

## Monthly Newsletter

February 7<sup>th</sup>, 2019

*"A wise man will make more opportunities than he finds" — Sir Francis Bacon*

*"Only one who continually re-examines himself and corrects his faults will grow" — The Hagakure*

### Clues from Recent Asset Classes' Behavior

**Macro: US and China Growth to Recouple...Focus on the Chinese Stimulus**

**Oil: The Venezuelan Catalyst**

**MENA: A Review of the 2018 IMF Article IV Consultation on the UAE**

### Introduction

Equity markets are sailing on optimism since mid- January. The bounce back that is taking place from the lows registered in the last quarter of 2018 is fostered by hopes of a potential trade deal between the US and China, which appears to have a higher probability than reconciling a divided Congress.

In addition, animal spirits were flying high with the flock of global central banks doves. The US Fed appears to be close to neutral as it decided to hold rates stable, to be patient and data dependent on future rate hikes while being ready to operate with "an ample supply" of bank reserves. The rest of the world is trending in the same direction. Major central banks refrained from taking further hawkish actions as is the case with the ECB or are in easing mode such as the Bank of Japan or the PBOC. As a result, the USD lost some ground since the beginning of the year which boosted risk appetite and provided emerging countries and commodities with a lift.

The easing tone or actions (if any) of the monetary authorities are justified due to a disinflationary trend on the back of lower oil prices and slowing Chinese factory gate prices. Slowing global macro-economic activities, falling global capex indicators, deterioration in business sentiment indices, and European issues such as Brexit, the Yellow vests protest, and Italy's economic challenges have led to increased uncertainty. The darkened outlook expressed itself as well through the deep fall in the Baltic dry index and the weakening manufacturing data of major world exporters notably China, Germany and Japan. The latter two appear to be highly dependent on the health of the Chinese economy as both economies contracted in Q3 2018.

Although we were positioned for this recent upward trend, we still seek to rebalance our portfolios as we move forward and to improve the quality of our holdings accordingly. In our opinion, too much market optimism should not overlook key concerns and thus we continue to fasten our seat belt. Despite the sanguine news about progress in trade talks these are yet to be validated through an agreement. In the same context the market is still ignoring the US case against Huawei which is a form of cold trade war. Other issues that are yet to be resolved or need some clarity include Brexit, the US government shutdown, and the US debt ceiling deadline which is due in the coming month, not to mention the wave of elections expected to take place in many countries. On the macro level, deteriorating data in Q1 is a source of risk and explains why earnings and guidance are being downgraded. In fact, we are at the end of the cycle and awaiting a regime shift and as a result, things will naturally slowdown. In this context, investors suddenly overlooked the fact that major financial risks were channeled from banks' balance sheets to the corporate bond market assuming that the Fed will come to rescue in turbulent times although quantitative tightening of the Fed's balance sheet has not stopped yet. Moreover, in a recent speech Fed's Mester said that rates may need to rise if US growth stays on track which shows that the end of interest rate hike cycle is not confirmed.

We are focusing on companies that have earnings quality and stability and on industries benefiting from a sweet spot in the business cycle. We are watching and assessing carefully the stimulus measures taken by China, both monetary and fiscal, which should be positive for China and emerging markets. We believe that many GCC countries are adopting a measured expansionary fiscal policy that will bode well amid their inclusion into global indices such as the MSCI. We continue to have a constructive view on oil and gold.

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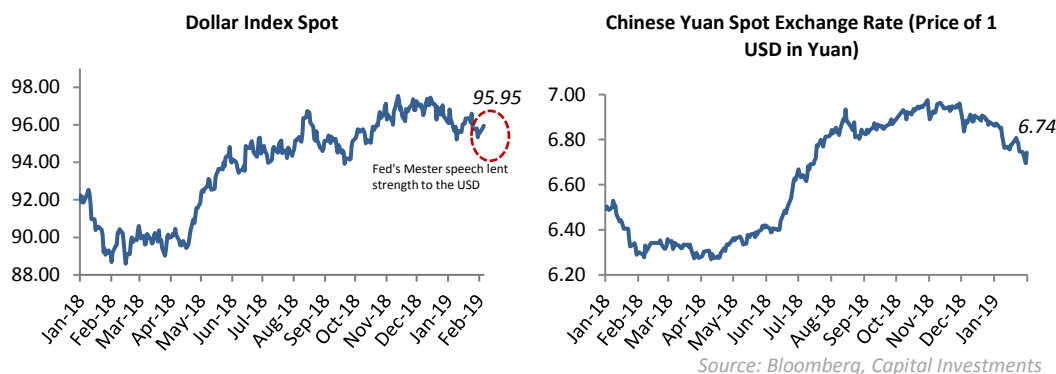
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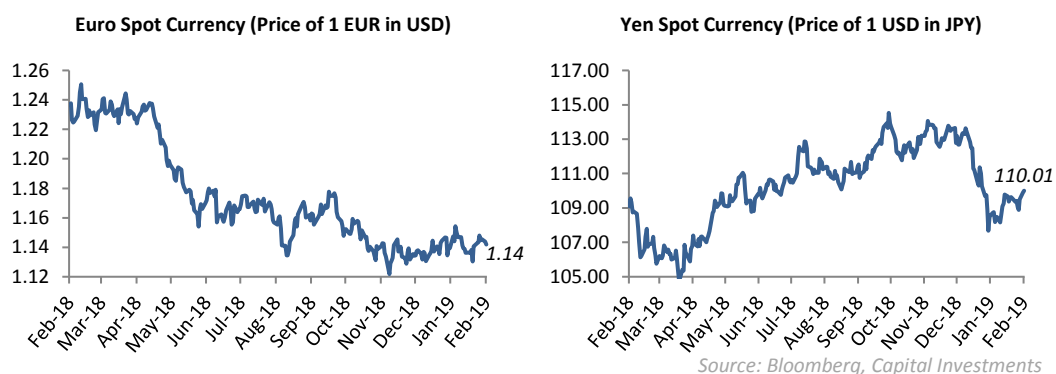
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**This report must be read with the disclaimer at the end of the report.**

### Clues from Recent Asset Classes' Behavior

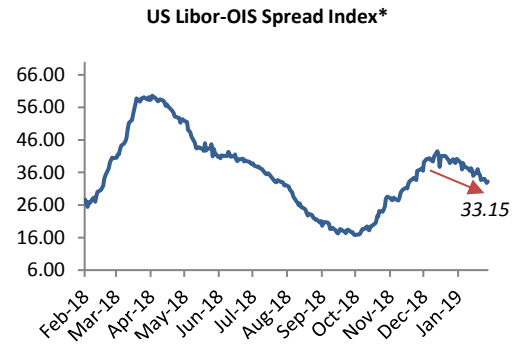
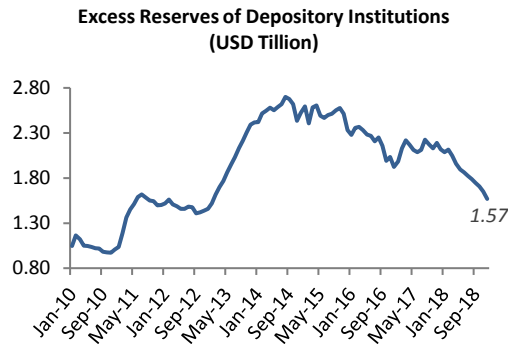


Many factors are driving the weakness in the US dollar, these include a potential slowdown in the US economy due to the government shutdown, the polar vortex impact during Q1, the fading effect of the tax cuts towards the end of the year, along with skepticism regarding global recession. The weakness in the USD is in correlation with the dovish tone of the Fed and the expectations regarding the tightening cycle over the medium term, along with the widening twin deficits- budget and trade. Despite these bearish factors, a weak global economy notably in Europe is lending some support to the USD or the Dollar Index (DXY), which explains why it is not breaking down sharply. The Chinese Yuan is recouping some of its losses on trade deal hopes and on optimism that the economic measures taken by Chinese authorities will bear fruit soon, and this is a sign that capital outflows have receded. A stable Yuan is good for the Chinese economy and for emerging market countries and commodities.



The Euro is backed by the end of the quantitative easing program by the ECB, but weak economic performance and political turmoil in Europe are weighing heavily on its performance and putting a cap on a potential rally. As for the Japanese Yen, it is being driven by the sliding US yields and safe haven demand. Both a strong Yen and Euro will create more headaches for their respective Central Banks as they will hurt the margin of exporters while taming inflation. We are more constructive on

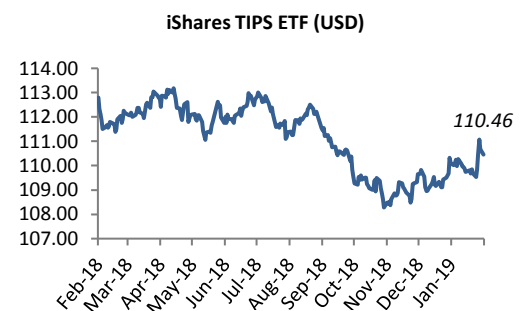
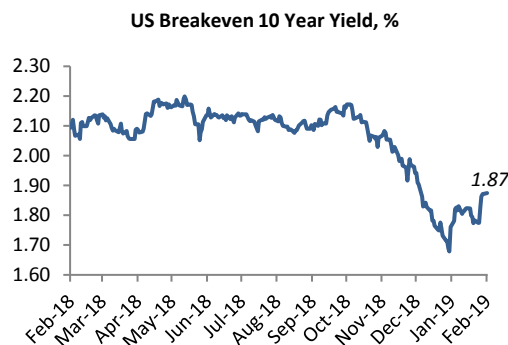
the Yen as it is acting as a safe haven and is benefiting from a stealth tapering performed by the Bank of Japan, which was not increasing its balance sheet lately, not to mention that in a weak USD environment, Japanese investors will call their capital back.



Source: FRED, Bloomberg, Capital Investments

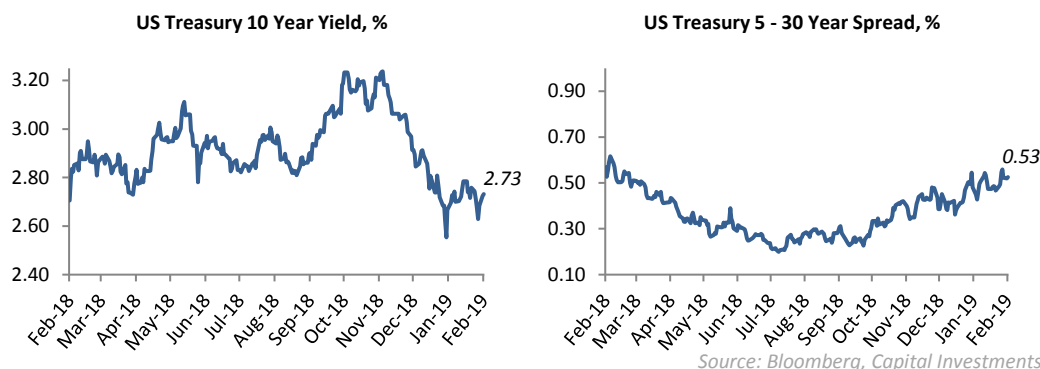
*\*The LIBOR-OIS spread represents the difference between the 3 month Libor rate, the unsecured rate at which banks lend to each other, and the 3 month overnight index swap (OIS), which represents the central bank rate. It is a gauge of perceptions of risk in credit markets. Hence, when the gap widens it is an indication of perceived credit and liquidity risk.*

The US Fed delivered a surprise by hinting that it weighs an earlier than expected end to its Treasury portfolio run-off and that it is ready to operate with “ample supply” of bank reserves. If the Fed moves from a dovish rhetoric to actual action, it will help in easing financial conditions and tame the rising borrowing costs for small banks and corporates. It is obvious that the Fed’s dovish tone is already calming down the Libor-OIS spread.



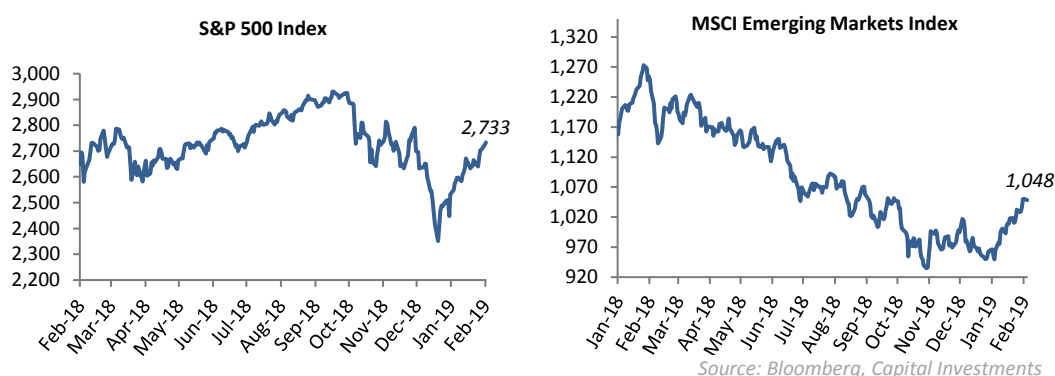
Source: Bloomberg, Capital Investments

Disinflationary trends were setting the tone over the past few months and recovery in inflation expectations inched up on the back of climbing energy prices and an easing USD. However, investors did not come back strongly to Treasury Inflation Protected Securities ETF (TIPS).



Source: Bloomberg, Capital Investments

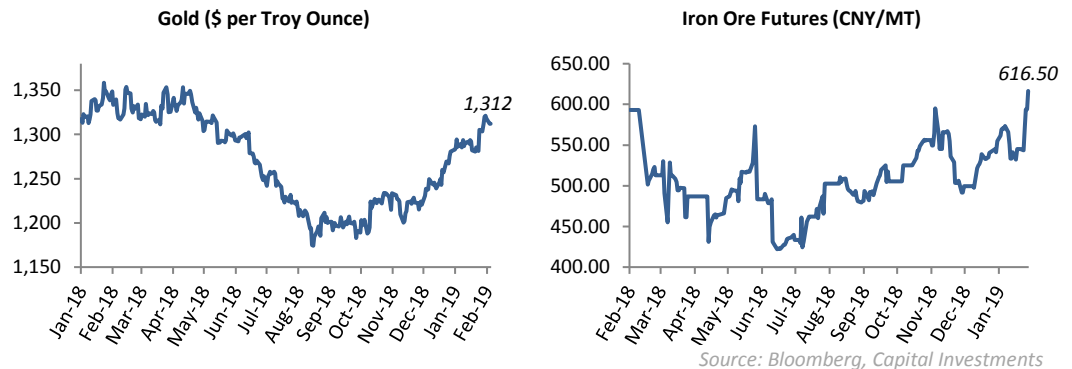
Falling yields was a global phenomenon over the past few months due to the reasons we explained earlier. Given that the yield curve is flat and already inverted on the short end, and since the Fed is hinting that it might shift the monetary policy regime, meaning either pausing or ending their interest rate hike cycle, then investors should pay attention to the steepening of the long-end of the curve since the front-end yields are set to go lower. This steepness will provide duration opportunities. Investors should consider that the Fed will allow some inflation pressure to form and since we already have low-term premium and low inflation, further flatness in the long end has a low probability. This hypothesis is supported by our expectation that the US 10-year yield will not drop below 2.5% as the Fed has not yet adopted a full easing mode, the economic data releases from the US are still showing that the economic engine has relatively sufficient grease to move, and although we are concerned about the mountain of corporate debt in the world amid tight global financial conditions, we are not in a middle of a credit crunch that will send deflationary waves.



Source: Bloomberg, Capital Investments

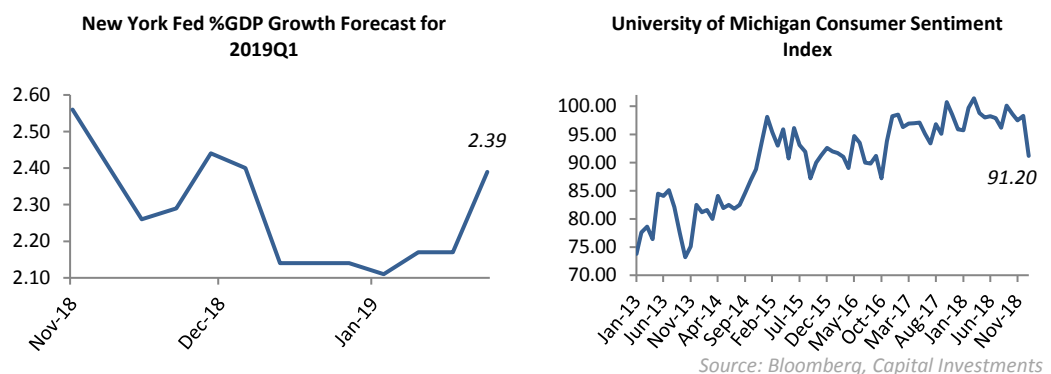
As the above charts illustrate, both the US and emerging markets equities gained track. The recovery was led mainly by cyclical stocks and by sectors that are set to benefit from a trade deal. We are not very optimistic about the US technology sector given that regulators are increasing their scrutiny, companies are lowering their guidance, and due to the Huawei issue and the “Made in China 2025” policy that aims at increasing semiconductors capacity in China. We are interested in China and India, and although deceleration and weak economic data are key risk factors we think that investors are

not paying attention to supportive policy actions taken by authorities in terms of fiscal stimulus. The Chinese government is also pushing for state-owned enterprise reforms, is set to provide funding to the private sector, and its central bank is expected to lower interest rates soon in addition to lowering the reserve requirement ratios for banks.

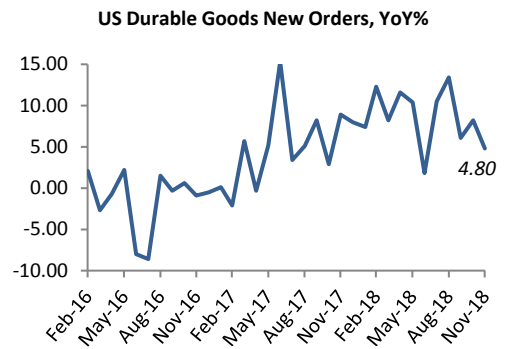
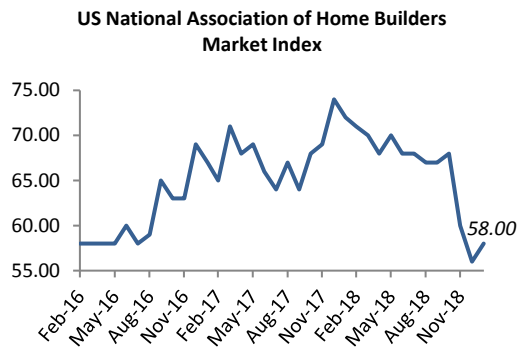


An inversion of the US yield curve coupled with a weak USD are usually supportive for gold prices despite the disinflationary trend that reigned recently. On the other hand, on January 25th, a tailings dam at Vale's Feijao mine in Brazil collapsed. The fear of disruption of Vale's operations given that Vale is one of the largest producers of metals in the world, has led to a spike in the price of many industrial metals, notably iron ore. This will impact inflation through rising input costs and will impact steel producers around the world.

**Macro: US and China Growth to Recouple...Focus on the Chinese Stimulus**

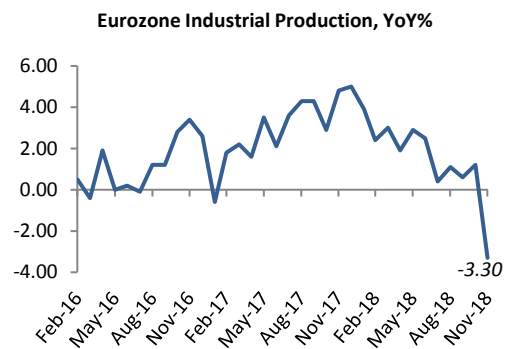
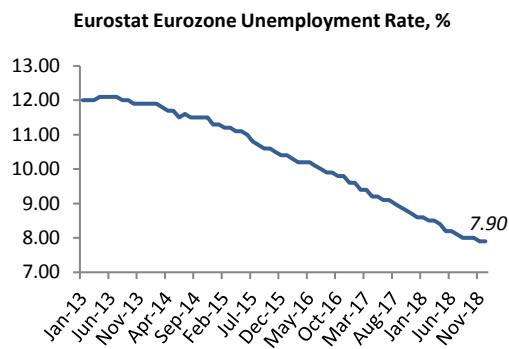


A combination of factors including the US government shutdown, a divided Congress, the US-China trade tensions, and rising borrowing cost weighed negatively on consumer sentiment indices in the US which dropped to 2-year lows, reaching the same levels when President Trump was elected. New single-family house sales continue to drop, and US durable goods orders (ex-transportation) weakened, correlating with declining Chinese imports.



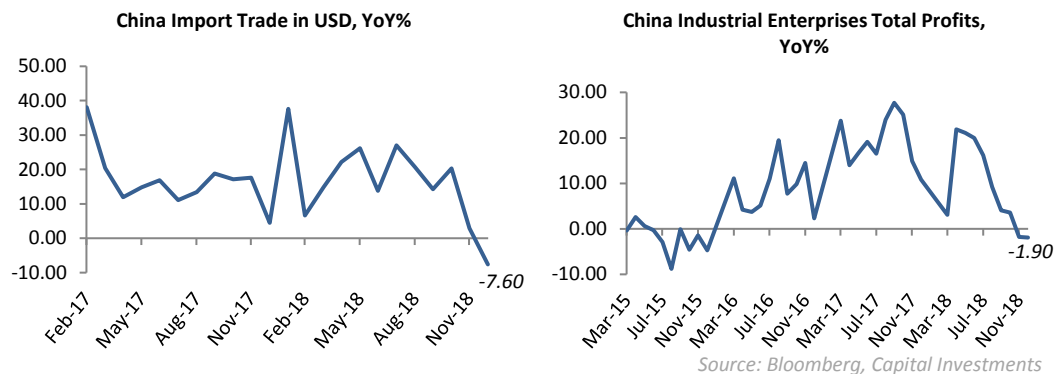
Source: Bloomberg, Capital Investments

Although the economy is still expected to grow above 2%, the general trend is pointing to a slowdown. Interestingly enough, initial jobless claims along with the unemployment rate appear to be bottoming while the homebuilding sentiment is showing signs of a rebound as indicated by the National Association of Home Builders index. This index may be indicating that the Fed tightening cycle is reaching an end and that a turning point for both the housing and car sectors may take place at year-end if the data shows an upward trend.

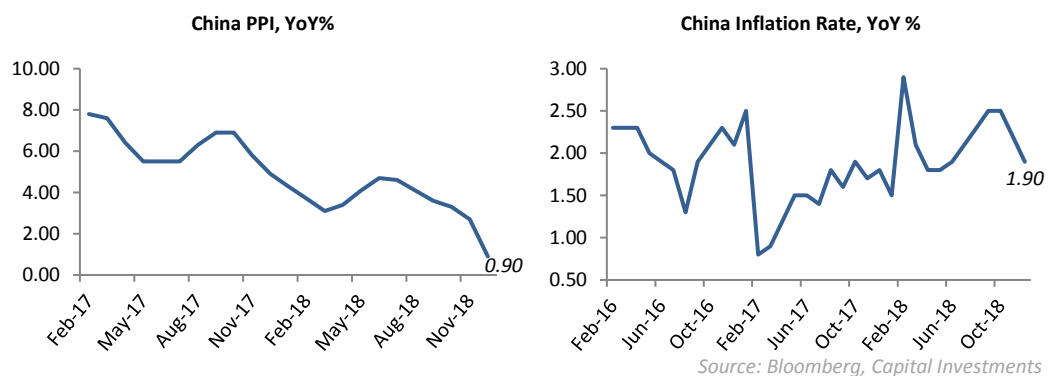


Source: Bloomberg, Capital Investments

In Europe, a record low unemployment rate is not saving the moment. Europe is suffering from the China effect. China is a major export market for Europe and a drop in the Chinese imports as illustrated in the graph below is negatively impacting industrial production in Europe, and thus its overall economic activity in the absence of muted domestic consumption. Although Germany took some measures last year to boost purchasing power including pension and welfare increases and a cut in taxes and social contribution, this will not be enough to save the moment in the absence of a full-scale fiscal stimulus.



Given the deterioration in China’s economic activity, policymakers are pursuing a proactive fiscal policy to support the economy. The government is considering a wider budget deficit of 2.8% of GDP than the 2.6% originally planned. China is adopting smart measures by relying on targeted fiscal measure rather than on pure credit growth. The government is enacting tax cuts and focusing on infrastructure investing and on reforming the state-owned enterprises, all this with the aim to stabilize the employment, financing, trade, and foreign capital activities. In addition, the government is trying to guarantee adequate liquidity in the system either through cutting the reserve requirement ratio for banks or by lowering interbank rates which is reflecting positively on borrowing costs. Yields on both swaps and long sovereign bonds have dropped which may encourage some activity but given tight narrow money supply, as indicated by the tightening M1, recovery will need some time to materialize. Given that China is the only country adopting both expansionary fiscal and monetary policies, we think that the divergence in growth between the US and China will narrow as the US will slow and the Chinese economy will gain track by year-end.



The two charts above show that China’s Producer Price Index has dropped below the Consumer Price Index which explains that the disinflationary trend in China is not over yet and given that China is the manufacturing hub of the world, this in part explains the lower inflation that we have been experiencing. In the table below, the PMI data indicate a slow trend across the board.

Purchasing Managers Indices (PMI) (2017-2018):											
	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan
Global Manufacturing	53.2	53.4	53.0	52.9	52.7	52.5	52.1	52.0	51.9	51.4	50.7
Global Services	53.2	53.8	54.3	54.6	54.0	53.5	52.9	53.4	53.7	53.0	52.6
Global Composite	53.2	53.8	54.0	54.2	53.7	53.4	52.8	53.0	53.2	52.7	52.1
US Manufacturing	59.3	57.9	58.7	60.0	58.4	60.8	59.5	57.5	58.8	54.3	56.6
US Services	58.7	57.2	58.9	58.7	56.7	58.8	60.8	60.0	60.4	58.0	56.7
US Manuf. New Orders	62.4	61.7	62.9	63.0	60.8	64.5	61.5	58.0	61.8	51.3	58.2
EU Manufacturing	56.6	56.2	55.5	54.9	55.1	54.6	53.2	52.0	51.8	51.4	50.5
EU Services	54.9	54.7	53.8	55.2	54.2	54.4	54.7	53.7	53.4	51.2	51.2
EU Composite	55.2	55.1	54.1	54.9	54.3	54.5	54.1	53.1	52.7	51.1	51.0
China Manufacturing	51.5	51.4	51.9	51.5	51.2	51.3	50.8	50.2	50.0	49.4	49.5
China Services	54.6	54.8	54.9	55.0	54.0	54.2	54.9	53.9	53.4	53.8	54.7
China Manuf. New Orders	53.3	52.9	53.8	53.2	52.3	52.2	52.0	50.8	50.4	49.7	49.6

\* PMI reading above 50 indicates economy expansion

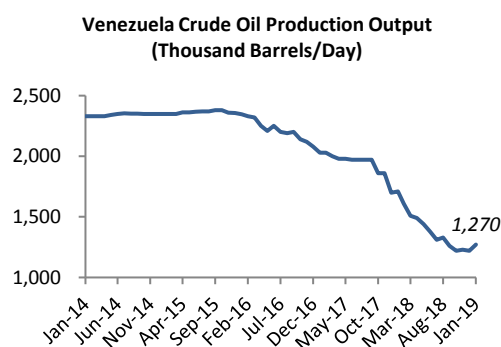
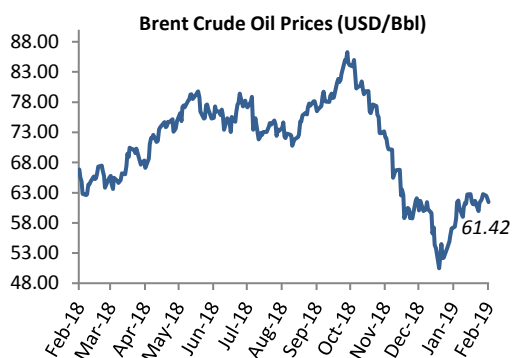
\* Red points displayed within the lines above indicate highest point in the range

\* Figures in green indicate acceleration from previous month, while red indicate deceleration

Source: Bloomberg, Capital Investments

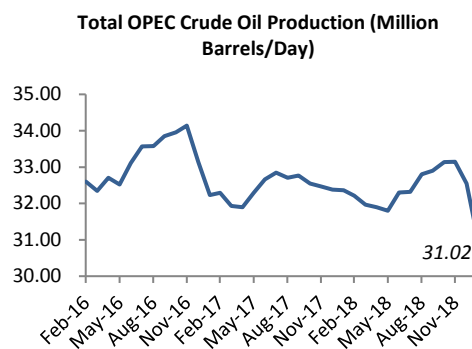
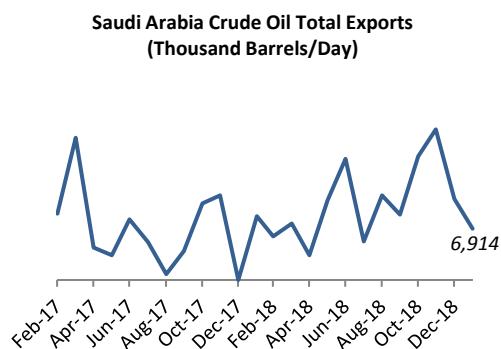
### Oil: The Venezuelan Catalyst

We maintain our bullish stance on oil, as the market seems to be rebalancing with a potential catalyst from Venezuela just around the corner. The market’s dynamics remain positive on the demand side as, according to the IEA, a demand boost from lower oil prices will counter a slowing economy in 2019. The IEA sees oil consumption increasing in 2019 to reach 1.4 mln b/d, which is slightly higher than last year’s expansion of 1.3 mln b/d.



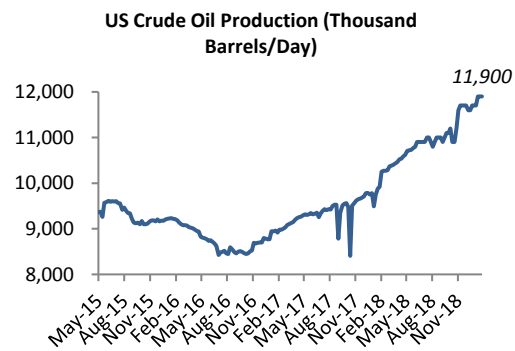
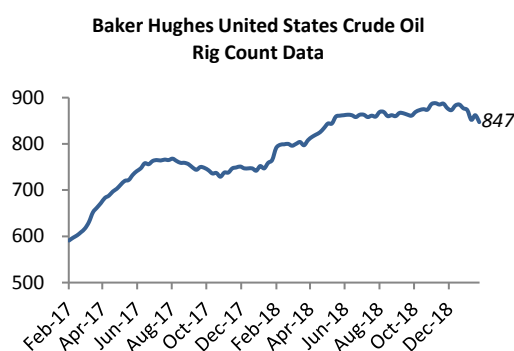
Source: Bloomberg, Capital Investments

Numerous factors on the supply side should also be supportive to oil prices. Saudi Arabia has pledged an even deeper oil cut in February under the OPEC deal which, as seen below, is already being reflected in lower exports. Additionally, fragile countries such as Libya, Iran, Nigeria, and mainly Venezuela, are not going to be able to deliver their production targets.



Source: Bloomberg, Capital Investments

Furthermore, according to few analysts expansion in US shale drilling is slowing, and US oil output is expected to grow by 1.5 mln b/d in 2019, down from 2.2 mln b/d in 2018. The U.S government’s decision to impose sanctions on Venezuela’s oil company is essentially a ban on selling the country’s crude to the US and potentially across the world. The sanctions on Venezuela, not to mention the political unrest there, should raise the risk for further supply disruptions.



Source: Bloomberg, Capital Investments

### MENA: A Review of the 2018 IMF Article IV Consultation on the UAE

The IMF issued its Article IV Consultation report on the UAE. According to the report, the UAE’s growth is expected to improve over the next few years on the back of higher oil prices, increased investment, improved prospects in trading partners, and a boost in tourism from Expo 2020. Overall real GDP growth is projected at around 3.7 percent for 2019–20. Non-oil growth is predicted to increase to 3.9% in 2019, and 4.2% in 2020, up from 2.5% in 2017, as the economy gradually recovers from a slowdown caused by the decline in oil prices. The IMF also expects an increase in the private sector’s contribution to the nonoil growth.

	2015	2016	2017	2018	2019
Current Account Balance, (% of GDP)	4.9	3.7	6.9	7.1	7.9
Real oil GDP, (%)	5.2	2.6	-3.0	2.9	3.1
Real nonoil GDP, (%)	5.0	3.2	2.5	2.9	3.9
CPI inflation (% average)	4.1	1.6	2.0	3.5	1.9
Adjusted nonoil primary balance, (% of GDP)	-27.7	-21.9	-25.7	-30.0	-27.0

Source: IMF, Capital Investments

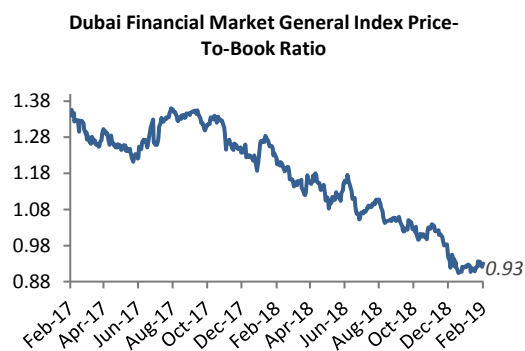
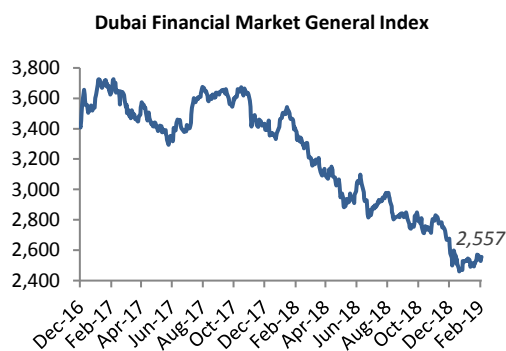
The IMF report commends the UAE's strong policy response to the numerous external shocks it has faced over the past few years. As shown in the diagram below, the UAE authorities have announced a series of structural reforms in 2018 in order to boost the nation's growth and competitiveness. Such reforms include lowering fees and easing business licensing and registration, introduction of long-term residence visas for professionals, as well as a reduction in electricity tariffs for the industrial sector. Moreover, fiscal easing and increased public spending are expected to further support the economy. Abu Dhabi, for instance, is planning to invest USD 13 billion over the next three years, besides Dubai's USD 6 billion investment for Expo 2020. The IMF expects the primary balance to turn into a surplus next year, and that fiscal consolidation will resume after 2020 as private sector activity picks up.

Government Fees	Business Licensing	Business Promotion	Foreign Investment and Resident Visas
Businesses with expired trade licenses (for more than 24 months) exempted from paying delayed and accumulated fees, provided they apply for license renewal, liquidation or cancellation <b>(Abu Dhabi)</b>	Instant licensing systems for most commercial activities to be implemented <b>(Abu Dhabi)</b>	A new local Production and Procurement Support Program encourages public institutions and large companies to procure from local suppliers <b>(Dubai)</b>	10-year residency visas introduced for specialists in medical, scientific, research and technical fields, entrepreneurs and exceptional students; 5-year residency allowed for other students. Visa extensions eased for dependents and graduating students. 5-year renewable residency visas announced for retirees
All government fees frozen for three years in <b>Dubai</b> . Private school fees frozen in 2018/19	Companies operating in <b>Dubai</b> exempted from late license renewal fines till end-2018	New initiatives to facilitate eco-tourism to be developed <b>(Abu Dhabi)</b>	100% foreign ownership of UAE-based businesses allowed in selected sectors
<b>Dubai</b> municipality market fee halved to 2.5% and 19 fees in aviation industry eliminated	All new business licenses exempted from the requirement of having a registered office or a work space for two years and permanent home licenses allowed <b>(Abu Dhabi)</b>	Abu Dhabi Accelerators and Advanced Industries Council ("Ghadan") to be established to support high value-added investments <b>(Abu Dhabi)</b>	Dual licenses allowed for companies operating in free zones, enable enabling on-shore operations and to participate in public procurement tenders
Selected companies to be exempted from fines and penalties accumulated as of end-2017 <b>(Dubai)</b>		A target of creating 10,000 jobs for nationals in the next five years announced	A review of all fines in the healthcare and education sectors initiated
Late payment fees on property registration waives (4 percent if not registered within 60 days) <b>(Dubai)</b>		Accelerated settlement of all delayed payments to private sector contractors announced <b>(Abu Dhabi)</b>	A review of real estate and infrastructure building regulations initiated with a view to easing compliance

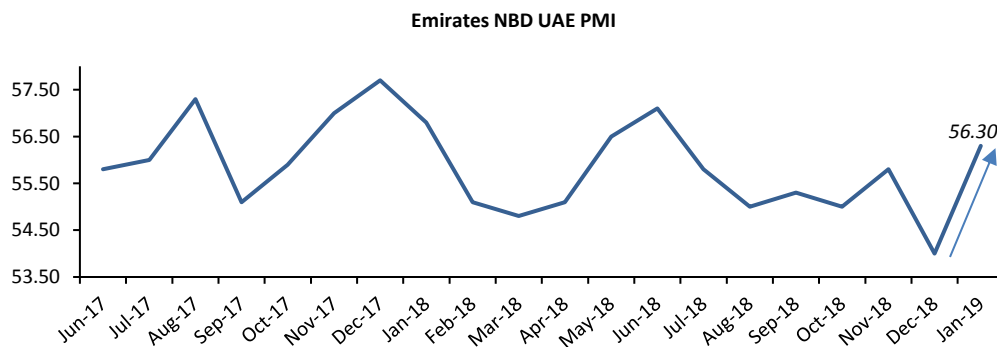
Source: IMF, Capital Investments

The UAE’s financial sector has also demonstrated some resilience. Banks’ profitability has improved due to higher interest margins, whilst Capital Adequacy has remained above 18% in Q2 2018. Although NPLs have risen to 7% in Q2 2018, they remain fully provisioned. Moreover, the banking sector has witnessed some recovery in credit growth, mostly to construction, trade, and manufacturing, owing to improved liquidity from increased government deposits.

The UAE authorities are more optimistic than the IMF about their growth outlook, arguing that favorable liquidity conditions will accelerate private sector lending, and that the impact of the announced fiscal stimulus could materialize at an earlier stage. Nonetheless, nonoil growth is expected to average 3.5% in the period between 2021-23, as the fiscal stimulus is phased out and Expo 2020’s hype fades away. Any improvement in the UAE’s growth prospects will offer some relief to the real estate market there and bring some flow into its deeply undervalued stock market.



Source: Bloomberg, Capital Investments



Source: Bloomberg, Capital Investments

Major Indices	Status as of end		Performance	
	December. 2018	January. 2019	January.2019	YTD (31 January. 2019)
<b>MENA</b>				
Abu Dhabi	4,915.07	5,044.85	2.64%	2.64%
Bahrain	1,337.26	1,391.42	4.05%	4.05%
Dubai	2,529.75	2,567.59	1.50%	1.50%
Egypt	13,035.77	14,126.68	8.37%	8.37%
Jordan	1,908.81	1,951.62	2.24%	2.24%
Kuwait	5,267.36	5,430.10	3.09%	3.09%
Lebanon	976.75	946.56	-3.09%	-3.09%
Morocco	11,364.31	11,350.73	-0.12%	-0.12%
Oman	4,323.74	4,166.47	-3.64%	-3.64%
Palestine	529.35	531.12	0.33%	0.33%
Qatar	10,299.01	10,720.31	4.09%	4.09%
Saudi Arabia	7,826.73	8,559.95	9.37%	9.37%
Tunisia	7,271.65	7,262.05	-0.13%	-0.13%
S&P Pan Arab Composite	728.72	775.67	6.44%	6.44%
Dow Jones MENA	556.65	591.38	6.24%	6.24%
<b>Americas</b>				
Dow Jones Industrial	23,327.46	24,999.67	7.17%	7.17%
S&P 500	2,506.85	2,704.10	7.87%	7.87%
NASDAQ Composite	6,635.28	7,281.74	9.74%	9.74%
S&P/Toronto Composite	14,322.86	15,540.60	8.50%	8.50%
<b>Europe</b>				
EURO Stoxx 50	3,001.42	3,159.43	5.26%	5.26%
S&P Europe 350 Index	1,367.94	1,451.54	6.11%	6.11%
FTSE 100 Index/ London	6,728.13	6,968.85	3.58%	3.58%
FTSE MIB Index/ Italy	18,324.03	19,730.78	7.68%	7.68%
DAX Index/ Germany	10,558.96	11,173.10	5.82%	5.82%
<b>ASIA/Pacific</b>				
NIKKEI 225/ Japan	20,014.77	20,773.49	3.79%	3.79%
S&P/ASX 200/ Australia	5,646.40	5,864.65	3.87%	3.87%
<b>BRIC</b>				
Brazil/ Bovespa	87,887.26	97,393.74	10.82%	10.82%
Russia/ RTS	1,066.13	1,214.45	13.91%	13.91%
India/ Bombay Sensitive	36,068.33	36,256.69	0.52%	0.52%
China/ Shanghai Composite	2,493.90	2,584.57	3.64%	3.64%
Hong Kong/ Hang Seng	25,845.70	27,942.47	8.11%	8.11%

Source: Bloomberg, Capital Investments

Description	Closing Prices as of end		Performance	
	December. 2018	January. 2019	January.2019	YTD (31 January. 2019)
<b>Commodities (in USD)</b>				
Brent Spot (Barrel)	53.17	60.91	14.56%	14.56%
WTI Cushing Spot (Barrel)	45.41	53.79	18.45%	18.45%
Natural Gas NYMEX (MMBtu)	2.85	2.81	-1.30%	-1.30%
Gold Spot (OZ)	1,282.45	1,321.20	3.02%	3.02%
Silver Spot (OZ)	15.50	16.06	3.67%	3.67%
Copper LME Spot (MT)	5,949.00	6,151.25	3.40%	3.40%
Corn CBOT Active Month (Bushel)	3.75	3.77	0.40%	0.40%
Wheat CBOT Active Month (Bushel)	5.03	5.17	2.63%	2.63%
Soybean CBOT Active Month (Bushel)	8.95	9.15	2.26%	2.26%
Rough Rice Futures (USD/cwt)	10.10	10.61	5.10%	5.10%
<b>Currencies Spot Exchange Rates Against US Dollar</b>				
Euro	1.15	1.14	-0.17%	-0.17%
GBP	1.28	1.31	2.78%	2.78%
CAD	0.73	0.76	3.91%	3.91%
Yen	0.01	0.01	0.69%	0.69%
CNY	0.15	0.15	2.66%	2.66%

Source: Bloomberg, Capital Investments

## Capital Investments

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