AI Rotation and the New Logic of Investment

August 2026 Market Review and September Allocation Framework

Report Period: August 2026 · For Professional Investors

Published by

DH Wealth Management Pte Ltd

Singapore CMS Licence: CMS101242

Trader Insights | AI Rotation and the New Logic — July Market Review and August Allocation Framework

Introduction: July was not an outright exit from AI trading. Rather, markets began to reassess which segments of the AI value chain are already demonstrating commercial viability, and which still require further evidence on valuation, crowding and return on capital.

July Market Review:

Major indices appeared calm on the surface, but experienced significant internal rotation. SPY rose 0.2 per cent, while QQQ declined 5.1 per cent. Equal-weighted indices outperformed, with RSP up 0.8 per cent, though small caps remained weak, with IWM down 2.7 per cent. The energy sector led, with XLE gaining 12.8 per cent; financials rose 3.9 per cent. Technology fell 5.5 per cent, with semiconductor ETFs down approximately 13-16 per cent.

These moves suggest market breadth is beginning to widen from mega-cap technology names, but a sustained, broad-based risk-on regime has not yet materialised. Capital rotated into energy and financials, while industrials and small caps did not participate—so a broader cyclical rotation cannot yet be confirmed.

The more meaningful change occurred within the AI value chain: investors are no longer willing to hold AI beta indiscriminately. Instead, they are increasingly focused on companies that can demonstrate direct evidence of demand growth, revenue conversion and profitability.

AI: Demand Evidence Strengthens, but the Return on Capital Question Remains

Late-month earnings from major cloud providers reinforced the evidence that AI demand is translating into cloud revenues, compute utilisation and backlog of contracted orders. For platforms capable of converting incremental compute capacity into customer consumption, the credibility of AI commercialisation pathways has improved notably.

However, these earnings have not fully resolved the broader question of return on capital. AI infrastructure spending remains elevated, with free cash flow at certain hyperscalers continuing to face pressure. The time lag from capital deployment to economic returns varies materially across companies.

Thus, July's earnings advanced the market debate but did not settle it: the demand-side evidence has strengthened, but markets still need to see that incremental AI revenues, after accounting for depreciation, operating costs and ongoing compute expansion, can generate adequate returns on capital.

This distinction was also reflected in market performance. Cloud and software-related assets received better support: CLOU rose 7.8 per cent, SKYY gained 4.9 per cent, and IGV rose 1.3 per cent. In contrast, semiconductor hardware and momentum strategies experienced significant drawdowns: SOXX fell 15.8 per cent, SMH declined 12.9 per cent, MTUM fell 8.7 per cent, and ARKK declined 13.0 per cent.

We do not interpret the hardware sell-off as a collapse in AI infrastructure demand. Rather, it appears to be a function of high valuations, crowded positioning, and the elevated "proof bar" following a period of substantial gains.

Nevertheless, the price action itself is informative. For semiconductors, memory, networking equipment and the broader CapEx supply chain to re-establish sustained leadership, confirmation will be required from upward earnings revisions, order visibility, capacity utilisation and hyperscaler investment returns.

Oil Prices, Sector Rotation and Market Structure

Oil was another critical cross-asset variable in July. The risk premium around Iran and expectations of geopolitical de-escalation drove notable positioning shifts, but crude-related assets ultimately closed substantially higher. USO rose 25.1 per cent, and the energy sector gained 12.8 per cent.

Higher oil prices keep inflation tail risks alive, creating a more complex environment for interest rates, consumer spending and margins for fuel-sensitive corporates.

The concurrent rise in oil prices and weakness in technology drove capital rotation into energy, financials and other less crowded market segments. At the same time, the decline in semiconductors and momentum factors far exceeded that of broad indices. We view this as consistent with de-grossing within AI and factor rotation, rather than a wholesale exit from the AI theme. Mechanical flows, short-covering and ETF rebalancing may have amplified the fundamental re-pricing.

Observing index-level volatility alone risks underestimating the change in market risk structure. Risk has shifted from directionality in broad indices towards dispersion in returns across sectors and individual securities. In such a market, portfolio performance depends less on a directional call on the broader market and more on selecting the right segments within the theme, identifying crowded trades and managing position sizes.

August Outlook

The core question for August is not whether the AI trade is over, but whether markets will continue to reward companies with clear AI commercialisation capabilities, while demanding a higher risk premium from crowded hardware and momentum assets.

Our baseline remains constructive, but more selective. Markets are likely to favour cloud platforms, AI software, data infrastructure and cybersecurity companies that can demonstrate usage growth, pricing power, earnings improvement or IT budget migration.

As positioning normalises, hardware segments may see a rebound; however, re-establishing sustained leadership will require confirmation from earnings expectations, customer orders and hyperscaler spending plans—not merely price momentum.

Beyond AI, we are monitoring whether the relative strength in equal-weighted indices, energy and financials can evolve into a broader market rotation. Industrial and small-cap segments would need to improve concurrently to constitute a valid confirmation. Until then, the breadth improvement seen in July is best treated as an early signal, rather than an established new market regime.

Key risks include: a slowdown in cloud or AI demand; a further widening of the CapEx-free cash flow gap; an escalation in geopolitical tensions pushing oil prices higher; a hawkish surprise in inflation or employment data; and a reversal of the incipient breadth improvement.

If oil were to fall materially, inflation pressures would ease, but this would likely reverse energy sector leadership and unwind some of the rotation trades established in July.

July reinforced a more disciplined market framework. AI remains the core variable driving dispersion in equity returns, but any associated investment increasingly requires evidence of commercialisation, upward earnings revisions and cash flow generation.

We continue to be constructive on the long-term AI investment cycle, but expect markets to differentiate more rigorously between beneficiaries and to penalise assets supported primarily by crowded positioning or speculative extrapolation.

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Executive Summary | Five-Minute Overview

- **I. AI Leverage Forced Clearance —** The SA hedge fund blow-up was the defining event, with highly leveraged AI positions forcibly liquidated. Markets completed a de-leveraging process without systemic crisis.
- **II. KOSPI's Historic Rally and Korea's Structural Reset —** After a "black July," KOSPI surged 17 per cent on 31 July. New leveraged ETF regulations took effect the same day, reshaping Korea's market volatility structure.
- **III. US-Japan Joint Intervention Reverses Yen Trajectory —** The 30-31 July joint intervention pushed USD/JPY from 163.99 to 157.40. The initial effect has been observed, though the direction of the yen is not yet settled.
- **IV. AI Earnings Season: The Narrative Inflection Point —** Results from Microsoft, Google, Meta and Amazon showed both "spending concerns" and "return validation." The FOMC's 9-3 vote revealed widening internal divergence.
- **V. AI Application Layers Gain Market Attention —** Physical AI, robotics and embodied intelligence are emerging as potential extensions of the AI theme, though still in early-stage formation and validation.
- **VI. Structural Lessons from July —** AI remains the core theme, but markets are demanding higher standards on valuation, positioning and CapEx returns. The high-leverage regime is over.
- **VII. Post-Clearing Focus Areas —** Key themes include earnings validation, yen carry trade risks and FOMC path determination. Markets are entering a "structural allocation" phase.

Introduction

July 2026 was the most volatile month of the year. The forced clearance of AI leverage, Korea's historic equity rally, the US-Japan currency intervention and the AI earnings season narrative shift together constituted a complete "stress test → market reset" cycle.

As markets entered August, a gradual recovery from extreme volatility began. Signals of US-Iran de-escalation and weaker-than-expected payroll data jointly suppressed expectations for a September rate hike, driving a modest recovery in global risk appetite. However, the debate within the AI value chain on "CapEx efficiency" and "commercial returns" is far from over—markets are transitioning from "theme-driven" to "earnings validation." This report provides a structural analytical framework to help readers understand the deeper logic of July's volatility and its implications for August allocation.

This report does not constitute investment advice, nor does it offer any individual security recommendations.

Chapter 1: Leverage Clearing — The SA Blow-up and the End of Crowded AI Positioning

1.1 The SA Hedge Fund Blow-up: The Fall of a "Teen Prodigy"

In July 2026, the blow-up of Situational Awareness LP (SA Fund), founded by former OpenAI researcher Leopold Aschenbrenner, became the defining event of the month's market volatility. Aschenbrenner, aged 25, had previously worked on AI safety at OpenAI. His fund employed just eight people (of whom four were investment professionals), yet at its peak managed approximately US$24-45 billion in assets—meaning over US$5 billion per professional.

SA Fund's strategy was highly concentrated in semiconductor and AI infrastructure equities (SK Hynix, SanDisk, CoreWeave, Bloom Energy), while shorting software names. Prior to the blow-up, the fund had generated a cumulative return of 1,551 per cent, with a 439 per cent return in the first half of 2026. However, this very structure—extreme concentration and high leverage—left the fund with no buffer when markets turned in July.

Transmission mechanism:

- **24-28 July:** AI sector saw significant selling pressure, with SA Fund's heavyweight positions leading the decline. Rumours of margin calls began circulating.
- **29-30 July:** SA Fund was forced to liquidate positions on a large scale. With leverage of approximately 4x combined with long-short exposure—long positions collapsing while shorts surged—the fund experienced a "double kill."
- **30 July:** Citadel acquired the bulk of SA Fund's public market holdings (approximately US$16 billion) at a discount of over 10 per cent, removing the forced selling pressure. Following the acquisition, SanDisk, CoreWeave and Bloom Energy rose 26 per cent, 21 per cent and 26 per cent respectively on the day.
- **31 July:** SA Fund founder Aschenbrenner issued a letter of apology, confirming that the fund had suffered significant losses from leveraged AI trading and had closed its primary strategies.

> **Narrative divergence between Western and Eastern media:** Western media (Bloomberg, Wall Street Journal) positioned the SA blow-up as a "bottom signal" for AI trading—"known forced sellers have exited; the bottom may have been established." Eastern media (Shanghai Securities News, China Securities Journal) focused more on the "textbook case of leverage stampede" and the systemic fragility of market structure. The difference in framing—opportunity after clearing versus systemic risk of high-leverage models—is itself worth noting for investors.

1.2 The Structural Context of the Blow-up

SA Fund's blow-up was not an isolated event. It occurred against a structural backdrop of:

- **High AI concentration:** US technology sector weighting remained above 50 per cent as of end-June, with AI-related names the "core holdings" of both institutional and retail investors.
- **Elevated leverage:** Hedge fund net leverage approached historical extremes in June, concentrated in AI. Korean retail leverage also reached a record above KRW 60 trillion.

- **Concentration risk:** Hartnett's May warning on 50 per cent technology weighting proved prescient—when everyone is crowded in the same trade, any disturbance can amplify into a stampede. July's volatility confirmed this assessment.

> **Dual meaning of the clearing:** SA Fund's blow-up was both a painful de-leveraging process and a signal that markets had completed a "stress test." It did not trigger systemic crisis, but was sufficient to make markets reassess AI positioning and valuation levels. The pain was localised, but the outcome is healthy—excess concentration risk has been released, creating space for subsequent structural allocation.

Chapter 2: KOSPI's Historic Rally and Korea's Structural Reset

2.1 July KOSPI: From "Black July" to a 17 per cent Single-Day Surge

KOSPI experienced extreme volatility in July: cumulative decline of ~20 per cent from 1-29 July, a 10.84 per cent drop on 28 July (the second-largest single-day decline on record), and circuit-breakers triggered on two consecutive trading days—a first for the Korean market. Foreign investors recorded net selling of KRW 197.2 trillion (approximately US$135 billion), 22 times the total net selling for the whole of 2025.

On 31 July, KOSPI surged approximately 17-18 per cent, the largest single-day gain in history. SK Hynix hit its daily limit-up (+30 per cent), and Samsung Electronics rose over 28 per cent.

Triple positive catalysts: ① positive signals from North American cloud providers (Microsoft Azure +43 per cent, Amazon AWS +37 per cent); ② SK Group Chairman Chey Tae-won's rare "bottom-fishing" personal purchase of SK Hynix shares; ③ South Korea's announcement of a KRW 20 trillion AI investment programme, allocating capital via KIC for targeted AI infrastructure investment.

2.2 Korea's Leveraged ETF Reforms: A Structural Reset

Korean regulators introduced multiple rounds of controls in July, including:

- **Margin requirements raised:** Minimum cash margin increased from KRW 10 million to KRW 30 million, with cash-only acceptance.
- **Investor training extended:** Total training time increased to 3 hours; chapter tests scoring below 60 per cent require re-taking.
- **Minimum trade size increased:** From 1 unit to 20 units.
- **Premium/discount controls tightened:** From 3 per cent to 2 per cent.
- **Leverage reduction proposed:** From 2x to 1.5x (effective 19 August).

Finance Minister Koo Yoon-cheol acknowledged in parliamentary questioning that the government had "given insufficient consideration" when introducing single-stock leveraged ETFs. Nomura noted that de-leveraging is a necessary precondition for markets to transition from "liquidity-driven" to "fundamentals-driven" dynamics, but KOSPI's stabilisation remains highly dependent on global tech CapEx guidance and memory pricing cycles.

> **Morgan Stanley's assessment:** Korea's extreme volatility stemmed from structural fragility ("high concentration + high leverage") rather than AI fundamentals. SK Hynix reported record Q2 revenue of KRW 79.32 trillion (+257 per cent) and operating profit of KRW 60.54 trillion (+557 per cent), yet selling was triggered by a marginal miss versus "perfect expectations."

Chapter 3: US-Japan Joint Intervention and Yen Reassessment

3.1 The Intervention: 163.99 → 157.40

On 30-31 July, Japan and the US conducted their first joint currency intervention in 15 years, pushing USD/JPY from 163.99 (a 39-year high) to 157.40 (approximately -4 per cent). The intervention was estimated to involve JPY 8.45 trillion (approximately US$52.8 billion).

This intervention was notable for its "tripartite coordination": Japan's Ministry of Finance and central bank led the action; the US Treasury conducted currency inquiries via the New York Fed and sold euros for yen; and Korea also participated in coordinated dollar-selling. US Treasury Secretary Bessent publicly stated that "the yen appears to be significantly undervalued," and former President Trump commented that "the United States is helping Japan boost the yen, both as a gesture of friendship and for the benefit of the global economy."

Following the intervention, USD/JPY traded in a 157-160 range. CICC noted that, referencing historical intervention patterns, the possibility of further intervention remains—previous episodes in 2022-2026 saw multiple interventions within the same cycle.

3.2 The Deeper Logic and Carry Trade Risks

US participation in the intervention reflected three motivations: ① yen weakness beyond 163 represents a threat to Japan's economic security, itself viewed as an extension of US economic security; ② Japan is the largest foreign holder of US Treasury securities; disorderly yen depreciation could force Japan to sell Treasuries, pushing up US long-term yields; ③ yen stability helps narrow the US-Japan trade imbalance and supports industrial reshoring.

Xie Guozhong (former Morgan Stanley Asia-Pacific Chief Economist) had previously warned that Japan was falling into a "1997 Thailand-style trap"—its massive foreign reserves, rather than deterring speculators, have made it a target. Hedge funds held 124,575 short yen contracts, near the highest levels since 2007. If USD/JPY breaks 160 again, the risk of a carry trade unwind will once again become a market focus.

> **Barclays' assessment:** Yen dynamics add macro complexity. Japanese government bond yields are already significantly above 2024 carry trade unwinding levels, and joint intervention is simultaneously suppressing both dollar and Treasury markets. Short yen positions and carry trade positioning remain structural sources of ongoing volatility in FX and rates markets.

Chapter 4: AI Earnings Season — The Narrative Inflection Point

4.1 Magnificent Seven Earnings Breakdown

The Q2 2026 earnings season revealed structural divergence in AI capital expenditure. The combined CapEx of the four major technology companies approached US$750 billion.

- **Microsoft (+15.5 per cent):** Azure grew 43 per cent, the fastest in four quarters. Microsoft 365 Copilot paid seats exceeded 30 million. The company has built a three-layer monetisation model—"compute infrastructure → Azure cloud services → Copilot enterprise software"—making it the most complete AI commercialisation model currently in place.
- **Amazon (~+10 per cent):** AWS revenue of US$42.23 billion (+37 per cent), the fastest in 18 quarters, with operating margins approaching 40 per cent. AI and self-developed chip revenues both exceeded US$25 billion on an annualised basis. Management indicated AWS demand would remain "very significant" through 2028.
- **Google (-7 per cent):** Cloud revenue growth of 82 per cent was exceptionally strong, with cloud backlog reaching US$514 billion and cloud operating margins at 35.6 per cent. However, Google Cloud remains materially smaller than AWS and Azure. News of further delays to Gemini 3.5 Pro undermined market confidence. Free cash flow turned negative for the first time since the company's listing.
- **Meta (-~8 per cent):** Meta is the only company among the group without a cloud business to demonstrate AI returns. All AI investment ultimately depends on advertising monetisation on its social platforms—an indirect, slow and difficult-to-quantify path. Markets fear Meta is repeating the pattern of its 2022 metaverse investment.

> **J.P. Morgan Private Bank observation:** The two halves of the AI trade (semiconductors and hyperscalers) rarely moved in tandem, but are now beginning to do so. The 20-day rolling correlation suggests investors are simultaneously rewarding both infrastructure beneficiaries and application-layer winners—implying that markets are beginning to see the AI ecosystem itself as valuable.

4.2 FOMC: The 9-3 Vote and Policy Path Uncertainty

The July FOMC meeting voted 9-3 to maintain rates, with three dissenters (Hammack, Logan, Kashkari) favouring a hike—the first time since 2016 that three dissenting votes were cast in a single policy decision. Cleveland Fed President Hammack stated: "A 25-basis-point hike may not have a significant impact on the economy; several hikes may be necessary."

CME FedWatch currently places the probability of a September hike at approximately 52 per cent, with October at 59 per cent and December at 77 per cent. However, after the weaker-than-expected payroll print, September hike probabilities briefly fell to around 40 per cent. August CPI data will be a key determinant—markets expect July headline CPI of 3.4 per cent and core CPI of 2.5 per cent. If inflation data surprises to the upside, it would pressure Chair Warsh to demonstrate his commitment to fighting inflation through action at the September meeting.

Chapter 5: AI Application Layers — The Next Frontier

5.1 The Arrival of the Inference Era

AI industry focus is shifting from training to inference. According to McKinsey, the global AI inference market is projected to reach US$150 billion by 2028, with a compound annual growth rate exceeding 40 per cent—well above the 20 per cent for training.

J.P. Morgan notes that frontier AI models continue to advance every few months, and inference demand from both closed and open models remains strong; as agentic AI accelerates, the overall profitability of the AI value chain is also improving.

Inference chip landscape:

- **Nvidia:** Rubin CPX (launching late 2026), 3nm process + CUDA ecosystem, full-scenario coverage.
- **Google:** Iron-wood TPU, ASIC architecture, 4.6 Exaflops per chip, extreme cloud inference efficiency.
- **Huawei:** Ascend 950/960/970 series, 7nm process, system-level optimisation.

Notably, China has achieved 520 trillion floating-point operations per second on a 14nm process, alleviating the "memory wall" bottleneck through architectural innovation. Alibaba also released Qwen3.8 (2.4 trillion parameters, sparse MoE architecture) in early August, ranking second globally on the Arena leaderboard, while simultaneously open-sourcing Qwen3.8-27B—marking continued progress by China's AI industry at the model layer.

5.2 Investment Characteristics of AI Application Layers

AI application layers (physical AI, robotics, embodied intelligence) remain in early-stage theme formation and validation, and should not be equated with a mature earnings cycle. We favour a focus on high-conviction AI core assets, with emphasis on "volume certainty" and a prudent approach to "price volatility."

> **J.P. Morgan assessment:** Interconnect technology may emerge as the next key bottleneck. Over the next 18-24 months, as semiconductor capacity increases, power supply is expected to replace chips as the primary constraint on AI compute infrastructure expansion.

Chapter 6: Structural Lessons from July

6.1 Answering the Opening Question

"Was July simply a forced clearing of AI leverage, or a deeper structural shift in markets?"

Conclusion: July was both a clearing and a reset. The forced liquidation of SA Fund's leveraged positions completed a "forced de-leveraging" process for the AI sector. At the same time, July's volatility exposed the fragility of the "high leverage + extreme concentration" model, accelerating markets' transition from "theme-driven" to "earnings validation."

6.2 Five Structural Judgements

- **AI remains the core theme:** J.P. Morgan sees no indicators suggesting a material fundamental weakening over the next 6-12 months. The AI investment cycle remains intact.
- **Markets are demanding more on valuation and positioning:** Microsoft (+15 per cent reward) vs Meta (-8 per cent penalty)—markets are distinguishing between "efficient CapEx" and "inefficient CapEx."
- **AI trades moving from "either/or" to "both":** J.P. Morgan Private Bank notes the 20-day rolling correlation between semiconductors and hyperscalers is turning positive—investors are beginning to reward both infrastructure and application-layer winners simultaneously.
- **August markets are in a "recovery" phase but not one-way:** US-Iran signals and weaker payroll data have weighed on September hike expectations, supporting risk appetite. However, the market remains driven by position-switching, and sector rotation sustainability is uncertain. The mid-to-late August earnings reporting season will be key to testing the durability of the recovery.
- **The "Sell America" trade has not yet fully returned:** Despite uncertainty over the Fed path, yen carry trade dynamics and AI CapEx sustainability having rekindled the "Sell America" narrative, a strong earnings season (S&P 500 Q2 earnings growth 50.4 per cent, 86 per cent of companies beating expectations) provides a significant cushion.

> **UBS assessment:** Strong earnings growth should drive global equities higher, and moderating inflation should allow the Fed to maintain rates for the remainder of the year. We recommend investors maintain diversified allocations—equities, high-quality fixed income and commodities.

Chapter 7: Professional Reminders

7.1 August Allocation Framework

From single-theme concentration to sector-balanced allocation: Markets are transitioning from "expectation-driven" to "reality-validation" dynamics. Three structural shifts are currently observable: the excess return premium of upstream hardware within the AI value chain is converging with downstream segments; the valuation discount of non-AI industrial sectors is showing signs of mean reversion; and the extreme dispersion between technology and non-technology sectors is beginning to narrow.

AI hardware can be moved from underweight to neutral: Following the notable correction in July-August, valuations in the AI hardware segment have partially discounted the overly optimistic expectations that prevailed earlier. We believe AI hardware can be adjusted from "underweight" to "neutral" — though the precise timing of incremental positioning should be guided by earnings visibility, free cash flow trends and evidence of price stabilisation.

Focus on earnings visibility and order visibility: Current market earnings surprises remain concentrated in a narrow set of large-cap names. After adjusting for one-off items such as investment gains, the overall beat rate remains relatively low. Market leadership continues to be concentrated. Investors should place greater emphasis on the sustainability of revenue growth and the visibility of actual order flows.

Monitor the post-intervention yen dynamics and carry trade risks: Following the US-Japan joint intervention, USD/JPY has traded in a 157-160 range. Further yen weakness could trigger a second intervention, adding volatility to FX and rates markets. A stronger-than-expected employment report or the upcoming CPI data could quickly revive market concerns that the Federal Reserve is falling behind the curve.

7.2 Risk Warnings

- AI sector valuations are at historically elevated levels; any earnings disappointment could trigger material drawdowns.
- FOMC internal divergence is widening; if inflation data surprises to the upside, the probability of a September rate hike will rise materially.
- Geopolitical risks (Middle East tensions) could push oil prices higher, exacerbating inflation concerns.
- Yen carry trade unwinding could trigger broader risk asset volatility.
- The effectiveness of Korea's new market regulations remains uncertain and could affect liquidity conditions.

> **Final thought:** Markets are transitioning from "theme-driven" to "earnings-driven" dynamics — the commercialisation validation of AI investment has replaced pure thematic enthusiasm as the core focus. Maintaining discipline, focusing on earnings visibility and structural allocation, and avoiding directional chasing are likely to be more rewarding than attempting to time short-term moves in an environment of elevated uncertainty.

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Report length: approx. 11,000 words