J. Safra Sarasin

Cross-Asset Weekly

17 March 2023

Tight policy exposes widening cracks in the system

We retain our cautious view on risk markets. Central banks in major advanced economies are determined to continue their fight against stubbornly high inflation rates despite increasing signs of stress in the banking system since the failure of Silicon Valley Bank. We do not expect a full-blown financial crisis, but one must not dismiss the underlying dynamics. Financial conditions will most likely tighten further and increase recession risks. We therefore advocate a defensive positioning with regard to risk assets and a tactically cautious stance on the banking sector, even though the constructive case for banks remains intact over the medium to longer term.

The ECB has hiked policy rates by 50bp and we expect the same from the SNB next week. The Fed is likely to hike the Funds rate by 25bp at their meeting on Wednesday, even though the cracks in the financial system are starting to appear. Central banks and regulators stand ready to ring-fence troubled lenders in order to prevent liquidity issues at individual institutions from becoming systemic. This is not without risks. Therefore, it doesn't come as a surprise that the Swiss Franc has strengthened markedly in the current environment. Finally, China is more immune to current turbulences. Activity data confirm a broad-based economic recovery as policy support has been stronger than expected.

This week's highlights

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US macro: Fed preview

The Fed can no longer have its cake and eat it

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The failure of several US regional banks has led investors to reassess sharply down their outlook for the Fed Funds rate, despite most macro data pointing to an overheated economy. Measures that were put in place last weekend to ensure that banks don't run out of liquidity should allow the Fed to 'free up' its policy rate for its inflation objective. At the same time, the existing monetary stance is set to have a bigger deflationary impulse than previously expected as banks will further tighten lending standards. Fed members are therefore unlikely to raise their terminal rate projection. Still, we expect another 25bp hike at next week's meeting, but also a strong hint that QT might end earlier.

In the past few days, financial markets have significantly repriced their outlook for the Fed

Runs on Silicon Valley Bank (SVB) and Signature Bank, and the failure of Silvergate Bank, in the space of 48 hours have significantly altered the investors' outlook for the Fed. Just last week, markets priced a terminal rate of around 5.75%, a 50bp rate rise at next week's FOMC meeting, and almost no cuts this year. The news at the time of writing of more troubles at Credit Suisse has led to another bout of panic, with European banks shares down about 15% over the past week, and bond markets pricing at some point almost 100bp of rate cuts by year end.

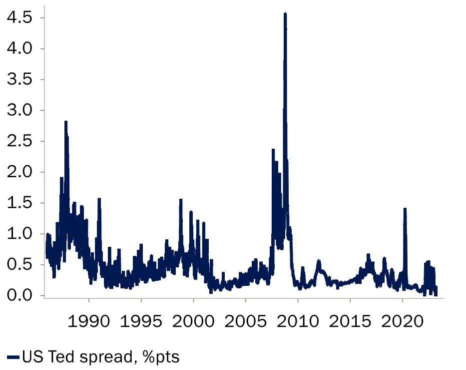
We continue to expect a 25bp rate hike on March 22, provided that the regional banking situation doesn't deteriorate much further

To say that the situation is highly volatile is probably a euphemism, and any forecast can quickly be overtaken by events. But provided that there are no more US regional bank runs between now and the FOMC meeting on March 21-22, the Fed is likely to hike by another 25bp, but also to hint that it's close to the end of its hiking cycle. The limited widening, so far, in the spread between the interbank rate and the Treasury bill yield (Ted spread, see Exhibit 1) points to the likelihood that this crisis of confidence is largely one of liquidity and not of solvency. In that case, the different plans put in place over the weekend (see Equity piece, p. 10) should succeed in ring-fencing regional banks and limit the deposit drain from them. Arguably, if global banking stress were to mount further, there would be a good chance that the Fed decides to pause at this meeting, in order to give itself time to assess the situation, but it would indicate that it's not yet done with tightening policy.

Fed likely to flag its QT program is under review. Its new macro projections might point to a weaker economic outlook

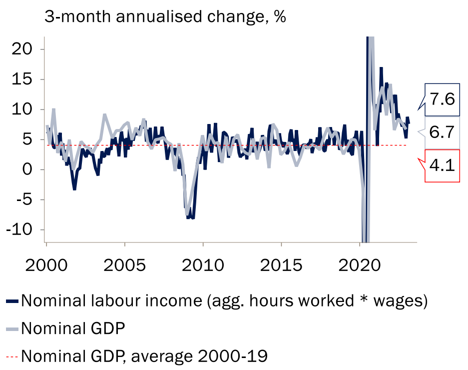
We also anticipate the Fed to flag an early end to QT. Finally, recent events reinforce our view that the US economy is likely to fall into recession in the latter part of the year. It will be hard, if not disingenuous, for the Fed not to show some deterioration in its GDP and unemployment forecasts in its new Summary of Economic Projections.

Exhibit 1: No sign yet of widespread stress



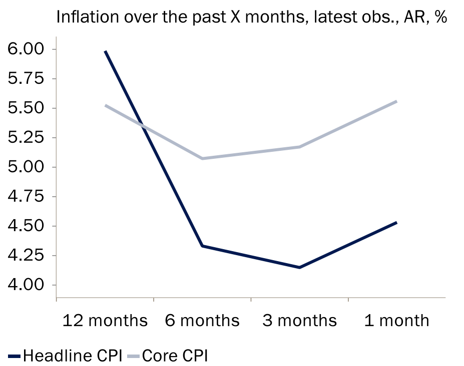
Source: Bloomberg, Bank J. Safra Sarasin, 15.03.2023

Exhibit 2: Too-strong labour income growth



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Exhibit 3: Disinflationary trend reversed



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Macro data continue to point to an overheated economy

Let's look into greater details at what has motivated our assessment. First, February macro data overwhelmingly point to an economy that is still overheated. The jobs report shows that nominal labour income is growing at an annual rate of close to 8%, twice as much as what's consistent with 4% nominal GDP growth rate (2% real GDP, 2% inflation) (Exhibit 2). The February CPI report shows that services inflation picked up further, and that any disinflationary trend that might have been visible a couple of months ago has disappeared (Exhibit 3). While headline retail sales fell last month, January numbers were revised higher. Core retail sales (excluding spending on cars, gasoline, building materials and food services), which are deemed to be a better measure of underlying consumer spending on goods, rose 0.5% mom (January number was revised up to 2.3%, from 1.7%). In short, consumer spending has reaccelerated in the first two months of the year, tallying with the rebound in labour income. The only piece of good news on the inflation front was the stronger-than-expected decline in producer prices, which means that the core PCE inflation print for February will probably come below its CPI counterpart.

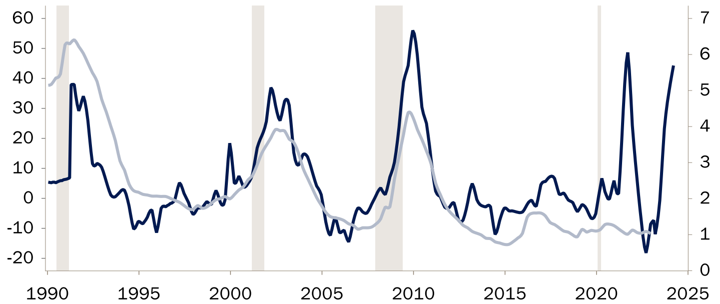
But Fed policy has started to 'break things'

At the same, the Fed is unlikely to treat these bank failures just as idiosyncratic events. True, they could be considered as 'special cases' due to the engrained vulnerabilities in their funding and business models (large asset-liability mismatches, deposits that were overwhelmingly uninsured, highly 'correlated' depositors and borrowers in the tech and crypto space). Still, these failures are the symptom of tight money, as well as the extremely rapid pace at which policy has been tightened over the past year. Put simply, these failures are an indication that the Fed is starting to 'break' things.

Lending standards are set to tighten further. Everything else equal, the Fed will need to do less than it previously thought to achieve the same objective

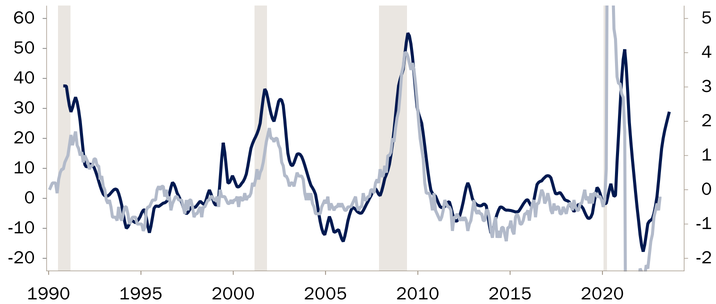
Moreover, lending standards are likely to tighten further. Everything else equal, the Fed would need to do less than it thought only two weeks ago in order to achieve the same objective. Bank funding costs will rise as they will need to pay more to attract deposits and to raise funds in wholesale and capital markets. The cost of the rescue of the uninsured deposits (>$250K) at these failed banks, and potential other ones further down the road, will be shouldered by the other lenders through increased insurance levies to the FDIC's Deposit Insurance Fund. A higher cost of capital and darker clouds looming above the economic outlook should act as a deflationary impulse to the real economy (Exhibits 4-5).

Exhibit 4: Lending standards will tighten further ...



Source: Macrobond, Bank J. Safra Sarasin, 16.03.2023

Exhibit 5: ... and lead to more economic pain



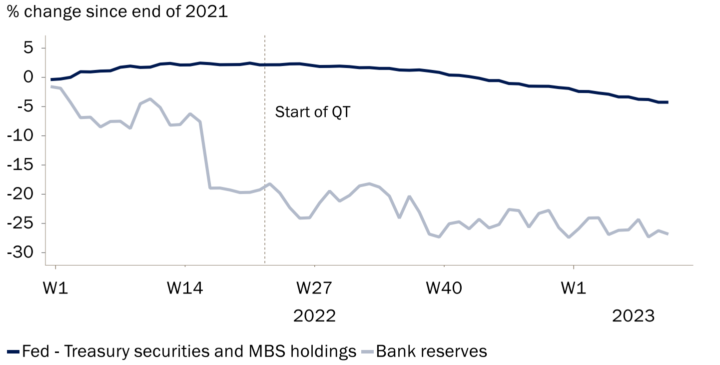
Source: Macrobond, Bank J. Safra Sarasin, 16.03.2023

Small and regional banks could struggle to stop the outflow of deposits, despite plans put in place by the Fed and the FDIC

Finally, pressure is likely to remain acute for small banks. While reserves in the banking system as a whole remain 'ample', this is not the case for small banks. In fact, they have fallen rapidly since the Fed started raising its policy rate rapidly and customers have shifted parts of their deposits into higher-yielding safe assets, such as Treasury bills. And QT has withdrawn additional reserves from the system (see "A closer look at Quantitative

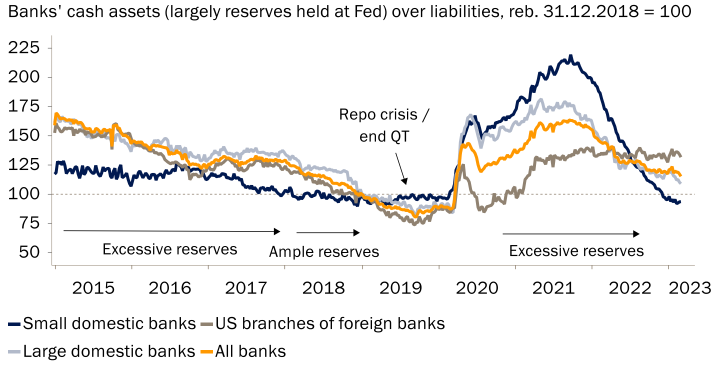
Tightening" – *Cross-Asset Weekly*, 18.11.2022). The Fed's new Bank Term Funding Program (BTFP) – which depository institutions can access to tap up-to-one-year loans against high-quality bonds as collateral, posted at par value – as well as the implicit guarantee of all bank deposits by the FDIC should support sentiment in the short term, and reduce any uninsured deposit flight. But there is no guarantee that deposits will not move outside the banking system or leave to larger banks.

Exhibit 6: Bank reserves have fallen by 25% since the end of 2021



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Exhibit 7: Small banks have seen a huge drop in deposits



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

The Fed to use its balance sheet to stem financial stability risks, and interest rates to address inflation

So what will the Fed do? Its new emergency facility was in part designed such that it could use its different tools in order to target its different objectives – financial stability on the one hand, and price stability on the other. By using its balance sheet to help contain banking stress, it frees up its interest rate tool to address inflation.

Fed will struggle to do QT and deal with bank funding stress at the same time

If we are right, the Fed is unlikely to persist with QT for much longer. Its new facility will create additional reserves in the banking system to avert funding stress, while QT removes reserves and deposits from the system. At best, doing both at the same time raises communication issues. At worst, it undermines the intended impact of each of the programs.

We expect the Fed to raise its policy rate by 25bp and to flag to review the wind-down of its QT program

The cleanest option would be for the FOMC to wind down its QT program, but to raise its policy rate a bit more. Pausing the fight now, or, worse, cutting rates before it has control over core inflation would possibly undermine investors' trust in the Fed's ability to return inflation back to 2%. Such a failure might then pave the way for a more permanent return of the inflation risk premium. We therefore expect the Fed to hike rate by 25bp next week, and to at least flag its intention review its QT program.

New Summary of Economic Projections is unlikely to show much of an increase in the Fed Funds terminal rate. But it might (and should) show that bringing down inflation requires slower growth and higher unemployment

As argued above, the expected rise in lending standards and the deterioration in credit conditions mean that its existing policy stance will have a bigger impact on the real economy than previously thought. As such, the new projections are unlikely to show a terminal rate that is much higher, if at all, than the one published in its December projections (5.125%). At the same time, the 2023 inflation projection is likely to be revised higher given revisions to past data and the recent hot numbers. But keeping the terminal rate unchanged while raising the inflation forecast would send the wrong signal, as it would flag that it's ready to let inflation run higher for longer. One way to square the circle would be to bring down the 4Q/4Q 2023 and 2024 GDP growth projection and raise its unemployment rate projection for 2024. As such, it would indicate that economic slack would eventually bring inflation back down towards the target. This would just simply recognise that its policy is having the intended effect, and that it involves making lenders nervous, loans expensive and businesses risk-averse. But this would also be an acknowledgement that the path towards a 'soft landing' that it has pushed forward is getting ever narrower.

Euro area macro: ECB meeting

ECB undeterred by market turbulences

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At today's press conference the ECB tried to foster confidence in both its willingness to fight inflation and in the stability of the European financial system. The ECB hiked its interest rates by 50bp today. It also indicated that its job fighting inflation is not done yet and that future rate hikes remain likely. However, instead of pre-announcing the number of future rate hikes, the ECB now follows a data-dependent approach for its policy decisions. It played down the notion that the recent turbulence has already tightened financing conditions. Instead, it reiterated its view that European banks are resilient, have solid capital and liquidity buffers, benefit from strong supervision in Europe and have limited exposure to critical US institutions. However, if required there are plenty of instruments and facilities which could quickly be activated.

Staying its course and injecting confidence

Injecting confidence appeared to be the main mission of the ECB today. President Lagarde confirmed that the interest hike by 50bp was supported by a very large majority of Governing Council (GC) members, with only three to four members arguing for a more cautious stance or delaying the decision. Thereby, the ECB left no doubt that fighting inflationary pressures is its main focus. Unfortunately, it cannot be said what the decision would have been without the ECB's pre-commitment to hike 50bp this time. Theoretically, a smaller rate hike could have been sufficient given the tightening of financial conditions that occurred as a result of the current market turbulences. Not taking the current market situation into account in its policy decision stands in contrast to President Lagarde's comments regarding the ECB's new staff projections. She seemed keen to play down their relevance as the cut-off day had been before the recent market turmoil. At least, the ECB confirmed that it would adopt a data-dependent approach in the future. It only indicated that its job isn't done yet. We consider two 25bp rate hikes in May and June as consistent with the ECB's communication and its macro scenario.

Plenty of instruments and tools would be available to support the financial sector if needed

President Lagarde and Vice President de Guindos stressed that financial stability and price stability are not two opposing goals. They stated that various instruments and facilities exist to support the financial sector and that ECB staff had shown their ability in past crisis to activate other tools timely. So far, however, the resilience of the banking system is considered to be strong, the capital and liquidity buffers are high, exposure to vulnerable US banks low and similarities to US banks' specific problems very limited.

New staff projections show
- GDP to be stronger this year and weaker in 2024 and 2025
- Headline inflation lower in 2023-2025
- Core inflationary pressure to be stronger this year but less persistent in the medium term

Exhibit 1: New and old ECB Macro projections

	2023		2024		2025	
ECB Macro projections in % yoy	*Dec 22*	*Mar 23*	*Dec 22*	*Mar 23*	*Dec 22*	*Mar 23*
GDP	0.5	1.0	1.9	1.6	1.8	1.6
Headline Inflation	6.3	5.3	3.4	2.9	2.3	2.1
Core inflation	4.2	4.6	2.8	2.5	2.4	2.2
Compensation per employee	5.2	5.3	4.5	4.4	3.9	3.6
Global growth ex euro area	2.6	3.0	3.1	3.2	3.3	3.3
Global trade ex euro area	1.9	2.5	3.3	3.4	3.3	3.4
Euro area foreign trade	1.2	2.1	3.0	3.1	3.1	3.3
Technical assumptions						
Oil price in USD	86.4	82.6	79.7	77.8	76.0	73.9
Natural gas price	123.6	58	98.4	61	68.9	51.0
Non-energy commodity prices	-10.8	-6.4	0.7	0.3	1.4	1.2
EUR-USD	1.03	1.08	1.03	1.08	1.03	1.1
Nominal effective exchange rate (EER42)	117.5	120.2	117.5	120.2	117.5	120.2

Source: Macrobond, Bank J. Safra Sarasin, 16.03.2023

Switzerland macro: SNB preview

We still expect a rate hike of 50bp

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The SNB will face a difficult situation next Thursday. It will have to balance the need to fight inflationary pressures that were stronger than anticipated in December with the one to preserve the stability of its financial system and its largest banks. We expect the SNB to separate these issues, which would argue for an interest rate hike and a willingness to provide additional liquidity lines if needed, similar to the approach the ECB adopted at its meeting this Thursday.

Tightening financial conditions while preserving financial stability is a delicate task

The SNB has an advantage compared to the ECB and Fed as it can monitor the market reaction to their interest rate decisions. Absent the current market turmoil, we would have expected a 50bp hike and a discussion on how much the SNB can fall behind the ECB with its rate hikes. We still expect a rate hike by 50bp, but the discussion more likely is on the fragilities in the Swiss banking sector and in particular within its largest banks. In general, we believe that central banks should be aware that the sharp increase of policy and market interest rates has reduced the fair value of many financial and real assets significantly. The losses the SNB had to report for last year makes this very transparent. It is less transparent in hold-to-maturity portfolios that are not necessarily marked to market. The SNB might be forced to comment which further safety measures it would consider if needed.

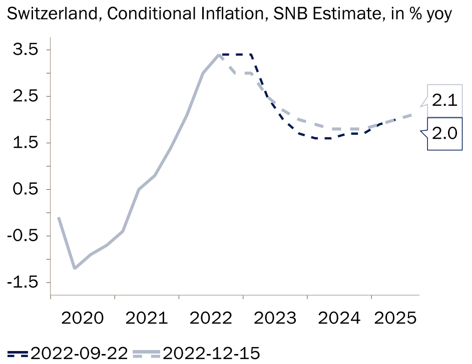
Growth assessment should be unchanged while risks have changed

In its monetary policy assessment, the SNB is likely to confirm its previous growth forecast of around 0.5% for this year. While some risks of its previous assessment did not materialise like energy shortages in Switzerland, risks for the global economy originating in the financial system might be considered to be higher this time. Additionally, the 0% GDP growth rate in Q4 2022 limits the carry-over effects from last year.

Inflation forecasts to show that more rate hikes are needed

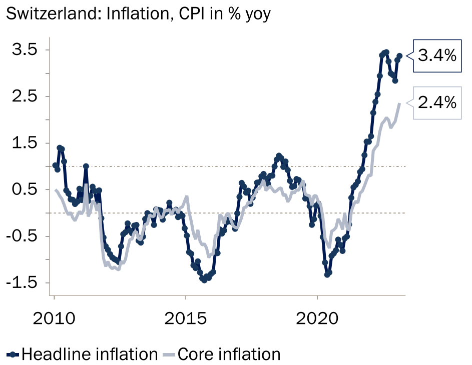
The SNB is likely to conclude that the inflation environment has not improved yet. In December, the SNB projected an inflation rate of 2.1% for 3Q 2025 in its inflation profile last quarter (Exhibit 1). Since then, oil prices have fallen but food prices have been increasing globally and in Switzerland much more than expected. Higher food prices cannot be taken lightly by the SNB as those prices are highly visible for consumers and could change their inflation perception more than price changes in other categories. Additionally, their weight of 11.0% is almost twice as high as the 5.7% energy and fuels have (Exhibit 3).

Exhibit 1: SNB forecasts of December



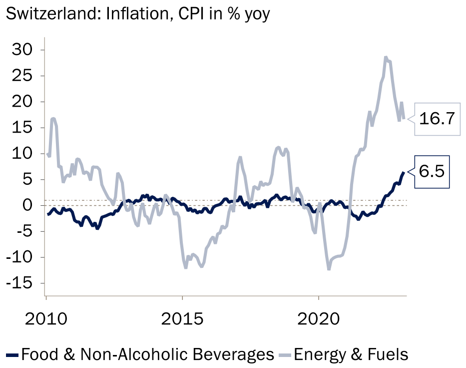
Source: Macrobond, Bank J. Safra Sarasin, 14.03.2023

Exhibit 2: February headline & core inflation



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2023

Exhibit 3: February food & energy prices



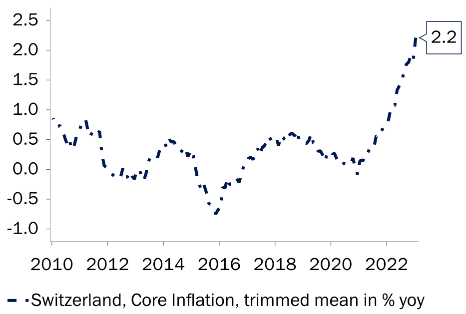
Source: Macrobond, Bank J. Safra Sarasin, 14.03.2023

Core inflation reached its highest level for more than 20 years

More worrying is the continuous increase of core inflation to 2.4% yoy (Exhibit 2), its highest level since 2001 when it was published the first time. Price pressures are relatively broad based as shown by the trimmed mean core rate that strips out the most extreme price changes (Exhibit 4). The only positive development that can be mentioned is that producer prices fell on a month-on-month base in February. They have also seen their peak on a year-on-year base and in general remain much more moderate than in other countries such that the cost pressure that producers might still pass on to consumers is not that elevated anymore (Exhibit 5). However, as the exchange rate did not appreciate further on a trade weighted base since September it cannot mitigate price pressures anymore (Exhibit 6). On a real trade weighted level, they are even lower than at the beginning of 2021.

Exhibit 4: Core inflation is too high

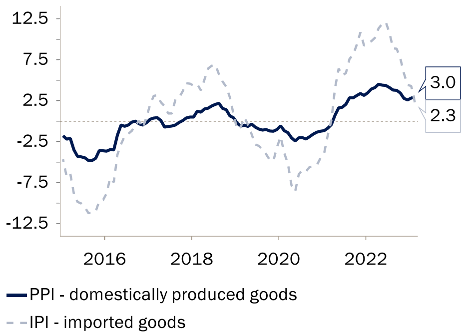
Switzerland, Consumer Price Index, Core Inflation, Trimmed Mean, in % yoy



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2023

Exhibit 5: At least producer prices fell lately

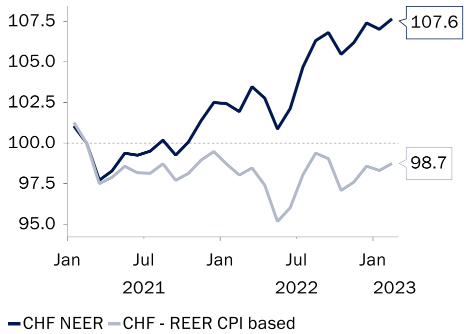
Switzerland, Producer Prices in % yoy



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2023

Exhibit 6: CHF appreciation has stalled

Switzerland, SNB FX Indices, 1.2.2020 = 100



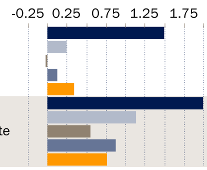
Source: Macrobond, Bank J. Safra Sarasin, 14.03.2023

A stronger Swiss franc would help to contain imported inflation

Obviously, a stronger exchange rate would help to reduce prices in Switzerland. The SNB has also clearly stated that it wouldn't resist a certain appreciation of the Swiss franc. However, that is easier said than done as currently all central banks are interested in a stronger exchange rate and most have to fight inflation with significantly higher rates than those that we can expect from the SNB. As a result, interest rate differentials between Switzerland and the euro area or the US have widened significantly to 1.5% before this week's ECB decision (Exhibit 7). The SNB is unlikely to let this differential become even wider this month.

Exhibit 7: Before the ECB started quantitative easing policy rate differentials were around 1.5 - 2%points

Policy Rate Differentials ECB-SNB



	Last	2006-10	2011-14	2006-14	2015-22
ECB, Deposit Facility Rate - SNB Policy Rate	1.5	0.25	-0.02	0.13	0.34
ECB, Main Refinancing Operations Rate - SNB Policy Rate	2.0	1.14	0.55	0.88	0.77

■ Last ■ 2006-10 ■ 2011-14 ■ 2006-14 ■ 2015-22

Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

FX

The Swiss franc is back

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Fears over the stability of the US banking sector have led to a marked re-strengthening of the Swiss franc. Near term, we expect risk aversion to act as the currency's primary driver. This should continue to counter headwinds from low Swiss yields, while slowing global activity is set to support the franc further down the road.

Fears over the US banking sector have pushed the Swiss franc higher

Fears over the stability of the US banking sector, triggered by the collapse of Silicon Valley Bank, have led to a sharp deterioration in risk sentiment and a surge in asset price volatility. Against this backdrop, EUR-CHF dropped markedly below parity, following a spike in bond market volatility (Exhibit 1), which exemplifies that the Swiss franc's safe haven property remains important for the currency's dynamics.

Safe haven property exerts bigger influence on EUR-CHF moves than yield differential

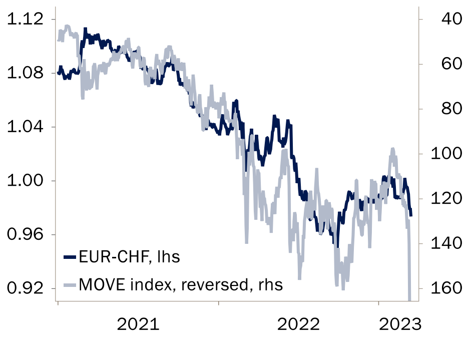
The franc's surge is particularly notable as it abruptly ends an episode during which the currency had softened versus the euro. To some extent, the recent softening reflected the divergence between German and Swiss government bond yields, which had risen over past months (see also «SNB preview», page 7). Yet we argue that going forward, the impact of the yield differential as a driver of EUR-CHF should be relatively contained. To highlight this point, we estimate a medium-term model for EUR-CHF, employing the differential between German and Swiss 10y government bond yields and the MOVE bond volatility index as explanatory variables. The result shows that the big bulk of EUR-CHF variation can be attributed to bond market volatility (which we label as «safe haven demand»). In contrast, the impact of relative yield levels is rather limited, in spite of having grown somewhat in magnitude as of late (Exhibit 2).

Swiss franc should be well-supported throughout this year

Given the level of uncertainty in financial markets, we believe that the Swiss franc should continue to be well-supported over the coming weeks. We note that EUR-CHF risk reversals have turned bearish in particular at the shorter end (Exhibit 3). Given the current market environment, and our expectation that the SNB will deliver a 50bp policy rate hike at next week's meeting, the odds are tilted towards a narrowing of the German-Swiss yield differential rather than a widening, in our view. We furthermore note that Swiss real yields continue to be appealing relative to other G10 real yields. Lastly, we reiterate our conviction that global activity should continue to slow towards the end of this year, which should act as an important tailwind for the Swiss franc further down the road.

Exhibit 1: High volatility pushed EUR-CHF lower

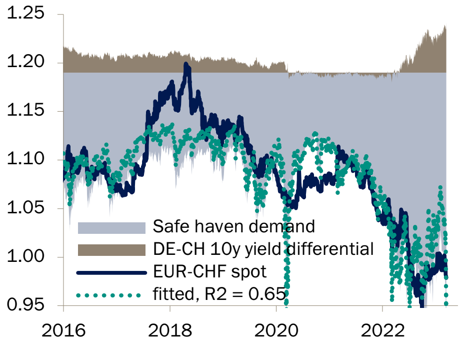
EUR-CHF vs bond volatility



Source: Macrobond, Bank J. Safra Sarasin, 16.03.2023

Exhibit 2: Safe haven demand matters most

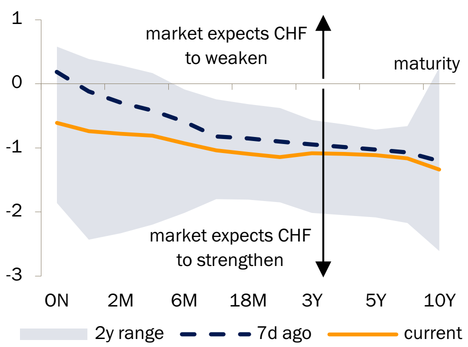
EUR-CHF: Safen haven demand and yield attributions



Source: Macrobond, Bank J. Safra Sarasin, 16.03.2023

Exhibit 3: Near-term positioning turned bearish

EUR-CHF 25-delta risk reversals by maturity



Source: Bloomberg, Bank J. Safra Sarasin, 16.03.2023

Global equities

A warning shot for banks

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Even though the asset-liability mismatch at Silicon Valley Bank (SVB) has been unique, one should not dismiss the underlying dynamics behind it: a variety of assets and portfolios have yet not been marked down to reflect a new yield environment. This does not only concern long-duration fixed income portfolios, but also private assets and certain segments of the real estate market. A slowing global cycle is set to bring more of these assets to the surface and may inflict further pain on balance sheets, not only in the financials space. The direct contagion from SVB to European banks should be limited and the shock absorption capacity at EU lenders has all but risen since the financial crisis. Yet we expect the positive backdrop of the last few months for banks to fade. Increasing competition for deposits is set to lead to higher deposit rates, portfolio revaluations will likely leave a dent in bank book values and the upside for the long end of the curve appears much more limited in the months ahead. While the medium to longer term constructive case for banks remains intact, all these factors argue for both, a more cautious stance on the banking sector over coming months and against attempts to buy the recent dip. We remain defensively positioned given the expected macro slowdown.

SVB is a special case but the underlying drivers are not unique to the bank

While the situation around Silicon Valley Bank (SVB) in the US has been quite unique and should have very limited direct spill-over effects on European lenders, the underlying dynamics are a function of the rate hiking cycle and should be regarded as a warning shot.

SVB stood in between two market segments which are particularly exposed to higher rates

Just to remind ourselves, SVB stood out even among second-tier US banks. It was running a significant asset-liability mismatch and was exposed to two market segments which were carrying large unaccounted losses: a) the private tech & VC space on the one hand and b) a large long-duration fixed income portfolio, which carried significant paper losses.

As ailing tech start-ups started to draw down deposits, the bank was forced to liquidate parts of its fixed-income portfolio, thereby realising those previously unaccounted paper losses. This adjustment wiped out the bank's regulatory capital and forced the regulator to step in.

The response by regulators was timely and effective

We think the measures taken by the Fed, the FDIC and the Treasury were sensible and helped to calm investors and depositors, avoiding a fully-fledged bank run. The two most important measures were:

a) A new facility called the Bank Term Funding Program (BTFP) through which financials receive 1-year funding by pledging US Treasuries, agency debt, and mortgage-backed securities at par

b) Announcing that all depositors would be able to access their deposits, regardless of the FDIC deposit guarantee threshold of USD 250'000

While there were anecdotal reports of deposit moves away from regional banks to larger institutions, a fully-fledged bank run on regional banks has not happened. We would also expect authorities to step up measures in order to back the banking sector if funding issues intensify and systemic risks rise.

J. Safra Sarasin
Cross-Asset Weekly

17 March 2023

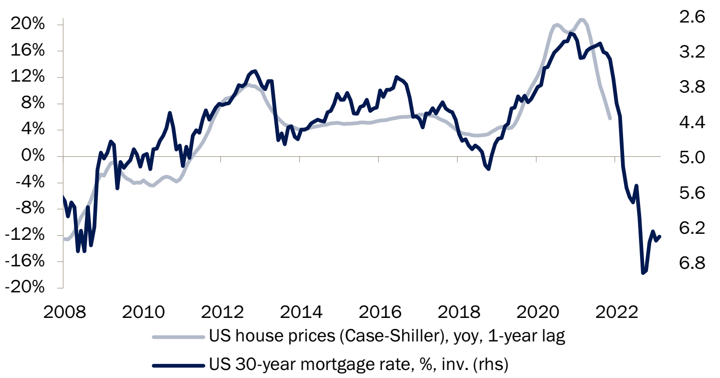
Direct contagion from SVB is limited

Direct contagion risks to larger US and European banks are limited in our view, yet we think the fundamental issues at play should not be dismissed. While global equity markets have already fallen sharply over the past year, losses in non-public markets have yet not fully been accounted for. SVB was the most exposed player in this regard, as it was sitting in between a) private tech and b) a badly managed long-duration fixed income portfolio.

Real estate portfolios are exposed as well

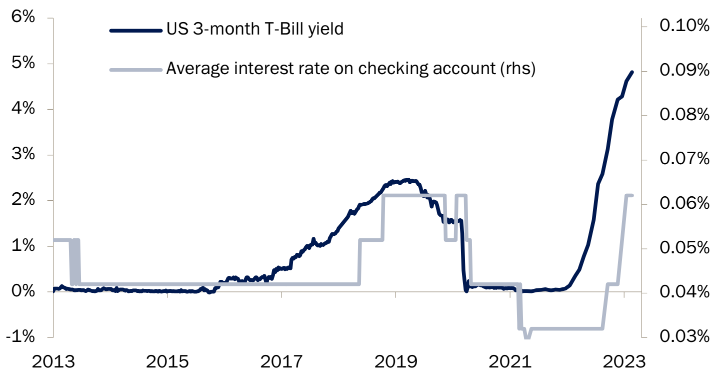
Both these issues can be traced back to a common factor, which is higher yields. We would add real estate and in particular commercial real estate portfolios to the list of market pockets, which have yet not fully digested the past increase in interest rates and thus caution against adding too much exposure to the sector. The price-adjustment process has been slow in the real estate space and will likely drag on for another year (Exhibit 1).

Exhibit 1: Real estate price adjustment not yet complete



Source: Refinitiv, Bank J. Safra Sarasin, 15.03.2023

Exhibit 2: Deposit rates will have to rise further



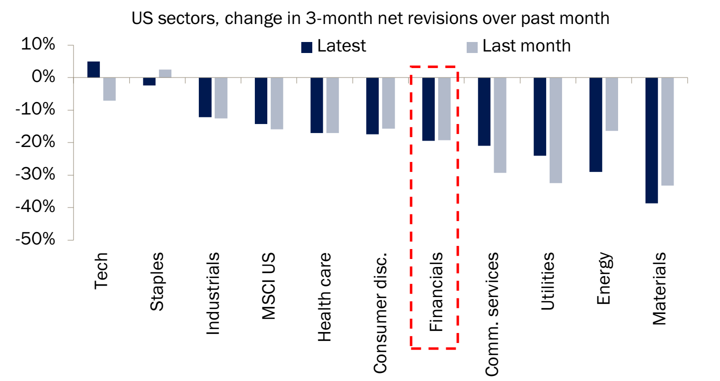
Source: Refinitiv, Bank J. Safra Sarasin, 15.03.2023

Bank earnings are set to come under increasing pressure, which may further weigh on the cycle via tighter lending standards

The second issue banks are faced with is a deteriorating backdrop for earnings. In particular in the US, where the rise of rates at the short end of the curve has been particularly pronounced. Banks are under pressure to lift their deposit rates (Exhibit 2), with corresponding negative consequences for their income margins. As a result, US financials earnings are set to face more downside (Exhibit 3). This will likely have repercussions for the economy. Banks are set to become increasingly selective with regards to their lending decisions. Lending standards, which have already been tightening for the past 15 months, may well tighten further and remain a drag on the cycle (Exhibit 4).

It should be noted though that what we are seeing is the transmission of monetary policy into the real economy happening in real time.

Exhibit 3: US financials earnings are seeing downgrades



Source: Refinitiv, Bank J. Safra Sarasin, 15.03.2023

Exhibit 4: Credit conditions are set to tighten further

Source: Refinitiv, Bank J. Safra Sarasin, 15.03.2023

What are the risks for European banks?

European banks' direct exposure to SVB is limited

Direct exposure to the situation in the US should be limited and some key factors which have led to the collapse of SVB are less prevalent in Europe.

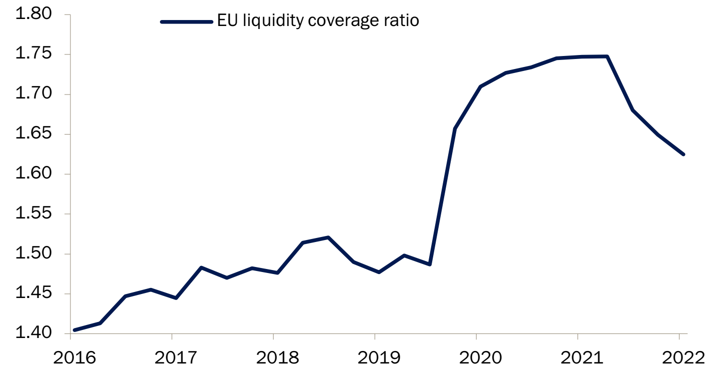
Deposit growth in Europe has been more stable than in the US

Firstly, deposit growth at euro area banks has been much more stable post-COVID and remained positive throughout 2022, while it turned negative for US banks as early as Q2 2022, as US consumers started to draw down their excess savings.

Liquidity and capital ratios at European banks are looking strong

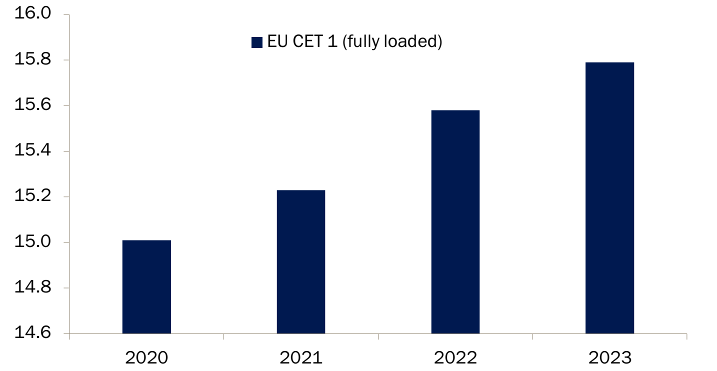
Secondly, liquidity and capital ratios of Euro area banks have strengthened over recent years. The liquidity coverage ratio is at a solid 1.62x (i.e. high-quality assets in order to cover 30 days of net cash outflows in a stress scenario, Exhibit 5) and the core Common Equity Tier 1 (CET1) ratio (fully-loaded) has risen to 15.8%, from 15% in 2020 (Exhibit 6). The latest stress testing exercise by the European Banking Authority (EBA), showed that it would not drop below a level of 10%, even in their adverse scenario.

Exhibit 5: EU liquidity coverage ratios are solid



Source: EBA, Bank J. Safra Sarasin, 15.03.2023

Exhibit 6: EU banks have a solid capital buffer



Source: EBA, Bank J. Safra Sarasin, 15.03.2023

The rise in interest rates has so far only had a positive impact on European banks, this may change going forward

Thirdly, the ECB also monitors the risk to bank capital stemming from higher interest rates. Their stress test finds that a 200bps rise in interest rates should have a negative impact of around 4% of CET1 capital on banks' aggregate net worth. This decline is expected to arise in the medium to long term, as banks would have to pay higher funding costs to cover legacy low-yielding assets. Furthermore, changes in banks' economic value of equity (EVE) do not always translate into accounting losses, but shed light on banking book value risks to changes in interest rates over the long run.

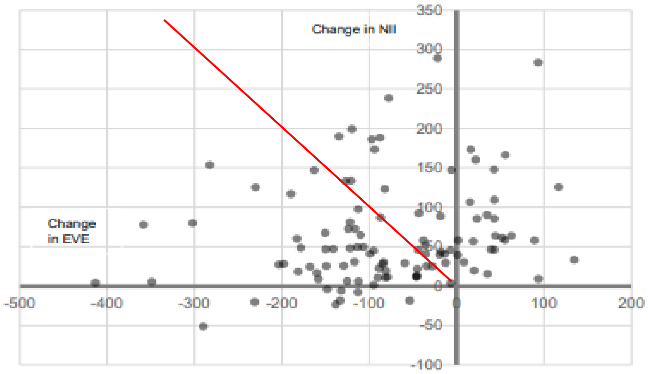
Rising rates are a two-sided sword: supporting earnings and weighing on balance sheet assets

The fact that a more than 200bps rise in euro area rates over the past year has had little impact so far shows, that a) book values may still need to be adjusted for lower fixed-income valuations (but it's hard to say by how much given that hold-to-maturity assets can be accounted for at par value) while b) strong net interest income (NII) on the back of higher yields have clearly been a support factor. Exhibit 7 shows the combined impact of these two channels on various EU banks. Those to the right of the red line should see a net benefit from higher rates, while those on the left are net losers. The split is roughly half-half, while the results of the ECB's stress test also show that capital is nowhere near to being wiped out for any of those institutions.

Expect earnings momentum to deteriorate for European banks as well

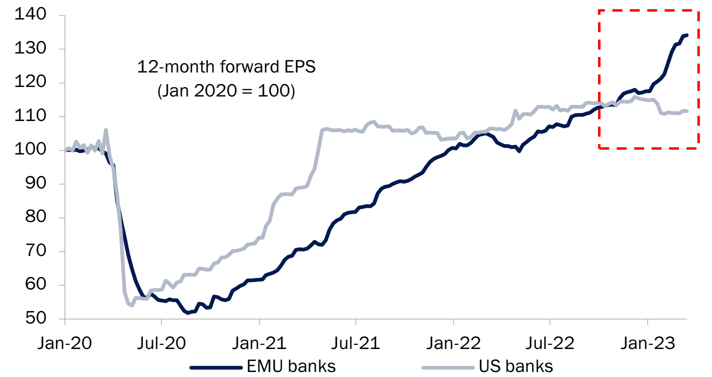
The earnings support for European banks, which has been substantially stronger than for their US peers, is likely to fade as well (Exhibit 8). Hence, it is likely that the higher level of rates is increasingly turning from tailwind to headwind for the European banking sector.

Exhibit 7: Impact of 200bps interest rate increase on EU banks



Source: ECB, Bank J. Safra Sarasin, 15.03.2023

Exhibit 8: EU banks earnings outpaced their US peers on rising rates



Source: Refinitv, Bank J. Safra Sarasin, 15.03.2023

Balance sheet resilience is not enough, cyclical headwinds are increasing for banks

Even though European banking sector balance sheets are much more resilient than just a few years ago and should be able to withstand potential further shocks, we re-iterate our more cautious stance on the European banking sector, first formulated in late February. The events over the past two weeks don't appear to be just idiosyncratic in nature, rather than a reflection of underlying balance sheet risks. As the cycle is slowing, we expect more of these risks to materialise and potentially hit bank capital. Earnings momentum for the sector has likely peaked as well, as deposit rates are set to rise, while upside for the long end of the yield curve is limited. As we expect the macro backdrop to deteriorate into the second half of 2023, we prefer to be positioned defensively. Medium to longer term, the constructive case for banks remains intact.

China macro

A solid rebound amidst strong policy support

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China's January-February activity data confirm that the economy is on a solid and broad-based recovery path. While Chinese policymakers appear quite cautious on the growth prospects at the National People's Congress (NPC), policy support has so far been strong. More surprisingly, the housing market has shown a significant turn-around earlier than we expected. The strong rebound indicates an upside risk to our Q1 growth forecast. Going forward, we are on the lookout for further government measures to support employment and the private sector. While the 2023 budget offers a neutral fiscal impulse, the effect of government spending should be stronger this year. The NPC's overall policy goals continue to be stability, high-quality development and security, with an emphasis on financial stability, support for the digital economy, self-reliance on science and technology, and data security.

A solid and broad-based rebound in activity

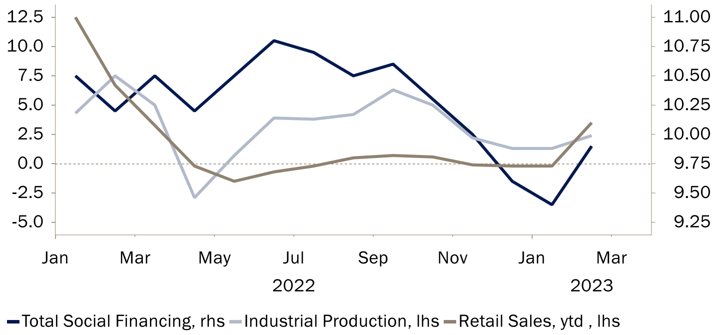
China's January-February activity data confirm a solid recovery of the economy. Monthly data show improvements across the board (Exhibit 1). Retail sales jumped from a contraction in December to growth of 3.5%. Sales were strongest in contact-intensive sectors such as restaurants and catering services (Exhibit 2). Retail sales outside of vehicle sales reached 5%. Weak auto sales were not a surprise as national subsidies for new electric vehicles ended in December. Industrial production rose slightly from 1.3% in December to 2.4%, aided by slightly better export and robust fixed-asset investment. The smaller drop in February exports was supported by the resilience in activity in developed markets. Fixed-asset-investment growth in manufacturing and infrastructure continues to be robust, while the contraction in housing investment has become smaller (Exhibit 3).

The housing market has staged a remarkable turnaround

The housing market has turned around earlier than we expected. Growth in housing sales shows a remarkable increase from -26.7% in December to 3.5% in January-February (Exhibit 4). Weekly data suggests that the positive momentum continues. Housing starts rose from a very weak level at -44.7% to -8.7%. The housing turnaround has also supported upstream industries such as steel (Exhibit 5). At this rate, housing starts and investment could return to positive growth by the beginning of Q2, earlier than our call for a stabilisation around mid-year.

Exhibit 1: Broad-based rebound in activity and credit growth

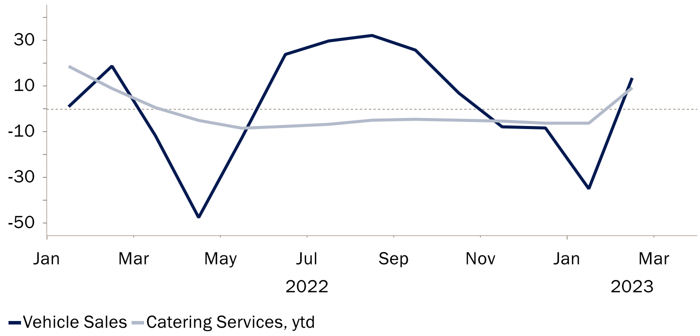
China, Monthly Activity Indicators and Total Social Financing, % yoy



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Exhibit 2: The service sector has rebounded significantly

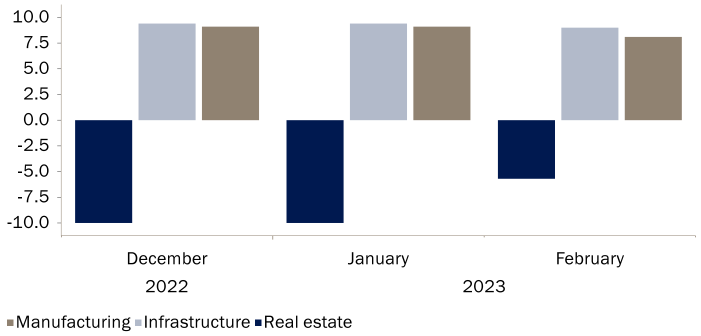
China, Retail Sales, % yoy



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Exhibit 3: Robust infrastructure and manufacturing investment

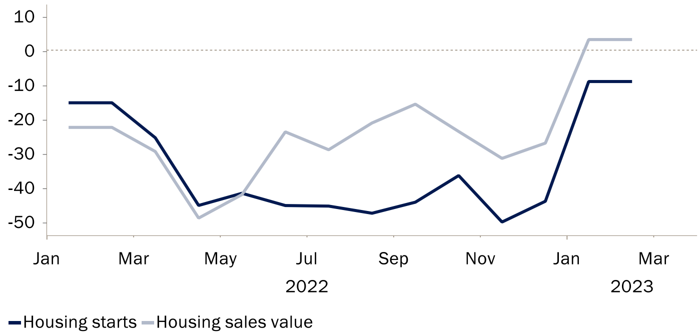
China, Fixed Assets Investment, YTD, % yoy



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Exhibit 4: A strong rebound in the housing sector

China, Housing Starts and Sales, NBS, % yoy



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

The labour market will need to improve further to ensure a durable recovery in consumption

One indicator that has not improved is the unemployment rate. Both youth and overall unemployment rates ticked up in February (Exhibit 6). In 2020, it took about a year for the unemployment rate to fall back to the pre-pandemic level. We believe that an improved employment outlook is required for a durable recovery in consumption. While hiring indicators have rebounded from low levels (Exhibit 7), we are on the lookout for further government measures to support employment, income and consumption.

Credit growth has supported industrial and investment activity

Despite the policymakers' cautious stance on growth prospects at the NPC (see more details on the NPC here), policy support has been strong so far. Total social financing growth picked up in February to 9.9% (Exhibit 1). Corporate medium- and long-term loans and government bond issuance have driven credit growth while household lending remains subdued amidst households' mortgage repayments (Exhibit 8). The frontloading of government bond issuance suggests that infrastructure investment will also be frontloaded.

2023 growth target of around 5% should be easily attained and we forecast 5.5%

The strong rebound so far indicates an upside risk to our Q1 growth forecast (2.9% yoy). We expect further support following the targets and policies set at the NPC. On the growth target of around 5%, we believe that the government's strategy has shifted towards setting relatively low expectations that could be easily met. In our view (with our forecast of 5.5%), the 5% growth target is likely the floor. Stabilising growth at a reasonable level and supporting consumption is the year's priority. The Government Planning Report to the NPC suggests that the government will introduce measures over the year to boost consumption such as support for green home appliance purchases and promotion of domestic tourism and live-streaming e-commerce. Indeed, a number of cities have already introduced new subsidies for electric vehicles to replace the national subsidies that ended. Growth will also be supported by fiscal policy. Our estimates suggest that the overall consolidated deficit for this year will be around the same as the 2022 level. While this in theory offers little fiscal impulse, we believe that this year's fiscal plan will yield a larger 'bang for the buck.'

Our NPC read-out: stability, high-quality development and security are key for the overall policy agenda

The read-out from the NPC suggests that policy continuity is key. Government reports to the NPC as well as various public sessions suggest that the overall policy direction focuses on stability, high-quality development and security, in line with the broad policy agenda set at the 20th National Party Congress last October. Retaining the government's key macro policymakers, notably the People's Bank of China (PBoC) Governor Yi Gang and Finance Minister Liu Kun reflects the emphasis on policy continuity.

Reforms of financial supervision and local financial controls are part of the "stability" pillar

The "stability" part is not only about social and economic stability, but also financial stability. Defusing risks from real estate companies as well as local government financing vehicles (LGFVs) are high on the agenda. To better control financial risks, the government plans to establish a new financial supervisor under the State Council and reform local financial supervisors. There is also a plan to phase out and transform LGFVs. These commitments are positive in our view.

High-quality development includes the government's embrace of the platform economy

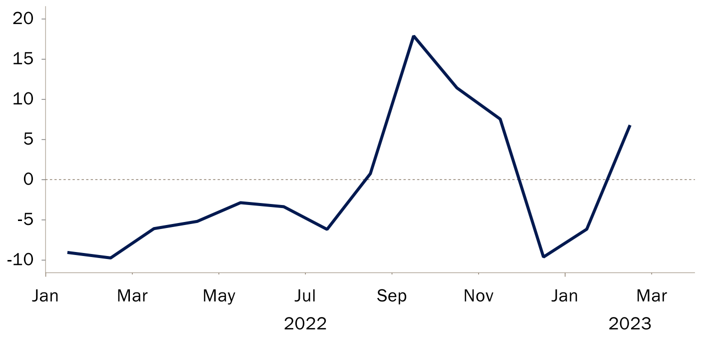
On "high-quality development", commitment to green development has been reiterated, while the government's support for the private sector has been reassured. In the government report, the line that appeared in the 2022 version, *"the government will step up efforts against monopolies and unfair competition"*, has disappeared from the current report. Instead, the government has embraced online platforms and would like to promote the well-regulated, healthy and sustainable development of the platform economy. The government would like platform companies to play a greater role in leading development, create jobs and go global.

Self-reliance in science and technology and advancing digital security

On the "security" front, there was no surprise in the emphasis of science and technology self-reliance and data security, given rising tensions between the US and China. According to the government report, improving the industrial competitive edge will help guarantee both development and security.

Exhibit 5: The housing turnaround has supported the steel industry

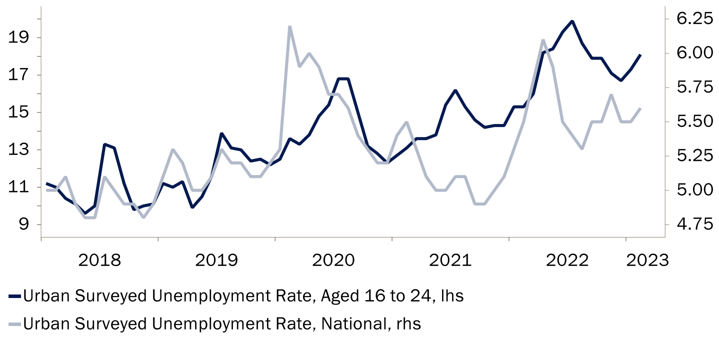
China, Average Daily Crude Steel Output, % yoy



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Exhibit 6: Unemployment rate remains elevated

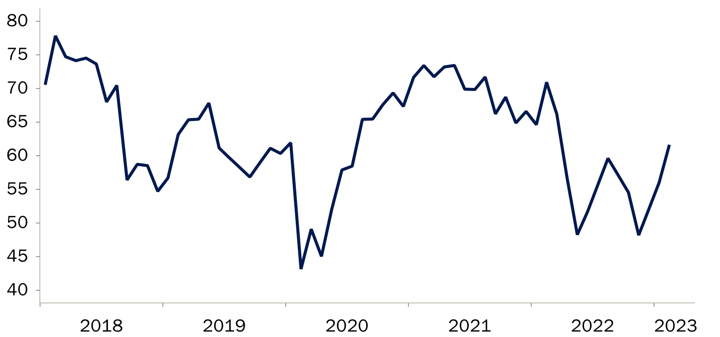
China, Unemployment Rate, %



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Exhibit 7: Hiring has rebounded from low levels

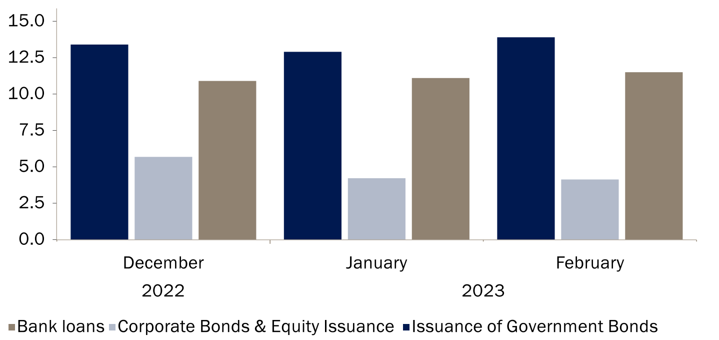
CKGSB Recruitment Index



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Exhibit 8: Strong growth in bank loans and government bond issuance

China, Total Social Financing Components, % yoy



Source: Macrobond, Bank J. Safra Sarasin, 15.03.2023

Economic Calendar

Week of 20/03 – 24/03/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 20.03.2023						
GE	08:00	German PPI MoM	Feb	mom	--	-1.00%
	08:00	German PPI YoY	Feb	yoy	--	17.80%
Tuesday, 21.03.2023						
GE	11:00	ZEW Survey Expectations	Mar	Index	--	28.10
US	13:30	Philadelphia Non-Mfg Activity	Mar	Index	--	3.20
	15:00	Existing Home Sales	Feb	mom	5.00%	-0.70%
Wednesday, 22.03.2023						
UK	08:00	CPI YoY	Feb	yoy	--	10.10%
	08:00	CPI Core YoY	Feb	yoy	--	5.80%
	12:00	CBI Trends Total Orders	Mar	Index	-14.00	-16.00
US	12:00	MBA Mortgage Applications	Mar17	wow	--	6.50%
	19:00	FOMC Rate Decision (UB)	Mar22	%	5.00%	4.75%
Thursday, 23.03.2023						
UK	13:00	Bank of England Bank Rate	Mar23	%	--	4.00%
US	13:30	Philadelphia Fed Bus. Outlook	Mar	Index	-16.60	-24.30
	13:30	Chicago Fed Nat. Act. Index	Feb	Index	--	0.23
	15:00	New home sales	Feb	1'000	645k	670k
	16:00	Kansas Fed Mfg Activity	Mar	Index	--	0.00
Friday, 24.03.2023						
JN	01:30	Jibun Bank Japan PMI Mfg	Feb	Index	--	47.70
UK	08:00	Retail Sales Ex Auto Fuel MoM	Feb	mom	--	0.40%
GE	09:30	S&P Global German Mfg PMI	Feb	Index	--	46.30
EU	10:00	S&P Global Eurozone Mfg PMI	Feb	Index	--	48.50
UK	10:30	S&P Global UK Mfg PMI	Feb	Index	--	49.30
US	13:30	Durable Goods Ex Transport	MarP	mom	0.40%	0.80%
	14:45	S&P Global US Mfg PMI	Feb	Index	--	47.30
	16:00	Kansas City Fed Services Act.	MarP	Index	--	1.00

Source: Bloomberg, J. Safra Sarasin as of 16.03.2023

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenossen 10 year (%)	1.09	-29	-53	4.5
German Bund 10 year (%)	2.29	-22	-28	2.7
UK Gilt 10 year (%)	3.43	-34	-25	3.7
US Treasury 10 year (%)	3.55	-15	-32	2.5
French OAT - Bund, spread (bp)	54	3	-1	
Italian BTP - Bund, spread (bp)	190	9	-25	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	10,719	16.7	-1.5	1.2
DAX - Germany	14,967	11.5	-4.3	7.5
MSCI Italy	811	8.2	-6.8	7.3
IBEX - Spain	8,890	10.6	-5.7	8.5
DJ Euro Stoxx 50 - Eurozone	4,117	12.2	-3.9	8.9
MSCI UK	2,125	10.1	-5.9	0.1
S&P 500 - USA	3,960	18.0	1.1	3.5
Nasdaq 100 - USA	12,581	24.3	4.9	15.3
MSCI Emerging Markets	941	10.7	-2.7	-1.3

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.93	8.8	0.5	0.1
EUR-CHF	0.99	6.7	0.7	-0.3
GBP-CHF	1.13	8.1	1.5	0.6
EUR-USD	1.07	8.6	0.2	-0.4
GBP-USD	1.22	10.1	1.1	0.7
USD-JPY	133.0	12.8	-1.5	1.4
EUR-GBP	0.88	6.9	-0.8	-1.0
EUR-SEK	11.15	8.3	-2.2	-0.1
EUR-NOK	11.40	10.3	0.8	8.6

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	103	13.1	-1.6	-8.4
Brent crude oil - USD / barrel	74	32.1	-8.5	-12.6
Gold bullion - USD / Troy ounce	1,931	13.7	5.5	5.9

Source: J. Safra Sarasin, Bloomberg as of 16.03.2023

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