J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

Cross-Asset Weekly

08 April 2022

ECB on a path for rate lift-off in September

The ECB is unlikely to adjust any policy parameters at its meeting next Thursday. However, higher inflation rates will lead to increasing risks of second-round effects with regard to wages. This will likely bring an end to asset purchases by the end of the second quarter and a first rate hike in September this year.

Meanwhile, the Fed has provided more details on its planned balance sheet run-off in May, which is used as an additional measure (on top of rate hikes) to tighten monetary policy fast. With a monthly run-off rate of 95bn USD, they intend to proceed twice as fast as in the last run-off phase. Such a rapid tightening of policy, while the economy is coping with several external shocks, means that managing a soft landing will be extremely difficult.

FX: The Japanese yen has lagged significantly in the past few weeks as domestic bond yields have risen much less than in other G10 rate markets. This trend is likely to continue in the near term, however, we expect that the Bank of Japan will become increasingly vocal about yen weakness.

Equities: Finally, we expect that the US Q1 earnings season will likely not present negative surprises overall, but we note that the high inflation rates have proved to be an important support factor for (nominal) earnings growth as of late. With the Fed now set to bring down inflation by slowing down the economy, we continue to retain our cautious stance.

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Contacts

Dr. Karsten Junius, CFA
Chief Economist
karsten.junius@jsafrasarasin.com
+41 58 317 32 79

Raphael Olszyna-Marzys
International Economist
raphael.olszyna-marzys@jsafrasarasin.com
+41 58 317 32 69

Mali Chivakul
Emerging Markets Economist
mali.chivakul@jsafrasarasin.com
+41 58 317 33 01

Wolf von Rotberg
Equity Strategist
wolf.vonrotberg@jsafrasarasin.com
+41 58 317 30 20

Alex Rohner
Fixed Income Strategist
alex.rohner@jsafrasarasin.com
+41 58 317 32 24

Dr. Claudio Wewel
FX Strategist
claudio.wewel@jsafrasarasin.com
+41 58 317 32 26

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ECB Preview

Preparing the next move towards a first rate hike

Dr. Karsten Junius, CFA
Chief Economist
karsten.junius@jsafrasarasin.com
+41 58 317 32 79

The ECB is unlikely to adjust any policy parameters at its meeting next Thursday. However, they are likely to indicate that the incoming data argue for an upward revision to its inflation forecast and a downward revision to its growth forecasts. Inflation rates that remain higher for longer are more likely to lead to higher wages and other second round effects. We expect that the next ECB macro projections will show medium term inflation at the ECB target and conditions for a first rate hike being in place. As a result, we expect the ECB not to extend their asset purchases into the third quarter at its June meeting. This would allow for a first rate hike in September.

The ECB to indicate the stagflationary nature of the war and that it will make higher medium term inflation rates more likely

Yesterday's ECB minutes of their March meeting show clearly that the Governing Council (GC) was aware that their macro projections were taken over by events. The war in the Ukraine is a negative external shock. We expect that the 2024 inflation forecast will be increased to 2% with short-term stagflationary effects that go beyond the March baseline scenario of the ECB's staff projections. Some GC members expressed doubts about the convergence to an inflation rate of 1.9% in 2024 as this would be a very fast mean reversion by historical standards. We agree. The inflationary shock is larger and by now already more persistent than we assumed just a few months ago. This makes it likely that wages pick up to at least partly compensate workers for their real income losses. Given the strength of the labour market and the persistent labour shortages, everything else would be a surprise. As a result, all three economic conditions for a first rate hike are likely to be met. Looking at a broad range of indicators for financial conditions (Exhibit 1), we also don't see any major dislocations or impairments of the transmission channel that would argue against tighter monetary policy. In particular, we note that real rates continue to be quite low while credit and periphery spreads remain contained.

An upward revision to its medium term inflation forecast should lead to an end of asset purchases in June and would prepare the ground for a first rate hike in September

At its meeting on Thursday the ECB could prepare the ground for a further tightening of monetary policy at the following meeting on June 9. Given that the ECB has stressed repeatedly that it is not changing the sequence of adjusting its policy tools, the end of net asset purchases would come first. Hence, we do not expect further bond purchases in Q3. This would open the way for a first rate hike in September and a second one in December.

Exhibit 1: Financing conditions in the euro area

		April (preliminary)	March	February	January	December	2y avg	5y avg
			(daily data is displayed as monthly averages)					
Upstream: Financing conditions in the banking sector and for governments								
Sovereign	GDP-weighted EA govie yield, nominal, %	*1.19*	0.90	0.78	0.39	0.14	**0.17**	**0.52**
Sovereign	Bund 10y yield, real, %	*-2.28*	-2.19	-2.11	-1.97	-2.10	**-1.70**	**-1.38**
Sovereign	EA peripheral spread, simple average, %	*1.40*	1.40	1.43	1.08	1.10	**1.07**	**1.61**
Banks	3m Euribor vs 3m OIS, %	*0.12*	0.08	0.05	0.02	0.00	**0.05**	**0.08**
Banks	10y EUR swap vs 10y Bund yield, %	*0.68*	0.68	0.57	0.44	0.49	**0.38**	**0.43**
Banks	EUR-USD cross-currency basis, bps	*-19.4*	-17.1	-20.5	-12.6	-7.4	**-10.6**	**-16.4**
Banks	Overnight index swap (OIS), %	*-0.58*	-0.58	-0.58	-0.58	-0.58	**-0.56**	**-0.56**
Downstream: Financing conditions for corporates and private households								
Market rates	EA HY spread, %	*3.90*	3.95	4.32	3.54	3.18	**3.77**	**3.74**
Market rates	EA IG spread, %	*1.31*	1.29	1.44	1.05	0.95	**1.06**	**1.11**
Bank loan rates	Bank loan rate, %	*n/a*	n/a	1.41	1.43	1.36	**1.47**	**1.57**
Bank loan rates	Mortgage rate, %	*n/a*	n/a	1.38	1.33	1.31	**1.34**	**1.58**
Bank loan rates	Consumer loan rate, %	*n/a*	n/a	5.30	5.31	5.05	**5.22**	**5.46**

Source: Macrobond, Bank J. Safra Sarasin, 07.04.2022

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US macro

The Fed is pressing hard on the brakes

Raphael Olszyna-Marzys
International Economist
raphael.olszyna-marzys@jsafrasarasin.com
+41 58 317 32 69

The Fed wants to bring its policy stance rapidly to neutral via a series of rate hikes and by shrinking its balance sheet by around $95bn a month. The reason is clear: the economy is overheating. Such a rapid tightening of policy, while the economy is coping with several external shocks, means that managing a soft landing will be extremely difficult.

The Fed is very likely to increase its policy rate by 50bp next month

The minutes that were published on Wednesday confirm that the Fed is heading for a rapid withdrawal of monetary accommodation. First, they highlight that the FOMC would have hiked by 50bp in March instead of 25bp if it was not for the war. But comments from Fed members, alongside a likely further increase in inflation to around 8.5%, suggest that the Committee will probably increase rates by 50bp when it meets next at the start of May.

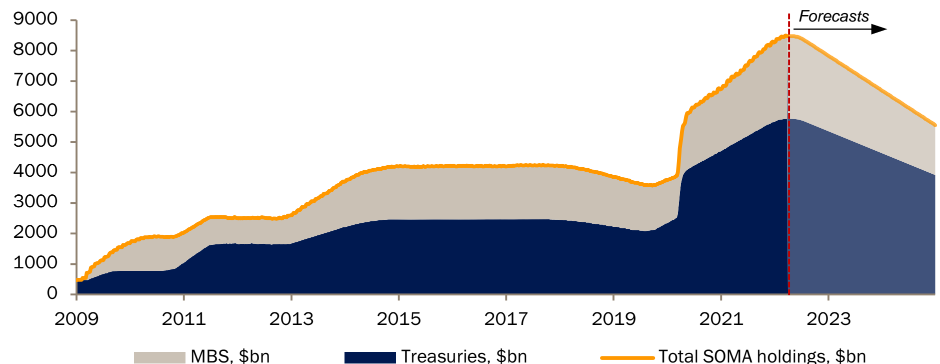
The balance sheet run-off will happen at a much faster pace than last time

Second, and as expected, the minutes indicate that the Fed will aim to run off its balance sheet much more rapidly than when it last did Quantitative Tightening (QT). Between 2017 and 2019, it took 12 months for the Fed to reach a maximum pace of $50 billion per month ($30bn for Treasuries and $20bn for Mortgage-backed Securities or MBS). It now wants to reduce its balance sheet by $95bn a month, with a cap of about $60bn for Treasuries and $35bn for MBS. The aim is to get to this 'cruise speed' over a period of about three months i.e., in August if it starts QT shortly after its next meeting, as we expect. Once the balance sheet run-off is well under way, the Fed also plans to sell MBS (rather than just not re-investing the proceeds from bonds that come to maturity) to enable a "suitable progress toward a longer-run SOMA portfolio composed primarily of Treasury securities".

Achieving a soft landing will be extremely difficult

The reason for this speedy process is clear. The balance sheet is much larger than it was ten years ago, and the economy is overheating. Yet as we explain here, QT is a blunt tool as it immediately and directly removes liquidity from the system – by the end of 2023, the market will have to absorb an extra $2trn worth of fixed income securities – and can come with unintended side effects (Exhibit 1). What's more, the Fed has indicated that it could raise rates by an extra 300bp over the next 12-18 months. This is a considerable amount of tightening that the economy will have to digest in a very short period of time. And on top of this, the economy will have to deal with the fallout from the war in Ukraine, while it is still adjusting from the shock the pandemic has brought about. Under such circumstances, the probability that the Fed will miscalibrate its policy adjustment is high.

Exhibit 1: The Fed plans to reduce the size of its balance sheet by $95bn a month



Source: Macrobond, Bank J. Safra Sarasin, 07.04.2022

FX markets

Near term, dovish Bank of Japan to keep yen weak

Dr. Claudio Wewel
FX Strategist
claudio.wewel@jsafrasarasin.com
+41 58 317 32 26

The Japanese yen has retreated by around 7% against the US dollar over the past five weeks. Given the Bank of Japan's dovish stance, the Japanese currency's near-term weakening potential largely depends on how much further global bond yields are set to rise. Energy prices have emerged as another yen headwind. Lastly, we note that the currency appears to have lost its relative edge from a geopolitical viewpoint.

Japanese yen has not benefited from risk-off sentiment amid the start of the Ukraine war

Contrary to our expectations, the escalation of the Ukraine conflict into a full-blown war has not pushed the Japanese yen higher. Instead, the yen has retreated by around 7% against the US dollar over the past five weeks, which calls for a closer look at the drivers.

JGB yields have fallen markedly behind in «the race to the top», pushing the Japanese yen lower

Most importantly, risk sentiment was unexpectedly quick to recover after the Russian invasion. The ensuing sell-off in government bonds has pushed yields substantially higher. Within G10, dollar yields led the rise against the backdrop of very hawkish policy rate expectations (Exhibit 1). By contrast, Japanese government bond (JGB) yields have risen much less, which has substantially widened Japan's yield disadvantage versus other G10 economies and has weighed on the yen as of late (Exhibit 2). Consequently, the yen's near-term fate will largely depend on how much further global bond yields are set to rise.

As wage pressures remain muted, the BoJ remains very dovish while it notes that its weak currency reinforces the rise in energy prices – an additional risk for growth

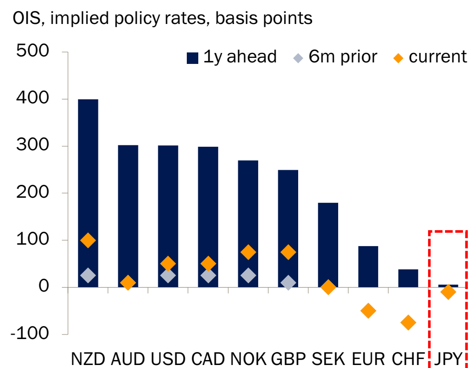
With wage pressures remaining muted and economic downside risks looming from the war in Ukraine, the Bank of Japan (BoJ) has remained dovish in its March economic assessment. Last week, the BoJ even announced a plan to buy unlimited amounts of 10y JGBs to defend its 0.25% yield cap such as to shield the economic recovery from a pronounced increase in yields. Yet BoJ Governor Kuroda has also expressed concerns about the quick pace of the yen's recent depreciation as the weaker yen reinforces the rise in energy prices, which could pose an additional risk for domestic growth as Japan's terms of trade deteriorate (Exhibit 3).

On a separate note, the yen appears to have lost its relative geopolitical edge in Russia's war in Ukraine

Lastly, the yen may also have lost its relative edge from a geopolitical viewpoint for now. While Japan appears to be substantially less exposed to the Ukraine conflict in geopolitical terms, Japanese sanctions over Russia's invasion have prompted Russia to halt mutual peace talks and conduct military drills on the disputed Kuril archipelago, which highlights the manageable but ongoing potential for conflict at the Russian-Japanese border.

Exhibit 1: BoJ not expected to hike anytime soon

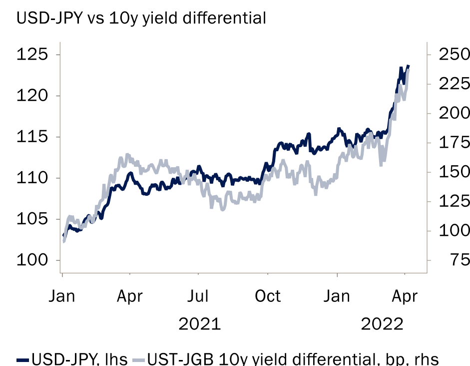
OIS, implied policy rates, basis points



Source: Bloomberg, Bank J. Safra Sarasin, 07.04.2022

Exhibit 2: Recent yen weakening was yield-driven

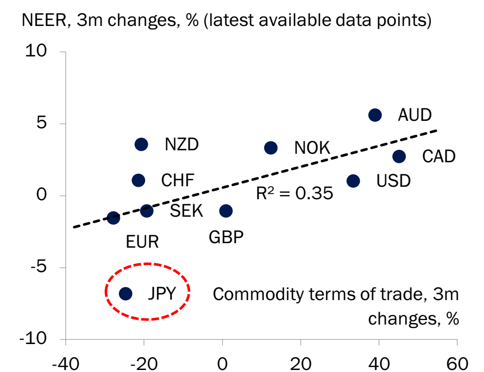
USD-JPY vs 10y yield differential



Source: Macrobond, Bank J. Safra Sarasin, 07.04.2022

Exhibit 3: High energy costs also weigh on yen

NEER, 3m changes, % (latest available data points)



Source: Macrobond, Bank J. Safra Sarasin, 07.04.2022

US equities

Q1 earnings season preview: inflation support, growth drag

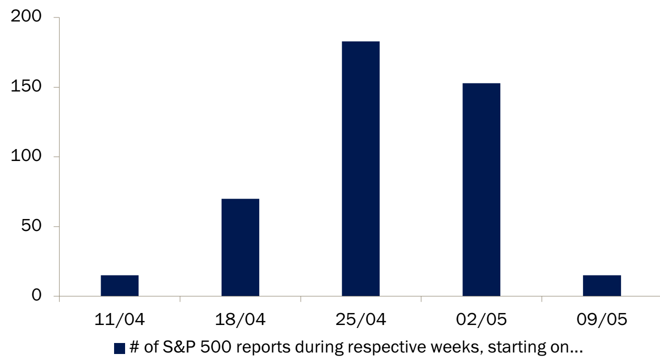
Wolf von Rotberg
Equity Strategist
wolf.vonrotberg@jsafrasarasin.com
+41 58 317 30 20

The US Q1 earnings season is about to kick off and gather speed over coming weeks. Consensus expectations appear reasonable, yet we do not expect a substantial overshoot versus consensus numbers. The drag from slowing macro momentum, which has pushed consensus revisions into negative territory for the first time since 2020, is partly offset by rising inflation numbers in the first quarter. We show how inflation has led earnings to decouple from income margins to the upside, reflecting the positive impact inflation has on earnings. Yet we warn that these dynamics could easily go into reverse if the Fed achieves its aim of bringing inflation down, which would most likely happen in line with a slowdown of demand and a further deterioration in the macro data.

Q1 earnings season is about to start with majority of reports in the last week of April and first week of May

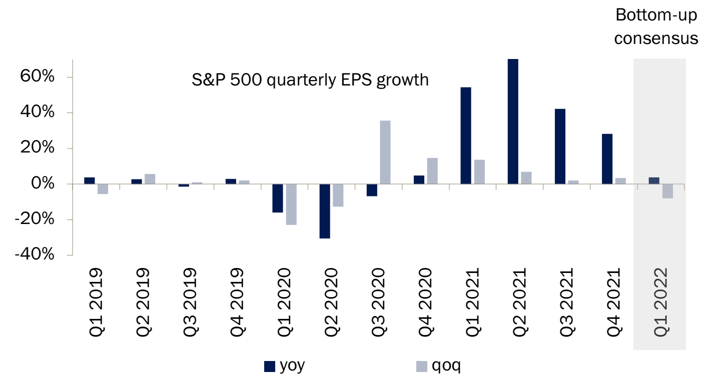
The US Q1 2022 earnings season is ramping up over coming weeks with the busiest period towards the end of the month (Exhibit 1). Consensus expectations are fairly moderate, projecting the lowest annual growth number since Q3 2020 and -8% EPS growth over Q4 2021 (Exhibit 2).

Exhibit 1: Earnings season ramping up



Source: Bloomberg, Bank J. Safra Sarasin, 06.04.2022

Exhibit 2: Expectations are moderate



Source: Refinitiv, Bank J. Safra Sarasin, 06.04.2022

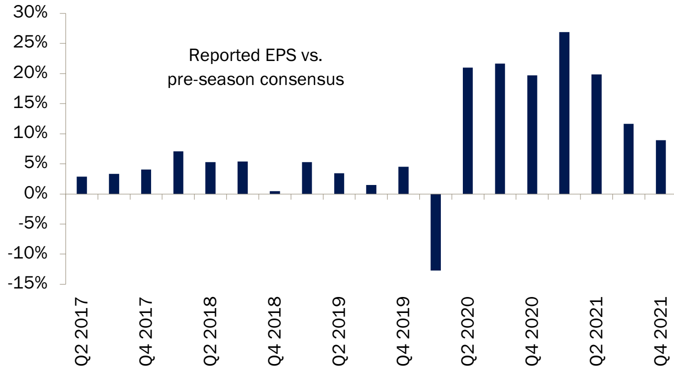
Reasonable starting point provides base for some upside, yet slowing trend to continue

The picture was fairly similar at the beginning of recent earnings seasons, which started off with consensus expectations projecting a negative quarter-over-quarter number and ended with a solid single-digit growth number over the previous quarter. Yet the extent of the earnings surprise (reported vs expected EPS level) has been in a fairly steady downtrend since Q1 2020, converging towards the long-term average of around 5% (Exhibit 3). We would expect the trend to continue in the upcoming Q1 earnings season, i.e., earnings to surprise to the upside but see a further erosion of the upside surprise vs expectations.

Weaker macro momentum has led to earnings downgrades and is suggesting further downside

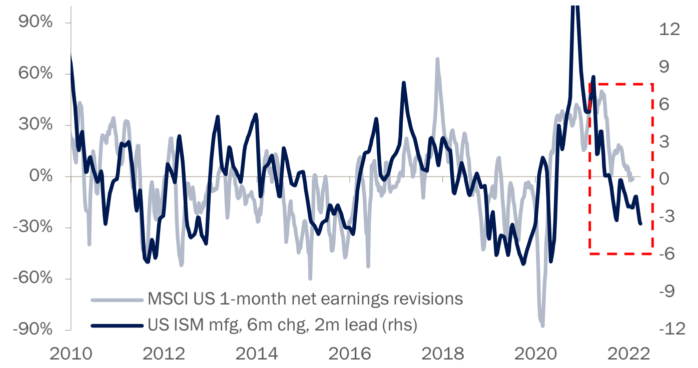
The predominant reason for this slightly cautious outlook is the fact that earnings revisions have started to turn negative. While this is sometimes regarded as a positive going into the season as the hurdle for upside surprises appears lower, we believe there are good reasons for this deterioration in consensus expectations. Macro momentum has turned sharply negative after the March ISM manufacturing print at 57.1. It is now at the lowest level since mid-2020. As macro momentum typically leads consensus earnings revisions by two months, it suggest that more downgrades are about to come (Exhibit 4).

Exhibit 3: The earnings surprise has been declining



Source: Refinitiv, Bank J. Safra Sarasin, 07.04.2022

Exhibit 4: Earnings revisions negative as macro momentum softens

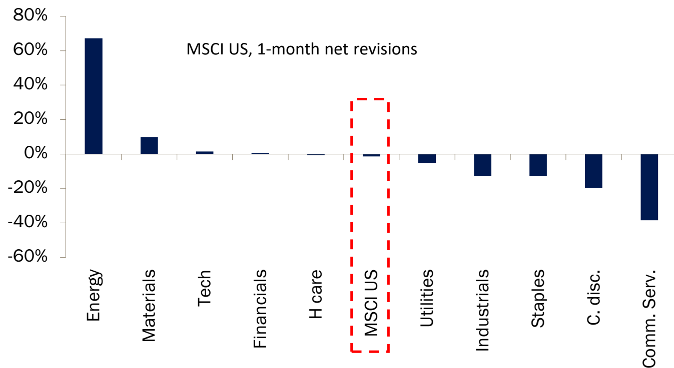


Source: Refinitiv, Bank J. Safra Sarasin, 07.04.2022

Rising inflation helps earnings

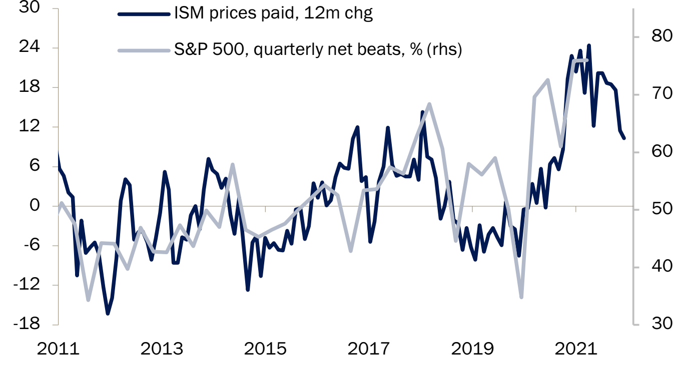
Interestingly, downgrades have been fairly broad-based across sectors over the past month, with commodity-heavy sectors energy and materials holding up substantially better than the rest of the equity universe (Exhibit 5). Yet despite this significant slowdown in the macro and earnings data, inflation has printed higher than expected over past quarters and since the beginning of the year. This matters for earnings as well as it boosts nominal growth rates from GDP to EPS, and is often not captured by analysts in their estimates. As a result, we find that net beats (companies beating estimates vs those missing) are positively correlated to the prices paid component of the ISM survey. It has continued to rise throughout the first quarter and suggests that net earnings beats should remain comfortably in positive territory for Q1 results.

Exhibit 5: Broad-based downgrades across sectors



Source: Refinitiv, Bank J. Safra Sarasin, 07.04.2022

Exhibit 6: Net beats have been boosted by rising inflation

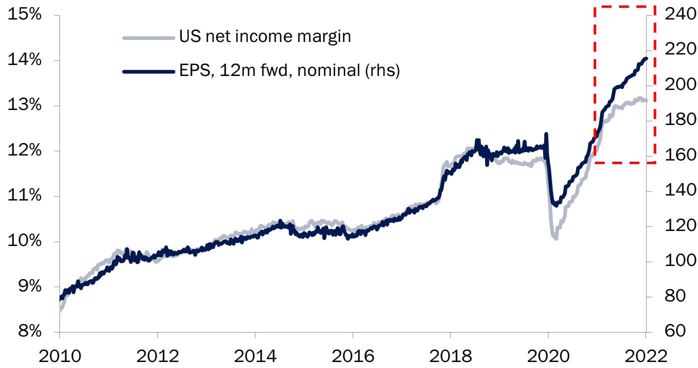


Source: Refinitiv, Bank J. Safra Sarasin, 07.04.2022

Since mid-2021, inflation provided an extra boost to earnings over margins

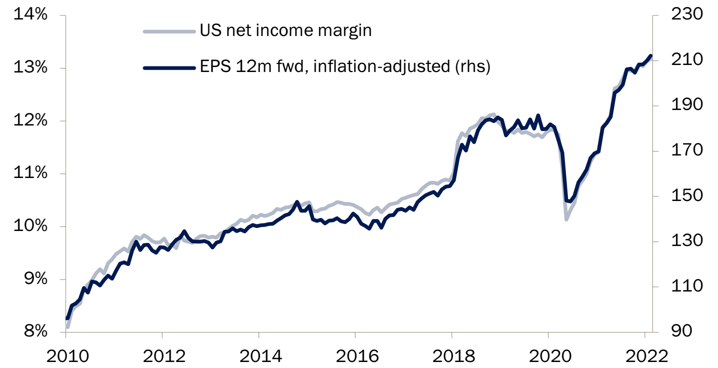
Reflecting a bit more on the impact of inflation on earnings, we note that the period since mid-2021, when inflation started to overshoot vs other macro indicators, has also been marked by earnings rising faster than net income margins, i.e., there has been an extra boost to sales coming from higher inflation. Once we remove inflation and look at "real" earnings, margins and earnings fall almost perfectly in line suggesting that there is a linear relationship between margins and earnings if inflation is ignored (Exhibit 8). As a result, it can be assumed that rising inflation supports corporate earnings on top of "real" growth indicators. What is not the case, on the other hand, is that rising producer price inflation affects margins negatively, neither does the spread between CPI and PPI.

Exhibit 7: Earnings rose faster than margins…



Source: Refinitiv, Bank J. Safra Sarasin, 07.04.2022

Exhibit 8: …with the gap vanishing once corrected for inflation



Source: Refinitiv, Bank J. Safra Sarasin, 07.04.2022

Q1 numbers should provide no major surprises, but we caution that Fed policy may bring lower inflation and a weakening macro cycle – reversing some of last year's gains

With regard to the Q1 season, we can assume that there should be a positive impact from rising inflation, yet stress the overwhelming importance of the direction of the cycle, which is now clearly negative. Bottom-line, we do not expect major surprises from the earnings season, yet warn against an environment of slowing inflation (disinflation), which would most likely go hand in hand with further slowing macro data, and is clearly the Fed's prime objective now.

Economic Calendar

Week of 11/04 – 15/04/2022

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 11.04.2022						
UK	08:00	Index of Services 3M/3M	Feb	mom	--	1.00%
Tuesday, 12.04.2022						
GE	11:00	ZEW Survey Expectations	Apr	Index	--	-39.9
US	12:00	NFIB Small Business Optimism	Mar	Index	94.9	95.7
	14:30	CPI Ex Food and Energy MoM	Mar	mom	0.50%	0.50%
	14:30	CPI Ex Food and Energy YoY	Mar	yoy	6.60%	6.40%
	14:30	Real Average Weekly Earnings	Mar	yoy	--	-2.30%
Wednesday, 13.04.2022						
US	13:00	MBA Mortgage Applications	Apr008	wow	--	-6.30%
	14:30	PPI Ex Food and Energy MoM	Mar	mom	0.50%	0.20%
	14:30	PPI Ex Food and Energy YoY	Mar	yoy	8.40%	8.40%
CA	16:00	Bank of Canada Rate Decision	Apr13	%	1.00%	0.50%
Thursday, 14.04.2022						
EU	13:45	ECB Deposit Facility Rate	Apr14	%	-0.50%	-0.50%
US	14:30	Retail Sales Control Group	Mar	mom	-0.20%	-1.20%
	14:30	Initial Jobless Claims	Apr09	1'000	--	--
	16:00	U. of Mich. 5-10 Yr Inflation	Apr P	%	--	3.00%
Friday, 15.04.2022						
US	14:30	Empire Manufacturing	Apr	Index	-1.50	-11.80
	15:15	Capacity Utilisation	Mar	%	77.90%	77.60%

Source: Bloomberg, J. Safra Sarasin as of 07.04.2022

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	0.70	9	83	-5.9
German Bund 10 year (%)	0.69	13	86	-6.9
UK Gilt 10 year (%)	1.73	12	75	-5.4
US Treasury 10 year (%)	2.65	27	114	-8.8
French OAT - Bund, spread (bp)	54	7	16	
Italian BTP - Bund, spread (bp)	163	9	28	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	12’372	18.0	1.8	-2.6
DAX - Germany	14’078	12.3	-2.3	-11.4
MSCI Italy	770	9.4	-2.2	-10.4
IBEX - Spain	8’467	12.5	0.6	-2.1
DJ Euro Stoxx 50 - Eurozone	3’802	12.7	-2.5	-11.2
MSCI UK	2’170	11.2	0.9	5.7
S&P 500 - USA	4’500	19.9	-0.6	-5.2
Nasdaq 100 - USA	14’532	25.6	-2.0	-10.8
MSCI Emerging Markets	1’126	12.0	-1.3	-8.2

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.93	7.3	0.9	2.3
EUR-CHF	1.02	6.7	-0.5	-1.6
GBP-CHF	1.22	7.2	0.3	-1.2
EUR-USD	1.09	8.0	-1.6	-4.0
GBP-USD	1.31	7.9	-0.4	-3.2
USD-JPY	124.1	8.7	1.3	7.8
EUR-GBP	0.84	6.7	-0.8	-0.4
EUR-SEK	10.27	7.5	-0.7	0.3
EUR-NOK	9.57	9.2	-0.9	-4.1

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	125	33.7	-0.8	26.2
Brent crude oil - USD / barrel	101	87.5	-5.1	28.7
Gold bullion - USD / Troy ounce	1’931	19.6	-0.4	6.4

Source: J. Safra Sarasin, Bloomberg as of 07.04.2022

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Bank J. Safra Sarasin Ltd
Elisabethenstrasse 62
P.O. Box
4002 Basel
Switzerland
T: +41 (0)58 317 44 44
F: +41 (0)58 317 44 00
www.jsafrasarasin.ch