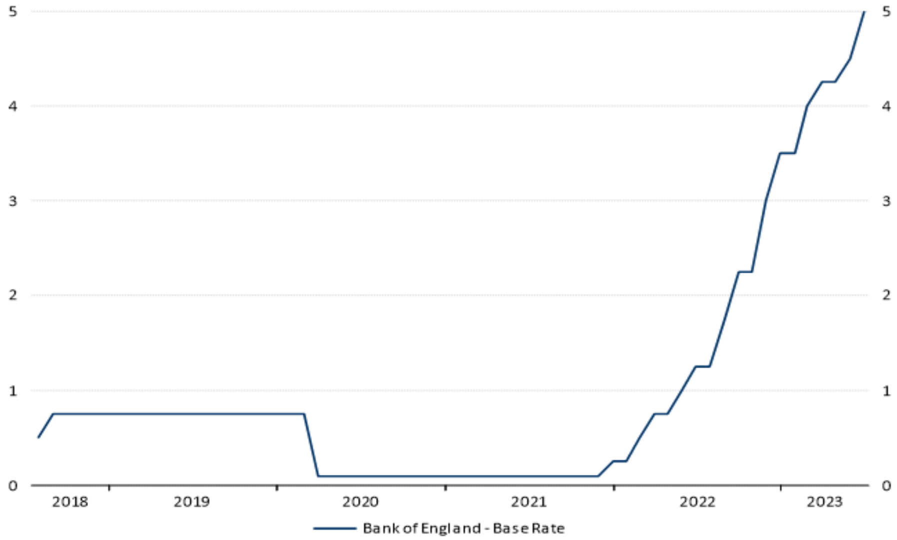
July 2023
Issue No. 28

GLOBAL INSIGHT

Overview

- In our Macro View, we consider the recent performance of equity markets in the context of our forward-looking views.
- The trend of disinflation accelerated over the quarter and is feeding investor optimism that economies can enjoy resilient growth and strong labour markets whilst avoiding the negative impact of higher interest rates.
- We highlight areas of opportunity which we feel have been left behind in this recent period of ebullience.
- In our Investment Outlook we map the impact of recent macroeconomic data on markets and sectors.
- In our feature piece the specialist team at Guinness Global Investors provide an insightful update on the energy transition.
- The growth described falls well short of the activity needed to achieve a **net zero / 1.5 degree scenario** in 2050, as targeted by the IPCC and reiterated at COP27.
- To achieve a net zero scenario, the deployment of renewable generation capacity, penetration of EVs and battery storage, use of alternative fuels and implementation of energy efficiency measures will need to accelerate markedly.

Bank of England forced to hike another 50bps...



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Macro Highlights

- The Bank of England were forced to hike interest rates by another 50bps as inflation came in higher than anticipated.
- Valuations have continued to rise, particularly in certain areas of the US equity market.
- Some of the share price moves resulting from the enthusiasm surrounding AI appear to be unsustainable.
- Certain areas of emerging markets look particularly attractive given their earlier victory over inflation.

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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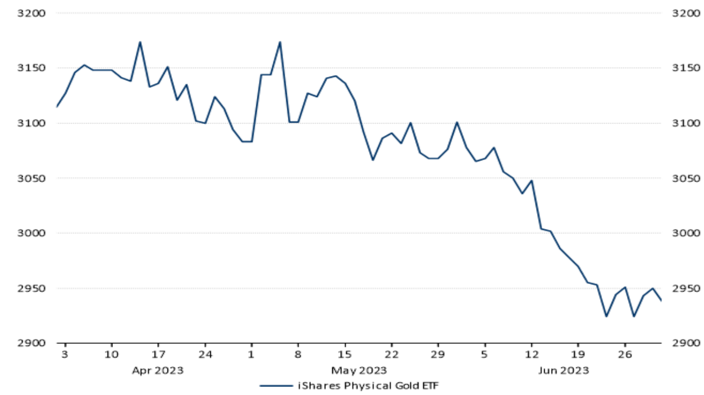
Key Issues in Charts

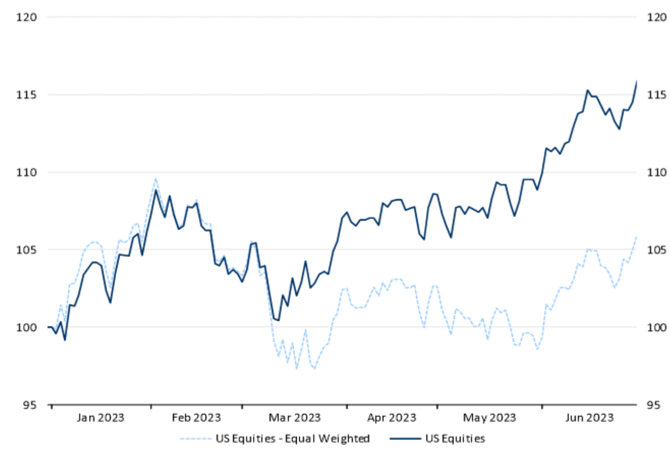
Gold feels the weight of gravity



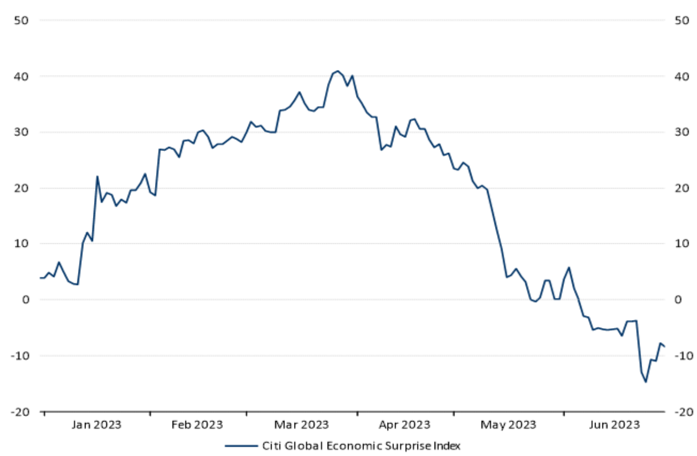
- In last quarter's 'Key issues' we highlighted that gold appeared to have detached from its underlying fundamentals.
- The price of the yellow metal went on to fall by c.6% over the past quarter as global inflation continued its retreat.
- We still believe in the benefits of gold as a diversifier hence maintain a small allocation within client portfolios.

Lack of breadth in the US equity rally

- The rally in US equities YTD has been lead by a very small number of large businesses.
- This disparity can be seen when looking at the performance of the equal-weighted US Index vs that of the Market Capitalisation weighted index.
- Excitement around the potential impact of AI has driven the valuations of certain businesses to extremes, a dynamic which is exacerbated by the sheer scale of index investing.



Global economic data disappointing expectations



- Citi's global economic surprise index is a measure of economic data points relative to consensus expectations prior to their release.
- Over Q2 the measure has declined rapidly, turning negative in June.
- This suggests to us that global growth is not holding up as well as expected by most forecasters. This could also, however, be interpreted as general expectations being too high.

Listening for bells...

*By **Adam Jones**, Senior Investment Manager*

Following our decision to strike a slightly more sombre tone in last quarter's 'Macro View' we find ourselves in the unfortunate position of having watched global equity markets continue their ascent over the past few months. Whilst we would never be so arrogant (or foolish) as to predict a market top, we are seeing more and more signs of investor behaviours that are at least consistent with past episodes of exuberance.

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"Nobody rings a bell at the top …"

Wall Street Proverb

Investor fervour over the first half of 2023 has centred primarily (and rather narrowly) on the US Technology sector, where the relentless bid for Artificial Intelligence related businesses has driven valuations in some areas to levels that can only be described as extreme.

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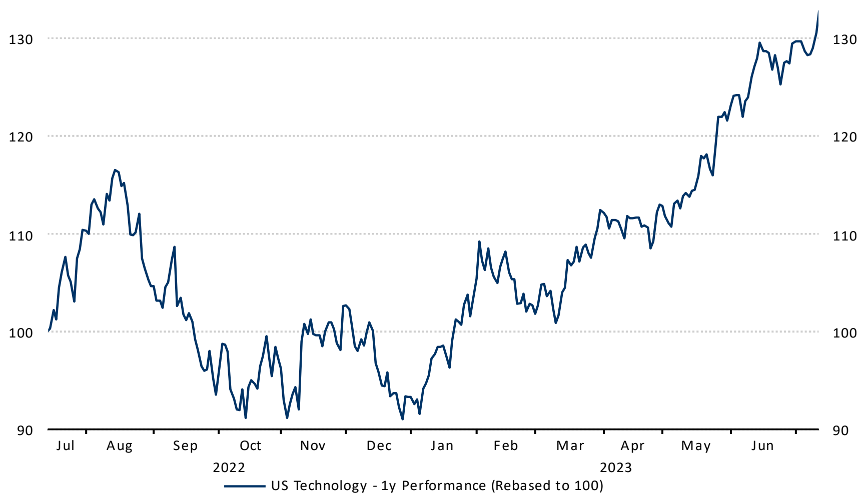
US Technology stocks leading the charge



Source: *Hottinger Investment Management / Refinitiv Datastream*

One such example is Nvidia, which is an unquestionably dominant and well-managed business engaged in the production of software, systems and chips which are currently enabling exponential growth in fields such as AI and Robotics. Clearly a wonderful place to be. Without wishing to draw too many historical parallels, however, we are currently struck by investors apparent disregard for almost any sensible measure of valuation.

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Do you realize how ridiculous those basic assumptions are?

You don't need any transparency. You don't need any footnotes.

What were you thinking? "

To illustrate this point, we refer readers to a timeless quote from the founder and CEO of Sun Microsystems in the aftermath of the 1999 dotcom bust;

"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate.

Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking? "

Scott McNealy, Business Week, 2002

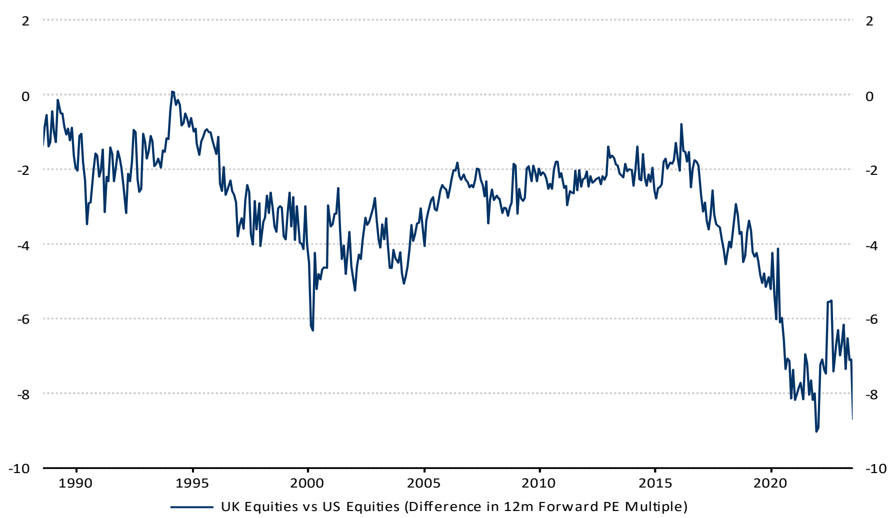
Nvidia today trades at a price of **43 times revenue**. Now, perhaps this is a great price given the potential impact of AI and the explosive revenue growth that Nvidia could go on to deliver as a result. Perhaps, however, this move merely represents the pendulum-like shifts in investor sentiment that have so frequently created opportunities for patient investors over many decades.

As ever, only time will tell.

One of the more interesting dichotomies to us in the meantime is that many more traditional businesses, particularly those in the more labour and capital-intensive industries, have been very much left behind.

One of the more interesting dichotomies to us in the meantime is that many more traditional businesses, particularly those in the more labour and capital-intensive industries, have been very much left behind in terms of valuation and remain completely overlooked by investors. This despite those areas arguably being some of the greatest beneficiaries of any improvements in efficiency and productivity that the promise of an AI revolution might bring. Whilst being mindful of our domestic bias we would argue that the UK equity market is especially illustrative of this dynamic given the composition of its equity index. UK equities today are almost as cheap (relative to US equities) as they have ever been. The UK certainly has its fair share of problems; however, these appear (at least to some extent) to be reflected in the valuation of its companies.

UK Equity valuations



Source: *Hottinger Investment Management / Refinitiv Datastream*

The other major development over the quarter was the apparent victory of Central Banks in their long-waged war against inflation. While services inflation remains elevated the headline measure itself is clearly trending lower. In large part this is a result of base effects, however our belief is that we will see ongoing declines as consumer demand slows in the face of a now significant rate hiking cycle which began almost 18 months ago. We accept that there are many areas of resilience (specifically in the US economy) however we also continue to believe that the tentative signs of a softening labour market are beginning to emerge, and that this data significantly lags both current and future activity the point at which this no longer remains the highest probability outcome.

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Our sense is that equities markets are currently being buoyed by the overarching narrative that inflation is cooling, the labour market remains well supported and that economic growth will remain resilient. This idea of a 'soft-landing' is a pleasant one, however it is an outcome to which we assign a relatively low probability (at least if history is any guide). Carrying far higher probabilities, in our view, are two very distinct outcomes;

- The first is that inflation persists and/or re-accelerates, necessitating additional rate hikes and the need for those higher rates to remain so for a longer period longer than is currently expected (interest rate markets currently price the first *reductions* in US interest rates around the first quarter of 2024).

- The second is a scenario in which the much talked about recession finally arrives (our best guess would be in Q4 of this year or Q1 of next) and central banks are forced to cut rates far more aggressively to support economic activity.

This idea of a 'soft-landing' is a pleasant one, however it is an outcome to which we assign a relatively low probability (at least if history is any guide)

Neither of these scenarios strike us as being particularly good news for fully valued equity markets and represent **the** key reason we are maintaining a cautious stance within portfolios at this juncture. This is a decision which is made far easier by the availability of returns comfortably exceeding 5% at the very short maturity end of UK & US government bond markets.

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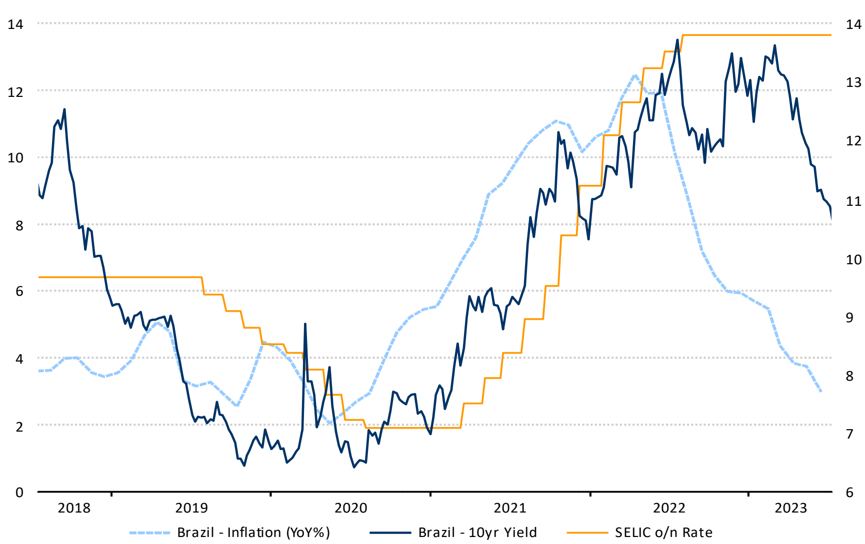
Interest rates & inflation in Brasil



Source: *Hottinger Investment Management / Refinitiv Datastream*

With all this talk of caution, however, it might strike readers as somewhat contradictory that we are becoming increasingly interested in areas of the global economy that find themselves in the dual position of a) having beaten inflation many months ago and b) offering incredibly cheap equity markets.

One such area is Latin America. The above chart highlights the rate of inflation in Brazil (*light blue*) alongside its overnight interest rate (*orange*). We can see very clearly that inflation rolled over in Brazil way back in the first quarter of 2022, and that the Brazilian Central Bank look increasingly likely to start *cutting* interest rates as a result of its continued decline. We believe this forthcoming rate-cutting cycle, coupled with the potential for US dollar weakness and continued political stabilisation (our belief is that Lula will not be as bad for the country as feared) could prove to be a potent catalyst for an equity market which trades at less than 9x next year's earnings and offers a dividend yield of more than 8%.

We can see very clearly that inflation rolled over in Brazil way back in the first quarter of 2022, and that the Brazilian Central Bank look increasingly likely to start

Similar pictures emerge when looking at other economies across the region (Mexico, Chile et al) and we are currently looking to identify the best vehicle through which to access this story. The other point to note is that should the EM interest rate cycle genuinely be shifting into reverse we would expect the corresponding fall in bond yields to provide support for equity markets to outperform. We have already witnessed this dynamic at play to some extent with Brazilian equities rising by more than 11% over Q2. When thinking about just how far valuations in these markets have fallen over the past 2 years, we believe there remains plenty of space to run.

Should the EM interest rate cycle genuinely be shifting into reverse we would expect the corresponding fall in bond yields to provide support for equity markets.

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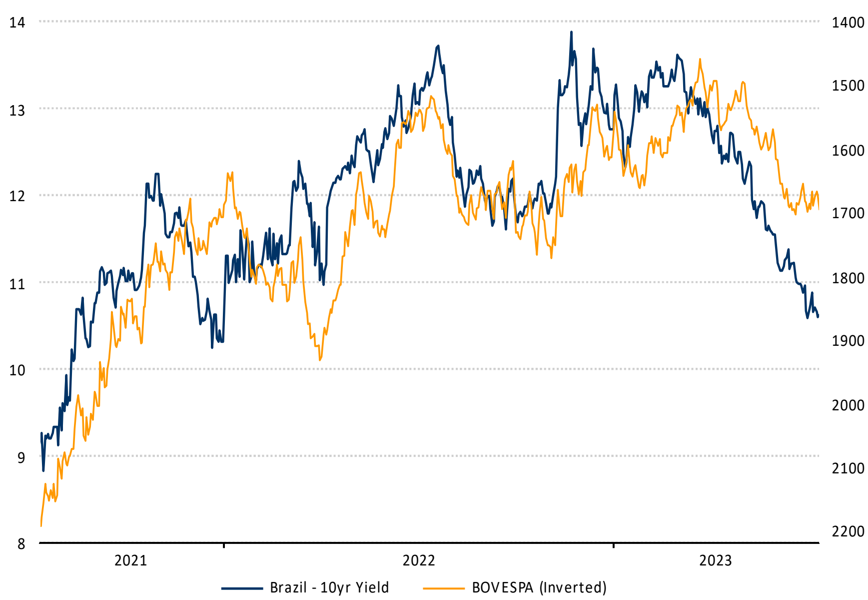
Historically, falling bond yields have been supportive of equity prices



Source: *Hottinger Investment Management / Refinitiv Datastream*

In summary, whilst it can be painful to watch the share prices of certain companies rise sharply, our adherence to time-tested fundamentals simply precludes us from engaging in some of the more speculative areas of markets. Our role is to preserve & grow the wealth of our clients in a consistent and steady manner. We will not be drawn in by the fear of missing out, which carries the great irony of knowing that we certainly will (at least in the short term).

Investment Outlook

The first half of 2023 has brought positive surprises for investors, following a challenging year in 2022. Developed market equities recorded a 7% increase in returns this quarter, primarily driven by the continued rally of large-cap tech stocks in the US and positive performance in EU equities year to date.

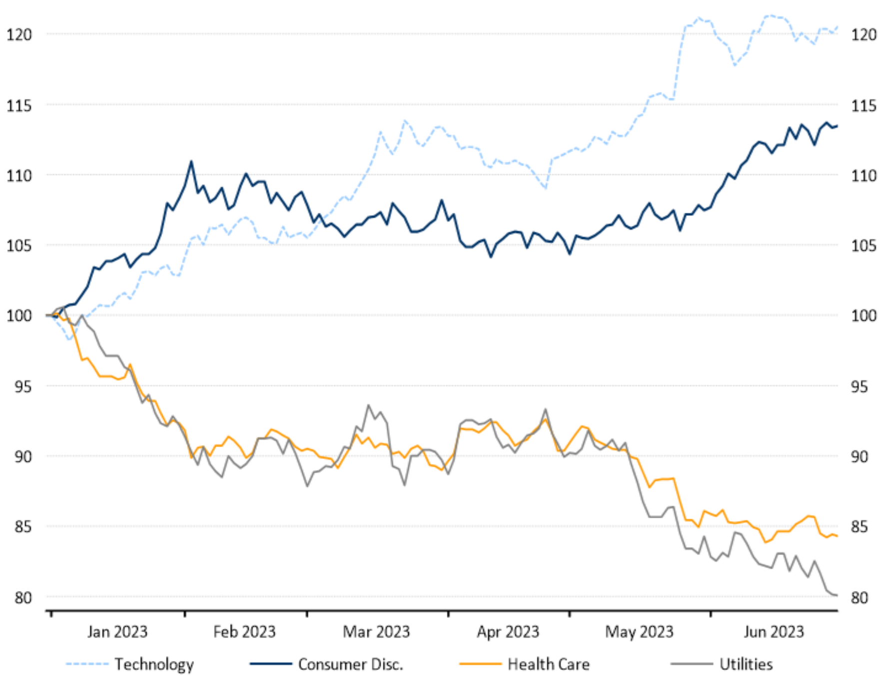
Developed market equities rallied, boosted by an AI fuelled rally in the U.S following Microsoft's acquisition of ChatGPT and Nvidia raising their outlook to reflect a growing demand for AI centric chips.

Within equity markets, big growth stocks in the US continued their upward trend, with the iShares US Technology Sector ETF experiencing a surge of 45.21% year to date and over 17% quarter over quarter. However, value stocks lagged growth by 5% across developed markets.

US equities finished the quarter on a positive note, with the majority of gains made in June. The US inflation rate saw a significant decline from its peak of 9% to 4%, mainly due to weaker oil prices. Economic data presented a mixed picture, with retail sales remaining positive while PMIs indicated weakness in the manufacturing sector. The US ISM Manufacturing PMI dropped to a contractionary level of 46.00, 8% below the break-even level of 50.00. Business investment intentions also declined, and there are concerns about weaker corporate loan demand, particularly among small banks that are disproportionately affected by potential losses in commercial real estate loans.

While equities enjoyed a rally, PMI’s paint a bleaker economic picture with manufacturing slipping further into contractionary territory.

US relative sector performance (YTD, rebased to 100)



Source: *Hottinger Investment Management / Refinitiv Datastream*

Services PMI’s slipped also however still remain above the 50.00 threshold indicating relative resilience within services.

The Federal Reserve implemented a 25-basis-point rate increase in May, followed by a hawkish pause in June as the committee sought greater clarity on the economy and inflation. The market still expects two more rate hikes in 2023. Although the US unemployment rate increased from 3.4% to 3.7% in May, the labour market remains historically tight.

The Federal Reserve hiked in May, however decided to pause in June as conflicting data makes it harder to assess the health of the economy.

The U.S managed to navigate their Debt Ceiling issue and saw CPI fall again, while the U.K grappled with stronger than expected jobs data, wages and sticky inflation.

At the beginning of the quarter, cautious investor sentiment was observed due to the US debt ceiling issue. However, as expected, Congress approved legislation suspending the debt ceiling in early June, with Democrats agreeing to spending concessions that are not anticipated to hinder economic growth.

The UK market closed the quarter 8% lower. The only sector with positive performance was technology, while telecoms (-11%), healthcare (-11.3%), and utilities (-10.12%) were the three worst-performing sectors. This decline was primarily attributed to weakness in commodity prices and concerns over China's economy. The strength of the sterling weighed on resource sectors, as well as other significant US dollar earners like consumer staples. Consequently, valuations for the UK 100 index dropped to 10.1x earnings, compared to 28.2x in the US and around 18x in Europe.

Core services inflation in the U.K rose, while manufacturing weakened further with a PMI of 46.5.

The domestic UK market faced challenges as the Bank of England raised interest rates by 0.25% in May and 0.5% in June. These rate hikes followed stronger-than-expected jobs data, wage growth, and core inflation readings, leading to a sell-off in UK Gilts and pushing yields higher, which in turn impacted mortgage rates and housebuilders.

Core services inflation in the UK, which excludes volatile energy and food prices, increased, reflecting a yearly rise in wages of 7%, outpacing even the US. To combat persistent inflation within the economy, the Bank of England raised rates to 5%. Manufacturing weakened, with PMIs slipping further into contractionary territory, as the latest reading of 46.5 indicated. Although the most recent PMI readings surpassed gloomier economist consensus predictions, it still paints a less-than-optimistic picture for manufacturing in the UK.

Data shows the pain of interest rate rises and mortgage costs going up are yet to be felt by the majority of the public.

The rise in rates and mortgage costs suggests that fewer homeowners than initially anticipated have felt the impact of rate hikes due to previously secured fixed-rate deals in times of low interest rates. However, over the next 18 months, 2.4 million households will see their fixed deals expire, necessitating the renegotiation of mortgage terms at significantly higher rates.

European equities held the majority of their year to date gains with IT and Technology sectors being beneficiaries from the hot semiconductor sentiment and uplifted forecasts from manufacturers in the U.S.

European markets showed relatively flat performance for the quarter, with modest gains observed in the European 600 index since January, totalling 4.5%. The IT sector received a boost from semiconductor stocks following higher-than-expected sales projections from US chipmakers. This development exemplified the growth expectations associated with the ongoing push toward AI implementation. In recent weeks, the Dutch government announced plans to require a license for shipping high-end chip manufacturing equipment overseas, aiming to make it more challenging for China to access the latest generation chips and semiconductor manufacturing equipment.

The European Central Bank (ECB) raised rates twice during the quarter, bringing the refinancing rate to 4.0%. Headline inflation moderated during this period, with June's annual inflation estimated at 5.5%, down from 6.1% in May. However, core inflation, which excludes more volatile measures such as food, energy, alcohol, and cigarettes, saw a marginal increase from 5.3% to 5.4%.

Data revealed that the Eurozone experienced a mild recession during the winter months, with GDP declining by -0.1% in both Q4 2022 and Q1 2023. Forward-looking indicators such as PMIs indicated a slowing economy, as numbers fell from 52.8 to 50.3. This represents a five-month low and suggests that growth could be perhaps stagnating within the region.

The EU slipped into a mild recession as PMIs teeter on the breakeven reading of 50.00

The best-performing market this quarter was Japan, which reached 33-year highs in June, with the index surpassing the 33,700 mark. The Nikkei225 Index is up over 25% year to date, with more than 15% of growth occurring this quarter alone. Weak yen, low interest rates maintained by the Bank of Japan, and continuous buying of Japanese shares by foreign investors fuelled this performance. The Bank of Japan held its first meeting with new governor Kazuo Ueda in April and the second in May, with no changes made to policies, indicating the continuation of their dovish monetary policy.

Japan outperformed in June with the Nikkei hitting its highest level in 33 years.

Following the early rally in emerging market equities driven by optimism surrounding China's reopening, markets retraced most of their gains due to disappointing economic data from China. Manufacturing output has been slowing due to disappointing consumer spending and weak export demand following central bank rate hikes globally.

Emerging Markets retraced their gains as China’s economy disappoints. Manufacturing PMI’s declined for a second month nearing breakeven level with a reading of 50.5.

Excluding China, some emerging markets experienced growth, such as the Ibovespa index in Brazil, which saw gains of 16% quarter over quarter, and India's Nifty50 index, which was up 11.5% quarter over quarter. South Korea and Taiwan also showed positive gains for the quarter, buoyed by positive sentiment around AI and semiconductors. India saw positive returns due to foreign inflows, steady earnings, and encouraging economic data. Nonetheless, emerging market returns significantly lagged behind those of most developed markets, with tensions between the US and China contributing to investor aversion to unnecessary geopolitical risks.

Brazil and India both outperformed, producing double digit returns over the quarter as investors assess whether these nations could be nearing the end of their rate hiking cycle.

The past quarter witnessed less volatility in global bond markets, with government bond yields rising once again. Divergence in yield levels is now apparent, primarily driven by central banks' ability to control inflation in different regions. The UK and Australia, both experiencing higher-than-expected inflation, saw yields rise more than others.

Despite a moderate increase in default rates, corporate balance sheets remain relatively strong. High-yield bonds outperformed investment-grade bonds as recessionary concerns in the US diminished. With better-than-expected growth in the US, a soft-landing scenario is now the market consensus. Investment-grade bonds posted negative total returns but outperformed US Treasuries over the quarter. US high-yield bonds delivered positive returns, while ten-year treasuries saw an increase in yields from 3.47% to 3.84%.

The market is now pricing a soft landing as the most likely scenario . Balance sheets for corporates remain robust, although we did see a small uptick in default rates.

Sustainable Energy Transition

By ***Guinness Global Investors***

Disruption in the banking sector, coupled with volatile sentiment around interest rates, brought about fears of a slowdown in funding that could affect the level of future sustainable energy investments.

Further details around the US Inflation Reduction Act continue to tempt sustainable energy equipment manufacturers and producers to locate and grow their activities in the United States.

The first half of 2023 saw continued positive momentum for the energy transition. Further details emerged on the significant energy transition policy commitments that were announced by the EU and US last year. Against this, disruption in the banking sector, coupled with volatile sentiment around interest rates, brought fears of a slowdown in funding that could affect the level of future sustainable energy investments. In this report, we review macro developments, contribution to fund returns in the quarter, outlook and portfolio valuation.

The key events, both positive and negative for sector sentiment, that have affected the energy transition, company profitability and share price performance so far this year have included:

- The EU announced its new **EU Industrial Strategy** in a number of stages over the half, although full details still remain thin on the ground. Currently, we understand that the strategy aims to quadruple the EU renewable fleet by 2030 (requiring around €1tn of capex); to shorten the renewable project permitting process from 4-5yrs to 9-18mths; and to establish an EU renewable supply chain with incentives for activities that achieve a “made in Europe" minimum threshold. In March, the EU unveiled its “Critical Raw Materials Act” which sets targets for the production, refining and recycling of key raw materials needed for the green and digital transitions.

- The **collapse of Silicon Valley Bank** and the **takeover of Credit Suisse by UBS** in mid March brought growing concerns of a developed world credit crisis that, together with higher interest rates, raised concerns around funding for sustainable energy projects. The full implications are not yet clear but further restricted funding from US regional banks could slow the growth rates of US residential solar installations.

- Further details around the **US Inflation Reduction Act** continue to tempt sustainable energy equipment manufacturers and producers to locate and grow their activities in the United States. Incremental detailed guidance on new tax rules (for example the proportion of domestic content that will be required for US manufacturing plants to qualify for the incentives) continued to be drip fed out by the treasury during the half, providing firms with the incremental certainty they need to make expansionary investments.

- The **removal of subsidies for new EV** sales in China and in certain parts of Europe slowed EV sales growth at the start of the year, however, this has eased materially as OEMs cut prices by as much as 20% to stimulate demand. The latest EV sales data suggests the industry is growing 40% YTD across all segments of road transport (passenger vehicles, light commercial vehicles, buses and 2/3 wheelers). Looking longer term, the quarter saw significant new investment announced in battery 'gigafactories' across the US.

- **Battery economics** improved meaningfully throughout the half with Chinese lithium supply growth prompting a material moderation in battery metal prices, helping to spur both EV and stationary storage demand. Battery demand now looks likely to grow by 40% for full year 2023.

- Following a rare bout of cost inflation in 2022, the **solar** complex resumed its deflationary trend during the half as a decline in input prices allowed the cost of solar modules to decline by 20%, making the economics of installation all the more compelling. In the US some developers struck a more cautious note on growth as a function of higher interest rates and the phasing of regulation in California, but offsetting that the US Department of the Treasury provided further clarity on incremental tax credits for companies using more than 40% domestic content in their projects. Overall, global solar installation have accelerated again, now looking up 30% yoy vs initial expectations of 20%.

- **Wind** OEMs have slowed the rate of new product launches year to date as sluggish demand and higher input costs hamper profitability. Europe has set meaningful wind power targets, but recent policy announcements have not led to the investments hoped for into the local supply chain, risking shortages in the latter half of the decade. In the US, with improved IRA clarity there are signs of improvement, meaning that US wind additions are likely to trough in 2023 before recovering in 2024.

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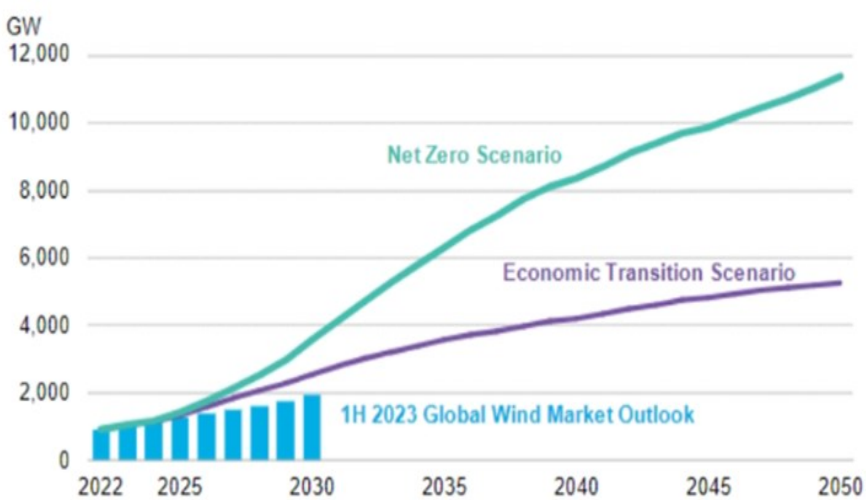
Wind outlook scenarios



Source: *BNEF*

Outlook

Looking at the remainder of 2023 and beyond, we expect a further acceleration of the energy transition :

- On the supply side of the energy transition, the IEA is forecasting that **renewable power additions** over the coming five years will be just over 2,400 GW; a 30+% increase on its previous five-year forecast and their largest upward revision. The world is set to add as much renewable capacity in the next five years as it did in the past 20 years, equivalent to the entire current power capacity of China.

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- The IEA has described **solar** power as "the cheapest electricity in history" and large-scale solar remains at the bottom end of the cost curve. At the start of the year we expected solar installations to grow around 20% yoy to 310GW, however, with increased clarity from the IRA and improving polysilicon prices, various commentators are now suggesting that this could be higher, with Bloomberg New Energy Finance suggesting a figure of 340GW is more appropriate, a 30% increase.

- Despite cost issues amongst the **wind** OEMs and absence of detail from the European Net Zero Industrial Act we continue to expect annual wind installations of 110GW for 2023, with lower installations outside of China driven by developers struggling with financing and supply chain costs. Thereafter, with improved IRA clarity and easing supply chains, we would expect to see an improvement into 2024, with global wind capacity quadrupling by 2040.

- Within EVs, we would expect current growth momentum, post EV subsidy cuts, to continue into year end, driving **EV sales to around 14 million units**, representing an 18% penetration rate. Chinese penetration will likely end up even higher than this in the 35-40% range.

Within EVs, we would expect current growth momentum, post EV subsidy cuts, to continue into year end.

- **Battery** economics are likely to benefit from current low metal prices, which, coupled with ongoing EV demand is likely to grow global battery demand by 40% in 2023 to nearly 1000GWh. Within that we expect stationary storage demand to double from 16GW in 2022 to 32GW in 2023. As a reminder we think that this moderation of commodity prices, coupled with improvements to cell chemistry and efficiency improvements in battery pack design will help deflate battery costs to $100/kWh by 2027, which is the point at which EVs become cheaper than internal combustion engines.

Battery economics are likely to benefit from current low metal prices, which, coupled with ongoing EV demand is likely to grow global battery demand by 40% in 2023 to nearly 1000GWh.

- While much progress has been made regarding the deployment of renewables into electricity generation, grid investment has struggled to keep up. With growing interconnection queues increasingly becoming a bottleneck to further renewable deployment, we foresee a step up in **grid investment** from $300bn in 2022 to closer to $600bn by 2030, driven by digitalisation, improving resilience and extending the grid to new generation facilities.

The outlook we summarise here is broadly consistent with current government activity and observable investment plans. To be clear, however, the growth described falls well short of the energy transition activity needed to achieve a **net zero / 1.5 degree scenario** in 2050, as targeted by the IPCC and reiterated at COP27. In a net zero scenario, the deployment of renewable generation capacity, penetration of EVs and battery storage, use of alternative fuels and implementation of energy efficiency measures will need to accelerate markedly.

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