J. Safra Sarasin

Cross-Asset Weekly

26 May 2023

How to position for the debt ceiling X-date

As US debt ceiling negotiations are approaching their final innings and the X-date is moving closer, we assess the risks priced in the market and how to hedge for an adverse outcome. While a default on US government debt remains extremely unlikely, the risk of a government shutdown is very real and may have significant repercussions for the US cycle. In either scenario, the Japanese yen is our favourite hedge, while gold and the Swiss franc also stand to benefit in case no agreement can be reached.

While US Treasuries would likely gain if a prolonged shutdown were to trigger a dovish repricing of the Fed, European fixed income looks more attractive at the current juncture. An interesting and unusual divergence has opened up between implied central bank rates in the US and in Europe, with forward markets pricing ECB and BoE policy rates at or above the Fed Funds rate up to five years out. This is unusual and not sustainable in our view. It is likely the result of a phase shift in respective inflation- and implied policy rate tightening cycles. These should converge over time, suggesting upside for euro area fixed income and UK Gilts in particular, relative to US Treasuries.

Contrary to euro area fixed income, euro area equities are no longer looking particularly attractive. The rally which started in Q4 last year feels exhausted as macro momentum has peaked and macro surprises have turned negative. Key drivers of the recent move higher, such as the drop in gas prices, a weaker euro and the demand boost from the China reopening, have faded or even reversed. We thus reiterate our cautious stance on euro area equities which we initiated last month. One bright spot in the euro area sector universe is real estate, which stands to benefit if rates were to drop in the months ahead, as is our base case.

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US debt ceiling

FX hedges for the 'X-date'

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With the US Treasury projected to run out of money in early June, bipartisan talks on the US debt ceiling remain in the market's focus. While an eventual default on US government debt remains extremely unlikely, the risk of a (partial) US government shutdown is very real. In this event, the Japanese yen is our favourite hedge, while both gold and the Swiss franc should also gain to some extent.

US Treasury is projected to run out of money in early June

Bipartisan talks on the US debt ceiling continue to be in focus as the «X-date» – the day on which the Department of Treasury is projected to run out of money – is moving closer. While this date is widely expected to fall into the first two weeks of June, the exact day is not entirely clear. Technically, the US government had already reached its borrowing limit in January and has since been operating under a number of accounting manoeuvres referred to as «extraordinary measures».

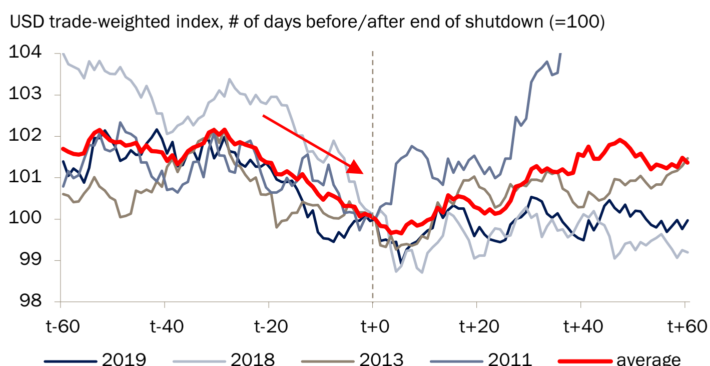
Given the divided Congress, fragmentation within both parties and the experience of past US debt ceiling talks, the risk of a (partial) US government shutdown is real

Reports on progress in the talks have been mixed. While Democrats and Republicans have started to close in on a deal as of yesterday, an array of details still needs clarification, suggesting that both sides will continue to fight to the very last minute. As this will most certainly go down to the wire, there is a real risk that no agreement can be reached by the X-date. Yet this would not automatically trigger a default, which still remains an unlikely scenario, in our view. Instead, we would expect Treasury to prioritise honouring its debt over other payments, even if their cash limits are reached. In consequence, a divided Congress, fragmentation within both parties as well as the experience of past US debt ceiling negotiations imply that a default is unlikely, but the risk of a (partial) shutdown of the US government is very real.

On average, the US dollar depreciated moderately prior to the resolution of the last four US debt ceiling negotiations

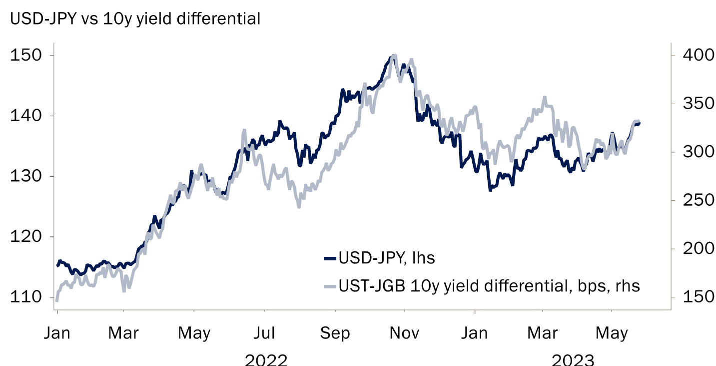
With G10 FX pairs having traded in a relatively tight range over the past days, we believe that markets are not fully discounting such a scenario. Hence a look at previous government shutdowns and debt ceiling episodes is instructive. In the 2010s, these are the 2019, 2018 and 2013 shutdowns as well as the 2011 debt ceiling crisis, which triggered Standard & Poor's to downgrade its US credit rating to AA+, from AAA. On average, the US dollar depreciated moderately in the weeks preceding the resolution of the last four US debt ceiling negotiations (Exhibit 1), which might also be the case this time around. Hence, we would expect alternative safe havens to benefit during a US government shutdown.

Exhibit 1: USD weakened during last four US debt ceiling talks



Source: Macrobond, Bank J. Safra Sarasin, 25.05.2023

Exhibit 2: USD-JPY largely yield-driven over the past 18 months



Source: Macrobond, Bank J. Safra Sarasin, 25.05.2023

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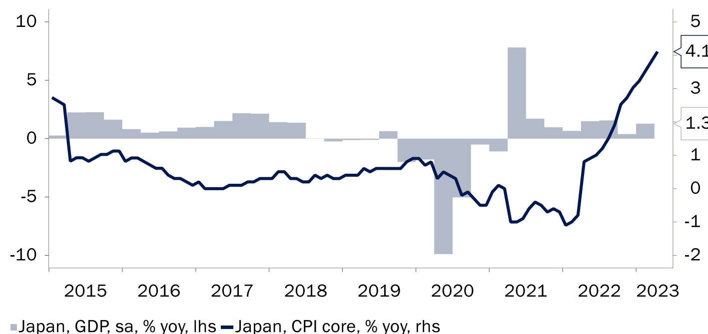
Exhibit 3: As of late, yen shorts have receded somewhat

CFTC COT, net non-commercial positions, futures, thousands

Source: Macrobond, Bank J. Safra Sarasin, 25.05.2023

Exhibit 4: Japanese growth is solid and inflation is on the rise

Japanese growth and core inflation



Source: Macrobond, Bank J. Safra Sarasin, 25.05.2023

Japanese yen is our favourite «X-date hedge»

Our favourite X-date hedge is the Japanese yen, which continues to show a strong correlation with the dollar-yen yield differential (Exhibit 2). If history is any guide, a prolonged government shutdown should trigger a surge in US unemployment and consequently weaken economic activity. (Lasting for 35 days, the 2019 shutdown, serves as a useful reference.) The latter should translate into lower US rate expectations, given that it brings the Fed closer to a pivot. Owing to the Fed's recent hawkish tilt, USD-JPY now looks even more overvalued, and investors have started to scale back their yen short positions (Exhibit 3). Beyond that, we continue to think that the BoJ should normalise its monetary policy further, given that Japanese GDP growth has surprised to the upside and core inflation has continued to edge higher (Exhibit 4). These developments essentially point towards a compression of the dollar's yield advantage over the yen, which should ultimately push the Japanese currency higher.

Gold and Swiss franc expected to benefit as well, but likely to a lesser extent

Furthermore, we believe that gold should move back above the $2'000 level as brinkmanship rises and negotiations intensify. Like the yen, gold would strongly benefit from falling US real yields. The 14-day relative strength index indicates that gold currently looks oversold, increasing the odds of a technical rebound (Exhibit 5). We also think that the Swiss franc should benefit, given that it has tended to perform well during past US debt ceiling talks. Yet we note that within the G10 FX space, the franc currently screens as the least undervalued currency versus the US dollar, which in our view should limit its gains to some extent (Exhibit 6).

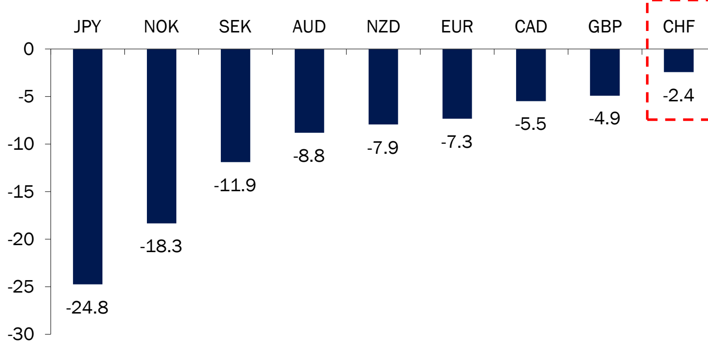
Exhibit 5: Gold price has dropped close to oversold territory

Gold: 14d relative strength index

Source: Macrobond, Bank J. Safra Sarasin, 25.05.2023

Exhibit 6: Swiss franc screens as least undervalued versus US dollar

PPP-implied valuation vs USD, %



Source: Macrobond, Bank J. Safra Sarasin, 25.05.2023

Global fixed income

Implied policy rates diverge

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An interesting divergence has opened up between implied Fed Funds rates on the one side and implied ECB and BoE policy rates on the other. Forward markets imply ECB and BoE policy rates at or above the implied Fed Funds rate in two years, and even up to five years out. This is unusual and not sustainable in our view. It is likely the result of a phase shift in the respective inflation- and expected policy rate tightening cycles. We therefore conclude that euro area fixed income, and UK Gilts in particular, are cheap versus US Treasuries with a 6 to 12 month horizon.

Fed likely at peak rate, ECB and BoE not yet

Developed markets' rate structures have repriced substantially since September 2021. At that time, markets priced hardly any rate hikes, but it turned out to be sharpest rate hike cycle in a long term. Improving inflation dynamics in the US and a soft economic environment currently suggest that the Fed is very close to the end of its rate cycle. In the euro area and the UK, inflation dynamics have not yet improved sufficiently to warrant a pause or even an end to their respective rate cycles. Forward markets are currently pricing another 50bp in total by the ECB and the BoE respectively over the next few months.

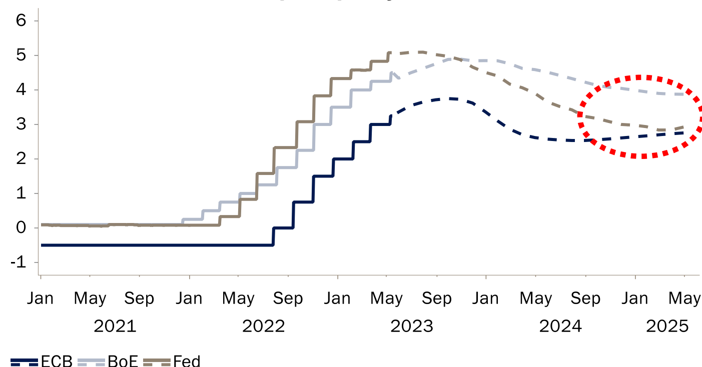
BoE and ECB implied policy rates 2y and 5y out years out are currently at or above implied Fed Funds

An interesting divergence has opened between implied Fed Funds rates on the one hand and implied ECB and BoE policy rates on the other. Forward markets imply ECB and BoE policy rates not only at or above the implied Fed Funds rate in two years (Exhibit 1), but up to five years out! This relative pricing contradicts our estimates for neutral policy rates for the Fed (2.5%), the ECB (1.5%) and the BoE (1.5%). That is, the Fed Funds rate should be substantially above their European counterparts in normal circumstances.

Forward market pricing of policy rates is a probability-weighted path

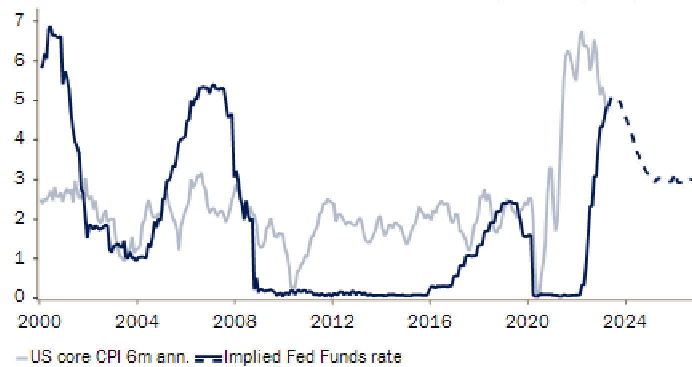
The reason for the current discrepancy lies in what implied forward rates really mean. It is important to realise that the current forward pricing of policy rates is not an explicit forecast by the market, but rather a probability-weighted rate for different scenarios. In fact, history shows that implied forwards generally have a poor track record in forecasting policy rates. Hence, what is currently priced is unlikely to be realised. What the market does instead, is constantly shifting probabilities for different rate scenarios. These scenarios are: (1) policy rates can stay elevated for an extended period of time and come down slowly to a level that is likely above what is currently deemed the neutral policy rate and (2) policy rates are being cut aggressively over the next 6 to 12 months to below neutral as economies fall into recession.

Exhibit 1: ECB and BoE implied policy rates at or above Fed Funds



Source: Macrobond, Bank J. Safra Sarasin, 21.05.2023

Exhibit 2: US 6-month ann. core inflation falling below policy rate



Source: Macrobond, Bank J. Safra Sarasin, 21.05.2023

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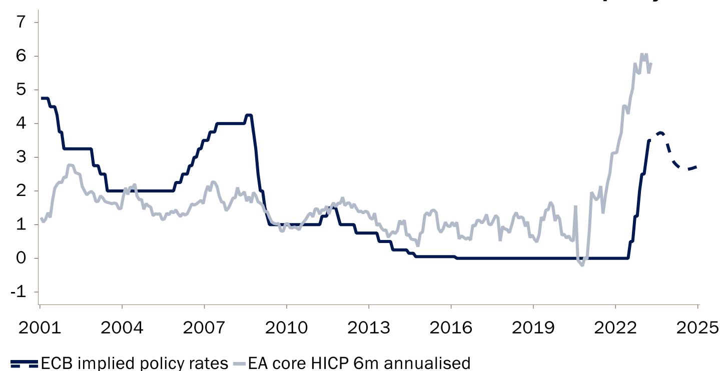
Euro area and UK lag the US by 3-6 months in the inflation cycle

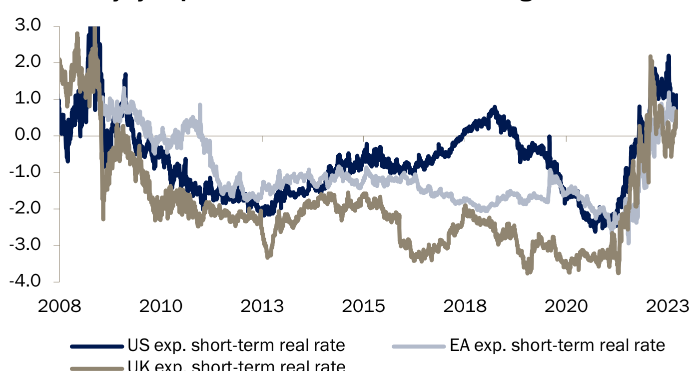
While a soft economic environment is common to all developed market economies, their inflation dynamics still differ. US core inflation has likely peaked and should come down significantly over the coming quarters. The nominal Fed Funds rate is already above 6-month annualised core inflation rates (Exhibit 2), providing room to the Fed to pause and observe the lagged effects of their cumulative monetary tightening. The situation is different in the Euro area (and in the UK), where annualised core inflation is still well above (priced) policy rates (Exhibit 3). The ECB and the BoE are therefore under pressure to do more until they see more evidence of inflation pressures easing. Given that the US is roughly 3 to 6 months ahead in the inflation cycle, markets have correctly concluded that both central banks will likely raise rates further over coming months, even if the Fed has stopped. As inflation moves lower in all currency spaces, their respective monetary policies will become more restrictive. In fact, implied real short-term rates in 12 months, that is nominal rates adjusted by expectations in the inflation swap market, are now at their highest level since 2008 (Exhibit 4).

Exhibit 3: Annualised 6m-month core inflation still above policy rates



Source: Macrobond, Bank J. Safra Sarasin, 21.05.2023

Exhibit 4: 1y1y implied real short-term rates are highest since 2008



Source: Bloomberg, Bank J. Safra Sarasin, 21.05.2023

The relative pricing divergence is a result of a phase shift in the respective inflation- and expected policy rate tightening cycles

Central banks have usually been able to maintain rates at peak levels for only a limited amount of time as the lagged effect of monetary tightening forced them to ease policy when recessions materialised. Once some clarity is established with regard to peak policy rates, as is the case in the US today, markets will focus on the length of stay of peak policy rates given the current economic environment. Consequently, with an average length of stay of peak policy rates of around 6-7 months in the US, and a weakening economic cycle, it is no surprise that markets are screaming for rate cuts 6 to 12 months down the line. In the case of the euro area and the UK, where market participants haven't agreed on an appropriate peak rate level for this cycle, they are more reluctant to focus on potential rate cuts. The relative pricing divergence between the US on the one side and the euro area and the UK on the other side is therefore likely a result of a phase shift in their respective inflation- and expected policy rate tightening cycles.

UK Gilts in particular look cheap against US Treasuries over the medium term

Government bond yields are by definition an extension of policy rates. A 10-year government bond yield is a function of the average expected short-term rate over the maturity of the bond plus a premium for the exposure to additional duration risk (term premium). Implied policy rate divergences therefore provide clues about the relative pricing for bond markets. From that point of view, we conclude that euro area fixed income, and UK Gilts in particular, are cheap versus US Treasuries with a 6 to 12 month horizon.

Euro area equities

Feeling exhausted

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The recent rebound in euro area equities has been one of the strongest on record. It came on the back of a sharp drop in gas prices, a weak euro before its rebound in 4Q22 and a surge in demand for European consumer goods after China reopened. We believe that these drivers have fully played out and are unlikely to provide further support in the months ahead. We reiterate our cautious stance on euro area equities and our least preferred position which we entered at the beginning of April. One bright spot in the euro area sector universe is real estate, which we believe is already priced for a substantial further drop in house prices. The sector would benefit if rates were to drop over the coming months and quarters, as we expect in our base case.

Warm weather, a dovish ECB and the re-opening in China spurred a sharp rally in euro area equities

Late 2022 felt like a sea change for euro area equities. A mountain of worries, which appeared to make a winter recession unavoidable, first shrunk to a speed bump before it disappeared altogether. Several factors contributed to this fundamental change in perception. First, the weather, which turned out to be a lot milder than previously feared. While this may already have a positive impact on economic activity in a normal year, last year it was nothing short of a game changer. Wide-ranging cuts to gas supplies, which were seen as a given after Europe had stopped buying from Russia, could be avoided. Gas prices tumbled when it became clear that storage levels would last until spring and have since dropped even below the levels prior to the Ukrainian invasion.

The ECB's reluctance to tighten led to a drop in the euro

Second, the ECB very much mirrored these market fears in its policy stance. They started to hike rates four months after the Fed, when it turned out that recession risks are lower than previously assumed. As a result, the euro was artificially depressed, further boosting euro area growth.

European luxury goods have been a key beneficiary from China's re-opening

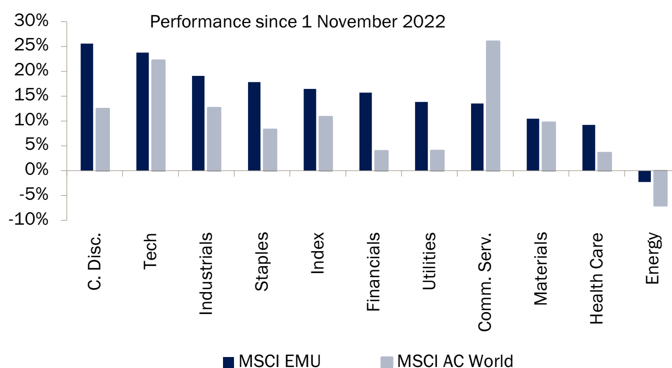
Lastly, the reopening in China came out of nowhere at the beginning of November and spurred a surge in demand for European consumer goods, in particular for luxury apparel.

The confluence of these three factors met a market which was priced for a recession and consequently led to one of the sharpest rallies in euro area equities on record. They outperformed by 15% until the beginning of March, a rally which was largely driven by luxury goods but also by banks and industrials (Exhibit 2).

Exhibit 1: Gas prices have returned to pre-invasion levels

Source: Refinitiv, Bank J. Safra Sarasin, 24.05.2023

Exhibit 2: Consumer discretionary has led the rebound



Source: Refinitiv, Bank J. Safra Sarasin, 24.05.2023

These key support factors have fully played out now

The rebound in euro area equities feels exhausted after these gains and as the supporting factors mentioned above have either fully played out or even started to reverse.

The euro has bounced back and should weigh on euro area earnings revisions

The positive impact from lower gas prices cannot be reaped twice. They have recoupled with the cycle and are thus unlikely to provide any kind of extraordinary stimulus in the months ahead. The euro has reversed sharply as the ECB finally came around to accept that inflation won't go away without a much tighter monetary policy stance. The currency, which was a tailwind for earnings last year, should thus increasingly weigh on euro area EPS in the months ahead (Exhibit 3). Lastly, the reopening boost coming out of China shows signs of fading with only limited further stimulus in the pipeline. In particular the real estate sector, the backbone of the Chinese economy, has been very sluggish to recover and weakened in April and May after a strong start to the year (Exhibit 4).

Exhibit 3: A strong euro in Q1 set to weigh on EMU earnings

Source: Refinitiv, Bank J. Safra Sarasin, 24.05.2023

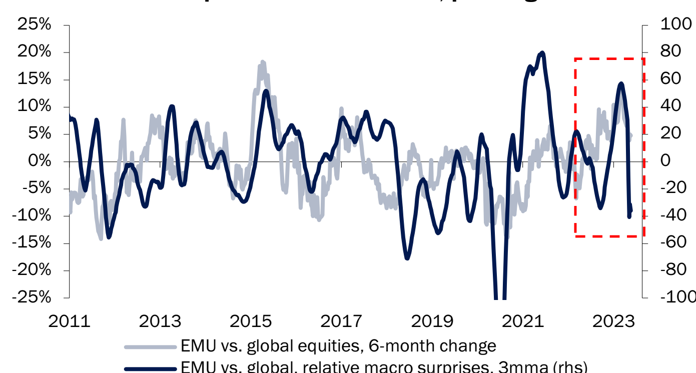
Exhibit 4: The Chinese housing market is softening again

Source: Macrobond, Bank J. Safra Sarasin, 24.05.2023

Euro area macro data has started to come in below expectations, pointing to market downside

With key support factors fading, European macro data has started to disappoint. Macro surprises have turned negative at the beginning of May and are now at the lowest level since August 2022. Euro area performance relative to global equities is not yet priced for this deterioration. Macro surprises would suggest another 5% to 10% underperformance from current levels (Exhibit 5), underlined by the recent deterioration in PMI momentum – typically marking peaks in tactical index upside (Exhibit 6).

Exhibit 5: Macro surprises have rolled over, pointing to downside



Source: Refinitiv, Bank J. Safra Sarasin, 23.05.2023

Exhibit 6: PMI momentum has likely peaked

Source: Refinitiv, Bank J. Safra Sarasin, 23.05.2023

Euro area cyclicals are exposed

The most vulnerable part of the euro area equity market are cyclical sectors in our view, led by consumer discretionary. They have been instrumental in the region's outperformance since the beginning of the year and are thus the most exposed to a reversal of

recent macro and demand drivers (Exhibit 7). We think cyclicals in the euro area are not only likely to underperform against more defensives EMU sectors, but also against their US peers (Exhibit 8).

Exhibit 7: Cyclicals are set to underperform

Source: Refinitiv, Bank J. Safra Sarasin, 23.05.2023

Exhibit 8: EMU cyclicals to underperform US cyclicals as well

Source: Refinitiv, Bank J. Safra Sarasin, 23.05.2023

One sector which we still like is euro area real estate, as it is already priced for a sharp drop in house prices

One sector which may still do well against the backdrop of a generally soft euro area equity market is real estate. We took a deep-dive in last week's Cross-Asset Weekly, showing that the sector is already priced for a sharp drop in house prices and that it should be able to absorb higher debt servicing costs. It is trading below half of its book value and at the lowest valuation since November 2008. Back then it gained by 50% over the following 12 months. If rates in the euro area were to retreat somewhat over the coming months, which is our base case, a similar scenario should be in the cards this time around.

We are cautious on euro area equities

Bottom-line, we reiterate our cautious stance on euro area equities and the least preferred position which we entered at the beginning of April. The key drivers of the recent recovery are fading or reversing, while macro indicators are also pointing to downside relative to global equities. This should largely play out through weakness in more cyclical sectors, while the real estate equity sector appears to be priced for potential further sharp declines in European house prices. It stands to benefit substantially if rates were to come down somewhat in the months ahead, as we expect

Economic Calendar

Week of 29/05 – 02/06/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 29.05.2023						
Tuesday, 30.05.2023						
EU	11:00	Economic Confidence	May	Index	--	99.30
	11:00	Industrial Confidence	May	Index	--	-2.60
	11:00	Services Confidence	May	Index	--	10.50
US	15:00	Case-Shiller 20 City	Mar	yoy	--	0.36%
	16:00	Conf. Board Cons. Confidence	May	Index	99.50	101.30
	16:30	Dallas Fed Manuf. Activity	May	Index	--	-23.40
Wednesday, 31.05.2023						
GE	14:00	CPI EU Harmonised MoM	May P	mom	--	0.60%
	14:00	CPI EU Harmonised YoY	May P	yoy	--	7.60%
US	15:45	MNI Chicago PMI	May	Index	--	48.60
	16:00	JOLTS Job Openings	Apr	1'000	--	9590k
	16:30	Dallas Fed Services Activity	May	Index	--	-14.40
Thursday, 01.06.2023						
EU	11:00	CPI Estimate YoY	May	yoy	--	7.00%
	11:00	CPI Core YoY	May	yoy	--	5.60%
US	14:15	ADP Employment Change	May	1'000	--	296k
	14:30	Initial Jobless Claims	May27	1'000	--	--
	16:00	ISM Manufacturing PMI	May	Index	47.10	47.10
Friday, 02.06.2023						
US	14:30	Change in Nonfarm Payrolls	May	1'000	180k	250k
	14:30	Unemployment Rate	May	%	3.50%	3.40%
	14:30	Average Hourly Earnings	May	mom	0.40%	0.50%

Source: Bloomberg, J. Safra Sarasin as of 23.05.2023

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	1.08	5	-53	4.5
German Bund 10 year (%)	2.52	9	-5	1.3
UK Gilt 10 year (%)	4.37	54	70	-3.0
US Treasury 10 year (%)	3.81	14	-6	1.5
French OAT - Bund, spread (bp)	58	0	3	
Italian BTP - Bund, spread (bp)	188	3	-27	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11,325	18.1	-1.0	8.6
DAX - Germany	15,794	11.2	-2.3	13.4
MSCI Italy	837	8.0	-2.6	11.1
IBEX - Spain	9,116	10.3	-1.0	12.9
DJ Euro Stoxx 50 - Eurozone	4,270	12.1	-2.0	15.4
MSCI UK	2,169	10.4	-2.2	3.0
S&P 500 - USA	4,151	19.0	-1.1	8.9
Nasdaq 100 - USA	13,939	26.8	0.8	27.9
MSCI Emerging Markets	964	12.5	-1.4	1.7

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.91	7.7	0.6	-2.1
EUR-CHF	0.97	5.3	-0.1	-1.8
GBP-CHF	1.12	6.9	-0.3	-0.2
EUR-USD	1.07	7.1	-0.7	0.3
GBP-USD	1.23	8.2	-0.9	2.1
USD-JPY	139.8	10.5	1.3	6.6
EUR-GBP	0.87	5.8	0.2	-1.7
EUR-SEK	11.60	7.0	1.9	3.9
EUR-NOK	11.86	10.1	0.8	13.0

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	100	12.9	-1.8	-11.7
Brent crude oil - USD / barrel	76	36.4	0.2	-10.6
Gold bullion - USD / Troy ounce	1,948	12.6	-0.5	6.8

Source: J. Safra Sarasin, Bloomberg as of 23.05.2023

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