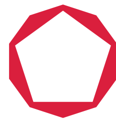
Advertising Material

Capital Market Report 3rd Quarter 2020

Waiting for a Vaccine



Flossbach von Storch

REVIEW

On a purely emotional basis, 2020 was not a bad year for equity investments. In spite of problems in some sectors that were particularly hard hit by the pandemic – such as the airline and travel industries – some prominent high flyers in the technology sector created the impression that things were generally progressing quite well.

This also applies to entire stock markets with indices that have big enough weightings for high flyers. The US S&P 500 equity index, for example, achieved a total return, consisting of price gains and dividends, of 5.1 per cent in the first three quarters (0.7 per cent in euros). The MSCI World Index, which includes a significant portion of US securities, also further reduced its losses, ending September with a loss of just 2.6 per cent (incl. dividends, calculated in euros).

The divergence between individual regions and sectors has rarely been this big before.

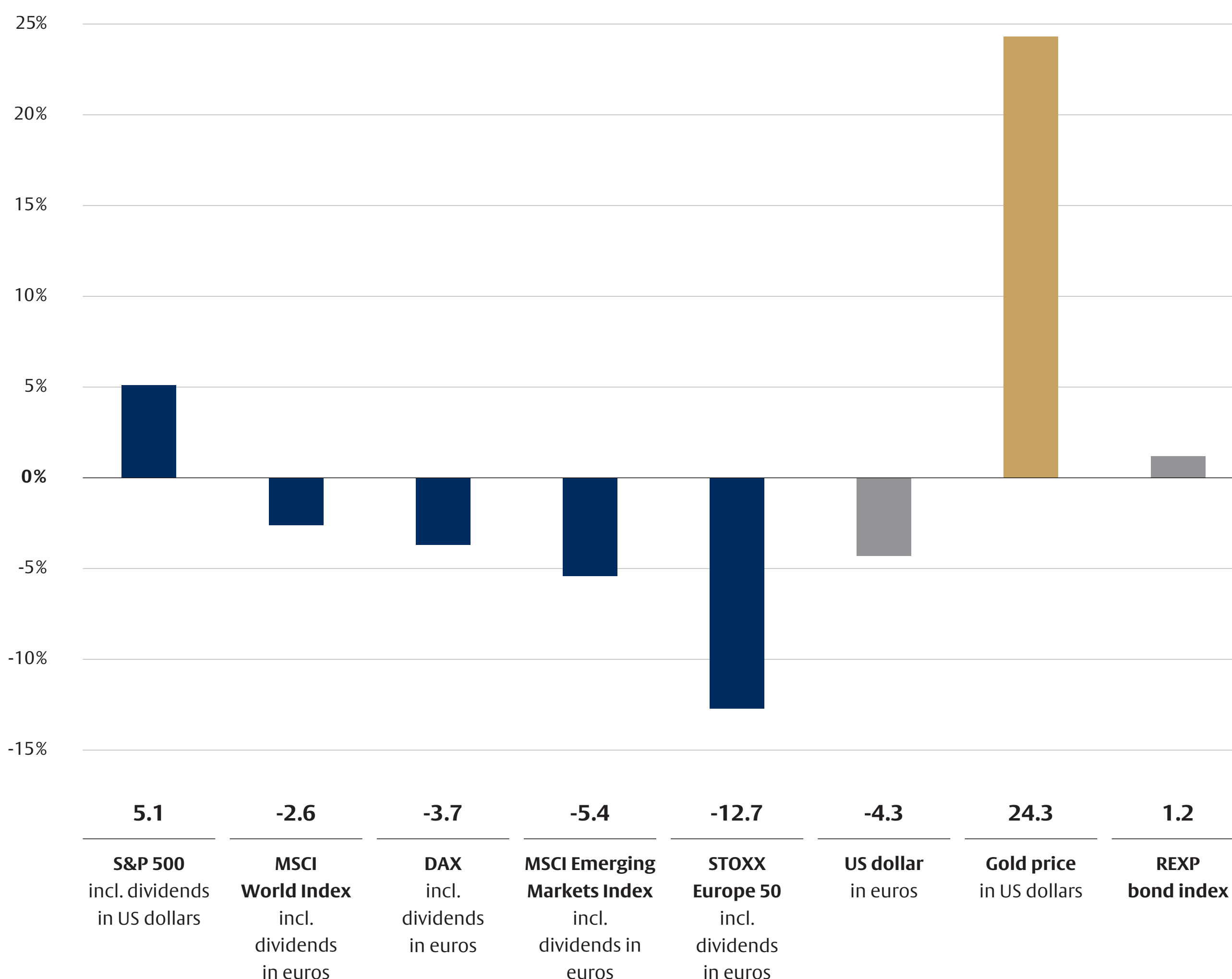
Under the surface, however, the picture is different. The divergence between individual regions and sectors has rarely been this big before. While US stock markets, driven by large technology companies, have largely decoupled from the economic slowdown, many European equities are still suffering from the economic collapse. Many share prices continued to fall in the third quarter, in some cases returning to the levels at the end of March. Annual stock-market performance was particularly poor in Spain, which was down 28 per cent, the United Kingdom, down 20 per cent, and France and Italy, which were down 18 per cent (including dividend payments in all cases), while the DAX Index recorded another gain in the third quarter that eliminated most of its losses, leaving a year-to-date loss of just 3.7 per cent due to the mild effects of the Coronavirus pandemic on the German economy and the strong recovery in China, an important sales market.

As previously noted in the semi-annual report, the differences between individual sectors were even greater than the regional differences. The gap between expected winners and losers of the pandemic has even widened in previous months (see Investment strategy on page 15).

Gold ETF purchases caused the price of gold to rise to a historic high of USD 2,075 in August.

Gold benefited from a significant increase in investment demand. Gold ETF holdings increased by almost 200 tonnes to around 3,400 tonnes in the first five weeks of the quarter alone, driving the price of gold above the USD 2,000 per ounce mark for the first time. After reaching a record high of USD 2,075, a correction occurred, causing the price to fall to around USD 1,900 again. The price of gold in US dollars has, however, still risen by 24 per cent since the beginning of the year, or 19 per cent in euros.

Figure 1 **Capital market performance 1 January to 30 September 2020**



Source: Bloomberg, Flossbach von Storch, data as at 30 September 2020
Past performance is not a reliable indicator of future performance.

OUTLOOK

Waiting for a Vaccine

In our Capital Market Report 1st Half 2020, we used a variety of letters to represent expectations for the form and progress of economic recovery. V stood for a rapid recovery, U for a slow recovery, W for an up-and-down movement, L for a long-term recession and J for a new boom. We also stressed that the change in gross domestic product (GDP) did not adequately reflect the different changes in individual economic sectors.

While some sectors will likely prove to be long-term losers of the Coronavirus crisis, in spite of a short-term recovery, others have already exceeded their pre-crisis levels and are benefiting from the change in consumption and investment behaviour. This divergence is represented by the letter K, which does not reflect the performance of the economy as a whole, but instead the widening gap between the winners and losers of the pandemic.

There will be no return to the world of yesterday, even after vaccination against Covid-19.

Whether, when and how much this gap will close again depends on when people can, and want to, resume living like they did before the pandemic again. A return to the world of yesterday should, however, not be expected, as too many things have changed in the meantime. The acceptance of home offices and the implications this has for the demand for office space, and the triumph of online shopping and cashless payments are just a few obvious examples.

Since the virus will not disappear by itself, at least one effective vaccine is required, which not only has to be produced in sufficient quantities, but also administered to the majority of the population. Dozens of companies are currently researching vaccines in various phases of clinical testing. It is impossible to seriously forecast which companies will win the race (there will likely be more than one). It is, however, highly probable that an effective vaccine will be discovered in the foreseeable future.

According to the World Health Organisation (WHO), 41 vaccine candidates are currently in phase I, II or III clinical studies worldwide. There are an additional 151 other vaccine candidates in pre-clinical development. Ten potential vaccines that are currently in final phase III studies are particularly promising. Successful conclusion of a phase III clinical study is required before a new drug can be submitted to the competent authorities for product licensing (see Figure 2).

Figure 2 **One will work**
Number of Coronavirus vaccine candidates in each clinical study phase

Source: World Health Organization, German Federal Institute for Drugs and Medical Devices, Flossbach von Storch, data as of 6 October 2020

If an effective vaccine is available in the first half of 2021, it still has to be produced in sufficient quantities and a large proportion of the population must be vaccinated. This involves substantial logistical obstacles in addition to on-site administration by doctors. Some of the most advanced vaccines have to be cooled to temperatures between minus 20 and minus 80 degrees Celsius during storage and transport. Such extreme cooling is required because no valid stability data exists yet. Children and youth cannot be vaccinated at present, because only adults have been tested so far. Even though children themselves hardly suffer from the virus, if they are not vaccinated, they continue to be potential carriers and therefore represent a risk for unvaccinated elderly people. Anti-vaxxers could also slow immunisation of the population.

It is unlikely that a sufficiently large share of the population will be vaccinated in the coming year.

It is therefore unlikely that a sufficiently large part of the population will be vaccinated in the coming year to allow us to return to our normal lives – an opinion that is also shared by members of the Robert Koch Institute Standing Committee on Vaccination. The head of Mainz biotechnology company Biontech, Ugur Sahin, even feels that the virus could circulate for another 10 years before everyone is immune.

In the meantime, effective medications could reduce the effects of serious infections. The first medications, such as Remdesivir and Dexamethason, are currently being administered in serious cases. Antibody therapies, which can already be used in milder cases to stop the progress of the illness, are more promising. Since it will likely be a long time before the world is immune to Covid-19, effective therapy options could partly normalise social and economic life even before an effective vaccine is obtained.

The longer it takes before the world is immune, the more money governments will have to spend on aid programmes.

The longer it takes for people to regain enough confidence to travel, go to events and meet as they did before the pandemic, the more money governments will have to spend on aid programmes to protect especially hard-hit sectors, companies and their employees from the economic consequences of the pandemic. This is understandable as long as the aid is in the form of bridge measures aimed at a return to normality in the foreseeable future. However, the longer the aid measures – support payments, assistance loans, short-time work or suspension of insolvency law – continue, the more they hide the actual performance and competitiveness of companies. This inactivates the process of creative destruction or renewal described by Schumpeter*, threatening to create a zombified economy with many half-dead companies. The performance of the government is also naturally limited, even if it can assume new debt at a zero rate of interest.

The lack of creative destruction threatens to create a zombified economy with many half-dead companies.

Without government assistance, however, many of the companies hard hit by the pandemic would not be able to survive a lengthy period under these exceptional conditions. In addition to leading to a new recession, the associated indirect collateral damage to suppliers, real-estate owners, banks and other creditors could also destabilise the financial system. One can therefore expect governments to do everything possible, in the hope of a rapid normalisation, to allow the most hard-hit companies to safely survive and limit the economic and social consequences of the pandemic.

This will inevitably lead to further large government deficits and further growth in the mountain of debt, which currently provides no difficulties because of the low level of interest rates. Funding the mountain of debt could, however, become a problem if interest rates rise again one day, possibly due to a significant increase in inflation or because higher inflation expectations become a self-fulfilling prophecy.

Governments can rely on central bank support.

The central banks are also aware of this risk. The US Federal Reserve (Fed) therefore signalled that rising inflation would not necessarily lead to higher interest rates. In addition to maintaining a key interest rate of zero (or in the range of 0 to 0.25 per cent) until 2023 at least, it also plans to realign its monetary policy.

* Joseph Schumpeter was an Austrian political economist. He was one of the most influential economists of the early 20th century, and popularised the term "creative destruction" in economics.

Monetary policy “realignment”

Fed Chair Jerome Powell started a new monetary policy trend in August. Its so-called “price-level targeting” strategy is no longer based on a symmetrical inflation target and avoiding inflation higher than the target, but instead on a cumulative target for an annual increase of two per cent in the consumer price index. The target does not apply to a single year, but instead to a longer period that is not precisely defined, but may cover multiple years. If inflation is less than two per cent for a long period of time, it can then be higher than two per cent for a long period.

What exactly does this mean? Low inflation rates in previous years have created a so-called **“inflation credit”** that the Fed can use to tolerate inflation over-shooting the two per cent mark in the future (see the green-shaded area in Figure 3). If inflation rises significantly, the central bank can therefore wait a while instead of immediately increasing interest rates as a countermeasure. The Fed could delay until it feels that people might get used to an inflation rate higher than two per cent and thereby endanger its goal of price stability. Inflation was less than two per cent almost continuously during the past five years. The “inflation credit” is therefore so large that the inflation rate could average around 2.5 per cent over the next five years before it was used up. Considerably higher inflation rates could also be tolerated for a year if the central bank felt the increase was temporary.

This monetary policy trend might also reach Europe soon. European Central Bank (ECB) President Christine Lagarde announced on 30 September that the ECB would also analyse “price-level targeting” as used by the Fed.

Due to the historically very low inflation rates in the eurozone, this would create an even larger “inflation credit” that would only be used up if inflation were to average 3.1 per cent over the next five years. But even without an explicit redefinition of the inflation target, we do not expect that an overshoot of the two per cent mark would necessarily lead to more restrictive monetary policy in the eurozone in the future.

Figure 3 **US Federal Reserve inflation credit**
From “inflation targeting” to “price-level targeting”

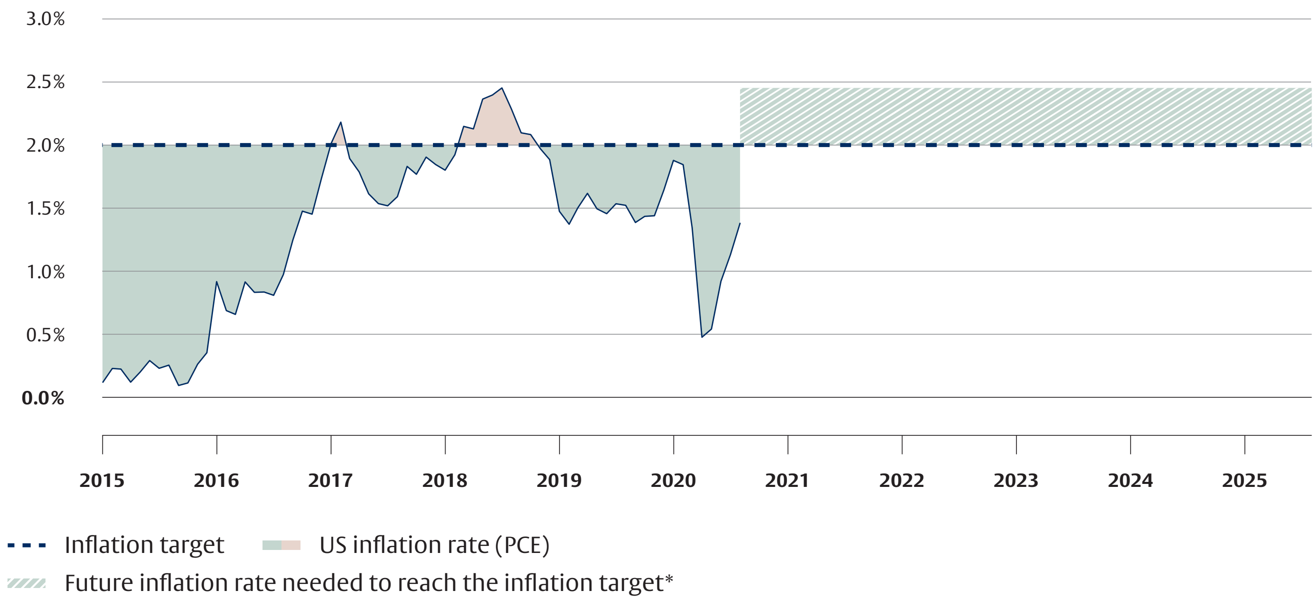
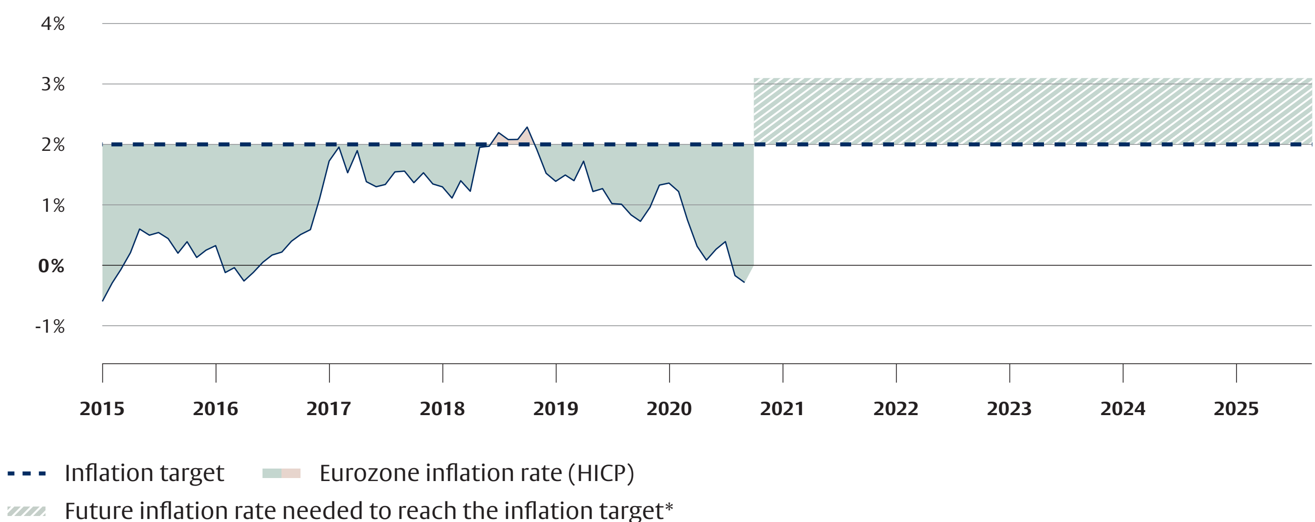


Figure 4 **ECB inflation credit**
Possible “price-level targeting” in the eurozone



* Assumption: average inflation target of two per cent over 10 years.

Sources: Refinitiv, Flossbach von Storch, data as at 6 October 2020
Flossbach von Storch scenario analysis: actual developments may differ from the developments shown.

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Monetary policy and fiscal policy merge

It is not without a certain irony that Christine Lagarde warned on 11 September that *"our accommodative monetary policy needs the support of fiscal policy, and none of us can afford complacency in the present time."*

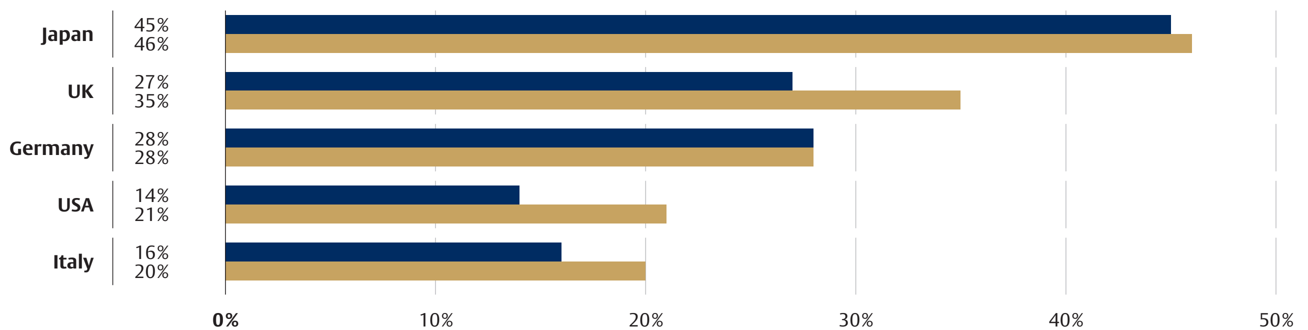
Reading this inevitably makes you think you have misunderstood something. The opposite, of course, is true. Governments want central banks to provide cheap money that makes it easier to fund their deficits, and central banks warn governments to practice sound budget management. Now, however, the central bank is asking governments to use the low interest rates to take on more debt and increase expenditures. Even the International Monetary Fund (IMF), which traditionally warns about excessive national debt levels, is recommending that industrialised countries worry less about their debt and instead take advantage of the low level of interest rates and use the cheap money for infrastructure investments.

Zero interest rates allow practically any deficit or mountain of debt to be easily funded.

National debt-to-GDP ratios have already reached historic highs. Gross national debt will likely exceed 260 per cent of GDP in Japan by the end of the year, and reach around 140 per cent in the USA and around 100 per cent in the eurozone. Concerns about the high level of debt being unsustainable in the long run are at least theoretically unjustifiable as long as interest rates and government bond yields remain close to zero. This is because zero interest rates allow practically any deficit or mountain of debt to be easily funded. The US budget deficit, for example, was greater than USD 3,000 billion for the fiscal year just ended on 30 September.

Investors might worry that the massive volume of new bonds needed to fund the budget deficits could cause yields to rise again. In spite of the explosion in national debt, however, the volume of freely available US Treasuries in circulation has hardly increased, because the Fed is buying up excess bonds like a giant vacuum cleaner. It now holds more than one fifth of all

Figure 5 **What is the limit of government financing?**
Share of government bonds held by national central banks is increasing



Ratio of government bonds held by national central banks to central/federal government bonds outstanding as of:*
31/12/2019 30/06/2020

* In-house calculations

Source: Refinitiv, various statistical offices/finance ministries/central banks, Flossbach von Storch, data as at 6 October 2020

US Treasuries outstanding. This is still small when compared internationally. The Bank of Japan has led the field for years, with recent holdings of around 46 per cent of all Japanese government bonds outstanding, and the United Kingdom, where the figure is 35 per cent (see Figure 5). This also illustrates how blurred the line between monetary policy and fiscal policy has become.

The question arises as to whether there is still any limit at all on government bond purchases.

Even though central bankers worldwide (still) do not consider their institutions to be at risk and continue to vehemently deny accusations of providing monetary government financing, the question arises as to whether there is still any limit at all on government bond purchases. Even self-imposed limits don't need to be permanent, as the ECB recently showed by omitting the upper holding limit of 33 per cent per government bond that applies to previous public sector purchase programmes from the Pandemic Emergency Purchase Program (PEPP). If the pandemic continues, the "limitless" PEPP could act as a source of government financing.

Government interest expenditures will soon be negligible.

Interest expenses already no longer represent a major burden for government budgets. If central banks continue to act as the buyer of last resort and the yields on government bonds remain low, the interest burden could become almost negligible for governments, as shown in Table 1 on the following page.

Table 1 **Debt with no burden**
Net general government interest payments as a percentage of gross domestic product (GDP)

	Debt-to-GDP ratio	Net interest payments		
	2019	**2010**	**2019**	**2030**
Germany	59.8%	2.1%	0.5%	0.0%
Spain	95.5%	1.5%	2.1%	1.1%
France	98.1%	2.3%	1.3%	0.6%
USA	108.7%	2.0%	2.0%	1.1%
Italy	134.8%	4.1%	3.2%	2.1%

Source: Bloomberg, Eurostat, International Monetary Fund, Flossbach von Storch, data as at 6 October 2020
Flossbach von Storch scenario analysis: actual developments may differ from the developments shown.

If our expectations for national debt-to-GDP ratios turn out to be too low, this would paradoxically lead to an even lower interest burden in some cases. This applies to countries whose bonds predominantly have negative yields, which generate interest income when a new government bond is issued. A bond requiring a repayment of 100 will be issued at a price greater than 100 in spite of having a zero coupon. The difference between the issuing and redemption price is included in the government budget as an issuing profit. That means the more the government borrows in future years, the lower the interest burden, until the mountain of debt eventually generates interest and becomes a source of revenue. This might already take place in Germany before 2030, if interest rates remain unchanged and there is a substantial increase in the level of debt.

This should not, however, be seen as a call to assume unlimited amounts of debt, but instead merely shows how permanently low interest rates can massively reduce the pressure on government budgets.

The apparent “free lunch” has a Sword of Damocles hanging over it, namely the risk of a loss of confidence in the currency.

Debt financing like this could be thought of as a perpetual motion machine or cascade system. The situation naturally cannot continue forever, and one has to ask how long it might last. The apparent “free lunch” has a Sword of Damocles hanging over it, namely the risk of a loss of confidence in the currency or, more precisely, its ability to preserve value. Confidence would be put to the test if inflation were to significantly exceed the two per cent mark and central banks provided reassurance by classifying the change as temporary. The newly

created money, however, is still stuck in the Keynesian liquidity trap. In the eurozone, for example, the M1 money supply, which includes currency in circulation and private household and company demand deposits at commercial banks, has risen a good 10 per cent since the beginning of the year. In the USA, Money Zero Maturity (MZM), which includes other readily available money in addition to currency and demand deposits, recorded an even larger increase of 25 per cent over the same period (see Figure 6).

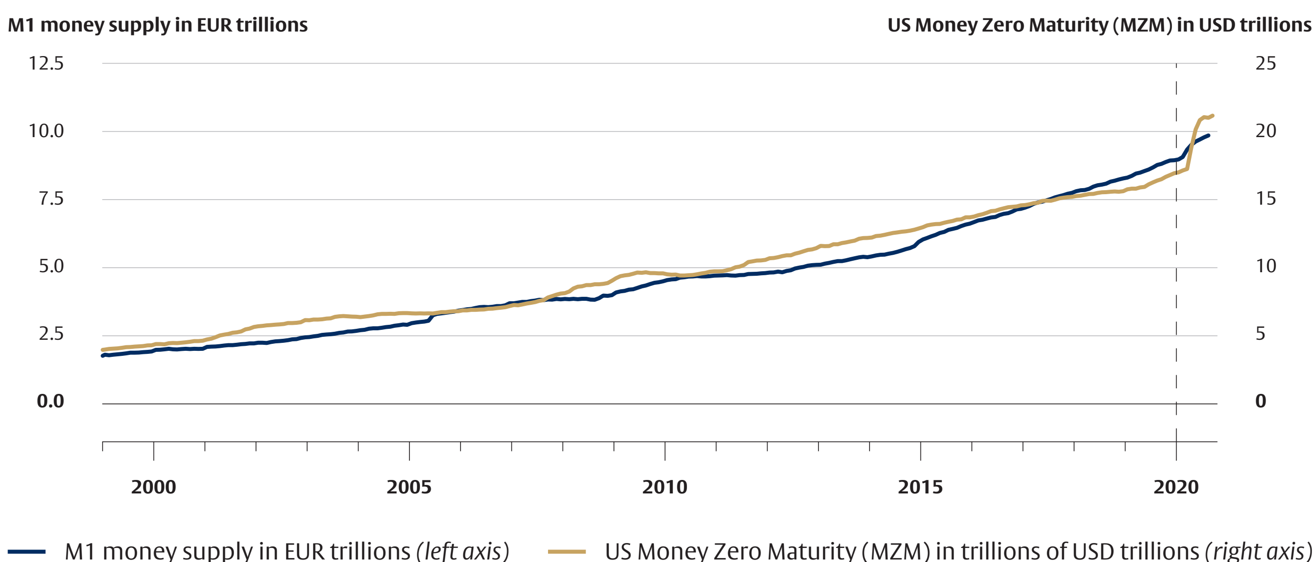
If optimism returns, inactive money could have an effect on demand.

However, as long as the money remains in accounts or is used to buy real estate, it has little or no effect on the demand for and prices of goods and services. This could change if people became optimistic again because a vaccine allowed a return to normality and the economy picked up again.

Because no central banker wants to take the risk of triggering a financial and economic crisis, we think it is very unlikely that central banks would respond by tightening monetary policy and raising interest rates again.

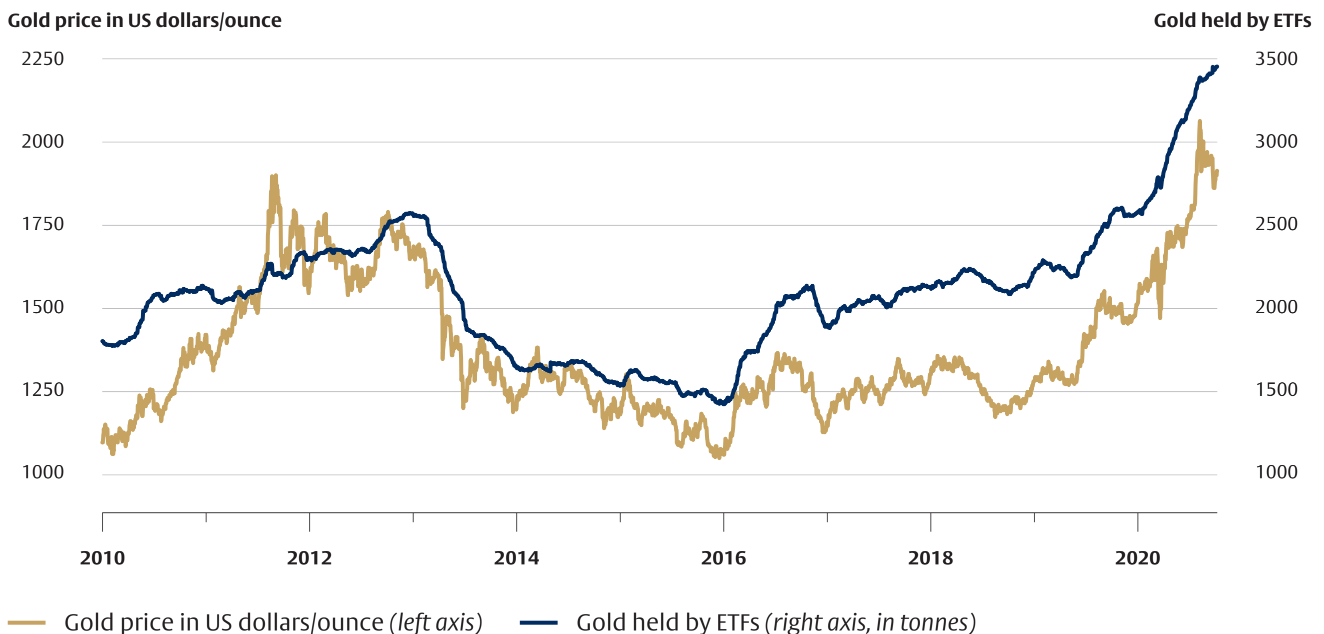
Whether one can take the significant increase in the demand for investment gold due to the pandemic – as shown by the inflow of funds into gold ETFs – as an indicator of increased inflationary expectations is another matter. It is

Figure 6 **Money supply growth has risen significantly since the beginning of the pandemic**
Eurozone M1 money supply and US MZM



Source: Refinitiv, Flossbach von Storch, data as at 6 October 2020

Figure 7 **Gold as an inflation and confidence indicator**
Significant increase in investment demand



Source: Bloomberg, Flossbach von Storch, data as at 6 October 2020
Past performance is not a reliable indicator of future performance.

noteworthy, however, that the volume in gold ETFs has more than doubled since 2016, when eurozone government bonds first had negative yields, increasing from around 1,500 tonnes to around 3,400 tonnes. The price of gold rose more than 40 per cent during the same period (see Figure 7).

Low and negative interest rates clearly also have a positive effect on the price of gold. Although gold pays no interest, it also has no negatives, if one ignores the cost of storage for the moment (around 0.1 per cent p.a.). The opportunity cost of lost interest income was previously a burden for gold investors. The opposite is true today. Gold is more profitable than German government bonds (Bunds), which have yields between minus 0.76 per cent (three-year maturity) and minus 0.11 per cent (30-year maturity). Although US Treasury yields are still slightly positive, their attractiveness compared to zero-interest gold has also fallen to an historic low.

Yields this low indicate the bond market is still showing no worries about inflation. Otherwise, German Bund investors would scarcely accept a guaranteed nominal loss of five per cent over 10 years, or, when buying a 30-year bond, be prepared to suffer a total loss of three per cent until 2050. In our view, the likelihood that buying and holding securities like these to maturity will outperform a zero-interest investment in gold is almost zero. One could, of course, object that permanent deflation turns negative nominal yields into positive real yields and increases the attractiveness of bonds versus gold. This scenario would, however, imply a global economic crisis and a collapse of social security systems, which is why one can reject it as purely theoretical or see it as just another reason for investing in gold.

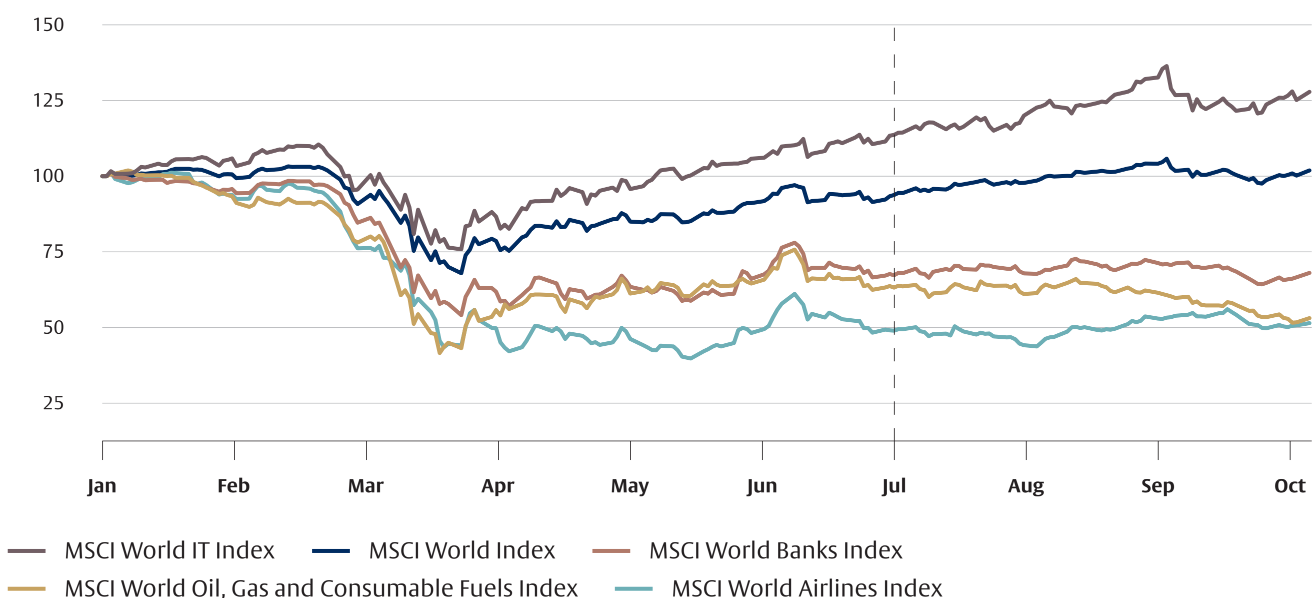
Gold therefore hedges two ways. First, against inflation and, second, in the event that it does not occur.

INVESTMENT STRATEGY

Covid-19 divergence

The gap between expected Covid-19 winners and losers widened further in the third quarter (see Figure 8). While some sectors, like oil and banking, have already been battling structural problems for years, the tourism sector has just recently come under pressure due to the pandemic. Some sectors and companies will return to their previous earnings levels after the end of the pandemic, some will remain behind permanently and others will disappear completely. The suppliers, landlords and lenders for these companies will be among the indirect losers.

Figure 8 **Extreme differences in performance by individual sectors**
A comparison of MSCI World (sub-) indices (indexed to 01/01/2020 = 100)



Source: Refinitiv, Flossbach von Storch, data as at 6 October 2020
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On the other hand, some companies that were already prosperous before the pandemic have seen their growth accelerate even more. This particularly applies to companies in the technology sector, which are directly and indirectly benefiting from the digitalisation trend, increase in online shopping and trend towards cashless payments. In some cases, however, it is just a temporary boom that would likely disappear again in the event of a normalisation.

Stock markets have driven the valuations of expected pandemic winners to highs that have rarely been seen before.

Stock markets reacted very quickly to these developments, driving the valuations of expected winners to highs that have rarely been seen before and that recall the excesses of the technology boom at the turn of the century, when the prices of anything related in any way to the Internet shot through the roof.

There are, however, a few major differences today. First, most of today's technology giants are generating large earnings and cash flows and also have major cash holdings on their balance sheets. Second, valuations have also risen for companies in the industrial and consumer sectors, which are no longer being generally discredited as the "old economy" as they were 20 years ago. True to their nature, providers of consumer staples are proving to be highly resistant to economic change and are earning stable cash flows that allow them to provide secure dividend payments, which in turn increase their attractiveness given the low level of interest rates.

It is almost always better to accept the current high valuation for a good company than pay a "bargain" price for the shares of a weak company. But even good companies can be too expensive.

Investors have mixed feelings about the apparent winners of the pandemic, especially the high flyers in the technology sector, since a high price has to be paid to acquire the growth potential of these companies. Quality naturally has its price, and it is almost always better to accept the current high valuation for a good company than pay a "bargain" price for the shares of a weak company. "Bargain" shares often turn out to be expensive "value traps" in the end. Shares with high valuations, on the other hand, have a more promising future and fast-growing companies are often not as "expensive" as their high valuations signal at the time of purchase.

But even good companies can be too expensive, if the best has already been priced in. If the share price of a well-managed company already reflects the promising future of its products and good growth opportunities, such as a tripling of sales in the next five years, then these expectations must be realised, or investors must be prepared to pay even more for the growth potential. There is a risk of serious price losses if the future expectations are not realised. We therefore try to determine the most realistic picture of a company's future earnings potential. A company only offers sufficient potential and an adequate safety margin against the possibility of us being

too optimistic if the sales, earnings and cash-flow growth assumed in our base scenario considerably exceed the expectations already reflected in the share price.

A company's growth potential should not be fully reflected in its price.

This applies not only to an assessment of the company's future development, but also to determining an appropriate valuation level, which is calculated by using a discount rate to discount future company earnings to their present value. The lower the discount rate, the higher the appropriate valuation. The discount rate is the sum of a risk premium and the risk-free rate. The size of the risk premium depends on how well future earnings can be forecast. The better they can be forecast, the smaller the risk premium that is added to the risk-free rate. The yield on safe government bonds, which is currently at an historic low and will likely remain there in the future, is generally used as the risk-free rate. That means that shares of companies with reliable earnings and small risk premiums and/or companies with high growth potential should have higher valuations today than in the past.

Figure 9 **Reliable earnings, growth potential and low interest rates are driving valuations**
Price-earnings ratio based on expected earnings for the next 12 months

Source: Refinitiv, Flossbach von Storch, data as at 6 October 2020
Past performance is not a reliable indicator of future performance.

Technology equity valuations are at their highest level since the beginning of the century.

This is confirmed by actual stock-market developments. Figure 9 shows that the valuations of companies included in the MSCI World Index (blue line) reached an above-average level of 20 times expected earnings for the next 12 months that is significantly higher than the level before the outbreak of the Coronavirus pandemic. The valuations of the technology companies in the MSCI World IT Index rose even more, reaching almost 30 times expected earnings (brown line) before the correction at the beginning of September. The valuations of shares of consumer staples providers, on the other hand, hardly increased at all over the past five years. Although the valuations of these companies also benefit from low interest rates, this is offset by the comparatively low rate of earnings growth.

In the high-growth technology sector, which is naturally more prone to investor euphoria, the rising tide has lifted (almost) all boats. The enthusiasm for the opportunities offered by the new world even after the Coronavirus is shown not only by significantly higher valuations, but has also created so-called "shooting stars", which are more similar in nature to lottery tickets. This also includes some special purpose acquisition companies (SPACs), i.e. shell companies used to collect capital from an IPO that will later be invested in the acquisition of an as-yet unidentified company. More than 130 of these vehicles have already been listed in the USA since the beginning of the year. The rapid spread of blank cheques like this, where investors buy a cat in the bag while imagining a rampant lion, reflects the massive risk appetite of many investors.

But even the shares of traditional companies with real assets whose business models have proven fragile as a result of the Coronavirus pandemic have started making bets with highly uncertain outcomes. Some of these companies already had to deal with structural problems before the crisis. Others, such as the airline industry, were hit unexpectedly. No one is immune to such cases, of course. Only the iron law of diversification helps.

An intelligently diversified portfolio should combine growth and earnings.

Diversification also means never betting everything on a single scenario, even if the individual investments are high quality. When the next virus infects computers, it could also cause problems for companies that were thought to be sure winners. A portfolio that only contains fast-growth, high-valuation technology companies would therefore be just as one-sided as a portfolio that only includes companies in the consumer goods, industrial or healthcare sectors. It's the mix that counts.

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CONCLUSION

It will still be a while before vaccines have immunised the world against Covid-19 and the restrictions on our lives have been lifted. Until then, governments will be forced to implement further aid programmes, which will be easily funded due to the low level of interest rates. However, the end of the pandemic will not mark the end of the period of low interest rates, even if inflation rises again. The Fed has already prepared for this by redefining its monetary policy. The ECB will likely follow and take advantage of its generous inflation credit.

The differentiation between expected winners and losers of the pandemic continued in the stock markets. The valuations of technology companies, which are among the clear winners, have risen significantly. In addition to focusing on quality, an equity portfolio should also find a good balance between growth potential and reliable earnings.

Dr Bert Flossbach — Cologne, 6 October 2020

PUBLICATION DETAILS

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VAT Number LU 25691460
Commercial register Luxembourg No B 171513
Competent supervisory authority
Commission de Surveillance du Secteur Financier (CSSF)
283, route d'Arlon, 2991 Luxembourg, Luxembourg

Editors Dr Bert Flossbach, Thomas Lehr, Julian Marx,
Christian Panster, Dr Tobias Schafföner, Philipp Vorndran
Editorial deadline 6 October 2020

Graphic design Heller & C and Markus Taubeneck
Printing Druckerei Gebrüder Kopp

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