Issued: 23 March 2020

WEEKLY INVESTOR RESEARCH

Ashmore

Assessing the EM policy reaction-function in the context of a COVID-19 induced recession

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Collapsing liquidity and the policy response in Developed Markets

The liquidity collapse resulting from the cumulative effects of the expected recession, the decline in oil prices and extreme market volatility was the main problem facing global markets last week. Liquidity dried up everywhere. Companies tapped any available credit lines in the banking system, thereby forcing the banks to sell liquid securities and reducing trading limits just as asset management companies attempted to sell assets to cover redemptions. At the same time, currency traders sold G7 currencies to raise US dollar liquidity on concerns that London – the world's largest FX market – would shut down in case regulators forbade trading from home as requirements for social distancing in order to combat the spread of the COVID-19 coronavirus were ramped up. The surge in the demand for US dollars to cover collateral positions precipitated a crash in G7 currencies versus the Dollar.

Technical indicators that suggest most markets are already at oversold territory are corroborated by surveys, which show that long-term investors pay a high price for increasing cash positions. Hoarding cash in the current market conditions is the real money equivalent of individuals paying a premium to hoard toilet paper; both are unsuitable safe-guards against the problem and both have significant costs to society, while adding little if anything in terms of insurance. At best, it is a placebo effect.

The drought in liquidity, if not addressed, would increase the volume of non-performing loans across a broad range of industries as the real economy enters the most significant recession since 2008/09. Over the last two weeks, central banks have done what they can with the limited tools they have left at their disposal. The United States (US) Federal Reserve Bank (Fed) and the Bank of England (BOE) cut policy rates to close to zero and announced at least USD 700bn (3.3% of GDP) and GBP 200bn (9% of GDP) of new asset purchases (also known as Quantitative Easing, or 'QE'). The ECB also expanded its QE programme by EUR 750bn (4.5% GDP). Japan announced more purchases of real estate investment trusts, equity Exchange Trade Funds (ETFs), commercial paper and corporate bonds. Central banks also reduced reserve requirement ratios (RRR) and loosened up capital rules, thereby freeing up yet more capital in the banking system in a further bid to shore up liquidity for corporates. Several monetary authorities also offered temporary regulatory forbearance for companies affected by Coronavirus.

Complementing central banks, fiscal authorities were quick to announce new countercyclical stimulus policies. The United Kingdom (UK) announced several programmes to support independent businesses, including postponement of taxes and covering up to 80% of salaries of employees making up to GBP 2,500 per month – the median income in the UK – for a period extending up to 3 months. The government did not provide an estimate of the total cost of these measures. In our view, the UK fiscal deficit may well go above 10% of GDP. In the US, Treasury Secretary Steve Mnuchin put forward the idea of paying USD 1,000 to all adults and USD 500 per child for two months. The US Treasury estimates the measure would cost USD 500bn or approximately 2.3% of GDP for this single measure. When combined with others, the US fiscal deficit is also likely to be in excess of 10% of GDP.

Monetary and fiscal policies can clearly ameliorate some of the economic damage from the Triple Shock of falling oil prices, the stock market collapse and the Coronavirus outbreak, but coordination will be very important, given already low rates and heavy debt burdens.

Sizeable fiscal stimulus in the context of the policy rate at zero and the term-structure of interest rates not far from zero begs the question why investors would buy government bonds without much upside potential from yields coming down? The wisdom of owning DM government bonds here can also be called into question considering the mammoth supply in the pipeline given enormous fiscal stimuli just announced. A buyers' strike for US Treasury bonds and the unwinding of 'risk parity' portfolios with leveraged positions in rates designed to hedge equity exposure go a long way towards explaining the wide swings in the market for US government bonds last week.

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Collapsing liquidity and the policy response in Developed Markets

We believe that, in the end, central banks will have no choice, but to follow what the Bank of Japan (BOJ) has been doing since 2016. They are going to have to exercise 'yield curve control' (YCC) with explicit targets not only for overnight rates but also extending out to 3-year, 5-year, or 10-year US Treasuries. If yields rise above target, the central bank will then have to step up purchases, while below the target the Fed would sell bonds. YCC is unavoidable, in our view, due to the substantial need for new financing by governments in the context of yields that make the bonds unattractive for the private sector. The alternative to YCC would be to purchase bonds in the market without any specific target, but that would introduce too much risk compared to credible interventions, which would enable private sector investors to profit from trading known ranges.

Of course, to all intents and purposes, this eliminates markets as determinants of interest rates except within very narrow tolerances. Market forces can simply not be allowed to operate freely once fundamentals get so bad that doing so would reveal Developed Markets (DM) are no longer 'risk free'. However, this is not the market's chief concern right now. Instead, the question in focus right now is how the Coronavirus recession evolves: will be it shallow or endure? Governments will be able to reverse quickly the massive volume of new stimulus if the recession is shallow. Otherwise the fiscal outlook becomes extremely bleak, for example, if recession extends beyond a few months, say, due to extended periods of social distancing, or if a significant number of small business go bankrupt, thereby bringing about mass permanent unemployment. The latter would likely require continuous monetisation of the government's debt, which in turn could lead to a significant erosion in the value of currencies in highly indebted countries, such as the US, Japan and part of the European Union.

Given these conditions, the main scenarios facing DMs over the next few months fall into two main categories depending on the length of the coming recessions and two sub-categories depending on the chosen direction of fiscal policy. Specifically:

1. Brief recessions:

a. Governments reduce fiscal stimulus in relatively short order. This still pushes debt to GDP ratios in most developed world economies beyond 100%, thereby forcing governments to raise taxes as soon as growth returns. The high levels of debt ensure low productivity growth and sluggish trend growth rates. DMs can, at best, hope for a U-shaped recovery amidst generally weak growth.

b. Governments continue to stimulate fiscal policy heavily. This creates a turbo-charged recovery (V-shaped), but would come together with high inflation. Debt to GDP would remain very high, despite higher nominal GDP growth and DMs would gradually sink into an inflationary trap as central banks would be constrained in terms of their ability to increase interest rates due to the adverse effect on governments' debt servicing costs.

2. Prolonged recessions due to longer-lasting social distancing, rising bankruptcies, and mass unemployment:

a. Significant increases in fiscal stimuli would become permanent, thereby forcing central banks to monetise government debt. This would generate low growth with high inflation and considerable currency weakness.

b. Fiscal austerity – and an alternative to stimulus – would trigger asset price collapses and push the economy into deep deflation and recession, not unlike what happened in the Great Depression. The eventual recovery, following a deep depression, would likely be L-shaped due to entrenched deflation.

None of the scenarios facing DMs is attractive. There are no easy options anymore. Markets will likely have to price the odds of these different outcomes in a dynamic fashion, which will also be influenced in large part by the evolution of the Coronavirus outbreak and the associated policy responses and their impact on the economy.

The imagination of most policy-makers does not extend far beyond DMs themselves. However, given the paucity of the scenarios outlined above it seems desirable that policy-makers extend their horizons to include greater policy coordination across G-20 countries, but also including other Emerging Markets (EM).

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The impact on Emerging Markets

We believe EM asset prices could do well, from current levels, in three out of the four scenarios outlined above. The main exception would be scenario 2(b). Of course, not all EM countries are in the same position. However, the reaction functions of EM countries can be grouped into two broad categories.

The first category ('Group 1') comprises the majority of large EM economies, which fund most of their liabilities in local currency, such as China, South Korea, Thailand, Indonesia, Malaysia, Poland, South Africa, Brazil, Mexico, Chile, Peru and others. The other category ('Group 2') contains countries, which mainly borrow in Dollars, either because their macroeconomic policies are so bad that they cannot find demand for local bonds, or simply because they have still not developed local bonds markets, or indeed a combination of both. This group includes countries, such as Argentina, Turkey, Angola, Zambia and others. A third group contains countries that operate US Dollar pegs or dollarised economies like Saudi Arabia, Qatar, UAE, Hong Kong, and Ecuador, Costa Rica, Panama, etc.. However, within this category the countries with enough FX reserves to defend their pegs have most in common with the first group, while countries with too few reserves (or too much foreign currency debt) to defend their currency pegs or dollarisation, can be thought of as being more akin the countries in the second group.

How do the countries in these two broad groups react to the Coronavirus shock?

Group 1:
Countries with mainly local currency liabilities

For countries with most of their debt denominated in the local currency, the demand shock arising from social distancing alongside the collapse in commodity prices should result in a significant disinflationary shock. During 2008/2009, most EM central banks increased interest rates to lean against currency depreciation. Their main fear was that weaker currencies would cause outflows and thus weaken growth. When the Fed cut its policy rate from 5.25% to 0.25% in 2008, the Brazilian Central Bank (BCB) hiked the Selic policy rate from 11.25% to 13.75%. The South Africa Reserve Bank (SARB) increased rates from 6% to 11% between 2006 and 2007 and then hiked further to 12% in 2008.

However, in the two previous global crises, EM currencies starting point was very expensive. In 2001 most EM countries were exiting pegged currency regimes that kept currencies prohibitively strong. At the same time, in 2008/2009, EM currencies were very strong at the start of the crisis after having rallied about 30% versus the Dollar from 2003 onwards. By 2008/2009, many EM countries had also grown sizeable current account deficits. By contrast, today EM currencies are trading close to their cheapest levels in two decades, both in nominal and real terms and large deficits are largely absent from EM today.

These circumstances now allow EM central banks in countries where the principle source of funding is local currency to act in a countercyclical manner; that is, cutting policy rates into weaker growth. Thus, BCB cut the policy rate by 50bps last week to 3.75% while SARB slashed rates by 100bps to 5.25%. On average, EM central banks have already cut policy rates by more than 1.0% since the beginning of February (for the 25 largest EM countries). In 2008, those same 25 central banks hiked policy interest rates by 0.85% on average.

Many investors still fear that rate cuts in EM could exacerbate currency depreciation at the same time as selling by foreign investors and EM hedge funds pushes up bond yields in local markets. However, these fears are likely to be unfounded. Cutting policy rates is the correct policy choice. Rate cuts anchor the front end of the curve at lower rates, so that companies and banks facing liquidity pressures pay less to raise cash. It also reduces the cost of funding for governments that issue floating-rate notes. Lastly, the argument that currencies can be anchored by holding rates high is unlikely to hold sway in the current environment. Short-term carry-traders will, if global risk aversion is severe enough, sell EM FX regardless of whether yields are 50bps, 100bps, or even 300bps higher. This is because what matters to carry trades is not the annualised return on the asset side, but the volatility of the currency against the funding currency (USD, EUR or JPY). Hence, EM currencies would remain under pressure as long as volatility remains elevated. This situation can clearly create a conundrum for investors, given that EM local assets trade at the most attractive levels in two decades, but display high volatility. The conundrum goes away when the panic begins to subside. EM currencies have reacted in a mixed manner to the recent wave of cuts. BRL rebounded almost 4% from its lows after the BCB 50bps cut, whereas ZAR closed the week at the lows. The difference can be partially attributable to the more favourable fundamental backdrop in Brazil than in South Africa. Furthermore, the ZAR has become one of the favourite proxies to 'trade EMFX' due to low intervention by the SARB and full convertibility. In both countries, however, we believe that it was the right decision to cut policy rates.

Indeed, we believe that the risk of currency depreciation would, in both countries, be far greater if policymakers failed to provide liquidity in the current environment, as tight financial conditions would directly impact GDP growth.

Continued overleaf

The impact on Emerging Markets

Even in countries, where funding is predominantly local currency, coordination with DM central banks is important. The Fed's provision of swap lines allows EM central banks to tap Dollar liquidity directly from the Fed at a time when international banks are pulling cash out of EM countries. This combination of local currency liquidity provision by local central banks and Dollar funding from the Fed helps countries to avoid the kind of deflationary and recessionary spirals, which could seriously put a dent into global growth over and above the growth shocks currently wracking DMs. To the extent that EM still holds much more monetary policy firepower than DM, we believe that financial conditions can and should be eased in EM not just for the sake of EM growth, but also for the sake of the submerging DMs.

Group 2:
Countries with mainly US dollar denominated liabilities

These countries are fundamentally more vulnerable by virtue of not being self-financing. They have fewer policy tools to fight recessions. Monetary policy easing may not be an option to the extent that currency depreciation would drive up the ratio of debt to GDP. Their central banks may therefore have to keep financial conditions tight to avoid excessive currency depreciation, thereby exacerbating the negative effect of external economic shocks, such as lower commodity prices or Coronavirus. Most at risk are countries with large debt burdens, especially if they also have significant short-term funding needs and depend on exports to balance their external and fiscal accounts, particularly commodity exports.

In the current circumstance, a lender (of Dollars) of last resort, The International Monetary Fund (IMF) and other multilateral institutions, such as the World Bank are typically the first ports of call. In the current crisis, the IMF should play a similar role as ECB currently plays vis-à-vis peripheral European economies. ECB can help to ensure that Italian, Spanish and Greek debt is sustainable by intervening to bring down severely dislocated interest rates during market panics. Similarly, the IMF and the World Bank should lend Dollars to EM countries in the grip of speculative attacks or where spreads have blown out due to panic selling, at least until global growth and market conditions normalise.

It is likely that the IMF will require more than the USD 50bn, which has already been pledged to supporting EM countries. The IMF will have a particularly important role to play in some oil-exporting countries and some countries with sub-investment grade credit ratings, which are currently feeling the brunt of the price action. Three countries which have been doing an excellent job at adjusting their fiscal policies over the last three years, but now find themselves in tough situations due to global market conditions are Ukraine, Ecuador and Angola. All three countries will need more resources to combat Coronavirus at a time when their economies are slowing and markets are not willing to finance new debt issuance.

The IMF should alleviate financing stresses during the most extreme market turmoil. For example, IMF should consider accelerating the disbursement of the already approved Extended Fund Facility (EFF) worth USD 5.5bn for Ukraine and immediately consider Ukraine's request for more money.

Meanwhile, the IMF should at the same time insist that fiscal policies are sustainable. This is not just a question of what debt trajectories look like at the point of maximum stress. In fact, at the moment the obligations of many high yield EM countries look unsustainable, because of the juxtaposition of economic slowdowns and the sharply higher cost of funding. However, herein lies an opportunity. The IMF can and should provide capital for countries to buy back Eurobonds, thereby engineering debt restructurings at market terms. This is far more preferable than distressed restructuring exercises, where the issuer attempts to impose unilateral haircuts on all bond holders. This turns a short-term liquidity problem into a solvency problem with the result that there is permanent impairment in relations between issuer and the market, which can hold back development for years, even decades.

The alternative of conducting debt buybacks with multilateral funding would allow countries to consolidate their debts and at the same time boost market confidence. For example, with Ecuadorian bonds trading at 40 cents a USD 1bn buyback would allow the country to repurchase most of the outstanding Eurobond maturing in 2022, thereby significantly reducing the risk of near-term default. Indeed, an extended programme to repurchase debt across all maturities would lead to significant savings on interest and dramatically reduce the country's total debt outstanding.

The challenge for the IMF in front-loading programmes via debt buybacks is that the country does not implement structural reforms and thus moves towards an unsustainable position within a few years. To ease such concerns, client countries could pass legislation to limit future discretionary expenditure to a fixed percentage of GDP, along the lines of the debt ceiling bill approved in Brazil during the interim government of Michel Temer. The debt ceiling did not impose a harsh fiscal consolidation when the country was in recession, but it forced a future government to reduce mandatory expenditure, such as the unsustainable pay-as-you-go pension system in order to free up discretionary expenditure.

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The impact on Emerging Markets

China stands out from other EM countries in many ways, not least in terms of the impact of the Coronavirus in China as well as China's policy reaction function. The number of new cases has dropped significantly in the country with all new cases imported, over the last two days. China was the first country to be hit by the virus and is the first country, where economic activity is normalising. The gradual return to normal in China is the result of an effective lockdown policy, particularly in the most affected province, Hubei. The risk of a rebound in cases still exists, but this risk remains low as long as the rest of the world enters into lockdown. In any case, we believe China will be better positioned than most to deal with a possible resurgence, given its experience from Hubei.

China has also responded differently on the economic front. The People's Republic Bank of China (PBoC) cut the 1-year loan prime benchmark rate only modestly to 4.05% and did not announce any significant QE programme. Instead, it provided massive liquidity injections and targeted lending directly to the sectors most impacted by the crisis, via the banking sector. The government also announced plenty of fiscal measures, including reducing taxation for the affected areas, providing funding for local governments to deal with the challenge, building hospitals, etc. There was, however, no 'Helicopter Money', unlike in the US and UK.

There is now plenty of anecdotal evidence that the Chinese economy is normalising, with key industries operating at 75%-85% of normal levels as of mid-March. The mobile company Xiaomi announced that 80% of its supply chain is now operational as the company reopened 1,800 stores in China ahead of the launch of its flagship 5G smartphone. Chinese equities have been outperforming the rest of the world, with much lower volatility too, positioning it amongst the best asset classes in the world in the current environment. The Chinese economy's gradual normalisation should provide a boost to activity in many other EM economies as new evidence strongly points to a rapid rise in intra-EM trade.[1]

Benchmark performance

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.2	–	-9.80%
MSCI EM Small Cap	7.3	–	-13.99%
MSCI Frontier	6.7	–	-8.09%
MSCI Asia	10.0	–	-8.71%
Shanghai Composite	8.7	–	-4.91%
Hong Kong Hang Seng	6.4	–	-5.51%
MSCI EMEA	7.1	–	-8.50%
MSCI Latam	8.1	–	-20.75%
GBI-EM-GD	5.90%	–	-7.41%
ELMI+	3.79%	–	-3.72%
EM FX spot	–	–	-5.30%
EMBI GD	7.66%	668 bps	-9.18%
EMBI GD IG	4.80%	378 bps	-8.02%
EMBI GD HY	11.95%	1,101 bps	-10.69%
CEMBI BD	6.92%	606 bps	-7.84%
CEMBI BD IG	4.58%	372 bps	-5.54%
CEMBI BD Non-IG	10.82%	997 bps	-11.20%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	12.3	–	-14.95%
1-3yr UST	0.28%	–	0.34%
3-5yr UST	0.42%	–	0.72%
7-10yr UST	0.81%	–	0.20%
10yr+ UST	1.41%	–	-0.43%
10yr+ Germany	-0.34%	–	-4.12%
10yr+ Japan	0.00%	–	-1.51%
US HY	10.93%	1,013 bps	-10.17%
European HY	9.46%	999 bps	-9.82%
Barclays Ag	1.52%	71 bps	-3.77%
VIX Index*	74.74	–	-7.95%
DXY Index*	102.15	–	4.08%
EURUSD	1.0726	–	-4.09%
USDJPY	110.28	–	4.17%
CRY Index*	123.88	–	-16.95%
Brent	26.1	–	-13.28%
Gold spot	1487	–	-1.80%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

[1] See: *'EM trade patterns after two years of Trump'*, The Emerging View, 3 March 2020.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-20.00%	-27.74%	-27.74%	-22.58%	-3.53%	-0.97%
MSCI EM Small Cap	-27.47%	-35.27%	-35.27%	-33.63%	-11.14%	-5.81%
MSCI Frontier	-23.75%	-28.27%	-28.27%	-21.90%	-5.18%	-3.46%
MSCI Asia	-16.70%	-22.68%	-22.68%	-17.86%	-0.69%	0.78%
Shanghai Composite	-4.68%	-9.98%	-9.98%	-8.99%	-3.28%	-3.36%
Hong Kong Hang Seng	-11.49%	-18.35%	-18.35%	-18.58%	-1.07%	-1.94%
MSCI EMEA	-25.30%	-37.41%	-37.41%	-31.93%	-10.56%	-5.93%
MSCI Latam	-37.98%	-48.50%	-48.50%	-46.15%	-14.57%	-6.73%
GBI EM GD	-13.50%	-17.52%	-17.52%	-10.67%	-1.74%	-0.24%
ELMI+	-6.00%	-9.27%	-9.27%	-7.02%	-0.64%	0.30%
EM FX Spot	-9.01%	-14.47%	-14.47%	-15.28%	-7.13%	-5.95%
EMBI GD	-17.66%	-17.22%	-17.22%	-10.42%	-0.93%	2.04%
EMBI GD IG	-13.05%	-10.57%	-10.57%	-0.29%	2.60%	2.93%
EMBI GD HY	-23.16%	-24.81%	-24.81%	-21.02%	-4.97%	1.01%
CEMBI BD	-12.95%	-11.62%	-11.62%	-4.55%	1.20%	2.96%
CEMBI BD IG	-8.77%	-6.52%	-6.52%	1.41%	2.98%	3.19%
CEMBI BD Non-IG	-18.76%	-18.56%	-18.56%	-12.58%	-1.30%	2.79%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-21.87%	-28.33%	-28.33%	-16.75%	1.00%	3.90%
1-3yr UST	0.91%	2.38%	2.38%	5.31%	2.59%	1.79%
3-5yr UST	1.32%	4.50%	4.50%	8.80%	3.99%	2.76%
7-10yr UST	0.96%	7.50%	7.50%	14.51%	6.31%	3.87%
10yr+ UST	1.27%	15.46%	15.46%	30.26%	12.04%	6.28%
10yr+ Germany	-2.71%	5.46%	5.46%	12.06%	7.09%	3.35%
10yr+ Japan	-3.41%	-1.35%	-1.35%	1.07%	2.34%	3.28%
US HY	-16.96%	-18.11%	-18.11%	-12.36%	-1.14%	1.55%
European HY	-18.23%	-19.91%	-19.91%	-15.60%	-3.68%	-0.46%
Barclays Ag	-5.17%	-3.31%	-3.31%	1.57%	2.70%	1.98%
VIX Index*	86.34%	442.38%	442.38%	353.52%	469.66%	457.35%
DXY Index*	4.09%	5.97%	5.97%	5.69%	2.39%	5.27%
CRY Index*	-22.30%	-33.32%	-33.32%	-32.73%	-32.54%	-42.58%
EURUSD	-2.73%	-4.35%	-4.35%	-5.19%	-0.53%	-2.01%
USDJPY	2.33%	1.54%	1.54%	0.28%	-0.59%	-7.89%
Brent	-48.42%	-60.52%	-60.52%	-61.12%	-48.46%	-53.40%
Gold spot	-6.24%	-2.01%	-2.01%	12.48%	19.40%	25.00%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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