

# Schroders

## Economic and Strategy Viewpoint

**Keith Wade**  
Chief Economist and  
Strategist  
(44-20)7658 6296

**Azad Zangana**  
European Economist  
(44-20)7658 2671

**Tina Fong**  
Analyst, Multi-Asset  
(44-20)7658 3278

**Harish Vekaria**  
Quantitative Analyst  
(44-20)7658 2722

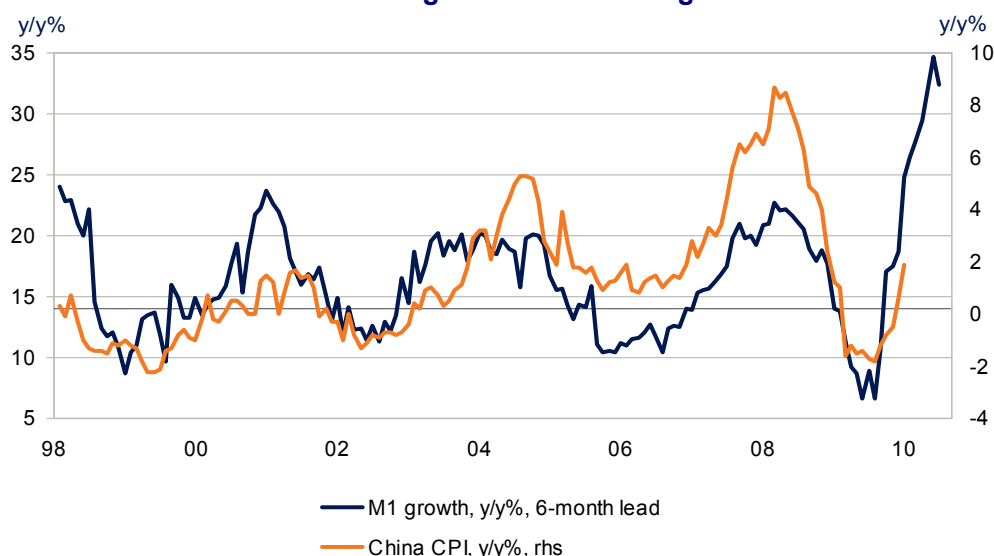
### Global: When growth is bad

- Recent developments in China's economy are a reminder that strong economic growth is not necessarily good for a country's stockmarket. The concern today is that China is overheating and running a risk of a sharp pick up in inflation. As a result the authorities have begun to tighten policy and markets recognise that a subsequent slowdown in liquidity growth will affect asset prices as well as the real economy.
- Despite the evidence for a de-coupling of emerging market growth from that in the developed world, there is still a very strong correlation between the leading indicator for the G7 and emerging equity performance. The former has now rolled over, another signal that a period of caution toward emerging equities is warranted.

### UK: It's growth, but not as we know it

- The UK recession is finally over, but with just 0.1% growth in the three months to December, early estimates disappointed many leading to further doubts over the sustainability of a recovery. Our Schroders Activity Index suggests growth will accelerate over the start of 2010, but our estimate of labour market activity within the service sector remains weak.
- Headlines of unemployment falling at the end of last year mask much weaker labour market conditions. The level of employment continues to fall, while real wage growth, particularly in the private sector, continues to contract. Taking this with the ample spare capacity in the economy, we forecast year on year inflation in the UK to fall after the expected spike in January's data, caused by VAT reversal effects.
- Given the risk of a double-dip recession together with political uncertainty surrounding the general election, we expect the Bank of England to keep interest rates on hold until September 2010, with gentle tightening to 2.5% by the end of 2011. This leaves plenty of room for more aggressive fiscal tightening, regardless of which political party wins the general election.

**Chart 1: Cause for concern - M1 growth indicates higher inflation in China**



Source: Thomson Datastream, 26 January 2010

# Global

***Little relationship between GDP growth and stock market returns***

## **When growth is bad**

In a widely quoted piece of research published in 2005, academics at the London Business School showed that there was no relationship between GDP growth and equity market performance<sup>1</sup>. Using data going back more than 100 years they found no correlation between a country's GDP growth and the performance of its stock market, thus undermining one of the central assumptions held by many investors who saw equities, particularly those in the emerging markets, as a means of accessing the growth of an economy. If anything, the correlation was slightly negative and as a result, some began to question the point of the asset class: if you did not buy equities for growth, then why hold them at all? Others went even further and asked whether this also made economists working in financial markets redundant.

Putting aside the question about employment of economists, recent developments were a timely reminder of the LBS findings. Earlier this month China announced GDP growth of 10.7% y/y in the fourth quarter of last year and, although an excellent result and stronger than expected, China's equity market subsequently fell.

Of course, what happens on one day cannot be seen as proof of a long run relationship between an economy and its markets, or anything else given the amount of statistical noise involved. However, it is a reminder that GDP growth alone is not sufficient for equity market performance.

***Strong growth in China is causing concern about inflation***

The problem for China at present is that stronger growth is fuelling fears that the economy is overheating and that policy makers face a challenge to bring inflation under control. Markets recognise that any subsequent tightening of liquidity will squeeze asset prices along with the real economy. This is a concern which we share and have flagged on previous occasions where we have highlighted the implications of the acceleration in China's money growth for inflation (see chart 1 on front page).

***The performance of equity markets in 2009 was driven by growth expectations, not the GDP outturn***

## **GDP may not matter on its own, but growth expectations do**

What markets require is evidence of sustainable growth. The story of last year's rebound in equity markets was largely one of a massive turn in growth expectations from fears of another Great Depression to stability to modest recovery. So even though the world economy experienced the worst GDP performance for more than fifty years, the turn in growth expectations drove one of the strongest rallies global equity markets have ever seen.

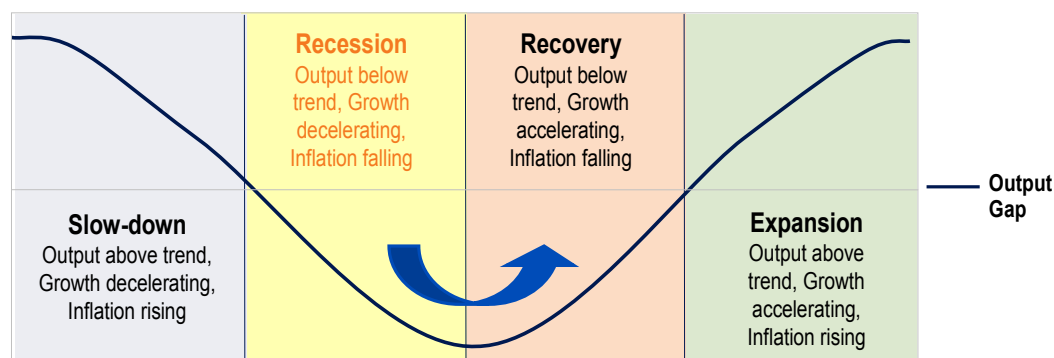
Our own macro investment framework is based on the same idea where we divide the economic cycle into four stages each characterised by different combinations of growth and inflation (see chart 2). One of the key conclusions is that equity markets can do well even when the economy is in recession i.e. as long as investors anticipate a recovery it does not matter if GDP is falling.

Another conclusion is that equity market performance deteriorates once inflation starts to pick up. The presence of rising inflation means that investors curtail their growth expectations as they wait for the impact of tighter monetary policy. The very worst phase (the slow down) is when the economy experiences a period of slowing growth and rising inflation, i.e. stagflation.

<sup>1</sup> Global Investment Returns Yearbook 2005, Dimson, Marsh and Staunton, London Business School

### Chart 2. Asset allocation through the cycle

Where are we in the cycle, what do we expect to outperform in 2010?



#### Ranked by preference\*

Cash	High Yield	Equity	Commodities
Government	Private Equity	Property	Private Equity
Bonds	Equity	Infrastructure	Property
Commodities	Investment	Private Equity	Equity
	Grade	High Yield	Hedge Funds

\*Assets are ranked by level of significant outperformance relative to a portfolio of global assets in each phase.

Source: Schroders. Graphs for illustration only. Average length of full cycle is about 5-6 years

China is not there yet, but clearly the danger is that this is where it is headed and by raising bank reserve requirements the authorities have started to tighten as concerns about the recovery have given way to worries about inflation.

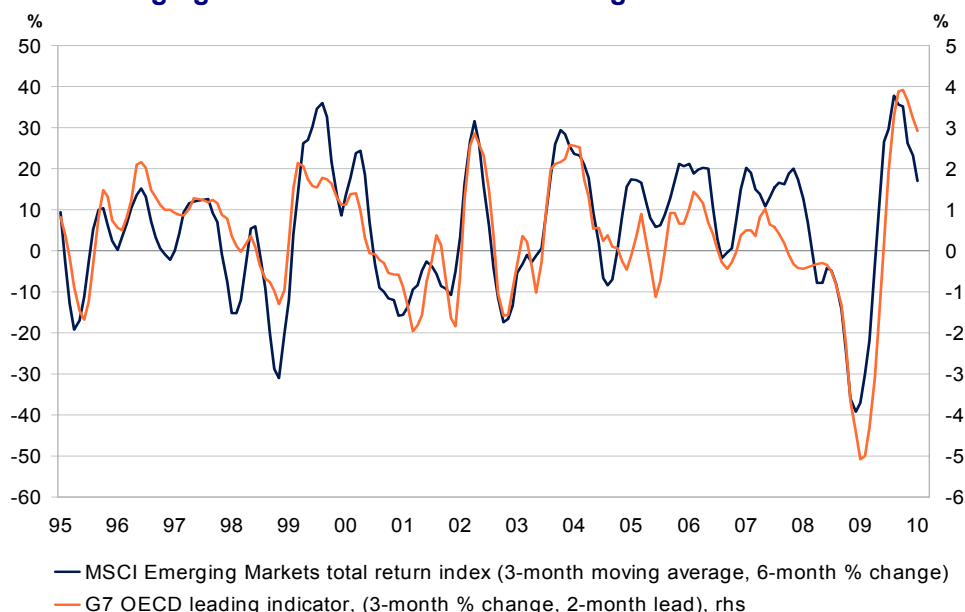
#### Have the emerging economies really de-coupled?

**Turn in leading indicator suggests spell of weaker performance for emerging equity markets**

One way of capturing growth expectations is to use leading indicators of economic activity. These have a better record of tracking market performance than GDP growth particularly in the emerging markets (see chart 3). Having risen sharply in 2009, the OECD's leading indicator for the G7 economies is now rolling over. Arguably, we should no longer put much weight on this measure as it is almost an accepted fact that the emerging economies have de-coupled from their more developed G7 counterparts. For example, figures for 2009 show that China grew by 8.7% while GDP in the US contracted by around 2½%.

However, despite the evidence of economic de-coupling, the performance of the emerging equity markets has still tracked that of the OECD leading indicator over the last year, just as they have done for the previous 15 years (see chart 3). The relationship is contemporaneous, rather than leading, and remains as close as ever.

**Chart 3: Emerging markets and the OECD leading indicator remain close**



Source: Thomson Datastream, Schroders, 26 January 2010

From this perspective, emerging market equities have not completely de-coupled from the developing world as their recent performance can still be explained by the OECD leading indicator. This may change in 2010 and we remain long run bulls of the emerging world, but given the earlier concerns about inflation and overheating we look set for a spell of underperformance compared to the past.

If we do move into a period where emerging markets cool, we would also watch out for knock on effects to commodities and some developed market sectors which have benefitted from the enthusiasm for companies linked to the emerging world.

Notwithstanding this we remain positive on developed market equities. For US, Europe and Japan are at an earlier stage of the cycle than emerging economies like China. They still have spare capacity and consequently should not face inflationary problems as growth picks up. For this group growth is still good.

**Developed economies at an earlier stage in cycle**

# UK

## It's growth, but not as we know it

With the new year upon us, encouraging survey data has finally begun to filter through to official statistics. The UK is out of recession, and the number of unemployed has started to fall.

### UK finally exits recession...

As we delve into the details, we find that labour market conditions remain very poor, and that negative real wage growth, particularly for private sector workers, could be discouraging households from returning to pre-recession spending patterns.

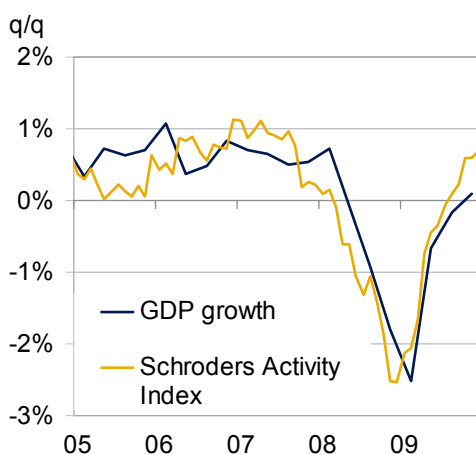
Meanwhile, British politicians have begun jostling ahead of a general election expected in May of this year. High on the political agenda is how the next government will tackle its fiscal mess, with investors watching closely in anticipation. The risk of a hung parliament is very real and could send gilt yields rocketing as threats of downgrades and a currency crisis could follow. Given the tail-risks over the first half of this year, the Bank of England will need to pay close attention to developments on many fronts as it begins to tighten monetary policy in 2010.

## Weak recovery underway

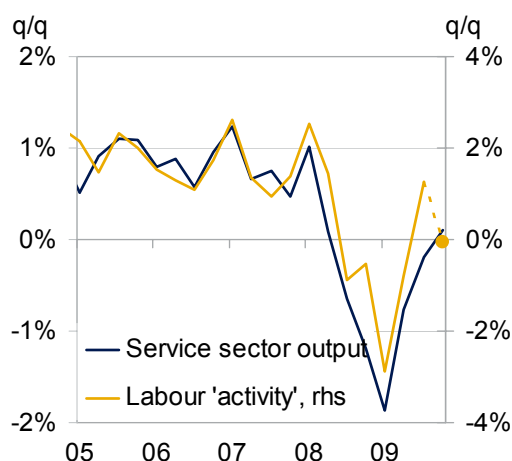
This month, the Office for National Statistics (ONS) released its preliminary estimate of GDP growth for Q4 2009, showing the economy grew by (+)0.1% in the three months to December, but contracted by (-)3.3% on a year on year basis. The latest estimate disappointed the City with consensus expecting 0.4% quarterly growth, while we were looking for a weaker 0.3%. Compared to our PMI composite, the 'Schroders Activity Index', GDP growth continues to lag by about one quarter, but more noticeably, has been weaker than surveys have been suggesting (Chart 4). However, it is important to bear in mind that the preliminary estimate only contains about 40% of the information required to produce a full estimate. We believe the ONS is having problems capturing the effects of the inventory cycle in its preliminary estimate. This is because data on inventories is collected very late, and estimates of final demand are not available until the second GDP release (due next month). As the ONS receive more information, they may revise estimates up as well as down, although we expect some upwards revisions in the coming months.

*...but GDP of 0.1% disappoints, raising questions over the sustainability of a recovery*

**Chart 4: GDP growth**



**Chart 5: Service sector output**



Source: Datastream, ONS, Markit, CBI, Schroders, 27 January 2010

Service sector growth has been particularly disappointing, especially as many large stores reported strong sales over the festive period. The Confederation of British Industry (CBI) reported a fall in the volume of retail sales for in its January survey, following weaker than expected sales over the fourth quarter.<sup>2</sup> As the CBI survey is carried out mid-month, it provides the first indicator of national sales for the Christmas period, as well as the first two weeks of January.

As Chart 5 (previous page) shows, our own service sector labour activity index indicated a significant improvement in the third quarter of last year, but had suggested flat quarterly growth for the fourth quarter – which the services data now shows.<sup>3</sup>

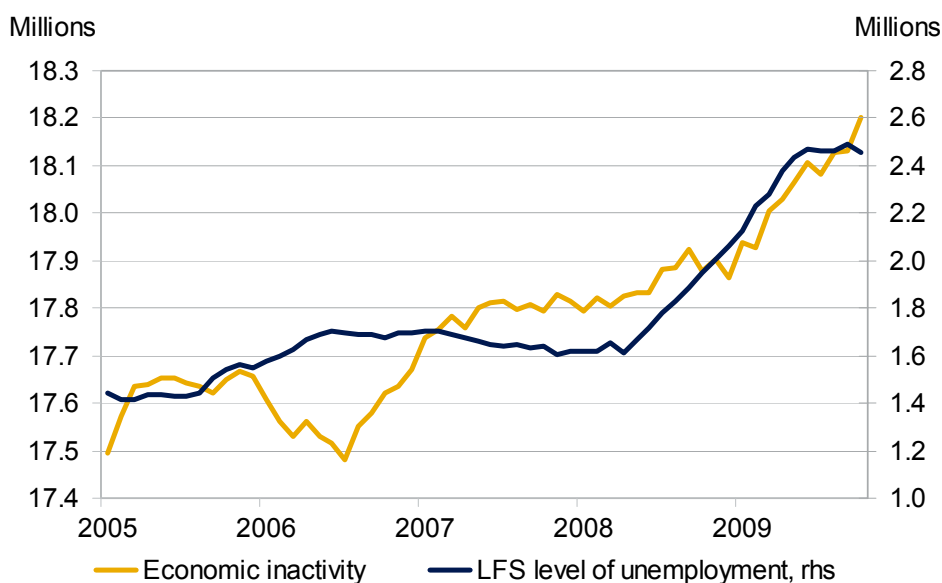
**Labour market headlines hide underlying weakness**

**Unemployment down, though headlines hide underlying weakness**

Unemployment was reported to have fallen in November for the first time in two years. While some politicians made hay with the news, the details behind the headline figures revealed a less positive story.

Unemployment is measured as the number of people who are without employment, who are active in the labour force. Chart 6 shows how the level of unemployment has risen since 2005, as well as the latest dip. The chart also shows the rise in the number of people who are economically inactive (not looking for work presently) since 2005.

**Chart 6: Unemployment levels vs. economic inactivity**



Source: DataStream, ONS, 27 January 2010.

We would expect economic inactivity to rise during a downturn. As job prospects worsen, some unemployed individuals become disheartened and decide to stop searching for work. They may choose to take a break, travel, or even undertake training or further education.

<sup>2</sup> January CBI Distributive Trade Survey, published 27 January 2010.

<sup>3</sup> Our labour activity index is constructed by taking service sector employment, earnings and hours worked together, which assuming a stable rate of productivity, gives us an early estimate of service sector output.

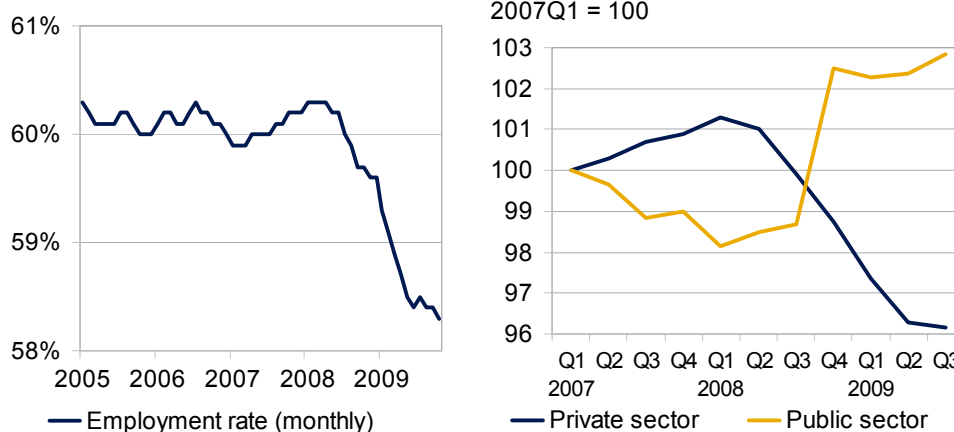
This has two potential effects. The first is to reduce spare capacity in the labour market, thus reducing competition and downward pressure on wages. This is a positive development in the sense that it reduces deflationary pressures.

The second effect however is more structural. The longer individuals are out of work, the less likely they are to return to work in the future. In the medium to long-term, this means an increase in the long-term unemployed, which can act as a negative drag on long-term trend GDP growth.

**Employment continues to fall, particularly in the private sector...**

Given the rise in people abandoning the workforce is greater than the latest fall in unemployment, this means that employment is actually still falling, as confirmed by chart 7. As the employment rate measures the number of people employed relative to the size of the population (taken as individuals over the working age of 16 years), it provides a better measure of overall conditions and the prospects for aggregate demand in the economy. Looking at a sector breakdown of employment, we find that private sector workers have been the worse effects, with public sector employment actually rising during the current crisis (Chart 8).

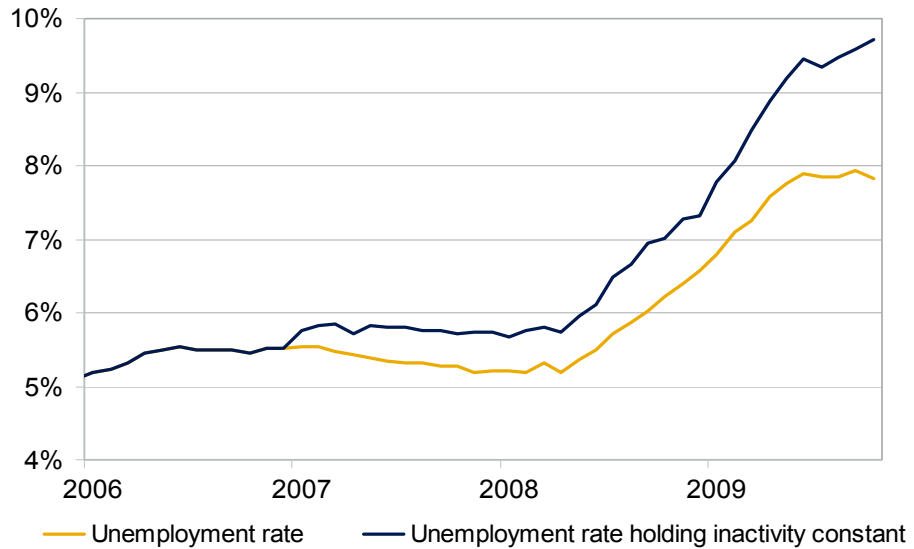
**Chart 7: Employment rate (16+ years old)    Chart 8: Employment by sector**



Source: DataStream, ONS, 27 January 2010.

To emphasise the deterioration in the UK labour market, Chart 9 shows the current rate of unemployment, and what the rate would be had those who have become economically inactive been counted as unemployed from the end of 2006. The rate of unemployment would be closer to 10% (or 3 over million people) and rising, rather than 7.8% today.

**Chart 9: Unemployment rate with constant participation**



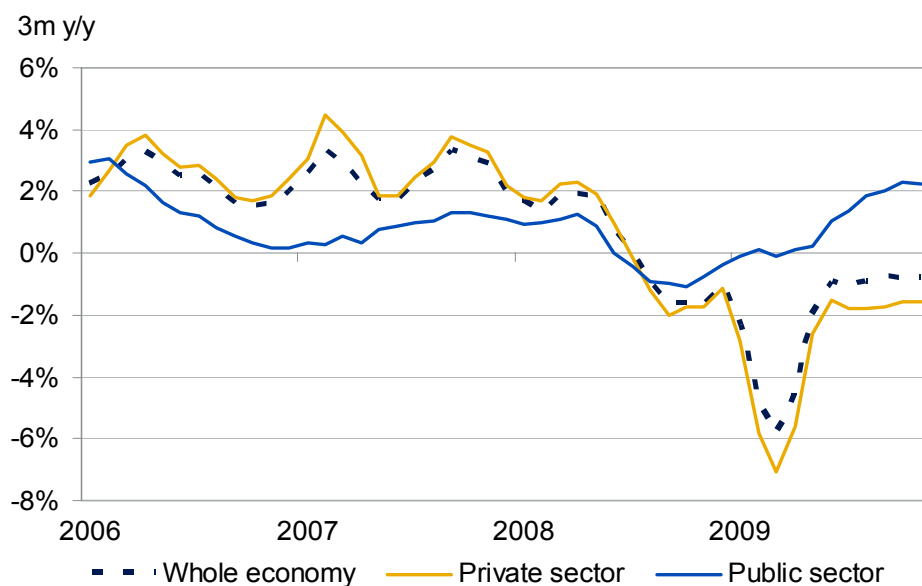
Source: DataStream, ONS, Schroders, 27 January 2010.

**Prospects for inflation**

With employment levels still falling and growth well below trend rates, the UK still has ample spare capacity in its economy. Real wage growth for the economy as a whole has been negative since mid-2008, with private sector wages worse affected (chart 10). Public sector wages are growing at their fastest pace since mid-2006 in real terms - a symptom of stronger trade unions and the government's objective to reduce wage inequality through public sector wage growth. The public sector makes up just under a quarter of the total workforce and with pressure on the government to reduce its deficit, we expect to see both public sector wage growth and employment levels falling from mid-2010 and beyond.

*...and so do real public sector wages...*

**Chart 10: Real average weekly earnings growth (CPI deflated)**



Source: DataStream, ONS, Schroders, 27 January 2010.

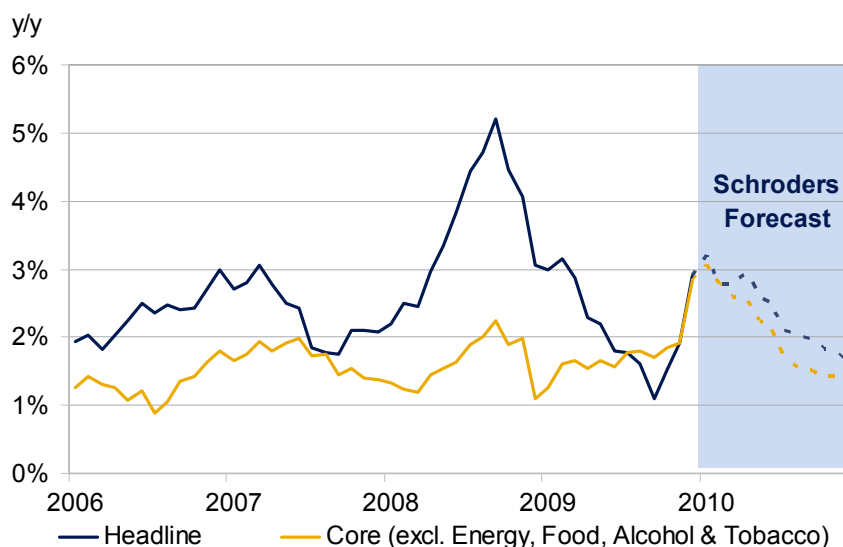


Negative real wages, falling employment and fiscal tightening on the horizon have all contributed to a weaker recovery in consumer confidence, and some of the surprising weaker retail sales survey data mentioned earlier. With the additional pressure on households to deleverage, we believe firms will struggle to increase prices over the next two years.

We expect headline CPI inflation to rise above the Bank of England's upper target limit of 3% in January, as VAT is reinstated at 17.5%. However, we, like the Bank of England, expect inflation to decelerate for the rest of the year, with core inflation causing most of the fall in the annual rate (chart 11).

**Chart 11: Schrodgers CPI inflation forecast**

*...keeping  
inflationary  
pressures subdued.*



Source: DataStream, ONS, Schrodgers, 27 January 2010.

### Bank of England policy

On the 28<sup>th</sup> of January, the Bank of England completed its planned £200bn asset purchase target. The Monetary Policy Committee (MPC) is due to announce whether they intend to extend the programme further, whether to pause the programme, or end it completely. Some city commentators have cited the disappointing GDP release as a reason why the MPC may choose to extend the programme further. After all, the committee did so and surprised the market twice in 2009, following weaker than expected GDP estimates.

*Bank of England  
not expected to  
extend quantitative  
easing...*

We do not expect the MPC to extend its programme, but we see little to gain from telling markets that it is ruling out further purchases in the future. 20 city economists polled by Bloomberg unanimously agree with our view of no new purchases announced in February.

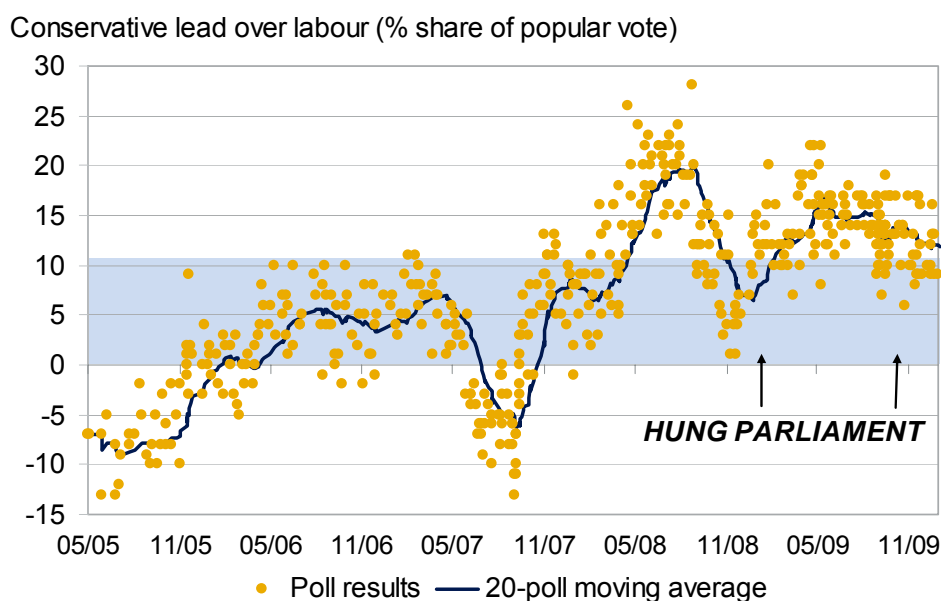
As for policy interest rates, MPC member Andrew Sentence acknowledged this month that as the UK emerged from recession, interest rates would have to rise. The difficulty of the MPC will be trying to set monetary policy during a period of great political uncertainty. As we have written on numerous occasions in the past, the UK government must set out a coherent plan to reduce its fiscal deficit in the near future, especially if it wants to avoid the market reaction Greece is enduring. However, a general election expected to be held in May means that we do not expect much detail until June at the very earliest.

There is the additional risk of no party winning an overall majority and a hung parliament. This would lead to either a coalition government being formed, or another election taking place. Both prospects would lead to a considerable delay in the announcement of changes to fiscal policy, and could even lead to a Sterling crisis.

*...and with a rising risk of a hung parliament...*

Chart 12 plots the lead of the Conservative party over the incumbent Labour party in all of the major political polls since the last general election in 2005. It also plots a simple 20-poll moving average, with the shaded area representing the region of results that would lead to a hung parliament. The first point we notice is since mid-2009, the 20-poll average has been drifting down, indicating a greater probability of a hung parliament. The second point is the dispersion of polls, increasing the uncertainty around the 20-poll average.

**Chart 12: General election polls\***



Source: ukpollingreport.co.uk, YouGov, ICM, Populus, ComRes, Aungus Reid, Ipsos-MORI, BPIX, Schroders, last poll end date: 24 January 2010.

\*Assumes Liberal Democrats win 20% share, and other parties win 10%

**The latest observation from the 20-poll average suggests a Conservative Party victory with a small majority (8 seat majority vs. Labour's current 63 seats in the House of Commons). However, we currently estimate a 35% probability of a hung parliament based on the results of the last 20 polls.**

*...is likely to keep policy rates on hold until the second half of 2010.*

Given the political uncertainty as well as the questions over the sustainability of a recovery, and the lack of inflationary pressure building, **we expect the Bank of England to keep policy interest rates on hold until September 2010.** Barring any major shocks, we expect gentle monetary policy tightening over the next two years, providing plenty of room for more aggressive fiscal tightening, regardless of which political party wins the general election. We forecast the policy rate to reach 2.5% by the end of 2011.

## Forecast Summary

### I. Forecast summary

#### Real GDP

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus	2011	Consensus
US	27.3	0.4	-2.5	-2.5	2.1	2.9	2.7	3.1
UK	5.1	0.7	-4.6	-4.7	1.1	1.5	2.5	2.2
Eurozone	25.8	0.6	-3.9	-3.9	1.2	1.3	1.6	1.6
Japan	9.3	-0.7	-5.7	-5.4	1.5	1.3	1.6	1.5
Australia	1.9	2.5	0.9	1.1	2.7	2.9	3.0	3.2
OECD	69.5	0.4	-3.5	-3.5	1.6	2.0	2.1	2.3
China	8.2	9.0	8.5	8.5	9.2	9.7	9.0	9.1
Emerging*	30.5	5.4	1.1	0.6	5.1	5.4	5.7	5.6
World	100.0	1.9	-2.1	-2.2	2.7	3.0	3.2	3.3

#### Inflation CPI

y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus	2011	Consensus
US	27.3	3.8	0.1	-0.3	2.7	2.2	1.0	1.9
UK	5.1	3.6	2.1	2.1	2.2	2.4	2.4	1.7
Eurozone	25.8	3.3	0.3	0.3	0.8	1.2	0.9	1.5
Japan	9.3	1.7	-1.2	-1.3	-0.5	-1.0	-0.8	-0.3
Australia	1.9	4.5	1.8	1.8	2.4	2.5	2.5	2.7
OECD	69.5	3.3	0.2	0.0	1.5	1.4	0.9	1.5
China	8.2	5.9	-0.5	-0.7	4.0	2.8	4.0	3.2
Emerging*	30.5	8.0	4.3	4.0	5.7	5.2	5.3	5.0
World	100.0	4.8	1.4	1.2	2.8	2.6	2.2	2.5

\* Emerging markets: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Slovakia, Romania, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

#### Interest rates

%	Wt (%)	Dec-08	Dec-09	Market	Dec-10	Market	Dec-11	Market
US	27.3	1.00	0.25	0.29	1.00	1.10	2.50	2.53
UK	5.1	2.00	0.50	0.61	1.25	1.53	2.50	3.03
Eurozone	25.8	2.50	1.00	0.72	1.50	1.50	2.00	2.39
Japan	9.3	0.10	0.10	0.47	0.10	0.37	0.25	0.47
OECD	67.5	1.52	0.53	0.50	1.09	1.18	2.00	2.23

Market data as at

28/01/2010

#### Key variables

FX	Current	Dec-08	Dec-09	y/y%	Dec-10	y/y%	Dec-11	y/y%
USD/ GBP	1.61	1.49	1.66	11.7	1.65	-0.6	1.55	-6.1
USD/ EUR	1.40	1.35	1.50	10.9	1.55	3.3	1.45	-6.5
JPY/ USD	89.9	91.1	88.0	-3.4	88.0	0.0	90.0	2.3
GBP/ EUR	0.86	0.91	0.90	-0.7	0.94	4.0	0.94	-0.4
Brent crude	71.2	40.5	75.0	85.2	82.2	9.5	83.3	1.4
US output gap %GDP	-7.9	-4.2	-8.0		-6.9		-4.5	
Unemploy. %	10.0	6.9	10.0		9.8		8.6	

Source: Schroders, Datastream, IMF, Consensus Economics (Jan. 10)

• Our forecast for global growth have been raised by 0.5% since the last CMF with the world economy now expected to grow by 2.7% next year. For 2011, we expect global growth to exceed 3% for the first time since 2007. The upgrade has largely been driven by a better than expected GDP performance in the third quarter and an increase in the contribution expected from the inventory cycle. Forecasts for the emerging markets have also been raised in response to the upgrade to OECD growth and the continued strength of China.

• The W shape growth profile. After the downleg in 2008 and 2009H1, the initial recovery is driven by the industrial sector and stronger government spending. The main impact of this is being felt now and should last until 2010 Q1. In mid-2010, we would look for growth to slow as the inventory cycle fades while final sales are constrained by ongoing de-leveraging in the household sector, tax increases and higher commodity prices. Thereafter, growth is expected to pick-up again as the corporate sector begins to recruit and employment rises following the improvement in profitability.

• After falling sharply in 2009, headline inflation is forecast to rise in 2010 following the recovery in commodity prices. However, outside commodities, deflationary pressures persist and the US is expected to experience a decline in core inflation (CPI ex food and energy) through 2010. In the absence of further gains in commodity prices, the slack created by the downturn keeps downward pressure on inflation such that the headline rate falls back in 2011. The pattern in the EM economies is different as there is less spare capacity and in economies like China, excess money growth is likely to push inflation higher in 2010 and 2011.

• Interest rates in the US and Europe are not expected to rise until September 2010 as the central banks pursue a cautious exit strategy from the ultra-loose period of monetary policy. By historical standards, rates stay very low through out the forecast period.

**Growth:** US GDP forecast raised to 2.2% for 2010 from 1.6%. In 2011, we look for growth of 2.7%, close to trend.

• Amongst the OECD, the weakest growth forecasts for 2010 can be found in Europe with the UK (1.1%) suffering from the after effects of the banking crisis and the Eurozone (1.2%) being held back by the strength of the Euro. Similarly, yen strength weighs on Japan which records growth of 1.5% in 2010.

• OECD activity now forecast at 1.7% in 2010 compared to a previous estimate of 1.3%.

• Emerging market growth has begun to pick up sharply led by China, which is now expected to grow by 8.5% this year and just over 9% in 2010. Overall, the emerging markets are expected to accelerate to 5% in 2010 from 1% in 2009.

**Inflation:** Global Inflation picks up in 2010 to 3% in line with higher commodity prices, however core rates drift lower as the output gap squeezes wages and pricing power. Consequently, headline inflation falls in 2011 in the OECD. By contrast, EM inflation is expected to remain high in 2011 as there is less spare capacity and the liquidity overhang increasingly feeds into consumer prices.

(Note: We use forward futures rates for commodity price assumptions).

**Monetary policy:** Central banks are expected to leave rates at current levels until September of next year when the Federal Reserve is expected to raise rates by 25 basis points (bps). The Bank of England and ECB are then expected to follow. Such a prolonged period of very low interest rates is consistent with concerns about the strength of the recovery and the banking sector, the need to offset tighter fiscal policy and low inflation at the core level. Policy is set to tighten in the EM with China expected to revalue the CNY in 2010H2.

**Currency:** The USD is expected to remain weak in 2010 as investors use the dollar to fund carry trades into higher yielding currencies. An outcome which the US authorities do not resist given the persistence of the current account and budget deficits. The USD stages a minor recovery in 2011 as the Fed continues to tighten.

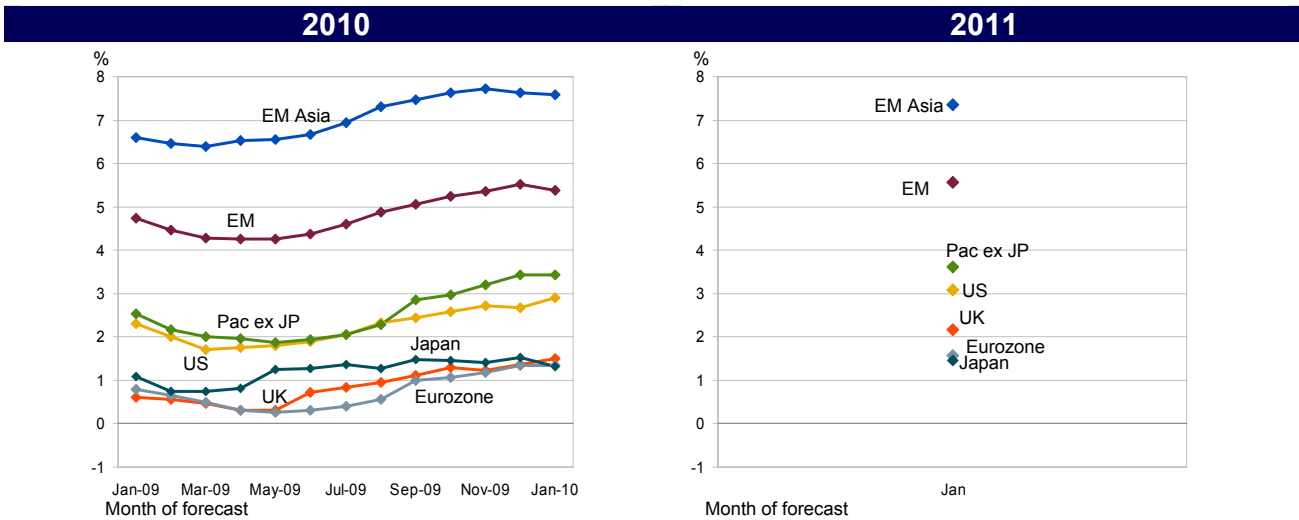
• The GBP is expected to weaken slightly over the forecast period to reflect the combination of a loose money/ tight fiscal policy which is more pronounced in the UK than elsewhere. Weakness is most marked against the EUR and JPY.

26th November 2009

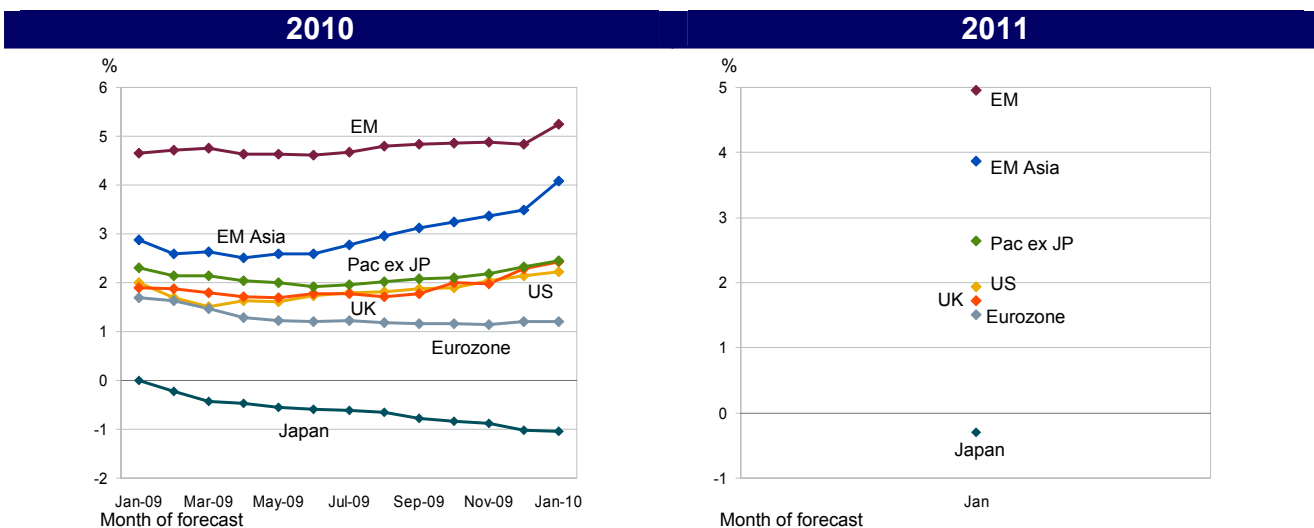
## II. Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

**Chart A: GDP consensus forecasts**



**Chart B: Inflation consensus forecasts**



Source: Consensus Economics (Jan. 10), Schroders

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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