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FIRST QUARTER 2015

MARKET PERSPECTIVES

FIRST QUARTER 2015 REVIEW AND OUTLOOK
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FIRST QUARTER 2015 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Global markets overcame a down January and renewed Greek political drama to finish Q1 modestly higher. We continue to expect a double-digit positive year for equities globally, powered by underappreciated global economic strength and solid political drivers.

America's equities stand on a solid foundation. Concerns of slowing growth and weakening earnings weighed on US equities in Q1, but these should prove fleeting false fears—bricks in the wall of worry bull markets climb. Meanwhile (and little noticed), The Conference Board's Leading Economic Index (LEI) rose 13 straight months through February. Politically, gridlock persists, with both parties already distracted by 2016 campaigning—2015 looks like a typical presidential third year, historically the four-year term's strongest. Markets tend to celebrate gridlock with positive quarterly returns in 86.4% of US midterm-year Q4s and Q1 and Q2 of the years after.

Porfolio Themes

- **Underweight to Commodity-Oriented Companies:** Companies that have significant commodity exposure (metals, oil and agricultural) should underperform over the next 12-18 months (reflected in our underweights to the Materials and Energy sectors).
- **Quality Tilt:** As the bull market progresses we favour equities with strong balance sheets and consistent profit margins.
- **Overweight to Health Care:** Health Care companies typically offer reliable sources of revenue and often have power to pass potentially higher costs to consumers, giving them stable longer-term growth prospects - qualities we expect investors to increasingly prefer.

Market Outlook

- **Earnings Growth:** Corporate earnings and revenues continue to grow alongside the global economy.
- **Sentiment Rising:** Sentiment is continuing to rise but expectations still remain low and easy to beat.
- **Recent Volatility:** While a correction is always possible, we expect the market's broader trajectory to be positive.

Investors fear the stronger dollar will hamper large US firms' overseas earnings, citing analysts' projections of a -4.6% Q1 S&P 500 earnings drop, but strong dollar eras historically reveal nothing about US equity performance—the late 1990s saw an even stronger dollar than today, as US equities shined and large multinationals outperformed.[i] A stronger currency is not a uniform negative or positive—multinationals have overseas costs as well as revenues, and many manufacturers import component parts. Q1 earnings fears also ignore the elephant in the room: falling Energy prices. Energy aside, earnings are projected to rise. Moreover, the strong dollar and weak oil have dominated headlines for months, and all liquid markets discount widely known information near-simultaneously. The likelihood these factors shock investors moving forward is low, just as the same two did not in the mid-to-late 1990s.

Europe's outlook has improved as economic reality defies dim expectations. "Lost decade" dread persists, yet eurozone GDP has grown seven straight quarters, and many indicators accelerated in Q1. Some worry deflation will reduce consumption, yet many nations' retail sales accelerated as headline consumer prices fell. Excluding food and energy, "core" inflation remains positive, broad money supply growth (M3) is accelerating, and loan growth is stabilising—all consistent with a growing, stronger-than-perceived economy. There, too, LEIs continue rising. While the European Central Bank (ECB) introduced headwinds by launching quantitative easing (QE) in March, eurozone sovereign bond markets anticipated the widely discussed move, with yield curves flattening months before QE began—markets largely already reflect QE's impact. Moreover, the ECB faces the added wrinkle of low bond supply, which may limit QE's scope.

Though Japanese markets were among Q1's best performers, data suggest this is another false dawn and that the Japanese economy has not returned to sustainable growth. In trade, February export values rose 2.4% y/y while imports fell -3.6% y/y. In volume terms, exports fell -2.1% y/y while imports rose 4.5% y/y. The numbers here are skewed both by the Lunar New Year - which impacted Asian trade - and currency valuation, with the yen weaker against the dollar but stronger versus the euro. February retail sales dropped -1.8% y/y and broader household spending (which includes services consumption) fell -2.9% y/y. Prime Minister Shinzo Abe's administration detailed its planned corporate governance reforms, a small positive. Action is needed to liberalise rigid labour markets, open the economy to trade and more, but Abe remains more focused on rewriting Japan's pacifist constitution, a lifelong ambition.

In emerging markets, Chinese data confirms growth continues to decelerate as readings generally slowed from last year and missed expectations. Though slower, economic data does not suggest broad economic weakness. Rather, it reflects a continued slowdown in economic activity amid the shift from industry-led growth to services. The People's Bank of China (PBOC) also continued the push for financial liberalisation, announcing deposit insurance would begin in May, paving the way for liberalised deposit interest rates. While reform remains a gradual process, it should keep the long-feared hard landing at bay.

Economic news from other emerging markets have been mixed. Brazilian struggles continue – a trend that seems likely to persist in the near future as demonstrators voice growing displeasure against the government over high inflation and recent corruption scandals. Contrarily, India's economic prospects look promising. The Reserve Bank of India reduced the repo rate following an announcement of the bank's new inflation target of 4% (plus or minus two percentage points). This followed Prime Minister Modi's first budget which included the inflation target and achievable reforms such as: reducing corporate taxes and simplifying the tax code; introducing a bankruptcy code; and increased spending on infrastructure. Other emerging markets took steps to encourage growth, such as Thailand and Korea cutting rates to respond to low or negative inflation rates driven by falling energy prices, not broader weakness.

Most risks today are either false or too small and widely discussed to move equities materially. Greece gets top media billing but poses little market risk. Its debt saga is five years old—widely known ancient history. Eleventh-hour negotiations over bailout funding continue, but even if Greece cannot meet its obligations, it lacks the size necessary to derail a bull market, and there is no evidence Greek woes are contagious. Equities rose through two Greek defaults in 2012.

Other fears are similarly false, in our view. Rising valuations prompt warnings equities are detached from reality, but P/E ratios today are only slightly above-average—suggesting growing optimism, not euphoric extremes. Pundits fixate on US Federal Reserve (Fed) rumblings, fearing a rate hike, but no initial rate hike since 1970 has ended a bull market. Global returns average 7% twelve months after the first hike, with positive results in seven of nine instances.

THEMATIC UPDATE & MARKET OUTLOOK

A Q1 Recap

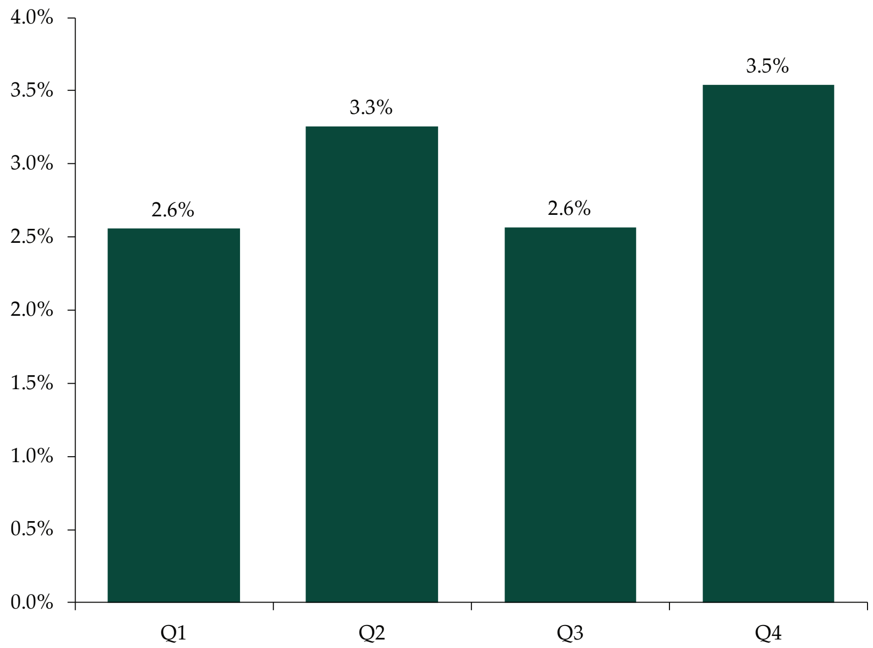
Global equities rose in Q1, weathering early volatility and slow-growth jitters to finish positively—and we believe more gains await. Equities' choppy rise is a gift: Mild returns lowered investors' expectations, potentially setting markets up to surprise with a strong year.

Mild Quarter, Big Year

After the muted quarter, professional and individual investors expect weak returns in 2015. Three hundred analysts polled by Reuters at quarter-end reduced their full-year forecasts, predicting 5.5% S&P 500 gains through year-end. On global developed markets, 6% gains in Europe were projected, and major developing countries like China fielded similar expectations.[ii] In our view, this outlook is bullish—equities often thrive when few expect it.

History shows a tepid Q1 does not often foretell the year's remainder. Quarterly returns vary wildly within any given year, and since 1926, Q2 and Q4's average returns have exceeded Q1 (Exhibit 1). While averages are not predictive, this illustrates the danger of assuming a modest Q1 suggests a tepid year.

Exhibit 1: S&P 500 Average Quarterly Return, 1926 – 2014

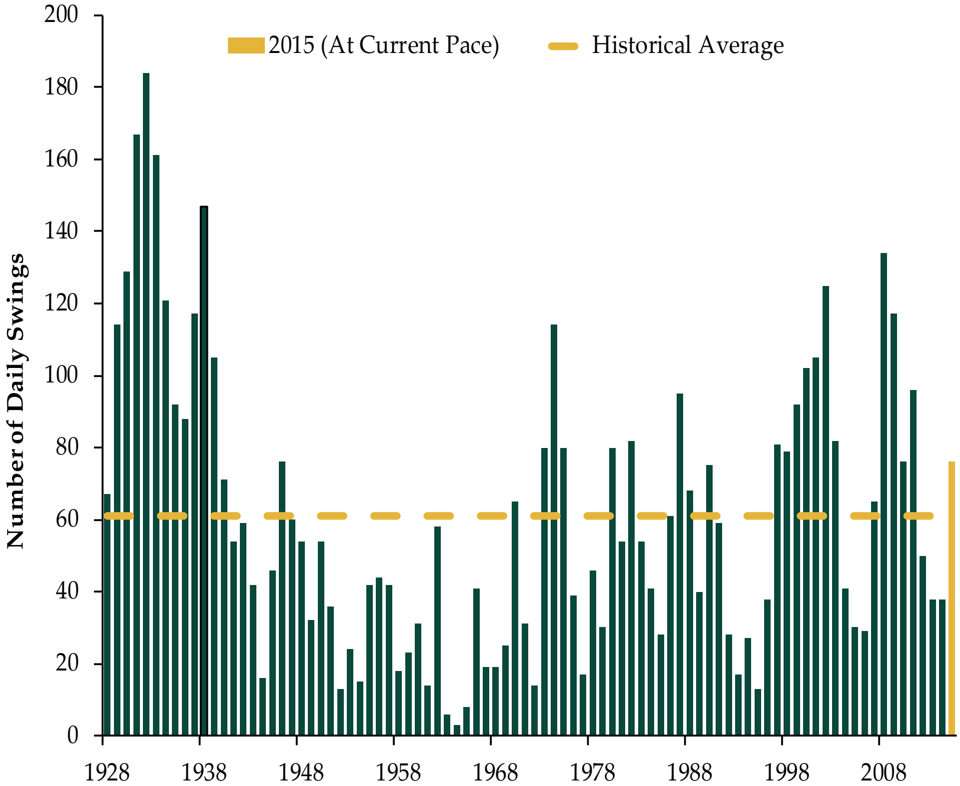


Source: Global Financial Data and FactSet, as of 7/4/2015. S&P 500 Total Return Index, 31/12/1925 – 31/12/2014. Based in $USD.

After leading last year, US equities returned only 1.0% in Q1 versus 3.5% for the MSCI ACWI ex-US index.[iii] However, we expect US equities to reassert themselves looking forward.[iv]

Volatility has been low since 2013 and is only mildly higher now. Q1 saw 19 daily moves of 1% or more in either direction—double 2013 and 2014's pace, yet below 2009, 2011 and much of the late 1990s (Exhibit 2). It might feel extreme, but human nature makes us emphasise the recent past and forget prior volatility. Myopic loss aversion—people's tendency to feel losses more than gains—makes recent volatility feel acute, while the financial media's short-sighted coverage whitewashes long-term financial memories. Few recall the comparatively high volatility of past decades.

Exhibit 2: Daily Swings of +/-1% or More, 1928 – 2015



Source: FactSet, as of 17/4/2015. Daily S&P 500 price returns, 1/1/1928 – 31/3/2015. 2015's total carries Q1's pace over the entire year, for illustrative purposes only. Based in $USD.

Equities Have Plenty to Like

Fundamentals remain ripe for a big year in the US. Politically, 2015 is a sweet spot for US equities, given that it is year three of the presidential term. Since 1926, S&P 500 returns average 18.5% in year three, with just two down years (both in the 1930s)—the highest average and frequency of gains in the four-year cycle.[v] Gridlock has escalated since midterms, and the benefits should carry through 2015.

Radical legislation in the US potentially roiling equities is near-impossible while a Republican Congress proves an inability to override President Obama's veto. For example, some "Audit the Fed" proposals presently in Congress could negatively reduce the Fed's independence, but none are likely to pass. Minor moves have passed, like Q1's rule requiring one Fed Governor to have community banking experience, but these have little fundamental impact. (Note: This will be the only Fed Governor post required to have any banking experience.)

US election campaigning should promote gridlock. Eight candidates have officially announced their presidential campaigns: Ted Cruz, Rand Paul, Marco Rubio, Ben Carson, Carly Fiona and Mike Huckabee on the Republican side; Hillary Clinton and Bernie Sanders for the Democrats. Noisy as elections are, most candidates who are in government are squeamish about passing big bills, fearing they will alienate voters and/or donors. This fosters a benign political backdrop, positive for equities.

Economic drivers are strong globally: Corporate earnings and revenues continue beating expectations; share buybacks and cash-based M&A dwarf new issuance, reducing equity supply; the Conference Board's US LEI is up 14 straight months, confounding fears growth is stalling; deflation dread masks a growing eurozone economy; the UK's mighty service sector is roaring; China is slowing, but its targeted 7% annual growth should be the world's envy; swift income growth there and in other Emerging Markets should drive consumption, benefitting large-cap multinationals.

In spite of this, sentiment is tame. Modestly above-average P/E ratios imply increased investor optimism, not euphoria. Falling expectations for global growth and corporate earnings help keep sentiment in check. Professional forecasts, as mentioned previously, remain muted. False fears of rate hikes and the strong dollar persist—as to be discussed in detail throughout the review. Equities have a sizable wall of worry to climb.

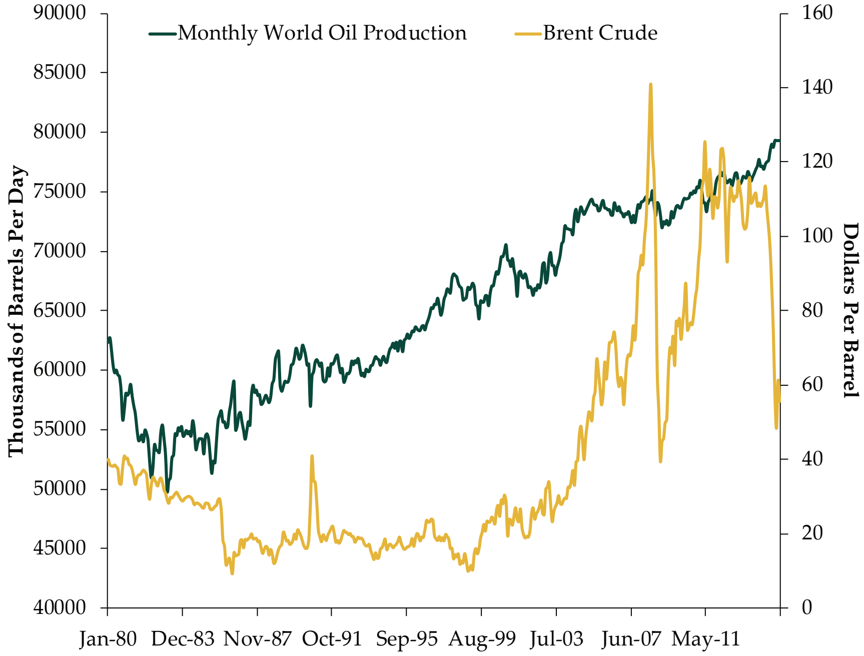
What About Energy?

With Energy equities down -26.4% since peaking last June, we are often asked if now is the time to overweight the sector—many assume what goes down must go up.[vi] Energy's time will come, but broad enthusiasm tells us it is not here yet. Bottom-fishing—viewing Energy as a "contrarian" play—is too popular. Energy sector capital inflows are sky-high. Headlines recommend hot funds and cheap oil equities near-daily. These are signs that sentiment has not burned out yet; turnarounds rarely happen before bull markets capitulate. In the case of such an Energy landscape, patience is of value.

Energy equities are down for a reason: Revenues depend on high oil prices, and crude oil is down roughly 50% since mid-June. Many are conditioned to believe in high oil prices and assume the drop must be temporary. Mankind has not yet overcome a "peak oil" mentality stemming from decades of falling US output, sideways global production and warnings of dwindling reserves. Few fathom how flush supply has become. Many assume America's output boom is temporary and production will soon resume its longer-term decline. However, the data show otherwise: Rising supply is a long-term phenomenon.

Energy is another sector where technology has fostered amazing efficiency. Most are aware that horizontal drilling and hydraulic fracturing have facilitated the economical extraction of shale oil, but fewer understand that mechanical improvements are the tip of the iceberg. Advancements in geological imaging—the fruit of Moore's Law and similar computing revolutions—vastly improved firms' ability to locate oil both on and offshore. Improving technology makes oil cheaper and easier to extract. Today resembles the 1990s, when oil prices spent years near rock-bottom as production surged globally (Exhibit 3).

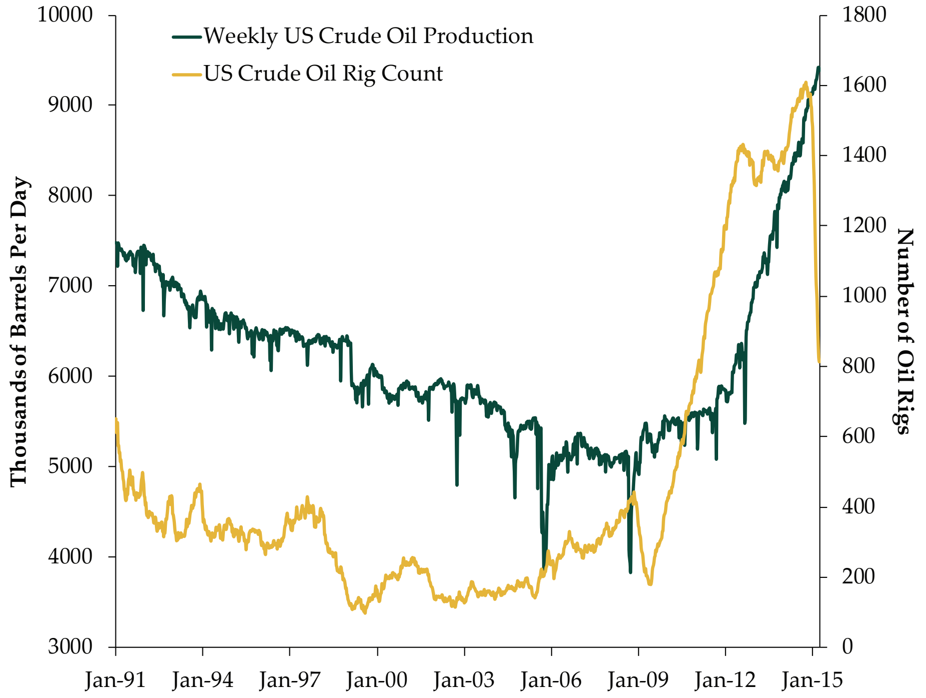
Exhibit 3: Global Crude Oil Production and Price, 1980 - 2015



Source: FactSet, as of 7/4/2015. Monthly World Oil Production (thousands of barrels/day) and Brent Crude Price, 1/1980 – 3/2015.

Supply and demand favour low prices. Demand is rising modestly, but production is booming. While the number of active US rigs has fallen sharply, output continues rising—firms are aspiring for efficiency, halting marginal wells while maintaining production at more profitable projects (Exhibit 4).

Exhibit 4: US Oil Rig Count and Production



Source: FactSet, as of 7/4/2015. Weekly Field Oil Production (thousands of barrels/day) and Baker Hughes Weekly Oil Rig Count, 1/1/1990 – 31/3/2015.

Oil wells require sizable up-front investment. For many firms, continuing to pump and reap some revenues is preferable to idle wells and costs that cannot be recouped. Production likely will fall eventually if prices remain low, but even when it does, firms are positioned to increase production relatively quickly if prices rise.

Portfolios do have a small Energy weighting, focused on integrated firms, which are better able to control costs. Our underweight has added value in recent quarters, and we believe it will remain beneficial over the foreseeable future.

US COMMENTARY

US's Strong Foundation

While the days of widespread pessimism over the economic direction of the US are mostly over, expectations are far from rosy presently. In Q1, fears of slowing earnings and economic growth perked, but the US economy continues showing signs of underappreciated strength. This brighter-than-appreciated reality has long helped fuel this bull market—extending the wall of worry. We anticipate fundamentals will continue exceeding expectations.

Earnings and Energy

S&P 500 earnings grew 3.7% in Q4 2014, slowing from Q3's 8.0%, and analysts are already projecting a -4.3% Q1 decline.[vii] Yet all are largely a function of Energy. Oil prices' -55% drop since mid-June 2014 heavily weighed on Energy firms' revenues and profits, which fell -14% and -22%, respectively.[viii] Earnings and revenues for the other nine sectors rose 6.9% and 4.8% (Exhibit 5).[ix]

Exhibit 5: Earnings Weakness Is Energy-Driven

	S&P 500		S&P 500 Ex. Energy	
	Revenues	Earnings	Revenues	Earnings
Q4 2014	2.0%	3.7%	4.8%	6.9%
Q1 2015 (Est.)	-3.2%	-4.3%	2.9%	3.8%
Q2 2015 (Est.)	-3.9%	-2.8%	2.9%	4.6%
CY 2015 (Est.)	-1.3%	1.8%	3.6%	8.9%

Source: Factset, as of 17/4/2015. All figures are year-over-year.

Similarly, Q1 S&P 500 earnings expectations are massively skewed by Energy, where profits are expected to fall a whopping -64% y/y.[x] Falling oil is not uniformly negative—for firms outside Energy, falling oil prices reduce input costs, propelling profits. Earnings "weakness" is mostly a widely known tale of falling oil prices, already reflected in Energy equities' roughly -25% decline since last June.[xi] Sufficiently liquid markets discount information near simultaneously.

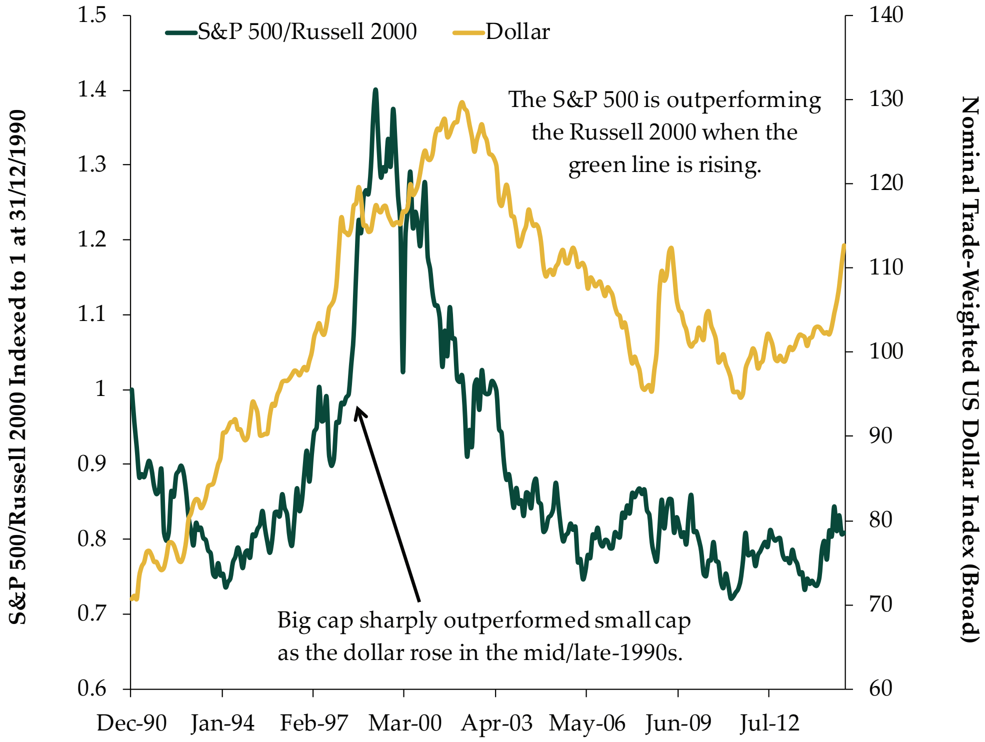
Strong Dollar Contributes and Detracts

Many cite the strong dollar as a negative for US earnings, particularly among large multinationals. However, currency moves do not foretell equities' direction—nor is the strong dollar's bottom-line impact uniformly negative.

Most pundits claim the strong dollar hurts US multinationals by making their products and services more expensive abroad, hurting revenues. While true to an extent, this is too narrow a view of how multinational firms work. Large multinationals have overseas costs, too—raw materials, labour and more. The strong dollar reduces those costs, as does cheap oil. US multinationals' products may be more expensive abroad, but they enjoy vastly reduced costs.

Some argue a strong dollar favours smaller US equities, believing them more purely domestic and less exposed to currency moves, but history and theory do not support this. In the late 1990s, the US dollar was stronger than today, and large-caps outperformed handsomely. In the 2002–2007 bull market, the dollar was weak, yet large US firms did not persistently outperform (Exhibit 6).

Exhibit 6: Large-Cap and the Dollar



Source: Factset, as of 2/2/2015. S&P 500 and Russell 2000 total return indexes and broad trade-weighted US dollar index, 31/12/1990 – 31/1/2015.

Additionally, the dollar's gyrations are widely watched, discussed and fretted. Widespread attention makes it likely equities have discounted the feared impact, priming US multinationals' earnings to positively surprise.

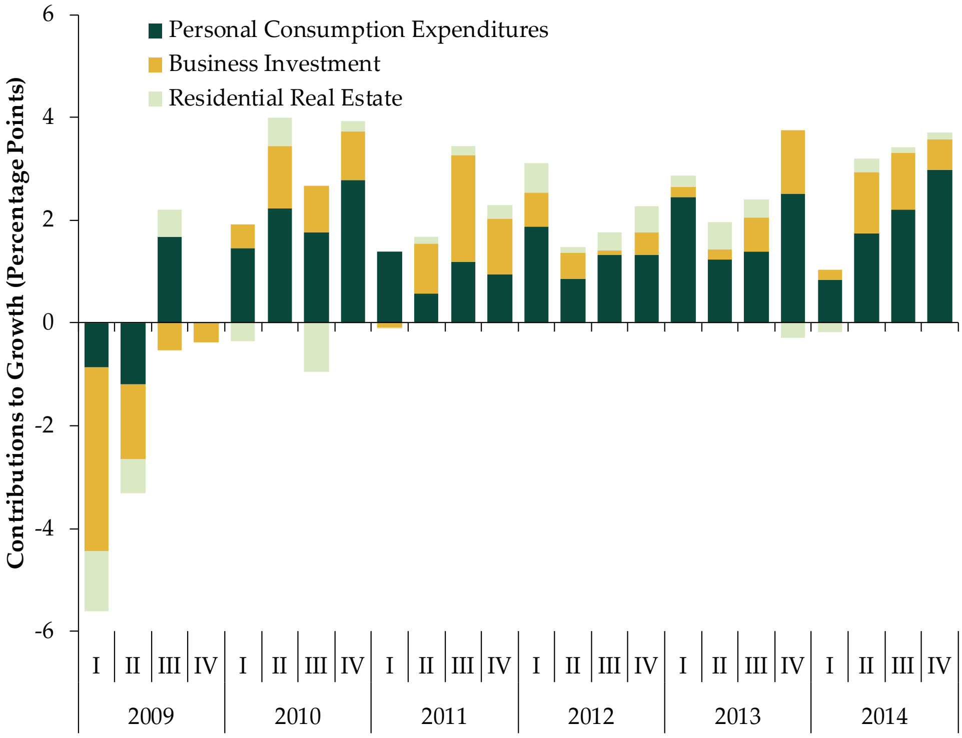
The US Economy Is Not Faltering

Many pundits spent Q1 fearing an economic slowdown, some pointing to the same strong dollar. We see little evidence of a sustained slowdown. While some indicators suggested weakness in Q1, this appears to be a one-off function of cold weather and a West Coast Ports labour dispute.

Slow-growth fears resurged after Q4 2014 US GDP grew 2.2%—less than half Q3's 5.0%.[xii] However, GDP's calculation quirks make this less than telling. Rising imports detract from GDP yet typically signal healthy demand. GDP treats government spending as uniformly positive, regardless of how the money is allocated or sourced. Falling inventories subtract in GDP math, even if they stem from surging consumption requiring restocking.

Together, Q4 2014's pure private-sector components—consumer spending, business investment and residential real estate—accelerated in Q4 (Exhibit 7). GDP's slowdown stemmed mostly from rising imports, falling defense spending and leaner inventories—none necessarily indicate weak growth.

Exhibit 7: Pure Private Sector GDP Components

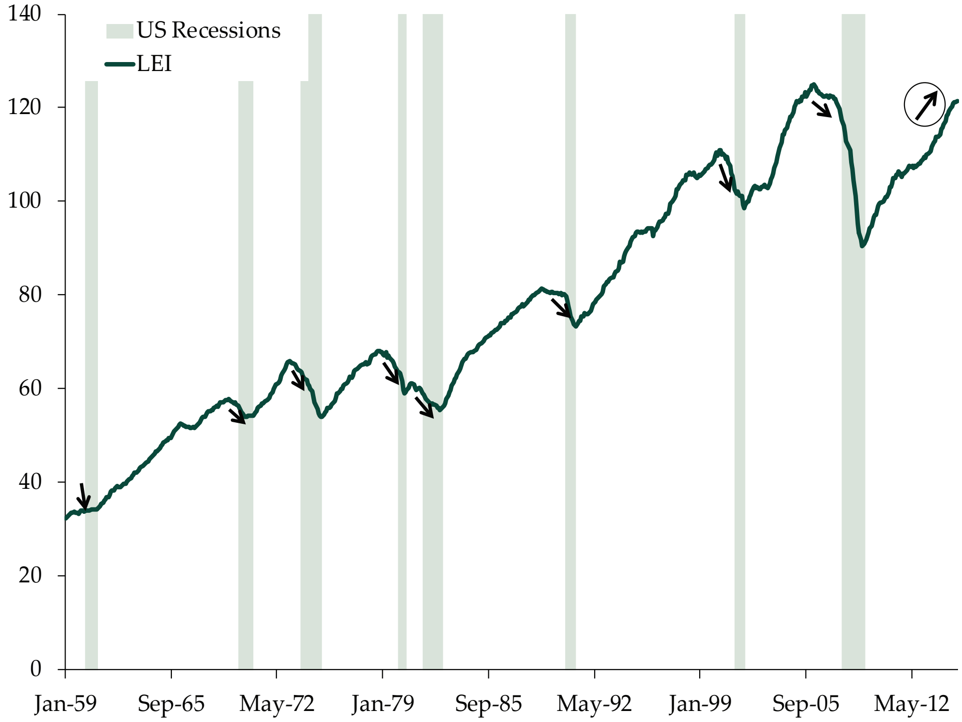


Source: US Bureau of Labor Statistics, as of 13/4/2015. Contributions to growth at seasonally adjusted annual rates.

The initial read of Q1 2015's preliminary GDP release showed a lower-than-estimated +0.2% growth. However, the slowdown was not shocking as forecasters polled beforehand anticipated it, with most expectations around +1.0%.[xiii] That said, we believe it is erroneous to call two straight slowdowns a trend. As shown in Exhibit 7, Q4 was not slow if carefully examined. Q1 appears heavily affected by fleeting one-offs like extreme winter weather and the now-resolved West Coast Ports labour dispute. These factors are evident in soft retail sales, weak international trade as ships idled in the Pacific, and tepid industrial production led by utilities, not factories. The Institute for Supply Management's Manufacturing and Services Purchasing Managers' Indexes remained in expansion throughout Q1, showing broad economic growth, though many businesses cited weather and the Ports dispute as headwinds.

The Conference Board's US LEI rose throughout Q1, putting the string at 14 straight months. Since 1959, no recession has begun when LEI is rising (Exhibit 8).

Exhibit 8: US LEI



Source: Factset, as of 17/4/2015. Conference Board US LEI and NBER recessions, 1/1/1959 – 31/3/2015.

Even if slower growth persists, it does not necessarily threaten the bull. Economic growth and equities do not move in tandem. Most bull markets are born in recession. The gap between investors' fears and economic reality is crucial. One of this bull market's major fears has been sluggish growth, keeping worries high and expectations low—setting up positive surprise.

Global Growth Continues

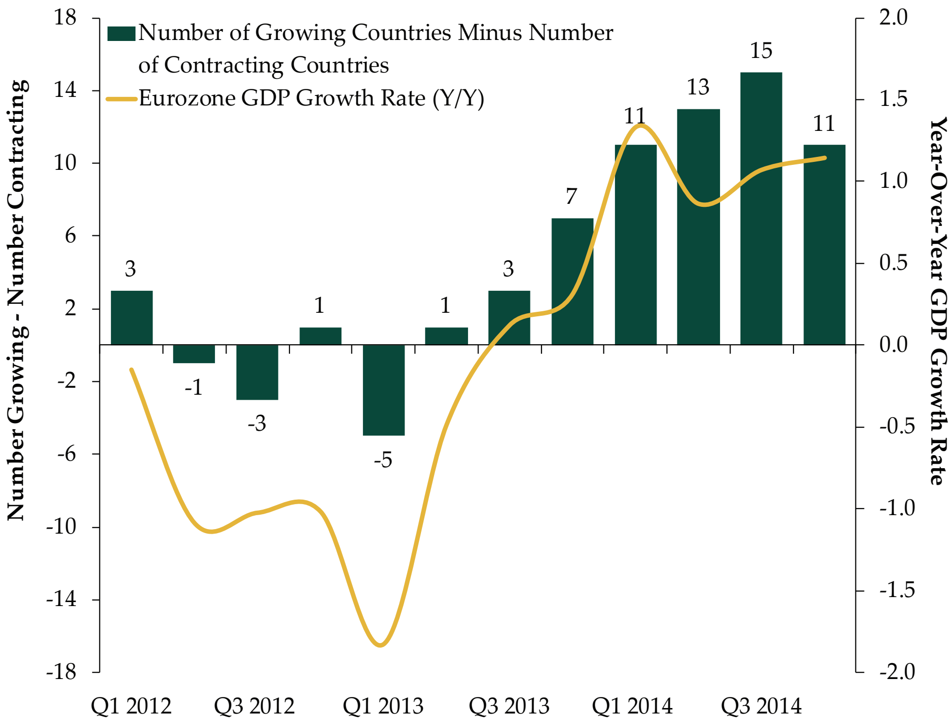
Non-US equities outperformed their US counterparts in Q1.Some sceptics suggest the eurozone's big bounce—a big contributor to non-US outperformance—was a QE sentiment boost, but economic fundamentals are improving through much of the world, particularly in Continental Europe.

Underpinning The Eurozone's Underappreciated Rally

Europe's ascendance is no mirage. Economic data, though not stellar, are improving and keep defying too-dour expectations. This gap is why we continue to expect eurozone equities to perform well—sentiment remains trapped in the past.

When financial media noticed positive economic data, the common refrain celebrated the region "finally" showing signs of a turnaround. Some invoked former Fed head Ben Bernanke's 15 March 2009 comment that "green shoots" were emerging—which he said before the US recession ended and days after the bull began.[xiv] But the eurozone has grown seven straight quarters through Q4 2014, and it is not a solely German affair—Ireland and Spain are growing swiftly, and the number of countries growing has increased (Exhibit 9).

Exhibit 9: Euro Area GDP Growth, 2012–2014



Source: Eurostat, as of 23/4/2015. All GDP data are year-over-year.

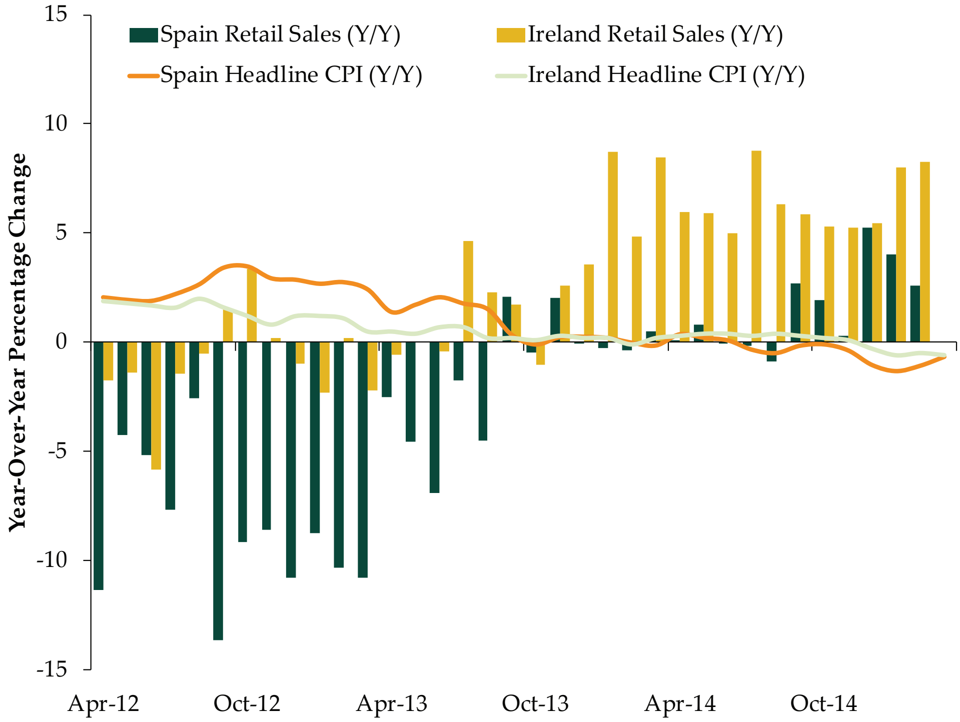
Although France is still a widely considered sore spot, the country continues growing. Most Q1 data indicate an across-the-board increase in economic activity. Composite Purchasing Managers' Indexes (PMI) picked up, nearing a four-year high in March. French February export growth topped 1% m/m.

While headlines are happily surprised by growth, we do not see this as new or unexpected. The Conference Board's LEI for the eurozone, France, Germany and Spain are all in long (though choppy) uptrends and have predicted Europe's recovery from the start. Eurozone LEI, up six of seven months through February and accelerating, predicted Q1's economic uptick. By contrast, the media views data through lagging phenomena like the debt crisis or "lost decade" fears. The handwringing is tiresome, but it lowers expectations.

Some argue QE is driving Europe's improvement, overlooking those seven quarters of pre-QE eurozone growth. QE adoration and related hyperinflation fears are two of the great delusions of our time. QE's bond buying reduces long-term interest rates—reducing the spread between long-term and short-term rates (flattening the yield curve). This spread heavily influences banks' loan profits: They fund loans by borrowing short term and lend long term, and the spread represents their net interest margin. Less profitable lending likely means it is harder to get a loan. Hence, by flattening yield curves, QE is a sedative—contradicting over 100 years of evidence steeper yield curves stimulate. Pundits believe newly created money buoys equities, but most new reserves remain on bank balance sheets as flatter yield curves discourage lending, limiting broad money supply growth. Others claim it will spur fast-rising prices, to the economy's detriment, but banks must lend against those reserves to stoke inflation.

The ECB believes QE addresses deflation, but the eurozone's falling prices are not problematic. Recent deflation stems from falling oil prices—excluding volatile food and energy, inflation is low yet stable. Some fret falling prices discourage consumption, eventually creating a vicious circle of falling prices and GDP. However, retail sales volumes have risen as prices fell, and broad money supply (M3) accelerated 10 straight months through February (Exhibit 10).

Exhibit 10: Euro Area Retail Sales Volumes and Harmonised CPI



Source: Factset, as of 24/4/2015. Spanish and Irish retail sales volumes and CPI, 4/2012 – 2/2015.

Loan growth is stabilising year over year, and French and German business lending have trended steadily higher for about the last twelve months.[xv] Loan growth's primary detriment is Italy, where banks must raise capital following last year's stress tests—a regulatory, not monetary, issue. Elsewhere, underappreciated strength is widespread.

UK Elections

The UK election took centre stage in Q1, and given what was thought a tight race, the chatter and angst likely weighed on British shares in the quarter. Most polls leading up to 7 May's vote suggested a hung parliament would result.

Yet when the votes were counted, the Conservatives surprised, winning a majority in Britain's House of Commons as the Scottish National Party swept Scotland. Opposition Labour lost seats throughout the Northeast and even in Wales. The Conservatives' coalition partner since 2010, the Liberal Democrats, were all but swept away.

While this ends the coalition government in place since 2010, it likely does not usher in an era of sweeping legislation that markets dislike. The Conservatives' majority is razor thin, and the backbenchers lack unity, so gridlock likely persists—as it did under John Major, who had a few more seats in the mid-1990s than Cameron does now but still relied on support from Northern Ireland's unionist parties to pass key bills. This outcome also reduces the risk of extreme legislation proposed by other parties, including Energy sector price controls and more stringent bank regulation—a positive to counterbalance the slight uptick in legislative risk under a weak majority government.

As for the major issues on Cameron's plate—the pledged referendum on EU (European Union) membership and greater autonomy for Wales and Scotland (and, potentially, devolved powers for England)—it is far too early to speculate. Both devolution and the EU membership referendum likely play out over time, with lots of chatter and showmanship. Before an EU membership referendum takes place, Cameron must renegotiate Britain's relationship with the rest of the EU, which might require treaty amendments—a painstaking bureaucratic process. The resulting deal is what the people will vote on, and it is impossible to handicap what that will look like. However, leaving the EU is not overwhelmingly popular in Britain, and repatriating some regulatory authority from Brussels might be enough to satisfy the eurosceptics.

Overall, while markets will be watching this over time, in the nearer term, they should enjoy the relatively inactive UK Parliament and solid economic fundamentals.

Other European Elections

Spain and Portugal hold general elections later this year, and mainstream pro-euro parties have regained some ground from eurosceptic parties. Here, too, early national polls are not so predictive. Both countries elect lawmakers proportionately by region. However, it does appear that anti-austerity party Syriza's misadventures in Greece have hurt the appeal of electing radical eurosceptics, increasing pro-euro parties' appeal.

France's departmental elections, held at Q1's end, underscore gridlock and the low risk of eurosceptic parties disintegrating the eurozone. France's centre-right Union for a Popular Movement (UMP), headed by former President Nicolas Sarkozy, won by taking 66 of 98 departments—mostly at the expense of President François Hollande's Socialist Party. While the media emphasised the far-right National Front's (FN) second-place finish in the popular vote, the FN did not win much legislative authority, taking only 62 of 4,108 seats at stake. The FN polled as well as the Socialists, an established party, but the FN's actual influence is rather limited comparatively. While speculation about this election's future implications is interesting, there is little market impact. Rather, the combination of an unpopular president and a sizable opposition party nearly assures gridlock in the near-future: a positive for equities.

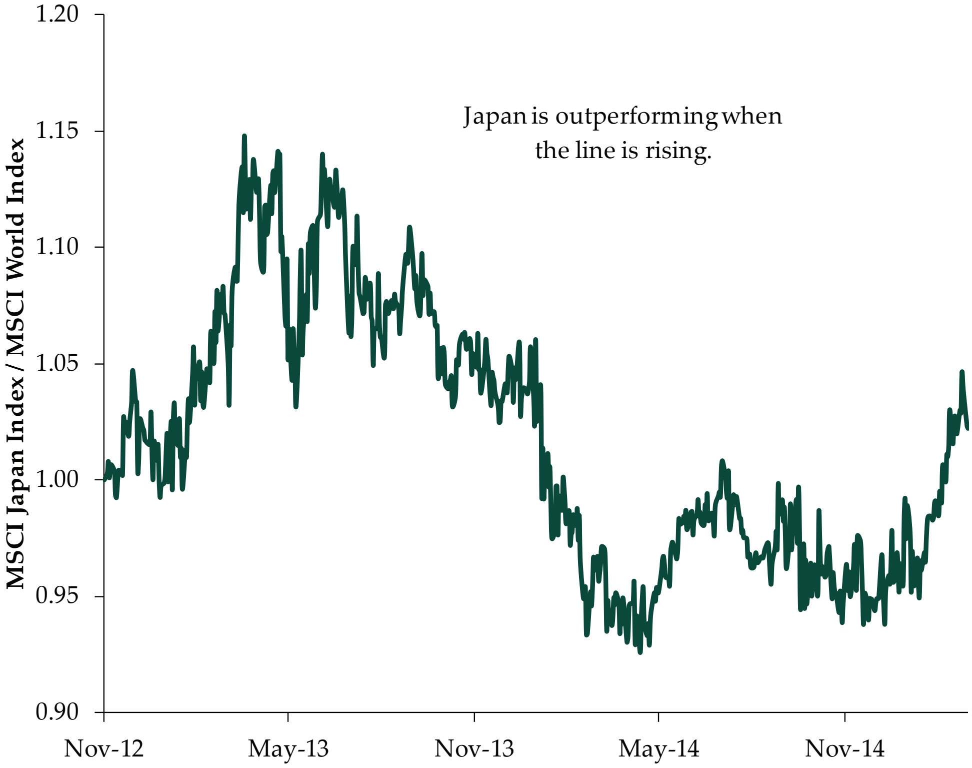
Japan's Misleading Q1

Japan was among Q1's best performers, but we believe it is another false dawn. Pundits hype the Nikkei 225, but the index is denominated in yen. Dollar-denominated returns are lower—and even they appear excessive, given Japan's fundamentals.

While Japan's recession ended in Q4 2014, GDP grew just 1.5% annualised, reminiscent of the weak, short-lived bounces following the 2011 and 2012 recessions.[xvi] Monthly indicators show similar weakness: February trade grew only due to the weak yen; "positive" inflation is actually 0.0% y/y when last year's sales tax hike is removed; retail sales and total household consumption fell.[xvii] Structural barriers to robust, sustained growth persist.

Reform remains the swing factor, but there is still too much talk, not enough action. Prime Minister Shinzo Abe's administration detailed its planned corporate governance reforms—a positive, but a small one—and far short of Abe's promises to overcome vested interests and liberalise trade barriers, labour markets, agricultural production and more. Abe's primary focus remains national security and rewriting Japan's pacifist constitution—a lifelong ambition—not economic revitalisation. In our view, nothing has changed today from 2013, when enthusiasm over the Bank of Japan's (BoJ) turbocharged QE drove a short-lived rally (Exhibit 11). It soon fizzled, and we expect Japan's outperformance to be similarly temporary today.

Exhibit 11: MSCI Japan / MSCI World from 30/11/2012–31/3/2015



Source: FactSet, as of 14/4/2015. Indexed to 1 on 30/11/2012.

DEVELOPING MARKETS COMMENTARY

Emerging Markets in Q1

The Emerging Markets' (EM) economic landscape was, in general, a tale of winners and losers from falling commodity prices in Q1, as some commodity exporters struggled while importers thrived.

Emerging Asia Growing Apace

Markets continued taking China's gradual slowdown in stride, yawning when Q1 GDP growth notched 7.0% y/y in Q1—matching the full-year target. [xviii] The expenditure breakdown suggests not much has changed from prior quarters: Services and consumption indicators are still outpacing heavy industry and fixed investment continues slowing—consistent with the government's long-running efforts to reengineer the economy. Some speculated March's trade data suggested the economic shift was going off track as exports and imports fell—theoretically implying weaker demand in China—but this does not appear to be the case. Imports' drop was tied largely to commodity prices: While imports fell -12.3% y/y in nominal terms, the volume of goods imported rose.[xix]

We expect more of the same looking forward—modestly slowing growth while the central bank provides targeted stimulus as needed. To that end, in March the PBOC cut its benchmark lending and deposit rates 25 bps each to 5.4% and 2.5%, respectively, and raised the ceiling for deposit rates to 1.3x the benchmark from 1.2x. They also cut the reserve ratio requirement (RRR) 50 bps for all banks, with an additional 50 bp cut for some municipal and rural commercial banks that meet a minimum threshold for small business lending. China Agriculture Development Bank received a 450 bp rate cut. All told, it appears officials are trying to ensure stimulus spreads beyond the largest state-run firms, whose return on investment continues falling.

India's economy remains firm. GDP grew 7.5% y/y in Q4—a tad slower than Q3's 8.2%, but still enviable and the fastest in emerging Asia.[xx] Industrial production remained in line with recent trends in Q1, rising 2.8% y/y in January and 5.0% in February.[xxi] The Reserve Bank of India cut the repo rate 25 bps to 7.5% in March, following the announcement of its new inflation target of 4% (plus/minus two percentage points). Indian inflation tumbled recently, from a relative high of 11.2% y/y in November 2013 to just 5.2% in March 2015.[xxii] With growth still swift, the central bank has plenty of breathing room, and Q1's two rate cuts flipped India's inverted yield curve. The spread between overnight and 10-year Treasury yields turned positive in January, and the rate cuts helped reduce yields on shorter maturities as well. One-month yields are now below 10-year yields for the first time in a year.

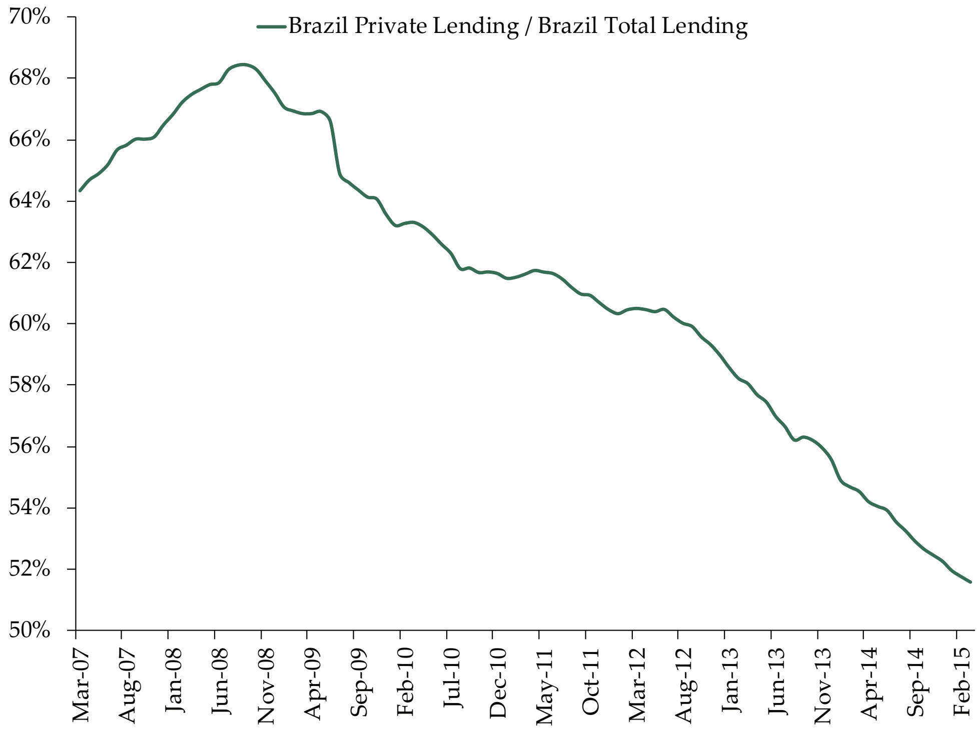
Indonesian Q1 GDP slowed to 4.7% y/y—the slowest since 2009—but under the surface there is little evidence Indonesia is weakening significantly.[xxiii] Consumer spending growth matched Q4's 5.0% y/y, and private investment sped slightly from Q4's 4.3% to 4.4%.[xxiv] On an industry basis, all categories grew on a year-over-year basis except for mining, which fell -2.3%.[xxv] This is an unsurprising effect of tumbling commodity prices and last year's unprocessed natural resources export ban, which had a downstream impact on production. However, Indonesia's economy is not commodity-dependent: Mining is just 10.5% of GDP, and the larger industrial and retail sectors are growing solidly at 3.9% y/y and 3.7%, respectively.[xxvi] Information technology, the fastest-growing sector at 10.5% y/y, contributed nearly half a percentage point to the total growth rate.[xxvii]

Finally, South Korean growth accelerated, rising 3.1% annualised (0.8% q/q) in Q1, beating expectations.[xxviii] Led by a strong pick-up in construction investment and illustrating the property market's ongoing recovery. Private consumption also improved, led by 3.2% annualised growth in household spending.[xxix] Net trade was the main detractor as exports were flat while imports rose 2.0%, yet rising imports signal healthy domestic demand.[xxx] Inflation remains benign, allowing the central bank to cut rates by 25 bps in March, joining several other Asian countries in a new easing cycle. The central bank and government are providing full monetary and fiscal support, which should help encourage a continued turnaround from 2014's softer data.

Falling Commodity Prices Take a Toll

While Brazilian GDP accelerated to 1.3% annualised in Q4 (from Q3's 0.6%), the economic recovery is on shaky footing.[xxxi] Industrial production, down in February and eight of the last 12 months, has yet to turn around meaningfully. While mining output held up fairly well, it is an open question how long the industry can sustain low oil and metals prices. Retail sales are weakening, growing just 0.5% y/y in January and falling -3.1% y/y in February—the sharpest slide in years.[xxxii] The Conference Board's LEI for Brazil fell -2.0% in March and is down in six of the last seven months.[xxxiii] Yet high inflation (8.2% y/y in March, the highest since 2004 and well above the target band of 2.5% to 6.5%) prevents the central bank from loosening monetary policy.[xxxiv] Instead, they raised rates twice in Q1, briefly inverting the yield curve in January. The long-running combination of a flagging economy, rising inflation and rate hikes illustrates how inefficient Brazil's economy has become—and how big a role state banks play in pumping money into the economy (Exhibit 12).

Exhibit 12: Brazil Private Lending vs. Brazil Total Lending



Source: FactSet, as of 8/5/2015.

Russia is in a similarly unenviable position. GDP fell -0.1% annualised in Q4 as falling oil prices, high inflation and Western economic sanctions took their toll.[xxxv] Combined crude oil and natural gas output fell in four of seven months through March. Imports fell -9.4% annualised in Q4, the sixth straight drop, illustrating how much domestic demand has eroded.[xxxvi] Inflation surged to 16.9% y/y in March, the highest rate since early 2002, and food inflation topped 20%.[xxxvii] In March, the central bank cited the strengthening ruble as evidence inflationary pressures are waning and cut its main policy rate by one percentage point, but we are sceptical of a near-term turnaround. The Energy sector is the last functioning pillar of Russia's economy, and roughly two thirds of government spending depends on oil rents. The weak ruble helped insulate Russian oil producers' export revenues from crude's decline to an extent in Q4, but that effect is diminishing as the ruble recovers. We suspect the increasing headwind from currency conversions lies behind the rate cut, but the exchange rate continued rising after the central bank acted. Overall, Russia's oil industry and broader economy still face numerous headwinds, leading us to believe Russian equities' early 2015 rally is likely a mirage.

Risks to Watch, False Fears to Embrace

As the bull turns six years old, many presume its days are numbered. On the contrary, bull markets do not die of old age, they end with the wall or the wallop. Most often, bulls fizzle after climbing the wall of worry—sentiment turns euphoric, expectations grow too high, and equities fall when reality cannot keep up. Less often, equities get walloped by a huge, unseen negative—a shock worth trillions. The 2002-2007 bull was walloped by the combination of FAS 157's (the mark-to-market accounting rule) misapplication to illiquid assets and the US government's haphazard attempts to stop the bleeding. In 1938, Nazi Germany's annexation of Czech territory walloped a new bull market.

We do not see any probable wallops on the horizon today. Most risks are too small and widely discussed to materially move markets—or false fears, which are bullish. Some smaller unseen negatives could wallop if they grew and stayed under the radar, but for now, they lack scale.

All About Rate Hikes

US rate-hike speculation hit fever pitch in Q1, as Fed Chair Janet Yellen and various Fed members dropped often-contradictory hints about their next move. Headlines warn near-daily that a rate hike could stall growth and sink equities, then offer fruitless survival guides. This is all noise, in our view, and largely unnecessary: Fed moves are not predictable, and history shows the first rate hike in a tightening cycle has never triggered a bear market since 1970.

Fed Words and Guessing Games

Q1's Fed obsession centred on one word: patient. In December, the Federal Open Market Committee (FOMC) changed its forward guidance from:

> The Committee anticipates, based on its current assessment, that it likely will be appropriate to maintain the 0 to 1/4 percent target range for the federal funds rate for a considerable time following the end of its asset purchase programme this month, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored.[xxxix]

To:

> Based on its current assessment, the Committee judges that it can be patient in beginning to normalise the stance of monetary policy.[xxxviii]

Many believe this started a countdown, as Yellen said "considerable time" equaled "around six months."[xl] After December's meeting, she said "patient" meant the FOMC "is unlikely to begin the normalisation process for at least the next couple of meetings." She clarified, "'a couple' means two."[xli]

In March, the FOMC deleted "patient," saying instead:

> Consistent with its previous statement, the Committee judges that an increase in the target range for the federal funds rate remains unlikely at the April FOMC meeting. The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labour market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term. This change in the forward guidance does not indicate that the Committee has decided on the timing of the initial increase in the target range.[xlii]

Many pundits claim this foretells a June hike, ignoring the final sentence. Others believe the Fed will move later, citing FOMC members' updated long-term interest rate projections, which showed rates rising more slowly than anticipated last December. Pundits also interpreted these projections as a sign rates will rise gradually, which many cheered. We advise against reading into this. Central bank guidance changes often. Before last year, the Fed said it would consider hiking after unemployment hit 6.5%.[xliii] After that happened sooner than members expected, "considerable time" replaced it. Yet QE ended six months ago—meeting Yellen's definition of "considerable time"—and rates remain on hold.

One thing the Fed has consistently said is their decision will depend on economic data. This is always true, hence why Fed moves are unpredictable. Economic, inflation and labour market indicators vary hugely month-to-month, often surprising economists (including Fed members). Moreover, humans interpret data differently. You can see this in other Fed members' comments. Some, like now-former Dallas Fed President Richard Fisher, Richmond Fed Chief Jeffrey Lacker and St. Louis Fed President James Bullard, say data imply the Fed should act soon. Others, like Chicago Fed President Charles Evans and Minneapolis Fed President Narayana Kocherlakota, say low inflation dictates rates should stay low for longer. Rate hikes require a majority vote on the 10-member FOMC. It is impossible to know how 10 people will interpret unpredictable data.

Rate Hikes are Not Bearish

It is not necessary to know when the Fed will raise interest rates—the first rate hike in a tightening cycle is not bearish. Nor is short-term volatility automatic. With a potential hike widely discussed, equities could yawn. Or they could rise, as they did moments after the Fed announced the "tapering" of QE in December 2013. Short-term swings are sentiment-driven—unpredictable.

Rather than timing potential wiggles, we advise looking longer-term: Since 1970, the first rate hike in a tightening cycle has never caused a bear market (Exhibit 13).

Exhibit 13: MSCI World Index Returns Before and After Rate Hikes

First Rate Hike	Prior 12 Months	Next 12 Months	Next 24 Months
16/07/1971	31.2%	13.5%	19.0%
16/08/1977	-1.5%	15.0%	19.8%
21/10/1980	18.9%	-13.6%	-8.0%
27/03/1984	11.8%	8.0%	62.6%
16/12/1986	40.8%	14.1%	37.6%
29/03/1988	0.9%	11.7%	9.8%
04/02/1994	27.2%	-3.9%	17.4%
30/06/1999	14.0%	10.7%	-12.1%
30/06/2004	21.4%	8.7%	22.4%
Average	**18%**	**7%**	**19%**

Source: Factset, as of 7/8/2014. MSCI World Index price returns, 31/12/1969 – 29/12/2006.

Initial hikes lack material impact because short rates alone are not nearly as important to markets as the yield curve, which influences lending and economic activity. With 10-year yields ending Q1 at 1.92% and the fed-funds target at 0-0.25%, the first hike will not invert the yield curve.

What matters for equities is whether the Fed hikes gradually or aggressively over time—unknowable, though as mentioned last quarter, Yellen's actions thus far suggest she prefers moving deliberately and gradually. She has always sought consensus, which moves slowly. She is also well aware the next President will have the option of reappointing her in 2018, but she does not know who the President will be. This gives her an incentive to moderate and move slowly—hike incrementally to appease potential hawks, but not so severely she upsets doves.

No 1937 Repeat

One well-known hedge fund manager made waves in March, warning of economic collapse if the Fed tightens prematurely. He drew parallels with 1937, arguing the Fed tightened too soon after the US began recovering from the Great Depression, choking the nascent recovery, creating what was then one of history's sharpest contractions, and sending equities in a tailspin.[xliv]

Yet 1937 is no parallel for today. The US has been out of recession since mid-2009. This expansion's below-average growth, dragged down by falling government consumption, masks a robust private sector. Nothing suggests the US economy cannot handle rates above zero.

Moreover, while the Fed erred in 1937, it was not by incrementally hiking short-term rates. Then, the reserve requirement was their primary policy tool. They reduced it to spur lending and broad money supply growth and raised it to soak up excess liquidity and avoid overheating.

Entering 1937, the reserve requirement was in the teens, but banks had significant excess reserves, theoretically enabling plentiful lending. Fearing runaway inflation, the Fed decided to raise reserve requirements to 33 1/3 percent, which would remove banks' ability to lend off these accumulated reserves. Policymakers considered the possibility they were moving too aggressively, potentially forcing banks to raise capital, but as the January 1937 meeting minutes show, they calculated that the amount of excess reserves in the system was nearly sufficient for banks to meet the new requirements. They estimated total excess reserves at $2.1 billion, exceeding total required reserves under the proposed ratio by $600 million. Some banks would have to raise cash, but the combined shortfall was estimated at $123 million. Policymakers thus decided to raise the reserve requirement to 33 1/3 percent beginning 1 May 1937.

This proved fatal. As Milton Friedman and Anna Schwartz wrote in *A Monetary History of the United States*, *1867-1960*, Fed members erred in assuming the change was simply an accounting entry—banks re-designating their excess reserves as required and continuing as normal. They ignored the possibility banks were hoarding cash because the wave of early-1930s bank failures fueled an unprecedented desire for liquidity—and since required reserves are in practice illiquid, banks would raise cash to replenish their usable liquid buffers. They did exactly that, dumping Treasurys en masse, causing interest rates to spike and broad money supply to plunge.

That situation bears little resemblance to today. While there are roughly $2 trillion in excess reserves in the banking system, inflation is low and loan growth is not abnormally high. Fed members show few signs they fear these excess reserves will suddenly lead to a substantial increase in lending, stoking hot inflation.

Rate Hikes and Emerging Markets

As the Fed ponders its next move, many fear a rate hike will cause trouble in EM by driving away foreign capital, hurting economies and equities. We view this similarly to the "taper terror" surrounding the end of QE: a ghost story with little likelihood of coming true.

Markets efficiently discount widely anticipated actions and oft-discussed fears. EM rate hike fears have swirled since early 2014, appearing in news articles near-daily, major reports from the International Monetary Fund (IMF) and others, and even the Fed's meeting statement. The US dollar has appreciated and short-term interest rates ticked up amid rate hike chatter, implying markets have discounted the eventual move here. Since all similarly liquid markets digest widely known information near-simultaneously, we see little likelihood these fears are not already reflected in EM returns.

Taper terror illustrates this concept well. Markets began discounting the eventual taper when former Fed Chair Ben Bernanke first alluded to it in May 2013. US rates jumped, with the 10-year yield gaining over 100 bps between Bernanke's speech on 22 May and the end of the year. EM saw some volatility, most notably in India and Indonesia—widely feared to be the most vulnerable. Yet capital did not flee in droves, rates did not soar, and both nations recovered from mid-year corrections. Both did fine once the Fed began tapering in January 2014 and steadily reduced monthly bond purchases throughout the year. India and Indonesia each rose more than 20% in 2014, while the MSCI Emerging Markets finished down -2.2%.[xlv]

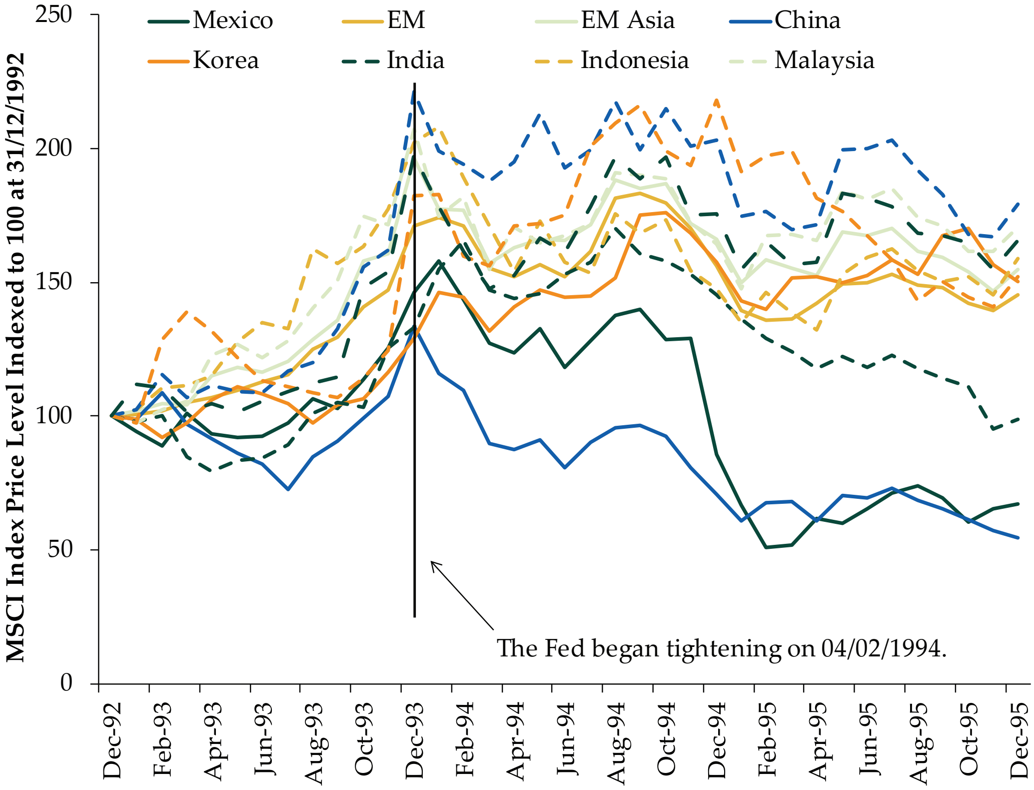
In addition to being discounted, EM rate hike fears stem from a false assumption: EM stability and growth is linked to low US interest rates, and rising/high US interest rates triggers EM capital flight and the occasional crisis. This seems to be grounded in an oversimplification of history. While EM crises over the past 20 years have coincided with Fed tightening, higher US interest rates alone did not necessarily cause them. The EM crisis hot zones all had severe pre-existing fundamental problems and unsustainable currency pegs—they were ticking time bombs, different from much of EM today.

A prime example is Mexico's 1994 "Tequila Crisis," which transpired after the Fed began a tightening cycle in February 1994. Mexico enjoyed a flood of foreign investment in the early 1990s as investors pounced on the opportunities created by the market-oriented reforms spearheaded by former President Miguel de la Madrid and his successor, Carlos Salinas de Gortari. Bolstered by strong inflows, low short-term rates and the stable currency (thanks to the peso's dollar peg), banks lent profligately but without much consideration for risk—Mexico lacked a central credit bureau to help assess and standardise borrowers' creditworthiness, and banks lent increasingly to shaky borrowers, putting them in a poor position once trouble hit. Additionally, as 1994 was an election year, Salinas's government spent heavily to boost the popularity of his Institutional Revolutionary Party (PRI) and hand-picked successor, Luis Donaldo Colosio, driving debt higher. So when the combined effect of the Chiapas uprising and the assassination of Colosio in March spooked foreign investors, officials chose not to hike rates to stem the tide, lest they choke the economic expansion and drive debt service costs higher. Instead, they intervened in foreign exchange markets to defend the peso.

As reserves dried up, Mexico issued dollar-linked short-term debt using the proceeds to continue its peso defense, and rolled over the new bonds as they matured. Fearing the state's increasingly uncertain finances, investors continued fleeing, and interest rates soared. The government finally bowed to market pressure in late December, devaluing the peso by 15% on 20/1
2/1994 and allowing it to float two days later. It plunged, making external debt impossible to service, and the rush to sell Mexican bonds drove short-term rates north of 37% in January 1995. Mexico received a $50 billion bailout from the US that month, GDP shrank about 6% in 1995, and Mexican equities fell -23.2% (compounding 1994's -44.4% drop).[xlvi]

Other Latin American nations were impacted by Mexico's troubles as fear spread throughout the region, but Emerging Asia held up fine, mostly bobbing sideways in 1994 and 1995 as Mexican equities plunged (Exhibit 14). The notable exception, China, was dealing with unrelated fundamental issues of its own, including the closing of its capital account, devaluation of the renminbi, and imposition of a dollar peg.

Exhibit 14: MSCI Mexico and Selected Emerging Asian Returns



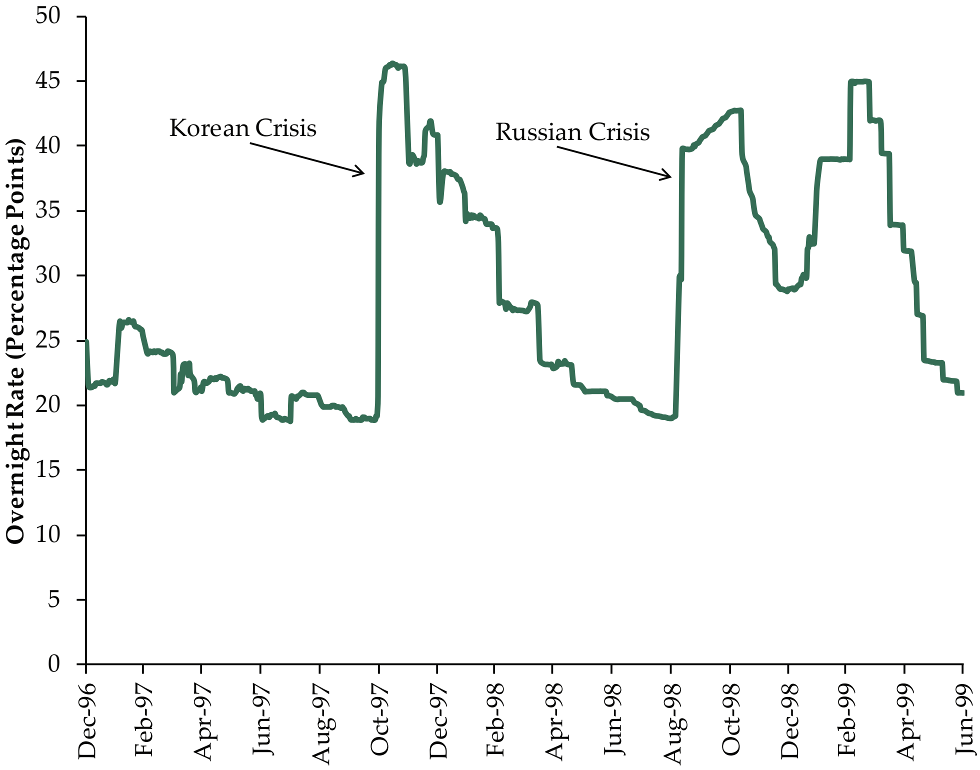
Source: FactSet, as of 4/5/2015. MSCI Mexico, Emerging Markets, Emerging Markets Asia, China, Korea, India, Indonesia, Malaysia, Philippines, Taiwan and Thailand price returns, 31/12/1992 – 31/12/1995. Price returns used in lieu of total due to data availability. Based in $USD.

The Asian Currency and Russian Ruble Crises of 1997 and 1998 were similarly fundamentally driven—they do not even coincide with a tightening cycle. Korea, Thailand and Indonesia, all of whom pegged their currencies to the US dollar, had run up sizeable dollar-denominated debt as they took advantage of low rates to finance swift growth. This worked for a while, but when the US dollar appreciated versus the yen, the pegged Asian nations were forced to defend their currencies in order to prevent a shock to their dollar-denominated bonds. Ultimately they were unsuccessful, and all three discarded the pegs, devalued and required bailouts from the IMF.

Russia followed the next year, forced to drop its peg as falling oil prices crushed its energy price-dependent economy. All the while, there was no tightening cycle—the Fed cut rates from 6.0% in June 1995 to 5.25% in March 1996, where they stayed until a 25-basis point hike in March 1997. Rates stayed there until September 1998, when the Fed loosened again.

Brazil's 1999 devaluation was a late offshoot of Asia's troubles, though the country's fundamental issues date back to 1994 and some unintended consequences of the "Real Plan"—the government's effort to battle inflation (then running at 900% annually), which included pegging the new currency (the real) to the US dollar to foster stability. While it succeeded in the first few years, by the late 1990s, Brazil was close to deflation, and investors began suspecting the real was artificially high. Contagion fears spiked during Korea's and Russia's crises, and overnight rates surged as the central bank tried to stem capital flight (Exhibit 15).

Exhibit 15: Brazilian Overnight Rates



Source: Global Financial Data, Inc., as of 6/5/2015.

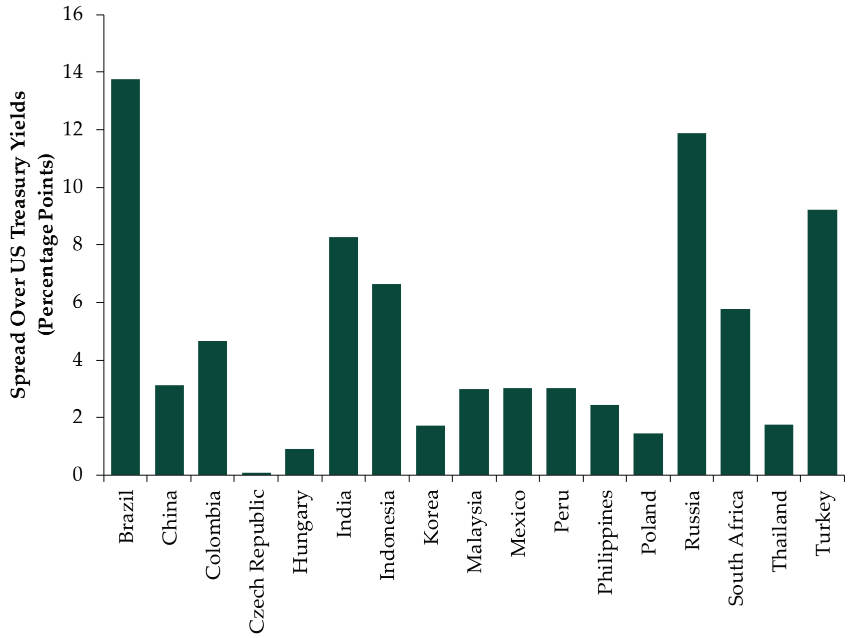
Yet capital outflows continued, and Brazil depleted half its foreign exchange reserves to defend the peg in 1998 (forex reserves began that year around $70 billion). As Brazil's deficit rose that year, confidence in the peg's long-term sustainability eroded, the market for long-term debt dried up, and Brazil was forced to rely on short-term debt to finance spending, making the country increasingly vulnerable to speculative attack. Officials arranged a pre-emptive $45 billion IMF loan in late 1998 to shore up confidence, but markets were not assuaged. Capital flight escalated to $350 million daily by year-end, Brazil dropped the peg in January, and the real fell sharply.

Emerging Markets overall have evolved considerably since the 1990s. Most currencies float, forex reserves are much bigger, growth does not depend wholly on foreign investment, and capital markets are more mature. The exception on the currency peg front, China, keeps its currency artificially low, not high. Economic weak spots are largely in commodity-dependent countries—well-known issues for nearly a year, and markets reflect much of this weakness already.

As for capital fleeing for the US once the Fed begins tightening, in our view, it is a fallacy to assume investors' preference for EM assets will suddenly shift. While many believe higher US rates will make EM look less attractive relatively, there appears to be little likelihood of US rates soaring any time soon—the first few hikes in a tightening cycle typically have minimal impact on long rates. The last US fed-funds target rate hike cycle, which ran from 2004 to 2006, included 17 rate hikes and increased overnight rates by 425 basis points. Yet the US 10-year yield rose only 51 basis points throughout. There is not a linear relationship.

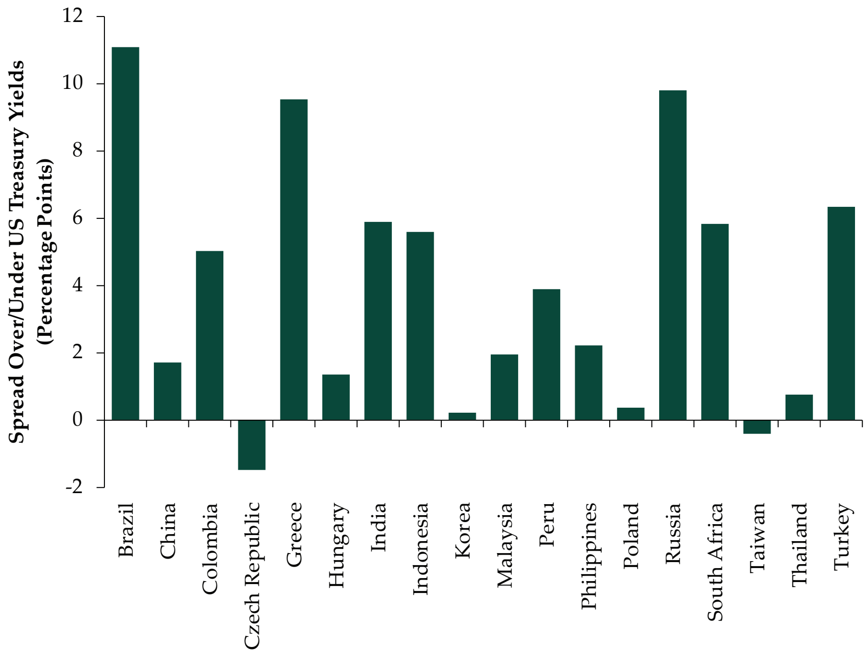
Moreover, most EM yields have a fairly wide lead over US Treasury yields at short and longer maturities, as shown in Exhibits 16 and 17, and it would be unusual for EM rates not to drift up with Treasury rates. To the extent higher yields in EM have attracted foreign investors, this feature does not appear likely to change much as the Fed begins tightening.

Exhibit 16: Select EM One-Month Yield Spreads (vs. US)



Source: FactSet, as of 4/5/2015. Select Emerging Markets one-month yields minus US one-month yields on 31/3/2015.

Exhibit 17: Select EM 10-Year Yield Spreads (vs. US)



Source: FactSet, as of 4/5/2015. Select Emerging Markets 10-year yields minus US 10-year yields on 31/3/2015.

A Word on Current Account Deficits

Many of the fears noted above are related to the common assertion that nations running persistent current-account deficits are "vulnerable" to external financing shocks. However, this is an oversimplification. Current account balances (surplus or deficit) are effectively the trade balance, and a deficit is not necessarily bad, unsustainable or a sign of fragility.

As the IMF's Atish Ghosh wrote in December 2006[xlvii]:

> If the deficit reflects an excess of imports over exports, it may be indicative of competitiveness problems, but because the current account deficit also implies an excess of investment over savings, it could equally be pointing to a highly productive, growing economy. If the deficit reflects low savings rather than high investment, it could be caused by reckless fiscal policy or a consumption binge. Or it could reflect perfectly sensible intertemporal trade, perhaps because of a temporary shock or shifting demographics. Without knowing which of these is at play, it makes little sense to talk of a deficit being "good" or "bad": deficits reflect underlying economic trends, which may be desirable or undesirable for a country at a particular point in time.

To this, we would add that imports exceeding exports may simply be a sign of strong domestic consumption and demand—not a sign of weakness or poor export competitiveness at all.

While a current account deficit may be indicative of an underlying problem, it is unlikely to be the problem itself. In fact, most of the evidence economists occasionally cite to support the notion that current account deficits are a risk are the same ones we discussed earlier (Mexico and the Asian Contagion). In our view, these better exemplify the inherent instability of currency pegs and the effect of political turmoil.

As a reminder, our political commentary aims to assess potential market impact. We favour neither party and believe political ideology is dangerous in investing.

When Government Creeps

Gridlock reduces a big source of political risk: radical legislation - but laws are not the only way politics can hurt markets. US regulatory and other government agencies are steadily gaining power to interfere with private business without oversight. If left unchecked, equities face the risk of too much intervention from too many overreaching governmental bodies.

For better and worse, the US has decided to create and devolve power to dozens of national, state and local bodies—think the Environmental Protection Agency, Department of Forestry, Fish and Wildlife Service, Consumer Financial Protection Bureau, Financial Stability Oversight Council, Department of Labor, Health and Human Services, Department of Energy and the like, and all their state and county-level equivalents. Many of these agencies try to influence and oversee businesses outside their jurisdiction, a trend we call "government creep."

There is no legal justification for agencies to creep over their boundaries, but few fight them. Firms with grounds to sue face severe reputational risk, so most take the path of least resistance. When out-of-state authorities ask them to change a certain business practice or threaten a fine for even imagined misdeeds, the firms comply and pay up, lest life become more difficult.

When governments overstep, businesses typically cower and take less risk. Uncertainty over business conditions is normal, and firms are largely comfortable with it. However, if the rules arbitrarily shift without warning, carrying unpredictable penalties, businesses struggle to assess risk and reward. Firms lose the incentive to grow, create and enter new markets. The impact cannot be measured and quantified precisely, but we can envision scenarios where such unpredictability quashes business investment and expansion.

While we are not arguing this caused 2008 on its own, Hank Paulson's redirect of the Troubled Asset Relief Programme (TARP) in 2008 exemplifies this. TARP wound up buying preferred equity in banks, not the troubled assets Congress voted to approve, changing directions after the legislation passed. Then banks were forced to sell preferred equity under TARP whether or not they needed funds.

Another recent example involves the US Treasury, which last year "reinterpreted" the tax code to strip most of the benefits of so-called "inversion" mergers and acquisitions, where a US firm would buy a smaller foreign competitor and re-domicile at the foreign address. Firms have occasionally done this to avoid double taxation on foreign earnings, a unique feature of the US tax code. By becoming "foreign" through mergers, firms could keep most operations in the US, do business internationally, and bring foreign earnings home to reinvest without an extra tax penalty. After a wave of inversion deals last year got some bad press for robbing the US of tax revenue, the US Treasury acted. Reinterpreting the tax code is not technically outside the Treasury's scope, but it is a grey area. It also set a precedent of Treasury tinkering—a slippery slope. This is just one example—others exist.

If Hillary Clinton Gets the Nod …

Last quarter, we detailed the risk of the Republicans sweeping 2016's elections, ending gridlock and setting markets up for the "perverse inverse"—markets' tendency to rally in years the Republicans take the White House, as investors cheer market-friendly campaign pledges, then suffer after the inauguration as reality disappoints (Exhibit 18). If Republicans win in 2016, equities could do great that year but fizzle in 2017.

Exhibit 18: The Perverse Inverse

	Election Year	First Year
Republican Elected	15.5%	0.7%
Democrat Elected	7.4%	16.2%

Source: Global Financial Data and FactSet, as of 7/1/2015. S&P 500 Total Return, 1926 – 2014.

While we cannot yet assess the likelihood of this, as the race is just starting, we can envision one scenario: If Hillary Clinton wins the Democratic nomination, history suggests the Republicans will have a major edge.

As we have written, Clinton does not fit the mold of a typical Democratic nominee. Democrats typically prefer fresh faces, a la Barack Obama in 2008 and Bill Clinton in 1992, but that requires credible challengers. It is unclear whether likely candidates Jim Webb and Martin O'Malley have the fundraising clout to challenge her. Senator Elizabeth Warren (D-MA) arguably does, but she insists she will not run. Absent serious opposition, Clinton could get the nod.

This would improve the GOP's odds of winning. Since the Civil War, Americans have never elected a Democrat who was a national figure and presumed Presidential nominee four years earlier unless he was already President. All who tried failed. John Kerry was a nationally known Senator for 19 years in 2004. Al Gore won the popular vote but not the electoral vote and therefore lost the presidency in 2000. His fellow former Vice Presidents, Walter Mondale and Hubert Humphrey, lost in 1984 and 1968. Al Smith, 1928's loser, served four non-consecutive terms as New York's governor—then a very prominent role nationally—and finished second at 1924's Democratic Convention, mirroring Hillary Clinton.

Today's Democratic Party does best following this blueprint: young, relatively unknown candidates who excite the base and rally the youth vote. Blank slates portrayed as leaders of a romantic, broad coalition, with no known negatives to distract. In 2008, fresh-faced Barack Obama ran on "Hope and Change"—a blank canvas for voters to project their dreams for the future. Bill Clinton did the same in 1992, running as a blank-slate "third way" candidate from "a town called Hope" He successfully rallied youthful idealism. So did John Kennedy—a new, handsome, little-known senator before 1960. He was among the freshest blank-slate candidates ever.

The strength of a blank-canvas candidate is that their drawbacks are easily painted over—the public has no previous conception of them. Well-known war horses, by contrast, have too many warts. Democratic strategists have far more success building positives than burying negatives. Once a contender has failed on the campaign trail, they are usually done for good—fresh faces become stale.

Hillary, with nearly 25 years in the national limelight and one failed campaign behind her, is a war horse. Then, too, since term limits began, only Harry Truman and George H.W. Bush have extended their party's White House tenure beyond two straight terms. Otherwise, voters have flipped parties every time they have selected a new President. History is not on Clinton's side. Winning is possible, but the odds heavily favour the Republicans. Unless they nominate a weak candidate who stumbles badly, a Hillary Clinton win is likely a long shot.

While many factors require consideration, a Clinton nomination increases the chances sentiment swings to euphoria in 2016, as markets price in the high likelihood of a Republican sweep. This would elevate expectations for 2017—and set up potentially dismal returns when the new president inevitably disappoints, moderates and proves to be just a politician, not the market-friendly leader they hoped for. Republicans could also retain their Congressional majority, as we detailed last quarter, since gubernatorial races likely counteract the Democrats' small structural Senate advantage. Republicans must defend more seats in opposition territory, but most of these seats have been in GOP hands for several cycles, and unseating them would require big money and flawless campaigning. Should Republicans keep Congress, a Republican presidential win ends gridlock—a negative for equities. Politics are only one driver and must be weighed against economic and sentiment drivers, so a 2017 GOP sweep is not an automatic bear market trigger, but it could shift a positive political environment to a negative.

As for the Rest

Most factors the financial media deem risks are too small, wrongly perceived and/or too widely known to wallop equities.

For instance, pundits falsely warn oil's decline could spill into equity markets. As previously discussed, one cannot use one liquid market to forecast another, as they digest known information near-simultaneously. Equities know oil is down and Energy earnings have fallen. They also know what caused oil's drop and that most non-Energy firms benefit.

The Islamic State of Iraq and Syria (ISIS), too, is widely discussed and too localised. Renewed Middle East conflict and related terrorist activity in Africa, though terrible on a human level, have not hurt markets and likely will not as long as they remain geographically isolated. Since 1947, Middle Eastern conflict has proven near constant and largely immaterial to markets.

The debt ceiling, too, is powerless. The US hit it in March, and the Treasury warned of default if it is not raised before "extraordinary measures" to fund government run out, but this is false. With monthly tax revenues exceeding interest payments—and the 14th Amendment requiring the Treasury to pay bondholders first—the US can service debt without new borrowing. Moreover, the debt ceiling has been raised over 100 times before, and standoffs in 2011, 2012 and 2013 (the last also included a government shutdown) did not sink equities.

Finally, Greece, which spent most of Q1 battling over bailout loans and austerity requirements. The situation is increasingly chaotic, with the erratic new government floundering and continually flip-flopping on key issues as creditors and markets grow impatient. While all involved are motivated to compromise and kick the can—and have repeatedly done so—whatever the outcome, there is no evidence Greece threatens global markets. Unlike 2011 or 2012, peripheral bond yields are detached from Greece's—markets do not fear contagion. Irish, Italian and Spanish 10-year rates fell below US and UK yields as 2015's Greek saga unfolded (Exhibit 19).

Exhibit 19: Eurozone Periphery 10-Year Sovereign Bond Yields

Source: Factset, as of 23/4/2015. 10-Year sovereign yields for Greece, Italy, Ireland, Spain and Portugal, 31/12/2009 – 22/4/2015.

Similarly, Greek bond default insurance (known as Credit Default Swaps, or CDS) costs are skyrocketing, yet other eurozone nations' have barely budged. Greek equities are sinking, yet the eurozone is one of the developed world's best performers this year. Absent contagion, Greece is far too small to wallop. With annual GDP near $190 billion, Greece is smaller than many major cities. A wallop takes trillions, and Greece lacks scale. Markets are rationally calm.

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