J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

Cross-Asset Weekly

19 March 2021

The Fed holds the line

Wednesday's dovish Fed meeting has led bond investors to price additional inflationary risks over the next several years. Though we think that over the longer term, inflation will pick up more than what the Summary of Economic Projections suggests, we see the risk of a large and prolonged increase in inflation and interest rates as limited.

Although the adjustment to a more normal rate structure in the US has progressed considerably, the risk remains that bond yields move somewhat higher over the coming months as inflation concerns and uncertainty with regard to Fed policy lead to a steeper yield curve. Risk markets are not behaving in a disorderly manner for now, hence the Fed will likely not push back against the recent back-up in yields in the near term.

In equity markets, we think health care is starting to look attractive. The sector has suffered from a drop in demand for medical treatments and screenings due to COVID, with the outlook improving in a vaccinated society. This does not appear to be priced yet. Further-more, macro headwinds appear to be fading. Rates, which typically weigh on the sector's relative performance, may continue to move higher, but at a much reduced pace. The US dollar may even turn from headwind to tailwind as its outlook appears more positive in the short term. The large US sales exposure of European pharma firms and their high US mar-gins make them particularly sensitive to USD strength. While a somewhat stronger USD improves the investment case for health care, oil prices are facing increased headwinds, making the energy sector less attractive.

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This week's highlights

US Macro 2
Testing the Fed's patience

US Fixed Income 3
The bad smell of inflation

Global Equities 4
Health care - the forgotten re-opening play

Economic Calendar 7
Week of 22/03 – 26/03/2021

Market Performance 8
Global Markets in Local Currencies

US Macro

Testing the Fed's patience

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Wednesday's dovish Fed meeting has led bond investors to price additional inflationary risks over the next several years. Though we think that over the longer term, inflation will pick up more than what the Summary of Economic Projections suggests, we see the risk of a large and prolonged increase in inflation and interest rates as limited.

The Fed believes it will take a long time for inflation to sustainably exceed 2%

Jay Powell maintained the same dovish line at Wednesday's FOMC meeting, despite a strong upward revision to the US GDP growth projections for 2021. Fed officials have revised up their 2021 inflation forecast markedly to 2.4% (from 1.8%), but they see this move as transient. Projections for 2022 and 2023 were only revised up by 0.1 pts, to 2.0% and 2.1% respectively, despite a lower-than-previously-expected unemployment rate. In short, they view the Phillips curve as pretty much flat. Higher inflation will have to be driven by higher inflation expectations, and according to Powell, this will take time after decades of low inflation. As a result, the median official still sees no rate hike before at least 2024.

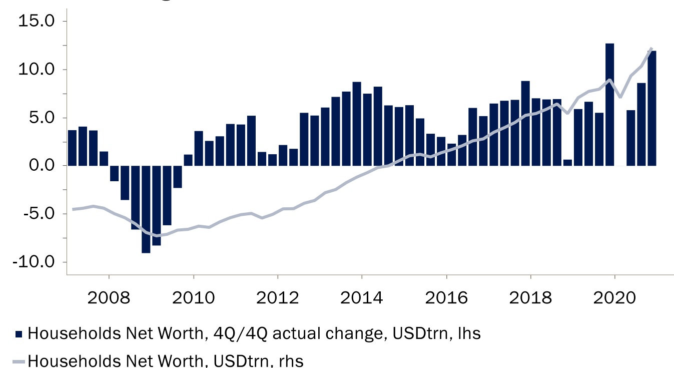
Bond investors are getting more worried about inflation

Longer-term maturity Treasury bond prices have been under renewed pressure, with yields on the ten-year picking up by another 10 basis points and five year inflation breakeven rates moving up to close to 2.6% – the rate investors expect CPI inflation to average over the next five years. Higher inflation prints over the coming months could push these numbers even higher. In other words, bond investors seem to be anticipating a more persistent rise in inflation than Fed officials do (and the need for more tightening). So who's right?

The truth lies probably somewhere in between

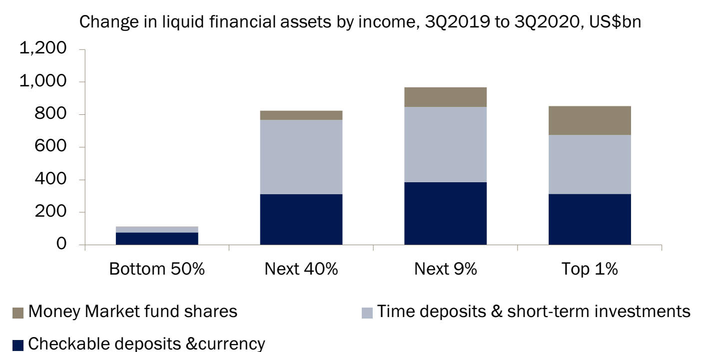
The truth lies probably somewhere in between. As we have argued before, there are good reasons to believe that over the longer term inflation is higher than it was over the past few decades. But we don't expect the fiscal stimulus to be as inflationary as some others do. It is true that the increase in net wealth, liquid assets and excess savings over the past year – thanks to generous fiscal transfers, a rise in equity and house prices and a drop in mortgage rates – has been impressive (Exhibit 1). If all of this is spent rapidly, then the risk of overheating will increase. But this is unlikely for two reasons. Most of the increase in liquid financial assets and excess savings are sitting on the bank accounts of wealthier Americans, who are better able to smooth their spending and consume less of any increase in income (Exhibit 2). In addition, the demand for services does not get as pent up as the demand for goods, which should limit the scale of the rebound.

Exhibit 1 : A huge increase in net wealth



Source: Macrobond, Bank J. Safra Sarasin, 18.03.2021

Exhibit 2 : An unequal distribution of gains in liquid financial assets



Source: Macrobond, Bank J. Safra Sarasin, 18.03.2021

US Fixed Income

The bad smell of inflation

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Although the adjustment to a more normal rate structure in the US has progressed considerably, the risk remains that bond yields move somewhat higher over the coming months as inflation concerns and uncertainty with regard to Fed policy lead to a steeper yield curve. Risk markets are not behaving in a disorderly manner for now, hence the Fed will likely not push back against the recent back-up in yields in the near term.

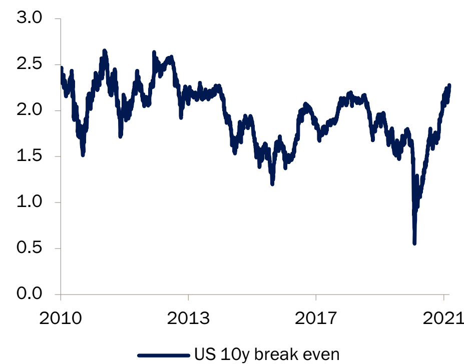
The Fed has doubled-down on its stance

The Fed has doubled down on its stance of leaving rates unchanged throughout 2023, although there is a shift to a slightly more hawkish stance beneath the surface. The updated forecasts show a substantial upward revision to growth expectations, however, inflation forecasts (core PCE) were left practically unchanged at 2.0% for 2021 and 2.1% for 2022, implying that the Fed will look through rising inflation readings over the coming quarters as it considers them transient. With regard to the tapering of bond purchases, the Fed chair has again stressed that the Fed would give advanced warning to the market. Therefore, tapering will likely not happen before 2022.

A perfect set-up for inflation expectations and curve steepness to increase further

An accelerating US economy accompanied by rising concerns about inflationary pressures and a Fed that is perceived to stand put for an extended period of time continue to be a recipe for a steeper curve as market participants demand a higher risk premium for long-term maturities. US 10-year break-even rates are still well below the 2.5% band where they usually turned in past cycles, hence they probably have some more room to rise (Exhibit 1). The front-end of the Treasury yield curve should do better as some of the near-term bets on rate hikes will likely be faded after Powell's comments. Consequently, we would expect the 2y/10y and 5y/30y to steepen further (Exhibit 2).

Exhibit 1: Higher inflation expectations

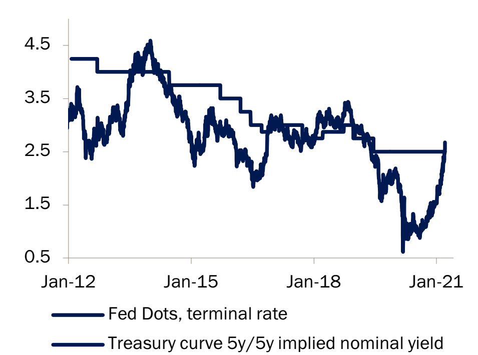


Source: Bloomberg, Bank J. Safra Sarasin, 18.03.2021

Exhibit 2: More curve steepness ahead

Source: Bloomberg, Bank J. Safra Sarasin, 18.03.2021

Exhibit 3: Expectations usually overshoot



Source: Bloomberg, Bank J. Safra Sarasin, 18.03.2021

Risk of an overshoot for yields over coming months

As we mentioned in our last forecast update, there are upside risks to our forecast over the next few months. Although the adjustment to a more normal rate structure has progressed considerably, there is a risk that bond yields move somewhat higher over the coming months as inflation concerns and uncertainty with regard to Fed policy lead to a steeper yield curve. (Exhibit 3). Markets are sounding out the Fed's pain threshold for nominal and real rates. Risk markets are not behaving in a disorderly manner for now, hence the Fed will likely not push back against the back-up in yields in the near term.

Global Equities

Health care - the forgotten re-opening play

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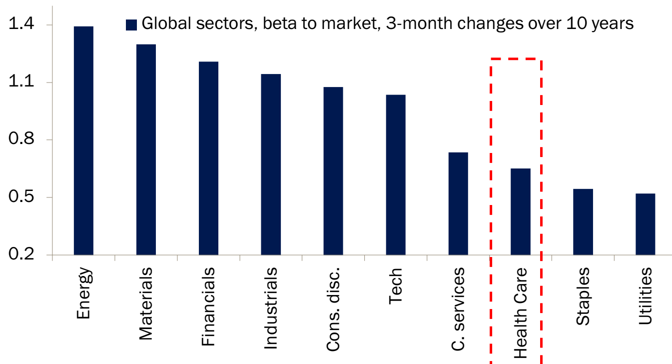
In our view health care is starting to look increasingly attractive. The sector has suffered from a drop in demand for medical treatments and screenings due to COVID, with the outlook improving in a vaccinated society. This does yet not appear to be priced. Furthermore, macro headwinds are fading. Rates, which typically weigh on the sector's relative performance, may continue to move higher, but at a reduced pace. The US dollar may even turn from headwind to tailwind as its outlook appears more positive in the short term. The large US sales exposure and high US margins make European pharma firms particularly sensitive to USD strength. While a stronger USD improves the investment case for health care, oil prices are facing increased headwinds, making the energy sector less attractive.

COVID is a health crisis but did not help the health care sector

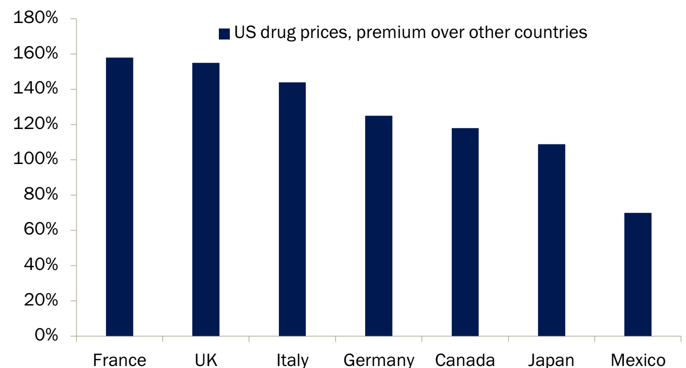
One sector which has done remarkably badly during a period which can easily be considered the greatest global health crisis of the post-war era, is health care. At first it may sound surprising, but a closer look reveals various reasons for its underperformance. Firstly, COVID led to a dramatic decline in treatments for other medical conditions. Patients either avoided medical facilities for the fear of getting infected with COVID or treatments were postponed due to exhausted hospital capacities. Across various forms of medical treatment, screening and hospital bed utilization, data for the US shows a drop in activity of between 30% and 75%, at different stages over the past year. Secondly, the sector's defensiveness (Exhibit 1) and rate sensitivity did not help beyond the initial sell-off in the first quarter of 2020, when it outperformed by 15%. As it became clear that health care providers and pharma firms would not generally benefit from the crisis, initial gains quickly reversed and turned into 20% underperformance until today.

Exhibit 1: Health care is defensive but less so than staples and utilities



Source: Refinitiv, Bank J. Safra Sarasin, 18.03.2021

Exhibit 2: US drug prices are significantly higher than in other regions



Source: RAND, Bank J. Safra Sarasin, 18.03.2021

A weaker US dollar and rising rates weighed on the health care sector in the second half of 2020

Thirdly, the sector's key macro drivers also turned against it. The quick rebound in both, equity markets and macro momentum, was accompanied by a drop in the US dollar and a comeback of nominal US yields, all of which weighed on health care performance. The US-dollar sensitivity of the health care sector derives from its large US footprint, which is particularly relevant for European pharma firms. US sales account for close to 30% of their total sales, more than for any other European sector. Furthermore, a decline in US volumes has a disproportionate effect on European pharma's net income, as higher US average drug prices (Exhibit 2) generate superior margins, compared to other regions.

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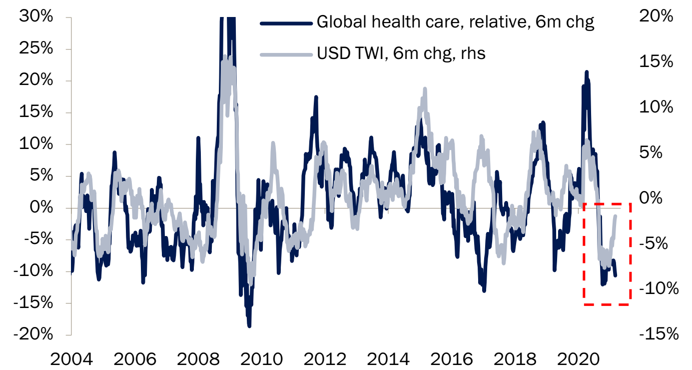
Saying all that and looking ahead, it seems that headwinds for the sector are fading. The rapid roll-out of vaccinations in the US has so far only had a significant positive impact on more immediate re-opening plays, such as airlines and leisure (Exhibit 3). In our view, the market has somewhat ignored the positive effect rising immunity levels can have on health care. Furthermore, the US dollar has stabilised since the beginning of the year and started to appreciate lately. The already wide yield gap between the US and the rest of the world, as well as the developing GDP growth gap suggest that the US dollar may appreciate further in the short term, with the health care sector yet not priced for it (Exhibit 4).

Exhibit 3: Airlines have led market performance since November

Source: Refinitiv, Bank J. Safra Sarasin, 18.03.2021

Exhibit 4: Health care is yet not priced for recent USD strength

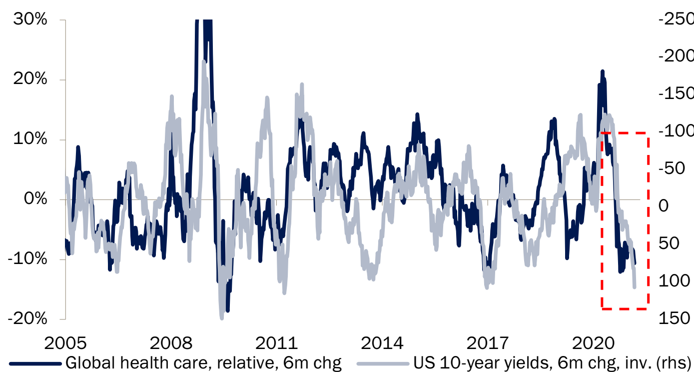


Source: Refinitiv , Bank J. Safra Sarasin, 18.03.2021

US yields have largely caught up with macro momentum

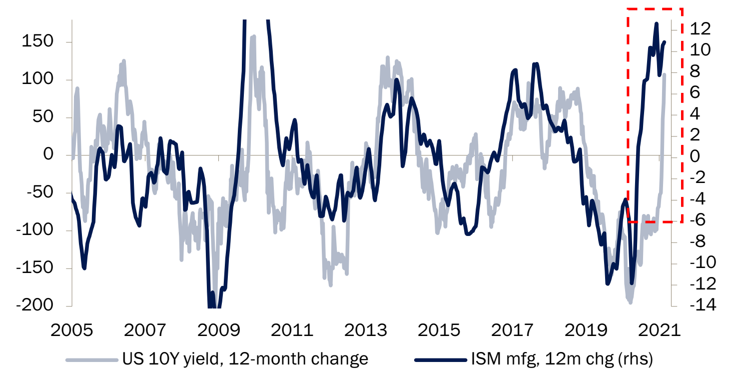
In addition, the surge in US yields could soon slow somewhat and thus fade as a headwind for relative health care sector performance (Exhibit 5). After rising by more than 100bps since October 2020, US nominal yields have now caught up with the surge in macro momentum (Exhibit 6). This move is also in line with the typical recovery in US rates after a downturn.

Exhibit 5: The rise in yields has been a headwind for health care



Source: Refinitiv, Bank J. Safra Sarasin, 18.03.2021

Exhibit 6: US yields have almost closed the gap to macro data

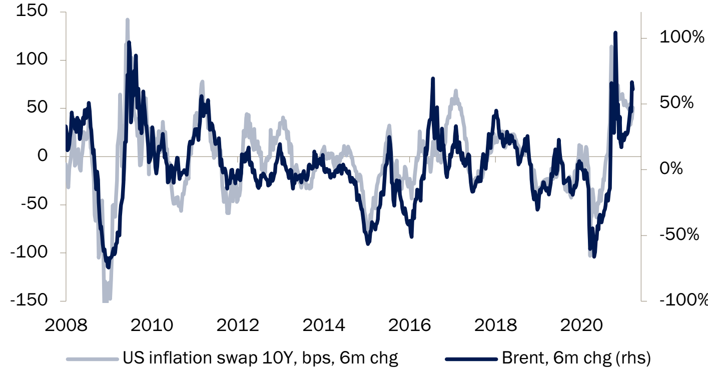


Source: Refinitiv, Bank J. Safra Sarasin, 18.03.2021

A stabilising oil price should dampen a further rise in inflation expectations

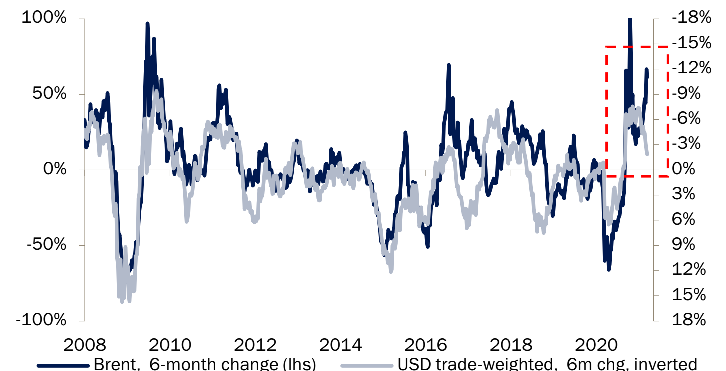
Will this time be different? At least the oil price, which typically drives inflation expectations, has stabilised over recent weeks and could no longer gain from re-opening hopes (Exhibit 7). It appears that the strengthening US dollar is weighing on oil prices for now and should help dampen a further rise in inflation expectations (Exhibit 8).

Exhibit 7: US inflation swaps follow the oil price



Source: Refinitiv, Bank J. Safra Sarasin, 18.03.2021

Exhibit 8: Oil price usually suffer when the USD rises

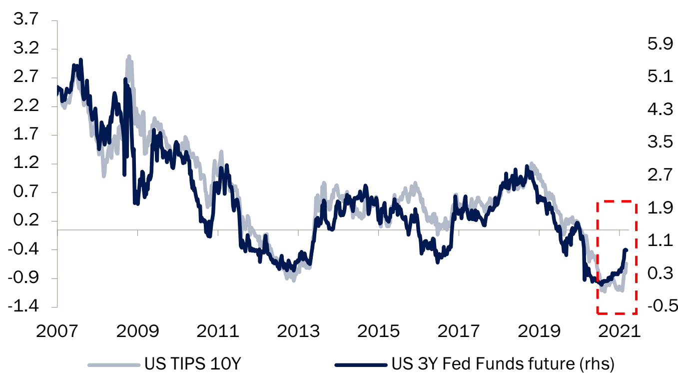


Source: Refinitiv, Bank J. Safra Sarasin, 18.03.2021

The gap between real rates and Fed pricing is much smaller now

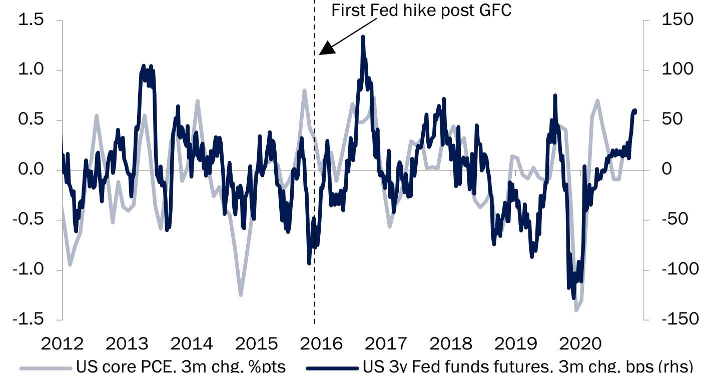
What about the real rate component? US real rates are a function of the market's pricing for the Fed (Exhibit 9), which itself loosely follows core inflation data (Exhibit 10). The recent re-pricing in US real rates, with the 10Y TIPS yield now at -57bps (more than 50bps above the 2020 trough) is increasingly in line with the market's expectations for policy rates (implying 3.5 hikes over the next 3 years, in contrast to the FOMC's dot plot median which has no hike). They may push somewhat higher as the market may want to test the Fed's determination, but large moves seem less likely from here. The correlation with inflation suggests that Fed expectations should only start picking up again if US core PCE were to come in substantially above expectations over coming months. This is not unrealistic but provides some buffer before fundamentals turn substantially more supportive again for real rates.

Exhibit 9: TIPS yields have largely closed the gap to Fed funds futures



Source: Refinitiv, Bank J. Safra Sarasin, 18.03.2021

Exhibit 10: Fed expectations tend to follow reported core PCE data



Source: Refinitiv, Bank J. Safra Sarasin, 18.03.2021

Health care should benefit from improving demand and key drivers turning

Bottom-line, rates may grind higher still, but the big swings, which helped to close the gap to the macro data appear behind us. We think this is becoming a better time to add some health care exposure, given the sector's improving outlook in a vaccinated society and its positive correlation with the US dollar. Rates may remain a headwind, but less than in the recent past, with other factors more than offsetting their negative impact. It should also be noted that it's still far too early to add exposure to proper defensive bond proxies, such as staples or utilities. Lastly, as mentioned above, the upside for the oil price seems quite limited in the current setup, raising headwinds for the energy sector.

Economic Calendar

Week of 22/03 – 26/03/2021

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 22.03.2021						
JN	06:00	Leading Index	Jan F	Index	--	99.10
US	13:30	Chicago Fed Nat Activity Index	Feb	Index	0.73	0.66
	15:00	Existing Home Sales	Feb	mn	6.52	6.69
	15:00	Existing Home Sales MoM	Feb	mom	-2.50%	0.60%
Tuesday, 23.03.2021						
US	15:00	Richmond Manufacturing Index	Mar	Index	--	14.00
Wednesday, 24.03.2021						
FR	09:15	Markit France Manuf. PMI	Mar P	Index	--	56.10
	09:15	Markit France Service PMI	Mar P	Index	--	45.60
GE	09:30	Markit Germany Manuf. PMI	Mar P	Index	--	60.70
	09:30	Markit Germany Service PMI	Mar P	Index	--	51.10
EU	10:00	Markit Eurozone Manuf. PMI	Mar P	Index	--	57.90
	10:00	Markit Eurozone Service PMI	Mar P	Index	--	45.70
UK	10:30	Markit UK Manuf. PMI	Mar P	Index	--	55.10
	10:30	Markit/CIPS UK Services PMI	Mar P	Index	--	49.50
US	14:45	Markit UK Manuf. PMI	Mar P	Index	58.80	58.60
	14:45	Markit/CIPS Services PMI	Mar P	Index	60.00	59.80
Thursday, 25.03.2021						
EU	10:00	ECB Economic Bulletin	Mar			
US	13:30	Initial Jobless Claims	Mar20	1'000	--	770k
	16:00	Kansas City Fed Manf. Activity	Mar	Index	--	24.00
Friday, 26.03.2021						
GE	10:00	IFO Expectations	Mar	Index	--	94.20
US	13:30	PCE Core Deflator MoM	Feb	mom	0.10%	0.30%
	13:30	PCE Core Deflator YoY	Feb	yoy	1.50%	1.50%
	15:00	U. of Michigan Expectations	Mar F	Index	--	77.50

Source: Bloomberg, J. Safra Sarasin as of 19.03.2021

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	-0.24	-1	31	-1.6
German Bund 10 year (%)	-0.31	0	26	-2.1
UK Gilt 10 year (%)	0.83	1	62	-5.1
US Treasury 10 year (%)	1.69	6	76	-5.7
French OAT - Bund, spread (bp)	25	1	2	
Italian BTP - Bund, spread (bp)	95	2	-16	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	10’938	18.0	1.3	3.7
DAX - Germany	14’734	16.3	1.4	7.7
MSCI Italy	779	14.1	0.7	9.0
IBEX - Spain	8’565	18.9	0.4	7.2
DJ Euro Stoxx 50 - Eurozone	3’852	18.7	0.6	9.2
MSCI UK	1’900	14.7	0.8	6.0
S&P 500 - USA	3’915	22.7	-0.6	4.6
Nasdaq 100 - USA	12’789	28.0	-2.0	-0.6
MSCI Emerging Markets	1’347	15.9	-0.7	4.5

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.93	6.6	-0.2	5.3
EUR-CHF	1.11	5.0	-0.5	1.9
GBP-CHF	1.29	7.5	0.0	7.8
EUR-USD	1.19	6.2	-0.4	-3.2
GBP-USD	1.39	7.7	0.1	2.3
USD-JPY	108.7	6.3	-0.3	5.4
EUR-GBP	0.85	6.4	-0.5	-5.4
EUR-SEK	10.15	5.3	0.1	0.7
EUR-NOK	10.13	8.9	0.5	-3.5

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	84	14.5	-1.5	8.4
Brent crude oil - USD / barrel	64	41.1	-7.7	25.8
Gold bullion - USD / Troy ounce	1’743	14.9	1.2	-8.0

Source: J. Safra Sarasin, Bloomberg as of 19.03.2021

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