Fisher Investments Europe™

FIRST QUARTER 2017

FISHER MARKET PERSPECTIVES

FIRST QUARTER 2017 REVIEW AND OUTLOOK
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FIRST QUARTER 2017 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Portfolio Themes

- **Underweight to Defensive Categories:** Defensive categories should underperform given our forecast for an ongoing bull market.
- **Quality Tilt:** As the bull market progress, we favour equities with stronger balance sheets and consistent profit margins.
- **Overweight to Health Care:** Large swaths of Emerging Markets populations are breaching key income thresholds, allowing for the purchase of pharmaceuticals and medical devices for the first time. Additionally, aging and longer-living developed world populations should increase total health care expenditures.

Market Outlook

- **Strong Economic Drivers:** In both developed and emerging markets, economic drivers remain strong. We believe these fundamentals will come to the forefront as sentiment improves.
- **Falling Uncertainty:** Investor sentiment should continue rising as gridlocked governments reduce the likelihood of sweeping legislation.
- **Positive Inaugural-Year:** We expect markets to receive Trump as they typically receive ***Democrats***, with big inaugural-year returns as the incoming administration does less than feared.

Global markets continued rallying in the first quarter of 2017 with the MSCI All Country World Index returning 6.9%.[i] We believe Q1 is only the beginning, an initial surge as this bull market enters its final third—typically an acceleration phase. This implies not only robust returns in 2017, but plenty of bull market ahead.

Q1 had many features we expect for the full year. Uncertainty continued falling—particularly over European politics, as the Dutch election proved to be immaterial for markets. We expect similar for French and German elections later this year. Non-US equities edged US, while small cap—particularly US small cap—lagged. Oil prices faltered. The Fed hiked interest rates in March, an event the headlines warned about, and long-term rates fell slightly. In the US, the new Trump administration took office with a lot of noise and many promises, yet has not been able to follow through with much at this point. As we wrote in Q4, globally, most investors' reaction to Trump ranges from trepidation to terror. The more Trump's administration struggles to enact campaign promises, bringing much less change than many expected, the more investors will feel relief. This should continue to boost sentiment, helping propel equities higher.

While optimism is growing, fear lingers—providing fuel for equities, which climb the wall of worry. For example, when the American Health Care Act failed in late March, many warned the so-called "Trump Rally" would become a "Trump Slump" as politicians dashed investors' hopes for tax cuts and market-friendly reforms. In reality, this rally was never about Trump. It began in February 2016, when the correction ended, powered by falling uncertainty—the resolution of the Brexit vote and US election brought bullish clarity. All along, we have said falling uncertainty would boost markets regardless of who won America's election. This bull market rose during and after 2010, when Congress passed the Affordable Care Act and Dodd-Frank. The same occurred for 2013's tax hikes. Equities don't suddenly require tax cuts, health care reform or a repeal of Dodd-Frank. Less radical shifting, for good or ill, lets businesses and investors assert themselves. We believe global markets will continue rising alongside a growing global economy.

As 2017 began, we said Europe had more economic surprise potential than America—and it did, with services and manufacturing surveys hitting six-year highs as order books swelled. Headlines treated growth as new, a post-crisis turning point, ignoring the 15 straight quarters of growth that preceded it. Central bankers there still talk of recovery, yet the economy is in a sustained expansion, having eclipsed pre-2008 highs. Pundits who acknowledge Europe's surge warn it is temporary, yet the data supports continued growth. The eurozone's Leading Economic Index is on a seven-month hot streak, most recently rising 0.5% m/m in February.[ii] Loan and money supply growth are steady. Yield curves throughout Europe steepened, even as America's

i Net of dividends. Source: FactSet.

ii The Conference Board, as of 28/03/2017.

flattened in Q1. So far Europe's ascendance has confirmed our expectations for a prolonged leadership shift and signs for global growth continue to point positive.

Within Emerging Markets, political developments dominated headlines during the quarter. An impeachment of South Korean President Park Geun-hye makes her the first South Korean president to be removed from office. While opposition candidates lead polls, the immediate market impact here is likely more limited than commonly believed as Park's term was set to expire at year end, which would have brought in a new government regardless. India shared the media spotlight as the incumbent Bharatiya Janata Party (BJP) won a landslide victory in state elections. With the party and its allies governing roughly two-thirds of India's population, the BJP should have room to continue pushing forward incremental economic reforms – a positive for one of the world's fastest-growing economies.

Chinese economic data suggest slower yet steady growth continued as 2017 began. In the two months starting the year, industrial production rose 6.3% y/y and property investment rose 8.9% YTD. Growth in the world's second-largest economy remains fine. With party officials affirming their comfort with slower economic growth (so long as social stability remains under control) growth is unlikely to deviate greatly from this long-running trend—especially since the government has shown a willingness to provide support as necessary.

In Latin America, Mexican currency is in recovery as the peso has climbed back over the past four months after dropping in the lead up to the US presidential election over fears that Donald Trump would disrupt longstanding economic ties. This all speaks to fears of Donald Trump exceeding reality, as the US administration's actions on trade with Mexico thus far are tamer than initially feared. Lingering Trump fears help depress sentiment towards Mexico, lowering the bar for positive, yet underrated, fundamentals to beat. Conversely, Brazil GDP contracted -0.9% q/q. Contraction was felt across multiple categories including Services, Industry, Materials and Energy. Given elevated global supplies in the Energy and Materials sectors, the continuation of Brazil's 2016 market rebound is questionable.

While we remain vigilant for large and unseen negative events, thus far 2017 is setting up to be a great year for equities. US businesses and the marketplace continue asserting themselves as the US economy continues growing and corporate earnings accelerate. In Europe, uncertainty should continue falling as EU election results continue to clear investor's view. Finally, we believe sentiment towards Emerging Markets remains too dour. Investors often fail to distinguish between EM nations—commodity-reliant economies that have struggled much more than those with burgeoning services sectors.

THEMATIC UPDATE AND MARKET OUTLOOK

Q1 RECAP

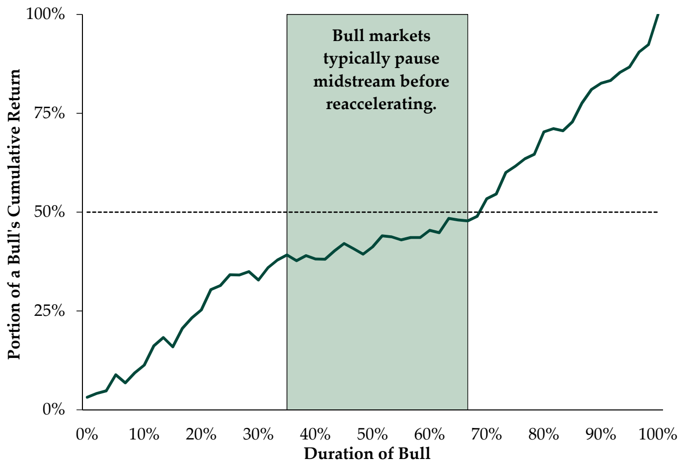
2017 is off to a strong start. The MSCI All Country World Index (ACWI) rose 6.9% in Q1[i]—the best quarter since 2013—with most major trends developing as we envisioned. We see Q1 as a good start to what we believe will be a great year for global equities as this bull market surges into its final third, fueled by growing confidence as uncertainty continues falling.

Maturing Bull Market

While optimism has spread, the euphoria typifying market peaks is absent. Despite turning eight in Q1, this bull market—history's second-longest—seems to have significant room left to climb. As Exhibit 1 shows, a bull's final third usually features fast-rising markets, with brightening sentiment and expanding valuations. We have had all three for months—likely the initial installment of this bull's final third.

Many investors recall the adage, "Bull markets die with a whimper, not a bang". While bulls do typically die with a whimper, it is important to note they tend to do so *after* the peak. Bears begin with a whimper. Ordinarily, the run to the top of a bull is steep and long—sometimes years—before irrational exuberance arises.

Exhibit 1: Bull Markets Reaccelerate Before Peaking



Source: Global Financial Data, Inc., as of 9/11/2016. Depicts bull markets from 1/6/1932 – 9/10/2007. Bull markets before 1990 rounded to nearest month to match GFD's S&P 500 Total Return extended data.

After markets peak, euphoric investors buy despite deteriorating fundamentals, often presuming small drops to be buying opportunities. Hence, bears usually begin with a long rolling top—a tug of war between fundamental negatives and mistakenly hopeful investors. The rolling is the whimper. Bears' steepest drops usually come late.

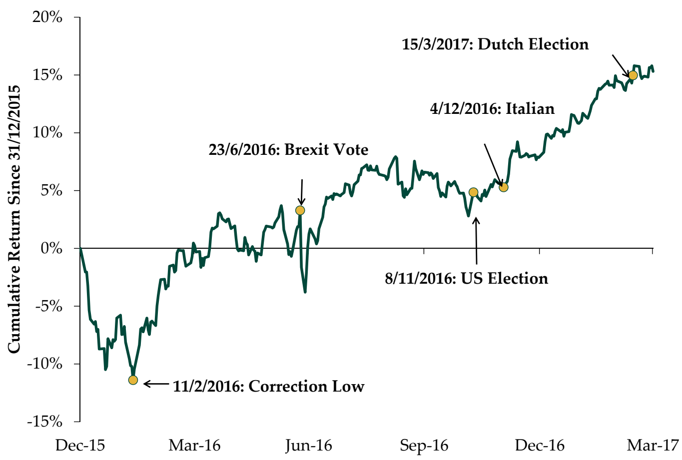
No Trump Bump—Or Trump Slump

As a reminder, our political commentary is intentionally non-partisan and focuses on how politics may—or may not—influence markets.

Pundits claim the post-election rise is a "Trump Rally," "Trump Trade" or "Trump Bump" built on investors' hopes for change—tax cuts, deregulation and revision of the Affordable Care Act (ACA) and Dodd-Frank Wall Street reforms. Failures to enact such change risk disappointment, they argue—morphing the Trump Bump into a Trump Slump. These concerns grew after the House of Representatives failed their first attempt to pass an ACA replacement bill in March.

Yet there is no Trump Rally. Equities' upward trend didn't begin November 8, 2016. It dates back to February 11, 2016's correction low—when seven Republican presidential candidates remained!

Exhibit 2: Global Equity Market Returns Since 2015



Source: FactSet, as of 5/4/2017. MSCI ACWI returns with net dividends, 31/12/2015 – 31/3/2017.

i Source: FactSet, as of 5/4/2017. MSCI World Index returns with net dividends, 31/12/2016 – 31/3/2016.

From the correction low to Election Day, global equities rose 18.3%—a 0.1% average daily rise.[ii] From Election Day to March 31, 2017, equities added another 9.98%, averaging 0.1% per day.[iii] Same song, different verse.

As Exhibit 3 shows, four of five US equity sectors leading before the vote went on to led after. The exception is Energy, a sector many (wrongly) presumed would benefit from Trump's win. Yet Energy's leadership imploded months before the vote—this change wasn't about Trump.

Exhibit 3: Sector Leadership Didn't Shift With Trump's Win

Sector	11/2/2016 - 8/11/2016	8/11/2016 - 31/3/2017
Energy	28.4%	1.7%
Financials	27.3%	19.7%
InformationTechnology	27.1%	14.0%
Materials	23.2%	12.1%
Industrials	20.7%	12.4%
S&P 500	18.9%	11.4%
Consumer Discretionary	16.5%	12.6%
Real Estate	15.8%	5.6%
Utilities	10.3%	6.2%
Health Care	9.1%	9.7%
Consumer Staples	9.0%	5.1%
Telecom Services	2.8%	8.4%

Source: FactSet, as of 5/4/2017. S&P 500 and S&P 500 sector total returns for the periods shown. Yellow shaded sectors underperformed the S&P. Green shaded sectors outperformed.

Since there was no "Trump Bump", fearing legislative disappointment will render a "Trump Slump" doesn't make sense. It also overlooks the fact Trump entered office more feared than any Republican we can recall, due to his anti-business campaign rhetoric. Trump accomplishing little—as in Q1—is bullish, not bearish, easing investors' fears.

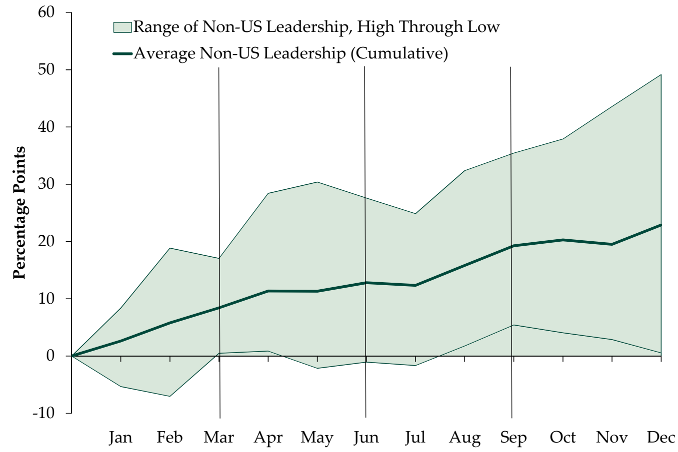
Equities Outside United States Take the Lead

The eurozone shined in Q1, with the MSCI EMU—an index of developed eurozone markets—rising 8.6%.[iv]

As detailed last quarter, 2017 seems ripe for a rotation to non-US leadership. Especially attractive is the eurozone, which should benefit from falling political uncertainty and positive economic surprise.

In Q1, non-US equities outperformed, albeit by a narrow margin. This is to be expected—leadership rotations are often small and disorderly early. Leadership may even alternate between US and non-US immediately ahead. But when non-US equities lead early in inaugural years, the lead usually increases later. Moreover, when non-US leads in Q1, it has led in 90% of quarters 2 – 4, and 100% of full years. Exhibit 4 shows this history, plotting average non-US outperformance in inaugural years when it led in Q1, as well as the range.

Exhibit 4: Non-US Leadership Accelerates After Q1 in US Inaugural Years



Source: Global Financial Data, Inc., as of 21/1/2017. GFD World Ex. US and S&P 500 price returns, calculated monthly in 1937, 1941, 1953, 1957, 1969, 1973, 1977, 1985 1993 and 2005. We omit 1933 due to massive currency swings as the US left the gold standard. Range is the highest and lowest cumulative return as of the indicated month.

Why does non-US leadership widen as the year progresses? Fears over a new US president are generally highest early—before presidents prove their inability to dictate huge change. As they take office and begin appointing a cabinet, issuing executive orders and setting the legislative tone, early fears dissipate—buoying US equities. By mid-year, uncertainty is mostly gone. This year is a case-in-point, as the early furor over Trump appointments and executive orders has cooled, assuaged by his inability to enact sweeping legislation. If non-US led when US equities benefited from falling uncertainty, they should do well later, once that tailwind is spent.

Yield Curves in Focus

While European yield curves steepened in Q1, America's flattened—another point underscoring European equities' likely outperformance. However, America's flatter yield curve doesn't bode ill. For one, flatter yield curves aren't recessionary. They make lending less profitable, which can drag on growth as money supply slows, but economies are resilient. Only when the yield curve inverts—when short rates exceed long rates—does recession

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ii Source: FactSet, as of 5/4/2017. MSCI World Index returns with net dividends, 11/2/2016 – 8/11/2016.

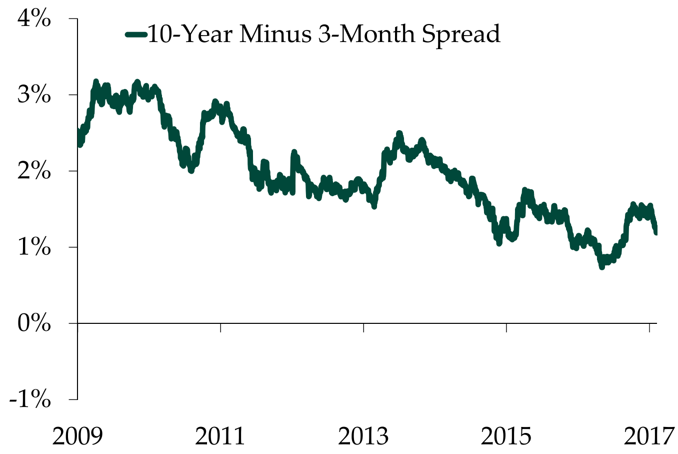
iii Ibid. 8/11/2016 – 31/3/2017.

iv Source: FactSet, as of 6/4/2017. MSCI EMU Index return with net dividends, 31/12/2016 – 31/3/2017.

likely loom. Even then, it isn't a timing tool—economies usually grow and markets rise for months after yield curves invert. It takes time for credit market problems to hit the economy or equities.

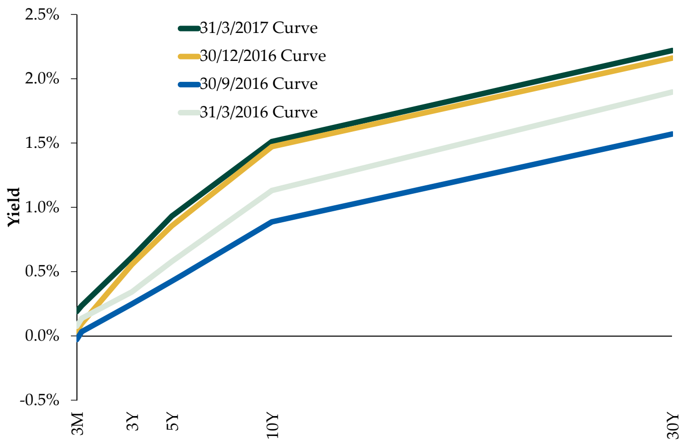
Then, too, the global yield curve matters more than any one country. As Ken wrote in *The Only Three Questions That Count*, money crosses borders freely. Banks can borrow in one country, lend in another and hedge for currency risk. Hence, we believe the most reliable gauge of future global economic activity is the GDP-weighted global yield curve. (Exhibit 5, 6) When all major countries are combined, outliers tend to offset each other. Today, Europe's relative steepness helps offset the flatter US.

Exhibit 5: GDP-Weighted Global Yield Curve Spread



Source: FactSet, Global Financial Data, Bloomberg and Thomson Reuters, as of 17/4/2017. 10-Year minus 3-Month Yields, weighted by quarterly real GDP as of 31/12/2016.

Exhibit 6: GDP-Weighted Yield Curve



Source: FactSet, Global Financial Data, Bloomberg and Thomson Reuters, as of 17/4/2017. Data is from 31/12/2009 – 31/3/2017.

Not Bullish on Oil and Energy

Energy still faces headwinds from an oversupplied market, restraining prices. Media hypes OPEC's cuts and deals with Russia, but these likely can't raise prices. Increasingly efficient US shale producers can produce profitably at lower oil prices. OPEC's late-2016 deal to slash output was offset by America. Barring a much bigger OPEC cut, higher demand or vastly lower sentiment toward oil equities, Energy should trail. Too many investors see opportunity or cling to Energy holdings. Capitulation hasn't come.

Don't Sweat Valuations—Especially CAPE

Rising equities and warmer sentiment expanded valuations, leading many to claim markets are overvalued—poised to fall. Particularly popular is the Cyclically Adjusted Price-to-Earnings ratio (CAPE, or Shiller PE). In our view, these worries wrongly presume valuations predict market direction—they don't. Moreover, CAPE is fundamentally broken and has never worked beyond mere coincidence.

P/Es don't predict markets. As Ken explained in 2006's *The Only Three Questions That Count* and 2015's *Beat the Crowd*, cheap equities get cheaper; pricey equities get pricier. In the 1990s bull, valuations exceeded average for years before 1999's Tech bubble inflated. This bull market began with lofty trailing P/Es, as the financial crisis hit earnings more than equity prices.

While they aren't predictive, typical valuations like 12-month forward and 12-month trailing P/Es are useful as sentiment signals. Presently, they are above long-term averages, but not extremely so—indicating optimism. This is typical in maturing bull markets. As confidence grows, investors become willing to pay up for firms with solid outlooks.

CAPE Is Very Flawed

Most valuation fearmongering cites CAPE, with S&P 500 CAPE presently at 29.5.[v] Media frequently claims this predicts a huge market decline, as this level was seen only twice before—before bears in 1929 and 2000. But CAPE wasn't created to target turning points. And no matter the intent, CAPE is not predictive, distorted by its calculation methodology.

v *Source: http://www.multpl.com/shiller-pe/. As of 8/5/2017.*

CAPE attempts to forecast the next 10 years' returns. To do so, CAPE's creators (Robert Shiller and John Campbell) smoothed away economic cycles by averaging the last decade's inflation-adjusted earnings, comparing those to current equity prices.

The gauge gained fame as a cyclical indicator because of a coincidence. Shortly before the Tech bubble burst in 2000, Shiller published *Irrational Exuberance*—which argued CAPE showed equities were overvalued. To the media, the subsequent decline validated the tool. But CAPE was flashing warnings for years by the time the book published, matching present levels from January 1997 through March 2000's peak. It inspired then-Fed head Alan Greenspan's December 5, 1996 speech questioning market valuations. The bull surged 116% over the next three years.[vi] Similarly, CAPE signaled trouble from 2003 – 2005. In this cycle, adherents began arguing it indicated froth in 2013. Since 1990, CAPE was below its long-term average—purportedly bullish—in only 17 of 326 months, a period containing three extended bull markets.

The slew of false reads should give anyone pause, but the real trouble is CAPE's methodology. As Ken wrote in *Financial Times* in March:

> *Using 10 years of earnings isn't better, just more backward-looking. CAPE today includes 2008-09 recessionary earnings, which are irrelevant to forward-looking equities. If CAPE falls when those old earnings fall out, it won't suddenly be bullish. "Official" CAPE … uses GAAP earnings. But GAAP standards have changed over history. The dataset doesn't account for this, destroying historical comparisons. As for the inflation adjustment, nominal equity price divided by deflated earnings is weird. Investors earn nominal equity returns. Companies reap nominal profits.*[vii]

Even at its stated purpose—forecasting 10-year returns—CAPE is not effective. Supply and demand determine equities' direction and magnitude. CAPE makes no attempt to foresee equity supply. Without that, it can't foretell returns. Even Shiller and Campbell's 1998 white paper outlining CAPE (which then used 30 years of deflated earnings) noted it explained less than half of market returns, which is underwhelming. But even if it nailed 10-year returns, that isn't very useful. If the next five years zoom, would you want to miss them because the subsequent five disappoint? Wouldn't you also want to know how equity returns compare to alternatives? CAPE is simply no help.

vi Source: FactSet, as of 7/4/2017. S&P 500 total return, 5/12/1996 – 24/3/2000.

vii "Stocks Aren't Overvalued, So Keep Buying," Ken Fisher, Financial Times, 21 March, 2017.

US Commentary

UNITED STATES

Donald Trump took office in January, and his first several weeks went about as we expected: Talk aplenty, from the media and administration, but far less action than people expected. As intraparty gridlock prevailed, many feared equities would slide down a slope of dashed hope for pro-business reforms. Instead, markets rose as the administration took shape and uncertainty fell, while the media's credibility drifted away. The more investors tune out the media hype and base judgements on personal experience, the more animal spirits should warm, boosting equities.

EARNINGS REACCELERATING

As shown in recent quarters, Energy's weakness drove 2015 and early 2016's feared "earnings recession." Now, with oil's drag waning, investors more clearly see strength.

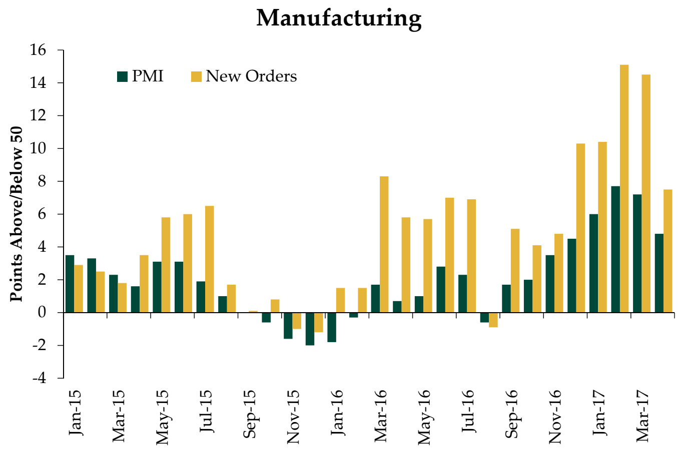
In Q4 2016, S&P 500 y/y earnings grew 5.0%, putting full-year earnings growth positive, at 0.5%.[viii] Excluding Energy, Q4 earnings rose 5.2%.[ix] With 292 firms reporting as of April 28, Q1 earnings growth is estimated at 12.5% y/y (8.4% ex. Energy).[x] This is in keeping with analysts' projected 2017 acceleration. Profit growth isn't a renaissance or Trump-driven. Fundamentals were fine outside Energy and remain so. As higher oil prices from 2014 and 2015 fell out of year-over-year calculations, oil's drag waned. In Q4, earnings math referenced Q4 2015, when oil prices were near today's level. Hence, the gap between earnings with and without Energy shrank. In Q1 2017, earnings math uses oil's lows—hence Energy's flip from headwind to tailwind.

THE US ECONOMY IS GROWING

The US economy is also doing well. Growth abounds, and forward-looking indicators remain positive. Equities still have ample US economic support.

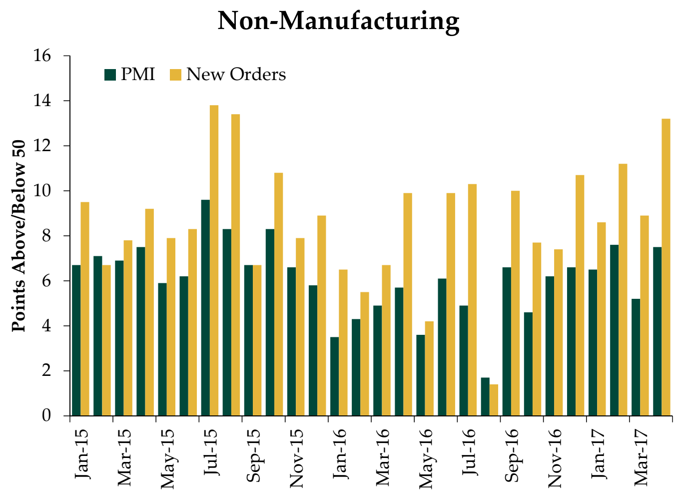
Manufacturing and non-manufacturing PMIs spent all of Q1 well above 50, with forward-looking new orders surging. (Exhibit 7, 8) While these surveys measure the breadth of growth, not the magnitude, it would be unusual for a recession to strike while so many firms see rising activity—particularly with new orders so strong.

Exhibit 7: PMIs Are Surging



Source: FactSet, as of 1/5/2017. ISM Manufacturing and Non-Manufacturing PMIs and New Orders Indexes, data from Jan, 2015 – April, 2017. Readings over 50 imply expansion.

Exhibit 8: PMIs Are Surging



Source: FactSet, as of 1/5/2017. ISM Manufacturing and Non-Manufacturing PMIs and New Orders Indexes, data from Jan, 2015 – April, 2017. Readings over 50 imply expansion.

While surveys provide "soft" data most "hard" data also showed growth—albeit, not as robust. Q1 2017 GDP growth slowed to 0.7% annualised, but falling inventories, rising imports and reduced government consumption detracted a huge 1.8 percentage points.[xi] None of those areas necessarily indicate a "weak" economy. Totaling pure private-sector domestic components (consumer spending, business investment and residential real estate) puts growth at 1.9% annualised—not far below long-standing trends.[xii]

viii Source: FactSet Earnings Insight, as of 7/4/2017.

ix Ibid.

x Ibid.

xi Source: US Bureau of Economic Analysis, as of 1/5/2017.

xii Ibid.

Similarly, volatile industrial production—which also seemingly defies PMIs—doesn't appear problematic. January's -0.3% m/m drop and February's small 0.1% gain were driven by warm winter weather—utility output fell -6.8% m/m and -5.8%, respectively. Manufacturing output rose in both months. In March, this reversed—utilities buoyed overall output while manufacturing dipped for the first time since August 2016—an outlier. Mining output rose all quarter, as Energy firms ramped up.

Growth looks set to continue. The Conference Board's US LEI—an uncanny indicator of future activity—rose seven straight months through February and has accelerated lately. The broadest money supply measure, M4, has grown 4% y/y or faster in every month since January 2016, implying the economy has plenty of fuel. [xiii]

While loan growth has cooled—and business lending fell in three of the last four months—this doesn't mean a credit crunch looms. Isolated business lending pullbacks are fairly normal during expansions, and this cycle has seen its fair share. Moreover, business lending fell for the expansion's first 16 months, yet growth persisted. [xiv] Today's pullback bears watching, but thus far it pales next to earlier weakness.

Getting Stuck in the Swamp

During his campaign, Trump promised to aggressively tackle the current political establishment, including influential lobby groups and corruption. Trump referred to this as "draining the swamp", the phrase that instantly became popular throughout the US media. However, Trump's first 100 days were fairly typical of a new administration. Like his predecessor, he made a splash with Executive Orders that sounded big but changed little. Some measures stirred ire, but all are either sociology—irrelevant to markets—or instructions for agencies to study something. As written before, Executive Orders are limited–sweeping change requires legislation. If presidents try bypassing Congress, the courts usually intervene, as they did with Trump's immigration directives.

Meanwhile, cabinet appointment confirmations dragged as Democrats fought hard, typical of an opposition party. Trump's cabinet is different from past administrations—more businesspeople, fewer people with time in the swamp. This alternately stirs fear and hope—only time will tell how these people influence policy. But there, too, cabinet members can't rewrite law, and most major changes must clear Congress—which remains gridlocked.

Presidents routinely get less done than people think. Even if Trump eventually drains the swamp somewhat, it will be a difficult and long process…

We have long said, gridlock is bullish. It reduces legislative risk, letting businesses plan and invest. Yet most investors detest it, hoping for supposedly market-friendly reforms and tax cuts. People get caught up in minutiae, debating whether Congress tackled health care reform wrong, should have addressed taxes first, or done something else. The more lawmakers floundered in Q1, the more folks feared the rally would stall, presuming equities had priced in reforms that now won't happen. This misses the bigger picture: Presidents routinely get less done than people think. Even if Trump eventually drains the swamp somewhat, it will be a difficult and long process.

We aren't making policy predictions, but we envision this president—like most—accomplishing just a few big things, with most "achievements" being little details. There should be few radical shifts, for good or ill. Meanwhile, businesses and markets will carry on, driving the economy and equities forward. The private sector is America's economic engine, and in a system like ours, government can't totally subsume capitalism.

xiii Center for Financial Stability, as of 6/4/2017. Divisia M4, January 2016 – February 2017.

xiv Source: FactSet, as of 13/4/2017.

It Is Not Duck Season, It Is Rabbit Season

Trump is in heavy conflict with the media, Democrats and several Republicans. Less obvious, but equally true: Trump doesn't really care what people think of him. Yes, he is widely perceived as thin-skinned and image-obsessed. By publicly stewing over inauguration crowd size and alleged voter fraud, Trump has done plenty to perpetuate this perception. But behind the scenes, he seems delighted to look dumb or crazy if it enables him to get what he wants—re-election in 2020.

Trump is more concerned with winning than public relations. He knows the media is his adversary and uses it to his advantage. As Former House Speaker Newt Gingrich explained:

> *Trump's core model is, you hit me, I hit back, and I hit harder than you hit. He learned it in the New York media when he was a business man. He's on permanent offense. He gets up in the morning figuring out, how am I going to stay on offense? He understands that the media has to chase rabbits, so he gives them rabbits to chase, because if he doesn't give them rabbits to chase, they'll invent a rabbit.*

Ken elaborated in his February 22 *Financial Times* column:

> *Opponents rarely figure [Trump] out, almost always underestimate him, and can't realise most of what he says is a diversion … from what he really wants to do.*
>
> *What does he want? To get his way—what he calls 'winning.' Today, he's doing unconventional things most folks say won't work. Like putting unconventional people in government. But in 2020, re-election time, if America is fine, he thinks most myopic voters will forget today's fuss and he'll be seen similarly as fine. He'll win again.*
>
> *Trump categorises some into groups, such as the media, which he calls dogs. It's in dogs' DNA to chase rabbits, so he gives them 'rabbits' to chase. Executive orders, tweets, rants, threats, accusations, 'alternative facts'—all rabbits, for the media to saturate their space—controlling their agenda. Woof, woof, woof. Otherwise the media finds its own rabbits, and Trump loses control. He doesn't care what they think of him. He's delighted to play the lout, feed them rabbits, and quietly get what he really wants while they woof-woof-woof down the trail.*[xv]

Trump's willingness to throw out nonsense as cover is one of his presidency's defining features. It allows him to continue wearing the "outsider" mantle, regardless of how much political reality forces him to moderate—key to keeping his base motivated. He will probably continue, presuming people overlook short-term dust-ups as long as the country seems on the right track in 2020. If people think things are going well, Trump presumes his base plus some converts spell re-election. If not, he figures he wasn't going to win anyway, so it was still worth the risk. In the meantime, Trump knows some will hate him, but he accepts it as the cost of doing business. Maddening as it all might seem at times, for Trump's supporters and detractors alike, investors are best off accepting this tendency, tuning out the noise, and getting on with life.

Media Credibility Waning

Media sentiment is also evolving as we expected. We see more and more sensational headlines, which doesn't match what people see firsthand. This results in media's lost credibility and investors' decision to ignore it – which is bullish.

When people expel negativity, animal spirits can warm. But ultimately, we can foresee consequences. As we have always said, the main reason for consuming media isn't to learn what is happening, but to gauge sentiment. With media's repeated noise driving folks away, it has become the boy who cried wolf. People are increasingly fed up and ignoring the boy. Should this continue, a major negative could eventually hide in plain sight—because no one is looking. We are keenly aware of this risk and actively looking for such factors. After all, the folk tale doesn't end with the villagers ignoring the boy and living happily ever after—it ends with the wolf ravaging the village, because no one paid attention when the boy was finally being earnest.

xv "Trump's Rabbit Season and the Howling Hounds," Ken Fisher, Financial Times, February 22, 2017.

Non-US Developed Commentary

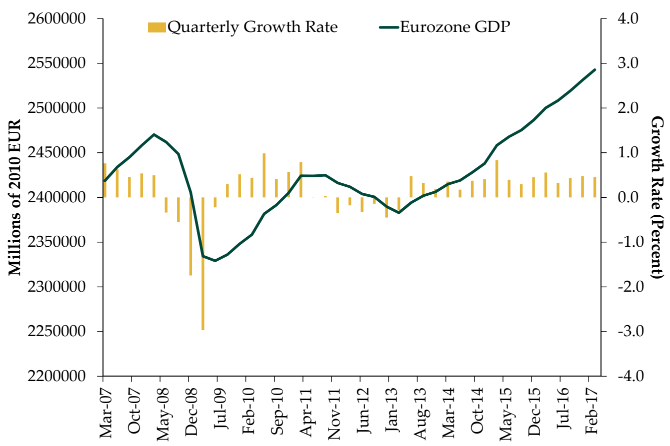
Non-US Developed Commentary

Americans aren't alone in tuning out a noisy, less credible media and making their own judgments. Investors abroad are going through much the same thing—particularly in Europe, where the media hype machine pounds endlessly about populist politicians. As Europeans tune this out, the experience of their life improving should cause animal spirits to stir. Equities are bought globally, and European investors' enthusiasm for equities counts every bit as much as American investors'.

What European Investors See

What continental Europeans see differs from media portrayals. There, headlines fret the eventual end of the ECB's quantitative easing (QE) programme—much like QE "taper" fears in the US in 2013 and 2014. Media warns economies will crumble without stimulus. Central bankers still talk of economic "recovery," as if growth is new and fragile and must be coddled closely—even though eurozone GDP grew 16 straight quarters through Q1 2017. The eurozone eclipsed its pre-2008 peak in 2015. This isn't a recovery—it is an expansion. (Exhibit 9) A broad-based expansion, no less.

Exhibit 9: Don't Call This a Recovery

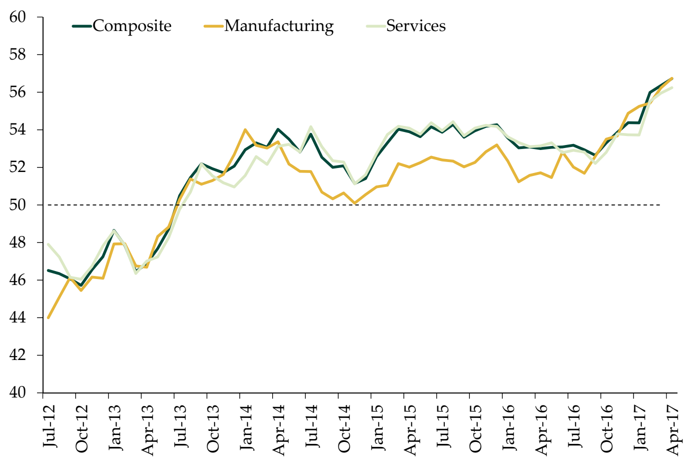


Source: FactSet, as of 5/4/2017. Eurozone quarterly GDP level and q/q growth rate, Q1 2007 – Q1 2017.

Eleven of the bloc's 19 members have topped pre-recession GDP—not just Germany, the Netherlands and France, but also bailed-out Ireland. Spain and Portugal are within shouting distance of prior peaks, and both have grown faster than the full eurozone in recent quarters.

Widespread growth should continue. Eurozone purchasing managers' indexes (PMIs)—surveys gauging how many firms saw increased activity—hit six-year highs in April after rising steadily in Q1. Manufacturing, once a slight headwind, is now broadly growing. Composite PMIs in the four largest eurozone economies have also accelerated. According to IHS Markit, which compiles Europe's PMIs, new business is burgeoning across the eurozone. Today's new orders are tomorrow's production. (Exhibit 10)

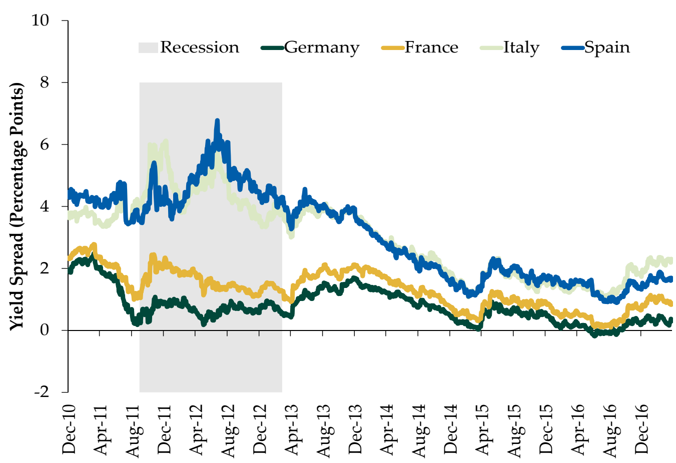
Exhibit 10: Eurozone PMIs Are Taking Off



Source: FactSet, Markit Economics as of 1/5/2017. Eurozone Composite, Manufacturing and Services PMIs, July 2012 – April 2017. Readings over 50 indicate expansion.

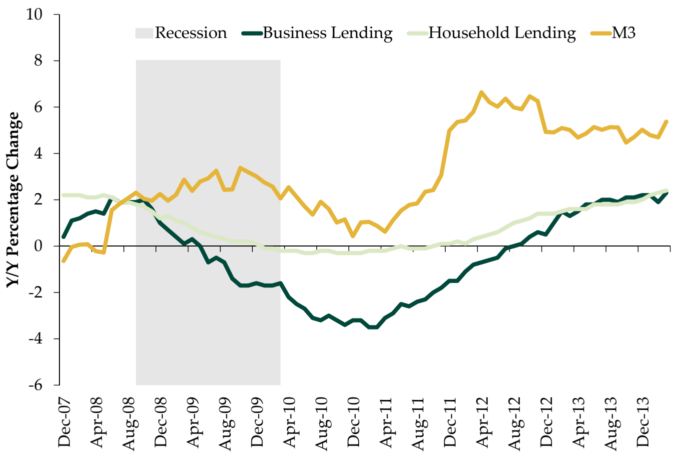
The Conference Board's Eurozone Leading Economic Index (LEI) also points positively. After a fitful spell in early 2016, it has risen seven straight months. The biggest contributor remains the yield spread, which has widened since last summer—including in Q1. Wider yield spreads boost loan and money supply growth. (Exhibit 11, 12 on next page) Capital fuels economic growth and the eurozone has more and more of it.

Exhibit 11: Eurozone Yield Spreads



Source: FactSet, as of 1/5/2017. Yield spreads are 10-year benchmark government bond yields minus the ECB's main refi rate. Eurozone Yield Spreads data from 31/12/2010 – 28/4/2017.

Exhibit 12: Eurozone Lending & Money Supply



Source: FactSet, as of 1/5/2017. Household and business lending are adjusted for securitisation. Eurozone Lending data from 31/12/2010 – 31/3/2017.

Sentiment in Europe Should Continue Improving

Few appreciate just how much room sentiment has to rise in continental Europe compared to the US. Sentiment in the US is sunnier, since Americans have had more time to work off the bear market hangover. The US had one recession and bear market, both ending in 2009, giving American investors eight years to work through pessimism, slowly shake scepticism and begin growing optimistic (sentiment's final stage, euphoria, seems far off). Continental Europe, however, had two recessions—2008 – 2009 and 2011– 2013 as the debt crisis wreaked havoc. While world equities only corrected, European equities had a 2011 regional bear market.

Hence Europe is only now reaching where American investors were a few years ago: starting to shake off the post-crisis mentality and fathom expansion. You can see this in ECB chief Mario Draghi and Fed head Janet Yellen's most recent comments. After the Fed's March rate hike, Yellen said, "The simple message is the economy is doing well," and "people can feel good about the economic outlook." No hedging.[xvi] Draghi, by contrast, spent March promising his stimulus programmes weren't on the way out.

As European elections pass and investors increasingly shun media noise, sentiment should improve. We have already seen this, to an extent, following the French and Dutch elections.

France – Macron Wins Decisively

French equities enjoyed a boost as uncertainty fell in the run-up to the presidential election's second round on May 7th. For much of the year, France underperformed the MSCI EMU index as investors wrestled with fear of anti-euro Marine Le Pen becoming France's next president. Compounding matters, the major parties' candidates were floundering in the polls, while far-left Jean-Luc Mélenchon mounted a late surge. Investors therefore pinned their hopes on Emmanuel Macron, an independent centrist who resigned as outgoing President François Hollande's economy minister a year ago to start his own political movement.

The election's first round on April 23rd ended much of this uncertainty. Macron won the most votes, Le Pen took second, and polls showed him winning handily in round two. French equities surged and ceased underperforming, buoyed by relief. By the time Macron won the second round with 65% of the vote, the uncertainty was gone, and markets had seemingly moved on.

Since Macron was the architect of many of Hollande's economic reform proposals, many investors hope he will be able to push further reforms when in office, but that seems unlikely. Macron doesn't represent an established party with a big contingent in Parliament. His En Marche movement hasn't even selected its slate of candidates for June's parliamentary vote yet, while the mainstream parties' candidates have been campaigning for months. These parties probably use their strong machinery to prevail in June's parliamentary vote. The resulting political gridlock should prevent extreme legislation. However, French equities don't depend on reforms. Economic drivers are favourable, and relief from fears over euroscepticism should boost sentiment—and equities.

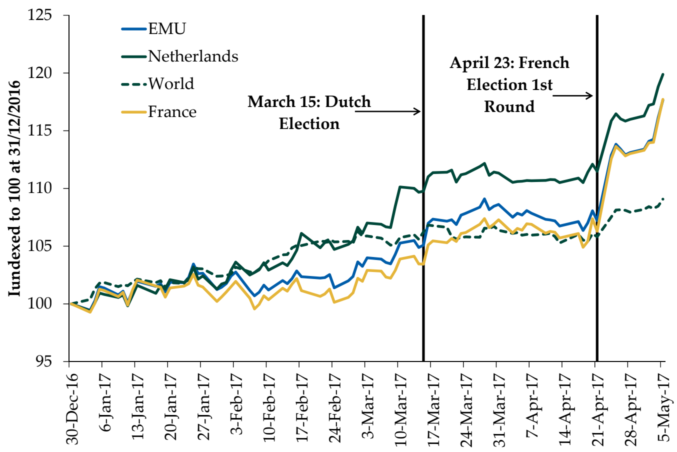
The Netherlands: Party for Freedom (PPV) Fails

March 15's Dutch election occurred against a similar backdrop. In January and February, anti-euro candidate Geert Wilders' Party for Freedom (PVV) polled ahead of incumbent Prime Minister Mark Rutte's Party for Freedom and Democracy (VVD), fanning fears the Netherlands—an original EU and euro member—would "Nexit." All along, we believed fears were overrated, as Dutch election "winners" usually must form multi-party coalitions. At the height of its polling, PVV was projected to take at most 35 of parliament's 150 seats. No major party was willing to join them in government. So if PVV won, they likely wouldn't have governed.

xvi "Fed Raises Rates; Yellen Holds Press Conference – Live Analysis," Staff, The Wall Street Journal, March 15, 2017. http://www.wsj.com/livecoverage/fed-decision-yellen-march-2017

But as March came, PVV's poll numbers faded, and they didn't win. VVD took the most seats, while PVV took 20, barely edging two other centrist parties for second. While Rutte still hasn't formed a coalition—which often takes time—for markets, PVV's failure reduced uncertainty, aiding Dutch outperformance. (Exhibit 13)

Exhibit 13: Falling Uncertainty Boosts Dutch—and Eurozone—Equities



Source: FactSet, as of 5/4/2017. MSCI Netherlands and MSCI EMU Indexes with net dividends, 31/12/2016 – 31/3/2017.

The UK Returns to the Polls

On April 18th, UK Prime Minister Theresa May surprised many by announcing she would seek a snap general election. The following day, Parliament overwhelmingly voted in favour, and its 650 seats will be up for grabs June 8—three years early. The vote surprised, but it doesn't change our view of Brexit or 2017.

Prime Minister May aims to bolster her Conservative Party's standing before Brexit talks. When the party selected her to replace the outgoing David Cameron following last year's Brexit vote, she inherited a slim 17-seat Parliamentary majority—and a party divided over Brexit. Just a few members breaking ranks could stymy her plans. May hopes an election now will deliver a much greater majority, given polling puts the Conservatives 20 points above Labour, the largest opposition party. Some observers think her party could get up to a 100-seat majority if polls hold—giving May a large buffer against intraparty dissenters. It delays the next general election to 2022 rather than 2020—further removed from Brexit.

As ever, polls may be wrong but whoever wins, Brexit is happening. Few argue for a new referendum. Should the Conservatives lose (unlikely), it changes only who heads the British contingent in talks and what sort of the post-Brexit UK/EU relationship they seek. If the Conservatives gain, the only new wrinkle is less gridlock. While that could mean more legislation on non-Brexit issues—a possible negative—Brexit mitigates this risk. A recent Thomson-Reuters study showed last year, before Brexit talks began, the number of new laws fell -29%. The government's Brexit focus should intensify limiting political action elsewhere.

Japan – Economy Still Struggling

In Japan, the first quarter was marked with a scandal surfacing around Prime Minister Shinzo Abe over his family's alleged involvement with a far-right nationalist educational foundation. The controversy started in February, when details emerged that a school received a large discount for a land purchase. Abe has denied direct or indirect involvement. Though the broader fallout seems limited and Abe's approval rating is still high, it is a keen reminder that political capital is a finite and fleeting resource, even for popular politicians like Abe. Should this controversy continue dragging Abe down, it could make passing long-delayed reforms difficult.

Meanwhile, Japan's tepid economic growth continued in Q4 2016. GDP grew 0.3% q/q (1.2% annualised), its fourth straight quarterly rise—a rare positive streak for an economy that has regularly fallen into contraction. However, the data shows Japan's expansion remains externally driven. Exports—the primary growth driver—rose 11.0% annualised. Private consumption was flat, though other gauges showed some positive signs. Imports, which represent domestic demand, rose 5.4% annualised, ending a streak of four straight contractionary quarters. If sentiment and expectations toward the country continue falling, it could reach a point that any positive news could surprise to the upside, providing a potential opportunity for investors.

Emerging Markets Commentary

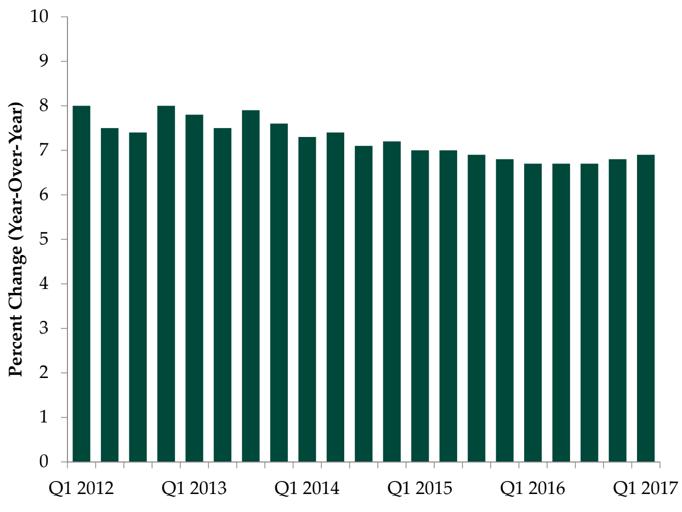
China

Despite continually besting dour expectations, China entered the year facing doubts about its 2017 prospects. Media keep raising questions like: Is an economic "hard landing" looming? Will a mountain of debt collapse and roil the economy? Is the government losing control? While China has its share of problems, we believe many of them are overstated and unlikely to hinder the global economic expansion and bull market—or Chinese equities.

Stability Is the Name of the Game

Data show China's growth remains stable, if slower than in this bull market's early years. GDP grew 6.8% y/y in Q4 and 6.7% in 2016—right in line with the government's target of 6.5% - 7%. In March, the National People's Congress confirmed this year's growth target will be around 6.5% y/y. However, they have also signaled their comfort with falling short of that target so long as the most critical objective—overall social stability—remains intact. This isn't a major surprise since slowing Chinese GDP growth has been the norm over the past several years. (Exhibit 14) That said, Q1 GDP picked up to 6.9% y/y, marking the first back-to-back acceleration in seven years. This doesn't mean the economy will speed up from here, but don't expect growth to slow every quarter.

Exhibit 14: Chinese GDP Growth Since 2012



Source: FactSet, as of 17/4/2017. Quarterly year-over-year GDP growth rates, from Q1 2012 – Q1 2017.

Q1's monthly data show China's service sector is doing most of the heavy lifting, offsetting the continued slowdown in manufacturing. Though the Lunar New Year tends to skew January and February economic data, first quarter numbers don't deviate from their long-term trends. Consumption metrics like retail sales continue notching double-digit growth rates. Heavy industry and investment gauges are slower but still growing. Official government and Caixin Markit's privately tabulated Purchasing Managers' Indexes (PMIs) indicate expansion in manufacturing and services. Plus, the government has long signaled its willingness to spur and maintain growth as necessary to ensure social stability. Thus, the constant fears about the Chinese economy seem exaggerated.

That Persistently Overwrought Debt Fear

One of those false fears revolves around Chinese debt. Because of the yuan's weakness, some worry imperiled Chinese firms will struggle to pay off dollar-denominated debt—begetting more currency outflows and further weakening the yuan. However, China has plenty of tools to intervene and support the yuan, from nearly $3 trillion in forex reserves to capital outflow restrictions that slow the amount of yuan exiting the country.

Even if some firms failed and couldn't make their debt obligations, this wouldn't necessarily be a bad thing. It would signal China finally allowing market forces to decide winners and losers, which would benefit the country's capital markets and instill greater investor confidence. That said, though the government has rebuked failing firms, officials have also shown a willingness to step in and protect investors. While this type of intervention represents a setback for economic liberalisation reform, it is right in line with the government's commitment to overall stability. Overall, we expect this theme to continue for the foreseeable future.

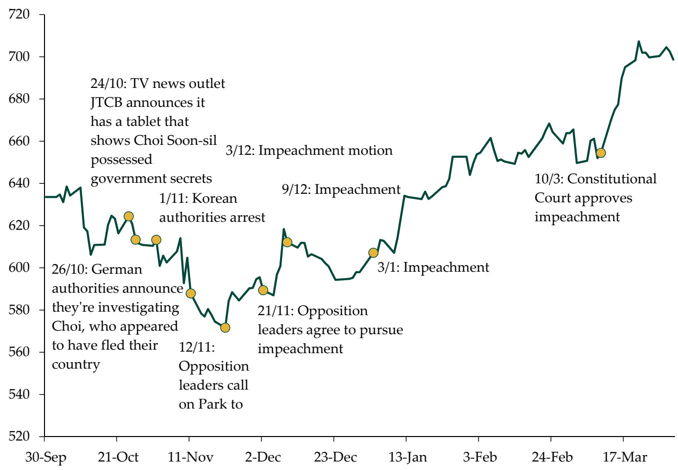
South Korea

Falling Political Uncertainty Sets Equities up to Outperform

As we type, most attention on the Korean Peninsula fixates on tensions between America and North Korea over North Korean dictator Kim Jong Un's continued pursuit of a long-range nuclear weapons programme. This is a source of uncertainty, but tensions with North Korea are a virtually constant source of uncertainty for Korean equities. There is no realistic way for a financial market observer or analyst to actually handicap whether tensions now are different than in the dozens of past episodes, like in the spring of 1994, when then-US President Bill Clinton considered a pre-emptive strike on a North Korean reactor. That being said, it is worth noting regional conflicts have no history of materially affecting global equities—it takes a truly global conflict to broadly impact equities. While a full-blown war on the Korean Peninsula could weigh on Korean equities—and perhaps those in the global IT supply chain—it is mere speculation to presume that is at hand now. Korean equities have barely budged in response to the tensions, finishing April near 2017 highs. In our view, this is a distraction from the positive political and economic drivers more likely to determine Korean equities' direction for the foreseeable future.

On the positive side, South Korea looks to benefit from falling political uncertainty this year amid a favourable economic backdrop that should buoy equities. (Exhibit 15) On March 10, South Korea's Constitutional Court upheld President Park Geun-hye's December impeachment, triggering an election on May 9.[xvii] As we are writing this review, the election results are still unkown. Regardless of the outcome, Korean equities should do well. They rallied after the Park scandal became a formal impeachment, and the election should erase the last bit of uncertainty.

Exhibit 15: Korean Equities Advance During Park Impeachment



Source: FactSet, The Telegraph, The Diplomat, JTCB and The New York Times, as of 11/4/2017. MSCI Korea Index with net dividends, 30/9/2016 – 31/3/2017.

CHAEBOL REFORM LOOKS MORE LIKELY

On domestic issues, the leading candidates favour ending the government's preferential treatment of the *chaebol*—family-controlled business conglomerates dominating the economy. Chaebol revenues are estimated to account for nearly 60% of South Korea's GDP, and the companies represent over half the country's equity market capitalisation.[xviii] Chaebol have come under intense scrutiny in recent years over their political influence and corruption allegations, including bribery for favourable regulatory outcomes. However, chaebol are Korea's most powerful political group, so true reform may prove difficult. In our view, chaebol reform is an incrementally positive medium-term step that further liberalises its economy, but not necessary for ongoing growth.

To take one emblematic example of South Korea's increasing fortunes and resilience, Samsung (almost a third of Korea's market capitalisation) by all accounts has had a difficult time over the last year—starting 2016 with a failed rollout of its flagship smartphone and later embroiled in Park's corruption scandal, resulting in the arrest of Samsung heir and Vice Chair Lee Jae-yong, who is presently on trial. Samsung shares are up since his arrest, likely a testament to the end of uncertainty over his involvement and perhaps markets' rising expectations for reform. His trial is something of a litmus test for the country's appetite to take on corruption. Despite all this, first quarter profits rose 48% y/y, the highest in over three years and the second-highest on record.

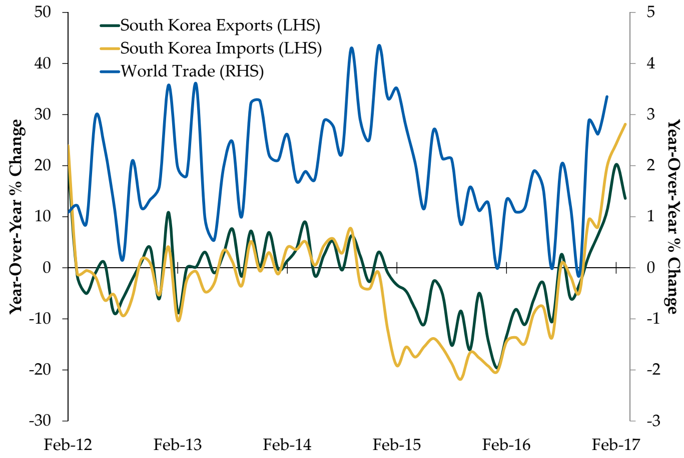
KOREA'S ECONOMIC TAILWINDS IMPROVE

While falling political uncertainty is one tailwind for Korean equities, improving economic conditions in Korea and globally are an equal, if not greater, boost. Korean economic growth never wavered throughout the political turmoil as GDP increased 0.5% q/q in Q3 and Q4 2016. Meanwhile, retail sales are up on the year through February, and have remained positive annually for two years. Industrial production has been choppy and the manufacturing PMI remains slightly below 50, indicating contraction, but both represent modest improvement in recent months. Global trade—one of the key headwinds against Korean manufacturing in recent years—has accelerated lately. Korean trade is benefitting from this revival—a trend clear to see in Exhibit 16 on the next page, although the year-over-year growth rates are likely exacerbated by a low comparison base tied to the shifting

xvii "South Korea presidential election date announced," Euan McKirdy, CNN, 15/3/2017. http://www.cnn.com/2017/03/15/asia/south-korea-election-date-announced/

xviii "Samsung Group's Market Capitalization Accounts for 28% of Korea's Total Market Cap," Jung Suk-yee, BusinessKorea, 21/3/2017. http://www.businesskorea.co.kr/english/news/industry/17589-market-capitalization-samsung-group%E2%80%99s-market-capitalization-accounts-28-korea%E2%80%99s timing of 2016's Lunar New Year. If global trade continues picking up, it should turn a major headwind for Korean production into a tailwind. Already, Korea's Leading Economic Index is accelerating higher, led by exports and machinery orders.[xix] With private sector lending recovering back near record highs, GDP from services and consumer spending continuing to power ahead and the external trade environment picking up strongly, the Korean economy looks on track for further growth this year.

Exhibit 16: Korea and Global Trade Revival



Source: FactSet and CPB World Trade Monitor, as of 18/4/2017. South Korea Exports and Imports, 29/2/2012 – 31/3/2017. Merchandise world trade volume, fixed base 2010=100, 29/2/2012 – 31/1/2017.

India – Poised to Deliver Business-Friendly Structural Reforms

Despite expectations for widespread economic and political fallout from India's demonetisation programme last November, data show little lasting impact. Unsurprisingly, this bolstered the ruling Bharatiya Janata Party (BJP) party, which picked up seats in recent state elections. In five state elections March 11, the BJP won 434 of 690 assembly seats, including a landslide victory in Uttar Pradesh, the country's most populous state, with 204 million people. Following the elections, the BJP now controls local assemblies accounting for two-thirds of India's population. This paves the way next year for the BJP to win a majority in India's upper house, where its current minority has hampered passing economic reforms. Expectations are now rising that Modi can implement more comprehensive plans to further India's economic development.

xix Source: The Conference Board, as of 7/4/2017.

Economic Effects From Demonetisation Limited

In a bold and sudden reform, India replaced 86% of circulating currency notes—which needed to be declared to banks and then exchanged for new notes—in two months late last year.[xx] While the aim was noble—to bring India's extensive cash-based black market economy (estimated at 20 – 50% of GDP) into the light—it accomplished less than that, while disrupting vast parts of economic activity as banks were unprepared and ill-equipped to handle the change.[xxi] As a result, money supply decreased, loan growth slowed and purchasing manager indexes (PMIs) changed to indicate contraction. The messy implementation weighed on sentiment, causing an equity market correction in which Indian equities fell -10.1% from November 8 to November 21.[xxii]

However, the pain was short-lived, and life soon returned to normal.[xxiii] While currency in circulation remains down (deposited in banks), M3 money supply has more than recovered, loan growth is picking up, PMIs are back in expansion and equities long since got over the episode. (Exhibit 17 on next page) Meanwhile, Q4 GDP advanced 7.0% y/y.[xxiv] Although decelerating slightly from Q3's 7.4% growth, it handily beat expectations for 6.4% growth.[xxv]

xx "India's bold experiment with cash," Martin Wolf, Financial Times, 21/2/2017. https://www.ft.com/content/e3f2aaa8-f77d-11e6-bd4e-68d53499ed71

xxi "The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008," Dev Kar, Global Financial Integrity, 17/11/2010. http://www.gfintegrity.org/storage/gfip/documents/reports/india/gfi_india.pdf

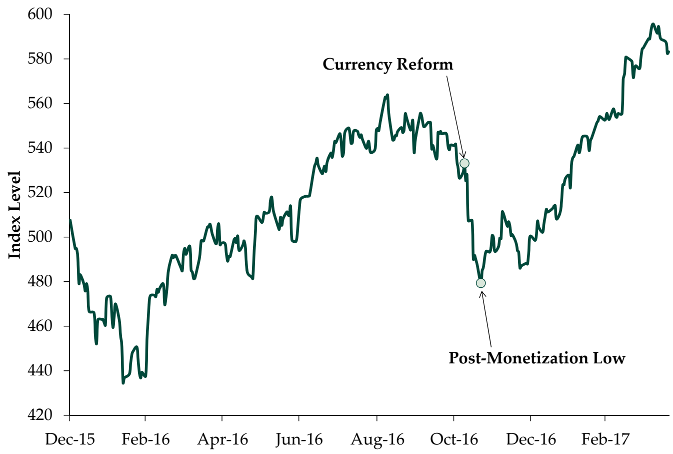
xxii Source: MSCI India Index with net dividends, as of 20/4/2017. 8/11/2016 – 21/11/2016.

xxiii "India ends cash rationing imposed after Modi's banknote ban," Amy Kazmin and Simon Mundy, Financial Times, 13/3/2017. https://www.ft.com/content/5f2adf44-06ef-11e7-97d1-5e720a26771b

xxiv Source: Government of India, Ministry of Statistics and Programme Implementation, as of 28/2/2017. http://mospi.gov.in/sites/default/files/press_release/nad_pr_28feb17r.pdf

xxv Source: Trading Economics, as of 26/4/2017.

Exhibit 17: India Equities Recover and Then Some



Source: MSCI India Index with net dividends, as of 20/4/2017. 31/12/2015 – 19/4/2017.

While the demonetisation seemingly failed to root out black money, as ultimately 97% of outstanding notes were exchanged, it did bring some ancillary benefits.[xxvi] Most notably, it made a substantial impact on the 42% of Indians who didn't have a bank account, many of whom signed up for digital payment services in order to conduct business.[xxvii]

Tax Reform

India's unified good-and-services tax (GST), which passed parliament March 29, is still scheduled to take effect July 1, though implementation could easily be pushed back given its bureaucratic complexity, technical hurdles and the complex nature of Indian politics. But it should be worth the wait. India currently ranks 172 out 190 countries for tax paying ease.[xxviii] Taxes levied haphazardly according to more than 15 different tax codes between central and state governments add around 25% to the final price of consumer goods on average.[xxix] Since only 12.5 million Indian citizens pay income taxes, a simplified GST tax has the potential to expand the tax base, lower consumer prices and boost economic activity.[xxx]

However, details still need to be worked out. The single nationwide tax rate originally envisioned has multiplied to four—5%, 12%, 18% and 28%—and it remains unclear what items fall into each bracket. A political council will meet in May with central and state government representatives to decide—everything from what counts as "unprocessed" food (and at what rate it will be taxed) to the more consequential potential application to bank interest payments, which could drive up borrowing costs. Meanwhile, each of India's 29 states must pass their own versions of the GST, which may be a lengthy process, particularly where the BJP does not control the state legislature. Then, to do business, companies must register with each state and renegotiate new terms with their suppliers. With July 1 looming, businesses are scrambling to fill in paperwork and meet yet-to-be-determined requirements. While a smooth rollout can be a challenge, the government looks to be prioritising minimising economic dislocations over meeting ambitious deadlines. The tax has already been delayed from its initially planned April rollout.

Concurrently, the government is rolling out technology infrastructure called the "GST Network" to support the new tax process and handle some 3 billion invoices per month. With about a quarter of 8 million companies still not enrolled, the deadline to register was extended to April 30 from March 31. Training for 60,000 central and state tax officials on the new system is expected to be completed in May.[xxxi] And with just around 140,000 practicing chartered accountants, audits are likely to remain inconsistent for some time.[xxxii]

xxvi "India Said to Get 97% Banned Notes in Setback to Graft Crackdown," Siddhartha Singh and Bibhudatta Pradhan, Bloomberg, 4/1/2017. https://www.bloomberg.com/news/articles/2017-01-04/india-said-to-get-97-banned-notes-in-setback-to-graft-crackdown

xxvii "Indian banks respond to Modi's Demonetization Shock Therapy," Elliot Wilson, AsiaMoney, 5/4/2017. http://www.euromoney.com/Article/3687173/Indian-banks-respond-to-Modis-demonetization-shock-therapy.html?single=true

xxviii Source: The World Bank, as of 13/4/2017.

xxix "India's ambitious plan to tax goods and services," Staff, Financial Times, 12/4/2017. https://www.ft.com/content/662213fa-1f75-11e7-b7d3-163f5a7f229c

xxx "India passes 'revolutionary' bill for goods and services tax," Kiran Stacey, Financial Times, 29/3/2017. https://www.ft.com/content/8063ced6-1460-11e7-80f4-13e067d5072c

xxxi "All tax data will be completely secure, GST Network assures India Inc.," Staff, The Financial Express, 11/4/2017. http://www.financialexpress.com/economy/all-tax-data-will-be-completely-secure-gst-network-assures-india-inc/624371/

xxxii "GST Network extends deadline till April 30 for firms to register," Sunitha Natti, The New Indian Express, March 30, 2017. http://www.newindianexpress.com/business/2017/mar/30/gst-network-extends-deadline-till-april-30-for-firms-to-register-1587528.html

India's Digitisation

More broadly, tax reform is part of Modi's desire to push the Indian economy into the digital age. In a highly ambitious technology infrastructure upgrade, the government has developed identity and verification services that businesses (and others) can build on—the so-called India Stack—that greatly enhance Indian citizens' access to financial services like payments, lending, investment and insurance.[xxxiii] In addition, health, education, employment, credit, police and tax records should be readily accessible online with the ability to share and sign documents securely. The hope is that with more efficient and accurate document processing capabilities, economic activity will increase significantly, while red tape and corruption dwindle.[xxxiv]

Biometric identification forms the basis for the India Stack. Since 2009, the government has biometrically identified nearly all adults—1.1 billion people—through fingerprint and iris scans and given them an Aadhaar number, akin to Social Security identification in the US.[xxxv] Issues of accuracy and availability—fingerprint scans of manual labourers may be difficult to read, for example, and internet access, never mind electricity, can be unreliable or nonexistent—are still being worked out, but aren't insurmountable. The cost of iris scans is declining, and rural electrification—a major plank of Modi's platform—is progressing.

Critics point to privacy concerns and potential misuse of sensitive information, but India is hardly the first country facing such issues. Authorities are well aware of the problems—and benefits—of maintaining and accessing a trusted identity database.[xxxvi] Not that Modi and the BJP can uniquely claim credit for India's current modernisation push—the Aadhaar plan began under the previous government—but by embracing digitisation they are putting every effort into cementing it as their legacy. While this is not a cyclical driver and isn't likely to materially impact markets in the foreseeable future, it is part of India's modernisation push, a structural positive for this large Emerging Market.

Mexico's Rebound

Last quarter, we detailed Mexico's post-US election weakness and our expectation the Trump administration would do far less than feared on trade—triggering a rebound. Thus far, reality has come fairly close to our expectations. We continue to believe lingering fears and uncertainty over the Trump administration's approach to Mexican trade will fall, lifting sentiment towards the country and allowing investors to better appreciate its solid fundamentals.

We have already seen Trump change his stance on NAFTA and trying to renegotiate it instead of revoking it altogether.

Trump's anti-trade and specifically anti-North American Free-Trade Agreement (NAFTA) rhetoric on the campaign trail led to a near-universal consensus that Mexico lost on November 8, 2016, when Trump took the White House. In the wake of the vote, Mexican equities and the peso fell sharply. Analysts fixated on Trump tweets—particularly an early January twitter battle with Mexican President Enrique Peña Nieto, in which Peña Nieto sharply refused to pay for a US/Mexico border wall and announced he wouldn't attend NAFTA renegotiation meetings. The presumption was Mexico's positive economic fundamentals didn't matter, because the US accounts for over 80% of its exports. Trump's protectionism—particularly if he ended NAFTA altogether—overshadowed all.

But this overlooked political and economic reality. For one, Trump's anti-trade rhetoric on the campaign trail may have been more dramatic in nature. We have already seen Trump change his stance on NAFTA and trying to renegotiate it instead of revoking it altogether. Moreover, an anti-trade rhetoric during a campaign trail is far from unique. In 2008, his predecessor, Barack Obama, similarly claimed NAFTA required renegotiation as it didn't work for American workers. In office, he resolved a longstanding debate over Mexican truck access to US highways—in effect completing the deal. Former President Bill Clinton argued NAFTA was ill-conceived in 1992's presidential race. Once elected, he championed small tweaks to it and promptly pushed it through. Politicians frequently use trade as a key campaign issue and they historically

xxxiii "India Begins Building on Its Citizens' Biometrics," Daniel Stacey, The Wall Street Journal, 20/2/2017. https://www.wsj.com/articles/india-begins-building-on-its-citizens-biometrics-1487509205

xxxiv "India Stack is the key technology platform that could transform India into a cashless economy," Staff, Firstpost, 12/12/2016. http://tech.firstpost.com/news-analysis/india-stack-is-the-key-technology-platform-that-could-transform-india-into-a-cashless-economy-352250.html

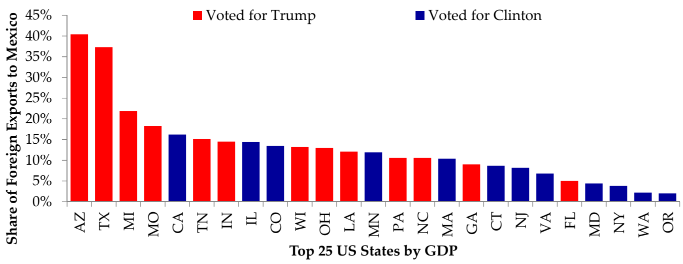
xxxv "India's ID system is reshaping ties between state and citizens," Staff, The Economist, 12/4/2017. http://www.economist.com/news/asia/21720609-long-they-have-mobile-signal-indias-id-system-reshaping-ties-between-state-and-citizens

xxxvi "What the U.S. can learn from India's move toward a cashless society," Vivek Wadhwa, The Washington Post, 23/1/2017. https://www.washingtonpost.com/news/innovations/wp/2017/01/23/what-the-u-s-can-learn-from-indias-move-toward-a-cashless-society/

haven't followed through. The market had a classic, sentiment-driven overreaction to Donald Trump's tough talk— pricing in almost certain NAFTA repudiation.

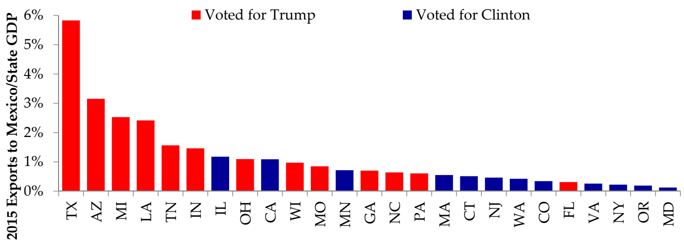
But the political reality is quite different. While it is difficult to pinpoint numbers with precision, virtually all economists agree millions of American jobs depend on NAFTA, many of them in Texas and Arizona, both of which Trump won in November. Mexico is an integral part of US businesses' supply chains—for produce, appliances, aircraft parts, medical equipment and cars. Politically, it would be hugely unwise for a new president who didn't win the popular vote and has very low approval ratings to take sharp action affecting such a wide group, especially a group that supported him last fall. (Exhibits 18, 19)

Exhibit 18: Exports to Mexico as % of State GDP



Source: US Census as of 31/12/2015.

Exhibit 19: Exports to Mexico as % of Foreign Exports



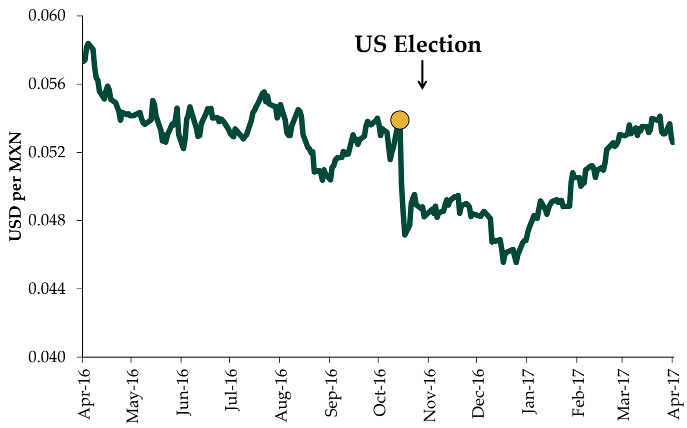
Source: US Census as of 31/12/2015.

In Q1, Trump's twitter battle gave way to a much more conciliatory tone on trade. The administration backed away from House Speaker Paul Ryan's border-adjustment tax on imports as the quarter progressed. Plans for NAFTA renegotiation emerged, with Commerce Secretary Wilbur Ross suggesting *building on* the existing deal rather than scrapping it. He said he aims to strengthen rules of origin in the deal, particularly involving auto parts. This was echoed in late April, when President Trump himself shot down rumors of a looming executive order announcing a NAFTA exit—and noted renegotiation was his priority.

AFTER SENTIMENT FADED, THE PESO AND EQUITIES REBOUNDED

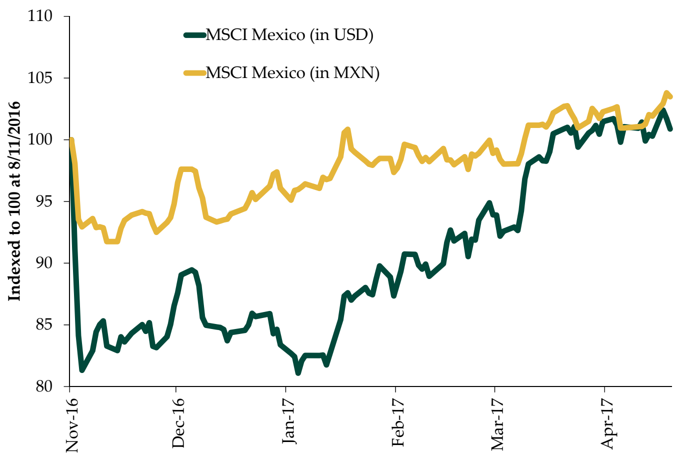
The more-benign-than-feared reality on NAFTA was a relief for Mexican equities and the peso. The currency has recouped its entire post-election decline as we type. Meanwhile, since mid-January—before Trump even took office—Mexican equities have been outperforming the MSCI Emerging Markets Index. Exhibits 20–22 illustrate this rebound. Looking forward, we believe there is still positive surprise left for Mexican markets, particularly if NAFTA negotiations open in 2017.

Exhibit 20: The Peso's Drop Was Fleeting



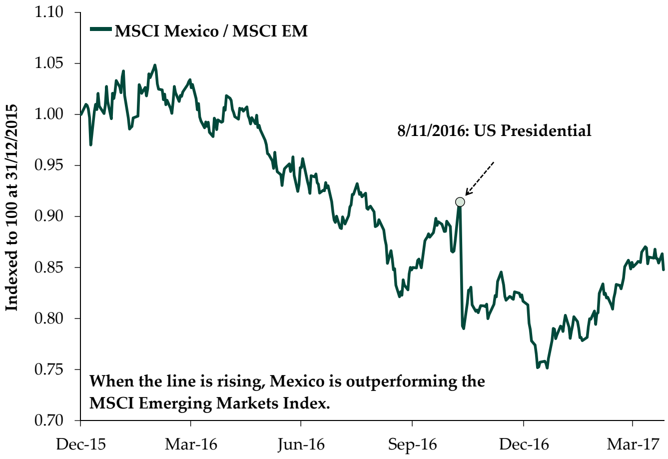
Source: FactSet, as of 27/4/2017.

Exhibit 21: Mexican Equities Since Election



Source: FactSet, as of 27/4/2017. MSCI Mexico 26/4/2016 - 26/4/2017 with net dividends, 8/11/2016 – 26/4/2017.

Exhibit 22: Mexican Equities Rebound Drives Recent Outperformance



Source: FactSet, as of 25/4/2016. MSCI Mexico and MSCI EM, with net dividends, 31/12/2015 – 24/4/2017.

Either way, Mexico's economy is in fine shape. Q4 2016 GDP grew 2.4% y/y, and manufacturing growth accelerated recently. Ironically, Mexican trade has jumped in recent months, with exports and imports growing 14.1% y/y and 15.0%, respectively, in March. Meanwhile, retail sales continue growing—if at slower rates. The yield curve is very flat presently, but with the peso's rebound, it is possible Banxico will choose to curtail rate hikes enacted to bolster the currency post-US election or even cut short rates. The short-term noise caused by Trump's win fading should allow investors to see positive fundamentals more clearly.

Elsewhere in EM

Turkey

Turkish President Recep Tayyip Erdoğan—who has steadily consolidated power since becoming Prime Minister in 2003—has further solidified his power through the constitutional referendum. Opposition groups are challenging the results, citing a host of irregularities, but the results seem likely to stand. Meanwhile, after a failed coup last summer, Turkey remains in a state of emergency, which was extended after the referendum to July 19, and the authorities have arrested dozens of protesters in Istanbul.

Yet equities have looked past this. Instead, Turkish equities appear fine with the result, lifted by the end of uncertainty over the referendum and eager to have the past few years of political instability behind them. For better or worse, the referendum extends a government status and equities care more about policies and falling uncertainty than personalities.

Brazil

In the latest developments, Operation Car Wash—the biggest political investigation in Brazilian history—is encroaching on President Michel Temer and eight members (a third) of his cabinet. Temer is unlikely to be removed, despite bribery allegations. However, with his approval ratings in single digits, it will be harder to advance tough legislation that would help improve Brazil's finances and bolster investor confidence after two years of recession—the worst on record. Pension reform—raising the minimum retirement age to 62 for women and 65 for men from the mid-50s—is next on the docket, and widely seen as a litmus test for Temer's ability to push through tough changes. It has also been heavily watered down from initial proposals, which doesn't bode well for planned education, labour and tax laws. The economic outlook isn't much better, as Brazil's commodity-heavy economy depends on a sustained rise in natural resources prices.

South Africa

Similar to Brazil, political turmoil is engulfing South Africa after President Jacob Zuma fired widely respected finance minister Pravin Gordhan over budgetary differences and sidelined 19 other members of his cabinet. Zuma also remains under fire over alleged influence peddling with the Gupta family, who control an extensive South African business empire. Opposition parties and influential members of Zuma's African National Congress (ANC) are calling for Zuma to resign, with some lobbying for an ANC National Election Committee (NEC) to formally address the situation.

The probability of Zuma's removal has risen, but the history shows it is going to be challenging. If he is ultimately removed—similar to Park in South Korea and Rousseff in Brazil—the resolution to the uncertainty and prospects for greater reform could lift South African equities, but the prospect remains speculative at this point. Moreover, like Brazil, South Africa is a commodity-heavy (mining) nation. So its fortunes likely rest as much on the direction of metals prices as they do the fate of Zuma's presidency.

Should you have any questions about any of the information provided above, please contact FIE by mail at 2nd Floor 6-10 Whitfield Street, London W1T 2RE or by telephone at +44 (0)207 299 6848.

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