J. Safra Sarasin

Cross-Asset Weekly

30 June 2023

Diverging fortunes

The euro area is a tale of diverging cycles. While manufacturing and construction are clearly in recession, the services sector continues to hold up. But that's not the only divergence. Southern European economies are doing substantially better than Germany and the Netherlands. These regional differences are likely to persist in the near term as pent-up demand for tourism is still strong. At the same time, euro area inflation remains too high and too sticky, hence the ECB will raise rates again. Tighter monetary conditions will increasingly be felt in coming quarters, resulting in growth far below potential.

In the US, the housing market has shown unexpected strength recently, likely due to a decline in mortgage rates in 4Q22 and incentives provided by homebuilders to stimulate sales. Importantly, the scarcity of existing homes has driven buyers to the new-built market. This situation is unlikely to change until mortgage rates fall significantly. In the short term, market dynamics will largely depend on homebuilders' willingness to continue subsidising mortgages.

Finally, we are turning more positive on UK equities after having abandoned them last year. The UK market has been flat since the start of 2023, trailing all other major indices, as it has close to zero tech exposure and is distinctly more defensive than other European equity markets. Depressed valuations, the UK market's value tilt, combined with a defensive exposure and the expectation for a weaker sterling against the US dollar, support a more optimistic view on UK equities for H2 2023.

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Euro area macro

Stagflation

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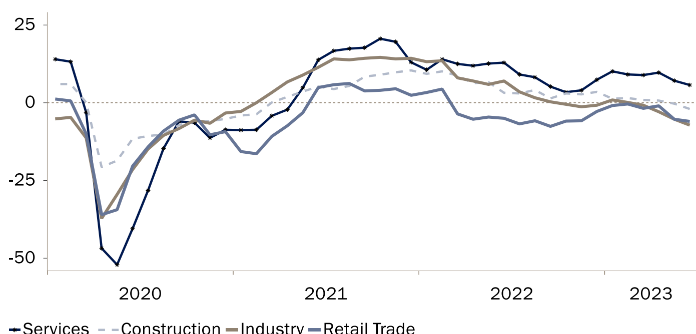
Euro area indicators clearly disappointed in June and pointed to a stagflationary environment in the second half of 2023. However, regional differences are huge. Southern European economies are doing better than Germany and the Netherlands. The differences are likely to persist in the near term as pent-up demand for tourism services is still strong. The services sector will continue to grow in the coming months while the construction and industrial sectors clearly are in recession. Tighter monetary conditions will be felt increasingly in the coming quarters such that a rebound of economic activity is unlikely in the near future. As core inflation remains sticky, the ECB has little choice but to keep financial conditions tight for the foreseeable future.

Lacklustre growth

Stagflation probably characterises the current economic environment best. Manufacturing activity likely has declined in Q2 and falling orders indicate that this is probably not going to change in the coming months. Employment intentions have declined in the past months, but so far, companies are not laying off workers. Mass lay-offs in the future are also unlikely as companies have learned from their experience during the pandemic that labour scarcity can severely limit production. Companies might opt for shorter working hours instead. This would moderate the cumulative negative effects that recessions usually have on household income and on aggregate demand. It would however lead to a bigger fall in profits in the short run. It also seems that production bottlenecks are normalizing and so do supplier delivery times. As a consequence, input and output price pressure is coming down as well. Both the June Purchasing Managers Indices (PMI) and the Economic Sentiment (Exhibit 1) show that the services sector is the only one that is expanding at the moment as pent-up demand for services still seems to be strong. However, it also seems clear that the dynamic in the services sector is coming down a bit as well. All sectors taken together will likely deliver growth far below potential in the coming quarters.

Exhibit 1: Economic sentiment declines in all sectors

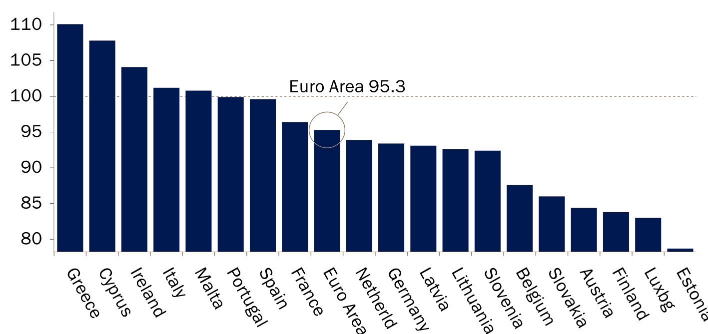
Euro Area, Confidence in different sectors (EU Commission), balance in %



Source: Macrobond, Bank J. Safra Sarasin, 26.06.2023

Exhibit 2: Regional differences are huge

Economic Sentiment Index, long-term average=100



Source: Macrobond, Bank J. Safra Sarasin, 26.06.2023

All Mediterranean countries plus Ireland have above-average economic sentiment levels

Regional differences are huge – likely reflecting strong demand for tourism services in some countries, lower-than-expected demand for investment goods from China in others and a shaky outlook for key industries like automobile production in Germany (Exhibit 2). In addition, sentiment in Greece has been improving steadily since the elections. Overall, it is noteworthy that all Mediterranean countries plus Ireland display above average economic sentiment levels. Similarly, it is remarkable how well peripheral countries managed to cope with the huge increase of policy rates, and the withdrawal of ECB liquidity. This

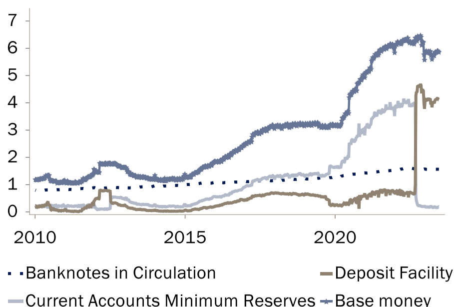
week alone, TLTROs in the order of around EUR 0.5 trillion were repaid without any significant market dislocations. This is most remarkable in Italy as Italian banks had to repay a large part of the latest TLTRO tranche. Currently, Italian bond spreads versus German Bunds are lower than both their 10-year average and the level they were trading before the ECB started increasing its policy rate. Still, financing conditions are becoming tighter for the Euro area on aggregate.

Tight financing conditions will stifle economic growth

The balance sheets of the European central banks (Exhibit 3) will be reduced further over time as the bonds purchased through the ECB Asset Purchase Programme (APP) will not be reinvested from July onward. Growth rates for all monetary indicators are decelerating already, most strongly for the most liquid components as funds are shifted into higher interest-bearing assets (Exhibit 4). Finally, loan growth is also coming down (Exhibit 5). We expect these trends to continue in the second half of this year with the implication that economic growth will remain far below potential for an extended period of time. This is also needed in order to bring down inflation rates towards the ECB's 2% inflation target.

Exhibit 3: Eurosystem balance sheets

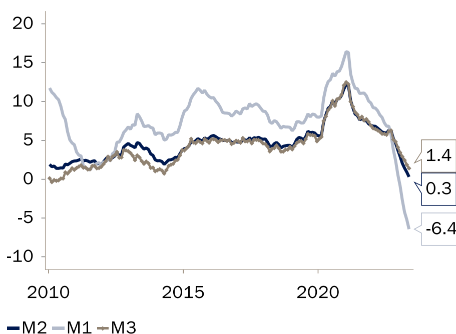
Consolidated Balance Sheet & Flows of MFI Sector, Eurosystem Liabilities in Trillion EUR



Source: Macrobond, Bank J. Safra Sarasin, 26.06.2023

Exhibit 4: Money growth decelerates

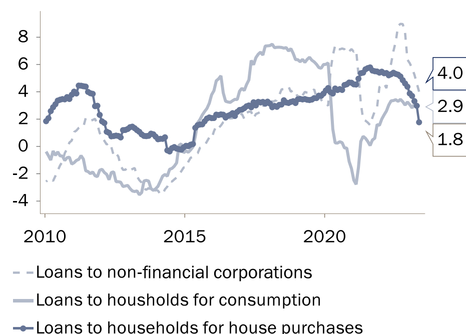
Euro Area: Monetary aggregates, wda, sa, in % yoy



Source: Macrobond, Bank J. Safra Sarasin, 26.06.2023

Exhibit 5: Loan growth declines already

Euro area, loans in % yoy, latest data: 05/2023



Source: Macrobond, Bank J. Safra Sarasin, 26.06.2023

Consumer confidence improves further

We end this note with a positive aspect: consumer confidence continues to improve and is currently significantly above the level at the beginning of the year – though still below average in all countries bar Greece (Exhibits 6 and 7). In spring, this could be explained by falling gas prices and the strong labour market. Now, it is more a reflection of the perception of the general economic environment. Still, households intend to save more in the coming 12 months and don't regard it as a good time to make major purchases.

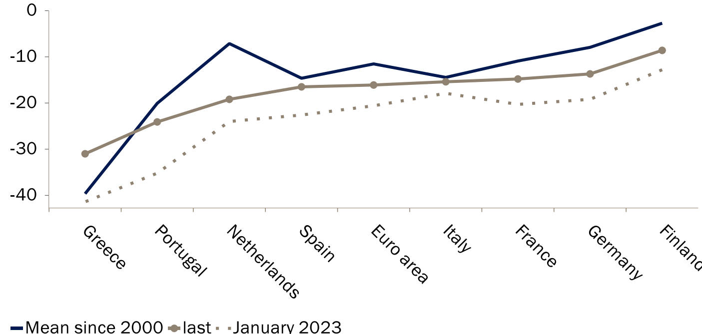
Exhibit 6: Consumer confidence continues to improve

Euro area, Consumer Confidence, balance in %, last data: 06/2023

Source: Macrobond, Bank J. Safra Sarasin, 26.06.2023

Exhibit 7: Confidence remains below long-term averages for most

Consumer confidence, balance in %



Source: Macrobond, Bank J. Safra Sarasin, 26.06.2023

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US macro

The surprising housing market rebound

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The housing market has shown unexpected strength recently, likely due to a decline in mortgage rates in 4Q22 and incentives provided by homebuilders to stimulate sales. Importantly, the scarcity of existing homes has driven buyers to the new-built market. This situation is unlikely to change until mortgage rates fall significantly. In the short term, market dynamics will largely depend on homebuilders' willingness to continue subsidising mortgages.

The housing market has rebounded since the turn of the year

The housing market appears to have turned a corner, with new house sales, starts and permits increasing strongly over the past three months (Exhibit 1). Prices too have been on the rise, after falling by around 3% from their recent peak over 2H22. This is surprising given the sharp price increases during the pandemic, and the fact that prices remain out of whack with fundamentals (see "Real estate markets feel the pinch" – *Cross-Asset Weekly*, 19.05.2023). If the housing market has truly turned, residential investment should boost GDP growth again, after contracting for eight consecutive quarters. The decline in rent inflation might also be shorter-lived than previously anticipated. This would suggest that the bulk of the impact of past monetary tightening on housing is behind us.

Lower mortgage rates, discounts and crucially limited inventory of existing homes for sale have supported the new-built market

We see three reasons for this rebound. First, mortgage rates came down by about 1 percentage point between October 2022, when they peaked at 7.4%, and January of this year. This, combined with the modest drop in house prices, has increased affordability a bit. Second, most homebuilders have offered steep discounts on listed prices, often in the form of mortgage buydowns, to attract potential buyers and keep sales ticking up. And third, the resale market is essentially frozen as elevated mortgage rates are preventing would-be sellers to move without incurring a massive increase in mortgage payments (Exhibit 2). So, any potential buyer has no other choice but to turn to the new-built market.

The resilience of the housing market will be tested over the coming months

The secondary market is likely to remain frozen until mortgage rates decrease significantly. Once that happens, inventories should rise and prices will fall. However, this is unlikely to occur until the economy weakens further. Interestingly, unlike in previous cycles, the housing market may not be the main source of the downturn. In the meantime, near-term dynamics will depend largely on the willingness of homebuilders to continue subsidising mortgages and offering discounts. However, with policy rates expected to increase, their willingness to do so will be tested (Exhibit 3).

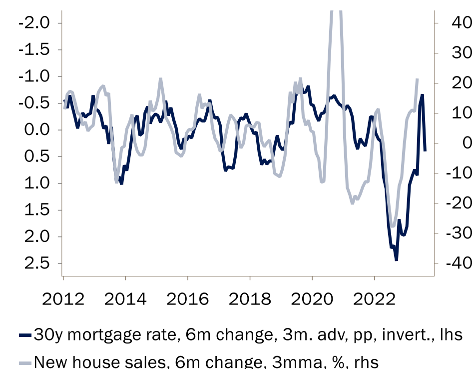
Exhibit 1: The housing market is rebounding

Source: Macrobond, Bank J. Safra Sarasin, 29.06.2023

Exhibit 2: Nobody wants to move out

Source: Macrobond, Bank J. Safra Sarasin, 29.06.2023

Exhibit 3: Can new house sales rise further?



Source: Macrobond, Bank J. Safra Sarasin, 29.06.2023

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30 June 2023

UK equities

A somewhat brighter second half

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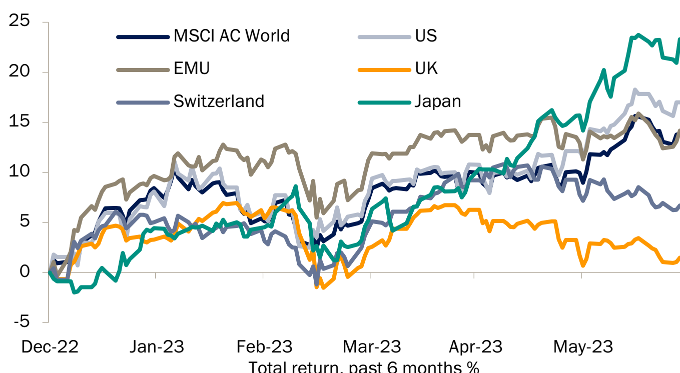
We are turning more positive on UK equities after having abandoned them last year. The UK market has been flat since the start of 2023, trailing all other major indices, as it has close to zero tech exposure and is distinctly more defensive than other European equity markets. In addition, sterling has risen, which tends to be one of the most important equity market drivers. Depressed valuations, the UK market's value tilt, combined with a defensive exposure and the expectation for a weaker sterling against the US dollar, support a more optimistic view on UK equities for H2 2023.

UK equities have had a tough first half

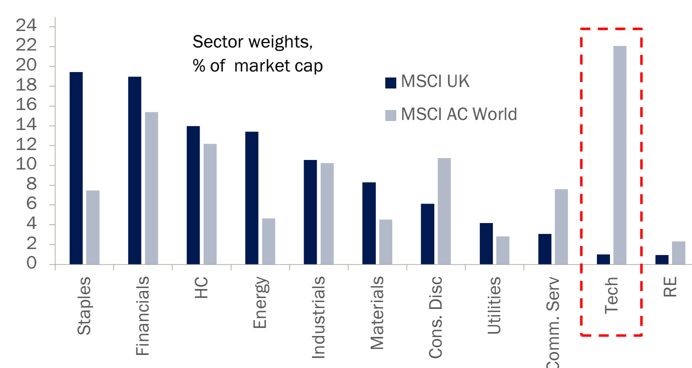
The UK market has been in a difficult spot over the past six months. While each of the developed world's major indices managed to move higher, UK equities have been almost flat, even with dividend payments included (Exhibit 1). The reasons are obvious. Being one of the key beneficiaries from last year's surge in oil prices and in energy names, the UK index has missed out on this year's rebound due to its total lack of tech exposure and its underexposure in cyclical names, which have done particularly well in Europe (Exhibit 2).

Exhibit 1: UK equities have not moved over past 6 months



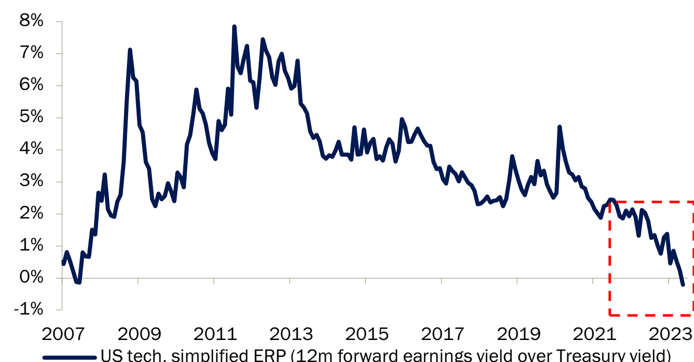
Source: Refinitiv, Bank J. Safra Sarasin, 29.06.2023

Exhibit 2: UK equities are heavily underweight tech



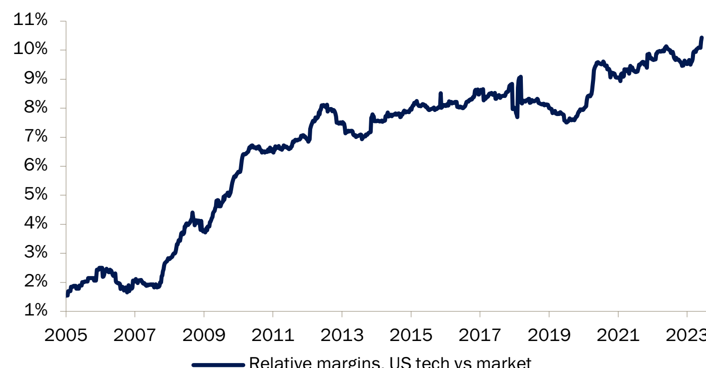
Source: Refinitiv, Bank J. Safra Sarasin, 29.06.2023

Exhibit 3: Tech valuations are massively stretched



Source: Refinitiv, Bank J. Safra Sarasin, 29.06.2023

Exhibit 4: At the same time margin expectations are sky high



Source: Refinitiv, Bank J. Safra Sarasin, 29.06.2023

We expect the second half of 2023 to look distinctly different to H1, with tech upside curbed by high valuations

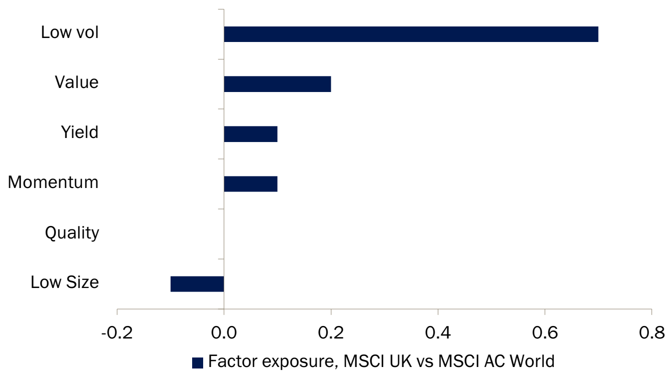
The second half of the year should look distinctly different to the first half, in particular when it comes to sector performance. The run-up in tech names has been extraordinary and appears well justified, yet it is unlikely that the sector can extend its valuations from

current levels. It clearly runs the risk of disappointing market expectations for another sharp ramp up in margins. For the first time since November 2007, the 12-month forward earnings yield for tech has fallen below the US 10-year Treasury yield, effectively fully removing a risk premium for the sector which has averaged 3.5% over the past 15 years (Exhibit 3). What's more, earnings expectations inched higher at the same time, taking tech margin expectations to a new record high relative to the market (Exhibit 4). AI is no bluff, that's for certain, but the lack of immediate capitalisation at some of the most bid-up names, may leave some disappointed in the short-term. We would thus believe that the upside for the tech sector is very limited in the coming quarters, with the value and more defensive end of the market better placed to outperform.

The UK market is defensive with a value tilt, which could do well against the backdrop of a slowing economy and growth underperformance

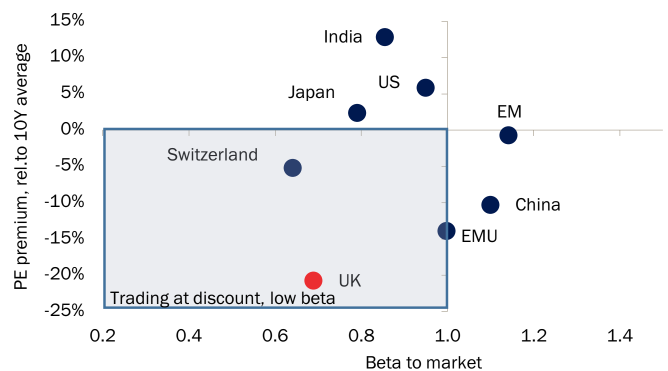
The UK market is squarely placed in that field. It has a clear defensive bias, while being one of the most value-driven major indices (Exhibit 5). Only the Swiss market has a lower beta to global equities, while no other major market is trading at a larger PE discount to its average long-term valuation vs global equities (Exhibit 6). Thus, in addition to boasting the right style exposure for the second half of this year, in our view, UK equities are also trading at very attractive valuations.

Exhibit 5: UK equities are a combination of defensive and value



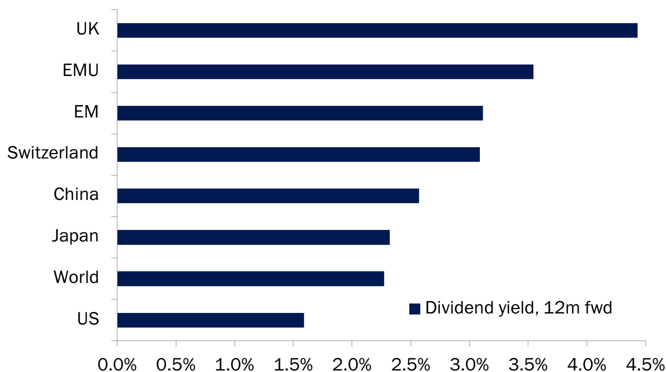
Source: Refinitiv, MSCI, Bank J. Safra Sarasin, 28.06.2023

Exhibit 6: They are attractively valued and have a low beta



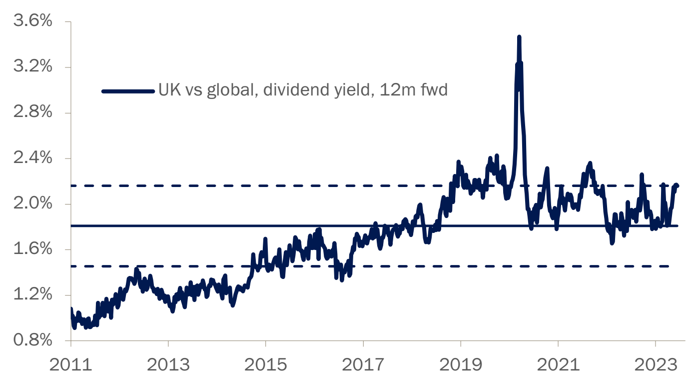
Source: Refinitiv, Bank J. Safra Sarasin, 28.06.2023

Exhibit 7: UK equities have a superior dividend yield



Source: Refinitiv, Bank J. Safra Sarasin, 28.06.2023

Exhibit 8: The dividend yield premium back at the top of the range



Source: Refinitiv, Bank J. Safra Sarasin, 28.06.2023

UK dividend yields are the highest among develop markets equity indices

The valuation appeal of the market, and a long-standing feature of UK equities, is the market's high dividend yield (Exhibit 7). While this not always a reason to buy, as it may just reflect a lack of opportunities to invest into and to grow, it provides a stable source of income in more difficult times, which we expect to lie ahead. Here again, on a relative basis vs global equities, the dividend yield is back at the upper ed of the range it has been

in over recent years, another reflection of the attractive valuation levels the UK market is trading on (Exhibit 8).

GBP-USD plays a key role for UK equity performance given the market's high share of foreign currency sales

More than valuations, FX supports our view that the UK market increasingly has upside potential vs global equities. Given the UK equity market's substantial foreign revenue exposure, with more than 70% of sales originating from outside the UK and various of the largest names having not more than their headquarters in the country, the index is heavily correlated to sterling.

UK equities are heavily geared to the USD

A weaker UK currency translates into higher foreign currency earnings and as such into positive performance. Notably, it is the correlation of sterling to the US dollar, which has the most significant impact on relative UK equity performance, partly stemming from the high commodity exposure via energy and miners. As a result, the UK stands out as the market that is the most sensitive among major markets to a depreciation in its domestic currency against the US dollar (Exhibit 9).

Exhibit 9: UK equities benefit the most from a weaker domestic currency vs the USD

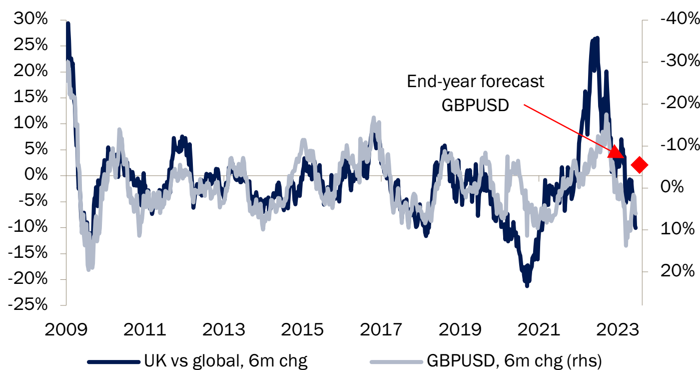
Correlation coefficient of FX vs relative equity performance, 6-month changes, last 20 years					
	Switzerland	EMU	Japan	UK	EM (US $)
vs USD TWI	0.72	0.44	0.49	0.62	-0.63
vs local FX TWI	-0.23	-0.39	-0.52	-0.64	0.74
vs USD/local FX	0.72	0.46	0.71	0.86	

Source: Refinitiv, Bank J. Safra Sarasin, 27.06.2023

The difficult macro setup in the UK would argue for a weaker GBP and a UK equity outperformance

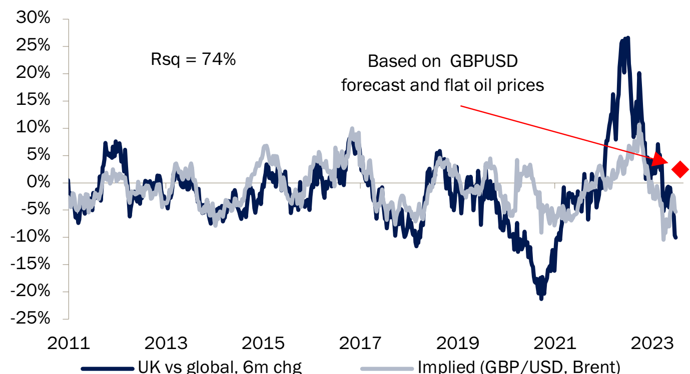
Given the challenging economic backdrop in the UK, with the central bank facing the strongest inflation overrun among major developed markets, a more substantial downturn and subsequent drop in the currency are likely over the coming six months. We assume as a result that sterling should weaken in the second half, in particular against the USD. This should generate around 5% to 10% upside on a relative basis to global equities, assuming oil prices remain fairly stable (Exhibits 10 and 11).

Exhibit 10: Our forecast for a weaker GBPUSD supports UK equities



Source: Refinitiv, Bank J. Safra Sarasin, 29.06.2023

Exhibit 11: Our model suggests a ~5% rise in UK equities vs global



Source: Refinitiv, Bank J. Safra Sarasin, 29.06.2023

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Economic Calendar

Week of 03/07 – 07/07/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 03.07.2023						
JN	01:50	Tankan Large Mfg Index	2Q	Index	3.0	1.0
	01:50	Tankan Non-Mfg Index	2Q	Index	10.0	8.0
US	16:00	ISM Manufacturing Index	Jun	Index	47.3	46.9
	16:00	ISM New Orders	Jun	Index	--	42.6
Tuesday, 04.07.2023						
CA	15:30	Canada Manufacturing PMI	Jun	Index	--	49.0
Wednesday, 05.07.2023						
EU	11:00	PPI MoM	May	mom	--	-3.2%
	11:00	PPI YoY	May	yoy	--	1.0%
US	16:00	Factory Orders MoM	May	mom	0.5%	0.4%
	16:00	Factory Orders Ex Trans MoM	May	mom	--	-0.2%
	20:00	FOMC Meeting Minutes				
Thursday, 06.07.2023						
EU	11:00	Retail Sales MoM	May	mom	--	0.0%
	11:00	Retail Sales YoY	May	yoy	--	-2.6%
US	13:30	Challenger Job Cuts YoY	Jun	yoy	--	286.7%
	14:15	ADP Employment Change	Jun	1'000	250k	278k
	14:30	Initial Jobless Claims	Jul01	1'000	--	--
	16:00	Jolts Job Openings	May	1'000	--	10103k
	16:00	ISM Services Index	May	Index	51.2	50.3
Friday, 07.07.2023						
US	14:30	Change in Nonfarm Payrolls	Jun	1'000	213k	339k
	14:30	Unemployment Rate	Jun	%	3.6%	3.7%
	14:30	Average Hourly Earnings MoM	Jun	mom	0.3%	0.3%

Source: Bloomberg, J. Safra Sarasin as of 29.06.2023

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	0.98	4	-64	5.3
German Bund 10 year (%)	2.42	7	-15	1.8
UK Gilt 10 year (%)	4.38	-2	71	-3.1
US Treasury 10 year (%)	3.85	12	-2	1.4
French OAT - Bund, spread (bp)	53	1	-1	
Italian BTP - Bund, spread (bp)	168	5	-46	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11,171	17.2	-0.1	7.2
DAX - Germany	15,947	11.3	-0.3	14.5
MSCI Italy	883	8.4	2.1	17.1
IBEX - Spain	9,511	10.5	1.8	18.3
DJ Euro Stoxx 50 - Eurozone	4,355	12.5	1.2	18.0
MSCI UK	2,136	10.5	-0.4	1.7
S&P 500 - USA	4,396	20.1	0.3	15.5
Nasdaq 100 - USA	14,940	28.3	-0.7	37.2
MSCI Emerging Markets	987	13.3	-1.3	4.7

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.90	6.8	0.3	-2.7
EUR-CHF	0.98	4.7	-0.1	-1.3
GBP-CHF	1.13	6.9	-0.6	1.4
EUR-USD	1.09	6.6	-0.3	1.4
GBP-USD	1.26	8.3	-0.8	4.3
USD-JPY	144.6	10.5	0.6	10.3
EUR-GBP	0.86	6.2	0.5	-2.7
EUR-SEK	11.80	7.4	1.1	5.8
EUR-NOK	11.71	10.6	-0.7	11.6

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	101	15.8	-4.1	-10.9
Brent crude oil - USD / barrel	75	32.8	0.6	-12.2
Gold bullion - USD / Troy ounce	1,904	10.5	-0.5	4.4

Source: J. Safra Sarasin, Bloomberg as of 29.06.2023

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30 June 2023

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