



Global Matters | Monthly

Russia - Ukraine: Implications for financial markets

February 2022

Contents

Global Market Review & Outlook

“There are decades where nothing happens; and there are weeks where decades happen.” Lenin

The quote is attributed to Lenin shortly before the Russian revolution. The week which started on February 24th, when Russia invaded Ukraine, is one of those weeks. Russia's aggression and the unfolding humanitarian disaster have shaken the West to its core. The self-indulgent complacency spanning three decades since the fall of the Berlin Wall and the break-up of the Soviet Union has hit the brick wall of an existential threat to the liberal order of the democratic free World.

Nowhere is this more evident than in Europe, and especially Germany which, against the judgement of several of its allies, has become critically dependent on Russian oil and gas, and ran down its armed forces to minimal needs. Within a matter of days of the invasion, Germany put a stop to the new gas pipeline running directly from Russia to Germany, Nord Stream 2, shortly before it was commissioned; for the first time since WWII it supplied lethal weapons for use in a conflict zone; agreed to increase its defence spending to meet the NATO requirement of at least 2% of GDP, with an initial commitment of EUR100bn; joined in with draconian sanctions against Russia, risking retaliation which could include the suspension of oil and gas exports from Russia; and despite the Green Party being in the government coalition it accepted the need to reconsider the planned closure of its three remaining nuclear reactors beyond the end of 2022 and to maintain, or even increase, the use of coal in a medium term effort to wean itself off Russian fossil fuel imports. The about-turn is dramatic, and other countries have taken similar action.

The strength of the sanctions imposed on Russia and the unity of the West have surprised many, not least the Russian leadership. The ejection of Russia from the Swift international payments system and the freezing of much of the central bank's reserve assets, some two thirds of which are thought to be held in Western jurisdictions, are especially damaging, and the mass exodus of Western companies from doing business in or with Russia will leave the country increasingly isolated. At a stroke, Russia has succeeded in turning itself into a totalitarian pariah state, and achieved the opposite of what it wanted: revitalising the Transatlantic relationship, strengthening the resolve of NATO, with much higher defence spending and potentially an extended membership as Sweden and Finland reconsider their neutrality, unifying and galvanising the EU, and bringing Ukraine firmly into the European fold. A major factor in shifting opinion across the West has been the extraordinary bravery, determination and resolve of the Ukrainian people to retain their independence and resist the aggressor against all the odds, galvanised by the leadership of President Zelensky – memorably epitomised by his riposte to the US when offered exfiltration to a safe haven: 'The fight is here. I need ammunition, not a ride'.

In an exceptionally uncertain and unpredictable situation, some of the implications of these events are becoming clearer, albeit with varying degrees of murkiness:

1. The scale, ferocity and depravity of the invasion is considerably worse than initial expectations and will leave an indelible stain on Russia. It has overturned post-Soviet conventional wisdom and the security order. Its consequences will run deep and long, and pose a greater risk to financial markets, at least in the short term, than initially seemed likely.
2. While Putin misjudged the strength of Ukraine resistance and Western sanctions, he will persist with his objective of bringing Ukraine into the Russian sphere of influence. That will mean the war is likely to be drawn out and bloody.
3. The longer the war goes on, the greater the risk of a miscalculation by Russia or the West. In turn this increases the risk of the use of nuclear weapons. It is impossible to assign any meaningful probability to such an outcome, and we construct our portfolios on the assumption that Armageddon will be avoided.
4. Even if Russia takes over Ukraine militarily it will find it very difficult to control the territory and its people with a sustainable pro-Russian regime. There is likely to be a well-armed, tough and motivated insurgency movement, supplied with sophisticated arms by the West. This outcome might lead Russia to the negotiating table in due course.
5. Russia had not sanction-proofed its economy through building up massive reserves in the way it expected, and faces a deep recession. The rouble has almost halved in value, from US\$1.3-1.4 cents before the invasion to US\$0.7-0.8 cents now, the central bank has doubled interest rates to 20%, yields on Russian rouble government bonds have risen from 10% to 15% and the equity market (still closed at the time of writing) faces a melt-down.
6. The duration of that recession depends in part on the speed with which the West reduces its imports of Russian oil and gas, and the extent to which China becomes a larger buyer from Russia (China already imports 15% of its crude oil needs from Russia, 5% of its natural gas and 18% of its coal). Russia produces one eighth of the world's crude oil and one sixth of its gas (as well as a tenth of its wheat plus a wide range of industrial and precious metals). The West is racing to impose the most damaging sanction of all on Russia, by curbing imports of fossil fuels from Russia and depriving the country of its principal source of dollars. This will not be implemented in full immediately given the dependency of the EU on Russian supplies, but there is no turning back.

“The strength of the sanctions imposed on Russia and the unity of the West have surprised many, not least the Russian leadership”

7. The sanctions and Russia's coming recession will cause some pain for Western companies and banks with any exposure. Russia's credit rating has been cut well into junk territory, and defaults on its offshore debt are possible, but this is very unlikely to cause systemic problems. Direct exposure of offshore investors to Russian securities is relatively small and is manageable. Now that Russia is essentially uninvestable its related securities have been, or soon will be, eliminated from global indices and investment portfolios and largely written down, in many cases to zero.

8. But the biggest impact will be transmitted through the sharp rise in commodity prices, particularly oil and gas. Security of supply risks have soared and the transition away from Russian supplies, especially for the EU which depends on Russia for 40% of its gas and 27% of its crude oil, will take time, as will replacing fossil fuels with green energy sources. The transition is underway and will be a positive development in the longer term, but in the meantime will push inflation higher for longer. It will not be energy alone driving inflation up: Russia and Ukraine combined provide around 30% of the world's exports of wheat and barley, and close to 20% of its maize (source USDA), and prices are rising rapidly.

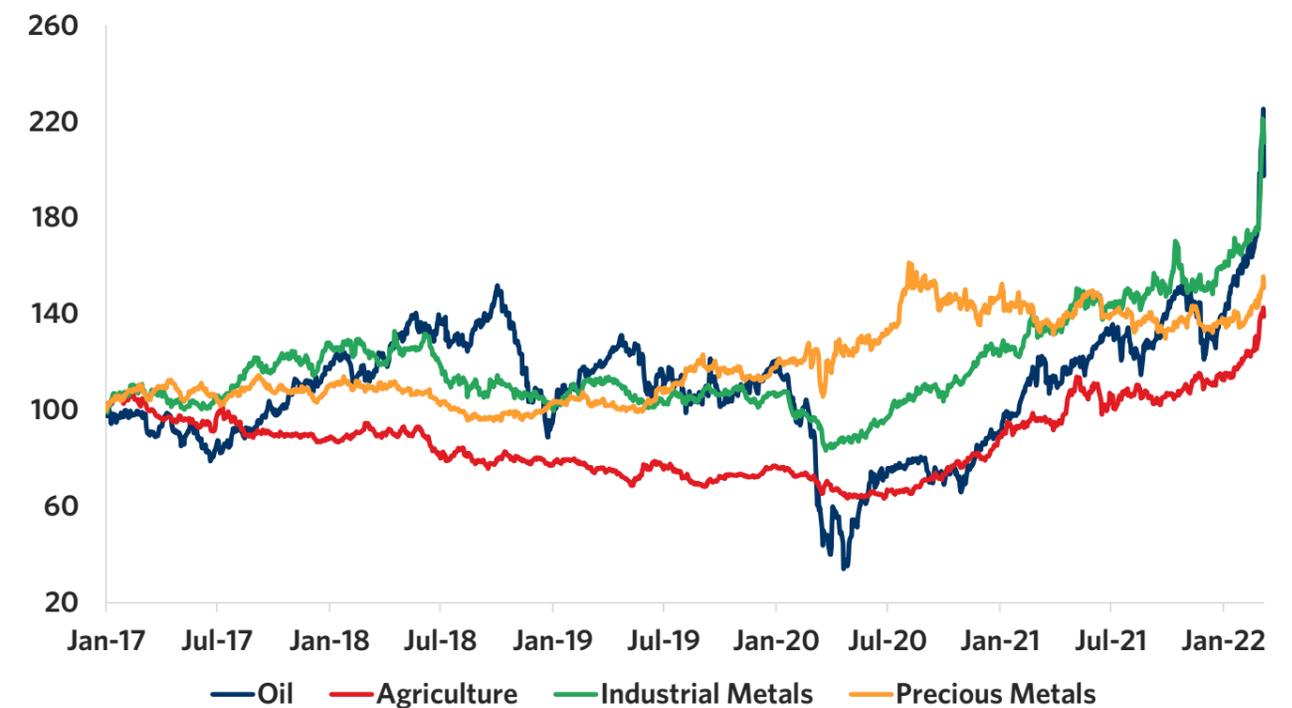
9. Persistently higher prices, especially in non-discretionary areas of spending like energy and food, are demand destructive, and will inevitably put pressure on disposable incomes of households. Combined with the uncertainty that war brings, and the tailing off of the post-pandemic release of pent-up demand, economic activity is likely to fade through 2022 into 2023. The combination of rising inflation and falling growth rates raises the spectre of stagflation, a tough environment for the corporate sector and an increasing risk for financial markets.

10. Central banks are faced with a very difficult conundrum. Sharply rising inflation due to supply problems combined with its deflationary impact on demand and slower growth ahead makes monetary tightening decisions much more complex. So far, market expectations of the Fed's tightening plans are little changed, with Fed Funds still expected to reach around 1.5% within 12 months and 2% during 2023. Given the deterioration in the immediate economic outlook, this seems to discount all and quite possibly more tightening than the Fed will in practice implement. Doing nothing is plainly not an option, and we expect the Fed and other major central banks to continue with a gradual tightening of policy through rate rises and reversal of quantitative easing, but with an increasingly cautious bias as the year progresses, especially in the case of the European Central Bank, with Europe more exposed to the financial consequences of the war than other regions.

11. Much has been written about the implications of the crisis for China's ambition to reunite Taiwan with the mainland. We have as much insight into the mind of President Xi as we do into that of Putin, but we are in no doubt that Xi will be watching developments in Ukraine intently. The difficulties faced by Russia in its invasion, the loss of civilian lives and the pace and ferocity of the reaction from the West will surely give pause for reflection. Taiwan has a sophisticated and well-armed military, and, unlike in the case of Ukraine, the US policy towards Taiwan of 'strategic ambiguity' means that it has no treaty obligation to defend Taiwan, but equally it has never said that it would not intervene in the event of an invasion by China. We suspect China will remain patient.

Markets are struggling to digest the implications of war in Europe, the rapidly evolving situation, and the intense uncertainty around its resolution, and to find a level which discounts the heightened risks. The initial reaction after the invasion was relatively subdued, and mostly as might be expected under the circumstances. There was a flight to safe havens out of risk assets, with yields on government bonds falling by around 20bps in 10 year maturities, gold up 6% in the month, and equity markets generally weakening, particularly in Europe. The biggest falls were in Eastern European markets, down 39% in February, with Russia accounting for over 50% of the index prior to the invasion, and in Emerging Market debt, down 11% in the month. The notable rises were in commodity markets, with oil reaching \$100 at the end of February, its highest since 2014 and up 11% in the month (30% year-to-date), and agricultural commodities up 7% in February, bringing the rise over 12 months to 36%.

Commodity Prices

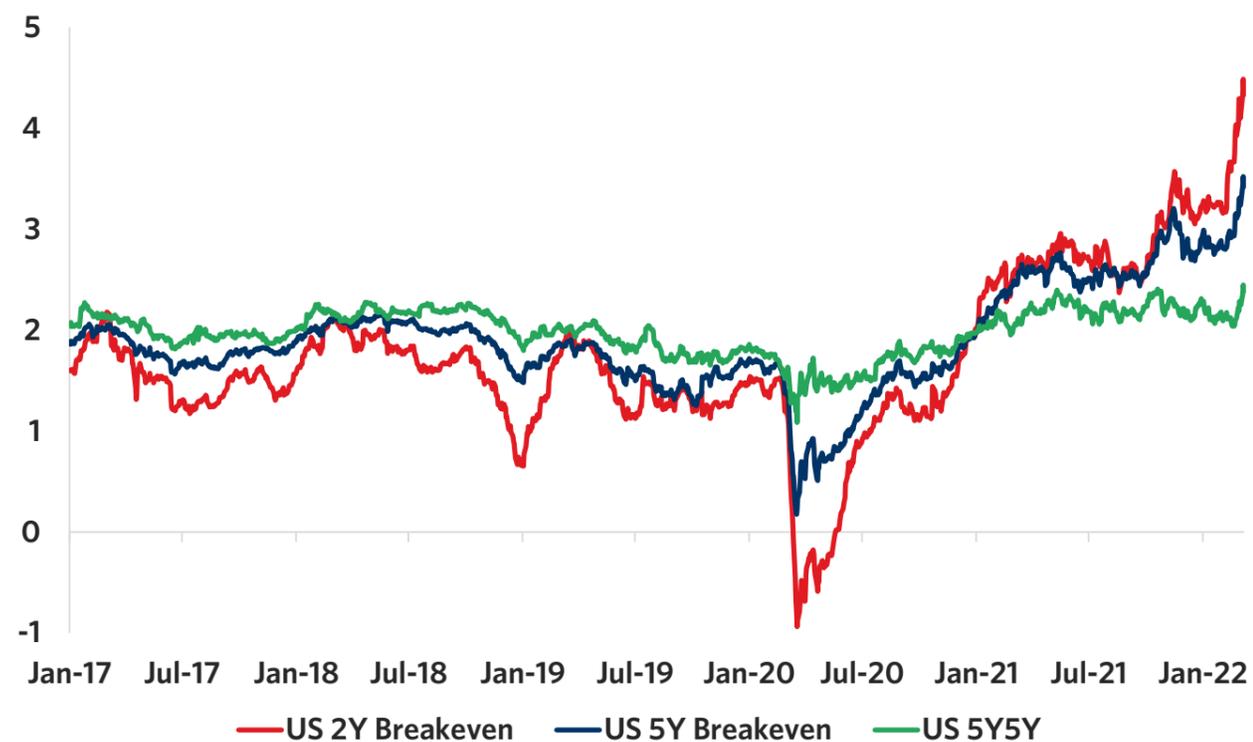


Source: Bloomberg Finance L.P., Momentum Global Investment Management

There was a flight to safe havens out of risk assets, with gold up 6% in the month

Inflation expectations as reflected in break-even rates rose in the US by about 20bps by month end from the lows earlier in February, with 10 year break-evens reaching 2.6%, higher at shorter terms, but the closely watched indicator of longer term inflation expectations, the 5 year 5 year forward rate, while moving higher, remained remarkably low at 2.2% at the end of the month. The shift to lower bond yields was driven by a sharp drop in real rates of 40bps, taking the real 10 year rate to -0.8% at month end.

Inflation Expectations



Source: Bloomberg Finance L.P., Momentum Global Investment Management

The early days of March have seen heightened volatility and an intensification of uncertainty. Investors are rightly deeply worried. The immediacy and horror of the crisis tends to lead to a compression of investor time horizons, something which we believe should be avoided. We recognise that much has changed and risks have risen, but the war will end, and history shows that it is unwise to sell at moments of greatest distress. The world enters the crisis with corporate and household balance sheets in good shape and financial conditions showing few significant signs of stress, other than in Russia. We cannot predict the circumstances that will end the carnage but we know they will come and when they do the rally in markets is likely to be swift and sizeable. We firmly advocate a long term and well diversified investment approach, continuing to blend equities for longer term growth and inflation protection with safe haven assets including government bonds and gold, alongside other relatively defensive assets such as infrastructure and sustainable energy.

Bond Yields



Source: Bloomberg Finance L.P., Momentum Global Investment Management

We are in a very much more challenging environment for markets than for some time; by far the most serious headwind is the war now raging in Europe, but we are also in the highest inflation period since the 1970's, and monetary tightening and slower growth lie ahead. But after their sizeable falls markets are rapidly discounting the risks and are offering some good longer term buying opportunities. Many stocks are priced at their most attractive valuation levels for some years and interest rates are likely to remain historically low, even after the tightening underway by central banks. Now, more than ever, is a time for longer term perspective, riding out the short term volatility, to participate in the recovery whose timing is unpredictable but which surely lies ahead.

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Market Performance - Global (local returns) as at 28 February 2022

Asset Class / Region	Index	Ccy	1 month	3 months	YTD	12 months
Developed Markets Equities						
United States	S&P 500 NR	USD	-3.0%	-4.0%	-8.1%	15.9%
United Kingdom	MSCI UK NR	GBP	1.1%	8.1%	2.8%	21.4%
Continental Europe	MSCI Europe ex UK NR	EUR	-4.1%	-3.8%	-8.7%	12.4%
Japan	Topix TR	JPY	-0.4%	-2.0%	-5.2% ^e	3.4%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	-1.1%	-3.3%	-5.1%	-12.1%
Global	MSCI World NR	USD	-2.5%	-3.7%	-7.7%	10.7%
Emerging Markets Equities						
Emerging Europe	MSCI EM Europe NR	USD	-38.8%	-42.4%	-42.2%	-33.5%
Emerging Asia	MSCI EM Asia NR	USD	-2.3%	-4.4%	-5.8%	-15.1%
Emerging Latin America	MSCI EM Latin America NR	USD	4.8%	19.2%	12.6%	14.3%
China	MSCI EM China NR	USD	-6.3%	-8.8%	-7.9%	-21.0%
BRICs	MSCI BRIC NR	USD	-3.9%	-9.7%	-6.7%	-31.3%
Global emerging markets	MSCI Emerging Markets NR	USD	-3.0%	-3.0%	-4.8%	-10.7%
Bonds						
US Treasuries	JP Morgan United States Government Bond TR	USD	-0.7%	-3.0%	-2.4%	-1.5%
US Treasuries (inflation protected)	BBgBarc US Government Inflation Linked TR	USD	0.8%	-1.1%	-1.4%	6.2%
US Corporate (investment grade)	BBgBarc US Corporate Investment Grade TR	USD	-2.0%	-5.4%	-5.3%	-3.4%
US High Yield	BBgBarc US High Yield 2% Issuer Cap TR	USD	-1.0%	-1.9%	-3.7%	0.6%
UK Gilts	JP Morgan UK Government Bond TR	GBP	-1.4%	-8.0%	-5.4%	-3.4%
UK Corporate (investment grade)	ICE BofAML Sterling Non-Gilt TR	GBP	-2.1%	-6.1%	-5.0%	-4.2%
Euro Government Bonds	ICE BofAML Euro Government TR	EUR	-1.9%	-4.6%	-3.0%	-4.0%
Euro Corporate (investment grade)	BBgBarc Euro Aggregate Corporate TR	EUR	-2.5%	-3.9%	-3.8%	-3.9%
Euro High Yield	BBgBarc European High Yield 3% Constrained TR	EUR	-2.9%	-3.5%	-4.3%	-2.1%
Japanese Government	JP Morgan Japan Government Bond TR	JPY	-0.6%	-1.6%	-1.4%	-0.3%
Australian Government	JP Morgan Australia GBI TR	AUD	-1.4%	-2.4%	-2.4%	-0.6%
Global Government Bonds	JP Morgan Global GBI	USD	-0.9%	-3.5%	-2.9%	-5.7%
Global Bonds	ICE BofAML Global Broad Market	USD	-1.3%	-3.8%	-3.5%	-5.7%
Global Convertible Bonds	ICE BofAML Global Convertibles	USD	-0.5%	-6.6%	-6.3%	-8.9%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	-11.3%	-13.2%	-14.7%	-13.9%

Asset Class / Region	Index	Ccy	1 month	3 months	YTD	12 months
Property						
US Property Securities	MSCI US REIT NR	USD	-3.2%	-2.2%	-10.0%	22.6%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	0.9%	-5.3%	-8.7%	19.5%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	-1.3%	0.3%	-0.1%	-9.4%
Global Property Securities	S&P Global Property USD TR	USD	-2.3%	-1.7%	-7.2%	11.1%
Currencies						
Euro		USD	-0.1%	-1.0%	-1.3%	-7.1%
UK Pound Sterling		USD	-0.2%	0.9%	-0.8%	-3.7%
Japanese Yen		USD	0.1%	-1.6%	0.1%	-7.3%
Australian Dollar		USD	2.8%	1.9%	0.0%	-5.7%
South African Rand		USD	0.1%	3.4%	3.8%	-1.6%
Commodities & Alternatives						
Commodities	RICI TR	USD	7.5%	25.1%	17.2%	45.3%
Agricultural Commodities	RICI Agriculture TR	USD	7.3%	16.3%	10.7%	36.0%
Oil	Brent Crude Oil	USD	10.7%	43.1%	29.8%	52.7%
Gold	Gold Spot	USD	6.2%	7.6%	4.4%	10.1%
Hedge funds	HFRX Global Hedge Fund	USD	-0.1% ^e	-1.1% ^e	-1.6% ^e	0.7% ^e
Interest Rates						
						Current Rate
United States						0.25%
United Kingdom						0.50%
Eurozone						0.00%
Japan						-0.10%
Australia						0.10%
South Africa						4.00%

Source: Bloomberg Finance L.P., Momentum Global Investment Management. Past performance is not indicative of future returns. e=estimate

Market Performance - UK (all returns GBP) as at 28 February 2022

Asset Class / Region	Index	Local Ccy	1 month	3 months	YTD	12 months
Equities						
UK - All Cap	MSCI UK NR	GBP	1.1%	8.1%	2.8%	21.4%
UK - Large Cap	MSCI UK Large Cap NR	GBP	1.8%	11.2%	6.1%	24.8%
UK - Mid Cap	MSCI UK Mid Cap NR	GBP	-3.1%	-5.4%	-9.6%	6.3%
UK - Small Cap	MSCI Small Cap NR	GBP	-3.9%	-7.2%	-11.1%	-0.9%
United States	S&P 500 NR	USD	-2.7%	-4.9%	-7.1%	20.7%
Continental Europe	MSCI Europe ex UK NR	EUR	-3.9%	-5.6%	-9.2%	8.6%
Japan	Topix TR	JPY	-0.1%	-4.6%	-4.5% ^e	-0.3%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	-0.8%	-4.2%	-4.1%	-8.5%
Global developed markets	MSCI World NR	USD	-2.2%	-4.7%	-6.7%	15.3%
Global emerging markets	MSCI Emerging Markets NR	USD	-2.7%	-4.0%	-3.8%	-7.0%
Bonds						
Gilts - All	ICE BofAML UK Gilt TR	GBP	-1.4%	-8.1%	-5.4%	-3.2%
Gilts - Under 5 years	ICE BofAML UK Gilt TR 0-5 years	GBP	0.0%	-1.1%	-0.7%	-1.5%
Gilts - 5 to 15 years	ICE BofAML UK Gilt TR 5-15 years	GBP	-0.5%	-4.4%	-3.2%	-3.2%
Gilts - Over 15 years	ICE BofAML UK Gilt TR 15+ years	GBP	-2.9%	-13.8%	-9.3%	-4.0%
Index Linked Gilts - All	ICE BofAML UK Gilt Inflation-Linked TR	GBP	-0.3%	-8.6%	-3.0%	9.5%
Index Linked Gilts - 5 to 15 years	ICE BofAML UK Gilt Inflation-Linked TR 5-15 years	GBP	1.4%	-2.2%	0.8%	8.5%
Index Linked Gilts - Over 15 years	ICE BofAML UK Gilt Inflation-Linked TR 15+ years	GBP	-1.3%	-12.1%	-5.2%	10.3%
UK Corporate (investment grade)	ICE BofAML Sterling Non-Gilt TR	GBP	-2.1%	-6.1%	-5.0%	-4.2%
US Treasuries	JP Morgan US Government Bond TR	USD	-0.7%	-4.3%	-1.4%	2.6%
US Corporate (investment grade)	BBgBarc US Corporate Investment Grade TR	USD	-2.0%	-6.7%	-4.4%	0.7%
US High Yield	BBgBarc US High Yield 2% Issuer Cap TR	USD	-1.0%	-1.9%	-3.7%	0.6%
Euro Government Bonds	ICE BofAML Euro Government TR	EUR	-1.9%	-4.6%	-3.0%	-4.0%
Euro Corporate (investment grade)	BBgBarc Euro Aggregate Corporate TR	EUR	-2.5%	-3.9%	-3.8%	-3.9%
Euro High Yield	BBgBarc European High Yield 3% Constrained TR	EUR	-2.9%	-3.5%	-4.3%	-2.1%
Global Government Bonds	JP Morgan Global GBI	GBP	-0.5%	-4.4%	-1.8%	-1.8%
Global Bonds	ICE BofAML Global Broad Market	GBP	-1.3%	-3.8%	-3.5%	-5.7%
Global Convertible Bonds	ICE BofAML Global Convertibles	GBP	-0.5%	-6.6%	-6.3%	-8.9%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	GBP	-11.0%	-14.0%	-13.8%	-10.3%

Asset Class / Region	Index	Local Ccy	1 month	3 months	YTD	12 months
Property						
Global Property Securities	S&P Global Property TR	GBP	-1.9%	-2.6%	-6.2%	15.7%
Currencies						
Euro		GBP	0.1%	-1.9%	-0.6%	-3.6%
US Dollar		GBP	0.2%	-0.9%	0.8%	3.8%
Japanese Yen		GBP	0.3%	-2.5%	0.9%	-3.8%
Commodities & Alternatives						
Commodities	RICI TR	GBP	7.8%	23.9%	18.5%	51.3%
Agricultural Commodities	RICI Agriculture TR	GBP	7.7%	15.2%	11.9%	41.7%
Oil	Brent Crude Oil	GBP	11.1%	41.7%	31.2%	59.0%
Gold	Gold Spot	GBP	6.6%	6.6%	5.5%	14.6%
Interest Rates						
						Current Rate
United Kingdom						0.50%

Source: Bloomberg Finance L.P., Momentum Global Investment Management. Past performance is not indicative of future returns.
e=estimate

Asset Allocation Views

Main Asset Classes	Change	Negative	Neutral	Positive
Equities	-	○ ○	●	○ ○
Fixed Income	-	○ ●	○	○ ○
Alternatives	-	○ ○	○	● ○

Our Overall View

We continue to favour equities over fixed income in recognition of their leverage to a sustained global economic recovery. Most fixed income remains expensive given the inflationary backdrop but pockets of credit continue to offer some value. Alternatives, including infrastructure, are attractive for their diversifying qualities as much as the return potential.

“We continue to favour equities over fixed income in recognition of their leverage to a sustained global economic recovery”

EQUITIES	Change	Negative	Neutral	Positive
Developed Equities	-	○ ○	●	○ ○
UK Equities	-	○ ○	○	● ○
European Equities	-	○ ○	●	○ ○
US Equities	-	○ ●	○	○ ○
Japanese Equities	-	○ ○	○	● ○
Emerging Market Equities	-	○ ○	●	○ ○

Equities offer the potential for further forward returns as the global economy continues to recover. Huge stimulus programs, central bank support and pent-up consumer demand and savings paint a favourable backdrop. The UK remains attractive as it slowly shakes off its Brexit discount and is well positioned sectorally to benefit from the economic recovery. We also favour Japan on valuation grounds and for the accompanying Yen exposure.

FIXED INCOME	Change	Negative	Neutral	Positive
Government	-	● ○	○	○ ○
Index-Linked	-	○ ●	○	○ ○
Investment Grade Corporate	-	○ ●	○	○ ○
High Yield Corporate	-	○ ○	●	○ ○
Emerging Market Debt	-	○ ○	●	○ ○
Convertible Bonds	-	○ ○	●	○ ○

Bonds remain expensive today. Sovereign yields have lifted off their lows but remain unattractive given the risk of inflation becoming more entrenched. Inflation linked bonds have marginally better prospects. We remain fundamentally constructive on corporate credit but see limited upside and returns to come mostly from carry in the near term. Convertibles play an important role in multi asset portfolios but look fairer value today.

REAL ASSETS / ALTERNATIVES	Change	Negative	Neutral	Positive
Commodities	-	○ ○	○	● ○
Property	-	○ ○	●	○ ○
Infrastructure	-	○ ○	○	● ○
Liquid Alternatives	-	○ ○	●	○ ○

Real assets look attractive on both fundamental and valuation grounds, with a bias to infrastructure assets which ultimately should benefit from government policy initiatives. Investors are paid well to wait, and the diversifying qualities, also offered by the more esoteric liquid alternatives allocation, is attractive today in a world of expensive bonds. The backdrop of supply chain disruption and buoyant consumer demand is likely to support commodity prices in the near term.

CURRENCIES vs. USD	Change	Negative	Neutral	Positive
GBP	▼	○ ○	●	○ ○
EUR	-	○ ○	●	○ ○
JPY	-	○ ○	○	● ○

US yields creeping higher makes it challenging for the more rate anchored currencies like the Euro not to depreciate. We take a more neutral view on Sterling following recent strength and a resetting higher in expectations for base rates both in the UK and the US. The Yen has continued to soften but its defensive qualities make it attractive as a portfolio diversifier.

The Asset Allocation views are as of December 2021 and are updated quarterly unless otherwise stated.



For more information, please contact:

Distribution Services

E: distributionservices@momentum.co.uk

T: +44 (0)207 618 1806

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