AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

03.06.22

Main Events

ECB MEETING – 09.06
Will the ECB announce a faster hike pace or confirm expectations of two 25 bps hikes?

US CPI – 10.06
If inflation does not moderate, particularly in the core component, the possibility of a less hawkish Fed would disappear

GERMANY ZEW – 14.06
For the past three months, the ZEW has been at levels consistent with a marked slowdown. Will the June reading be any better?

FED MEETING – 15.06
The press conference will be crucial to understand whether the speculation of a possible slowdown in the pace of rate hikes is plausible or not

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

BEWARE OF QT

- **So far, central bank actions have been limited to rate hikes, but balance sheets have not yet been reduced**
- **The Fed began quantitative tightening (QT) on June 1, and other central banks may follow in the near future**
- **The implications of QT on financial asset prices could be more substantial than generally estimated**

The start of 2022 was one of the worst in the last century, with MSCI World (equity) and Barclays Global Aggregate (bond) indices at -13.3% and -11.6%, respectively, in dollar terms as of last Friday.

These declines are easily explained by the increasingly restrictive monetary policies announced and/or implemented by the world's central banks. Aside from verbal interventions (forward guidance), until May, the only action taken by the major western central banks was to raise interest rates (the Fed and the BoE to 1%, the BoC to 1.5%), while the ECB and the SNB did nothing and kept rates steady at -0.5% and -0.75%, respectively.

Nothing had yet been done in terms of balance sheet reduction (quantitative tightening or 'QT'). In fact, the ECB is still implementing its QE, which is scheduled to finish in a month.

This has changed since June 1st, when the Fed officially started the QT. The US central bank has just started reducing its balance sheet by $47.5 billion per month ($30 billion of treasury bonds and $17.5 billion of MBS), which will be increased to $95 billion per month ($60 billion of treasury bonds and $35 billion of MBS) after three months. This is almost double the pace of the previous QT, which started in October 2017 at $10 billion per month and culminated at $50 billion per month before being phased out in March 2019 and ending in September 2019.

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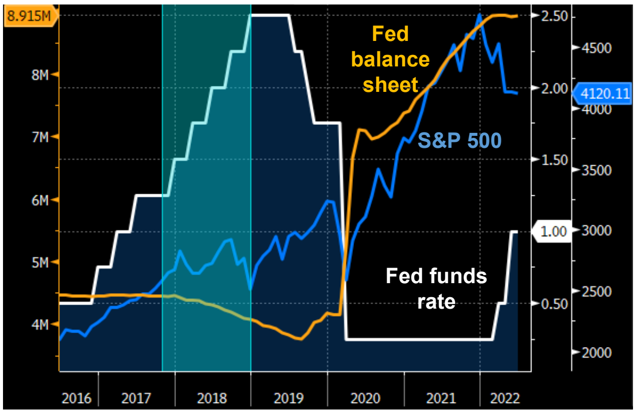
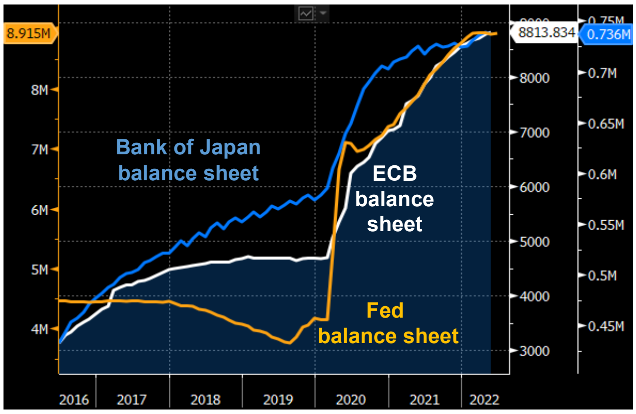


Source: Bloomberg



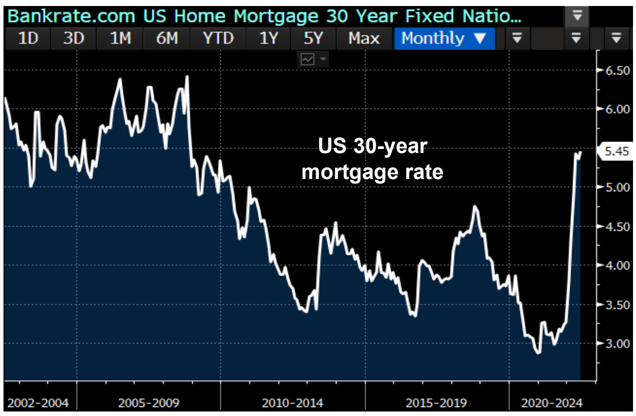
Source: Bloomberg

The Fed had already begun rising rates, as it had done in the only other QT precedent (then to 1.25% today to 1%). When interest rates reached 2.5% in December 2018, the Fed declared that the QT would be scaled back. Throughout the period when the Fed maintained its restrictive stance, the S&P 500 moved sideways with increasingly pronounced corrections, hitting a low in December 2018. Both the Fed's rate hikes and the balance sheet reduction are now twice as large as they were then, hence the impact on markets will realistically be more pronounced than in 2018.

But there is one more important factor to consider that is often overlooked. Despite the Fed's QT, the Bank of Japan and the European Central Bank continued to expand their balance sheets in 2018, essentially offsetting the Fed's liquidity drain. As a result, global liquidity remained largely constant at the aggregate level. Today, not only is no other central bank undertaking QE, but it is also likely that other central banks will begin performing their own QT in the coming quarters, further worsening the overall liquidity.

One should not underestimate the effect of changes in central banks' balance sheets on financial markets. As the graph on the left above shows, there isn't a strong correlation between interest rates and the equity markets, at least not when rates are close to zero (the so-called 'lower bound' problem). Conversely, as can be seen in the below graph on the left, there seems to be a much stronger correlation between the level of the aggregate balance sheet of central banks and the MSCI World index.

There is one more significant distinction between a rate hike and a QT. The mere expectation of a future rate hike has immediate effects on interest rates, not only in the financial markets but also in the real world. To see the repercussions on the markets, you don't have to wait for central banks to act. For example, the Fed has only recently begun its rate hike cycle, but 30-year US mortgage rates have already risen to 5.5%, the highest level since 2008.



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The mechanics of liquidity are fundamentally different. The market is unable to anticipate a reduction in the money supply, because investors have to allocate all the liquidity in circulation in the market at any given time, regardless of its amount. As a result, the effects of a reduction in the central banks' balance sheets are only felt when the liquidity reduction is actually implemented.

Therefore, caution is advised in the medium term as further corrections are still possible, particularly if fears of a strong economic slowdown materialize. In the short term, the current rebound which was called for in the previous report considering the extreme oversold situation may still have some room to go. But one has to be mindful that it might just be a bear market rally that is eventually to be sold.

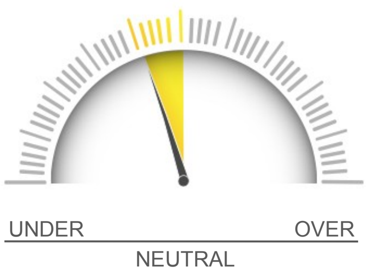
Asset Allocation View

	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

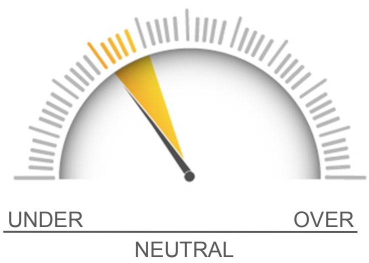
Developed Markets



We maintained our recommendation on Developed Markets Equities as **Slightly Underweight**. The ongoing rebound in equity markets after the extreme oversold conditions of recent weeks may still have room to run. Nonetheless, risks related to Ukraine conflict, rampant inflation, rising rates, risks of economic slowdown, and now QT suggest that this may just be a bear market rally. Therefore, those who are overexposed to equities are advised to reduce their positions if the bounce continues. Stock markets could start sliding again if central banks continue to tighten their stance in upcoming meetings.

US	Neutral	**Europe**	Under	**Japan**	Neutral

Emerging Markets

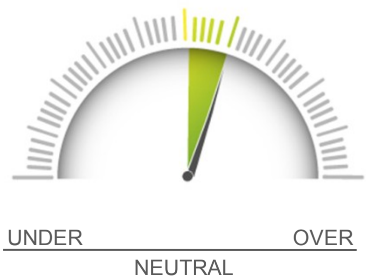


We kept our **Underweight** recommendation on Emerging Markets Equities. Hawkish central banks, increases in nominal rates in developed countries and geopolitical tensions warrant a cautious stance on Emerging Markets. It is possible that China's equity market will recover if the country's zero-Covid policy is relaxed and the country is reopened. An easier approach to bet on China's reopening is to invest in Latin America, as South America is a major commodity exporter to the Asian giant, and demand for commodities will undoubtedly rise if China effectively reopens.

Asia ex-Japan	Neutral	**EEMEA**	Under	**LATAM**	Over

Fixed Income

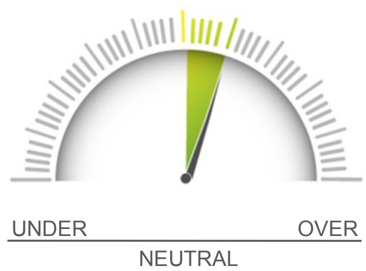
Developed Markets Sovereign



We maintained our **Slightly Overweight** view on Developed Markets Sovereign Bonds. The moderately positive outlook on the asset class is limited exclusively to the very short end of the sovereign curves (6 months to maximum 12 months) which will be used as a safe haven to park money during the period of interest rate normalization and fight against inflation. Inflation is not showing signs of slowing down, and central banks are continuing to maintain or strengthen their restrictive policies, thus the outlook for the short, medium, and long parts of the curves is negative.

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

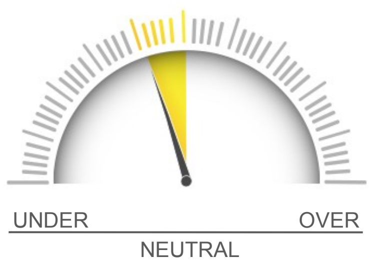
Developed Markets Corporate



We maintained our recommendation on Developed Markets Corporates as **Slightly Overweight**. The decision to keep the recommendation is primarily motivated by the fact that spreads have not yet reached sufficiently appealing levels in light of the numerous concerns we are now facing (potential economic slowdown, hawkish central banks, and geopolitical risks). We prefer short-dated, high-grade corporate bonds within corporates, because they are less vulnerable to duration and/or spread risks. We remain cautious on high yield bonds.

IG Europe	**IG US**	**HY Europe**	**HY US**

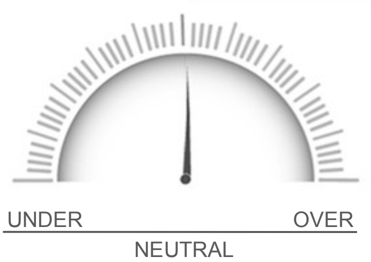
Emerging Markets



We maintained our **Slightly Underweight** recommendation on Emerging Market bonds. Despite spreads reaching high levels, it is reasonable to expect developing market bonds to remain under stress as long as Western central banks continue to release progressively hawkish statements.

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

Commodities



We maintained our Neutral view on Commodities. We continue to prefer precious metals over commodities, owing to their safe haven status in light of the current events in Ukraine. We have a relatively constructive view on agricultural commodities, which we believe can remain strong in the face of supply disruptions. We have tactically turned positive on industrial metals in view of the potential abandonment of the zero-covid policy in China and the sharp correction they have experienced in recent weeks.

Precious	**Energy**	**Industrial**	**Agricultural**

Currencies

The Committee confirmed its **neutral view on the US dollar**. After strong outperformance against the major currencies, supported by widening rate differentials and growing concerns in the rest of the world, it is likely that the US dollar could extend the short term retracement it started few weeks ago.

The view on the **Euro is neutral** as well. In addition to a physiological rebound against the dollar after the steep decline of the past three months, the Euro could benefit from bolder actions by the ECB considering the rampant inflation in the Eurozone, thereby reducing the rate differential with the dollar.

The view on the **Chinese Renminbi** has been tactically maintained to **neutral**. Chinese monetary authorities have recently implemented some measures to support the markets, and the possibility of a reopening after the drop in covid-19 cases may lead to an extension of the rebound of the Renminbi.

We maintain our Neutral recommendation for other emerging market currencies, but with a relative preference for those of Latin America.

Euro =	**USD** =	**CNY** =	**Other EM** =