

Schroders

Economic and Strategy Viewpoint

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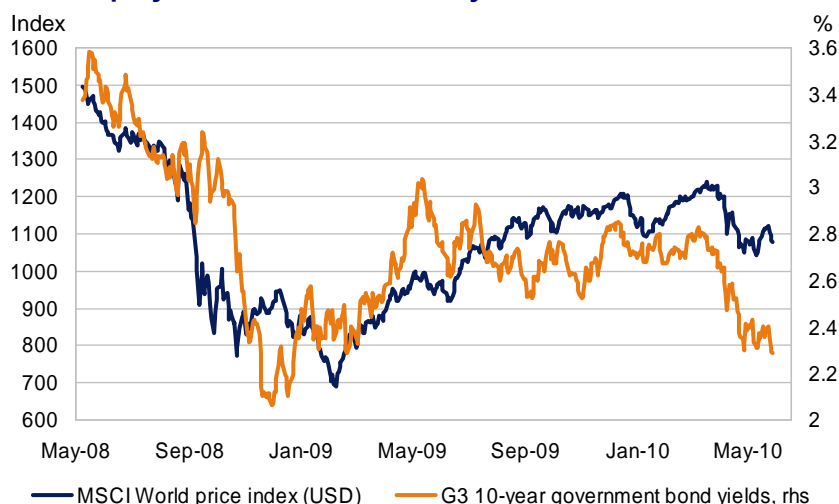
Global: The return of risk aversion

- **Doubts about sovereign creditworthiness and the economic recovery have led to a horrid performance from equity markets in the second quarter. With government bonds in the US, Japan and Germany rallying, risk aversion has increased sharply.**
- **We remain confident in our baseline forecast of a modest global recovery but do not see a quick solution to the sovereign crisis. Furthermore, near term cyclical indicators look set to turn down as the boost from the inventory cycle fades and investors are likely to be debating the double dip through the summer.**
- **However, on our measures markets are already behaving as if we have gone back into recession given the outperformance of the more risk averse areas and equity valuations are looking attractive again. Consequently, we maintain a modest tilt toward risk assets, hedged by holding some high quality bond exposure, gold and by avoiding the Euro.**

Eurozone: Will the Eurozone double-dip?

- **Weakness in Southern Europe is likely to continue for some time. This is likely to have both a direct impact on aggregate growth along with indirect impacts which include trade channels, financial markets, and the spread of contagion to sovereigns. Will the sovereign debt crisis cause a double dip recession?**
- **Taking a close look, we think downside risks to wider Eurozone GDP growth are limited. The weakness of the Euro has already boosted export orders, though more export oriented member states are more likely to benefit than the rest. As a result, Eurozone growth is expected to remain positive, but will be more uneven across member states.**

Global equity markets and G3 bond yields



Source: Thomson Datastream, Schroders, 28 June 2010
 G3: weighted average of US, German and Japan 10-year government bond yields

Global

Risk assets have weakened during the second quarter

The return of risk aversion

After a reasonable start in April, equity markets have had a weak quarter with the US S&P 500 recording its worst performance in May for 48 years. Government bond yields have fallen with the G3 yield touching its lowest level since the early part of 2009 (chart on front page). Risk aversion has risen and the Credit Suisse risk appetite indicator is in panic mode. Alongside G3 government bonds, the US dollar (USD) and gold have strengthened as investors have sought safe havens.

Echoes of 2008

Not surprisingly, the situation has been compared to late 2008 as the collapse of Lehman Brothers drove down both equity markets and government bond yields. Although market behaviour is similar, there are key differences. The tightening of financial conditions has not been as severe in credit or interbank markets and bank lending has not dried up, a reflection of the better position of the sector in terms of profitability and capital.

In 2008, markets fell as leveraged investors scrambled for liquidity. Many were forced sellers and markets became dysfunctional. Today there are areas where funding is hard to come by such as the Spanish banks, but liquidity generally remains healthy albeit as a result of central bank action and the excess private sector savings generated by the downturn.

Solvency is now the issue

However, this time the concern is solvency rather than liquidity. As we noted in the last Viewpoint “as budget deficits rise to the highest levels ever seen during peace time, markets have begun to question the sustainability of government support”. Fiscal tightening has become the order of the day as governments now need to demonstrate their ability to get borrowing back under control.

Liquidity crisis tend to be brutal but short, sovereign debt crisis are more drawn out

History is repeating itself. The move from banking to fiscal crisis has been well documented, most recently by Reinhart and Rogoff in their study of 800 years of financial crisis¹.

The difference between a liquidity and a sovereign debt crisis is that whilst the former tend to be brutal and short, the latter are less violent, but more drawn out. Liquidity crisis are solved by plugging gaps, whereas solvency crisis require something more permanent. It is the difference between a sticking plaster and surgery.

Consequently, we will be facing the issue for some time. The process of bail out, trying to enforce conditions, relaxing conditions, debt forgiveness and eventual restructuring can take years. Meanwhile, the fiscal crisis will act as a long run headwind on growth as governments bring borrowing under control.

Markets are acknowledging this through the fall in bond yields and interest rate expectations. Monetary policy will have to stay loose to offset the tightening of fiscal policy. Equities are suffering because growth may well be weaker given (a) the difficulty monetary policy has in stimulating growth in an environment where lenders and borrowers are de-leveraging and (b) the private sector will be paying the higher taxes needed to put the public finances in order.

¹ See “This Time is Different: Eight Centuries of Financial Folly”

2

Funding crisis?

However, we should keep the issue in perspective. The crisis is in the Eurozone and is not global. Markets are differentiating between debtors, but have not rejected the idea of lending to governments altogether. Capital has been reallocated within bond markets but not withdrawn. Although there is constant talk in some quarters of the US government defaulting, 10-year Treasury yields have just dropped below 3%. Even within Europe, German Bunds are heading towards 2.5%. This could change, but does not indicate a global funding crisis at present.

The baseline view

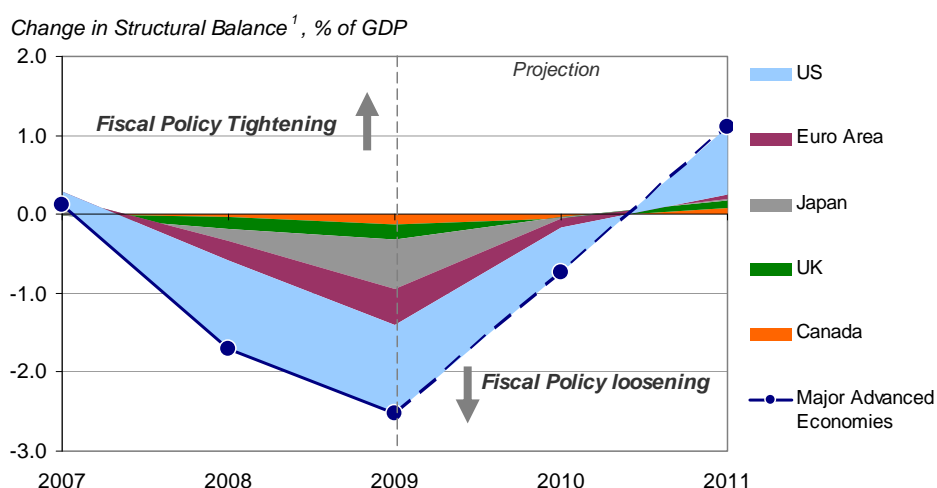
In terms of our central forecast, greater fiscal tightening in Spain, Portugal, Italy and Greece will have an adverse effect on demand, as will greater uncertainty over the Euro and increased caution by the Euro area banks. The fall in the Euro will reduce activity in the rest of the world as Euro area companies gain market share. It is therefore a deflationary shock.

Euroarea crisis should not derail global growth

However, the effect should not be enough to derail global growth. The main tightening countries (Portugal, Ireland, Greece and Spain) account for less than one fifth of Eurozone GDP, which in total represents 26% of global activity. Not insignificant, but the Euro area's contribution to global growth has been on a declining trend and the region is not a driver of global activity, a reflection of the weakness of consumption. The Euro area's trade position with the rest of the world is close to balance. Of course, the region can and will become more of a drag on global activity, but this should not be significant enough to derail the world economy (see below for more on the Eurozone).

Finally, it should also be remembered that overall Euro area fiscal policy will be expansionary this year as Germany and others ease taxes and spending. Alongside the other advanced economies, global fiscal policy is expansionary as the structural deficit expands. The drag will come in 2011 as policymakers tighten and the structural deficit contracts (see chart 1).

Chart 1: Fiscal policy turns contractionary next year



Source: IMF, World Economic Outlook, April 2010
 1. Cyclically-adjusted budget deficit

but remains the biggest threat to the baseline forecast

Arguably, this is too sanguine. We are assuming that the political will to relax the conditions attached to loans for Greece will be forthcoming and that when combined with action from the ECB, this will limit the contagion effect from Greece to other countries. However, there is a risk that Euro governments balk at the level of support required and that the crisis deepens. To capture this we attach a high probability to a crisis scenario where growth and the Euro are much weaker with more dramatic effects on global GDP.

China

There are other threats to growth. In China, the authorities are attempting to cool activity in order to bring property speculation under control and prevent a damaging rise in inflation. In our view, they have to tighten further as the economy has a significant overhang of liquidity following last year's fiscal expansion. There is evidence that action taken so far is having an effect, but is unlikely to be enough to prevent further rises in inflation through the summer.

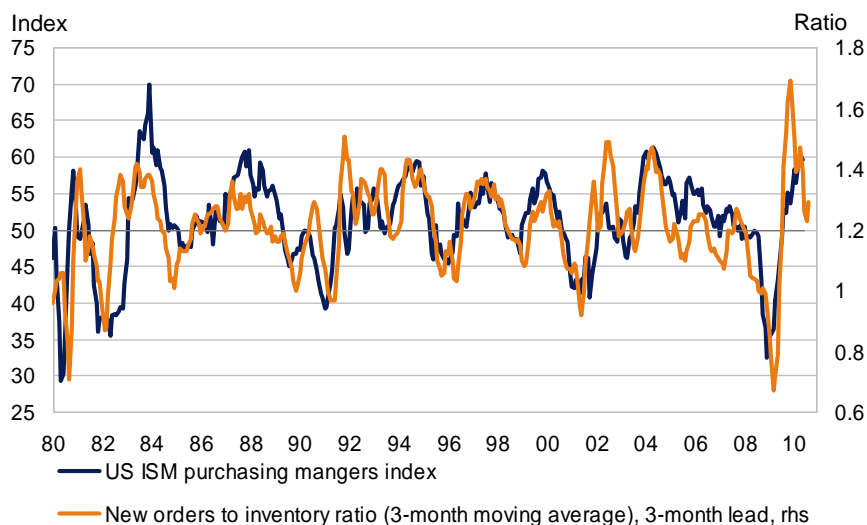
The recent announcement by the People's Bank of China suggests that part of this action will include a revaluation of the Yuan. However, there is a risk that action will be delayed or inadequate and we could still be in for an uncomfortable period where US politicians in Congress bring protectionist legislation against China.

The end of the beginning

We still believe that the world economy is on a sustainable recovery path led by the improvement in profitability and increase in corporate spending on capex and employment. Growth may not be strong by past recovery standards, but it should be sustainable. Although the May US Employment report was greeted with dismay as the number of new private sector jobs fell short of expectations, the report showed a healthy rise in hours worked and wages. Consequently, household incomes continue to improve.

Boost from inventory rebuild is waning

Nonetheless, fears of a moderation in growth are not without foundation as there is evidence that the initial phase of the recovery is drawing to a close. The sharp upswing generated by a change in inventory accumulation has nearly run its course. For example, the ratio of inventories to orders has turned down, signalling weaker ISM readings ahead (chart 2 on next page).

Chart 2: US ISM to moderate as inventory turns

Source: Thomson Datastream, 9 June 2010

Furthermore, countries at the leading edge of the upswing (i.e. the Asian emerging markets) are beginning to experience a moderation in growth. On this basis, regardless of developments in Europe, we should be heading for a peak in activity.

For those still debating the shape of the recovery, such an outcome would be consistent with a 'square root shape' where growth levels out after a sharp rebound. However, fears of a double dip are likely to persist in today's febrile environment and will have a bearing on investment strategy in coming months.

Asset allocation strategy

**Risk assets
normally perform
well in the
recovery phase**

Out of recession and into recovery...

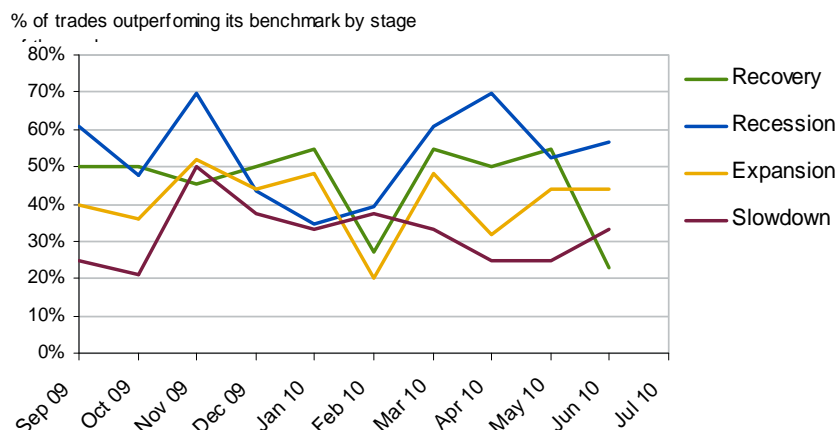
Using our four stage cycle model, we moved out of recession and into the recovery phase in April. This is generally a good period for risk markets, often referred to as the "sweet spot" where rising activity and earnings are accompanied by low inflation and interest rates. When taken from start to finish, equities have always beaten cash over this phase, which averages 17 months in duration. Returns are driven by the growth in earnings as valuations tend to decline i.e. price-earnings ratio (P/E) falls – a move consistent with higher real interest rates and bond market underperformance as activity strengthens. Commodities perform well in the recovery phase led by outperformance by industrial metals.

...and back?

Clearly, markets are not following the script at present. Using the results from our models, we have been able to identify a number of trades, which perform at different stages of the cycle. By then looking at actual performance, we have been able to back out what the market is saying about the economic cycle. On this basis, the past 3 months have seen a marked move away from recovery trades, which have almost stopped performing (chart 3). Instead, recession trades have come to the fore. For example, gold and investment grade bonds have performed relatively well, whilst more cyclical assets like industrial metals have underperformed.

Market performance indicates that fears of a double-dip are driving investors at present

Chart 3: Recovery trades experience a plunge in performance



Based on 3 month rolling performance periods.
Source: Schroders

So effectively the markets are behaving as if we have gone back a phase into recession – a move consistent with fears about growth and a double dip. Whilst we see such concerns as over done, the loss of growth momentum discussed above will mean that it may be difficult to change this in the near term.

Tactical indicators suggest caution may persist

For example, the ISM index is likely to decline, a development normally associated with a spell of equity market weakness and strength in government bonds. In addition, the risk appetite index is also signalling a period of weakness in equity markets relative to bonds. We would see these as tactical indicators, which can enhance timing when in different phases of the cycle.

Arguably, markets are already discounting bad news. On a valuation basis, equity markets are beginning to look attractive. Our profits forecast suggests that the US market is on a prospective P/E valuation of around 13x, well below the historical average of 16x since 1950.

Table 1: US profits forecasts

	2008	2009	2010F	2011F
Economic profits				
y/y%	-23.8	-2.7	28.8	5.0
Non.fin. share % GDP	6.4	6.4	7.9	9.1
Operating \$	50	57	82	86
y/y%	-40	15	44	5
Reported \$	15	51	75	79
y/y%	-78	243	47	6
S&P500 PE (market at 1078)				
Based on operating EPS	21.8	19.0	13.1	12.5
Based on reported EPS	72.4	21.1	14.4	13.6

25/06/2010

Source: Schroders June 2010

Pulling this together means that we would remain structurally positive on equities and risk assets, but would be tactically cautious whilst markets fret about growth and sovereign risk. In practice, this means maintaining a modest positive degree of exposure to risk assets, whilst holding bond duration and gold positions as a hedge. We would also be underweight the Euro and very underweight cash.

EUROZONE

Eurozone: Will the Eurozone double-dip?

The sovereign debt crisis in southern Europe has raised fears over the sustainability of not only the Eurozone's economic recovery, but also the wider global economy.

Euro debt crisis polarises opinion

A full blown Euro crisis is no longer just a tail risk. Markets seem to be pricing in a bi-modal probability distribution, or a very binary view on how the recovery will unfold. One scenario is that the world continues on its current path – a slow bumpy and uneven recovery. The other outcome is that the European debt crisis spreads and causes a second credit crunch. The fear in markets is that there is nothing in between these two views, and any additional upside risk to the recovery. We explore the channels through which the debt crisis can affect the real economy.

Direct impact

Last year, Ireland gave southern Europe a flavour of what is needed to be done to avoid a sovereign debt crisis. Greece was slow to react and arguably dishonest with its reporting of government finances. Now Greece faces years of austerity, several years of negative and poor GDP growth, with plenty of uncertainty over how its situation will resolve itself. We have discussed the Greek crisis in great detail in past Economic and Strategy Viewpoints, and are now instead focusing on the wider picture.

Channels of influence

Portugal, Spain and Italy are the latest to announce new tougher measures to tackle their own fiscal deficits. Measures that include nominal cuts in public sector salaries, increases in VAT and income tax are bound to hurt the recovery in these countries, with there being a real possibility that they fall back into recession.

The direct impact of the crisis on aggregate Eurozone growth is the contributing share of some of these countries. For example, **Greece, Portugal, Ireland and Spain make up approximately 18% of Eurozone GDP**. Weak growth in these countries will have a knock on impact on total Eurozone GDP growth, however, there are also indirect channels to consider.

Indirect channels

There are three key indirect channels that can impact Eurozone growth:

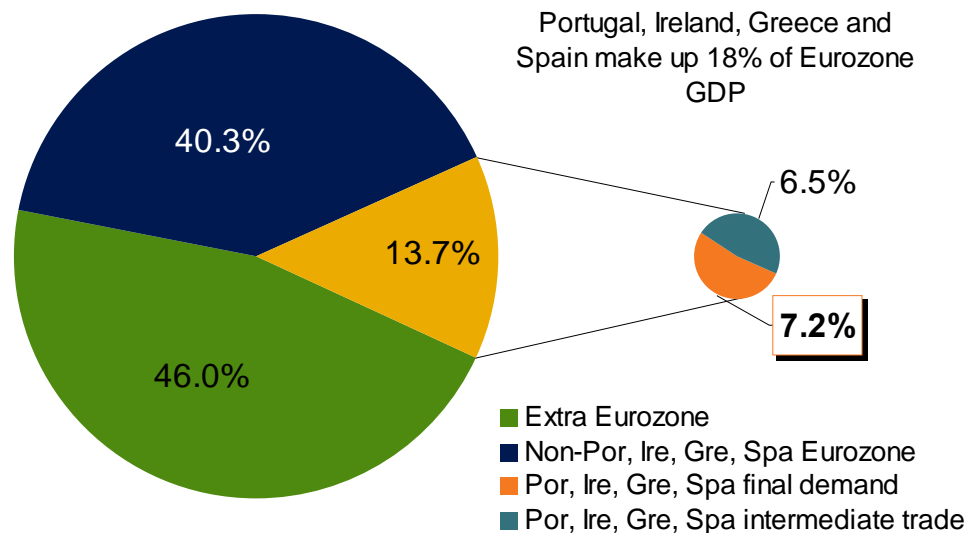
1. **Trade** – weaker growth in southern Europe is likely to dampen demand, though the recent weakness in the Euro may boost demand from outside the Eurozone.
2. **Financial markets** – higher corporate spreads across Europe could lead to reduced investment, and an even weaker recovery.
3. **Contagion to other sovereigns** – other European governments end up being bailed out, resulting in a repeat of this vicious cycle.

Trade links are not significant

Starting with the trade channel, weaker demand from southern Europe will hit Eurozone exports to the region, however, when we examine the details of Eurozone trade flows, we find that the impact is likely to be much smaller than initially feared.

Despite Portugal, Ireland Greece and Spain making up 18% of Eurozone GDP, only 13.7% of total Eurozone exports go to the quartet. 46% of Eurozone exports go to non-Eurozone trade destinations, and the remaining 40.3% go to other Eurozone countries. However, of the 13.7% of exports that go to Portugal, Ireland Greece and Spain, just under half are exports linked to intermediate trade. This is trade in goods that is generally used in the production of another good, which is usually then re-exported to another part of the world. For example, an American consumer buys a German made car. Part of the car may be produced in Spain. The exports required to complete the manufacturing of the car are not linked to domestic demand in either Germany or Spain. Of total Eurozone exports, just 7.2% go to Portugal, Ireland, Greece and Spain, that is actually linked to final demand (see chart 4).

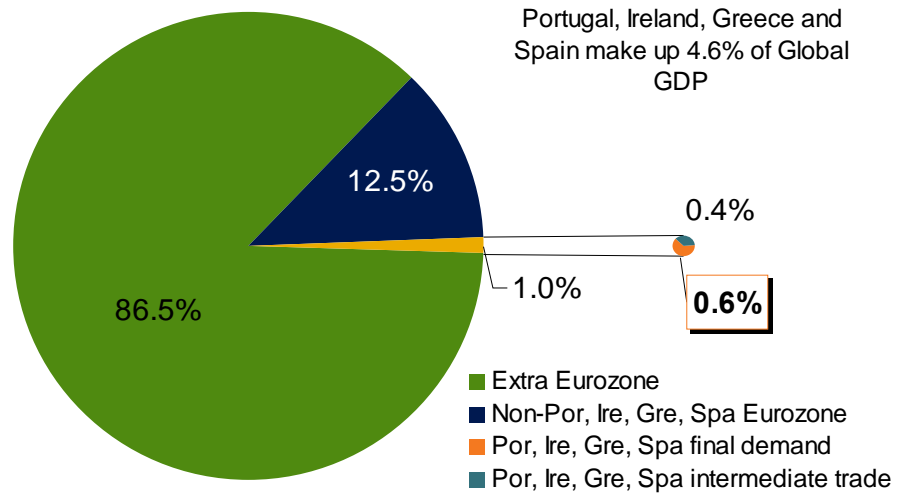
Chart 4: Breakdown of Eurozone exports



Source: Eurostat. Average of data covering 01-2005 to 01-2010. Updated 7/06/2010.

In fact, when we apply the same analysis to global trade that goes to Portugal, Ireland, Greece and Spain, we find that only 0.6% is linked to final demand, despite the four making up 4.6% of global GDP (see chart 5).

Chart 5: Breakdown of Global exports



Source: Eurostat. Average of data covering 01-2005 to 01-2010. Updated 7/06/2010.

From the above analysis, we can conclude that the indirect impact from trade with Portugal, Ireland, Greece and Spain is likely to be limited and small.

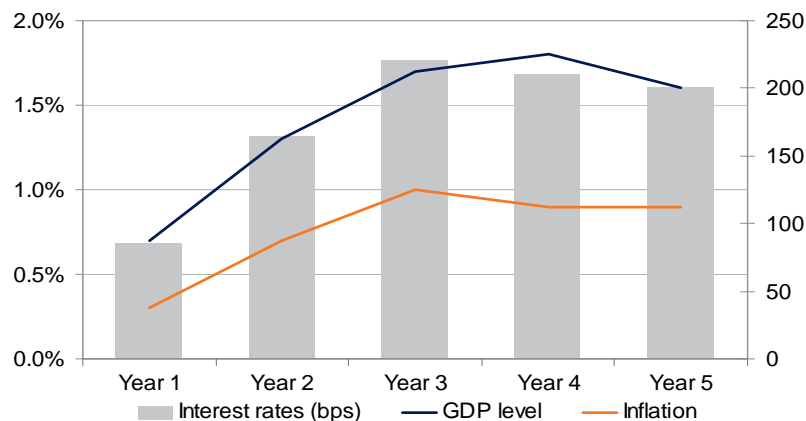
The impact of a weaker Euro

As the crisis has unfolded, uncertainty over the solvency of Greece has hit the Euro. Since December, the Euro has depreciated by some 18% against the US dollar, and by 13% against its major trading partners. Can the depreciation in the Euro help the Eurozone recovery?

10% fall in Euro adds around 1.6% to the level of GDP and 1% to inflation after three years

According to the OECD's New Global Macroeconomic Model, the Eurozone could benefit substantially through increased export demand. Chart 6 shows the cumulative impact on GDP, inflation and interest rates from a one-off 10% nominal depreciation in the Euro against trading partners' EER (effective exchange rate). The model estimates the impact on variables starting from a steady-state position (with a neutral output gap).

Chart 6: Impact of a 10% depreciation in nominal EER for Eurozone



Source: Based on 'the OECD's New Global Model. Economics Department Working Paper No.768 (05/05/2010).

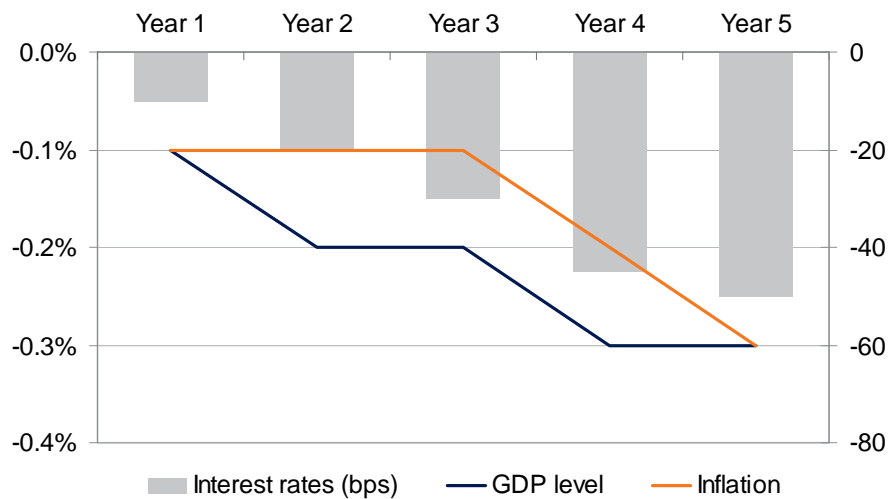
Given the 10% depreciation, the model estimates real GDP growth to rise by 1.6% by year 3, while inflation is expected to be one percentage point higher. The model assumes that the ECB respond by raising interest rates by 200 basis points. This in turn causes GDP growth and inflation to slow, which can be seen by year 5.

The depreciation of the Euro is of course no free lunch. A weaker Euro helps Eurozone exporters take a larger share of the global export market cake. However, that cake remains the same size, which means that there are losers as well as winners.

The OECD's model maps the impact of the Euro's depreciation on other regions as well as the Eurozone. Arguably, the most important market for global investors is the US, which the OECD suggests will suffer from a depreciation in the Euro. However, the model estimates that US GDP will be just 0.2% lower by year 3 - significantly smaller than the 1.6% gain in the Eurozone (chart 7).

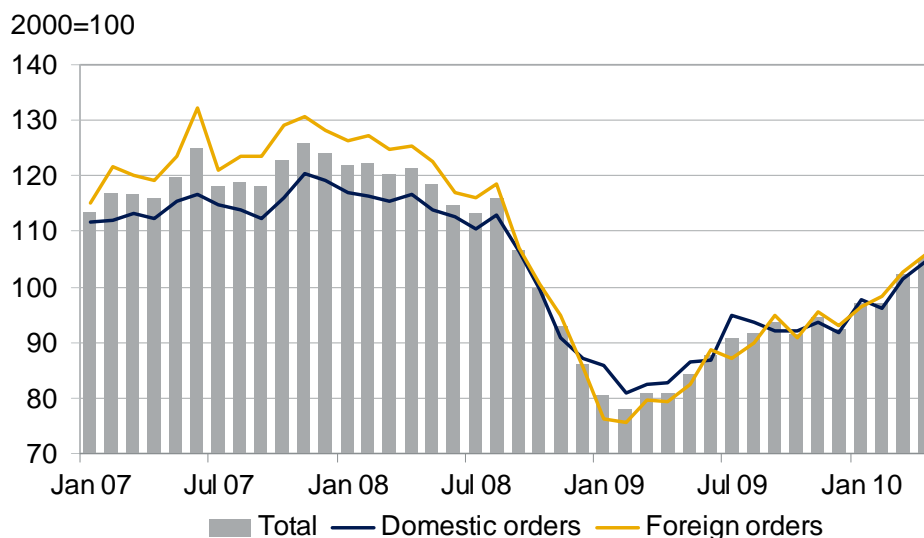
**Zero sum game:
Asia is the biggest
loser from a weak
Euro**

Chart 7: Impact of a 10% depreciation in nominal EER for US



Source: Based on 'the OECD's New Global Model. Economic Department Working Paper No.768 (05/05/2010).

So who are the big losers? According to the OECD model, Eurozone exports mainly compete with exporters from emerging Asia and Japan. Perhaps the recent weakness in the Euro is a step in the right direction for re-balancing global growth. Possibly, but what recent data shows is a strong surge in export orders for Eurozone member states (chart 8 on next page).

Chart 8: Eurozone industrial orders

Source: Eurostat, DataStream. 24 June 2010.

The impact on financial markets

Increased risk premiums add to the cost of capital

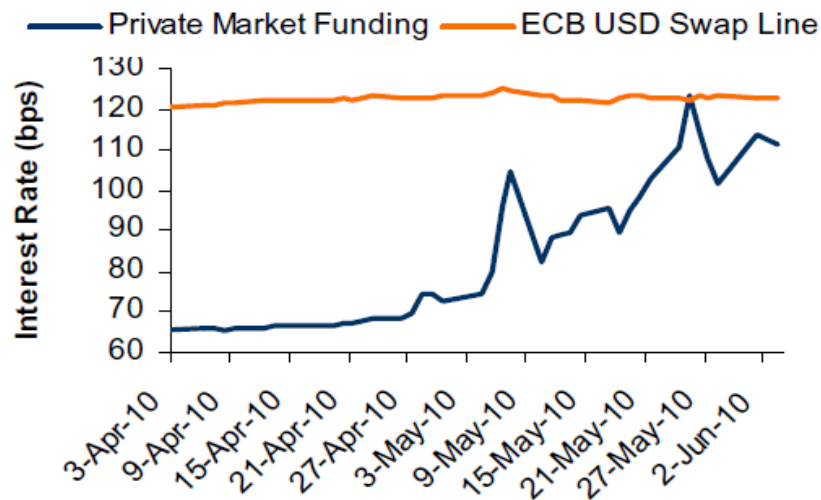
The second indirect channel is for the possible spread of fear from sovereign debt markets into the cost of borrowing for corporates as many firms borrow at some cost made up of a risk-premium or spread over the 'risk free' rate – usually the yield on its own government debt.

Towards the end of May, we began to see sign of stress emerge as LIBOR-OIS² spreads began to widen once again. Fear over the solvency of European banks was back in the focus, which led the market to ask for higher yields in exchange for lending to these Banks.

As illustrated by chart 9 (on next page), the cost of private funding from debt markets rose significantly over the period. However, as soon as the spread reached approximately 120bps, the banks that were eligible to access the ECB's re-instated US dollar–Euro swap facilities, decided to hold a sellers strike. This is because the ECB's US dollar-Euro swap line acted as a ceiling or a maximum cost of borrowing for European banks.

² London Interbank offered rate – overnight indexed swap
12

Chart 9: Cost of private market funding vs. ECB dollar swap line



Source: Bloomberg, Bank of America/Merrill Lynch, 7 June 2010.

ECB action is limiting the impact on cost of capital for companies and governments

In addition to the swap-lines, the ECB has made a commitment to continue to provide banks unlimited liquidity through its special liquidity auctions. These two policies serve as a powerful weapon in the fight to defend Europe's banking system. Therefore, as long as the ECB remains committed to these measures, then the impact through financial markets could be limited.

Contagion spreading to other sovereigns

Arguably, the crisis is already spreading to other sovereigns within Europe. Spreads over German Bunds are being re-assessed for all countries, with many seeing their yields higher today than before the crisis relative to bunds (see chart 10).

Chart 10: 10 year Government bond yield Spreads over Bunds, bps

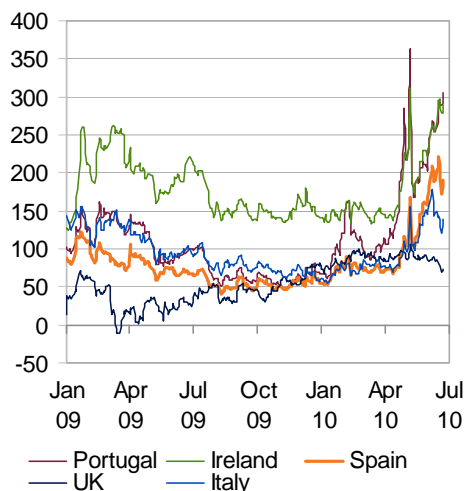
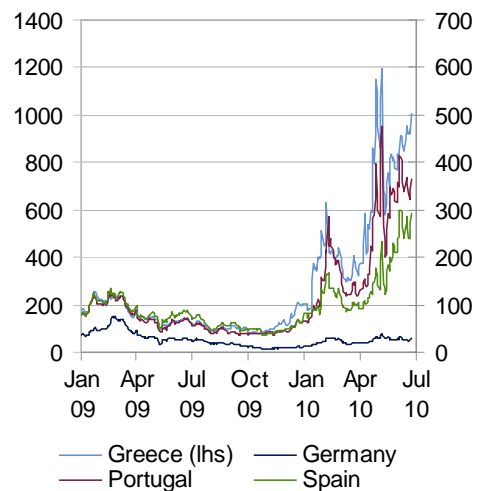


Chart 11: Two year credit default swaps (CDS) contracts, bps



Source: Bloomberg, June 2010

The ECB is also intervening in these markets to ease the pain. On the grounds of providing liquidity for holders of debt owed by the likes of Greek, Portugal and Spain, the ECB is purchasing government bonds through secondary markets, and sterilising the assets (issuing short-dated debt in order to offset the total stock of money pumped into the banking system).

Government bond purchases have helped bring down spreads for certain sovereigns, though this does not mean the solvency risk has gone away. Chart 11 (previous page) shows the cost for a selection of 2-year sovereign credit default swap contracts which are effectively premiums for insuring against the event of a given default. When we examine these indicators, we not only see a big divergence, but a clear signal that investors remain concerned about a potential default from within Southern Europe. At least for sovereigns, lower yields keep borrowing costs down as well as the funding for future deficits.

Conclusions

Eurozone growth to stay positive, but become more uneven

The direct and indirect channels for which the European sovereign debt crisis can impact the wider Eurozone real economy are complex and introduce a great deal of uncertainty. The direct impact is clear. Southern Europe's GDP growth is likely to suffer greatly from very fast corrections to their out of control public finances.

However, while the indirect impacts of the crisis are more difficult to assess, we feel the downside risks to wider Eurozone growth is limited at this stage, and that the weakness in the Euro can go a long way to offset much of the negative factors from rapid fiscal austerity. It is worth noting that the crisis and depreciation of the Euro will mean that growth becomes very uneven. Export oriented economies and firms are likely to enjoy better trading conditions and more profitable activities. On the other hand, economies that have relied in the past on domestic demand to drive growth will suffer, as it is those economies that will face the greatest negative pressure from the need of households to deleverage their balance sheets.

Real GDP

y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	-2.4	3.2	3.3	2.7	3.1
UK	5.1	-4.9	1.3	1.3	2.3	2.3
Eurozone	25.8	-4.1	1.2	1.1	1.5	1.4
Japan	9.3	-5.2	2.5	2.4	1.6	1.7
Australia	1.9	0.9	3.6	3.0	3.2	3.4
OECD	69.5	-3.5	2.2	2.2	2.1	2.2
China	8.2	8.6	10.5	10.2	9.0	9.0
Emerging*	30.5	1.1	6.7	6.4	5.7	5.7
World	100.0	-2.1	3.6	3.5	3.2	3.3

Inflation CPI

y/y%	Wt (%)	2009	2010	Consensus	2011	Consensus
US	27.3	-0.3	1.5	1.7	0.9	1.7
UK	5.1	2.2	2.8	3.1	2.8	1.9
Eurozone	25.8	0.3	1.7	1.4	1.0	1.5
Japan	9.3	-1.1	-1.0	-1.0	-0.3	-0.2
Australia	1.9	1.8	2.6	3.1	3.0	3.0
OECD	69.5	0.0	1.4	1.4	1.0	1.4
China	8.2	-0.7	4.5	3.3	3.8	3.5
Emerging*	30.5	4.3	5.8	5.4	5.3	5.0
World	100.0	1.4	2.7	2.6	2.3	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-09	Dec-10	Market	Dec-11	Market
US	27.3	0.25	0.25	0.81	2.00	1.38
UK	5.1	0.50	0.50	0.98	1.75	1.61
Eurozone	25.8	1.00	1.00	1.05	1.75	1.36
Japan	9.3	0.10	0.10	0.36	0.25	0.39
OECD	67.5	0.53	0.53	0.85	1.64	1.25

Market data as at

25/06/2010

Key variables

FX	Current	Dec-09	Dec-10	y/y%	Dec-11	y/y%
USD/ GBP	1.49	1.62	1.40	-13.7	1.45	3.6
USD/ EUR	1.23	1.46	1.20	-17.7	1.18	-1.7
JPY/ USD	89.6	90.0	95.0	5.5	97.5	2.6
GBP/ EUR	0.82	0.90	0.86	-4.6	0.81	-5.1
Brent crude	76.6	74.9	78.1	4.4	79.5	1.8
US output gap %GDP	-7.3	-8.0	-5.9		-3.4	
Unemploy. %	9.7	10.0	9.1		7.9	

Source: Schroders, Datastream, IMF, Consensus Economics (June 10)

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

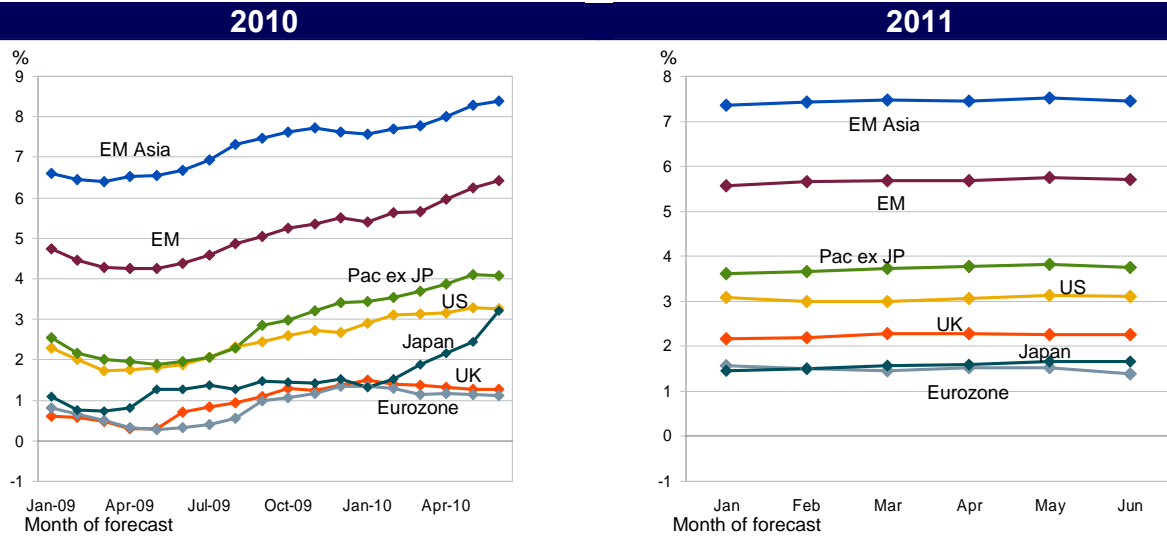
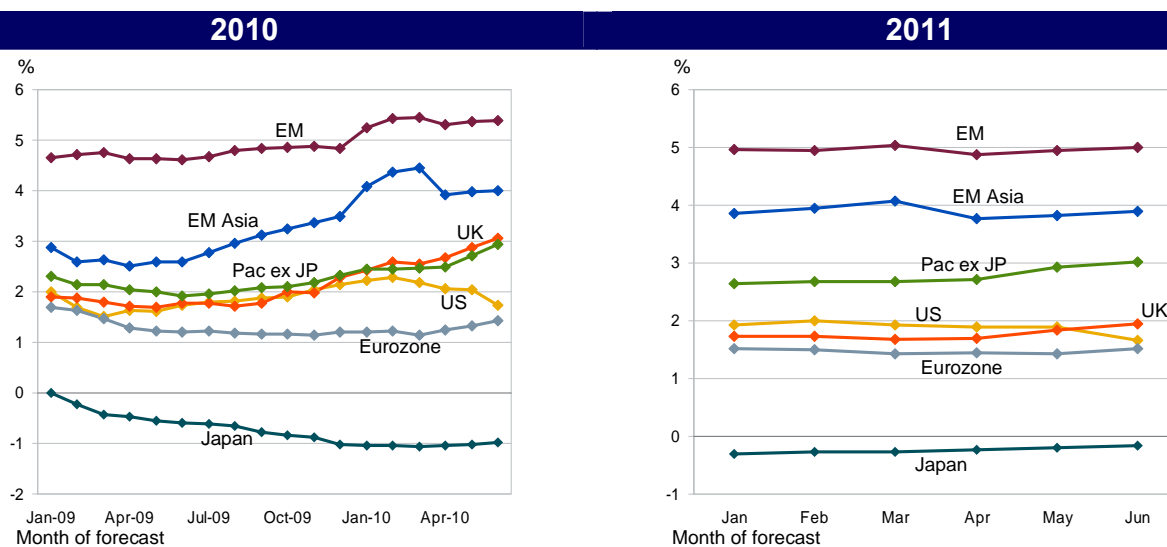


Chart B: Inflation consensus forecasts



Source: Consensus Economics (June 2010), 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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