

Schroders

Economic and Strategy Viewpoint

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Global: Where are the bond market vigilantes? (page 2)

- The ability of government bond markets to absorb significant and rising amounts of paper has had little apparent impact on yields, which remain low by historical standards. We see this as a reflection of the downturn in demand for private capital and the risk of a further deterioration in the economic outlook.
- Looking further ahead, however, the bond market vigilantes need not be completely relaxed. The US and UK are likely to be very different to Japan in terms of their supply side reaction and long run behaviour of inflation. One of the principal causes of deflation in Japan has been the failure of the corporate sector to purge excess capacity. By contrast, US and UK companies have been quick to restructure and although this means higher unemployment in the near term, the economy will build a better base for future growth.
- Funding considerations also point to yields being higher rather than lower in the medium term, unless the US and UK can demonstrate that they can raise savings and bring government borrowing under control. Otherwise, they will simply be swapping the debt problem from the private to public sector, threatening their long term creditworthiness.

UK: Taking away the punch-bowl (page 8)

- The Bank of England's Monetary Policy Committee surprised markets by not extending quantitative easing (QE) beyond the announced £125 billion programme. The possible end of QE sent gilt yields higher and it seems the market has forgotten the objectives of QE – increasing the supply of money to generate adequate inflation, and not to defend the cost of borrowing for government.
- UK public finances continue to deteriorate with politicians using the issue as a political football. Regardless of the impact of this current recession, the UK's medium term finances are very poor, even compared to Ireland, Spain and the US.
- There is clear evidence that the end of the recession is within sight, lending support should the MPC choose to stop QE. However, considerable risks remain and the committee will remember past recessions that featured false dawns and 'double dips', which it will be keen to avoid.
- In any case, the end of QE is close and yet gilt yields remain below recent peaks. It appears that some participants are still in denial and the market will be forced to go through a period of cold turkey, before sudden realisation hits.

Forecast summary (page 13)



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Global

Investor appetite for government paper is strong, despite record issuance

Where are the bond market vigilantes?

Despite record levels of issuance, investor appetite for government bonds remains strong. Auctions have been well bid and sovereign bond markets remain buoyant with yields close to their recent lows. The benchmark ten year US Treasury is currently yielding 3.3%, having declined from 4% only a month ago. Meanwhile, UK gilts are trading at well under 4%, even after the Bank of England's rather abrupt decision to slow down quantitative easing (QE) at their July monetary policy committee meeting.

Concerns that investors would balk at the amount of paper they were being asked to swallow have not been realised. All good news for the authorities who have plenty more to sell as they attempt to fund record levels of borrowing. Indeed, the lack of any sign of bond market unease has meant that discussion of a second fiscal package has already begun in Washington following the disappointing employment report earlier in the month.

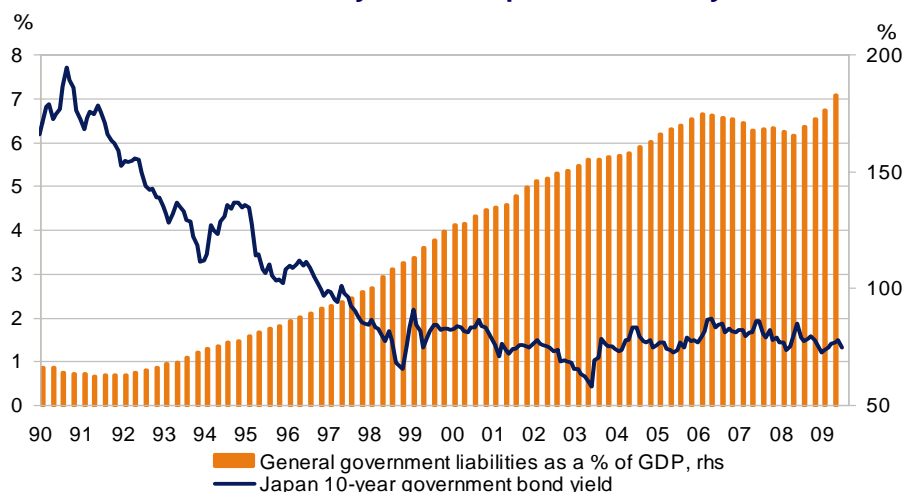
This has led some to ask, where are the bond market vigilantes? A reference to that group of investors who are seen as the guardians of the bond market investor's interest against the tendency of governments to borrow too much and boost inflation.

Higher supply, higher yields?

Weak demand for capital from the private sector...

The absence of any response should not be a huge surprise as experience from the past shows that the relationship between government borrowing and bond yields is not a simple case of higher supply, higher yields. Periods of economic weakness typically mean a fall in private sector demand for finance as company capex spending slumps, thus leaving the government to face little competition for funds. When combined with an increase in investor risk aversion, as the economic outlook darkens, the result is that the economy's savings are increasingly funnelled into safe government bond markets, so keeping yields down.

An extreme example of this can be seen in Japan in the 1990s where, despite soaring government debt and deficits, the yield on the ten-year government bond (JGB) fell significantly, from around 7% to less than 1% between 1990 and 1998. Since then the rate has deviated little from a range of 1 to 2%, even though government debt is approaching 200% of GDP (see chart 1 on next page).

Chart 1: Government bond yields in Japan 1990 - today

Source: Thomson Datastream, 17 July 2009

...and fears of a repeat of the Japanese experience of the 1990's have supported bond markets

Notwithstanding concerns about budget deficits, fears that the Japanese economic experience of the 1990s is about to be repeated on a larger scale by the US will have helped keep government bonds well bid. That risk may have been reduced recently as evidence of "green shoots" has emerged, but the prospect of deflation is still not remote and, as we have repeatedly argued, the need for de-leveraging in the private sector remains a powerful headwind on activity.

So perhaps the bond market vigilantes are not asleep. Instead, recognising the similarities with Japan a decade ago, they are happy to pay a premium for holding government debt in the US and UK despite the deteriorating fiscal outlook.

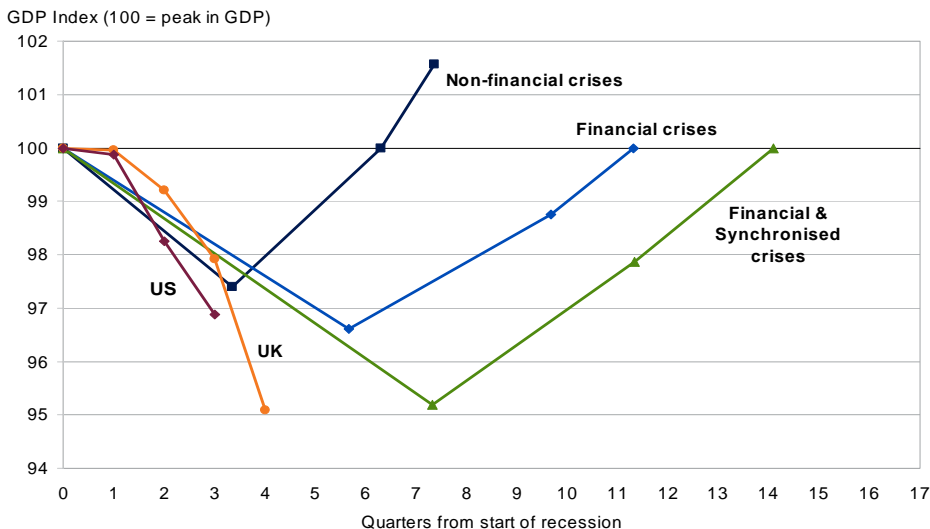
Speed of policy response reflects scale of crisis

Much has been made of the rapid speed of response of the authorities in this crisis compared to that of the Bank of Japan (BoJ) a decade ago. Having cut interest rates more rapidly, the US Federal Reserve and Bank of England embarked on quantitative easing (QE) at a far earlier stage than their Japanese counterparts. This suggests that we might avoid the prolonged deflation that hit Japan and the fear is that policy is left too loose for too long, resulting in a sharp rise in inflation. Furthermore, policymakers will be keen to avoid the mistake of the BoJ in tightening policy too early and stifling a nascent economic recovery. An indication that the risks are skewed toward higher, rather than lower inflation.

However, speed of action alone does not guarantee a better outcome: the response may be impressive, but the patient could still be dead on arrival. As we highlighted in last month's *Viewpoint*¹, analysis from the IMF (International Monetary Fund) clearly shows that recoveries from financial crisis are weaker than those in conventional cycles. Periods of synchronised financial crisis, such as the situation today, tend to be the weakest of all (chart 2 on next page). Remember, Japan had the benefit of an expanding world economy to provide an export led route out of the crisis. Clearly, this is not the case today with one of the main engines of global demand, the US consumer, broken.

¹ See Economic and Strategy Viewpoint June 30th 2009: Risk appetite returns, but for how long?

Chart 2: Recessions caused by financial crisis are deeper and recoveries slower



Source: IMF WEO (April 2009), ONS, 16 July 2009, Schroders
Based on 122 observations of recession and recovery in industrial countries since 1960

Along with the synchronised nature of the crisis, the depth of the recession and amount of global spare capacity today is more substantial. Consequently, the output gap and downward pressure on inflation will be greater. The authorities have acted earlier, but this must be seen in the context of a greater crisis.

Why Japan is not the road map for today

However, before taking 1990s Japanese bond market as the template for today's markets, there are two major differences, which suggest that US Treasury yields will not be following the path of JGB's toward 1%.

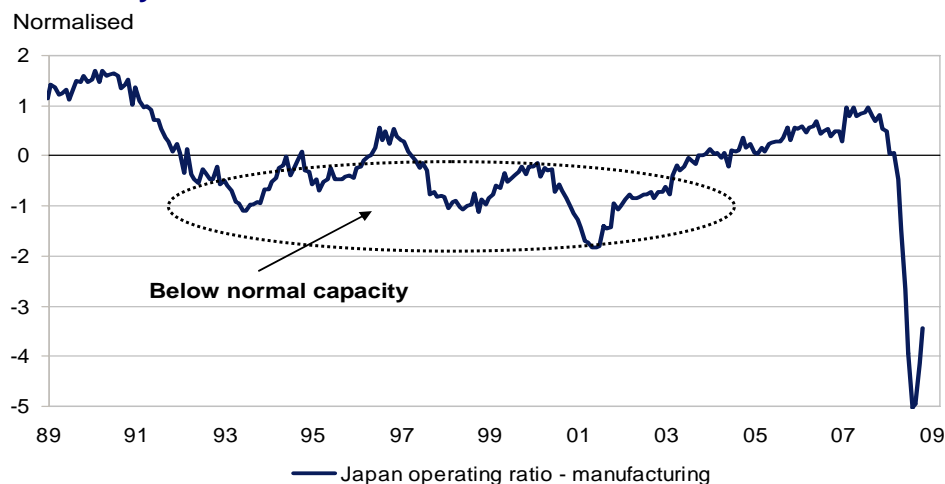
Greater inflation risk

The first is inflation. Although the near term risk is one of deflation as the output gap saps pricing power, we would not expect a sustained period of falling prices in the US or UK. The main reason relates to the response of the corporate sector in purging excess capacity.

One of the features of the Japanese economy is the convoy system where companies essentially support each other through periods of economic difficulty. Firms are not just linked through trading relationships, but also a complex web of cross shareholdings. What this means in practice is that it is very difficult to effect change and restructure failing companies as shareholder pressure is absent. Tie this in with the Japanese preference for lifetime employment and the result is that spare capacity tends to persist for considerable periods. From a macro perspective, this means that output gaps endure, thus creating over supply and persistent deflationary pressure. Japanese companies spent much of the 1990's operating below normal capacity, responding slowly to changed economic circumstances (chart 3 on next page).

Japan failed to restructure and cut spare capacity, unlike the US and UK today

Chart 3: Between 1991 and 2003, Japanese capacity utilisation was persistently weak



Source: Thomson Datastream, 16 July 2009

In contrast, US companies have been quick to restructure. Employment and capital spending have fallen sharply as firms have reacted to the downturn. Whilst this is clearly painful in the short run, as unemployment has risen significantly, the removal of unprofitable capacity means that those companies which survive the downturn will be better placed to regain pricing power.

Those who survive the downturn will be well placed to regain pricing power

In effect, the US is responding to the downturn in demand by cutting capacity. There is still considerable slack in the economy and inflation is more likely to fall over the next year than rise, but the output gap will be closing as potential output falls. In the long run, lower supply side potential is bad for an economy as it means lower trend growth. However, during a recession such a move should be temporary as it enables the economy to reallocate its resources toward more profitable activity. Trend growth can then pick up again as the economy directs its resources towards areas with more potential.

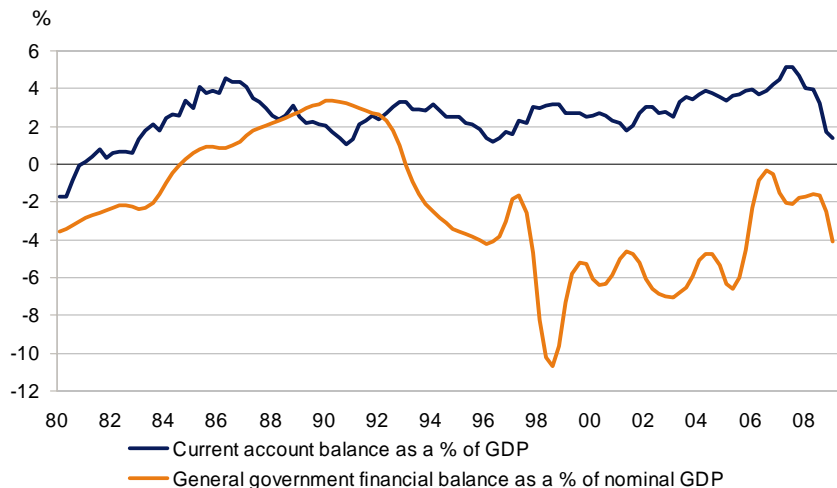
The problem for Japan was that the economy became ossified as firms did not restructure and release resources to start anew. This limited the rise in unemployment, but meant that profits were crushed as oversupply created deflation. The only winners were the large exporters who could escape the intensity of domestic competition.

This suggests that the US and UK and most of the European economy will not experience a prolonged period of deflation as excess capacity will be purged from the system. After a period of falling inflation, in which we would not rule out deflation for a spell, the surviving firms should regain pricing power and inflation will rise again.

Greater funding risk

Japan funded its budget deficit from domestic savings

It will take time before differences in inflation performance become apparent, but there is a more immediate risk that reflects differences in saving and borrowing behaviour, which have a bearing on funding, or creditworthiness. During the 1990s, Japan had a high level of domestic saving such that even as the budget deficit surged to more than 10% of GDP, the economy continued to run a current account surplus. Household savings rates remained high and the budget deficit could be funded internally without recourse to overseas investors (chart 4 on next page).

Chart 4: Japan budget deficit and current account

Source: OECD, Thomson Datastream, 16 July 2009

The UK and US rely on overseas investors to fund borrowing

This is in contrast to the situation in the US and UK which have run persistent current account deficits, a reflection of their low domestic savings rates. Both have had to rely on overseas investors to fund their budget deficits. For the US, of course, most of this has come from China where the authorities have been prepared to build their dollar holdings as part of a strategy to hold down the value of the renminbi.

In a global market where capital can flow freely across borders, reliance on overseas investors need not be a problem. However, investing overseas rather than at home brings in the additional risk of exchange rate fluctuations as well as possible political factors. As a result, overseas capital may be more footloose than domestically generated savings, creating the risk of a funding crisis. Bond markets would reflect this by demanding a yield premium on those who are more dependent on overseas capital.

In this respect, the UK is more vulnerable than the US. China has expressed concerns about fiscal trends in the US and has initiated a debate about the role of the US dollar as the world's reserve currency. However, there is little prospect of the dollar's status changing in this respect and China continues to accumulate reserves primarily in US dollars which have now passed \$2 trillion.

By contrast, the pound sterling gave up its reserve role many years ago and while still a major currency, it could be vulnerable given the need to draw in foreign capital to fund the budget deficit. An indication of the UK's reliance on overseas investment is apparent in the breakdown of the ownership of the gilt market, which shows that over one third is held by foreign investors.

More recently of course, the government has been funded by the Bank of England's QE programme, which has exceeded issuance from the debt management office (DMO). Effectively printing money to pay for government expenditure. Whilst this removes the need to generate domestic savings to fund the budget deficit, QE is clearly unsustainable (unless the UK was planning to follow the path of Zimbabwe).

This highlights the importance of the UK having a credible plan to bring government borrowing under control. The country has already been put on watch by Standard and Poor's and a downgrade from AAA status would undoubtedly result in higher yields.

Conclusion

The ability of government bond markets to absorb significant and rising amounts of paper has had little apparent impact on yields, which remain low by historical standards. We see this as a reflection of the downturn in demand for private capital and the risk of a further deterioration in the economic outlook.

Looking further out, the bond market vigilantes need not be completely relaxed. The US and UK are likely to be very different to Japan in terms of their supply side reaction and long run behaviour of inflation. Funding considerations also point to yields being higher rather than lower in the medium term, unless the US and UK can demonstrate they can raise savings and bring government borrowing under control. Otherwise, they will simply be swapping the debt problem from the private to public sector threatening their long-term credit worthiness.

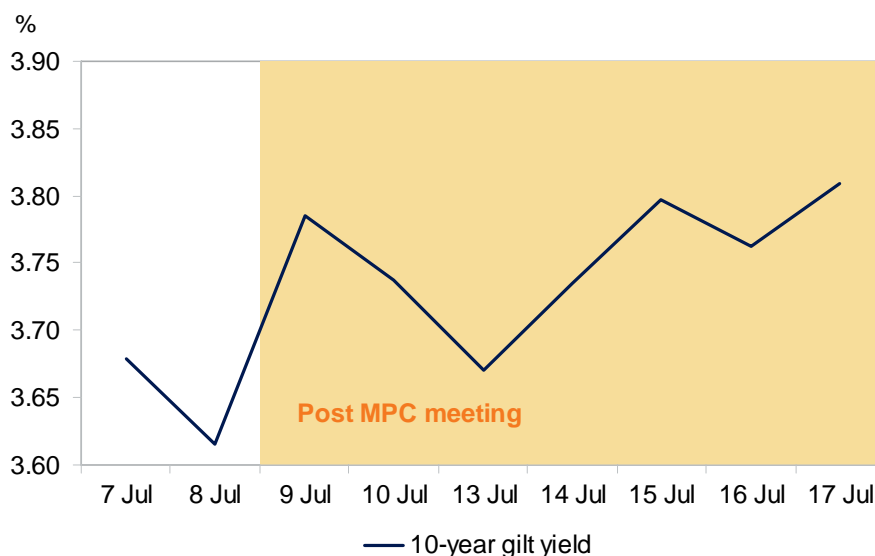
UK

It was inevitable that quantitative easing would come to an end

UK: Taking away the punch-bowl

It was inevitable that quantitative easing (QE) would come to an end at some point in time, but this month's events surprised most economists and market analysts alike. The Bank of England's Monetary Policy Committee (MPC) voted unanimously not to extend the planned £125 billion up to or beyond the £150 billion ceiling set by the Chancellor. Instead, the MPC has decided to reduce the pace of gilt purchases, which is now due to end on 29 July (albeit possibly temporarily). The gilt market was certainly caught off guard. Yields on 10-year gilts rose a little over 17 basis points on the day of the announcement, and have since continued to rise (Chart 5).

Chart 5: 10-year gilt yield



Source: Bloomberg, 21 July 2009

Bank of England only interested in boosting money supply...

This may be the end of the bank's purchases, or it may just be a pause and a way for the MPC to test the water ahead of a total stop. It appears the market has forgotten that this is an extreme policy that must come to an end. The MPC has been very clear that its objective in utilising QE is to increase the supply of money to generate adequate inflation, and not to defend the cost of borrowing for government.

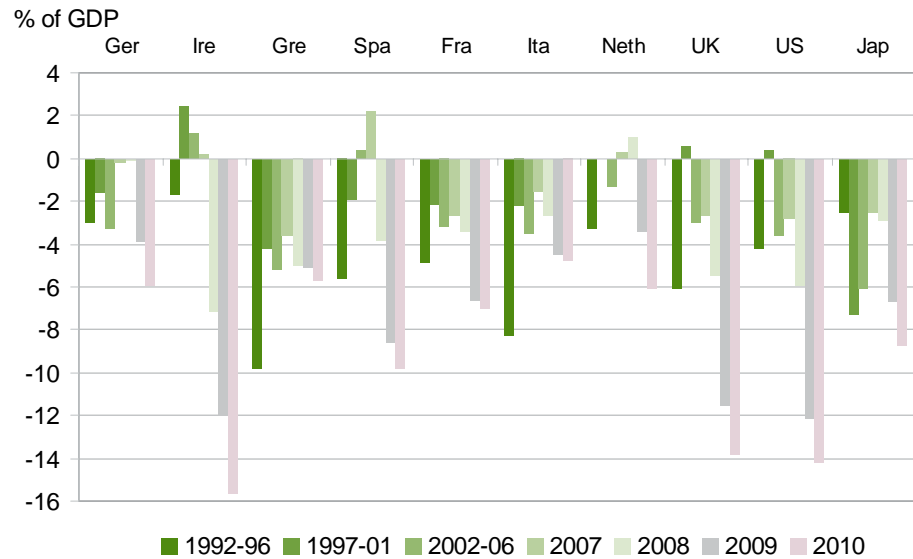
The MPC is not in the business of defending the cost of borrowing for the government. This has never been more evident than during Mervin King's attack on the Government in June where he criticised the lack of planning for bringing public debt back under control. This of course followed the Governor's first public criticism of spending plans in March before the Treasury select committee, ahead of the Chancellor's budget.

Public finances in crisis

...as government borrowing reaches all time high

We have highlighted in the past the public finances crises this and future governments will face. The MPC's action (or lack of it) this month could be seen as a warning of things to come for the government. Chart 6 (next page) shows the path of government fiscal balances and the European Commission's forecast until 2010. It is worth bearing in mind that this forecast was done before the Budget 2009 record borrowing announcement. Nevertheless, the UK along with the US and Ireland are in a perilous position.

Chart 6: Government surpluses(+)/deficits(-)

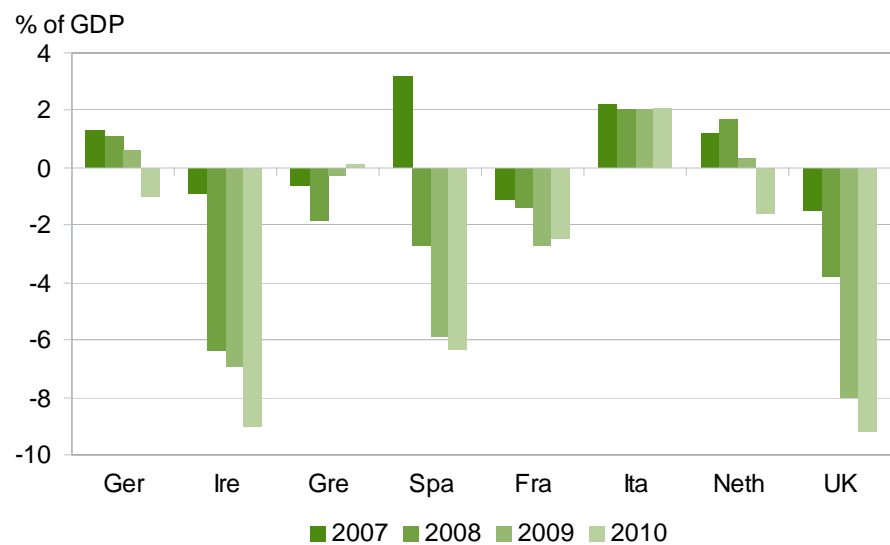


Source: European Commission Forecast, Spring 2009, 21 July 2009

Recession not the only cause of the crises in public finances

Much of the rise in the UK's government deficit is due to a sharp fall in tax revenues and increase in the take-up of unemployment benefits as a result of the credit-crunch. Official figures show public borrowing increased to a record-breaking £13 billion in June while tax revenues in the year to June fell by £32 billion, the biggest fall since the 1920's. Despite these cyclical factors, chart 7 shows that spiralling debt cannot just be blamed on the cyclical nature of the current recession. By adjusting the government deficit for cyclical effects and removing the cost of interest payments, we can assess the medium term state of public finances. Looking at the cyclically adjusted primary deficit, we can see that the UK is expected to experience a very sharp deterioration, and is expected to be in a worse position than Ireland, Spain and Italy.

Chart 7: Cyclically adjusted primary surpluses(+)/deficits(-)



Source: European Commission Forecast, Spring 2009, 21 July 2009

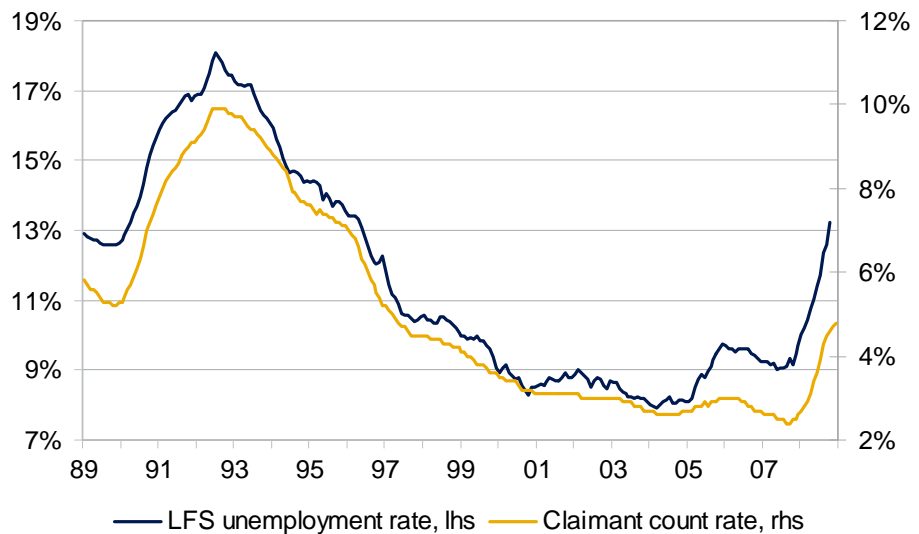
So why stop now?

Green shoots continuing to grow...

The question that then arises is why would the Bank of England stop QE now? There has been little sign of new money boosting lending so far, and the third estimate of GDP for the first quarter showed that the depth of the recession was worst than originally thought (-2.4% versus previous estimate of -1.9%). The MPC meeting minutes pointed to the forward-looking private business surveys and a possible peak in the rise in unemployment.

July's labour market statistics release showed a continued slowdown in the rise in the claimant count for May and June. Though the claimant count measure underestimates total unemployment, it does tend to provide an indication of trends and turning points (Chart 8).

Chart 8: Unemployment and claimants

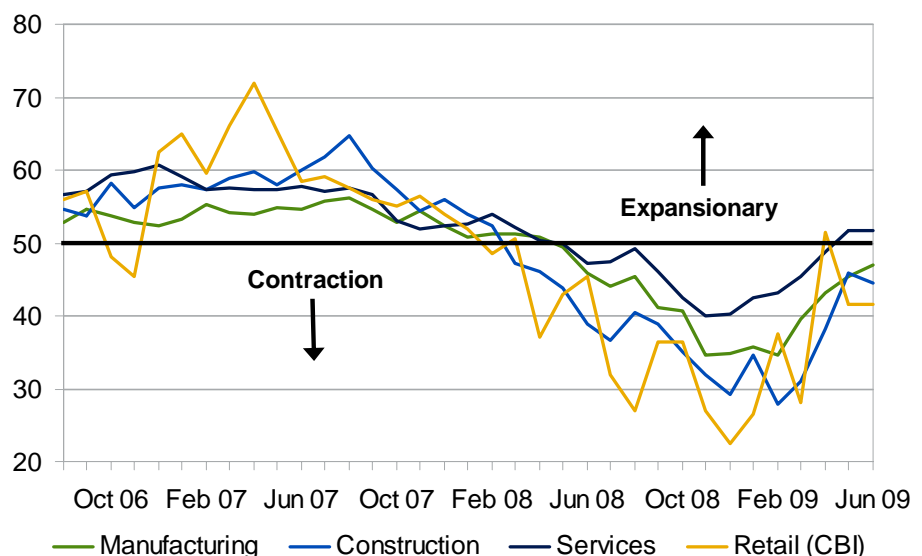


Source: Office for National Statistics, 21 July 2009

... as PMIs signal end of recession is near...

As for private business surveys, the CIPS/Markit purchasing managers indices (PMIs) have continued to improve over recent months (Chart 9).

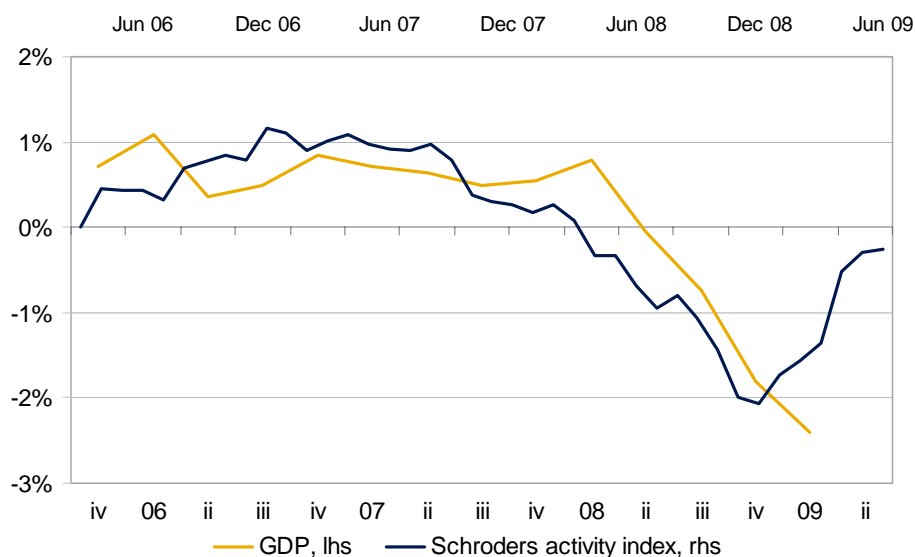
Chart 9: Private business surveys



Source: CIPS/Markit, CBI, DataStream, 21 July 2009

Most notably, the service sector PMI has been above the 50 expansion/contraction mark for the last two months. The manufacturing and construction PMIs are also improving, but remain in negative territory while the Confederation of British Industry's (CBI) retail sales survey is also showing signs of recovery. Taking the four indicators above and weighting them together by the sector weights for GDP, we have created the Schrodgers Activity Index. As illustrated in Chart 10, the Schrodgers Activity Index provides a monthly estimate for GDP. The index is not quite suggesting a return to positive growth, but the estimate for second quarter GDP should show a marked improvement.

Chart 10: Schrodgers activity index



Source: Office for National Statistics, DataStream, Schrodgers, 21 July 2009

At the time of writing, the Bloomberg consensus for second quarter GDP growth was -0.3%. Should second quarter GDP growth meet expectations and taking the above evidence (improving unemployment and PMIs) together with sticky inflation highlighted in last month's viewpoint, the MPC may decide to end QE sooner rather than later. In fact, the MPC have said on a number of occasions that rising yields are an early indication of a recovery.

A little more for good measure?

... however risk of double-dip is high and the MPC will want to avoid a fallback

Despite the more positive news, very few economists are forecasting a strong economic recovery. The UK consumer faces substantial risks in the form of higher unemployment, weak wage growth, and the need to deleverage. In addition, the current political debate regarding tax and spending generates great uncertainty. The debate is no longer about whether or not to cut public spending and raise taxes (despite the efforts of Prime Minister Gordon Brown) but by how much and by when. This has been unnerving for consumers who we expect to increase precautionary savings – having a negative impact on the economy in the short term.

The MPC will be aware of these risks and will remember the false dawns and 'double-dips' of past recessions, particularly those in the 1970s. The committee may therefore decide that while it has the mandate, it will increase its purchasing programme to the £150 billion ceiling, but then start to discuss the dreaded exit strategy.

In denial

Even if the Bank of England increases purchases by another £25 billion, surely the end of QE is in sight. So why are gilt yields still trading below recent peaks? Can it be due to the sell off in risk-assets over the past month? Naturally, it is very difficult to disentangle the effect of QE from changes in risk appetite.

Since the MPC announcement, gilt auctions have fared well with sufficient demand to cover the government's borrowing needs. We expect this trend to continue until the MPC announces when QE will end. However, with yields still some 14 basis points below their recent 4% peak, gilt yields look remarkably low given the amount of supply that is about to flood the market. It appears some participants are still be in denial over the withdrawal of QE and the market will be forced to go through a period of cold turkey, before sudden realisation hits.

Conclusion

The July MPC meeting minutes stated *"little evidence had emerged since May to change the Committee's views about the broad shape of the prospects for the economy in the medium term, although the risks to GDP in the near term had probably diminished"* – a clear indication that the committee feel that medium term risks remain significant.

There will be no further announcements until the MPC next meet in August, which along with the *August Inflation Report*, presents a good opportunity to reassess the size of the asset purchase programme and to clearly communicate their strategy (wishful thinking perhaps).

Forecast Summary

I. Forecast summary - Schroders

Real GDP						
y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	1.1	-3.1	-2.6	0.8	2.1
UK	5.8	0.7	-4.4	-4.0	0.3	0.8
Eurozone	25.5	0.7	-4.8	-4.4	0.1	0.4
Japan	9.2	-0.7	-6.5	-6.2	1.0	1.4
Australia	1.9	2.5	-1.0	-0.2	1.5	1.5
OECD	71.4	0.7	-4.2	-3.8	0.6	1.3
China	7.1	9.0	7.0	7.5	7.5	8.4
Emerging*	28.6	6.3	1.2	0.5	3.8	4.5
World	100.0	2.3	-2.6	-2.5	1.5	2.2

Inflation CPI						
y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus
US	28.9	3.8	0.0	-0.6	1.2	1.8
UK	5.8	3.6	1.9	1.8	1.7	1.8
Eurozone	25.5	3.3	0.4	0.4	0.5	1.2
Japan	9.2	1.7	-1.5	-1.2	-0.6	-0.6
Australia	1.9	4.5	1.8	1.6	1.5	2.2
OECD	71.4	3.3	0.2	-0.1	0.7	1.3
China	7.1	5.9	3.0	-0.3	4.0	1.6
Emerging*	28.6	7.9	2.7	4.2	3.3	4.6
World	100.0	4.7	0.9	1.2	1.5	2.2

* **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

Interest rates						
%	Wt (%)	Dec-08	Dec-09	Market	Dec-10	Market
US	28.9	1.00	0.25	0.78	0.75	2.08
UK	5.8	2.00	0.50	1.12	1.00	2.84
Eurozone	25.5	2.50	1.00	1.02	1.25	2.13
Japan	9.2	0.10	0.10	0.48	0.25	0.59
OECD	69.5	1.52	0.53	0.86	0.89	1.97

Market from forward futures strip as at 16/07/2009

Key variables						
FX	Current	Dec-08	Dec-09	y/y%	Dec-10	y/y%
USD/ GBP	1.64	1.49	1.55	4.3	1.40	-9.7
USD/ EUR	1.41	1.35	1.40	3.5	1.30	-7.1
JPY/ USD	93.8	91.1	90.0	-1.2	100.0	11.1
GBP/ EUR	0.86	0.91	0.90	-0.8	0.93	2.8
Brent crude	62.6	40.5	59.1	45.9	65.7	11.2
US output gap %GDP	-6.3	-4.1	-8.2		-8.7	
Unemploy. %	8.1	6.9	9.7		10.5	

Source: Schroders, Datastream, IMF, Consensus Economics (July 09)

Key changes to UK baseline forecast:

- Slight upgrade to growth in 2009 and 2010 as monthly output data suggest recession is close to an end. We expect positive GDP growth over the second half of 2009, but growth to remain weak going into 2010.
- Stickier than expected inflation has led us to revise up the CPI and RPI forecast for 2009. Our inflation model showed both measures bottoming out in the third quarter of this year as the falls in energy prices last year worth their way out of base effects.
- Given the weak growth profile, we have not changed our rates forecast. We do not expect any rate rises until the second half of 2010.

	Changes to UK baseline forecast			Forecast	
	2008	2009	2010	2009	2010
GDP Growth (%)	0.7	-4.4	(-4.5)	0.3	(-0.5)
CPI inflation (yr average %)	3.6	1.9	(1.6)	1.7	(1.5)
RPI inflation (yr average %)	2.7	-1.0	(-1.3)	1.7	(2.3)
BoE policy rate (Dec %)	0.50	0.50		1.00	

Source: Schroders, 21 July 2009

Numbers in brackets represent previous forecast.

Key changes to Eurozone baseline forecast:

- Upward revisions to 2009 and 2010 growth as monthly industrial orders and trade data has been more supportive of a near-term recovery, particularly in Germany and France.
- Our inflation profile has been revamped with a new model. Inflation is forecast to remain weak but rise into 2010 as the output gap begins to close and higher non-core inflation (energy prices and food) feeds in.
- Weak money supply growth will keep the Refi. rate firmly grounded well into 2010.

	Changes to Eurozone baseline forecast			Forecast	
	2008	2009	2010	2009	2010
GDP Growth (%)	0.6	-4.8	(-5.5)	0.1	(-0.5)
HCPI inflation (yr average %)	3.3	0.4	(1.0)	0.7	(-0.5)
ECB policy rate (Dec %)	1.00	1.00		1.25	

Source: Schroders, 21 July 2009

Numbers in brackets represent previous forecast.

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

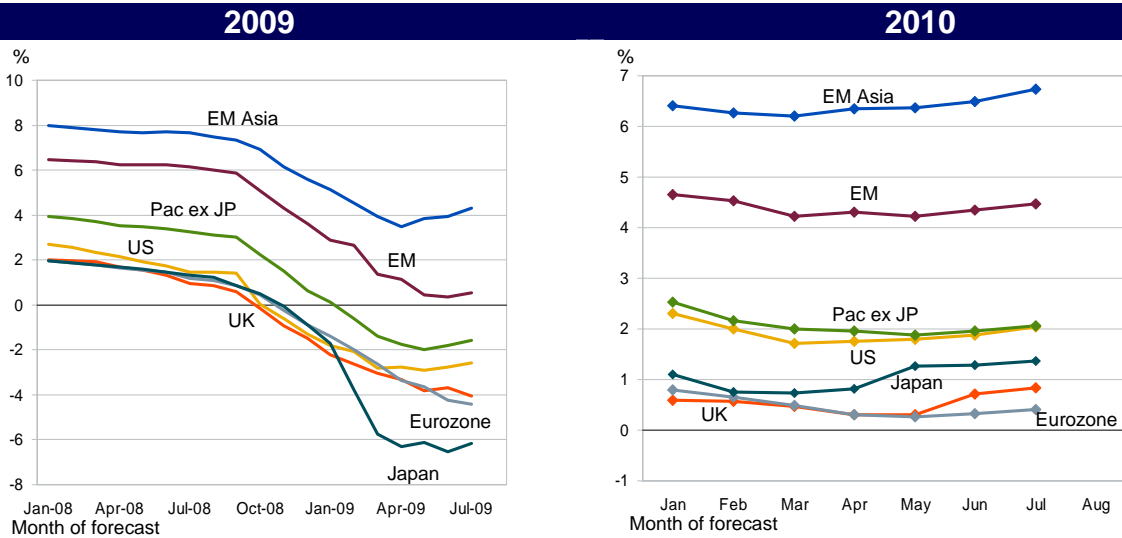
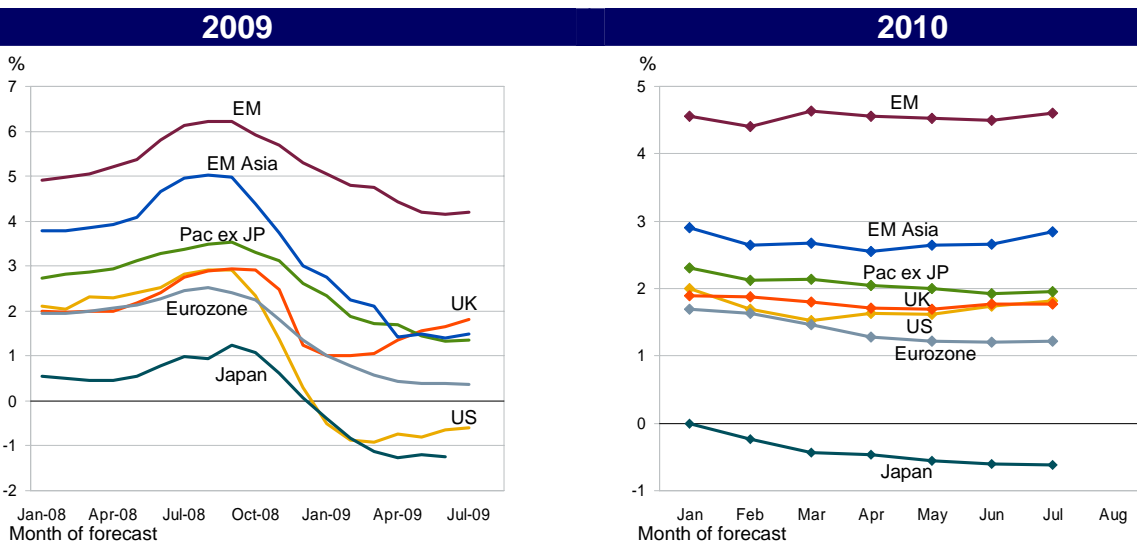


Chart B: Inflation consensus forecasts



Source: Consensus Economics (July 09), 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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