FISHER INVESTMENTS EUROPE™

FOURTH QUARTER 2014

MARKET PERSPECTIVES

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FOURTH QUARTER 2014 REVIEW AND OUTLOOK
MARKET PERSPECTIVES

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FOURTH QUARTER 2014 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Despite October and mid-December choppiness, global equities ended 2014 positively, with the MSCI All Country World Index rising 0.4% in Q4, bringing full-year returns to 4.2%.[i]

Bigger equities beat smaller in 2014, though the largest lagged slightly. Leadership shifts are an uneven but gradual process. As this continues, we expect the largest securities to shine soon. US equities led most global equities, as they have for the majority of this bull market—a trend we expect to continue in 2015. However, the benefits of a globally diversified portfolio providing exposure to many currencies and economies are as important as ever—despite short-term US leadership. Eventually equity leadership shifts, and reacting to past returns is misguided.

As 2014 began we thought the most likely outcome was equities ending 2014 up over 20%, and up 0% to 20% second most probable. Ultimately, global equities ended up modestly—our second most likely outcome—as sentiment improved slower than expected, particularly toward non-US equities.

Portfolio Themes

- **Underweight to Commodity-Oriented Companies:** Our opinion is companies that have significant commodity exposure (metals, oil and agricultural) will underperform over the next 12-18 months (reflected in our underweights to the Materials and Energy sectors).
- **Quality Tilt:** As the bull market progresses we favour equities with strong balance sheets and consistent profit margins.
- **Overweight to Health Care:** Health Care companies typically offer reliable sources of revenue and often have power to pass potentially higher costs to consumers, giving them stable longer-term growth prospects—qualities we expect investors to increasingly prefer.

Market Outlook

- **Earnings Growth:** Corporate earnings and revenues continue to grow alongside the global economy.
- **Sentiment Rising:** Sentiment is continuing to rise but expectations still remain low and easy to beat.
- **Recent Volatility:** While a correction is always possible, we expect the market's broader trajectory to be positive.

Peering into 2015, the global bull market should continue, with equities likely rising double digits. Nearly six years in, market fundamentals remain robust. The global economy is growing, with an accelerating US leading the developed world. Most western nations' governments are gridlocked, reducing radical legislative risk materially hurting equities—particularly in the US, where 2014's midterms brought more gridlock, as we expected. Markets have historically celebrated gridlock with positive quarterly returns in 86.4% of US midterm-year Q4s (technically, that percentage goes to 87% after a positive Q4 2014) and Q1 and Q2 of the years after (an occurrence we have called, "The 86.4% Miracle"). This solid start helps explain why the third year of a US president's term is historically the strongest of the four-year cycle, with an 18.5% average return and only two negative years since 1926—both in the 1930s.[ii]

We do not currently see a compelling reason for this bull market to end soon. Bull markets end one of two ways: the wall or the disruptive shock. Bull markets climb a wall of worry until there is no more worry and no more wall to climb. At the euphoric top, reality cannot meet lofty expectations, and equities start their slide. Alternatively, the bull market gets shocked by a huge, unseen negative with enough power to severely disrupt global trade or GDP growth. Sentiment is warming but far from euphoric—most still do not fathom how bright the future can be. Some stubborn fears persist, providing equities more wall to climb. A disruptive shock, though possible, is not probable—today's risks are either too widely known or too small to have a massive, surprising negative impact.

Professional forecasters were too timid in 2014 and remain so now. Average return expectations are about as muted as 2014, with none higher than about 14%—well below historical bull-market averages. Given equities' tendency to land outside the main cluster of professional forecasts—and the low likelihood of a bear market—this implies equities rise more than expected.

Geographically, America remains favourable economically, with growth above its post-war average in four of the past five quarters. The Leading Economic Index (LEI) continues rising, fueled by the yield spread and credit availability, implying growth ahead. In addition, new orders in manufacturing and services are surging while earnings and revenues grow apace. Further, loan growth is accelerating and corporate balance sheets are cash-flush—providing fuel for continued capex and expansion.

While most acknowledge America's strength, few fathom the global economy's strength. In the eurozone, for example, most fixate on slowing services and manufacturing indexes, fearing a deflationary depression, yet overall economic growth continues. Choppy but rising LEIs indicate continued, uneven growth, which should beat dreary expectations. Similarly, in the UK, many fret strong household spending and services means the expansion remains "unbalanced"—a misdirected pessimism, in our view.

In China, most focus on slowing monthly numbers, ignoring it is growing around 7%, contributing more than ever to global GDP growth. Positive political developments in India helped equity markets and the approval of a new land acquisition measure should enable large infrastructure projects' to move forward in the coming year. Fears of a Russian contagion are overblown and other Emerging Market countries look poised for growth in 2015.

Risks exist, as always, but as mentioned previously, we see none likely to truncate this bull market. Falling oil prices are often cited as such, but crude's steep decline is tied largely to a vast supply increase as the shale boom continues and Saudi Arabia remains dedicated to retaining market share. Meanwhile, energy demand is healthy. Some suggest commodity markets' volatility must soon spill over to equity markets. This is a fallacy. Information flows freely and swiftly through all capital markets, making it impossible for oil markets to know something equity markets do not.

THEMATIC UPDATE & MARKET OUTLOOK

A Q4 Recap

The bull market continued in Q4, with equities shrugging off volatility to finish the quarter and year mildly positive. We expect equities to continue climbing through 2015 at least.

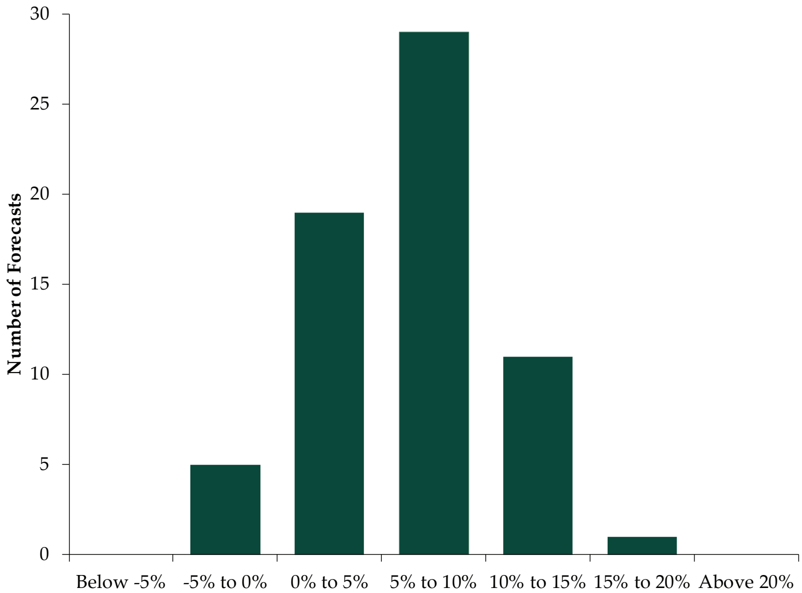
While many feared factors like geopolitical tensions, sharply falling commodity prices and equities repeatedly reaching prior record highs, global markets were mainly positive for the year. At a country and sector level, 2014 played out largely as we expected. Technology—one of our overweights—led, while Energy and Materials, our main underweights, lagged badly as commodity prices fell. Our US overweight benefited many portfolios, as did our decision to underweight Japan.

The Bull Market Continues in 2015

We believe the bull market will continue, with double-digit gains likely in 2015. Professional predictions cluster in the single digits, with a median forecast of 6.9%—slightly above last year's—and none exceeding 16%. (Exhibit 1) Markets are quite efficient and typically price in consensus forecasts, making it unlikely full-year returns land in the cluster.

This suggests returns will top 16%—but does not hint at how far above. The year could resemble 2013, when equities beat most forecasts. Alternatively, a correction (sharp drop of -10% to -20% over a few weeks or months) could happen late in an otherwise great year, reducing 2015 returns but setting up an early 2016 bounce.

Exhibit 1: Professional S&P 500 Forecasts



Source: Fisher Investments Research, as of 16/01/2015.

Corrections can happen any time, for any reason or no reason. Entering 2014, many believed a correction was near since 2013 was correction-free. None came. The autumn pullback came close but did not reach -10%. Now many expect a 2015 correction since nearly three years of bull market have passed without one. Yet corrections are random. Whether or not a correction has occurred recently does not tell you whether one is near.

A down year is also possible, though less likely. With no professional forecast below -5%, a modestly negative year would also fall outside the bell curve. However, fundamentals and sentiment point positively, so this likely hinges on short-term swings.

A bear market—a longer, fundamentally driven decline of -20% or worse—is unlikely. Most often, equities peak after climbing the wall of worry as depicted by Sir John Templeton's quote: "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." They die when investors run out of things to worry about, become euphoric, and reality fails to meet sky-high expectations. Or, they die prematurely, hit by a huge unseen negative with the power to erase a few trillion of economic activity from the roughly $75 trillion global economy. Neither seems likely. Euphoria is absent, suggesting more wall for equities to climb. Risks always exist, but we see no high-probability, sufficiently sizable impact to knock equities -20% or more. Most negatives today are too small, too widely known or both—like Greece. They are bricks in the wall of worry—bullish.

Fundamentals at a Glance

Conditions are ripe for strong returns. 2015 opens amid "The 86.4% Miracle," the US post-midterm election sweet spot. Republicans swept November's US midterms but did not win veto-proof majorities—continuing gridlock, as we expected. Gridlock is why equities rose in 86.4% of midterm-year Q4s (now 87%, after Q4 2014's gain) and the following two quarters.[iii] When Washington does little, legislative risk drops. Gridlock also explains why year three has the Presidential cycle's strongest returns, averaging 18.5% since 1926.[iv] Third years are also the most frequently positive, with just two negatives—1931 and 1939, the former during the Great Depression and the latter World War II's outbreak in Europe. (Exhibit 2) Positive third years average 22.6%—with 13 of 22 finishing above 20%.

Exhibit 2: The Presidential Term Anomaly

Party	President	First Year		Second Year		Third Year		Fourth Year	
R	Coolidge	1925	N/A	1926	11.1%	1927	37.1%	1928	43.3%
R	Hoover	1929	-8.9%	1930	-25.3%	1931	-43.9%	1932	-8.9%
D	FDR -- 1st	1933	52.9%	1934	-2.3%	1935	47.2%	1936	32.8%
D	FDR -- 2nd	1937	-35.3%	1938	33.2%	1939	-0.9%	1940	-10.1%
D	FDR -- 3rd	1941	-11.8%	1942	21.1%	1943	25.8%	1944	19.7%
D	FDR / Truman	1945	36.5%	1946	-8.2%	1947	5.2%	1948	5.1%
D	Truman	1949	18.1%	1950	30.6%	1951	24.6%	1952	18.5%
R	Ike -- 1st	1953	-1.1%	1954	52.4%	1955	31.4%	1956	6.6%
R	Ike -- 2nd	1957	-10.9%	1958	43.3%	1959	11.9%	1960	0.5%
D	Kennedy / Johnson	1961	26.8%	1962	-8.8%	1963	22.7%	1964	16.4%
D	Johnson	1965	12.4%	1966	-10.1%	1967	23.9%	1968	11.0%
R	Nixon	1969	-8.5%	1970	4.0%	1971	14.3%	1972	18.9%
R	Nixon / Ford	1973	-14.8%	1974	-26.5%	1975	37.3%	1976	23.7%
D	Carter	1977	-7.4%	1978	6.4%	1979	18.4%	1980	32.3%
R	Reagan -- 1st	1981	-5.1%	1982	21.5%	1983	22.5%	1984	6.2%
R	Reagan -- 2nd	1985	31.6%	1986	18.6%	1987	5.2%	1988	16.6%
R	Bush	1989	31.7%	1990	-3.1%	1991	30.5%	1992	7.6%
D	Clinton -- 1st	1993	10.1%	1994	1.3%	1995	37.6%	1996	23.0%
D	Clinton -- 2nd	1997	33.4%	1998	28.6%	1999	21.0%	2000	-9.1%
R	Bush, G.W.-- 1st	2001	-11.9%	2002	-22.1%	2003	28.7%	2004	10.9%
R	Bush, G.W.-- 2nd	2005	4.9%	2006	15.8%	2007	5.5%	2008	-37.0%
D	Obama -- 1st	2009	26.5%	2010	15.1%	2011	2.1%	2012	16.0%
D	Obama -- 2nd	2013	32.4%	2014	13.7%	2015	?	2016	?
Republicans Average		0.7%		8.2%		16.4%		8.0%	
Democrats Average		16.2%		10.0%		20.7%		14.1%	
All (Average)		9.2%		9.1%		18.5%		11.1%	

Source: Global Financial Data, Inc., as of 07/01/2015. S&P 500 Total Return Index, 1/1/1926 – 31/12/2014.

The global economy is growing nicely. America, buoyed by quantitative easing's (QE) end, leads the developed world, followed closely by Britain. Though long-term interest rates fell in 2014, the yield curve—the gap between short-term and long-term rates—retains a healthy positive slope. QE's end gives banks more clarity, too, as the US Federal Reserve (Fed) interferes less with long rates. Loan growth continues accelerating, The Conference Board's Leading Economic Index is high and rising, earnings are up and corporate balance sheets are cash-rich. Most Emerging Markets are growing swiftly, driving revenue growth for firms globally. Eurozone growth remains sluggish, yet choppy and slow growth beats near-universal deflationary depression fears. Eurozone GDP has grown six straight quarters—widely underappreciated but true. Genuine weak spots exist, namely Japan and Russia, but markets know these years-old issues well. Growth elsewhere more than offsets the isolated sore spots.

Sentiment enters 2015 mildly optimistic, not euphoric. The 6.9% median S&P 500 forecast modestly exceeds 2014's 5.5%—and contrasts sharply with 2000's and 2001's excessive optimism, when most projected double-digit returns, not fathoming a drop. Today, few fathom robust returns. Media portrays economic news more positively, but not irrationally optimistic—negative news frequently resurrects headlines' pessimism. Tellingly, bearish forecasts get respect—when bond guru Bill Gross announced he believes "the good times are over" and a bear market lurks, headlines were reverent. Usually, euphoric investors ridicule bears. We are not there yet.

A Long Bull Market?

This bull turns six in March, and we are often asked how long the it can last. While we believe forecasts beyond 18 months are unreliable, market cycles do seem to have elongated since 1980. The 1980s bull was long. The 1990s bull was history's longest. The 2000s bull seemed just over halfway through, judging by sentiment and size leadership, when FAS 157 (the mark-to-market accounting rule) and the government's chaotic response derailed it. Today, sentiment is warming—implying a long stretch of mature bull market ahead, absent an impactful surprise.

US monetary conditions also support this. At no point in history have bull markets come this far without a single Fed rate hike. With QE over, normality returns: The Fed controls the yield curve's short end and the free market determines longer rates. Former Fed head William McChesney Martin famously said the Fed's job is to yank the punchbowl just as the party gets going, but QE's end is the reverse.

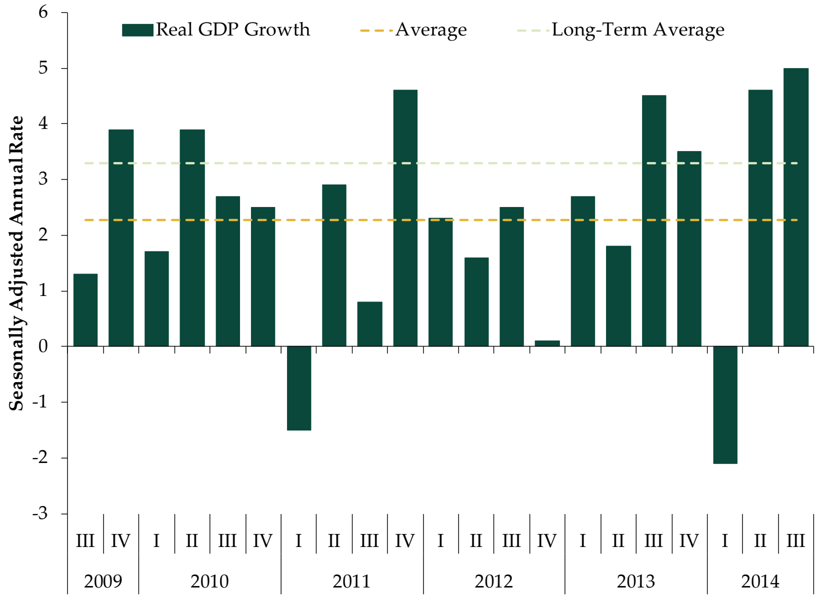
US COMMENTARY

US Economics

Q3 corporate earnings rose 8.0% y/y, continuing the long-running growth trend.[v] Growth was again broad-based, with nine of ten sectors rising (Consumer Discretionary was the outlier, tied largely to one major homebuilder and automaker). Revenues rose 4.0% y/y with every sector growing except Energy as falling oil prices weighed heavily—hence our underweight. Overall, continued growth paints a bright picture of corporate America.

US GDP surged at a 5.0% seasonally adjusted annual rate, the fastest since 2003.[vi] The private sector remains strong as household spending grew 3.2%—2014's fastest rate—and business investment jumped 7.7%.[vii] Exports grew 4.5%, while imports shrank -0.9%, driven by falling oil prices.[viii] Excluding petroleum products, imports rose.[ix] The private sector has powered US growth past its post-WWII average in four of the past five quarters.

Exhibit 3: US GDP Growth



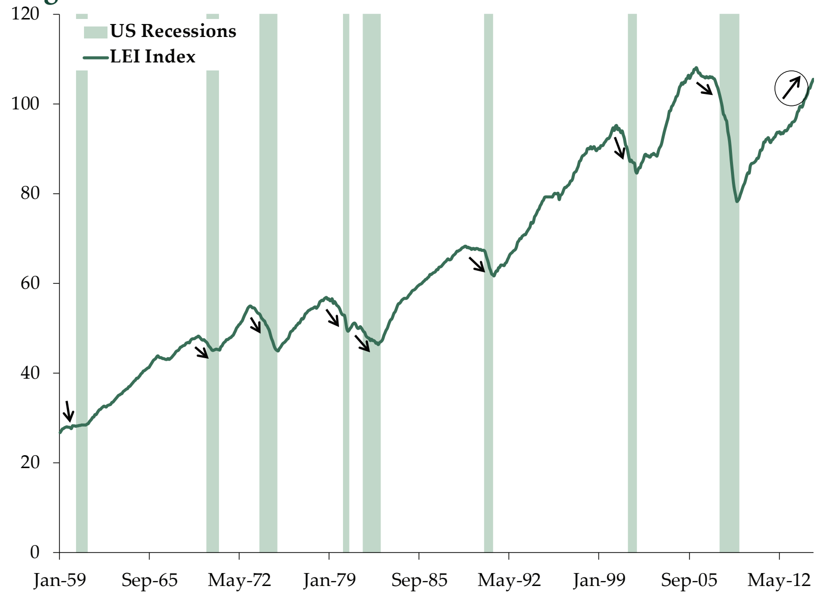
Source: US Bureau of Economic Analysis, as of 02/01/2015. Percent change in real US GDP, seasonally adjusted annual rate, Q3 2009 – Q3 2014, and average growth rate from Q2 1947 – Q3 2014.

Growth likely continued in Q4. Manufacturing and services Purchasing Managers' Indexes (PMI) stayed well above 50 (the line between growth and contraction). Retail sales rose 4.0% in 2014, despite falling gas-station sales.[x] While headlines claim falling gas prices are a massive stimulus, this is overstated. Falling gas prices merely create winners and losers.

Disposable income increased in Q4, driving consumer spending upward. Real personal disposable income growth sped to 2.9% y/y in November, 2014's fastest.[xi] Interestingly, while media bemoans sluggish income growth, recent choppiness is mostly tied to the payroll tax holiday's 2013 expiration. Several firms pulled bonus payments into late 2012, before the tax rose, skewing year-over-year comparisons. Industry-specific wage and salary growth is in line with the prior expansion and much of the 1990s. Pundits underestimate current and future strength—a bullish indicator.

While headlines look backward, we watch widely ignored forward-looking indicators, like The Conference Board's Leading Economic Index (LEI). During LEI's 55-year history, no recession began during an uptrend. LEI continued rising in Q3 with November's 0.6% m/m jump, its ninth rise in 11 months.[xii] (Exhibit 4)

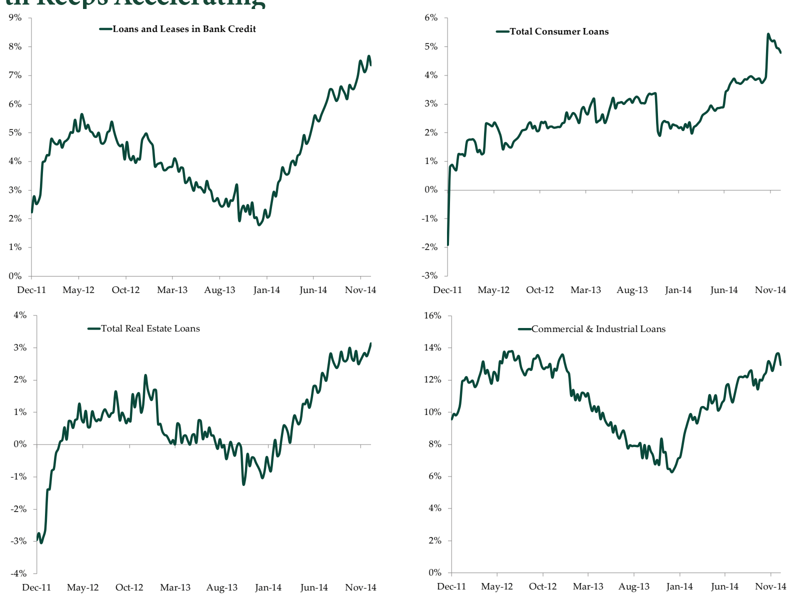
Exhibit 4: LEI-- The Magic Indicator



Source: The Conference Board, as of 15/01/2015. Leading Economic Index and NBER Recessions, January 1949 – November 2014.

The yield spread remains LEI's biggest contributor, with the Leading Credit Index (measuring credit availability) close behind—showing credit markets strengthened as QE ended. Loan growth accelerated in 2014, finishing at 7.4% y/y—driven by business lending, which sped to 13.0% at year-end.[xiii] Rising lending and cash-rich corporate balance sheets should fuel continued capex, share buybacks, cash-based M&A and earnings growth.

Exhibit 5: Loan Growth Keeps Accelerating



Source: Federal Reserve, as of 15/01/2015. Loans and leases in bank credit, commercial & industrial lending, real estate lending and consumer lending, y/y change, 31/12/2011 – 31/12/2014.

Fedside Chatter

The end of QE bond buying centred speculation on a potential fed-funds target rate hike—the first since 2006. Uncertainty raised as the Fed adjusted its forward guidance—after QE ended, the Fed deemphasised language stating rates would stay near zero for "a considerable time", a pledge to be "patient in beginning to normalise monetary policy" was added, and additional new language called the two synonymous. Pundits searched for hike-timing hints—a futile exercise. Fed guidance is deliberately obtuse, non-committal and always changing.

Whether or not the Fed will hike the target rate is unforeseeable. The Fed has always said the decision hinges on members' interpretations of economic data. Forecasting data is extremely difficult—much less humans' (biased) interpretations.

Forecasting is also unnecessary. Most assume a rate hike is negative for equities, but there is little history of an initial rate hike ending a bull. (Exhibit 6)

Exhibit 6: Rate Hikes and Equities

Date of First Rate Hike	Percent Change Prior 12 Months	Percent Change Next 12 Months	Percent Change Next 24 Months
16/07/1971	31.2%	13.5%	19.0%
16/08/1977	-1.5%	15.0%	19.8%
21/10/1980	18.9%	-13.6%	-8.0%
27/03/1984	11.8%	8.0%	62.6%
16/12/1986	40.8%	14.1%	37.6%
29/03/1988	0.9%	11.7%	9.8%
04/02/1994	27.2%	-3.9%	17.4%
30/06/1999	14.0%	10.7%	-12.1%
30/06/2004	21.4%	8.7%	22.4%
Average	**18%**	**7%**	**19%**

Source: FactSet and Federal Reserve, as of 09/01/2015. MSCI World Index price return, 31/12/1969 – 31/12/2006.

Initial rate hikes do not end bull markets because short rates, alone, do not determine whether credit loosens or tightens. The yield curve influences that more, and the first hike typically does not materially affect this. That usually happens later if the Fed overshoots—like Alan Greenspan in 2000. Exhibit 7 shows how long the yield curve stayed positive after initial hikes.

Exhibit 7: Rate Hikes and the Yield Curve

Date of First Rate Hike	Months Until Yield Curve Inverts	Months Until Bear Market Begins
16/07/1971	18	18
16/08/1977	12	39.5
27/03/1984	21	41
16/12/1986	0.5	8
29/03/1988	9	27.5
04/02/1994	20	73.5
30/06/1999	9	9
30/06/2004	21	39
Average	**13.8**	**31.9**

Source: FactSet and Federal Reserve, as of 15/01/2015. The yield curve spread is the 10-year US Treasury yield minus the effective fed-funds rate. 1980 is excluded as the yield curve was inverted when Paul Volcker hiked.

For now, with a positively sloped yield curve, strong loan growth and steady GDP, America should easily digest a small rate hike. Once a tightening cycle begins, the question is whether the Fed tightens gradually, keeping the yield curve positive, or hikes aggressively.

There is no way to foretell how fast the Fed hikes but we can speculate based on Fed head Janet Yellen's actions. She tends toward gradualism and consensus building—suggesting she will move slowly and deliberately. Plus, the 2016 presidential election will give her a new boss when she faces reappointment in 2017—motivation to act moderately. Perhaps she will hike at least once to counter concerns she might be too "dovish," but not aggressively, lest she appear overly "hawkish." A gradual middle ground would make her palatable to a Democratic or Republican president. For example, Yellen might hike rates 25 basis points to break the ice—then wait, let it sink in, and boast when all goes fine before hiking again. This is not a prediction, just a hypothetical illustration of how a politically motivated Fed may act.

Political Drivers for a Non-Election Year

With government gridlocked and President Obama's term entering year three, political drivers are positive for equities.

The 86.4% Miracle

November's midterms brought more gridlock, as the Republicans won a 247-to-188 House majority and 54-to-46 Senate majority—not veto-proof. Equities shine when gridlock blocks radical new laws affecting property rights or otherwise affecting markets. This is why US equities rose in 86.4% of midterm-year Q4s (87% after 2014) and the next two quarters—"The 86.4% Miracle."[xiv]

Gridlock does not mean nothing happens. The last Congress closed 2014 by repealing a sliver of Dodd-Frank—namely, a measure banning banks from trading certain derivatives within FDIC-insured units—a small change giving banks more flexibility. The first law enacted this year was another Dodd-Frank tweak exempting airlines, farmers and other non-bank companies from restrictions on derivatives trades. More Dodd-Frank adjustments are possible. Congress and Obama will likely compromise on the upcoming debt ceiling increase. Small and compulsory measures can pass. Gridlock simply prevents major, contentious new laws from spooking markets—a factor few investors appreciate, getting caught up in gridlock's squabbling. Partisans hate that their party's proposals stall, and independents bemoan arguing and crave bipartisanship. Few fathom the benefits of doing nothing—hence why The 86.4% Miracle is a regularly recurring phenomenon that is rarely priced in.

A Look at 2016

Political pundits already focus on 2016—too distant to handicap, but worth weighing in general terms. The results could erase gridlock and introduce market risk.

Most pundits say 2016's Senate race structurally favours Democrats, mirroring Republicans' advantage last year—true, but barely. As Exhibit 8 shows, Democrats have fewer seats to defend in opposition territory. However, sweeping will be difficult. Governors' races are also the inverse of 2016 with Democrats defending more in red states, potentially diverting money from Senate races. (Exhibit 9) Furthermore, it is virtually impossible to knock out Chuck Grassley (IA), Marco Rubio (FL) and Rob Portman (OH)—many believe Ohio is a swing state, but its state-level offices are predominantly Republican. Democrats would have to win every other seat, including John McCain's (AZ). This could happen if the Democratic presidential candidate wins with coattail-generating momentum—possible, but unknowable today. We do not know the candidates, much less how campaign momentum will swing.

Exhibit 8: 2016 Senate Races

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

Source: Fisher Investments Research and US Senate, as of 15/11/2014.

Exhibit 9: 2016 Gubernatorial Races

Governor	Party	State	Percent of Vote for Bush in 2000	Percent of Vote for Bush in 2004	Percent of Vote for McCain in 2008	Percent of Vote for Romney in 2012	Year Elected	Senate Seat Up for Election?
Herbert, Gary R.	R	UT	67%	72%	63%	73%	2009	Yes
Tomblin, Earl Ray	D	WV	52%	56%	56%	62%	2010	No
Beshear, Steven L.*	D	KY	57%	60%	57%	60%	2007	Yes
Dalrymple, Jack	R	ND	61%	63%	53%	58%	2010	Yes
Jindal, Bobby*	R	LA	53%	57%	59%	58%	2007	Yes
Bullock, Steve	D	MT	58%	59%	50%	55%	2012	No
Bryant, Phil*	R	MS	58%	59%	56%	55%	2011	No
Pence, Mike	R	IN	57%	60%	49%	54%	2012	Yes
Nixon, Jay	D	MO	50%	53%	49%	54%	2008	Yes
McCrory, Pat	R	NC	56%	56%	49%	50%	2012	Yes
Hassan, Maggie	D	NH	48%	49%	45%	46%	2012	Yes
Inslee, Jay	D	WA	45%	46%	40%	41%	2012	Yes
Markell, Jack	D	DE	42%	46%	37%	40%	2008	No
Shumlin, Peter	D	VT	41%	39%	30%	31%	2010	Yes

*Source: National Governors Association, as of 15/11/2014. *Governor Beshear faces re-election in 2015*

Speculation abounds regarding potential candidates. Former Florida Governor Jeb Bush and former Virginia Senator Jim Webb are publicly exploring bids, while rumors surround others. Opinion polls show Hillary Clinton defeating Democratic rivals and Rand Paul, Chris Christie and Jeb Bush leading Republicans, but this means little. Opinion polls at similar points in 2008's campaign did not mention Barack Obama. Gallup's 2010 poll on potential Republican 2012 candidates ranked Sarah Palin and Mike Huckabee second and third—neither ran.

As detailed in past writings, Clinton does not fit the typical mold for Democratic nominees. Democrats prefer newcomers and underdogs. Bill Clinton was the "Comeback Kid" in 1992, trailing Paul Tsongas early. Obama did not surpass Hillary Clinton until 2008. Michael Dukakis, Jimmy Carter, Walter Mondale and even JFK all came from behind. Meanwhile, Republicans prefer time-tested candidates. They hate surprise and want a nominee with a well-known past, raising questions about Paul's and Christie's staying power. Tellingly, the same poll showed 30% of Republicans would nominate Mitt Romney—they want the war horse. The GOP might bend for Bush, given his lineage, but only time will tell.

As for equities, a weak Democrat winning in 2016 likely extends gridlock—a positive. If Republicans sweep, however, gridlock could end in 2017, a negative.

A Republican sweep would also introduce what we call the "Perverse Inverse"—markets' tendency to rally in election years when Republicans take the presidency from Democrats, then fall the next. (Exhibit 10) Republicans typically make market-friendly campaign promises, lifting election-year sentiment. However, after inauguration, reality disappoints as the new president, already eyeing re-election, moderates. Our experience shows most investors lean Republican, and a Republican sweep could push sentiment into euphoria, implying a huge 2016, but create lofty expectations for 2017, potentially implying downside.

Exhibit 10: The Perverse Inverse

	Election Year	Inauguration Year
Presidency changed from Republican to Democratic	-2.8%	21.8%
Presidency changed from Democratic to Republican	13.2%	-6.6%
Both presidency and Congress changed from Republican to Democratic	-8.9%	52.9%
Both presidency and Congress changed from Democratic to Republican	18.5%	-1.1%

Source: Global Financial Data, Inc., as of 15/01/2015. S&P 500 Total Return Index, 1926 – 2014.

Again, this is too distant to know today—as are economic fundamentals and future equity supply. However, it is a potential risk we monitor, and we will share updates when pertinent.

NON-US DEVELOPED COMMENTARY

Developed Politics Still Positive

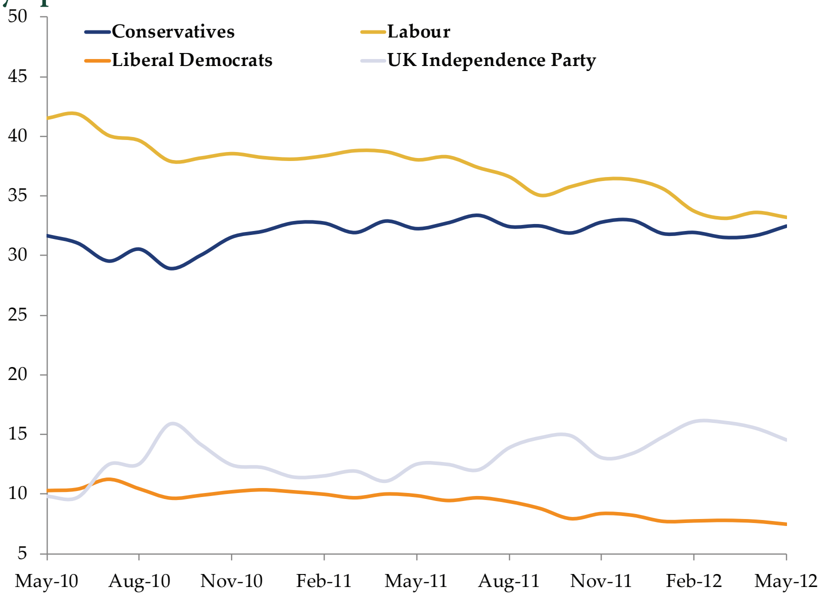
Throughout the Developed world, countries are largely gridlocked. Canada and Australia have prime ministers with declining popularity who cannot pass much. Canada holds a general election this year (date TBD), and polling is tight—implying the current government will not want to rock the boat. France has a weak Socialist president with pro-growth proposals opposed by many in his party—he may pass small measures, but nothing major. One contentious law from early in his term, a 75% payroll tax assessed to businesses on amounts above €1 million paid to an individual annually, expired, highlighting his moderation. Spanish and Portuguese elections are due by year-end with polls showing tight races, but it is too early to assess outcomes. Italy's government is wobbling as Prime Minister (PM) Matteo Renzi struggles to pass reforms, but that is not new.

UK Politics

Britain votes in May, creating some uncertainty, but the contest should yield more gridlock—bullish.

While Labour has led opinion polls since 2011, their lead has narrowed. (Exhibit 11) Through 15 January, average January polls put Labour one point ahead of the Conservatives—a virtual tie—followed by the UK Independence Party (UKIP) at 14.5% and the Liberal Democrats at 7.5%. Since the major parties have not released their election manifestos yet, it is too early to handicap the outcome. National opinion polls also are less telling in a first-past-the-post system like the UK's. However, unless momentum shifts radically, a hung Parliament looks likely. Whether Labour and the Conservatives form a grand coalition or either party cobbles together a coalition with smaller parties, the result will be a weak government unable to pass much. While it is possible either party could win outright, it would take flawless campaigning—and the margin of victory would likely be slim, making sweeping legislation difficult.

Exhibit 11: UK Party Opinion Polls



Source: UK Polling Report, as of 16/01/2015. Monthly average polling results from YouGov, Ipsos-MORI, Populus, Opinium, ICM, ComRes, Ashcroft, TNS BMRB and Survation, 31/12/2012-16/01/2015.

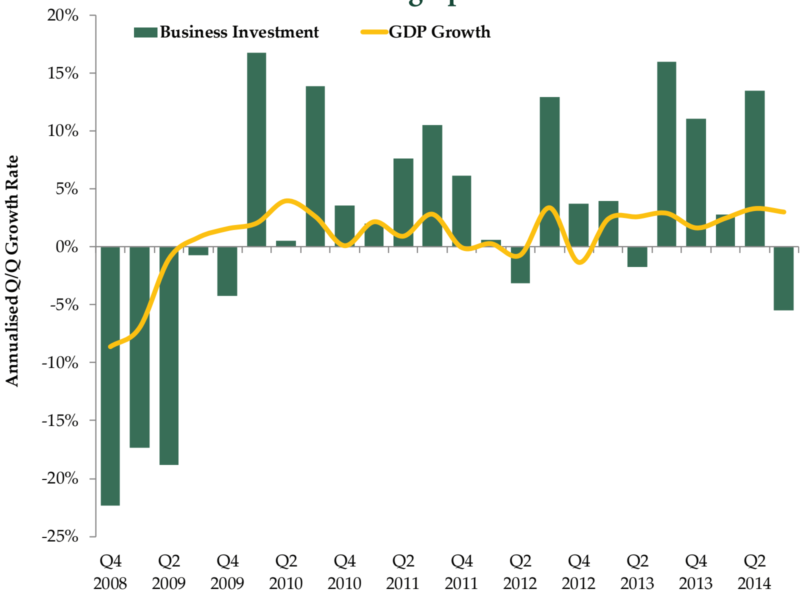
As in America, a gridlocked Britain reduces the risk radical new laws pass impacting property rights, regulations or the distribution of resources and capital. Markets love it when governments stand little chance of creating major winners and losers.

Gridlock also reduces the likelihood Britain exits the EU within the foreseeable future. While PM David Cameron pledged to renegotiate Britain's role in the EU and hold an in/out referendum on the new terms, this likely depends on the Conservatives winning a solid majority. The Liberal Democrats oppose a referendum, and Labour has said it would hold one only if there were a proposal to transfer additional sovereign powers to Brussels. Should the Conservatives be part of the next government and Cameron's pledge survive coalition negotiations, the UK government would have roughly two years to negotiate reforms with other EU nations—a long, slow process, giving markets time to digest potential changes and outcomes. Additionally, most areas Cameron wants to negotiate are sociological, not economic. While negotiations could heighten uncertainty (similar to the uncertainty before Scotland's independence referendum), slow and widely discussed potential changes likely lack the surprise power necessary to severely disrupt a bull market.

UK Economics

The UK continues its post-QE revival. Q3 GDP grew 3.0% annualised, led by the giant service sector's 4.5% annualised growth.[xv] While Britain's strength is obvious, many worry about an "unbalanced" expansion, with consumer spending growing too much and business investment and trade not enough. On the surface, Q3 numbers seemingly support that: Consumption rose 3.8% annualised, while business investment fell -5.5%.[xvi] However, context matters. UK business investment is often choppy. The occasional drop after a strong run is normal and has not derailed growth previously. (Exhibit 12)

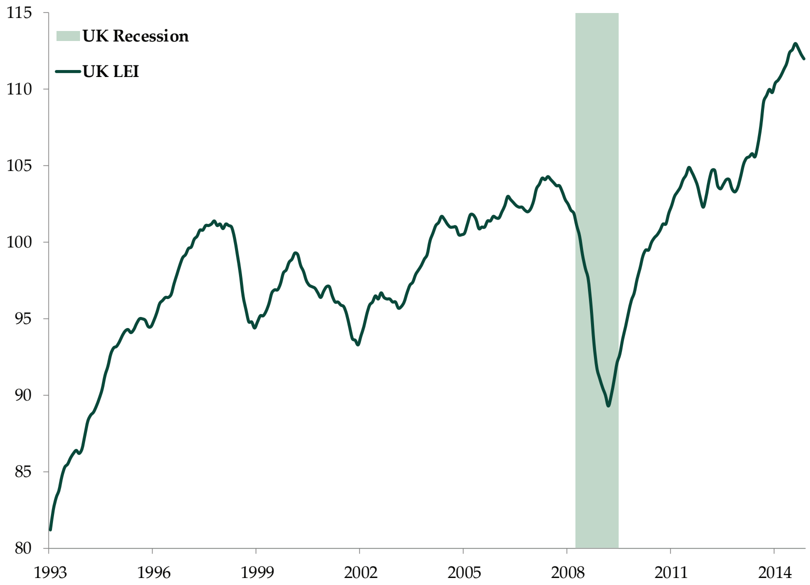
Exhibit 12: Business Investment Is Volatile but Trending Up



Source: FactSet, as of 15/01/2015. Annualised percentage change in real GDP and business investment, Q4 2008 – Q3 2014.

Most Q4 data suggest Britain is fine. Preliminary Q4 GDP (which do not categorise expenditures) grew 2.0% annualised.[xvii] PMIs stayed above 50, with services leading. New business growth cooled yet remains above 2009 – 2012 levels and in line with previous expansions, implying healthy demand. The Conference Board's UK LEI dipped in September-November, but occasional slips are normal and not consistent with recession (Exhibit 13). Moreover, these dips were driven by a drop in factory orders' three-month moving average and October's UK equity-market dip—both rebounded. The yield curve remains steeper today than during Britain's QE. Little implies a weakening UK.

Exhibit 13: UK LEI



Source: The Conference Board, as of 16/01/2015. UK LEI, January 1993 – November 2014.

Some longer-running headwinds linger, like weak lending. While the yield spread supports loan profitability, slow-recovering UK housing markets outside London weighed on bank balance sheets. UK banks face the world's strictest capital requirements, constraining their ability to lend. Recent stress tests added regulatory uncertainty, which should fade with the results in and the biggest banks passing. Banks' capital raising has satisfied regulators (for now), and housing markets are improving—all should give banks more flexibility to lend.

Eurozone Economics

Eurozone growth is not robust, but it beats ultra-dour expectations. Sentiment vascillates between Japan-style lost decade fears and deflationary depression dread—uneven growth is a positive surprise. Additionally, while total eurozone GDP grows slowly—0.6% annualised in Q3—member-states' growth rates vary.[xviii] Several are growing swiftly—widely unnoticed. (Exhibit 14)

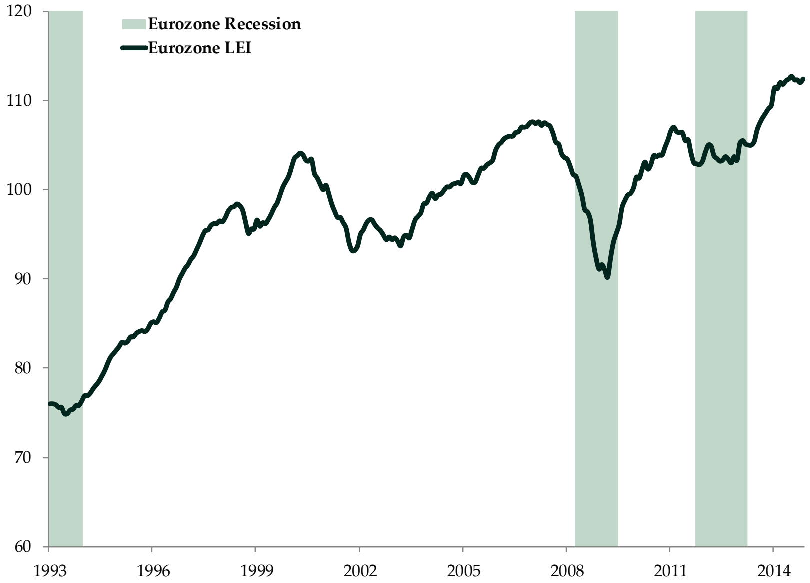
Exhibit 14: Eurozone Real GDP Growth by Country

Country	Q4 2013	Q1 2014	Q2 2014	Q3 2014
Austria	0.9%	0.2%	0.1%	-1.0%
Belgium	0.6%	1.5%	0.3%	1.2%
Cyprus	-2.4%	-2.2%	-1.4%	-1.0%
Estonia	3.6%	0.6%	3.5%	1.6%
Finland	-1.0%	-1.4%	1.6%	0.7%
France	0.8%	0.0%	-0.4%	1.0%
Germany	1.8%	3.1%	-0.3%	0.3%
Greece	-3.1%	-0.4%	0.4%	1.9%
Ireland	-1.6%	11.7%	4.5%	0.4%
Italy	-0.5%	-0.1%	-0.9%	-0.6%
Latvia	2.8%	1.3%	3.3%	2.2%
Lithuania	3.3%	1.8%	3.7%	1.8%
Luxembourg	0.3%	3.9%	1.9%	9.4%
Malta	4.1%	3.7%	5.3%	3.1%
Netherlands	2.4%	-1.4%	2.4%	0.5%
Portugal	3.9%	-1.5%	1.0%	1.0%
Slovakia	2.5%	2.8%	2.4%	N/A
Slovenia	5.2%	0.4%	4.3%	2.7%
Spain	1.2%	1.4%	2.1%	2.2%

Source: FactSet and Bloomberg, as of 16/01/2015. Greek figures y/y; all others are annualised rates.

The Conference Board's eurozone LEI remains in a variable uptrend—implying growth should top rock-bottom expectations. (Exhibit 15) German, French and Spanish LEIs look similar.

Exhibit 15: Eurozone LEI

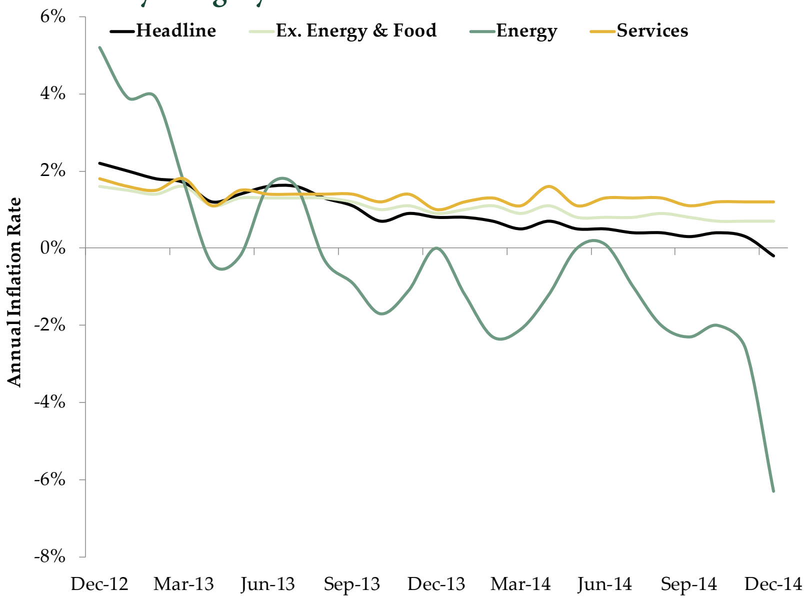


Source: The Conference Board, as of 16/01/2015. Euro Area LEI, January 1993 – November 2014.

Inflation turned negative in December, falling -0.2% y/y and heightening deflation fears and calls for the ECB to buy sovereign and private-sector bonds (QE).[xix] In January, the ECB announced a €1.1 trillion QE programme, with monthly bond purchases of €60 billion from March through September 2016—smaller than US QE as a percentage of GDP or the central bank balance sheet. We believe this is counterproductive and unnecessary, but not a significant hinderance.

December's dipping prices seem benign. Falling oil prices drove the decline—widely known and not negative. Core inflation, which excludes energy and food, remains positive, and service-sector prices continue rising moderately. (Exhibit 16) Broad money supply (M3) is rising and accelerated in Q4. Loan growth is showing signs of stabilising, with lingering negativity largely due to well-known headwinds in Italy's banking system. Deep, depressionary deflation is unlikely when money supply is growing—it happens when money evaporates.

Exhibit 16: Eurozone Inflation by Category

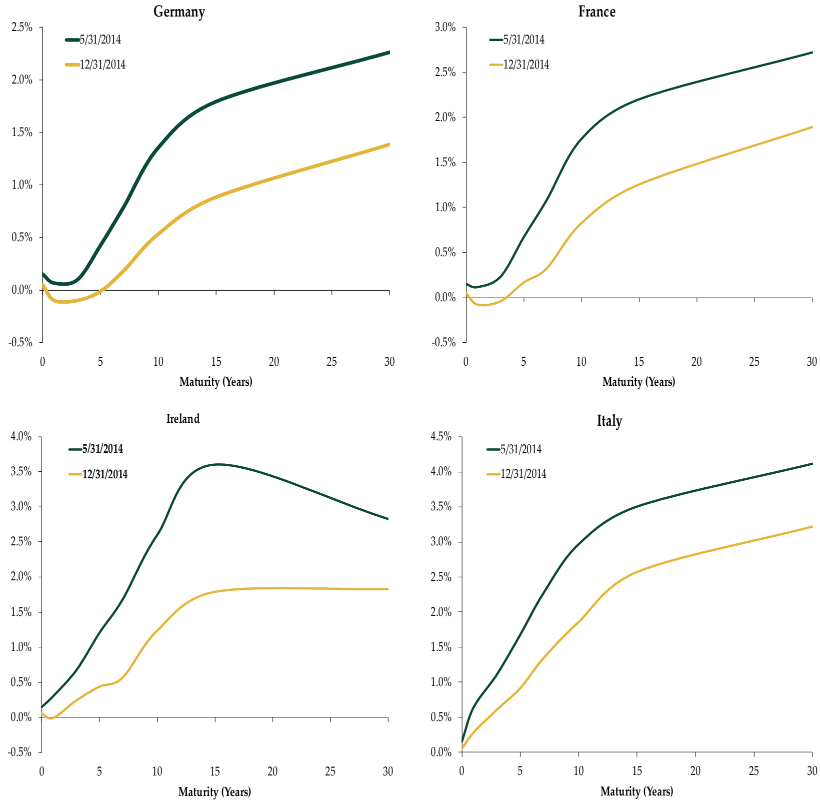


Source: FactSet, as of 15/01/2015. Eurozone Harmonised Index of Consumer Prices (Total, Ex. Energy & Food, Energy, Services), 31/12/2012 – 31/12/2014.

While some suggest QE will add liquidity, this is not lacking in the eurozone. Banks have excess cash, but yield curves are ultra-flat. (Exhibit 17) In June, the ECB started charging banks to hold excess reserves—aiming to encourage lending. Instead, banks moved cash from central banks to sovereign debt, driving down short- and medium-term sovereign yields. Germany's five-year yield is now negative. Long-term yields fell as markets priced in widely expected QE.

QE means more pressure on long-term yields—hampering lending and potentially creating deflation. As written in past Review & Outlooks, QE obstructed broad money supply growth (M4) in the US and UK and would likely affect the eurozone similarly.

Exhibit 17: Select Eurozone Yield Curves



Source: FactSet, as of 15/01/2015.

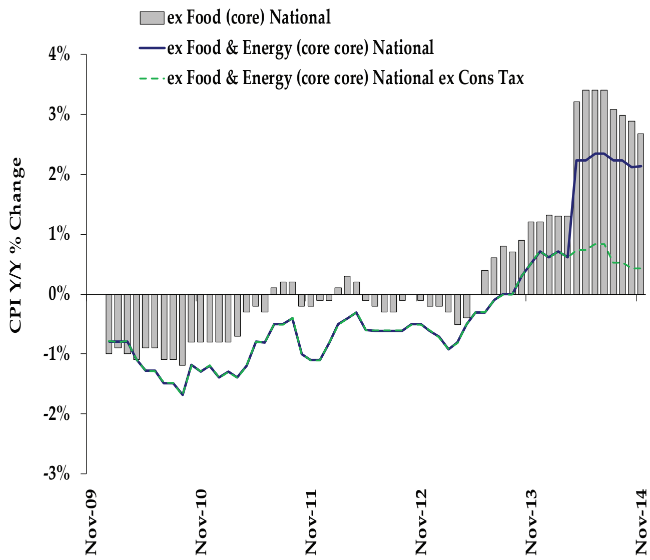
While QE is a drag, we do not believe it is a significant negative. It is widely known, and large programmes in America, Britain and Japan did not end the bull market or expansion. Plus, the rest of the world is growing strong enough to pull along a struggling Continent—just as it did after Continental Europe's similarly sized recession in 1993.

In Depth: Japan

Japanese equities underperformed again in Q4 and for full-year 2014. We believe Japanese underperformance likely continues looking forward, as investors continue to put too much equity in monetary moves and Prime Minister Shinzo Abe's ability and willingness to reform the economy.

Data released in Q4 showed continuing sluggishness in the Japanese economy. Q3 GDP data revealed a -1.9% SAAR contraction. This marks the second straight quarter of contraction, a technical recession—Japan's third since 2009. Inflation, too, is flagging. In November, headline prices rose only 2.4% y/y—technically, above the BoJ's target, but nearly two percentage points of this are attributable to the sales tax hike implemented in April. Excluding fresh food, alcohol and energy (core-core CPI), prices rose only 2.1%, again, before the sales tax is backed out. Hence, it seems the positive inflation many Japan bulls cited earlier this year is actually gradually reversing. (Exhibit 18) What little evidence Japan's massive quantitative easing programme might be stimulating inflation and growth appears to be evaporating with it.

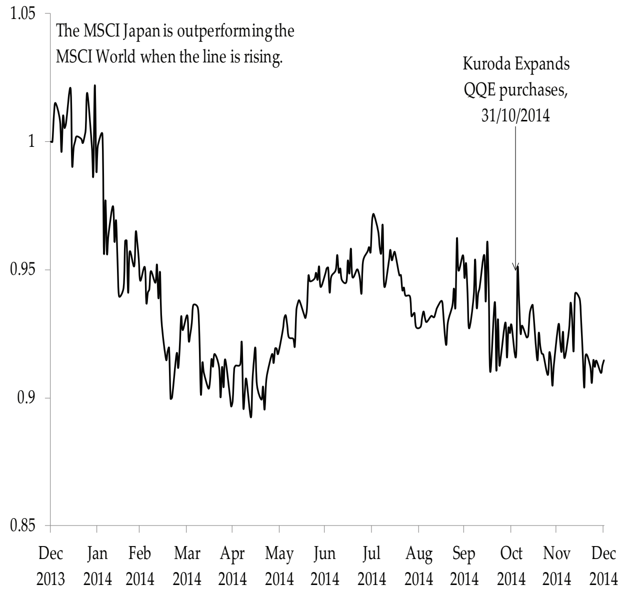
Exhibit 18: Japan CPI and the Sales Tax Impact



Source: FactSet, Japanese Ministry of Finance, as of 26/01/2015. Japan CPI data for the period November 2009 – November 2014.

The falling prices also caught the eye of Bank of Japan (BoJ) Governor Haruhiko Kuroda. After September's Consumer Price Index report showed prices fell month-over-month for the second straight period, the BoJ added to its massive quantitative easing programme on 31 October, bringing yearly bond buying up to 80 trillion yen. Equities responded with a short-lived, one-day-long rally that mostly benefited investors in yen. Shortly thereafter, Japanese equities resumed lagging the MSCI World. (Exhibit 19)

Exhibit 19: MSCI Japan v MSCI World



Source: FactSet, MSCI Japan and MSCI World Indexes in USD including net dividends.

While the current contraction's proximate cause appears to be continued fallout from April's sales tax hike, which wreaked havoc on Japan's economy, the broader problems confronting Japan's economy remain unchanged. Abe's administration talked touted potential reforms as the so-called Third Arrow of "Abenomics," but even minor reforms—like permitting Casinos—have not advanced. More contentious reforms to free up rigid labour markets, open markets to foreign trade, reform agriculture and promote immigration are all stalled and unlikely to advance given the political backdrop, which became even murkier in Q4.

Delaying the Second Sales Tax Hike and the Snap Election

The news Japan had returned to recession led Abe to first reconsider and ultimately delay the second leg of the sales tax hike, slated for October 2015. In conjunction with the delay, Abe announced he would dissolve Parliament and hold new elections, which he billed as a referendum on Abenomics.

The vote took place 14 December, and as expected, Abe's Liberal Democratic Party (LDP) and coalition partner New Komeito maintained their supermajority—slightly increasing their hold on power. Before the election, Abe's coalition had a 67.7% majority. Post-election, their majority amounts to 68.6%.

Some suggest this act as a second wind for Abenomics, but it appears to us more a pure political ploy by Abe to extend the LDP's control of Parliament for two additional years past 2016. Abe still polls relatively well today, though approval is down after an initial surge following his 2012 election. This is effectively step one in Abe's plan to retain his own post. Most local governments hold elections in Q1 2015. With Abe's term as LDP leader expiring in September, he will be required to run for re-election as party leader. Many local officials who oppose reform are necessary for LDP election success, making it unlikely he pursues big reforms and instead aims to curry favour.

Also, Abe has had a supermajority for two years and yet reforms are slow in coming, if they arrive at all. His stump speech showed a similar lack emphasis on reforms. No proposed legislation to cut agricultural tariffs, complete free trade deals or labour code overhauls. The Trans-Pacific Partnership—a multination free trade deal-in-progress and a cornerstone of his 2012 campaign—was barely mentioned. Abe did reiterate plans to delay next October's sales tax hike and bring the corporate tax rate below 30% within a few years. While more competitive corporate taxes would be a positive, but they are far off, not yet law, and only a small step to improving Japan's economic structure.

Abe's victory address struck a similar note. The only specifics were promises to draft a fiscal stimulus package by year-end and attempt to goad corporate Japan into raising wages at next year's annual labour negotiations. If Abe could not pass anything of note with a supermajority and sky-high poll ratings during the last two years, it's hard to see will be very different now.

A Major Distraction

Compounding matters, the economy is not the only thing on Abe's agenda. Abe's lifelong ambition of restoring Japan's military might has been well-documented by Japanese historians. His grandfather, Nobusuke Kishi, was Japan's Prime Minister in the 1950s, and scrapping the constitution's anti-war clause (Article Nine, written in after World War II) was his primary goal—ultimately his political downfall. Abe championed the same goal in school papers, his early political career and his first term as Prime Minister in 2006—which ended after one year as voters soured on his nationalist agenda. This time around, he has spent significant political capital acting on his inclinations. In July, after being unable to secure enough Parliamentary votes to outright repeal Article Nine, Abe's government chose to "reinterpret" the clause, allowing Japan to bolster its military for self-defense purposes. This triggered protests and even instances of self-immolation in response, sending Abe's poll numbers reeling.

Yet he is undeterred. After the election when discussing boosting the military, he promised: "We'll submit relevant bills at an appropriate time during the special Diet session next year and enact them"—far more specific pledges than the economy received. Article Nine revision was front and centre on the LDP's election manifesto—another specific pledge, again drawing sharp contrast with the economy. Abe's infatuation with revising the constitution may not entirely preclude economic reform, but both agenda items require significant political capital. Unless Abe is willing to forgo an Article Nine rewrite to focus on economic reform, the likelihood contentious economic liberalisation measures pass appears low.

DEVELOPING MARKETS COMMENTARY

Entering 2015, sentiment surrounding Emerging Markets remains too dour. Most believe the category is slowing markedly, with Russia's issues threatening to spread. However, reality does not match this perception. A close look at individual economies shows growth broadly continues, and Russia remains an isolated, non-contagious sore spot. With economic growth continuing at a healthy pace, overall and on average, Emerging Markets economies seem poised to surprise doubters in 2015.

Asia

China grew 7.3% y/y in Q4, bringing 2014 GDP growth to 7.4%—within the government's target range of 7.2% - 7.5%.[xx] While headlines bemoaned the slight slowdown from 2013's 7.7%, growth beat broad expectations and again defied long-running hard-landing fears. Overall, China's economy appears stronger than most perceive.

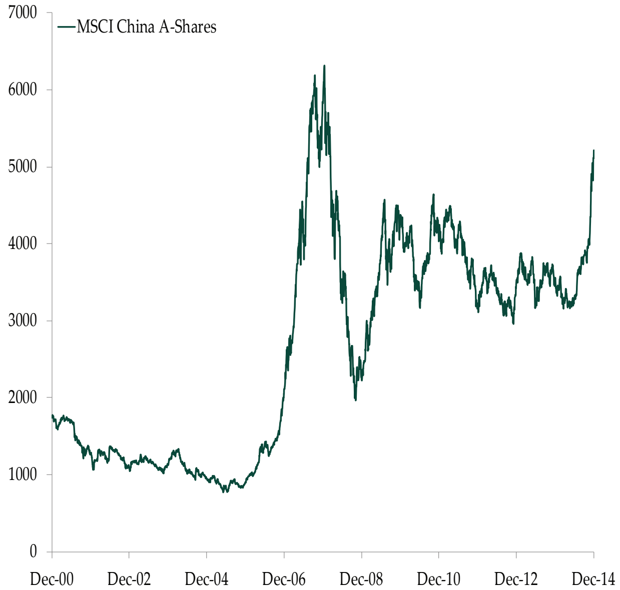
Slower growth is somewhat intentional, a byproduct of China's ongoing shift from investment and export-led growth to domestic consumption. Prior years' double-digit growth rates stemmed from a government-engineered, export- and factory-led boom. This model worked when wages and Chinese manufacturing costs were low, but it reached its limits as costs rose, factories overshot and credit-fueled growth became increasingly less efficient. So, officials decided to overhaul their model, increasing the role of the private sector in the economy and promoting services and consumption while dialing back manufacturing and constraining credit. Slower growth, they believe, is a tradeoff for higher-quality output over the long term.

The data underlying Q4 GDP suggest the shift continued. Industrial production and fixed asset investment slowed, while retail sales accelerated in November and December. Manufacturing PMIs slowed, but services PMIs stayed strong. Producer prices fell as commodity prices dropped, but consumer prices grew moderately as M2 money supply grew swiftly. Significant structural reform also began to lay the groundwork for financial liberalisation and deregulation – critical to increased capital efficiency. Most indicators simply do not support the notion of a significantly weakening China—just an evolving China. With most observers painting a dour picture and lowering their expectations, there remains plenty of room for growth to surprise positively.

China took another big step toward opening its capital account in November, launching the long-awaited "through train" programme allowing foreign investors to buy selected Chinese A-shares (traded on the Shanghai exchange) through Hong Kong brokerages. Giving foreign investors more access to A-shares should help China's capital markets become increasingly modernised—a long-term positive.

In recent years, Chinese A-shares have not reflected the economy's rapid growth. They boomed at times during the 2000s bull market, but the burst was short-lived and out of step with the global bull that began in 2003. As of year-end, A-shares were still 17% under their 14th January, 2008 peak.[xxi] Meanwhile, China's economy surged, overtaking Japan as the world's second largest. While equities and GDP do not move one-to-one, this underscores how China's political climate, capital market controls and sentiment have offset economic tailwinds.

Exhibit 20: MSCI China A-Shares



Source: FactSet, as of 20/01/2015. MSCI China A-Shares Index returns with net dividends, 29/12/2000-31/12/2014.

Many believe heavy restrictions on foreign equity investment are a big reason why. Most mainland Chinese do not own equities. Most A-shares are state-run companies. The party lets some shares float but ownership remains concentrated. Disclosure requirements, corporate governance and investor protections are weak. Many Chinese citizens do not trust their equity market so they buy real estate.

Observers believe the through train will change the landscape and improve the market's functioning. More shares will be owned and traded by presumably rational, informed foreign investors who follow sound strategies, and buy and sell on fundamentals. Assuming the programme expands slowly over time as expected, China should begin to resemble a modern equity market – but that is still a ways away.

Other Emerging Asian nations slowed modestly, too, but overall growth continued. Despite falling industrial production and weak trade, South Korea grew 2.7% y/y in Q4. Taiwan grew 2.8% y/y in Q4, with consumer spending and industrial production holding firm.[xxii] Thailand's GDP accelerated to 0.6% y/y and, after a back-and-forth August and September, industrial production grew in October and November.[xxiii] The Philippines' GDP accelerated 6.9% y/y in Q4, mirroring industrial production's acceleration to 7.4% y/y 7.6% in October and November, respectively.[xxiv] Malaysian and Indonesian Q3 GDP growth slowed to 5.6% y/y and 5.0% y/y, respectively, with industrial production growing steadily in October and November.[xxv] India's 5.3% y/y Q3 GDP growth was modestly slower than Q2 but faster than the two quarters before that, and the World Bank estimates full-year growth accelerated to 5.6%.[xxvi] With the central bank embarking on a fresh easing cycle, fiscal pressures easing with lower commodity prices, and the government's push toward pro-market reform, many do not appreciate India could be one of the world's fastest growing economies the next few years.

Emerging Asian nations have increasingly diverse economies, and we would not expect them to move as a bloc. Pockets of relative strength and weakness will always exist but data broadly do not support the perception of a sharp regional slowdown. Modest deceleration in some nations and modest acceleration in others to still-healthy growth rates should beat too-dour expectations.

Latin America

When the World Bank and International Monetary Fund (IMF) reduced their 2015 growth forecasts for developing countries, both cited Latin America as a big culprit—highlighting deteriorating sentiment toward the region. While South and Central America are not growing quite as fast as Emerging Asia, they are not static.

The best example is Mexico, which accelerated to 2.2% y/y GDP growth in Q3—the fastest since Q4 2012.[xxvii] Private consumption sped to 2.2% y/y, exports grew a large 7.1%, and fixed investment grew 4.3%, its first growth since Q2 2013.[xxviii] Most indicators suggest growth continued in Q4. Exports and imports grew all quarter, implying healthy demand at home and abroad. Industrial production rose in October and November. Retail sales continued pulling back, but retail sales are only one part of total household spending. Mexico's yield curve spread also remains relatively steep, which should support continued growth.

South American nations broadly bounced from recent weakness. Peruvian GDP grew 1.8% y/y in Q3, slightly faster than Q2.[xxix] Chile and Colombia both rebounded from small Q2 contractions, growing 0.4% q/q and 0.6% y/y, respectively. Colombian industrial production was choppy in Q4, yet retail sales grew solidly.[xxx]

Brazil continues to face economic headwinds, narrowly emerging from technical recession in Q3. President Dilma Rousseff escaped elections to win a second term and may offer concessions to some of the interventionist policies that dominated her first years in office. However, she faces inflation above the government's target range of 4.5%-6.5%, and a twin deficit (fiscal and current) exceeding 10%. Monetary and fiscal policy is consequently constrained, suggesting growth is unlikely to reaccelerate markedly in 2015.

Russian Weakness is not Contagious

Russia, one of the world's primary weak spots, will almost certainly not follow the current Emerging Markets' growth trend. Plummeting oil prices and Western-country sanctions make recession all but assured in the nation. The central bank projected a -4.7% 2015 GDP contraction if oil prices remained at $60 (they opened 2015 at $57).[xxxi] With oil tugging down output, the weak ruble making foreign debt pricier and sanctions crippling some domestic firms (and driving inflation), Russia has few near-term growth drivers.

However, these issues are unique to Russia—they do not threaten growth elsewhere. Other Emerging Markets have far more diverse, less commodity-dependent economies. Falling oil prices, which hurt Russia, create winners in energy-importing developing nations like India, Korea and Taiwan. Sanctions are also a uniquely Russian headwind.

Russia could have a knock-on effect if other nations depended on trade with Russia for continued growth. This is not the case. For example, Russia accounts for less than 0.4% of ASEAN's total exports.[xxxii] Weaker Russian demand could impact China, as Russia comprises nearly 14% of annual Chinese exports, but China should also receive a boost from Russia's ban on Western agricultural imports.[xxxiii] Other large Emerging Markets should barely blink: Russia accounts for just 0.7% of Indian exports, 1.8% of Korean exports and 1.7% of Brazilian exports.[xxxiv]

In Depth: EM Currency Concerns

The stronger dollar and Russia's ruble collapsing resurrected fears of a broad EM currency crisis late in Q4. Many feared the rising dollar would make EM foreign currency-denominated debt cripplingly expensive, stoking default risk and eventually causing a repeat of the 1997-1998 Asian Currency Crisis. However, some key differences between then and now make a crisis repeat unlikely.

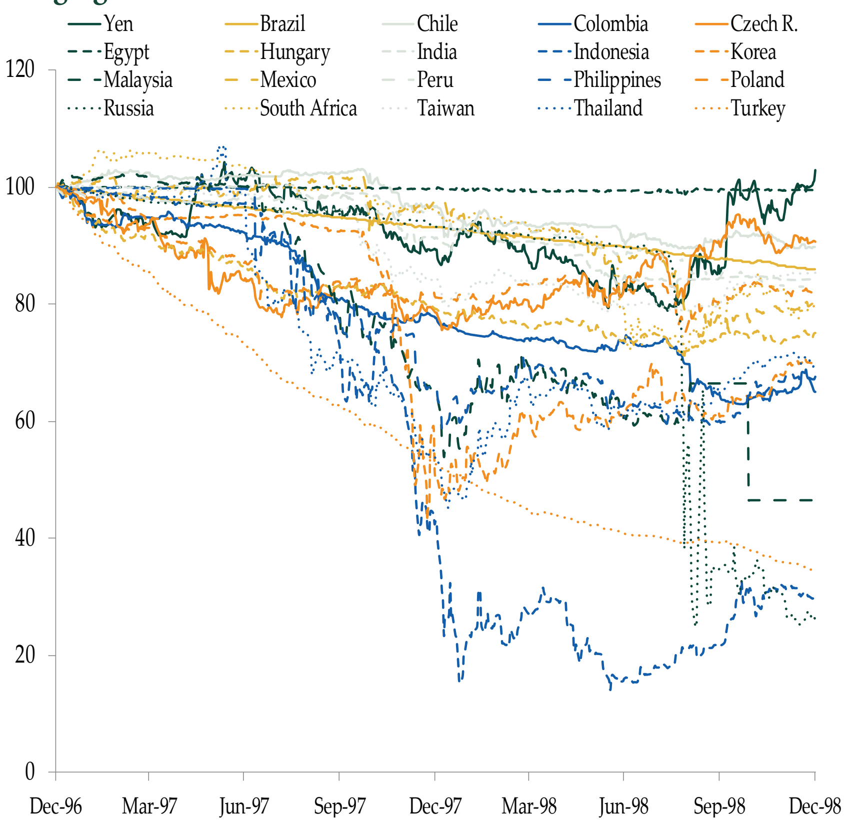
For those not familiar with the Asian Currency Crisis, it stemmed from several countries' efforts to maintain currency pegs to the dollar. Many EM nations had dollar pegs in the 1990s, allowing them to borrow cheaply and heavily in dollars to finance growth. All went fine for several years until the yen weakened significantly against the dollar. Japan was a key trading partner for many of these nations, and the yen's weakness pressured their currencies, making the pegs expensive to maintain. Developing Asian nations defended the pegs at first, but the effort nearly depleted some countries' foreign exchange reserves, ultimately forcing them to abandon the fixed exchange rates and devalue. Thailand fell first and subsequently received an IMF bailout. South Korea and Indonesia soon followed. The trauma drove a correction in global equities from 07/10/1997 – 12/11/1997, and a larger correction followed in 1998 as Russia fell.

Many believe low US interest rates have created similar problems now, driving heavy dollar borrowing by EM sovereigns and corporations. With the dollar rising and growth slowing in some EM nations, investors fear borrowers could get squeezed, putting nearly $10 trillion of external debt at risk of default when the Fed begins hiking rates.

While there are some similarities between now and 1997, there are also key differences that reduce the likelihood of a repeat. For one, most EM nations today have floating currencies—not pegged. Even though the dollar is strengthening, they are not trying to defend pegs, mitigating the risk of a sudden devaluation destroying their ability to service external debt. Additionally, developing countries today have far more firepower. Then, countries classified by the IMF as "emerging and developing economies" had $605.2 billion in foreign exchange reserves among them. Today, they have nearly $8.1 trillion. Reserves then were 9.6% of GDP vs. 27.8% today. Countries have largely learned from history and are far more insulated.

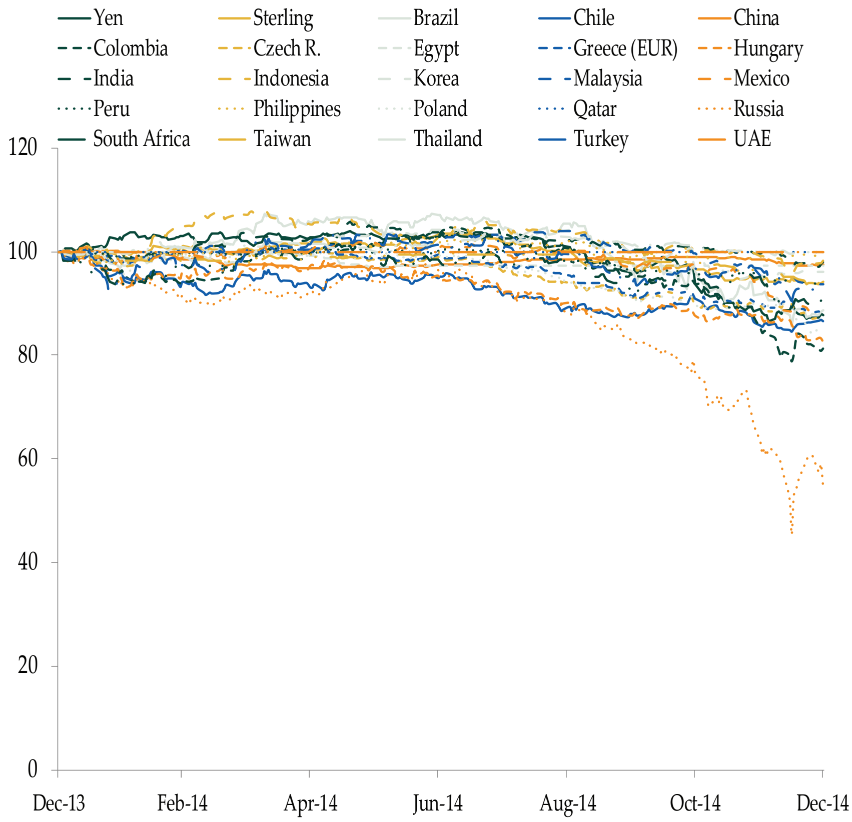
Currency markets today also do not resemble the late 1990s. As Exhibit 21 shows, EM currencies were extremely volatile in 1996 and 1997 as pegs were defended, then discarded. (Switzerland's sudden end to its euro/franc floor in mid-January is more evidence of pegged currencies' instability.) Today, as shown in Exhibit 22, markets are much tamer. 14 of 24 fell less than 10% vs. the dollar last year. Many moved similarly to the British pound, yet no one warns of a British currency crisis. Russia is plunging, but its troubles are a uniquely domestic issue—other EM nations do not have oil-dependent economies and are not barred from Western capital markets.

Exhibit 21: Select Emerging Markets Currencies and the Yen in 1997 – 1998



Source: FactSet, as of 22/01/2015. Exchange rates vs. the US dollar, 31/12/1996 – 31/12/1998

Exhibit 22: Emerging Markets Currencies, the Yen and Sterling in 2014



Source: FactSet, as of 22/01/2015. Exchange rates vs. the US dollar, 31/12/2013 – 31/12/2014.

Some Latin American nations have weakened more, but they are far from the levels of weakness that broke Thailand, Korea and Indonesian the 1990s. A slow, quite possibly temporary, drift weaker is not a massive negative. Currencies would have to plummet to rock-bottom levels and stay there for significant problems to arise. With growth overall continuing and inbound investment still strong, that is an exceedingly unlikely outcome. Also, sovereign foreign currency debt issuance is less common today than it was then. While some EM corporations issue US dollar-denominated debt, far fewer governments do, so a rise in the dollar does not stress sovereign balance sheets as it did in the late 1990s.

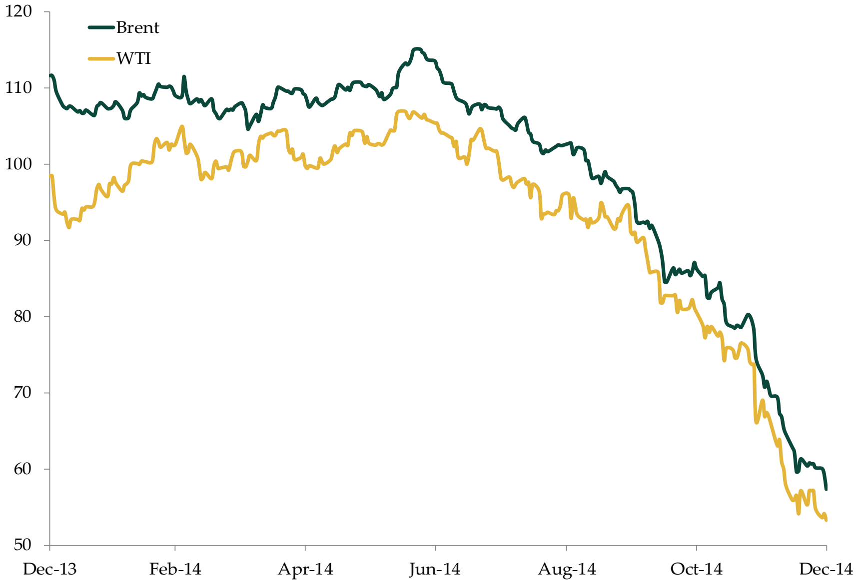
If an EM foreign debt implosion were a significant risk, we would expect to have seen yields spiking whenever the dollar strengthened, as external debt has been rising a long time. Brazil's has more than doubled since 2001. Korea's, relative to GDP, is about where it was in 1997. Yet yields are largely tame. Markets know these countries do not depend on artificial exchange rates and central bank intervention to remain competitive, which removes a huge question about long-term viability and source of uncertainty. When exchange rates are not artificially set, markets typically do not need to question whether a given currency value is "right." This helps limit contagion when one currency crashes, like the ruble.

Pundits continually try to have currency moves both ways. For nearly two years now, many have claimed Emerging Asia needs weak currencies to compete with Japan. Yet now that some currencies are weaker, headlines are not cheering the prospect of cheaper exports and a big boost from trade. They are still negative. While we believe both viewpoints are erroneous, this reaction is telling about sentiment—it remains far more dour than reality warrants.

OIL'S DECLINE

Oil prices have plunged since June, a topic the media heavily discussed during Q4. West Texas Intermediate Crude finished 2014 down -46%. Brent fell -49%. (Exhibit 23)

Exhibit 23: Brent and West Texas Intermediate Crude Oil Prices



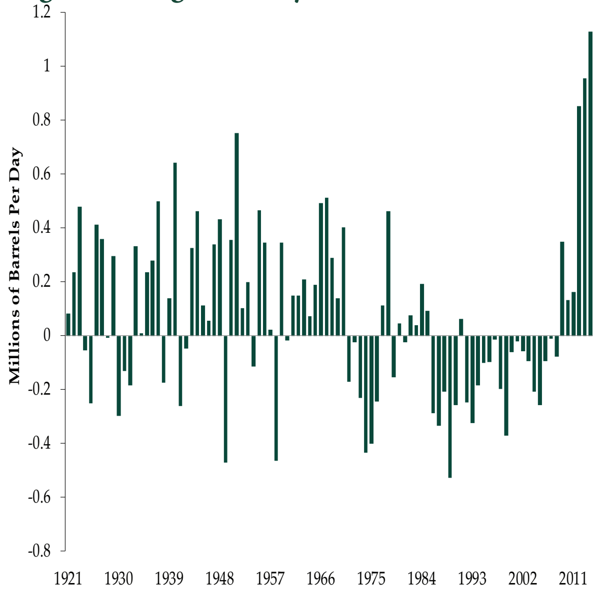
Source: FactSet, as of 06/01/2015. Brent and WTI benchmark and crude oil prices, 31/12/2013 – 31/12/2014.

We have long underweighted Energy equities, expecting supply growth to outstrip demand, dragging down prices. As detailed in past Review & Outlooks, many Energy firms' profits tend to move with oil prices. America's shale boom increased supply, depressed prices and ultimately hurt their profits.

Falling oil prices' impact will extend beyond Energy equities, but not in ways many assume. Some claim oil's big drop will fuel a consumer-led boom, while others fret it signals weakening demand equities and bonds have not yet discounted. Nevertheless, oil is just a commodity—few would expect a boom or bust because iron ore, tungsten or pork bellies fell. We do not get wildly bullish or bearish because any commodity rises or falls. Sufficiently liquid markets effectively discount widely known information. Markets—commodity, equity, bond—are equally forward-looking. Consider the fact that oil-reliant nations' markets and Energy firms' equities and bonds fell alongside oil.

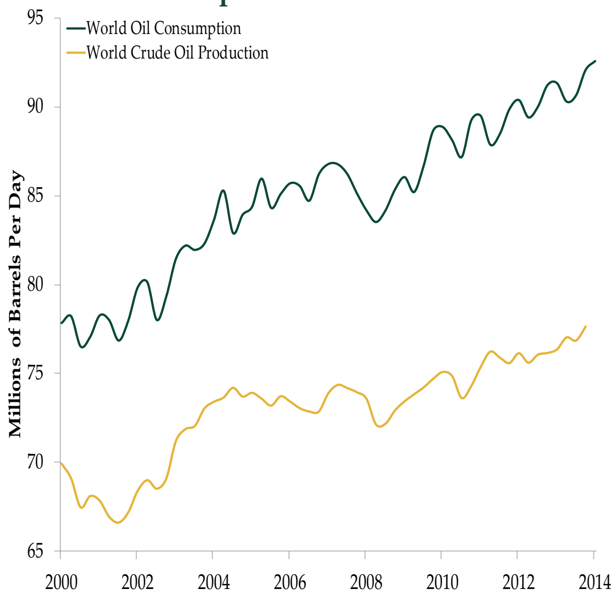
If falling demand caused the drop, it could be a symptom of economic weakness. Yet, demand is up—supply is simply up more, thanks partly to the shale boom. Through October, 2014's US monthly production averaged more than 1 million barrels per day above 2013 levels—a change from falling output before 2008. (Exhibits 24 and 25)

Exhibit 24: Year-Over-Year Change in Average Monthly US Oil Production



Source: US Energy Information Administration, as of 07/01/2015. US oil production, Jan. 1920 – Oct. 2014.

Exhibit 25: Global Oil Production and Consumption



Source: US Energy Information Administration, as of 15/01/2015. World oil consumption and crude oil production, 31/12/2000 - 30/09/2014. Consumption exceeds production as it includes unconventional oil-equivalent products.

OPEC's Decision

Usually, the Organization of Petroleum Exporting Countries (OPEC), which comprises roughly 40% of world output and 60% of oil traded internationally, would cut output if prices fell.

But member-countries are not united. Saudi Arabia controls most OPEC and world spare capacity (excess production that could be pumped within thirty days) and is relatively cash-rich.[xxxv] Few other OPEC nations and virtually no non-OPEC nations have spare capacity and many members' budgets hinge on selling expensive oil. (Exhibit 26) The cartel lacks uniform interests, and production quotas require unanimity.

Exhibit 26: OPEC Spare Production Capacity by Member, Millions of Barrels per Day

Country	Nov. 2014 Production	Full Production Capacity	Spare Capacity
Saudi Arabia	9.6	12.4	2.8
United Arab Emirates	2.7	2.9	0.2
Venezuela	2.4	2.6	0.2
Libya	0.7	0.9	0.2
Iran	2.8	2.9	0.1
Angola	1.7	1.8	0.1
Kuwait	2.8	2.9	0.1
Nigeria	1.9	2.0	0.1
Qatar	0.7	0.7	0.0
Algeria	1.1	1.2	0.0
Iraq	3.4	3.4	0.0
Ecuador	0.6	0.6	0.0
Total OPEC	**30.3**	**34.2**	**3.9**

Source: International Energy Agency, Oil Market Report dated 12/12/2014.

Because the Saudis have cash and spare capacity, cutting production is more their call than OPEC's. That seems partly behind OPEC's Q4 decision to keep production at thirty-million barrels per day. Saudi Arabia appears willing to accept lower prices to maintain market share. Oil dropped on the news (more evidence falling oil prices are a supply issue). Currencies of heavily oil-dependent nations like Venezuela and Russia plunged.

Winners and Losers

Many theorize falling oil prices will drive a consumer spending-led boom, but this is dubious. Money spent on gasoline circulates like any other dollar.

Falling oil creates winners and losers. Money not spent on fuel allows consumers to spend more elsewhere, so some retailers win. Oil drillers lose. Oil refiners, for whom oil is an input cost, benefit. Consumers' balance sheets may win too, since spending less on gas lets them save or pay down debt. Winners and losers also emerge among nations. Oil-producing nations, like Russia, Brazil and Venezuela, lose. Countries with little oil production (Japan and much of Europe) should benefit from shifting consumption and reduced business expenses.

US shale producers likely see mixed results. Many suggest US production will dive—possible, though prices would have to remain low for a long time. Oil exploration takes significant time and investment to reap returns. Firms pumping today already sank huge costs into wells, discouraging them from slashing output. Should prices stay low, firms may cancel exploration and drilling in uneconomical fields. The 1980s' and 1990s' low prices caused declining investment in domestic oil, contributing to the 2000s' higher prices.

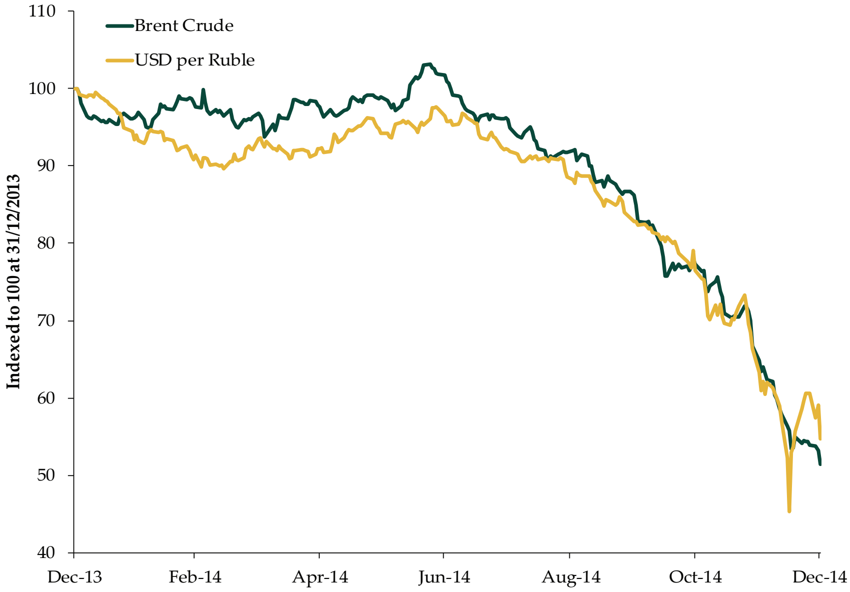
Some fear small US Energy firms have too much debt, putting the economy at risk should they default now that some projects' profitability is threatened. Select firms likely will face trouble. Yet, while Energy high-yield debt is up--it totals about $200 billion— it is insufficient to drive recession and recent price swings do not threaten all firms.

Shale's breakeven prices vary. Newer, more complicated fields like Mississippi and Louisiana's Tuscaloosa Marine Shale are presumed unprofitable with oil below $80 per barrel.[xxxvi] However, America's three biggest shale fields, North Dakota's Bakken and Texas' Permian and Eagle Ford, have far lower breakeven prices. Combined, these three regions produce 4.7 million barrels daily, exceeding all but three nations. [xxxvii]Some analysts estimate the Bakken is profitable with oil as low as $43 per barrel. The two Texas fields are believed to break even in the $50s. Certainly, not all wells within a field will see the lowest breakeven. Oil producers understand these fluctuations and typically hedge using futures contracts, so most selling oil today likely still reap early 2014 prices. Even if firms take losses, they may prefer reaping some revenue rather than none, especially if it means retaining an experienced crew—difficult to replace.

One Big Loser: Russia

Falling oil prices hurt Russia. Energy is Russia's last functioning economic leg, responsible for over half of state revenue. [xxxviii] Russian social programmes hinge on oil rents. Weak oil prices have historically wrecked Russia: Falling oil in the 1980s contributed to the Soviet Union's downfall and the 1990s' low prices triggered 1998's ruble crisis and default. In Q4, the ruble fell precipitously.

Exhibit 27: Brent Crude Oil Prices and the Russian Ruble, Indexed to 100 at 31/12/2013



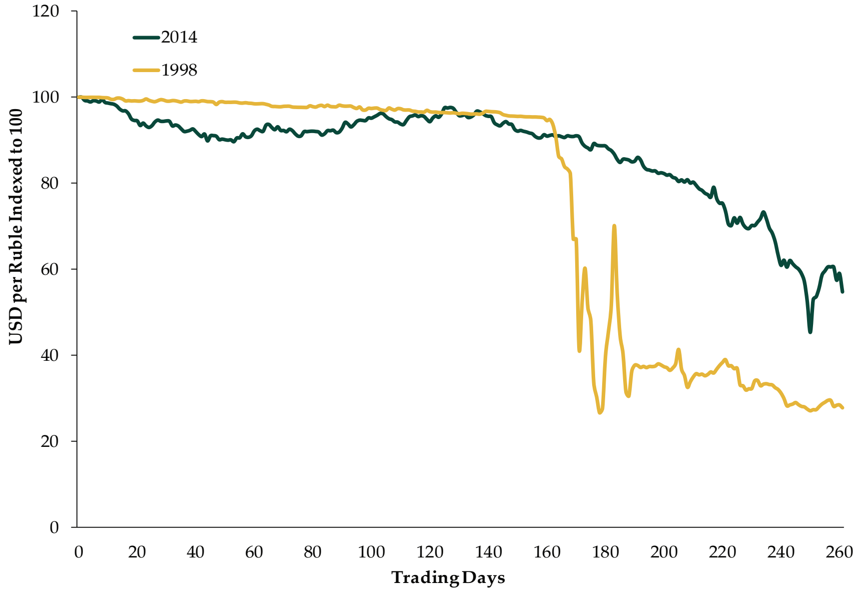
Source: FactSet, as of 13/01/2015. US Dollars per Russian Ruble and Brent Crude Prices, 31/12/2013 – 31/12/2014.

Prices this low make deep Russian recession near-inevitable. In mid-December, the Central Bank of Russia (CBR) predicted 2015 GDP could fall -4.7% if low oil prices stick. The ruble subsequently fell 13% the next day, bringing its full-year slide to an oil-like -45% versus the dollar. The day after, the CBR hiked overnight interest rates 6.5 percentage points to 17%, up 11.5 percentage points from 2013. After initially failing, this steep hike (and currency market interventions) seems to have stanched the ruble's decline.

There are a few similarities for Russia between now and 1998. The ruble's fall resembles then, though not quite as deep. (Exhibit 28) Brent crude prices declined similarly (42% in 1998, 49% in 2014), though the current drop came far faster.

Yet, as mentioned earlier in the Review, critical differences abound. In the 1990s, many Emerging Markets, including Russia, pegged their currencies to the dollar. While pegs sought to protect economies from exchange rate fluctuations, they are inherently unstable. The dollar's extreme strength in the late 1990s, particularly against the Japanese yen—a major trading partner for Asian nations—imperiled pegged Asian currencies. This led to the 1997-1998 "Asian Contagion" as currency pegs broke.

Exhibit 28: The Ruble's Decline



Source: FactSet, as of 15/01/2015. US Dollars per Russian Ruble, 31/12/1997 – 31/12/1998 and 31/12/2013 – 31/12/2014, both indexed to 100 at the year's start.

Russia was no exception. As hard currency fled and the ruble crashed in May 1998, the CBR hiked overnight rates from 30% to 150% in eight days. It liquidated foreign exchange reserves, a futile attempt to stop the drop. In August, Russia removed the peg. The ruble collapsed and Russia defaulted. Global markets corrected.

Today's Russia does not face all those issues. Learning from 1998, few EMs peg their currencies and most have substantially increased reserves, Russia included. Russia's public and private foreign debt service costs due this year are estimated at $102 billion, a figure covered three times over by Russia's $419 billion in reserves.[xxxix] A default is unlikely.

Some suggest Russia's threatened finances may make President Vladimir Putin even more unpredictable. However, little evidence supports such speculation. As discussed in past Review & Outlooks, geopolitical tensions typically must be global and surprising to impact markets. There is little sign of global escalation.

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

For professional client use only.

i. FactSet, as of 02/01/2014. MSCI All Country World Index returns with net dividends, 30/09/2014 – 31/12/2014 and 31/12/2013 – 31/12/2014.
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vii. US Bureau of Economic Analysis, as of 08/01/2015. Percent Change in Real Personal Consumption Expenditures and Nonresidential Fixed Investment, Q3 2014.
viii. US Bureau of Economic Analysis, as of 08/01/2015. Percent Change in Real Exports and Imports of Goods and Services, Q3 2014.
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x. US Census Bureau, as of 15/01/2015. Percentage change in retail sales (seasonally adjusted), 2014.
xi. US Bureau of Economic Analysis, as of 09/01/2015.
xii. The Conference Board, as of 09/01/2015.
xiii. Federal Reserve, as of 16/01/2015.
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xv. FactSet, as of 09/01/2015. Annualised percentage change in UK real GDP, Q3 2014.
xvi. FactSet, as of 09/01/2015. Annualised percentage change in UK real GDP, Q3 2014.
xvii. FactSet, as of 28/01/2015. Annualised percentage change in UK real GDP, Q4 2014.
xviii. FactSet, eurozone Q3 2014 GDP (annualised), as of 16/01/2015.
xix. Eurostat. Eurozone Harmonised Index of Consumer Prices for December 2014, as of 16/01/2015.
xx. FactSet, as of 23/01/2015. Year-over-year percentage change in China's real GDP, Q4 2014, and full-year percentage change in real GDP, 2014.
xxi. FactSet. MSCI China A-Share Index with net dividends (in USD), 14/01/2008 – 31/12/2014, as of 28/01/2015.
xxii. FactSet, as of 23/01/2015. Year-over-year percentage change in Taiwan's real GDP, Q4 2014,
xxiii. FactSet, as of 23/01/2015. Year-over-year percentage change in Thailand's real GDP, Q3 2014, and month-over-month percentage change in industrial production, August - November 2014.
xiv. FactSet, as of 23/01/2015. Year-over-year percentage change in Philippines' real GDP, Q4 2014, and month-over-month percentage change in industrial production, October and November 2014.
xv. FactSet, as of 23/01/2015. Year-over-year percentage change in Malaysia's and Indonesia's real GDP, Q3 2014.
xvi. FactSet and World Bank, as of 23/01/2015. Year-over-year percentage change in Philippines' real GDP, Q3 2014. "Global Economic Prospects: Having Fiscal Space and Using It," World Bank, January 2015.
xvii. FactSet, as of 26/01/2015. Year-over-year percentage change in Mexico's real GDP, Q3 2014.
xviii. FactSet, as of 26/01/2015. Year-over-year percentage change in Mexico's real private consumption, exports and gross fixed capital formation, Q3 2014.
xix. FactSet, as of 26/01/2015. Year-over-year percentage change in Peru's real GDP, Q3 2014.
xxx. FactSet, as of 26/01/2015. Year-over-year percentage change in Colombia's real GDP, Q3 2014.
xxxi. FactSet, Brent Crude Oil, USD per barrel as of 31/12/2014.
xxxii. ASEAN, as of 26/01/2015. ASEAN trade by selected partner country/region, 2013.
xxxiii. FactSet, as of 26/01/2015. Exports to Russia as a percentage of total Chinese exports, 2014.
xxxiv. FactSet, as of 26/01/2015. Exports to Russia as a percentage of total Indian, Korean and Brazilian exports, 2014.
xxxv. International Energy Agency, Oil Market Report dated 12/12/2014.
xxxvi. "Investors Punish Debt, High Cost US Shale Barrels in Sell Off," Staff, Reuters, 14/10/2014
xxxvii. "Oil at $75 Means Patches of Texas Shale Turn Unprofitable," Isaac Arnsdorf, Bloomberg, 20/11/2014. The three nations are Saudi Arabia, the US and Russia, per the Energy Information Administration.
xxxviii. Energy Information Administration, Russia Country Brief dated 26/11/2013.
xxxix. FactSet, as of 15/01/2015.

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   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, advising on pension transfers and pension opt outs, agreeing to carry on a regulated activity, arranging deals in investments, dealing in investments as agent, making arrangements with a view to transactions in investments, and managing investments.

   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.

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   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 has its headquarters in the USA and is 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.

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   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.

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   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.

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   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.

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    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.

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    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.

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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.