J. Safra Sarasin
Cross-Asset Weekly

10 November 2023

Macro and Strategy Outlook 2024

We believe that 2024 will be increasingly marked by the cumulative effects on the real economy of the rapid and sharp monetary tightening implemented by developed market central banks over the past 18 months. Financial conditions have tightened significantly and central banks generally share the view that the peak impact of past monetary tightening still lies ahead of us. But central banks will also want to see clear evidence pointing to a sustained return of inflation to 2% before easing policy. We expect the first rate cuts in the third quarter of 2024, but they will likely be more gradual than in previous cycles.

We retain a constructive outlook for fixed income for 2024 and into 2025. Developed markets' rates structures have repriced sharply over the past 18 months and provide a meaningful cushion against adverse yield moves. We expect lower bond yields over the next 6 to 12 months and prefer intermediate maturities. Credit spreads remain below historical medians. Hence, they do not price a meaningful economic slowdown. We retain a preference for Investment Grade over High Yield.

We expect the US dollar to weaken and remain cautious on the British pound. The yen should rise markedly in the coming year, but also the euro and the Swiss franc should be well supported. Lower real rates in 2024 will likely be a tailwind for gold.

Finally, we retain a cautious view on global equities as the US market in particular is priced for a very favourable economic development. Within the equity space, we find the euro area and Switzerland attractive. We prefer sectors that usually benefit from lower rates and hold up even if the business cycle were to slow. These include typical defensive sectors such as staples and health care, but also utilities.

Risks shifting from high inflation to high financing costs

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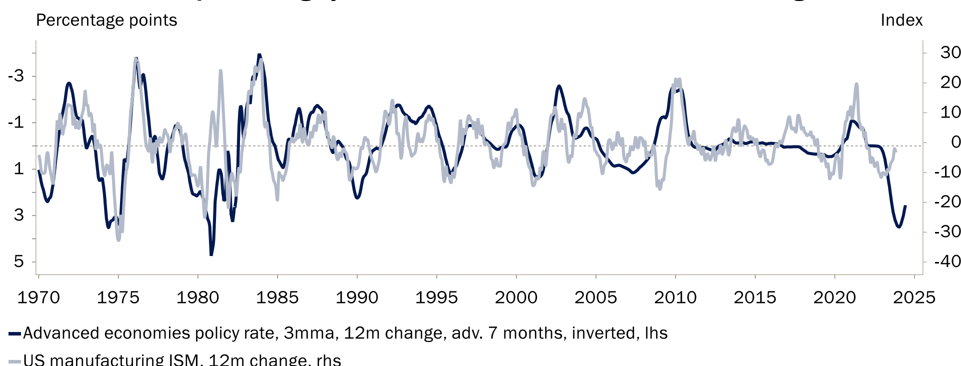
The global economy surprised by its resilience in 2023. But the impact from tight monetary policy is likely to be more visible through 2024. Ongoing structural changes will probably cushion some of the negative implications for labour markets. Still, unemployment is likely to rise over the coming quarters, with growth falling below advanced economies' potential rates. Fiscal expansion in China is likely to offset this only partly. As economic slack opens up, disinflation should continue albeit at a gradual pace. As a result, major central banks are unlikely to push rates any higher, but we expect the first rate cuts in the third quarter of 2024 only. Policy easing should be more gradual than in the past given more persistent underlying inflationary pressures. We retain a positive outlook for fixed income for 2024. We expect lower bond yields over the next 6 to 12 months. We also retain our preference for Investment Grade over High Yield. In the currency space we expect the dollar and the British pound to suffer from lower policy rates in 2024, while we expect gold to do well as real interest rates move lower. Finally, we retain our cautious view on equities as the US equity market in particular is priced for a very positive economic scenario. Within the equity space we find Switzerland attractive and focus on sectors, which usually benefit from lower rates and hold up even if the cycle were to slow. These include sectors such as staples and health care, but also utilities. **(See forecast overview table on page 17)**

Global macro

Can the global economy remain as resilient in 2024 as it was in 2023? We are inclined to believe that it will not

The global economy and particularly the US have been much more resilient to higher interest rates than we had anticipated. Looking back in history, a monetary tightening cycle of such amplitude should have resulted in much weaker economic activity and a rise in joblessness (Exhibit 1). Instead, unemployment has stayed low, while inflation has fallen in all advanced economies. And even in sectors where activity has slowed, such as manufacturing, the 'hard' data have in general been stronger than surveys had indicated. The outlook for the global economy and financial markets hinges on whether this resilience can persist. This requires us to understand why the economy has managed so far to shrug off the sharp increase in interest rates. We are inclined to believe that the current situation is looking too good to last for very long.

Exhibit 1: The sharpest hiking cycle since the 1980s was met with resilient growth



Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

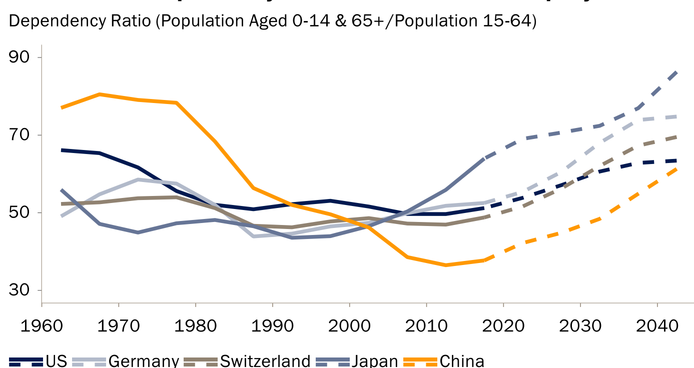
Persistent strength would imply that the structure of the economy has fundamentally changed

One possible answer is that the structure of the word economy has fundamentally changed to one with a lower sensitivity to tighter monetary policy. This would imply that the neutral interest rate, the equilibrium rate that balances the world's desire to save and to invest, has risen significantly. As a result, the economy would require much higher policy rates to slow down to potential growth.

The global economy has changed in some aspects. Adverse demographic trends suggest that the labour market will remain structurally tighter

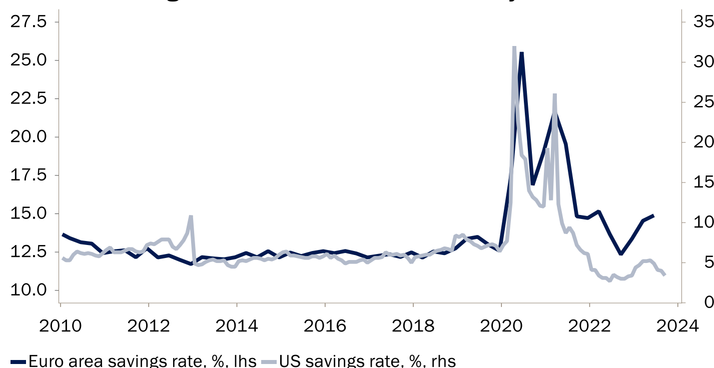
Important structural changes have indeed been ongoing under the surface for some time. It is becoming increasingly clear that the pandemic and acute geopolitical tensions have accelerated them. First demographics. True, this is nothing new. Dependency ratios troughed in the decade prior to the pandemic in major economies, according to UN estimates. They have risen for the past years and projections show that the ascension is set to continue (Exhibit 2). The pandemic has likely brought this trend to the fore. Companies have been scarred by the inability to re-hire enough workers after the pandemic. Looking ahead, they are probably less inclined to let go of their staff as rapidly as they used to, since labour scarcity will only get worse. In the US, many workers aged 55+ have left the labour force since the pandemic. So far, they have shown little inclination to come back. But if job security has risen for those in the labour force, households might not have to save as much as in the past. The savings ratio therefore might be structurally lower and the marginal propensity to consume higher (Exhibit 3).

Exhibit 2: The dependency ratio is set to increase rapidly



Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

Exhibit 3: Savings rates could remain structurally lower



Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

AI should boost productivity growth

One way to deal with labour scarcity would be to boost labour productivity. Recent advances in Artificial Intelligence (AI) are therefore encouraging. But AI could also contribute in raising the neutral rate. Indeed, when people expect their real wage to rise over time, they have less need to save today. Companies expecting higher sales could become keener to invest too.

Governments will need to spend a lot more in the future

Another fundamental change that the last two years have brought to light is the return of the so-called 'big government'. Russia's invasion of Ukraine has put an end to the post-cold war peace dividend. Western nations will need to spend and invest several additional percentage points of GDP over the coming years to rebuild their armies and their military-industrial complex. Bringing strategic industries closer to home, 'de-risking' supply chains as well as investing for the green transition will also require a huge amount of public and private investment. The IMF calculates that annual bill for governments to pay for all of this will amount to about 7.5% of rich countries' GDP in the coming decade.

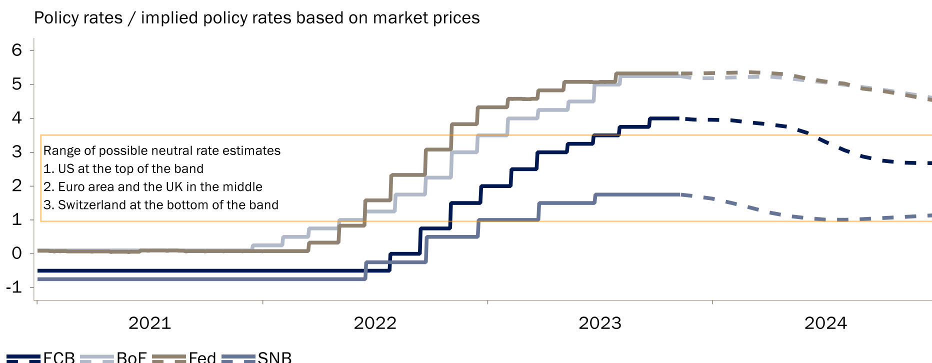
All of this should lead to a higher neutral rate

Fewer savings and much larger investment needs suggest that the multi-decade downward trend in the equilibrium neutral rate has likely ended. What is much more uncertain is the extent to which this unobservable variable has risen.

But the policy stance is still tight even if we assume a higher neutral rate

Fed officials are inclined to believe that in the US, the short-term neutral rate might be around ½ percentage point higher than a few years ago. Our best guess is that the neutral policy rate across all major advanced economies has risen by the same amount, given that a lot of the forces that we describe above are global. Even if we were to assume that it has risen by twice as much, the stance of monetary policy, the difference between the policy rate and the neutral rate, would still be historically tight (Exhibit 4).

Exhibit 4: Monetary policy is tight even with a higher neutral rate



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

So, the resilience of the global economy in 2023 largely rested on transitory factors. We see three:

If the ongoing structural changes are not the main force behind the ongoing resilience of the global economy, other transitory factors must be behind that relative strength. In the case of the US, a big and unexpected fiscal expansion directly supported growth. A further unwinding of pandemic-related distortions to demand and supply also played an important role in boosting world economic activity and reducing inflationary pressures. These forces have largely run their course, in our view. This means that the outlook for the economy largely depends on the lags between past monetary tightening and economic activity. Let's explore these different dynamics in more details below:

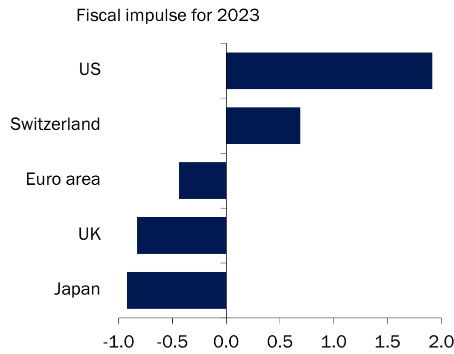
(i) A much looser-than-expected US fiscal stance

In its latest Fiscal Monitor, the IMF revised up considerably its 2023 estimate for the US primary deficit to 5.5%, from 3.8%. The fiscal impulse for the country in 2023 (what discretionary fiscal policy has likely added to GDP) amounts to 1.9%. In most other advanced economies, it is negative. The US numbers don't even consider the tax credits, subsidies and other incentives imbedded in the Inflation Reduction Act (IRA) and the CHIPS Act designed to attract investment on US soil in battery and semi-conductor factories. The rise in construction spending on manufacturing structures this year has been impressive, and probably added about ½ percentage point to GDP (Exhibits 5-7).

The US fiscal stance in 2024 is likely to be neutral, at best

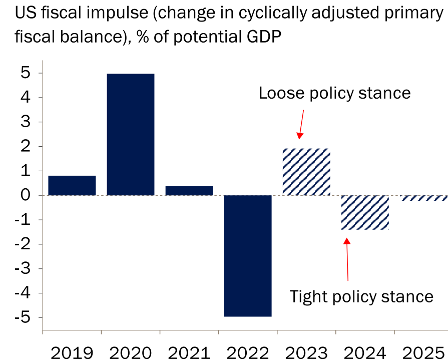
The Fed's own indicator of financial conditions suggests that its monetary stance probably chipped away 1 to 1.5% from GDP this year, thus not enough to offset the 2 to 2.5% fiscal boost. Looking into 2024, both the IMF and the Congressional Budget Office expect the impulse to turn negative. The White House has some leeway to delay this expected fiscal consolidation. But the historically high deficit and rising interest rate expenses most likely imply that this leeway will be constrained. Further flows into manufacturing structures are expected to persist. But for growth, what matters is the rate of change in those flows. Given the almost exponential increase this year, it is hard to imagine that they can strengthen significantly from current levels (Exhibit 7).

Exhibit 5: US fiscal exceptionalism



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 6: US fiscal impulse to turn negative



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

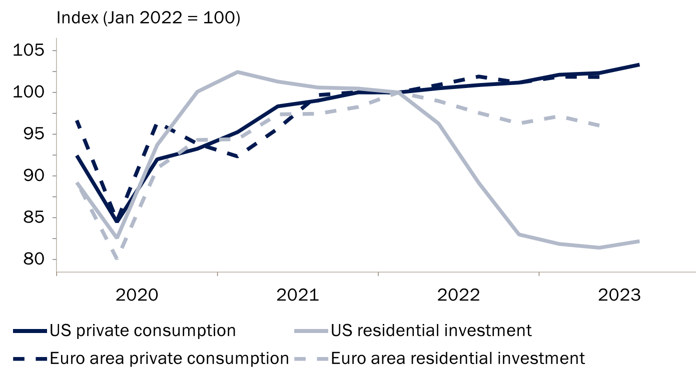
Exhibit 7: IRA and CHIPS Act in action

Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

(ii) A rebalancing of demand away from credit-sensitive sectors has muted the impact of higher interest rates

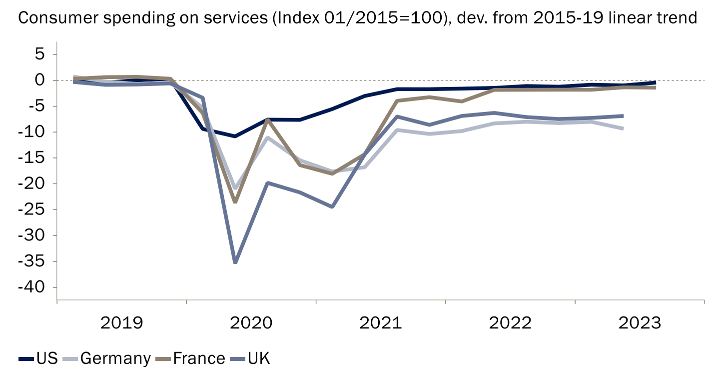
The rebalancing of demand also appears to have muted the impact of tighter monetary policy and weaker credit flows on growth, both in the US and Europe. The release of pent-up demand for services, such as concerts, dining out and travelling, has meant that consumer spending has remained relatively resilient. In contrast, activity in credit-sensitive sectors, such as housing, contracted in the previous 18 months (Exhibit 8). While consumer appetite for services appears to remain relatively large, the level of spending is back to its pre-pandemic trend in the US and some European countries. This suggests that the potential catch up, or 'revenge spending', on experience is more limited over the coming quarters (Exhibit 9). High financial costs have also sapped consumers' appetite to buy durable goods over the coming year, according to surveys on both sides of the Atlantic.

Exhibit 8: Investment fell but consumer spending was resilient



Source: Macrobond, Bank J. Safra Sarasin, 09.11.2023

Exhibit 9: Pent-up demand for services has shrunk



Source: Macrobond, Bank J. Safra Sarasin, 09.11.2023

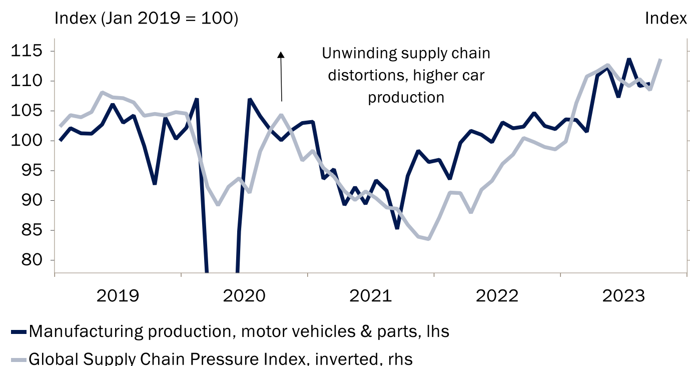
(iii) An unwinding of supply-side constraints

Finally, the unwinding of pandemic-related supply constraints and the decline in energy prices have helped boost supply this year and reduce inflationary pressures. The car industry is a good example, where production both in the US and Germany have tracked the New York Fed global supply chain pressure index (Exhibit 10). But with the index back at its historical lows, the supply-side of the economy has already largely normalised. In short, there is no huge amount of additional pent-up supply to be released.

The normalisation process of the economy is also reflected in relative price changes

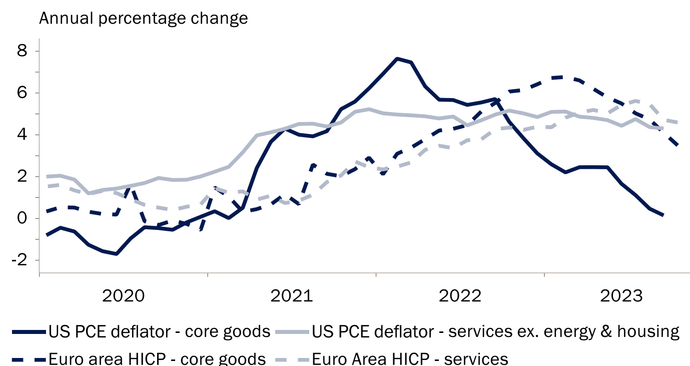
These trends are visible in price dynamics, too. The combination of stronger supply and the normalisation of consumer spending shifting back towards services has led to a sharp drop in goods inflation this year, but pushed up services inflation in all major advanced economies (Exhibit 11).

Exhibit 10: Unwinding of supply constraints boosted activity



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 11: Price dynamics reflect a normalisation of the economy



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

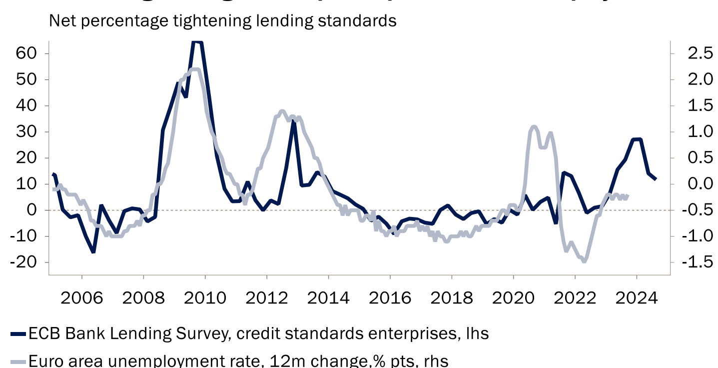
The standard sequence of events following a tightening of credit supply still appears to be holding up

If the lagged effects of past tightening are still to feed through in their entirety, aggregate demand should deteriorate once the economy has fully normalised. There tends to be a standard sequence of events that follows a tightening of loan or credit supply: first, marginal borrowers have trouble rolling over credit; second, signs of credit stress emerge, including higher delinquency rates and corporate bankruptcies; finally, those pressures feed into weaker demand and a softer labour market. That sequence still appears to be holding up. Corporate bankruptcies in America are on course to hit their highest level since 2010. Insolvencies have already reached a post-financial crisis high in the UK and have surged in the euro area. What's more, delinquency rates are rising on auto loans and credit cards. Even a softening labour market looks consistent with the normal lags between tightening credit conditions and a weaker economy (Exhibits 12 and 13).

Exhibit 12: Tighter lending standards to push up US unemployment

Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 13: Tightening also to push up euro area unemployment



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Unemployment should rise as demand slows, but probably less than in previous cycles

The growth outlook in the US and Europe thus depends, to a large extent, on the degree to which unemployment will increase. Indeed, economists typically describe recessions as non-linear events as a rise in unemployment leads to less spending, more bankruptcies, new rounds of lay-offs and so forth. But as we argue above, if companies have become more concerned with a structurally tighter labour market, they might be more hesitant to lay off workers. This concern could be more pronounced in the euro area, where demographic trends are the most adverse and labour markets rather inflexible.

There are plenty of signs suggesting the US labour market might not be as strong as generally perceived

In the US, the pace of net job growth, as measured by payrolls has declined significantly over the last two years, and has recently fallen into the range where it's mostly just keeping up with population growth. The surge in quits rate has ended, while the hiring rate has

declined substantially and is back to its pre-pandemic average. Early indicators, such as payrolls growth in temporary help service have turned negative (Exhibit 14). Slowing job and wage growth means that aggregate labour income has decelerated substantially and is now close to its pre-pandemic average. Finally, firms' hiring plans have fallen steadily over the last few years. Importantly, the unemployment rate, which is based on the household survey, has already increased by 40bp from its trough to 3.9% in October. Historically, whenever the 3-month moving average of the unemployment rate rose by more than 50bp above its 12-month rolling through, unemployment shot up, precipitating the economy into recession (Exhibit 15).

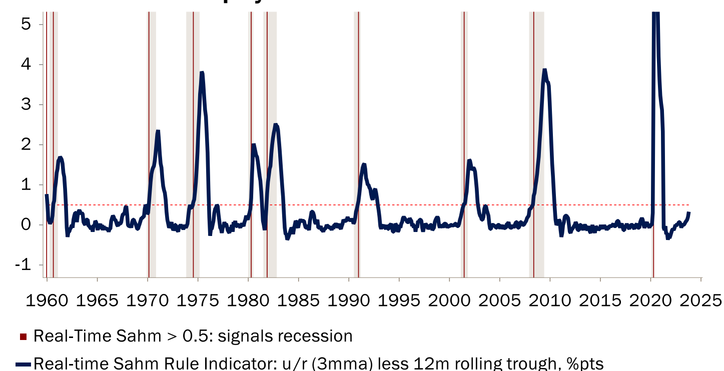
We expect the US to fall in a mild recession around the middle of next year

We expect US growth to slow materially over the coming quarters and the economy to fall into a mild recession around the middle of 2024. The recovery that we anticipate to start in the final quarter of the year is likely to be relatively slow too. US economic activity should expand by 1% in 2024 and 1.4% in 2025.

Exhibit 14: US employment growth has weakened

Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 15: US unemployment rate could soon cross a threshold



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

The euro area is likely to stay in stagflation

In the euro area, a lack of workers remains a key factor limiting production, despite weaker demand. This goes a long way towards explaining why the unemployment rate has trended lower over the past year. A structurally tighter labour market should prevent unemployment from shooting up. In addition, the drop in headline inflation and positive real wage growth should support consumption somewhat next year (Exhibit 16). These are important reasons underlying our view that the bloc might see a prolonged period of very weak growth rather than a more abrupt but perhaps shorter period of economic contraction. If our forecasts turn out to be correct, the economy will have expanded at a sub-trend pace for eight consecutive quarters. But despite these structural concerns, the unemployment rate will most probably increase further in the coming months, opening some slack in the economy. We expect GDP growth to average 0.8% in 2024 and 1% in 2025. Besides weak growth we are worried about the material increase in bond yields that will increase governments' interest expenses significantly over the coming years. As pension, defence and infrastructure spending will need to increase as well, fiscal sustainability is likely to become more challenging for some highly indebted countries.

The Swiss economy should remain weak at least through to the middle of next year

Switzerland's GDP growth is likely to remain weak at least through the middle of next year. Private consumption should remain subdued on the back of higher administered prices that push up inflation rates above 2% again and a weaker labour market. Unemployment has already started to rise, reflecting greater flexibility and perhaps less adverse demographic trends, and is likely to pick up further (Exhibit 17). With growth in the rest of Europe and in China expected to remain weak, alongside the strong Swiss franc, the external

sector is unlikely to provide much of a lift. GDP will expand by 0.8% in 2024 and 1% in 2025, in our view.

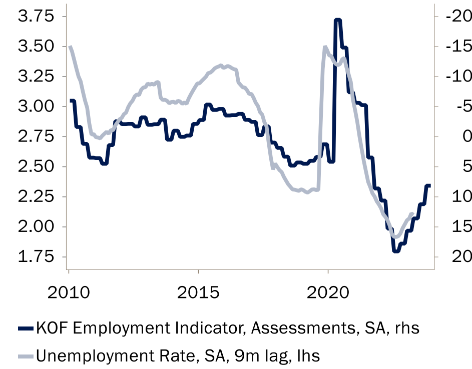
Residential investment should depress UK GDP growth in 2024

Finally, there are more signs in the UK that sluggish growth over the past year is feeding through to the labour market. According to the latest Bank of England (BoE)'s Decision Maker Panel survey, recruitment difficulties were either normal or easier than usual for about half of the companies surveyed. In contrast, at the start of the year between 70% and 80% of companies struggled to hire staff. BoE staff estimates that only about half of the impact of the cumulative tightening on GDP has been felt to date. Residential investment is likely to be particularly weak next year (Exhibit 18). We expect the economy to largely move sideways over the coming quarters. GDP growth should average 0.2% in 2024 and 1% in 2025.

Exhibit 16: Real wages to support activity

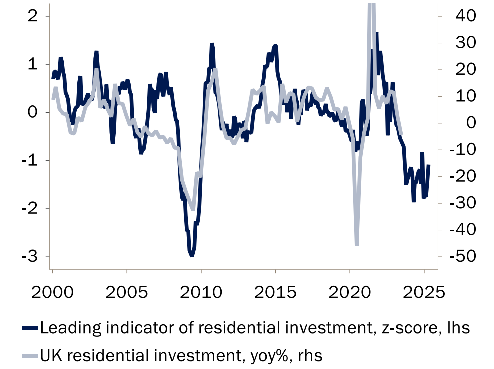
Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 17: Swiss unemployment is going up



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 18: UK investment to contract



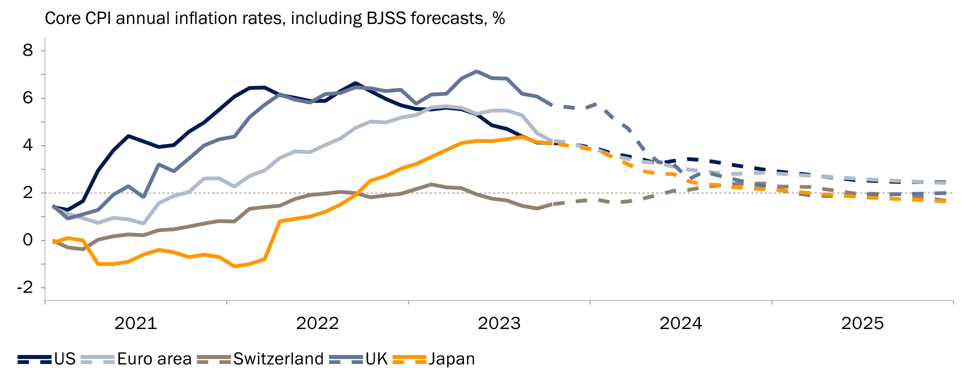
Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

We expect core inflation to trend down in Europe and the US next year

Weak economic growth and a further rise in unemployment in 2024 should open up some economic slack and weigh on inflation in the US and Europe. We expect wage growth and core inflation to trend down over the coming two years (Exhibit 19). Still, inflation is unlikely to move down in a straight line and will most likely be bumpy. Geopolitical tensions, and a potential rise in the oil price is an important risk to our view.

Exhibit 19: Core inflation rates should trend down over our forecast horizon

Core CPI annual inflation rates, including BJSS forecasts, %



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Japan's economy stands out, as it is largely catching up

The one economy that stands out in our forecasts is Japan. This shouldn't come as a surprise. While all major central banks have tightened policy aggressively over the past 18 months, the Bank of Japan (BoJ) has kept its policy stance extremely accommodative. This has led to a sharp depreciation of the yen, boosting net exports. We expect GDP to grow

again above its trend rate in 2024, at 0.9%, following a likely very strong expansion in 2023 (1.9%). This reflects still-loose monetary policy, continued fiscal support to offset the negative impact from higher energy prices and a likely big increase in wages following the next round of wage negotiations in spring. As a result, we expect Japan's inflation to remain relatively sticky next year, and above the BoJ's 2% target.

Major central banks should keep rates unchanged until 3Q24, then loosen policy only gradually. The BoJ should lift its policy rate in spring

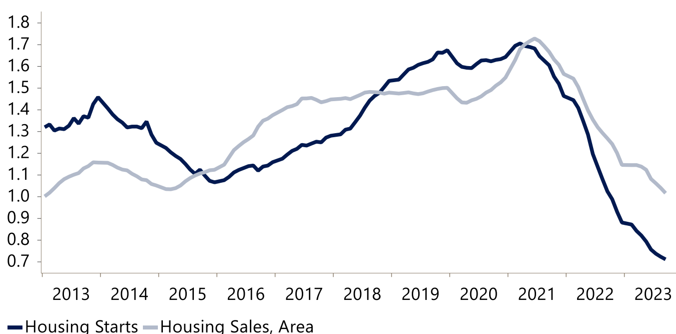
So, what are central banks likely to do? In our view, all the major ones have probably reached the end of their hiking cycle. Financial conditions have tightened significantly in the past few months, and all share the view that the peak impact of past monetary tightening still lies ahead. Still, we expect them to keep a hawkish bias and to wait for plenty of evidence pointing to a sustained return of inflation to 2% before cutting rates. We anticipate the first rate cuts to take place in third quarter of next year. But central banks will probably ease policy rates more gradually than in the past as underlying inflationary pressures are likely to be more persistent. Finally, we anticipate the BoJ to end negative interest rate policy in spring next year, and to gradually lift its policy rate to 0.3% by year end. The 'Shunto' wage negotiations should be the key trigger, confirming that inflationary pressures are more ingrained and that the deflationary mindset has ended.

The Chinese economy will be driven by policy support, services consumption and the housing decline

In China, we expect the economy in 2024 to be driven by policy support and services consumption, and still be dragged by the weak housing market. While the housing decline will continue to weigh on growth and dampen overall sentiment, the drag should be less than this year's (Exhibit 20). China's credit impulse has already turned positive in the third quarter and should underpin investment activity in the coming quarters. The government's decision to increase the central government's deficit by around 1 percentage point of GDP and to frontload local government bond issuance sends a clear signal that it is committed to stabilise near-term growth. We expect 2024 annual growth to decline to 4.5% from 5.2% this year (Exhibit 21). On the domestic side, the risk that poor overall sentiment could lead to a more severe housing decline remains. Further policy support will be needed if the government wants to set a growth target of "around 5%", similar to this year. Potential growth over the next 2-3 years is set to decline to close to 4%.

Exhibit 20: Housing sales to bottom out at the end of 2023

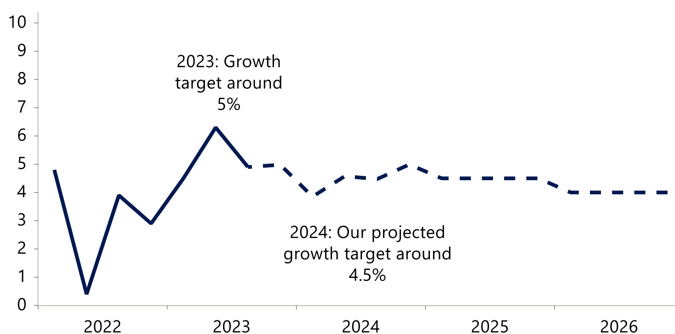
China, Residential Floor Space Sales and Starts, Sqm Billion, 12-Month Rolling Sum



Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

Exhibit 21: Policy support and service consumption to drive activity

China, GDP Growth, BJSS Forecast, % yoy



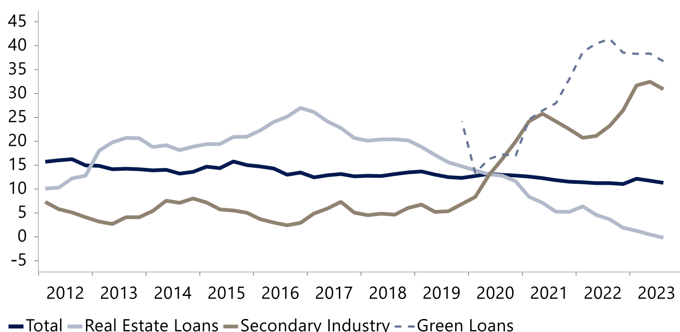
Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

Risks to growth beyond a sharper housing decline include weaker global demand and more trade tensions

China's latest fiscal expansion to finance infrastructure investment like the reconstruction of the flooded areas also suggests that Chinese policymakers continue to prefer to drive domestic demand through investment rather than through consumption, which would require deeper tax cuts and social welfare reforms. Resource reallocation away from real estate has gone into strategic manufacturing sectors (Exhibit 22). Without enough domestic demand to absorb these products, China needs to rely on external demand. Indeed, China's trade balance has risen again since the pandemic and is now around $800 billion

annually or about 5% of GDP (Exhibit 23). This is likely not sustainable given the currently inward-looking political climate around the world. The 2018 US-China trade war came after the last peak of China's trade balance in 2016, and during China's last housing downturn.

Exhibit 22: Credit has shifted from real estate to manufacturing



Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

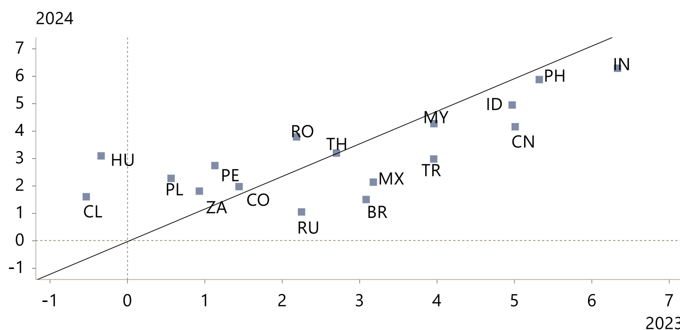
Exhibit 23: Large trade surpluses are not politically sustainable

Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

EM growth to slow and disinflation to continue

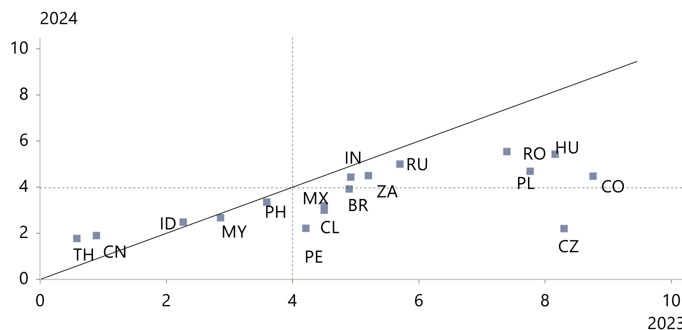
Growth is also set to slow in major Emerging Markets (EM) economies in 2024 due to tight financial conditions and weaker global demand (Exhibit 24). But China's growth stabilisation and the improvement of the global tech cycle are two important supporting factors. Inflation in EMs should continue its downward trend as slack increases and supply-side pressures wane in general, but there is a large variation among EMs (Exhibit 25). Some EMs have already achieved their central bank targets (such as Indonesia and Thailand). Some EMs that experienced high inflation in the past year (such as Colombia and Hungary) will take some time to re-anchor inflation expectations even if their economies have slowed significantly. Other EMs (such as Mexico and Poland) expect a positive fiscal impulse next year which could prolong higher-than-target inflation expectations. For others, higher food and/or energy prices (such as in the Philippines and South Africa) could still push up headline inflation and generate a second-round effect.

Exhibit 24: Growth is set to slow next year in most EMs



Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

Exhibit 25: Inflation to remain above targets for some EMs



Source: Macrobond, Bank J. Safra Sarasin, 07.11.2023

EM central banks are more cautious with regard to easing policy

The Fed's higher-for-longer narrative has made EM central banks more cautious in lowering their policy rates. External stability concerns have come to the forefront as capital flows out of EMs. Central banks in Asia, where interest rate differentials with the Fed are the lowest, have had to resort to hiking interest rates further (Indonesia and the Philippines) and/or to intervening in FX markets and tighten domestic liquidity. They will likely

stay on hold and wait for the Fed's first cut. In Latin America, where interest rates are most elevated, central banks have become more vigilant of adverse global financial conditions. We can see this through Brazil's latest minutes of the Monetary Policy Committee (MPC) and Chile's reduced pace of policy rate cuts at its most recent MPC meeting. We expect the monetary policy stance in EMs to remain relatively tight through 2024.

Fixed income

2024 fixed income outlook is constructive

We have a constructive outlook for the fixed income asset class for 2024 and into 2025. Our view is based on the sharp repricing in developed markets' (DM) rates structures over the past 18 months, which culminated in a rapid and large increase in DM long-term real yields in the 3rd quarter of 2023. While this latest rise in long-term yields has led to meagre returns year-to-date, it further strengthens the constructive case for fixed income. In particular, we would highlight the following points:

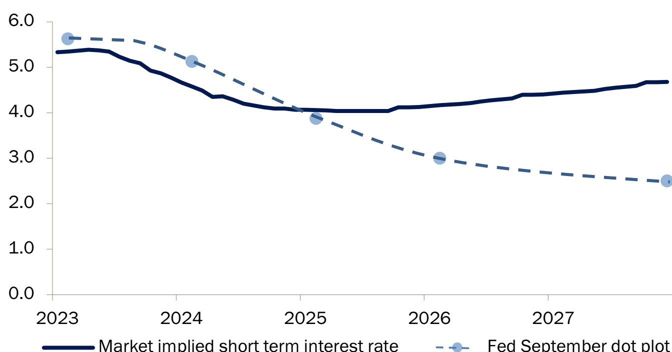
1. Valuations look attractive

While forward markets priced hardly any rate hikes by developed markets' central banks in August 2020, market expectations have now flipped to the other extreme, with hardly any rate cuts being priced. The US implied Fed Funds rate market is a case in point: It prices the rate to trough at above 4% in this cycle and to rise again thereafter (Exhibit 26). Clearly, this pricing is not consistent with a meaningful economic slowdown, let alone a recession. The pricing is also inconsistent with the Fed's estimate of a 2.5% to 3% nominal neutral interest rate. Moreover, we note that developed markets' long-term real yields, as measured by inflation-linked government bond markets, are now at or above estimates of long-run potential real growth rates (Exhibit 27).

2. The monetary policy stance looks tight

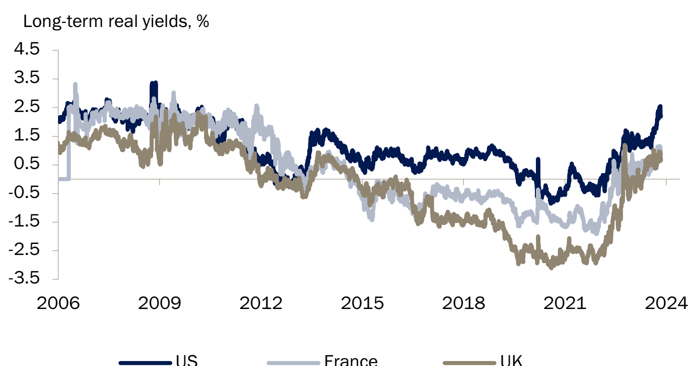
The monetary stance of developed markets' central banks is likely already tight. Again, the US is a case in point: US 10-year real yields, as measured by the inflation-linked market, are at their highest level relative to the Fed's estimate of the real neutral interest rate since 2007 (Exhibit 28). Sharply tightening lending standards, much weaker credit creation and rising delinquency rates on consumer and car loans clearly support the notion that the monetary stance is starting to bite in the US.

Exhibit 26: Markets do not price a meaningful rate cut cycle



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 27: Real yields at or above most estimates of potential growth



Source: Bloomberg, Bank J. Safra Sarasin, 08.11.2023

3. Tighter monetary conditions will likely be felt increasingly over the coming quarters

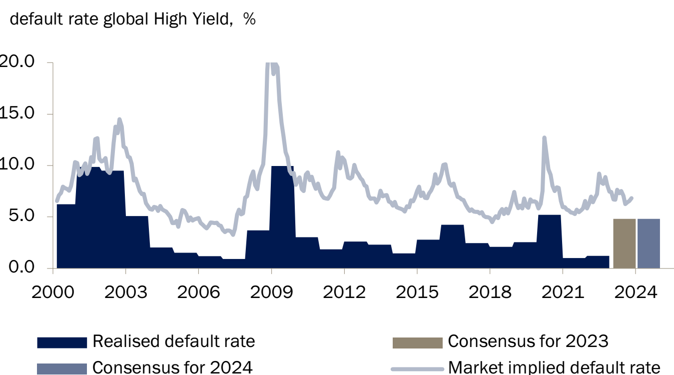
The US economy has proven much more resilient to higher rates so far than anticipated. Nevertheless, we expect the cumulative effects of tighter policy to become more evident in the US over coming quarters as fiscal support could turn into a drag next year. In the euro area and the UK, where fiscal support has been less prominent in 2023, the impact

of tighter policy is already much more visible. Increasingly, the market's focus will shift from inflation to concerns about the negative effects of higher rates.

Exhibit 28: US monetary policy is likely already tight

Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 29: A rise in default rates usually leads to spread widening



Source: Bloomberg, Bank J. Safra Sarasin, 08.11.2023

Credit spreads are below their historical median, Investment Grade will likely do better than High Yield

Credit spreads of Investment Grade (IG) and High Yield bonds both trade below historical medians. This implies that spreads do not reflect the risk of a substantial economic slowdown, let alone a recession. As an example, consensus expectations are looking for default rates of around 4.5% both in 2024 and in 2025, a sharp increase from 2022 and 2023. Sharp rises in default rates have usually been accompanied by a more meaningful widening in spreads (Exhibit 29). The recent rapid increase in long-term real government bond yields will likely tighten financial conditions further, raising the risk of more pronounced economic weakness than markets currently anticipate. Therefore, we retain our preference for IG over High Yield and would generally stick to higher quality.

Intermediate maturities should do well over the next 6 to 12 months, with limited downside risk

We expect lower nominal yields over the next 6 to 12 months in almost all developed currency spaces, with a more benign steepening of the yield curve. Intermediate maturities (5- to 7-year) are to be preferred: (1) they benefit from steeper yield curves, (2) they have enough duration to profit from lower yields, and (3) current yields give significant downside protection in an adverse yield scenario (Exhibit 30).

Exhibit 30: Attractive yields provide substantial cushion against adverse yield moves

			Break-even yield increase over horizon (bp)			Break-even yield over horizon (bp)		
	Duration	YTM (bp)	3m	6m	12m	3m	6m	12m
US Treasuries	5.7	489	22	45	94	5.11	5.34	5.82
US Aggregate	6.1	550	23	47	99	5.73	5.97	6.49
US Investment Grade	6.6	621	24	49	102	6.45	6.70	7.23
US High Yield	3.6	937	68	140	303	10.05	10.77	12.40
EU Treasuries	7.2	371	13	27	55	3.84	3.97	4.26
EU Aggregate	6.3	387	16	32	66	4.03	4.19	4.54
EU Investment Grade	4.6	470	26	54	116	4.96	5.24	5.85
EU High Yield	3.0	838	73	153	338	9.11	9.91	11.76
UK Gilts	8.6	467	14	28	58	4.81	4.95	5.25
UK Aggregate	7.7	506	17	34	71	5.23	5.40	5.77
UK Investment Grade	5.8	637	28	57	119	6.64	6.93	7.56
EM Corporate (CEMBI)	4.1	797	50	104	221	8.47	9.01	10.18
EM Sovereign (EMBIG)	6.4	908	36	74	154	9.44	9.82	10.62

Source: Bank J. Safra Sarasin, 08.11.2023

A sustained decline in US rates should lead to better performance of EM assets

Emerging markets (EM) asset prices have been driven by high and volatile US rates in the past few months. Once there is a sustained relief in the US rates market, for example the US labour market and macro data become consistently weaker, EM assets should look attractive again. Despite a slowdown in EM growth, the EM growth differential to

developed markets (DM), especially in EM Asia, remains high and carry remains attractive in many EMs (such as Brazil, Colombia, and Hungary). Moreover, China's improved outlook, especially for the first half of 2024 when its fiscal expansion should kick in, should help support commodity exporters as well as EM FX. We continue to prefer EM local currency bonds given sound fundamentals and our expectations that central banks (especially those with high policy rates such as in Brazil and Colombia) will continue or start their rate-cut cycle before the Fed. When considering local currency bonds, there are some selected country fiscal risks that could push bond yields up. There are concerns for example that Brazil's revenue targets for 2024 may not be met, while the large fiscal expansion in Mexico would keep its policy rate higher for longer. In addition, weak revenues in South Africa will remain a concern for 2024. While EM USD credit should also gain once US rates ease, we could see another round of increase in credit spreads, especially among weaker credit, as global growth slows and financial conditions remain tight.

FX

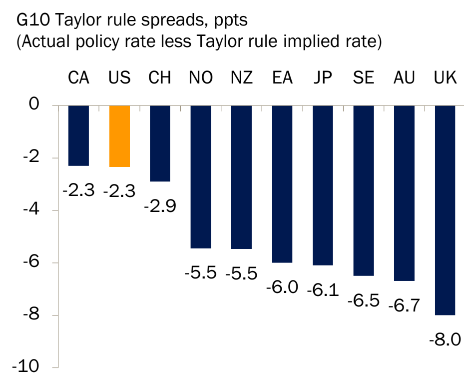
Three FX themes for 2024

In spite of some recent softness, the US dollar continues to be highly valued versus most G10 currencies. This largely reflects the Fed's comparatively tight monetary policy indicated by the Taylor-rule implied policy rate spreads (Exhibit 31). In the coming year, we think that three major drivers will dominate FX dynamics: (1) a dovish shift in central bank policy, (2) elevated market uncertainty and (3) a moderate recovery of the euro area.

1. The advent of the Fed's first rate cut historically favours euro and Swiss franc. We expect the Japanese yen and gold to benefit most, while we are cautious on sterling

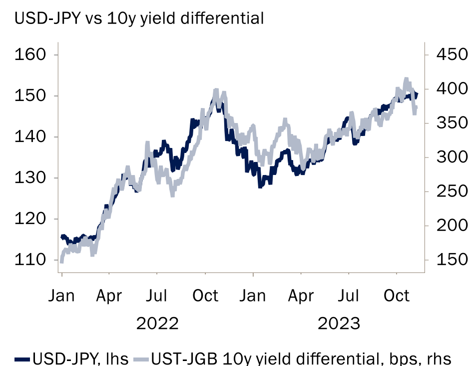
In 2024, we believe that depressed personal savings and the negative net fiscal impulse will lead to a more pronounced slowdown in US growth and eventually to a dovish shift in central bank policy. On average, the Fed's past five rate hiking cycles favoured both the euro and the Swiss franc in the months before and following the Fed's first rate cut. This time around, we believe that within G10 FX, the Japanese yen should perform particularly well against the US dollar once the Fed's rate cuts are in focus (Exhibit 32). The yen should also benefit from the end of the BoJ's yield curve control policy, which we expect for H1 2024. Though to a lesser degree, a dovish shift in the Fed's monetary policy stance should also help Scandinavian currencies to rebound, which have suffered heavily from the policy divergence between the Fed on the one side and the Riksbank as well as Norges Bank on the other. Perhaps most importantly, we expect gold to be the primary beneficiary from lower interest rates, given its high sensitivity to real yields. The precious metal's past negative correlation with the US 10y TIPS yield suggests that it could rise by around 15% in case real yields would drop by 100bps as we could see in the coming year (Exhibit 33). We remain cautious on sterling, given the relative weakness of the UK economy.

Exhibit 31: Taylor rule suggests that Fed's monetary policy is comparatively tight



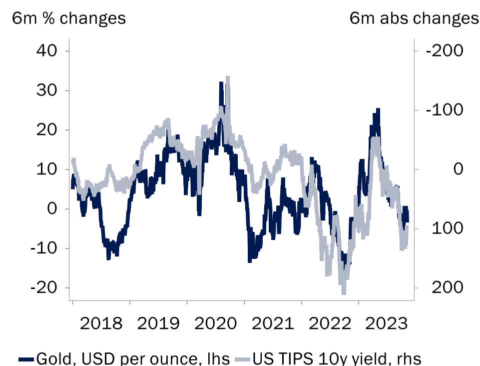
Source: Bloomberg, Bank J. Safra Sarasin, 08.11.2023

Exhibit 32: For the past 2 years, the USD-JPY pair correlated closely with carry



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 33: Lower US real yields would push gold markedly higher



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

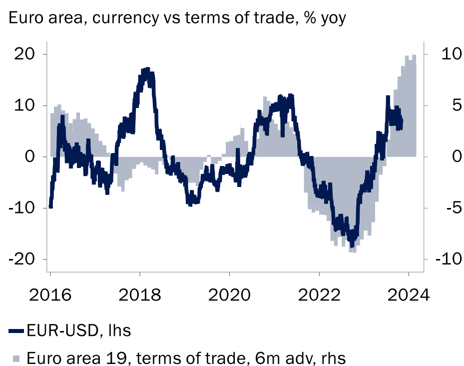
2. Elevated market uncertainty to support safe havens

More generally, we believe that market uncertainty is poised to remain high in 2024. In particular, the likelihood of a recession in the US and various sources of geopolitical uncertainty argue for a superior performance of safe haven currencies. Within G10 FX, we expect both the Swiss franc and the Japanese yen to demonstrate their relative edge once the slowdown of the US economy becomes more pronounced. Both currencies tend to behave very anti-cyclically and usually benefit on the back of lower US yields. With regard to geopolitical uncertainty, we note that gold reacts very sensitive to geopolitical threats (see last year's gold valuation framework) as does the Swiss franc, which should create temporary opportunities.

3. A moderate recovery of the euro area should spur a rebound of its currency

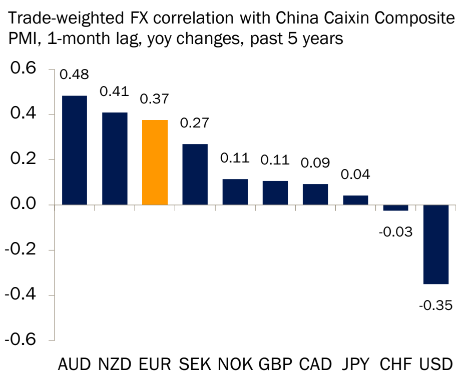
As a third key theme, we expect a moderate recovery in the euro area, which should support the euro in the coming year. First, the data indicate that last year's terms of trade shock has largely reversed. Indeed, relative price changes are looking much more favourable for the euro area and suggest that EUR-USD should be somewhat higher (Exhibit 34). Given that Chinese authorities recently demonstrated more willingness to support their domestic economy, we also expect Chinese growth to stabilise into the coming year. This should also support the euro on balance, along with the Australian and the New Zealand dollar (Exhibit 35). Lastly, we also expect higher real wages to support a pick-up in private consumption, which should additionally help to turn relative cyclical dynamics back in favour of the euro (Exhibit 36).

Exhibit 34: Terms of trade support the euro



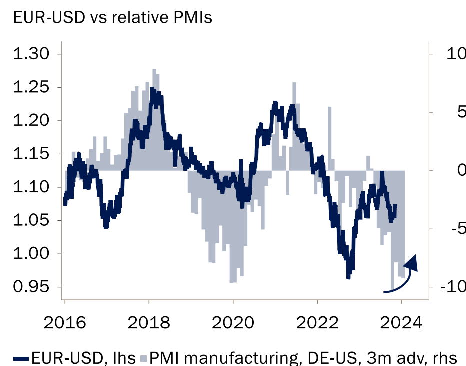
Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 35: Euro is sensitive to Chinese cycle



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Exhibit 36: Relative dynamics to favour euro



Source: Macrobond, Bank J. Safra Sarasin, 08.11.2023

Equities

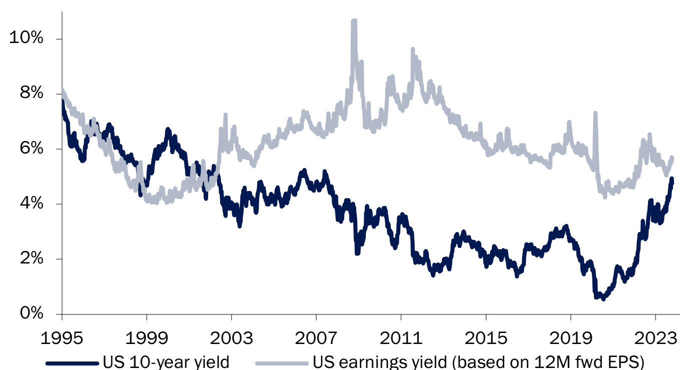
We remain cautious on the global equity market as we are approaching 2024. This view is predominantly a function of US valuations which are priced for a very favourable macro backdrop and, as such, are out of line with our own macro base case. Yet we think there are opportunities within the equity market while we continue to have a preference for fixed income. Hence, our ranking favours sectors that would benefit from lower rates. In terms of regions, the euro area market is looking more attractive after its recent underperformance and given that it may receive some support from a stabilising cycle in China. Apart from that, Swiss equities should benefit as rates headwinds are fading and Japanese equities may reverse some of their recent gains as the yen rebounds in a slowing global cycle.

US equities are priced for perfection

The US equity market remains priced for a very favourable economic backdrop. The premium that equity investors can earn relative to US Treasury bonds over the coming 12 months is at the lowest level in 20 years (Exhibit 37). At these levels, equities only appear attractive if GDP and earnings growth were to hold up and accelerate in the coming years.

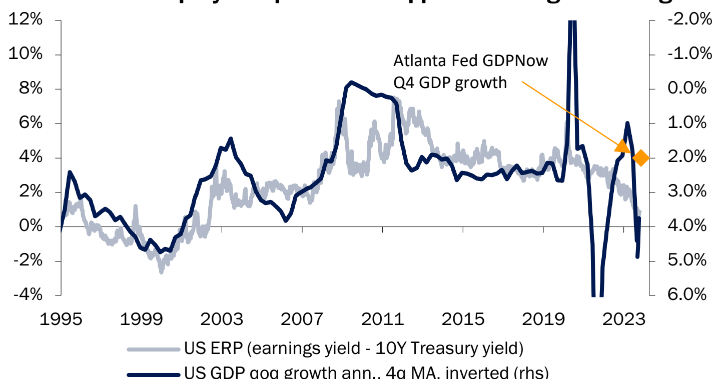
With US GDP growth increasing to almost 5% (annualised) in the third quarter, recession fears have completely faded and market pricing has recovered to levels only seen during the strongest of economic expansions in the past 30 years (Exhibit 38).

Exhibit 37: US equities return barely more than government bonds



Source: Refinitiv, Bank J. Safra Sarasin, 07.11.2023

Exhibit 38: US equity risk premium dropped as GDP growth surged



Source: Refinitiv, Bank J. Safra Sarasin, 07.11.2023

A slowing cycle requires a higher equity risk premium

This is not sustainable, in our view. The US economy is unlikely to keep on printing GDP growth rates of 3% to 4% in the coming quarters, rather than slowing to long-term average growth rates and potentially even entering a recession in mid-2024. Looking at the Atlanta Fed GDP growth tracker, which has been extremely accurate in projecting GDP growth at a very early stage in Q3, the normalisation in the cycle is already becoming visible. It is currently indicating that GDP growth should come in at around 2% in Q4, which would argue for an equity risk premium substantially above current levels.

In a slowdown, the equity risk premium will also be lifted by falling rates

However, an adjustment in the equity risk premium is unlikely to be driven by lower equity markets alone. If growth were to slow, a drop in yields would likely contribute to a normalisation in the equity risk premium. As regards the impact on the equity risk premium, a 100bp decline in the 10-year yield is roughly equivalent to a 10% to 15% decline in the equity index level. Thus, if growth were to slow back to 2.5% on a sustained basis, the equity risk premium would have to rise to 3% (see Exhibit 38). If yields decline by 150bp in such a scenario, the US equity market would have to drop by around 10% in order to bring the equity risk premium and GDP growth back into balance, according to their historical relationship.

US fixed income looks substantially more attractive than equities

The most obvious conclusion from these observations is a clear preference for fixed income. If US growth were to come down from its currently elevated level, as we expect to happen in 2024, the repricing potential in fixed income is substantial while the upside for equities would be very limited.

We prefer sectors which tend to benefit from lower rates, in particular defensive sectors with leverage

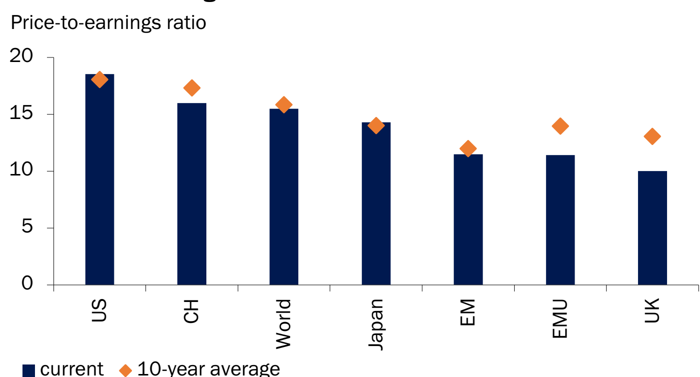
This has implications for our global sector preferences. We prefer sectors which usually benefit from a repricing in rates and hold up even if the cycle were to slow. These include typical defensive sectors such as staples and health care, but also the more levered part of the defensives universe, such as utilities and residential real estate.

Euro area equities are looking more attractive after the recent underperformance

With regard to our regional preferences, valuations provide a pretty clear message. Every region is more attractively valued than the US on 12-month forward PEs, and most regions are trading below their 10-year averages (Exhibit 39). This adds to a cyclical picture which has been substantially weaker in Europe and in Asia over the past year, implying that most markets apart from the US are priced for the macro weakness they are currently experiencing. We have upgraded euro area equities from a least preferred position, given that

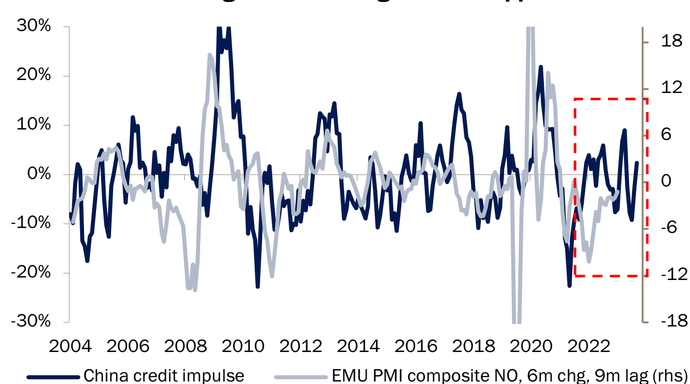
they are priced for a slowdown and as they may benefit substantially if China manages to revive its macro cycle. The most recent data at least suggests that a stabilisation is underway. The Chinese credit impulse has been fluctuating around the zero line for the past few months, which lends some support to the euro area. Typically, euro area PMIs follow the Chinese credit stimulus with a lag of around 9 months (Exhibit 40). This means, that even though there's substantial uncertainty over how the Chinese economy will look like in the future, recent efforts by the government to stabilise growth at 5% should have a positive short-term impact on growth in the euro area.

Exhibit 39: Most regions' valuations seem more attractive than US



Source: Refinitiv, Bank J. Safra Sarasin, 08.11.2023

Exhibit 40: Euro area growth should get some support from China



Source: Refinitiv, Bank J. Safra Sarasin, 08.11.2023

Swiss equities are one of our key regional preferences in 2024

Apart from that, we believe the Swiss market should do significantly better in 2024 than it has done in 2023, as rising rates are likely to be much less of a headwind and its defensive features will be a positive. Opposed to that, Japanese equities are likely to reverse some of the gains they have seen over recent months, which have largely been a result of the weakness in the yen. An end to the upside in US yields would also mean an end to yen weakness. Hence, a stronger yen should weigh on Japanese equities relative to the rest of the world in 2024.

J. Safra Sarasin Cross-Asset Weekly

10 November 2023

Exhibit 41: JSS Forecast overview

Breakdown per Asset Class

Equities Countries / Regions	
USA	→
Eurozone	→
Switzerland	↑
United Kingdom	↓
Japan	↓
Emerging Markets	→
China	→

Equity Sectors	
Energy	→
Materials	↓
Industrials	↓
Consumer Discretionary	→
Consumer Staples	↑
Health Care	↑
Banks	→
Insurance	→
Information Technology	→
Communication Services	→
Real Estate	↑
Utilities	↑

Fixed Income Performance	
US Treasuries	→
German Bunds	→
UK Gilts	→
Swiss Eidgenossen	→
IG Credit	→
HY Credit	↓
EM USD Government Bonds	↓

↑ **Overweight** → **Neutral** ↓ **Underweight**

Asset class views (overweight, neutral, underweight) express a tactical recommendation with a 3-month horizon. Tactical views might diverge from year-end stock index targets, which are based on our long-term economic and interest rate forecasts.

Stock Index Price Targets

	09.11.	2Q24	4Q24	4Q25
S&P 500	4’347	4’300	4’600	5’000
MSCI UK	2’140	2’050	2’200	2’320
DJ Euro Stoxx 50	4’229	4’200	4’350	4’600
DAX	15’353	15’100	16’400	17’700
SMI	10’645	10’800	11’300	12’300
MSCI Japan	1’430	1’380	1’470	1’550
MSCI EM	956	960	1’015	1’090
MSCI China	58	60	62	67

Key Policy Rates in %

	09.11.	2Q24	4Q24	4Q25
US Fed Funds	5.50	5.50	4.50	3.50
EUR Depo Rate	4.00	4.00	3.25	2.50
SNB Target Rate	1.75	1.75	1.25	1.00
BoE Base Rate	5.25	5.25	4.25	3.25
BOJ Policy Balance Rate	-0.10	0.00	0.30	0.60

Bond Yields (10yr Benchmark)

	09.11.	2Q24	4Q24	4Q25
USA	4.65	4.00	3.75	4.00
Germany	2.62	2.50	2.30	2.50
Switzerland	1.11	1.20	1.20	1.20
United Kingdom	4.36	4.30	4.10	3.50
Japan	0.84	1.10	1.10	1.10

FX-Forecasts

	09.11.	2Q24	4Q24	4Q25
EUR-CHF	0.97	0.95	0.93	0.93
EUR-USD	1.07	1.08	1.10	1.12
EUR-GBP	0.88	0.89	0.90	0.90
GBP-USD	1.22	1.22	1.22	1.24
USD-JPY	151	140	130	125
USD-CHF	0.90	0.88	0.85	0.83
USD-CNY	7.29	7.20	7.10	7.05
Gold, USD per ounce	1’960	1’990	2’050	2’100

Macro Forecasts

		2023	2024	2025
US	GDP	2.4	1.0	1.4
	CPI	4.2	2.8	2.2
Euroland	GDP	0.3	0.5	1.1
	CPI	5.5	2.6	2.3
Switzerland	GDP	0.7	0.8	1.0
	CPI	2.2	2.3	1.9
UK	GDP	0.5	0.2	1.0
	CPI	7.3	3.1	2.0
Japan	GDP	1.9	0.9	0.8
	CPI	3.2	2.3	1.8
China	GDP	5.2	4.5	4.5
	CPI	0.4	1.6	2.4

Economic Calendar

Week of 13/11 – 17/11/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 13.11.2023						
JN	00:50	PPI MoM	Oct	mom	0.00%	-0.30%
	00:50	PPI YoY	Oct	yoy	1.00%	2.00%
US	10:30	NY Fed 1-Yr Inflation Expectations	Oct	%	--	3.67%
Tuesday, 14.11.2023						
EU	11:00	ZEW Survey Expectations	Nov	Index	--	-1.10
	11:00	GDP SA QoQ	3Q P	qoq	--	-0.10%
	11:00	GDP SA YoY	3Q P	yoy	--	0.10%
US	12:00	NFIB Small Business Optimism	Oct	Index	--	90.80
	14:30	CPI Ex Food and Energy MoM	Oct	mom	0.30%	0.30%
	14:30	CPI Ex Food and Energy YoY	Oct	yoy	4.10%	4.10%
Wednesday, 15.11.2023						
UK	08:00	CPI YoY	Oct	yoy	--	6.70%
	08:00	CPI Core YoY	Oct	yoy	--	6.10%
US	13:00	MBA Mortgage Applications	Nov10	wow	--	2.50%
	14:30	Retail Sales Control Group	Oct	mom	0.10%	0.60%
	14:30	PPI Ex Food and Energy MoM	Oct	mom	0.30%	0.30%
	14:30	PPI Ex Food and Energy YoY	Oct	yoy	--	2.70%
	14:30	Empire Manufacturing	Nov	Index	-2.10	-4.60
Thursday, 16.11.2023						
US	14:30	Initial Jobless Claims	Nov11	1'000	--	--
	14:30	NY Fed Services Business Act.	Nov	Index	--	-19.10
	14:30	Phil. Fed Business Outlook	Nov	Index	-11.50	-9.00
	16:00	NAHB Housing Market Index	Nov	Index	40.00	40.00
	17:00	Kansas City Fed Manf. Activity	Nov	Index	--	-8.00
Friday, 17.11.2023						
UK	08:00	Retail Sales Ex Auto Fuel MoM	Oct	mom	--	-0.90%
	08:00	Retail Sales Ex Auto Fuel YoY	Oct	yoy	--	-1.00%
US	14:30	Building Permits	Oct	1'000	1450k	1473k
	14:30	Housing Starts	Oct	1'000	1350k	1358k
	17:00	Kansas City Fed Services Activity	Nov P	Index	--	-1.00

Source: Bloomberg, J. Safra Sarasin as of 09.11.2023

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W (bp)	Δ YTD (bp)	TR YTD in %
Swiss Eidgenosse 10 year (%)	1.14	1	-48	4.5
German Bund 10 year (%)	2.69	4	12	1.3
UK Gilt 10 year (%)	4.31	-19	64	-0.4
US Treasury 10 year (%)	4.60	3	73	-2.9
French OAT - Bund, spread (bp)	59	0	4	
Italian BTP - Bund, spread (bp)	187	1	-27	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	10'624	16.4	0.5	2.3
DAX - Germany	15'292	11.2	1.4	10.3
MSCI Italy	914	7.6	0.4	21.3
IBEX - Spain	9'412	9.9	1.6	18.8
DJ Euro Stoxx 50 - Eurozone	4'213	12.0	1.4	15.0
MSCI UK	2'140	10.6	0.3	3.3
S&P 500 - USA	4'347	20.1	0.7	14.8
Nasdaq 100 - USA	15'188	26.9	1.8	39.8
MSCI Emerging Markets	956	13.4	2.8	2.6

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.90	6.7	0.4	-2.3
EUR-CHF	0.96	5.1	0.0	-2.6
GBP-CHF	1.10	6.3	-0.8	-1.3
EUR-USD	1.07	6.7	-0.5	-0.3
GBP-USD	1.22	7.5	-1.2	1.2
USD-JPY	151.4	8.7	1.3	15.4
EUR-GBP	0.87	4.8	0.7	-1.4
EUR-SEK	11.65	6.7	-0.3	4.4
EUR-NOK	11.88	8.8	0.2	13.1

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	102	13.3	-2.1	-9.6
Brent crude oil - USD / barrel	83	32.9	-6.5	1.7
Gold bullion - USD / Troy ounce	1'957	14.2	-1.5	7.3

Source: J. Safra Sarasin, Bloomberg as of 09.11.2023

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