J. Safra Sarasin

Cross-Asset Weekly

28 July 2023

Data dependence is the new forward guidance

Central banks in the US and in the euro area matched market forecasts this week without providing much guidance on the path ahead. Both, the Fed and the ECB raised their policy rates by 25bps and made clear that further tightening depends on the incoming data. The ECB provided a balance assessment of the current situation, acknowledging that headline inflation is falling and that higher policy rates are leading to tighter financing conditions, while underlying inflation remains too high. President Lagarde indicated that upcoming policy steps will be entirely data-dependent. As economic indicators point to a contracting or at best stagnating economy in Q3, we would favour a hold instead of a September hike.

FX markets focused on the dovish aspects of the ECB meeting and as a result, the euro sold off sharply. In our view, the European currency continues to look stretched. In trade-weighted terms, the euro has remained close to its all-time high, leaving the currency exposed to a further weakening in economic activity and a cooling Chinese recovery. Moreover, growing headwinds from the yield side and speculative repositioning could trigger a sharper downward move.

Solid Q2 macro data in the US has also left a mark on US Q2 earnings which are providing the strongest picture since Q2 2022. After about a third of reports for the season, more than 70% of S&P 500 companies have beaten expectations, with reported earnings coming in 4% above pre-season consensus data. With several major reports yet to come, the picture could still change, but the start to the season has undoubtedly been strong, spurring hopes that the worst is behind us with regard to corporate earnings in the US.

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ECB Meeting

From now on deliberately data-dependent

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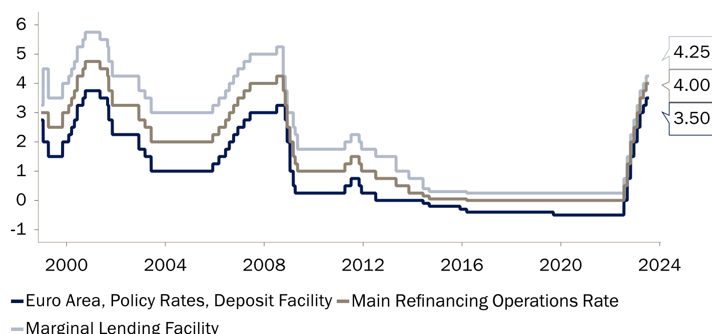
The ECB raised its policy rates by 25bp, as broadly expected. It also lowered the remuneration of required reserves to 0% in order to save interest expenses. It acknowledges that headline inflation is falling and that higher policy rates are leading to tighter financing conditions and lower credit demand. However, it also stresses that underlying inflation remains high overall. President Lagarde clearly indicated that the September and any subsequent policy decisions will be entirely data-dependent. As economic indicators point to a contracting or at best stagnating economy in Q3, we would favour a pause in September. If anything, a faster balance sheet run-down by actively selling bonds of its PEPP portfolio would be our favourite measure of future policy tightening. However, President Lagarde also confirmed that interest rates would remain the ECB's main policy tool and that a further reduction of its bond portfolios haven't been discussed at this meeting. She left no doubt in her determination to bring inflation back to 2% and that she is willing to make significant sacrifices in terms of lost output to do so.

ECB acknowledges that tighter monetary policy is slowing down the economy already

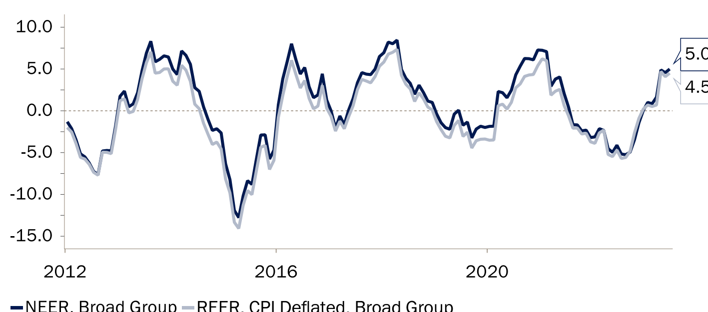
As broadly expected, the ECB increased its policy rates by 25bp at yesterday's meeting (Exhibit 1). Similar to the Fed, it did not give much guidance for its September meeting and indicated that its future action would be entirely data-driven. The ECB acknowledged that the economic outlook has deteriorated due to lower domestic and external demand, especially for manufactured goods. In combination with tighter financing conditions, the euro's appreciation is slowing down export activity (Exhibit 2). Services, in particular contact-intensive industries like tourism, have remained strong so far, which is also reflected in a robust labour market. Yet investment spending by households and corporates is slowing down. This is not surprising but the deliberate consequence of tighter monetary policy. Therefore, it is an indication that the transmission mechanism of monetary policy is working as intended.

Exhibit 1: Policy rates have never increased that fast before



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

Exhibit 2: The strong euro is additionally weighing on the economy



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

Zero remuneration of minimum reserves saves the ECB interest rate expenses of around EUR 5.9 billion annually

The ECB also lowered the rate at which it remunerates banks' minimum reserves to 0%. So far, the ECB paid banks interest equal to the deposit rate. Banks are required to hold minimum reserves of 1% of their deposit base at the ECB. These reserves currently amount to EUR 157 billion. At current interest rate levels, not remunerating minimum reserves further will lead to savings of EUR 5.9 billion annually.

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Not enough progress in bringing underlying inflation down

In yesterday's press conference, ECB President Lagarde stressed that inflation would remain too high for too long, in spite of a slowing economy. She also mentioned that the drivers of inflation are changing: While external price pressures are falling, domestic price pressures are increasing. According to the ECB's assessment, profit margins are high enough for wages to increase without necessitating additional price increases. In other words, falling profit margins would be in the interest of the ECB and no reason to ease the burden for the corporate sector by easing financing conditions. Importantly, President Lagarde mentioned that some measures of inflation expectations need to be monitored as they have risen beyond the 2% target. We have stressed this point before and observed that market based inflation expectations have been increasing steadily since March 2020. Given that their current level of 2.5% might include some risk premia, they are not necessarily incompatible with the inflation target. But it is also clear that it would be at the upper limit of any plausible range that is compatible with it.

A September pause is becoming more likely

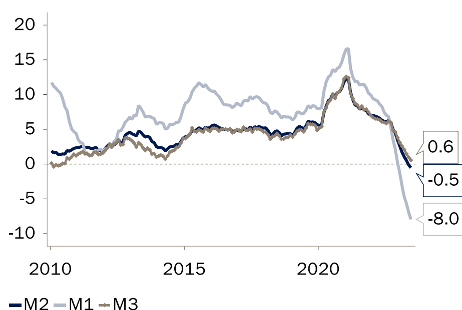
In contrast to previous meetings, President Lagarde did not give any forward guidance for the September meeting. Instead, she indicated that policy decisions in September and the subsequent meetings would be entirely data-dependent. The ECB could pause or hike further. Furthermore, a pause in September would only be a pause and not necessarily the end of the hiking cycle. Given the current slowdown of the euro area, this is absolutely appropriate. The cumulative tightening of 425bp within a year is completely unprecedented and is showing its effects already. Monetary and credit aggregates are declining and banks' credit standards have tightened (Exhibits 4-6). As monetary policy works with lags, prior tightening is likely to show additional effects in the coming quarters. This should lead to a longer period of below-potential growth. Whether that will be enough to moderate inflationary pressures is less certain.

We expect another rate hike in H2

The ECB's main criteria for its policy decisions will remain (i) the assessment of the inflation outlook, (ii) the dynamics of underlying inflation, and (iii) the strength of monetary policy transmission. When analysing them we conclude that it will take quite a while before the ECB would drop its current tightening bias. In particular, we are concerned about the high level of market-based inflation expectations and that high inflation expectations would become entrenched. As a consequence, we could imagine that a slowing economy will not necessarily lead to lower underlying inflation rates such that the ECB will be forced to deliver an additional rate hike in H2 2023. While we would also favour a faster balance sheet reduction to higher policy rates in order to tighten financing conditions, President Lagarde made it clear at the press conference that interest rates would continue to be the ECB's main policy tool.

Exhibit 4: Monetary aggregates

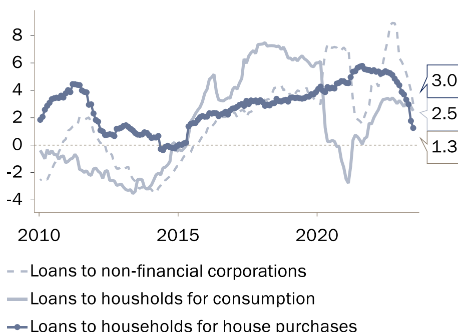
Euro area, Money growth, wda, sa, in % yoy, latest data: 06/2023



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

Exhibit 5: Credit growth

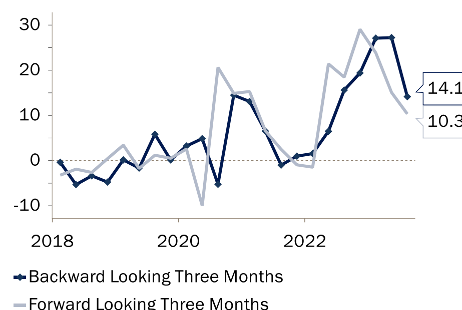
Euro area, loans in % yoy, latest data: 06/2023



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

Exhibit 6: Bank lending survey

ECB, Bank Lending Survey, All Enterprises, Net Tightening of Credit Standards



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

FX markets

The euro's recent rally should prove short-lived

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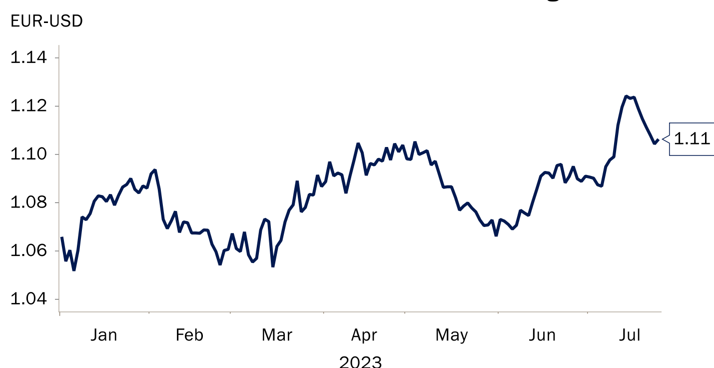
FX markets provided a dovish assessment of the ECB meeting and hence the euro continued to reverse its recent gains. In our view, this should carry on. The euro remains close to its all-time high in trade-weighted terms, leaving the currency exposed to a further weakening in economic activity. Moreover, growing headwinds from the yield side and speculative repositioning could trigger a sharper downward move.

We think that the euro's will continue to reverse its recent recovery

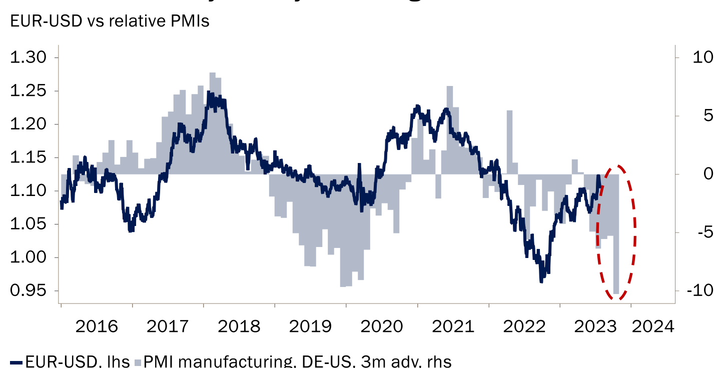
In spite of yesterday's sell-off, the euro is up by around 5% year-to-date (Exhibit 1). Over the past weeks, the currency primarily benefitted from softening US inflation along with somewhat weaker than expected US nonfarm payrolls. Recent data led the market to price an «immaculate disinflation» scenario – a soft landing of the economy with a concomitant return of inflation to the Fed's target. In principle, this would imply that the Fed has reached the end of its hiking cycle. Reflecting the shift in market expectations, US yields have fallen over the past two weeks, diminishing the US dollar's yield advantage to some extent. Yet we are sceptical about the prospects for a soft landing and have assigned a probability of less than 50% to such an outcome (see «The convoluted path to a soft landing»). In our view, this has important implications for the euro, which – at current levels – looks stretched on various metrics.

Exhibit 1: The euro has started to reverse its recent gains



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

Exhibit 2: Weaker cyclical dynamics argue for euro downside



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

The euro does not yet reflect the weakness in European manufacturing

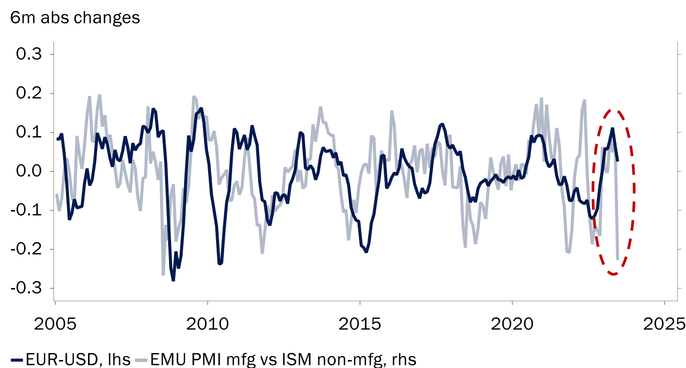
Most importantly, we expect the euro to realign to the euro area's cyclical dynamics (relative to the US) which usually drive the European currency to a considerable extent. Hence we would expect EUR-USD to drop more meaningfully, going forward (Exhibit 2). Preliminary data on manufacturing activity in July came in remarkably weak for the euro area and substantially lower than the US data. Indeed, German new orders data fell to their lowest since May 2020 and the ifo business climate index experienced a further drop on Tuesday. Given that the euro area relies to a substantially higher degree on manufacturing than the services-driven US economy, the current weakness should be particularly damaging to the euro (Exhibit 3).

Near term, China is unlikely to boost the euro area economy

Owing to the high degree of economic integration between China and the euro area, the European manufacturing sector additionally suffers from slowing growth in China. Much of China's current weakness can be attributed to the ongoing problems in its real estate sector, which contributes roughly 20% to Chinese GDP. The sector particularly struggles with housing sales and property prices declining, even in so-called tier 1 cities. Similarly,

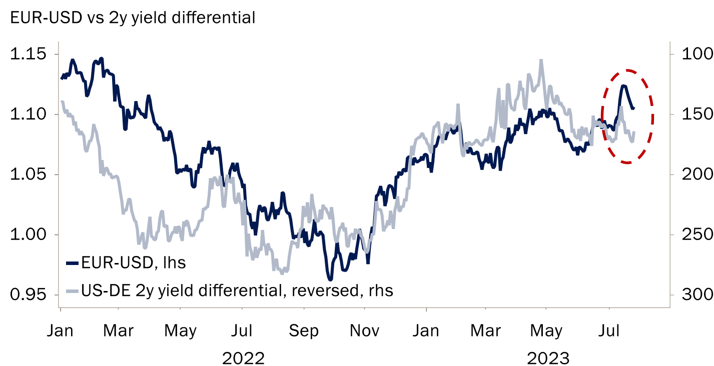
housing starts have dropped further in June. And with youth unemployment rising beyond 20%, the job market seems to be in the worst state in years. Last week, we conjectured that China might be already in a balance sheet recession (see «Waiting for the stimulus»). While the Communist Party pledged to step up its fiscal support, we are doubtful that it will be enough to catalyse a turnaround. This means that the euro area is also unlikely to receive a meaningful boost from China.

Exhibit 3: Strong US services usually weigh on the euro



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

Exhibit 4: Recent euro recovery barely supported from yield side



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

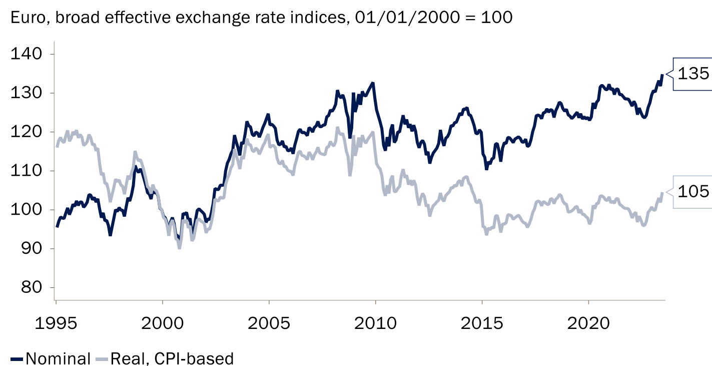
Given that the ECB is close to the end of its hiking cycle, markets will begin to price future policy rate cuts

Eventually, we expect the weakness in European manufacturing to push euro area yields lower, which should widen the current gap between the EUR-USD pair and 2-year yields (Exhibit 4). Yields are also facing headwinds from policy makers' comments. Notably, leading ECB hawks (Bundesbank President Joachim Nagel and Dutch Central Bank Governor Klaas Knot) have turned remarkably dovish with regard to the prospect of further ECB policy rate hikes. In our view, the ECB's return to a data-dependent approach raises the odds that the market will begin to price future policy rate cuts, which should continue to weigh on the European currency going forward.

The euro looks expensive and is vulnerable to a speculative repositioning

Two final points are worth considering: The euro looks highly valued, given that the trade-weighted exchange rate lately reached an all-time high (Exhibit 5), putting the euro's recent advances into question. Lastly, we note that while net speculative long positions have been reduced somewhat, they remain at elevated levels (Exhibit 6). In our view, this additionally argues for near-term downside for the euro once a larger bulk of long positions is closed.

Exhibit 5: Trade-weighted euro has reached an all-time high



Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

Exhibit 6: Likely position squaring implies downside for the euro

Source: Macrobond, Bank J. Safra Sarasin, 27.07.2023

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US equities

Q2 mid-season: Strong beat on soft expectations

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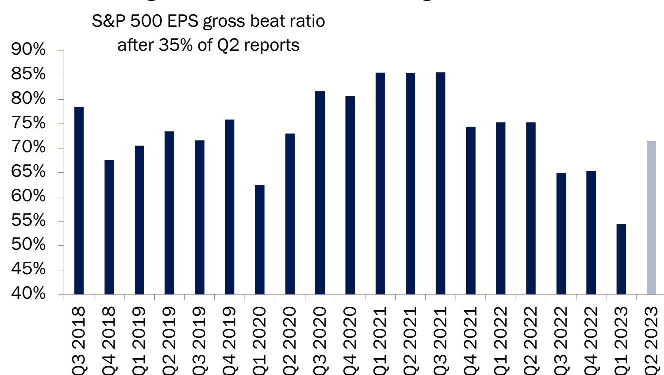
So far, Q2 earnings have come in well ahead of expectations in the US. After 35% of companies have reported, the beat rate stands at 71%, the highest since Q2 2022. Reported earnings are 4% above the levels consensus had expected going into the season. If reporting remains as strong over the remainder of the season, quarterly earnings growth could rise to 3%, which would be the strongest qoq growth number since Q2 2022. Despite the strength of the data, the market reaction has been rather muted. In particular the tech sector and growth in general have started to fall behind the rest of the index despite broadly beating consensus expectations – a reflection of extended valuation levels. We would expect value and small cap to catch up further to growth, given that their valuation levels are a lot less challenging and even minor beats seem sufficient for these segments of the market to re-rate to higher multiples.

Beats are at the highest since Q2 2022

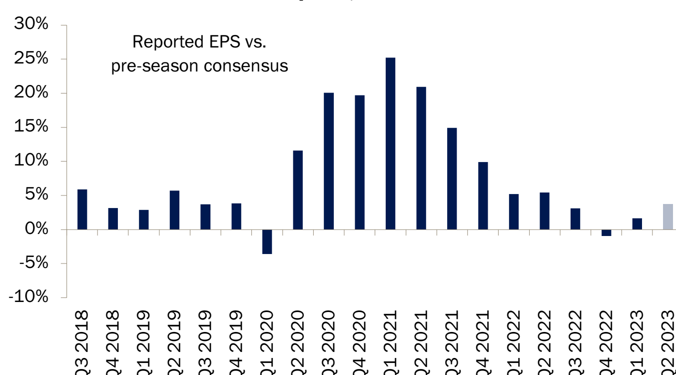
The US Q2 earnings season is off to a solid start. After 35% of reports, 71% of companies managed to beat pre-season consensus expectations, which would be the highest beat rate since Q2 2022 and well above the 50% beat rate in Q1 (Exhibit 1). The strong beat count also translates into earnings coming in well ahead of expectations. Current reported EPS for the S&P 500 is 4% above the levels consensus had expected, which would mark the strongest earnings surprise since Q2 2022 as well.

Exhibit 1: The gross beat rate is at the highest since Q2 2022...



Source: Refinitiv, Bank J. Safra Sarasin, 26.07.2023

Exhibit 2: ...as is the beat surprise, with EPS 4% above consensus



Source: Refinitiv, Bank J. Safra Sarasin, 26.07.2023

On track to record positive qoq EPS growth

If the remaining reports until the end of the season were to be in line with expectations, yoy EPS growth for the S&P 500 would be at -7% and at -1% qoq. Yet if companies manage to beat to the same extent until the end of the season as they have done so far, qoq earnings growth would turn positive 3% and the yoy drop in EPS would be reduced to -3%. This would mark Q1 as a trough in the earnings cycle, when qoq growth came in flat and yoy EPS declined by -4%.

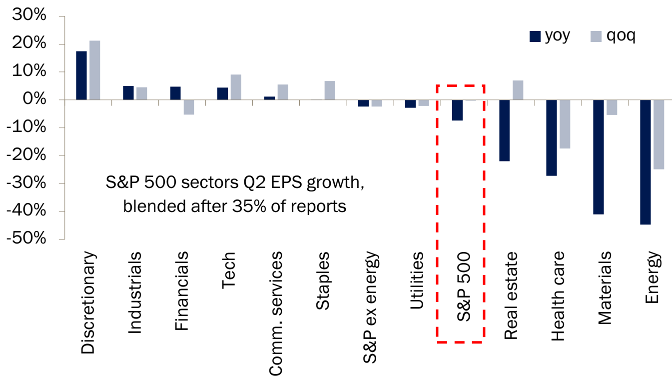
Consumer discretionary earnings lifted by travel & leisure

Consumer discretionary has so far seen the strongest EPS increase among sectors this season, driven by a rebound in travel & leisure earnings (Exhibit 3), with airlines being a key driver. Other subsectors of discretionary have not done as well though. Auto EPS for example are down 5% yoy, which may still change over coming weeks, given that various major manufacturers yet have to report.

Financials with solid results

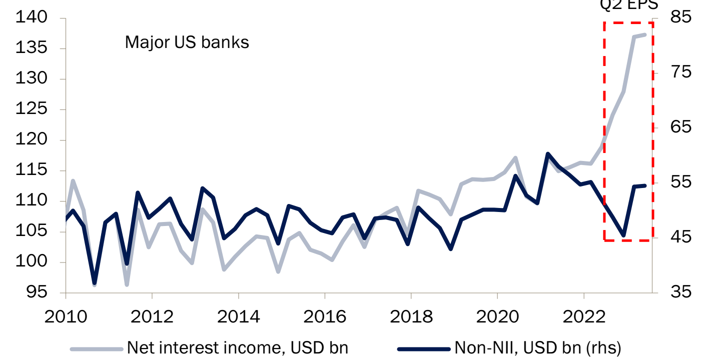
Financials, which dominated the first few days of the season, have also been notable. They have benefitted not only from another solid increase in net interest income in Q2, but also saw other sources of income recover from the Q1 slump (Exhibit 4). The headline EPS growth number for financials at -5% qoq (+6% yoy) does not reflect this underlying strength though. Yet once Goldman Sachs is excluded from the sector aggregate, the qoq number jumps to +2% and yoy growth to +12%.

Exhibit 3: Discretionary with strongest growth, driven by travel



Source: Refinitiv, Bank J. Safra Sarasin, 27.07.2023

Exhibit 4: Banks earnings are looking solid across business lines

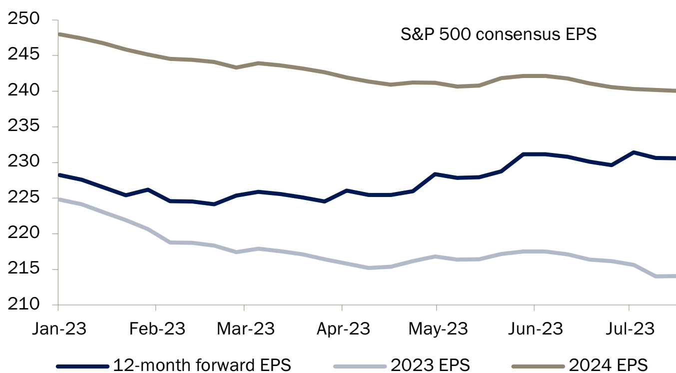


Source: Refinitiv, Bank J. Safra Sarasin, 27.07.2023

Tech shows resilience but high bar to pass for further outperformance

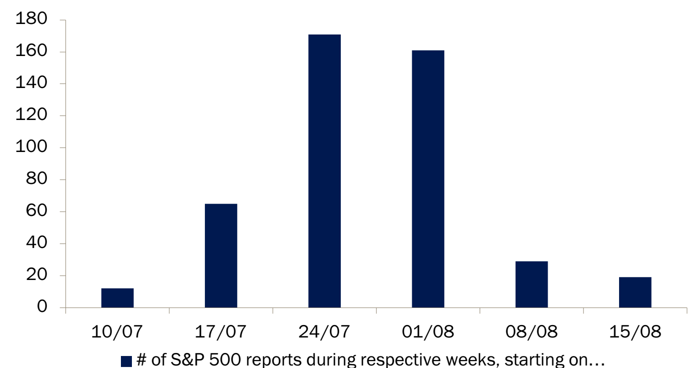
Tech earnings have also been strong as compared to expectations, with more than 90% of companies beating consensus numbers so far. Yet given elevated valuations, the bar was quite high for these numbers to translate into performance, leaving the sector's performance trailing the market since the start of the season. Key take-aways from the earnings reports are that (i) AI revenues will likely be spread out over the coming quarters rather than materialising immediately, while (ii) tech-related communication services names show that advertising revenues have rebounded in Q2 and (iii) cost-cutting continues, helping the bottom-line in the tech space. Some of the largest names in the sector yet have to report. We would expect the picture to hold: small disappointments are likely to suffer more than beats are being rewarded.

Exhibit 5: Consensus earnings have been very soft year-to-date



Source: Refinitiv, Bank J. Safra Sarasin, 26.07.2023

Exhibit 6: Next week is another busy week with 161 Q2 reports



Source: Refinitiv, Bank J. Safra Sarasin, 26.07.2023

Consensus earnings, which have been very weak year-to-date, should see upgrades

While there's been no reversal of the downtrend in consensus earnings so far (Exhibit 5), we would expect the season to provide some positive impulse for EPS revisions in the weeks to come. Yet given that valuations are already substantially more stretched than at any point over the past year, market upside is set to materialise only very gradually, if at

all. We prefer pockets of the market which have trailed the recent rebound, such as value and small caps.

Another busy week ahead

The coming week will be the second busiest week this season, with 161 names reporting (Exhibit 6). Most importantly, Apple will report on Thursday. Other names which will likely receive some more market attention are Caterpillar on Wednesday, and Pfizer and Starbucks on Tuesday.

Exhibit 7: Our Q2 earnings season dashboard

S&P 500 earnings dashboard Q2 2023	Reported					Blended (reported + consensus)		Net income margin	
Sector	% reported	EPS yoy	Sales yoy	EPS beats	EPS surprise	EPS yoy	Sales yoy	Blended	5-year avg
Energy	29%	4%	-63%	71%	-3%	-45%	-24%	11%	7%
Basic materials	33%	-49%	-14%	33%	-8%	-41%	-13%	11%	12%
Industrials	37%	9%	13%	79%	3%	5%	8%	13%	12%
Consumer discretionary	36%	85%	18%	73%	9%	17%	8%	6%	5%
Consumer staples	33%	10%	10%	91%	8%	0%	6%	6%	7%
Health care	21%	-6%	10%	92%	3%	-27%	3%	12%	14%
Financials	64%	6%	14%	49%	-1%	5%	10%	18%	19%
Technology	35%	9%	11%	95%	8%	4%	5%	23%	24%
Communication services	18%	-14%	-13%	100%	2%	1%	-3%	15%	14%
Utilities	7%	9%	58%	50%	-2%	-3%	4%	12%	13%
Real estate	16%	-7%	28%	40%	-8%	-22%	2%	16%	19%
S&P 500	**35%**	**7%**	**7%**	**71%**	**4%**	**-7%**	**2%**	12%	12%
S&P ex energy & financials	30%	7%	11%	79%	6%	-3%	5%	11%	12%
S&P ex energy	34%	7%	11%	71%	4%	-2%	6%	12%	13%
S&P ex financials	30%	7%	6%	78%	5%	-9%	2%	**11%**	**11%**
S&P cyclicals	36%	19%	13%	73%	4%	3%	7%	8%	8%
S&P defensives	21%	-4%	6%	89%	4%	-15%	4%	10%	11%

Source: Refinitiv, Bank J. Safra Sarasin, 27.07.2023

Economic Calendar

Week of 31/07 – 04/08/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 31.07.2023						
CN	03:30	China Composite PMI	Jul	Index	--	52.3
	03:30	China Manufacturing PMI	Jul	Index	48.9	49.0
	03:30	China Non-manufacturing PMI	Jul	Index	53.0	53.2
EU	11:00	CPI	Jul P	yoy	5.2%	5.5%
	11:00	CPI	Jul P	mom	-0.2%	0.3%
	11:00	CPI core	Jul P	yoy	5.3%	5.5%
US	15:45	Chicago PMI	Jul	Index	43.5	41.5
	16:30	Dallas Fed Mfg. Activity	Jul	Index	--	-23.2
Tuesday, 01.08.2023						
DE	10:00	Germany Manufacturing PMI	Jul F	Index	38.8	38.8
EU	10:00	EMU Manufacturing PMI	Jul F	Index	42.7	42.7
UK	10:30	UK Manufacturing PMI	Jul F	Index	45.0	45.0
US	15:45	US Manufacturing PMI	Jul F	Index	--	49.0
	16:00	JOLTS job openings	Jun	1'000		9824
	16:00	US Manufacturing ISM	Jul	Index	46.8	46.0
	16:00	US Mfg ISM New Orders	Jul	Index	--	45.6
Wednesday, 02.08.2023						
US	13:00	MBA Mortgage Applications	Jul28	wow	--	-1.8%
Thursday, 03.08.2023						
JP	02:30	Japan Services PMI	Jul F	Index	--	53.9
	02:30	Japan Composite PMI	Jul F	Index	--	52.1
CN	03:45	China Caixin Services PMI	Jul	Index	52.7	53.9
	03:45	China Caixin Composite PMI	Jul	Index	--	52.5
EU	10:00	EMU Services PMI	Jul F	Index	51.1	51.1
	10:00	EMU Composite PMI	Jul F	Index	48.9	48.9
US	15:45	US Services PMI	Jul F	Index	--	52.4
US	15:45	US Composite PMI	Jul F	Index	--	52.0
US	16:00	US Services ISM	Jul	Index	53.2	53.9
	16:00	US Durable Goods Orders	Jun	yoy	--	4.7%
Friday, 04.08.2023						
DE	08:00	Factory Orders	Jun	mom	-2.4%	6.4%
	08:00	Factory Orders	Jun	yoy	5.7%	-4.3%
US	14:30	Non-farm payrolls	Jul	1'000	180	209
	14:30	Unemployment Rate	Jul	%	3.6%	3.6%

Source: Bloomberg, J. Safra Sarasin as of 27.07.2023

J. Safra Sarasin
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Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W (bp)	Δ YTD (bp)	TR YTD in %
Swiss Eidgenosse 10 year (%)	0.99	3	-63	5.4
German Bund 10 year (%)	2.47	1	-10	1.7
UK Gilt 10 year (%)	4.31	9	64	-2.3
US Treasury 10 year (%)	4.00	17	13	0.5
French OAT - Bund, spread (bp)	52	0	-2	
Italian BTP - Bund, spread (bp)	160	-1	-55	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11,373	18.1	1.5	9.2
DAX - Germany	16,406	11.7	1.2	17.8
MSCI Italy	930	8.8	2.4	23.5
IBEX - Spain	9,695	10.5	1.8	21.6
DJ Euro Stoxx 50 - Eurozone	4,447	12.8	1.7	20.6
MSCI UK	2,196	11.1	0.6	4.7
S&P 500 - USA	4,537	21.1	0.1	19.3
Nasdaq 100 - USA	15,465	28.3	0.0	42.0
MSCI Emerging Markets	1,035	13.8	1.7	10.4

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.87	7.7	0.4	-6.0
EUR-CHF	0.95	5.3	-0.9	-3.6
GBP-CHF	1.11	7.1	-0.1	-0.6
EUR-USD	1.10	6.8	-1.3	2.6
GBP-USD	1.28	8.1	-0.5	5.9
USD-JPY	139.0	9.9	-1.9	6.0
EUR-GBP	0.86	5.9	-0.8	-3.0
EUR-SEK	11.57	7.6	0.2	3.7
EUR-NOK	11.17	10.5	-0.4	6.4

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	107	14.2	1.3	-5.2
Brent crude oil - USD / barrel	84	24.3	5.3	-1.5
Gold bullion - USD / Troy ounce	1,952	9.3	-0.9	7.0

Source: J. Safra Sarasin, Bloomberg as of 27.07.2023

J. Safra Sarasin

Cross-Asset Weekly

28 July 2023

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