

2024 Q1 MARKET OUTLOOK

Executive Summary

Over the past 18 months, we have prepared for a slowing economy that has been surprisingly resilient. However, despite this resilience, data suggests the risk of entering a recession is as high as it has been since we exited the pandemic. Elevated equity valuations and overly optimistic earnings forecasts suggest stocks are largely priced for a soft-landing scenario, which exacerbates downside risk should that view fail to materialize. The combination of a slowing growth trajectory, elevated recession risk, and limited margin safety in stocks, lead us to favor a defensive investment posture.

Economic Data Check

Data still indicates a recession is probable.

- Resilience of the US consumer was a key theme in 2023, but we question how long this trend can sustain (p3).
- We expect growth will slow after accelerating throughout most of 2023, and that inflation will continue to slow as the lagged impact from reduced housing activity feeds through to shelter inflation (p3).
- Leading economic data has been contracting for 23 months, while coincident data is at an all-time high. This prolonged divergence between the two datasets is surpassed only by the 26-month period leading up to the Great Financial Crisis (p4). Despite signs of economic resilience, data suggest the risk of recession remains high.
- We are skeptical that the Fed will have the data to justify the rate cuts needed to achieve a soft landing before the economy incurs significant job loss.

Equities

Favor remaining underweight stocks.

- Global equities rebounded **+11.0%** in Q4, bolstered by a combination of oversold conditions and a dovish pivot in Fed speak. Stocks finished the year up **+22.2%**, driven by an expansion in valuation multiples.
- We favor being underweight stocks because they tend to underperform during periods of slowing growth and are particularly vulnerable in recessionary environments (p6).
- Despite growing confidence in a soft landing, prevalent recession signals and elevated valuations indicate that equity risk is still biased to the downside in the intermediate term (p7).
- Within equities, we favor increasing exposure to defensive sectors like healthcare and consumer staples (p8).

Fixed Income

Favor being overweight bonds.

- The US Aggregate Bond Index rallied **+6.8%** in Q4, posting its best quarter since 1989. The Q4 rally pushed the index into the black for 2023 (**+5.5%**), avoiding its third consecutive year of losses.
- We favor an overweight posture in fixed income while maintaining a bias toward US Treasuries given our expectation for slower economic growth, and the observation that credit spreads are tight (p9).

Commodities

Favor being overweight commodities via gold.

- The Goldman Sachs Commodity Index declined **-10.7%** during the quarter and finished the year down **-4.3%**. In contrast, gold performed very well, gaining **+11.1%** during the quarter to finish the year up **+14.6%**.
- We favor remaining underweight broad commodities due to concerns about economic demand. Conversely, we favor remaining overweight gold given as a hedge against falling real interest rates, rising debt burdens, and a continued increase in the money supply (p10).

Summary

Favor a defensive posture given that economic risks and equity valuations are elevated.

- The combination of heightened recession risk and an unfavorable growth outlook dictate a cautious approach.
- We believe bonds and gold present a more favorable risk-reward profile than stocks, especially given that stocks appear priced for a soft-landing.
- We favor being overweight cash because investors can earn attractive yields while waiting for an opportunistic time to add to stocks.

Positioning Summary:

○ Underweight
Global Equities

○ Overweight
Fixed Income

○ Overweight
Commodities
(via gold)

○ Overweight
Cash

Note: This document, including important disclosures on Page 12, is meant to be read in its entirety.

Q4 Review: Dovish pivot in Fed speak fueled rally in stocks, bonds, and gold.

- **Global equities rebounded +11%** in Q4, driven by a combination of oversold conditions and a dovish shift in the tone of the Fed, which caused market participants to price in an additional 3.5 rate cuts in 2024 (current expectation is a net of 6 total). Growth outperformed value by **+5%** for the quarter and **+31%** for the year, while the stocks that endured the most pain as a result of rate increases over the past two years, like regional banks and innovative tech stocks, significantly outperformed in Q4.

Global equities finished the year up **+22.2%**, led by US equities which gained **+26.0%**. Notably, these gains were driven solely by multiple expansion, as earnings growth remained flat in 2023.

- **U.S. bonds** surged **+6.8%**, marking their best quarter since 1989. This rally enabled bonds to end the year **+5.5%**, averting a third consecutive year of negative returns.
- **Broad commodities declined -10.7%**. Despite strong equity performance, price action across the commodity complex suggests that aggregate demand remains muted.
- **Gold gained +11.1%**, reaching a new all-time high during the quarter, fueled by declining real interest rates. Since gold does not yield interest or dividends, when real interest rates rise, the opportunity cost of holding gold increases, leading to a decrease in its price as investors favor interest-bearing assets. Gold outperformed broad commodities by **+19%** in 2023.

MARKET REPORT CARD — As of December 31, 2023

Performance Reported in US Dollars	4Q23	2023	2022–2023
Equities			
Global (MSCI All World Equity Index)	+11.0%	+22.2%	-0.2%
United States (Russell 3000 Index)	+12.1%	+26.0%	+1.8%
US Equal Weight (S&P 500 Equal Weight Index)	+11.9%	+13.9%	+0.8%
International Developed (MSCI EAFE Index)	+10.4%	+18.2%	+1.2%
Emerging Markets (MSCIEM Index)	+7.9%	+9.8%	-12.2%
Fixed Income			
Bloomberg Barclays US Aggregate Bond Index	+6.8%	+5.5%	-8.2%
Long-Term Treasuries (Barclays 20+ Year)	+13.4%	+2.7%	-29.3%
Investment-Grade Bonds (Barclays USCorp)	+8.5%	+8.5%	-8.6%
High-Yield Bonds (Barclays US HYCorp)	+7.2%	+13.4%	+0.8%
Commodities			
Commodities (S&P GSCI Index)	-10.7%	-4.3%	+20.6%
Crude Oil (S&P Crude Oil Index)	-18.8%	-3.8%	+22.7%
Gold (LBMA Gold PM Price Index)	+11.1%	+14.6%	+15.8%

Source: Bloomberg, GMAG Research

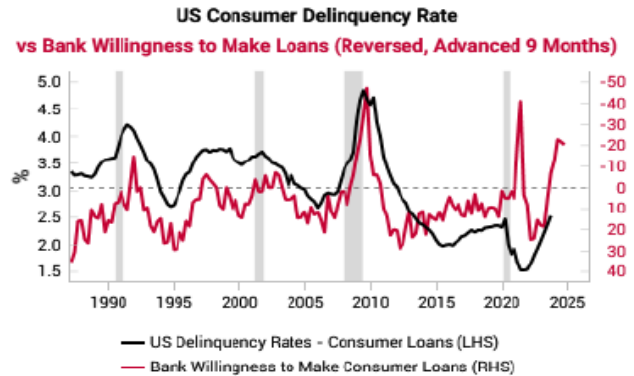
Economic Data Check (1): Although we have underestimated the resilience of the consumer, data still suggests economic risk remains skewed to the downside.

- The resilience of the US consumer was a notable theme in 2023.
- It appears that US consumers are still spending robustly, seemingly unconcerned about job loss, even as their personal finances deteriorate. This is underscored by the significant [divergence between the two primary consumer sentiment surveys](#) conducted by the Conference Board, which gives more weight to employment conditions, and the University of Michigan survey, which focuses more on personal finances.

However, with lending conditions tightening (Fig 1), consumers may become more vulnerable to job loss. Consequently, we are skeptical that this robust spending trend can sustain.

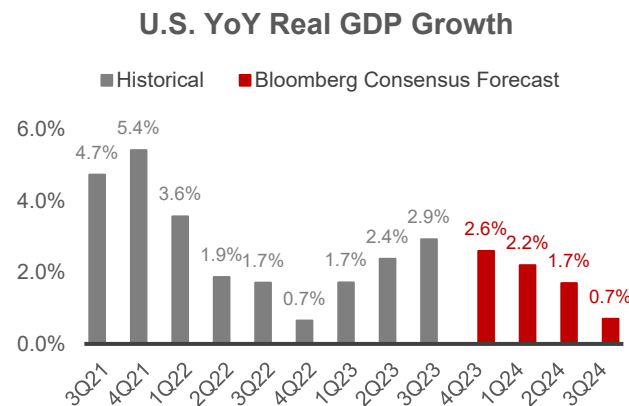
- Going forward, we expect growth will decelerate (Fig 2) as the impulse from government spending fades and higher interest rates weigh on economic activity.
- We also expect inflation will continue to slow in the upcoming quarters (Fig 3), largely to the lagged impact of [decreased housing activity on shelter inflation](#), which is the largest component of CPI.

Fig 1: Consumer lending conditions remain tight, making consumers vulnerable to job losses.



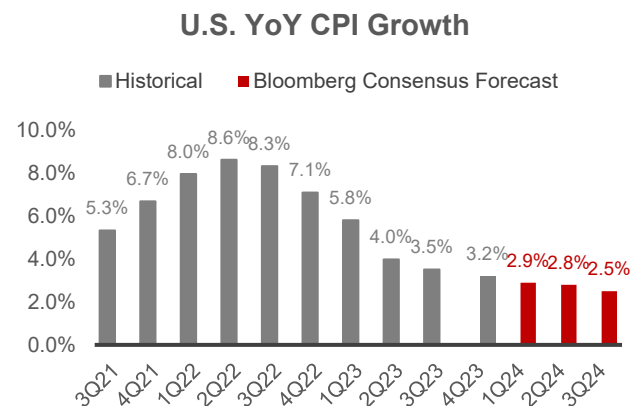
Source: Variant Perception

Fig 2: We expect growth will slow in the coming quarters.



Source: Bloomberg, GMAG Research

Fig 3: We also expect inflation will continue to slow.



Source: Bloomberg, GMAG Research

- In summary, we expect the economy will transition from a goldilocks regime (growth ▲, inflation ▼) to disinflation (growth ▼, inflation ▼) in the coming quarters (Fig 4), which could catalyze higher equity market volatility.

Fig 4: We expect growth and inflation to slow in the coming quarters, catalyzing a regime we refer to as disinflation.

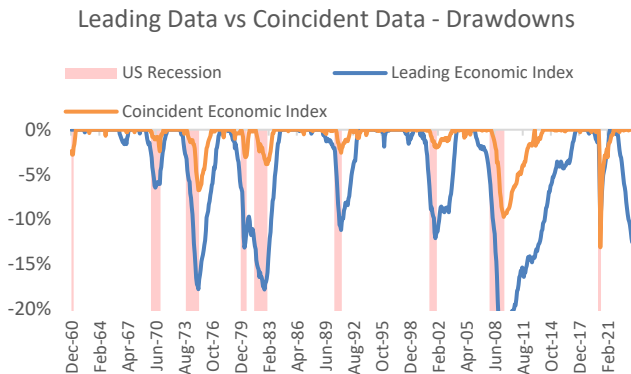
Historical Forecasts												Forecasts			
4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24
R	R	R	S	R	S	S	D	D	G	G	G	D	D	D	D

Source: Bloomberg, GMAG Research G = Goldilocks (G ▲, i ▼) R = Reflation (G ▲, i ▲) S = Stagflation (G ▼, i ▲) D = Disinflation (G ▼, i ▼)

Economic Data Check (2): Leading economic data continues to deteriorate, and history suggests that it's only a matter of time before coincident data follows suit.

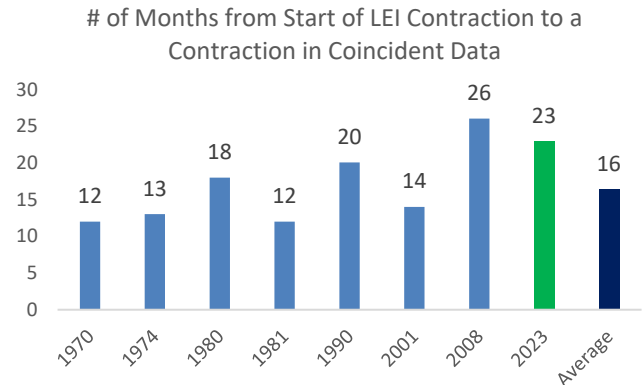
- Leading Economic Indicators (LEIs) have been declining for the past 23 months, while coincident data has remained resilient, reaching record highs (Fig 5). **Historically, coincident data typically starts to contract with a 12-to-18-month lag following LEIs.** The current prolonged lag between leading and coincident data is unusual but not without precedent. From early 2006 to mid-2008 (Fig 6), LEIs contracted for 26 months before a noticeable contraction occurred in coincident data. **We are skeptical that this divergence can persist much longer.**

Fig 5: Coincident economic data remains resilient, despite a deep contraction in leading data.



Source: Bloomberg, GMAG Research

Fig 6: Historically, coincident data begins to deteriorate 12 to 18 months after leading data. We are currently 23 months in.



Source: Bloomberg, GMAG Research

- We believe one of the factors contributing to this extended lag is labor market hoarding. This has been a key feature of the post-COVID environment, as observed by [elevated hiring intentions despite weaker earnings](#). Our partners at Variant Perception have highlighted that in the initial pandemic aftermath, businesses captured a substantial portion of inflation as profit. However, [most of the inflation benefit is now accruing to labor, which has pressured profit margins](#).

As corporate profits decline, we expect layoffs will increase, rendering the trend of labor hoarding susceptible to reversal. Per **Figure 7, we may recently have reached a jump condition in the labor market following a material increase in the number of job losses.**

Fig 7: Historically, when the number of unemployed persons has risen by 10% from its low, it has generally preceded a sharp increase in unemployment.

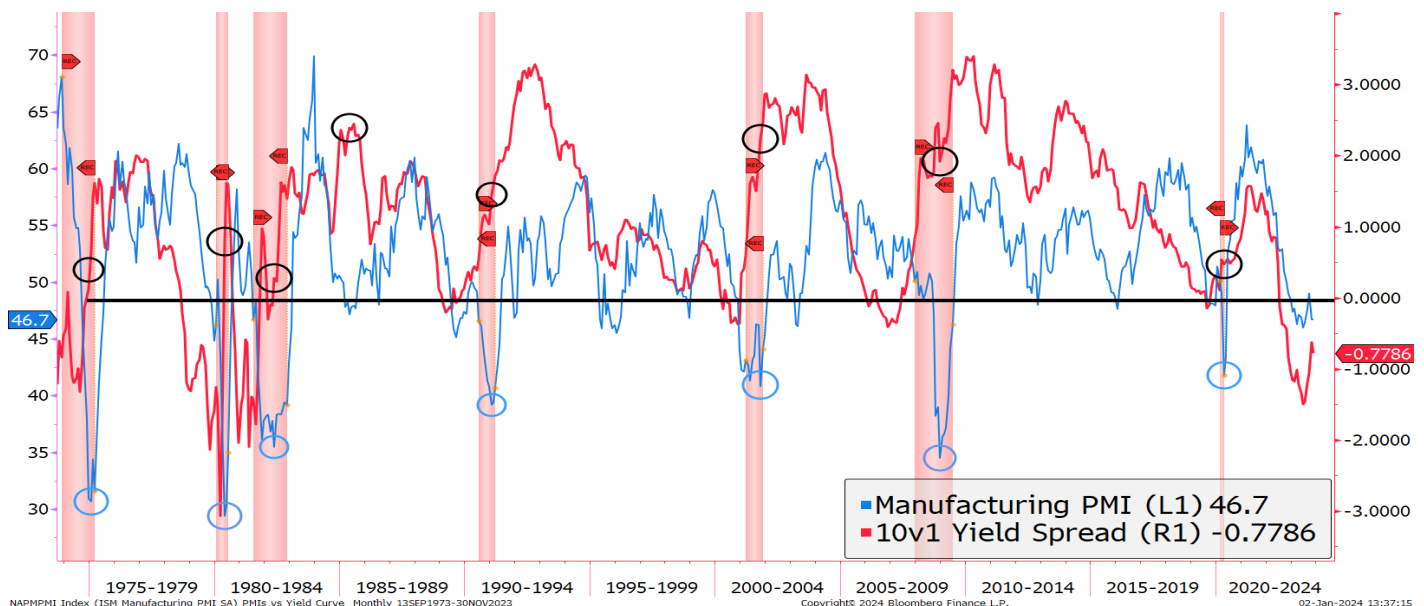


Source: Bloomberg, GMAG Research

Economic Data Check (3): Without rate cuts, a recession appears inevitable, and history suggests the Fed may be late to pivot.

- Nine of the ten green bars on the previous chart coincided with economic recessions. The year 1967 was the exception; during this time, the economy managed to avoid a recession despite a deeply inverted yield curve and a mild contraction in leading economic data. The avoidance of a recession in 1967 can be attributed to a few factors:
 1. The Fed quickly pivoted following its hiking cycle, which helped mitigate economic damage.
 2. Regulation Q imposed an interest rate ceiling on savings and deposits, dampening the transmission of higher interest rates into the broader economy.
 3. Fiscal spending increased to finance the Vietnam War and implement LBJ's "Great Society" programs.
- Fast forward to today, implementing rate cuts seems to be the clear strategy to stimulate economic growth. However, **we believe the Fed will unlikely materially reduce rates while inflation exceeds its target and the economy is well beyond full employment, because doing so could cause inflation to reaccelerate.** Instead, it is more probable that they will wait for unemployment to rise and inflation to decrease further before engaging in material rate cuts. When this happens, it will likely warrant a pivot to a more aggressive investment posture. We don't believe it is prudent to front-run this move, because the Fed has a history of acting late, and there could be a significant decline in economic activity and corporate profits between now and then.
- Some of our peers believe the manufacturing economy is in the process of bottoming and will reaccelerate. Although we acknowledge the possibility that manufacturing activity could rebound temporarily, history suggests a sustained rebound is unlikely until the yield curve normalizes, an outcome which will likely require several rate cuts to induce. Per **Figure 8**, contracting manufacturing PMIs have never bottomed while the yield curve is inverted. Therefore, we conclude that, **until there are substantial rate cuts, manufacturing activity will likely worsen before it improves**, which should cause cyclical equity sectors to underperform.

Fig 8: Historically, manufacturing PMIs have not bottomed until the yield curve normalizes (i.e., the spread turns positive). The black circles highlight the yield curve spread at each time that manufacturing activity bottomed.



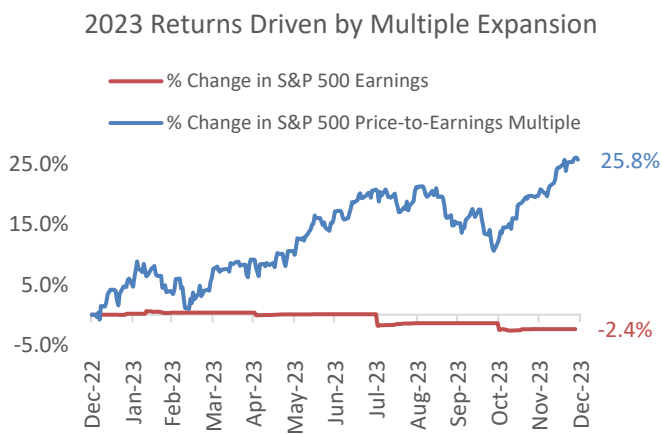
Source: Bloomberg, GMAG Research

Equities (1): Favor Underweight

Slowing growth and a high recession risk dictate an underweight in equities.

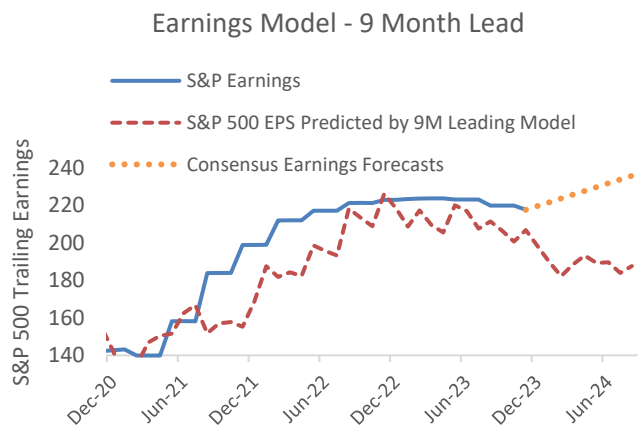
- 2023 was a strong year for stocks, as the MSCI All World and S&P 500 indexes gained **+22%** and **+26%**, respectively. However, we observe that these gains were entirely driven by multiple expansion, while earnings trended sideways (**Fig 9**). Given that valuations are now near the 90th percentile of historical readings, **earnings will likely need to reaccelerate for stock prices to make meaningful gains from here**. We believe this is unlikely absent several rate cuts, and consensus earnings expectations remain significantly higher than what is implied by leading data (**Fig 10**).

Fig 9: S&P 500 returns were driven by multiple expansion in 2023, while earnings trended sideways.



Source: Bloomberg, GMAG Research

Fig 10: Leading data suggests consensus remains too optimistic with respect to earnings forecasts.



Source: Bloomberg, GMAG Research

- We favor being underweight equities, informed by our anticipated deceleration in economic growth and heightened recession risk. Historically, such periods have yielded poor equity returns (**Fig 11**).

Fig 11: We're likely transitioning to a disinflationary environment with elevated recession risk, which should present a more challenging environment for risk assets.

	Avg Quarterly Return by Regime							
	Recession				No Recession			
	G	R	S	D	G	R	S	D
# of Observations	0	0	6	8	39	34	39	28
Average Return			-5.3%	-8.0%	4.9%	4.6%	1.8%	3.3%
S&P 500			-6.0%	-8.2%	5.1%	5.0%	1.5%	3.0%
Technology			-6.1%	-8.7%	7.3%	8.0%	2.6%	2.3%
Consumer Discretionary			-6.1%	-6.2%	6.5%	4.8%	1.1%	2.9%
Financials			-11.5%	-11.0%	5.2%	5.2%	1.7%	4.5%
Materials			-5.3%	-7.0%	5.4%	4.8%	0.9%	2.2%
Energy			-2.3%	-12.4%	3.7%	5.8%	4.4%	1.8%
Industrials			-6.8%	-10.2%	5.2%	5.2%	1.5%	4.1%
Utilities			-3.1%	-8.0%	2.2%	1.2%	4.5%	4.4%
Healthcare			-3.1%	-5.2%	4.0%	4.2%	1.1%	4.9%
Consumer Staples			0.3%	-5.0%	3.9%	3.4%	1.0%	4.1%
Real Estate			-4.7%	-8.4%	3.6%	3.3%	1.9%	4.3%
Emerging Markets			-8.7%	-5.5%	6.3%	4.9%	-0.6%	1.5%

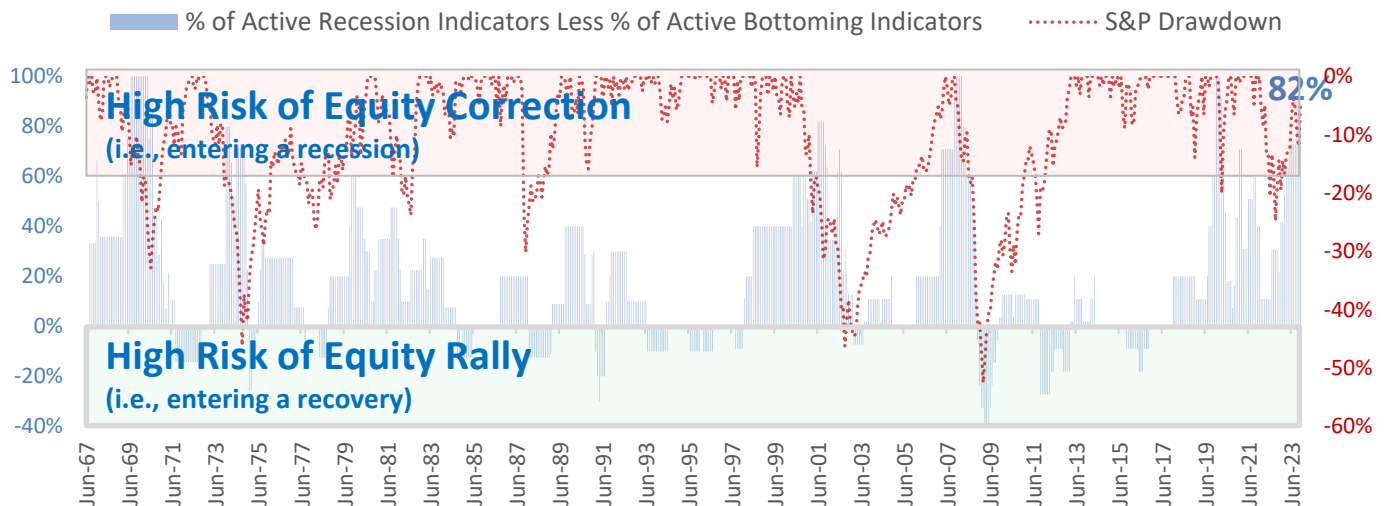
Source: Bloomberg, GMAG Research G = Goldilocks (G▲, i▼) R = Reflation (G▲, i▲) S = Stagflation (G▼, i▲) D = Disinflation (G▼, i▼)

Equities (2): Favor Underweight

Despite economic resilience, risk-reward in stocks is unfavorable.

- Although consensus confidence in a soft-landing is increasing, we believe **recession signals are still overwhelming bottoming signals**. All five (or 100%) of our recession indicators remain active, whereas only 2 of our 11 (or 18%) indicators for identifying market bottoms are active. The blue bars in **Figure 12** reflect the net result of these two models (+82%). Higher values suggest the risk to equity prices is skewed downwards, whereas lower values suggest risk is skewed upwards. A current score of 82% indicates that the risk-reward in stocks remains unfavorable.

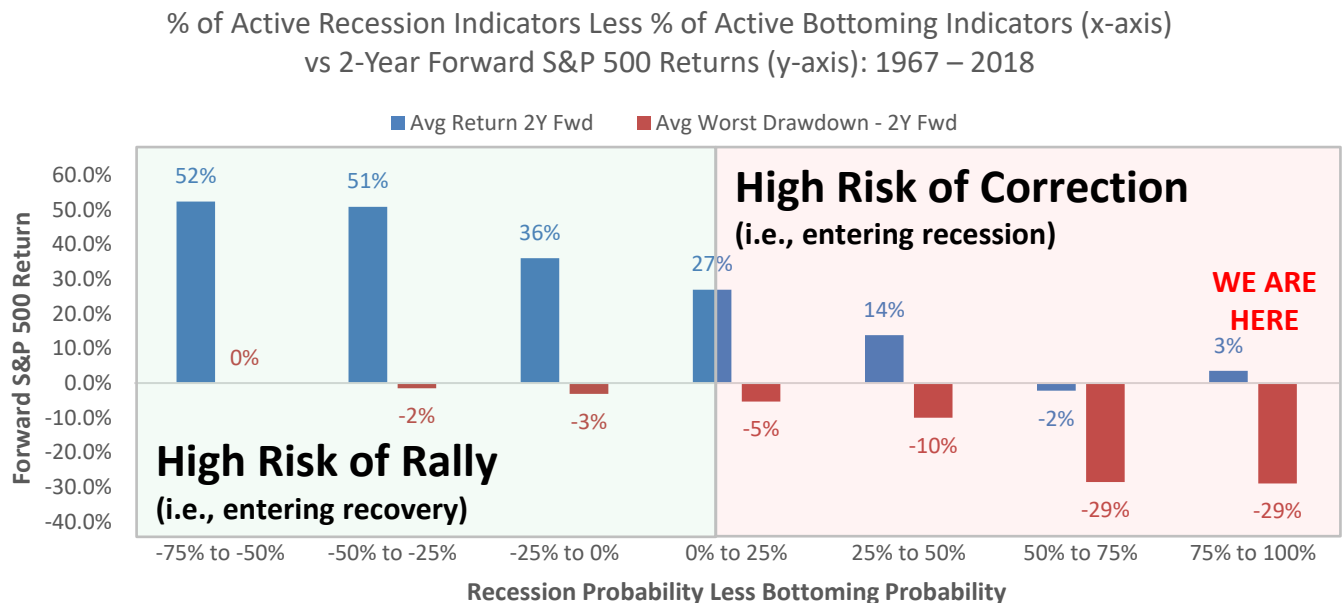
Fig 12: Recession signals are overwhelming market bottoming signals, which suggests the risk-reward in stocks is unfavorable.



Source: Bloomberg, GMAG Research

- Figure 13** offers further insights into potential future equity returns within this framework. **The prevalence of active recession indicators implies greater downside for stocks in the intermediate term.**

Fig 13: Recession signals are overwhelming market bottoming signals, which suggests the risk-reward in stocks is unfavorable.



Source: Bloomberg, GMAG Research

Disclosure: We've excluded 2020 from this analysis because of the anomalous nature of the recession and the unprecedented stimulus response.

Equities (3): Favor Underweight

Favor increasing exposure to defensive sectors within stocks.

- We favor increasing allocations to defensive sectors within equities, such as healthcare and consumer staples. These sectors typically have more stable revenues and often outperform the broader market in disinflationary periods regardless of whether a recession occurs (Fig 14).

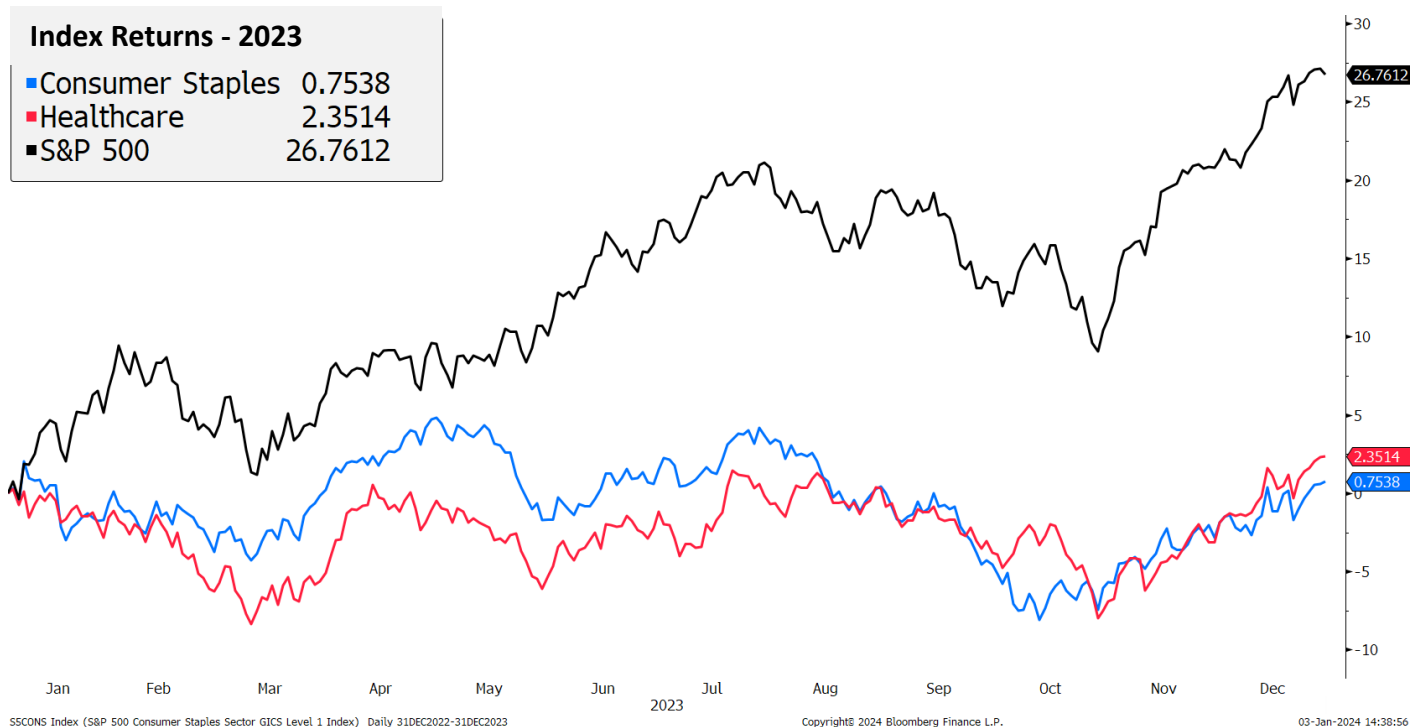
Fig 14: Defensive equity sectors like Healthcare and Consumer Staples generally outperform during disinflation regimes.

	Avg Quarterly Return by Regime							
	Recession				No Recession			
	G	R	S	D	G	R	S	D
# of Observations	0	0	6	8	39	34	39	28
S&P 500			-6.0%	-8.2%	5.1%	5.0%	1.5%	3.0%
Healthcare			-3.1%	-5.2%	4.0%	4.2%	1.1%	4.9%
Consumer Staples			0.3%	-5.0%	3.9%	3.4%	1.0%	4.1%

Source: Bloomberg, GMAG Research G = Goldilocks (G▲, i▼) R = Reflation (G▲, i▲) S = Stagflation (G▼, i▲) D = Disinflation (G▼, i▼)

- These sectors' recent underperformance compared to the broader market may enhance their appeal. Since the beginning of 2023, the S&P 500 Healthcare and Consumer Staples indices have lagged behind the S&P 500 by about **-25%** (Fig 15).

Fig 15: Since the start of 2023, healthcare and consumer staples stocks have underperformed the S&P 500 by roughly 25%.



Source: Bloomberg

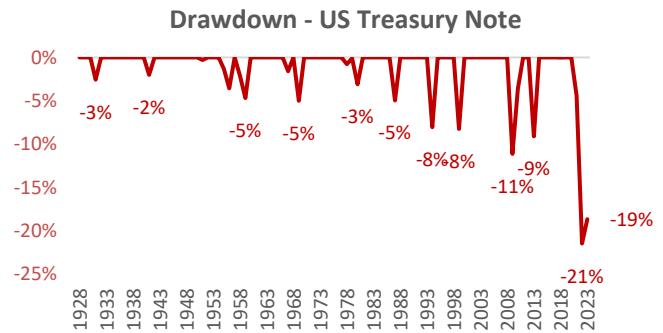
Fixed Income: Favor Overweight

We still believe the risk-reward is more favorable for bonds than stocks.

- We believe treasury bonds have bottomed following the worst stretch of performance in their history (**Fig 16**), and at this juncture, we favor bonds over stocks for the following reasons:

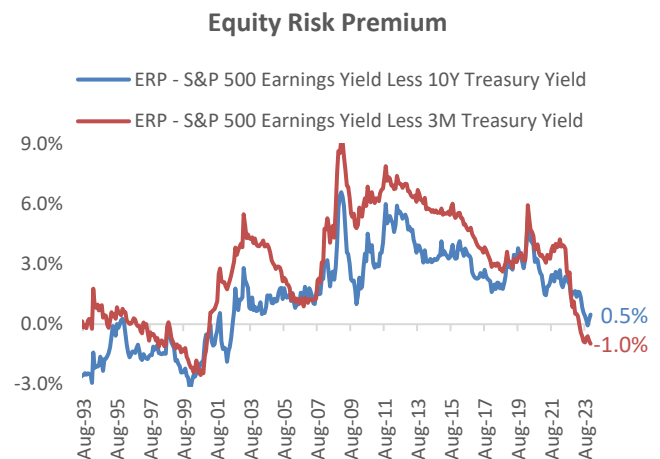
1. **We anticipate a shift to a disinflationary setting**, characterized by simultaneous slowing of growth and inflation. Historically, bonds have performed well in such environments, and their appeal may be heightened given that they have been heavily out of favor for more than three years.
 2. If the economy enters a recession, **bonds will likely benefit from a flight to quality**. Treasury bonds have rallied more than **+20%** in four of the past six recessions, and today, they are starting from a much lower base than they have historically.
 3. **The equity risk-premium**—the additional compensation investors can expect to receive from investing in stocks versus bonds—is **at a two-decade low (Fig 17)**. This suggests that stocks may be perceived as expensive relative to bonds, and investor preferences will likely shift from stocks towards bonds if the outlook for corporate profits deteriorates.
- Although credit has outperformed treasuries in the past year, looming recession risk tilts our preference toward the latter. Credit yields, although seemingly attractive on an absolute basis, are tight relative to treasury yields. A recession could cause spreads to widen (**Fig 18**), which would put pressure on the price of riskier credit instruments like high-yield bonds.

Fig 16: The past three years have yielded the worst stretch of bond performance since 1928.



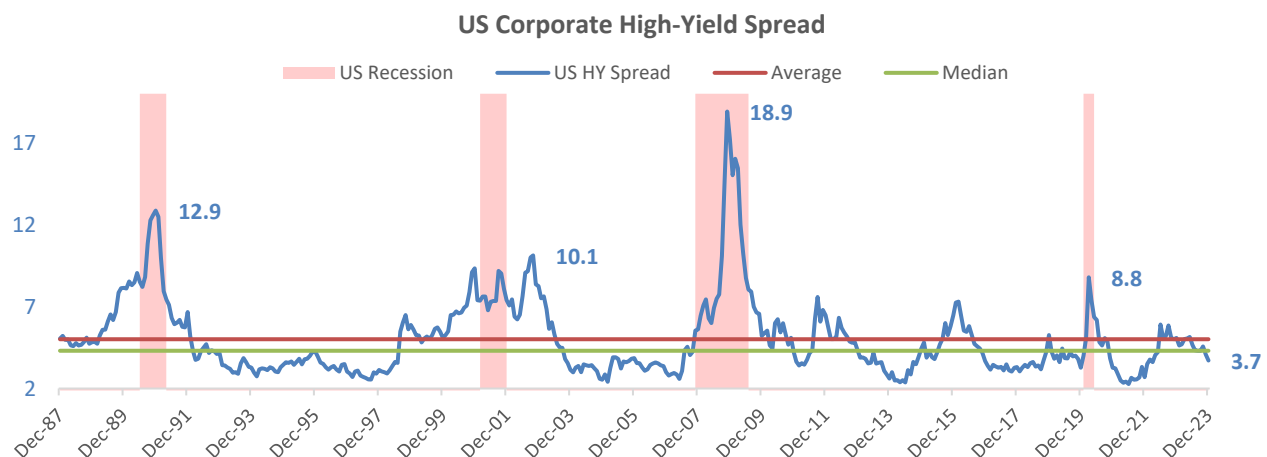
Source: NYU Stern, Bloomberg, GMAG Research

Fig 17: We believe the recent surge in rates was primarily driven by the spike in oil prices.



Source: Bloomberg, GMAG Research

Fig 18: Credit spreads can widen substantially if the US economy enters a recession.



Source: Bloomberg, GMAG Research

Commodities: Favor Overweight (via gold)

We remain cautious on oil and broad commodities given concerns about growth.

- Last year, we favored a bias toward gold given our view that the majority of the post-pandemic economic acceleration was behind us. This strategy proved beneficial, as gold outperformed the broad commodity index by **+19%** in 2023.

- Our preference for gold persists, as we expect synchronized slowing of growth and inflation (i.e., disinflation) in the upcoming quarters, and believe that recession risk remains high. **Per Figure 19**, historically, gold has outperformed oil and broad commodities during periods of disinflation, regardless of whether a recession has occurred.

Fig 19: Although oil rose sharply in Q3, many commodity prices declined during the quarter. This does not signal reaccelerating global demand.

	Avg Quarterly Return by Regime							
	Recession				No Recession			
	G	R	S	D	G	R	S	D
# of Observations	0	0	6	8	39	34	39	28
S&P GSCI			5.4%	-15.1%	1.6%	6.1%	2.9%	-4.8%
Oil			9.9%	-17.7%	2.3%	10.6%	4.1%	-7.4%
Gold Spot			4.7%	2.7%	2.4%	2.3%	1.2%	-0.9%

Source: Bloomberg, GMAG Research

G = Goldilocks (G ▲, i ▼) R = Reflation (G ▲, i ▲) S = Stagflation (G ▼, i ▲) D = Disinflation (G ▼, i ▼)

- We are also encouraged by gold's resilience during the recent increase in real interest rates. Generally, when real rates increase, investor preferences tend to shift away from gold toward interest-bearing assets, like stocks and bonds. However, this relationship has not held in the past two years, as gold has climbed to an all-time high despite a significant **+3.7%** increase in the 10-year real interest rate (**Fig 20**).

- [Central banks have notably increased their gold holdings](#), buying 1,182 tons in the past four quarters, which is 2.4 times the annual rate of purchases that persisted prior to 2023.

Presumably, gold demand is accelerating despite rising real interest rates because participants perceive gold as a robust store of value and a hedge against rising public debts and an expanding money supply.

- In the past 20 years, the M2 money supply across the US, Europe, China, and Japan has grown at an annualized pace of **+8.5%** in US Dollar terms. In contrast, the supply of gold has increased at a modest pace of only **+1.5%** to **+2.0%**, annually. This discrepancy has led to a pronounced devaluation of fiat currencies against gold (**Fig 21**). We expect this trend will continue, as monetary expansion will likely be required for governments to service their burgeoning debt burdens. Since 2007, the combined debt-to-GDP across the US, Europe, and Japan has ballooned from 77% to 122%. This likely explains why gold is making all-time highs despite the recent interest rate surge.

Fig 20: Gold remains near its all-time high despite surging real interest rates. We view this as a sign of strong demand for gold.

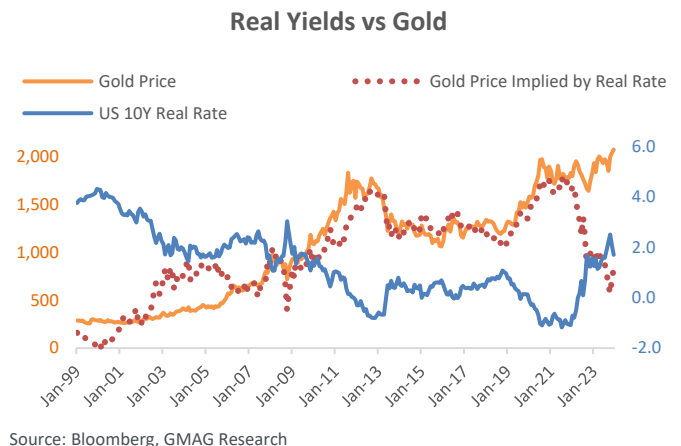
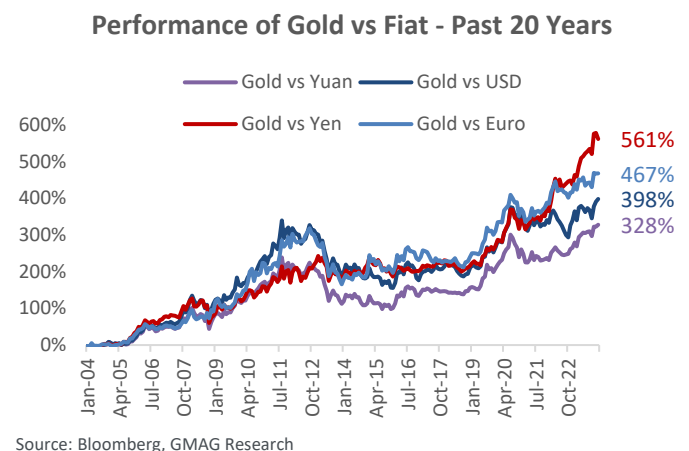


Fig 21: Gold has appreciated materially versus fiat currencies in recent years, in large part due to incessant money printing.



Positioning Summary:

○ Underweight
Global Equities

○ Overweight
Fixed Income

○ Overweight
Commodities

○ Overweight
Cash

Positioning Details:

- **Equities: Underweight**

We favor being underweight equities due to our expectation of slowing growth, coupled with a high risk of recession. Additionally, the combination of elevated valuations and extremely tight labor market conditions likely limits the potential upside in stocks over the next one to two years.

- **Fixed Income: Overweight**

We favor increasing fixed income exposure to overweight because we anticipate a shift to a disinflationary setting, characterized by simultaneous slowing of growth and inflation. Historically, bonds have thrived in such environments, and their appeal may be heightened given that they have been out of favor for more than three years.

- **Commodities: Overweight**

We favor an overweight position in gold as a hedge against slowing growth, burgeoning debt burdens, and a continued increase in the money supply. However, we exercise caution towards broad commodities, which historically tend to underperform amidst slowing economic growth.

- **Cash: Overweight**

We favor being overweight cash because of slowing growth and elevated recession risk. Cash should help portfolios achieve lower levels of performance volatility while providing them with dry powder to reinvest opportunistically. Within cash, we favor holding short-term treasury bills.

As always, we thank you for your ongoing trust and confidence. Please do not hesitate to reach out with any questions relating to our outlook or the management of your individual portfolio. We will keep you apprised of any important developments.

Sincerely,



Please see below for important disclosures.

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