AZIMUT
DEFINING INVESTMENT DIRECTION

AZIMUT GLOBAL VIEW

11.04.22

## Main Events

**US PPI** — 13.04
How much have producer prices been impacted by the labor shortages and the sudden increase in commodity prices after Russian's invasion of Ukraine?

**ECB MEETING** — 14.04
Will the ECB follow the Fed's path in communicating increasingly restrictive monetary policy at every opportunity?

**US RETAIL SALES** — 14.04
Will consumers have continued their shopping spree in March after a strong start of the year?

**EU PMI** — 22.04
In March reading, European business confidence was largely unchanged despite the war. Will this still be the case in April?

# DON'T FIGHT THE CENTRAL BANKS

- **In recent decades, market players have become accustomed to the reality that central banks have almost always been supportive of the market.**
- **Therefore, despite central banks' explicit predictions of considerably more restrictive monetary policies in the near future, the market refuses to surrender to the new attitude.**
- **The fact that so far the market has snubbed hawkish messages from central banks makes stock markets vulnerable to further corrections**

"Don't fight the Fed" has always been one of the most established market mantras. Originally "don't fight the Fed" applied in both directions: if the Fed was accommodative, market participants maintained a bullish attitude, if the Fed was restrictive, a cautious attitude. This began to change in the 1990s, when the concept of "Fed's put" was introduced, i.e. the Fed's tendency to intervene in support of the markets whenever they began to correct. In the course of the last few decades, therefore, the meaning of "don't fight the Fed" has changed, becoming unidirectional: "you have to buy always and in any case because if there is a problem the Fed will support the market".

This has encouraged market participants to take on increasing amounts of risk in their portfolios, regardless of valuations or macroeconomic conditions. Over the last two years, this has grown even more apparent, and today we are experiencing the paradox that the market has begun to fight the Fed, because what the Fed wants to do (raise rates) would produce a market correction that market participants do not want. In practice, the market accepts "don't fight the Fed" if and only if the Fed is helpful, not the other way around.

The minutes of the latest Federal Reserve and ECB meetings seem to be clearly telling the market that it is wrong, and that it needs to get used again to the fact that "don't fight the Fed" applies in both directions.

**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

# (continued)

It is clear from the minutes of the last Fed meeting that the decision to raise interest rates by only 25 basis points was exclusively justified by the high uncertainty regarding the effects of the war in Ukraine. Without this, rates would have been raised by 50 basis points. More importantly, the minutes revealed that many governors believe one or more half-point raises may be necessary in the future to combat the highest inflation in four decades.

What surprised the market, however, were the details of the plans for reducing the size of the balance sheet. According to the minutes, "all participants agreed that elevated inflation and tight labor market conditions warranted commencement of balance sheet runoff at a coming meeting, with a faster pace of decline in securities holdings than over the 2017–19 period", and "Participants generally agreed that monthly caps of about $60 billion for Treasury securities and about $35 billion for agency MBS would likely be appropriate".

Fed Governor Lael Brainard, speaking at a forum on inflation, clarified that "at a coming meeting" means potentially as early as May, and that "the Fed will continue tightening policy methodically". The market was taken aback by the larger-than-expected extent of balance sheet runoff (far faster than the prior occasion) and the earlier-than-expected start date of the QT.

Another Fed governor who will vote this year, James Bullard, indicated last week that the current policy rate is roughly 300 basis points too low relative to the level that would be suitable to combat far-too-high inflation. He believes the Fed funds rate should be raised to 3 percent - 3.25 percent by the end of the year.

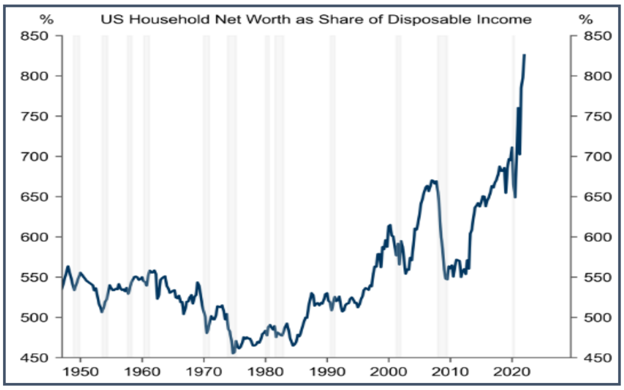
William Dudley, the former president of the Federal Reserve Bank of New York and vice-chairman of the Federal Open Market Committee, delivered the latest punch to the bulls. He was the governor of the New York Federal Reserve, and he was in charge of the Fed's open market operations. He may speak freely now that he is no longer employed by the Fed, and because of the position he previously had, he has a thorough understanding of how the Fed thinks and behaves, so his comments should be taken with caution.

He made it clear that the Fed's primary objective right now is to tighten financial conditions to tame inflation. However, financial conditions are not only dependent on the Fed monetary policy, but also on the level of financial markets, the households net worth and what the market expects regarding future Fed actions. The recent rebound of the US stock market, which has almost entirely erased the correction of the first part of the year, along with the fact that the curves are flattening (which implies that the market expects the Fed to reverse its course on rates as early as a year from now), has led to a significant easing of financial conditions, exactly the opposite of what the Fed wants to achieve (charts on the next page).

Dudley has been particularly outspoken. "One thing is certain: to be effective [the Fed] will have to inflict more losses on stock and bond investors than it has so far" and "market participants expect higher short-term rates to undermine economic growth and force the Fed to reverse course in 2024 and 2025, but these very expectations are preventing the tightening of financial conditions that would make such an outcome more likely", Dudley said. He further added that "the Fed will have to shock markets to achieve the desired response", and that "this would mean hiking the federal funds rate considerably higher than currently anticipated. One way or another, to get inflation under control, the Fed will need to push bond yields high and stock prices lower".

In Europe, although the ECB minutes showed that the ECB's hawkish stance is more moderate than that of the United States, the intention expressed by Lagarde during the press conference to make monetary policy less accommodative and act more quickly was confirmed by the meeting accounts. As reported in the minutes, "a large number of members held the view that the current high level of inflation and its persistence called for immediate further steps towards monetary policy normalization".

# (continued)




*Source: Harver Analytics, GS Global Investment Research*


*Source: Goldman Sachs Global Investment Research*

Additionally, "among those calling for action at the present meeting, some members preferred to set a firm end date for APP net purchases during summer". This is very important with respect to the sequencing. ECB will only hike after APP is finished, and in fact, the minutes further reported that "this could clear the way for a possible rate rise in the third quarter of this year in the light of the deterioration in the inflation outlook".

But the most significant message in the minutes, however, was perhaps the one in which the governors appear to have lost at least some trust in the ECB staff's economic projections, particularly on inflation: "doubts were expressed about the convergence of inflation to 1.9% as expected in the baseline staff projection for 2024, the last year of the projection horizon. The question was raised as to how one could expect such a fast mean-reversion in inflation, faster than in the previous projection round, after the current huge shocks to inflation. It appeared puzzling that inflation projections would still fall somewhat short of the 2% target in 2024 despite consecutive upside surprises in inflation outcomes, a persistently positive output gap for most of the projection horizon and the latest increases in longer-term inflation expectations. It was accepted in this context that models based on historical data have their limitations in the face of exceptional shocks and possible turning points or regime upheavals."

The fact that the ECB's staff expects inflation to revert to a more moderate level is categorized as potentially unreliable could allow the ECB to change its posture and measures at any time. This may be a simple emergency exit, allowing the ECB to avoid being forced to maintain negative rates at a time when European inflation is at its highest level in 40 years.

The ECB will have the opportunity to confirm or contradict these theories on Thursday. If a hawkish shift is confirmed, global interest rates will likely continue to increase, and markets will continue to suffer. If not, we could witness a temporary pullback of bonds from their present oversold levels, as well as a recovery in equities markets. The ultimate fate of the markets, however, will be decided by the Fed at the start of May.

# 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

UNDER OVER
NEUTRAL

We maintained our **Underweight** recommendation on Developed Markets Equities. The reasons why the Committee is particularly cautious on the equity markets have been outlined in full in the prologue of this report, as well as in the previous one. We continue to believe that equities will provide the best inflation-adjusted returns over the medium term, but given the combination of historically high valuations and outspokenly restrictive central banks, we recommend maintaining a cautious stance and waiting for a correction before increasing equity exposure again.

| | | | | | |
|---|---|---|---|---|---|
| **US** | = | **Europe** | = | **Japan** | = |

### Emerging Markets

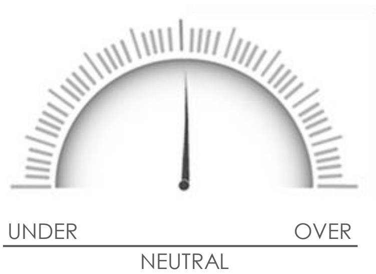
UNDER OVER
NEUTRAL

We further downgraded our recommendation on Emerging Markets Equities to **Underweight**. Given their vulnerability to rising rates and diminished liquidity, the shift toward increasingly restrictive monetary policies by Western central banks could lead to a further downside on emerging countries. Given the recent surge in Covid-19 infection and the fact that Asia is a commodity importer, we have a more cautious outlook on Asia among emerging markets. We continue to favor Latin America since it is a significant commodities exporter and benefits from being the only region unaffected by geopolitical concerns.

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

# Fixed Income

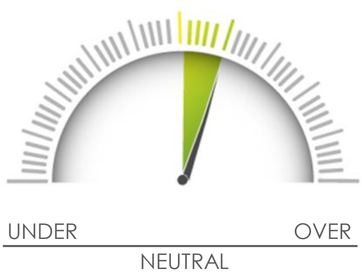
## Developed Markets Sovereign




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 central banks continue to normalize rates as dsicussed in the prologue. Another reason why we maintain a neutral recommendation on government bonds is that while we expect interest rates to continue to rise from current levels causing significant losses on long duration bonds, government bonds with short residual maturities have a limited downside.

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

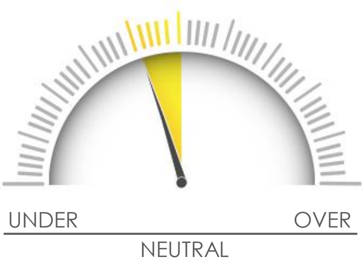
## Developed Markets Corporate




We kept our recommendation on Developed Markets Corporates to **Slightly Overweight**. The decision to keep the recommendation stems mostly from a cautious outlook on all risky assets, which might see further losses if the conflict worsens and/or interest rates continue to increase. Short-dated, high-grade corporate bonds are seen as a viable alternative to other asset classes for weathering the storm. The recent rise in risk-free rates, combined with a small widening of spreads on companies with strong fundamentals, has resulted in a decent return with low volatility. The outlook for high-yield and short-term corporate bonds remains bleak.

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

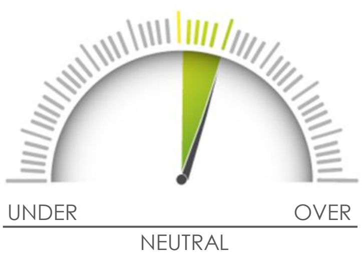
## Emerging Markets




We maintained our **Slightly Underweight** recommendation on Emerging Market bonds. Despite spreads reaching high levels spreads, it is reasonable to expect developing market bonds to remain under stress as long as Western central banks continue to send out progressively hawkish statements. We prefer local currency bonds issued by commodities 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 may serve as an inflation hedge if inflation proves to be not temporary. We have a positive view also on agricultural commodities, whose prices should continue remain strong in view of the supply disruptions caused by the war in Ukraine. 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 the ambiguous position of China with respect to the conflict in Ukraine.

We maintain our Neutral recommendation for other emerging market currencies, 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** | = |