Vontobel

US Investors' Outlook

Seeking stability

November 2023

Vontobel Swiss Financial Advisers AG

Content

Imprint

Publishing by
Vontobel Swiss Financial Advisers AG
Gotthardstrasse 43
8022 Zürich

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Frequency
Ten times per year
(next issue December 2023)

Concept
MetaDesign AG

Creation & Realization
Vontobel

Images
Gettyimages,
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Input deadline for this edition
November 10, 2023

Remarks
* Legal information on page 13

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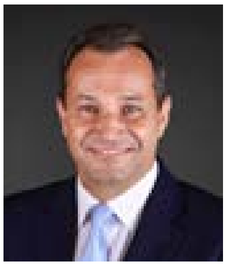


—
Dr. Pascal Köppel
Chief Investment Officer,
Vontobel SFA

Dear readers,

The attacks on Israel and the tension and unrest that followed brought the spotlight right back on geopolitical risks again. The oil price also rose (temporarily) again. At the same time, 10-year Treasury yields reached a new high of 5 percent in the second half of October, a level not seen since 2006.

The US dollar tends to benefit from global market uncertainty. Indeed, it has been rising since the summer until early October. That said, the Swiss franc still outperformed, not only against the euro, yen and pound sterling, but also against the US dollar, in October and the whole of 2023 so far.

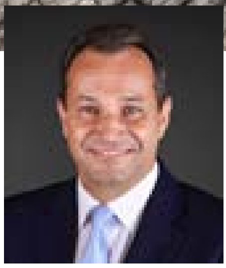
Most people outside Switzerland may associate Switzerland primarily with mountainous landscapes, ample mountain lakes, high quality chocolate, an infinite choice of cheeses, precious and state-of-the-art watches. Most Europeans at least are also aware of the use of the three different main languages, German, French and Italian. Not many people think about attractive investments in Switzerland's corporate sector, as the Swiss equity market is not on the radar of many investment advisors.

But Switzerland is one of the most attractive investment destination. The Swiss Confederation's history dates back around 800 years. It gained independence from the Holy Roman Empire in 1499 and the current federal constitution was created in 1848. Switzerland is a direct democracy that is unique, at least in Europe. It was not involved in either of the two world wars of the 20th century and internationally, Switzerland's neutrality is well respected and honored by its political partners in Europe and abroad.

This has created long-lasting political stability, something that investors value highly. TheGlobalEconomy.com, which ranks 194 countries globally with respect to political stability, placed Switzerland in the top ten. Late September the WIPO (World Intellectual Property Organization) reconfirmed Switzerland as the most innovative country in a ranking that consists of 132 countries.

The Swiss equity market has performed well since the end of 1999 and outperformed key markets, including the US. Investing in Swiss equities also provides significant sector diversification, as technology has a very low weighting in the Swiss equity index. Swiss equities can therefore be seen as complementary to US equities.

This month, we want to explain and highlight some of the strengths of the Swiss economy and Swiss financial assets. We believe these make Switzerland an attractive market for adding long-term returns and providing diversification benefits.



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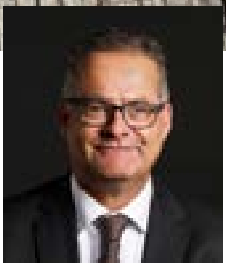

—
Markus Bruhin
Head Managed Solutions,
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Ongoing macro and geopolitical uncertainty

The conflict between Hamas and Israel and uncertainty surrounding the potential spreading of the conflict further increased geopolitical risks during October. Investor nervousness was compounded by greater volatility in both the bond and equity markets.

The global macro and market environment remains very uncertain. This is despite confirmation that US economic growth remains solid with third quarter growth of 4.9 percent quarter over quarter on an annualized basis. The attacks on Israel pushed the oil price, at least temporarily, higher again. Gold also bounced back to levels last seen during spring. Despite expectations that the Fed will keep interest rates on hold, bond yields rose further and the 10 year Treasuries yield even tested the 5 percent mark in October.

Volatility remains elevated in the bond and equity markets with the VIX index exceeding 20 during October. Although these volatility levels are indicative of increased risk awareness and nervousness among investors, they are not in panic mode.

In the current environment, environment, with risks to both economic growth and geopolitics expected to remain elevated and to continue to do so for the time being. Despite the strong current level of US growth, we forecast a gradual slowdown as US consumer and business fundamentals weaken. We see no evidence of an imminent recession risk.

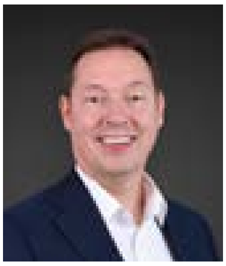
We do however continue to see value in high quality bonds and prefer relatively long duration. This provides protection to the portfolio in case there is a more pronounced deceleration in economic growth but is also an opportunity to lock in historically attractive yields for a longer period. As we are comfortable with our current portfolio positioning, we see no reason for amendments at present. See the details of our asset allocation on page 5.

	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 are attractive.
2 Bonds				→		We are sticking to our slightly positive view on fixed income and reiterate 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 a higher dependence on external borrowing are more at risk and their bond prices do not compensate for that risk. Lastly, we also remain positive on emerging market debt, supported by an expected softening US dollar because of less hawkish US central bank rhetoric and the Fed's pause communicated in June. We should see lower two- and ten-year rates in the quarters ahead, and therefore recommend extending duration slightly in investment grade bonds.
3 Equities			→			Central banks continue to be a very important driver of financial markets. Global growth is holding up overall, despite some regional and sectoral weaknesses. In the scenario of a delayed recession, we therefore believe that an allocation to equities close to the strategic weight is still appropriate. We have introduced a defensive tilt via an overweight in Swiss equities versus UK equities. While having no regional preference for US, Asia Pacific developed markets, Europe and emerging market equities, we acknowledge the valuation discount of Europe and emerging markets.
4 Commodities / Gold			→			Q3 commodities' performance improved with the help of tight energy supply conditions. However, as the global economic manufacturing component has not yet improved, demand will stay weak. We confirm our general underweight allocation to other commodities. The precious metal complex performance year-to-date remains positive but it softened in Q3. Nonetheless, the longer-term case for gold remains unchanged and we are keeping an overweight allocation, as it has been a systemic portfolio diversifier during times of rising market stress.

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

Switzerland's solid economic and political foundation

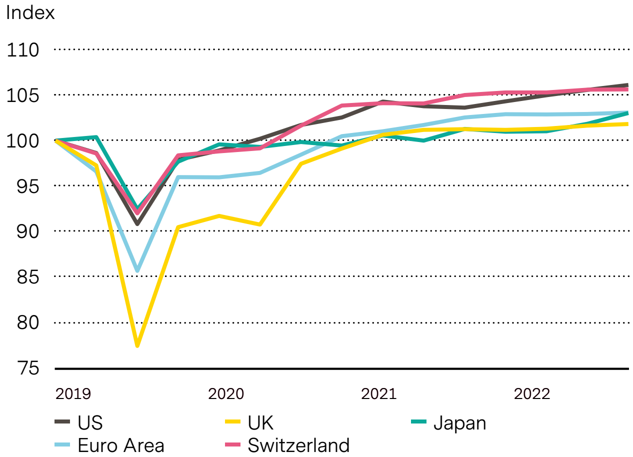
Switzerland has a history of political stability, international neutrality and a solid economic performance with low inflation. The currency, which is discussed further in the FX section, has become stronger over time.



—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

A stronger and even a strengthening currency usually implies a continued loss of international competitiveness. However, this is not a burden for the Swiss economy. Rather, it represents an incentive for high innovation and investment spending within the Swiss corporate sector, in order to preserve the excellent international competitiveness of the Swiss economy. An average capital investment ratio of 25 percent of GDP over the past 25 years is strong evidence for this innovation willingness and ability. High investment spending in Switzerland goes hand in hand with a high gross savings rate, which currently stands above 30 percent. It is also reflected in the development of the Swiss current account. The Swiss economy has had a current account surplus since the early 1980s, which has averaged 7.3 percent of GDP over the past 40 years. This average for the Swiss current account even exceeds the current account surplus of Germany, which is sometimes referred to as the world export champion. Switzerland is therefore ranked among the greatest net creditors in the advanced world.

Chart 1: Real GDP development



Source: Bloomberg, Vontobel

Furthermore, the World Economic Forum and IMD rank the Swiss economy number one with respect to global competitiveness. This top score includes a highly flexible labor market, highly skilled labor force, transparent legal system, exceptional infrastructure, efficient capital markets and low corporate tax rates in an international context. According to Price Waterhouse Coopers (PwC), the direct federal corporate income tax rate stands at 8.5 percent and the overall tax rates, including federal, cantonal and communal taxes, dropped to a range of between 12 and 15 percent after the Federal act on Tax Reform and AHV Financing (TRAF) became effective in 2020. The average corporate tax rate in the advanced economies is approximately 10 percentage points above the Swiss rate.

Altogether, this has created a prosperous and modern market with a structurally low unemployment rate, which has averaged around 3.8 percent over the past 30 years, according to the Swiss Federal Statistical Office. Key employers are the financial sector and other services companies, which account for approximately 75 percent of the Swiss economic value added. Given the high level of competitiveness, the manufacturing sector is therefore dominated by companies that are highly specialized in machinery, chemicals, precision instruments and pharmaceuticals.

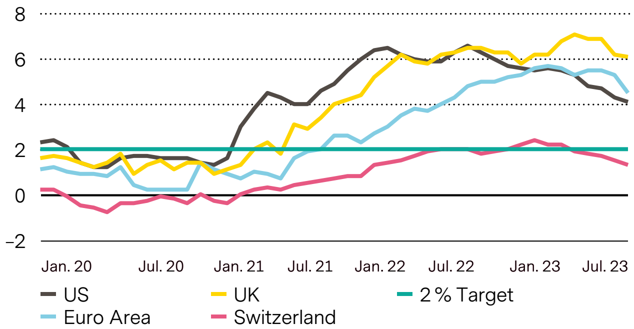
With a stable political environment, and an innovative and highly competitive economy, Switzerland generates one of the highest GDP per capita in the world. It is surpassed only by Luxemburg, which ranks first, and Bermuda. Full employment for many decades also significantly contributes to this economic success.

Since the Covid-19 crisis, the Swiss economy was able to keep pace with the US, whereas other countries lagged behind. This can be seen in chart 1, which shows real GDP development from the pre-Covid-19 peak onward.

Inflation under control
Switzerland has also experienced an increase of inflation over the past two years, similar to other countries. However, its core inflation did not rise as much as elsewhere. As of May 2023, Swiss core inflation had already returned to below 2 percent again. Other countries, primarily the UK and the euro area, are still dealing with sticky core inflation that remains well above the respective central bank targets. It also suggests that the Swiss National Bank (SNB) has had to increase interest rates less than in other countries. Until the end of October, the SNB had increased its official interest rate by 250 bp, compared with increases of 450 to 525 bp by the central banks in the other countries, as shown in chart 2.

Chart 2: Core inflation developments

In %

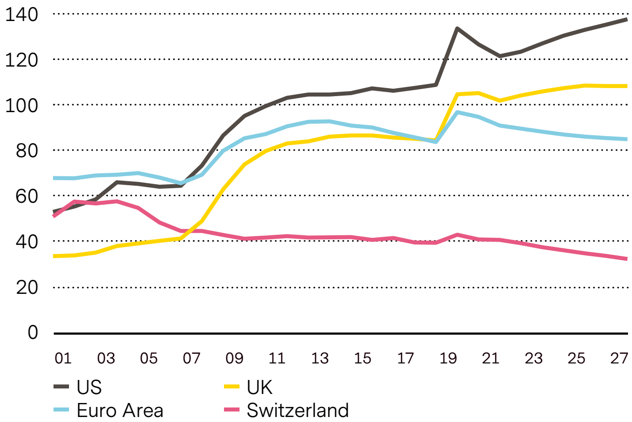


Source: Bloomberg, Vontobel

Low indebtedness
The strong competitiveness of the Swiss economy, combined with robust economic growth and low inflation against a background of high savings, also enabled higher fiscal discipline in comparison with other Western economies. Unlike other developed economies, the Swiss government has used the stronger economic environment to reduce fiscal deficits in the post-Covid-19 period quickly and currently has fiscal surpluses. This together with strong growth has resulted in a favorable debt dynamic. Where some other countries are still seeing their government debt ratios rise, it has fallen in Switzerland to pre-Covid-19 levels (see chart 3). The chart also shows the IMF forecasts, which imply that the US government debt ratio will continue to rise throughout the forecast horizon. With a fiscal deficit in the US that is currently running at nearly 8.5 percent, a significant reduction is required to return the debt ratio to a sustainable trajectory.

Chart 3: Government debt as % of GDP

In %



Source: Bloomberg, Vontobel

Low yields look unattractive at first

—
Matthias Ribback
Portfolio Manager,
Vontobel SFA

Bonds issued in Swiss francs (CHF) offer notoriously low yields. The Swiss Government can borrow funds at a yield of 1 percent for 10 years and corporations on average pay just 2 percent for the same time frame. Savings accounts in Swiss francs offer 1.5 percent at best, with banks touting that level as a great opportunity.

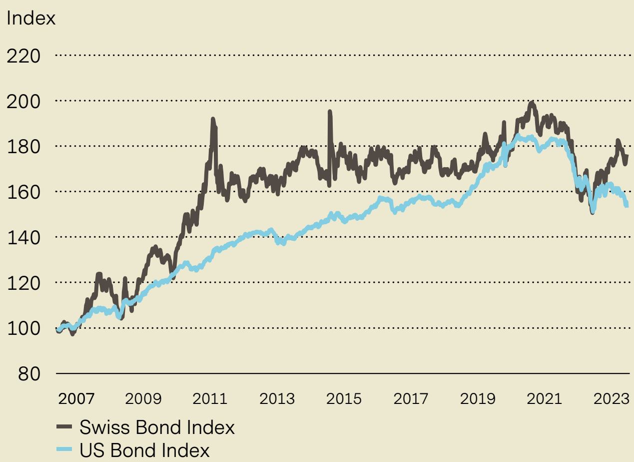
My colleague Pieter Jansen will give a good explanation for this low yield environment in his paragraph about currencies. In essence, it is a mix of prudent government finances, structurally low inflation and a consistently positive trade balance with other countries.

These low nominal yields of Swiss franc bonds might look unattractive initially, especially in the light of the current yield environment in the US.

But there is a catch
While nominal US dollar yields are indeed much higher than Swiss franc yields, the US dollar has also lost its purchasing power at a faster pace than the Swiss franc. This inflation differential between the US and Switzerland is one of the main drivers behind the depreciation of the US dollar against the Swiss franc. In other words, a US investor would have achieved similar returns from investing in US dollar bonds as from investing in Swiss franc bonds, simply because the Swiss franc appreciated enough to cover the difference in interest rates (see chart 1 and 2). The opposite is true as well. A Swiss based investor was not better off by investing in US dollar bonds, despite their higher nominal yields. The US dollar depreciated heavily against the Swiss franc—not consistently every year but in waves.

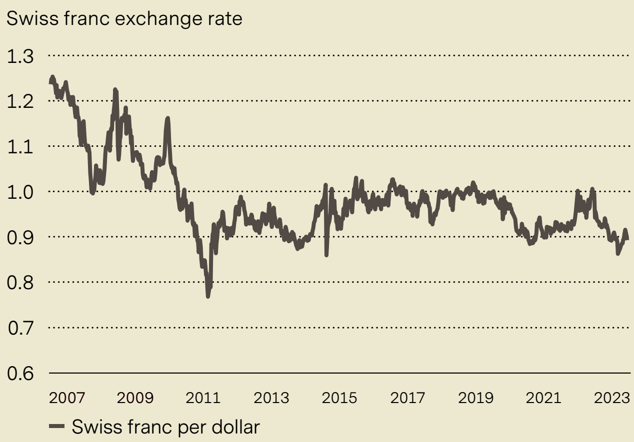
We think a case can be made for currency diversification, especially in times of large fiscal deficits, volatile inflation and geopolitical turmoil. Swiss franc bonds can be a suitable option and investors should look at both the nominal yield on such bonds as well as the potential currency gains.

Chart 1: Swiss and US Bonds measured in USD



Source: Bloomberg, Vontobel

Chart 2: USD / CHF Exchange Rate



Source: Bloomberg, Vontobel

When the going gets tough, the tough get going

—
Markus Bruhin
Head Managed Solutions,
Vontobel SFA

October was not a pretty month for financial markets. We are back to positive correlation between bond and equity prices, and government bond yields rose considerably to come close to multi-year highs. In contrast, equity indices around the globe fell during the month. The Swiss equity indices fell in sympathy and are now trading in negative territory. We still believe that a constructive view on stocks makes sense within the positioning along our long-term strategic view. Regionally, we remain focused on quality, defensiveness and strong earnings predictability, which we find in Switzerland.

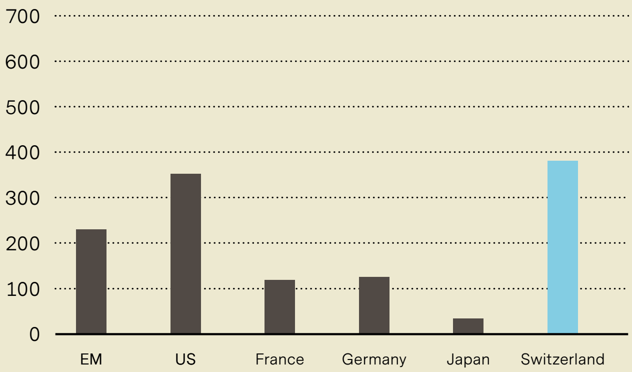
Although the Swiss stock market is small in size, it appears gigantic in terms of market capitalization measured relative to nominal GDP. Capitalization of USD 2 trillion market is on par with the German stock market. Switzerland hosts 13 companies out of the top 100 European and 12 out of the top Fortune Global 500 worldwide by market capitalization. These large multinational corporations play a significant role in the nation's GDP and employ approximately one third of Switzerland's workforce. Additionally, these blue-chip companies have a proven track record of steady profitability, high competitiveness in the global market and have built an unrivaled global reputation for quality and innovation. Nevertheless, the country's economic backbone is formed by its multitude of small and medium-sized enterprises (SMEs), which make up 99 percent of all businesses. These operate across a wide array of industries. What most listed Swiss companies have in common are resilient margins and healthy balance sheets, combined with healthy dividend payouts.

Businesses operating in Switzerland enjoy the advantages of efficient markets, excellent infrastructure and business-friendly regulations featuring relatively low corporate tax rates. The country also boasts a highly educated workforce, contributing to its status as one of the most innovative nations globally. Additionally, Switzerland maintains a high degree of equality and social mobility. The debt brake, introduced in 2003, enabled Switzerland to improve and safeguard its fiscal policy space, resulting in a notably low debt-to-GDP ratio of 42 percent in 2021. In US dollars, the Swiss equity market has a solid performance track record, outperforming other markets since since December 31 in 1999 (chart 1).

We believe it's a good time to start investing or remain invested in Swiss equities. Swiss indices have underperformed year-to-date despite a strong Swiss franc (chart 2). This underperformance is due to the unusual weakness of large defensive companies operating in pharma and consumer staples, which make up around 43 percent of the MSCI Switzerland Index. In addition, the exposure to international markets represents a considerable asset, in that it allows investors to participate indirectly in global growth.

Chart 1: Total return of equity markets

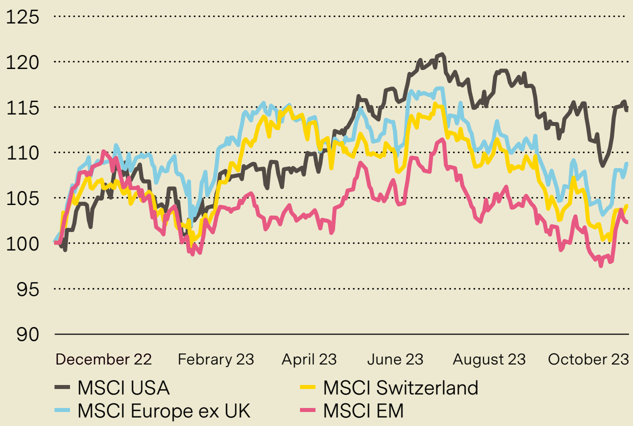
Total return from end of 1999 until now, measured in USD, in %



Source: Bloomberg, Vontobel

Chart 2: Year to date equity performance in USD

Index



Source: Bloomberg, Vontobel

Gold shines again

—
Christoph Windlin
Deputy Head
Investment Management,
Vontobel SFA

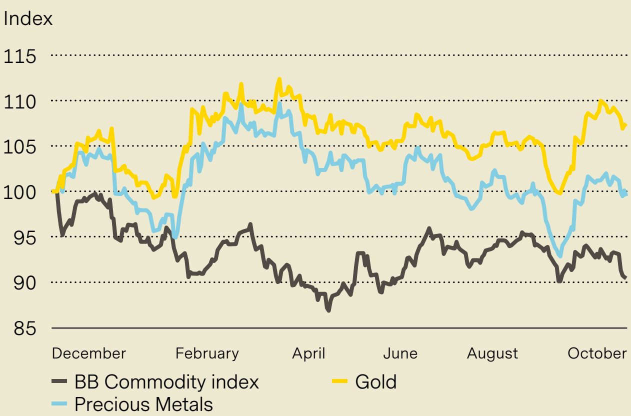
Interest rate insensitive demand and uncertainty support gold. The conflict in the Middle East led to a quick rise in the price of gold, which came close to the peaks of August and September, despite a continued rise in global bond yields.

Falling inventories and lack of swing producers fuel the bullish narrative
Commodities had a mixed to negative year so far. The Bloomberg commodity index is trading nearly 7 percent lower than at the start of the year. Precious metals have been the strongest of the different commodity sectors. Gold has not only outperformed the broad commodity index but also the precious metal index (see chart 1). In addition, this was in a year during which the US 10-year yield has risen by more than 100 bp.

Has gold become insensitive to real yields?
Looking at the relation between the price of gold and real yields, the gold price appears to have become less sensitive to real yields since 2022 (see chart 2). Previously, the price of gold and real yield levels were clearly negatively correlated, as was the case between 2018 and 2021, Fundamentally, this does not make sense. Gold is a non-interest-bearing asset and, as a cash substitute, has to compete with interest-bearing assets such as savings accounts and government bonds. With higher (real) yields, the opportunity costs of holding gold increases.

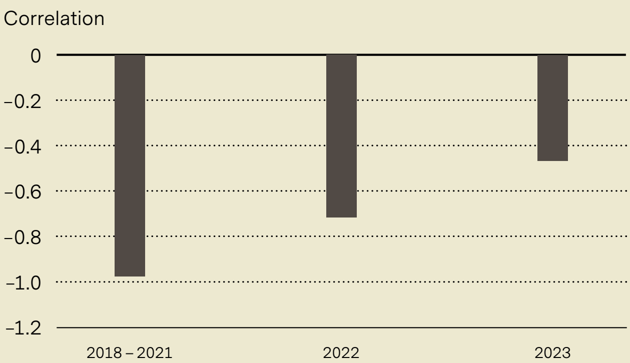
Why then are we not seeing a price correction as real yields continue to reach new highs? We see two key reasons for this. First, there is evidence of gold buying by parties who are not interest rate sensitive. These are primarily central banks that are broadening their FX reserve asset base. Among those buyers that have significantly increased their gold holdings this year include the People's Bank of China, the Monetary Authority of Singapore and the National Bank of Poland. We believe this trend will continue in the years ahead too, as central banks are diversifying their assets further. Second, uncertainty has significantly supported gold this year. This was explicitly evident when regional bank were experiencing problems in early 2023 and more recently during the renewed Middle East crisis (see chart 1). Global uncertainties remain high for now, and macroeconomic and geopolitical uncertainties are here to stay for a while. At the same time, we see that speculative investors are already significantly underweight in gold.

Chart 1: Gold versus commodity performance



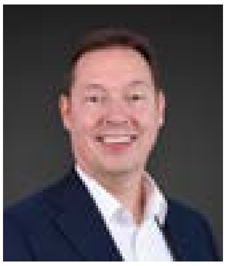
Source: Bloomberg, Vontobel

Chart 2: Correlation between gold price and the real yield



Source: Bloomberg, Vontobel

The Swiss franc has held its ground versus the US dollar



—
Dr. Pieter Jansen
Chief Investment Strategist,
Vontobel SFA

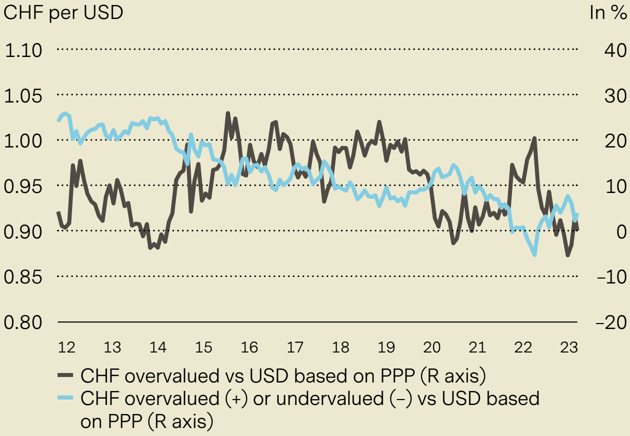
The Swiss franc has held its ground this year versus the US dollar and has improved by 3 percent year to date. Compared with a broad basket of currencies (weighted on trade exposure), the appreciation is slightly higher (4 percent). The Swiss franc has generally shown a gradual increase over a long period of time. Over the past 24 years, the Swiss franc has gained 35 percent versus the US dollar and 41 percent versus the EUR.

By far, most of this can be explained by the lower structural inflation in Switzerland. That said, if it is based purely on purchasing power parity (PPP), the Swiss franc seems slightly overvalued versus the US dollar right now (see chart 1).

Swiss franc remains attractive
The relatively low level of inflation versus the US supports a continued appreciation of the Swiss franc, as we have seen over the past decades. That said, the real effective exchange rate can also vary over time (see chart 2). Demand and supply forces are key drivers of real exchange rate developments. Fundamental factors, such as productivity growth, (structural) current account balances, the holding of foreign assets and the government fiscal position (deficit / surplus and debt ratio), also influence the real exchange rate. Currencies that are seen as a safe haven can also benefit from flight to safety flows. An international reserve currency status is also an important driver of demand for a currency vis-à-vis other currencies.

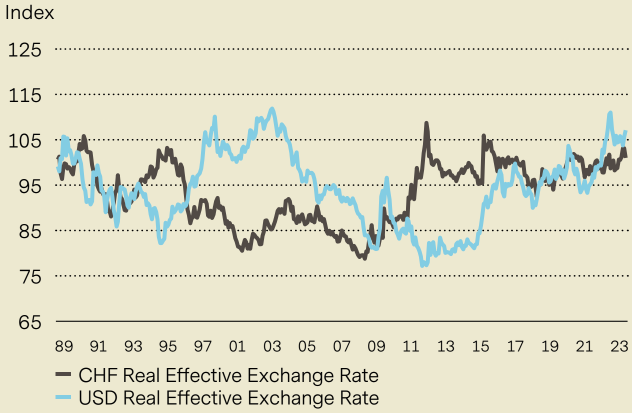
Both the US dollar and the Swiss franc are safe haven currencies. The US dollar has additional benefits, such as a deep and liquid market, and has the status of the world's reserve currency. However, we see that in times of stress (days where the VIX is above 20 points), the Swiss franc on average outperforms the US dollar and that especially Asian central banks are diversifying their international reserves structurally out of US dollar and into other currencies. In addition, the Swiss fiscal position is strong with fiscal balanced budgets and a low government debt ratio, together with a structural net national savings surplus. This compares to a sharp rise of national indebtedness in the US, while the structural current account deficit has accumulated to a negative international investment position of nearly USD 17 trillion, according to the IMF.

Chart 1: CHF per USD and over / undervaluation on PPP basis



Source: Bloomberg, Vontobel

Chart 2: Real Effective Exchange Rate developments



Source: Bloomberg, Vontobel

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 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	2.6	3.3	2.5	2.1
Eurozone	5.3	3.5	0.5	0.5	0.8
USA	5.9	2.1	2.9	2.2	1.0
Japan	2.3	1.1	1.6	1.8	1.0
UK	8.5	4.0	0.6	0.4	0.4
Switzerland	4.3	2.0	0.6	0.8	1.1
Australia	5.3	3.6	2.1	1.7	1.5
China	8.4	3.0	4.9	5.0	4.5

INFLATION	2021	2022	CURRENT[2]	2023 CONSENSUS	2024 CONSENSUS
Global (G20)	3.5	7.3	4.1	5.5	4.6
Eurozone	2.6	8.4	4.3	5.6	2.7
USA	4.7	8.0	3.7	4.2	2.7
Japan	–0.3	2.5	3.0	3.1	1.9
UK	2.6	9.1	6.7	7.4	3.1
Switzerland	0.6	2.9	1.7	2.2	1.6
Australia	2.9	6.6	5.4	5.6	3.4
China	0.9	2.0	0.0	0.5	1.8

KEY INTEREST RATES (IN %)	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
EUR	–0.50	2.00	4.00	3.98	3.30
USD	0.25	4.50	5.50	5.50	4.45
JPY	–0.10	–0.10	–0.10	–0.08	–0.03
GBP	0.25	3.50	5.25	5.30	4.55
CHF	–0.75	1.00	1.75	1.77	1.47
AUD	0.10	3.10	4.10	4.35	3.80
CNY	3.80	3.65	4.35	4.25	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	2.85	2.51	2.28
USD	1.5	3.9	4.87	4.3	3.77
JPY	0.1	0.4	0.88	0.79	0.83
GBP	1.0	3.7	4.57	3.96	3.6
CHF	–0.1	1.6	1.14	1.11	1.02
AUD	1.7	4.1	4.81	4.26	3.88

FOREIGN EXCHANGE RATES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
CHF per EUR	1.04	0.99	0.95	0.97	1.00
CHF per USD	0.91	0.94	0.90	0.90	0.89
CHF per 100 JPY	0.79	0.72	0.60	0.64	0.67
CHF per GBP	1.23	1.12	1.09	1.12	1.14
USD per EUR	1.14	1.06	1.06	1.08	1.12
JPY per USD	115.00	130.00	150.00	140.00	133.00
USD per AUD	0.73	0.67	0.63	0.66	0.70
GBP per EUR	0.84	0.88	0.87	0.87	0.88
CNY per USD	6.37	6.91	7.32	7.20	6.93

COMMODITIES	2021	2022	CURRENT	CONSENSUS IN 3 MONTHS	CONSENSUS IN 12 MONTHS
Brent crude oil, USD per barrel	79	86	90	88	86
Gold, USD per troy ounce	1,829	1,824	1,986	1,950	1,995
Copper, USD per metric ton	9,720	8,372	7,986	8,515	9,000

1 Latest available quarter
2 Latest available month, G20 data only quarterly
Source: Vontobel, respective statistical offices and central banks; as of October 27, 2023

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