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HOTTINGER

DUBLIN LONDON GENEVA

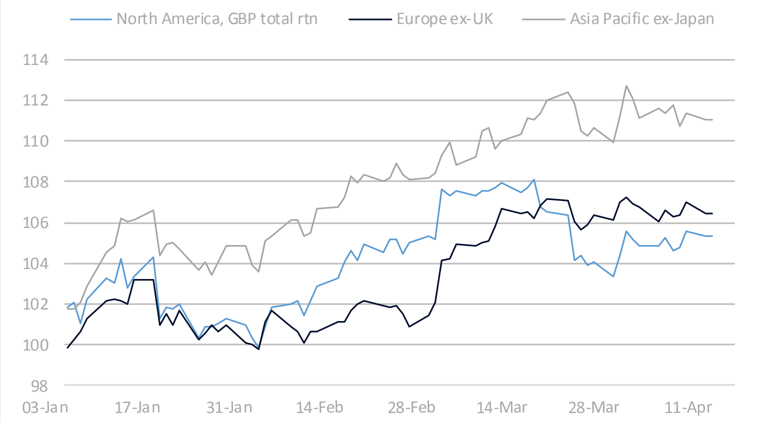
Family Office of the Year 2017
City of London Wealth Management Awards

GLOBAL INSIGHT

Overview

- With Britain setting in motion the process of leaving the EU, our feature article—written by John McGrane, Director General of the British Irish Chamber of Commerce—looks at the implications for the UK's closest neighbour.
- Both PM May's Article 50 letter and the EU's reply acknowledged the extent and importance of links between Ireland and the UK. 34% of Ireland's imports come from the UK, 16% of its exports go to the UK.
- Disrupted supply chains will affect Ireland—the British Bentley is trimmed with bright metal from Galway and sold with purchaser finance from Dublin
- But Irish firms will respond by diversifying trade towards other markets, by harvesting displaced UK business and by highlighting their merits to overseas investors who need a base from which to trade with the EU.
- Finally, talk of Ireland voting to leave the EU is fanciful. Instead, Ireland will carefully manage its relationships with both the UK and the EU.
- In the Macro View, unsurprisingly, the Brexit decision is front and centre of the UK outlook: we expect slower growth and higher inflation in 2017.
- Elsewhere, we think growth prospects are easing but political uncertainty is rising in the US but the converse may be true in the eurozone.
- In the Investment Outlook, global equities started the year in a positive mood for the first time since 2013 and bonds also gave satisfying returns.
- Among equity markets, we dislike the UK and the US and prefer Europe, Japan and emerging markets. In the fixed income markets, we think the focus is the tension between low bund yields and higher US Treasury yields.

Asia Pacific equities lead the way in 2017



Inside this issue

Economic Highlights

- The global economy is set for steady growth and low but rising inflation
- UK growth will slow to 1.75% in 2017 as real incomes falter
- Eurozone — solid growth, moderate political risk
- The Fed raised rates again on 16th March and promised two more rate hikes this year

Contact Details

Hottinger Investment Management Limited

27 Queen Anne's Gate
London SW1H 9BU

+44 (0) 20 7227 3400

info@hottinger.co.uk

www.hottinger.co.uk

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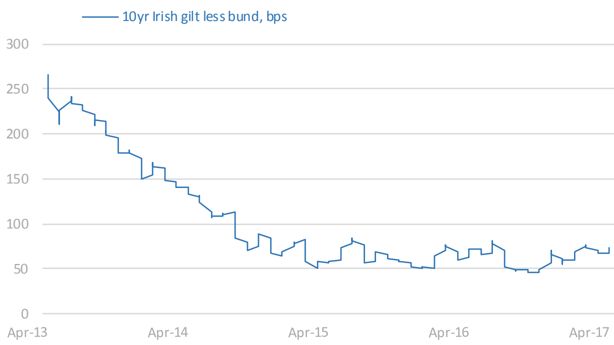
Based upon information available up to and including 12th April 2017

Key Issues in Charts

Irish markets taking Brexit in their stride ...

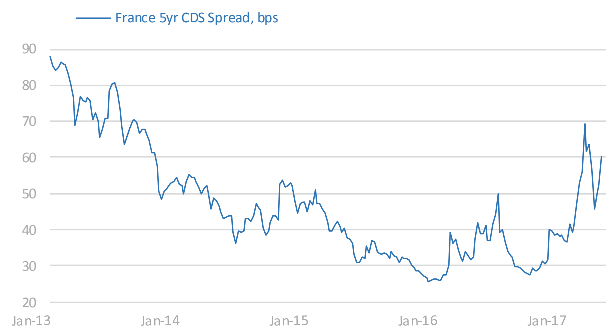


Source: Bloomberg

- In our feature article, John McGrane of the British Irish Chamber of Commerce ponders how the UK decision to leave the EU will affect Ireland.
- But what do the markets think? One measure is the yield spread between 10 year Irish gilts and German bunds where the bund is the "risk-free" asset.
- The latest spread is 74 basis points. That compares with 95 bps a week before the referendum. Conclusion – the markets are watching warily.

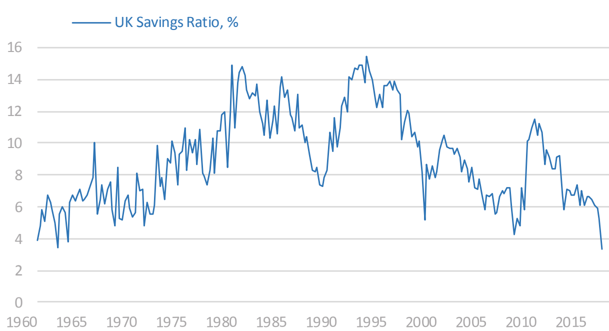
French markets show mild concern over 7th May election ...

- The French people will choose their new president in two rounds on 23rd April and 7th May from a choice of eleven candidates.
- However, the two clear frontrunners are Marine Le Pen of Front National and Emmanuel Macron of En Marche!
- The markets strongly favour Macron who favours Europe over Le Pen who wishes to exit the euro. The French sovereign CDS spread is currently 57 bps which tends to suggest a Macron win.



Source: Bloomberg

UK consumers push savings ratio to 56-year low ...



Source: ONS

- The UK economy has fared better than seemed likely last June when the UK voted to leave the EU. It grew 0.5% qoq in the third quarter and 0.7% in the fourth.
- However, much of that growth was driven by consumer spending which in turn was the result of dipping into savings and borrowing more.
- The household savings ratio fell to 3.3% in the fourth quarter, a 56-year low, and consumer credit increased by 10.5% yoy in February.

Brexit—the Ireland/UK Perspective

by John McGrane
Director General, The British Irish Chamber of Commerce

Nine months on since June 2016, nothing suggests that UK voters (business owners or employees) on either side of the EU referendum debate have changed their minds and both Leaver and Remainer opinions are of course to be respected. Noting that there are far more small firms than larger ones, the great majority of SME's don't trade internationally (though they get business from many others who do) so many of them are not yet feeling the impact of the UK's decision to leave the EU.

However, for the growing number of firms in both the UK and Ireland which are carrying out real-world assessments of the possible impact of Brexit on their businesses, many are beginning to foresee significant new costs not only in tariffs but in logistics, staffing, distribution, travel, ports and in untested new customs systems.

"No other EU member state is as affected by the UK's departure from the EU than Ireland."

The extent and importance of the links between Ireland and the United Kingdom are underlined by the fact that both Prime Minister May's letter triggering Article 50 and the EU's reply both acknowledge them. No other EU member state is as affected by the UK's departure from the EU than Ireland. That's because the UK is Ireland's largest two-way trading partner, with 34% of Ireland's imports coming from the UK and 16% of its exports going to the UK.

34%

*"**The UK is Ireland's largest two-way trading partner**, with 34% of Ireland's imports coming from the UK and 16% of its exports going to the UK*

The UK is the largest buyer of Ireland's food exports and indeed Ireland is the UK's largest food export market. Almost all of Ireland's energy supplies are sourced from or through the UK; thousands of students from both countries study in the other. The scale of the two islands' connectedness, whether in tourism or financial services and many more trades, has made the Dublin/London air route the second busiest in the world. There is extensive cross-integration of industries on both islands as diverse as food processing, sport and racing, education, life sciences, technology, finance and energy.

Little wonder then that Irish business needs to see a strong trade deal between the UK and the EU, if Ireland's own economy is not to suffer. Any restriction of the long-standing open trade border or of the free movement of people, goods, services and capital between Ireland and the UK would hit key industries like food and tourism especially hard and leave few other sectors undamaged.

Indeed, the pain of the UK's vote to leave the EU was more immediately felt in Ireland than in the UK in the aftermath of the June 2016 referendum. While a slump of up to 17% in sterling's value against the euro made UK exports more competitive and inward tourism to the UK better value, in Ireland the currency weakness immediately reduced exporters' margins - in some cases existentially.

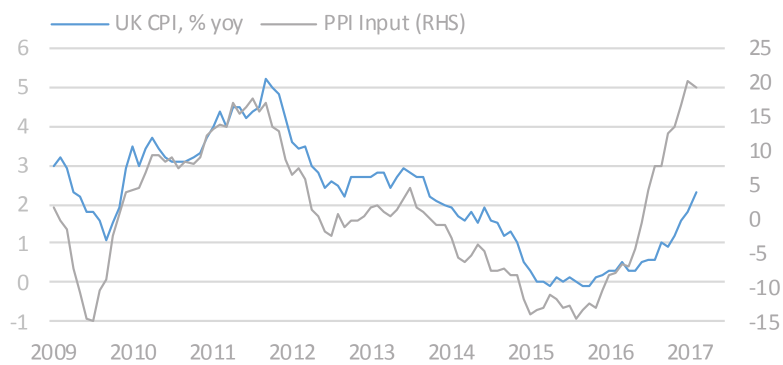
But the even greater concern for Irish business now is that their nearest neighbour's economy may be about to go into reverse, bringing a worrying reduction in overall export demand to pile difficulty on top of currency weakness and the prospect of tariff and non-tariff costs. In a little-reported but alarming statistic, whereas UK consumer price inflation is worryingly nudging 3%, manufacturing input prices are rising at fully 20% year-on-year. Until recently, UK firms were insulated from sterling weakness because 75% of their currency hedging as at June 2016 was still in place at February 2017. But it's running off rapidly now.

This has to mean trouble ahead. In a looming squeeze on real incomes and corporate profits, it won't be possible for UK business to absorb cost increases of 20% and it won't be possible either for them to be passed on to consumers, most of whose continued spending since the referendum has been debt-fuelled. With considerable uncertainty now affecting everything, a key question now emerging is whether job losses would change voter sentiment in the UK and how might that change the tone of the negotiations.

20%

*“In a looming squeeze on real incomes and corporate profits, **it won't be possible for UK business to absorb cost increases** of 20%*

UK Producer Prices Point To Faster Inflation Ahead



Source: ONS

Absent a change in the expected direction of the negotiations, economic demand in the UK seems likely to fall and it won't be offset by export competitiveness because of the extent of the UK's dependence on imports. Take the key example of the motor industry - 80% of the cars made by Nissan in Sunderland are exported but half their raw materials are imported. Indeed there is no such thing as a truly British car (or many other products or services) any longer.

*“Economic demand in the UK seems **likely to fall** and it won't be offset by export competitiveness”*

The iconically British Bentley, for example, starts life as a chassis assembled in Bratislava, it gets a German engine from Volkswagen, is trimmed with bright metal from Galway and the purchaser finance for Chinese buyers is made in Dublin's International Financial Services Centre.

Of course nobody has left anything yet and, on the plus side, the UK may become a stronger player in fishing, for instance. However, with no sign of any new trade agreements with markets anywhere nearly as valuable as the EU, UK employers are also bracing themselves for the risk that the UK will run out of EU-national staff in tourism, in research, in healthcare and food processing and indeed in motor manufacturing.

Suggestions that the UK will attract new foreign direct investment by reducing corporation tax rates probably ignore the UK's inability to fund them, given its two trillion pound debt burden. FDI will also look for the ability to export to the EU what they produce in the UK using local and EU staff.

Investors meanwhile are concerning themselves to understand how managers are brexit-proofing their business models. UK firms are already weighing up their relocation options in response to confirmation of what is now expected to be a Hard Brexit. In both Britain and Ireland, investors will also be little interested in the political issues but will watch keenly for progress on key components of any deal including a transition framework to avoid "cliff risk" and a viable agreement on free movement of the skills needed by business.

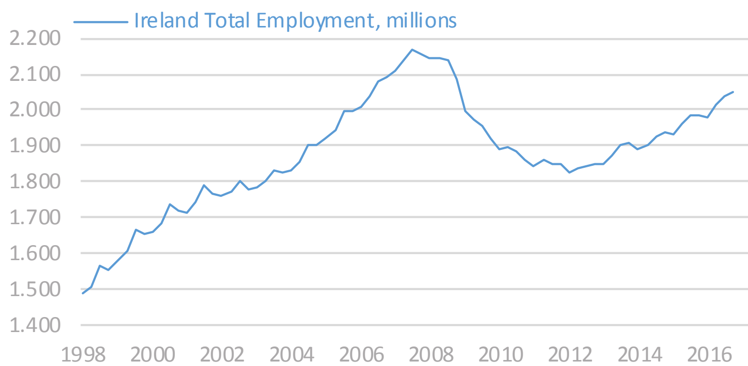
"UK firms are already weighing up their ***relocation*** *options in response to confirmation of what is now expected to be a Hard Brexit"*

If the future is indeed a Hard Brexit, then the certainty of value reduction for Irish firms trading with the UK means that Ireland will accelerate diversification of its trade towards other markets and harvest such displaced UK business as it can attract. It will also spotlight its own attractiveness to overseas investors who might have chosen a UK base from which to trade with the EU.

Ireland is positioned as "next best" to the UK itself for many UK firms. That's why not only financial services firms but many others are already planning to open a base in Ireland, to assure their continued unfettered access to the EU market of roughly 450 million consumers. And Irish firms are being helped to establish a base in the UK to maintain unimpeded access to the UK market of over 60 million consumers.

*"Ireland is positioned as "**next best**" to the UK itself for many UK firms."*

The Irish Economy Is Working



Source: CSO Ireland

Finally, talk of Ireland voting to leave the EU is as fanciful as talk of Brexit leading to a United Ireland. Significant portions of FDI already based in Ireland trade into the EU and Northern Ireland costs the UK more to subsidise than the UK's cost of membership of the EU. And while Ireland is in good shape with low unemployment and the best performing economy in EU, a bad deal for the UK in its future trade relationship with the European Union would be a bad outcome for Ireland. Instead, Ireland's strategy will be to carefully manage its relationships with both the UK and the EU. We should expect to see Irish support for a soft deal between the UK and the EU and by consequence between the UK and Ireland.

"Talk of ***Ireland voting to leave the EU*** *is as fanciful as talk of Brexit leading to a United Ireland."*

29th April

"EU Summit: Brexit talks commence"

Macro View

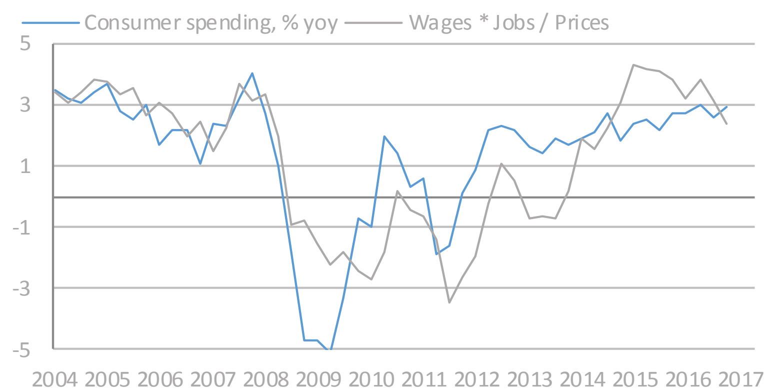
The global economy is set for steady growth and low but rising inflation ahead. We do not foresee a global recession or boom this year but there are plenty of national and regional undercurrents.

UK – Brexit Under Way. The decision to leave the EU is front and centre of the UK outlook. PM Theresa May triggered Article 50 of the Lisbon Treaty on 29th March, setting in motion a two-year Brexit process. The next milestone is an EU Summit on 29th April after which talks should start in earnest.

The politics is difficult. For the UK, there must be control over migration and freedom from the European Court of Justice. For the EU, the trade deal with the UK must be clearly worse than remaining a member.

Whatever the outcome, British firms and households face two years of uncertainty which may dampen growth at the margins. In addition, rising inflation due to the pound's post-Brexit fall will squeeze real incomes and slow consumer spending. We expect growth to be 1.75% this year and 1.5% next year.

UK Consumers Face Real Income Squeeze



Source: ONS

United States – Trump Card. Growth prospects have eased and political risks risen since the start of the year. Barclays "now-cast" for first quarter growth started out at 2% qoq annual rate but is now 1%. "Soft" survey data hit fresh highs but "hard" economic indicators have been stubbornly subdued.

*"Unless productivity improves, the US faces a **choice between slow growth or higher inflation**."*

The slowdown may prove helpful in that the economy is at full employment but productivity growth has been weak. Unless productivity improves, the US faces a choice between slow growth or higher inflation. We think inflation will exceed economic growth in 2017 for the first time in six years.

Meanwhile, Donald Trump's presidency made a faltering start with setbacks on immigration and healthcare and doubts over crucial tax reforms. Rumours and revelations about Trump ties with Russia may ultimately prove even more serious. Life is not dull in Washington.

Euro Area – Brightens. In contrast, we think political risks are easing in the eurozone and growth prospects picking up a little. In the French election, Emmanuel Macron looks increasingly set to defeat Marine Le Pen on 7th May. In Germany, it is too early to say whether Martin Schulz can beat Angela Merkel this September but a regional election in Saarland gave Merkel's hopes a lift. In any event, Schulz is a European insider rather than outsider.

Turning to the economy, ECB president Mario Draghi in March listed five reasons to be cheerful about growth – solid quarterly growth for the past 15 quarters, strong business confidence, falling unemployment rates, over 4m new jobs created in three years and greater integration within the Euro Area. Even so, growth has been sub-2% since 2010 and may be so again in 2017.

Inflation did manage to hit 2% in February but only thanks to surging energy and commodity prices. Provisional data for March revealed headline inflation falling back to 1.5% and underlying inflation of only 0.7%.

Japan – Yet Another Lost Decade? Despite PM Shinzo Abe's best efforts, Japan's two lost decades could become three. One cannot fault the Bank of Japan for trying: it has turned all the monetary taps on. There has also been modest structural reform so far as Japan's deep vested interests allowed. But the fiscal policy arrow was never fired which doomed Abenomics to failure.

"Japan: Yet Another Lost Decade?"

In figures, Japan's growth was 1% last year. It could reach the dizzy heights of 1.25% this year before falling back to around 1% in 2018. In the meantime, inflation was minus 0.1% in 2016 and we think it will be around 1% in 2017.

China – Taking The Long View. In yet another contrast, Japan's powerful neighbour remains broadly on the reform track set out five years ago. True, the plan made little progress in 2016, as the authorities resorted to monetary easing and fiscal stimulus to counter a slowdown. However, there are longer term signs that the economy is shifting in favour of consumption and services and away from fixed investment and manufacturing.

"China—Taking The Long View"

Real GDP growth was 6.7% last year and is likely to be around 6.5% this year. Indeed, Chinese reflation may have been significant in underpinning global growth. Inflation has also been relatively well-behaved, coming in at 2% in 2016 but set to be slightly higher in 2017. While there are concerns about high corporate debt levels in China, the alarm bells are muffled at present.

Central Banks – A Mood Swing. Against this backdrop, fears of deflation have gone away. The mood music, led by the US Federal Reserve, is tighter rather than easier policy ahead. The Fed made its third interest rate increase in this cycle on 16th March, with promises of two more to come this year.

The ECB has kept its bias to ease for now but has reduced its bond-buying to €60bn a month from 1st April. It is probable the ECB will steadily move away from its accommodative policy, perhaps by adopting neutral forward guidance in June and setting out the timeline to end asset purchases in September.

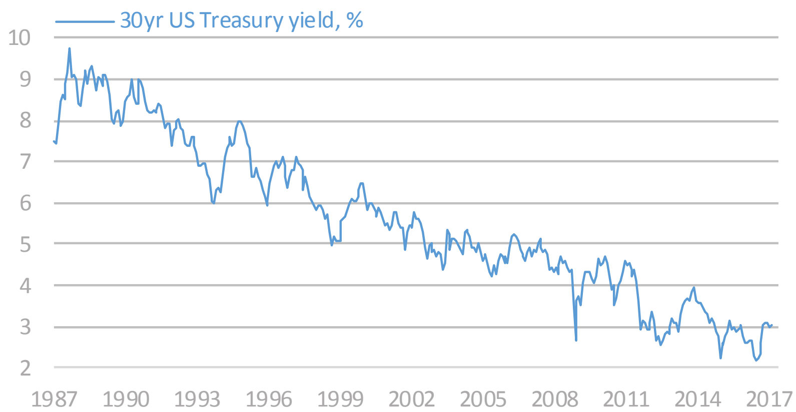
Finally, the Bank of Japan and the Bank of England may keep monetary policy loose for now, despite a hawkish tone to the latest Bank of England policy minutes and depending upon how the data unfold.

Investment Outlook

“Charts seem to say that the 30-year ***bull market in government bonds is officially over”***

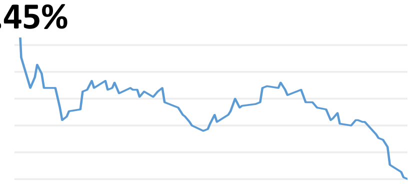
Global equity markets started the year in a positive mood for the first time since 2013. The upbeat mood, associated with the first experiences of the Trump presidency, may mean the deflation trade is over and a reflation trade is now in place. Charts seem to say that the 30-year bull market in government bonds is officially over, although this is a matter for debate in some quarters.

Is Thirty Year Bull Market Now Over



Bond Market Surprises and Tensions. Following the sell-off in G7 government bonds in the fourth quarter, as reflation trades came to the fore, it may come as a surprise that many bond investors were reasonably satisfied with returns in the first quarter.

2.45%



2.38%

The big increase in yields in a short space of time coupled with a strong rally in risk assets left relative valuations of bonds and equities rather stretched. Thus, by the time the Fed raised rates by 25 basis points in March, bond yields in fact fell on the news and the US dollar weakened.

“10 year US Treasury yields fell to 2.38% from 2.45% “

10 year US Treasury yields fell to 2.38% from 2.45% at the end of January despite markets pricing in three Fed rate hikes in 2017 rather than two. Furthermore, yields on corporate bonds outperformed sovereign bonds, leaving investment grade and high yield spreads at historically tight levels.

The downtrend in bond yields may have been broken in December but the return of interest rates to normal levels seems a long way off at current economic growth rates. Thus, it seems unlikely that bond yields will be a one-way bet over the rest of 2017 unless inflation fears significantly grow. A yield of say 3% for 10 year US Treasuries may well attract significant investor interest.

“A yield of say 3% for 10 year US Treasuries ***may well attract significant investor interest****.”*

After three interest rate increases, the US Fed is well ahead of its G7 counterparts. Other central banks are still either engaging in asset purchases or have a neutral stance. This puts the valuation of long dated bonds back under the spotlight.

The difference between 30 year US Treasury and German bund yields were roughly 190 basis points at end-March, down from 220 basis points at end-December but above the average for the past 12 months. The global nature of markets has brought this wide spread firmly into focus. It will be interesting to see if low bund yields will dampen the increase in US Treasury yields or the opposite, as long dated bonds react to changing central bank policy, inflation forecasts and each other.

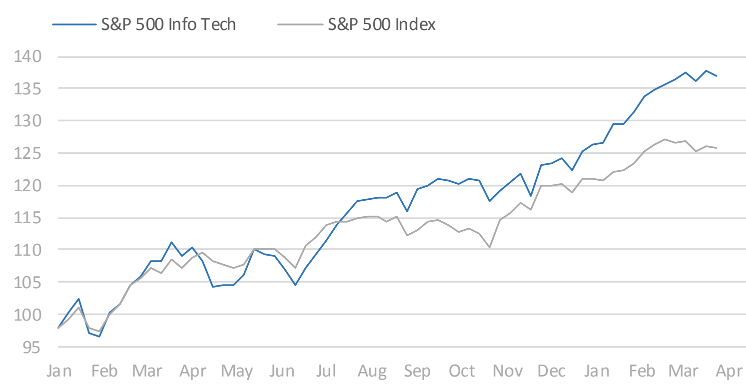
The Trump Effect. Since Trump's inauguration the first policies have been swift and in line with his rhetoric on the campaign trail. This has unnerved many who thought that Trump the president would be more benign than Trump the candidate. So far this has proved to be incorrect. However, we can take some comfort from the fact that there are many checks and balances in the US system, as shown by the failure to overturn Obamacare legislation.

*"The feeling is that President **Trump's policies will be fiscally positive for US companies**. This should boost US growth and in turn be good for global growth."*

The feeling is that President Trump's policies will be fiscally positive for US companies. This should boost US growth and in turn be good for global growth. Thus, there has been a boost to high growth areas such as Asia ex Japan where returns have been strong so far this year. The MSCI World index gained 5.9% in the first quarter. Many developing countries saw strong investor interest pushing the MSCI Emerging Market Index up 11.2%.

One of the largest beneficiaries of the rally in risk assets has been the US technology sector which had its best quarter since 2013. The S&P 500 IT sector rose 12.2% during the quarter and the technology heavy Nasdaq Composite was up 9.8% compared with the S&P 500 which gave a 5.5% return.

Tech Companies Gain From Trump Trade



Source: Bloomberg

$6bn

Technology companies are expected to be among the biggest beneficiaries of potential Trump fiscal reforms including any reduction in corporate tax rates and encouragement to repatriate overseas earnings where the sector has significant holdings.

Many investors have bought into the Trump trade with approximately $6bn allocated to technology funds so far this year. However, with the sector trading at 18.5 times estimated 2017 earnings, valuations are looking extended.

*"Many investors have bought into the **Trump trade** with approximately $6bn allocated to technology funds so far this year."*

Equity Market Trends. Elsewhere, performance by sector was mixed, with little to choose between cyclical and defensive sectors. However, a notable laggard was Oil & Gas, the only faller, down 7.3% roughly in line with the oil price.

2010

*"It has been unusual since 2010 to see **both developed and developing markets recovering at the same time**."*

It has been unusual since 2010 to see both developed and developing markets recovering at the same time. However, increased consumerism in developed markets, as governments introduce more populist policies, seems to be creating a slow but sustainable recovery for all, especially as 60% of emerging market exports go to developed economies.

Robust company, bank and country balance sheets lead us to favour Asian markets. We think that emerging economies stand in good stead to withstand any shocks delivered from developed economies where the main uncertainties currently lie.

Political pressures in the Netherlands, France and Germany have weighed on the eurozone so far in 2017 but stronger growth and falling unemployment are supporting real wages and consumer spending. Eurozone equity markets have gained 6.8% so far this year despite the uncertainty of Brexit negotiations. Rising inflation expectations, loose monetary conditions and markets priced for bad news all help us to like European equities at present.

Article 50 was triggered by the UK government on 29th March, ending months of uncertainty and pointing to the near certainty of a "Hard Brexit". The gains from the devaluation of sterling for larger companies with overseas earnings has largely been discounted and signs of imported inflation squeezing real incomes have dampened expectations. Thus, UK equities gained only 3% in the first quarter, trailing US and European markets.

"It is difficult to see how the course of UK politics can change"

It is difficult to see how the course of UK politics can change so the financial markets are now left to react to media feedback on the progress of negotiations and the reality of economic statistics.

Portfolio Conclusions. The ending of the bond bull market was expected to signal a great rotation from bonds into equities. However, we have our doubts due to high levels of political and economic policy certainty and overly extended equity valuations.

One key point is the divergence between soft data based on sentiment and hard, quantifiable economic statistics. Upside surprises appear to be completely driven by soft data whereas we have made very little change to our economic forecasts. Indeed, the FOMC during the March meeting made little revision to its own economic forecasts. Past evidence suggests that since 2006 differences in the outlook for soft data and hard data have not lasted long before they realign. Thus, the question for investors is whether economic activity will pick up to match the optimistic sentiment and thereby justify the expensive valuations of risk assets.

*"We believe **European equities are under-estimating the strength of the eurozone** economy and over-estimating the political risk"*

This leaves us a little cautious as we enter the second quarter with many potential pitfalls to upset the path of the reflation trade. The uncertainty surrounding potential US policy leaves US equity valuations priced for perfection whereas we believe European equities are under-estimating the strength of the eurozone economy and over-estimating the political risk. Finally, we are positive on Japanese equities, encouraged by a strong recovery in the domestic housing sector, by reviving inflation expectations and earnings and by robust growth across the Asian continent.

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