Market Letter

Second Quarter 2022

2nd Quarter 2022 Investment Letter:
Stagflation or soft landing?
China, countercyclical. Commodities, a hedge.

- *The toughest first half in nearly fifty years.* The first half of this year has delivered several adverse shocks (Ukraine, its effects on commodity markets, supply chains, inflation, and financial conditions) that dramatically raised inflation while significantly weighing on growth. Negative growth and near 10% annualized inflation in the US looks like an uncomfortable backdrop for markets, as the worst combined returns for bonds and equities in more than a century attest to.

- *Recession or not?* The fastest deceleration in global growth over 80 years. The probability of global recession has increased meaningfully. It now looks likely the first half of 2022 saw a two-consecutive quarter of negative US GDP growth.

- *Can a hard landing be avoided?* The debate now is whether the recession will be shallow but last awhile, or a hard landing. Weaker global real GDP growth is likely in upcoming quarters on the back of tighter financial conditions, high energy prices, and negative fiscal impulse, and geopolitics. However, a global recession is not the central scenario, but a picture of a partial one. Bloomberg yield curve-based model saysrecession has a 58% probability within the next 2 years. JPM has recession at 50/50.

Inflation was the dominant theme in Q2. Upward surprises continue. Inflation rates in the US and Europe, ran at north of 8% y/y by the end of Q2. The drivers are different though, with inflation in the US becoming more entrenched, and in the Eurozone most of the increase in prices being a function of commodity prices. China remains the exception on this front, with CPI at 2% y/y currently. US Core goods price inflation remains elevated, but moderating demand and an easing of supply constraints has started to reduce this pressure. The high readings in the US have mainly been from March through May, and we may be in for another couple of months of bad numbers. Inflation in most places has been high for some months now and continues to rise. It's been unexpectedly abrupt for financial markets. They are troubled not just by the Fed's 75bps hike and a clear signal from the ECB that it could soon be lifting the policy rate in at least 50bps steps, but also by the huge uncertainty over just how much interest rates may have to rise and to assess how painful the tightening might be.

- *How fast will inflation decline?* The history of peaks, particularly post-1990, adds to confidence that there could be a sharp deceleration in the headline rate.

- EM growth has withstood a barrage of shocks since the start of this year. The World Bank has downgraded growth in more than 80% of commodity importers, they have upgraded growth forecasts for 60% of energy exporters. Facing high inflation and already well-advanced hiking cycles, EM central banks must decide when enough is enough. Despite a worsening in twin deficits relative to last year, the risk of a late-cycle crisis for the larger EM countries is mitigated by excess savings positions; for more vulnerable frontier markets those risks are higher.

- The impact of the war in Ukraine continues to worsen, with Moscow now even restricting gas supplies to parts of Europe. Commodity prices for energy, metals and particularly food have recently been at, or close to, record highs, even if some are receding now. Meanwhile, the battle against COVID-19 will be ongoing. The regional lockdowns in critically important manufacturing hubs and international ports in mainland China are starting to ease, offering hope that some of the temporary supply chain disruptions could soon unclog.

- With the key exceptions of the Bank of Japan and the PBOC, central banks are making it clear that they cannot cease tightening until inflation comes down. The ECB shifted dramatically, revising its inflation projections notably higher for 2023 and 2024 despite lower projections for growth. It also emphasized the need for a speedy start to rate normalization.

- Among EM central banks in low-yield economies, those that started hiking earlier are not yet at the end of their hiking cycles as inflation continues to surprise uncomfortably to the upside. But as their growth outlooks face headwinds, they are signaling less aggressive tightening paces and more concern with macro stability. Much of EM Asia has been slow to see elevated inflation—although rising incomes, as post-Omicron growth recoveries take hold, should pressure core inflation higher—and the region's central banks are still early in their more gradual hiking cycles.

- **Food security** is emerging as the **next crisis** alongside energy security, raising the risk of social instability in low-income EM countries. Frontier markets are on trial and will bear the brunt of the economic fallout. Nearly 60% of the poorest EM countries were already in debt distress, or at high risk of it, before the Russia/Ukraine war, while the debt-service burdens in middle-income countries are at 30-year highs, according to the World Bank. Speakers at IMF/World Bank Spring Meetings highlighted the risk that Sri Lanka, Tunisia, Jordan, and possibly Pakistan may also need to restructure their sovereign debt.

- **China is bouncing**, but its zero Covid policy is holding back the economy. Policymakers are keen to add support. Various measures have been introduced to jumpstart the economy.

- **FX** performance was dominated by the **stronger USD** in Q2. All G10 currencies lost ground versus the greenback, and so too did most EM currencies. Indeed, performance in G10 over Q2 largely reflected movements in relative terminal rate expectations.

Global Drivers:

- **Global growth:** *Global activity data were worse than expected in Q2. Growth has slowed but many areas of demand have remained firm.*

  The World Bank has revised growth down in nearly 70% of countries they track, which includes 80% of commodity importers, and now expect global economic activity to slow to 2.9% in 2022 from 5.7% in 2021. Growth in developed economies has been revised down by 1.2%-pts to 2.6% while emerging economies are expected to post 3.4% growth in 2022—well below its annual average from 2011-2019 of around 5%.

  Supply chain disruptions have increased from the war in Ukraine, but disruptions from China could start to ease in coming months. The future outlook will be divergent as the economy slows down again, with parts of it proving much more resilient than others. On the consumer side, housing market activity is starting to slow in many places as interest rates rise, but in the advanced economies at least, households are still increasing the volume of their spending, particularly on travel and recreation. This discrepancy partly reflects the pent-up demand for some services as the world emerges from lockdowns and restrictions but also the distributional impact of the enormous stock of additional savings accumulated by many households in 2020-21. If confident, such consumers can draw down some of these “excess savings” – or at least not raise them as much as they typically would in a downturn – to sustain such spending even in the face of a severe cost of living squeeze. That means that aggregate consumer spending may continue to be resilient even as lower income people – whether low-paid workers or those relying on benefits or pensions not linked to inflation– must curtail any discretionary spending.

US: *A soft landing is far from assured. A US recession can’t be ruled out.*

COVID rebound is nearly complete, with nearly 21 million jobs added and tight labor markets exerting upward pressure on prices, raising the risk of recession.

- **Monetary policy outlook:** *Central banks are saying they will do whatever it takes to tame inflation. Central banks’ inflation credibility may need no quick policy reversal.*

Global monetary policy normalization may have started in 2021 but inflation has continued to rise. Amid rising investor concerns about recession risk, US Treasury yields have retreated from their high in recent weeks. The economy is slowing and will slow more as rate hikes take hold. Powell & Co. would like to avoid a recession, but taming inflation is a higher priority. Central banks globally remained firmly in tightening mode. The Fed announced the start of its QT program, alongside hikes of 50bp and 75bp, respectively. Though the ECB has not acted on the rate channel yet, it is widely anticipated to start hiking rates in Q3 and to backstop peripheral spreads. The BoJ continued to be the dovish outlier, reiterating its desire to maintain yield curve control. Rate hikes also continued in emerging markets, from CEE to LatAm and increasingly also Asia – with China being the dovish outlier.

Fed: *Aggressive Fed action to address inflation, but many factors are outside of its control: food and energy, COVID-19 breaking supply chains, war in Europe*.

The FOMC needs confidence that inflation will fall enough in coming months to engender confidence that inflation will fall toward its 2.0% target next year. Given the current high rate of inflation, it is unlikely the easing of policy will occur as quickly during this downturn as it has in the past. If inflation expectations de-anchor, as they did in the 1970s, as a result of persistently elevated inflation and repeated inflationary shocks, the interest rate increases required to bring inflation back to target will need be greater and at a faster pace than those currently anticipated by markets to a level of 5-6% for real rates if core inflation remains elevated at 6%.

- **Commodities:** *Commodity prices for energy, metals and particularly food are at, or close to, record highs, even if some commodity price indices have been showing signs of fatigue. Evidence of slowing has emerged, and commodity prices fell. The price contraction in many commodities points to lower manufacturing input prices, possibly implying lower PPI readings going forward and tamer CPIs down the road.*

The World Bank forecasts energy prices to increase more than 50% this year with an 81% increase in coal prices and a 75% increase in natural gas prices, while agricultural prices are forecast to rise 18% this year (see the World Bank’s Commodity Markets Outlook report, April 26). Although energy prices are expected to moderate in 2023 as production rises elsewhere, including in the US, prices will remain well above the average over the past 5-10 years.

Copper prices tumbling. From the March high of 500 future prices plunged to 360 at the end of June, way below the pre-war trading range in the low 400s. But it’s obviously not just Copper, Zinc fell from its April peak of 4,500 to 3,000, again markedly below pre-war levels. Lumber futures almost halved. Iron Ore dropped from 950 to 740. Even Wheat futures got slammed, skydiving from almost 1,300 in May to 850.

While there is no such retreat in prices detectable in crude, gas, and coal markets, the overall Bloomberg Commodity Index has after all sharply corrected by 15% in the past 3 weeks. The direct impact of the war in Ukraine, alongside the sanctions imposed by the West and retaliatory measures from Moscow – which is now restricting gas supplies to parts of Europe, sending wholesale gas prices higher again – continues to worsen.

The speed of European governments reducing dependency on Russian energy imports remains challenging. Years of oil underinvestment have contributed to overall commodity shortages, with the potential for commodity volatility to become a bigger headwind. Moreover, tradeable commodity inventories ex-China are near depleted levels having shrunk from about 75 days of demand pre-COVID to just 47 days of consumption today. The consequences from low inventories range from surging market volatility in many commodity futures markets to a rise in physical prices. In contrast, China currently holds an estimated 82% of global copper, 69% of corn, 49% of wheat, 45% of soybeans, 26% of oil, and 23% of aluminum inventories.

EM Investment Outlook: *Farewell to the Great Moderation. Ongoing tightening in global financial conditions will remain a challenge in 2H22. China seems countercyclical and commodities a hedge.*

*So long and farew*ell to negative yields as secular forces are driving real yields higher. Structural forces driving real yields include an inflation-induced reduction in the savings glut with increasing dependency rates, an increase in investment intensity to meet climate objectives, deglobalization reducing the pool of savings accessible to the US, and the legacy of high fiscal debts and deficits.

The first half of the year has been difficult for investors with prices declining across asset classes. Parts of the global economy appear to be heading into recession. The first releases of Q3 are already pointing toward weaker growth. What will the impact be on the inflation trend? Larry Summers expects a slower speed of mean reversion this time around.

- Commodity super-cycle: commodities and commodities related assets (sectors, countries, etc.) are a hedge against inflation and geopolitics. Commodity prices continue to cushion a large share of countries, particularly in reducing default risks.

- China growth will significantly accelerate to 7.5% in the second half, up from basically zero (0.5%) in the first half of the year. This will provide tremendous support not just to EM Asia assets such as China equities, but also for the global cycle.

- Some risky asset prices seem too cheap. Positioning and sentiment of investors is at multi-decade lows.

- EM fixed income will remain challenged into H2 by the tightening in global financial conditions.

- USD strength is set to continue, particularly versus commodity importers.

Will the Fed have to raise rates harder for longer than the market expects?

The markets have already done a lot of the Fed's heavy lifting to tighten financial conditions. So far, the FOMC may have only raised rates three times by a total of 150bps and signaled an intention to shrink its balance sheet by about USD1trn in the next year. Markets are pricing in more rate rises and trying to assess the impact of the quantitative tightening (QT), causing bond yields to rise, credit spreads to widen, mortgage rates to jump, equity markets and crypto assets to drop and the dollar to strengthen. With inflation at a 40-year high FOMC will need more than 2 months of lower inflation prints. Investors will respond to any improvement in inflation as proof the FOMC will go 0.25% in September. Banks will begin to increase lending standards as the economy slows tightening credit availability. As more companies guide Wall Street lower, non-energy earnings estimates will come down. The combination of tough talk from the FOMC and slower growth is creating a recession scare. The first phase of the stock market decline was due to higher Treasury yields. This caused compression in P/E ratios especially for high P/E stocks. The next phase of P/E compression could be driven by downward earnings estimates.

- For a better second half to the year, we would need comfort for central banks and bond markets, which unfortunately could require worse economic news.

- Strong CPI print led to a surge in yields, along with the sell-off in crypto, which are weighing on investor sentiment and driving the market lower. The move in markets prices in a high recession risk. However, near-term recession may be avoided thanks to consumer strength, COVID reopening/recovery, and policy stimulus in China.

- Negative yielding debt has fallen by nearly two-thirds from a peak of $17trn in early 2020 to $6rn. Nearly 40% of negative-yielding debt in the longer duration buckets (5+ years) has been erased, with Japan accounting for 78% of the remaining stock and the only country with negative yielding debt in the medium-term (3-5 year) bucket.

- JPM sees a long-term scenario of higher macro and inflation volatility. US inflation averaging 3-4% and a target of 2.5% real yields for 10-year US Treasuries over the next decade, producing a nominal yield target of 5.5% for US Treasuries by 2030.
- The structural forces are *driving real yields higher,* reversing most long-term forces that applied downward pressure on US real bond yields since the 1980s. These forces include a demographic-induced reduction in the savings glut, an increase in investment intensity to meet climate objectives, deglobalization, and the legacy of high fiscal debts and deficits.

Risks: *higher inflation and tighter monetary conditions, coupled with rising recession risks. There is a considerable risk that inflation will remain high and could continue to rise. COVID-19 health implications continue to linger.*

The risk of **stagflation** has risen. Even if a global recession is averted, the pain of stagflation could persist for several years.

3 Key Areas:

- First, food and energy price shocks are occurring alongside supply shocks and elevated global inflation, preceded by a protracted period of highly accommodative monetary policy in major economies that was accompanied by negative real rates and marked fiscal expansion.
- Second, prospects for weakening growth over the longer term. Between 2021 and 2024, global growth is projected to have slowed by 2.7%-pts.
- Third, EM countries are vulnerable to monetary policy tightening by advanced economies due to the adverse shocks of the past two years, with real income per capita in 2023 below pre-COVID-19 levels in about 40% of developing economies.

At the same time, external public debt for EM economies is at record levels, with the largest, fastest, and most broad-based increase in government debt by emerging markets in the past 50 years. Debt distress—previously confined to low-income economies—is spreading to middle-income countries. Central banks have accumulated credibility over the past several decades with more tools available to fight inflation along with better defined monetary policy frameworks, better-anchored inflation expectations and a more flexible economy, including in the labor market, to withstand supply shocks.

Fear of the Fed is not just about the magnitude of rate hikes, but also volatility and “hard landing” concerns – both of which are rising. Downside pressures on global growth, despite expectations for China’s economy to improve, represents another prominent headwind for EM.

The impact of the war in Ukraine continues to worsen, with Moscow now even restricting gas supplies to parts of Europe. Its effects on commodity markets, supply chains, inflation, and financial conditions have steepened the slowdown in global growth. One key risk to the outlook is the possibility of high global inflation accompanied by tepid growth, reminiscent of the stagflation of the 1970s. This could eventually result in a sharp tightening of monetary policy in advanced economies, which could lead to financial stress. Low-income countries will continue to see serious challenges when it comes to basic staple commodities.

Meanwhile, the battle against COVID-19 will be ongoing. The regional lockdowns in critically important manufacturing hubs and international ports in mainland China are starting to ease, offering hope that some of the temporary supply chain disruptions could soon unclog.

Countries

China: *Policy makers stepped up policy support on both the fiscal and monetary side in Q2. Omicron wave recedes, but headwinds persist. Beijing would stick to the “dynamic zero” COVID-19 strategy this year.*

With the current wave receding and supply chain bottlenecks easing, things are normalizing on the ground. The stepped-up policy support will also provide a buffer to the downturn. That being said, the recovery path is highly dependent on the evolution of the domestic COVID-19 situation. With multiple headwinds, China's "all-out" infrastructure push should lead to an investment-driven recovery. Issuance of local government special bonds is ramping up. At the same time, local governments can tap into accumulated landsale revenues and new funding sources such as infrastructure REITs (real estate investment trusts) to finance various projects. But challenges are still rippling through. The unemployment rate has been elevated (May: 5.9%), only slightly below the peak in Q1 2020. Export growth will likely soften, while an investment-driven recovery may lead to more imports when commodity prices are elevated.

The PBoC will likely continue its easing stance, especially as inflationary pressures should prove manageable.

In the 20th Party Congress, likely to be held in 4Q22, the key focus will be the change in CPC Party leadership teams, which will be followed by the change in the state's leadership in March 2023. A consensus assumption is that President Xi will have a third term as the core leader.

Indonesia: *Good fundamentals and improving domestic economic recovery.*

The economy rebounded in Q4 2021, and the recovery is projected to accelerate supported by favorable global commodity prices, easing restrictions on activity, continued policy support, and rising mobility and confidence as the vaccination program expands into more remote areas. Private sector activity and investment will be bolstered by last year's omnibus law on job creation, and its impact could be enhanced by complementary reforms such as improvements to education, infrastructure, and efforts to strengthen governance frameworks.

The robust inflow of FDI has continued through the pandemic and the trend is likely to continue. Thanks to favorable government policies that have spurred significant investment into processing industries, Indonesia has the world's largest nickel reserves, a key component for EV batteries. After it banned exports of nickel ores in 2020 to develop its downstream industry, Indonesia has now emerged as a key player in battery-grade chemicals. Recently, President Joko Widodo stated that Indonesia will go ahead with its plan to stop exports of other raw materials, including bauxite, to help downstream processing industries (like aluminum) to grow.

Inflation has remained lower than in other emerging and advanced economies, allowing BI to support the recovery through accommodative policies. Indonesia has the highest real yields in EM alongside a steady inflation profile. Real money and foreign investors flows are somewhat mixed (strong FX, weak FI), but it should continue to benefit from the surge in commodity prices, especially from coal exports. IDR and the outlook on external debt sustainability remain susceptible to sharp swings in sentiment.

Malaysia: *Oil price up implies positive bias*. *External strength mitigates its weakening debt sustainability*

The economy is showing signs of a gradual yet steady recovery thanks to the authorities' impressive vaccine rollout, as well as swift and coordinated implementation of multi-pronged support measures. Nevertheless, it remains uneven and the output gap sizable, with significant downside risks. Growth is projected to be solid in the medium term, although risks of long-term economic scarring are real. Growth in 2022 is projected at about 5¾ percent driven by pent-up domestic demand against the backdrop of high vaccination rates and limited movement restrictions, as well as continued strong external demand.

Sri Lanka: *On 12 April Sri Lanka suspended the normal debt servicing of external public debt. Prime Minister Ranil Wickremesinghe said the country is bankrupt. Restructuring talks are set to begin.*

The country will go into a deep recession this year with acute shortages of food, fuel, and medicine to continue, he told parliament. As a bankrupt nation, Sri Lanka must face a more difficult and complicated situation in the ongoing bailout talks with the International Monetary Fund (IMF) than in previous negotiations, said Wickremesinghe.

Sri Lanka still must pay almost USD 21bn until the end of 2025 despite a suspension of repayments on about USD 12bn of foreign debt in April. Central Bank of Sri Lanka, Wickremesinghe estimated that the country will suffer an economic contraction of 4% to 5% this year, with inflation to hit 60% by the year-end. Sri Lanka will set up a donor's conference with China, India, and Japan to seek more foreign aid amid its worsening economic crisis.

The tourism sector has just begun to recover from pandemic-led disruption. Tourist arrival in 1Q touched 50% of the pre-pandemic levels. Visitor arrivals have moderated to 15% of pre-pandemic levels in May.

Rising inflation, a higher oil import bill, tighter monetary policy, currency devaluation, and weaker growth have exacerbated Sri Lanka's economic challenges.

Agricultural growth remained below pre-pandemic levels. Cultivation of rice and vegetables (together constituting c20% of the agricultural output) remained contractionary (in %q-o-q sa terms) for the third quarter. Industrial activity is just 1% above the pre-pandemic levels. Within industry, manufacturing witnessed a steep fall which could be attributed to power outages hampering domestic production.

Since reserves were being used to repay debt obligations, there is very little money left to pay for the import of essentials like food, fuel, and medicines. The shortage of essentials resulted in wide-spread public protests.

Russia: Russia's *expiry of grace period brings sovereign default, but acceleration may wait*

The grace period for about USD 100m in Russian sovereign coupon payments due on 27 May 2022 expired on 26 June. This would normally prompt formal declarations of default from the rating agencies, but EU sanctions prevent them from covering Russian entities. Non-residents held almost USD20bn in Russian Eurobonds. Coupon payments are stuck in international depository Euroclear.

The Finance Ministry published a new Eurobond payment procedure that allows foreign noteholders to convert RUB payments into foreign currency and withdraw them from Russia.

Noteholders can declare an event of default and accelerate the debt if owners of 25% of the outstanding bonds agree one has occurred. That would in turn trigger clauses that allow the acceleration of the rest of Russia's foreign debt. However, investors may decide to wait and see if the sanctions are softened, as most Russian overseas assets are frozen by sanctions, and this cannot be attached to any claims. The claims on the bonds become void only three years following the payment date, according to the documentation of Russia's 2026 and 2036 bonds.

Ukraine: *Presidential advisor admits potential need for debt restructuring talks*

Ukraine will have to start debt restructuring talks if the war with Russia continues. The country can't function as it did before the invasion and the current situation qualifies as force majeure, presidential advisor Oleh Ustenko said on national television. The need to restructure Ukraine's debt as part of a wider financing program for rebuilding the country after the end of the armed conflict has been widely recognized by all parties, although the Ukrainian authorities have wished to postpone such a process. Ukraine's ratings were downgraded by S&P and Moody's in May on the increased risks to the debt sustainability from the invasion by Russia. One proposed solution, floated by some large bondholders, is to issue a new bond partially guaranteed by the World Bank or a similar institution. Ukraine is expected to start considering restructuring options closer to a USD 1bn Eurobond maturity in September.

Brazil: *Contractionary stance of monetary policy. Positive factors for activity in the short term*

The short-term growth picture in Brazil has improved on the back of external and domestic factors. Rapid decline in unemployment, and higher consumer and business confidence – suggest growth should remain resilient. The central bank (BCB) raised the Selic rate to 13.25%.

Brazil will hold presidential and congressional elections in October and opinion polls continue to show polarization between the two leading candidates, former President Lula and incumbent President Jair Bolsonaro. Economic policy could suffer a shift in post-election scenarios leading to looser fiscal policy and higher inflation-rates equilibrium. The composition of Congress should continue to favor a somewhat fiscally responsible stance.

Argentina: *Country risk at record levels reflects a high likelihood of a new default, fueling financial instability and weakening the macro environment.*

The IMF program approved in March did not imply relevant reforms or changes to macro policy. Supply bottlenecks of energy, fuel, or inputs due to FX scarcity impact economic activity. Demand for imported goods is growing above what GDP growth would suggest and goods exports are lagging. Payments for services abroad have soared (this includes both tourism, and intracompany services) while the government has acknowledged that non-registered services exports have surged.

High inflation should help fiscal dynamics, driving up revenues, but authorities are under significant pressure, even from within the ruling coalition, to spend away any revenue windfalls. This pressure could turn into a destabilizing factor as funding for a higher deficit may either have to come from additional monetary printing or domestic debt issuance, as external markets remain inaccessible. The former would fuel FX pressures. The latter is becoming increasingly challenging, requiring higher real rates.

Bond markets are pricing credit events under the next administration. Domestic debt issuance is expected to accommodate significant funding needs. The market has demanded inflation or FX linked debt. Yields for maturities beyond the election are significantly higher and thus short-term roll-over needs will be challenging. Foreign currency bonds were restructured in 2020 and maturities are not significant until 2025.

Colombia: *Wait-and-see*

Gustavo Petro was elected president in the June 19 second round election, bringing the left to power for the first time in modern Colombian history. The president-elect's agenda aspires to profound change via a state-led model, but he has also professed gradualism and responsibility; it remains to be seen whether the president-elect will curb his enthusiasm.

Petro wants to lower the dependence on oil exports and phase out coal exports amid a transition to clean energies. He said he will ban fracking and open-pit mining and would not allow new oil exploration. Mr. Petro has also proposed an overhaul of the social security system, nationalizing private funds and transitioning to a full pay-as-you-go system. He has suggested the central bank needs new board members oriented to favor growth and better coordinate policies with the Executive. He believes recent interest rates hikes were not necessary as the economy is not overheated and that inflation is being caused by an increase in imported food costs. He thus has proposed subsidizing domestic food production and introducing tariffs on food imports.

Looking at unemployment levels, which are much higher than prior to the pandemic, it could be argued that the economy is far from closing the output gap. External accounts, however, tell a different story, with soaring imports widening the current account deficit.

We thank you for your continued support.

The RVX Team

RVX Asset Management LLC

20900 NW 30th Avenue, Suite 401

Aventura, FL 33180

www.RVX-AM.com | Phone: +1-305-363-6847

Fax: +1-305-675-0394

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