MONTHLY HOUSE VIEW

August 2022

Focus

Germany: the sword of Damocles

Architects of Wealth

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FROM MONETARY TIGHTENING TO ENERGY TIGHTENING?

VINCENT MANUEL

Chief Investment Officer, Indosuez Wealth Management

Dear Reader,

Will summer be as hot on the markets as it is on the beaches and in our suffocating cities?

Although we have now entered the low gas-consumption period of the year in which our gas stocks are generally replenished, the fear of a Russian shutdown has added another source of stress for markets already marked by the context of stagflation and monetary tightening. Even if the closure of the Nordstream 1 pipeline was only temporary, this event reminds us of Europe's dual geopolitical and industrial vulnerability. While Russia has no interest in depriving itself of its inflows of foreign currencies, it has a sword of Damocles against Europe, a weapon of energy dissuasion that should continue to be wielded and that also conveniently helps to keep energy prices high.

This new saga maintains and amplifies a scenario of stagflation that has now become consensual. In reality, economists and investors are essentially weighing two scenarios for the Euro Area: a strong slowdown scenario with the possibility of a limited contraction of GDP over one or two quarters, and a more severe scenario with an entry into recession at the end of 2022 or beginning of 2023. The tipping point between these two scenarios lies precisely in whether or not gas supplies are maintained. Such a scenario should help keep inflation high until the spring of 2023, with (a perhaps slower) easing in inflation next year. It is important to note that two-year inflation expectations are now much higher in Germany than in the US. What a change in reality after a decade of near-zero inflation in Europe!

This context makes the task of the European Central Bank (ECB) even more complex, as it is caught in a dilemma between fighting inflation and managing the risk of fragmentation. Rationally, this should lead it to reverse the doxa that prevailed until recently in Frankfurt (ending asset purchases and then a moderate and very gradual rise in rates).

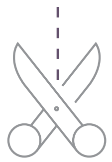
Indeed, in this context, it now seems more appropriate to raise rates quickly into positive territory while continuing asset purchases to combat the rise in sovereign risk premiums. This was confirmed by Christine Lagarde at the 21 July press conference.

Paradoxically, this darkening of the macroeconomic outlook has not yet translated into a lowering of corporate earnings expectations, which usually tend to adjust with some delay. This is one more element to add to the long list of divergences in this atypical regime. For the moment, messages from company management remain surprisingly confident on the resilience of their results, both in terms of order books and margins, with a significant ability to pass-through cost increases into prices. However, this should give us cause for concern on two counts. Firstly, because it confirms the formation of a price spiral (the pricing power of companies was a good inflationary signal in 2021). Secondly, the weakening of the growth trend and the fall in purchasing power will inevitably have an impact on sales volumes, with consumer goods and retail sectors on the front line.

After the shock caused by the conflict in Ukraine at the end of February, equity markets went from a correction triggered by the rise in long term rates to a valuation adjustment (April correction) caused by fears of recession (June correction), and the issue for the summer is whether it is now margins and balance sheets that will now move to the top of the list of concerns. This only strengthens our conviction, held since May, in high Quality stocks, and the return to profitable technology stocks and certain Defensive sectors, after having favoured Value since the beginning of 2021. Dividend stocks also continue to do well as investors look for above-inflation returns.

GERMANY: THE SWORD OF DAMOCLES

Germany is at the heart of the EU's energy crisis. The DAX has suffered heavily on European equity markets this year, and the worst could still be ahead if Russia continues to threaten its gas deliveries. However, on a more long term view the German economy could present some interesting opportunities, but patience will be required.



5.6
PERCENTAGE POINTS
of 2023 GDP erased if Russian gas cut-off

THE PERFECT STORM: H2 2022

The German economy is currently facing a number of major headwinds: a massive supply shock linked to its exposure to Russian energy and a badly timed demand shock from major trading partners due to on/off lockdowns in China and a probable recession in the US. May activity data remained relatively resilient given the circumstances (industrial production down only 0.2% Month-on-Month, retail sales were up 0.6%). Exports were 19% higher than in May 2021, while manufacturing backlogs remain large as supply bottlenecks have limited industrial production (Chart 1). Imports, however, have increased 34% Year-on-Year (YoY) due to higher commodity import prices, causing the first German trade deficit in 20 years.

Thanks to temporary government price caps on transport and fuel, inflation saw some relief in June (at 7.6% YoY from 7.9% in May). Wages increased by 4% YoY in Q1 2022, while the rise in the unemployment rate in June (to 5.3%) is essentially linked to Ukrainian refugees registering for work. Nevertheless, survey data depicts the extreme levels of uncertainty surrounding the energy crisis.

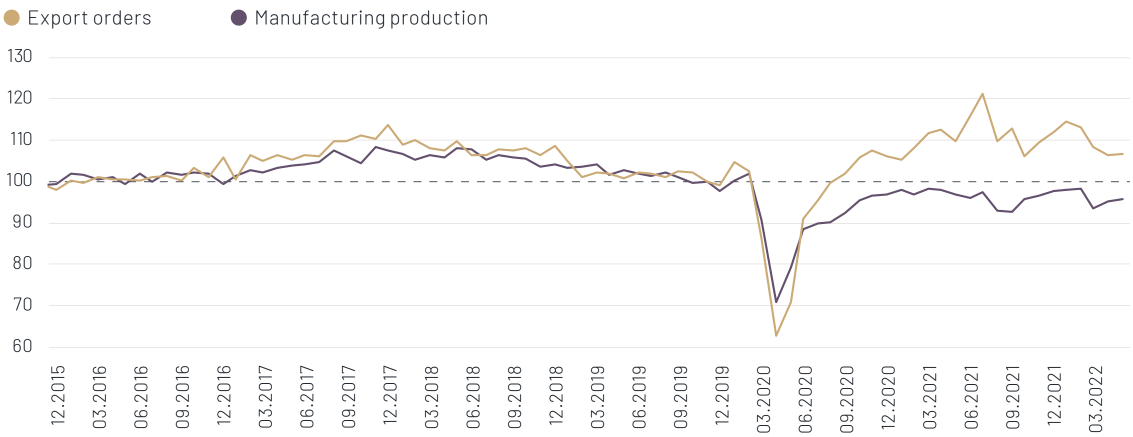
The IFO Business Climate Index fell to 92.3 points in June (down from 98 in February), while the GFK consumer survey is well below March 2020 levels. The pace of job creation is also slowing in surveys.

The possible decision by Russia to stop gas deliveries is a severe threat to the entire economy: potentially shaving -1.4 percentage points off growth in 2022 and 5.6 in 2023 (Table 1, page 7). Again this is bad timing, as German exporters are beginning to recover with the reopening of the Chinese production chain which is expected to support growth going into 2023, as well as the weakness in the euro that slightly cushions the impact on competitiveness from the recent spike in producer prices (+33% YoY in June).

EUROPEAN EQUITIES: CONTINGENCY PLANNING

Germany has suffered heavily on European equity markets Year-to-Date: the DAX is down 18% and the MDAX (with a high exposure to the German economy) is down 27%. The current environment of extreme uncertainty and increased recession risks calls for an increase in underweight in European (and notably German) equities, despite this already stark correction.

CHART 1: MANUFACTURING PRODUCTION SUFFERS FROM SUPPLY-CHAIN BOTTLENECKS, 100=31.12.2015



Source: German Federal Statistics, Indosuez Wealth Management.

Nevertheless, given its international exposure, the DAX could benefit in the short term from the weak euro or any good news on Russian gas imports, but volatility will remain high and event-driven. In contrast, green investment areas should witness in the coming year dynamic capex growth supporting future earnings growth.

TRANSFORMING CHALLENGES INTO GROWTH OPPORTUNITIES

In the midst of uncertainty, Germany indeed hosts a number of sources of future growth. Its low public debt level[1], still accommodative ECB policy, along with the weakness of the euro and political stability should help the economy go through the major transitions ahead.

2030 TARGET:
80%
of German produced energy from renewable power

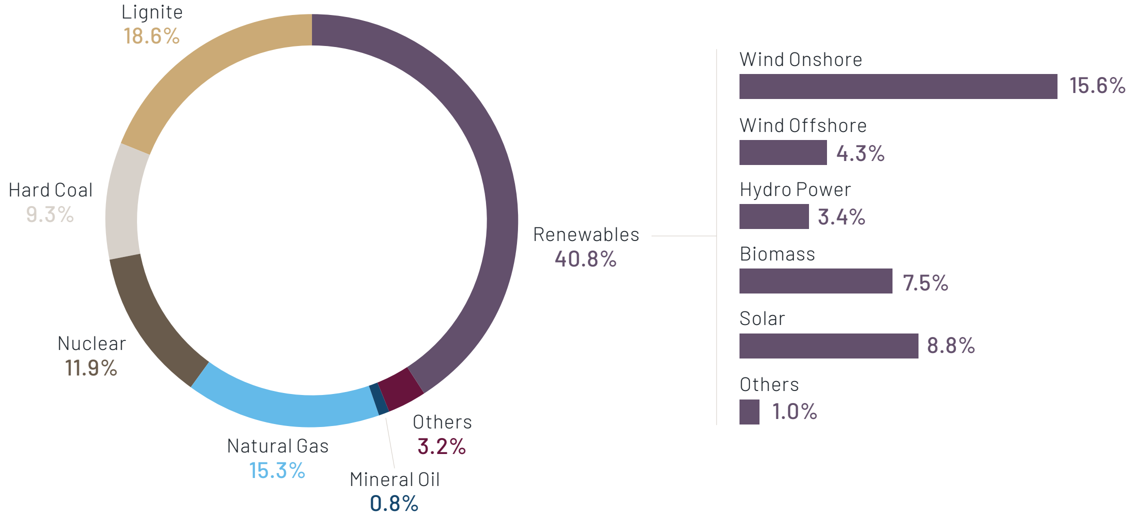
Higher fossil fuel prices a further catalyst towards cleaner energy

Even before the Ukraine war energy reforms took centre stage in Germany. However, German industry remains very gas-intensive, particularly the automotive and chemical sectors. To deal with the risk of shortage, Germany has been forced to reignite coal-fired power plants thereby pushing back its greenhouse gas emissions neutrality after 2035. It is also planning a significant push in liquefied natural gas (LNG) solutions: an increase in LNG imports, EUR 200 billion by 2026 on charging infrastructure, hydrogen technology and modernisation of industry, EUR 3 billion for the acquisition of four FSRUs (Floating Storage Regasification Unit) and EUR 500 million in the construction of an LNG terminal - a boon for builders of this type of infrastructure.

Furthermore, on 8 July the Parliament announced its largest expansion plan for renewable energy. The road-map foresees: streamlining laws, doubling Germany's onshore wind power capacity (to 115 GW), tripling the solar energy (to 215 GW) and expanding the offshore wind energy (to 30 GW) by 2030.

The new target is to produce 80% of its energy from renewable power by 2030 (compared to 41% today, Chart 2). Corresponding infrastructure investments are expected to be announced, but the grey area remains the intermittent nature of renewable energies and storage technologies, which today accentuates reliance on gas in the winter season.

CHART 2: SHARE OF ENERGY SOURCES IN GROSS GERMAN POWER PRODUCTION, 2021, %



Source: BDEW-German Association of Energy and Water Industries, Indosuez Wealth Management.

1-Despite EUR 30 billion on supportive energy measures, the debt-to-GDP ratio will fall from 69% of GDP in 2021 to 63% in 2022 thanks to the end of COVID-19 measures and the positive impact from inflation on the nominal GDP denominator.

03 • Macro economics

TURNING POINTS

The US and Europe are facing different headwinds, but are both expected to only narrowly escape recession in H2 2022, with risks in Europe skewed to the downside. Emerging markets are more or less prepared to face global monetary tightening, with some countries set to benefit from China's ongoing recovery which should soften the blow from the fall in commodity prices.

US: PICK YOUR POISON

Inflation or recession that is the Fed's question. The combination of a robust jobs report and higher-than-expected inflation reading in June (9.1% YoY) confirms another 75 basis points (bps) Fed rate hike end of July. The real estate market is the first in line to feel the pain, with 30-Year fixed mortgage rates at 5.5% in July and existing home sales already down 9% YoY as of May. Overall inflation-adjusted consumer spending dropped 0.4% in May. However, gloomy consumers appear to be listening to the Fed's harsh rhetoric and have stabilised their 12 month inflation expectations in surveys at the admittedly still high rate of 5.3%. Furthermore, July PMI (Purchase Managers' Index) surveys point to an easing in elevated input price growth, but show a broad-based fall in demand in both services and manufacturing. Future output expectations and new orders point to a fall in activity in the summer months. Surveys, like markets, can be overly pessimistic, but the stakes are high as midterm elections approach in November. The IMF recently cut its 2022 US growth forecast to 2.3% from 2.9% in late June, and to 1.0% from 1.7% in 2023, with the economy narrowly avoiding recession as the Fed reassesses the effect of its action later this year. The impact of its policy is expected to have squeezed domestic demand going into 2023 in order to bring down inflation.

US consumer
12-MONTH INFLATION
expectations
stable at
5.3%

CHINA: REOPENING

China remains in a world of its own with enviably, low inflation, a property market to clean up (see Fixed Income page 8) and a need to stimulate its economy with a much anticipated infrastructure plan as its COVID-19 lockdowns continue to constrain the economy. Retail sales surprised to the upside in June (up 3.1%), while industrial production expanded by 3.9% YoY. In contrast with the west, both fiscal and monetary policy are expected to remain accommodative and we expect the economy to accelerate as of Q3, with growth of 5.3% anticipated in 2023 (after 3.5% in 2022). The improvement in Chinese trade should support the recovery of its main trade partners, notably South Korea (9% of China's imports in 2021), Japan (8.4%), Australia (6.7%), Germany (4.9%) and Brazil (4.5%).

>10
PERCENTAGE POINT INCREASE
in Brazil central bank rate since Q3 2021

EMERGING MARKETS: STAYING AHEAD OF THE CURVE

Latin American countries face a number of political hurdles this autumn, but have sufficient experience with hyperinflation to remain ahead of the tightening curve, even if the Chilean peso was recently sanctioned for not having tightened as much as expected. These economies are also impacted differently from the changes in commodity prices, with on the one hand relief on food and energy price inflation and on the other lower government and export income from raw materials, notably metal exporters as we await the impact of the full recovery in Chinese demand. Gulf countries are still benefiting from high energy prices and demand (for both oil and gas), while also tightening their monetary policy in order to safeguard their peg to the rising USD. The appreciation in the USD is the biggest risk for emerging markets as it increases the price of imports and makes it difficult to service foreign bonds. Following Sri Lanka's default, credit default swaps have risen to extreme levels for El Salvador, Ghana, Egypt, Tunisia and Pakistan. Turkey also remains on alert due to its hyperinflation (79% YoY). But as inflation stabilises and the USD softens, countries ahead of the rate cycle may see a return in inflows as uncertainty lingers in advanced economies.

This is the case notably for Brazil that raised its interest rate by over 10 percentage points since March 2021. The latter should also manage to at least temporarily reduce its public debt-to-GDP ratio to 78% from 89% in 2020, thanks to a one-off boast in commodity inflows.

EUROPE: THE MAIN RISK TO OUR SCENARIO

Euro Area retail sales were up 0.2% YoY in May (compared to consensus decline of 0.4 expected) and appear to have returned to their pre-COVID-19 trend thanks to important fiscal buffers and a still robust jobs market (unemployment rate still at historical lows at 6.6% in May). This is good news for Q2, but is certainly no guarantee for Q3 as confidence indicators have now fallen in both manufacturing and services. Europe's energy crisis (see Focus on page 4) will be the breaking point for H2 economic activity. The ECB and other European central banks published an adverse scenario in June whereby GDP would fall by 1.7% in 2023 if Russian energy exports where cut-off completely in Q3-2022 (Table 1).

TABLE 1: EURO AREA NATIONAL CENTRAL BANK FORECASTS: BASELINE VS. ADVERSE (RUSSIAN ENERGY CUT-OFF) SCENARIO, %

	GDP GROWTH, %			INFLATION, %		
	2022	2023	2024	2022	2023	2024
Germany - Baseline	1.9%	2.4%	1.8%	7.1%	4.5%	2.6%
Germany - Adverse	0.5%	-3.2%	4.3%	7.6%	6.1%	2.8%
France - Baseline	2.3%	1.2%	1.7%	5.6%	3.4%	1.9%
France - Adverse	1.5%	-1.3%	1.3%	6.1%	7.0%	0.7%
Euro Area - Baseline	2.8%	2.1%	2.1%	6.8%	3.5%	2.1%
Euro Area - Adverse	1.3%	-1.7%	3.0%	8.0%	6.4%	1.9%

Source: Amundi Institute, ECB, Bundesbank, Banque de France, Banco de España (June 2022), Indosuez Wealth Management.

WHAT COMES AFTER INFLATION?

If the Sri Lankan President is the first political figure to pay the price of inflation, tensions are rising in Europe on stellar energy prices, in Asia on falling real estate, in the UK on broad-based inflation. After historic negative performances during the first quarter, is fixed income a must have investment in the second quarter of this year?

After years of chirurgical rate shifts, central bankers now use

MASSIVE HIKES

CENTRAL BANKS

Central banks struggle to fight inflation and keep on hiking rates. Liquidity is rapidly drying up in economies, the latest banking survey published by the ECB shows rapid tightening in credit conditions for the private sector, for both consumers and corporates.

Yield curves have flattened (Chart 3) on cloudy prospects for growth in the coming quarters: long term rates pricing-in dovish central banks in 2023 while short dated are propped-up by actual rate hikes.

Inflation markets receded sharply since mid-June, on the back of lower energy and metal commodity prices.

The ECB hiked by 50 bps at its July meeting, a magnitude not seen since the end of the 90's. President Lagarde also announced the shape of the Transmission Protection Instrument, designed to ensure a smooth financing for treasuries. We will comment further in the next publication.

CREDIT

In European credit, we maintain a cautious stance on euro investment grade (IG) credit even though spreads and yields look attractive at this time.

Some market participants expect that in the case of total shut down of gas delivery, credit spreads would widen by roughly 100 bps for IG and 325 bps for high yield (HY).

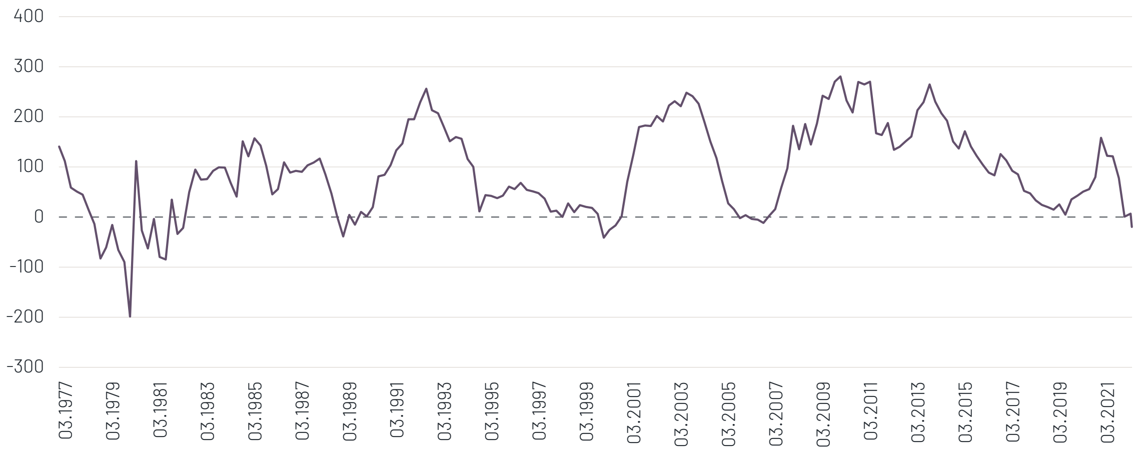
However, we identify some interesting points in this context. At current levels, the implied default rate is close to 10% (cumulative levels over 5 years) which is more than 10x the historical IG default rate. Supply should be muted in the coming months to the point where some analysts foresee net supply for euro IG close to zero for the second half of the year!

As per European HY, current levels of around 600 bps for the Xover index implies an almost 40% cumulative default rate within 5 years, significantly above historical levels of realised rates.

For corporates hybrids we saw a parabolic rise of spreads and drop in bond prices, which were mainly caused by the real estate markets.

On a positive note, some issuers have been active in liability management and have bought debt in the market at deep discounts sending a positive signal to the market.

CHART 3: 2-10 YEARS SLOPE AND RECESSIONS IN THE US



Source: Bloomberg LP, Indosuez Wealth Management.

FUNDAMENTALS

The S&P has conducted a recession stress test on European HY corporates in four different scenarios, even though their base case remains an absence of recession in Europe. B- and below rated corporates, which would be most vulnerable to a downturn, have indeed become larger proportionally post-pandemic. By sector, utilities, chemicals, hotels, gaming and leisure, could see much higher leverage in a severe recession scenario. The strength of the pandemic recovery has boosted corporate earnings and balance sheets. In the highest stress scenario of a full-recession, a 20% decline in corporate EBITDA, about 50% of European HY could have negative free operating cash flow. Nevertheless, the extent and pace of downgrades will depend on how persistent rating agencies think cash-flow deficits will be, since most issuers face limited near-term liquidity-event risks, thanks to their well-extended debt maturities.

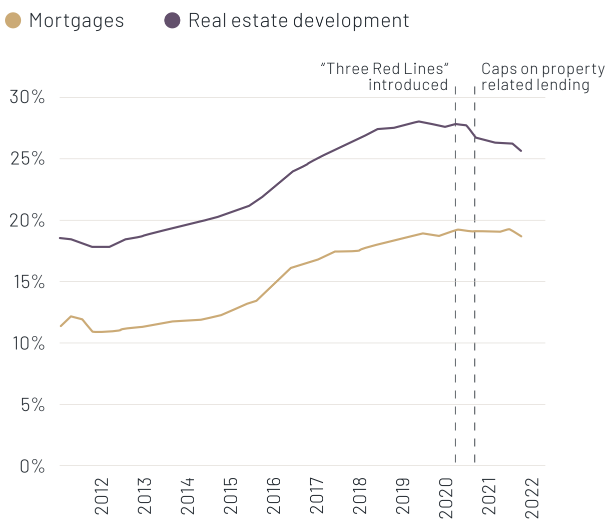
ASIAN CREDIT

Challenges remain for Asia Credit, as both Asia investment grade and Asia HY continued to face pressures on multiple fronts. Conditions worsened further by further fund outflows from Emerging Markets and consequently Asia Credit. Furthermore, Asia Credit is faced with its own challenges, with China's zero-COVID policy driving lockdowns in major cities. Despite measures to soften the impact and stimulate the economy, the lockdowns saw economic activity slow materially across many sectors, including property sales in April and May. Policies remain supportive, leading to some preliminary indicators of recovery, though investors remain cautious and staying sidelined.

Given the strains in Asia high yield, there has been a structural shift in the Asia Credit Universe. Asia HY used to comprise 18% of Asia Credit - with Chinese Real Estate representing 45% of Asia HY, nearly half of this pocket. Today, Chinese Real Estate has fallen to just 15% of Asia HY, with Asia HY consequently falling to just 11% of the Asia Credit universe in one year.

The situation remains unprecedented in Asia Credit history - at least 21 developers with a combined USD 80 billion in bonds having defaulted since July last year - while another 16 developers with a further USD 6 billion have extended their obligations this year. As of July, however, the Chinese property sector has been dealt yet another blow, with buyers of at least 230 projects across 80 cities boycotting mortgage payments – estimates of the total mortgages stalled to amount to roughly CNY 2 trillion (USD 300 billion). The latest policy announcement calls for a possible payment holiday for stalled projects without incurring penalties as authorities attempt to prevent the confidence crisis in the housing market. Although we remain positive on chinses equities and the reopening in H2, the Chinese property loan market (Chart 4) is a risk factor to keep on the radar.

CHART 4: CHINA PROPERTY LOANS, % OF TOTAL LOANS



Source: Refinitiv Datastream/Fathom Consulting, Indosuez Wealth Management.

NAVIGATING IN A BEAR MARKET

The past weeks have seen a strong change in market risk perception with recession risk now dominating inflation fears. This has been reflected by the recent drop in long term yields. Earnings growth expectations are resilient, but the new earnings season will be a reality check. In this context, Chinese stocks as well as Quality and Environmental thematic stocks offer some pockets of resilience and diversification.

We favour
QUALITY AT REASONABLE PRICE
(QARP)

EARNINGS AND VALUATION

The earnings season for the second quarter of 2022 is already advanced in the US and at its beginning in Europe. Earnings revisions continue to be resilient (Chart 5), but widely driven by commodities. In the US, the earnings-per-share (EPS) trend is starting to decline, but at a moderate pace. In the current context of higher volatility, investors will be very attentive and weary to company guidance.

On the valuation side, real yields have been stabilising over the past weeks. Globally, absolute levels remain below their long term averages, with the exception of the S&P 500, which despite its sharp decline has merely returned to its historical average.

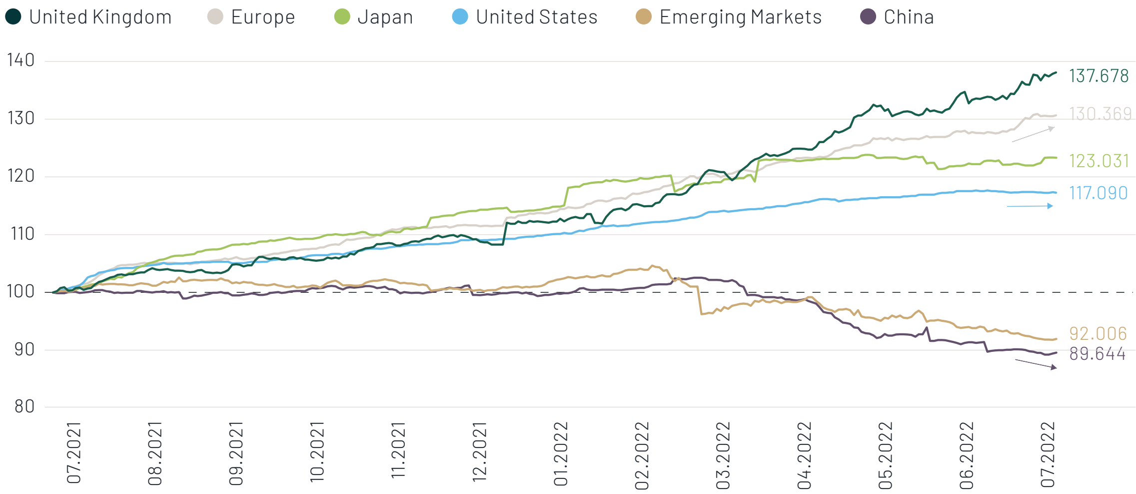
UNITED STATES

Prudence is still warranted as the latest macroeconomic releases show that inflation has not peaked and is beginning to impact consumer spending (the primary driver of US growth, down -0,4% in inflation-controlled terms in June).

Investors are now expecting a rate hike between 75 to 100 bps in July. However, for several weeks, equity indices have been stabilising. The 10-Year US Treasury yield has consolidated in at range of around 3%, which brought a brief lull to the market, in particular for Growth stocks.

US markets remain for some investors a safe haven during periods of geopolitical uncertainty, as reflected in the recent strengthening of the USD. In such a context, we favour Quality at Reasonable Price (QARP) and are still cautious on Cyclical stocks. Recent negative revisions and disappointments on Q2 earnings releases in the US are mainly affecting Cyclical stocks (industrial, banking and consumer discretionary), but this is holding up well at this stage for technology (+6% EPS growth surprise) and healthcare (+7%), thus validating our preference for Quality.

CHART 5: EARNINGS REVISIONS BY ZONE, 100 = JULY 2021



Note: EPS 12-Month Forward are still up for major developed markets. Europe and UK are accelerating on the upside while the US are stabilising. However, on Emerging Market and China side, the trend is still on the downside.

Source: Bloomberg, Indosuez Wealth Management.

EUROPE

The macro environment stays challenging for the Euro Area, with the Russia/Ukraine conflict having a disproportionate impact in terms of inflation and energy costs. The focus of investors has now switched from monetary tightening to recession. Despite positive guidance from management and an earnings season that started with upwards revisions on expectations, investors believe that the lack of visibility for the coming quarters will lead at some point to some significant negative revisions. Hence, the historically low valuations on European markets are no longer a catalyst, and we are staying cautious, waiting for a clear signal/relief from either inflation, rates or the Russia/Ukraine war. In the meantime, we favour a defensive play through the UK and Swiss markets, but once again on a relative basis.

Positive on
CHINESE EQUITIES
for H2 2022

EMERGING MARKETS

We continue to be positive on Chinese equities from the second half of 2022. China's economy has continued to improve. Exports were again a bright spot in June as released data substantially beat expectations. There has been a steady flow of policy support messages from the Chinese government over the recent weeks. We are expecting a major ramp-up in infrastructure spending over the year. While watching out for possible targeted COVID-19 suppression measures, we believe a shift in the official platform economy-regulation message should bode well for growth technology and consumer blue chips over the second half of the year.

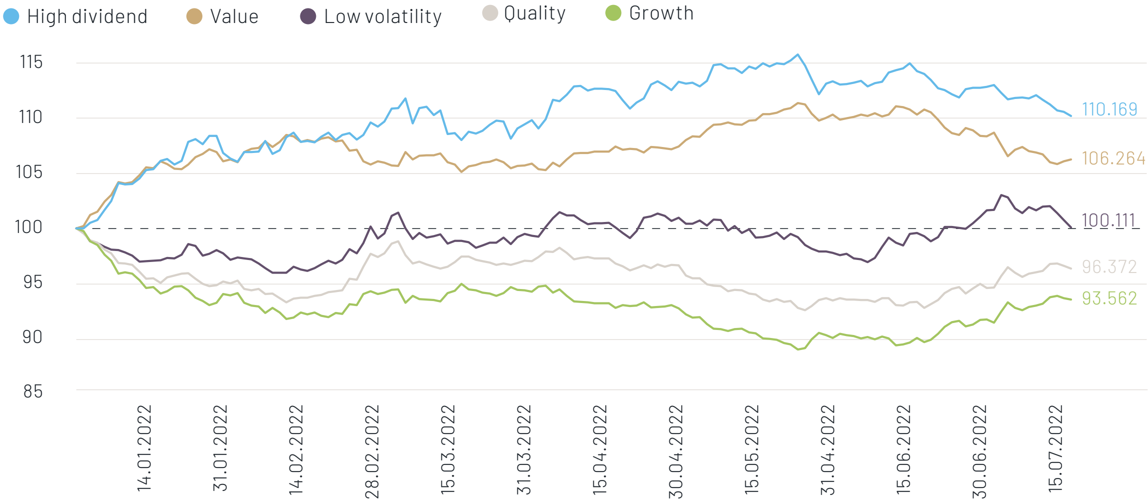
STYLE: FOCUS ON QUALITY, COMPLETE WITH VALUE

The recent drop in long term yields has been a strong catalyst to the renewed outperformance of Quality themes (Chart 6). The upcoming earnings season should be another support for these Quality stocks, as investors should reward companies with more visibility on their guidance and showing resilience on earnings. In the context of stagflation, we turn towards resilient dividend stocks offering a good protection against inflation.

With yields turning downward, Value has lost one of its main drivers. The recent correction on Oil/commodity prices has equally impacted the strategy. Regarding the strength of the recent correction, we prefer to wait for a technical rebound in the style to reduce our exposure.

The current rotation has benefited Growth stocks, thanks to the fall in bond yields, which has favoured a short term rerating of long duration stocks. We considered that it is still too early to come back widely on Growth companies, but we have some preference for the Environmental Focus theme (as the shortage of gas will reinforce investments on alternative energy, see Focus page 4) and the Silver Age theme for its defensive aspects.

CHART 6: MSCI EUROPE FACTORS, RELATIVE PERFORMANCE YEAR-TO-DATE



Note: Value and High dividend have been the best factors YTD but are losing momentum since LT yield are not rising anymore. Low Volatility (defensive) and Quality on the opposite are gaining momentum, the same as Growth.

Source: Bloomberg, Indosuez Wealth Management.

06 • Forex

EXTREME VOLATILITY AND UNCERTAINTY FOR FOREX

The summer of 2022 has seen many significant long term Forex levels broken as the USD climbs to new heights amid broad risk-aversion, whilst central banks shift monetary policy in large steps and at a fast pace. The future for some currencies, especially in Europe, is as uncertain as ever.

CHF likely
BEST
HAVEN
for the long term

CHF

CHF is a reliable safe haven in the inflation storm hanging over markets. In fact, we feel it is the only other safe haven apart from the USD within the G10 Forex space. Since December the Swiss National Bank (SNB) has made some very significant changes to its monetary policy which means CHF is likely to be the most resilient currency against inflation:

- In Q4-2021 they allowed the CHF Forex rate to re-appreciate to mitigate global inflationary pressures;
- In mid-June 2022 they raised rates by 0.5% and added that they would intervene to buy CHF on Forex markets if it were to weaken too far.

Given the enormous Forex reserves of the SNB (> CHF 900 billion, or about 125% of annual GDP), and the determination of the SNB to fight inflation, there is little reason to believe the CHF will be able to depreciate significantly. In addition, Switzerland's low dependence on fossil fuels means its current account surplus from high value-added exports is likely to remain resilient.

Whilst the USD is likely to be the first currency to benefit in a significant "risk off" environment, the CHF's low inflation and extremely strong fundamentals mean it is likely to be the best haven for the long term.

EUR

Although the ECB raised interest rates by a surprising 50 bps, the EUR failed to climb much; perceived as a lack of weight (or rather too much conditionality) on the Transmission Protection Instrument - the markets appear to be doubting its clout. It's also worth noting that even with rate hikes and an anti-fragmentation tool the EUR outlook is still clouded by war and recession fears so even if the tool had been stronger it would have been hard to break back above 1.04. For now though, the EUR will remain in limbo, whilst we need to watch Euro Area data very closely over the summer.

GBP

The GBP/USD has been under pressure lately following the latest strings of positive macro data from the US economy, paving the way for a hawkish Fed during the July FOMC meeting.

While Boris Johnson's resignation in the UK has had no significant effect on the British pound, the UK's economy still faces strong headwinds starting with soaring inflation figures (at 9.4% YoY) forcing the Bank of England to raise rates at a moment when the UK's economy might contract in June under the pressure of the contraction in real incomes.

Moreover, the prospect of a new stand-off with the European Union - should the Northern Irish protocol be unilaterally suspended by the British government - adds to bearish sentiment on the GBP.

Gold falls through the
USD 1'800
support level

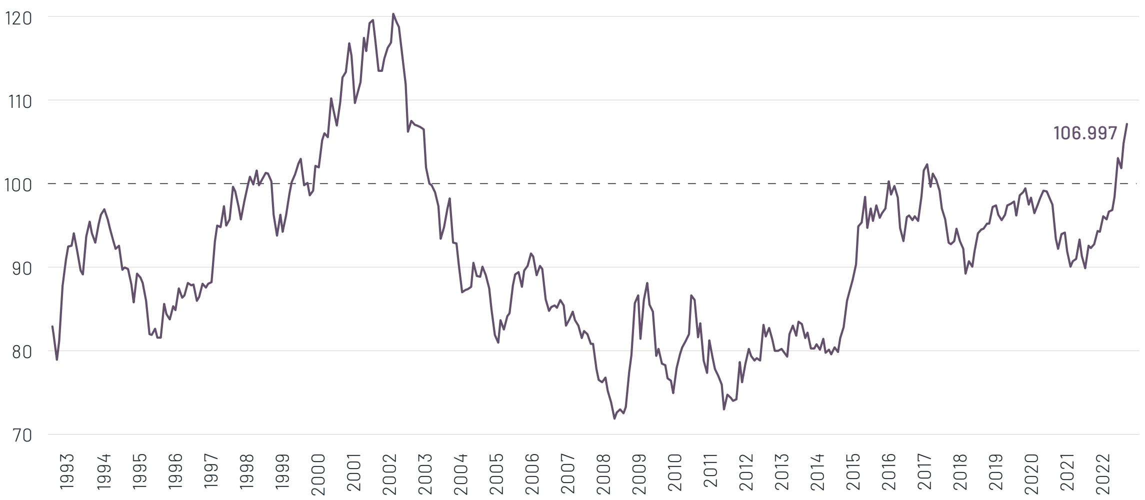
USD

The USD has reached new heights (Chart 7) as market volatility remains strong and investors are faced with a plethora of macroeconomic uncertainties. The comfort of being able to get short term deposit yields over 3% in the world's primary reserve currency is too alluring to investors whose confidence has been thrown by bear markets and recession risks. These are however extreme levels of strength on a long term basis, and whilst the USD will provide a haven in the storms roiling markets, buying into it at this price is also not an easy choice.

GOLD

Gold finally gave in to pressure from multiple sides in July, falling through the USD 1'800 support level under pressure from large selling flows in Gold ETFs and short bets being placed through futures. From a macro perspective, the strength of USD interest rates and the USD itself were the significant factors. After testing USD 1'680 it is clear that support is strong at that level, however it will take a new narrative or catalyst to help it properly recover (or US interest rates to ease off).

CHART 7: USD INDEX MULTI-DECADE



Source: Bloomberg, Indosuez Wealth Management.

INVESTMENT SCENARIO AND ALLOCATION

HIGHER
PROBABILITY
to enter recession

INVESTMENT STRATEGY

- **Geopolitics and energy:** the level of uncertainty will probably remain very elevated this summer with a risk that Italian politics, the conflict in Ukraine and energy tensions continue to drive risk aversion.
- **Growth:** a higher probability to enter a recession, with a variety of scenarios ranging from a temporary GDP contraction of one or two quarters, to a more severe recession. The trigger factor remains the scenario on Russian gas, as a full pipeline tapering could hit Euro Area GDP by several points. Consumers pay most of the price of this stagflation context, as reflected by the recession-level of consumer confidence. US consumers begin to lower inflation expectations, but are paying the ultimate price of the Fed's hawkish policy. The outlook in China improves, albeit gradually with a risk on the property market to keep on the radar.
- **Inflation:** inflation will remain elevated (around 8% in 2022) on the back of elevated energy and food prices, while social tensions caused by inflation will fuel rises in wages, extending inflationary tensions. 2023 inflation could be a mix of lower (or negative) contributions to inflation from energy due to base effects, whilst core inflation should remain above 3%, unless a recession significantly weakens employment.
- **Central Banks:** confirmed accelerated normalisation with ECB exiting negative rates and adapting its stance to this new environment, which requires higher rates, but also greater balance sheet action to control peripheral spreads. The Fed maintains its commitment to fight inflation, but with a question mark on the resilience of this stance in case of recession. The Fed will probably end rate hikes in Q1 2023 and recession fears fuel expectations of rate cuts in H2 2023. Several emerging market central banks are already well engaged on this normalisation journey, while the Chinese central bank will remain accommodative.
- **Long term bond yields:** as a consequence, the flattening of yield curves should continue, notably in the Euro Area, reflecting both accelerated short term rate normalisation as well as the impact of recession fears and the introduction of the ECB's new Transmission Protection Instrument (TPI) on long term bond yields.
- **Corporate earnings:** we continue to observe a strong divergence between depressed macroeconomic data and upbeat analyst forecasts translating confident management guidance, notably on their pricing power. However, we believe that earnings will soon start to reflect a worsening environment, either through lower revenue growth or through higher provisions/lower margins, especially compared to the exceptional level of earnings generated in 2021. This is front-runned by equity markets, where the correction has been increasingly driven by recession fears since June.
- **Default rates and liquidity conditions:** default rates will undoubtedly rise in a stagflation context beyond what rating agencies expect, but not to the implicit level reflected by the significant widening of credit spreads. The credit market thus offers generous risk premia to investors, compensating not only for default probability, but also liquidity risk and volatility. In the short term, limited summer liquidity and recession risks should continue to weigh on market prices.
- **Market regime:** as the market regime is shifting from normalisation fears to a higher recession probability, we are (possibly temporarily) returning to a regime of inversed correlation between bonds and equities. Nevertheless, if the recession risk should find its roots in the energy crisis, comparison with market regimes of past recessions would probably be misleading. Therefore, investors should remain agile in the face of these unstable correlations, whilst the absence of central bank puts is resetting equity and credit volatility at higher levels.

ALLOCATION STRATEGY

- **Equities:** we maintain a moderate underweight due to expected EPS revisions as well as rising recession risks, even if valuations appear now more attractive. In a complex environment, we are increasing our preference for Quality assets and for Value companies benefiting from this stagflation context, with a higher tilt towards resilient dividend stocks offering a good protection against inflation. The reversal of bond yield direction may sustain Growth stocks, but investors should focus on profitable technology. We continue to remain underweight on Cyclicals, industrials and consumer discretionary. In terms of geography, we maintain a moderate exposure on Euro Area equities with a preference in this context for UK and Switzerland, while remaining neutral on the US and overweight on China.

- **Carry on corporate bonds:** constructive view maintained on quality corporate bonds offering the most attractive spreads since the pandemic climax; more cautiousness on high yield in the short term as credit spreads can continue to widen notably in the case of energy shortages and higher recession risks, but patience will be rewarding for long term investors with a buy and hold approach and selective philosophy.
- **Currencies:** we had stated on several occasions in this publication that it was premature to become short dollar against euro, as it means fighting the Fed normalisation path or ignoring the Euro Area challenges which are far greater than the US economies imbalances. We think that the greenback is approaching its peak, but investors may want to wait to see the Fed adopting a softer stance before buying the euro. We keep constructive long term views on the CNY, but find little interest in the short term in view of China's monetary divergence towards easing. Investors may want to wait further to reinitiate positions on other emerging market currencies.
- **Macro hedges:** government bonds have finally started to play a positive role in portfolios since mid-June. This is in line with our expectations; the rotation of investor worries from monetary normalisation towards recession has indeed started to sustain government bonds. We are now neutral on duration after several years of a short-duration positioning. After the recent correction on gold, and in view of the rising recession probability, we find current levels more attractive, without a clear conviction on market direction in the short term, but rather as a hedge against macro risks.
- **Risk positioning:** overall, we prefer to maintain a moderate risk approach, with both some cash buffers in the riskiest investment profiles and higher macro hedges so as to reduce volatility and have the capacity to seize the opportunities that the market will offer.

KEY CONVICTIONS

	TACTICAL VIEW (ST)	STRATEGIC VIEW (LT)
FIXED INCOME		
GOVERNMENTS		
Core EUR 10-Year (Bund)	=/-	=
EUR Periphery	=	=/-
US 2-Year	=/+	=/+
US 10-Year	=	=
EUR Breakevens Inflation	=	=
US Breakevens Inflation	=/-	=
CREDITS		
Investment grade EUR	=	=/+
High yield EUR/BB- and >	=	=
High yield EUR/B+ and <	=/-	=/-
Financials Bonds EUR	=/+	=/+
Investment grade USD	=	=/+
High yield USD/BB- and >	=	=
High yield USD/B+ and <	=/-	=/-
EMERGING DEBT		
Sovereign Debt Hard Currency	=	=
Sovereign Debt Local Currency	=	=
Latam Credit USD	=	=
Asia Credit USD	=/-	=
Chinese Bonds CNY	=/-	=
EQUITIES		
GEOGRAPHIES		
Europe	-/=	=
United States	=	=/+
Japan	-	-/=
Latin America	-/=	=
Asia ex-Japan	=	=
China	=/+	+
STYLES		
Growth	-/=	+
Value	-/=	=
Quality	+	=/+
Cyclical	-	=
Defensive	=/+	-/=
FOREX		
United States (USD)	=	=/-
Euro Area (EUR)	=	=/+
United Kingdom (GBP)	=/-	=
Switzerland (CHF)	=/+	=
Japan (JPY)	=/-	=/-
Brazil (BRL)	=	=
China (CNY)	=/-	=/+
Gold (XAU)	=/+	=

Source: Indosuez Wealth Management.

OVERVIEW OF SELECTED MARKETS

DATA AS OF 22 JULY 2022

GOVERNMENT BONDS	YIELD	4 WEEKS CHANGE (BPS)	YTD CHANGE (BPS)
US Treasury 10-Year	2.75%	-37.97	124.03
France 10-Year	1.62%	-35.10	142.20
Germany 10-Year	1.03%	-41.00	120.90
Spain 10-Year	2.25%	-29.70	168.40
Switzerland 10-Year	0.72%	-56.20	85.20
Japan 10-Year	0.21%	-1.60	14.40

BONDS	LAST	4 WEEKS CHANGE	YTD CHANGE
Governments Bonds Emerging Markets	33.45	-2.38%	-14.72%
Euro Governments Bonds	205.45	1.62%	-6.00%
Corporate EUR high yield	190.86	1.65%	-10.66%
Corporate USD high yield	301.27	2.97%	-9.37%
US Government Bonds	304.11	1.31%	-5.05%
Corporate Emerging Markets	42.66	-1.43%	-16.35%

CURRENCIES	LAST SPOT	4 WEEKS CHANGE	YTD CHANGE
EUR/CHF	0.9832	-2.76%	-5.23%
GBP/USD	1.1999	-2.19%	-11.33%
USD/CHF	0.9629	0.48%	5.48%
EUR/USD	1.0213	-3.22%	-10.18%
USD/JPY	136.12	0.66%	18.28%

VOLATILITY INDEX	LAST	4 WEEKS CHANGE (POINTS)	YTD CHANGE (POINTS)
VIX	23.03	-4.20	5.81

EQUITY INDICES	LAST PRICE	4 WEEKS CHANGE	YTD CHANGE
S&P 500 (United States)	3'961.63	1.28%	-16.88%
FTSE 100 (United Kingdom)	7'276.37	0.94%	-1.46%
STOXX 600	425.71	3.09%	-12.73%
Topix	1'955.97	4.78%	-1.82%
MSCI World	2'650.82	1.20%	-17.98%
Shanghai SE Composite	4'238.23	-3.56%	-14.21%
MSCI Emerging Markets	990.37	-2.06%	-19.61%
MSCI Latam (Latin America)	1'987.81	-3.07%	-6.67%
MSCI EMEA (Europe. Middle East. Africa)	198.87	1.91%	-27.87%
MSCI Asia Ex Japan	643.94	-2.32%	-18.41%
CAC 40 (France)	6'216.82	2.36%	-13.09%
DAX (Germany)	13'253.68	1.03%	-16.56%
MIB (Italy)	21'211.98	-4.10%	-22.43%
IBEX (Spain)	8'051.60	-2.34%	-7.60%
SMI (Switzerland)	11'096.12	2.52%	-13.82%

COMMODITIES	LAST PRICE	4 WEEKS CHANGE	YTD CHANGE
Steel Rebar (CNY/Tonne)	3'829.00	-10.97%	-15.81%
Gold (USD/Oz)	1'727.64	-5.43%	-5.55%
Crude Oil WTI (USD/Bbl)	94.70	-12.01%	25.91%
Silver (USD/Oz)	18.59	-12.02%	-20.41%
Copper (USD/Tonne)	7'452.50	-11.08%	-23.33%
Natural Gas (USD/MMBtu)	8.30	33.42%	122.49%

Source: Bloomberg, Indosuez Wealth Management.
Past performance does not guarantee future performance.

MONTHLY INVESTMENT RETURNS, PRICE INDEX

FTSE 100 · Topix · MSCI World · MSCI EMEA · MSCI Emerging Markets
STOXX 600 · S&P 500 · Shanghai SE Composite · MSCI Latam · MSCI Asia Ex Japan

	APRIL 2022	MAY 2022	JUNE 2022	4 WEEKS CHANGE	YTD (22.07.2022)
BEST PERFORMING	0.38%	6.46%	8.79%	4.78%	-1.46%
	-1.20%	1.87%	-0.42%	3.09%	-1.82%
	-2.40%	0.84%	-1.38%	1.91%	-6.67%
	-3.79%	0.69%	-2.70%	1.28%	-12.73%
	-4.89%	0.20%	-6.46%	1.20%	-14.21%
	-5.23%	0.14%	-7.10%	0.94%	-16.88%
	-5.75%	0.01%	-7.20%	-2.06%	-17.98%
	-8.43%	-0.16%	-7.43%	-2.32%	-18.41%
	-8.80%	-1.56%	-8.07%	-3.07%	-19.61%
WORST PERFORMING	-13.86%	-4.29%	-16.81%	-3.56%	-27.87%

Source: Bloomberg, Indosuez Wealth Management.
Past performance does not guarantee future performance.

Basis point (bp): 1 basis point = 0.01%.

Blockchain: A technology for storing and transmitting information. It takes the form of a database which has the particularity of being shared simultaneously with all its users and generally does not depend on any central body.

BLS: Bureau of Labor Statistics.

BNEF: Bloomberg New Energy Finance.

Brent: A type of sweet crude oil, often used as a benchmark for the price of crude oil in Europe.

CPI (Consumer Price Index): The CPI estimates the general price level faced by a typical household based on an average consumption basket of goods and services. The CPI tends to be the most commonly used measure of price inflation.

Cyclicals: Cyclicals refers to companies that are dependent on the changes in the overall economy. These stocks represent the companies whose profit is higher when the economy is prospering.

Defensives: Defensives refers to companies that are more or less immune to the changes in the economic conditions.

Deflation: Deflation is the opposite of inflation. Contrary to inflation, it is characterised by a sustained decrease in general price levels over an extended period.

Duration: Reflects the sensitivity of a bond or bond fund to changes in interest rates. This value is expressed in years. The longer the duration of a bond, the more sensitive its price is to interest rate changes.

EBIT (Earnings Before Interest and Taxes): Refers to earnings generated before any financial interest and taxes are taken into account. It takes earnings and subtracts operating expenses and thus also corresponds to non-operating expenses.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation): EBITDA takes net income and adds interest, taxes, depreciation and amortisation expenses back to it. It is used to measure a company's operating profitability before non-operating expenses and non-cash charges.

ECB: The European Central Bank, which governs the euro and Euro Area member countries' monetary policy.

Economic Surprises Index: Measures the degree of variation in macro-economic data published versus forecasters' expectations.

Economies of scale: Decrease in a product's unit cost that a company obtains by increasing the quantity of its production.

EPS: Earnings per share.

ESG: Non-financial corporate rating system based on environmental, social and governance criteria. It is used to evaluate the sustainability and ethical impact of an investment in a company.

Fed: The US Federal Reserve, i.e. the central bank of the United States.

FOMC (Federal Open Market Committee): The US Federal Reserve's monetary policy body.

GDP (Gross Domestic Product): GDP measures a country's yearly production of goods and services by operators residing within the national territory.

Gig economy: system characterised by flexible, temporary or freelance jobs.

Growth: Growth style refers to companies expected to grow sales and earnings at a faster rate than the market average. As such, growth stocks are generally characterised by a higher valuation than the market as a whole.

IEA: International Energy Agency.

IMF: The International Monetary Fund.

Inflation breakeven: Level of inflation where nominal bonds have the same return as inflation-linked bonds (of the same maturity and grade). In other words, it is the level of inflation at which it makes no difference if an investor owns a nominal bond or an inflation-linked bond. It therefore represents inflation expectations in a geographic region for a specific maturity.

Inflation swap rate 5-Year, 5-Year: A market measure of what 5-Year inflation expectations will be in five years' time. It provides a window into how inflation expectations may change in the future.

IPPC: The Intergovernmental Panel on Climate Change.

IRENA: International Renewable Energy Agency.

ISM: Institute for Supply Management.

Japanification of the economy: Refers to the stagnation the Japanese economy has faced in the last three decades, and is generally used to refer to economists' fears that other developed countries will follow suit.

Metaverse: A metaverse (portmanteau of meta and universe) is a fictional virtual world. The term is regularly used to describe a future version of the internet where virtual, persistent and shared spaces are accessible via 3D interaction.

OECD: Organisation for Economic Co-operation and Development.

Oligopoly: An oligopoly occurs when there is a small number of producers (supply) with a certain amount of market power and a large number of customers (demand) on a market.

OPEC: Organization of the Petroleum Exporting Countries; 14 members.

OPEC+: OPEC plus 10 additional countries, notably Russia, Mexico, and Kazakhstan.

PMI: Purchasing Managers' Index.

Policy mix: The economic strategy adopted by a state depending on the economic environment and its objectives, mainly consisting of a combination of monetary and fiscal policy.

Pricing power: Refers to the ability of a company or brand to increase its prices without affecting demand for its products.

Quality: Quality stocks refers to companies with higher and more reliable profits, low debt and other measures of stable earnings and strong governance. Common characteristics of Quality stocks are high return to equity, debt to equity and earnings variability.

Quantitative easing (QE): A monetary policy tool by which the central bank acquires assets such as bonds, in order to inject liquidity into the economy.

SEC (Securities and Exchange Commission): The SEC is an independent federal agency with responsibility for the orderly functioning of US securities markets.

Spread (or credit spread): A spread is the difference between two assets, typically between interest rates, such as those of corporate bonds over a government bond.

Secular stagnation: Refers to an extended period of little or no economic growth.

SRI: Sustainable and Responsible Investments.

Stagflation: Stagflation refers to an economy that is experiencing simultaneously an increase in inflation and stagnation of economic output.

Uberisation: Term derived from the name of US company Uber which develops and operates digital platforms that connect drivers and riders. It refers to a new business model that leverages new digital technologies and is part of the sharing economy, insofar as it puts customers in direct contact with service providers, at a reduced cost and with lower prices.

Value: Value style refers to companies that appear to trade at a lower price relative to its fundamentals. Common characteristics of value stocks include high dividend yield, low price-to-book ratio, and a low price-to-earnings ratio.

VIX: The index of implied volatility in the S&P 500 Index. It measures market operators' expectations of 30-day volatility, based on index options.

WTI (West Texas Intermediate): Along with Brent crude, the WTI is a benchmark for crude oil prices. WTI crude is produced in America and is a blend of several sweet crude oils.

WTO: World Trade Organization.

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Edited as per 22.07.2022.