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Vontobel

US Investors' Outlook

Traversing risky terrains

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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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Vontobel

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Traversing risky terrains

—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

Dear readers,

April turned out to be volatile for both high-risk and low-risk assets. After an impressive equity market rally that started in early November, the market took a breather in April. The MSCI World Index reached a peak on March 29, 2024. It then fell by slightly over 5 percent before being followed by a sluggish recovery.

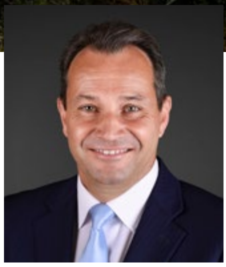
Equity market setbacks in the order of 3 to 5 percent are quite common. They can even be seen as a healthy development, as equity investor sentiment normalizes after a period of overenthusiasm. That is also the case this time around, as US equity investor sentiment measured by the American Association of Individual Investors (AAII) shows that the bullish sentiment has neutralized over the past weeks.

Equity market corrections such as those seen over the past month typically have a trigger. It was no different this time. A combination of factors drove equity investors to secure some of their profits. First, there was a combination of strong US economic data and evidence that inflation remains sticky. This led to more pricing out of Fed rate cuts and further increases in bond yields. Second, the situation escalated further in the Middle East, with Iran launching a direct attack on Israel. This all contributed to equity investors taking some risk off the table.

There are a few key takeaways from the news flow and market dynamics of the last month. With regard to inflation, we see evidence that the disinflationary trend is becoming more uneven across countries. Core inflation, and especially service price inflation, has become very sticky in the US, while the disinflation trend in both headline and core inflation remains intact in Europe. This has implications for the timing and possibly the total amount of policy easing we will see this year. More specifically, the ECB may very well stick to its plan of a June rate cut while the Fed may not start cutting until after the summer. The implication for fixed income is that bond yields may fall less this year than previously expected. Nevertheless, the recent rise in bond yields offers investors the opportunity to lock in high yields for a longer period.

Another observation is that gold is doing exactly what you would expect it to do in times of rising uncertainty. Gold has booked new highs and has once again proven to be a key diversifier against portfolio risk.

What are the implications for asset allocation? Equity markets are well supported by strong macroeconomic fundamentals, with US growth slowing less and global leading indicators picking up. The setback in equities coincided with a normalization of investor sentiment from elevated levels. This increases the attractiveness of equities going forward. We are sticking to a medium overweight in equities. We also continue to favor high-quality corporate bonds with a longer duration and even after the gold price rally, we prefer to be overweight in gold. This is supported by our view that geopolitical uncertainties are unlikely to ease substantially in the months and quarters ahead.



—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

April showers

Strong US economic data, sticky inflation, pricing out of Fed rate cuts and growing geopolitical tensions in the Middle East were among the heaviest of the April "showers". This created higher volatility across financial assets during the month, with bond yields moving higher and equities weaker, while commodity prices rose further.

Amid strong consumer spending and a resilient labor market, US economic data has continued to surprise on the upside. This translates into stickier-than-expected inflation, which is likely to make the latter stages of the US Federal Reserve's (Fed) fight against inflation more difficult. It also means that the first interest-rate reductions will probably occur later than originally anticipated. Fed Chair Jerome Powell indicated this last month, saying that policymakers can keep rates steady for "as long as needed" should price pressures continue.

Conditions are quite different on the other side of the Atlantic. The eurozone economy is showing signs of improvement: the bloc's manufacturing and services industries appear to be growing, inflation has slowed down sharply and industrial production in Germany, the region's biggest economy, rose more than expected. The European Central Bank (ECB) is now planting the seeds for a first interest-rate cut. ECB President Christine Lagarde said with regard to the central bank's policy "if we don't have a major shock in development, we are heading towards a moment where we have to moderate the restrictive monetary policy." Other ECB members echoed that sentiment.

The Vontobel SFA Investment Committee has kept the asset allocation unchanged. We continue to favor long-duration, high-quality bonds and still have with a medium overweight in equities overall. Gold remains attractive as a diversifier against different risks. Find the details of our asset allocation on page 5.

	UNDERWEIGHT		NEUTRAL	OVERWEIGHT		
	significantly	slightly		slightly	significantly	
1 Liquidity	→					We are keeping a significant underweight in cash, as we see scope 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 yields across the treasury curve 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. After the recent equity correction, investor sentiment has become more realistic. Regionally, we prefer the euro area and Switzerland, while the UK remains an underweight.
4 Commodities / Gold			→			We remain positive on gold. The yellow metal has rallied strongly. Lower interest rates, higher geopolitical uncertainties and continued strategic buying of gold, especially by emerging market central banks, will be positive drivers of gold for the remainder of 2024.

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

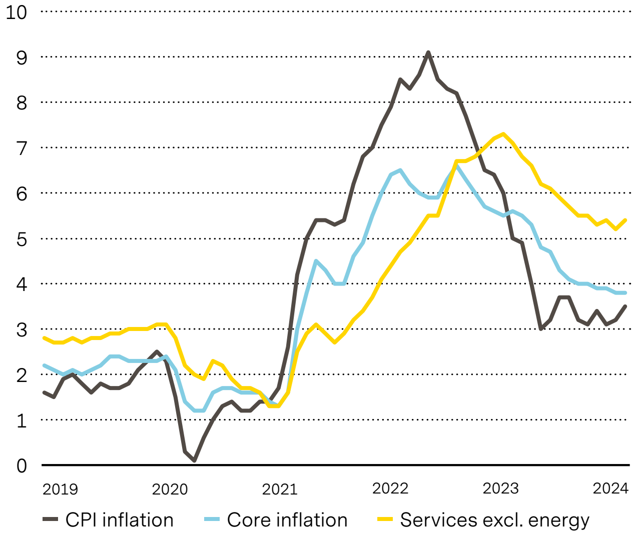
Diverging paths of inflation normalization

The inflation data that was released in April have made clear that the gap is widening further between the progress on bringing inflation back to target in the US compared to Europe. And this has monetary policy implications as well.

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

Chart 1: Year over year US CPI inflation

In %



Source: Bloomberg, Vontobel SFA

Spanner in the US disinflation works

Both the US headline and the core inflation data releases for the month of March (as published in April) were higher than markets had expected. Headline CPI inflation increased from 3.2 percent to 3.5 percent, while core inflation (which excludes the volatile components of food and energy) remained unchanged at 3.8 percent. This compares with the decline expected by analysts surveyed by Bloomberg. US Headline and core inflation had surprised on the upside too in February (see chart 1).

Sticky US inflation is driven in particular by service price inflation. In addition, energy has become inflationary again having previously been disinflationary. This is the result of the recent significant increase in the price of oil after the situation escalated further in the Middle East. Goods price inflation has currently turned negative but the impact this has on the overall inflation level is minimal.

The Fed looks primarily at PCE core inflation for setting its monetary policy stance. This measure is much broader as it applies to actual consumer spending. The CPI measure on the other hand is a basket that does not account for substitution effects. PCE core inflation is running a full percentage point below the CPI core inflation measure. That said, we are seeing upward momentum of core PCE inflation as well, where the three-month annualized inflation rate in particular is above the 12 month inflation rate (see chart 2).

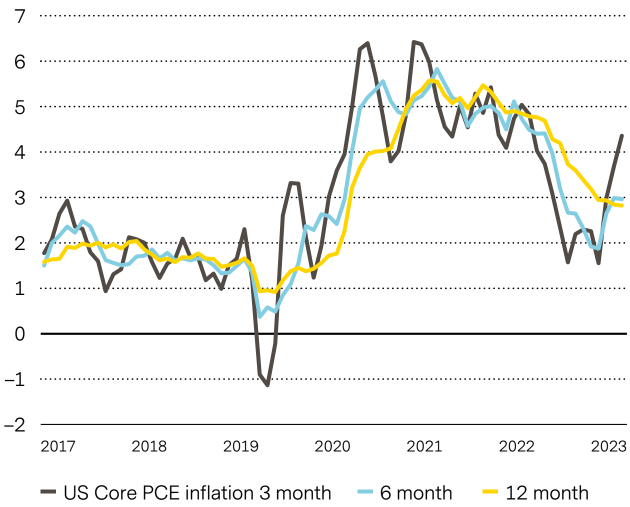
This has impacted the start of Fed's rate cutting cycle and probably also the aggregate amount of Fed rate cuts in 2024. Where previously the Fed was eager to start cutting rates soon and signaled that the FOMC was confident that inflation was on the path of returning towards the inflation target, this confidence has clearly dropped.
The result is that the start of the rate cutting cycle will be postponed until this level of confidence is restored.
In other words, the Fed is data dependent once again.

Euro area disinflation trend continues

Where US disinflation is stagnating, the trend in Europe still remain intact. Both headline and core inflation estimates for March surprised markets on the downside (see chart 3). While service sector inflation remains stubbornly

Chart 2: US Core PCE inflation momentum

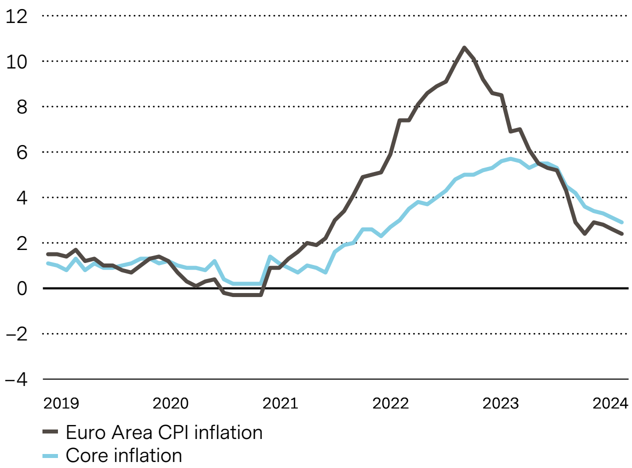
In %



Source: Bloomberg, Vontobel SFA

Chart 3: Year over year Euro Area CPI inflation

In %



Source: Bloomberg, Vontobel SFA

high in the US, this component is much lower for the euro area. At 1.7 percent year-over-year in March, it is already below the ECB target. Food price inflation is still above the 2 percent target.

As the European disinflation trend continues, a first rate cut by the ECB is also coming closer. However, the ECB wants to see more evidence before it acts. It is particularly focused on wage inflation. As we already noted last month, we find 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). This is because wages typically only react to past inflation. In our opinion, the ECB should not get too hung up on wage data. All that said, an ECB rate cut still seems to be on the table for June.

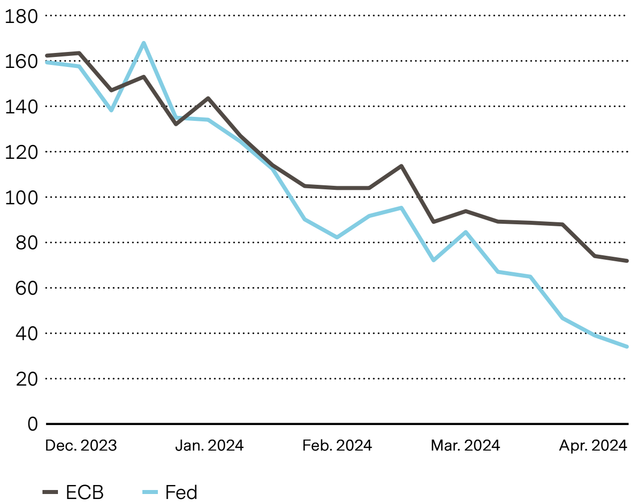
ECB cutting rates before the Fed is unusual

The market has significantly priced in the first Fed rate cut. A full 25bp rate cut is priced in for November this year, and no more than two rate cuts are priced in by the end of the year. For the ECB, the market has priced in close to a full rate cut by June (22bp) with a total of nearly three rate cuts priced in for the whole of 2024. This compares with the beginning of the year, when the market still assumed that the Fed and ECB would cut rates to a similar degree this year (see chart 4).

The Fed typically moves earlier and more aggressively in rate cutting cycles. Since the ECB was established, we have seen two significant rate cutting cycles in 2001 and 2008. In both cases, the Fed moved earlier and much more aggressively. There were two periods in which one central bank cut rates and the other did not. During the European sovereign debt crisis in 2011, the ECB cut rates by 125bp, while the Fed remained sidelined. It was clearly because the crisis was more of an issue for the European economy rather than for the US. In 2020, as economies went into lockdown, the Fed slashed rates by 150bp

Chart 4: Market implied 2024 rate cuts Fed and ECB in basis points

Basis points



Source: Bloomberg, Vontobel SFA

within one month. The ECB held fire as rates were already at 0 percent at that time.

The Fed's generally more aggressive stance on the downside can be explained by the difference in the central bank mandates. The Fed has a dual mandate, where the two targets are achieving full employment and price stability, whereas the ECB has only one target, namely price stability. The Fed therefore will react sooner and more aggressively to downside growth risks.

As regards growth, current growth remains strong in the US and offers no reason to cut rates, and suficient progress has not been made yet on inflation in the US. We could therefore see an earlier start by the ECB as well as more rate cuts for the whole of 2024 this time around.

Shifting economic currents and the elusive "Year of the bond"

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

2024 was initially expected to be a year marked by a slump in growth, easing inflation and early, significant rate cuts. However, it now seems to be evolving into a year characterized by steady growth, persistent inflationary pressure and a more gradual approach to policy normalization that will begin later. What should have turned out to be the "Year of the bond" has not materialized … yet.

Large parts of the US economy continue to show signs of stability, even after aggressive monetary policy tightening in 2023. The absence of an immediate recession together with more persistent inflation has become the base scenario for most economists, including those working at central banks. Most Fed officials anticipate two or three rate cuts this year. However, a prolonged delay before inflation improves, inflation expectations spiraling out of control or an unexpected decline in the labor market could significantly alter the situation.

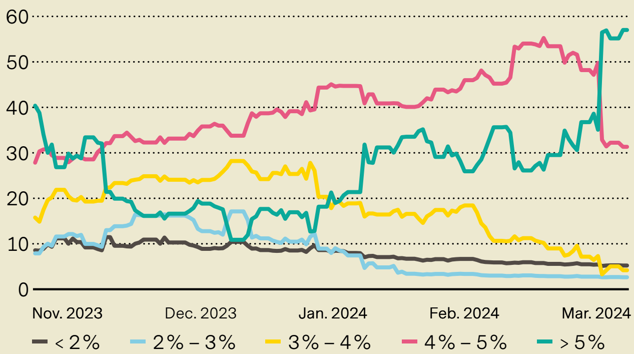
Markets have also dramatically shifted their rate cut expectations. Early in the year, the market priced in a 10 percent probability of a Fed funds rate of 2 percent or less by year-end—a scenario describing a recession. Four months later, the market seems to be pricing in benign economic outcomes with recession odds virtually off the table. Current options are pricing in a 30 percent likelihood that the Fed funds rate will be between 4 and 5 percent at year-end, and a 60 percent likelihood that they will even stay above 5 percent (see chart 1).

Another window to lock in long-term yields

As the odds for a rate cut fall, longer-term yields have also moved higher in recent weeks. This makes sense, since stickier inflation means that investors are demanding a higher return on bonds and many market participants see less need to move out of short-term treasury bills. On a stand-alone basis, we think both short-term and longer-term bonds are attractive. However, in a multi-asset portfolio context, longer-term bonds offer hedging properties that T-bills do not. If an investor wants to reduce risk in the portfolio, we therefore think buying longer-term bonds (10 year maturities for example) is a smarter move instead of reducing equities and increasing the cash quota.

Chart 1: Markets assign an increased probability to "higher for longer" Fed funds

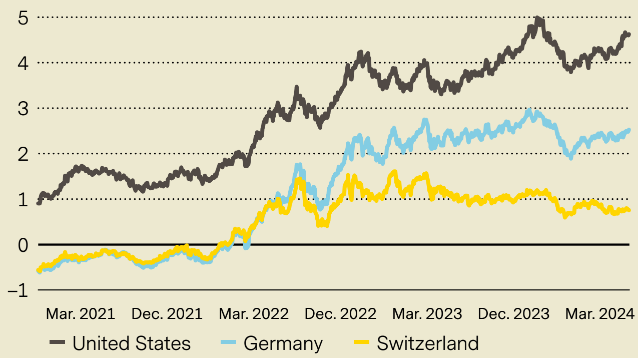
Option implied probability for December 2024 in %



Source: Bloomberg, Vontobel; data as of April 16, 2024.

Chart 2: Long-term yields have repriced inline with diminishing rate cut odds

In %



Source: Bloomberg, Vontobel SFA

Can earnings keep stocks rolling?

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

After nearly five months of consistently strong performance, equity markets have entered a period of widespread consolidation since late March. Stock investors are grappling with uncertainties. Will the earnings season sustain the momentum in stocks? Can economic growth hold up against persistent high interest rates, challenging the Federal Reserve's stance of maintaining "higher for longer" without a sense of urgency to reduce rates, especially given its ongoing dissatisfaction with the progress in containing inflation?

In the first quarter of 2024, equities posted their best returns over bonds since 2020, with the main indices reaching new all-time highs. Resilient growth, a decent earnings season and onset of the central bank easing cycle boosted soft landing expectations. AI, technology and the Magnificent 7 stocks drove gains earlier in the quarter, supporting the S&P 500 outperformance. Europe also started outperforming later in the quarter, as signs of a recovery in domestic cyclical activity and improving data surprises helped the region. However, as inflation showed signs of stickiness, aggressive rate cut expectations from the start of the year were pared back in the US.

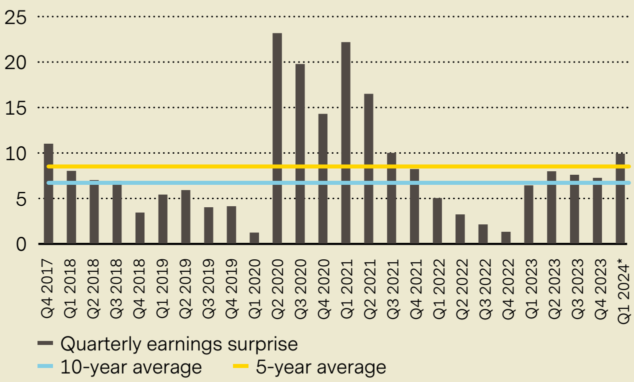
The Federal Reserve's commitment to returning inflation to target led to an increase in bond yields and a reassessment of market predictions regarding imminent rate cuts. Markets had initially anticipated as many as seven rate cuts for the year, with the first cut potentially occurring as early as March. However, current expectations have evolved to anticipate fewer than two rate cuts, possibly starting in the third quarter at the earliest.

Is this the beginning of a stronger correction? We don't think so. First, given the backdrop of higher inflation coupled with very bullish investor sentiment at the end of March, a consolidation is certainly not surprising. Statistically, we have observed three to four pullbacks of about 5 percent or more per annum on average since 1920. Second, the onset of the Q1 2024 earnings season should return the focus of equity market attention to fundamentals. Although they are still early days, results so far are beating the much-lowered consensus estimates and stock price reaction has been broadly positive.

Further decent earnings reports and a positive outlook from firms should provide a backstop to equities against the threat of higher interest rates, and could show a continuation of earnings surprises that were seen in the last quarters (see chart 1). This view is backed by the fact that global earnings revisions, albeit in negative territory, seem to have bottomed out and are trending upwards (see chart 2). Our medium overweight stance on equities remains in place. More on this on page 5.

Chart 1: Quarterly earnings surprises for the S&P 500 over the last 8 years

In %

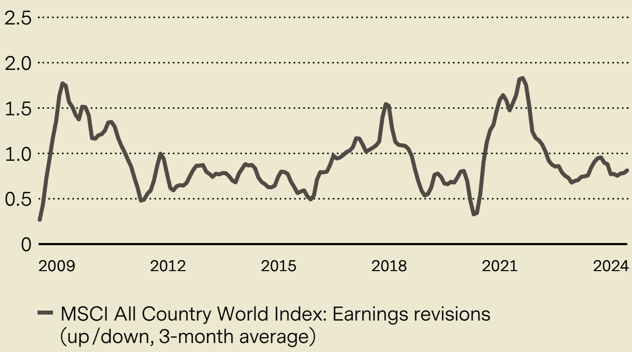


*Reporting season in progress. An earnings surprise is a difference between the reported earnings and the expected earnings of a company.

Source: Bloomberg, Vontobel; data as of April 19, 2024.

Chart 2: Global earnings revisions remain in negative territory, though they seem to have bottomed out

Earnings revisions*



* Values above 1 represent the majority of companies in the MSCI AWCI that had upward earnings revisions; values below 1 represent downward revisions.

Source: LSEG, Vontobel; data as of April 19, 2024.

Crude climbs, gold glitters

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

The Israel-Hamas conflict has dominated the oil market headlines since October 2023. At the time, we outlined three possible scenarios: one in which the conflict remains limited to Israel and Hamas, one in which Hezbollah becomes involved and one in which the "shadow war" fought between Israel and Iran escalates into a more direct conflict. The third scenario became a reality in mid-April, when Iran sent drones and missiles towards Israel in response to an Israeli attack on its consulate in Syria earlier that month (for which Israel has not assumed official responsibility).

The attack marked a new, serious phase in the conflict and pushed WTI oil firmly above USD 80 per barrel (see chart 1). Looking ahead, much depends on how the conflict develops. If there is no further escalation, the focus will sooner or later return to the most important drivers (supply, demand, etc.). However, the potentially higher geopolitical attention of the markets in general could remain in place. In the event of further escalation, higher oil prices (even an oil price shock) could be expected.

Should a shock occur, the Organization of the Petroleum Exporting Countries (OPEC) and its allies could also rush to the rescue, as they currently have around five million barrels per day of spare production capacity.

As we go to press, many stakeholders are trying to deescalate the situation. While US President Joe Biden assured Israel's Prime Minister Benjamin Netanyahu of his support, he aims to limit escalation. The Saudi Foreign Ministry also expressed great concern about the military escalation in the region and called on all parties involved to exercise the utmost restraint.

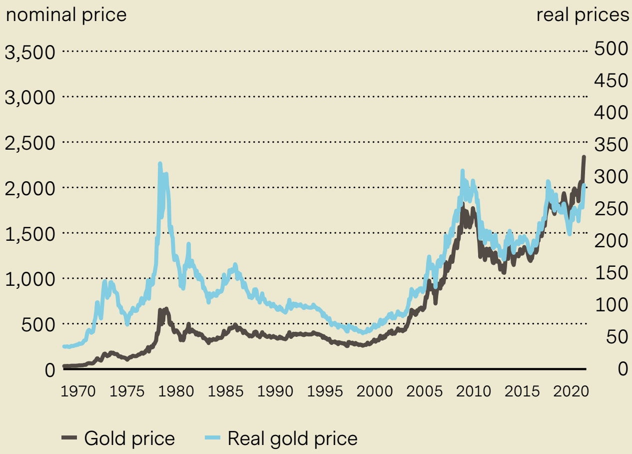
Gold's latest surge cannot be explained by geopolitics alone. The yellow metal has chased one high after the next, despite rising US real yields and US dollar strength (both usually headwinds for gold). A frequently-used explanation is strong central bank demand in emerging markets (China and India added gold at a strong pace).

Although gold has reached a new high in nominal terms, it does not look as extreme in real terms. When we adjust the price for inflation, we can see that gold has been at these peaks before, in 1980, 2011 and 2020 (see chart 2).

Chart 1: WTI oil price (USD per barrel)

Source: Bloomberg, Vontobel SFA

Chart 2: Gold in nominal and real terms (indexed at 1970 prices)



Source: Bloomberg, Vontobel SFA

US dollar riding high on rate-cut reversals

—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

US dollar bears have experienced a frustrating beginning to 2024. So far this year, the US Dollar Index has climbed about 4 percent (see chart 1), buoyed by market expectations that have shifted from anticipating six rate cuts by the Fed to fewer than two. A fresh bout of risk aversion is also filtering through markets, compounding the US dollar's advance.

Still, the potential for further gains from its current high levels is likely limited. If upcoming data and communication suggests that the Fed will only delay its initial rate cut by a few months, yet still implement rate reductions this year with more on the cards for next year, dollar bears might soon gain the upper hand again.

However, if indications from the Fed suggest that rate cuts may not happen this year or that further tightening is still required, the recent dollar rally will likely continue. These developments would underscore the dollar's strengthening trend in response to the Fed's monetary policy signals.

Short-lived geopolitical boost to the Swiss franc
Although a fresh wave of geopolitical tensions provided some support to the Swiss franc, the underlying fundamentals remain unchanged: the Swiss National Bank (SNB) is confronted with significant dovish risk, indicating that the risks to the franc still lie to the downside in the short run.

Despite another disappointing March CPI and the prospect of further weakness ahead, markets continue to anticipate a limited SNB rate-cutting cycle, with only two more cuts fully priced in for this year. This would ultimately reduce the policy rate to 1 percent (see chart 2). Swiss inflation showed an unexpected slow down, reinforcing the decision of the SNB to cut interest rates last month. The SNB surprised investors by lowering its key rate last month, a move that was the first of its kind among G-10 central banks since the global inflationary spike.

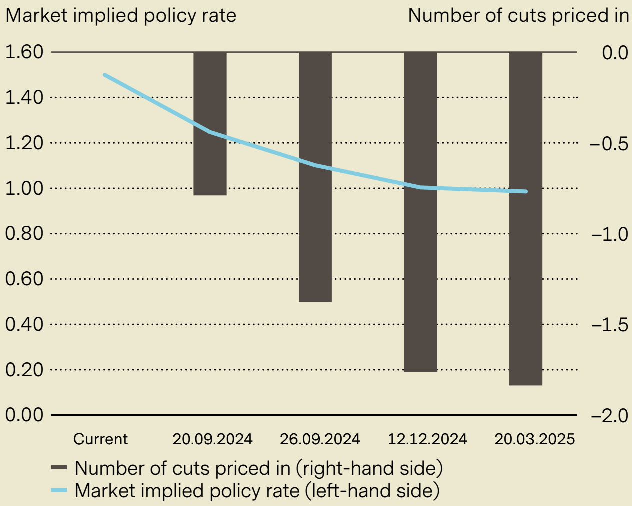
In March, consumer prices increased by just 1 percent year-over-year, marking the lowest increase in two and a half years. This was contrary to the 1.3 percent rise economists had forecasted. The drop in inflation was broad based, indicating that inflationary pressures are subsiding more rapidly in Switzerland than anticipated. Outgoing SNB President Thomas Jordan expressed confidence that there is "very little risk" of inflation climbing beyond the 2 percent upper limit of the central bank's target. The SNB had previously anticipated a modest acceleration in inflation during the second and third quarter, primarily driven by expected increases in rent.

In the longer run, the franc has enough potential to return to the gradual path of appreciation, supported by relatively low inflation, and a strong financial and economical foundation. The current weakness of the franc may offer investors an interesting entry point.

Chart 1: Riding high on rate cut reversals: the Dollar index jumps 4% amid shifting Fed expectations

Source: Bloomberg, Vontobel SFA

Chart 2: Market implied SNB policy rate and number of cuts priced in



Source: Bloomberg, Vontobel; data as of March 16, 2024.

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	3.0	3.2	2.6	2.6
Eurozone	3.4	0.4	0.1	0.5	1.4
USA	1.9	2.5	3.1	2.4	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	2.2
China	3.0	5.2	5.3	4.7	4.4

INFLATION	2022	2023	CURRENT[2]	2024 CONSENSUS	2025 CONSENSUS
Global (G20)	7.5	4.4	3.6	5.1	3.2
Eurozone	8.4	5.5	2.4	2.3	2.1
USA	8.0	4.1	3.5	3.0	2.4
Japan	2.5	3.3	2.7	2.3	1.8
UK	9.1	7.3	3.2	2.4	2.2
Switzerland	2.8	2.2	1.0	1.3	1.2
Australia	6.6	5.7	4.1	3.3	2.8
China	2.0	0.2	0.1	0.7	1.6

KEY INTEREST RATES (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	2.50	4.50	4.50	3.55	2.70
USD	4.50	5.50	5.50	5.00	4.00
JPY	–0.10	–0.10	0.10	0.20	0.20
GBP	3.50	5.25	5.25	4.70	3.60
CHF	1.00	1.75	1.50	1.11	0.98
AUD	3.10	4.35	4.35	4.20	3.50
CNY	3.65	3.45	4.35	4.25	n.a.

GOVERNMENT BOND YIELDS, 10 YEARS (IN %)	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR (Germany)	2.6	2.0	2.50	2.21	2.16
USD	3.9	3.9	4.60	3.96	3.76
JPY	0.4	0.6	0.85	0.91	1.06
GBP	3.7	3.5	4.26	3.68	3.46
CHF	1.6	0.7	0.77	0.70	0.80
AUD	4.1	4.0	4.26	3.95	3.78

FOREIGN EXCHANGE RATES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
CHF per EUR	0.99	0.93	0.97	0.99	1.01
CHF per USD	0.94	0.84	0.91	0.91	0.90
CHF per 100 JPY	0.72	0.60	0.59	0.63	0.67
CHF per GBP	1.12	1.07	1.13	1.15	1.17
USD per EUR	1.06	1.10	1.07	1.09	1.12
JPY per USD	130.00	141.00	155.00	145.00	135.00
USD per AUD	0.67	0.68	0.64	0.67	0.70
GBP per EUR	0.88	0.87	0.86	0.86	0.86
CNY per USD	6.91	7.10	7.24	7.20	7.00

COMMODITIES	2022	2023	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	86	77	86	84	81
Gold, USD per troy ounce	1,824	2,063	2,377	2,106	2,125
Copper, USD per metric ton	8,372	8,559	9,735	8,914	9,275

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

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Vontobel Swiss Financial Advisers AG
Gotthardstrasse 43
8022 Zurich
Switzerland

vontobel.com