April 2021
Issue No. 19

GLOBAL INSIGHT

Overview

- In our Macro View, we look at the diverging path of the economic recovery in different countries due to the effectiveness of the vaccination programme as the rebound picture remains unclear.
- Central banks continue to signal that they will maintain their stimulus efforts until the recovery reaches sustained levels, which to us implies continual tolerance for running the economy on the hotter side.
- In our Investment Outlook, we assess activity in the first quarter and the position that financial markets find themselves.
- The first quarter of the year was dominated by the reflation trade that has seen a significant rotation into cyclical, value stocks from perceived long duration growth stocks as rising bond yields dominate.
- In our opinion, the key to returns in 2021 may hinge on the management of the back up in real yields and finding alternatives to bond exposure.
- In our educational article, Tim Sharp, Managing Director, Hottinger & Co. Limited, defines a CTA and describes how sophisticated investors might make use of their inclusion in portfolios.
- The money flowing into managed futures has grown from $10 billion in 1980 to over $340 billion by 2017.
- During periods of inflationary pressure investing in certain managed futures strategies could potentially provide a hedge to the downward pressure exerted on bond markets and then equity markets under certain conditions.

The Rotation from Growth into Value as illustrated by Technology vs. Financials

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Economic Highlights

- US consumer spending finished 2020 marginally down at -2.6%.
- The UK Manufacturing PMI rose to 58.9 over the quarter, the steepest month of expansion since 2011.
- Consumer confidence in the Euro area was confirmed at -12.1 at the end of the quarter, nearing that of February 2020 before the pandemic broke out.
- Japan's debt to GDP ratio represents 266%, a far bigger portion relative to other advanced economies.

Contact Details

Hottinger & Co. Limited
4 Carlton Gardens
London SW1Y 5AA
+44 (0) 20 7227 3400
info@hottinger.co.uk
www.hottinger.co.uk

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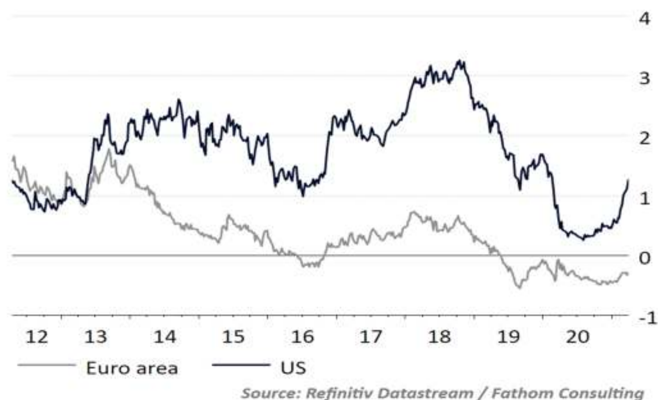
Based upon information available up to and including
16th April 2021

Key Issues in Charts

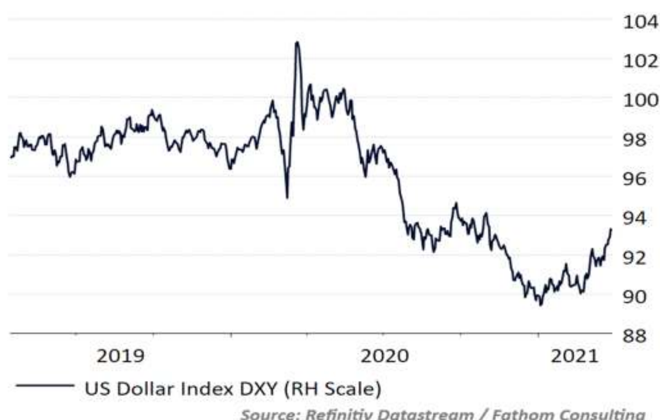
Two-year inflation-linked swap rates, per cent



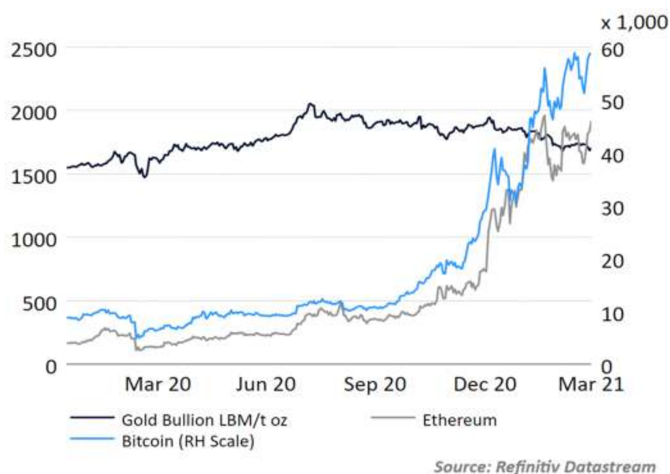
- A leading headline of the quarter has been a pickup in investors' inflation expectations.
- The two-year expectation on US inflation rose rapidly to 1.277% by the end of Q1, below the Fed's target of 2% but close to precrisis levels.
- Growth stocks and bonds tumbled as investors factored in the higher discount to future earnings.
- In turn, the yield on the US 10yr Treasury finished the quarter at 1.745%.

USD Index (DXY)

- The Dollar lost its strength after the start of the pandemic as stimulus was injected into the US.
- A weak Dollar is generally viewed as favourable for markets and growth as it has positive implications for Emerging Market companies and global trade.
- The start of 2021 has seen the trend reverse and the Dollar has strengthened. Markets view the US favourably as a result of economic data and vaccine rollout success, which has led to investment into USD.



Historic prices of Gold, Ethereum and Bitcoin, USD



- While cryptocurrencies are being touted by some as a gold alternative, the contrasting performances of the two assets since the second half of 2020 demonstrate how far from that reality we currently are.
- Both assets performed similarly in the fallout of the pandemic as investors diverted funds away from investments with a positive correlation with equity markets.
- However, since September 2020, cryptocurrencies have appreciated dramatically with the largest two, Bitcoin and Ethereum, over quadrupling their value.
- Investors are polarised in their views of whether Bitcoin and Ethereum will appreciate further from here or revert to their long-term historical values.

Macro View

The first quarter of 2021 has proven anything but uneventful. Global trends include a rotation from defensive positionings into financials and cyclical sectors and a further rise in inflation concerns, leading equities to new highs whilst fixed income has struggled. During the quarter, the US Treasury yield curve has steepened significantly, reflecting the progress and efforts made in vaccine rollouts around the globe and the more positive economic outlook thereof. Several major economies, most notably both the UK and the US, have exceeded their targets in distributing the vaccine and this is starting to drive a noticeable divergence between the economic outlook for economies that have been successful in their vaccine rollouts as opposed to those that have not.

United States

The US has had a strong start to the year. The Federal Reserve raised its forecast for 2021 GDP growth by more than 50% from its December estimate, now predicting an increase of 6.5%. The US Manufacturing Purchasing Managers Index (PMI) was also reported higher at 59.1 in March 2021[i] and represents the second-highest growth in factory activity on record. This expansion was supported by a sharp rise in new orders, despite a slight delay in production and a hold up in supply.

US Manufacturing PMI was revised higher to 59.1 in March 2021

The US labor markets created more jobs than expected during the quarter, partially due to a fall in new Covid-19 infections but also because of the support provided by the additional pandemic stimulus package of $1.9trn. The Fed's bond buying program is expected to continue steadily until at least January 2022[ii]. Whilst the stimulus is positive overall for the wider economy, it continues to fuel investors' fears of rising inflation, which unsurprisingly in turn has coincided with an increase in consumer spending.

Consumer spending finished 2020 marginally down at -2.6%, driven by a steep increase in durables supported by the rise of eCommerce. Early reports released this year would suggest consumers are resuming their spending habits[iii], with a higher emphasis on services going forward. If vaccines in the US were to reach a point of over 3 million doses distributed every day the US nation could be vaccinated by summer and serves as a key catalyst for resuming appetite for service spending.

Consumer spending remains strong and increase in Services is widely expected.

UK

Like the US, the UK's accelerated vaccine roll-out should support the economy going into this year and with restrictions easing across the nation it is widely forecast that the economy will embark upon a sustained recovery period throughout the remainder of 2021[iv]. With that, inflation is expected to pick up marginally this year but will likely remain below the Bank of England's 2% target[v], keeping interest rate rises at bay whilst the economy recovers.

The BoE remain a massive source of support for the UK economy.

The UK Manufacturing PMI rose to 58.9 over the quarter from 57.5 Q4 2020[vi], representing the steepest month of expansion in manufacturing since 2011. This expansion was supported by a boost in orders despite a relatively subdued

Brexit bears permanent cost increases in the manufacturing sector and is expected to weigh on its recovery.

rise in export sales, paving hope for a sustained rebound in customer demand. In contrast to the economy itself, household savings across the UK have seen a sharp rise expected to support spending and investments.

The outlook for the UK looks less fragile with a Brexit deal in place and the remaining trade frictions in the market seem to be diminishing. However, while orders have risen, export orders are still in decline, which has led to a drop in manufacturing investment. Not only that, but much of the increase in costs that firms are experiencing is not going to fade as they adapt but represent an endemic feature of Brexit and trade with European peers.

Eurozone

Faster economic recovery in Asia-Pacific and the US would help drive the region's exports back on track.

The Eurozone Manufacturing PMI was higher at the end of March at 62.5 from the 55.2 recorded at the end of last year[vii]. Both output and new orders rose at record rates, suggesting that operating conditions are steadily improving and nearing pre-pandemic levels. A faster economic recovery in the Asia-Pacific and U.S will help drive the region's exports on the back of large fiscal stimulus. With restrictions easing over the next quarter, domestic demand is expected to follow and trigger a rebound in consumption and services.

Consumer confidence in the Euro area was confirmed at -12.1 at the end of the quarter[viii], nearing that of February 2020 before the pandemic broke out, and represents a sign of recovery in all components; household financial conditions (past and future), intensions to make major purchases and confidence about the general economic situation. Inflation will be subject to volatility over the coming quarters but is broadly expected to remain subdued around 1.2 - 1.4%[ix].

So far, European markets still present favorable financing conditions and have largely been unmoved by the increase in long-term treasury yields. The German 10-year yield only rose 30 basis points and remains negative both in nominal and real terms. Financing conditions remain historically loose and continually supported by the ECB's bond buying program .

Japan

Japan's manufacturing sector is recovering, but domestic demand continues to slow pace of inflation .

The economic outlook for Japan has been determined by its overall response to the pandemic. Up until early this year, Japan had the lowest amount of new Covid-19 cases amongst the G7 but has recently had to extend its local restrictions due to a surge in cases. As the country waits for more vaccines to be distributed, domestic demand will likely remain subdued for the first half of this year. Because Japan's vaccine approval process requires more clinical trials than most other countries, the rollout of the vaccine has been slower than its peers and it has also been a victim of more contagious variants. With muted domestic recovery, the economy has come to rely on overseas demand. Exports to China and the rest of Asia have been particularly strong so far this year and boosted the PMI .

PMI readings came in at 52.7 in March[x] which represents the strongest reading since October 2018 alongside a steep increase in new orders. Meanwhile, employment levels stabilised from previous negative levels but continued weak domestic demand may contribute to a slow pace of inflation which was already

at low levels prior to the pandemic.

As for the rest of the world, policy has played a key role in supporting the Japanese economy with low rates and extremely high levels of fiscal spending. At the point of writing, Japan's debt to GDP represents 266%[xi], a far bigger portion relative to other advanced economies.

Emerging Markets

The response to the pandemic across Asia has been swift. We believe Chinese, Indian, and Korean populations are expected to be vaccinated by the end of summer and with that the economic outlook has significantly improved for 2021.

Debt to GDP ratios in nearly all emerging economies are rising and current accounts remain distressed.

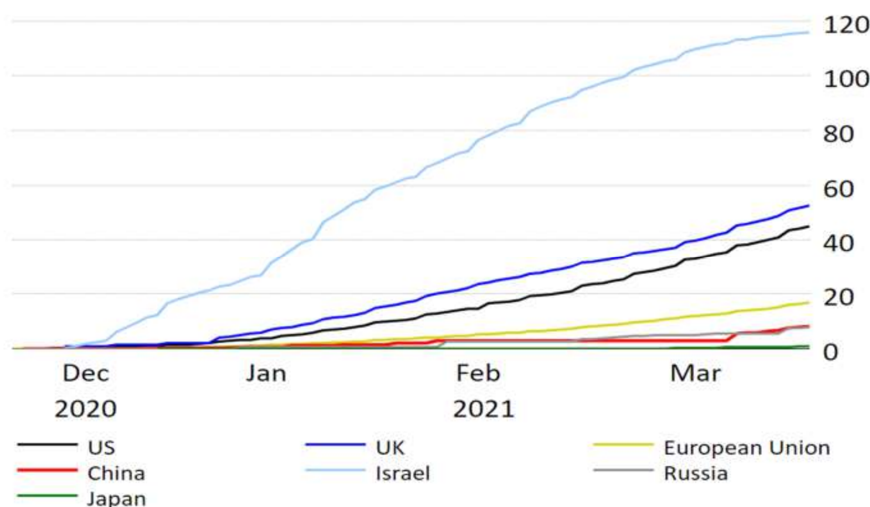
Whilst the pandemic has caused a deterioration in budget balances across the region and has further increased debt-to-GDP ratios in nearly all emerging economies, emerging markets are still well placed to benefit from the increase in global recovery and the demand for exports. Current accounts remain distressed, but the actual deterioration in fiscal health has been much less severe compared to that of developed markets.

Many emerging economies have also increased their USD-reserves, which should serve as a cushion against additional currency pressure.

China output growth at a ten-month low has set 2021 growth trajectory lower.

China Manufacturing PMI read at 50.6 in March 2021[xii], down from 50.9 a month earlier and from 53 in December. Output and new orders both grew at muted rates while employment moved in the opposite direction closer to stabilised levels. From an output growth perspective, this represents a ten-month low and total new work expansion was recorded at the lowest rate for nine months. This has set China's growth trajectory going into 2021 lower and its domestic consumption continues to lag investment.

COVID-19 vaccines administered per 100 people



The global recovery from the pandemic still lies at the mercy of the effectiveness of vaccine rollouts.

Central banks continue to signal that they will maintain their stimulus efforts until the recovery reaches sustained levels, which to us implies continual tolerance for running the economy on the hotter side.

Conclusion

The global recovery from the pandemic still lies at the mercy of the effectiveness of vaccine rollouts. Whilst various containment strategies have been deployed all over the world, coupled with both fiscal and monetary support from central governments, the rebound picture remains unclear and highly diverse. We expect policy settings to remain generally accommodative, at the very least until most countries start rebounding back to pre-pandemic levels. Central banks continue to signal that they will maintain their stimulus efforts until the recovery reaches sustained levels, which to us implies continual tolerance for running the economy on the hotter side.

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[i] 322ab094199748349d51a349d5fe2fb8 (markiteconomics.com)
[ii] Fed to Taper Asset Purchases in 2022 or Later, Say Economists - Bloomberg
[iii] The Return of Consumer Spending | J.P. Morgan
[iv] Can the UK economy complete its recovery in 2021? - Insurance - Schroders
[v] • UK inflation rate forecast 2019-2024 | Statista
[vi] 1442d4c0244941d8966a69a89be37529 (markiteconomics.com)
[vi] § (markiteconomics.com)
[vii] European Union Consumer Confidence | 1985-2021 Data | 2022-2023 Forecast | Historical (tradingeconomics.com)
[ix] ECB inflation forecast 1.5% for 2021 and 1.2% for 2023 (eudebates.tv)
[x] 9da32e047e1347c3bbe15f23ff1caa5d (markiteconomics.com)
[xi] Japan Approves Record $1 Trillion Budget for Next Year - Bloomberg
[xii] 5eb45da6eedd4c888f4ba73005e22ce1 (markiteconomics.com)

Investment Outlook

The scale and pace of the policy response to the pandemic has been significant, increasing expectation of a strong re-opening, and leading to sharp increases in economic growth projections for 2021. The first quarter of the year was dominated by the reflation trade that has seen a significant rotation into cyclical, value stocks from perceived long duration growth stocks as rising bond yields dominate. Overall, the MSCI Developed World Index gained 4.5% over the quarter hitting an all-time high in February and is 20% higher than the levels at the end of 2019[i].

The scale and pace of the policy response to the pandemic has been significant, increasing expectation of a strong re-opening.

The rise in bond yields has seen the US Treasury 10-year yield move from 0.90% to 1.75% and has been correlated to the outperformance of financials versus technology stocks. More specifically, banks will benefit from steeper yield curves that are the result of the anchoring of policy rates near zero by central bank policy, and the growing inflation risk being priced into longer duration bonds. While policy rates may be on hold, there is little central banks can do to control the steepening of yield curves and a move to 2% in US 10-year yields over the course of the year is largely forecast by markets. In our opinion a move to 2.5% cannot be ruled out either, however, there is a question as to how far US 10-year yields can retrench without similar moves from UK and European government bonds that currently sit at 0.84% and -0.29% respectively. Plausibly, a widening of the regional yield differential can only go so far before bond investors prevent anomalies from forming in the medium term. Absolute Strategy Research note that following the UK-EU trade deal UK bond markets have become more sensitive to global factors but there is still Brexit premia priced into yields. This would suggest that the reflation trade has further to adjust in the UK and EU thereby offering the potential to close the curve steepening differential[ii]. It is worth considering that the US 10-year nominal yield has only really returned to pre-pandemic levels, and we believe it would probably take a move to positive real yields before investors are tempted into re-investing in the medium term.

The rise in bond yields has seen the US Treasury 10-year yield move from 0.90% to 1.75%

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The vaccination roll-out in the US and the UK has ensured that 37% of American and 58% of British adults have received at least one dose of a vaccine[iii]. Although COVID-related headwinds look set to prevail longer in Europe, investors continue to focus on the successful reopening of economies, perpetuating the rally in equity markets. European equities gained 8.6% and Japan's Nikkei 225 has rallied 6.3% during the quarter assisted by the strength in bank shares and the global demand for capital goods. We expect export dependent economies, like many in Europe, will likely be major beneficiaries of spending, and that European luxury goods and capital goods' companies will see the return of strong demand.

We believe the UK stock market remains one of the cheapest value-led developed markets, with biases towards sectors such as energy, mining and financials that are clear beneficiaries of a post-COVID expansion. Year-to-date the FTSE All-Share Index is 4.3% higher with both the service sector and manufac-

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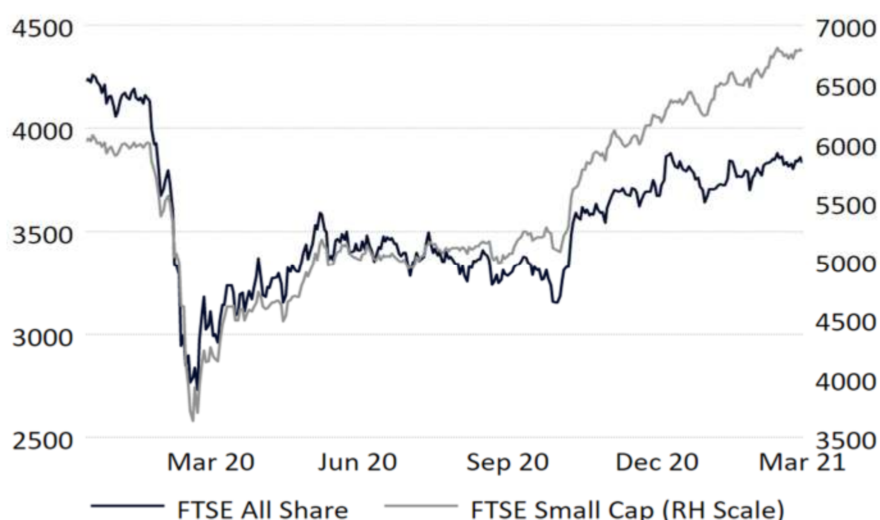
The more domestically focused UK FTSE Small Cap Index has reflected optimism.

turing purchasing managers indices (PMI) expanding significantly. The services PMI rose from 49.5 in February to 56.8 in March, while manufacturing improved to 57.9 from 55.1 in February, suggesting that the economy has already started preparations for the scheduled re-opening during the second quarter. The more domestically focused UK FTSE Small Cap Index has reflected this optimism gaining 7.73% during the quarter.

FTSE Small Cap Index vs. FTSE All-Share index



We believe UK equities remain under-owned by global investors who feel that the problems that have emerged following the post-transition UK-EU trade deal will continue to hold back the UK economy.

However, we believe UK equities remain under-owned by global investors who feel that the problems that have emerged following the post-transition UK-EU trade deal will continue to hold back the UK economy in the medium term. While we envisage that it is not within the interests of the EU to negotiate a services agreement that is favourable to the UK, the pessimism reflected in the relative prices of FTSE 100 equities maybe overdone in our opinion.

We believe inflation remains the main concern for investors, as illustrated by the contrasting performances of the main US equity indices over the quarter.

The creation of a Democrat majority in both the Senate and the House in February paved the way for the passing of the $1.9 trillion American Rescue Plan by the Biden administration that has largely underpinned the performance of risk assets during the quarter. Moreover, newly appointed Treasury Secretary Janet Yellen's announcement during her January 19 inauguration speech that it was time to "act big" on fiscal easing was referred to as her "Draghi moment" referring to Mario Draghi's "whatever it takes" speech in July 2012. We believe inflation remains the main concern for investors, as illustrated by the contrasting performances of the main US equity indices over the quarter. The technology heavy NASDAQ has led the market rally through popular growth sectors since last year's March lows but has struggled with a rotation into value sectors. The index is up 2.78% over the quarter compared to the S&P500, with a more balance list of constituents, up 5.77%. To highlight the extent of the underlying rotation from growth into value we can show that the S&P500 Technology Sector has gained 3.59% over the quarter whereas the S&P500 Financials sector has risen 16.93%. Moreover, the iconic Dow Jones Industrial Average of 30 stocks,

many of which are traditional cyclical stocks, has also had a good quarter up 7.76%. The Russell 2000 to some extent embodies the economic strength that is being felt in the US, from a leading vaccination roll-out and the resultant shorter reopening timeline. The index made up of more domestically-focused stocks, was also stronger and ended the quarter up 12.44%.

The Russell 2000 to some extent embodies the economic strength that is being felt in the US, from a leading vaccination roll-out and the resultant shorter reopening timeline.

The final stages of the quarter saw President Biden unveil his $2.25 trillion infrastructure plan, increasing the anxiety amongst some investors that the size of the fiscal spend across developed economies could lead to an above consensus pick-up in inflation when combined with pent-up savings. It is likely that the global economy will expand at a rate not seen since the 1980's in 2021 and US inflation remains the biggest risk[iv]. Few assets benefit from higher inflation, but commodities usually do, and we believe commodities might offer protection as strengthening demand causes prices to rise. Over the course of the quarter the Wisdom Tree Enhanced Commodities Exchange Traded Fund in sterling has gained 5.36%. More specifically the energy sector has bounced back as global growth is revised upward, with Brent Crude Oil up 21.90% over the quarter, while industrial metals are likely beneficiaries of increased infrastructure spend. Conversely, higher real yields have reduced the attractiveness of gold outside of its safe haven status leaving the yellow metal down 10.04% year-to-date.

The uneven roll-out of COVID-19 vaccines is causing divergent global growth prospects.

Finally, the depreciation of the US Dollar during 2020 created a favourable environment for emerging markets, however, the uneven roll-out of COVID-19 vaccines is causing divergent global growth prospects. These disparities have been reflected in the performance of emerging market assets and have also provided a short-term boost to the dollar, as shown by a gain of 3.69% in the Dollar Index this quarter. Chinese equities have sold off over the second half of the quarter due to monetary policy tightening concerns, leaving the Shenzen Stock Exchange Index down 0.90%, while the MSCI Emerging Market Index eked out a gain of 1.95% over the course of the first quarter.

Overall, it has been a poor quarter for bond markets and a positive one for equity markets despite the obvious sector rotation that has taken place. We believe that both equities and bonds remain expensive on an historical basis, but that as developed economies reopen the excess liquidity created by fiscal stimulus plans and above average savings rates will continue to support risk assets in the medium term. Investors continue to look to alternative investments to allow them to run equity risk for longer in the absence of the historical comfort offered from holding bonds. In our opinion, the key to returns in 2021 may hinge on the management of the back up in real yields and finding alternatives to bond exposure.

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[i] Societe Generale – Global Equity Market Arithmetic – April 1, 2021

[ii] Absolute Strategy Research – ASR Multi-Asset Strategy – Gilts' Brexit Legacy - April 7, 2021

[iii] JP Morgan Asset Management – Monthly Market review – April 1, 2021

[iv] Absolute Strategy Research – ASR Investment Strategy Overview – March 23, 2021

What is a CTA?

By Tim Sharp,** Managing Director at **Hottinger & Co. Limited

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Managed futures traders are more commonly known as Commodity Trading Advisors, or CTA's.

Managed futures traders are more commonly known as Commodity Trading Advisors, or CTA's, and they are systematic managers who employ computerised trading rules that have been back tested on historical data to manage assets. A diversified managed futures account would tend to have exposure to a number of different markets and will have a stated trading programme that describes its approach to strategy. They employ a range of strategies trading across commodities, currencies, equities and bonds that are characterised as trend following.

Trend followers do not try to predict future price movements but systematically follow existing price trends until there is evidence of a trend reversal.

Trend followers do not try to predict future price movements but systematically follow existing price trends until there is evidence of a trend reversal. Trading decisions are usually based on fundamental analysis backed up by sentiment, market positioning and technical studies. CTA's can take both long and short positions so that they can potentially profit from declines in asset markets, although it may not always be successful, thereby generating a different return profile from traditional long-only investing. Managed futures will also allow investors to gain exposure to other asset classes not always easily accessible to retail investors such as commodities which may have the effect of reducing volatility and risk through diversification and liquidity when used in conjunction with traditional assets.

Since its inception in January 1980 the annualised return of the BarclayHedge CTA Index is 8.86% and over the period it has shown a negative correlation to equities.

Since its inception in January 1980 the annualised return of the BarclayHedge CTA Index is 8.86%[i] and over the period it has shown a negative correlation to equities and only a 0.24 / 1.00 correlation to US Government Bonds. Studies by Abbey Capital (a firm specialising in CTA manager selection) show that the index has delivered positive returns in both negative and positive years for the S&P500 Total Return Index[ii]. In fact, the index has been positive in each of the major equity bull and bear markets since 1987 suggesting that the performance of CTA's is unconnected, or uncorrelated, to equities.

The index has delivered positive returns in both negative and positive years for the S&P500 Total Return Index.

Historically, traditional, long-only multi-asset investment management tends to analyse the macro-economic environment to build an investment picture, whereas trend following analyses price trends within financial markets which we believe works most effectively when there are strong, sustainable trends, up or down, rather than short term volatility. This fundamental difference in the basis for executing a trading strategy is the reason behind the historically low long-term correlation to traditional assets.

The fundamental difference in the basis for executing a trading strategy is the reason behind the historically low long-term correlation to traditional assets.

The money flowing into managed futures has grown from $10 billion in 1980 to over $340 billion by 2017[iii]. The Commodities Futures and Trading Commission (CFTC) and the National Futures Association (NFA) are responsible for regulating the managed futures industry ensuring credibility and trust for potential investors. The heavy regulation of the industry has been another reason why investors may have become associated with CTA's over hedge funds. In the US, all CTA's have to register with the CFTC before they can offer themselves to the public as money managers as well as FBI background checks and independent auditing that is reviewed by the NFA. Any investor looking at investing in CTA's is able to request disclosure documents that outline the trading strategy, performance data and the annualised returns.

When evaluating CTA's we would look beyond pure historical track record of returns to include the size and the length of drawdowns, as well as the period of time taken to recover. Clearly, the shorter the time period for recovery from a drawdown the better the performance profile. A worst-case historical loss does not mean that drawdowns will remain the same in the future, but it does provide a framework for risk assessment based on past performance periods. As a general rule, the CME Group reports that investors tend to have drawdowns representing no more than 50% of the CTA's historical annualised returns with no more than 10% drawdown in any given month[iv].

When evaluating CTA's we would look beyond pure historical track record of returns to include the size and the length of drawdowns, as well as the period of time taken to recover.

This may indicate the level of risk taken to generate returns and we would look for the greatest returns consistent with the lowest risk. This type of risk-adjusted return calculation is actually used across all fund types both long-only and alternatives and is known as the Sharpe Ratio. A Sharpe Ratio of 1.0 implies that each unit of risk taken by the fund achieved an equal amount of return, therefore, a ratio above 1.0 for any fund investment would be considered positive.

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We would class a managed futures fund as an alternative investment similar to a daily liquid fund of hedge fund strategies and would expect investors to be comfortable with alternative strategies before considering investing.

We would class a managed futures fund as an alternative investment similar to a daily liquid fund of hedge fund strategies and would expect investors to be comfortable with alternative strategies before considering investing. Abbey Capital have also studied the performance of CTA indices with that of multi-strategy Hedge Fund indices and the results suggest that managed futures offer better diversification for long-only investors particularly at time of severe market stress, such as the Global Financial Crisis (GFC). Furthermore, during periods of inflationary pressure investing in certain managed futures strategies could potentially provide a hedge to the downward pressure exerted on bond markets and then equity markets under certain conditions.

Of course, there is no guarantee that CTA's will be able to capitalise on future periods of market stress, and as with any investment in financial instruments, investors capital is at risk, and investors may not get back the original amount invested.

Managed futures offer the prospect of returns uncorrelated to equities and bonds from a notably different return profile.

In summary, we are likely in an environment that could see the traditional 60/40, equity/bond portfolio increasingly under pressure not just because of equity growth, but the inability of government bonds to hedge performance risk due to their own expensive valuations. While government bonds may still offer an element of diversification there is less protection available when equities are under pressure, and they are vulnerable to a potential pickup in inflation risk. Managed futures offer the prospect of returns uncorrelated to equities and bonds from a notably different return profile, with the potential to make gains in both equity bull and bear markets, even during periods of inflation, due to fundamentally different drivers of investment returns. Alternative investment strategies are aimed at "Sophisticated investors" and no reliance may be placed on the information herein, and no responsibility or liability is accepted for any opinions contained in this article.

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[i] Returns calculated using Bloomberg Terminal

[ii] Abbey Capital - Why Managed Futures – July 2018

[iii] CME Group – CME Institute - Compelling Reasons to Allocate to Managed Futures

[iv] CME Group – CME Institute - Evaluating CTA's

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