FISHER INVESTMENTS EUROPE™

THIRD QUARTER 2016

FISHER MARKET PERSPECTIVES

THIRD QUARTER 2016 REVIEW AND OUTLOOK
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THIRD QUARTER 2016 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Portfolio Themes

- **Underweight to Commodity-Oriented Categories:** 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 Technology:** As an economically cyclical sector that is heavily skewed toward large, high-quality firms—we expect Information Technology companies to outperform in the later stages of a bull market.

Market Outlook

- **Falling Uncertainty:** While the Brexit added short-term volatility, we expect the bull market will continue as concerns over UK trade agreements, Chinese growth, the US election and energy prices slowly fade.
- **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.

Global markets rose in Q3, shrugging off Brexit and other political noise, as the MSCI All Country World Index (ACWI) finished the quarter up 5.3%.[i] Uncertainty has decreased as the year has progressed. With more clarity we expect the bull market to continue in Q4 and into 2017.

Much of the uncertainty that was prevalent in markets earlier this year is gone. Brexit fears proved to be excessive as UK equities climbed post-referendum and most economic data rose. Chinese markets calmed and the economy remained steady. In the US, most economic indicators defied recession fears. Additionally, earnings expectations improved as analysts anticipated better times in the oil patch and realised overlooked strengths of other sectors.

Uncertainty should lift further from here. After the 8th of November, we will know the next US president and US Congress's makeup. Cabinet appointments will emerge over the following weeks. Spain and Italy hold key votes later in the quarter, clarifying their prime ministers' futures. At some point the Fed will hike rates again, ending the waiting game and giving investors another chance to realise minor rate moves are benign.

While fundamental drivers point positively, investors lack the optimism that typically prevails at this point in a bull market cycle. Eight years into the 1990s bull, cheerful optimism abounded, consistent with Sir John Templeton's oft-quoted truism: "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." In this bull's eighth year, investors are still sceptical, which has lengthened the bull market and weighed on returns. However, flatter stretches like the present aren't self-perpetuating. Equities can deviate from this trend at any time and have done so historically.

Weak sentiment benefitted the typically defensive Utilities, Telecom and Consumer Staples sectors during early 2016's volatility, generating year-to-date outperformance. But their upturn was brief, and all three fell in Q3 while broad markets rose. Energy similarly had strong returns in Q1 and early Q2, but resumed lagging as the reality of an oversupplied oil market reasserted itself. Meanwhile, previously underperforming sectors, Financials, Technology and Consumer Discretionary led in Q3.

The US elections will challenge investors in Q4. Never before have two such unpopular major-party nominees faced off. Normally, markets believe candidates' campaign pledges, viewing Democrats as anti-business and Republicans as market-friendly. This keeps election-year returns mild when Democrats win and usually boosts them when Republicans win. The opposite occurs in the inaugural year, as the winner does less than hoped or feared. This election, markets fear Republican Trump as much as Democrat Clinton. Many believe his anti-trade rhetoric is economically dangerous. No Fortune 100 CEO has endorsed his campaign. The lack of a perceived market-friendly candidate likely means milder returns this year, while positioning politics as a positive next year.

Monetary policy remains ineffective throughout Europe and Japan, but markets are accustomed to this. European investors' focus seemed most trained on bank fears, particularly centring on Germany's Deutsche Bank late in Q3 2016. Many investors once again worried about a 2008 redux—as has been the case throughout this market cycle surrounding this and other institutions. Despite fears over banks curtailing lending and raising capital, bank lending and money supply are growing. While eurozone growth is not fast, it is broad-based and remains in line with the trend since 2013.

Fears of a Chinese hard landing driven by a debt implosion have been widespread, but economic data have shown improvement. We continue to believe fears of a looming China collapse are disconnected from reality. While growth has slowed, China continues to expand at an overall healthy rate as its economy becomes more focused on services and consumption than heavy industry. Most Emerging Markets are growing nicely, yet sentiment towards Emerging Markets as a group remains too dour, with investors broadly failing to differentiate between nations. The majority downplay continued swift growth in non-commodity-dependent nations and escalating economic reforms throughout Latin America and Southeast Asia.

Most Leading Economic Indexes are still high and rising and broad money supply (M4) is growing steadily. Yield curves have flattened somewhat but remain positively sloped, keeping bank lending profitable. While risks always exist, we do not believe any are big or overlooked enough to end this bull market and we remain optimistic.

THEMATIC UPDATE AND MARKET OUTLOOK

Q3 RECAP

Three quarters into 2016, markets remain on course for a fine year. Economic fundamentals are underappreciated—global growth persists, corporate earnings outside the Energy sector are solid, and leading economic indicators point positively. Yet sentiment remains sceptical. Investors are erroneously spooked by past events (exemplifying recency bias), and the euphoria commonly seen at the apex of a bull market is absent.

Uncertainty Continues Falling

We labeled 2016 "The Year of Falling Uncertainty". It has lived up to its name, and we expect to gain more clarity over the next several months. As the year begins its conclusion, the initial reaction to the Brexit vote looks increasingly exaggerated and blown out of proportion with the political upheaval now settled and UK economic data resilient. New Prime Minister Theresa May has taken office, and Jeremy Corbyn remains Labour Party leader. With no general election until 2020, politics in the United Kingdom look stable for the foreseeable future. While some uncertainty surrounds the start of Brexit negotiations and related legislation—May said she is aiming for March 2017—this should fade once talks formally begin.

Oil prices have also mostly stabilised since Q1. Rampant fears over banks' exposure to struggling Energy firms have largely faded. Oil producers proved to be more resilient than most initially believed, as big efficiency gains helped companies produce more for less, letting many firms breakeven at lower prices. While efficiency gains are a plus to an extent, they also suggest the supply glut has staying power. As prices crept up mid-year, oil-related investment (e.g., durable goods orders) improved, easing an economic headwind.

Elsewhere, corporate yield spreads narrowed further, boosting firms' balance sheets as they refinanced debt at cheaper rates. Despite its presence over the past couple years, negative interest rates concerned investors earlier this year. However, this fear is also waning. Even Greece, the poster-child for eurozone problems, hasn't stirred anxiety. A make-or-break reform deadline came and went with little fanfare, and the country secured its aid tranche.

More political clarity arrives throughout the remainder of the year with the U.S. election as well as the elections yet to take place globally. In Italy, a referendum on electoral reform could decide Prime Minister Matteo Renzi's fate in early December. Spain's caretaker leader, Prime Minister Mariano Rajoy, is on the verge of forming a government after 10 months of deadlock. France and Germany hold general elections next spring and September, respectively. Both will show how much clout populist eurosceptic parties truly have post-Brexit vote, perhaps easing fears of a domino effect.

More political clarity arrives throughout the remainder of the year with the U.S. election as well as the elections yet to take place globally.

The Long, Joyless Bull Market

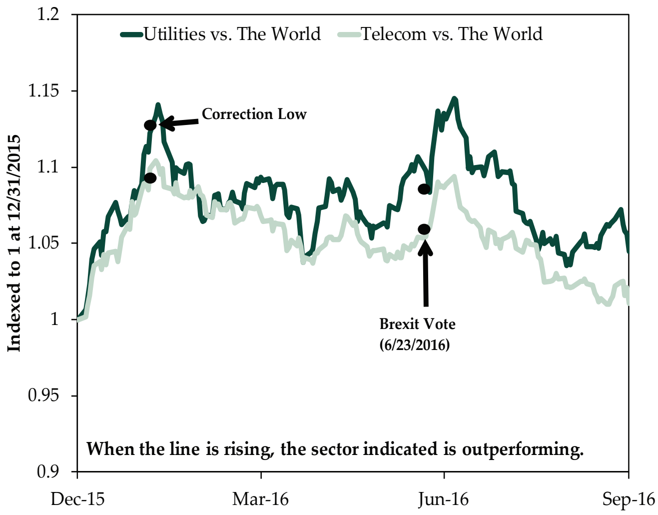
While uncertainty is fading, it isn't boosting sentiment significantly. Investors are less pessimistic now than during early-2016's correction, but they aren't optimistic. This far into a bull market, we would usually see more cheer. Instead, investors are still frequently reminded of financial crisis, employing recency bias and fearing a market downturn around every corner. Ken Fisher often references Sir John Templeton who stated that "bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria". In the current market environment, we can't escape scepticism. We are currently in a lull in which the "bull market marches on morosely [yet] our persistent scepticism keeps us joyless."

Joylessness has muted gains, as the tailwind of improving sentiment hasn't been strong. But there is a silver lining: tamer expectations probably lengthened the bull market and will likely continue doing so. The far future is impossible to forecast, as economic drivers are unknowable, but based on sentiment, this could pass the 1990s bull as history's longest. Usually people are optimistic for a long stretch before equities peak.

Lately, we have seen investors crowd into sectors that display attractive year-to-date returns and higher dividends—Utilities and Telecom—believing added yield can make up for equity's muted price returns. However, the outperformance of these categories is isolated to two specific, narrow timeframes: the correction at 2016's onset and around the Brexit vote in June.

Utilities' and Telecom's year-to-date returns obscure this. Both lagged significantly in Q3, falling as the broader markets rose (Exhibit 1). It is becoming evident the sectors' earlier bursts were brief countertrends, and not the start of a sustained leadership shift. Meanwhile, sectors that got punished during the correction—Financials, Information Technology, Consumer Discretionary—rebounded, and all three outperformed in Q3. Patience paid off, and we think it will keep doing so.

Exhibit 1: Telecom and Utilities Outperformance Was Short-Lived



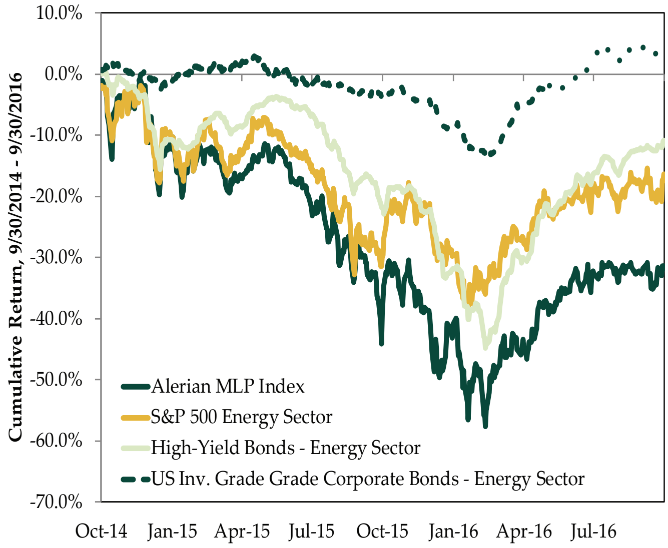
Source: FactSet, as of 11/10/2016. Returns with net dividends for the MSCI World Index, MSCI World Utilities and MSCI World Telecom sector, indexed to 1 at 31/12/2015.

Part of Utilities' and Telecom's attraction may be relatively higher dividend yields, but eschewing diversification and chasing yield rarely ends well for investors. Throughout this bull market, the quest for yield lured investors into narrow categories, only to hurt them later.

For example, consider Master Limited Partnerships (MLPs)—energy infrastructure-focused securities (e.g., pipelines), known for high dividend-like payments and deferred taxation. Many investors over allocated to this category for the yield, viewing them as an attractive bond alternative. However, the trend came to an abrupt end when oil prices started plunging in mid-2014, slamming Energy equities and MLPs (as shown in Exhibit 2).

It is important to remember that higher yield is compensation for higher risk, and high-yield equity is often low quality equity—one rung above junk bonds.

Exhibit 2: MLPs—No Bond Alternative



Source: FactSet, as of 11/10/2016. Total returns of Alerian MLP Index, S&P 500 Energy Sector Index, BofA Merrill Lynch US High Yield Energy Sector and US Investment Grade Corporate Energy Sector, 30/09/2014 – 30/09/2016.

Meet the New Sector

Real Estate, particularly Real Estate Investment Trusts (REITs), are also in fashion now, for similar reasons. Previously, the industry was a part of the Financials Sector, but the Global Industry Classification Standard (GICS) sector system just rewarded Real Estate's popularity by making it the 11th sector. While this has further drawn attention, we would warn investors to tread cautiously.

Though the history is limited, sector reclassifications tend to be a reaction to recent strong returns. Until 1988, there were just three sectors: Industrials, Utilities and Transports. Financials were added to the classification and S&P 500 in 1988. The four-sector system stood until 1999 when interest in the Tech industry hit an all-time high. Thus, the desire to illuminate Tech returns gave rise to the 10-sector GICS system, and all before the bubble burst.

Similarly, MSCI's country reclassifications (moving a nation from standalone to Frontier Market, Frontier to Emerging, Emerging to Developed, or vice versa) tend to follow returns. Unsurprisingly, returns tend to be strongly positive 12 and 24 months preceding upward reclassification—and negative afterward.[i] The flipside also holds true: Average returns are strongly negative in the 12 and 24 months before a downward reclassification, but flat and positive 12 and 24 months after, respectively.

Absent Real Estate's recent outperformance, there is no logical reason to make them a separate category. Real Estate comprises just 3.3% of the MSCI World.[ii] Why aren't similarly sized industries broken out? Why not Insurance or Banks, which are 8.5% and 3.9% of the index, respectively?[iii] It would be more logical for Retailers, 3.9% of the MSCI World, to be reclassified over Real Estate.[iv] A "sin sector" with liquor, tobacco and firearms, would make it easier for investors to restrict these categories for personal reasons if they wished. But for the most part, these industries lack Real Estate's recent hot returns and high-yield allure. Since debuting in mid-September, the Real Estate sector is down and trailing Financials. We caution investors from loading up on any one sector, but especially one that is getting attention tied to recent outperformance. The sector's small benchmark weight means holding even 10% in Real Estate development companies or REITs amounts to a big overweight—a substantial risk should it underperform.

US Commentary

As always, our political commentary is nonpartisan by design. We prefer no candidate, party or ideology, as political bias breeds investment errors. We assess politics solely for its potential market impact. At the time of writing, election results in the United States have yet to be determined. Fisher Investments will make available election results commentary once results are known.

This was a highly unusual election year, for well-documented reasons. We won't rehash those here, as much of the strangeness is sociological and personality-driven. Equities overlook such things. Yet there is a market-related take we believe isn't well understood.

The Perverse Inverse's Perverse Inverse

We have discussed this history many times before—a phenomenon we call the "Perverse Inverse." It relates to the long history of returns under Democrats and Republicans during election and inaugural years (Exhibit 3). Historically, when Democrats win, returns are below-average in the election year, then strong in the inaugural year. Under Republicans, it typically flips, with above-average election-year gains and muted inaugural year returns.

Exhibit 3: Perverse Inverse Four-Box

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

Source: Global Financial Data, Inc., as of 1/6/2016. 1928 – 2015. S&P 500 total return in election and inaugural years, 1928 – 2015.

"Why" is always harder to pinpoint than "what," but we believe markets' perception of campaign rhetoric drives this pattern. Democrats typically make relatively anti-business campaign pledges, often threatening the distribution of resources and capital. This, in turn, drives fear when they win, thus souring sentiment. But once in office, they typically moderate as they begin to eye re-election and encounter Congressional resistance, forcing them to water down or abandon key pledges. Reflectively, when investors realise new laws (to the extent there are any) aren't as bad as feared—their relief buoys markets. With Republicans, it is the reverse. Republican candidates typically tout pro-business agendas, exciting investors with the prospect of market-friendly reforms. Once in office, however, they too moderate and have to deal with Congress, dashing investors' hopes. That disappointment weighs on returns—equities move most on the gap between reality and expectations.

This year, there is a twist to this normal occurrence which we colloquially call the perverse inverse of the perverse inverse, if you will. For reasons we will describe momentarily, markets feared both candidates equally – typical for Clinton as a Democrat, but unusual for Trump as a Republican. This year's muted returns support this hypothesis.

If Hillary Clinton wins, markets should follow the typical blueprint. Her campaign trail jawboning about ending "quarterly capitalism" by changing the capital gains tax code, capping prescription drug prices and scrapping proposed free-trade agreements like the Trans-Pacific Partnership adds to the traditional anti-business aura. But if she is elected, gridlock and self-interested moderation probably block these from occurring exactly as envisioned today—if at all—bringing investors relief.

If Donald Trump wins, markets likely behave as they would when a Democrat wins. He is more feared, in a business sense, than traditional GOP candidates. There are few broad pro-business hopes to dash. Never in recent history has so much of the Republican Party been so against their own nominee. House Speaker Paul Ryan refuses to campaign for him. Attacks in The Wall Street Journal and critical editorials in Investors' Business Daily are common. No Fortune 100 CEO endorsed his campaign. People fear his anti-trade rhetoric will render economic disaster. His corporate tax cut might appear pro-business, until you realise he also plans to tax US firms' foreign-sourced profits immediately, instead of deferring until the funds are repatriated.

Generally, presidents are only able to expend a limited amount of political capital to accomplish one or two things during his/her term. If the president wastes political capital on partisan fighting and relatively insignificant issues, even less gets done. Looking at past presidential accomplishments, a great example is that of our most recent president – President Obama had two accomplishments: watered-down versions of the Affordable Care Act and Dodd-Frank, and that was with a Democratic House and Senate in his first two years.

Gridlock, Two Ways

Congress looks unlikely to swing veto-proof either way. The presidential contest doesn't look like a monstrous landslide on either side, a major last-minute surprise notwithstanding. Libertarian candidate Gary Johnson and the Green Party's Jill Stein have been polling just under 10% combined, Trump and Clinton are a few points apart, whoever wins likely won't capture 50% of total votes.

While the Congressional race is too close to call, Capitol Hill probably won't be lopsided come January. The Democrats have a structural advantage in the Senate, with fewer seats to defend in Republican strongholds. They could take the chamber if they campaign phenomenally or the GOP implodes. But the odds are stacked heavily against a supermajority. Meanwhile, incumbency and gerrymandering give Republicans an edge in the House, though the Democrats could pick up seats.

Hence, a President Trump or President Clinton will likely encounter gridlock. Even if Clinton wins and the Democrats seise Congress, support for major initiatives should be limited. Democratic Senators have incentives not to act rashly, as the GOP has a structural advantage in 2018's midterms (Exhibit 4 - next page).

The Democrats must defend several seats in states that voted Republican in the last several national elections or, in the case of Florida and Ohio, have Republican governors. The affected senators know this and won't want to alienate swing voters. Nor will Chuck Schumer (D-NY), who would likely become the Majority Leader of a Democratic Senate. He won't want to take big risks that could potentially sabotage plans for 2018—for the Democratic Party and his popularity within it. Like all politicians, his chief concern will be keeping his role. As anyone in his shoes would be, he'll be more interested in himself than in legislating Clinton's agenda. The same goes for all vulnerable senators who have incentives to be cautious.

As for a President Trump, even if the GOP maintains their stronghold in Congress, that doesn't mean gridlock ends. Anecdotally, about 20% of Republican lawmakers oppose Trump on key issues. That would create a new form of gridlock: intraparty gridlock.

Then, too, winning legislation on signature issues usually requires heaps of political capital. Neither Trump nor Clinton seem likely to have that much. Unless something changes radically to allow either to win a majority of the popular vote, neither would be able to claim a huge mandate. They will be on notice from day one: Moderate significantly, or risk losing in 2020.

Don't Overrate Presidential Politics

Because presidential elections loom large in the media and rattle emotions, investors tend to presume the Executive Branch hugely influences equity returns. While they are a political driver, US presidential politics aren't as impactful on equities as many presume. Economic and sentiment drivers are hugely important to market direction. Moreover, even within politics, it is worth remembering the US is just 25% of global GDP and, as we have previously noted, the president's authority is limited. There isn't much they can do, on their own, to impact economic growth in the US, much less the entire world.

While they are a political driver, US presidential politics aren't as impactful on equities as many presume.

Exhibit 4: 2018 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	Election Date
Hatch, Orrin G.	R	UT	67%	72%	63%	73%	1976
Barrasso, John	R	WY	68%	69%	65%	69%	2007
Manchin, Joe, III	D	WV	52%	56%	56%	62%	2010
Fischer, Deb	R	NE	62%	66%	57%	60%	2012
Corker, Bob	R	TN	51%	57%	57%	59%	2006
Heitkamp, Heidi	D	ND	61%	63%	53%	58%	2012
Cruz, Ted	R	TX	59%	61%	55%	57%	2012
Tester, Jon	D	MT	58%	59%	50%	55%	2006
Wicker, Roger F.	R	MS	58%	59%	56%	55%	2007
Donnelly, Joe	D	IN	57%	60%	49%	54%	2012
McCaskill, Claire	D	MO	50%	53%	49%	54%	2006
Flake, Jeff	R	AZ	51%	55%	54%	54%	2012
Nelson, Bill	D	FL	49%	52%	48%	49%	2000
Brown, Sherrod	D	OH	50%	51%	47%	48%	2006
Kaine, Tim	D	VA	52%	54%	46%	47%	2012
Casey, Robert P., Jr.	D	PA	46%	48%	44%	47%	2006
Baldwin, Tammy	D	WI	48%	49%	42%	46%	2012
Heller, Dean	R	NV	50%	50%	43%	46%	2011
Klobuchar, Amy	D	MN	46%	48%	44%	45%	2006
Stabenow, Debbie	D	MI	46%	48%	41%	45%	2000
Heinrich, Martin	D	NM	48%	50%	42%	43%	2012
Cantwell, Maria	D	WA	45%	46%	40%	41%	2000
King, Angus S., Jr.*	I	ME	44%	45%	40%	41%	2012
Murphy, Christopher	D	CT	38%	44%	38%	41%	2012
Menendez, Robert	D	NJ	40%	46%	42%	41%	2006
Carper, Thomas R.	D	DE	42%	46%	37%	40%	2000
Warren, Elizabeth	D	MA	33%	37%	36%	38%	2012
Feinstein, Dianne	D	CA	42%	44%	37%	37%	1992
Cardin, Benjamin L.	D	MD	40%	43%	36%	36%	2006
Whitehouse, Sheldon	D	RI	32%	39%	35%	35%	2006
Gillibrand, Kirsten E.	D	NY	35%	40%	36%	35%	2009
Sanders, Bernard*	I	VT	41%	39%	30%	31%	2006
Hirono, Mazie K.	D	HI	37%	45%	27%	28%	2012

*Source: United States Senate and Fisher Investments Research, as of 06/13/2016. *Sanders and King tend to caucus with the Democratic Party, hence our color coding.*

Most of Clinton and Trump's signature issues require legislation, making gridlock the swing factor. Trade policy is an exception of sorts as Congress previously granted the White House authority to raise tariffs on individual countries; many legal scholars even believe the president could unilaterally exit NAFTA. These issues bear watching, regardless of who wins, as both candidates speak ill of free trade. However, this isn't a reason to make major portfolio changes today. Markets move on probabilities, not possibilities. It is not really possible to know what, if anything, either candidate would do in office. Candidates routinely talk tough on trade without ever doing anything. In 2008, Barack Obama spoke of slapping tariffs on China. Mitt Romney did the same in 2012. Bill Clinton campaigned against NAFTA in 1992, then steered it through Congress. Talk is often cheap and we should weight each word cautiously.

For now, there is no way to know whether 2016's trade talk is similarly empty rhetoric. With that said, given how many American jobs in logistics, manufacturing and service depend on NAFTA, exiting it would be a radical political move, especially if the president lacks a sweepingly popular mandate. Severely disrupting supply chains probably would not win over independents in 2020, and winning re-election is always the president's chief first-term concern.

Politics Point Positive in 2017

So despite personal opinions of a President Trump or a President Clinton, he or she probably accomplishes less than you hope or fear. To the extent any new laws might be bad, they will probably be watered-down shells of their initial proposals.

Political forces should therefore be positive for equities in 2017. Surprises move markets, and next year, the surprise should be the new president not doing as many bad things as people fear. While it is premature to forecast 2017 returns as other forces are at work – namely economic and sentiment drivers – this election at least is consistent with a below-average 2016 and potential above-average returns in 2017.

Big Political Events Typically Don't Bother Equities

Fears of the vote triggering a crash are another example of people fixating on big political events and headline fears. When 2010's Affordable Care Act passed Congress over the March 20-21 weekend, some feared equities would crater the following Monday. They rose. People called 2012's sequestration the "Fiscal Cliff" – a crises in the making. Equities barely batted an eyelash over either. The same case goes for 2013's government shutdown. The world dreaded last year's Greek vote against bailout terms, but it was incredibly tame in reality. Politics matter for equities, but one must always approach the matter with caution. Bias can blind, and accepting politicians' promises and the media's claims at face value is risky. Big, widely watched votes and political events rarely have the impact many expect. All the attention allows markets to discount the event itself.

US Economy on Solid Footing

US economic growth enters Q4 in fine, if unspectacular, shape. GDP accelerated modestly in Q3, growing 2.9% annualised versus Q2's 1.4%.[v] Headlines cheered the fastest growth rate in two years, though a look at GDP's components suggests reality was a bit more nuanced. Consumer spending slowed from Q2's 4.3% to 2.1%, and most of the acceleration came from higher government spending—always open to interpretation—and the first inventory build since Q1 2015 as businesses restocked.[vi] Exports surged 10.0%, though a one-off jump in soybean exports contributed much of the gain.[vii]

With that said, there is still plenty of evidence domestic demand—particularly in the private sector—ended Q3 on firm footing. Business investment accelerated slightly, from Q3's 1.0% to 1.2%, as the decline in oil-related investment eased and tech-related investment jumped 8.7%.[viii] R&D spending cooled a bit, but still grew 1.2%. Imports—which GDP treats as negative but actually signify domestic demand—rose 2.3%, the biggest gain since early 2015.[ix]

While it is fair to characterise Q3's GDP report as a bit mixed, equities are forward-looking and have long since discounted economic activity that occurred between June 30 and September 30. Markets typically look about 3 to 30 months ahead, and most indicators suggest growth will continue over the foreseeable future.

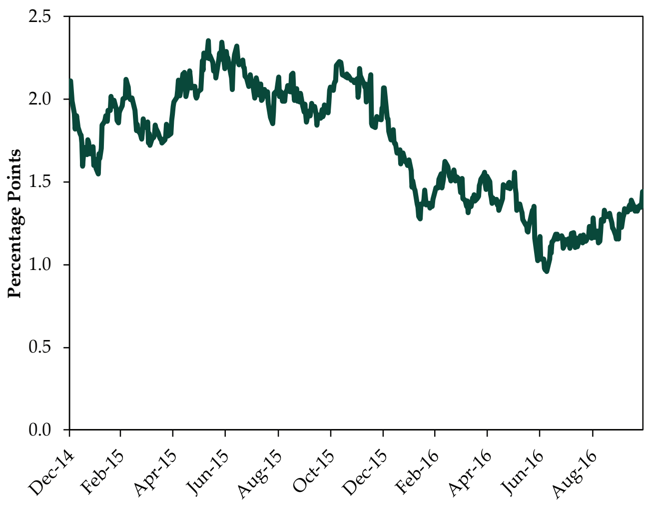
Recent data suggest growth continues. The Institute for Supply Management's PMIs started the quarter strong, with July Manufacturing and Non-Manufacturing registering 52.6 and 55.5, respectively (readings above 50 indicate growth). Each slowed in August but reaccerlerated in September. Furthermore, expansionary New Orders indexes suggest growth will continue (Exhibit 5). The New Orders component of the Institute for Supply Management's PMIs reaccelerated in September (readings over 50 indicate expansion)—today's orders are tomorrow's output.

Exhibit 5: ISM PMI New Orders

Source: FactSet, as of 6/10/2016. January 2008 – September 2016.

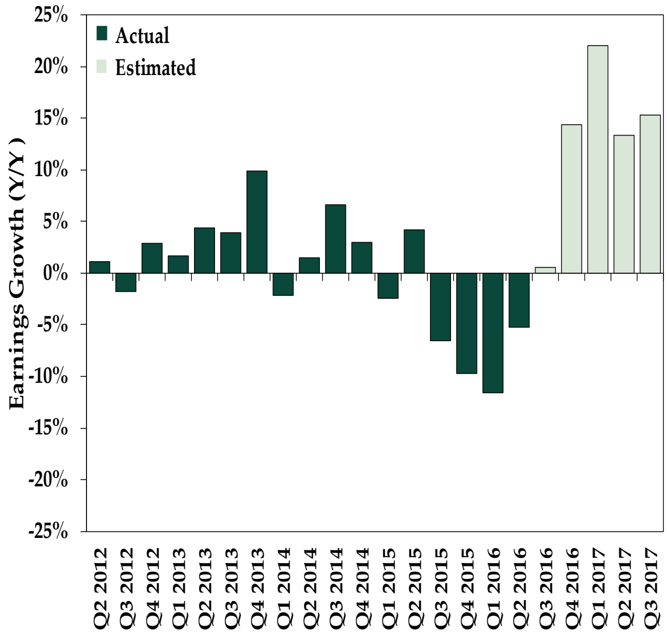
The Conference Board's Leading Economic Index (LEI) rose 0.2% m/m in September, extending an uptrend.[x] No recession in LEI's nearly 60-year published history began while the index was high and rising. Loan growth (which averaged +8.1% y/y in the four weeks ended October 5) and broad money supply (5.5% y/y in September) are rising swiftly.[xi] While business lending faltered in Q3, weakness was concentrated in late July and August—a seven-week stretch. Similar soft spots earlier in this expansion didn't derail overall economic growth, and more recent readings are strong. Moreover, the yield curve has steepened in recent weeks, which should support loan growth—and continued economic expansion—looking ahead (Exhibit 6).

Exhibit 6: US Yield Curve Spread (10-Year Treasury Yield Minus Fed Funds Rate)



Source: FactSet, as of 6/10/2016. 31/12/2014 – 27/10/2016.

Exhibit 7: Earnings Expected to Improve



Source: Factset, as of 24/10/2016. MSCI World blended earnings growth, Q1 2012 – Q2 2016. FactSet estimated net-income weighted earnings growth from Q3 2016 on, as of 24/10/2016. Forward estimates cover ~78% of MSCI World market capitalisation.

Earnings Growth Ahead

Last quarter, we discussed how Energy firms dragged on S&P 500 earnings, the major driver of recently weak results. But now, with oil prices stabilising and year-over-year comparisons becoming easier, the drag seems poised to wane. Analysts are starting to notice health elsewhere in corporate America and expect strong earnings later this year (Exhibit 7).

Interest Rates and the Fed

We aren't surprised the Fed won't do the very much anticipated four rate hikes that many expected this year.

While Fed moves can't be forecast—they are an opaque cabal of humans acting on biased interpretations of data—we don't expect much action this year. The next president will decide whether to reappoint Fed Chair Janet Yellen, and hiking rates close to an election invites controversy. Hence, barring runaway inflation or economic implosion, Fed heads tend to do little as elections approach, as doing nothing gets scant attention. Few see inactivity as the active choice it is.

After the election, the Fed will be much freer to act. It could raise rates in December—as good a time as any—matching 2015's total of rate hikes. Investors are on edge over the possibility, but it doesn't have much significance for equities.

Pundits fret a Fed hike will raise borrowing rates, cutting off capital from businesses and crimping broader economic activity. However, rate hikes don't directly impact long rates—which hover around generational lows—as much as global market forces do. To clarify, if a business owner is planning to launch a long-term investment such as a new plant, a tiny increase in borrowing costs should not deter them. If that is the case, the project was likely not very viable to begin with. Any halfway feasible project will still advance.

Big monetary errors can roil markets, but small adjustments such as a rate hike don't mean much.

Incremental rate moves have minimal impact on the broader economy, especially on a growing one such as that of America's. Broad money supply (M4) is expanding nicely, and trying to fine-tune it through monetary policy is the height of arrogance. Arguably the greatest mind in monetary economics, Milton Friedman, argued as much and advocated for replacing Fed governors with a computer algorithm that will increase the money supply with no variation for cyclical conditions—a sensible take, in our view.

Big monetary errors can roil markets, but small adjustments such as a rate hike don't mean much. People worry it will signal the end of the bull, presuming it is a Fed-fueled bubble. However equities have risen for seven and a half years despite the Fed, not because of it. The central bank's actions since 2009 have mostly flattened the yield curve, adding headwinds. The same is true globally. The BoJ, ECB and now the BoE (again) are buying bonds, and it is all misguided—a point BoJ governor Haruhiko Kuroda indirectly conceded in a recent speech. Central banks' buying, among other factors, should keep long rates from rising much. Bond markets are global, and developed-world interest rates are pretty highly correlated. A surge in one country alone is unlikely.

Non-US Developed Commentary

For most of this expansion, investors have alternately feared recession and bemoaned slow growth, with few appreciating this simple fact: The global economy is expanding. Technically, a recovery is when GDP (or GDP per capita) is rising, but remains below its pre-recession peak. Even Fed officials like Janet Yellen and Jerome Powell, who should know better, mentioned the economic "recovery" as recently as mid-October. Yet the world economy isn't in recovery—it is in expansion. Global GDP—as well as most major regions (the US, UK and eurozone)—exceeds pre-recession highs and has for years. While growth rates aren't fast, expansion continued in Q3, again defying fears. This disconnect between economic fundamentals and investors' perceptions is at this bull market's core.

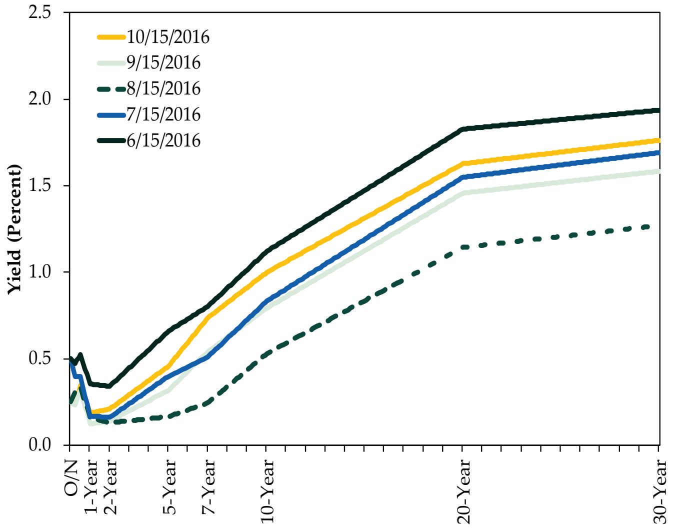
United Kingdom

Q3 recession fears centreed on the UK, where many expected the "Leave" vote on June 23rd's EU membership referendum to cause contraction. In July, survey-based data seemed to support their case. Several confidence surveys plunged, and Purchasing Managers' Indexes (PMIs, surveys attempting to measure the breadth of growth) plunged into contractionary territory. Economists slashed their estimates of Q3 GDP growth, with the consensus still presently expecting a sharp slowdown from Q2.[xiii] Furthermore, the Bank of England anticipated economic weakness—even going so far as to cut overnight rates from 0.5% to a record-low 0.25%—and restarted quantitative easing (QE) with a small amount of Gilt and corporate bond purchases. Neither of the two actions carries the significance in size or power to materially change the environment, but it shows the prevalence of Brexit fears.

The rate cut and new programme, called the Term Funding Scheme (TFS), are probably incremental positives. When the BoE last cut rates, to 0.5% in March 2009, there were widespread concerns that banks weren't passing cheaper funding to consumers and thus preventing stimulus from being truly effective. At the time—in the wake of the financial crisis—banks were desperate for deposits, and many actually raised deposit rates after the BoE cut. While savers benefited, borrowers didn't, as banks charged higher loan rates to preserve profit margins. TFS is an effort to fix this. As the BoE noted, banks can't realistically expect to pass a 0.25% deposit rate to customers without driving them off, which would force credit to tighten. So via TFS, the BoE will lend directly to banks at 0.25% for fixed four-year terms—a largely sensible way to improve the rate cut's efficacy.

QE, however, is a modest negative—albeit a small one, as the programme is tiny and expires in February. The BoE will purchase just £60 billion in Gilts and £10 billion in Sterling-denominated corporate bonds, making its monthly footprint just over half the size of the last round of QE, in 2012. Back then, the yield curve flattened, money supply crawled and economic growth wobbled, but the country didn't re-enter recession. It should prove similarly resilient this time around, with the programme much smaller. The yield curve has even steepened in recent weeks, as markets have begun eyeing the programme's approaching end and the prospect of higher borrowing under Chancellor Philip Hammond, who scrapped George Osborne's deficit targets (Exhibit 8 on next page).

Exhibit 8: UK Yield Curve on Various Dates



Source: FactSet, as of 24/10/2016.

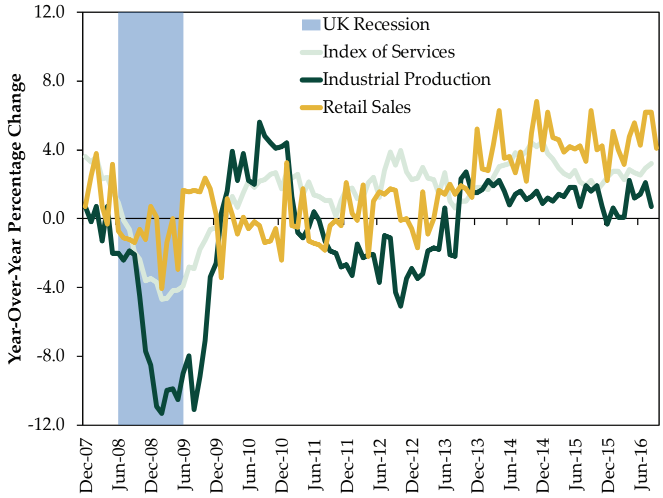
Brexit was a Bust

Neither the revised Q3 GDP estimates nor the QE is significant in size or power, but they show the Brexit fears' prevalence. However, with time and additional data, it is clear Brexit fears were a bust. Manufacturing and Services PMIs reversed July's drop and stand above pre-referendum levels. Actual output gauges refuted the faltering PMIs, suggesting the latter were skewed by sentiment. GDP rose 2.0% annualised in Q3, powered by the service sector.[xiv] While industrial output fell in the quarter, monthly data suggest this is skewed by faltering North Sea oil production. Moreover, industrial production has been choppy throughout this expansion. The service sector, comprising approximately 80% of UK output, is the country's economic growth engine and appears to be firing on all cylinders. The expenditure-based breakdown of Q3 GDP isn't yet available, but retail sales data suggest consumption is healthy. Sales volumes rose 1.8% y/y in Q3—solid growth, and the fastest since Q4 2014.[xv] UK services industry output—almost 80% of GDP— rose 0.4% m/m (+2.9% y/y) in July.[xvi] Industrial production has been choppy but grew to 0.7% y/y in August.[xvii] With retail sales, industrial production and services output in uptrends, Brexit's impact appears minimal (Exhibit 9).

British markets, too, have moved on. After two days of declines immediately following the vote, UK equities surged and are well above pre-referendum levels. Rather than spiking as many feared, Gilt yields are lower and demand for British debt is strong at auction. Many cite the weak pound as evidence that Brexit-related problems continue to lurk, but currency markets aren't any more telling than equity or bond markets are. They are also heavily influenced by interest rates—the weak pound may partly result from lower gilt yields and the BoE's actions.

As we wrote in the months surrounding the referendum, the vote carried little economic weight. Britain and/or the EU might eventually struggle if the exit agreement hampers trade. However, it will probably be years before an exit agreement is complete. UK Prime Minister Theresa May announced in early October she wouldn't launch talks until March 2017, and the negotiations will be complex and lengthy. In the meantime, the UK is a full member of the single market. Brexit could eventually be a plus, a minus or a non-event for Britain's economy. Thus far, it is a non-event.

Exhibit 9: UK Economy Unscathed by Brexit Vote



Source: FactSet, as of 20/10/2016. Industrial Production,year-over-year percentage change, December 2007 – August 2016. Index of Services year-over-year change, December 2007 – July 2016. Retail Sales Volumes, year-over-year percentage change, December 2007 – September 2016. Recession dating as per BoE methodology.

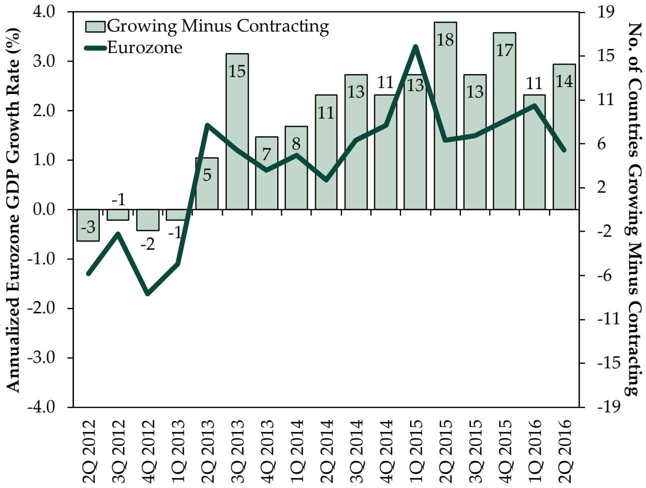
The Eurozone: Fundamentals Exceed Sentiment

Outside Brexit, European investors seem most focused on bank fears, particularly Germany's Deutsche Bank. Fears stem from the US Department of Justice reportedly seeking a $14 billion fine from Deutsche Bank regarding pre-2008 actions. Many note this amount more or less matches Deutsche Bank's market capitalisation and worry the fine will wipe the firm out. However, this is an incorrect comparison—market capitalisation isn't relevant to bank health. This is a solvent bank with more than €200 billion in liquidity, access to the ECB and roughly €1.7 trillion in assets.[xviii] It also has €5.5 billion earmarked for legal settlements. DoJ initial settlement demands are usually much larger than the eventual deal, and rumors are swirling the two sides have agreed to a much smaller settlement. Either way, although the DoJ's opening $14 billion ask was bigger than Deutsche had expected, it wasn't likely to put the bank's viability at risk. The bank did raise capital from private investors, which diluted shareholders' stake. But this isn't likely to fuel a financial crisis.

Bank fears are just one factor clouding investors' ability to appreciate eurozone economic health. As revised data confirmed, eurozone

GDP grew 1.2% annualised in Q2 2016—the 13th straight quarter of growth.[xix] With 18 of 19 nations reporting, only two reported contraction (France and Finland, at -0.43% and -0.2% annualised, respectively) (Exhibit 10).[xx] Yet France rebounded in Q3, growing 0.9% annualised.[xxi] Spain, the only other major eurozone country to have reported Q3 results as we write, grew 2.8% annualised.[xxii] While aggregate eurozone growth isn't fast, it is broad-based and in keeping with the trend since 2013, and many member nations are growing at nice rates.

Exhibit 10: Eurozone GDP Growth—Better and Broader Than Appreciated



Source: Eurostat, as of 7/10/2016. Eurozone annualised GDP growth rate and net number of countries growing, Q2 2012 – Q2 2016. The eurozone has 19 member nations. Country count is based on annualised seasonally and calendar adjusted growth rates except Slovakia, which is annualised and seasonally adjusted only.

More recent data suggest growth continues. Eurozone retail sales volumes jumped 1.1% m/m in July—smashing estimates of 0.4%.[xxiii] September M3 grew 5.0% y/y, maintaining its steady rise.[xxiv] Sales rose in five of eight months reported year to date. July, August and September Purchasing Managers' Indexes (PMI) for services and manufacturing were expansionary, and preliminary October data show continued growth. While fears over banks curtailing lending and raising capital remain, bank lending and money supply are growing. Lending to both households and non-financial corporations also rose. The Conference Board's Eurozone Leading Economic Index has been flat lately, but the major detractor has been business sentiment—among the least predictive components.

Italy

On December 4, Italians vote in a constitutional referendum that will decide the country's political future and, potentially, the fate of Prime Minister Matteo Renzi. Polls are tight, and many fear the political instability that could arise if the referendum fails and Renzi resigns. However, government turnover and stalemates are fairly regular occurrences in Italian politics, limiting the surprise factor and making it difficult to view this as a wallop, squelching the bull market.

The referendum in question would reduce the size and powers of Italy's upper house (Senate), fostering governmental stability and easier legislation. It would also shift decision-making on infrastructure and other spending initiatives from regional governments to the central government. While these reforms would end Italian gridlock, they would also enable lawmakers to address Italy's structural economic issues, including tax evasion, cronyism and byzantine labour markets. Passage would be a long-term economic positive.

However, it faces a tough road. Polls are split down the middle, with many undecided voters. Many view the referendum as a national vote of confidence for Renzi's government, who initially said he would resign if the referendum failed (he has since backed away from that statement). His popularity fell as Italy's economy continued stagnating, and the migration crisis further eroded his support. To curry favour, Renzi's government included targeted fiscal stimulus in its 2017 budget, but it remains to be seen whether this will boost support.

Should the referendum fail, it could be difficult for Renzi's government to survive long, and snap elections or the appointment of a technocratic government could follow. Many say this opens Pandora's box, as the anti-establishment Five Star Movement (M5S) took advantage of the centre-right's leadership vacuum to become the primary opposition party. At one point earlier this year, it led party opinion polling, and it won the Rome and Turin mayoralties in recent regional elections. Should it capitalise on this support and win a general election, many fear it could pave the way for a referendum to exit the euro, potentially splintering the currency union.

For now, this fear appears overstated. Even if M5S does head up the next government, Italy's constitution prevents referendums from overruling international treaties. Absent constitutional reform, it is unlikely such a major treaty change would pass through Italy's fractured parliament. Then, too, it is not at all clear how M5S would do in a snap election. Its poll support has slipped since summer, and it is behind Renzi's Democratic Party. So far, the party has little to show for its local victories in Rome and Turin. New Rome Mayor

Virginia Raggi took over three months to form an administration after several high-profile resignations, and she is under fire for appointing Paolo Muraro, who is presently under investigation for corruption allegations, in charge of tackling the city's infamous garbage problem. Compounding matters, Federico Pizzarotti, elected as Mayor of Parma in 2012 for M5S, recently left the party after repeated conflicts over abandoned campaign pledges. The more voters see M5S members have difficulty governing and doing what they say, the more their support slips.

If the referendum fails, short-term volatility wouldn't surprise, but markets should be resilient—just as they were after the Brexit vote. Italian governments collapse fairly regularly, Italy's economy has been structurally uncompetitive for decades, and the anti-euro parties presently lack the political clout to pull off an exit from the eurozone. Heightened political instability would merely extend the status quo of the last several years.

Spain

After 10 months of deadlock, Spain finally implemented a government in late October. Worried about their electoral prospects in a potential third election, the Socialist Party voted to replace leader Pedro Sanchez and support Prime Minister Mariano Rajoy's minority government. Rajoy's Popular Party is expected to govern on its own, without a coalition, and will have limited political capital.

Though a minority government will have little ability to push through future reforms, this shouldn't be a major issue for Spain, as Rajoy's administration addressed the labour market years ago. Those reforms boosted Spanish productivity and made the labour force significantly more competitive, and Spain's economy is reaping the benefits. Its GDP growth rates are consistently among the eurozone's fastest, and the ability to keep growing swiftly despite the country's lack of government this year is a testament to the private sector's increased clout. Hence, having a government in place probably won't change much fundamentally in Spain, though the reduction in political uncertainty should boost sentiment somewhat.

Japan

Japan's economic struggles continued in Q3. Revised Q2 2016 GDP grew 0.7% annualised—up from the initially reported 0.2%.[xxv] But business investment remains weak—private capital expenditures contracted -0.6%, the second straight drop. August consumer spending declined -3.1% y/y, the fourth straight decline.[xxvi] September exports plummeted -6.9% y/y in price terms, and though they rose 4.7% y/y in volume terms, this is mostly a function of a low comparison base.[xxvii] The longer-term trend is negative. Imports fell -16.3% y/y in value terms and -1.6% y/y in volume terms, as domestic demand continued struggling.[xxviii] Industrial production was a rare ray of sunshine, rising 4.6% y/y.[xxix] But this is only one positive reading: Industrial production has fallen for most of the last two years.

The BoJ is the first central bank to publicly acknowledge that quantitative easing flattens yield curves

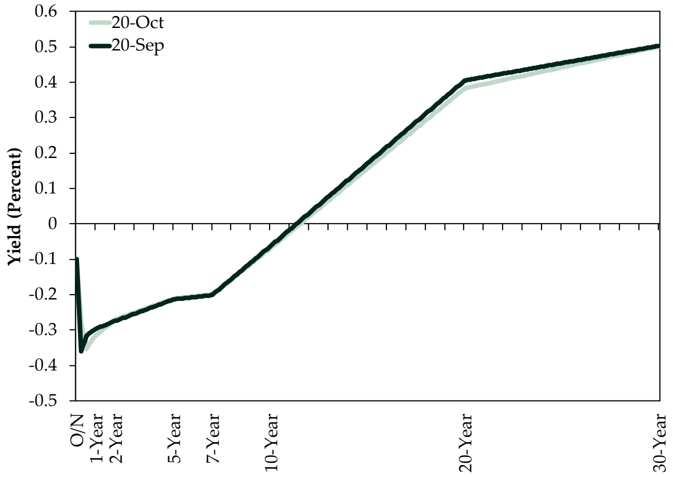
The Bank of Japan, meanwhile, completed its "Comprehensive Assessment of Monetary Policy." This investigation aimed to identify reasons why the BoJ's unconventional policies (asset purchases and negative rates) haven't boosted faster growth and inflation, as well as any ancillary positives and negatives. The BoJ cited the flat yield curve and its impact on banking profitability as a negative consequence of its policy decisions. While policymakers didn't change short-term interest rates (presently -0.1%) or the size of the Quantitative and Qualitative Easing (QQE) programmeme, they set a new interest rate target of 0% for 10-year government bond yields in an effort to steepen the yield curve. While the rationale is noteworthy, it doesn't change much fundamentally, as even success would ensure the yield curve remains quite flat.

The BoJ is the first central bank to publicly acknowledge that quantitative easing flattens yield curves, making it difficult for banks to lend profitably and broadly. Negative interest rates on excess reserves compounded the problem, as they fueled demand for higher-yielding, longer-dated bonds, further dragging down long-term bond yields. Since they were enacted in Japan in January, Japanese Financials complained bitterly about reduced profitability.

The latest policy tweaks seem mostly like lip service to banks. The BoJ won't cut its bond purchases in order to remove the pressure on long-term yields. It is just altering the type and pace of bond purchases by excluding bonds with maturities between 7 and 12 years. Meanwhile, the Ministry of Finance will issue more longer-dated bonds in an effort to increase supply.

While the bank expects this to steepen the yield curve, so far, it hasn't accomplished much. The day before the announcement, Japanese 10-year yields were -0.0624%. One month later, they were -0.0688%—slightly further from zero (Exhibit 11).

Exhibit 11: Japanese Yield Curve on 9/20 and 10/20

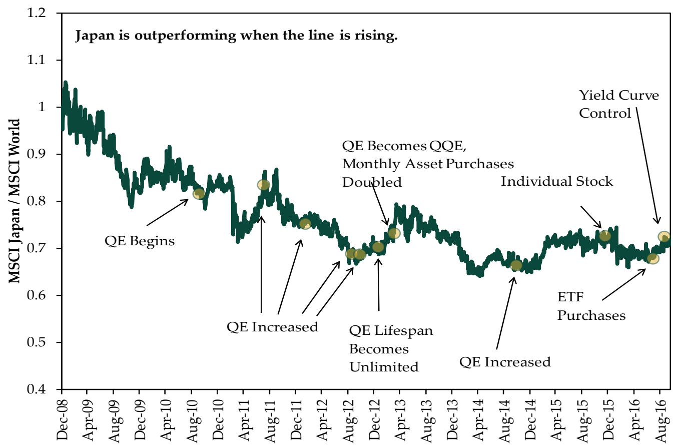


Source: FactSet, as of 24/10/2016.

Overall, despite the BoJ's admission, nothing has fundamentally changed. The bank continues scrambling to solve self-inflicted problems—chasing its tail to steepen a yield curve that the bank itself flattened—instead of just ending the problematic programmeme. This confused, misguided policy is a key reason we remain underweight Japan, which has lagged the world throughout its evolving QE experiment (Exhibit 12).

Looking at the overall landscape, we continue to believe Japan needs significant structural reform to put its economy on more stable footing. But there is little more than talk to report. Prime Minister Shinzo Abe announced he would convene a labour market reform panel to recommend reforms targeting increased wages, productivity and labour force participation. But this amounts to planning a panel to plan, suggesting enactment of actual reforms is distant.

Exhibit 12: MSCI Japan Relative



Source: FactSet, as of 20/10/2016. MSCI Japan and MSCI World Index returns with net dividends, 31/12/2008 – 19/10/2016, indexed to 1 on 12/31/2008.

EMERGING MARKETS COMMENTARY

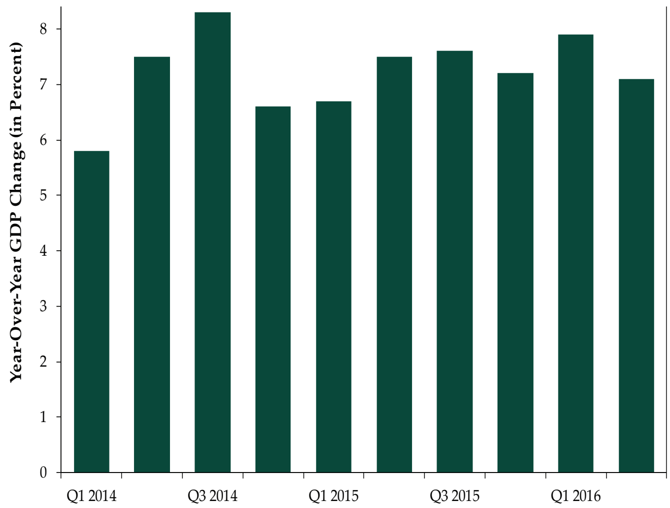
The MSCI Emerging Markets Index (MSCI EM) rose 9.0% in Q3, beating the developed world and bringing its year-to-date return to 16.0%.[xxx] Economically speaking, Emerging Markets' (EM) health remains divided. Those heavily reliant on commodity prices—like Brazil and Russia—continue floundering, although the pace of contraction seems to have eased. In non-commodity heavy Emerging Markets, growth is in better shape.

> Economically speaking, Emerging Markets' health remains divided... In non-commodity heavy Emerging Markets, growth is in better shape.

INDIA

India boasts one of the world's fastest growth rates, with the latest data showing the country expanded 7.1% y/y in Q2. Though down from Q1's 7.9%, it is in line with recent robust growth rates (Exhibit 13). Notably, domestic demand and services drove growth. Private consumption expenditures rose 6.7% y/y, and industry-wise, the services sector grew fastest at 9.6%. Its three subsectors boasted robust rates: Trade, hotels, transport & communication grew 8.1%; financing, insurance, real estate & bus services rose 9.4%; and community, social & personal services jumped 12.3%.

Exhibit 13: India's Growth Since 2014



Source: FactSet, as of 20/10/2016.

CONTINUED REFORM PROGRESS

When it comes to economic policy, Indian Prime Ministers have a long history of pledging big, sweeping reforms but not following through, disappointing investors. Often, gridlock and the decentralised government got in the way. Even when the central government could pass legislation, states would regularly veto or simply not implement the changes. So when Narendra Modi assumed office in 2014, folks anticipated more of the same. Modi, however, has mostly sought incremental, achievable reforms rather than grandiose plans for economic overhaul that stand little chance of becoming law. Small successes, coupled with robust economic growth, boosted Modi's political capital, and in Q3 he won his first "big bang" reform, surprising many sceptics.

Goods and Services Tax Passed

That big bang is what Finance Minister Arun Jaitley called the "biggest tax reform since 1947," when India gained independence. In September, Indian states ratified a historic constitutional amendment to replace India's byzantine system of state-administered taxes with a national Goods and Services Tax (GST). The GST will replace all indirect taxes, including excise duty, state VATs, service taxes and the like. The government is now drafting secondary legislation to set tax rates and exemptions, making implementation of the new system likely to occur in 2017's second half.

While the new system might initially create headaches for businesses, who will have to overhaul their accounting systems, it should be a long-term positive. Its power is in its efficiency—it creates a common market, unburdened by myriad state and local rules. Under the old patchwork system, interstate commerce was prohibitively burdensome. Companies would often spend days at checkpoints, filling out inordinate amounts of paperwork in order to do business across state lines. The World Bank estimated the ensuing road delays drove Indian manufacturing costs two to three times higher than international benchmarks—and that cutting waiting times in half could reduce logistics costs by up to 40%. Complying with over a dozen different tax systems also weighed heavily on businesses, and disputes were common as multiple states would regularly claim the same cross-border transaction as part of their tax base.

Once complete, the new tax system should streamline interstate commerce and expand opportunities for Indian firms. Companies will be able to operate more freely and cheaply throughout the country, and less money spent on tax compliance means more funds available to invest. The new national system should also improve tax collection, boosting government revenues and badly needed infrastructure investment.

On the sentiment front, this reform likely squashes the misguided view of Modi falling short as a reformer, but this doesn't automatically make sentiment too lofty. There is a big difference between investors finally noticing progress and becoming overly optimistic about the potential for further sweeping changes. Expectations presently seem tame enough, and there are still plenty of opportunities for positive surprise.

RBI Reforms Promote Lending

One such opportunity is in the partial liberalisation of India's corporate bond market, which former Reserve Bank of India (RBI) chief Raghuram Rajan announced in late August and his successor, Urjit Patel, is running with. The new measures, slated to take effect in 2017, aim to clean up and recapitalise state-run banks while improving Indian companies' credit access.

Until now, corporate debt issuance was tightly controlled, and banks accounted for some 80% of total financing. State-run banks have long played an outsized role, and cronyism has historically caused funds to be directed to less efficient uses. During the last boom-bust cycle, this led to a mountain of bad debt on state-run banks' balance sheets, as they lent mostly to state-supported infrastructure and industry projects, which stalled under political opposition and excessive red tape. When payments stalled, banks simply slashed or delayed collection, putting off a true accounting of their financial state. This has prevented them from financing many long-term investments during this cycle. Meanwhile private-sector banks, which conduct more objective risk assessments, focused on lending to consumers and firms needing short-term working capital. As a result, most loan growth in recent months has come from private-sector banks, where loan growth is running at about 25% y/y.[xxxi]

The one-two punch of bank reform and bond market liberalisation should help firms secure more financing for long-term projects.

The one-two punch of bank reform and bond market liberalisation should help firms secure more financing for long-term projects. First off, banks must properly label all nonperforming loans as such by March 2017, recognising bad debt instead of offering interest forbearance and term extensions. Then, when the corporate bond market is developed, they may issue rupee-denominated bonds overseas, known as "masala bonds" (similar to Hong Kong's "dim sum bonds"), to help them recapitalise. With this system, banks can raise perpetual debt that counts as Tier 1 and Tier 2 capital, skirting the thorny "political" issue of recapitalisation (New Delhi doesn't want to lose control of public sector banks but can't afford to recapitalise them directly).

In addition, the RBI is attempting to increase corporate credit access in a couple ways: First, more corporate bonds will be eligible for "credit enhancement," which offers buyers greater assurance of repayment and is therefore more appealing to Indian institutions (like insurance companies and pension funds), which generally don't invest in debt with ratings below AA. Second, the RBI will cap banks' exposure to a single counterparty or group of connected counterparties at 20% and 25% of Tier 1 capital, respectively—effectively reducing banks' reliance on large borrowers, which account for about half of all loans but a roughly 86% share of nonperforming loans. This both reduces risk to banks and encourages large firms toward corporate bond issuances, increasing the bond market's depth and freeing up bank capital for smaller and mid-sized firms. To raise demand for bonds alongside the supply increase, the RBI will permit banks to use corporate bonds as collateral for overnight loans (providing an incentive to own then), and give Foreign Portfolio Investors direct access to corporate bond trading platforms, eliminating the need to go through a local broker. While hedge funds, individuals and other "higher-risk" investors are excluded from the programmeme, improved access for regulated institutional investors should broaden the pool of buyers and sellers, boosting liquidity.

New Trouble in Old Kashmir

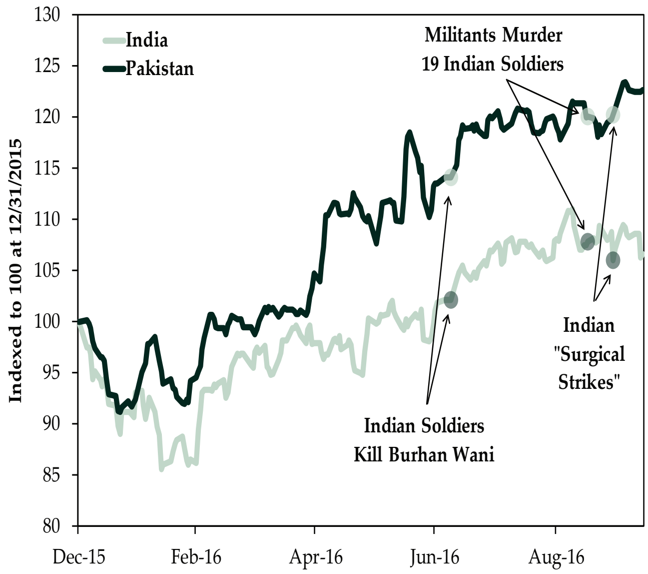
Decades-old tensions between India and Pakistan resurged in Q3, spurring fears of a wider conflict involving two nations with nuclear capabilities. While breathless headlines capture widespread attention, markets' reaction has been muted—suggesting equities see this as a temporary hiccup.

Fighting began July 8, after Indian security forces in the disputed region killed Burhan Wani, a 21 year-old militant fighting for Kashmir's independence. His death and funeral led to myriad protests and skirmishes between security forces and militants, leading to scores of deaths and several thousand arrests. Many militants claim this shows the Indian government is going too far. In September, militants based in Pakistan attacked an Indian military installation in eastern Kashmir, killing 19 soldiers.

For its part, India blames Pakistan for the attacks and unrest, claiming the militants are backed by the government and repeatedly labelling Pakistan a "terrorist state." Late in Q3, Indian troops retaliated in what they claim was a surgical strike against a militant camp. (Pakistan disputes the terminology and claims India merely lobbed artillery over the border area known as the Line of Control.) Reports of soldiers trading gunfire in the Kashmir are frequent and, at the mid-October BRICS summit, Indian Prime Minister Narendra Modi reiterated the government's earlier claims, calling Pakistan a terrorist "mothership."

Tensions between the two are nothing new, with four wars since 1947 and plenty of stand-offs and skirmishes along the way. However, in the last 15 years, relations have improved. Yet, despite the seemingly surprising setback, markets aren't terribly phased (Exhibit 14). Investors appear to see the skirmish as a mere setback along the longer-term march to warmer relations and deeper trade ties.

Exhibit 14: Tensions Haven't Swayed Equities Much



Source: FactSet, as of 17/10/2016. MSCI India and MSCI Pakistan in USD with net dividends, 31/12/2015 – 14/10/2016. Indexed to 100 at 31/12/2015.

However, it is quite possible continued or, potentially, escalating tensions stoke volatility, particularly in the affected nations' markets. That being said, regional conflicts' broad market impact tends to be quite limited and fleeting. Despite the heated rhetoric and hostility between the two in recent months, most analysts do not anticipate the situation escalating into full-fledged war. This is particularly true as most of the global community is aligning itself behind India, including the US.

Big Political Changes in Brazil

Brazilian politics stayed in the spotlight in Q3, as the Senate impeached Dilma Rousseff and interim President Michel Temer officially replaced her. Temer, a member of the centre-right opposition Brazilian Democratic Movement Party (PMDB), wasted no time in launching reform efforts. While interim president, he started building alliances to build support for his policies, like slowing government spending to address the fiscal deficit. In July, Rodrigo Maia, a Temer ally, was elected as speaker of the lower house—a sign Temer's reforms could have a receptive audience.

Though unpopular and also linked to corruption scandals, Temer has made meaningful, quick progress on some much-needed measures. For example: Congress's lower house approved a bill freezing government spending in real terms for at least 10 years—a big win for Temer and a positive for the country. The budget deficit is currently around 10% of GDP, and most consider reining in automatic increases in public sector spending vital to getting the country's fiscal house in order. While the Senate must still approve the bill, investors appear optimistic Temer possesses the political capital necessary to be successful and tackle other issues like pension reform. However, equities move on the gap between expectations and reality.

Broken Correlation?

Though typically correlated with energy due to the country's oil-heavy economy, Brazilian equities diverged in recent months and surged as political drivers held more sway—markets liked the prospect of replacing Rousseff with anybody else. As Rousseff's impeachment looked more and more likely earlier this year, the positive surprise drove forward-looking equities higher. While Temer's early successes seem promising, we don't see cause to celebrate just yet. Yes, Brazilian politicians are proving to be more capable of unifying for reforms—a positive. However, the current optimism could set Brazilian markets up for disappointment if anticipated reforms get watered-down or aren't passed. There are reasons for doubt, like the notoriously fractured nature of Brazilian politics. Plus, many Brazilian politicians, Temer included, face their own corruption accusations, potentially impeding legislative progress. This nascent positive political environment could quickly flip back to a negative.

More importantly, as markets start pricing in current political drivers, economic drivers—namely, the persistent commodity supply glut—will likely regain influence. Brazil's oil-dependent economy is still struggling mightily, and though the worst of its recession may have passed, robust growth isn't necessarily around the corner. The oil glut persists as producers around the world show no signs of meaningfully reducing output. This essentially means outperformance could hinge on Temer's ability to enact reforms exceeding presently high expectations. We are sceptical of his ability to do so.

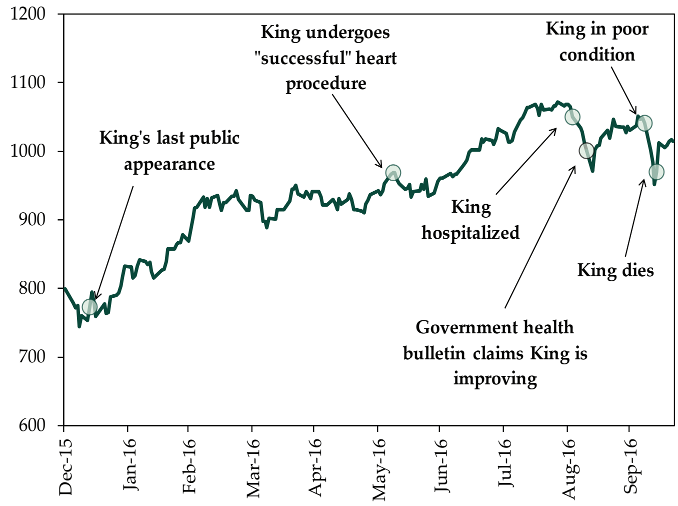
Thailand's King Passes Away

Thailand's 88-year old king, Bhumibol Adulyadej, passed away on Thursday, October 13, ending his 70-year reign. While holding little official political power, the King was widely seen as a source of stability in a country long-hampered by roughly a dozen coups and 20 constitutions. Its factional politics currently centre on the divide between the military and urban elite on one hand, and the supporters of ousted Prime Minister Thaksin Shinawatra on the other.

Many fear Adulyadej's death will open tensions between the military and the Crown Prince, Maha Vajiralongkorn, the designated successor to the late King. The Crown Prince is reportedly close to Thaksin Shinawatra, which puts him at odds with the present government of Prayut Chan-o-cha, whom the military installed in May 2014 and backs today.

As Exhibit 15 shows, the MSCI Thailand has wobbled recently, with the King's fading health a likely influence on volatility. Crown Prince Vajiralongkorn has not yet assumed the throne, having requested a short delay for mourning. But he is expected to begin his (mostly ceremonial) reign shortly—the military presently supports his succession, and has publicly stated its intention to transition power to the new monarch and proceed with planned national elections for the rest of the government next year. Some fret the pause ahead of Crown Prince Vajiralongkorn's coronation, but precisely when it occurs isn't very material—what matters is markets can anticipate the country's upcoming political scene with reasonable confidence. Whether the calm holds isn't presently knowable but, as undemocratic as it may be, the military's support of the current government provides some stability. Longer-term, risks of strife remain. But presently, the resolution of uncertainty surrounding the King's passing should add clarity.

Exhibit 15: MSCI Thailand and King Bhumibol Adulyadej's Health in 2016



Source: FactSet, as of 21/10/2016. MSCI Thailand with net dividends, 31/12/2015 – 21/10/2016.

China

While isolated fears of a Chinese hard landing or recession linger—typically, regarding recycled years-old debt and property market worries—most investors seem to have moved on. The make-up of Chinese debt is a critical reason a crisis is not on the immediate horizon. The country's debt pile is largely owned by the government and nearly entirely based in renminbi. China's banking sector is unique – the state owns the big banks and its debtors, leaving the government in a much better position to dictate the outcomes than other developed market peers. In the 1990s, the Chinese recapitalised its banking sector after years of inefficient lending to state-owned enterprises brought them to the brink of insolvency.

> The fears China is going down a similar path as Japan in the 1990s are misguided.

Today, the government has acknowledged the potential for debt issues and announced a similar programme, trading bad debt for equity. The fears China is going down a similar path as Japan in the 1990s are misguided. It took Japanese authorities decades to acknowledge its bad debt problem. Moreover, loans to state owned enterprises have more than halved since the last crisis at roughly 30% of total loans, as banks have shifted to lending to private enterprise and households.

Uncertainty surrounding China's economic outlook further waned, as data continue confirming the economy isn't crashing. Chinese Q3 2016 GDP grew 6.7% y/y, matching Q2's pace and only slightly off rates seen in recent quarters.[xxxii] Though some pundits questioned the report's accuracy, we think this misses the bigger point: Chinese growth, while slowing, isn't showing any signs of crashing. The government seems committed to maintaining growth within its expected range, utilising various stimulus programmes while remaining vigilant in capping frothy areas (e.g., the property market). This won't necessarily prevent pain for certain sectors, but it shouldn't imperil broad growth in the world's second-largest economy. Retail sales continue topping 10% y/y.[xxxiii] Industrial production and fixed asset investment are also growing at healthy clips. Both the government's and Caixin/Markit's PMIs are in expansionary territory. As the monthly data shows, China continues transitioning its heavy industry- and export-driven model to consumption-led growth—a process that will take years and doesn't necessitate the oft-feared "hard landing." The evidence suggests growth is fine.

Other EMs

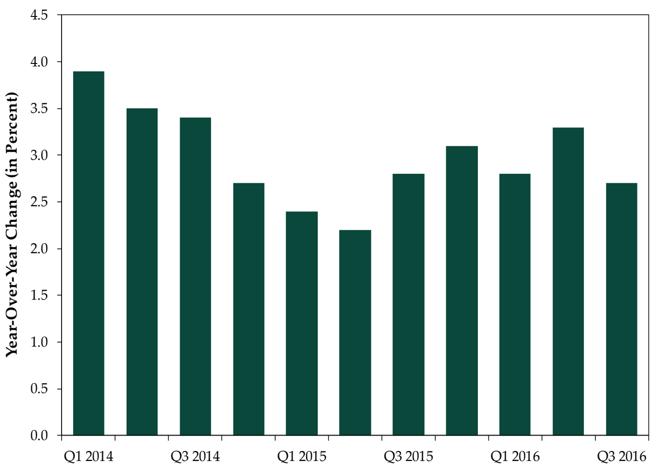
In a marked contrast from earlier in the year, Energy wasn't the driving force behind Emerging Markets' (EM) rally. EM Energy underperformed in Q3, while EM Technology—our largest sector overweight—led, returning 16.1%. Similarly, countries that aren't reliant economically on commodity production mostly outperformed, while oil-dependent countries struggled to keep up. In their place, non-commodity-reliant EMs—most notably Korea, China and Taiwan have outperformed.

Looking ahead, we expect EMs with less commodity exposure and stronger domestic consumption to lead. So, too, should sectors tied to growing demand both at home and throughout the developed world—namely, Consumer Discretionary, Financials and Technology. Like non-commodity-reliant EMs, these sectors all trailed the MSCI EM during Energy's countertrend but have rallied nicely since. EM Tech firms are especially well-positioned, as demand for software and hardware among consumers and enterprises alike, and firms throughout Emerging Asia play a key role in the global supply chain. Health Care, another overweight sector, has struggled as US campaign trail rhetoric about restricting prescription drug prices has dampened sentiment toward the sector globally. However, this should fade as political gridlock forestalls major change, allowing otherwise strong fundamental drivers (e.g., rising demand for prescription drugs and health services in the emerging world) to regain influence. While India's recent decision to expand its list of price-controlled drugs is a negative for the sector, positive reforms elsewhere—most notably Indonesia which rejected drug price caps in Q3—should offset it.

Taiwan's GDP grew 2.0% y/y in Q2, and August and September export order rose 8.3% y/y and 3.9%, respectively – led by electronics and information technology orders.[xxxiv] August was the first year-over-year gain since March 2015, and the gauge will be widely watched as a possible signal of health for Technology demand. Also, August industrial production smashed estimates, rising 1.8% m/m (7.7% y/y), the third gain in four months.[xxxv]

Other Emerging Markets—particularly those with developing consumer bases—continue growing, too. After slowing a bit in 2015, growth is picking up in Korea, as shown in Exhibit 16, driven by household spending (and on services in particular).

Exhibit 16: Korean Growth Since 2014



Source: FactSet, as of 25/10/2016.

Exemplifying the power of consumption-driven growth, countries like Mexico and Indonesia are expanding apace despite sizable segments of their economy knocked by low energy prices. Though Mexican GDP contracted -0.2% q/q in Q2—the first quarterly contraction since 2013—this seems more like a blip than a sign of trouble.[xxxvi] On a year-over-year basis, Mexico grew 2.5%.[xxxvii] Though its mining sector has struggled, manufacturing hasn't tanked, and services including transportation and financial services have grown over the past year. Similarly, retail sales volumes (8.9% y/y in July) signal consumer demand isn't wavering.[xxxviii]

Indonesia grew 5.2% y/y in Q2, with household consumption a primary driver.[xxxix] Beyond healthy domestic demand, however, government spending has also picked up recently. This could be evidence President Joko Widodo's promised infrastructure spending is starting to take effect—a positive for the country.

Financial liberalisation also continues in some EM nations. In Peru, for example, the new administration has responded to falling commodity prices by launching legislation to reform the tax code and labour markets (bringing more workers into the formal economy) and modernise the financial system to boost productivity outside the mining sector. While our Peruvian overweight detracted in Q3, if politicians are able to pass and implement these measures—which would reduce the country's economic dependence on copper exports over time—it should be a modest tailwind.

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. Source: MSCI, FactSet, as of 14/10/2016. Average price return of the seven upgraded and seven downgraded nations before and after the change, in US dollars. Analysis excludes Bangladesh, Serbia and Lithuania due to data availability.

ii. Ibid.

iii. Source: FactSet, as of 13/10/2016. Real Estate sector weight in MSCI World.

iv. Ibid.

v. Ibid.

vi. RealClear Politics, as of 20/10/2016.

vii. Source: US Bureau of Economic Analysis, as of 28/10/2016. Q2 and Q3 2016 Real GDP Growth.

viii. Ibid.

ix. Ibid.

x. Ibid.

xi. Ibid.

xii. Source: The Conference Board, as of 20/10/2016.

xiii. Source: Federal Reserve, as of 21/10/2016.

xiv. Source: FactSet, as of 5/10/2016. Median forecast for Q3 UK GDP quarter-over-quarter GDP growth.

xv. Source: UK Office for National Statistics, as of 20/10/2016. Gross Domestic Product, Preliminary Estimate: July to Sept 2016.

xvi. FactSet, as of 27/10/2016. UK September 2016 retail sales volumes, three-month period versus same three months a year ago.

xvii. Source: Ibid. UK Office for National Statistics' Index of Services output, July 2016.

xviii. Source: FactSet, as of 10/10/2016.

xix. Source: FactSet, as of 3/10/2016.

xx. Source: Eurostat, as of 3/10/2016.

xxi. Source: FactSet, as of 28/10/2016.

xxii. Ibid.

xxiii. Ibid.

xxiv. Source: FactSet, as of 3/10/2016.

xxv. Source: European Central Bank, as of 27/10/2016.

xxvi. Source: Statistics Japan, as of 27/10/2016.

xxvii. Ibid.

xxviii. Source: Japan Customs Office, as of 27/10/2016.

xxix. Ibid.

xxx. FactSet, as of 17/10/2016. MSCI Emerging Markets Index returns with net dividends, 30/6/2016 – 30/9/2016 and 31/12/2015 – 30/9/2016.

xxxi. Ibid.

xxxii. FactSet, as of 17/10/2016. MSCI Emerging Markets Index returns with net dividends, 30/6/2016 – 30/9/2016 and 31/12/2015 – 30/9/2016.

xxxiii. Gavekal India's Quiet Revolution, as of 2/9/2016.

xxxiv. FactSet, as of 17/10/2016. MSCI Emerging Markets Index returns with net dividends, 30/6/2016 – 30/9/2016 and 31/12/2015 – 30/9/2016.

xxxv. Ibid.

xxxvi. Source: FactSet, as of 21/10/2016.

xxxvii. Ibid.

xxxviii. FactSet, as of 1/11/2016

xxxix. FactSet, as of 1/11/2016

xl. FactSet, as of 1/11/2016

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