FISHER INVESTMENTS EUROPE™

SECOND QUARTER 2013

MARKET PERSPECTIVES

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SECOND QUARTER 2013 REVIEW AND OUTLOOK
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SECOND QUARTER 2013 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Global stocks were largely positive in Q2. The pullback starting in late May seems like normal bull market volatility over the Fed's tapering of quantitative easing (QE) and concerns about China's interbank lending market. Both seem like typical correction chatter rather than anything fundamental.

Market Recap

There's plenty of upside surprise remaining to push markets higher, however—fundamentals are overwhelmingly better than appreciated. The US and global economies continue growing at a modest but healthy pace. Q1 US GDP growth was revised down to 1.8% with government spending still a big drag on growth. Importantly, economic data suggest the private sector continues driving growth as evidenced by corporate spending, manufacturing and consumption. The US Leading Economic Index (LEI) is high and still rising—recessions normally don't start until after the LEI consistently falls for some time. Housing's rebound continues apace, providing a small economic tailwind. Equity valuations remain very favourable amid all-time-high-and-growing corporate earnings. The yield curve is steepening in the US and globally—no thanks to central banks—and contributes positively to future growth. China and other Emerging Markets seemingly slowed some, but global markets don't need robust economic growth for this bull to continue. Even at slower growth rates, China and others still materially contribute to global trade and GDP.

Japanese Prime Minister Shinzo Abe previewed his structural reform programme—the "third arrow" of his agenda to end deflation and stimulate economic growth in the country. However, the initiative fell short of investors' expectations further supporting FI's (Fisher Investments) underweight. It lacks game-changing initiatives like sweeping corporate tax cuts and labour market reform—not surprising, considering these are politically charged measures. Abe likely wants to curry favour ahead of July's upper house election. The investment and trade reforms Abe did announce are positive in theory but far from the changes needed to pull Japan out of its economic malaise. Looking ahead, Abe has suggested further proposals may come after the elections, provided his Liberal Democratic Party secures a majority.

Chinese stocks had a challenging Q2 as investors feared rising interbank rates and a rumoured credit crunch. China did experience an interbank funding squeeze, appearing politically engineered as a measure to reign in non-bank credit growth. The central bank (PBOC) seemingly let interbank funding rates rise in order to force banks to clean up their balance sheets—and eased once it made its point. FI continues to see limited risk of a Lehman-type moment in China. Contagion effect outside the country is minimal, as the sector is closed, state-run and has low levels of foreign credit (lowering risk of capital flight). The Chinese hold $3.4 trillion in foreign currency reserve, protecting against capital flight and currency runs if they were to occur.

FI believes the bull market cycle is at its mid-point, which is typically when earnings growth slows and investors seek stocks they believe will hold up well in that environment. Characteristics like trading liquidity, non-cyclical earnings, balance sheet strength, high market share, geographically diverse revenue streams and name recognition—become increasingly important to investors. FI continues to believe the best days lay ahead for FI's current exposure.

Risks exist—they always do. However, many of today's risks are either widely discussed—and therefore likely already reflected in current market prices—or misinterpreted, like investors' fear of QE tapering. FI covers these topics and more in the upcoming full Review & Outlook.

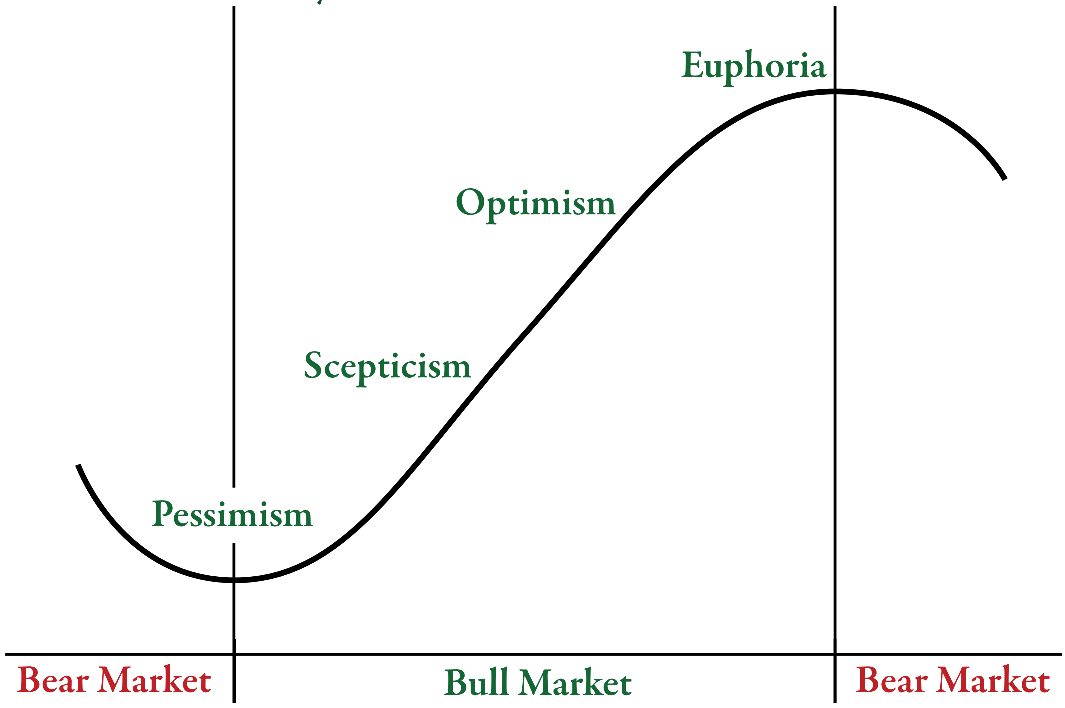
THEMATIC UPDATE & MARKET OUTLOOK

The Bull Continues

Global stocks rallied out of what appears to have been a slight pullback to end the quarter in positive territory. As FI writes, many broad indices including US indices have already reached new highs. Volatility led some to wonder whether a deep correction or even a bear market is in the offing. Volatility may well continue—stocks by their nature are volatile to varying degrees at various times—but it is most likely nothing more than normal bull market deviations. FI has strong conviction 2013 should end with global stocks up a lot (20%+) for the year.

As covered in recent Review & Outlooks, we seem to be somewhere near the mid-point of this bull market. Exhibit 1 illustrates legendary investor Sir John Templeton's famous quote, "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." FI believes we are still somewhere between scepticism and optimism, with most of the second half of this bull market still in front of us.

Exhibit 1: Market Sentiment Life Cycle



Note: This hypothetical graph is illustrative and not indicative of actual returns or market behaviour.

Improving investor sentiment is just one factor likely to support higher equity prices. Though unspectacular by most measures, fundamentals remain much better than broadly appreciated. The LEI, a reasonably reliable indicator of future economic direction, remains high and rising. Globally, yield curve spreads widened during Q2—positive for continued growth going forward. Earnings growth continues to outpace expectations, and firms still have huge amounts of cash available for growth-oriented spending.

With a number of indices near or at new highs, many fear a new high signals a bull market nearing its end. Bull markets end for many reasons; however, neither age, duration nor height is one of them. Bull markets typically hit new highs and run much further. There is nothing fundamental about a new high making stocks roll over. With sentiment still mixed and fundamentals still underappreciated, there is tremendous steam left in this bull.

FI is cognisant the world is not free of risks. However, FI believes today's risks are mostly known—lacking surprise power to knock the bull off course. Furthermore, they are misinterpreted. For example, many fear the potential tapering of the US Federal Reserve's (Fed) quantitative-easing (QE) related long-term bond purchases should remove the primary force driving the bull market. It is not surprising tapering talk has contributed to some market volatility considering how many investors incorrectly view QE's impact on equity markets. However, FI believes the Fed's now endless rounds of QE have been a drag on growth, and slowing or ceasing bond purchases should ultimately be a positive, not a negative—more so because most misinterpret it.

Positive Fundamentals Underpin the Bull

With sceptical sentiment still widespread, many seemingly believe this bull market lacks fundamental support. One common view is the bull market and expansion are due primarily or solely to the Fed's "easy money," (i.e., quantitative easing). Others view the gradual and incremental sentiment improvements in recent quarters as a dangerous level of euphoria signaling an imminent end to the bull. Similarly, many see stocks hitting new highs and fear we have come "too far, too fast."

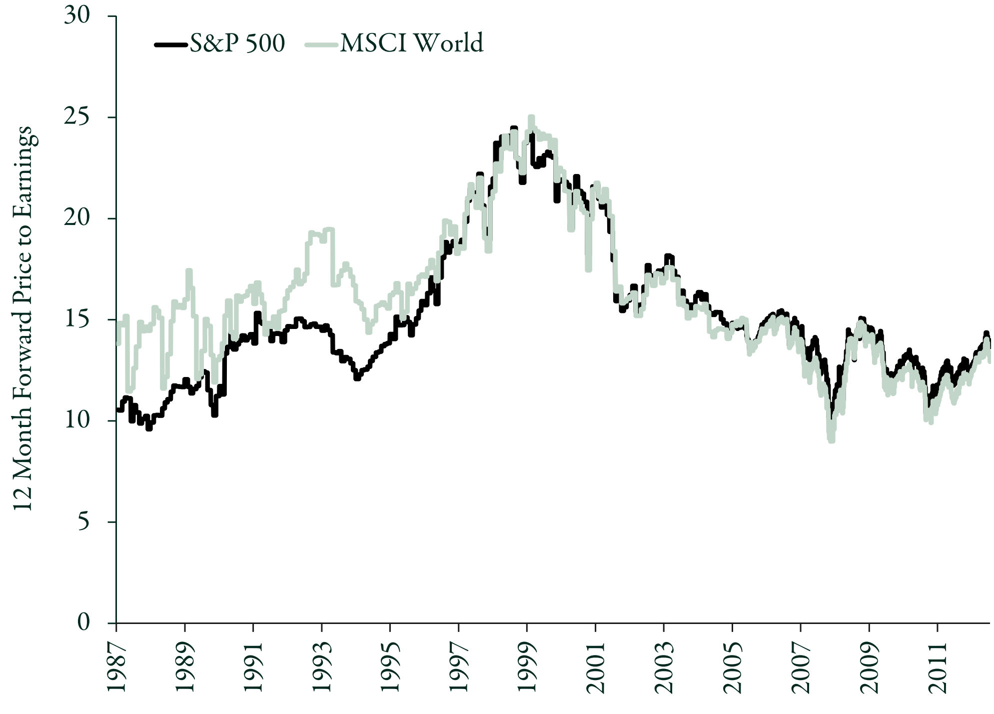
FI believes these fears are misplaced, and the bull market has been driven overwhelmingly by the disconnect between dim expectations and better-than-appreciated fundamentals—and there appear to be ample positive fundamentals to fuel the bull market further.

Earnings and Valuations Remain Attractive

Q1 S&P 500 earnings overall grew 5.4% y/y—the 14th consecutive quarter of earnings growth and 4th sequential quarter of new record-high operating earnings-per-share (EPS)[i]. Outside the US, earnings also continue growing. Globally, firms are profitable and private sector strength has been a key driver of this global bull market.

Moreover, despite the bull market being over four years old and earnings beating expectations throughout, valuations remain historically low. Valuation metrics like the Price to Earnings (P/E) ratio by themselves are not predictive of future stock market returns. There have been many periods where relatively high P/E ratios preceded good market returns, and vice versa. However, P/E ratios do provide a sense of how much value investors assign to future earnings, and as Exhibit 2 demonstrates, investors still are not putting a premium on future earnings. The lack of material P/E growth (i.e., "multiple expansion") suggests P/E ratios can expand considerably from here before hinting investors are too optimistic about the future.

Exhibit 2: Global and US 12-Month Forward P/E Ratios



Source: Thomson Reuters. 12-month forward S&P 500 and MSCI World P/E ratios from 31/12/1987 – 30/6/2013. Based in USD.

Something can end the bull market prematurely. FI believes the 2002-2007 bull market ended early tied to the bank balance-sheet-distorting impact of FAS 157 and the associated government response. The Nazi invasion of the Sudetenland truncated a nascent bull market beginning in 1938. Today, FI believes the bull market likely continues with prolonged multiple expansion, barring some major unforeseen event.

Revenue Growth Does Not Tell the Full Story

Headline US revenue growth was perfectly flat in Q1, but this high-level number was skewed by a few sectors.

Exhibit 3: S&P 500 Q1 2013 Revenue Growth by Sector

Sector	Revenue in Billions of USD		Growth $B	Growth %
	Q1 13	Q1 12	Q1 13	Q1 13
Healthcare	293.3	274.3	19.1	7.0%
Utilities	84.0	78.7	5.3	6.8%
Discretionary	371.2	354.6	16.6	4.7%
Technology	282.0	270.6	11.4	4.2%
Financials	279.4	268.4	11.0	4.1%
Staples	384.1	380.1	4.0	1.0%
Telecom	77.5	76.8	0.8	1.0%
Industrials	273.2	272.4	0.8	0.3%
Materials	104.0	106.2	-2.2	-2.1%
Energy	377.8	443.8	-66.0	-14.9%
S&P	2526.6	2525.9	0.7	0.0%

Source: Thomson Reuters, "This Week in Earnings," 28 June 2013.

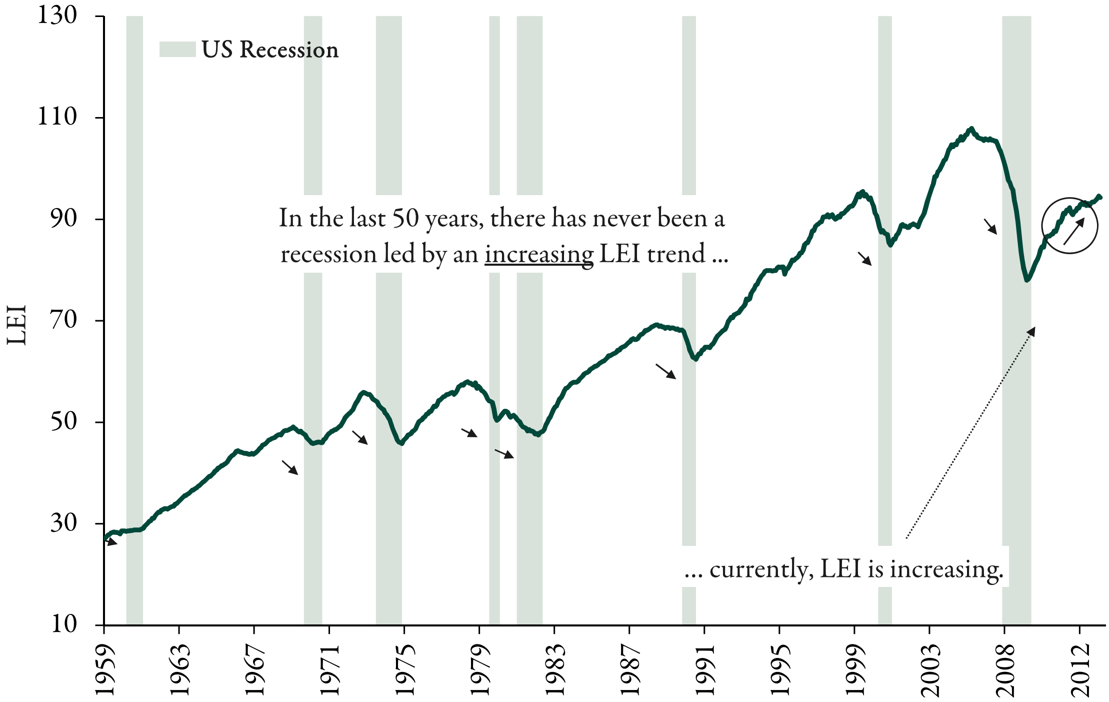
Energy sector revenues fell -14.9%, Materials dropped -2.1% and Industrials grew weakly (+0.3%). However, weakness in those three sectors is just what FI would expect at this stage of the bull market and expansion. All three are more economically sensitive—and those categories tend to underperform as a bull market matures. Additionally, falling commodity prices hit those three sectors particularly hard. The other seven sectors grew revenues an average of 4.1%, consistent with FI's expectation for less cyclical categories to fare better during the bull's latter stages.

Global Economic Growth Continues

Final Q1 2013 US GDP grew at a truncated pace of 1.8% seasonally adjusted annual rate (SAAR). Yet, as has been the case for much of the expansion, falling government spending detracted from the headline number—dragging it down nearly a full percentage point in Q1. Nevertheless, the underlying data continue showing a healthy and expanding private sector. Consumer spending grew at a 2.6% clip. Business spending rose a sharp 7.4% in Q1, led by a 14.0% rise in residential real estate activity and 4.1% growth in business investment in equipment and software[ii].

Growth likely continues through Q2 and beyond. The Conference Board's Leading Economic Index (LEI) rose through much of Q2. Historically, recessions have not started until LEI has fallen steadily for some time. (Exhibit 4) Moreover, LEI has been rising in part because rising long-term interest rates have steepened the yield curve—an underappreciated positive associated with markets pricing in slower QE bond buying.

Exhibit 4: Leading Economic Index



Source: Thomson Reuters, US National Bureau of Economic Research, The Conference Board, January 1959 – June 2013.

Other data support ongoing private sector health. After May's 0.6% m/m rise, retail sales have grown in 9 of the last 12 months[iii]. While the Institute of Supply Management (ISM) manufacturing gauge has shown slower growth, there have been only two sub-50 (contractionary) readings since 2009. One was May 2013's 49.0, falling between April's 50.7 and June's reacceleration to 50.9[iv]. May's dip looks like a blip. ISM's gauge of the US's dominant non-manufacturing (services) industry has been solidly expansionary. Under the hood, both manufacturing and services sub-indices measuring new orders, a more forward-looking gauge of economic activity, grew in Q2[v].

While a relatively much smaller contributor to growth, the US housing market has continued showing signs of irregular sales, price and starts growth. US Housing improvements are a tailwind, albeit a small one. The bigger impact may be on sentiment—investors have been dour on housing for years now. Some fear recently rising prices and mortgage rates may slow housing market growth. However, housing is still very affordable by historical standards and the supply of homes for sale remains low.

Eurozone Improvements

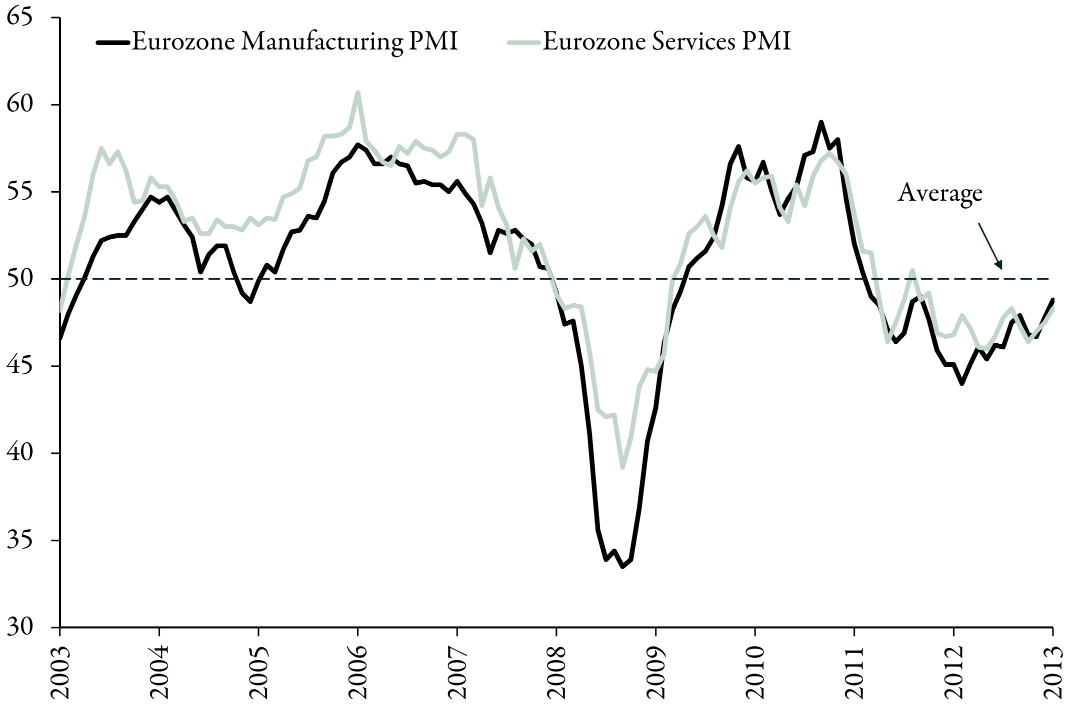
British growth certainly has not been high during the current global expansion, but the UK economy has shown signs of acceleration in recent months. Many have bemoaned the UK's double-dip recession and the potential for a triple dip. However, revised UK GDP calculations showed no double dip.

UK manufacturing PMI accelerated throughout the quarter, though it is a relatively small slice of the British economy. The much bigger non-manufacturing sector grew quicker, and the more forward-looking new orders sub-index showed solid growth[vi]. UK retail sales grew 2.1% m/m in May, snapping back after a weak April. On a yearly basis, retail sales rose 1.9%[vii].

Mark Carney took over as Governor of the Bank of England (BoE), replacing Mervyn King, and the transition went largely as expected. The Carney-led Monetary Policy Committee voted unanimously against restarting QE and started issuing forward guidance for monetary policy decisions—similar to the US Fed—pledging to keep short rates low for the foreseeable future. The yield curve has steepened since QE ended in late 2012, fostering a favourable environment for future growth.

The eurozone, still a global economic weak spot, seems to be stabilising some. GDP contraction slowed quarter-over-quarter in Q1, to a modest -0.3% q/q pace (-1.1% y/y). April industrial production grew 0.4% m/m, but May output fell -0.3% m/m—not robust, but not dire either. Total trade (exports plus imports) was essentially flat year-over-year in April. Eurozone manufacturing and services PMIs remain in contractionary territory, but only slightly (see Exhibit 5). Manufacturing's stabilisation was broad-based in June—while Germany contracted a hair quicker, Ireland grew, Spain was flat and Italy, the Netherlands, France, Austria and Greece all saw slower contractions[viii].

Exhibit 5: Eurozone Manufacturing and Services PMI



Source: Bloomberg, Markit. Eurozone Manufacturing and Services PMIs from 30/6/2003 – 30/6/2013. 50 is considered the dividing line between growth and contraction.

Politics Largely Remain a Positive

As always, FI's commentary on politics is intended to be nonpartisan and approach the issue solely to assess potential market impact (or lack thereof).

In US politics, most seem focused on the scandals emerging in Q2. FI will not delve deeply into the scandals specifically, but from a market impact standpoint, they are yet more reason for gridlock—a bullish feature for stocks. Gridlock likely impedes passage of legislation radically altering key economic and market factors like property rights.

Scandals are also perfectly normal in a president's second term and have been for decades, if not centuries. Many remember President Clinton's second term as being particularly scandal-plagued—yet his second term featured hugely above-average stock returns and strong US growth. President Reagan had the Iran-Contra scandal, also amid overall strong growth and a long bull market. There is no evidence scandals are bull market poison and plenty of evidence they prevent much market-spooking legislation.

This time seems no different. With 2014's midterm elections fast approaching—an election structurally favouring Republicans, as more Democrats are up for re-election in battleground states—vulnerable Democrats are expected to further distance themselves from scandal, adding still more to gridlock.

Election season is already underway outside the US. In Germany, Chancellor Angela Merkel enjoys a sizable lead as September's elections approach. There is some jostling over European Central Bank (ECB) policy in Germany's Federal Constitutional Court—likely political theater, in FI's view. The case challenges the heretofore-unused Outright Monetary Transactions—a programme of sovereign bond buying ECB head Mario Draghi announced in 2012—on the grounds it puts German taxpayer funds at risk without review by Parliament. However, it is an odd case, considering the Federal Constitutional Court has no legal authority over the ECB. Further, this is not the first challenge to eurozone crisis measures, and the Court has upheld (with some hedged language) the bailout tools at every turn. Tellingly, the plaintiff is Peter Gauweiler, a noted eurosceptic parliamentarian who has challenged the ECB in court multiple times since 2003. This seems to be his electoral calling card.

Elsewhere, Australia has a new Prime Minister, Kevin Rudd—who is also the former Prime Minister—after an intraparty vote ousted Julia Gillard. Gillard, who assumed the Prime Ministerial post after similarly deposing Rudd, called for the vote due to her waning popularity ahead of upcoming elections. Rudd will now square off against Tony Abbott in late August's national elections.

The End of Quantitative Easing Is Bullish

One key investor fear during Q2, likely contributing to some equity volatility, was the potential end to the Fed's QE policy, namely ongoing purchases of long-term bonds.

Many investors and much of the media seemingly believe QE has been the sole or primary force behind both the bull market and the expansion; therefore ceasing it would be devastating. In FI's view, this is a near total misunderstanding of both the Fed's plans and QE's impact. Rather than being devastating, QE's end would be bullish—even more so because most see this nearly perfectly backward, and fear of a false factor is almost always bullish.

Quantitative Easing's End Is Not Imminent

One common misperception about the Fed's plan is QE's end is imminent, and the Fed balance sheet should soon start shrinking. However, though the Fed has hinted it may begin tapering at a future point—possibly the end of 2013—it has not committed to a certain date. Further, Fed Chairman Ben Bernanke has indicated tapering would depend on the Federal Open Market Committee's (FOMC) assessment of the economy's health, a very subjective condition.

Additionally, the Fed has said it would taper its purchases initially, meaning the Fed balance sheet would continue growing, but at a slower pace. Even ceasing purchases altogether at some point, would not lead to an immediate reduction of the Fed's balance sheet. Further, when the Fed does decide to start shrinking its balance sheet, extraordinary action is not necessarily required. It can simply let securities mature—a very long, slow, predictable process. Plus, it is far from given the Fed would shrink its balance sheet entirely, considering many US banks have used interest earned on the newly created excess reserves to help meet higher regulatory capital requirements—one of the Fed's less advertised goals.

The Fed can certainly make policy errors in exiting. The risk of monetary policy errors is a constant—in FI's view, the endless rounds of QE have been fairly faulty policy. Furthermore, major monetary policy errors do have the potential to cause or exacerbate a bear market and/or recession. However, the Fed does have the capacity to exit QE in a fairly non-disruptive manner.

Quantitative Easing's End Would Be Bullish

The bigger misperception, in FI's view, is the belief QE is and has been the sole or primary factor behind the expansion/bull market. Near universally, the investing world and media worry QE's end as a material negative. In FI's view, this is backwards. As FI has covered in past writings, FI views endless rounds of QE as deflationary and contractionary. Slowing QE would be good, and stopping it quite bullish. In fact, UK economic growth has accelerated since the BoE stopped purchasing assets in November 2012.

FI's view on QE's end is, thus far, fairly unique—somewhat odd, because the economics behind it are well established. Quite simply, a steeper yield curve is economically beneficial—even the Fed holds this view. A wider yield spread contributes positively to Leading Economic Indices (LEI) globally for good reason: The yield spread—the difference between short-term and long-term rates—reflects the profit banks can make on their next loans. The wider the spread, the more profitable lending becomes. Readily available credit is a critical component to economic expansions. Conversely, a flatter yield curve is a disincentive to bank lending.

Few would disagree with the preceding. Yet, illogically in FI's view, by buying long-term bonds via QE, the Fed has been flattening the yield curve. Furthermore, loan growth has been slow during the current expansion—one reason US economic growth has been subpar.

Recall, while the Fed controls the amount of money in the banking system, it is up to banks to lend available funds in order to grow the money supply. By flattening the yield curve, the Fed has been sapping bank eagerness to lend, limiting the amount of new money flowing through the broader economy. By slowing or ceasing QE bond purchases, the Fed would allow long-term interest rates to rise, increasing banks' potential operating profits (net interest margins) and encouraging lending. This would be bullish.

Some fear rising interest rates would sap demand for loans. However, since long-term rates are still near historic lows, they can rise a fair bit and still be relatively benign. Further, many who would want loans now are effectively shut out because banks prefer to lend to those with pristine credit ratings since net interest margins are leaner than they should be. Wider net interest margins should increase bank appetites to lend to a larger group of consumers.

Another concern is rising rates could increase America's debt interest costs. As FI has shown often in past Review & Outlooks, America's debt interest costs relative to GDP are historically low and approximately half what they were during the bulk of both the 1980s and 1990s bull markets. It is key to remember higher interest rates impact newly issued debt only. Further, short-term rates are still exceptionally low and have not budged much. Exhibit 6 shows total outstanding US federal debt at varying maturities. America's average debt maturity is currently 66.3 months—most debt rolling over is getting refinanced at still-historically low shorter-term rates[ix]. Higher long-term rates would not impact total debt interest costs much.

Exhibit 6: US Treasury Debt Maturities ($ Billions)

Maturity	Amount	Percent
One Year or Less	**$2,952.9**	**26%**
1-5 Years	**$4,633.4**	**41%**
5-10 Years	**$2,434.1**	**21%**
10-20 Years	**$372.9**	**3%**
20 Years and Over	**$937.6**	**8%**
Total Outstanding	**$11,330.9**	**100%**

Source: US Department of the Treasury, as of 12/7/2013. Percentages may not sum to 100% due to rounding. Based in USD.

Further, there is no evidence rising long-term rates are negative for stocks. 10-year US Treasury rates increased, with volatility, from their low of 1.6% in 1945 to a peak of 15.8% in 1981. During this period, US stocks annualised 10.0%—about matching stocks' long-term annualised average. Nor are falling rates necessarily bad for stocks. From the 1981 Treasury yield peak to today's relatively low yields, US stocks have annualised 11.5%[x]. Simply put, there is no strong historical long-term relationship between stocks and bond yields.

New Fed Chairman

Current Fed Chairman Ben Bernanke has indicated he is not interested in a third term, meaning we may likely have a new Chairman come January 2014. Already there is chatter about potential replacements. FI has no way to handicap the likely replacement—nor does anyone else.

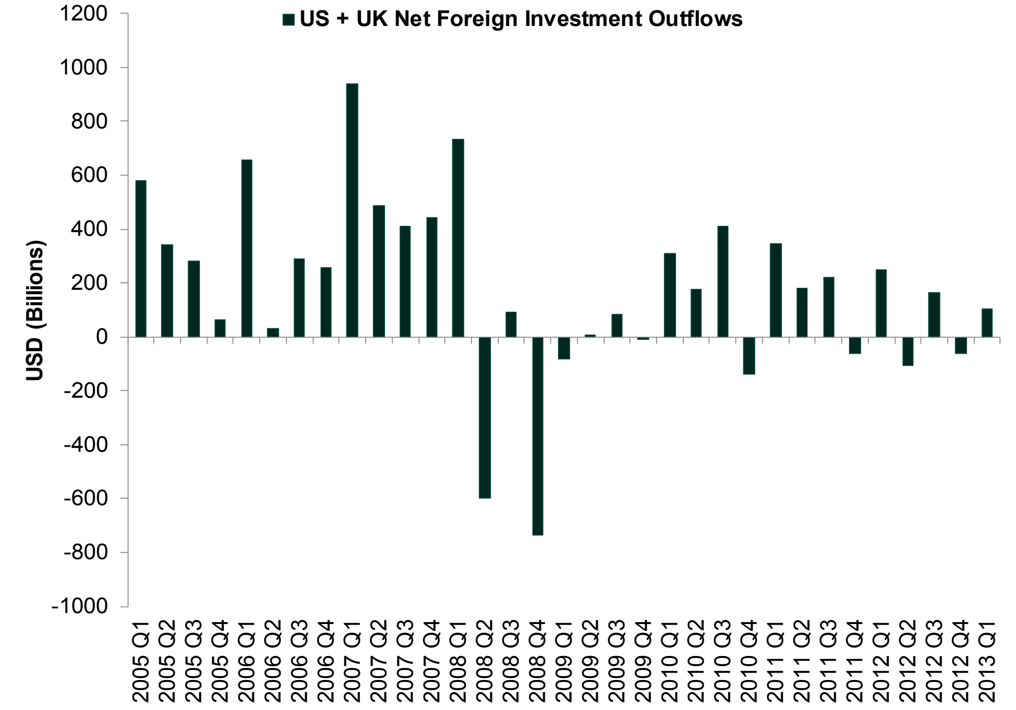
President Obama may telegraph early who the next Chairman could be. If he does not, there may be some uncertainty as the day draws closer, potentially causing some near-term volatility but is supremely unlikely to start a new bear market. Further, FI has not been a huge fan of Bernanke as Chairman, so the next Fed head is unlikely to be much worse.

Emerging Markets Won't Suffer

QE's other big misperception surrounds Emerging Markets (EM). Many believe massive amounts of "hot money" from the US and UK has poured into EM assets since QE began, and the end of QE policies could prompt massive capital flight, hurting EM equities and overall growth.

This fear is vastly overstated, in FI's view. For one, data does not support the notion of hot money pouring into EM. The US and UK's combined net investment outflows since QE began are far below pre-2008 levels (Exhibit 7). Additionally, capital need not automatically retreat once QE ends—as Exhibit 7 also shows, it took a severe financial crisis to cause a huge pullback in developed-world foreign outflows.

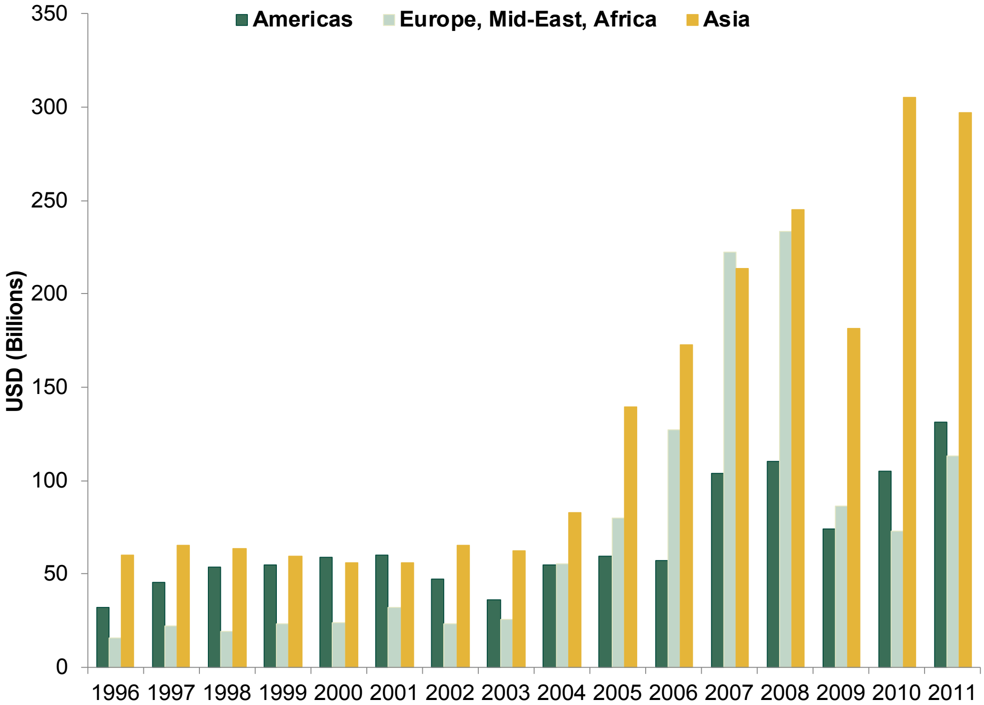
Exhibit 7: US Plus UK Foreign Investment Net Outflows



Source: Bureau of Economic Analysis, Office for National Statistics, as of 9/7/2013. Based in USD.

Even then, EM nations still saw strong net foreign inflows (Exhibit 8), suggesting even if UK and US investors were to retreat some, EM could still see plenty of capital from other areas.

Exhibit 8: Emerging Markets Foreign Investment Net Inflows, by Region



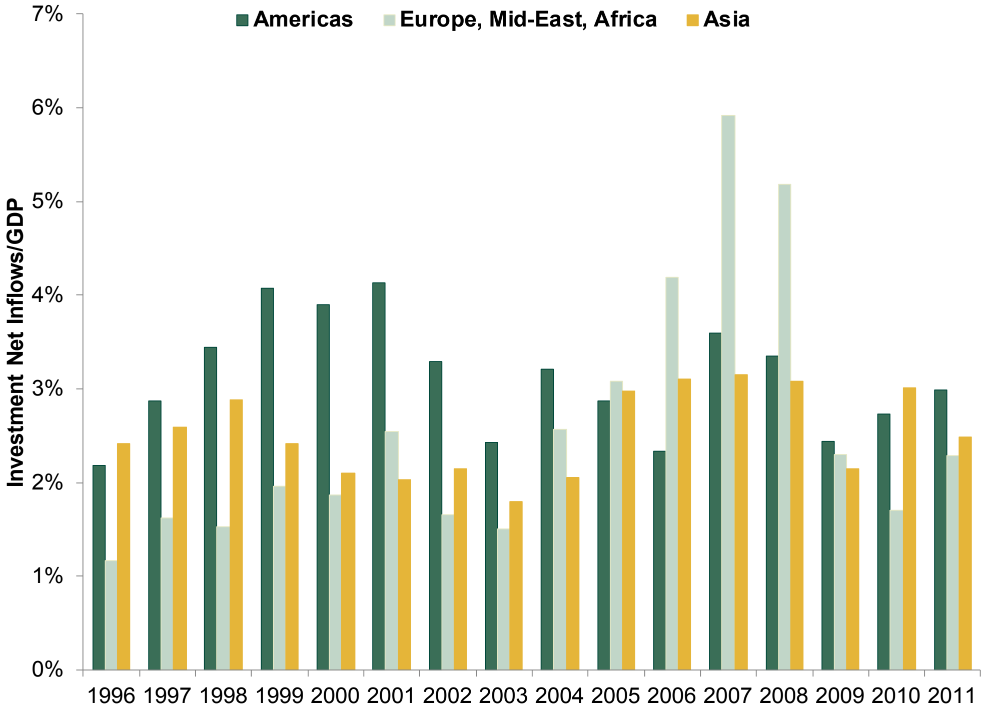
Source: World Bank, MSCI as of 9/7/2013. Americas includes Brazil, Chile, Colombia, Mexico and Peru. Europe, Middle East and Africa includes Czech Republic, Egypt, Greece, Hungary, Poland, Qatar, Russia, South Africa, Turkey and United Arab Emirates. Asia includes China (including Taiwan), India, Indonesia, Korea, Malaysia, Philippines and Thailand. Based in USD.

Some say the real impact would come from investors globally—swapping EM for higher-yielding US assets when interest rates rise. This might happen to some degree, but a full flip from EM to US appears unlikely. For one, investors have not done the reverse since QE began. Some investors likely have moved funds from low-yielding sovereigns to higher-yielding assets, but EM equities, bonds and construction projects are not the only recipients. Funds have also flowed to US infrastructure projects, typically having similar risk profiles as US Treasurys, investment-grade corporate bonds and other comparable assets.

Equally important, QE has not fostered robust EM stock returns—EM underperformed for five straight quarters in late 2010 and 2011. Many other variables impact EM equity markets. For instance, the latest pullback appears largely tied to concerns over slower economic growth, a metals and mining downturn and worries over Chinese liquidity. Given QE does not appear to have been a huge positive market driver for EM equities, FI would expect its end to be similarly immaterial.

Economically, foreign capital is not vital for EM to continue growing. Foreign investment does aid growth some, but overall and on average, public and private domestic investment play a greater role. EM nations have created significant wealth in recent years, and much of this wealth underpins continued growth. Moreover, growth, in turn, creates new investment opportunities for foreigners—hence why foreign inflows in Emerging Asia, though high in absolute terms, remain low relative to GDP. (Exhibit 9)

Exhibit 9: Emerging Markets Foreign Investment Net Inflows/GDP



Source: World Bank, United Nations Statistics Division, as of 10/7/2013. Based in USD.

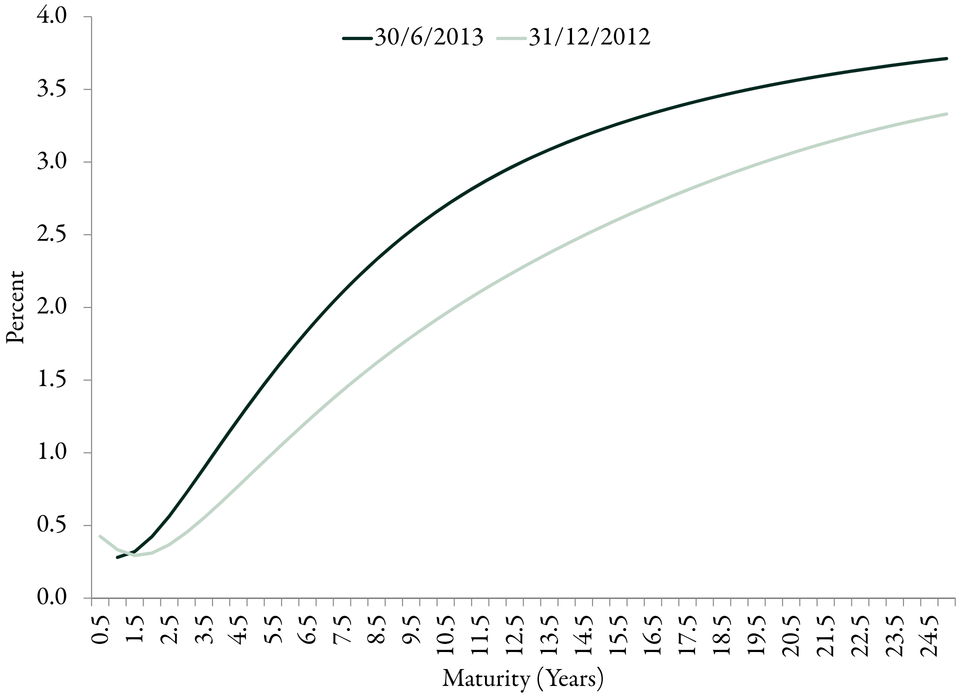
Most EM nations—especially in Asia and the Americas—also have positive current accounts, providing extra insulation from departing foreign capital. Foreign outflows can be problematic if a country has a fixed exchange regime, but few remain after the late-1990s Asian Currency Crisis. China has a fixed float, but it also has strict capital controls, limiting the risk of fund flight, and about $3.4 trillion in forex reserves. Overall, there appears to be little risk of QE tapering driving a big EM economic slowdown.

Even if foreign investors become net sellers of EM equities, the category can fare just fine. Stocks are an auction marketplace—where each transaction has a buyer and a seller. The number of sellers is not the sole input. Buyers remaining willing to bid share prices higher could be an offsetting factor. Since EM fundamentals are still attractive on balance, investors have plenty of reasons to bid prices up after QE ends.

UK Quantitative Easing and Lending Update

As mentioned previously UK economic growth has accelerated since the Bank of England (BoE) stopped purchasing assets in November 2012. Like its US counterpart, the UK's quantitative easing flattened the yield curve, creating a disincentive to lend. The yield curve has steepened since the BoE stopped purchasing gilts (the UK equivalent to US Treasuries) in late 2012 (Exhibit 10), widening banks' net interest margins and making lending more profitable—and therefore more attractive for banks (once they are through raising capital).

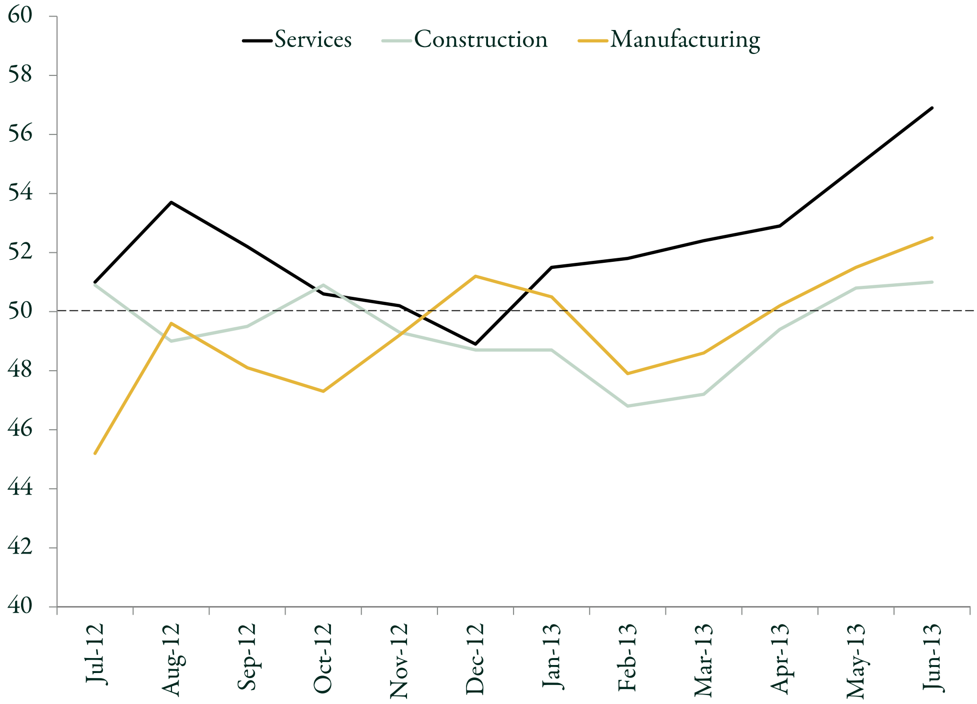
Exhibit 10: UK Yield Curve—Current and 31/12/2012.



Source: Bank of England.

Notably, the UK is already seeing signs of post-QE economic improvement as PMI surveys have generally improved since the programme ended (Exhibit 11). GDP growth has also accelerated since Q4 2012's -0.2% contraction, notching 0.3% q/q in Q1 and 0.6% q/q in Q2[xi].

Exhibit 11: UK PMI Surveys



Source: Markit as of 5/7/2013.

Keeping the BoE's Asset Purchase Programme on hold would also likely help boost lending and overall growth. Additional efforts to boost bank lending continued in Q2, with the BoE and Treasury extending their Funding for Lending Scheme (FLS). Through FLS, the BoE provides cheap, Treasury-guaranteed funding to the banks, thereby lending the funds to households and non-financial corporations at reduced rates.

Since FLS took effect last August, bank funding costs and mortgage rates have fallen by 1 percentage point, and small- and mid-sized business (SME) loan rates have fallen by 0.5 percentage point. Mortgage approvals have risen, household lending has grown, and lending surveys show improving credit conditions for households and larger corporations, but total lending is still shrinking. The BoE and Treasury made some incremental adjustments to FLS to improve its effectiveness—banks would have to lend twice as much for any funds borrowed—but this likely brings marginal help at best.

FLS alone likely cannot turn around UK lending. In order for capital to flow more freely, regulators should stop hitting the banks with costly new rules and capital requirements exceeding international standards. For example, The BoE—now having sole regulatory oversight—is forcing banks to hit Basel III's 7% capital reserve requirement by year-end (Basel III guidelines mandate compliance by 2019). In March, UK banks' capital shortfall was £25 billion, but by late-June it was only £11.3 billion—banks raised £13.7 billion during the quarter[xii]. Lending fell, with SMEs feeling the biggest pinch, thereby robbing the economy of a vital source of business investment.

How new BoE Governor Mark Carney addresses bank regulations should be key over the period ahead. Provided regulators do not change the rules again, banks should not face significant capital raises after 2013, thereby allowing them to lend more enthusiastically. On this front, FI is cautiously optimistic—in early July the BoE resisted calls from some deputy governors to force banks to comply with Basel III's 3% leverage ratio immediately, likely requiring banks to raise significantly more capital, though the BOE is pushing some banks to comply by 2014 or 2015 (on a case-by-case basis). As FI writes, Chancellor George Osborne has also resisted calls from the Parliamentary Commission on Banking Standards to raise the leverage ratio to 4% or higher.

Potential Risks

FI has strong conviction in FI's current outlook and believes the bull market should continue through the rest of the year and into 2014. However, FI is aware risks exist—they always do. However, most of today's risks are either widely discussed—and therefore likely already largely reflected in current market prices—or misinterpreted. Those that bear watching appear very low-probability events.

As Benjamin Graham famously said, "In the short run, markets behave like voting machines, but in the long term they act like weighing machines." Voting machines measure sentiment—investors' emotions and automatic reactions to current events. Emotions are volatile and can change without warning. Worries like QE tapering and a Chinese credit crunch can scare investors, and such fear can trump fundamentals in the very near term. But over time, fundamentals win out.

Higher Bank Leverage Ratios Likely Have Little Impact

Many investors are watching the impending US implementation of the Basel III international capital standards, globally agreed to by regulators in 2010. The new rules, agreed to by participating countries to phase in between 2013 and 2019, require banks to adjust risk-modeling methods and increase their capital buffers.

US regulators are debating, among other provisions, the leverage ratio—the amount of equity capital banks are required to hold relative to their total, non-risk-weighted assets. Basel III sets the leverage ratio at 3%. However, the FDIC and the Fed have proposed a 4% leverage ratio system-wide and are reportedly considering adopting a 6% leverage ratio for the largest US banks, with off-balance sheet assets included in the calculation.

Making banks stronger seems like a perfectly fine goal, but it can also inhibit lending—an economic negative. Making new loans actually deteriorates banks' leverage ratios, at least initially. However, the largest banks subject to the more stringent requirements are already largely in compliance. Those not in compliance miss the mark by just a small amount. Retaining earnings should get them there well in advance of the deadline, all else equal. Further, the provision is still under discussion and might not make regulators' final proposal. If it does, banks have ample time to meet the more stringent requirements before the 2019 implementation date. In FI's view, there is little market-moving impact here, and the alleviation of fear surrounding higher leverage ratios could actually be a small positive.

Trade Protectionism

A huge rise in trade protectionism could threaten any bull market—barriers to trade are a negative for global commerce—but today's protectionist threats appear to be mere market noise.

The prime example is the long-simmering argument between the European Union (EU) and China, which flared during Q2. EU officials have long complained China's subsidies for solar energy firms (an odd complaint, considering many European countries subsidise solar energy), allow Chinese manufacturers to sell solar panels in Europe below market price—known as "dumping," illegal under World Trade Organisation (WTO) guidelines. In June, the EU enacted a tariff on Chinese solar panels, starting at 11.8% and quadruples in August. China responded with an investigation into alleged dumping by European winemakers. The EU countered by challenging China's steel tariffs at the WTO. Then China struck retaliatory tariffs on certain EU chemical imports.

It is possible this could escalate into a full-blown trade war, but not probable—both sides recognise the importance of trade to economic growth, and negotiations over solar policies are already in progress. Moreover, small disagreements like this are common and tend not to materially disrupt cross-border commerce. For example, the US and China have filed several grievances against each other with the WTO since China joined in 2001, but total trade between the two has grown leaps and bounds. Simply, economic need often trumps politics.

Additionally, on balance, the world is trending toward freer trade, with several prospective deals in the works. The US and EU launched free trade talks in early July. Negotiations between Korea, Japan and China are ongoing, as are the multilateral Trans-Pacific Partnership talks. The EU and Canada are finalising a deal. Moreover, while some of these deals may take years to become reality (if they ever do), the continued push to lower trade barriers globally is a positive.

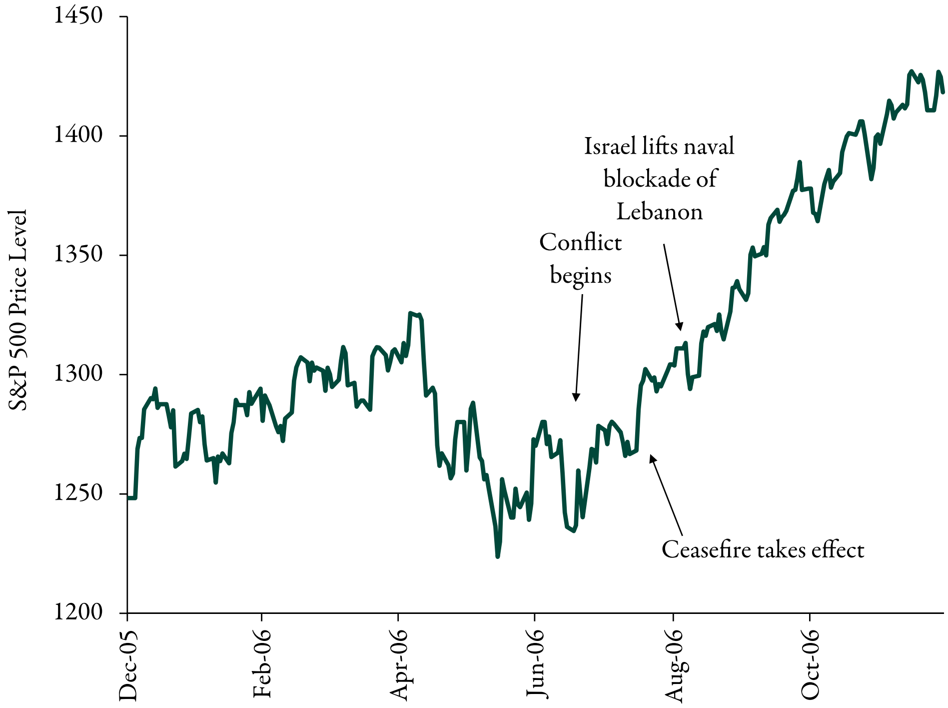
Geopolitical Tensions Heating Up?

The Middle East yet again saw tension throughout Q2, with Egypt garnering most headlines as the quarter ended. Following protests, President Mohammed Morsi was ousted by the military just after the quarter closed. His replacement is former Supreme Constitutional Court Chief Justice Adly Mansour. Mansour, widely considered a moderate technocrat, initially launched the rewriting of the constitution.

Tensions in Syria also made headlines in Q2 as the civil war escalated and threatened to pull in Israel and Lebanon. Turkey also gained notice with widespread protests against Prime Minister Recep Tayyip Erdogan's increasingly authoritarian rule. As FI has written in past Review & Outlooks, Middle East tensions are a 2,000-plus-year, pulsating near-constant—and history shows they have a fleeting (and not necessarily bearish) market impact. The anticipation of a coup or military action can heighten volatility, but an outbreak of armed conflict often provides relief from the angst leading up to it.

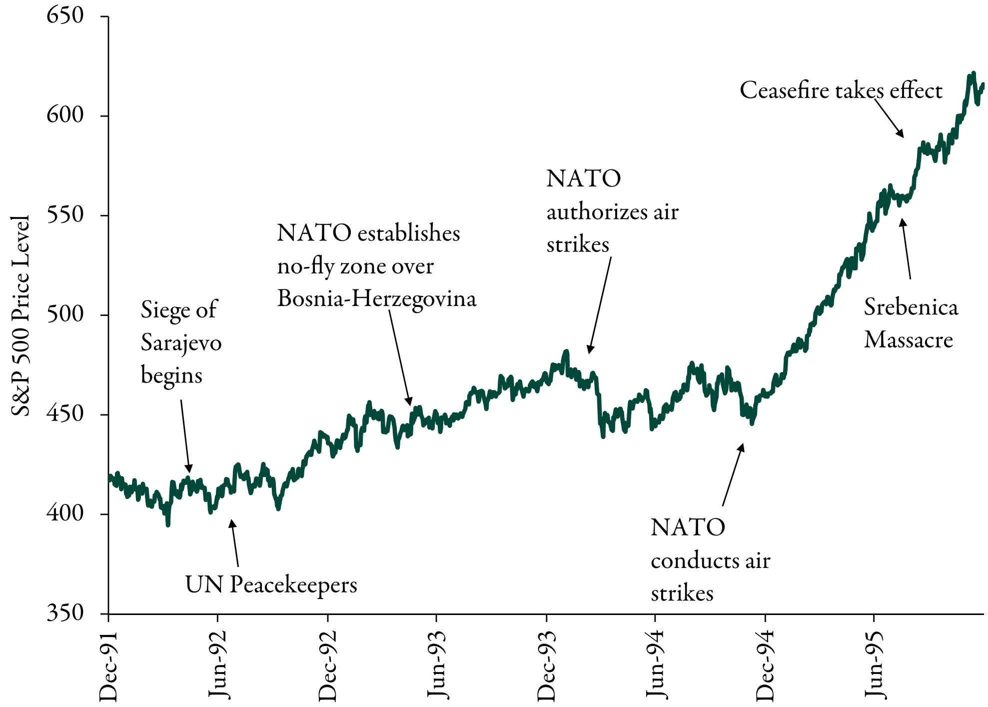
Exhibits 12, 13 and 14 show three examples. Markets were volatile in the run-up to the Israel-Hezbollah conflict in 2006, but stocks rallied well before the conflict subsided. The early stages of the Bosnian War of the 1990s were choppy, but markets skyrocketed after NATO airstrikes began in 1994, and the bull lasted over five more years. Furthermore, stocks fell slightly before the Six-Day War among Israel, Egypt, Jordan and Syria, but rose in each session after the outbreak.

Exhibit 12: The Israel-Hezbollah Conflict and S&P 500 Returns



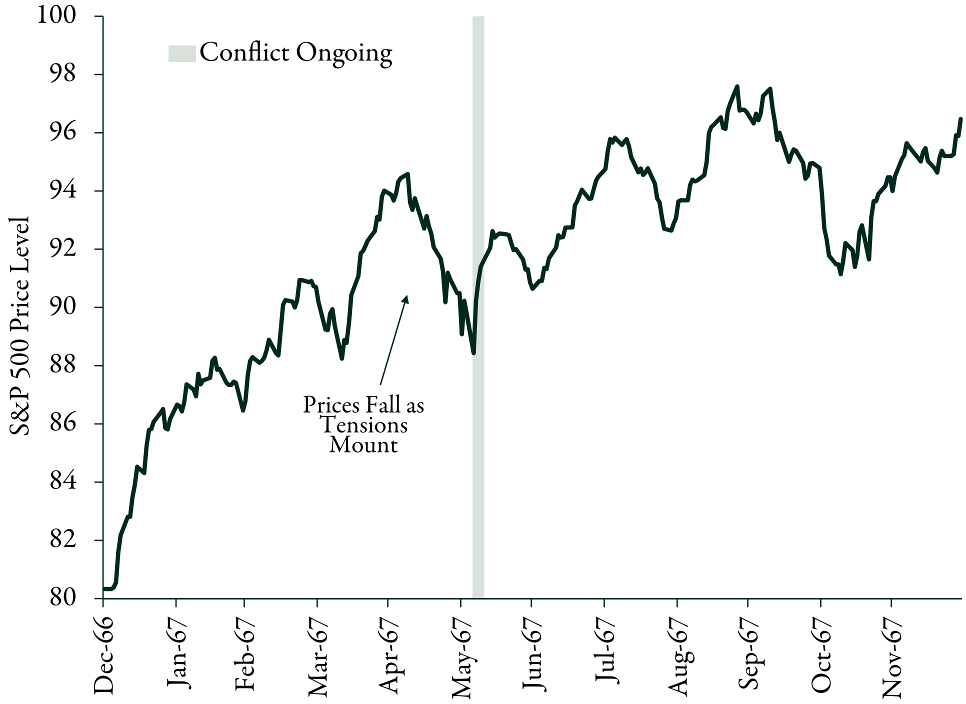
Source: Thomson Reuters. S&P 500 Composite Price Index from 31/12/2005 to 31/12/2006. Based in USD.

Exhibit 13: The Bosnian War and S&P 500 Returns



Source: Thomson Reuters. S&P 500 Composite Price Index from 31/12/1991 to 31/12/1995. Based in USD.

Exhibit 14: The Six-Day War and S&P 500 Returns



Source: Thomson Reuters. S&P 500 Composite Price Index from 30/12/1966 to 29/12/1967. Based in USD.

There are dozens more examples, including both Gulf Wars and the Jordanian Civil War in the 1970s. In fact, the onset of World War II in Europe is the only modern example of war knocking a bull market off course. Even then, however, stocks bottomed in 1942, three full years before the war's end. Stocks can and do rise during periods of even major conflict.

Regulatory Risk in the UK

The Parliamentary Commission on Banking Standards released its long-awaited report on the UK's financial services industry in June, and in early July Chancellor George Osborne confirmed the bank reform bill (pending in Parliament) expects to adopt the report's recommendations to boost transparency and competition in UK banking. These are benign enough goals, but the proposed measures likely exacerbate the UK's long-running regulatory headwinds and could impact London's future as a global financial hub.

For example, one proposed change would defer bonuses for "Senior Persons and licensed bank staff" for up to 10 years and enable claw-backs if the bank receives state aid or misdeeds come to light[xix]. The commission believes this better aligns compensation with the time it can take to determine a transaction's success or failure, removing the incentive to make risky plays for short-term (and potentially temporary) profit. Yet recent history shows 10 years might be too long. If a 10-year deferral were law in the US in 1999, investment bankers at Lehman Brothers who helped underwrite Blackrock Holding's IPO may never have been paid. Bankers working on the same Blackrock deal for Prudential Securities—absorbed in the early 2000s by Wachovia, which failed in 2008—might also go unpaid for their efforts.

If bankers see a chance they would get no pay for legitimate, value-added work, they have little incentive to perform—nor is there incentive for top talent to work in UK banking. Banks could offset the latter by offering higher guaranteed salaries, consequently misaligning executives' and shareholders' interests—the opposite of what the proposed rules aim to achieve.

Another major change would introduce criminal punishment for "reckless misconduct in the management of a bank," making senior executives criminally liable for "the most serious of failings, such as where a bank failed with substantial cost to the taxpayer, lasting consequences for the financial system, or serious harm to customers." Those found guilty could also face civil suits, making them financially liable as well. However, nowhere in the commission report's 571 pages is "reckless misconduct" clearly defined—lawmakers likely leave it to the UK's financial regulatory bodies. Even then, the definition could very well remain subjective or change over time.

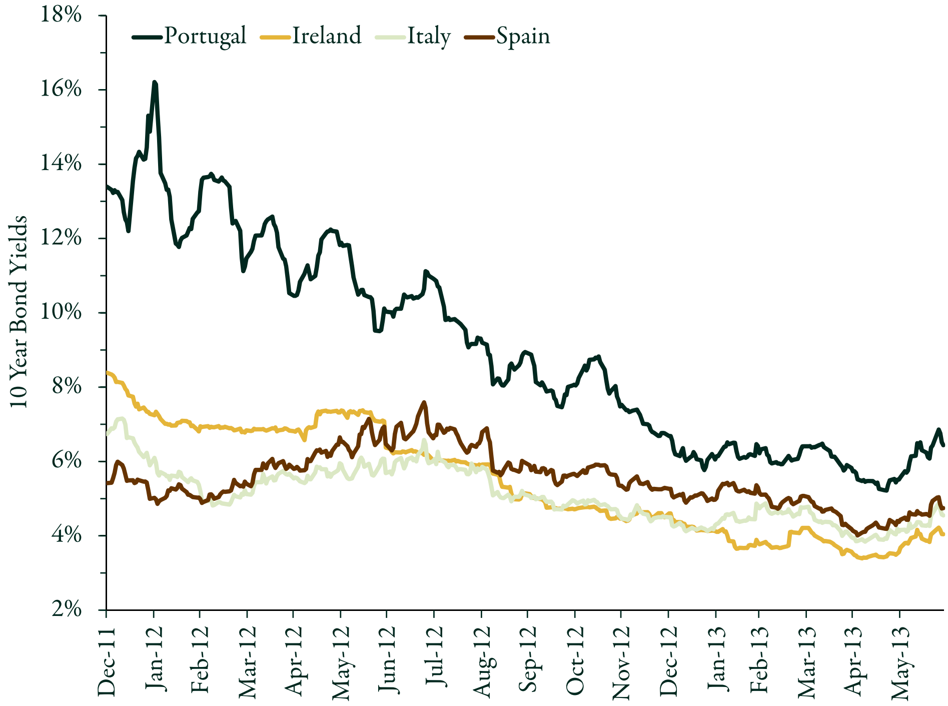
By making bankers criminally liable for as-yet undefined behavior, regulators make bank management a riskier profession, and fewer people could be willing to assume such extra risk. To avoid this potential talent drain, Financials firms could move outside the UK—perhaps to New York, Singapore, Hong Kong or nearby Dublin. This would create economic headwinds for the UK over time. Moreover, in the near term, the proposed changes add to UK Financials' existing regulatory issues, continuing to weigh on bank lending and overall growth—further supporting FI's positioning in the country.

Eurozone Political Theater

Portugal's political situation grew murky as Q3 dawned with two key ministers resigning, raising the likelihood of a government collapse. First to go was Finance Minister Vitor Gaspar, who said Portugal's failure to meet deficit targets undermined his credibility. The next day, Foreign Minister Paulo Portas resigned in protest of Gaspar's replacement, Treasury Secretary Maria Luis Albuquerque, saying the latter represented a continuation of "failed austerity policies." Since Portas is the leader of junior coalition partner People's Party (CDS-PP), guaranteeing the current government, Prime Minister Pedro Passos Coelho's leadership appeared in jeopardy for much of July. He and Portas ultimately agreed to keep the coalition intact with Portas as Deputy PM, though opposition Socialist Party (PS) leader Antonio Jose Seguro continues calling for early elections.

Should a snap contest occur—and the coalition led by Passos Coelho and his Social Democratic Party (PSD) lose power—it likely should not change matters much for Portugal. Opposition parties have made many similar pronouncements in other peripheral nations, only to conform to the troika's bailout conditions when necessary. In fact, PS signed Portugal's initial bailout memorandum, giving them little wiggle room should they take power. They might attempt to further relax deficit targets, but abandoning the programme altogether seems unlikely. Most importantly, Portugal is well positioned to meet its 2013 bond payments, so there is minimal risk of default in the near term. Even if the nation does not return to primary debt markets on schedule in 2014, the impact on the eurozone as a whole appears limited—other peripheral yields have not risen in tandem with Portugal's since this political dust-up began (Exhibit 15), suggesting investors expect the eurozone to continue muddling through.

Exhibit 15: 10-Year Benchmark Sovereign Yields



Source: Thomson Reuters. Portugal, Spain, Italy and Ireland 10-Year Sovereign Bond Yields, 30/12/2011 – 28/6/2013.

Elsewhere on the eurozone political front, Germany holds a general election in September. Currently, Chancellor Angela Merkel's coalition is polling ahead of the main opposition parties, and her personal poll numbers beat her challenger, Social Democrat Peer Steinbrück, by 40 points. Regardless of who wins, the result should not much alter the political will to preserve the euro. Steinbrück is pro-euro, and the Social Democrats have largely supported recent bailouts. Additionally, while Merkel has seemingly cooled on longer-term eurozone integration in recent weeks, this appears more of a political move to curry favour with German eurosceptics than a material, permanent shift in policy direction.

Japan's Third Arrow Unfired

Japanese stocks pulled back sharply in Q2 as enthusiasm over monetary stimulus faded and Prime Minister Shinzo Abe's economic reform proposals fell well short of expectations. Neither development was a surprise. As FI wrote in their Q1 Review & Outlook, unlimited monetary easing is not a panacea for Japan's economic and structural issues, and FI has never believed Abe would pursue needed but politically unpopular issues like labour reform, broad corporate tax cuts and deregulation—at least not right away.

Still, it is possible Abe has some tricks up his sleeve. Abe could very well be saving more politically charged plans until autumn, assuming he would have more clout since his Liberal Democratic Party has secured a strong majority in the upper house. At the same time, Abe's dragging his feet on economic reform is not necessarily a huge boost for stocks.

Though the Abenomics measures announced thus far may be a step in the right direction, more important and controversial reforms, such as labour reform, are not even up for consideration. Markets generally move on the gap between expectations and reality—and better-than-expected reality is what typically lifts prices. In Japan, however, Abenomics expectations have greatly surpassed their true economic benefit in FI's view. Going back to the aforementioned Benjamin Graham quote, FI does not know how investors could vote for Abenomics in the short-term, but when it comes to weighing the actual economic benefits, investors are likely to be disappointed ultimately. This is a large reason why FI has remained underweight to Japanese stocks.

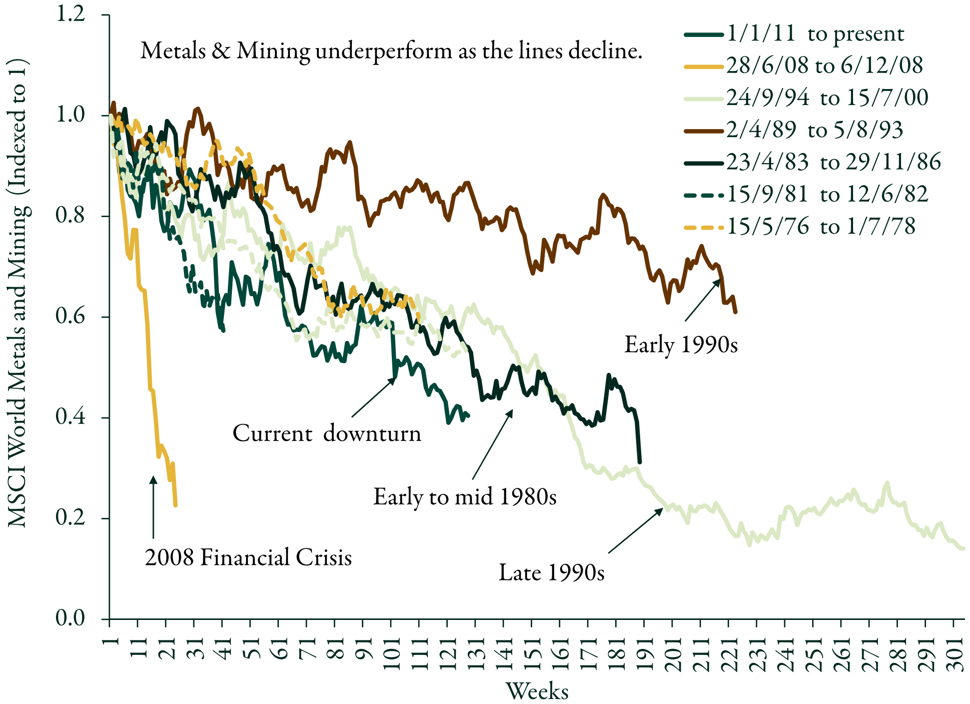
However, economic disappointment in Japan is hardly new and need not derail stocks globally. The past 15 years have shown the global economy can grow just fine even with five Japanese recessions and overall slow growth in Japan. Additionally, global stocks have far outstripped Japanese returns during this bull market. FI sees little likelihood Japanese markets widely and consistently outperform global markets in the period ahead.

Putting the Recent Metals & Mining Downturn in Perspective

From September 2000 through the end of 2010, the MSCI World Metals & Mining Index went on a historically large run, outperforming the MSCI World by 455 percentage points[xiii]. However, since the start of 2011, the MSCI World Metals & Mining Index has consistently underperformed the MSCI World Index, lagging by -62 percentage points (through 31/5/2013)[xiv]. Because investors appear to have become accustomed to this industry outperforming in tandem with rising equity markets, and the industry has recently underperformed markedly, some predict a sharp Metals & Mining rebound. However, history appears to argue against a lasting turnaround in the industry's relative performance anytime soon.

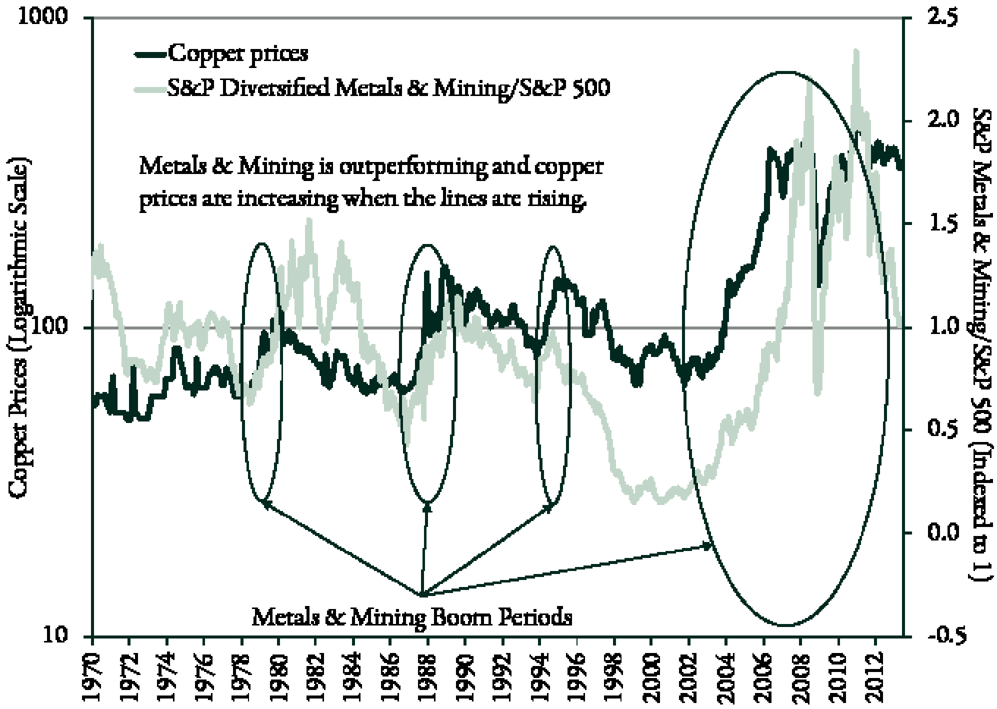
As seen in Exhibit 16, the pace and magnitude of underperformance in Metals & Mining since the start of 2011 is not particularly exceptional and is quite similar to most of the industry's downturns since 1970.

Exhibit 16: Comparing Recent Metals & Mining Relative Performance to Previous Industry Downturns



Source: Global Financial Data, Inc., as of 1/6/2013. Weekly price returns of S&P Diversified Metals & Mining divided by the S&P 500, with all performance indexed to 1 at the start of each time period. Based in USD.

Exhibit 17: Metals & Mining Relative Performance Vs. Copper Prices



Source: Global Financial Data, Inc. Copper electrolyte wire prices in US cents per pound. S&P Diversified Metals & Mining price returns divided by the S&P 500 price returns (indexed to 1 at 31/5/2013) as of 31/5/2013. Based in USD.

Furthermore, Exhibit 16 just looks at periods of consistent underperformance with no significant counter trends. By allowing short counter trends to catch larger industry cycles, history shows larger and longer cycles of Metals & Mining outperformance, like we experienced from 2000 through 2010, typically lead to larger and longer cycles of subsequent underperformance. (Exhibits 18 and 19 show outperformance and underperformance cycles, allowing for up to a 15-month counter trend.) As such, there may be more underperformance ahead for the industry.

Exhibit 18: Commodity Cycles Sorted by Magnitude of Outperformance

Outperformance Cycles	S&P Diversified Metals Minus S&P 500	Underperformance Cycles	S&P Diversified Metals Minus S&P 500
04/1959 - 07/1961	45 ppts	07/1961 -07/1963	-23 ppts
04/1950 - 02/1952	50 ppts	02/1952 - 12/1953	-34 ppts
07/1963 - 11/1967	50 ppts	11/1967 - 06/1978	-51 ppts
12/1953 - 01/1957	98 ppts	01/1957 - 04/1959	-41 ppts
06/1978 - 08/1981	182 ppts	08/1981 - 11/1986	-146 ppts
11/1986 - 08/1989	237 ppts	08/1989 - 06/2000	-360 ppts
06/2000 - 12/2010	1276 ppts	12/2010 - Present	-77 ppts

Source: Global Financial Data, Inc. S&P 500 price returns as of 1/6/2013. Based in USD.

Exhibit 19: Commodity Cycles Sorted by Duration of Outperformance

Outperformance Cycles	Duration in Months	Underperformance Cycles	Duration in Months
04/1950 - 02/1952	22	02/1952 - 12/1953	22
04/1959 - 07/1961	27	07/1961 -07/1963	24
11/1986 - 08/1989	33	08/1989 - 06/2000	130
12/1953 - 01/1957	37	01/1957 - 04/1959	27
06/1978 - 08/1981	38	08/1981 - 11/1986	63
07/1963 - 11/1967	40	11/1967 - 06/1978	127
06/2000 - 12/2010	126	12/2010 - Present	29

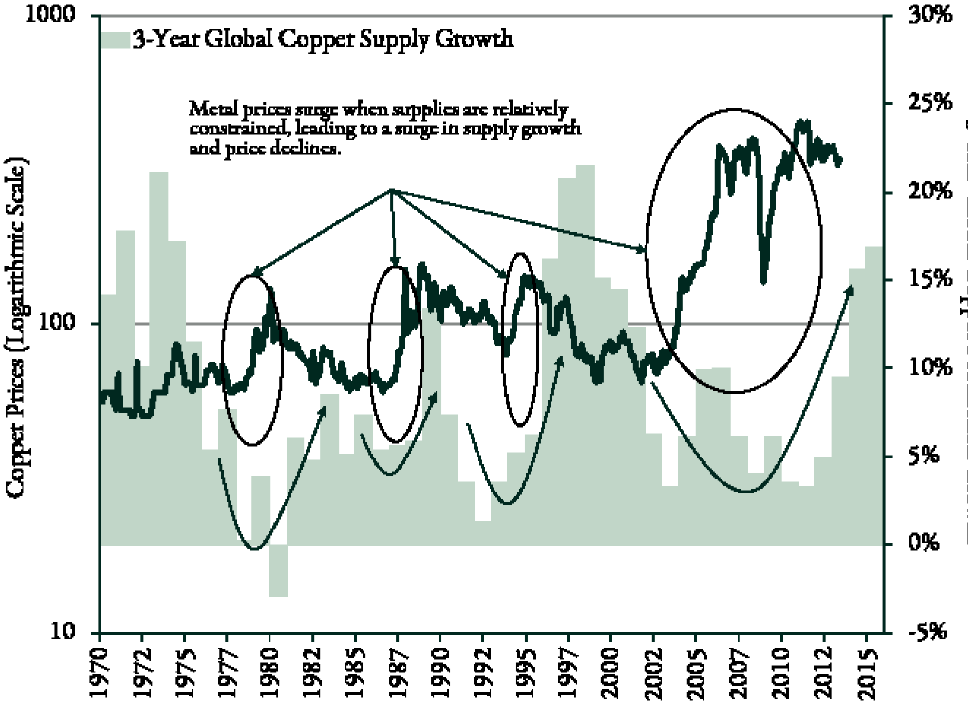
Source: Global Financial Data, Inc. S&P 500 price returns as of 1/6/2013. Based in USD.

Larger and longer cycles of underperformance appear to follow larger and longer cycles of outperformance in part due to the industry's supply response to increasing and decreasing prices.

The cycle typically starts with a surge in demand following a period of constrained supply growth, leading to a surge in metal prices. The industry responds to the price incentives by increasing production until it inevitability overshoots demand. The industry is especially prone to this given its capital-intensive nature and the long (multi-decade) life of its assets, making production difficult to turn on and off as conditions change. Metal prices then fall and the industry suffers tremendously due to its high fixed cost structure. This is followed by the industry promising not to overbuild again, constraining supply and setting the foundation for the re-birth of the cycle.

This cycle can be seen in Exhibit 20, looking at copper prices versus the three-year growth of global copper production (light green bars). The past booms in the metal industry are circled. Surges in copper prices (green line) typically correspond with low levels of supply growth but are followed by a surge in production and declining prices. Following the last decade's tremendous surge in metal prices, the industry has progressively responded with major expansion programmes. Metal supplies are now set to grow significantly as years of major cap-ex programmes come to fruition. Therefore, if the current cycle follows the industry's historical pattern, it appears metal prices are likely to continue to fall, and Metals & Mining stocks are likely to continue to underperform—supporting FI's underweight to the category.

Exhibit 20: Copper Production Surges in Response to High Prices, Leading to Price Declines



Source: Global Financial Data, International Copper Study Group (ICSG) and Chilean Copper Commission. Copper electrolyte wire prices in US cents per pound as of 31/5/2013 and global mined copper production as of 30/6/2013, copper production estimates for the years 2013 to 2015.

INSIDE CHINA'S SUPPOSED CREDIT CRUNCH

Chinese stocks had a bumpy Q2, falling -7.0% in June alone as investors chewed over softening economic data, mixed messages from policymakers and a widely feared credit crunch[xv].

In FI's view, China's current risks are rather overstated. Economic growth likely slows looking ahead, but FI's global equity forecast never depended on vastly better-than-expected Chinese growth. More important: Even at a slower growth rate, China still contributes heavily to global trade and GDP as it is now growing off a much larger base. Policy-wise, FI is not surprised by the apparent give and take—as written in previous Review & Outlooks, FI has long expected Chinese economic reform to move in fits and starts.

The "credit crunch," at first, seems somewhat more complex. When interbank funding costs spiked and the government did not immediately intervene to stabilise wholesale funding markets, many feared China could have a Lehman moment. However, evidence suggests this strain was intentional and temporary, and the issue more political than economic.

Credit Bubble?

At issue is a huge credit expansion. Total social financing—including forms of credit, traditional and nontraditional—grew roughly 52% y/y in 2013's first five months[xvi]. Much of this was outside traditional bank lending, in what is known as shadow finance—a term for common off-balance sheet lending vehicles such as the commercial paper and corporate bond markets. These come primarily through "wealth management products" (WMP), offered by many Chinese banks as a high-yielding alternative to traditional deposits, having artificially low interest rates. WMPs generally invest in trust loans and other illiquid assets—essentially complex securitised debt.

Last year, officials vastly expanded shadow-financing markets in an effort to improve small- and mid-sized firms' (SMEs) access to credit. As explained in previous Review & Outlooks, SMEs have historically been credit starved as China's main lenders—big state-run banks—lend primarily to big state-run firms. So officials began legitimising private lending and raised caps on corporate debt issuance, in theory allowing large firms to secure financing on primary markets and freeing up bank capital for private SMEs. However, capital did not flow as officials intended. They legalised private financing but did not define it—so no one knew the dividing line between legitimate financing and "illegal fundraising." This is a rather important distinction, as illegal fundraising is a crime punishable by death. Understandably, the lack of clarity crimped demand.

Meanwhile, banks continued shunning SMEs, opting instead to extend traditional and trust loans primarily to regional and local governments and the corporations they controlled, allegedly deploying most of the funds on unapproved (and unprofitable) real estate and infrastructure projects. The result was a sizable increase to municipalities' already large (and, many suspect, toxic) debt load and a huge jump in the money supply not reaching the real economy.

Regaining Control

The latter is an anathema to a government which has long used strict loan quotas to control money supply and influence economic growth—stricter loan quotas when they need to tame inflation, and looser caps when they need to boost growth. Having at least partly deregulated many aspects of shadow financing, officials cannot cap it the same way they can traditional bank lending. Instead, they should incentivise the banks to lend more judiciously.

Thus, in March, the government announced strict new rules governing WMPs' underlying investments. Illiquid assets were capped at 35% of each WMP's portfolio or 4% of a bank's total assets, and quotas for money market funds and high-grade bonds were raised. Banks have until year-end to comply with the new guidelines. But because they diminish WMPs' potential return (and, by extension, banks' potential profits), the institutions have been slow to adapt—credit expansion continued at a torrid pace in early June. The government needed to create additional urgency.

An Engineered Interbank Funding Squeeze

Per Chinese regulations, banks are required to report capital and comply with minimum standards at the end of each quarter. Thus, as the quarter winds down, banks typically start hoarding cash in order to rebuild buffers. This can make money markets slightly constricted.

Ordinarily, China's central bank (PBOC) adds liquidity to offset this, typically through repo operations. However, this time around, they did not immediately intervene, and the Shanghai Interbank Offered Rate (SHIBOR) moved up—and the longer the PBOC stayed out, the more uncertain markets grew, and the higher SHIBOR rose. It peaked on 20 June, with the three-month rate hitting 5.8% and the overnight rate hitting 13.4%[xvii].

As rates climbed sharply, many worried banks would not be able to meet funding obligations, creating volatility in the banking system. Many WMPs mature quarterly, with several coming due in late June/early July. Chinese banks depend heavily on wholesale financing, and with money markets seemingly seizing, some speculated banks would not be able to raise enough cash to roll over maturing WMPs, causing the supposed credit bubble to burst—i.e., the Lehman moment. They looked to the government for help, but the PBOC released a statement confirming there was plenty of liquidity in the system, and banks simply needed to manage it more prudently. The government's apparent refusal to help signaled to many a potential transition. Investors have long been used to the Chinese government supporting the economy at any sign of softening, with the apparent refusal to tame money markets seemed a paradigm shift likely contributing heavily to June's volatility. This volatility reached its apex on 24 June when the Shanghai composite fell over 5%[xx].

In FI's view, the PBOC's move was most likely a political message aimed at bank leadership: Lending profligately off balance sheet has consequences, and if banks are not more judicious, the PBOC would not support them with unlimited liquidity. It was a warning shot, not a permanent policy change. Tellingly, once officials made their point, they intervened with targeted liquidity injections, helping ease the acute strain in Chinese money markets. The PBOC also reiterated its commitment to moderate credit expansion and confirmed banks complying with its lending guidelines should continue getting assistance.

What the Future Holds

Looking ahead, FI expects the PBOC to remain similarly accommodative. Chinese officials still understand maintaining financial stability is tantamount to maintaining social stability, giving them incentive to continue supporting liquidity and ensuring banks and businesses can access capital. The State Council pledged to do this in a 19 June policy statement, laying out plans to direct capital to advanced manufacturing firms, the service sector, agricultural modernisation and smaller businesses.

At the same time, it would not surprise us if credit tightened and economic growth slowed some from here. Officials have been very vocal about their plans to shift the economy away from export- and infrastructure-led growth and toward domestic consumption and services, likely meaning China moves away from using state-run banks to fund infrastructure projects with a high ROI, ending the days of credit-intensive double-digit economic growth. In fact, the government has acknowledged its 7% annual GDP growth target for the next 10 years may be difficult to meet.

However, economic growth is not the sole driver of China's—or any country's—stock market returns. Furthermore, China's economic growth is an even less significant driver for global markets. In FI's view, economic reform is likely a bigger driver, and the recent events augur well for continued (albeit slow) reform. In order to restructure the economy, Chinese officials would have to continue reforming the financial system. Liberalised interest rates, private banking and clear, transparent financial regulation are vital to sustainable economic growth, and the cabinet has pledged to pursue these endeavors over time.

However, in the near term, Chinese market volatility could very well continue as investors acclimate to a government willing to employ shock therapy—and allow businesses to experience short-term pain in exchange for long-term economic gain and stability. Recent events recall the policies of former Premier Zhu Rongji, who cut down many of the largest state-run firms in the late 1990s, believing their bloated size hindered longer-term economic progress. Chinese markets were very choppy during this period, also coinciding with the Asian Currency Crisis, and later a global bear market. However, over time, Zhu's gambit paid off. Additionally, by telegraphing the areas of the economy it plans to support, the cabinet might help limit the uncertainty typically coming when a government picks winners and losers—a noteworthy, often overlooked point likely providing global markets with useful clarity and Chinese equities with a welcome boost.

Should you have any questions about any of the information in the Second Quarter 2013 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.

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ii. Thomson Reuters, US Bureau of Economic Analysis. Third estimate of US Real GDP. All figures at seasonally adjusted annual rates.
iii. Thomson Reuters. US retail sales including food services, May 2012 to May 2013.
iv. Thomson Reuters, US ISM Manufacturing PMI (Seasonally Adjusted), January 2010 to June 2013.
v. Thomson Reuters, US USM Manufacturing and Non-manufacturing PMI, April to June 2013.
vi. Markit, UK Manufacturing and Non-manufacturing PMI for the period April to June 2013.
vii. Thomson Reuters.
viii. Markit, Eurozone Manufacturing and Non-manufacturing PMI, June 2013.
ix. US Department of the Treasury, as of 12/7/2013.
x. Global Financial Data, Inc. (GFD), as of 10/7/2013, USA 10-Year Bond Constant Maturity Yield, S&P 500 Total Return Index from 30/11/1945 to 30/9/1981 and S&P 500 Total Return Index from 30/9/1981 to 30/6/2013. The S&P 500 Total Return Index is based upon GFD calculations of total returns before 1971. These are estimates by GFD to calculate the values of the S&P Composite before 1971 and are not official values. GFD used data from the Cowles Commission and from S&P itself to calculate total returns for the S&P Composite using the S&P Composite Price Index and dividend yields through 1970, official monthly numbers from 1971 to 1987 and official daily data from 1988 on.
xi. Office for National Statistics, as of 25/7/2013.
xii. Bank of England.
xiii. "Changing Banking for Good, Volume I: Summary, Conclusions and Recommendations," Parliamentary Commission on Banking Standards, 12/6/2013.
xiv. MSCI World Metals & Mining minus MSCI World, net returns from 30/9/2000 to 31/12/2010.
xv. MSCI World Metals & Mining minus MSCI World, net returns from 31/12/2010 to 31/5/2013.
xvi. Thomson Reuters. MSCI China Total Return With Net Dividends from 31/5/2013 to 30/6/2013.
xvii. Thomson Reuters. Chinese Monetary Financial Institutions' Social Financing from January 2013 to May 2013.

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 our liability towards you because of our 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.