Fisher Investments Europe™

FIRST QUARTER 2014

MARKET PERSPECTIVES

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FIRST QUARTER 2014 REVIEW AND OUTLOOK
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FIRST QUARTER 2014 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Global equities rebounded from January volatility to finish Q1 slightly positive. We continue to expect positive equity market returns in 2014 as the global bull market continues.

Market Outlook

The bull market is now in its fifth year, prompting some investors to question how much longer equities can keep rising. While bull markets can end for many reasons—age and magnitude are not among them. Unless a bull is truncated early by a sweeping, underappreciated negative force, which we do not expect, it will typically continue until sentiment becomes euphoric to the point where reality cannot possibly live up to investors' expectations.

This is not the case today, while sentiment has improved somewhat in recent months, scepticism still remains quite strong. Fears of overvalued markets, geopolitical tensions in Eastern Europe and anxiety over future US Federal Reserve (Fed) actions have helped keep expectations low. Investors broadly still do not appreciate how favourable the current landscape is. Final data showed the US economy grew 2.6% in Q4 2013, with corporate profits and business investment reaching all-time highs. Nevertheless, investors fretted growing cash levels and rising equity buybacks as signs businesses are not "investing in the future," robbing the economy of future growth opportunities.[i] As news broke the UK grew 0.7% q/q (2.8% annualised) in Q4, with business investment accelerating in every quarter of 2013, headlines continued to warn about an "unbalanced," consumer-driven recovery.[ii] In our view, headlines that continue to view good news negatively indicates equities still face plenty of scepticism.

Looking ahead, the fundamental backdrop for equities globally appears bright. Corporate earnings continue growing, driven by rising revenues and steady profit margins. Economically, the US and UK continue leading the developed world. The Leading Economic Index (LEI) in both countries is high and rising, driven primarily by a wider spread between short and long-term interest rates—a result of less quantitative easing (QE). Severe winter weather in the US weighed on some indicators, but the majority of economic readings released during Q1 showed continued growth. The eurozone's recovery continues, with growth becoming increasingly broad-based and even long-beleaguered Greece showing signs of life, with manufacturing Purchasing Managers Indexes (PMI) returning to growth for the first time since 2009. Ireland exited its 2010 bailout, returning to capital markets with debt yields at pre-crisis lows. China showed some signs of slowing economic growth, which contributed to the usual hard-landing fears, but as we have seen for three years now, a slower-growing China still contributes heavily to global growth.

Risks exist, as always, but most of these risks remain either widely discussed, misperceived, or too small to have significant impact globally. Tensions between the West and Russia over the Crimea and Ukraine likely persist, but in our view, the chance the situation spirals into a severe global conflict is very unlikely. Sanctions on both sides could escalate, but the global economic impact should be small. Sanctions likely hurt Russia, but Russia has been weakening for a while—and with Russia representing only 2.8% of the global economy, growth elsewhere should more than offset.[iii] Similarly, while political disruptions and weakening currencies in Turkey and Argentina rattled markets in January, coinciding with heightened volatility, the troubles are localised and the impacted areas are only a tiny fraction of world output.

New Fed Chair Janet Yellen concerned investors a bit after her first meeting in charge, implying short-term interest rates could rise as soon as spring 2015, but we do not believe this is cause for alarm. For one, Fed press conferences are not indicative of future policy—when the Fed ultimately moves will depend on how policymakers perceive the risk of higher inflation down the road. Furthermore, interest rate increases are not inherently negative for equities—six of the past nine initial rate increases saw positive returns over the next year. How markets will fare after the Fed raises rates this time will depend on the conditions surrounding it and whether the move is appropriate—something we cannot predict today.

THEMATIC UPDATE & MARKET OUTLOOK

More Bull Ahead

Equities were volatile but global markets finished the quarter on a strong note.[iv] Some have interpreted the volatility to mean 2014 will be materially weaker than 2013, but Q1 returns do not predict full-year results.

Investors tend to speculate the recent past will predict the future. However, past performance does not dictate future returns, and equities usually do not move in one direction over an entire year. Even 2013, which many see in hindsight as a straight shot up, had short-lived downside volatility. It is not unusual for markets to end a quarter or two flat, then reward patient investors with strong returns. This pattern occurred in 2006, when the MSCI World Index had a flat return through 13 June, but finished the full year up 20%.[v] In summary, returns often come in bursts.

Despite somewhat higher volatility in January and February, we never experienced a correction (short, sharp downward move of -10% or greater over a few weeks or months). We do not believe this indicates whether markets correct this year—corrections can strike at any time, for any reason (or even no reason) and are impossible to predict with certainty. January's pullback has no bearing on future volatility.

Further, the drop was not very large—peak to trough, the MSCI World Index lost -5.5%, then rebounded to its original level in two weeks.[vi] However, investors were shaken. This was partly due to the media's tendency to sensationalise. With the pullback came excessive stories blaming US Federal Reserve (Fed) policy for currency fluctuations and political turmoil in Argentina and Turkey and predictions of a 1997-style currency crisis in Emerging Markets (EM). This was misinterpreted, in our view, as Argentina's and Turkey's troubles resulted from localised political issues, and Fed bond buying has not had a material direct impact on EM currencies and markets. Investors seemed to realise this as markets quickly recovered, despite Argentina's and Turkey's troubles persisting. In fact, equities in the so-called "Fragile 5" EM—Indonesia, India, Brazil, Turkey and South Africa, which many investors came to believe were particularly vulnerable to foreign investment outflows—all rose in the quarter.[vii]

Looking ahead, we expect 2014 to finish up-a-lot. Though sentiment is starting to become more optimistic, investors still do not appreciate how favourable current fundamentals are. Corporate earnings are growing, with S&P 500 earnings per share hitting another all-time high in Q4 2013—driven by continued revenue growth, despite media claims otherwise.[viii] The US economy is still expanding. The final tally of Q4 GDP showed annualised growth of 2.6%, with business investment and corporate profits hitting all-time highs.[ix] Harsh winter weather disrupted some activity early in Q1 but retail sales, manufacturing output and service sector activity all held up well. The US Leading Economic Index (LEI)—a reliable gauge of future trends—rose all quarter.[x]

Global growth continues, too. The UK's recovery broadened at the end of 2013, as business investment and exports improved alongside consumer spending in Q4.[xi] There, too, harsh weather impacted some economic readings during Q1, though the larger growth trajectory appears intact. The eurozone grew for the third straight quarter in Q4, with recovery increasingly broad-based. Despite widespread fears otherwise, Emerging Markets—China included—continue pushing forward. Politics remain gridlocked in the US, UK and other economically competitive nations. Political turmoil likely continues in some Emerging and Frontier Markets, but the impacted areas are not large enough to significantly affect global commerce or capital markets.

A Striking Parallel

With the global bull market turning five and the economy expanding at a steady, if not robust pace, we find several parallels with the mid-1990s—the middle of history's longest bull market. This does not guarantee the current bull market lasts years longer but it does illustrate the underappreciated favourable backdrop for equities today.

Then, as now, we were five-plus years into a bull market that still appeared to be in its early stages, with small cap leading for an extended period. We were also half a decade out of a banking crisis—the Savings & Loan crisis—similar to how we are now five years past the global financial crisis.

The US similarities are uncanny. Both periods featured second-term Democratic presidents—Bill Clinton then, Barack Obama now. Neither president's party controlled Congress—gridlock kept legislative risk low. In early 1996, the US was coming off several years of below-average GDP, loan and money supply growth—just like today. Then, too, many complained of too-slow growth, but in reality, the economy was in a very good position—growth was moderate and not at risk of overheating, inflation was tame and interest rates were benign. Today is very similar, with growth modest, inflation low and interest rates still near historic lows.

Europe, too, recalls the mid-90s. Continental Europe was recovering from a 1993 recession and currency crisis—akin to the sovereign debt crisis and 18-month recession that ended last June. As written in prior Review & Outlooks, the early-90s crisis stemmed from the European Exchange Rate Mechanism (ERM)—a precursor to the euro. European countries synchronised exchange rates to prepare for euro adoption, but a lack of monetary policy coordination caused the system to fracture. Countries first defended, then discarded currency pegs, depleting foreign exchange reserves and driving regional recession.

The most recent crisis occurred when eurozone nations' divergent competitiveness threatened to tear the currency apart. Lacking the ability to manipulate currency values, struggling nations enacted spending cuts, labour market reforms and more in an effort to restore competitiveness. These austerity measures were a heavy burden, but even the most distressed nations are showing signs of growth as a growing world helps pull a shaky Europe along—just as it did in the mid-90s.

There are some differences—no analogy is perfect. Japan, for example, was the world's second-largest economy and still a powerful force in the mid-90s. Japan today is floundering, and China is number two, perhaps filling the same role. Then, the Internet was technology's new frontier. Today's new technology advances are mobile and cloud computing, hydraulic fracturing (fracking) in energy and biotechnology in health care.

The IPO Factor

Both time periods also featured a developing market for initial public offerings (IPOs) while equity supply remained constrained. Most recall the 1990s as an IPO extravagansa, but the market was not large until many low-quality firms went public late in the decade. In the mid-90s, issuance was more tame—a sign of improving sentiment.

We believe the same holds today. Though some worry about rising IPO activity, the number of IPOs alone is not very telling. Importantly, overall supply is not growing quickly thanks to share buybacks and cash-based M&A. Net issuance (total new offerings minus buybacks and cash-based M&A) contracted at a faster pace in Q1—and has fallen an average of -0.5% to -1% per quarter since 2009. While absolute gross issuance is steady, as a percentage of total market value, it is trending down. The four-quarter buyback total is at a cyclical high, and while equity-funded M&A spiked during Q1, there does not appear to be a noticeable trend.[xii]

Additionally, there does not appear to be evidence of euphoria in the current IPO market. Recent IPOs' initial returns do not come close to IPOs' early returns in the late 1990s, when new offerings would regularly double or triple. Additionally, many recent debuts have decent revenues, even if they are not yet profitable. This is a large difference from 2000, when firms went public with only clicks and hopeful aspirations. IPO trouble comes when countless new offerings lacking real fundamentals are heavily promoted by investment bankers trying to take advantage of an increasingly optimistic environment.

A Long-Lasting Bull

The 1990s bull peaked on 24 March 2000.[xiii] This does not mean the current bull will last similarly long—analogous current conditions do not guarantee an analogous outcome. However, the 1990s showed bull markets can run on and on given the right conditions. This provides a precedent showing equities do not need to roll over soon simply because this bull is of above-average length.

A bull market will keep running until it loses momentum or hits a fundamental negative large enough to harm the global economy causing market surprise. We do not see any fundamental negatives within the next 12-18 months. Risks exist, as always, but none today appear sweeping or surprising enough to disrupt markets.

Furthermore, it does not appear likely that markets will lose momentum in the foreseeable future. Economic and corporate conditions typically exceed investors' expectations through most of a bull market—a powerful force pushing equity prices higher. This bull market has been no exception. US and global economic growth have been lackluster, but even slow growth has exceeded pessimistic growth expectations and fears of global economic disaster have proven unfounded.

Bulls stall when investors become euphoric and fail to notice declining fundamentals, like in 2000. Then, investors were convinced the new internet fueled economy would never falter. Investors stopped paying attention to corporate profits. A US based news outlet, CNN, hosted a debate on whether the economic cycle had fundamentally changed, with "boom and bust" outdated. When demography-based market forecasters predicted in 1999 the Dow Jones Index would hit 35,000 by 2009, everyone believed them. Today, we have the opposite. Headlines claim earnings and revenues are weak, even though both are at all-time highs and rising. Leading indicators are rising, too, but most are concerned over future weakness. Many investors that exited out of equities after 2008 have not yet come back.

We do not know how long sentiment takes to reach the euphoric heights typical of bull market peaks. Distant events are impossible to forecast due to the many unforeseen variables that inevitably arise. However, we would not be surprised if it took a while, considering how long it has taken to get from 2009's deep pessimism to today's growing optimism.

Recent bull markets have trended longer. The 1990s bull lasted nearly 10 years. The 2002-2007 bull was on track to be long, too. When the imposition of FAS 157 (mark-to-market accounting) truncated that bull in October 2007, sentiment was well short of euphoria. We believe the media deserves some credit for this. Mass media both reflects and influences broad sentiment, and media has changed remarkably over the past 30 years. Before, US news sources were limited—three national news networks and a few major national financial publications. Now, multiple 24/7 cable news outlets, dozens of major financial websites and the blogosphere compete for attention. Most of these outlets figured out sensationalism catch readers' attention, and they compete on excitement and exaggeration. They take longer to flip from pessimism to optimism, too. With more media comes more of a herd mentality—no one wants to stand out. They move together, finding consensus as sentiment gradually changes over many years. We would not be surprised if this were to extend bull and bear markets alike, though it is impossible to know with certainty.

A Look Ahead

Forecasting beyond the next 12-18 months is a guessing game. For example, investors often ask what we see over the next five years. We can speculate at possibilities, but it is too far out to predict specific outcomes.

Technology will likely continue advancing and colliding in ways no one can predict today—a positive. Elections globally could heighten political risk (a negative) but could also foster more gridlock (a positive). We know that Baby Boomers (those born between 1946 and 1964) will retire. Some say it could decrease equity demand if they get more conservative, but it could also increase demand if they sell their businesses and invest the proceeds. Others believe an aging America could diminish global consumption overall, but a longer-living population might very well increase consumption of health care, pharmaceuticals, medical devices, and food, among other things. US Social Security and Medicare could keep running big deficits, or the US Congress could pass entitlement reform and markets might not care either way. Debt could rise even as interest payments become still more affordable.

None of this is known with certainty. Possible is not probable, and markets move most on events or developments reasonably probable in the next year or so. That is why we constrain our forecast to this range—it improves the likelihood our outlook is accurate and that we are focused on meaningful factors for markets.

Investor curiosity about the longer term is indicative of where sentiment is today. This is not 2011, when people feared the eurozone collapsing or other disasters happening overnight. Myopic fears no longer dominate, and people are looking further out which is another sign of budding optimism and what you would expect as the sentiment cycle matures. But investors are not yet willing to extend their gaze too far into the future, leaving ample room for sentiment improvement from here. When it eventually reaches a euphoric peak, investors likely will not be asking about the short or long term but will be convinced the future will be great.

Global Growth Continues

Many wonder how this bull market can last without intense economic growth. Some point to the Fed's register of cash on household balance sheets, believing this will make markets rise when investors put it back in equities. However, equities do not need swift economic growth or injections of new money to keep rising. In an auction market, where every transaction has a seller and buyer, what matters is investor willingness to pay more for a share in future earnings. Fundamental reality exceeding expectations, which has been the case since the bull began, is all that is needed for demand to rise. Though sentiment has become more optimistic, investors still fail to appreciate bright economic reality.

Earnings Growth Continues

The gap between sentiment and reality is clear in the broad interpretations of Q4 earnings. Growth continued, with S&P 500 aggregate earnings per share up 8.5% y/y.[xiv] Headlines claimed firms relied on cost-cutting to boost results, citing revenues' 0.8% y/y growth.[xv] Growth rates do not tell the full story, however, and a look at revenue and earnings growth in dollar terms shows growing profits hinge mostly on rising sales, not cutting costs. Because total revenues of $2.7 trillion vastly exceed total earnings of $264 billion, both can grow similarly in dollars but register divergent growth rates—as seen in Q4.[xvi] In Q4 2013, S&P 500 total earnings were up $20.8 billion from Q4 2012; total revenues were up $21.5 billion.[xvii] In 8 of 10 sectors, dollar-based revenue growth beat earnings growth. (Exhibit 1) Energy revenues fell more than earnings and a drop in Financials' costs—largely due to falling legal and regulatory fines and loan losses—helped offset Financials' first year-over-year revenue fall since Q2 2010.[xviii]

Exhibit 1: Q4 2013 Breakdown of US Earnings and Revenue Growth

Sector	Revenues (USD Millions)	Earnings (USD Millions)
Consumer Discretionary	$11,768	$1,588
Consumer Staples	$6,545	$639
Energy	($11,159)	($3,245)
Financials	($30,334)	$9,661
Health Care	$17,375	$1,660
Industrials	$6,692	$3,888
Information Technology	$13,819	$3,860
Materials	$3,145	$1,538
Telecom Services	$1,589	$1,063
Utilities	$2,196	$209
Total (S&P 500)	$21,547	$20,828

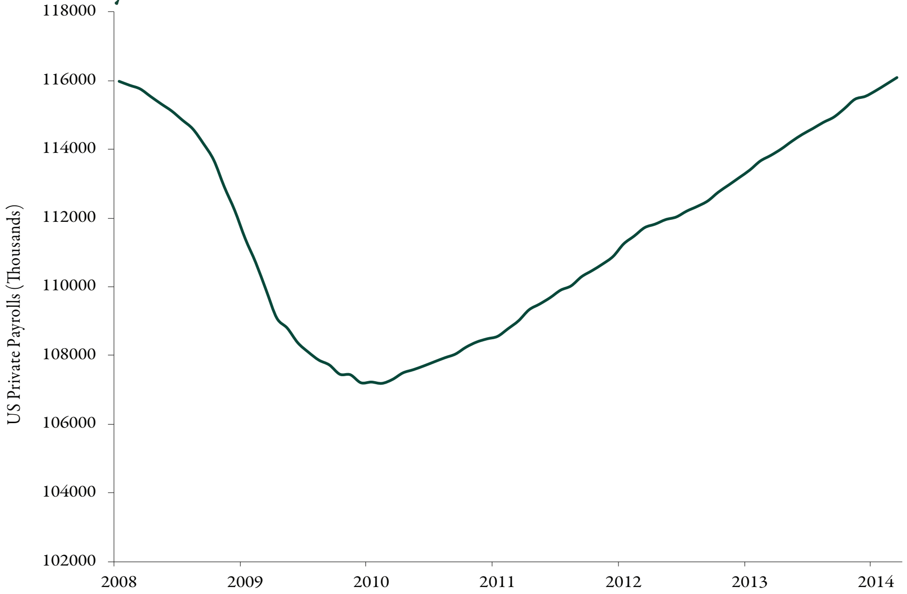
Source: FactSet, as of 17/04/2014. Year-over-year S&P 500 earnings and revenue growth in Q4 2013.

Steady Growth, Low Inflation and the Bull Market

The economic backdrop remains favourable, with growth continuing, though not at a fast pace. In our view, the US economy currently has all the right conditions for a continuing bull market—growth is not too fast or too slow, while interest rates are low and inflation is low. Headlines express the opposite opinion, however, suggesting growth must speed up for the economy to avoid lapsing back into recession. Economies, however, are not airplanes—growth need not rev up to maintain momentum. They are also not subject to the laws of physics, like the force of gravity. Slow growth does not prevent continued growth and faster growth is not necessary for the bull to continue.

The US economy appears in fine shape, at least as far as markets are concerned. The economy entered 2014 with continued growth. GDP grew at a 2.6% seasonally adjusted annual rate in Q4, and corporate profits hit a new high of $1.7 trillion.[xix] This, too, led many to claim firms are cutting costs, with profits high only because firms are not investing. However, business investment hit its first all-time high in real (inflation-adjusted) terms since 2008.[xx] Total business investment has taken longer to recover than the broader economy but the weakness was concentrated in commercial real estate. Investment in equipment and intellectual property (including R&D) passed their pre-recession peaks in Q4 2012 and Q4 2010, respectively, and have continued rising since.[xxi] That firms have produced more with less over the past five years speaks more to productivity gains than inherent weakness. Meanwhile, hiring also continues with March's unemployment report showing total private payrolls passed their prior high, observed in February 2008. (Exhibit 2)

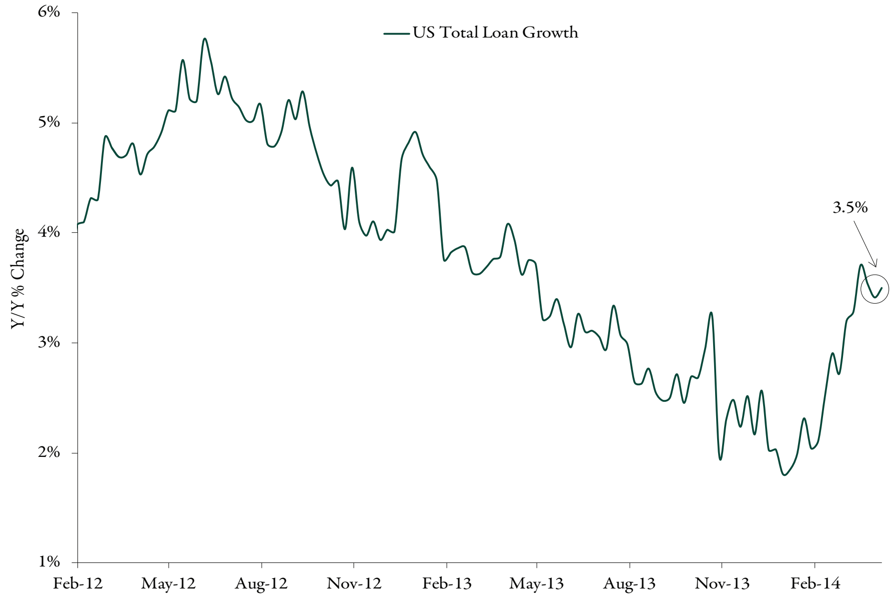
Exhibit 2: Total Private Payrolls



Source: Federal Reserve Bank of St. Louis, as of 14/04/2014. Total private non-farm payrolls, February 2008-March 2014, Current Employment Statistics Summary (Establishment Survey).

Data released during Q1 suggest growth continued. Severe winter weather caused some readings to sway, but it is normal for weather to pull some demand forward and push other activity back. Consumer spending held up, for example, as people spent more on utilities to keep warm, but weather-related factory closures and power outages weighed on services and manufacturing throughout the quarter. Some questioned whether this signaled something more negative than weather, citing slower new business growth, but we do not believe the slowdown says much as most leading economic indicators, including The Conference Board's LEI continued to point higher. As written in past Review & Outlooks, LEI aggregates 10 mostly forward-looking indicators. LEI continued climbing in Q1, led by a widening yield spread.[xxii] The wider yield spread also drove increases in bank lending as a bigger margin between short- and long-term rates—banks' funding costs and loan revenues—made lending more profitable. Total household debt increased for the second straight quarter in Q4—the first consecutive quarters of growth since 2008.[xxiii] In addition, total loan growth rates accelerated noticeably in Q1. (Exhibit 3)

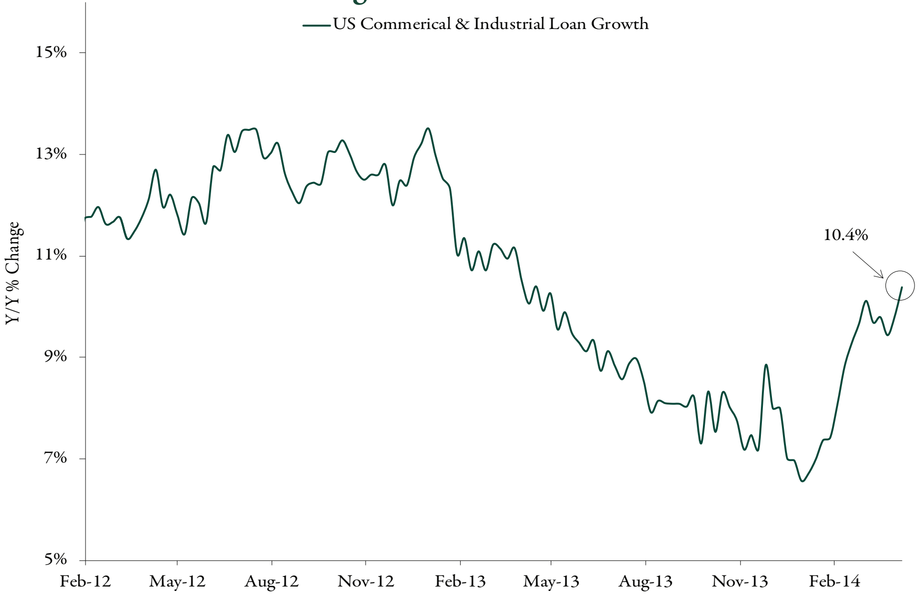
Exhibit 3: Total Year-Over-Year Loan Growth at US Banks



Source: Factset, as of 21/04/2014. Seasonally adjusted weekly assets of Commercial Banks, Loans & Leases in Bank Credit, from 03/02/2012-11/04/2014.

Fed data showed continued growth in real estate and consumer lending throughout Q1. Business lending accelerated in Q1, with commercial and industrial loans growing impressively throughout much of the quarter.[xxiv] (Exhibit 4)

Exhibit 4: Commercial and Industrial Lending Year-Over-Year Growth at US Banks



Source: Factset, as of 21/04/2014. Seasonally adjusted weekly C&I loan assets of Commercial Banks, Loans & Leases in Bank Credit, from 03/02/2012-11/04/2014.

Developed Economies Keep Expanding

The global economy is growing, with the UK among developed-world leaders. GDP grew 0.7% q/q (2.8% annualised) in Q4, bringing 2013 growth to 1.7%—matching 2010 as the fastest of this expansion.[xxv] The UK economy was an undeniable success in 2013, rebounding from 2012's 0.3% rise.[xxvi] Again, the media claimed growth was unbalanced or unsustainable since services and consumer spending were the biggest contributors. Reality does not support this though. Business investment grew in all four quarters. It was the first consecutive four quarter growth since 2006 and 2007.[xxvii] Exports grew over the whole year, albeit at more variable quarterly rates and imports showed similar levels of growth, indicating robust domestic demand. Early data indicate continued growth in Q1, with retail sales and service, manufacturing and construction PMIs showing strength despite England's wettest winter since 1776.[xxviii]

The eurozone recovery continues. In a sign of investor sentiment, headlines greeted Q4's 0.3% q/q growth (1.1% annualised) with claims the eurozone is "finally" recovering—seemingly failing to realise it was the third straight rise in GDP.[xxix] Perhaps that is because growth became increasingly broad-based. Portugal and Spain continued growing at 0.6% and 0.2%, respectively, and even Italy grew for the first time since 2011, at 0.1%.[xxx] Irish GDP fell, largely due to a -10.5% drop in net exports, but capital investment rose 3.1%.[xxxi] Germany—the eurozone's biggest economy—sped up to 0.4% as rising exports and capital investment helped offset a big inventory drawdown and a small dip in household spending.[xxxii] To many, the biggest surprise was France. After French PMIs contracted for most of Q4, most anticipated a recession—even though France's LEI was rising. France ended up growing 0.3%.[xxxiii]

These results speak to what we would largely expect of the eurozone moving forward. Growth likely stays slow and uneven as the region's 18 economies move in fits and starts—normal for any big, economically varied region. As Q4 showed, even if demand in any single economy drops—even one as big as Germany—growth elsewhere can be enough to pull the rest of the region along.

Elsewhere in the developed world, Japan appears to be struggling, but this does not surprise us. As discussed in previous Review & Outlooks, fiscal stimulus and a weak yen alone cannot fix all things fundamentally wrong in Japan. Though they helped GDP bounce back in the first half of last year, growth slowed markedly as the year closed.[xxxiv] Q1 GDP likely looks somewhat better, but improvement does not signal strength. Japan's sales tax rose from 5% to 8% on 1 April, and consumers likely front-loaded big-ticket purchases. This probably boosts Q1 results but weighs on growth looking forward. As will the tax itself, which further burdens households already strained by rising inflation—prices have risen as policymakers hoped, but wages have not.[xxxv] This is an obstacle for Japan, but it should not derail global growth or markets—Japan's weak growth and policy problems are widely known.

Emerging Markets Continue to Grow

With Chinese growth easing to 7.7% in 2013 and several indicators slowing in Q1, hard-landing fears resurfaced.[xxxvi] While growth is slowing, in our view, the data do not support a hard landing. Crashing economies do not achieve double-digit retail sales and fixed investment growth, and China's 7.4% y/y growth rate in Q1 would be considered enviable by most other standards.[xxxvii] Moreover, after three years of hard-landing fears, a slowdown has little-to-no surprise power. Markets long ago absorbed the likelihood of slower Chinese growth. As written in prior Review & Outlooks, what matters more than China's growth rate is its total contribution to global GDP. With China's contribution rising by roughly $327 billion in 2012 and $340 billion in 2013—even as growth rates slowed—it seems clear slower growth rates are not hugely negative.[xxxviii]

Simply, markets have had more than three years to get used to a slowing China. Some indicators wobbled more than investors are used to in Q1, but it is normal for data to vary over short periods, and there were external factors at work. For one, the Lunar New Year holiday week regularly distorts data in January and February as its shifting calendar placement from year to year distorts the year-over-year comparisons—this calendar characteristic bears some of the blame for exports' -18% y/y slide in February. Compounding matters, the comparable same store sales from 2013's first half are likely artificially high thanks to exporters who allegedly wrote up fraudulent invoices to shield illegal capital inflows from the authorities—this inflated export totals at least through April, when officials claimed they began prosecute the practice. March's -6.6% y/y export drop, too, was at least partly tied to these distortions.

Most other readings were similarly variable. Imports fell 11.3% y/y in March, though this followed a 10.8% y/y rise in January and 10.4% y/y rise in February—a prolonged fall would not be great, as imports are an indicator of domestic demand, but time will tell whether the dip is significant or not. Retail sales slowed to 11.8% y/y in January and February combined (these months are usually aggregated to strip out the New Year effect) and industrial production slowed to 8.6% y/y, but a slowdown is not surprising with credit tighter. The same applies for weak readings in both the official and HSBC manufacturing PMIs, which reflect both the squeeze on shadow lending and the government's continued efforts to battle overcapacity. Services PMIs held up far better—notable, as services passed manufacturing to become the largest component of China's economy as 2013 closed.

This is not the first time China wobbled in Q1—we saw similar patterns in 2012 and 2013. On both occasions, however, officials intervened with mini stimulus packages, and growth firmed as the year progressed. Right on schedule, the State Council announced some targeted measures as March closed. Small business tax breaks were extended to more firms, railway investment was boosted (along with measures to increase private investment), and shantytown reconstruction projects were accelerated. Though small, they bear resemblance to measures taken in 2012 and 2013, which largely consisted of targeted tax breaks and acceleration of previously approved infrastructure projects. Full-year growth figures, though slower, were fine.

Some observers might be dismayed by the lack of more sweeping fiscal or monetary stimulus, but those tactics seem out of step with the government's aims. As discussed in detail in previous Review & Outlooks, officials are presently re-engineering China's economic model from export- and manufacturing-led growth to services and consumption. Premier Li Keqiang acknowledged as much in March, when he remarked that the cabinet would consider full-year growth of 7.2% or so as meeting the official target, which he clarified was "around 7.5%." Officials are thinking longer term and are less concerned with boosting growth in the here and now—laying a stronger structural foundation is more important to them, and over time, it is likely more beneficial for China than an easy stimulus fix. Markets are well aware of this and likely look beyond the slowing economy—continued financial reform, in our view, should suffice to satisfy equities.

Overall and on average, broader Emerging Markets continue growing as well. Russia is slowing, but markets are well aware of weakness there as low natural gas and stable oil prices weigh on Russia's state-run Energy industry. Plus, Russia is only 2.8% of the global economy—its lower contribution to global growth in 2013 was more than offset by other countries.[xxxix] South Africa, too, remains imperiled by the slowing in metals and mining. Elsewhere, economies are in better shape.

South Korea closed out 2013 with 3.9% y/y GDP growth in Q4, the fastest pace in three years. Exports rose only 0.7% y/y in the combined January/February period, but they rebounded to 5.2% y/y in March. The weaker yen, so widely feared as a threat to Korean exports since early 2013, has not reduced Seoul's competitiveness. Imports, too, stayed healthy, following the combined January/February 1.4% y/y rise with a 3.5% gain in March. Other Asian nations continue advancing as well. Across the Pacific, Brazil avoided a narrow brush with recession by returning to growth in Q4, and industrial production showed further signs of stabilising throughout Q1. Mexico's service sector pulled back a bit in January, but industrial production achieved its fastest growth in a year at 0.5%, and manufacturing PMIs remained in expansionary territory all quarter.

Risks and the Wall of Worry

As always, risks exist. However, it typically takes a surprising event with the power to upend trillions of dollars of economic activity to cease a bull market, and most risks today lack the necessary size and surprise. Investors have likely already acted on widely known factors (to the extent they would have), sapping their power to move markets for long. It illustrates still-sceptical sentiment that these negatives get significant attention. Today, unlike bull markets' typically euphoric peaks, the investing public is tuned in to negatives and fears.

Tensions in Ukraine

A new fear attracting attention in Q1 was the tension between Russia and Ukraine over Crimea but this is just the newest geopolitical tension to dominate headlines. Last year, it was Syria. The year before, it was fears regarding Israel bombing Iran's nuclear facilities. In 2011, the Arab Spring led to tensions across the entire Middle East and North Africa. While 2008 was a terrible year for equities, the financial crisis was not tied to Russia's invading Georgia. The invasion of Iraq in 2003 occurred at the outset of a strong bull market. The 1990s also were not regional conflict-free (Israel and Lebanon, Israel and Syria, Bosnia, etc.). Regional fighting is terrible for the destruction it brings to the lives, liberty and property of those directly involved, but it is not usually a material factor for global equity and bond markets. This likely holds true again with Russia and Ukraine. The conflict would have to escalate dramatically to have any real market impact.

Tensions between Ukraine and Russia are nothing new. Russian President Vladimir Putin has been increasingly wary of a shift in Ukrainian foreign and economic policy toward the EU. He offered a customs union with Russia and other former Soviet republics instead, seeking to maintain Russia's influence in its backyard. In November, then-Ukrainian President Viktor Yanukovych announced a step away from the agreement with the EU, and massive protests ensued over the next three months. In February, Yanukovych's government reacted violently to the protests. International pressure increased, and Yanukovych stepped down, heading into hiding in Russia.

Putin and Russia saw the ouster of Yanukovych as an affront, and a propaganda campaign claiming the new Ukrainian government consisted of anti-Russian fascists began. Putin cited fears for the security of culturally Russian Ukrainians, particularly in eastern Ukraine and Crimea. Crimea is particularly tied to Russia culturally. The Russian Black Sea Fleet has stationed in Crimea (Sevastopol) since Catherine the Great took the warm-water port from the Ottoman Empire in 1783. In the mid-19th century, Russia fought a bloody war against the Ottomans, British and French over the territory. Russia lost the Crimean War but it retained the territory, and stories of the conflict are etched into Russian military folklore. In 1954, Soviet Premier Nikita Khruschev (of Ukrainian heritage) handed the territory to Ukraine but it was all one Soviet Union anyway. When the USSR dissolved in 1991, Russia negotiated an arrangement to maintain its Sevastopol base.

There is very little evidence Russian Crimeans faced material oppression from Ukraine's leadership, but this is Russia's backyard. Russia militarised the region which later voted to leave Ukraine and join Russia, in a vote most nations do not recognise. The West's language condemning the move is harsh, but so far announced sanctions (largely targeting individuals) are a nonfactor economically. Maybe more sanctions follow, but we are sceptical they will be sweeping in scope.

The highest functioning leg of Russia's economy is its state-run Energy sector, which supplies 30.3% of European natural gas, 34.3% of European oil and 26.1% of hard coal.[xl] Cutting off this energy trade would likely hurt both sides, but most of it would hurt Russia. However, as we mentioned early, Russia is only 2.9% of global GDP, has been weakening for some time and growth in other countries should more than offset any weakness from Russia.[xli]

Germany is Russia's biggest Western trade partner, but Russia accounts for only 4.5% of German trade.[xlii] The US engaged in total trade of $38 billion with Russia in 2013, or 0.8% of US total trade. That is barely a ripple in US GDP—0.2%. Russia is significant to the former Soviet states in the EU—Estonia, Latvia and Lithuania. These are widely considered great success stories in the EU, and as a result, it is unlikely European leaders slap Russia with stiff sanctions imperiling the Baltics. As for Ukraine, it amounts to 0.2% of global GDP and is getting aid from the West, mitigating the impact of its major trade partner—Russia.[xliii]

Perhaps occasional volatility does occur with media pointing at Putin as the cause, but barring any major global escalation, it is highly unlikely markets suffer any fundamental or lasting fallout from the Crimean tensions. The situation is worth following for potential escalation, but as of this writing, there are no material signs of it. If the scenario does not change, the Ukrainian conflict appears to be a case of a great military/geopolitical power exerting control over matters in its bordering regions. This is common historically and poses little, if any, threat to the bull market.

Affordable Care Act

The Affordable Care Act (ACA) continued to garner frequent headlines as implementation progressed and the enrollment "deadline" approached. As we frequently say of politics, the only real deadline is the next election—all others can be moved. The ACA's deadlines have moved frequently.

Whatever your opinion of this politically charged law, implementation and deadlines carry little, if any, weight for markets. Surprise power is gone. Delay after delay, implementation problems, policy change, policy challenge—all have been highly publicised, and none arrived speedily. ACA implementation is the opposite of surprising. In addition, the ACA is not a takeover of the US health care system—it is health insurance reform. The majority—about 85%—of the publicly traded health care sector is medical device firms or pharmaceuticals, which are less affected by ACA than insurance and health care providers.[xliv]

Most of the still-lingering fears tied to ACA seem unrelated to markets. They are long-term concerns—things years down the line with no current market impact. These include the long-range costs and effects on government finance, the effect on health care quality, full versus part-time work, growth of the entitlement state or others. There is no one living who can forecast all these long-range outcomes, and we are not inclined to try. Virtually anything is possible. Maybe the system enrolls many previously uninsured individuals, consumption of preventive medicine rises significantly and catastrophic health care costs fall. Maybe employers significantly curtail employee plans, kicking folks onto the exchanges, but they compensate employees with higher cash compensation. Maybe private health care insurance suffers the fate private unemployment insurance did when the New Deal federalised it. (It died.) Maybe a Republican president and Congress are elected in 2016 or 2020 or 2024 and the law is repealed in full or in part. All of these are possibilities, but none can be forecast.

Moving Towards a European Banking Union

The EU's pending banking union continued to develop in Q1 as the European Commission, Council and Parliament overcame key differences on the Single Resolution Mechanism (SRM)—common rules for winding down failing banks. Progress on the agreement, however, stalled at quarter-end on concerns it could prevent central banks from acting as lender of last resort.

The 20 March compromise between Parliament and member states was what both sides deemed a workable middle ground between the member states' 19 December agreement and Parliament's draft legislation. While the basic framework of the December agreement remained in place, the bank backstop fund was accelerated and the approval framework for bank resolution was streamlined. The €55 billion backstop fund will now be funded over eight years (down from 10) and will be mutualised earlier (40% in the first year, on 1/1/2016, and 60% in the second year). Finance ministers will set bank levies to build the fund.

The key compromise on the resolution approval framework involved reducing national governments' influence—a concession Parliament saw as necessary to prevent resolutions from being slow and unwieldy. Under the compromise, the process is now as follows: After the ECB identifies a bank as likely to fail, an independent "resolution board" will decide whether there is systemic risk associated with the bank's failing. If not, they will adopt a resolution scheme and authorise any potential use of the backstop fund. The European Commission will then review the board's decision—particularly scrutinising the use of backstop funds—and if Commissioners reject the proposal, it will be sent back to the resolution board. Finance Ministers still have the power to reject resolutions in certain cases, though these instances will be limited.

Overall, the compromise was an incremental improvement. The backstop fund's earlier mutualisation should slightly weaken the link between sovereign nations and their banks, and the more streamlined decision making process should help some when markets are panicking. However, there remains a lot of bureaucracy as any bank failure and subsequent resolution must still be agreed upon by three different organisations (the ECB, independent board and European Commission). Additionally, several key questions remain, including what would trigger resolution and creditor or depositor "bail-ins." The vague criteria leave room for regulators to act inconsistently and potentially too hastily, potentially setting up significant uncertainty down the road—not a near-term issue, but something to stay aware of.

One of these issues came to light as Q1 closed, when UK officials realised a bank's use of the Bank of England's Emergency Liquidity Assistance facility could technically trigger resolution proceedings and force losses on shareholders, creditors and large depositors.[xlv] This programme was used extensively in late 2008 (as were similar facilities in Ireland and Belgium) and is largely credited with continuing the financial crisis's fallout in the UK (and the impetus for former Prime Minister Gordon Brown's infamous "we saved the world" declaration). Officials asked for a rewrite of the provision in question so central banks could continue acting as lender of last resort—even when the lent funds are guaranteed by the state—but some countries, specifically the Czech Republic and Denmark, are currently not keen on reopening negotiations as they believe the UK's requested adjustments introduce too many loopholes.[xlvi]

With the European Parliament set to vote on the legislation in early April—and all parties hoping to finalise matters before May's elections—time is running short. If the draft regulations are not amended, it could vastly alter central banks' roles, potentially negating one of their primary purposes. For over 100 years, having central banks serve as lender as last resort has been key to much greater financial stability—it is no coincidence banking panics became extremely rare after the Fed's creation in 1913. Removing this key function could very well end up compounding the very problem EU regulators and politicians aim to solve.

These regulations are still in flux, so it remains premature to draw any firm conclusions—the near-term risks, in our view, are minimal. There could be consequences the next time Europe's financial system is under severe stress and the ongoing negotiations and potential amendments are important looking forward.

Politics in France

In Q4 2013, headlines named France Europe's "sick man"—a claim Purchasing Managers Indexes (PMI) pointed to contraction and a continued declining economy, bucking the eurozone's overall recovery that began quarters earlier. The economic pressure has weighed heavily on French President François Hollande's popularity—a factor leading him to greatly moderate from the Socialist staples he victoriously campaigned on in 2012's election. Q4 2013 GDP data denied the recession expectations—output grew 0.3% y/y.[xlvii] Reality in France is brighter than many claim. However, few in the media or public seemed to register that, heaping pressure on Hollande. As he has since election, this is forcing Hollande to the political middle, reducing the likelihood of extreme legislation. The political driver in France has been a positive for French equities—and it appears likely to continue.

In January, France's National Audit Office announced French sovereign debt would reach 93.4% of GDP when 2013's complete data are tallied, generating a round of French debt fears. These fears, too, seem misplaced to us. The figure is gross debt, not net—and therefore counts debt the French government itself owns. Additionally, French interest payments amount to 2.6% of GDP—down from 2.8% in 2003.

Regardless, in part due to debt fears, Hollande announced another round of French economic reforms, also in January. Like earlier deficit reduction targeting reforms, the latest round includes spending reductions—€50 billion enacted from 2015 through 2017 via government streamlining. Further, Hollande promised to reduce bureaucracy, offer tax incentives designed to spur worker training programmes and eliminate €30 billion in certain payroll taxes. In February, Hollande announced a plan to stabilise corporate tax rules and reduce obstacles to international trade. Hollande claims he can enact these reforms by presidential decree, avoiding some in his own party upset by the seemingly centre-right policy proposals. His actions on these issues are worth watching.

At quarter end, French voters went to the polls to vote in municipal elections. While not directly a vote for or against the Socialist party nationally, municipal votes often reflect satisfaction with the various parties nationally. The Socialists did not fare particularly well.

While Anne Hidalgo upset the anti-Socialist trend to become Paris' first female mayor, this was one of the few victories the Socialist could celebrate. The Socialists lost control of more than 150 municipalities nationwide. The big winners in France this spring were the centre-right Union for a Popular Movement, the party led by former French President Nicolas Sarkozy until 2012. UMP won the majority of Paris' suburbs—surrounding Hidalgo in more heavily populated regions. They also took many traditional Socialist strongholds, like Toulouse and Limoges—a city run by left-leaning parties since before World War I. In all, a poll conducted by newspaper Le Figaro suggested on a national basis, UMP took a larger share of the vote—45% versus the Socialists' 43%, while Marine Le Pen's euro-sceptic, far right party, the National Front (FN), garnered 7%.[xlviii]

Much of the media's attention centered on the uptick for FN, but their successes were mostly centered in small cities with relatively small populations. The exception was Marseille's seventh district and its 150,000 citizens, which ranks as FN's largest-ever win. FN won 13 municipalities across France, a sharp rise from zero but a bit short of Le Pen's claim her party is now a "major independent force."[xlix] It is very premature to suggest it represents a landmark shift and not mere disaffection with Hollande.

Socialist politicians, including Hollande, took the election results as a signal voters sought a more overtly centrist government. In their immediate aftermath, Hollande requested and received the resignation of Prime Minister Jean-Marc Ayrault—replacing him with Manuel Valls. Valls is a Socialist by registration, but he is noted for being outspoken against the party orthodoxy. Just two years ago, his run for the presidency ended with him receiving less than 10% of the vote, while the Hollande's appeal to his Socialist base won him the presidency. Instead of quashing his political career, Valls' widely perceived pro-business and a political centrist stance has catapulted him from being a political outsider to the second highest ranking seat in the Party.

Hollande's government moving toward the middle is just another sign fears over France stretch far beyond reality. Rather than taking an anti-business stance—as was thought likely by many investors and analysts when Hollande was elected—he has moderated greatly. This political moderation has been a tailwind for French equities, and is one contributor to their cumulative outperformance since Hollande was elected—outperformance that continued (albeit slightly) in Q1 2014.

Italian Reforms

Italy received a new Prime Minister (PM) in February, after the ruling Democratic Party's (PD) leader, Matteo Renzi, rallied other party leaders to unseat Enrico Letta. Renzi became Italy's fourth PM in two years and its third straight unelected Premier—and for a month, the 39-year-old was the EU's youngest-ever PM (until 34-year-old Taavi Rõvias was sworn in as Estonia's PM on 26 March). Renzi's agenda is ambitious, and Italy would benefit from many of the proposed changes, but how much he accomplishes remains to be seen.

Topping Renzi's agenda is a two-pronged electoral reform package aimed at modernising Italy's archaic political system and giving future governments more clout—ending the succession of weak, fractured coalitions. The first half focuses on the lower house. Under the proposed system, if a party wins a general election with at least 35% of the vote, they will get an automatic 18% majority premium in the lower house. The remaining seats will be divided proportionately among the parties meeting the minimum threshold for parliamentary participation (5% for coalitions and 8% for single parties). If no party won 35%, the top two hold a runoff, the winner gets 53% of the seats, and the remaining parties divvy up the rest.

The lower house passed these reforms in mid-March, but they have not cleared the Senate, and things are looking formidable. The second half of the proposed reforms focuses on the Senate, which currently must approve every law. The proposed changes would replace the directly elected senators with representatives from each of Italy's regions, strip most of the chamber's legislative power, and force it to play more of a consulting role (similar to Germany's upper house). Renzi and former PM (and convicted felon) Silvio Berlusconi co-wrote these reforms in January, but Berlusconi's support has cooled dramatically. His Forza Italia party's power is concentrated in the Senate, and losing the chamber would significantly reduce his influence over Italian Politics.

Renzi has staked his political future on electoral reform, vowing to quit if the Senate reforms are blocked. However, Berlusconi has demanded the reforms be renegotiated. Mathematically, Renzi does not need Berlusconi's support—PD, its centre-right coalition partner, the aptly named New Centre-Right Party, and their junior partners have enough Senate seats to pass the legislation without Forza Italia. However, if more than 15 lawmakers rebel and vote against the change, Renzi will need at least some Forza Italia senators to break with Berlusconi.

The saga will likely play out well into May, at the very least. Renzi hopes to have the deal done before the European Parliament holds elections on 25 May, but given the divide between him and Berlusconi, that seems a touch ambitious.

In the meantime, progress on economic reform remains tepid. Parliament did pass a measure to streamline local governments, reducing some bureaucracy and spending, and Renzi has announced some small tax cuts. He pledged to cut spending by €26 billion over the next two years, but his cabinet has not said where the cuts will fall. Symbolic measures, including the sale of 151 government-owned luxury cars on eBay, happened relatively quickly, but more substantive and wide-reaching reforms are moving slowly. The cabinet's latest estimates say labour reforms may take over a year to finalise—assuming Renzi is still in office then.

In short, while the faces have changed, it is largely business as usual in Italian politics—big plans and slow progress. While Italy would benefit from more substantive actions and a freer economy over time, the status quo is not necessarily negative—gridlock also impedes less business-friendly reforms, which is a silver lining. Furthermore, markets are quite used to Italian political stalemates.

The Scottish Referendum

With the referendum on Scottish independence less than half a year away, projections about the economic impact of a "yes" vote seem to be everywhere. Some reports say it could hollow out Scotland's banking industry. Others say declining North Sea oil output would endanger an independent Scotland's public finances. Debate over whether Scotland could continue using the pound and how much of the UK's national debt it would absorb continues.

In our view, it remains far too premature to speculate. For one, while the "yes" vote is gaining some traction, it is still polling behind "no" at (41% yes to 46% no, with 14% undecided).[l] Should voters ultimately choose independence, it does not mean Scotland secedes overnight. Rather, it gives Scotland's government a mandate to negotiate an independence agreement with the UK government—a process that could take a substantial length of time. Debt alone could take ages—if the "yes" campaign wins, the UK has pledged to guarantee all debt issued up to the moment Scotland becomes independent, but the government still expects Scotland to assume a share of the national debt. How much Scotland would end up accepting would likely be the subject of fierce, protracted debate.

While there would undoubtedly be winners and losers if Scotland were to secede, the near-term market impact is likely minimal. The length and breadth of the negotiation process should give markets ample time to discover and digest the changes well before they occur.

The discovery process has already started. For example, while Scottish First Minister Alex Salmond has said an independent Scotland would continue using Sterling—and threatened to default on Scotland's share of the natural debt if the UK denies Scotland membership in a currency union—both the Treasury and Bank of England have ruled out a formal currency union. This would not prevent Scotland from using the pound anyway, similar to how Ecuador and El Salvador use the US dollar, but Scotland would have no say in its own monetary policy, and the Bank of England would not serve as lender of last resort. Neither would be a positive development for Scotland, but that these outcomes are part of the conversation allows markets to slowly get used to them, limiting their surprise power in the event of a "yes" vote. As for that threatened default, this is likely more a negotiating ploy than an actual policy prescription.

As for Scotland's broader public finances, some speculate an independent Scotland would have to slash projected spending, as they believe declining North Sea oil output will cause tax revenues to fall short of recent projections.[li] Revenue jitters are exacerbated by certain Scotland-based banks' warnings that they will likely redomicile to England or elsewhere within the remaining union if Scotland goes. Interest costs, too, remain up in the air—without a current market for Scottish debt, it is unclear how big a premium investors will charge for Scottish sovereigns. However, markets may not be in the dark for long. In February, the UK government granted Scotland authority to issue debt in its own name, without Treasury backing. Should Scotland take them up on the offer, it would give leadership the ability to test its market clout, and give investors a clear view into the market's expectations of an independent Scotland.

Market Liberalisation in China

China's ongoing financial liberalisation took a key step forward in Q1, when officials allowed the country's first ever onshore corporate bond default—a necessary prerequisite for having a true market-based system.

Historically, whenever a domestic firm has risked missing a loan repayment, the government has intervened—typically by directing state-run banks to font the cash and guaranteeing the loans. Officials long considered financial rescues necessary to maintain a stable, orderly financial system—which they considered necessary for political and social stability. However, this tactic distorted the market. Because debt came with an implicit government guarantee, markets were not able to price risk efficiently, prices were less transparent, and capital was not flowing to the most productive users.

When Chinese leaders pledged last November that the market would play a "decisive role" in China's economy, most anticipated this would involve a break with bailout tradition—it was just a matter of when. In January, a "wealth management product"—essentially a securitised package of entrusted loans—offered by China Credit Trust Company nearly defaulted. However, this occurred amid widespread fears over a potential contagion in the so-called shadow banking sector, and the government stepped in at the last minute, persuading strategic investors to lend the issuer 3 billion yuan to cover its obligations. China's credit markets seemed placated by the move, but the default watch continued.

On 4 March, Shanghai Chaori Solar Energy Science and Technology (aka Chaori Solar) announced it wouldn't make an 89.8 million yuan interest payment due bondholders on 6 March. Bondholders held a protest outside a local government office in Shanghai to demand assistance, but officials did not bend. Chaori Solar's board secretary said officials were "treating the debt crisis according to market rules," and the default proceeded.

While the default was a negative for bondholders, it is a positive step toward gaining market-driven interest rates. In a free market, bond yields are influenced by risk—the higher the default risk, typically, the greater the compensation investors demand in exchange. To get truly market-driven interest rates—as officials have pledged—markets need to be able to efficiently price risk. If all bank and corporate debt comes with an implicit guarantee, the market cannot do its job—the issuer's creditworthiness takes a back seat. If the implicit government guarantee evaporates, pricing becomes more efficient and markets more transparent.

If officials continue this course of action, it should promote a healthier corporate bond market over time. As investors pay more heed to companies' creditworthiness, balance sheets and business plans, they will likely allocate capital more efficiently. As long as investors believe they can count on officials to backstop their industry of choice, they will likely spend good money on bad companies, not caring about corporate profitability and the likelihood the business gets an actual return on that investment. This robs healthier, more productive companies of investment—companies that would ultimately likely use that cash far more efficiently. Take the government out of the equation, and profitability becomes more important, and investors ultimately give stronger companies more capital so they can invest and grow, either incentivising the weaker firms to get more competitive or languish. It would also likely foster better corporate governance and business planning—the risk of default makes for better corporate accountability.

Officials' resolve will likely be tested over the next several months as other firms risk making payments. Premier Li Keqiang warned of forthcoming defaults in mid-March, calling them "unavoidable," but if some large issues go under, officials may still feel tempted to intervene.

Some outlets have theorised that Chaori Solar's default will prove to be China's "Bear Stearns moment," likening it to the two Bear Stearns hedge funds that collapsed in 2007—the event widely seen as the proverbial shot heard round the world in the global financial crisis. While we believe this misperceives what happened in 2007/2008, the comparison seems to be a huge stretch. While defaults likely do lead to some repricing of risk, it is highly unlikely that this triggers asset fire sales and write downs on the scale of the $2 trillion the US financial sector wrote down after mark-to-market accounting rules forced firms to take paper losses on mortgage-backed debt they planned to hold till maturity.

China's markets will almost surely have to make some adjustments, with interest rates likely to rise, but rising rates does not mean a contagion. It is exceedingly unlikely every issue in China's $1 trillion corporate bond market is at risk of insolvency. Some companies are troubled, but their troubles have been widely discussed for quite some time, just as Chaori Solar's troubles were well-known long before they defaulted. While heightened fears could drive volatility in the near term, in our view, the troubled sections of China's corporate bond markets should lack the size and surprise power necessary to materially impact markets in the mid-to-longer term.

Korean Reforms

President Park Geun-hye celebrated her first year in office by launching a big economic reform initiative in late February. The proposed reforms, which include some tax cuts and broad deregulation, aim to reduce Korea's reliance on exports and develop the local service sector, heightening the country's long-term economic potential.

Korea's current model—a legacy of the policies of Park's father, former President (and longtime dictator) Park Chung-hee—favours manufacturers and exporters. This helped foster strong growth in the latter half of the 20th century, but services were left behind. Korea's service sector currently accounts for 58% of GDP, vs 71% in Japan, 76% in the UK, and 78% in the US.

Low investment in services bears much of the blame for this. Because the tax code favoured manufacturers, most capital went there. Outdated regulatory measures compounded matters. For example, a number of foreign banks have scaled back their Korean operations, citing bureaucratic barriers to running a profitable business. Not only does it rob Korea of foreign investment, but it reduces competition in banking and potentially makes credit less available.

The proposed changes, which Park plans to enact over the next three years, aim to make life easier and cheaper for all service-based firms. The broad goals include reducing regulations in finance, health care, software development, tourism and education. Zoning restrictions, too, should become far less onerous. One already-announced change involves lifting an infamous ban on construction in designated "school zones," which has prevented one conglomerate from building a luxury hotel on a vacant lot in northern Seoul for over seven years—a flashpoint in a seven-hour televised cabinet debate on deregulation in late March. Other early changes include lifting the bans on modifying commercial vehicles and doing business in parks, which officially legalises food trucks—a small change, but emblematic of the archaic regulations that restricted small and upstart businesses.

On the tax side of things, the cabinet plans to change the corporate tax code to reduce the extra burdens on the service sector and no longer favour manufacturing. Officials believe this will attract significantly more investment over time, particularly in R&D. Other tax adjustments include raising the incentives for businesses to hire women and young people in order to broaden Korea's workforce and fulfill prior campaign pledges to improve "economic democratisation."

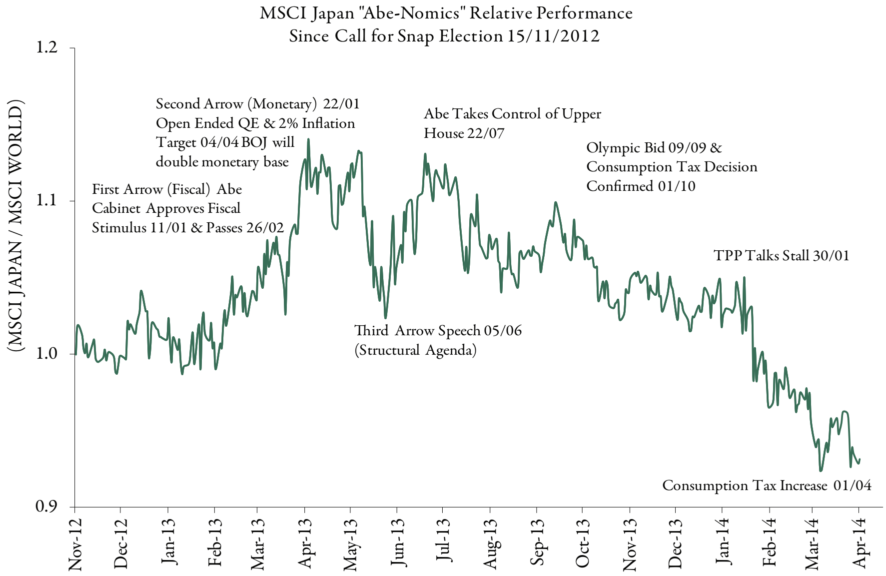
Other broad pledges include capping the total number of regulations—enacting a requirement to eliminate one existing restriction for every new one introduced—easing restrictions on the resale of primary property purchases, increase funding for start-ups to $3.7 billion by 2017, encourage the construction of new homes, and subsidise home loans for low-income first-time buyers. Reforms of state-run firms are also in the works, which include lowering the 2017 public debt target for 18 highly indebted institutions by 9%.

While none of these changes will boost Korean growth overnight, they represent an encouraging, decisive shift in policy. Throughout 2012 and 2013, the current and prior government relied on a series of short-term fiscal stimulus measures to jumpstart sluggish GDP growth. While these provided a quick boost, structural reform—assuming officials see these proposals through—should create a better foundation and more sustainable improvement in the long run.

Still No Third Arrow

Japanese equities underperformed in Q1 as free trade negotiations stalled, Prime Minister Shinzo Abe's reform efforts stagnated and the 1 April sales tax hike approached. (Exhibit 5) Given Japan topped many analysts' 2014 forecasts, many were perplexed by the disappointing returns, but we were not surprised. Expectations for Japan have been far too high, in our view, since Abe became PM in December 2012, and we expect the country to continue underperforming looking ahead.

Exhibit 5: MSCI Japan Relative Returns



Source: FactSet, Fisher Investments Research, as of 01/04/2014

When Abe became PM on promises to restore Japan's economic (and military) might, investors' expectations soared. Abe promised to fire "three arrows" at Japan's long-declining economy: aggressive monetary stimulus, fiscal stimulus and economic reform. It was not the first time that economic reforms had been promised, but with a 70%-plus approval rating, Abe seemed to have the support. He also seemed to understand the importance of pursuing all three policies— the whole is greater than the sum of the parts. That would suggest Abe knew pursuing monetary stimulus or fiscal stimulus, alone, would not cut it.

As a result Japanese equities rose, enjoying a sentiment-driven rally as Abe initiated monetary and fiscal stimulus in early 2013. Abe's cabinet front-loaded ¥10.3 trillion in fiscal stimulus, and the BOJ launched an open-ended "quantitative and qualitative easing" (QQE) plan to increase the monetary base by ¥62 trillion in 2013 and ¥70 trillion this year, with a goal of weakening the yen and bringing inflation to 2% annually within two years. As for reform, Abe has talked a lot but not taken any action. Throughout 2013's first half, he assured investors his "growth committee" was exploring ways to cut corporate taxes, reform the labour code, improve corporate governance and encourage large businesses to restructure, improving competition. That created expectations for groundbreaking measures to be announced in June, but the package died—it was full of unrealistic growth targets and general wants, but short on actual policy changes. Minor reforms like casino legalisation, small incentives for female labour force expansion and ending the decades-old system of direct payments and quotas for rice farmers kept markets somewhat satisfied. However, promises of vastly freer trade, capital spending increases, efficiency and productivity increases, deregulation to growth industries such as health care and labour mobility measures seemed to never materialise.

Japan optimists tried to rationalise the disappointing proposals by saying Abe did not want to pursue what could possibly be controversial reforms just before July's upper house election. And Abe, with an upper house victory in his belt, did gather the press for another reform announcement in September—but this, too, lacked anything concrete. When Abe tried again in January, claiming he would "drill" through vested interests in order to finally bring Japan into the 21st century, few took him seriously.

Early on, to the untrained eye, monetary stimulus and fiscal stimulus seemed to work. Real GDP grew at seasonally adjusted annual rates of 4.5% and 4.1% in Q1 and Q2, respectively, and export values soared thanks to the weak yen. Inflation, too, improved. Still falling when Abe took office, CPI was positive by June and finished February 2014 at 1.5% y/y. However, a closer look revealed that these improvements were superficial. Export volumes barely increased even as values regularly rose over 20% y/y—the weak yen did not do much for actual output. It also hurt businesses and households by making imported energy far more expensive—not a great development for a country relying on foreign fuel after taking every nuclear power plant offline. The inflation number is largely a function of expensive imported fuel: Excluding food and energy, inflation is up to just 0.7% y/y as of February—this is not a virtuous cycle of growth and prices lifting each other. It is the negative effect of higher energy prices.

Now, consider the sales tax hike. It was raised from 5% to 8% on 1 April. Consumers have been front-loading big-ticket purchases in advance, with household spending growth outstripping GDP growth in Q4. Common sense says that pull-forward effect would last until the tax took effect, yet household spending fell -0.25% in February. That also defies the main premise behind the government's efforts to drive up inflation. As their logic went, while Japan remained in deflation, consumers would always delay spending in hopes of a better deal—higher prices were supposed to encourage people into spending more today. The problem with this idea is, if prices and overall cost of living rise while wages stay stagnant, people will be forced to save wherever they can. Some major firms recently agreed to raise base salaries for the first time in years, but overall, wages have not kept pace with prices.

Japanese households, simply, are squeezed. Finance Minister Taro Aso announced the government's solution in late March: frontload 40% of Japan's fiscal-year spending into Q2 to offset the expected drop in demand. It is the same tactic Japan has tried, off and on, through 17 years of lackluster growth. We doubt it works any better this time.

We also would not put much stock in Abe's continued reform pledges. Abe is expected to unveil a new growth strategy in June including special economic zones to attract foreign investment, tax reform and reduced protectionism. However, the likelihood of sweeping change still appears low. Labour reform to relax strict termination policies, immigration reform to offset a declining population, meaningful corporate governance reform, reductions in one of the highest corporate tax rates in the world, a resumption of a broad nuclear power programme to provide relief to rising utility costs, and free trade policies such as the stalled Trans-Pacific Partnership all face significant entrenched opposition. Special economic reforms could attract broad support, but these are unlikely to feature sweeping deregulation.

Compounding matters, Abe is still spending significant energy pushing for a buildup of Japan's self-defense forces—a lifelong ambition—and these initiatives are costing some hefty political capital. Pacifist coalition partner New Komeito is not pleased, and insiders say the government's cracks are showing. Meanwhile, within Abe's Liberal Democratic Party, some factions are disappointed by slow economic progress and proposed electoral reforms that would cut into the party's rural power base. The agricultural lobby is upset over the Trans-Pacific Partnership and other pending free-trade agreements, which would require Japan to slash tariffs on long-protected products. Agriculture, along with labour groups and the notoriously bureaucratic Japan Business Federation, are the vested interests Abe will have to drill through.

Japanese equities have now underperformed, cumulatively, since Abe's election. Looking ahead, there does not appear to be much reason for this to radically reverse course. With economic drivers deteriorating and reform likely remaining on hold, we believe better opportunities lie elsewhere.

Turkish Taper Terror

Emerging Markets fell harder than developed countries when global equities pulled back in late January. Investors feared currency slides in Turkey, South Africa and Frontier Market Argentina were the start of a categorical currency crisis caused by the Fed's "tapering" of quantitative easing (QE). For years now, many pundits have held the belief QE propped up Emerging Markets economies and markets by prompting a flood of hot money into developing countries, setting them up for a crash once QE ended and flows reversed.

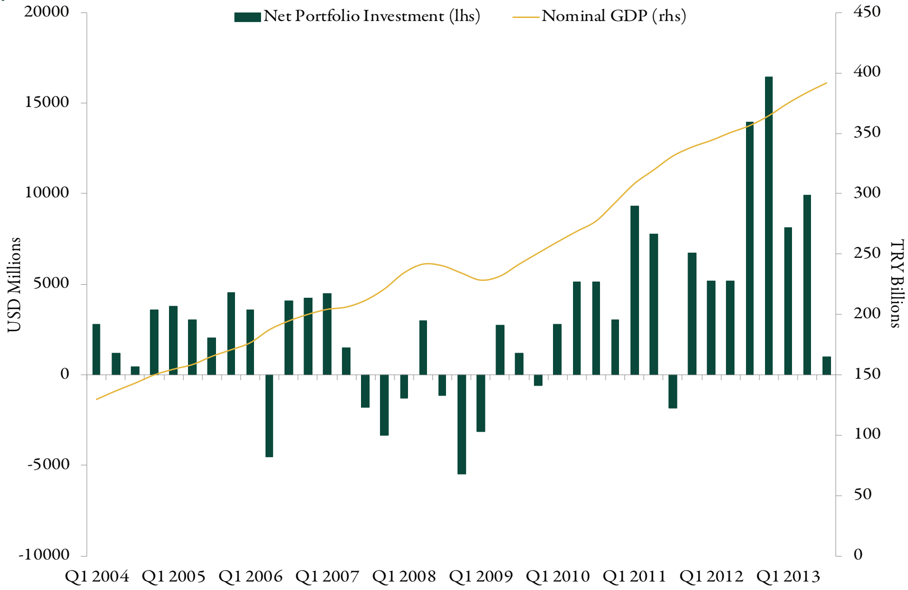
As written in prior Review & Outlooks and elsewhere, this narrative is largely a false fear that does not square with fundamental reality. For instance, if developing economies were fueled by massive amounts of foreign money during QE, we would probably have seen fast growth—not the general slowdown that actually happened. The same goes for asset prices—Emerging Markets equities have not wildly outperformed during this bull market. There is little evidence Emerging Market equities were artificially inflated by QE. Two, the widely discussed capital inflows are largely myth. Foreign portfolio investment inflows were high when QE began, but that was mostly a reversal of huge outflows during the financial crisis. Since then, they have fallen off and are largely in line with historical norms (and have often turned negative over the past couple years).

Turkey, South Africa and Argentina's currency troubles stemmed from localised issues. South Africa's economy is extremely commodity-dependent. Its fortunes largely depend on metals and mining—locked in a deep slowdown after years of heavy investment created a supply glut. That weighs on prices, and as commodity prices go, so goes South Africa's economy and the rand, overall and on average.

Argentina is in increasingly bad shape. Since defaulting in 2001, the country has been shut out of international capital markets. President Cristina Fernandez's socialist policies—including price controls and the seizure of foreign-owned oil interests—have chased off most private investors. The central bank depleted forex reserves trying to keep the peso afloat, but inflation is still off the charts. It finally gave up trying in late January, temporarily discarding the peg and allowing market forces to take over and drive down the peso. After the devaluation, officials claimed it's at an "acceptable level," resuming measures to hold it in place.

Turkey, formerly the symbol for 21st century development, received the most attention. Most believed Turkey was a big recipient of QE capital inflows , and it is true the country has occasionally seen high portfolio investment inflows since QE began, but there does not appear to be a direct relationship between the two. As shown in Exhibit 6, net inflows were quite choppy through 2010. They have gained steam since in absolute terms, but so has Turkey's economy. For much of that span, Turkey was considered one of Emerging Markets' success stories, with a rapidly modernising economy and ambitions to join the EU (many observers were willing to turn a blind eye to Prime Minister Recep Tayyip Erdogan's increasingly authoritarian methods, which included weakening the military and silencing journalists). Higher inflows since 2011 were likely tied to the growing opportunities as Turkey expanded and gained more international notice.

Exhibit 6: Turkey Portfolio Investment Inflows vs. GDP

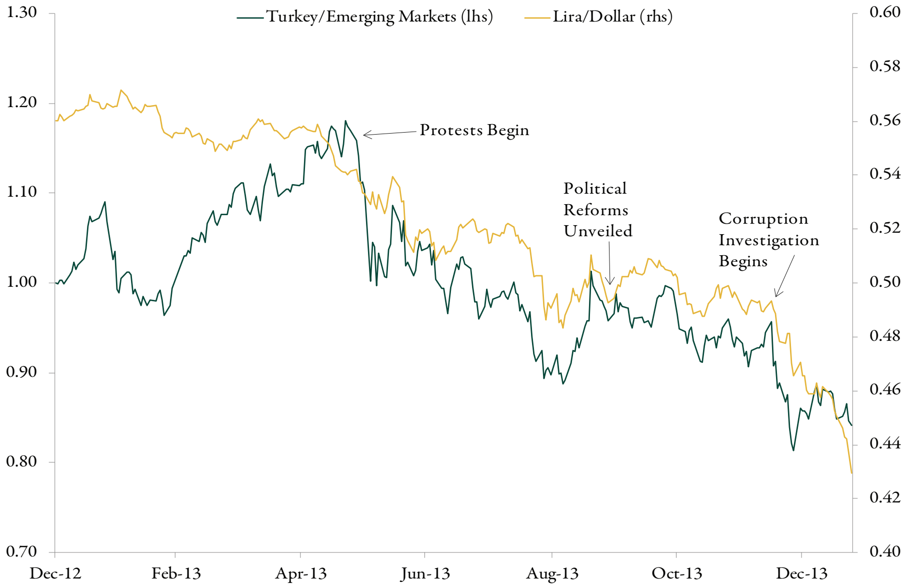


Source: Central Bank of the Republic of Turkey, Federal Reserve Bank of St. Louis, as of 27/01/2014.

Turkey's problems stem from within its borders—namely, from mounting political instability (something most Emerging Markets do not share). Late last May, what began as a small protest against the destruction of a public park turned into countless throngs demonstrating against Erdogan across 20 cities—and suffering police brutality for their trouble. According to one report from the Turkish Medical Association, protesters were exposed to tear gas "for up to eight hours a day over multiple days," in June, and thousands reported lingering after effects in September.

The violence startled markets (Exhibit 7). The lira had been relatively stable and Turkish equities outperforming for much of 2013's first five months, but that changed when the protests kicked off. The lira plunged, Turkish equities underperformed wildly, and portfolio investment flows turned negative in June and July—when violence was at its peak. Markets briefly stabilised late last year—and portfolio investment inflows were positive through November—after Erdogan announced a raft of shallow political reforms, but the trouble began anew in late December, when the judiciary hit Erdogan with a corruption investigation. Protests resumed (and then some), Erdogan sacked dozens of judges, and the ruling and opposition parties came to blows in Parliament (landing the opposition's deputy leader in the hospital). The crackdown was swift and brutal, with Erdogan likening the unrest to civil war.

Exhibit 7: Turkish Markets and Unrest



Source: FactSet, as of 27/01/2014.

This unrest is what touched off the lira's January freefall. Political chaos drives massive investor uncertainty. Compounding matters, political concerns tied the central bank's hands. Typically, central banks will intervene to stem a currency slide, hiking overnight rates to attract foreign capital. But Turkey's central bank operates under the control of Erdogan's and he has all but ruled out a rate hike by fiat, denouncing it as out of step with the country's cultural aims. So the bank has resorted to using its forex reserves, by some reports depleting one-third of its net reserves since June. It has not helped, however, and now the central bank is in a pickle. As the currency slide accelerated, policymakers first tried to placate both Erdogan and the markets, keeping money market rates at 7.75%—except for special "additional monetary tightening days," when they would rise to 9%. But the lira kept falling—haphazard monetary policy fueled, rather than helped, uncertainty. So they acted again, raising the overnight lending rate from 7.75% to 12% and the borrowing rate from 3.5% to 8%, and they switched the main policy rate to the one-week benchmark repo rate and hiked it from 4.5% to 10%.

The lira has since stabilised, as has Turkey's political situation. Voters went to the polls for local elections just before Q1's end, and Erdogan's Justice & Development Party (AKP) won a stronger than expected share of the vote at 46% (vs. 28% for the main opposition Republic People's Party). This was AKP's largest showing in local elections since its 2001 formation, though it roughly matches the level of support it received in the 2011 national elections.

The victory appears to show that while the corruption scandals and surrounding turmoil may have further polarised those who already opposed Erdogan, they have had very little effect on his or his party's overall popularity. This is despite his strong-arm tactics, which included a Twitter ban—a move denounced by Turkey's president—which took effect two weeks before the election and ended mere days after.

Turkish political theatrics likely are not over. Erdogan followed the local contests with a speech promising to punish his rivals for backing a foreign led conspiracy to topple his government. He said, 'tomorrow there may be those who have to flee. But we will go into their caves. They will pay the price." The results likely also affect his potential run for President in August—the first time the position will be elected—which many suspect he will do to remain in power after getting termed out of the premiership. For now, however, markets seem to have interpreted the results as increasing political stability—a positive, despite the impact of the unrest on citizens quality of life and private property.

A Look at 2014 US Midterm Elections

As always, our political commentary is intended to be nonpartisan and approach issues solely to assess potential market impact (or lack thereof). Political bias is blinding.

Our Q4 2013 Review & Outlook shared our analysis of the structural backdrop of this fall's US midterm election, which favours continued gridlock. Gridlock greatly mitigates the risk the government enacts sweeping legislation affecting property rights or other factors potentially impacting markets. Big, broad legislative change is likely also politically contentious. While the bitterness of debate may occasionally stir some emotion, markets tend to smile on little legislation. However, structural factors do not guarantee outcomes—they are just a baseline for determining probabilities and the degree of campaign success necessary for either party to win a majority. It is too early to project the results, but there are a few factors we believe will influence the outcome or help shape markets' expectations.

How State Houses Impact the Senate

Democrats have more vulnerable Senate seats and they are playing defense. However, for Republicans, gaining a majority would take near flawless campaigning, akin to 1994's "Republican Revolution" or 2010's big midterm win. This is possible, but flawless campaigning takes resources. The Senate races are not the only contests vying for GOP funds. Thirty-six states hold gubernatorial races. These structurally favour Democrats, who must defend only one Republican-leaning state (the other 13 contested Democratic governorships are in states President Obama carried in 2008 and 2012). Republicans must defend nine states in Democratic territory. Of these contests, three occur in states where Democrats are defending Senate seats—Branstad (Iowa), Snyder (Michigan) and Martinez (New Mexico). (Exhibit 8)

These three gubernatorial races are among the most vulnerable seats the Republicans have in 2014. However, their corresponding Senate seats are basically must-win if the Republicans are to win a Senate majority. For the Republican Party, it is a question of resources. Which races are the most important? Which get more campaign cash? If Republicans choose to spend most of their cash defending vulnerable state houses, it could divert resources away from the Senate races in these same states. This would counterbalance their structural advantage.

As the election nears, many in media will likely point to special elections as an indicator for the direction of midterms—as they did with March's special election in Florida, which went Republican. These are not predictive, however, and nor are widely discussed states like Illinois. States with both Senate and gubernatorial races are more telling, and how polls shape up in these races will be a key indication of how the post-midterm Congress may look.

Exhibit 8: Gubernatorial and Senatorial Races in 2014

State	Governor	Senator	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
WY	Mead (R)	Enzi (R)	67%	69%	65%	69%
OK	Fallin (R)	Inhofe (R)	60%	66%	66%	67%
ID	Otter (R)	Risch (R)	67%	68%	62%	65%
AR	Beebe (D)	Pryor (D)	51%	54%	59%	61%
AL	Bentley (R)	Sessions (R)	56%	62%	60%	61%
NE	Heineman (R)	Johanns (R)	62%	66%	57%	60%
KS	Brownback (R)	Roberts (R)	58%	62%	57%	60%
TN	Haslam (R)	Alexander (R)	51%	57%	57%	59%
SD	Daugaard (R)	Johnson (D)	60%	60%	53%	58%
TX	Perry (R)	Cornyn (R)	59%	61%	55%	57%
AK	Parnell (R)	Begich (D)	59%	61%	59%	55%
SC	Haley (R)	Graham (R)	57%	58%	54%	55%
GA	Deal (R)	Chambliss (R)	55%	58%	52%	53%
NH	Hassan (D)	Shaheen (D)	48%	49%	45%	46%
IA	Branstad (R)	Harkin (D)	48%	50%	44%	46%
CO	Hickenlooper (D)	Udall, M. (D)	51%	52%	45%	46%
MN	Dayton (D)	Franken (D)	46%	48%	44%	45%
MI	Snyder (R)	Levin (D)	46%	48%	41%	45%
NM	Martinez (R)	Udall, T. (D)	48%	50%	42%	43%
OR	Kitzhaber (D)	Merkley (D)	47%	47%	40%	42%
ME	LePage (R)	Collins (R)	44%	45%	40%	41%
IL	Quinn (D)	Durbin (D)	43%	44%	37%	41%
MA	Patrick (D)	Markey (D)	33%	37%	36%	38%
RI	Chafee (D)	Reed (D)	32%	39%	35%	35%

Source: The Cook Political Report, as of 04/04/2014.

Countertrends in Rural and Urban Polls

Another key factor to watch will be trends in urban and rural polling. Each party's power base has become increasingly concentrated geographically in recent years. The Democrats' base is now largely in high population density areas—the major cities—while the GOP's support covers a broader geographical area, but one with much lower population density.

If either urban or rural areas shift party preference, it could drive a landslide for the party benefitting. Should this happen, it could give Republicans control of the Senate or Democrats the House.

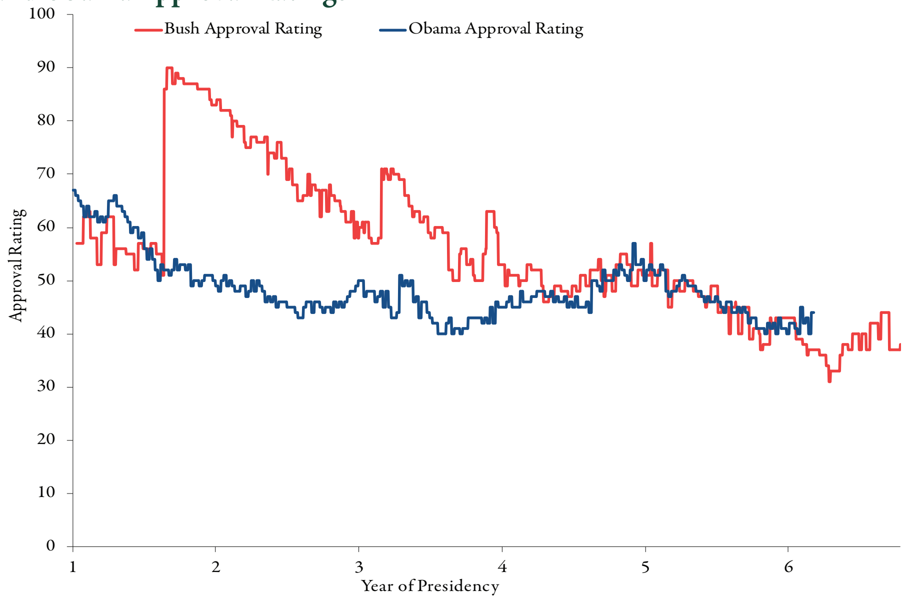
Obama's Approval Rating

The president is widely seen as the standard bearer for his party, and his approval rating often suggests voters' attitudes toward his party. Since President Obama's reelection, his approval ratings have largely tracked former President George W. Bush's at the same point in his second term. (Exhibit 9)

The explanations are not yet clear. Perhaps post-Internet Americans disdain second-term presidents. The prior three presidents' approval ratings—Clinton, George H.W. Bush and Reagan—do not match George W. Bush's and Obama's. The pattern of declining approval may simply show second-term presidents are victims of information overload. Voters may be tiring of a president's pitch due to the near-constant media and punditry coverage. This constant barrage of media coverage via Twitter, YouTube and many more sources was not prevalent prior to the Bush II administration.

In our view though, it would be myopic to ignore the parallel's potential implications for November's contests. Bush's sixth year—2006—was characterised by near-persistent popularity decline. This seemingly found official form in the 2006 midterms when Democrats won a major victory, picking up 6 Senate seats, 31 House seats and 6 governorships.

Exhibit 9: Bush and Obama Approval Ratings



Source: Gallup, as of 02/04/2014.

In recent weeks, the pattern has diverged some. However, if Obama's numbers do not improve further and Bush's declining popularity is a guide, it signals a potentially big Republican rout—increasing the odds Senate control shifts. Again, this is not our expectation as of now—the race remains too early to handicap, and any number of as-yet unknowable variables could influence Obama's popularity in the coming months. But this is a factor to follow as Q2 unfolds. Will Obama's approval rating continue to diverge from Bush's, or will it revert?

In-Depth: What Janet Yellen and the US Federal Reserve Did in 2008

Janet Yellen debuted as the head of the Fed at the FOMC's March meeting, and monetary policy largely stayed status quo. Monthly quantitative easing (QE) bond purchases were reduced by another $10 billion to $55 billion, and the fed-funds target rate stayed in the 0-0.25% range. Investors seized the official policy statement's removal of a 6.5% unemployment rate as a threshold for considering a rate hike—officials will instead consider "a wide range of information" on labour markets, financial developments and inflation.

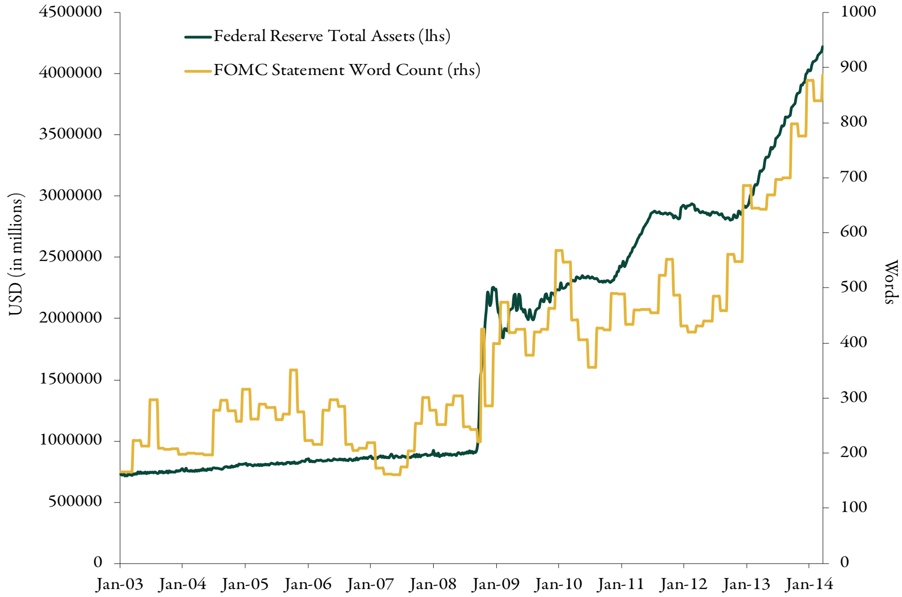
Forward Misguidance

The financial media did not take kindly to this change, assuming future Fed policy should be transparent and predictable—a fallacy largely stemming from former Chair Ben Bernanke's pledge to communicate more than your typical Fed chief. In our view, this is misguided. Central banks are not supposed to be transparent and have historically sought to be vague. Alan Greenspan once said, "Since I have become a central banker, I have learned to mumble with great incoherence. … If I seem unduly clear to you, you must have misunderstood what I said."[lii]

Central bankers know if they are too clear, investors will try to front-run them, and they do not want to be held to concrete expectations. If they act contrary to what folks believe their guidance suggests, they lose credibility—and credibility is key. Forward guidance was never meant to be a clear statement of what the Fed will do. It was merely a tool Bernanke used to put markets at ease about supposedly premature tightening. While Bernanke talked of transparency and communication, he did not deviate much from the Greenspan mold. FOMC policy statements became lengthier as his tenure progressed, giving the appearance of more explanation and transparency but extra words are often used to distract. A concept articulated in 15 words, rather than two, is not as clear.

In our view, it is no coincidence the Fed's statements have grown in word count as its balance sheet has swelled. (Exhibit 10) As policy became more multifaceted, it took more words to cloud it. Word count jumped when QE began in late 2008, jumped again with QE2 in November 2011 and has increased steadily since indefinite QE began in December 2012. Yellen hit a new high of 887 words in March.

Exhibit 10: FOMC Statement Word Count vs. Fed Balance Sheet



Source: Federal Reserve. Total Assets of Federal Reserve Banks, 01/01/2003-19/03/2014, and the word count of every regular policy statement during this period.

Market reaction to Yellen's guidance change further shows why Fed heads want to be vague. When pressed, Yellen admitted rates could rise six months after QE ends. Markets sold off, judging her policy statement as a rate hike on autopilot that will come too soon—a headache for Yellen, whom headlines decided "laid an egg."[liii] She said nothing of the sort, hedging her language throughout—"about six months or that type of thing"—but introducing a number still makes the error of being too specific. Most jumped to conclusions about market impact, forgetting initial rate hikes in a tightening cycle have no relationship with equities. (Exhibit 11)

Exhibit 11: MSCI World Index Returns Following Initial Rate Hikes

Date of Initial Hike	Six Months	12 Months	18 Months
16/07/1971	4.1%	13.5%	24.9%
16/08/1977	-1.5%	15.0%	17.3%
21/10/1980	-1.0%	-13.3%	-16.3%
27/03/1984	-0.9%	8.8%	17.9%
16/12/1986	34.7%	14.6%	30.2%
29/03/1988	-1.2%	11.1%	22.1%
04/02/94	0.3%	-2.9%	10.3%
30/06/1999	14.4%	11.0%	-1.6%
30/06/2004	10.1%	8.1%	18.4%
Average	6.5%	7.3%	13.7%

Source: Global Financial Data, Federal Reserve, as of 24/03/2014. MSCI World Price Index Returns following the announcement of the first rate hike in the past nine tightening cycles.

Part of the Problem, Not the Solution

Implicit in the worries over Fed guidance is another fallacy. The obsession assumes the Fed presents the solution to any perceived economic problem, whether that is too-slow growth, too-low inflation, too-high inflation, too-high unemployment or something else. Whether it is QE, swap lines, lending facilities or interest rates, investors believe the Fed can and must have the perfect solution for everything—including potential asset bubbles. We see it differently. To paraphrase Milton Friedman, the Fed—and central banks in general—is much more often the problem. Central bankers' ability to spot asset bubbles—or broader problems in financial markets—is demonstrably woeful. The world experienced this in 2008.

A Look Back at the US Financial Crisis From the Fed's Viewpoint

Five years from the financial panic, many still believe anyone and everyone could have, should have or did foresee the crisis. As we wrote at the time, these beliefs are based on a widely held misinterpretation of the crisis's causes. Many point to the housing crash and proliferation of mortgage-backed securities (MBS) and credit derivatives, but these are bit players in a larger story—the story of how one accounting rule upended the entire financial system.

The rule in question was FAS 157—the mark-to-market accounting rule—which took effect in October 2007. This rule forced financial firms to mark their assets to the price at which they could sell them in quick transactions, no matter how thinly traded and even if they never planned to sell. These write-downs put pressure on weaker firms, some of whom were forced to sell illiquid assets at prices far below those warranted by the quality of the assets. When one firm sold something at bargain prices, other firms had to use those transactions as reference points when valuing their assets.

Many hedge funds used MBS as margin collateral. As the value of this collateral fell in 2008, they had to liquidate to meet margin calls—with every sale, all banks had to revalue assets accordingly. This led to a vicious circle of liquidations and write-downs, which eventually wiped $2 trillion from the US banking system in mere months. The accounting rule made MBS look like toxic assets, but the toxicity was the rule itself. Loan losses incurred never came anywhere near the amount banks wrote down. And the Fed, which itself took a position in MBS when it backed JPMorgan Chase in its buyout of Bear Stearns, earned a profit on the very assets that took Bear Stearns down. (The Fed is not, and has never been, subject to mark-to-market accounting.)

The result was bank capital fell, institutions hoarded cash and stopped lending to each other, and when some could not secure funding to meet overnight capital requirements, they were deemed bankrupt regardless of their book value. When the Fed and Treasury responded inconsistently to a burst of failures in September, panic ensued.

We are not aware of anyone who predicted how FAS 157 would produce this effect or how the federal government would handle the situation so poorly. We now have confirmation the Fed missed this, too. In February, the Fed released transcripts of every meeting and conference call from 2008. In these 1,825 pages, it is clear Fed officials did not foresee the extent of the financial sector's losses, and they did not grasp the impact of their actions in September.

What Bernanke Saw

The Fed was not blind to FAS 157's impact. Rather, officials vastly underestimated its reach. During a 9 January 2008, conference call, Bernanke estimated the 21 biggest banks would have to transfer up to $300 billion in off-balance sheet assets to their balance sheets, mark them to market and raise capital.[liv] True in theory, but $300 billion was a gross underestimation, as was his forecast of the economic impact which was only tighter consumer credit and a subsequent decline in home prices.

One Fed employee came close to calling it during the 10 March 2008, conference call, when the Fed proposed creating the Term Securities Lending Facility (TSLF), an effort to inject liquidity into the financial system by lending against MBS and other collateral. William Dudley, then manager of the New York Fed's System Open Market Account (now New York Fed President and FOMC interim Vice Chair), warned of a "dangerous dynamic" that could, if left unchecked, trigger a vicious cycle of asset write-downs and fire sales, warping money markets and causing major institutions to become insolvent. He had observed a fall in interbank lending, with deeper haircuts applied to collateral, and he noted some hedge funds were having trouble meeting margin calls—and theorised about how this could roil the financial system:

> Asset price declines—say, triggered by deterioration in the outlook—lead to margin calls. Some highly leveraged firms are unable to meet these calls. Dealers respond by liquidating collateral. This puts downward pressure on asset prices and increases price volatility. Dealers raise haircuts further to compensate for the heightened volatility and the reduced liquidity in the market. This, in turn, puts more pressure on other leveraged investors. A vicious circle ensues of higher haircuts, fire sales, lower prices, higher volatility, and still lower prices, and financial intermediaries start to break as a liquidity crisis potentially leads to insolvency when assets are sold at fire sale prices. … If the vicious circle were to continue unabated, the liquidity issues could become solvency issues, and major financial intermediaries could conceivably fail.[lv]

Though Dudley did not put a number on this or suggest the Fed at least temporarily suspend mark-to-market accounting rules for illiquid, held-to-maturity assets, he came closer than most to describing what ultimately transpired. The FOMC, however, did not pay much attention. Some, like Yellen, Tim Geithner and Donald Kohn, supported Dudley's analysis, stressing the need to stop the spiral of write-downs and deleveraging—act now, iron out regulatory concerns later. Most, however, harped on administrative details, too-big-to-fail and the desire to extend the Fed's regulatory reach. Dallas Fed President Richard Fisher wondered whether the Fed could gain further oversight over broker-dealers—"we need to use this as leverage somehow over the longer term, as we become more comfortable with this, to exert our authority." Philly Fed President Charles Plosser fretted the "slippery slope" of "taking assets of a particular class that is in distress." Richmond Fed President Jeffrey Lacker opposed TSLF entirely: "I have yet to see a plausible case for market failure that would warrant such intervention by a central bank here. In this case, I don't think the concerns raised by the New York staff memo really come close, and it strikes me that they could equally well rationalise buying tech equities in late 2000."[lvi]

Looking Backward, at the Wrong Things

This epitomises Fed behaviour in 2008. Though peripherally aware of ongoing banking troubles, policymakers focused primarily on the potential economic risk from falling home prices. Thus, they never used traditional monetary policy tools to boost liquidity. One time-honored trick is to set the discount rate—the rate where banks borrow from the Fed—below the fed funds rate, at which banks lend to each other. This would allow banks to borrow cheaply from Bernanke, lend at slightly higher rates to each other and pocket the spread—an incentive to move more money through the system more quickly. However, the Fed set the discount rate 25 basis points (bp) above fed funds—and kept it there all year. This was a recipe for a credit freeze.

The Fed's economic forecasts further illustrate how blindsided policymakers were. They continually looked at the wrong factors and backward-looking data. This is abundantly evident in Yellen's forecasts and recommendations. On 9 January 2008, Yellen called rising oil prices and falling home values the biggest economic risks. She supported a 25 bp rate cut, believing the market had priced in extant risks, and feared markets would interpret a bigger cut "as a sign of panic."[lvii] Twelve days (and 9.4% in S&P 500 declines[lviii]) later, she agreed to a 75-bp cut.[lix]

At the Fed's 30 January 2008, meeting, Yellen downgraded her near-term economic forecast based on the December employment report—a late-lagging indicator. But she also foresaw growth in the year's second half after a brief "brush with recession."[lx] She downgraded her forecast again at the March meeting, this time citing "soaring" sales of cheap wine, advocating another 75-bp cut.[lxi] She called for another 25-bp cut at the April meeting, though she also forecast 1.5% growth in the second half, claiming, "The likelihood of severe financial panic has diminished."[lxii] At the June meeting, she raised her Q2 forecast based on strong economic data and predicted continued growth in the second half thanks to fiscal stimulus, though at a slower rate than she first expected, based on a swifter fall in home prices.[lxiii]

By August, Q2 growth had disappointed, stimulus had fizzled and Yellen dropped her second-half growth forecast to 0.75%. She acknowledged worsening credit conditions but claimed the big risk remained falling home prices—or, as she put it, "an adverse feedback loop from tighter credit to higher unemployment, to rising foreclosures, to escalating financial sector losses to yet tighter credit." But oil prices had dropped, so she was comfortable keeping rates on hold.[lxiv]

Lehman Goes Under

Lehman Brothers' bankruptcy filing on 15 September 2008, was the proverbial shot heard round the world. The investment bank's troubles had been well known for a while. After Lehman took big write-downs throughout the spring and summer, other institutions questioned the value of the collateral it posted for interbank loans, and by September, Lehman had extreme difficulty getting funding to meet overnight capital requirements and short-term obligations. Most expected the Fed to resolve Lehman's difficulties as it had handled Bear Stearns and its near-identical issues in March by arranging and helping to fund a buyout by a larger, stable institution. JP Morgan was Bear Stearns' buyer and Barclays was first in line for Lehman. However, the Fed denied Barclays funding, forcing Lehman's bankruptcy and shocking the world with its inconsistent response.

The Fed held its regular September meeting the next day. Transcripts show members celebrating a job well done. St. Louis Fed President James Bullard praised colleagues for "denying funding to Lehman suitors." Richmond Fed President Jeffrey Lacker called the decision "obviously good," and then-Kansas City Fed President Thomas Hoenig and Boston Fed President Eric Rosengren deemed it "the right thing." Then-Fed Governor Kevin Warsh said the decision "not to provide official-sector money" should make everyone "feel good."[lxv]

Yellen did not join the celebrations, but her economic forecast reveals she, too, was out of touch: "My contacts report that cutbacks in spending are widespread, especially for discretionary items. For example, East Bay plastic surgeons and dentists note that patients are deferring elective procedures. [Laughter] Reservations are no longer necessary at many high-end restaurants. And the Silicon Valley Country Club, with a $250,000 entrance fee and seven-to-eight-year waiting list, has seen the number of would-be new members shrink to a mere thirteen. [Laughter]" After minimising the US's economic woes, she suggested keeping rates on hold, believing a 2% fed funds rate, 2.25% discount rate and combination of underused, ineffective credit facilities was "an appropriate response to the turmoil."[lxvi]

No Fed decision maker grasped the severity of the situation their choices contributed to. They did not fathom the uncertainty and panic they caused by making Lehman fail after marrying off Bear Stearns and nationalising mortgage underwriters Fannie Mae and Freddie Mac. They believed Lehman's bankruptcy would end the crisis, not touch off something far worse than anything they had seen to date. One and a half months later, at the October meeting, Yellen stated, "The deterioration in overall financial conditions since the September FOMC meeting is truly shocking."[lxvii]

Looking Forward

The best way to gauge someone's future decision-making ability is to study their actions and the logic behind them. The 2008 transcripts are a powerful record of Yellen's beliefs, thought process and decisions. However, they were released mere weeks after her Senate confirmation vote. Currently, we cannot help but wonder how those confirmation hearings would have gone if Senators had these records at their disposal. Would questions have still centred on her political views, beliefs about income inequality and QE? Or would they have questioned her over her actions in 2008? One can only speculate.

Yellen is Fed Chair because of things she has said and politicians' beliefs about her expertise, not what she has actually done. Her words tell you what she thinks she can do—her track record, as illuminated in the 2008 transcripts, tells you what she has actually done. Actions matter more.

That said, her actions in 2008 are not necessarily a blueprint for how she will act in the future. Fed heads frequently change their feathers once they sit in the big chair. Many do the opposite of what their prior experience, statements and writings suggest. Yellen could very well do the opposite of what her actions in 2008 would indicate. None of this is predictable, however—we, like markets, can only weigh her actions and their likely impact after the fact.

Should you have any questions about any of the information in the First Quarter 2014 Review and Outlook, please contact FIE by mail at 2nd Floor 6-10 Whitfield Street, London W1T 2RE or by telephone at +44 (0)800 144-4731.

Fisher Investments Europe Limited (FIE) is authorised and regulated by the Financial Conduct Authority (FCA). It is registered in England, Company Number 3850593. Fisher Investments (FI) is an investment adviser registered with the United States Securities and Exchange Commission. FIE delegates investment management to FI. As of 31 March 2014, FI managed over $54 billion USD. FI maintains two principal business units – Fisher Investments Institutional Group (FIIG) and Fisher Investments Private Client Group (FIPCG). FIPCG services substantially all private client accounts managed by FI and FIIG services substantially all institutional accounts managed by FI. FI's Investment Policy Committee (the IPC) is responsible for all strategic investment decisions for both business units. The presented strategy is managed by FI. When FI cannot directly manage assets for clients in select European countries, its wholly-owned subsidiary based in the UK, FIE, serves as the investment manager. In this arrangement, FIE delegates portfolio management to its parent company, FI. FIE's Investment Oversight Committee (IOC) oversees portfolio management conducted by FI. The IOC helps ensure FI, as sub-manager, manages the portfolio in accordance with the investment management agreement between FIE and the client. The IPC has ultimate decision-making authority and accountability for the firm's strategies. The IPC is also responsible for all strategic investment decisions affecting this mandate, subject to oversight by the IOC.

FIE is wholly-owned by FI, which is wholly-owned by Fisher Investments, Inc.(FII). Since inception, FII has been 100% Fisher-family and employee-owned, with Kenneth L. Fisher owning more than 75% of FII.

Unless otherwise specified, references to investment professionals, operations personnel, and middle and back office personnel are references to FI employees. "We", "our," "us" and "the firm" generally refer to the combined capabilities of FIE and FI.

This review constitutes the general views of Fisher Investments and should not be regarded as personalised investment advice. No assurances are made FI will continue to hold these views, which may change at any time based on new information, analysis or reconsideration. In addition, no assurances are made regarding the accuracy of any forecast made herein. Some clients may have different benchmarks reflecting different objectives and circumstances. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customisations and start dates may preclude certain elements of this strategy from being implemented. The MSCI World Index measures the performance of selected equities in 24 developed countries and is presented net of dividend withholding taxes and uses a Luxembourg tax basis. The S&P 500 Composite Index is a capitalisation-weighted, unmanaged index that measures 500 widely held US common equities of leading companies in leading industries, representative of the broad US equity market. Past performance is no guarantee of future results. A risk of loss is involved with investments in equity markets.

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Terms of Business:

1. Fisher Investments Europe

Fisher Investments Europe Limited is registered in England and authorised and regulated by the Financial Conduct Authority (FCA). Fisher Investments Europe's FCA reference number is 191609. Fisher Investments Europe's permitted business is advising on investments, making arrangements with a view to transactions in investments, arranging investments, managing investments, and advising on pension transfers and pension opt-outs. You can check this on the FCA's online financial services register: www.fca.org.uk or by contacting the FCA on +44 20 7066 1000.

2. Communications

Fisher Investments Europe can be contacted by mail at 6-10 Whitfield Street, London W1T 2RE, or by telephone on 0800 144 4731. All communications with Fisher Investments Europe will be in English only.

3. Services

These Terms of Business explain the services offered to professional clients and will apply from when Fisher Investments Europe begins to advise you. As part of its services, Fisher Investments Europe seeks to:

a) Reasonably determine your client categorisation;

b) Understand your financial circumstances and investment aims to determine whether a full discretionary service and the proposed investment mandate and accompanying benchmark(s) are suitable for you;

c) Explain features of the investment approach;

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

e) Provide a full explanation of costs;

f) Assist in the completion of documentation;

g) Where specifically agreed, review your position periodically and suggest adjustments where appropriate.

4. Discretionary Investment Management Service and Investments

To help you achieve your financial goals, Fisher Investments Europe may offer its discretionary investment management services. In such case, Fisher Investments Europe will delegate the investment management function, as well as certain ancillary services, to its parent company, Fisher Asset Management, LLC, trading as Fisher Investments, which is based in the USA and regulated by the US Securities and Exchange Commission. Where appropriate, Fisher Investments Europe may recommend that you establish a discretionary investment management relationship directly with Fisher Investments. In such case, Fisher Investments Europe acts as an introducing firm. A separate investment management agreement will govern any discretionary investment management relationship whether with Fisher Investments Europe or with Fisher Investments. Subject to applicable regulations, for qualified investors Fisher Investments Europe may recommend an investment in an Undertaking for Collective Investment in Transferable Securities (UCITS) regulated by the Central Bank of Ireland and managed by Fisher Investments.

5. Client Categorisation

Fisher Investments Europe deals with both retail clients and professional clients. As a user of Fisher Investments Europe's institutional services, you have been categorised as a professional client. You have the right to request re-categorisation as a retail client which offers a higher degree of regulatory protection, but Fisher Investments Europe does not normally agree to requests of this kind.

6. Financial Services Compensation Scheme (FSCS)

The activities of Fisher Investments Europe are covered by the FSCS and therefore if (i) you are eligible to claim under the FSCS, (ii) you have a valid claim against us and (iii) we are unable to meet FI's liability towards you because of FI's financial circumstances, the FSCS will be able to compensate you for the full amount of your claim up to £50,000. However, since you have been categorised as a professional client, you are unlikely to be eligible. You can contact us or the FSCS in order to obtain more information regarding the conditions governing compensation and the formalities which must be completed to obtain compensation. Please note that the protections of the FSCS do not apply in relation to any services provided by Fisher Investments.

7. Custody and Execution

Neither Fisher Investments Europe nor Fisher Investments is authorised to hold client money. This means neither Fisher Investments Europe nor Fisher Investments can accept cheques made out to Fisher in respect of investments, nor can they handle cash. All client assets are held at external custodians where each client has a direct account in their own name. If you appoint Fisher Investments Europe or Fisher Investments as your discretionary asset manager, execution of transactions will be arranged through such custodians and brokers and at such prices and commissions that Fisher Investments determines in good faith to be in your best interests. Further information regarding selection of brokers is set out in Fisher Investments' Form ADV Part 2.

8. Risks

Investments in securities present numerous risks, including various market, currency, economic, political, business and other risks, and can be very volatile. Investing in securities can result in a loss, including a loss of principal. Using leverage to purchase and maintain larger security positions will increase exposure to market volatility and is not recommended.

9. Data Protection

To advise you on financial matters, Fisher Investments Europe may collect personal and sensitive information subject to the Data Protection Act 1998. By engaging in business with Fisher Investments Europe, you consent to Fisher Investments Europe processing your data, both manually and electronically, including transferring data outside the European Economic Area, including to its parent, Fisher Investments, in the United States, for the purposes of providing services and enabling Fisher Investments to provide services, maintaining records, analysing your financial situation, providing information to regulatory bodies and service providers assisting Fisher Investments Europe and/or Fisher Investments in providing services.

10. Conflicts of Interest

Fisher Investments Europe has a conflicts of interest policy to identify, manage and disclose conflicts of interest Fisher Investments Europe, Fisher Investments or any of their employees or representatives may have with a client of Fisher Investments Europe, or that may exist between two clients of Fisher Investments Europe. Fisher Investments Europe's conflicts of interest policy covers gifts and favours, outside employment, client privacy, inadvertent custody, marketing and sales activities, recommendations and advice, and portfolio management. In addition, Fisher Investments Europe provides a copy of Fisher Investments' Form ADV Parts 2A and 2B to all clients.

11. Fees

If you appoint Fisher Investments Europe as your discretionary investment manager, you will pay management fees to Fisher Investments Europe as detailed in the investment management agreement. Fisher Investments Europe will pay a portion of such management fees to Fisher Investments as the sub-manager. If you appoint Fisher Investments directly as your discretionary investment manager, you will pay management fees directly to Fisher Investments as detailed in the investment management agreement. If you invest in a UCITS fund managed by Fisher Investments, Fisher Investments will receive its management fee indirectly through the UCITS. Fisher Investments Europe does not charge a separate fee for its introducing or distribution services. You will also incur transaction and custody fees charged by brokers and custodians. However, any such additional fees will be payable directly to brokers/custodians, and neither Fisher Investments Europe nor Fisher Investments will share in any commission or other remuneration.

12. Termination

If you wish to cease using the services of Fisher Investments Europe or Fisher Investments at any time, then send notification and the arrangement will cease in accordance with the investment management agreement. However, if a transaction is in the middle of being arranged on your behalf at that time and it is too late to unwind it, then the transaction may need to be completed first.

13. Governing Law

These Terms of Business are governed by English law.