J. Safra Sarasin

Cross-Asset Weekly

15 March 2024

The ECB is preparing for lower excess liquidity

The ECB has decided on a new operational framework that should remain functionable as the size of its balance sheet shrinks. The ECB will continue to steer money market rates with its Deposit Facility Rate in a system of excess liquidity. However, this excess liquidity will be supplied both by the ECB's asset purchases, and, increasingly, also by commercial banks' demand for credit operations with the ECB.

Consequently, the ECB will target EUR overnight rate levels close to the Deposit Facility Rate (DFR) with weekly refinancing and 3-month liquidity operations, while retaining a structural bond portfolio to keep an appropriate stock of bank reserves. With the current pace of balance sheet reduction, it will take time before excess liquidity approaches levels where overnight rates detach meaningfully from the DFR and where the operational framework can prove itself.

Over in the US, a hotter-than-expected US CPI print and the weak retail sales report released earlier this week are a reminder that last year's disinflationary boom has likely ended. With the normalisation of the supply side of the economy largely done, inflation will be driven by more sticky demand-related factors. As such, central banks' best course of action is to lengthen the runway on which to land the economy.

Finally, gold's sharp upward move towards $2'200 per ounce can be attributed to a large degree to continued demand from Emerging Markets (EM). The overall environment should remain supportive and keep the gold price elevated throughout 2024.

This week's highlights

ECB operational framework 2
Preparing for a smaller balance sheet

Euro are fixed income 5
Dealing with lower excess reserves

Global macro 6
Navigating the final stretch of inflation

Gold 7
Emerging Market demand will likely remain key

Economic Calendar 9
Week of 18/03 – 22/03/2024

Market Performance 10
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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ECB operational framework

Preparing for a smaller balance sheet

Dr. Karsten Junius, CFA
Chief Economist
karsten.junius@jsafrasarasin.com
+41 58 317 32 79

The ECB has decided on a new operational framework that should remain functionable as the size of its balance sheet shrinks. The ECB will continue to steer money market rates with its deposit facility rate in a system of excess liquidity. However, this excess liquidity will be supplied both by the ECB's asset purchases, and, increasingly, also by commercial banks' demand for credit operations with the ECB. These will be conducted at full allotment procedures and will satisfy the marginal liquidity needs of the banking sector. In order to encourage the use of these facilities from September 18 onwards, the ECB will reduce the spread between the deposit rate and the main refinancing rate to 15bp, from currently 50bp. The ECB has also decided to keep the minimum reserve ratio at 1%. Minimum reserves are not remunerated.

ECB will continue to use a floor system to steer the money market rate

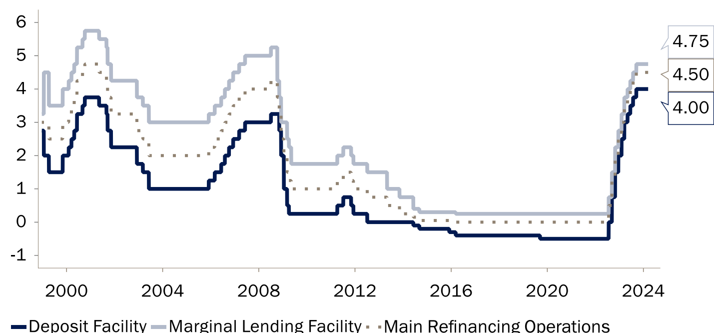
The ECB decided to maintain the current "floor system" in which excess liquidity provisioning will guarantee that the ECB's deposit rate (DFR) is the central policy rate for money markets (Exhibit 1). It is called a floor system as the deposit rate provides a floor under which money market rates don't fall significantly as financial institutions with access to the ECB facilities can always deposit their liquidity at the DFR safely with the ECB.

Under the "corridor system" money market rates stayed within a corridor set by the deposit and the marginal refinance rates. It centred around the main refinance rate

Before the financial crisis, the ECB was using a so-called "corridor system" in which structural liquidity shortages guaranteed a certain demand for central bank liquidity. This liquidity was mainly provided through refinancing operations against collateral at the main refinancing rate (MFR). The ECB provided just as much liquidity as necessary such that there were no systematic excess reserves in this system. The system came to an end when the ECB created a substantial amount of bank reserves once it started its quantitative easing programmes (Exhibit 2). Quantitative easing increased the asset side of the ECB balance sheet mainly through the volume of assets purchased and the credit extended to financial institutions via the Targeted Long-Term Refinance Operations (TLTRO) (see position 7.1 and 5.2 in Exhibit 3). In exchange, liabilities to credit institutions increased on the liability side of the ECB balance sheet (see position 2.2 in Exhibit 3). The substantial volume of deposits that financial institutions held at the ECB exceeded their minimum reserve requirements by a huge margin. This constituted the excess liquidity that guaranteed that short-term money market rates did not exceed the ECB's deposit rate. That rate is called the floor as banks wouldn't lend funds at a lower rate than the one they can earn from the ECB.

Exhibit 1: The deposit rate will remain the main policy rate

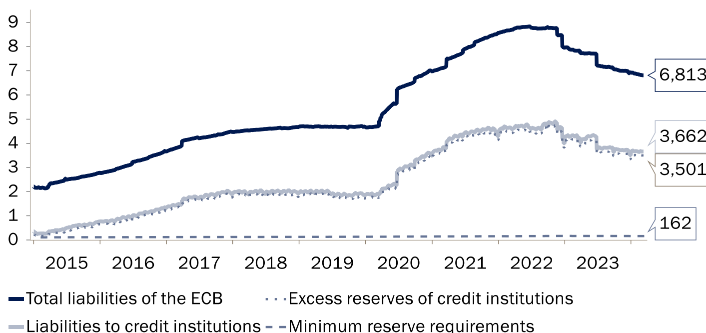
Euro Area: policy rates in % (at announcement date)



Source: Macrobond, Bank J. Safra Sarasin, 13.03.2024

Exhibit 2: ECB balance sheet still shows sizable excess reserves

Liability Side of ECB Consolidated Balance Sheet, in billion EUR, last data: 08/03/2024



Source: Macrobond, Bank J. Safra Sarasin, 13.03.2024

Exhibit 3: The balance sheet of the ECB

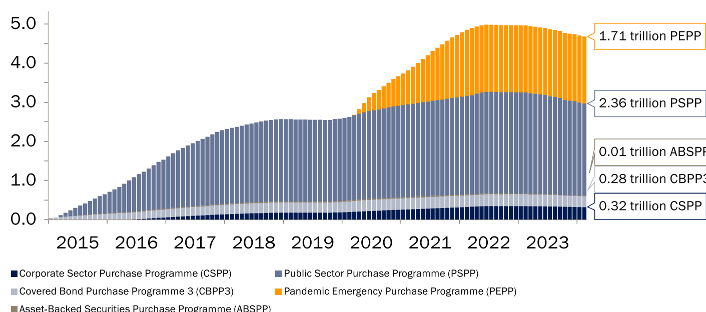
Assets (millions)		Liabilities (millions)	
1 Gold & Gold Receivables	649,094	**1 Banknotes in Circulation**	1,543,359
2 Claims on Non-Euro Area Residents Denominated in Foreign Currency, Total	499,887	**2 Liabilities to Euro Area Credit Institutions Related to Monetary Policy Operatio**	3,662,105
2.1 Receivables from the IMF	229,619	2.1 Current Accounts (Covering the Minimum Reserves System)	197,994
2.2 Balances with Banks & Security Investments, External Loans & Other Extern	270,269	2.2 Deposit Facility	3,464,083
3 Claims on Euro Area Residents Denominated in Foreign Currency	15,120	2.3 Fixed-Term Deposits	0
4 Claims on Non-Euro Area Residents Denominated in Euro, Total	15,412	2.4 Fine Tuning Reverse Operations	0
4.1 Balances with Banks, Security Investments & Loans	15,412	2.5 Deposits Related to Margin Calls	28
4.2 Claims Arising from the Credit Facility under ERM II	0	**3 Other Liabilities to Euro Area Credit Institutions Denominated in Euro**	33,056
5 Lending to Euro Area Credit Institutions Related to Monetary Policy Operations	401,615	**4 Debt Certificates Issued**	0
5.1 Main Refinancing Operations	3,571	**5 Liabilities to Non-Euro Area Residents Denominated in Euro**	191,632
5.2 Longer-Term Refinancing Operations	398,044	5.1 General Government	148,240
5.3 Fine-Tuning Reverse Operations (Assets)	0	5.2 Excluding General Government	81,616
5.4 Structural Reverse Operations	0	**6 Liabilities to Other Euro Area Residents Denominated in Euro, Total**	229,856
5.5 Marginal Lending Facility	0	**7 Liabilities to Euro Area Residents Denominated in Foreign Currency**	17,037
5.6 Credits Related to Marginal Calls	0	**8 Liabilities to Non-Euro Area Residents Denominated in Foreign Currency, Total**	3,576
6 Other Claims on Euro Area Credit Institutions Denominated in Euro	23,729	8.1 Deposits, Balances & Other Liabilities	3,576
7 Securities of Euro Area Residents Denominated in Euro	4,832,661	8.2 Liabilities Arising from the Credit Facility under ERM II	0
7.1 Securities Held for Monetary Policy Purposes	4,630,121	**9 Counterpart of Special Drawing Rights Allocated by the IMF**	177,116
7.2 Other Securities	202,540	**10 Other Liabilities**	215,231
8 General Government Debt Denominated in Euro	20,853	**11 Revaluation Accounts**	634,891
9 Other Assets	354,817	**12 Capital & Reserves**	105,329
Total Assets	**6,813,189**	**Total Liabilities**	**6,813,189**

Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Over time, the liquidity needs of the financial sector have increased

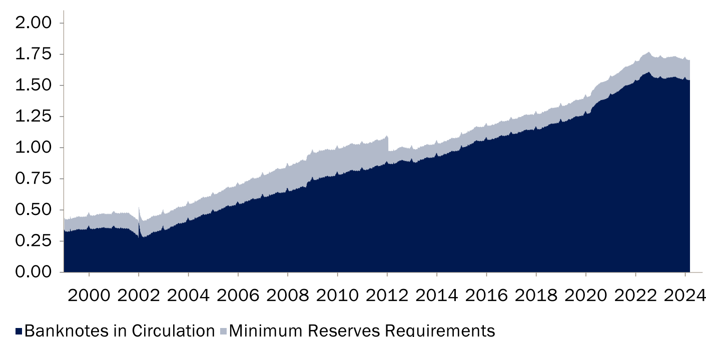
In the past two years, excess reserves of financial institutions decreased significantly through two developments. (1) Banks had to repay maturing TLTROs and some proceeds from maturing bonds held in the asset portfolios of the ECB were not reinvested (Exhibit 4). (2) Liquidity demand of the financial sector increased mainly as the demand for banknotes in circulation that they provide for their clients surged (Exhibit 5). As both trends can be expected to continue, it is a question of time before excess reserves fall to a level at which short-term money market rates might not remain anchored at the DFR anymore, but would be bid up instead towards an undesirably higher level. Unfortunately, neither the ECB nor the financial sector knows exactly at which level of reserves that is the case.

Exhibit 4: Quantitative tightening reduces the ECB balance sheet



Source: Macrobond, Bank J. Safra Sarasin, 13.03.2024

Exhibit 5: Demand for banknotes increases over time



Source: Macrobond, Bank J. Safra Sarasin, 13.03.2024

Money demand could become more volatile

It is also highly likely that the equilibrium level of excess reserves will be very volatile as banks may want to hold more liquidity in financially turbulent times and when interbank lending dries up. It is also likely that online banking will increase the liquidity that banks will want to hold for precautionary reasons over time, as clients can shift their deposits

from one institution to the next with a mouse click. This would facilitate digital bank runs. The new operational framework has to guarantee that financial institutions have access to enough liquidity-providing instruments such that also in crisis times short-term money market rates remain close to the level desired by the ECB.

The new framework combines elements of the floor and the corridor system

With the new operational framework, the ECB operates under a system of excess reserves such that short-term money market rates remain close to the deposit facility rate. However, in contrast to the current system and the one by the Fed, it is not supplying the whole liquidity through the purchase of assets. Instead, it intends that in the future only the structural liquidity needs are provided that way. The marginal liquidity demand of financial institutions shall be satisfied by refinancing operations (mainly position 5.1., but also 5.2. and 5.5 on the asset side of the ECB balance sheet). As a result, the ECB should also be able to learn about banks' demand for liquidity, that for the moment it can assess only very vaguely. Hence, the new operational system is hybrid in two ways. (1) It combines monetary tools from the *floor* and the *corridor* system and (2) it creates excess liquidity through the *supply* of central bank reserves via asset purchases but also through *demand* for its refinancing operations. That also implies that "excess reserves" become "voluntary reserves" of financial institutions.

The reduction between the spread between the main refinancing and the deposit rate provides an incentive for banks to use the regular refinancing operations

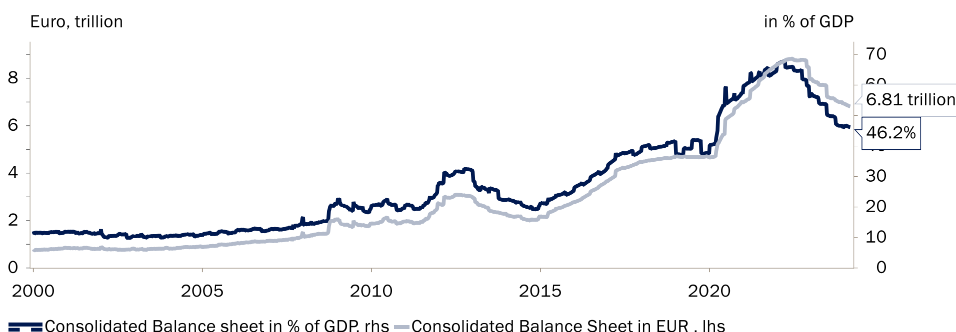
The ECB has lowered the spread between the main refinancing and deposit facility rate from 50bp to 15bp in order to encourage banks to use the regular refinancing tender operations. They will be operated at a full allotment fixed rate procedure. This means that financial institutions receive the full amount they are requesting from the ECB at a fixed rate. As a result, banks can rely that their refinancing costs do not increase if their demand for funds increases. This will also limit the volatility of money market rates.

The ECB will not unwind its asset portfolios completely. Instead they will grow in the medium term

The provision of structural liquidity by structural means has the advantage that financial institutions don't have to roll over most of their liquidity needs on a weekly basis. This clearly reduces their operational risks and requires less collateral. However, it also means that the ECB will have to hold structural asset portfolios for that purpose. Hence, it will not unwind all the quantitative easing of the past years. Instead, at some point in the future, it will even have to increase its asset holdings again – at least in nominal terms – yet not in % of euro area GDP (Exhibit 6). The ECB also stated that it has to support the EU's general policies as a secondary objective. Therefore, it plans that these structural asset portfolios will have a "green tilt". We conclude that these asset portfolios will also include corporate bonds because the ECB may find it politically difficult to apply ESG criteria for government bonds.

Exhibit 6: ECB balance sheet will decline further in % of euro area GDP

Consolidated Balance Sheet & Flows of MFI Sector, Eurosystem, Total Assets & Liabilities



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Euro are fixed income

Dealing with lower excess reserves

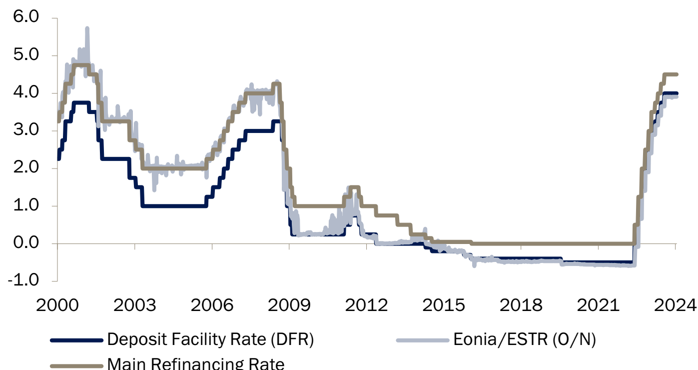
Alex Rohner
Fixed Income Strategist
alex.rohner@jsafrasarasin.com
+41 58 317 32 24

The ECB's new operational framework has been set up to deal with the implementation of monetary policy in times of lower excess reserves. The ECB will steer EUR overnight rates close to the Deposit Facility Rate (DFR) with weekly refinancing and 3-month liquidity operations, while retaining a structural bond portfolio to keep an appropriate stock of bank reserves. Yet it will take time before excess liquidity approaches levels where overnight rates could detach meaningfully from the DFR and where the operational framework can prove itself.

The Global Financial Crisis 2008 marked a regime change

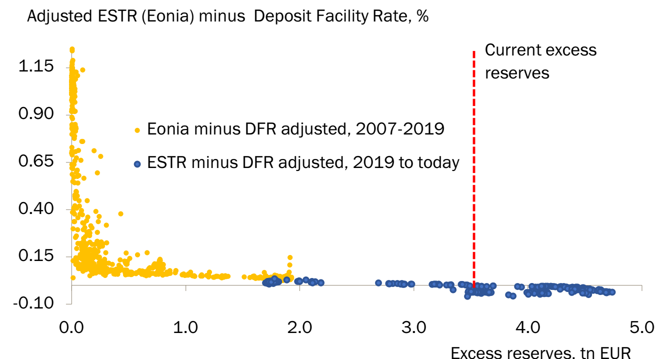
Before 2008, the ECB provided the banking system with tailored amounts of reserves to fulfil their reserve requirements, mainly through regular refinancing operations. The overnight EUR rate therefore closely tracked the Main Refinancing Operations (MRO) rate. With non-standard monetary policies after the Global Financial Crisis 2008 and the concomitant large oversupply of bank reserves, the EUR overnight rate (O/N) dropped to the ECB's Deposit Facility Rate (DFR) – the rate at which banks can deposit their excess reserves with the ECB. Since 2008, the EUR O/N rate has closely tracked the DFR (Exhibit 1).

Exhibit 1: Eonia-ESTR O/N rate has moved down to the DFR in 2008



Source: Macrobond, Bank J. Safra Sarasin, 13.03.2024

Exhibit 2: Higher excess reserves lead to lower O/N rates



Source: Macrobond, Bank J. Safra Sarasin, 13.03.2024

Excess reserve level at which EUR O/N rates detach from DFR is likely below 2tn EUR

The ESTR (O/N) rate is an unsecured rate at which bank reserves are traded and which replaced Eonia in 2019. While the DFR should theoretically constitute a floor for overnight rates, in practice, the ESTR (O/N) has traded often below the DFR. There are a few reasons: (1) the average ESTR rate also includes transactions with counterparties (lenders) that do not have access to the ECB Deposit Facility, and hence have to settle for slightly lower rates. (2) The oversupply of reserves has reduced demand from banks for short-term liquidity and caused downward pressure on overnight rates. The latter point is substantiated by the clear relationship of excess reserves and the negative spread of EUR overnight rates with the Deposit Facility Rate (Exhibit 2). Past data suggest that an excess liquidity level where O/N rates could start to detach from the DFR is likely below 2tn EUR.

It will take time before the new framework can prove itself

According to the new ECB operational framework, the ECB will steer EUR overnight rates close to the Deposit Facility Rate (DFR) with weekly refinancing and 3-month liquidity operations. However, at the current pace of balance sheet reduction, it will take time before excess liquidity approaches levels where EUR overnight rates will start to meaningfully detach from the DFR, and where the operational framework can prove itself.

J. Safra Sarasin
Cross-Asset Weekly

15 March 2024

Global macro

Navigating the final stretch of inflation

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

The hotter-than-expected US CPI print and the weak retail sales report released earlier this week are a good reminder that last year's disinflationary boom has likely ended. With the normalisation of the supply side of the economy largely done, inflation will be driven by more sticky demand-related factors. Still, a less predictable supply side will complicate the assessment of how much spare capacity there is. As such, central banks' best course of action is to lengthen the runway on which to land the economy.

Supply chains, either alone or in interaction with labour-market slack, explain most of the rise and fall in inflation

Inflation in advanced economies fell rapidly in 2023, while economic activity was often more resilient than anticipated. This outcome was very much the result of a rapid pick-up in the supply side of the economy as it normalised after the series of shocks of the previous years. The inflation overshoot at the start of the pandemic resulted from clogged supply chains, either alone or in interaction with labour market slack, as well as strong demand for goods. In the US, most of the decline over the past year can be explained by a reversal of that same process (Exhibit 1). But with the normalisation of the supply side of the economy largely done, this benign disinflationary phase has likely come to an end. Indeed, supply chains have healed. And the factors that led to stronger labour supply, such as the significant increase in net immigration into the US, are unlikely to play out again.

Inflation is now driven by more sticky demand-driven factors. To what extent fewer vacancies will feed into higher unemployment remains highly uncertain

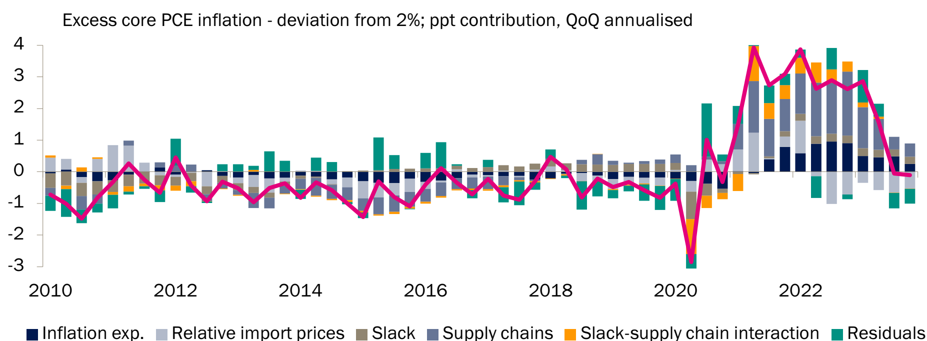
Services inflation, labour market slack and inflation expectations will be the key drivers of the next disinflation phase. While labour markets have cooled and wage growth has peaked in most countries, it remains at levels that are inconsistent with central banks' 2% inflation targets in some countries. Policymakers will want to see a further cooling of labour market conditions. Yet there are two important sources of uncertainty. The first one relates to the rise in unemployment associated with a further decline in unfilled positions, the second to inflation expectations. While inflation expectations remain well anchored for the long term, short-term expectations seem to be less well anchored than prior to the pandemic. This could require more economic pain to return inflation back to target.

The return to 2% inflation is likely to be bumpy. Central banks are likely to ease policy gradually later this year

In our view, underlying inflation will be stickier and the return to central banks' targets bumpier. Given such an uncertain environment, the best course of action is probably to lengthen the runway on which to land the economy. As a result, we expect central banks to proceed with gradual and carefully calibrated rate cuts later this year.

Learn more on this topic by reading our latest Macro & Strategy Focus

Exhibit 1: The supply-driven disinflation phase has ended. Will the last mile be the hardest?



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Gold

Emerging Market demand will likely remain key

Dr. Claudio Wewel
FX Strategist
claudio.wewel@jsafrasarasin.com
+41 58 317 32 26

With gold surging towards $2'200 per ounce, the precious metal is shining once again. The moderate retreat in real yields and the persistence of high inflation partially explain its strong performance. But in our view, higher physical demand from Emerging Markets (EM) remains key. Central bank buying continues to be strong and there is ample evidence that Chinese and Indian private demand has risen over the past few quarters. The overall environment should remain supportive and keep the gold price elevated throughout 2024. Yet some caution is warranted in the near term, given that gold looks overbought from a tactical perspective.

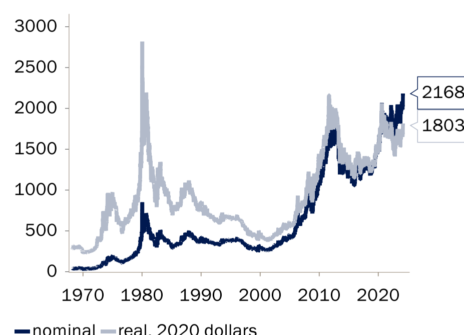
Gold has reached a new all-time high in nominal terms, but not in real terms

Gold's sudden surge to a new all-time high has come a bit as a surprise, given the lack of an obvious trigger. Over the past two weeks, gold rose from just above $2'000 to almost $2'200 per ounce (Exhibit 1), while it remains substantially below its all-time high in real terms (Exhibit 2). Of course, the moderate retreat in real yields partially explains the year-to-date performance. But the move looks outsized. While it had been tight for many years, gold's correlation with real yields has loosened over the past two years. In early 2022, the strong surge in global yields opened up a substantial gap between the US TIPS 10-year yield and gold (Exhibit 3).

Exhibit 1: Gold at new all-time high...

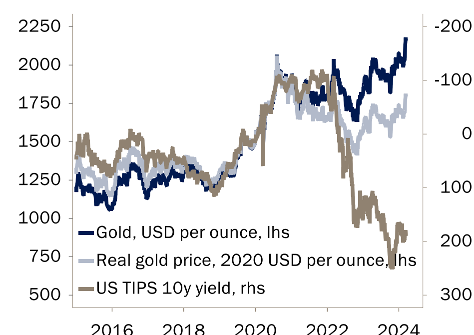
Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Exhibit 2: ...but not in real terms



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Exhibit 3: Gold decoupled from yield levels



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Elevated inflation prints have pushed the gold price to a higher level...

If we deflate gold with US headline inflation, the gap diminishes to some extent. This shows that the current gold price level also is a result of the high inflation experienced over the past few years. Going forward, we think that inflation readings could remain a relevant driver as markets reassess the probabilities that inflation remains more elevated or weigh the possibility that central banks revise up their inflation targets.

...but the higher physical demand from EM probably is most important

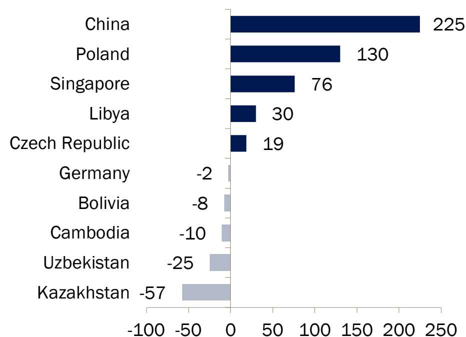
Yet structural changes likely account for the largest portion of the gap. Sometime ago, we noted that central banks in Emerging Markets had emerged as important buyers of gold. Last year's gold purchases confirm this notion. The World Gold Council (WGC) reports China as the largest buyer of gold in 2023 (Exhibit 4). Moreover, central banks' gold purchases have risen substantially in aggregate (Exhibit 5). We see these purchases as part of a greater effort to reduce political dependence on the US dollar, for which the freeze of Russian dollar assets at the onset of the war in Ukraine has likely acted as an important catalyst. In essence, the surge in institutional demand has created a «central bank put» which shields gold against the high prevailing real yield levels.

J. Safra Sarasin
Cross-Asset Weekly

15 March 2024

Exhibit 4: PBoC was largest buyer in 2023

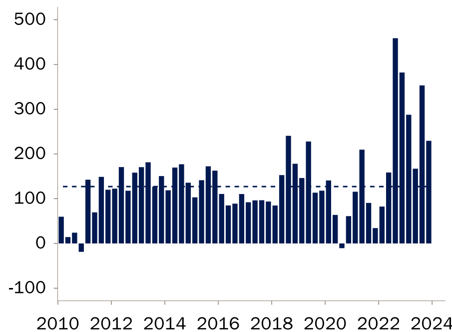
Largest changes in official gold reserves in 2023, tonnes



Source: WGC, Bank J. Safra Sarasin, 14.03.2024

Exhibit 5: CB demand has surged since 2022

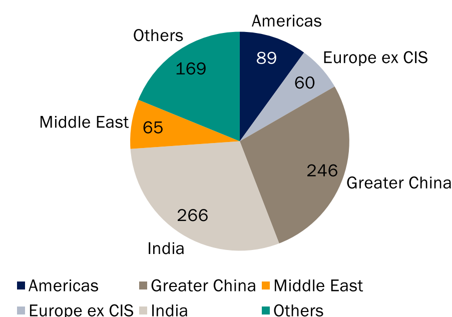
Worldwide quarterly central bank gold purchases, tonnes



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Exhibit 6: Chinese and Indian buyers matter

Gold, world private consumption (jewellery, bars, coins), metric tonnes



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Given muted growth, weak sentiment and a restricted investment universe, gold is in demand among Chinese investors

While institutional demand is significant, its volume remains second to private purchases. In this space, Chinese and Indian consumers remain the key players (Exhibit 6). Yet incentives to invest in gold have clearly risen for Chinese buyers, given weaker growth prospects and the underperformance of China's equity market. Neither is an improvement of China's housing market in sight. Sharp capital controls and the absence of viable investment alternatives make gold bars and coins an appealing safe haven for Chinese investors. In addition, the opportunity cost of holding gold is comparatively low for Chinese investors, given low interest rates. As a result, the Shanghai-London gold premium has recently risen to elevated levels (Exhibit 7).

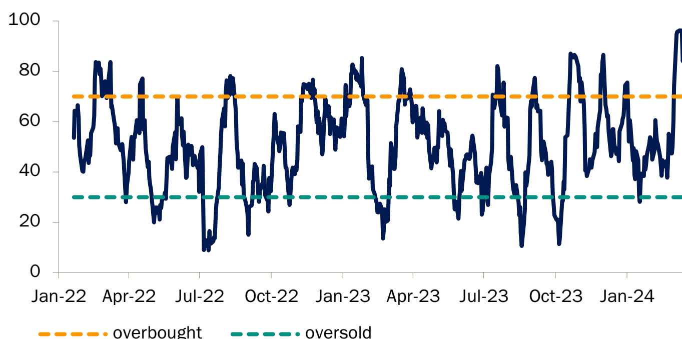
Exhibit 7: The China gold premium has repeatedly risen to $100

China gold premium, USD per ounce

Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Exhibit 8: Relative Strength Index (RSI) indicates gold is stretched

Gold, USD per ounce, RSI 14d



Source: Macrobond, Bank J. Safra Sarasin, 14.03.2024

Indian consumers could make a difference to physical demand as the economy matures

In contrast to China, India's macro dynamics continue to be strong with GDP growing at more than 6% in 2023. Given the significance of the Indian market for the demand for jewellery, we believe that India's growth dynamics should turn into an increasingly important structural driver of the gold price. Putting these pieces together, we expect higher structural demand from Emerging Markets to support gold at elevated levels throughout the year. Yet some caution is warranted in the near term, given that the metal looks overbought from a tactical perspective (Exhibit 8).

J. Safra Sarasin

Cross-Asset Weekly

15 March 2024

Economic Calendar

Week of 18/03 – 22/03/2024

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 18.03.2024						
US	13:30	New York Fed Services Bus. Act.	Mar	Index	--	-7.30
Tuesday, 19.03.2024						
JN	03:30	BOJ Policy Balance Rate	Mar19	%	-0.10%	-0.10%
	03:30	BOJ 10-Yr Yield Target	Mar19	%	0.00%	0.00%
GE	11:00	ZEW Survey Expectations	Mar	Index	--	19.90
US	13:30	Building Permits	Feb	1'000	1500k	1470k
	13:30	Housing Starts	Feb	1'000	1430k	1470k
Wednesday, 20.03.2024						
UK	08:00	CPI mom	Feb	mom	--	-0.60%
	08:00	CPI Core YoY	Feb	yoy	--	4.00%
	08:00	RPI MoM	Feb	mom	--	-0.30%
	08:00	RPI YoY	Feb	yoy	--	4.90%
US	13:00	MBA Mortgage Applications	Mar15	wow	--	7.10%
	20:00	FOMC Rate Decision (Upper B)	Mar20	%	5.50%	5.50%
Thursday, 21.03.2024						
JN	00:50	Jibun Bank Japan PMI Mfg	Mar	Index	--	47.20
GE	09:30	Germany Manufacturing PMI	Mar	Index	--	42.50
EU	10:00	Eurozone Manufacturing PMI	Mar	Index	--	47.10
UK	10:30	UK Manufacturing PMI	Mar	Index	--	47.50
	13:00	Bank of England Bank Rate	Mar21	%	--	5.25%
US	13:30	Philadelphia Fed Bus. Outlook	Mar	Index	-2.50	5.20
	13:30	Initial Jobless Claims	Mar16	1'000	--	209k
	14:45	US Manufacturing PMI	Mar	Index	--	52.20
	15:00	Leading Index	Feb	mom	-0.30%	-0.40%
Friday, 22.03.2024						
JN	00:30	Natl CPI YoY	Feb	YoY	2.90%	2.20%
	00:30	Natl CPI Ex Fresh Food YoY	Feb	YoY	2.90%	2.00%
GE	10:00	IFO Expectations	Mar	Index	--	84.10

Source: Bloomberg, J. Safra Sarasin as of 14.03.2024

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W (bp)	Δ YTD (bp)	TR YTD in %
Swiss Eidgenosse 10 year (%)	0.79	9	9	-0.1
German Bund 10 year (%)	2.43	16	40	-2.7
UK Gilt 10 year (%)	4.09	10	55	-3.1
US Treasury 10 year (%)	4.27	20	40	-2.2
French OAT - Bund, spread (bp)	45	0	-9	
Italian BTP - Bund, spread (bp)	128	-4	-40	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11,721	18.7	1.8	6.5
DAX - Germany	17,942	12.9	0.6	7.1
MSCI Italy	1,076	9.2	1.3	11.9
IBEX - Spain	10,491	10.7	1.7	4.3
DJ Euro Stoxx 50 - Eurozone	4,993	14.2	0.4	10.8
MSCI UK	2,222	11.4	0.8	1.3
S&P 500 - USA	5,150	21.4	-0.1	8.3
Nasdaq 100 - USA	18,015	26.7	-1.5	7.3
MSCI Emerging Markets	1,049	14.7	1.9	2.8

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.88	6.0	0.9	5.1
EUR-CHF	0.96	4.4	0.3	3.6
GBP-CHF	1.13	5.3	-0.1	5.2
EUR-USD	1.09	5.5	-0.5	-1.4
GBP-USD	1.27	6.0	-0.9	0.1
USD-JPY	148.1	8.5	0.7	5.0
EUR-GBP	0.85	4.1	0.4	-1.5
EUR-SEK	11.27	5.5	0.8	1.1
EUR-NOK	11.52	7.0	1.0	2.6

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	99	7.8	1.6	0.8
Brent crude oil - USD / barrel	86	23.0	0.8	10.2
Gold bullion - USD / Troy ounce	2,170	10.8	0.5	5.2

Source: J. Safra Sarasin, Bloomberg as of 14.03.2024

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