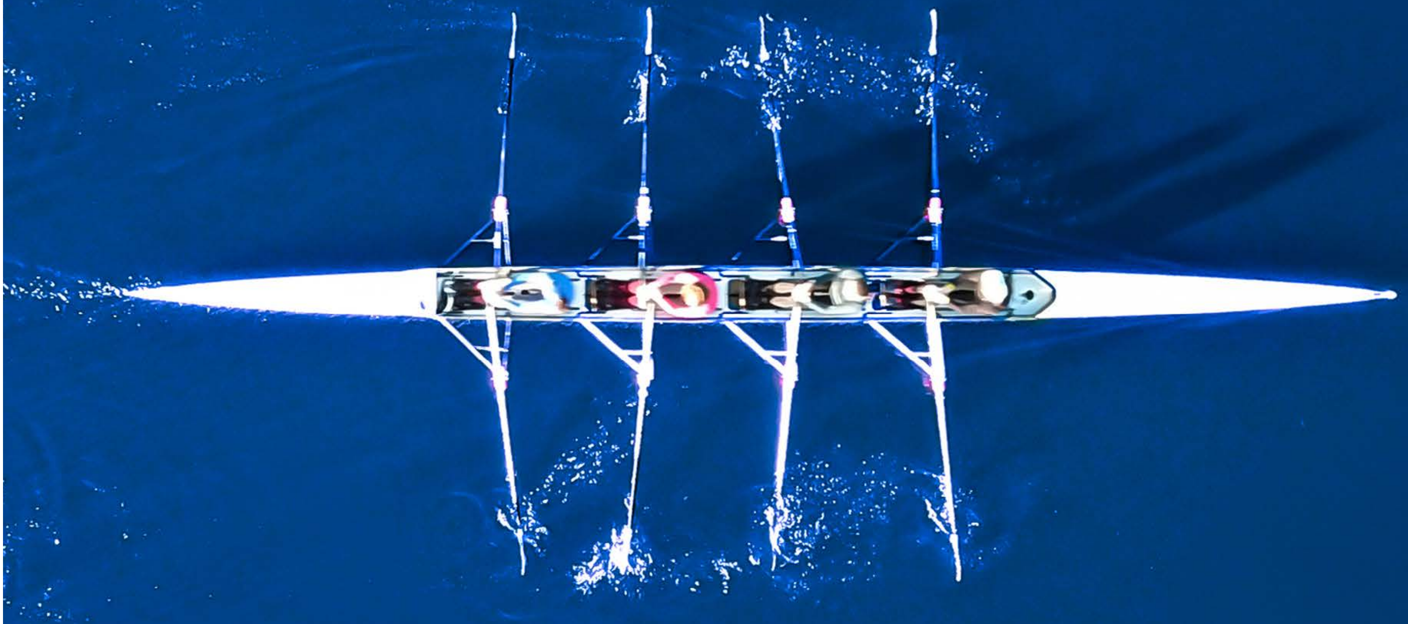
Vontobel

Investors' Outlook

Not a time to change course



May 2023

Vontobel Swiss Financial Advisers AG

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Vontobel Swiss Financial Advisers AG
Gotthardstrasse 43
8022 Zürich

Editors
Vontobel Editing team

Authors*
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA
Dr. Olaf Liedtke
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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Not a time to change course

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

Dear readers,

Navigating through choppy water needs experience, destiny, boldness and responsibility for freight and people. A typical symbol for such attitudes is the coxswain. The German lyric poet Theodor Fontane raised awareness of such a brave person with his poem "John Maynard" in 1886. John Maynard, the coxswain of the paddle steamer Erie, rescued the crew and the passengers after an explosive fire in rough sea on the Erie Lake by keeping the course to the coast of Buffalo.

We are currently in choppy waters. Uncertainties about the future path of the global economy is still elevated as inflation continues to prove to be much stickier than originally expected forcing central banks to keep course to fight inflation. Tight financial conditions are taking their toll on local and regional banks, especially in the US, propelling concerns that these idiosyncratic risks may result into a very similar situation emerged in 2008/2009 known as the "Great Recession". We think this fear is much too premature. The rise in bond prices over the last few weeks signals the expectations of bond investors that the deceleration of economic activity in the advanced economies still has room to go. At the same time, investors are now anticipating central banks to start pausing with further rate hikes and have already embedded rate cuts in the summer months, a view that we do not share.

The broader equity markets have digested the March turmoil caused by the collapse of the Silicon Valley Bank. On the earnings front, instead, market expectations remain very optimistic, signaling a disconnect between the deceleration risks bonds are pricing in and current equity valuations. In such an environment of conflicting signals we think we should stay our current course and advise investors to remain cautious. Against the backdrop of geopolitical tensions between the US and China, financial market stress and low confidence in the robustness of the global economic recovery we continue to keep equity allocations close to the strategic weight. While we do not see systemic issues, tightening financial conditions are increasing risks to the outlook. In this Investors' Outlook, you will find our take on the most recent developments in the economy and financial markets. We will take a closer look on the origination of inflation in the euro area based on a recent study of the European Central Bank as well as the current and expected economic situation in China and its respective impact on the world economy. We also highlight the reasoning of our profit talking on gold and why we are closing our overweight allocation for the Norwegian and Swedish Kroner.
You can also read up on the details of our asset allocations and why we have decided to refrain from any changes.

While we let the dust settle before making a move again, we are keeping a close eye on any signs of convalescence of the economy.

Best regards,
Pascal Köppel

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

Global economy on a bumpy road to recovery—we favor bonds over liquidity

Inflation in the advanced economies, especially in the US and the euro area (EA), continues to fall but remains well above of the policy objectives of most central banks. Monetary policy currently has no leeway to cut interest rates in the foreseeable future to bring inflation back to the targets within a reasonable timeframe. The global economy can digest high or even higher rates, as many sentiment indicators have turned again to the upside making a severe economic downturn less likely.

Purchasing Manager Indices (PMI) for the most relevant economic regions such as China, US and EA started to improve in late 2022 and entered expansionary territory at the beginning of 2023. These important leading indicators have continued to rise since then and are now showing positive economic growth in 2023. This trend is confirmed by the steady rise in OECD consumer confidence and stabilization of the OECD business sentiment indices. The upward trend in the advanced economies remains fragile as the loss of purchasing power continues to take its toll on private consumption spending, and tighter financial conditions and stricter lending standards are curbing corporate investment spending. So far, the reopening of the Chinese economy has not yet been a tailwind for the global economy, as the recovery in China has been skewed towards its domestic economy. As we believe the global economy is strong enough to escape a severe downturn, we remain comfortable allocating global equities close to their strategic weight. Earnings have come in better than expected so far, and the Fed and the ECB report that many companies still have strong pricing power. This should protect earnings growth. We have no regional preferences and invest in all equity markets close to their strategic allocation. Within the fixed income space, we favor investment grade corporate bonds over government bonds. Although spread compression appears limited, corporate bonds still offer an attractive risk-adjusted yield pick-up over government debt. Spreads for emerging market debt denominated in local and hard currencies are trading approximately two standard deviations above the risk-adjusted average spread and offer attractive investment opportunities. This should also be supported by a USD leaning toward some weakness and easing rates impetus. We have also decided to close our overweight allocation to the Norwegian krone and Swedish krona. Both currencies, which lag the expectations created by the firm rhetoric on fighting inflation, have experienced losses against our reference currencies. Given the rapid increase in the price of gold to around USD 2,000, we are taking profit on our gold overweight but keeping a small overweight to stabilize performance in case things turn sour.

	UNDERWEIGHT		NEUTRAL	OVERWEIGHT		
	significantly	slightly		slightly	significantly	
1 Liquidity		→				We continue to underweight cash. This gives us some leeway if investment opportunities arise.
2 Bonds				↗		We are sticking to our slightly positive view on fixed income and also reiterate all sub-asset class views. We remain overweight in investment grade (IG) credit due to our belief that current spreads offer an attractive risk-adjusted expected return, as long has the global economy can avoid a severe downturn. We remain underweight in high-yield bonds due to the rising odds of a recession and our outlook for the US economy. Lastly, we also remain positive on emerging markets debt. We are closing our overweight allocation to the Norwegian krone in our global mandates and to the Swedish krona in our international mandates, as these two currencies have failed to appreciate. We have moved the respective proceeds into reference currency bonds, therefore reducing the vulnerability of our portfolios in case of rising volatility.
3 Equities			→			Central banks continue to curb inflation—at the expense of employment and economic growth—especially in EA where core inflation proved stickier than expected. As the economic downturn is losing momentum but the recovery remains rocky, the risks of a global recession have started to abate. The probability of a significant deceleration of the US economy in 2023 is slowly declining. However, when looking at equity multiples comparing the current equity market drawdown with past drawdowns, it becomes evident that markets have already priced in much of the above. In the absence of a broad-based global recession, we therefore believe that a neutral view on equities is still justifiable. We are close to the respective strategic allocation weight for most equity markets. We also reiterate our neutral view on emerging markets equities.
4 Commodities / Gold				↘		We are taking profit on some of our gold holding as the gold price approaches USD 2,000 per ounce. However, we are keeping an overweight allocation to gold, as it has been a systemic portfolio diversifier during times of rising market stress. As the global economy increasingly loses momentum, we confirm our general underweight allocation to other commodities, including energy.

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

An analysis of the origination of EA inflation

Soaring energy prices in the aftermath of the outbreak of the Ukraine war 2022 has caused inflation in the euro area (EA) to reach record highs since decades and remains elevated for a longer time. More than a half of total energy is imported to EA at much higher prices resulting into a strong drop of income for private households and companies. Supply chain disruptions put additionally pressure on import prices.

—
Dr. Olaf Liedtke
Chief Investment Strategist,
Vontobel SFA

In such a situation, corporates try to raise prices to safeguard profit margins or even to grow their margins above the rise of input costs to compensate real income declines occurred during the past three year. Another incentive may be to move prices ahead of input costs to create a reserve of retained profits as a protection of elevated uncertainty about the future path of the economy and future inflation. Employees intend to increase wages to keep real wages unchanged.

In the light of huge inflation shocks, many firms try to increase their prices relatively quick while wage negotiations take place at different points in time and these negotiations are very time consuming. Nevertheless, both price and wage settings in a high inflationary environment is expected to be price raising and may create further price and wages adjustments in the future. This amplification of higher prices, higher wages and so on, may create a price wage spiral with the danger that inflation expectation may become unanchored moving away from the ECB's long-term policy objective of 2 percent.

According to the ECB, the GDP deflator represents the sound basis to assess the impact of earnings and wages on the domestic price development in EA. This price deflator used to price gross added value can be dissembled as shown by the ECB into unit profits (gross operating surplus per unit of real GDP), unit labor costs (compensation of employees per unit of real GDP) and unit taxes (which reflect taxes on production net of subsidies per unit of real GDP).

Since late 2021, domestic inflation measured by the GDP deflator, in EA surged and reached with 5.8 percent the highest level since the introduction of the currency union in the last quarter of 2022. Both, unit labor costs and unit profits contributed to the latest increase in the GDP deflator. Unit profits were responsible for approximately 52 percentage points for the increase of domestic inflation while unit labors costs contribution stood at only 38 percentage point. This shows the strong efforts of firms and employees (trade unions) to offset the loss of real income in terms of profits and wages, albeit not to the same extent.

Chart 1: 2019 Q4 to 2022 Q1

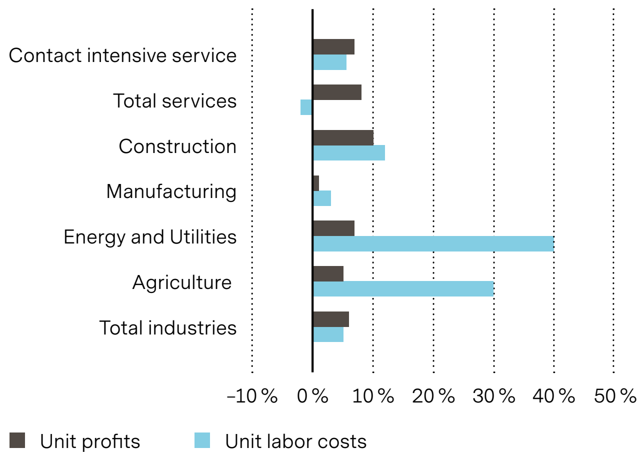


Chart 2: 2022 Q1 to 2022 Q4

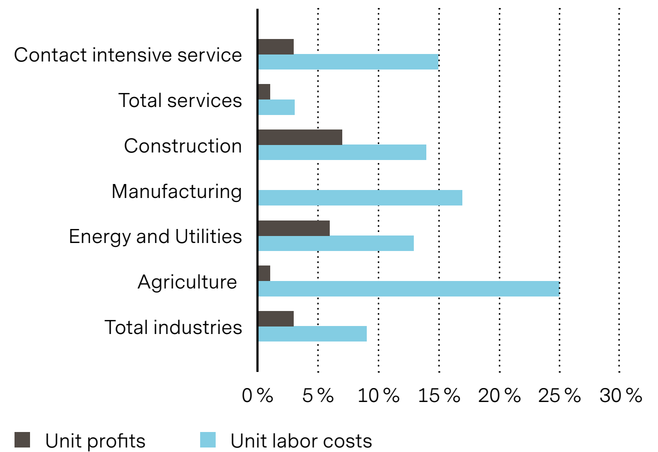
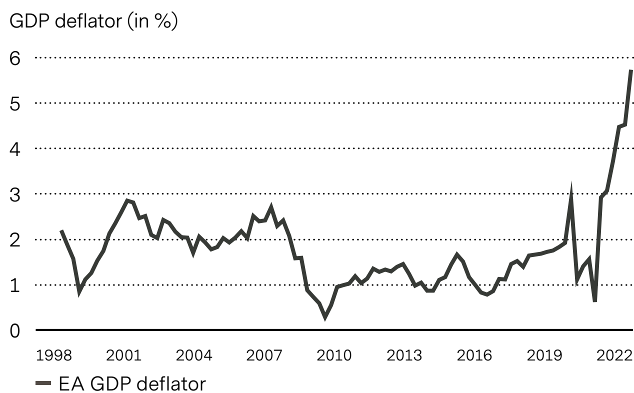


Chart 3: At the highest level since the introduction of the EUR

GDP deflator (in %)



Source: European Central Bank, Vontobel SFA

The expansion of unit profits was a surprise in the course of 2022, as unit profit are usually positively correlated with the business cycle and terms of trade (represent the ratio between export and import prices expressed in the respective currency). Economic activity in EA decelerated during 2022 and EA terms of trade deteriorated considerably, as import prices rose substantially and the EUR lost against many major currencies. We would expect profits to decline in such an environment, but the opposite happened. What are the reasons for such an unusual development that allowed many companies to expand their profit margins? One major reason is that in the aftermath of the lockdowns and the re-opening of the European economies, growth of domestic demand was much stronger than the growth of supply in the face of unprecedent high supply bottlenecks. Sharply increased energy and other input prices enabled many companies to maintain or even increase their pre-crisis margins as it was not clear for the public whether inflation is driven by rising input costs or stronger profit margins.

A comparison of developments since the start of the pandemic shows that in the euro area, unit profits have increased faster than unit labor costs since the start of 2022, and in some economic sectors already since the end of 2019. Looking at sectoral developments, the ECB provided evidence that profits have grown much stronger than unit labor costs in the following sectors. Agriculture, energy and utilities, construction manufacturing and contact intensive services sectors, fostered by rising food prices, the explosion of energy prices, the surge in construction raw martial prices and supply chain disruption induced increases of output prices in manufacturing and contact intensive service sectors.

Collecting credit spreads in a prudent manner

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

Expectations for the rate-hike cycle in the US to end soon amid cooling inflation and economic activity makes for an attractive environment for investment grade bonds. This also applies to emerging-market bonds, which should additionally benefit from a weaker US dollar.

We maintain our overweight bond positioning with a preference for investment grade corporate bonds over government bonds. Credit spreads are still trading at a level that indicates heightened risk aversion among fixed income investors, who have in turn piled into government debt.

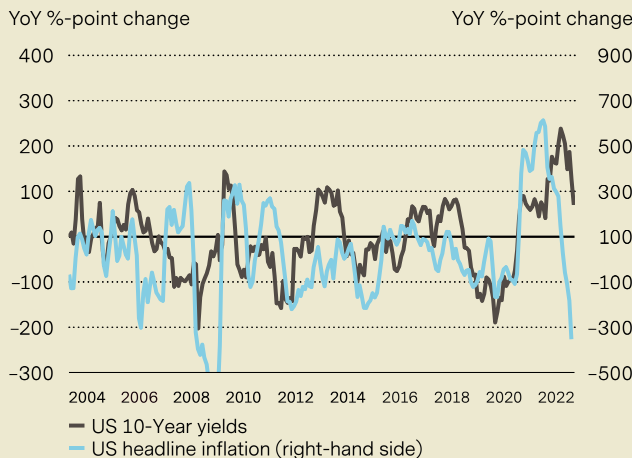
Anticipating falling US government bond yields
In our view, 10-year US government bond yield levels are too high. They have traded in a range of between 3.4 and 4.2 percent for the last six months. There are several reasons that will probably ensure the bottom end of this range will soon be breached. First, the economy—at least in the US—continues to weaken. Second, inflation continues to fall. It has retreated much more than is visible in government bond yields (see chart 1). Third, we anticipate a deceleration of economic activity.

If the past seven decades are any guide, yields can be expected to fall to an average of 2.5 percent if a recession does indeed materialize.

Even if we avoid a recession, there is a strong case against yields continuing to rise significantly. They are currently trading well above the Fed's assumed "neutral rate" level of 2.5 percent. The neutral rate is an estimate of the interest rate level at which the economy is in equilibrium. This was the Fed's intention in its attempts to tame high inflation. But it is questionable whether the economy and the government can withstand such high interest rates in the longer term.

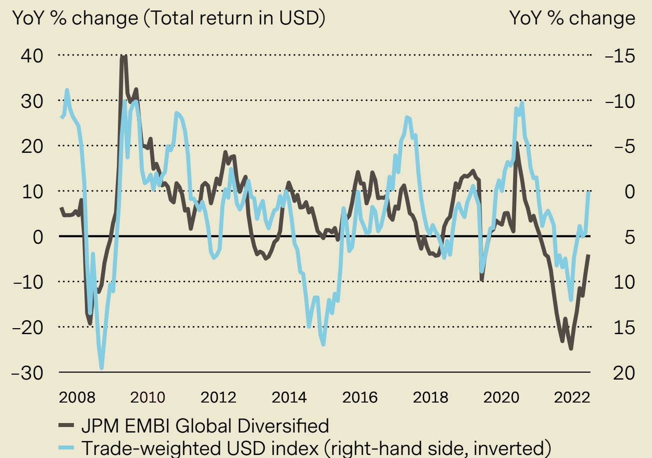
Emerging-market bonds are attractive
We remain overweight in emerging-market government bonds, but for different reasons. This asset class is also likely to face headwinds if our recession scenario materializes, but these risks are currently well compensated. In addition, emerging-market bonds denominated in hard currencies should benefit from a weaker US dollar, as it eases the debt burden for these governments (see chart 2). The greenback will likely weaken as the US rate-hike cycle comes to an end.

Chart 1: Lower inflation usually results in falling yields



Source: Refinitiv Datastream, Vontobel

Chart 2: Emerging market bonds perform better in USD bear markets



Source: Refinitiv Datastream, Vontobel

In anticipation of less restrictive monetary policy

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

Despite the growing likelihood that central banks will turn to a looser monetary policy towards the end of the year, along with a stronger-than-expected economic recovery in China, our equity weighting remains neutral.

Equity markets have been undisturbed in their bullish progression since mid-March. The noticeable sector rotation in terms of investment styles towards quality and growth in the first few months of the year accelerated with the unfolding US banking crisis. Investors favored large companies with strong earnings visibility, solid growth, sound cash generation and very little leverage or—even better—net cash positions.

The MSCI World Technology Index's strong Q1—the best quarterly performance in nearly 15 years—reflects these factors. Valuation multiples across equity markets don't look overly stretched (see chart 1), earnings estimates have been cut on average by about 15 percent from last July and growth forecasts for 2023 are in negative territory (see chart 2). The earnings season so far paints an encouraging picture. Still, the latest surveys show that investor sentiment remains depressed.

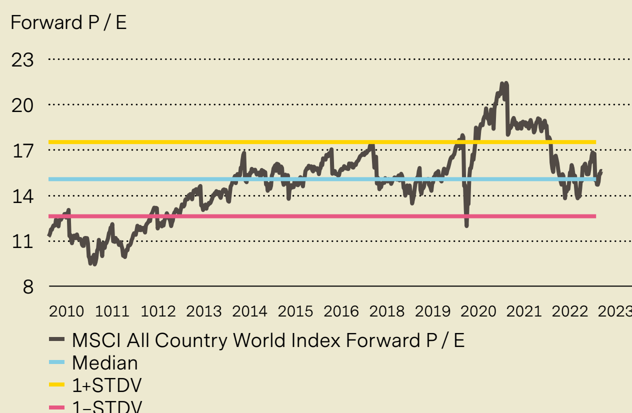
Underexposure to equities among institutional investors is close to March 2009 levels, while net short positions are nearing extreme levels again.

What's next? We expect three factors to dictate the direction of equity markets in the medium term. First, inflation, which is slowly easing; second, the pending pause in the Fed's rate hikes—likely as early as June; and third, the magnitude of a broadly-anticipated recession, which might hit the real economy towards year-end. Combined with a weaker US dollar, this should benefit growth and cyclical sectors, such as IT, communication services, consumer discretionary and materials as well as industrials.

While we still have half the reporting season ahead, we are seeing some evidence that negative revisions have overshot the market at least for Q1. Amid the renewed macro and banking jitters, better-than-feared earnings so far for bellwether companies in big tech, industrials, and systemic banks look to have backstopped the nervous equity markets. EPS growth is running at 5 percent in Europe and is flat in the US, beating consensus estimates of negative growth for the latter. However, the response of equity prices to earnings is very dispersed and the outlook remains uncertain with soft demand and conservative guidance.

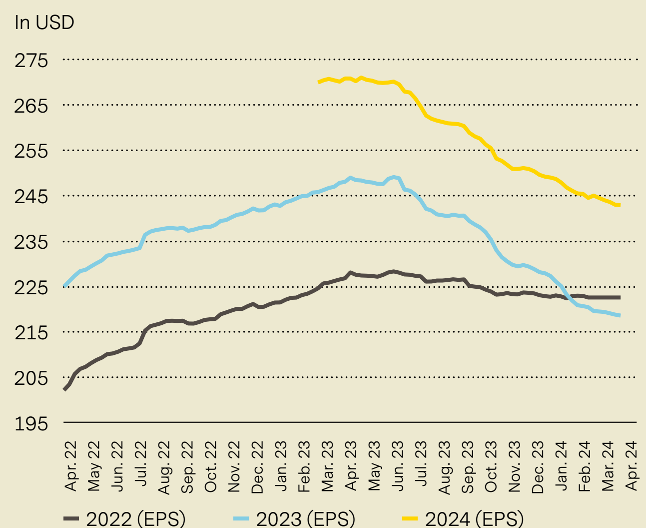
Our regional views remain unchanged and we feel comfortable with a neutral view on equities.

Chart 1: Valuations for global equities look normalized



Source: Refinitiv Datastream, Vontobel

Chart 2: Earnings revisions for the S&P 500 Index



Source: Refinitiv Datastream, Vontobel

Move over: “America First”— here comes “OPEC+ First”

Dr. Olaf Liedtke
Chief Investment Strategist,
Vontobel SFA

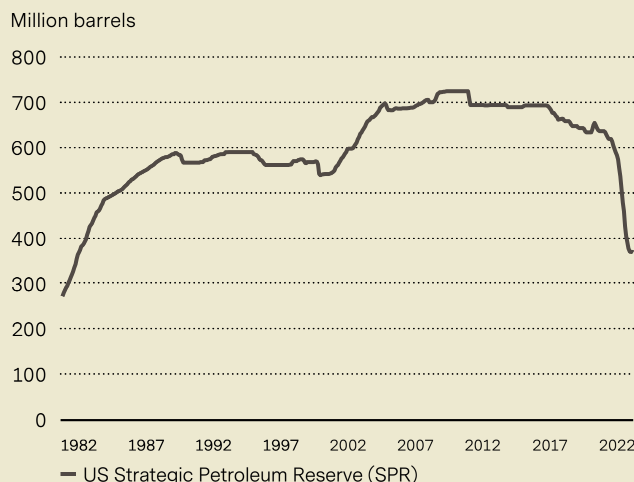
The decision by the Organization of Petroleum Exporting Countries (OPEC) and its allies (OPEC+) to cut oil production by some 1.16 million barrels per day starting in May took markets by surprise and pushed up prices for “black gold”. The move once again exhibited the cartel’s market power and sent a clear message to Washington.

There are several reasons for the production cuts. According to the official OPEC+ version, it is a measure to “stabilize” oil markets. Unofficially, however, the move is likely also driven by concerns about weaker global demand. Shortly before the announcement, oil prices had fallen to USD 70 per barrel amid the banking crisis and heightened fears of a recession. Deteriorating relations between OPEC heavyweight Saudi Arabia and the US is another factor. The latter had recently signaled that it would take its time refilling the Strategic Petroleum Reserve, therefore snubbing Saudi Arabia (see chart 1).

What does this mean for oil prices?
USD 80 per barrel represents the “line in the sand” that the cartel will continue to defend. The curtailment, coupled with the Russian reduction, will result in a production-quota cut of 1.16 million barrels per day. Unless there is a severe global recession, oil prices could rise above USD 90 a barrel towards the end of the year.

Take profit on gold and keep an underweight allocation to broad commodities
Since the beginning of the year, the gold price has gained approximately 11 percent to over USD 2,000 per ounce. We have therefore reduced our overweight allocation to gold and realized some of the cumulative profits. We still maintain a smaller overweight allocation to gold as it has proven to be an efficient portfolio hedge against uncertainty about the future direction of the economy and therefore future central bank rates. It is negatively correlated with real yields. As inflation is expected to decline further, nominal rates are projected to fall and real rates should fall too. Given that global economic momentum is not expected to gain traction for some time and demand for commodities should remain limited overall, we maintain an underweight allocation to broad commodities. The strong appetite of the Chinese economy at the early stage of its reopening process might argue against the underweight position in broad commodities. However, supply chain distortions have already abated fully to pre-crisis levels, so that additional demand for commodities should also have normalized and current prices should absorb the pick-up in demand from higher manufacturing activity in China.

Chart 1: Repeated US SPR draws might have angered OPEC+



Source: Refinitiv Datastream, Vontobel

Chart 2: Gold price reaching new highs

Source: Bloomberg Finance l. P., Vontobel SFA

Weaker times ahead for the US dollar

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

The equity market recovery that kicked in last October contributed to a noticeably weaker US dollar. Higher risk appetite often goes hand in hand with a weaker greenback and vice versa. A US recession could give the dollar a temporary boost. However, long-term drivers argue for continued weakness.

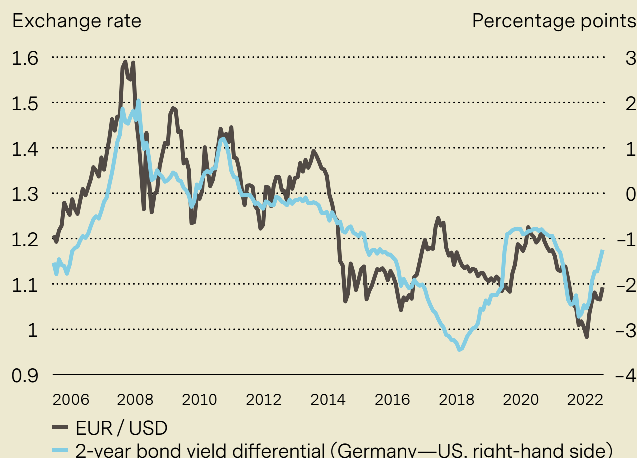
The dollar is the undisputed reserve currency around the globe. While the emerging multipolar world order is likely to challenge its status, such changings of the guard do not happen overnight. The greenback also remains crucial to financial markets. For example, most commodities worldwide are still denominated in dollars.

Where is the US dollar headed?
The dollar is overvalued. This is reflected in the purchasing power parity, which compares the prices of major consumer goods between countries. Higher US inflation than in Switzerland, for example, has driven the fair value of the dollar down significantly over the past two years. In the long term, exchange rates are expected to fluctuate around this fair value and the greenback should lose value. However, the current exchange rate may also deviate from it over several months, as we have seen in the past two years.

The headwind from unfavorable interest rate differentials is likely to be just as strong for the dollar (see chart 2). Two-year interest rates in the US have been rising less than elsewhere since last fall, right around the peak of the greenback. For example, short-term interest rates in Germany are rising more than in the US, which has boosted the EUR/USD exchange rate. Interest rate differentials already point to a weaker dollar, a development that will likely continue when the Fed ends its cycle of interest-rate hikes.

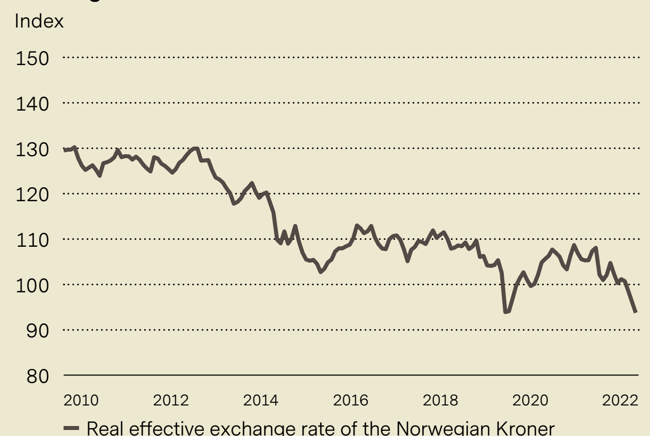
We have decided to eliminate the overweight allocation to the Norwegian krone back to neutral and to shift the proceeds into our reference currencies. The Norwegian central bank (Norge Bank) with its tighter policy stance since 2021 has failed to bring inflation down. Consumer price inflation in Norway continued to creep up to around 7 percent and is expected to stay high according to the Norge Bank, despite further future central bank rate hikes. It seems that investors have lost trust in Norge Bank's ability to bring down inflation in the foreseeable future. Even with rising central bank rates, the NOK measured by its effective exchange rate has depreciated by around 10 percent since the beginning of 2022.

Chart 1: Interest rate differentials speak against the US dollar



Source: Refinitiv Datastream, Vontobel

Chart 2: The real effective exchange rate of the Norwegian Kroner



Source: Bank of International Settlement, Vontobel SFA

Economy and financial markets 2021 – 2024

The following list shows the actual values, exchange rates and prices from 2021 to 2022 and consensus forecasts for 2023 and 2024 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates, and commodities.

GDP (IN %)	2021	2022	CURRENT[1]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	5.6	2.1	2.3	2.2	2.6
Eurozone	5.3	1.8	1.9	0.6	1.2
USA	5.9	0.9	0.9	1.1	1.2
Japan	2.3	0.4	0.4	1.0	1.1
UK	8.5	0.6	0.4	–0.2	0.9
Switzerland	4.3	0.8	0.8	0.6	1.4
Australia	5.3	2.7	2.7	1.7	1.6
China	8.4	4.5	2.9	5.3	5.0

INFLATION	2021	2022	CURRENT[2]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	3.5	7.3	5.5	5.4	3.6
Eurozone	2.6	8.4	6.9	5.6	2.5
USA	4.7	8.0	5.0	4.2	2.6
Japan	–0.3	2.5	3.2	2.4	1.4
UK	2.6	9.1	10.1	6.5	2.4
Switzerland	0.6	2.9	2.9	2.5	1.5
Australia	2.9	6.6	7.8	5.5	3.1
China	0.9	2.0	0.7	2.3	2.3

KEY INTEREST RATES (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	2.00	3.00	3.64	3.29
USD	0.25	4.50	5.00	5.20	4.10
JPY	–0.10	–0.10	–0.10	–0.09	–0.07
GBP	0.25	3.50	4.25	4.35	3.85
CHF	–0.75	1.00	1.50	1.84	1.64
AUD	0.10	3.10	3.60	3.85	3.60
CNY	3.80	3.65	4.35	4.30	4.25

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	–0.2	2.6	2.45	2.44	2.21
USD	1.5	3.9	3.53	3.55	3.31
JPY	0.1	0.4	0.47	0.65	0.66
GBP	1.0	3.7	3.74	3.41	3.12
CHF	–0.1	1.6	1.12	1.44	1.26
AUD	1.7	4.1	3.46	3.62	3.31

FOREIGN EXCHANGE RATES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS END OF 2024
CHF per EUR	1.04	0.99	0.98	1.00	1.01
CHF per USD	0.91	0.94	0.89	0.91	0.91
CHF per 100 JPY	0.79	0.72	0.67	0.72	0.72
CHF per GBP	1.23	1.12	1.11	1.13	1.14
USD per EUR	1.14	1.06	1.10	1.11	1.12
JPY per USD	115	130	134	127	125
USD per AUD	0.73	0.67	0.67	0.70	0.71
GBP per EUR	0.84	0.88	0.88	0.89	0.89
CNY per USD	6.37	6.91	6.89	6.75	6.70

COMMODITIES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	79	86	81	86.75	90
Gold, USD per troy ounce	1,829	1,824	1,986	1,946	1,946
Copper, USD per metric ton	9,720	8,372	8,881	8,820	9,100

[1] Latest available quarter
[2] Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of March 25, 2023

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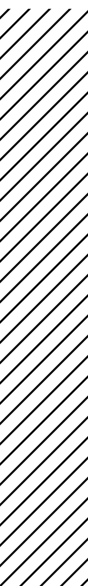

Vontobel Swiss Financial Advisers AG
Gotthardstrasse 43
8022 Zurich
Switzerland

vontobel.com