# UBS House View

Monthly Letter | 12 October 2023 | Chief Investment Office GWM, Investment Research

### Bond yields rising

The rise in long-term Treasury yields in recent months has prompted some observers to ask whether the bond vigilantes are back.

### Growth a key driver

We think the outlook for Treasury yields will depend more on the US economic growth trajectory than on fears around the federal deficit.

### Slower momentum?

Looking ahead, we expect yields to fall as US growth slows and attention shifts to the prospect of Fed policy easing in 2024.

### Asset allocation

Bonds remain our preferred asset class. We are neutral on global equities overall, but continue to favor emerging market stocks.


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## Return of the bond vigilantes?

James Carville, a political adviser to former US President Bill Clinton, once said that if reincarnation were real, he would like to come back as the bond market because "you can intimidate everybody."

Carville was speaking in the context of what was then a remarkable increase in the 10-year US Treasury yield, from around 5% to just over 8% between October 1993 and November 1994, driven in part by concerns over surging federal spending. The episode came to be known as the Great Bond Massacre.

Between early May and early October of this year, the 10-year yield rose from 3.3% to 4.8%, with around half of that increase taking place since the start of September. Yields have moderated in recent days. But the question remains: Are the bond vigilantes back?

While we acknowledge that we are in a period of heightened concern about the US fiscal situation, we think the outlook for Treasury yields will depend more on the growth trajectory of the US economy than on fears around the federal deficit.

Looking ahead, we expect yields to fall as US growth slows and the Federal Reserve finishes tightening and starts to ease policy later next year. We see bonds as an effective hedge to investor portfolios: In our downside scenario in which the US economy enters a recession, we expect 19% total returns for 10-year Treasuries by June next year. Quality bonds also present an attractive opportunity to earn good returns with limited risk if held to maturity. In our base case of a softish economic landing, we see 10-year yields falling to 3.5% and 10-year Treasuries returning 13%.

We also see upside potential in the equity market. Although we have a least preferred view on the US relative to other markets where we see better value, in our base case we expect the S&P 500 to reach 4,500 by June next year. Our sector preferences include global energy stocks, which we believe are attractively valued and can act as a geopolitical hedge.

Overall, we maintain our view that this remains a good environment for investors to start to put money to work in balanced portfolios, with attractive prospective returns across asset classes and diversification benefits from holding a combination of equities, bonds, and alternatives.

## What's next for yields?

Bond vigilantes are attracting headlines once again.

The term "bond vigilantes" was coined in the 1980s to describe bond investors who would sell holdings in the government bonds of countries with fiscal policies deemed to be overly profligate. Amid upward surprises in the US Treasury's borrowing forecasts, a downgrade to the US sovereign AAA credit rating by Fitch, and the risk of a near-term government shutdown (see boxout), it's unsurprising that the bond vigilantes are attracting headlines once again.

Yet not even this formidable group of market influencers thinks that a country with its own currency and central bank is likely to default. Five-year credit default swaps—a measure of appetite for insurance—suggest a 0.04% probability of a US government default.

So what's going on, and what's next for yields?

We think about Treasury yields as a function of overall expectations about growth and the Fed's reaction function, market expectations about inflation, and supply and demand dynamics.

## What are the risks from a potential US government shutdown?

Congress narrowly averted a US government shutdown at the beginning of October. But the enactment of a continuing resolution to fund federal spending will last only until 17 November, and we believe the subsequent ousting of Kevin McCarthy as House speaker increases the probability of further delays in reaching a bipartisan budget compromise, making a mid-autumn shutdown more likely.

The economic impact of a shutdown tends to be marginal at first, and markets have historically taken such episodes in stride. However, after around the third week, when federal workers' paychecks fail to arrive, the effects could grow larger. For example, in the last shutdown from December 2018 to January 2019, some US airports were forced to temporarily close due to absences among air traffic control staff.

In the current environment of rising yields and mixed messages from the economic data, much of the investor reaction to the shutdown could depend on the market's stability heading into it. If sentiment is already negative as the shutdown hits, it could have a bigger market impact than in the past, though we would still expect markets to recover once an agreement is eventually reached.

## We expect demand to meet rising supply

*Supply has been high and is likely to stay high*

The supply of Treasury securities has been higher than expected.

Higher-than-expected supply of US Treasury securities to fund the country's fiscal deficit does appear to have contributed to higher bond yields in recent weeks. Ten-year yields were still less than 4% before the Treasury Department announced on 31 July that it would borrow USD 274 billion more than expected during the third quarter.

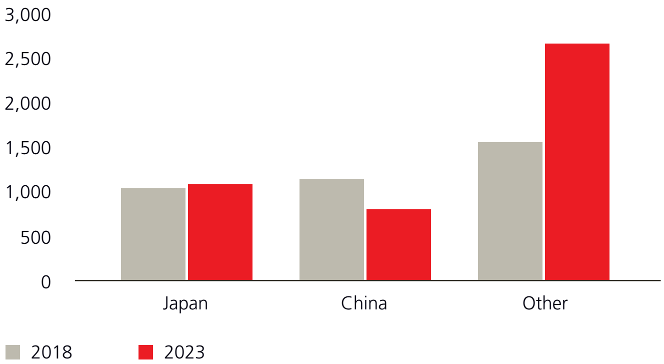
Although we do not expect further outsize adjustments in borrowing estimates, we think it's fair to say that US government bond supply will remain elevated going forward. The Congressional Budget Office projects that the federal deficit will rise from around USD 1.3 trillion last year to USD 1.4 trillion this year, USD 1.7 trillion next year, and USD 1.8 trillion in 2025.

But although higher Treasury supply could put some near-term upward pressure on yields, we ultimately think the demand for Treasuries is likely to remain sufficiently strong to meet the additional supply.

Figure 1

### Foreign demand has increased

Foreign holders of US Treasuries, holdings amount in USD bn, 2018 vs. 2023




Source: Bloomberg, UBS, as of October 2023

*Foreign demand is likely to remain robust*

Foreign investors are likely to remain an important source of Treasury demand.

In total, around one-third of outstanding US Treasuries are held by foreigners, and as a result we often get questions like, "What happens if Japan and China start dumping Treasuries?"

We have a pragmatic view of this scenario. On one hand, demand shifts from China and Japan are more usually influenced by changes in their trade balances than active decisions by reserve managers. On the other, their significance in the Treasury market has declined markedly in recent years. Japan and China now each hold less than 4% of US government debt, down from highs of 7% and 9%, respectively, in 2011–12.

Meanwhile, other countries including the UK, Belgium, Luxembourg, Switzerland, and Ireland have become more active buyers (Figure 1). The data could reflect changes in where overseas buyers hold their Treasuries—for example, China holding Treasuries with overseas banks. But the overall point is that foreign demand has increased and is likely to prove robust given US Treasuries' established role as a marketable collateral within the global financial system. We believe this role is unlikely to change anytime soon.

*The Fed will remain a flexible buyer*

The Fed's shift from quantitative easing to quantitative tightening has contributed to lower demand for Treasuries.

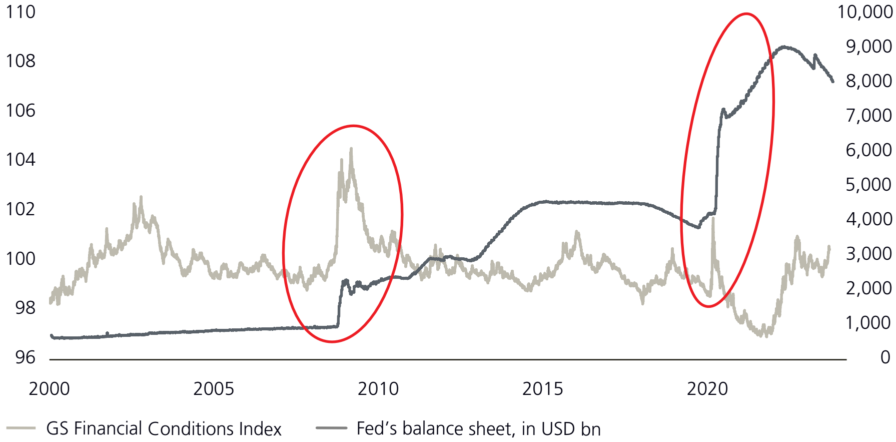
A quarter of US Treasuries are held by the Fed, and the shift in the central bank's use of asset purchases as a monetary policy tool has clearly contributed to lower demand for Treasuries. Under quantitative easing, at the height of the COVID-19 pandemic, the Fed was buying USD 80 billion of Treasuries and USD 40 billion of mortgage-backed securities each month. Today, under quantitative tightening, it is allowing up to USD 60 billion of Treasuries and USD 35 billion of mortgage-backed debt to mature without replacement each month, as it moves to shrink its balance sheet.

However, as we have seen in recent years, the Fed can quickly change its stance, and we would expect it to step in should the Treasury market's functioning become impaired. And if higher Treasury yields were to lead to overly tight monetary policy and an economic contraction, we think the Fed would restart quantitative easing.

Figure 2

In the past, the Fed provided liquidity when financial conditions tightened sharply

Goldman Sachs Financial Conditions Index (lhs) and Fed's balance sheet in USD bn (rhs)




Source: Bloomberg, UBS, as of October 2023

*Treasuries are attractive from a portfolio perspective*

Institutional demand for Treasuries should remain robust.

A third of US Treasuries are held by financial institutions including mutual funds, pension funds, banks, insurance companies, and other private holders, and here we expect demand to also remain robust.

Within the US, regulatory changes should mean continued bank buying of Treasuries. An increase in risk-weighted capital requirements and greater liquidity capital needs for large banks should result in increased purchases in the coming years. Nearer term, we think that downward adjustments by banks to their Treasury holdings in the wake of Silicon Valley Bank's collapse are largely complete.

A significant proportion of institutional demand is insensitive to price, driven by such regulatory requirements or collateral needs. But even among investors such as mutual funds and private buyers, we think demand will stay strong. In a portfolio context, US Treasuries remain nearly unmatched as a safe-haven asset, as seen from their recent rally following the Hamas attack on Israel (see boxout).

And despite lingering questions about whether we are entering an environment of permanently higher real interest rates or permanently higher economic uncertainty, we do not see evidence that the long-term "neutral" level of interest rates (also known as "r star" or r*) has changed, nor that the economic future is fundamentally more volatile.

## The Israel-Hamas war and the hedging value of quality bonds

Demand for quality bonds is likely to be supported by elevated levels of geopolitical uncertainty following Hamas's attack on Israel. We think concerns about, or an actual regional escalation of, the conflict would lead to lower yields as investors seek shelter in safe-haven assets.

Broadly, we see the following potential scenarios:

- **Contained confrontation.** At the time of writing, Israeli troops are gathering on the border with Gaza, suggesting the exchange of hostilities could be protracted. In this scenario, the conflict continues for an extended period but remains largely confined between Hamas and Israel in their respective areas of control. The impact on global financial markets fades, but with the potential for a longer-lasting impact on local markets and assets.

- **Regional escalation.** In a downside scenario, the conflict could expand to draw in other regional actors, with a heightened risk of Iranian involvement. In this scenario, we would expect a larger impact on financial markets, with oil prices spiking given the risks to Iranian oil supply and heightened risks to energy flows out of the region. Safe-haven assets including US Treasuries and gold would rally as investors attempt to hedge against further escalation or a global economic slowdown driven in part by higher oil prices.

- **De-escalation.** The best outcome from a humanitarian perspective would be a swift cessation of hostilities. In this scenario, we would expect geopolitical risk premiums to fade quickly as investors refocus their attention on previous market drivers, namely developments in the US and Chinese economies.

### Inflation has not contributed to higher yields

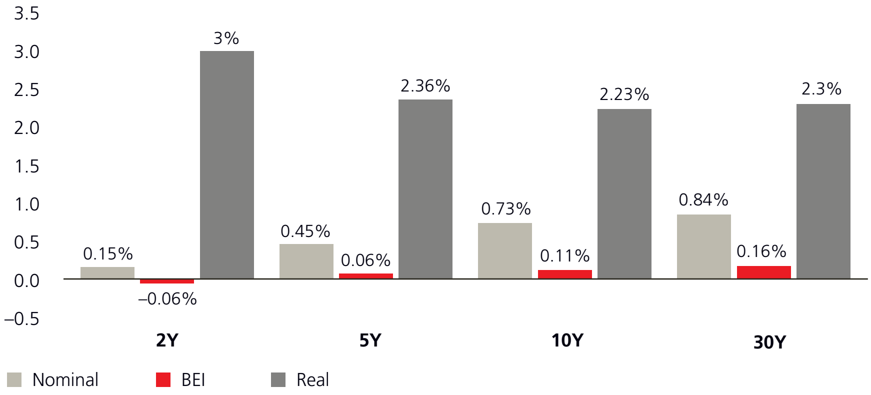
Inflation has not been a significant factor in the recent rise in yields.

While persistent and surprisingly high inflation was clearly an initial cause for higher central bank rates and bond yields, we do not think that inflation has been a factor in the recent rise in yields.

Figure 3

Yield changes in 3Q can be attributed primarily to real rates, not breakeven inflation rates

Changes in the nominal, real, and breakeven inflation rates in 3Q, in %




Source: Bloomberg, UBS, as of October 2023

Ten-year US breakeven inflation rates have remained stable in recent weeks and are currently trading at 2.31%. Recent data has also supported the notion that inflation continues to make progress toward the Fed's 2% target.

The Fed's preferred inflation measure—the core personal consumption expenditures (PCE) deflator—was up 3.9% year-over-year in August, the lowest since May 2021. Month-over-month, it rose by just 0.1%. Following monthly increases of 0.2% in June and July, this brings the three-month run rate close to the Fed's 2% inflation target.

Looking ahead, we anticipate inflation expectations to remain well contained and the economic data to validate the message that inflation is under control.

### Slower growth and lower rate expectations should lead to lower yields

Economic resilience has been a key driver of the rise in yields.

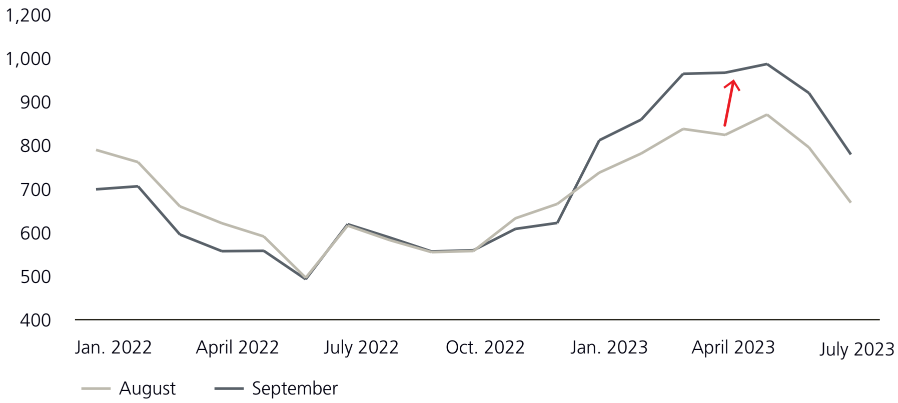
With structural demand likely to keep pace with supply, and inflation not being a major contributor to the recent moves in yields, by process of elimination we are left with economic growth and the Fed's reaction function as the primary yield driver.

The resilience of the US economy has led investors to assume that interest rates will remain higher for longer. Recent official revisions to the national accounts suggest that US consumers are using up their excess savings built up during the

Figure 4

The US consumer has more excess savings left than previously thought

Bureau of Economic Analysis estimates of households' savings, in USD bn, August vs. September release




Source: BEA, Bloomberg, UBS, as of October 2023

pandemic far less rapidly than previously reported—by around USD 50 billion a month rather than USD 100 billion. And labor demand remains strong: Nonfarm payrolls grew by 336,000 in September, more than twice the expected number, with the unemployment rate still at just 3.8%.

As a result, markets are now anticipating the first rate cut from the Fed only in May or June next year, and a total of three 25-basis-point cuts by December 2024.

However, we do expect the US economy to slow in 2024, leading to lower Fed policy rate expectations, even if the sturdiness it has shown so far reduces the risk of a recession in the next 12 months.

Consumer spending and business investment are likely to slow.

While US consumers may have spare capacity to spend, they are likely to tighten their purse strings as interest rates rise and the labor market cools. They also face additional headwinds from the end of childcare subsidies, the trimming of Medicaid rolls, new work requirements for food assistance programs, and the resumption of student loan payments. Business investment is also unlikely to be sustained at the current pace given higher borrowing costs.

With this in mind, we think it is unlikely that bond markets will continue to price the Fed keeping rates above 4% throughout 2025. We expect that data demonstrating slower growth will lead to lower interest rate expectations and bond yields.

## Messages in Focus

| | |
|---|---|
| **Get in balance** | Equity and bond markets have weakened in recent weeks, but with economic growth still resilient and bond yields high, in our base case we expect cash, bonds, stocks, and alternatives all to deliver good returns over the next 6–12 months and over the longer term. We believe that investors who review their portfolios and ensure an effective balance across asset classes will be well positioned to manage potential risks and earn durable long-term returns. |
| **Manage liquidity*** | Cash rates are currently attractive, but we believe the central bank tightening cycle is close to completion and high rates are likely to prove short-lived. We therefore recommend that investors hold no more than two to five years of expected net portfolio withdrawals in a Liquidity strategy. The remainder should be put to work in a balanced portfolio. Within Liquidity portfolios, we believe investors can optimize and future-proof yields by using a combination of deposit vehicles, bond ladders, and select structured solutions. |
| **Buy quality bonds** | Within fixed income, we are focused on quality bonds—at current yield levels, we see it as unlikely that they will deliver negative returns over the next 12 months. Our preferred duration stance is the 5–10-year range, where we see the combination of income durability and greater scope for capital appreciation as attractive. We are less positive on emerging market and high yield bonds given that the extra yield in these asset classes seems limited for the additional risks borne. |
| **Look for equity laggards** | With stock market gains this year concentrated in a few companies, an economic soft landing looking more likely, and more investors actively seeking cheaper stocks, we see opportunity in the parts of the market that have lagged global indexes this year. In US equities, we prefer equal-weighted indexes to cap-weighted ones. In Europe, we like small- and mid-caps. And within emerging markets, which have lagged global markets this year, we favor India and Indonesia. |
| **Pick leaders from disruption** | Technological disruption across industries is creating compelling opportunities for investors looking for longer-term portfolio growth potential. In the technology sector, among disruptors, we like platform companies with network effects in industries like internet and software, which should benefit as the impact of artificial intelligence (AI) broadens. In energy, we see a variety of opportunities in the transition to renewables. We also like education services companies as both beneficiaries of, and providers of training in, AI. |
| **Navigate volatility** | Volatility across asset classes has increased, creating opportunities for investors to earn income and benefit from asymmetric payoffs. In equities, we see opportunities to stay exposed to market upside while mitigating downside risks. In commodities and currencies, we focus on strategies that enable investors to take advantage of range-bound market movements. Elevated fixed income volatility creates opportunities for cash and bond yield enhancement. |
| **Diversify with alternatives** | Alternative asset classes are a key part of long-term portfolio diversification, particularly during market environments when stocks and bonds move together. We currently see particular opportunity in specialist credit hedge fund strategies and secondaries in private equity. Higher interest rates can also support return potential for alternative asset managers, given higher yields and returns on offer in underlying assets, including private debt. |
| **Invest in infrastructure** | Infrastructure benefits from powerful structural tailwinds including digitalization, deglobalization, and decarbonization. Government support is likely to spur capacity expansion and improve project economics, notably for renewables. In a portfolio context, we think the asset class is a valuable source of steady and inflation-linked income with lower sensitivity to economic developments and market fluctuations. |
| **Go sustainable** | Sustainability is a key fundamental trend that will continue to shape markets, in our view. Investors focused on sustainability can put each of our investment ideas into practice in a sustainable way. This includes through sustainable multi-asset class portfolios, thematic sustainable and multilateral development bank bonds, ESG leader and thematic equities, and a growing universe of sustainable private markets and hedge funds. |

* Time frames may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

**What does all this mean for investors?**

*Bonds*

We continue to like quality bonds.

We retain our preference for the higher-quality segments of fixed income, given the all-in yields on offer and likely capital appreciation as inflation cools, growth slows, and Fed rate expectations reduce. We favor high grade (government) and investment grade bonds, and are neutral on high yield and emerging market credit.

In our base case, we expect the 10-year US Treasury yield to fall to 3.5% by June 2024, which would translate into total returns of 13% over this period. In our downside scenario, we expect a drop to 2.75%, for a return of 19%. In our upside economic scenario, we could see the 10-year yield at 5%, for a total return of 1%.

*Equities*

Within equities, we favor areas of the market that have lagged this year's rally.

We hold a neutral view on global equities. While we see upside potential over our forecast horizon—8% for the MSCI All Country World Index by June 2024 in our base case—uncertainty about the monetary policy outlook may keep markets range-bound and choppy for now. We recommend focusing on areas that have lagged this year's rally, such as emerging market equities. In the US, we expect the S&P 500 to reach 4,500 by June 2024 and 4,700 by December 2024.

In our downside scenario of a recession, global stocks could fall 16% by June 2024. But for diversified investors, we would expect this decline to be offset by performance in bonds as markets move to price swifter Fed rate cuts. Meanwhile, in our upside scenario of a positive surprise in economic growth, global stocks could rally by 16%.

Energy remains one of our preferred global equity sectors. The global energy sector (MSCI ACWI Energy) trades on a 12-month forward price-earnings ratio of 10x, a 35% discount to the broader benchmark and a 32% discount to history, with a supportive return on equity and free cash flow yield. Consensus earnings growth expectations for 2024 also appear somewhat pessimistic, in our view. In a portfolio context, we believe energy stocks can serve as a good hedge against both geopolitical and inflation risks. Higher oil prices are one factor that could lead inflation and interest rates to stay higher for longer.

*Currencies and commodities*

The US dollar should be well supported in the months ahead but may weaken in 2024 as growth slows.

The US dollar is finding support from multiple angles, particularly from resilient US macro data and a Fed that has signaled its intention to keep policy rates higher for longer. We think the greenback is likely to stay well-bid until the end of 2023, though we still expect it to weaken next year as US growth slows. We maintain a neutral view on the US dollar. Short term, we like to use option markets for yield pickup when it comes to the USD, and we think investors should consider beneficiaries of higher energy prices (e.g., the Norwegian krone, the Australian dollar, or the Canadian dollar) in the crosses.

Within commodities, we hold a preference for oil. Oil prices have had a volatile October so far, falling amid global growth concerns before rising after Hamas's attack on Israel. We still look for higher prices over our forecast horizon driven by an undersupplied oil market, and expect Brent crude to move back into the USD 90–100/bbl range. We are neutral on gold, but we see it as a good portfolio hedge in the current environment. We also maintain a neutral view on commodities overall, and recommend that investors in the asset class actively manage their exposure.

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Global Wealth Management

# Global forecasts

## Economy

Real GDP y/y, in %

| | 2022 | 2023E | 2024E |
|---|---|---|---|
| **US** | 1.9 | 2.4 | 1.0 |
| **Canada** | 3.4 | 1.4 | 0.5 |
| **Japan** | 1.0 | 2.0 | 0.8 |
| **Eurozone** | 3.5 | 0.5 | 0.7 |
| **UK** | 4.1 | 0.2 | 0.6 |
| **Switzerland** | 2.7 | 0.7 | 0.9 |
| **Australia** | 3.7 | 1.9 | 1.6 |
| **China** | 3.0 | 4.8 | 4.2 |
| **India** | 7.2 | 6.2 | 6.0 |
| **World*** | 3.4 | 2.9 | 2.6 |

Inflation (average CPI), y/y, in %

| | 2022 | 2023E | 2024E |
|---|---|---|---|
| **US** | 8.0 | 4.2 | 2.5 |
| **Canada** | 6.8 | 3.5 | 2.3 |
| **Japan** | 2.5 | 3.1 | 2.0 |
| **Eurozone** | 8.4 | 5.5 | 2.4 |
| **UK** | 9.0 | 7.3 | 2.4 |
| **Switzerland** | 2.8 | 2.2 | 1.8 |
| **Australia** | 6.6 | 5.7 | 3.2 |
| **China** | 2.0 | 0.5 | 1.2 |
| **India** | 6.7 | 5.6 | 5.0 |
| **World*** | 8.4 | 6.3 | 5.1 |

* Excludes Venezuela

Source: Bloomberg, UBS, as of 12 October 2023. Latest forecasts available in the *Global forecasts* publication, published weekly.

## Asset classes

| | Spot | Jun-24 |
|---|---|---|
| **Equities** | | |
| S&P 500 | 4,377 | 4,500 |
| Eurostoxx 50 | 4,201 | 4,600 |
| FTSE 100 | 7,620 | 8,200 |
| SMI | 11,038 | 12,000 |
| MSCI Asia ex-Japan | 610 | 670 |
| MSCI China | 59 | 65 |
| Topix | 2,308 | 2,500 |
| MSCI AC World | 808 | 870 |
| | | |
| **Currencies** | | |
| EURUSD | 1.06 | 1.10 |
| GBPUSD | 1.23 | 1.24 |
| USDCAD | 1.36 | 1.30 |
| AUDUSD | 0.64 | 0.69 |
| EURCHF | 0.96 | 0.97 |
| USDCHF | 0.90 | 0.88 |
| USDJPY | 149 | 140 |
| USDCNY | 7.30 | 7.20 |

| | Spot | Jun-24 |
|---|---|---|
| **2-year yields, in %** | | |
| USD 2y Treas. | 4.98 | 4.00 |
| EUR 2y Bund | 3.09 | 2.50 |
| GBP 2y Gilts | 4.77 | 4.00 |
| CHF 2y Eidg. | 1.21 | 0.75 |
| JPY 2y JGB | 0.05 | 0.05 |
| | | |
| **10-year yields, in %** | | |
| USD 10y Treas. | 4.56 | 3.50 |
| EUR 10y Bund | 2.72 | 2.25 |
| GBP 10y Gilts | 4.32 | 3.50 |
| CHF 10y Eidg. | 1.06 | 0.90 |
| JPY 10y JGB | 0.76 | 0.80 |
| | | |
| **Commodities** | | |
| Brent crude, USD/bbl | 86 | 95 |
| WTI, USD/bbl | 83 | 91 |
| Gold, USD/oz | 1,873 | 1,950 |

Source: Bloomberg, UBS, as of 12 October 2023. Latest forecasts available in the *Global forecasts* publication, published weekly.

# Disclaimer

## Non-Traditional Assets

**Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments).** Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-US securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.

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Version C/2023. CIO82652744