



## The ECB ends the year with a bang

**European Central Bank:** The ECB increased its policy rates by 50bp and had a very hawkish message for markets, indicating that it intends to raise policy rates significantly further. Inflation forecasts were revised up significantly, while growth expectations were lowered. The ECB also plans to start the balance sheet run-off in March 2023.

**US macro:** The Fed's new dot plot was considerably more hawkish, with the median dot moving to 5.0-5.25%. Bond investors expect price pressures to subside more rapidly, the Fed Funds rate to peak at a lower level and the FOMC to loosen policy in 2H23 already. We think investors are pricing a too dovish rate path for 2023, it will probably require a prolonged period of tight policy to bring demand and supply back into balance.

**Swiss National Bank:** The Swiss National Bank increased its policy rate to 1% as it continues to see elevated inflationary pressures. We forecast another 50bp hike in March and a terminal interest rate level of 2% to be reached this summer.

**FX:** We think that the US dollar has peaked in October and expect further weakness ahead. We particularly like USD-JPY shorts, while the upside for EUR-USD longs looks limited.

**Swiss equities:** Small- and mid-cap valuations relative to large caps have dropped to levels typically associated with outperformance over the subsequent 24 months. However, this likely only works out once the global manufacturing cycle turns up.

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## ECB-Meeting

### 50bp and a very hawkish message

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The ECB increased its policy rates by 50bp and indicated remarkably strongly that it intends to raise them significantly further. The ECB also decided to reduce the size of its APP bond portfolio by EUR 15 billion/month from March to June by not reinvesting parts of the maturing bonds. It will publish further details in February and decide how much it will roll off in the second half of 2023 at a later stage. The ECB revised its economic forecasts and now expects a shallow and short-lived recession starting this quarter. It sees the risks for growth on the downside especially in the short term. It increased its forecasts for the inflation outlook and sees risks to the upside. Financial markets' implied policy rates adjusted to the hawkish tone during the ECB statement and increased to slightly above 3%, which is the policy rate we forecast by end 2023. We note that a level of 3% is now at the lower end of what is compatible with today's statements.

**A deposit rate of 3% during and at the end of this year is now at the lower level that is compatible with today's ECB messages**

In a surprisingly hawkish policy statement and press conference, the ECB delivered four main messages: Policy rates have to rise (1) significantly, (2) at a steady pace, (3) until they are sufficiently restrictive and that (4) they need to remain at restrictive levels for a while. President Lagarde explained that this likely implies several hikes of 50bp at the coming meetings and that the ECB would stay on a restrictive course afterwards. She also clarified that the step from 75bp hikes in August and October to 50bp now should not be interpreted as a "pivot". She explained that the ECB would have longer to go than the Fed and that it would be in for the long haul. We see confirmation for our call that the ECB will raise the deposit rate to 3% and won't lower it in 2023. We also acknowledge that a level of 3% is now at the lower end of what is compatible with today's statements.

**The ECB balance sheet be expected to shrink by at least EUR 150 billion in 2023 by not reinvesting maturing bonds**

The ECB also decided to reduce its balance sheet from March onwards, at a pace of EUR 15 billion/month by not reinvesting around 50% of the average amount of maturing bonds until end-June. It will decide on the future pace of the balance sheet run-off at a later stage and publish details on its composition (public/private/green bonds) in February.

**Inflation is too high and is expected to stay above target for too long according to the ECB**

The ECB revised its macro forecasts significantly. It now sees substantially higher inflation and lower growth in the coming years. The new ECB projections for headline inflation are 8.4% in 2022, 6.3% in 2023, 3.4% in 2024 and 2.3% in 2025, while core inflation is expected at 3.9%, 4.2%, 2.8% and 2.4% respectively. The ECB also lowered its growth assessment and expects a recession this winter with negative growth rates of -0.2% in 4Q22 and -0.1% in 1Q23. While it acknowledges downside risks, it expects the recession to be short-lived and shallow. This also implies that job creation is likely to slow and that unemployment could increase in the coming quarters. Still, the ECB expects growth to recover once headwinds fade, such that quarterly growth rates recover to at least 0.4% from 4Q23 until end-2025.

**Lagarde secured a broad consensus on the inflation fighting course – that now is truly hers as well**

President Lagarde stated that some Governing Council members would have preferred a 75bp hike and others a 25bp, but that there was as sufficiently large consensus on the four main messages. It seems that she and the Governing Council are determined in bringing inflation down, regardless of political considerations and spread developments in the euro area (for now).



## US macro

## Don't fight the Fed

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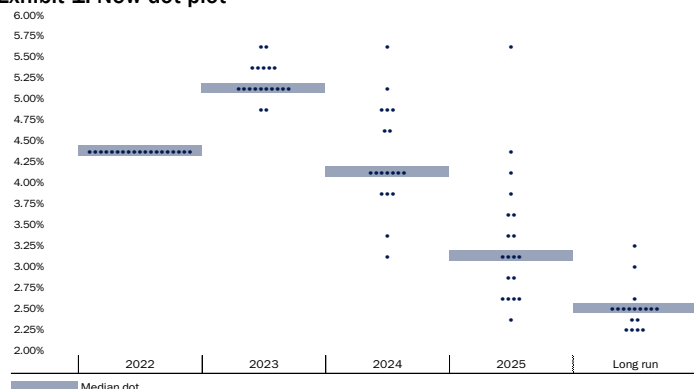
The Fed's new dot plot was considerably more hawkish, with the median dot moving to 5.0-5.25%. Although Mr. Powell stressed again the need to 'stay the course' in order to defeat inflation, bond investors expect price pressures to subside more rapidly, the Fed Funds rate to peak at a lower level and the FOMC to loosen policy in 2H23 already, most probably as the economy falls into recession. While we agree with the latter point, we think investors are pricing a too dovish rate path for 2023, it will probably require a prolonged period of tight policy to bring demand and supply back into balance.

## A more hawkish dot plot

## Fed meeting

The FOMC was unanimous in its decision to raise the Fed Funds rate to 4.25-4.5%. The statement repeated the message that ongoing increases in the policy rate will be appropriate, with 17 out of the 19 members who participated to the new round of projections anticipating a peak rate of above 5% in 2023. The range of projections, which excludes the top and bottom three, lies between 5.1-5.4%, with the median 'dot' sitting at 5-5.25%. Members see the first rate cuts in 2024 only (as they previously did). These new projections point to a considerably tighter policy stance than officials had anticipated back in September, despite two encouraging CPI reports in between these meetings. Back then, no member thought rates would move up to 5%, and the median projection was for a terminal rate of 4.5-4.75% (Exhibits 1-2).

Exhibit 1: New dot plot



Source: Federal Reserve, Bank J. Safra Sarasin, 14.12.2022

Exhibit 2: New vs old projections

	2022	2023	2024	2025	Longer run
GDP 4Q/4Q	0.5	0.5	1.6	1.8	1.8
September projection	0.2	1.2	1.7	1.8	1.8
Unemployment rate 4Q	3.7	4.6	4.6	4.5	4.0
September projection	3.8	4.4	4.4	4.3	4.0
PCE inflation 4Q/4Q	5.6	3.1	2.5	2.1	2.0
September projection	5.4	2.8	2.3	2.0	2.0
Core PCE inflation 4Q/4Q	4.8	3.5	2.5	2.1	
September projection	4.5	3.1	2.3	2.1	
Fed funds rate year end	4.4	5.1	4.1	3.1	2.5
September projection	4.4	4.6	3.9	2.9	2.5

Source: Federal Reserve, Bank J. Safra Sarasin, 14.12.2022

The market doesn't buy this new dot plot as it believes the economy will fall into recession, bringing down rapidly inflation with it

Bond investors, however, ignored the more hawkish dot plot, and continue to expect a peak rate of around 4.85%. Crucially, they think the Fed will not be able to 'stay the course' and price about 50bp worth of rate cuts in the back end of next year. So what explains this divergence? Investors have become much more relaxed about the inflation outlook, with the TIPS market pricing a monthly change in headline CPI hitting a 2% annualised rate for the next 12 months. In short, inflation should no longer be an issue. This probably reflects much lower commodity prices and a high conviction that the economy will fall into recession next year, with 85% of yield curves between 3 months and 30 years inverted.

FOMC members expect the labour market to remain quite strong next year, despite slower growth and see inflation falling gradually

The Fed is far less convinced that the inflation problem is over. True, it is welcoming the last two positive CPI reports, but according to Chair Powell these reports support their projections that inflation will fall rather than change their outlook. In fact, the new projections show a higher core inflation rate by the end of next year than previously anticipated (at 3.5% vs 3.1%), although this is largely a function of a higher starting point (4Q22 inflation was revised up). Fed members still expect that their policy stance will bring down GDP



growth to low levels but that it will not tip the economy into recession. 2023 4Q/4Q GDP growth was revised down to 0.5%, from 1.2% previously. Indeed, the unemployment rate for 2023 was marginally revised up to 4.6%, from 4.4%, which is still only somewhat higher than their long-term estimate of 4%. The reason behind this remains the same: in a world of suppressed labour supply, employers might be reluctant to shed workers, despite much softer demand. This explains why Fed officials believe that inflation will take until 2025 to get back to target.

**To us, this 'soft-landing' scenario remains a best case one. We also think the market is too optimistic about the future path for the Fed Funds rate**

To us, this 'soft-landing' scenario is possible but represents the best case rather than our baseline view. As explained [here](#), tight policy should eventually lead to more layoffs than the Fed anticipates. Our view also diverges from the market: we take the dot plot more at face value. Inflation is back for the first time in four decades, and there is a lack of reliable precedents. With the labour market seemingly impermeable to all the monetary tightening that has happened so far, it seems easy for the Fed to keep on tightening. If it is going to be a mistake, it will be tightening policy too much, not too little.

**A large drop in core goods was largely behind the positive November CPI report. But core services came in lower than expected too**

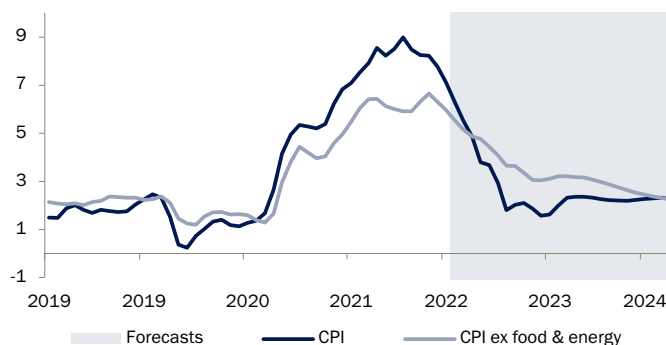
## Inflation outlook – an update after the positive November CPI report

CPI in November came in lower than expected for a second consecutive month. Core prices rose by 0.2%, which is pretty much in line with the Fed's target, and was the smallest increase since summer 2021. The drop in energy prices meant that headline CPI rose only by 0.1% on the month. The annual inflation rate fell to 7.1%, from 7.7%, and is now 2ppt below the peak reached in June. As expected, core goods prices fell, though the decline was larger than we had anticipated at -0.5%. Services excluding rent was only up 0.15% on the month. To us, this was particularly surprising given price dynamics for most of these services should be closely correlated with the state of the labour market, with wages making up the largest cost in delivering these services. The drop in airline fares, however, probably reflect lower fuel costs, which might not last (see Table 1 at the end of the document). The fall in medical care services was also exaggerated due to the change of the index that the BLS uses to calculate health care premiums.

**We see inflation falling to 3% by Q3 next year. Afterwards it should take until the end of 2024 to get back to target**

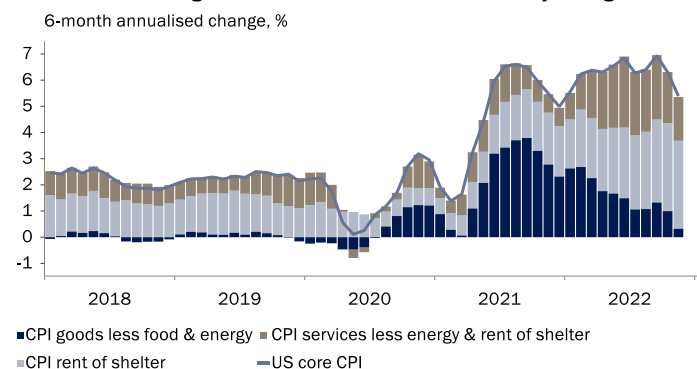
So will this positive development turn out to be a false dawn as it was back in summer 2021, or the confirmation of a more sustained downtrend in inflation? As our forecasts show, core inflation should fall steadily over the next 10 months to reach 3% in 3Q23, but it should then take until the end of 2024 to get back to target (Exhibit 3). Headline inflation should fall more rapidly and drop below 2% before rebounding, reflecting the large decline in energy prices and the associated base effects. To showcase our thinking, it is useful to break core inflation into three broad categories: core goods inflation, housing services inflation (rent of shelter), and inflation in core services other than housing (Exhibit 4).

**Exhibit 3: Inflation to fall in 2023, 2024 could prove more difficult**



Source: Macrobond, Bank J. Safra Sarasin, 14.12.2022

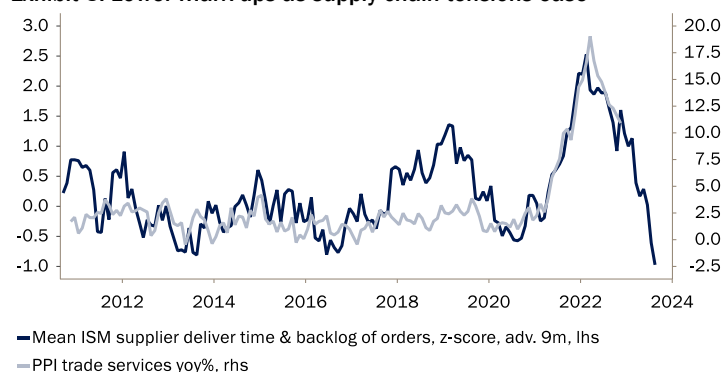
**Exhibit 4: Breaking down core inflation into three key categories**



Source: Macrobond, Bank J. Safra Sarasin, 14.12.2022

**Core goods should act as a significant deflationary force for the next 6-9 months**

Lagged effects from the strong dollar, an easing of supply chain constraints, lower commodity prices, and the inventory build-up all mean that core goods will continue to act as a strong deflationary force over the next 6-9 months (Exhibits 5-6). The direction of travel is clear, though the speed at which core goods inflation will come down remains uncertain.

**Exhibit 5: Lower mark-ups as supply-chain tensions ease**

Source: Macrobond, Bank J. Safra Sarasin, 13.12.2022

**Exhibit 6: Retailers need to get rid of their inventories**

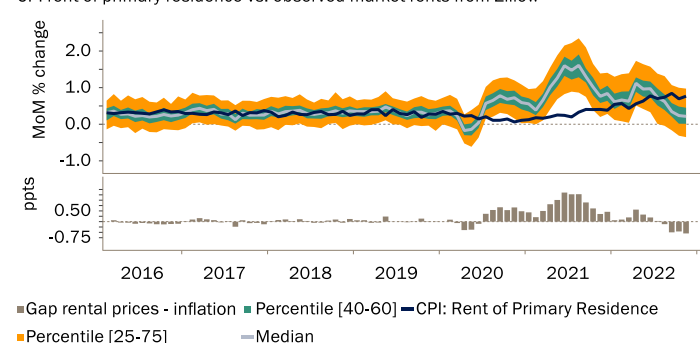
Source: Macrobond, Bank J. Safra Sarasin, 13.12.2022

**Rent inflation is likely to peak in 1H next year, then fall materially over the subsequent 18 months**

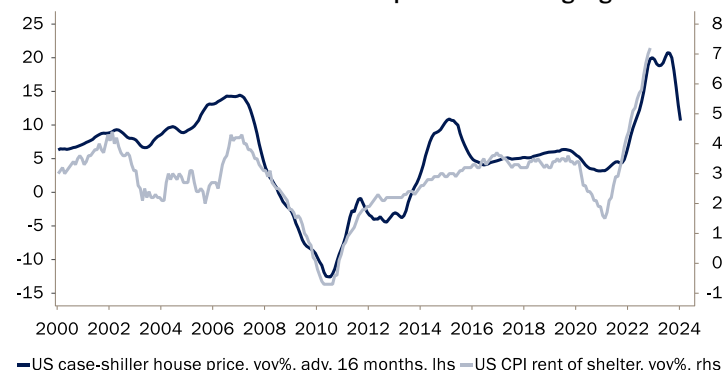
While rent inflation has still not peaked, the rate of change in the price of new leases has fallen sharply in recent months (in some cities, they are now falling), and it's just a matter of time before these get reflected in CPI figures (only a small fraction of existing leases gets renegotiated every month) (Exhibit 7). Given that rents account for 40% of the core CPI basket, they matter greatly for the inflation outlook. Over time, rents tend to follow house prices (but not only). If we are right in our view that prices will fall by around 15% from their peak, rent inflation should also drop sharply in the second half of next year and in 2024 (Exhibit 8).

**Exhibit 7: New lease inflation is coming down**

CPI rent of primary residence vs. observed market rents from Zillow



Source: Macrobond, Bank J. Safra Sarasin, 14.12.2022

**Exhibit 8: Rent inflation tracks house prices with a long lag**

Source: Macrobond, Bank J. Safra Sarasin, 14.12.2022

**Core services excluding rents holds the key for future inflation. Prices dynamics in this category are largely a function of labour market tightness**

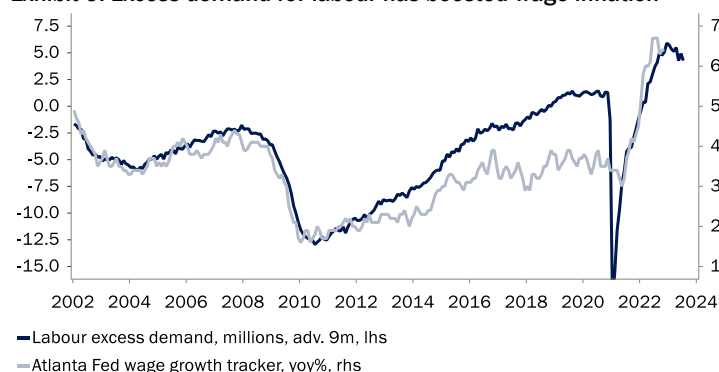
The outlook for the final category – services excluding rents – is perhaps the most uncertain one, at this stage. But how prices evolve in this category will be crucial in determining how easy or difficult it will be for core inflation to move down eventually from the 3-4% range to 2%, the Fed's target (the first leg down will be largely driven by goods then rents). For core CPI, this category accounts for about 35% of the basket, but for core PCE, the Fed's favourite measure, it accounts for 55%. As mentioned above, the labour market is believed to hold the key to understanding inflation in this category given that wages are making up the largest cost in delivering these services.



The problem is that structural factors appear to have depressed labour supply. If supply doesn't come up, demand will need to be suppressed

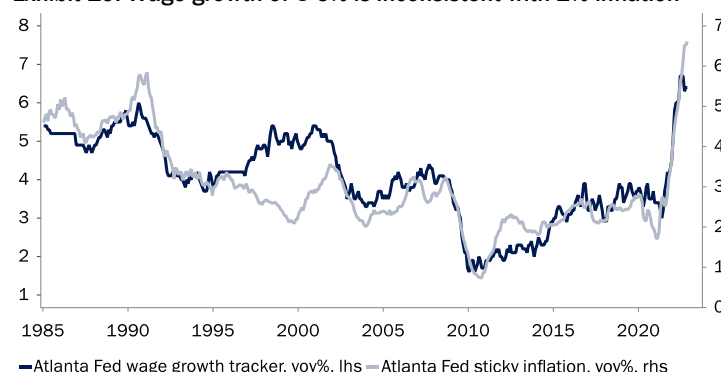
The problem is that demand for workers far exceeds the supply of available workers, by about 4.3 million (Exhibit 9). As a result, nominal wages have grown at a pace well above what would be consistent with 2% inflation over time. The other problem, as Mr. Powell reminded us in his November 30 speech and again yesterday, is that this excess demand is largely the reflection of a shortfall in the labour force of about 3½ million people. This shortfall, in turn, can be explained by a big drop in the participation rate due to excess retirements since the start of the pandemic (accounting for about 2/3<sup>rd</sup> of the shortfall) and slower working-age population growth due to a big drop in net immigration and excess deaths during the pandemic. If labour supply doesn't pick up meaningfully, which seems likely given the nature of the shortfall, demand will need to be brought down meaningfully towards that lower supply level in order to bring wage pressures down. Whether the Fed has the will to go all the way is another question.

Exhibit 9: Excess demand for labour has boosted wage inflation



Source: Macrobond, Bank J. Safra Sarasin, 14.12.2022

Exhibit 10: Wage growth of 5-6% is inconsistent with 2% inflation



Source: Macrobond, Bank J. Safra Sarasin, 14.12.2022

Table 1: Energy, core goods, transportation and medical care services saw big price drops  
US CPI, month-on-month change (%)

	-25	-15	-5	5	15	25	Latest	-1m	-2m	Mean (2000-19)	Weight
All Items							0.1	0.4	0.4	0.18	100.0
Food							0.5	0.6	0.8	0.19	13.7
Food at Home							0.5	0.4	0.7	0.16	8.5
Cereals & Bakery Products							1.1	0.8	0.9	0.16	1.1
Meats, Poultry, Fish & Eggs							-0.2	0.6	0.4	0.22	1.9
Food at Home, Dairy & Related Products							1.0	-0.1	0.3	0.14	0.8
Fruits & Vegetables							1.4	-0.9	1.6	0.16	1.1
Nonalcoholic Beverages & Beverage							0.7	0.5	0.6	0.10	1.0
Other Food at Home							-0.1	0.9	0.5	0.13	2.3
Food Away from Home							0.5	0.9	0.9	0.23	5.2
Energy							-1.6	1.8	-2.1	0.32	8.1
Energy Commodities							-2.0	4.4	-4.7	0.47	4.4
Fuel Oil							1.7	19.8	-2.7	0.55	0.2
Motor Fuel							-2.1	4.0	-4.8	0.47	4.2
Gasoline (All Types)							-2.0	4.0	-4.9	0.48	4.1
Energy Services							-1.1	-1.2	1.1	0.22	3.6
Electricity							-0.2	0.1	0.4	0.22	2.6
Utility (Piped) Gas Service							-3.5	-4.6	2.9	0.22	1.0
All Items Less Food & Energy							0.2	0.3	0.6	0.17	78.2
Commodities Less Food & Energy Commodities							-0.5	-0.4	0.0	0.00	21.0
Apparel							0.2	-0.7	-0.3	-0.03	2.5
New Vehicles							0.0	0.4	0.7	0.01	4.1
Used Cars & Trucks							-2.9	-2.4	-1.1	-0.04	3.7
Medical Care Commodities							0.2	0.0	-0.1	0.21	1.5
Alcoholic Beverages							0.7	0.8	0.0	0.16	0.9
Tobacco & Smoking Products							0.7	0.3	0.2	0.48	0.5
Services Less Energy Services							0.4	0.5	0.8	0.23	57.2
Shelter							0.6	0.8	0.7	0.22	32.7
Rent of Primary Residence							0.8	0.7	0.8	0.26	7.4
Owner's Equivalent Rent							0.7	0.6	0.8	0.22	24.0
Lodging Away from Home							-0.7	4.9	-1.0	0.15	0.9
Medical Care Services							-0.7	-0.6	1.0	0.31	6.8
Physicians' Services							0.0	0.0	0.5	0.20	1.8
Hospital & Related Services							-0.3	-0.2	0.2	0.45	2.5
Transportation Services							-0.1	0.8	1.9	0.22	6.0
Motor Vehicle Maintenance & Repair							1.3	0.7	1.9	0.23	1.1
Motor Vehicle Insurance							0.9	1.7	1.6	0.34	2.5
Car & Truck Rental							-2.4	-0.5	2.5	0.10	0.1
Airline Fares							-3.0	-1.1	0.8	0.08	0.6

■ 3-year range (low, high) ● Latest ● Previous month

Source: Macrobond, Bank J. Safra Sarasin, 14.12.2022



## SNB meeting

### 50bp hike and no indication of a pause next time

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The Swiss National Bank (SNB) increased its policy rate to 1% as we and markets expected. It continues to see elevated inflationary pressures and doesn't exclude the necessity to counter them with higher policy rates next year. The reason for this can be found in the inflation projections that sit at 2.1% by the end of the forecast horizon – hence above the target corridor of 0% to 2%. Compared to September, inflation forecasts are slightly lower for 2022 but slightly higher for 2025. SNB Chair Thomas Jordan confirmed that the SNB has sold FX reserves in the past months and that it intends to do so in the next months as well. We forecast another 50bp hike in March and a terminal interest rate level of 2% to be reached this summer. We also expect the Swiss franc to appreciate toward 0.95 EUR-CHF and to 0.90 USD-CHF until end 2023.

No indication that the SNB's job is done already

The wording of the SNB statement was a tad more hawkish than markets might have expected as there was no indication that the SNB could pause or slow down its rate hikes. Markets saw a risk of a smaller hike than the 50bp delivered by the SNB. Chair Thomas Jordan stated that inflationary pressures have increased, also because of higher inflation abroad. As a result, the SNB increased its inflation forecast for 2025 to 1.8% from 1.7%. The last quarter of its projection horizon now shows an inflation rate of 2.1%, which is an indication that monetary conditions are not yet sufficiently tight. The SNB forecasts GDP growth to slow to 0.5% in 2023, but does not see a recession. The SNB maintained its tiering system of reserve remuneration in which the lower rate remains 50bp below the policy rate.

SNB confirmed FX interventions in the past months

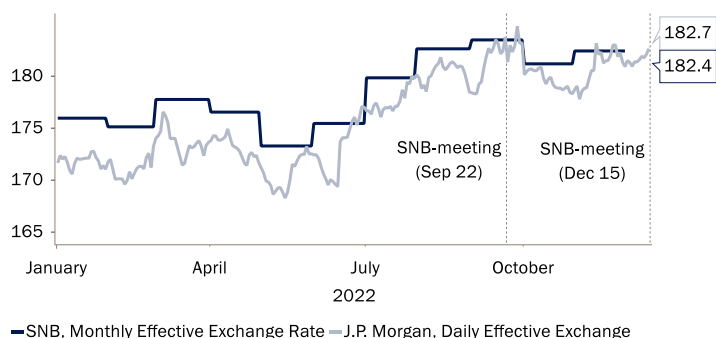
Monetary conditions are a combination of financing conditions and the exchange rate. Chair Jordan confirmed that the SNB has sold foreign reserves and intends to do so in the coming months without targeting a specific exchange rate level. Given the marginal upward move of the nominal and the slight decline of the real effective exchange rate, we assume that this was just to prevent a depreciation of the Swiss franc (Exhibit 1). Monetary aggregates have declined as a result of the SNB FX interventions and its liquidity absorbing open market operations. Additionally, the demand for cash fell as banks don't charge negative interest rates anymore (Exhibit 2).

Negative equity would lead to a period in which no disbursement of future profits would be made

Finally, Jordan explained that in case the SNB balance sheet would show negative equity, it would need to be rebuilt over time through its own operations and that no disbursement to the public sector could be made until reserves are at their mandatory level again.

**Exhibit 1: The exchange rate didn't move much since the last meeting**

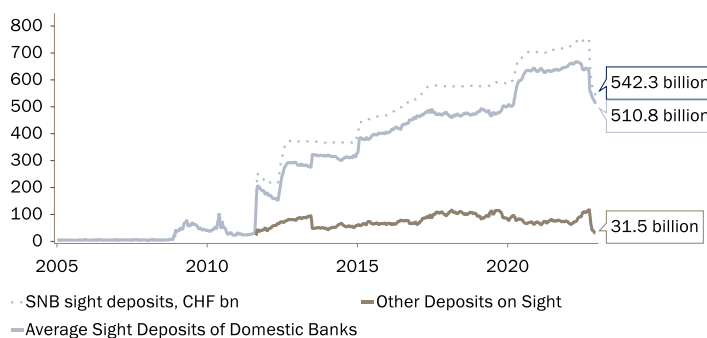
Switzerland, Nominal FX Indices - 1.1.2000 = 100



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 2: Monetary aggregates are shrinking rapidly**

Switzerland, Monetary Aggregates, M1, in billion CHF



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022



## FX markets

### Further dollar weakness ahead

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**We think that the US dollar has peaked in October and expect further weakness ahead. We particularly like USD-JPY shorts, while the upside for EUR-USD longs looks limited. Furthermore, USD-CHF shorts and AUD-USD longs should be a good way to benefit from expected dollar weakness.**

**Expectations of a slowing Fed hiking cycle are weighing on the US dollar**

With 0.1% versus an expected 0.3% mom and 7.1% versus an expected 7.3% yoy, the growth in US consumer prices slowed further in November, surprising once again to the downside. Following the release, the DXY dollar index slid by more than 1%. Year to date, the dollar has closely followed UST 10y yields, which were on an upward trend until October and hence constituted the primary source of dollar strength in 2022 (Exhibit 1). Yet the recent moderation in US consumer prices has changed the market narrative of Fed policy rates peaking well above 5%. In anticipation of a slowing hiking cycle, the retracement in US rate expectations was particularly pronounced, which has led to a drop in UST yields across the curve and reversed the dollar upward trend.

**In the last two Fed hiking cycles, the dollar has peaked well ahead of policy rates**

While we acknowledge that dollar weakness kicked off a bit earlier than we had expected, the currency's move broadly follows historical patterns. In particular, the dollar is mimicking the dynamics it showed throughout the past two Fed rate hiking cycles – 2004-06 and 2016-18. During both episodes, the dollar embarked on a downward trend well before the Fed policy rates reached their peak (Exhibit 2).

**Exhibit 1: USD has largely followed movements in the UST 10y yield**

US dollar vs UST 10y



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 2: In previous cycles, USD peaked well ahead of policy rates**

US dollar vs US policy rate



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

**In our view, USD weakness should extend into 2023, begging the question which dollar pairs will be the most trending**

In spite of the recent weakness, the dollar's real effective exchange rate reveals that the currency remains very strong by historical standards (Exhibit 3). And from a current account perspective, the picture is similar (Exhibit 4), while the misalignment with fundamentals has moderated as of late. In combination with a US cycle that is potentially slowing fast, this suggests that dollar weakness trend is likely to extend into 2023. This begs the question which dollar pairs will move most.

**It probably won't be the euro...**

Over the past weeks, EUR-USD has seen a remarkable recovery, driven by an improvement in euro area sentiment – a reflection of the diminished likelihood of a European energy shortage and easing global supply pressures. The recent move has diminished the gap between exchange rate and short-term yields (Exhibit 5). Yet we do not expect the gap to close completely given that it partly represents the deterioration in Europe's energy terms of trade, which are unlikely to reverse anytime soon. On the back of a cold December, gas





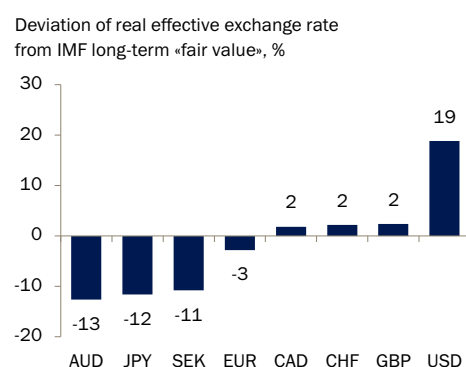
prices have inched higher again. Moreover, the war in Ukraine and slowing industrial production are set to remain challenges for the euro. In consequence, we do not expect EUR-USD to rise much further from here.

**Exhibit 3: USD continues to be expensive**



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 4: USD substantially above fair value**



Source: IMF, Bloomberg, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 5: Part of the FX-yield gap to remain**



Source: Bloomberg, Bank J. Safra Sarasin, 15.12.2022

## USD-JPY likely to move most

In our view, USD-JPY will move most in 2023. Contrary to other developed economies, Japanese inflation prints continue to inch higher (Exhibit 6), which increases the odds for a BoJ policy shift in 2023 (see [«2 out 3 scenarios point to BoJ dropping YCC»](#), *Cross-Asset Weekly 2022/11/04*). We think that the BoJ is likely to abandon its yield curve control in the second half of 2023, when it sees more evidence of Japanese wages picking up. We expect that a narrowing UST-JGB yield differential should reverse much of the yen's year-to-date decline versus the dollar.

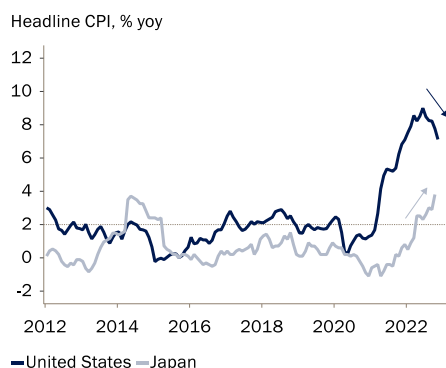
## USD-CHF shorts remain a good place to be

The Swiss franc should remain a good place to be. Due to low domestic inflation (Swiss inflation is lower than in any other G10 economy), Swiss real yields are much more attractive than their euro area counterparts. What's more, Switzerland's economy is relatively resilient to a weakening US economy. This is reflected in a negative correlation between ISM and Swiss franc, which should push USD-CHF lower (Exhibit 7).

## AUD-USD longs should benefit from Chinese reopening

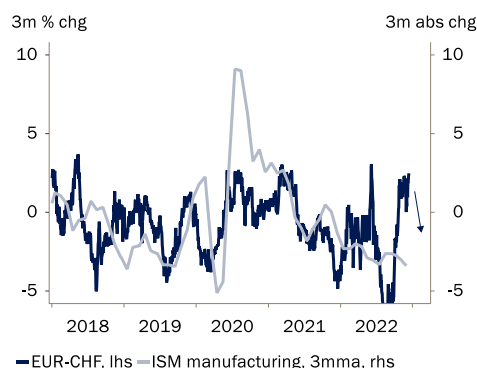
Within the group of commodity currencies, we think that the Australian dollar should do comparatively well as AUD-USD valuations look historically cheap. Given China's importance as a trading partner to Australia, the currency should benefit from a pickup in Chinese activity on the back of China's COVID reopening (Exhibit 8). We note that a successful vaccination rollout will probably require some time, yet it will prove necessary for a sustainable recovery to materialize.

**Exhibit 6: Japanese inflation edges higher**



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 7: CHF to gain on weaker US activity**



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 8: AUD-USD offers China exposure**



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

## Swiss equities

### Making a positive case for small- and mid-caps

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Small- and mid-cap valuations relative to large caps have sharply dropped as a result of the underperformance over the past 1.5 years. Looking at the SMIM vs the SMI, they are now at levels which would typically be associated with outperformance over the subsequent 24 months. The view around the fundamental drivers of such a trade is less clear-cut. If China were to succeed in restarting its economy, the global manufacturing cycle may find a trough and reverse some of detrimental dynamics for small- and mid-cap indices over past quarters. An improving manufacturing cycle - while the US economy is still slowing - would likely not only improve the outlook for cyclical sectors and styles (such as small- and mid-cap), but also weigh on the US dollar. This has been another key headwind for the SMIM vs SMI trade over the past 1.5 years.

**Small- and mid-cap indices have been among the weakest equity market segments in the past 12 months**

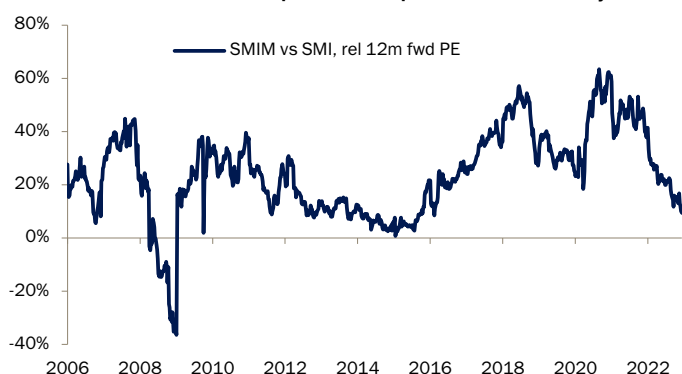
Small- and mid-cap indices across developed markets have been one of the weakest performing equity market segments over the past 12 months. Index levels have fallen by 15% to 25% in 2022, unequivocally underperforming their large-cap peers.

As a result, valuations relative to large-caps have fallen to multi-year lows, and are now at levels which would typically be associated with medium-term outperformance. The Swiss SMIM mid-cap index here stands exemplary for most small- and mid-cap indices.

**Relative valuations are now clearly attractive, followed by outperformance in the past**

The premium of the SMIM's 12-month forward PE over the SMI has fallen to 9%, from around 60% at the beginning of last year (Exhibit 1). This marks the lowest relative valuation level since 2016 and is only slightly above par to the SMI's PE, which has only been breached once in the past 15 years, during the Global Financial Crisis. More than just looking attractively valued, there has been a tendency for the SMIM to outperform over the following 24 months once it traded at a PE premium of less than 30% (Exhibit 2).

**Exhibit 1: Small- and mid-cap valuation premiums are at 6 year lows**



Source: Refinitiv, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 2: Current valuations were typically followed by outperformance**



Source: Refinitiv, Bank J. Safra Sarasin, 15.12.2022

Yet for this to happen, fundamental drivers also need to fall into place, and that's where it becomes trickier.

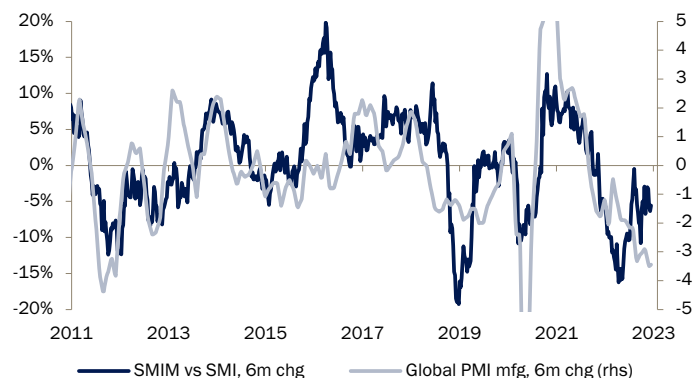
**Most important drivers are the global manufacturing cycle and a weaker US dollar**

The index is dominated by industrials and financials, while more defensive sectors play a less prominent role. This makes the SMIM (like most other small- and mid-cap indices) strongly pro-cyclical and is a key reason why it has suffered disproportionately over the past year (Exhibit 3). The second major headwind for the SMIM vs the SMI has been the strength in the US dollar. The SMI's large US exposure, with more than 25% of total SMI sales generated in the region, turn FX into a key support factor in periods of US dollar



strength. The SMIM's sales exposure has a stronger European bias with some of its major constituents having large Asia & China businesses.

**Exhibit 3: Key driver of SMIM vs SMI trade is the manufacturing cycle**



Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 4: A weaker US dollar also helps the SMIM vs the SMI**



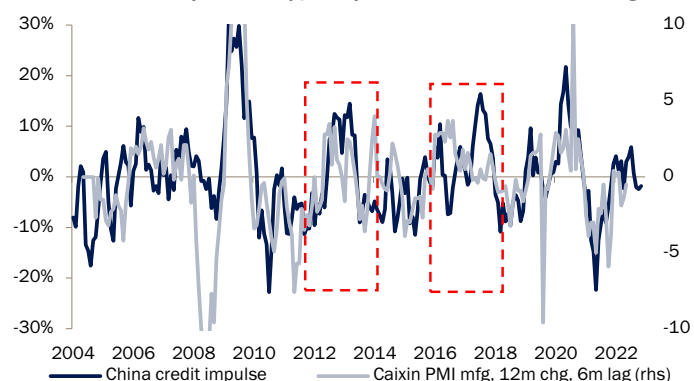
Source: Macrobond, Bank J. Safra Sarasin, 15.12.2022

**The US will likely slow further. China is the wildcard to restart the global manufacturing cycle**

As mentioned above, the global cycle has been slowing for the past 1.5 years and a trough does not appear in sight, at least when looking at global central banks and their lagged impact on the consumer. One hope, which may not be completely unjustified, is a manufacturing rebound in China. In the past 15 years, China has always come to the rescue when the rest of the world was slowing. This happened not only in 2008 after the Global Financial Crisis, but also in 2012 and in 2015/16. Whenever the global cycle started to cool and China felt that global demand was waning, they ramped up credit growth, which helped the global manufacturing cycle to re-accelerate. Typically, the domestic cycle in China picked up with a 6-month lag to the rise in the credit impulse (1<sup>st</sup> derivative of credit growth, Exhibit 4). Another 3 months later, the global manufacturing PMI tends to follow (Exhibit 5).

Whether this plays out this time around remains to be seen. While it appears obvious that the government is desperate to stimulate the economy, rising infection numbers and a cooling housing market may make it a lot tougher to translate credit growth into economic growth.

**Exhibit 5: China's cycle has typically been a function of credit growth**



Source: Refinitiv, Bank J. Safra Sarasin, 15.12.2022

**Exhibit 6: The global manufacturing cycle follows with a 3-month lag**



Source: Refinitiv, Bank J. Safra Sarasin, 15.12.2022

**A bottoming in the global manufacturing cycle would likely lead to a softer US dollar**

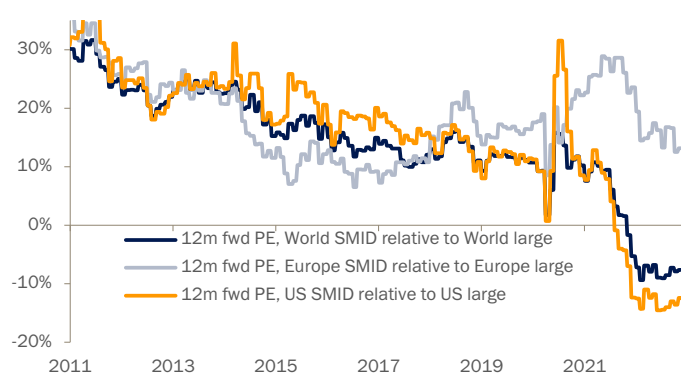
If the global manufacturing cycle were to bottom in the coming months, driven by a Chinese stimulus, this may also lead to a reversal of the support factors for the US dollar. The US cycle has so far clearly led the rest of the world post-COVID. This is reflected by the strong divergence between the US non-manufacturing ISM, which is one of the best proxies for US GDP, and the manufacturing ISM, which is more closely correlated to the global

manufacturing cycle (Exhibit 6). In a scenario in which the US economy continues to slow, driven by central bank tightening and increasing pressure on the consumer, while the rest of the world (most notably China) find a bottom, the US dollar should weaken. This would remove a key headwind for a SMIM vs SMI relative trade

**Exhibit 7: The US dollar is a function of the services vs manuf. cycle**



**Exhibit 8: Small- and mid-cap valuations are attractive in most regions**



**The jury is still out on the manufacturing cycle, but it is obvious that small and mid-cap valuations are attractive**

While so far purely hypothetical and subject to large obstacles, a case can be made for a trough in the global manufacturing cycle over coming quarters. This would likely not only reverse the trajectory of the US dollar, but also help small- and mid-cap equities to start recovering from their relative lows. Although the jury remains out on fundamentals, relative valuations are speaking a clearer language: Small- and mid-caps are cheap and in the past these valuation levels provided the basis for medium-term outperformance.



## Economic Calendar

### Week of 19/12 - 23/12/2022

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
<b>Monday, 19.12.2022</b>						
GE	10:00	IFO Expectations	Dec	Index	--	80.00
US	16:00	NAHB Housing Market Index	Dec	Index	34.00	33.00
<b>Tuesday, 20.12.2022</b>						
JN	06:00	BOJ 10yr Yield target	Dec20	%	--	0.00%
GE	08:00	PPI MoM	Nov	mom	--	-4.20%
	08:00	PPI YoY	Nov	yoy	--	34.50%
US	14:30	Building Permits	Nov	1'000	1500k	1526k
	14:30	Housing Starts	Nov	1'000	1400k	1425k
<b>Wednesday, 21.12.2022</b>						
US	13:00	MBA Mortgage Applications	Dec16	wow	--	3.25%
	16:00	Existing Home Sales MoM	Nov	mom	-5.20%	-5.20%
	16:00	Conf. Board Expectations	Dec	Index	--	75.40
<b>Thursday, 22.12.2022</b>						
US	14:30	Initial Jobless Claims	Dec17	1'000	--	--
	14:30	Chicago Fed Nat. Activity Index	Nov	Index	--	-0.05
	16:00	Leading Index	Nov	mom	-0.40%	-0.80%
	17:00	Kansas City Fed Manf. Activity	Dec	Index	--	-6.00
<b>Friday, 23.12.2022</b>						
JN	00:30	Natl. CPI Ex Food, Energy YoY	Dec	yoy	--	2.50%
US	14:30	Durable Goods Ex Transp. MoM	Nov P	mom	0.00%	0.50%
	14:30	Cap. Goods Orders Nondef Ex Air	Nov P	mom	0.00%	1.50%
	16:00	U. of Mich. 5-10 Yr Inflation	Dec F	%	--	3.00%
	16:00	New Home Sales	Nov P	1'000	600k	632k

Source: Bloomberg, J. Safra Sarasin as of 15.12.2022



## Market Performance

### Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	1.23	7	136	-8.9
German Bund 10 year (%)	2.08	15	226	-16.2
UK Gilt 10 year (%)	3.24	20	227	-14.5
US Treasury 10 year (%)	3.48	-10	197	-12.3
French OAT - Bund, spread (bp)	51	4	13	
Italian BTP - Bund, spread (bp)	208	18	73	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	10'880	17.8	-1.1	-13.1
DAX - Germany	13'986	11.1	-2.0	-12.0
MSCI Italy	753	7.6	-2.0	-12.0
IBEX - Spain	8'219	10.3	0.1	-2.2
DJ Euro Stoxx 50 - Eurozone	3'836	11.5	-2.2	-7.7
MSCI UK	2'136	9.6	-0.6	6.6
S&P 500 - USA	3'896	17.7	-1.7	-17.0
Nasdaq 100 - USA	11'345	21.9	-2.5	-29.9
MSCI Emerging Markets	960	11.5	-0.9	-19.6

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.93	7.7	-0.8	1.4
EUR-CHF	0.99	6.0	0.4	-4.5
GBP-CHF	1.13	7.7	-1.3	-8.3
EUR-USD	1.07	8.1	1.2	-5.9
GBP-USD	1.22	9.5	-0.4	-9.6
USD-JPY	137.2	10.6	0.5	19.2
EUR-GBP	0.87	6.8	1.6	4.1
EUR-SEK	10.98	7.1	0.9	7.2
EUR-NOK	10.49	9.2	-0.4	5.1

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	114	17.3	2.7	14.3
Brent crude oil - USD / barrel	81	38.4	7.8	3.2
Gold bullion - USD / Troy ounce	1'784	16.8	-0.3	-1.7

Source: J. Safra Sarasin, Bloomberg as of 15.12.2022





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