CITY OF LONDON
Investment Management Company Limited

Developed Markets Quarterly Outlook

February 2024*

Overview

The Year of the Pivot

Our 2024 growth forecast distribution remains wide between hard and soft-landing scenarios. However, we have greater confidence that the US interest rate outlook has shifted towards rate cuts this year as recent inflation prints have fallen towards the Fed's 2% target. Given this shift, our allocations are moving towards equities that typically perform better in falling rates environments while we continue to balance between contrasting economic growth outcomes. Our bias is tilted towards a slower growth environment, but recent activity remains resilient and does not currently support an aggressive defensive stance.

The macro narrative has shifted on some fronts for 2024. Investors' growth expectations are less pessimistic than in early 2023, and rate expectations have shifted lower as inflation measures have fallen. The Fed raised interest rates by 525bps over 2022-23, and their dot plot is now signalling three rate cuts this year. The exact number of rate cuts and the timing of the first cut remains debatable, but over the past 50 years, a decline in bond yields has consistently followed the last Fed rate hike. Our changes this quarter reflect a move towards assets that typically perform better during rate-cutting cycles.

On a similar note, Technology stocks have historically benefited from rate cuts given the lower discount to future earnings. The US has the highest weighting to Tech, which should support earnings growth. Still, we are reluctant to hold overweight exposure to the US at a 20x forward P/E multiple, which already reflects significant optimism. Instead, we favour Emerging Markets (EM) exposure, which includes a considerable weighting to advanced semiconductor stocks and a more attractive valuation.

China remains the largest weight in EM and a key driver of global growth and commodity demand. China's outlook remains challenged by various structural issues, but real GDP growth of "around 5%" remains achievable this year, and policymakers appear committed to keeping growth stable. Despite these efforts, the ongoing property sector weakness should limit demand for industrial commodities (such as iron ore) this year. As a result, Australia will likely be a laggard. However, EM can still outperform despite its direct exposure to China. Chinese stocks have a weak correlation to GDP, and the overall EM index is highly exposed to growing demand for advanced chips. The MSCI EM Index is expected to deliver 18% earnings growth this year and outpace the broader ACWI. Cheap valuations, a fall in US rates, and a decline in the US dollar will also help reinforce robust EM earnings growth.

Geopolitical risks should remain an ongoing theme for oil prices, with Middle East tensions being the primary driver. We look for oil prices to be supported by these risks. However, US shale production has exceeded expectations, which will reduce the impact on supply if tensions escalate. We, therefore, trim our overall Energy exposure (via a reduction to the UK) but maintain some Energy allocation (via a small overweight to Canada).

Market Strategy: Our allocations balance a 'soft' and 'hard' landing scenario given the contrast between resilient current activity and warning signals from forward-looking indicators (e.g., an inverted yield curve and tight credit conditions). However, we made changes this quarter to reflect further evidence that the outlook for Developed Market (DM) rates (ex BoJ) has shifted to potential cuts later this year. Since the last Quarterly Outlook, we made the following changes to our country allocation:

- Upgrade **Switzerland** to *neutral*. Switzerland tends to outperform other European markets as rates fall. We are therefore closing our underweight.
- Downgrade the **UK** to *neutral*. The UK trades at a low multiple and may see some rebound with any oil price strength. However, our empirical models suggest it will likely lag the benchmark as rates fall.
- Downgrade **Australia** to *underweight*. We see limited upside in iron ore demand, while Australian Financials are expected to see profits come under pressure.
- Upgrade the **Eurozone** to a less negative *underweight*. Business surveys continue to signal contraction in the Eurozone from higher energy prices and past policy tightening. However, the deterioration in activity may be moderating, favouring a smaller underweight allocation.

Global Equity Allocation Breakdown

	Chg	-2	-1	0	+1	+2
US	–			■		
Canada	–				■	
Eurozone	↑		■			
Switzerland	↑			■		
UK	↓			■		
Japan	–			■		
Australia	↓		■			
EM	–				■	

International Equity Allocation Breakdown

	Chg	-2	-1	0	+1	+2
Canada	–				■	
Eurozone	↑		■			
Switzerland	↑			■		
UK	↓			■		
Japan	–			■		
Australia	↓		■			
EM	–				■	

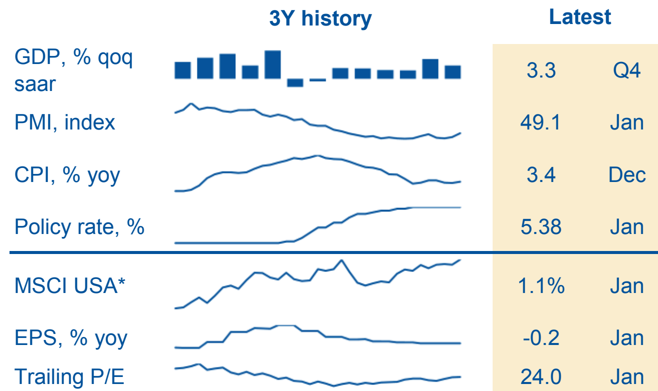
Note: Up/down arrows indicate a positive/negative change in our asset allocation compared to the previous quarter. A dash indicates no change.
Source: CLIM

**This publication reflects asset performance up to 31 January, 2024, and macro events and data releases up to 7 February, 2024, unless indicated otherwise.*

United States

NW (Global Index)

Economic resilience supports robust earnings growth, but the market valuations remain unattractive.



	3Y history	Latest	
GDP, % qoq saar		3.3	Q4
PMI, index		49.1	Jan
CPI, % yoy		3.4	Dec
Policy rate, %		5.38	Jan
MSCI USA*		1.1%	Jan
EPS, % yoy		-0.2	Jan
Trailing P/E		24.0	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

US data has surprised to the upside in recent months. GDP has been stronger than expected, and the labour market has been resilient. Importantly, inflation has continued to trend down. However, some indicators suggest weakness ahead; for example, the yield curve remains inverted, and the unemployment rate, while low, has risen since last year and historically has tended to keep rising once it starts. The impact of the Fed's rate hikes may not have fully fed through the economy yet, and pandemic excess savings will soon be depleted.

A soft landing is increasingly the consensus view, with markets becoming more confident that policy rates have peaked and that rate cuts are likely this year. Rate cuts are possible, but policy easing is more likely due to weaker activity and inflation data. The Fed will struggle to justify removing restrictive policy if growth remains above trend, particularly in an election year.

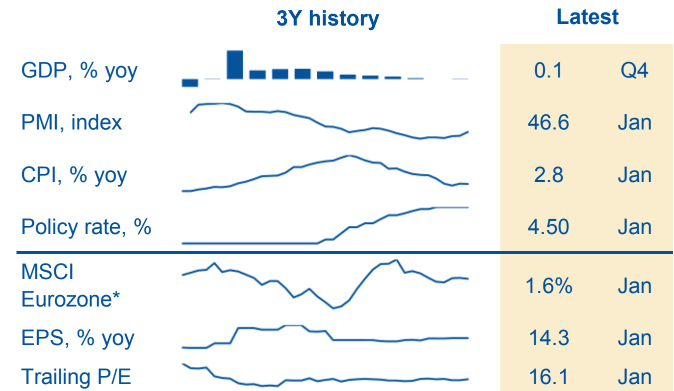
MSCI US is trading at a forward P/E ratio of 20x, ahead of its historical average, and above its peers. Some valuation premia can be justified given the robust earnings from the large-cap tech stocks – the aggregate market forecast is 11% earnings growth in 2024 – but it remains priced for perfection and vulnerable to pullbacks.

Market Strategy: We remain *neutral* on US equities. The US market has persistent momentum, and it tends to outperform in a below trend growth environment. However, the US is the most crowded position, trading at a premium to both its peers and historical norms.

Eurozone

UW (Global and Global ex-US index) ↑

Europe is teetering on the brink of a recession and at risk of earnings downgrades.



	3Y history	Latest	
GDP, % yoy		0.1	Q4
PMI, index		46.6	Jan
CPI, % yoy		2.8	Jan
Policy rate, %		4.50	Jan
MSCI Eurozone*		1.6%	Jan
EPS, % yoy		14.3	Jan
Trailing P/E		16.1	Jan

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

The Eurozone economy has underperformed most other major economies and looks likely to face a recession (led by Germany). Despite some incremental improvement in recent business surveys (PMI data remains below 50), we continue to see a downside risk for earnings, which are expected to grow 6% in 2024.

The Eurozone economy has a higher weighting to cyclical and value sectors. It, therefore, tends to underperform in periods of slower economic growth and lower interest rates. We are considering a broad range of possible economic scenarios but are biased towards conditions that are unlikely to favour European equities. MSCI Eurozone is priced cheaper than the ACWI at a forward P/E ratio of 14x; however, its valuation ranks closer to the middle of non-US equities.

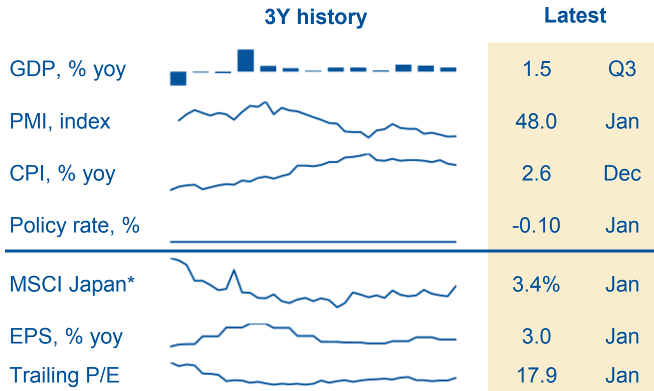
In response to lower inflation and weak growth, the ECB is expected to cut rates later this year – in line with most other DM central banks. Companies remain at risk from the lagged impacts of restrictive monetary policy. Europe is also exposed to an energy shock, though current inventories seem sufficient if geopolitical risks from the Middle East and Russia/Ukraine remain contained. In addition, Europe has a large trade surplus with the US and may be exposed to tariffs if Donald Trump is re-elected.

Market Strategy: We reduced our position to a smaller *underweight* in the Eurozone. Europe's economic outlook is weak, and its earnings risk being downgraded. However, its valuations have cheapened, and growth, although still soft, might be stabilising at a weaker growth rate.

Japan

NW (Global and Global ex-US index)

Corporate reforms may create value, but stocks are vulnerable to cyclical headwinds.



**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

The Japanese equity market is likely to underperform in periods of weaker global growth given its higher weighting to cyclical and value sectors. Although we are considering a wide range of possible outcomes for the global economy, our bias is tilted towards the weaker growth scenarios where Japanese equities have historically underperformed. Also, Japan's unfavourable demographics and slower potential future growth rate are a long-term headwind for the more domestically oriented sectors.

Corporate reforms in Japan offer to unlock value in the market. For example, reducing the number of companies trading at a price/book ratio below one by deploying corporate cash more effectively should be a welcome development by investors. While these actions are positive, Japanese stock investors have been disappointed in the past, and equities are already pricing some of the initial developments. Japan's valuation (forward P/E of 16x) is elevated relative to recent years, but one could argue the index is cheap using a longer timeseries including the 1990 to early 2000 period.

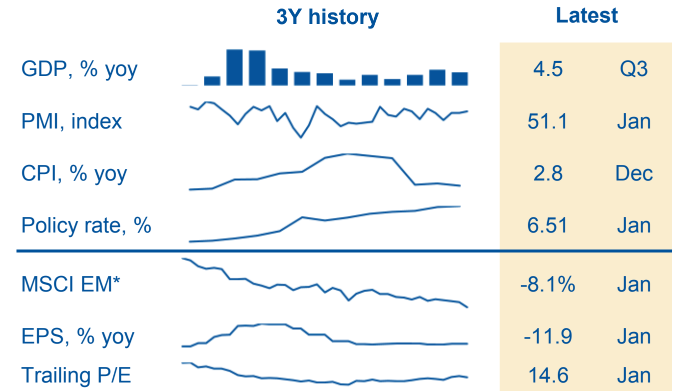
Although the equity market tends to underperform in times of global economic weakness, some of this is offset by the Yen, which can strengthen in that environment. This may be exacerbated in coming months, as the Bank of Japan looks likely to begin raising rates, in contrast to other central banks, potentially further supporting the Yen.

Market Strategy: We stay *neutral* Japan. Corporate reforms remain supportive and could unlock further value. On a more cautious note, our bias towards economic weakness and lower US rates is historically a headwind for Japan.

Emerging Markets

OW (Global and Global ex-US index)

Earnings growth and attractive valuations skew risks towards a re-rating.



**US$ total return relative to MSCI ACWI. Latest is three-month return. Economic indicators are GDP-weighted with the exception of PMI, which is value-added-weighted.*

Source: Bloomberg

Earnings expectations are the most positive for Emerging Markets. This is primarily due to a recovery in the semiconductor cycle, led by Taiwan and South Korea. Earnings expectations are also positive in China (which is more due to the tech sector than the economy) and India. EM's forward P/E multiple is low relative to earnings expectations – i.e. the index is due for a re-rating, or earnings expectations need to fall to justify EM's cheap valuation. Our bias is towards a re-rating.

The Emerging Markets index has seen disappointing returns, primarily due to China's continued underperformance. We are neutral on China, weighing the structural growth challenges against depressed sentiment and performance that are potentially closer to a bottom. The possibility of further policy stimulus should put a floor on sentiment and prices. In recent months, EM ex-China has performed relatively well, helped by falling rates and a weaker USD, in addition to a recovery in semiconductors.

Geopolitics are a major factor for Emerging Markets. US-China tensions have moderated following the Xi-Biden meeting last November, and the Taiwan election passed without causing a significant escalation. The US election may heighten global tensions, with both parties favouring a more hawkish stance towards China. However, foreign ownership is already low relative to history.

Market Strategy: We remain *overweight* Emerging Market equities. MSCI Emerging Markets has attractive earnings prospects that will benefit from growing demand for advanced semiconductors. Also, EMs offer exposure to the tech sector at more compelling valuations than the US. Finally, more forceful stimulus from policymakers in China may start to lift depressed sentiment.

United Kingdom

NW (Global and Global ex-US index) ↓

Despite its cheap valuation, the UK is vulnerable to a shift in global rate expectations.

As our top-down assumptions shift towards a DM rate-cutting cycle this year, the UK ranks poorly on our metrics. Historically, the UK has the highest beta to the US 10-year yield and is therefore vulnerable if the Fed starts cutting rates. In addition, while the UK tends to have a relatively defensive sectoral makeup and trades more defensively than Europe, it tends to underperform other DM peers in a slowdown scenario. UK valuations are very cheap (forward P/E ratio is 11.1); however, the lower multiple aligns with lower earnings expectations for the UK.

The Bank of England is expected to start cutting rates this year. While cuts may weaken Sterling, benefiting the equity market for which a large percentage of profits are made abroad, expectations for the BoE to cut rates later than many other DMs may support Sterling over the short term.

Market Strategy: Despite the UK trading at cheap valuations, we are reducing our overweight to *neutral*. The UK could benefit from an oil price spike but stronger-than-expected US shale production limits the upside potential from an oil-shock scenario.

Australia

UW (Global and Global ex-US index) ↓

Weak earnings growth for Australia and a relatively high P/E multiple leave the market vulnerable to a de-rating.

Australian equities have seen P/E multiple expansion relative to other DM ex-US markets over the past year. Part of this re-rating may be attributed to China's unexpectedly robust iron ore demand despite the weakness in the property sector. Australia's current valuation leaves it vulnerable, given that earnings growth expectations are also the lowest among the developed markets, and iron ore demand is unlikely to accelerate further.

The Financial sector is the largest weight in the Australian index. Australian banks have benefitted from higher rates and are already trading at a relatively elevated P/E ratio. However, net interest margins are expected to suffer as interest rates fall later this year.

Market Strategy: We moved from a neutral position to *underweight*. Australia's current P/E is unattractive relative to a weak earnings outlook. The Materials and Financial sector may come under pressure this year. Also, should China reaccelerate (which historically benefits Australia), we prefer exposure to EM, which trades at a more attractive multiple.

Canada

OW (Global and Global ex-US index)

Canada's Energy exposure is well placed to benefit from an oil-shock scenario.

Canadian equities should perform reasonably well in our baseline scenario but offer upside potential should there be an oil shock, due to their high weighting to the Energy sector. If geopolitical risks moderate, lowering the risk of an energy crisis, then we are likely to reconsider our Canadian position. Canadian equities are priced relatively cheaply (forward P/E ratio 13.9) and have expected earnings growth of 6% in 2024.

Financials are also a considerable weight in the MSCI Canada Index. If global rates begin to fall, this will likely reduce bank net interest margins. However, lower interest rates may also alleviate some of the risks for Canadian banks exposed to highly leveraged households and prevent a rise in non-performing loans under higher interest rates.

Market Strategy: We remain *overweight* Canadian equities. The possibility of an oil price rise and its comparatively attractive valuation mean that on our probability-weighted projections, it should perform well. High household leverage is the main risk for Canada, but this risk has been well-flagged by strongly capitalized banks over the past 15 years.

Switzerland

NW (Global and Global ex-US index) ↑

Defensive characteristics and relatively strong earnings expectations have improved the market's outlook.

The Swiss economy has many of the same risks as the Eurozone – weak growth and vulnerability to oil shocks. The MSCI Switzerland Index has a defensive sectorial composition and historically outperforms the Eurozone when global rates fall. As our top-down views shift from a rate-hiking cycle to a rate-cutting regime, Switzerland's ranking becomes more attractive in our framework. Its ranking would further improve should the odds of a recession increase later this year.

The Swiss market historically trades at a premium to ACWI, but this has diminished as expectations of a soft landing have increased. Currently, the market is trading at a forward P/E of 18x. Earnings expectations are 9.3% for 2024. The CHF has also strengthened against the Euro in recent years and tends to do well during periods of economic weakness.

Market Strategy: We have moved our Swiss exposure to *neutral*, having previously been underweight. Ongoing resilience in the global economy is a risk for Swiss equities, but our forward-looking analysis suggests Switzerland's outlook has improved.

The information contained herein is obtained from sources believed by CLIM to be accurate and reliable. No responsibility can be accepted under any circumstances for errors of fact or omission. Any forward looking statements or forecasts are based on assumptions and actual results may vary from any such statements or forecasts.

INTERNATIONAL EQUITY - KEY ECONOMIC AND FINANCIAL INDICATORS

		Macroeconomic Data														Market Performance				Forecast†	
		% change on year ago				Latest 12 months															
	Developed Market	Annual GDP Growth	Quarterly GDP Growth QoQ*	Industrial Production Growth	Consumer Price Index	Budget Balance % of GDP 2024F**	Trade Balance	Current Account Balance	Foreign Reserves 2023 Latest	Foreign Reserves 2022 Year Ago	Currency vs $ 2024 Latest	Currency vs $ 2023 Year ago	Short-Term Interest Rates	Sovereign Rating S&P	% MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US$	Change since 12/31/23 US$	Change since 12/31/23 Local	2024 P/E Forecast	3 month Currency vs $ +/-
		%	%	%	%		$ Bns	$ Bns	$ Bns	$ Bns			%		Jan. 31, 2024	Jan. 31, 2024	%	%		
Overweight	EM****	4.5	n.a.	4.1	2.8	-4.4	723.2	484.1	7702.61	7458.11	1723.93	1692.14	6.51	n.a.	27.03	509.04	-4.64	-3.49	13.4	n.a.
Overweight	CANADA	1.1	-1.1	-0.5	3.4	-1.3	-1.2	-19.2	89.91	79.73	1.35	1.34	5.06	AAA	7.68	7738.34	-0.78	0.53	15.1	+
Neutral	DENMARK	-0.5	-2.8	7.3	0.7	1.0	10.7	45.4	96.97	84.48	6.92	6.92	3.60	AAA	2.28	64102.94	5.03	6.79	33.4	+
Neutral	HONG KONG	4.3	2.0	4.4	2.4	-1.3	-59.3	108.9	424.43	423.10	7.82	7.85	4.63	AA+	1.28	50956.86	-9.72	-9.62	12.8	+
Neutral	ISRAEL	3.3	2.7	-3.7	3.0	-5.0	-31.7	62.7	200.07	189.74	3.65	3.46	4.42	AA-	0.46	151.54	1.70	2.34	10.3	-
Neutral	JAPAN	1.5	-2.9	-0.7	2.6	-4.1	-68.0	138.0	1170.44	1108.19	147.97	130.57	-0.11	A+	15.25	8325.14	4.62	8.47	16.6	+
Neutral	NEW ZEALAND	-0.6	-1.2	-7.7	4.7	-2.6	-8.3	-18.9	12.11	11.06	0.61	0.64	5.38	AA+	0.13	590.59	-2.34	0.45	35.7	-
Neutral	NORWAY	-1.5	0.4	0.8	4.8	14.5	80.8	98.4	71.88	63.31	10.58	10.29	4.70	AAA	0.41	9614.20	-5.73	-2.94	10.4	+
Neutral	SINGAPORE	2.8	5.6	-2.5	3.7	0.1	172.2	86.7	331.29	281.75	1.34	1.32	3.95	AAA	0.86	1097.72	-4.40	-3.26	11.0	+
Neutral	SWEDEN	-1.4	-1.2	1.3	4.4	-0.6	4.9	39.4	41.68	46.30	10.48	10.54	4.06	AAA	2.00	30892.99	-4.15	-1.73	15.3	+
Neutral	SWITZERLAND	0.4	1.2	2.0	1.7	0.3	53.7	72.5	779.97	848.51	0.87	0.92	-0.75	AAA	6.46	18048.96	-0.31	1.61	20.1	+
Neutral	UK	0.3	-0.4	-0.1	4.0	-3.6	-34.5	-65.9	108.77	110.29	1.26	1.21	5.22	AA	9.58	7802.69	-1.34	-1.23	11.3	+
Underweight	AUSTRALIA	2.1	0.8	0.6	4.1	-0.5	81.8	20.4	40.90	38.48	0.65	0.70	3.50	AAA	4.87	5365.82	-1.57	1.60	15.7	+
Underweight	EUROZONE	0.1	0.0	-6.8	2.8	-3.0	-2.3	0.5	297.51	316.85	1.08	1.08	0.69	n.a.	21.86	432.36	0.47	2.16	13.3	+

*Note: All data shown are as at February 7, 2024 unless otherwise stated. S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate. **Bloomberg consensus forecast.*
****MSCI All Country World ex USA Index Daily Total Return Net. ****IP data from CPB; Currency level from MSCI EM Currency Index; GDP, CPI, budget and interest rate data from Bloomberg.*
†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.

Source: Bloomberg, CLIM

GLOBAL EQUITY - KEY ECONOMIC AND FINANCIAL INDICATORS

	Macroeconomic Data														Market Performance				Forecast†	
		% change on year ago				Latest 12 months														
	Developed Market	Annual GDP Growth	Quarterly GDP Growth QoQ*	Industrial Production Growth	Consumer Price Index	Budget Balance % of GDP 2024F**	Trade Balance	Current Account Balance	Foreign Reserves 2023 Latest	Foreign Reserves 2022 Year Ago	Currency vs $ 2024 Latest	Currency vs $ 2023 Year ago	Short-Term Interest Rates	Sovereign Rating S&P	% MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US$	Change since 12/31/23 US$	Change since 12/31/23 Local	2024 P/E Forecast	3 month Currency vs $ +/-
		%	%	%	%		$ Bns	$ Bns	$ Bns	$ Bns			%		Jan. 31, 2024	Jan. 31, 2024	%	%		
Overweight	EM****	4.5	n.a.	4.1	2.8	-4.4	723.2	484.1	7702.61	7458.11	1723.93	1692.14	6.51	n.a.	9.96	509.04	-4.64	-3.49	13.4	n.a.
Overweight	CANADA	1.1	-1.1	-0.5	3.4	-1.3	-1.2	-19.2	89.91	79.73	1.35	1.34	5.06	AAA	2.83	7738.34	-0.78	0.53	15.1	+
Neutral	DENMARK	-0.5	-2.8	7.3	0.7	1.0	10.7	45.4	96.97	84.48	6.92	6.92	3.60	AAA	0.84	64102.94	5.03	6.79	33.4	+
Neutral	HONG KONG	4.3	2.0	4.4	2.4	-1.3	-59.3	108.9	424.43	423.10	7.82	7.85	4.63	AA+	0.47	50956.86	-9.72	-9.62	12.8	+
Neutral	ISRAEL	3.3	2.7	-3.7	3.0	-5.0	-31.7	62.7	200.07	189.74	3.65	3.46	4.42	AA-	0.17	151.54	1.70	2.34	10.3	-
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Neutral	UK	0.3	-0.4	-0.1	4.0	-3.6	-34.5	-65.9	108.77	110.29	1.26	1.21	5.22	AA	3.53	7802.69	-1.34	-1.23	11.3	+
Neutral	UNITED STATES	3.1	3.3	1.0	3.4	-6.0	-773.4	-839.1	37.32	37.21	1.00	1.00	5.29	AA+	63.16	13695.29	1.53	1.53	23.1	uc
Underweight	AUSTRALIA	2.1	0.8	0.6	4.1	-0.5	81.8	20.4	40.90	38.48	0.65	0.70	3.50	AAA	1.79	5365.82	-1.57	1.60	15.7	+
Underweight	EUROZONE	0.1	0.0	-6.8	2.8	-3.0	-2.3	0.5	297.51	316.85	1.08	1.08	0.69	n.a.	8.05	432.36	0.47	2.16	13.3	+

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Source: Bloomberg, CLIM

CITY OF LONDON
Investment Management Company Limited

Contacts

Macroeconomic Analysis

Justin Kariya, London Office
Phone: 011 44 207 711 1558
E-Mail: justin.kariya@citlon.co.uk

Tom Traill, London Office
Phone: 011 44 207 860 8316
E-Mail: tom.traill@citlon.co.uk

Yasemin Engin, London Office
Phone: 011 44 207 711 1551
E-Mail: yasemin.engin@citlon.co.uk

London Office
77 Gracechurch Street
London EC3V 0AS
United Kingdom
Phone: 011 44 20 7711 0771
Fax: 011 44 20 7711 0774
E-Mail: info@citlon.co.uk

Philadelphia Office
17 East Market Street
West Chester, PA 19382
United States
Phone: 610 380 2110
Fax: 610 380 2116
E-Mail: info@citlon.com

Singapore Office
20 Collyer Quay
10-04
Singapore 049319
Phone: 011 65 6236 9136
Fax: 011 65 6532 3997

Website

www.citlon.com
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