

June 2024

MONTHLY HOUSE VIEWS



CROSS CURRENTS

Macro

Consensus forecasts for 2024 growth have been revised higher across the board in recent months. Year-to-date, the biggest upward adjustments have been in the US (up 110bp to 2.4%) and China (up 40bp to 4.9%) while estimates for the Eurozone are only 15bp higher at 0.7%. However, recent trends in data releases suggest that the laggards may see some improvement. For example, Citi's economic surprise index for the Eurozone has recorded many more positive surprises than negative for the past four months, while the equivalent index for the US has been negative since early May. Moreover, the latest revision to US Q1 GDP showed growth slowing to 1.3% annualised, down from 3.4% in Q4, while the Institute of Supply Management's manufacturing confidence survey is back in contraction territory after brief respite in March. And in China, real GDP growth in Q1 hit 5.3% year-on-year, above the authorities' 2024 target and better than the most optimistic forecasts.

Central Banks

The consensus among economists expects the European Central Bank (ECB) to deliver the rate cut promised by President Lagarde at its early June meeting. Thereafter, the ECB may go on hold as it awaits further deceleration in inflation – the core inflation rate accelerated from 2.7% year

-on-year to 2.9%, uncomfortably far above the ECB's 2.0% target. The US Federal Reserve on the other hand is not expected to ease policy until its September meeting, although a cut is by no means certain – that meeting will be held less than two months before the presidential election and the Fed may be wary of accusations of political partisanship during the most critical period of the campaign. Moreover, core personal consumption expenditure prices (core PCE, the Fed's preferred inflation gauge) has risen at a 4.1% annualised rate since the start of this year.

Markets

After a period of consolidation which saw MSCI World index of global equities drop -3.9% in April, the bull market resumed last month – the index reached new all-time highs mid-month and ended the month up 4.2%, its sixth advance in the last seven months. At the factor level, there was a switch back from Value to Growth, which outperformed for the first time in three months, while the only sector to lose ground last month was energy which shed -0.2%. The weak run of US macro data brought some respite to bonds in May and Bloomberg's Global Aggregate bond index rose 1.3%, its best monthly return of the year so far. However, the weakness also penalised energy prices which dropped -5.1% last month.

Bottom Line

While equity allocations should remain unchanged at modestly Overweight, we suggest taking advantage of this year's strong performance to hedge part of the exposure against any volatility in coming months. Our geographic picks also remain unchanged, with the US preferred to Europe and Europe to Asia. We continue to call for a balanced exposure across factors to avoid too much concentration in areas like Technology where valuations remain somewhat demanding. Our allocation to US duration (i.e., sensitivity to changes in rates) remains at Neutral while historically tight credit spreads (the yield difference between corporate and sovereign bonds) suggest investors should remain very selective.

Summary House Views

OUR ASSET ALLOCATION

The tables below present the latest conclusions of our Global Investment Committee.

Equities	Equity performance has pushed allocations into slightly Overweight territory. We continue to recommend investors strike a balance between Value and Growth. We prefer the US to Europe, and Europe to Asia.	+
United States	We have adjusted our US allocation to achieve a better balance between Growth and Value. Quality and Growth stocks have dominated recent market performance, but their valuations are getting stretched.	+
Eurozone	The bear story for Eurozone equity markets is well-known. However, the markets are still cheap, still under-owned and still in an uptrend.	=
UK	Recent macro data in the UK has shown some improvement, and the equity market has begun to catch up with its neighbours.	-
Switzerland	The Swiss market is dominated by high-quality, defensive stocks, which should help cushion any downside, while inflationary pressures remain well below those suffered by its neighbours.	=
Japan	The Tokyo Stock Exchange's efforts to improve corporate governance to focus on shareholder returns, combined with cheap valuations, have fostered a bull run in Japanese stocks.	=
Emerging (EM)	The Chinese authorities have taken some measures to shore up domestic equity markets and Chinese stocks look cheap in light of expected earnings growth.	=

Fixed Income	Today's environment of sticky inflation, elevated policy rates, quantitative tightening and inverted yield curves will continue to prove challenging for fixed income investors.	-
Sovereigns	The sharp rise in policy rates and the inverted yield curve have created attractive opportunities in short-dated bonds. Nonetheless, the risk of a downturn led us to rebuild exposure to duration.	-
Duration	We have now rebuilt a Neutral allocation in duration which has both reduced our Underweight compared to the market and provided a hedge against macro weakness and Fed easing.	=
Inflation-linked	Inflation-protected securities tend to have very high duration, making them extremely sensitive to small shifts in inflation expectations.	=
Investment Grade	The sharp rise in policy rates and inverted yield curve have created some buying opportunities in short-dated EUR-denominated high-quality corporate bonds. We remain Underweight nonetheless.	-
High Yield	Credit spreads have tightened to unattractive levels, especially if growth weakens. Investors should remain very selective given the potential for a deterioration in credit quality.	-
Emerging debt (in € and \$)	In recent months, we have warned that political risk in Latin America required careful monitoring. The reaction to the recent presidential elections in Mexico underlines this point.	=

Upgrade

Downgrade

Overweight

Neutral

Underweight

Commodities	Although the slow recovery in China likely to gradually boost demand for raw materials, worries about a slowdown in advanced economies in H2 have led us to reduce allocations to commodities to Neutral.	=
Energy	With OPEC+ cutting output and oil majors reluctant to invest in new production capacity, crude oil supply is constrained. However, fears of economic slowdown in the west have kept prices rangebound.	=
Industrial metals	The key driver for industrial metal prices will be Chinese demand as the economy picks up. We also continue to highlight the attractions of transition metals like copper and nickel.	=
Precious metals	Central bank demand for gold remains strong and bullion continues to provide useful diversification benefits in terms of portfolio construction.	+

Currencies	Since late 2022, the dollar index has been stuck in wide range. The 3.3% rally this year has been fostered by favourable interest rate differentials.	
EUR/USD	The European Central Bank (ECB) has begun to deliver on the promised rate cuts, which could remove one of the single currency's supports.	=
GBP/USD	The growth outlook has begun to improve despite the UK's structural weaknesses, but election uncertainty could weaken sterling in the near term.	=
EUR/GBP	Both currencies face strikes and political challenges, and the advantage conferred by the Eurozone's better budget discipline is offset by sterling's higher rates.	=
USD/JPY	The shift in official statements about yen weakness suggests that the authorities may intervene to prevent further dollar strength at some point.	=
EUR/CHF	Switzerland's success in bringing inflation back in line allowed the Swiss National Bank to start cutting rates ahead of the ECB which accentuated the downward pressure on the Swiss franc.	=
Emerging	Attempts by EM currencies to build a base after recent lows against the US dollar in early October appear to have run out of steam.	-

CROSS CURRENTS

Recent months have brought a mixed bag of US macro-economic data. 2024 GDP growth forecasts have been revised up from 0.6% to 2.4% since last summer, while Citi's index of economic surprises has turned negative for the first time since early last year. Retail sales volumes are 15.7% above pre-pandemic levels but MNI's Chicago Business Barometer has plunged close to its pandemic-era lows. Is the US economy accelerating or slowing down? And what does this mean for financial markets?

The US publishes two separate diffusion indicators of business sentiment, S&P Global's Purchasing Manager Index (PMI) and the Institute of Supply Management's surveys (ISM), both of which are split into manufacturing and services businesses. Over the years, their results have mostly been consistent but, from time to time, stark divergences appear.

May's manufacturing gauges provided a striking example of divergence. According to the PMI, confidence jumped to 51.3 points (50 points marks the frontier between expansion and contraction) and has been in expansionary territory since January. For the ISM on the other hand, confidence dipped to 48.7 and has been in contraction for 16 of the last 17 months. There is another striking contrast between the results for service companies and manufacturers. Both services surveys are solidly in expansion territory, with a simple average of 54.3 points, while the manufacturers' average in May was only 50.0. There are a number of explanatory factors, but one that stands out is household wealth. For example, household cash deposits ticked higher in Q1 and remain close to all-time highs.

The first full week of every month brings a flurry of US job market data. It is not uncommon for reports to send conflicting signals, but the level of inconsistency has grown sharply in recent months. The starkest divergence is perhaps to be found between the two main job creation reports published by the Bureau of Labor Statistics, known as the "establishment" and the "household" surveys. In May for example, the companies polled for the establishment report announced an increase of 272'000 employees while households reported a loss of 408'000 jobs. Such a discrepancy is almost unprecedented. But the explanation is actually quite simple. The household survey counts each individual only once, irrespective of how many jobs they hold. But if an individual has been forced to take on three jobs, each of his employers will count him separately for the establishment survey.

The difference in respondents to the surveys helps explain why the unemployment rate (which is based on the household report) rose to 4.0% in May. This is just below the Federal Reserve's estimate of the long-run, sustainable unemployment rate, which is currently 4.1%, but it is well above the 70-year low of 3.4% which was reached early last year. This sharp increase has triggered speculation that the Sahm rule might signal a recession – this rule, named after the former Fed economist Claudia Sahm, holds that a 50bp increase in the three-month average in unemployment from

its twelve-month low indicates a recession has already started. In May, the difference reached 37bp, so no downturn so far. However, if the upswing in the unemployment rate continues in coming months, a signal could be triggered by the autumn.

So why do economists expect the US to continue to outperform its peers? One common answer is the US's capacity for innovation, which helps boost productivity. Non-farm productivity grew 2.9% year-on-year in Q1, well above the 2.0% average over the last three decades. The other major contributor to the US growth advantage has been debt. Growth has been explosive – according to US Debt Clock.org, the federal debt to GDP ratio is currently 122.3%, up from 57.5% at the turn of the century. Over the same timeframe, the Eurozone's debt to GDP has also risen, but only from 71.6% to 88.6% according to Eurostat. And the gap is set to grow further. The US is currently running a budget deficit of 5.9% of GDP versus 3.6% in the Eurozone.

This raises the problem of debt service costs. At the end of last year, federal outlays on interest as a percentage of GDP had shot up from 1.2% in 2015 to 2.4%, the highest level since 1998. And the Congressional Budget Office expects debt service to reach 3.9% by 2034, which would be a new all-time high. The increasing diversion of tax dollars to simply pay the interest on borrowing does not augur well for the growth potential of the US economy in the long term.

Bottom Line

Services represent 77.6% of US GDP which means that the current level of ISM and PMI confidence will keep GDP strong for now. The job market continues to look very strong, particularly when viewed through the prism of the establishment survey. We should not underestimate the importance of fiscal policy in underpinning US growth, and also in providing the liquidity to keep asset prices buoyant, which has in turn bolstered consumer confidence and spending.

For now, this backdrop remains supportive for US equity markets. However, investors should remain alert to signs of a downturn in the economy. Expectations of forthcoming interest rate cuts on the back of signs of lower inflation and some weak data-points like ISM manufacturing have encouraged investors to bid valuations higher. But we would caution that recessions tend to lead to a much less favourable environment for equity investors.

EQUITIES

The MSCI World index of global equities recovered quickly from its -3.9% drop in April with a 4.2% jump last month, its sixth advance in seven months. Yet again, the Magnificent Seven group of stocks led the way last month, jumping 9.1% to take year-to-date performance to 24.8%. The US S&P500 index outperformed the pan-European STOXX600 index for the first time in three months, with 4.8% and 4.2% gains respectively. On the other hand, emerging market stocks marked time with a second consecutive 0.3% advance (all data in dollar terms).

US . The proportion of stocks trading above their 200-day moving average (DMA) was unchanged at end May at 72% and participation in the rally has remained elevated, between 70% and 80%, since last December. Last month's recovery in prices was driven mainly by the Growth, Quality and Momentum factors – MSCI's US indices for these factors all rose by between 5.5% and 6.5% while Value lagged with a 2.7% advance. At the sector level, only energy lost ground last month with a -0.9% decline while technology and utilities led the way, rising 9.3% and 8.5% respectively – investor interest in the latter has been bolstered by the increase in energy demand triggered by the data farms required to run artificial intelligence models.

May's rally in stock prices pushed S&P 500 valuations back up from 22.6x trailing earnings to 23.1x, well above end October's 19.1x, just before the stock rally commenced. However, the Q1 earnings season was encouraging – final reports show earnings were in aggregate 8.2% above expectations with all eleven sectors beating consensus estimates, according to Bloomberg. The trailing valuation premium over European stocks edged higher from 9.0 points to 9.1 and remains well above end October's 7.9 points. This premium cannot fully be explained by the market-dominant valuations of the Magnificent Seven stocks – the valuation premium of US information technology stocks over their European peers while the biggest overvaluations is one of the lowest among sectors at 16.5%, well below consumer discretionary and financial stocks, which are 97.3% and 86.2% more expensive respectively. The same holds true for factor indices - according to MSCI, US Growth stocks trade at a 48.7% premium to Europe and US Value 71.8% higher. We continue to call for a blend of Growth and Value stocks in portfolios.

Europe . Investors have long been bearish on European equities. Indeed, the geopolitical backdrop remains worrisome – the war in Ukraine seems to have turned in Russia's favour while Israel's war with Hamas has spilled over to the broader region and Houthi attacks on cargo ships in the Red Sea continue to disrupt supply chains, adding to inflationary pressures. In addition, investors continue to shy away from European equity funds – according to EPFR, redemptions since the start of this year total \$22.1bn. However, the macro backdrop may be improving. Since the start of February, there have been more positive than negative surprises among economic reports according to Citi's Economic Surprise Index and economists have begun to revise their forecasts for 2024 's real GDP growth higher. Moreover, there are early signs of a turn up in business

confidence – the Eurozone's composite PMI survey has been in expansion territory since March and strengthened further in May to its best level in a year. This is also beginning to feed through to earnings – according to Bloomberg, analysts now expect 1.4% growth in 2024 MSCI Europe earnings, a sharp turnaround from the -1.9% decline they expected last month. Finally, Eurozone equity markets continue to perform satisfactorily – since bottoming at the end of September 2022, the STOXX 600 index has provided a 40.1% net total return versus 35.4% for the S&P 500 in euro terms.

In valuation terms, European equities continue to look cheap compared to history and to other markets, notably the US. As highlighted above, the MSCI Europe index trades at 14.2 x trailing earnings versus 23.3x for its US counterpart. Moreover, European stocks are expected to pay investors a handsome 3.4% dividend yield in 2024, more than twice the forecast 1.4% yield on the MSCI US index.

Emerging Markets . Stocks in emerging Europe and Asia both rose in April, by 2.2% and 1.2% respectively, while Latin America lagged with a -3.9% tumble. This big outlier in LatAm was again Argentina – stocks jumped a massive 22.2% in April taking year-to-date returns to 60.4%, easily the strongest returns among all the markets we follow. In Asia, strength in technology stocks helped propel Taiwan to the top of the leader board with a 4.2% advance, while financials-heavy Indonesia dropped -3.6% over the month. Finally, regional heavyweight China has slightly outperformed the region as a whole – the MSCI China index was up 2.1% in May and 6.3% YTD versus 1.2% and 5.2% for the MSCI EM Asia benchmark (all data in dollar terms).

After suffering a deep bear market in 2022 when prices fell -31.6% peak-to-trough, Taiwan's TAIEX index has rallied by 67.2%. Over the period, correlation has been extremely high with the Nasdaq Composite index, little surprise given that information technology and internet platforms represent the majority of market capitalisation in both. Analysts are optimistic for the next twelve months with forecast earnings growth for Taipei at 30.4% while valuations at 17.4x forward earnings are relatively attractive, versus 28.8% and 28.0x respectively for the Nasdaq.

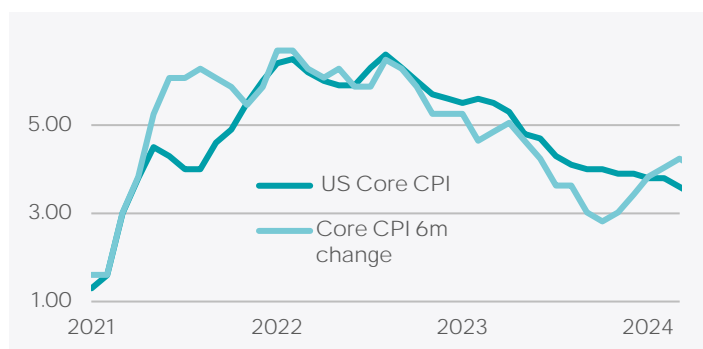
Bottom Line

Our Investment Committee has decided to keep equity allocations unchanged for now, at a modestly Overweight allocation to stock markets. Our geographic picks remain unchanged, with the US preferred to Europe and Europe to Asia.

FIXED INCOME

Bloomberg's Global Aggregate bond index rose 1.3% in May, reducing year-to-date losses to -3.3%. Despite last year's 5.7% rally, the global bond market has been in decline for most of the past four years.

US . After surprising on the upside in April, inflation came in below expectations in May but the three and six-month annualised rates continue to trend higher. The minutes from the latest Fed meeting clearly point toward a more patient approach to lowering interest rates – they stated that “Various participants are willing to tighten more if needed” and that “many [...] commented on their uncertainty about the degree of restrictiveness”. This means that it is much less clear than before that we will see a Fed rate cut this year unless there are major changes in the economy. Accordingly, the expected number of 25bp rate cuts has fallen to less than two, down from almost seven at the start of the year according to Bloomberg's probability calculator.



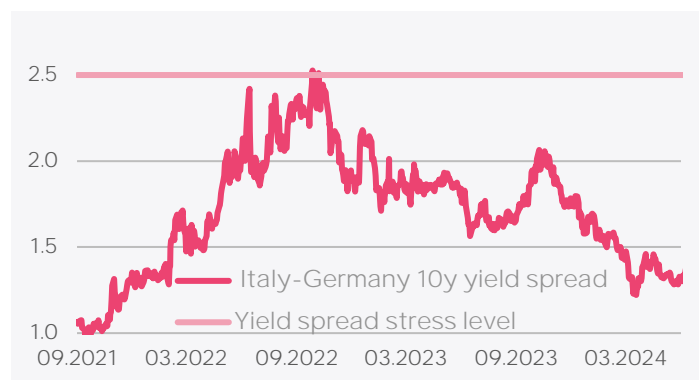
Source: Bloomberg

Although longer dated bond yields fell in May, they remain in an uptrend. Moreover, the mismatch between supply and demand means that the risk tilted toward higher yields. The US federal deficit is now at 6% of GDP which means that Treasury borrowing needs have shot up – issuance plans for the next two quarters equate to an eye-watering \$2.2 trillion annual pace. In addition, although the Fed has begun to slow the pace at which it is shrinking its balance sheet, it is still a net seller of \$25 billion of Treasuries each month.

Foreign central banks, an important source of demand for Treasuries, are slowing their purchases. For many emerging world central banks, gold has become a more attractive asset following the freezing of Russian financial assets. On the other hand, the Japanese central bank, traditionally a large buyer, has resumed its purchases recently. However, this may not last. For one, current Treasury yields hedged into Yen are still less attractive than the equivalent Japanese Government Bond yields. Moreover, the authorities may be forced to step up their purchases of yen to prop up the currency following its recent weakness, which does not bode well for purchases of Treasuries for reserve purposes. This leaves households. For the moment, they are increasing their holdings but mostly at the short end of the curve, matching the Treasury's issuance of notes. However, another bout of inflation could push them to demand higher yields to compensate for rising prices and skyrocketing supply.

Europe . In the Eurozone, while it might still be early to tell, inflation has been coming down much more steadily and the ECB has already indicated that it will lower interest rates in June. Although there may still be some upside surprises in inflation ahead, the market is taking the ECB at its word and has priced in a rate cut for the June meeting. Moreover, governing board member Francois Villeroy (a voter) said that a June cut was a done deal barring any surprises and that the ECB should not rule out a second rate cut in July.

In Europe, there is less likelihood of a spurt in inflation but correlations with US fixed income remain strong, which could limit the upside for euro-denominated bonds. Italy continues to perform well economically, and BTPs look attractive relative to German Bunds. Moreover, if the ECB does cut rates this summer, that should be supportive for all fixed income assets denominated in euros.



Source: Bloomberg

Asia . In Asia, the picture is more mixed. China continues to ease as it is still in the midst of a slump in its real estate market. Japan has removed its yield curve control cap on long-dated yields, which have begun to move higher from a very low base – bonds there remain rather unattractive compared to Western alternatives.

Credit . Credit spreads – the difference in yields between corporate and sovereign bonds – have tightened significantly over the last two years and are now near their historical lows, despite abundant issuance by borrowers in May. There have been a number of instances of bankruptcy among companies who had taken too much debt at low rates. However, these are isolated cases and the majority of companies we follow have been deleveraging and remain prudent with credit. Moreover, generous fiscal spending is likely to push nominal GDP higher, thereby reducing companies' real debt burden in aggregate. Credit analysis is more important than ever – higher rates will put some companies in difficulty but, overall, corporate balance sheets look in a solid financial position.

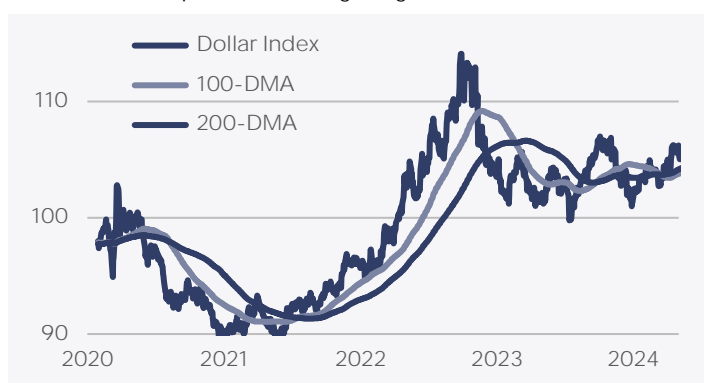
Bottom Line

Although we remain defensive overall in our fixed income allocations, with a clear focus on high quality credit, we have now rebuilt a Neutral allocation in duration given the possibility of some economic weakness later this year.

CURRENCIES

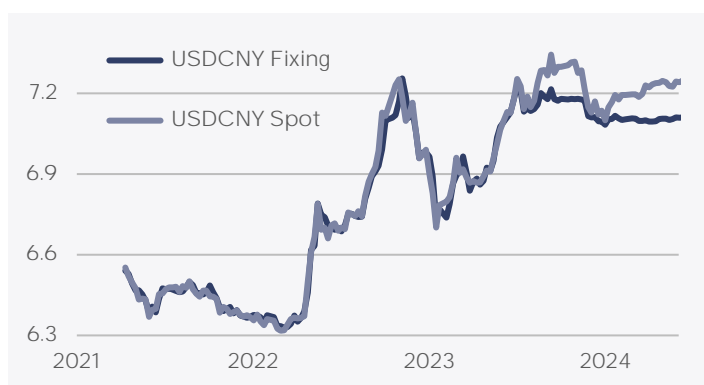
Since late 2022, the dollar index has been stuck in wide range. The 3.3% rally this year has been fostered by favourable interest rate differentials.

USD . Growth in the US remains more resilient than in Europe or China which means the Fed may stick with today's elevated key rates for longer than many investors expect, a dollar-positive combination. It would take a resurgence in global growth to reverse this dynamic. Although this is not completely out of the question given current low levels of activity in China and Europe, there are few signs that such a reversal is imminent. All in all, the dollar index could trade towards the top of its trading range.



Source: Bloomberg

Asia . Asian currencies seem attractive short candidates given the differential in interest rates versus the US dollar, especially the Japanese yen. Moreover, growth in Japan and China is sluggish. However, these are crowded positions and any change in policy could push JPY or CNY sharply higher versus USD.



Source: Bloomberg

COMMODITIES

Global spot commodity prices dropped -2.2% in May, dragged lower by sharp falls in crude oil prices.

Energy . Brent crude prices fell -7.1% in May, their first negative month this year, taking year-to-date (YTD) performance back to 5.9%. The weakness was driven by a slew of weaker macro data in the US which traders feared might mean reduced oil demand. Apparently, the OPEC+ cartel agree. During their biannual meeting on Sunday June 2nd, oil ministers voted to extend some of their output curbs into next year. Going into the meeting, these curbs totalled 5.86m barrels per day (mb/d), of which 2.2mb/d were due to expire in June. This reduction has been extended until September this year, after which it will be tapered over twelve months. An additional 3.66mb/d of cuts, which were due to expire in December, have been extended until the end of next year. The only exemption has been granted to the United Arab Emirates, which will be allowed to increase its output gradually by 0.3mb/d next year. This means that supply equivalent to between 3.2% and 5.7% of global demand will remain offline over the next 18 months, in an attempt to keep oil prices high.

In its May report, the International Energy Agency (IEA) revised its forecast for global oil demand growth down by 0.1mb/d to 1.1mb/d, taking this year's estimated demand to 102.9mb/d. For 2025, the IEA sees a slight acceleration in demand growth to 1.2mb/d. On the supply side, the IEA expects that strong output growth from non-OPEC producers will help compensate for OPEC+ curbs, pushing world crude production up 0.6mb/d to a new all-time high at 102.7mb/d. With supply and demand close to equilibrium and both at all-time highs this year, we would expect crude oil prices to continue to trade in a wide band until year end.

Gold . Gold prices gained a further 1.8% in April to \$2'327 per ounce, after reaching a new all-time high at \$2'425 mid-month. As noted last month, gold has now clearly entered a new bull market after failing on three separate occasions – in August 2020, August 2022 and March 2023 – to break above its previous peaks around \$2'000. Importantly, this breakout has occurred despite dollar strength and rising bond yields. The dollar index has risen 3.3% since the start of the year while 10y Treasury yields are up 62bp. Gold is of course traded in dollars and tends to strengthen when the greenback falls while the opportunity cost of holding gold, a non-interest-bearing asset, tends to fall when rates decline. Interestingly, gold's strong performance has not attracted buyers of gold-backed ETFs in size – although May was the first month in twelve to see modest inflows of around 8 tonnes (t), total redemptions so far this year amount to 138t.

On the other hand, demand for gold from emerging world central banks and consumers in China and India remains robust. In 2023, central bank buying of gold reached 1'037t, only slightly below 2022's all-time high at 1'082t. With little growth forecast in mining output, the longer-term picture for gold prices remains bright.

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