J. Safra Sarasin

Cross-Asset Weekly

03 March 2023

Difficult terrain for central banks

UK macro: Conditions for a sharp slowdown in housing activity are in place and residential investment is likely to drop significantly this year, knocking about one percentage point off GDP growth. The sharp increase in mortgage rates will depress households' purchasing power as well as increase financial stability risks. The good news is that we see some signs of underlying inflation coming down. As such, we don't expect the Bank of England to raise rates as much as what's priced in financial markets.

Euro area fixed income: The latest batch of inflation data from the euro area shows that the upward trend in core inflation has not been broken. On top of that, the euro area economy is starting to show signs of a cyclical improvement. The ECB will therefore need to retain an aggressive stance. Rates markets are already pricing a 4% peak ECB policy rate. Given the lagged effects of monetary policy on the economy and inflation, fixed income investors should use the sharply higher yields to add exposure incrementally on sell-offs. The objective is to accumulate duration at reasonable yield levels to prepare for an eventual pivot by the ECB.

EM and European equities: The strong PMI print out of China this week underlines the progress the economy is making after lockdown measures have been lifted. The Chinese equity market has been reluctant lately to price too much optimism, which leaves upside potential as we expect the macro recovery to continue. While the European cycle is closely tied to the Chinese one, and should improve further in the months ahead, the European equity market is largely priced for it, with some exceptions. We still like Swiss mid-caps in this regard.

This week's highlights

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UK macro

Housing blues

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Conditions for a sharp slowdown in housing activity are in place and residential investment is likely to drop significantly this year, knocking about one percentage point off GDP growth. The sharp increase in mortgage rates will depress households' purchasing power as well as increase financial stability risks. The good news is that we see some signs of underlying inflation coming down. As such, we don't expect the Bank of England to raise rates as much as what's priced in financial markets.

Conditions for a sharp slowdown in housing activity are in place

Recent macroeconomic data and events have come in a bit better than expected. Inflation surprised on the downside in January and retail sales rose, a reflection of discounting and lower energy prices. The Windsor framework, which was recently agreed with the European Commission and ought to make life easier for firms trading between Great Britain and Northern Ireland, is not a game changer for the UK economy. But it does signal, at last, more pragmatism from the UK government. One important area that is not looking better is housing. In fact, conditions for a sharp slowdown are in place.

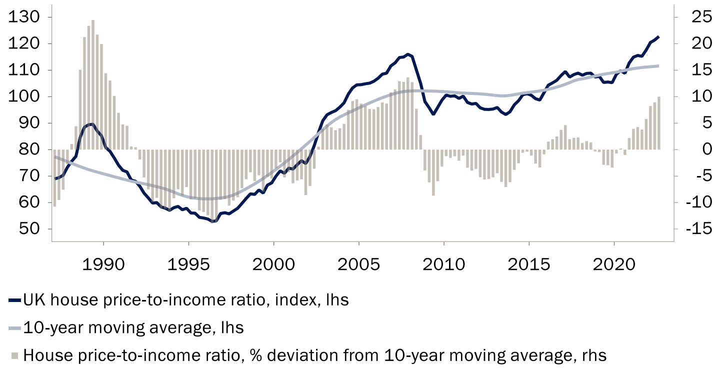
UK house prices have already fallen by 4% from their peak. Another 5-10% contraction is highly likely

A price correction is already underway, reflecting the real income squeeze, higher mortgages rates, and, as a result, lower affordability. More pain probably lies ahead. A net 75% of respondents to the RICS survey expect prices to fall further over the coming months, which could translate into a 10% annual drop in the Nationwide house price index by mid-year (Exhibit 1). While this might sound like a big number, this adjustment would just be enough to bring valuations closer in line with fundamentals (Exhibit 2).

Exhibit 1: House prices are set to drop further

Source: Macrobond, Bank J. Safra Sarasin, 01.03.2023

Exhibit 2: Houses are overvalued



Source: Macrobond, Bank J. Safra Sarasin, 01.03.2023

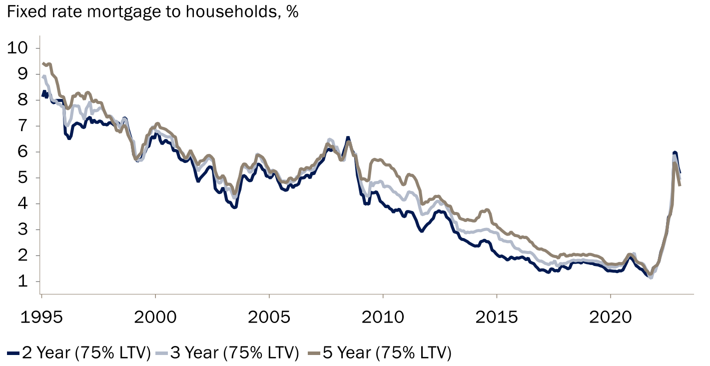
Indicators of housing activity have deteriorated sharply

Alongside falling prices, indicators of housing activity have deteriorated sharply. Mortgage rates have increased considerably over the past year (though they are down a bit from their peak reached during the 'mini-budget' crisis) and approvals have fallen by 50% over that period, to levels not seen since the onset of the pandemic. Credit conditions, as measured by the Bank of England Credit Conditions Survey, have deteriorated to their lowest point since the Global Financial Crisis (GFC), outside that sharp drop recorded during the pandemic. As a result, buyer enquiries have fallen significantly and the housing construction PMI is down to 44.8, suggesting that the sector is in contraction (Exhibits 3-4).

Residential investment is likely to drop significantly and could shave about one percentage point off GDP growth

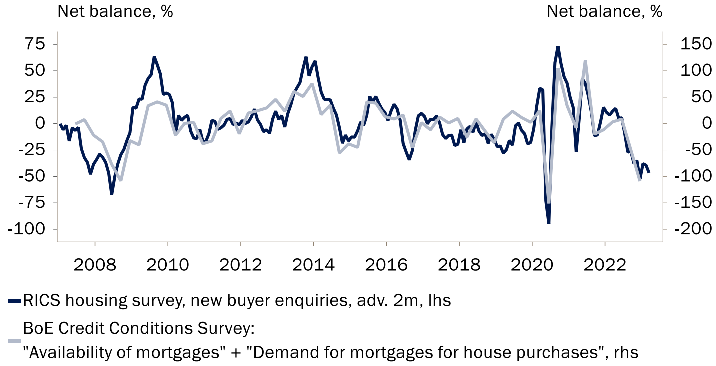
A weak economic outlook, combined with the impact of higher mortgage rates and tighter credit conditions are expected to weigh on housing investment. The various indicators mentioned above, and combined into a single indicator as shown in Exhibit 5, suggest that a 20% decline can't be ruled out this year. This would be on par with what we saw during the GFC, and enough to knock about one percentage point off UK GDP growth.

Exhibit 3: Mortgage rates have risen significantly over the past year



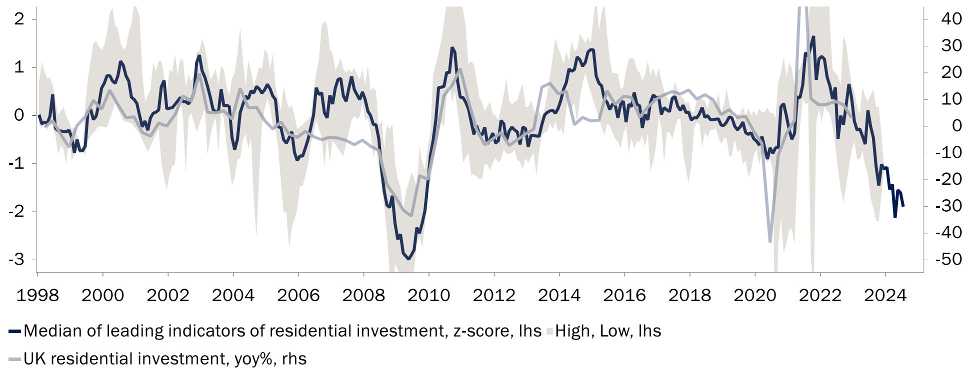
Source: Macrobond, Bank J. Safra Sarasin, 02.03.2023

Exhibit 4: Credit conditions have tightened, discouraging buyers



Source: Macrobond, Bank J. Safra Sarasin, 02.03.2023

Exhibit 5: Residential investment is set to drop sharply this year



Source: Macrobond, Bank J. Safra Sarasin, 02.03.2023

We don't think the BoE will tighten as much as financial markets currently anticipate

Despite this negative backdrop, financial markets in recent weeks have significantly repriced the Bank of England (BoE)'s peak rate, and see an additional 70-80bp of tightening by this autumn. In our view, this is a bit too much. We expect the BoE to hike by 25bp in March, and then stay put for the rest of the year. Rate cuts, however, will have to wait for 2024. There are three broad arguments supporting our view.

Households will most likely have to cut spending in order to offset the sharp increase in mortgage payments and energy bills

First, a big chunk of the impact from the cumulative tightening still lies ahead of us. As argued above, the correction in residential investment is likely to be severe. Moreover, about one in five households that have a mortgage will have to re-mortgage in 2023. Annual interest payments for those households are likely to rise by just under £3000. This will come on top of the £500 increase in the average annual energy bill, which will hit households starting in July. Though some of that will be offset by higher deposit rates, households will most likely have to cut spending in order to make ends meet.

Financial stability risks are likely to rise too

Second, financial stability risks are likely to rise too. According to the BoE's latest Financial Stability Report, households with cost-of-living adjusted mortgage debt-servicing ratios over 70% are projected to increase over 2023 to 2.4%, or around 670,000 households.

These levels would approach those reached around the start of the GFC. Households with debt-servicing ratios above this point are more likely to default, or cut their consumption sharply to manage repayments. While the banking system is much better capitalised than in 2007, and households are less indebted than they were back then, the BoE has to take those risks into account when setting policy.

Some indicators suggest that underlying inflation has come down over the past 6-9 months

Finally, February's Monetary Policy Committee (MPC) meeting made clear that the path of future rate hikes will hinge on indicators of "inflation persistence". This means that the MPC is likely to put more weight on price-setting behaviour in general than month-to-month swings in inflation prints. On that front, the BoE's latest Decision Maker Panel survey (released yesterday) is encouraging. It shows companies expecting prices to grow by 5.4% over the next year, from a peak of 6.7% reached last summer (Exhibit 6).

It will probably take time for labour market tightness to ease, but lower wholesale gas prices are likely to weigh further on services inflation

True, the same survey shows that recruitment difficulties remain acute, and actually worsened in February, reversing some of the improvement of the previous months (Exhibit 7). Given some of the structural issues facing the labour market – the rise in long-term illness associated with COVID and lower inward EU migration – labour shortages, and hence wage growth, are unlikely to fall rapidly. But wages aren't the only driver of core inflation. Energy prices are a more commonly cited factor than labour costs as a reason for raising prices in the services sector, according to the ONS business insight survey (Exhibit 8). This suggests that the recent collapse in wholesale gas prices should reduce a key source of cost pressure for firms. If this is true, the softer-than-expected services inflation print in January might not have been a data quirk but rather an encouraging step in the right direction.

Exhibit 6: Inflation expectations have come off their peak

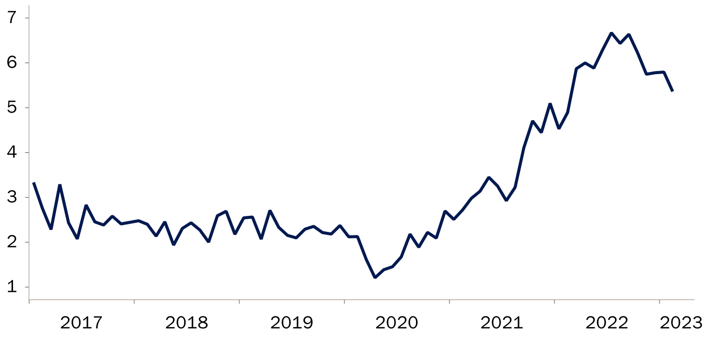


Exhibit 7: Recruitment difficulties remain acute

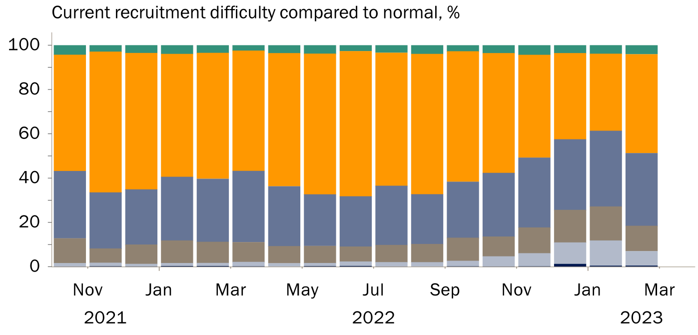
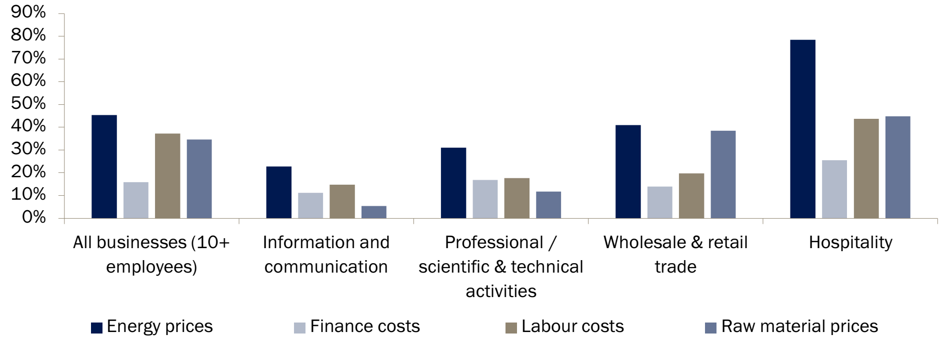


Exhibit 8: Energy is a more frequently cited factor than labour costs as a reason for raising prices



Source: Macrobond, ONS, Bank J. Safra Sarasin, 02.03.2023

J. Safra Sarasin
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Euro area fixed income

The ECB is put to the test

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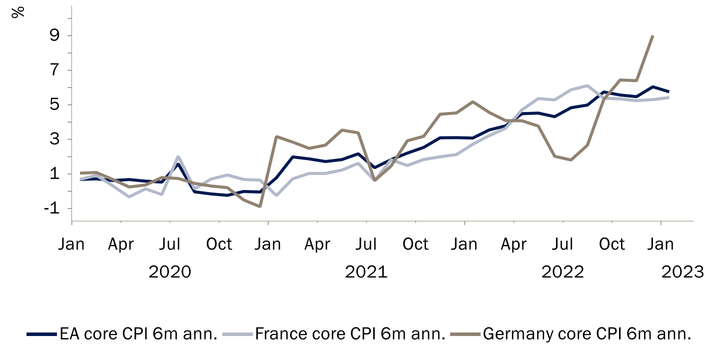
The latest batch of inflation data from the euro area shows that the upward trend in core inflation has not been broken. On top of that, the euro area economy is starting to show signs of a cyclical improvement, also thanks to sharply lower energy prices and expectations for a successful China reopening. Rates markets are already pricing a 4% peak policy rate this year. Given the lagged effects of monetary policy on the economy and inflation, it makes sense for fixed income investors to use the sharply higher yields to add exposure incrementally on sell-offs. The objective is to accumulate duration at reasonable yield levels to prepare for an eventual pivot by the ECB.

Markets price a 4% peak policy rate for the ECB

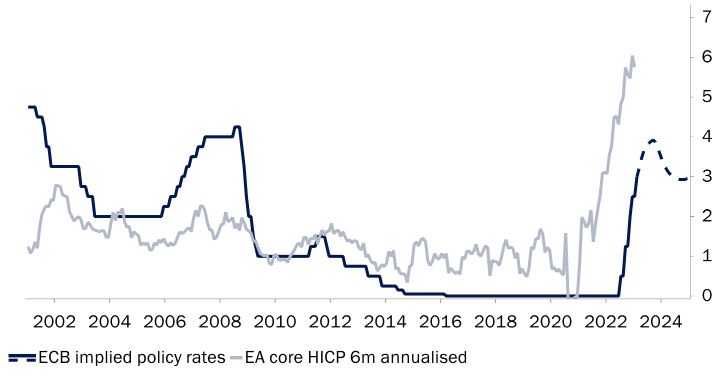
Core inflation numbers in the euro area show few signs of improvement. They continue to print substantially above the ECB's 2% target, and inflation dynamics are not going in the right direction yet (Exhibit 1). Clearly, businesses are able to pass on higher prices as demand is still strong enough. The implication for rates markets is clear: the ECB will likely be forced to do more to break the back of inflation quickly. At the same time, cyclical indicators are starting to show some improvement thanks to massively lower energy prices, still lingering fiscal support packages and expectations for a successful Chinese reopening. Policy rate expectations have surged again in February, pricing a further 150bp to now 4% over the next few months. If realised, the ECB will have hiked policy rates by 450bp within roughly 12 months.

Exhibit 1: Inflation dynamics are going in the wrong direction



Source: Macrobond, Bank J. Safra Sarasin, 02.03.2023

Exhibit 2: 3- and 6m annualised core inflation way above policy rates

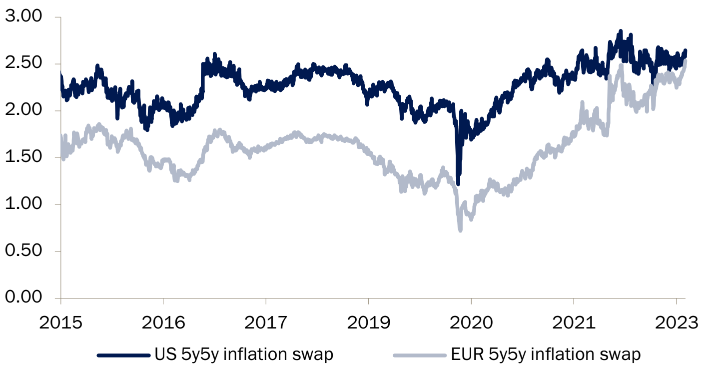


Source: Macrobond, Bank J. Safra Sarasin, 02.03.2023

Markets do not view the ECB's current monetary stance as sufficiently tight

The 300bp rise in policy rates (and bond yields) so far has failed to reverse adverse inflationary dynamics. 3- or 6-month annualised core inflation rates are substantially above the actual and implied policy trajectory, suggesting that the current policy stance is still too loose (Exhibit 2). We highlighted the fact that monetary policy works with lags of roughly 12 months, hence the cumulative tightening so far has not yet brought its full effect on the real economy and hence inflation (see our Cross Asset Weekly "*Be patient – and accumulate duration on weakness*", 24 February 2023). Nevertheless, the latest batch of numbers is worrying and markets are clearly expressing the view that the ECB is behind the curve. 5y5y euro area inflation swaps have risen to 2.5% over the past few weeks, on par now with the US (Exhibit 3). Current 5y5y euro area swap rates deflated by these inflation swaps, suggest real EA 5y5y swap rates at +0.75%, a valid proxy for real long-term rates, and most likely in restrictive territory (Exhibit 4). However, markets are notoriously impatient, which is exemplified by the rise in market based inflation expectations in February. The ECB needs to show quick results on the inflation front and will certainly have noticed market signals. Therefore, it will retain its aggressive stance and most likely deliver a 50bp hike in March, with the prospect of another one in May. It will take more time before markets are closer to establishing a credible peak to policy rates.

Exhibit 3: 5y5y inflation swaps up sharply in February, on par with US



Source: Macrobond, Bank J. Safra Sarasin, 03.03.2023

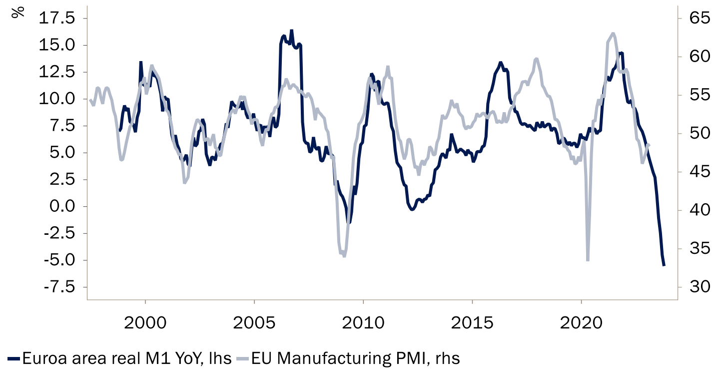
Exhibit 4: Real 5y5y euro area swaps are at a positive 0.75%

Source: Macrobond, Bank J. Safra Sarasin, 03.03.2023

Higher rates should increasingly be a headwind for the euro area economy

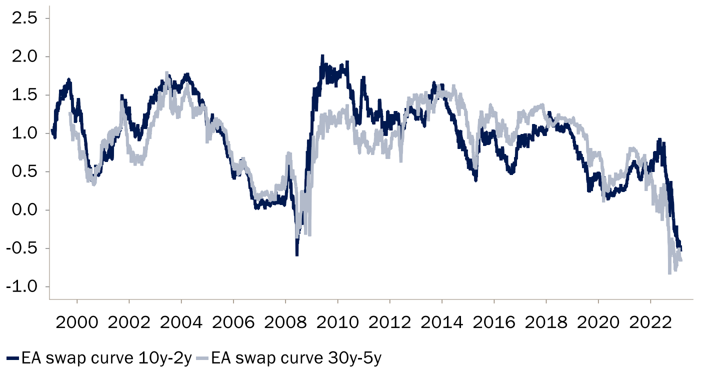
While the euro area economy will likely show signs of improvement over coming months, we are doubtful about the sustainability of the current cyclical acceleration. Typically, cyclical indicators sustainably improve once central banks ease policy and not while monetary policy is still being tightened. Euro area real M1 is contracting at the fastest rate since the financial crisis (Exhibit 5). As mentioned, monetary policy works with lags. It would therefore be premature to expect a central-bank-induced slowdown to be visible already in the data. Swap curves and core euro area yield curves are also reflective of this fact. They are deeply inverted, suggesting that the ECB is hiking into a relatively difficult economic environment (Exhibit 6).

Exhibit 5: Euro area credit impulse is dropping sharply



Source: Macrobond, Bank J. Safra Sarasin, 03.03.2023

Exhibit 6: EA swap curve as inverted as in 2008



Source: Macrobond, Bank J. Safra Sarasin, 03.03.2023

Add exposure incrementally on sell-offs

We note that there is not enough conclusive evidence yet that (1) substantial economic weakness is forthcoming and that (2) the fight over inflation is won. Probabilities around different ECB peak policy rate scenarios could shift to an even higher outcome over the coming months, in particular if a successful Chinese reopening is visible in the economic data. However, given the sharp repricing so far, both in terms of expected policy rates and bond yields, it makes sense to add exposure incrementally on sell-offs. The objective is to accumulate duration at reasonable yield levels to prepare for an eventual pivot by the ECB.

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EM and European equities

China PMI rebound to support China and EM equities

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The strong PMI print out of China this week underlines the progress the economy is making after lockdown measures have been lifted. In particular the strong manufacturing data is encouraging with regards to the equity market. The Chinese market has been reluctant lately to price too much optimism, which leaves upside potential as we expect the macro recovery to continue. While the European cycle is closely tied to the Chinese one, and should improve further in the months ahead, the European equity market is largely priced for it, with some exceptions. We still like Swiss mid-caps in this regard.

China PMIs have surprised to the upside in February

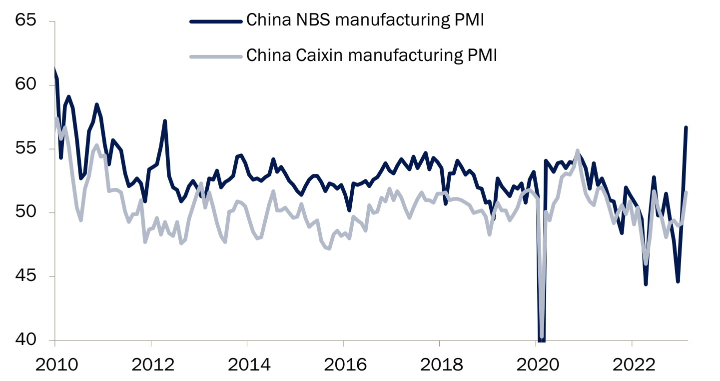
February PMI data out of China have been strong. In particular the manufacturing readings came in well above expectations. The NBS manufacturing PMI, which mostly tracks SOE activity, has risen to the highest level since 2012, while the Caixin manufacturing PMI, which tracks private sector activity and tends to be more important for the market, has surged back above 50 (Exhibit 1).

In particular the strong manufacturing data implies more equity market support

While a recovery was expected, the strength of the rebound in PMIs came as a surprise. Manufacturing in particular was expected to be more muted as compared to consumption-driven services data. We think that the signal from the data is encouraging and shows that the re-opening momentum is well on track, with remarkably little credit support so far.

The Chinese equity market's reaction has been quite pronounced, following persistent declines over the past month. Investors have been cautious to buy into the re-opening story recently, with the market not moving far ahead of earnings, which are primarily driven by PMIs (Exhibit 2).

Exhibit 1: China PMIs surged in February



Source: Refinitiv, Bank J. Safra Sarasin, 01.03.2023

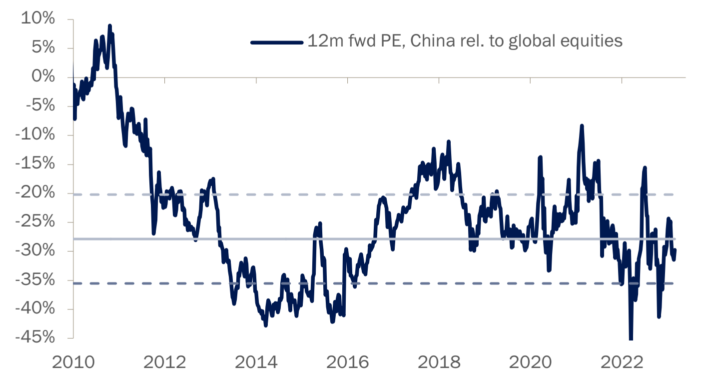
Exhibit 2: Caixin manufacturing PMI is a key driver of earnings revisions

Source: Refinitiv, Bank J. Safra Sarasin, 01.03.2023

The Chinese equity market has been trading in line with earnings, keeping valuations in check

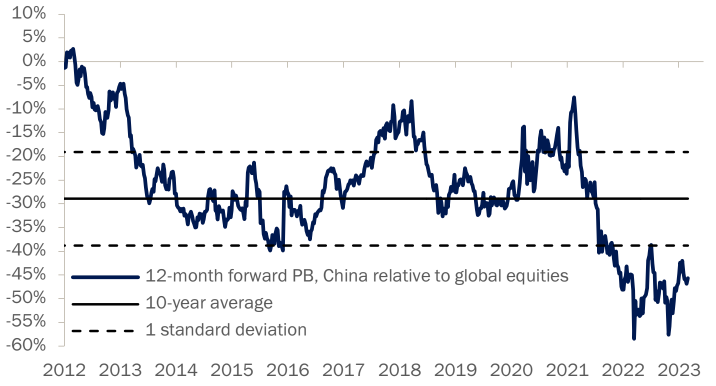
As a result, valuations of the Chinese equity market have been kept in check, leaving more upside as the recovery continues. Relative PEs are below their long-term averages, while earnings revisions have started to turn higher (Exhibit 3). This leaves room for a re-rating, combined with earnings support. Relative price-to-book ratios, which are more neutral to the cycle, remain well below their long-term averages as a result of the strong underperformance of Chinese equities over the past two years (Exhibit 4). If there was a more sustained stabilisation beyond the 2023 rebound, the re-rating potential would extend by another 15% to 20%.

Exhibit 3: The Chinese market is yet not priced for an earnings recovery



Source: Refinitiv, Bank J. Safra Sarasin, 01.03.2023

Exhibit 4: Cyclically neutral price-to-book ratios are still very low

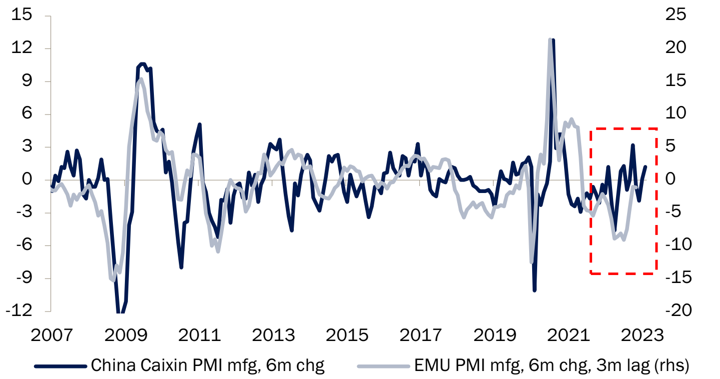


Source: Refinitiv, Bank J. Safra Sarasin, 01.03.2023

The European cycle should benefit from the China recovery, but euro area equities are largely priced for it

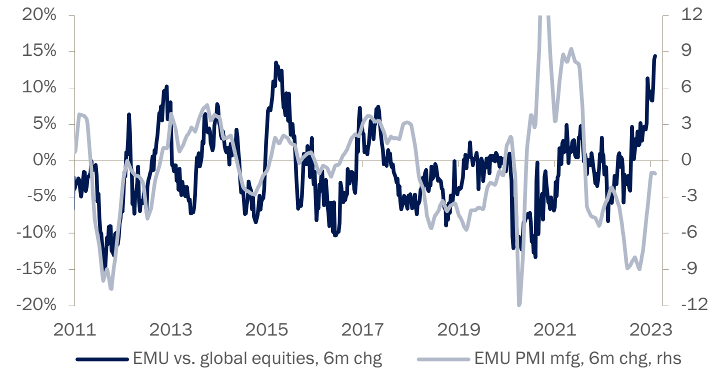
A key beneficiary of the recovery in China is Europe, with the cycle typically trailing China by 3 months (Exhibit 5). While this implies a euro area PMI above 50 by April, the market appears priced for such a bounce (Exhibit 6). Euro area equities have outperformed global equities by a record 15% over the past six months, leaving limited upside in our view.

Exhibit 5: The European cycle should get a boost from China data



Source: Refinitiv, Bank J. Safra Sarasin, 01.03.2023

Exhibit 6: Euro area equities are priced for a strong bounce already

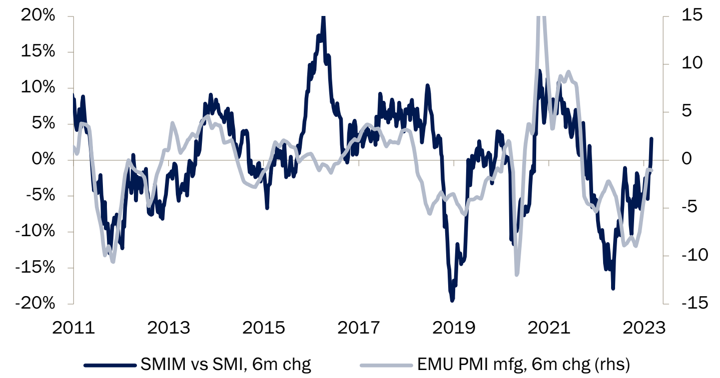


Source: Refinitiv, Bank J. Safra Sarasin, 01.03.2023

We think Swiss mid-caps are a way to further participate in the re-opening recovery

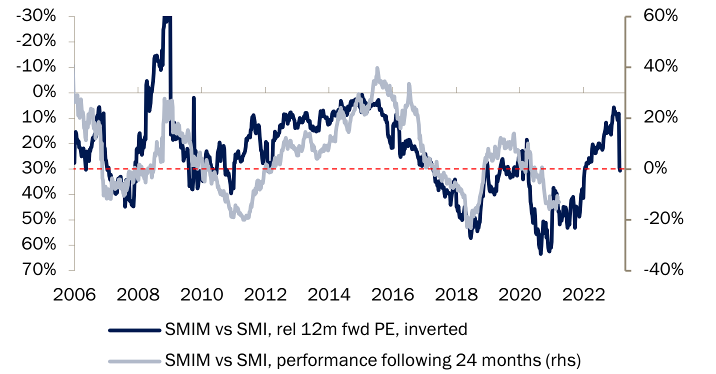
We think Chinese and emerging markets equities provide a better entry point to participate in the re-opening story. Within Europe we continue to see upside potential in the mid-cap space and re-iterate our preference for Swiss mid-caps over large-caps (Exhibits 7, 8).

Exhibit 7: Swiss mid-caps should benefit



Source: Refinitiv, Bank J. Safra Sarasin, 01.03.2023

Exhibit 8: Swiss mid-cap valuations are still looking fairly attractive



Source: Refinitiv, Bank J. Safra Sarasin, 01.03.2023

Economic Calendar

Week of 06/03 – 10/03/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 06.03.2023						
GE	11:00	Sentix Investor Confidence	Mar	Index	--	-8.00
US	16:00	Factory Orders	Jan	mom	-1.30%	1.80%
Tuesday, 07.03.2023						
GE	08:00	Factory Orders MoM	Jan P	mom	--	3.20%
US	21:00	Consumer Credit	Jan P	bn	25bn	11.6bn
Wednesday, 08.03.2023						
JN	06:00	Leading Index CI	Feb	Index	96.90	97.20
GE	08:00	Retail Sales MoM	Jan	mom	--	-3.10%
	08:00	Retail Sales YoY	Jan	yoy	--	3.40%
US	13:00	MBA Mortgage Applications	Mar3	wow	--	-5.70%
	14:15	ADP Employment Change	Feb	1'000	200k	106k
CA	16:00	Bank of Canada Rate Decision	Mar8	%	4.50%	4.50%
US	16:00	Jolts Job Openings	Jan	1'000	--	11012k
Thursday, 09.03.2023						
US	13:30	Challenger Job Cuts	Feb	yoy	--	440.00%
	14:30	Initial Jobless Claims	Feb24	1'000	--	--
Friday, 10.03.2023						
JN	08:00	BoJ Policy Balance Rate	Mar10	%	--	-0.10%
	08:00	BoJ 10-Yr Yield Target	Mar10	%	--	0.00%
US	14:30	Change in Nonfarm Payrolls	Feb	1'000	220k	517k
	14:30	Change in Mfg Payrolls	Feb	1'000	10K	19k

Source: Bloomberg, J. Safra Sarasin as of 02.03.2023

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	1.56	9	-6	0.8
German Bund 10 year (%)	2.76	22	18	-1.5
UK Gilt 10 year (%)	3.88	28	21	-0.2
US Treasury 10 year (%)	4.04	10	17	-1.3
French OAT - Bund, spread (bp)	48	0	-6	
Italian BTP - Bund, spread (bp)	186	-4	-29	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11,166	17.2	-0.7	4.1
DAX - Germany	15,328	12.3	-1.0	10.1
MSCI Italy	862	7.7	0.7	14.0
IBEX - Spain	9,327	11.2	1.0	13.9
DJ Euro Stoxx 50 - Eurozone	4,241	12.5	-0.4	12.1
MSCI UK	2,280	10.8	0.6	7.2
S&P 500 - USA	3,981	18.1	-0.7	4.0
Nasdaq 100 - USA	12,045	23.3	-1.1	10.3
MSCI Emerging Markets	980	11.0	-0.8	2.6

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.94	7.8	-0.1	1.6
EUR-CHF	1.00	5.7	0.5	0.8
GBP-CHF	1.13	7.5	0.2	0.6
EUR-USD	1.06	7.9	0.6	-0.9
GBP-USD	1.20	9.6	0.3	-0.9
USD-JPY	136.5	11.5	0.0	4.1
EUR-GBP	0.89	6.5	0.4	0.1
EUR-SEK	11.13	7.8	0.4	-0.2
EUR-NOK	11.08	9.5	1.1	5.5

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	107	13.0	1.0	-5.0
Brent crude oil - USD / barrel	85	29.4	3.3	-0.5
Gold bullion - USD / Troy ounce	1,843	12.1	1.1	1.0

Source: J. Safra Sarasin, Bloomberg as of 02.03.2023

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