



Q2/H1 Strategy & Market Update—Understanding, Evaluating, and Positioning in the Current Market

(Parenthetically: As previously advertised, last quarter we celebrated the launch of our brand-new website. We have worked hard to make it chockful of state-of-the-art information from the frontiers of the asset management industry and academic finance. And we ensured it includes a great deal of substantive and contrastive information on our proprietary thinking and the philosophy and workings of our strategies. We will send on this another note soon, but in-between please make it a point to visit us at www.gnhcapitalgroup.com where you can find answers to many of your questions, updated commentary, and also access a secure portal to enter into your accounts. Without further ado...)

How can one best evaluate what is happening currently in the market?

The best way to assess its causes, supportive and undermining factors, overall health, and likely arc is to see it in the perspective of time as the third wave of the CoViD exogenous ⁽¹⁾ shock.

This view has a crucial benefit—it explains why all three phases are characterized by explosive volatility, large drawdowns and draw-ups, plus violent reversals. All those characteristics are typical for markets that originated in crashes under the impact of an exogenous shock.

Seen at a deeper level, the current market action began in Q1 2020 and has had three phases to date.

1. **Phase 1 (Feb. – Mar. 2020):** the exogenous shock of the pandemic brings about a market crash not seen since 1987 and perhaps the Great Depression.

While Wall Street braced for a possible new Great Depression, our strategies took the measure of the market activity and the economy unemotionally. First, we believe our strategies verified that the crash was unfolding amid an ongoing bullish market regime that had run uninterrupted since Mar. 2009. Then, by x-raying its behavior, our strategies concluded that, in our opinion, the crash did not have the necessary power to graduate into a sustainable bear market (lower-for-longer), despite its ferocious -35.4% drawdown (!). Similarly, our strategies assessed that the economic contraction caused by the shutdowns was not likely to turn into a full-blown recession.

2. **Phase 2 (Mar. 2020 – Jan. 2022):** we witness the spectacular V-shaped recovery.

Despite the drawdown of -35.4% for the S&P 500 index, the broader market only spent seventeen days below the -20% trip-wire, traditionally considered the demarcation line for bear markets. And the economic contraction that triggered the official 'recession' mark ended within mere weeks. The broader market finished the year strongly positive, and we believe our strategies capitalized on it, *against* all the fears of a 'Depression'-caliber bear market coupled with a generational recession.

Wall Street continues to include this episode in the list of bear markets and recessions of record. We believe this inclusion is an error.

3. **Phase 3 (YTD 2022):** the market has been in a rolling correction punctuated by volatility, drawdowns, and an unprecedented decline in bonds—all registering in the backdrop of a wave of higher prices (marked as

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‘inflation’) reverberating across the global economies.

Wall Street gives many reasons for the backpedaling, including money ‘overprinting’ (excess CoViD stimulus from governments and central banks), excessive valuations, unsustainable earnings expectations, and the bursting of various mini bubbles (crypto, meme stocks, etc.). However, almost universally, the wave of higher prices (so-called “inflation”) is identified as the head falling domino responsible for triggering the central banks’ rate hikes and, through that, exposing all other market weaknesses and setting in motion the entire corrective chain reaction.

The chain reaction is transparent: The exogenous CoViD outbreak sends a shockwave across the economy and the markets. Under its pressure, the market first recoils heavily but then, owing to the resilience of its underlying bullish market regime, does not break but rebounds in a pendulum-swinging to an equally overstretched position from which we believe it is now correcting. Anybody that has hit a guitar string, thrown a stone in a pond, or rolled out a yo-yo has a good idea of how all this has worked.

Beyond accounting for the repeated waves of volatility, drawdowns, and draw-ups that have characterized the market action since 2020, this model sheds light on the nature of the current Phase 3’s key ingredient—“inflation.” Inflation is considered the widow maker of this market and the Gordian knot that needs to be cut to prevent the market from sliding into bear territory and the economy from falling into a recession. Let’s look more closely at “inflation”—the shaping force of our current Phase 3 market.

4. **Inflation, Supp(ly)-flation:** Why is the wave of higher prices we are experiencing considered the ‘widow maker’ of the market? Simple—it’s because of the specter of the stagflation of the 1970s/1980s. But like the previously drawn parallel of the CoViD crash to the Great Depression, we believe the comparison is wrong. To wit:

The 1970s/1980s inflation was a demand-driven runoff of prices amid a severe currency dilution, with gold going dramatically up and the dollar collapsing. Currently, our wave of higher prices is driven by an unprecedented collapse of the global supply and transportation chains—courtesy of the CoViD shutdowns—and is accompanied by the weak performance of gold and a strengthening dollar! While the 1970s/1980s higher prices were a demand-flation, our wave is definitely a supp(ly)-flation—indeed apples to oranges.

The 1970s/1980s inflation was the external manifestation of severe endogenous disease in the US economy associated with loss of competitiveness, lower productivity, war fatigue, and money devaluation. The combination was challenging to cure, but demand-flation was still amenable to monetary remedies like higher interest rates. In contrast, our wave of high prices is the result of an exogenous factor—the self-inflicted collateral damage of the unprecedented demobilization of the global supply chain as a result of the shutdowns. It’s an external constraint and not an internal disease of the economy. This is good news/bad news.

The good news? The consequences of such exogenous forces are usually easier to reverse. More good news? The relief ship (revamped supply) has already started to leave the Asian ports and is heading to our shores. Asia, the world’s production center, is facing an existential imperative to restore the global supply chains—because, while we are suffering from higher prices because of the scarcity of goods, producers are facing a much more urgent ‘shortage’ of paychecks (no deliveries, no payments).

The bad news? The more shortages persist, the more functional damages can turn structural as businesses switch to survival mode and consumers retrench. More bad news? Under mounting political pressure to address the “inflation” problem, central banks are slipping into the mode ‘we only have a hammer, and so everything will be treated as a nail’ and are applying detrimental monetary pharmacology (higher interest rates) to supp(ly)-flation. Higher interest rates cannot cure supply-driven higher prices but can undoubtedly increase the borrowing costs of small and mid-size businesses. These businesses have borne the brunt of the shutdown

burden and are now between the rock of supply shortages and the hard place of the higher cost of borrowing. So undoubtedly, there is tension, as described in our previous updates.

In response to these pressures, the market has stepped 'up' by stepping down around -20%. This drop is counterpressure to the Fed to moderate its hawkishness for rate increases and monetary tightening. This is important to understand.

In this context, the market's correction is a carefully equilibrated decline that undercuts the central bank's hawkish plans. The Fed is challenged by the market—if it continues aggressively on its quest to conquer inflation with higher interest rates—which is the Fed's second mandate—the market threatens to go down enough to trigger corporate layoffs and cause the Fed to default on its first mandate—preservation of full employment. This is the tug of war we have been pointing out for nearly a year we believe is far more a chess game than a train wreck, as described by the financial press.

5. **All the same, aren't we already gone far enough—hasn't the broader market tripped the bear market wire of -20%? And aren't we inevitably careening into a recession if we haven't indeed already fallen into one?**

By the conventional definition of a bear market as a drawdown larger than -20%, the dividend-reinvested S&P 500 violated the -20% trip wire first on May 23 and remained in the bearish zone until June 23, at which point...erased the bear market by floating above the -20% line. All in all, an 8-day bear market. But on June 28, it fell anew into another bear market, which it erased again by rising above the -20% line on July 6.

This notwithstanding, Wall Street's official record of bear markets is replete with contradictions that raise a significant question mark as to the validity of the conventional criteria for a bear market. We invite you to read the following section carefully.

Beware of "Bear Markets" and "Recessions" – but even more so of...those who declare them!

Since 1929 the typical Wall Street record lists no less than 22 bear markets, defined as drawdowns below -20%. A good number of them are accompanied by recessions—the dreaded double whammy. Investors are conditioned to think of those episodes in the light of the painful experiences surrounding the destructive bears of 2000 and 2008.

But is the threshold of a -20% drawdown with or without a confirmed recession a reliable sign of slipping into a capital-destructive market environment? Do those two accurately signal the onset of an authentic "bear market" that brings about capital destruction and derailment? What does the historical record show?

Take a careful look at the below table. It tabulates 15 of the 22 bear markets on Wall Street's official record. Despite tripping the -20% wire—just barely or as much as -42% in the case of the 1930s' episode—those 15 "bear" markets just...weren't!

On their own, they did not have the power to cause capital destruction or derailment, as the last column featuring the broader market's annual return for that period demonstrates. It does not even help that there was an accompanying recession in 40% of those instances. Recession or not, still there was no power to effect capital destruction or derailment! On the contrary, the overwhelming majority of those episodes ended up benefiting patient investors!

(Table 1 – see next page)

TABLE 1: “Bear markets” that Weren’t

“Bear Market” (that wasn’t!)	Duration (months)	Max Drawdown	Recession	S&P 500 return
Feb.-Mar. 2020	1	-35%	Feb. – Apr. 2020	2020 +18.40%
Sep. - Dec. 2018	3	-20%	no	2018 -4.38%
May - Oct. 2011	5	-22%	no	2011 +2.11%
Jul.- Oct. 1998	3	-22%	no	1998 +28.58%
Jul.- Oct. 1990	3	-20%	Jul. 1990 – Mar. 1991	1990 -3.10%
Aug.- Oct. 1987	2	-36%	no	1987 +5.25%
Nov. 1980 – Aug. 1982	22	-28%	Jul. 1981 – Nov. 1982	1981 -4.91% ; 1982 +21.55%
Sep. 1976 – Mar. 1978	18	-20%	no	1976 +23.84% ; 1977 -7.18% ; 1978 +6.56%
Feb. - Oct. 1966	8	-24%	no	1966 -10.06%
Dec. 1961 – Jun. 1962	6	-29%	no	1961 +26.89% ; 1962 -8.73%
Aug. 1956 – Oct. 1957	14	-21%	Aug. 1957 – Apr. 1958	1956 +6.56% ; 1957 -10.78%
Jun 1948 – Jun 1949	12	-21%	Nov. 1948 Oct. 1949	1948 +5.50% ; 1949 +18.79%
May 1946 – May 1947	12	-28%	no	1946 -8.07% ; 1947 +5.71%
Jul. 1933 – Mar. 1935	20	-34%	no	1933 +53.99% ; 1934 -1.44% ; 1935 +47.67%
Sep. 1932 - Feb. 1933	5	-41%	Aug. 1929 – Mar. 1933	1932 -8.19% ; 1933 +53.99%

6. The earliest of those cases hails from the Great Depression. And the latest episode is the very productive “unbear” market of the CoViD crash of 2020, which we detailed above.

And in-between is the “bear market,” which started with the storied crash of 1987. As we wrote in our April 2020 Update, this crash did graduate to a veritable bear market but still came far short from inevitably causing an enduring capital impairment (overall, 1987 was a positive year!).

All in all, the overwhelming majority of conventionally defined “bear markets” (68% or 15 of the 22) did not have on their own the power to cause capital destruction or financial derailment. Being so much off the mark, the simplistic definition should have been discarded long ago. Instead, it is being taken at face value and used in virtually everything that comes out of Wall Street. We believe the only reason this failed rule lingers is a void in the conventional theory, plus the desire for a quick-and-dirty rule of thumb that can supply headlines and automatically set portfolio direction without much awareness or research.

But why is the validity of Wall Street’s simplistic definition of a bear market so poor? And why does it seem to work in the rest of the seven cases while it breaks down in the 15 we just examined? What gives? Let’s look at the following table.

(Table 2—see next page)

TABLE 2: Bear markets that **Were**

“Bear Market” (actual bear!)	Duration (months)	Max Drawdown	Recession	S&P 500 return
Oct. 2007 – Mar. 2009	17	-58%	Dec. 2007 – Jun. 2009	2007 +5.49% ; 2008 -37.00% ; 2009 +26.46%
Mar. 2000 – Oct. 2002	31	-51%	Mar. 2001 – Nov. 2001	2000 -9.10% ; 2001 -11.89% ; 2002 -22.10%
Jan. 1973 – Oct. 1974	21	-50%	Nov. 1973 – Mar. 1975	1973 -14.66% ; 1974 -26.47%
Dec. 1968 – May 1970	17	-37%	Dec. 1969 – Nov. 1970	1968 +11.06% ; 1969 -8.50% ; 1970 +4.01%
Nov. 1938 – Apr. 1942	36	-46%	no	1938 +31.12% ; 1939 -0.41% ; 1940 -9.78% ; 1941 -11.59%
Mar. 1937 – Mar. 1938	12	-54%	May 1937 – Jun. 1938	1937 -35.03% ; 1938 +31.12%
Sep. 1929 – Jun. 1932	33	-86%	Aug. 1929 – Mar. 1933	1929 -8.42% ; 1930 -24.90% ; 1931 -43.34% ; 1932 -8.19%

The “Duration” column provides the first clue. The 15 “un-bear” episodes are brief (with the CoViD “un-bear” market lasting just 17 days, rounded up to one whole month in the table). In contrast, the seven genuine bear episodes average a much lengthier duration—doing justice to the ‘lower-for-longer’ intuition we have for destructive markets.

A second clue is that the table of “un-bear” markets includes two of history’s worst market crashes (1987 and 2020). In both cases, the market succumbed to exogenous shocks—it did not suffer from an inner malaise (like the credit problems underpinning the 2008 bear or the inventory problems fueling the 2000 bear).

Keep in mind that our current market correction is the product of a rolling crash caused by an exogenous factor (CoViD) and that the head domino in the chain of the market’s woes, we strongly suggest, is the supply-chain collapse from the self-imposed shutdowns that is fueling the supp(ly)-flation.

Those two clues, plus a helpful dose of 4th-Generation investment theory, can reveal to investors the truth about genuine bear markets. The critical glue is theoretical:

When the market is viewed as a punch-bag of external forces—from earnings to Fed decisions and from geopolitics to interest rates—its health and vitality (bull/bear status) is daily on balance and remains a fragile derivative of uncontrollable outside developments to which the market succumbs deterministically. In this view, a war spells disaster, a hawkish Fed is seen as insurmountable, inflation destroys profits and spending, and the three of them in unison usher in a recession full of layoffs and credit crunch, and a bear market that is bound to cause capital destruction and derailment. This is the image of the market throughout the first three generations in the evolution of investment thought since the days of Modern Portfolio Theory, indexing, strategic asset allocation, and goal-oriented portfolios.

This deterministic and reductionist view of the market fails to account for the dramatic difference between the episodes listed in the two tables. Thankfully, over the last two decades, innovative academic research and industry breakthroughs have coalesced to provide us with a far richer and more realistic and explanatory view of the market. Our strategies have been at the forefront of that effort to usher in 4th Generation disciplines (read more about it on our brand-new website <https://fa.wellsfargoadvisors.com/gnh-capital-group/evolution.htm>).

In this view, the market is a **regime**—a term with roots in cybernetics and the study of adaptive dynamic systems. As a regime, the market is a complex system with primary agency of its own and a high degree of

relative autonomy in interfacing with external developments. As a regime, the market has the capacity to set and sustain through self-organization and self-regulation a large-scale (broad-based and longer-lasting) bullish/upward or bearish/downward orientation of its own. The workings of the regime are masked by the bustling and noise of its functioning, but once correctly filtered out, we believe its health and trajectory are decipherable. Corrections are manifestations of the market's self-regulatory interventions to sustain its existing orientation. This capacity is not unlimited, so over time, the market re-equilibrates from a bullish to a bearish regime but not without giving out signals of a regime change that are discernible to attentive disciplines (<https://fa.wellsfargoadvisors.com/gnh-capital-group/regimes.htm>).

So once we combine a more realistic view of the market with the clues we got from studying the “bear” and “un-bear” markets, we can understand that, in view of our market philosophy:

True bear markets are broad-based lower-for-longer paths triggered and sustained by an adverse market-regime shift. Three essential corollaries to that:

- 1. In the absence of a bearish market-regime shift, even significant drawdowns accompanied by recessions do not last long and are not pervasive enough to derail portfolios that remain market-adaptive and focus their risk vigilance squarely on the management of shortfall instead of its varied downstream manifestations of volatility and drawdowns.**
 - 2. Nevertheless, poorly managed portfolios can still get derailed by the “un-bear” markets that flash within otherwise market regimes that remain bullish. This is especially true in the case of portfolios that are prone to false-positive errors (crying wolf). And it is also true in the case of investors driven by risk avoidance and rigidly intolerant of drawdowns and volatility spikes.**
 - 3. Destructive bear markets are the products of bearish market-regime shifts. Still, this argument has no circularity—we do not attempt to explain one ‘bear (market)’ with another ‘bear (regime).’ Bear markets are usually characterized by high volatility and deep drawdowns but are truly ‘bearish’ (capital-destructive) in the presence of a bearish market regime which should be independently identified through other characteristics. Our strategies specialize in assessing the status of the market regime by using both macro-economic (CORE, FOCAL) and market-based (QUAD) signals that are different from the external manifestations of bearish declines (like drawdowns and volatilities). Drawdowns, spikes of volatility, and sharp reversals are, at best peripheral, downstream, and mostly unreliable indicators of bearish market-regime shifts (and we see those shortcomings in the case of the flash ‘un-bear’ markets that have taken place in bullish market regimes).**
- 7. Putting it all together—Deciphering the current market environment**

Here is our list of conclusions:

1. The ongoing market correction is Phase 3 of the same rolling crash process that was initiated by the CoViD outbreak (Phase 1), then perpetuated by the global supply-chain demobilization (Phase 2), and now further complicated by the inevitable concomitant supp(ly)-flation (Phase 3). We have the same characteristics of violent reversals, volatility spikes, and drawdowns and draw-ups throughout this episode's multiple chain links.
2. The CoViD panic originated during a bullish market regime, and its Phase 2 V-shaped recovery was primarily underwritten by the vitality and immunity of that regime. (Perma-bears love to point out that the V-shaped recovery was artificially induced by money-printing and fiscal over-stimulation but fail to account that all those measures have repeatedly applied in Japan to no

avail. No amount of stimulation or printing can reverse in 17 days a bearish market regime). So this episode has taken place on a solid market backdrop.

3. As of now, our strategies are documenting that there is still no bearish market-regime shift. This does not eliminate the possibility of a flash (ultra-short) “un-bear” market like those cataloged in the above table. Still, it makes such a scenario less likely (after all, historically, there have been only nine such cases) and, ultimately, lowers the chances of a decisive negative impact (derailment) registering by the end of this episode (as shown in the table’s rightmost column).
4. That said, the strategies’ current assessment of the status of the market regime could change (and eventually and inevitably, it will change at some point). So this evaluation should not be taken as a forecast or a bet. Our strategies remain at all times agnostic and unbiased. Moreover, our strategies are prepared to adopt a wholly defensive posture whenever the right signals emerge, including going 100% to cash, as they did for the better part of 2008. Simply put, that decisive signal for the CORE/FOCAL and QUAD has not surfaced yet and may not even arise in this episode.
5. We are aware that there are other signals supportive of market exit. While we are fully aware of them and tracking them closely, there should be made clear that those signals are known to be noisy and have a poor record of accuracy. In contrast, the most reliable, low-noise, high-accuracy exit signals have not flashed yet, and those are the ones our strategies obey most closely. Investment success is an exercise in odds, and we must focus on playing the better odds.
6. But our strategies do not see market adaptation only as a binary process—we need not be either fully exposed to the market or entirely on the sidelines. On the contrary, while the critical signals of a full-cash exit have not flashed yet, our strategies have taken substantial measures to account for the decreased vitality of the market. As detailed previously, our strategies have adopted a 1/3 defensive – 2/3 assertive posture. Our defensive posture includes cash and positions in the low volatility spectrum, which has shown resilience, plus commodities. This breakdown illustrates the chances our strategies currently assign to a positive (2/3) versus negative (1/3) resolution of the current episode.
7. **How can we account for the heightened worry and sour sentiment that seem pervasive?**

This is an accurate observation. What fuels sentiment this time is the unprecedented collapse of bonds—yes, bonds, not stocks. Bonds have registered the worst return in the history of their indices. As an illustration, the longest duration US bonds have fallen more than -30% (cf. ICE BofAML Long US Treasury Principal STRIPS Index), edging out even the Nasdaq 100. In the process, they have wiped out the returns of the better part of the last ten years! This event represents the ripple effect of the original CoViD crash that drove yields to all-time lows and then catapulted them to 6X highs. The impact on portfolios of conservative, older, and ultra-high-net-worth investors has been devastating.

But perhaps more than the capital impairment it has caused, the bond rout has registered a singularity in asset management theory and practice. For too long, three generations in the evolution of investment thought since the 1950s have considered bonds an essential portfolio diversifier used as a counterbalance, suppressor, or diffuser, of the volatility and drawdowns of stocks and an overall de-risking asset. Conservative, older, and wealthy investors have been advised to seek safe-haven in bonds. All this changed this year. And even more than changed—it simply delivered the final blow to the obsolete Generation 1 “Modern Portfolio Theory” and its

successors, Gen. 2 and Gen 3 theories that underpin the majority of portfolio constructions and dominate traditional financial thinking.

Our strategies have flagged this risk and have decried conventional investment theory for over two decades. Our practice has always been aware of the flaws that explain the recent bond collapse, and our strategies are engineered around 4th-Generation principles of market adaptation and risk control that transcend traditional assumptions. Read more about that on our brand-new website <https://fa.wellsfargoadvisors.com/gnh-capital-group/mediahandler/media/455234/GNH%20Capital%20Group%20-%20Our%20Offering.pdf> .

Last Word

We invite you to spread the word about your GNH Capital Group experience within your circles of influence. The last five years have been challenging for most investors. They have been battered by the sliding bond market and whipsawed in the historic downdrafts of 2018, the crash of 2020, and the turmoil of 2022. And throughout the last thirteen years, they have been torn between the Scylla of speculation and greed and the Charybdis of worry and indecision. As our veteran clients have come to discover, our strategies' adaptability and risk-control vigilance have been an excellent antidote to haphazard performance and a booster of investor confidence. Please assist us in spreading the word.

We remain grateful for your trust, loyalty, support, and friendship!

On behalf of GNH Capital Group's entire team with Henrik, Richard, Chad, and Isabel,

Kostas

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⁽¹⁾ Exogenous shocks, like pandemics, acts of terrorism, natural disasters, and wars, represent adverse events that originate outside of the economic system. In contrast, endogenous shocks, like credit events, overvaluation, and inventory excesses, mark disruptions of the economic system.

Indices are unmanaged and investors cannot invest directly in them. The ICE BofAML Long US Treasury Principal STRIPS Index is an unmanaged index comprised of long maturity Separate Trading of Registered Interest and Principal of Securities (STRIPS) representing the final principal payment of U.S. Treasury bonds. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding) with each stock's weight in the Index proportionate to its market value. The S&P 500 is one of the most widely-used benchmarks of U.S. equity performance. Performance includes reinvestment of dividends.

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