Vontobel

Asset Management

Investors' Outlook

Global economy may find its stride in the second half

September 2019

Global economy may find its stride in the second half

Dear readers

This year's New York triathlon was cancelled due to a heatwave. The global economy is also battling with exhaustion: the energy drinks provided by central banks will only have their desired effect toward the latter half of 2019.

— The three main economies competing in the global "triathlon" are not performing so well: the American competitor, normally so successful, is suffering from heatstroke. China, an equally ambitious rival, is increasingly falling behind. Germany, usually a promising contender, is also flagging. On top of that, all the competitors seem to be in an argumentative mood.

Liquidity injections make no difference

Since they are the key organizers of the triathlon, central banks make every effort to ensure the competition runs smoothly. There has been no further mention since January 2019 of the interest-rate hikes and liquidity scarcity announced back in 2018. The US Federal Reserve has even cut interest rates recently, and the European Central Bank (ECB) wants to relax its monetary policy even further. Although plenty of energy drinks are on offer to boost the competitors' performance, they are not having any effect. Economic growth is particularly sluggish in Europe and China.

— Many observers are wondering whether central banks are losing control. Several answers are possible. On the one hand, supportive measures are welcome, as healthy economic growth requires low interest rates and adequate liquidity. On the other hand, the renewed liquidity injections are increasingly losing their effect, as the economic principle of diminishing marginal returns also applies to money. In our opinion, however, this return is still well above zero. The sharp decline in bond yields suggests that the economic outlook has deteriorated significantly. In this respect, the much more generous monetary policy recently pursued by global central banks is only logical. As a result, corporate financing costs are falling, although the positive effect will only materialize with some delay (see chart). Our analysis shows that economies should only be able to reap the fruits of their revised monetary policy in the second half of 2019.

Can other sponsors step in to help?

Could a different organizing committee come to the rescue? After all, governments can resort to other instruments such as tax incentives or investment programs to stimulate economic growth. Germany is repeatedly mentioned in this context. It could finance the desperately needed modernization of its infrastructure fairly comfortably. But Berlin continues to resist such plans and for the time being wants to keep the public budget balanced. Italy is also thinking aloud about support measures for the economy, but cannot afford them due to the crippling level of public debt. Government intervention is therefore very unlikely. However, both the US and China could surprise everyone by launching much more ambitious economic stimulus packages than previously expected.

More obstacles on the course

When the top runners stumble over each other, sensible measures taken by the competition organizers are of little use. The smoldering trade war between the USA and China has since escalated again: at the beginning of August, President Donald Trump decided to impose an import tariff of 15% on 300 billion US dollars' worth of Chinese imports not previously taxed. But he only imposed the tax immediately on half the goods, probably out of concern about the reaction of stock markets. He has scheduled the taxation of the other half for the end of the year. But the fear of a further escalation in the dispute weighs heavily on market participants.

Situation should not be overdramatized

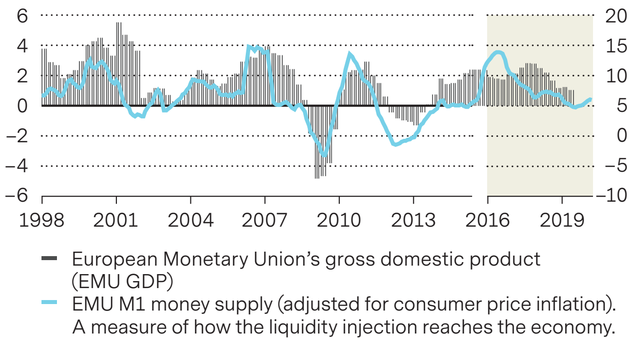
No matter how serious the trade conflict between the world's two superpowers, it is important to keep things in perspective. In the cold light of day, both the US and China are able to cope with the new tariffs. We anticipate a negative impact on economic growth of around -0.1% for the US and -0.2% for China. Contrary to popular opinion, the Chinese economy is not very dependent on the

In the «triathlon of the main economies», the US, China and Germany are trying to catch their breath

US Although 20 % of Chinese exports go to the US, America only accounts for some 5% of China's industrial production. Around 70% of Chinese production capacity is destined for the domestic market, and 25% for other countries. This is why we think the current fears of recession are overdone. For the outlook to improve, however, the major central banks must not only talk, but also act. We expect them to do so, even though the chair of the US Federal Reserve Jerome Powell, for example, is doing everything in his power to play down expectations about a further loosening of monetary policy.

Chart: European economy usually benefits from central bank liquidity with a 9-month time lag

In %, yoy change (right-hand side with a delay of 9 months)



Source: Thomson Reuters Datastream, Vontobel

We are still comfortable with risk

We still have a moderate risk appetite. We retain our overweighting since the summer in equities, and our long-standing overweighting in corporate bonds. However, we have adopted a defensive stance for equities. Within this asset class we have an overweight position in Switzerland and in industrialized countries in general, but an underweight position in emerging markets. We still view Swiss real estate as a safe investment, especially for Swiss franc portfolios compared with bonds denominated in Swiss francs. As a stabilizer in portfolios, gold should generally do well if nominal interest rates fall or uncertainty increases.

Kind regards,

Frank Häusler
Chief Strategist, Vontobel

Equities becoming more attractive – partly due to a lack of alternatives

Recently we've warmed to equities again, as we expect economic growth to stabilize in response to the support measures being taken by the major central banks. But another reason why we like equities is because other asset classes are becoming increasingly expensive. The prices of government bonds have climbed to unimaginable heights. As a result, yields on the sovereign bonds of some European countries have turned negative for all maturities. One reason for this is burgeoning demand for low-risk government bonds, as investors fear a possible recession triggered by the escalating trade dispute between the US and China. On the other hand, market players anticipate another dip in benchmark interest rates – a scenario that is likely to persist for some time.

	UNDERWEIGHT		NEUTRAL	OVERWEIGHT	
	significantly	slightly		slightly	significantly
1 Liquidity		↘			
2 Bonds		→			
3 Equities				↗	
4 Gold				→	
5 Commodities			→		
6 Alternative strategies			→		

Changes quarter-on-quarter:
same, higher, lower.

→ ↗ ↘

—
Reto Cueni, PhD
Senior Economist, Vontobel Asset Management

Our global perspective and risk outlook

The US and China remain locked in a trade war. As a result, the pace of economic growth in the US, the euro zone and Switzerland will ease much more than expected. We see our forecasts confirmed for an economic slowdown in the US. Japan seems destined to carry over its anemic growth from the previous year. So far, China has succeeded in cushioning most of the economic impact of the import tariffs imposed by President Trump through adopting a generous monetary and fiscal policy.

Inflationary pressure remains moderate, although the inflationary effect of higher import tariffs is likely to make itself felt. The core rate is now comparatively close to the two percent target in the US, but the euro zone, Switzerland and Japan in particular are well short of this mark. Signs from the major central banks have been pointing to a further easing since early summer. We expect the US Federal Reserve and the European Central Bank to take further expansionary steps in the coming autumn.

The risk of an escalating trade conflict and the possible chaotic exit of the UK from the European Union increased last month. In addition, the continuing political crisis in Hong Kong is likely to play a role in the trade talks between China and the US. These circumstances tend to complicate any agreement. However, there is still a chance, albeit a shrinking one, that both sides could agree another ceasefire in the trade war or even reach an agreement. Donald Trump could also decide to introduce the threatened US import tariffs on automobiles at any time, which would also harm the EU and Japan in particular. He may also decide not to introduce them, or to only do so gradually. We think the last option is more likely. In our view, there is a balanced risk that escalating crises in Iran, Syria or Venezuela could drive oil prices sharply up or down.

	GROWTH	INFLATION	CENTRAL BANKS
	GDP in 2Q was resilient, but we expect growth to decelerate in 2H due to trade uncertainties and slower global growth.	PCE inflation to remain below the Fed's target this year.	We expect two additional key rate cuts in 2019.
	Sentiment very weak for manu-facturing, solid for services, hard data mixed. We expect growth to stabilize in 3Q, trade talks are key.	Headline and core inflation expected to remain weak until 4Q.	We expect additional stimulus measures from September onwards.
	Weak manu-facturing PMI, strong labor market, solid KOF leading indicator: 2019 GDP forecast unchanged.	Inflation remains weak despite low unemploy-ment.	We expect the SNB to follow the ECB's policy with some delay.
	Likely to slow to 6.1% in 2019 and 5.8% in 2020 as trade war tensions hurt the economy.	Higher tariffs and pork prices leading to slightly higher CPI inflation (~2.5%).	More stimulus to come as hard economic data disappoint once more.
	2Q GDP better than expected, trade talks, China growth are a risk. VAT hike to dampen growth in 4Q.	Core and headline inflation see weakening until the end of summer.	We expect the BoJ to keep its very expansionary stance.

The measures taken by central banks to stimulate economic growth favor exposure to most asset classes other than liquidity. This has prompted us to trim our cash position. As all the main central banks are pursuing a very similar monetary policy, we do not see any reason to be tempted into any major "currency bets".

Demand for low-risk government bonds continues to surge, making them increasingly unattractive. Even so, political uncertainties and unclear economic prospects are encouraging us to hold on to some government bonds. We retain our overweighting in corporate bonds, although we did take some profits back in August. In the emerging markets segment we still favor bonds denominated in hard currencies.

We have been slightly overweight in equities since July, as we reckon the greater risk compared with government bonds is handsomely rewarded at present. We also anticipate some stabilization in the leading economic indicators over the coming months. In terms of countries, we are now overweight in industrialized nations in general and Switzerland in particular. We retain our underweight position in Japan, and now emerging market countries as well.

We remain slightly overweight in gold, which benefits from the current decline in US real interest rates. The fact that no further rise is expected in the US dollar also helps the precious metal. In addition, gold is suitable as a hedge against negative economic or political surprises.

Investments in commodities can provide protection against political uncertainties in the Middle East. However, weaker economic growth is depressing expected demand for commodities and pushing down their prices. We therefore retain our neutral positioning.

In the current climate of heightened political risks, alternative strategies can be useful for diversification. Compared with cash investments, however, they only offer a modest return, considering the higher risk. We therefore adopt a neutral positioning overall in alternative strategies.

With trade contracting, prospects of an economic rebound are diminishing

—
Reto Cueni, PhD
Senior Economist,
Vontobel Asset Management

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel Asset Management

With the US-Chinese trade spat showing no signs of abating, and given weak sentiment in the most important regions, we have downgraded our economic forecasts. We now expect global growth to stabilize rather than rebound modestly in the second half of 2019.

— This spring's hopes for a recovery in global export growth didn't last long. The latest figures show a drop into negative territory (see chart 1), suggesting a "weaker for longer" trade scenario. In August, the Trump administration announced new punitive tariffs of 15% on additional 300 billion US dollar of Chinese imports coming to effect at the beginning of September, which immediately elicited a Chinese response. This tit-for-tat lowers the prospect of a trade agreement. Further US measures could include a tariff of 30% on 250 billion US dollars' worth of Chinese imports from October 1 onwards, up from 25% at present.

— The US economy, while still going strong at an annualized rate of close to 2% in the second quarter, won't be immune to the global slowdown. We expect it to lose steam in the second half before bottoming out at the turn of the year. The August indicator for US manufacturing sentiment dropped to a multi-year low, and there are fears that the gloomier outlook for the industry could spread to other economic sectors (see chart 2). The purchasing managers index (PMI) for US manufacturing, now below the critical mark of 50, bodes ill for production. Likewise, consumer sentiment has started to sour after the announcement of new tariffs and a related stock-market sell-off in August. We now expect the US economy to grow at a rate of 2.3% in 2019, versus 2.6% previously.

Euro zone walking a tightrope

Europe is doing its best to avoid being drawn in the escalating trade conflict, buts its position is a precarious one. For one, the US and China are the currency bloc's largest and third-largest trading partners, respectively. Moreover, the increasing likelihood of an acrimonious separation from the UK, the euro zone's second-biggest trading partner, is weighing on economic sentiment. Germany, the euro area's premier exporter, saw its economy contract in the second quarter, adding to the weak sentiment in the currency bloc. In addition, Europe faces homemade political problems, notably in Italy, where another government has collapsed.

— As expected, the euro zone's second-quarter performance was poor with the economy barely growing versus

At present, fewer containers are shipped across the world's oceans

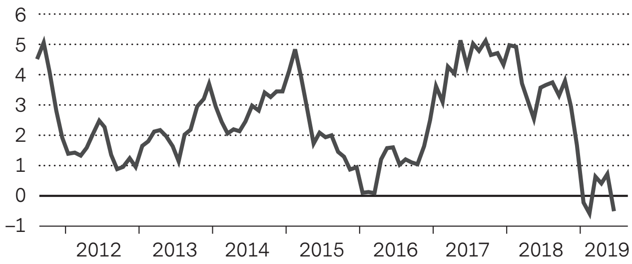
the December-to-March period (0.2% quarter-on-quarter growth), and markets remain worried. Without taking into account any worsening of the trade war or Brexit turmoil, we still expect a stabilization in the next two quarters and an annual GDP growth rate of 1.2% in 2019, versus our previous forecast of 1.3%. While the euro zone's manufacturing PMI, stuck below the important level of 50, is indicating a contraction of the sector, the expansionary trend in the service sector is more encouraging (see chart 3). Meanwhile, consumers retain a degree of optimism, but this cannot be said of the industry. In such an environment, businesses are unlikely to grow their investment.

US to cut again, Europe to follow

The July 25-basis-point cut in US key rates, the first in ten years, surely wasn't the last. We believe the US Federal Reserve will announce two additional rate cuts this fall, swelling the ranks of central banks announcing measures to support the economy. Risks are skewed towards additional cuts should the deterioration in activity intensify. We expect the European Central Bank to lower rates by 10 basis points at its next meeting in September, and to arrange a fresh asset-purchasing program worth some 350 billion euros running for roughly a year. Another parting gift of Mario Draghi could be new long-term loans known as TLTROs designed to support to the euro zone's banking sector.

Chart 1: Global trade contracting again after brief flare-up earlier in 2019

In %*

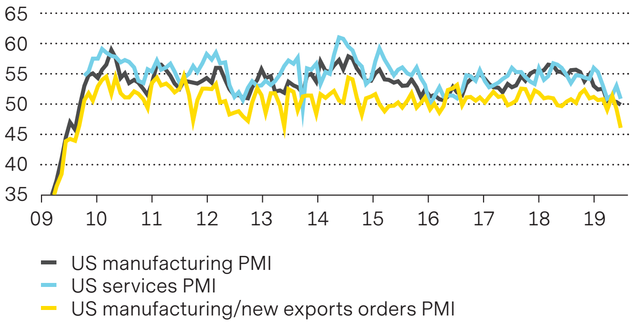


*year-on-year change global exports, moving average

Source: Centraal Planbureau, Thomson Reuters Datastream, Vontobel

Chart 2: US services sector holding up, but industry sector could sour the mood

Index



Source: Markit, Thomson Reuters Datastream, Vontobel

Chart 3: Euro zone manufacturing stuck in negative territory while services do fine

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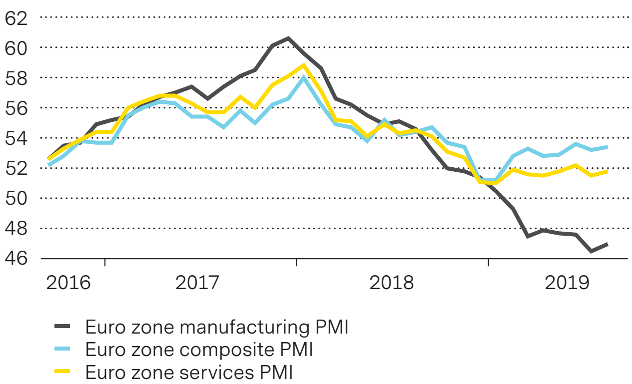


Source: Markit, Thomson Reuters Datastream, Vontobel

No summer break for government bonds

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel Asset Management

Investors hoping for a quiet summer were probably caught off-guard by the recent market volatility. Rather than sipping a drink by the pool, bond market participants faced a cocktail of negative news-flow on trade and signs of weaker economic sentiment leading to a collapse in bond yields and rocketing prices.

— Sovereign bond markets explored unknown depths, breaking countless records in terms of lower long-term yields, inverted yield curves and deeper negative interest rates. Global yield curves were flattened or pushed lower especially in Germany, the Netherlands, and Switzerland. In these three markets, all maturities are now deeply in the red (see chart 1). Most other countries also experienced near post-crisis low rates of return, which comes with ever-increasing prices.

First US yield curve inversion since 2007

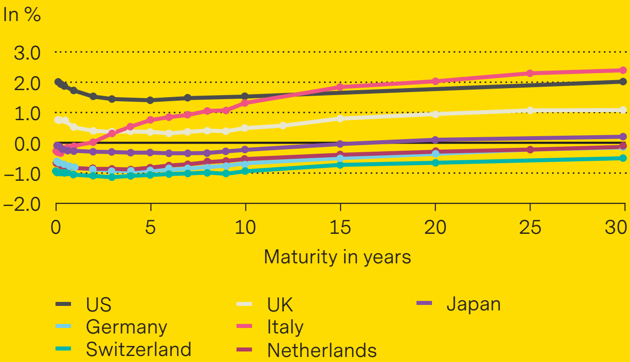
The yellow flag on the beach went up when the US yield curve inverted mid-August. The yield on ten-year Treasuries fell below that of the two-year maturity for the first time since 2007, following similar inversions of other parts of the curve since May (see chart 2). The two-year-to-ten-year yield curve then continued trading in and out of subzero throughout the month, i.e. it seesawed between an inversion and a normal upward-sloped situation. This raised concerns that the recession signal it is sending may become a self-fulfilling prophesy, and increased demand for "safe" bonds.

— Anemic long-term growth and muted inflation pressure have been pushing interest rates down for nearly a decade. This summer's more dovish stance from central banks as well as depressed inflation expectations implied in various market measures point in the same direction. In light of the increasing political risks that could materialize this autumn and our expectations of interest rate cuts in the US and the euro zone, we do not anticipate bond yields to increase over the coming months. Generally, rate volatility could remain high for the rest of the year. We believe that central bank actions as early as September will prevent a rise in bond yields or any massive sell-off in bond markets. With the storms building up on the horizon, and more central bank money inundating the markets, demand for government bonds is likely to remain high.

Government programs could improve prospects

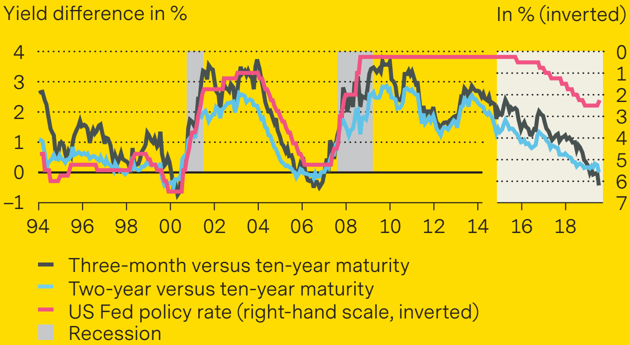
At present, only generous fiscal policies such as tax incentives could lead to a rebound in interest rates, in our view. But such programs tend to be reactive rather than proactive, and are therefore unlikely to occur before next year. Moreover, we believe it would take a dramatic worsening of economic prospects for governments to move and announce bold fiscal policy packages during the autumn. So for the time being, investors looking for a safe place in uncertain economic times will in all probability continue to engage even in expensively valued government bonds.

Chart 1: Yields hit rock bottom in Germany, the Netherlands, and Switzerland



Source: Thomson Reuters Datastream, Vontobel

Chart 2: US Treasury yield curve inversion bodes ill for economy



Source: Thomson Reuters Datastream, Vontobel

Equities warrant close attention in an era of "no fixed income"

—
Ireneus Stanislawek, CFA, FRM
Equity Strategist,
Vontobel Asset Management

Interest-bearing products are currently more expensive than ever. Equities are expected to generate significantly better returns in the long run, because they are cheaper than bonds. Among equities, "value" and bank stocks have taken a hit. We believe it is still too earlier to buy into these segments.

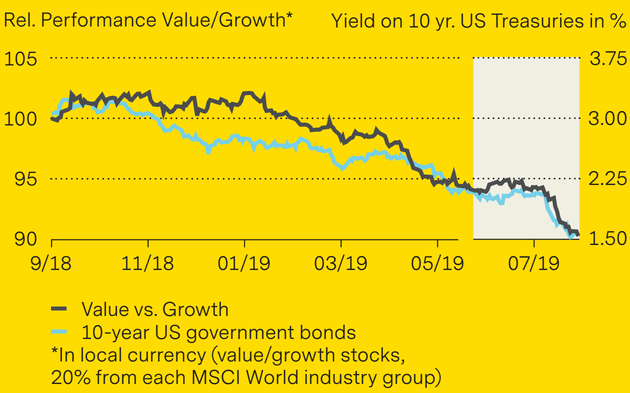
— Fixed income products are actually generating "no fixed income" for investors at present. With interest rates falling to new lows, especially in Switzerland, they have become more expensive than ever. How do rock-bottom interest rates affect equities? The situation can be viewed from a quantitative and a fundamental perspective.

Growth stocks offer better prospects
In quantitative terms, equities can be divided into "growth" and "value". Their value can be calculated by discounting future cash flows using a factor that decreases as interest rates fall. Because growth stocks produce large cash flows that typically occur in the distant future and are therefore heavily discounted, a smaller discount factor has a disproportionately positive effect on valuations. Value stocks, on the other hand, which are often inexpensive because of risky business models, for example, are expected to generate lower or barely rising future cash flows (or the trend is uncertain). The cash flows of traditional automobile makers, for example, which are suffering from falling sales and the trend towards electric mobility, are today already discounted with a high factor. A reduction in the discount factor due to falling interest rates is less significant in this case. In relative terms, a low interest rate environment will therefore benefit growth stocks. A climate of higher interest rates, on the other hand, would boost value stocks (see chart 1).

— From a fundamental viewpoint, bank stocks are a good example for illustrating the interest effect. Put simply, banks take customer deposits and lend them at higher interest rates over the longer term. If long-term interest rates fall, banks' profits decrease. It is not surprising, therefore, that bank stocks are being hit particularly hard on days when interest rates are falling (see chart 2).

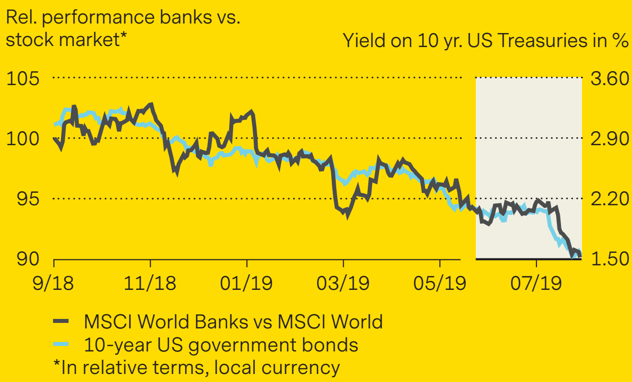
Still too early to consider bank stocks
At present, clearly more than half of European banks partially trade even below their theoretical book value on the stock exchange. They can therefore reasonably be called value stocks. Some investors may be thinking about a low entry level in view of the weaker return on bank shares and value shares in general. The right time is approaching, but has not yet come in our view, as we do not see much upside potential for interest rates at the moment. For the time being, we think investors should focus on the shares of quality companies with better than average growth prospects.

Chart 1: Growth stocks better than value stocks when interest rates are low



Source: Factset, MSCI, Vontobel

Chart 2: Banks suffer in a low interest-rate environment



Source: Factset, MSCI, Vontobel

Commodities could become more appetizing in the long run

—
Stefan Eppenberger
Investment & Commodity Strategist,
Vontobel Asset Management

While falling interest rates generally brighten the mood on financial markets, they tend to spoil investors' appetite for commodities. But this situation could improve in the mid-term due to a weaker US dollar, a strong economic recovery, or rising inflation.

— The adoption of more expansive monetary policies by the world's major central banks has boosted most asset classes (see chart 1). Falling interest rates have a direct positive effect on bond prices. Equities benefit indirectly, as lower interest rates push valuations higher. Commodities, on the other hand, stand at a tricky level – apart from gold, which has done exceptionally well, not least thanks to its role as a safe haven in uncertain times (see also Investors' Outlook, July/August issue).

Lower interest rates are a burden

Commodity prices react primarily to changing forecasts of demand and supply. Economic growth is slowing worldwide at present, which is dampening demand expectations. At the same time, there are no major supply bottlenecks, so commodity prices are unable to rise. Lower interest rates occasionally have a severely negative impact on commodities. If commodity companies can refinance themselves more cheaply, they may be able to realize costly projects that they would otherwise be reluctant to undertake.

— In addition, the decision by central banks to cut interest rates is linked to the lack of inflationary pressure due to the economic slowdown of recent months. At the same time, higher inflation would make commodities a more attractive asset class (see chart 2).

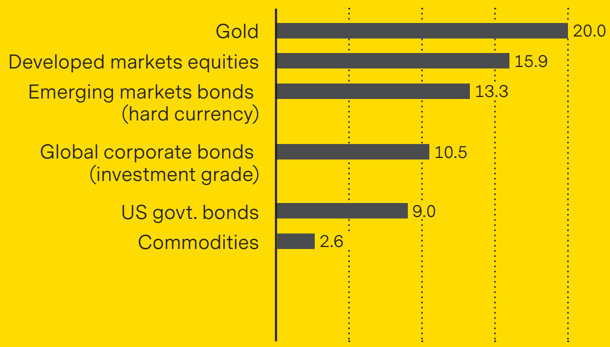
Still solid arguments for commodities

Even so, we retain our neutral positioning, as we believe that commodities still offer advantages over other asset classes – and even more so since the latest price hike in bonds and equities. Bonds are extremely expensive compared with their historical average, and equities are pricey too. Valuations are not a consideration in the case of commodities, as this asset class does not generate any regular cashflows, unlike equities and bonds.

— Our forecasts for the US dollar and the economy also argue against underweighting commodities. We do not expect the greenback to strengthen any further over the next twelve months, and this is likely to help commodities. The latest measures taken by central banks should revive economic growth and boost demand for raw materials as well. Viewed in this light, cheaper money could eventually fuel investors' appetite for commodities.

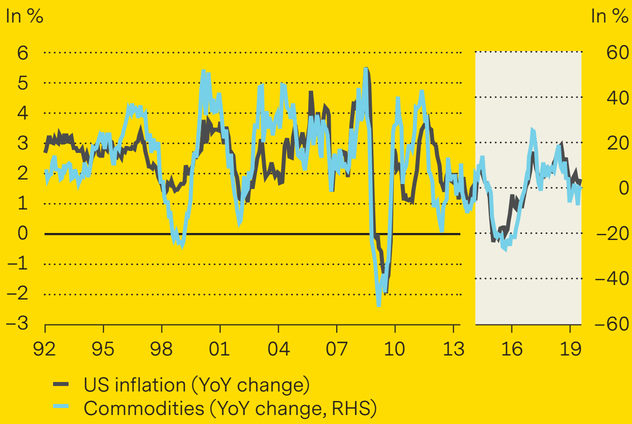
Chart 1: Commodities flagging since January, but gold shines

Performance 2019 in local currency, up to 29 August



Source: Thomson Reuters Datastream, Vontobel

Chart 2: Commodities provide protection against rising inflation



Source: Thomson Reuters Datastream, Vontobel

Franc and yen sought after – euro still lifeless

—
Sven Schubert, PhD
Head of Strategy Currencies,
Vontobel Asset Management

Demand for the Swiss franc and Japanese yen should remain strong in the short term in view of their safe-haven status. The US dollar, on the other hand, is definitely past its peak on a trade-weighted basis considering its performance versus the major global currencies. The ailing euro, by contrast, would benefit from some government tax incentives, although we must almost certainly wait until next year for this to happen.

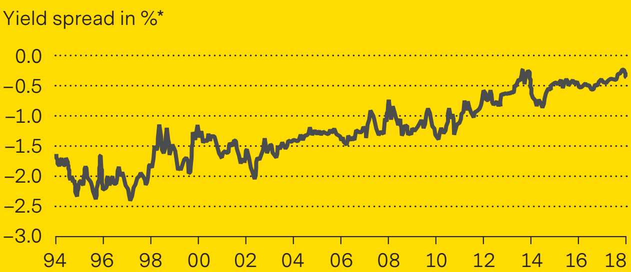
— In recent months, the Greenback has not really been able to hold its own as a safe haven against market volatility. The US Federal Reserve has issued a kind of insurance policy to financial markets: its chairman Jerome Powell is prepared to cut the benchmark interest rate further if the trade war escalates again. In the short term, however, the dollar is likely to appreciate a little against the euro, as the European Central Bank will probably also loosen its monetary policy further.

— The Swiss franc (see chart 1) and the Japanese yen, which are sought after as safe havens, are currently benefiting from the interest-rate trend. Whether they can continue to gain ground depends on the respective central banks. While the Bank of Japan has so far held back, the Swiss National Bank has probably already intervened in the currency market to curb the appreciation of the currency. We therefore only anticipate limited upside potential for the Swiss franc against the euro. But the US dollar could easily appreciate much more versus the Swiss currency, so that a franc could be worth around 96 cents in twelve months' time.

No upside expected for the euro until 2020
The positive effect on the economy of the monetary easing measures taken by the major central banks has diminished over time. Economic stimulus (which should push the euro higher) must therefore now come from other sources, for example from the state via fiscal policy in the form of tax incentives. However, we do not expect a stimulus program for the European economy – boosting the euro at the same time – until next year at the earliest.

Cheap US dollar does not help emerging-market countries
Although emerging-market currencies generally benefit from any relaxation of monetary policy by the US Federal Reserve, they are currently being restrained by the weak pace of economic growth in the countries in question. In addition, the escalating trade war undermines hopes for an economic recovery any time soon. The key question is how China will manage to cope, especially as it has been the main motor of virtually every economic upturn in the emerging markets region for the past 20 years (see chart 2). We only anticipate a sustainable rally in emerging-market currencies if the Chinese government implements aggressive monetary and fiscal policy measures – or if the current trade war does not have any lasting impact.

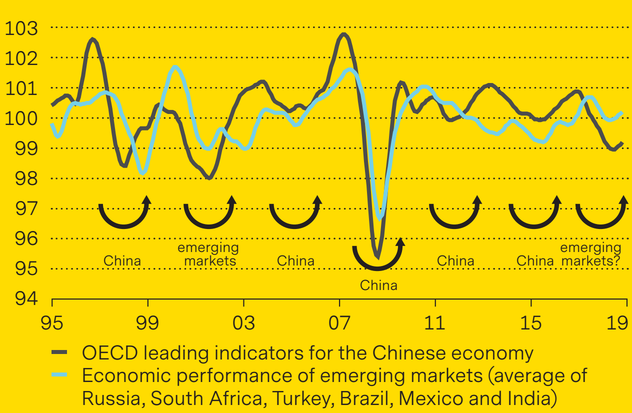
Chart 1: Swiss franc benefits from narrow yield spread with Germany



*Between ten-year government bonds of Switzerland and Germany

Source: Thomson Reuters Datastream, Vontobel

Chart 2: China sets the pace of economic growth for emerging markets



Source: Thomson Reuters Datastream, Vontobel

Key macroeconomic and financial market forecasts for 2019

USA		**2019**
Real GDP growth	↓	2.3%
Inflation		1.9%
Key interest rate[1]	↓	1.75%
10-year government bond yield[1]	↓	1.6%

EUROZONE		**2019**
Real GDP growth	↓	1.2%
Inflation	↓	1.3%
Key interest rate[1]		–0.50%
10-year government bond yield[1]	↓	–0.7%

CHINA		**2019**
Real GDP growth	↓	6.1%
Inflation		2.3%
Key interest rate[1]		4.35%

SWITZERLAND		**2019**
Real GDP growth		1.3%
Inflation		0.7%
Key interest rate[1]		–0.75%
10-year government bond yield[1]	↓	–1.0%

FOREIGN EXCHANGE RATES[1]		**2019**
USD per EUR		1.12
CHF per EUR	↓	1.08
CHF per USD	↑	0.96

COMMODITY PRICES[1]		**2019**
Crude oil (Brent, USD per barrel)	↓	70
Gold (USD per ounce)	↑	1'500

[1] Financial market forecast are for end of year
Arrow indicate change in forecast compared to last publication

Editor
Martin Gelnar, Gabriela Mayer

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Vontobel Asset Management AG
Gotthardstrasse 43
8022 Zurich
Switzerland

vontobel.com