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The dominance of politics: investment implications

Concerns about trade continue to take centre stage. While US assets have so far been resilient amid escalating protectionist rhetoric, markets targeted by tariffs are under pressure. We still don't believe a full trade war is likely and we still expect decent economic growth, though decelerating and less synchronised, and with only mild inflationary pressure. But, trade disputes could impact business confidence and investment plans, interfering with central banks (CB)' interest rate normalisation processes.

Trade talks are just the tip of the iceberg in a more complex geopolitical world. In our view, we have entered a **new era of the dominance of politics vs economics**. New forces, more inward-looking, with nationalist nuances are now underpinning new political agendas all over the world. Bilateral relationships are likely on the rise vs multilateralism; threats to globalisation could come more into play. This new order could influence markets in many ways. **First**, due to permanently higher levels of **geopolitical risk**. These risks are not easy to price and can create short-term volatility, but also have long-term implications. This means that predictability of a central scenario that underpins investment decisions decreases significantly, and with it, the opportunities for strong directional risk exposures. **Second**, due to trade tensions, global growth will not necessarily lead to **global trade growth**. This new order, with forces at play pointing to further fragmentation, resulting in divergences in economic and market performances, implies a reorientation of strategies towards more domestic/autonomous stories. **International diversification** that did not work properly in the last 30 years, due to correlation of markets to global trade factor, **should do better going forward**. Global and diversified approaches become paramount to taking advantage of opportunities in this new framework. **Third**, on a medium-term perspective, the more proactive/expansionary fiscal policies promoted by the populist wave will put pressure on public debt and fiscal sustainability. This is of particular concern considering that total global debt skyrocketed to USD 250tn in 1Q18. **Fourth**, we may see **mounting political pressures on CB**, especially in the US. The threat to CB autonomy and credibility is a risk not currently priced into the market. Deficit and debt monetisation could become the ultimate temptation.

In conclusion, the scenario for investors is becoming increasingly complex. In the short term, **it looks to be too soon to call an impending bear market**. It is important to exploit opportunities in areas that can still benefit the most from the extension of the cycle (**US equity**) and **rotate towards new themes** (sector divergences are relevant, and in Europe, we have already seen a rotation towards defensive sectors). For long-term investors, **looking for entry points** in asset classes that have already discounted most of a gloomy scenario (**EM assets**) is a key strategy to add value, with a focus on bottom-up selection. Due to higher risks on the horizon, **enhancing the resilience of portfolios** – ie, improving credit quality, increasing liquidity buffers and further reducing risk concentration -- is becoming paramount in order to protect investor assets.

High Conviction Ideas

- **Multi-Asset:** Geopolitical uncertainty and a maturing financial cycle call for limited directional exposure on risk assets. We see three themes for the next few months: 1) play the last phase of the cycle by focusing on equity markets with stronger earnings growth (US equity) or rotating to value in Europe; 2) play CB divergences (shorter duration view in the Eurozone, close to neutral in the US); and 3) be selective on EM (positive on China equities vs EM). Hedges remain crucial to try to protect portfolios from overall risk-off situations.
- **Fixed Income:** Concerns about trade are preventing yields on core govies from rising. We keep a short duration view (more so in Europe) and we have reduced credit risk, with tighter liquidity ahead. Currency volatility dominates in EM, affecting FX for countries with higher current account deficits. We are cautious on EM bonds in the short term; we see possible entry points opening up in the autumn.
- **Equities:** Trade tensions drive divergences in market performances. Earnings per share growth is still strong, especially in the US, our favourite region. However, the cycle is maturing, with diminishing liquidity and rising costs for corporations. The outlook for equity is still overall constructive on a relative basis. But, as volatility is expected to increase, we encourage a cautious approach, with limited risk concentration in specific regions/sectors and a focus on quality and stock picking.
- **Real Assets:** In search of additional sources of diversification, on a long-term perspective, energy transition infrastructure is, in our view, a theme to consider. Environment-themed investments have increased considerably in Europe over the past five year. This situation is consistent with the objective of increasing infrastructure spending and pursuing sustainability within a supportive regulatory framework.

CB= Central Banks.

MACRO &
STRATEGY

**Philippe
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**Monica
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Research



**Didier
BOROWSKI**
Head of
Macroeconomic
Research

“
**Risk asset
outlook: credit
sector and
corporate
fundamentals
are the key
variables to
monitor.**”

Uncertainty over tariff barriers will drag down global trade, but is not expected to endanger global growth

Tensions on trade have risen a notch: President Trump has explicitly threatened China and Europe with higher tariffs on more products. China and Europe have been accused of not respecting the rules of the game and thus causing the US trade deficit. Even though this argument is not valid, it is unlikely that the US president will abandon his strategy before the mid-term elections. At this stage, the products targeted by tariff increases represent such a small portion of international trade that they should not have an impact on growth. Thus, unsurprisingly, so far, we haven't seen trade tensions have a significant impact on domestic demand, except for the decline of some business surveys. We keep our macroeconomic scenario unchanged this month (except for an upward revision to inflation in some emerging countries). We expect the continuation of the global expansion, with, however, a slight slowdown in global growth in 2019. Conversely, for the second consecutive month, we have increased the probability of our downside risk scenario (from 20% to 25%) at the expense of the upside risk scenario precisely because of concerns regarding global trade.

It is important to note that even in the absence of

a global trade war, an uncertain environment can affect trade between countries. We should reiterate that among the identified causes of the slowdown in global trade after the Great Financial Crisis, we note less trade liberalisation compared to the 1990s and 2000s; the rise of non-tariff barriers, particularly in emerging countries; and maturing global value chains. Added to this is uncertainty about the tariff environment, which some studies show tends to have a direct negative impact on trade (based on the higher risk of disruption to global value chains being seen, for instance). In other words, the climate of uncertainty alone is able to slowdown trade. In April – before the announcement of protectionist measures – we observed a significant decline in world trade (-2.4%, 3m/3m, at an annual rate), without there being a clearly identifiable cause. Rising by 3.8% yoy (three-month moving average), world trade is now tending to grow less rapidly than global GDP. As such, even without an outright trade war, international trade (goods) may slow further. Against this backdrop needless to say, domestic demand is more than ever the cornerstone of global economic expansion.

The strategist's view: Global risk gyration, from rates and inflation to growth concerns in 1H18...

After some market complacency, in January, investors started to reprice higher inflation and higher long-term interest rates, and hence stretched valuations in fixed income and equity. Volatility suddenly returned after touching historical lows, pointing to a mature phase of this financial cycle. In February, financials and value started to outperform. Historical defensives struggled, due to their bond proxy features, and correlation among asset classes increased significantly. Credit and fundamentals proved to be resilient, as usually happens in a market correction to the upside. Spreads remained relatively stable in both DM and EM. The US dollar remained stable and EM equities were relatively resilient in relative terms. In March, the picture changed dramatically. President Trump announced his intention to impose tariffs on imports. **In Q2, the risks gyrated from inflation and rates to growth concerns**, due to the expected negative impact of tariffs on world trade. The USD began to appreciate, EM assets faced very significant selloffs, sector allocation shifted from financial and high tech to defensive like utilities, consumer staples and healthcare. Credit started flashing some stress signals as growth concerns posed some questions regarding global synchronised recovery, confirmed by some disappointing figures in Japan and Europe. Moody's spread, an indicator of credit stress, widened above 90bps (100bps is our alert threshold) and core rates moved lower, discounting lower growth and a less hawkish tone for the ECB and, possibly, the Fed.

...to trade conflicts which remain the key risk for the markets

Despite the global profit cycle proving resilient and valuations looking more compelling than in January, world trade dynamics and a stronger USD could become significant headwinds for 2H reporting seasons. The somewhat unexpected USD strength (on the back of trade concern) is also weighing on its hedging features. Equity valuations and fundamentals remain supportive for 2H, although increasing risks regarding growth, combined with ongoing CB normalisation could change the overall healthy picture: we think that the **credit sector and corporate fundamentals are the key variables to monitor**. A marked deterioration could trigger the end of the prolonged bull market phase in light of a mature financial cycle.

MULTI-ASSET

Risk reduction as markets sail in stormy waters

Our central scenario is still for a continuation of global growth and inflation trending mildly higher. So far, there has been a very limited impact on global growth from the announced trade tariffs, and, indeed, the US may actually benefit slightly due to import substitution. However, if a serious escalation were to occur, global trade and financial markets would be hit and no markets would be immune from the effects. We expect the US to be the most resilient area, particularly supported by fiscal expansion. Europe is also expected to grow above trend. However, the main risks are still to the downside and the higher probability attached to the negative scenario could prevent risky assets from showing strong upside trends. In this environment, we believe investors should maintain low directional risk exposure (close to neutrality) and focus on three major themes: 1) last phase of the cycle (selective exposure on equity); 2) CB divergences; and 3) EM winners vs leftovers.

High conviction ideas

It is difficult to see a major correction in equity markets as likely when growth is strong and earnings are expected to be good. So, we play the phase of the earnings cycle focusing on equity markets with stronger earnings growth, with a preference for the US, and UK vs European equities. The UK market can benefit from higher oil prices while the industrial components of the EMU index may be impacted by tariffs and lower margins. A rotation towards value (vs the EU market) is another means of taking advantage of recent weakness in the sector. The second theme, CB divergences, is about fixed income and FX. It implies a short duration bias, but with a shorter

duration stance in Europe, where yields are still at zero, vs the US, where yields are getting more attractive. We would also exploit opportunities in inflation-linked bonds, as inflation dynamics remain in focus and the market is discounting inflation levels below our expectations. On FX, after the USD rally, most EM CB became more hawkish and divergences appeared within EM FX. We believe that some opportunities have opened up in currencies of countries with strong current account balances vs the USD, mainly in Asia (South Korea, Taiwan, Philippines). The third theme is about identifying EM winners vs leftovers. In a framework of neutrality vs EM assets, we would search for the most valuable relative value opportunities (to temper overall risk exposure), focusing on countries with stronger fundamentals that are less fragile (ie, less external vulnerability). In this respect, we still like Chinese equities vs EM. They could benefit from the transition of the economic model towards domestic consumers. However, we are more cautious on the renminbi.

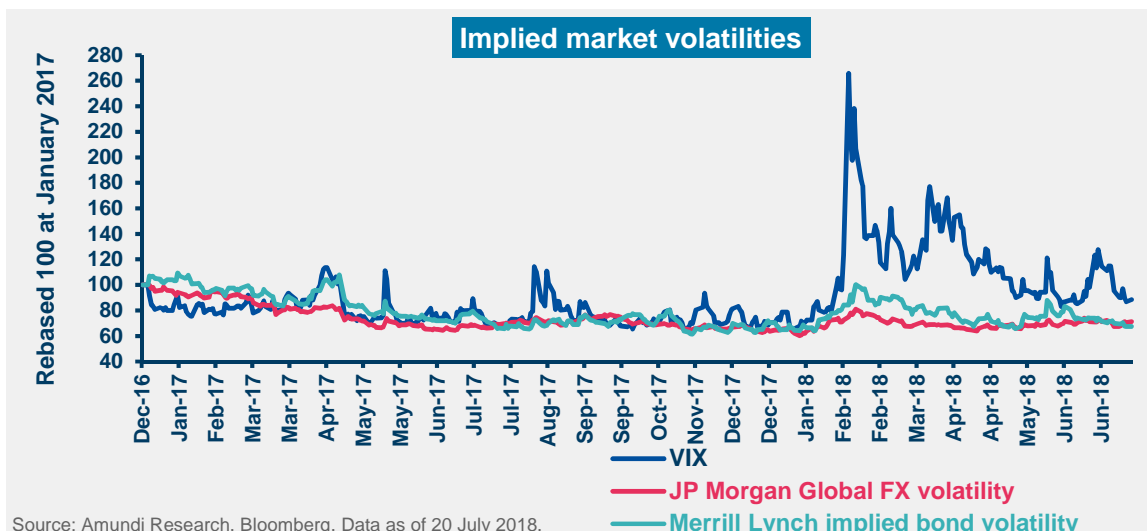
Risks and hedging

The list of risks is longer: not only structural risks related to possible CB mistakes or to the cycle downturn, but new geopolitical risks due to tariff rhetoric or political changes in Europe (Italy, Spain, Germany) as well as specific idiosyncratic stories in EM could become concerns for investors. Hedging strategies should aim to protect portfolios from risk-off situations, including gold, options on the S&P500, the yen vs the USD/AUD. It is worth also including hedges to specific risks, such as on the credit market (HY), which could be negatively affected in case of liquidity tensions.



Matteo GERMANO
Head of Multi-Asset

“
The economic backdrop is positive, but risks have recently risen: this calls for a neutral exposure to risk assets.
”



FIXED INCOME



Eric BRARD
Head of Fixed Income



Yerlan SYZDYKOV
Head of Emerging Markets



Kenneth J. TAUBES
CIO of US Investment Management

“
Focus on credit quality, as conditions become tougher and there may be a contraction in liquidity.
”

Low summer liquidity could create price dislocations

Overall assessment

Concerns about an escalation of trade talks into a full-scale trade war are the dominant theme regarding fixed income preventing rates on core govies from reaching new yearly highs and increasing market divergences. Spread widening across the board indicates that the market is starting to price in tighter financial conditions and higher risks on growth. Conditions remain in place for a short duration bias, especially in Europe, where CB normalisation is at an earlier stage. On credit, investors should become more cautious, improving credit quality. In fixed income, keeping a liquidity buffer is also a strategy to consider, especially during the summer season. This could also enable investors to take advantage of liquidity events and consequent price dislocations which could intensify in the next few weeks.

DM government bonds

The flight to quality is prevailing on CB normalization policy effects. In the US, the 10Y T-bond yield is moving in a broad range, down from yearly highs. This is occurring regardless of inflation pressures that are building on both the wage front and regarding costs of goods and commodities, as has been constantly reported in surveys. The pro-cyclical fiscal stimulus increases risks of overheating, and compensation dynamics may accelerate in a non-linear way should unemployment rates decline further. However, due to current rates levels, which are closer to neutral rates, there is a limited scope to remain heavily short duration. The yield curve is expected to remain flat until the Fed further raises rates. In the Eurozone, 10Y Bund yields are close to yearly lows. A mild rebound (not at the 2017 pace) in the Eurozone economy after the 1H18 soft patch (already some signs of stabilisation of business surveys) could again support expectations of higher

core rates as soon as trade rhetoric eases. We expect volatility on EU core rates to increase.

DM corporate bonds

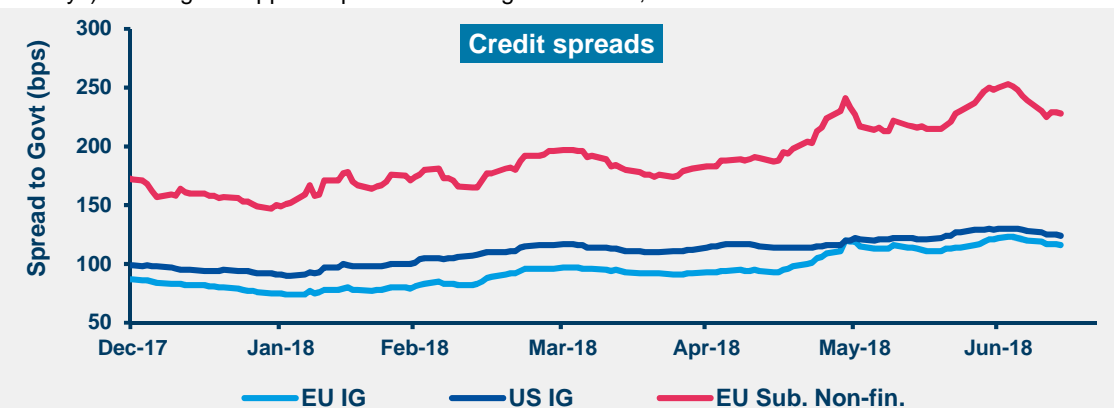
Credit conditions are tougher, with mild spread widening across the board. US corporates are resilient, due to the positive cyclical momentum in the US, but leverage is high. So, we are more prudent regarding highly leveraged names. In the EU, leverage is lower and balance sheets solid, despite the slowdown in revenue growth. We see limited contagion from Italy, thanks to ECB support. Overall, we are more cautious on credit.

EM bonds

On the back of USD stabilisation and expectations of significant outflows that have not materialised, EMB spreads recovered from their June peak. At the current level of spreads (EMBI), sovereign debt is not expensive, but market sentiment is fragile, possible downward revisions in growth are expected, and liquidity conditions are poor. We continue to be cautious in the short term, but we see good value for long-term investors to build on recent corrections. In terms of regional allocation, we prefer the Middle East; we are constructive on Central Eastern Europe bottom-up stories, and on Latam over Asia due to valuations. Volatility is likely to remain high over the summer and this could open up opportunities, particularly after elections in Brazil.

FX

CB divergences are the main driver in this phase of our view on currencies: in the short term, the USD continues to be strong vs the EUR, but most of the window of opportunity for USD appreciation is over. We are cautious on the GBP, with Brexit risk underestimated, and more constructive on the JPY, due to its safe-haven status.



Source: ICE BofA Merrill Lynch Bond Indices, Amundi. Data as 20 July, 2018.

EQUITY

Trade disputes result in market divergences

Overall assessment

While US equities have so far been resilient amid escalating trade disputes, the markets that will be most affected by tariffs are under pressure (Europe as a more open economy vs the US; Germany, which is exposed to the auto sector; China and other EM, which are integrated into the international value chain, in Asia; in Latam, commodities exporters). Divergences will remain in place, and eventually increase, supporting the case for active selection. The earnings outlook remains constructive for the time being, and it should continue to support equity in relative terms. The global cyclicals/defensives ratio continues to move in an uptrend for now, but momentum is weaker; should a trade war come into play, this trend could eventually revert.

Europe

Despite resilient EPS prospects, investors have become more risk averse, due to ongoing political uncertainty and exposure to external risk (sensitivity to tariffs on cars and to EM, should EM be more affected by tariffs). Without becoming outright defensive, we believe that an additional focus on quality and value is needed to build more resilient portfolios in this phase. At the sector level, we still see opportunities in energy, tech and luxury.

United States

The Q2 earnings season is at an early stage and we expect very strong results given the backdrop of very healthy fundamentals. The potential drag from tariffs should be limited compared to benefits from fiscal stimulus, as the estimated size of tariffs is about a sixth of the overall expansionary effect on corporations. Margins will be a key area of scrutiny, as some threats could emerge: most companies have signaled confidence in their abilities to get

enough pricing to offset raw material cost pressures. But, for the most part, costs are rising faster than companies can raise prices. Another factor to consider is dollar strength: if this continues or even accelerates, it could become a headwind for exporters and international-exposed stocks. As global conditions have become more challenging, we favour a shift to higher quality and lower profit volatility with more staples or staple-like stocks (ie, health care equipment or consumer experience), with low business model volatility. In cyclicals, we prefer energy, banks/credit cards and semiconductors, which provide valuation and fundamental support. Corporate IT spending is another appealing area, as tax reform should favour the modernisation of tech infrastructure and the shift to the cloud, big data and automation. A defensive strategy in this phase is also about reducing risk concentration at sector/stock levels.

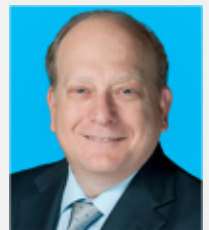
Emerging Markets

We expect positive EM EPS growth for 2018/19, but decelerating compared to previous estimates. The downward pattern of world trade growth and EM exports for the rest of 2018 and 1Q19, together with base effects, suggest a downward revision of earnings. We are still cautious on this asset class in the short term, but we continue to believe we are close to oversold and opportunities for long-term investors are opening. China is significantly discounting trade war tensions, and in the last month, China valuations vs MSCI EM have become more attractive. On the other hand, we see some deterioration in terms of earnings revisions. Domestic consumers are the favourite theme. Overall, we believe that heterogeneity will prevail in the market, with countries that are more exposed to global trade under more pressure.

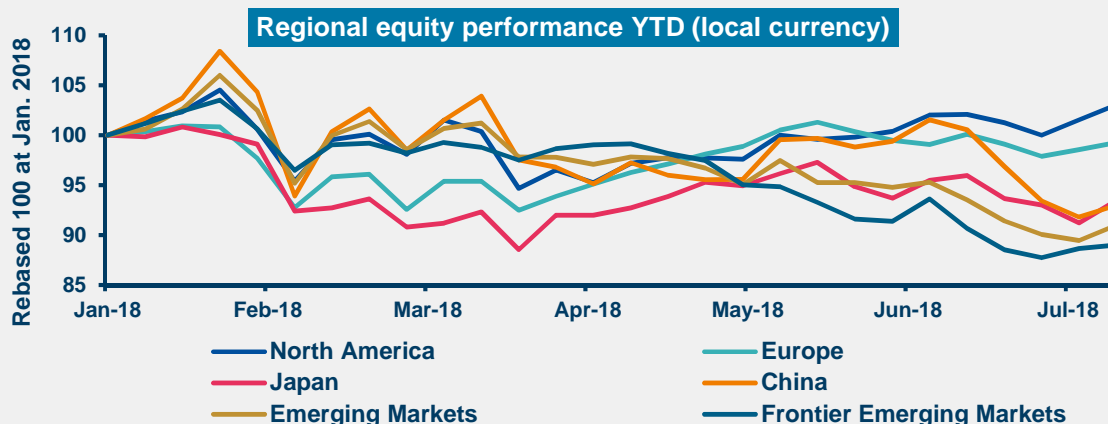
“
Q2 earnings seasons should support equity markets.
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Yerlan SYZDYKOV
Head of Emerging Markets



Kenneth J. TAUBES
CIO of US Investment Management



Source: Bloomberg, Amundi. MSCI indices. Data as of 20 July 2018

REAL ASSETS



Pedro-Antonio ARIAS
Global Head of Real & Alternative Assets

“
The green infrastructure market is growing significantly in Europe, but it is important to help investors in overcoming the entry barriers.
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Green infrastructure: a promising innovative market

Moving towards a greener economy

Over the two past decades, we have been witnessing strong political momentum to shifting away from a fossil-fuel intensive towards a green economy in Europe (i.e. the French government increased the budget to achieve this goal by 50% in 2017). In this regard, the EU has set ambitious targets to reduce energy consumption and greenhouse gas emissions and diversify the sources of energy supply. However, continuing to foster a greener economy requires cumulative investments in renewable infrastructures. In order to implement the COP21 2030 targets, it has been estimated by the European Commission that the investment gap to fill in is c. EUR 180 billion per year (study dated March 2018). This investment gap is so huge that the public sector cannot support it alone, revealing the key role that the private sector plays in meeting global climate change goals. Given the transition from a ‘black’ to a ‘green’ economy, with the resulting need for increased investment in energy transition infrastructures, the challenge for asset managers is to provide financial solutions that are appealing to their clients as new investment opportunities.

The state of the market for green funds

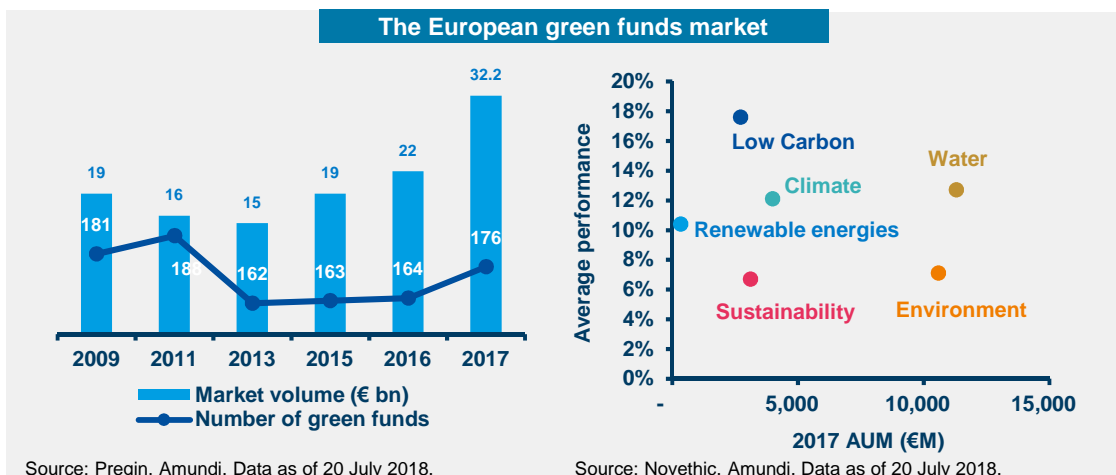
The energy transition infrastructure market is growing significantly in Europe. Market data reveal investors’ booming interest in green funds, with net inflows having been positive for €32 billion in 2017. Invested assets have increased by 49% in one year and 115% over the past four years. In particular, the bullish trend is being driven by factors that give green funds both more visibility and credibility: 1) the sound performance of the funds in 2017 with an

average performance of 10.6%); 2) the gradual diversification of the market offering on both the listed and unlisted sides, with the emergence of green bond products and equity funds, along with private infrastructure funds; and 3) a favorable political environment that, in some countries, has supported a rise in responsible investments (eg, the French Energy and Ecological Transition Act voted in 2015). This strong momentum in the market has made green funds accessible to a far more diversified investor base, both institutional and individual, but it’s still a small drop in the ocean.

Challenges and opportunities

For now, it appears that green infrastructure investments have not been fully embraced by investors. This may be in part because many investors lack familiarity with this more recent and complex asset class which suffers also from a relative lack of track record vs. traditional investments. Many investors feel they do not have the tool set to evaluate the risks associated with green infrastructure. In this respect, it is important that asset managers are fully committed to helping investors gain a better understanding of and access to this asset class.

We think that investments in green infrastructure can provide regular and reliable cash flows, especially when investing in markets that strongly promote responsible investments, like France. In addition, we believe that a greater allocation to green infrastructure can provide diversification benefits, given the low correlation to other asset classes and no relationship with energy and oil markets.



Amundi high conviction positions

Asset Allocation: Multi-Class Outlook								
	1 month change	---	--	-	0	+	++	+++
Equities vs govies	↘				■			
Equities vs credit	↘				■			
Credit vs govies	→					■		
Duration	→			■				
Oil	→					■		
Gold	→					■		
Euro cash	→				■			
USD cash	→				■			

The table above represents cross asset assessment on a 3-6 month horizon, based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/+/++/+). This assessment is subject to change.

	3-6 month research view	Relative Outlook and Convictions by Major Asset Class				
		Asset Class	1 month change on view	Underweight	Neutral	Overweight
GOVIES	-/=	US	→	●		
	-	Euro core	→	●		
	=/+	Euro peripherals	→			●
	-	UK	→	●		
	-	Japan	→	●		
CREDIT	=	US IG	→		●	
	+/=	Euro IG	→			●
	=	US HY	→	●		
	=/+	Euro HY	→			●
	=/+	GEM debt hard curr	↘		●	
	=/+	GEM debt loc curr	↘		●	
EQUITIES	+	US	→			●
	=/+	Eurozone	→		●	
	=/+	UK	↗			●
	=	Japan	→		●	
	=	Pac ex Japan	→		●	
	=/+	Global EM	↘		●	
	+	Convertibles	→			●

CURRENCY AND REAL ASSETS

FOREX	=	EUR vs USD	→
	+	EUR vs GBP	→
	=	EUR vs JPY	→
	+	USD vs JPY	→
REAL ASSETS	+	Real estate	→
	++	Global Infrastructure	→
	+	Private Debt	→

LEGEND

- Negative
- = Unchanged
- + Positive
- Underweight
- Neutral
- Overweight

Source: Amundi, as of 17 July 2018. The 3-6 month return outlook refers to research views based on expected returns by asset class. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. **This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.**

AMUNDI Investment Insights Unit

The Amundi Investment Insights Unit (AIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs.

In a world in which investors are exposed to information from multiple sources, we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

The screenshot shows the Amundi website interface. At the top, there is a navigation bar with links for 'ABOUT AMUNDI', 'INDIVIDUAL INVESTORS', 'FINANCIAL PROFESSIONALS', 'RESEARCH CENTER', 'Journalists', and 'Contact'. Below this is the Amundi logo and 'ASSET MANAGEMENT' text. A secondary navigation bar includes 'ABOUT US', 'NEWSLETTER', 'PUBLICATIONS', and a search icon. A main menu lists 'Italy', 'ECB', 'Emerging markets', 'Asset allocation', 'ESG', and 'Fed'. The main content area features two prominent cards: one titled 'CIO Insights - Key investment convictions for the short and long term' with a 'READ MORE' button, and another titled 'AmundiWIF18' with a 'READ MORE' button. Below the cards, there is a 'Visit us on:' section with icons for Twitter, LinkedIn, Facebook, Instagram, and YouTube. At the bottom of the screenshot, a blue banner contains the text: 'Discover more Amundi's investment insights at www.amundi.com'.

INSIGHTS UNIT



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