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US Investors' Outlook

Cut! That's a wrap

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Gotthardstrasse 43
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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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Cut! That's a wrap

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

Dear readers,

Financial markets concluded 2023 on a positive note with an impressive year-end rally in equities, bonds and gold. As part of that process, the US dollar suffered a loss. At the start of this year, investors are reviewing the challenges they face in the year ahead.

The resilience of the US economy was evident in the second half of 2023. The US labor market held up well and real wage growth actually improved on the back of normalizing inflation. The January employment report confirmed that the labor market is still in a very good shape. Consumers' real purchasing power continues to grow at a solid rate. Businesses have strong balance sheets and have been careful with their capital expenditure plans. They have even been able to reduce their net interest payments, despite significant monetary policy tightening.

The weakening of some of the growth drivers, such as fiscal stimulus, will eventually lead to a slowdown in US economic growth. While the average consumer and business seem to be coping well so far with higher interest rates, they will eat into their income and earnings over time. That said, given the strong fundamentals and starting point, growth will probably only slow down to somewhat below trend.

We can expect many uncertainties in 2024. In addition to economic uncertainties, there are elevated geopolitical tensions and several elections on the cards. Of course, we also have the unknown unknowns. US commercial real estate, for instance, is one of the areas we are keeping an eye on as a potential risk factor and the impact it can have on the financial system.

It is important for investors to focus on asset fundamentals and monitor how they can be impacted by risks. Although diversification is always important, we see a relatively high level of uncertainty in 2024. Fixed income remains attractive. We expect lower bond yields this year, supported by declining inflation and scope for central banks to lower rates. On top of that, high-quality bonds provide protection in case the slowdown in growth is more than is currently expected.

In addition to diversification across assets, it is also crucial across geographical markets. This was highlighted in the last two months of 2023; when markets accelerated and the US dollar weakened, international stocks outperformed US assets in US dollars. For instance, where the MSCI North America Index increased by 14.2 percent in those months, the MSCI EMU Index rose by 16.5 percent and the Swiss Leader Index by 18.3 percent.

Although European economic growth was soft in 2023, the European equity universe offers some strong companies that command a unique global position in their segment and can offer high growth in the future. In the last few years, they have also significantly outperformed the wider European equity indices in terms of overall performance, earnings and revenue growth. We have labeled this group of companies the Magnificent Seven of Europe. In addition to strong growth, these stocks and the broader European equity indices offer significant diversification benefits to US investors. The European sector composition has a much lower exposure to the technology sector. Currency differentiation also lowers the vulnerability to US dollar underperformance.

This year is poised to be an eventful one. As an active manager, we are ready for the bird's eye view and the close-up of the important topics, and can handle any plot twists 2024 may throw at the world.

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

Ongoing macro and geopolitical uncertainty

Things don’t always turn out as expected and 2023 served as yet another reminder of that. Among the events that caught investors off guard were the shock-waves rippling through financial markets, triggered by inconspicuous names such as Silvergate Capital and Silicon Valley Bank, the collapse of an iconic Swiss bank, the downgrading of the US sovereign rating and Hamas attacks in Israel, followed by tensions in the Red Sea. So what might 2024 have in store?

2024 started off for the US with economic growth remaining strong while inflation continues to slow. Core PCE inflation has now eased to below 3 percent, the first time since March 2021. We also expect core inflation to continue slowing further in the coming months, which means that the Fed is moving closer to removing some of the tightening bias. Overall, we expect US growth to slow gradually to below trend, inflation to ease further and developed market central banks to start cutting rates. We see some room for improvement in other regions where growth has been weaker over the past quarters.

The moderate slowdown in US growth should coincide with a gradual recovery in growth in Europe and Asia and lead to greater convergence in growth levels.

A continued decline in inflation and the onset of monetary policy easing is positive for bonds. Although yields have declined from the October peaks, we think bonds still offer good value in a year of elevated macro and geopolitical uncertainties. Our view on the global economy remains constructive. We do not expect a recession and anticipate that corporate earnings growth will continue to hold up.

Although balance sheets are strong on a macro level, on both the consumer and business side, higher interest rates over the past two years have had a disparate effect. They impact the balance sheets of those consumers and businesses that depend heavily on external finance. We therefore have a preference for quality in our asset allocation, within fixed income and equities.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				We continue to hold an underweight in cash, as the expected returns on bonds remain more attractive.
2 Bonds				→		We are sticking with our positive view on fixed income and reconfirm all sub-asset class views. We remain overweight in investment grade (IG) credit, supporting our belief that current spreads offer a fair value risk-adjusted expected return, provided the global economy can avoid a severe downturn. We also remain underweight in high-yield bonds. In our opinion, companies with weaker balance sheets and greater dependence on external borrowing are more at risk, and their bond prices do not compensate for that risk. Lastly, we remain positive on emerging market debt, supported by an expected softening of the US dollar. This is backed by a less hawkish US central bank rhetoric and the Fed's rate pause. 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 remain neutral on equities and prefer quality on a regional level. We prefer high-quality, defensive regions such as Switzerland, which also display high earnings predictability. This is financed via an underweight in the UK, where there is significant exposure to cyclical commodities. A slowdown in growth that avoids a recession, combined with rate cuts, may not require significant earnings adjustments. This translates in a positive fundamental view on equities. However, we find that equity investor sentiment and valuations are stretched. An equity allocation in line with the strategic weight is justified.
4 Commodities / Gold			→			We maintain a positive view on gold. The yellow metal rallied strongly last year. Lower interest rates, higher economic and geopolitical uncertainties, and continued strategic buying of gold by especially emerging market central banks are positive drivers for gold in 2024.

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

A softer landing

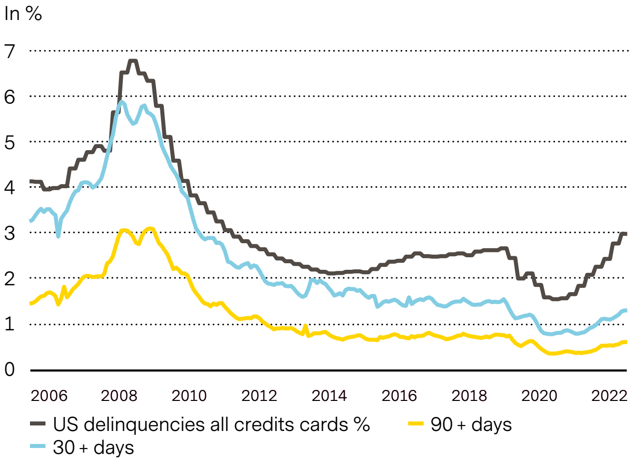
During the fourth quarter of 2023, the US economy expanded by 3.3 percent adjusted for inflation. This shows that the US economy remains strong, and, above all, exceeded the 68 forecasts polled by Bloomberg among economists. This begs the question as to whether a hard landing is still a viable option in the shorter run.

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

We were not in the recession camp during 2023; we found it was always more of a risk scenario rather than a base case. That said, we did and do anticipate a slowdown in US economic growth. In 2023, it was largely supported by fiscal stimulus and a vast pool of excess consumer savings. Government expenditure and investment increased by 4 percent in real terms and the pool of excess pandemic savings supported consumer spending.

It is well known that monetary policy lags can be long and variable. It is therefore not clear when businesses and consumers will feel the pain of higher funding costs. It will depend instead on when these are passed on, but also depends on pro-active action by consumers and businesses (lengthening maturity in time, paying down debt). That said, there are indications that the higher funding costs are impacting businesses and consumers with weaker balance sheets. For instance, credit card delinquencies are on the rise (chart 1). Companies rated BB or lower with weaker balance sheets are seeing a significant deterioration in their interest coverage ratio. In contrast, the average US business has anticipated the rise in funding costs and brought debt to a manageable level. Despite the significant increase in the Fed funds target rate and the rise of bond yields in recent years, US businesses succeeded in reducing their overall interest payments in 2023 (chart 2).

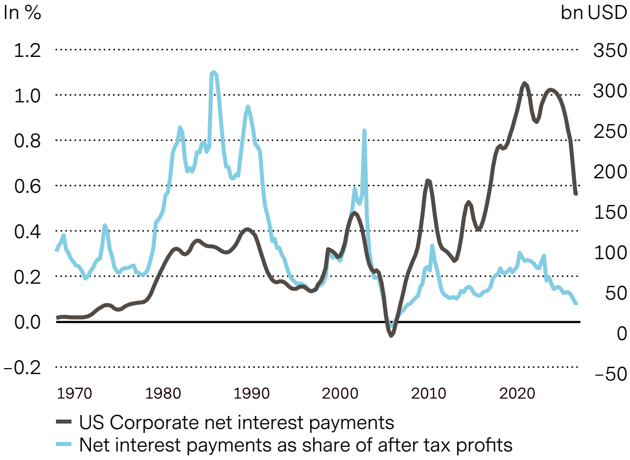
Chart 1: US Credit card delinquencies



Source: Bloomberg, Vontobel SFA

In short, we expect a slowdown in growth. The growth drivers of 2023 are losing momentum as the rise in consumer income is expected to slow on the back of a softer labor market in 2024. We do not think this will be enough to lead to a recession but are looking for sub-trend growth.

Chart 2: US Corporates net interest payments



Source: Bloomberg, Vontobel SFA

More economic convergence in 2024

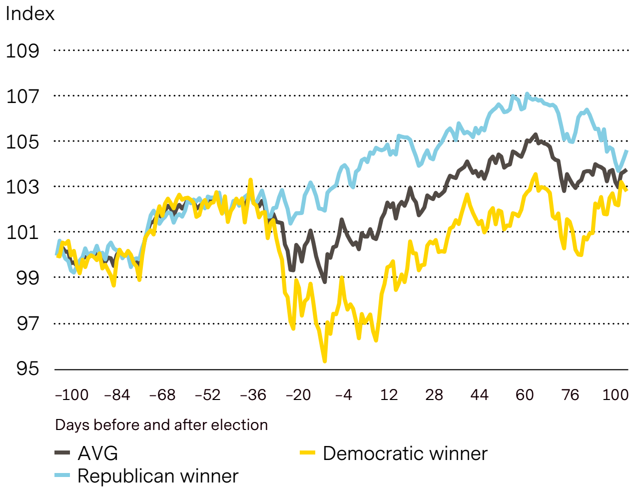
Economic growth in 2023 was unusually desynchronized in terms of sector growth and regional growth. In a typical global recession, synchronization is high as the global economy is hit hard via the trade channel (export growth), financial market channel (financial conditions) and confidence channel (consumer and producer confidence). The service sector held up well in 2023 but manufacturing was weak. Large manufacturing economies such as China and Germany lagged behind, while others such as the US continued to grow solidly. As stated above, we expect the US economy to slow but think the manufacturing sector can recover somewhat from its 2023 weakness. We also anticipate some cyclical recovery in Europe and Asia.

The known unknowns versus the unknown unknowns

From a macro perspective, we see developments that will enable a moderate economic slowdown and a recovery in Europe and Asia. The economic cycle can of course be affected by other shocks. We can categorize the shocks as known unknown and unknown unknown, with the latter (obviously) being hard to predict. An example of this unknown unknown is the mini banking crisis of 2023, which caused significant market volatility and required a significant response by central banks. Ultimately, however, it did not alter the growth path.

An example of a known unknown is the US election, where it is very hard to predict the outcome. The elections and referenda of the past 10 years have shown that both betting markets and polls have found it difficult to forecast the outcome. How relevant is the outcome for the economy and financial markets? It depends primarily on the policies of the elected government. Stimulative policies, either via more fiscal spending or lower tax rates, drive growth higher and increase corporate earnings. If the stimulus takes place in an overheating economy, this can also fuel inflation and trigger monetary policy tightening. It is far too early to make such predictions for potential US presidential candidates in the 2024 race. What we can conclude is that historically, it did not matter too much for equity markets in the longer run whether a Democratic or Republican candidate won the election. Since 1972 we have seen eight elections won by the Republicans and six by the Democrats. Even though the equity market underperformed in the months before a Democratic Party victory, the post-election performance was stronger. 100 days after the election, the equity market was essentially back at the same point as the average path of a Republican win (chart 3). Although it is important to focus on the election race and how new policies may affect equity and bond markets, it is equally important to focus on economic fundamentals. And these are still quite solid.

Chart 3: Equity performance around presidental elections since 1972



Source: Bloomberg, Vontobel SFA

A rollercoaster year for 10-year treasury bonds

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

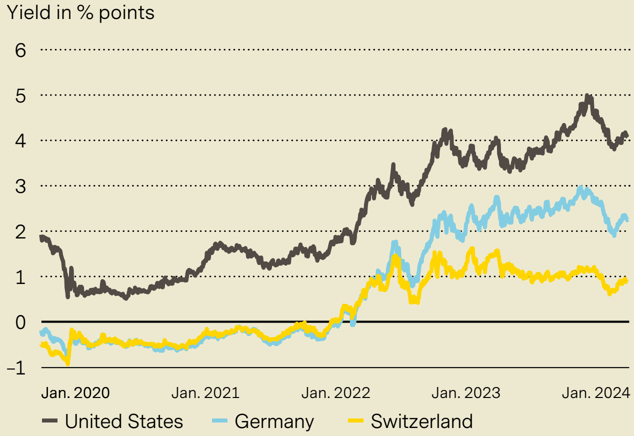
While central bank rates only knew one direction in 2023, long-term yields made one big round-trip. We suggest reallocating from money markets into medium- to long-term bonds before anticipated rate cuts become a reality.

Central banks have emerged victorious from their fight against inflation, albeit much later than everyone had wished for. The Federal Reserve combined its ability to raise short-term interest rates and reduce its balance sheet to achieve this long-awaited normalization of inflation. By summer 2023, the Fed funds rate reached 5.50 percent and has stayed on that plateau since. Other central banks such as the Bank of England, the European Central Bank or the Swiss National Bank deployed similar tactics in 2023, with all of them now expected to lower interest rates in 2024. It is important to remember that short-term interest rates are agreed upon in meetings and have little to do with market mechanisms. The situation is completely different for long-term government bond yields, where investors and market forces determine the price of borrowing. 10-year yields in USD and EUR peaked at the end of October and have fallen by roughly 100 basis points since then, returning to where they were at the beginning of 2023 (chart 1). This suggests that investors are relatively certain that inflation is back under control and that the global economy is slowing down. It also means that market participants foresee lower returns in the money market and are locking in the still elevated mid- to longer-term yields.

We agree with what markets are telling us and recommend our clients to reconsider their high cash allocations. Holding longer-term bonds offers two advantages:
1. Investors can lock in attractive yields right now without being at the mercy of central bankers.
2. Longer-term bonds act as a hedge, if the soft-landing scenario turns into a sharper economic downturn in which short- and long-term yields fall dramatically.

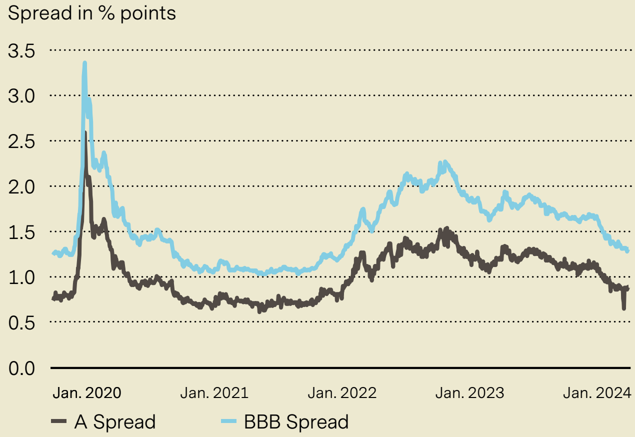
Treasuries or corporates?
Corporate bonds yield more than maturity-matched treasuries. This difference is referred to as the credit spread and it can widen or tighten depending on economic conditions. Spread widening leads to falling corporate bond prices, while spread tightening has the opposite effect. We argue that even though credit spreads tightened in 2023 as the US averted a recession, it still makes sense to favor corporates over treasuries for one particular reason: most of our clients are investors, not traders and are therefore focused more on long-term total returns rather than short-term price fluctuations (chart 2). A portfolio of corporate bonds is very likely to beat an investment in treasuries over a three to five-year period, unless credit spreads are unsustainably low and an economic crisis with a material rise in defaults is about to unfold.

Chart 1: 10-Year Government Bond Yields



Source: Bloomberg, Vontobel SFA

Chart 2: Investment grade credit spreads



Source: Bloomberg, Vontobel SFA

A memorable year for equities

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

Equity investors can look back on a remarkable year. Against all odds, equities ended up delivering great absolute return in a year in which many expected a recession, a possible second wave of inflation or one in which the bond market outperformed stocks. Global equities ended the year close to record highs.

The solid performance of equities that began in late October 2023 continued into December, albeit at a slower pace than in November. Cooling inflation and the expectation of an approaching Fed pivot were powerful catalysts, resulting in an impressive comeback and creating a reversal from what transpired in 2022 (chart 1).

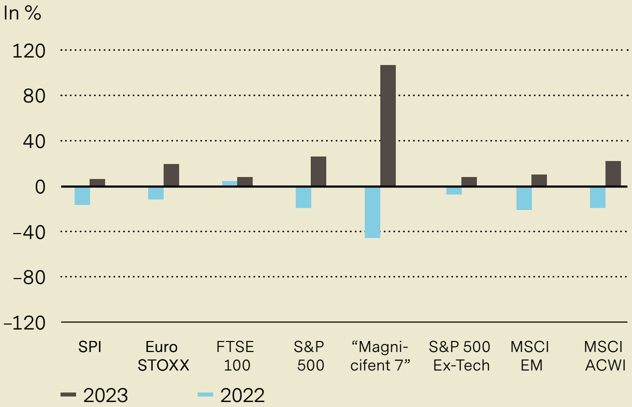
The S&P 500 Index rose more than 26 percent, while the Euro Stoxx 50 Index climbed nearly 20 percent last year. We have previously pointed to this growth being driven by few sectors, such as technology stocks, which were boosted by the increasing importance of artificial intelligence. Companies included in the Magnificent Seven delivered an absolute return of more than 100 percent. Excluding technology stocks, the return was 8 percent. Europe may lack its own Magnificent Seven tech cohort, but a pared-down version of that phenomenon has emerged spanning different sectors, such as energy, luxury goods, industrial and technology. The largest constituents in the MSCI Eurozone Index are global best-in-class companies that are capable of generating the earnings growth that appeals to investors. In addition, the eurozone benchmark remains highly international, with less than a third of its constituents' revenue generated within the euro area. Roughly 37 percent is generated in broader Europe, 22 percent in North America, 25 percent in Asia and 16 percent in emerging markets.

How are we positioned for 2024?
We remain neutrally positioned on equities. A pause in rate hikes has historically been followed by positive market reactions in the subsequent 12 months, but geopolitical risks have increased recently, levelling out a more positive stance in equity allocation. Valuations are rich but remain below their peak levels and forward earnings estimates moved roughly 15 percent lower on average over the last 12 months.

Estimated real 2024 year-on-year earnings-per-share growth is now in negative territory in most markets, implying an easy comparison base for 2024. Additionally, producer price indexes across developed markets have been trailing consumer price indices for more than a year now. Historically, this boosted margins for manufacturing industries (chart 2), which could eventually lead to positive earnings surprises.

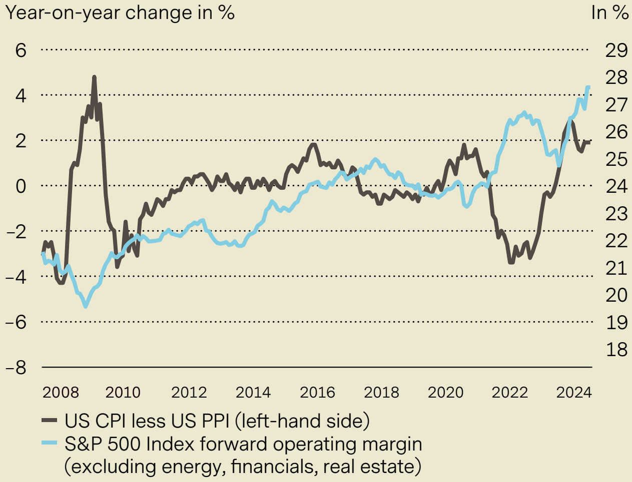
Finally, central bank pivots will be a major driver. We remain regionally diversified in our tactical allocation and continue to favour quality, high profitability and earnings predictability.

Chart 1: Comparing 2022 and 2023 absolute returns (in local currencies)



Source: Bloomberg, Vontobel

Chart 2: Consumer Price Index spread to Producer Price Index vs. operating margins



Source: Bloomberg, Vontobel

Red-hot tensions in the Red Sea

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

In 2023, oil prices were driven down by fears of a slowdown in economic growth, the output policy of the Organization of the Petroleum Exporting Countries and its allies (OPEC+) and tensions in the Middle East.

While there are some pockets of weakness, global oil consumption is back to pre-Covid levels. The problem is that there is simply too much supply. In response to the OPEC+ cartel's repeated production cuts, non-OPEC+ members have ramped up their own production (see chart 1). Some OPEC+ members, such as Iran and Russia, have also surprised markets with higher-than-expected output.

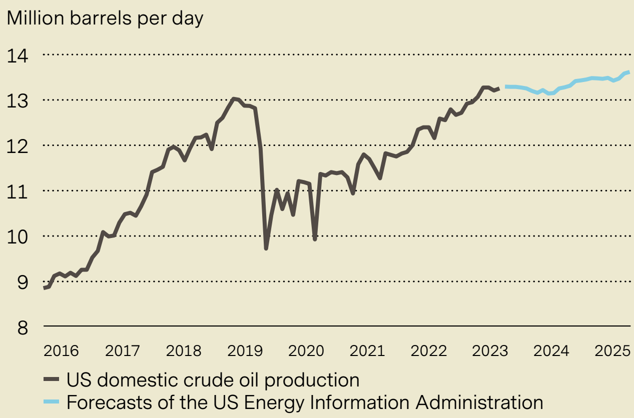
Closed waterways as a tail risk
Investors' attention has returned to the Middle East in recent weeks, where Houthi rebels' attacks on shipping vessels in the Red Sea sparked fears of an escalating conflict and disrupted trade flows. The Bab el-Mandeb Strait, which serves as a vital link between the African and Arabian Peninsulas, is a particular concern. Some 8.2 million barrels of liquids were transported via the Red Sea each day in the January-November 2023 period, according to data from analytics firm Vortexa. Breaking this figure down, 2.9 million barrels were northbound (Europe), 3.9 million were southbound (Asia) and the remainder were imports or exports within the region. Roughly 70 percent of southbound shipments were of Russian origin, according to Vortexa.

At present, southbound shipments have largely been spared. While tankers carrying Russian oil continue to sail through the Red Sea, others are rerouting around the Cape of Good Hope. This results in longer journeys (a trip from Singapore to Rotterdam now takes roughly 10 days longer) and higher costs (see chart 2).

What about the Strait of Hormuz?
It is dubbed the world's most important oil chokepoint, as more than 20 percent of global petroleum liquids for consumption flow through it. Fears have risen that Iran, which secured strategically important islands in the Strait some five decades ago, might try to limit or block access to it.

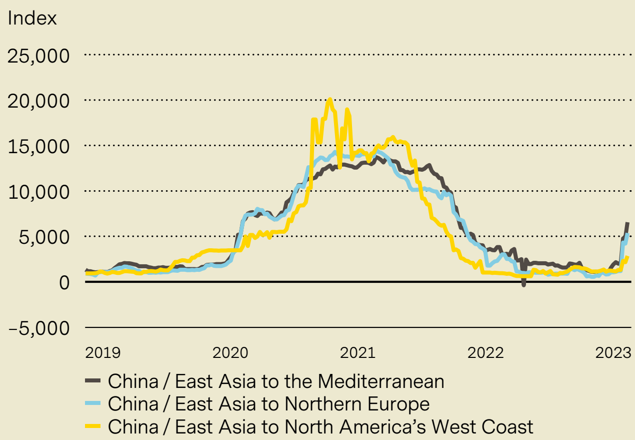
While such an escalation could push prices significantly higher, it is not our base case. Iran has repeatedly threatened to close the Strait in the past but has not followed through. Its own economy depends on it as well and Iran will also likely be mindful of its key trading partners, particularly China. In the absence of such a shock, oil should trade in the range of US dollar 70 to 85 per barrel.

Chart 1: OPEC+ cuts as an involuntary lifeline for the US oil industry



Source: LSEG, Vontobel

Chart 2: Shipping costs have picked up



Source: LSEG, Vontobel

Currency crossroads: zooming in on the US dollar and Swiss franc

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

In 2023, the US Dollar Index (DXY) experienced its first annual decline in three years as the Fed indicated that its tightening cycle was coming to an end. This shift led markets to anticipate interestrate reductions.

Overall, the DXY retreated from its high in October 2023 and closed the year 2.1 percentage points lower (see chart 1). With the onset of the new year, the US dollar gained strength after somewhat stronger data fueled expectations that the Fed won't be rushing to lower interest rates.

At its meeting on 31 January, the Federal Open Market Committee (FOMC) indicated that it is gradually moving towards easing monetary policy with a removal of the tightening bias in the policy statement. However, Fed chair Jerome Powell also made it clear that a March rate cut is "probably not the most likely case". That said, we expect to see more evidence of normalizing inflation in the coming months, which should allow the Fed to start reducing rates in the second quarter.

Ambitions for the strong Swiss francs vs. economic reality

Over the past two years, the Swiss National Bank's (SNB) desire for a stronger Swiss franc has had a major positive impact on the currency. However, as inflation starts to retreat and the economy decelerates, this goal may become increasingly questionable. The total volume of the SNB's total intervention was CHF 22 billion in 2022. However, this figure ballooned to CHF 110 billion by the end of the third quarter of 2023 (see chart 2).

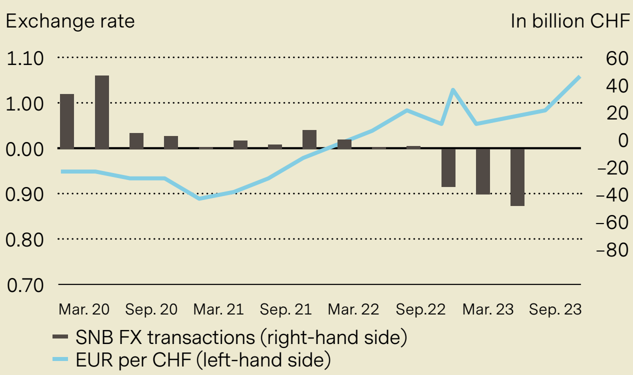
In the third quarter, the SNB marginally reduced its foreign exchange sales as the Swiss franc neared its current peaks against the euro and the US dollar. During the period from July to September, the SNB engaged in the sale of foreign currencies totaling CHF 37.6 billion, down from the CHF 40.3 billion sold in the preceding quarter.

As a rule, the SNB purchases its own currency and offloads foreign exchange reserves, thereby bolstering the exchange rate while simultaneously shrinking its substantial balance sheet. This approach has been instrumental in safeguarding Switzerland from the global surge in inflation. SNB Chairman Thomas Jordan raised concerns about the appreciating Swiss franc. Speaking at the World Economic Forum in Davos at the end of January, he highlighted the potential impact this trend could have on the SNB's capability to maintain inflation above zero in the Swiss economy. Going forward, we expect to see the SNB take a more balance approach on the currency. This means that it will prefer to keep the real effective exchange rate stable. Given the structurally lower inflation in Switzerland, this should still allow for a small nominal appreciation versus the US dollar in 2024.

Chart 1: US dollar ended 2023 lower

Source: Bloomberg, Vontobel

Chart 2: SNB continues to sell foreign currencies



Source: Bloomberg, Vontobel

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	2.7	3.4	2.2	2.5
Eurozone	3.4	0.5	0.0	0.6	1.4
USA	1.9	2.4	2.9	1.3	1.7
Japan	1.0	2.0	1.5	0.8	1.0
UK	4.5	0.4	0.3	0.4	1.2
Switzerland	2.7	0.8	0.4	1.2	1.5
Australia	3.8	1.9	2.1	1.5	2.3
China	3.0	5.2	5.2	4.5	4.3

INFLATION	2022	2023	CURRENT[1]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	7.5	4.4	3.6	5.0	3.20
Eurozone	8.4	5.5	2.9	2.3	2.10
USA	8.0	4.1	3.4	2.6	2.30
Japan	2.5	3.2	2.6	2.3	1.70
UK	9.1	7.4	4.0	2.8	2.10
Switzerland	2.8	2.2	1.7	1.6	1.40
Australia	6.6	5.7	5.4	3.6	2.90
China	2.0	0.3	–0.3	1.4	1.75

KEY INTEREST RATES (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	2.50	4.50	4.50	4.20	3.35
USD	4.50	5.50	5.50	5.15	3.90
JPY	–0.10	–0.10	–0.10	–0.02	0.05
GBP	3.50	5.25	5.25	5.05	3.85
CHF	1.00	1.75	1.75	1.61	1.15
AUD	3.10	4.35	4.35	4.40	3.75
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)	2.56	2.02	2.34	2.20	2.24
USD	3.88	3.88	4.16	3.94	3.68
JPY	0.42	0.60	0.67	0.85	0.95
GBP	3.66	3.53	3.92	3.81	3.59
CHF	1.58	0.65	0.90	0.89	0.97
AUD	4.05	3.96	4.29	4.20	3.80

FOREIGN EXCHANGE RATES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
CHF per EUR	0.99	0.93	0.95	0.97	–
CHF per USD	0.94	0.84	0.87	0.88	–
CHF per 100 JPY	0.72	0.60	0.59	0.63	–
CHF per GBP	1.12	1.07	1.10	1.11	–
USD per EUR	1.06	1.10	1.09	1.11	–
JPY per USD	130.00	141.00	148.00	140.00	–
USD per AUD	0.67	0.68	0.66	0.68	–
GBP per EUR	0.88	0.87	0.86	0.88	–
CNY per USD	6.91	7.10	7.19	7.10	–

COMMODITIES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	86	77	79	82.5	83
Gold, USD per troy ounce	1,824	2,063	2,028	2,033	2,100
Copper, USD per metric ton	8,372	8,559	8,310	8,450	9,000

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of January 19, 2024

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Vontobel Swiss Financial Advisers AG
Gotthardstrasse 43
8022 Zurich
Switzerland

vontobel.com