J. Safra Sarasin
Cross-Asset Weekly
02 February 2024

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Not so fast

While central banks are preparing to ease policy in 2024, they are trying to dampen the enthusiasm of markets that are already pricing multiple rate cuts. They want to make sure that inflation is on a sustained downward trend towards their respective targets. A decisive victory over inflation cannot yet be declared, and 2024 has barely started. So, central banks want to take their time and watch incoming data carefully.

We expect central banks to ease policy starting in Q2 2024, both by cutting rates as well as making adjustments to their quantitative tightening programmes. Chair Powell has confirmed that discussions about the pace of the balance sheet run-off will commence at the March FOMC meeting. According to our estimates, optimal reserve levels for the US banking system are probably not far below current levels, hence reducing the pace makes sense. The US Treasury Department's preference to fund an important part of the deficit with increased Treasury bill issuance at the expense of longer-duration bonds could even lead to an earlier end to quantitative tightening.

In the FX space, we note a significant drop in volatility as central bank policies seem to converge at the moment, rendering carry trades attractive. Having said that, the relative calm is likely temporary and should end once rate cuts start in earnest or in case of a rapid escalation in geopolitical tensions.

This week's highlights

US macro

Fed is determined not to repeat mistake of the 1970s

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Chair Powell struck a balanced note, arguing that a lot of progress has been made towards achieving their objectives but not wanting to rush into cutting rates. May is likely to be the time when the Committee has enough confidence that inflation is moving sustainably towards 2% to pull the trigger. In their base case, the strength of the real economy allows them to proceed carefully and methodically. We still think the economy will soften somewhat more than the FOMC currently anticipates, forcing more aggressive easing. The good news is that the Fed will not hesitate to do so if needed. Finally, the Committee left the discussion on tapering QT for the next meeting in March. We think it will reduce its pace soon after and end the program in 2H24.

No more rate hike bias but the Fed wants to be very confident that it won the inflation fight before easing policy. We expect a first rate cut in May

Chair Powell's message on Wednesday was balanced, reflecting the different views on the Committee. The Fed recognises that a lot of progress has been made towards achieving its objectives and removed the tightening bias in its statement. Still, it raised the bar for an early rate cut. It added that it "doesn't expect [...] to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2%". Jay Powell added that they need to see more good data to build that confidence but doesn't think the Committee will reach it by the time of the March meeting. As long as the real economy is strong, the Fed can afford to wait a bit before lowering rates "methodically and carefully". A first rate cut in May remains our base case.

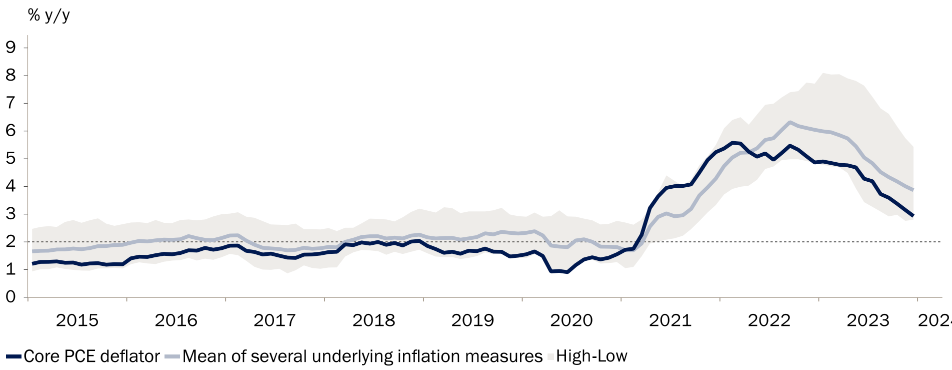
Growth is likely to slow and disinflation to be bumpier as tailwind from supply normalisation wanes

Given the rapid drop in inflation over the past 6 months – core PCE prices have grown by 2% on an annualised basis – why so much prudence (Exhibit 1)? Largely because the road forward is unlikely to be as smooth as it was last year. Strong growth and the fall in inflation largely reflects the positive supply shock from healing supply chains and more people entering the labour force. Solid growth in aggregate demand was met with an improvement in productive capacity. But this will peter out over the coming year. As we argued before, we think these forces have already largely run their course. The Fed is more optimistic and thinks the normalisation process can run somewhat further.

We expect the Fed to taper QT in spring and end the program at some point in 2H24

Finally, the Fed will discuss QT in detail at its March meeting. The program will be gradually reduced soon after and discontinued in 2H24, in our view. Indeed, O/N RRP balances have shrunk rapidly. And banks' demand for reserves is likely to be relatively strong, in part due to incoming regulatory changes and unrealised balance sheet losses.

Exhibit 1: Core PCE has come down close to target but other measures remain higher



Source: Macrobond, Bank J. Safra Sarasin, 01.02.2024

US fixed income

From quarterly refunding to quantitative tightening

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The bond market sell-off coincident with the quarterly refunding announcement (QRA) from the US Treasury department in August last year has demonstrated that there is a limit to the amount of duration the private sector is prepared to buy without large risk premiums. Consequently, the US Treasury has skewed additional issuance more towards Treasury bills to alleviate pressure on long duration bonds. As a side effect of this, the Fed will likely have to end quantitative tightening earlier than planned.

Quarterly refunding announcements have had a significant impact on the Treasury market lately

The latest quarterly refunding announcements (QRA) from the US Treasury department have spurred a lot of attention. The US Treasury regularly publishes its estimated borrowing requirements for the next quarters and the intended auction sizes for different maturities of Treasury securities to finance government outlays. An unexpected sharp increase in announced auction sizes because of sharply higher federal deficits in August last year coincided with the start of a significant Treasury bond sell-off in Q3 2023.

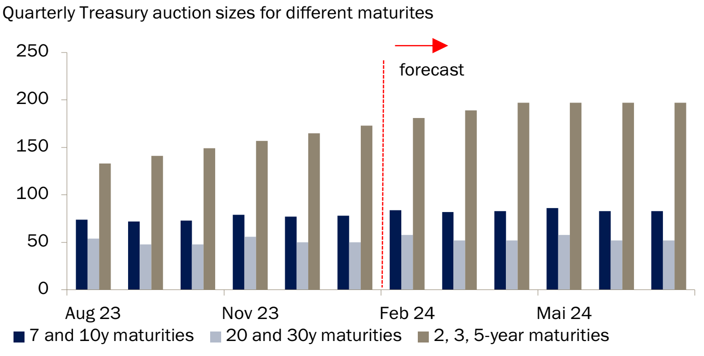
More reliance on Treasury bill funding than on long-term bonds

The market reaction to the August QRA has demonstrated that there is a limit to the amount of duration that the private sector is prepared to take up without large risk premiums. Authorities have reacted by shifting a substantial part of additional funding requirements to duration insensitive Treasury bills, as well as to the shorter end of the yield curve, while issue sizes for longer duration Treasuries were much less affected (Exhibit1). The tweaked QRA in November promptly led to a fierce bond rally into year-end.

Abundance of Treasury bills and other money market instruments impacts the length and size of Quantitative Tightening

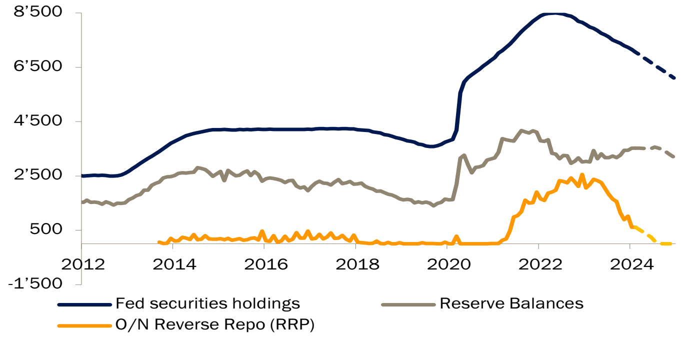
The skew towards shorter instruments to alleviate pressures on duration has also implications for the Fed's ongoing quantitative tightening programme. The abundant availability of Treasury bills with different maturities offers money funds an attractive riskless alternative to their holdings in the ON/RRP facility at the Fed, in particular for funds wishing to lock in current interest for a longer horizon instead of just getting an overnight rate. As a consequence, holdings at the ON/RRP facility have dropped precipitously and are expected to be close to depleted during H2 2024. We have already touched on the ON/RRP facility as a buffer for dwindling bank reserves (see here). As this buffer disappears, bank reserves will start to drop again in line with the balance sheet run-off again. The banking system's high preference for liquidity suggests that the amount of optimal bank reserves is probably not far below current levels (Exhibit 2). We therefore expect the Fed to start to reduce the pace of the balance sheet run-off, probably in May, and to end it in H2 2024.

Exhibit 1: Increase in auction sizes mostly in the 2, 3 and 5y buckets



Source: US Treasury, Bank J. Safra Sarasin, 01.02.2024

Exhibit 2: Optimal bank reserves not far below current levels



Source: Bloomberg, Bank J. Safra Sarasin, 01.02.2024

FX volatility

'Sideways' will likely remain the near-term direction

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Option-implied FX volatilities have experienced an extended downward trend over past months. Given that central banks' policies have converged, we expect most currencies to trade within tight ranges in the near term. This means that the dollar should only weaken very gradually. At the same time, the appreciation of the euro and the Swiss franc will likely be moderate. In our view, pound sterling and the Japanese yen will probably exhibit more directionality. Lastly, we note that the current environment is favourable for carry trades, whose unwinding could lead to a pickup in FX volatility, along with the US elections later this year.

Currencies have traded within relatively tight ranges throughout January

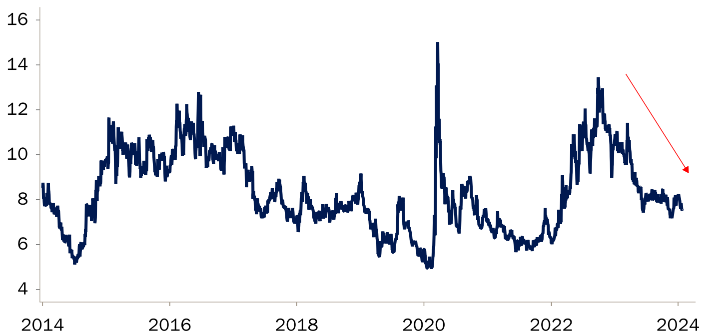
Currencies have struggled to find direction over the past weeks, and, as a result, FX pairs have traded within relatively tight ranges throughout January. With a year-to-date performance of close to 2%, the US dollar posts the highest gains on a trade-weighted basis, while the Japanese yen has dropped by more than 2% year-to-date.

Market pricing suggests that currencies will continue to trade sideways for a while...

Option-implied FX volatilities indicate that the market also expects FX movements to be constrained going forward. FX volatility already trended down throughout most of 2023 and the past weeks suggest that this trend will probably continue for a while (Exhibit 1). Meanwhile, implied volatilities have reached two-year lows (Exhibit 2).

Exhibit 1: FX volatility has trended downwards for more than a year

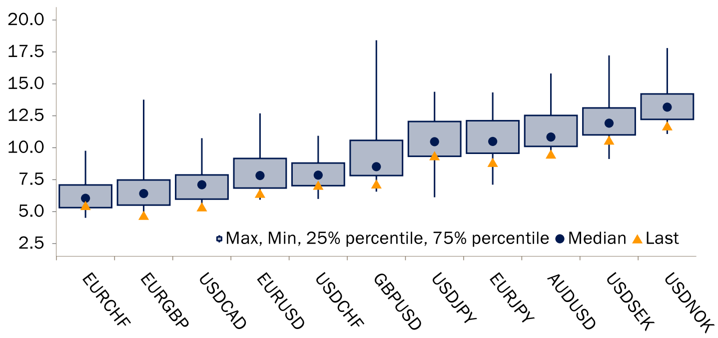
VXY G7 implied FX volatility index



Source: Bloomberg, Bank J. Safra Sarasin, 01.02.2024

Exhibit 2: Implied FX volatility is at around a 2-year low

3m option-implied FX volatility, past 2y



Source: Bloomberg, Bank J. Safra Sarasin, 01.02.2024

...which is largely driven by the convergence in central bank policies

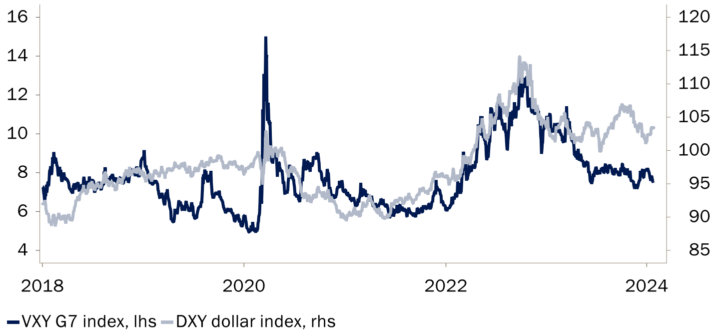
But what's driving these expectations? In essence, we think that it is the convergence of central bank policies that constrains FX dynamics to a tighter trading range, while a higher dispersion of policy choices should translate into higher FX volatility. To this date, most central banks have hiked their policy rates in line with the Fed's hiking cycle and the market similarly expects central banks to follow suit once the Fed embarks on a cutting cycle.

We expect the dollar to weaken only at a very gradual pace

The observations from the volatility space are also a reassuring signal for our FX forecasts. In particular its historical co-movement with FX volatility points towards a somewhat weaker dollar in 2024 (Exhibit 3), which adds to our perception that the currency looks overvalued (Exhibit 4). As we have noted before, we expect the outperformance of the US economy to fade going forward. This should weaken the dollar, given that US data is set to lose more momentum than euro area data. It also means that the dollar is unlikely to strengthen, even in the event of a global recession.

Exhibit 3: FX volatility usually co-moves with the US dollar

FX volatility vs US dollar



Source: Bloomberg, Bank J. Safra Sarasin, 01.02.2024

Exhibit 4: The US dollar screens as expensive

USD REER, CPI-based, deviation from 30y mean, in %

Source: Macrobond, Bank J. Safra Sarasin, 01.02.2024

The euro and Swiss franc should appreciate moderately, while the odds for pronounced moves of the British pound and the Japanese yen are somewhat higher

In turn, we expect the euro and the Swiss franc to appreciate only moderately in 2024. As the market continues to bank on a soft landing in most developed economies, macro surprises have diminished steadily for both the US and the euro area over past months (Exhibit 5), which has likely added to the recent decline in FX volatility. Yet we expect to see some more directionality in the British pound and the Japanese yen.

Unwinding of carry trades could trigger a resurge of FX volatility further out

While FX volatility is likely to remain low in the near term, we are well aware of potential triggers for a reversal. The combination of a high dispersion of policy rates within the G10 FX universe and low volatility has created a benign environment for carry trades, with the Japanese yen or the Swiss franc as likely funders (Exhibit 6). While such carry trades should not lead to a meaningful pickup in FX volatility in the near term, we will likely see a surge in FX volatility once these trades are unwound, which could be triggered in case the Fed starts to cut policy rates earlier than markets currently expect.

US presidential election carries further potential for sharper FX moves

Finally, it should be noted that FX reacts sensitively to political developments. The onset of the war in Ukraine sent the euro substantially lower, pound sterling temporarily dropped amid the UK government crisis in 2022, and the Israeli shekel came under considerable pressure when the Israel-Gaza conflict broke out in October 2023. Given that we are in a super election year, we think that election outcomes and in particular the rising odds of Donald Trump's victory in the US presidential election will probably revive FX volatility in the second half of this year.

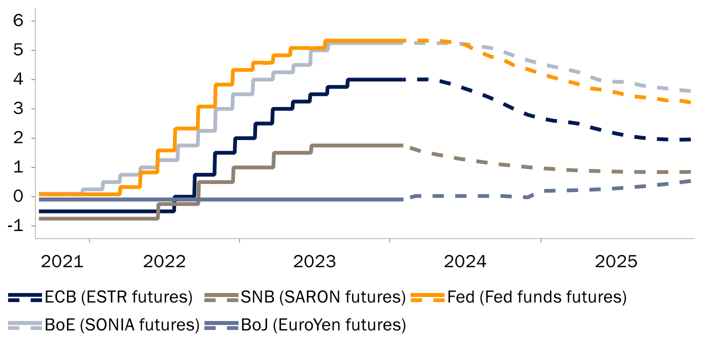
Exhibit 5: Macro surprises have diminished over the past months

Leading Indicators, Citi, Economic Surprise Index, Index

Source: Macrobond, Bank J. Safra Sarasin, 01.02.2024

Exhibit 6: Rates dispersion amid low FX volatility favours carry trades

Central banks' policy rates and market-implied rate trajectories



Source: Bloomberg, Bank J. Safra Sarasin, 01.02.2024

Economic Calendar

Week of 05/02 – 09/02/2024

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 05.02.2024						
EU	10:30	Sentix Investor Confidence	Feb	Index	--	-15.80
	11:00	PPI MoM	Dec	mom	--	-0.30%
	11:00	PPI YoY	Dec	yoy	--	-8.80
US	16:00	ISM Services Index	Jan	Index	52.20	50.60
	20:00	Senior Loan Officer Survey				
Tuesday, 06.02.2024						
EU	10:00	ECB 1 Year CPI Expectations	Dec	%	--	3.20%
	10:00	ECB 3 Year CPI Expectations	Dec	%	--	2.20%
	11:00	Retail Sales MoM	Dec	mom	--	-0.10%
	11:00	Retail Sales YoY	Dec	yoy	--	-0.30%
Wednesday, 07.02.2024						
JN	06:00	Leading Index CI	Dec P	Index	--	107.60
US	13:00	MBA Mortgage Applications	Feb02	wow	--	-7.20%
Thursday, 08.02.2024						
US	14:30	Initial Jobless Claims	Feb03	1'000	--	--
Friday, 09.02.2024						
JN	00:50	Money Stock M3 YoY	Jan	yoy	--	2.70%
FR	08:45	Wages QoQ	4Q P	qoq	--	0.50%

Source: Bloomberg, J. Safra Sarasin as of 01.02.2024

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W (bp)	Δ YTD (bp)	TR YTD in %
Swiss Eidgenosse 10 year (%)	0.82	-8	12	-0.5
German Bund 10 year (%)	2.18	-12	15	-0.4
UK Gilt 10 year (%)	3.75	-26	21	-1.3
US Treasury 10 year (%)	3.89	-25	1	0.7
French OAT - Bund, spread (bp)	48	-1	-5	
Italian BTP - Bund, spread (bp)	156	3	-12	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11'214	19.2	0.0	0.7
DAX - Germany	16'859	12.5	-0.3	0.6
MSCI Italy	977	8.2	2.5	1.6
IBEX - Spain	10'014	10.3	1.0	-0.4
DJ Euro Stoxx 50 - Eurozone	4'639	13.5	1.2	2.8
MSCI UK	2'185	11.3	1.3	-1.3
S&P 500 - USA	4'906	23.2	0.3	3.0
Nasdaq 100 - USA	17'345	31.5	-1.0	3.1
MSCI Emerging Markets	982	13.4	-0.6	-4.0

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.86	7.3	-0.8	1.9
EUR-CHF	0.93	5.5	-0.5	0.4
GBP-CHF	1.09	6.3	-0.4	2.0
EUR-USD	1.09	6.6	0.3	-1.4
GBP-USD	1.27	7.0	0.4	0.1
USD-JPY	146.6	9.6	-1.1	3.9
EUR-GBP	0.85	4.7	-0.1	-1.5
EUR-SEK	11.30	6.8	-0.4	1.5
EUR-NOK	11.36	8.6	0.5	1.2

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	98	10.0	-0.9	-1.1
Brent crude oil - USD / barrel	83	30.1	-0.1	7.0
Gold bullion - USD / Troy ounce	2'056	9.6	1.7	-0.4

Source: J. Safra Sarasin, Bloomberg as of 01.02.2024

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