FISHER INVESTMENTS EUROPE™

SECOND QUARTER 2016

FISHER MARKET PERSPECTIVES

SECOND QUARTER 2016 REVIEW AND OUTLOOK
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The below table of contents contains hyperlinks allowing the reader to quickly navigate to the desired section.

SECOND QUARTER 2016 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Portfolio Themes

- **Underweight to Commodity-Oriented Companies:** Companies with significant commodity exposure (metals, oil and agricultural) should underperform.
- **Quality Tilt:** As the bull market progresses, we favour equities with larger size, stronger balance sheets and consistent profit margins.
- **Overweight to Health Care:** Health Care companies typically offer reliable sources of revenue and often have power to pass higher costs to consumers, giving them stable longer-term growth prospects.

Market Outlook

- **Falling Uncertainty:** While the Brexit added short-term volatility, we expect the bull market will continue into 2016 as concerns over UK trade agreements, Chinese growth, the US election and energy prices slowly gain clarity.
- **Political Gridlock:** While politics dominate recent headlines, governments of most developed markets remain gridlocked, reducing the likelihood of extreme legislation – a market positive.
- **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.

The end of the second quarter did not lack drama, yet despite all the uncertainties, the MSCI ACWI rose 1.0% in the quarter.[1] This year's swings follow late-2015's volatility, extending an up-and-down period. We expect the bull market to continue into 2016's second half.

Our thematic overweight to Health Care generally helped portfolios. Energy and Materials underweights hurt as the sectors benefited from the commodities countertrends – a rally which we view as unsustainable. High yield defensive sectors have benefited from both the low interest rate environment and a general flight-to-safety. We believe these sectors should underperform as investors gain clarity on global events and sentiment improves.

Most recent attention has been focused on Britain's referendum on EU membership, the so-called "Brexit" vote. After Leave's victory became apparent, bond, currency and equity markets swung wildly, and sterling dropped to 30-year lows. Headlines were very pessimistic, and the sell-off over the next couple trading sessions reflected that anxiety—with hindsight, it is clear markets had priced in a Remain win. Yet a week later, markets mostly clawed back those losses, nearing pre-Brexit levels. This was not a crash and we do not believe the Brexit will end the global bull market.

Many of the Brexit related economic questions revolve around trade. Actual negotiations are not likely to begin any time soon, and when they do, they will likely take years. Though rhetoric may be tense, both the UK and EU benefit from trading with each other—they have incentive to reach some sort of compromise. At this point, predictions on how these trade negotiations will conclude is speculation. Importantly, though, talks will proceed slowly and publicly, mitigating shocks. For now, the UK is still part of the EU, with free trade and free movement with the other 27 member-states. Politically, headlines dwell on Prime Minister David Cameron's resignation, the race to replace him and the disarray in the opposition Labour Party.

As we detailed last quarter, gradually falling uncertainty should lift equities this year. Brexit was a setback, but a temporary one—its impact seemingly waning already. The near-term political uncertainty it caused should fade with time. America's election has taken shape as the field has narrowed to two—Hillary Clinton and Donald Trump. The Republican and Democratic conventions start soon, officially beginning the general election—a stretch where equities typically do well, with America outperforming non-US equities.

As a reminder, our election analysis is solely focused on the investment implications over the next 12-18 months. We have no favourite candidate or party and can envision a scenario for either candidate winning, hinging on whether states vote as they have in recent Presidential elections (as the media expects) or as their state legislatures have trended. According to top-down analysis, "blue" states—which voted Democratic in at least four of the last five contests—have 257 electoral votes, 13 short of the 270 necessary to win. "Red" states that went Republican have just 206 electoral votes, with five swing states. This top-down view favours Clinton. Yet a bottom-up view, which considers recent state-level elections, favours Republicans. Since 1994, the GOP has captured many state legislatures, controlling 30 today—many in states the media considers blue, like Michigan and Pennsylvania. Bottom-up, they are red. Because top-down analysis and recent polls favour Clinton, pundits underrate Trump's chances. In a bottom-up vote, Trump could win the Electoral College while losing the popular vote. Whatever candidate wins, it is unlikely they can do much to impact markets unilaterally. Presidential power is more limited than many think, and gridlock will likely persist – a market positive.

Economically, most data points to reaccelerating US growth, underpinned by healthy consumption, a strong services industry and improving manufacturing data. US earnings fell less than expected in Q1, and the Energy sector accounted for most of the decline. Energy's drag should wane as early 2015's higher profits fall out of the year-over-year comparisons. Looking ahead, The Conference Board's Leading Economic Index (LEI) is in a long uptrend, suggesting growth should continue. Since its 1959 inception, no recession has begun when LEI is rising.

Most major foreign economies are growing. After eurozone GDP accelerated in Q1, newer data suggest growth continues, countering lingering debt fears and bank jitters. The disconnect between Europe's positive fundamentals and negative sentiment is bullishly wide. The 19-nation bloc has experienced existential uncertainty before, when troubles with members on the periphery like Ireland, Spain, Italy, Portugal and Greece put downward pressure on the Euro at the beginning of the decade. Yet disaster did not follow, and only Greece has remained perpetually troubled due to its long-running structural economic issues. Without knowing how the EU's relationship with the UK will evolve—something that will play out in the coming months and years—nothing about the eurozone in particular will change in the immediate future.

Commodity-heavy nations aside, most Emerging Markets are growing nicely, boosting global growth. China's economic data remain in line with their longer-term trend: slower but still expansionary. Despite the Reserve Bank of India's governor Raghuram Rajan stepping down, a political setback, India continues making solid progress with economic reforms. Elsewhere, the divergence between services and consumption-based economies and commodity-reliant ones remains stark.

Overall, the diminishing uncertainty should reveal a much more positive world than investors appreciate. Negatives exist, as always, but are too small or widely discussed to end this bull market. While volatility or a correction is always possible, the global bull market appears poised to run for the foreseeable future.

THEMATIC UPDATE AND MARKET OUTLOOK

Q2 RECAP

Brexit brought increased volatility to Q2's close, yet the MSCI ACWI finished up 1.0%—little movement, by historical standards, but also a microcosm of recent quarters.[i] Global markets returned only 4.4% between 2013's close and Q2 2016.[ii] Yet over that span, global equities experienced one near-correction in late 2014 and one lengthy correction with two sharp downdrafts from mid-2015 to early 2016. Despite the challenges, we continue to expect the bull market to continue as 2016 progresses.

Many seem to worry that a flat trend line means the bull market is losing steam. But flat periods in a bull market are not uncommon, and corrections often contribute. This closed the ninth flat period exceeding 300 days during a bull market since 1930. Not coincidentally, eight contained a correction. Exhibit 1 shows these periods along with ensuing market returns over the subsequent 12, 18 and 24 months. A flat stretch does not necessarily mean a bull market is dying.

Year of Falling Uncertainty Still Developing

As we wrote last quarter, we believe the flat returns and associated volatility are largely tied to elevated uncertainty. While we believe events such as US elections, volatility in oil prices, the Chinese slowdown, implementation of negative interest rates and the Brexit vote will not cause a bear market, their unpredictability could (and, in our view, did) hurt sentiment. But as they fade, we believe increased clarity will improve sentiment.

The most notable shock to sentiment in Q2 was the Brexit referendum. Markets, having largely priced in a "Remain" vote in the week leading up to the vote, dropped sharply across the board as the results were released. The Sterling hit 30-year lows and most markets saw significant volatility in early trading hours. Despite the market's sharp reaction to the event, very little has actually been established. Political turmoil suggests continued gridlock – a market positive. We expect the recent volatility to be temporary, and that most long-term risks relate to potential unintended consequences of renegotiation of trade agreements and other pacts.

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Other Uncertainty Falling

Uncertainty is falling elsewhere, which should boost equities in 2016's second half. The US election is coming into focus, with both candidates set-Donald Trump against Hillary Clinton. Markets can begin pricing in the eventual outcomes as the general election begins.

High-yield debt concerns focused around Energy junk bonds have largely subsided. The three distressed-debt funds that blocked redemptions in late 2015 proved to be relatively isolated cases. Negative interest rates in Japan and the eurozone, are becoming more commonplace, and the increased scrutiny diminish the chance of any drastic impacts.

At the year's start, the steep decline in Brent and West Texas Intermediate (WTI) crude oil prices stirred fears of spillover into the broader economy and equity market, contributing to the aforementioned high-yield bond fears. However, Brent and WTI hit lows on 20 January and 11 February, respectively, and have since

Exhibit 1: S&P Sideways Streaks In Bull Markets Since 1930

S&P 500 Sideways Streak > 300 Days			S&P 500 Return After Crossing Previous High		
Start	End	Duration	12 Months	18 Months	24 Months
18/7/1933	21/10/1935	825	40.4%	42.8%	-2.2%
14/7/1943	13/6/1944	335	18.6%	36.8%	48.7%
5/1/1953	10/3/1954	429	37.2%	65.2%	75.8%
3/8/1959	26/1/1961	542	12.4%	-5.6%	8.7%
21/9/1976	14/8/1979	1057	14.7%	18.6%	24.2%
10/10/1983	18/1/1985	466	21.7%	38.0%	55.4%
2/2/1994	13/2/1995	376	37.1%	37.5%	66.7%
29/4/2011	23/2/2012	300	11.2%	22.0%	34.7%
21/5/2015	8/7/2016	414	?	?	?
	Average	541	24.1%	31.9%	39.0%
	Median	448	20.1%	37.1%	41.7%

Source: Global Financial Data, Inc., as of 12/7/2016. S&P 500 price returns for periods shown. Duration count is in calendar days. Sideways streak is defined as a period between record highs.

rallied, easing pressure and reducing fears of an Energy-sector driven collapse.

This rally also triggered Energy equities' counter-trend rally to start the year. In our view, early 2016's oil selloff overshot fundamentals, setting up the bounce. However, global oil production remains far above demand, and more new supply is poised to enter the market relatively quickly should prices advance. This likely acts as a weight on oil prices, although we do not anticipate them falling back to early-year lows.

Chinese concerns revolving around a hard landing and currency manipulation have proven false fears, as the slowdown in growth has been in line with trends and years in the making.

Despite recent setbacks in sentiment, we expect that as 2016 progresses, uncertainty should continue to dissipate as the market focuses on fundamentals.

US Commentary

As always, our political discussion is non-partisan and aims to analyse politics solely for market impact, as markets prefer no candidate, party or ideology.

Election uncertainty has fallen considerably. Donald Trump and Hillary Clinton are the Republican and Democratic nominees, respectively. In early July, the FBI recommended against indicting Clinton for storing confidential information on her private email server, advice Attorney General Loretta Lynch formally announced she would follow days later, removing the last big question mark hanging over Clinton's candidacy. After a contentious primary, Bernie Sanders endorsed her in mid-July. A movement to derail Trump's nomination at the convention failed. Markets are no longer distracted by what-ifs, which clouded sentiment earlier this year. Now they can start pricing in November's contest as the general election officially begins—a period when equities typically do well, with the US outperforming.

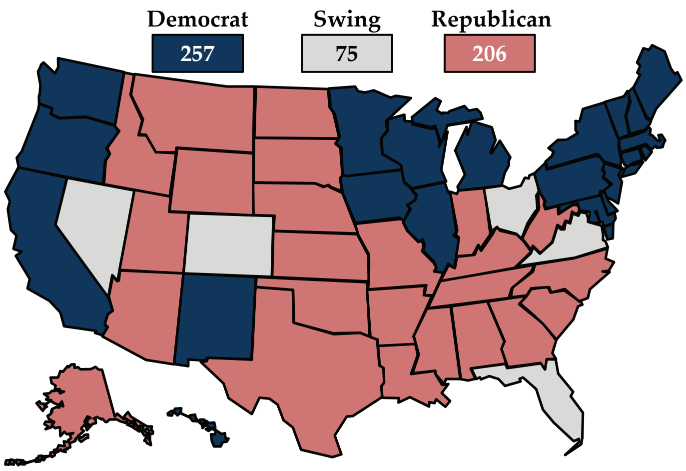
> The outcome [of the US election] depends on whether America votes "top down"….or "bottom up".

We cannot know who will win. We can envision a scenario for either candidate, but the outcome depends on whether America votes "top down," with states voting as they have in recent presidential elections—or "bottom up," with states voting as they have in recent state elections.

The Clinton Scenario—Top Down

A top-down view heavily favours Clinton. This analysis, widely used in the media, labels states "blue," "red" or "swing" based on which party won in recent presidential contests. As Exhibit 2 shows, 21 states and Washington, D.C. are blue—having voted Democratic in at least four of the last five. Twenty-four states are red-having voted Republican-leaving five swing states. The blue states have 257 electoral votes, just 13 shy of the 270 needed to win. If Clinton sweeps these blue states and takes just one or two swing states, she will win the presidency.

Exhibit 2: Electoral Map According to Top-Down Analysis



Source: The Wall Street Journal, US National Archives, Fisher Investments Research, as of 20/7/2016.

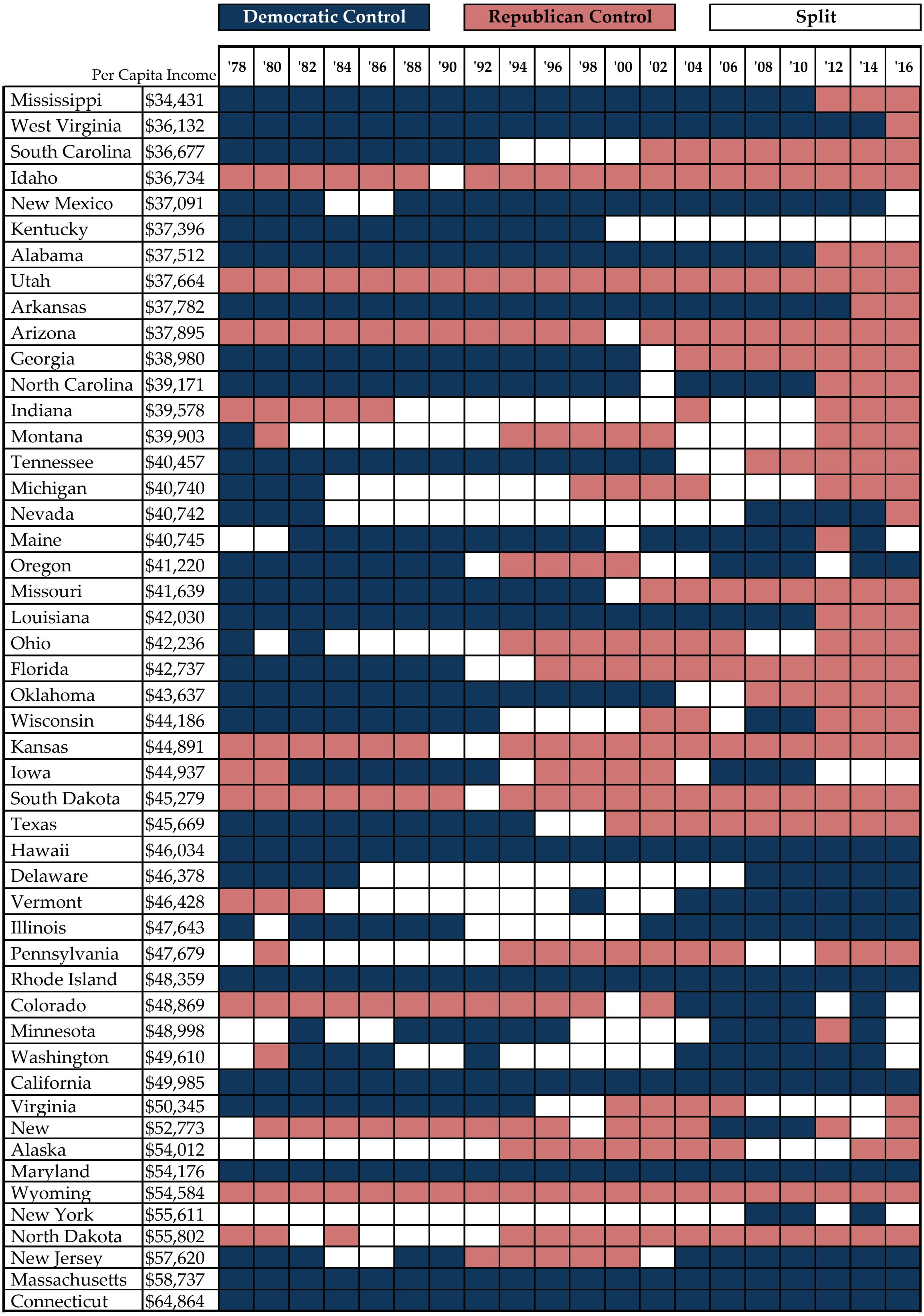
The Trump Scenario

Top-down analysis is perfectly valid and the most commonly used. Bottom-up analysis is equally valid, in our view, but seldom seen, hence most observers underestimate Trump's chances. A Trump victory would shock them but is entirely plausible.

Though little-noticed, Republicans control most state governments bottom-to-top. In Michigan, a blue state per top-down analysis, Republicans hold both legislative houses and all state offices. Pennsylvania and other top-down "blue" states are also heavily Republican at the state level. Republicans' rise in several state governments is relatively recent and non-urban, hence widely overlooked.

Exhibit 3 shows the evolution of state governments since 1978, with states organised by present-day per-capita income. In 1978, Democrats held 31 state legislatures, including 20 in the 33 lowest-income states, making them the majority party—and the blue-collar party. Today, Democrats hold just 2 of the lowest-income 33

Exhibit 3: State Legislatures Organized by Present-Day Per Capita Income

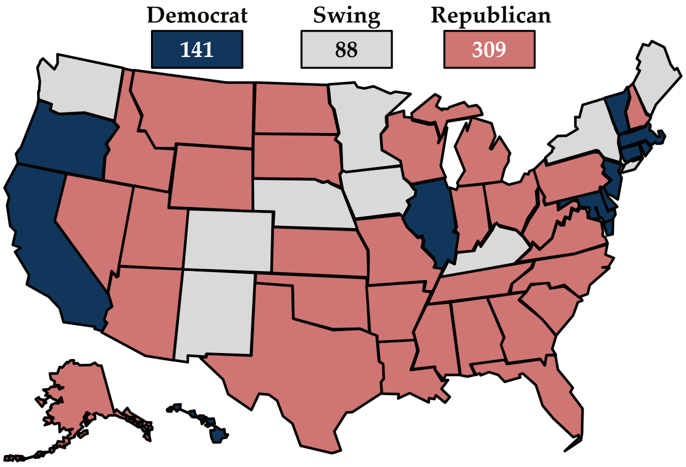


Source: US Bureau of Economic Analysis, National Conference of State Legislatures. Nebraska has a non-partisan, unicameral legislature.

states, while Republicans controlling 30 legislatures overall. Yet few see it, because most media is centered in major urban areas, where lower-income voters still lean heavily Democratic. Republicans' dominance is primarily rural.

If we take a bottom-up approach and label states "blue" or "red" depending on their state legislature, the electoral map looks quite different (Exhibit 4). Blue states have just 141 electoral votes, versus red states' 309—39 more than Trump would need to win.

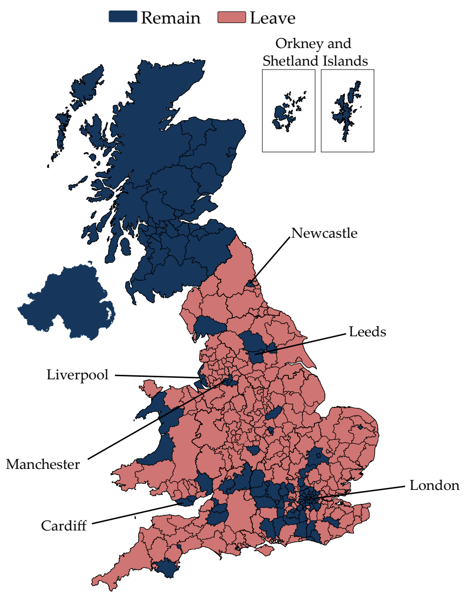
Exhibit 4: Electoral Map According to Bottom-Up Analysis



Source: National Conference of State Legislatures, US National Archives. Nebraska has a non-partisan, unicameral legislature, but leans Republican. DC is counted as Democratic.

The Brexit referendum largely split along an urban versus rural divide, with voters in large cities voting to Remain while the rural UK voters voted to Leave (Exhibit 5). It is possible the US election mirrors this result, with urban areas supporting Hillary while rural voters support Trump.

Exhibit 5: UK Brexit Vote Map



Source: Bloomberg, EU Referendum Final Results, as of 24/6/2016.

Most current polls show Clinton ahead, but this could be misleading. The Brexit vote is a testament to even last-minute polls' unreliability. The final poll, conducted the day of the vote, showed Remain beating Leave, 52% to 48%. A two to four-point lead can vanish quickly.

As for Market Impact…

Typically, market returns in presidential election and inaugural years follow a trend. When Republicans win, US equities tend to do well in the election year, as pro-business campaign rhetoric inflates investors' hopes, then perform below average in the inaugural year as the new president moderates and disappoints those expectations. Conversely, when Democrats win, equities tend to have below-average returns in the election year as investors react to anti-business campaign pledges, then surprise nicely the following year as the Democratic president also moderates, exceeding investors' low expectations (Exhibit 6). Therefore, if Trump wins, history and sentiment imply a nice second half for 2016, and perhaps a more tame 2017. If Clinton wins, the political cycle argues for a modest finish to 2016 and a strong 2017 . Of course, politics are only one factor to weigh—and US politics a piece of that.

Exhibit 6: The Impact of Election Years on S&P Returns

	Election Year	First Year
Republican Elected	15.5%	0.7%
Democrat Elected	7.4%	16.2%

Source: Global Financial Data, Inc., as of 6/1/2016. 1928 – 2016.

Now, Trump's rhetoric is not exactly pro-business in a traditional sense, and Clinton is a well-known commodity. Both may influence whether the typical pattern holds this year or not. However, the 2016 contest has driven investor worries to the point that any resolution could reduce uncertainty, boosting sentiment and equities. With party conventions concluded, the general election campaign is beginning in earnest. Equities usually discount the election's outcome before November, with US equities frequently performing well during this stretch.

Exhibit 7: 2016 Senate Races

	Senator	Party	State	Percent of Vote for Bush in 2000	Percent of Vote for Bush in 2004	Percent of Vote for McCain in 2008	Percent of Vote for Romney in 2012	Year Elected
	Lee, Mike	R	UT	67%	72%	63%	73%	2010
	Lankford, James	R	OK	60%	66%	66%	67%	2014
	Crapo, Mike	R	ID	67%	68%	62%	65%	1998
	Boozman, John	R	AR	51%	54%	59%	61%	2010
	Shelby, Richard C.	R	AL	56%	62%	60%	61%	1986
	Paul, Rand	R	KY	57%	60%	57%	60%	2010
	Moran, Jerry	R	KS	58%	62%	57%	60%	2010
	Hoeven, John	R	ND	61%	63%	53%	58%	2010
	Thune, John	R	SD	60%	60%	53%	58%	2004
Open →	Vitter, David	R	LA	53%	57%	59%	58%	2004
	Murkowski, Lisa	R	AK	59%	61%	59%	55%	2002
Open →	Scott, Tim	R	SC	57%	58%	54%	55%	2013
	Coats, Daniel	R	IN	57%	60%	49%	54%	2010
	Blunt, Roy	R	MO	50%	53%	49%	54%	2010
	McCain, John	R	AZ	51%	55%	54%	54%	1986
	Isakson, Johnny	R	GA	55%	58%	52%	53%	2004
	Burr, Richard	R	NC	56%	56%	49%	50%	2004
	Rubio, Marco	R	FL	49%	52%	48%	49%	2010
	Portman, Rob	R	OH	50%	51%	47%	48%	2010
	Toomey, Patrick J.	R	PA	46%	48%	44%	47%	2010
	Ayotte, Kelly	R	NH	48%	49%	45%	46%	2010
	Grassley, Chuck	R	IA	48%	50%	44%	46%	1980
	Bennet, Michael F.	D	CO	51%	52%	45%	46%	2010
	Johnson, Ron	R	WI	48%	49%	42%	46%	2010
Open →	Reid, Harry	D	NV	50%	50%	43%	46%	1986
	Wyden, Ron	D	OR	47%	47%	40%	42%	1996
	Murray, Patty	D	WA	45%	46%	40%	41%	1992
	Kirk, Mark	R	IL	43%	44%	37%	41%	2010
	Blumenthal, Richard	D	CT	38%	44%	38%	41%	2010
Open →	Boxer, Barbara	D	CA	42%	44%	37%	37%	1992
Open →	Mikulski, Barbara A.	D	MD	40%	43%	36%	36%	1986
	Schumer, Charles	D	NY	35%	40%	36%	35%	1998
	Leahy, Patrick J.	D	VT	41%	39%	30%	31%	1974
	Schatz, Brian	D	HI	37%	45%	27%	28%	2012

Source: Fisher Investments Research, US Senate, as of 7/6/2016.

Bullish Gridlock Should Persist

However the presidential contest goes, Congress should remain bullishly gridlocked, keeping legislative risk low. Neither party appears poised to win a super majority. Whoever wins the presidency will likely have an opposing Congress or a very weak majority, incapable of passing much new legislation.

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In the House, Republicans have the advantage of incumbency and gerrymandering. In the Senate, Democrats have a structural edge, with fewer seats to defend in traditional opposition territory (Exhibit 7). Yet a sweep would take flawless campaigning and resources, and the Democratic Party must play defense in several key governors' races, which could divert campaign cash from the senate contests (Exhibit 8 - see next page). Moreover, it is exceptionally rare for Congress to flip control in a presidential election year. Switches mostly happen in midterms.

Should both houses change hands, it would be a weak Democratic majority—likely much weaker than President Obama's first two years, when it required significant political capital to pass watered-down versions of the Affordable Care and Dodd-Frank Acts. A congress lacking a supermajority is unlikely to pass anything nearly as sweeping.

Presidents Cannot Do Much Unilaterally

Republicans fear Clinton doing extraordinary things. Democrats fear the same of Trump. In reality neither will do as much as people think. The Constitution's checks and balances were designed to limit executive power. Presidents cannot do much unilaterally. Only Congress can write and pass laws. The president can issue Executive Orders or amend rules through regulatory agencies, but this is not unchecked power, as recent events demonstrate. In June, courts overturned an Executive Order to shield some undocumented immigrants as well as an Interior Department's attempt to regulate hydraulic fracturing (aka fracking) on

Exhibit 8: 2016 Governors' Races

	Governor	Party	State	Percent of Vote for Bush in 2000	Percent of Vote for Bush in 2004	Percent of Vote for McCain in 2008	Percent of Vote for Romney in 2012	Year Elected	Senate Seat Up for Election?
	Herbert, Gary R.	R	UT	67%	72%	63%	73%	2009	Yes
Open →	Tomblin, Earl Ray	D	WV	52%	56%	56%	62%	2010	No
Open →	Dalrymple, Jack	R	ND	61%	63%	53%	58%	2010	Yes
	Bullock, Steve	D	MT	58%	59%	50%	55%	2012	No
Open →	Pence, Mike	R	IN	57%	60%	49%	54%	2012	Yes
Open →	Nixon, Jay	D	MO	50%	53%	49%	54%	2008	Yes
	McCrory, Pat	R	NC	56%	56%	49%	50%	2012	Yes
	Hassan, Maggie	D	NH	48%	49%	45%	46%	2012	Yes
	Brown, Kate*	D	OR	47%	47%	40%	42%	2015	Yes
	Inslee, Jay	D	WA	45%	46%	40%	41%	2012	Yes
Open →	Markell, Jack	D	DE	42%	46%	37%	40%	2008	No
Open →	Shumlin, Peter	D	VT	41%	39%	30%	31%	2010	Yes

*Source: Fisher Investments Research, National Governors Association, as of 7/6/2016. *Became acting governor 18/2/2015; special election will be held Nov 2016 for remainder of former Gov. John Kitzhaber's original term.*

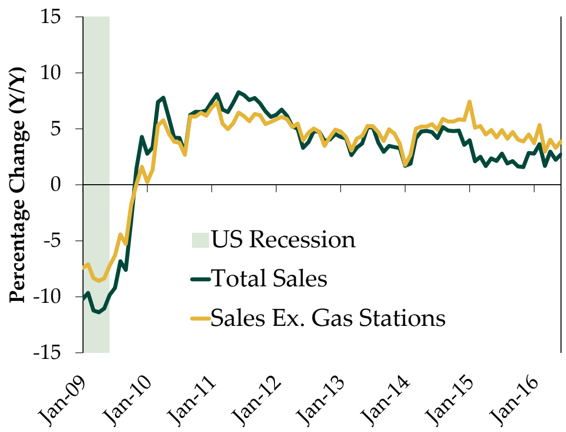
federal lands. The Constitution limits the scope of presidential rulemaking, and the judicial branch has a long record of keeping things in check. Not just the Supreme Court—the lower Federal Courts and the 50 state court systems are also capable of checking an overreaching president.

The US Is Accelerating

US data show a reacceleration from Q1's slowdown. Many noted Q1's initially reported 0.5% annualised GDP growth—with some wondering if a recession loomed.[iii] Yet by Q2's close, this figure had been revised up to 0.8% annualised—still not fast, but not recessionary by any means.[iv]

More importantly, recent data show economic activity picking up. Retail sales rose in April, May and June and, after weighing on headline data for months, gas station sales are now positive on a monthly basis—an after-effect of stabilising oil prices (Exhibit 9).

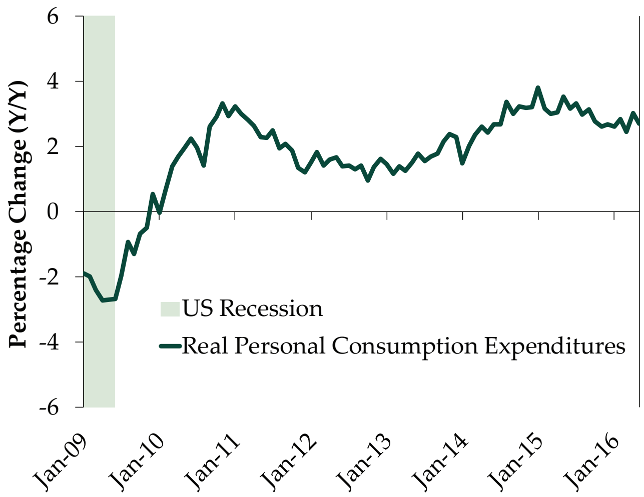
Exhibit 9: US Retail Sales



Source: US Census Bureau, as of 15/7/2016. January 2009 – May 2016.

A broader measure of consumption—personal consumption expenditures, which includes services spending and comprises about 70% of GDP—has also risen steadily (Exhibit 10). Industrial production has rebounded after a recent soft patch. In addition, manufacturing and non-manufacturing PMIs are both in expansionary territory with healthy contributions from the forward-looking new orders components.

Exhibit 10: US Real Consumer Spending



Source: FactSet, as of 15/7/2016. January 2009 – June 2016.

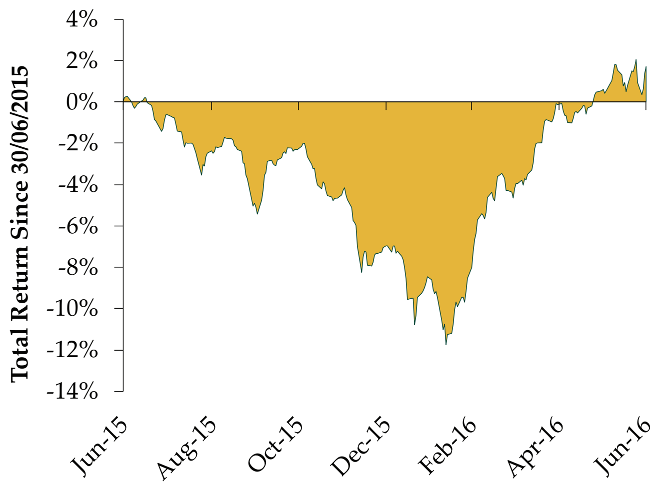
The Glacial Fed

There is also little sign the Federal Reserve (Fed) has any thoughts of materially hiking interest rates this year, if they do at all. After an initial rate hike in December 2015, analysts started guessing how many moves would be in store for 2016. Many anticipated several, consulting different information like the Fed's "dot-plot" projection of FOMC member forecasts. However, such projections are not proven to indicate future Fed actions, and with the Fed often citing a global viewpoint on policy choices, Brexit and the associated media headlines suggest the Fed will avoid any significant moves in the near future.

High-Yield Bond Fears

In late 2015 and early 2016, weakness in high-yield bonds and sharply rising yields triggered fears of looming trouble for equities and the economy. When three distressed-debt funds blocked investor redemptions in mid-December, they drew parallels to two Bear Stearns hedge funds that blocked withdrawals on the eve of 2008's Financial Crisis, fanning concerns of a sequel. But these specialised funds were buying only the riskiest debt—they did not indicate broad problems. Nor were high yield's troubles widespread—they were tied mostly to Energy's weakness. High-yield defaults are up, with 100 corporate defaults year-to-date, versus 62 during the same period last year, with the majority in the resources sectors.[v] But markets priced these events based on widespread fears and opinions. With time and oil's rebound, fears faded, high-yield bond prices rebounded and yields retreated (Exhibit 11).

Exhibit 11: High Yield Index Returns

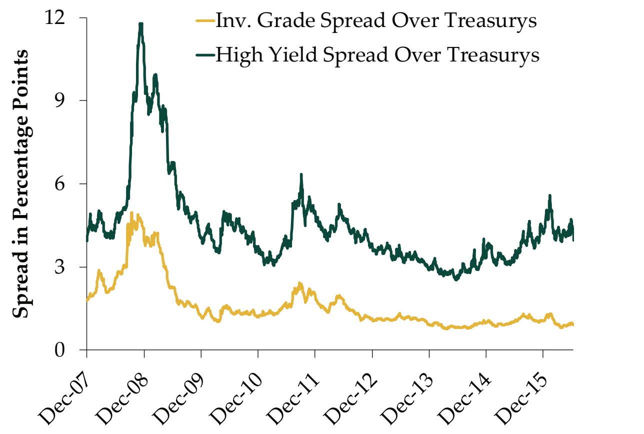


Source: FactSet, as of 12/7/2016. BofA/ML High Yield Index total returns, 30/6/2015 – 30/6/2016.

Credit Spreads Narrowing

Relatedly, the difference between corporate rates (high-yield and investment grade) and Treasurys has fallen. As Exhibit 12 shows, spreads fell sharply from the beginning of the year—and did not move much with Brexit.

Exhibit 12: US Corporate Credit Spreads

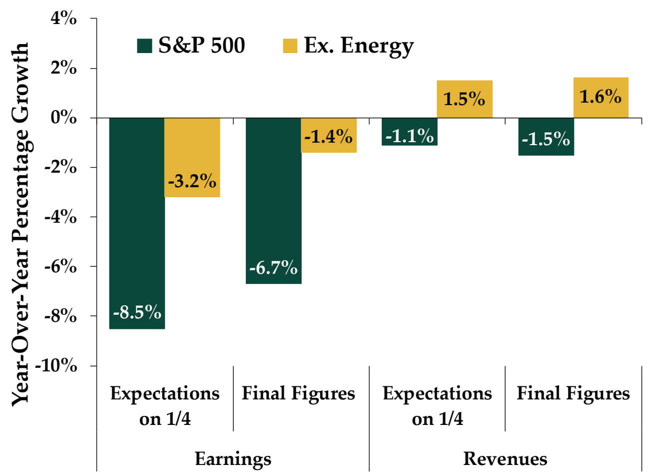


Source: FactSet, as of 8/7/2016. Spreads are US BofA/ML US High Yield (BB) and US AA Corporates Index minus US Treasurys, 7-10 Year Indexes, 31/12/2007 – 12/7/2016.

US Earnings: Still Better Than Appreciated

Corporate America continues beating dour expectations. With Q1 2016 earnings season concluded, earnings fell -6.7% y/y, exceeding analysts' April 1 projection of -8.5% y/y—continuing a long-running trend of analysts undershooting firms' profits.[vi] Moreover, the primary cause for recent negative earnings is unsurprisingly the long-struggling Energy sector. Q1 Energy sector earnings fell 107.2% y/y. Excluding this drop, the other nine sectors' profits fell a meager 1.1%.[vii] Similarly, S&P 500 revenues fell 1.5% y/y in total—more than expected—but rose 1.6% when Energy's 29.4% decline is excluded (Exhibit 13).[viii]

Exhibit 13: US Earnings and Revenue Growth Skewed by Energy



Source: FactSet Earnings Insight, as of 1/4/2016 and 13/6/2016.

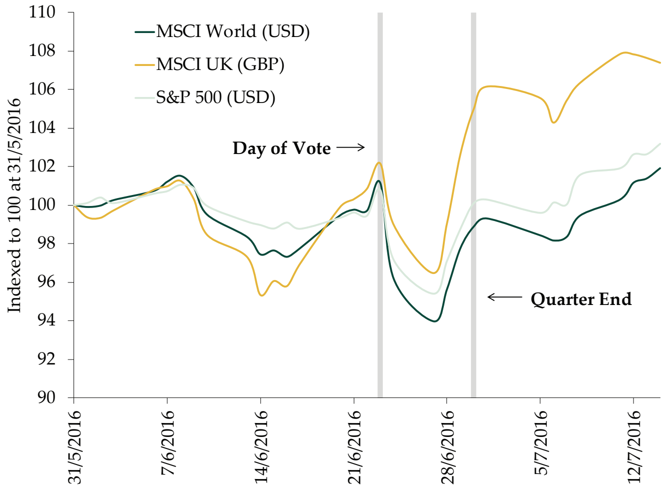
Importantly, Energy earnings should improve as the year-over-year comparisons become easier, adding clarity. This should help investors overcome widespread fears of an "earnings recession." While non-Energy earnings did fall in Q1, this isolated event looks unlikely to persist.

Non-US Developed Commentary

Brexit a Temporary Setback

The United Kingdom's (UK) vote on European Union (EU) membership was an unpredictable source of uncertainty, and we anticipated a resolution—whether "Leave" or "Remain" won—would at least let investors and markets move on. In the very short term, Leave's victory appeared to be a temporary setback—creating uncertainty, not alleviating it. However, this effect is already fading. With hindsight, it appears markets had priced in a "Remain" win and the sharp volatility the two days after "Leave" won was markets adjusting. Once they did, Brexit's impact waned (Exhibit 14).

Exhibit 14: Brexit's Short-Term Impact



Source: FactSet, as of 15/7/2016. MSCI ACWI in USD with net dividends, MSCI UK in USD with net dividends and S&P 500 total return in USD, 31/5/2016 – 14/7/2016.

While Brexit surprised markets, we argued throughout that the race was too close to call. UK polling is in a state of flux, with different agencies trying different methods to address their collective failure to predict 2015's general election. As a result, some polls gave Leave the edge, while some favoured Remain. Prediction markets heavily favoured Remain, but these were skewed by bets originating from pro-Remain London, where people could not fathom pro-Leave sentiment dominating non-urban England and Wales. Brexit has again highlighted the weaknesses of political polls and prediction markets.

We did not have an opinion on whether Brexit would ultimately be good or bad for the UK economy, and still do not. That will largely depend on the final exit agreement and the UK's resulting trade relationship with the EU and other partners—unknowable today. Politicians make sweeping claims about what will or will not happen when the UK leaves. Some say the UK will be more competitive free of Brussels' red tape and able to sign its own free-trade deals. Others say the country will be isolated, particularly if Scotland and Northern Ireland—both of which voted Remain overwhelmingly—choose to leave the UK. In our view, it is impossible to say what will happen. The final agreement could be good for both the UK and the EU, or there could be unintended consequences. Additionally, Scotland could call for unification, while Ireland may look to unify with Northern Ireland. There is not yet sufficient information to make accurate predictions.

Brexit created near-term political uncertainty, but this is already beginning to fade. Former Home Secretary Theresa May won the Conservative Party's leadership race when her last remaining challenger dropped out on July 11, and she became Prime Minister two days later. The probability of a snap election declined, as May has said she has no plans to call one before 2020's general vote. The opposition Labour Party is still in disarray—its leader, Jeremy Corbyn, lost a confidence vote decisively after Brexit, but he refused to step down and now faces a formal leadership challenge from two former shadow cabinet members. For equities, these theatrics conceal a bullish fact: Parliament was gridlocked before the referendum, given the Conservatives' narrow, majority and their internal divisions over Brexit. Now both major parties are in disarray, an extreme form of gridlock suggesting very little legislation is likely to pass soon.

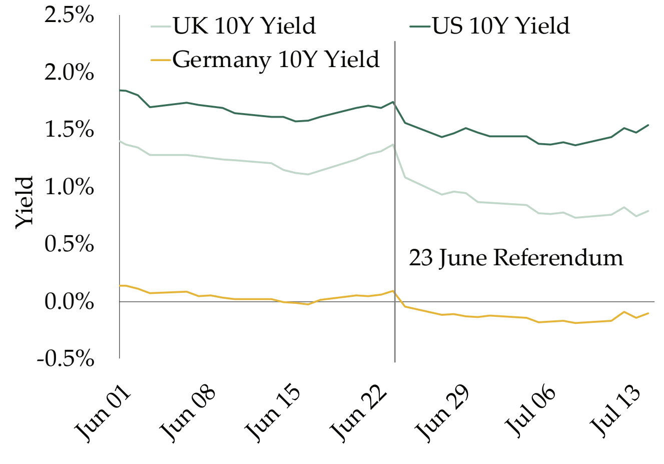
Most important for equities is the trade relationship between the EU and UK. The UK wants to maintain its access to the single market, allowing goods to flow relatively unrestricted across borders and preserving passporting rights for service firms based in the UK—including London's sizable financial services industry. Talks over this have not begun and will likely take years. The Lisbon Treaty's Article 50—the mechanism for leaving—says exit talks can take up to two years, or longer if member-states approve. May has said she will not start this process until agreeing a unified approach with the governments in Wales, Northern Ireland and Scotland—which could take a long while, given the latter two's desire to remain in the EU. If talks stretch on, the government that starts them might not be the one that finishes them.

> The Lisbon Treaty's Article 50…says exit talks can take up to two years, or longer if the member-states approve.

While protracted talks drag out uncertainty, which could weigh on sentiment toward the UK and Europe, they are beneficial for markets. Negotiations will play out publicly, with endless media dissection, letting markets slowly discover and discount the likely outcome—and reducing the potential shock factor. Helpfully, expectations are low, as EU leaders have taken a hard line, saying "out" means out—recalling the tough stance they took repeatedly with Greece during the euro crisis. They compromised then, and they have every incentive to do so with the UK now, given Continental firms' strong UK trade ties.

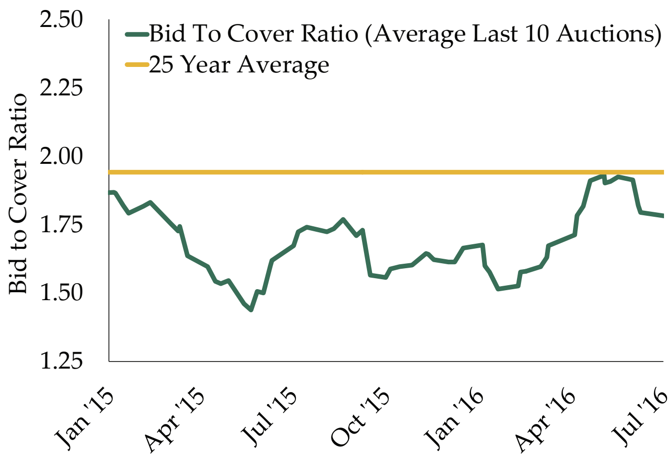
Meanwhile, as talks progress, the UK remains in the single market. There is little immediate economic impact. Standard & Poor's downgraded the UK's credit rating, citing Brexit risk, but markets—a better indicator of credit risk—are not worried. Gilt yields have fallen to historic lows, and demand at post-Brexit Gilt auctions is robust (Exhibits 15 & 16). Demand for UK assets remains strong.

Exhibit 15: Developed Market Yield Curves Post-Brexit



Source: FactSet, Inc.; United Kingdom, United States and Germany 10-year yields from 1/1/2015 to 13/7/2016

Exhibit 16: Demand for UK Gilts High Despite Brexit



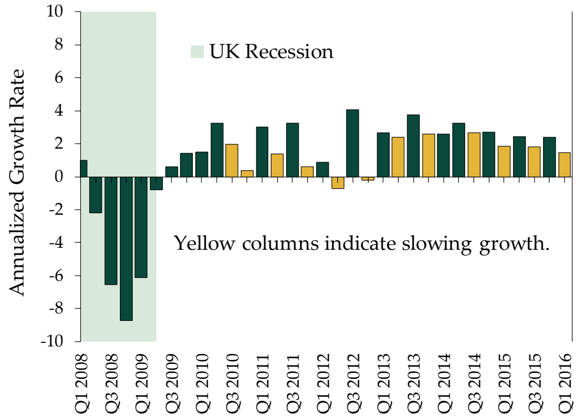
Source: United Kingdom Debt Management Office; Gilt yields from 1/1/2015 to 7/7/2016

Perhaps tied to some "Remain" proponents' argument that a "Leave' win meant a British recession—possibly even global weakness—the days after Leave's victory saw economic fears spike globally. However, much these fears were vastly overstated. While the long-term effects are unknown, not much was changed by the June 23 vote. The UK remains part of the EU with unfettered access to the single market. US economic data suggest growth is reaccelerating after Q1's slowdown. Across the world, from the eurozone to China, growth remains underappreciated. Though economic expansion is not universal, growth is considerably better than widely appreciated—and more importantly, seems set to continue for the foreseeable future.

The UK's Healthy Economy

Plenty of evidence suggests the UK economy was on firm footing before the vote. Q1 GDP grew at a 1.4% annualised rate, slowing from Q4 2015's 2.4%, but this is not unusual.[ix] Growth rates have fluctuated throughout the current expansion, and subsequent quarters have often rebounded (Exhibit 17).

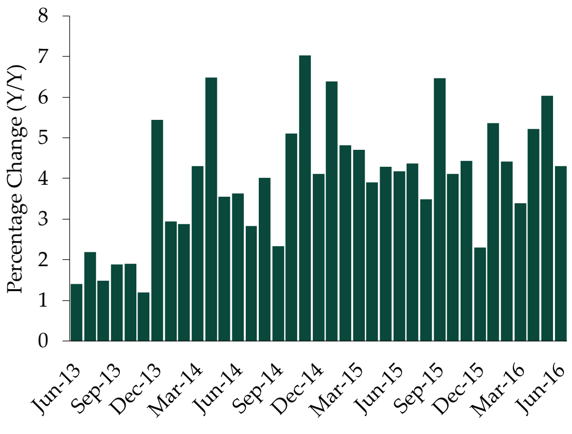
Exhibit 17: Growth Rate Fluctuations Are Not Unusual



Source: FactSet, as of 15/7/2016. UK GDP growth (annualised), Q1 2008 – Q1 2016.

June's Retail sales fell 0.9% m/m (+4.3% y/y)—which was broadly overhyped as showing Brexit fallout (Exhibit 18). However, it's worth noting that on an absolute basis, the downtick followed two consecutive record highs. Further, the UK Office for National Statistics noted sales rose 1.6% q/q in Q2 and said June's dip was unlikely to have been materially impacted by Brexit. Such data are frequently volatile, and one month's dip is not telling about future growth.

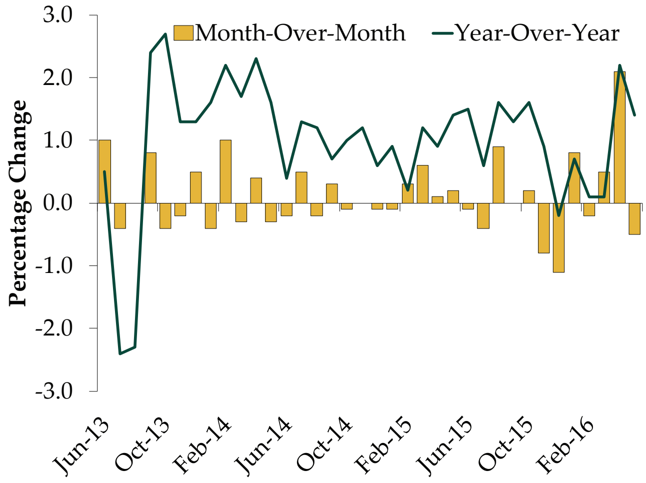
Exhibit 18: UK Total Retail Sales Volumes



Source: FactSet, as of 22/7/2016. June 2013 – June 2016.

Many claim the UK's economy is too reliant on consumption, lacking "balance" brought by heavy industry and exports. While industrial production has been choppy throughout the expansion, it comprises only 15% of UK GDP. Moreover, it is neither uniformly weak nor dragging down growth—recent releases showed acceleration (Exhibit 19).

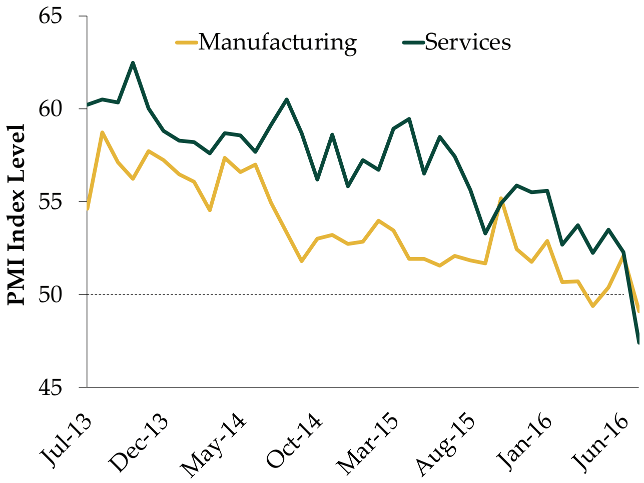
Exhibit 19: UK Industrial Production



Source: FactSet, as of 22/7/2016. June 2013 – June 2016.

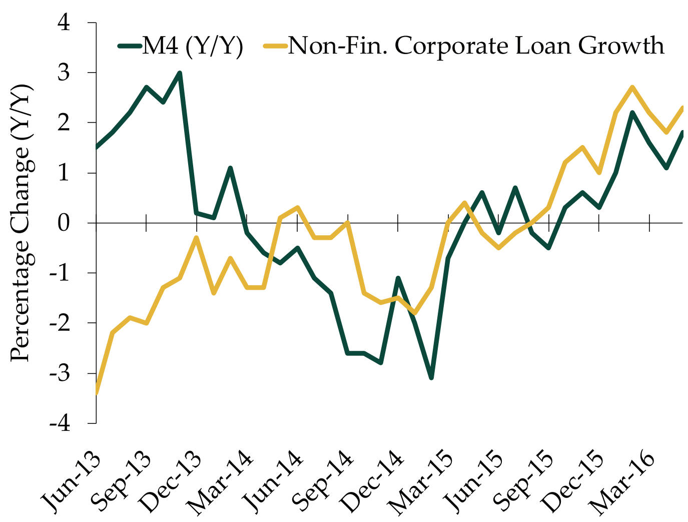
Preliminary "Flash" Purchasing Managers' Indexes (PMI)—surveys measuring the breadth of growth—showed both manufacturing and services fell slightly below 50 in July (indicating contraction), but this seems heavily influenced by short-term sentiment (Exhibit 20). As we frequently note, one data point proves little—these gauges could easily reverse soon. Looking ahead, conditions favour growth. Broad money supply is growing (Exhibit 21 - see next page). Lending to non-financial companies is rising, and while long-term bond yields are down, the Bank of England's commercial bank liability yield curve is relatively steeper—indicating lending remains profitable for banks, supporting continued expansion.

Exhibit 20: UK PMIs



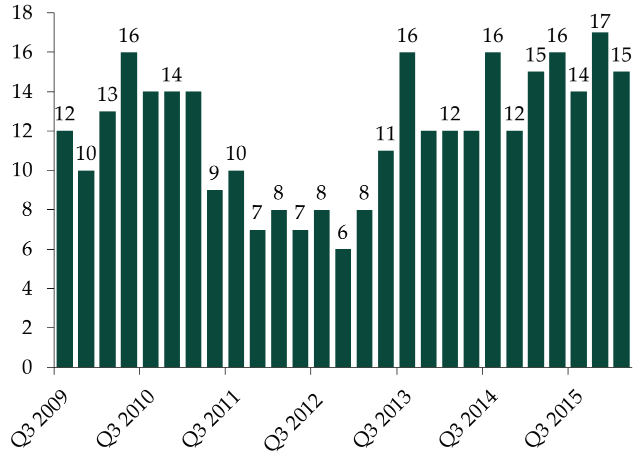
Source: FactSet, as of 15/7/2016. July 2013 - July 2016.

Exhibit 21: UK M4 and Loan Growth



Source: Bank of England, as of 15/7/2016. June 2013 – May 2016.

Exhibit 23: Number of Countries Growing



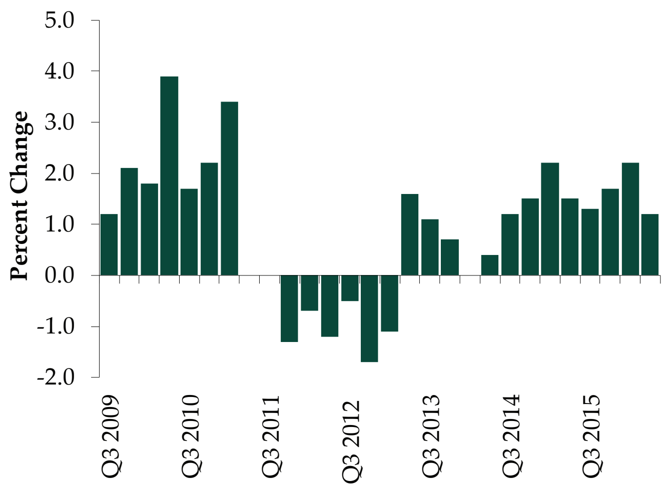
Source: FactSet and Eurostat, as of 29/7/2016.Slovakia does not report seasonally and calendar-adjusted quarterly growth. Count is nations with annualised GDP above 0.0%. Q3 2009 – Q1 2016.

The Eurozone's Growth—Still Underappreciated

The eurozone's economic fundamentals remain brighter than most believe. While some fear Brexit fallout, the same logic that applied to the UK applies here in reverse—there is no present fundamental disruption to trade, and the specific impact (if any) is likely to take years to arrive.

Some fear other nations will follow the UK's lead, splintering the EU or eurozone, but the bloc has experienced existential uncertainty during much of this global bull market. Despite those fears, the region has not remained recessionary. As of Q2 2016's preliminary reading, the eurozone has grown for 13 straight quarters and, while irregular, growth is broad-based (Exhibit 22).[x] As of the latest country-level data (Q1 2016), only 2 of 18 reporting countries contracted (Greece and Ireland) (Exhibit 23).[xi]

Exhibit 22: Eurozone GDP Growth



Source: FactSet and Eurostat, as of 29/7/2016. Eurozone annualised GDP growth rate, Q3 2009 – Q2 2016.

Monthly readings like PMI and retail sales were largely expansionary in Q2, and leading indicators point positively. The Conference Board's Leading Economic Index (LEI) is in a long uptrend, and bank lending to non-financial corporations and households has picked up.

Yet many note long-running structural concerns, like peripheral debt levels and the occasional breach of Maastricht Treaty-deficit restrictions by peripheral countries such as Spain and Portugal in July. However, these concerns are much more structural than cyclical, and do not present headwinds sufficient to derail global markets in the near term. It would not surprise us if Brexit talks add to the structural background noise weighing on sentiment, but otherwise carrying little immediate impact.

Spain

Spain held parliamentary elections in late June, attempting to break the deadlock that followed December 2015's inconclusive contest. Once again, Prime Minister Mariano Rajoy's Popular Party (PP) won the most seats, gaining 14, but failed to win a majority. The main opposition Spanish Socialist Workers' Party (PSOE) came in second, beating some forecasts, but lost some seats. The coalition between the United Left and populist Podemos, dubbed Unidos Podemos, came in third, matching its December seat count, while centrist Ciudadanos came in fourth, losing eight seats.

The PP has 137 seats, 39 short of a majority. Rajoy made overtures to the PSOE in an attempt to form a unity government, but party leader Pedro Sanchez rebuffed him, saying PSOE will not support a government led by Rajoy. Ciudadanos, the PP's natural ideological ally, has been more receptive, but they have only 32 seats, so Rajoy would need to gather support from smaller parties to secure a majority.

Rajoy did make some progress in mid-July, when he made a deal with Ciudadanos to elect one of his closest allies as parliament speaker. While negotiations on forming a government are moving slowly, most players want to avoid a third election, creating incentive to compromise. A minority government or relatively unstable coalition likely emerges, extending political gridlock and reducing the potential for parliament to repeal recent economic reforms. While this also makes further reforms unlikely, Spain is on much more sound economic footing today than in years past. Gridlock should not be a negative.

The election results are also an interesting counterpoint to fears of the Brexit vote sparking a populist revolution and secession movements in the rest of the EU. Perhaps nervous following the media's and markets' strongly negative initial reaction to Brexit, Spanish voters gravitated toward the PP. While voters are frustrated over issues like corruption and find the prospect of a fresh start appealing in theory, the establishment presents a known quantity in what many perceive as an uncertain environment. Spain ultimately supported the status quo, rather than forge a new path. This does not guarantee every EU country makes the same choice, as euroscepticism is stronger in other nations, but it is a counterpoint to the narrative that Brexit will trigger the EU's disintegration.

Italy

Italy is one place where euroscepticism runs deeper, and might provide the next test of voters' willingness to challenge convention. The Five Star Movement (M5S), founded by Beppe Grillo, currently tops political polls and would stand a reasonable chance of winning a majority if elections were held now. M5S made a strong showing in Q2's municipal elections, winning mayoralties in Rome and Turin. While their crusade against corruption appears to be the primary selling point with voters, they have pledged to hold a referendum on Italy's euro membership if they run the government.

For now, Prime Minister Matteo Renzi remains in power, but his hold is tenuous. Unlike most eurozone nations, Italy has not addressed crisis-era nonperforming loans in its banking system, and the issue is coming to a head. The government wants to recapitalise the banks, but eurozone rules require creditors to take losses before banks can receive state money—a rule aimed at making large institutional investors shoulder some of the load—but in Italy's case, this would primarily hurt individual savers, as banks routinely sold bonds as a high-yielding alternative to a bank account. When one bank "bailed in" creditors early this year, it sparked a political controversy, eroding Renzi's support. Fears of a repeat on a wider scale—however unlikely—have further damaged his popularity.

With the next election not scheduled until 2018, this would not be an issue, but Renzi has staked his political future on an October referendum to reform Italy's electoral system and make it easier to form a workable government in the future. When he called the vote, Renzi pledged to step down if it failed, making it a referendum on his premiership. Though investors should always take political polls with a grain of salt, it is worth noting that an early July survey showed 34% of Italians oppose Renzi's plan, while only 28.9% support it (the remainder are undecided on the issue or whether to vote at all).[xii] As Renzi is the third unelected Prime Minister in a row, if the referendum fails and he steps down, new elections will likely follow.

It is impossible to know how the referendum or any snap election will go. Polls are not predictive, and sentiment could evolve over the coming months. German Chancellor Angela Merkel is a pragmatist who recognises the need to keep euro-friendly governments in power, and her rhetoric toward Italy has softened. She and fellow eurozone leaders have every incentive to compromise over Italian banks, which could restore some of Renzi's political capital. Alternatively, M5S' municipal election success could prove not worth the cost, if their high-profile mayors are unable to achieve noticeable success. The situation is a story to watch, but not a material risk to eurozone equities today.

Eurozone bank stress tests, completed in late July, held few (if any) surprises. Banks were shown to hold vastly more capital than in the pre-2008 era and troubles were isolated. Only one Italian bank was shown to have negative capital in the "stressed" scenario, Banca Monte dei Paschi di Siena, whose well-known issues have drawn headlines and regulators' attention for years. While many noted Italian banks' weakness before the tests, the results seemingly highlight the localised nature of their problems, which largely stem from long-discussed non-performing loans. As ever, we are sceptical of findings published in these stress tests—and all regulator stress tests, which are a purely hypothetical exercise with many flaws. But the broader picture they paint—of a eurozone financial system in better health than widely appreciated—is in line with our views.

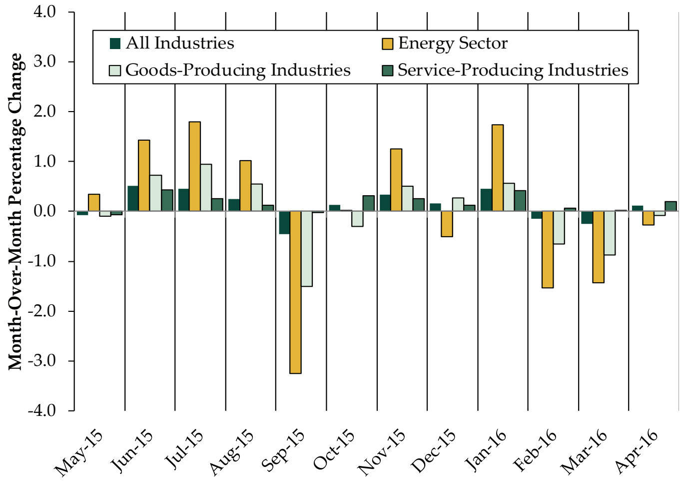
While many criticised the tests for not including a pass/fail grade, we view this as an incremental positive. When eurozone regulators crafted the rules forcing junior bondholders to shoulder losses before a troubled bank can receive state aid, early guidance suggested simply failing a stress test could trigger a "bail-in." Scrapping the grading system removes some of the arbitrary decisions surrounding bail-ins, which could help reduce uncertainty. Notably, Banca Monte dei Paschi di Siena announced it will raise capital by utilising equity markets, avoiding the need for state funding and easing bail-in concerns.

CANADA IS GROWING

Q1 Canadian GDP reaccelerated to 2.4% annualised after slowing to 0.5% a quarter earlier.[xiii] Underpinning faster growth were a considerable uptick in exports, which added 2.2 percentage points to growth after detracting -0.5 percentage point in Q4 2015.[xiv] Private and government consumption both added to growth in Q1, though businesses slashed both investment and inventories.

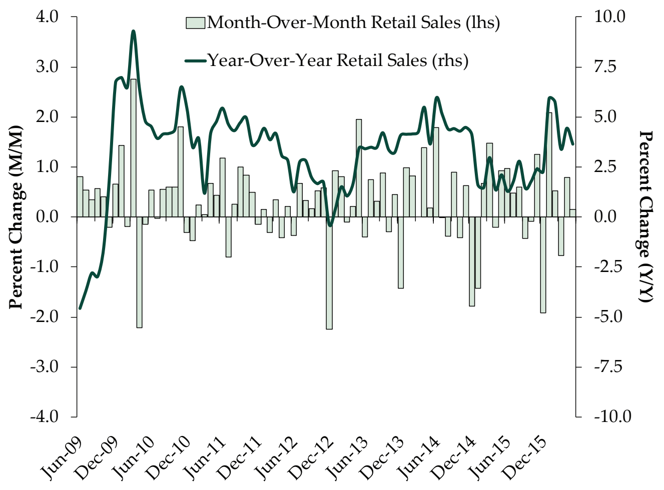
A look at sector-level growth, which is reported monthly, adds more color and shows Energy hurting headline growth in recent months (Exhibit 24). However, this is mostly offset by Canada's strong services industries and consumption. On a monthly basis, retail sales are up on in four of five months in 2016 through May, when sales rose a sound 3.6% y/y (Exhibit 25).[xv]

Exhibit 24: Canada GDP by Industry Group



Source: Statistics Canada, FactSet, as of 27/7/2016. May 2015 – April 2016.

Exhibit 25: Canada Retail Sales Show Consumer Strength



Source: FactSet, as of 27/7/2016. June 2009 – May 2016.

AUSTRALIA

After eight days of vote counting, Prime Minister Malcolm Turnbull and his Liberal-National coalition claimed victory in Australia's July election, winning 76 seats versus 69 for the opposition Labour and 5 for independents and small parties, a narrow majority. Turnbull called for the snap election in hopes of breaking the gridlock blocking his reform agenda. Instead, he lost seats, resulting in more gridlock.

For a competitive developed economy like Australia's, gridlock is generally bullish, reducing legislative risk. Markets should also appreciate the fact that the political revolving door, which was starting to rival Japan's, did not turn again. Stability could help improve sentiment somewhat, though perhaps not enough to overcome the country's rather lackluster economic fundamentals. Natural resources play a large role in Australia's markets and economy, making the ongoing supply glut and decelerating Emerging Markets demand rather stiff economic headwinds.

While markets should appreciate gridlock, ratings agencies apparently do not. Standard & Poor's put the country on notice for a possible downgrade, arguing gridlock would prevent measures to address Australia's elevated deficits. Many suggest losing its AAA credit rating would send yields spiking, potentially triggering a financial crisis, but this is a false fear. At 18.9% of GDP, Australia's net public debt is among the lowest in the developed world. 10-year bonds yield just 1.9%, a sign markets are not worried about creditworthiness. Moreover, the US and UK have long since proven credit rating agency decisions do not materially affect markets.

JAPAN

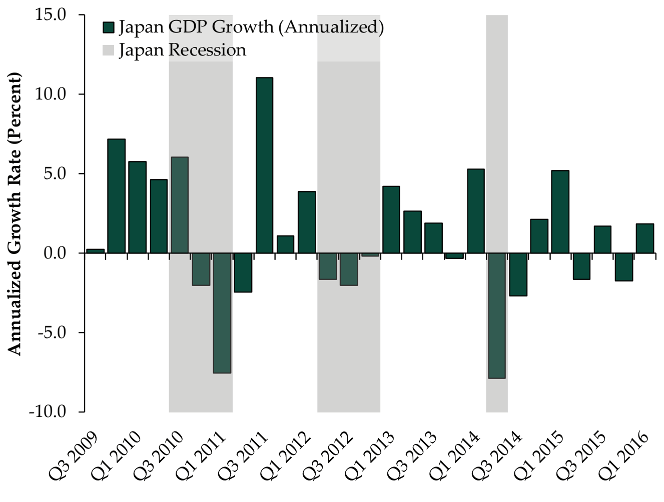
Prime Minister Shinzo Abe's Liberal Democratic Party and its coalition partner, Komeito, won 69 of 121 contested seats in Japan's Upper House elections in July, giving the ruling coalition a two-thirds majority of the 242 Upper House seats. Abe claims the economy will be his focus, and his first order of business is a ¥28 trillion stimulus package (~$270 billion), renewing investors' optimism for Japan. Yet as ever, the swing factor for Japan is structural economic reform, and we see ample reason to doubt this will become more likely. Abe's coalition has had the majority for three years—and a supermajority in the lower house since last year—yet structural reforms are few and far between. Having a few extra seats in the upper house probably will not make much difference. Absent reform, we continue to believe better investment opportunities lie elsewhere.

> As ever, the swing factor for Japan is structural economic reform, and we see ample reason to doubt this will become more likely.

Japanese economic data suggest the country still suffers from long-running structural issues, and policymakers are turning yet again to ineffective stimulus measures unlikely to yield a material economic return. In our view, there is little suggesting the improving fundamentals in Japan.

Q1 GDP data showed growth, continuing Japan's recent trend of alternating between growth and contraction (Exhibit 26).

Exhibit 26: Japanese GDP Growth Since Global Expansion Began

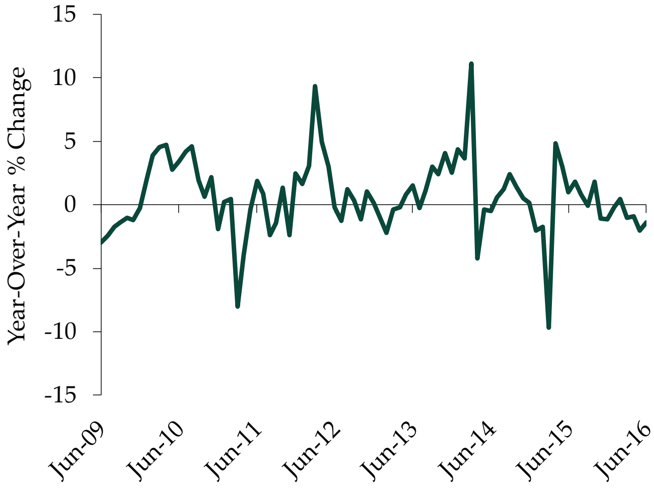


Source: FactSet, as of 29/7/2016. Japanese real GDP growth (annualised), Q3 2009 – Q1 2016.

According to one definition of recession (two consecutive contractionary quarters), this averted the fourth Japanese recession since 2009. However, the 1.9% annualised growth rate was somewhat misleadingly overstated.[xvi] Government spending added 0.6% to the headline figure. While private consumption did rebound from its -3.2% Q4 drop, growing 2.6%, gross fixed capital formation fell faster—a -2.7% annualised drop after Q4's -0.4%.[xvii] Moreover, some economists note that private consumption benefited from the leap year's added day. Business investment flipped from positive growth to a -2.6% contraction. And, finally, trade added 0.7% to growth, but this was in part due to declining imports—a sign of weak domestic demand.

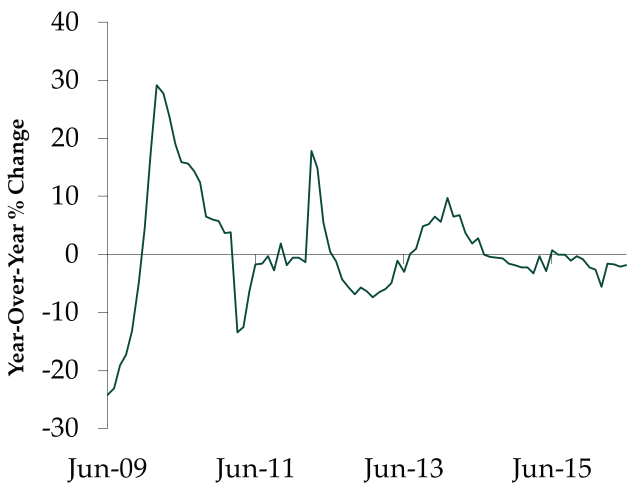
Throughout Q2, weak data continued. Retail sales, industrial production and inflation slowed (Exhibits 27-29). The latter remains well below the Bank of Japan's 2% target, and both core and headline rates are disinflationary.

Exhibit 27: Japanese Retail Sales



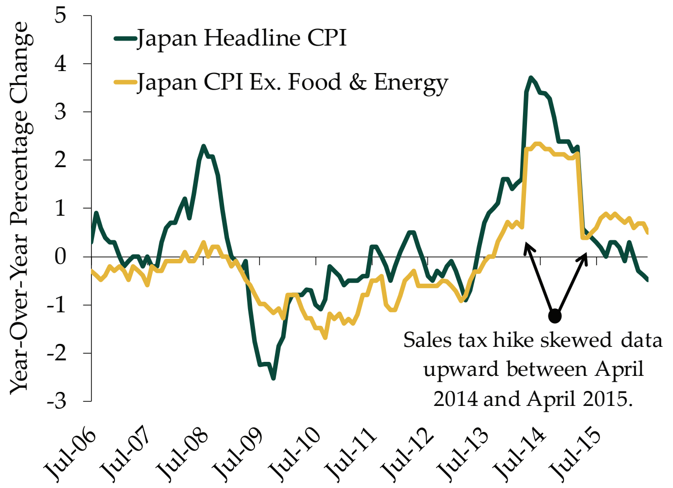
Source: FactSet, as of 29/7/2016, June 2009 - June 2016.

Exhibit 28: Japanese Industrial Production



Source: FactSet, as of 29/7/2016, June 2009 - June 2016.

Exhibit 29: Inflation's Perk Is Faltering



Source: FactSet, as of 28/7/2016. Japanese CPI and Core-Core CPI, 7/2006 – 6/2016.

After the July election solidified his parliamentary power base, Abe announced a new round of fiscal stimulus, which was followed days later by the BoJ increasing its ETF purchases.

Many details are lacking in Abe's fiscal stimulus announcement. The ¥28 trillion yen figure is somewhat overstated as various sources are claiming only ~25% of this figure is actual direct spending. Half is unaccounted for and the balance would be loans extended to state-run companies. Also unknown is how rapidly the package would be deployed.

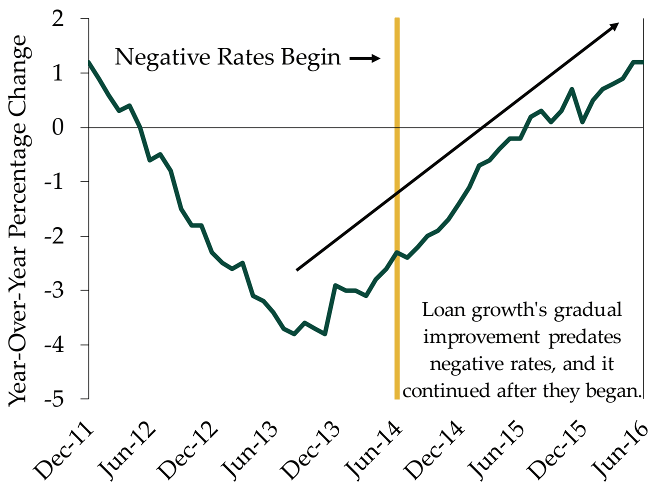
As for the BoJ, it will double equity ETF purchases (despite owning half of the Japanese ETF market) yet leave policy rates (presently negative) and the pace of government bond purchases unchanged. The BoJ also reduced its inflation forecast (seemingly justifiably, given the trend) while maintaining its 2% inflation target. It also revised up its economic outlook to reflect the delay of the second stage of the consumption tax hike.

However, absent are measures targeting Japanese structural issues we have long said are the key swing factor to Japan's outlook going forward. Without moves to liberalise labour markets, open the economy (including agriculture) to trade and more thoroughly address corporate governance issues like cross-shareholding, continued attempts to stimulate via monetary and fiscal policy are unlikely to generate success, akin to earlier attempts.

Negative Interest Rates

Although central banks first enacted negative interest rates in 2012, fears over their use in the eurozone and Japan spiked early this year. While some fret the impact of negative interest rate policy hitting eurozone banks, rising loan growth and money supply suggest these concerns are overwrought (Exhibit 30). As we noted in Q1, negative interest rate policies amount to taxing banks' excess reserves deposited at central banks—a counterproductive move achieving little more than encouraging banks to buy sovereign debt.

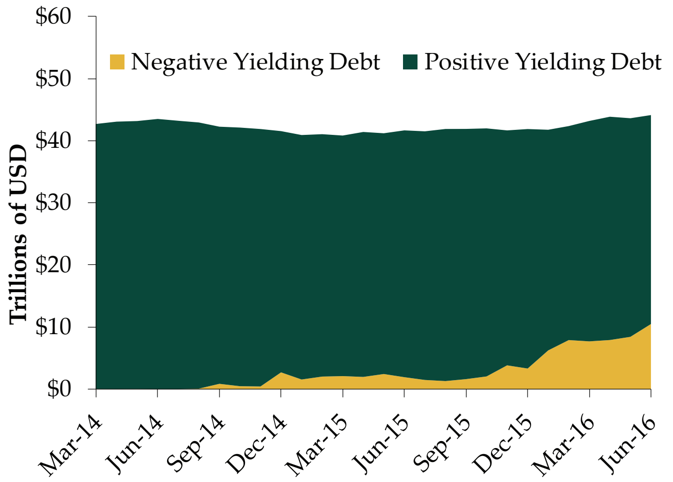
Exhibit 30: Negative Rates Are Not Slowing Lending in the ECB



Source: FactSet, as of 29/7/2016. December 2011 – June 2016.

Due partly to this, sovereign yields globally are at record lows, and the media frequently trumpets German or Japanese sovereign debt falling deeper into negative yield territory. More than $13 trillion worth of the $40-plus trillion in developed-world sovereign debt presently has a negative yield (Exhibit 31).

Exhibit 31: Global Negative Yielding Debt Is Becoming More Commonplace



Source: Bloomberg, as of 13/7/2016. BofA Merrill Lynch Global Fixed Income Markets Index, monthly breakdown of yields on bonds exceeding on year in maturity, 31/1/2014 - 30/6/2016.

Many claim this is a growing problem, overlooked by rising equities. Yet bond markets are unlikely to be uniquely aware of anything equities miss, particularly something so widely discussed. On the contrary, with frequent mention and broader prevalence, negative yields have become more familiar—reducing uncertainty. Eurozone GDP has grown alongside negative yields since 2014, underpinned by improving lending.

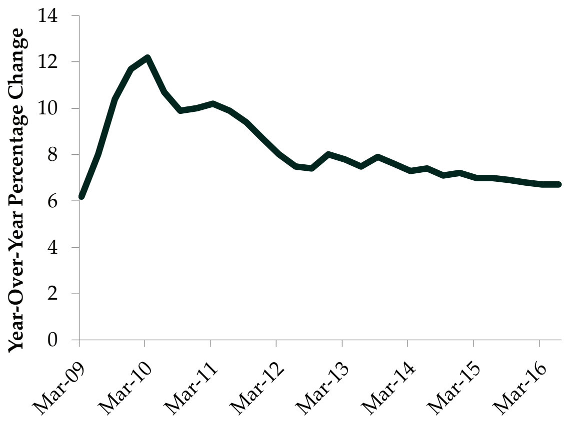
Emerging Markets Commentary

Though some commodity-dependent nations (e.g., Brazil and Russia) still struggled economically, many resource importing Emerging Markets (EM) nations benefited from low commodity prices. Moreover, these EMs have growing services sectors, making strong domestic demand a big contributor to growth. China and India fall into this category, as does Korea. With scepticism toward EM still prevalent, we believe underappreciated opportunities exist.

China: Still No Hard Landing in Sight

Though slowing, China's economy is not crashing—contrary to longstanding fears of an economic "hard landing." Q2 2016's 6.7% y/y GDP growth matched Q1's. While growth slowed after hitting its fastest rate of the current global expansion in 2010, the slowdown was gradual (Exhibit 32).

Exhibit 32: China's Quarterly GDP Growth Rates



Source: FactSet, as of 2/8/2016. From Q1 2009 – Q2 2016.

Slower expansion is a byproduct of China's deliberate transition from an export and industry-focused economy to services and consumption-led growth, and very much in line with Chinese officials' stated goals. For instance, though industrial production and retail sales slowed in recent years, the latter still remains in the double-digits, growing 10.6% y/y in June. Industrial production, on the other hand, grew just 6.2% y/y in the same month.

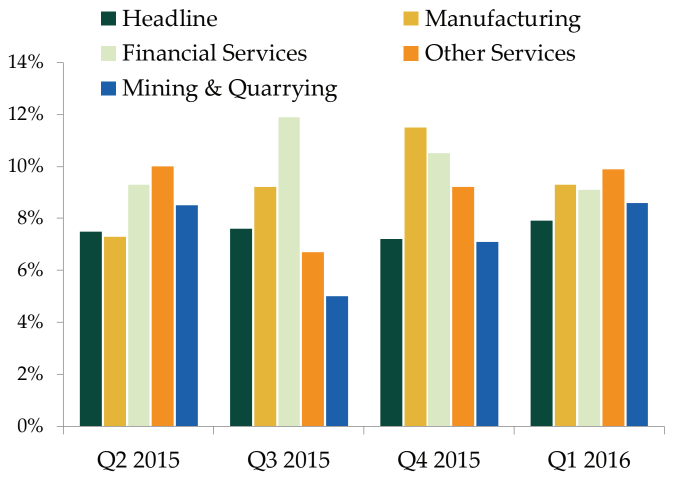
Skeptics question the veracity of Chinese data, arguing growth is much slower. While opacity is an issue in China, consider: China is an integral part of the global supply chain, and though slowing, cross-reads from trade partners do not show a steep drop in economic activity. China's history of interfering with its markets partly explains the negative reaction to the central bank's attempt last August to change how the yuan is priced—even though the government allegedly did so to increase the market's influence on the yuan, an incremental positive. Likewise, regulators reduced their efforts to control domestic equity markets after attempts to curb last summer's big market pullback only exacerbated volatility and hurt investor sentiment.

That said, the government is not relaxing control completely-liberalisation is a gradual process, taking decades. In May, officials announced an infrastructure package totaling more than 5 trillion RMB ($700 billion) aimed at various infrastructure projects over the next three years—evidence the government will step in when deemed necessary to spur growth. So while its growth rate is slowing, China is still expanding at an impressive pace and is not showing signs of halting any time soon.

India in the Lead

India remains one of the world's fastest-growing economies, benefitting from both external (e.g., low oil prices) and internal (domestic reform) factors. India grew 7.9% y/y in Q1 2016, accelerating from Q4 2015's 7.2% y/y expansion. Services, manufacturing and even mining contributed to high growth rates (Exhibit 33).

Exhibit 33: Indian Headline GDP and Select Sector Breakdown



Source: Central Statistics Office, as of 25/7/2016. "Other Services" includes Trade, hotel, transport, communication and services related to broadcasting. Q2 2015 – Q1 2016.

Though June CPI rose 5.77% y/y—the fastest pace since August 2014—India's inflation outlook remains steady. Moreover, reforms should help gradually open India's economy. This combination—high growth plus positive reforms—is a bullish combination.

Modi's Cautious Reforms Slowly Bear Fruit

Indian Prime Minister Narendra Modi and his Bharatiya Janata Party (BJP) won in the 2014 elections by promising economic revitalisation through business-friendly tax policies, a downsized central bureaucracy and a crackdown on corruption. Markets in India performed well—with many seemingly expecting these major reforms to have positive impacts.

But today, Modi faces many challenges—a long to-do list, an undisciplined coalition and powerful entrenched interests. In this environment, policy changes are difficult—but, as he has shown, not impossible. Through a mixture of executive action and compromise, Modi is making gradual but definite progress. Progress has been slower than some hoped for—which leads to occasional criticism in the global press—but Modi's focus on incremental, achievable reform is actually a positive. While hurdles remain and change may come slowly, it is reasonable to expect India's economy—and markets—to perform well. Indian economic growth is already among the world's highest, finishing up 7.6% in the latest fiscal year ending in March. Experts forecast a similarly rapid rate of expansion for the next several years as the country builds on modest inflation, falling commodity prices and growing foreign investment. This positive economic backdrop may amplify the effect of political tailwinds.

Modi Moves Without Parliament

The BJP holds the premiership and lower house of India's parliament, but it does not control the upper house, where the Indian National Congress and several other parties occasionally block Modi's legislative agenda. In addition, many of Modi's reforms face populist criticism—further preventing the likelihood of sweeping reforms passing.

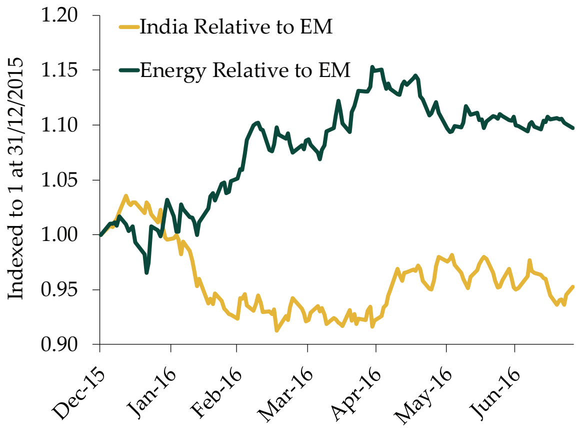
In response, Modi is using his executive authority to implement smaller reforms. Just this year, the government raised the price of subsidised kerosene, loosened rigid labour rules in the textile industry, allowed greater foreign ownership in certain domestic industries and relaxed local sourcing requirements for retailers. Modi also followed through on promises to rein in corruption. Coal mines implemented transparent auctions, while portions of the telecom sector stopped transactions based on favouritism and political connections. Meanwhile, state-owned banks are under pressure to equally enforce policies among delinquent debtors.

For the most part, the Modi administration is acting on its own. The changes are not dramatic, to be sure—heavier political battles like easing land use restrictions and privatising the transport and communications sectors have been abandoned. Nonetheless, they demonstrate Modi's willingness to work with Parliament when he must, and without it when he is able.

Indian Markets Lag on Energy's Strength

Although Indian equities rose through July and have outperformed broader Emerging Markets during Modi's tenure, they lag EM thus far in 2016. In 2016's first half, the five top-performing EM countries were Peru, Brazil, Colombia, Russia and Thailand—all heavily dependent on exporting natural resources such as oil and metals. India imports 75% of the oil it consumes—low prices, therefore, are a tailwind. Countries reliant on Energy, on the other hand, benefited from oil prices' rebound. As Exhibit 34 shows, Energy's recovery has largely moved inversely to India's performance versus overall Emerging Markets.

Exhibit 34: India, Energy Diverges



Source: FactSet, as of 27/7/2016. MSCI India and MSCI Energy, each indexed to 100 at 31/12/2015 and divided by MSCI Emerging Markets index (also indexed). All gauges in USD and including net dividends, 31/12/2015 to 25/7/2016.

In our view, Energy's rebounding relative performance is a temporary countertrend. Markets seem to have overshot fundamentals early this year in pushing oil prices down to $26 per barrel. The rebound is likely that overshot reversing—a sentiment feature. Fundamentally, headwinds remain. OPEC oil supply hit a record last month, while US producers are activating more rigs and locking in today's prices in anticipation of more production. As demand holds steady, continued high output both in the United States and elsewhere should limit further significant increases in oil prices, even if they do not decline significantly. This will likely dim relative returns in Energy-focused countries, while India should benefit.

Goods and Services Tax Fight

The most significant political battle facing the BJP today is a goods and services tax bill (or GST), which would replace India's complex system of state-administered taxes with a single nationwide regime. Business support is strong, as the change would simplify the tax system and make it much easier to do business across multiple states. The proposal requires a constitutional amendment, which hinges on the approval of two-thirds of both houses of Parliament, plus a majority of the 31 voting bodies (29 states, plus two Union Territories with legislatures). Early estimates suggest enough states already support it, but completing the first stage is not easy. Although the BJP gained seats in the upper house in elections this summer, they remain just shy of the support needed to send the constitutional amendment to the states. Consensus in the upper house is close—but last-minute debate has derailed the bill before. Modi ordinarily prioritises incremental, achievable reforms. The GST is less incremental, but nonetheless looks increasingly achievable.

Rajan Out At Reserve Bank of India

This September, Reserve Bank of India (RBI) head Raghuram Rajan will leave his post—a slight setback for India, as Rajan has proven a capable chief. While we do not think losing Rajan's expertise is all that vital a change, the reason he's leaving—due to pressure from certain parliamentarians in the BJP—highlights challenges India still must overcome.

Since the former University of Chicago professor and IMF chief economist assumed the position in September 2013, his inflation targeting helped with India's inflation struggle, while his insistence on an independent RBI garnered respect throughout the financial world. Rajan also initiated a number of banking reforms meant to clean up balance sheets. Last October the RBI began an asset quality review of Indian banks—11.5% of assets were classified as "stressed" in Q1 2016—and set a deadline of March 2017 to reduce problem loans and set aside more capital for potential write-downs. Given this backdrop, it seems largely appropriate that the RBI also cut reserve requirements and lowered the rate on emergency loans from the RBI.

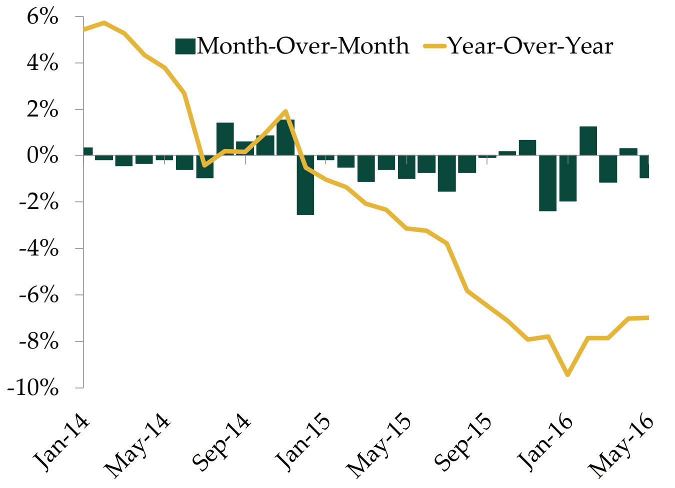
Nonetheless, supporters of easier money within the BJP objected to the slow pace of interest rate cuts Rajan championed—tighter monetary policy, they said, needlessly limits growth. Rajan stayed the course, but his refusal to cave to political pressure may have led to his resignation. His occasional disputes with other government officials—and the fact he was appointed by the previous Prime Minister (Manmohan Singh)—also contributed to his announcement in June that he will not seek reappointment for a second three-year term.

Ultimately, Rajan's exit is a reminder of the political and economic risks India still faces. Central banks should be independent of politics to whatever extent is possible—central bankers must be permitted to enact policies that may be short-term unpopular, but wise economically. Indian elected officials' meddling is not a welcome development in this regard. That said, it does not signal the end of reforms in the country. This, combined with India's strong economic fundamentals and world-leading growth, underpins our positive outlook on the country.

Brazil: Are the Struggles Nearing an End?

Brazil's economy continues contracting, but there are signs the worst has passed. Q1 GDP fell -0.3% q/q, the fifth straight contraction, as household spending and manufacturing fell. However, the contraction slightly beat analysts' estimates, and other data suggest the tide is turning. Industrial production rose in March and April and remained unchanged in May. Monthly retail sales volumes appear to be stabilising after a long downtrend (Exhibit 35).

Exhibit 35: Brazilian Retail Sales



Source: IBGE and FactSet, as of 3/8/2016.

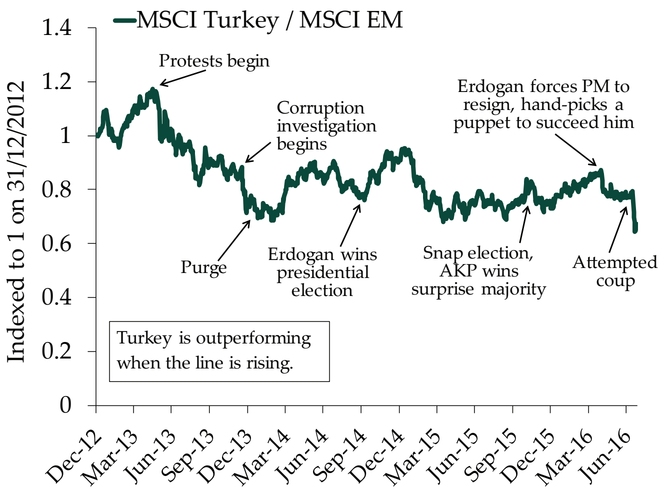
Inflation moderated after hovering at double-digit levels last year, alleviating yet another headwind facing Brazilian consumers. This does not mean Brazil is poised for a big near-term economic rebound—its commodity-heavy economy still faces headwinds from the global supply glut. Though Brazilian equities staged an impressive rally this year, it seems mostly sentiment-driven. Without fundamental support from oil and commodity prices, we doubt outperformance will continue.

Turkey

In mid-July, an attempted coup in Turkey led to significant declines in the lira and Turkish equities. Consistent with prior Turkish coups, it was a hastily and poorly executed one, organised by a small, mid-level subset of the army—and it was foiled within a few hours. However, it did reportedly leave over 200 dead, including civilians, and President Recep Tayyip Erdogan has subsequently cracked down, using this as an opportunity to consolidate power. Tens of thousands of members of the military, judiciary, civil service, police and media have been detained or dismissed on suspicion of involvement. Erdogan has suspended the European Convention on Human Rights, and there are reports of torture and false confessions. With opposition parties pledging solidarity with the administration, Erdogan has renewed his push to revise and ultimately replace the constitution.

The human tragedy is high, and the saga epitomises Turkey's political risks. Markets tend to prefer a stable, predictable rule of law. At the same time, Turkey is no stranger to turmoil, and markets are somewhat used to it. This was the seventh attempted coup since 1913 (five succeeded), and Erdogan's controlling governance style is widely known. Political upheaval—including mass protests, a corruption investigation against Erdogan and a massive purge—weighed on Turkish equities in 2013 and early 2014, but stability won out, economic growth continued, and markets recovered (Exhibit 36).

Exhibit 36: Turkish Equities Are Used to Erdogan



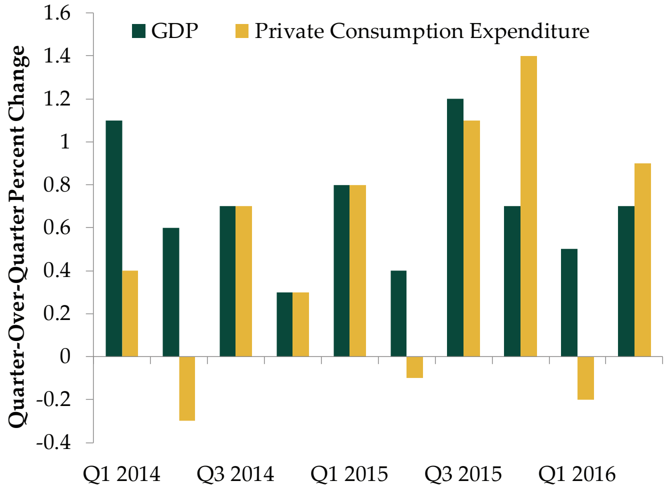
Source: FactSet, as of 27/7/2016. MSCI Turkey and MSCI Emerging Markets Index returns with net dividends, 31/12/2012 – 26/7/2016. Indexed to 1 on 31/12/2012.

Once the initial shock wears off, Turkish equities should prove similarly resilient. Whatever your opinion of Erdogan and his tactics, the fact that his administration has emerged stronger does preserve the status quo—firms at least know what they are dealing with. Erdogan has also widely telegraphed his desire to rewrite the constitution for years, limiting the potential shock factor if this happens. Meanwhile, Turkey's economic fundamentals remain solid. GDP continues growing swiftly—most recently, at 4.8% y/y in Q1—led by private consumption's 6.9% y/y rise.[xviii] Government spending was also strong, as Erdogan's Justice and Development Party (AKP) delivered on election promises, including wiping out young people's debt to the general health insurance system and increasing pension payouts. The central bank has also continued its efforts to streamline monetary policy, phasing out the current system—which uses three target rates—so the one-week repo rate can become the primary policy tool. Having a more functional monetary policy should be a long-term positive.

KOREA AND OTHERS

Beyond the biggest economies, economic strength remains underappreciated. Led by steady domestic demand, Korean GDP growth accelerated to 2.9% annualised in Q2 (Exhibit 37).

Exhibit 37: Korea GDP and Private Spending



Source: Bank of Korea, as of 28/7/2016.

While Korean heavy industry was mixed at 2016's outset, recent readings showed rising output. May and June industrial production rose 4.7% y/y (manufacturing 4.8%) and 0.8% (1.1%), respectively. The series can be choppy, but this reading aligns with an industrial rebound in many developed and Emerging Markets nations. Added to strong consumption and services industry data, growth appears in fine shape. Other EMs are growing, too. Mexico grew 0.8% q/q in Q1 (3.3% annualised), with consumer spending a large contributor. [xix] Mexican retail sales suggest consumers remained strong in Q2, with April and May's retail volumes rising 10.6% y/y and 8.6% y/y, respectively.[xx] Thailand, Southeast Asia's second-largest economy, grew 0.9% q/q in Q1 (3.8% annualised), with the non-agricultural sector leading.[xxi] However, growth is not uniform: Russian monthly GDP fell -0.8% y/y in May. Its economy is dependent on oil prices, which has helped equities during the countertrend rally that started in January 2016, but like Brazil, we doubt it translates to sustained growth and outperformance.

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)800 144-4731.

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i. FactSet, as of 11/7/2016. MSCI ACWI return with net dividends, 31/3/2016 – 30/6/2016.

ii. Ibid. MSCI ACWI return including net dividends, 31/12/2013 – 30/6/2016.

iii. US Bureau of Economic Analysis, as of 15/7/2016. US Q1 Real GDP growth, preliminary estimate.

iv. Ibid. US Q1 2016 Real GDP Growth, third estimate.

v. S&P Global Fixed Income Research as of 14/7/2016.

vi. FactSet Earnings Insight, as of 13/6/2016 .

vii. Ibid.

viii. Ibid.

ix. FactSet, as of 14/7/2016.

x. FactSet, as of 27/7/2016.

xi. Eurostat, as of 27/7/2016.

xii. "A Prime Minister, a Referendum and Italy's Turn to Get Worried," Chiara Albanese and John Follain, Bloomberg, 4/7/2016. http://www.bloomberg.com/news/articles/2016-07-04/a-prime-minister-a-referendum-and-italy-s-turn-to-get-worried

xiii. FactSet, as of 27/7/2016. Canada Q1 2016 and Q4 215 real GDP growth, annualized.

xiv. Ibid. Contributions to GDP growth in Q1 2016.

xv. Ibid. Month-over-month percent change, Canada retail sales, January – May 2016 and year-over-year percent change, Canada retail sales, May 2016.

xvi. FactSet, as of 29/7/2016.

xvii. Ibid.

xviii. FactSet, as of 27/7/2016.

xix. FactSet, as of 8/3/2016.

xx. Ibid.

xxi. Ibid.

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   d) Describe investment performance as it relates to your investment mandate;
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