Cross-Asset Weekly

11 December 2020

Well calibrated but slightly underwhelming ECB package

Parents know that the best way to ensure a positive surprise and a happy face on their kids' birthdays is to pretend to having forgotten it in the days prior, or at least having lost their whish list. Central banking is not that different. If they talk too often about the great things they are about to do, central bankers raise the expectations of what will come. In the case of monetary policy this serves a purpose. Market prices move in the direction that central banks like to direct them to, even before the actual policy decision is taken and before their full commitment to them. But as on your kid's birthday, you can only eat a cake once. ECB-President Lagarde might have realized this yesterday when financial markets did not really cheer at the broad package of policy measures that the ECB announced, which, in all fairness, is well calibrated and the appropriate response to the meagre outlook for growth and inflation she presented at the same time. Market speculation about the duration of the ECB's expansive policies has already had a positive impact over recent weeks. Euro area yields increased less than US yields since the beginning of November, in response to the news of an effective COVID vaccine. This may also have limited the upward pressure on the euro. It just made it more difficult to produce another positive surprise yesterday.

Still, the message of the ECB is clear: Monetary policy intends to keep yields low, liquidity ample and credit to the corporate sector flowing. This will benefit bonds of the euro area whose spreads to bunds might tighten further. It will also ensure flat yield curves and low real yields – at least for the foreseeable future - and has implications for equities. In our view, the recent rebound in European banks has run its course. The gap to the 10-year Bund yield, a key driver of the sector's relative performance, has closed. Further upside would require yields to rise and yield curves to steepen. The ECB's policy stance aims to achieve exactly the opposite. Sure, inflation expectations may pick up somewhat as oil prices rise, but this will likely be more than offset by slowing macro data when further COVID-related restrictions bite in the coming weeks. We believe that this picture is unlikely to change as long as the second COVID wave shows no signs of abating. If it did, it would be a positive surprise.

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

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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Fixed Income Europe

ECB – a recalibration of existing measures

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

Despite a slightly less ambitious package of easing measures from the ECB than we expected, substantial monetary accommodation will again be provided in 2021. Consequently, core euro area government yields will likely stay at depressed levels with only a moderate rise to be expected in 2021. Peripheral euro area bond markets should be the main beneficiaries from continued ECB buying, with spreads likely to tighten further in 2021.

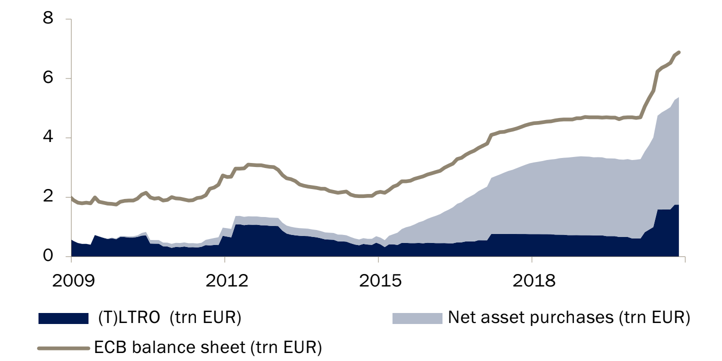
Lots of measures, but PEPP volume of an additional EUR 500bn lower than we expected

The ECB has announced further easing measures at its December meeting. The envelope of the *Pandemic Emergency Purchase Program* (PEPP) will be increased by EUR 500bn to EUR 1.85trn and will be extended until at least March 2022, while the regular APP will continue at EUR 20bn a month. The terms for its third *Targeted Long Term Refinancing Operations* series (TLTRO III) were adjusted, but not materially eased. The ECB also announced that it will add an extra three TLTRO III operations between June and December 2021, four additional *Pandemic Long Term Refinancing Operations* (PLTROs) and maintain easier collateral rules until June 2022. It amounts to a recalibration of existing measures rather than an increase in stimulus, in particular TLTRO III financing rates were not lowered and the 'tiering multiplier' was not touched.

Asset purchases and TLTROs remain the ECB's primary policy tools in 2021

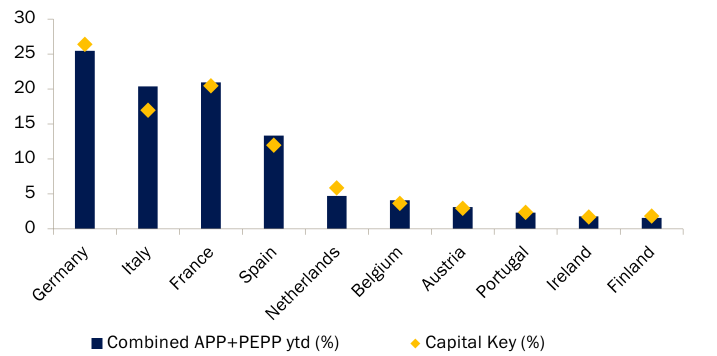
With the extensions of the PEPP by nine months and of the TLTRO III window (for the most favourable applicable rate) by 12 months, the ECB has made it clear that the *Net Asset Purchase Program* (NAPP) and TLTROs continue to be the main policy tools for 2021 and probably beyond Exhibits (1, 2).

Exhibit 1: TLTROs, NAPP main drivers of ECB balance sheet expansion



Source: ECB, Bloomberg, J. Safra Sarasin, 10.12.2020

Exhibit 2: NAPP has so far been geared towards the EA periphery



Source: ECB, National Treasuries, J. Safra Sarasin, 10.12.2020

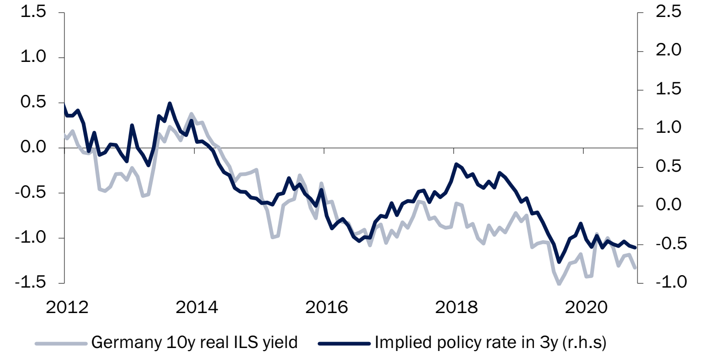
TLTROs are an elegant way to ease policy without cutting the deposit rate

TLTROs are a cheap long-term financing source for euro area financial institutions at below market rates in order to incentivise bank lending to non-financial corporations and households. The interest rate paid for TLTRO III financing is tied to net lending performance, i.e. the new net lending created within a specified time period. The floor currently stands at 50bp below the current ECB deposit rate, which equates to a favourable -1% for institutions that fulfil the (modest) criteria. For the ECB, TLTROs are an elegant and flexible way to ease financing conditions without having to resort to a cut in the deposit rate.

Current ECB policy is all about maintaining favourable financing conditions in the euro area

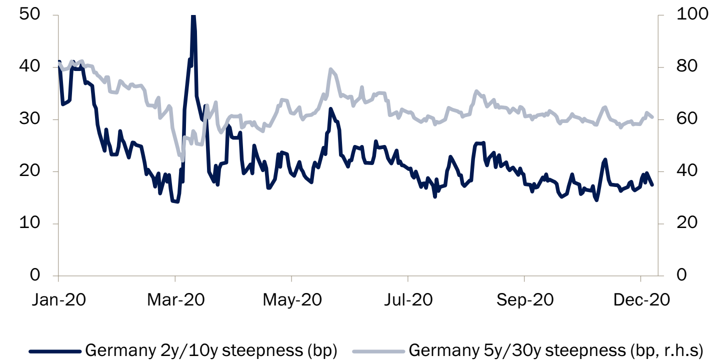
In a recent speech, the ECB's chief economist Philip Lane stressed the need for loose financing conditions, also during the post-pandemic recovery, to ensure that monetary policy is transmitted as effectively as possible to all sectors and jurisdictions within the euro area. He also warned of the dangers of a premature yield curve steepening. Consequently, current ECB measures are calibrated to maintain low long-term euro area government bond yields. While yield curve control is not an ECB policy measure, the extended forward guidance on short-term rates as well as the substantial asset purchases are having a comparable effect of maintaining low long-term core euro area yields and flat yield curves. In fact, unlike their counterparts in the US, Canada or Australia, the euro area yield curves have not steepened over the past few months despite the prospect for an improving economic outlook over the medium term (Exhibits 3, 4).

Exhibit 3: Forward guidance has lowered long term real yields



Source: Bloomberg, J. Safra Sarasin, 10.12.2020

Exhibit 4: Euro area yield curves have flattened in 2020

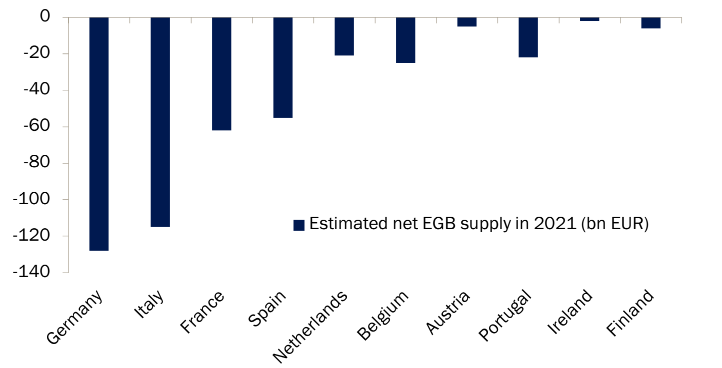


Source: Bloomberg, J. Safra Sarasin, 10.12.2020

The ECB will again remove net EGB supply from the market in 2021

The ECB asset purchase programs have effectively removed net Euro Area Government Bond (EGB) supply in 2020, despite substantially higher issuance volumes. It is reasonable to assume that the rate of asset purchases in 2021 will be similar to this year's rate. The PEPP also gives enough flexibility to deviate from the capital keys if necessary. Consequently, the ECB is set to purchase all of net EGB issuance in 2021 once again (Exhibit 5). This will keep core euro area yields low and support peripheral markets. In fact, Portugal is the first peripheral market where 10Y yields have dropped below 0% (Exhibit 6).

Exhibit 5: Net negative EGB supply after ECB purchases



Source ECB, National Treasuries, J. Safra Sarasin, 10.12.2020

Exhibit 6: Portuguese 10-year bond yields have dropped below 0%

Source: Bloomberg, J. Safra Sarasin, 10.12.2020

Core euro area bond yields to remain depressed, peripheral spreads to tighten further

The continued monetary accommodation should ensure that core euro area real yields stay at depressed levels. Yields will likely rise only moderately as yield curves will struggle to steepen meaningfully. The euro area periphery will be the main beneficiary. With strong ECB support investors will be more inclined to chase the last bit of carry available in the government bonds markets such that peripheral spreads will likely tighten further in 2021.

European equities

Upside for banks limited from here

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

In our view, the recent rebound in European banks has run its course. The gap to the 10-year Bund yield, a key driver of the sector's relative performance, has closed. Further upside would require yields to rise and yield curves to steepen. As mentioned in the fixed income section above, the ECB's policy stance aims to achieve the exact opposite - flat yield curves and persistently low real yields. Inflation expectations may pick up somewhat as oil prices rise, but this will likely be more than offset by slowing macro data. This picture is unlikely to change as long as the second COVID wave shows no signs of abating.

European banks have rebounded strongly on solid Q3 earnings and vaccine news

European banks' relative performance troughed at the end of September, before rebounding by almost 30%. The move was driven by a combination of solid Q3 earnings and the hope for an improving macro backdrop in 2021, as news about an effective COVID vaccine broke. This allowed the sector to rebound from the depressed levels it had reached after underperforming by almost 40% since the beginning of the year.

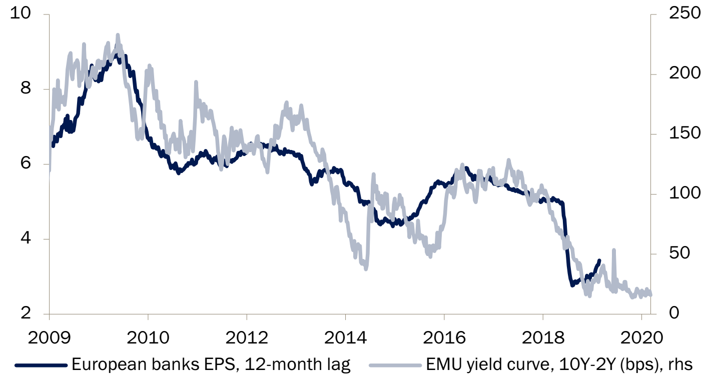
Although European banks continue to look attractive on some metrics, the ECB's policy stance makes it difficult to see further upside

At current levels, banks may still look attractive as (a) they continue to trade significantly below book value, at 0.6x 12-month forward book (Exhibit 1) and (b) prices remain around 20% below the levels at the beginning of the year (relative and absolute). However, in our view, the short-term upside is limited from here and the catch-up potential is exhausted after the recent move higher. Valuations are only looking cheap compared to historical levels, but not relative to profitability (Exhibit 1). The return on equity remains low and is unlikely to pick up as long as yield curves stay as flat as they are right now. As mentioned in this week's fixed income section (see chapter above), the ECB's current policy aims to keep the long end of the yield curve at low levels, which limits the potential for the euro area yield curve to steepen meaningfully. As a result, the potential for banks' earnings to rise is limited as well, keeping their profitability in check (Exhibit 2).

Exhibit 1: Price-book ratio has moved in line with profitability

Source: Refinitiv, J. Safra Sarasin, 10.12.2020

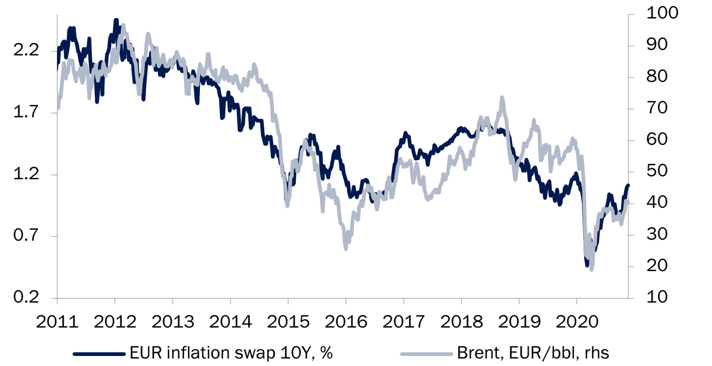
Exhibit 2: Bank earnings are suffering from a flattening yield curve



Source: Refinitiv, J. Safra Sarasin, 10.12.2020

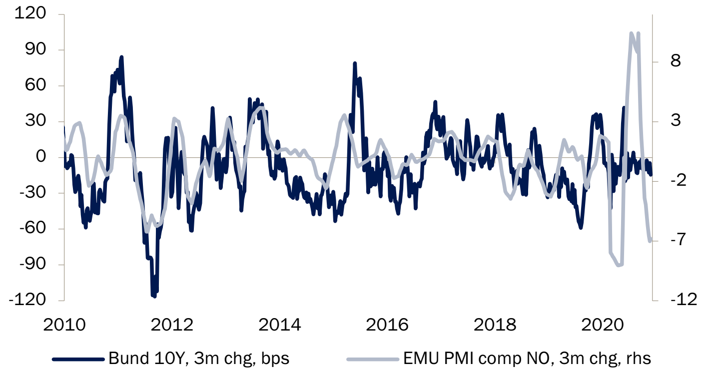
Another implication of the ECB's policy stance are persistently low real yields in the euro area. It is unlikely to move far above current levels until the second COVID wave has passed. As a result, banks would require inflation expectations to move substantially higher in order to gain from rising 10-year nominal yields. While a higher oil price, which is being supported by a weaker USD and the expectation for a vaccine-driven demand recovery, may provide limited tailwinds to inflation expectations, this will likely be more than offset by headwinds from the emerging weakness in the economic data.

Exhibit 3: Higher oil price may lift inflation expectations somewhat…



Source: Refinitiv, J. Safra Sarasin, 10.12.2020

Exhibit 4:…but will likely be more than offset by weakening macro data

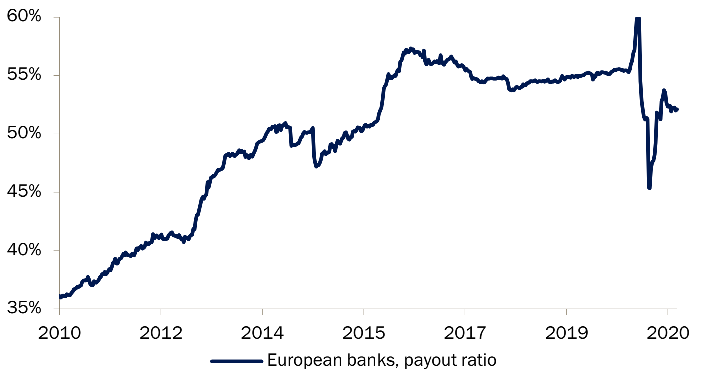


Source: Refinitiv, J. Safra Sarasin, 10.12.2020

Lastly, European regulators remain adamant that banks need to protect their capital via the suspension of dividends into 2021 (Exhibit 5). While some institutions may be allowed to distribute earnings again soon, the sector as whole will likely not see a full resumption of dividend payments until (a) the second wave has passed and (b) its impact on default rates and loan provisioning can be assessed fully.

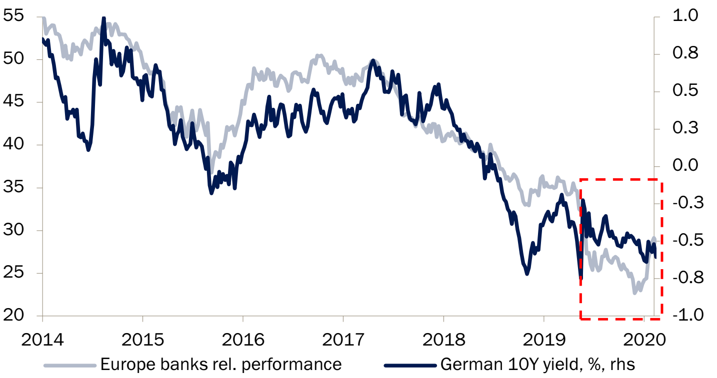
Bottom-line, we believe the rebound potential for European banks is exhausted, as they have fully closed the gap to 10-year yields (Exhibit 6). Further upside would require yields to move higher and curves to steepen, which is unlikely until the ECB steps back from its current easing bias. A policy change seems unlikely to happen before the end of the second COVID wave is in sight.

Exhibit 5: European banks' pay-out ratio has suffered



Source: Refinitiv, J. Safra Sarasin, 10.12.2020

Exhibit 6: Banks' outperformance requires higher yields



Source: Refinitiv, J. Safra Sarasin, 10.12.2020

CARBON NEUTRAL 2035 CLIMATE PLEDGE

Economic Calendar

Week of 14/12 – 18/12/2020

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 14.12.2020						
JN	00:50	Tankan Large Non-Mfg Index	4Q	Index	-7.00	-12.00
EU	11:00	EU Industrial Production SA MoM	Oct	mom	1.80%	-0.40%
Tuesday, 15.12.2020						
FR	08:45	CPI EU Harmonized MoM	Nov	mom	--	0.20%
	08:45	CPI EU Harmonized YoY	Nov	yoy	--	0.20%
IT	10:00	CPI EU Harmonized YoY	Nov	yoy	--	-0.30%
US	15:15	Capacity Utilisation	Nov	%	73.00%	72.80%
Wednesday, 16.12.2020						
JN	01:30	Jibun Bank Japan PMI Mfg	Dec	Index	--	49.00
	01:30	Jibun Bank Japan PMI Services	Dec	Index	--	47.80
FR	09:15	Markit France Manuf. PMI	Dec	Index	--	49.60
	09:15	Markit France Services PMI	Dec	Index	--	38.80
GE	09:30	Markit Germany Manuf. PMI	Dec	Index	56.00	57.80
	09:30	Markit Germany Services PMI	Dec	Index	44.00	46.00
UK	10:30	Markit/CIPS PMI Manuf. PMI	Dec	Index	55.50	55.60
US	15:45	Markit US Manufacturing PMI	Dec P	Index	56.00	56.70
	15:45	Markit US Services PMI	Dec P	Index	56.50	58.40
Thursday, 17.12.2020						
FR	08:45	Business Confidence	Dec	Index	--	79.00
	08:45	Manufacturing Confidence	Dec	Index	--	92.00
EU	11:00	CPI Core YoY	Nov F	yoy	0.20%	0.20%
UK	13:00	Bank of England Bank Rate	Dec17	%	0.10%	0.10%
US	14:30	Philadelphia Fed Bus. Outlook	Dec	Index	20.00	26.30
	14:30	Initial Jobless Claims	Dec12	1'000	--	853k
Friday, 18.12.2020						
JN	08:00	BOJ Policy Balance Rate	Dec18	%	--	-0.10%
	08:00	BOJ 10-Yr Yield Target	Dec18	%	--	0.00%
UK	08:00	Retail Sales ex Auto Fuel MoM	Nov	mom	--	1.30%
	08:00	Retail Sales ex Auto Fuel YoY	Nov	yoy	--	7.80%
GE	10:00	IFO Business Climate	Dec	Index	89.00	90.70
	10:00	IFO Business Expectations	Dec	Index	93.00	91.50
US	16:00	Leading Index	Nov	mom	0.40%	0.70%

Source: Bloomberg, J. Safra Sarasin as of 11.12.2020

Cross-Asset Weekly

11 December 2020

CARBON NEUTRAL 2035 CLIMATE PLEDGE

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenossen 10 year (%)	-0.58	-6	-11	0.7
German Bund 10 year (%)	-0.62	-7	-44	3.0
UK Gilt 10 year (%)	0.17	-18	-69	5.2
US Treasury 10 year (%)	0.89	-7	-98	9.9
French OAT - Bund, spread (bp)	25	1	-6	
Italian BTP - Bund, spread (bp)	116	-2	-44	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	10’382	19.9	0.5	1.3
DAX - Germany	13’239	19.4	0.3	0.4
MSCI Italy	706	23.3	0.6	-9.3
IBEX - Spain	8’091	34.9	-0.2	-12.0
DJ Euro Stoxx 50 - Eurozone	3’506	22.7	0.2	-3.4
MSCI UK	1’856	21.6	1.8	-11.1
S&P 500 - USA	3’668	26.0	0.1	15.5
Nasdaq 100 - USA	12’402	32.1	-0.5	43.2
MSCI Emerging Markets	1’255	19.5	1.3	15.1

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.89	6.7	-0.6	-8.5
EUR-CHF	1.08	4.5	-0.5	-0.9
GBP-CHF	1.17	9.9	-2.1	-7.7
EUR-USD	1.21	6.8	0.0	8.3
GBP-USD	1.32	10.9	-1.6	0.9
USD-JPY	104.1	6.4	-0.1	-4.4
EUR-GBP	0.92	9.7	1.6	7.3
EUR-SEK	10.26	6.3	0.1	-2.0
EUR-NOK	10.67	8.9	0.0	8.1

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	75	9.1	0.2	-8.3
Brent crude oil - USD / barrel	50	34.1	3.5	-25.1
Gold bullion - USD / Troy ounce	1’833	21.4	-0.5	21.0

Source: J. Safra Sarasin, Bloomberg as of 11.12.2020

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Bank J. Safra Sarasin Ltd
Alfred-Escher-Strasse 50
P.O. Box
CH-8022 Zürich
T: +41 (0)58 317 33 33
F: +41 (0)58 317 33 00
www.jsafrasarasin.com