THE BIG PICTURE REPORT

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January 15th, 2015

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"Quantitative approach for asymmetric results"

2015

2015 Investment Outlook: from polarization to divergence

INTRODUCTION:
WHY FROM POLARIZATION TO DIVERGENCE

Figure 1: chart showing the 2014 performance of major world stock indexes. Source: dshort.com

The 2014 has been to some extent even better than the 2013, hardly to believe it eas even possible last January. Central banks worldwide played a key role in how the asset classes performed in the last twelve months.

However since last October we entered in a (slight) different environment which is and will cause asset classes to behave differently. In fact that time marked the end of the QE (Quantitative Easing) of the Federal Reserve and almost at the same time, marked the increase of the Japanese QE.

No change in action is currently planned for Bank of England and the SNB (Swiss National Bank) while it has been announced the intention of the ECB to boost its balance sheet up to another one trillion euros.

Lastly, the very recent fall in price of Oil is causing turmoil in Russia where the Central bank has been acting in the last weeks to defend its currency. Since the end of the American QE there has been a substantial increase in other Central Banks interventions.

That alone will lead to the asset classes to behave differently from the past.

Actions of Central Banks are also a reflection of how the respective economies are marching so far. The end of QE in the US is the result of strong economic recovery tied to fall of in unemployment to pre-crisis level, while the start of QE or an increase of it is signalling that other economies are in need of extra help.

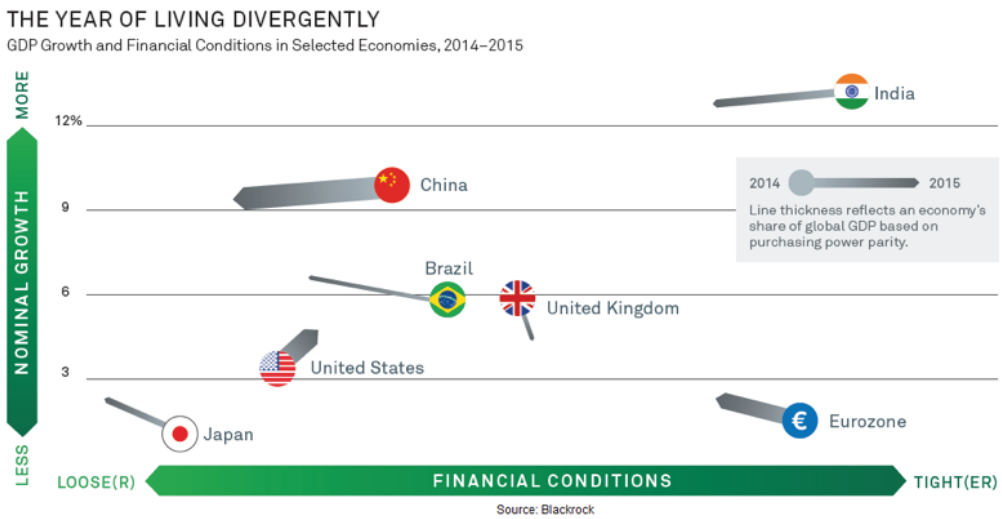


Figure 2: Chart showing possible move in GDP and financial conditions for main economies

In the chart above it can be seen exactly what I was referring to earlier: potential move in GDP as well as Central Banks actions.
This brief introduction brings the title to this year investment outlook:

From Polarization to Divergence

Basically since 2009 we experienced a period of polarization, meaning that before that year, in different aspects of life there were a fragmentation, a number of different providers: be it banks or suppliers in general, and performance contributors too. Just as an example let's take the number of banks in the US pre 2009: that number has dramatically decreased since.

At the same time, number of performance contributors for investors decreased likewise. There hasn't been much choice in the last twelve or twentyfour months especially. The crowded trades were US and EU Bonds, US Equities and German Equities, and in a more tactial way even equities of peripherical Europe.

In the chart in Figure 1 are presented as the 2014 winners the Shanghai and Indian equities, but those are still in the Emerging Market sphere. To give an idea about the major crowded trade investors (and the Fed alike) were in, in 2014, here in Figure 3 is presented the Vix, the volatility index for the US Equity Market.

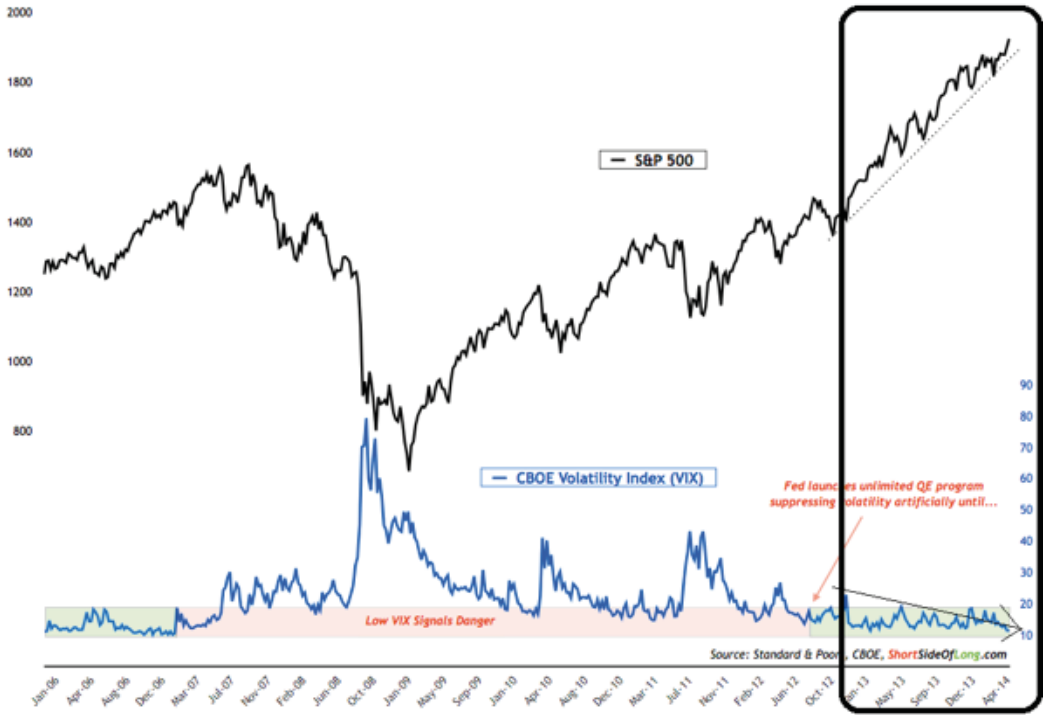


Figure 3: Chart showing Sp500 and VIX

The movements of Vix in its most general acception signals ups and downs of the Sp500, which means buying and selling activity. If the Vix moves continously lower to its lowest level, it means that there is no selling activity in that market, but only buying activity. That is quite a crowded trade.

Same situation can be described for US and EU bonds, where yields are starting to enter into negative territory (see December 2014 Bobl issuance, the German 5yr bond).

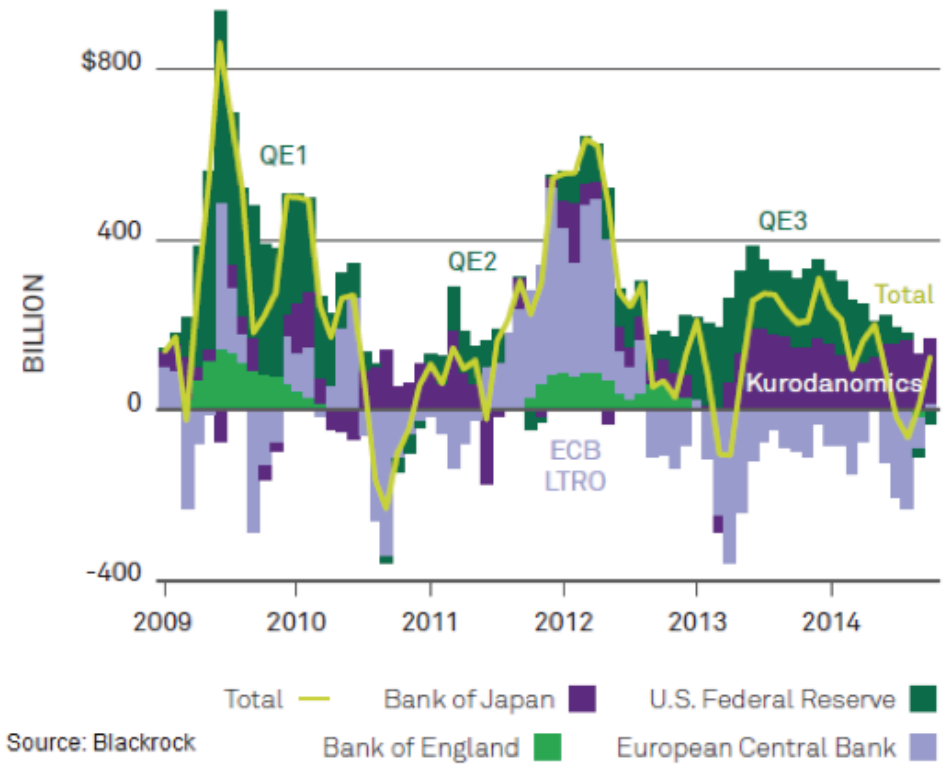


Figure 4: Central Banks interventions

The above charts and explanation shows well the polarization I refer to. Different actions from Central Banks together with different economic growth around the world will necessary bring the divergence I am expecting among all asset classes.

Before going into 2015 please find below some data and performances of 2014 which may be useful to have in mind when looking ahead.

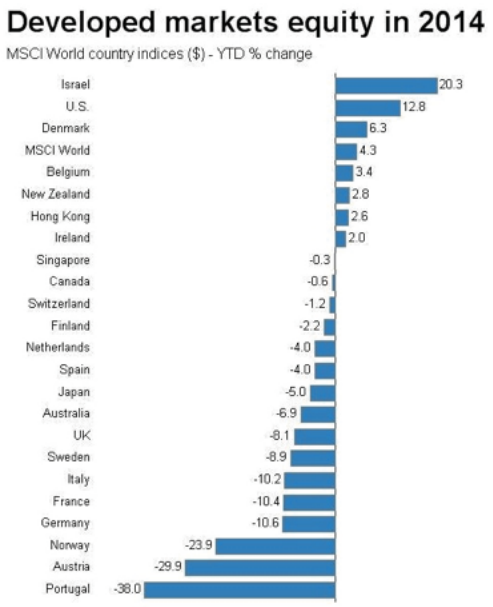


Figure 5: Equities performances in 2014

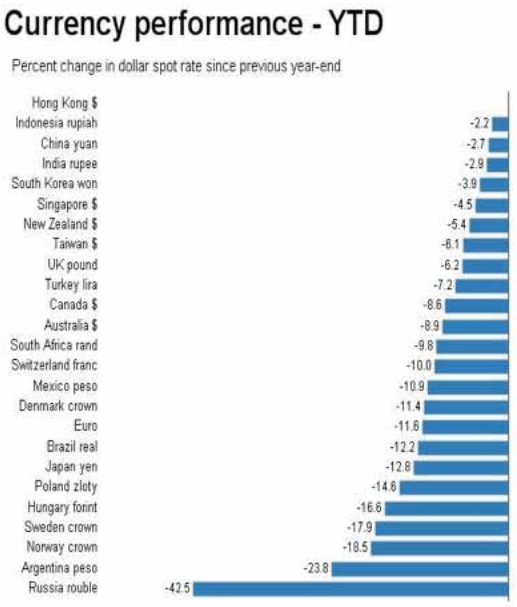


Figure 6: Currencies performances in 2014

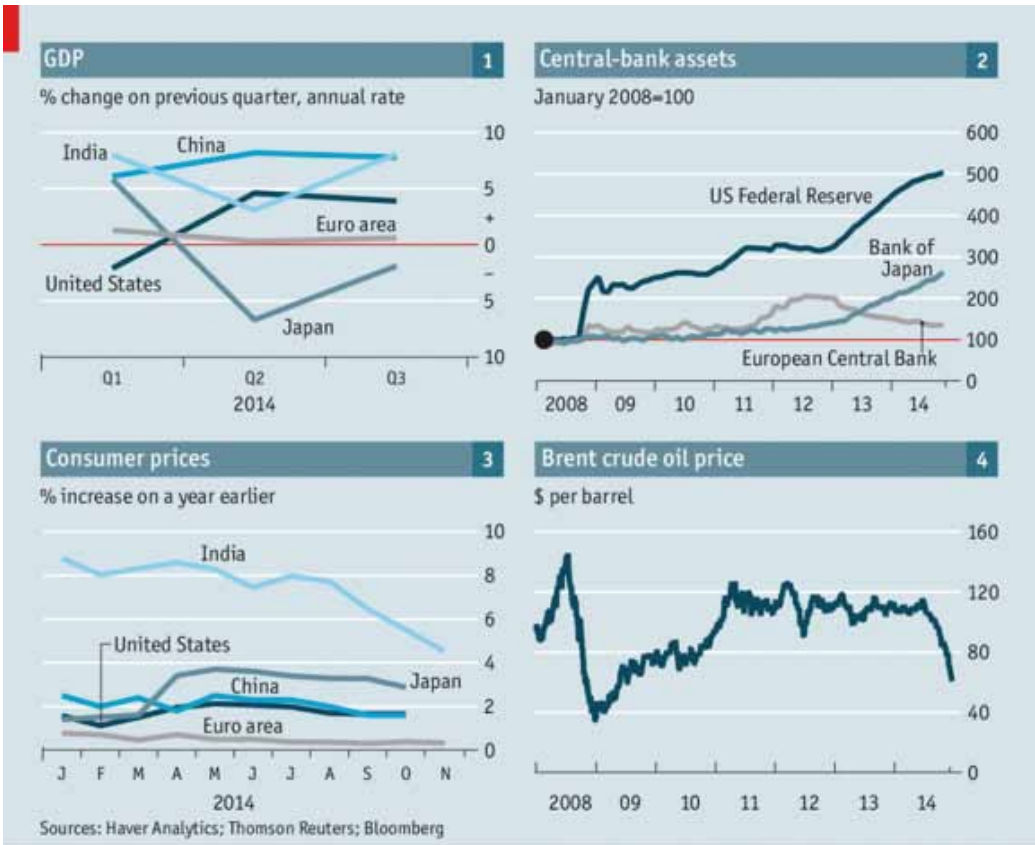


Figure 7: Year 2014 in four charts

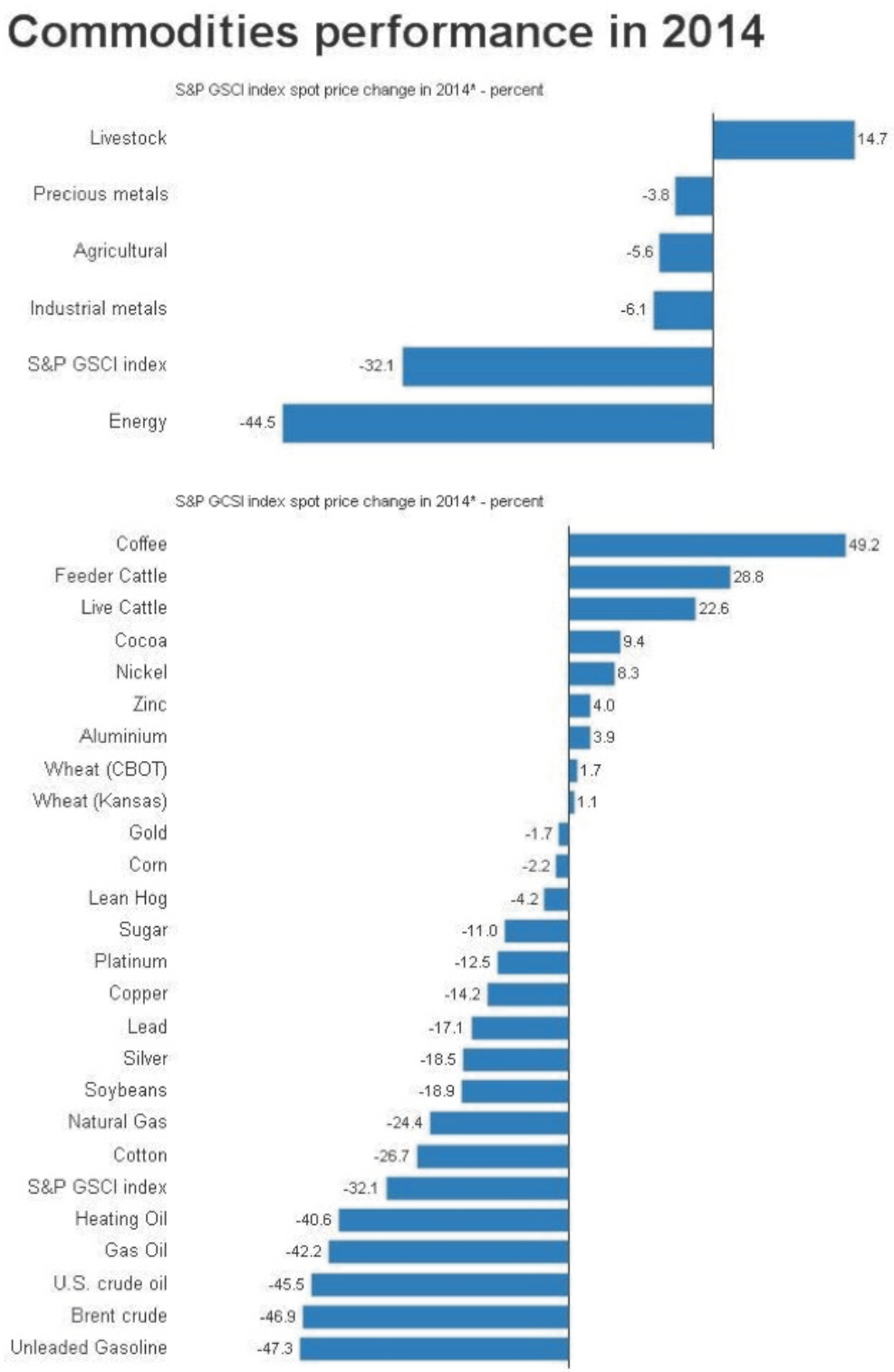


Figure 8: Commodities performances in 2014

In the following pages you will find what I currently see in each investible asset for 2015.

BONDS: STAY BUT RAISE QUALITY AND SHORTEN DURATION

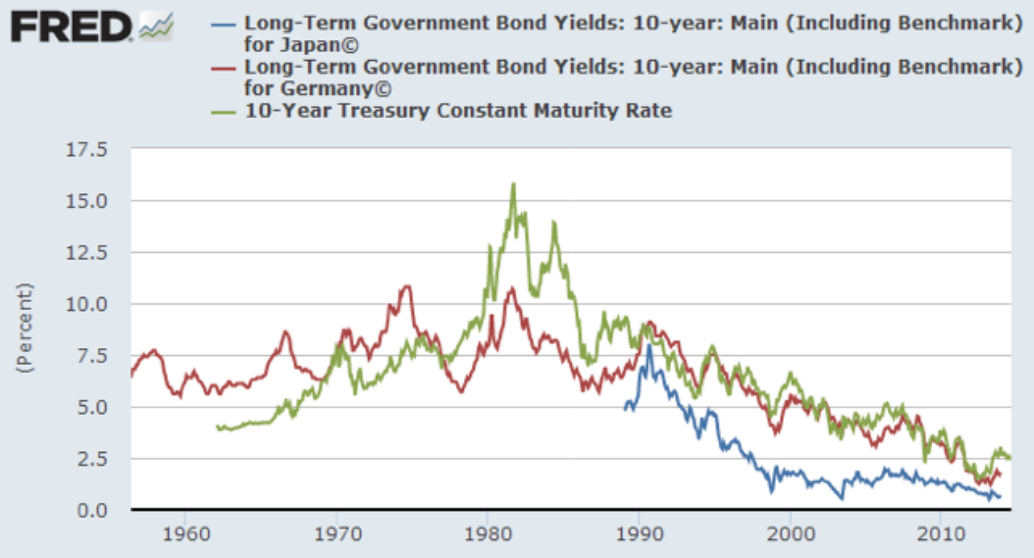


Figure 9: Yields for major 10yr bonds

The very first effect of Central Banks' interventions is the capitulation of interest rates to the lowest level in eighty years. The chart in Figure 9 shows precisely the behaviour of the yields for major 10 year government bonds, namely Japan, Germany and US. What should be of striking evidence is when exactly yields started to change trend from upward to downward. If we take the US as a benchmark, the trend inversion happened in the late 1970s and since then we lived (mostly without even knowing it) in a secular bullish environment for bonds. However we are fast approaching a possible secular trend inversion here, from bullish to bearish for what concern bonds yields (therefore a new environment of raising yields).

But what is similar to the behaviour of yields, meaning what has been constantly falling since the 1970s? The American GDP, have you ever noticed?

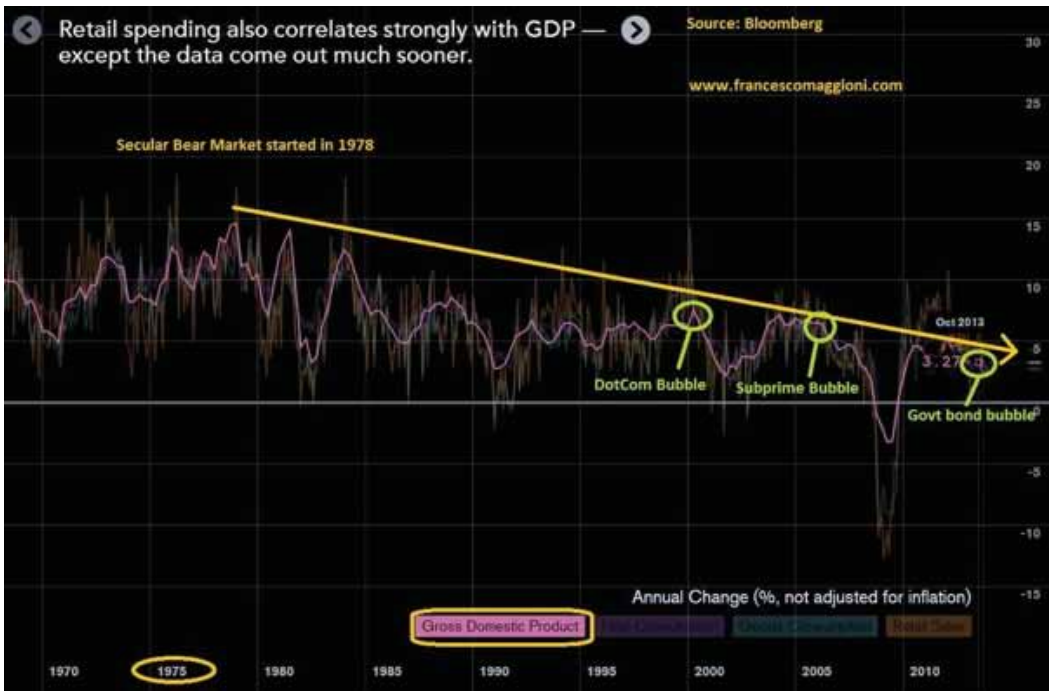


Figure 10: Yields for major 10yr bonds: from one of my tweet @fmaggioni

My point is that 1970 marks the border between multi year economic expansion and multi year economic recession and right now we are witnessing the slow end of this multi year recession.

Before a trend inversion in interest rates I sense it will happen what technical analysts call a “capitulation”.

A capitulation happens when the price of an instrument (tipically a stock) continues to fall, more or less in an ordinarly fashion and then, all of the sudden, it drops dramatically and vertically to absolute low levels. In such instances the vertical drop is accompanied to an explosion of volume of that instrument, giving the sign that everybody who had the stock until then, was selling it in that precise moment, no matter at what price.

That is what I am expecting in bonds. But what exactly means a capitulation in interest rate?

It means that there could be a moment during the 2015, or 2016 at the latest, when everybody will run for safety and will buy government bonds (mainly) paying any price, just to be on the safe side. If today we

are at the lowest level for yields, what I am expecting is an even lower yields enviroment, probably a negative territory for most government bonds.
I am well aware that this is an extreme event, but this is what I expect. If the extreme event will not take place, than we should witness an ordinarly and slow path towards higher rates.

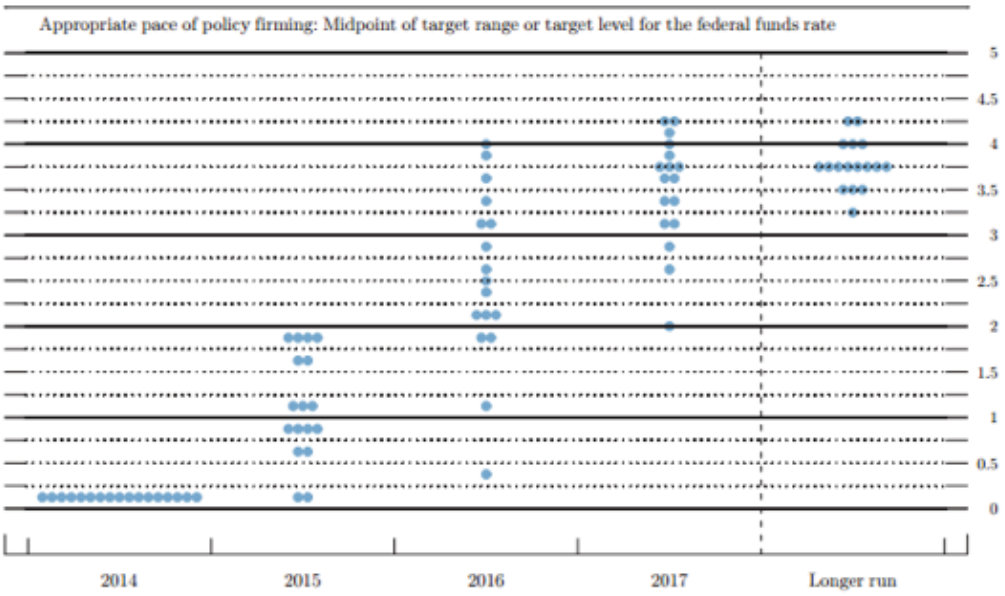
In both cases there is no need to liquidate current holdings in the bond space, but rather re-act. A trend inversion will not happen overninght, so there is no need to unload or resize current holdings in this space, but sooner or later this inversion (not the extreme event) will take place.

As written earlier, there are plenty of QE now around the world and those QE will end up buying primarily bonds.

Market commentators and people close to the Fed are signalling that a first rate hike in the US will happen as soon as May 2015.

A confirmation that a rate hike may happen in 2015, giving that general economic conditions remain “ceteris paribus” comes directly from the Federal Reserve, in its September 2014 statement. In such statement can be found the “dot chart” which shows for each (of the seventeen) member of the board where the federal funds rate should be.

Below in Figure 11 you can see the “dot chart” taken directly from the FOMC’s September statement.



NOTE: In the upper panel, the height of each bar denotes the number of FOMC participants who judge that, under appropriate monetary policy, the first increase in the target range for the federal funds rate from its current range of 0 to 1/4 percent will occur in the specified calendar year. In September 2014, the numbers of FOMC participants who judged that the first increase in the target federal funds rate would occur in 2014, 2015, and 2016 were, respectively, 1, 14, and 2. In the lower panel, each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run.

Figure 11: Federal Funds rate projections – FOMC Sept '14 statement.

A good strategy in the bond space could however be to raise asset quality and reduce duration: in this way even if rates should start moving upward, the effect on a portfolio should be contained.

Preferred assets: Sovranationals as EIB, World Bank, then in this order: German Bunds, high quality European corporates, Japanese JGBs, high quality US Corporates, US Treasuries.

On the low end of quality there is the High Yield space. This segment is duable as long as equity markets are trending higher. But are the ones who are going to be hit the hardest in case of sharp declines or corrections. Much of the High Yield space is made by energy related companies, therefore with Oil probably going below 40 USD per barrel, there is (and will be) much stress in this asset class going forward.

On the Emerging Market space the preference should be on hard-currency denominated debt (USD or Euro), but knowing that rising issuance and volatility in the oil market – that impacts negatively some

EM countries – have created pockets of vulnerability.

Even for emerging market is valid the initial advice, raise asset quality and reduce duration.

When a first rate hike will happen, it will be a good idea to start looking for floating rate bonds.

Same argument for inflation linked bonds, it is better to re-act than anticipate: wait for signs of inflation to pick up (more so in US and EM than in EU) to start buying these assets. Preferred currency: USD, then EUR.

Wild cards: if interested in something more appealing and therefore riskier, part of allocation could be in Russian energy (megacap only) related bonds, in EUR or better in USD.

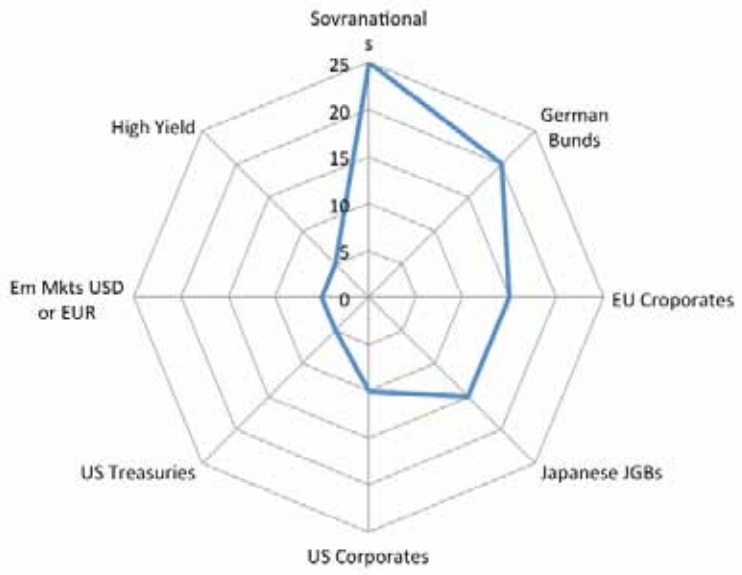


Figure 12: Proposed allocation for asset class: bonds

From Polarization:
Buy US and EU bonds alike, govies first than corporates, then JGBs, EM and High Yield.

To Divergence:
Buy Sovranationals, EU govies and corporates, then JGBs, then US Corporates and govies alike, EM and High Yield.

EQUITIES: BUY THE DIPS BUT READY TO JUMP SHIP (March or June?)

In the equities, it is good to put things into context, so let me start with two charts listing all major world indexes respectively from the year 2009 and from year 2000.

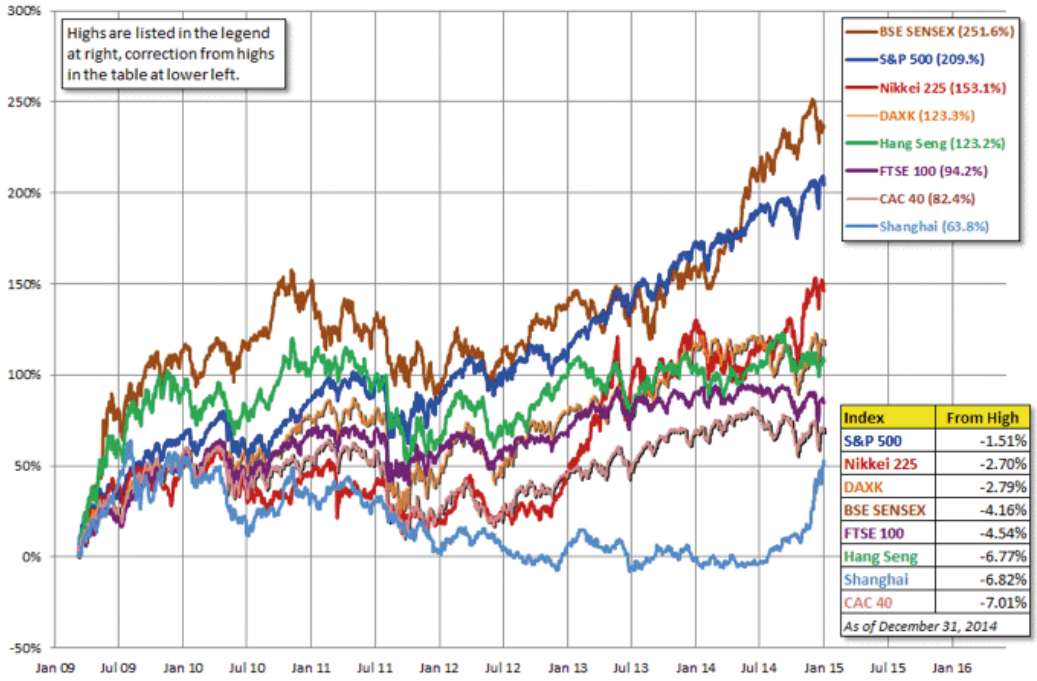


Figure 13: Major world indexes with performance starting in 2009

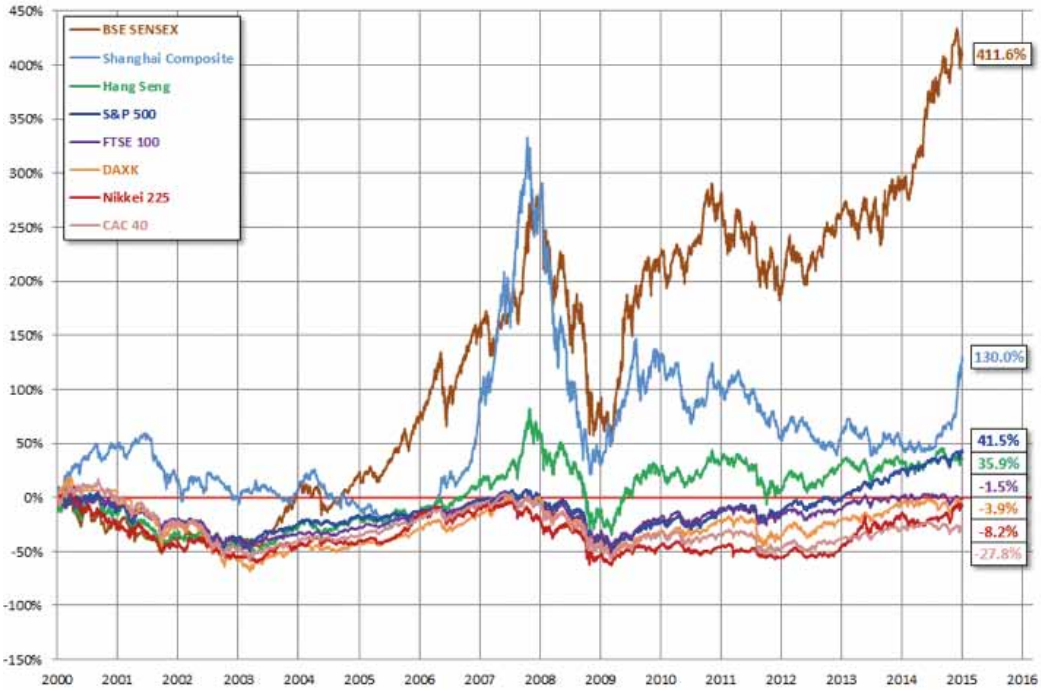


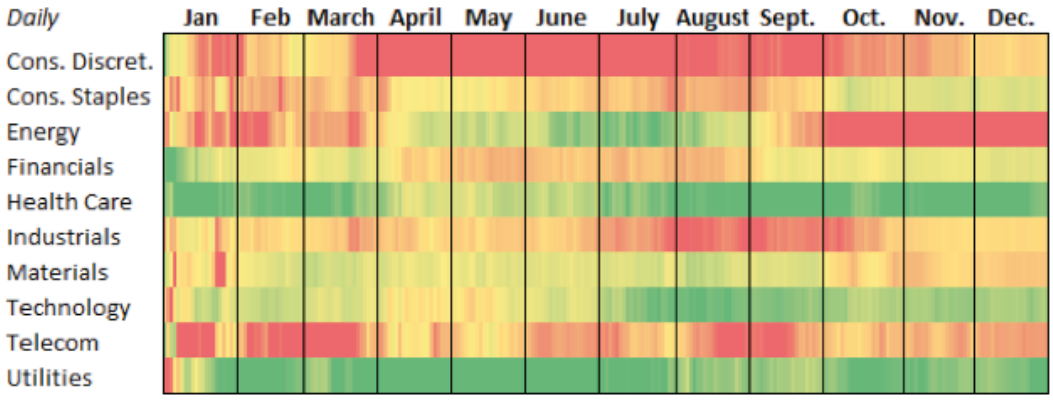
Figure 14: Major world indexes with performance starting in 2000

As it can be seen equity markets enter the 2015 in an over stretched situation: it doesn't matter which market. Of course Indian and Chinese are the two most stretched markets, but if we look at the least performers such as Nikkei, Dax and Cac, they are all up at least 30% in the last two years. Performance rises if we look a bit further, but the picture changes completely looking from the year 2000.

My point is that in the short term markets are stretched, but some are even more so in the long term too. It is becoming increasingly difficult to really understand where markets are and what to expect, also due to the latest Central Banks' interventions. A misleading picture can be easily derived looking at the last two or three years, but looking at five to ten years, it helps to see things in a broader context.

Going back to 2015, equity markets that can be preferred are the ones where QE are still in place, therefore Europe (to be confirmed on January 22nd during ECB meeting) and Japan with a smaller allocation, the latter poised to see a lift from the increase in massive QE from both the Central Bank and the country's largest pension fund. Concerning US Equities, the judgment is currently a hold for those who are already in it while for new comers the suggestion is to wait for sharp decline before entering ("buy the dips"). Such declines should materialize as QE has ended last October so a substantial big buyer is not there anymore leaving the door open for an increase in volatility.

Looking at sector performances for 2014, the result is not what normally someone would expect. In fact the best performing sectors are Healthcare and Utilities, two defensive sectors in the US: similar picture in Europe, with the addition of Consumer Staples. Having the SP500 reached new All Time High, it should be expected that cyclicals did the job. To me this is quite worrysome, it means that index is not pushed by the right sectors, so the current cycle cannot be completely labelled as outright expansion.



Month End	Jan	Feb	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.
Cons. Discret.	-5.97	-0.24	-3.16	-4.53	-1.92	-0.13	-1.49	2.77	-0.23	1.86	7.24	8.50
Cons. Staples	-5.30	-2.00	-0.16	2.54	4.33	3.78	0.20	4.78	5.07	8.65	14.43	14.47
Energy	-6.33	-2.04	0.19	5.31	6.41	11.66	7.86	9.83	1.44	-1.59	-10.30	-9.17
Financials	-3.73	-0.90	2.15	0.48	1.72	4.04	2.42	6.54	5.97	8.99	11.30	14.39
Health Care	0.87	6.87	5.40	4.77	7.46	9.69	9.66	14.84	15.20	21.26	25.12	24.62
Industrials	-4.53	-1.17	-0.39	1.10	2.80	2.91	-1.34	2.55	1.25	4.94	7.88	8.55
Materials	-4.66	1.71	2.30	3.01	5.93	7.47	5.33	9.07	7.18	4.37	5.62	5.77
Technology	-2.59	1.64	1.86	2.07	5.63	8.02	9.54	13.57	12.71	14.58	20.28	19.94
Telecom	-4.16	-5.16	-0.73	-0.31	3.07	1.76	4.37	3.25	3.61	3.41	4.56	-0.69
Utilities	2.88	5.76	9.02	13.60	11.73	16.42	8.37	13.19	10.76	19.52	20.39	28.02

Figure 15: Returns for US sectors during 2014

The best performing cyclical sector is third in line and is technology.

Adding to this unclear situation is the commodity side (see Figure 8), with Copper, Silver, Natural Gas and in December the Oil debacle, which doesn't confirm the expansion thesis neither.

The result, adding all the information above, is that equities are going up for the wrong reasons: still the job is to follow trends, not being right, so as long as equities go up, the result is to stay invested especially in the strongest sectors, being conscious that something can happen due to such unusual situation.

Even if a raising interest rates environment should materialize, for most people welcomed as a sign of a new expansion period, I would be personally cautious and wait for consequences. Again it is better to re-act than anticipate.

Current level of debts, especially for autos and students loans are at

historical high levels so an increase of interest rates will have at least two opposite effects, and we do not know which the end result will be.

In addition if there will be a capitulation in interest rates as described earlier it would probably mean that a new crises could emerge, which will bring equities to a stress period at least.

What I expect in 2015 is a year with two different faces. The first period which should go up to March or June this year, should be a period of increased volatility but with potential new All Time Highs for the strongest markets, SP500 and DAX and relative new 2014/2015 highs for peripheral Europe: once these target will be achieved, a period of stress should materialize which could potentially result in negative performance for stock markets at year end.

This is in line with my secular outlook, online now for two years at the link
http://www.francescomaggioni.com/secular_outlook.php

The best course of action is buy the dips which they will tend to be larger in the US than potentially in Europe, but with the finger on the sell button the moment it can be realized that investors believed to buy what they think is a dip, but in reality is a new (downward) trend forming.
For the ones who have been invested in equities at least in the last 12 months and are still correctly invested, lowering the exposure to equity selling part of the holdings will bring no harm for sure, but only a healthy profit locking, considering that many US and EU stocks are at all time highs. Adopting hedging strategies will potentially result in a great winning strategy also.

In addition I reveal a little secret to efficiently investing: buy equities at the highest unemployment level, and sell equities at the lowest unemployment level.

Unemployment is a great contrarian indicator. See the chart on the following Figure 16.

This little secret should anyway favour European to US Equities and indeed the start of 2015 is seen professional investors look into this divergence.

There are a number of indicators that are showing that at least the US market is in a topping process, another one is the Bull and Bear Ratio which shows the investors attitude towards the equity market, and right now it is at the highest Bull level equal only to the year 2000 (see Figure 17): peaks in highest to Bull/Bear ratio coincide to lowest unemployment rate level, surprised?

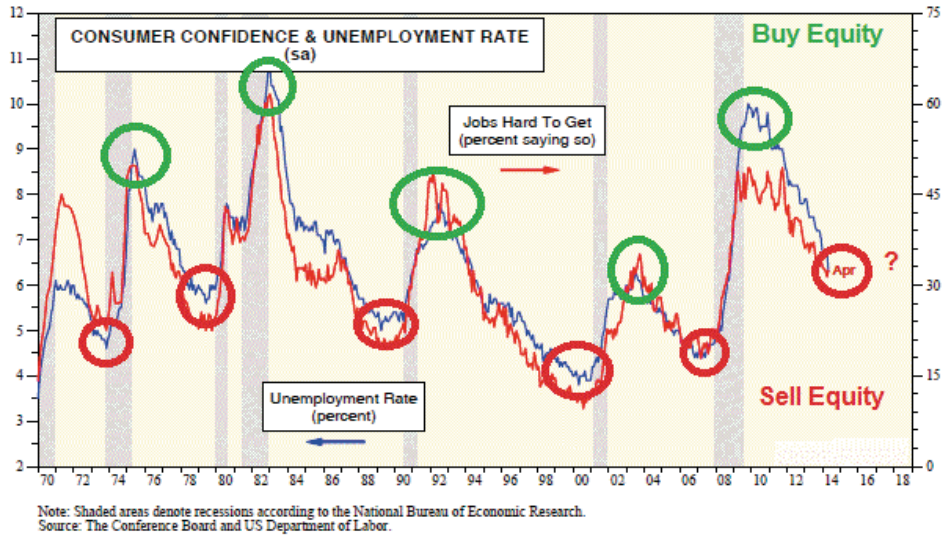


Figure 16: Timing Equity exposure to US Unemployment

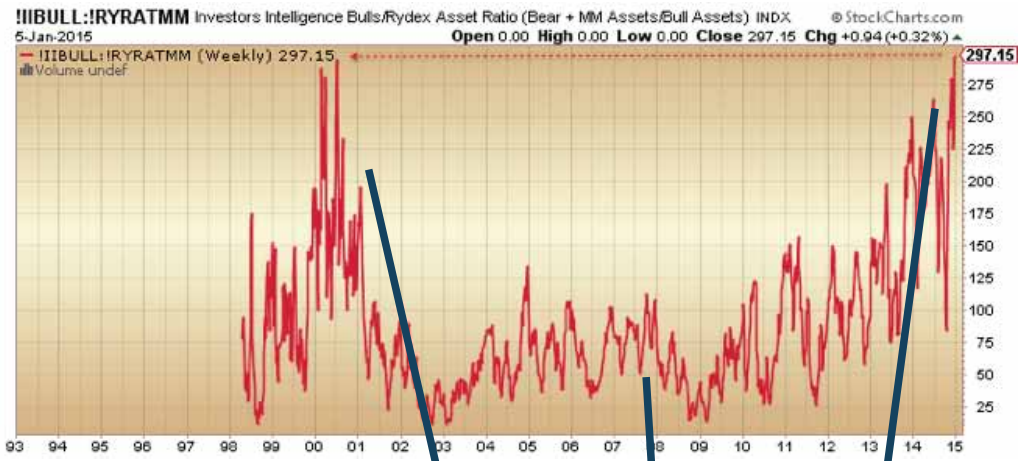


Figure 17: Bull/Bear Asset ratio

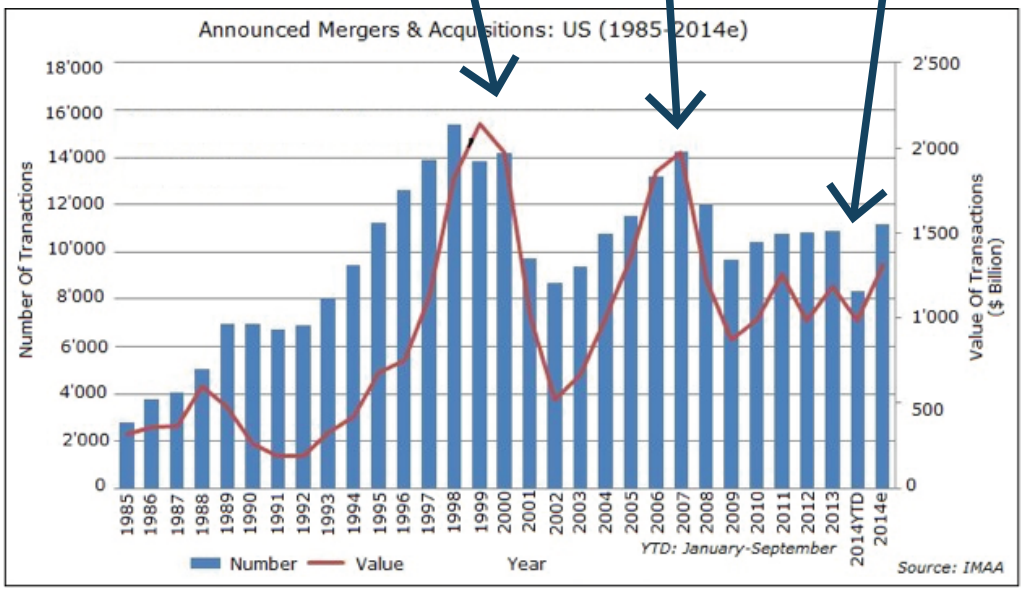


Figure 18: Number and amount of M&A in the last 30 years (see hedge funds chapter later on)

If we consider the american equities as leading almost worldwide, then two main scenarios can be drawn, a Plan A and a Plan B, that are presented in the chart on Figure 19 below.

Figure 19: SP500 index with plan A and Plan B scenarios

If the above would turn to be correct, than a hedging strategy will avoid lots of headaches for investors: those are strategies that can be implemented via options or buying etf inverse, 1x or 2x time leverage.

You can get used to hedging strategies going on my website and try the portfolio backtest tool, at the link (http://www.francescomaggioni.com/portfoliobacktest/) and see how a portfolio of stocks with an inverse etf would have been behaved in the past. At the following charts a simple example.

Figure 20: Behaviour of Coach (COH) compared to SP500 last 12 months

Figure 21: Behaviour of a portfolio of 70% Coach and 30% ETF INVERSE SP500, last 12 months

The above charts represent the stock Coach (ticker COH) compared to its reference index, the SP500 on Figure 20, while on Figure 21 there is a portfolio of 70% Coach and 30% the ETF 1x Inverse on the SP500, both in the last 12 months.

Even if the charts seem identical, the statistics are not. You can see the differences in returns (-31.88% vs. -26.36%) and in volatility (26.54% vs. 17.83%).

Hedging strategies are implemented typically (but not only) buying protetcion on an index. In this case the protection was effective but not as much as desired since the SP500 in the last twelve months has been trending higher.

What I would expect in the second part of the 2015 is a significant stress in the markets which would affect indexes too: in that case a hedging strategy will be much more effective.

Summing it up:

- Do not rush but wait and buy the dips;
- Buy the strongest sectors (buy the trend);
- Be careful and look for clues on potential trend inversions in March or June;
- Start favouring more Euorpean equities than US ones;
- Japanese market is the least performer, keep an eye on it if starts trending up.
- Consider adding hedging strategies if strong corrections arise, both via options or etf inverse 1x or 2x.

To have a good idea on which sectors are the strongest, you can look at my adaptive asset allocation that is updated monthly, here is the link and in Figure 22 below:
http://www.francescomaggioni.com/asset.php

In my adaptive asset allocation you will find not only main general equity sectors for Eu and US, but also bonds (black area) and Gold (yellow area).

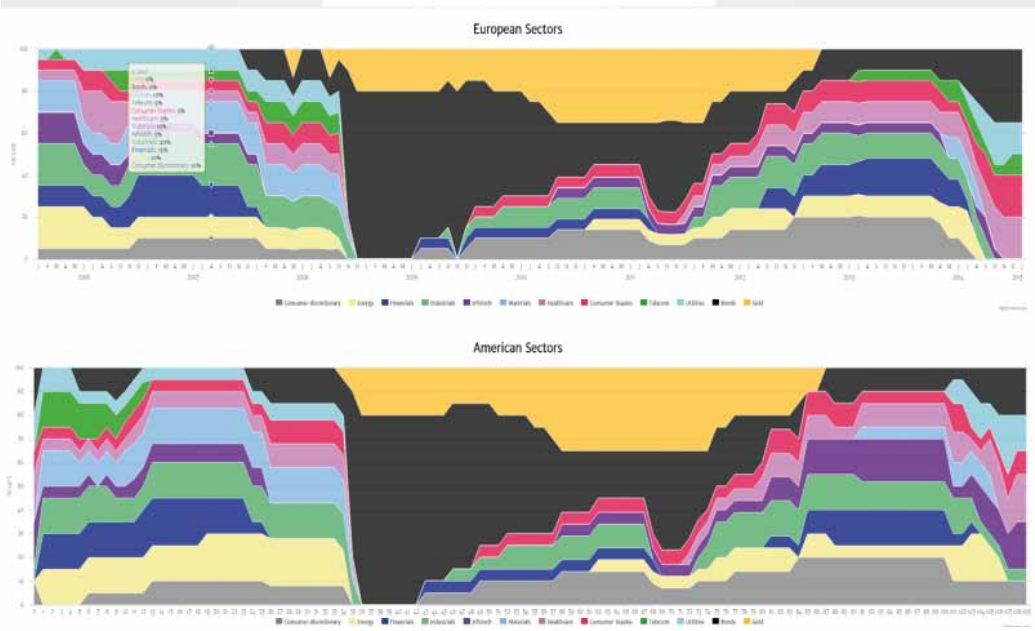


Figure 22: My EU and US adaptive asset allocation in my website, since 2006.

From Polarization:
Buy US and EU equity alike, then EM and Japan.

To Divergence:
Prefer EU Equities and Japan then US and EM, with a tactical hedging strategy.

HEDGE FUNDS: LOOK FOR STRATEGIES THAT GIVE REAL HEDGES

Hedge Funds performed decently in 2014 but times of stellar performances are something of the past. Someone could be actually frustrated with performances, as looking at the table below and comparing it with outright equity and bond allocation. However hedge funds usually form their strategies around some sort of hedges indeed, which is a protection and could cost a (good) part of the net performance. So in reality it is correct that hedge funds underperform the markets.

Credit Suisse Hedge Fund Indexes

Performance | Overview | Constituents | Methodology | Documents | FAQ

Performance

Monthly Performance

Index / Sub Strategies	Currency	Nov 2014 Value	Nov 2014 ROR	Oct 2014 Value	Oct 2014 ROR	YTD Return	1 Year Return	Avg Anni*	Std Dev*	Sharpe*
Credit Suisse Hedge Fund Index	USD	553.85	1.50%	545.68	-0.80%	4.12%	5.36%	8.53%	7.18%	0.81
Convertible Arbitrage	USD	416.64	-0.10%	417.04	-1.79%	-0.53%	0.00%	7.06%	6.58%	0.66
Dedicated Short Bias	USD	30.01	0.64%	29.82	-3.99%	-6.45%	-7.18%	-5.59%	16.37%	-0.51
Emerging Markets	USD	434.50	1.71%	427.20	-1.12%	1.34%	2.64%	7.28%	14.07%	0.32
Equity Market Neutral	USD	266.49	0.57%	264.98	0.45%	-0.51%	0.78%	4.80%	9.76%	0.21
Event Driven	USD	636.04	0.55%	632.53	-2.16%	2.13%	3.77%	9.25%	6.11%	1.06
Distressed	USD	771.52	0.14%	770.44	-1.96%	3.06%	5.06%	10.26%	6.35%	1.18
Multi-Strategy	USD	578.65	0.73%	574.44	-2.24%	1.72%	3.22%	8.76%	6.61%	0.91
Risk Arbitrage	USD	343.87	0.57%	341.92	-2.35%	-1.40%	-1.02%	6.08%	4.06%	0.82
Fixed Income Arbitrage	USD	301.29	0.21%	300.67	-0.10%	4.44%	4.63%	5.41%	5.40%	0.49
Global Macro	USD	885.36	1.65%	870.97	-0.92%	3.37%	4.10%	10.99%	9.21%	0.90
Long/Short Equity	USD	651.78	1.89%	639.71	0.01%	5.18%	7.07%	9.38%	9.48%	0.70
Managed Futures	USD	314.37	7.50%	292.43	1.81%	16.42%	16.55%	5.63%	11.54%	0.25
Multi-Strategy	USD	499.86	1.22%	493.85	-0.49%	5.66%	7.39%	8.10%	5.13%	1.04

Figure 23: CS hedge fund indexes as of November 2014 performances

On my website you can also find a hedge fund section, here is the link (http://www.francescomaggioni.com/hedge-funds.php) and below a preview of the page itself where you can find performances for main hedge funds strategies, visually adapted.

Figure 24: Hedge funds performances visually presented on my website

QWhat comes out with striking evidence from the chart above in Figure 24 is who is the real winner in an almost ten year period: the Global Macro hedge fund (black line).

It can be seen that outpaced any other strategy but more importantly was the second best during the 2008-2009 financial crisis and since then performed best. The best strategy in the 2004-2007 period has been the Emerging Market one (red line) which in the chart above can be seen at the end of such period

The least performer has been the Fixed Income Arbitrage (purple line) which underperformed any other strategy for almost ten year straight. This is even more astonishgly considering that in the last 18 months there have been quite a number of Quantitative Easing around the world. Without considering previous TARP and ZIRP. In the fixed income world Convertible Arbitrage (light blue line) has done better, but still is another strategy that seems not to have any protection in the down side.

Interesting behaviour has been the Managed Futures (yellow line) that contrary to general belief that tends to perform decent in any market enviroment, it turned out it perform well only in clear and strong trends, while get basically lost in any other market situation.

Event driven strategy (green line) are generally associated to (but not only) takeovers and mergers and acquisitions (M&A). Usually takeovers happen at the end of an expansion cycle since companies have no other ways to boost returns other than "acquire" revenues. How have been the M&A in the last few years? See Figure 18 to have an idea and with Figure 17 and 16 you can see periods like year 2000, year 2007 and 2014 what coinceded and coincides currently.

What is then the point here?

The point that can be derived from the above chart is that generally speaking the best strategies are the ones mostly related to equities, which tend to outperform most of other strategies in both good but also bad times.

Fixed Income strategy isn't something very appealing, and if someone is looking for steady returns, he or she can directly get exposed to a long only fixed income fund, in 2015 especially a High Grade one rather than a High Yield. The investor will very likely get extra return with the same volatility.

An all season strategy, one that can be bought in and forget about it (but a check from time to time is always good) is the Global Macro one. From 2009 we lived in very clear global macro themes and good global macro managers have strongly profited from those. In addition this strategy seems to protect well capital in period of financial crises and should not bring too much stress for his investors, as the 2008-2009 returns show.

Going back to the title of this chapter, which strategies then offer a real hedge?

As discussed above Global Macro is surely one, but the real performer for hedging is the Managed Future strategy. As said before this strategy seems to perfom only in periods of strong trends, both bullish and bearish and indeed this strategy (yellow line in Figure 24) is trending steady higher in the 2008-2009 crisis and in the last twelve months of QE and low volatilty.

THE UNKNOWN UNKNOWNS

"There are known knowns; there are things we know we know.

We also know there are known unknowns; that is to say we know there are some things we do not know.

But there are also unknown unknowns -- the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones"

Defense Secretary Donald Rumsfield, February 2002, White House Press Conference

Nobody knows the future, and we live in an era of chaos, despite what central bankers want us to believe.

Volatility is at historical low levels, US markets are the historical high levels, so does the general bond market.

Those levels will not continue forever so investors should be anyway worried and plan for possible multiple worst case scenarios. Western economies have not solved any of their problems that surfaced in 2009 so things are not as great as we may see them.

Personally I would like to add to the above analysis that the first requirement of any investment: liquidity. Do not take position of any illiquid investment, or at least make it no bigger than 5% of your allocation. You should be able to exit any position in one day at the maxiumum, or have an hedging strategy in place otherwise. As Buffet said: "it is only when the tide leaves that we discover who is swimming naked".

Allocate part of your portfolio for hedging purposes, either through outright options or via Inverse ETFs.

And as Mohammed El-Erian said two of the most important characteristics an investor must have today are: Agility and Absortion.

Francesco Maggioni

Mr. Maggioni has been working in the financial markets for the last 15 years covering different roles and working in tier 1 consulting companies and banks worldwide.

In recent years his studies have been focused on the psycho-emotional aspects of trading and how those aspects have an impact on traders' behavior.
Before starting this venture, he was head of a hedge fund desk at HSBC Private Bank in Monaco and before that he was employed at Credit Suisse Asset Management (CSAM) in Zurich covering the in-house single manager hedge funds.

Most of his experience in hedge funds was gained while working in a Swiss family office where he was in charge of the research and analysis as well as due diligence for US and European hedge funds. He also performed quantitative analysis and portfolio construction for several funds advised by the family office.

Prior to that he worked as an external consultant for KPMG Financial Services in the Milan office. In 2002 he has been hired by Ernst & Young LLP, San Francisco as auditor for hedge funds, auditing large single funds and fund of funds. In 2000 he joined Ernst & Young in Milan as an auditor for mid-sized companies.

Mr. Maggioni holds an MBA from IUM and a Portfolio Management degree from the University of Chicago GSB.

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