

**Economic Update**  
Q2 2026

# Risk repriced, but not resolved



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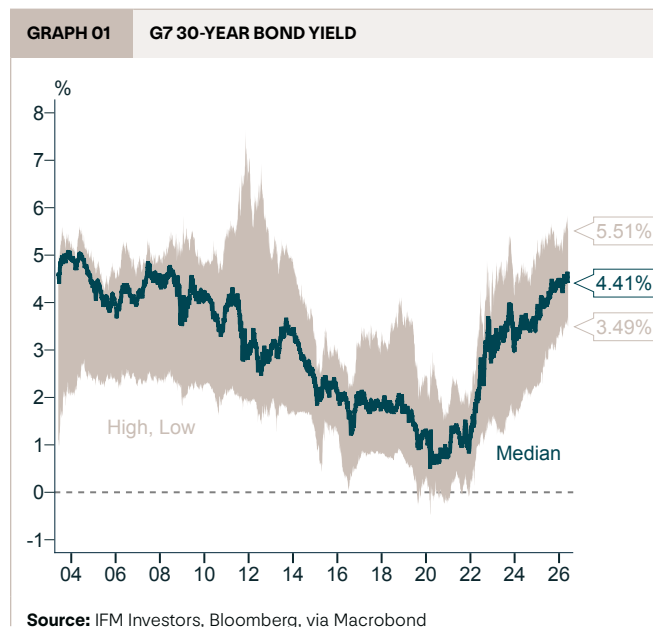
Global markets are navigating an increasingly uneasy mix of geopolitical risk and shifting macro fundamentals. The escalation in the Middle East has reintroduced a stagflationary impulse via higher energy prices, yet risk appetite has remained resilient. Equities have pushed to new highs even as long-end bond yields have climbed to multi-decade levels, reflecting inflation, fiscal and policy uncertainty.

**GLOBAL: Markets climb the wall of worry**

Global markets have spent the second quarter of the year trying to reconcile an increasingly uncomfortable macro and geopolitical mix. The renewed escalation in the Middle East has lifted energy prices, disrupted confidence and reintroduced yet another stagflationary impulse into the global outlook. Yet risk appetite has remained surprisingly resilient. Equity markets have continued to push higher, particularly in the US with the S&P500 pushing through record highs, despite the deterioration in the geopolitical backdrop. At the same time long-end bond yields across advanced economies (GRAPH 01) have also moved higher, collectively hitting levels not seen in nearly 20 years as investors reassess inflation, fiscal and central bank risks.

The impact of the Middle East conflict has broadened. While initially regionally contained, the fallout is now a truly global macro event transmitted primarily through energy markets – although the shock is broader than simply one affecting the price of oil. Higher fuel prices flow through to transport, food and fertiliser costs; shipping and insurance premia rise as trade routes are disrupted; and confidence is undermined by the persistent uncertainty around escalation. Risk markets are seemingly pricing in much of the good news flow, while discounting the bad that often comes shortly thereafter. The scenario we’re seeing is not yet a 1970s-style stagflation shock, but it has reintroduced a familiar and uncomfortable trade-off for policymakers and investors: weaker real income growth on one side and renewed inflation pressure on the other.

The reintroduction of this trade-off matters because the global economy began the quarter with the disinflation



narrative still broadly intact. Central banks were expected to ease policy gradually as inflation returned closer to target and growth cooled. That confidence has been challenged. The market pricing of central bank moves has reversed through the quarter. Previous expectations of rate cuts, particularly by the US Federal Reserve (Fed), have been scaled back and, in some jurisdictions, replaced by renewed concern that policy may need to stay restrictive for longer. For central banks, the complication is clear. A supply-side energy shock weakens

growth, but it also risks lifting inflation expectations if it proves persistent. That makes the policy reaction function less straightforward and leaves markets more sensitive to each inflation print, labour market release and central bank communication. While the US is at the centre of the geopolitical shock, the impact on an economy largely able to meet its own energy needs is more limited than other advanced economies. Those more energy dependent, such as the UK, Europe, through to Asian nations and including Australia, face risks from both price and lack of volume.

The quarter has also been defined by the volatility of the newsflow. Signs of optimism that a ceasefire might be agreed, largely emanating from the US Administration, have repeatedly been followed by reports suggesting that any agreement remains incomplete, and is fragile or contested. This has created a market environment driven less by a single durable narrative and more by a rapid repricing of probabilities. Risk assets have rallied on headlines suggesting de-escalation, only to give back gains when those hopes have faded. Rates and commodities have been similarly reactive. The result is not just higher volatility, but a more fragile form of investor confidence.

What has been striking, however, is the strength of equity markets in the face of these risks. In a more orthodox macro environment, rising energy prices, declining expectations for central bank easing and higher long-end bond yields would be expected to weigh more heavily on valuations. Instead, equities have remained well supported. Part of this reflects the resilience of nominal growth and corporate earnings in the US (GRAPH 02), while it also reflects a renewed enthusiasm around AI-related capital expenditure and the broader investment cycle in technology, energy infrastructure and defence. It also seemingly reflects a market that has become increasingly willing to look through geopolitical shocks where the damage to earnings is not yet visible.

For investors this resilience should not be dismissed, but neither should it be extrapolated too confidently given the uncertainty that clouds the outlook. Equity markets are

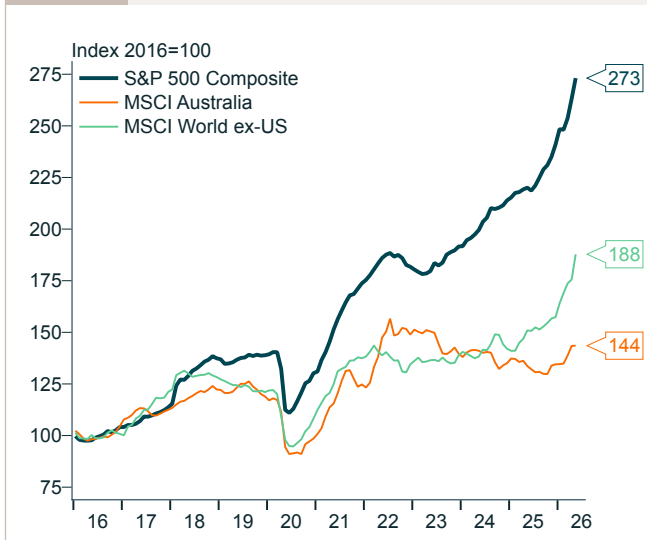
effectively assuming that the inflationary impulse from the Middle East conflict will be contained, that central banks will not be forced back into a more aggressive tightening bias, and that earnings growth will remain sufficiently robust to absorb higher discount rates. Those assumptions may prove correct, but the margin for error has narrowed. The more long-end yields rise, the more equity valuations must rely on earnings delivery rather than multiple expansion.

Fixed income markets have been less sanguine. Long-end government bond yields in advanced economies have continued to grind higher, reflecting the combined pressure of inflation risk, fiscal supply, term premia and uncertainty around central bank reaction functions. This is one of the defining market signals of the quarter. In highly-indebted Japan, for example, 30-year yields are at record highs, currently 3.8%, amid fiscal pressures and weaker demand from institutions. And we have seen how market sentiment can shift towards these trends and impart volatility across markets. A defensive investor, concerned about the economic outlook, is finding that view comes at a cost, as duration positions see yields drift higher and equity markets rise.

For institutional investors, the portfolio construction implications are important. The case for maintaining exposure to growth assets has not disappeared; indeed, the persistence of equity momentum suggests that investors remain reluctant to move too defensively while nominal growth and earnings remain intact. But the combination of stagflation risk, elevated long-end yields and headline-driven volatility argues for more deliberate diversification. Portfolios need assets that can withstand a wider range of inflation and growth outcomes, rather than relying solely on the traditional equity-bond balance.

Real assets remain central to this discussion. Infrastructure in particular continues to offer attractive characteristics in the current environment: resilient cash flows, potential inflation linkage, lower correlation to listed markets and exposure to long-term structural investment themes. In a world where geopolitical risk is persistent, inflation shocks are more frequent and government bond markets are no longer providing the same defensive ballast, the role of infrastructure as a portfolio stabiliser remains compelling.

**GRAPH 02 EARNINGS PER SHARE**



Source: IFM Investors, IBES, via Macrobond

**Key takeaways**

**Equity markets**

Surprisingly buoyant despite elevated geopolitical and macro risks.

**Fixed income**

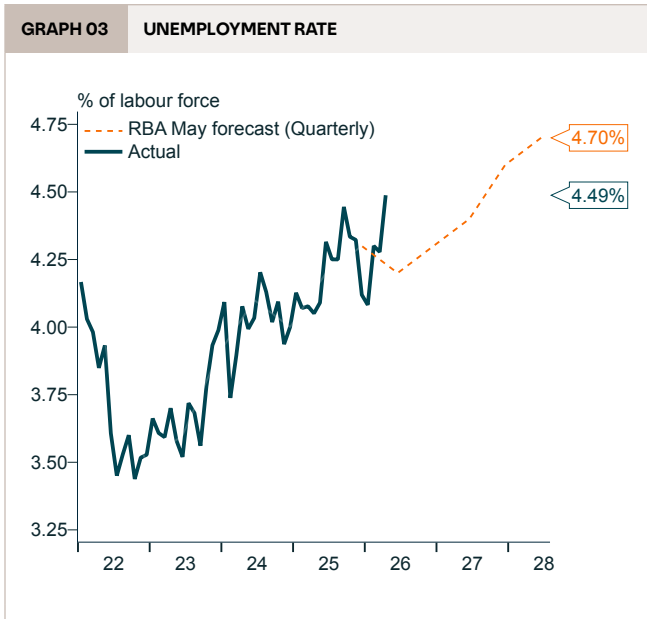
Long-end yields grinding higher as inflation and policy risks are repriced.

**Real assets**

Infrastructure remains attractive for resilience, inflation linkage and diversification.

**AUSTRALIA: Cracks start to show?**

The Reserve Bank of Australia (RBA) has raised the cash rate 25bp in March and May since our last quarterly economic update, marking a return to its previous cycle high of 4.35%. This makes the Bank a clear outlier among major developed-market central banks – all of which elected to hold rates steady in May. We stress that starting points matter, where prior to the Middle East conflict the Australian economy was arguably growing beyond potential – with subdued productivity growth a binding constraint – characterised by resurgent domestically-generated inflation.



Source: IFM Investors, RBA, ABS via Macrobond

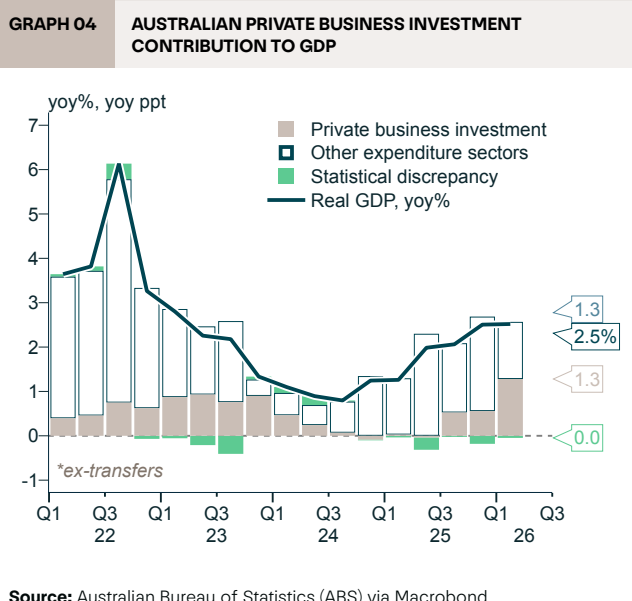
The May press release was cautiously hawkish, noting that higher fuel prices were “already adding to inflation” and consequently there were “early signs that many firms experiencing cost pressures [were] looking to increase prices”. This was reinforced by the more policy-relevant trimmed mean inflation printing at 3.5%yoy in Q1 — confirming that underlying inflation remained uncomfortably elevated even before the full pass-through of conflict-related cost pressures. A subsequent speech by the Bank’s Chief Economist leaned further in the same direction, drawing on recent RBA research showing that Australian firms pass on cost increases fully and more rapidly when inflation expectations are drifting higher and capacity is constrained. The paper’s prescribed policy response in such environments is ‘front-loaded tightening’ – a framework that explains the three consecutive hikes delivered across as many meetings since the onset of the conflict.

That said, the statement did acknowledge the conflict’s potential to weigh on domestic activity and characterised the 75 basis points of tightening delivered in 2026 as providing sufficient headroom to respond to incoming data. Indeed, the deterioration in leading indicator data was already apparent in the lead-up to the May meeting, but cracks are now beginning to appear in the hard data for the first time since the onset of the conflict and the RBA’s policy pivot in February. Employment fell by 19,000 in April, a significant downside surprise, while the unemployment rate jumped 20bp to 4.5% - materially above the bank’s forecasts. Should the labour market continue to deviate from the RBA’s base case (GRAPH 03), it may effectively cap further rate hikes. The bank has sought to make

preserving labour market gains a key facet of its interventions, but this may be tested should inflation accelerate in the near term. Further, we see the risk that AI is already impacting the labour market to slow employment growth and this could present upside risk to the unemployment rate should labour supply remain strong.

The Australian federal government’s 2026-27 Budget continued in setting an expansionary fiscal policy. While there was a \$44.9bn improvement in the bottom line over the forward estimates, \$36.6bn came from parameter variations (including a stronger-than-expected economy and higher commodity prices) and a further \$8.2bn came from policy decisions (mainly future spending reform to the National Disability Insurance Scheme). Deficits are expected over the forward estimates, with no return to surplus – which we regard as a conscious choice after budget surpluses were recorded in FY23 & FY24. Changes to the capital gains tax framework and a shake-up of negative gearing were the most contentious reforms, designed to address intergenerational equity in the property market. This will likely add, at the margin, to a property market already slowing under the weight of tighter monetary policy. Compounded by rising costs in the sector, property investment is a clear downside risk to economic growth in the near term. On productivity, the Budget offers a modest package of measures. While welcome, the measures were not enough to get the government to upgrade its productivity forecasts.

Real GDP grew 0.3%qoq and 2.5%yoy – ahead of RBA expectations and further indication growth is above potential. Of course, the result predates the deterioration in the outlook owing to higher energy prices and the full impact of rate hikes. The headline understates domestic activity with domestic demand surging 3.5%yoy – primarily due to business investment tied to datacentre installations. This was offset by a related rise in data processing equipment imports and a net trade drag. Meanwhile, household consumption accelerated, dwelling investment growth slowed and public demand edged higher. We see the result as the calm before the storm, with leading indicator data and the latest employment read suggesting the slowdown necessary to close the output gap is underway.



Source: Australian Bureau of Statistics (ABS) via Macrobond

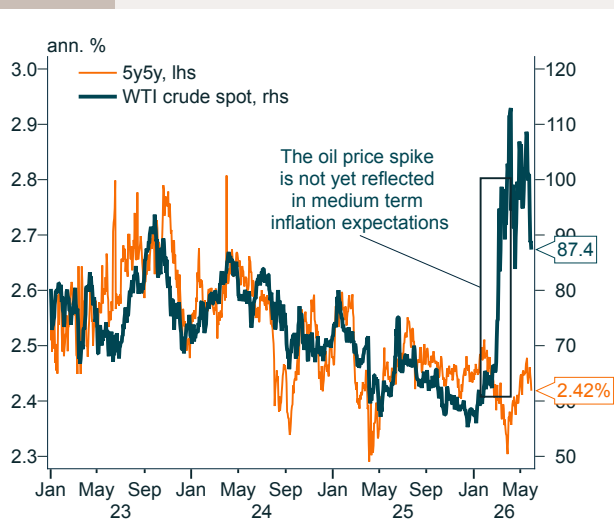
**US: Capex in command**

Real GDP in the US expanded 1.6%saar in Q1 (revised lower in second print) – modestly below consensus but compositionally sound. The more telling signal came from final private domestic purchases, which outgoing Fed chair Jerome Powell highlighted in April as offering “a better signal of momentum in the economy” than the headline figure. That measure — which strips out government spending, net trade and inventory swings — rose a solid 2.4%saar, underpinned by business fixed investment (10.1%saar) and consumer spending (1.4%saar), while residential investment (-6.2%saar) the lone weak spot. Government spending meanwhile edged higher following the resolution of Q4’s shutdown, and a change in inventories was a small positive contribution and net trade was a drag.

watchful of inflation expectations becoming dis-anchored, so far there has only been a modest rise in long-term expectations despite a large increase in domestic oil prices (GRAPH 05).

Powell simultaneously framed economic resilience and a balanced labour market as ample cover to keep rates ‘at the high end of neutral or modestly restrictive’ for longer. The decision and apparent discomfort of some members in retaining an easing bias pushed front-end yields higher. It also marked a departure from the cuts that markets had slated for the second half of 2026 – prior to the oil shock, while also reflecting the presumed nomination of Kevin Warsh (GRAPH 06).

**GRAPH 05 US OIL PRICES AND INFLATION EXPECTATIONS**



Source: IFM Investors, Bloomberg, via Macrobond

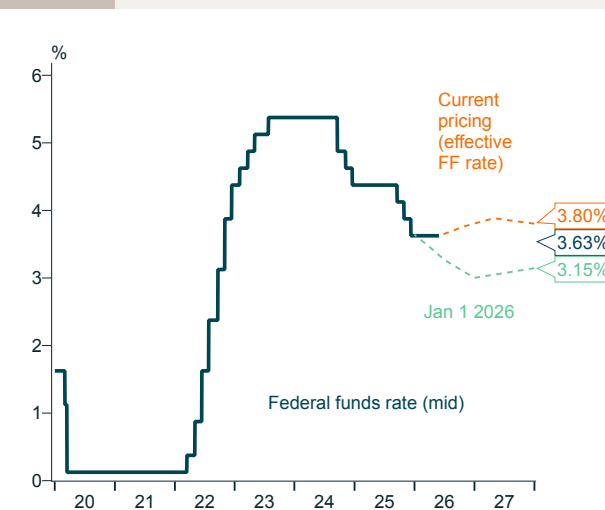
Interestingly, real consumer spending on goods has hardly increased over the past two quarters – with tariff and oil-shock related price pressures potential headwinds – while real spending on services continues to outperform. The AI investment boom remains a defining feature of the capex landscape. Real equipment investment rose 17.2%saar and intellectual property – encompassing software and R&D – expanded 11.6%saar, both pointing to sustained corporate commitment to AI adoption and digital infrastructure. The import data corroborates this: computers, peripherals and parts surged 122.5%saar, reflecting the scale of hardware procurement underpinning the buildout.

The May labour force print reinforces the case for patience. Payrolls rose 115k in April (the second consecutive increase surpassing 100k) taking the six-month average to 55k while the unemployment rate remained steady at 4.3%. In addition, wages growth is suggestive of a broadly balanced labour market with average hourly earnings expanding 3.6%yoym in April – allowing for some modest real wage growth but not posing a direct threat to the Fed’s 2% target. At the same time, through the year productivity growth recorded the fastest growth rate in over two years while unit labour costs undershot expectations – consistent with the idea that AI adoption is starting to show up in the aggregate data. These developments support claims made by Powell in April that the labour market ‘is not a source of inflationary pressure’.

The outlook remains clouded by geopolitical uncertainties. By the Fed’s own admission, a more prolonged oil shock is a clear upside risk to inflation and a downside risk to growth. On average, tax refunds delivered to households through the One Big Beautiful Bill Act (OBBBA) risk being entirely eroded by higher gasoline prices. The outcome of the US midterm elections are also consequential with the possibility of a more divided government constraining the scope for additional fiscal measures. The bright spot remains the ongoing structural AI-capex boom which will provide an offset against any slowdown in household consumption.

In April, the Federal Open Market Committee (FOMC) left the target funds rate steady at 3.50-3.75%. While forward guidance was left unchanged, three members dissented in favour of removing language that reflected an ‘easing bias’ in the post-meeting statement. With core inflation modestly above target at 3.2%yoym in March – the FOMC determined that they are not ready to rely on model-based arguments to ‘look through’ supply shocks due to years of above target inflation. As such, inflation criteria for the timing of future cuts have become more stringent. Powell highlighted that 1) tariff-related price impacts must be shown to have a one-off impact and 2) energy inflation must have well and truly peaked before easing is discussed. While the Fed will remain

**GRAPH 06 FEDERAL FUNDS RATE PRICING**



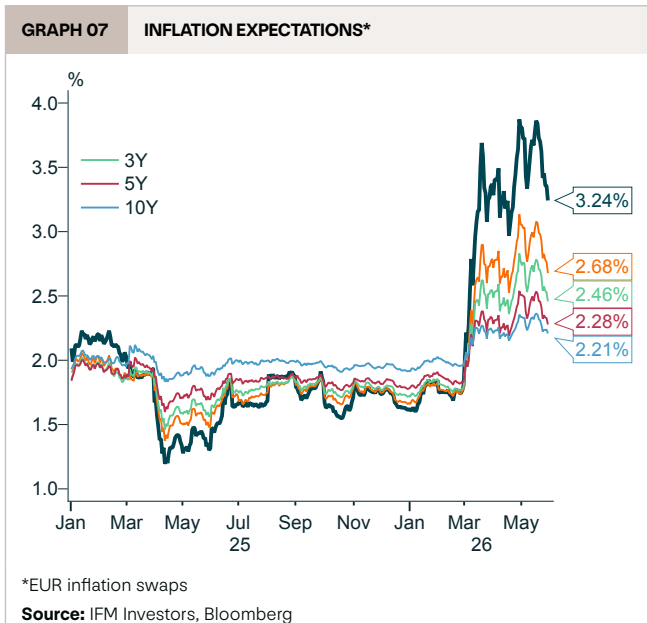
Source: IFM Investors, Bloomberg, via Macrobond

**EUROPE & UK: Cloudy skies**

Euro-area GDP surprised to the downside as real growth edged up 0.1%qoq – a tenth below consensus expectations. The outturn points to mixed-to-soft growth across the majors. Real GDP was flat in France – with a positive contribution from inventories offsetting declines across household consumption, investment and net trade. Germany (0.3%qoq) saw broad based strength across private and public consumption and exports while weak domestic demand in Italy (0.2%qoq) was offset by external demand. Meanwhile Spain (0.6%qoq) continues to outperform. Growth in household and government consumption remains solid and external demand added despite a marked slowdown in gross fixed capital formation.

to bleed significant export market share, predominantly to China. By contrast, investment has the potential to provide a tailwind to growth, particularly from the recent German fiscal package and digitisation measures.

In the UK, real growth was solid in Q1 at 0.6%qoq – outpacing Bank of England (BoE) expectations for 0.3%qoq. Household consumption expanded by the same amount, while government consumption and inventories also increased. Gross fixed capital formation declined 0.6%qoq as decreases in public housing investment more than offset a rise in business and private residential investment. The monthly output data for March (0.3%mom) was also solid, with increases across services and construction partially offset by the production sector.

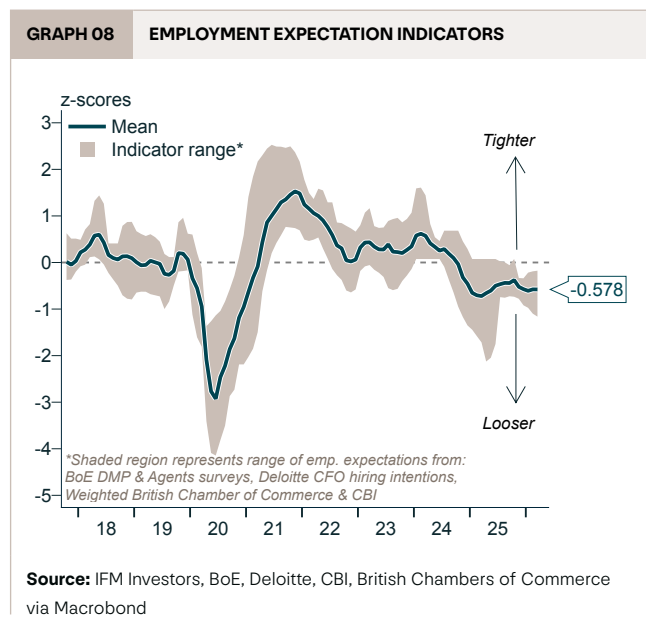


The Bank of England (BoE) voted 8-1 to hold the bank rate at 3.75% at its April meeting – with one member dissenting in favour of a 25bp hike. Communications were hawkish, with Governor Andrew Bailey characterising the decision as an “active hold” and the BoE’s Monetary Policy Committee (MPC) reiterating that they “stand ready to act as necessary” to ensure inflation meets the 2% target. In the week prior to the meeting, March headline CPI edged up 30bp to 3.3%yoy on higher energy prices before unexpectedly softening to 2.8%yoy in April on a material slowdown in services inflation – an undershoot of 20bp to BoE projections. Three scenarios were put forward by the MPC with varying timelines for a moderation in energy prices and even under the most optimistic of these the Bank rate is expected to increase by 25bp.

The European Central Bank (ECB) convened in May, voting to leave all policy parameters unchanged. President Lagarde highlighted that key supports for the hold were that monetary policy settings were in a ‘good place’ prior to the oil shock, financial conditions had already started to tighten, and the incoming hard data had been close to the ECB staff’s March projections - with core inflation running at 2.2%yoy in April. That said, communications were hawkish, with ECB president Christine Lagarde noting that a hike had been actively discussed as intensifying risks to the inflation and growth outlooks, suggesting the situation was “moving away” from their baseline scenario. The Governing Council also noted that short-term inflation expectations had increased sharply, with preliminary signals of second-order inflationary effects via supply chains. This upheaval follows a period of expectations running at target, even in the aftermath of Liberation Day (GRAPH 07). We see a hike in June as likely, factoring in elevated inflation expectations, the perceived deviation from baseline (already predicated on two hikes) and active debate around hiking in May. On the dovish side, a hold is possible if incoming price data is benign or there is a rapid decline in energy prices.

While we see the BoE continuing to tighten policy, weak March labour force figures could see the MPC on hold in June. Since the April meeting, labour market data have weakened, with the March unemployment rate rising a tenth to 5.0% - above BoE expectations – while payrolls contracted 100,000 and private sector pay growth dropped to 3.0%yoy. The latter is a key indication of inflationary pressure in the labour market – given payrolls are subject to large upward revisions. To complicate matters for the BoE – a range of forward-looking labour market indicators suggest more weakness is to come (GRAPH 08).

Going forward, we see the continent coming under pressure – having entered the oil shock with low momentum. In addition to tighter financial conditions, higher energy prices will weigh on disposable incomes and depress manufacturing activity. Structurally, as flagged in recent editions, Europe continues

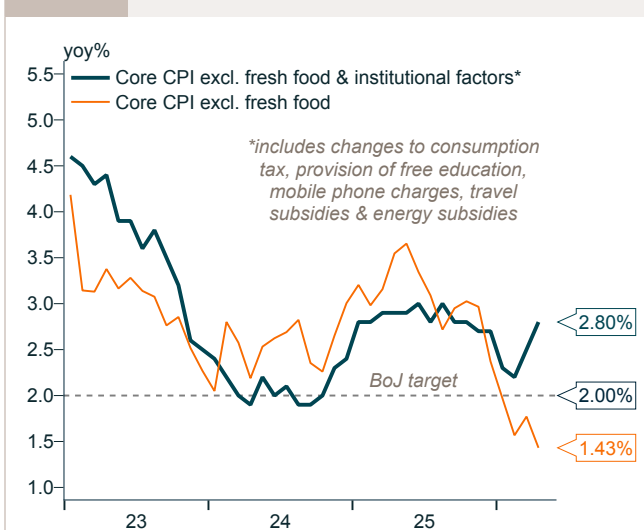


**NORTH ASIA: Better than expected**

Japan’s real Q1 GDP growth came in at 2.1%saar – beating expectations and a rapid acceleration from the downwardly revised Q4 outturn of 0.8%saar. Private consumption maintained its positive trend for the fifth consecutive quarter, supported by services consumption and non-durable goods which turned positive for the first time since Q4 2024. Capex decelerated but remained positive for the second consecutive, quarter with corporate investment demand remaining strong – efforts to improve efficiency, digitalisation and environmental measures remain key supports. Public investment also turned positive for the first time in three quarters and the positive contribution from external demand continued.

The Bank of Japan (BoJ) decided to maintain its policy interest rate at 0.75% by majority vote – with three of the nine members dissenting in favour of a 25bp hike. The BoJ continued to assess the balance of risks as skewed to the upside for the price outlook and to the downside for growth. On forward guidance, the BoJ maintained its stance that it will “continue to raise the policy interest rate”, citing that real interest rates remain at low levels. However, its minutes highlighted that many members had advocated for a wait-and-see approach due to the fluidity of the situation in the Middle East. In addition, growth forecasts were revised materially lower, as were core-CPI (excluding fresh food) forecasts. While these projections have core-CPI reaching 2.8%yoy in June, the April print saw a marked 40bp deceleration to 1.4%yoy – distorted by policy impacts including free elementary school lunches and universal daycare access. Stripping these factors out, inflation is straying further from the BoJ’s target (GRAPH 9).

**GRAPH 09 JAPAN CORE INFLATION MEASURES**



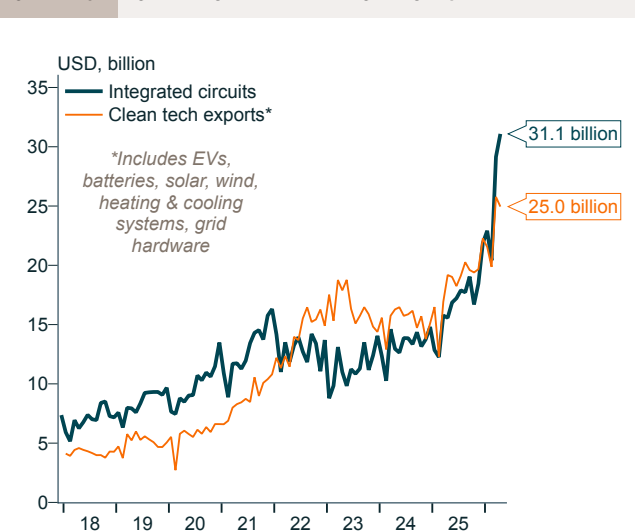
Source: IFM Investors, Bank of Japan, Ministry of Internal Affairs & Communications via Macrobond

In China the economy grew 5%yoy – meeting the upper band of its 4.5-5.0% growth target. The result was partly flattered by downward and upward revisions to Q1 and Q2 2025 quarterly growth estimates respectively. Industrial production (IP) edged up in March but decelerated in year-on-year terms owing to a higher base. Solid output growth in autos and chemical industries were offset by slowdowns across non-metal products, electric machinery and computers. Fixed asset investment also moderated with slowdowns in infrastructure

investment partially offset by solid manufacturing investment growth. Real estate remains a drag, while retail sales softened across categories apart from spending on gasoline. With this data in hand the People’s Bank of China (PBoC) maintained its moderate easing bias, becoming incrementally constructive on growth and inflation. Indeed, PPI grew at the fastest pace since 2022 – expanding 2.8%yoy in April due to higher energy and chemical prices. CPI also expanded 1.2%yoy, impacted by energy prices and tourism-related services.

As flagged previously, China’s economy remains bifurcated – relying heavily on external demand to meet growth targets – yet has weathered global shocks. We were surprised by the speed with which China was able to diversify its export markets away from the US following Liberation Day. And now it is seemingly benefitting from the conflict in the Middle East that has brought into focus traditional (fossil fuel) energy vulnerabilities prevalent across many economies. This has catalysed demand for EVs and renewable forms of energy, underpinning a dramatic surge in clean technology exports. Simultaneously, the AI thematic and insatiable demand for computing power have supported China’s exports of semiconductors (Graph 10).

**GRAPH 10 CHINA MONTHLY THEMATIC EXPORTS**



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

Benefiting from similar tailwinds, Korea’s economy expanded a strong 1.7%qoq in Q1, rebounding from a -0.2%qoq contraction in Q4. Net exports made the largest contribution since Q2 2023, driven by strong tech demand. Domestic demand was also firm, with investment supported by semiconductors and displays, according to the Bank of Korea (BoK). Private consumption strengthened, while government consumption eased.

The BoK held its policy rate at 2.5%, with two members dissenting in favour of a 25bp hike. Communication was hawkish: the Governor highlighted upside inflation risks from the Middle East, stronger semiconductor-driven growth, elevated USD/KRW, and housing stability concerns, describing the case for further tightening as ‘exceptionally clear.’ So far, the oil shock has had limited pass-through to core CPI, which remained at 2.2%yoy in April.

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