View

Fideuram Asset Management

Macroeconomic Scenario

The strongest period of growth in advanced economies is expected during the summer (by reason, in particular, of the significant acceleration expected in Europe); nevertheless, **the spread of the delta variant signals risks** (contained, for now**) linked to activities taking place during the final part of the year**. Inflation has continued to surprise with an upward tendency in the US, although this is most likely only a temporary effect and will significantly wane over the next year. Overall, **monetary policies remain expansionary**; this signal was also sent by the ECB with its new monetary policy strategy presented at the beginning of July.

Equity Markets

Equity markets in July continued to climb, with the component that is more oriented towards quality/growth styles that continues to outperform the more cyclical components that had prevailed through mid-May, similarly to what took place last month.

The debate on the persistence or otherwise of inflationary pressures, especially in the US, combined with concerns linked to the surpassing of the peak of the current economic cycle and a possible loss of momentum for the rest of 2020 **continues to generate a prolonged uncertainty**, especially **in terms of leadership** rather than the direction of the market.

The beginning of the profits season, on the other hand, opened on a positive note both in the US and in Europe, a circumstance that supported the markets. Macroeconomic data also continued to provide support so far, with both manufacturing and service PMI indices still very strong, although the peaks are probably behind us.

The market has probably taken some signals to the extreme and **we are therefore maintaining our positive view on Japan, Europe and the emerging markets and our neutral view on the US**.

Bond Markets

Inflation data continues to surprise with upward tendencies but the market considers this phenomenon to be temporary. Government bond yields are sinking further, both in the real component and in inflation expectations owing to, among other things, the expected loss of cyclical momentum for the quarters to come.

Despite the uncertainty linked to the spread of the new Covid-19 variants, **we believe that the US rate is lower than what is suggested by US macro fundamentals and their foreseeable evolution**. This is due to an economic growth that is expected to be above the potential also next year, as well as upside inflation risks and QE tapering during 2022. We therefore confirm the underexposure of duration and reintroduce a preference for US inflation-linked securities over nominal US Treasuries.

We continue to prefer credit risk with a focus on financial sector issues and Chinese debt. In general, credit spreads are very tight and hardly capable of absorbing duration movements. However, at the same time, we believe they can still provide extra carry depending on the underlying environment that combines growth with monetary policy that remains highly expansionary.

Macroeconomic scenario

US: Yet another upside inflation surprise

GDP growth remained strong in the second quarter (6.5% annualized), but below consensus as a result of weak federal spending, while private consumption and investment were il line with expectations. **Growth is expected to stay strong in the current quarter**.

Furthermore, a significant positive contribution from restocking should is expected this quarter as an effect of the partial reduction of imbalances between supply and demand. These imbalances, however, helped **push inflation – now at 5.4%, well above expectations in June as well**, even though price increases remained concentrated in a very limited number of items (primarily cars) – for the third consecutive month.

After the unexpected restrictive turn announced at the meeting in mid-June, there were no major surprises at the end of July FOMC meeting.

Euro Area: Facing the delta variant

The recovery endures and the **third quarter is expected to exhibit the year's most robust growth**. The spread of the delta variant and the sharp increase in infections in some countries of the Euro Area, as well as in the UK, is cause for concern.

Vaccines are, nevertheless, effective in reducing hospitalisations and deaths, and the vaccination campaign continues at a good pace (at the end of July, 50% of the population in the Euro Area had received two doses). We only marginally reduced growth in the third quarter (now at 13.5%, down from the previous 15% annualised), while it appears more at risk in the fourth quarter.

In July, the ECB revised its monetary policy strategy: the inflation target is now officially symmetrical at around 2% and the ECB **reinforced the need to maintain interest rates low in the long term**, even tolerating temporary upward inflation deviations (something that will take place in the second half of this year).

We continue to expect new expansionary measures by year end.

China: A more complicated scenario

GDP growth in the second quarter was stronger than expected, although it slowed down sharply yoy due to the lack of a substantial base effect as a result of the pandemic that marked the first quarter.

Overall, economic activity in June was also stronger than expected. **For 2021 and 2022, we have slightly revised our GDP growth estimates upwards.**

The unexpected decision made by the authorities at the beginning of July to reduce the reserve requirement ratio cannot be interpreted as a response to the weakening of the economy; instead, it is probably aimed at ensuring adequate levels of liquidity in the coming months, as well as signalling an overall more flexible economic policy in the second half of the year.

Equity Markets

The return of technology

The sector rotation that began in mid-May and passed the baton of market leadership back to sectors with a longer duration such as technology and health care continued to take place in July. Fears linked to inflation and its persistent nature, the more aggressive than expected approach to monetary policy adopted by the Fed and fears linked to some components of the economic cycle slowing down continue to weigh on the long-term rates of the US curve, with the ten-year rate at all-time lows since the beginning of the year, down from the peak recorded at the end of last March. All this has shifted the attention of operators towards securities that, by their nature, maintain solid growth prospects in terms of turnover and profits (growth), and guarantee good profitability and high cash flows (quality).

We did not modify the approach to the equity component of the portfolios, which include a modest overall overweight and a preference for markets outside the US. The overweight is explained by relative valuations that are still attractive compared to bonds and profit growth that we believe still has room for improvement compared to market expectations.

To sum up, we confirm our fairly positive view on European, Japanese and emerging equities and our neutral view on US equities.

Specifically:

- **in the US** the fundamentals and profit growth are solid and are expected to remain so in the coming year. We nevertheless maintain a neutral stance, given that the peak of profits has been surpassed and on account of heightened uncertainty stemming from economic and regulatory policies. We also hold that a rise in real rates is plausible and could have an effect on technology sector valuations. We remain more uncertain than consensus on the effect of rising costs of commodities on corporate operating margins in the second half of the year and in 2022;

- **we maintain a fairly positive view on Europe**, given that we expect Europe to surpass the US in terms of both economic activity and earnings. We believe it is too early to consider the cyclical rotation phase over and that the most recent movements are more related to the evolution of the rates than corporate fundamentals. However, given the risks posed by the new variants and the approaching peak of the cyclical recovery, equity exposure is not particularly high at the moment. The medium-term approach to the equity component remains constructive;

- **we maintain a positive view on the Japanese market** as a result of the gradual improvement in profits linked to the progress made in the vaccination campaign and a greater connection to the global economic cycle in the second half of the year. This positive view is also based on our expectation of an upward adjustment of real rates in the US, a scenario that is usually beneficial to the Japanese stock market, also as a result of its effects on the currency;

- **we confirm the overweight in emerging markets** although the signals are mixed. Profit growth is accelerating albeit with regional and sectoral discrepancies linked to the activities of commodity importers/exporters and the exposure to the global cycle. Valuations remain attractive compared to other areas. The risks are linked to the performance of the dollar and the effect on the cost of debt of a rate hike of real US rates, against the backdrop of a new Covid-19 wave prompted by the beta and delta variants. Particular attention should be paid in the short term to the regulatory measures on private capital that China is introducing, especially in the education sector, and perhaps in the finance and technology sectors.

Bond Markets

The ECB also changed its inflation target by setting a symmetric 2% target

The ECB put forward the timing of revision of its strategy by announcing a new symmetric inflation target of around 2%, which moves in the direction already taken by the Fed. A revision of forward guidance is expected in July. Risk-free yields fell further, while credit remains well supported thanks to an economic cycle that remains sustained and with plentiful monetary support.

Government bonds

US Treasuries remain at lower yield levels than those suggested by the economic fundamentals that typically underpin their evolution; at these levels, the risks embedded in the rates also reflect a downturn beyond our expectations.

Together with the absence of an inflation risk premium and the Fed tapering drawing near – which will result in the automatic reduction in the hedging of issues – **lead us to confirm a negative positioning in terms of duration and our preference for the inflation-linked component over the nominal component**.

The ECB´s reiterated accommodative stance and the newfound correlation with the Treasury, as well as concerns on a new Covid-19 wave, also pushed the Bund below the level that is compatible with the reference scenario.

We maintain a negative positioning on European core rates and a relative preference for peripheral rates for carry purposes.

Spread products

We maintain a neutral view on investment grade credit because the level of compression of the spreads is at an all-time low, with little capacity to absorb potential interest rate hikes. **We therefore prefer exposure to the financial component**, for example in Europe, which benefits from the cyclical recovery even during a phase of rising government rates.

The neutral valuation on the high yield component responds to a portfolio logic, in the search for carry given the overexposure to equities, which is currently limited. Increased holdings by institutional investors and the drop in holdings by retail investors tend to make the asset class more stable.

Conversely, valuations are compressed and attention should be paid to possible increased market volatility.

Overall, we maintain an overweight exposure on emerging market bonds for cyclical and valuation reasons, with exposure to the Chinese bond market, where we continue to favour government and quasi-sovereign market components. Since the Chinese currency may experience volatility in the short term as a result of the new regulatory measures implemented by the Chinese authorities, we have tactically scaled back the overweight in this component.

Overall, financial conditions in developed countries remain strongly expansive, which creates a favourable environment for the emerging asset class, while spreads are still far from the levels of maximum historical compression in an outlook which upholds cyclical expansion.

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