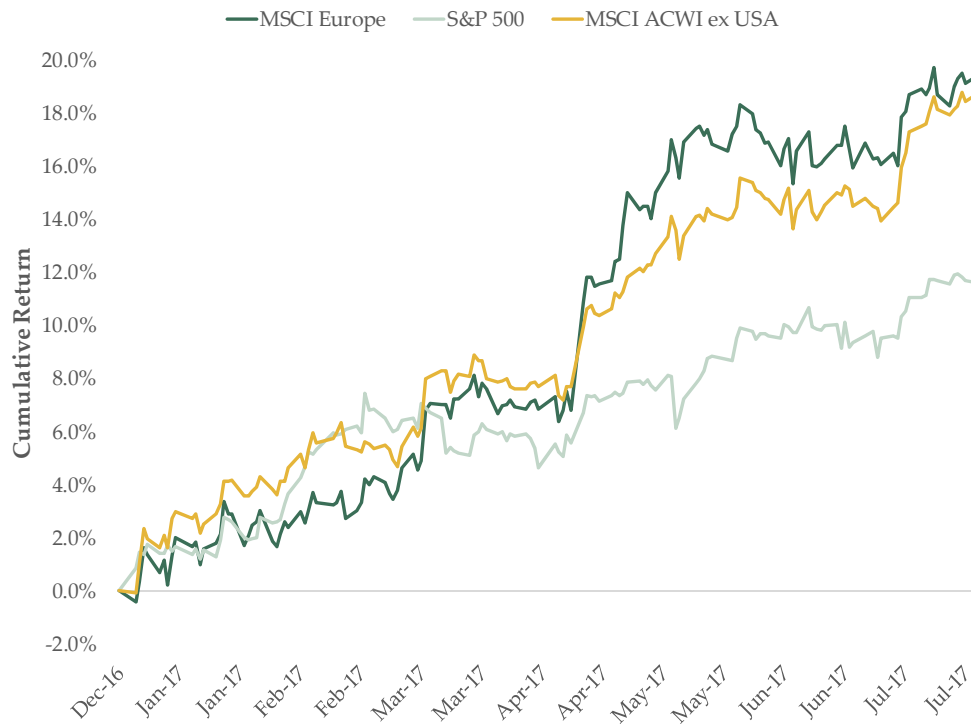


European Leadership

Entering 2017 we forecasted the leadership rotation towards non-US stocks – with European equities leading the charge. The forecast was tied to falling political uncertainty and underappreciated economic fundamentals within the European Union (EU). So far, our expectations have started to come to fruition, with the MSCI Europe being one of the best performing indices year to date (Exhibit 1).

Exhibit 1: Index Performance as of 31/07/2017



Source: FactSet as of 31/07/2017.

One of the most attractive ways to gain exposure to economic growth in Europe, particularly within Emerging Markets (EM), is through Poland. As the largest economy in Eastern Europe with a strong economic relationship with developed Europe, Poland offers a broad exposure to the European market.

Economy of Poland – Overview

Poland is the 9th largest economy in the EU, with the Nominal Gross Domestic Product (GDP) of \$469.5 billion as of 2016¹. Poland has had one of the fastest growing economies in the last decade, averaging 6.2% Y/Y real GDP growth since 2007 – handily outpacing Eurozone’s 0.4% growth during the same time period. More recently, Poland’s real GDP grew by 4.9% Y/Y in Q1 2017 – the fourth highest growth rate among EU members².



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The Polish economy is dominated by the service sector, which accounts for approximately 64% of the overall GDP. Some of the largest industries in Poland include machine building, coal mining, chemicals and iron & steel³.

Additionally, Poland remains the favorite outsourcing destination for Western European countries. Business Services Sector, which includes Business Process Outsourcing (BPO), IT and R&D companies, has seen a tremendous growth in recent years. In 2016, it employed more than 212,000 people, a 25% Y/Y increase⁴. One of the primary drivers of this growth has been Poland's education system, which provides Poland a significant edge over other developing countries. Polish schools consistently rank in the top of world rankings for science and mathematics. In 2015, Organization for Economic Co-operation and Development (OECD) has placed Polish schools 11th in the world and 5th in Europe⁵. The outsourcing sector in Poland should remain one of the fastest growing industries, benefiting from high-skilled labor and an increasing trend towards business outsourcing.

Why Invest in Poland Now?

We expect European stocks to continue outperforming in the second half of 2017, tied to falling political uncertainty (German and Austrian elections in Q3 provide this catalyst) and improving economic fundamentals. When Developed Europe outperforms the MSCI World, Poland typically outperforms Emerging Markets as well (Exhibit 2).

Exhibit 2: Poland Outperformance Correlated with Developed Europe Leadership



Source: FactSet, as of 31/07/2017.

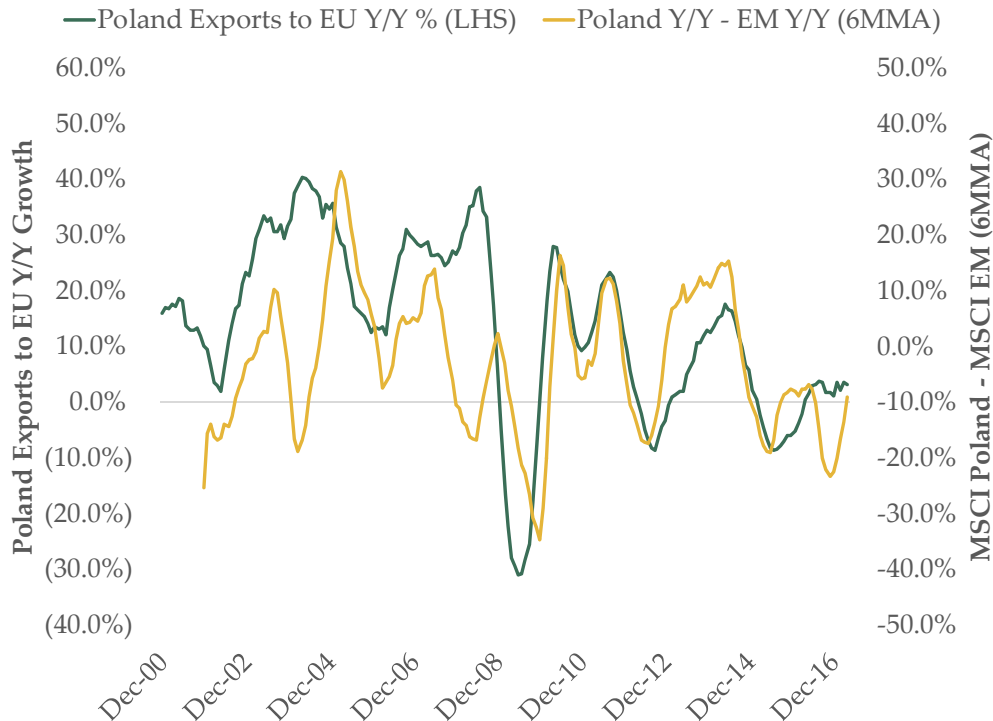


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This connection is due to the proximity effect and a robust economic relationship between Developed Europe and Poland. Approximately 80% of Polish exports go to EU members, with Germany responsible for the lion's share. Historically, Poland tends to outperform EM peers when trade activity with developed Europe is on the rise (Exhibit 3).

Exhibit 3: Poland is Heavily Linked to Developed Europe Demand Growth



Source: FactSet, IMF Direction of Trade Statistics (DOTS) as of 28/04/2017.

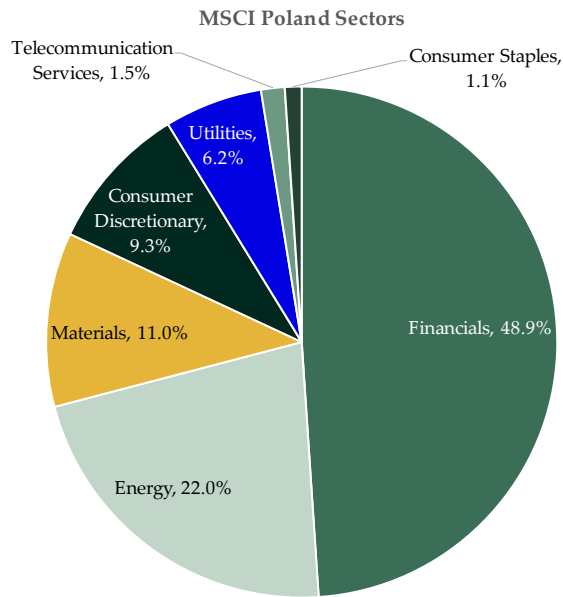
European Financials

Eurozone loan growth has been slowly accelerating and European Banks have been getting more comfortable with regulatory change. Coupled with what we think is overly dour sentiment on Eurozone banks today – vestiges of 2008 and the sovereign debt crisis – we believe European Financials provide a good investment opportunity.

Polish equities represent a good way to add European Financials exposure to our portfolios. The MSCI Poland index is heavily concentrated in Financials, with 3 of the largest 4 constituents operating in banking or insurance industries (Exhibit 4). European Financials are highly correlated to their country performance and usually have higher beta – Poland is no exception.



Exhibit 4: MSCI Poland Sector Breakdown



Source: FactSet, as of 30/06/2017

There are several positive economic fundamentals that should provide a tailwind for Polish Financials. Polish Banks have continued to improve their balance sheets since 2013 – a positive sign for a future loan growth (Exhibit 5).

Exhibit 5 Non-Performing Loans (NPLs) Have Been Decreasing

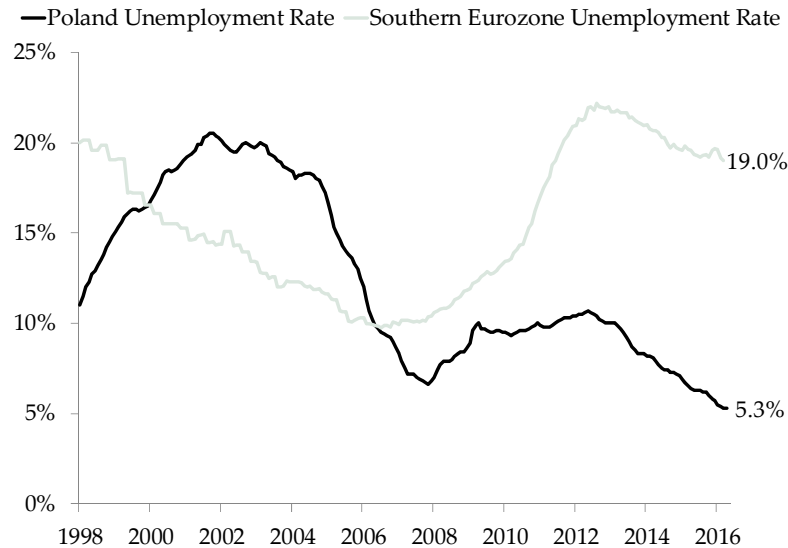


Source: Bloomberg, as of 31/03/2017.



Furthermore, the banking sector in Poland should benefit from record low unemployment levels in Poland. As previously mentioned, Poland has become one of the most attractive locations for business outsourcing in Europe, taking an increasingly larger share of jobs from Southern Europe (Exhibit 6).

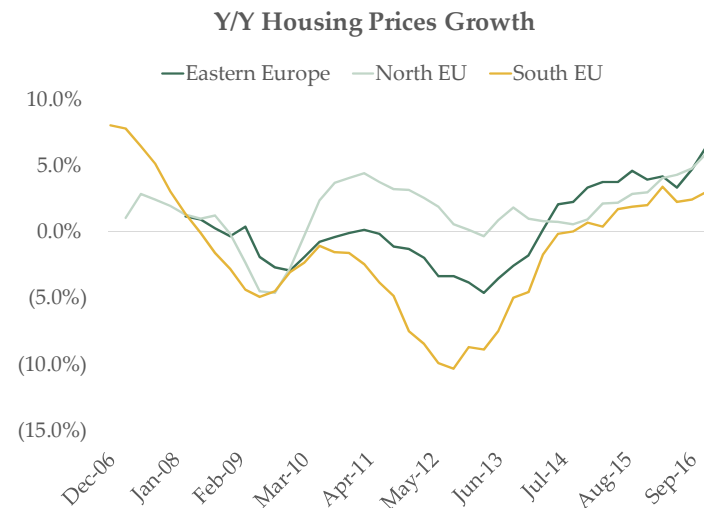
Exhibit 6: Poland Unemployment Level at Record Lows



Source: FactSet as of 28/04/2017.

Finally, the housing market in Poland and EM Eastern Europe region has been strong, which should support the banking sector and future loan growth in Poland (Exhibit 7).

Exhibit 7: The Strength of the Housing Market



Source: FactSet, Eurostat as of 31/12/2016



Poland – Political Risk Factors

Politics remain the biggest risk factor in Poland. The Law & Justice Party (PiS) won an outright parliamentary majority in 2015. The PiS is one of the most conservative governments across Europe and has been fairly aggressive in pushing legislative changes.

Most recently, parliament passed three bills that threatened to limit the Supreme Court's independence. These bills would allow the Justice Minister power to fire heads of all lower courts, force all Supreme Court justices to step down, except those approved to stay by parliament, and give parliament an authority to appoint members of the National Council of Judiciary. This was met with strong opposition from the European leaders and the Polish population, leading to widespread protests in Poland. In a surprising move, the President of Poland, Andrzej Duda, has signed the bill that would allow firing of the heads of lower courts, but has vetoed the other two. While this is a positive development, the future of the bills still remains unclear and we will keep monitoring the situation closely.

It is important to note, however, that these political developments haven't really affected Poland's relative returns. Even recently, Poland's outperformance continues to track Europe's outperformance – but with slightly more volatility. Going forward, we believe economic fundamentals should outweigh political factors, leading to Poland's outperformance.

There is also the risk of a looming banking 'tax' which would require private banks to help pay for the cost of converting Swiss Franc mortgages into Zloty. The details of this have yet to be worked out, and this comes as no surprise to the market, as it initially was a campaign promise of Duda, when he ran for the office back in 2015. There have been numerous proposals over the last few years, with no meaningful progress to speak of—so while it is a risk, it is far from a certainty and even so has limited surprise power.

Sources: Fisher Investments Research, FactSet, Bloomberg, The World Bank

¹The World Bank

² FactSet as of 10/08/2017

³ The World Bank

⁴ Ernst & Young, *Doing Business in Poland*

⁵ OECD, *Programme for International Student Assessment (PISA) 2015*.

