BANQUE HAVILLAND

Q4 2021 OUTLOOK

OCTOBER 2021

*Banque Havilland, a well-established banking group offers services to both **private** and **institutional** clients, who can benefit from the advantages of a robust banking platform located across seven financial centres. The bank was founded in 2009 in Luxembourg, where it has its head office, and today also has presences in Monaco, Liechtenstein, London, Dubai, Geneva and Zurich.*

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MARKET ENVIRONMENT

There is a palpable sense of uncertainty in financial markets at the moment, even as the S&P 500 reached new highs, as several dominant narratives converge at once to pull investor risk sentiment in different directions. The 'Goldilocks' narrative of stronger growth, economic recovery and low inflation, underwritten by never-ending central bank easy monetary policy appears to have come to an end as all three of these factors are no longer a given. Certainly the rate of economic growth has slowed, with data from the US, Europe and China all falling away from the post-pandemic rebound highs seen earlier in the year with expectations of a new 'roaring 20's' starting to fade. The overall economic picture will probably remain decent at global level, but it is expectations that matter to risk assets, and the expectations now seem to be of a more protracted rebound and decelerating growth as the threat of further Covid-19 restrictions still linger and supply bottlenecks frustrate activity. World industrial production fell in July and retail sales declined in almost all major economies, while the business surveys suggest that activity softened again in August. The tribulations of the Chinese property developer, Evergrande, while idiosyncratic in some ways is nevertheless symptomatic of the wider slowdown happening there and typical of highly leveraged (indebted) businesses being the first to squeal when conditions become less favourable - and also a consequence of the credit-tightening in China that we wrote about in the last Outlook. Comparisons between Evergrande and the collapse of Lehman Brothers are easily made (underperforming property loans, the unknown liabilities on other financial/property institutions balance sheets etc), and while this situation is still to fully unfold we believe it does not represent a systemic threat in the way a global investment bank defaulting did. Indeed, it is likely that the management of the Evergrande situation by the Chinese Government will be in line with the general policy direction of periodically reining in growth and credit expansion. Allowing Evergrande to sweat will send a message to the rest of the property sector to subdue their excesses – but will most likely be ready to step in to limit wider financial damage, and protect individual consumers as they did with the asset management firm Huarong.

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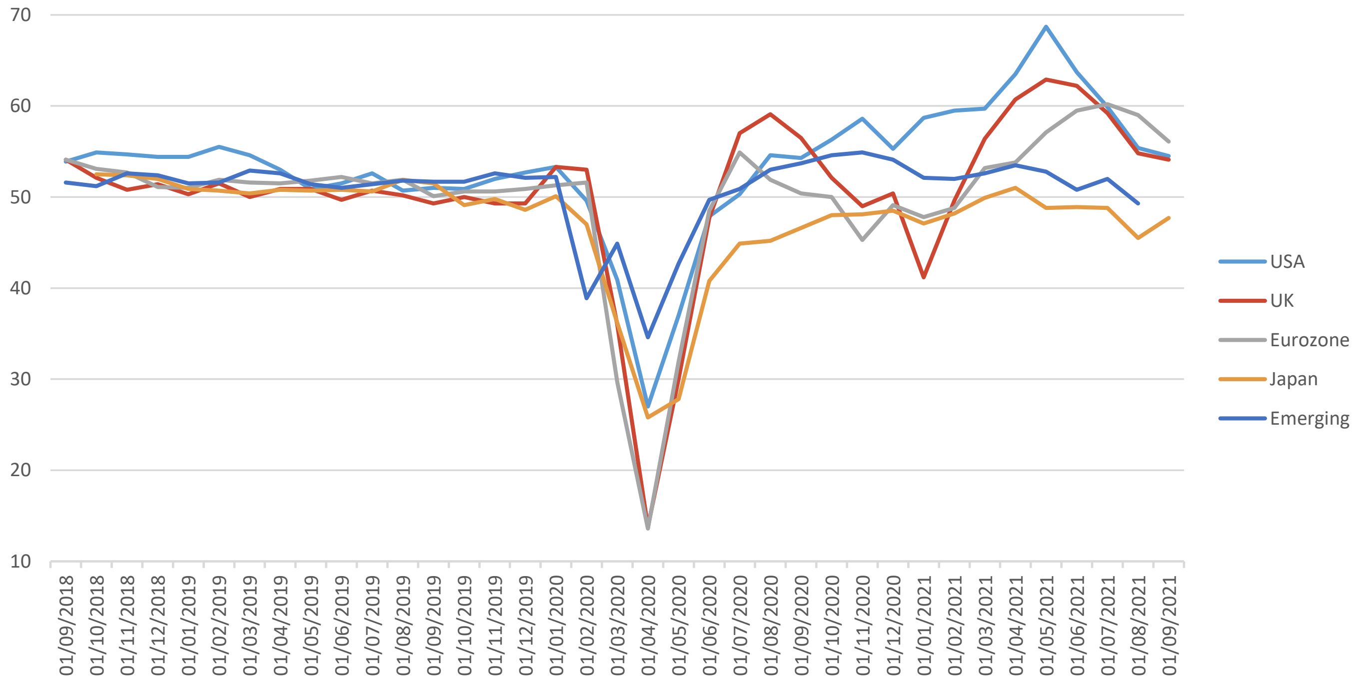
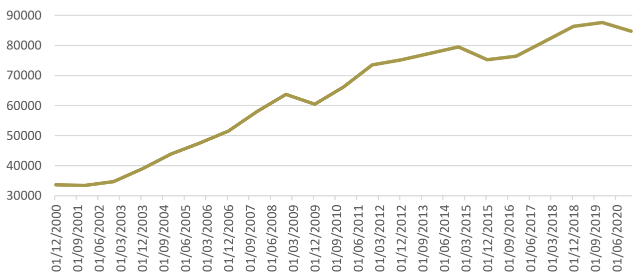
As we know, China's rise has been a significant tailwind for economic growth since the turn of the century, not just in terms of the post-pandemic recovery and a meaningful slowdown (self-imposed or otherwise) will impact global markets, particularly if it continues to coincide with more stodgy growth elsewhere. We can hope that Covid-driven lockdowns, a tightening of credit supply earlier this year and Beijing's regulatory reforms affecting large parts of the Chinese economy are temporary.

Composite PMI Readings



It is clear that the economic rebound peaked in the early summer this year. Fears over the Delta variant and supply chain bottlenecks are weighing on sentiment.

Global GDP

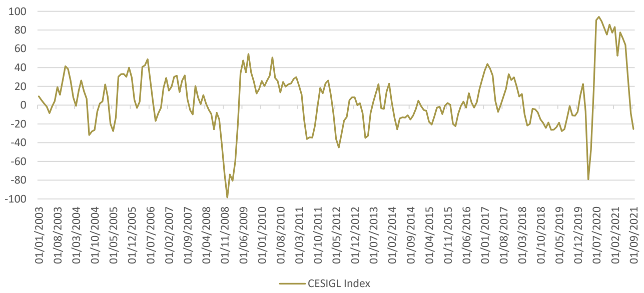


Global GDP also seems to have peaked

China Credit Impulse

The credit impulse measures the impacts of new lending increments, or acceleration of credits to GDP Growth. Currently the Chinese goverement is restricting borrowing as can be seen by the falling line.

Citi surprise Index



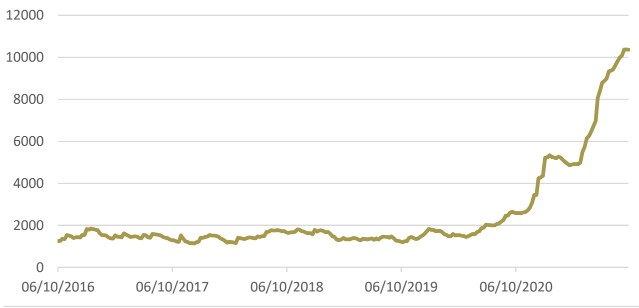
The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

While the spread of the infectious Delta variant of Covid-19 has undoubtedly curbed sentiment, so far a return to more lockdowns have been restricted to New Zealand, Vietnam and Australia with the major economies of US and Europe looking to 'live with' the virus following high vaccination rates, even though cases in the US remain stubbornly high. Importantly death rates remain low in developed economies, suggesting that vaccines have severely weakened the link between cases and serious illness and deaths. To some degree the moderation in growth mentioned earlier reflects a natural normalisation of activity as the effects of past stimulus fade and output approaches or exceeds pre-virus levels. However, high frequency data on activities such as restaurant dining show that consumer caution has returned in some places as virus cases have risen again, so the potential emergence of even non-lethal variants look certain to dampen activity. It is with this fragile growth picture in mind, as well as an inflation backdrop (that seems increasingly non-'transitory') that central banks are treading a cautious line with respect to their communications to the market. As people are encouraged back to work and overcome their fears in venturing out and about, the reopening of the economy continues and along with it widespread shortages of goods and labour leading to higher prices that are becoming ever more apparent in everyday life, (if not fully in official inflation statistics.

From shipping costs, to semiconductor prices, to energy - suppliers and deliverers are struggling to keep up with the demand of consumers, while employers are starting to see the number of unemployed per jobs openings declining. Currently, rising inflation is mainly seen as a consequence of the economic re-opening and therefore perceived as temporary. The temporary element may fade alongside the deceleration of global growth, but other structural inflationary forces may prove more stubborn. Many global supply chains may be broken permanently, with the deflationary trend of globalisation already fading pre-pandemic with many nations looking to become more self-sufficient, while the disruption during the pandemic will not be instantly reversed – shipments are constrained and freight costs are skyrocketing. Furthermore, the top-down governmental charge towards 'net-zero', decarbonisation and green energy is likely to put sustained pressure on commodities involved in the green transition itself. Significantly for the central banks, the markets have been consistently surprised by the extent which actual inflation has been growing – the index that measures this is at a high for the US, with Europe and the Global readings trending higher also. It follows, then, that the intonation of "elevated inflationary pressures are transitory" that central banks have been chanting for some time is getting a little less plausible. The Federal Reserve will be hoping that it's tapering programme alone will be enough to temper inflation, (with bond markets in particular becoming adept at pricing in tapering expectations as carefully signalled by policy-makers), however rate rises are another matter due to the instant effect on bond values. While household debt levels in the US have actually fallen back in line with the lowering (pre-Covid) trend (which suggests consumer debt-holders may be able to stomach incrementally higher interest rates to a certain extent), the public debt has surged once more due to the pandemic response with further federal infrastructure spending to come. This will surely limit how high rates can be risen.

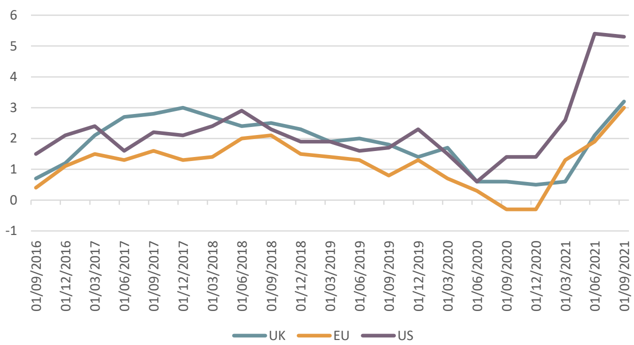
The danger here is that inflation quickly runs riot as it did in the late 1970's leaving the central banks to desperately fight a rear-guard action to rein it back in – this risk looks especially relevant with the Fed's new approach of 'average' inflation over a period, rather than a simple hard target. Our suspicion is that while inflation may peak in the coming months it will not quickly return to pre-pandemic levels and investors need to be prepared for this eventuality.

Freight Container Benchmark per 40 ft box



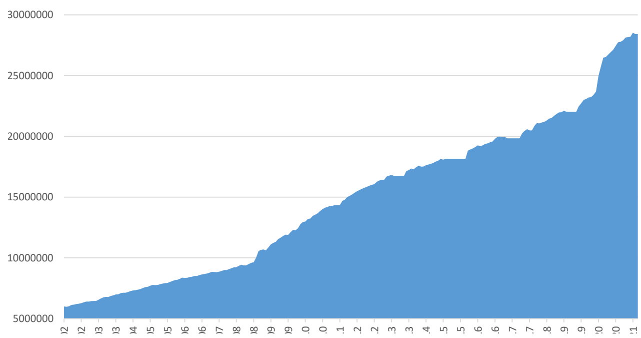
One of the major factors contributing to inflation is the cost of shipping that has spiked dramatically from pre-pandemic levels.

CPI



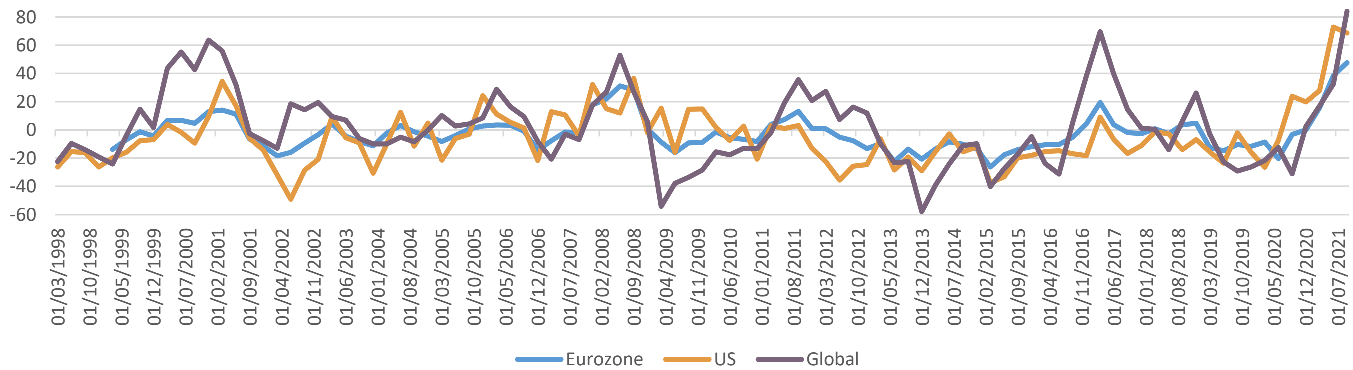
Inflation has spiked in the major economies - time will tell if this is indeed 'transitory' or more embedded.

US Total Outstanding Debt($ Millions)



US debt has leapt in response to the pandemic. The cost of servicing this is unthinkable should rates rise - so we believe rate rises will be limited.

Citi Inflation Surprise Index



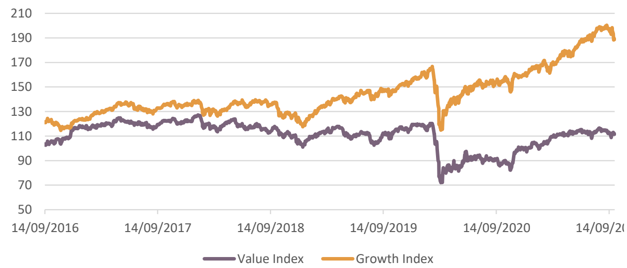
Inflation readings have been increasingly surpassing the markets' (and central banks) expectations now for over a year. This is undermining the 'transitory' narrative.

EQUITIES

If by nothing more than little competition, equities remain our most favoured asset class moving toward the conclusion of 2021, with even the expensive US market looking relatively good value when compared with the real yields of 'risk-free' assets such as Treasuries. The US market's valuation is high on any metric, and (as it is such a large component of the global index) so by proxy are global equities which is the principle reason for us holding no more than a neutral weighting to stocks within a multi-asset class portfolio. The S&P 500 long term PE ratio is now at 1999 levels, and the metric favoured by Warren Buffet - that of the market cap of the whole US index divided by the US's GDP – is also at record highs. However, if we look at the forward PE valuation for the next 12 months to discount the unnatural rebound from the 2020 Covid lows it looks a little more reasonable. As we know from recent years, valuations alone are not reason enough to precipitate a sharp fall in markets especially when earnings growth is continuing, but it does make it vulnerable once previous long-held inflation and loose monetary policy assumptions start to fade. While bears will point to an inevitable correction of absolute valuations that at some point will revert to historic levels, bulls will argue that it is only relative valuation to other assets that matters for the equity markets – but before this theory is fully realised the current inflationary environment needs to be passed. The increased volatility that we have seen starting to pickup in September may help provide a more favourable environment for active stock pickers as passive investors who have enjoyed an easy ride since March 2020 are shaken out of the markets. In particular this will be the case if the five largest stocks in the index that have previously benefitted from the 'stay at home' trend, higher earnings, and falling interest rates (that reduce the cost of capital and support higher valuations, especially for long-duration assets such as high-growth stocks) continue to underperform. It is quite possible that rather than seeing an outright correction as we did in 1999 that the prospect of higher interest rates should persuade investors to rotate away from longer-duration assets, such as mega-caps stocks, towards shorter-duration stocks like value and cyclicals.

"The increased volatility that we have seen starting to pickup in September may help provide a more favourable environment for active stock pickers as passive investors who have enjoyed an easy ride since March 2020 are shaken out of the markets."

European Value vs Growth

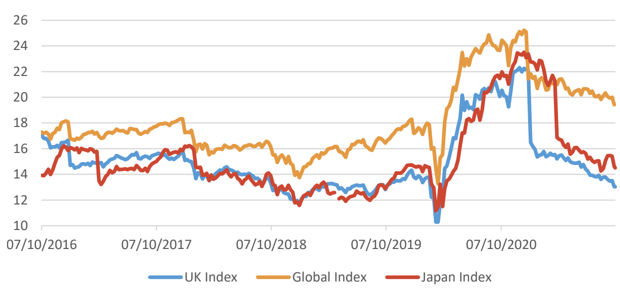


The valuation gap between Value and Growth is at extreme levels - this is likely to converge, favouring value companies.

Active managers typically outperform when dispersions are elevated while a passive approach performs better when there is a lack in return dispersions, so a more fragmented market now that the initial euphoric rebound is over should benefit more discerning investors. The valuation gap between growth and value stocks is still fairly extreme, with European value companies trading at a more than 50% discount to their peers with stronger earnings growth, so it makes sense to maintain a good portion of an equity portfolio positioned for the 'rotation' to value to continue.

As far as regional equity dispersions are concerned, this year markets have largely been chronologically following the various economies' progress in battling the virus. China was first out the blocks with respect to lifting social restrictions, but has since rolled over for a number of reasons, while the US was ahead of Europe in its reopening and vaccine roll-out and so stole an early march as its economy rebounded rapidly. Since then, however, European markets have closed the gap in terms of performance as the EU got it's vaccine programme back on track and travel restrictions were eased for its citizens – essentially a catch-up trade. Economic data is encouraging in the Eurozone with retail sales and services activity stabilising above pre-pandemic trends while many companies are revising their earnings revisions upwards – taking confidence from the approach of 'living with the virus' rather than countries defaulting to lockdowns. Value stocks, particularly financials and banks makeup a good chunk of the market, that offer upside potential should interest rates rise in the region - and while this doesn't look especially imminent, such characteristics present a nice way to offset the more growth-orientated companies within a wider stock portfolio. Furthermore, there are a raft of companies publishing good results with very strong long-term fundamentals that we feel are not being noticed for the quality businesses they truly are, and that once the fear of further lockdowns has finally disappeared the markets will invariably acknowledge and recognise them. Holding growth stocks at a reasonable price remains our core mantra, with the aim being to participate in economic growth with the comfort of not being exposed to the extremely valued parts of the market. Alongside favouring Eurozone stocks, we continue to hold overweight positions in the UK and Swiss equity markets. Britain faces bottleneck supply problems as much as anywhere (particularly with respect to higher energy prices) as well as a higher tax regime that risks curbing growth just as it looks set to take off - but the valuation discount (not only to its's own historic value but to other indices) keep it as a high conviction of ours. Our allocation to Switzerland gives our portfolio a quality dimension that is currently in demand during uncertain times, with a hefty exposure to healthcare companies that will surely do well as medical expenditure picks up in a pandemic-conscious world. Likewise the Japanese equity market remains a part of our allocation across portfolios for its attraction valuation and for what we think

British and Japanese stocks: 12M Fwd P/E



British and Japanese stocks are cheap compared with the Global index and also against their own recent valuations.

is the underestimated potential for domestic growth, and despite the renewed surge in Covid infections (which looks to have now peaked as Tokyo restrictions are lifted) the Topix has rapidly caught up following the prime minister resignation and the expectation of his replacement to bring even more pro-market policies. Indeed, the reception Fumio Kishida received by Japanese business has been very positive with a large tick up in the Tankan Manufacturing survey, while the prospect of a further bout of stimulus bodes well for the market. We choose to tilt our exposure to that of the domestic economy rather than the typical export-led international Japanese companies – thus avoiding too much indirect vulnerability to a downturn in nearby China - while the accompanying Yen denomination serves as a useful currency diversifier in a global portfolio. With respect to China, we believe in a temporarily cautious approach as the CCP's recent actions in curbing corporate ambitions are still washing through the economy. The propensity to resort to severe lockdowns is a concern, while the administration is also having to battle to reverse the contraction in credit creation it triggered earlier in the year. In the long term we still believe in China and emerging Asia as a region of unparalleled growth opportunity (and by proxy strong returns for equity investors). Although the forward PE ratio has fallen, we know that the Chinese market is prone to periodic corrections more severe than today's levels - so we will be patient in waiting for a new buying opportunity.

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EQUITIES				**Equities remain relatively attractive as Covid restrictions in major economies continue to be relaxed and growth is strong, however valuations are high and sector/style allocation is required to be selective.**
US				Remains a very expensive market, supported by Federal Reserve liquidity and high investor participation. Quality stocks seem to have assumed market leadership.
UK				British stocks are at their cheapest versus global stocks for many years, and should benefit from the catch-up/value rotation.
Eurozone				Continental European stocks are leading the rotation charge, as the economic recovery gathers pace. ECB in no hurry to tighten.
Switzerland				Quality, defensive nature of the market continues to see Swiss stocks in demand.
EM				Though we retain an allocation to emerging Asia for the long-term growth story, most developing markets look challenged by Covid, while China has lost some of its appeal and India is expensive.
Japan				Attractive valuation for a developed market, and we like the safe-haven qualities of the currency. Vast BOJ asset-buying is underpinning market, and growth is returning.

FIXED INCOME

It is difficult to make the case for holding anything other than a minimum allocation to bonds in general, with yields currently so low and the asset class so uniquely vulnerable to rising inflation. Indeed, in terms of real yields, many bonds are so deeply negative that they seem un-investable on a stand-alone basis by the standards of history! There has never historically been this magnitude of fiscal and monetary stimulus unleashed upon the economy and financial markets before, of course, which is the principle reason that bonds remain in demand, and ironically it is this ultra-loose policy and stimulus that now indirectly threatens the market. Central banks have been essentially following the same playbook since 2008, and many investors have questioned what the unintended consequences or side effects would be of this down the line. Inflation was always a potential consequence, but before the pandemic the lack of inflation considering the stimulus was the real mystery (largely explained away by the forces of globalisation and the efficiency advances enabled by technology). However, now pandemic-related bottlenecks and gaps in the global supply chain as economic demand recovers are causing meaningful price rises, the claims of central banks that this is just a transitory phenomenon are sounding increasingly strained. So it is that the bond markets may soon start to notice and the extreme valuations will look more and more precarious with each elevated inflation print. Since the start of September it seems that Treasuries have started to 'price in' the tapering of the various central bank's asset purchasing programmes, and we can at least take some comfort that it has not been a 'tantrum' such was seen in 2013 – the US 10yr Treasury yield has risen 30 basis points since July but remains 20 short of its March highs, and it remains to be seen if this is the start of a more sustained sell-off or not.

> *"Central banks have been essentially following the same playbook since 2008, and many investors have questioned what the unintended consequences or side effects would be of this down the line. Inflation was always a potential consequence, but before the pandemic the lack of inflation considering the stimulus was the real mystery (...)"*

US 10 year Treasury yield

Since the mid-80's, the bond market has been a one-way bet. Will this reverse as yields approach zero and inflation arrives?

2 Year Bond Yields

COUNTRY	MATURITY	YIELD
Switzerland	SWISS 2 11/02/2023	-0.810
Austria	RAGB 0 15/07/2023	-0.780
Finland	RFGB 3 1/2 15/04/2023	-0.770
Netherlands	NETHER 3 1/4 15/07/2023	-0.740
Belgium	BGB 4 1/4 22/06/2023	-0.710
Germany	BKO 0 015/09/2023	-0.700
France	FRTR 0 25/02/2023	-0.700
Portugal	PGB 2.2 25/10/2023	-0.690
Ireland	IRISH 0.8 20/03/2023	-0.680
Denmark	DGB 0 1/4 15/11/2022	-0.630
Spain	SPGB 0.4 30/04/2023	-0.590
Greece	30/01/2023	-0.510
Italy	BTPS 2.3 15/06/2023	-0.460

COUNTRY	MATURITY	YIELD
Sweden	SGB 5 13/11/2023	-0.310
Japan	JGB 0.1 03/01/2023	-0.130
Australia	ACGB 2 15/07/2023	0.030
Hong Kong	HKGB 1.52 23/08/2023	0.060
Israel	ILGOV 5 1/2 31/07/2023	0.090
United States	T 0 3/8 20/09/2023	0.300
United Kingdom	UKT 0 1/2 31/01/2024	0.430
Canada	CAN 1 1/2 01/08/2023	0.520
Singapore	SIGB 1 1/4 01/02/2024	0.560
Norway	24/05/2023	0.770
New Zealand	15/05/2024	1.215
Iceland	15/04/2024	2.894

Jerome Powell and his peers are acutely aware of the effect their rhetoric has on the bond market (and equities) and have been at pains to strike a cautious note, telegraphing any intended action well into the future giving the market time to digest. It is notable that the most violent reaction in the rates space has been in the UK Gilts market, with a near 50bp move and surely no coincidence that the Bank of England have sounded the most hawkish of the major banks in recent weeks. While it is good that government bonds seem to be absorbing the coming tapering of asset purchases in an orderly fashion, it's also worrying that higher inflation is apparently not being factored in - leaving them especially prone to a change in sentiment towards the official 'transitory' narrative. Perhaps, the best way for bondholders to reassure themselves in the face of the logical unattractiveness of Treasuries is to look at a chart of the 10yr yield since 1980's, and one of the most enduring and important trends in financial markets: that of lower yields. Of course, as the yield gets nearer zero (or more deeply negative in real terms) this trend will be questioned more and more – but it would hardly be surprising if following a rise to around 2% they then fall back in line with a 30 year trend.

Nevertheless, the risk of investing in Sovereign bonds has never been more asymmetrically tilted away from the interests of the investor. i.e. with the upside being the potential to hold short-term value during a time of market turbulence and perhaps a few basis points of capital gains, and the downside being guaranteed long term wealth erosion due to negative real yields, next to no nominal income and high potential for capital loss in the secondary market. As such we are very much underweight government issued fixed income in our allocation and prefer to hold a diversified basket of higher yielding, low duration bonds, acknowledging that while yields are still paltry there is at least the chance to receive some income. Selection in such bonds is crucial: a competent US high-yield bond manager, for example, is able to put together a reliable portfolio of BB/CCC rated corporate bonds with short maturities yielding 4% or so by simply screening out the weak names in the universe and avoiding those most vulnerable to default risk by way of proper analysis. Similarly, there are plenty of emerging market companies that you can be sure are able to service their debt and repayments over 3 or 4 years, even though there will be some that inevitably won't. Of course, we have grown used to very few defaults in recent years due to the low-rate environment so must be aware of these increasing if and when base rates start to rise – but we are not there yet, as the central banks are keen to reassure us.

We are interested in Chinese Onshore bonds for similar reasons, with the market dominated by domestic investors it is very stable and yielding around 3%, and importantly still seems to have a negative correlation with equities particularly in times of stress, or when concerns over the China economy are eminent. It is probable however, that like us, international investors will be increasingly drawn to Renminbi bonds in the coming years which not only will reduce the diversification benefits of the asset class but may also prompt the Chinese government to increasingly monitor ownership of its debt – representing something of an unknown risk. It may be wise to see how the Evergrande situation plays out before investing.

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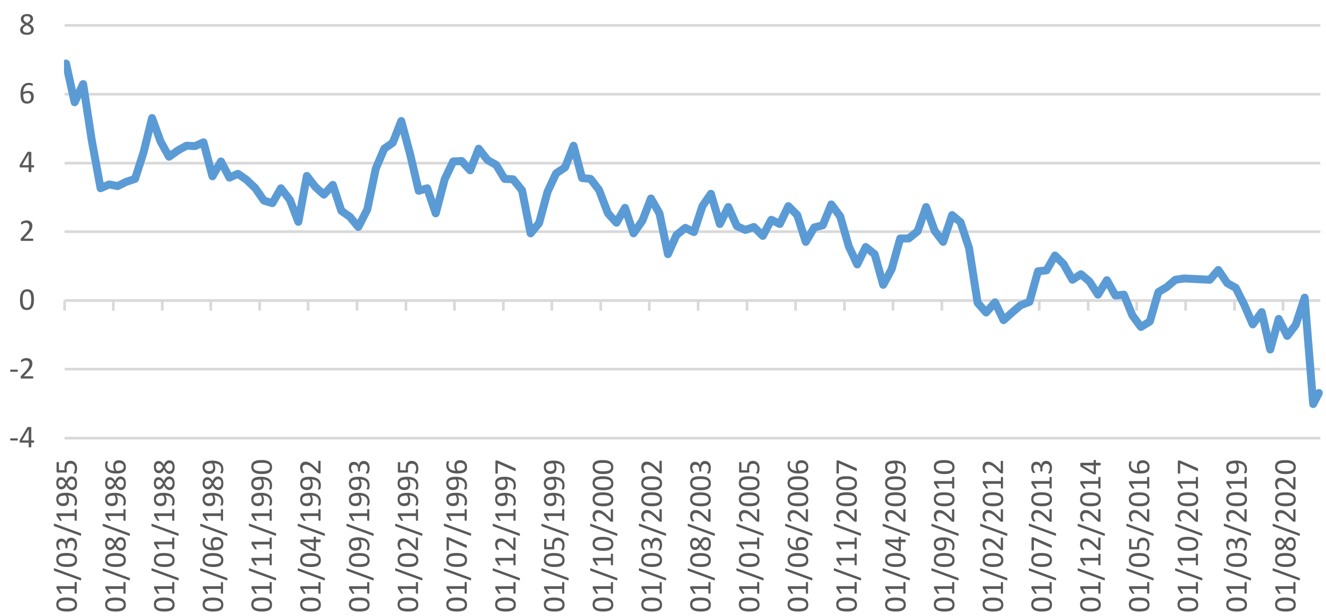
FIXED INCOME								**Headline yields are near record lows once more, and with economic recovery and inflation prevalent, bonds look too expensive.**
Sovereign Bonds								Sovereigns offer safe harbour in time of market stress, but have limited upside remaining and negative real yields long-term.
Corporate I.Grade Bonds								Central bank asset purchasing is supporting corprates for now, but tapering is on the horizon and spreads are very compressed.
High Yield Bonds								Yield pick-up is still relatively attractive, but low historically. Default risks are a concern.
E.M. Bonds								Local currency appreciation in an economic recovery, together with meaningful yield pickup make certain EM bonds relatively attractive. Short duration.

CURRENCIES AND COMMODITIES

The US Dollar strengthened significantly over the summer as the US economy powered on and with it expectations of monetary tightening - and certainly there appears to be daylight between the Federal Reserve and the ECB in terms of tapering timelines looks set to be exacerbated by the long term yield differential of holding USD debt versus EUR debt. The economic rebound has since started to fade in the US though, while the delayed European recovery is in full swing pointing to the Dollar being a little curtailed in the short term. As such we don't have particularly strong convictions for the currency markets in general, and therefore are not making any outsized currency bets away from any given portfolio's base currency. We accept that the trajectory of global growth will influence how much demand there is for the Dollar, and that when there are bouts of risk-off sentiment, investors liquidating assets will generally see a demand for USD cash at the expense of other 'risk-on' currencies such as GBP and EUR. Fed policy announcements and the impact these have on real rates, as well as inflation levels of course, will steer demand for Dollars as they will over the longer term for precious metals. As, on balance, we think policy makers are restricted on how high they can push rates while also suspecting inflation is set to be greater than expected, we believe in a supportive environment for gold as an alternative store of wealth as investors are confronted with negative real rates for longer than the market is currently pricing. We continue to hold a little weighting in Japanese Yen and Swiss Francs that should hold value in times of stress - and especially so having sold off year to date i.e. there is room for them to rise before getting back to 'normal' levels.

FED US Treasury 10yr Real Yield Curve Rates



Rates adjusted for inflation have sunk to new (negative) lows. This should be a positive backdrop for gold, though it has yet to react.

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CURRENCIES				Distant rate rises mean the Dollar will struggle to gain too much upwards momentum, and other developed nations are closing the growth gap. We expect the current USD strength to subside from here.
U.S. Dollar (DXY)				Rate rises are some way off and while a huge stimulus bill will boost the economy, it will inflate the twin deficit pointing to a lower move long term.
Sterling (GBP)				The UK recovery has peaked, and despite short-term energy tribulations the pound should continue to claw back post Brexit underperformance, supported by BOE.
Euro (EUR)				Central bank looks a little hamstrung, but will likely let inflation pick-up significantly before acting. Vaccine programme is back on track, and economy recovering.
Japanese Yen (JPY)				JPY has fallen back in 2021, but only back to pre-Covid levels and broadly in line with its 5yr average. A nice currency for diversification in risk-off times.
Swiss Franc (CHF)				CHF remains a genuine safe haven. Nice diversifier, though global recovery could dampen demand, with SNB curbing upside.
EM				Many EM nations remain mired with Covid and Political setbacks. CNY strength has plateaud, as Chinese economy slows and government ramp up corporate restrictions.

Perhaps a surprising development in recent weeks has been the resurgence of industrial commodities and crude oil despite the evidence of a slowing economic recovery both in the US and China. This suggests the slack from reduced demand is being matched by the still-lingering Covid effects hampering the supply chains while commodities' reputation as an inflation hedge can be a self-fulfilling driver of demand, as speculators look to increase their exposure. There are likely to be equity-like spasms of volatility in reaction to risk-off headlines, but the commodities bull-market that started in 2020 looks ready to go further due to two major top-down government policies. Firstly, both the US and China are embarking on huge infrastructure programmes that point to a sustained period of commodity demand. Namely, a US$1 trillion bill has just been passed in the senate for roads, railways, airports communications and broadband projects amongst others, while local Chinese governments raised RMB4.5 trillion of debt in 2020 much of which is earmarked for infrastructure construction. Secondly, many governments have committed to environmental change and energy transition which may in time reduce the use of hydrocarbons but in the transitional period will require many different commodities to construct the 'electrification' of our energy world. Copper, nickel, Aluminium, Tin, Silver and Platinum are all needed in great quantities, and at this point the demand for these looks like it may well outstrip the rate of supply thus supporting prices higher and longer than the regular economic cycle, with miners battling to undo years of underinvestment. It is also quite possible that the markets are underestimating our ongoing reliance on traditional fossil fuels, and even if the various green energy technologies are developed and rolled out on schedule we will still not be able to keep up with the overall increases of energy usage which is always going up (led by the US, China and India). This could result in higher prices for oil and gas as there will be less of it around having incentivised the traditional fuel providers to reduce production and move to green, while demand in emerging economies for cheap energy in particular is likely to see an ongoing need. With inflation looming it therefore may be a good time to have some exposure to a broad basket of commodities in case the transitory period of higher prices turns out to be longer than imagined.

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Author: Jonathan Unwin
Asset Management Department
e. j.unwin@banquehavilland.com

BANQUE HAVILLAND S.A.
35a, avenue J.F. Kennedy | L-1855 Luxembourg
t. +352 463 131 | f. +352 463 132 | e. info@banquehavilland.com

BANQUE HAVILLAND S.A. (UK BRANCH)
5 Savile Row, London | W1S 3PB | United Kingdom
t. +44 20 7087 7999 | f. +44 20 7087 7995 | e. info.uk@banquehavilland.com

BANQUE HAVILLAND (MONACO) S.A.M.
Le Monte Carlo Palace | 3-7, Boulevard des Moulins | MC-98000 Monaco
t. +377 999 995 00 | e. info.monaco@banquehavilland.com

BANQUE HAVILLAND (LIECHTENSTEIN) AG
Austrasse 61 | LI-9490 Vaduz
t. +423 239 33 33 | e. info.lie@banquehavilland.li

BANQUE HAVILLAND S.A. REP.OFFICE (DUBAI)
Aspin Commercial Tower | Office # 4001 | Sheikh Zayed Road
P.O. Box 414678 | Dubai, United Arab Emirates
t. +971 4 306 28 88 | e. info.dubai@banquehavilland.com

BANQUE HAVILLAND (SUISSE) S.A.
Boulevard du Théâtre 10 | Case Postale | CH - 1211 Genève 3
t. +41 22 818 82 22 | e. info.switzerland@banquehavilland.com
Zurich Branch: Bellariastrasse 23 | 8027 Zurich
t. +41 44 204 80 00 | e. info.switzerland@banquehavilland.com

LUXEMBOURG LONDON MONACO
LIECHTENSTEIN DUBAI GENEVA ZURICH

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