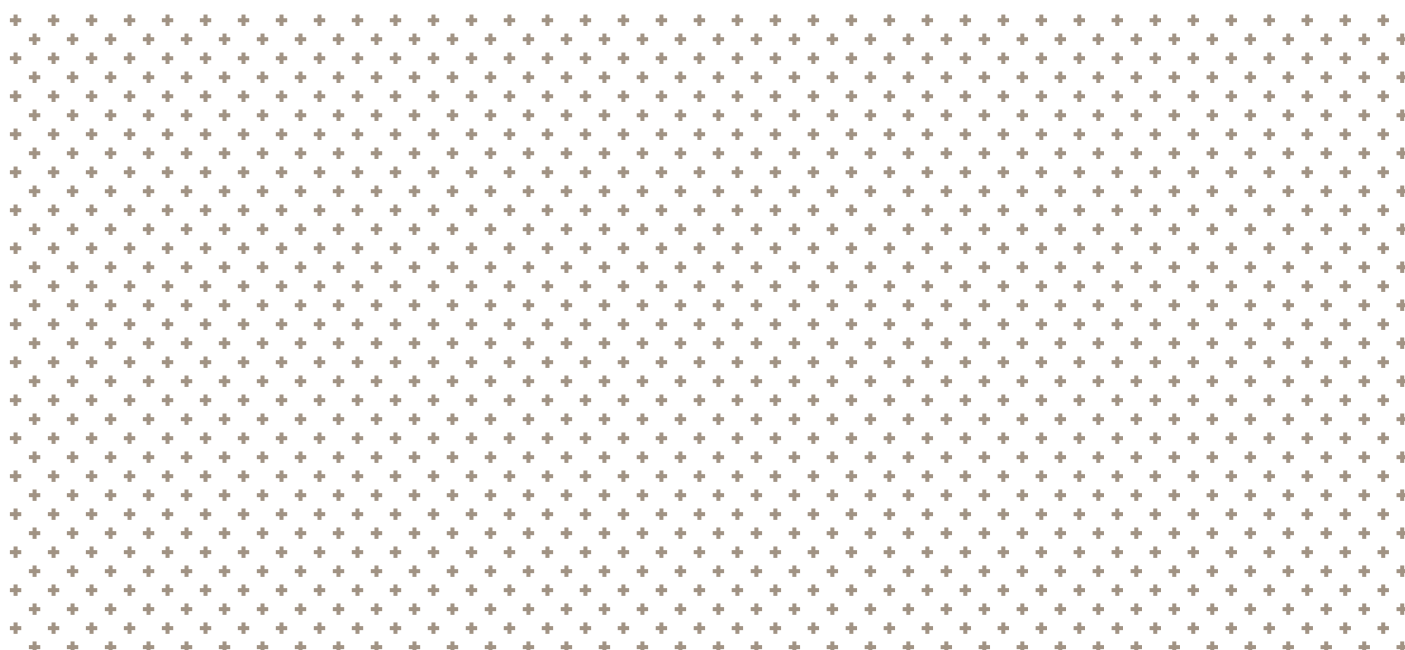




STRATEGY INSIGHT EMERGING MARKETS: CHALLENGES VERSUS OPPORTUNITIES

Emerging markets are under intense scrutiny and recent developments in China have added to investor nervousness. Inside, we explore both the challenges and the opportunities in this demanding asset class.



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Executive summary



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Over the last two years, emerging market (EM) assets have come under intense pressure. The continuing slowdown in EM growth led by China has increased investor concerns and has raised questions about the attractiveness of the world's developing economies as asset classes. Increasing geo-political risks and wider political tensions have only served to add to this underlying uncertainty.

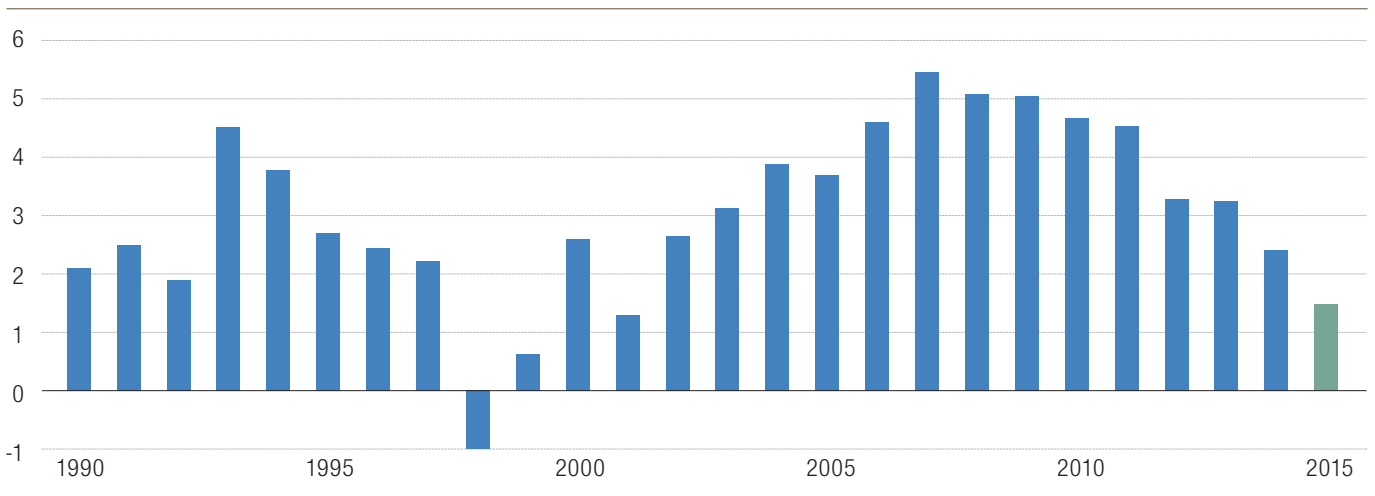
This strategy insight explores both the current challenges and the opportunities in these demanding asset classes and offers Lombard Odier IM's views.

Indeed, China undoubtedly continues to have a significant role to play in shaping EM and global outcomes going forward. Here, in our view, the likelihood of a full-blown financial meltdown in the world's second largest economy remains low.

In addition, despite tighter global financing conditions, we believe that underlying fundamentals for many developing economies remain sound, especially when compared to 1997/8. However, we are of the firm opinion that a fundamentals focussed approach is the best way to successfully navigate investing in these asset classes. Both for the challenges faced by individual markets and also to access the most promising opportunities (such as the secular trend of increasing consumption in China and its positive implications for the consumer facing part of the equity market).

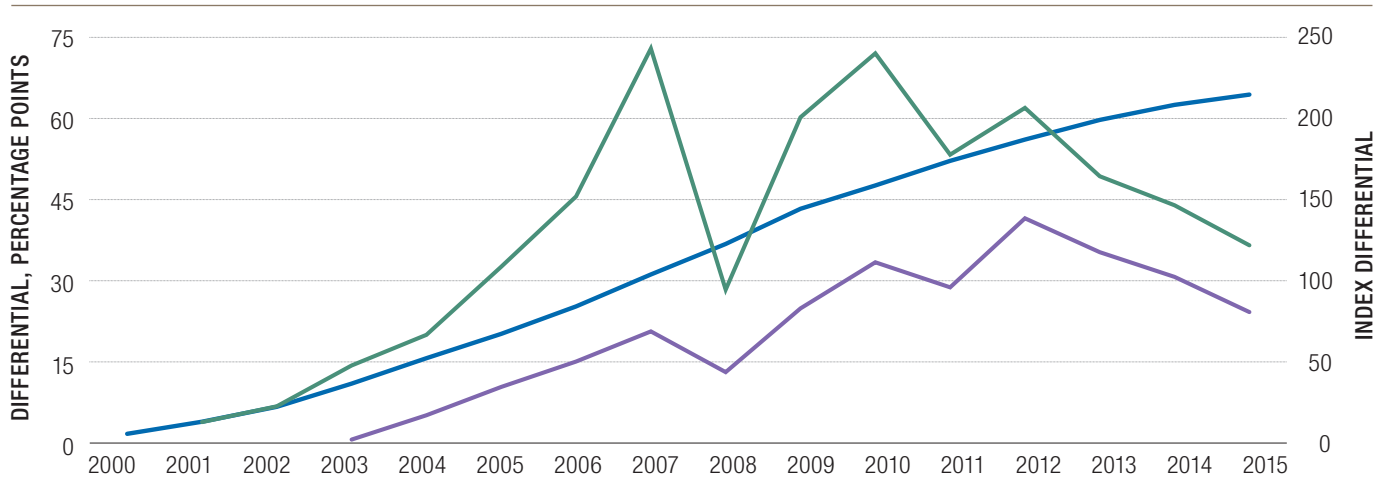
After nearly a decade of strong economic growth (which was only briefly damaged by the 2008/9 crisis), we have recently seen a sustained slowing of EM activity growth led by China. This slowdown is also reflected in the declining growth premium enjoyed by EM economies over developed economies, and which has been a permanent feature of the global growth landscape since the early 2000s. (Figure 1). Comparing this decline in excess EM growth premium over developed markets over the last few years with relative asset price performance, the outsized sensitivity that EM asset prices have exhibited in response to this change in the key underlying structural trend is also clearly displayed (see Figure 2).

FIG. 1 DIFFERENCE BETWEEN GDP GROWTH IN EMERGING AND DEVELOPED ECONOMIES¹



Source: Credit Suisse. For illustrative purposes only.
¹ 2015 figure, Credit Suisse forecast.

FIG. 2 THE CUMULATIVE ECONOMIC GROWTH, FIXED INCOME PERFORMANCE AND EQUITY PERFORMANCE DIFFERENTIALS BETWEEN EM AND ADVANCED ECONOMIES SINCE 2000²



■ Growth (LHS)
 ■ Equity, Base Year 2000 (RHS)
 ■ Fixed Income, Base Year 2002 (RHS)

Source: MSCI, IMF, JP Morgan, Bloomberg. For illustrative purposes only.
² Differentials calculated are EM-advanced. MSCI indices for equities, JP GBI-EM LC debt (USD) and Barclays Treasuries (USD) for fixed income.

China's economic growth slowing on a more sustained basis and its official policy to shift growth away from commodity intensive investments, has added to the downside momentum for commodity prices, and the impact has spread into the broader EM universe. For instance, South Africa (iron ore and coal exporter), Brazil (commodities) and Chile (copper exporter) and MENA and Russia (oil exporters) have been particularly hard hit as demand slowdown has amplified the price effects of increasing supply. This is especially noticeable in oil markets, where OPEC has adopted a high supply policy in a bid to protect market share. On the other hand, commodity importers are seeing a boost to their current accounts as their import bill declines, and so not all the news is bad for emerging markets.

However, the concurrent rise of the greenback witnessed over last two years (driven by economic decoupling of the US versus other G4 economies) has also created a financing-related headwind for emerging markets (to a varying extent for the various countries). Expectations around the start of the hiking cycle in the US (at a time when growth in a number of EM countries is slowing) has added to sustained downward pressure on EM asset classes, which has now been in place for more than two years.

Given this backdrop, emerging markets across the board are grappling with capital outflows as expectations grow that the Fed is close to raising interest rates resulting in tighter global financial conditions. Indeed, the situation has been made worse by increased geo-political risks (e.g., Russia) and political tensions (Brazil and Turkey) in a number of major developing countries. EM bond and equity funds have both experienced sustained capital outflows since the middle of the year although recent weeks have seen the pace of outflow moderate somewhat after intense pressure in August/September (Figures 3 and 4).

FIG. 3 FLOWS TO EM DEDICATED BOND FUNDS

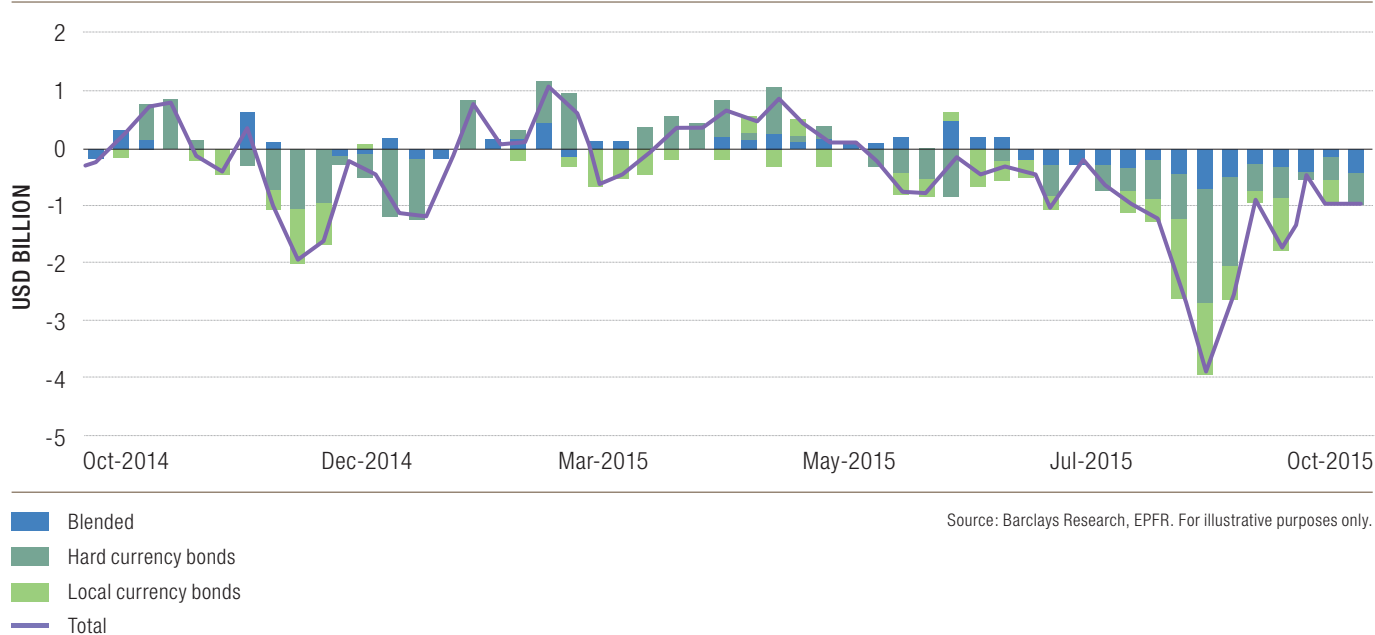


FIG. 4 FLOWS TO EM DEDICATED EQUITY FUNDS



The IMF estimates that part of the growth slowdown is structural, especially following the 2008/09 global economic crisis, which stunted productivity growth as debt burdens increased across the board.

However, looking ahead to 2016, EM economic growth is expected to pick up as a large number of EM governments boost spending and provide fiscal support. We should also begin to see some benefit of the sharp depreciation of their currencies witnessed over the last two years. Of course when it comes to supporting growth and backstopping the financial system, the effectiveness of policy measures undertaken by Chinese authorities remains key for both the emerging and the wider global 2016 outlook.

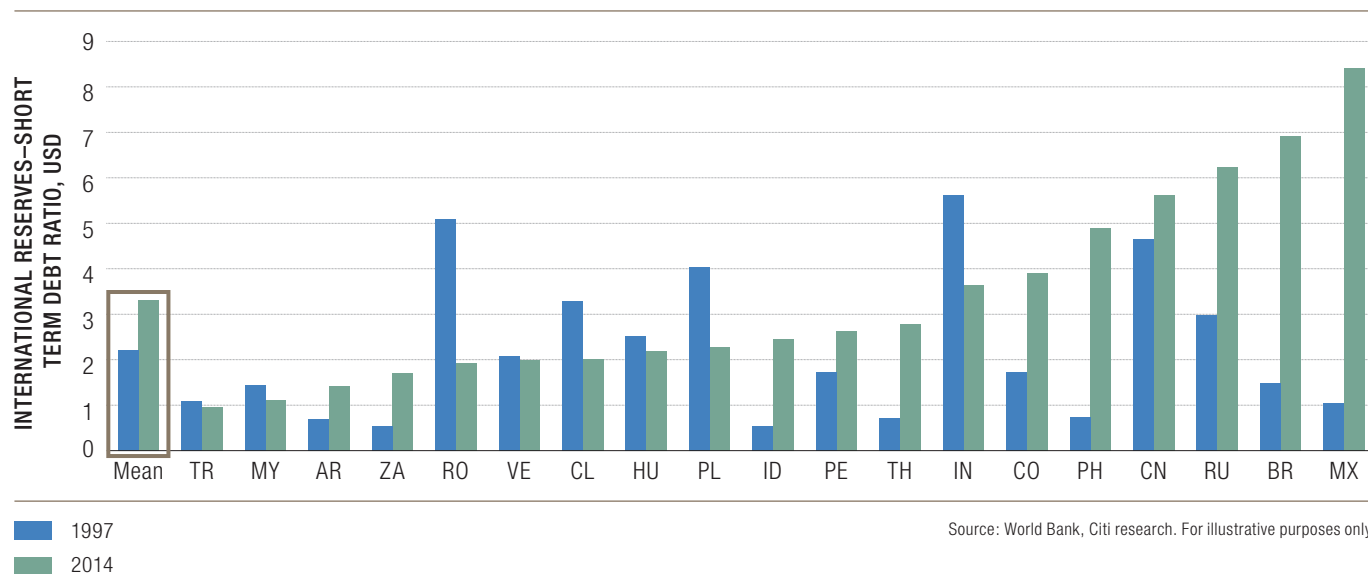
EM fundamentals remain solid compared to 1997/8

Recent events such as the slowdown in China's growth and fears around a financial meltdown (given the sharp rise in debt in recent years) have investors concerned about the prospects for emerging markets. In our view, key macro fundamentals of major developing countries are solid and any comparison with previous emerging crises such as the EM turmoil in 1997/98 and the 1998 Russian default are unwarranted. International reserves are significantly higher for most emerging markets in our 19-country sample,³ whether looking at import cover or relative to short term debt. Inflation is lower, external debt is lower and exchange rate regimes are flexible which is helping economies adjust to economic shocks.

International reserve metrics are significantly stronger

On average, country specific international reserve cover is stronger than in 1997/98 (Figure 5). In Brazil the Real has recently depreciated to levels last seen in 2002 as investors worry about FX liabilities against a backdrop of lower commodity prices and severe political tensions. Despite this international reserve cover relative to short term debt is significantly stronger than it was in 1997 (Figure 5).

³ Sample countries: Argentina (AR), Brazil (BR), Chile (CL), China (CN), Colombia (CO), Hungary (HU), India (IN), Indonesia (ID), Mexico (MX), Malaysia (MY), Peru (PE), Philippines (PH), Poland (PL), Romania (RO), Russia (RU), Thailand (TH), Turkey (TR), Venezuela (VE), South Africa (ZA).

FIG. 5 COMPARISON OF INTERNATIONAL RESERVES⁴-SHORT TERM DEBT⁵ RATIOS ACROSS THE SAMPLE IN 1997 AND 2014

Of the 19 countries in Figure 5, 8 have seen their international reserve cover of short-term debt deteriorate, versus 11 that have seen an improvement. For instance, India has seen its international cover decline over that period but remains above the average. All of the ASEAN countries that were at the epicentre of the Asian financial crisis have seen their international reserve ratios improve.

The level of international reserve cover across these 19 economies has, on average, improved from 2.2 times in 1997 to 3.3 times in 2014 of short-term debt. International reserve cover has also improved in terms of months of imports from 5.5 months in 1997 to 7.8 months in 2014.⁶

Trade finance makes up a large proportion of short term debt

A large proportion of short-term debt is typically trade finance which tends to be sticky with high rollover rates even during periods of stress. In India, trade credit made up more than 80% of total short-term debt owed at the end of 2014.⁷ Even during the 2008/09 global financial crisis when many of the global banks providing trade finance were under pressure, the majority of the financing was rolled over. For trade finance lines to remain open, what's important is that domestic banks in emerging markets continue to provide letters of credit, and are seen as robust. Indeed, many emerging market banks enjoy book values significantly greater than their developed market peers and have built up capital buffers in excess of the Basel III required capital ratios.

External leverage as a whole has declined across most emerging markets

External leverage is a key measure for assessing country default risk since the great majority of external borrowing tends to be in foreign currency. Domestic debt can be serviced with domestic currency resources which, in theory at least, a country can print to a limited extent without triggering inflation.

⁴ International reserves comprise holdings of monetary gold, special drawing rights, reserves of IMF members held by the IMF, and holdings of foreign exchange under the control of monetary authorities.

⁵ Short-term debt includes all debt having an original maturity of one year or less and interest in arrears on long-term debt.

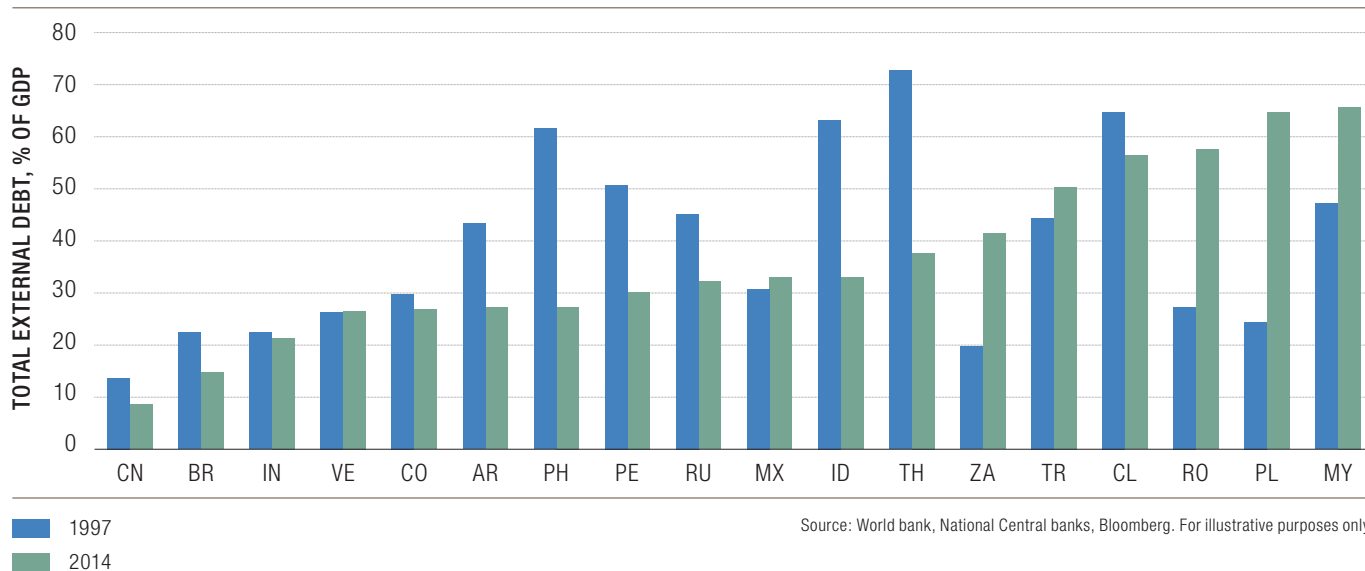
⁶ International reserve cover computed as $[\text{Reserves}/(\text{Imports}/12)]$ using international reserves data as above and annual import data from IMF.

⁷ India trade credit from World Bank.

The news on external debt front looks good. Out of the sample of 19 countries, 11 have seen their external debt ratios decline since 1997 (Figure 6). This is in contrast to the lead up to the 1997/8 Asian crisis when external leverage had been rising to take advantage of lower USD interest in the belief that fixed exchange pegs were there to stay which meant corporates were not factoring in exchange rate risk.

In our sample, 12 countries have external leverage ratios less than 40% of GDP, which compares to 9 at the time of the Asian financial crisis. This highlights that most have made considerable strides in improving their vulnerability to a tightening of capital flows. Even in China where investors have highlighted the sharp rise in total debt, most of that remains domestic and external debt is declining as a share of GDP.

FIG. 6 COMPARISON OF EXTERNAL DEBT AS A PERCENTAGE OF GDP FIGURES ACROSS THE SAMPLE IN 1997 AND 2014⁸



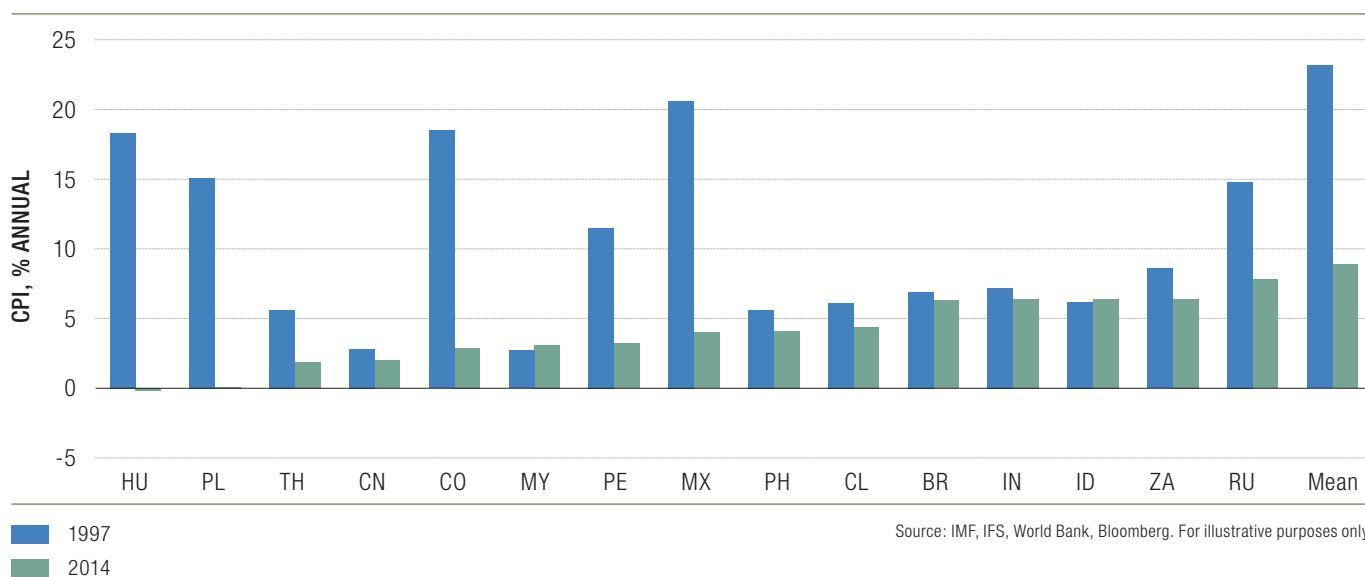
Macro fundamentals are in much better shape even as growth slows

For the great majority of countries underlying macro fundamentals are solid with Venezuela and Argentina being notable exceptions. Inflation in particular has fallen significantly in our sample (Figure 7). In 1997, 9 countries were running inflation rates well into double digits but by 2014 17 of the 19 countries⁹ had inflation below 10%. In fact, 11 countries out of 19 had inflation rates below 5%. Standout countries are Mexico, Turkey and Romania all of which were able to deliver declines in inflation in excess of 15 pps; Turkey inflation declined from 85.7% to 8.9%. Only Argentina and Venezuela in our sample of emerging markets have experienced a significant rise in inflation.

Inflation is now better anchored, with policy interest rates negative in most countries, in part due to low global rates. This has allowed emerging markets considerable room to raise policy rates if exchange rate pass-through from the recent depreciations prove higher than expected. Fiscal deficits have remained broadly similar to 1997 levels.

⁸ Hungary External debt as a percent of GDP Figures 51.95% (1997), 132.88% (2014). Chart excludes Hungary for ease of scaling.

⁹ Exceptions being Venezuela and Argentina.

FIG. 7 COMPARISON OF INFLATION RATES ACROSS THE SAMPLE IN 1997 AND 2014¹⁰

Emerging markets are witnessing a growth slowdown and not a balance-of-payments crisis

Our read of the current economic data supports the thesis that emerging markets are witnessing a growth slowdown rather than the beginning of a 1997/8 type sharp crisis. With US dollar funding tightening, some of the portfolio capital that took advantage of higher rates and growth in emerging markets in recent months is reversing. This is resulting in tighter financial conditions as we see long-term interest rates rise in local markets.

However, based on our analysis discussed above, we don't believe the current growth slowdown is likely to lead to a systemic crisis in EM, given much stronger buffers in place in a number of countries. Specifically, underlying fundamentals for a number of major EM countries have improved significantly since 1997. While there are clear pockets of stress, more flexible exchange rate regimes mean economies are better able to absorb capital flow shocks, external debt levels are manageable, and in most countries FX reserve cover relative to short-term debt has improved considerably.

Rather, we continue to see scope for differentiating carefully across the different emerging markets. Exchange rates continue to adjust to slower growth and, in some cases such as Brazil, to deteriorating macroeconomic fundamentals and tighter financial conditions. These should be seen as necessary adjustments in fundamentals with a weaker exchange rate helping to close external current account deficit and boost export competitiveness in response to slower growth.

Differentiation in emerging market fundamentals against a back drop of tighter financing conditions

A key feature of the current EM landscape which has come to the fore over the last two years is one of stronger differentiation in key economic fundamentals. For instance, *Table 1* below shows shifts in real economic growth, inflation, current account and budget balance dynamics over 2014/15.¹¹ Of course, commodity price dynamics and their impact on various countries depending on their net export/import status has played a role in driving this differentiation, but underlying structural shifts have also been in play (as we've seen in India).

¹⁰CPI Figures for excluded nations: Romania – 153.35% (1997) 1.1%(2014), Turkey – 85.7% (1997) 8.9% (2014), Venezuela – 50.04% (1997) 62.2% (2014), Argentina – 0.53% (1997) 38% (2014). Mean includes high inflation countries of Romania, Turkey, Venezuela and Argentina not shown individually in the chart to ease scaling.

¹¹2015 based on Bloomberg contributor composite/IMF estimates.

Looking ahead, we expect the fundamental-based differentiation we are witnessing to become a more permanent feature of the EM landscape. In our view, this means the label of “emerging markets” has become less helpful especially, when it comes to asset allocation decisions, as divergent country specific factors continue to become more dominant.

Indeed, the increasing structural differentiation we are seeing in emerging markets leads us to treat each country on its own merit and to use a fundamental focused approach to investing (especially when it comes to EM fixed income). This also raises the question as to whether it is sensible to treat EM as a single asset class and if not, what would be the appropriate way to organise it; this important and difficult question is the focus of our on-going research.

It is also important to note that this fundamental-based differentiation is taking place despite the constant risk of higher interest rates in advanced economies (specifically, in the US)¹² and the corresponding implications on the general financing environment. Here, the over-leveraged commodity-oriented corporate sectors (both EM debt and equities) are at risk, especially, if the Fed turns out to be more hawkish than current expectations. That said, given the broad-based global disinflation trends we are witnessing today, we think key central banks would remain in highly accommodative mode until tangible evidence supporting a turn in inflation appears on the horizon. (As confirmed during the latest ECB meeting, where President Draghi opened the door for additional QE by year-end.)

TABLE 1 THE DIFFERING DIRECTIONS OF KEY FUNDAMENTAL DATA POINTS FOR EM NATIONS FROM 2014 TO 2015¹³

COUNTRY	REAL GDP GROWTH	INFLATION	CURRENT ACCOUNT BALANCE	FISCAL BALANCE
Argentina	↑	↓	↓	↓
Brazil	↓	↑	↑	↓
Chile	↑	↑	↑	↓
China	↓	↓	↑	↓
Colombia	↓	↑	↓	↓
Hungary	↓	↑	↑	↑
India	↑	↓	↑	↓
Indonesia	↓	↑	↑	↓
Malaysia	↓	↓	↓	↑
Mexico	↑	↓	↓	↓
Peru	↑	→	→	↓
Philippines	↓	↓	↑	↓
Poland	↑	↓	↓	↑
Romania	↑	↓	↓	↑
Russia	↓	↑	↑	↓
South Africa	→	↓	↑	↑
Thailand	↑	↓	↑	↑
Turkey	↓	↓	↑	↓
Venezuela	↓	↑	↓	↓

↑ Increased / become less negative
 ↓ Decreased / become more negative
 → No Change

Source: Bloomberg, IMF.

¹²See Strategy Insight, Are EM investors focusing too much on short-term worries?

¹³Units for fundamentals: Real GDP growth - % YoY, Inflation - CPI % YoY, Current Account Balance - % of GDP, Fiscal Balance - % of GDP.

FIG. 8 RATIO OF LOIM'S FUNDAMENTAL EM LC INDEX TO JP-GBI EM INDEX¹⁴

Turning to asset market trends, the underlying trend of fundamental differentiation discussed above has been a powerful driver of performance in debt space. For instance, our fundamental based EM local debt index has outperformed the relevant market-cap index (JP- GBI EM) to the tune of almost 50bp year-to-date (see Figure 8). This clearly shows that markets have strongly rewarded/punished strength/weakness in underlying fundamentals, when various EM countries are assessed on the basis of this dimension.

China experiencing a growth slowdown not a financial meltdown

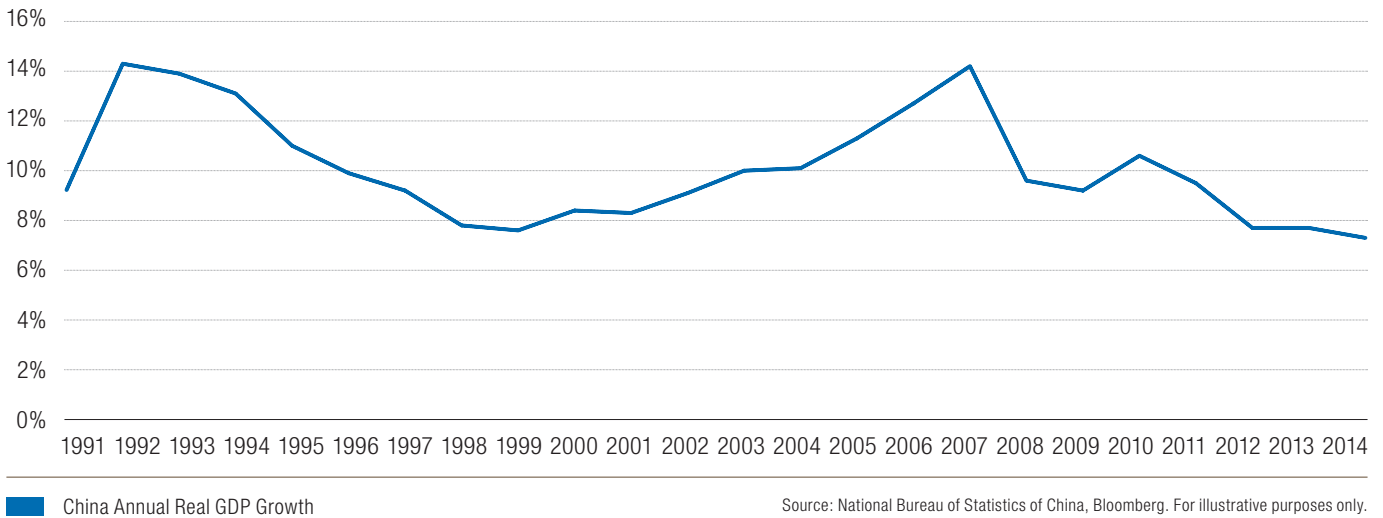
Despite the increase in divergent country-specific dynamics in EM coupled with risk of tighter financing conditions, we think it is critical to understand the nature of the risk factor posed by China. The sharp rise in Chinese debt burden (where total debt to GDP ratio has increased to 282% in mid-2014 from 158% in 2007 according to a McKinsey study) means the solvency of the various heavily indebted sectors has come under intense scrutiny in recent months.

However, from an external public balance-sheet perspective, we should remember that China remains a very closed economy when it comes to the capital account. At the end of 2013 before capital outflows started in earnest it was a net creditor to the world (around USD 2 trillion). In addition, focusing on the asset side of the balance sheet, the vast majority of which are in FX reserves (around USD 3.5 trillion based on latest data) are available in liquid form, that can be leveraged-up if required, in order to back-stop the system.

Despite very strong backstops, growth in China continues to slow (Figure 9) as a result of the slowdown in Fixed Asset Investment (FAI) which reached highs of almost 50% as a share of GDP. Developing nations transitioning towards a more developed economy often have sustained cycles of elevated fixed investment expenditure as they build out the capital stock, including infrastructure and private investment with the aim to push productivity closer to developed economy levels – Japan and Korea are examples during their transition to developed economy status.

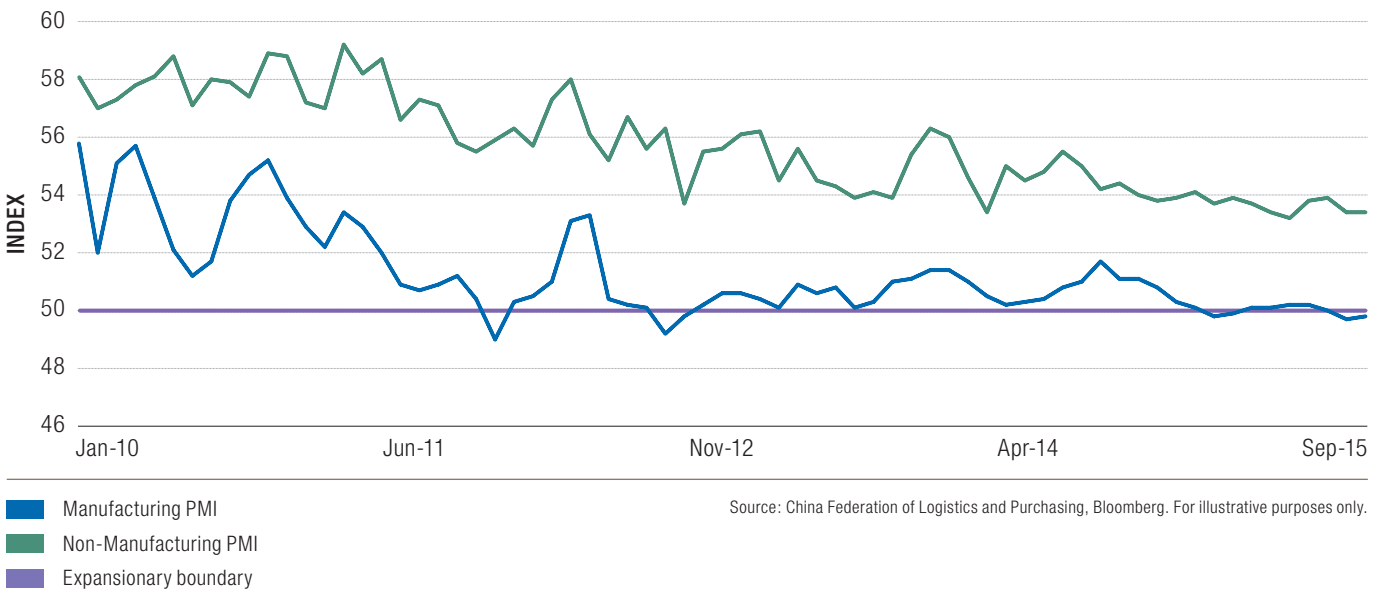
¹⁴Rebased to 100.

FIG. 9 CHINA'S ANNUALISED GDP GROWTH IS SLOWING FROM A PEAK IN 2007



Looking at growth numbers in the non-manufacturing sector, the situation is healthier as they continue to expand at a solid pace. For instance, the non-manufacturing PMI remains well into expansion territory (above 50) even as the manufacturing PMI is signaling little or no growth. The manufacturing sector PMI has averaged 50.1 over the last 12 months, while the non-manufacturing PMI has averaged 53.7 over the same period (Figure 10). This is a clear sign that the economy is rebalancing in favour of non-manufacturing, the majority which is services.¹⁵

FIG. 10 COMPARISON OF CHINA'S MANUFACTURING AND NON-MANUFACTURING PMIS AGAINST THE EXPANSIONARY BOUNDARY

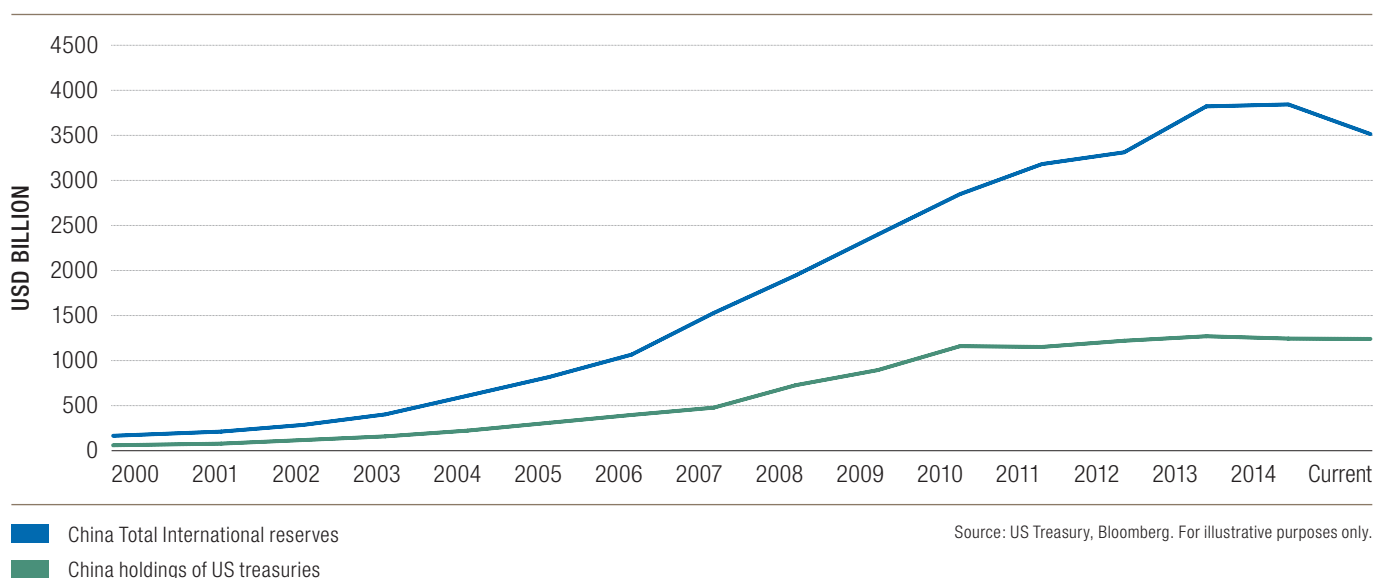


¹⁵Non-Manufacturing and Manufacturing PMI's discussed are seasonally adjusted, national Figures.

In the past, some of the high levels of investment has been channelled to uneconomic projects whose rates of return are inadequate to service the debt used to finance the projects. However, as noted above, while there are pockets of stress, most of financing has been domestic. This gives the government considerably more room to cushion the investment slowdown in by selectively supporting struggling projects. This helps to avoid a domino of falling asset prices and tightening credit conditions.

Furthermore, the Chinese government has considerable fiscal space to support growth with a central government debt to GDP ratio of 41% of GDP in 2014. Also, as noted above, large foreign exchange reserves are available should the need arise to support various systemic entities in the case of financial stress. Total international reserves stand at around USD 3.5 trillion of which USD 1.2 trillion alone are in US treasuries (Figure 11).

FIG. 11 CHINA'S TOTAL INTERNATIONAL RESERVES AND HOLDINGS OF US TREASURIES



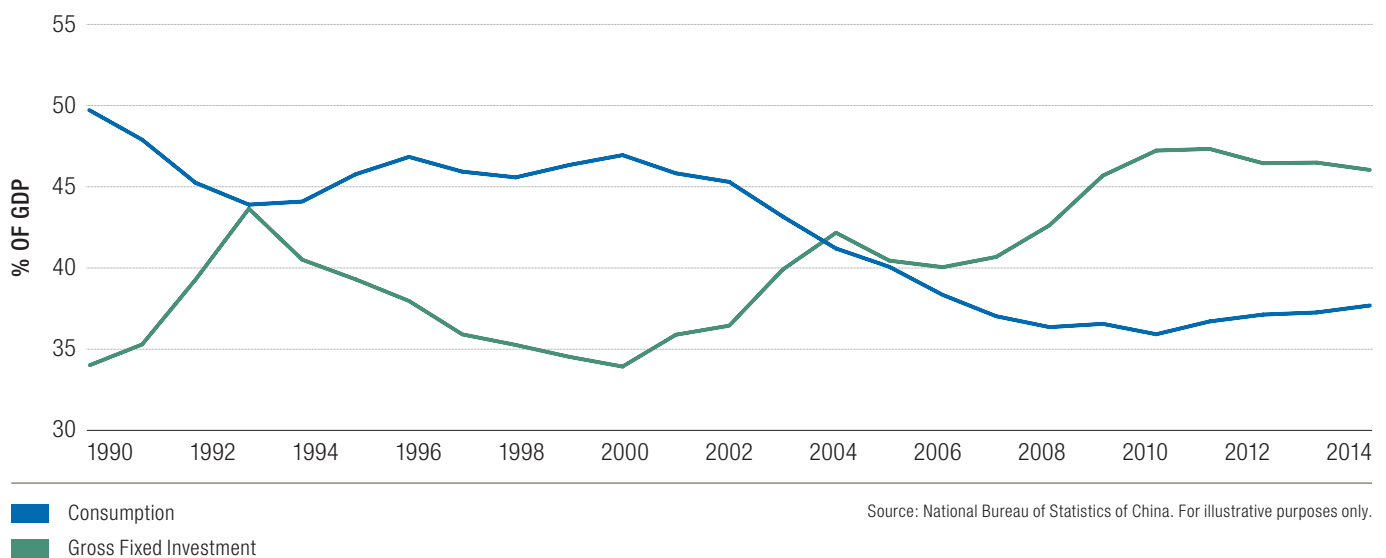
To engineer a soft landing in growth the government is supporting a transition to consumption and is visibly assisting in channelling resources away from FAI. To that end, the government is committed to a number of reforms:

For instance, the government has in its 13th 5-year economic plan prioritised a rebalancing of the economy away from FAI toward consumption spending. One example is a commitment to gradually ease the one-child policy. This should help boost consumer spending among younger households. Other reforms will target the gradual introduction of a social safety net through broadening of a pension system and setting up a system for providing healthcare. One of the reasons that household saving is currently high is the need for consumers to provide for their own safety net.

The investment share in GDP nonetheless remains high and needs to ease further for the government to address the imbalance between investment and consumption. Emerging markets typically have investment shares of between 15 and 25%. The transition to consumption-led growth is ongoing but is likely to be gradual.

That said, there are clear signs in the data that that transition is taking place. The share of FAI in GDP is declining (Figure 12) while that of consumption is rising.

FIG. 12 CHINA'S CONSUMPTION AND GROSS FIXED INVESTMENT, AS A PERCENTAGE OF GDP



Specifically, growth in consumption remains above GDP growth and has been broadly stable over the last couple of years even as growth in FAI slows. Household savings rates have declined slowly as the government gradually rolls out social safety nets. Health insurance, old-age benefits and free schooling, although work in progress, appear to have helped check the remarkable propensity of Chinese to save. At 40% of income, the household savings rate has stopped rising in recent years.

Of course, monetary policy has a role to play here as well given the sharp pressure on the manufacturing sector, which has put broad-based pressure on cyclical economic growth. We think given falling inflation, the Chinese policy makers have ample room to reduce real interest rates in a further bid to support economic growth. Already on this front, we have seen rate and Reserve Ratio Requirement cuts, which we believe are likely to continue well into 2016. On the fiscal policy front, more information will be available at the upcoming Fifth plenum, which will set the government's next 5-year plan.

Indeed, the structural rebalancing of the Chinese economy is ongoing, and given the cyclical support, which is likely to come to the fore from the government going forward, we think, important catalysts are taking shape, which can potentially change the shape of current challenges facing the EM world into compelling opportunities. We discuss one specific example of an evolving opportunity in the next section.

Chinese equities – accessing value in a world of rebalancing and easy policy

In terms of view expression, we think that the equity market offers a compelling way to take advantage of the combination of easier Chinese monetary and fiscal policies and structural economic rebalancing.

After the Chinese stock market's volatile gyrations witnessed earlier this year, the broad MSCI China market index appears to be cheap against many of its peer economies (India, Philippines) as well as the broad MSCI EM (Table 2). Specifically, China is cheap on a price-earning (P/E),¹⁶ price-to-book (P/B) basis despite having a similar return on capital employed (ROCE) compared with Thailand and India, and considerably higher than the EM average.

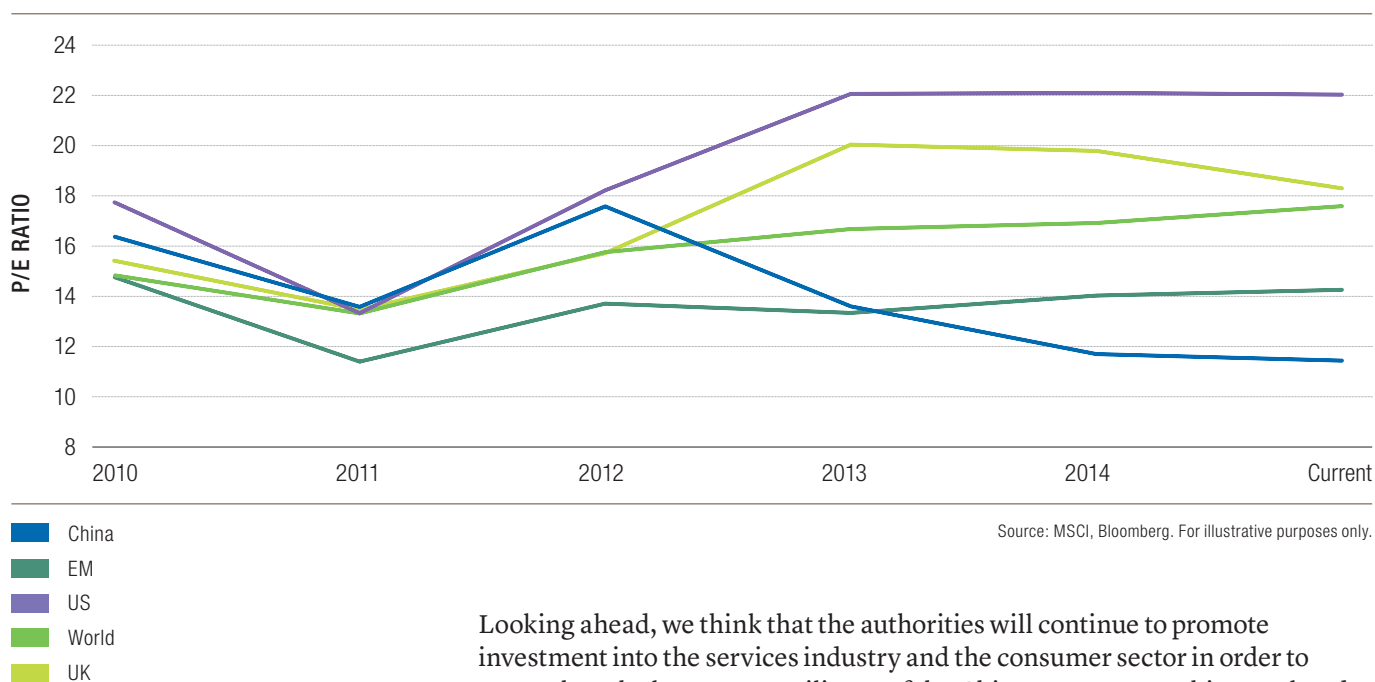
¹⁶ 12 month-trailing P/E ratios.

TABLE 2 MSCI CHINA INDEX – CHINA VERSUS EM PEERS AND THE WORLD¹⁷

	MSCI INDEX						Best Worst
	CHINA	EM	PHILIPPINES	THAILAND	INDIA	WORLD	
P/B	1.18	1.26	1.83	2.75	3.1	2.03	
P/E	8.7	11.53	15.76	20.06	22.1	17.11	
Dividend Yield	3.67	3.11	3.24	2.08	1.39	2.7	
ROCE	14.47	10.75	12.11	14.37	14.24	11.04	

Drilling down and homing in on playing the rebalancing of the economy theme, it is instructive to take a closer look at China's Consumer discretionary sector. Over the past five years this has been getting progressively cheaper than markets in major developed economies and the MSCI World index more generally (especially since 2012) (Figure 13).¹⁸

In addition, China Consumer discretionary equities also trade at a sizeable discount to the broader EM Consumer discretionary universe.

FIG. 13 P/E RATIOS OF MSCI CONSUMER DISCRETIONARY INDICES FOR CHINA, DEVELOPED NATIONS, EM NATIONS AND THE WORLD.¹⁹

Looking ahead, we think that the authorities will continue to promote investment into the services industry and the consumer sector in order to strengthen the long-term resilience of the Chinese economy. This can already be seen in consumer credit data and incentives being provided in this area (such as lower down payments required on home purchases).

¹⁷ MSCI indices and their respective equity valuation statistics in Table 2 are indicative of the stated universe (e.g. EM, China etc.) as a whole, and not for any one sector in particular. Data correct as of 2 October 2015.

¹⁸ MSCI world index includes developed world markets and does not include emerging markets.

¹⁹ 12 month trailing P/E ratios 2015 specific to MSCI indices covering the consumer discretionary sector. 'Current' Figures refer to 2nd October 2015.

Given current valuations, we think it makes sense to acknowledge the current cheap valuations presented by consumer discretionary names (both through time and against peers). To some extent the MSCI China Consumer discretionary discount is explained by the poor sentiment toward the old-economy names that face headwinds as growth slows and the economy rebalances. Looking ahead, we believe that this valuation discount is likely to start reversing as the intensity of the global investor community's concerns about a potential Chinese financial meltdown starts to recede.

To summarise, there is clearly a strong policy drive behind an economic rebalancing strategy in China. As seen in macro data with investment share of GDP beginning to decline and the consumption share rising, this policy is bearing fruit. In our view, this process has only just started and there is considerably more space for that balancing to continue and for investors to take advantage of this secular trend going forward. Indeed, further targeted easing of monetary and fiscal policy are additional positive factors, which should also help to strengthen this underlying dynamic in 2016.

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