FISHER INVESTMENTS AUSTRALASIA™

FOURTH QUARTER 2015

FISHER MARKET PERSPECTIVES

FOURTH QUARTER 2015 REVIEW AND OUTLOOK

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FOURTH QUARTER 2015 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Global markets rebounded from Q3's correction, with the MSCI All World Country Index (ACWI) finishing Q4 up 5.0%.[i] We believe the bull market continues in 2016, as conditions are better than most perceive. Politics continue to garner much attention—particularly in the US—but still are not worrisome. Sentiment is far too gloomy relative to reality, leaving ample room for more optimism ahead.

Our Q4 2014 Review & Outlook mentioned sentiment swings—a correction late in an otherwise fine year—could diminish full-year returns and forestall some of the positivity we anticipated. This indeed happened, as sentiment did not warm and the correction weighed. Full-year returns finished negative at -2.4% for the MSCI ACWI.[ii]

Porfolio Themes

- **Underweight to Commodity-Oriented Companies:** Companies that have significant commodity exposure (metals, oil and agricultural) should underperform.
- **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

- **Markets Rebound from Q3's Correction:** Full-year returns finished down slightly after rebounding from a correction in Q3, with the MSCI ACWI down -2.4% for the year.
- **Underappreciated Global Economic Strength:** The global economy continues growing, with the US, Europe and China healthier than most perceive. Falling oil prices are widely known, limiting their market-wide shock value.
- **Overly Dour Sentiment:** Investors, still scarred from the financial crisis, are struggling to shake off scepticism. How high equities rise in 2016 hinges on sentiment's evolution.

As 2015 came to a close, the US economic expansion continued rapidly. Per the US Bureau of Economic Analysis' third estimate of Q3 data, US Gross Domestic Product (GDP) grew at a 2.0% seasonally adjusted annual rate. Economic data released during the quarter suggest domestic demand and the service sector remain strong, likely outweighing a continued manufacturing weakness. Despite a contractionary reading from The Institute for Supply Management's November Manufacturing Purchasing Managers' Index (PMI) of 48.6—its first drop below 50 since 2012—the ISM's Non-Manufacturing PMI remained expansionary throughout the quarter. Lending has picked up, rising 8.4% y/y in the week ending 23 December 2015, above 2015's average of 7.9%. Inflation also remains low, excluding falling food and energy prices, core CPI remains in line with its overall trend. The Conference Board's Leading Economic Index (LEI) extended its long-term uptrend during the quarter, and no US recession since 1959 has started with LEI high and rising, as it is now.

In Europe, economic data throughout the quarter continued its positive trajectory, with 18 reporting members reporting growth in Q3—only Greece, Finland and Estonia contracted. Formerly the focus of eurozone fears, Spain and Ireland continued leading, showing growth is not confined to the bloc's core. The eurozone's broadest measure of money supply—M3—continued to rise during the quarter, and accelerated during Q3. Furthermore, LEI for the eurozone rose during the quarter—continuing a trend of six rises in seven months, suggesting more growth ahead. In the UK, domestic demand and the strong UK consumer continue to drive growth as retail sales volumes continued their steady climb during the quarter. Businesses are keeping pace, too—Markit's Manufacturing and Services PMIs are well into expansionary territory.

China continued its overall trend in Q4—a bit slower and transitioning away from heavy industry to services and consumption—to close out an eventful year. Many fixated on Chinese trade data as evidence of marked deterioration, as both imports (-8.7% y/y) and exports (-6.8% y/y) fell in November. However, falling imports largely reflect the decline in oil and commodity prices. In volume terms, crude oil imports are up 7.6% y/y—pointing to healthy demand. Retail sales growth continued during the quarter, perhaps partly reflecting China's big "Singles Day" shopping day. While investors continue debating about what a slowing China means both for the country and the global economy, reality likely exceeds these dour expectations.

Political drivers also point to a fine 2016. Presidential election years are usually positive, and the US overwhelmingly outperforms as the contest nears. The global economy continues growing, with the US, Europe and China healthier than most perceive. Falling oil prices are widely known, limiting their market-wide shock value. Investors fretted the US Federal Reserve (Fed) finally hiking rates for the first time in this cycle, but we saw it as a positive. False fears are bullish. The realisation modestly higher short-term rates are an economic non-event, particularly while the yield curve spread remains wide, should dispel this myth. Meanwhile, the Fed likely does ever less as the Presidential election draws near. The Fed likes to portray itself as apolitical—in reality, it is anything but.

The Presidential election remains too distant to handicap. Early polling is not predictive for primaries or the general election—particularly now, given polls' recent misses. Congressional races are also unpredictable at this point. This Presidential contest is notable for its many apparent abnormalities, particularly the rise of GOP outsider candidates. There is a strong likelihood these abnormalities fade, leaving a more traditional race in the end. However, alternatives are also worth considering, as we will discuss in the full Review & Outlook.

This bull market is months away from becoming history's second-longest, yet it remains perhaps history's least loved. Investors, still scarred from the financial crisis, cannot shake scepticism. Many see signs of another 2008 around every corner, even in tiny, obscure and isolated assets. In reality, one bear market's cause rarely triggers the next, so it is usually best to look elsewhere for an approaching bear. How high equities rise in 2016 hinges on sentiment's evolution. Does optimism emerge after fears are disproven? Or does scepticism reign, spurred by headline-grabbing events that dampen returns?

It would not shock us if sentiment never reaches true euphoria in this cycle, with complacency instead marking the peak. Dourness could keep returns below bull market averages, as the surging confidence that typically powers big returns in late-stage bulls never arrives. We might instead see a longer, slower grind higher, defying the many who describe this bull as "long in the tooth" and potentially making this history's longest bull market in time if not magnitude.

We do not believe a bear market is likely this year, though a correction is always possible. That one struck in 2015 does not mean 2016 will be correction-free. Corrections are random—based exclusively on sentiment's whims. We believe now is a time to appreciate the positives others fail to see before they awaken and drive up equity prices.

THEMATIC UPDATE AND MARKET OUTLOOK

Q4 RECAP

As 2015 concluded, fears about slowing developed world growth increased. Many fret a possible global recession in 2016, interpreting recent weakness in commodities and industrial production as a harbinger for broader problems. While industry and manufacturing are indeed mired in a soft patch—with many indicators skewed by falling commodity prices, particularly oil—this overlooks a more important point: Developed world economies are predominantly services-based, and we are seeing broad expansion in services globally. With few exceptions (e.g., Norway and Canada), Energy is a tiny slice of GDP in most advanced economies, minimising the effects of the global Energy sector depression. Lower energy prices benefit countries like the US, UK and much of the eurozone since they reduce business costs across the board. Outside high-profile weak spots Brazil and Russia, many Emerging Markets (EM) economies are also net commodity importers, resulting in a net-positive from the Materials sector fallout. While weak spots steal the most headlines, they are few and isolated. Strong countries more than offset them and should keep global growth alive.

A Tough January Doesn't Mean a Bad Year

January got off to a difficult start. The MSCI All Country World Index (ACWI) fell -8.7% in January's first 10 trading days, with big daily swings the norm.[iii] January's volatility seems like a continuation of 2015's second-half correction—a short, sharp, sentiment-driven move exceeding -10%. While uncomfortable, corrections are normal in bull markets. Volatility is random, and pullbacks often end as suddenly as they began.

As we write, the MSCI ACWI is down -18.3% since its 21 May 2015 peak, officially making this a double-bottom correction.[iv] In our Q3 2015 Review & Outlook, we noted the late-summer slide didn't prompt corrections' typical fear surge, and we warned another sharp drop could bring it. Now, fear is rising. As equities breached their prior low, sensationalist headlines predicted more huge drops, encouraging hasty overreactions. One longtime bear saw "cataclysmic" conditions and urged investors to "sell (mostly) everything".[v] Another warned the S&P 500 could fall -75% this year.[vi] Media hyped both forecasts, promoting fear, neglecting to mention both analysts similarly forecasted doom the past five years.

Hyperbolic negative forecasts abound—encouraging evidence sentiment might finally be capitulating, teeing up a strong rebound. While headlines shriek, none present new, bearish drivers. They cite long-running false fears, like potential deflation, the strong dollar, China's slowdown, low oil prices and Fed tightening. These aren't new fears, and fundamentally, little has changed.

This correction is somewhat long, but not abnormally so. Double-bottom corrections aren't rare, either. One also struck in 2011 as euro breakup fears rocked investors. Like last year, 2011 finished flat. Strong returns followed in 2012 and 2013. No one can know when this correction will end. Perhaps, as you read this, it already has—turning points are clear only in hindsight. But we believe most of the downside lies behind us, not ahead of us.

What's in Store for 2016?

After a flattish 2015 and volatile January, many question 2016's potential. Some wonder if the sun has set on the almost seven-year-old bull market. It's understandable, given rampant fearful headlines. But with positive economic and political drivers, we expect the bull market to continue in 2016. How much gusto it has hinges on sentiment.

To us, this year's key question is: Will good news finally spur optimism, inspiring investors to bid equities higher; or will scepticism persist, dampening returns as in 2015?

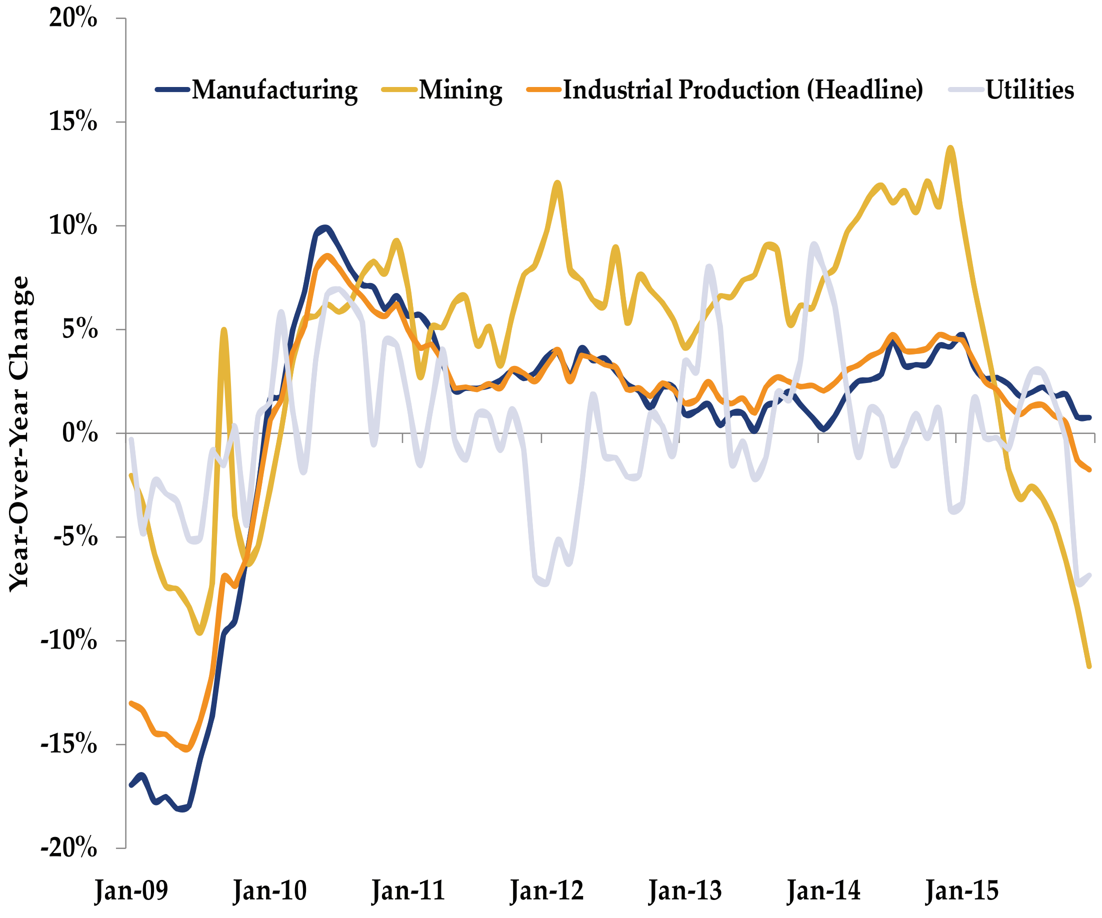
The answer likely determines whether 2016 is another tepid year or a more memorable year of growing optimism. It could swing on several wild cards, as we'll discuss.

US COMMENTARY

The US economic expansion continued through Q4, and GDP grew 2.4% in 2015, matching 2014's growth rate.[vii] Growth slowed a bit to 0.7% (seasonally adjusted annual rate) in Q4, as private investment fell.[viii] The drop dominated headlines, but it was driven by the oil & gas industry, which suffered all year as plunging prices hurt revenues. While Energy has powerfully influenced business investment over the past year, its impact on GDP and investment has materially declined after peaking in 2014. However, even at this peak, Energy investment comprised only 0.86% of GDP, and if no recession occurred when Energy had a larger impact, we fail to see how a reduced Energy component threatens growth now. Even if Energy's struggles continue, much of its impact on headline growth has likely already passed.

More significantly for US growth, consumers remain in good shape. Consumer spending grew 2.2% annualised in Q4, in line with its recent trend.[ix] Imports rose 1.1% q/q, further evidence of healthy domestic demand.[x] What's more, flagging imports from the Organization of Petroleum Exporting Countries (OPEC) nations and Canada are a clear sign of oil's influence. Heavy industry remains weak, but this weakness is concentrated in Utilities and Mining, not the broader economy. Manufacturing—which comprises more than 70% of industrial production and is a better gauge of actual US industry—hasn't been hit nearly as hard (Exhibit 1), and choppiness in this indicator is fairly normal during an expansion.

Exhibit 1: Industrial Production YoY Change



Source: Board of Governors of the Federal Reserve System, as of 15/01/2016. Monthly data series, 01/01/1972 – 01/12/2015.

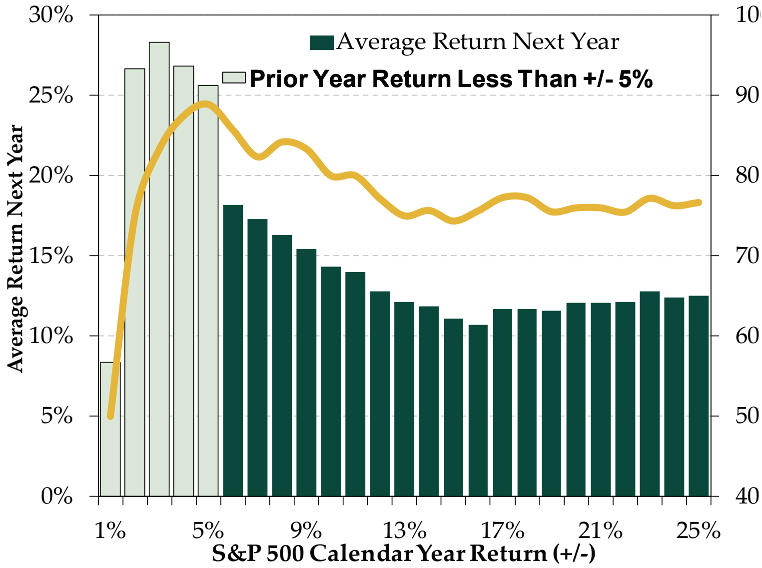
Plus, manufacturing is just 12% of US GDP. The service sector, 67% of GDP, drives the bulk of activity, and its growth is stronger and more consistent. The Institute for Supply Management's Non-Manufacturing Purchasing Managers' Index (PMI) has been expansionary, with monthly readings over 50, since February 2010.[xi] Similarly, its New Orders subindex has exceeded 50 since August 2009—today's orders are tomorrow's production, suggesting growth lies ahead. Many other indicators point positively: The yield curve is positively sloped, loan growth remains positive post-QE and broad money supply (M4) is accelerating. Even with an occasional down month, The Conference Board's Leading Economic Index (LEI) remains in a long uptrend. No US recession since 1959 has begun while LEI was in an uptrend.

Mediocre Years Don't Foretell Bears

The mediocre 2015 frustrated many, but as Ken often says, equity returns come in clusters. Getting bull markets' good returns requires participating in their not-as-good returns—a trade-off. Last year's returns are no reason for gloom in 2016—good years often follow mediocre years. Excluding last year, nine years posted returns between -5% and +5% since 1932. The next year was double-digit positive eight times, an above-average frequency of positive returns. (Exhibit 2's table shows the individual years, and the chart plots the average return and frequency of positivity in years following mediocre years.) The one negative year after a mediocre year, 1940, occurred amid a five-year bear market. This doesn't ensure a great 2016 follows a muted 2015, but it does show mediocre years don't regularly foretell weakness or trouble.

Exhibit 2: S&P 500 Returns: Often Big After Flattish Years

Year	S&P 500 Returns <+/- 5%	Following Year Return
1934	-2.3%	47.2%
1939	-0.9%	-10.1%
1953	-1.1%	52.4%
1960	0.5%	26.8%
1970	4.0%	14.3%
1990	-3.1%	30.5%
1994	1.3%	37.6%
2005	4.9%	15.8%
2011	2.1%	16.0%
2015	1.4%	?
Average		25.6%



Source: Global Financial Data, Inc., as of 04/01/2016. S&P 500 total return, 1926 – 2015.

Sentiment Is the Swing Factor

Fundamentally, 2016 has the ingredients for a great year. But whether we get one depends on whether investors get cheerier and bid up share prices.

Usually confidence ascends late in a bull as folks shed worries, get more optimistic and eventually reach euphoria. The 1990s bull's second half saw years of rational optimism, helping drive double-digit returns in five straight years. But sentiment has progressed glacially in this bull. Nearly seven years in, scepticism persists and joylessness abounds.

Why is sentiment stuck? It's an academic question without a clear answer, but we can hypothesise. We increasingly seem to live in an upside-down world, where things like the media, monetary policy and politics don't do what people expect. Hence confusion reigns, fueling investors' scepticism. Prolonged scepticism could result as investors grapple with the unknown.

Media has changed. There is very little traditional journalism—straightforward articles presenting only "who, what, where, when, why and how." Bias and opinion now infect even basic reporting, making it hard to discern fact from fiction. It's often subtle, evident through word choice: Saying Congress "failed" to do something, rather than "didn't," shows the writer believes "something" was good or necessary—an opinion, distorting the facts. Many articles—editorials and reports alike—include unsupported generalisations, false dilemmas, cherry-picked numbers and unsourced data. Without independently fact-checking articles, it is increasingly difficult to know what is credible.

In past years, the optimal US Presidential candidate would be a two-term governor with demonstrable success. Now, that is poison. Even in a three-person Democratic race, Martin O'Malley could barely get coverage. Scott Walker, Rick Perry, George Pataki, Bobby Jindal and Chris Christie exited the GOP race. Jeb Bush and John Kasich are barely hanging in. Outsiders poll favourably and garner most media coverage. First-term Senators are on their heels. Even though Republicans derided Barack Obama's relative inexperience as a first-term Senator in 2008, their primary "establishment" candidates sport similar resumes.

As Vox's Matthew Yglesias observed recently: "The presidency is, among other things, a complicated administrative job that seems to have a lot in common with being chief executive of a state. But the nationalisation of politics appears to have created a dynamic in which the nomination contests are more about who you are than what you've done, in a way that favours deep engagement with the national media ecology over the inevitable fuzziness that comes with running an institution." [xii] That encapsulates the upside-down world.

An Upside-Down Election

As always, we favour no candidate or party and assess politics solely to analyse how it may impact markets. We believe political bias is blinding and dangerous for investors.

The Presidential election is about nine months away, but it remains too early to handicap. Early polling doesn't predict primary races, let alone November's vote—especially given polls' recent misses (e.g., last year's UK election). Struggling candidates could surge, while early favourites often slip. Plus, as we write, eight candidates remain in the fray.

A GOP Primary Primer

Early primaries are nigh, and the "silly season" is giving way to serious campaigning. On the GOP side, 11 candidates have withdrawn since September, winnowing the field to a still-robust six (as of this writing).

Even handicapping a likely pack of leading contenders seems premature. Polls highlight Donald Trump, Ted Cruz and Marco Rubio, but polling rarely predicts primary results, which hinge on turnout. Many primary voters remain undecided until the eleventh hour. Results in Iowa and New Hampshire—the first two contests—don't predict the eventual nominee, either. Iowa victors include Rick Santorum in 2012 and Mike Huckabee in 2008—yet Mitt Romney (finished second) and John McCain (finished fourth) took the Republican nomination. McCain won New Hampshire in 2000, as did Pat Buchanan in 1996. The eventual nominees—George W. Bush and Bob Dole—finished second.

Will people vote as they poll, or are they just blowing off steam? Only time will tell. Voters often say one thing in polls when considering hypotheticals, then do something else in the voting booth after weighing the likely ramifications of a certain choice.

Yet, globally, anti-establishment parties and candidates are rising. Though ideologies vary, all fuel the narrative of "outsiders" disrupting mainstream politics. Their results have been mixed. Greece's far-left Syriza won two elections in 2015, and leftist Jeremy Corbyn won the UK Labour Party's leadership. Far-left Podemos finished third in Spain's general election but cut deeply into mainstream parties' support. The eurosceptic UKIP (Britain) and Front National (France) made noise but fizzled when votes were tallied. This is a wild card potentially spooking sentiment.

Clinton's Challenges

Hillary Clinton likely wins the Democratic nomination, but she remains an atypical Presidential victor—especially for a Democratic candidate. The history of the President's party winning third terms goes against her. Since WWII, only Franklin D. Roosevelt/Harry Truman and George H.W. Bush extended their party's two-term stay. They also rode the coattails of an enormously popular predecessor, an edge Clinton lacks.

Plus, Clinton struggles to present a fresh, new image to mask her well-known political scars, perhaps why she hasn't pulled away from her primary challenger, Bernie Sanders. Against a stronger front-runner, the self-avowed socialist Senator who long refused to identify as a Democrat would stand little chance. This is why Democrats tend to favour fresh, blank-slate faces over battle-tested war horses—yet former Maryland Governor Martin O'Malley is an afterthought. This, like the GOP contest, is an upside-down race in an upside-down world.

What We're Weighing

For all the early races' abnormalities, the oddities likely fade, leaving a mainstream Republican against Clinton. Historical precedent includes the 1968 Democratic primary, when socialist Eugene McCarthy and populist Robert Kennedy (assassinated in the summer) dominated early, but the establishment Hubert H. Humphrey eventually won the nomination (losing the general election to establishment Republican Richard Nixon). Should this happen, we would expect traditional Presidential cycle market trends to apply: a positive election year, with US outperforming as the contest nears. (Exhibit 3)

Exhibit 3: The US Typically Outperforms as Elections Near

			31 May - 31 December Returns		
Year	Election Winner	Incumbent	US	World ex US	US Minus World ex US
1928	Hoover - R	Coolidge- R	21.8%	2.5%	19.3%
1932	Hoover - R	FDR - D	54.8%	11.4%	43.4%
1936	FDR - D	FDR - D	19.3%	2.1%	17.2%
1940	FDR - D	FDR - D	14.1%	10.5%	3.6%
1944	FDR - D	FDR - D	7.5%	-28.4%	36.0%
1948	Truman - D	FDR - D	-8.9%	-23.9%	15.0%
1952	Ike - R	Truman - D	11.4%	7.1%	4.2%
1956	Ike - R	Ike - R	3.3%	-1.0%	4.3%
1960	JFK - D	Ike - R	4.1%	3.2%	0.9%
1964	LBJ - D	LBJ - D	5.4%	-2.1%	7.5%
1968	Nixon - R	LBJ - D	5.2%	3.0%	2.2%
1972	Nixon - R	Nixon - R	8.0%	9.7%	-1.8%
1976	Carter - D	Ford - R	7.3%	1.8%	5.5%
1980	Reagan - R	Carter - D	22.0%	13.4%	8.6%
1984	Reagan - R	Reagan - R	11.1%	4.1%	7.0%
1988	Bush - R	Reagan - R	5.9%	12.5%	-6.6%
1992	Clinton - D	Bush - R	4.9%	-8.1%	13.0%
1996	Clinton - D	Clinton - D	10.7%	1.1%	9.6%
2000	GW Bush - R	Clinton - D	-7.1%	-7.7%	0.7%
2004	GW Bush - R	GW Bush - R	8.1%	16.4%	-8.3%
2008	Obama - D	GW Bush - R	-35.5%	-42.3%	6.8%
2012	Obama - D	Obama - D	8.8%	20.3%	-11.5%
		Average	8.3%	0.3%	8.0%
		Median	7.7%	2.8%	6.2%

Source: Global Financial Data, Inc., as of 21/01/2016. USA returns are the S&P 500 price index. Foreign is the GFD World Ex. US Price Index. 31 May – 31 December returns, 1928 – 2012.

Under this a traditional election scenario, a Republican victory could set up the "perverse inverse," markets' tendency to rally in election years when Republicans win, then deliver below-average returns the next. (Exhibit 4)

Exhibit 4: 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%				
	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., as of 22/01/2016.

The Republicans sweeping Congress would compound this by eliminating the bullish gridlock equities have enjoyed since 2011. As discussed in recent Review & Outlooks, while Congressional races are up for grabs, the GOP has some advantages. In the House, incumbents are tough to beat. In the Senate, the Democrats have the structural edge, defending fewer seats in states that voted Republican in 2008 and 2012. But winning a majority would require unseating very popular incumbents, including Rob Portman (OH), Chuck Grassley (IA) and John McCain (AZ). Marco Rubio's FL seat is likely another must-win. The Democrats must campaign almost flawlessly to seize the Senate.

On the flipside, if the Democratic nominee wins the Presidency and generates coattails, the Democrats could sweep. That could imply lower returns this year but stronger returns in 2017, as markets first fear radical change, then realise campaign pledges seldom become reality.

President Trump, Clinton Indictment and Other Possibilities

But what if abnormalities persist, or even come to fruition? What if Donald Trump wins? Most experts presume he will fade and an "establishment" candidate will triumph. But what if they don't? For all his bluster, we have no idea what a President Trump would actually do, and uncertainty could drive volatility.

But a President Trump also seems unlikely to cause a bear market. Equities move on policies, not personalities, and there is little evidence bellicose rhetoric translates into actual policy. Very little of Trump's stated agenda can be enacted by fiat. For example, Trump says he will renegotiate or end 1994's North American Free Trade Agreement. Yet this was an act of Congress that requires legislation to undo. Most legislators (in both parties) don't support this or other Trump proposals—making radical change unlikely.

There is also the possibility a third-party candidate (such as former New York Mayor Michael Bloomberg or even Trump) runs, like businessman Ross Perot did in 1992. Perot won almost 19% of the popular vote then—among the most successful third-party runs ever—but won zero Electoral College votes. More importantly for investors, his running didn't cause a bear market.

On the Democratic side, it is possible Clinton is indicted for past controversies after it's too late to not nominate her. However, scandal and legal troubles aren't foreign to the Presidency and needn't roil markets. Bill Clinton faced impeachment in 1998, yet the decade-long 1990s bull persisted. Nixon's resignation happened during a bear market but wasn't the proximate cause. And on the eve of 1992's election, the indictment of Caspar Weinberger, President Ronald Reagan's Secretary of Defense, brought allegations that George H.W. Bush lied about his involvement in the Iran-Contra Affair. Though later proven untrue, some Republicans argue this negative press contributed to Bush's defeat—regardless, the bull market proceeded on.

As campaigns escalate and rhetoric reaches fever pitch, don't get caught up in the bluster—with so much unknown, and so many competing proposals and viewpoints jockeying for attention, we are long on possibilities but short on probabilities. Markets move on probabilities, but for now, there is just noise. Later, as outcomes become possible to handicap, is the time to start considering more actionable takeaways.

NON-US DEVELOPED MARKET COMMENTARY

The UK Is OK

The UK's expansion continues apace, powered by domestic demand. UK GDP grew 2.0% annualised in Q4, a slight uptick from Q3's 1.8%.[xiii] Services once again drove growth, renewing long-running angst over a supposedly "unbalanced" expansion where heavy industry doesn't pull its weight. But this is a misplaced fear. Developed economies naturally become more service-based as they evolve, and the UK is behaving like most advanced economies. Moreover, while choppy industrial output stole headlines, the UK economy is multifaceted. Business investment rose 2.2% q/q in Q3 (expenditure data for Q4 aren't available in the preliminary estimate).[xiv] Trade, though uneven, is slowly grinding higher. And similar to the US, UK growth also looks likely to continue. Bank lending has been growing, with business lending positive—a sign companies are accessing capital to grow further. The UK's yield curve is positive and its LEI is also high and rising: both signs that counter recession fears.

The "Brexit" Wild Card

Negotiations to reform Britain's EU membership are heating up, with talks set to top the agenda at the 16-17 February EU summit. Though both sides have high incentive to complete a deal, early rounds have been tense, and PM David Cameron and European Commission President Jean Claude Juncker have suggested they could stretch on. Without knowing what the final agreement will entail, it is impossible to handicap the referendum on EU membership. The vote is a wild card for UK markets, but for now there is too much noise, and we don't believe any of it is actionable for investors.

Sound and Fury, With Little Substance

World leaders, financial luminaries and market forecasters have all weighed in on the potential consequences of "Brexit." Bank of England Governor Mark Carney warned leaving the EU could reduce demand for gilts, driving up Britain's borrowing costs.[xv] German Finance Minister Wolfgang Schäuble called it a potential "disaster" for the EU, and French Prime Minister Manuel Valls claimed the union "could fall apart within months" if Britain goes.[xvi] Deutsche Bank forecasters warned Brexit would consign continental Europe to "second rate status."[xvii] For Britain, Bank of America predicted a run on the pound, whilst Credit Suisse warned of "immediate and simultaneous economic and financial shock."[xviii]

These warnings are eye-catching and alarming, but premature. Some are dubious on their face. Not only is it impossible to predict the referendum at this juncture, but without knowing the terms of the final deal, it is impossible to assess whether staying or going would be a net benefit. The EU is a free-trade marvel, and being its financial hub helped catapult London to its position as the world's pre-eminent financial centre. But creeping EU financial regulations threaten the Financials sector's competitiveness. Whether continued membership is beneficial will likely depend on how this and other tax and regulatory issues are addressed, as well as what terms of trade Britain would face if it were to leave. Tellingly, UK businesses have no uniform view on the matter. As The Telegraph recently noted:

> *YouGov spoke to top executives at 11 FTSE 100 organisations (such as BT, Whitbread, Diageo, HSBC and Centrica), three FTSE 250s and two privately owned companies. Only one of the top FTSE executives backed Brexit; interestingly, however, just five of the 11 companies have a public position on the matter. In stark contrast, one out of the two bosses at the privately owned firms (Sir Rocco Forte, the hotelier, as it turns out) backed Brexit. As to the 501 owners and managing directors of smaller firms also polled by YouGov, a small plurality of 47pc are in favour of staying, while 42pc want to leave, which was strikingly balanced.*[xix]

Plus, in the event of a vote for Brexit, the UK probably wouldn't leave the bloc overnight. EU treaties currently don't have an exit provision, and it would likely take time to agree on one, particularly considering how intertwined the UK's economy and financial sector have become with the rest of Europe. The lengthier this process, the more time markets would have to discover and adapt to the change, likely reducing the shock factor.

Polls Aren't Predictive

Unsurprisingly, early polling is all over the map. Some late-2015 polls showed "Remain" firmly ahead, some showed "Leave" with a solid lead, and some were a dead heat. We wouldn't read into any of it.

In the referendum, voters will weigh in on the UK's renegotiated EU membership. None today know what that relationship will entail, so it is impossible for voters to consider the ramifications of staying or leaving. Polls today reflect feelings about broad hypotheticals. Very early polling in the Scottish and Quebec independence referendums gave the edge to the pro-independence movements, but in both cases, the status quo won resoundingly. When considering the actual pros and cons of independence, many voters did an about-face from their earlier inclinations. Also telling, nearly all the polls place 10-20% of voters in the undecided category.

Additionally, the UK polling industry is in a state of flux. An academic investigation of the inaccurate polling for last year's general election suggested pollsters broadly had trouble gathering representative samples of the electorate, and they are still trying to refine their methodology. Online polls have gained prominence as voters become more difficult to reach over the phone, but online polls have limitations. Participants self-select and tend to be more plugged in politically than the broader electorate, which can skew the results. That is potentially a crucial factor in the EU referendum polling, as there is some evidence the general public isn't tuning into the debate. According to Google Trends, whilst Internet searches for Brexit and the referendum have risen, they are dwarfed by queries for the Six Nations tournament, Premier League, Strictly Come Dancing and other events. Though this analysis is obviously unscientific, it is a good sign public interest isn't there yet. It will be, when the vote nears, but that is months away at least.

The Eurozone's Underappreciated Growth Continues

The eurozone's underappreciated recovery continues. The region has grown for 10 straight quarters—most recently rising 0.3% q/q in Q3—and growth is increasingly broad-based.[xx] Countries both big and small are expanding, and former laggards are now among the top-performing economies. French GDP grew 0.2% q/q (1.0% annualised) in Q4 and 1.1% for 2015 while Spain grew 0.8% q/q (3.2% annualised) in Q4 and 3.5% for the year.[xxi] The latest data show Germany grew by 1.7% last year while Ireland, the region's fastest-growing economy, grew at 9.2% annualised in Q1, 7.8% in Q2 and 5.6% in Q3—all fast rates.[xxii]

Despite modest economic growth, improving lending and swift money supply growth, inflation remains near zero, stoking deflation fears. In our view, the "deflationary spiral," in which falling prices of goods and services perpetuate further falling prices, is a myth. Deflation has a perfectly good explanation: falling oil prices, which have dragged down headline CPI readings globally for more than a year now. Stripping away volatile energy and food prices, "core" CPI has been much more benign.

However, weak inflation did prompt the ECB to extend its quantitative easing (QE) programme in October—another example of central bank policy hindering growth. Originally slated to end in September 2016, the ECB's QE will now run at least through March 2017 barring further changes. Yet QE hasn't boosted growth or inflation thus far. We also doubt it will, as extending QE is like pushing on a string. The theory: buying up long-term bonds—and lowering long-term interest rates—stimulates demand for new loans. This allegedly leads to increased lending, and as a byproduct, higher inflation. Yet as was the case in the US, UK and Japan, QE is no economic stimulant—it flattened the yield curve, discouraging banks from lending.

The same is the case with negative interest rates, which the ECB implemented in 2014. The Bank of Japan (BoJ) announced a similar policy at the end of January, and Sweden's Riksbank cut rates deeper into negative territory in February. Negative rates are theoretically supposed to push banks to lend, since reserves held at the central bank carry a penalty. However, rather than lend, banks bought sovereign debt instead—bringing down long-term interest rates further (and flattening the yield curve more).

Relatedly, EU banks are under pressure from fears over weak profits and, in a few cases, capital ratios. This is driving up yields on contingent convertible ("coco") bonds and driving down bank share prices. However, this isn't 2008. Bank balance sheets are smaller, capital ratios are higher and non-performing loans are down. Fears over banks' profits are far removed from a bank panic, which are based on liquidity fears—yet liquidity is abundant and balance sheets are cash-rich. We believe concerns here are primarily sentiment-driven, not a sign of broader trouble.

These minor headwinds and fears needn't stunt eurozone growth, which has plenty of cyclical drivers going in its favour. While not gangbusters, M3, the eurozone's broadest money supply, has been rising, as has household and business lending—particularly in nations that have worked through most of their banking issues. Eurozone LEI is also in a long-term uptrend, suggesting more growth—though choppy—is likely.

Portugal

Portugal's post-election stalemate finally settled in November, when the Socialist Party secured Parliamentary support from the far-left Communist Party and Left Bloc to form a minority government. Socialist Party leader Antonio Costa became Prime Minister, and has since set about rolling back some of the bailout-era austerity measures. Portuguese yields have risen since then, diverging from most other eurozone yields, perhaps registering some market discomfort with the early policies. However, EU budget rules and the reality of an unstable government probably limit the ability to undo past reforms, and the likelihood the changing of the guard raises the risk of a disorderly eurozone breakup is exceedingly low.

The new government has started out with a bang, reinstating four public holidays (that had been canceled as part of the bailout-related reforms), unwinding some privatisations, and submitting legislation to undo public sector labour market reforms. This has understandably raised questions about Portugal's competitiveness, but the EU's budget policing powers likely provide a leash. Brussels has already taken issue with many provisions of the 2016 budget, citing "big differences" in their assessment of Portugal's growth prospects if these changes take effect. The need to compromise and honor EU commitments likely prevents much radical change.

Even if Portugal does slip, it is just 1.74% of eurozone GDP [xxiii] and 0.50% of MSCI European Economic and Monetary Union market cap [xxiv] —likely too small to move the needle. Its recent economic success is a testament to the speed with which the eurozone periphery worked its way back, but the eurozone can keep growing without Portugal firing on all cylinders.

Some fear Portugal's debt troubles could resurge, but this seems premature for now. Even with the recent rise, 10-year yields remain near euro-era lows, at 2.98% as of 02/02/2016. Should things snowball and Portugal be forced back to the bailout negotiation table, some fear the government could have a standoff similar to Greece's last year, but the current administration is less radical than Greece's, who ultimately capitulated to EU demands.

Spain

Prime Minister Mariano Rajoy's Popular Party won the most seats in December's election but lost its majority, and the outcome remains unsettled. Rajoy's overtures to Socialist Party leader Pedro Sánchez to form a grand coalition were unsuccessful, and the centrist upstart Cuidadanos—PP's natural ally—didn't win enough seats to form a joint majority. Thus, Rajoy declined the King's offer to form a government in late January.

It is now Sánchez and the Socialists' turn to try, and they have two months before new elections must be called. Sánchez has called on the far-left upstart Podemos and other smaller parties to form a "progressive government for change," but reaching agreement will be difficult. Podemos's manifesto calls for independence referendums in Catalonia, the Basque Country and Galicia, which the Socialists oppose. Additionally, this coalition would require the support of the Catalan and Basque nationalists, and the Catalan parties have said they won't join a coalition that includes Podemos.

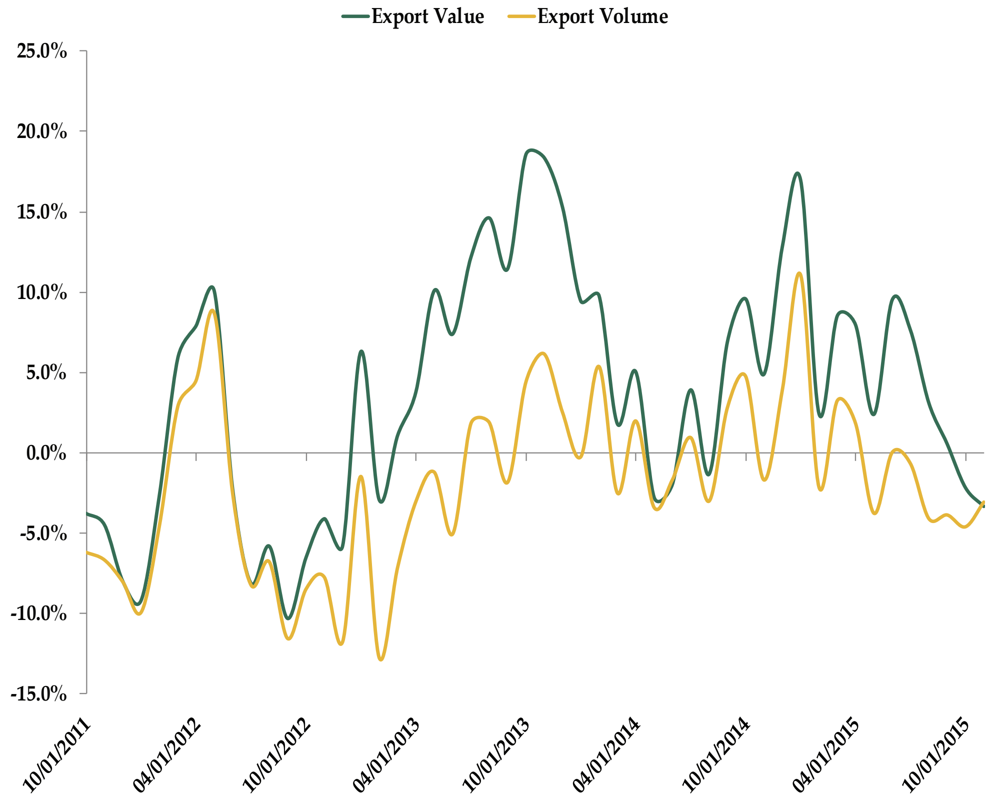
Politicians cross red lines all the time, and these positions are only the starting point for negotiations. Compromise could emerge, but any government formed would either be a minority government or have strongly conflicting views, making new elections likely whether or not near-term agreement is reached.

While political uncertainty could create short-term volatility, Spain's economy is in a decent position to weather the storm. Political gridlock might be positive, as it won't allow a new government to sweep in and reverse positive reforms, like those focused on labour markets.

Japan: No Dawn in Sight for the Land of the Rising Sun

Japan, however, remains the developed world's weak link, and we don't expect that to change looking forward. Japan's 2015 recession was revised away after Q3 GDP was updated from -0.8% annualised to 1.0%, but economic data still look weak.[xxv] Household spending fell -4.4% y/y in December after a -2.9% decline in November. The BoJ's monetary policy—through its massive quantitative easing programme and negative interest rates, announced in January—has failed to stimulate growth as officials hoped. By deliberately weakening the yen, the BoJ aimed to boost growth through increased exports. However, though export values got a temporary boost, volumes have not. Export volume growth has fallen or remained flat for eight straight months (Exhibit 5), evidence of monetary policy's failure to generate sustainable growth.

Exhibit 5: Monthly Japanese Export Volumes



Source: FactSet, as of 31/12/2015.

Sustained growth will require structural reforms, and progress here remains lacking. Near-term prospects look bleak after Economy Minister Akira Amari—the supposed champion of structural economic reforms—resigned due a corruption scandal. This raises the question of whether his replacement, Nobuteru Ishihara, can expedite passage or will face delays as he adjusts to the role—we believe the latter is likelier. Japan continues relying on monetary stimulus alone, which hasn't worked. The BoJ changed tack in January, adopting a negative interest rate on excess reserves to try and spur banks to lend. But negative rates didn't spur anything in Europe. Banks moved reserves from the central bank to sovereign debt, opting for low-risk return, instead of backing aggressive new lending. In our view, Japan's struggles likely continue—better investment opportunities remain elsewhere.

EMERGING MARKETS COMMENTARY

While several high-profile, commodity-reliant countries continue struggling, Emerging Markets (EM) overall aren't uniformly impacted. Many fixate on oil-heavy EMs and overlook those with larger services sectors and healthy consumers. This latter group—larger than commodity-reliant EMs—benefits from weak commodity prices, a vastly underappreciated factor. For every Peru hampered by weak metals prices, an Indonesia offsets, plus some. For every Russia—locked in a deep, oil-driven recession—a larger India benefits from weak commodity prices. Brazil is an economic quagmire, but China is vastly larger and, despite fears to the contrary, growing at a steady pace. Overall, the underappreciated Emerging Markets story is differentiation. Investors broadly still paint EMs in broad, categorical brushstrokes, obscuring strength and weakness. The more discerning investor who digs into country differences and analyses drivers at a more granular level likely finds sentiment very disconnected from a much more robust reality—opportunity abounds.

China—Smoke but No Fire

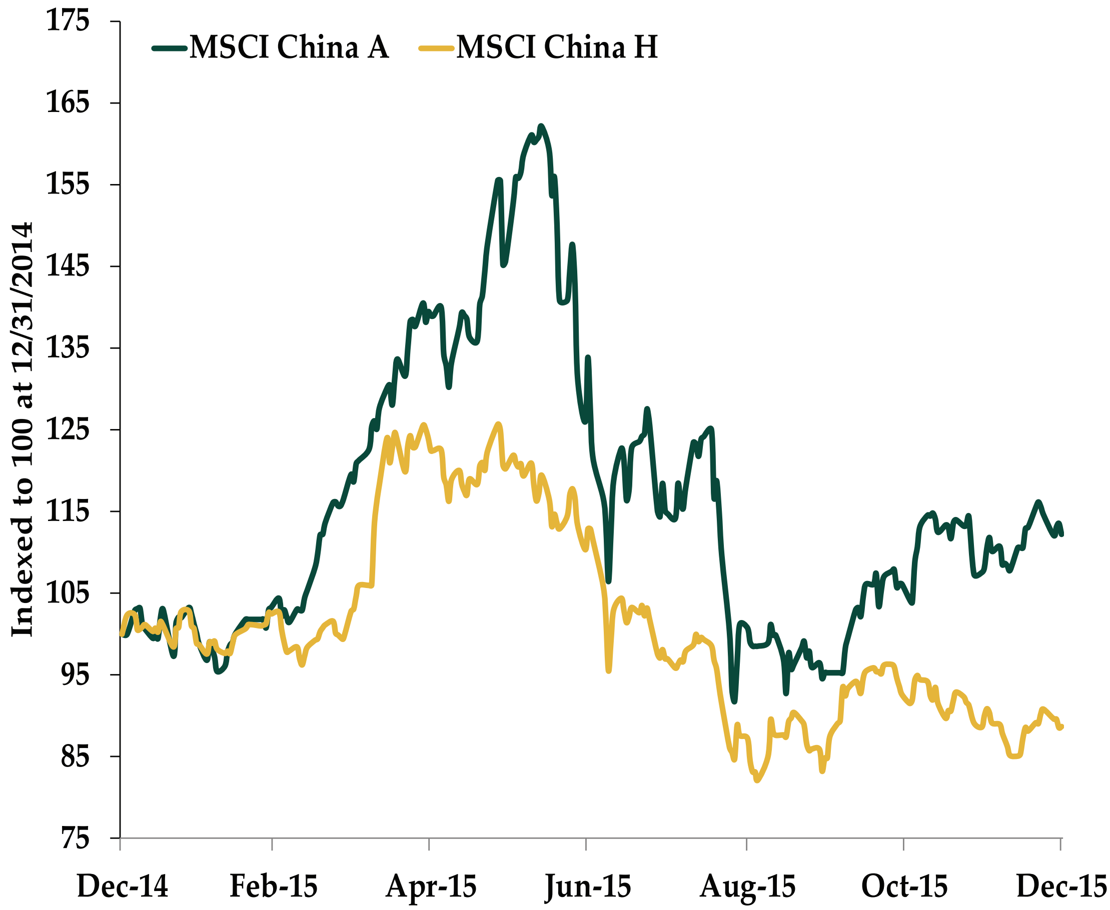
China "hard landing" fears lingered in Q4 and escalated anew as January's volatility rekindled late 2015's global correction. Much of the discussion isn't really new—most fears are tied the four-year old economic slowdown, with many now fretting China's government has lost control over. As evidence, they cite the falling yuan, regulatory back-and-forth (illustrated most dramatically with the creation and subsequent deletion of A-share "circuit breakers"), continued volatility and economic data showing slowing growth.

However, most news isn't truly new at all—we covered nearly all of it in last quarter's Review. Economically, the slowing data are largely a side effect of the long-running attempt to shift the emphasis from heavy industry, infrastructure and export-led growth to services and domestic consumption. With respect to economic and currency-related reforms, while there have been some missteps, they are minor compared to the global and local positives of a more open, less-government controlled Chinese economy. We continue to believe the volatility hitting Chinese equities isn't a signal the long-feared hard landing is approaching.

A-Share Volatility and China's Broken Circuit Breaker

After Q3's sharp volatility, Chinese markets stabilised in Q4, capping a wild year. (Exhibit 6) In keeping with their wild tradition, A-shares rose a whopping 53.2% in the quarter, putting full-year gains at 12.1%.[xxvi] H-shares, the less volatility share class predominantly owned by foreign investors, closed the quarter up 4.0%, paring the full-year decline to -11.6%.[xxvii]

Exhibit 6: China A- and H-Shares in 2015



Source: FactSet, as of 01/02/2016. MSCI China A and MSCI China H Indexes, 31/12/2014 – 31/12/2015.

In January, though, volatility returned right out of the gate, stoking concerns over China's economic health. As we type, A- and H-shares are down -23.9% and -13.6% on the year, respectively. [xxviii]

A-shares' decline seems to have been exacerbated by the China Securities Regulatory Commission's (CRSC's) attempt to quell volatility by installing a "circuit breaker." This mechanism, implemented on January 1, was designed to halt trading for 15 minutes if the index fell -5%. After the delay, which regulators saw as a cooling-off period of sorts, equities would reopen for trading. If they continued falling and hit -7%, markets would close for the day. For contextual purposes, the S&P's circuit breaker thresholds are 7%, 13% and 20%—substantially larger thresholds for a historically less volatile index.

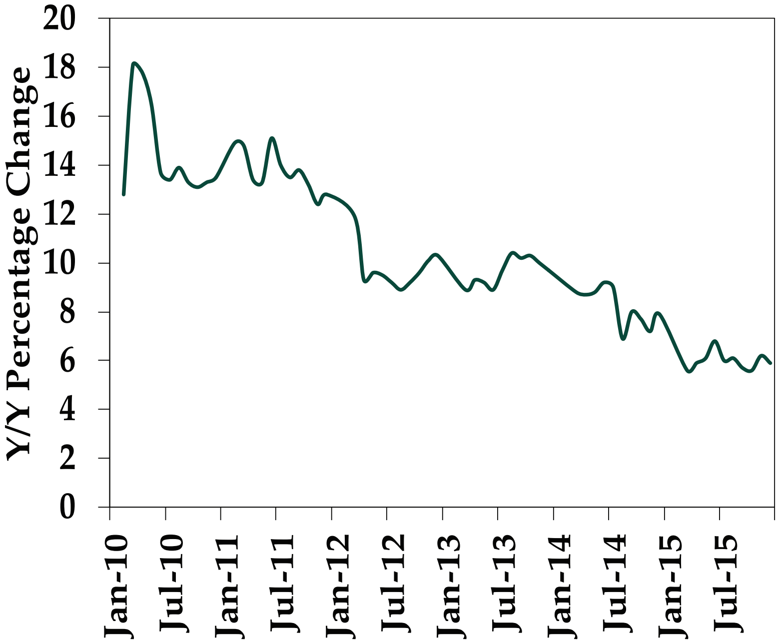
In practice, however, the newly implemented system backfired. On January 4—the year's first trading day—equities hit -5% and the 15-minute pause kicked in. When markets reopened, it appears as though traders used the break to queue up sell orders, fearing they would be unable to exit. The -7% mark was reached within minutes—shuttering markets for the day. The same pattern was repeated only three days later. Upon reviewing market behaviour, the CRSC decided to eliminate the circuit breaker. This hasn't eliminated the volatility, but it seems to have removed some uncertainty driven by the clumsy tool.

The Engineered Economic Slowdown

The rocky start to the year comes against a backdrop of prevalent fears regarding China's economic health. However, like last quarter, there are few signs indicating long-existing trends in Chinese economic growth have suddenly taken a turn for the worse. Rather, data suggest a continuation of gradually slowing overall growth as a side effect of the government's effort to shift the economy's emphasis from export and heavy manufacturing-led growth to services and consumption.

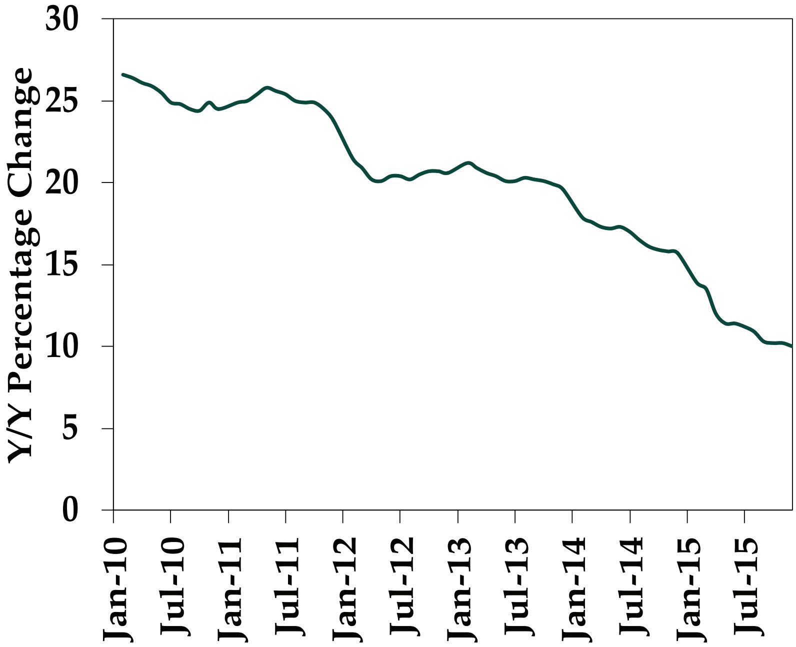
Q4 2015 GDP data illustrate this point. Headline growth slowed incrementally to 6.8% y/y from Q3's 6.9%—full-year data show a similar slight deceleration from 7.4% to 6.9%. Much of the slowdown stemmed from weaker exports, slower growth in industrial production and a slower pace of urban fixed-asset investment growth. (Exhibits 7 & 8)

Exhibit 7: Industrial Production



Source: FactSet, as of 05/02/2016.

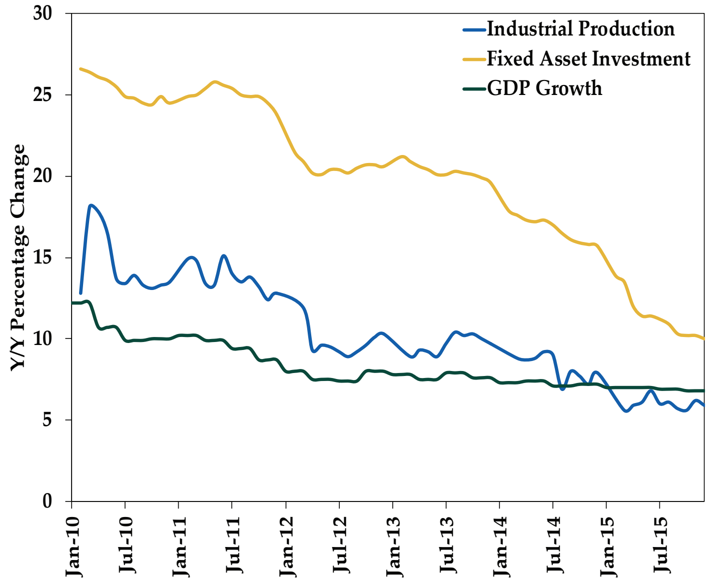
Exhibit 8: Urban Fixed Asset Investment



Source: FactSet, as of 05/02/2016.

Unsurprisingly, decelerating growth rates in industrial production and fixed investment bear a striking resemblance to GDP's overall slowdown in roughly the same timeframe. (Exhibit 9)

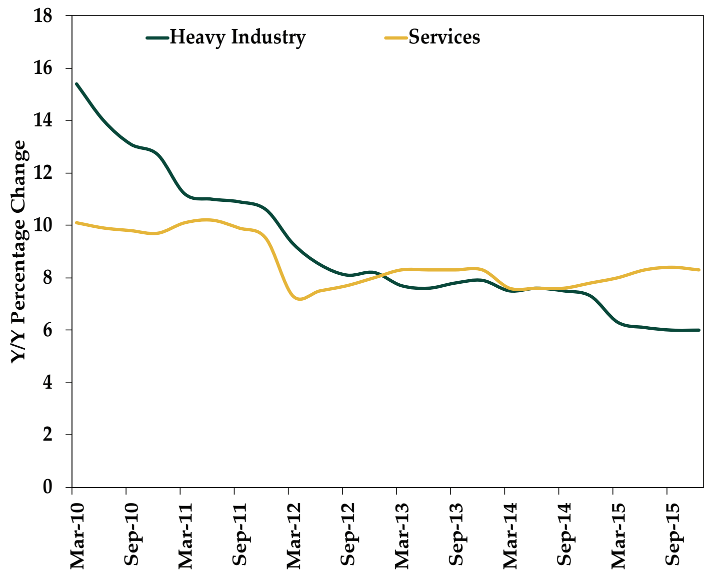
Exhibit 9: Fixed Asset Investment, Industrial Production and GDP



Source: FactSet, as of 05/02/2016. Fixed Asset Investment, Industrial Production and quarterly GDP at year-over-year rates, January 2010 – December 2015.

As Exhibit 10 shows, this trend dates back to at least 2010—it is neither new nor surprising. What's more, fixed asset investment and industrial production have slowed much more markedly than GDP, as the latter is boosted by growth in services and domestic consumption. In 2015, more than half of Chinese economic output came from the Services sector. While many still cling to the idea China is the world's assembly line, reality has been shifting for years.

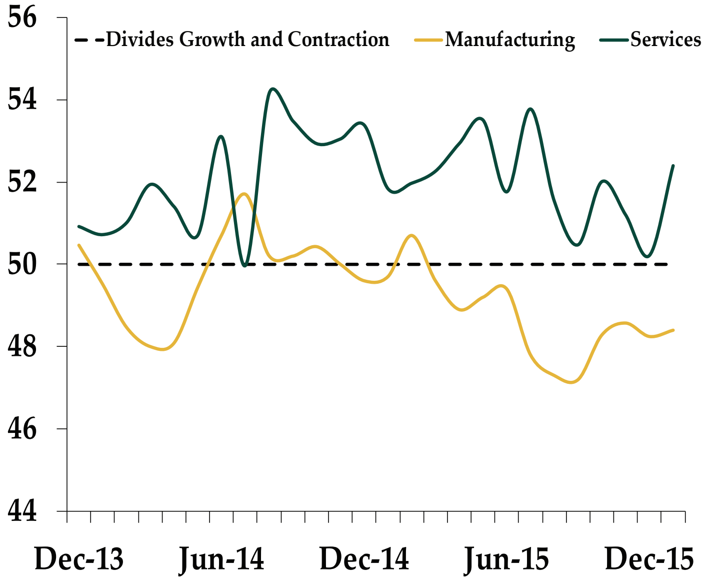
Exhibit 10: Services vs. Heavy Industry



Source: FactSet, as of 01/02/2016.

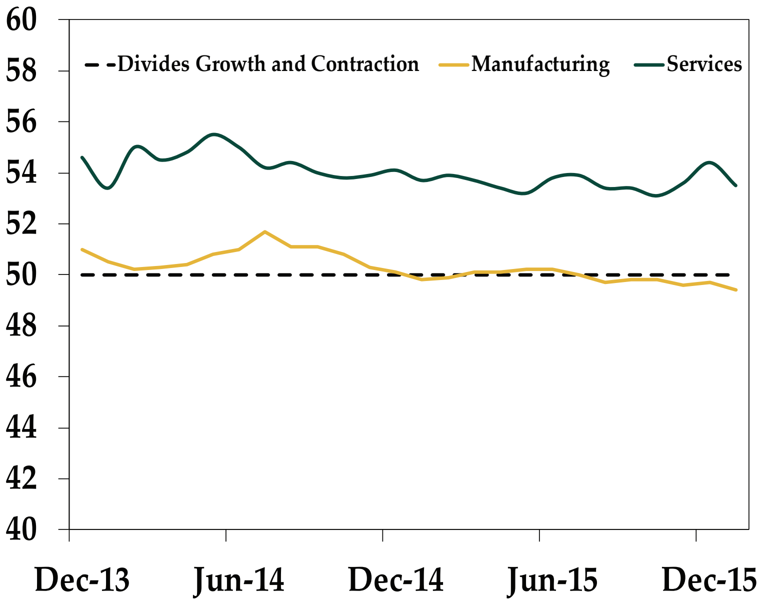
Purchasing Managers' Index data and retail sales echo this point. Manufacturing PMIs (both the government's official gauge and Caixin/Markit's version) flip in and out of contractionary territory, but services gauges consistently point to growth. (Exhibits 11 & 12)

Exhibit 11: Caixin Markit PMIs



Source: FactSet, as of 05/02/2016. December 2013 – January 2016.

Exhibit 12: Official PMIs

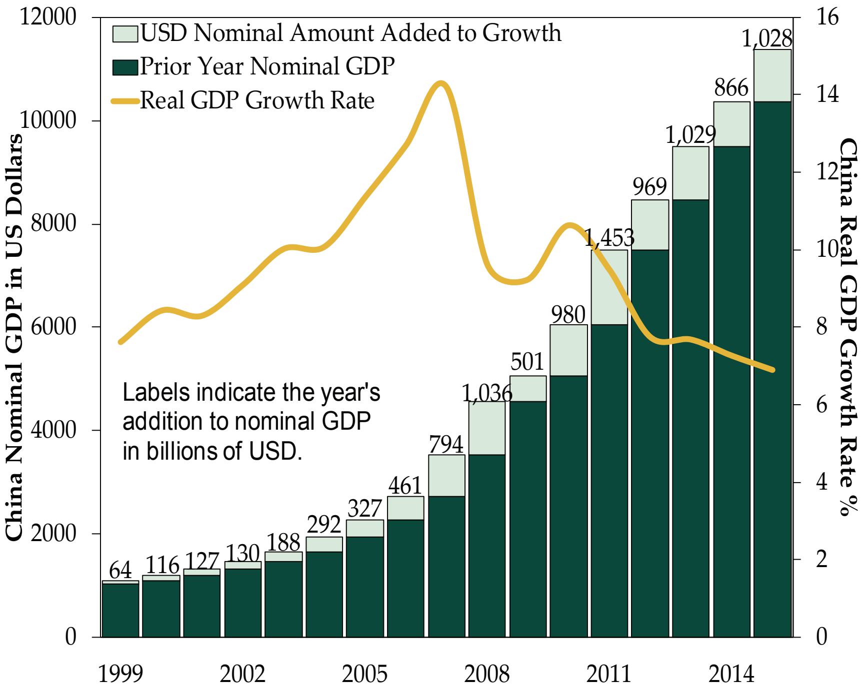


Source: FactSet, as of 05/02/2016. December 2013 – January 2016.

While import data show falling growth rates, this is heavily impacted by commodity prices. Oil imports (in millions of tons) rose 8.8% in 2015, with December imports rising 9.3%, according to the Customs Administration. The world's largest commodity export terminal, Australia's Port Hedland, sent 32.2 million tons of iron ore to China in December 2015—a 5% y/y gain, capping off a record year.[xxix] While January dipped slightly, this seems to have been the result of the port being shuttered due to an approaching cyclone. Australia is China's largest supplier of iron ore, providing more than half of China's iron ore imports. Such data suggest Chinese import decline is a function of the global commodity supply glut—domestic demand is fine.

While China's absolute growth rates have slowed, it is worth remembering they build off of a bigger base. Hence, despite the slower rate, China continues to add hundreds of billions of dollars to its GDP—essentially adding the equivalent of a country like Norway to global GDP every year. (Exhibit 13)

Exhibit 13: In Dollar Terms, China's Growth Hasn't Slowed Much



Source: FactSet, International Monetary Fund, as of 05/02/2016.

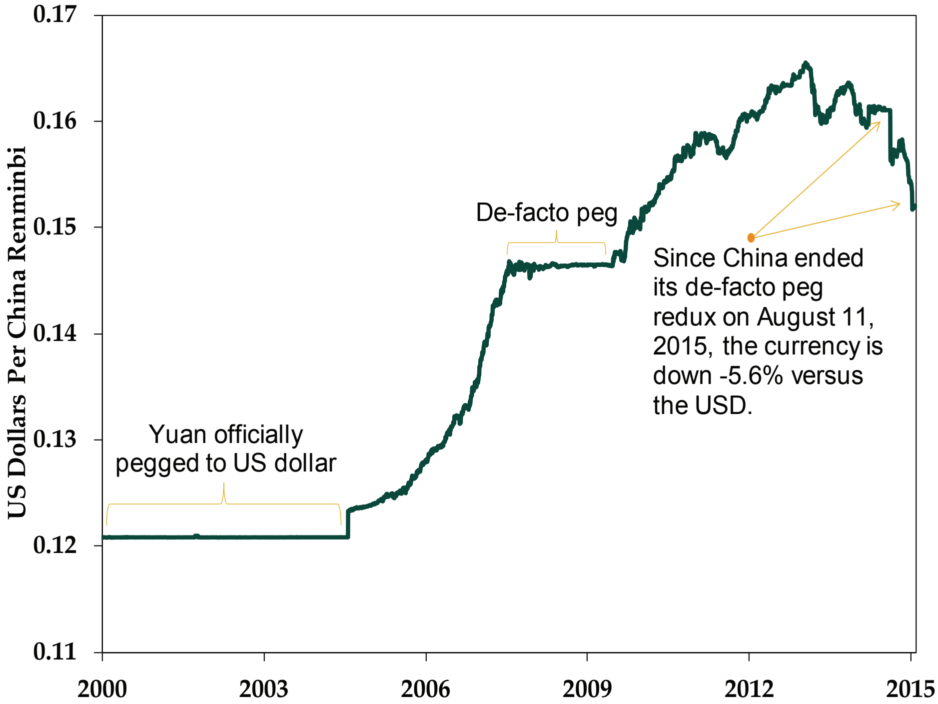
Currency Devaluation Is Overstated

Last 11 August, the central bank caused a stir when they set the yuan's reference rate (the midpoint for that day's trading) -2% below the prior day's close and changed how the yuan would trade moving forward. Instead of setting the reference rate directly, officials said it would be based on the previous day's closing price and market makers' quotes. The daily trading band would remain at +/- 2%, though aside from that limit, the change nominally injected more market forces into the currency. Since then, policymakers have allowed the yuan to depreciate gradually, while reportedly intervening to slow the pace at times.

In January, the People's Bank of China outright set the reference rate lower in two successive days, which, like August's move, many misinterpreted as a desperate move to stoke exports or other parts of the economy. But this seems like a stretch. The yuan's decline from last 10 August to today is tiny—far too small to materially boost exports.

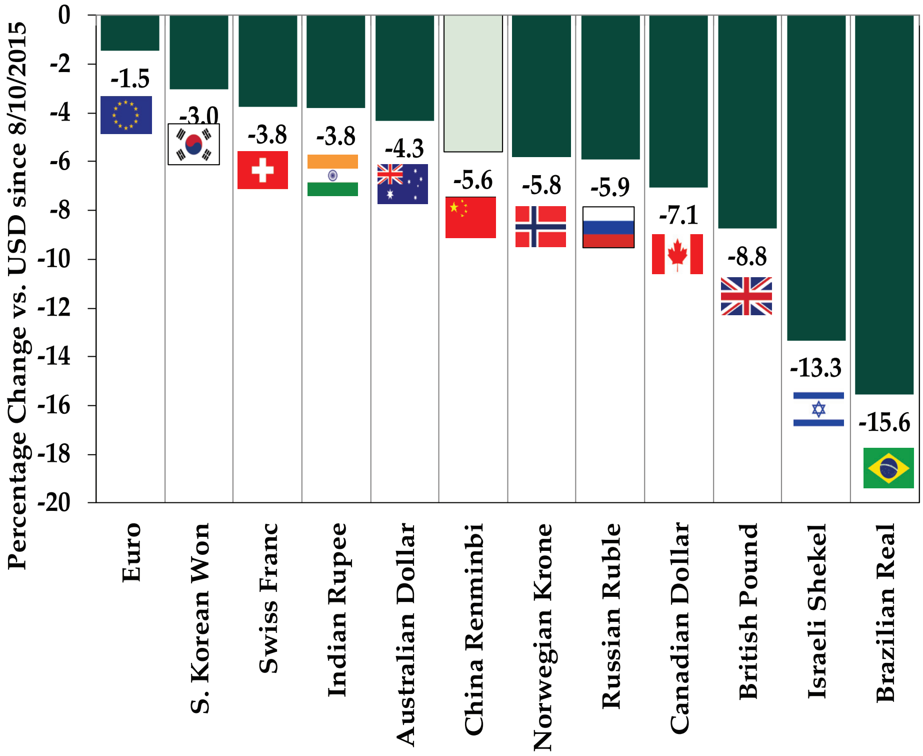
Exhibits 14 and 15 put the yuan's recent move into perspective. Though it's down -5.6% versus the US dollar since last 10 August (as of 31/01/2016), it's still significantly higher than where it was for much of the 2000s. Also, that -5.6% decline is a smaller move than a handful of other world currencies over this period. The yuan simply isn't cratering.

Exhibit 14: The Yuan Since 2000



Source: FactSet, USD/RMB exchange rate, 29/12/2000 – 31/01/2016.

Exhibit 15: Selected Major Currencies vs. the US Dollar Since 10/08/2015



Source: FactSet, as of 05/02/2016.

Lost in the confusion over China's weakening yuan is that it is resulting from market forces—exactly the kind of reform Western leaders and investors are hoping to see. This is why China has drawn down its currency reserves some—to prop up the yuan after introducing more leeway into the system. Communication around the concept could have been better, but this is a step in the right direction, not a misstep.

Many, seeing China draw down reserves to support the yuan, fear China rapidly depleting reserves. While it is true China's reserves have fallen from roughly $4 trillion to roughly $3.2 trillion, it is worth noting this has taken place over a 20-month period of time. Moreover, should the leadership reduce its interventions in the currency markets as planned, it is likely the strain on forex reserves would be mitigated. That hasn't happened as yet, largely due to sentiment-based volatility striking China's currency. But it is highly unlikely trillions worth of reserves would be depleted in short order.

Qualified Foreign Institutional Investor Reforms

In late January, China announced the biggest overhaul to its QFII programme, the inbound investment programme for foreigners, since its launch in 2003. QFII will no longer be subject to individual quotas assigned by the regulator. Instead, all QFIIs will be allowed to invest roughly 20% of total assets into China without special permission. An institution will still need to apply for permission if it wishes to exceed this amount.

Total QFII quotas have grown steadily from $22 billion in 2011 to $81 billion at the end of last year—still small in the scope of China's economy and markets. But, interestingly, this goes a long way toward removing the major impediments to MSCI including A-shares in its Emerging Markets gauges.

Coupled with the moves to restrict capital outflows like restricting Chinese citizens' purchase of certain insurance policies, sceptics are noting that this move seems an attempt to boost the yuan. While possibly true, we'd suggest the earlier example of yuan reform suggests it is merely a very gradual, cautious reform with much more permanency than temporary measures enacted to address short-term currency issues. Ultimately, we believe reforms such as these exemplify the gradual, "two steps forward, one step back" reform approach the government has long employed, and are a vastly underappreciated positive.

Brazil—Economic Troubles

Brazil's economic headwinds persisted throughout 2015, and they don't look likely to abate any time soon. Falling oil prices have pounded the sizable Energy sector of Latin America's largest economy. Brazilian GDP contracted -1.7% q/q (-6.7% annualised) in Q3, and this third straight quarterly drop pushed Brazil into its longest recession in over 75 years.[xxx] More recent data confirm Brazil's economic struggles. Industrial production continues falling as low commodity prices wreak havoc on Brazil's Energy and Materials sectors, and for 2015, the gauge dropped -8.3%.[xxxi] Retail sales remain mired in a slump, down -7.8% y/y in November 2015, illustrating consumers' struggles.[xxxii] And inflation has broken double-digits and hit 12-year highs, causing the Brazilian Central Bank to hike interest rates—tightening the screws on money supply.

While political troubles have weighed on sentiment—as we discuss momentarily—this fundamental backdrop would be a powerful negative regardless. Even a strong government would struggle to offset this influence, illustrated well by Q2 and Q3 2015 data. Government consumption rose in both quarters, 3.0% and 1.1% annualised, respectively.[xxxiii] Yet GDP fell -8.0% and -6.7% annualised.[xxxiv] With metals and oil supply gluts persisting, it is unlikely these headwinds turn soon. Some believe the upcoming Olympics will jolt consumption, but this seems overly optimistic. Historically, Olympics hosts don't receive meaningful boosts from the games, just as Brazil didn't get much of a bump from hosting 2014's World Cup. Unfortunately for Brazil, economic and political drivers look dim in the near-future—and in our view, Brazilian equities likely continue struggling.

…and Political Troubles

Brazilian politics took some wild turns in Q4, with the impeachment threat against President Dilma Rousseff mounting and Finance Minister Joaquim Levy being replaced after less than a year on the job. While the scandals and turnover raise questions about economic policy, they are likely a secondary factor for Brazilian equities for the foreseeable future. With or without pro-market reforms, the commodities downturn continues weighing heavily on Brazil's economy and markets.

As most observers expected, in October the electoral court opened an investigation into Rousseff's 2014 campaign financing, attempting to discover whether some donations were actually kickbacks. Separately, the federal audit court recommended Congress reject the administration's accounts for 2014, alleging the widening deficit was disguised ahead of the election. Together, these developments increased the impeachment threat, but for the time being, Rousseff appears to have the votes to survive.

In mid-December, Brazil's lower house did form a committee to review the opposition's impeachment request, though this procedural move doesn't necessarily boost the chances of Rousseff's ouster. The closed-door vote was immediately challenged by the Supreme Court, which argued it was unconstitutional, and one week later the court decided in Rousseff's favour. Judges ruled that any vote to form an impeachment committee must be open, and the Senate will have the final say.

The numbers appear to be on Rousseff's side. While the closed-door vote was seen as surprisingly anti-Rousseff, it also wasn't surprising, as the opposition controls the lower house. Notably, the vote won with only 272 votes, while 342 are necessary to move forward with impeachment in an open vote. If the opposition can't get the necessary two-thirds majority in a secret vote, it's conceivable that they'll never be able to move the process to the Senate. Even if they do, government allies hold the balance of power in the Senate, reducing the likelihood of a conviction.

Regardless of the outcome, any resolution would help reduce uncertainty, perhaps an incremental positive. While Rousseff's policies aren't market-friendly, if these proceedings are resolved in her favour, markets will at least know who will be in charge and what to expect for the next few years. However, we wouldn't expect a massive tailwind here. Even if Rousseff regains political capital, Brazil's budget has little capacity for fiscal stimulus, and double-digit inflation prevents the central bank from doing much. As long as the commodities downturn continues pressing Brazil, the country will likely keep underperforming most other Emerging Markets.

India

India is one of the big winners from falling commodity prices, and with the Modi administration making incremental progress with economic reform, positive drivers persist for one of EM's largest economies. India grew a robust 7.3% y/y in Q4 2015, slightly slower than the prior quarter's 7.7% rate.[xxxv] Private consumption drove growth, rising 6.4% y/y.[xxxvi] Though headlines focus on how India's growth rate now exceeds China's, this is a trivial point. What matters more: One of the biggest EM economies is expanding, bolstered by weak Energy and commodities prices.

Besides an expanding economy, many of Prime Minister Narendra Modi's economic reforms have progressed—meaningful incremental positives for long-term growth. Some examples: a proposed uniform goods and services tax, aimed to reduce uncertainty caused by huge regional tax policy variations; the easing of foreign direct investment restrictions; and bankruptcy reform, which seeks to speed up the process. Now, not all these reforms are finalised yet—the uniform tax must still be approved by Parliament, and implementation at the state and local level is always a wild card in India, whose government is heavily decentralised. Also, regional elections in some economically impactful regions loom, and if Modi's Bharatiya Janata Party doesn't fare well, it could cost him some influence in passing more reforms. But ultimately, for equities, Modi seems to focus on smaller, achievable reforms rather than the big talk and little action of past administrations. While small moves won't shatter the calcified scepticism generated by earlier administrations' big talk and little follow-through, it is a backdrop for positive surprises to pile up—a tailwind for equities.

Korea

Korean economic growth picked up in the second-half of the year after the Middle East Respiratory Syndrome (MERS) scare subsided. After the economy grew at a 1.3% q/q rate (5.3% annualised) in Q3—the fastest pace in more than five years—GDP rose another 0.6% q/q (2.3% annualised) to close the year.[xxxvii] Though growth hasn't been strong across the board—investment, and in particular construction, has been a bit weak—consumer spending is firm. Private consumption rose 1.5% q/q (6.0% annualised) in Q4, up from Q3's 1.2%.[xxxviii] And for 2015, private spending—which includes households and non-profit institutions serving households—was up 2.1%, the fastest rate since 2011.[xxxix] Korean consumers are in good shape, and the country is yet another EM benefitting from low commodity prices.

Other Emerging Markets

The performance of other EM economies further highlights the divide between commodity-reliant EMs and more diverse economies. Consider Indonesia, Mexico and Russia. Even though Indonesia and Mexico have sizable Energy sectors, they also have growing services sectors and robust consumer demand, helping offset the drag from low oil prices.

Indonesia does have a sizable Energy sector, and in Q4, it announced it would rejoin the OPEC. Yet Indonesia is a net oil importer, consuming twice as much as it produces—the country benefits from lower prices. In 2015, Indonesian GDP rose 4.8% y/y (5.0% y/y in Q4) as private consumption (5.0% y/y for 2015, 4.9% y/y in Q4) and government spending (5.4% y/y for 2015, 7.3% y/y for Q4) supported growth.[xl] Q4's rise in government spending is notable since it signals President Joko Widodo's big investment push to improve Indonesia's infrastructure—a major campaign pledge—is finally taking off.

Similarly, despite Mexico's big Energy sector, Q4 GDP grew 0.8% q/q (3.0% annualised), accelerating from Q2's 0.6%, as Mexican consumers drove growth. An early read on Q4 growth published in late January suggested GDP grew 0.6% q/q and 2.5% for all of 2015—the fastest in three years. While industrial production barely grew, services offset, expanding 0.9% q/q (3.5% y/y) in Q4.[xli]

Compare these to oil-reliant Russia, where GDP contracted -3.7% in 2015.[xlii] The country remains mired in recession, with consumers taking the brunt of the blow. Retail sales dropped -15.3% y/y in December as double-digit inflation continued sapping consumers' purchasing power.[xliii] And considering the lack of diversification in Russia's economy, these headwinds aren't likely to abate any time soon.

While oil-reliant EMs steal most headlines, weakness isn't endemic to the entire category. EM as a category is contributing to global growth, which is currently underappreciated overall.

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