J. Safra Sarasin
Cross-Asset Weekly

19 January 2024

Thinking about rate cuts

With the ECB coming up on Thursday, it will be one of the first major central banks to hold a policy meeting after the 'Fed's pivot' in December. While their policy stance is set to remain unchanged, they may guide to an easing in June, but push back against market expectations for a March rate cut. Both the Fed and the Bank of England will likely strike a similar tone in their meetings. They will acknowledge the room for cautious policy easing in case there is sufficient progress on the inflation front.

While inflation has generally evolved more favourably than expected, central banks are unlikely to declare victory yet. Current tensions in the red sea are a timely reminder that supply chains remain vulnerable and could add to inflationary pressures.

In our fixed income piece, we take a close look at Fed policy rate expectations. While markets currently price more policy easing in 2024 than the Fed has communicated, it is important to remember that implied policy rate expectations are never an explicit market forecast. They are a smooth probability-weighted average of different expectations by market participants. A closer look reveals that a substantial part of market participants still count on "high for longer", while a growing number of investors is hedging for substantially lower policy rates. Therefore, we see room for policy rate expectations to move lower if macro data disappoint.

Finally, we do not think that sterling's strong performance in 2023 can be repeated this year. Rate differentials and valuations should prove to be a headwind. The risk to our base case is that UK inflation falls less than expected, which would lift the BoE's rate trajectory and reduce GBP headwinds.

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Global macro

Red Sea tensions threaten another supply shock

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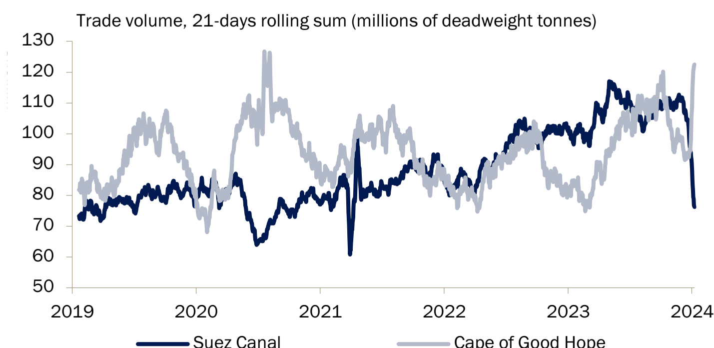
Increased tensions in the Red Sea and disruptions to shipping lanes threaten another supply shock. But today's disruptions occur within a very different macroeconomic context compared to those in 2020/21. As a result, the bar for a prolonged surge in goods prices is high, in our view. Still, the more they rise, the greater the need for disinflation in services to bring inflation back to target. Given the prevailing view that the economy is on track for a soft landing, there is a risk that investors may need to reassess their level of confidence if the data begins to indicate a different path.

Freight costs have doubled since the end of last year as tensions in the Red Sea are rising

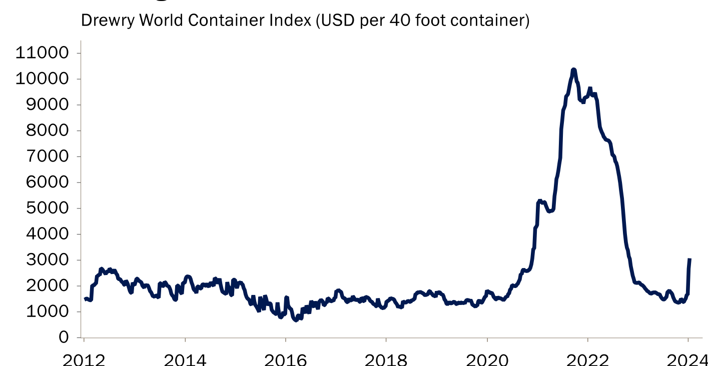
Growing tensions in the Red Sea, with Houthis firing missiles at commercial shipping lanes, are forcing more and more ships to reroute from the Suez Canal around the Cape of Good Hope. According to the IMF's PortWatch data, trade volumes passing through the canal have fallen by a quarter compared to last year (Exhibit 1). This is significant. In normal times, about a third of shipping container traffic and 10-12% of total global maritime trade pass through the Bab el-Mandeb Strait and the Suez Canal, particularly those vessels travelling between Asia and Europe. For a container ship from Shanghai to Rotterdam, rerouting around South Africa lengthens the trip by eight days and adds half a million dollars in fuel costs. Even for those ships that take the risk, insurance costs have soared. As a result, freight costs have doubled for containers since the start of the crisis (Exhibit 2).

Exhibit 1: Rerouting ships around the Cape of Good Hope



Source: IMF PortWatch, Bank J. Safra Sarasin, 16.01.2024

Exhibit 2: Freight costs have doubled since the end of 2023



Source: Macrobond, Bank J. Safra Sarasin, 16.01.2024

Delays to shipments have started to impact car producers in Europe

This, on top of reduced access to the Panama Canal due to earlier droughts, has started to disrupt production. Imports into European ports have fallen sharply since the middle of December. Car manufacturers have been especially affected by delays to ships, which have until recently mainly affected container vessels carrying manufactured goods and semi-finished components. Last week, Tesla and Volvo announced temporary plant closures in Europe due to shipping delays. And tyre manufacturer Michelin said Red Sea delays would lead to "occasional stoppages" at its European factories in January.

Other industries are likely to see delays too with more classes of ships being diverted

Figures from Clarksons, a London-based shipping services company, suggest that more classes of ships are beginning to divert. Between January 13 and 15, arrivals of dry bulk carriers in the Gulf of Aden, by the Red Sea, had fallen 25 per cent from the first half of December. Until last week, arrivals of such vessels had hardly been affected. That decline threatens delays and extra costs for other industries, including food manufacturing and metals, that receive shipments of the many commodities transported in dry bulk carriers.

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The IMF recently estimated that a doubling of freight rates led to a 0.7 percentage points increase in domestic inflation

So rising tensions in the Middle East and disruption to shipping lanes threaten another negative supply shock, with upside risks to inflation and downside risks to growth. Back in 2022 and looking at data between 1992 and 2021, the IMF found that a doubling of freight rates led to a 0.7 percentage points increase in domestic inflation over the subsequent 12 months. But as with any econometric model, the result represents the average response, with possibly the unique conditions of the pandemic skewing up the results. So, to what extent do current conditions suggest that this number applies today?

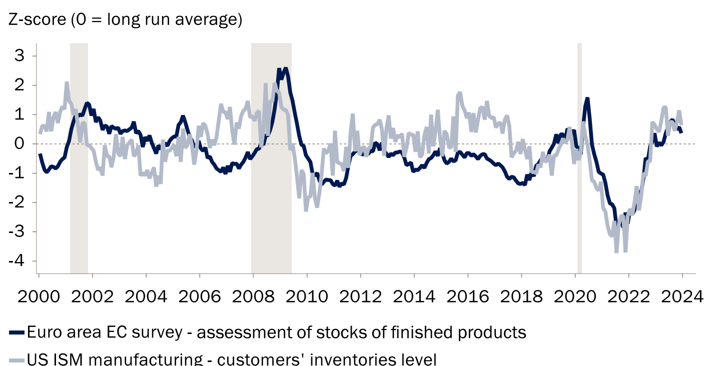
But the impact might not be as large. Today's disruptions are happening against a very different macroeconomic backdrop to those in 2020-21, with more slack in the system

Starting with the good news, today's disruptions are happening against a very different macroeconomic backdrop to those in 2020-21. Demand for goods has normalised and inventory levels have recovered (Exhibits 3). What's more, shipping capacity should expand over the coming two years as new orders placed during the pandemic come online. China is still exporting deflationary pressures to the rest of the world. Finally, the response from commodity prices has been relatively muted so far. All of this suggests that there is greater slack in the economy and the bar for a sustained acceleration in goods prices remains high.

Still, any increase in goods inflation will slow down the return of inflation to its target

Still, we shouldn't brush aside the risks these tensions pose to the global economy and financial markets. Prior to the start of the hostilities in the Red Sea, the negative impulse from the post-pandemic normalisation of supply chains had already run its course (Exhibit 4). As we have argued in previous notes, the next phase of disinflation is likely to be more lengthy and painful. Services inflation is unlikely to fall sustainably if labour markets remain tight. So, some increase in unemployment seems necessary for inflation to return to target. Any rise in goods prices either pushes back a return to target, or shifts the burden of adjustment onto the services sector and the labour market. Neither of these scenarios appear to be currently priced in financial markets.

Exhibit 3: Inventory levels are back at more normal levels



Source: Macrobond, Bank J. Safra Sarasin, 16.01.2024

Exhibit 4: Risk to goods inflation is up not down

Source: Macrobond, Bank J. Safra Sarasin, 16.01.2024

Tensions in the Middle East could still escalate

What's more, the scope for geopolitical tensions to heat up further is large, in our view. The Houthis appear undeterred by the American coalition's counter-strikes on some of its military installations. This means that the US and its allies might have to escalate retaliation against the organisation. In addition, the war between Israel and Hamas may yet spread to its northern border.

This ongoing crisis poses a threat to the soft-landing view

In short, while upward pressure on goods inflation should heat up, the bar for a sustained acceleration in goods prices remains high. Still, given the consensus view in financial markets that the global economy is headed for a soft landing, the risk is that investors will have to revise their degree of conviction if the data start indicating a different path.

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US fixed income

A closer look at policy rate expectations

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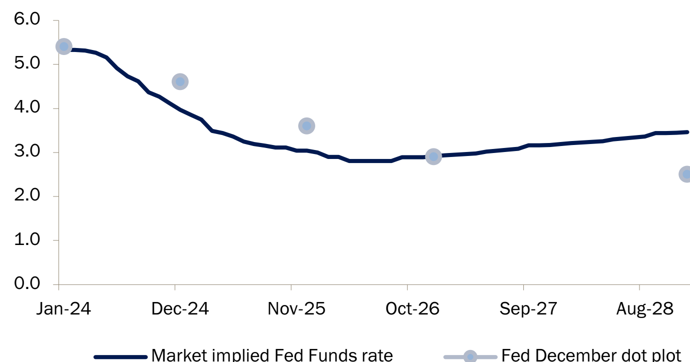
Since the Fed pivoted in December, investors have been pricing a bit less than 6 cuts for 2024 to a policy rate of roughly 4%. This pricing represents a probability-weighted average of different expectations by market participants. A closer look reveals that the distribution for different policy rate outcomes is distinctly skewed to the left. There is an implied 20% probability of sub 3% policy rates by year end, while a substantial part of market participants still counts on "high for longer", with a 45% probability of policy rates above 4%. This set-up leaves room for lower rate expectations and lower bond yields for 2024 if cracks were to appear in the soft-landing scenario.

The Fed pivot in December has opened the door for rate cuts in 2024

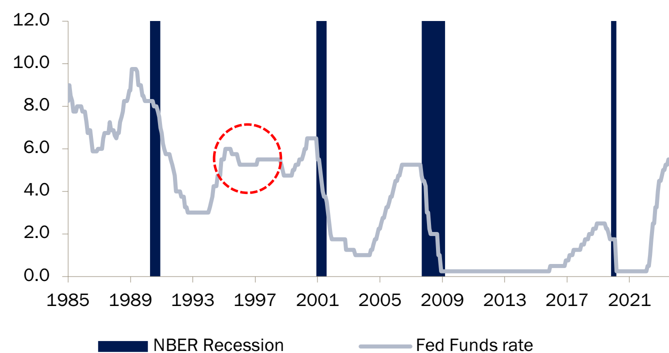
With the Fed pivot in December, the market's focus has shifted to timing and magnitude of rate cuts in 2024 and 2025. Monetary policy is tight, also by the Fed's own assessment, and would become even tighter if nominal policy rates stay unchanged as inflation falls. Given progress on inflation and on balancing the labour market, the Fed sees room for 3 cuts in 2024 as evidenced in their December dot plot. Forward markets currently price a bit less than 6, implying a smooth trajectory to around 4% (Exhibit 1).

Exhibit 1: Fed dots and forward markets see rate cuts in 2024



Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

Exhibit 2: Smooth policy rate trajectories happen rarely



Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

Market-implied policy rate expectations are not explicit forecasts

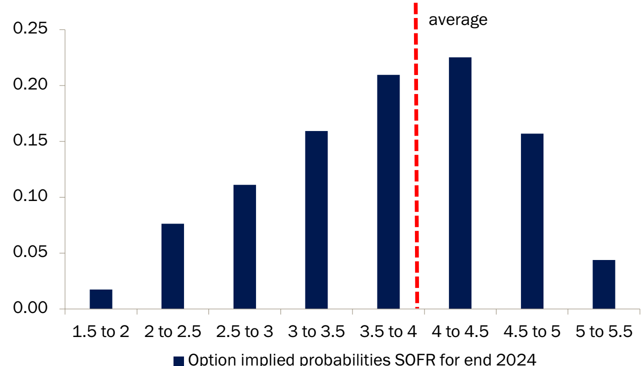
Market-implied policy rates are not an explicit forecast by the market. They rather represent aggregate probability-weighted policy rate expectations by different market participants. Some investors will have expectations for substantially lower policy rates going forward and are positioned accordingly, thus skewing the average lower. Since market-implied forward rates reflect an average, they usually come as smooth trajectories, which very rarely turn out to be a good prediction. The only instance where policy rates ultimately followed a relatively smooth path was in the period of the Asia-centred financial crisis (1996 to 1998) where the US achieved a soft landing, with only 125bp worth of rate cuts necessary to stabilise the economic cycle. In all other instances since the 1980s, sharp tightening cycles have always been followed by substantial rate cuts to levels significantly below neutral (Exhibit 2).

The distribution of possible Fed policy rate outcomes by the end of 2024 is distinctly skewed to the left

Option-implied probabilities from the market for the secured overnight financing rate (SOFR), an overnight repo rate and hence a good proxy for the Fed Funds rate, confirm a wide range of different rate expectations. The distribution of possible policy rate outcomes by the end of 2024 is distinctly skewed to the left, with a large left tail towards lower policy rates. This is indicative of some investors expecting (and hedging for) much lower policy

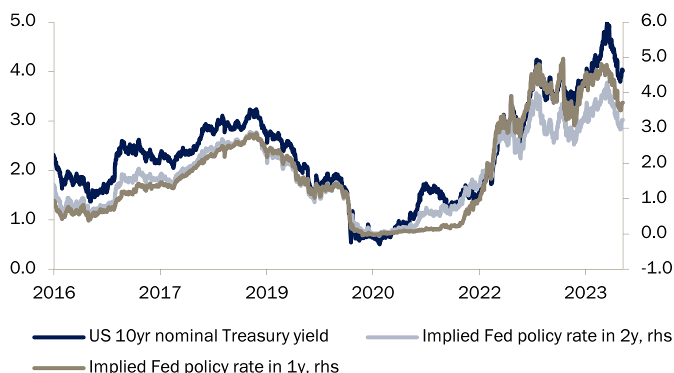
rates (Exhibit 3). At the same time, a substantial part of market participants still count on "high for longer", with the modal outcome implying about 4 cuts. This set-up leaves room for policy rates to price lower if cracks were to appear in the currently priced soft-landing scenario.

Exhibit 3: Substantial part of investors still believe in high for longer



Source: Bloomberg, Bank J. Safra Sarasin, 18.01.2024

Exhibit 4: Policy rate expectations drive bond yields



Source: Bloomberg, Bank J. Safra Sarasin, 18.01.2024

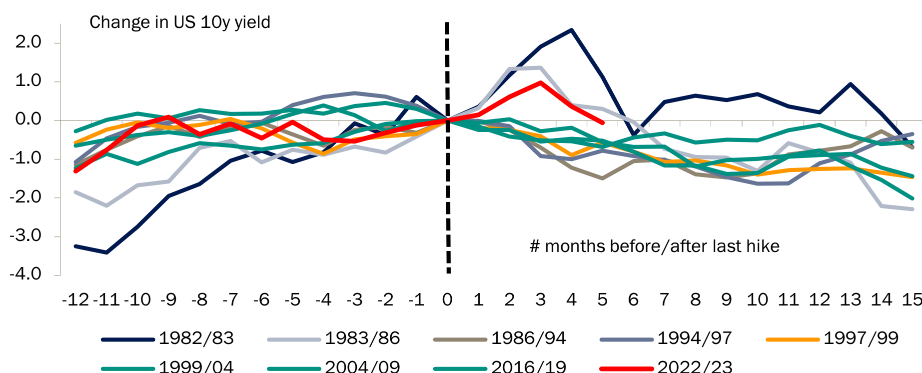
We expect some collateral damage from Fed tightening for the US economy

The soft-landing scenario that markets currently embrace assumes in particular that the labour market can come into balance without a significant rise in the unemployment rate. However, we believe that the cumulative effects of past monetary tightening have not yet been fully reflected in the real economy as evidenced by still falling credit flows, rising bankruptcies and default rates. Weaker aggregate demand going forward will increasingly result in layoffs rather than the cancelling of unfilled positions or the reduction of working hours for existing employees. We therefore expect the US to enter a recession, even if it is relatively mild, by mid-2024, enough to move policy rate expectations lower.

The last rate hike is usually accompanied by lower bond yields over subsequent 12 to 15 months

Historically, the 12 to 15 months following the last Fed rate hike have been characterised by downward pressure on long-term bond yields. The logic is intuitive: an overly restrictive monetary policy stance requires easier policy in the future, that is, lower policy rates. As markets price for them, policy rate expectations, which are the most important driver for long-term bond yields, move lower. Unsurprisingly, the current cycle exhibits some similarities with the 1980s inflationary cycles where bond yields started to move lower only after rising initially further. While bond yields never move in a straight line, we conclude that at the current stage of the economic and the interest rate cycle, the odds for lower bond yields over the next 12 months are high (Exhibits 4, 5).

Exhibit 5: Last rate hike usually followed by lower bond yields



Source: Bloomberg, Bank J. Safra Sarasin, 18.01.2024

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Pound sterling

Risks are tilted to the downside

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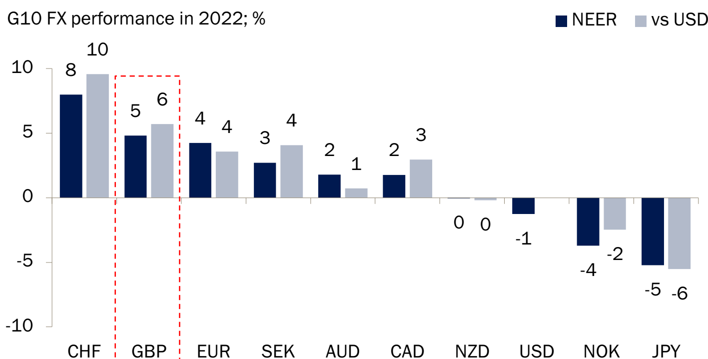
We do not think that sterling's strong performance in 2023 can be repeated this year. Market-implied policy rate expectations for the UK are probably too high and should come down, given that the degree of monetary tightening should continue to weigh on the real economy. Furthermore, sterling's high valuation argues for a longer-term retracement. The risk to our base case is that UK inflation falls less than expected, which would flatten the BoE's rate cutting cycle and reduce GBP headwinds.

In 2023, sterling was the second-best performer within the G10 FX group

Pound sterling delivered a solid performance in 2023. Notably, the currency's appreciation was only second to the Swiss franc (Exhibit 1). Against the backdrop of a relatively benign risk sentiment, the currency gained around 6% versus the US dollar and close to 4% versus the euro (Exhibit 2).

Exhibit 1: In 2023, GBP performance was only second to CHF



Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

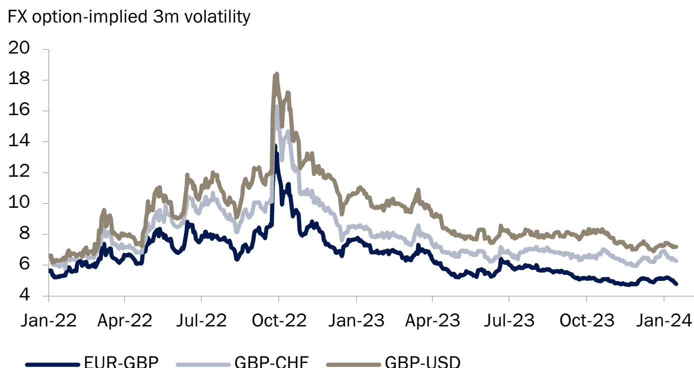
Exhibit 2: GBP-USD rose by 6%, while EUR-GBP dropped by 4%

Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

GBP has also turned substantially less volatile, making it attractive for carry trades

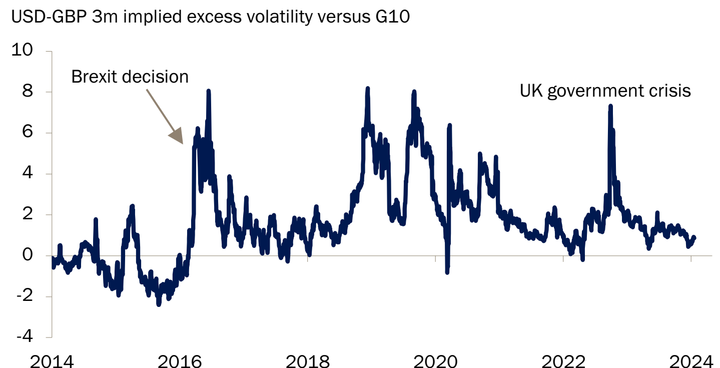
Pound sterling has also turned considerably less volatile over time. The option-implied volatility has trended down since the UK government crisis in October 2022 (Exhibit 3). The dwindling volatility has made long GBP carry trades much more attractive, which has likely added to the pound's recent strength. Given this constellation, we will probably see further inflows for the time being, which should support the British currency for now.

Exhibit 3: Sterling has turned less volatile throughout 2023



Source: Bloomberg, Bank J. Safra Sarasin, 18.01.2024

Exhibit 4: GBP excess volatility is back at pre-Brexit levels



Source: Bloomberg, Bank J. Safra Sarasin, 18.01.2024

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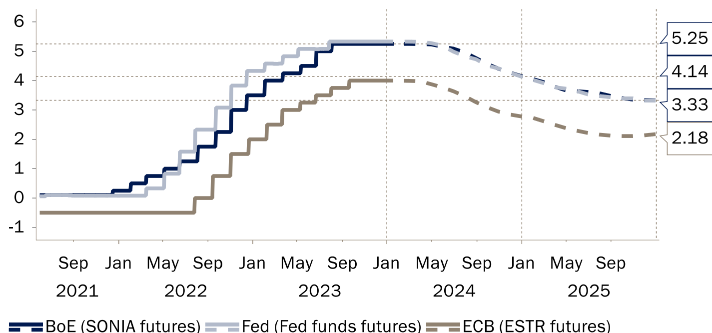
GBP excess volatility has faded

So, with sterling's excess volatility back to its pre-Brexit levels, monetary policy and cyclical drivers will likely come to the forefront again (Exhibit 4).

Exhibit 5: Market expects the BoE to cut by 100bp in 2024

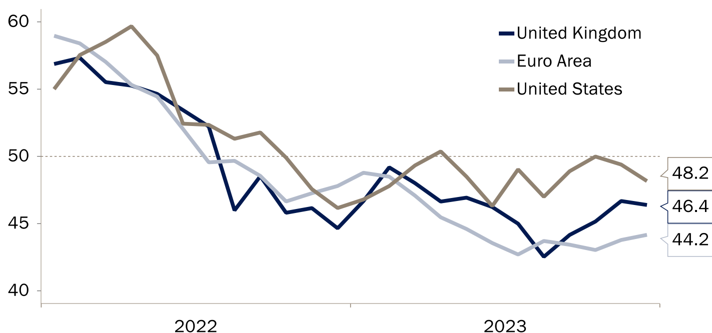
Central banks' policy rates and market-implied rate trajectories



Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

Exhibit 6: Slowdown most pronounced in manufacturing sector

Markit Manufacturing PMIs



Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

Market-implied policy rate expectations for the UK are probably too high

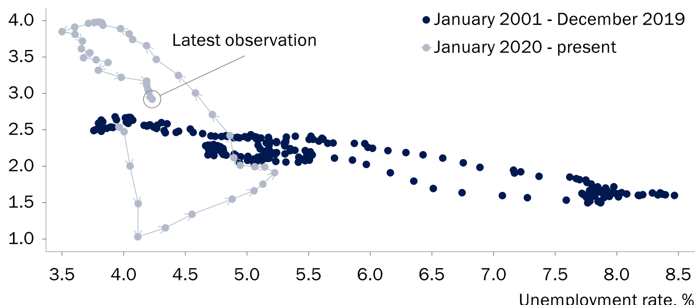
This begs the question of how long the UK will be able to sustain its marked policy rate advantage versus most other G10 economies. As we wrote last week, we still believe that global economic growth will weaken further, given that past monetary tightening still needs to work fully through the system. Yet the market currently prices a benign soft-landing scenario. Notably, the market expects the BoE to cut its policy rate by about the same amount as the Fed over the coming two years (Exhibit 5). We think that market-implied policy rate expectations for the UK should eventually re-adjust to levels that are closer to those of the ECB once domestic data shows more evidence of weakness, which should exert downward pressure on the pound.

We think that the degree of monetary tightening should continue to weigh on real growth and push up unemployment

So far, the drag on economic activity has been particularly visible in the manufacturing sector, with the UK holding up somewhat better than the euro area, but worse than the US (Exhibit 6). Given high mortgage costs and tight lending standards, the BoE's restrictive stance should continue to weigh on households and corporates. With unemployment ticking up and a falling number of vacancies, the UK labour market has started to reflect the economic slowdown (Exhibit 7).

Exhibit 7: Beveridge curve indicates a loosening UK labour market

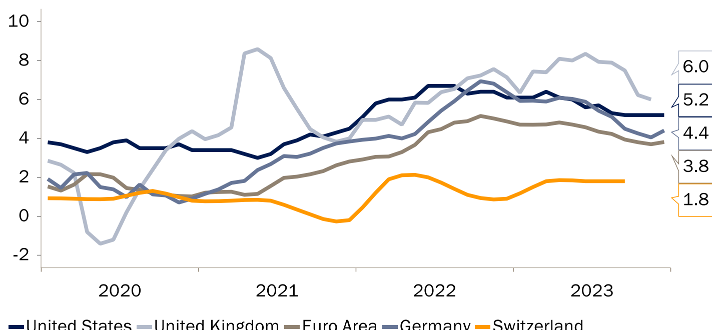
UK Beveridge Curve
Vacancy rate, %



Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

Exhibit 8: UK wage growth is very elevated, but moderating

Private sector wage growth, % yoy

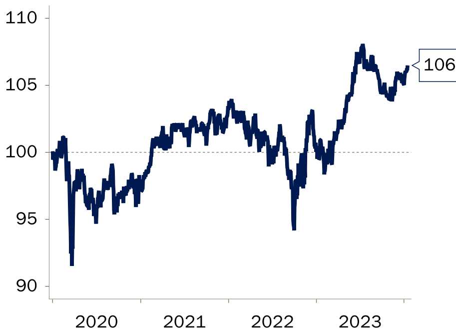


Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

But UK inflation could fall less than expected, which would flatten the BoE's rate cutting cycle

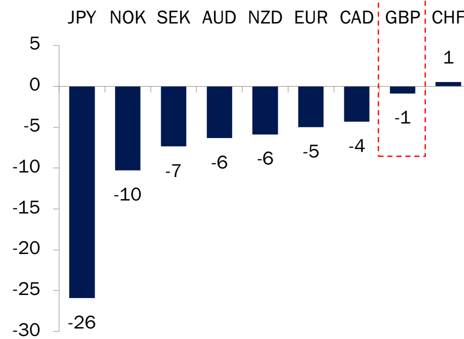
Yet we acknowledge risks to our base case. Wage growth remains elevated and exceeds other G10 economies by far (Exhibit 8). While the latest data point towards a rapid decline, an increase in the minimum wage could easily stall this trend. Furthermore, inflation expectations appear to be slightly less well anchored in the UK than in the euro area, suggesting that the BoE will be particularly cautious before embarking on its policy rate cutting cycle. Lastly, heightened geopolitical tensions carry the risk of resurging fuel prices. While the UK energy price cap will cushion the immediate impact, higher energy prices could push headline inflation higher again. This would argue for a hawkish tilt in the BoE's coming meeting on February 1 and a flatter rate cutting cycle than currently expected.

Exhibit 9: Marked appreciation in real terms

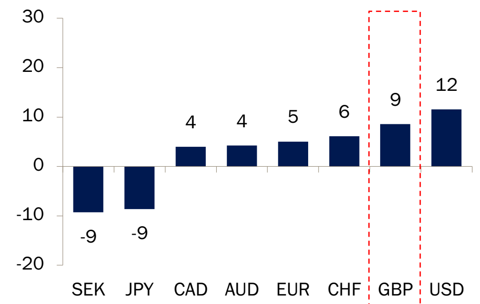


Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024

Exhibit 10 and 11: Sterling is overvalued to a similar extent as the US dollar



Source: Macrobond, Bank J. Safra Sarasin, 18.01.2024



Source: IMF, Bank J. Safra Sarasin, 18.01.2024

Valuations argue for a longer-term retracement of the British pound

From a valuation standpoint however, the odds continue to be tilted towards a sterling retracement. Over the course of the past year, the pound's real effective exchange rate has risen substantially above its post-Brexit average (Exhibit 9). In terms of purchasing power parity (Exhibit 10) and from a current account sustainability perspective (Exhibit 11), the pound is overvalued to a similar extent as the US dollar. Hence the currency screens as expensively valued against most other G10 currencies and should retrace in particular against the yen and the Scandinavian currencies.

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Economic Calendar

Week of 22/01 – 26/01/2024

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 22.01.2024						
US	16:00	Conference Board Leading Index	Dec	mom	-0.30%	-0.50%
Tuesday, 23.01.2024						
JN		BOJ Policy Balance Rate	Jan23	%	--	-0.10%
		BOJ 10-Yr Yield Target	Jan23	%	--	0.00%
US	14:30	Phil. Fed Non-Manuf. Activity	Jan	Index	--	6.30
	16:00	Richmond Fed Manufact. Index	Jan	Index	--	-11.00
Wednesday, 24.01.2024						
GE	09:30	German Manufacturing PMI	Jan P	Index	--	43.30
EU	10:00	Eurozone Manufacturing PMI	Jan P	Index	--	44.40
UK	10:30	UK Manufacturing PMI	Jan P	Index	--	46.20
US	13:00	MBA Mortgage Applications	Jan19	wow	--	10.40%
	15:45	US Manufacturing PMI	Jan P	Index	--	47.90
CA	15:45	Bank of Canada Rate Decision	Jan24	%	5.00%	5.00%
Thursday, 25.01.2024						
GE	10:00	IFO Expectations	Jan	Index	--	84.30
EU	14:15	ECB Deposit Facility Rate	Jan25	%	--	4.00%
US	14:30	Chicago Fed Nat Activity Index	Dec	Index	--	0.03
	14:30	Initial Jobless Claims	Jan20	1'000	--	--
	14:30	GDP Annualized QoQ	Dec P	4QA	1.80%	4.90%
	14:30	Cap Goods Orders Nondef Ex Air	Dec P	mom	--	0.80%
	14:30	Cap Goods Ship. Nondef Ex Air	Dec P	mom	--	-0.20%
	16:00	New Home Sales	Dec	1'000	650k	590k
	17:00	Kansas City Fed Manf. Activity	Jan	Index	--	-1.0
Friday, 26.01.2024						
GE	08:00	GfK Consumer Confidence	Feb	Index	--	-25.10
US	14:30	Personal Income	Dec	mom	0.30%	0.40%
	14:30	Personal Spending	Dec	mom	0.30%	0.20%
	14:30	PCE Core Deflator MoM	Dec	mom	0.20%	0.10%
	14:30	PCE Core Deflator YoY	Dec	yoy	3.00%	3.20%
	17:00	Kansas City Fed Services Activity	Jan	Index	--	-10.00

Source: Bloomberg, J. Safra Sarasin as of 18.01.2024

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W (bp)	Δ YTD (bp)	TR YTD in %
Swiss Eidgenosse 10 year (%)	0.90	6	20	-1.4
German Bund 10 year (%)	2.35	17	33	-2.1
UK Gilt 10 year (%)	3.93	11	39	-2.8
US Treasury 10 year (%)	4.16	22	28	-1.5
French OAT - Bund, spread (bp)	50	0	-4	
Italian BTP - Bund, spread (bp)	158	3	-10	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11'186	18.7	0.3	0.4
DAX - Germany	16'567	12.2	0.1	-1.1
MSCI Italy	966	8.1	0.1	0.4
IBEX - Spain	9'880	10.4	-1.2	-1.8
DJ Euro Stoxx 50 - Eurozone	4'453	12.7	0.3	-1.4
MSCI UK	2'138	11.0	-1.7	-3.4
S&P 500 - USA	4'781	22.2	0.0	0.3
Nasdaq 100 - USA	16'982	30.2	1.1	1.0
MSCI Emerging Markets	961	13.1	-3.4	-6.1

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.87	7.1	1.9	3.2
EUR-CHF	0.94	5.6	1.2	1.7
GBP-CHF	1.10	6.3	1.4	2.8
EUR-USD	1.09	6.5	-0.7	-1.4
GBP-USD	1.27	7.2	-0.5	-0.4
USD-JPY	148.4	9.6	2.4	5.2
EUR-GBP	0.86	4.7	-0.1	-1.1
EUR-SEK	11.40	7.1	1.3	2.3
EUR-NOK	11.44	9.2	1.5	1.9

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	97	11.2	-0.1	-1.3
Brent crude oil - USD / barrel	81	35.3	0.4	4.1
Gold bullion - USD / Troy ounce	2'026	13.1	-0.2	-1.8

Source: J. Safra Sarasin, Bloomberg as of 18.01.2024

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