J. Safra Sarasin

Cross-Asset Weekly

24 February 2023

One swallow doesn't make a spring

Global macro: Although macroeconomic indicators are pointing to a more resilient world economy we think more weakness lies ahead. To us, recent positive momentum probably reflects a recovery from last year's gas/war shock and extreme interest rates moves, rather than confirmation of a soft- or no landing. Our leading indicators suggest that past monetary policy tightening will start to bite over next months and quarters. Recession remains more likely than not.

Global fixed income: Rates markets are still grappling with pricing the appropriate policy rate trajectory. The tightening cycle is advanced, but not yet at a stage at which central banks are ready to stop hiking. Until then, there won't be a sustained bond rally, hence a reasonable strategy is to accumulate duration on sell-offs in order to prepare for an eventual central bank pivot.

Global equities: The recent run-up in markets has left equity valuations at elevated levels. The US earnings yield is at the lowest relative to the Treasury yield since 2007, while consensus expectations project an overly optimistic margin expansion into 2024 and beyond. Valuations are unlikely to be sustained at current rates levels, while earnings are facing persistent headwinds, with the US slowdown likely to drag into the second half of 2023.

This week's highlights

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Global macro

A 'Wile E. Coyote' moment for the global economy?

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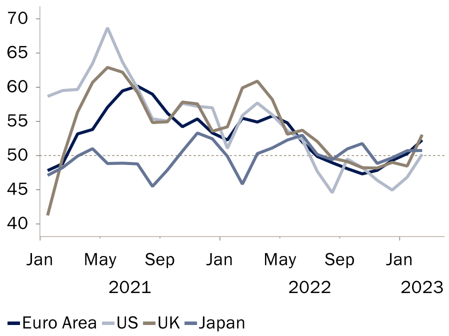
Macroeconomic indicators continue to point to a world economy that is more resilient than expected. In fact, some indicators suggest that the economy could even be at the beginning of a cyclical recovery. We remain sceptical of that view. To us, recent positive momentum probably reflects a recovery from last year's gas/war shock and the extreme interest rates moves, rather than confirmation of a soft- or no landing. Our leading indicators suggest that past monetary policy tightening will start to bite over the next months and quarters. Recession remains more likely than not.

Economic sentiment improved in February, largely reflecting stronger services activity

Economic sentiment improved further in February. Flash composite PMIs for the major advanced economies all moved above 50, the demarcation line between expansion and contraction. The main driver was services, which rebounded in all major economies. The manufacturing contraction, on the other hand, accelerated in the euro area and in Japan, although it did ease somewhat in the UK and in the US. Still, all indices remain below 50, suggesting that the sector remains in recession territory (Exhibits 1-3).

Exhibit 1: Composite PMIs above 50 again

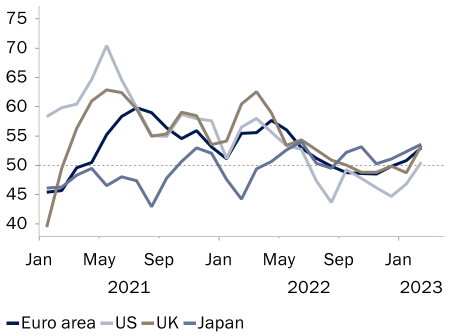
Composite PMI - output (Index, > 50 = expansion)



Source: Macrobond, Bank J. Safra Sarasin, 20.02.2023

Exhibit 2: as services activity rebounded

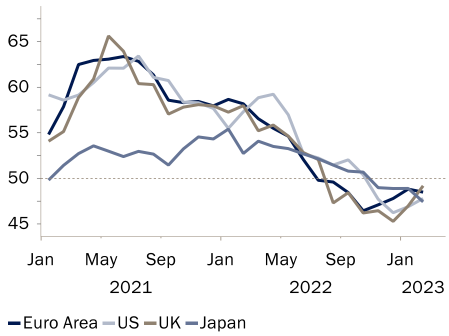
Services PMI - business activity (Index, > 50 = expansion)



Source: Macrobond, Bank J. Safra Sarasin, 20.02.2023

Exhibit 3: Manufacturing remains in recession

Manufacturing PMI (Index, > 50 = expansion)



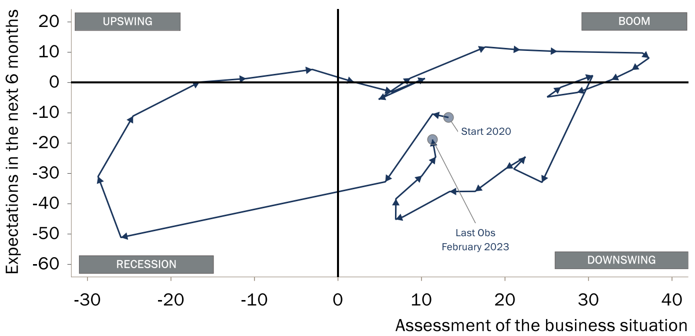
Source: Macrobond, Bank J. Safra Sarasin, 20.02.2023

Three factors are supportive of the near-term outlook:

In our view, three main factors continue to support a stronger-than-expected near-term economic outlook: (1) Mild weather and lower energy prices, which are providing a boost to real disposable income; (2) Ongoing fiscal support; and (3) China's reopening.

Exhibit 4: German business sentiment is up, but so far largely on hopes

Germany: ifo business cycle clock, cycle since Jan 2020



Source: Macrobond, Bank J. Safra Sarasin, 20.02.2023

Exhibit 5: No sharp contraction, but subdued growth remains likely

Source: Macrobond, Bank J. Safra Sarasin, 20.02.2023

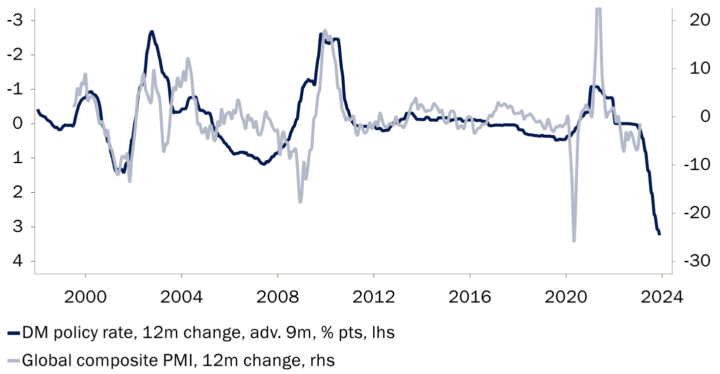
(1) Lower energy prices; (2) Fiscal support; (3) China's reopening

Natural gas prices are down by about 30% year-to-date, both in Europe and the US, and Brent prices have fallen by 12% since the end of October. Translated into euros, the drop in the oil price has been even bigger, at 18%. This goes some way to explain the rebound in consumer sentiment over past months. Another important factor that might have been underestimated is the extent to which European governments have used their balance sheets to offset the energy crisis. In Germany, for example, the government's fiscal stimulus programmes and price caps in 2022 amounted to around 8% of GDP, just shy of the 10% disbursed during the pandemic. In the US, the infrastructure and green transition bills that were passed in the past two years, worth about $1.5tn, might explain why companies continue to hire construction workers, despite the sharp adjustment in the housing market. Finally, while it's still too soon to evaluate the impact of China's reopening on the global economy, it has clearly contributed to boosting expectations (Exhibits 4-5).

These factors alone are unlikely to be enough to offset the drag from the sharp tightening in monetary policy

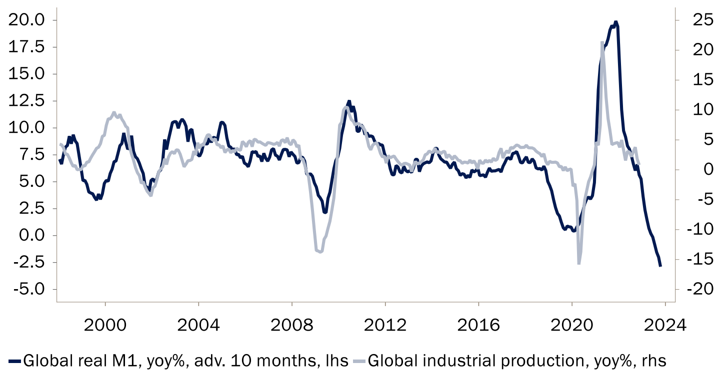
Looking ahead, we remain sceptical that these factors alone will be sufficient to offset the lagged and cumulative impact from past monetary tightening. Central banks across advanced economies have raised policy rates by more than 350bps over the past year, as well as reduced the size of their balance sheets, resulting in a 3% yoy contraction in real narrow money supply. In addition, if demand proves to be more resilient, central banks will simply do more. Historically, such moves have always been associated with a contraction in the business cycle. We doubt this time will be different (Exhibits 6-9).

Exhibit 6: Past monetary tightening should start to feed through



Source: Macrobond, Bank J. Safra Sarasin, 20.02.2023

Exhibit 7: Decline in money supply points to a sharp contraction in IP



Source: Macrobond, Bank J. Safra Sarasin, 20.02.2023

Exhibit 8: US composite ISM is likely to drop further

Source: Macrobond, Bank J. Safra Sarasin, 23.02.2023

Exhibit 9: Any rebound in euro area activity is likely to be short-lived

Source: Macrobond, Bank J. Safra Sarasin, 23.02.2023

Global fixed income

Be patient - and accumulate duration on weakness

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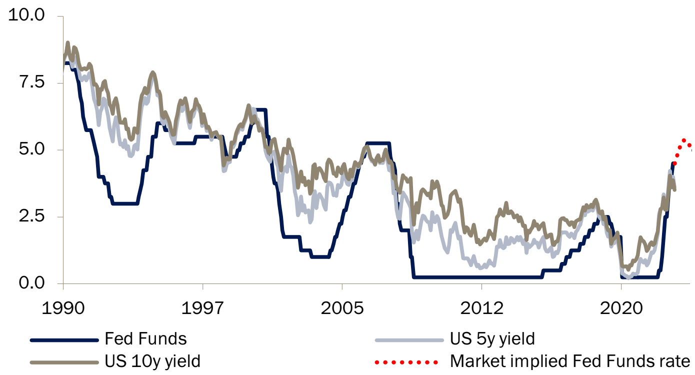
Rates markets are still grappling with pricing the appropriate policy rate trajectory. The tightening cycle is advanced, but not yet at a stage at which central banks are ready to stop hiking. Until then, there won't be a sustained bond rally, hence a reasonable strategy is to accumulate duration on sell-offs to prepare for an eventual central bank pivot.

The tightening cycle is already well advanced

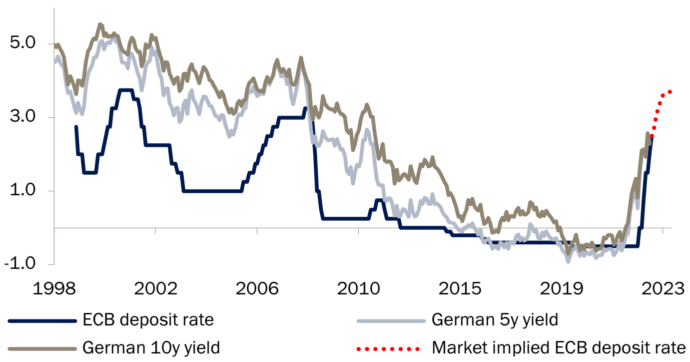
After a brief period of relative calm in January, volatility in developed markets rates has again started to pick up. Core inflation numbers have generally disappointed and economic data have held up better than expected, dismissing the notion of a forthcoming recession. The implication is clear: central banks will likely need to raise rates further and keep them there for longer than previously expected. Nevertheless, it is important to realise how far we have already come in this tightening cycle. Developed markets' central banks have embarked on one of the swiftest and sharpest tightening cycle ever. For example, if the Fed delivers what markets are pricing, the peak policy rate will be the highest since 2000 when the Fed Funds rate topped at 6%. The Fed will have hiked rates by 500bp in the matter of 15 months. At a priced peak rate of 3.7%, the ECB would have also raised policy rates by over 400bp (Exhibits 1, 2). Additionally, both central banks are reducing their balance sheets, which equates to an additional tightening of financial conditions.

Exhibit 1: Highest implied Fed Funds rate since 2000



Source: Bloomberg, Bank J. Safra Sarasin, 23.02.2023

Exhibit 2: The sharpest tightening cycle in the ECB's history

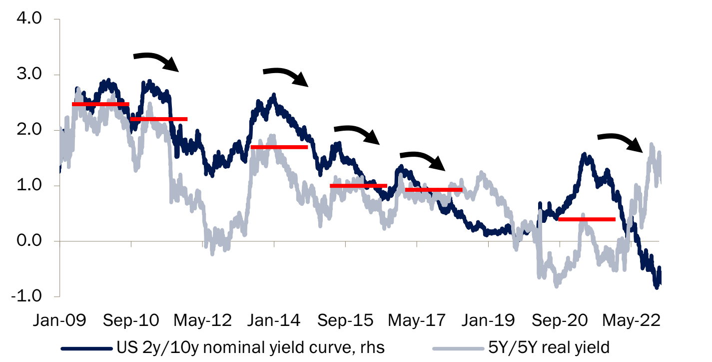


Source: Bloomberg, Bank J. Safra Sarasin, 23.02.2023

Monetary policy is likely already tight

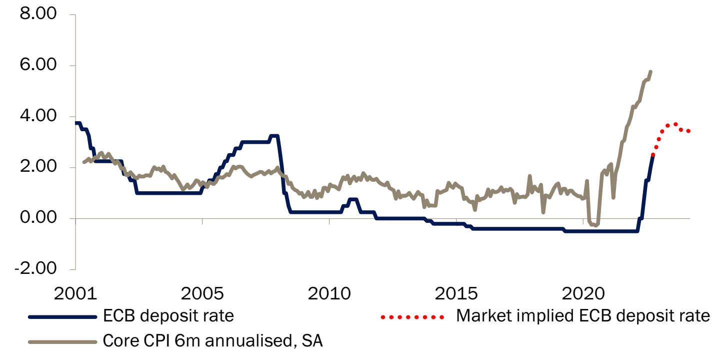
Given the Fed's own estimate of the neutral rate at 2.5% (at which the economy neither accelerates nor decelerates) and a 2% inflation target, the real neutral rate would equate to 50bp. US 5y5y real rates, a valid estimate for long-term real yields, currently sit at roughly 150bp, which would put them at a restrictive level. The markets' clearest signal with regard to the degree of tightness is usually the yield curve. In fact, the Treasury yield curve started to flatten meaningfully once 5y5y real rates crossed above 50bp and has inverted substantially as real rates repriced up further (Exhibit 3). A similar picture is observable in the euro area, where 5y5y real rates are in positive territory, and with a yield curve that has also inverted meaningfully. Market-implied signals therefore suggest that monetary policy is already tight across the DM rates structure. Looking at inflation dynamics, we note that the market-implied peak Fed Funds rate is now above the 6-month annualised US core CPI rate, indicating that actual real policy rates are positive too. The picture in the euro area is more worrisome with 6-month annualised core CPI still significantly above market implied peak rates, suggesting the ECB has more work to do (Exhibit 4).

Exhibit 3: The US yield curve signals a tight monetary stance



Source: Macrobond, Bank J. Safra Sarasin, 23.02.2023

Exhibit 4: Inflation dynamics in the euro area are still uncomfortable

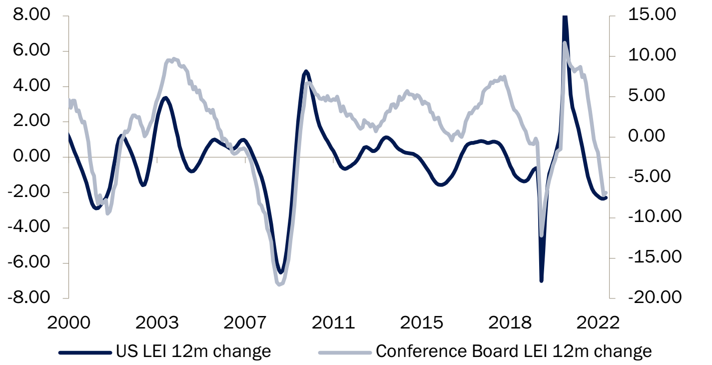


Source: Macrobond, Bank J. Safra Sarasin, 23.02.2023

Cyclical indicators are sending mixed messages

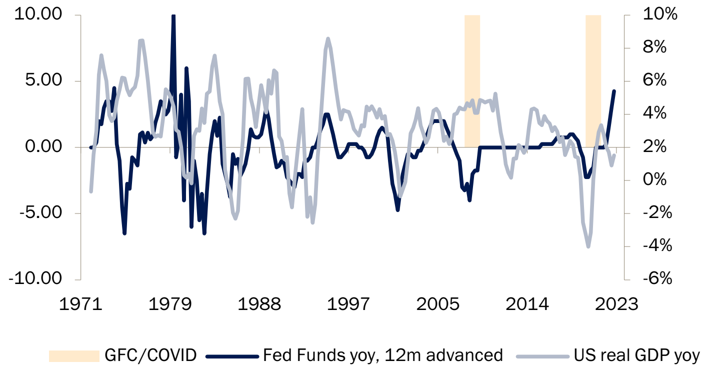
After a sharp decline in forward-looking indicators last year, flagging a recession in 2023, recent data point to some improvement, albeit from low levels. These indicators seem to be troughing, while services PMIs in Europe and in the US have moved above 50, suggesting expansion (Exhibit 5). The global manufacturing sector, on the other hand, shows few signs of improvement. Typically, cyclical indicators improve once central banks ease policy and not while monetary policy is still being tightened, casting doubt on the sustainability of this improvement. Historically, it takes 12 months for monetary policy to take its full effect (Exhibit 6). With labour markets tight and fiscal stimuli from the pandemic and cost-of living-crises programs still lingering, the lags could be even longer. It would therefore be premature to expect a central-bank-induced slowdown to be visible already in the data.

Exhibit 5: Forward-looking indicators show signs of troughing



Source: Bloomberg, Bank J. Safra Sarasin, 23.02.2023

Exhibit 6: Monetary policy acts with 'long and variable lags'



Source: Bloomberg, Bank J. Safra Sarasin, 23.02.2023

Accumulate duration on sell-offs to prepare for an eventual central bank pivot

Central bank policy drives short-term bond yields. Policy rate expectations set the direction also for longer-term yields, and while the bond market can protest by inverting the yield curve, it cannot escape the overall direction of policy rates. Currently, markets are still grappling with pricing the appropriate policy rate trajectory, hence bond yields swing around accordingly. There is not yet enough conclusive evidence that (1) substantial cyclical weakness is forthcoming and that (2) the fight over inflation is won. Hence, probabilities around different peak policy rate scenarios are still a moving target. But one thing is clear: there is not going to be a sustainable bond rally until central banks are close to the end of the hiking cycle. Until then, a reasonable strategy is to accumulate duration on sell-offs (such as the current one) and not to chase the subsequent rallies. The objective is to accumulate duration at reasonable yield levels to prepare for an eventual pivot by central banks.

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Global equities

Goldilocks may just be a fairy tale

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The recent run-up in markets has left equity markets priced for a Goldilocks scenario. The US earnings yield is at the lowest relative to the Treasury yield since 2007, while consensus earnings expectations are implying a very optimistic margin expansion into 2024 and beyond. Yet valuations are unlikely to be sustained at current rates, while earnings are facing persistent headwinds, with the US slowdown lasting into the second half of 2023. We would caution against adding further equity exposure and see a re-emerging opportunity in defensive over cyclical sectors. The tactical rebound in banks is starting to look stretched, although the strategic case for the sector remains strong.

The equity rally year-to-date followed some improved macro data and softer inflation

The market rebound over the past three months has come on the back of easing inflationary pressures, falling rates and an improving global demand picture. We think that this has been more of a transitory development than a trend reversal. The underlying macro backdrop has not changed in our view. If anything, recent inflation data in the US have shown that hopes for an "immaculate" disinflation are unlikely to be fulfilled. The Fed has to do more in order to bring down inflation. The fixed income market has started to price for that eventuality, while the equity market reaction has been muted so far.

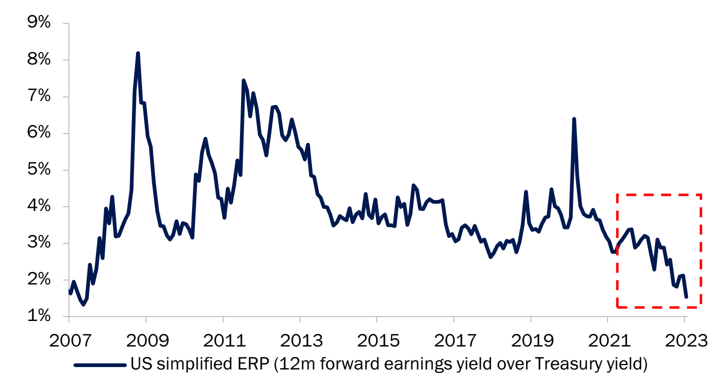
The equity risk premium has dropped back to 2007 levels

The recent divergence between the rates and the equity market has left valuations at elevated levels. The PE has risen back above 18x 12-month forward earnings, the highest ratio since early 2022, while the rates market implies a ratio below 15x (Exhibit 1). Another way of looking at the relationship between equities and rates is a simplified equity risk premium (ERP: earnings yield over the 10-year treasury yield). The ERP is back at levels last seen in 2007, on the eve of the global financial crisis (Exhibit 2).

Exhibit 1: Rates and valuations have diverged this year

Source: Refinitiv, Bank J. Safra Sarasin, 22.02.2023

Exhibit 2: The equity risk premium is at its lowest since 2007

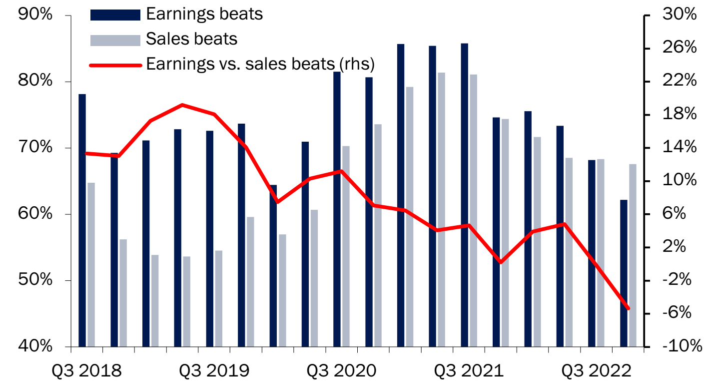


Source: Refinitiv, Bank J. Safra Sarasin, 22.02.2023

Rates would have to drop by 100bp or earnings would need to be upgraded significantly to justify current valuations

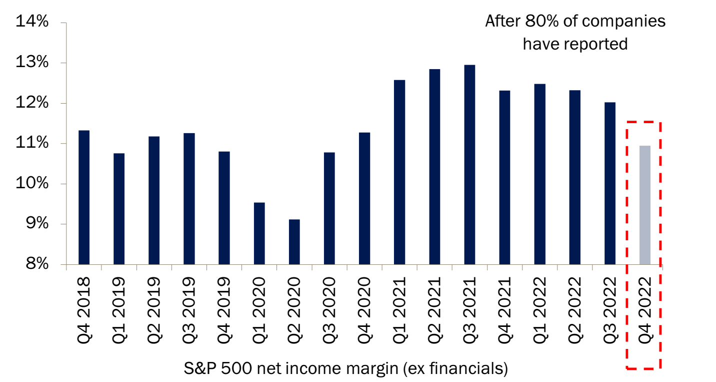
There are two potential ways to resolve these discrepancies without equities coming down. Either rates would have to drop by around 100bp, or consensus earnings would need substantial upgrading. Neither seems likely in the near term. In the fixed income section above, we show that an immediate and steep drop in rates is not in the cards. And when it comes to earnings, the consensus trajectory for 2024 and 2025 already appears quite optimistic. Moreover, corporate income margins have started to come under pressure and are likely to remain under pressure for the time being. The quarterly US earnings beat rate has fallen behind the sales beat rate the most in the last 5 years (Exhibit 3). While sales have continued to grow at a healthy 8% year-over-year in the fourth quarter of last year, earnings have fallen by 5% from Q4 2021. As a result, net income margins have compressed sharply. At 11.5%, they are at the lowest level since Q3 2020 (Exhibit 4).

Exhibit 3: Sales beats > earnings beats = lower margins



Source: Refinitiv, Bank J. Safra Sarasin, 21.02.2023

Exhibit 4: Margins back at lowest levels since Q4 2020



Source: Refinitiv, Bank J. Safra Sarasin, 21.02.2023

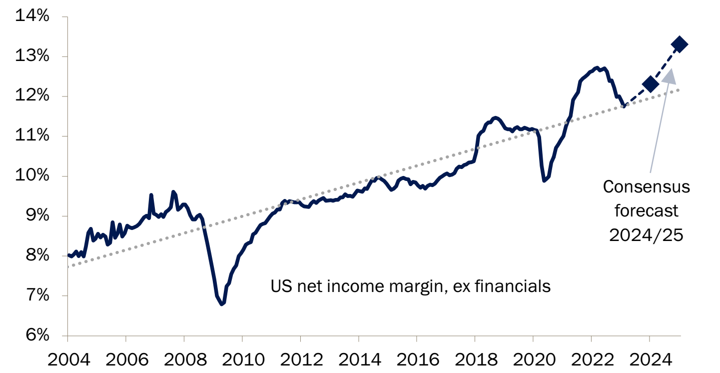
Consensus expects margins to recover into 2024 and reach new highs in 2025, which appears very optimistic

Consensus expectations though suggest that this margin compression is only short-lived and that they expand rapidly again in 2024. The implied levels of 12.3% next year and a new (implied) record of 13.5% by 2025 appear fairly optimistic, given that i) current inflation dynamics are unfavourable for margins and ii) earnings are set to drop further if the economic slowdown deepens in 2H23, as we expect.

The shift in inflation dynamics away from goods to services weighs on margins

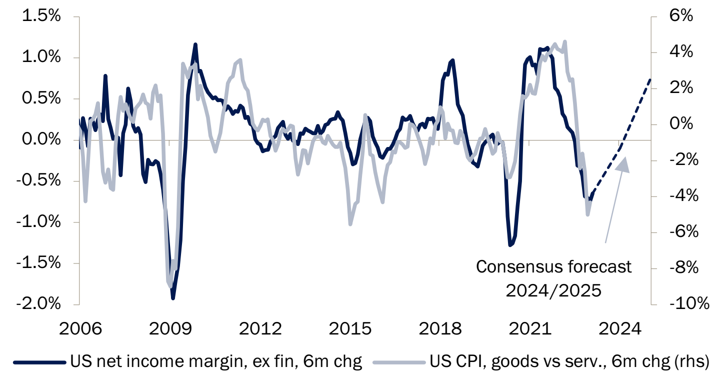
The change in inflation dynamics is also not favourable to margins. High goods inflation last year strongly supported margins as companies could raise prices. But goods inflation has been declining since mid-2022, while services inflation proved much stickier, partly driven by its correlation with wages. Margins have started to drop sharply as a result. Companies are still seeing their top line growing, but rising costs are leaving deep scars in their bottom line. As these dynamics are unlikely to change quickly, the margin trajectory implied by consensus assumptions appears too steep and too optimistic in our view.

Exhibit 5: Consensus assumes a pretty strong rebound in margins



Source: Refinitiv, Bank J. Safra Sarasin, 22.02.2023

Exhibit 6: Inflation dynamics would have to improve for higher margins

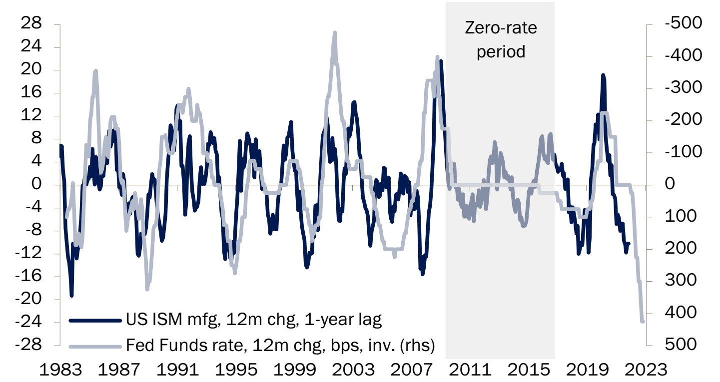


Source: Refinitiv, Bank J. Safra Sarasin, 22.02.2023

Lower wage inflation is a pre-condition for margins to recover, but this is unlikely to happen without a macro slowdown

For wage inflation to cool down, the labour market will need to get back to a balance. This should happen once companies start cutting jobs more aggressively. While macro indicators may improve in the short-term, we believe the slowdown later in the year is already baked in. Looking at the past 40 years of data, the "long and variable lag" that the Fed is talking about is typically 12 months long (Exhibit 5). Considering that the current Fed hiking cycle started in March 2022, most of the tightening impact thus still lies ahead. We expect US GDP growth to decline in the second half of the year, which should drag earnings lower from current levels and keep margins in check (Exhibit 6).

Exhibit 7: The cycle typically lags Fed policy by 12 months



Source: Refinitiv, Bank J. Safra Sarasin, 22.02.2023

Exhibit 8: Our GDP forecast implies declining EPS in 2023

Source: Refinitiv, Bank J. Safra Sarasin, 22.02.2023

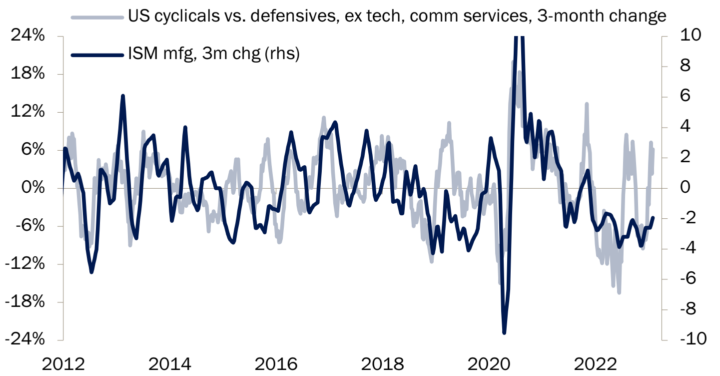
We prefer defensives after the cyclicals rebounded year-to-date

We don't see the current unfavourable backdrop for US equities to be resolved quickly and are cautious after the rally year-to-date. An area which we find attractive again is defensive sectors (staples, utilities, health care – in that order). The outperformance of cyclical sectors over the past three months has moved well ahead of the underlying macro momentum (Exhibit 7) and should fade, while defensives clearly have relative upside potential.

We continue to like banks structurally but the tactical rebound looks stretched

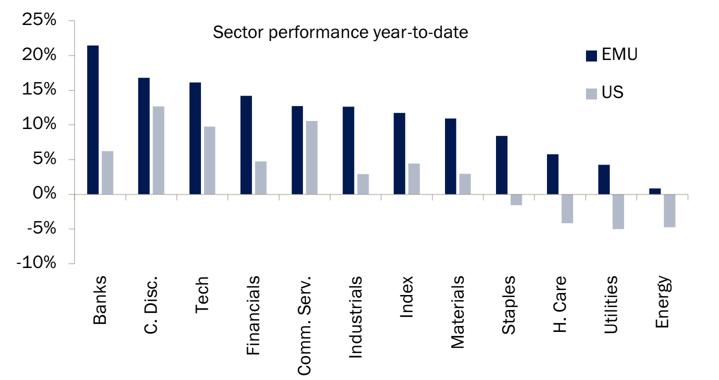
We would also caution against adding further exposure to banks, and financials in general. The rally year-to-date appears quite stretched, in particular in Europe. While we continue to strongly favour the sector from a strategic point of view, the short-term potential is limited as the sharp improvement in risk sentiment is set to fade.

Exhibit 9: We prefer defensives, after the cyclicals rally year-to-date



Source: Refinitiv, Bank J. Safra Sarasin, 22.02.2023

Exhibit 10: Banks tactical bounce looks stretched after strong YTD



Source: Refinitiv, Bank J. Safra Sarasin, 22.02.2023

Economic Calendar

Week of 27/02 – 03/03/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 27.02.2023						
EU	11:00	Industrial Confidence	Feb	Index	--	1.30
US	14:30	Durables Ex Transportation	Jan P	mom	0.10%	-0.20%
	14:30	Cap Goods Orders Nondef Ex Air	Jan P	mom	--	-0.60%
	16:00	Pending Home Sales MoM	Jan P	mom	1.00%	2.50%
US	16:30	Dallas Fed Manufacturing Index	Feb	Index	-9.00	-8.40
Tuesday, 28.02.2023						
FR	08:45	CPI EU Harmonised MoM	Feb P	mom	--	0.40%
	08:45	CPI EU Harmonised YoY	Feb P	yoy	--	6.00%
US	14:30	Wholesale Inventories MoM	Jan P	mom	0.10%	0.10%
	14:30	Retail Inventories MoM	Jan P	mom	--	0.50%
	15:45	MNI Chicago PMI	Feb	Index	--	44.30
	16:00	Richmond Fed Business Cond.	Feb	Index	--	-10.00
	16:30	Dallas Fed Services Activity	Feb	Index	--	-15.00
Wednesday, 01.03.2023						
GE	14:00	CPI EU Harmonised MoM	Feb P	mom	--	0.50%
	14:00	CPI EU Harmonised YoY	Feb P	yoy	--	9.20%
US	13:00	MBA Mortgage Applications	Feb24	wow	--	-13.30%
	16:00	ISM Manufacturing PMI	Feb	Index	47.70	47.40
Thursday, 02.03.2023						
EU	11:00	CPI MoM	Feb P	mom	--	-0.20%
	11:00	CPI YoY	Feb P	yoy	--	8.60%
	11:00	Core CPI YoY	Feb P	yoy	--	5.30%
US	14:30	Initial Jobless Claims	Feb24	1'000	--	--
Friday, 03.03.2023						
JN	00:30	Tokyo CPI Ex Food, Energy YoY	Jan	yoy	3.40%	4.40%
US	16:00	ISM Services Index	Feb	Index	54.30	55.20

Source: Bloomberg, J. Safra Sarasin as of 23.02.2023

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	1.41	-3	-21	1.7
German Bund 10 year (%)	2.45	1	-12	0.6
UK Gilt 10 year (%)	3.59	10	-9	0.9
US Treasury 10 year (%)	3.87	6	0	0.0
French OAT - Bund, spread (bp)	47	1	-7	
Italian BTP - Bund, spread (bp)	189	3	-25	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11'248	17.4	0.5	4.8
DAX - Germany	15'476	12.0	-0.4	11.1
MSCI Italy	856	7.9	-2.2	13.2
IBEX - Spain	9'232	10.9	-1.0	12.7
DJ Euro Stoxx 50 - Eurozone	4'258	13.1	-0.9	12.6
MSCI UK	2'272	10.4	-1.0	6.5
S&P 500 - USA	4'012	18.2	-3.2	4.8
Nasdaq 100 - USA	12'180	23.5	-4.0	11.5
MSCI Emerging Markets	988	7.3	-2.3	3.4

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.94	8.0	1.1	1.2
EUR-CHF	0.99	5.7	0.2	0.1
GBP-CHF	1.12	7.7	1.0	0.5
EUR-USD	1.06	8.0	-1.0	-1.1
GBP-USD	1.20	9.8	-0.2	-0.6
USD-JPY	134.8	12.0	0.5	2.8
EUR-GBP	0.88	6.6	-0.8	-0.5
EUR-SEK	11.03	7.8	-1.3	-1.1
EUR-NOK	10.93	9.5	-0.6	4.1

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	106	12.8	-0.9	-5.7
Brent crude oil - USD / barrel	82	31.4	-1.4	-3.0
Gold bullion - USD / Troy ounce	1'822	12.6	-0.8	-0.1

Source: J. Safra Sarasin, Bloomberg as of 23.02.2023

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