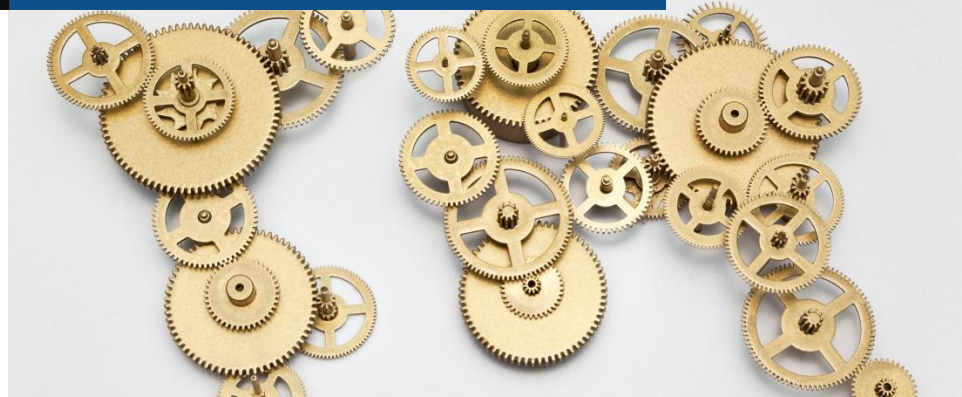


# Europe Strategy

1 April 2020



## A new European investment paradigm

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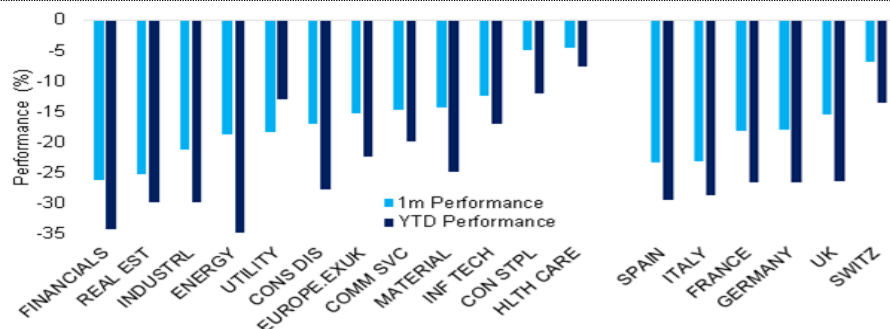
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- Europe has moved from 'containment' to the 'mitigation' stage in relation to COVID-19 in most countries. We expect phased lockdowns in the months ahead, so as to ease pressures on national healthcare systems.
- Central bank and government financial support programmes are necessary and have further to go. Implementation – ensuring that the individuals and companies most in need receive timely and sufficient support – will be very challenging.
- GDP contractions will be severe in the second quarter, with no powerful recoveries to follow immediately. However, we are confident that support measures will help preserve long-term economic and corporate health.
- More bond market stability – supported by liquidity from the European Central Bank and the Bank of England – will help stabilise the outlook for regional equities.
- Equities are likely to have a prolonged consolidation phase within wide trading ranges. We expect selective buying opportunities, particularly in companies with strong balance sheets.
- The virus's impact will likely reinforce some of our recommendations from the start of the year. These include staying invested, diversifying sensibly, and embracing higher volatility. Our long-term Unstoppable Trends like fintech and cybersecurity still offer attractive equity potential.

**Figure 1: Country sector performance – 1 month and YTD**



Source: Bloomberg as of March 31st 2020. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

## The spread of COVID-19 in Europe

Europe is seeing a rolling COVID-19 impact after the first infections in Italy a month ago. Along with the general lack of preparedness and diverse national government responses, we do not expect the virus to be contained as quickly as in Asia.

Europe has moved from attempting to contain COVID-19 to attempting to mitigate its impact as it spreads. The European epicentres of Italy and Spain have now reached infection and fatality levels that are the highest in the world and not noticeably slowing yet. France and the UK are not far behind and are accelerating.

The level of preparedness has varied. While Germany and Switzerland have been able to offer some medical support to Italy and France, healthcare systems across the region are under growing strain. The government responses have differed too, both in terms of timing and the extent of lockdowns.

With economic pressures acute during the lockdowns, governments face a delicate balancing act between containing the virus, not overwhelming the healthcare systems, maintaining social stability, and preserving economic capacity.

For this reason, there is a growing likelihood that we see phased and partial lockdowns in the months ahead, after the current lockdown periods end. We expect the virus to run its course, with a possible peak in the rate of new infections in late May. However, it could take several months thereafter to defeat it entirely. From an economic and market perspective, the implication of this could be prolonged uncertainty, even after the acute stage of the virus impact has passed.

## Market shocks but no full immediate rebounds

The first phase of weakness in equities and fixed income is likely over. The 30% falls in equities were extreme in terms of the extent and speed of the moves by any historical measure. **See Figure 1.** This was exacerbated by passive funds, redemptions, and margin-related selling. However, spreads in the fixed income market have narrowed slightly, and moves are now less indiscriminate. A key support factor has been the US Fed's actions to support swap lines for the US dollar. This has eased the currency's intense appreciation in mid-March.

We are now expecting a period of stockmarket consolidation during the second quarter. The lows may possibly already have been made, but significant ongoing uncertainties will nonetheless cap recovery rallies. As well as the uncertainty relating to the path of the virus, there will be great uncertainty with regard to central bank and government policies and their impact. The implication is that the economic and corporate landscape will be highly fragile for some time, such that making reliable growth forecasts will be particularly challenging. Europe currently trades at 15x historic earnings, with the UK at 16.3x historic earnings, but prospective valuations cannot be made with confidence yet.

During this consolidation period, we expect wide trading ranges and substantial volatility within those ranges for all European asset classes. As an indicator of the extreme volatility already seen in the foreign exchange markets, the British pound in the last three months has swung from \$1.30 to \$1.14 to \$1.24. The Euro has moved from \$1.14 to \$1.06 to \$1.11.

### Significant central bank and government policy responses

As demand and markets collapsed in early March, the Bank of England (BoE) and the European Central Bank (ECB) took aggressive and appropriate actions (see [UK announces aggressive monetary and fiscal measures](#) and [ECB disappoints markets, all European assets plunge as further government support await](#)).

The ECB introduced a €750 billion 9-month Pandemic Emergency Purchase Programme (PEPP); added €120 billion to its bond purchase programme; and has allowed banks to borrow at 25bp less than its deposit rate.

More recently, the ECB has guided all Eurozone lenders to cancel dividends and share buybacks, at least until October. This is after recently relaxing bank capital requirements, amounting to €120 billion of capital relief. In addition, the European Union regulator has also pledged to delay by one year the tough new capital rules that had previously been agreed. European banks generally did not have solvency concerns going into this crisis. Average CET1 ratios averaged around 13%. However, the ECB and bank regulator want to remove any risk of the banks being unable to lend to stressed individuals and corporates. As French banks have not officially stated whether they will comply, there is a growing possibility that the guidance could be made legally binding.

In the UK, the Prudential Regulation Authority, the supervisory arm of the Bank of England, could make a similar decision with UK banks. This could happen even before Barclays is due to pay a full-year dividend at the end of this week. In total £7.5 billion of dividends are due to be paid within a few weeks.

The key impacts have been to keep the bank payments systems functioning, and also in the bond markets with the expanded asset purchase programmes playing a decisive role in steadying prices and spreads. More measures are going to be needed. In particular, the ECB could adjust its capital key – which sets the maximum percentage of each Eurozone member's bond market that can be purchased at 33%. It could also adjust its rules to allow itself to buy investment grade corporate bonds and financials.

While there have been sizeable and prompt fiscal support packages from all European governments – **Figure 2** – more is going to be needed at the pan-Europe level to enable full fiscal absorption, as virus infections continue to escalate and as lockdowns continue. Bridges need to be built for consumer incomes and for corporate productive capacity.

However, after recent discussions EU leaders have not come to agreement on European Stability Mechanism (ESM) support, nor on joint debt issuance through a 'Coronabond'. Their finance chiefs have been tasked with formulating proposals within ten days. France, Italy, and Spain are in favour of progressing in these two areas, while Germany and the Netherlands are against. Of the two, it's more likely that ESM funding will progress, with light conditions attached.

The UK has announced an expansionary budget and three emergency packages in the space of a fortnight. This takes the total support measures to £60 billion, or around 3% of GDP. With lower tax receipts in the year ahead of at least £50 billion, the fiscal deficit will rise to over £100 billion, which would be almost 5% of GDP. The UK Institute of Fiscal Studies has forecast a fiscal deficit of £200 billion, which could

be realistic if a significant portion of the recently announced £330 loan guarantees are eventually needed.

**Figure 2: Key fiscal / monetary moves**

Monetary		Fiscal	
Euro area	No change (deposit rate at -0.5%).	€120bn APP + €750bn pandemic emergency purchase programme	<b>Germany</b>
			€67bn fiscal package, including extra healthcare investment, tax deferrals, grants/loans for SME's. KfW to provide €550bn guaranteed loans. Proposed €156bn rescue package to provide social benefits and support for struggling companies. €50bn liquidity fund for self-employed. Bankruptcy leniency.
			<b>France</b>
			€45bn fiscal package, payment salary (2 months) to prevent people working, tax holidays, €300bn guaranteed loans. €1,500 handout to independent workers, possible rescue of companies with state shareholdings (i.e. Air France)
UK	Two cuts to base rate, going from 0.75% to 0.10%	£200bn asset purchase increase (Gilt + some corporates).	<b>Italy</b>
			€25bn fiscal package, including €3bn for healthcare system and 1.5bn for civil protection agency. Tax deferral, wage supplements for those forced to stop work, gov't guarantees on bank loans, increased healthcare spend (€3.5bn). Proposed support of Alitalia (national carrier - state has already provided €900mm in loans so far).
			<b>Spain</b>
UK	Two cuts to base rate, going from 0.75% to 0.10%	£200bn asset purchase increase (Gilt + some corporates).	€17bn fiscal package, €100bn gov't loan guarantees, no social security contributions if job preserved, €600m to help vulnerable, mortgage payment holiday
			<b>UK</b>
			£29bn fiscal package, funding for statutory sick pay, business tax rate cuts, gov't guarantees on £330bn loans, €12bn package to help health service, companies and individuals

Source: Bloomberg as of March 31<sup>st</sup> 2020

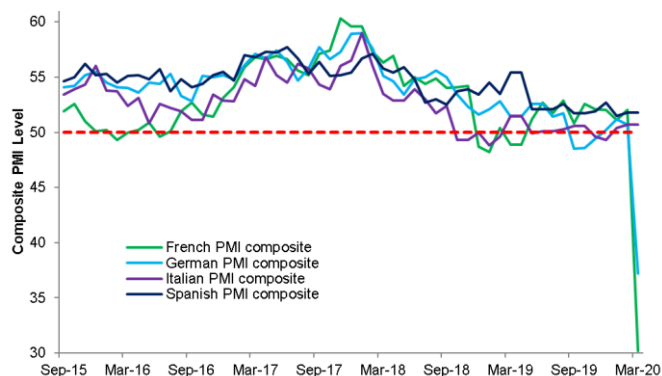
### Large GDP decline immediately ahead

The second quarter will be one of the weakest on record, with probable falls of around 15% in GDP. Manufacturing and services PMI data is already indicating a sharp slowdown. **See Figure 3.** Services sectors have been particularly hard hit by collapsing demand, while manufacturing faces significant supply chain impacts.

We have rising confidence that central bank and government support will help the outlook beyond eighteen months. There is heavy emphasis in the programmes announced upon preserving producing capacity by focussing on income support, company support, and tax forbearance. What is less clear is whether Europe and the UK economies will rebound strongly in the second half of this year and into 2021. There are three medium-term concerns:

1. Even before this crisis, lending growth and consumer sentiment were weak. They are unlikely to rebound quickly even when the COVID-19 problem eases.
2. The pan-European support programmes needed may disappoint in both size and timing. Eurozone leaders have not shown full solidarity and cohesion so far in this crisis.
3. The crisis could expose vulnerabilities that already exist. Social pressures could mount in the peripheral countries if there is not enough EU flexibility in its rules. Italy has €2 trillion debt and a weak banking sector, which could see it spiral into a significant debt deflation problem if growth remains sluggish – **See Figure 4** and see [Europe Strategy | COVID-19 pandemic could expose Italy's economic vulnerability](#)

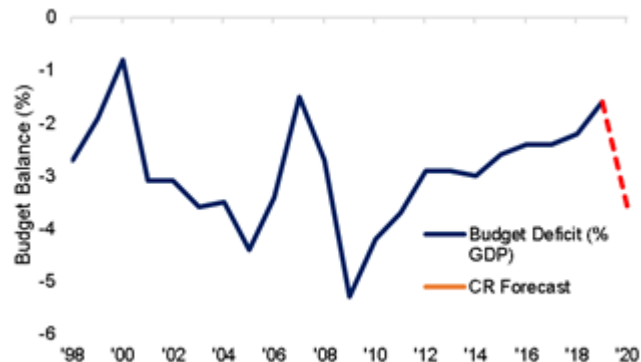
Figure 3: European PMI collapse



Source: Bloomberg as of March 31<sup>st</sup> 2020

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Figure 4: Likely budget deficit widening in Italy



Source: Bloomberg as of March 31<sup>st</sup> 2020

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### Possibility of Brexit extension growing

The European People's Party, the large centre-right group within the European Parliament, has called on the UK to seek an extension of its post-Brexit transition period beyond the end of 2020. With talks having been postponed due to COVID-19, and now being a lesser priority for both sides, the likelihood of an extension is rising. Also, as the economies on both sides weaken, the possibility of eventually concluding a trade deal is rising.

**Despite the economic and market uncertainty, we continue to see opportunities for longer-term investors looking to build positions in tranches, although we advocate selectivity by asset class, region, and theme.**

### Focus on strong balance sheets

The earnings outlook remains very challenging. Companies do not have much visibility as to their outlooks, so analysts have even less visibility. The key challenge is the unknown duration of the virus containment battle. However, there are also major questions surrounding likely dilution (from government bailouts and distressed rights issues), and dispersion in recoveries.

Consensus earnings estimates from top-down strategists in Europe remain too high, and dividends also remain at risk. In the last week, the ECB has advised European banks to suspend their dividends until October, while UK banks look likely to follow suit. Germany has stated that seeking state aid would also need to halt dividend payments. Current futures are pricing in over a 50% cut in European dividends in 2020 – **figure 5**. Sector selectivity also remains key. We think healthcare, utilities

and telecom dividends look the most sustainable, but energy and bank dividends show the most vulnerability. Energy shares and their dividends have been especially impacted by the recent drop in oil prices.

In the event of a weak European economic upturn, long-term investors should focus on companies that have strong balance sheets, sustainable cash levels, and manageable leverage. (see [Long-term focus on strong company balance sheets](#) and [The \(Underestimated\) Power of Panic](#)). They are far more likely to not only survive, but also keep paying dividends.

### **Focus on Unstoppable Trends**

This sell-off provides compelling opportunities within our longer-term Unstoppable Trends. As discussed during Outlook 2020, companies need to balance investor needs for higher returns against a clean energy and ESG focus – [A Cleaner Way to Play European Equities](#). As new technologies emerge and the economic viability of alternative energy sources improve, we think the recent sell-off provides interesting opportunities among our preferred clean energy names. Additionally, cybersecurity and fintech trends are likely to gain momentum as people are working from home, and as companies invest in online security and alternative digital solutions.

### **Focus on healthcare**

Performance of the sector over the last month has demonstrated resilience. Since the beginning of March, European healthcare companies are only down 5% at a time where broader Europe is down 15%, with the worst hit sectors down 20-25% - **see Figure 1**. We expect this relative outperformance to continue amid the COVID-19 crisis, also driven by long-term trends including technology and demographic trends. We believe Swiss healthcare companies look particularly compelling.

### **Focus on higher quality corporate credit**

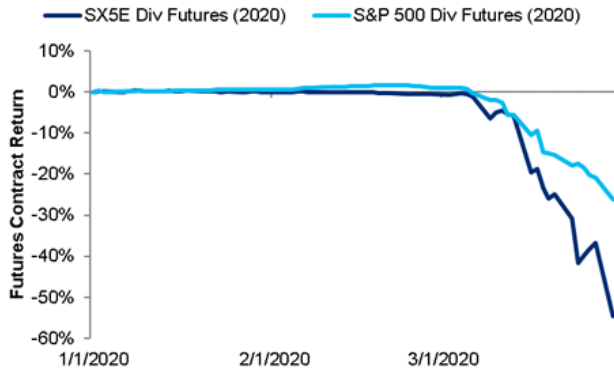
Both European Investment Grade (IG) and High Yield (HY) have sold off in 2020, down 7% and 15% respectively – **see Figure 6**. Following these moves, IG offers spreads of 240bps and yields averaging 1.80%, while HY offers spreads of 800bps and yields of 10.6%. While European HY has a lower proportion of energy related exposure (1-2%, versus near 15% in US HY) the crisis will likely see defaults rise, especially in companies with higher leverage levels and lower cash balances. The BBB market will also be in focus, given BBB's account for nearly 50% of the IG market. The risk of downgrades into HY will also be a significant risk in the coming months. We focus on higher quality fixed income names, with sufficient cash balances, sustainable leverage metrics, and little credit rating downgrade potential.

### **Selective opportunities in the preferred and AT1 markets**

European bank balance sheets are starting from a position of strength. Common Equity Tier 1 ratios for most banks are well above the required threshold. In Europe, Additional Tier 1 (AT1) securities have lost between 23-25% since the early March highs, with some AT1 securities falling over 25pts in a week. It remains unlikely the ECB will require a ban on AT1 coupons, however selectivity at the issuer level remains critical. For instance, Rabobank earlier this week announced it would not pay the following three distributions on one of its Membership Certificate (MC) issues, given the ECB's recommendations regarding dividends. However, AT1 payments were not mentioned within the press release. We stay focused on the

bigger, better capitalised banks within the space. Please see our note from last week: [Preferreds stocks – Use one hand catching this knife](#)

**Figure 5: European dividends get revised lower**

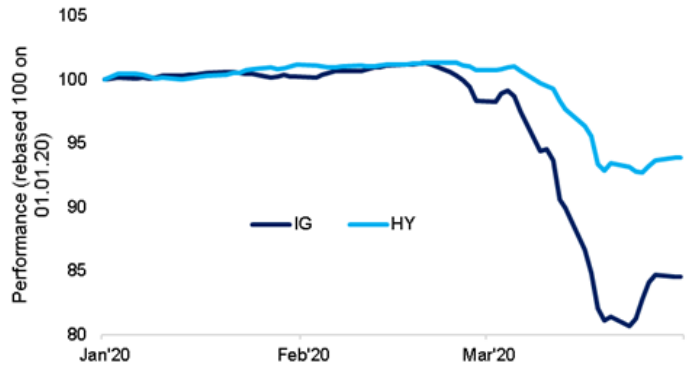


Source: Bloomberg as of March 31<sup>st</sup> 2020

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SX5E stands for EuroStoxx 50.

**Figure 6: IG & HY performance YTD**



Source: Bloomberg as of March 31<sup>st</sup> 2020

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## Asset allocation definitions

Asset classes	Benchmarked against
Global equities	MSCI All Country World Index, which represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.
Global bonds	Bloomberg Barclays Capital Multiverse (Hedged) Index, which contains the government -related portion of the Multiverse Index, and accounts for approximately 14% of the larger index.
Hedge funds	HFRX Global Hedge Fund Index, which is designed to be representative of the overall composition of the hedge fund universe. It comprises all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.
Commodities	Dow Jones-UBS Commodity Index, which is composed of futures contracts on physical commodities traded on US exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The major commodity sectors are represented including energy, petroleum, precious metals, industrial metals, grains, livestock, softs, agriculture and ex-energy.
Cash	Three-month LIBOR, which is the interest rates that banks charge each other in the international inter -bank market for three-month loans (usually denominated in Eurodollars).
<b>Equities</b>	
Developed market large cap	MSCI World Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in 23 developed markets. Large cap is defined as stocks representing roughly 70% of each market's capitalization.
US	Standard & Poor's 500 Index, which is a capitalization -weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.
Europe ex UK	MSCI Europe ex UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in each of Europe's developed markets, except for the UK.
UK	MSCI UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in the UK. FTSE 100 Index: Capitalisation weighted index of the 100 most highly capitalised companies traded on the London Stock Exchange FTSE 250 Index: Capitalisation weighted index of the 250 most highly capitalised companies outside of the FTSE 100 traded on the London Stock Exchange
Japan	MSCI Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in Japan.
Asia Pacific ex Japan	MSCI Asia Pacific ex Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the performance of large cap stocks in Australia, Hong Kong, New Zealand and Singapore.
Developed market small and mid-cap (SMID)	MSCI World Small Cap Index, which is a capitalization-weighted index that measures small cap stock performance in 23 developed equity markets.
Emerging market	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure equity market performance of 22 emerging markets.
<b>Bonds</b>	
Developed sovereign	Citi World Government Bond Index (WGBI), which consists of the major global investment grade government bond markets and is composed of sovereign debt, denominated in the domestic currency. To join the WGBI, the market must satisfy size, credit and barriers-to-entry requirements. In order to ensure that the WGBI remains an investment grade benchmark, a minimum credit quality of BBB-/Baa3 by either S&P or Moody's is imposed. The index is rebalanced monthly.
Emerging sovereign	Citi Emerging Market Sovereign Bond Index (ESBI), which includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.
Supranationals	Citi World Broad Investment Grade Index (WBIG)—Government Related, which is a subsector of the WBIG. The index includes fixed rate investment grade agency, supranational and regional government debt, denominated in the domestic currency. The index is rebalanced monthly.
Corporate investment grade	Citi World Broad Investment Grade Index (WBIG)—Corporate, which is a subsector of the WBIG. The index includes fixed rate global investment grade corporate debt within the finance, industrial and utility sectors, denominated in the domestic currency. The index is rebalanced monthly.
Corporate high yield	Bloomberg Barclays Global High Yield Corporate Index. Provides a broad-based measure of the global high yield fixed income markets. It is also a component of the Multiverse Index and the Global Aggregate Index.
Securitized	Citi World Broad Investment Grade Index (WBIG)—Securitized, which is a subsector of the WBIG. The index includes global investment grade collateralized debt denominated in the domestic currency, including mortgage -backed securities, covered bonds (Pfandbriefe) and asset -backed securities. The index is rebalanced monthly.



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Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from

the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

#### Bond rating equivalence

Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	Moody's <sup>1</sup>	Standard and Poor's <sup>2</sup>	Fitch Ratings <sup>2</sup>
<b>Investment Grade</b>			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
<b>Not Investment Grade</b>			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

<sup>1</sup> The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.

<sup>2</sup> The ratings from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standing within the category.

(MLP's) - Energy Related MLPs May Exhibit High Volatility. While not historically very volatile, in certain market environments Energy Related MLPS may exhibit high volatility.

Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Past performance is no guarantee of future results.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory

compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

The information contained herein is not intended to be an exhaustive discussion of the strategies or concepts mentioned herein or tax or legal advice. Readers interested in the strategies or concepts should consult their tax, legal, or other advisors, as appropriate.

Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks.

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