J. Safra Sarasin
Cross-Asset Weekly

24 March 2023

A rate pause is moving closer

The latest bank failures in the US reveal that the rapid tightening in monetary policy over the past 12 months is starting to cause cracks in the financial system. More restrictive lending standards will contribute to tighter financial conditions, and help bring down elevated inflation rates. As a result, the FOMC no longer anticipates a need for 'ongoing rate increases' in order to attain a sufficiently restrictive monetary policy stance, but just that some additional tightening 'may be appropriate'. The Bank of England also struck a more cautious tone, while still hiking the Bank Rate by 25bp. The ECB and the SNB have increased their policy rates by 50bp at their last meetings as the monetary stance is not yet deemed restrictive enough to bring inflation quickly down to target levels. Nevertheless, we also expect smaller rate increases from both central banks going forward. We forecast two more 25bp increases from the ECB and one 25bp hike from the SNB.

As central banks move closer to peak policy rates, we also expect yield curve dynamics to start changing. In fact, the deeply inverted yield curves that we observe in many developed markets rates structures already reflect a fairly tight monetary stance, which ultimately will be loosened as disinflationary forces build up. Therefore, the potential for yield curves to re-steepen over the next 6 to 12 months is rising, in particular in the US.

Finally, the recovery in equity markets since the beginning of the year has closely tracked the turnaround in the global manufacturing PMI, led by China's reopening. However, compared to past cycles, China seems to do less to support the manufacturing sector, while banking issues in the US will likely negatively impact growth. We therefore remain cautious on equity markets in the months ahead.

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US macro: Fed meeting

Time for a break, but what comes after is unclear

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The Fed tightened policy on Wednesday and indicated that the end of its hiking cycle is in sight. While the new Summary of Economic Projections depict a slightly darker growth outlook, it shows that Fed officials still expect inflation to take the next three years to move back to target. As a result, no rate cuts are projected until next year. For now, policy rates and the balance sheet will focus on different goals. Market participants, however, see things differently. Given the banking turmoil, they think the Fed will be forced into a U-turn almost as soon as this summer. This is likely too aggressive.

Main message from J. Powell: we have the tools to address both our financial and price stability mandates at the same time

Jerome Powell was clear on Wednesday: the Fed, with the other government agencies, has the tools to address stress in the banking sector, which, as a result, will not undermine its objective of bringing down inflation back to its 2% target. As we had anticipated, the FOMC raised it policy rate by 25bp, but also flagged that the end of the hiking cycle is in sight. The main change to the statement is that the FOMC no longer anticipates a need for 'on-going increases' in order to attain a sufficiently restrictive monetary policy stance, but just that some additional tightening 'may be appropriate'.

Fed officials see the need to hike rates only one more time given the expected tightening in credit conditions

This change of heart since the Chairman's Testimony earlier in March obviously has to do with the recent bank failures. Credit conditions will most probably tighten further, though the extent, the duration and hence the impact on the economy is still very uncertain. What's quite clear, however, is that fewer rate hikes will be needed to attain the same objective. The dot plot was little changed compared to December's (J. Powell mentioned in his Testimony that it would) and indicates that the Fed might hike its policy rate by a final 25bp in May, then would leave it unchanged for the rest of the year.

Officials have become a bit more pessimistic about their economic outlook. We think that pessimism has further scope to grow

The new Summary of Economic Projections (SEP) also points to a more challenging environment for growth, with 4q/4q 2023 GDP revised down to 0.4% (from 0.5%), and to 1.2% for 2024 (from 1.6%). Note that this 2023 median projection implies a drop in the level of GDP between now and the end of the year, if GDP falls in line with the Atlanta Fed's Nowcast measure in the first quarter. The new SEP continues to show a gradual decline in inflation (but according to Powell, a bumpy one), which is projected to get back to target only by the end of 2025. Though projections for unemployment remain broadly unchanged, with a rise to 4.5% by the end of this year (vs. 4.6% previously), the Chair admitted that current banking stress doesn't help their 'soft-landing' case. We clearly see risks to their growth forecasts skewed to the downside, and those to unemployment skewed to the upside.

Investors expect rate cuts in 2H23. FOMC members don't

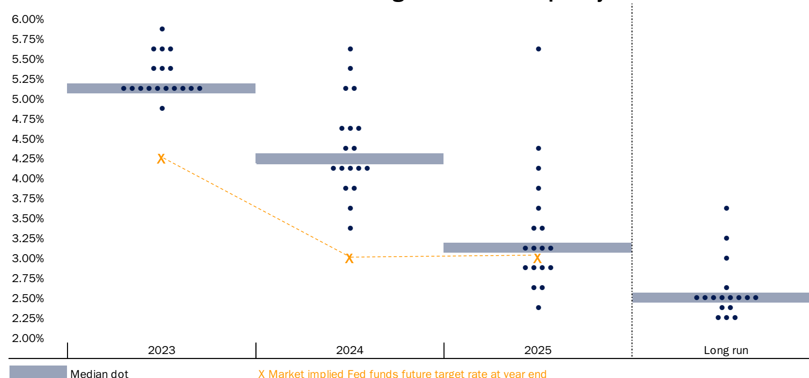
The current turmoil in the banking sector makes our case for a 'hard landing' stronger. Something similar often happens towards the end of a tightening cycle: credit spreads widen, lending standards tighten, which tighten financial conditions and reduce the flow of credit, despite falling risk-free rates. This isn't a process that the Fed can hope to control with any precision. The question is how quickly the Fed will then resort to cut interest rates. The risk to financial markets, which still price about 80bps of cuts in the second half of the year, is that the Fed will not play ball given sticky and elevated inflation rates (Exhibits 1, 2).

For now, rates and the balance sheet will focus on different goals

One thing that surprised us was that FOMC members apparently didn't discuss QT. They don't see a contradiction in increasing the size of the Fed's balance sheet through liquidity operations and contracting it via selling bonds, as both things have different purposes

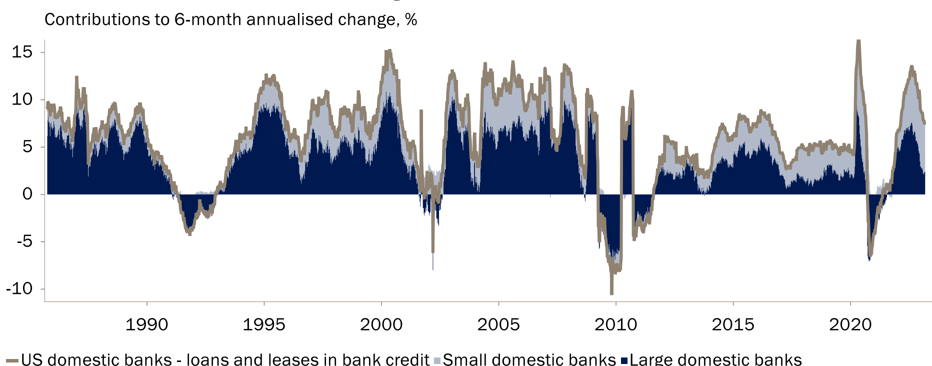
(Exhibit 3). They're also of the view that reserves in the banking system remain ample. What worries us is their distribution, with smaller regional banks at risk of seeing more deposit outflows. We continue to think that if banking stress builds up further, the Fed is more likely to end QT early and will cut rates prematurely only if instability in the financial system becomes too big to bear.

Exhibit 1: The Fed and financial markets disagree about the policy outlook



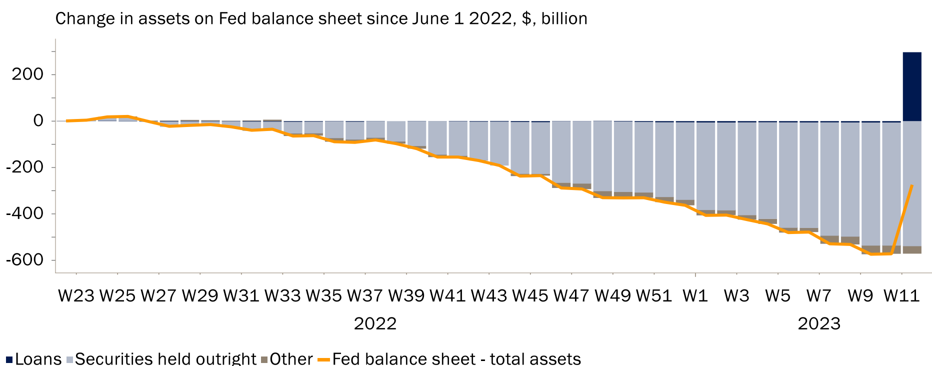
Source: Federal Reserve, Bloomberg, Bank J. Safra Sarasin, 23.03.2023

Exhibit 2: Small banks contribute a large share to total bank credit flows



Source: Macrobond, Bank J. Safra Sarasin, 23.03.2023

Exhibit 3: Liquidity provisions and QT are pulling the Fed's balance sheet in opposite directions



Source: Macrobond, Bank J. Safra Sarasin, 23.03.2023

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Switzerland macro: SNB meeting

Higher rates required and further FX sales likely

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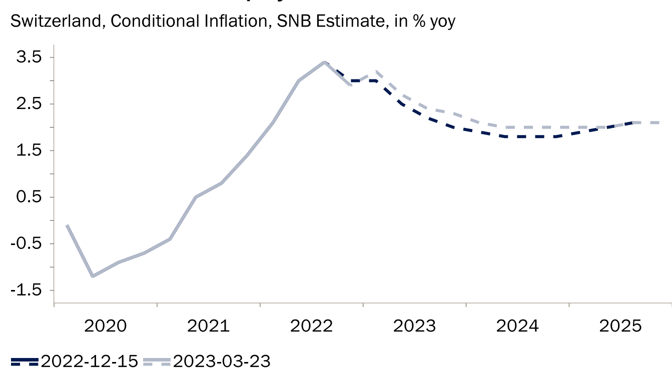
The SNB increased its main policy rate by 0.5% to 1.5%. It also signalled that at least another rate hike is needed as inflationary pressures have become stronger and prices have broadly risen. The SNB also stressed that it used its FX reserves to strengthen the Swiss franc and that it is likely to do so again in the future. We expect another rate hike by 25bp in June and no further rate changes this year. Questions in the press conference focused on the situation around Credit Suisse. The SNB explained that a swift decision had been needed in order to avoid insolvency. Significant outflows of deposits and the reduction of inter-bank credit lines indicated the considerable erosion of trust in the bank. The SNB stands ready to provide liquidity to both UBS and Credit Suisse through several facilities, partly against collateral, partly unsecured and partly backed up by federal guarantees.

Higher inflation projections make a rate hike in June and further FX interventions to strengthen the Swiss franc very likely

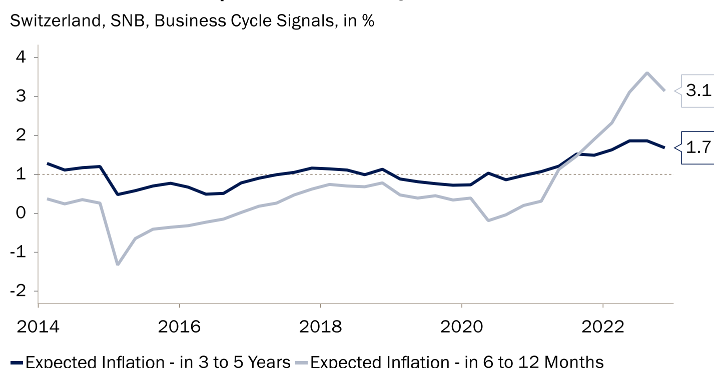
According to the SNB, inflationary pressures have increased and broadened in Switzerland. Second-round effects and stronger imported inflationary pressures have been the main contributors. The SNB revised up its inflation projections for 2023 and 2024 to 2.6% and 2.0% from 2.4% and 1.8%. In Q4 2025, the end of the projection horizon, inflation is forecast to be at 2.1%, which still exceeds the upper bound of the target inflation rate of 0-2% (Exhibits 1, 2). This clearly makes tighter policies necessary. We expect another rate hike by 25bp in June. The SNB also stated that it intervened in the FX market by selling foreign exchange reserves and buying Swiss franc, and that it is likely to do so again. Thereby, the SNB signals that it welcomes some appreciation of the Swiss franc. However, it could also buy FX reserves in case the Swiss franc would appreciate too strongly over a short period. The SNB revised up its growth forecast to 1.0% from 0.5% as energy prices have fallen and China has re-opened.

Exhibit 1: SNB inflation projection based on constant interest rates



Source: Macrobond, Bank J. Safra Sarasin, 23.03.2023

Exhibit 2: Inflation expectations as of Q4 2022



Source: Macrobond, Bank J. Safra Sarasin, 23.03.2023

SNB explained that an orderly resolution of Credit Suisse or a nationalization had not been an option

In the press conference, the SNB explained that nationalization of Credit Suisse would have come with significant risks to the tax payers. An orderly resolution had not been an option either because, in the currently fragile environment, a resolution of Credit Suisse could have led to more uncertainty and triggered a bigger crisis internationally. No action until Sunday evening would have led to an insolvency of Credit Suisse. The risks that the new and even bigger UBS poses to the stability of the Swiss financial system and to the taxpayers is likely to be discussed intensively in the coming months.

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US fixed income

Don't ignore the yield curve

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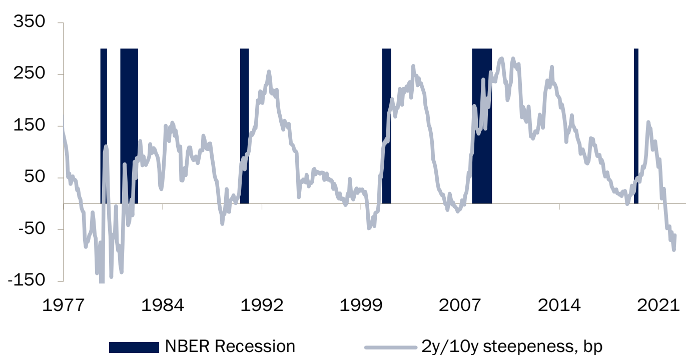
All meaningful yield curve inversions (2y/10y) have correctly signalled a recession (as defined by the NBER) since the late 1970s, even if the length of time between the points at which the curve inverts and the recession can vary significantly. The current 9-month old inversion therefore implies that (1) the odds of a recession in the US and lower rates are increasing, although with few indications as to the time, and (2) the odds of a meaningfully steeper curve 6 to 12 months down the road have materially increased. Therefore, the 5- to 10y sector likely presents the best risk/return trade-off, while curve steepening trades are best executed via the 5y/30y segment.

All meaningful US yield curve inversions have correctly signalled a recession

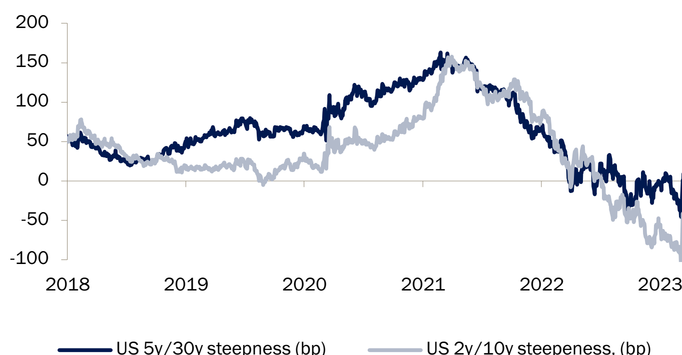
The messaging from the yield curve is based on the fact that, roughly speaking, an inverted yield curve implies that market participants perceive current short-term rates as too high to be sustained, and hence will need to move lower at some stage. A few observations are important here: (1) all meaningful yield curve inversions (2y/10y) have correctly signalled a recession (as defined by the NBER) since the late 1970s, (2) the length of the inversion until the recession starts can vary significantly and (3) the recession is usually closer at hand once the yield curve re-steepens sharply after an extended period of inversion. Our second point is of particular interest: we note that in the late seventies and early eighties, the yield curve was inverted for 21 months (1978-1979) and 12 months (1981-1982). Rooting out embedded inflation took a long time and caused two subsequent recessions in short order, while in later cycles, the inversion periods was shorter (Exhibit 1).

Exhibit 1: Meaningful curve inversions correctly signalled recessions



Source: Bloomberg, Bank J. Safra Sarasin, 23.03.2023

Exhibit 2: The US yield curve has started to re-steepen



Source: Bloomberg, Bank J. Safra Sarasin, 23.03.2023

The odds of a recession and a meaningfully steeper curve 6 to 12 months down the line have increased

In the current interest rate cycle, the US 2y/10y yield curve segment has been inverted for the past 9 months. This is still less than in the late 1970s, but closing in on what happened from 1981-1982. This implies that (1) the odds of a recession in the US and lower rates are increasing, although with yet few indications as to the timing, and (2) the odds of a meaningfully steeper curve 6 to 12 months out have materially increased. The recent moves in the yield curve would perfectly fit the playbook of a sharp (bull) re-steepening as the recession is moving closer (Exhibit 2). We conclude that the sweet spot on the yield curve shifts from ultra-long maturities to 5y to 10y maturities, which still have enough duration to profit from lower yields, but will also benefit from a steeper curve. As far as a positioning for curve trades is concerned, we would focus on the 5y/30y segment, which we have mentioned on several occasions (see here, and here).

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Global equities

Why is the equity market so resilient?

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The equity market recovery since the beginning of the year has closely tracked the turnaround in the global manufacturing PMI, which has been led by China's reopening. While this level of fundamental support would be an encouraging signal in a normal cycle, there are several arguments which make us cautious on the strength of the recovery in the months ahead. China has done less than in the past cycles to support the manufacturing sector while banking issues in the US will likely lead to tighter lending conditions in the months ahead. In the euro area, the picture is similar, with the bank lending survey implying fading domestic support.

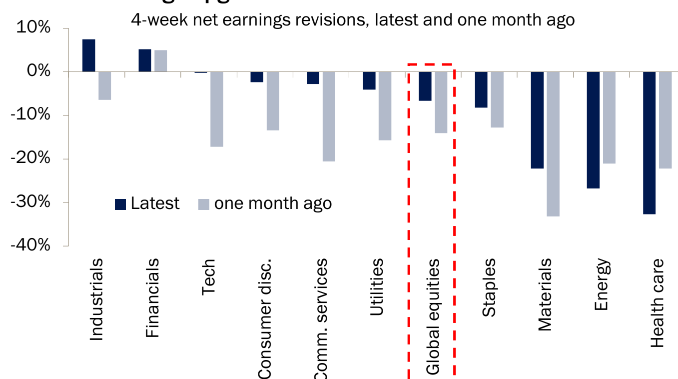
The rebound in the market over recent months is real, supported by somewhat improving earnings....

While some argue that the recovery since October has been a function of technical factors and was largely flow-driven, underlying data suggest that improving fundamentals have been the key driver (Exhibit 1). Global equities have gained around 7% over the past 6 months, in line with an uptick in earnings revisions. These have started to turn higher after persistently deteriorating revisions since August 2021 (Exhibit 1). It was not only the improvement in the headline earnings number which provided some support, but also the breadth of revisions across sectors (Exhibit 2).

Exhibit 1: The equity market rebound has seen earnings support

Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

Exhibit 2: Earnings upgrades have been broad-based across sectors



Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

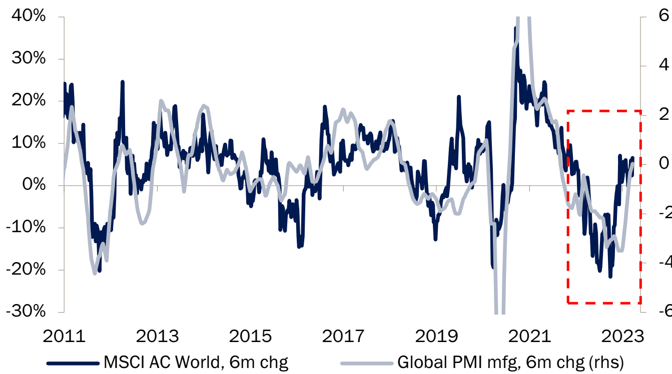
...and a rebound in the global manufacturing PMI

What's more, the turnaround in global macro momentum has been key for the turnaround in earnings revisions and has led global equities higher (Exhibit 3). The global manufacturing PMI has rebounded from its 3-year low in the fourth quarter of last year and moved above 50 in February, for the first time since August. As a result, the 6-month momentum of the PMI turned sharply higher, typically marking troughs in the equity market.

If this were a normal cycle, the current data would provide reason for optimism

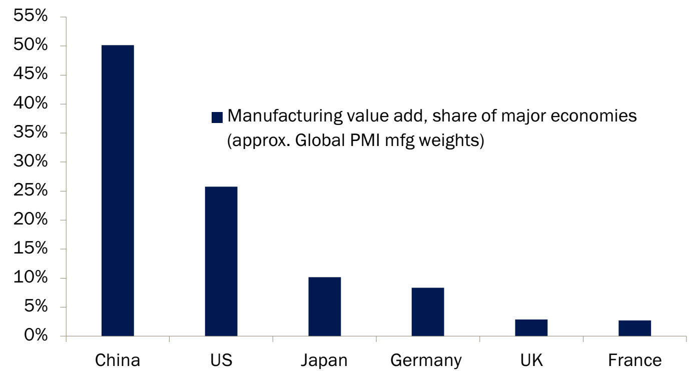
With the market closely tracking the PMI, one could easily assume that a new bull market is in the making. We agree that this improvement in macro momentum would typically justify a much more optimistic outlook for risk assets. Yet we believe there are good reasons to remain cautious this time around. One reason is that the rebound has been very concentrated in one region, which is China. China has become the world's dominant manufacturing hub over past decades, not only producing for the world but also driving the cycle itself. Between the world's major economies, it now accounts for more than 50% of manufacturing value-add and, as a result, has become the swing factor in the global cycle (Exhibit 4).

Exhibit 3: Fundamentals have clearly improved over past months



Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

Exhibit 4: China accounts for half of major economies' mfg value-add

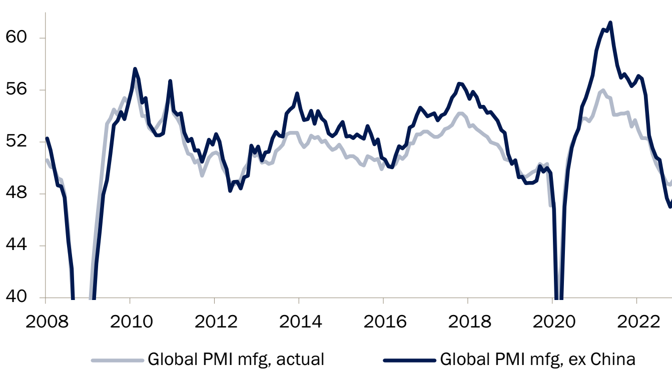


Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

China's recovery has been the dominant factor driving global manufacturing data higher

Looking at the most recent rebound in the global PMI, China's re-opening has been instrumental in driving it. Once China data are removed from the global manufacturing PMI, the recovery largely disappears (Exhibit 5). With the rest of the world merely bouncing off the lows, the question is how powerful and sustainable the Chinese recovery is. It seems reasonable to ask whether the Chinese economy can provide the same support to the global cycle as it did in past years. Aware of the structural challenges the country is facing, the Chinese administration has provided a fairly unambitious GDP growth target of "around 5%" for 2023. While recent data have clearly surprised to the upside, a crucial element of past recoveries is missing: credit impulse was not turbo-charged, putting a lid on the potential upside for manufacturing. Fully aware of the diminished returns from ever growing debt levels and the structural challenges which come with it, the government seems to bank on the return of the consumers instead of starting another big credit cycle (Exhibit 6). As such, we believe that the impulse for the global economy will be less pronounced and more short-lived than in previous instances when China led the global recovery.

Exhibit 5: Ex-China, the manufacturing recovery is barely visible



Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

Exhibit 6: China's rebound has little to no credit support

Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

Little credit support in China and tightening lending standards in the US make us cautious on the outlook

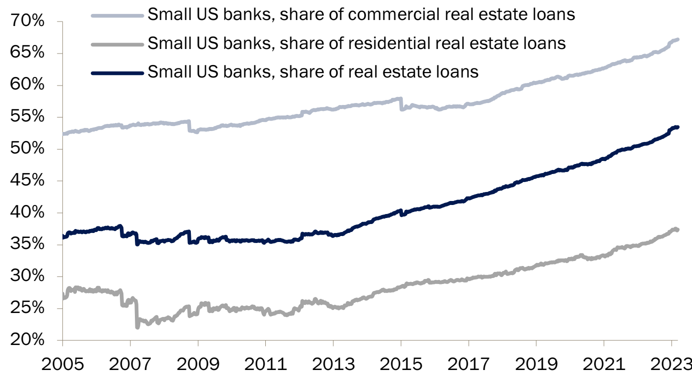
While China's manufacturing could see stable growth, it is also weighed down by weak exports as developed markets slow. The question is whether the upside for manufacturing in other regions looks more promising. We think the outlook in the US has all but deteriorated over recent weeks. The situation in the US banking sector will likely further weigh on bank lending standards, which have been tightening for almost a year now (Exhibit 7). The relevance of regional banks for the US must not be underestimated. In particular when it comes to real estate lending, they are as important as larger US institutions, having un-

derwritten more than half of all US real estate loans (Exhibit 8). This share has risen substantially over recent years, with close to 70% of commercial real estate loans sitting on regional banks' balance sheets, accounting for about 28% of regional banks' total loan books. While residential borrowers tend to rely more on large banks, the share of small lenders in this market has risen as well. This just goes to show that tightening lending conditions at smaller banks has the potential to fundamentally alter the course of the US economy, which will likely be felt in the months to come.

Exhibit 7: US bank lending standards have tightened

Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

Exhibit 8: Small US banks dominate the real estate loan market



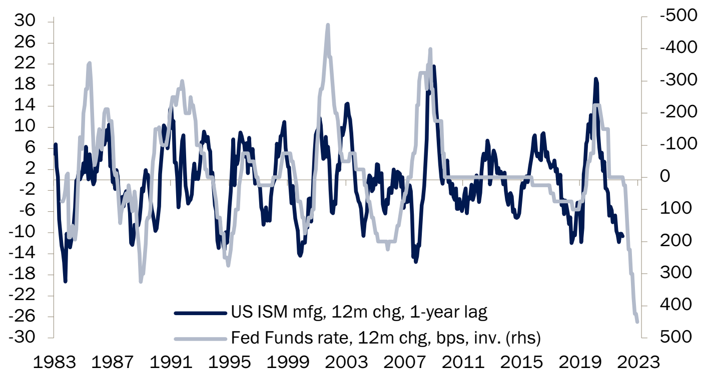
Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

Fed tightening should increasingly become visible in macro data

Historically, Fed rate changes also affected the cycle with a 12-month lag (Exhibit 9). Given that the Fed started to hike rates in March 2022 in the current cycle, the slowing impact from higher rates should just start to show in the macro data.

Lastly, the lending situation in Europe does not look much better. While the manufacturing sector has benefitted from China's re-opening, monetary policy tightening is weighing heavily on bank lending standards (Exhibit 9), implying downside risk for the cycle as well.

Exhibit 9: Fed tightening typically affects the cycle with a 12-month lag



Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

Exhibit 10: Euro area bank lending standards are tightening as well

Source: Refinitiv, Bank J. Safra Sarasin, 22.03.2023

Macro support should soften again in the months ahead, removing some of the support year-to-date

This leaves us to conclude that the rebound in the macro data, which has helped to reverse the earnings cycle and lifted markets higher, should be more of an intermediate rebound rather than a new bull market in the making. With the monetary tightening cycle still in full swing, the banking issues in the US should be regarded as part of the transmission channel, passing on less favourable financial conditions, rather than a crisis which should be avoided at any cost.

Economic Calendar

Week of 27/03 – 31/03/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 27.03.2023						
GE	10:00	IFO Expectations	Mar	Index	--	88.50
EU	10:00	M3 money Supply YoY	Feb	yoy	--	3.50%
US	16:30	Dallas Fed Manf. Activity	Mar	Index	-11.00	-13.50
Tuesday, 28.03.2023						
US	14:30	Wholesale Inventories MoM	Feb P	mom	--	-0.40%
	16:00	Conf. Board Expectations	Mar	Index	--	69.70
	16:00	Richmond Fed Manufact. Index	Mar	Index	-8.00	-16.00
	16:30	Dallas Fed Services Activity	Mar	Index	--	-9.30
Wednesday, 29.03.2023						
GE	08:00	GfK Consumer Confidence	Apr	Index	--	-30.50
US	13:00	MBA Mortgage Applications	Mar24	wow	--	3.00%
	16:00	Pending Home Sales MoM	Feb	mom	-3.50%	8.10%
Thursday, 30.03.2023						
EU	11:00	Economic Confidence	Mar	Index	--	99.70
GE	14:00	CPI EU Harmonised MoM	Mar	mom	--	1.00%
	14:00	CPI EU Harmonised YoY	Mar	yoy	--	9.30%
US	14:30	Initial Jobless claims	Mar25	1'000	---	--
	14:30	GDP Price Index	4Q T	%	---	3.90%
	14:30	Core PCE QoQ	4Q T	qoq	---	4.30%
Friday, 31.03.2023						
JN	01:30	Tokyo CPI Ex-Fresh Food, Energy YoY	Mar	yoy	--	3.20%
EU	11:00	CPI MoM	Mar P	mom	--	1.00%
	11:00	CPI Core YoY	Mar P	yoy	--	5.60%
US	14:30	PCE Core Deflator MoM	Feb	mom	0.40%	0.60%
	14:30	PCE Core Deflator YoY	Feb	yoy	--	4.70%
	15:45	MNI Chicago PMI	Mar	Index	43.60	43.60

Source: Bloomberg, J. Safra Sarasin as of 23.03.2023

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Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	1.15	16	-47	3.9
German Bund 10 year (%)	2.17	6	-40	3.2
UK Gilt 10 year (%)	3.36	4	-31	3.9
US Treasury 10 year (%)	3.41	-2	-47	4.3
French OAT - Bund, spread (bp)	53	-5	-2	
Italian BTP - Bund, spread (bp)	190	-5	-25	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	10,719	16.6	0.0	1.2
DAX - Germany	15,210	11.7	1.6	9.2
MSCI Italy	827	8.4	2.1	9.5
IBEX - Spain	8,970	10.6	0.9	9.5
DJ Euro Stoxx 50 - Eurozone	4,207	12.4	2.3	11.4
MSCI UK	2,151	10.2	1.3	1.4
S&P 500 - USA	3,949	18.0	-0.3	3.3
Nasdaq 100 - USA	12,729	24.5	1.2	16.6
MSCI Emerging Markets	978	12.0	3.9	2.6

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.92	8.6	-0.9	-0.8
EUR-CHF	0.99	6.5	0.6	0.4
GBP-CHF	1.13	7.9	-0.2	0.7
EUR-USD	1.08	8.6	1.5	1.2
GBP-USD	1.23	9.7	0.9	1.6
USD-JPY	130.5	13.1	-1.1	-0.5
EUR-GBP	0.88	6.8	0.7	-0.4
EUR-SEK	11.19	8.1	0.1	0.3
EUR-NOK	11.26	10.0	-1.2	7.2

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	103	11.9	0.6	-8.9
Brent crude oil - USD / barrel	75	31.2	1.8	-11.3
Gold bullion - USD / Troy ounce	1,986	18.8	3.5	8.9

Source: J. Safra Sarasin, Bloomberg as of 23.03.2023

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