Money, Macro & Markets Monitor

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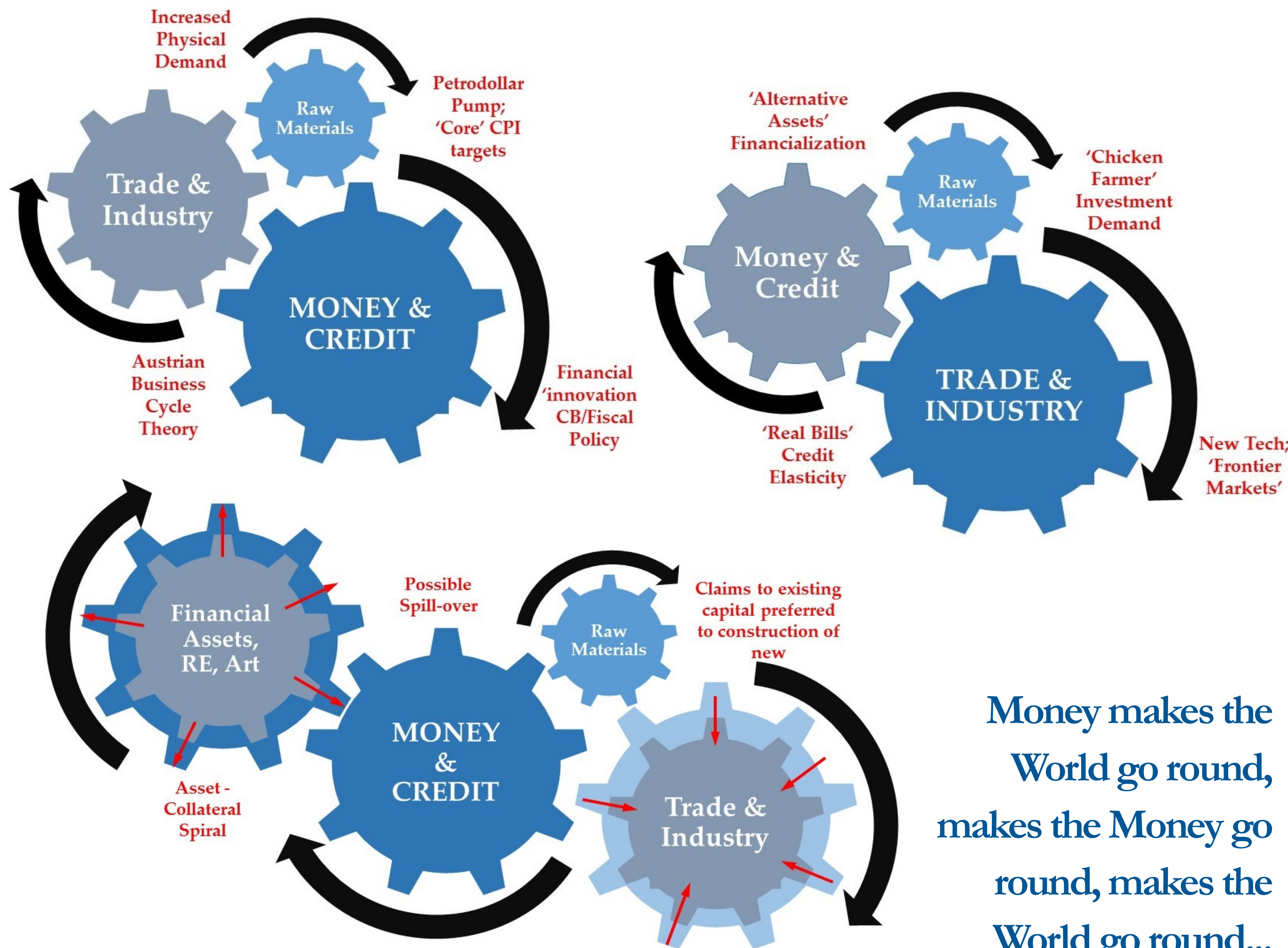
November 2018



IN THIS ISSUE:-

History: a Rhyme, not a Repeat

Banking on no re-rerun of 2008

A Class on '87

The Rhino that is China

Beijing hits the Panic Button

US equities: Sentimental Swing

Slowing sales, crumbling credit = Dismal DAX

The real story of yields

The dollar's date with destiny

Energy liquidation: looking for a signal

Volume II, Issue IX

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It IS Different This Time

As we pass the tenth anniversary of the '*Bubble that Broke the World'* (actually the title of a short, but masterful treatment of the 1920s boom by the great Garet Garrett, first published in 1932), it seems that a whole industry has grown up in which all those hoping to feature in 'The Big Short - The Sequel' spend half the waking day sending each other the same charts and recycling the same tweets, all of them featuring either climbing debt levels or price-to-something ratios, by way of a bid to book a post-implosion screen test.

Among them are two main classes of candidate: the first composed of veterans who were active in the lead up to Lehman's ruinous fall – inwardly aware, as a group, that they were completely blindsided, both by the event itself and by the pervasiveness of the rotten substructure of malinvestment which the bank's collapse subsequently laid bare. As such, they are determined not to seem to be the patsies a second time around and so talk with a weary, knowing air of the perils of 'kicking the can down the road' - a posture which does not preclude them from simultaneously shrieking, "Wolf!", every time some policy maker threatens to keep his feet to himself for a change.

Then there are this breed's successors: those who began their careers after the GFC broke out. For this less hoary population, raised in a world of overweening central bank hubris, of ever lower bond yields, ever higher stock prices, ever more compressed credit spreads, and ever lower volatility, their readiness to indulge in a little amateur Permabearishness is a cocktail of juvenile rebelliousness mixed with a stiff shot of ennui from having to operate in a hyper-regulated, no-mobile-phones-in-the-office-or-drinks-with-the-broker world of BTFD and HODL and a corresponding desire to have some actual markets to trade for a change.

This latter urge perhaps constitutes a faint echo of the excruciating eagerness with which the Lost Generation of the 1900s – lulled into romantic dreams of earning bloodless glory by the long, prosperous placidity in which its boys had grown to manhood - marched off, singing merrily, to the industrial carnage of Flanders. For our own generation of largely untried gunslingers, myths of the Ragnarök of 2008 were what comprised their bedtime trading stories and so they have become steeped in a sense of the tragic inevitability of it all. Many of them, therefore, in the endearing arrogance of youth, fondly imagine that THEY will never be as foolish as were their lambs-to-the-slaughter forefathers – a vaunt they repeat with every Zero Hedge excerpt, Citibank 'Surprise Index' reading, and new instalment of 'credit impulse' chart-porn they so eagerly exchange.

Now, a certain degree of scepticism about the state of the boom is not something we would ever decry. Nor is a deepening of that disbelief into a more pressing sense of foreboding always entirely unwarranted. We are all subject to the ills of inherent human fallibility magnified by official stupidity and *Wille zur Macht*.

No, the issue with the indiscriminate churn of the 'Everything Bubble' faction is that its proponents either offer no compelling diagnosis of why this particular patient is in imminent need of intensive care or, where they do attempt one (or, more often, an often incompatible miscellany of them, plural), they simply point to one or more of an array of superficial likenesses to the things that went so horribly wrong in 2008. In the first, they are being merely facile: in the second, dully unimaginative. It is not only generals who always prepare to fight the last war, it seems, but economic pundits and practitioners, too. When it comes to the specifics of each cycle of folly, 'It' usually IS 'different this time'!

The reader will now grasp that the irony of the opening paragraph is that an 85-year old book sounds so eerily contemporary, suggesting that there is indeed 'nothing new under the sun'. In fact, my own, short compilation of mainly Victorian case-histories of financial manias was entitled '*Santayana's Curse'* precisely to underline the

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recurrent nature of our follies. As an advocate of Austrian thinking since – oh, around about the time a new internet book-seller called 'Amazon' started on a bitcoin-like tear that saw its stock price rise nearly ninety-fold (only to surrender 95% of those gains in an equally short space of time and so nearly founder) – the idea that there is an identifiable chain of causation in the wasteful hysteresis of Boom and Bust, one rooted in the suppression of interest rates and the over-provision of unsound credit, has been central to my thinking for longer than I can remember.

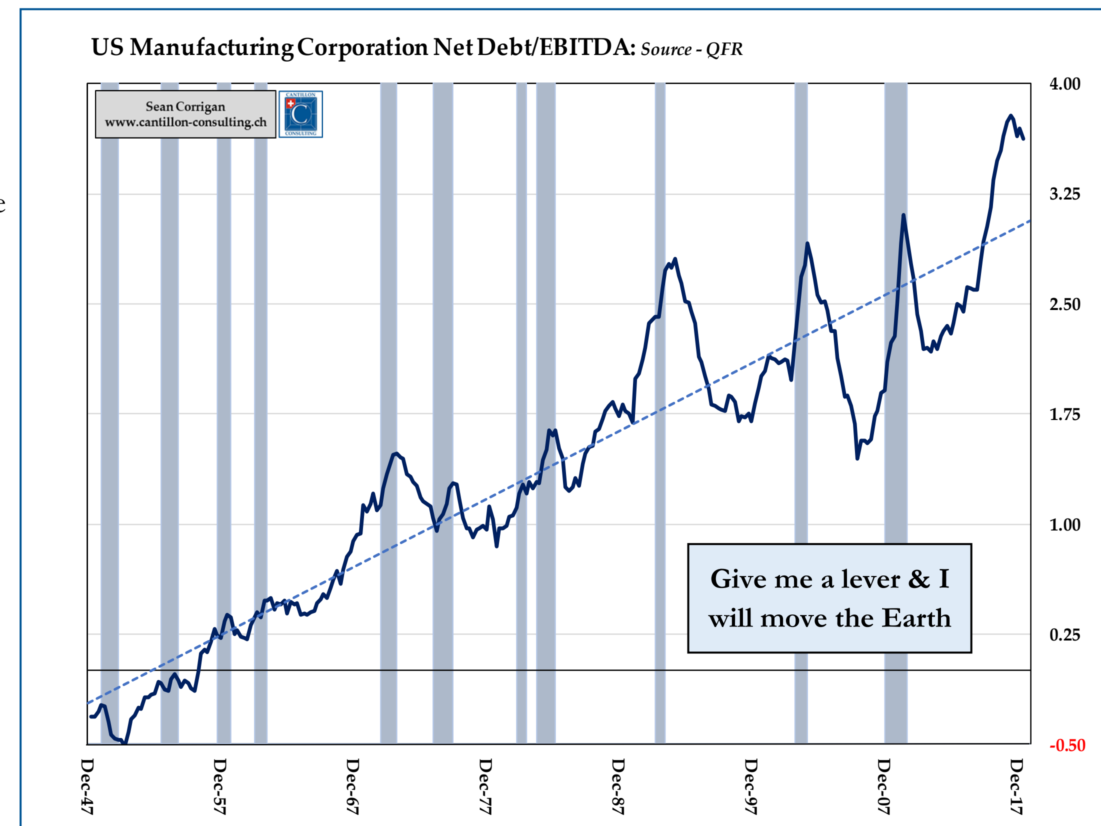
But, let me reiterate: to be aware that an economic structure built amid the warm, narcotic glow of secularly – in some cases unprecedentedly – low interest rates and easy credit terms is highly unlikely *not* to contain critical vulnerabilities, or to harbour hidden, self-generated malignancies, is one thing. But to simply wave one's hands over pictures of Crashes Past or to regurgitate official puffery about how 'global debt has risen 50% since Lehman' – i.e., at a hardly remarkable 4% per annum before accounting for the fall in the contemporary value of the money in which those debts are reckoned – is to do little to advance the cause of identifying how, when and where such weaknesses are most likely to manifest themselves, this time around.

Dancing in the Dark

For example, there is a vague sense that the coming crisis will repeat the playbook of the Lehman crisis – with the added admonition that, since we have so much more debt this time and since interest rates are already so low, that central banks either will not have enough 'ammunition' to cope with it or, conversely, that they will immediately go nuclear and obliterate what little remains of the market mechanism after the 'Whatever it takes', 'Three Arrows', 'We have a technology called the printing press' carpet-bombing of the past decade.

For example, there has been much ballyhoo about corporate debt levels (some elements of which we have participated in) and much invocation of the curse word 'leveraged', as in 'leveraged loan'.

Undeniably, the amount of debt on balance sheets has expanded as the search for yield on the part of investors and the temptation to sweeten the earnings-per-share count on the part of issuers has been magnified by the prolonged period of depressed real and nominal interest rates through which we have been living. Nor should this come as any surprise. Indeed, this upsurge in borrowing was the avowed intention of the same central banks and supranational bureaucracies who are now hypocritically warning of the potentially dire consequences of their own policy settings.



However, here we must be clear: for all the undoubted increase in the risks being run by operationally leveraged businesses (and, by extension, by those who hold

their obligations), these are of a very different order to the highly non-linear, financial system leverage which brought the Temple crashing down about our ears a decade ago. Yes, there may be CLOs aplenty, but CDO-squareds and -cubeds there are not. Yes, there are record numbers of covenant-lite bonds and a record proportion of more lowly ranked issuers in both the investment-grade and high-yield baskets. But the sort of crazed tiering of ever-more concentrated (and foolishly-retained) risks we saw in the US mortgage market while Chuck Prince was still on his feet and dancing seems thankfully to be notable by its absence. Nor, by and large, are such hazards as there are principally concentrated in the hands of the banks - institutions with relatively meagre capital coverage and a heavy reliance upon short-term funding, thus highly susceptible to the sort of reputational collapse which has, throughout history led to their own creditors making a 'run' upon them.

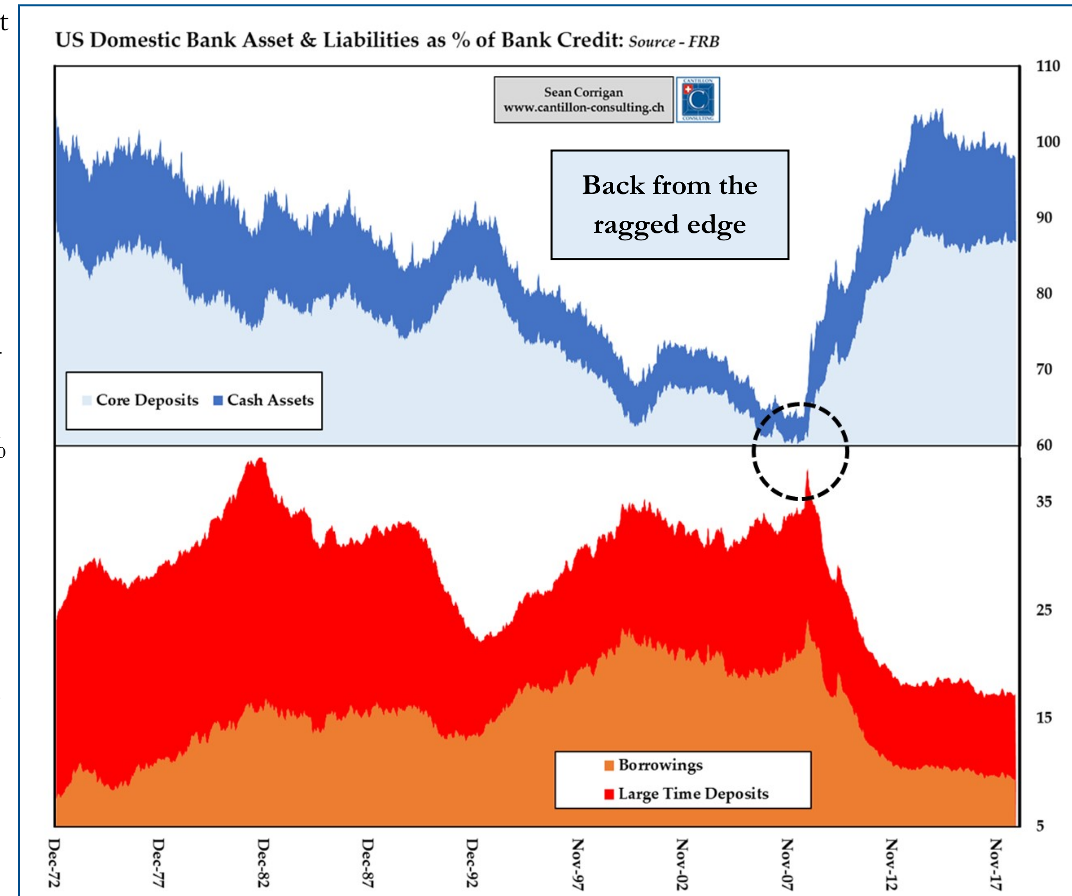
None of this is to argue that the next downturn will not deliver prodigious numbers of failures, tremendous amounts of loss, or spread financial distress far and wide. What is does suggest, however, that the chances of such a reversal being sufficient to trigger another 'Snowball Earth' episode of acute 'secondary depression' in the manner of the one brought about by Lehman's demise are much lesser.

Take US banks a case in point. On the eve of the crisis, for every dollar of bank credit they had extended (in the form of loans, leases, and securities), 25 cents were being funded by 'borrowings' (principally volatile wholesale funds, often derived - in full pass-the-parcel fashion - from among their temporarily more liquid peers) while another 15¢ were in the form of 'large time deposits' – typically corporate and institutional placements of singularly low stickiness.

The proportion extant then of the first of these more fickle liabilities has only once been surpassed; viz., amid the deregulatory surge and Volcker-inspired upheaval of the early Eighties: the latter had not been seen since the start of the Nineties. Together, their ~40% contribution was unprecedented in its scale.

Contrast that with the situation today. Now borrowings only account for around 10% of the bank credit total – a four-decade low ratio – while large time deposits have sunk to around 8% for the first time since the 1993/4 'credit crunch'. That combination, at under 20% of the loans and securities portfolio, has not been as insignificant in the 45-year weekly history with which the Fed routinely provides us.

In slightly different terms, we can see that the eve-of-calamity bank had 'core' deposits of only some 60% and easily-mobilized cash assets of a paltry 3% (vanishingly few of those actual FRB reserves) of the contemporary loan book in what was essentially a record low margin of safety. Today, the difference is stark: core deposits are up to 87% and cash – the bulk of it in FRB reserves – amounts to more than 10% and so implies almost total coverage.



There is another departure from 2008, too. Back then, US-based foreign banks had lent a record $600 billion to their affiliates outside the borders in what was some combination of carry trade and own-account contribution to the US sub-prime disaster. In June that year, gross claims amounted to $780 billion (an impressive 28% of total assets) and net claims to $630bln (30%). As quantitative easing got into gear – and as shell-shocked foreigners decided that it might be wise, after all, to hold a few reserves against their FX and Eurodollar commitments – the balance had swung all the other way to a net $650bln placement before the Fed finally decided to unwind its intervention, six years later.

The flipside, of course, is that the bulk of those borrowed dollars flowed back to US banks' own offshore networks, making them reliant in their turn on $600 billion of funding from that latter source – including around $200 billion ostensibly owed to Ireland and Luxembourg ('Dumb Germans in Dusseldorf') and up to $800bln to the Cayman Islands (the hottest of the hot). Today, the position has reversed, leaving them as net creditors to their network in the amount of $150bln.

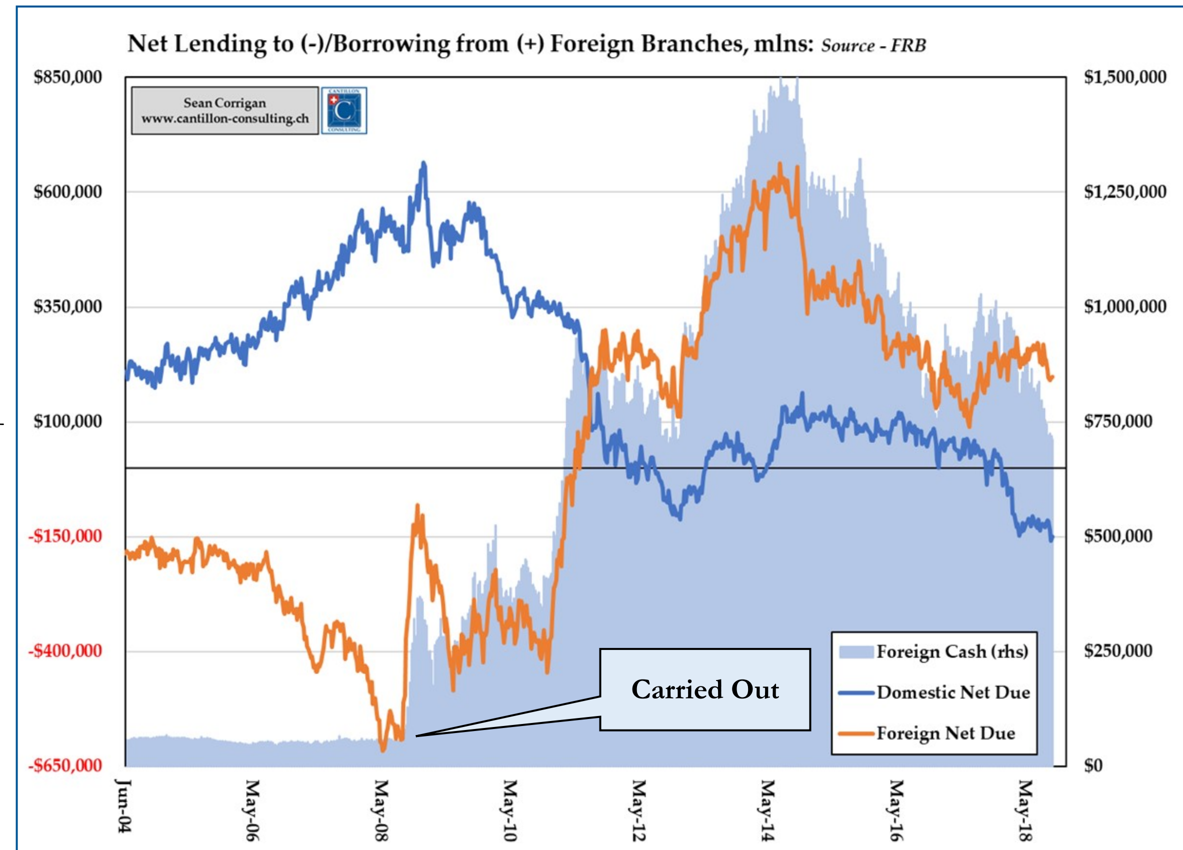
All in all then, at least as far as exposures to and within the US banking system go, the next one will not be your father's recession. .

Why WAS Alan Greenspan Bullish?

Another loose analogy which enjoys a certain vogue is that of the Crash of '87, if only because of a vague awareness that bond yields were rising then, too, and that its anniversary is upon us. We offered readers a look at the events leading up to that discontinuity way back at the start of the year. What we did not then do was compare conditions leading up to that fabled jolt with those prevailing today. Upon such closer inspection, we quickly realize that the parallels are hardly compelling.

Take the relation between T-Notes and earnings yields on equities. At their most favourable in the middle of 2016, stocks' 4.1% were markedly in excess of the 10-year's 1.45%, whereas, at the cyclical interest rate lows of August 1986, Treasuries came at 6.9% (yes – unimaginable today, isn't it?) while stocks showed 6.0% for a *negative* 90bps spread.

A year later, rates had risen 210bps to 9.0% even as earnings yields had dwindled to 4.5% - a full 450bps *under* what fixed income was offering. That exceptionally large, 360bp shift came as equities outperformed by a massive 50% on a total return basis in a move with no post-war precedent in at least three decades and only subsequently bested in the first flush of QE-reflation in 2009-10. This past year, the scorecard reads: notes up 175bps, earnings yields up 45bps to narrow the equity premium to 135 bps with total returns diverging by a much less extreme 20% or so.



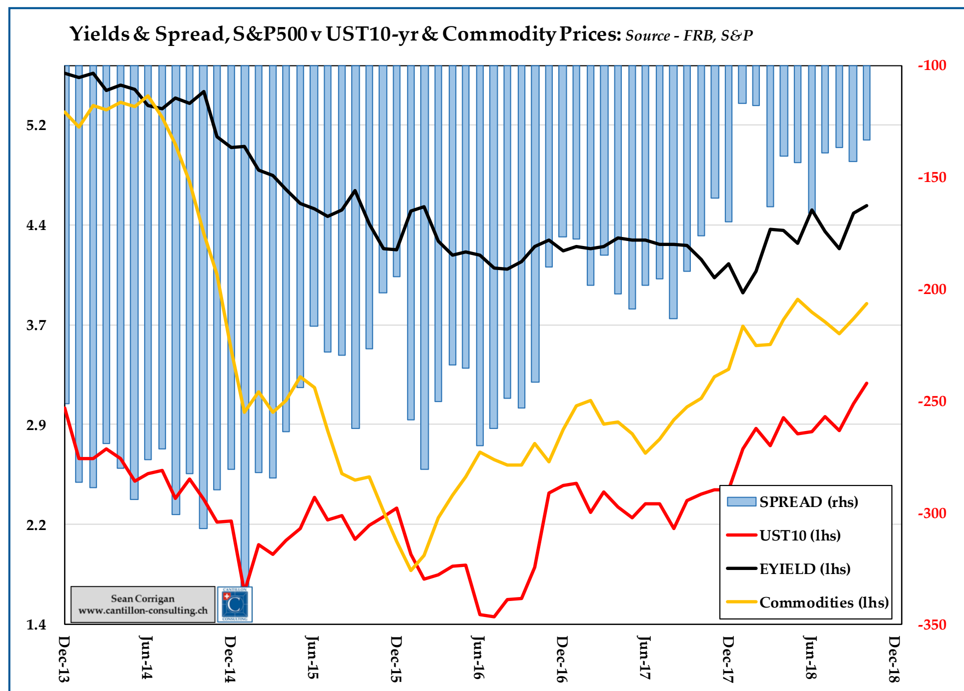
There were two other salient differences between now and then.

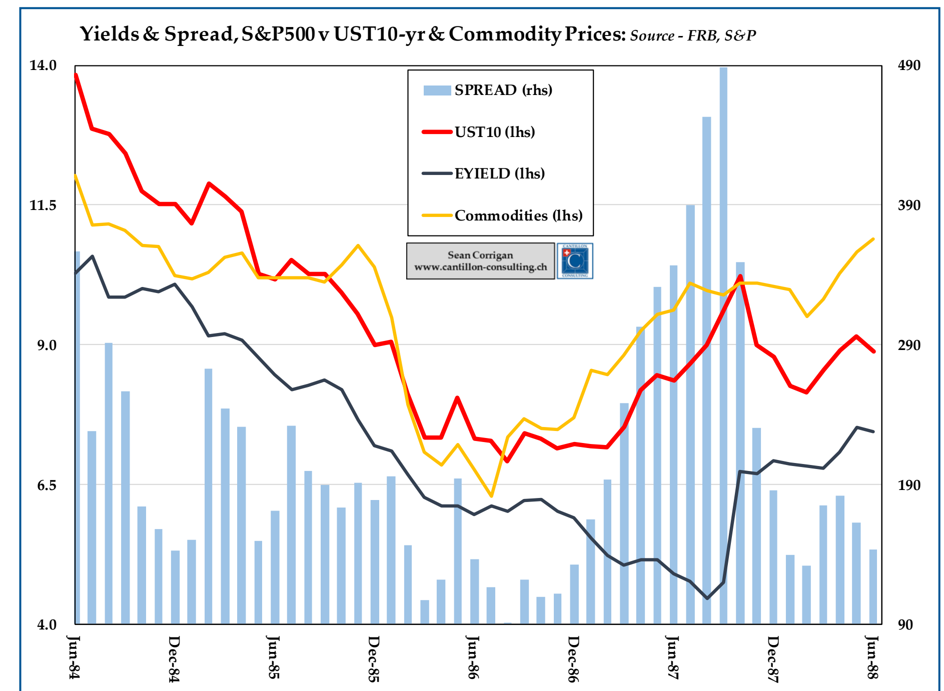
Firstly, from its 20-year low reading of 1.1% at the end of 1986, CPI had risen to a 3-½ year high when equities finally crumbled, after an acceleration only beaten since the Korean War by the two great oil shocks; something which re-ignited painful memories of the severe bear markets which each of those two events had entrained. By contrast, the past year has seen the uptick into July's 2.9% subside once more to leave 'inflation' unchanged at 2017's 2.3% YOY pace, thus alleviating many of the market's fears, if perhaps a little prematurely. Secondly, in 1987 the US dollar had slumped by a third – despite the Louvre Accord signatories' attempts to prop it up by means of concerted intervention - after rising 45% in under 5 years to 1985's soaring highs.

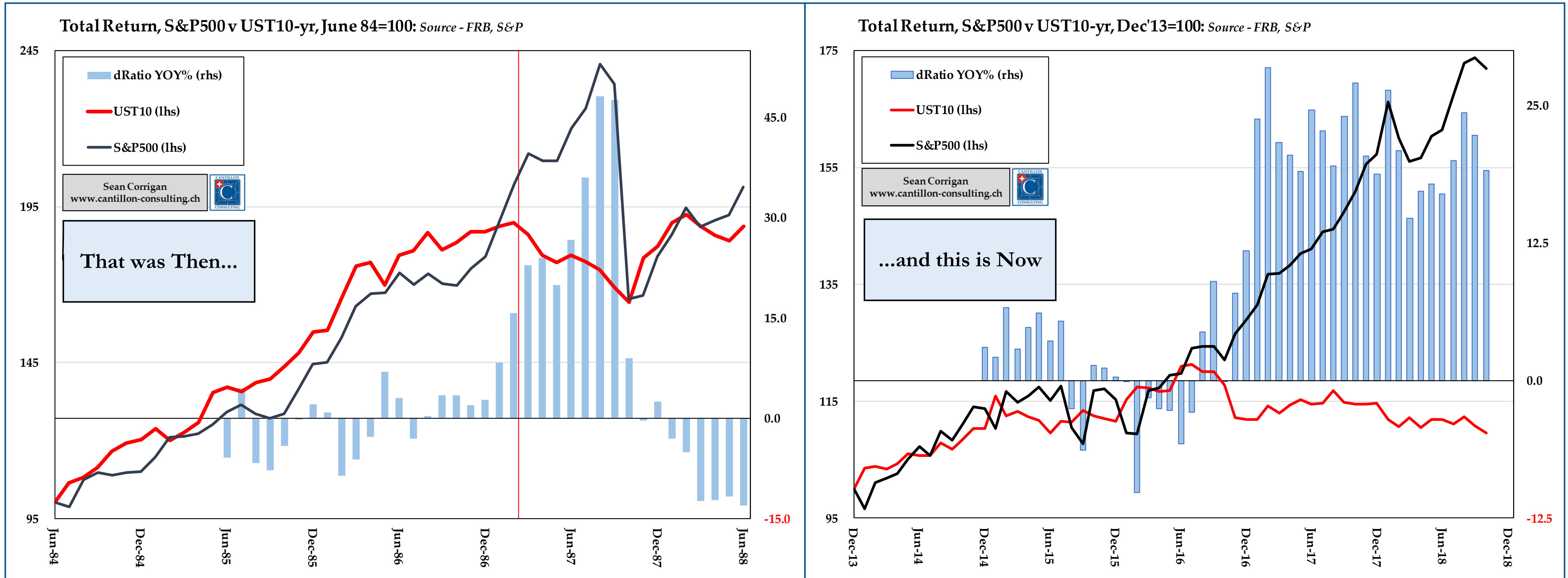
Added to this was the fact that the Administration was actively unsettling investors by making noises about letting it fall further in order to try to reduce America's then-record trade deficit of circa 3% of GDP. Finally, the reassuring presence of the figuratively and physically towering Paul Volcker had been somewhat surprisingly replaced as Chairman of the Fed by the little-know, but ostensibly more pliant, Alan Greenspan of wincingly-mistimed *Fortune* magazine headline fame..

This time around, the dollar still sits – as it has for nearly four years now - within 5% or so of the best levels attained after another 40+% rally – this time, one conducted from a record low. Meanwhile, the new Fed Chairman seems to display a pleasingly more pragmatical bent than either of his two Ivory Tower predecessors or, indeed, from those running the world's other major central banks. Capital flight out of the States is therefore not presently an issue as much as capital flight into it is.

So, if not 2008 Part II or 1987 Redux, where will the next bust come from to give the stopped clocks of doom their brief instant of 'I told you so' glory?







Hunting the Rhino

It is never hard to list possible candidates – if a trifle more demanding to assign meaningful probabilities to one's imaginings. Corporate debt implosion. Widening Euro-schism. EU-sown financial chaos, post-Brexit. Middle East conflagration. Hot war with Russia. Who can rule any of them out?

But, nevertheless, the largest and most aggressive of the 'grey rhinos' confronting us must surely be a credit collapse in China.

For some time now, we have been publishing charts of the deceleration in money creation in China, coupled with the evaporation of banking's so-called 'shadow' financing adjuncts. We have also taken to tweeting snippets relating to that country's emerging difficulties, as well as to the increasingly frantic pace of interventions aimed at alleviating them, with the factious hashtag #DONTPANIC.

Well, ladies and gentlemen, last week China officially DID panic.

A lengthy treatment of something now filling the financial columns everywhere is probably superfluous but, just for completeness, here is a partial list.

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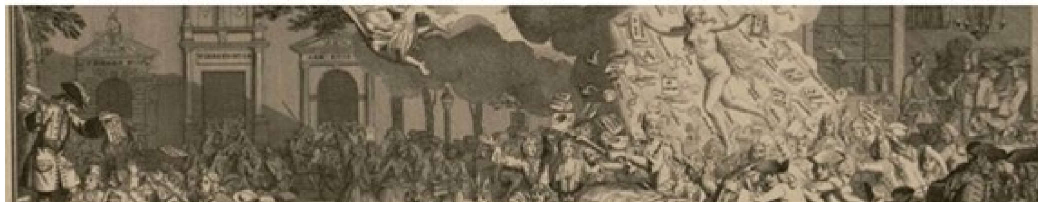

For much more, please visit the blog: www.truesinews.com

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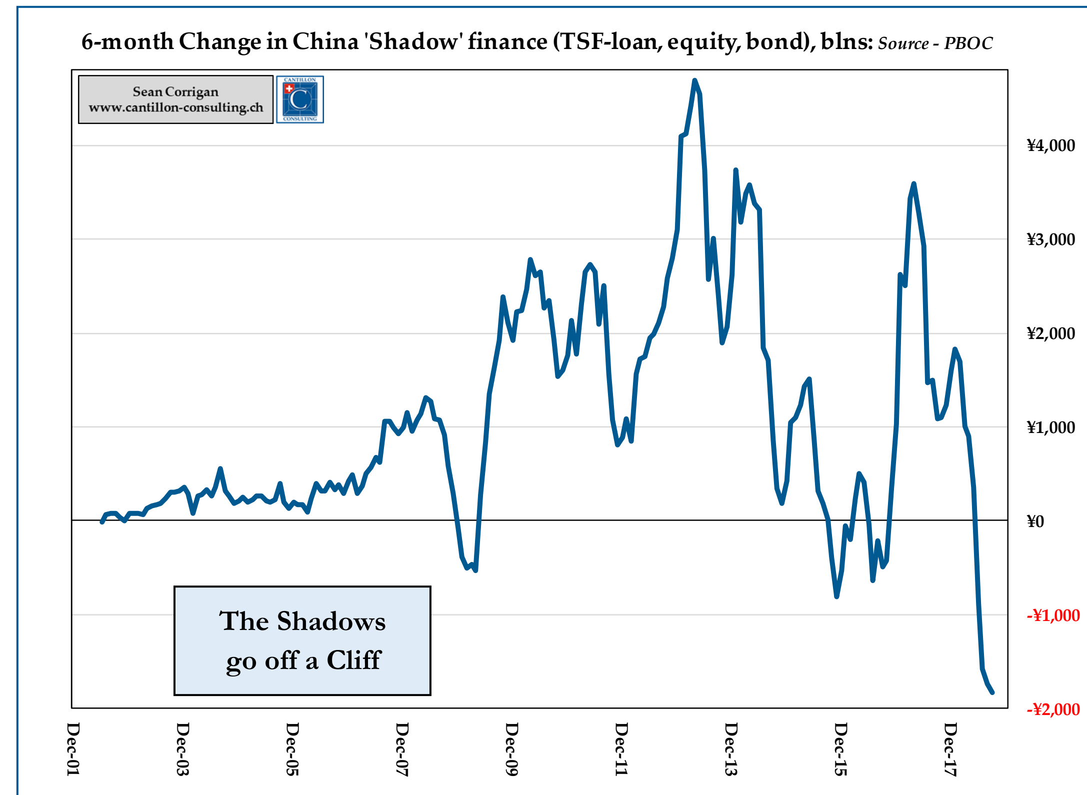
CSRC boss Liu Shiyu authorised the previously *verboten* application of 'extend and pretend' forbearance with respect to maturing wealth-management products; eased procedures for 'protective' corporate buybacks; encouraged local governments to follow the multi-billion lead of Shanghai, Shenzhen and others by undertaking greater interventions in aid of floundering businesses; and exhorted both domestic private equity and foreign investors to support the equity market. The China Securities Association immediately obliged, announcing a plan by eleven member firms to club together to set up a joint asset management company with a Y100 billion initial investment target.

Meanwhile, PBOC supremo, Yi Gang, promised more support for private bond issuance, a willingness to prop up the disastrous equity-pledge schemes currently crippling the market, and the provision of some, as-yet unspecified, 'credit enhancement' for existing borrowers. As a tangible follow-up, an additional CNY150 billion in rediscounting facilities was announced for banks with a large proportion of SME loans, doubling the injection made as recently as June.

Gio Shiqing of the CBIRC chimed in to urge lenders to hold off on issuing margin calls until they had '*comprehensively evaluated risks*' (!); to tell the insurers under his aegis that if they made long-term funds available to aid financial 'resolution', they were free to ignore the 30% of gross/100% of net asset cap on equity exposures, especially where the monies were being directed to firms '*down 60-80%, at 3-year lows, and with improving fundamentals*' (such 'improvement' presumably to be very much in the eye of the beholder). Vague mention was also made of some sort of ABS being set up to help carry sickly share-collateral loans – of which there are said to be some CNY4.4 trillion in existence (i.e., around 10% of total A-share market cap) among which numerous firms thought to have 'pledged' up to 70% of their float!

More generally, Vice Premier Liu He – Xi Jinping's economic point man – tried to assuage growing fears that all this was little more than an opportunistic implementation of the policy that the '*state advances; the private sector retreats*' by declaring that one should not entertain any political qualms about aiding non-public enterprises.



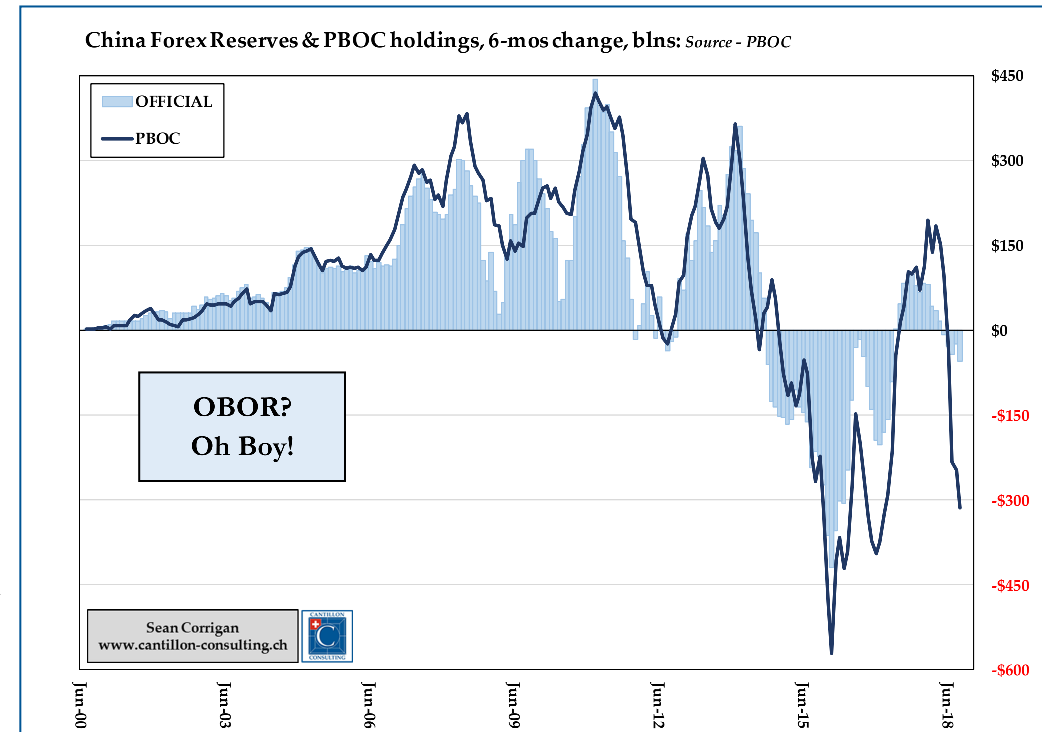
Though this last rang more than a little hollow, the combined effect was to spark a two-day burst of enthusiasm which powered the CSI300 to almost 10% above its 2 ½ year lows. Whether that is a swallow which makes a summer out of the bleak midwinter which has gripped the land, ever since the rally topped out back in January, yet remains to be seen. The fact that there was subsidence rather than extension in the net two session might suggest the auguries are not that good.

What is undeniable, however, is that 'deleveraging with Chinese characteristics' means making more credit available to all, even if it has to be funnelled through the very institutions – the eternally cash-strapped and largely incontinent local governments whom S&P has just inconveniently accused of having staked up CNY40 trillion in hidden debts – whose addiction to borrowing it was supposed to have been 2018's goal to fix, if by the curious route of inviting them to issue CNY5.5 trillion in 'special' bonds so far this year.

Back in 2015, when the government first hit upon the genius solution of promoting a stock market bubble in order to persuade creditors to engage in what was effectively a voluntary debt-for-equity swap, we dubbed the ensuing insanity the 'Mississippi Bubble 2.0' in honour of that 18th century conniver and daemon of modern central banking, John Law.

Now, alas, it seems as if the Big Muddy has had its course reversed through a major feat of hydro-geographical engineering and is currently draining its metaphorical Gulf of Mexico as it rolls north instead, replacing private-sector equity with public-sector debt as it does.

China, according to the latest BIS estimates for QI this year, has alone been responsible for 45% of the $64 trillion global increment of non-financial debt outstanding which has taken place since the pre-GFC peak. Leave out the (less reliably-measured) government component and we find the Chinese contribution has swollen to two-thirds of the total, rising at just under 20% a year, compounded, versus everyone else's paltry 1.4% CAR. Among EMs themselves, the disparity is even more marked: China has borrowed $4 out of every extra $5, meaning those other countries have seen their burden of obligations rise at less than a third the rate of their Big Mother, that is, at 5.9% CAR.



Now, given that we all fret about US or UK or European balance sheets; and given too, that any number of EMs have already either blown up or have shown signs of increasing fragility, how bad do we imagine things in China to be??

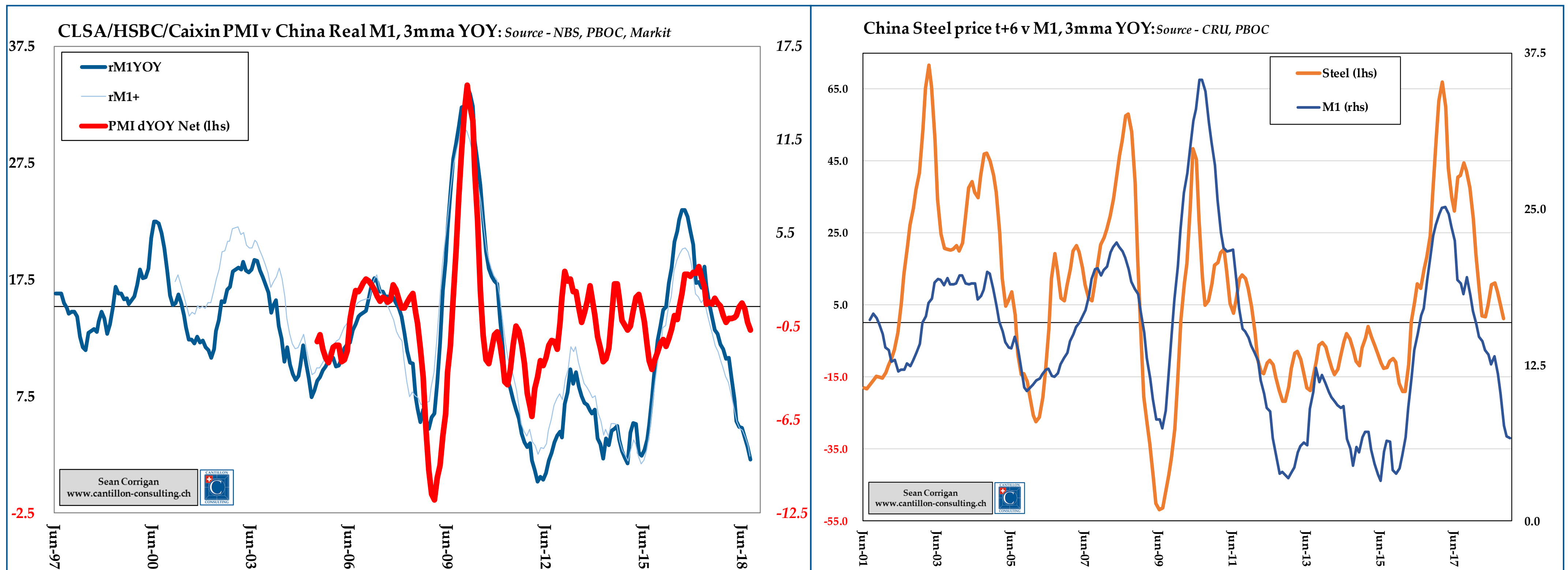
While all this goes on, an ominous and, frankly, glaring discrepancy has emerged between the state of the nation's forex reserves as detailed separately in USD and as recorded on the PBOC's balance sheet in renminbi. Over the past six months, the former have declined by $56 billion – some part of which may be attributable to the dollar's ascent against its rivals – but the latter have fallen by over $320 billion in that same stretch if we apply month-end forex rates to the total.

With no corresponding pick up in other banks' holdings of foreign currency to provide an offset, might the gap be explained by the use of liquid, FX reserves for the purposes of providing project finance for China's ambitious – if often commercially dubious – One Belt-One Road schemes?

For now that must remain no more than conjecture, but it does raise the pertinent question of just how great a reserve pool remains to be mobilized in the defence of the yuan, should another rush for the exits occur – whether because the current stimulus effort is seen to have failed or, conversely, because it has succeeded only by dint of flooding the country with too much cheap, new credit to allow for an effective defence of the talismanic CNY7.0000 level in the face of rising US interest rates.

As we have frequently noted, there is – as Adam Smith himself first remarked – '*a lot of ruin in a country*', so China may very well once more succeed in postponing its day of reckoning and so refrain from exerting too depressing an effect on the wider world economy for another few years.

But it may also be that the rustling you can hear in the undergrowth is the sound of this most aggressive of horned pachyderms building up to a charge. The best advice we can give is to keep a very careful eye on the financial market reaction to late October's barrage of measures and to keep your Mauser M9 locked and loaded as you do.



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Shanghai Comp

So far, the response to the flurry of stimulus measures has been nervy at best.
If renewed enthusiasm does not quickly take hold….

Growing conviction that the 'sentimentals; have shifted. No more 'BTFD' and 'HODL', but 'Sell the rally' and 'Get me out!' instead.
Minor support comes in at the January lows around 5700. After that, the Trump rally mid at 5375/00 and, below that, the GFC mid at 4400
VALUE LINE INDEX
www.cantillon-consulting.ch
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(6522.9)
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(3608.2)
(2019.3)
(992.0)
2008
2010
2012
2014
2016
2018
2020

S&P500 Financials

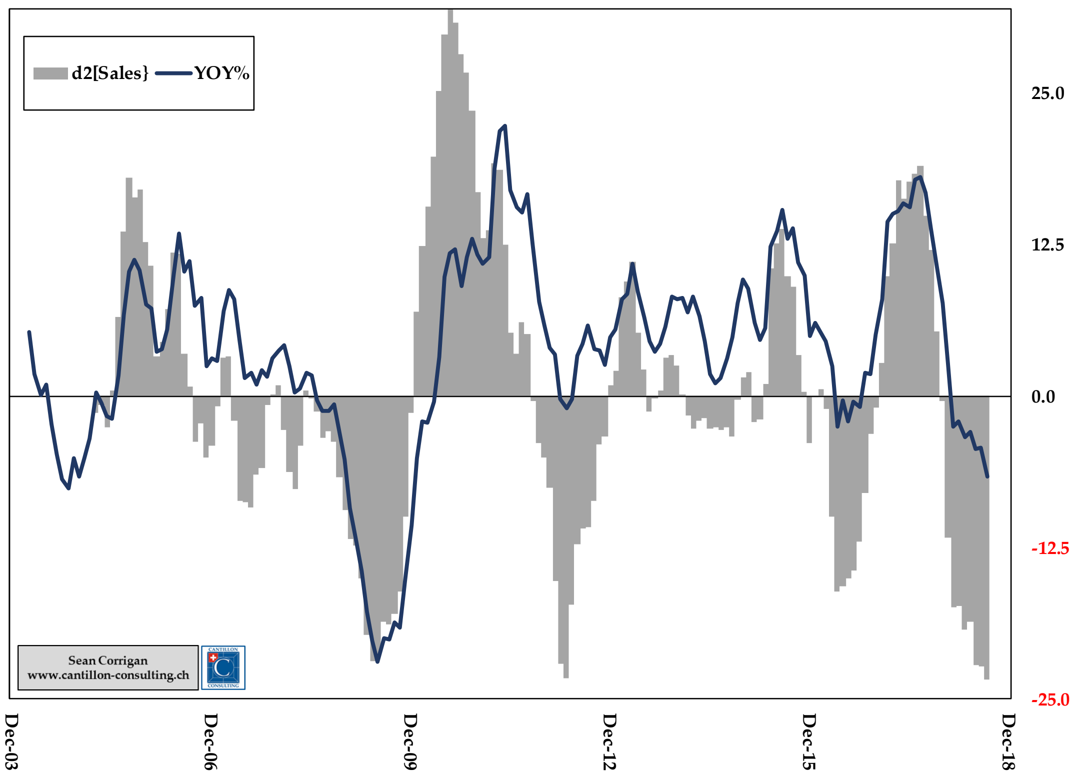
(509.75)
(444.73)
(344.16)
(293.02)
(241.87)

2001 2003 2005 2007 2009 2011 2013

Non-financials are clearly in a bad way but even more ominous is the pattern for Financials. Despite our fundamental arguments about the lack of 2008 parallels, the charts are looking increasingly similar, putting us at the equivalent to November 2007 in the previous cycle.

We tend to treat these two—admittedly, in a not very scientific way—as bellwethers for the wider economy, tracking as they do general commerce and employment.

Neither look overly reassuring.



With Eurozone money supply showing the lowest real growth in 5 1/2 years—and with the stock of real bank credit (M3 ex-M1) off 35% from its peak to hit the lowest level seen since early 2001, the ECB is already showing its lack of teeth, well before it quits its fatuous bond-buying.

Meanwhile, formerly perky German revenues have stalled, led by a nasty slump in consumer durable sales, especially those made outside the Zone. Is 'Dieselgate' adding to Trump tribulations for Big Auto, perhaps?

Regardless of the proximate cause, it all leaves the DAX in danger of another 10-15% decline

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(24516.5)
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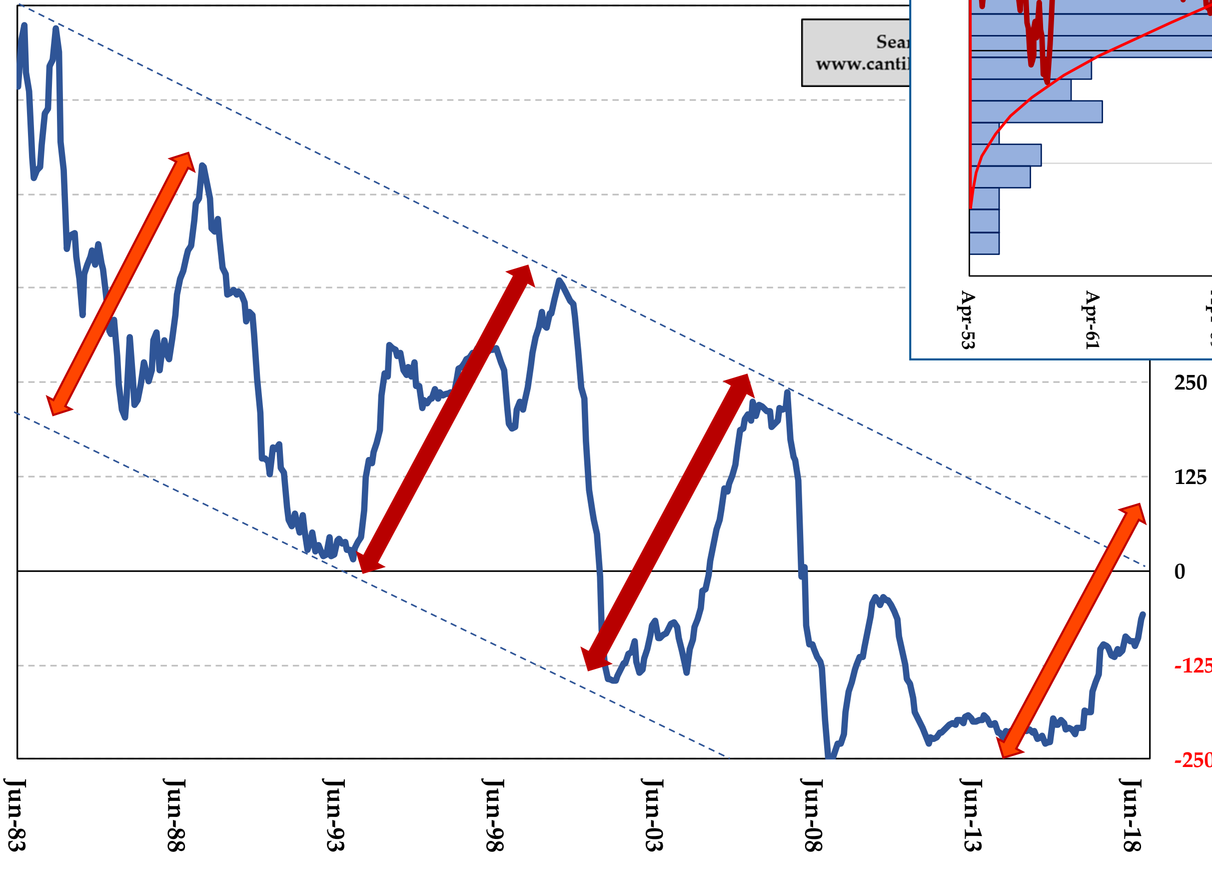
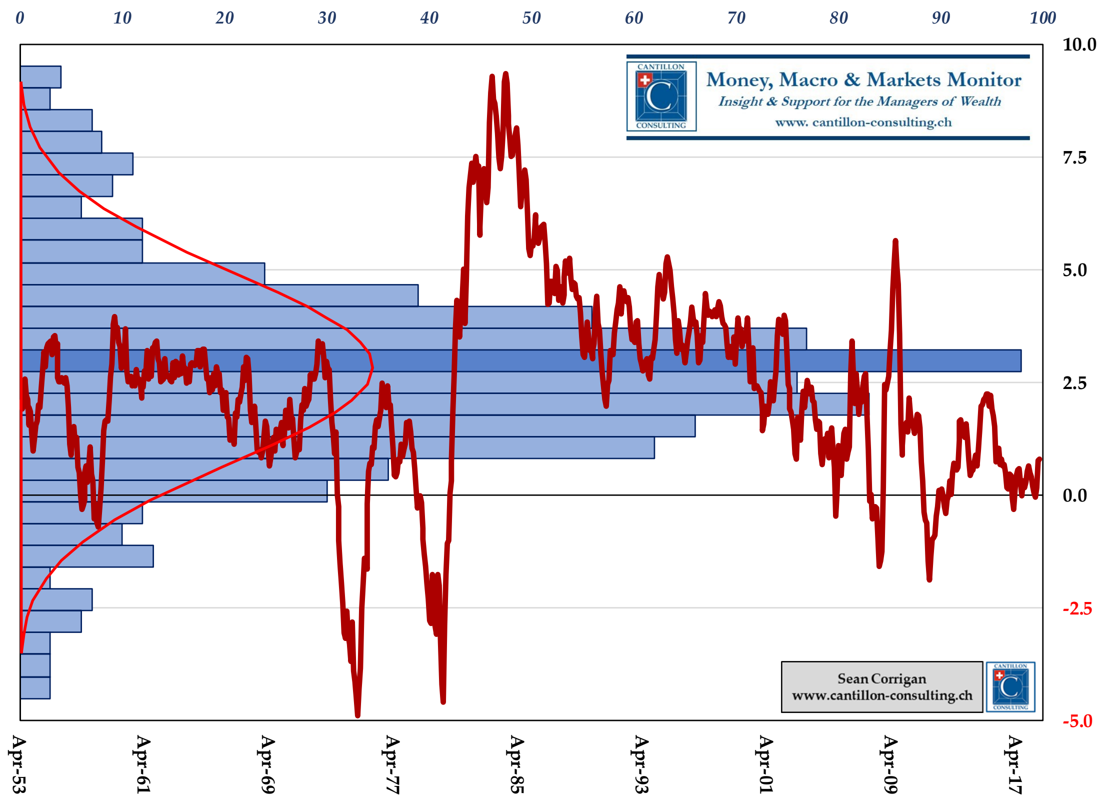
(17809.9)
(15738.2)
(13648.9)
(9593.3)
(6959.8)
NIKKEI 225
Though corporate balance sheets look the most solid of all in Japan, squeezed between a slowing China and a belligerent US, even the Nikkei could be in for a meaningful correction if the trend breaks near multi-year highs.
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019

Keep in mind that, despite all the angst, real rates—both short and long—are still abnormally low (even if, in the former instance, we allow for the generational decline they have undergone since the Great Inflation ended). Note, moreover, that tightening cycles typically stretch further than this one so far has.

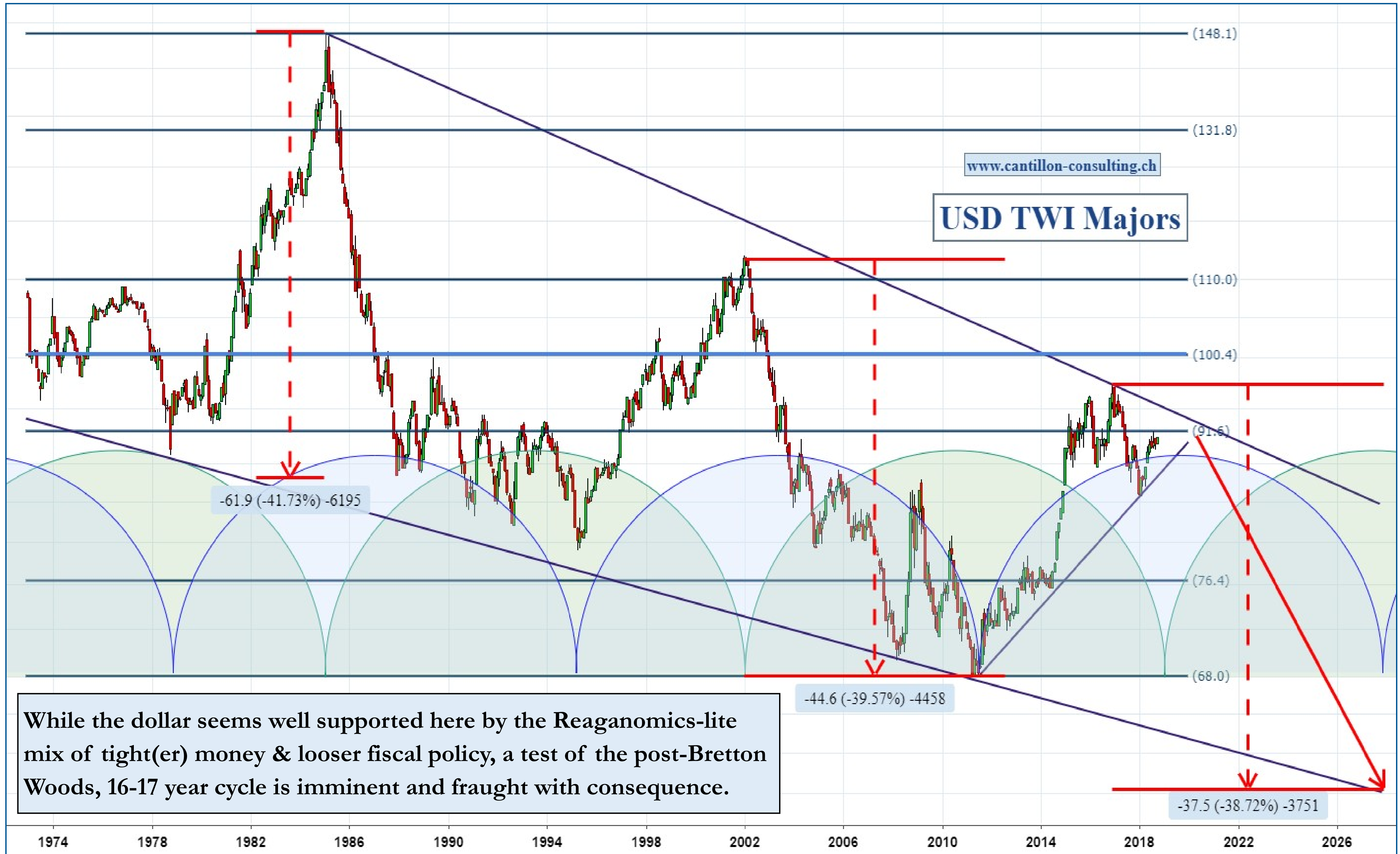




Thus, the Powell Fed's drive toward more normal rate settings will not cease until either (A) compelling evidence of a lessening of the current, brisk economic pace is found or (B) the financial markets move from retracement to full-blown rout.

Unless and until one of those intrude, upwards and onwards we go—perhaps by as much as a further 4 or 5 delivered (plus imminently expected) rate rises if the Eurodollar chart is any guide

Flight-to-quality flows out of the shaky equity market may counsel against taking too bearish a tactical stance on fixed income just now, but the overall trend toward higher yields has not yet been called into question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USD TWI Majors
-61.9 (-41.73%) -6195
-44.6 (-39.57%) -4458
-37.5 (-38.72%) -3751
While the dollar seems well supported here by the Reaganomics-lite mix of tight(er) money & looser fiscal policy, a test of the post-Bretton Woods, 16-17 year cycle is imminent and fraught with consequence.
1974
1978
1982
1986
1990
1994
1998
2002
2006
2010
2014
2018
2022
2026

If the long liquidation in energy fails to push prices out through the channel low—or, at worst, below the last 6 months' congestion—it would be signal to go long at what might then be seen to mark the mid-point of the broader, rising trend.

Base metals will be highly China-dependent. If they should break through the 4-month range lows, where buyers have emerged on three previous occasions, a further 10% loss looms.

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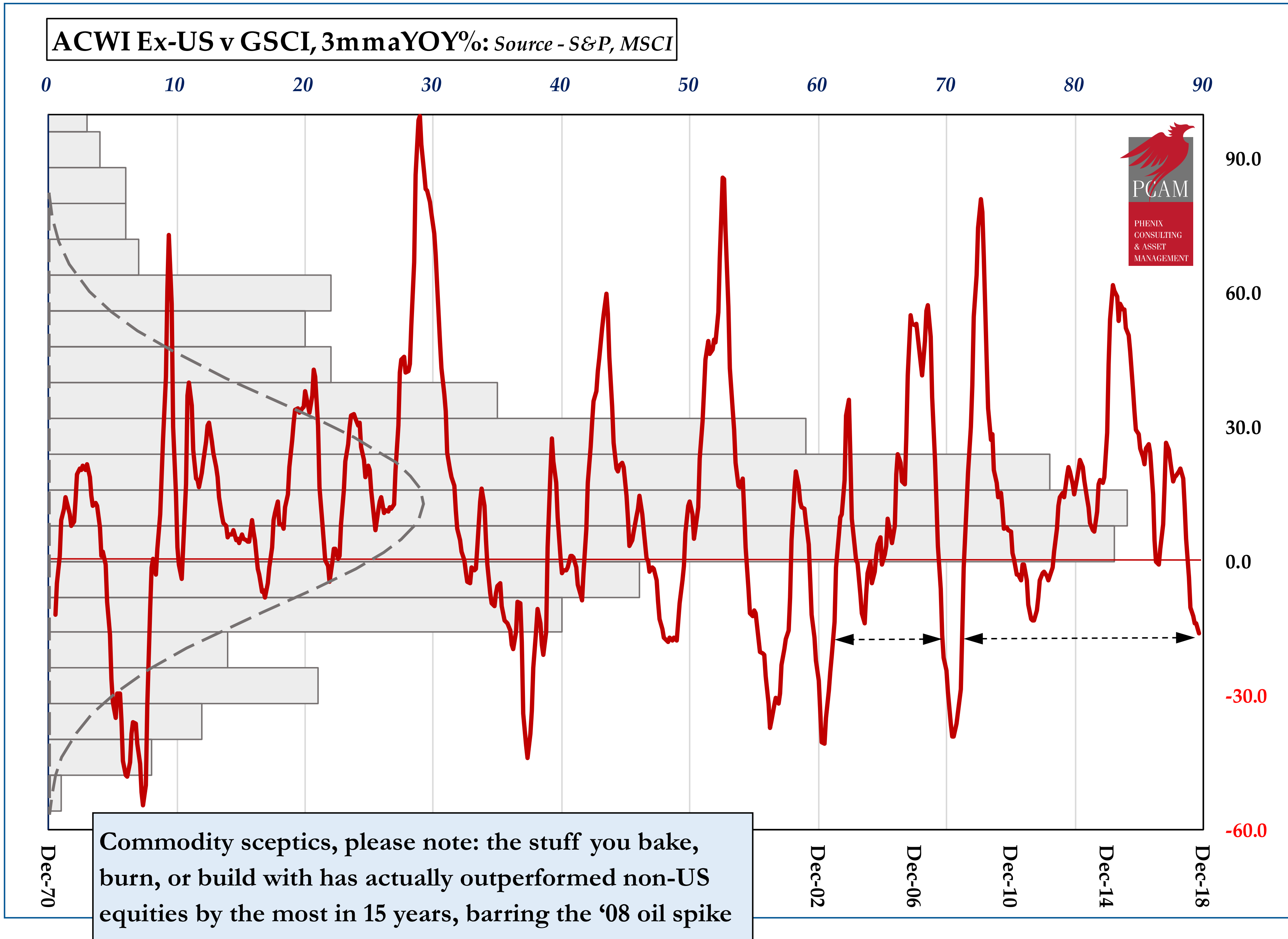
ACWI Ex-US v GSCI, 3mmaYOY%: Source - S&P, MSCI
0
10
20
30
40
50
60
70
80
90
90.0
60.0
30.0
0.0
-30.0
-60.0
PCAM
PHENIX CONSULTING & ASSET MANAGEMENT
Dec-70
Dec-02
Dec-06
Dec-10
Dec-14
Dec-18
Commodity sceptics, please note: the stuff you bake, burn, or build with has actually outperformed non-US equities by the most in 15 years, barring the '08 oil spike

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