



J. Safra Sarasin Cross-Asset Weekly

05 April 2024

China's manufacturing push pays off for now

China's doubling down on its investment in strategic manufacturing sectors paid off last year. Investment growth was led by the renewables power sector and its related products, including "new energy vehicles". However, investment growth in related manufacturing capacity should slow this year as overcapacity is rampant. Together with our expectation that the correction in the housing sector will continue this year, growth in total fixed asset investment should be lower than last year's. Due to already existing overcapacities, China is trying to boost exports even more. China's export market share expansion, including in renewables-related products, could lift growth close to the government's target, but comes with rising risks of trade restrictions down the road.

Over in the US, we note that the destocking phase that weighed on the manufacturing ISM for most of last year appears to have come to an end. Our new model suggests that the ISM should gain momentum over the coming months, driven by stronger expected demand, the big upswing in semiconductor sales over the past six months and a lesser drag from the dollar.

The UK equity market has trailed the global equity rebound by around 15% since November. Yet in our view, the tide is turning for UK equities. The recovery in tech-driven strategies and styles feels exhausted, while the ongoing global manufacturing rebound provides support to commodity sectors and value strategies. The UK equity market should tactically benefit from a more favourable FX backdrop and reversing sector dynamics. Strategically, however, the lack of growth and tech exposure limits the long-term return potential.

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China macro

Manufacturing investment drives growth

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China's doubling down on its investment in strategic sectors paid off handsomely last year in terms of their contribution to GDP growth. Investment was led by the renewables power sector and its related products, including new energy vehicles. Investment in other manufacturing industries also played an important role. While China continues to prioritise expanding its installed electricity capacity, investment growth in related manufacturing capacity should slow this year as overcapacity is rampant. Together with our expectation that the correction in the housing sector will continue this year, growth in total fixed asset investment should be slower than last year's. To use the already-built capacity, China has turned to exporting these goods. China's export market share expansion, including in renewables-related products, could lift growth close to the government's target, but comes with increasing risks of trade restrictions further down the road.

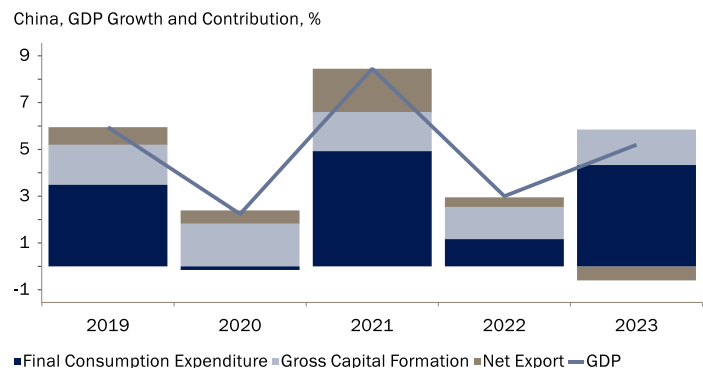
China's 2024 growth path will likely be somewhat different from last year's investment-driven growth

The main question for the Chinese economy this year is whether it will be able to repeat last year's "around 5%" growth as it maintains the macro strategy of letting the real estate sector adjust while doubling down on strategic manufacturing sectors. In this article, we look at the drivers of China's growth last year, and assess whether the manufacturing investment-driven growth will be repeated this year.

Last year, China's total investment grew despite the deep housing downturn

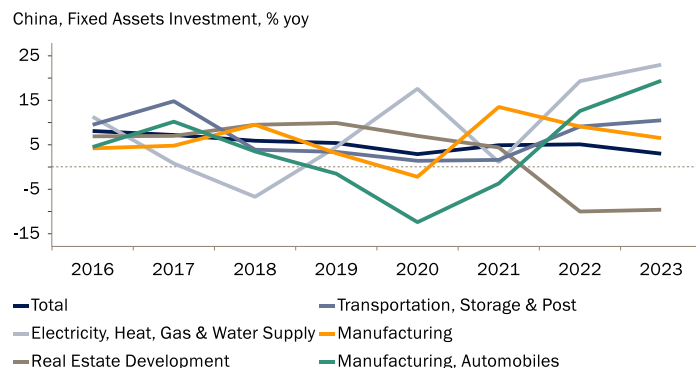
Usually, when a country goes through a housing bust after a significant boom, GDP growth suffers for a number of years as construction stops and the wind-down process takes a toll on the economy. It may be puzzling how China managed to grow at 5.2% last year even though its housing sector went through a significant correction (Exhibit 1). From the consumption side, it is clear that the low base of 2022 due to COVID lockdowns led to a strong recovery in private consumption in 2023. But how did investment grow when housing investment, which accounted for about 20% of total fixed asset investment (FAI) in 2022, fell by 10%? In fact, total fixed asset investment grew by 3% last year (Exhibit 2). The answer lies in China's acceleration of investment in manufacturing and infrastructure.

Exhibit 1: 2023 growth was driven by consumption and investment



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 2: Manufacturing and green energy were leading sectors



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

The investment drivers were mostly in the renewables and manufacturing space

The sectors that drove total investment were renewables and manufacturing. Investment in electricity, heat, gas and water supply (7% of total FAI in 2022) jumped 23% while that of transport and storage (13% of total FAI) grew by 11%. Within manufacturing, which is about 45% of total FAI, the highest growth rates were seen in electrical machinery and



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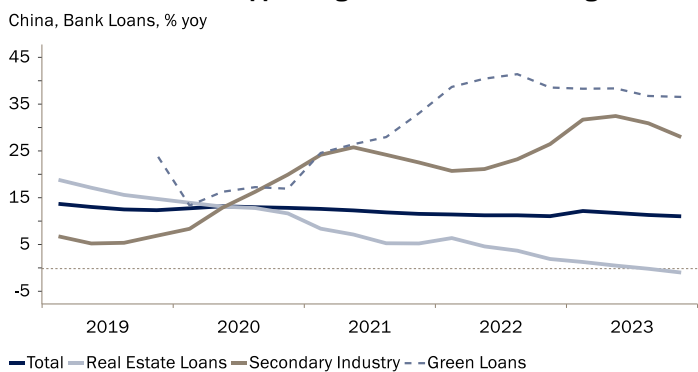
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equipment (4% of total FAI), which grew by 32%, and automobiles (2% of total FAI), which increased by 19%. Electrical machinery and equipment include power equipment for renewables. Other manufacturing sectors with a higher than 10% FAI growth include chemicals, foods, non-ferrous smelting and special purpose machinery (together accounting for 10% of total FAI). FAI in telecommunication equipment and computers also grew by 9%. The growth areas reflect the government's strategic direction of energy security and self-reliance on science and technology. The investments in these sectors have been supported by bank credit, which also rose significantly last year (Exhibit 3).

Investment in renewables has skyrocketed

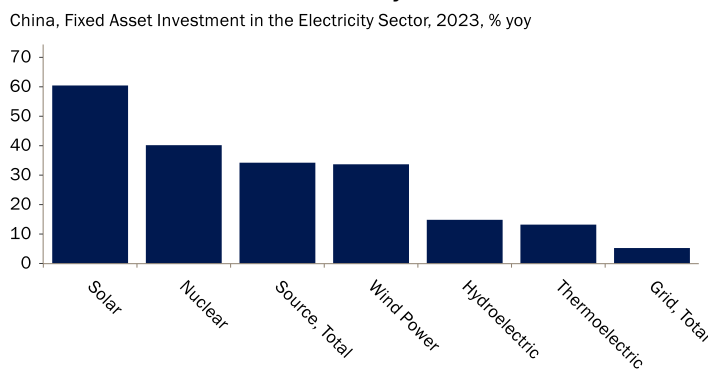
Investment in renewable electricity production capacity skyrocketed last year across all types of renewables. Solar power led with 60% and wind power contributed more than 30% (Exhibit 4). As a result, total capacity increased by 14%, and the share of thermal power installed capacity dropped below 50% for the first time (Exhibits 5 and 6). Still, the actual generation continues to be dominated by thermal power (69%, Exhibits 7 and 8). The stark difference between installed capacity and actual generation reflects: (i) the lack of distribution capacity to bring renewable electricity supply on to the grid, and (ii) the lagging capacity of electricity storage. Notably, electricity grid investment was outpaced by the capacity increase by a large margin. Significant wind and solar capacities have been built in the west of the country, but most of the demand is on the east coast. Even though the State Grid has been building Ultra High Voltage transmission lines to connect supply and demand, the bottlenecks remain. As a result, actual renewable electricity generation remains much lower than its installed capacity.

Exhibit 3: Bank loans supported green and manufacturing investment



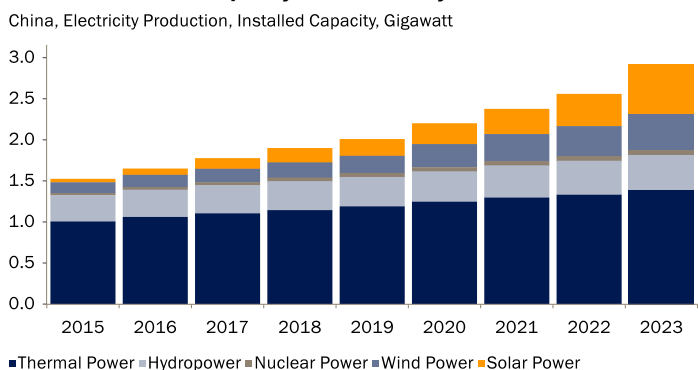
Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 4: Investment in the electricity sector soared



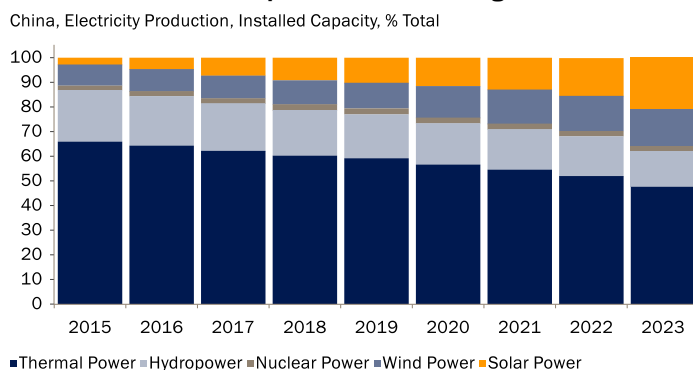
Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 5: Installed capacity rose markedly...



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 6: ...with thermal power now accounting for less than half



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024



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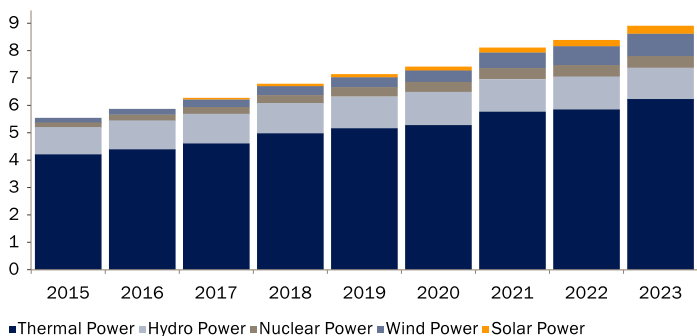
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Capacity installation for renewables was supported by manufacturing investment

China's ability to accelerate its investment in renewables hinges on its full-fledged supply chains of products and equipment such as photovoltaic (solar PV) and wind turbines. It is well-known that China dominates the world's solar cells production with its share at all manufacturing stages exceeding 80% of global supply. China also leads the world in wind turbine manufacturing capacity with 60%. Investment in renewables equipment drove FAI in electrical machinery and equipment to increase by 32% in 2023. The International Energy Agency estimates that China's share in solar PV production will reach 95% by 2025. Indeed, industrial production of solar PV rose 58% last year, supporting the installation of solar power electricity capacity (Exhibit 9). With lower domestic demand than total supply of PV, Chinese manufacturers found markets abroad, and export volumes grew in double digits (Exhibit 10). Overcapacity and competition among producers led to lower prices and the export value (in US dollar) fell.

Exhibit 7: Much lower electricity generation from renewables than installed capacity suggests

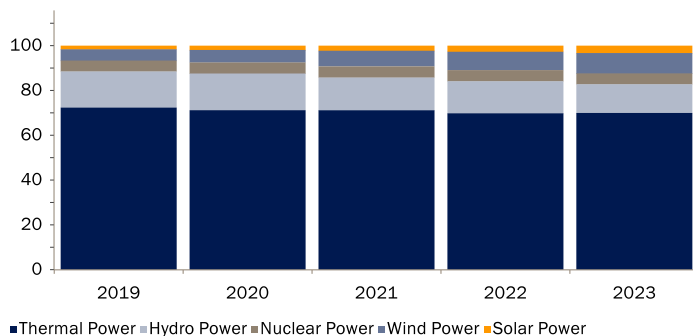
China, Electricity Generation, KWH Trillion



Source: Macrobond, Bank J. Safra Sarasin, 19.03.2024

Exhibit 8: This means thermal power is still 70% of total generation

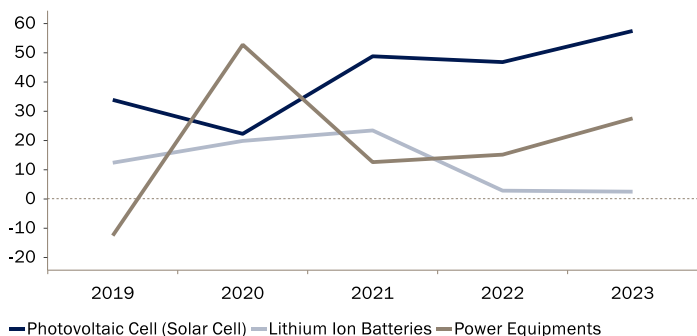
China, Electricity Generation, % Total



Source: Macrobond, Bank J. Safra Sarasin, 19.03.2024

Exhibit 9: Solar PV production rose by almost 60%

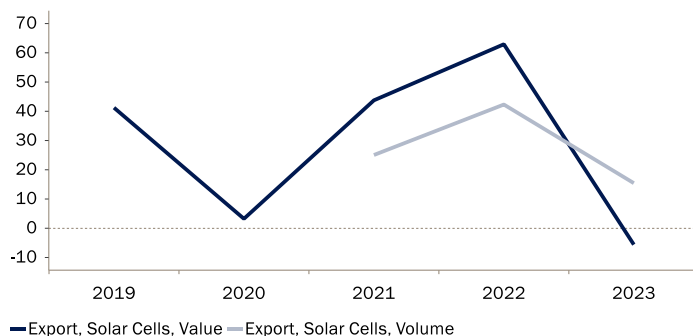
China, Industrial Production, By Product, % yoy



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 10: Cheaper solar PV export grew in volume

China, Export, Solar Cells, % yoy



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Investment in NEV production capacity continued

Another important industry that has been flooded with investment is automobiles, especially the electric vehicles and related products (i.e. batteries). Large investment in these "new-energy vehicles" (NEV) translates into a 36% increase in production, with domestic sales of NEV reaching 7.8 million units, implying an NEV penetration rate of 36% (Exhibit 11). The investment has likely gone too far as excess capacity is already estimated at around 5-10 million units per year. Domestic sales have been supported by sales tax exemption and a significant increase in charging stations at 65%. NEV exports hit 1.76 million units and grew at an impressive rate of 66% (Exhibit 12).



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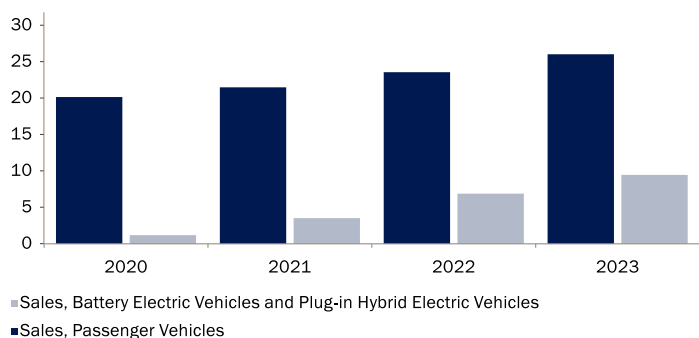
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This year's renewables and NEV investment growth should be slower than in 2023

Will the frenzy in renewables and NEV investment be repeated this year? In general, we still expect robust activity, but at a slower pace in both sectors. China Electricity Council forecasts that the installed capacity for wind and solar power will reach 1300 GW by the end of the year, or an annual increase of 24%, compared to an almost 40% increase last year. Such levels of installed capacity would already put China way ahead of its 2030 target of 1200 GW of wind and solar power installed capacity. Grid and transmission line investment is expected to see limited growth as State Grid Corporation of China is expected to invest "more than 500 billion yuan" in 2024, after last year's 520 billion yuan investment. On NEV, while production should still increase given the capacity and demand, overcapacities should lead to slower investment growth. Various sources (such as China Association of Automobile Manufacturers and China Passenger Car Association) expect around 20% of production and sales growth this year.

Exhibit 11: NEV domestic penetration has increased rapidly

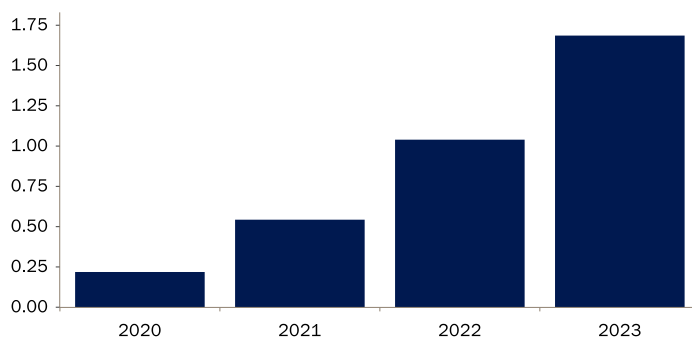
China, Vehicle Sales, Million Unit



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 12: NEV exports also surged

China, Exports of Electric and Plug-in Hybrid Vehicles, Million Unit



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Higher investment growth in AI-related computers will not be a game changer

Slower FAI growth in renewables and automobiles this year could be partly mitigated by faster investment growth in computers and electronics (AI and data driven investment, as indicated in this recent Emerging Market Weekly), as well as the policy drive to upgrade industrial equipment. Still, the electronics sector only accounts for 5% of total FAI and should not be a game changer, and it remains unclear how the industrial upgrade will be financed.

The elephant in the room remains the housing sector

Other important drivers of investment are infrastructure and real estate. Both are driven by the state of the housing market as the bulk of the non-utility infrastructure investment is done by local governments, whose incomes have been severely hit by the housing downturn. As we wrote in the past (see here for example), we believe that the housing downturn will continue in the next two years. But how much more of a correction in real estate investment should we expect?

We see another year of negative housing investment growth

Housing investment in China in 2023 already dropped 19% from its 2021 peak. Comparing China's case to past housing boom and bust cycles such as in Spain and Ireland, China's correction has been milder so far. While these cases may not best reflect China's circumstances today (i.e. they happened during the Global Financial Crisis and the euro crisis), they could give some indication of how far the adjustment could go. Another year of a 10% drop in housing investment would bring it down to 73% from the peak level (Exhibits 13 and 14). This would still be less than the two European cases. This is also much less severe than the IMF's latest projection that housing investment will fall to around 50% of its peak by 2025.



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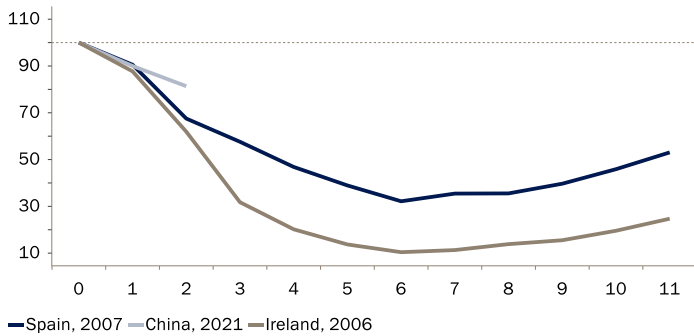
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China's export market share expansion could lift growth close to 5%, but comes with increasing risks of trade restrictions further down the road

Taking all these together, our GDP growth forecast rests on a somewhat lower total fixed asset investment growth and lower consumption growth (due to fading base effects). Our baseline is that the net export contribution could see a significant improvement compared to 2023. The global manufacturing cycle is turning and China continues to actively expand its market share as its capacity to produce many products is much larger than domestic demand. The latest manufacturing PMIs in the first quarter have confirmed the export surge story as new export orders rose across sectors. China's exports could come to rescue the economy this year, even as the risks of trade restrictions increase. Yet it will be more difficult to repeat the strategy next year.

Exhibit 13: China's housing investment correction has been mild compared to the European cases

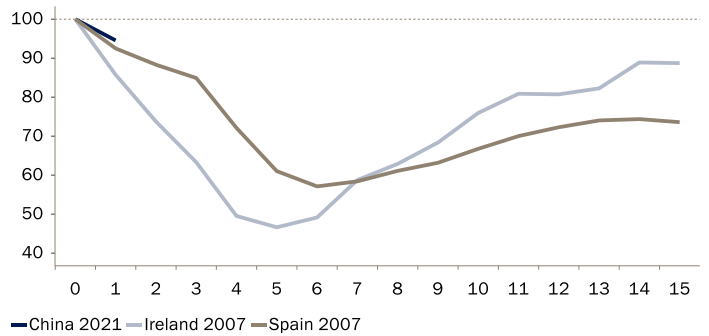
Housing Investment, Rebased to 100 at the Peak of Housing Investment, Annual



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 14: It took Spain and Ireland 6-7 years to see the bottom of the housing investment cycle

House Prices, t=0 in the Year that House Prices Peaked, BIS



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024



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US macro

More upside to the manufacturing ISM

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The destocking phase that weighed on the manufacturing ISM for most of last year appears to have come to an end. Our new model suggests that the ISM should gain momentum over coming months, driven by stronger expected demand, the upswing in semiconductor sales over the last six months and a lesser drag from the dollar.

The manufacturing cycle appears to have turned a corner

The manufacturing ISM index surprised positively in March at 50.3 and crossed the 50-demarcation line between contraction and expansion for the first time since September 2022. True, this is barely expansionary territory. Still, it points to a turn in the global manufacturing cycle (manufacturing activity is highly correlated across countries) and to an end to the destocking phase that lasted for most of last year (Exhibit 1).

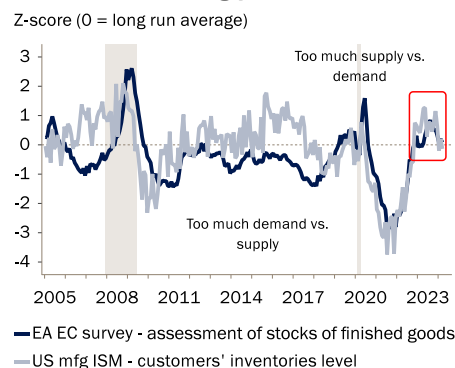
Our new ISM model points to more upside in the coming months ...

Looking ahead, manufacturing activity should gain some momentum as companies re-stock and new orders rise. Inventory cycles tend to last one to three years, and once they get going, they tend to have a life of their own. This seems to be confirmed by our new model, which gives us a six-month lead on the ISM. We use US households' net wealth, the dollar/euro exchange rate, the future shipment component of the Philly Fed manufacturing survey and Korea's semiconductor exports, a good proxy for global chips sales, as explanatory variables. All tend to lead the ISM by 6 to 12 months, with the exception of net wealth that has more of a coincident relation. We use its pre-pandemic trend rate to forecast its value over the next six months. Finally, we use data between January 1998 and December 2019 to estimate our model.

... driven by stronger expected demand, the big upswing in semiconductor sales over the last six months and a lesser drag from the dollar

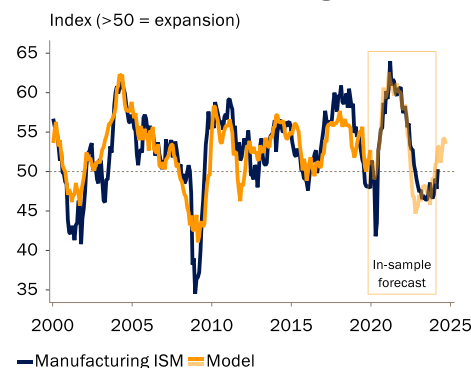
Our model has a good fit, with an R-square of 0.63, and does a good job at forecasting the ISM within our sample. Our predictions closely track the observable values during the pandemic years and up to now (Exhibit 2). It also shows that the initial phase of the ISM decline between mid-2021 and mid-2022 was driven by a moderation in the rate of growth followed by lower US households' net wealth (Exhibit 3). The subsequent weakness in the ISM can be expected by poor expected demand and falling semiconductor global sales. Our model shows that the turn in the manufacturing cycle over the past few months has been driven, to a large extent, by a rebound in those same chips sales in the second half of last year. This, combined with stronger expected demand for manufactured goods, as well as a lesser drag from the dollar should contribute to push up the ISM to around 53-54 by this summer.

Exhibit 1: Destocking phase is done



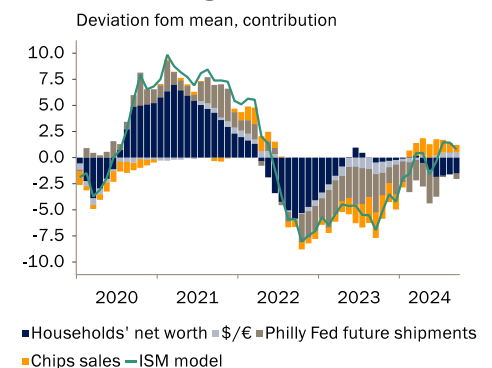
Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 2: ISM should move higher



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024

Exhibit 3: Breaking down our ISM model



Source: Macrobond, Bank J. Safra Sarasin, 04.04.2024



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UK equities

Tactical outlook improving

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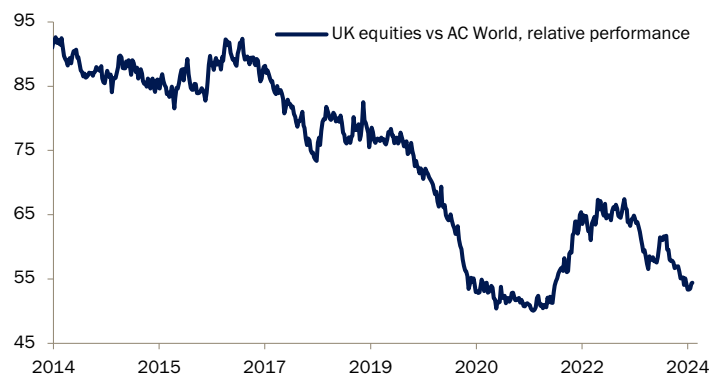
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The UK market has trailed the global equity rebound by around 15% since November. Neither has it benefited from the upswing in momentum, quality and tech, nor has the currency provided support. Sterling has strengthened more than any other major developed market (DM) currency since the beginning of November, which proved to be particularly painful for a market that relies heavily on foreign revenues. Yet, in our view, the tide is turning for UK equities. Sterling now looks expensive, with limited upside potential in the near term. At the same time, the recovery in tech-driven strategies and styles feels exhausted while the ongoing global manufacturing rebound is providing support to commodity sectors and value strategies. The UK equity market should tactically benefit from a more favourable FX backdrop and reversing sector dynamics. Strategically, however, the lack of growth and tech exposure limits the long-term return potential.

UK equities have been hit by their underweight in tech-driven styles and by the strength in sterling

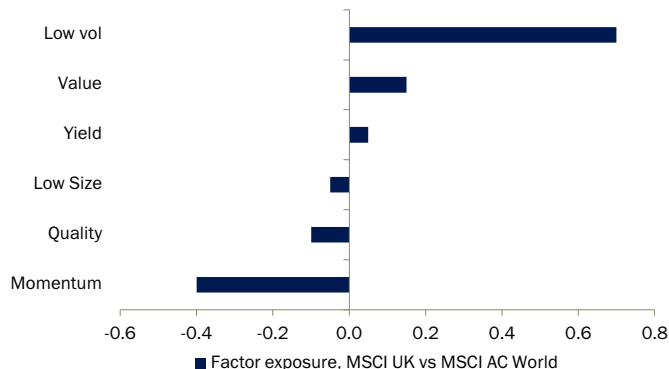
UK equities have been among the weakest performing major equity markets over recent months. They have gained a meagre 8% since the beginning of November while global equities have moved up by 23% over the same period (Exhibit 1). The reason for the underperformance in UK equities is twofold: i) the UK market has not benefited from the global growth/quality/momentum rebound, given its unfavourable sector structure, which is dominated by value & commodity sectors (Exhibit 2) and ii) GBP has been the strongest major global currency since 1 November 2023, weighing heavily on the UK equity market, which generates more than 70% of sales in foreign currencies.

Exhibit 1: UK equities have underperformed in the recent recovery



Source: Refinitiv, Bank J. Safra Sarasin, 03.04.2024

Exhibit 2: UK is underweight momentum and overweight value



Source: Refinitiv, Bank J. Safra Sarasin, 03.04.2024

Value sectors and commodities should benefit from the ongoing global manufacturing recovery

In our view, both these factors are likely to reverse, at least temporarily, opening a window of opportunity to tactically add exposure to UK equities. Firstly, we believe the setup is increasingly favourable for value sectors to outperform in the coming months, driven by the ongoing recovery in global manufacturing. This should support demand for commodities, such as oil and copper, and lift their prices further from current levels. While the oil price is predominantly a function of demand in the US, copper prices are being driven by both the US as well as the Chinese manufacturing cycle (Exhibits 3, 4). Both have bottomed out and are trending higher, which should hold for a couple more months, given the improving credit cycle in both regions.

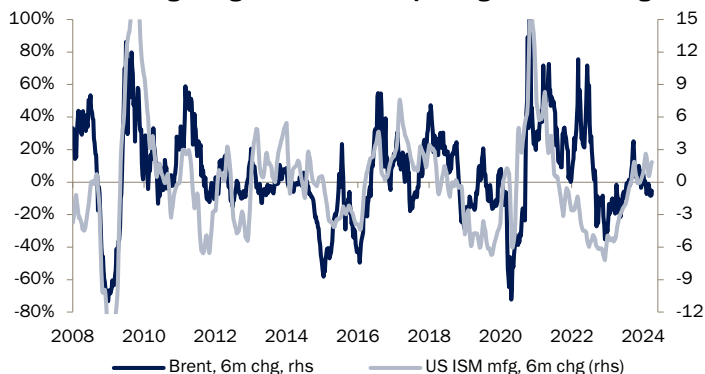


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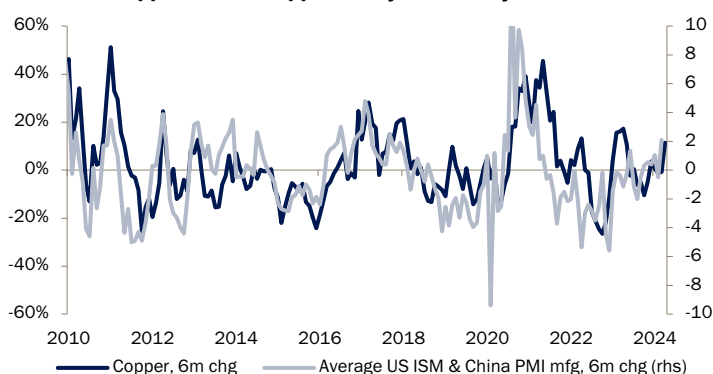
The UK equity market would be a key beneficiary from those cyclical commodity price gains, given its ~20% market-cap weight in energy and mining, more than double the weight in global equities.

Exhibit 3: Oil is getting a boost from improving manufacturing data



Source: Refinitiv, Bank J. Safra Sarasin, 03.04.2024

Exhibit 4: Copper is also supported by a recovery in China

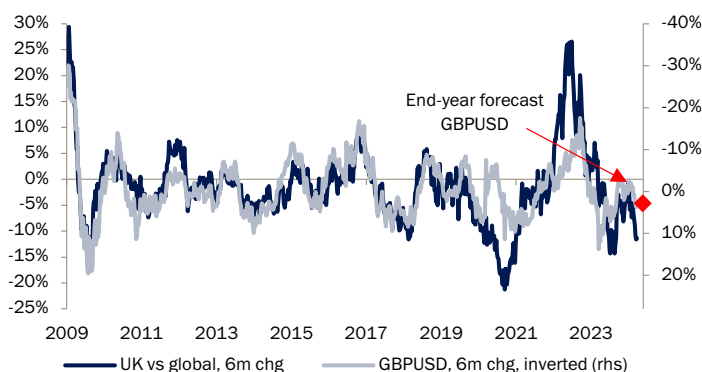


Source: Refinitiv, Bank J. Safra Sarasin, 03.04.2024

Sterling appears expensive, given a moderation in UK macro data, and less of a headwind for UK equities in coming months

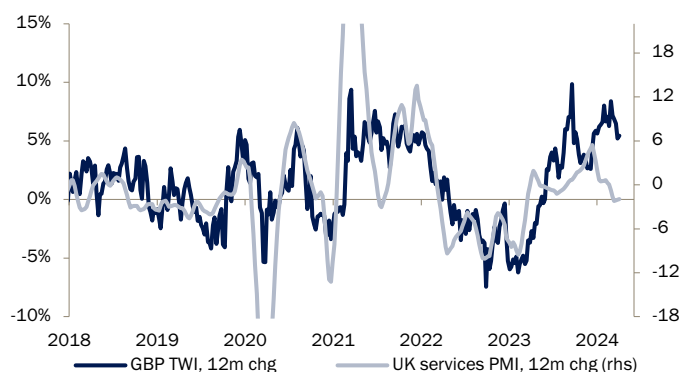
The second key driver of UK equities is FX. As mentioned above, more than 70% of UK equity market revenues are generated outside the UK, with many major companies having only their headquarters in the country. Swings in the currency thus translate more directly into performance than in other markets. To put it into numbers, a 10% drop in sterling vs the US dollar roughly translates into 7% outperformance of UK equities vs global equities, and vice versa (Exhibit 5). While we don't expect sterling to depreciate substantially in the coming quarters, it is fair to say that it is highly valued. While the domestic macro cycle, expressed by the UK services PMI, has flatlined over past months, sterling has appreciated by 2.5% since November (Exhibit 6). Downside risks for the currency thus appear larger than upside risks at the current juncture.

Exhibit 5: UK equities have suffered from a stronger sterling



Source: Refinitiv, Bank J. Safra Sarasin, 03.04.2024

Exhibit 6: Sterling upside seems limited given the UK macro data



Source: Refinitiv, Bank J. Safra Sarasin, 03.04.2024

UK equities are the second most attractively-valued market among major markets

Lastly, relative valuations of UK equities have fallen back to the lows over the past 1.5 years. As a result, the market is now the second most attractively-valued among the regional markets in our universe (Exhibit 7). We would thus conclude that the backdrop has improved substantially for UK equities to outperform tactically. Strategically, however, we retain our more cautious stance on UK equities, given the total lack of growth and tech exposure, sectors that should deliver highest long-term returns globally.



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Exhibit 7: UK equities are second on our valuation score card. Only Chinese equities are valued more cheaply

	Region	Price-to-earnings	PE vs world, rel. to 10Y avg	Price-to-book	PB vs world, rel. to 10Y avg	Dividend yield	DY vs world, rel. to 10Y avg	Shiller-PE	Shiller-PE vs world, rel. to 10Y avg
1	China	8.9	-22%	1.0	-28%	3.1%	1.0%	11.4	-21%
2	UK	11.3	-18%	1.7	-16%	4.1%	0.2%	11.3	-14%
3	EM	12.1	-8%	1.5	-13%	3.0%	0.5%	11.3	-2%
4	Switzerland	17.8	-9%	3.2	-7%	3.2%	0.5%	18.9	-14%
5	EMU	13.5	-12%	1.7	-7%	3.3%	0.3%	15.2	3%
6	Japan	15.5	-1%	1.5	-3%	2.2%	0.3%	20.4	-2%
7	US	21.3	5%	4.2	6%	1.4%	0.0%	25.5	4%
	World	17.9		2.8		2.0%		17.3	

Source: Refinitiv, Bank J. Safra Sarasin, 04.04.2024



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Economic Calendar

Week of 08/04 – 12/04/2024

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 08.04.2024						
EU	10:30	Sentix Investor Confidence	Apr	Index	--	-10.50
US	17:00	NY Fed 1-Yr Inflation Expectations	Mar	%	--	3.04%
Tuesday, 09.04.2024						
US	12:00	NFIB Small Business Optimism	Mar	Index	90.00	89.40
Wednesday, 10.04.2024						
US	14:30	CPI Ex Food and Energy MoM	Mar	mom	0.30%	0.40%
	14:30	CPI Ex Food and Energy YoY	Mar	yoy	3.70%	3.80%
	13:00	MBA Mortgage Applications	Apr05	wow	--	-0.60%
CA	15:45	Bank of Canada Rate Decision	Apr10	%	5.00%	5.00%
US	20:00	FOMC Meeting Minutes				
Thursday, 11.04.2024						
EU	14:15	ECB Deposit Facility Rate	Apr11	%	--	4.00%
US	14:30	PPI Ex Food and Energy MoM	Mar	mom	0.20%	0.30%
	14:30	PPI Ex Food and Energy YoY	Mar	yoy	--	2.00%
	14:30	Initial Jobless Claims	Apr06	1'000	--	--
Friday, 12.04.2024						
UK	08:00	Manufacturing Production MoM	Feb	mom	--	0.00%
	08:00	Manufacturing Production YoY	Feb	yoy	--	2.00%
US	16:00	U. of Mich. Expectations	Apr	Index	--	77.40
	16:00	U. of Mich. 5-10 Yr Inflation	Apr	%	--	2.80%

Source: Bloomberg, J. Safra Sarasin as of 04.04.2024



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Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W (bp)	Δ YTD (bp)	TR YTD in %
Swiss Eidgenossen 10 year (%)	0.75	6	5	0.2
German Bund 10 year (%)	2.36	6	34	-2.0
UK Gilt 10 year (%)	4.02	9	48	-2.3
US Treasury 10 year (%)	4.31	11	43	-1.9
French OAT - Bund, spread (bp)	50	-1	-3	
Italian BTP - Bund, spread (bp)	139	0	-29	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11,691	18.5	0.2	6.5
DAX - Germany	18,403	13.5	0.1	9.9
MSCI Italy	1,103	9.2	-0.9	14.7
IBEX - Spain	11,091	11.2	1.3	10.8
DJ Euro Stoxx 50 - Eurozone	5,071	14.3	0.1	12.7
MSCI UK	2,285	11.7	0.3	4.4
S&P 500 - USA	5,147	21.3	-1.9	8.3
Nasdaq 100 - USA	17,879	26.3	-2.2	6.5
MSCI Emerging Markets	1,049	12.6	0.8	3.0

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.90	6.7	0.1	7.2
EUR-CHF	0.98	5.2	0.4	5.2
GBP-CHF	1.14	5.8	0.2	6.3
EUR-USD	1.08	5.9	0.3	-1.9
GBP-USD	1.26	6.4	0.0	-0.8
USD-JPY	151.2	8.1	-0.1	7.2
EUR-GBP	0.86	4.0	0.3	-1.1
EUR-SEK	11.54	6.1	0.3	3.6
EUR-NOK	11.65	7.2	-0.4	3.8

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	102	8.1	3.7	3.4
Brent crude oil - USD / barrel	90	23.6	3.9	16.4
Gold bullion - USD / Troy ounce	2,280	12.0	2.3	10.5

Source: J. Safra Sarasin, Bloomberg as of 04.04.2024



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