Insight INVESTMENT

GLOBAL MACRO RESEARCH
TARIFFS AND TRADE WARS

IMPLICATIONS OF A SECOND TRUMP PRESIDENCY

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EXECUTIVE SUMMARY

- This paper explores the implications of a second Trump presidency on the US and its trading partners, and the second-order implications of a more restrictive US trade regime.
- In the event of a second Trump presidency, we believe all countries that are currently in a trade surplus with the US will be negatively impacted by the imposition of tariffs. However, we do not expect the US to apply tariffs on all countries at once.
- We believe China will represent the primary target of any trade restrictions and a second Trump administration will aim to prevent policy circumvention by corporates funnelling trade to China via third-party countries. We expect any tariffs imposed on China to be larger than those imposed on other countries.
- Canada and Mexico will fall under the protection of the United States-Mexico-Canada Agreement (USMCA) and may remain unaffected until the sunset clause timing triggers. On 1 July 2026, the US, Mexico and Canada will confirm in writing whether to continue the agreement. If any party chooses not to continue, a joint review will occur every year for the following 10 years to try to resolve the issue, with the agreement terminating at the end of this process if no consensus can be reached.
- A number of other countries appear in notable positions:
  - Vietnam will likely be impacted disproportionately because of the size of its trade surplus with the US in relation to its economy.
  - South Korea will also be heavily impacted given the importance of US trade to its tech industries.
  - India and Brazil both have high tariffs on imports so are vulnerable to US countermeasures.
- Other countries, including those in Europe, would likely see a reduction in trend growth of at least 0.2% per annum – a meaningful impact.
- The markets are currently focused on inflation proving stickier than expected. If President Trump is re-elected and succeeds in lowering taxes and raising tariffs it is likely to increase inflation, although lower gasoline prices could cushion the impact. This could prevent the Fed from easing or even result in higher rates if inflation meaningfully reaccelerated, which could provide another upward leg to the US dollar bull market. However, a second Trump administration would likely pursue a weaker dollar and, if Robert Lighthizer becomes Treasury Secretary, a formal weak dollar policy is a real possibility.

It is fair to say that the range of possible outcomes would increase significantly in a second Trump term, and this is likely to result in a complex and choppy outlook for the US dollar.

BACKGROUND:
TRUMP'S PREVIOUS TRADE POLICIES

The first Trump administration attempted a partial re-orientation of US trade policy away from the decades-long dominance of free-trade. Accordingly, the administration instituted a series of tariffs which primarily targeted China, but affected other US trade partners, including the EU, Canada and Mexico.

President Trump's break with the free-trade consensus derived from his belief that several US trading partners had taken advantage of it, pointing to large US trade deficits as evidence. Accordingly, the administration argued applying tariffs would protect American industries, jobs, reduce the trade deficit and promote "fairer" trade practices. The administration imposed tariffs on a wide range of goods, including steel, aluminium and a plethora of Chinese imports.

The administration justified the imposition of tariffs on several grounds, including national security (invoking Section 232 of the Trade Expansion Act of 1962) and unfair trade practices (Section 301 of the Trade Act of 1974). By the end of President Trump's term, his administration had levied tariffs on Chinese goods worth approximately $350bn.

The administration argued applying tariffs would protect American industries, jobs, reduce the trade deficit and promote "fairer" trade practices.

THE IMPACT ON US GROSS DOMESTIC PRODUCT

Unsurprisingly, applying tariffs on its significant trading partners led to multi-faceted and complex effects on US consumption, investment and trade balances. While they were intended to protect American industries and reduce the trade deficit, the results were mixed, as set out below.

CONSUMER SPENDING AND PRICES

Tariffs increase the cost of imported goods, leading to higher prices for consumers. Higher prices can lead to reduced consumer spending with households allocating more of their budget to cover the higher cost of goods affected by tariffs. For example, the tariffs implemented by the Trump administration on Chinese electronics and appliances meant American consumers faced increased costs. Accordingly, the New York Federal Reserve estimated that Trump's tariffs increased the cost of goods for the average US household by approximately $831 annually.[1] These higher pass-through costs reduced consumers' disposable income, dampening overall consumer spending, which accounts for 68% of US GDP.[2]

BUSINESS INVESTMENT AND SUPPLY CHAINS

President Trump's tariffs also created higher costs for business, impacting their investment decisions. For example, companies that rely on imported materials faced higher productions costs, leading to lower profit margins and reduced capital for investment. Additionally, the uncertainty surrounding trade policy made businesses hesitant to commit capital to long-term investments.

[1] https://libertystreeteconomics.newyorkfed.org/2019/05/new-china-tariffs-increase-costs-to-us-households/, May 2019.
[2] US Bureau of Economic Analysis, May 2024, data as at March 2024.

Many American manufacturers, particularly those in the automotive and technology sectors, faced increased costs for components imported from China and other countries. Some companies attempted to preserve margins by passing these costs on to consumers, while others absorbed them, lowering profitability. In addition, corporates delayed planned expansions and investments, negatively affecting GDP growth.

Moreover, the disruption of global supply chains forced some companies to restructure their operations, which involved significant costs and inefficiencies. For example, the tariffs led to a re-evaluation of supply chains, with some businesses relocating production to other countries to avoid tariffs, further complicating their logistics.

TRADE DEFICIT AND EXPORTS

While reducing the US trade deficit represented a stated aim of President Trump's imposition of tariffs, it did not significantly fall. One contributing factor was the retaliatory measures implemented by other countries, particularly China, with tariffs imposed on targeted US exports, such as agricultural products. As a result, demand for US goods abroad fell.

US farmers were particularly affected by Chinese retaliatory measures on key US agricultural exports like soybeans, pork and corn. In response, the Trump administration provided aid packages to support affected US farmers, totalling billions of dollars. Despite their cost, the support packages provided to farmers offered only partial relief, with famers still subject to lost export revenue. Moreover, the uncertainty generated by the tit-for-tat retaliation made long-term planning difficult for farmers.

LONG-TERM ECONOMIC EFFECTS

The long-term effects of the Trump administration's tariffs on GDP are still unfolding. While some industries may benefit from the protection against foreign competition, the overall economy faces several challenges. In addition, the increased costs of goods and disrupted supply chains have long-term implications for American competitiveness.

Some studies suggest that the tariffs could lead to a permanent reduction in GDP. The National Bureau of Economic Research (NBER) estimated that the first Trump administration's tariffs could reduce US GDP by about 0.4% per annum in the long run.[3] This was attributed to the inefficiencies tariffs generally introduce, such as misallocated resources and reduced economic integration.

Additionally, the tariffs may have long-lasting effects on global trade relationships. Heightened uncertainty could lead to a reconfiguration of global supply chains, with countries seeking to reduce their reliance on the US market. Such a shift could diminish the role of the US in the global economy, further impacting long-term GDP growth.

SUMMING UP PRESIDENT TRUMP'S PREVIOUS TARIFFS

While they were intended to protect American industries and reduce the trade deficit, the Trump administration's tariffs produced mixed results. Higher consumer prices, disrupted supply chains, reduced business investment and retaliatory tariffs from other countries all contributed to a complex economic environment. The immediate effects included higher costs for consumers and businesses, reduced export demand, and increased uncertainty.

Over the longer term, the tariffs could lead to a permanent reduction in GDP and a reconfiguration of global trade relationships. As the global economy continues to evolve, the full impact of these tariffs will become clearer, but it is evident that the policy shift marked a significant departure from previous trade practices, with wide-ranging implications for the US economy.

[3] The Economic Impacts of the US-China Trade War, National Bureau of Economic Research – Working paper 29135, December 2021.

TRUMP II:
THE SEQUEL

ASSESSING PRESIDENT TRUMP'S POTENTIAL FUTURE TRADE POLICY

To anticipate the likely trade polices of a second Trump administration, we believe taking instruction from past experience, as explored above, and the utterances and publications of key officials is the best way to gauge the potential policies. Recent statements from Peter Navarro, the former Director of the White House Office of Trade and Manufacturing Policy; Robert Lighthizer, the former US Trade Representative; and statements from President Trump himself may offer some illumination.

Statements from key administration personnel

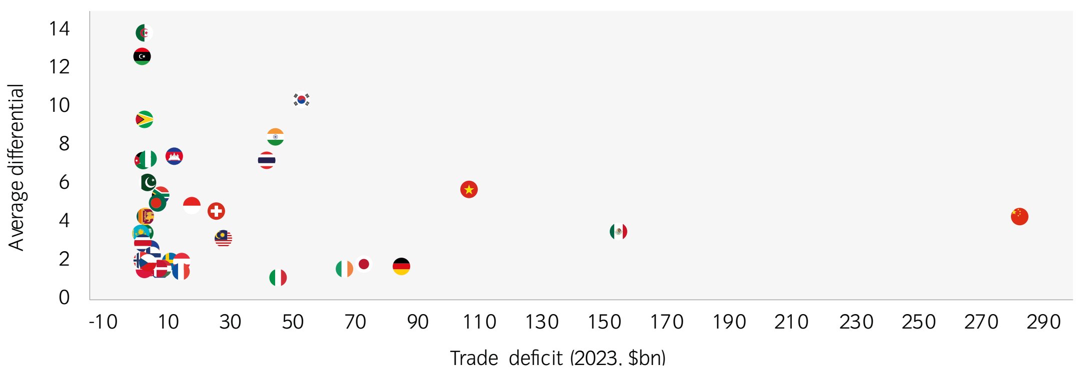
Peter Navarro has written: "both the unfair, unbalanced, and nonreciprocal trade institutionalized by the WTO and Communist China's economic aggression are weakening America's manufacturing and defense industrial base."[4] Navarro has also called for a universal baseline tariff on all imports, which can be raised on countries that engage in "unfair" trade practices, as well as formulating several policy proposals specifically aimed at China.

Meanwhile, Robert Lighthizer advocates raising tariffs on imports, most recently in The Economist[5] and his book, No Trade Is Free: Changing Course, Taking on China, and Helping America's Workers.[6] According to Lighthizer, tariffs have the added advantage of existing within the control of the White House. In his book, he suggests tariffs should be imposed on all imports "at a progressively higher rate, year after year until we achieve balance"[6] between the US and its trading partners, offering 10% as a minimum opening bid.

President Trump's own statements indicate tariffs are the preferred tool for his new administration, with the candidate offering a 10% tariff in every good coming into the US, as well as a tariff of 60% on all Chinese imports.

The positions outlined above indicate tariffs are the preferred tool for implementing a second Trump administration's vision of fairer trade between the US and its trading partners. In addition, the administration will likely use tariff differentials between the US and its trading partners to identify target countries.

Figure 1: Tariff differentials between the US and trading partners[7]



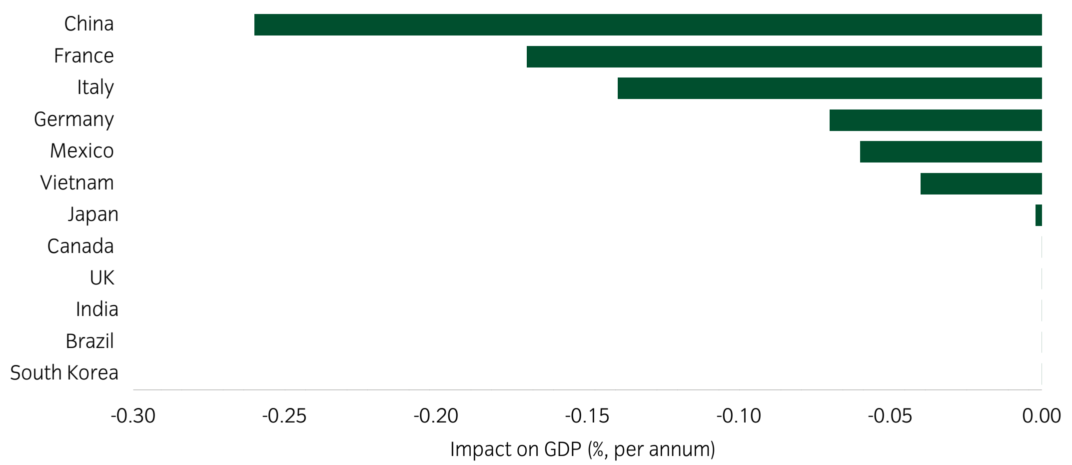
Taking the statements outlined above as a basis, we have estimated the effects of three potential scenarios outlined below.

[4] https://static.project2025.org/2025_MandateForLeadership_CHAPTER-26.pdf
[5] https://www.economist.com/by-invitation/2024/03/08/donald-trumps-former-trade-chief-makes-the-case-for-more-tariffs
[6] Robert Lightizer, No Trade Is Free: Changing Course, Taking on China, and Helping America's Workers, Broadside Books, August 2023.
[7] US Census Bureau, World Bank and Insight Investment, as at 6 May 2024.

SCENARIO 1 Partner countries forced to reduce tariffs to match US tariff rates

In this scenario, US partner countries are forced to lower their own tariffs to match those applied by the US. Overall, this strategy would prove least impactful overall, as exhibited in Figure 2.

Figure 2: Potential impact on annual GDP of key countries in scenario 1[8]



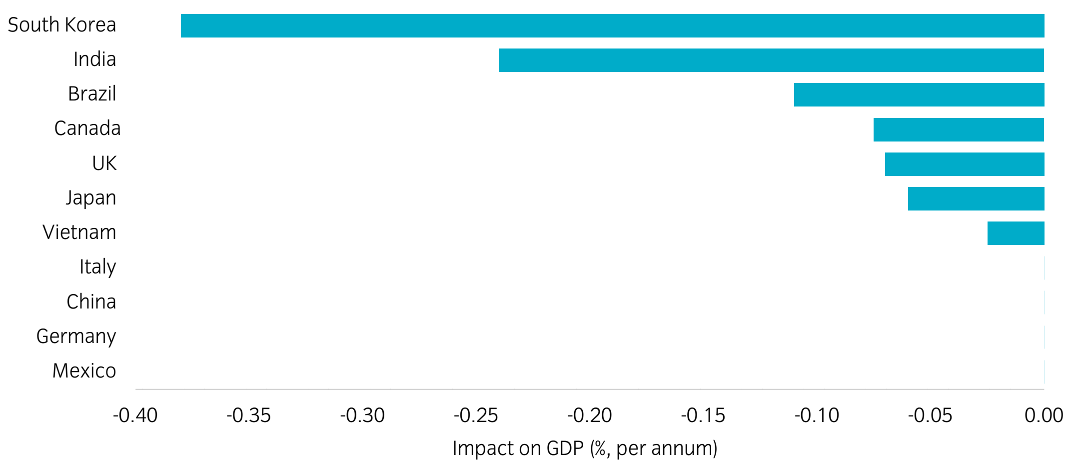
The most impacted countries are those which import a greater proportion of goods from the US. Unsurprisingly, the reduction of partner countries' tariffs boosts imports from the US and lowers net exports, producing a slightly negative impact on the affected countries' GDP. For example, South Korea, a large importer of US goods, would feel the largest impact on its economy, amounting approximately 0.25%. Likewise, Brazil and India would also experience proportionally larger impacts, due to higher tariff walls, than Europe or Mexico and Canada, with the latter two countries partners to the USMCA trade agreement.

Despite the relatively low negative impact, this first scenario is the least likely of the three possible regimes for one crucial reason: China is unaffected, which is the primary target of Navarro and Lighthizer.

SCENARIO 2 US raises tariffs to match its partners existing tariff rates

Our second scenario envisages the US lifting its own tariff rates to match those of its partners. Rather than increasing the cost of imports for trading partners, the economic cost from this policy stems from falling exports to the US and produces a larger negative impact on US trading partners than Scenario 1.

Figure 3: Potential impact on annual GDP of key countries in scenario 2[9]



Again, South Korea, Brazil and India face the largest long-run negative impacts to their economies for the same reasons outlined in Scenario 1. Likewise, China remains insulated, given its large positive trade balance and the

[8, 9] Insight, as at June 2024.

relatively closed nature of its economy.

SCENARIO 3 Blanket at least 10% applied across the board and 60% applied to China

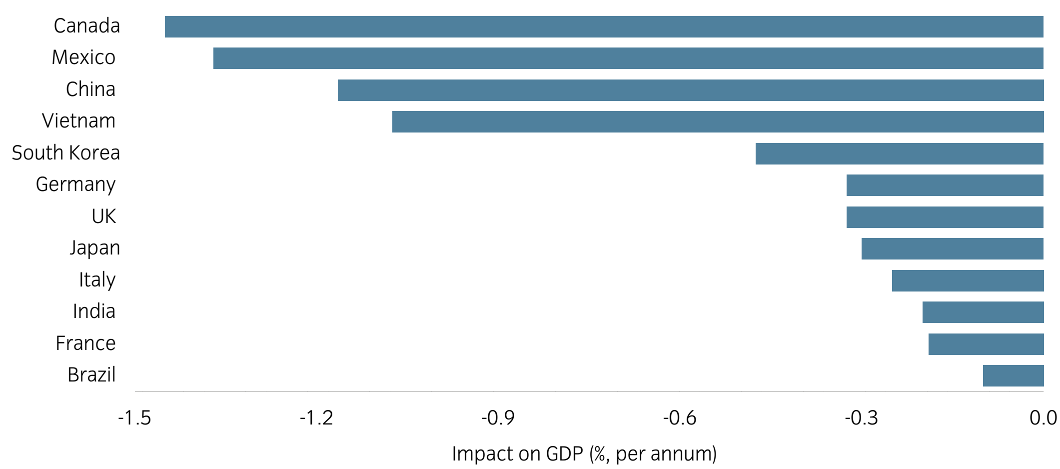
In our final scenario, the US unilaterally lifts tariffs to at least 10% and applies a 60% rate on imports from China. Unsurprisingly, all countries on our list experience much larger GDP reductions.

We have included Canada and Mexico in our assumptions for Scenario 3, despite the protection afforded by their membership of the USMCA. This is because the agreement has a sunset clause by 2026 which, if triggered, leaves both economies facing the comparatively larger long-run economic losses than other trading partners.

With the application of a 60% tariff rate China faces a much larger negative impact to its GDP of -1.2% per annum. Likewise, Vietnam will also experience comparatively higher effects due to the high proportion of exports relative to its GDP, with South Korea facing the same challenges outlined in Scenarios 1 and 2 more acutely.

For Europe, we estimate a reduction in growth of around -0.2% per annum, which, while relatively small versus the losses faced by the other economies analysed, represents a significant proportion of trend growth.

Figure 4: Potential impact on annual GDP of key countries in scenario 3[10]



KEY POTENTIAL LOSERS FROM HIGHER US TARIFFS

Looked at in aggregate, the countries most likely to be affected by a widespread application of tariffs are:

- China, because of bipartisan political support in the US for policies that prioritise US interests versus China;
- South Korea, because of the high value of its trade with the US (both exports and imports) as a proportion of its GDP;
- Vietnam, because of the size of its exports to the US as a proportion of GDP; and
- India and Brazil, because of their high tariffs in comparison to the US, raising the risk of countermeasures.

[10] Insight, as at June 2024.

CONSEQUENCES AND RESPONSES

TRADE PARTNERS’ CURRENCY PLANS

Currency devaluation is one possible response to the imposition of tariffs. We think South Korea will allow the won to devalue, while India will manage the decline of the rupee to align with the US tariff schedule.

How China reacts is something of an uncertainty without knowing the motivation behind a particular policy decision. For example, Chinese authorities may wish to project the renminbi as a symbol of Chinese stability and importance and hold its value steady against the dollar. Conversely, if the Chinese administration wishes to prevent outflows, or maintain the renminbi as an attractive store of value, then policymakers are more likely to let the currency weaken to offset tariffs.

EFFECT OF RETALIATORY MEASURES ON US GDP

Raising tariffs in a such a dramatic fashion is likely to result in retaliatory responses from, most significantly, Europe and China. The US exports $167bn to China and Europe buys $270bn of US goods. We must assume that growth will be more affected than the above estimates indicate on a global scale.

If Europe, China and other trading partners retaliate in kind, tariffs imposed on the US are likely to have negative direct and indirect effects on US GDP. However, tax cuts funded by tariff revenue could provide at least a partial offset. Below, Figure 5 provides an estimation of how US tariffs and retaliatory tariffs might affect US GDP.

Figure 5: Channels through which tariffs could impact US GDP[11]

Effect	Description	Estimaded peak impact of 1pp increase in effective tariff rate on GDP level
	Direct effects	
Real income effect	Import tariffs raise consumer prices, lower real income and lower consumption.	-0.09%
Net trade effect	Import tariffs lower import volimes, though retaliatory tariffs could lower export volumes.	+0.06%
Total of direct effects		-0.03%
	Indirect effects	
FCI effect	Trade conflict tightens financial conditions and imposes impulse on GDP, for instance via a negative equity wealth effect on consumption.	-0.1%, but highly uncertain
Policy uncertainty effect	Trade conflict lowers capex as firms wait for trade policy uncertainty to resolve before making irreversible spending decisions.	Modestly negative
Business sentiment effect	Trade conflict makes firms pessimistic about the outlook, which in turn leads them to invest, hire or produce less.	Modestly negative
Supply chain reshuffling effect	Import tariffs raise input costs of US producers. Hence, US producers buy more untargeted goods including US inputs and/or lower activity.	Likely negative
	Retaliatory tariffs	
Net trade effect	Foreign tariffs imposed on US exports could lower export volumes. We assume that retaliatory tariffs would be 1-on-1.	-0.02%

[11] Goldman Sachs Global Investment Research.

Fiscal offers		
Under divided government	Congress is unlikely to pass legislation to spend the funds earned from tariffs.	0.00%
Under unified Republican control	Modest tariff increases would likely go toward deficit reduction, while larger increases would likely fund, for example, new tax cuts for middle-income households and small business or domestic manufacturing incentives. Tax cuts could also have positive indirect effects on GDP.	+0.00% to +0.08%

Total impact of a 1pp increase in the effective tariff rate on the level of GDP in a scenario with...

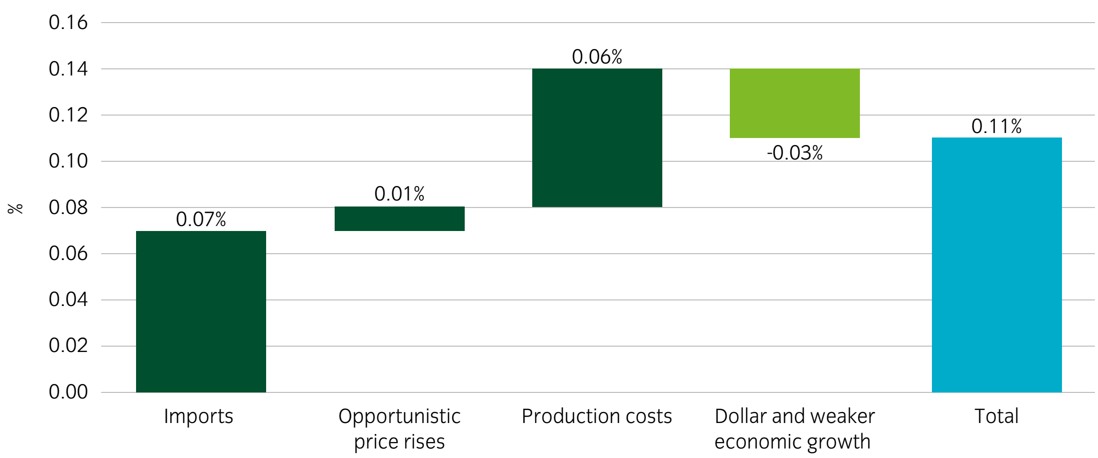
	Retaliatory tariffs	No retaliaton
Tax cuts	-0.07%	-0.05%
No tax cuts	-0.15%	-0.13%

EFFECT OF TARIFFS ON DOMESTIC US INFLATION

According to one estimate, for every percentage point increase in the US effective tariff rate, core personal consumption expenditures would rise by slightly more than 0.1%. This increase reflects:

- the full pass through of tariffs to the price of directly imported consumer goods, increasing core prices by 0.07%;
- domestic producers of tariffed goods opportunistically raising prices, contributing another 0.01%;
- producers passing higher input costs through to consumers at a greater rate than usual due the broad-based nature of higher input costs, increasing prices by 0.06%; and
- a weaker economy and stronger dollar tariff rate offsetting the increase by 0.03%.

Figure 6: Impact of a 1 percentage point increase in the US effective tariff rate on PCE inflation[12]



With higher tariffs leading to increased inflation, it seems incongruous that a populist administration would accept these consequences without attempting any policy changes to offset the negative impact on voters. Likewise, a stronger dollar could present problems in reducing the US trade deficit, given foreign goods will be cheaper than those produced domestically.

Given recent polling indicates inflation and prices represent some of the most important issues for American voters and President Trump's stated goal of reducing the US trade deficit,[13] we believe a second Trump administration would devote significant energy to solving these issues via two channels: dollar revaluation and oil production.

[12] Goldman Sachs Global Investment Research.
[13] The Economist/YouGov Poll, May 19-21 2024. 1784 US adult citizens.

THE COMPLEX ISSUE OF DOLLAR REVALUATION

THIS IS AN ENVIRONMENT THAT COULD PROVE POSITIVE FOR THE US DOLLAR

If President Trump is re-elected and succeeds in lowering taxes and raising tariffs it is likely to increase inflation. However, President Trump's commitment to "drill baby drill", increasing domestic oil production, could mitigate this impact to some extent if US energy prices fall. Stickier inflation could prevent the Fed from easing or even result in higher rates if inflation meaningfully reaccelerates, which could provide another upward leg to the US dollar bull market. This would obviously be compounded if those countries impacted by additional tariffs choose to devalue their currencies to mitigate the impact.

A STRONGER DOLLAR IS UNLIKELY TO BE WELCOMED BY A TRUMP ADMINISTRATION

Aligning with President Trump's overarching goal of reducing the US trade deficit, he has in the past consistently called for a weaker US dollar. In addition, Robert Lighthizer is speculated to be a candidate for the role of Secretary of the Treasury. Given Lighthizer's support for a lower trade deficit, we envisage a downward currency revaluation will be a priority for the new administration.

To achieve that aim, a Trump administration may be tempted to review the independence of the Federal Reserve and exert greater political control over monetary policy. During his first administration, Trump routinely criticised the Fed, regularly called for lower interest rates to boost the US economy and expressed dissatisfaction with Fed Chair Jerome Powell's decisions. For example, in 2019 he said Fed officials had "no guts, no sense, no vision".

However, moves to limit the independence of the Fed would likely prove controversial and any tampering with its operations could adversely affect the perception of US as a stable store of wealth.

This is likely to create a complex backdrop for the dollar, with markets likely to be choppy as investors try to anticipate the impact of policy responses from the US and impacted trading partners.

We envisage a downward currency revaluation will be a priority for the new administration.

KEY RISKS AND OPPORTUNITIES

Given the relatively dramatic changes to trade policy outlined above, we believe there are several key risks and opportunities that could follow if a second Trump administration can implement its agenda.

- **Second-order effects**

  The magnitude of second-order effects is incredibly hard to quantify and could dictate the outcome more than first-order effects. Much depends on the reaction function of policymakers (note: we assume a static FX rates in our scenarios), corporates' willingness and ability to pass on rising import prices to consumers, and sentiment feedthroughs resulting from asset-price performance. There is also significant uncertainty around the extent of supply-chain disruptions.

- **Domestic business investment**

  However, tariffs can boost domestic business investment in the US. This is especially true in the case of global, product-level tariffs. For instance, following the implementation of tariffs on steel and aluminium, $4bn of incremental expansion projects were announced in the sector. Likewise, the use of proceeds of tariffs, if directed towards fiscal expansion, can have positive effects on growth.

- **One-off inflationary shock**

  We also take the view that tariffs would mostly be a one-off inflationary shock as we expect increased substitutability over time to result in a levelling of prices across products. However, there is a non-negligible risk that corporates initially fight for market share and drop their margins, only to pass through high input costs at a later stage to capture the full benefit of pricing out competitors.

- **Geopolitical implications**

  The geopolitical implications of the current tensions are unclear. For instance, whilst China or Japan are unable to match US tariffs, they could extend their actions to other fields; for example through a boycott of US goods, the redirection of reserves, or increased tensions in the Korean peninsula, Taiwan and/or the South China Sea.

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Tariffs would mostly be a one-off inflationary shock as we expect increased substitutability over time.

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CONCLUSION

If President Trump wins a second term, we believe all the countries that currently run a trade surplus with the US will be negatively impacted by tariffs. Trade negotiations are very time consuming and challenging so it seems logical that the administration will not try to take on all countries at once.

China will be the primary target, and the administration will do its best to prevent policy circumvention through third-party countries. It would not be unreasonable to assume that China may face a 1% GDP hit from tariffs and other focused decoupling. The size of tariffs that China is likely to experience will be larger than elsewhere. There would be retaliation as there was last time and that will cost the US growth-wise. Canada and Mexico will fall under the protection of the USMCA and may remain unaffected until the sunset clause timing triggers. On 1 July 2026, the US, Mexico, and Canada will confirm in writing whether to continue the agreement, but it would take a decade to unwind even if one of the parties decided to terminate it.

Vietnam would likely be impacted disproportionately because of the size of its trade surplus with the US relative to the size of its economy, as would South Korea, given the importance of US trade to both imports and exports. India and Brazil both have high tariffs on US imports, so are vulnerable to countermeasures. Elsewhere, European countries would likely see their GDP reduced by at least 0.2% per annum, a decent proportion of trend growth.

For currency markets, the outlook appears complex. President Trump believes that both interest rates and taxes are too high. We believe it is possible he uses the remaining money from the Inflation Reduction Act, income from tariffs, defence-cost sharing and reduced aid to reduce taxes. But this would likely stimulate growth and lead to higher rates and upward pressure on the US dollar. However, a second Trump administration would likely prefer a lower dollar and, if Robert Lighthizer becomes Treasury Secretary, a weaker dollar policy is a real possibility. As a result, we could see increased political pressure on the Fed to keep rates lower than they would otherwise be.

It is fair to say that the range of possible outcomes would increase significantly in a second Trump term, and this is likely to result in a complex and choppy outlook for the US dollar.

CONTRIBUTORS

Mark Dragten
Head of Discretionary FX
Insight Investment

Peter Andrews
Investment Content Specialist
Insight Investment

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com

European Business Development
europe@insightinvestment.com

Consultant Relationship Management
consultantrelations@insightinvestment.com

North America Business Development
inquiries@insightinvestment.com

Australia Business Development
insightau@insightinvestment.com

company/insight-investment

www.insightinvestment.com

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