J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

# Cross-Asset Weekly

18 March 2022

## Inflation is the Fed's top priority

The number one priority at the Fed is to bring inflation down, which will require interest rates to move higher much faster than previously anticipated. Fed officials have no clear view about how elevated inflation will turn out to be at the end of the year, and hence the extent to which they will need to tighten policy. Still, they expect to bring inflation down with minimum collateral damage to growth and the labour market, which we find highly optimistic.

Unsurprisingly, the USD yield curve continues to flatten and has even started to invert at selected maturity points. This reflects the market's view that the Fed will have limited capacity to raise rates given a macro cycle that is already decelerating. While a flat or slightly inverted yield curve does not necessarily signal a firm top for long-term rates, it is a bright warning sign that the Fed runs the risk of tightening too much too fast, with all the negative implications for asset prices.

US equities, finally, remain in a difficult spot. With more than 70% of items in the CPI basket seeing prices rise faster than 5%, the risk of high inflation rates becoming entrenched has risen. At the same time, macro momentum is softening, which is also reflected in weakening earnings prospects. Consequently, risks remains elevated as potentially more Fed tightening and higher real rates on the one hand are met with a moderating cycle and falling earnings expectations on the other.

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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

## US macro

# Fed has become laser focused on bringing down inflation

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

**The number one priority at the Fed is to bring inflation down, which will require interest rates to move higher much faster than previously anticipated. Fed officials have no clear view about how elevated inflation will turn out to be at the end of the year, and hence the extent to which they will need to tighten policy. Still, they expect to bring inflation down with minimum collateral damage to growth and the labour market, which we find highly optimistic.**

**Lift-off finally happened on Wednesday. The median dot shows another six 25bp rate hikes this year, and at least three in 2023**

The focus of the meeting was clearly on inflation. With the war raging in Ukraine, it is likely to peak at a higher level and later than previously expected. The answer from Fed officials is to bring the monetary stance back to neutral and then into tight territory as soon as possible. At 2.75%, the median expectation for the policy rate is expected to be higher than the neutral rate (2.4%) by the end of 2023. And this doesn't take into account the tightening of monetary conditions that will result from the balance sheet runoff, which could start as soon as May.

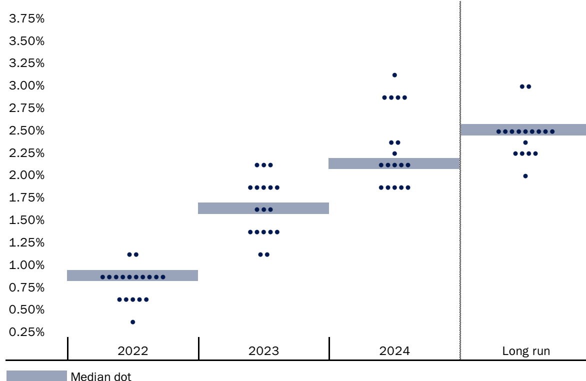
**Officials are highly optimistic about their ability to bring inflation down, while doing minimum damage to growth or the labour market**

The new forecasts for the economy are very optimistic, Fed officials think that they can tighten policy much faster and bring inflation down eventually toward its target with minimum impact on growth and without hurting the labour market. Indeed, GDP growth forecasts for 2023 and 2024 were left unchanged. And while their forecasts for this year were revised down quite materially (2.8%, from 4.0%), Mr. Powell mentioned that it had more to do with the fallout from the war rather than with tighter policy. The forecasts for the unemployment rate was basically left unchanged over the next three years. Needless to say, many things will need to fall into place for this scenario to materialize.

**There is no consensus within the FOMC about how much and how fast they will need to tighten policy to bring inflation under control**

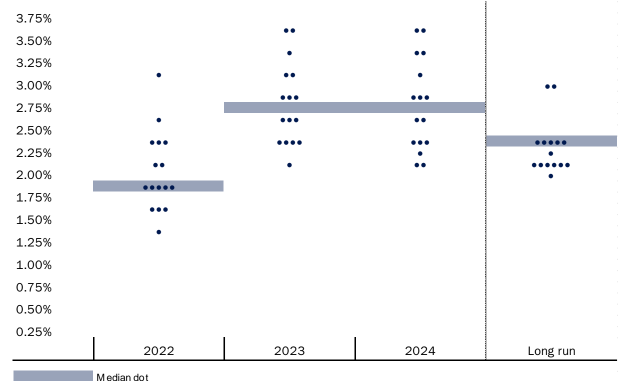
In addition, the range of estimates has become very wide. Back in December, no Fed official thought that rates could go beyond 2.25% by the end of 2023. Now, almost all of them think that they will go at least this far, and two officials believe rates will go as high as 3.75% (Exhibits 1-2). The spread between the lowest and highest estimates has increased from 0.75 percentage points (pp) to 1.75. This wide range of views clearly reflects the spread of views on inflation, which covers almost 2pp (from 1.2 three months ago). Obviously, uncertainty has risen significantly as the economy is being hit by yet another exogenous shock, which could evolve in very different ways. While it's obvious where monetary policy is headed to, the pace at which it will be tightened is all but certain.

**Exhibit 1: December 2021 dot plot**




Source: Federal Reserve, Bank J. Safra Sarasin, 17.03.2022

**Exhibit 2: March 2022 dot plot**




Source: Federal Reserve, Bank J. Safra Sarasin, 17.03.2022

## US fixed income

# USD yield curve shows signs of inversion


**Alex Rohner**
Fixed Income Strategist
alex.rohner@jsafrasarasin.com
+41 58 317 3224



**The market's attention continues to focus on the shape of the US yield curve and the fact that it has started to invert at selected maturity points. This reflects the market's view that the Fed will have more limited capacity to raise rates given a macro cycle that is already decelerating. While a flat or slightly inverted yield curve does not necessarily signal a firm top for long-term rates, it is a bright warning sign that the Fed runs the risk of tightening too much too fast, with all the implications for asset prices.**


**The Fed has delivered what was expected**

As expected, the Fed has confirmed that it is committed to tighten policy quickly in order to rein in rapidly rising inflationary expectations. The March median FOMC projections put the Fed Funds rate at 2.75% by the end of 2023. Consequently, monetary policy would be in restrictive territory by the Fed's own definition of the neutral rate (which was brought down to 2.4% from 2.5%). Additionally, the balance sheet run-off could start as early as May and should largely run in the background.

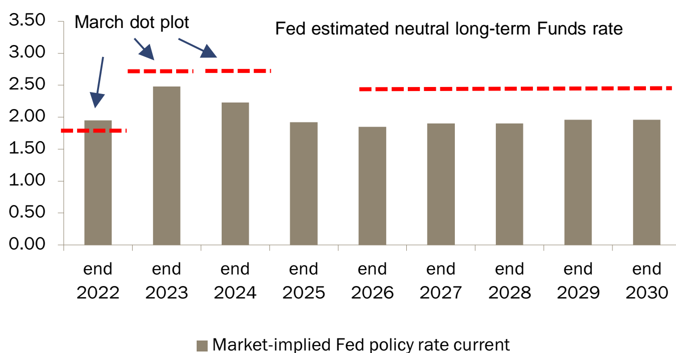
**The market's reaction to the FOMC decision was muted**

The reaction to the latest dot plot and the hawkish statement from Chair Powell was fairly muted since the market had already repriced rate expectations. Still, the market continues to price a shallower rate cycle than the FOMC members' own projections (Exhibit 1). Indeed, their growth projections for 2023 and 2024 look quite optimistic given the rapid pace of expected rate rises.

**The yield curve continues to flatten and inverts at selected maturity points**

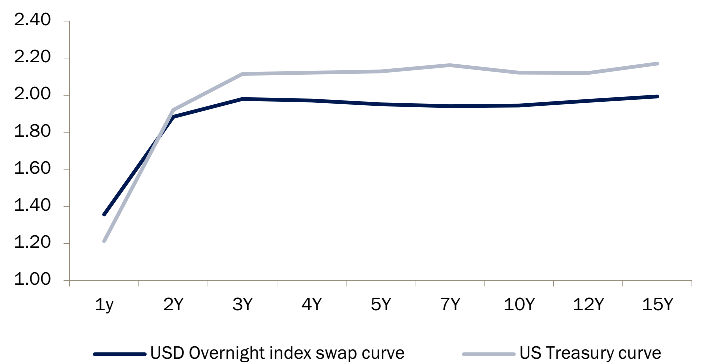
The Treasury yield curve has continued its flattening trend after the FOMC decision, as one would expect in a tightening cycle. Interestingly, the USD yield curve has started to invert selectively from the 3-year maturity onwards, underlining the market's view that the Fed will have a much more limited capacity to tighten given a macro cycle that is already decelerating (Exhibit 2).

**Exhibit 1: Fed wants to rapidly guide Funds rate into restrictive territory**




Source: Bloomberg, Bank J. Safra Sarasin, 17.03.2022

**Exhibit 2: USD yield curves are starting to selectively invert**




Source: Bloomberg, Bank J. Safra Sarasin, 17.03.2022

**The yield curve is flashing a bright warning sign that the Fed runs the risk of tightening too much too quickly**

Still, a flat or slightly inverted yield curve at the current stage does not necessarily signal a firm top for long-term rates yet. There is a risk that further upward pressure on short-term rates – in case the Fed needs to do even more - could also drag long-term rates up for a while. Nevertheless, the yield curve is flashing a bright warning sign that the Fed runs the risk of tightening too much too fast.

J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

# US equities

## Fundamentals remain challenging

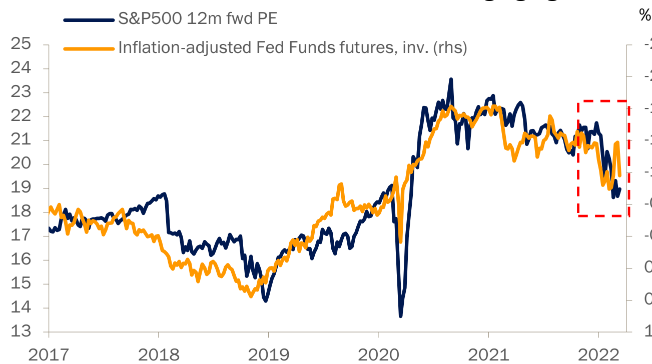
**Wolf von Rotberg**
Equity Strategist
wolf.vonrotberg@jsafrasarasin.com
+41 58 317 30 20

**US equities remain in a challenging environment. We would not recommend to chase the recent rebound. After the onset of the Ukraine war, the Fed is in an even more difficult spot. With more than 70% of items in the CPI basket seeing prices rise faster than 5%, the risk of high inflation rates becoming entrenched has risen. Yet the Fed is priced for the shallowest hiking cycle on record. At the same time, macro momentum is softening, which is also reflected in weakening earnings prospects. Consequently, risks remain elevated as potentially more Fed tightening and higher real rates on the one hand are met with a weaker cycle and falling earnings expectations on the other.**

**Markets have recovered somewhat as risks have faded**

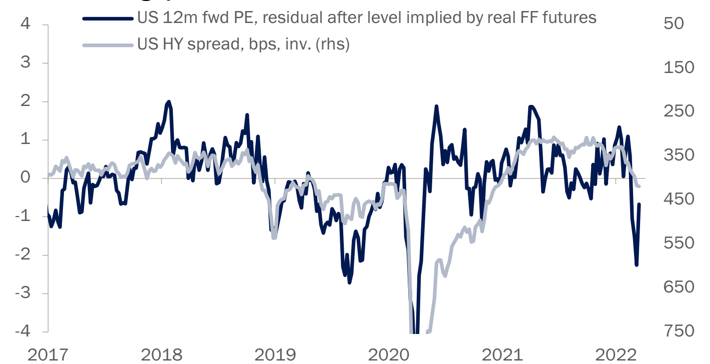
As markets perceive that some risks from the Ukraine war have faded somewhat over recent days, equity markets have rallied. US valuations have recovered from their sub-19x levels, which had been reached despite a sharp drop in real rates (Exhibit 1). The reason for this divergence was a typical risk-off reaction across asset classes. Bond yields retreated, equities dropped and credit spreads widened. As risks have abated, rates and valuations have started to converge again from both ends and the equity market gap to the rates and credit market is disappearing quickly (Exhibit 2).

**Exhibit 1: Real Fed Funds futures and PEs converging again**




Source: Refinitiv, Bank J. Safra Sarasin, 16.03.2022

**Exhibit 2: The gap can be attributed to a risk-off reaction**

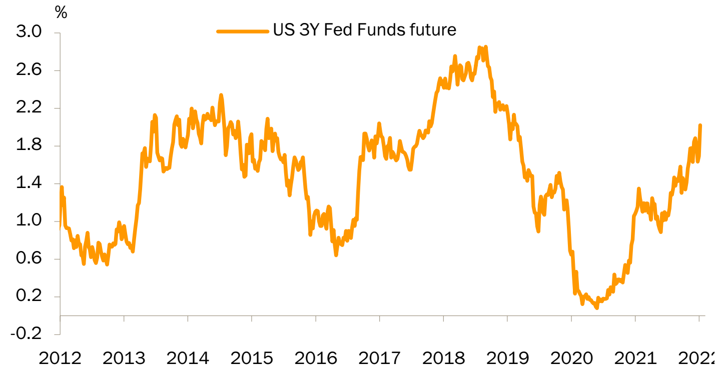



Source: Refinitiv, Bank J. Safra Sarasin, 16.03.2022

**Fundamental challenges remain in place**

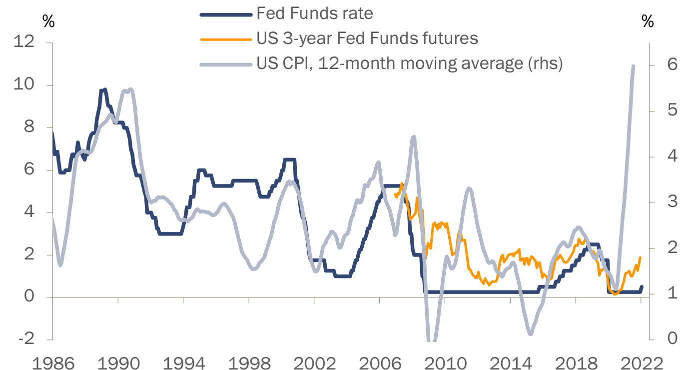
With the prospect for markets to move beyond the immediate shock of the Ukraine invasion, we revisit our cautious tactical stance on equities. Although some major pressure points, like commodity prices, have eased slightly, the fundamental situation remains largely unchanged compared to four weeks ago. While the market has sharply repriced expectations for the Fed and equities have de-rated accordingly, we believe the fundamental setup remains challenging. Market pricing for the Fed's current cycle is much shallower than in previous ones (Exhibit 3), in line with the Fed's own guidance. Yet inflation rates are substantially higher, suggesting that even after the latest repricing, the Fed might still need to do more (Exhibit 4).

**Exhibit 3: The current Fed pricing sees a shallower cycle than 2018**




Source: Refinitiv, Bank J. Safra Sarasin, 16.03.2022

**Exhibit 4: Inflation is highest in 40+ years**

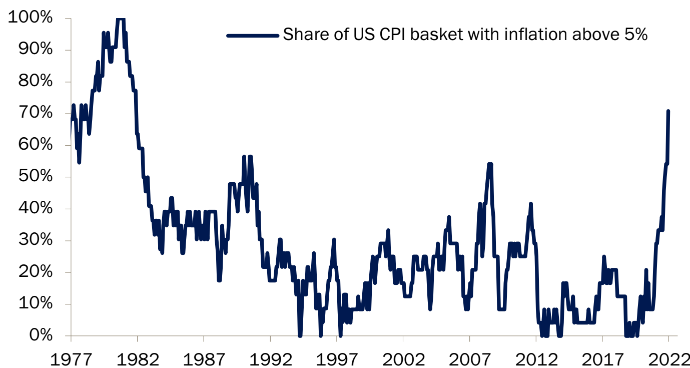



Source: Refinitiv, Bank J. Safra Sarasin, 16.03.2022

**Inflation remains high and broad-based, while the Fed is priced for a fairly shallow cycle**

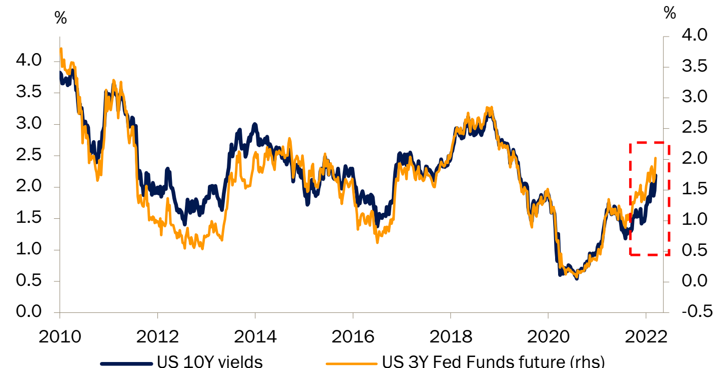
There is the hope that inflation comes down naturally due to base effects and pandemic-driven shortages unwinding. However, this is at odds with the inflation dynamics itself. While inflation was a function of just a few items in the consumer basket initially, it has broadened substantially over recent months. As of February, more than 70% of the US inflation basket is seeing prices rise by more than 5% (yoy), which is the highest share of above-5% items since the late 1970s (Exhibit 5). With the risk of high inflation becoming increasingly entrenched, risks biased towards a more hawkish Fed policy trajectory remain in place, keeping upside pressure on Fed Funds futures alive. Accordingly, US 10-year yields are unlikely to retreat from their current 3-year high, unless weaker economic data start to bite (Exhibit 6).

**Exhibit 5: The breadth of inflation across CPI basket items is worrying**




Source: Refinitiv, Bank J. Safra Sarasin, 16.03.2022

**Exhibit 6: Fed Funds futures are driving 10-year yields higher**

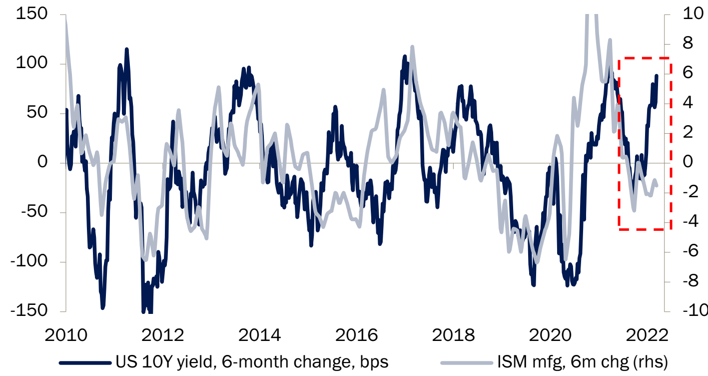



Source: Refinitiv, Bank J. Safra Sarasin, 16.03.2022

**Fed tightening into a softening macro momentum bears risks as earnings fail to provide much support**

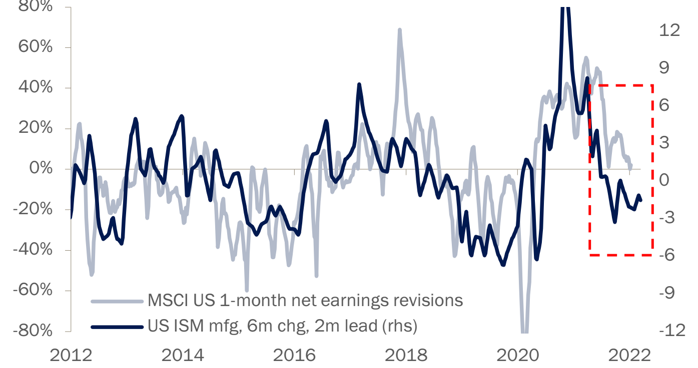
Such a scenario cannot be fully discounted. The 100bp rise in the 10-year yield over the past six months happened against the backdrop of a falling US macro momentum. This is a reflection of the more advanced stage of the cycle during which the Fed now starts to tighten. Under its old framework, it would likely have raised policy rates last year when growth was still accelerating. This time around, the Fed is tightening into a softening cycle (Exhibit 7). This deceleration in the momentum data is more than just base effects as can be seen in consensus revisions for US earnings. These have turned negative this week, for the first time since mid-2020, mimicking 6-month changes in the US manufacturing purchasing managers index ISM (Exhibit 8).

**Exhibit 7: Rise in 10-year yields comes a macro momentum slows**




Source: Refinitiv, Bank J. Safra Sarasin, 16.03.2022

**Exhibit 8: Earnings revisions are negative for first time since mid-2020**




Source: Refinitiv, Bank J. Safra Sarasin, 16.03.2022

**The Fed remains in a difficult spot, with higher real rates or a weakening cycle the most likely outcome. Either are headwinds for equities.**

Bottom-line, the Fed remains in a difficult spot. Inflation proves to be a bigger challenge than it had assumed and may well require more tightening than currently priced – unless demand fades more quickly for other reasons. In either scenario, equities continue to face headwinds and are unlikely to see new highs for the time being.

## Economic Calendar

## Week of 21/03 – 25/03/2022

| Country | Time | Item | Date | Unit | Consensus Forecast | Prev. |
|---|---|---|---|---|---|---|
| **Monday, 21.03.2022** | | | | | | |
| **GE** | 08:00 | PPI MoM | Feb | mom | -- | 2.20% |
| | 08:00 | PPI YoY | Feb | yoy | -- | 25.00% |
| **US** | 13:30 | Chicago Fed Nat. Activity Index | Feb | Index | -- | 0.69 |
| **Tuesday, 22.03.2022** | | | | | | |
| **US** | 15:00 | Richmond Fed Manuf. Index | Mar | Index | 0.0 | 1.0 |
| **Wednesday, 23.03.2022** | | | | | | |
| **UK** | 08:00 | CPI YoY | Feb | yoy | 5.90% | 5.50% |
| | 08:00 | CPI Core YoY | Feb | yoy | -- | 4.40% |
| **US** | 12:00 | MBA Mortgage Applications | Mar18 | wow | -- | -1.20% |
| | 15:00 | New Home Sales | Feb | 1'000 | 814k | 801k |
| **Thursday, 24.03.2022** | | | | | | |
| **FR** | 09:15 | Markit France Manf. PMI | Mar | Index | -- | 57.20 |
| **GE** | 09:30 | Markit Germany Manf. PMI | Mar | Index | -- | 58.40 |
| **EU** | 10:00 | Markit Eurozone Manf. PMI | Mar | Index | -- | 58.20 |
| **UK** | 10:30 | Markit UK Manf. PMI | Mar | Index | -- | 58.00 |
| **US** | 14:45 | S&P Global US Manf PMI | Mar | Index | 55.00 | 57.30 |
| | 16:00 | Kansas City Manf. PMI | Mar | Index | -- | 29.00 |
| **Friday, 25.03.2022** | | | | | | |
| **GE** | 10:00 | IFO Expectations Index | Mar | Index | -- | 99.20 |
| **US** | 15:00 | U. of Mich. 5-10 Yr Inflation | Mar F | % | -- | 3.00% |

Source: Bloomberg, J. Safra Sarasin as of 17.03.2022

# Market Performance

## Global Markets in Local Currencies

| Government Bonds | Current value | Δ 1W | Δ YTD | TR YTD in % |
|---|---|---|---|---|
| Swiss Eidgenosse 10 year (%) | 0.41 | 6 | 55 | -3.8 |
| German Bund 10 year (%) | 0.40 | 15 | 58 | -4.4 |
| UK Gilt 10 year (%) | 1.57 | 7 | 59 | -4.1 |
| US Treasury 10 year (%) | 2.18 | 19 | 67 | -5.4 |
| French OAT - Bund, spread (bp) | 45 | -2 | 8 | |
| Italian BTP - Bund, spread (bp) | 152 | -8 | 17 | |

| Stock Markets | Level | P/E ratio | 1W TR in % | TR YTD in % |
|---|---|---|---|---|
| SMI - Switzerland | 12'062 | 17.6 | 6.4 | -5.2 |
| DAX - Germany | 14'388 | 12.9 | 7.0 | -9.4 |
| MSCI Italy | 758 | 9.3 | 5.0 | -11.8 |
| IBEX - Spain | 8'412 | 12.6 | 4.2 | -3.1 |
| DJ Euro Stoxx 50 - Eurozone | 3'885 | 13.3 | 6.4 | -9.3 |
| MSCI UK | 2'108 | 11.3 | 4.0 | 2.4 |
| S&P 500 - USA | 4'412 | 19.6 | 3.6 | -7.1 |
| Nasdaq 100 - USA | 14'119 | 24.8 | 3.9 | -13.3 |
| MSCI Emerging Markets | 1'121 | 12.2 | 1.7 | -8.8 |

| Forex - Crossrates | Level | 3M implied volatility | 1W in % | YTD in % |
|---|---|---|---|---|
| USD-CHF | 0.94 | 6.6 | 0.4 | 2.6 |
| EUR-CHF | 1.04 | 7.1 | 1.9 | 0.4 |
| GBP-CHF | 1.23 | 7.3 | 1.2 | 0.0 |
| EUR-USD | 1.11 | 7.6 | 1.5 | -2.2 |
| GBP-USD | 1.32 | 8.0 | 0.9 | -2.6 |
| USD-JPY | 119.0 | 6.9 | 1.4 | 3.4 |
| EUR-GBP | 0.84 | 6.5 | 0.6 | 0.4 |
| EUR-SEK | 10.45 | 8.5 | -1.9 | 2.0 |
| EUR-NOK | 9.75 | 9.1 | -0.8 | -2.4 |

| Commodities | Level | 3M realised volatility | 1W in % | YTD in % |
|---|---|---|---|---|
| Bloomberg Commodity Index | 125 | 31.0 | -0.9 | 25.4 |
| Brent crude oil - USD / barrel | 113 | 76.7 | -1.3 | 43.5 |
| Gold bullion - USD / Troy ounce | 1'934 | 19.6 | -3.2 | 6.6 |

Source: J. Safra Sarasin, Bloomberg as of 17.03.2022

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