Cross-Asset Weekly

13 January 2023

J. Safra Sarasin

China set to bring back emerging markets equities

Monthly forecast update: Our fundamental view on the macroeconomic outlook remains broadly unchanged. Most advanced economies should fall into recession in 2023, but central banks will be reluctant to cut rates, given the still very tight labour markets. Two recent developments, however, have brightened this downbeat outlook. First, the mild European winter has alleviated the risk of a major energy crisis. Second, the Chinese government's U-turn on its COVID policy and the renewed focus on the economy suggest that the rebound should come earlier and be stronger than previously anticipated. On the fixed income side, we maintain our positive outlook for fixed income developed markets' as rates structures have repriced substantially and most of their economies are set to fall into recession. Despite the recent tightening in credit spreads, we remain cautious with regard to credit, with a preference for IG vs High Yield. With regard to currencies, we stick to our expectation that the US dollar should continue to weaken because of relative yield movements, a fast deceleration of the US cycle and the Chinese reopening. Finally, in equities, we are upgrading Chinese and EM equities to most preferred, driven by the end to zero-COVID, reduced regulatory headwinds and an improving backdrop for China real estate. Additionally, we have downgraded Swiss equities and Japanese equities, driven by FX.

This week's highlights

Monthly macro and strategy forecast update 2

Global macro 2

Fixed income 3

FX 5

Equities 6

Economic Calendar 10
Week of 16/01 – 20/01/2023

Market Performance 11
Global Markets in Local Currencies

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

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

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

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Monthly macro and strategy forecast update

Dr. Karsten Junius, CFA
Chief Economist
Raphael Olszyna-Marzys
International Economist
Mali Chivakul
Emerging Markets Economist
Alex Rohner
Fixed Income Strategist
Dr. Claudio Wewel
FX Strategist
Wolf von Rotberg
Equity Strategist

Our fundamental view on the macro outlook remains broadly unchanged. Most advanced economies should fall into recession this year, but central banks will be reluctant to cut rates, given tight labour markets. Two recent developments, however, have brightened this downbeat outlook. First, the mild European winter has alleviated the risk of a major energy crisis. Second, the Chinese government's U-turn on its COVID policy and the renewed focus on the economy suggest that the rebound should come earlier and be stronger than previously anticipated. We maintain our positive outlook for fixed income developed markets' as their rates structures have repriced substantially and most of their economies are set to fall into recession. Despite the recent tightening in credit spreads, we remain cautious with regard to credit, with a preference for IG vs High Yield. We stick to our expectation that the US dollar should continue to weaken because of relative yield moves, a fast deceleration of the US cycle and the Chinese reopening. We are upgrading Chinese and EM equities to most preferred, driven by the end to zero-COVID, reduced regulatory headwinds and an improving backdrop for China real estate. Additionally, we have downgraded Swiss equities and Japanese equities, driven by FX.

Global macro

We still expect most advanced economies to fall into recession this year, but our view has become a bit less downbeat

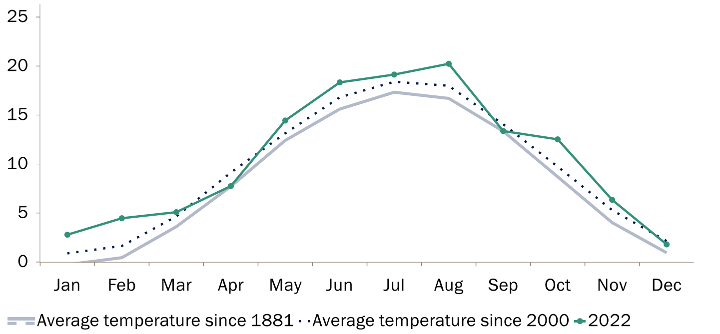
Our macroeconomic outlook remains broadly unchanged: we still expect most advanced economies to fall into recession this year, the global manufacturing cycle to weaken further over the coming months, and central banks to start cutting rates only in 2024. Still, our view has become a bit more optimistic, for two reasons.

The probability of energy rationing this winter, a key downside risk to the outlook for the European economy, has fallen

First, the downside risk of forced energy rationing in Europe, and associated deep cuts to industrial production, has receded. A mild European winter, at least so far, has to be thanked for. Gas tanks remain close to full, and prices are down to pre-invasion levels (Exhibits 1-2). The recession in the euro area is likely to be shallower than previously expected. We have therefore revised up our 2023 GDP growth forecast for the bloc to 0%, from -0.5% previously. We have also raised our terminal (deposit) rate forecast for the ECB to 3.5%, from 3% previously, given the ECB's much more hawkish forward guidance. Everything else equal, tighter policy should weigh on economic growth, though that impact is likely only to be felt in the latter part of this year and in 2024, given the policy transmission lags. Better-behaved inflation data in the US over the past several months should allow the Fed to move in smaller 25bps steps, and we now see the Fed Funds rate peaking at 5.25% in the second quarter, instead of 5.5% previously.

Exhibit 1: Temperatures have been mild ...

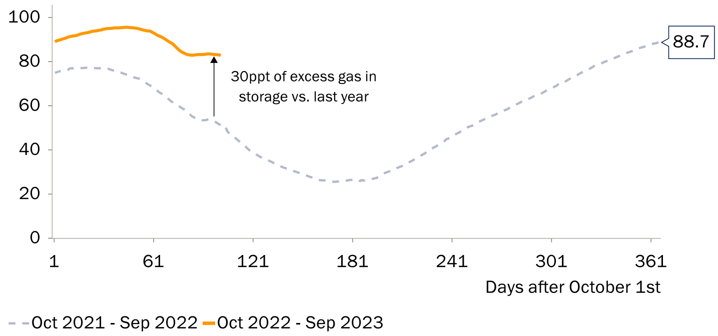
Germany: Average monthly temperature since 1881 in °C



Source: Macrobond, Bank J. Safra Sarasin, 11.01.2023

Exhibit 2: ... and gas withdrawals from storage have been small

Europe natural gas inventory as % storage capacity, evolution through year



Source: Macrobond, Bank J. Safra Sarasin, 11.01.2023

China's economic recovery should come earlier and stronger than previously anticipated

The second reason for our 'slight whiff of optimism' results from the turnaround in China's COVID policy and the government's commitment to boost growth in 2023. To be clear, China's economic situation in the coming weeks will be difficult, with COVID infections remaining elevated. The 'good' news, however, is that they should peak at the end of the month already, leaving December and January as the worst months in terms of the negative economic implications from the wave of infections (Exhibit 3). As a result, we have pulled forward the expected rebound in economic activity to the second quarter, from the second half of the year. Together with the anticipation for more government support, we now see GDP expanding by 4.8% this year, compared with our earlier forecast of 4.4%.

Services consumption should rebound first. A recovery in the housing market will take more time

Services consumption, such as travel, tourism, entertainment, catering, should rebound first, while a recovery in goods consumption may be more gradual (Exhibit 4). Once the labour market in the services sector improves, consumer sentiment should pick up, likely leading to a stabilisation in housing demand and eventually housing starts. Finally, we have also raised our 2023 inflation forecast from 2% to 2.9% as we expect price pressures to increase following the reopening of the economy.

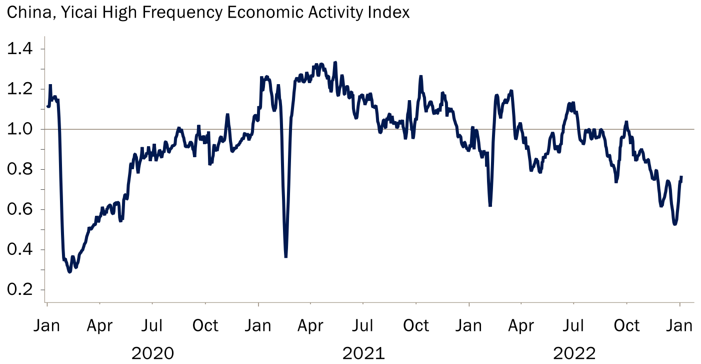
China's reopening will put upward pressure on the oil price, but metals demand should improve more gradually. Parts of the world that have put no restrictions on Chinese tourists stand to gain

A rebound in travel and tourism should add to oil demand and put some upward pressure on oil prices, which poses an upside risk to our headline inflation forecasts more broadly. Outbound tourism, which restarted on January 8, should benefit Hong Kong and Macau most in the near term. Other countries that have not imposed any restrictions on Chinese tourists also stand to gain (e.g., Thailand and Vietnam). Once cases subside in China, countries that have imposed restrictions such as the EU, Japan and Korea are likely to remove them. Outbound tourism should gather pace in the second quarter and discretionary consumer products tied to outbound tourism should also benefit. Metals demand should improve more gradually given our view on the housing market.

China's reopening should offset some of the blow from higher interest rates on global growth

In short, China's reopening should offset some of the blow from higher interest rates on global growth, though the nature of the rebound implies that its impact will take some time to filter through to the global economy.

Exhibit 3: High-frequency indicators of Chinese activity are troughing



Source: Macrobond, Bank J. Safra Sarasin, 11.01.2023

Exhibit 4: On the road again

Source: Macrobond, Bank J. Safra Sarasin, 11.01.2023

Fixed income

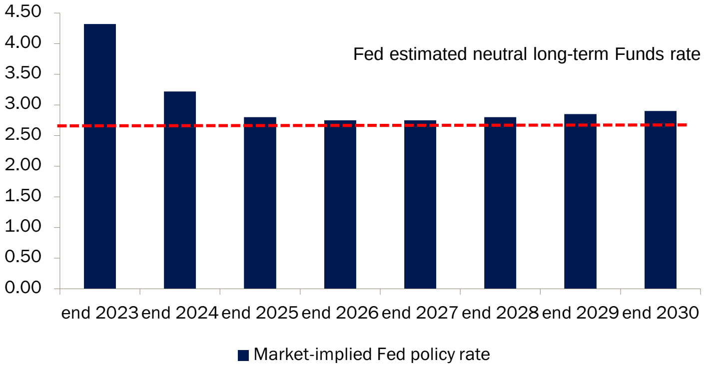
The environment for fixed income is generally positive

The environment for fixed income markets has become substantially more positive as (1) developed markets' (DMs) rates structures have repriced significantly over the past 12 months, incorporating tight monetary policy for years to come, (2) the global economic cycle is slowing sharply, and (3) headline inflation should trend meaningfully lower over the next 12 to 18 months. While the Fed and the Bank of England will likely moderate their pace of rate hikes, we expect the ECB to continue to hike in 50bp increments in February and March.

Slight upward revision to 10y euro area yields due to higher expected ECB policy rates

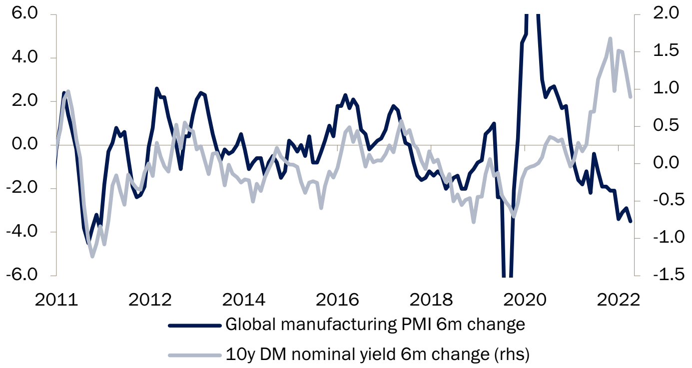
We have revised up our policy rate forecast for the ECB (to 3.5%), hence we have made a slight upward adjustment to our euro area yield targets. But we continue to expect lower yields by the end of 2023 and 2024.

Exhibit 5: Rates structures still pricing tight policy



Source: Bloomberg, Bank J. Safra Sarasin, 11.01.2023

Exhibit 6: Weak economic cycle points to downward pressure on long-term yields



Source: Bloomberg, Bank J. Safra Sarasin, 11.01.2023

Rates structures still pricing tight policy

Although rate expectations for Anglo-Saxon central banks have eased somewhat recently, rate structures are still pricing tight policy for years to come. That is, they are pricing policy rates that are higher than what is considered a neutral level (Exhibit 5). Given the expected downturn in the global economic cycle (Exhibit 6), the pricing looks attractive. We therefore conclude that the risk/return trade-off for fixed income instruments is vastly improved, and they should deliver substantially better returns in 2023.

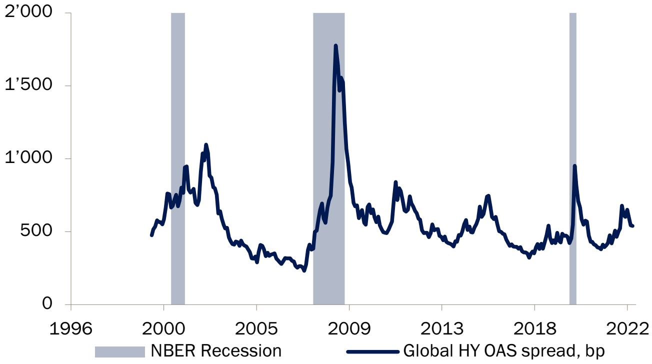
Start accumulating high quality duration to prepare for an eventual central bank pivot

Volatility will persist as markets grapple with pricing peak policy rates, but investors are advised to use the volatility to incrementally add exposure to high quality duration to prepare for an eventual central bank pivot. Historically, bond markets have started to rally sustainably after the last hike in the rate cycle.

We are still reluctant to give a green light for credit just yet

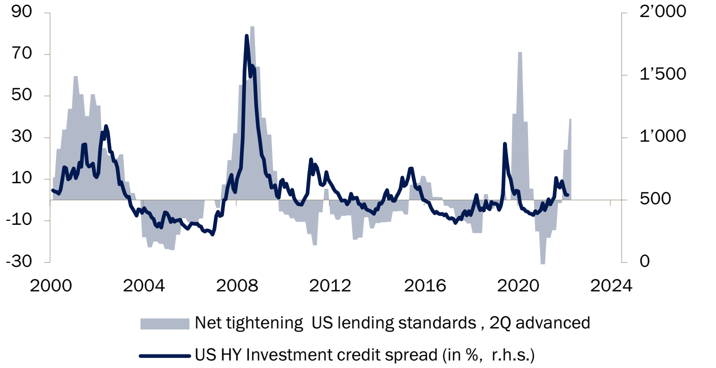
We already commented on the fact that credit spreads had not widened as much as one would have expected in 2022 (see our Cross Asset Weekly "*Wider spreads, but maybe not wide enough*", 25th November 2022). The fact that central banks stay tighter for longer should increase the odds of a recession, and hence the risk of wider spreads. Historically, credit spreads have always risen sharply during recessions (Exhibit 7). Nevertheless, after hitting a high at the end of September 2022, credit spreads have retracted half of the 2022 widening over the past 3 months. The tightening was due to the expectations of a potentially faster drop in inflation, fewer additional rate hikes (or even cuts in H2 2023), and hence a more benign growth environment in 2023. It goes without saying that a shallow economic downturn in 2023 would likely not be enough to move spreads meaningfully wider from here and would justify the recent tightening move. We remain cautious, however. It is important to remember that the bulk of the aggressive central bank tightening has happened over the last 6 to 10 months only and will therefore continue to have an impact on the real economy over the coming quarters. The risk remains therefore that markets underestimate the headwinds for the global economy and overestimate the willingness of central banks to provide support for markets (Exhibit 8). Given their lower spread volatility, we still prefer Investment Grade bonds (IG) to the more susceptible High Yield sector.

Exhibit 7: Credit spreads always rise sharply during recessions



Source: Bloomberg, Bank J. Safra Sarasin, 11.01.2023

Exhibit 8: Tighter financial conditions to be a headwind for the economy



Source: Bloomberg, Bank J. Safra Sarasin, 11.01.2023

Carry is most powerful over long horizons

In order to get a feel for the current attractiveness of credit versus governments, it is helpful to look at the breakeven spreads for different fixed income sub-classes over different horizons. We define the breakeven spread increase as the magnitude of spread widening that would erode excess carry over respective government bonds. A few points are noteworthy: (1) current spreads are roughly at historical long-term averages, that is, a recession is likely not priced in, and (2) carry is most powerful over longer term horizons. While credit looks reasonably attractive over a 12-month horizon, breakeven spreads are relatively small over shorter horizons. Risks remain elevated in the shorter term, in particular for sub-classes at the lower end of the credit spectrum, given current high credit volatility (Exhibit 9).

Exhibit 9: Credit susceptible to wider spreads over shorter investment horizons

	Starting spread	Duration	Breakeven spread increase			Breakeven spread		
			3m	6m	12m	3m	6m	12m
Global HY	550	4.2	70	131	344	620	681	894
Global IG	149	6.3	12	24	56	161	173	205
CEMBI	317	4.3	39	74	193	357	391	510
EMBIG	459	6.8	35	68	159	494	526	617
CEMBI HY	602	4.0	80	150	401	682	752	1003
CEMBI IG	177	4.7	20	37	95	197	215	272
EMBIG HY	815	5.6	76	146	356	892	961	1171
EMBIG IG	151	7.9	10	19	43	161	170	194

Source: Bloomberg, Bank J. Safra Sarasin, 12.01.2023

FX

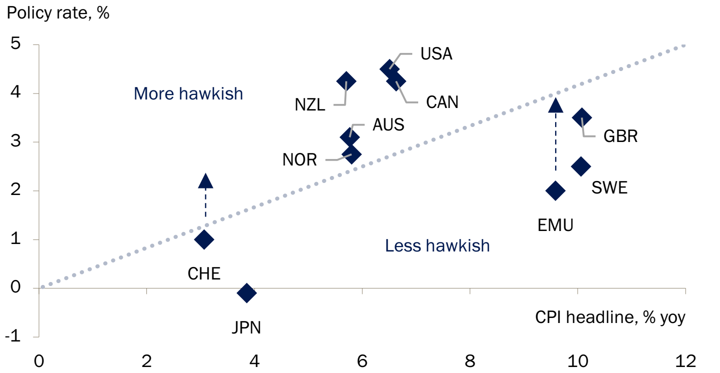
US dollar weakening trend to carry on in 2023

In FX, we expect US dollar weakness to carry on this year. In our view, these dynamics will be driven by three major factors (see FX Atlas January 2023). First, the Fed's rate hiking cycle itself points towards this direction. According to the playbook of previous hiking cycles, the US dollar starts to weaken well before the Fed hikes to its peak rate, reflecting the expected narrowing of the dollar's policy rate advantage as other G10 central banks are catching up (Exhibit 10). Second, the relatively faster pace at which the US cycle currently slows versus the rest of the world argues for continued dollar depreciation. And third, the reopening of the Chinese economy is set to additionally weigh on the US dollar.

We expect the Japanese yen to trend up most strongly, while both the euro and the franc should hold up well

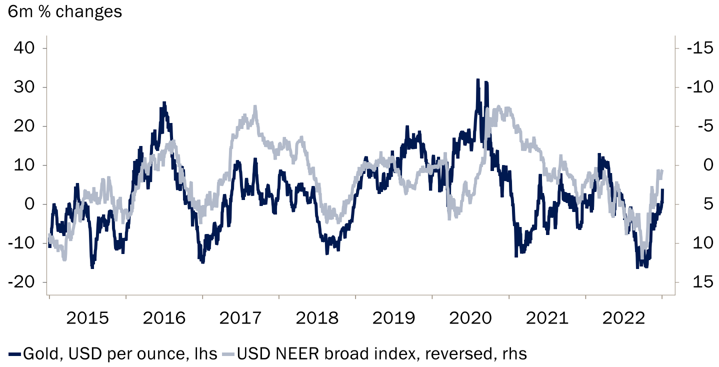
In consequence, we have raised our year-end target for EUR-USD from 1.05 to 1.10, given that euro area activity is holding up better than expected, which is helped by falling energy prices and the Chinese recovery. We continue to expect that the Japanese yen will be the top performer in 2023, given that the continued rise in Japanese inflation argues for further BoJ policy normalisation steps going forward. This should push the USD-JPY pair closer towards the 120-level. Despite some possible near-term weakness, the Swiss franc should hold up well against the global recessionary backdrop and Switzerland's continued inflation advantage. We expect pound sterling to remain range bound versus the US dollar, while we will likely see some retracement against the euro. Lastly, we think that gold should mainly benefit from a weaker dollar (Exhibit 11), while the precious metal is set to benefit from a possible pick up in Chinese consumer demand and a drop in real yields further down the road.

Exhibit 10: More G10 central banks to catch up with the Fed



Source: Macrobond, Bank J. Safra Sarasin, 12.01.2023

Exhibit 11: Gold prices should primarily rise on dollar weakening



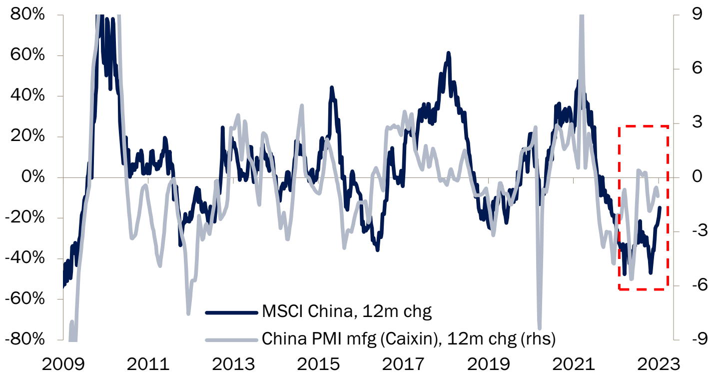
Source: Macrobond, Bank J. Safra Sarasin, 12.01.2023

Equities

We are upgrading Chinese and EM equities to most preferred, driven by the end to zero-COVID, reduced regulatory headwinds and an improving backdrop for China real estate

In equities, the most notable change this month is the upgrade of Chinese and emerging markets equities to "most preferred". This follows the removal of COVID restrictions in China, which, combined with a moderation of regulatory activity in the tech space and a revival of construction activity, should lead to a solid growth rebound in 2023. Given that these restrictive measures have culminated in Chinese equity underperformance over the past two years, the market stands to benefit substantially from their removal. Put differently, it is not only the economic rebound which should help earnings of Chinese corporates, but also the removal of the regulatory overlay, which has heavily weighed on valuations (Exhibits 12 & 13).

Exhibit 12: Chinese equities should be supported by a macro rebound



Source: Refinitiv, Bank J. Safra Sarasin, 11.01.2023

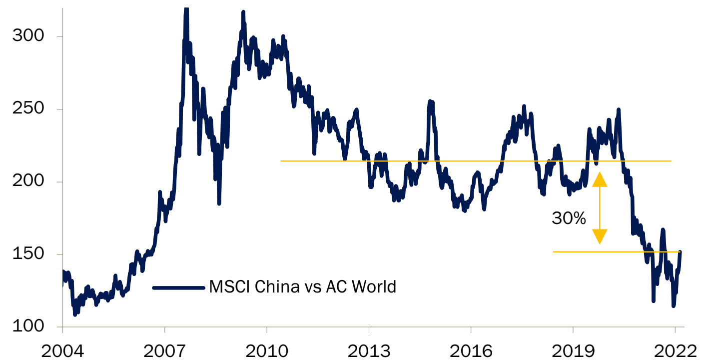
Exhibit 13: Chinese equities' relative valuations are looking attractive

Source: Refintiv, Bank J. Safra Sarasin, 11.01.2023

Chinese equities continue to look attractive, despite the outperformance since October

We believe that the Chinese equity market has further to go in the current cycle, given that even after the 25% rebound (vs global equities) from its October troughs, it continues to trade more than 30% below its relative levels over the past 10 years (Exhibit 14). Given that China continues to account for more than 30% of EM equity market capitalisation (ahead of India in second place with 15%), we are also upgrading our view on EM equities (Exhibit 15). This is further supported by i) the positive impact that an increase in Chinese demand should have on metals prices and ii) our generally cautious view on the US dollar for 2023. Given that a weaker US dollar reduces the pressure on EM central banks to follow the Fed and eases the stress on EM domestic US dollar creditors, it is generally positive for EM assets.

Exhibit 14: Chinese equities remain 30% below 2010 levels



Source: Refinitiv, Bank J. Safra Sarasin, 10.01.2023

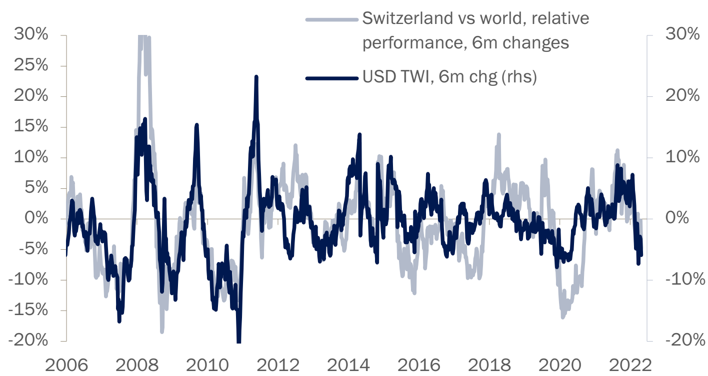
Exhibit 15: Chinese equities are still the dominant driver of EM equities

Source: Refinitiv, Bank J. Safra Sarasin, 10.01.2023

We have downgraded Swiss equities and Japanese equities, driven by FX

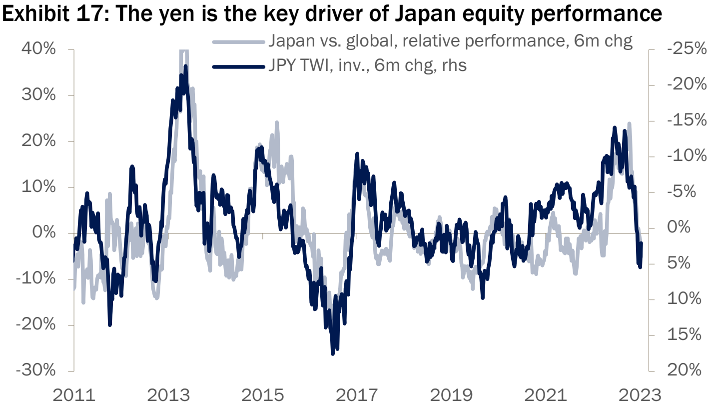
FX views also play a major role in our preference changes for Swiss equities and Japanese equities. We have downgraded both, to neutral and "least preferred", respectively. Swiss equities tend to be correlated positively with the US dollar and should thus be facing increasing headwinds in the coming months (Exhibit 16). Japanese equities continue to suffer from a stronger yen, which we expect to appreciate further in 2023, given a moderation of yield increases and a cooling global macro backdrop (Exhibit 17).

Exhibit 16: Swiss equities tend to suffer from a weaker US dollar



Source: Refinitiv, Bank J. Safra Sarasin, 11.01.2023

Exhibit 17: The yen is the key driver of Japan equity performance

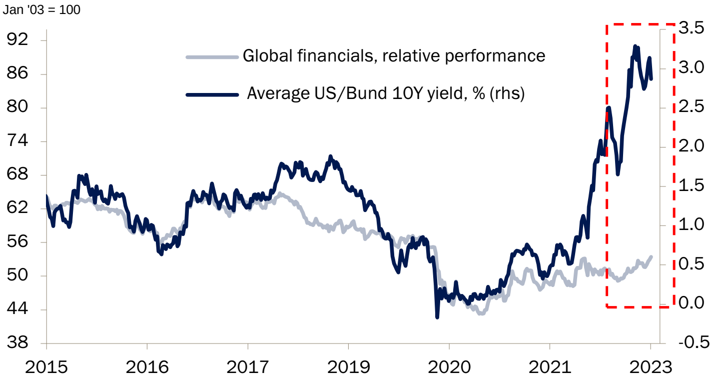


Source: Refinitiv, Bank J. Safra Sarasin, 11.01.2023

We have a preference for financials and like Swiss mid-caps

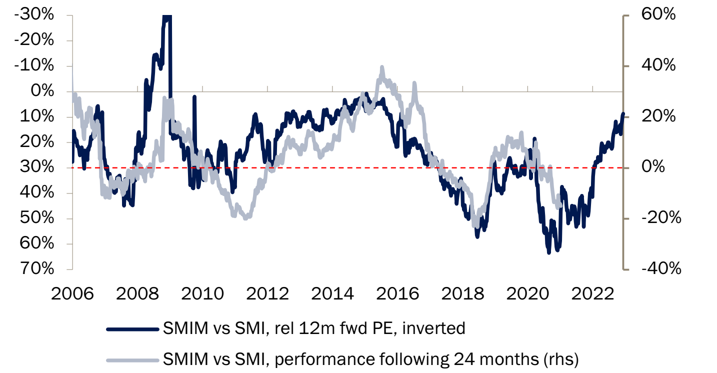
Lastly, two key convictions which we are holding are i) a preference for global financials, which we believe should structurally benefit from higher rates, while they still appear attractively valued (Exhibit 18), and ii) a preference for small- and mid-cap stocks in Switzerland vs large caps. In this case, it is not only a weaker US dollar which should help – given its negative impact on Swiss large-caps – but also i) the more pronounced China exposure of Swiss mid-cap names as well as ii) attractive valuation levels, which have served well in guiding future performance over past years (Exhibit 19).

Exhibit 18: Financials have room to catch up with yields



Source: Refinitiv, Bank J. Safra Sarasin, 11.01.2023

Exhibit 19: Valuations of Swiss mid-caps indicate outperformance



Source: Refinitiv, Bank J. Safra Sarasin, 11.01.2023

Cross-Asset Weekly

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J. Safra Sarasin

Exhibit 20: JSS Forecast overview

Breakdown per Asset Class

Equities Countries / Regions	
USA	→
Eurozone	→
Switzerland	→
United Kingdom	↓
Japan	↓
Emerging Markets	↑
China	↑

Equity Sectors	
Energy	→
Materials	↓
Industrials	↓
Consumer Discretionary	→
Consumer Staples	↑
Health Care	↑
Banks	↑
Insurance	→
Information Technology	→
Communication Services	→
Real Estate	→
Utilities	↑

Fixed Income Performance	
US Treasuries	→
German Bunds	→
UK Gilts	→
Swiss Eidgenossen	→
IG Credit	→
HY Credit	↓
EM USD Government Bonds	↓

↑ Overweight **→ Neutral** **↓ Underweight**

Asset class views (overweight, neutral, underweight) express a tactical recommendation with a 3-month horizon. Tactical views might diverge from year-end stock index targets, which are based on our long-term economic and interest rate forecasts.

Stock Index Price Targets

	12.01.	2Q23	4Q23	4Q24
S&P 500	3'983	3'920	4'000	4'400
MSCI UK	2'239	2'122	2'100	2'300
DJ Euro Stoxx 50	4'127	3'747	3'700	4'100
DAX	15'058	13'962	14'000	16'000
SMI	11'288	10'965	11'200	12'200
MSCI Japan	1'164	1'124	1'100	1'300
MSCI EM	1'018	1'003	1'050	1'100
MSCI China	71	70	75	80

Key Policy Rates in %

	12.01.	2Q23	4Q23	4Q24
US Fed Funds	4.50	5.25	5.25	3.50
EUR Depo Rate	2.00	3.50	3.50	2.00
CHF Saron	0.94	1.75	2.00	1.00
BoE Base Rate	3.50	4.00	4.00	2.00
JP O/N Call Rate	-0.02	0.00	0.15	0.15

Bond Yields (10yr Benchmark)

	12.01.	2Q23	4Q23	4Q24
USA	3.45	3.85	3.60	3.00
Germany	2.13	2.35	2.05	1.75
Switzerland	1.16	1.45	1.25	1.25
United Kingdom	3.33	3.55	3.65	3.25
Japan	0.42	0.50	0.75	0.75

FX-Forecasts

	12.01.	2Q23	4Q23	4Q24
EUR-CHF	1.00	0.97	0.95	0.93
EUR-USD	1.08	1.08	1.10	1.12
EUR-GBP	0.89	0.89	0.90	0.90
GBP-USD	1.22	1.21	1.22	1.24
USD-JPY	129	125	122	118
USD-CHF	0.93	0.89	0.86	0.83
USD-CNY	6.76	6.80	6.80	6.80
Gold, USD per ounce	1'891	1'860	1'900	1'950

Macro Forecasts

		2022	2023	2024
US	GDP	2.1	-0.5	1.0
	CPI	8.0	3.6	2.5
Euroland	GDP	3.2	0.0	1.0
	CPI	8.4	5.3	2.8
Switzerland	GDP	2.0	0.6	1.1
	CPI	2.8	2.5	1.4
UK	GDP	4.0	-1.2	0.8
	CPI	9.1	7.2	2.6
Japan	GDP	1.2	1.3	1.0
	CPI	2.5	2.1	1.3
China	GDP	2.7	4.8	4.9
	CPI	2.0	2.7	3.0

Economic Calendar

Week of 16/01 – 20/01/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 16.01.2023						
JN	00:50	PPI MoM	Dec	mom	0.40%	0.70%
	00:50	PPI YoY	Dec	yoy	9.50%	9.30%
Tuesday, 17.01.2023						
GE	11:00	ZEW Expectations	Jan	Index	-16.70	-23.30
US	14:30	Empire Manufacturing	Jan	Index	-7.50	-11.20
Wednesday, 18.01.2023						
JN	08:00	BoJ Policy Balance Rate	Jan18	%	--	-0.10%
	08:00	BoJ 10yr Yield Target	Jan18	%	--	0.00%
UK	08:00	CPI MoM	Dec	mom	---	0.40%
	08:00	CPI YoY	Dec	yoy	10.60%	10.70%
US	13:00	MBA Mortgage Applications	Jan	wow	--	1.20%
	14:30	NY Fed Services Bus. Activity	Jan	Index	--	-17.60
	14:30	Retail Sales Control Group	Dec	mom	-0.60%	-0.20%
	14:30	PPI Ex Food, Energy MoM	Dec	mom	0.10%	0.40%
	14:30	PPI Ex Food, Energy YoY	Dec	yoy	5.40%	6.20%
Thursday, 19.01.2023						
US	14:30	Building Permits	Dec	Index	1370k	1351k
	14:30	Philadelphia Fed Business Outl.	Jan	Index	-10.80	-13.80
	14:30	Initial Jobless Claims	Jan14	1'000	--	--
Friday, 20.01.2023						
UK	08:00	Retail Sales Ex Auto, Fuel MoM	Dec	mom	--	-0.30%
	08:00	Retail Sales Ex Auto, Fuel YoY	Dec	yoy	--	-5.90%
GE	08:00	PPI MoM	Dec	mom	--	-3.90%
	08:00	PPI YoY	Dec	yoy	20.70%	28.20%

Source: Bloomberg, J. Safra Sarasin as of 12.01.2023

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	1.15	-14	-46	3.5
German Bund 10 year (%)	2.15	-6	-42	2.9
UK Gilt 10 year (%)	3.33	-16	-34	2.6
US Treasury 10 year (%)	3.45	-11	-42	3.5
French OAT - Bund, spread (bp)	45	-6	-9	
Italian BTP - Bund, spread (bp)	182	-20	-33	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11'288	16.2	2.1	5.2
DAX - Germany	15'058	12.0	4.3	8.1
MSCI Italy	819	8.5	3.4	8.3
IBEX - Spain	8'828	11.3	2.9	7.7
DJ Euro Stoxx 50 - Eurozone	4'127	12.4	4.3	8.9
MSCI UK	2'239	10.3	2.0	4.5
S&P 500 - USA	3'983	17.7	4.6	3.8
Nasdaq 100 - USA	11'460	21.7	6.7	4.8
MSCI Emerging Markets	1'018	12.3	3.5	6.5

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.93	8.9	0.1	0.5
EUR-CHF	1.01	6.7	2.0	1.8
GBP-CHF	1.13	8.5	1.0	1.3
EUR-USD	1.08	8.5	1.8	1.2
GBP-USD	1.22	10.6	0.9	0.9
USD-JPY	128.7	13.8	-2.5	-1.8
EUR-GBP	0.89	7.4	1.0	0.4
EUR-SEK	11.29	7.8	0.8	1.2
EUR-NOK	10.73	9.9	0.9	2.2

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	111	18.8	2.3	-1.6
Brent crude oil - USD / barrel	83	41.1	7.0	-2.5
Gold bullion - USD / Troy ounce	1'896	14.8	3.4	3.9

Source: J. Safra Sarasin, Bloomberg as of 12.01.2023

Important legal Information

Bloomberg

ICE Data Indices

J.P. Morgan

MSCI Indices

SMI

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