Fisher Investments Europe™

MARKET PERSPECTIVES
REVIEW & OUTLOOK

SECOND QUARTER
2020

SECOND QUARTER 2020 REVIEW & OUTLOOK

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SECOND QUARTER 2020 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

09 July 2020

PORTFOLIO THEMES

- We continue to favour larger, high-quality companies, but our assessment of the market's future path will determine if we shift toward smaller cyclical firms.
- Unlike many past cycles where the bull market's leading category underperformed in the subsequent bear, large Technology equities have held up relatively well during the bear market and initial bounce off the market lows. Consequently, we are not yet convinced the recovery will be a conventional new bull led by small value.

MARKET OUTLOOK

- **Equities Appear to be in a New Bull Market:** The rally since late March looks to us to be a new bull market forming as equities look further into the future and anticipate a recovery.
- **Equities are Leading the Economic Recovery:** As a leading indicator, equities have started recovering well before Covid-19 is gone, restrictions are removed, or the economy recovers.
- **Early Bull Markets Begin with Pessimism:** Volatility is to be expected, but with pessimism about a second wave growing and positive data garnering little fanfare, we think more gains are likely.

Global equities followed one of history's worst quarters with one of its best in Q2, soaring 19.2%.[i] Year-to-date, global equities are down -6.3%.[ii] Similarly, emerging market (EM) equities rose 18.1% in Q2, as growing progress—and clarity—on major emerging and developed countries' Covid-19 lockdown relaxations continued.[iii] Though we believe an initial recovery is indeed underway, equities' path from here isn't pre-determined. While we remain vigilant and monitor multiple variables, there is little reason equities shouldn't do well from here.

To quote Q1's Executive Summary, "The coronavirus wasn't even known to researchers until mere months ago—and much about it remains unclear. Beyond this, will government mandated social distancing and Covid-19 containment guidelines expire soon, or will governments around the world extend them again? Will infection rates keep falling in Europe and allow normal life to resume, or will containment efforts there long endure? These questions can't be answered now, but all have resolutions. Yet equities should increase long before those resolutions emerge." At that time, equities were one week past March 23's low. From then through quarter end, they rose 33.0% in a V-shaped rebound, catching most of the world off guard.[iv]

We see this bounce as a new bull market starting, but one that is acting more like the recovery side of a hugely oversized market correction than a conventional early bull market. That said, it is far too early to be certain and we aren't suggesting markets are on a pre-set course. However, a sustained climb with periodic volatility seems much more likely than another steep downturn. As noted in Q1's Review, relatively quick reopenings would likely fast-track a recovery, triggering a correction-like market rebound in speed and lack of leadership rotation. That seemingly is underway.

i. Source: FactSet, as of 30/06/2020. MSCI ACWI Index return with net dividends, 31/03/2020 – 30/06/2020.

ii. Ibid. MSCI ACWI Index return with net dividends, 31/12/2019 – 30/06/2020.

iii. Ibid. MSCI Emerging Markets Index return with net dividends, 31/03/2020 – 30/06/2020.

iv. Ibid. MSCI ACWI Index return with net dividends, 23/03/2020 – 30/06/2020.

Sentiment is classically early bull market. Few investors believe the rally. As Ken highlighted in a recent column, pundits dismiss positives as fleeting or faulty—a mindset he coined "the Pessimism of Disbelief." Most see the abysmal forecasts for Q2 GDP and quarterly earnings and believe equities are disconnected from reality—inflated by government or central bank largesse. They say markets ignore upticks in Covid-19 caseloads. Few fathom the simple fact that equities are leading indicators. Equities typically pre-price conditions 3 – 30 months out. In the all-time record-fast bear market, equities shifted focus to the very near end of that range, pricing the sudden, sharp economic contraction lockdowns wrought. But as that reality became widely known, markets shifted their focus. As is normal after a bear market-sized plunge creates pessimism, equities shifted to the 3 – 30 month range's far edge—a time when Covid-19 is old news, having been vanquished by a vaccine or just gradually diminishing.

Already, easing lockdowns have helped sprout economic green shoots. This should have surprised no one, considering there was nothing fundamentally wrong with the economy before lockdowns halted growth. This improvement is getting plenty of attention, but few expect it to last. As several states and countries pause or even reverse reopening plans, fears of renewed lockdowns remain. While a renewed, widespread lockdown could have a severe effect on equities, this scenario seems unlikely. Crucially, nearly every investor is considering this, so the markets have likely factored in a potential Covid-19 recurrence to a large extent already. To justify bearishness, we think it would take a probable negative that isn't widely discussed—and therefore isn't pre-priced now. We don't see any such thing.

The US election in November also garners many headlines. Polls currently show the Democratic presumptive nominee, former Vice President Joe Biden, far ahead of President Trump. However, in our view, it remains premature to forecast this election. Almost any outcome from a Democratic sweep to a Republican one is possible. We will detail those in the full Review—plus the potential market impacts of the various outcomes, none of which should apply quite yet.

In Europe, the EU's €1.85 trillion budget proposal grabbed headlines. The EU announced its long-term 2021-2027 budget—the key item: a coronavirus relief proposal of €500 billion in grants and €250 billion in loans, financed in part by newly issued common EU debt-a big step toward fiscal transfer union. Though headlines were positive on the development-both for the alleged near-term benefits for Covid-19 relief and the longer-term benefits of greater EU unity-we don't think its passage or failure will materially impact Europe's economic recovery. Additionally, the UK announced its tariff regime-the UK Global Tariff (UKGT)—which details what Brexit on World Trade Organization (WTO) terms would look like. While the regime upholds a few tariffs for industries such as the auto sector and agriculture, the outcome is broadly freer trade with non-EU nations. We also have greater clarity now, for even if a no-deal Brexit occurs, UKGT terms would apply to the EU. Ultimately, this very different from fears of a more-protectionist UK, and the removal of no-deal Brexit uncertainty is a positive, in our view.

In emerging markets, tensions between China and India briefly surged last month after military incidents at a disputed border region, leaving some concerned with further conflict between these nuclear-armed nations. However, both sides seem to be focused on de-escalation. Additionally, in Brazil, calls mounted in May for the impeachment of President Jair Bolsonaro. In addition to criticisms of the government's handling of the coronavirus response, these center around allegations by ex-Justice Minister Sergio Moro that President Bolsonaro fired the head of the federal police in order to install an ally. Presently, the legislature and President Bolsonaro are occupied with Covid-19 matters. While EM equities' rapid June ascent may slow, and further reopening hinges on politicians' unpredictable decisions, we think the rebound is a new bull market beginning—running alongside a similar move in the developed world.

At a sector and style level, things are evolving largely as we expected. As equities fell in Q1, we observed that the market behaved as it typically does in a correction, rather than a long bear market with volatile declines late. It was just much bigger than a correction. Accordingly, we expected the categories that led as the last bull market matured to lead in the recovery—namely, the largest growth-oriented equities in Tech and Tech-like industries. Only if the bear market persisted did we expect a leadership shift toward smaller, more cyclical companies. So far, that has worked well in global markets. While many called for small value equities to lead based on historical data, that hasn't happened with consistency. The categories that led before the decline fell less than broad markets in the decline and have led markets higher in the upturn. Of course, like always, days and multi-week periods have seen countertrends. But overall, large, high-quality companies have outperformed. We expect this to continue, but we are actively monitoring this trend.

Risks exist—as always and bear market recoveries are rarely smooth. Yet as we will show in the full Review, equities retracing the gains and re-testing March's low after this large a recovery would be a historical anomaly. While many remain pessimistic, we believe this is indication of the pessimism that characterises early bull markets. With positive economic data being met with broad skepticism and negativity about a second wave growing, we think more gains are likely.

GLOBAL UPDATE AND MARKET OUTLOOK

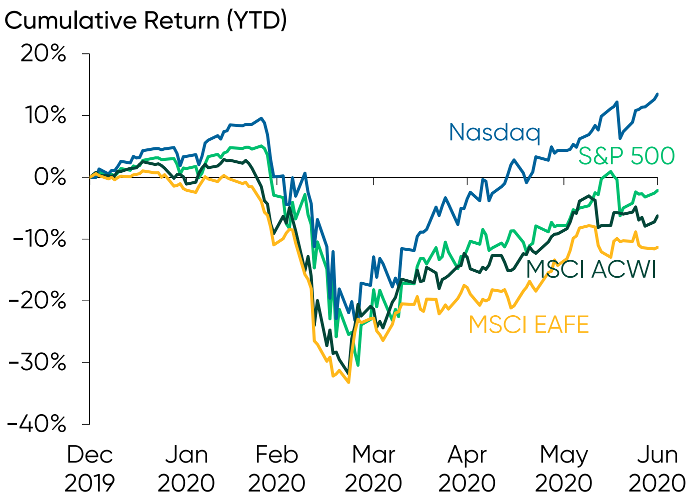
06 August 2020

Q2 MARKET RECAP

A NEW BULL MARKET

If Q1 was the left half of a V-shaped economic downturn, Q2 looks like the right half (Exhibit 1). Global equities finished June up 38.2% from their 23 March low.[v] To us, this looks like a new bull market, with equities looking past dour sentiment to a brighter future. For history to record otherwise, it would require a dramatic market drop to new lows—unprecedented and improbable, as we will show. A continued recovery is a much more realistic expectation, in our view.

EXHIBIT 1: S&P 500, MSCI ACWI, MSCI EAFE AND NASDAQ IN 2020

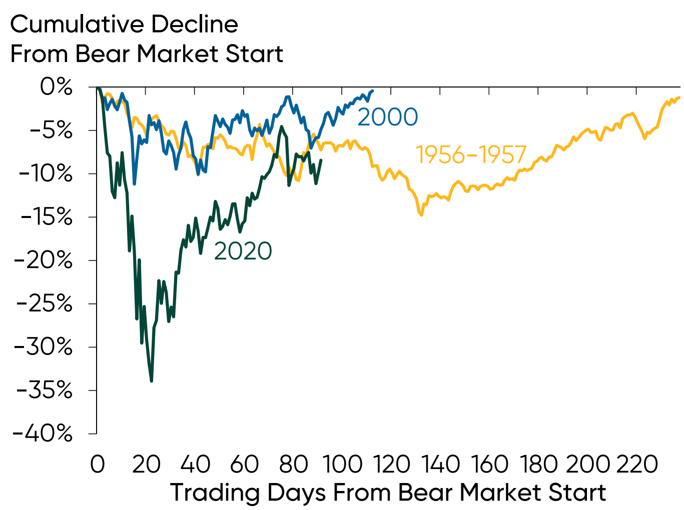


Source: FactSet, as of 06/08/2020. S&P 500, Nasdaq total returns, MSCI ACWI, and MSCI EAFE return with net dividends., 31/12/2019 – 30/06/2020.

We expect volatility and it would also be unrealistic to expect Q2's torrid gains to repeat over the rest of the year. A correction is always possible, for any reason. But a double dip to new lows would be a first. Market history isn't predictive, but it does illuminate probabilities. Using the US market as a proxy, since March's low, the S&P 500 has recouped over 75% of its bear market decline. Only two bear market rallies in S&P 500 history recovered that much or more, only to plunge to new lows: 1957 and 2000.[vi]

Neither resembles the present. In 2000, US equities fell just -11.2% between 24 March and 14 April. From then through 01 September, they retraced nearly the entire drop before grinding slowly lower to 2002's bear market depths.[vii] In 1956 – 1957, US equities fell -14.8% between 2 August 1956 and 12 February 1957. They recaptured nine-tenths of that in the next five months before falling into bear market territory.[viii] Unlike now, neither rally started from full-scale bear market depths. (Exhibit 2) Nothing is impossible. However, in our view, a renewed bear market is an exceedingly low probability.

EXHIBIT 2: 2020'S UPTURN DOESN'T RESEMBLE BEAR RALLIES IN 1957 AND 2000



Source: Global Financial Data, Inc., as of 14/07/2020. S&P 500 price return, 19/02/2020 – 30/06/2020, 19/08/0256 – 15/07/1957 and 24/03/2000 – 01/09/2000.

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v Source: FactSet, as of 30/06/2020. MSCI World Index return with net dividends, 23/03/2020 – 30/06/2020.

vi Source: Global Financial Data, as of 6/2/2020. Statement based on S&P 500 Price Index return, 03/01/1928–01/06/2020. Analysis includes rallies that occurred anywhere in a bear market and recaptured at least 70% of the total bear market drop to that point. A "retest" is any subsequent decline coming within 5% of the previous low. The 2000 retracement was 96.1% of the drop. 1957's was 91.7%.

vii Ibid. Bear market began 24/03/2000; retracement rally was from 14/04/2000 – 01/09/2000.

viii Ibid. Bear market began 19/08/0256; retracement rally was from 12/02/1957 – 15/07/1957.

THE PESSIMISM OF DISBELIEF

One hallmark of every new bull market is a phenomenon we call the "Pessimism of Disbelief"—investors' tendency to see only bad news, dismiss positives as false or sowing future trouble, and seek reasons the rally must be premature. This mentality is everywhere today. People say equities are ignoring dismal forecasts for Q2 GDP and corporate earnings. They say investors are irrationally dismissing rising Covid-19 caseloads and the risk of a second lockdown or that equities are inflated by Fed largesse. Improved economic data get attention, but few expect a lasting recovery. When June's employment report showed non-farm payrolls rose by 4.8 million, commentators warned the survey covered the midmonth pay period—before Covid-19's resurgence caused some states to pause or delay reopening—creating a false positive.[ix]

The Robinhood headlines perhaps best exemplify the Pessimism of Disbelief. It extrapolates anecdotal evidence into a false caricature of all investors. The theory goes like this: Bored millennials who couldn't get a thrill from gambling or fantasy sports during lockdown turned to equity trading apps with flashy, game-like layouts. Instead of buying diversified funds to build a nest egg over many decades, they sought quick riches in penny stocks and alleged coronavirus winners. Pundits drew parallels between these folks and Joe Kennedy's proverbial shoeshine boys offering equity tips in the late 1920s and dot-com buying cab drivers in 2000. Their conclusion: Euphoria must be driving markets.

Some young people are actively trading, as the press coverage shows. Yet the Robinhood crowd is a sliver of the investing populace and doesn't represent investors in equity markets at large. Part of Robinhood's allure is the ability to buy fractional shares—by definition, anyone doing that is putting very little money to work. The vast majority of investors aren't engaging in this sort of speculation. But when people presume a rally must be fake and participants irrational, Robinhood speculators become the perfect justification. It seems like a classic example of confirmation bias—the tendency to see only evidence supporting your preconceived notions and discard all other information—fueling the pessimism of disbelief.

ix Source: BLS, as of 13/07/2020.

EQUITY MARKETS ARE THE LEADING INDICATOR

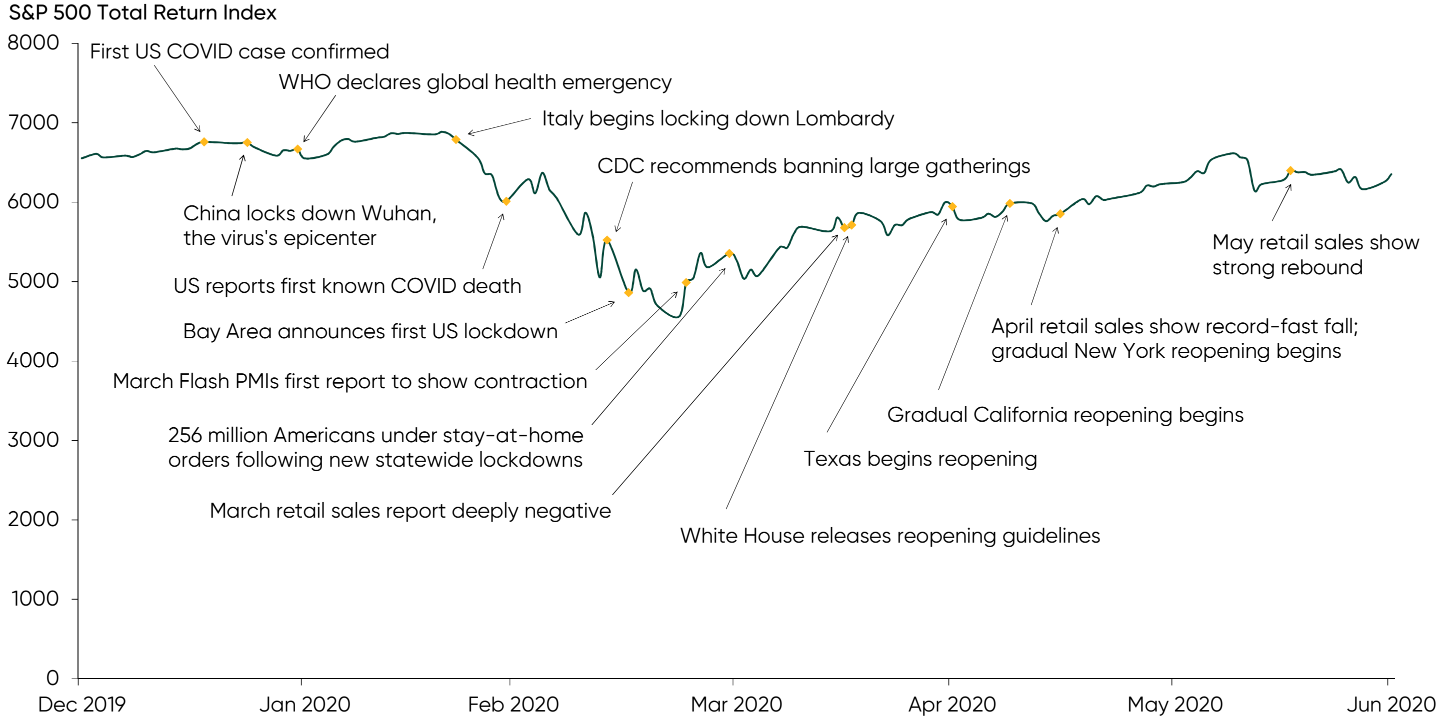
In our view, this new bull market has a simple, rational underpinning: Equities are a leading economic indicator. They generally look 3 – 30 months ahead. On both sides of the V, they efficiently discounted what was to come.

On the way down, equities looked to the very short end of that 3 – 30 month window. The record-fast plunge to bear market territory preceded any economic data hinting at the severe economic contraction resulting from lockdowns. Equities didn't wait for retail sales, industrial production or GDP to confirm the carnage. They fathomed the contraction and its effect on earnings as lockdowns took effect, registering it in pricing. The market bottomed on 23 March and most economic indicators suggest the economic contraction bottomed out in Q2—equities were three months ahead of economic data.

> "IN OUR VIEW, THIS NEW BULL MARKET HAS A SIMPLE, RATIONAL UNDERPINNING: EQUITIES ARE A LEADING ECONOMIC INDICATOR."

At the low, equities seemingly shifted focus further out, toward the 30-month end of the range. They soared in April and May, even as most of the world remained shut and economic data hit numerous worst-ever records (Exhibit 3). But soon the developed world began reopening. Increased economic activity quickly registered in real-time indicators such as TSA checkpoint crossings, restaurant reservations, credit card activity, retail foot traffic and electricity generation. Soon these green shoots showed in more traditional metrics, including purchasing managers' indexes and retail sales.

EXHIBIT 3: MARKETS MOVED FIRST



Source: FactSet, Centers for Disease Control, The New York Times and Santa Clara Country (CA), as of 21/07/2020. S&P 500 Total Return Index level, 31/12/2019 – 30/06/2020.

In our view, equities aren't just pricing in this near-term recovery. They are looking further ahead, to a time when Covid-19 is old news and some semblance of normalcy has returned, whether because we have a vaccine or the virus otherwise faded. People have trouble understanding this, but equities have always been able to see what people can't. This happened after the last bull market began in 2009. Then, equities bottomed in early March. The recession wouldn't end until June, and data wouldn't register the recovery until lateJuly. The economic rebound wasn't a perfect V and took some time to rebound. Similarly, corporate earnings took time to improve. But equities looked to a brighter eventuality, regardless of the path there. Investors who trusted the market reaped its rewards.

We believe markets' foresight will prove similarly rewarding this time. Markets have always been able to see through things like Covid-19's resurgence and the threat of new lockdowns. No one expected smooth sailing once lockdowns began lifting. An uptick in cases was virtually a foregone conclusion to some degree as millions emerged from sheltering in place. Beyond this, fear of a second Covid-19 wave circulated widely even before the first one ebbed. The likelihood of more cases as lockdowns ended—and possibly a second wave—was therefore widely known to society and reflected in equities. Surprises move markets. More Covid-19 cases weren't a surprise. Nor were the pauses and delays in reopenings in some regions—a process few expected to be smooth.

Fears of a second wave are a twist on double-dip fears—normal in new bull markets. In the last bull market, many feared a double dip throughout 2009 and 2010. Investors had negative reactions to Alt-A mortgages, Dubai's debt crisis, municipal debt concerns and Meredith Whitney's infamous 60 Minutes interview. All these events and others were allegedly the second leg down, much like a second Covid-19 wave today. None of these fears materialised.

We aren't dismissing a second global lockdown, which could be bad. We think the probability of one large enough to shock equities has diminished greatly, but it isn't zero. However, positioning for a distant possibility is unwise. Lockdowns are political decisions—inherently unpredictable. We can only assess the situation as it unfolds and weigh the risks. Should we identify a material negative that markets haven't priced, we won't hesitate to act.

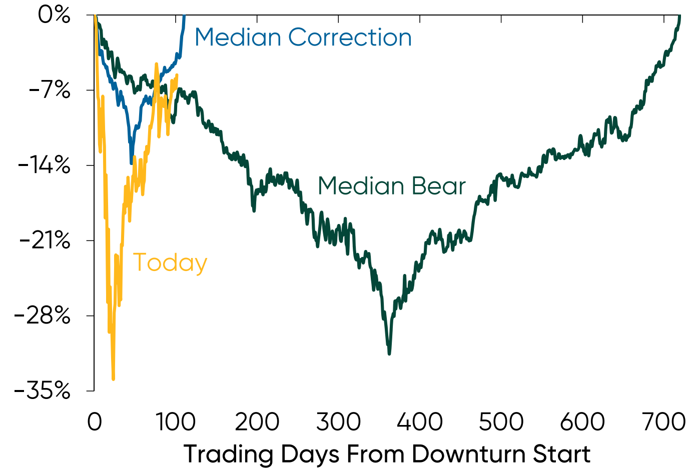
WHAT WORKED IN THE BEAR MARKET

Last quarter, we observed that, from a speed and leadership standpoint, equities were behaving as they typically would in a huge correction, not a traditional bear market. Usually bear markets start slowly, luring investors into complacency for months before their late plunges. This time, equities seemingly fell off a cliff from the start—a sudden start, just like a correction. We anticipated that if this continued, and the bear market was as short as corrections typically are, it could have implications for portfolio positioning.

As we wrote in our Q1 Review: "If equities continue behaving as they would in a correction, and the economic contraction is short and sharp, that argues for maintaining our present sector weights and emphasis on quality and growth-oriented names. Usually, what leads heading into a correction leads during the recovery. Should this pain prove short-lived and businesses begin reopening soon in much of the US and Europe, we would expect the biggest companies to continue leading. However, if closures persist and we get a longer, more grinding economic contraction and bear market, equities may act more like they usually do at the end of a full market cycle. That would argue for repositioning into smaller and more value-oriented companies, which normally lead in a new bull market."

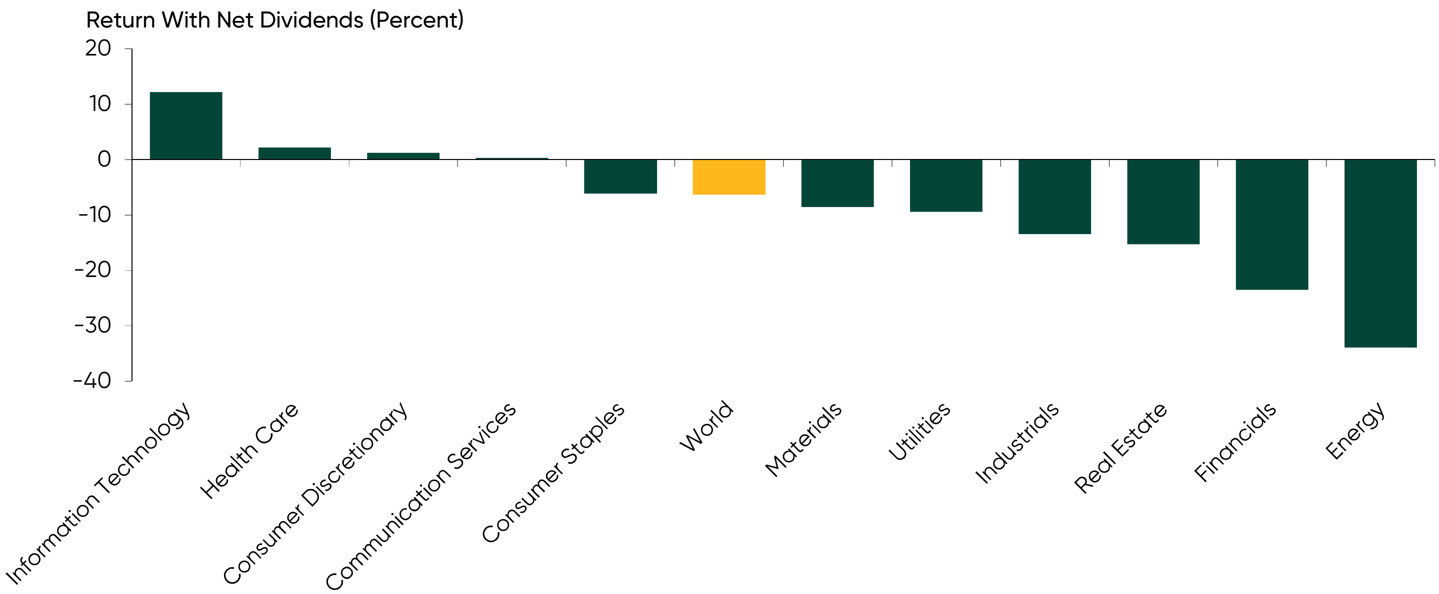
Today, equities' trajectory still looks correction-like. (Exhibit 4) Technology equities have continued leading alongside growth equities (Exhibits 5 & 6).

EXHIBIT 4: BEAR BY MAGNITUDE AND CAUSE; CORRECTION-LIKE SPEED



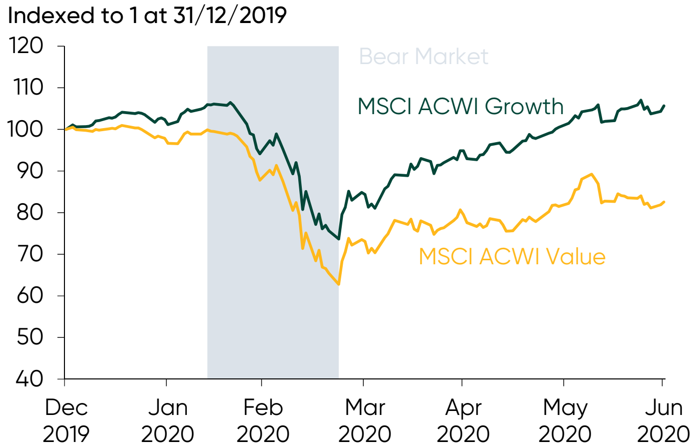
Source: FactSet, as of 16/07/2020. Median S&P 500 price index returns in bear markets and corrections from 03/01/1928 - 31/12/2019 and S&P 500 price index return from 19/02/2020 – 15/07/2020.

EXHIBIT 5: SECTORS RETURNS



Source: FactSet, as of 05/08/2020. MSCI ACWI sector index returns with net dividends, 31/12/2019 – 30/06/2020.

EXHIBIT 6: GROWTH VERSUS VALUE

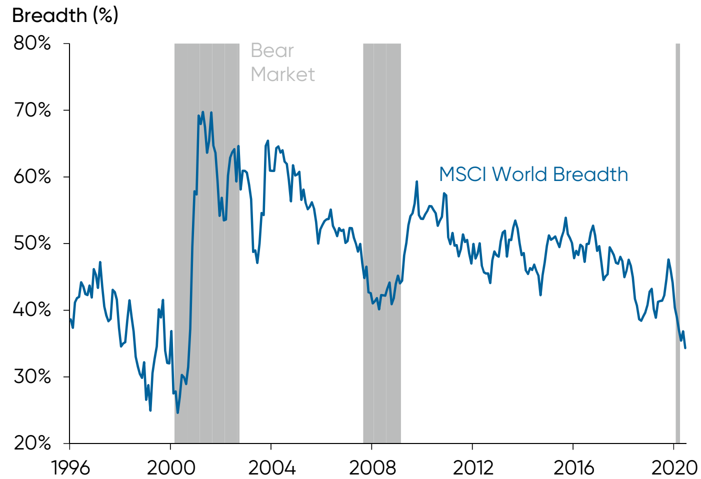


Source: FactSet, as of 06/08/2020. MSCI ACWI Growth and MSCI ACWI Value divided by MSCI ACWI Index returns with net dividends, 31/12/2019 – 30/06/2020. Indexed to 1 at 31/12/2019.

Growth equities typically lead in a bull market's second half, when investors who were scared out of equities during the prior bear market usually begin returning. They gravitate toward well-known companies, with diverse revenue streams and a perceived ability to grow and profit through periods of strength and weakness. Value equities, on the other hand, usually outperform as a bull markets begins. These economically sensitive companies usually lag during a traditional bear market's panicky final stages, as investors flee companies that look unlikely to survive the recession. As the new bull market begins, these same companies are the beneficiaries of bargain hunters seeking big returns in unfairly punished companies and turnaround opportunities. These were the "spring-loaded" categories long-term clients may remember from our 2009 writings.

This history leads many to expect small value outperformance today. That widespread attention makes the history priced in, however—when everyone expects one thing, equities usually do another. That different thing, this time, is growth equities' leadership in the new bull market. This also applies to declining market breadth (the number of equities outperforming broad markets). Breadth declined during the bear market and has continued to decline in the new bull market, with just 38.1% of MSCI ACWI equities outperforming at quarter-end.[x] (Exhibit 7) Usually, breadth rises in early bull markets, which many skeptics argue is a sign the upturn isn't sustainable. But to us it is yet another factor highlighting markets' correction-like environment, despite the downturn easily qualifying as a bear market. We expect large growth equities to continue leading and breadth remaining narrow as a result.

EXHIBIT 7: MARKET BREADTH DECLINED IN THE BEAR MARKET—AND THE NEW BULL MARKET



Source: ClariFI; MSCI World constituent and headline index prices (monthly) using IDC pricing data from 31/01/1995 to 30/06/2020. Trailing 12 month performance based on constituents with 12 months of observations, breadth calculated as number of companies outperforming the headline index.

This isn't only because no one expects it. The bear market didn't last long enough for value to receive its typical late-stage underperformance. It ended before the recession even became official and before the worst earnings results hit the wires. Additionally, value typically benefits from a steeper yield curve, which improves higher risk companies' credit access. Today, the yield curve is relatively flat.

x Source: Clarifi, as of 09/07/2020. Breadth based on trailing 12-month S&P 500 and constituent returns.

THE GREEN SHOOTS EQUITIES SEE

In our view, equities are already pricing in an economic recovery tied to reopening, which newer data support. The first hints showed in non-traditional high-frequency data points ranging from credit card swipes, spending, restaurant reservations and pollution. Now official data are showing a positive turn. While we are seeing hints of positive real-time economic data starting to emerge, nearly all backward looking data from Q2 will be sharply negative. We will provide more detail on this in the following sections.

INFLATION OUTLOOK AND INTEREST RATES

After central banks responded to the Covid-19 lockdowns' economic fallout by cutting rates, deploying special lending programmes and relaunching QE, many began fearing the massive money supply increase would stoke runaway inflation—echoing 2009's big fear. While we believe these fears are misplaced, at least these fears hinge on money supply. As Nobel laureate Milton Friedman put it decades ago, inflation is a monetary phenomenon—too much money chasing too few goods and services. After spending most of the last five years hovering in a 4 – 6% y/y range, US M4 money supply surged 10.0% in March, 22.0% in April and 28.5% in May.[xi]

Those are very large increases, but we see many reasons to think they won't make inflation surge. In an economic crisis, one of the biggest risks is money drying up, forcing businesses under. With revenue halted for many firms, that was a clear risk this time. While we are often quite critical of central bankers' actions—and definitely don't think their response this time was perfect—they clearly learned this lesson from history. Increasing the money supply dramatically is mostly a one-time move designed to prevent a credit crisis and offset the otherwise deflationary impact.

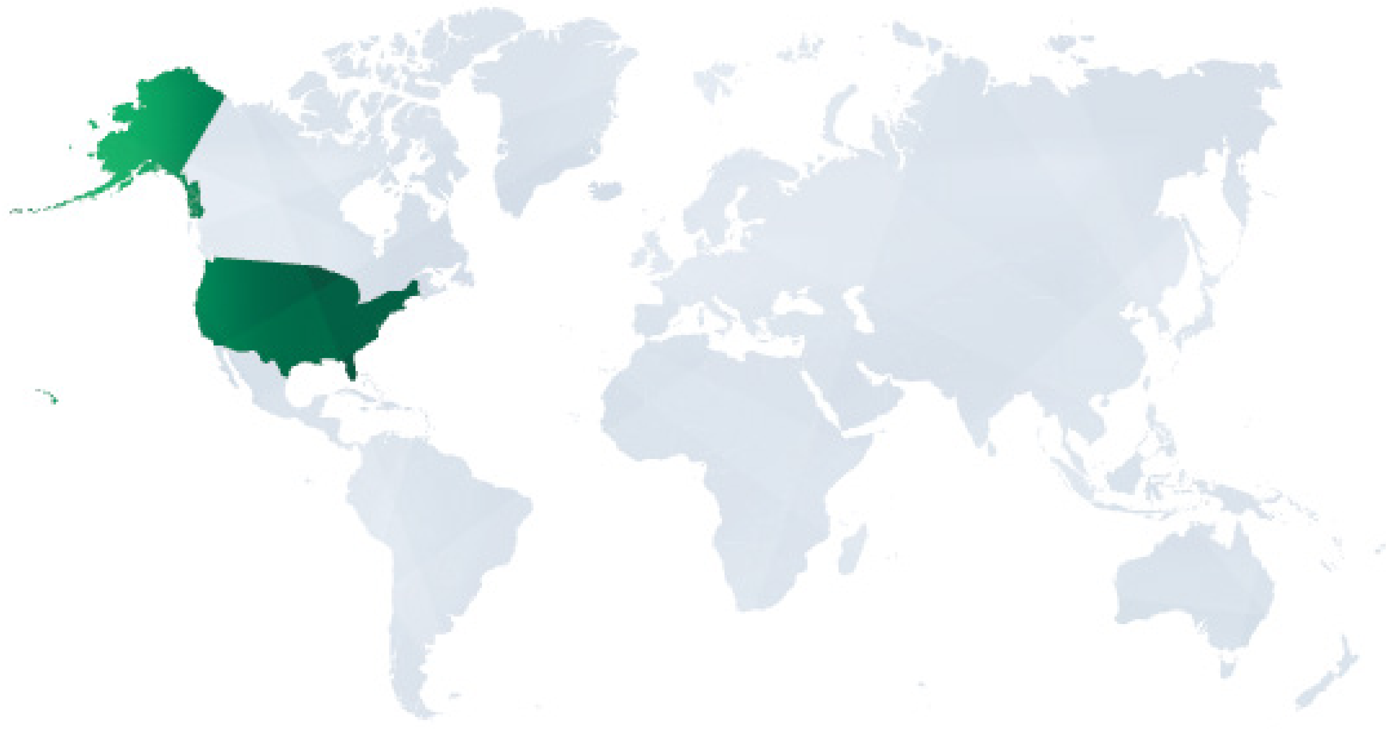
Furthermore, one of the Fed's actions—QE—flattens the yield curve by lowering long-term interest rates. For years observers mistook this for "printing money" and expected hot inflation. However, this is wrong. The Fed isn't printing money with QE. It is increasing bank reserves, which may boost money supply a ton if banks lend aggressively. But banks borrow short term to fund longer-term loans. The spread between short and long rates is therefore a key indicator of new lending's profitability. When the Fed buys long-term bonds under QE, it pushes down long rates. With short rates pinned at 0% – 0.25%, that makes lending less profitable—and hence, less plentiful. As we have noted in Reviews for years, QE is a disinflationary policy masquerading as stimulus. We don't think it is powerful enough to disrupt the recovery, but neither is it likely to spur fast growth or inflation.

> "AS WE HAVE NOTED IN REVIEWS FOR YEARS, QE IS A DISINFLATIONARY POLICY MASQUERADING AS STIMULUS. WE DON'T THINK IT IS POWERFUL ENOUGH TO DISRUPT THE RECOVERY, BUT NEITHER IS IT LIKELY TO SPUR FAST GROWTH OR INFLATION."

Similarly, many investors fear interests rateswill soon rise, tied to the big deficits and debt issuance. However, long rates are influenced mostly by inflation expectations. Without signs of accelerating inflation, there isn't much fuel for rising rates. While it would be natural for rates to rise some as economic conditions improve, we don't expect anything major.

xi Source: Center for Financial Stability, as of 13/07/2020.

UNITED STATES **COMMENTARY**



A POLITICAL PRIMER BEFORE THE US ELECTION

As always, our political commentary is intentionally non-partisan. We favour no politician nor any political party and assess developments solely for their potential market impact (or lack thereof). We believe political bias can blind—increasing the risk of investment error.

With the US elections in November, headlines have begun warning of market turbulence—particularly should presumptive Democratic nominee Joe Biden beat incumbent President Donald Trump. In our view, it is too early to know the winner, let alone their future policies. Further, we think most election fears mistake how politics usually affect markets, overweighting personalities and partisan bias. To that end, we begin this section with a primer on how markets and politics interact before discussing 2020 specifics.

EQUITIES ARE POLITICALLY AGNOSTIC

When analyzing politics' market impact, many focus on whether a politician or political party is "market-friendly." Our view differs. We believe policy, not personality, matters more to markets, and no person or group has a monopoly on legislation markets like (or hate). Equities care primarily about whether new rules will affect critical matters like property rights and the ease of doing business. Campaign trail promises set investors' expectations on this front. Equities then move on the gap between these expectations and what materialises.

With few exceptions, investors' expectations—particularly during election years—stem from generalisations. Because of how each party typically appeals to its base, investors traditionally see Democrats as favouring increased regulation, higher taxes and other "anti-business" policy. In contrast, Republicans usually run on cutting taxes and reducing regulations, making them appear business friendly. But in reality, neither party is inherently good nor bad for equities. US equities average 9.5% yearly returns under Republican presidents and 14.8% under Democrats.[xii]

Both parties have passed policies creating winners and losers. Among Democrats, President Obama signed 2010's Dodd-Frank Wall Street Reform and Consumer Protection Act. Though not a massive negative for US banks, the law unintentionally punished small banks by increasing their compliance costs and giving bigger institutions an aura of safety based on enhanced scrutiny. It also created new regulatory bodies subject to little oversight—posing the risk of "government creep." It didn't derail the bull market, as the final legislation was more benign than expected. But beyond increasing bank capital somewhat, it didn't address the financial crisis's causes and did pick winners and losers. Decades prior, President Roosevelt's (FDR) "New Deal" contained programmes that stifled productivity. The National Recovery Administration, for example, imposed myriad new codes and strict price controls on firms, weighing on production and investment until the Supreme Court ruled the programme unconstitutional.

On the GOP side, President George W. Bush signed 2002's bipartisan Sarbanes-Oxley Act. SarbOx made CEOs criminally liable for accounting and reporting errors, burdening Corporate America—and likely extending the 2000 – 2002 bear market. President Nixon enacted price controls and bullied the Fed to keep interest rates low—teeing up high inflation, recession and contributing to the 1973 – 1974 bear market. There are many other examples for both parties.

GRIDLOCK: WHY LESS ACTION IS MORE BULLISH FOR EQUITIES

In the US, major changes generally require legislation. Hence, equities care primarily about how active Congress is and whether sweeping laws can easily pass. The more Congress can get done, the greater the uncertainty. This can discourage risk-taking, as it incentivises businesses to enter wait-and-see mode. If you are concerned future taxes or regulations could impact the return on an investment, you may wait for clarity before launching a project.

> "...EQUITIES CARE PRIMARILY ABOUT HOW ACTIVE CONGRESS IS AND WHETHER SWEEPING LAWS CAN EASILY PASS. THE MORE CONGRESS CAN GET DONE, THE GREATER THE UNCERTAINTY."

Therefore, in our view, the key political positive isn't the party in power, but simple gridlock. When legislatures are too divided to enact radical changes, uncertainty eases, and legislative risk aversion doesn't weigh on markets. We think investors must weigh not only the presidential contest, but also Congress—and the likelihood of more or less gridlock.

xii Source: Global Financial Data, Inc., as of 16/07/2020. S&P 500 average annual total return in years Democratic and Republican presidents are in office, 1926 – 2019.

ELECTION YEARS AND THE PERVERSE INVERSE

Investors' partisan biases can still affect sentiment—and returns—surrounding presidential elections. History shows election years are typically positive, with returns back-end loaded as uncertainty gradually fades. (Exhibit 8) Radical campaign rhetoric can dominate early in the year, weighing on sentiment, while the sheer number of primary candidates makes it impossible to assess the likelihood of any proposal becoming law. As Election Day gets closer, the range of potential outcomes narrows, reducing uncertainty. The winner's policy stance—and ability to enact big legislation—gets clearer, too, helping markets see forward. While it is possible other factors may weigh more heavily in 2020, we think this is a tailwind for equities later this year. (Interestingly, this year's first half return doesn't differ much from the average election year—despite the highly unusual path this year has taken.)

EXHIBIT 8: EQUITIES IN AN AVERAGE ELECTION YEAR

Source: Global Financial Data, as of 23/07/2020. Average S&P 500 price returns for 4th presidential year, indexed to 1 on 01/01/1925, 01/01/1925 – 3/12/2019; 01/01/2020 – 22/07/2020, indexed to 1 on 01/01/2020.

Following the election, markets usually follow a trend we call the "Perverse Inverse." When a Republican wins, equities typically do wonderfully during the election year, cheered by the GOP's pro-business reputation. A Democratic victory means muted market returns as folks fear a tough business environment. These are just perceptions—we aren't saying these reputations always match reality. But remember, markets move, always, on changes in relative expectations.

This phenomenon reverses the following year. When a Republican administration is inaugurated, elevated sentiment sets up high expectations—which often leaves investors disappointed when the president inevitably begins to moderate or gridlock blocks big changes. A Democratic president also moderates upon entering the White House, but that reality usually exceeds investors' dour expectations. The upshot: Returns over this two-year stretch show no party favouritism. It is merely a matter of when the returns come (Exhibit 9).

EXHIBIT 9: PERVERSE INVERSE

	Election Year	First Year
Republican Elected	15.2%	2.6%
Democrat Elected	7.4%	16.2%

Source: Global Financial Data, Inc., as of 22/10/2018. S&P 500 total return in election and inaugural years, 1928 – 2017.

NOT YOUR TYPICAL CANDIDATES

Most commentators argue President Trump stands no chance in November. Not with a nine-point polling deficit versus Biden and constant criticism over his handling of Covid-19, the recession and social unrest. Perhaps, but it is much too early to predict the winner. There is so much we—and everyone—don't know at this juncture.

Contrary to popular belief, Joe Biden's path isn't easy. For one, he isn't the kind of candidate Democrats typically win with. Since the Civil War, unless the Democratic candidate was already president, no one who was perceived as a likely candidate four years earlier has won. Grover Cleveland (the poster child for this phenomenon), Woodrow Wilson, Franklin D. Roosevelt (FDR), John F. Kennedy, Jimmy Carter, Bill Clinton, Barack Obama—all were completely unexpected nominees four years before winning—real shockers. Some would quibble with FDR's inclusion in this list because he was better known, not young and had been the vice presidential nominee in 1920.

But after the Democratic ticket lost that election, many presumed his political career was over. That is, until 1928 Democratic presidential nominee Al Smith tapped FDR to succeed him as New York governor. Four years later he was elected president—completely unexpected in 1927. A fresh face isn't an automatic ticket to victory, or course. Some have lost by running poor campaigns—like Michael Dukakis or George McGovern.

Some fresh faces are literally fresh, youthful blank canvases. Others are older but newcomers to the national scene and therefore carry no baggage. This allowed the party to brand and paint the campaign in ways that inspired voters' hopes and dreams. Whatever your personal opinion of Joe Biden, that doesn't describe him. Not with several prior presidential runs, a lengthy Senate tenure, eight years as Obama's vice president and a number of well-known scandals. This works against him, as old war horse Democratic candidates usually lose—sometimes by a lot, sometimes by a little. The list of failed Democratic war horses has some of the party's most familiar names: Hillary Clinton, John Kerry, former Vice President Al Gore, former Vice President Walter Mondale, former Vice President Hubert Humphrey, Adlai Stevenson (fresh-faced in his first unsuccessful bid, trounced as a war horse in his second). Going much further back, William Jennings Bryan was the Democratic nominee more times than anyone else. His best performance was his first run, in 1896. His support fell successively in his second two attempts, as his war-horse qualities grew. If Joe Biden wins, it would be unprecedented. While the outcome is not impossible, it would be a first.

Then again, everything about President Trump is unprecedented. Before 2016, the old Bill Clinton maxim held that Republicans fall in line behind the party's preferred candidate, while Democrats fall in love. That flip-flopped four years ago. Democrats tried falling in line behind Hillary Clinton, and the GOP tried falling in love with President Trump. Neither side pulled off the role reversal well. This time, President Trump is a classic fall-in-line Republican candidate. But Joe Biden, the seasoned politician, doesn't fit the fall-in-love mold. Right now, he is playing up that he isn't President Trump. That may be enough. We just don't know.

TOO EARLY TO KNOW THE WINNER

Anyone claiming now to know how the race will go is demonstrating they don't know much about political forecasting. They focus on polls and known factors, utterly disregarding the potential for surprises. So many are possible today. Fact is, we don't know a lot about how this race will shape up.

Pundits now point to campaign chaos and intraparty opposition as reasons President Trump can't win. Trouble is, they said the same thing in 2016 and completely miss the obvious parallels between then and now. They cite President Trump's demotion of campaign manager Brad Parscale in mid-July as a huge red flag, ignoring that President Trump reshuffled campaign leadership twice in 2016—ousting Corey Lewandowski in June and Paul Manafort in August. They hype former GOP Ohio Governor (and 2016 candidate) John Kasich's decision to endorse Joe Biden, but Kasich didn't endorse President Trump in 2016 either. As for polls, the Trump/Biden poll differential today basically matches the Trump/Clinton gap at this point in 2016. According to Rasmussen, President Trump's approval rating as of this writing is one percentage point behind Barack Obama's at the same point in 2012 and six points ahead of the day President Trump was elected.[xiii] Joe Biden is out-fundraising President Trump, but so did Clinton.

There are differences, too, which speaks to the unknowns. Though President Trump trails the fundraising race, his campaign has more money now than at any point in 2016. How will he use it? Covid-19 means rallies are out—a key difference and potentially the linchpin to his success or failure. President Trump also has dramatically more GOP insider support than he did four years ago. In 2016 virtually no Republicans in Congress endorsed him. Now almost all of them do. Perhaps most importantly, President Trump is a known quantity this time. How will this affect turnout? Last time, he made many strong promises that appealed to some voters who hadn't turned out in years. This time, he has said very little and made few promises. So far, his campaign theme is primarily that he was good in his first term. Voters generally dislike this, and it usually doesn't work.

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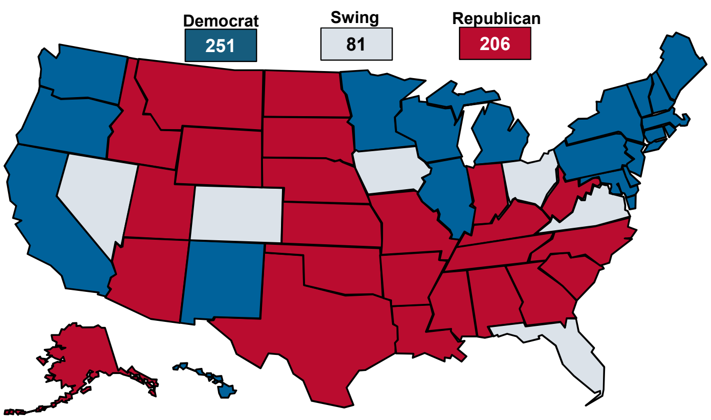
xiii Source: Rasmussen Reports, as of 27/07/2020. Daily Presidential Tracking Poll comparing Obama and Trump on 27/07/2020 and 27/07/2012.

A lack of promises means a lack of motivation for voters. Of course, he could make many more promises from here. That he hasn't yet doesn't mean he won't. But to this point, it seems he has been asking voters to rubber-stamp a first term—historically, a failing strategy.

BOTTOM-UP OR TOP-DOWN?

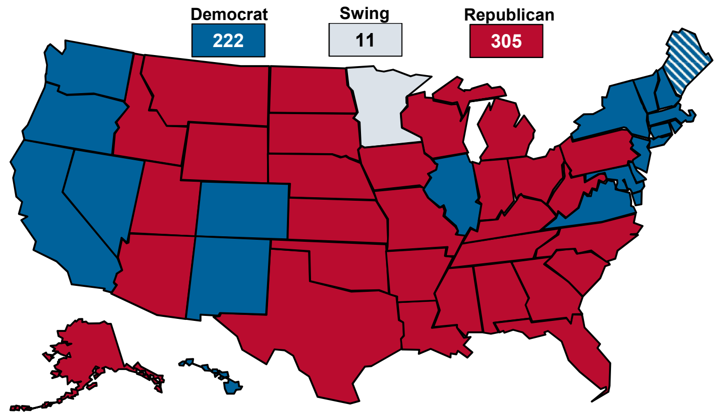
Another parallel with 2016: President Trump has more of a chance in the Electoral College than national polls suggest. One way to see this: Deploying the "top-down" versus "bottom-up" analysis we have shown you in past Reviews, like Q2 2016's. Exhibit 10 uses a "top-down" methodology, which labels states Red, Blue or Swing (gray) based on how they voted in the past five elections. In this depiction, a state must have elected a member of each party twice. But a "bottom-up" map, which breaks the electoral college down by party control of state legislatures, favours President Trump. Not as much as in 2016, but an edge is an edge. (Exhibit 11)

EXHIBIT 10: TOP-DOWN MAP



Source: The Wall Street Journal, US National Archives and Fisher Investments Research, as of 28/07/2020.

EXHIBIT 11: BOTTOM-UP MAP



Source: National Council of State Legislatures, US National Archives and Fisher Investments Research, as of 11/19/2019. Nebraska has a non-partisan, unicameral state legislature but leans Republican. DC is counted as Democratic based on the city council's breakdown. Swing state defined as a state without uniform party control of the legislature.

Which map will prove correct? Bottom-up analysis, a creation of Fisher Investments, has predicted 6 of the past 10 elections and proved uncannily accurate in 2016. Top-down predicted three. We just don't know enough now to know how it will go this time.

Those leaning on national polls make a critical error beyond forgetting the Electoral College's primacy: They overestimate the percentage of voters who are up for grabs. Yes, people may tell pollsters they are undecided. But there is so much confirmation bias, and so many set-in views, that it is difficult to get people to sway one way or the other. That goes double in 2020, with no fresh Democratic face and a widely hated incumbent. People may self-identify as independents more often now than in the past, but they don't necessarily vote that way. In 2016, Clinton won 48% of the popular vote while President Trump won 45.9%. Those figures include independents. In all likelihood, these people have already decided. The only question is: Do they actually turn out to vote?

Popularity won't shift materially and affect turnout nationally unless there is an October surprise. But it is marginally more likely to shift in the eight states that swing the election—which hinges on get-out-the-vote efforts. Success requires building staff in swing states—hiring more and better boots on the ground. Whose staff will execute this ground game better? That is unknowable now.

Turnout is everything. Joe Biden's widely heralded national lead is among likely but not actual voters. Pretend national turnout ends up being 60% of registered voters, would be the highest since Humphrey/Nixon in 1968. In this scenario, one side being more effective at mobilising voters by even a small amount could cover a three-to-five point polling gap. Sometimes campaign execution is everything. It could even create an Electoral College landslide for President Trump. How so? Joe Biden will unquestionably take California, giving him a large edge in the popular vote. If President Trump takes Texas—perhaps by a narrow margin—he gets the state's many electoral votes yet would be behind sizably in the popular vote. If Georgia is close but goes to President Trump too, we could easily get a scenario where the popular vote mirrors Joe Biden's present 9% margin while President Trump wins easily in the Electoral College. Again, it is impossible to know whether this will happen. There is too much we don't know. But we think notions that the race is over now are premature.

INCREASING UNCERTAINTY OVER CONGRESSIONAL RACES

Congressional races are also up in the air. A Joe Biden landslide could sweep a blue wave through Congress. A second President Trump term could bring a Republican Senate and House majority. Reality may also fall somewhere in the middle. With races only just taking shape, any projection is a wild guess. For example, former governor and ex-presidential candidate John Hickenlooper—who will challenge incumbent Republican Senator Cory Gardner—just won Colorado's Democratic Senate primary on 30 June.

Covid-19-related delays have extended uncertainty. Indiana, West Virginia, Kentucky, Virginia, New Jersey and Maine all delayed their primaries from early Q2 dates to June and July. Alabama, Texas and Georgia rescheduled critical primary runoffs. In Alabama, Tommy Tuberville became the GOP candidate on 14 July—initially, his runoff with Jeff Sessions was scheduled for 31 March. Tuberville will now challenge incumbent Democrat Doug Jones, widely considered vulnerable. With more primaries scheduled in Q3, final Senate races will remain uncertain for a while (Exhibit 12).

EXHIBIT 12: 2020 SENATE RACES

Senator	Party	State	Date of Primary	2016 % Vote for Trump	2012 % Vote for Romney	Senator	Party	State	Date of Primary	2016 % Vote for Trump	2012 % Vote for Romney
Enzi, M. (OPEN)	R	WY	18/08	70%	69%	Loeffler, K.*	R	GA	09/06	51%	53%
Moore Capito, S.	R	WV	09/06	69%	62%	Perdue, D.	R	GA	19/08	51%	53%
Inhofe, J.	R	OK	30/06	65%	67%	Tillis, T.	R	NC	03/03	51%	50%
Jones, D.	D	AL	03/03	63%	61%	McSally, M.*	R	AZ	04/08	50%	54%
McConnell, M.	R	KY	23/06	63%	60%	Peters, G.	D	MI	04/08	48%	45%
Rounds, M.	R	SD	02/06	62%	58%	Shaheen, J.	D	NH	08/09	47%	46%
Alexander, L. (OPEN)	R	TN	06/08	61%	59%	Smith, T.	D	MN	11/08	45%	45%
Cotton, T.	R	AR	15/06	60%	61%	Warner, M.	D	VA	23/06	45%	47%
Sasse, B.	R	NE	12/05	60%	60%	Collins, S.	R	ME	14/07	45%	41%
Risch, J.	R	ID	02/06	59%	65%	Gardner, C.	R	CO	30/06	45%	46%
Hyde-Smith, C.	R	MS	10/03	58%	55%	Booker, C.	D	NJ	07/07	42%	41%
Cassidy, B.	R	LA*	03/11	58%	58%	Coons, C.	D	DE	15/09	42%	40%
Daines, S.	R	MT	02/06	57%	55%	Merkley, J.	D	OR	19/05	41%	42%
Roberts, P. (OPEN)	R	KS	04/08	57%	60%	Reed, J.	D	RI	15/09	40%	35%
Graham, L.	R	SC	09/06	56%	55%	Udall, T. (OPEN)	D	NM	02/06	40%	43%
Sullivan, D.	R	AK	18/08	53%	55%	Durbin, R.	D	IL	17/03	39%	41%
Cornyn, J.	R	TX	03/03	53%	57%	Markey, E.	D	MA	15/09	34%	38%
Ernst, J.	R	IA	02/06	52%	46%						

Source: Fisher Investments Research, US Senate and Ballotpedia, as of 13/07/2020. *Special election in 2020. "OPEN" indicates the incumbent isn't contesting the seat. Yellow highlights indicate a Q3 primary. *Louisiana uses a majority-vote system instead of primary elections.

THE PRIMARY TAKEAWAY

Overall, we think cumulative returns in 2020 and 2021 will probably be largely the same whether President Trump or Joe Biden wins. We expect markets to greet the victor as they would a traditional Republican or Democratic winner. If Joe Biden wins, 2020's returns will probably be less buoyant than if Trump is re-elected—consistent with the perverse inverse. Yet that trend would flip in Joe Biden's inaugural year as a more moderate reality relieves investors. If Trump wins, vice-versa. Exhibit 13 shows returns in the election and inaugural years with a re-elected Republican or a newly elected Democrat—as well as the very similar returns over the two-year stretch.

EXHIBIT 13: DIFFERENT PATHS TO SIMILAR TWO-YEAR RETURNS

	Election Year	Inaugural Year	First Two Years
Re-Elected Republican	10.6%	2.7%	13.1%
Newly Elected Democrat	-2.8%	21.8%	15.9%

Source: Global Financial Data, Inc., as of 15/07/2020. Based on S&P 500 total returns, 31/12/1925 – 31/12/1926.

Both candidates will likely make big campaign promises, cheering some investors and worrying others. Joe Biden is already touting an economic plan and a climate-related programme. Market observers warn a Joe Biden presidency will roil Energy and Financials as a result. Tax hike chatter likely also weighs on sentiment. But campaign promises don't often dictate future policy.

Presidents can't do everything they promise even if they wanted to. At most, they can push through a few signature laws, usually before midterms. Even these usually bear little resemblance to campaign promises. President Trump had a Republican Congress but passed only one major measure—tax reform—which was watered down. While people talk up tweets and executive orders, those targeted at the economy change very little. President Trump's attempted repeals of the ACA failed. Regulatory relaxation may have slightly effected Dodd-Frank, but the law is largely unchanged since President Obama left office.

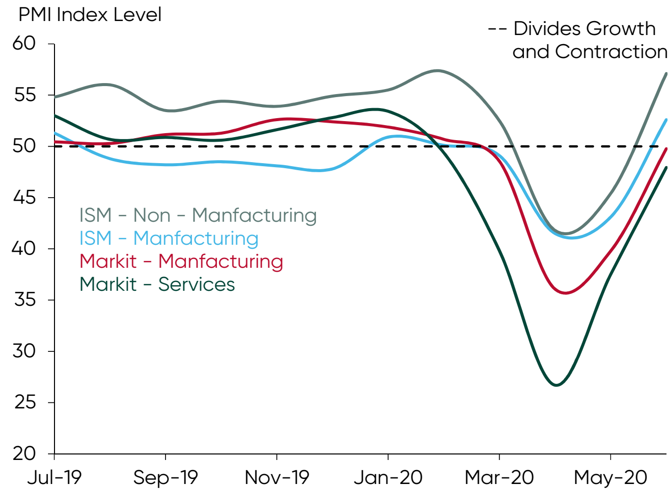
Similarly, President Obama didn't enact as much change as he pledged while campaigning despite having a Democratic Congress his first two years. He signed the Affordable Care Act (ACA) and Dodd-Frank, but compromises tempered both. The ACA, for instance passed without the government-run "public option." Dodd-Frank amounted to instructions for regulators to study issues and make changes if necessary. Some of those changes eventually happened, some didn't, and those that did were mostly watered down. Still other provisions, like those targeting credit-ratings agencies, were internally contradictory and resulted in no actual change at all. President Obama also promised to end the Bush tax cuts—yet extended most of them.

Even if Joe Biden wins alongside a Democratic Congress, our baseline assumption is that his promises will likely fail to materialise as outlined today.

REAL TIME ECONOMIC DATA SHOWING SIGNS OF IMPROVEMENT

While many skeptics argued high unemployment and virus dread would forestall a recovery, the data argue otherwise. After tumbling -8.2% m/m and -14.7% m/m in March and April, US retail sales surged 17.7% in May and 7.5% in June.[xiv] A broader gauge of consumption that includes more services spending trended similarly—falling -6.6% and -12.6% in March and April, respectively, then bouncing 8.2% in May.[xv] While industrial production rose only 1.4% m/m in May after April's steep -12.5% drop, Covid-19 wasn't to blame. Rather, warm weather curtailed utility production and low oil prices hit mining and drilling activity.[xvi] The largest subsector, manufacturing, grew 3.8% m/m. The rebound persisted into June, with industrial production climbing a record 5.4% m/m, underpinned by manufacturing's 7.2% climb.[xvii] Purchasing Managers' Indexes (PMIs)—surveys tallying the breadth of growth across a range of private-sector firms—show a similar pattern. (Exhibit 14) The market's upturn since 23 March—widely derided as an optimistic fantasy distorted by stimulus—quite rationally anticipated this improvement, in our view.

EXHIBIT 14: US PMIS



Source: FactSet, as of 12/07/2020. IHS Markit and Institute of Supply Management PMIs, July 2019 – June 2020.

After shedding a staggering 19.8 million jobs in April, US private-sector employers added 3.2 million jobs in May and 4.8 million in June.[xviii] Of course, like all these measures, employment hasn't come close to regaining pre-downturn levels. Nevertheless, markets don't wait for output and employment to regain prior highs—the trend's overall direction matters more.

xiv Source: FactSet, as of 12/07/2020.

xv Source: FactSet, as of 12/07/2020. US personal consumption expenditures, April and May 2020.

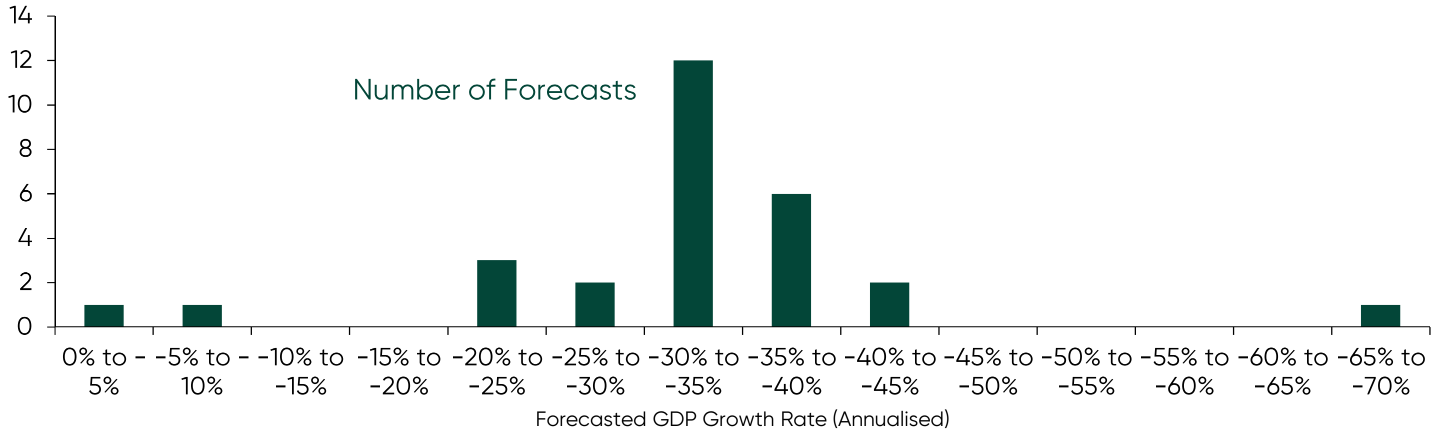
xvi Ibid.

xvii Source: Federal Reserve, as of 15/07/2020.

xviii Source: US Bureau of Labor Statistics, as of 13/07/2020.

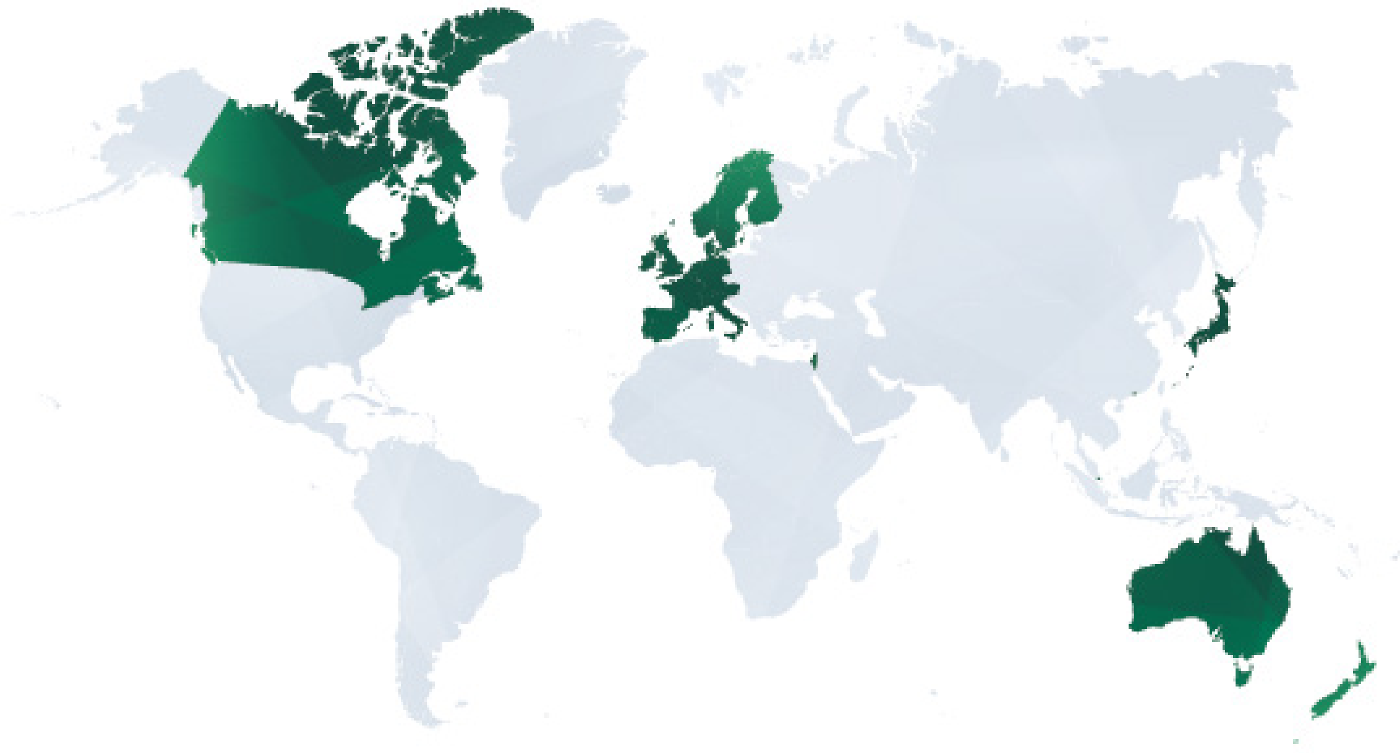
Q2 GDP fell at a record -32.9% annualised rate, not quite as bad as expected (Exhibit 15). Analysts factored in steep contraction months ago, so the release was largely a formality as far as equities are concerned. More important is recovery, which more timely data indicate is underway. There is little surprise power in negatives that everyone expects—and no one expected positive GDP.

EXHIBIT 15: BELL CURVE OF US Q2 GDP GROWTH FORECASTS



Source: FactSet, as of 12/07/2020. Uses the 28 forecasts FactSet collected from 12/06 to 12/07 to eliminate stale forecasts included in the consensus figure.

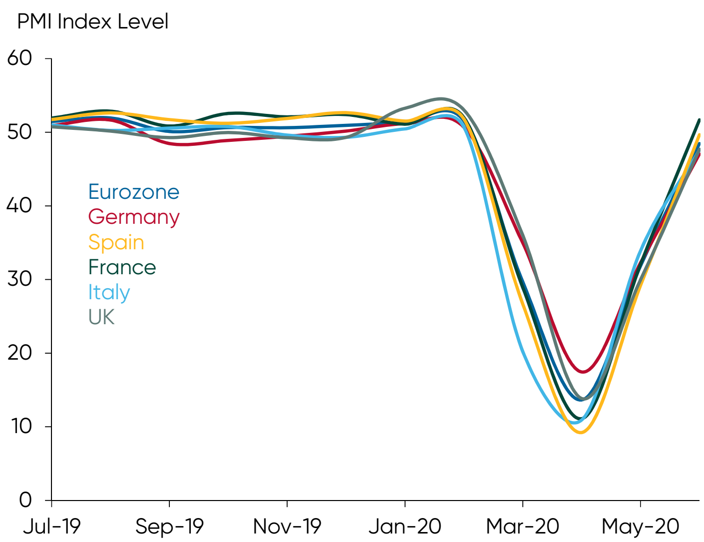
GLOBAL DEVELOPED EX-US COMMENTARY



EUROPE'S RECOVERY

The same holds in Europe, where most data show reopening fostered recovery. After high-frequency data hinted at it, PMIs were the first data to signal improvement. Exhibit 16 shows this using composite PMIs for the eurozone, Germany, France, Italy, Spain and the UK. These gauges combine output-related survey questions from the Manufacturing and Services PMIs. While only France finished June above the 50 mark that indicates more than half of firms reported higher output, many of the rest were close—suggesting recovery is beginning

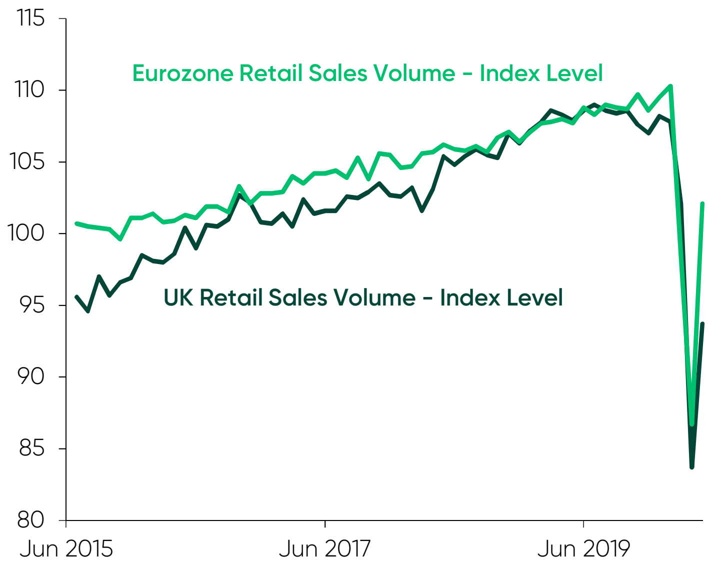
EXHIBIT 16: COMPOSITE PMI'S FOR THE UK AND KEY EUROZONE NATIONS



Source: FactSet, as of 12/07/2020. IHS Markit composite PMIs, July 2019 – June 2020.

That same pattern—a steep downturn followed by a steep upturn—holds in other data, including retail sales. (Exhibit 17) The UK, which locked down and began reopening later, has seen a smaller rebound to date.

EXHIBIT 17: EUROZONE AND UK RETAIL SALES FELL FAR, BOUNCED BIG



Source: FactSet, as of 12/07/2020. UK retail sales gauge is indexed to 100 at 2016 levels; eurozone is indexed to 100 at 2015 levels.

Data showing the Covid-19 lockdowns' full economic effects have emerged, with many major nations' Q2 GDP reports beginning to be released. As anticipated, many have been historically negative. However, these reports merely confirm the damage that was inevitable due to the lockdowns—information we think equities anticipated in their February – March decline. While these data may hit sentiment, we think markets are looking beyond Q2 to a healthier economy, which timelier data have already begun registering.

That markets are looking ahead to a brighter time leads many to claim they are irrationally disconnected from reality today. Yet this is precisely what equities normally do in early bull markets. In the depths of the downturn, equities obsess over the conditions immediately ahead—the short end of the 3 to 30 month range markets pre-price. Markets effectively have two jobs: Their first job is factoring in widely known information. Their second job is valuing corporate future earnings power—the present value of all future profits. In a downturn, markets are pre-pricing when and where awful economic conditions will end up and largely aren't focused on longer term earnings. But once they have a sense of when and where contraction will end, equities shift completely and start looking ahead and weighing future earnings—far future earnings. Markets look ahead to conditions at the very far end of the 3 to 30 month range they weigh. They do this before recessions end. This is normal at this stage of a market cycle.

We expect Q2 GDP will be bad in most of the world—far worse than Q1. The reason is simple: The lockdowns designed to mitigate Covid-19's spread limited economic activity. Most Western lockdowns didn't begin until late February or early March. Hence, only a small slice of Q1 saw their full effect. April and May bore the brunt, dragging down Q2. While restrictions began relaxing in Q2, first across Europe and later in the US, the gradual reopenings were likely insufficient to offset lockdowns' impact. Yet equities' job of pre-pricing this is done, in our view. Equity markets are now looking far past these data.

A WORD ON ECONOMIC DATA METHODOLOGIES

Before going further, it is important to note that countries tabulate many economic statistics differently—including GDP—potentially affecting how people view them. For example, most European nations report GDP growth at quarter-over-quarter rates. This is the percentage change in GDP from the preceding quarter (usually seasonally adjusted to account for calendar effects like holidays). The US and Japan report the percentage change from the prior quarter at annualised rates. This is the annual rate of change in GDP if growth persisted at the same clip for an entire year. You can't compare an annualised rate to quarter-over-quarter at face value. You must convert one or the other. Similarly, if US GDP falls by 50% annualised in Q2, that wouldn't mean economic output halved. It equates to about an 11% quarter-over-quarter contraction compounded over four quarters.

EXHIBIT 18: Q1 GDP GROWTH AND CONSENSUS ESTIMATES FOR Q2

	Q1 2020		Q2 2020 (FactSet Consensus Estimates)	
	Q/Q	Annualised	Q/Q	Annualised
Eurozone	-4%	-14%	-12%	-39%
France	-5%	-20%	-12%	-40%
Spain	-5%	-19%	-14%	-46%
Italy	-5%	-20%	-12%	-40%
UK	-2%	-9%	-18%	-54%
Japan	-1%	-2%	-5%	-25%
Canada	-2%	-8%	-12%	-40%
Australia	0%	-1%	-9%	-24%

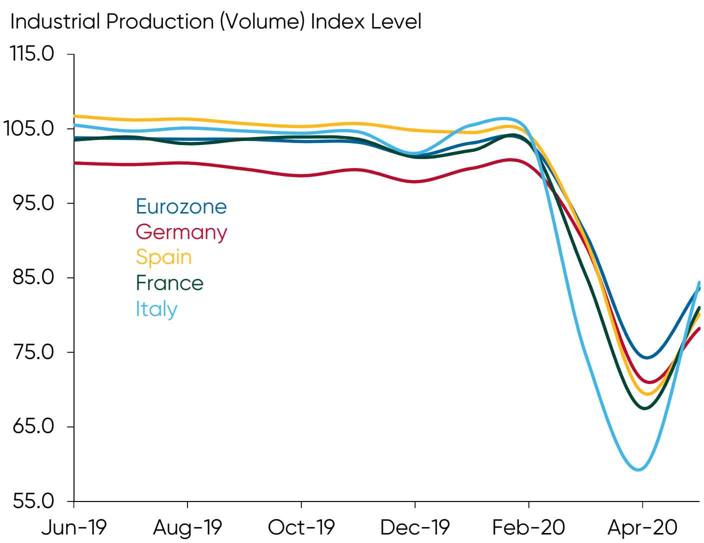
Source: FactSet, US Bureau of Economic Analysis and Eurostat, as of 12/07/2020.

FOR Q2 ECONOMIC DATA, EXPECT AWFUL

Regardless of measurement, analysts universally expect developed world GDP to be the worst on record. Exhibit 18 above shows major developed nations' Q1 GDP growth rates and Q2 estimates. These consensus estimates encompass a much wider range than normal.

Industrial production also jumped in May across the eurozone and its four biggest economies—Germany, France, Spain and Italy, which saw output surge 42.1% m/m. (Exhibit 19)

EXHIBIT 19: INDUSTRIAL PRODUCTION REBOUNDS AS FACTORIES REOPEN



Source: Eurostat, as of 15/07/2020. June 2019 – May 2020.

Ultimately, these reports are backward looking. In our view, they suggest equities' big Q2 isn't detached from the economy or a sign of markets' irrationality. Instead, it strongly suggests markets anticipated growth's return once reopenings began. They discounted the present and looked to the future—just as they normally do.

The EU's €1.85 trillion budget proposal grabbed headlines. First, German Chancellor Angela Merkel and French President Emmanuel Macron announced their support for €500 billion in joint EU bond issuance, popularly named "coronabonds". The following week, the EU announced its long-term 2021-2027 budget. The key item: a coronavirus relief proposal of €390 billion in grants and €360 billion in loans, financed in part by newly issued common EU debt-a big step toward fiscal transfer union. Though headlines were positive on the development-both for the alleged near-term benefits for Covid-19 relief and the longer-term benefits of greater EU unity-we don't think its passage or failure will materially impact Europe's economic recovery. Relief funds wouldn't become available until March 2021 at the earliest-at that point, a recovery may be well underway. In addition, these measures would effectively act as bridge loans that support businesses and consumers until growth resumes. They aren't traditional "stimulus" that aims to create new demand where it didn't exist before. As ambitious as the proposal is, the eurozone has proven recoveries don't depend on fiscal stimulus. During the 2011 – 2013 eurozone recession, governments pursued austerity over stimulus policies-which didn't stop growth from returning.

In late July, the fifth round of formal Brexit trade deal talks between Britain and the EU concluded—with no material progress toward an agreement. Chief EU Brexit negotiator Michel Barnier went so far as to say a trade agreement between the EU and UK looked "at this point unlikely."[xix] The continued stalemate and sharp rhetoric adds to worries that the two sides will fail to reach a deal by yearend—when the Brexit transition period concludes. But even if the UK and EU can't agree to a new trade agreement, commerce won't automatically come to a halt. Rather, World Trade Organization (WTO) rules would go into effect. Because the UK has "Most Favoured Nation" (MFN) status, it can set its trade terms for entities it doesn't have a separate agreement with. Moreover, in May, the UK shared what its approach to post-Brexit commerce will look like via its new tariff regime, the UK Global Tariff (UKGT).

BREXIT ON WTO TERMS

On the UK's side, the announcement of the UKGT should greatly reduce uncertainty about how a no-trade deal Brexit would look. The UKGT eliminates all of Britain's "nuisance" tariffs—levies of 2% or lower—and reduces most other tariffs. The upshot: The percentage of imported products subject to tariffs will drop from 53% to 40%, and in value terms, 60% of imports will be tariff free. Not all tariffs have been done away with, as the government will maintain certain duties to "protect" industries including agriculture and the auto industry. But overall the UKGT promotes freer trade and counters a long-running fear that Brexit was inherently anti-globalisation or protectionist.

THE NO-DEAL WORRY

Critically, the UKGT also provides clarity on the UK's interpretation of the Brexit agreement regarding Northern Ireland, as questions persisted over the treatment of goods crossing its border. The 1998 Good Friday peace accord mandated an open border between Northern Ireland and the Republic of Ireland. When both countries were in the EU, this was easily manageable, as there are no customs checks between member-states. However, Brexit set the EU's border there, which would necessitate customs inspections.

In January the UK and EU agreed to keep the border frictionless but with mandated checks on certain goods crossing the Irish Sea. UKGT states that food and live animals going from Great Britain to Northern Ireland would be subject to inspection—but not those traveling the other way. Tariffs would also apply only to goods destined to be transshipped to the EU. Yet it remains unknown whether the EU agrees with this interpretation—and some observers think Brussels may take issue with it. The two sides also apparently aren't close to agreement on other matters like EU fishing rights in UK waters, the role of the European Court of Justice (ECJ) and the application of "level playing field" guarantees that aim to ensure fair competition.

> "...THE ANNOUNCEMENT OF THE UKGT SHOULD GREATLY REDUCE UNCERTAINTY ABOUT HOW A NO-TRADE DEAL BREXIT WOULD LOOK."

Many worry the lack of a new trade agreement will hurt both sides—particularly the UK. In 2019 43% of all UK exports went to the EU while 51% of imports were from the EU. However, in the "no-deal" outcome, UKGT would apply to the EU. That imposes some new barriers, but they aren't high—and they are unlikely to be onerous enough to cease trade between UK businesses and their Continental counterparts. Similarly, even applying MFN tariffs to UK exports destined for the EU doesn't erect high barriers to trade. The average non-agricultural EU tariff rate under WTO terms is 2.8%.[xx] Certain favoured industries like autos are higher (10%) and agriculture higher still. But for most industries, these are not insurmountable and could very well get passed on to EU consumers, in part or in full. We aren't saying there would be no effect—but broad-based fears this would destroy UK competitiveness seem far removed from reality, in our view. Moreover, the UK and EU could always negotiate a deal that promotes freer trade in the future—either in 2021 or several years down the line.

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xix "Brexit: Trade Deal Some Way Off, Say UK and EU," Staff, BBC, 23/07/2020.

xx "Brexit: What Is the No-Deal WTO Option?," Chris Morris, BBC, 16/06/2020.

None of this precludes an agreement from happening before end of the year. Drawn-out negotiations are the norm, and some experts believe both sides will compromise in the coming months, eyeing an October summit as the "real" deadline. But should that fizzle, both businesses and markets ended Q2 with a much better sense of what a no-deal Brexit would actually look like—and that clarity is a positive, in our view.

ELSEWHERE IN DEVELOPED MARKETS

The latest developed world economic data show early signs of a recovery. For example, in Australia retail sales soared 16.3% in May and remained positive in June after declining -17.7% in April. Similarly Japan's June retail sales jumped from May's 1.9% m/m to 13.1% while June industrial production rose 2.7% m/m, returning to growth after May's -8.9%. In our view, these rebounds indicate some pent-up demand is finding a release. The easing of COVID-19-related restrictions has allowed many businesses to reopen-a positive-though weak demand remains a concern.

EMERGING MARKETS **COMMENTARY**

EMERGING MARKETS RECOVERY

Emerging Market (EM) equities rose sharply in Q2 2020, significantly recovering from the 23 March low. In our view, EMs' strong rebound likely constitutes the beginning of a new bull market, running alongside a similar move in the developed world. Behind it: growing progress-and clarity-on major emerging and developed countries' Covid-19 lockdown relaxations. Although gradual and uneven, much of the world is seemingly starting to return to a form of normalcy, helping EM equities look further into the future and anticipate a recovery.

As EM countries reopened over the quarter, economic data showed signs of positivity moving into the second half of the year. China's GDP rose 3.2% y/y after Q1's -6.8% decline—offering a positive outlook. GDP hasn't fully recovered from Q1's lockdowns, but recovery continues—as evidenced by expansionary purchasing managers' index (PMI) readings since May. In July, Caixin/IHS Markit's manufacturing PMI—which includes smaller private firms—registered its highest reading in a decade at 52.8.[xxi] While PMIs show the breadth, not the magnitude of expansion, they indicate more Chinese businesses are getting back on their feet. Additionally, South Korean GDP fell -3.3% q/q (-2.9% y/y), driven by exports' -16.6% q/q contraction. However, private consumption rose 1.3% q/q, suggesting domestic demand continues benefiting from the country's less disruptive pandemic response.

xxi Source: Caixin/IHS Markit, as of 03/08/2020.

TENSIONS RISING IN THE TIBETAN AUTONOMOUS REGION

Tensions between China and India surged in June after a violent encounter between the countries' troops at a disputed border region in the Himalayas. While some fear further conflict between the two nuclear-armed nations, we think this is only a distant possibility today. Moreover, past India/China border skirmishes haven't escalated meaningfully or had a lasting impact on either country's equity market. Considering both sides are trying to defuse tensions—with tentative success thus far—we don't think this time will prove different.

The 15 June clash followed months of increasing tensions along the "Line of Actual Control" deep in the Himalayas that divides the two nations. China had sent tanks, artillery and construction equipment to its side of the line, and troops initially brawled in May as concerns of potential Chinese encroachments heightened. While the most recent battle's precise cause isn't clear, India said 20 of its soldiers were killed and more wounded. China didn't release casualty figures. The encounter sparked fears the two countries might antagonise each other further, potentially spurring broader conflict.

In our view, though, history indicates this outcome isn't likely. Disputes like June's have recurred periodically since India achieved independence in 1947 and Mao Zedong declared the People's Republic of China in 1949. The latter has never accepted the India/China border British and Tibetan officials drew in 1914, largely because the accompanying deal included Tibetan autonomy. China and India went to war in 1962 largely over this issue, and the conflict was mostly a stalemate. Afterwards, both sides consolidated control of the territory they held, even though it didn't match either's border claim. This was the Line of Actual Control. Since, tensions have spiked in 1967, 1987, 2013 and 2017. The India/China border saga has parallels to the disputed Kashmir territory, which has led to several wars and many disputes between India and Pakistan over the years.

Despite their contentious history, no India/China dispute since 1962 has led to war. Instead, governments have worked to defuse the conflicts—likely because each country would have much to lose in an all-out conflict. Neither China nor India's soldiers patrolling the Himalayan border carry firearms—a measure intended to prevent fights like June's from getting out of hand and risking a major military response.

De-escalation may be underway now. Chinese and Indian military officials—already in talks before the clash—have continued negotiations since. Although neither side has withdrawn its troops from the region, and India has actually bolstered its forces there— both have seemingly pulled back from the border itself. While a final accord hasn't materialised, a return to an uneasy détente seems fairly likely right now.

Even if tensions resurge, history indicates these skirmishes have little lasting impact on either country's equity market. Indian equities did fall -28.6% amid China border tensions between 17 May and 28 August 2013, more than doubling EM equities' decline during that stretch.[xxii] But they rebounded sharply thereafter, eventually surpassing May 2013 levels the following April.[xxiii] Even November 2008's terrorist attacks by Pakistani militants—occurring near the depths of the global bear market—didn't appear to have a noticeable, prolonged effect on Indian equities, despite driving up tensions between these two frequent combatants. Since the 15 June altercation, Indian equities have risen 15.0% while Chinese equities have risen 12.3%—both outpacing overall EM equities' 11.8% pace.[xxiv] For matters like this to materially affect the two nations' markets—or EM equities generally—we think there would need to be outright conflict that interrupts business broadly. We see little evidence the latest bout of tensions along India's northern borders are likely to amount to that and don't think this scenario is likely to prove more problematic for markets than past disputes.

xxii Source: FactSet, as of 24/07/2020. MSCI India Index and MSCI Emerging Markets Index returns with net dividends, in USD, 17/05/2013 – 28/08/2013.

xxiii Ibid. Statement based on MSCI India Index returns with net dividends, in USD, 28/08/2013 – 01/04/2014.

xxiv Ibid. MSCI India Index returns with net dividends, in USD, 15/06/2020 – 27/07/2020

BRAZILIAN IMPEACHMENT CALLS GROW LOUDER

A movement to impeach President Bolsonaro began gaining popular support as his opposition to lockdowns and overall unorthodox political response to Covid-19 eroded his approval ratings in late March and early April. Brazil's caseload initially rose more slowly than the rest of the world, but most observers expected it to worsen significantly as the country entered its peak flu season—typically April – September. Those expectations became reality as cases began rising exponentially in early April, likely due in no small part to the disjointed political response. As a result, investors had to price in political uncertainty and the prospect of lockdowns in April, just when the rest of the world was beginning to eye reopening.

At April's end, the impeachment movement gained momentum as Brazil's Supreme Court approved an official corruption investigation. Accusations against President Bolsonaro include interference with police investigations, obstruction of justice and passive corruption—all of which the president denies. This followed the justice minister's resignation and claims that President Bolsonaro replaced the police chief with someone who would share classified information with the president, including information on investigations targeting President Bolsonaro's sons. The situation escalated in mid-June, when one of President Bolsonaro's friends was arrested, increasing the likelihood of a lengthy investigation process and, potentially, impeachment.

Brazilian market history includes just two prior impeachments, and the results are mixed. In both cases—Fernando Collor in 1992 and Dilma Rousseff in 2016—Brazilian equities underperformed in the run-up to impeachment proceedings and outperformed afterward. During the proceedings themselves, Brazilian equities outperformed during Collier's trial but underperformed during Rousseff's. But neither impeachment began during a global bear market (Exhibit 20).

In our view, impeachment itself isn't positive or negative. However, heavy focus on impeachment and the troubles battling Covid-19 has soured sentiment deeply. We suspect President Bolsonaro's early-July COVID diagnosis doesn't help on that front. This greatly diminishes expectations.

In the medium to longer term, resolution of the impeachment saga either way should ease uncertainty, helping Brazilian equities move on.

EXHIBIT 20: BRAZILIAN RELATIVE RETURNS BEFORE AND AFTER IMPEACHMENT

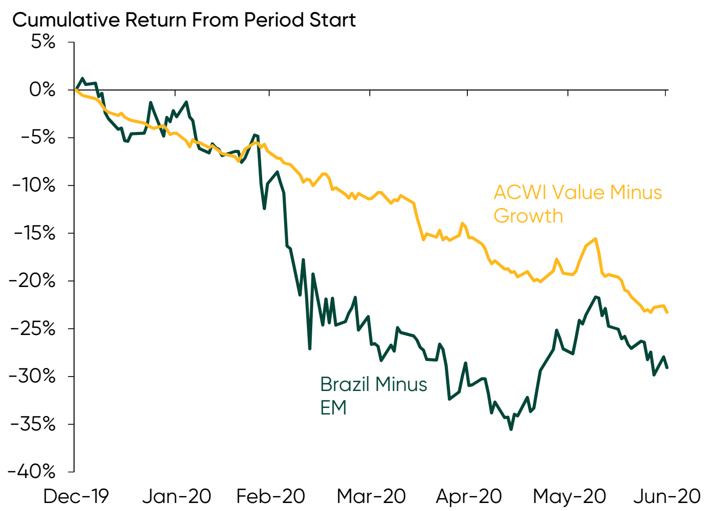
	Brazil Minus EM								
	12-Month Trailing	6-Month Trailing	Impeachment Initiated	1-Month Forward	3-Month Forward	6-Month Forward	12-Month Forward	18-Month Forward	24-Month Forward
Collor	14.6%	-4.8%	01/09/1992	7.9%	-21.3%	-4.7%	19.2%	47.2%	108.0%
Rousseff	-26.7%	-15.1%	02/12/2015	-3.4%	3.8%	17.6%	38.6%	31.8%	40.5%
Bolsonaro	-23.1%	-31.2%	29/04/2020	-11.0%	14.8%	-	-	-	-
	-12%	-17%	Avg.	-2%	-1%	6%	29%	39%	74%
	-23%	-15%	Med.	-3%	4%	6%	29%	39%	74%
	33%	0%	Freq. of Outperformance	33%	67%	50%	100%	100%	100%

Source: FactSet, as of 14/05/2020. MSCI Brazil and EM price returns in USD, 01/09/1991 – 29/04/2020.

However, that still leaves another headwind. As Exhibit 21 shows, Brazil's relative returns tend to track value's. As discussed in Appendix I, because the global bear market was correction-like in speed and the lack of a shift in style leadership, we don't expect value to enjoy its usual early-bull-market outperformance. However, we position our portfolios to account for unanticipated results. Hence, we want to ensure we carry some weight in value-oriented categories—particularly those sentiment is quite negative on. Our overweight to Brazil is largely the result of this.

In the event we are wrong regarding our expectation of growth leading, we think Brazil's combination of dour sentiment and value tilt would drive outperformance—perhaps substantial outperformance.

EXHIBIT 21: BRAZIL'S RELATIVE RETURNS TRACK VALUE'S



Source: Factset, as of 27/07/2020. MSCI Brazil minus EM and MSCI All-Country World Value Index Minus MSCI All-Country World Growth Index, all using net returns in USD, 31/12/2019 – 30/06/2020.

TURKEY AND ARGENTINA'S UNCERTAIN EM CLASSIFICATION

In June, index provider MSCI warned it might reclassify Turkey and Argentina from Emerging Markets (EM) to either Frontier Markets or standalone status due to restrictions limiting international investors' access to domestic equity markets. Given their small weights in EM—0.4% for Turkey and 0.1% for Argentina—the uncertainty over their classification shouldn't impact the EM benchmark much.[xxv] Moreover, while many see such shifts as key to national stock markets' relative performance, we don't think it means much for their local markets either.

In Turkey's case, MSCI cited the country's short selling ban, enacted in October 2019, and restrictions on stock lending put in place in February 2020. These moves limit liquidity and investors' ability to hedge. They are also key to MSCI's infrastructure requirements for market accessibility. If, after consulting with relevant market participants, MSCI deems Turkey doesn't meet its market accessibility criteria for EM, it could reclassify the country, removing it from the EM benchmark and putting it either into Frontier Markets or standalone, although it gave no timeframe for this decision. As for Argentina, the government enacted capital controls in September 2019, which restricted foreign access to its domestic equity markets, potentially violating MSCI's "ease of capital inflows/outflows" criteria. That said, MSCI noted the MSCI Argentina's three equities remain accessible to foreign investors via listings outside the country.

More recently, Turkey eased market access restrictions, but it was selective. Starting in July, Turkey's Capital Markets Regulator allowed short selling to resume for the 30 largest listed equities on the Istanbul Bourse. The ban remains for all other shares. However, Turkey confusingly barred six major Western firms (Goldman Sachs, JPMorgan Chase, Merrill Lynch, Barclays, Credit Suisse and Wood & Co.) from shorting any Turkish equities days later. The government says these bans will last up to three months. Meanwhile, the Turkish lira has plunged on forex markets, leading the central bank to aggressively defend it. This has drained the bank's foreign exchange reserves rapidly. Year to date, reserves

xxv Source: FactSet, as of 28/07/2020.

have dropped from $81 billion to $49 billion, even as the lira hovers near all-time lows hit in May against the US dollar.[xxvi] Many now speculate capital controls are the country's next step. If so, that could further imperil the country's accessibility to foreign investors and its status in the EM index.

Argentina's potential MSCI reclassification seems mostly dependent on the fate of its capital controls, which may in turn hinge on successful debt restructuring. In 2009, MSCI downgraded Argentina to Frontier Market status after then-President Cristina Fernández de Kirchner instituted capital controls. But she was ousted after the country's economy languished for almost a decade, with reformer Mauricio Macri taking her place in 2015. Following a broad series of structural forms by President Macri, including trade liberalisation and ending foreign exchange controls, MSCI reversed its 2009 decision and put Argentina back in the EM category. However, President Macri's mission to undo the damage wrought by decades of interventionist economic policy had major near-term contractionary side effects. Attempts to liberalise markets and stabilise the exchange rate required him to lift price controls, which sent inflation skyward and stymied growth. Amid plunging popularity, he was forced to moderate and reform efforts stalled. When polls showed he trailed current-President Alberto Fernández, Kirchner's former Chief of the Cabinet, fears of a return to Peronist policy grew. This is perhaps doubly true considering Kirchner was President Fernández's running mate. As the election drew near and fears grew, outflows from the peso gained steam. Similarly, interest rates spiked tied to elevated inflation and fears of how a new Peronist regime would approach external creditors, including the IMF. Just before October 2019's general election, President Macri instituted capital controls to stem outflows.

Unsurprisingly, Mauricio Macri lost the presidency to Alberto Fernández. This May, Argentina defaulted for the ninth time in its history, setting up debt restructuring talks with creditors that have lasted until now. Whether they reach a deal remains unclear, but ongoing negotiations seemingly indicate they may be close. Argentina's Economy Minister Martin Guzman indicated the government would consider easing currency controls when debt restructuring talks conclude and Covid-19-associated economic uncertainty subsides. MSCI may be evaluating these prospects before making a decision on Argentina's reclassification. Regardless, the political backdrop makes Argentina's standing questionable.

> "ARGENTINA'S POTENTIAL MSCI RECLASSIFICATION SEEMS MOSTLY DEPENDENT ON THE FATE OF ITS CAPITAL CONTROLS, WHICH MAY IN TURN HINGE ON SUCCESSFUL DEBT RESTRUCTURING."

As for EM classifications' effect on relative returns, we doubt there is much long-term impact. MSCI reclassification often follows events—positive (e.g., major structural reforms) or negative (like trading restrictions and capital controls). With Turkey and Argentina, that seems to be happening now, too. But these issues are well known and likely incorporated into prices already. We think it would be a mistake to believe reclassification will do much to drive their returns from here. How their fundamentals fare relative to prevailing expectations is of greater consequence, in our view.

xxvi Ibid.

Should you have any questions about any of the information provided above, please contact FIE by mail at Level 18, One Canada Square, Canary Wharf, London, E14 5AX or by telephone at +44 (0)207 299 6848.

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