CITY OF LONDON
Investment Management Company Limited

Cross-Asset Quarterly Outlook

March 2023*

Overview

Fixed Income Returns Are 'Sticky' Despite Elevated Inflation

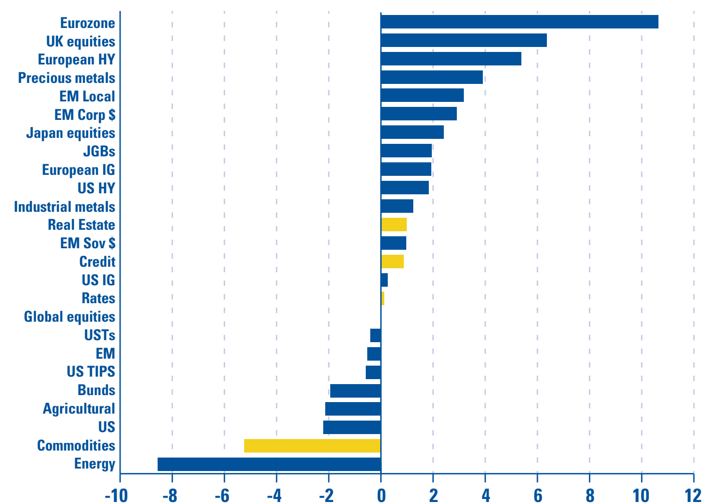
- *Fixed income marginally outperformed global equities over the quarter.*
- *Valuations have improved for bonds, with the equity earnings yield spread to bond yields at the tightest level since 2010.*
- *We upgraded Rates to neutral and downgraded REITs to neutral. Overall, the shift adds to our duration overweight. Commodities and Equities remain neutral.*
- *Our asset allocation focuses on relative value opportunities intra-asset class.*

Despite upside surprises to global activity and persistent inflation, fixed income marginally outperformed global equities over the quarter. This result may be surprising given that this growth/inflation mix is typically associated with stronger equity returns relative to bonds. However, Chart 1 highlights +0.4% returns for fixed income, while global equities produced a flat return over the quarter. This performance can be explained from yield levels and valuations.

Chart 2 shows that the earnings yield for US equities is now on par with the 6-month US Treasury bill and the US 10-yr Treasury bond yield. As investors allocated away from fixed income products, the spread between 10-year bonds and equities has become the tightest since 2010. The relative yield differential now favours bond allocations relative to equities. High-yield (HY) bonds are currently outperforming, reflecting a period of attractive yields and positive global growth surprises. However, we do not anticipate a strong growth reacceleration this year and prefer to position for activity deceleration as lagged monetary policy effects impact the US and European economies later this year. In this scenario, high-quality bonds should outperform.

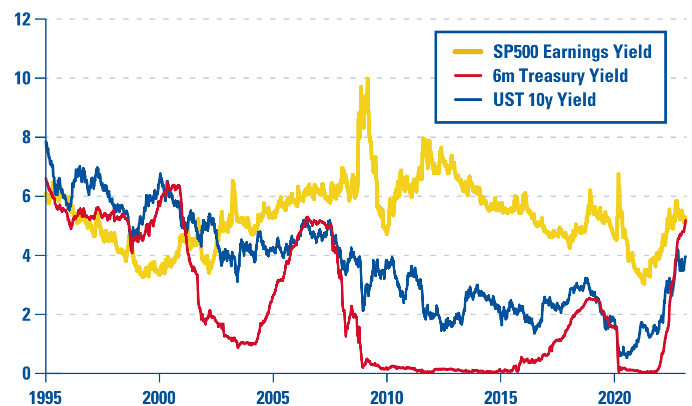
"Sticky inflation and central bank tightening are often viewed as negative drivers for duration-sensitive assets such as bonds, REITs, and growth stocks. In the case of the US, a tight labour market and disruptions to the disinflationary trend pose risks that may keep bond volatility and yields elevated over the coming months. However, it is important to note that the current environment is a significant shift from 2022, when bonds experienced a sell-off due to rapidly surging headline and core inflation measures stemming from the Covid reopening, supply-chain readjustments, and commodity supply shocks. In addition, DM central banks were 'behind the curve' as they gradually shifted away from the transitory inflation narrative. Most DM central banks now have the highest policy rates since the Global Financial Crisis and are likely to reach their terminal rates by mid-year. While inflation may be 'stickier' than initially expected, the probability of another rapid inflation surge, that results in a surprise shock to bond investors, is much lower.

Chart 1: Asset returns, Dec-Feb, %



Source: Bloomberg

Chart 2: US Earnings Yield, 6m Treasury Yield and US 10Y Treasury Yield



Source: Bloomberg

**The publication reflects asset performance up to February 28, 2023, and macro events and data releases up to March 8, 2023, unless indicated otherwise.*

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Asset Allocation

	Chg	-3	-2	-1	0	+1	+2	+3
EQUITIES	-				■			
RATES	↑				■			
CREDIT	-					■		
REAL ESTATE	↓				■			
COMMODITIES	-				■			

	Chg	-3	-2	-1	0	+1	+2	+3
US equities	↓				■			
Eurozone equities	-		■					
UK equities	-					■		
Japan equities	-				■			
EM equities	↑					■		
USTs	-				■			
TIPS	↓					■		
Bunds	-			■				
JGBs	↑			■				
EM local bonds	-						■	
US IG credit	-							■
US HY credit	-	■						
European IG credit	-					■		
European HY credit	-			■				
EM Sov $ credit	-				■			
EM Corp $ credit	-				■			
Energy	-				■			
Industrial metals	-				■			
Precious metals	-				■			
Agricultural	-				■			

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

Source: CLIM

Market Strategy

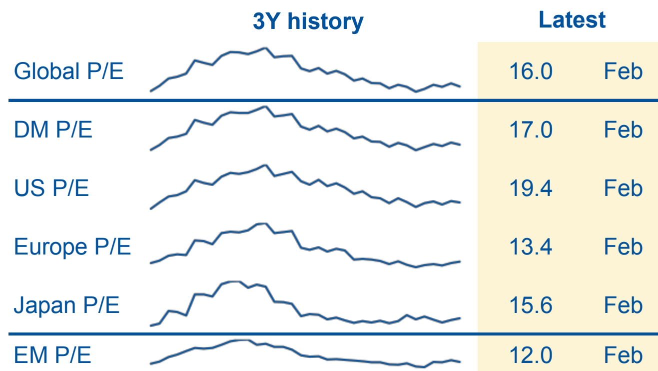
Since the last Cross-Asset Quarterly, we have continued to favour owning duration. Our Asset Allocation upgrades Rates to neutral, raising our overall fixed income allocation (Rates + Credit), and we downgrade REITS to neutral. We adjust our relative value allocations as outlined below:

- We remain *neutral* on **Equities**. Our medium-term cyclical indicators have turned more positive towards pro-cyclical assets like equities. However, valuations do not justify an equity overweight. In relative value, we upgrade MSCI EM to *overweight* and downgrade MSCI USA to *neutral* to reflect a more desynchronised cycle where EM Asia growth stabilises relative to an expected slowdown in the US and Europe.
- We upgrade **Rates** to *neutral*. EM local bonds and US duration remain *overweight*. We also remain *underweight* Bunds. The JGB underweight is trimmed to bring Rates to *neutral*.
- We stay *overweight* **Credit** to express a preference for more duration via investment grade credit. High-yield (HY) bonds remain *underweight* as we see limited value at current spread levels.
- We downgrade **Real Estate** to *neutral*. We continue to see attractive valuations in REITS relative to equities, but our overall asset allocation favours moving more risk into fixed income. The rise in bond yields leaves the REIT's dividend yield spread to bonds around the tightest level since 2011.
- We remain *neutral* in **Commodities**. In oil markets, weaker global demand continues to weigh on energy prices. However, rising China mobility and geopolitical shocks remain upside risks. China's reopening may also continue to support industrial metals, but a more consumer-driven activity boost may limit this trend.

Equities

Neutral

Improving macroeconomic indicators favour pro-cyclical assets near-term, but a restrictive policy environment should dampen equity performance.



	3Y history	Latest	
Global P/E		16.0	Feb
DM P/E		17.0	Feb
US P/E		19.4	Feb
Europe P/E		13.4	Feb
Japan P/E		15.6	Feb
EM P/E		12.0	Feb

Source: Bloomberg, MSCI. Trailing P/E ratios are shown.

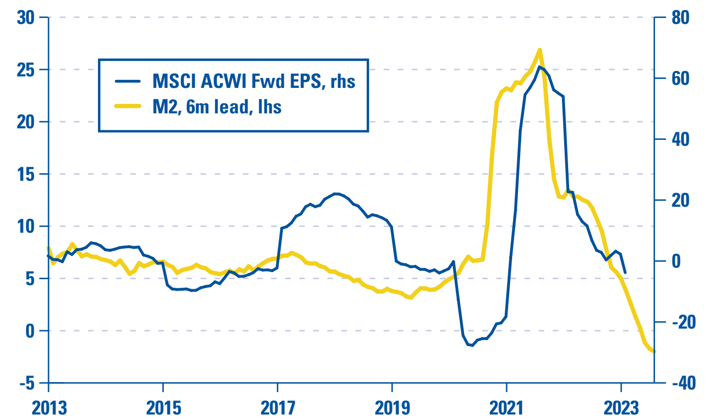
Global equities started the year on solid footing amid China's reopening optimism and the tempering of inflationary pressures and policy expectations. In addition, eurozone equities were supported by an unseasonably warm winter, which reduced the likelihood of an energy crisis. However, the rally in equities lost steam in the past month as US interest rates were repriced higher on the back of stronger-than-anticipated US non-farm payrolls and CPI print. As such, ACWI returns were flat between December-February.

The Federal Reserve and other major central banks continue to tighten policy as inflation tracks above target rates. We think the rates market is correctly anticipating a peak in rates later this year following 450bp of Fed hikes. However, a higher-for-longer interest rate environment does not bode well for equities. Earnings have been slow to adjust, with 2023 EPS estimates for the US, eurozone and Japan still quite optimistic at 2.0%, 0.9% and 4.1% respectively. We think the lagged impact of prior tightening (see Chart 3) leaves scope for earnings downgrades. Elsewhere, 2023 EPS estimates for the UK and EM are -1.9% and -3.9% respectively.

Meanwhile, valuations are not attractive for global equities. Indeed, the gap between the earnings yield for MSCI ACWI and the US 10Y bond yield has narrowed, making a switch from equities to bonds more attractive (see Rates section). At a country level, the UK still has the lowest forward P/E of 10.4x and the US is still the most expensive market with a forward P/E multiple of 18.4x.

Market Strategy: In a desynchronised growth cycle environment, we prefer relative value opportunities over choosing between pro-cyclical and defensive markets. As a result, we downgrade our allocation to **MSCI USA** from *overweight* to *neutral*. The market appears expensive compared to its DM peers, while the expectation of a US recession within the next year suggests downside for earnings growth. However, with a peak in US terminal rate likely approaching, we stay *neutral* rather than *underweight* US equities.

Chart 3: US M2 growth and MSCI ACWI EPS, % yoy



Source: Bloomberg

In contrast, with an improved outlook because of the China reopening, we upgrade our allocation to **MSCI EM** to *overweight*. China's exit from its zero-COVID policy should help lift ASEAN markets and the beleaguered semiconductor sector, albeit the downturn in the latter likely has further to go. As we approach peak US rates and the USD, the easing in financial conditions should also give EM some breathing space. The rise in the EM forward P/E multiple suggests that this optimism has already been priced in, but at 11x, its multiple is still below its five-year average. We thus add *overweight* exposure.

We maintain our *underweight* to **MSCI Eurozone** as the ECB appears intent on pursuing an aggressive tightening policy, which will weigh on the economy. Meanwhile, energy issues could resurface in the summer as the eurozone prepares for the winter with limited Russian natural gas and competition for LNG from China.

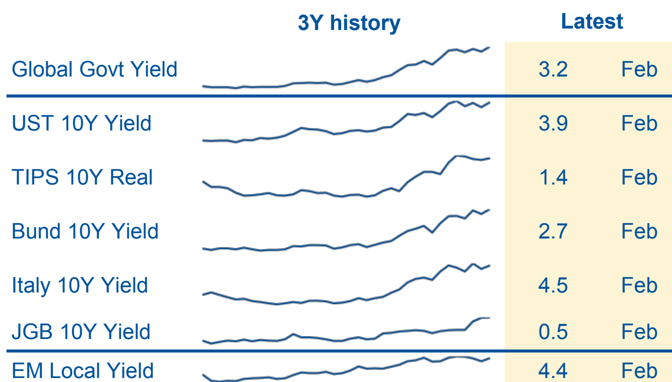
The upcoming change of guard at the BoJ means a potential change to YCC and, thus, a volatile Japanese yen. Historically, Japanese P/E's have a positive correlation to bond yields, which means an exit from YCC may contribute to some re-rating. However, we expect a slower global growth environment and a global disinflationary trend, which should cap the rise in yields, limiting the boost to equities. As a result, we keep our *neutral* allocation to **MSCI Japan**.

The **MSCI UK** was the second-best performer after the eurozone over the quarter. UK equities are still attractively valued on a relative (to MSCI ACWI) and an absolute basis. The UK has one of the weakest growth outlooks this year among DM, while real rates are expected to stay in negative territory despite the BoE's best efforts, weighing on GBP. Foreign-exposed firms in the MSCI UK should benefit, supporting our *overweight* allocation.

Rates

Neutral ↑

We expect US and EM local bonds to outperform lower-yielding Japanese government bonds (JGBs).



	3Y history	Latest	
Global Govt Yield		3.2	Feb
UST 10Y Yield		3.9	Feb
TIPS 10Y Real		1.4	Feb
Bund 10Y Yield		2.7	Feb
Italy 10Y Yield		4.5	Feb
JGB 10Y Yield		0.5	Feb
EM Local Yield		4.4	Feb

Source: Bloomberg Barclays Indices. Yield in %.

The rate performance during the past quarter was flat, in stark contrast with the 2022 record bond underperformance. The last three months have witnessed 75bps of hikes from the Fed and 100bps from the ECB. We see two important takeaways which support our preference for holding duration exposure at current levels (expressed via a Credit overweight). Firstly, government bonds only delivered modest negative returns, despite the ongoing central bank tightening and high inflation levels, while EM local bonds performed strongly. Secondly, the 2023 investment environment should differ from that of 2022. Inflation is currently 'sticky,' and there is debate around the terminal rate level. Although bond investors may not receive a green light for a sharp drop in yields until activity slows down, bond bears are unlikely to witness another episode of rapidly surging inflation on core measures. The risk-reward still favours holding bonds relative to equities around current levels.

On inflation, we expect the trend to remain disinflationary while the overall level of inflation is still above target for most DM central banks. The US headline CPI is currently tracking 6.3% yoy and will likely continue falling into mid-year due to base effects. US core PCE yoy may be 'sticky' at around the current 4.8% yoy. But we see limited risk of this measure reaccelerating, as in 2022. In other words, the risks around the terminal rate pricing are more balanced (around 5.5% for the Fed), and investors have already reduced their bond allocations in response to inflation risks.

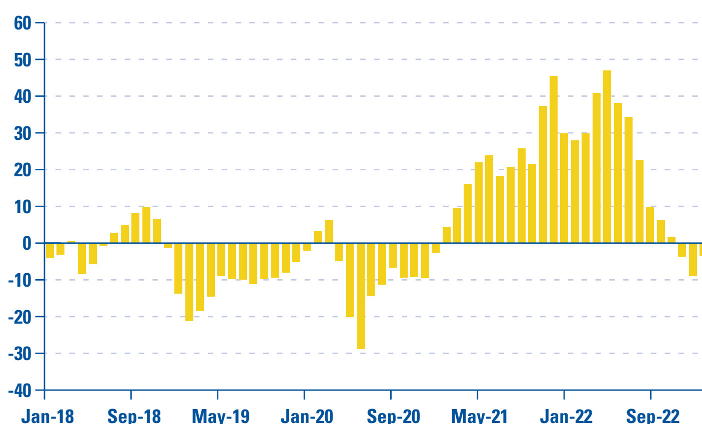
One critical risk for bond investors is an expected adjustment to the Bank of Japan's Yield-Curve-Control (YCC) policy. We expect the new incoming Governor Ueda to adjust the YCC band to +/-100bps this year (from 50bps) or shift the YCC to the 5Y tenor. The direct impact will be some sell-off in JGB's, which are already partially priced by the Japan 10y swap market (trading around 80-85bps). The policy readjustment will likely feed into global term premia. However, we do not expect a material shock to global bonds, given that Japanese investors were already selling record amounts of foreign debt in 2022. A further YCC adjustment is unlikely to surprise the market.

Nominal DM Bonds (US NW, EZ UW, JP UW): No change to our nominal DM bond views. US government bonds remain our preferred market, given attractive bond yields and expectations for US rates to peak this year. While we expect positive returns from US bonds, we like to express this view via US IG (see Credit section). Therefore, the US nominal bond view remains *neutral*. We stay *underweight* German Bunds. Inflation measures remain elevated in the eurozone, and the ECB remains one of the most hawkish DM central banks. Upward revisions to the terminal ECB rate support our *underweight* position in the near term. Later this year, we expect lagged monetary policy effects will eventually weigh on European growth and European government bond yields. We maintain our *underweight* exposure in Japan in anticipation of a YCC adjustment, but we trim the overall exposure to reduce our FX exposure.

US TIPS (OW): We continue to favour US inflation-protected bonds in our allocation, but we reduced our allocation. US TIPS will generate positive returns in a mild or deep recession scenario. In the tail-risk event where long-end inflation rises (i.e., a stagflation scenario), US inflation-protected bonds should outperform other bond markets.

EM local bonds (OW): EM local bonds remain our preferred overweight exposure within Rates. The broader EM disinflationary trend stalled in January (see Chart 4), which was a minor hiccup for EM duration exposure. However, we expect headline inflation rates (ex-China) to fall due to base effects, supply chain normalisation, monetary policy effects, lower commodity prices, and recent EM currency strength. In addition, the USD level remains rich on long-term valuation measures, which provides a good entry point for holding some long EM currency exposure.

Chart 4: EM Inflation Surprise Index

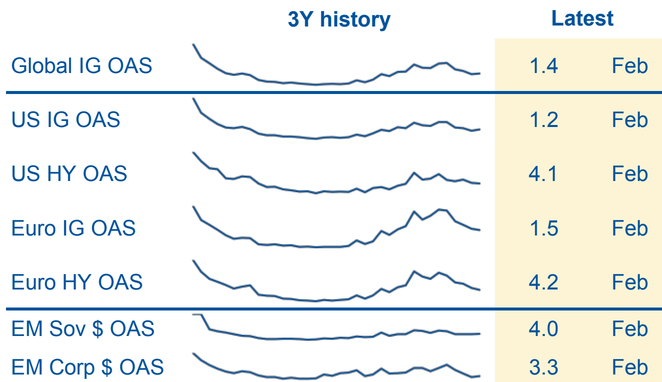


Source: Citi, Bloomberg

Credit

Overweight

Investment grade bonds offer better risk-reward than high-yield bonds.



	3Y history	Latest	
Global IG OAS		1.4	Feb
US IG OAS		1.2	Feb
US HY OAS		4.1	Feb
Euro IG OAS		1.5	Feb
Euro HY OAS		4.2	Feb
EM Sov $ OAS		4.0	Feb
EM Corp $ OAS		3.3	Feb

Source: Bloomberg Barclays Indices. Yield in %.

Better economic data supported spread products, such as high-yield (HY) bonds, which saw outperformance over the quarter. European HY bonds were the best-performing asset during the period, which received a boost from lower natural gas prices and Europe avoiding a recession in Q1. Conversely, elevated inflation prints continued to weigh on higher-duration IG indices.

Although IG bonds have recently underperformed compared to HY, we still favour them due to the current spread differential. This spread is priced for a more optimistic growth cycle than the ISM index suggests (Chart 5). The US HY index yields 8.5%, which is attractive compared to the Bloomberg US IG bond index's 5.5% yield and US equities' earnings yield of 5.2%. In a typical growth expansion, US HY spreads would narrow, and default rates would remain low, making an 8.5% yield highly attractive. This possibility remains in a soft-landing scenario. However, with current spread levels (around 400bp for US HY), we see risks of spread widening. Moreover, US HY default rates are currently around 2%, below the 30-year average of over 3%. These levels indicate that modest spread widening and some mean-reversion in default rates will erode the HY spread return over IG and government bonds.

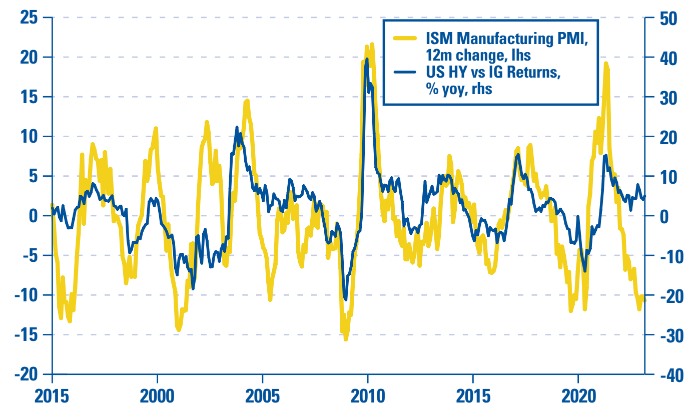
During the quarter, US IG credit spreads also tightened; however, current rates volatility has increased spreads (Chart 6). While IG spreads, like HY, are not at attractive levels, around 120bps for the US IG index, we still anticipate that US IG bonds will deliver the best returns this year in our cross-asset universe. The overall US IG yield is still favourable at 5.5%. Additionally, the higher terminal rate (currently priced around 5.5%) increases the likelihood of a recession later this year, making higher-duration bonds such as IG attractive.

US (OW IG, UW HY): We prefer US IG to US HY. US IG bonds have higher duration exposure that will benefit from a peak in the terminal rate prices in the coming months. In addition, HY bonds are more exposed to a disappointment in the growth cycle based on current spreads levels. We thus remain *overweight* US IG and *underweight* US HY.

Eurozone (OW IG and UW HY): Similar to US credit, the Euro HY-IG spread has compressed to levels more consistent with a growth expansion. Better economic data and lower energy prices have helped Europe avoid a recession, resulting in better European asset performance. We continue to see risks skewed towards wider HY spreads from current levels. We thus remain *overweight* Eurozone IG and *underweight* Eurozone HY.

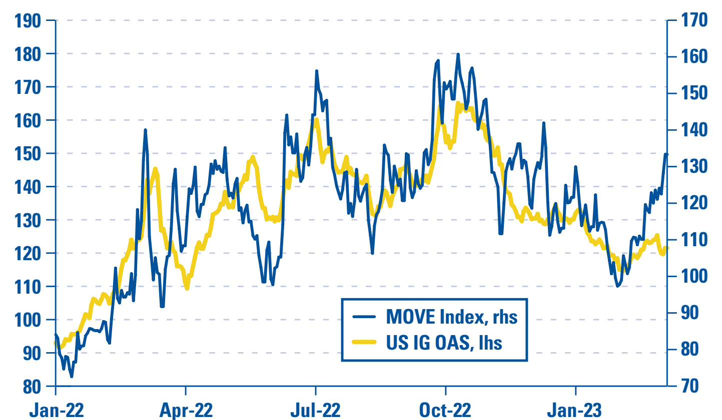
EM (NW $ Sovereign and NW $ Corporate): EM Sovereign and Corporate credit produced positive returns over the quarter. The EM Sovereign spread was roughly unchanged, around 400bps, which does not compel us to shift away from our neutral stance. On the other hand, EM Corporate spreads have compressed to 335bps, which is now below its 10-year average of 355bps. Should spreads continue to tighten below 300bps, we would reassess our neutral stance. But currently, we maintain our *neutral* stance on EM hard currency bonds.

Chart 5: US ISM Manufacturing PMI and HY vs IG returns



Source: Bloomberg

Chart 6: US IG Spreads and MOVE Index, bps

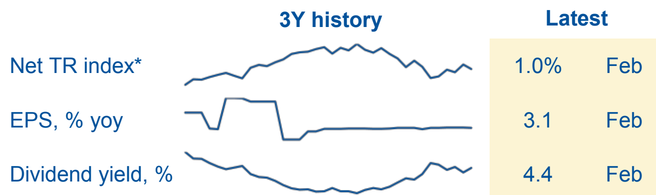


Source: Bloomberg

Real Estate

Neutral ↓

Real estate valuations appear less attractive relative to fixed income.

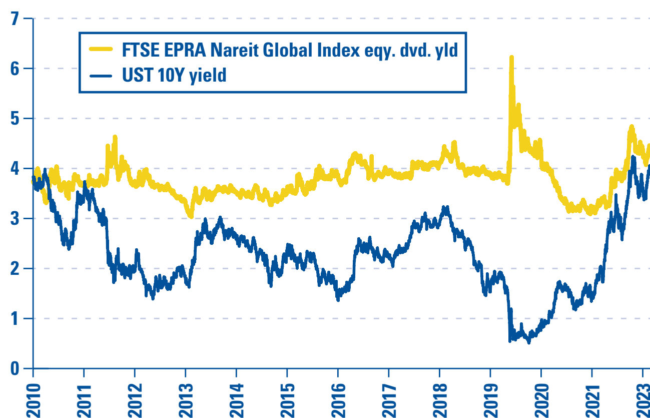


	3Y history	Latest	
Net TR index*		1.0%	Feb
EPS, % yoy		3.1	Feb
Dividend yield, %		4.4	Feb

*Source: Bloomberg. 3M return is shown in "Latest". *FTSE EPRA/NAREIT Global Index.*

Global real estate was the best-performing asset class in the three months to end-February, helped by rising global economic data surprises. The current elevated rates and slowing growth climate is challenging for cyclical assets like real estate. The eventual pause in the Fed's tightening cycles could provide some relief, and real estate retains value against equities when comparing relative dividend yields. However, valuations for real estate are now less attractive than US bond yields (see Chart 7), resulting in our allocation switch to fixed income from real estate.

Chart 7: REIT Dividend Yield & US 10-Year Treasury Yield, %



Source: Bloomberg

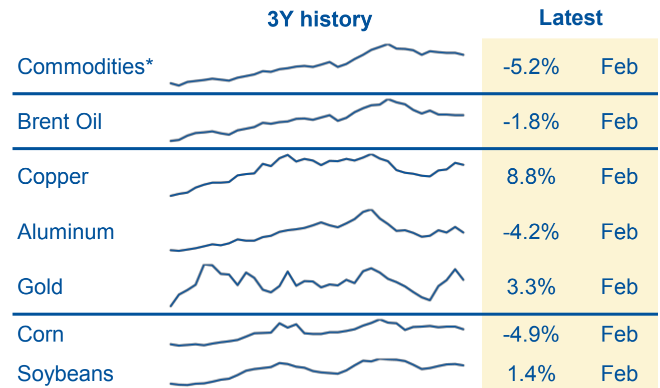
There are signs of a slowdown in the direct real estate market. Property service provider JLL noted that global investment volumes fell by 58% yoy in Q4, while the bid-ask gap remains wide. Reflecting investor caution, global fundraising dipped sharply last year. On the occupier side, the slowdown in office leasing demand and ample supply pipelines point to weakening office rental growth. The retail market recovery has eased in mature markets but is expected to strengthen in Asia Pacific. The longer-term outlook for residential and logistics is still bright.

Market Strategy: We continue to see value in real estate relative to equities. But the dividend yield is now on par with the 10y US Treasury yield, making an allocation to fixed income more attractive. Thus, we reduce our allocation to *neutral*.

Commodities

Neutral

The cross-current between slowing global demand and China's economic recovery will leave commodity prices struggling to find direction.



	3Y history	Latest	
Commodities*		-5.2%	Feb
Brent Oil		-1.8%	Feb
Copper		8.8%	Feb
Aluminum		-4.2%	Feb
Gold		3.3%	Feb
Corn		-4.9%	Feb
Soybeans		1.4%	Feb

*Source: Bloomberg. 3M return is shown in "Latest". *S&P GSCI Total Return Index.*

Commodities were the worst-performing asset class during December-February for the third consecutive quarter. Weakness was concentrated in energy and agricultural commodities.

Focusing on oil, the EIA expects the global oil market to remain in a small surplus this year due to strong supply growth from non-OPEC+ producers. Supply in the US is expected to be restrained by capital discipline, while Russian output could be affected by the EU ban on seaborne products, as it is more difficult to divert product flow than crude. On the demand side, OECD demand is set to be flat due to slowdowns in the US and Europe. Meanwhile, an increase in China mobility should help put a floor under prices. In addition, there are geopolitical risks to oil supply from a Russia cut-off or Iranian aggression in the Middle East. Overall, oil prices may struggle to find direction without another geopolitical shock (upside) or recession (downside).

Elsewhere in the commodity complex, industrial metals should benefit from China's economic recovery. However, ongoing deleveraging in the property sector will keep a lid on demand. The copper market is expected to be broadly balanced this year, but prices could soften if China's property sector activity fails to accelerate further. For precious metals, higher rates will pressure gold prices, which are already expensive in real terms. Gold could find some support from renewed geopolitical risk or the likely US recession later in the year.

Market Strategy: The drag on commodity prices from higher rates and, by extension, a stronger US dollar is expected to continue until peak rates have been reached. But there are still many upside risks for individual commodities from supply disruptions. We remain *neutral*.

Any forward looking statements or forecasts are based on assumptions and actual results may vary from any such statements or forecasts.

KEY ASSET ALLOCATION INDICATORS *(All data shown are as at end-February 2023 unless otherwise stated)*

	ASSET ALLOCATION							PERFORMANCE						BENCHMARK INDEX & WEIGHTS	
	-3	-2	-1	0	+1	+2	+3	5Y	3Y	1Y	2022	Ytd	Dec-Feb		
EQUITIES				■				**32.7**	**28.8**	**-8.3**	**-18.4**	**4.1**	**0.0**	**MSCI ACWI**	**50%**
US				■				55.3	38.4	-8.9	-19.8	4.0	-2.2	MSCI USA	25%
Eurozone		■						13.1	25.8	0.7	-17.9	10.7	10.6	MSCI EMU	7%
UK					■			16.1	27.2	-0.1	-4.8	6.8	6.4	MSCI UK	3%
Japan				■				0.3	10.6	-9.3	-16.6	2.1	2.4	MSCI Japan	5%
EM					■			-9.0	2.9	-15.3	-20.1	0.9	-0.5	MSCI EM	10%
RATES				■				**-13.0**	**-18.0**	**-15.6**	**-17.5**	**-0.6**	**0.1**	**Bloomberg Barclays Global Treasury Total Return Index Value Unhedged**	**27%**
USTs				■				1.8	-12.1	-10.1	-12.5	0.1	-0.4	Bloomberg Barclays US Treasury Total Return Unhedged USD	10%
US TIPS					■			13.5	0.6	-10.4	-11.8	0.4	-0.6	Bloomberg Barclays US Treasury Inflation-Linked Bond Index	3%
Bunds			■					-24.2	-23.5	-21.0	-22.9	-1.1	-1.9	Bloomberg Barclays Euro Aggregate Treasury Germany TR Index Unhedged USD	3%
JGBs			■					-24.2	-26.2	-18.3	-17.5	-2.3	1.9	Bloomberg Barclays Asian-Pacific Japan Treasury TR Index Unhedged USD	5%
EM Local						■		-8.5	-10.2	-7.5	-10.2	0.8	3.2	Bloomberg Barclays EM Local Currency Liquid Govt TR Index Unhedged USD	6%
CREDIT					■			**-2.2**	**-11.9**	**-11.7**	**-16.7**	**0.7**	**0.9**	**Bloomberg Barclays Global Aggregate Credit Total Return Index Value Unhedged USD**	**13%**
US IG							■	5.7	-11.1	-10.4	-15.8	0.7	0.3	Bloomberg Barclays US Corporate Statistics Index	4%
US HY	■							15.2	4.1	-5.5	-11.2	2.5	1.8	Bloomberg Barclays US Corporate High Yield Statistics Index	3%
European IG					■			-19.0	-15.1	-14.6	-19.0	0.1	1.9	Bloomberg Barclays EuroAgg Corporate Statistics Index USD	2%
European HY			■					-9.1	-4.4	-9.1	-16.1	2.4	5.4	Bloomberg Barclays Pan-European High Yield (Euro) Index Statistics USD	1%
EM Sov $				■				-5.1	-15.1	-9.2	-17.4	0.8	1.0	Bloomberg Barclays Emerging Markets Sovereign TR Index Value Unhedged USD	2%
EM Corp $				■				0.9	-11.3	-7.8	-14.9	0.9	2.9	Bloomberg Barclays Emerging Markets Corporates TR Index Value Unhedged USD	1%
REAL ESTATE				■				**4.9**	**-6.3**	**-15.2**	**-24.2**	**3.7**	**1.0**	**FTSE EPRA/NAREIT Global Index Net TRI USD**	**5%**
COMMODITIES				■				**31.4**	**58.6**	**-0.3**	**26.0**	**-3.9**	**-5.2**	**S&P GSCI Total Return Index**	**5%**
Energy				■				26.1	56.0	3.7	42.3	-5.3	-8.6	S&P GSCI Energy Total Return Index	2%
Industrial metals				■				19.5	50.5	-15.7	-7.6	0.5	1.2	S&P GSCI Industrial Metals Total Return Index	1%
Precious metals				■				30.6	13.3	-4.9	-0.4	-0.8	3.9	S&P GSCI Precious Metals Index Total Return Index	1%
Agricultural				■				33.6	63.9	-6.0	12.1	-3.6	-2.1	S&P GSCI Agriculture Index Total Return Index	1%

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

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
The Barn, 1125 Airport Road
Coatesville, PA 19320
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
www.citlon.co.uk

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