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Vontobel

US Investors' Outlook

Budding hope

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Editors
Vontobel editing team

G.J. Midge Brown
Business Developer,
Vontobel SFA

Authors*
Dr. Pascal Köppel
Chief Investment Officer (CIO),
Vontobel SFA
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA
Christoph Windlin
Deputy Head Investment Management,
Vontobel SFA
Markus Bruhin
Head Managed Solutions,
Vontobel SFA
Matthias Ribback
Portfolio Manager,
Vontobel SFA

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Vontobel

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Budding hope

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

Dear readers,

Central banks once again attracted significant attention in March. Following strong economic data reports and with inflation data coming in above market expectation in the US, the market was very concerned as to whether the Fed would reduce the number of rate cuts projected for 2024, according to the famous dot plot. This was not the case, even though the growth and inflation outlook was raised somewhat. Dovish undertones were detected at the press conference that followed the FOMC meeting, with chairman Powell highlighting that positive inflation surprises were not changing the path of slowing inflation. The door to a rate cut towards the end of Q2 seems to be wide open.

However, the Fed or even the ECB are not the first among the G10 central banks to cut rates. The Swiss National Bank (SNB) reduced rates already at its March meeting. Arguably, Switzerland is in a somewhat different place. Core inflation there has already slowed to 1.1 percent and given the strength of the Swiss franc towards the end of last year, the SNB is trying to stem the currency's strength. Although the Swiss franc has weakened in the short run it is expected to revert to its long-term trend of gradual appreciation in the medium term. On the one hand, low structural inflation contributes to a gradual appreciation to keep the real effective exchange rate stable. On the other hand, underlying Swiss fundamentals are strong, with a strong fiscal position and a structural current account surplus. This reinstates the safe haven position of the Swiss franc in case of sudden market turbulence.

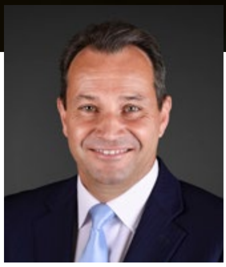
On the macro side, economic developments continue to improve. US economic activity is holding up well and global leading indicators and regional economic data in Europe are signaling that the global economy continues to prosper. Up until last month, China was the odd one out, with persistent economic underperformance. However, it too delivered a batch of positive surprises on economic activity last month. This has led to a relatively rare situation where all the key regions are showing positive economic surprises.

China also held its annual meeting of the National People's Congress early last month, sending out a message that the country was now focused on growth following years of putting geopolitical priorities and security in the spotlight. The government kept its GDP growth target for 2024 at around 5 percent, unchanged from the previous year, and pledged to transition to advanced manufacturing and efforts to mitigate risks in its real estate market. It also set its consumer inflation target at 3 percent.

We believe this might be the first sign that Chinese officials recognize the need to pay more attention to the economy again. While investors have been disappointed by the lack of major support measures so far, we believe the 3 percent inflation target cannot be reached without fiscal stimulus, structural reform or monetary impulse. Although it is up to the Chinese officials to decide on which steps to take, it seems clear to us that they will have to deliver some kind of policy support.

Some pundits like to refer to the sickness of Europe. But how "sick" is Europe really? What are the chances of a cyclical upturn? This question we try to answer in our market highlight. What is clear to us is that Europe is underestimated by many US investors.

All in all, more green shoots are appearing outside of the US. With the slowdown in the US being less pronounced than many had previously thought, the global macro environment has become constructive for risky assets, while still allowing central banks to reduce some of their monetary policy tightening stance as we head into spring.



—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

Springing forth

While US Federal Reserve (Fed) and European Central Bank (ECB) policymakers assessed the economic environment and contemplated the timing of interest-rate cuts, the Swiss National Bank (SNB) forged ahead, becoming the first major central bank to ease its monetary policy. The move weakened the Swiss franc, therefore achieving one of the reasons for the rate cut. Meanwhile, the Bank of Japan, "the last dove standing", delivered its first rate hike in 17 years, ending its negative-interest era and scrapping its controversial yield curve control policy that has been in place since 2016.

While recent inflation data came in stronger than expected in the US, we do not expect it to pose much of a problem this year. Fed Chair Jerome Powell seems to share that view, stating that the underlying story has not changed. The Fed still expects to cut interest rates three times by the end of 2024.

The Fed also updated its growth outlook. It now expects the world's biggest economy to grow by 2.1 percent in 2024, well above its December forecast of 1.4 percent. Markets have moderated their rate cutting expectations but assume the Fed will deliver on its current statements. The ECB is also expected to deliver its first cut by late spring.

We consider the Chinese government's 5 percent growth target and the 3 percent inflation goal to be quite ambitious. The former is up against challenging base effects, while the latter seems even more difficult to achieve, considering China is currently flirting with deflation rather than inflation. We expect more fiscal stimulus in the months ahead.

Find details about our asset allocation stance on page 5.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity	→					We are keeping cash at a significant underweight, as we see room for bonds and equities to outperform versus cash.
2 Bonds				→		The outlook for high quality fixed income remains supportive. We remain overweight in investment grade (IG) credit. This supports our belief that current spreads offer a fair value risk-adjusted expected return, provided the global economy can avoid a severe downturn. We remain underweight in high-yield bonds. In our opinion, companies with weaker balance sheets and a greater dependence on external borrowing are more at risk, and their bond prices and spreads over higher quality bonds do not compensate for that risk. We should see lower 2-year and 10-year rates in the quarters ahead and therefore recommend extending duration in investment grade bonds.
3 Equities				→		We are keeping equities at a medium overweight. The macro environment has become more favorable overall for equities. We are seeing improved momentum in the global manufacturing sector, while the downside risks to the US economy continue to fall. Investor sentiment is high but not at extreme levels. Furthermore, investors' appetite for risk and equity overweights are moderate in a long-term historical context. Regionally, we prefer the euro area and Switzerland, while the UK remains an underweight in our tactical allocation.
4 Commodities / Gold			→			We maintain a positive view on gold. The yellow metal rallied strongly last year. Lower interest rates, higher geopolitical uncertainties and continued strategic buying of gold, especially by emerging market central banks, will be positive drivers of gold in 2024.

Changes month-on-month: same → higher ↗ lower ↘

A European spring?

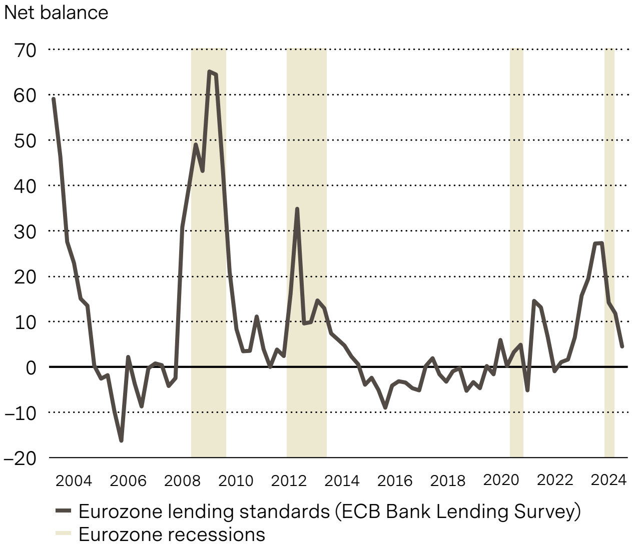
Popular media often like to refer to the "sick man of Europe" when referring to the underperformance of the European economy. In 2022 and 2023, a whole armada of "men" seemed to be suffering: Germany, Europe's largest and heavily export-driven economy, was weighed down by weak demand from abroad, the aftermath of the 2022 energy crisis after Russia's invasion of Ukraine. Challenges in the domestic real estate market and repeated protests were also factors. France and Italy also struggled with subdued industrial demand and workers going on strike. But how sick is Europe really or is it, as Germany's finance minister Christian Lindner said about Germany, in need of a "good cup of coffee"? What are the chances of a cyclical upturn?

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

After two years of below-average growth, the region's economy has recently appeared to have stabilized somewhat. There are several reasons for this. On the one hand, the worst effects of higher interest rates seem to be behind us. According to the European Central Bank's euro area bank lending survey (BLS), European banks have significantly relaxed their lending standards in the last few months (see chart 1). At the same time, banks are expecting higher demand for credit in the second half of the year.

Lower inflation is a further tailwind. European producer prices have been in negative territory for months and fell by a further 8.6 percent year-on-year in January. This was partly due to significantly lower energy prices. Consumer prices are also on the right track, rising "just" 2.6 percent in February. However, inflation on certain expenditure items, such as services, remain stubbornly high at just under 4 percent. Services are considered the most complicated component of inflation, as wage growth in labor-intensive production is passed on with a considerable time lag.

Chart 1: Eurozone banks have significantly eased lending conditions



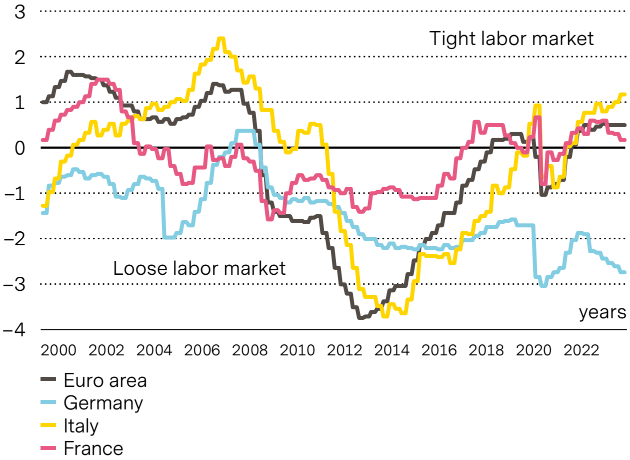
Source: LSEG, Vontobel; data as of March 15, 2024.

Room for a cyclical improvement
While lower interest rates and decreased inflation should provide a boost to the economy, there is little support from the fiscal side. According to the International Monetary Fund (IMF), European heads of state, unlike their American counterparts, are exercising fiscal restraint. This can be observed, for example, in the fact that the fiscal impulse has been shrinking for two years.[1] While private consumption in the US has repeatedly surprised on the upside and proven to be extraordinarily resilient, the story

[1] The fiscal impulse is a key figure, expressed as a percentage of gross domestic product, which measures the change in the fiscal budget and its impact on the economy.

Chart 2: Tightness of labor market (Natural rate of unemployment – / – current unemployment rate)

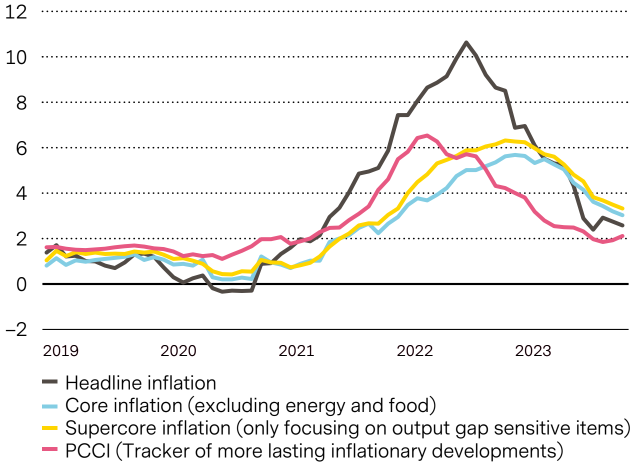
% pts



Source: Bloomberg, Vontobel SFA

Chart 3: Core inflation measures are easing steadily

Year-on-year percentage change



Source: LSEG, Vontobel; data as of March 15, 2024.

looks very different across the pond, where private consumption experienced a setback. That said, labor markets remain tight in most of the eurozone (see chart 2) and real consumer income should improve as inflation slows further. According to the consumer confidence survey of the European Commission, consumers too are becoming more positive about their current and expected financial situation. Consumer confidence itself has significantly improved from the lows of 2022.

However, most of the cyclical support that we see coming through in leading indicators and economic data surprise indices is more linked to the global economic environment. The indicative improvement of the global manufacturing sector should particularly benefit Germany, the laggard within the euro area over the past year. The euro area composite PMI has improved to 49.9 points, which indicates that we should see growth again soon in the euro area in general.

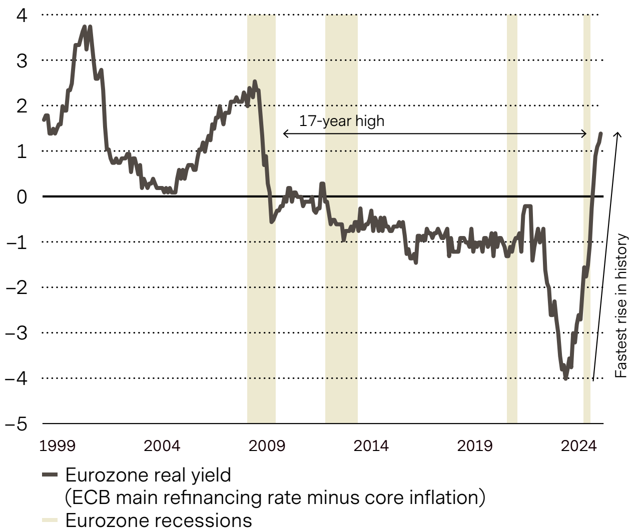
ECB will probably start cutting rates in June

The ECB is in no hurry to cut interest rates, with ECB President Christine Lagarde repeatedly referring to continued robust wage growth. As usual, the ECB tends to err on the safe side (moving too late rather than being surprised by another inflation acceleration). Lagarde, along with many of her colleagues, therefore wants to wait for wage data to be published in the second quarter. Her comment that we will know "a little bit" in April and "a lot more" in June could point to an initial interest-rate cut in June.

In our view, this fixation on wages is misplaced. Firstly, wages are one of the most lagging indicators. The recent strong rise in wages can be viewed as a kind of catch-up process for real income (i.e., income adjusted for inflation).

Chart 4: Real yields continue to rise (now due to lower inflation)

In %



Source: LSEG, Vontobel; data as of March 15, 2024.

This is because wages typically only react to past inflation. We believe the ECB should not get too hung up on wages. Secondly, certain core inflation measures developed by the ECB itself have already returned to the 2 percent inflation target (see chart 3).[2] Thirdly, a look at real interest rates (ECB refinancing rate minus core inflation) also shows that it is time for interest rate cuts: for as long as the ECB does not cut rates, monetary policy only gets tighter in an environment of falling inflation (see chart 4).

[2] One example is the Persistent and Common Component of Inflation indicator (PCCI), which measures underlying, persistent inflation, according to the ECB.

First stirrings of easing

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

The unexpected rate cut by the SNB cemented expectations for a worldwide easing of monetary policy, beginning late spring. Traders are therefore now putting greater odds on a rate cut by the ECB in June, followed by the Fed and then the Bank of England (BoE). This prospect gives the bond market a boost in the wake of the most recent Fed meeting.

During its March meeting, the Fed kept the federal funds rate target range unchanged and continued to signal that three rate cuts of 25 basis points each are the most probable course of action for 2024, despite recently stronger inflation. The summary of economic projections released after the Federal Open Market Committee (FOMC) meeting was adjusted in line with market expectations on the economic variables. This means that the growth and inflation estimates were revised up while the unemployment estimate was revised down. Many market participants were concerned that the median FOMC forecasts on rate cuts this year would be lowered as a result. However, this did not happen, thereby making the outcome of the meeting more dovish.

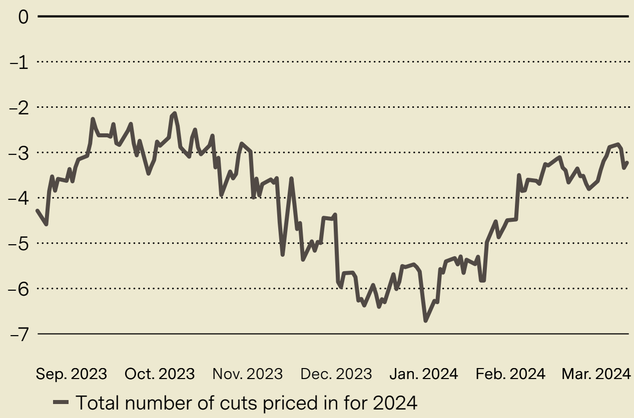
Also, the press conference after the meeting had dovish undertones and showed that policymakers expect interest rates to decline this year. The FOMC is poised to start reducing rates in June if the inflation picture continues to make headway in the right direction.

While incoming data remains strong, it is not strong enough to propel yields meaningfully higher from here, especially at a time when the Fed is biased to ease. Bond yields are supported again this year and reflect a much more realistic number of Fed rate cuts. The market is now fully aligned with the Fed in expecting three cuts this year (see chart 1). The longer the Fed keeps policy on hold, the greater the impact on the economy; hence, we are retaining our bias towards lower yields. Against this backdrop, we are maintaining a preference for investment grade bonds with an overweight position. At current levels, investment grade bonds provide protection and offer an asymmetric payoff—meaning there is a greater probability of profit rather than loss.

Navigating tight spreads: a case for caution in high risk credit markets
We continue to prefer high quality bonds. Spreads have tightened significantly in the high yield segment of the corporate bond market. They have only been tighter than current levels on a mere 6 percent of trading days in the last 25 years (see chart 2). We find this makes it hard to justify taking on extra risk in this segment of the fixed income market and we believe investors are not compensated here for that additional risk. This supports our preference for being underweight high yield.

Chart 1: Markets correct towards Fed's forecast as investors see three cuts in 2024

Number of cuts

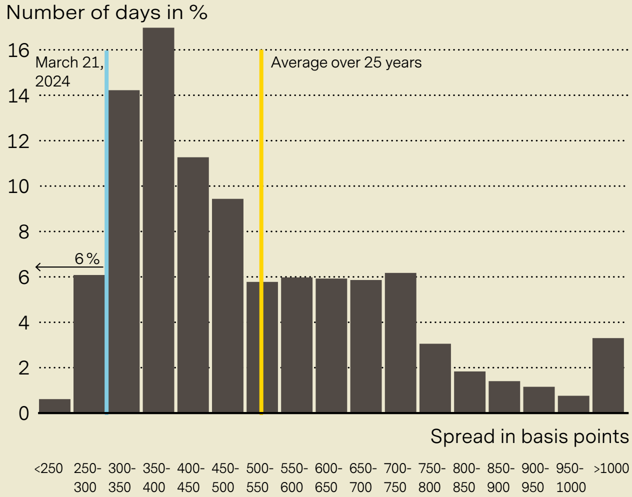


Note: Negative numbers reflect the expected number of interest-rate cuts of 25 basis points each.

Source: Bloomberg, Vontobel; data as of March 21, 2024.

Chart 2: Number of days traded in the respective range for high-yield bonds in the last 25 years

Number of days in %



Source: Bloomberg, Vontobel; data as of March 21, 2024.

Equity markets in full bloom

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

Despite lingering concerns surrounding inflationary pressures, geopolitical tensions and the uncertain trajectory of interest rates, equity markets have continued to move higher. Strong corporate earnings reports, especially in the US, and the perceived approach of central banks' policy shifts are fueling investor optimism.

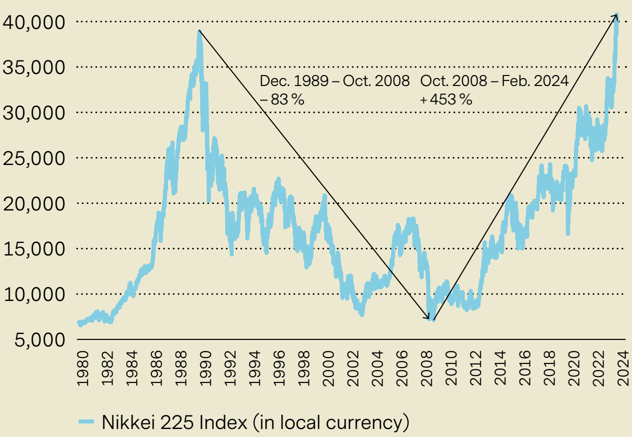
Various indexes have flourished and reached milestones: the MSCI All Country World Net Total Return Index surpassed its all-time high of December 2021; the S&P 500 Index made history by crossing the 5,200-mark for the first time ever. And at the end of February, the Nikkei 225 Index finally surpassed its historic 1989 record (see chart 1).

The rally broadened further last month, driven by a better-than-expected reporting season. Earnings per share growth, excluding the energy sector, was positive for the US and Europe and higher than in Q3 2023. Company commentaries showed a more positive view on the economy, an improved guidance outlook, a strong commitment for share buyback as well as dividend announcements and increased capital expenditure intentions.

Where do we stand now?
Investors need to consider the drastic fundamental and structural change in equity markets that has occurred over the past two decades. Taking the US technology sector as an example, the emergence of new structural megatrends resulted in stronger revenue growth, higher margin contribution and free cash flow generation, which led to excess cash positions often being returned to shareholders within the scope of buybacks. This environment can hardly be compared with the dot.com bubble in 2000 (see chart 2). By way of an example, even as Nvidia has become a USD 2 trillion company, its forward price-to-earnings ratio has come down sharply.

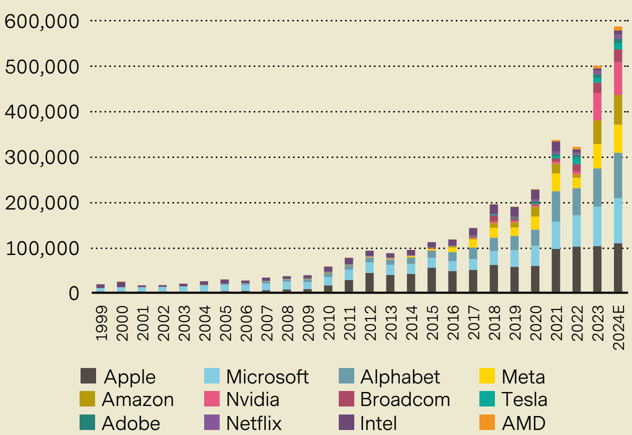
Global headwinds such as trade disruptions due to geopolitics and stubbornly weak Chinese economic growth remain a drag on global activity. However, rate cuts have historically tended to precede improving data. We believe it is reasonable to expect that easing financial conditions will further lift activity momentum as we go through the year. As outlined in our last Investors' Outlook, we believe Europe still offers attractive risk-reward and diversification effects in a global context, given our expectation of a pickup in activity. China matters a lot to Europe, and while there is still no decisive stimulus, the market has stabilized, and expectations are low. We remain moderately overweight in equities. Find the details of our asset allocation on page 5.

Chart 1: The Nikkei 225 at a record after more than three decades



Source: LSEG, Vontobel; data as of March 21, 2024.

Chart 2: Cumulative profit for the top 12 largest tech/mega-caps in the US



Source: LSEG, Vontobel; data as of March 21, 2024.

Recovery across commodities

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

Oil prices received a geopolitical boost in March (see chart 1). The wind seems to be shifting increasingly in Russia's favor and Western support for Ukraine is waning. The latter has stepped up its attacks on Russian oil infrastructure and has attacked numerous oil refineries.

The resulting reduction in Russian refinery capacity is exacerbating the situation for oil products. If Russia cannot process its crude oil, its stockpiles will rise. Russia has already announced that it will increase its oil exports. This is positive for oil products; not necessarily for oil per se, but more for supply. In the absence of any escalation of the conflict, WTI oil can remain above USD 80 per barrel.

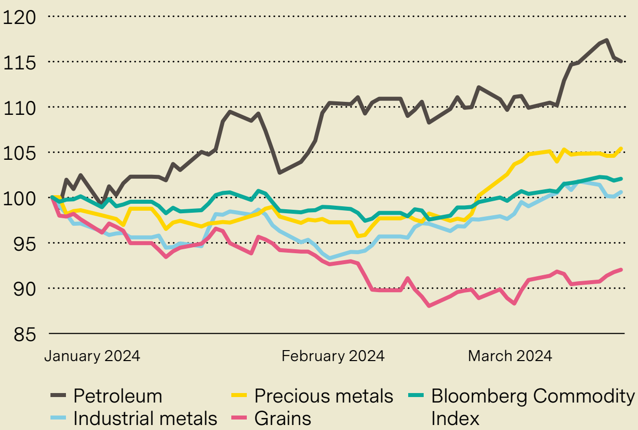
Copper recover for now
The recent rise in copper prices was primarily driven by a supply threat. After it was announced that loss-making Chinese copper smelters had jointly agreed to cut output, the red metal briefly approached the USD 9,000 threshold. However, no concrete details were provided and the rally lost momentum again. There are still headwinds on the demand side. Investments in the Chinese real estate sector, which is important for copper, fell 9 percent in the January-February period. A look at the significant rise in Chinese inventories also raises questions (see chart 2). Without significant stimulus or supply shocks, the upside potential is likely to be limited.

Gold shines
The price of gold reached an all-time high of more than USD 2,200 per Troy ounce in March. While global gold exchange-traded funds (ETFs) have long struggled with outflows – investors withdrew around USD 2.9 billion in February alone, according to the World Gold Council—this was more than offset by unabated strong demand from central banks. China's central bank (PBoC) stands out in particular: it bought gold (+390,000 troy ounces) in February for the 16th consecutive month and is now sitting on around 72 million troy ounces.

China's consumers have also made bold purchases despite the elevated prices. One possible explanation could be the country's economic situation. While future central bank demand is difficult to predict (and data on this is published with a lag), gold is likely to benefit from the prospect of a weaker US dollar and lower US real interest rates. Elevated geopolitical uncertainty and tension may also potentially provide additional support to the gold price this year.

Chart 1: Commodities' year-to-date performance

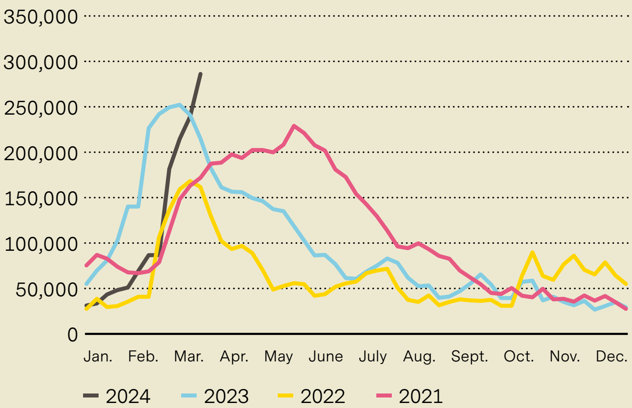
Rebased to 100 = start of 2024



Source: LSEG, Bloomberg, Vontobel; data as of March 21, 2024.

Chart 2: Chinese copper inventories suggest muted demand

Shanghai copper inventories in tons



Source: LSEG, Vontobel; data as of March 21, 2024.

The Swiss National Bank rings in the rate-cut season

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

The Swiss National Bank (SNB) took a preemptive step by reducing its key interest rate by 0.25 percentage points on March 21, setting the new policy rate at 1.5 percent from previously 1.75 percent. This decision placed the SNB ahead of its global counterparts, which are expected to follow with similar rate cuts in the near future.

The move came as a surprise to many analysts, who had predicted that the central bank would keep its policy rate steady at 1.75 percent. SNB President Thomas Jordan noted that effective measures to tame inflation over the last two and a half years facilitated the step. Furthermore, the SNB lowered its inflation forecast to 1.45 percent for 2024, down from its December prediction of 1.9 percent.

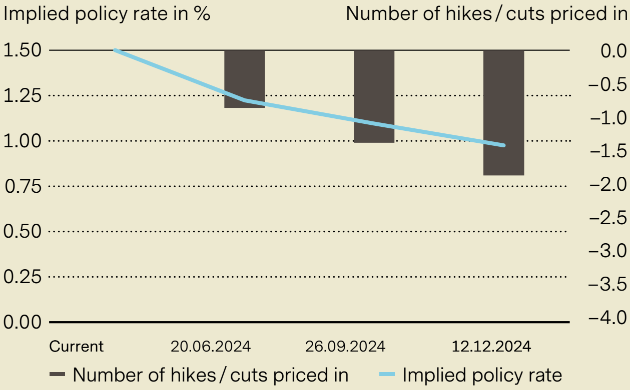
Historically, the SNB has not shied away from stunning the market with sudden moves and this rate cut could be seen as a continuation of that trend. Previous noteworthy moments include dropping the Swiss franc's cap against the euro in 2015 and the unexpected 50 basis-point rise in borrowing costs in 2022. The SNB's policy path for the remainder of the year suggests a bias towards further easing, with currently close to two further cuts priced in (see chart 1). This would bring the policy rate to 1 percent by the end of the year.

The negative momentum for the Swiss franc may last a little longer, however, this very much depends on investor sentiment. Fundamentally, we see mainly upside potential in the longer run and would rather lock in these weak levels. Currencies are currently largely driven by central bank action. However, the market has already priced another 0.5 percentage point rate cut for this year, which would take the policy rate to the lower end of the SNB neutral range. Other central banks still have to start cutting and will likely cut more than the SNB. In other words, central bank momentum may turn more in the favor of the Swiss franc during spring / summer. In the longer run, we see factors that will contribute to a sustained appreciation of the franc. The relatively low structural inflation rate in Switzerland compared to other regions will enable a steady appreciation trend. Furthermore, the sound fiscal position and structural current account surplus will provide support, especially when market volatility increases.

Yen still significantly undervalued

The Bank of Japan's decision to end its negative interest rate policy may also lead to the beginning of a recovery of the yen. Over the past years, there has been a significant shift in the valuation of the yen away from fair value (see chart 2). While the BoJ hike is probably not enough to get this process going, it is likely to gain momentum as soon as other central bank start to lower rates. This may trigger a correction in investor positioning, which is still significantly underweight in yen.

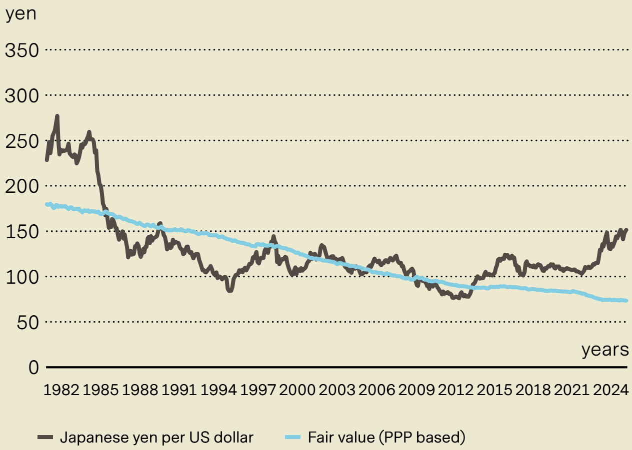
Chart 1: Implied overnight rate and number of hikes and cuts



Note: Negative numbers represent priced in cuts, while positive numbers would represent priced in hikes (no hikes are currently priced in)

Source: Bloomberg, Vontobel; data as of March 21, 2024.

Chart 2: Japanese yen vs US dollar compared to fair value



Source: Bloomberg, Vontobel SFA

Economy and financial markets 2022 – 2025

The following list shows the actual values, exchange rates and prices from 2022 to 2023 and consensus forecasts for 2024 and 2025 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates, and commodities.

GDP (IN %)	2022	2023	CURRENT[1]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	2.9	3.1	3.1	2.5	2.6
Eurozone	3.4	0.4	0.1	0.5	1.4
USA	1.9	2.5	3.1	2.1	1.7
Japan	1.0	1.9	1.2	0.7	1.1
UK	4.5	0.3	–0.2	0.3	1.2
Switzerland	2.7	0.7	0.6	1.2	1.5
Australia	3.8	1.9	2.1	1.4	2.3
China	3.0	5.2	5.2	4.6	4.3

INFLATION	2022	2023	CURRENT[1]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	7.5	4.5	3.6	5.3	3.3
Eurozone	8.4	5.5	2.6	2.4	2.1
USA	8.0	4.1	3.2	2.8	2.4
Japan	2.5	3.3	2.2	2.3	1.8
UK	9.1	7.3	3.4	2.5	2.1
Switzerland	2.8	2.2	1.2	1.5	1.2
Australia	6.6	5.7	4.1	3.3	2.8
China	2.0	0.2	0.7	0.8	1.6

KEY INTEREST RATES (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	2.50	4.50	4.50	3.60	2.80
USD	4.50	5.50	5.50	5.25	4.20
JPY	–0.10	–0.10	–0.10	0.01	0.10
GBP	3.50	5.25	5.25	5.10	3.85
CHF	1.00	1.75	1.50	1.52	1.06
AUD	3.10	4.35	4.35	4.35	3.70
CNY	3.65	3.45	4.35	4.25	–

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	2.6	2.0	2.43	2.18	2.09
USD	3.9	3.9	4.28	3.97	3.73
JPY	0.4	0.6	0.74	0.86	0.95
GBP	3.7	3.5	3.99	3.82	3.56
CHF	1.6	0.7	0.72	0.83	0.83
AUD	4.1	4.0	4.09	4.06	3.78

FOREIGN EXCHANGE RATES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
CHF per EUR	0.99	0.93	0.98	0.97	1.00
CHF per USD	0.94	0.84	0.90	0.89	0.89
CHF per 100 JPY	0.72	0.60	0.59	0.61	0.64
CHF per GBP	1.12	1.07	1.14	1.12	1.14
USD per EUR	1.06	1.10	1.09	1.09	1.11
JPY per USD	130.00	141.00	151.00	145.00	139.00
USD per AUD	0.67	0.68	0.66	0.67	0.69
GBP per EUR	0.88	0.87	0.86	0.86	0.86
CNY per USD	6.91	7.10	7.20	7.15	7.10

COMMODITIES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	86	77	86	83	83
Gold, USD per troy ounce	1,824	2,063	2,188	2,050	2,100
Copper, USD per metric ton	8,372	8,559	8,928	8,500	9,182

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of March 21, 2024

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Vontobel Swiss Financial Advisers AG
Gotthardstrasse 43
8022 Zurich
Switzerland

vontobel.com