J. SAFRA SARASIN
ASSET MANAGEMENT

Cross-Asset Weekly

08 February 2019

Europe Down but 'Patient' Fed to Support Risk Assets

European financial markets were rattled on Thursday after the EU slashed its forecast for euro area GDP growth in 2019, but at 1.3% we believe that its projections are still optimistic. With little evidence of inflationary pressures within the currency union, we have now pushed back our forecast for a first interest rate hike by the ECB into 2020. By contrast, we have left most of our other macroeconomic forecasts unchanged, and continue to believe that solid growth in the US will ensure that the Fed raises rates again later this year as signs of improvement in China boost the global outlook.

For the time being, though, the Fed will remain "patient". In this environment we expect bond yields to remain low, while the Fed's U-turn has opened up a window of opportunity for risky assets. We have nudged up our year-end target for equity markets in Switzerland. Meanwhile, after being underweight last year, we are now more constructive on the near-term outlook for Emerging Market (EM) fixed income, particularly local currency government bonds.

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Global Macro and Equity Forecasts Update

Europe Down but 'Patient' Fed to Support Risk Assets

We have revised down slightly our growth and inflation forecasts for 2019, but our view on the global economy remains relatively unchanged. Growth should weaken in the first half of the year but pick up somewhat after, partly reflecting looser fiscal and monetary policy in China. The Fed's 'patience' should keep bond yields low and provide a tailwind for risk assets in the near term.

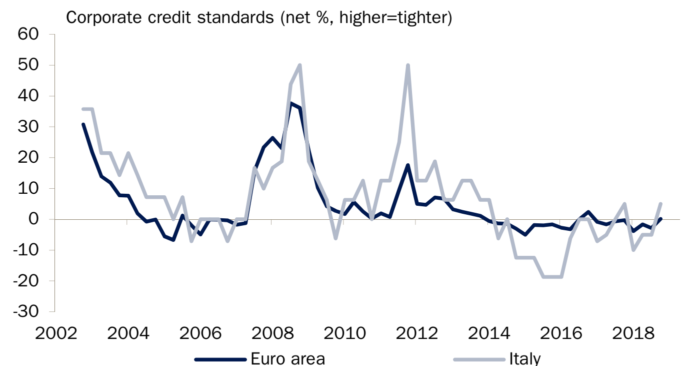
We have revised down our growth forecasts for the euro area and the UK

We have lowered our euro area growth forecast for 2019 to 1%, down from 1.3%. Sentiment surveys have continued to deteriorate, indicating that growth in 1Q will be weaker than we previously expected. The slowdown in China should continue to depress exports and also capital spending within the euro area (Exhibit 1). In addition, exports to the UK should are expected to shrink further as uncertainties over Brexit are likely to persist in the near term, hurting UK investment spending. Social tensions in France – and the impact it has had on business and consumer confidence – and tighter credit standards in Italy are likely to weigh on domestic demand too (Exhibit 2).

Exhibit 1: Euro area exports to China are likely to shrink

Source: J. Safra Sarasin, 07.02.2019

Exhibit 2: Lending standards to Italian corporates have tightened



Source: J. Safra Sarasin, 07.02.2019

Higher euro area wages have yet to translate into higher core inflation

Wage growth in the euro area has continued to pick up and is back to rates last seen prior to the financial crisis. But this has not yet translated into higher core inflation. With other input prices weakening and uncertainty about the economy remaining high, businesses are not yet pricing through the increase in wages. We therefore expect core inflation to remain close to 1% in the near term. Yet there should be some upward movement in the latter part of the year as the global economy improves. Asian demand should rebound somewhat as looser Chinese fiscal and monetary policy support the economy. An extension of the US-China trade truce beyond the end of February, as we expect, should help European exporters too. Finally, we still think that the only deal that could command a majority in the UK parliament is one that maintains the country in a much closer relationship with the EU than is currently envisaged.

The ECB should remain on hold this year, keeping bond yields low

As a result, the ECB should keep interest rates on hold in 2019, but start to flag towards the end of the year its intention to raise rates in 2020. We expect the ECB to increase its deposit rate in the first quarter (which currently stands at -0.4), but increase the refinancing rate (traditionally its main policy rate) only in the second half of 2020. This also implies that core bond yields in Europe will stay low in the next few quarters. We expect to see a more sustained rise in yields once there are more tangible signs of an increase in short term rates.

US Core inflation should move gradually higher

We have kept our 2019 growth forecast for the US economy unchanged at 2.5%. We have nudged down our inflation forecasts to reflect the impact of lower energy prices. But the bigger picture is that we continue to anticipate core inflation to rise over the next 18 months, as higher wages and relatively strong consumer demand should allow corporates to pass on some of the increases in labour costs to consumers.

Our scenario suggests that fixed income markets will have to re-price some Fed hikes later this year

We think the Fed will remain "patient" in the near term, but will hike rates twice in the second half of the year as the global economy strengthens somewhat. In the near term, a combination of the Fed's U-turn stance and weak incoming global data will probably see yields at the front end of the Treasuries curve try to invert below the Fed Funds target rate if markets believe that the tightening cycle has already peaked. However, our view that the Fed will begin to raise rates again in the second half of this year means that the front end of the curve will have to re-price at some point in the middle of this year. Even so, given that we are at a late stage in the rate cycle, we do not expect US bond yields to rise substantially from current levels.

Exhibit 3: JSS growth and inflation forecasts (% yoy)

		2018	2019	2020
US	GDP	2.9	2.5	1.6
	CPI	2.4	1.8	2.6
Euroland	GDP	1.8	1.0	1.6
	CPI	1.7	1.3	1.7
Switzerland	GDP	2.5	0.7	1.6
	CPI	0.9	0.7	1.0
UK	GDP	1.4	1.2	1.5
	CPI	2.5	1.9	2.2
Japan	GDP	0.7	0.5	0.6
	CPI	1.0	0.4	1.0
China	GDP	6.6	6.3	6.5
	CPI	1.9	2.1	2.4

Source: J. Safra Sarasin, 07.02.2019

Exhibit 4: JSS policy rates forecasts

Key Policy Rates

	06-Feb-19	Jun-19	Dec-19	Jun-20	Dec-20
US Fed Funds	2.50	2.50	3.00	3.25	3.00
EUR depo rate	-0.40	-0.40	-0.40	-0.20	0.00
CH 3m LIBOR target	-0.75	-0.75	-0.75	-0.75	-0.50
BoE base rate	0.75	0.75	1.00	1.25	1.25
JP O/N call rate	-0.06	-0.10	-0.10	0.00	0.00

Source: J. Safra Sarasin, 07.02.2019

Exhibit 5: JSS interest rates forecasts

Bond Yields (10yr benchmark)

	06-Feb-19	Jun-19	Dec-19	Jun-20	Dec-20
USA	2.70	2.90	3.10	3.00	2.60
Germany	0.17	0.35	0.60	0.65	0.65
Switzerland	-0.21	-0.05	0.25	0.30	0.30
UK	1.22	1.65	1.80	1.85	1.95
Japan	-0.01	0.15	0.15	0.20	0.20

Source: J. Safra Sarasin, 07.02.2019

Expected earnings growth rates for 2019 has substantially declined

Equity markets have rebounded from the December selloff, on the back of the Fed's clearly accommodative stance. We assume that equity markets have already largely priced in a mid-cycle slowdown. We see tentative signs of bottoming in manufacturing PMIs in the US, France and Italy, yet acknowledge that economic newsflow for China, most of Asia and Germany is likely to remain weak during 1H19. The 4Q 2018 correction in equity markets triggered a substantial downgrade of expected earnings growth rates for 2019 (Exhibit 6). We witnessed more specifically a sharp decline in projected earnings growth for US and EM equities, while those for Swiss equities held their ground. To some extent, this negative shift in expectations and sentiment ushered in more realistic earnings forecasts, which contrarians would welcome as a positive sign.

We expect earnings growth to exceed consensus in the US and UK in 2019

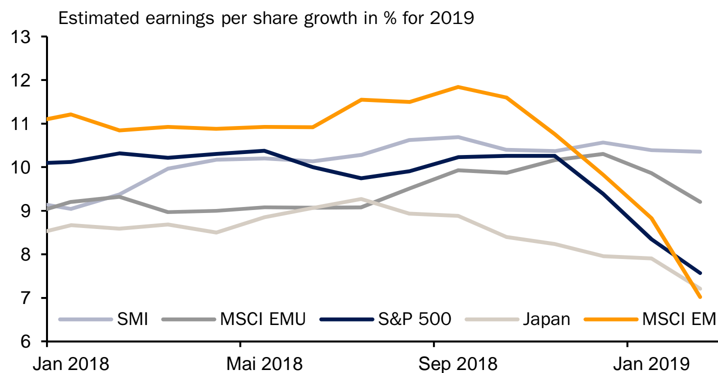
We compare in Exhibit 7 our own growth projections with consensus earnings growth expectations for 2019. Our macro models warrant earnings growth rates above consensus for US and UK equities in 2019. Our quantitative work also supports an upbeat

view on the earnings of Swiss companies in 2019, which should expand about 8%. Our macro models tend to disagree most with consensus views when it comes to anticipated earnings growth for euro-area and Japanese companies. We forecast fairly pedestrian earnings growth rates to the tune of 3-4% for those regions. We stay slightly below consensus for EM equities, expecting their earnings growth to reach close to 5% in 2019, yet still anticipate a turnaround there once Chinese growth bottoms in 2H19.

We turn more positive on the Swiss SMI with a new target at 9'000 points

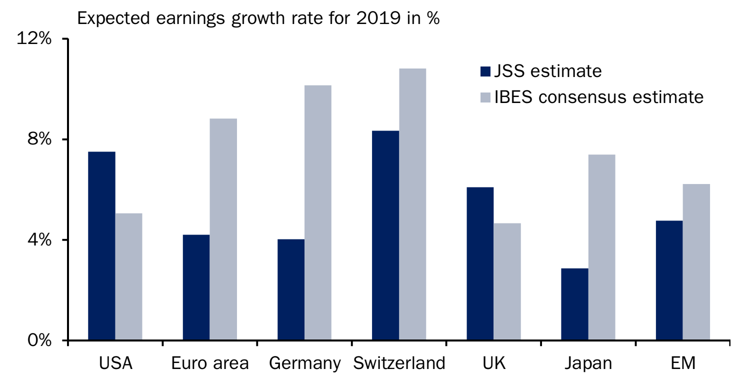
We only tweaked our end-2019 stock index price targets. The Fed's dovish stance for 1H 2019 creates a window of opportunity for equities, and most stock market indices will probably exceed them by late 2Q 2019. As global growth bottoms during 1H 2019, the Fed is then expected to tighten rates twice in 2H19, which would drain liquidity and boost risk aversion again. We thus left our year-end targets for the S&P 500 and Nasdaq 100 unchanged at 2'700 and 7'000. We leave our year-end target for the Euro Stoxx 50 at 3'000, as a weak macro backdrop does not entirely warrant current valuations. Recent earnings trends warrant more optimism for Swiss equities and we raised our target for the SMI index from 8'700 to 9'000 points and for the mid-cap index SMI from 2'300 to 2'500. We also raise our year-end target for the Nikkei 225 from 20'000 to 21'000. We leave our target for the MSCI Emerging Markets index unchanged at 1'100. Finally, as our new economic scenario significantly reduces the likelihood of an economic slowdown in 2020, we forecast modest gains for all markets.

Exhibit 6: Equity analysts have significantly lowered their 2019 earnings growth estimates for US and EM equities



Source: Datastream, J. Safra Sarasin, 05.02.2019

Exhibit 7: We expect brisker earnings growth in the US than consensus in 2019, yet are more prudent on the euro area and Japan



Source: Datastream, J. Safra Sarasin, 05.02.2019

Exhibit 8: Stock index price targets for major regional equity markets

USA	06.02.2019	P/E ratio	Dec 19	Dec 20
S&P 500	2'732	15.9	2'700	2'800
Nasdaq 100	6'998	16.5	7'000	7'200
Europe				
MSCI UK	2'072	11.9	2'100	2'200
DJ Euro Stoxx 50	3'213	13.0	3'000	3'100
DAX	11'325	12.5	11'000	11'500
SMI	9'143	15.6	9'000	9'300
SPI	10'695	16.7	10'500	11'000
SMIM (Mid-Caps)	2'342	14.3	2'500	2'600
Japan				
Nikkei 225	20'874	12.1	21'000	22'000
Emerging Markets				
MSCI EM	1'048	11.9	1'100	1'200

Source: J. Safra Sarasin, 06.02.2019

Emerging Markets

Window of opportunity for EM fixed income

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After being underweight for most of last year, we believe that the "Powell Put" has opened a window of opportunity for Emerging Market (EM) fixed income in the first half of 2019. Valuations suggest that aggressive spread compression in the hard currency space is unlikely, but the decent carry on offer should support solid returns. We are most optimistic on local currency government bonds, where real interest rates are high and currencies are not overvalued.

The "Powell Put" has changed the short-term outlook for EM

Ever since Fed Chair Powell made it clear that US interest rates will not rise in the near future, and that balance sheet reduction is no longer on autopilot, investors have flooded back into EM fixed income. As a result, benchmark indices have rebounded strongly, erasing the losses that were racked up last year.

Hard currency bonds can deliver solid returns even if spreads do not tighten

In the hard currency space, we do not anticipate an aggressive tightening of spreads. After all, spreads never reached particularly compelling levels during the sell-off last year and are already back below long-run averages. Nonetheless, even if spreads are unchanged, the decent carry on offer – particularly in the high yield space – would be sufficient to deliver solid total returns. From a top-down perspective, we prefer sovereign bonds, since they tend to offer higher spreads, valuations are less stretched and the most vulnerable governments already have some form of external financial support.

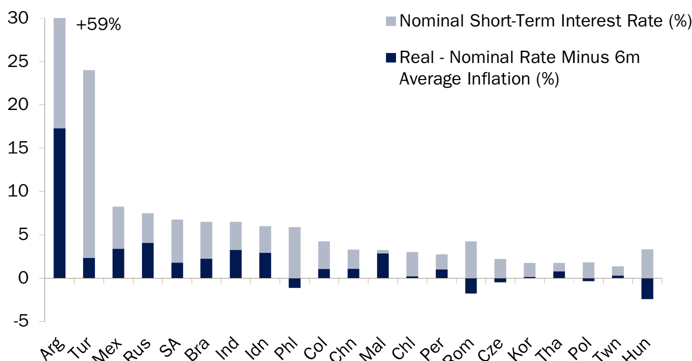
Local currency bonds may outperform as currencies also get a lift

We are most optimistic on local currency bonds, for two reasons. First, the turbulent period last year has left a legacy of high real interest rates in many major EMs. Second, EM currencies are not generally overvalued. Since the Fed's U-turn, currencies and bonds in those EMs that offer high real interest rates have rallied strongly, and many have room to post further gains (See Exhibits 1&2, and our Cross Asset Weekly, "*The strengths and weaknesses of EM currencies*", 25th January).

Not going overboard

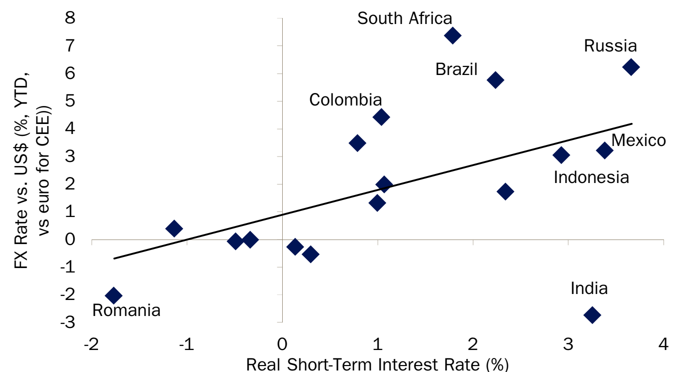
However, we are not going overboard. Even if it is partially priced in, the further slowdown that we expect in China's economy in the first half of this year still has the potential to unsettle investors. But perhaps more importantly, the fact that the window of opportunity for EM has been opened by the Fed means that those same policymakers have the ability to close it again. Our view remains that the Fed will resume its tightening cycle later this year, and so EM fixed income could eventually come under pressure again if markets start to anticipate higher US interest rates.

Exhibit 1: Many major EMs offer attractive carry in local currency



Source: Datastream, J. Safra Sarasin, 07.02.2019

Exhibit 2: High carry EM currencies have outperformed



Source: Datastream, J. Safra Sarasin, 07.02.2019

Cross-Asset Weekly

08 February 2019

Economic Calendar

Week of 11/02 – 15/02/2019

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 11.02.2019						
CH	08:30	CPI	Jan	yoy	+0.6%	+0.7%
UK	10:30	GDP, prel.	4Q18	yoy	-	+1.5%
	10:30	Total Business Investment, prel.	4Q18	yoy	-	-1.8%
	10:30	Industrial Production	Dec	yoy	-	-1.5%
US	00:00	Nonfarm Productivity, prel.	4Q18	qoq	+1.6%	+2.3%
	00:00	Unit Labor Costs, prel.	4Q18	qoq	+1.7%	+0.9%
Tuesday, 12.02.2019						
JP	05:30	Tertiary Industry Index	Dec	mom	0.0%	-0.3%
	07:00	Machine Tool Orders, prel.	Jan	yoy	-	-18.3%
Wednesday, 13.02.2019						
EMU	11:00	Industrial Production	Dec	mom	-	-1.7%
	11:00	Industrial Production	Dec	yoy	-	-3.3%
DE	00:00	Wholesale Price Index	Jan	yoy	-	+2.5%
UK	10:30	CPI	Jan	yoy	-	+2.1%
	10:30	PPI Input	Jan	yoy	-	+3.7%
	10:30	PPI Output	Jan	yoy	-	+2.5%
US	14:30	CPI	Jan	yoy	+1.5%	+1.9%
	14:30	CPI ex Food & Energy	Jan	yoy	+2.1%	+2.2%
	14:30	Avg. Weekly Earnings	Jan	yoy	-	+1.2%
Thursday, 14.02.2019						
EMU	11:00	Employment, prel.	4Q18	qoq	-	+0.2%
DE	08:00	GDP wda, prel.	4Q18	yoy	-	+1.1%
US	14:30	PPI Final Demand	Jan	yoy	+2.3%	+2.5%
	14:30	PPI ex Food & Energy	Jan	yoy	-	+2.7%
	14:30	Initial Jobless Claims	Feb 9	1 000	-	-
	14:30	Continuing Claims	Feb 2	1 000	-	-
Friday, 15.02.2019						
JP	05:30	Capacity Utilization	Dec	mom	-	+1.0%
CN	02:30	PPI	Jan	yoy	-	+0.9%
US	15:15	Capacity Utilization	Jan	index	78.8%	78.7%
	15:15	Manufacturing Production	Jan	mom	+0.2%	+1.1%
	16:00	U. of Mich. Expectations, prel.	Feb	index	-	79.9

Source: Bloomberg, J. Safra Sarasin

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	-0.27	-3	-2	0.6
German Bund 10 year (%)	0.11	-6	-13	1.3
UK Gilt 10 year (%)	1.18	-7	-10	0.9
US Treasury 10 year (%)	2.65	-3	-3	0.3
French OAT - Bund, spread (bp)	44	3	-3	
Italian BTP - Bund, spread (bp)	285	26	35	

	Spread over govt bonds	Change in credit spread		Credit index
Credit Markets (bp)		Δ 1W	Δ YTD	TR YTD in %
US Investment grade corp. bonds	68	2	-19	2.6
EU Investment grade corp. bonds	73	3	-14	2.1
US High yield bonds	363	6	-86	4.5
EU High yield bonds	319	10	-34	2.7

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	9'036	14.7	0.7	7.2
DAX - Germany	11'022	11.9	-1.4	4.4
MSCI Italy	661	9.6	-1.4	6.3
IBEX - Spain	8'938	11.4	-1.3	5.2
DJ Euro Stoxx 50 - Eurozone	3'151	12.5	-0.3	5.3
MSCI UK	2'050	12.4	1.8	5.5
S&P 500 - USA	2'706	16.1	0.1	8.1
Nasdaq 100 - USA	6'905	19.0	0.0	9.2
Nikkei 225 - Japan	20'333	14.8	-0.1	3.7
MSCI Emerging Markets	1'042	12.0	-0.8	7.9

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	1.00	6.1	0.6	2.0
EUR-CHF	1.14	4.7	-0.4	0.9
GBP-CHF	1.30	11.0	-0.4	3.6
EUR-USD	1.13	6.5	-1.0	-1.1
GBP-USD	1.30	11.7	-1.0	1.5
USD-JPY	109.8	7.0	0.2	0.1
EUR-GBP	0.88	10.7	0.0	-2.6
EUR-SEK	10.50	5.6	1.3	3.4
EUR-NOK	9.74	5.8	0.8	-1.7

Commodities	Level	3M realised volatility	1W in %	YTD in %
BBG Commodity Index	80	11.8	-1.3	4.1
Brent crude oil - USD / barrel	61	28.4	-2.4	14.8
Gold bullion - USD / Troy ounce	1'308	8.5	-0.7	2.0

Source: J. Safra Sarasin, Bloomberg

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