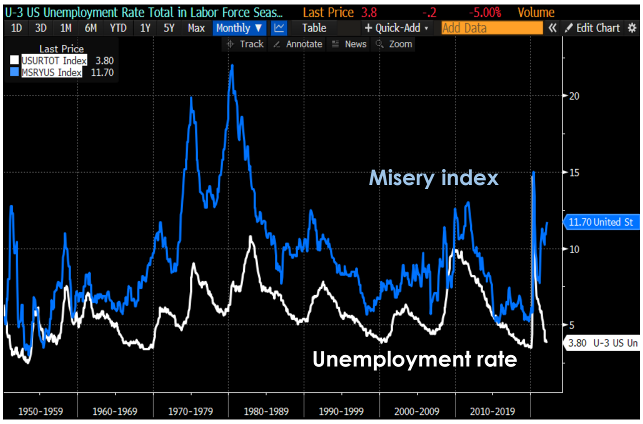

Source: Bloomberg

Powell's tone was notably strong during the conference call that followed the FOMC, as well as his testimony a few days later, stating explicitly the possibility of hiking at all meetings, even by more than 25 basis points per meeting. After being blatantly wrong last year that inflation would be transitory, the Fed has cornered itself where the gap between policy rates and CPI inflation is now the widest in history.

Furthermore, unlike in the past, the current issue is primarily related to inflation, not the labor market. In the graph on the top right, the "misery index" (unemployment rate plus inflation rate, blue line) is compared with only one of its component, the unemployment rate (white line). Implicitly, inflation is the distance between the two lines.

What is certain is that until last year, the two lines were always moving in tandem (with larger swings in the misery index), implying that when inflation was rising the unemployment was growing as well. Because the Fed has a dual constitutional mandate to pursue full employment and price stability, it had to strike a balance in its actions between the need to raise rates to combat inflation and the need to decrease them to keep the labor market afloat. The Fed, on the other hand, can't argue that it has to maintain rates low to improve the labor market in the current circumstances because the US economy has already reached full employment. Instead, the Fed is grossly missing its other mandate of price stability and it will be held accountable if it does not act vigorously to tame inflation.

The market has been forced to acknowledge Fed's recent hawkish posture, and currently expects Fed funds rates to increase an additional 2.38% until year end (white line in the chart below). This corresponds to a hike of at least 50 bps at each of the 2022 sessions. The market has priced-in that the current hiking cycle will end at about 3% in 2023. Thereafter, the expectation is that these rate hikes will result in a policy error, forcing the Fed to reverse its stance. As a result, the market is now expecting 25 bps rate cut and a half between mid-2023 and December 2024.

Only time will tell whether or not these assumptions are correct. In order to restore price stability, rates have always had to be raised to levels close to or above the inflation rate, if history is any guide.

Inflation, which was already at 7.9% before the conflict and the new wave of covid-19 in Asia, could climb into the double digits in the next months. It's possible that assuming interest rates to peak at 3% and then stay "lower for longer" is overly optimistic.

Source: Bloomberg

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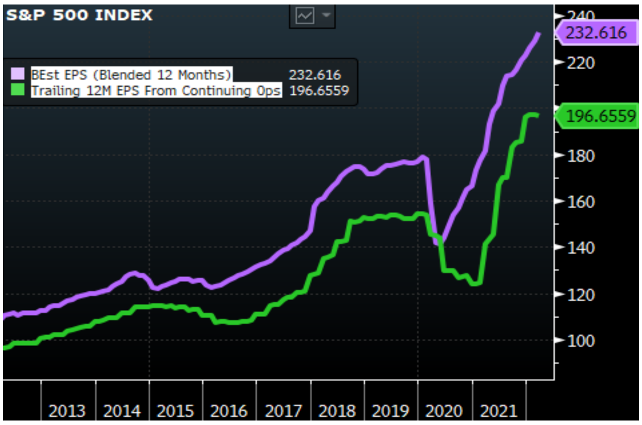
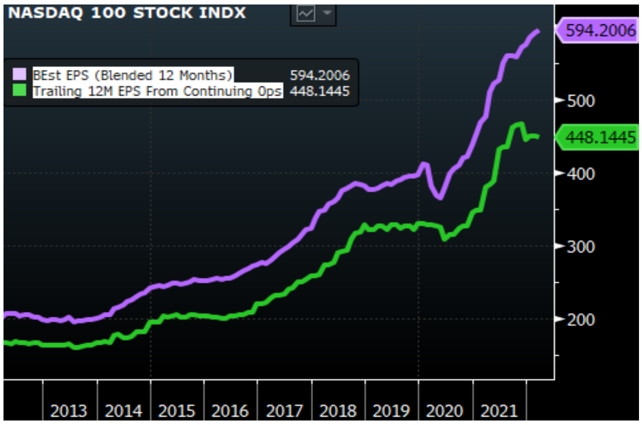


Source: Bloomberg



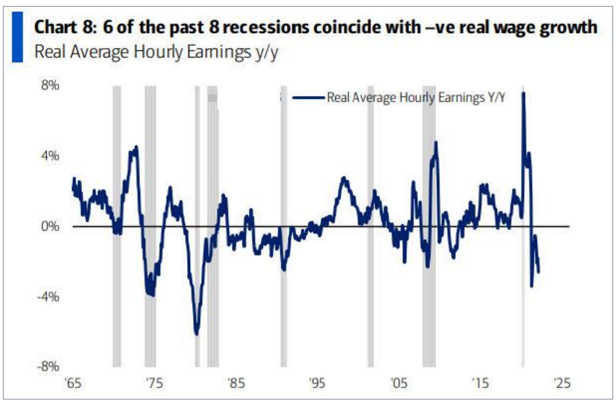
Source: Bloomberg

The positive reaction from equity markets was likely based on the assumption that rates (and inflation) will come down again in a year's time, and Powell's reassurances that the economy is strong enough to withstand higher rates.

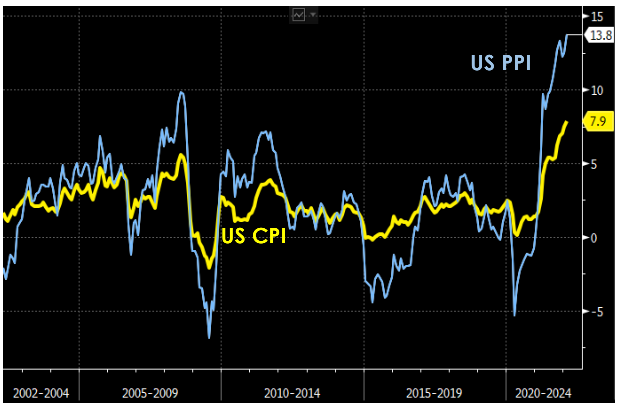
Aside from these optimistic assumptions, equity analysts continue to project recent EPS growth for the foreseeable future, regardless of the trajectory of rates, risks of slower GDP growth and narrower margins. The expected EPS for the next 12-months and the trailing 12-months EPS are compared in the charts above, purple and green, respectively. Even if the green line is slowing, the purple line continues to develop undeterred at its current rate.

For the S&P 500 and for the Nasdaq 100, these numbers show that there is an expectation of 18% and 33% earning growth over the next two years (the next 12 months versus to the previous 12 months). It is worth noting that the trailing 12-months EPS still includes the two quarters that recorded the highest beat rate in history, and two of the largest fiscal stimuli ever. Assuming that EPS can continue to grow at these rates from such a strong base is perhaps again overly optimistic.

Flattening or even inversion of the curves indicates that growth rates are likely to slow or even reverse in the near future. Furthermore, when wages fall in real terms, as they are now, a recession is likely to follow.



Source: BofA Global Research, Bloomberg



Source: Bloomberg

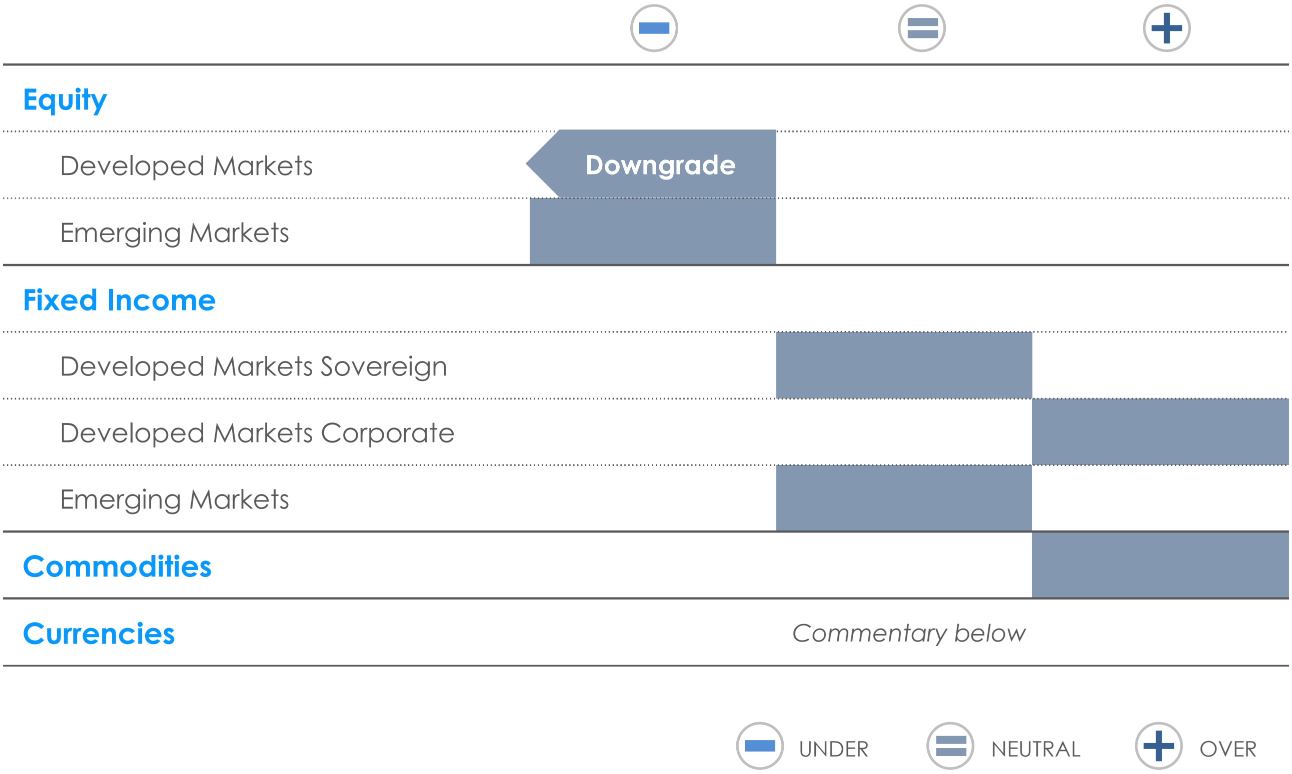
Finally, higher input costs (PPI) will either pass on to the consumer (but then inflation will become entrenched) or negatively impact corporate margins for the portion that is not passed on the CPI. There's no magic here, higher input costs cannot simply disappear without any fallout.

(continued)

So, what to do now? First remember that the major concern right now is how to best preserve our customers' portfolios from a rising and maybe not-so-transient inflation, and stocks tend to be the best asset class over the medium term when prices are soaring.

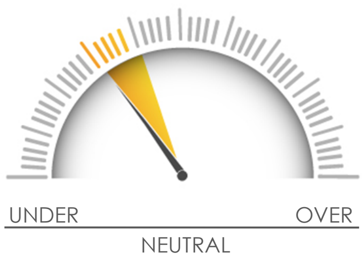
Despite the war induced problems, higher commodity prices, higher rates, and tighter central banks, stocks have recovered to pre-invasion levels. Therefore, if some clients are overexposed to equities relative to their risk tolerance, we can take advantage of the current rally to partially reduce their overall equity exposure. If the clients are fairly exposed to equities and/or took advantage of the recent correction to increase their allocation to equities, we can maintain the positions and continue in the gradual accumulation of equities.

Asset Allocation View



Equity

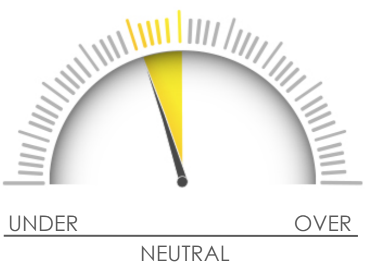
Developed Markets



We further downgraded our recommendation on Developed Markets Equities to **Underweight**. The prologue of this paper goes into great length about the reasons for the tactical downgrading. We consider the current bounce that has pushed the main indices back above their pre-invasion levels as an opportunity to trim the overall equity exposure for those who are overexposed to equities. We reiterate our view that stocks are expected to deliver the best inflation-adjusted returns over the medium term, and we recommend re-entering the market on any meaningful correction.

US	**Europe**	**Japan**

Emerging Markets

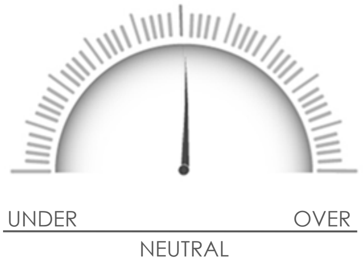


We kept our Emerging Markets Equities rating unchanged at **Slightly Underweight**. During the recent upswing, emerging markets lagged behind developed markets, owing to anticipation of a faster rate hike from Western central banks. Nonetheless, we advise continuing to accumulate emerging markets equities because they trade at a deep discount to developed markets. Among emerging markets we have a moderately cautious view on Asia given the spike in covid-19 infection, as well as because it's a commodity importer. On the contrary, we recommend buying Latin America on any downturn because it's a major commodity exporter and benefits from being the only region unaffected by geopolitical worries.

Asia ex-Japan	**EEMEA**	**LATAM**

Fixed Income

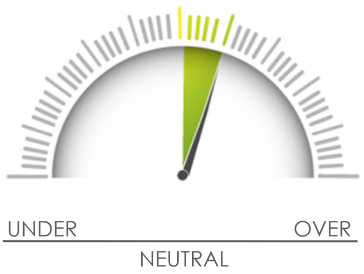
Developed Markets Sovereign



We kept our **Neutral** recommendation on Developed Markets Sovereign Bonds. On one hand, sovereign bonds may benefit from their safe-haven status if the conflict escalates, but on the other hand they are still exposed to downside should rates continue to normalize to higher level as a result of the runaway inflation. We believe that these two risks are balanced in the short term. Following the main central banks' more aggressive attitude, the risk of considerably higher rates has increased in the medium term.

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

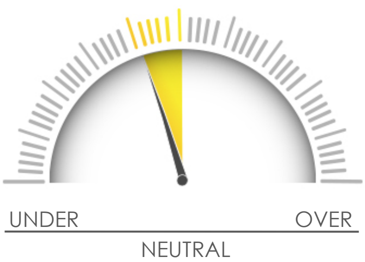
Developed Markets Corporate



We kept our recommendation on Developed Markets Corporates to **Slightly Overweight**. The decision to maintain the recommendation stems mostly from a cautious outlook on all risky assets, which could see further downside if the dispute escalates and/or interest rates rise further. Short-dated, high-grade corporate bonds are viewed as the greatest option for weathering the storm among the other asset classes. The recent increase in risk-free rates, together with the slight widening of spreads on companies with strong fundamentals, allows for a solid return with low volatility. High-yield and short-term corporate bonds continue to have a negative outlook.

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

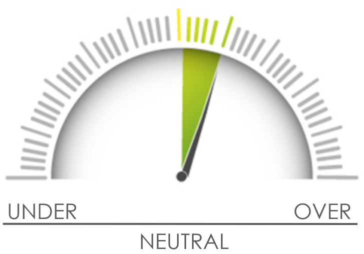
Emerging Markets



We maintained our **Slightly Underweight** recommendation on Emerging Market bonds. The invasion of Ukraine resulted in a sharp reversal of flows into emerging market bonds seen in the first weeks of this year, causing spreads to widen significantly mainly in the hard currency space. Hard currency bonds have also been affected by the very long duration typical of the asset class. As long as Western central banks will continue to send out ever increasingly hawkish messages, it is reasonable to expect emerging market bonds to remain under stress, despite spreads reaching high levels. We prefer local currency bonds issued by commodity exporting countries.

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

Commodities



We maintained our **Slightly Positive** view on the Commodities. We continue to prefer precious metals, particularly because of their safe haven status amid the current developments in Ukraine. Additionally, the precious metals continue to be supported by deeply negative real interest rates, and may serve as an inflation hedge if inflation proves to be not temporary. We have maintained a more cautious view on the other commodities.

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

Currencies

The Committee strengthened its positive view on the US dollar, owing primarily to its status as a safe haven, which typically outperforms during periods of market turbulence. Additionally the greenback should be supported by the expectation of higher inflation rates, wider rate differential against the other currencies and the US economy's relatively limited exposure to Russia.

The view on the Euro is negative, considering that Europe will be the hardest hit by the war in Ukraine due to higher commodity prices, disruption in the supply chain, greater exposure of financial companies to Russia, geographical proximity to the area of conflict and an increased risk aversion towards Europe.

The view on the Chinese Renminbi continue to be negative due to the expectation of looser monetary policies, and by the ambiguous position of China with respect to the conflict in Ukraine.

We maintain our recommendation for other emerging market currencies as a group to Neutral, as commodity exporters in emerging markets will benefit greatly from the significant increase in raw material prices. On the contrary, commodity-importing countries' currencies remain vulnerable to further depreciation.

Euro	−	USD	+	CNY	−	Other EM	=