

## Monthly Pulse – Wednesday, 1<sup>st</sup> July 2021

### Economic Outlook

Today, over 15 months after COVID-19 outbreak was declared a pandemic the virus still poses a threat to the markets. Another new variant forces cities into lockdowns and travellers into quarantines. However, some countries, such as Singapore, are already overcoming the COVID-19 situation and declaring an end to contact tracing and other measures taken as soon as there are enough people vaccinated. Therefore, the focus is on the real economy: a rapid recovery that has been observed in some countries makes investors nervous, as it might bring high inflation and early tapering. The ambitious spending plans proposed by the US president require financing, which introduces an additional risk factor: an increase in corporate taxes that would hurt companies' profit margins and thus result in lower yields to investors.

#### Tactical Asset Allocation

Liquidity	Neutral
Bonds	Underweight
Equities	Neutral
Alternative Investments	Overweight

#### Macroeconomics

Economic recovery is now evident around the globe in the data as well as in the markets. PMIs in Europe and the US suggest that both regions' business activity is strongly expanding: both services and manufacturing figures in the regions are significantly above 50. Unemployment and initial jobless claims are slowly but steadily falling - although in the labor market, there is still a lot of room for improvement. In Europe, unemployment was 8.0% in April, but is expected to have stalled at this level in May. In the US, initial jobless claims were stuck around 400k in June, almost twice the average pre-pandemic level, and unemployment was 5.8% in May, slightly below the April level of 6.1%. However, both regions' unemployment figures are elevated relative to the pre-pandemic levels.

Therefore, monetary and fiscal support continues for now. The US Fed has just started hinting at the beginning of a tapering discussion and recognized the fact that the economy is expanding at a greater than expected pace. As recovery and vaccination progress in the EU is lagging the US, the ECB is staying dovish. Moreover, to provide further support to the region, the first payments from the EU Recovery Fund have been handed out at the end of June. Overall, while the US is experiencing its peak post-pandemic growth and inflation right about now, Europe is likely to be at this stage in the second half of the year. The latest year on year CPI growth

reading of 2.0% in May technically exceeds the central banks' target of just under 2%, while in the US, CPI rose by 5% over the same period - high above the target of the 2% average. In both regions, inflation is stronger than it has been in many years, but more is yet to come for Europe. Thus, with the backdrop of noticeably rising prices - sparked up by pent up demand and supply bottlenecks and amplified by the base effect - the main question on investors' and economists' minds is whether inflation is going to pass with the recovery normalization or whether we are entering a new higher-inflation environment.

#### Fixed Income

In Q2 US Treasury yields started to stabilise. After the 10-year yield peaked at 1.75% in late March, they traded sideways and closed Q2 at around 1.50%. Although inflation fears have been confirmed by higher-than-expected CPI data, 10yr rates did not react. On the contrary, even after a more hawkish tone at the latest Fed policy meeting, where the central bank signalled that interest rate hikes will now begin in 2023, instead of 2024, 10yr yields dropped unexpectedly below 1.50%. It seems that the market is accepting the Fed's mantra that higher inflation will prove transitory.

All eyes are on the Fed, looking to get signals of the timing of its monthly bond purchases reduction. At current levels (UST 10yr at 1.5%), we see a larger probability of higher yields than lower ones. Although "the taper tantrum" - scenario is heavily discussed and might already be reflected in prices, it needs to be tested by the market. Therefore, we stay cautious on duration and prefer the short end.

The environment for Fixed Income investors remains challenging. At current yield levels we avoid locking them in for longer. However, we think that the economic recovery allows us to add some credit risk. Bonds from the energy, materials and financial (AT1's) sector still offer some additional spread. We feel comfortable going down the credit curve picking up some names from the BB segment.

As the economy recovers, credit fundamentals are improving and therefore expected default rates are declining. Consequently, rating upgrades are more likely. That is why we like a well-diversified credit portfolio with a bias towards cyclical names. We stick to our strategy as we believe in a full recovery of the economy. Sure, new variants (Delta) of the COVID-19 virus can delay the recovery scenario, but not destroy it. Macro data and Fed comments will be closely watched for the rest of the year. Therefore, we expect

volatility in Fixed Income coming more from the rates, than the credit side.

## Equities

The highlight last month was set by the Fed. The correction on the stock markets is related to the surprisingly hawkish tones of the Fed. Although the US monetary watchdogs have not yet given a clear signal for tapering, the discussion about tapering has begun. However, the timing of taper remains uncertain. The US central bank wants to have more data, particularly on the labor market, before it is confident that “substantial further progress” has been made. Analysts believe that two to three good labor market reports will be enough to give the go-ahead for a reduction in bond purchases in August or September, either already at the end of the year or at the beginning of next year. In the meantime, investors have digested the hawkish tones, and the financial markets, similarly to the Fed, see inflation only as a temporary event.

We believe the equity markets can live with this course of action, as monetary policy will remain expansionary and growth-supportive for a considerable time yet. This also means that the earnings outlook for companies should remain very positive. However, the risks for the equity markets will increase if the rise in inflation proves to be more persistent and monetary policy has to react to this. There are a few indications of this at present. By contrast, key interest rate hikes as a normalization of monetary policy due to a faster than previously expected achievement of employment targets and sustained good growth prospects are not a problem for the equity markets. Nevertheless, with the emerging change in the course of US monetary policy, the path for the stock markets is likely to become bumpier.

### Equity Indicators

Valuation	Neutral
Momentum	Neutral
Seasonality	Neutral
Macro-Economics	Positive

For the time being, equities are faced with an unusual configuration: high but falling growth, high but falling inflation, and tightening financial conditions. There are a few sectors that perform in all three states of the world, namely Energy, Pharma and Telecoms. We are keeping our neutral stance and becoming more selective on the cyclical exposure.

## Alternative Investments

In the FX space, the USD was the major winner after the Fed has given hints of the tapering discussion. It has surprised us since there was fundamentally no change nor any shift in monetary policy. Whether it is a gamechanger remains to be seen. Fed’s Powell defied consensus expectations that the topic about tapering would be raised only at Jackson Hole or the September meeting. While the medium-term upside risk for the USD has risen, analysts continue to regard the global recovery environment, which should persist in 2H, to favor risk-on and export-driven currencies. As for the EURUSD, we think the upside is rather limited for the next month or two and expect rather range trading within 1.18 – 1.20.

Gold took a hard hit as the Fed communicated that tapering and rate hikes could start sooner than expected. Same as in G10 currencies, the price pressure was driven by stronger USD and higher US 10Y yields. The yellow metal should arguably serve as an inflation hedge but for the time being, we may see further price pressure. Investors could consider a reduction in their tactical long holding but keep their strategic positions.

A spike in COVID-19 infections as a result of the Delta variant of the virus has caused a minor wobble in the oil price. While it is certainly sensible to pay close attention to data, the probability of countries returning to full-scale lockdowns is low. As usual, with oil near the top of the recent trading range, sentiment is more than usually susceptible to news flow that threatens the prevailing positive supply and demand narrative. The OPEC+ seems likely to consider additional easing of productions cuts. Even with the expected increase of 500kb/d, the market would remain in deficit this year, limiting material downside risk for oil.

Hedge Funds strategies closed all in positive territory in May. Some macro strategies were flat when Event Driven strategies performed well. We expect this development to have continued within June due to benign markets. The return of CTA strategies with an impressive performance of 8% year-to-date surprised us most despite of the positive markets. Year-to-date, Long/Short equities as well as event-driven strategies outperformed the other strategies and profited from their high correlation to risk-on assets. Private markets were also profiting from a benign market environment. Most strategies were up within the last months. Nevertheless, dispersion between the different funds has never been wider than this year since the financial crisis. It pays off to focus on well-established and connected fund managers in order to catch a superior performance. Most of the strategies profit from the increased appetite for mergers and acquisition as the uncertainty about the future fades away.

## Market Overview as of Wednesday, 01 July 2021, 2:17 PM

### Fixed Income

	Rate	Δ 1m	Δ 3m	Δ ytd		Δ 1m	Δ 3m	Δ 6m	Δ ytd
USD Overnight	0.08	0.02	0.01	0.01	USD Deposit 1m	0.2%	0.5%	0.9%	0.9%
USD 1y Swap	0.18	0.04	-0.03	-0.01	USD Aggregate 1-3y	-0.1%	0.1%	0.0%	0.0%
USD 3y Swap	0.58	0.15	0.08	0.34	USD Aggregate 3-5y	-0.2%	0.1%	-0.8%	-0.8%
USD 5y Swap	0.97	0.08	-0.05	0.54	USD Aggregate 5-7y	0.2%	1.0%	-1.8%	-1.8%
USD 10y Swap	1.44	-0.14	-0.27	0.52	USD Aggregate 7-10y	0.9%	2.1%	-2.4%	-2.4%
EUR Overnight	-0.48	0.00	0.00	0.02	EUR Overnight	0.0%	-0.1%	-0.2%	-0.2%
EUR 1y Swap	-0.50	0.01	0.02	0.03	EUR Aggregate 1-3y	0.0%	-0.1%	-0.2%	-0.2%
EUR 3y Swap	-0.39	0.02	0.07	0.11	EUR Aggregate 3-5y	0.1%	-0.2%	-0.3%	-0.3%
EUR 5y Swap	-0.25	0.02	0.09	0.21	EUR Aggregate 5-7y	0.2%	-0.3%	-0.8%	-0.8%
EUR 10y Swap	0.12	0.00	0.08	0.38	EUR Aggregate 7-10y	0.5%	-0.5%	-1.9%	-1.9%
CDX Xover 5y	2.74%	-0.11%	-0.25%	-0.19%	US Corp. HY	1.3%	2.6%	3.6%	3.6%
iTraxx Xover 5y	2.31%	-0.14%	-0.15%	-0.12%	EUR HY	0.5%	1.2%	2.7%	2.7%

### Equity

	Price	P/E	D. Yield	FCF yield		Δ 1m	Δ 3m	Δ 6m	Δ ytd
MSCI World	9 053	20.6	1.8%	5.7%	MSCI World	1.3%	6.7%	13.0%	13.0%
S&P 500	4 298	22.7	1.4%	3.3%	S&P 500	2.3%	6.9%	14.4%	14.4%
NASDAQ	14 555	29.6	0.7%	3.0%	NASDAQ	6.6%	9.2%	12.9%	12.9%
Euro Stoxx 50	4 077	18.3	2.7%	15.3%	Euro Stoxx 50	0.1%	3.3%	14.7%	14.7%
SMI	11 960	19.1	2.8%	4.4%	SMI	4.6%	7.6%	11.7%	11.7%
FTSE 100	7 100	13.6	3.9%	16.3%	FTSE 100	0.3%	5.4%	9.9%	9.9%
DAX	15 586	15.3	2.8%	10.7%	DAX	0.1%	3.2%	13.6%	13.6%
MSCI Asia Pacific	208	16.5	2.3%	7.1%	MSCI Asia Pacific	-1.1%	1.1%	4.0%	4.0%
FTSE China A50	17 581	14.7	2.3%	16.1%	FTSE China A50	-3.0%	-0.8%	-0.7%	-0.7%
MSCI Emerging Market	1 375	14.5	2.4%	7.4%	MSCI Emerging Market	-1.2%	3.0%	6.5%	6.5%
PH Semiconductor	3 345	23.2	1.2%	3.4%	PH Semiconductor	5.4%	3.2%	19.7%	19.7%

### Commodity

	Price	FCST 21	FCST 22	Δ Future		Δ 1m	Δ 3m	Δ 6m	Δ ytd
Gold	1 778	1775	1712.5	-0.5%	Gold	-6.6%	3.0%	-6.2%	-6.2%
Silver	26.40	25.49	24	-3.0%	Silver	-6.2%	5.5%	-0.7%	-0.7%
Platinum	1 088	1189.78	1275.25	6.1%	Platinum	-9.6%	-10.2%	0.2%	0.2%
Palladium	2 787	2675	2712.5	-0.9%	Palladium	-2.7%	5.0%	13.5%	13.5%
Crude Oil	75.73	62	62.5	-8.3%	Crude Oil	12.2%	24.1%	56.6%	56.6%
Brent Oil	76.44	65.79	65.5	-5.7%	Brent Oil	9.4%	19.9%	49.3%	49.3%

### Foreign Exchange

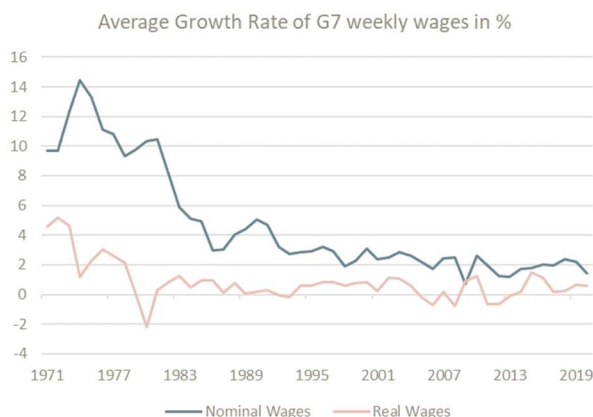
	Price	FCST 21	FCST 22	Δ Spot		Δ 1m	Δ 3m	Δ 6m	Δ ytd
EUR/USD	1.1882	1.21	1.23	3.5%	EUR/USD	-2.7%	0.9%	-2.7%	-2.7%
GBP/USD	1.3809	1.42	1.44	4.2%	GBP/USD	-2.4%	-0.2%	1.0%	1.0%
USD/CHF	0.9245	0.92	0.92	-0.5%	USD/CHF	-2.9%	1.9%	-4.2%	-4.3%
USD/JPY	111.44	110	110	-1.3%	USD/JPY	-1.8%	-0.7%	-7.4%	-7.3%
EUR/CHF	1.0985	1.12	1.13	2.8%	EUR/CHF	-0.2%	1.0%	-1.6%	-1.6%
USD/RUB	72.86	71	71.3	-2.2%	USD/RUB	0.9%	4.7%	2.1%	2.1%
EUR/RUB	86.56	86.4	84.71	-2.2%	EUR/RUB	3.9%	3.7%	4.5%	4.7%

Source: Clarus Capital Group, Bloomberg

## Special Topic

### Inflation – will history repeat itself?

The younger part of today's active population knows about inflation of over 5% only from history books. If one ignores the two world wars, the inflation trend from 1972 to 1985 in particular serves as a cautionary example of rampant and damaging inflation - so-called stagflation. In the G7 countries, inflation reached levels of over 10% during that period and was so high that the Fed under Paul Volker, had to initiate a drastic period of interest rate hikes in the early 1980s to get inflation under control. Other central banks followed suit. The logical consequence was an economic downturn. Coming back to the present, the recent inflation trend is comparable with the inflation trend in the 1970s and 1980s, after the most recent year-on-year price increase of 5% in the USA. There are indeed parallels that give cause for concern. However, monetary and currency policy achievements make an inflationary development like back then very unlikely.



Source: Clarus Capital, Bloomberg

The foundation for the high inflation in the 1970s was laid long before the oil price shock of 1973. During the 1960s, the US government budget was in a heavy deficit. The Cold War arms race, space programs and the fight against poverty caused government spending to rise sharply. At the same time, wages increased steadily in the Golden Era thanks to powerful unions. A prosperous and consumer-friendly middle class established itself in the US, as well as in Europe. In the G7 countries, higher inflation rates in the 1960s were not a major factor, especially since average real GDP growth more than compensated for inflation.

Toward the end of the 1960s, the US government deficit widened further due to high military expenditures for the Vietnam war. On the other side of the US current account deficit were weighty economies with current account surpluses or, because of USD pegs, with high US reserves. The major currencies were pegged to the USD under the Bretton

Woods Agreement. In return, non-US central banks could exchange their USD holdings at the Fed for gold. In 1971, US President Nixon was forced to abandon the gold backing of the USD because the US was not at all in a position to meet the gold exchange obligation for USD agreed in the treaty. Confidence in the USD, which was highly overvalued at that time, was gone. In 1973, the Bretton Woods system collapsed, leading to a sharp devaluation of the USD. At the same time, the OPEC countries effectively cut oil production because of the Yom Kippur War, and the price of oil skyrocketed. The already almost perfect storm.

The fact that the perfect inflation storm reached global dimensions was related to the fact that central banks could not pursue an autonomous monetary policy in a system with fixed exchange rates like Bretton Woods. The three monetary policy objectives; fixed exchange rates, free international capital movements and autonomous monetary policy are not compatible. Only two goals can be achieved at the same time. As world trade was already increasing during the Bretton Woods system, capital movements were also increasingly liberalized. The Fed's expansionary monetary policy in the 1960s forced central banks of countries with current account surpluses to hold even higher USD reserves. This intervention requirement inflated central bank balance sheets and led to forced competitive devaluation of currencies of export-oriented nations. This proved to be insidious. Strong demand from abroad also led to a booming economy outside the USA and to a completely unnecessary expansion of the money supply. At that time, the central banks - including the Fed - had neither the necessary experience nor effective instruments to combat rising imported inflation. Clumsy attempts to restrict foreign trade and to take economic stimulus measures slowed growth, but inflation, or stagflation, remained.

The adjustment of global currency imbalances, together with the now flexible exchange rates, initially still caused strong economic fluctuations. When inflation seemed to have been gradually tamed, the second oil price shock followed in 1979. The central banks had learned their lessons and were now geared to fighting inflation - above all the Fed under the aegis of the pragmatic monetarist Paul Volker. Since central banks independently pursued inflation targeting, inflation increased only moderately and cyclical fluctuations decreased. The "Great Moderation" period lasted until the Minsky moment in 2007. This, however, had nothing to do with inflation, but with exaggerations in the credit market.



Strong stimulation of the economy, supply bottlenecks, pent-up demand, base effects, deglobalization ideas and temporarily increased inflation are normal after a severe recession. All of these factors, together with an aging population, form an inflationary base. But for inflation to become persistent, the output gap must close, full

employment must be achieved, and wages and the prices of essential goods must rise steadily. It only becomes threatening when central banks, monetary and fiscal policy collectively fail. The returns of the economy to its old path is more likely than a new perfect storm.

## Sustainability, ESG, Impact Investing – an overview about responsible investments

Investors start to pay attention not only to profitability, but also to the responsibility of conducting business. Normally, if a factor gets into investor's focus, it is also becoming a return driver and should therefore be considered carefully like the other relevant factors such as momentum, value, growth, etc. But what is ESG Investing? One of the principles of responsible investing is to check companies for compliance with ESG-factors, which stands for Environmental (ecology), Social (social development) and Governance (corporate governance) factors. Below are some examples of the issues that contribute to each of them.



### Environmental

- Climate change risk and opportunities
- Greenhouse gas emissions
- Environmental pollution
- Depletion of natural resources



### Social

- Security of employees
- Diversity and inclusion
- Working conditions
- Investments in social projects
- Support for education



### Governance

- Corruption
- Top-management remuneration
- Information disclosure
- Relationship with shareholders

## Environmental, Social and Governance (ESG)

ESG ratings can be either numerical or categorical. Higher numeric scores can represent higher ESG compliance or, the opposite, higher ESG risk. Categorical assessment can, for example, take form of a risk scale from Negligible to Severe, as in Sustainalytics' ESG Risk Ratings, or it can resemble credit ratings, like MSCI's ESG ratings that goes from CCC-B for ESG-compliance laggards to AA-AAA for leaders.

Some companies report these ratings on their websites and, and in their presentations; some indexes report ESG ratings of the constituent companies. A low rating is not necessarily a bad sign for a company. Currently there is no single standardized ESG evaluation, so what is average to some rating agencies can be outstanding to others. Moreover, the fact that the company reports on its environmental, social and governance issues and was rated in the first place might already indicate that it is working in right direction at the very least by increasing awareness and transparency. Sometimes the most return potential is offered not by the champions but by the upcoming champions.

One of the most used filters in ESG are exclusion criteria such as no weapon, tobacco, alcohol, etc. It could be implemented either strictly or with certain thresholds. If a criterion is applied strictly, e.g. "no weapons", it might exclude any company that works together with the Pentagon and would therefore exclude the bigger IT companies. However, typically, thresholds are applied instead. For example, companies that receive more than 5% of their revenues from coal energy can be excluded from an ESG-focused portfolio. There is no limit and no standard in defining thresholds,

which is why they might allow a lot of flexibility and compromise.

ESG ratings can be applied to any instruments, however it is most reasonable for bonds and equities. Commodities normally are excluded by their nature. As hedge funds are lacking transparency, it is normally difficult to prove them to be ESG compliant.

A more devoted approach is called impact investing, which means that the investor actively seeks investments with a true positive impact, and an adequate return on investment might not even be a priority. The investor's goal in this case is to improve the world.

### ESG is becoming Mainstream

According to Ernst & Young, 97% of institutional investors already assess a company for its social responsibility. This interest is growing not only among institutional investors, but also among private ones, and especially among younger generations.

Amid the COVID-19 pandemic, as the world is forced to consider a global existential threat for the first time in decades, investors' interest in ESG indices has surged. The advancement of green technologies, reduction of CO2 emissions, waste sorting, etc. all contribute to prevention of deterioration of the ozone layer and slowdown of global warming, and thus have been seen by investors as especially attractive in 2020. Furthermore, in modern realities, in order to qualify for large investments and compete in the global

market, it is often necessary to follow environmental trends and strive for high performance ESG-wise, as this will be one of the main funding criteria in the near future.

Sustainability is also receiving substantial tailwinds from governments across the globe. The so-called Paris agreement, that has been signed by 195 countries, specifies a 2°C limit for the world temperature increase relative to pre-industrial levels and proposes carbon-neutrality among the possible ways to achieve this goal. Thus, most countries in the world have already established the goal of carbon-neutrality by mid-century, and the trend continues. For example, China, the second economy in the world and

currently the largest carbon dioxide emitter, has recently pledged to become carbon neutral by 2060.

The fact that younger generations, that are just now beginning their professional track, are increasingly interested and involved in the more sustainable ways of living and investing, together with the global systematic sustainability efforts, will inevitably propel ESG-compliant companies and increase the return on ESG-focused investments not only in the short run, but also within strategic planning horizons. Moreover, it will generally raise the standard for business conduct and investment toward a more sustainable and transparent path.

## Implementation

An ESG-oriented strategy can be implemented directly, which requires screening each and every potential company not only for its growth and profitability potential, but also for its ESG impact. Alternatively, the strategy can be implemented through ETFs or funds, which requires only selecting an appropriate index or a trustworthy and competent fund manager. The approach of a typical ESG-themed index usually involves screening and strict or, more frequently, threshold-based elimination of companies whose profits come from certain controversial sectors and activities, for example, coal mining, gambling, biological, chemical, or nuclear weapons. A manager of an ESG-themed actively managed fund conducts a more intricate selection of constituents based on their ESG reporting, commitments, and potential. It is a common practice for managers of such funds to communicate with the companies they are invested in or are considering investing into about the state of their ESG-related practices. Fund managers can point out the company's ESG-shortcomings or emphasize advantages. They can even help the company develop a strategy to improve its sustainability.

### ESG by Clarus Capital

Within Clarus Capital, we believe that sustainable investing adds value to the performance just like factors such as value and growth. Not always will ESG compliant investments

outperform market capitalisation-based indices. Nevertheless, in the long run, ESG-compliant investments can prove to be more robust and resilient, due to selection of companies that are inherently less exposed to compliance, fraud, and reputation risks. This is why Clarus can offer its clients to devote some of their investments to an ESG-oriented strategy. Within the equity asset class, we implement this strategy by investing into funds and ETFs, that are carefully screened and picked to offer an optimal combination of performance and sustainability. For fixed income investments, we concentrate on screening and exclude certain industries, such as mining, tobacco, controversial weapons, gambling, and others, in addition to monitoring companies for various ESG related risks. Moreover, we also strongly believe that companies and governments can strengthen their progress towards sustainability and are not only including the ESG champions.

Our solutions also cover impact investing, but they are thoroughly discussed and evaluated by the client together with the relationship manager before being implemented.

You can always consult your relationship manager on how to make your investment more suitable to your principles and risk tolerance. Do not hesitate to contact us if you are interested in learning more about ESG and how to increase sustainability of your finances.

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