



Economic and Market Update – March 7, 2011

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Summary

Although fourth quarter, 2010 GDP growth was revised down to 2.8% from 3.2%, the revisions did not change my thinking going forward. Despite some downside risk in the first quarter due to weather and in the second quarter to sharply rising gas prices, I look for growth in the first half to be 3-4%, sufficient to provide one million jobs. But the range that I forecast is not fast enough to bring the unemployment rate much below 8.5% until the second half. And, then, the employment rate will only fall further if Congress passes a reasonable budget that preserves investment incentives in the short run, but cuts the deficit meaningfully in the longer run, a difficult task.

After three disappointing months, payrolls increased by a solid 192,000, and revisions of the past two months added in 58,000 more jobs. At the same time the flat hourly wage rise neutralized the up 0.4% from February. This will keep a lid on, but not eliminate the potential for commodity price increases to spread to the underlying core inflation. Still, the risk to my inflation forecast is to the upside, a conclusion expressed by Fed Chairman Bernanke in recent testimony. In particular I have raised my full year headline inflation number by a full percent to 3% to reflect the rise in oil price and my core inflation rate by ½ percent.

I am slightly more optimistic about the ability of Congress and the president to make some progress on the reducing the budget deficit. The failure of the administration to take the initiative to reduce the longer term deficit by accepting the conclusion of the president's own budget commission was disappointing. However, the recent "olive leaves" extended by the president and short-term Congressional budget cutting agreements, while only token, are encouraging. So too are the statements by two Republican Congressional leaders that they will propose cuts in entitlement programs despite polls showing that the public's continued unwillingness to accept the pain necessary to achieve significant deficit reduction.

Middle-East developments will drive market prices in the near-term. The dollar is weaker than I anticipated. Historically, periods of uncertainty and risk in the U.S. resulted in dollar support. Moreover U.S. growth is improving. But the trade deficit remains stubbornly high and money flowing out of the Middle-East increasingly seems to be flowing to Europe. Gold, oil, the Swiss Franc and even the Euro seem to be the main beneficiaries. I am not revising my forecast but may issue an inter-month change if parameters that I expect to hold are violated.

Interest rates remain in a range. The fall in Treasury yields prompted by the Middle-East induced "risk off" trade are being offset by upward pressure on yields from increased inflation and supply

risks. Despite the fact that the S&P remains near its high and exceeded my near term range, I think we are in the midst of a small 5-8% correction based on Middle-East concerns and peaking margins. It won't be easy for businesses to pass along increased input costs as households continue to repair their balance sheets. My range though the end of this quarter is 1250-1350, although I do not expect both ends of this range to be reached. I am holding my second quarter range at 1235-1380 for now.

Economy

Growth: Although fourth quarter, 2010 GDP growth was revised down to 2.8% from 3.2%, the revisions did not change my thinking going forward. Personal consumption was revised down a couple tenths and net exports were revised down by a tenth, but still contributed 3.55% to growth. However, the reversal of inventory accumulation subtracted 3.7% leaving inventories very lean and supporting the case for strong growth in the first quarter.

Although awful January weather likely cut into growth, all indicators to date suggest that both the manufacturing and service sectors are expanding at a healthy clip. Thus, even if there is a reduction in the contribution of net exports as I expect, a reversion to inventory accumulation will likely more than offset the reduction. Table one indicates my quarterly forecasts for key economic variables.

Table 1: Economic Forecast 2011

	First qtr.	2 nd qtr.	3 rd qtr.	4 th qtr.
Growth (%)	3.0-4.0%	3.0-4.0%	2.5-3.5%	2.5-3.5%
Unemployment (%)	8.8-9%	8.4-9.2%	8.2-8.6%	8.0-8.4%
Inflation (qtrly %)	3.5%	4.0%	3.0%	2.5%
Core Inflation (%)	1.8%	2.0%	2.2%	2.4%
Fed Funds	0-0.25%	0-0.25%	0-0.25%	0.25-0.50%

Regarding components of growth, I see the sum of personal consumption and residential housing contributing 2.4% to growth in the first quarter and 3.0% in the second quarter. The rise in the second quarter is driven by the pickup in job creation and the resulting increase in household income. The number would be even higher, were it not for what I anticipate will be the negative impact of rising oil prices on consumer confidence and discretionary income after paying for gas.

Given the pickup in private sector growth, exports and investment incentives, I expect non-residential investment to contribute 0.8% to growth in the first quarter and 1.1% in the second quarter. However, net exports will almost certainly reverse their anomalous 3.55% contribution in the fourth quarter, 2010 and subtract 1.6% from the first quarter and an additional 0.8% in the second quarter. On the other hand the "head scratching" 3.7% subtraction from growth due to

inventory reductions in the fourth quarter of 2010 will be reversed as the pickup in consumer and business confidence leads to inventory accumulation. I look for inventories to contribute 2.2% to growth in the first quarter and another 0.8% in the second quarter.

Government spending will likely continue to subtract from growth throughout 2011. State and local spending have already subtracted 0.11% and 0.18% in 2009 and 2010 respectively and will, in my opinion, subtract even more in 2011. Most of that cutback is likely to occur in the first half. Thus, I estimate state and local government will subtract 0.4% in both the first and 0.2% in the second quarter. Federal government spending will also be slowly curbed. The effects from the year-end extension of tax cuts, the extension of UI benefits, and the incentives to business are on government revenue, not spending. On balance, I expect Federal government spending to subtract 0.1% and 0.2% from the first and second quarters respectively.

The biggest uncertainty over the next few months is the impact of events in the Middle-East. I think Libyan developments are much more ominous than events in Egypt. I liken Egypt to India and Libya to Iraq. There is some sectarian violence in India, but basic democratic principles exist and the situation is not likely to degenerate into chaos or civil war. Moreover there is a tendency to move toward, not away from a market-based economy. I think Egypt is likely to evolve in this direction.

Libya, like Iraq and the former Yugoslavia, is more likely to have major tribal problems and differences that could lead to impasses and a potential civil war for control of the country. While not on par with Saudi Arabia, Russia and other large oil producers, Libyan oil is particularly “sweet” and therefore more desirable. Moreover, the secular upward oil consumption trend in Asia is likely to continue apace at a time when excess capacity exists only because of the sharp economic turndown in the mature economies. That has now ended. Thus, oil prices are much more sensitive to supply shocks than would be the case if capacity far exceeded ongoing demand.

Were it not for the negative impact of this uncertainty, my growth forecast for the second quarter would be 5% or higher as economic momentum in the U.S. gains traction. However, it is my opinion that Middle-East uncertainty, including the potential for oil shocks in countries other than Libya will continue for a minimum of several months, perhaps longer. This will mitigate, hopefully not eliminate the growth in consumer and even business confidence. It will also rob consumers of a portion of their rising incomes as gas prices continue to rise.

My growth forecast range for the second half is ½ percent lower than for the first half. Although I am a bit more optimistic about constructive budget developments than previously, Middle-East developments offset this positive development. Moreover, the budget deficit is only marginally improved. Only a huge deficit reduction agreement that would curb the growth in entitlement spending and raise revenue along the lines of the Simpson/Bowles commission, would improve my outlook significantly. And even that could cut short-term growth, depending on the composition of cuts and revenue increases.

Employment: After three disappointing months, payrolls increased by a solid 192,000, and revisions of the past two months added in 58,000 more jobs. Private payrolls increased by

222,000 while public payrolls declined 30,000. Moreover the unemployment rate fell by another tenth, lowering the level to 8.9%. The good news is that, in contrast to the previous two months when the unemployment rate declined because of a net exit from the labor market, the rate declined in February because more people got jobs than entered the labor force.

Part of the jobs increase may be due to the recapture of workers who may have been temporarily out of work for weather reasons in January. And while the weather in February wasn't great, it was more "normal" for the winter. Thus, it is probably best to average the revised gain of 63,000 January increase with the February gain in order to estimate the underlying job growth trend (128,000).

I think that, based on a gain in economic momentum, private payroll gains in coming months will exceed 200,000 a month. At the same time job losses in the public sector will likely continue at more than 20,000 a month. On balance, I forecast average gains to be 200,000 over the next 4 months and would not be surprised to see an "outlier" gain of 300,000 or more in one or two of these months. Thus, I expect total job gains in the first half of 2011 to exceed one million. There is some downside risk due to the negative impact of any further rise in oil and gas prices. However, I think that will have a greater effect in mitigating job gains in the second half of 2011.

My forecast job gains are not likely to lower the unemployment rate much, as potential workers will tend to reenter the labor force as job prospects improve. Thus I do not expect the unemployment rate to fall below 8.5% by mid-year or below 8% until late in 2011 at the earliest. Nevertheless, the decline in the unemployment rate has exceeded my expectation and I have revised my quarterly ranges down to reflect my revised view.

Although job prospects are improving, unfortunately the reason for the decline in the unemployment rate beyond my expectations is not the improvement in job availability. Rather I think it is a secular decline related to the interaction of demographics and long-term unemployment. The working population is aging and many of those laid off who could not find work for an extended period are nearing what would have been their retirement. Lowered income expectations will likely cause many workers to retire later than they anticipated. However, many older workers who were lucky enough to have higher wages and have accumulated enough assets may be opting out of the labor force before they intended, content to live within the means allowed by the assets they have accumulated.

My thinking on the unemployment rate is based on anecdotes that I have accumulated and not yet documented and validated by statistical data. But, as a former labor economist, I use it as my working hypothesis. If correct, then the unemployment rate may not rise as much as I previously expected or as many economists predict. Rather, the labor participation rate may stay down. I still expect many workers to enter the labor market in coming months, but not to the extent consistent with previous economic recoveries.

If my reasoning is correct, the lower-than-expected unemployment rate is not good for income and GDP growth. That is driven by the overall labor wages that are the multiple of total hours worked times the average wage. To the extent that lower participation will be associated with downwardly-revised household income and spending intentions, growth will be slower than

would otherwise be the case. This is a major factor in my belief that the PIMCO-coined “new normal” is for lower growth.

Inflation and Monetary Policy: I have raised my forecast on both headline and core inflation by a percent and half a percent respectively. In recent testimony Fed Chairman Bernanke acknowledged that, near-term, inflation would be boosted by the sharp rise in food prices and by the rise in energy prices precipitated by Middle-East instability. He also said the Fed would be focused on the impact of these developments on longer-term inflation. The Chairman cannot forecast an increase in inflation longer-term without reacting with a policy change and for fear of contributing to a rise in expectations. But reading between the lines and based on my own analysis, I anticipate inflation to be higher than what the Fed currently forecasts. And even though I already built in an increase that exceeds the Fed forecast, I felt it necessary to respond by raising my forecasted inflation rate, both headline and core, even further.

Despite more near-term pressures, the rise in inflation will continue to be mitigated by the absence of wage pressures. The hourly wage rate was flat in February, neutralizing fears that a January rise of 0.4% signaled rising wage pressures. Unit labor costs continue to be well controlled and with labor contributing 65-70% of the value added in our service-based economy, I continue to consider the rise in commodity prices as a relative price shift, not an indicator of a general price rise as it turned out to be in the 1970s.

The risk of inflation is twofold. First, policy makers may decide that moderate rates of inflation ease the distribution of pain among various groups in society of the sharp increases in energy and food prices that is accompanied by an onerous debt level. Indeed, the Fed has a 2% target inflation rate because the consequences of deflation are much more severe than the admittedly negative consequences of inflation. So the Fed likes some “wobble room” and Chairman Bernanke in particular becomes concerned when inflation is below two percent and falling.

The second risk, related to the first, is that in the present circumstances of high unemployment and low inflation, Fed policy remains committed to monetary liquification to foster rising asset prices and business activity. If, for example, the Fed did not follow through on its QE2 commitment, the gains that have accrued from this in the form of rising stock prices and a rising business confidence might be reversed. Traders can change their response to economic, political, and market developments quickly, but if the Fed did so it would result in an inconsistent policy and message to businesses and investors.

Is there a chance that stagflation, i.e. an increase in inflation relative to growth, will increase? Yes. Bottlenecks can develop well before the economy reaches full resource utilization. To date, the commodity price rises have occurred in the context of a weak economy and have only resulted in a relative price shift, not a general price increase. However, when the economy is overly liquid, the price rises in one sector may not be matched by price declines elsewhere. This can occur even when there is still slack in the economy. Such was the case in the 1970’s when the oil shock increased inflation expectations at the same time consumer confidence was negatively affected.

The Fed chairman is very aware of the potential for inflation expectations to rise although he must be careful not to contribute to them. As a result, he and his vice chairman Janet Yellen have both begun to emphasize their growing investigation of an exit strategy from QE2. Fortunately, the private sector appears poised to sustain growth at a level where both life-support from fiscal and monetary policy can be gradually reduced. But as the chairman also pointed out, a sharp oil price shock could undermine consumer confidence, cut into discretionary spending and thus slow growth. Thus it is still too early to announce, with certainty, an end to quantitative easing, let alone a reversal of the rise in the Fed's balance sheet.

On balance, recent economic developments lead me to forecast that the Fed will end quantitative easing at mid-year but adjust its purchases on a month-to-month basis to effect a gradual reduction in purchases rather than an abrupt mid-year termination. Moreover it is premature to expect the fed to lower its \$2.5 trillion balance sheet. The higher level is still needed for support due to reduced money velocity and the fact that consumers and state and local governments continue to reduce debt and repair balance sheets.

Fiscal and Policy: Over the past month my thinking about budget developments has been whipsawed. The President's state of the Union address contained what, in my opinion, offered an excellent assessment of budgetary needs stressing public investments and private incentives that would allow the U.S. to gain competitiveness, while stressing the need to curb the budget deficit in a meaningful way. While not accepted by many on the left and right, the President's own budget commission outlined a roadmap for success.

Subsequently, the president's budget release was even more disappointing than the State of the Union speech was encouraging. The budget failed to incorporate any of the long-term admittedly painful solutions to the budget deficit. Yet near-term it proposed cuts in the very investments we need to make. On balance it failed to offer the leadership that is best exhibited by the executive branch. It was roundly criticized from almost all quarters.

Recent compromises have improved my optimism. Some progress is being made on the budget. While the \$4 billion in cut in order to obtain a two week extension of the current budget is a "drop-in-the-bucket" it appears to be the start of a "dance" that has included an administration offer to make an additional immediate \$6 billion further budget cuts and statements by two key Republican leaders, House Speaker Boehner and Budget Committee Chairman Ryan that they would propose more substantial cuts including future cuts in the growth of entitlement programs even if these cuts were unpopular.

Now that the Administration and a number of members of Congress appear ready to negotiate seriously, perhaps the biggest stumbling block are polls that indicate the voters are still not ready to accept the pain necessary to avoid a crisis. Continued avoidance will impose far more pain than addressing the budget deficit before a crisis forces a much more drastic solution. Clearly leadership is needed on both sides of the aisle and by the Administration to sell a credible budget plan to the public.

Although numerous outcomes are possible, my proscription against which I will judge the results and likely impact on the economy and markets. What follows is consistent with the prescriptions of the Simpson/Bowles proposal. A credible plan should include:

- Cuts in the growth in entitlement programs, especially Medicare. Because of the need to satisfy individual members of Congress the health bill is in effect a “Rube Goldberg” conglomeration of rules that, while broadening coverage, did not give the proper incentives for bending the cost curve. Moreover, given the current lifespan the age of receiving social security benefits could be gradually raised as it previously was under the Tower commission’s 1970’s proposal adopted by Congress.
- Even with cuts in entitlement programs, revenue has to be raised. Unfortunately, in the name of supply-side economics the Bush tax cuts greatly favored the upper-income households and those household that had accumulated huge assets. As a result, the income distribution has become much wider since the early 2000’s, and for the first time since WW2. As the recovery evolved, median income fell even as mean income rose. The pain should be shared. Since the burden of Medicare and Social Security curbs falls mainly on low and middle-income families, tax rates for incomes above some amount should be raised and the tax deduction for mortgages above a certain amount should be phased out. Perhaps many of my readers do not like this solution but neither do the poor and middle-income families like to see their benefits curbed.

Although spending cuts have to be large, they should be scheduled to spread out the impact over a decade so as to minimize an immediate sizeable loss of household income. Nevertheless they should gradually, but persistently eliminate the budget deficit.

Revenues are best raised by growth to broaden the tax base rather than raise tax rates. Thus, cuts are not the only way to provide a healthy reduction in debt. Some of the savings should be redirected to spending on investment that will improve growth and competitiveness. A plan should include:

- Incentives for businesses in order to become more competitive in the global environment. Also it is businesses that create jobs, increasing the tax base.
- Targeted investment in infrastructure and education also designed to improve competitiveness. To the extent that investment is made in education at the national level it should be targeted towards merit-based solutions and providing basic skills and supplies that equip children and adults with what is needed to increase productivity.

In summary, three principles should be followed to rationally reduce the huge budget deficit without engendering a crisis:

- Cuts should be made that favor investment over consumption. A consumption tax would do this but I don’t think that has a chance of being adopted.
- The pain should be shared. The burden of cuts should be distributed in a fair manner.
- Some strategic spending increases should be adopted to improve incentives, foster U.S. competitiveness and broaden the tax base.

Finally it would be good for party leaders to persuade their “wings” to tone down ideological bias. Government does have a role and it is better to have a partnership of business and government than to eliminate the government’s role. If the excesses of the banking crisis did not

teach us that, then we will become even more mired in a system based on privilege rather than merit. At the same time a smaller, more focused government is called for.

Markets

Interest Rates: Middle-East developments are having two opposing impacts on Treasuries. On one hand, the rise in oil prices has, as indicated in recent Congressional testimony by Fed Chairman Bernanke, increased near-term inflation prospects. Conversely, the potential negative impact on consumer confidence and possible spending could slow growth below what otherwise would be realized. The inflationary impact will raise rates, both Treasury and other rates.

The confidence and growth-slowing impact of Middle-East developments reverse the “risk on” trade I have emphasized in previous monthlies. Thus, Treasuries are benefitting relative to other fixed income instruments. Another factor that could benefit Treasuries is the recent apparent attempts of both the Administration to reach across party lines and make progress in reducing the budget deficit. However, the outcome of these efforts is still quite uncertain and the public is still not “on-board” with accepting the pain necessary to make substantial progress.

On balance, I think both real growth momentum and the upward price tendency will outweigh the positives. But rates have already risen in the past few months and the question is whether they already capture the effect of the growth and inflation pickup. I do not think these effects are fully captured and thus I have raised my range on the 10-year note for the second quarter by 10 basis points to 3.35-3.85%. However, I am keeping my forecast range for the second half of 2011 on the expectation that somewhat better budget developments than I earlier expected will offset the worsening inflation effect. Nevertheless, this continues the tendency for Treasury rates to gradually arise with the 10-year note moving to a central tendency around 4% in the fourth quarter. Table two indicates my March and subsequent quarterly ranges for key market variable for the remainder of 2011.

Table 2: Market Forecast Ranges 2011

	March	2 nd qtr.	3 rd qtr.	4 th qtr.
10 yr. Treasury Rate (%)	3.35-3.75%	3.35-3.85%	3.40-4.00%	3.70-4.10%
Dollar Index (futures)	75-78	75-80	76-82	78-82
Euro (in U.S\$)	1.28-1.42	1.28 -1.42	1.28-1.42	1.28-1.42
Dollar/Yen	80.5-84.5	83-84	85-88	86-90
Canadian (in U.S.\$)	1.00-1.04	1.00 -1.04	1.01-1.06	1.02-1.06
S&P	1250-1350	1235-1350	1250-1350	1280-1380

Currencies: Despite my longer-term negative opinion on the dollar, it has been even weaker than I expected the past month. Normally the rise in uncertainty in the world, especially in the Middle-East would lead to a dollar flight. However, what appears to be happening is that flight from the Southern Mediterranean countries appears to be flowing disproportionately to Europe. Moreover, in its most recent communication, ECB president Trichet indicated a strong possibility that the ECB will hike rates in April. And while uncertainty over the impact of Middle-East developments may yet stay his hand, the more hawkish tone relative to the U.S. is supporting the Euro at higher levels than I previously anticipated. Still neither the yen nor euro has moved above the top of my range.

I expect a moderate rebound in the dollar over the remainder of the first half of 2011. Some positive budget developments and continued pickup in growth will be supportive. At the same time, the rebound is mostly because of the relative performance of the U.S. economy compared with Europe and Japan. In general, though, I think that monetary reflation, Asian growth, and Middle-East uncertainty support a positive environment for gold, which I consider a “hard” currency alternative.

Longer term I think the dollar will continue to fall. The trade deficit remains unsustainably high. And budget deficit reduction, whether it comes from intelligent legislation or is forced on the U.S. by crisis, will not prevent a further the dollar decline. Although it will remain the reserve currency for years to come, the dollar will continue to lose dominance. Investors will continue to rebalance their holdings in a manner that will likely not allow continued financing of the sum or U.S. indebtedness and monthly trade deficit without further dollar depreciation. The trade deficit will shrink, but not fast enough to avoid this result.

The Chinese yuan is appreciating very slowly, less than my earlier prediction of a 10-15% yearly rise. Still, I expect the decline to be ongoing and persistent. Increasingly the Chinese will reweight their foreign reserve holdings to achieve lower relative exposure to the U.S. dollar. And over the longer term if my forecast is correct, by weighting their reserves to a market basket rather than disproportionately in the dollar, the result will be that the yuan will appreciate a bit faster against the dollar than against the weighted average of other currencies.

Last month I raised my quarterly range and the range for the remainder of the year to 1.28-1.42, with the caveat that I would either lower or raise the range later in the second quarter based on the outcomes of both U.S. and European fiscal and monetary policies. The factors that will determine whether the euro rises above the top of my range are:

- ongoing Middle-East uncertainty,
- the outcome of the March 11 European conference to discuss ways to achieve more standardization of tax and regulatory rules among EEU members, and,
- the outcome of the U.S. budgetary process in the second and third quarters.

For now I am not changing the range, but may do so in an intermonth communication.

As with the euro, the yen has also been stronger than I expected. The Japanese economy is performing somewhat better and it appears that the disproportionate move to the euro due to Middle-East uncertainty is affecting the dollar/yen cross by driving down the dollar. I have

adjusted my dollar/yen quarterly ranges down a bit but still expect a gradual rise in the dollar against the yen.

I have adjusted the bottom of my Canadian range up a bit. In the current environment or rising energy prices I see less downside risk to the Canadian dollar even if the U.S. dollar rebounds moderately against the yen and euro. Canada continues to have a better mix of monetary and fiscal policy than the U.S. and instability in the Middle-East accentuates the importance of Canada as a dependable resource-exporting country. As a result investment funds have been flowing into Canada and I expect this to continue.

Stocks: Stocks rose with more persistence than I anticipated in the first quarter and the S&P exceeded the top of my range, 1320, by 23 points. However, recent developments in the Middle-East will, in my opinion, lower what might otherwise have been a move much higher than the top of my range later in the year. Several forecasters that I respect have a target in the 1450 to 1500 range. And my own work suggests that given earnings forecasts and a supportive policy context this level is achievable without extending PE ratios.

The onset of Middle-East instability has exacerbated input price increases with over 80% of manufacturers and non-manufacturing businesses reporting higher input prices. At the same time, wage increases are lagging and the rise in gas prices is likely to curb the growth in discretionary consumer spending even as households continue to repair their balance sheets. Thus, I doubt that businesses will be able to pass on the full extent of cost increases in coming months. As a result margins, which improved much earlier in the business cycle than normally due to more aggressive layoffs, are likely to have peaked.

I expect instability in the Middle-East and the increase in oil prices that have already increased to result in the near-term equity correction that has, to date, eluded forecasters. At the same time, positive budget developments, while modest, are supportive as is economic momentum. Thus I expect a correction to be mostly sideways and to not exceed 5-8 percent. 2011 and 2012 S&P earnings expectation will likely fall a bit short of the current “bottom up” projections of about \$95 and \$100 respectively. If, as I expect, investors begin to build a risk premium into the expectations, a reasonable PE ratio tendency based on 2011 earnings in the second quarter in my opinion is 13-14.5 and implies a range of 1235-1377. But because I think caution will prevail as the probable end of QE2 approaches and as investors build in these risk premiums, the top of my range, at 1350, is a bit less than 1377. A PE range of, say, 13-15 based on expected earnings of \$100 in 2012 implies a range of 1300 to 1450 in the second half. The outcome of budget negotiations and Middle-East developments will determine whether the S&P meets or exceeds the upper boundary. My current forecast top in the fourth quarter is 1380.

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