

Economic Update Q3 2025

The rally amidst the risks



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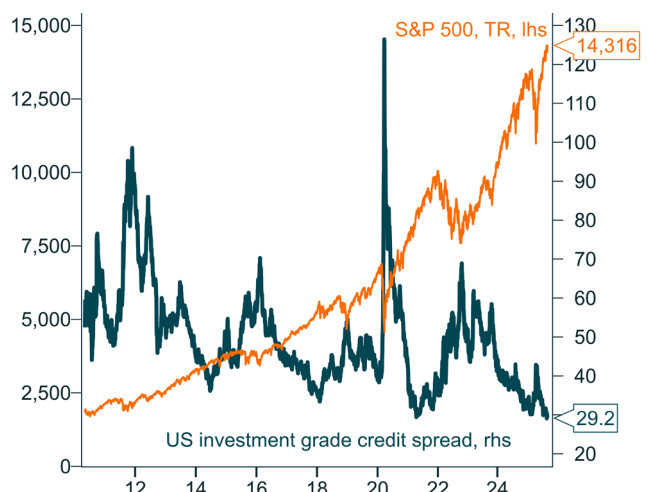
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Risk assets in the US have scaled new highs despite the ongoing uncertainty regarding the economic outlook and core fixed income is struggling to digest competing themes. Investors are rightly cautious about the US economy, leveraging geopolitical thematics near term to generate returns. Yet over the medium term the US economy and markets remain relatively attractive.

GLOBAL: US confidence misplaced or not?

While uncertainty in the global economy remains historically elevated, equity markets have shrugged off post-‘Liberation Day’ jitters to surge ahead. Indeed, the news flow around tariffs continued to be incrementally “less bad”, which has helped many advanced economy exchanges post all-time highs. There’s also been tailwinds from negotiated trade deals, key trade deals delayed, renewed AI optimism and better-than-feared corporate earnings all contributing to the apparent optimism. Also supportive was expansionary US fiscal policy that may provide an offset to tariffs in boosting the US economy, despite the question it raises around US fiscal sustainability. Even the bad news was viewed as good, with a deterioration in the soft data showing early signs of manifesting in the hard data as the US labour market begins to slow. This served to bolster expectations of rate cuts this year, supported by a relatively dovish speech by US Federal Reserve Chair Powell at Jackson Hole, viewed positively by markets. Further, mixed inflation data in the US has tempered concerns of a material tariff pass through at least in the near term. Investors seem to be discounting clear risks to the economic outlook and have pushed US equity valuations to historic highs and investment grade credit spreads to near historical tights. While downside risks may not be as acute as they were we believe investors may have become too sanguine given the high level of uncertainty and potential for the environment to change quickly.

GRAPH 01 US EQUITIES & CREDIT SPREADS



Source: IFM Investors, Bloomberg, via Macrobond

By contrast core fixed income markets in the US have drifted since 'Liberation Day', the 10-year yield dipping below 4.25% intermittently, but not being able to sustain that trend. This comes as the risk of soft stagflationary dynamics in the US persist. While some tariff deals have been largely done, notably the Eurozone and Japan, any resolution with China remains outstanding. While the US and China have stepped back from the brink of trade collapse, progress towards any binding agreement has been incremental without any breakthrough. As it stands President Trump has signed an executive order extending the negotiation period for another 90 days, pushing the deadline to 12 November - leaving core fixed income markets in limbo, unable to move emphatically in either direction. Lingering in the background is growing concern around the US fiscal position in the wake of the One Big Beautiful Bill Act (OBBBA). This is another source of uncertainty for growth and inflation and potentially concerning that such stimulatory fiscal policy be reflected in higher term yields. Higher starting yields in core fixed income and spread products may be attractive to investors but it remains an open question as to whether mark-to-market performance will be a tailwind and if confidence in the corporate sector will remain.

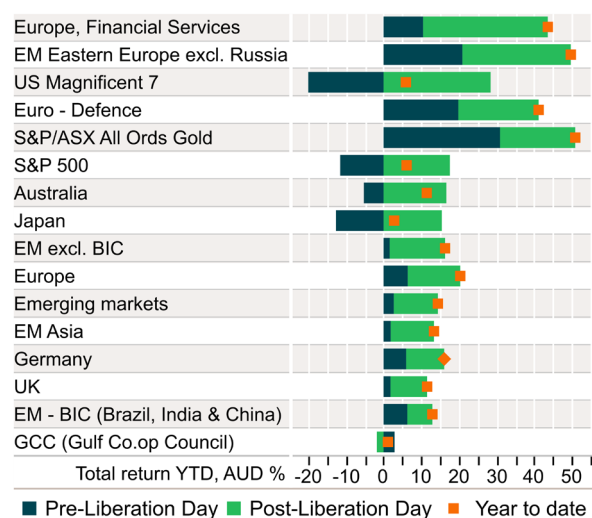
The volatility and uncertainty seen across trade, fiscal policy and consequently monetary policy in the US is characteristic of the evolving face of geopolitical risk - heightened risks for investors in previously low risk jurisdictions. This instance in particular has seemingly prompted a rotation into other advanced economy equity markets and emerging markets. But we'd assert that much of the performance leverages off shorter-term thematics and relatively attractive valuations rather than longer term confidence of outperformance. It is notable that relative EM outperformance (from the perspective of the AUD investor) in 2025 to date largely took place before 'Liberation Day' when it was up 2.7% (see Graph 02). At the same time US equities were under pressure, down 11.5%. US underperformance of this time was largely caused by the challenge to US AI supremacy that caused a sell-off in the 'Magnificent 7' and 'Liberation Day' itself. That EM outperformance was due to a relatively narrow sub-index of EM in Eastern Europe that rallied 21%. This was likely driven by the same thematic that saw a simultaneous surge in European defence stocks as it became clear that the Europe would need to increase defence spending to cover demands from the US. And European banking stocks that would facilitate both government defence spending and fiscal policy designed to ward off the impact of US tariffs.

However, since 'Liberation Day' the rally in Emerging market equities has not been as strong as the rhetoric around it would suggest. In AUD terms it has been a very solid 11.7% but as a relative trade this is unremarkable with Europe up 13.9%, Japan 15.4% and Australia 16.7%. This is before we consider the relative trade narrative comparison with the US where the S&P500 is up 17.6%, Magnificent 7 itself recovering 28.4%. To us the 'EM rotation' is simply part of a broader tactical rotation to non-US markets as US economic exceptionalism fades, policy uncertainty remains high and equity market valuations are stretched to a point that other markets look relatively attractive. There's also the weaker US dollar as a tailwind.

The question is whether these thematics present a buy and hold trend or tactical switch that will fade. We would assert that it is the latter, even considering the potential headwinds

near term in the US from policy uncertainty. Considering the longer term, and making the potentially courageous assumption that the US political environment becomes less adversarial, we think the outlook for financial markets and real assets broadly will have similar drivers. The US remains one of the largest, richest (in terms of GDP per capita) most diverse economy and entrepreneurial economies globally. Its economy is heavily skewed to the private sector (even when considering the fiscal programs of the last two Administrations), its relatively strong productivity performance over recent years is underpinned by higher rates of business investment and broader investment in research & development than peer economies - importantly it is highly leverage into AI and tech thematics. We expect that these factors will, over the medium term, drive a structural growth premium over other advanced economies that will be attractive to offshore investors.

GRAPH 02 SELECTED EQUITY MARKETS, TOTAL AUD RETURNS



Source: IFM Investors, Bloomberg, MSCI, Nikkei Inc., STOXX, FTSE Russell, Deutsche Boerse, via Macrobond

Key takeaways

Equity markets

Valuations in the US are stretched with investors discounting risks to the economic outlook.

Fixed income

Bond yields drifting with fiscal, economic and soft stagflation risks prompting lack of clear direction.

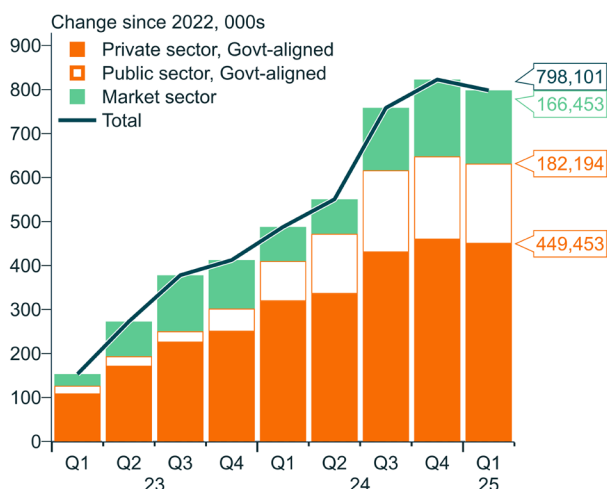
Geopolitics

While current risks in the US have prompted a rotation into non-US and EM equities, we think this is a short term dynamic rather than a longer-term trend.

AUSTRALIA: From Pause to Pivot

The Reserve Bank (RBA) caught markets off-guard earlier this quarter, opting to leave the cash rate unchanged at its July meeting in what was a split decision (5-3 voting in favour). Despite a soft Q1 GDP outturn and further disinflationary signals in the monthly CPI gauge the RBA was content awaiting further confirmation that inflation was settling sustainably at the midpoint of the 2-3% target. Indeed, the confidence threshold was surpassed following what Deputy Governor Hauser described as a 'very welcome' Q2 CPI print with the headline and policy relevant trimmed mean measures moderating further to 2.1%yoy and 2.7%yoy respectively. Moreover, the jobless rate edged up to a cycle high of 4.3% in July after tepid jobs growth taking the quarterly average to be exactly in line with the Bank's outlook.

With these signals in hand, the Board cut the cash rate 25bps to 3.6% in August in what was a unanimous decision. The statement and post meeting press conference conveyed an incrementally dovish bias. The labour market was no longer characterised as 'strong' while downgrades were made to economic growth and productivity assumptions. Governor Bullock noted the latter was intended to account for growth outcomes that had consistently undershot RBA forecasts despite inflation and employment outcomes that had been more or less in line. As have wages growth over Q1 that rose 3.4%yoy. We expect that the RBA will remain cautious with its reaction function focussing a little more on the labour market than inflation. For some time the composition of jobs growth has been skewed to the non-market sector (Graph 03), and we agree with RBA commentary from the May statement that an efficient 'hand-off' to market sector generated jobs growth is critical to keep the unemployment rate low and support the recovery in household consumption. That is why we acknowledge that intra-quarter meetings are live given the frequency of labour market releases but our base case remains for a cautious RBA to ease further in November and February – acknowledging the economy may need additional support but there's no emergency to address.

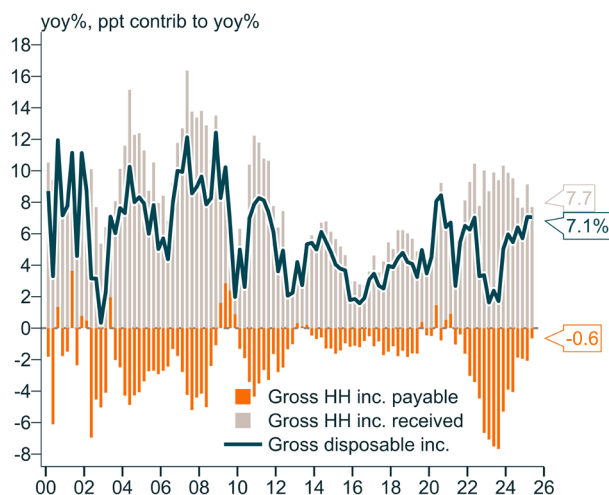
GRAPH 03 GOVT.-ALIGNED CONTRIBUTIONS TO FILLED JOBS

Source: IFM Investors, ABS via Macrobond

In August, as government representatives, industry leaders, union heads and regulatory bodies convened in Canberra for the Economic Reform Roundtable, the mood was more about consensus building and stakeholder consultation rather than sweeping reform. Behind closed doors, discussions centred on lifting productivity, economic resilience and fiscal sustainability. Discussions yielded what Treasurer Chalmers identified as 10 key 'reform directions' – these centred on breaking down barriers to a single national market, streamlining trade and regulation and accelerating approvals in key sectors like housing and infrastructure. At the same time, the agenda highlights future drivers of growth – positioning AI as a national priority, attracting capital and modernising the tax system. While these are all worthwhile pursuits we do not think enough will happen to materially move the economic growth needle near term.

The Australian economy expanded 0.6%qoq and 1.8%yoy in the June quarter, finally moving back to per capita growth. The result came in slightly stronger than RBA expectations (benefitting from an upward revision of the March quarter) further weakening the case for another rate cut in September.

Private demand improved in the quarter lead by the household sector where the stars aligned to drive solid growth. Spending was supported by end of financial year sales, disposable income growth, lower savings rates, energy rebate impact and the proximity of Anzac Day to Easter. It was facilitated by strong disposable income growth (as headwinds from rates and taxation fade) and a decline in the savings ratio. Dwelling investment edged higher as the residential construction cycle fails to gather any momentum as yet. But it was business investment that was the drag, disappointing modest expectations with uncertainty around the global and domestic environment holding back the sector. Public demand was relatively soft overall as a strong contribution from spending was offset by a decline in investment (the largest fall since Q3 2017, outside the pandemic period). The narrative of this quarter is that strong spending from households and government drove growth while investment from businesses and governments was weak.

GRAPH 04 HOUSEHOLD DISPOSABLE INCOME

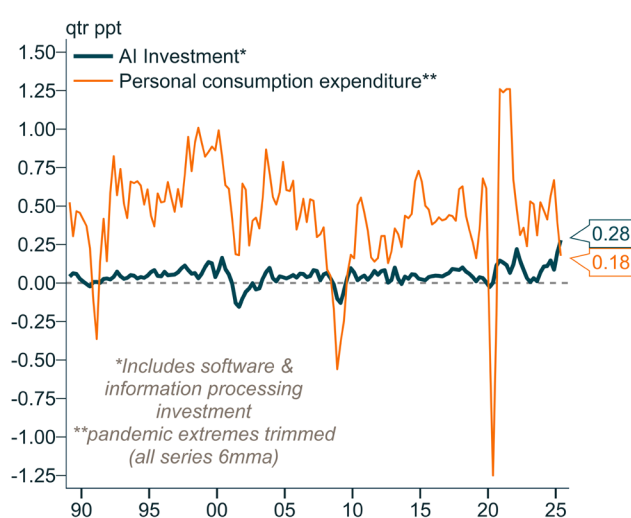
Source: IFM Investors, ABS, via Macrobond

US: Central bank showdown

Real GDP in Q2 surprised to the upside, expanding 3.3% saar (and was upwardly revised in the second print). Compositionally, a 30% saar fall in imports artificially exaggerated the headline result with the 4.6ppt net export drag in Q1 on tariff front-running turning into a 5ppt boost in Q2. Indeed domestic demand was relatively modest, with final domestic purchases stable at a 1.9% saar pace from an average of 3.0% through 2024. Real personal consumption did edge higher at 1.6% saar and this was a material improvement from 0.5% observed in Q1 but still significantly below 2024 levels. This outcome was driven primarily by goods spending on a strong rebound in motor vehicle purchases.

As we cautioned in our previous quarterly, forward looking capex surveys suggested an imminent slowing in business investment as firms are reticent to deploy capital during episodes of heightened policy uncertainty. Indeed, this notion has been corroborated by the hard data with non-residential business investment slowing sharply to 5.7% saar in Q2 with increases in equipment and IP investment unable to offset a marked decline in that for structures. What's more, investment in sectors tied to the AI thematic has emerged as an important, and robust, driver of investment. Indeed these sectors contributed more to growth in the recent quarter than the entire household sector (see Graph 05).

GRAPH 05 AI INVESTMENT & PCE, QUARTERLY REAL GROWTH CONTRIBUTIONS



Source: IFM Investors, U.S. Bureau of Economic Analysis, via Macrobond

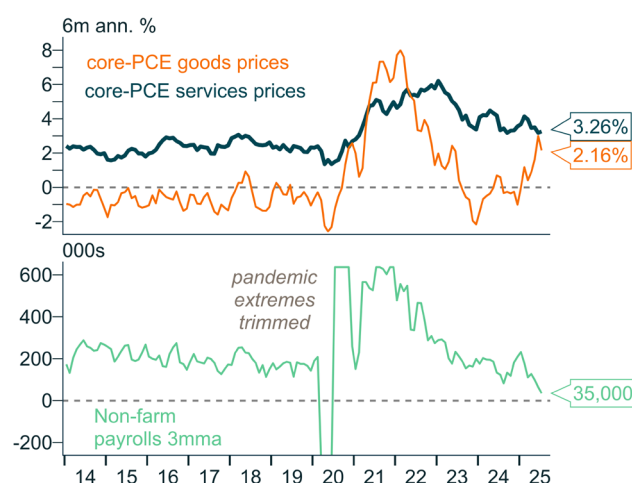
On fiscal policy, Q2 saw the Trump Administration sign the One Big Beautiful Bill Act (OBBBA) into law despite pushback from fiscal hawks that spurred a rift between the Department of Government Efficiency and proponents of the Bill. We see OBBBA as imparting a positive - albeit temporary - tailwind for aggregate demand. The main feature is a growth-neutral extension of the first Trump tax cuts but this is layered with new expansionary measures including one-off payments to households, temporary full expensing of investment tax deductions, no tax on tips and overtime (among others).

Meanwhile, the Fed has had the unenviable task of balancing its inflation and employment mandates. In July, the FOMC left the Funds rate unchanged at 4.5% with two Governors dissenting for the first time since 1993. Minutes revealed the committee majority judged upside risks to inflation to be 'greater' than downside risks to employment with core goods PCE edging higher in June. This assessment was likely short-lived with the 3-month average monthly payrolls pace slowing to 35k in July (with some heavy downward revision) in contrast to the 2024 average of 168k. Labour market slack however was stable with unemployment remaining at 4.2% as curbed immigration places downward pressure on labour supply.

In August, markets looked to Powell's address at the Jackson Hole Policy Symposium for the Fed's assessment on how the balance of risks had shifted in the short space of a month. Chair Powell allayed fears of a sustained tariff driven inflation dynamic, arguing that a soft labour market would make it difficult for tariff related price gains to spill over into 'adverse wage-price dynamics' suggesting this may warrant an adjustment of policy. Our read is that this tips the balance in favour of a September cut, absent a surprise in the August employment and inflation data.

At the same time, Fed policy signalling has been obfuscated by an ongoing standoff with the White House. President Trump has been vocal in his criticism of Chair Powell for being 'stubborn' in his reticence to deliver rate cuts. The President has now also called for the removal of Governor Lisa Cook on mortgage fraud allegations. What's clear is that the Fed's independence and institutional credibility is as much under the microscope as its policy stance. The President nominated close ally and economic adviser Stephen Miran to replace the outgoing Adriana Kugler, and should the removal of Cook hold up legally, the Administration may cement a majority in the seven-member board necessary to influence regional appointments (and policy outright). That said, akin to the bond market riot said to have prompted April's tariff policy rethink markets may again play a part in limiting the Administration's willingness to exert undue influence over the Fed.

GRAPH 06 RISKS BUILDING ON BOTH SIDES OF THE FED'S MANDATE



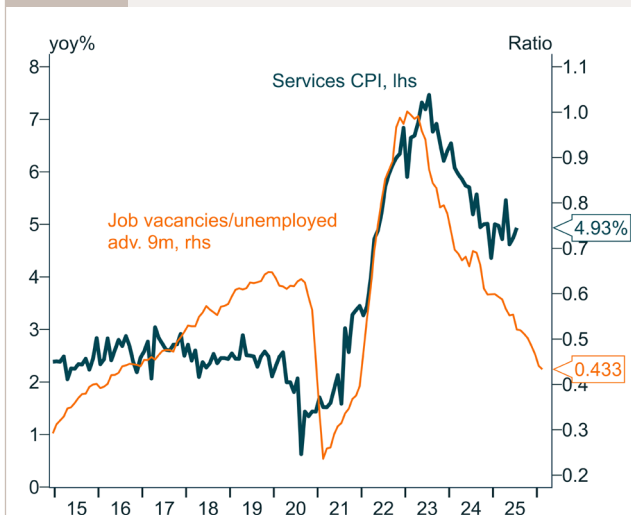
Source: IFM Investors, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis via Macrobond

UK & EUROPE: Modest growth

Monthly UK real GDP growth edged up 0.4%mom in June flattered by exceptionally warm weather that saw a surge in utilities spending. This contributed to a 0.3%qoq outturn for the June quarter data – two tenths higher than consensus expectations, though the result was compositionally weak. Indeed, private consumption growth slowed to just 0.1%qoq, unsurprising given ongoing weakness in the labour market. Meanwhile business investment exhibited strong payback contracting 4%qoq after a solid Q1 with capex related noise attributable to the Office of National Statistics finding it difficult to adjust for capital expensing which tends to occur into the end of the fiscal year. Government consumption was a ‘stop-gap’ for an otherwise lacklustre result rising 1.2%qoq in spending that was announced in October’s budget. However, the fiscal peak has now likely been surpassed and the private sector will looked upon to support growth from here – if it can.

Further support from monetary policy is likely forthcoming but inflation in August may test the Bank of England’s (BoE) comfort levels as service price inflation edged up to 5% (from 4.7%) – a tenth higher than expectations. The result, driven mainly by an increase in airfares, also saw headline and core measures come in firmer than the Bank had anticipated. That said, a weakening labour market and muted growth outlook should place downward pressure on stickier services inflation as suggested by the ratio of job vacancies to unemployed (now lower than pre-pandemic levels). This comes after the BoE lowered the Bank Rate by 25bps to 4.00% in August, conveying an incrementally hawkish bias. Indeed more members than expected dissented in what was a decision that went down to the wire (5-4 in favour) while there was heavy emphasis on elevated headline inflation despite ongoing weakness in the labour market. Nonetheless, minutes revealed that dissenters advocated for a ‘slower pace’ to reducing the cash rate rather than an outright pause.

GRAPH 07 UK SERVICES INFLATION AND VACANCIES TO UNEMPLOYED



Source: IFM Investors, UK Office of National Statistics via Macrobond

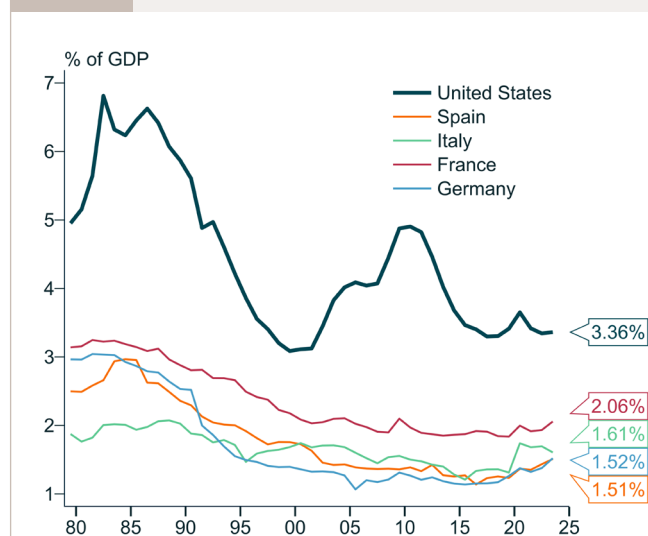
On the continent, Q2 GDP came in stronger than expected yet real growth was still only very modest at 0.1%qoq. Across the majors, real growth in Spain was a standout and stronger than expectations at 0.6%qoq with firm growth in household

consumption and investment. France posted 0.3%qoq growth – two tenths higher than consensus but was compositionally soft with a modest improvement in household consumption dampened by weak investment. Germany was in line and Italy missed expectations for a modest increase – and concerning both economies contracted 0.1%qoq. Net trade was soft across the bloc as tariffs bite and despite a deal being done with the US there’s little relief in sight for the region’s major exporters.

Earlier in the quarter, the European Central Bank (ECB) left the policy rate unchanged in July at 2.0% in what was a unanimous decision. President Lagarde highlighted the ‘resilience of the economy’ and reaffirmed the importance of a ‘wait and see approach’ in dealing with the ‘inconclusive’ tariff impacts on inflation and growth. Absent a marked deterioration in the outlook, the bar for additional cuts is high even as ECB staff projections forecast a modest inflation undershoot. Indeed, July’s final HICP print had headline and core inflation at 2%yoy and 2.3%yoy respectively with many council members characterising inflation as ‘more or less at target’. Moreover, a positive PMI result in August, supported by firm manufacturing output and orders does not suggest that there is a further deterioration in the outlook that the ECB needs to address at present.

Vindicating the cautious approach taken by the ECB was the announcement of a US-EU trade deal. The contours of the agreement involve a baseline 15% tariff on most European exports, notably including autos (previously 27.5%), while sectoral tariffs on steel and aluminium remain and pharma tariffs are widely expected to increase. In return, members pledged \$750bn in purchases of US energy products within the next three years (a tripling from current annual levels) and \$600bn in investment into the US. Further, commitments made among NATO members, after US lobbying, to increase defence spending as well as plans to increase infrastructure spending (notably Germany’s €500bn infrastructure programme) points to a sharp pickup in public demand ahead.

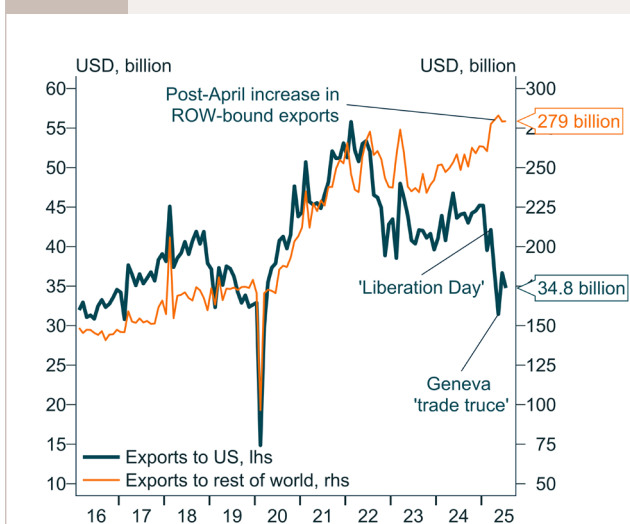
GRAPH 08 NATO MEMBER DEFENCE SPEND



Source: IFM Investors, World Bank via Macrobond

NORTH ASIA: Fragile peace, firmer trade

In Asia, China's Q2 GDP surprised to the upside, expanding 5.2%yoy, a tenth ahead of expectations. Industrial production accelerated from 5.8%yoy in May to 6.8%yoy in June on faster output growth in computer, equipment and chemical sectors. Strength here was underpinned by resilient external demand which saw headline exports rise 5.8%yoy in June with momentum spilling over into Q2 (up 7.2%yoy in July) primarily driven by a recovery in US-bound exports after the Geneva 'trade truce'. That said, since April trade re-diversion has helped mitigate tariff headwinds (see Graph 10) with China's share of real global exports remaining steady. By comparison, domestic activity remains weak: fixed asset investment (FAI) continues to slide in line with the ongoing property sector downturn, while retail sales fell in June after May's "618 shopping festival" and funding shortages hit consumer trade-in schemes.

GRAPH 09 CHINA EXPORTS BY DESTINATION

Source: IFM Investors, China General Administration of Customs via Macrobond

On the policy front, 'anti-involution' was the focal point at July's Central Commission meeting with President Xi calling for regulation of disorderly price cutting to address persistent deflation. Indeed, producer price deflation continues with PPI contracting 3.6%yoy in July due to upstream sectors and weaker export prices. Leading manufacturers and industry associations announced plans to curb output as profitability comes under pressure and as weakness in FAI and IP continued in July. Meanwhile, the People's Bank of China (PBoC) maintained its easing bias in its Q2 monetary policy report calling for targeted rather than broad based policy easing.

In Japan preliminary Q2 GDP expanded 1.0% saar, comfortably beating expectations. The positive result was broad-based – private consumption grew for the fifth consecutive quarter expanding 0.6% saar driven by increases in durable goods demand. Elevated rice prices saw consumers continue to pare back food consumption while services turned down slightly – contracting for the first time since December 2023. Tariff related uncertainty has not compromised capex strength edging up 5.5% saar amid ongoing digitalisation, efficiency improvements and environmental measures. External demand was supported

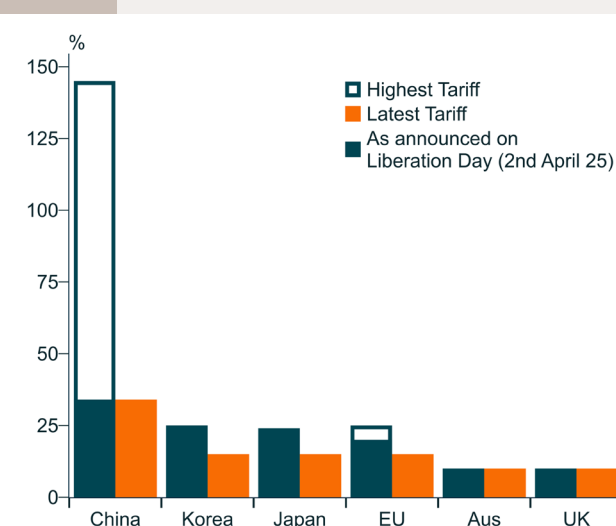
by tariff front-loading, most notably for IT products. Goods exports surged 8.2% saar while services exports contracted 11.2% saar as foreign visitor spending moderated.

On trade, tariff uncertainty has been managed with a US-Japan framework deal inked before the August, the provisions of which see increased Japanese investment into the US and easier access to Japanese markets. In return, most exports (with aluminium and steel notable exceptions) will be tariffed at a rate of 15% (c.f. 'Liberation Day' starting point of 27.5%).

The Bank of Japan (BoJ) left the policy rate unchanged at 0.5% in July but in light of the aforementioned trade negotiations was less pessimistic on the external sector. Near term inflation forecasts were upwardly revised as food prices continue to be impacted. Indeed, the July inflation print had the policy relevant core-core measure stable at 3.4%yoy and while strong shunto wage negotiation outcomes have been positive, real wage growth remains negative potentially holding back consumer spend.

In Korea, real growth rebounded 0.6%qoq in Q2 (prior: -0.2%) a tenth ahead of expectations. Standouts were private consumption rising 0.5%qoq, public demand edging up 1.2%qoq on pre-election spending and a recovery in net exports. Fixed investment fell for the fifth consecutive quarter with the Bank of Korea (BoK) projecting that incremental investment from the government's first supplementary budget will materialise in Q3.

In August, the BoK kept the policy rate unchanged at 2.5% in line with expectations. Guidance was incrementally dovish with 5 of 6 committee members conveying openness to lower rates over the next 3 months (previously 4). A lone dissenter called for a 25bp move citing progress on the Bank's financial stability mandate amid a slowdown in household debt levels. While trade risks were again flagged, a US-Korea trade deal inked in July is a positive. The contours of the deal will see most Korean exports subject to a 15% tariff, the creation of a US-bound investment vehicle and pledged purchases of US energy products.

GRAPH 10 EVOLUTION OF RECIPROCAL TARIFF RATES SINCE 'LIBERATION DAY'

Source: IFM Investors, The White House, via Macrobond

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