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SECOND QUARTER 2015

MARKET PERSPECTIVES

SECOND QUARTER 2015 REVIEW AND OUTLOOK

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SECOND QUARTER 2015 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Global equities rallied through most of Q2 until a Greece-induced selloff in late June left the MSCI ACWI up slightly for the quarter and 2.7% year to date (USD).[i] Days before quarter-end, global equities were up nearly 4% for the quarter and 6% for the year (USD)—well on their way to the double-digit full-year returns we expect.[ii] A bit of volatility does not change our forecast—back-end loaded years are common, and 2015 still has the makings of a great year.

Upside volatility can move markets just as swiftly as late-June's downturn. Since 1988 the MSCI ACWI's median quarterly return is 2.95%—a magnitude not seen since Q2 2014.[iii] Volatility is normal and can change full-year returns quickly—either higher or lower. However, in bull markets, upside volatility surpasses downside over time. With fundamentals strong, sentiment tame and no surprising big negatives in sight, this bull market should keep running, bringing many positive returns.

Portfolio Themes

- **Underweight to Commodity-Oriented Companies:** Companies that have significant commodity exposure (metals, oil and agricultural) should underperform over the next 12-18 months.
- **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 higher costs to consumers, giving them stable longer-term growth prospects.

Market Outlook

- **Earnings Growth:** Corporate earnings and revenues continue to grow alongside the global economy.
- **Sentiment Rising:** Sentiment continues to rise but remains sceptical, extending the bull market's proverbial "wall of worry."
- **Recent Volatility:** Volatility in June's final days weighed on first-half returns, lowering expectations for the remainder of 2015. However, our forecast for double-digit gains remains unchanged. Equities can move quickly, and it will not take much upside volatility for equities to have a great year.

Many 2015 trends are developing as we expected. Our Energy underweight continued helping portfolios. UK markets surged after May's election, finishing among Q2's best. The 86.4% Miracle—the high frequency of positive US returns following midterm elections described in past Review & Outlooks—stayed on track, with US equities up again in Q2. With three positive post-midterm quarters complete, it now becomes The 87.0% Miracle. The strong dollar did not negatively impact US Q1 earnings, which trounced negative expectations to rise 0.8% y/y (8.5% y/y excluding Energy).[iv] 10-year US Treasury yields fluctuated but finished flattish on the year at 2.35%.[v] The eurozone's economic recovery accelerated and broadened, and rising Leading Economic Indexes (LEI) suggest growth continues. US and UK LEIs are also high and rising—global growth is healthy.

Yet sentiment remains sceptical. As we have written, bull markets usually climb a "wall of worry" as depicted by Sir John Templeton: "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." Six-plus years into this bull, optimism is sprouting, but scepticism remains. For example, few fear weak economic data—deep pessimism is gone—but many see bad news as good, believing it will delay a US interest rate hike. Though the US economy has been in expansion since 2012 (when real GDP surpassed its pre-recession peak), many still call it a "recovery." Virtually no one calls it a "boom." Few see equities' strong fundamental support, instead mistakenly believing the US Federal Reserve (Fed) alone is powering markets. This scepticism extends the wall of worry and should help prolong this bull market.

As always, we watch for surprising negatives that could derail the bull. But in a $77 trillion-and-growing (USD) world economy, it would take a few trillion US dollars' worth of negatives to render recession and trigger a bear. No risks we can identify today come close. Instead, we have the opposite: Small, feckless, misperceived fears dominate headlines, like Greece and a Fed rate hike. When big false fears exist, the most bullish outcome is for them to happen fast—proving them immaterial. Dispelling false fears converts sceptics to optimists, pushing equities further up the wall.

Greece and a US rate hike are immaterial. With annual GDP near $200 billion USD, Greece is about as big as a major US city. If Greece vanished overnight, global GDP would lose only 0.3%.[vi] Greek problems are also contained. Bond yields and default insurance costs show almost no contagion risk. As for US rate hikes, no initial rate hike has ever ended a bull.

Growth among Emerging Markets remained mixed, as commodity-dependent countries struggled in Q2. For example, Russia and its energy price-dependent economy continued to face headwinds from low oil prices. Q1 GDP was revised down to -2.2% y/y, lower than an initial estimate of -1.9% y/y. With rising food prices due to economic sanctions from the West and high inflation weighing on domestic demand, the Russian economy is likely to remain weak for the foreseeable future—though such struggles do not come as a surprise. Meanwhile, Thailand's central bank announced that while business investment dropped -0.5% m/m, private consumption rose 1.3% m/m—a sign of domestic demand driving growth. Similarly in Mexico, though May manufactured exports fell -6.6% m/m, non-oil consumer imports rose 7.4% m/m—the fastest since May 2010 and an indication of healthy domestic demand.

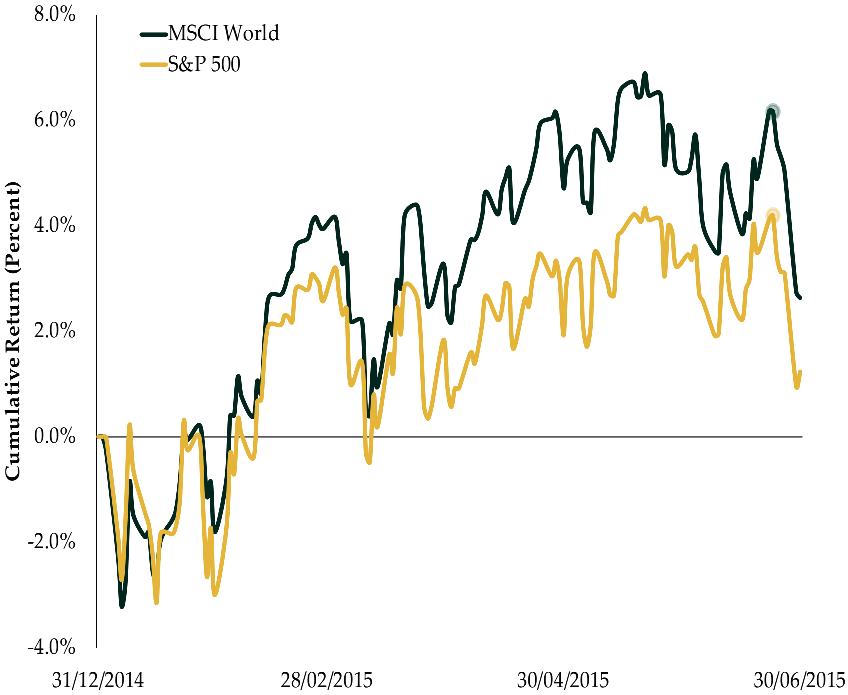
Chinese A-shares' volatility continued in June, claiming many headlines. Though A-shares fell sharply over June's last two weeks, the market is mostly limited to domestic investors, and we do not believe it indicates future returns for those Chinese markets accessible to foreign investors. The A-share market has historically proven volatile and insulated—rendering it an unreliable forward-looking indicator. H-shares—domestic shares listed in Hong Kong accessible to foreigners—have been much tamer than their A-share counterparts, and index provider MSCI cited A-shares' limited liquidity for foreigners as a key reason it denied adding them to its MSCI Emerging Markets Index on 9 June.

THEMATIC UPDATE AND MARKET OUTLOOK

A Q2 Recap

Q2's final trading sessions muted an overall solid quarter for global equities. A week before quarter end, the MSCI All Country World Index (ACWI) was up 6.0% for the year.[vii] US equities were up 4.2%.[viii] Another round of Greek brinksmanship wrought volatility—reducing ACWI returns to 2.7% and US returns to 1.2%—but such moves can reverse quickly (Exhibit 1).[ix]

Exhibit 1: Cumulative Returns Through 30 June



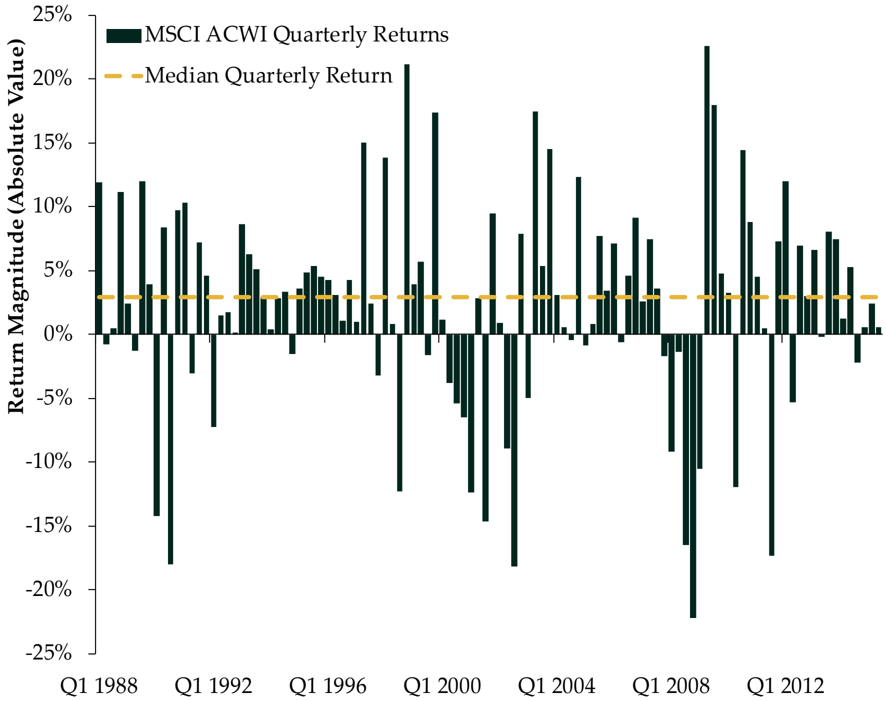
FactSet, as of 08/07/2015. MSCI ACWI with net dividends, 31/12/2014 – 30/06/2015. 23 June is circled.

In our view, fundamental support for double-digit global returns in 2015 abounds: sceptical sentiment persists, economic fundamentals point to growth and most major developed nations have gridlocked governments. We believe the backdrop for equities is bullish.

Volatile Volatility

Before its final days, Q2 was another relatively calm period for equities. The MSCI ACWI finished the quarter up less than 1%, far lower than the index's median quarterly return of 2.95% (Exhibit 2).

Exhibit 2: MSCI ACWI Quarterly Returns



FactSet, as of 08/07/2015. MSCI ACWI quarterly returns with net dividends, 31/12/1987 – 30/06/2015.

The MSCI ACWI last topped the median return in Q2 2014, rising 5.2%. In bull markets, upside volatility is more common than downside. Since 1969, 64 of 87 bull market quarters exceeded the median return.[x] Bull market years are also frequently back-end loaded, with roughly 40% of years since 1970 posting double-digit gains.[xi]

Markets Do Not Need Rescuing

Six-plus years into the bull market, scepticism's persistence is surprising. Even now, with many indexes globally well beyond 2007 peaks and US GDP into record territory, the financial press often presumes the US "recovery" still needs support via low interest rates or stimulus. The "recovery" technically ended in 2011, when US GDP passed its pre-recession peak.[xii] The US is in expansion.

Fear of a crash when central banks and governments—the "rescuers"— pull support is a central theme of this bull. First, it was the end of 2009's $787 billion US fiscal stimulus programme. Then it was QE's end, 2012's fiscal cliff, sequestration, another bout of QE-cessation fears and more recently rate hikes. Many worry a recession now would find the "rescuers" out of ammunition, given rising debt, a huge US Federal Reserve (Fed) balance sheet and near-zero overnight rates.

These beliefs overlook the fact that this bull market is not unusual—it is climbing the wall of worry like all before it. It is rare for such fears to exist so long into a bull market, but society's obsession with central bankers might explain it. Pundits analyse every data point for its implications for Fed moves. Bad news on jobs reports is good news because it means the Fed will not hike rates yet. Contrarily, good news such as surging consumer spending is considered bad news because the Fed will be more likely to hike rates.

Rate Hikes: Nothing to fear when it does happen

Throughout this bull market, we have heard near constant fretting about the end of fiscal or monetary government "support." Today investors fear hiking rates after nearly seven years of near-zero rates will kill the bull. As we have documented in the past, equities are usually positive after the Fed hikes.

Six-plus years have passed since the bull began—the longest ever without a rate hike. People focus on this, assuming near-zero interest rates fueled equities, but this is like driving forward while looking backward. Few mention the length of time between the first hike and a bull's end (Exhibit 3). The six bull markets since 1970 have all lasted over a year after the Fed's first move. The average length after an initial hike is 3.3 years, with returns through the peak ranging from 21% to 225%. Initial rate hikes do not end bull markets.

Exhibit 3: Bulls Keep Running After Initial Rate Hikes

Bull Market Beginning	First Rate Hike	Bull Market End	Years From 1st Hike to Market Peak	Return From 1st Hike Through Peak
26/05/1970	16/07/1971	11/01/1973	1.5	21.3%
03/10/1974	16/08/1977	28/11/1980	3.3	43.8%
12/08/1982	27/03/1984	25/08/1987	3.4	114.1%
04/12/1987	29/03/1988	16/07/1990	2.3	41.9%
11/10/1990	04/02/1994	24/03/2000	6.1	225.1%
09/10/2002	30/06/2004	09/10/2007	3.3	37.2%
Average	**--**	**--**	**3.3**	**80.6%**

Source: Federal Reserve and FactSet, as of 27/07/2015. S&P 500 price returns, 26/05/1970 – 09/10/2007.

In fact, the Fed usually hikes several times before bull markets end. In 2004 – 2006, they hiked at 17 straight meetings—the bull ran until 2007 (and its end was unrelated to rates). Alan Greenspan hiked seven times in 1994/1995.

Historically, the first few hikes are not problematic. Trouble comes when the Fed overshoots, inverting or flattening the yield curve and stifling lending. With a 223-basis point gap between overnight and 10-year interest rates, today's yield curve can withstand a hike. Also, rate hikes are not irreversible. An initial hike (or even several hikes) does not mean tightening must continue. Both the 1982 – 1987 bull and the 1990s bull saw a series of rate hikes turn to cuts—and cuts back to hikes—all while equities rose. Assuming one hike means steadily rising rates is wrong.

The sooner the Fed hikes, the sooner markets climb over the fear and up the wall of worry. Markets have priced in the fear—it has been widely discussed for nearly two years and markets have efficiently discounted central bank moves during this bull market. Most thought QE tapering would raise long-term rates, instead they fell. Rates rose in 2013, before tapering began in January 2014. Most thought eurozone QE would drag down interest rates, but eurozone bond yields fell before QE began in March, then rose after it started.

Fear is priced in, setting markets up for a big rally once the Fed hikes rates and investors see it is feckless. Investors should welcome the rate hike, not fear it.

The Globe Is Growing

Many overlook the global economy's health. The US Bureau of Economic Analysis revised US Q1 GDP up from a -0.2% contraction to 0.6% growth to address shortcomings in its seasonal adjustment calculations.[xiii] Though the revised figure still represented a slowdown, West Coast ports' work stoppage and cutbacks at oil producers were the primary drivers. With dockworkers back on the job in Q2, growth reaccelerated to 2.3%.[xiv] The UK economy continues growing nicely, with growth also accelerating in Q2, and the eurozone's resurgence continues, with all four major economies—Germany, France, Spain and Italy—contributing. Q1 S&P 500 earnings grew, defying strong dollar fears and surprising analysts. The Conference Board's Leading Economic Indexes (LEI) for the US, UK, Spain, France, Germany and the eurozone continue lengthy uptrends.

Weak spots persist, particularly in commodity-heavy economies (Russia, Brazil, Canada, Australia), but this is unsurprising—and offset by nations benefiting from lower commodity and energy costs. Many nations' longer-term interest rates rose in Q2, steepening yield curves. US lending and money supply are growing at a healthy rate. Eurozone lending has resumed growing. Data can be chaotic month-to-month and even quarter-to-quarter, but global growth seems poised to continue.

Politics Point Positively

Politics remain a tailwind for equities for the remainder of 2015 at least. 2015 is the third year of President Obama's second term and, since 1926, 91% of third years and 82% of fourth years have been positive—far exceeding years one and two (Exhibit 4).[xv]

Exhibit 4: Frequency of Positivity and Average Return by Presidential Term Year

Year of Term	1	2	3	4
Frequency of Positive Returns	54.5%	65.2%	90.9%	81.8%
Average Return	9.2%	9.1%	18.5%	11.1%

Source: Global Financial Data, Inc., as of 07/01/2015. S&P 500 Total Return Index, 1926 – 2014. See US Commentary for a more detailed version of this table.

As discussed later in this Review & Outlook, this reflects presidential power's front-end loaded nature. Presidents' political capital is usually highest right after winning election. Therefore, they generally try passing contentious legislation during the first two years. By year three, most Presidents focus on the next election or their legacy via diplomacy and foreign policy. Divisive legislation tends to hamper campaigns, which mostly target America's political middle. With over 20 candidates in the fray, political focus is shifting.

Outside the US, developed economies remain gridlocked. The Conservatives won a razor-thin majority in the UK's May elections, probably too slim of a margin to pass extreme laws. Most eurozone Parliaments have tightened too - core nations like Germany and France remain too divided to pass much legislation. Political fracturing in Spain and Portugal, which hold elections later this year, should prevent the next governments from unwinding recent reforms, another benefit.

Considering the Next Bear Market

While we are bullish and believe the next bear market will not begin soon, we know it will eventually arrive, and preparation is important. We always watch for signs of a bear forming, and we aim to identify it in time to avoid as much of the downside as possible.

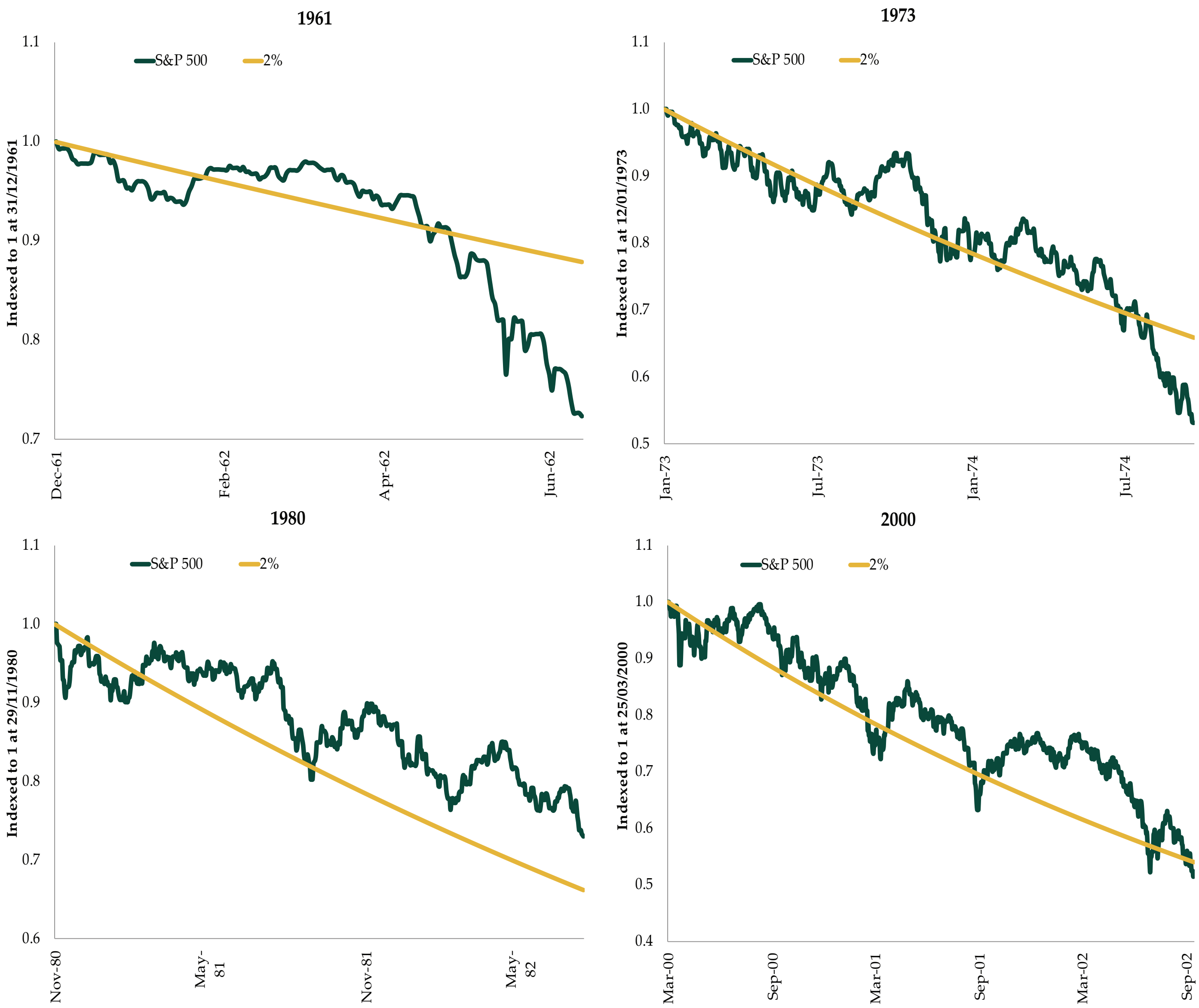
Spotting a Bear Market

Bear markets begin one of two ways: the wall or the wallop. The first occurs when equities have topped the bull market's proverbial "wall of worry"—investors run out of fears, become too euphoric and develop outlandish expectations reality cannot beat. Euphoria blinds them to creeping negatives like the inverted yield curve and a falling US LEI in 2000, a global liquidity squeeze in 1987 and unprofitable Energy firms' unsustainable run in 1980. Euphoria is difficult to quantify, but signs include an avalanche of articles irrationally whitewashing bad news, extreme bullishness in investor confidence surveys, wildly speculative IPOs, widespread ridicule of bearish pundits, endless advice that you should never turn bearish and a rush to shun diversification and pile into hot categories.

Wallops occur when an unseen, shocking negative capable of knocking trillions from global GDP emerges before investors reach euphoria. This might include unnoticed protectionism increasing a trade war's likelihood; monetary policy errors potentially causing severe money supply contraction; big legislative changes that could discourage risk-taking; or regulatory changes that could squeeze financial institutions, triggering asset sales and freezing credit. The 2007 – 2009 bear market exemplifies a regulatory wallop—implementation of FAS 157 (the mark-to-market accounting rule) walloped equities while markets were only partway up the wall of worry, as equities were forced to begin pricing in the ultimate destruction of around $2 trillion in bank capital. The government's haphazard crisis response—nationalising Fannie Mae and Freddie Mac, arranging mergers of smaller failing banks and mortgage lenders, then forcing Lehman Brothers to fail even though its problems were identical to Bear Stearns' (which the Fed married off to JPMorgan Chase in March)—created sheer panic. Other wallops include the Fed's doubling of reserve requirements in 1937 (aborting the recovery from the 1929 – 1933 contraction) and WWII's onset in 1938, which truncated a nascent recovery.

Bear markets usually begin with a whimper, not a bang. They typically roll over slowly, lulling investors into complacency. At euphoric peaks, those noticing declines tend to deem them "buying opportunities"—expecting a quick rebound. Early declines are usually quite small, averaging perhaps 2% monthly over the first three months or so (Exhibit 5). This "rolling top" is another sign we watch for.

Exhibit 5: The 2% Rule



Source: Global Financial Data, Inc., as of 23/07/2015. S&P 500 Price Index, 12/12/1961 – 09/10/2002.

What Might the Next Bear Look Like?

It is impossible to know today when the next bear will start, how big it will be or how long it will last. However, it might not be as bad as most fear. Our goal is to reduce downside for our investors. We have noticed fear of another 2008, making some investors question whether they should reduce equity exposure now—a dangerous tactic.

After 2000 and 2008, many believe huge bear markets are the norm. The Tech Bubble's aftermath lasted over two years, with US equities falling nearly 50%. The 2007-2009 bear was shorter, just 17 months, but much deeper with a -57% S&P 500 decline. Recency bias makes investors think extreme bears are typical, but many were far shorter and shallower. Approximately one third lasted less than a year. Five of thirteen fell less than -30% (Exhibit 6).

Exhibit 6: S&P 500 Bear Markets

Start	End	Months	S&P 500 Change
07/09/29	01/06/32	33	-86%
06/03/37	28/04/42	62	-60%
29/05/46	13/06/49	36	-30%
02/08/56	22/10/57	15	-22%
12/12/61	26/06/62	6	-28%
09/02/66	07/10/66	8	-22%
29/11/68	26/05/70	18	-36%
11/01/73	03/10/74	21	-48%
28/11/80	12/08/82	20	-27%
25/08/87	04/12/87	3	-34%
16/07/90	11/10/90	3	-20%
24/03/00	09/10/02	30	-49%
09/10/07	09/03/09	17	-57%
Average		21	-40%
Median		18	-34%

Source: FactSet, Global Financial Data, Inc., as of 19/03/2015. S&P 500 Price Index, 07/09/1929 – 09/03/2009. Price returns used instead of total returns due to the longer available dataset.

Monster bear markets have limited history, but the ensuing bull tends to be longer than average. Since WWII, three bear markets have breached the average decline: 1973 – 1974; 2000 – 2002; and 2007 – 2009. The bull market following the early-1970s bear lasted 74 months—well above the average of 57. The 2002 – 2007 bull lasted 60 months before it was walloped prematurely. This current bull is at 76 months and appears to have plenty of room left to run.

We cannot be certain, but it is possible long bulls tend to follow devastating bears because emotionally scarred investors take longer to climb the wall of worry. Monster bears seem to create a broad societal effect. They purge CEOs and investment managers who were too bold before the downturn and suffered extreme losses. Their replacements are usually bland and risk-averse.

Today, with few exceptions, colorful "hero CEOs" are gone. Steve Jobs qualified before he passed on, as do the likes of Elon Musk and Richard Branson. For the most part, we have "batten down the hatches" CEOs who did well in 2008 or were hired to replace the bold ones. Their goal is to avoid 2008-style disaster, so they are reducing risk. Society shares this risk-averse mentality. Whether CEOs lead society or vice-versa, there is an agency effect at work between corporate leadership and societal trends, causing risk aversion to rub off on one another.

Should this batten-down-the-hatches mentality persist, it could extend the bull market and mitigate the next bear when it arrives. There is no way to know today, as evidence is too limited.

US Commentary

Seasonal factors and a strong business backdrop propelled the US economy past its winter soft patch in Q2 and most evidence suggests growth should continue. The political gridlock in the US should continue to provide additional tailwinds for returns.

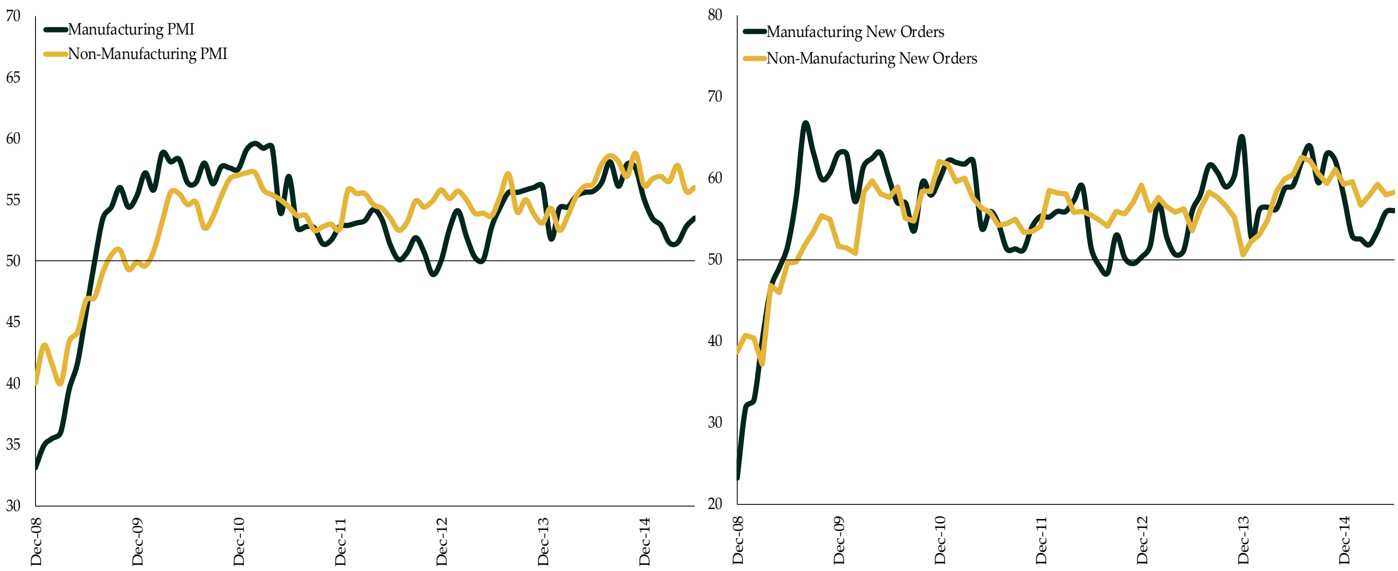
US Economy Steadily Moving Higher

US Q1 GDP growth, previously reported at -0.2%, was revised up to 0.6% on 30 July, after the Bureau of Economic Analysis (BEA) changed its seasonal adjustment computations. Though slower than previous quarters, there are some mitigating factors.[xvi] Most notably, US West Coast ports' winter work stoppage heavily impacted trade. When work resumed in earnest in March, imports spiked. Since GDP calculations subtract imports (even though they actually signal healthy demand), imports' 7.1% rise heavily detracted.[xvii] Growth resurged in Q2, speeding to 2.3% as consumer spending accelerated and exports resumed growing—more evidence strong dollar fears are misplaced.[xviii] GDP has little to no implications for forward-looking equities as it is released at a significant lag, but it does reaffirm economic trends, and in this case, it confirms the US expansion is alive and well.

How trends match with expectations is crucial for equities, and economically, the US is on better footing than many believe. Consumer spending rose in four of the past five months, capped by May's 0.9% m/m (3.6% y/y) gain.[xix] Investors often fixate on retail sales and ignore consumer spending. This is backwards, as consumer spending includes retail sales and services spending. Consumer spending is the broader, less volatile, more telling statistic of the two, and it has broadly trended higher since 2014.

Throughout Q2, the Institute for Supply Management's (ISM) manufacturing and non-manufacturing (predominantly services) Purchasing Managers' Indexes (PMIs) remained above 50—indicating more firms grew than contracted—as they have for most of this expansion. Both surveys' New Orders Indexes—today's demand, tomorrow's production—show growth (Exhibit 7).

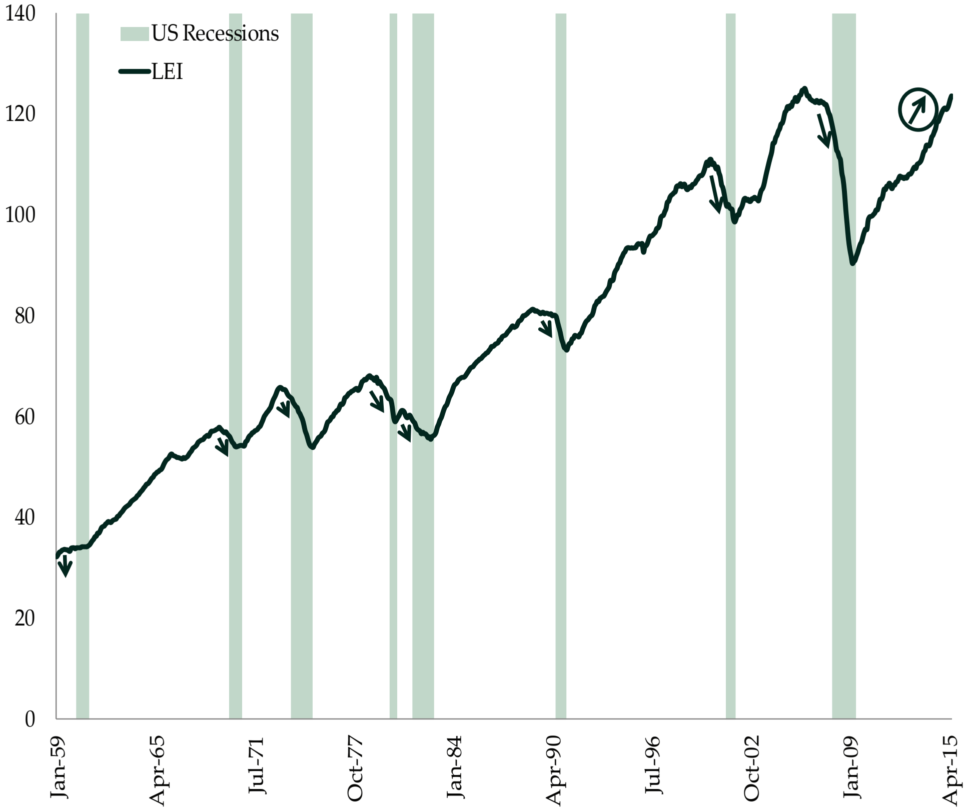
Exhibit 7: ISM Manufacturing and Non-Manufacturing PMIs and New Orders



Source: FactSet, as of 24/07/2015. ISM Manufacturing and Non-Manufacturing PMI and New orders, December 2008 – June 2015.

Looking ahead, growth likely continues. The Conference Board's US LEI has risen in 16 of 17 months (up 0.6% m/m in June) (Exhibit 8). In US LEI's 55-year history, no US recession has started while the index was high and rising.

Exhibit 8: US LEI



Source: FactSet, as of 27/07/2015. The Conference Board's US Leading Economic Index, January 1959 – June 2015.

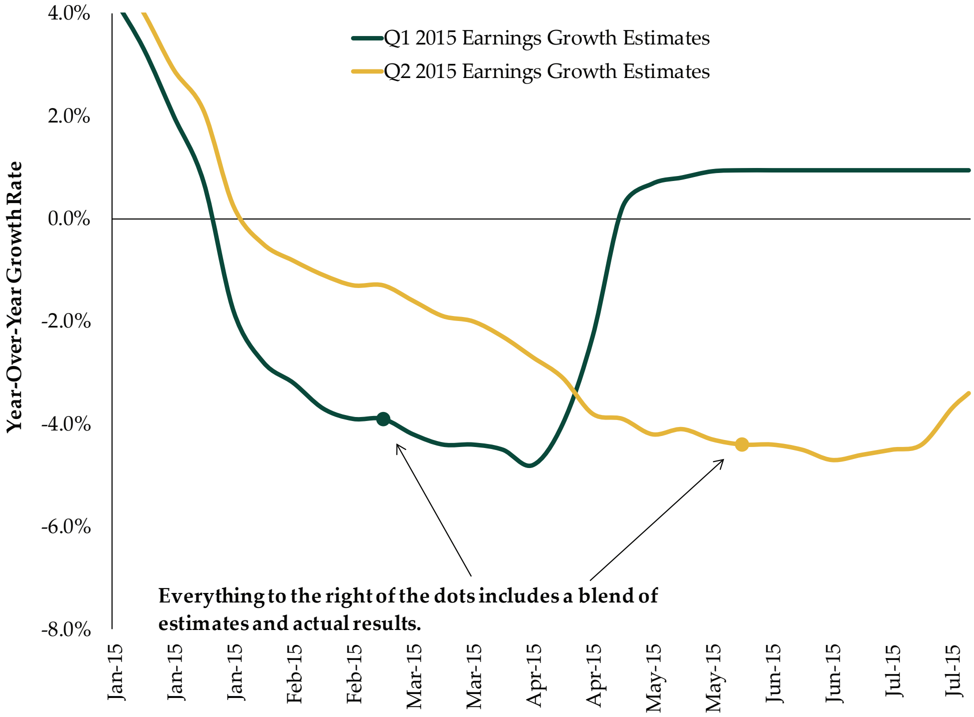
US Earnings Stronger Than the Dollar

Entering Q1's earnings season, analysts expected aggregate S&P 500 earnings to fall -4.6% y/y, as the strong dollar hit export revenues. Yet earnings grew 0.9% y/y. Excluding the Energy sector's -56.6% earnings decline—a category to which we have limited exposure— profits rose 8.7% y/y.[xx]

Revenues largely met pre-season expectations for around -2.9% y/y (+2.4% excluding Energy)—evidence analysts underestimated earnings because they underestimated the dollar's impact in reducing costs. Most know a strong dollar reduces overseas revenues through currency conversions or lower sales. However, it also lowers overseas costs, and the impact is often zero-sum or close to it.

Fortunately, few have caught on. Although the dollar was not a huge headwind in Q1—forcing analysts to boost estimates as data rolled in—most still expect pain as Q2 results arrive. As of 2 July, analysts expected a -4.5% y/y Q2 earnings dip, nearly matching their Q1 preseason projection (Exhibit 9).[xxi] Strong-dollar false fears remain, potentially setting up a more positive surprise.

Exhibit 9: The Dollar, Earnings and Earnings Expectations



FactSet, as of 22/07/2015. Estimated growth in S&P 500 earnings for Q1 and Q2 2015.

US Politics

For the next 12 – 18 months, politics should support equities. 2015 is the third year of US President Obama's second term—historically the most frequently positive (90.9%), building off the 87% Miracle we discussed in the Executive Summary of this Review & Outlook. Exhibit 10 shows US equities' returns by presidential term year since 1926. Note the significant reduction in negatives in third and fourth years. By year three, Congress has likely already acted on the President's legislative priorities (to the extent they will), and politicians are eyeing the next election.

Major, contentious legislation takes significant political capital, and presidents are usually strongest early. 2010's Dodd-Frank and Affordable Care Acts, 2001's Patriot Act, the 1981 tax reforms, and the avalanche of New Deal legislation in 1933 and 1934 all occurred in the President's first and second years. Once election season begins, campaigning politicians typically avoid radical change.

Exhibit 10: The Presidential Term Anomaly

Party	President	First Year		Second Year		Third Year		Fourth Year	
R	Coolidge	1925	**N/A**	1926	**11.1%**	1927	**37.1%**	1928	**43.3%**
R	Hoover	1929	**-8.9%**	1930	**-25.3%**	1931	**-43.9%**	1932	**-8.9%**
D	FDR -- 1st	1933	**52.9%**	1934	**-2.3%**	1935	**47.2%**	1936	**32.8%**
D	FDR -- 2nd	1937	**-35.3%**	1938	**33.2%**	1939	**-0.9%**	1940	**-10.1%**
D	FDR -- 3rd	1941	**-11.8%**	1942	**21.1%**	1943	**25.8%**	1944	**19.7%**
D	FDR / Truman	1945	**36.5%**	1946	**-8.2%**	1947	**5.2%**	1948	**5.1%**
D	Truman	1949	**18.1%**	1950	**30.6%**	1951	**24.6%**	1952	**18.5%**
R	Ike -- 1st	1953	**-1.1%**	1954	**52.4%**	1955	**31.4%**	1956	**6.6%**
R	Ike -- 2nd	1957	**-10.9%**	1958	**43.3%**	1959	**11.9%**	1960	**0.5%**
D	Kennedy / Johnson	1961	**26.8%**	1962	**-8.8%**	1963	**22.7%**	1964	**16.4%**
D	Johnson	1965	**12.4%**	1966	**-10.1%**	1967	**23.9%**	1968	**11.0%**
R	Nixon	1969	**-8.5%**	1970	**4.0%**	1971	**14.3%**	1972	**18.9%**
R	Nixon / Ford	1973	**-14.8%**	1974	**-26.5%**	1975	**37.3%**	1976	**23.7%**
D	Carter	1977	**-7.4%**	1978	**6.4%**	1979	**18.4%**	1980	**32.3%**
R	Reagan -- 1st	1981	**-5.1%**	1982	**21.5%**	1983	**22.5%**	1984	**6.2%**
R	Reagan -- 2nd	1985	**31.6%**	1986	**18.6%**	1987	**5.2%**	1988	**16.6%**
R	Bush	1989	**31.7%**	1990	**-3.1%**	1991	**30.5%**	1992	**7.6%**
D	Clinton -- 1st	1993	**10.1%**	1994	**1.3%**	1995	**37.6%**	1996	**23.0%**
D	Clinton -- 2nd	1997	**33.4%**	1998	**28.6%**	1999	**21.0%**	2000	**-9.1%**
R	Bush, G.W. -- 1st	2001	**-11.9%**	2002	**-22.1%**	2003	**28.7%**	2004	**10.9%**
R	Bush, G.W. -- 2nd	2005	**4.9%**	2006	**15.8%**	2007	**5.5%**	2008	**-37.0%**
D	Obama -- 1st	2009	**26.5%**	2010	**15.1%**	2011	**2.1%**	2012	**16.0%**
D	Obama -- 2nd	2013	**32.4%**	2014	**13.7%**	2015	?	2016	?
Republicans Average		**0.7%**		**8.2%**		**16.4%**		**8.0%**	
Democrats Average		**16.2%**		**10.0%**		**20.7%**		**14.1%**	
All (Average)		**9.2%**		**9.1%**		**18.5%**		**11.1%**	

Source: Global Financial Data, Inc. and FactSet, as of 07/01/2015. S&P 500 Total Returns, 1926 – 2014.

The US presidential election season is ramping up, with more and more candidates entering the fray. Many will be tempted to assess candidates' strengths and weaknesses, digest their plans and handicap their chances, but such analysis is premature where portfolios are concerned. Now is a time to assess broad trends more than specifics, which will change massively before 2016's vote.

2016 and the Perverse Inverse

In our Q4 2014 Review & Outlook, we detailed the principal risk we see in 2016's elections currently: A Republican sweep eliminating gridlock, setting up what we call, "The Perverse Inverse"—markets' tendency to rally in election years when Republicans seize the presidency from Democrats, but falter the next (Exhibit 11).

Exhibit 11: 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 07/01/2015. S&P 500 Total Return, 1926 – 2014.

In our experience, the investing public leans Republican. Campaigning Republicans typically tout market-friendly promises, lifting election-year investor sentiment and returns when they win. However, after inauguration, reality disappoints when the new president proves to be a politician, eyes re-election and moderates. By contrast, Democrats often stir fears of redistribution and anti-market change while campaigning, dampening election-year returns. Though, after inauguration they, too, prove to be politicians and moderate—a positive for equities post-inauguration. Should a Republican take the White House, the Perverse Inverse implies a big 2016, but weak 2017. If a Democrat wins, it favours below-average returns in 2016, but big returns in 2017. This is only one factor of many, but still a noteworthy historical tendency.

Below-average returns are not necessarily negative or a bear market. Nonetheless, if the Republicans hold the House and Senate, a Republican presidential victory would end the bullish gridlock equities have enjoyed since 2011.

An Early Look at the Senate Races

Most pundits say 2016's Senate races structurally favour the Democrats—true, but barely. With the Republicans holding a 54-46 Senate majority (the two independents caucus with Democrats), Democrats must win a net five Republican seats. Republicans must defend seven seats in states that voted Democratic in recent Presidential elections, while the Democrats are not defending any in Republican territory—hence their structural edge. However, the seven seats include Chuck Grassley (IA) and Rob Portman (OH)—difficult to unseat. Meanwhile, Democrats must defend Harry Reid's open Nevada seat, which will likely be heavily contested. While further retirements, appointments and other factors could change the backdrop, Democrats face a difficult road to a majority.

With Republicans holding the House by a wide margin, incumbency favours a continued edge there. Further raising the likelihood a new Republican President would have a Republican Congress in 2017, eliminating gridlock.

As we have written, gridlock prevents major, contentious new laws from shocking markets. It requires compromise on big bills, likely defanging potentially problematic tweaks to property rights. While some might relish a government with less squabbling, developed economies do not need active governments. Sweeping legislation often has unintended consequences bringing more harm than benefits. 2002's Sarbanes-Oxley Act is a relatively recent, powerful example. The possibility of extreme legislation in 2017, while most investors remain cheery over a Republican victory, is a noteworthy risk to the bull.

Hillary Remains the Democrats' Front-Runner

As detailed last quarter, Hillary Clinton does not fit the mold of a typical Democrat nominee. Ordinarily, Democrats favour underdogs that surge from the back of the pack; little-known fresh faces providing blank canvases party leadership can paint any which way to generate enthusiasm.

Currently, few signs suggest an underdog is emerging, but that is not unusual. In a 26 June 2007 CBS News poll of likely Democratic voters, Clinton led Barack Obama 48% to 24%.[xxii] Real Clear Politics had a smaller margin (37.0% vs. 22.8%) with Clinton in the lead. Virtually no polls showed Obama leading until early 2008.

However, it is not clear the current candidate pool contains the charismatic, fresh-faced underdog Democrats typically rally around. Bernie Sanders is a 73-year-old career politician on Capitol Hill since 1991. His rise in polls draws comparisons with Eugene McCarthy's surge in 1968, which spoiled Lyndon Johnson's chances, but McCarthy did not get the nod. Rhode Island Governor Lincoln Chafee has long been on the political scene, having served in the Senate (as a Republican) from 1999 – 2007. Former Baltimore Mayor and Maryland Governor Martin O'Malley, less of a national figure, is arguably the most typical Democratic candidate in the race thus far. The longer it takes for a blank-slate candidate to emerge, the more likely Hillary gets the nod. As we wrote last quarter, history does not favour her winning a general election.

The Republican Fracas

It is impossible to discern who comes out of that (currently) 16-person GOP fracas. It will likely take the early primaries to narrow the still-growing field.

Ultimately, good campaigners win campaigns. Of the 16 in the race officially now (including just-announced John Kasich), only Rick Perry, Rick Santorum and Mike Huckabee have run this track before. Of the rest, it is impossible to identify the good campaigners today. People get too carried away over money, name recognition, resumes and who they like. Most of these candidates are untested on the big stage.

Polling's Limitations

Early polls, based mostly on name recognition, are rarely accurate. At this point in 2007, former New York Mayor Rudy Giuliani and former Tennessee Senator and Law & Order star Fred Thompson led the eventual candidate, Arizona Senator John McCain.[xxiii]

Even polls close to elections have not been telling lately. As Cliff Zukin (Rutgers Professor and past president of the American Association for Public Opinion Research) wrote in a recent New York Times op-ed, "Election polling is in near crisis, and we pollsters know. Two trends are driving the increasing unreliability of election and other polling in the United States: the growth of cellphones and the decline in people willing to answer surveys." Some estimates suggest nearly 40% of American households do not have a landline now, so fewer phones can be auto-dialed, due to 1991's Telephone Consumer Protection Act. Response rates have cratered, making sampling even less representative. Finally, as renowned pollster Nate Silver wrote at Five Thirty Eight, "pollster herding" is an additional issue.[xiv] Polling firms will occasionally discard results that seem like outliers.

Non-US Developed Commentary

Throughout Europe, earnings growth has been largely unnoticed, and economic growth is broadening. In the UK, the Conservatives won a thin majority in recent elections, but elsewhere in Europe, governments remain heavily divided.

Eurozone's Continued Growth

After Q1's 0.4% q/q (1.5% annualised) growth, the eurozone has grown eight straight quarters - and big economies like Spain (0.9% q/q) and France (0.6% q/q) were not alone. Out of the 17 reporting countries as of 27 July 2015, only four (Estonia, Finland, Greece and Lithuania) contracted—growth is increasingly widespread.[xv]

June's eurozone PMIs also illustrate growth's breadth. The bloc's composite PMI (services plus manufacturing) stayed in expansion all quarter, as did German, French, Spanish and Italian composite PMIs. Eurozone LEI rose an eighth straight month in June (0.4% m/m), suggesting growth should continue.[xxvi]

Eurozone Earnings' Overlooked Strength

Firms' earnings and revenues in non-US developed countries have exceeded expectations, too. With 239 of 240 companies reporting, the MSCI European Economic and Monetary Union Index's Q1 earnings grew 12.8% y/y—strong growth and better than the initial estimate of 9.3% y/y.[xxvii] This includes big (and unsurprising) declines in Energy (-18.3% y/y) and Materials (-25.8% y/y). Revenues tell a similar story. Though total revenues fell -3.1% y/y, Energy (-28.7% y/y) was the primary detractor—weakness is not broad-based. Excluding Energy's big negative contribution, revenues grew nicely, illustrating Energy's large skew.

These exemplify the underappreciated positive fundamentals supporting eurozone equities' strong year-to-date returns. While many credit these equity returns to the European Central Bank's (ECB) QE bond buying, QE launched in March. It likely had nothing to do with eurozone corporations' excellent earnings results. The credit given to the ECB for "rescuing" the eurozone with QE shows investors overlook the positives. The gap between sentiment and reality is wide indeed.

The UK Economy Is Still Growing

Despite nagging criticism of allegedly "unbalanced" growth, the UK economy remains among the developed world's strongest. GDP rose 0.4% q/q (1.5% annualised) in Q1 and 0.7% q/q (2.8% annualised) in Q2, led once again by services—the bulk of UK economic activity. While soft patches remain, the backbone is strong.

Business investment continued rebounding from its brief autumn dip in Q1, growing 2.0% q/q. Though many believe UK growth is not "stable" until components like business investment and exports pick up, consider that quarterly business investment has risen 37.1% since 2009 ended and hit an annual all-time high in 2014.[xxviii] While trade remains choppy, it also has not prevented growth. Plus, the UK is a services- and consumption-oriented economy. Though Manufacturing PMI slowed in June, Services PMI accelerated to 58.5 from May's 56.5, capping a strong Q2. Retail sales are in a long uptrend. Those areas are driving growth, and there is nothing inherently unstable about it.

The UK's Unexpected Majority Government

Prior to the UK's May general election, nearly all pundits forecasted no one would win a majority, yet the Conservatives gained a surprising parliamentary edge. While unexpected, the impact is limited by their slim margin and intraparty disagreements on matters like Europe.

David Cameron's 12-seat edge over the combined opposition in a 650-seat body is not sufficient to force through legislation. It reminds us of John Major's 21-seat majority following his shocking win in 1992. Like Cameron, Major faced a eurosceptic backbench while negotiating Britain's relationship with the EU. Backbenchers were not keen when he signed the Maastricht Treaty, despite winning exemptions, including keeping the UK permanently out of the euro. His majority disintegrated through defections and by-election defeats, evaporating totally by his term's end.

Like Major, Cameron faces pushback on Europe. To quell eurosceptic Conservatives during the campaign, Cameron pledged to renegotiate Britain's relationship with the EU and hold a referendum on membership under those revised terms by 2017's end. This has raised fears in the business community Britain will leave the EU's single market. Despite Brussels' penchant for red tape, the EU is a free-trade marvel.

While anything is possible, it seems premature to fear equity market fallout. Neither Cameron nor EU officials want the UK to leave, incentivising both sides to negotiate. European Commission President Jean Claude Juncker has already indicated willingness to make concessions. If Cameron wins a few, the changes (which include repatriating judiciary and police powers, curbing "benefits tourism" and regaining some financial regulation autonomy) could appease the eurosceptics. Either way, this issue will play out glacially, in public, giving markets ample time to discover and discount potential changes.

Gridlock in Denmark

Denmark held general elections in May after Prime Minister Helle Thorning-Schmidt called snap elections. Thorning-Schmidt, who headed a minority government, seemingly based her call on polls suggesting her coalition would win a majority. The day before the vote, polls showed her bloc winning 50.7% to 49.2%. However, her centre-left bloc lost by a 51.5% to 48.5% margin. The centre-right bloc took power, with former Prime Minister Lars Loekke Rasmussen getting a second tour.

Gridlock likely forestalls radical efforts here, too. The Danish People's Party, which won the second-most seats and is in the coalition, campaigned on an anti-EU platform, calling for Copenhagen to renegotiate its relationship with Brussels. (Denmark, like Britain, is not in the euro and has several special opt-outs.) However, like Britain, it is unlikely Denmark exits any time soon—particularly with the centre-right bloc's edge so narrow.

Spain

Spain's general elections are due by 20 December, with mainstream pro-euro parties leading according to most polls. That said, the austerity-protest party Podemos launched in early 2014 has gained traction. Party members took mayoral seats in Barcelona and Madrid earlier this year, and it has polled well nationally.

These polls may not reflect reality, but there is an added reason for scepticism over Podemos: Greece. Greece poses a problem for Podemos, given their ideological allies (Syriza) are widely blamed in Europe for Greece's return to recession and crisis. Centre-right Prime Minister Mariano Rajoy is making an issue of it, too, claiming his reforms have not only delivered some of the continent's fastest economic growth rates, but helped Spain avoid a Grecian fate—overwrought politicking but possibly an effective strategy. Syriza's forced acceptance of draconian austerity in July may further limit Podemos' appeal.

While it is premature to handicap Spain's election, given the political landscape, the contest will likely yield a gridlocked government that accomplishes very little—a positive. Gridlock would prevent the unwinding of several reforms passed since 2011.

Japan

Sentiment continues to remain detached from fundamentals—in our view, better opportunities exist outside of Japan. Corporate governance reforms passed and took effect in June, many are expecting an influx of outside directors to make firms more accountable to shareholders. While positive, this likely does not address the deep-seated problem among Japan's bloated conglomerates. Labour reforms passed in June as well, which is another small, beneficial step. However, these reforms are similarly insufficient to address the culture of lifetime employment, which most investors agree is a large roadblock to productivity.

Japan's Q1 GDP was revised up to 1.0% q/q (3.9% annualised) from an initial estimate of 0.6% q/q (2.4% annualised) after an upward revision in business investment. The biggest contributor to growth remains inventories, which are open to interpretation—companies may allow inventories to draw down if meaningful consumer demand is not foreseen. Other data paint a bleaker picture for Japan. While Japanese exporters saw a modest gain from currency conversions with export values rising 2.4% y/y, export volumes contracted -3.8% y/y while import volumes fell -5.3% y/y in May. This report suggests the weak yen still has not boosted output and domestic demand remains weak. The Conference Board's LEI for Japan halted its decline in April with a flat read, but it still has not risen since November. As LEI trends take time to develop in coincident data, we would not be surprised if soft readings still lurk.

Developing Markets Commentary

In Q2, sentiment toward Emerging Markets (EM) economies soured. Two factors seem mostly behind the negative sentiment shift: Chinese equity market volatility (which we will discuss in depth shortly) and falling commodity prices. A third factor continued to unfold during the quarter causing volatility: Greek bailout negotiations. However, we continue to see Greece as too small to derail the current bull market.

Many presume weak commodity prices categorically threaten EM, assuming emerging economies all rely on mining and oil as a source of growth. While this is true for some individual nations, it is not universally correct. Many EMs—India, Taiwan, Korea, Indonesia and others—receive a net benefit from falling energy and raw materials costs, as Energy and Materials represent smaller shares of their economies. For many firms and consumers in these nations, falling commodity prices amount to a cost cut. The blanket negative sentiment overlooks this, creating a bullish disconnect between sentiment and reality in non-commodity-heavy EM nations.

India

India is a clear beneficiary of lower raw materials and energy prices. In Q1, GDP grew 7.5% y/y, beating expectations of 7.3% and accelerating from Q4 2014's 6.6%. The acceleration was underpinned by quick 11.5% y/y growth in India's services sectors, like Finance and Insurance. Manufacturing also grew nicely in Q1, 7.1% y/y.

Monthly data suggest growth continues at a solid rate. Industrial Production is up in seven straight months. Services and manufacturing PMIs are both in expansionary territory. Inflation is slower than a year ago, with CPI running at 5.4% y/y versus 8.5% in June 2014. While food prices are the key swing factor in Indian inflation—accounting for nearly half of the CPI basket when beverages are included—falling oil prices are still a big benefit.

Politically, news from India is mixed. India's Minimum Alternative Tax (MAT) returned to headlines after over 100 fund managers received demands for back taxes totaling over $6 billion. While this tax historically did not apply to foreign businesses, a 2012 ruling implied foreign companies might have to pay it. Many had hoped Prime Minister Narendra Modi's budget would abolish this "retrospective tax" law, so the moves against the fund managers surprised some. However, the government confirmed it issued notices to 68 overseas funds for $9.6 million in back taxes—a much smaller number than feared. We anticipate some asset managers will fight these notices in court, delaying resolution. While the move does highlight the limits of Modi's power, we believe India's positive fundamentals outweigh the occasional political setback.

Reform of the Reserve Bank of India (RBI) also continued, with the Modi government proposing in July to eliminate the RBI Governor's unilateral decision-making authority and establish a seven-member monetary policy committee charged with enacting policy. In theory, this is a positive—a check against potential policy error. However, the draft states that the RBI will appoint only three of the board members itself—the other four appointed by the government. It is possible this negative aspect of the rule negates the positive by threatening the RBI's independence. Politically motivated monetary policy has long been a headwind in EM. It seemed India, by establishing an inflation target and then moving toward a monetary policy committee, was trying to turn the page. Ultimately, this mixed news is worth watching, but does not signal a landmark shift—positively or negatively—at this point as the proposal is in its infancy and subject to change. Modi has already started distancing himself from it and recently suggested alternative plans are in the works.

Brazil

On the other hand, struggles continued for commodities-heavy Brazil and a near-term turnaround looks unlikely. Q1 GDP contracted -0.2% q/q (-1.6% y/y) as domestic demand dropped -1.4% q/q, reversing after Q4's 0.4% q/q rise. Both private consumption (-1.5% q/q) and investment (-1.3% q/q) fell from Q4 (1.1% q/q and 0.6% q/q, respectively)—highlighting the country's struggles. Most major economic statistics fell in Q2. May retail sales fell -4.5% y/y and were down in three of 2015's five monthly reports issued to date. Industrial production has similarly faltered. The Conference Board's LEI for Brazil fell throughout Q2, with June's -0.6% m/m drop following May's -0.1% and April's -1.1%. Oil and commodities prices' nearing new lows in July and early August suggest pressure is unlikely to abate soon.

While most of the world enjoys low inflation and rates, Brazilian inflation exceeds 8% y/y (over 7% excluding food and fuel), leading to rate hikes despite the economy's weakness. Concurrently, the government is embroiled in corruption scandals. Lending is another sign of economic inefficiency in Brazil. Prior to 2008's financial crisis, private lending accounted for about 68% of loans extended. Today, fewer than 52% of loans are from private institutions—government subsidised credit has retaken significant share. In the last three years alone, the private sector's share of lending has fallen by nearly 10 percentage points.

Greece

At the time of writing, Greece and the eurozone have agreed in principle on a new bailout, which could grant Greece up to €86 billion in loans over the next three years if Greece implements several contentious reforms. Additionally, the EU extended Greece a €7.16 billion bridge loan, allowing it to clear its arrears with the International Monetary Fund (IMF) and repay €4.2 billion due the ECB 20 July. Markets cheered the agreement, but the terms are as onerous as prior bailout conditions, which Greece failed to meet. Given Greece's history of not implementing reforms even before its current anti-austerity government took power, we see little reason to believe this is the last of "Grexit" brinksmanship. Should Greece ultimately leave the euro, we expect the global fallout to be minimal, relieving investors of a long-held false fear.

Wallops impact typically need to be in the trillions. Greece's GDP is roughly $200 billion—0.3% of the world.[xix] Compare its GDP to corporate revenues (both rough snapshots of annual output), and Greece roughly matches General Motors (GM) in 2007, the year before its implosion began. GM's bankruptcy did not sink equities. GM announced impending default in April 2009, weeks after the bull began, and filed bankruptcy that June. Equities soared in 2009. Greece today is similar to Chevron's and Samsung Electronics' 2014 revenues and smaller than Toyota's and Volkswagen's revenues. It is unlikely any of these would cause a global recession by going bankrupt.

Greece's GDP is roughly the size of Detroit's in 2013, the year it went bankrupt—a great year for equities.[xxx] Greece is a bit bigger than San Diego and San Jose, smaller than Phoenix (Exhibit 12). It is comparable to Frankfurt, Madrid and Buenos Aires, smaller than Toronto and Melbourne. A regional bankruptcy in any of these is unlikely to cause global calamity.

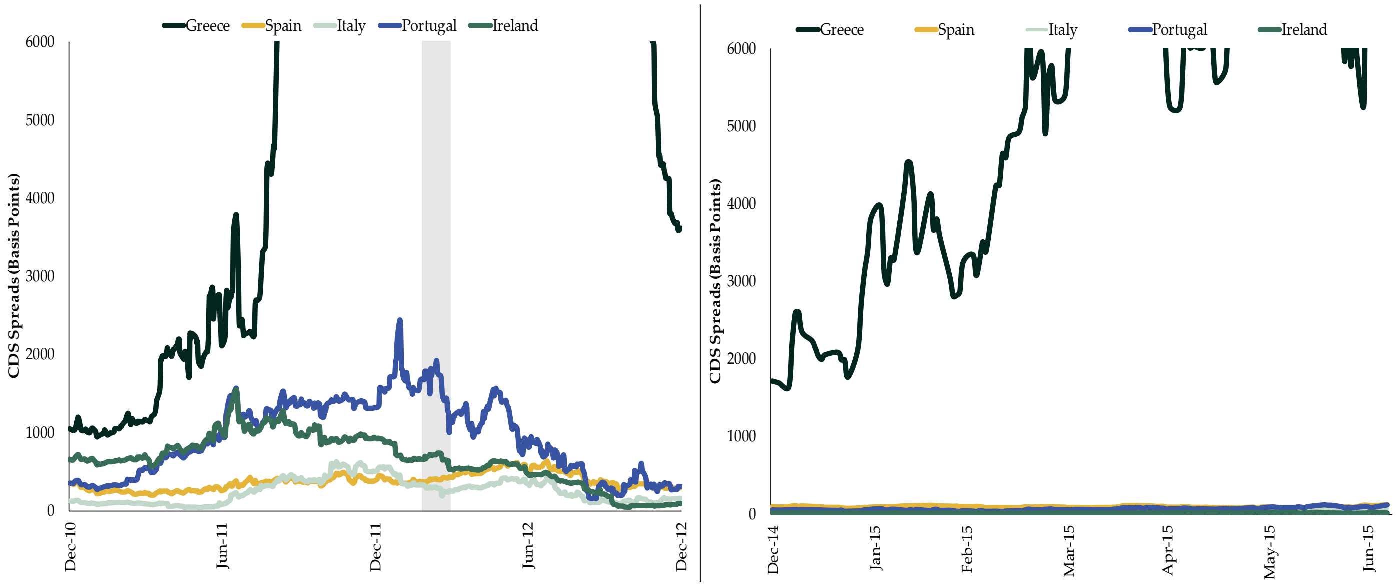
Exhibit 12: If Greece Were a US City

Rank	Top US Metro Areas and Greece	Billions of Dollars	Rank	Top US Metro Areas and Greece	Billions of Dollars
1	New York City	1,471	11	Seattle	285
2	Los Angeles	827	12	Miami	281
3	Chicago	590	13	Minneapolis	228
4	Houston	517	14	Detroit	225
5	Washington, DC	464	15	Phoenix	210
6	Dallas	448	**16**	**Greece**	**200**
7	San Francisco	388	17	San Diego	198
8	Philadelphia	383	18	San Jose	197
9	Boston	371	19	Denver	179
10	Atlanta	307	20	Baltimore	169

Source: US Bureau of Economic Analysis and FactSet, as of 03/06/2015. US Metropolitan Area nominal GDP in 2013, Greek nominal GDP in 2014.

Greece may stoke volatility, but true contagion is unlikely. As bailout talks faltered and "Grexit" risk soared in early Q3, markets outside Greece were relatively calm. Greek bond yields and Credit Default Swaps (CDS)—the cost of insurance against default—soared. However, yields elsewhere rose only slightly (Exhibit 13). Portuguese CDS, which rose as Greece's early 2012 default approached, remained near rock-bottom. Greek equities fell -25.7%, but eurozone and global equities were resilient.[xxxi]

Exhibit 13: CDS Costs, 2012 Versus Today



Source: FactSet, as of 07/07/2015. One-year CDS spreads for Greece, Spain, Italy, Portugal and Ireland, 31/12/2010 – 31/12/2012 and 31/12/2014 – 06/07/2015. Shading indicates Greece in default. Y-axis is truncated at 6,000 basis points to better display the other four nations.

China

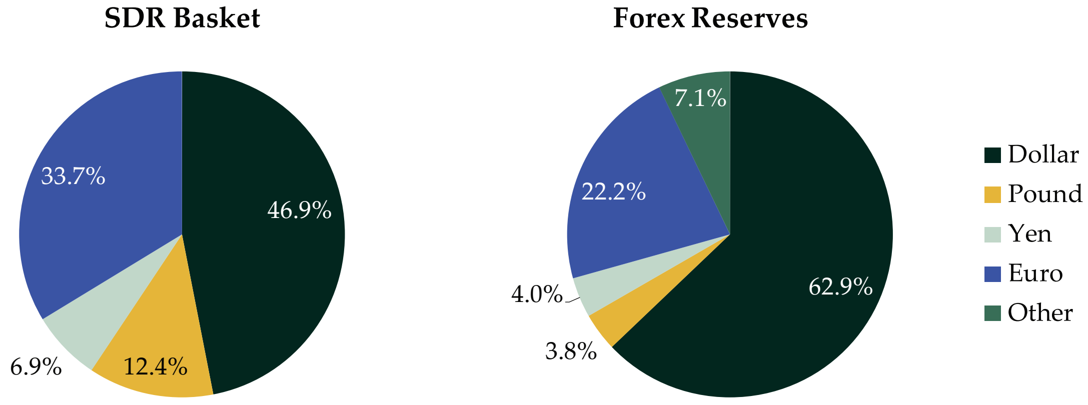
China hogged headlines in Q2, as investors fretted an equity bubble and the yuan's drive for global reserve currency status. We see little threat to the global financial system on either front.

Dethroning the US Dollar?

In November, the IMF will vote on whether to include China's yuan (also known as renminbi) in its Special Drawing Rights (SDR) currency basket, elevating it as a global reserve currency. The SDR is mostly symbolic, with little real-world use outside IMF bailouts. However, investors wonder if this could displace the US dollar as primary reserve currency, causing demand for US Treasuries to implode, interest rates to soar or the dollar to collapse. While the yuan could take market share over time, we do not believe this is a risk for US or global markets.

If the yuan joins the SDR, it would not replace the dollar—it would join the dollar, euro, pound and yen. Currencies' SDR weightings do not mirror their share of global foreign exchange reserves. The dollar is about 47% of the SDR but roughly 63% of allocated reserves (Exhibit 14).

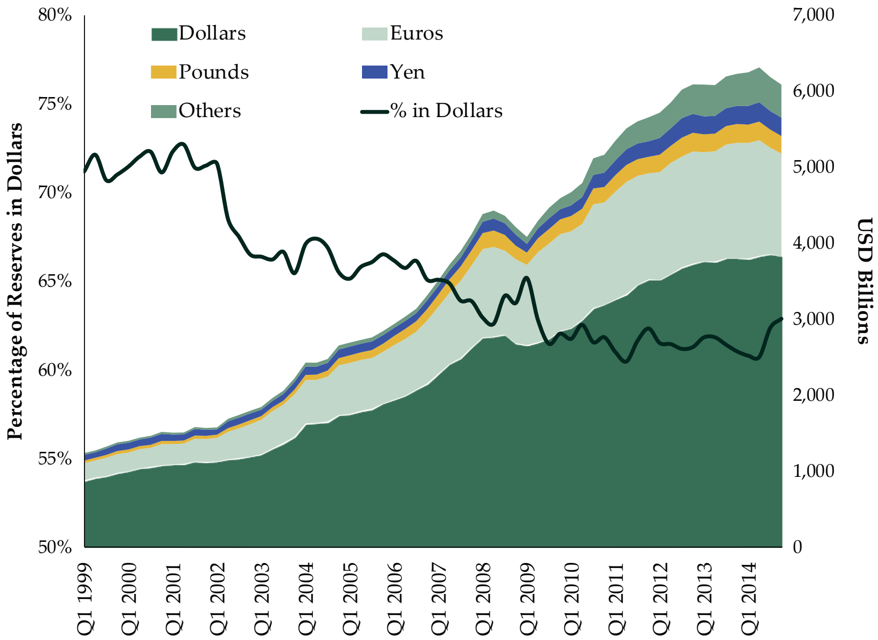
Exhibit 14: Major Currencies' Share of the SDR and Forex Reserves



Source: IMF, as of 24/06/2015.

The yuan's rise will likely be long and gradual, likely with setbacks along the way—much like the euro's gradual ascendance. The euro, Australian and Canadian dollars, pound and other currencies have taken market share since 1999—with no ill effect for the US. Even as the dollar's share of reserves fell from 71.2% in 1999 to 62.9% in 2014, total dollar holdings rose from about $882 billion to more than $3.8 trillion—the dollar has a smaller share of a much bigger pie (Exhibit 15).

Exhibit 15: Currency Composition of Allocated Forex Reserves



Source: IMF, as of 24/06/2015.

IMF blessing alone would not catapult the yuan to the top. Being a major reserve currency requires a deep, stable and liquid pool of assets to draw from. The US Treasury market is unmatched, with about $13.1 trillion in bonds circulating.[xxxii] Japan comes second with $5.1 trillion, followed by Britain at $2.4 trillion.[xxxiii] The four biggest eurozone economies—Germany, France, Spain and Italy—add up to $6.4 trillion. China has just $1.4 trillion in gross central government debt (not a perfect gauge, as this includes intergovernmental holdings) and capital controls impede foreigners' access.[xxxiv] At last count, foreign investors owned just $15 billion in Chinese central government bonds. Unless supply soars and China allows free-flowing foreign investment, it will be difficult for other nations to accumulate large yuan stockpiles.

Either way, the US gains little from being the primary reserve currency. The Treasury does not receive a fee or international influence. Nor does reserve currency status determine interest rates. If it did, one would expect US rates to be the world's lowest. Yet of the four SDR currencies, US rates have not been the lowest in the last 15 years. Counterintuitively, US rates fell as the dollar lost forex market share. They have also fallen since 2008, while the percentage of net US debt held in reserves declined from 58.7% then to just 29.3% now.[xxxv] The US does not rely on the world's other central banks for debt financing. Domestic investors, banks, the Fed and foreign firms and people are a bigger source of demand. Total supply and demand drives interest rates.

China Is Not Open

China has moved toward a market-oriented economy, but it has a long way to go before achieving full openness—ultimately necessary for China to be a major reserve currency. The reforms required to get there would be long-term positives for China and more mature Chinese capital markets would be great for the world. This will likely be a long, slow-moving process. China tends to take a three steps forward, two steps backward approach to market-oriented reforms and has stepped back lately as officials intervene in volatile domestic markets.

The IMF's primary SDR criteria is full convertibility—the ability for countries to convert their currency to yuan without using other currencies as stopovers. The yuan is fully convertible for international trade purposes (the current account), but not for investment (the capital account). Chinese officials have stated intent to achieve full capital account convertibility by year-end, but they also intend to retain foreign investment quotas, as they are concerned volatile cross-border investment flows could undermine economic stability. People's Bank of China (PBOC) Governor Zhou Xiaochuan recently said China is striving for "managed convertibility."[xxxvi] Perhaps this suffices for the IMF, but capital controls are a real-world roadblock. Note, also, the yuan remains essentially pegged to the dollar.

However, China has undertaken several reforms this year and more are expected. Officials approved five private banks on a trial basis late last year and the first—backed by Tencent Holdings—launched in January. Interest rate liberalisation continued in May, when the PBOC lifted the ceiling on deposit rates to 1.5 times the benchmark rate. China also launched deposit insurance in May, guaranteeing deposits up to 500,000 yuan—a move widely seen as necessary to instill market discipline because it implies the government will be less likely to fully back faltering banks. The introduction of floating-rate CDs followed in June and the PBOC is targeting fully market-set interest rates by year-end.

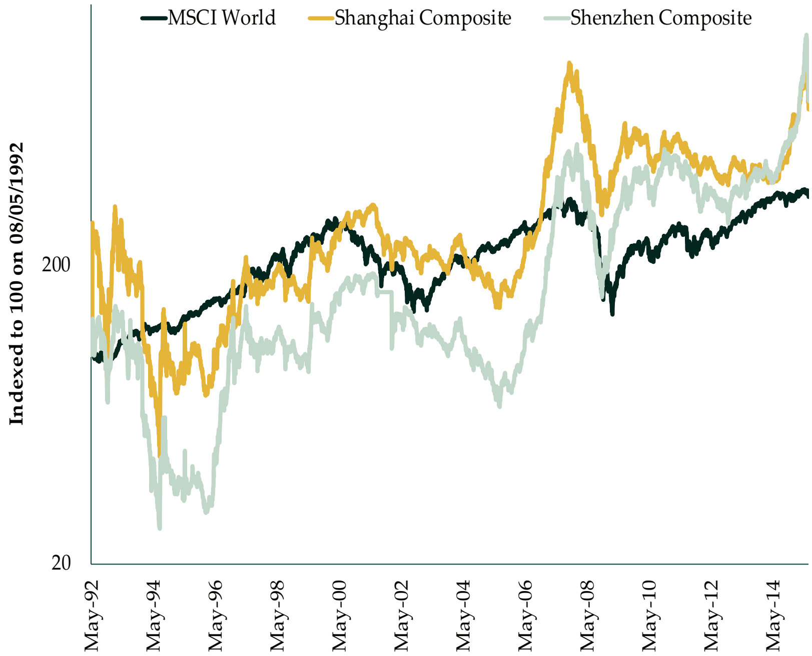
Open markets would benefit China and the world—freer trade and investment are always a net positive—but officials have incentives to move gradually. Pegged currency and capital controls enable them to manage the economic slowdown. As written in past Review & Outlooks, Chinese political stability requires economic stability. Removing capital controls and floating the yuan overnight could introduce volatility officials are not prepared to deal with. Removing controls gradually reduces the risk of sudden swings as the market system finds its footing.

China's Bubble Bursting?

Mainland equities zoomed from May 2014 through mid-June 2015, sparking bubble fears. Frenzied buying from highly margined, unsophisticated mainland investors drew comparisons with US markets on the eve of 1929's crash. As if on cue, the Shanghai and Shenzhen Composite Indexes began tumbling on 15 June. By 8 July, each was down over 30%.[xxxvii] Mainland market activity suggested sentiment was detached from fundamentals. Near-term movement is impossible to predict—markets could rebound fast, or more downside could come. However, this is not a global risk.

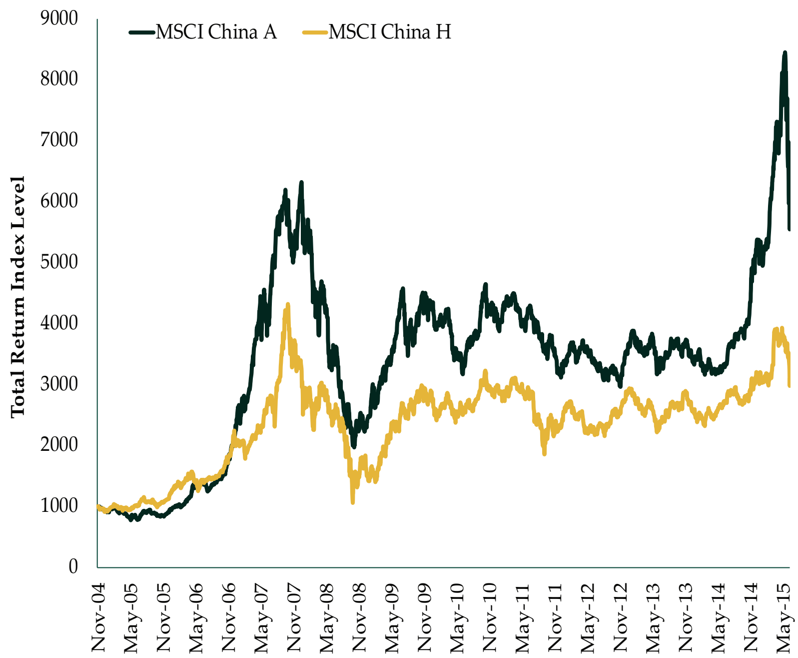
Chinese equities have two main classes: A-shares and H-shares. H-shares—mainland equities traded on Hong Kong exchanges—comprise most of the universe accessible outside China. A-shares are mainland equities accessible mostly to Chinese investors. The sharp rise and fall is primarily limited to A-shares, not H-shares, making China's mania a local event, not a global one. A-shares have a wild history—and very little correlation with global markets. Exhibit 16 shows the Shanghai and Shenzhen Composites alongside the MSCI World Index, using a logarithmic scale (displaying China's huge percentage movements better than a linear scale would). A-shares' wild swings since 1992 are far detached from global equities. China's strict capital controls are a huge equity market firewall. A-shares' isolation is also apparent when you compare them with H-shares (Exhibit 17). From 30 April 2014 through their peak on 12 June 2015, A-shares rose 163.2%. H-shares gained a far tamer 52%.[xxxviii]

Exhibit 16: Mainland Chinese and Global Equities



Source: FactSet, as of 09/07/2015. Shanghai Composite, Shenzhen Composite and MSCI World Index price returns, 08/05/1992 – 08/07/2015. Price returns used instead of total due to data availability.

Exhibit 17: A-Shares Vs. H-Shares—Total Return



Source: FactSet, as of 09/07/2015. MSCI China A and MSCI China H returns with net dividends, 30/11/2004 – 08/07/2015.

Mainland sentiment has less impact on H-shares—foreign investors have far more influence and are sceptical about the boom's staying power. State-run media encouraged Chinese citisens to buy equities as an alternative to real estate as property prices fell and editorials rationalised the market's surge at every turn. Foreign investors saw the increasingly irrational reasoning offered by Communist Party mouthpieces for local investors to stay in equities. They saw the flood of IPOs rising by the daily limit for weeks on end. Unlike local investors subject to China's strict media controls, foreigners saw the many articles warning of A-shares bubble and enumerating the detachment from sentiment and fundamentals. H-shares are much more able to discount the full picture.

The H-share market's balance between sentiment and fundamentals is more favourable. Long-running false fears of a local government debt crisis and economic hard landing persist. Neither is any more likely today than in 2011 and 2012, when fears first perked. Officials have launched several programmes to help local governments refinance maturing debt. The PBOC also launched a programme to let banks swap local government bonds for three-year loans and has over $3.8 trillion in forex reserves. They can easily recapitalise banks if needed. The risk of a wallop in H-shares—or global markets—from Chinese debt appears low.

If Chinese growth hits the government's official target of "around 7%" this year, it would increase global GDP by nearly 1%—an increase most investors do not yet fathom.[xxxix] An A-share slump should not prevent China from nearing the target. While cyclical shifts in more open equity markets are leading indicators of economic cycle shifts, A-shares show no such tendency. This is A-shares' third bear since 2009, yet China's economy has grown throughout—even accelerating during 2009 – 2010's. Chances of the crash causing a recession this time seem slim. Some speculate about a "wealth effect," where falling equity prices could dent consumption because people "feel" less rich. However, the wealth effect is as overstated in China as it is elsewhere and only about 6% of China's population invests in equities.[xl] Disposable income is the primary driver of consumption and officials continue doing what is needed to ensure growth boosts incomes. In addition, consumer spending is roughly one-third of China's economy—quite small.

China's economic policies are shifting its growth engines from manufacturing, fixed investment and exports to consumption and services. While this slows growth, the model is more sustainable long-term as China's workforce shrinks due to the one-child rule and labour costs rise, eroding its manufacturing edge. The shift remains apparent in the latest economic data: Industrial production has slowed dramatically, but retail sales are growing at double-digit rates. Manufacturing PMIs frequently flirt with contraction, but service PMIs are solidly expansionary. Moreover, officials have repeatedly done what is necessary to keep GDP growth near their 7% target and their monetary stimulus efforts continued throughout Q2. A modest slowdown is not a hard landing.

Some suggest the Chinese government's response to A-shares' selloff increases political risk. Since taking power in 2012, President Xi Jinping has gradually transitioned China to a more market-oriented economy, but officials have intervened heavily to stem the A-share decline. Measures include removing mandatory margin requirements (leaving margin call thresholds to brokerages' discretion), increasing margin financing support (with the central bank agreeing to inject liquidity directly), establishing a "market stabilisation fund" to buy equities and getting 21 securities firms to agree not to sell equities from their books while the Shanghai Composite trades below 4,500. Securities regulators also banned corporate executives, directors and shareholders with stakes above 5% from selling their shares for six months. Liquidity tightened and at one point, roughly 75% of listed A-shares had halted trading (some have since come back online).

The seemingly haphazard approach, with new measures announced daily, adds to uncertainty and fear, but we believe it is premature to fret a political overhaul. Chinese officials have always been figuring out how to manage their economy and markets as they go along. Prior attempts to allow market forces to play greater roles have not always gone as planned. Last year, they tried to allow state-owned and private firms to default on corporate bonds so markets could better price risk. Each time they eventually caved, arranging deals to make investors whole. There has always been a tradeoff between reform and ensuring stability—it is just more high-profile today.

Elsewhere

Weak spots are the exception in EM. South Korean Q1 GDP beat estimates, rising 0.8% q/q (3.1% q/q annualised), with growth led by accelerating construction investment and private consumption. Indonesian Q1 GDP grew 4.7% y/y, slightly slowing from Q4's 5.0% y/y growth, but growth was underpinned by strong domestic demand, suggesting the country is stable.

Mexico expanded 2.5% y/y (0.4% q/q) in Q1, led by its services sector (2.9% y/y, 0.5% q/q). Oil prices are a headwind for Mexican GDP, but its proximity and tight trade relationship with the US are positives. The Philippines also grew, up 5.2% y/y, led by consumer spending (5.4% y/y). On an industry basis, mining (7.1% y/y), manufacturing (5.9% y/y) and services (5.6% y/y) led, while agricultural activities lagged (1.6% y/y).

Finally, the Bank of Thailand cut interest rates by 25 basis points to 1.5%. With Thailand being one of the biggest beneficiaries of lower resource prices, its export-oriented economy should be well positioned looking ahead. The military junta running the country has not helped recently, but this also serves to dampen expectations. The economy should be able to positively surprise.

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This material is designed for use with wholesale prospects and clients.

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