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THIRD QUARTER 2015

MARKET PERSPECTIVES

THIRD QUARTER 2015 REVIEW AND OUTLOOK

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THIRD QUARTER 2015 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Volatility increased in Q3 as global markets entered their first correction since 2012 led by a downturn in Emerging Markets (EM). Corrections (short, sharp, sentiment-driven drops exceeding -10%) are normal in bull markets. These unpredictable mass sentiment swings do not reflect meaningful shifts in fundamentals. While the volatility is uncomfortable, corrections tend to come and go relatively quickly—temporary setbacks in a broader bull market.

The present correction, at its lowest point to date, reached -14.9%—middling by historical standards.[i] In the quarter, the MSCI All Country World Index (ACWI) fell -9.5%, bringing full-year returns to -7.0%.[ii] Developed nations outside the US experienced similar volatility during the quarter, entering correction territory and breaching 25 August's low in September's final days. The MSCI AC World ex-US fell as far as -18.9%[iii] by 29 September from its 27 April high. However, typical client portfolios fared better, bolstered by our underweights to Energy and Materials and overweight to larger firms.

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

- **Sentiment Driven Global Equity Correction:** Fundamentals are still strong and recency bias leads investors to misperceive the magnitude of volatility in respect to historical norms.
- **Earnings Growth:** Corporate earnings and revenues beat analyst expectations (when excluding energy) and continue to grow alongside the global economy.
- **Underappreciated Developed Market Strength:** Developed nations' economies continue to grow and the Chinese slowdown is not as negative as many investors believe.

While the global correction is not unusually large, after years of relatively calm markets, it feels severe to many. Recency bias—investors' tendency to place greater importance on the recent past—might make the low volatility, correction-free stretch in the three years before Q3 feel standard. This is the sixth correction since the global bull market began in 2009. Pullbacks in 2010 and 2011 were larger than the present one, yet equities rebounded swiftly and the global bull market continued. The current global correction may have already ended, or more downside may lie ahead—impossible to know. That being said, corrections rarely end without fear peaking, and we have yet to see this.

As often happens during corrections, frightening headlines captured investors' attention—namely, false fears over China's slowdown and a US Federal Reserve (Fed) rate hike. Yet for all the noise, remarkably little happened in Q3. A much-hyped Chinese currency "devaluation" amounted to a -3% move, and Chinese authorities have continued propping up the currency ever since. After much talk, the Fed did not hike rates. US politics took centre stage, but this is not the time for investors to analyse 2016's elections—too early, too much variability. Economically, little changed from Q2 as most measures continue showing growth in the US, Europe and non-commodity-dependent EM. Q2 S&P 500 earnings contracted slightly, but excluding the Energy sector, profits grew nicely—a repeat of Q1. The global bull market's positive fundamentals remain intact.

Amid the volatility, eurozone data suggest the 19-member bloc's streak of underappreciated economic growth continued throughout the quarter. The second estimate of eurozone GDP was revised up to 0.4% q/q from 0.3%.[iv] The report also reveals the increasing breadth of that growth. Including Ireland's later-reported 6.7% y/y growth, 18 of the eurozone's 19 member nations expanded on a quarter-over-quarter basis in Q2, with Luxembourg the sole exception.[v] There are some caveats however as Greece was revised up to 0.9% q/q, but most of this activity occurred before capital controls took effect in Q2's final days. We expect future reports to contract, reflecting the negative fallout. However, Greece's lack of growth does not represent the broader region.

EM remain in better shape than many investors believe. While many view the entire category as vulnerable to weak commodity prices, this is not true. Many nations—most notably India, Korea, Indonesia and Taiwan—receive a net benefit from falling commodity prices. Commodity-dependent nations simply receive more attention, keeping expectations for other EM nations overly low. For example, many remain focused on Russia's Energy-heavy economy, which is feeling significant pressure from low oil prices and Western economic sanctions. Similarly, Brazil continues to struggle due to low commodity prices and high inflation (in addition to ongoing political headwinds and a recent credit rating downgrade to junk status). Contrarily, Mexico and Indonesia both have large commodities sectors yet reported growth during Q2 due to greater diversification within their individual economies, expanding 2.2% y/y and 4.7% y/y respectively. [vi]

While fears of a Chinese hard landing persist, the data remain in line with longstanding trends—slower growth, not a hard landing. For example, fixed asset investment in August rose 10.9% y/y versus 16.5% over the same period in 2014.[vii] While many doubt the accuracy of China's economic numbers, with some suggesting growth is closer to 4% or 5% rather than 7%, we view this issue as overwrought. If this were the case, China's many trade partners would note the slowdown in their numbers. Yet many executives have indicated at earning calls that Chinese growth, while slowing, is overall fine.

THEMATIC UPDATE AND MARKET OUTLOOK

A Q3 Recap

Q3's correction led many to fret an economic slowdown, despite the fact global data largely show growth trends continuing from recent quarters and years. Manufacturing data from developed and Emerging Markets (EM) overall slowed, but strong service sector data suggests it—the dominant sector in the US, UK, eurozone and even China—is propelling growth. Commodities are also a major story economically, as falling oil and raw materials prices weigh on commodity-heavy economies and skew earnings, trade, inflation and retail sales data globally. Overall, we continue to believe the world economy is on solid footing, led by the US, UK, eurozone and non-commodity reliant EMs.

Beyond the volatility, elections and political machinations highlighted the quarter, which we will discuss in depth in this review. Noteworthy elections took place in several developed nations, and in the US, the 2016 presidential campaign garnered attention from the media before the primaries get underway early next year. We expect the campaign landscape to evolve in the coming months; however, it is too early to give credence to headlines.

US COMMENTARY

US Economic Growth Is Sound

US Q2 GDP growth, initially reported at 2.3% (seasonally adjusted annual rate), was revised up to 3.9% as consumer spending and construction activity accelerated. While GDP itself does not have many implications for forward-looking equites, it does reaffirm economic trends. In Q2, it confirmed America's expansion reaccelerated sharply in Q2 after Q1's slowdown.

Data released during Q3 similarly show continuing growth, not a material slowdown. While many decry "sluggish" retail sales like September's 0.1% m/m rise, this narrow gauge comes with an asterisk. For one, headline retail sales figures omit much of the services sector beyond restaurants and bars. Health care, housing, financial services, transportation and other services are absent, causing retail sales to measure only about half of the actual spending constituting GDP.

Personal consumption expenditures (PCE) data are far broader and rose in six of the past seven months through August, when they logged a 3.2% y/y gain.[viii] Moreover, both PCE and retail sales are impacted by commodity prices. Exhibits 1 and 2 show this effect by comparing headline sales and sales excluding energy goods and gasoline station sales, respectively. Excluding energy's skew, September retail sales rose 0.4% m/m while PCE rose 4.4% y/y.

Exhibit 1: Personal Consumption Expenditures

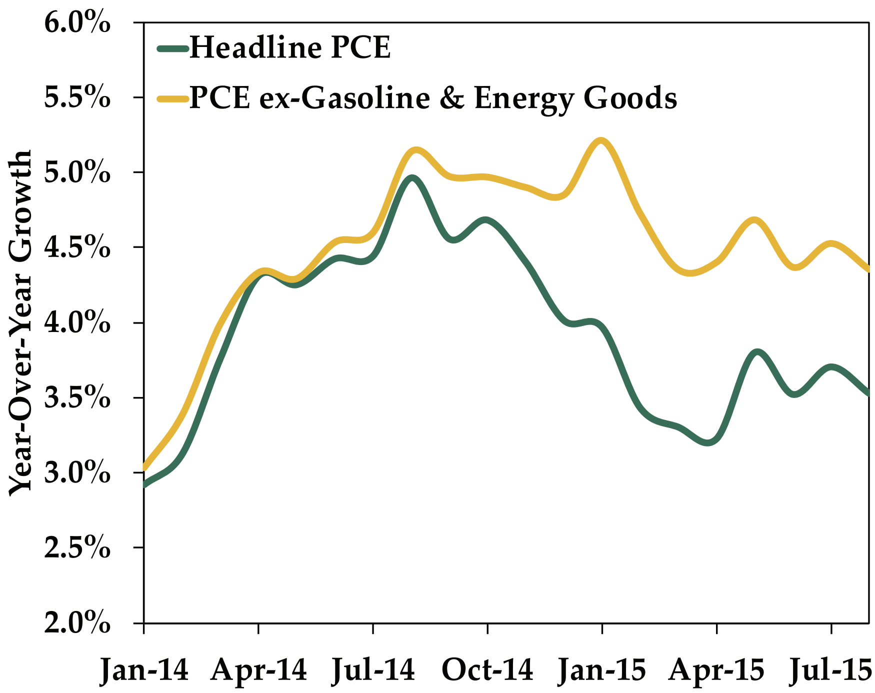
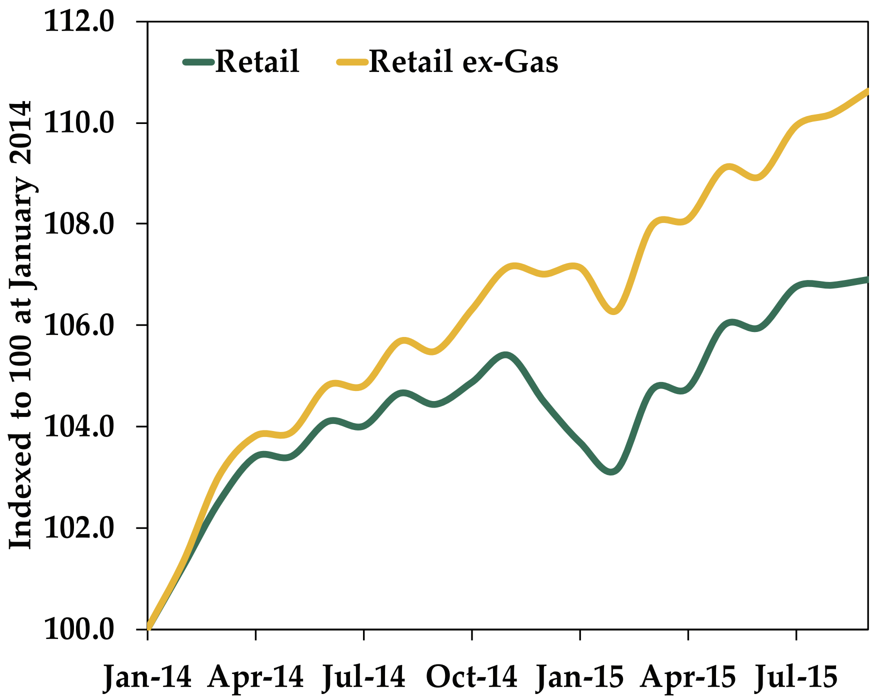


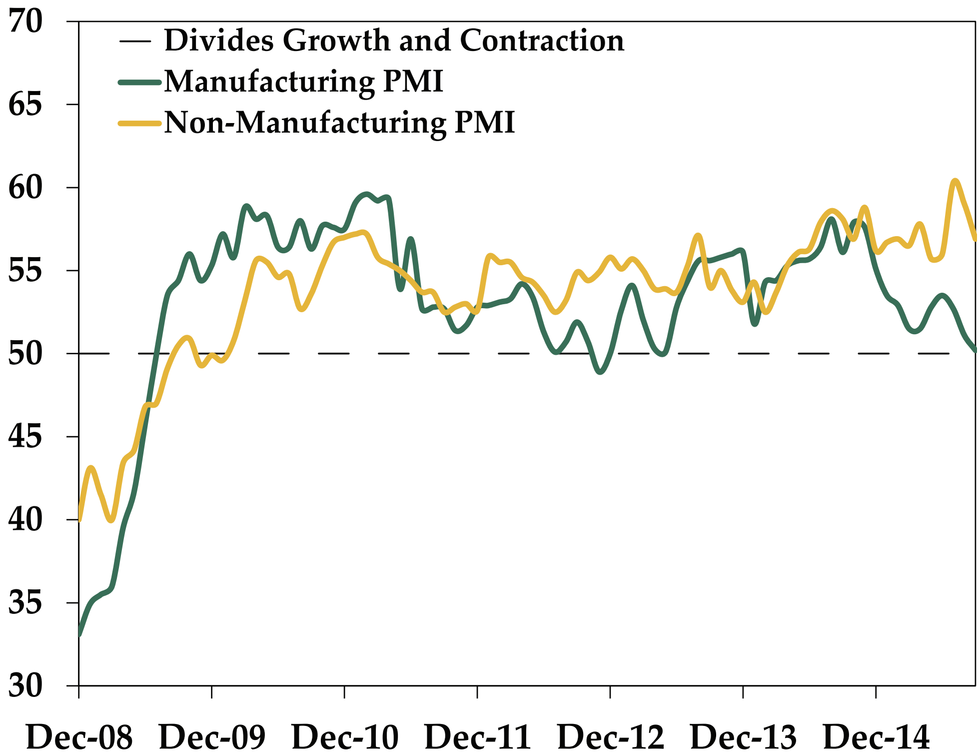
Exhibit 2: Retail Sales

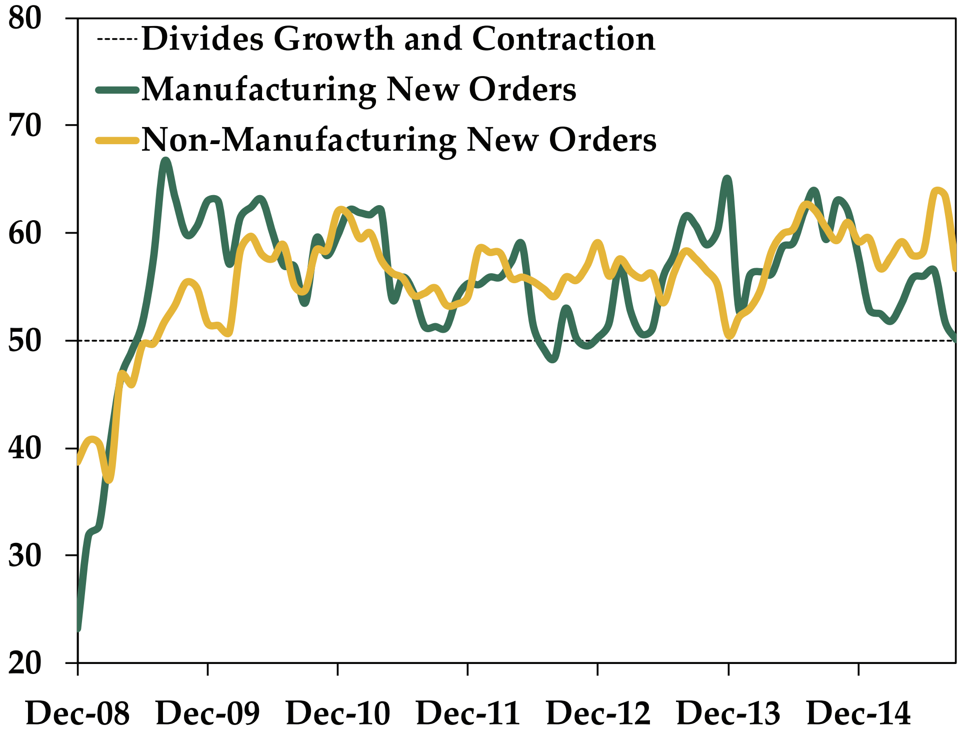


Sources: US Census Bureau and US Bureau of Economic Analysis, as of 15/10/2015.

Throughout Q3, the Institute for Supply Management's 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 3) Note that in both output and new orders, non-manufacturing posted broader growth than manufacturing, a sign the 78% of US GDP comprised by the services industry is healthy.

Exhibit 3: ISM Manufacturing and Non-Manufacturing PMIs and New Orders

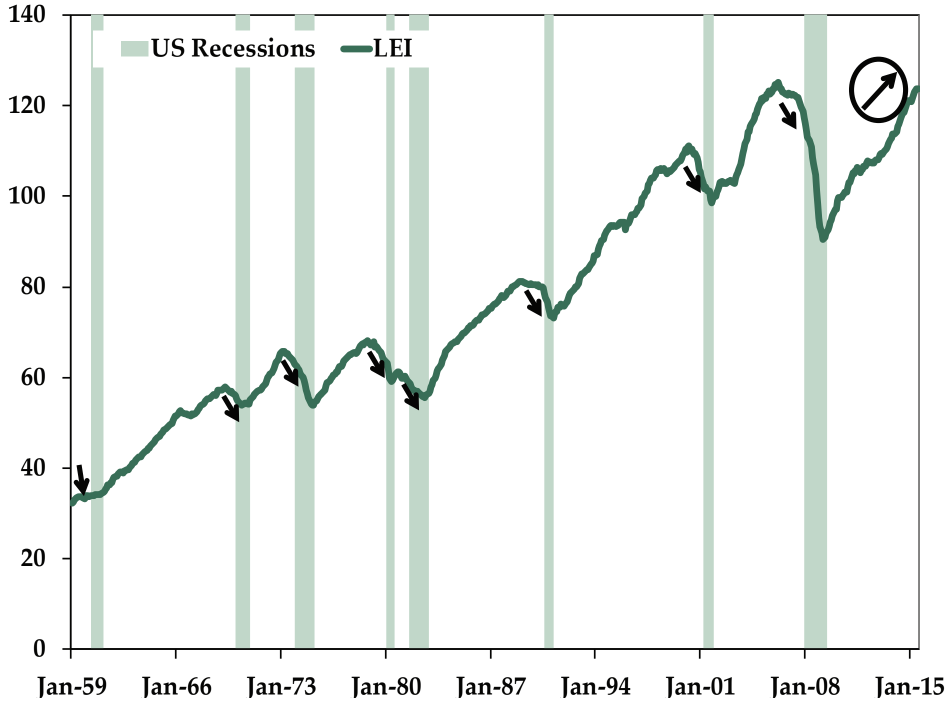




Source: FactSet, as of 22/10/2015. December 2008 – August 2015.

Looking ahead, growth likely continues. While The Conference Board's September US Leading Economic Index fell -0.2% m/m, this seems likely to prove a one-off. The dip was driven most by equity prices, tied to the correction retesting the lows, and at the time of writing, we have already seen significant recovery in global equity markets. Building permits were the next biggest detractor, which have been subject to volatility all summer tied local government policy changes in New York and Florida. The most reliable components in the series, the yield spread and Leading Credit Index, positively contributed. The Conference Board's US Leading Economic Index (LEI) has risen in 18 of 20 months, underpinned by a steep yield curve. In LEI's 55-year history, no US recession has started while the index was high and rising (Exhibit 4).

Exhibit 4: The Conference Board's US LEI



Source: FactSet, as of 24/07/2015. January 1959 – August 2015.

Not an Earnings Recession—An *Energy* Earnings Recession

Similar to Q1, as Q2 earnings season began analysts expected aggregate S&P 500 earnings to fall -4.5% y/y, blaming the strong dollar—which makes exports more expensive when purchased in weaker currencies and reduces revenue earned overseas when converted back to US dollars. Yet in a near repeat of Q1, earnings surpassed dour expectations, falling just -0.7% y/y. Excluding the Energy sector's –55.4% earnings decline, profits rose 5.9% y/y [ix].

What analysts seem to persistently overlook is the fact a strong dollar is not a categorical negative for US multinationals. It may dampen revenues some after conversion—and perhaps impair price-competitiveness to the extent US firms try to mark prices up abroad to cover the rising dollar. However, that is not the only impact: the strong dollar also reduces costs for foreign-sourced components, raw materials and labour. Hence, the overall impact to profits is often zero-sum or close to it.

Entering Q3, analysts once again project a decline—the second straight quarter, which some have been quick to label an "earnings recession," fretting the potential impact on equities and once again accusing the dollar. As of the 2nd of October, analysts expected a -4.2% y/y Q3 earnings dip, nearly matching their Q1 and Q2 preseason projections. However, analysts' forecasts also pin most weakness again on Energy earnings—this time projected to fall -65.9%. It remains to be seen if their forecast will come to fruition, but it seems to us this is less an earnings recession and more an Energy earnings recession resulting from the widely known fall in oil prices.

US Politics

Political Disclosure: As always, we favour no candidate or party and assess politics solely from the perspective of how legislation, regulation or plans may impact markets. We believe political ideology is blinding and dangerous for investors.

Summer was full of political news. We had two Republican debates, two candidate dropouts (as of this writing) and plenty of headline fodder. It is still too early, by any historical standard, to handicap the primaries, much less who wins next November. We are still in what journalists call "the silly season." The serious race typically starts much closer to the first primaries. In recent cycles, these have occurred in early January, but the Iowa caucus (February 1st) and New Hampshire primary (February 9th) are later this round, delaying serious campaigning. It might be December or early January before the serious campaigning begins. For now, it is too early to fear or cheer potential market impact.

Same Old Story

The Republicans have whittled their field down to 15 candidates. Polls show candidates with nontraditonal political backgrounds leading, but polls this early are primarily based on name recognition and have little predictive power. Consider the polls in November 2007, a year before John McCain and Barack Obama faced off. Leading the Republican field were a nationally famous New York City mayor (Rudy Giuliani) and a Senator-and long-time television star (Fred Thompson). Neither made much noise in the primaries (Exhibit 5).

Exhibit 5: November 2007 Presidential Primary Polling

Republican Candidate	% Support	Democratic Candidate	% Support
Rudy Giuliani	28%	Hilary Clinton	48%
Fred Thompson	19%	**Barack Obama**	**21%**
John McCain	**13%**	John Edwards	12%
Mitt Romney	12%	Dennis Kucinich	4%
Mike Huckabee	10%	Joe Biden	2%
Ron Paul	5%	Bill Richardson	2%
Tom Tancredo	1%	Christopher Dodd	1%
Duncan Hunter	1%	Mike Gravel	1%
Other	*	Other	*
None/No Opinion	9%	None/No Opinion	9%

*Source: Gallup, as of 06/10/2015. Both polls taken 11-14 November 2007. Boldface indicates eventual nominee. *Indicates less than 0.5%.*

Hillary Clinton remains in pole position among Democrats (Exhibit 6), but she is not your typical Democratic nominee or successful candidate. As Ken wrote in his June 29 Forbes column, "Since the Civil War we've elected Democrats who were either (1) already President or (2) a fresh new face (Obama, Clinton, Carter, Kennedy, FDR, Woodrow Wilson, etc.) … Democratic coalitions require emotional legs to get marginal voters out—and old dogs have fewer new tricks, and known negatives undermine hope." Clinton does not match those two requirements. She has spent almost 25 years in the nation's eye. She is a political war horse with well-known blemishes—not the prototypical "blank canvas" candidate Democrats prefer.

Democrats would likely fare better nominating a current or former governor with a roughly three-to-six year tenure. Options abound, and the fresh face would let them project whatever image they want to cultivate enthusiasm and build the broad coalition needed to mobilise turnout. However, the longer a dark horse takes to emerge, the lower the likelihood it happens. It is not impossible, and former Maryland Governor Martin O'Malley fits the profile, to an extent. However, we must wait and see how things turn out when he begins campaigning in earnest.

Exhibit 6: Current Presidential Primary Polling

Republican Candidate	% Support	Democratic Candidate	% Support
Donald Trump	23%	Hilary Clinton	42%
Ben Carson	17%	Bernie Sanders	25%
Carly Fiorina	10%	Joe Biden	19%
Marco Rubio	10%	Jim Webb	1%
Jeb Bush	8%	Martin O'Malley	1%
Ted Cruz	6%	Lincoln Chaffee	0%
John Kasich	3%		
Mike Huckabee	3%		
Chris Christie	3%		
Rand Paul	2%		
Rick Santorum	1%		
Bobby Jindal	1%		
Lindsey Graham	0%		
George Pataki	0%		
Jim Gilmore	0%		

Source: Real Clear Politics, as of 06/10/2015. Average of polls for 17/09/2015 to 04/10/2015. Webb dropped his bid for the Democratic nomination on 20th of October but may run as an independent. Biden announced he will not run on 21st of October.

Further, as we discussed last quarter, poll accuracy has been questionable lately—even near election day. Leading up to the UK's May general election, polls predicted no party would win outright, leading to a coalition or minority government. Yet the Conservatives won an outright (albeit slim) majority. Polls also indicated a tight race in Canada's 19th October contest, yet the Liberal Party won handily.

The GOP fracas will sort itself out in time. It has already eliminated two candidates: Wisconsin Governor Scott Walker and former Texas Governor Rick Perry. A more tactically minded candidate probably would not announce his or her intention to run until after campaigning begins in earnest, thus avoiding the tendency to flame out early. By declaring later, a candidate can skip the debates, giving rivals fewer soundbites to twist. Debates have little to do with governing, and there are other ways to broadcast one's views and resumé: traditional media, social media and other public forums. Walker is a perfect example of this. Considered an early favourite after declaring in July, he peaked too early. His performance in the two Republican debates hurt him, resulting in an early exit.

What to Make of Proposals

Several candidates have already announced policy proposals. Clinton offered one on capital gains taxes and another targeting prescription drug prices. Jeb Bush and Donald Trump introduced tax plans. Still others have made vague references to taxes and trade. However, at this point, this is a meaningless exercise. Proposals and campaign lines this early will not meaningfully influence markets. There is too much noise, too many conflicting proposals and opinions.

It is easy to pick a controversial agenda item and argue it hurts markets—e.g., Clinton's proposed intervention in Pharmaceuticals or Trump's vows to raise trade barriers with China and Mexico—but there is no way to isolate its impact. Moreover, markets do not have enough information to form probabilities—and equities move on probabilities, not possibilities. Equities will eventually begin discounting campaign rhetoric and the likely winner's proposals, but not until the field narrows further and it becomes possible to assess the likelihood of various outcomes—both for the White House and Congress.

Looking ahead, Republicans currently hold an edge for 2016's Congressional elections. Though Democrats must defend fewer Senate seats in opposition territory, strong Republican incumbents stand in their way of gaining ground. Winning a majority would require Democrats to virtually sweep toss-up seats. Though possible, this will depend on where both parties direct resources and the campaigns' strength. Meanwhile, the Republican presidential candidate will likely have an edge if the Democrats nominate Clinton, due to the aforementioned reasons.

If the GOP swept, it would set up the "perverse inverse," markets' tendency to rally in election years when new Republicans win the presidency, then falter the next—and vice versa when a new Democrat is elected. It would also end gridlock, raising legislative risk, which markets generally dislike. These are considerations we will weigh as the campaigns get more serious—and we will share our thoughts when appropriate.

NON-US DEVELOPED MARKET COMMENTARY

Unfounded Market Volatility

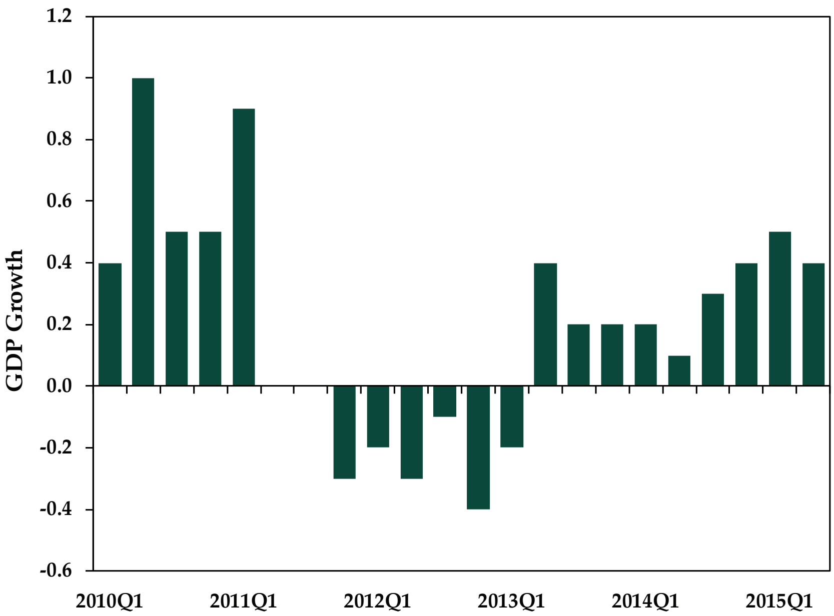
Non-US developed equities officially entered correction territory in August, with the MSCI World ex-US falling as much as -13.1% between its 21 May high and 25 August low, before rising to finish the month of August down -10.8% from all-time highs. [x] Most of the negativity hit in August's final two weeks. The index finished the quarter down -10.6% from Q2's close. [xi]

Many pundits attributed the volatility to China, claiming its economic slowdown had taken a new turn. However, we do not believe conditions in China have fundamentally shifted from the long-established trend of gradual economic slowdown amid intermittent economic reforms. Further, developed market fundamentals generally continued to improve in Q3, and thus, we see this as normal bull market volatility driven by sentiment—typical characteristics of corrections, not the beginning of a bear market.

Eurozone: Underappreciated Growth

Q2 eurozone GDP was revised up to 0.4% q/q (1.5% annualised) growth, and Q1 was similarly bumped to 0.5% q/q. While many were quick to laud the ECB's quantitative easing programme, growth predates the launch of bond buying by about two years—the eurozone has grown nine straight quarters (Exhibit 7). Further, it is increasingly broad-based. Out of the 19 eurozone nations, only Luxembourg reported contraction—evidence growth is increasingly widespread and, in light of the negative volatility, largely underappreciated.[xii]

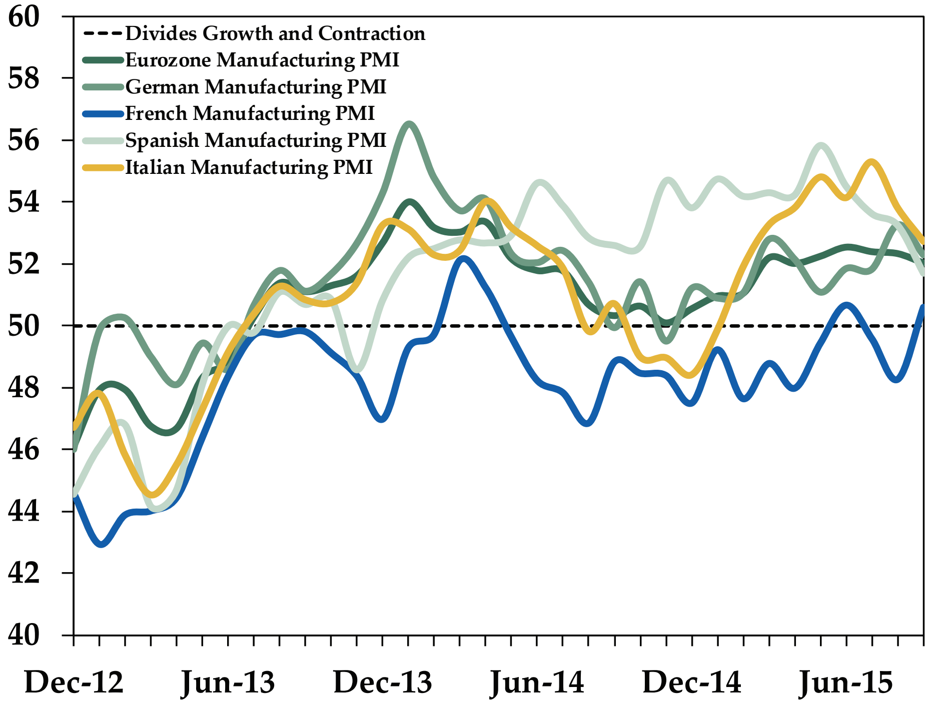
Exhibit 7: Eurozone Quarter-Over Quarter GDP Growth

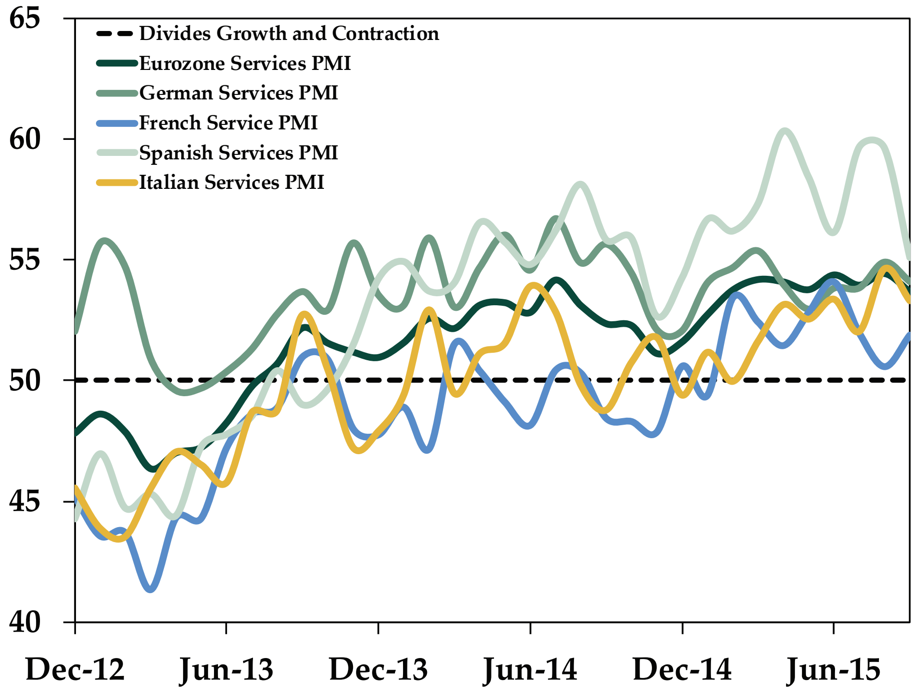


Source: Eurostat, as of 20/10/2015. Eurozone GDP growth, Q1 2010 – Q2 2015.

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. Here, like the US, services PMI show much broader growth than manufacturing—but both measures are overall indicating growth (Exhibit 8).

Exhibit 8: Eurozone Manufacturing PMI and Services PMI





Source: FactSet, as of 21/10/2015. Markit PMI, December 2012 – September 2015.

Yield curves in the eurozone are positively sloped and The Conference Board's Eurozone LEI rose a 10th straight month in August (0.2% m/m).[xiii] However, September's LEI was unchanged m/m at 108.0. We remain confident growth should continue in the region.

European Politics

Nonstop coverage of Greece fell silent in Q3. Now the media is primarily focusing on the refugee crisis, and to a lesser extent China. We do not believe any of these present a material risk to the bull market. The Syrian War and refugee crisis is a major humanitarian tragedy, but the economic impact is small. These issues have the power to scare investors—and potentially swing short-term sentiment—but they should not have the power to materially sway markets for long.

Portuguese Election

Portugal voted in early October, a contest widely considered a referendum on incumbent Prime Minister Pedro Passos Coelho's stewardship during the debt crisis, bailout and subsequent recovery. While Portugal's economy is recovering, led by private consumption and investment, voters are fatigued with austerity, and the centre-left Socialist Party sought to capitalise.

Passos Coelho's central-right alliance won the most votes but lost its Parliamentary majority, taking just 107 of the 230 seats. Initially, Socialist leader Antonio Costa said he would not block a minority centre-right government, and he and Passos Coelho began negotiations for his support. However, Costa left open the possibility of a coalition between the Socialists and smaller leftist groupings. Together, the Socialists, Left Bloc and Communist/Green alliance hold 122 seats, and as talks with Passos Coelho broke down, Costa announced he had secured enough support for a leftist majority government. Yet the decision rested with President Aníbal Cavaco Silva, and on the 22nd of October he named Passos Coelho Prime Minister and asked him to form a government, citing his concern over the Communists' and Left Bloc's euro scepticism. The Socialists have already threatened to block Parliamentary ratification of Passos Coelho's minority government, raising the likelihood of new elections next year.

Whilst this saga raises political uncertainty for Portuguese markets, its actual impact should be limited—a point underscored by Portuguese interest rates, which remain near euro-area lows. Portugal has already implemented several reforms, and though a stalemate stalls further progress, it also prevents past measures from being undone. Moreover, Portugal is only 1% of eurozone GDP, smaller than even Greece.

Up Next: Spain

Spain's general election is scheduled for the 20th of December, and polls show a tight race might yield the first coalition government since Spain's return to democracy in 1978.

The centre-right Popular Party (PP)—led by current Prime Minister Mariano Rajoy—and centre-left Socialist Party (PSOE) have dominated Spanish politics since Franco's fall, but two upstart parties are challenging their dominance. One, Ciudadanos, was formed in 2005 with a platform based on individual freedoms and tackling corruption. Many of their economic policies overlap with PP's, leading many to label them as centre-right, and the two parties have formed coalitions in regional governments. The other newcomer, Podemos, is an anti-austerity populist party formed in 2014 by Pablo Iglesias, a young political science professor. Their ideology has much in common with Greece's radical-left Syriza.

Current polls show PP and PSOE on top, followed by Ciudadanos, with Podemos in last. While Podemos enjoyed strong polling gains and local election victories in Madrid and Barcelona earlier this year, Syriza's many setbacks and failure to win many concessions from Brussels dented much of the enthusiasm for Podemos, reducing their support. However, we caution against reading too much into these standings, as pre-election polling has been wildly inaccurate throughout Europe this year.

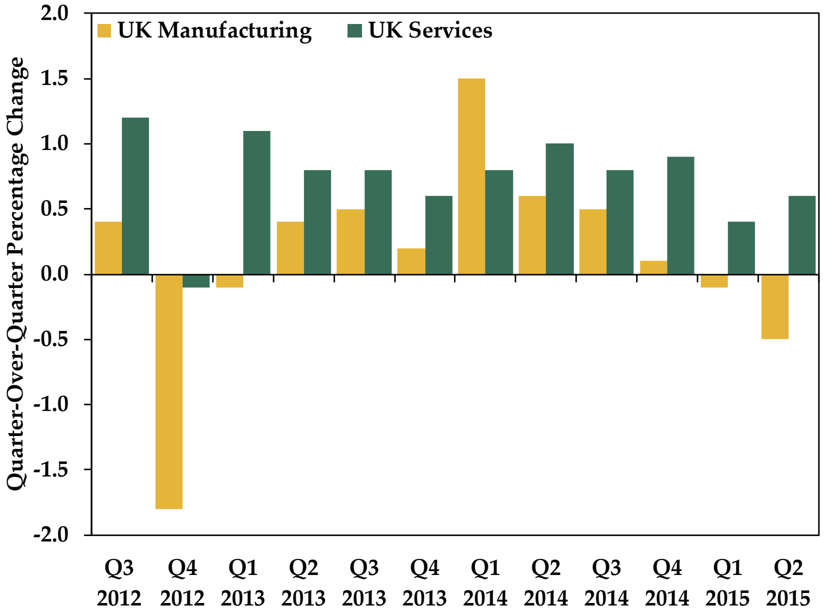
Regardless of how the vote breaks down, we do not expect much to change in Spain. PP has already made coalition overtures toward Ciudadanos, and should they form a government, their agenda would probably uphold the status quo. Podemos has ruled out being a junior partner in a PSOE coalition, raising the likelihood of a unity government should PSOE win the most votes. Overall, whoever ends up in power will likely have a weak mandate, making it difficult to pass much substantial legislation. Spain has already passed several economic reforms in recent years, and gridlock reduces the likelihood of unwinding them—a positive.

UK Economics

The UK economy remains among the developed world's strongest. Q1 and Q2 GDP both rose 0.7% q/q (2.6% annualised), led once again by services. While soft patches remain, the foundation is strong.

Business investment continued rebounding from its brief 2014 autumn dip in Q2, growing 2.9% q/q and 5.0% y/y. Though many believe UK growth is not "stable" until components like business investment and exports pick up, consider: Quarterly business investment hit an annual all-time high in 2014.[xiv] 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 September, Services PMI remained firmly in expansion territory. Sectoral GDP breakdowns show fairly steady services growth, while manufacturing is weaker(Exhibit 9). Given services comprise about 79% of UK GDP, a healthy services sector can drive growth.

Exhibit 9: UK GDP Sectoral Breakdown: Manufacturing Vs. Services



Source: FactSet, as of 21/10/2015. UK GDP by Industry, Q3 2012 – Q2 2015

The UK's Labour Party Gets a New Leader

After the Conservative Party won an unexpected majority in May, Labour Party Leader Ed Miliband stepped down, triggering a wild leadership contest. Initially, it looked like supporters would choose from three shadow cabinet members: Yvette Cooper, Andy Burnham and Liz Kendall. However, party members worried the debate was too narrow, as all three had close ties with the Blair and Brown administrations, so they drafted leftist Jeremy Corbyn to widen the debate. Corbyn, an MP since 1983 with no ministerial experience and a history of voting against Labour Party leadership (he has rebelled on more than 500 votes since 1997), was not expected to win many votes. Yet he captured the national attention and won in a landslide. His economic platform includes re-nationalising railways, hiking taxes on business and high earners, upping infrastructure and public investment and launching "people's quantitative easing," through which the Bank of England would use new reserves to purchase bonds issued by a public development bank.

Corbyn's success and radical agenda triggered much chatter among the punditry and investors, but it is largely a non-issue for markets at this point. The Conservatives have a Parliamentary majority, and the next general election is not until May 2020—much too far out to handicap. Markets move on probabilities, not possibilities, and equities generally do not discount events beyond the next 30 months or so.

Moreover, it is far from certain Corbyn will lead the Labour Party in the next election. Most Labour MPs voted for Cooper, Burnham or Kendall, and many refused to join Corbyn's shadow cabinet. At the Labour Party Conference in October, several shadow cabinet members openly criticised Corbyn's national defense stance. Corbyn faced another rebellion two weeks later, over Chancellor George Osborne's fiscal charter, which sets stricter budget targets. Several senior MPs threatened to vote for the bill or abstain, defying party whips, forcing Corbyn to allow abstentions at the last minute. Over a dozen took advantage, raising big questions about Corbyn's authority.

Corbyn could easily survive these early scrapes and lead Labour for a while longer, but his dismal polling and lack of control could very well prompt the party to replace him before the next election. Either way, in the meantime, the Conservatives' slim majority should keep Parliament gridlocked, bringing bullish political stability to UK equities.

Japan: Still Weak

Japanese equities fell -11.8% in Q3, underperforming the MSCI ACWI by more than two percentage points. While we would expect Japan to participate in the rebound we are beginning to see from Q3's correction, we continue to believe Japan has not enacted the structural economic reforms necessary to unshackle the economy and support equity outperformance.

Japan's economy is showing persistent signs of weakness. While export values rose slightly in Q3, export volumes have declined in five straight months—gains are solely the result of currency translation, while the actual units shipped is down. Meanwhile, domestic data remain torpid. Retail sales closed the quarter by decelerating markedly to 0.8% y/y growth in September, showing the post-sales tax hike upswing in April was merely a function of low year-over-year comparisons, not a sustained rebound. Industrial production contracted in July and August. Most analysts believe Japan's GDP contracted in Q3, and if so, this would mark the second straight quarter of contraction—putting Japan back in a recession by one common definition. All this stands as a stark reminder that Abe's economic strategy is long on misguided quantitative easing (QE) and short on the structural reforms Japan needs. However, many pundits continue to see any renewed sign of weakness as a call for an extra budget or more QE. These persistent calls show sentiment still does not appreciate the actual issues on the ground in Japan.

In early September, Japanese Prime Minister Shinzo Abe was re-elected as leader of Japan's governing Liberal Democratic Party, after running unopposed. Optimists may suggest this means Abe has renewed clout to push through contentious reforms—and they point to his claims he will refocus on Abenomics after passing defense reforms in the summer. However, this overlooks the fact he is now a lame duck. The LDP has term limits on its leadership, and Abe will term out at the end of this three-year term. That means Japan will get a new Prime Minister, and this could set up more intraparty disputes, as would-be successors attempt to position themselves.

Abe followed the re-election by reiterating a number of well-known initiatives, like cutting corporate taxes by 3.3 percentage points, a measure already passed. He also reiterated his focus on the Trans-Pacific Partnership free-trade deal as a key policy aim and an agreement was reached, but it still must be ratified by the 12-negotiating nation's legislatures, which will be difficult.

Australia Gets a New Prime Minister …

Malcolm Turnbull became Australia's fifth Prime Minister since 2007 in September, as the Liberal Party deposed Tony Abbott in a backroom leadership vote. This is Australia's third interparty coup since 2010, and no Prime Minister has served a full term since John Howard from 2004 to 2007.

This time around, Australia's weakening economy turned the revolving door. While Australia has not endured a recession in 24 years, its commodity-heavy economy faces big headwinds from the global supply glut and low prices, and GDP growth slowed to just 0.2% q/q in Q2. Rivals seized on this, and the opposition Labour Party surged ahead of the Liberals in polling for next year's national elections. Abbott's personal polling was down as well, and the Liberals replaced him in hopes of energising voters with a fresh face.

Some investors are encouraged by Turnbull's private-sector history and strong business contacts, but this seems a touch optimistic and could overly inflate sentiment toward Australian equities. Despite Turnbull's "market-friendly" reputation, Australia's economy and markets face a substantial headwind from weak commodity prices. Though its economy has a strong financial system and relatively healthy consumers, the commodity pinch restricts growth. This could drive continued political upheaval, but Australian markets are quite used to this by now.

… And So Does Canada

Canadians hit the polls on 19 October, faced with a choice between incumbent Prime Minister Stephen Harper and his Conservative Party—in power nearly 10 years—the centre-left Liberal Party and the upstart New Democratic Party. Though Harper argued his stewardship and fiscal conservatism was necessary to guide Canada out of its ongoing recession, Liberal leader Justin Trudeau's youth and platform of change and fiscal stimulus resonated most with voters. The Liberals won handily, taking 184 of Parliament's 338 seats—a 30-seat majority.

Trudeau, the son of long-serving Prime Minister Pierre Trudeau, has pledged to raise taxes on the highest earners, cut taxes for middle-income folks and run deficits for the next three years as he battles a struggling economy with C$60 billion in new infrastructure spending. The strong majority means Canada will not enjoy bullish gridlock, and a more active government may be at hand, raising the risk of sweeping legislation—something equities typically dislike.

However, Trudeau's election does not really alter investment opportunities within Canada, which faces economic headwinds similar to Australia's. Though his tax changes do appear likely to pass, a four-point hike in income taxes for the top one percent of Canadian earners should not have much market impact. Nor should the tax cut for middle earners. Small tax changes are usually not a huge factor for markets, as US history has proven time and again. As for the spending, fiscal stimulus can help when there is a dearth of demand, but we are sceptical that it will help much in Canada, whose recession stems from the well-known troubles in Energy and Mining. Canadian growth does not depend as heavily on commodities as other countries like Russia, but they do represent a fair chunk of GDP, and falling prices hurt them enough to offset growth in other sectors. This is even more apparent in Canada's equity market, where Energy and Materials account for 30% of total market capitalisation

The Trans-Pacific Partnership (TPP)—a trade agreement between Canada, the US and 10 other nations—was another central campaign issue. The agreement, negotiated by Harper's administration, was finalised in October but must be ratified by all 12 nations before taking effect. Trudeau and the Liberal Party say they strongly support free trade, but they are non-committal on the TPP, claiming they cannot say which way they lean until they assess the entire agreement and its impact on "supply management, [the] auto sector, and Canadian manufacturers." [xv] Compounding matters, Trudeau has not decided whether to grant Liberal MPs a free vote on the deal, which could impact its chances of passing. This is one of many hurdles TPP faces before taking effect, along with the US's 2016 elections, and the road will be difficult. However, while TPP would be a long-term positive, its absence is not a negative—it just extends the status quo.

EMERGING MARKETS COMMENTARY

Throughout the quarter, the media blamed several major fears for the global equity markets correction, but China seems to bear the brunt, with many supposing a sharp economic slowdown has now arrived. Pundits argue recent Chinese government moves are acts of desperation—flailing efforts to stanch the bleeding. While these fears run rampant, economic data, announced reforms and commentary from Western executives suggest the long-existing trend of gradually slowing, but still-strong growth continues amid a backdrop of incremental reform.

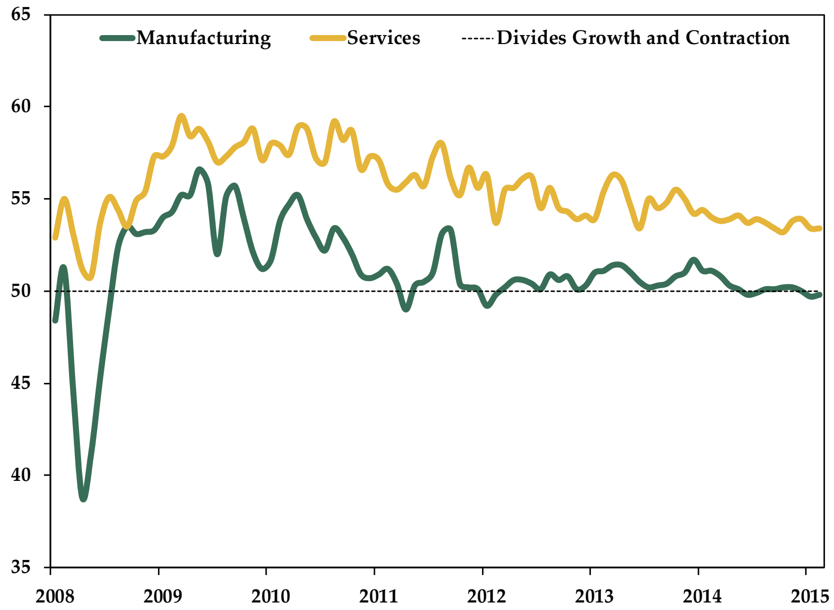
China's Gradual, Engineered Slowdown

To be sure, China's economy is not growing at double-digit rates like it was in 2010. Nor are manufacturing and trade skyrocketing. Far from being a surprising new negative, this has been the general trend in Chinese data for nearly four years. In addition, it is the government's stated objective to shift the emphasis of growth from export- and infrastructure-development driven to domestic consumption and services-led. Recent data suggest this trend continued.

Now, many are sceptical of Chinese data, partly because of the government's opacity and partly because of a 2010 Wikileaks release in which current Chinese Premier Li Keqiang called China's GDP "manmade" and urged observers to use alternate statistics. However, the IMF's in-house estimates largely echo China's official figures and some data (like the aforementioned trade data) can be cross-checked against major trade partners. Moreover, while it may not yield a quantitative picture of China's economy, commentary from non-Chinese firms doing business domestically suggests the economy is largely in fine shape—high absolute levels of growth, but slower than earlier years in this global expansion.

As for economic data, Purchasing Managers' Indexes garnered a great deal of attention in Q3. Headlines frequently decry the Official and Caixin/Markit manufacturing gauges being slightly in contractionary (sub-50) territory, although both measures have spent much of the last few years below 50. The latter gauge, a private-sector survey tilted towards smaller, private manufacturers, has contracted far more often than it has grown since 2011, as these smaller firms struggle to obtain credit. Meanwhile, services gauges are outpacing manufacturing and remain expansionary in both series (Exhibit 10).

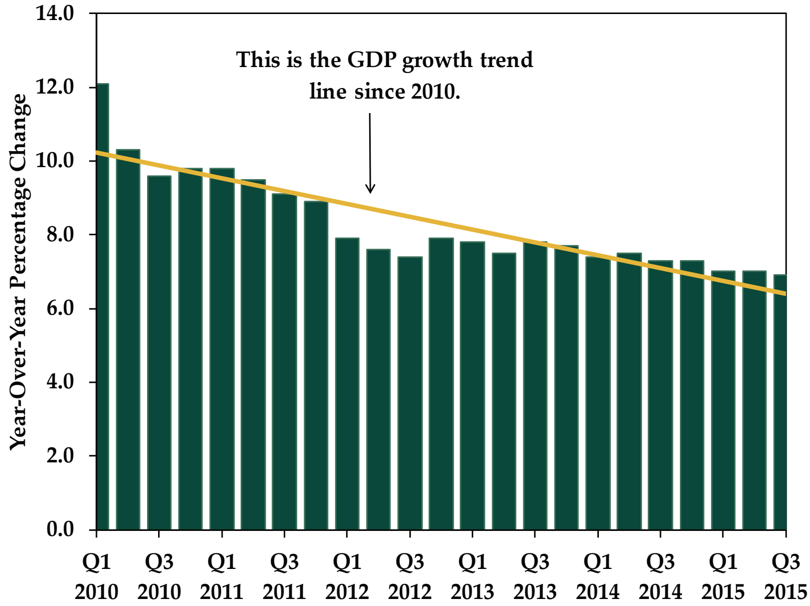
Exhibit 10: China Official PMI—Services and Manufacturing



Source: FactSet, as of 22/10/2015.

In Q3, GDP slowed to 6.9% y/y from 7.0%, again in keeping with a long-running trend. Exhibit 11 shows the trend in Chinese year-over-year real GDP growth since 2010.

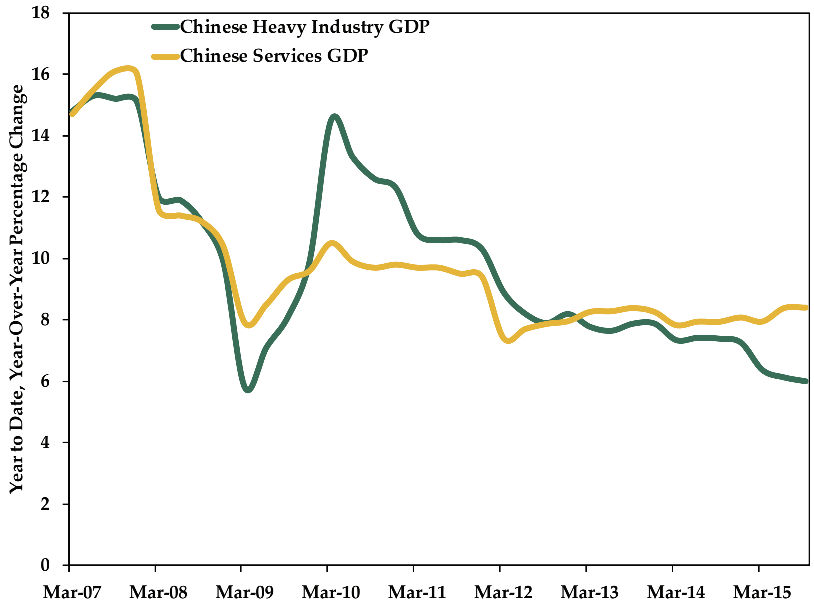
Exhibit 11: China Real GDP Growth (Year-Over-Year)



Source: FactSet, as of 22/10/2015.

Under the surface, GDP data show the same rotation from manufacturing to services. As Exhibit 12 shows, service sector growth eclipsed heavy industry in Q1 2013 and has led ever since. Through Q3, the service sector grew 8.4% year to date from 2014's first three quarters, compared to just 6.0% for heavy industry.

Exhibit 12: China GDP, Heavy Industry v. Services



Source: FactSet, as of 19/10/2015. China Secondary and Tertiary Industry GDP growth, Q1 2007 – Q3 2015.

Some suggested the equity market decline would act as a reverse "wealth effect" and hurt Chinese consumer spending. Less than 10% of Chinese actually own equities, suggesting that the impact is not broadly felt. And even with that, consumption is not hugely swayed by a "wealth effect" or other sentiment features. In our view, real wage growth, which continues apace in China, has far more influence over consumers' actions.

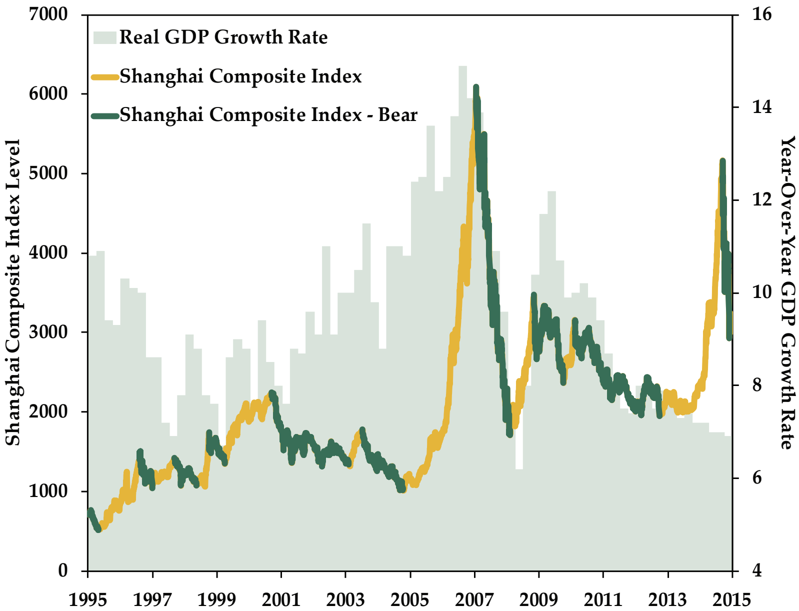
Economic data from China's October 1 - 7 "Golden Week" national holiday showed strength, refuting the reverse "wealth effect" claims. Sales at restaurants and retailers rose 1.082 trillion yuan ($170 billion), an 11% y/y increase.[xvi] In the week, about 11.5 million tourists visited Beijing and another 4 million Chinese tourists traveled abroad.[xvii] While many fret trade data showing weak imports suggests all is not well with Chinese consumers, weak numbers like September's -20.5% y/y drop in imports were a function of commodity prices, not slumping demand. Australia's commodity export hub, Port Hedland, reported record iron ore export volumes to China in August. There are few signs China's economy is markedly weakening, much less approaching the long-rumored "hard landing."

Economic Slowdown Fears

China economic slowdown fears seemingly build on Q2's concerns over a steep drop in Chinese domestic A-shares. After surging 152% in the preceding 12 months, the Shanghai Composite Index fell -43.3% from its June 12 high to the lowest point seen to date (26 August) [xviii]. Last quarter, we discussed the fact moves in A-share markets are largely limited to domestic investors, due to restrictions on foreign investment. As volatility continued, many assumed the bear market foretold big trouble in China's economy. However, while equity markets are frequently good forward-looking gauges, China's domestic markets are not liquid and open enough to function as a reliable leading indicator.

As Exhibit 13 shows, the Shanghai Index has had nine bear markets since 1995. While some have correlated with global recessions and bear markets—like 2008's—most did not.

Exhibit 13: China's Domestic Markets Aren't a Reliable Leading Indicator



Source: FactSet, as of 22/10/2015. Shanghai Composite Index and year-over-year Real GDP growth rate, Q3 1995 – Q3 2015.

Despite the nine bears, there were no Chinese recessions during the period. Quite the contrary: From 2001 through 2005, the Shanghai had two -40% drops, yet the economy accelerated from 7% y/y GDP growth to over 10%. Similarly, the Shanghai fell 32% between August 2009 and July 2010, yet growth accelerated markedly into double-digit territory.

Intervention and Reform

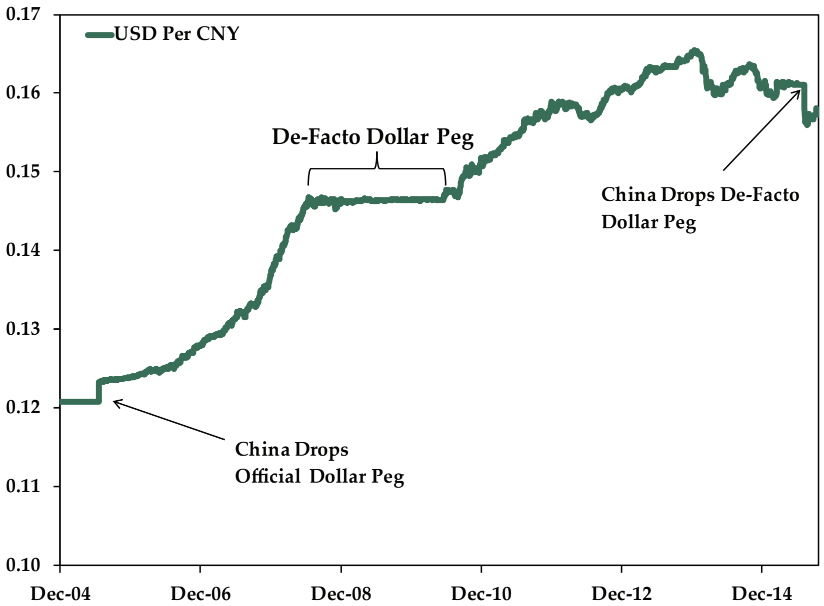
In July and early August, China's government frequently intervened in the A-share markets with short selling and IPO bans, public cajoling via state-run media, and outright purchases of equities by government-directed Financials. Of course, this runs counter to the market-oriented reforms enacted in recent years, highlighted in the equity markets by China's opening the Shanghai-Hong Kong Stock Connect last year. We have noticed China's reforms often come in two-steps forward, one-step back manner, which seems to be the case here.

The Commonly Misperceived Devaluation

While much of the world saw it as a sign of economic desperation, China enacted yet another market-based reform in August. On 11 August, the government reset the yuan's official value 1.9% lower against the dollar and announced a new method of determining the exchange rate. The result was the yuan's biggest decline against the dollar in two decades and a slew of claims the government was desperate and trying to "steal growth" from trading partners via a competitive devaluation to boost exports.

However, a little perspective is in order. A -1.9% decline would be considered relatively normal volatility in markets less controlled than China's. The new exchange rate regime, too, was ostensibly meant to be more market-oriented than its predecessor. Before August 11, China used a managed float in which exchange rates were determined by fiat and then allowed to trade in a 2% bandwidth (up or down). The next day, the government would set a new rate that may or may not be influenced by the prior close. A number of times, this system has amounted to a de-facto peg against the dollar (Exhibit 14).

Exhibit 14: US Dollar Per Chinese Yuan



Source: FactSet, as of 22/10/2015.

The new methodology bases the daily rate on the prior day's close and market makers' quotes. While this is not perfectly market-set and the 2% bandwidth remains, rates are much more market-like than before. What is more, the devaluation was an acknowledgement the government had been propping up the yuan against the dollar for some time. In essence, the yuan was de-facto pegged to the dollar because the government was preventing it from falling, a stark contrast to US politicians' continuing claims the yuan should rise.

Since the new exchange-rate regime's announcement, most reports indicate China has intervened to prevent the yuan from falling further. At Q3's close the yuan was down a mere -2.1% against the dollar—a tiny move relative to the media firestorm it triggered.

A related issue is the IMF's Q4 vote on including the yuan in its reserve-currency basket, the special-drawing right (SDR). The SDR, designed in 1969, is an accounting unit presently comprised of the US dollar, British pound, Japanese yen and euro. It is not a currency in itself nor a claim on the IMF for the underlying currencies. A central bank seeking to redeem its SDRs must exchange them with other IMF members for the underlying currency. China has long expressed a desire for the yuan to be the fifth currency in the basket, and leaks in October suggested the IMF is leaning that way, seeing August's moves as steps toward a freer yuan. That being said, there is little fundamental benefit to inclusion in the SDR. Inclusion does not give an issuing country rights, fee revenue or lower bond interest rates, contrary to some popular notions. This is a symbolic matter—a sign of China's advance and reform.

The rest of EM…

Credit ratings agency Standard & Poor's downgraded Brazilian debt to BB+—junk status—late-lagging confirmation of Brazil's longstanding economic struggles. While headlines focused on the debt downgrade, Brazil's data have long shown the country's weakness. Q2 GDP fell -1.9% q/q, pushing the country into what most economists consider a recession—two consecutive quarters of contraction. Brazil's mid-September National Wide Consumer Price Index (IPCA CPI) remained at 9.57% y/y, matching August's 11-year high. Along with a stagnant economy, Brazil's political scene remains unsettled as the "Car Wash" corruption scandal continues to incriminate high-ranking officials. Talks of impeaching President Dilma Rousseff have strengthened, and while the likelihood is low, the political uncertainty is another headwind. With forward-looking indicators like The Conference Board's Brazil Leading Economic Index (LEI) falling -1.5% m/m in August—its 10th straight monthly decline—Brazil's near-term prospects look unattractive.

While many commodity-heavy Emerging Markets (EM) economies struggle, the category is not uniformly affected. Many nations—most notably India, Korea, Indonesia and Taiwan—receive a net benefit from falling commodity prices. India, for example, has remained positive, evidence EM are not a cohesive bloc and remain attractive on a selective basis. Services growth led India's calendar Q2 7.0% y/y GDP growth rate, particularly transportation and financial services. Tax revenues have risen 35% y/y year to date due to improvements in tax collection. August CPI slowed to 3.66% y/y compared to July's 3.69% y/y. While energy prices figure into that lower number, it is a marked improvement compared to the double digit levels of 2013. Given weaker-than-expected inflation, the Reserve Bank of India cut its policy repo rate by 50 basis points to 6.75%—more than most economists forecasted. With accommodative monetary policy, less dependency on China for growth and a tailwind from low energy prices, India appears to be gradually improving economically. Politically, while some are frustrated with the slow pace of reform, Prime Minister Narendra Modi has made progress on this front during his time in office and his government has pulled back from some potential market negatives. On September 1, Finance Minister Arun Jaitley reversed earlier statements, saying India will not apply the controversial alternate minimum tax to foreign institutional investors.

Many fret the struggles of EM overall—emphasising poor exports figures—while overlooking steady domestic demand. Taiwan GDP missed expectations of 2.5% y/y, growing just 0.6% y/y in Q2, though this is primarily due to weakness in the tech trade. However, domestic demand grew—private spending rose 2.8% y/y and imports were up 1.9% y/y. Indonesia grew 4.7% y/y in Q2—meeting expectations—driven by private consumption (5.0% y/y). Mexico also expanded resulting from Services industry growth. Q2 GDP rose 2.2% y/y (0.5% q/q) as services rose 3.1% y/y. Though countries like Indonesia and Mexico have large commodity sectors, they are also more diversified. While growth is by no means substantial, it shows not all EM are dependent on commodity prices (like Brazil or Russia) or robust Chinese economic growth. For better-diversified economies, the pain has not been as severe. Countries with solid consumer demand like Mexico and South Korea benefit from low energy costs. They also have large service sectors that can help offset some weakness in trade (and Energy in Mexico's case). In our view, it is not accurate to suggest a slowing Chinese economy will bring down all EM with it.

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iii. FactSet, as of 06/10/2015. MSCI AC World ex-USA Index returns with net dividends, 27/04/2015 – 29/09/2015
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v. Irish Central Statistics Office, as of 10/09/2015
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