FISHER INVESTMENTS EUROPE™

MARKET PERSPECTIVES
REVIEW & OUTLOOK

SECOND QUARTER
2022

SECOND QUARTER 2022 REVIEW & OUTLOOK

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SECOND QUARTER 2022 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

13 July 2022

PORTFOLIO THEMES

- We believe a recovery is likely in the back half of 2022 and high-quality companies that led the decline will likely lead the recovery.
- We remain constructive on global equities and believe that growth and Technology will lead when global markets recover.
- Economic growth and inflation expectations likely continue to moderate as supply and labour constraints subside, supporting our preference for growth equities.

MARKET OUTLOOK

- **Continued Negative Volatility is Not a Foregone Conclusion:** Global markets have likely priced in well-known fears including a mild recession, which is far from certain, in our view. Meanwhile, positive economic factors are largely ignored.
- **Investor Sentiment Supports an Unexpected Recovery:** Depressed sentiment, driven by concerns on inflation, global monetary policy, China's lockdowns and a variety of other factors has significantly lowered investor expectations, increasing the likelihood that markets realise a better-than-expected outcome.
- **Global Markets Typically Reward US Political Gridlock:** The incumbent party routinely loses power during the midterm year, reducing political uncertainty and the likelihood of extreme legislation. Increased gridlock likely acts as a tailwind for global markets in the back half of the year.

Equities' rocky, fear-filled first half intensified in Q2, with global developed markets approaching a -20% decline in May and piercing that threshold in mid-June. Emerging market equities have fared slightly better this year, but are in the midst of a protracted downturn as well. From a technical standpoint, history will recall this as a bear market, although we don't think that a backward-looking label has much forward-looking significance. The difference between a steep correction and a shallow bear market is not meaningful as both usually precede strong rebounds. Nevertheless, we recognise our bullish stance and related emphasis on growth has weighed heavily on absolute and relative returns in Q2.

The full Review will detail our perspective on the downturn and its many fears—including a potential recession, rising interest rates, inflation, supply chain issues, China's lockdowns, oil and gas prices, American political acrimony and more. What is important for investors now is to look forward. We believe capturing the bounce that typically follows sharp downturns is crucial. So is having the correct sector and style emphasis. Once markets breach -20% from a prior high, the low is generally quite near. Median returns for global developed markets 6 and 12 months from lows after -20% drops are 25.9% and 33.3%, respectively.[i]

i Source: FactSet, as of 30/06/2022. MSCI World Index price returns, 31/12/1969 – 30/06/2022.

As 2022 dawned, we expected the first half would likely be volatile, with moments of genuine fear, although we never expected a downturn of this magnitude. We also expected equities to rally in the year's second half as post-midterm political gridlock became apparent and uncertainty fell. We are now entering that period, and the stage looks set for big returns most can't fathom now. This might sound overly optimistic given where equities are, but global markets have made up big deficits in quick fashion before. In 2019, after equities endured a nearly -20% decline late in 2018, global developed markets were back at breakeven by mid-year. In 1998, equities were negative on the year in October—but a Q4 rally lifted full-year returns to 22.8%.[ii] While the exact timing of any recovery is only clear in hindsight, equities can flip bad years to good very quickly.

The vast majority of individual and professional investors can't fathom a recovery. Headlines continually emphasise bad news and ignore good—or obfuscate it with an abundance of objections. While a shallow recession is possible, equities are likely already pricing this in, and most indicators don't signal one is underway or imminent. In the US, durable goods orders have risen in seven of the last eight months, accelerating to 0.7% m/m in May from April's 0.4%.[iii] The outlook for technology investment also seems bright. A recent JPMorgan survey of 142 chief information officers controlling over $100 billion in annual enterprise spending suggested budget growth for corporate technology expenditures of 5.3% this year and 5.7% next year. [iv] Of course, budget plans aren't written in stone, but the available evidence doesn't show Corporate America broadly cutting back investment. Elsewhere indicators also remain positive. Purchasing managers' indexes (PMIs) for the UK, eurozone and Japan remained expansionary in June, albeit with eurozone surveys signaling slower growth.

Yet as the full Review will show, headlines blare ad nauseam that we are in a recession. Some investors perceive falling business survey readings as recessionary, even though most officially registered expansion. Slower growth, but growth nonetheless. The occasionally inverted 10-year to 2-year US Treasury yield spread continues garnering attention while the more meaningful, wider 10-year to 3-month spread goes unnoticed. Ken Fisher has long called this fixation on negatives and dismissal of contrary evidence "the pessimism of disbelief." It often accompanies market lows, and it reigns now. The pessimism of disbelief helps markets pre-price worries, reducing their surprise power. Even if a shallow recession materialised, its market impact from here likely wouldn't be huge.

Usually, large downturns feature at most two or three scary stories—be it COVID-19 in 2020, tariffs and hedge fund liquidations in 2018 or China's devaluation in 2015. This time, we see no fewer than seven, possibly more depending on how you tally interconnected worries. Their sheer number amplifies uncertainty and increases downside volatility. However, it also primes markets for a big relief rally as these concerns fade. Lately, we have observed that it takes about four months for headline fears to drift out of the public consciousness.

ii Source: FactSet, as of 27/06/2022. MSCI World Index price returns, 31/12/1997 – 31/12/1998.

iii Source: Census Bureau, as of 27/06/2022.

iv "Despite Recession Fears, Companies Aren't Pulling Back on Technology Investments," Susan Caminiti, CNBC, 01/07/2022.

Our emphasis on growth equities worked against us during the downturn, as those were hit hardest while some fears benefitted traditionally value-heavy sectors like Energy and Utilities. Now many tout value's leadership and extrapolate it far forward, arguing value normally leads after bear markets. Yet as the full Review will detail, value's leadership this year is heavily entwined with market direction amid sentiment-driven swings. On days when global stocks fell, growth routinely underperformed. Growth led 72.7% of the up days.[v] So in an up environment, we think growth should lead. Further supporting that, what falls the most usually bounces the highest. Today that is growth equities in Tech, the Tech-like portion of the Communication Services sector, e-commerce and Luxury Goods. They are likely to be the recovery's biggest beneficiaries. The effect won't necessarily last forever, but it often does for at least six or more months after market lows.

Fears of a recession in the developed world also weighed on EM equities in Q2. This is perhaps most visible in EM Materials, which fell -20.6% in the quarter.[vi] In our view, this is predominantly sentiment-based. Recession fears tend to have an outsized impact on commodity-oriented industries as people presume an economic downturn will hit demand for oil, copper, steel and other key growth-sensitive inputs hard. Yet Western economic indicators broadly don't indicate a significant recession is underway or imminent, which we think creates a bullish gap between sentiment and reality. If the developed world simply trends sideways, it should bring commodity exporters some relief.

China's emergence from this spring's COVID-19 restrictions—which helped it lead all EM nations with a 3.4% return in the quarter—offers another counterpoint to global recession fears.[vii] Shanghai ended its two-month lockdown on 1 June, with most activities returning. Beijing and several other locations followed suit, enabling some of the targeted stimulus measures announced in recent weeks to begin kicking in. Since then, some parts of Shanghai and Macau have reinstated restrictions, leading to concerns that any economic bounce will be short-lived, but we think this is too hasty. For one, policymakers announced they would cut quarantine timeframes for travelers late in the month, suggesting a lighter approach. Also, data already started improving in May despite restrictions remaining at the time, indicating Chinese businesses are getting better at managing restrictions. While consumption and residential real estate remain headwinds, strong activity at factories and ports—combined with targeted stimulus boosting money supply and velocity—points to continued modest economic growth this year. Additionally, there were further signs of China's Tech regulatory push easing in the June, with some apps previously banned from signing up new users will be allowed to resume, including Didi. China also approved about 60 video games in early June, the largest number seen July 2021—about when the regulatory push began.[viii]

While the global economy shows pockets of weakness and strength, it is a better reality than the picture painted by increasing numbers of recession forecasts. Such a wide gap between reality and expectations indicates to us a bear market trough is near. When negativity drives fear and sentiment overshoots to the downside, markets are primed to rebound as uncertainty clears. We don't know when, but priced-in pessimism sets the stage for a growth-led recovery over the foreseeable future.

v Source: FactSet, as of 01/07/2022. MSCI World Growth Index frequency of outperformance versus MSCI World Value Index on days the MSCI World Index rose, 31/12/2021 – 30/06/2022.

vi Source: FactSet, as of 06/07/2022. MSCI Emerging Markets Energy and Materials Index returns in USD with net dividends, 31/03/2022 – 30/06/2022.

vii Ibid. MSCI China Index return in USD with net dividends, 31/03/2022 – 30/06/2022.

viii China's Regulators Exclude Tencent, NetEase as They Approve 60 Online Game Titles in June," Pearl Liu and Zhou Xin, South China Morning Post, 07/06/2022.

GLOBAL UPDATE AND MARKET OUTLOOK

8 August 2022

Q2 MARKET RECAP

BEYOND THE BEAR MARKET

Entering 2022, we anticipated a choppy market early with higher volatility than 2021—possibly even a down first half—before midterm years' typical second-half rally drove markets higher. In short, we expected markets to act as they normally do in US midterm years, struggling amid rising uncertainty over politics and various other factors early, before surging late.

However, we did not expect a bear market which officially arrived in Q2, with US and global equities piercing -20% on 13 June and ending the first half at -20.3%.[ix] Fixed income markets have also fallen materially this year on stubbornly high inflation and rising interest rates. Despite a challenging first half, we are optimistic a strong second-half recovery awaits.

AN UNUSUAL, MOSTLY SENTIMENT-DRIVEN BEAR MARKET

While this is a bear market by magnitude, we think it lacks some key bear market features, which suggests to us a recovery is likely closer than almost anyone anticipates. For one, markets' decline seems mostly sentiment-driven versus fundamental—a correction-like trait. Usually, such sentiment-driven swings are sharp, fleeting drops of -10% to -20%. This one seems extended and deepened by an unusual factor: Rather than just one or two fears for investors to consider, today there are many taking turns at hitting sentiment and markets.

Depending on how you define and delineate these occasionally overlapping stories, we count at least seven key concerns stoking volatility. Political fears ahead of the midterms were—and are—typical. Supply chain issues extended from 2021 to this year. Inflation. Rate hikes. The Ukraine war. Oil worries. Food shortages in Emerging Markets. China's on-again, off-again lockdowns. Then contentious Supreme Court rulings and the 6 January hearings exacerbated already hot political rhetoric. We don't think any of them alone pack the multi-trillion dollar hit to economic activity necessary to cause a steep global recession. Yet they seemingly conspired to roil sentiment, spike uncertainty and send equities reeling.

Relatedly, the bear market also has pundits seeking recession signs everywhere. Bear markets often precede recessions, although not always. While the US recently recorded a second consecutive quarterly GDP contraction, we see little suggesting that a significant recession is building or underway. The National Bureau of Economic Research (NBER), which is the official arbiter, doesn't define a recession as two sequential GDP contractions. Rather, it defines it as a "significant decline in economic activity that is spread across the economy and lasts more than a few months." Taking a closer look at recent GDP reports (which we will discuss in later sections), there are reasons to question whether the US economy meets that threshold.

Market leadership also supports this, in our view. In most bear markets, economically sensitive value firms—Energy, Materials, Industrials—lead the way lower. This makes sense, considering their profits are tied closely to near-term economic growth. Growth equities, which ride longer-term economic trends, generally hold up better when economic conditions are weaker.

ix Source: FactSet, as of 01/07/2022. MSCI World Index return with net dividends, 31/12/2021 – 30/06/2022.

Not this time. Growth equities' decline has far exceeded value's, as Exhibit 1 shows.

EXHIBIT 1: GROWTH AND VALUE IN 2022'S FIRST HALF

Source: FactSet, as of 01/07/2022. MSCI World Growth and Value Indexes, 31/12/2021 – 30/06/2022. Indexed to 31/12/2021.

Value holding up better indicates markets are suggesting a deep recession isn't imminent. If one does arrive, it would likely be very shallow—something markets' decline already pre-priced to a great extent. Those scenarios suggest to us the recovery is nearby. Furthermore, following deep corrections and bear markets, what falls the most usually bounces highest.

Also, if we are wrong and a deep recession and another steep market drop lie in wait, value equities—especially Energy and Materials, which have driven value's leadership—would likely suffer severe losses. We don't expect that and remain optimistic about a recovery in 2022's second half. However it is possible and that is part of our calculus in retaining our growth emphasis today.

THE SECOND-HALF RECOVERY WE ANTICIPATE

Bull markets generally start sooner than most fathom. Many pundits claim the decline breaching -20% means much more downside ahead. However the reverse tends to be true: Once you hit -20%, the trough is usually much closer than the beginning. Since good global data start in 1969, the median distance from -20% to the low is just 0.8 months and -7.6%.[x] Now, medians don't predict future returns, but they disprove the notion crossing -20% means significantly bigger declines surely loom.

Whenever recovery arrives, returns from these moves' lows have historically been strong. Exhibit 2 shows the recoveries 6 and 12 months off of all -20% MSCI World declines since its inception. Note: This table includes 1998, 2011 and 2018, which were large corrections (twin corrections in 2018's case), not bear markets. We include them to highlight why the difference between a deep correction and shallow bear market isn't hugely significant. Big recoveries can follow either way.

EXHIBIT 2: WHAT TO EXPECT IN A RECOVERY

-20% Decline Dates		Post-Trough Performance	
Peak	Trough	Return 6 Months From Trough	Return 12 Months From Trough
02/28/1973	09/30/1974	30.3%	24.1%
11/20/1980	08/12/1982	36.2%	47.3%
08/27/1987	10/26/1987	21.4%	24.7%
01/04/1990	09/28/1990	18.6%	20.9%
07/20/1998	10/05/1998	32.6%	35.8%
03/27/2000	10/09/2002	9.7%	35.5%
10/30/2007	03/09/2009	60.7%	70.5%
05/02/2011	10/04/2011	20.2%	23.7%
01/26/2018	12/25/2018	20.5%	31.0%
02/12/2020	03/23/2020	43.9%	74.0%
	Median	25.9%	33.3%
	Average	29.4%	38.7%

Source: FactSet, as of 30/06/2022. MSCI World Index price returns, 31/12/1969 – 23/03/2021.

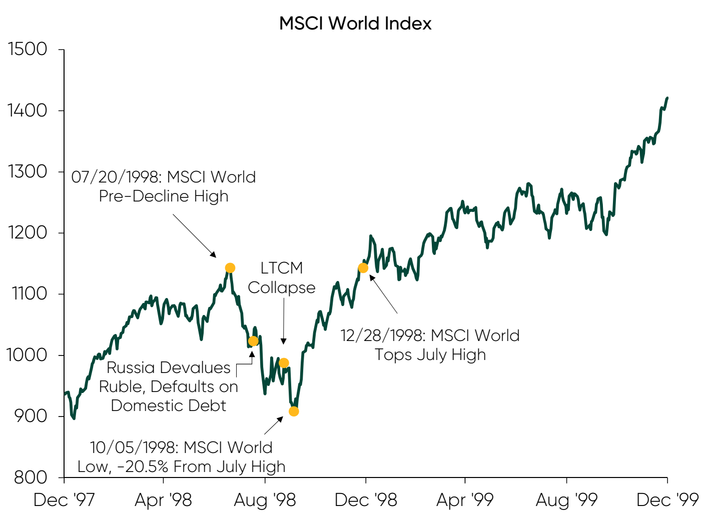
x Source: FactSet, as of 01/07/2022. MSCI World Index price returns, 31/12/1969 – 30/06/2022.

A CASE STUDY—1998

Don't underestimate markets' ability to gain big ground in a short period of time. Consider 1998, when a Russian currency crisis triggered a default, causing the ironically named, highly leveraged hedge fund Long Term Capital Management (LTCM) to collapse. That year began with equities recovering nicely from 1997's Asian currency contagion. By 20 July, the MSCI World was up 22.0% on the year.[xi] Then Russia's pegged exchange rate came under pressure while its economy flagged. As it became clear the Russian Central Bank couldn't maintain the peg, fears over the impact grew. On 17 August, the peg broke and Russia defaulted on its domestic debt. LTCM, highly exposed to the ruble, failed in September. From 20 July's high to 5 October's low, global equities tumbled -20.5%, leaving markets negative on the year. Many feared much worse to come.

It didn't. Seemingly assuaged by the feared events happening—and resolving uncertainty—world markets soared. World equities finished 1998 up 22.8% on the year.[xii] (Exhibit 3) While we aren't suggesting this recovery will be as swift as 1998's, this illustrates two key points: One, it is a mistake to underrate the recovery's potential power. Two, recoveries tend to come when things look most bleak.

EXHIBIT 3: ILLUSTRATING RECOVERY - 1998



Source: FactSet, as of 30/06/2022. MSCI World Index price return, 31/12/1997 – 31/12/1999.

SENTIMENT SEEMS TOO DOUR

In our view, dismal sentiment abounds now. A look at global confidence and sentiment gauges suggests widespread economic pessimism. Many pundits see these surveys' dire readings as a sign of trouble ahead. We disagree. They are concurrent, showing you sentiment now. They hint at what markets have pre-priced. As Exhibit 4 shows, many are testing historic lows. Now, to be clear: No metric quantifies sentiment perfectly. Qualitative analysis is requisite, in our view, but we think these measures are illustrative.

EXHIBIT 4: SELECTED SENTIMENT INDICATORS

Indicator	Level	Lowest Since
University of Michigan US Consumer Sentiment Index	50.0	Record Low (Data Start in 1952)*
The Conference Board US Consumer Confidence	98.7	February 2021
--Consumers' Economic Outlook	*66.4*	*March 2013*
American Assn. of Individual Investors Bull-Bear Spread	-41.1	April 28, 2022 -- March 5, 2009 Prior
Bank of America Global Fund Manager Survey--Econ. Optimism	-73.0	Record Low (Data Start in 1994)
GfK UK Consumer Confidence Index	-41.0	Record Low (Data Start in 1974)
GfK Germany Consumer Confidence Index	-26.6	Record Low (Data Start in 1995)
ZEW Eurozone Financial Market Survey - Economic Situation	-35.0	May 2021
--ZEW Eurozone Financial Market Survey - Stock Market Outlook	*5.9*	*June 2020*

Source: FactSet, American Association of Individual Investors, The Conference Board and Bank of America, as of 29/06/2022. *Italics* indicate the gauge is a subset of the overall survey above it. *Survey was conducted three times year or quarterly until 1977, monthly thereafter.

xi Source: FactSet, as of 01/07/2022. MSCI World Index price return, 31/12/1997 – 20/07/1998.

xii Source: FactSet, as of 01/07/2022. MSCI World Index price return, 31/12/1997 – 31/12/1998.

Still, many say we haven't seen capitulation—implying more downside remains. Possibly. However it is unclear whether we will see traditional capitulation, simply because so many asset classes are down. Bonds are enduring a rare period of dropping significantly alongside equities. Cryptocurrencies have been hit particularly hard. High inflation erodes cash, especially with deposit rates low. Foreign currency bonds generally offer lower yields and significant risk, given the strong dollar. Gold held up well through early March but is down more than global equities since then, despite accelerating inflation—proving again it is unreliable as a safe-haven or inflation-hedge.[xiii] Residential real estate is very costly, especially as rising mortgage rates crimp demand.

POSITIONING FOR THE RECOVERY

We believe that now is the time to position for the rally, potentially set to start at some perfectly unpredictable moment. While our emphasis on growth equities hurt relative returns on the way down, we think it is likely to benefit portfolios in the recovery. Too many tout value equities' leadership as a fundamental, lasting shift many years in the making—extrapolating the trend far into the future. We think this is an error, one mistaking temporary trends emanating from today's procession of fears for something more durable.

Value's leadership is narrower than many presume. Energy has done phenomenally well, as fears over oil supply drive prices higher. Materials has at times done well, too, as fears over metals shortages aided returns. Defensive Consumer Staples and Utilities now benefit from recessionary fears. Yet Financials didn't do nearly as well, while Industrials lagged. Meanwhile, growth was impacted significantly enough that several growth equities were reclassified by some index providers as value. We see that as being indicative of current sentiment—their growth-oriented business models didn't change. Their share prices were just hit very hard.

Sentiment also drives an unseen entanglement: Growth overwhelmingly led on up days; value led when markets fell. Through 30 June, global equities rose on 55 days. Growth led on 40 of them, or 72.7%.[xiv] Equities fell on 74 days, with value leading on 57—77.0%.

After bear markets, what falls most tends to bounce biggest. Since 1970, when sector compositions shifted closer to their current configuration, US bear markets' worst-performing sectors have typically rebounded strongest. In the 7 bear markets since, sector returns during the downturns had a median correlation of -0.73 with returns six months post-bottom.[xv] This indicates leadership normally rotates around bear market lows. Laggards become leaders. Today, that points to Tech and growth-oriented names in the Communication Services and Consumer Discretionary sectors leading in the recovery.

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xiii Source: FactSet, as of 01/07/2022. MSCI World Index return with net dividends and gold returns, 08/03/2022 – 30/06/2022.

xiv Source: FactSet, as of 01/07/2022. MSCI World Index count of up and down days based on price returns, and frequency of MSCI World Growth versus Value Index on them.

xv Source: FactSet and Refinitiv, as of 28/09/2021. Statement based on frequency of MSCI World Information Technology outperformance versus the MSCI World (price returns) when US 10-year constant maturity Treasury yields are rising, 31/12/1973 – 27/09/2021.

INFLATION, INTEREST RATES AND THE YIELD CURVE

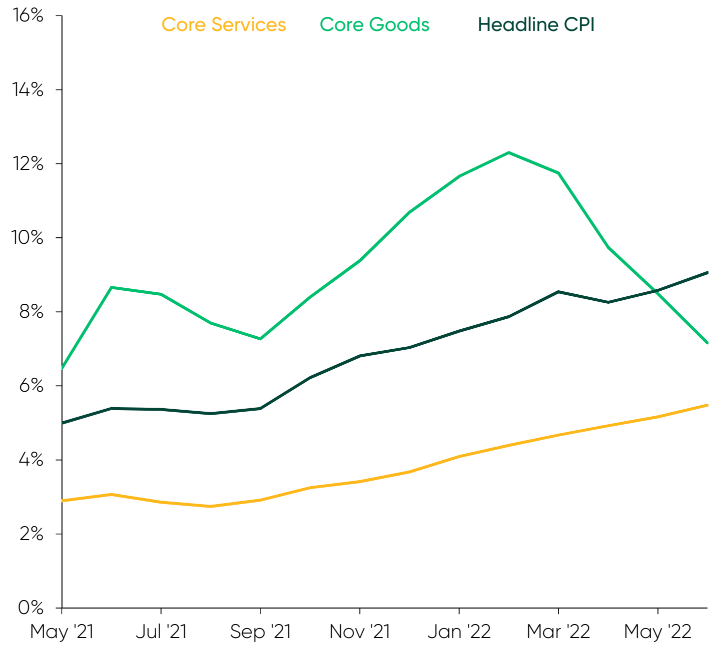
Please note, our commentary on inflation and associated matters is apolitical, focused on the market and economic impact only.

INFLATION

As last quarter's Review detailed, inflation is spiking higher for longer than we initially expected—due largely to dislocations from continued reopening-related issues, Omicron and the Russia – Ukraine war. With US CPI accelerating to 9.1% y/y in June, many now worry prices are running away and higher inflation will become entrenched.[xvi] That would then force the Fed to aggressively hike rates, risking impairing the economy to tame inflation.

That outlook is too pessimistic, in our view. While it has taken longer than we first thought, we still believe inflation is likely to slow before long. Surging demand for travel and leisure services—hit hard by COVID-19 restrictions—along with high supply costs and labour shortages have contributed to rising services prices. Food and energy, which tend to be more volatile, are the primary drivers of elevated goods prices. (Exhibit 5) Excluding those two categories, goods prices have actually decelerated on a year-over-year basis, while month-to-month data may remain volatile. In our view, the inflation rate is likely to ease as pre-lockdown trends return, though we can't know exactly when that will happen.

EXHIBIT 5: YEAR-OVER-YEAR PERCENT CHANGE IN US CPI AND SELECT CATEGORIES



Source: FactSet, as of 13/07/2022. Core goods refers to commodities less food and energy commodities. Core services refers to services less energy services.

A contributing factor to slowing prices: the base effect, which can skew the year-over-year change. To see this, go back to April 2021, when inflation began speeding. It reflected a larger numerator—reopening-related demand outstripped supply in early 2021, driving many goods and services prices higher—and a lower denominator (due to deflated prices from early 2020's lockdowns). A year later, April 2021's higher prices became the base. That base will get higher still as last year's accelerating inflation enters the denominator. Late-2021's higher Energy prices will begin raising the comparison point for oil and gas. Unless prices continue jumping from month to month, this higher base should help the year-over-year rate moderate.

We don't know when inflation will peak—that will be clear only in hindsight. We also don't know how the Fed will react, as there is no way to predict its interpretation of economic data. That said, inflation isn't likely to continue accelerating or linger over 8% for years, leaving room for fears to prove too pessimistic. It likely won't take much for reality to prove better than anticipated.

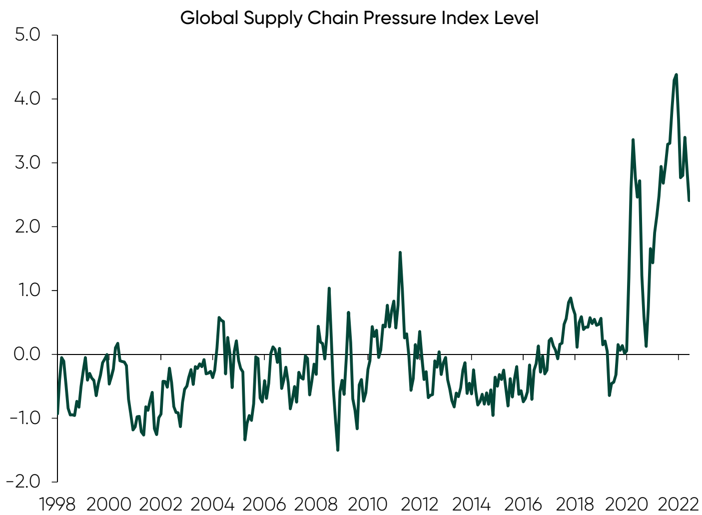
xvi Source: FactSet, as of 29/06/2022.

SUPPLY CHAINS

Related to inflation, supply chain issues remain a widespread concern. Headlines dwell on shipping bottlenecks, China's lockdowns causing shortages, a lack of workers and all the rest—even as dislocations are starting to even out. Some headwinds here clearly persist, stemming largely from an after-effect of 2020's lockdown. Airlines stopped recruiting and training pilots in the immediate aftermath of lockdowns, spawning today's high airfares. Component shortages (e.g., semiconductors) have raised prices for new and used cars. Delays at ports and a lack of containers drove inefficiencies in shipping.

It has taken time, but there are signs of these pressures easing. See the New York Fed's Global Supply Chain Pressure Index, which aggregates transportation costs, input-output prices and several purchasing managers' index (PMI) components (delivery times, backlogs and inventories) to gauge supply bottlenecks' intensity. Though the index remains elevated, it appears to be subsiding. (Exhibit 6)

EXHIBIT 6: SUPPLY CHAIN PRESSURES LIKELY EASING



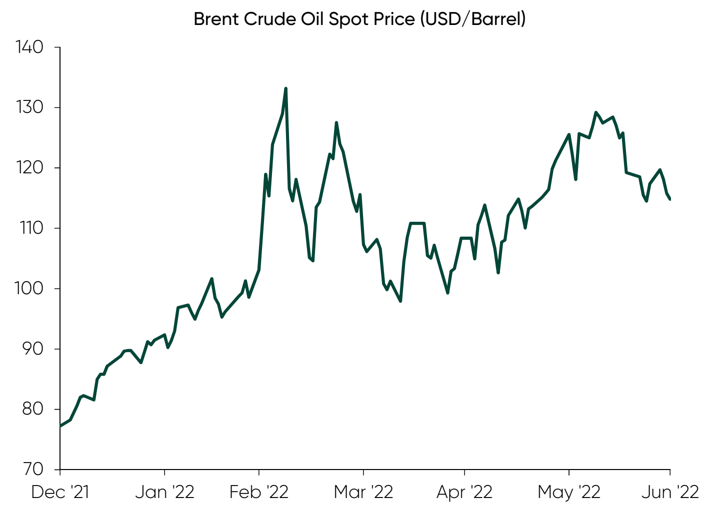
Source: Federal Reserve Bank of New York, as of 11/07/2022. Global Supply Chain Pressure Index, January 1998 – June 2022.

Elsewhere, the Baltic Dry Index, a gauge of shipping costs, is down -35.1% from 23 May's year-to-date high.[xvii] China's reopening from lockdowns in major economic hubs, including Shanghai and Shenzhen, further eases global supply chain pressures. The Korean truckers' strike in June, which caused severe disruptions at ports—impacting semiconductor shipments—has resolved. PMI work backlogs for developed nations are falling, signaling pressures at goods producers and service providers are easing. Inflation is too much money chasing too few goods and services. It appears the "too few goods" problem should ease soon.

ENERGY

Oil prices have dominated headlines this year. General public perception is that they are skyrocketing, yet they have largely moved sideways after hitting a year-to-date high on 8 March. (Exhibit 7)

EXHIBIT 7: BRENT CRUDE, YEAR-TO-DATE



Source: FactSet, as of 05/07/2022. Brent crude oil spot price, 31/12/2021 – 30/06/2022.

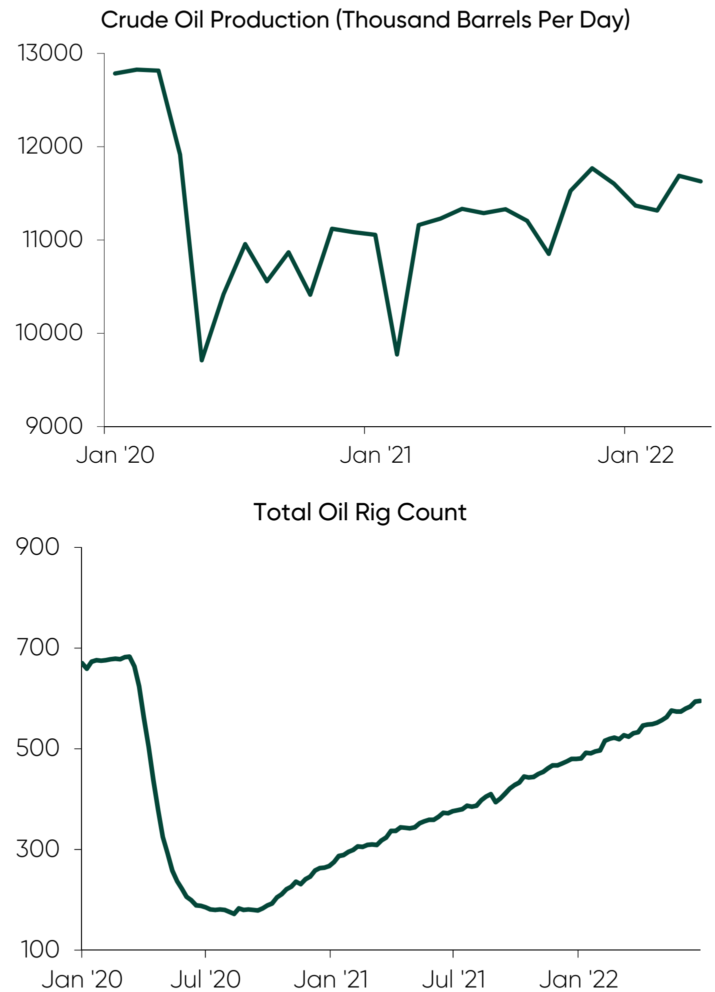
xvii Ibid. Baltic Dry Index, 23/05/2022 – 29/06/2022.

Western sanctions tied to Russia's invasion of Ukraine haven't kept Russian oil off the market. The EU announced sanctions on Russian oil in late May, including banning seaborne imports of Russian crude (while allowing shipments via pipeline to assuage land-locked and Russia-dependent nations including Hungary) and prohibiting EU insurers from covering seaborne shipments globally. In response, Russian producers have tapped black and gray markets. They are also reportedly turning to Russian insurers to cover shipments. Insurers in non-sanctioning nations can also provide coverage.

With Russian crude trading at a big discount, non-sanctioning Asian countries—specifically China and India—have replaced Western European buyers. China's crude oil imports from Russia were up 55% y/y in May.[xviii] According to industry estimates, India received around 1 million barrels per day (bpd) from Russia in June compared to 30,000 bpd in February.[xix] The more oil China and India buy from Russia, the less they buy from Middle Eastern and North African producers—freeing up oil for Western Europe to purchase. Many reports suggest Indian refiners are shipping refined Russian oil elsewhere globally. Russian tankers are also reportedly operating clandestinely or using ship-to-ship transfers to avoid sanctions. That isn't great for Western sanctions' efficacy, but it shows Russian oil isn't stranded.

Another factor boosting global supply: Other nations are ramping up production. US rig counts are up and production is rising, despite both political parties arguing it isn't. (Exhibit 8)

EXHIBIT 8: RISING US OIL PRODUCTION



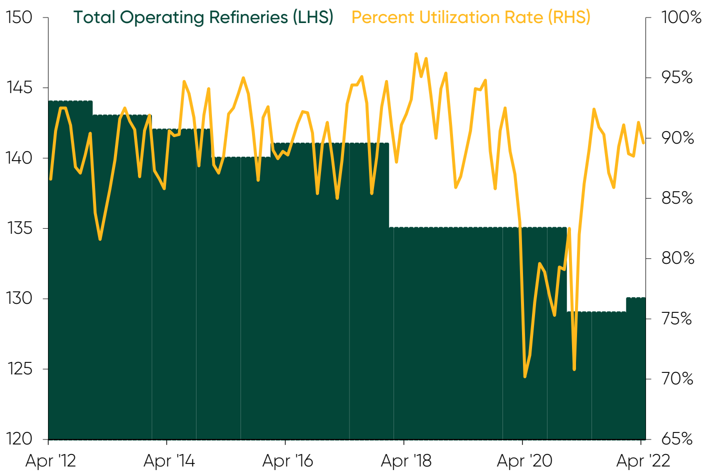
Source: FactSet and EIA, as of 05/07/2022. Baker Hughes Weekly Rotary Rig Count (US Oil), 31/12/2019 – 01/07/2022 and total crude oil monthly production, January 2020 – April 2022.

xviii "China's Imports of Russian Crude Oil Hit Record High," Staff, Reuters, 20/06/2022.

xix "India's Finance Minister Defends Increased Purchases of Russian Oil," Brendan Moran and Shan Li, The Wall Street Journal, 27/06/2022.

So why aren't gas prices lower? In large measure, refinery issues explain this. Though refinery utilisation is up, the number of refineries fell during the pandemic as owners balked at expensive upgrades, permitting issues and other factors. (Exhibit 9)

EXHIBIT 9: AMERICA'S DWINDLING REFINERY CAPACITY



Source: EIA, as of 05/07/2022. US total number of operating refineries, annual, 2012 – 2022, and utilisation of operable refinery capacity (percent), monthly, April 2012 – April 2022.

Nevertheless, high gas prices aren't necessarily recessionary. They create winners and losers, but spending on gas still adds to GDP. High oil prices aren't inherently negative economically, either. Oil consistently exceeded $100 per barrel from Q1 2011 – Q3 2014. US GDP grew in 12 of the 15 quarters, a cumulative 7.9% increase.[xx] The S&P 500 rose 69.9% over that stretch.[xxi]

INTEREST RATES

The Fed raised its benchmark rate by 25 basis points (bps) on 17 March—and followed with bigger hikes of 50 bps on 5 May and 75 on 16 June and 27 July, the biggest hikes since 1994. Nearly everyone expects more to come, raising fears that the Fed risks inducing a recession in the name of fighting inflation. Some allegedly worrisome evidence: A widely watched section of the US Treasury yield curve (the 10-year minus 2-year spread) inverted in late March.

While the yield curve is a useful leading indicator, focusing on the right section matters. Banks' core business is to borrow short-term and lend long. 10-year rates are the reference rate for long-term lending, but 2-year rates reveal little about banks' borrowing costs—they don't take in much through 2-year time deposits or CDs. Instead they borrow overnight or very short-term, via deposit accounts or interbank borrowing, so shorter-term yields are more relevant. We think the best spread is the 10-year to 3-month. Despite four rate hikes and some flattening since June, this yield curve section isn't inverted.

The yield curve is the key way central banks influence the economy through monetary policy. The Fed's power is rather limited. It doesn't control businesses' hiring, banks' lending, mortgage rates or inflation in general. Its policy encourages or discourages loan growth by affecting lending's profitability—a very indirect influence. Accordingly, it is widely accepted that monetary policy affects economic activity at an undetermined lag—around 6-18 months. No theory or research suggests three hikes in three months will tame inflation. Monetary policy can't bring new energy sources online, force businesses to invest if the potential return isn't worthwhile, end the war in Ukraine or ease COVID-19 restrictions.

We see the pessimism of disbelief at work here. Many fear *any* positive data—e.g., a falling unemployment rate or rising durable goods orders—make rate hikes likelier. Treating good news as bad while arguing rate hikes will hurt the economy speaks to how dour sentiment is—a prime area for falling uncertainty to power positive upside surprise if reality even barely exceeds exceptionally low expectations.

xx Source: BEA, as of 01/07/2022. US real GDP, percent change, Q1 2011 – Q3 2014.

xxi Source: FactSet, as of 30/06/2022. S&P 500 Total Return, 31/12/2010 – 30/09/2014.

A WORD ON FIXED INCOME

Bonds' decline alongside equities is one of the year's more unique developments. As Exhibit 10 shows, bonds don't necessarily zig every time equities zag. It is rare for bonds to drop alongside equities, but not unprecedented.

EXHIBIT 10: BONDS DON'T USUALLY ZIG WHEN EQUITIES ZAG

	Bonds Up	Bonds Down	Total
Stocks Up	57.9%	17.5%	75.4%
Stocks Down	20.3%	4.3%	24.6%
Total	78.2%	21.8%	100.0%

Source: Global Financial Data, Inc., as of 11/07/2022. Frequency of positive and negative S&P 500 and 10-year US Treasury rolling 12-month total returns, January 1926 – June 2022.

From here, inflation expectations—and long-term interest rates—will largely determine where bonds go. We think expectations for higher rates ahead have probably overshot. We don't see a fundamental reason for rates to keep soaring. They could even drift down a bit as sentiment and inflation expectations improve.

Many might point to the Fed's plans to allow bonds it acquired under quantitative easing (QE) to mature as a factor pushing up rates. However, we learned in 2017 that bonds pre-price Fed balance sheet runoff. Yields temporarily jump on the rumors, announcement and start, then drift lower as it becomes clear supply and demand fundamentals haven't altered significantly. This suggests whatever influence the Fed's unwinding QE has already happened and points further to yields drifting lower over the foreseeable future. As for corporate bonds, their yields have risen somewhat versus Treasury rates during the downturn, as recession fears percolate. Yet as recession worries fade, that should reverse—boosting corporate performance versus Treasury's.

A STRONG US DOLLAR DOESN'T DOOM MARKETS

Except for a brief March – April 2020 spike in the midst of pandemic lockdowns, the US dollar has never been higher against the Fed's broad trade-weighted currency basket than it is now. Against the euro and yen, the dollar has exceeded its pandemic peaks and reached multi-decade highs. While many fear dollar strength's repercussions, we think such worries are likely overblown.

We believe there is a simple explanation for the dollar's appreciation: US interest rates are higher than in most other developed markets. All else equal, we find global capital typically flows to higher yielding assets. The US's yield curve is higher than Japan's and major European ones, save Italy's beyond 7-year maturities. That largely reflects differentials in central bank activity and expectations. Money has flowed to America with US short-term interest rates higher than most of the rest of the developed world's and rampant speculation the Fed will continue tightening aggressively. Canada, notably, is an exception. Short-term rates there have often exceeded US rates this year, thanks in part to the Bank of Canada's 100 basis point rate hike 13 July. Counterintuitively, the US dollar has strengthened by 2.4% against the Canadian dollar year to date.[xxii]

Additionally, when all else isn't equal in times of market stress like now, a flight to quality also tends to boost US Treasury and dollar demand. Besides fundamental rate differentials, we think the dollar is also rallying for just such sentiment-driven reasons. Given the dollar's safe-haven status, the wide range of fears this year—protracted Russia-Ukraine war, spiking oil and gas prices, China's lockdowns, ongoing supply-chain disruptions, high inflation, rising interest rates and recession—boosted dollar demand.

xxii Source: FactSet, as of 27/07/2022. USD/CAD, 31/12/2021 – 27/07/2022.

Dollar strength has sparked further fears. In the developed world, they centre on the dollar rendering US exports too costly and harming American multinationals' foreign profits when converted back to US dollars. Both fears ignore the reality that many firms import quite a lot to make their end products and/or operate in diverse geographic locations. A strong dollar lowers imported components, resource and labour costs. They also ignore that currency conversions are often accounting entries that don't reflect the core business, as money earned abroad in foreign currencies is often redeployed in those same currencies. Hence, many multinational firms now include constant-currency earnings and revenues alongside GAAP and IFRS reports. Of course, many companies hedge for currency effects to offset big swings, too.

Exhibit 11 shows how recessions generally have more impact on exports and profits than the dollar by itself. Outside of recessions there is no clear relationship. There are times when a strong dollar has coincided with temporary dips in exports and profits, but there are also extended periods when all have risen together (like in the 1990s). Lastly, analysts generally recognise when the dollar is strong and its effects aren't fundamental to a business. In such circumstances, many tend to focus on constant currency revenues and profits.

EXHIBIT 11: DOLLAR STRENGTH NEEDN'T HURT EXPORTS OR CORPORATE PROFITS

Dollar Strengthening vs. Profits and Exports				
Rising Dollar Period	Quarters (in Recession)	Dollar Index % Chg.	Corp. Profits % Chg.	Exports % Chg.
Q2 1973 – Q3 1977	18 (6)	21.8%	66.8%	76.6%
Q4 1978 – Q2 1985	27 (6)	103.9%	-1.9%	48.1%
Q4 1987 – Q3 1998	44 (3)	98.9%	112.4%	138.5%
Q4 1999 – Q1 2002	10 (2)	12.3%	-3.3%	-6.0%
Q1 2008 – Q1 2009	5 (5)	18.1%	-14.1%	-16.6%
Q2 2011 – Q4 2016	23 (0)	36.9%	19.3%	7.0%
Q1 2018 – Q1 2020	9 (1)	14.0%	-10.4%	-4.7%
Q4 2020 – Q2 2022*	7 (0)	8.7%	?	?

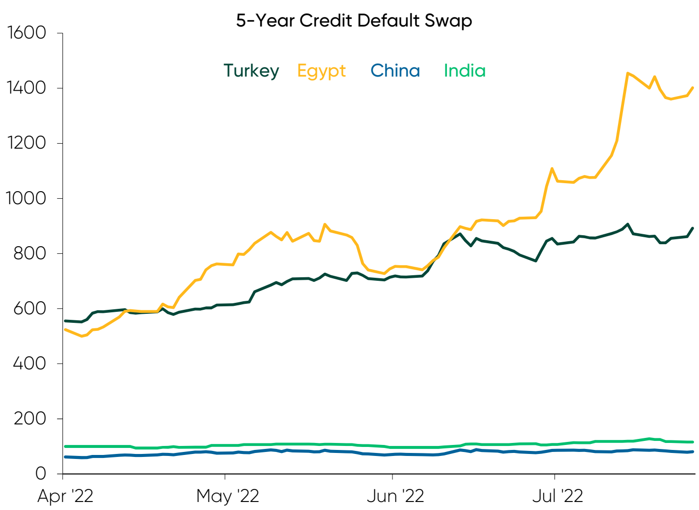
Source: FactSet and Federal Reserve Bank of St. Louis, as of 25/07/2022. Broad trade-weighted dollar, corporate profits and exports, Q1 1973 – Q2 2022. *To date.

Additional concerns concentrate on dollar strength causing the UK, eurozone and Japan to import inflation, as a strong dollar makes US exports of goods and services—and all dollar-denominated imports—more costly. It is true a strong dollar can exacerbate oil prices—and energy has been a big contributor to the rising costs in Europe, the UK and (to a lesser extent) Japan. However inflation is a global phenomenon, especially in the developed world, where capital flows freely across borders. Most of the world is suffering from the same principal price pressures—namely, supply chain issues tied to reopening and the Ukraine war. Besides, American exports constitute about 10% of UK imports, 11% of eurozone imports and 11% of Japanese imports. This is likely too small to move the needle in a major way. Past spells of currency weakness in Britain, Europe and Japan haven't brought runaway inflation.[xxiii]

xxiii Source: Eurostat and World Bank, as of 27/07/2022. Share of imports in 2019 for the UK and Japan (via World Bank), 2021 for the eurozone via Eurostat.

We also find pronounced strong-dollar fears regarding Emerging Markets (EM), namely that it risks a repeat of 1997's Asian Currency Crisis. Yet we think the lessons from the whole series of 1990s EM financial crises have largely stuck. While a few smaller EM countries like Turkey and Egypt face funding pressures, they are well known—sovereign debt markets' credit spreads currently reflect risks well already. Turkey's 10-year yield currently stands at 16.1%—and its yield curve is deeply inverted, with 3-month rates at 22.1%.[xxiv] Its five-year credit default swap (CDS) spread is near two-decade highs.[xxv] Egypt's CDS spread implies a better-than-even chance of default.[xxvi]

EXHIBIT 12: MARKETS REFLECT EM CREDIT RISK



Source: FactSet, as of 27/07/2022. Five-year CDS for Turkey, Egypt, China and India, 01/04/2022 – 26/07/2022.

Meanwhile, the largest EM economies in East and South Asia have free-floating currencies, relatively little dollar-denominated debt and ample reserves to service it. Less than 5% of Asian EM government debt is in dollars.[xxvii] Reserves as a percentage of external debt are 122% in East Asia and 83% in South Asia, more than double the average for least developed countries.[xxviii] Plus, their higher value-added exports remain in high demand and generate sufficient foreign exchange to maintain an adequate level of reserves. Bond yields in China, Taiwan, India and South Korea aren't showing any signs of overt credit stress, in our view. Note the differentiation in Exhibit 12's CDS spreads between the former and latter groups.

Another difference today from the 1990s: Many EM central banks implemented quantitative easing (QE) during pandemic lockdowns. They include India, the Philippines, Chile, Poland and Indonesia.[xxix] We think assets amassed under QE allows them additional monetary policy flexibility. Take Bank Indonesia (BI), which has started selling some of its QE bonds. This allows BI to raise bond yields and attract demand to support the rupiah without having to hike short-term policy rates or expend foreign currency reserves. That said, there is risk to this strategy and a balance to strike, as BI Deputy Governor Dody Budi Waluyo recently acknowledged, "BI of course will ensure that liquidity in the economy remains adequate to support the economic recovery and we have done a careful calculation."[xxx] However we see this as an unappreciated positive among several EM nations. Although a handful struggle to pay off their dollar debts—monopolising headlines—few reports seem to recognise many more have improved financial circumstances beneath the surface, setting up significant upside surprise potential.

xxiv Source: FactSet, as of 27/07/2022. Turkey 10-year and 3-month government bond yields, 26/07/2022.

xxv "Turkey Credit Default Swaps Jump to 19-Year High Amid Lira Woes," Tugce Ozsoy, Bloomberg, 12/06/2022.

xxvi "The Big Default? The Dozen Countries in the Danger Zone," Marc Jones, Reuters, 15/07/2022.

xxvii "Dollar-Denominated Public Debt in Asia and Latin America," Paulina Restrepo Echavarria and Praew Grittayaphong, Federal Reserve Bank of St. Louis, 03/08/2021.

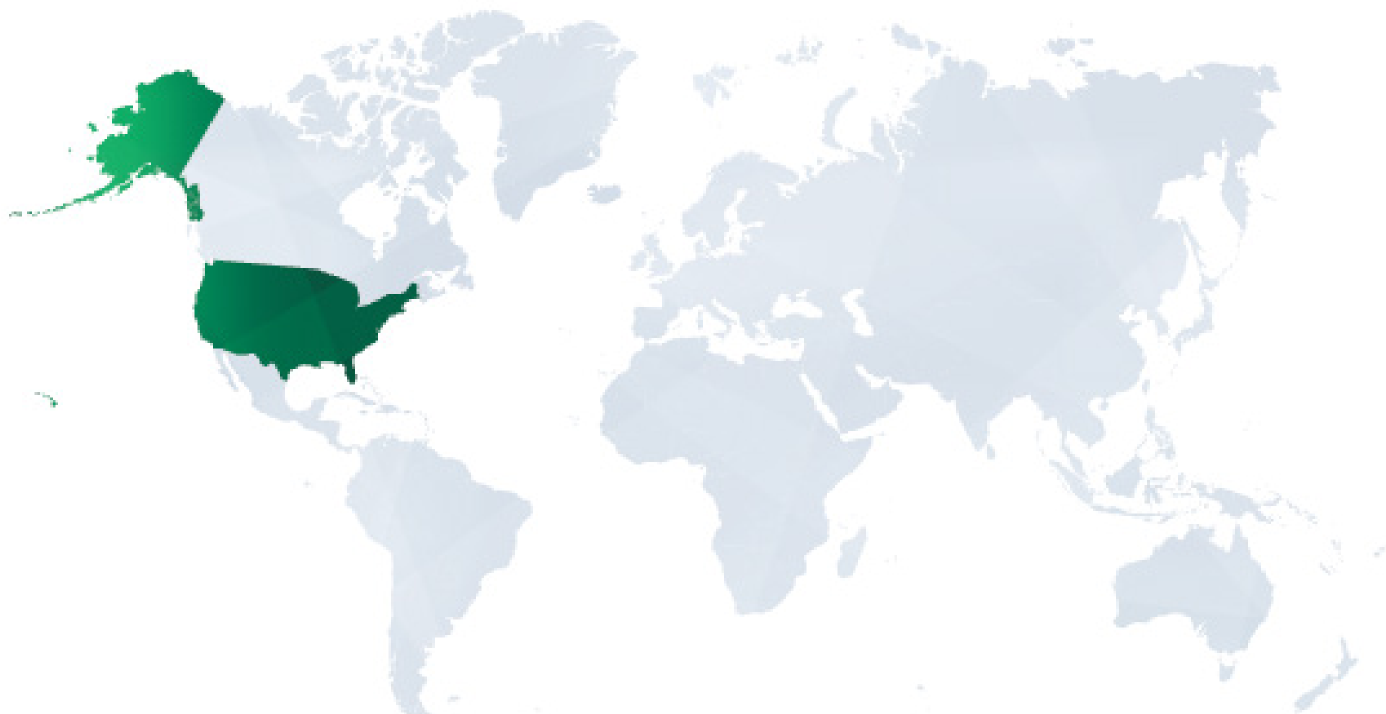
xxviii Source: World Bank, as of 27/07/2022. Total reserves percent of total external debt for East Asia & Pacific (excluding high income), South Asia and least developed countries (UN classification), 2020.

xxix "Emerging and Frontier Markets: Policy Tools in Times of Financial Stress," Dimitris Drakopoulos, Rohit Goel, Fabio Natalucci and Evan Papageorgiou, IMF, 23/10/2020.

xxx "Indonesia Central Bank Says It Will Ensure That Quantitative Easing-Era Bond Sales Do Not Disrupt Market," Gayatri Suroyo and Stefanno Sulaiman, Reuters, 25/07/2022.

In our view, the worries over dollar strength are a sign of pessimistic sentiment—one more area where uncertainty is high and set to fall. It has joined the number of concerns we documented in our discussion on sentiment, but the impact is likely far smaller than feared. As that reality dawns on investors—and the retreat of fears takes some of the attention off the dollar—we suspect relief should help buoy equities in both the developed and developing world.

UNITED STATES **COMMENTARY**



With each day, more recession forecasts are published. Some argue we are already in one since US GDP contracted in Q1 and Q2 of 2022. Others say economic conditions will continue to deteriorate. (Exhibit 13) In one very interesting sign of sentiment, many who say a significant recession is coming also say it isn't yet priced into markets. With all the chatter, both are very unlikely to be true simultaneously—markets are too efficient for that. We think recession fears are already reflected in equities to a very great degree, sapping surprise power should one occur—and creating big positive surprise potential if things go better than feared. We see a high likelihood of the latter.

EXHIBIT 13: RECESSION HEADLINES ARE UBIQUITOUS


With Recession Looming, the Fed May Be Doing More Harm Than Good

Wall Street Says a Recession Is Coming. Consumers Say It's Already Here

Inflation Soars to Highest Level in 40 Years as Recession Risk Rises

Fed Paper Finds Elevated Probability of Recession

How to Recession-Proof Your Life

World Bank Says Recession Will Be 'Hard to Avoid' for Many Countries

The Risk of Recession Is Growing. Here's Why Recessions May Be Inevitable

A Recession Could Last 2 Years According to Connecticut Economics Experts

All the Recession Warning Signs This Week

Actually, a Recession Is Inevitable

Source: *The Hill*, *Bloomberg*, *Politico*, *The Washington Post*, *CNN*, *CNBC*, *The Wall Street Journal*, *FOX61* and *Forbes*, as of 08/07/2022.

WEIGHING US ECONOMIC DATA

As previously noted, the yield curve spread remains slightly positive. While it has narrowed since the Fed started hiking rates, it remains upward sloping—consistent with moderate credit growth, as it preserves the incentive for banks to lend. There is a risk of further Fed hikes inverting the curve, assuming they drag down inflation expectations as Fed officials intend. That would depress long rates as short rates rise. We are watching this closely, but for now the positive spread is an underappreciated plus.

Business investment is a crucial economic swing factor, and firms' access to credit is key to it. Most recessions begin when an inverted yield curve causes banks to cut lending, robbing businesses of funding. That triggers deep cutbacks as firms reduce excess to survive. This manifests in sharp business investment contractions, which drive broader economic contraction. When bank lending is healthy—supported by a wide yield curve spread—investment can flow. People commonly focus instead on consumer spending—understandable, as consumption represents about 70% of GDP.[xxxi] Hence, the focus on inflation eroding households' budgets. When consumer spending fell -0.4% m/m on a "real" (inflation-adjusted) basis in May, recession fears went into overdrive.[xxxii] Yet real consumer spending has fluctuated for months, without turning the quarterly measure included in GDP negative and consumer spending remained positive again in Q2. Meanwhile, business investment was robust in Q1.[xxxiii]

EXHIBIT 14: OVERCOMING CHOPPY CONSUMER SPENDING

	Q3 2021			Q4 2021			Q1 2022		
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Consumer Spending (M)	-0.3%	0.7%	0.3%	0.7%	-0.1%	-1.4%	1.3%	0.0%	0.3%
Consumer Spending (Q)	2.0%			2.5%			1.8%		
Business Investment	1.7%			2.9%			10.0%		
GDP	2.3%			6.9%			-1.6%		

Source: US Bureau of Economic Analysis (BEA), as of 30/06/2022. Monthly figures are seasonally adjusted month-over-month percent changes, and quarterly figures are seasonally adjusted annualised growth rates.

GDP's Q1 and Q2 contractions may make our observation that recession doesn't appear to be underway seem odd (since one technical definition of a recession is two subsequent declines in quarterly GDP). Yet a recession is a broad decline in economic activity, and GDP isn't "the economy." It counts all government spending and investment as positive, even though it can displace private activity and is often divorced from private sector trends. GDP also removes imports, even though they represent domestic demand. Both factors detracted heavily from GDP in Q1. Imports alone shaved -2.7 percentage points off headline growth, yet their 18.9% annualised jump signaled robust private sector activity.[xxxiv] Moreover, the pure private sector components—consumer spending, real estate and business investment—grew a combined 2.5% annualised.[xxxv]

xxxi Source: US BEA, as of 30/06/2022.

xxxii Ibid.

xxxiii Ibid.

xxxiv Ibid.

xxxv Ibid.

Regarding Q2 GDP's -0.9% decline, we believe some additional analysis is warranted.[xxxvi] Trade added to GDP—exports rose more than imports—but inventories' big subtraction more than offset it. This could be a delayed giveback from Q4's huge inventory surge, presuming it stays in the data. Inventories are always open to interpretation. A reduction could mean demand outstripped supply, or it could mean businesses had to clear a supply glut. The latter seems more likely. All last quarter, major retailers reported heavy discounting to clear inventory overhangs. It is possible Q4's huge holiday stocking met with ongoing supply chain uncertainty in Q1 to keep reductions at bay, but as bottlenecks started to ease in Q2, managers felt more comfortable letting inventories run off. Additionally, consumer spending rose 1.0% annualised, a slowdown, while fixed investment fell -3.9%, shaving -0.72 percentage points off headline growth. This has many worrying the downturn is more than just temporary supply-chain-related hiccups. The investment drop, however, was almost entirely residential real estate. While it took a chunk out of GDP last quarter as new home sales stalled, residential real estate is a sliver of the total US economy. No surprise many got cold feet from rising mortgage rates, which could persist near term. Yet with new homes under construction hitting record levels, affordability could improve in time. Finally, business investment, usually recession's swing factor, declined -0.1% annualised, subtracting a miniscule -0.01 percentage points from headline growth. Now, flattish capital expenditures aren't exactly a resounding economic confidence booster. Coupled with the inventory decline, it could signal businesses are getting lean and presage investment decreasing further. We hesitate to draw that huge of a conclusion from a single-quarter's minute dip.

Nonetheless, months-old economic activity has little relevance for stocks, which we think have already dealt with the mild economic contraction and are looking ahead to what the next 3 to 30 months have in store relative to expectations.

POLITICAL DRIVERS STILL POINT POSITIVELY

Please remember that our political commentary is intentionally non-partisan. We favour no politician nor any party, assessing developments solely for potential market impact.

While this year's first-half decline differs greatly from the typical midterm year's early grind, we still think the falling political uncertainty that accompanies midterms presents a strong tailwind later this year. The elections should clearly entrench gridlock, as we anticipate the Republicans will win a decisive edge in the House of Representatives. They may retake the Senate, too, although that looks tougher to us. With the opposition party controlling one or both chambers of Congress, investors should better appreciate gridlock, launching the late-year rally typifying midterm election years.

Ordinarily, equities lack clear direction in midterm years' early quarters, posting below-average returns and a relatively low frequency of gains. (Exhibit 15)

xxxvi Source: BEA, as of 28/07/2022. GDP, Q2 2022.

EXHIBIT 15: THE MIDTERM YEARS TYPICALLY HAVE A STRONG SECOND HALF

Midterm Year	Midterm Q1	Midterm Q2	Midterm Q3	Midterm Q4	Subsequent Q1	Subsequent Q2	Subsequent Q3	Subsequent Q4
1926	-9.1%	8.9%	10.1%	2.0%	4.6%	7.3%	16.1%	5.2%
1930	18.4%	-17.8%	-8.2%	-16.4%	10.2%	-9.9%	-33.6%	-14.8%
1934	7.4%	-8.0%	-6.2%	5.4%	-9.9%	22.1%	14.4%	17.0%
1938	-17.8%	38.5%	7.3%	9.0%	-16.0%	0.0%	21.4%	-2.9%
1942	-5.9%	5.8%	8.5%	12.1%	20.1%	8.0%	-0.9%	-2.1%
1946	5.1%	2.9%	-18.0%	3.5%	0.3%	1.5%	0.5%	2.7%
1950	4.9%	4.0%	11.9%	6.9%	6.7%	-0.3%	12.8%	3.8%
1954	10.1%	9.8%	11.9%	12.6%	2.8%	13.3%	7.5%	5.1%
1958	6.4%	8.5%	11.6%	11.2%	1.2%	6.3%	-2.0%	6.1%
1962	-2.1%	-20.6%	3.7%	13.1%	6.4%	5.0%	4.2%	5.4%
1966	-2.7%	-4.3%	-8.8%	5.9%	13.2%	1.3%	7.5%	0.5%
1970	-1.8%	-18.0%	17.1%	10.3%	9.7%	0.2%	-0.6%	4.6%
1974	-2.8%	-7.6%	-25.2%	9.3%	23.0%	15.4%	-10.9%	8.6%
1978	-4.9%	8.5%	8.7%	-5.0%	7.1%	2.6%	7.6%	0.1%
1982	-7.3%	-0.6%	11.5%	18.3%	10.0%	11.1%	-0.2%	0.4%
1986	14.1%	5.9%	-7.0%	5.6%	21.3%	5.0%	6.6%	-22.5%
1990	-3.0%	6.3%	-13.7%	9.0%	14.5%	-0.2%	5.3%	8.4%
1994	-3.8%	0.4%	4.9%	0.0%	9.7%	9.5%	7.9%	6.0%
1998	13.9%	3.3%	-9.9%	21.3%	5.0%	7.0%	-6.2%	14.9%
2002	0.3%	-13.4%	-17.3%	8.4%	-3.1%	15.4%	2.6%	12.2%
2006	4.2%	-1.4%	5.7%	6.7%	0.6%	6.3%	2.0%	-3.3%
2010	5.4%	-11.4%	11.3%	10.8%	5.9%	0.1%	-13.9%	11.8%
2014	1.8%	5.2%	1.1%	4.9%	1.0%	0.3%	-6.4%	7.0%
2018	-0.8%	3.4%	7.7%	-13.5%	13.6%	4.3%	1.7%	9.1%
2022	-4.6%	-16.1%						
Average Return	1.0%	0.3%	0.8%	6.3%	6.6%	5.5%	1.8%	3.5%
Average Positive	7.7%	8.0%	8.9%	9.3%	8.9%	6.8%	7.9%	6.8%
Average Negative	-5.1%	-10.3%	-12.7%	-8.7%	-9.7%	-3.5%	-8.3%	-9.1%
% Positive	48.0%	56.0%	62.5%	83.3%	87.5%	87.5%	62.5%	79.2%

Source: Global Financial Data, Inc. and FactSet, as of 30/06/2022. Quarterly S&P 500 total returns in midterm years, Q1 1926 – Q2 2022.

We think much of this stems from political rancor and campaign rhetoric driving up uncertainty. That is doubly true this year, considering the once-a-decade redistricting tied to 2020's census. Very few redrawn districts became more susceptible to flipping parties. Instead, they are pushed further right or left. The effect: more *extreme* campaign rhetoric. With no need to court centrists, politicians worried about a primary challenge or seeking to mobilise voters employ sharper, partisan pitches.

However as Exhibit 15 also shows, the frequency of gains surges in midterm Q4s, which continues into Q1 and Q2 of the next year. As the elections approach, markets start to see the high likelihood those campaign promises fail to materialise amid increased gridlock. Voters usually hate gridlock, seeing it as the *absence of positive action*. Yet equities see gridlock as the *positive absence of action* that often carries unintended consequences. It prevents sweeping rule changes that could interfere with businesses' long-term plans. It blocks or waters down legislation potentially creating winners and losers and, in very extreme cases, walloping markets.

THE PRESENT STATE

Many observers define gridlock as at least one chamber of Congress being controlled by the party opposing the president's. We don't have that now, as President Joe Biden's Democratic Party nominally controls the White House and both chambers of Congress. Yet relatively few contentious bills have passed. Why? *Intraparty* gridlock. The Democratic Party's majorities are historically slim, with a 10-seat House edge and Vice President Kamala Harris breaking ties in the 50-50 split Senate.

That means the party needs virtual unanimity to pass partisan legislation, but Democratic politicians agree on fairly few key issues, which has prevented major, divisive legislation from passing. Take President Biden's signature *Build Back Better* plan. Despite being talked up since last year, it has gone basically nowhere.

Regardless, the Democratic Party's nominal control of government has stirred legislative anxiety among right-leaning investors. Inaction thus far notwithstanding, a unified government stirs fears of old legislation eventually finding a way back to life. Even now, after so long in limbo, senators are still trying to revive *Build Back Better*. It is a watered-down version, thanks to intraparty gridlock, but it isn't dead, which keeps fears simmering among Republican-leaning investors. In our experience, around two-thirds of US investors lean Republican, so these legislative fears weigh on sentiment. Meanwhile, many Democratic-leaning investors are likely frustrated by inaction.

THE (LIKELY) FUTURE STATE

Midterm elections handing one or both chambers of Congress to the GOP would likely relieve that stress and buoy sentiment, even subconsciously. That is what we expect, with the House most likely to flip from Democratic control to Republican. The Senate could shift too, although that will likely be tougher.

In the postwar era, only one midterm election gave the president's party more House seats—2002's midterms, skewed by post-9/11 patriotism. In all the rest, the president's party lost seats. Furthermore, when you get to June, the president's popularity reveals a lot about how midterms will go. While even popular presidents usually lose seats, presidents with below-average popularity—like President Biden—tend to lose more. (Exhibit 16) With the Democratic Party's small House edge, history strongly suggests the GOP will take control, by around 15-25 seats.

EXHIBIT 16: MIDTERM HOUSE SEAT SHIFT AND APPROVAL RATING IN JUNE

Midterm Year	President	Approval Rating in June of Midterm Year	House Seat Change for President's Party
1946	Truman	43	-56
1950	Truman	37	-28
1954	Eisenhower	62	-18
1958	Eisenhower	54	-50
1962	Kennedy	69	-6
1966	Johnson	48	-47
1970	Nixon	55	-12
1974	Nixon	28	-48
1978	Carter	42	-14
1982	Reagan	44	-26
1986	Reagan	64	-4
1990	Bush	69	-8
1994	Clinton	44	-54
1998	Clinton	60	-2
2002	GW Bush	74	8
2006	GW Bush	37	-31
2010	Obama	47	-64
2014	Obama	42	-13
2018	Trump	42	-42
2022	Biden	41	???
Average (Pre-2022)		50.58	-27
Average Seat Change With Low Popularity		--	-38
Average Seat Change With High Popularity		--	-12

Source: Gallup, House of Representatives Archives, as of 01/07/2022.

The Senate is less clear. A big shift in relative control looks unlikely. While just one net seat flipping could alter control, there are fairly few swing seats truly in play—Nevada, Georgia, Arizona, New Hampshire and Pennsylvania. Whether Senate control flips depends largely on whether Republican candidates perform several percentage points better than their polls, as they did in 2020, or whether pollsters have corrected the errors leading them to previously underestimate the GOP vote. If the polls aren't fixed and Republicans outperform, then their likelihood of taking a slight Senate majority increases. If the polls are more accurate, the Democrats would likely retain control and could even gain a seat or two.

In Georgia, incumbent Senator Raphael Warnock faces former football star Herschel Walker. Most early polls following 24 May's primary have Senator Warnock ahead, but the race is just beginning in earnest, as Mr. Walker had to defeat five other challengers for the GOP nomination. Both men are good speakers, and the race is widely expected to tighten as the campaign progresses. Regardless, though, if the numbers don't dramatically change, Mr. Walker would have to markedly outperform the polls on Election Day to win.

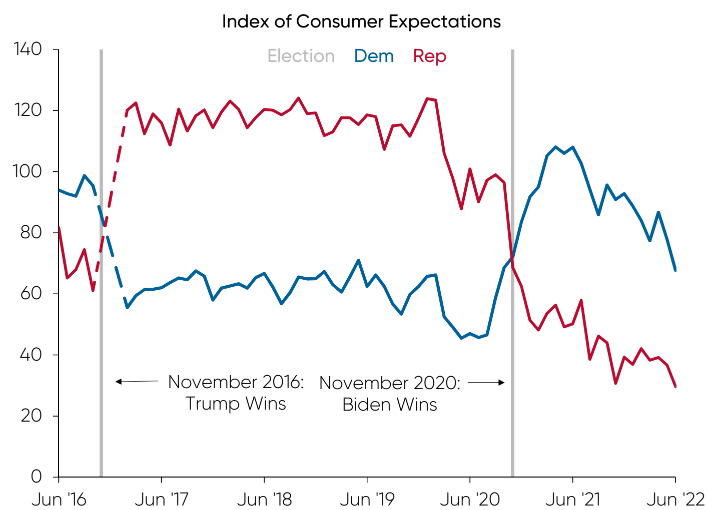
In Arizona and New Hampshire, primaries don't occur until 2 August and 13 September, respectively. That hinders Republican candidates running against Democratic incumbents. First-term Senator Maggie Hassan (D-NH) faces little opposition. Senator Mark Kelly (D-AZ) faces no primary opposition. This lets the two pour nearly all their substantial funding and campaign efforts into the general election. GOP challengers have no such luxury. In Arizona, five candidates are vying for the nomination; four in New Hampshire. In the latter, a University of New Hampshire survey conducted in late April showed a close race—all four within striking distance of Hassan. That shows this is a rare toss-up seat, but it also illustrates how these Republicans cannot shift focus until the primary is won.[xxxvii]

Ultimately, whether the GOP wrests control of the Senate and House or just the House is rather academic. One of the two is enough to make gridlock more visible and ease uncertainty.

BEWARE BIAS

In any election year, and arguably more so this year, political bias is a risk to investors. Many commonly believe their party is best for markets and that the opposition awful or destabilising. This is why we think investors must take a nonpartisan view of developments and how likely they are to drive legislation impacting equities. Equities and the economy have done well and poorly under both parties' leadership. Dwelling on personalities or sharp rhetoric is a recipe for error. We see this regularly among investors, and polls like the University of Michigan's also reveal it. Since 2016, University of Michigan pollsters have fairly regularly asked consumers their outlook on the economy and general political affiliation. They found presidential elections in 2016 and 2020 showed a sharp reversal in economic optimism around the vote. (Exhibit 17)

EXHIBIT 17: THE PARTISANSHIP INFECTS AMERICAN'S ECONOMIC VIEWS

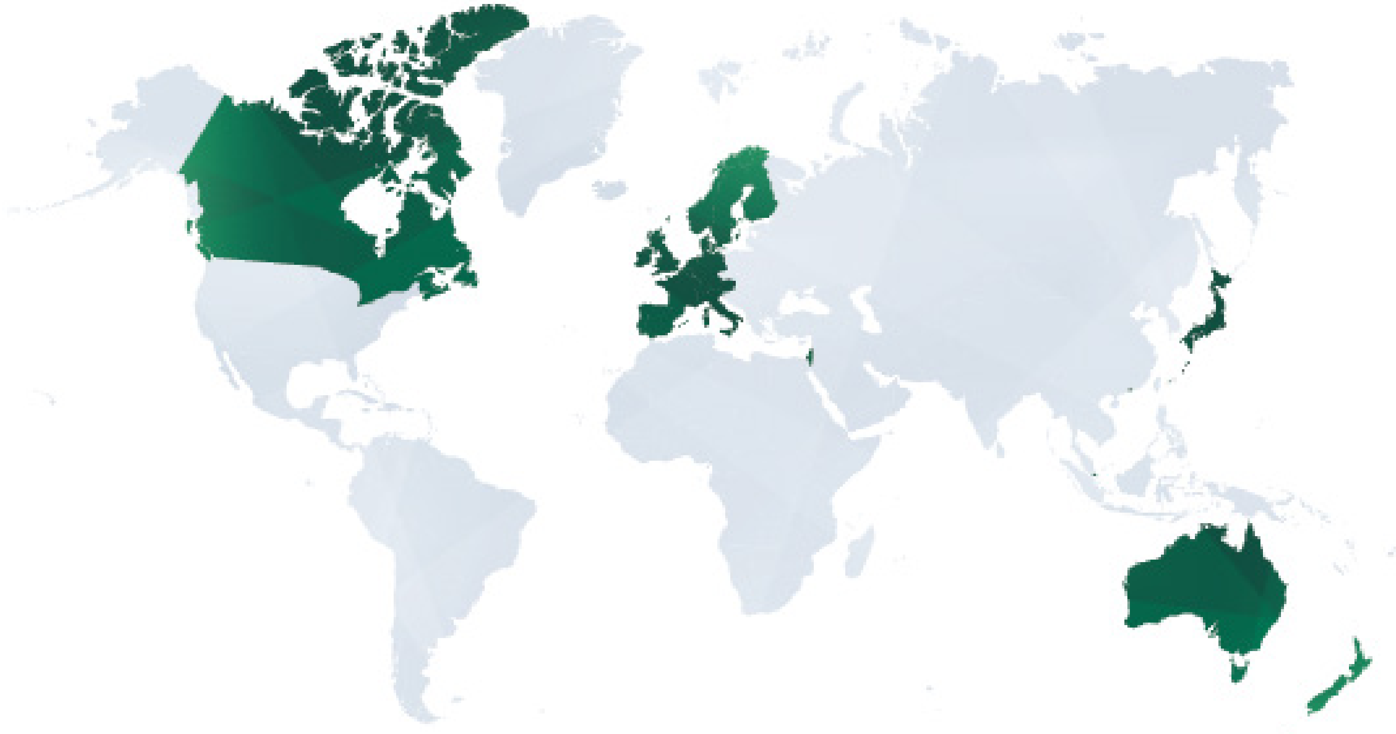


Source: University of Michigan, as of 06/07/2022. Dashed lines indicate gaps in the data.

There is little rational reason an election would shift the economy's near-term future so markedly. Respondents' viewpoints were simply infected by partisanship. While politics do intersect with the economy, it is a mistake to overrate elections' and personalities' influence on markets and the economy.

xxxvii "Hassan & GOP Challengers Tied in Race for Senate in NH; Sununu Leads Little-Known Sherman in Governor's Race," Sean P. McKinley, Zachary S. Azem and Andrew E. Smith, The Granite State Poll¸ 21/04/2022.

GLOBAL DEVELOPED EX-US **COMMENTARY**



ENERGY'S EFFECTS ON EUROPE

The risk of recession is heightened in Europe, largely due in large part to the potential for energy shortages—an eventuality much of the eurozone is preparing for. Russia has already cut natural gas shipments to large utilities across Europe as Moscow continues reacting to EU sanctions on its Energy industry. France, theoretically insulated from Russian retaliation due to its abundant nuclear power, faces the risk of rolling blackouts due to deferred maintenance issues at several key reactors, as well as drought. Shortages aren't a problem now, but electricity demand is typically lower during the summer. More importantly: This is when eurozone nations typically replenish gas reserves ahead of the winter heating season, and Russia's cuts are hindering that. The UK is re-exporting as much American liquefied natural gas (LNG) to Continental Europe as its limited export infrastructure will allow, but that likely isn't enough to fill the shortfall. Meanwhile, eurozone utilities are forging new relationships with suppliers in Central Asia, the Middle East and North Africa, and new import terminals to facilitate shipments of American LNG are under construction.

Supply lines are readjusting, which is positive, and most governments are confident they will make it through the winter. Yet they are also implementing contingency measures allowing them to restart idled coal plants and, if necessary, ration power this winter. If the situation worsens materially, forced blackouts could impede activity enough to render a regional recession. In our view, markets have already been pricing this risk.

Yet while that would be negative for the eurozone, it wouldn't necessarily drag the rest of the world into recession. The eurozone recession that accompanied the sovereign debt crisis was geographically isolated—it didn't cause one in the US, UK or Asia. All of those countries expanded and, eventually, helped pull the eurozone along with them.

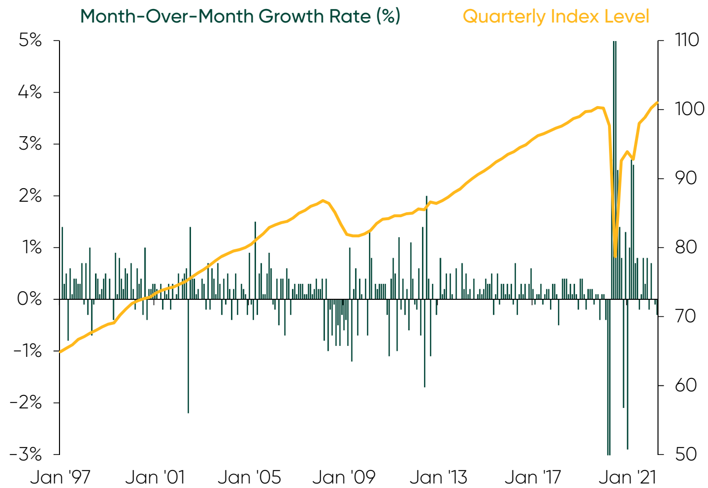
Similarly, when Continental Europe endured a double-dip recession in the early 1990s after the system of currency pegs that predated the euro collapsed, global GDP still grew.

THE UK'S MUCH-MALIGNED ECONOMY

To hear headlines (and the Bank of England) tell it, the UK is closest to recession of all major nations—and probably already in it. The proximate cause: severe cost of living pressures. Not only have consumer prices risen much faster than disposable incomes—bringing a year-long slide in real incomes—but tax hikes and a sharp increase in the household energy price cap are hitting families hard. Monthly GDP has now fallen two straight months through April after being flat in February, and the Bank of England forecasts a contraction in Q2, with worse to come after that.

UK GDP may be volatile throughout the rest of 2022. While Q1 GDP grew, business investment fell and the government and inventory builds were responsible for the majority of the positives. Consumer spending rose modestly, but that was before the tax hikes and new energy price cap took effect in April—hence why April's deepening GDP slide drew such attention. Yet monthly GDP volatility isn't unusual during a UK expansion. (Exhibit 18) Moreover, the early year monthly GDP declines aren't quite what they seem. In March, the service sector's slide stemmed primarily from falling auto sales—a function of limited supply, and a factor that reversed nicely in April. That month's negativity stemmed from a -5.6% m/m plunge in human health and social work activities—reflecting the end of the COVID-19 test-and-trace programme and the vaccine drive's winding down. UK monthly GDP has been skewed by COVID-19 activity since the pandemic began, due largely to the way the National Health Service's activity feeds into the data (monthly data reflect value-added by industry, not the sum of expenditures). The Office for National Statistics has long warned monthly data are therefore a rough estimate. However, stripping away that skew, consumer-facing services grew 2.6% m/m—and stand to benefit further as Brits return to office working this summer, raising foot traffic at businesses in urban centres.[xxxviii]

EXHIBIT 18: MONTHLY GDP DECLINES AREN'T UNUSUAL



Source: UK Office for National Statistics, as of 01/07/2022. Percentage change in monthly real GDP, February 1997 – April 2022 and level of real GDP (chained volume index), Q1 1997 – Q1 2022. Primary y-axis truncated to reduce visual skew from outliers during and after lockdowns.

PMIs offer more insight and, as Exhibit 19 shows, are expansionary. Businesses have noted the headline headwinds in their responses, but they also estimate growth is continuing despite these pressures. At the same time, retail sales fell -0.5% m/m adjusted for inflation.[xxxix] While that is a discouraging development, it is also worth noting that the UK's retail sales measure excludes most services, and services are the backbone of total consumer spending. Amid a global shift from goods back to services consumption, that is a glaring omission. Extrapolating sales' slide to a severe broad downturn risks error, in our view.

EXHIBIT 19: UK PMIS

	Jan '22	Feb '22	Mar '22	Apr '22	May '22	Jun '22
Manufacturing	57.3	58	55.2	55.8	54.6	52.8
Services	54.1	60.5	62.6	58.9	53.4	54.3
Construction	56.3	59.1	59.1	58.2	56.4	52.6

Source: FactSet, as of 08/07/2022.

xxxviii Source: Office for National Statistics, as of 30/06/2022.

xxxix Source: FactSet, as of 30/06/2022.

While a UK recession is possible, it is highly likely that equities have already dealt with much of the potential damage. UK equities outperformed the world in the first half, but that is due primarily to their high exposure to Energy, which has benefited from rising oil prices. The UK's more cyclical sectors—namely Financials and Industrials—fell into bear market territory and underperformed the MSCI World Index from UK equities' peak on 13 January through their year-to-date low on 17 June, which is consistent with a rising risk of recession. To be clear, we don't think the data necessarily indicate recession is underway, but we also think those who suggest UK equities are ignoring that risk are mistaken, creating ample positive surprise potential.

BORIS JOHNSON STEPS DOWN

After dodging scandal and fending off potential leadership challenges for over half a year, Boris Johnson announced in early July that he would step aside as UK prime minister once the Conservative Party elected a new leader. The move—and subsequent leadership contest—touched off a wave of frantic commentary and speculation about economic policy. What would the change mean for taxes? Brexit? Energy policy? The cost of living crisis? In our view, these questions illustrate the primary impact on markets: Uncertainty is high but set to fall, likely bringing relief for equities.

Markets dislike high and rising uncertainty. UK markets got a dose of that in July's opening days as the series of ministerial resignations heightened the questions about PM Johnson's future. His decision to stand down answered those questions but set up several more. However, that uncertainty is now poised to fall in the near future, likely in concert with falling uncertainty in the US. As it does, it should ease the wait-and-see mentality that tends to hover over business and household investment decisions, enabling more risk-taking—generally a positive for markets.

Concerning the matter of replacing PM Johnson, Tory members of parliament winnowed the list to former Chancellor of the Exchequer Rishi Sunak and Foreign Secretary Liz Truss on 21 July. The next step is a late summer campaign with debates nationwide, where markets will get to know the contenders, their policy preferences and how much support they will command. Regardless, we will have a winner and new PM on 5 September. We will likely also get clarity on whether they will call a snap election in hopes of securing a fresh mandate from the people, as PM Johnson did after defeating Theresa May in 2019, or whether they will serve out the current term as Gordon Brown did after succeeding Tony Blair in 2006. Crucially, if they choose the latter, we will very quickly get a sense of how much legislation they can push through Parliament.

While these events are difficult to assign probabilities to, we do think the likely outcome is political gridlock. If there is a snap election, polls don't presently indicate either Labour or the Conservatives are on course to win a commanding majority, although polls so far ahead of a contest are rarely reliable. If the new leader decides to serve out 2019's mandate, we see a low likelihood of major legislation sailing through. As these past few weeks have demonstrated, there are deep divisions within the Conservative Party. The 2019 class of new MPs—particularly those in the "Red Wall" of traditionally Labour seats—tends to be more supportive of PM Johnson and hasn't taken kindly to what they view as an inside coup against him. MPs in the party's traditional wing are frustrated over Sunak's tax rises as Chancellor and complicity with policies they view as more consistent with traditional European social democrats than the party's traditional low-tax agenda. There has already been a great deal of criticism between Chancellor Sunak's and Foreign Secretary Truss's camps, likely making it very difficult to unite the party behind anything contentious.

All of this should help reduce equities' legislative risk aversion, as gridlock tends to reduce the likelihood of major legislation creating winners and losers. Already we are seeing this in action, with Chancellor Sunak's proposed Energy windfall profits tax, which was introduced in late May but hasn't yet cleared the House of Commons. Initially, the tax was to apply to all firms in the industry, including household energy providers as well as oil and gas producers (with investment allowances that sought to offset the disincentives usually inherent in a windfall tax). However, after significant pushback, Johnson decided to exempt energy providers, which are already under severe stress due to the price cap on the default household tariff. Continued opposition from the rest of the industry could water down the bill further or block it outright, easing one source of uncertainty hanging over UK Energy companies.

LITTLE SURPRISE IN FRENCH ELECTIONS

France's elections went largely as expected in Q2, awarding a second term to incumbent President Emmanuel Macron but ending his Together! party's majority in the National Assembly. His coalition lost seats to both the leftist alliance known as Nupes, which collectively took the second-most seats, and nationalist Marine Le Pen's National Rally, which emerged as the second-largest individual party. This has left France heavily gridlocked. Macron has managed to form a minority government headed by PM Élisabeth Borne, but leftist leader Jean-Luc Melenchon's France Unbowed party heads the finance committee—widely seen as one of the most powerful posts in government.

For now, politicians are preoccupied with the problems at state-backed electricity provider EDF, which has warned of the risk of rolling blackouts this winter due to deferred maintenance issues at critical nuclear reactors. The government has moved to re-nationalise the company in order to tackle these issues and give households relief from rising energy costs without incurring the ire of minority shareholders. Given the broad support for this amongst the Nupes alliance's core constituency, it won't surprise us if this passes. However beyond that, it is difficult to envisage President Macron or the Nupes accomplishing much.

There is very little common ground between Together! and the opposition parties in the National Assembly. Although there is some overlap with the centre-right Republicans and centre-left Socialists, both parties are keen to burnish their own images and rebuild support, which argues against blindly supporting President Macron's initiatives. The early-July revelations about President Macron's dealings with ride-hailing company Uber while he was finance minister under former President François Hollande have already eroded his political capital severely, leading to a no-confidence motion on 11 July (which failed). Meanwhile, the parties within Nupes disagree on much and, while they may share some economic policy preferences with the National Rally, that party's history likely makes joint legislation a non-starter.

As in Britain, political gridlock is likely beneficial for French markets. Throughout the campaign, investors feared an ascending Nupes or National Rally would pull fiscal policy in an extreme direction, leading to soaring debt and threatening to take France out of the euro by virtue of breaking all of its budgetary commitments. Those outcomes always appeared unlikely, and now they are all but impossible. Gridlock probably does forestall other mooted reforms, including pension changes, but those have been on ice for years—a status quo French equities are familiar with. To the extent such reforms might have been beneficial, the absence of a potential positive isn't a negative, and the benefits of reduced uncertainty should outweigh any residual disappointment.

AUSTRALIAN POLITICS

Australians also voted in Q2, flipping parliamentary control from the Liberal-National Coalition to the Australian Labor Party (ALP), elevating Anthony Albanese to Prime Minister. Here, too, political gridlock appears likely, as ALP's edge in the lower house is tiny and no party has a majority in the Senate, leaving the Greens and a handful of independent parties to play kingmaker.

Some suspect that could elevate political risk modestly, as allying with the Greens could motivate PM Albanese to push his government further on climate. We aren't passing judgment on the merits of this from a sociological perspective, but some warn legislation on this front could have a deleterious impact on Australia's large Metals & Mining industry, which is a key cog in its economy and markets. That risk is worth watching, although the likelihood looks low, which should make this an opportunity for falling uncertainty as this year unfolds.

For one, consider the backdrop: Australia's huge mining and natural gas industries are increasingly in demand, given the fears of shortages erupting from Russia's invasion of Ukraine and the associated sanctions. That gives PM Albanese's government not only a domestic incentive not to move radically due to the industry's economic importance, but a geopolitical one. Furthermore, the ALP has only 77 of the lower house's 151 seats, with the Greens adding 4. Combined, this edge may not be big enough to weather many defections on a potentially divisive policy vote.

We also suspect the new government will want at least something of a honeymoon period, especially given the history of political churn in Australia before now-former PM Scott Morrison. From 2007 to 2018, the PM post flipped with frequent intraparty leadership votes, rotating from Labor's Kevin Rudd to Julia Gillard and back to Rudd, before the L-NC won 2013's vote and subsequently flopped from Tony Abbott to Malcolm Turnbull to Morrison. It was an infamous revolving door—and, likely, a cautionary tale for PM Albanese.

Barring PM Albanese shifting policy radically from the campaign trail to now, the government looks too gridlocked to accomplish very much. We will keep an eye out, but our initial impression is inactivity likely reigns, adding to the global tailwinds of gridlock and falling uncertainty.

JAPAN'S SELF-CREATED WEAK YEN HEADWIND

One developed-world nation is bucking the trend of slowing PMIs: Japan. It is only just now reopening from Omicron, fueling a nice bounce. (Exhibit 20) This is welcome news after restrictions led to a modest GDP contraction in Q1, but we think it is unrealistic to expect a rapid, lasting rebound—modest growth seems much likelier.

EXHIBIT 20: JAPAN MONTHLY DATA

	Jan '22	Feb '22	Mar '22	Apr '22	May '22	Jun '22
Manufacturing PMI	55.4	52.7	54.1	53.5	53.3	52.7
Industrial Production	-2.2%	2.3%	-0.4%	-1.3%	-6.7%	?
Services PMI	47.6	44.2	49.4	50.7	52.6	54
Retail Sales	-0.9%	-0.9%	1.7%	1.0%	0.6%	?

Source: FactSet and Japanese Ministry of Economy, Trade and Industry, as of 06/07/2022.

Japan is dealing with a unique headwind right now: the twin problems of the yen's weakening to generational lows and energy prices' increase. In the Fukushima disaster's wake, Japan imports much of its energy, which is priced globally in US dollars. Therefore, when the yen weakens, it compounds commodities' price increases. That creates severe pressure for Japanese businesses and households.

The yen isn't weakening because Japan is in bad shape. Rather, it appears to be a symptom of the continuation of easy monetary policy. While central banks throughout the developed world have ended (and in some cases begun reversing) quantitative easing and started raising their benchmark interest rates, the Bank of Japan (BoJ) is stuck on negative rates and has refused to lift the peg on 10-year yields. In recent months, it has purchased "unlimited" quantities of 10-year Japanese Government Bonds (JGBs) to keep the 10-year yield at 0.25%. Meanwhile, rates in the US and Europe have risen, attracting capital away from Japan—and leaving the yen behind. The BoJ could fix this by letting market forces take hold, but so far it isn't budging.

We don't view the current situation as automatically negative, but it creates winners and losers and may be a tough way forward for domestically focused businesses. Large multinationals have the benefit of reaping big export profits from currency translation, which can offset their increased costs. Yet domestic businesses that don't benefit from exports—and face rising costs from imported energy—will have a tougher time. Portfolio positioning accounts for this, focusing on large and globally focused Japanese companies.

Overall though, the end of start-stop COVID-19 restrictions should help Japan muddle through. Additionally, at 2.5% year-over-year, inflation is more of a political than economic issue at this point.[xl] Consumer spending doesn't look likely to fade. That said, we continue to doubt Japan is any closer to a lasting, virtuous cycle of fast growth than it has been at any point in the past two-plus decades, justifying our underweight to the country.

xl Ibid

EMERGING MARKETS **COMMENTARY**

RECESSIONARY FEARS IN CHINA

The possibility of the world's second-largest economy suffering a "hard landing" has been a reoccurring fear for years. The latest version features China's zero-COVID policy and related economic slowdown supposedly hindering global growth.

The country's reopening has been uneven. This spring's lockdowns hurt growth—particularly consumer activity—and weighed on broader sentiment. However, we see many overlooked positives. Loosening restrictions have brought improving economic data and easing global supply chain pressures. Targeted stimulus also supports the recovery. (More in a later section) Another unseen bonus: The government's Tech sector regulatory push appears to be slowing, with regulators reportedly concluding their nearly yearlong investigations.

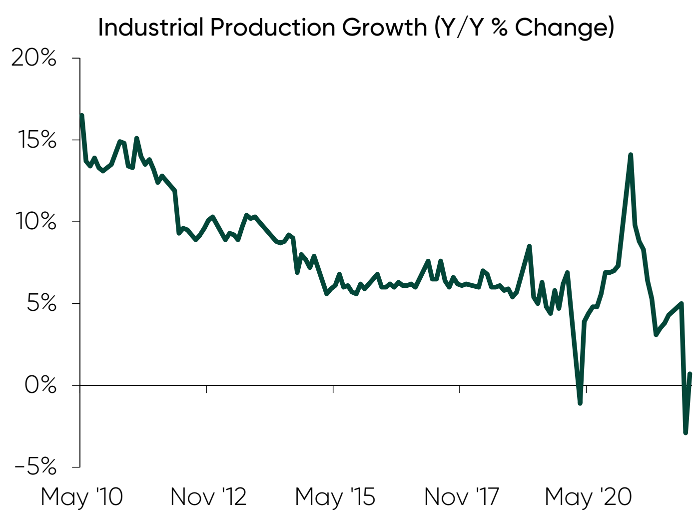
Yet people remain focused on isolated new lockdowns and their negative fallout. That is understandable given the zero-COVID approach's well-known economic damage—and that government officials' decisions are impossible to predict.

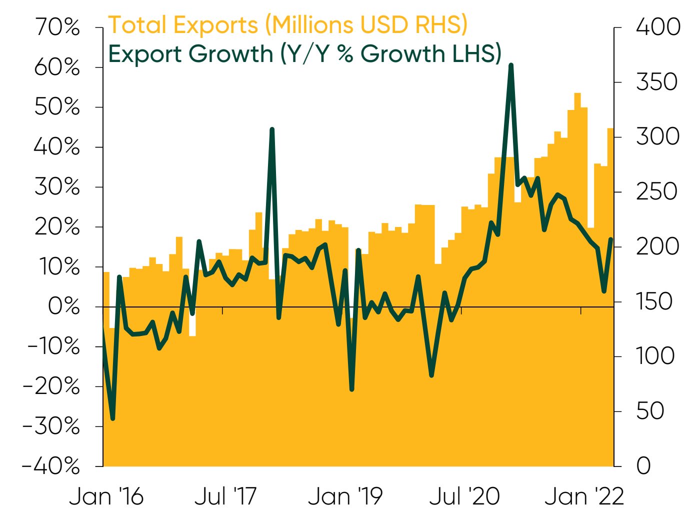
Be that as it may, few appreciate the potential impact of the National Party Congress later this year, which is the closest thing to an "election" in China's one-party political system. With President Xi Jinping seeking an unprecedented third term as party leader and president, it is in his interest to quell discontent. One of the most effective ways to do so: prioritising economic stability—key to social stability. As government officials loudly proclaim the zero-COVID strategy victorious, they are also taking a myriad steps to get the country back to normal. Now, "normal" doesn't mean GDP growth will surge. Policymakers have long signaled their comfort with slower economic growth even before the pandemic. However a return to normal also argues against lockdowns remaining in place indefinitely—and in our view, that cuts against fears of continued global supply chain disruptions.

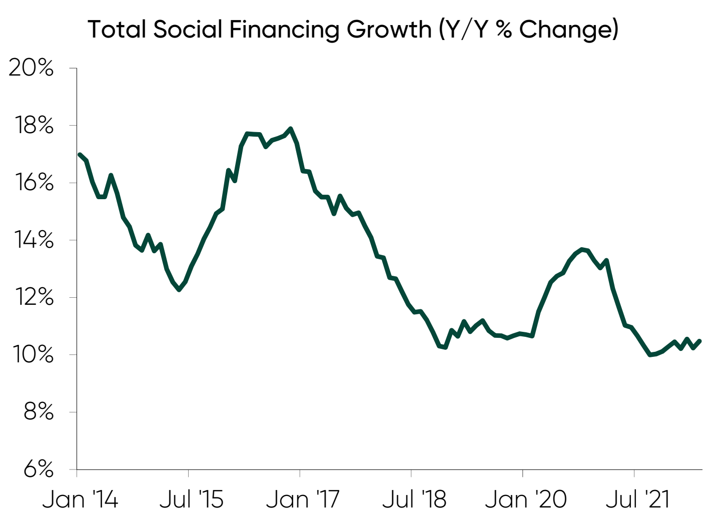
THE UNEVEN REOPENING AND BEYOND

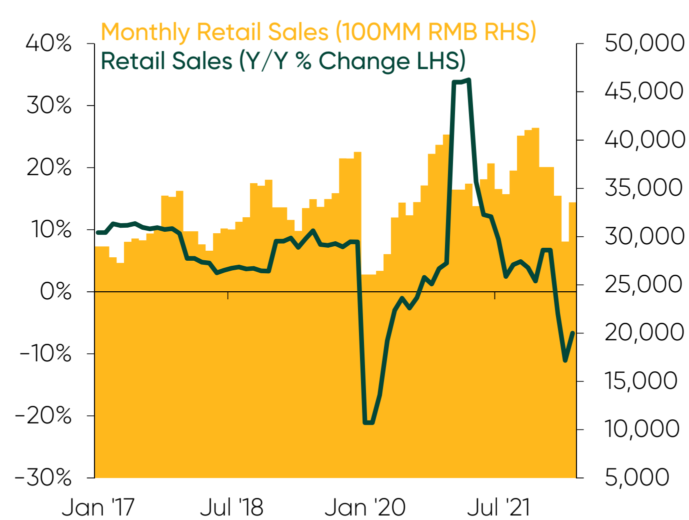
China had the toughest economic road in Q2, due largely to the government's "zero-COVID" strategy, which forced lockdowns across Shanghai, Beijing and many other metropolises. Economic data suffered in March and April, with some nascent improvement in May as some factories were allowed to reopen. (Exhibit 21) Most of the restrictions eased in June, which should pave the way for an economic rebound, but with the virus flaring up again in parts of Shanghai, uncertainty lingers.

EXHIBIT 21: CHINA MONTHLY DATA









Source: FactSet, as of 06/07/2022.

Overall, though, the outlook is optimistic. We already know, from China's experience and elsewhere, that growth can rebound very fast when restrictions end. PMIs show this is already underway, with most flipping well above 50 in June. That also augurs well for global supply chains, which endured more shortages as restrictions impeded production at Chinese factories and ports. Goods and services are once again flowing within and from China.

From here, policymakers have every incentive to foster a recovery given the aforementioned National Party Congress—and appear to be doing so. A growing economy is critical for stability, making it politically important for officials to offset lockdowns' economic impact to the extent they are able.

Already, there are several measures in place to this effect, including big infrastructure projects, monetary easing, increasing local government funding (which finances investment) and other targeted programmes. Critics say these programmes aren't large enough, mainly because they pale next to the massive stimulus programme during the global financial crisis, but we think this is misguided. It presumes stimulus hasn't worked because it didn't boost monthly indicators this spring. Yet these measures couldn't do anything while major cities were shut, with residents confined to their homes and checkpoints scattered throughout major thoroughfares. They were designed to kick in once restrictions ended, giving a little extra fuel to the rebound that naturally follows.

Chinese growth likely won't return to the double-digit rates of old, but it doesn't need to. One, China is much bigger now, and slower growth off a larger base still adds a hefty contribution to global GDP. Two, the government is focused on sustainable growth that doesn't require huge increases to local government debt, which is consistent with more modest growth rates. The official target for this year is 5.5% GDP growth, and the government has reaffirmed this—suggesting more stimulus awaits if current measures appear to be falling short later this year. Growth somewhere in that neighbourhood would not only beat today's low expectations, but it would likely deliver an underappreciated global tailwind.

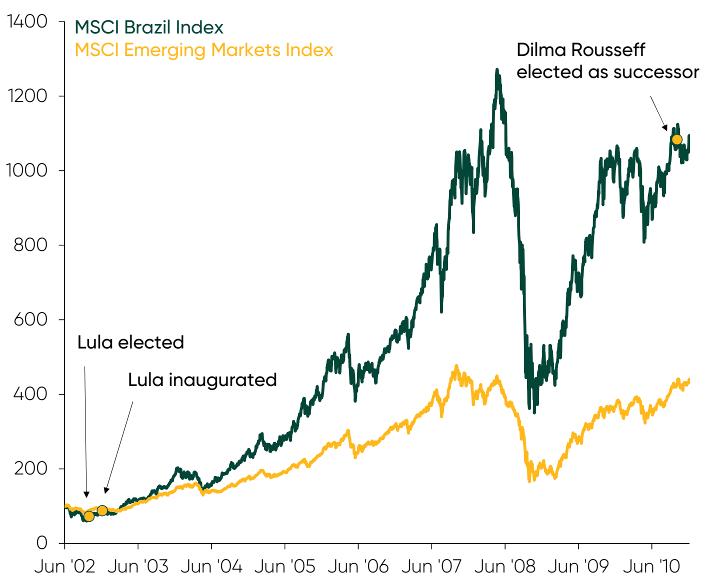
POLITICS IN BRAZIL

Brazilian voters will go to the polls on 2 October for the first round of the presidential election, with a runoff between the top two candidates on 30 October if no candidate wins at least 50% of the vote. The front-runners are right-wing incumbent President Jair Bolsonaro and left-wing former President Luiz Inácio Lula da Silva, who is leading in the polls and widely expected to win. Investors' concerns are twofold: In the near term, there are fears that if President Bolsonaro loses, he will challenge the election's legitimacy, stoking domestic unrest—a sociological matter that is hard to predict. Hence, we think it is outside markets' purview. The second concern is more relevant, in our view: fears that policy will take a leftist turn, upending domestic investment and equities. In our view, recent regional history—and Lula's own record—argue strongly against the election's having a bearish impact.

As a general rule, while investors mainly consider politicians' personalities, markets focus on policies—and don't get caught up on labels like right and left. Campaign pledges and biases lead many to view some candidates as pro-business and others as anti-market, but reality is often much more complex. Nominally pro-business leaders have overseen plenty of policies that created winners and losers over time, and those widely seen as anti-market have surprised positively with beneficial reforms.

Former President Lula himself is a prime example of this. When he won 2002's presidential election, his leftist campaign rhetoric sparked fears of increased state intervention in the economy and the distribution of wealth and resources. However, he moderated significantly over his two terms in office and largely continued the economic policy of his predecessor, centre-right former President Fernando Henrique Cardoso. Where investors feared big public spending would send the deficit soaring, his government ran frequent surpluses, completed the IMF's adjustment programme (a legacy of the country's debt crisis and economic problems in the 1980s and early 1990s) and didn't interfere with the Brazilian Central Bank's efforts to fight inflation. Over Lula's entire two terms in office, Brazilian equities outperformed Emerging Markets (EM) massively. Granted, this coincided with a period of strong commodity prices and Brazil also underperformed significantly during this period's corrections and bear markets, yet that is mostly a reminder that heightened volatility can be a positive or a negative—not a function of who was in office at the time.

EXHIBIT 22: FORMER PRESIDENT LULA WASN'T BEARISH LAST TIME



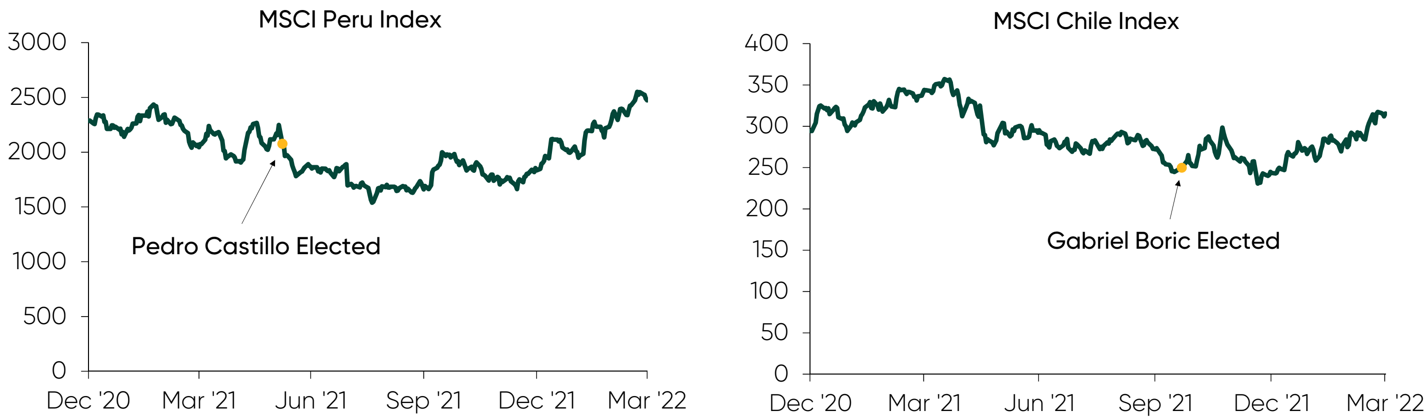
Source: FactSet, as of 18/07/2022. MSCI Brazil and MSCI EM Index returns in USD with net dividends, 30/06/2002 – 31/12/2010. Indexed to 100 at 30/06/2002.

This time around, Lula is already moderating once again. His agenda focuses on taming inflation, addressing food poverty, strengthening Indigenous people's defences against illegal mining and logging, reforming the public spending cap and fighting deforestation. These plans, as loosely sketched thus far, raise the fear of food and fuel price caps and meddling with state-run Energy giant Petrobras, but they also exclude several items investors feared heading into the campaign, including heavy-handed media regulation and land reforms that could threaten property rights. Additionally, his running mate is former São Paolo Governor Gerlado Alckmin, who was Lula's centrist opponent in 2006's election and is a member of Cardoso's Brazilian Social Democratic Party.

Brazil also holds legislative elections in October, and it is far from clear that Lula's Workers' Party can win an outright majority. To gather support in the presidential election, he has been building a broad coalition of the left and centre-left. In our experience, such alliances rarely pass extreme legislation, as their ideological differences quickly come to the forefront, causing major initiatives to become less impactful. We have seen one version of this during President Bolsonaro's presidency, with gridlock forestalling pension reforms and other flagship initiatives, and the inverse under a President Lula wouldn't surprise investors.

If Lula wins, he won't be the first leftist presidential victory in Latin America to scare investors in recent years. President Pedro Castillo's victory in Peru in June 2021 caused considerable angst, as did President Gabriel Boric's victory in Chile that November. However, soon gridlock became apparent, generating considerable relief. It wouldn't surprise us if Brazilian equities followed a similar path as these nations—if anything, the initial negative impact on sentiment could be less extreme, given Lula is a known quantity.

EXHIBIT 23: PERU AND CHILE



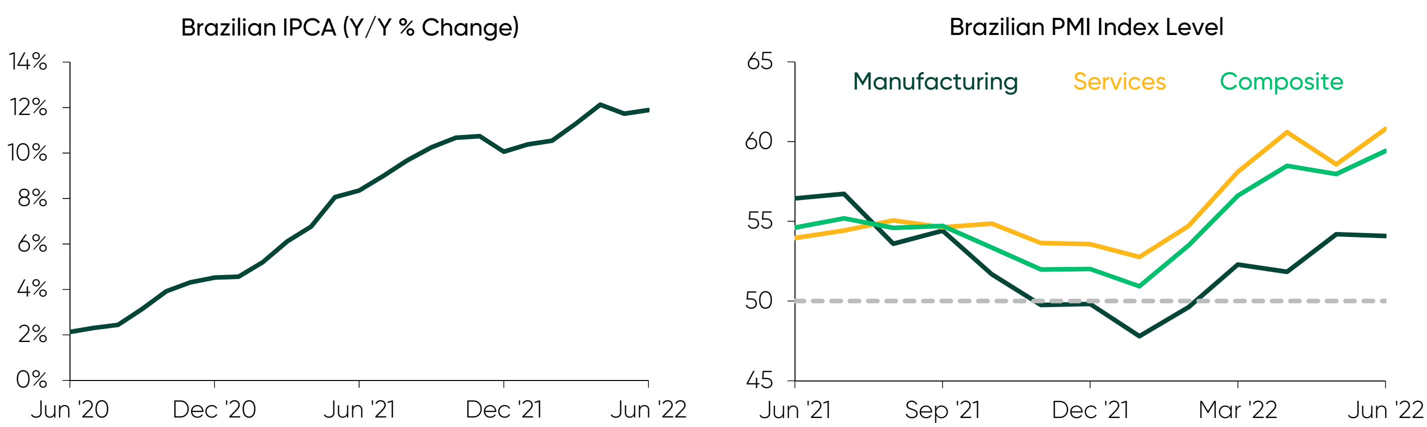
Source: FactSet, as of 20/07/2022. Left chart: MSCI Peru Index with net dividends, 31/12/2020 – 31/03/2022. Right chart MSCI Chile Index with net dividends, 31/12/2020 – 31/03/2022.

HIGH INFLATION HASN'T CRIMPED BRAZIL OR INDIA

High inflation has been a global phenomenon, and with rising prices weighing on businesses and households, the development has taken on an increasingly political tone in EM. However, while a headwind, elevated inflation hasn't derailed broad economic growth yet—as evidenced in India and Brazil, two of the world's largest economies.

In Brazil, Latin America's largest economy, inflation has been in the double-digits since Q3 last year. Yet economic data have held up. After big monthly contractions in January and February, Brazilian retail sales have grown since March—and rose 3.7% m/m in May.[xli] Industrial production also grew on a monthly basis from February through May following a January dip.[xlii] Survey-based indicators have implied expansion, too. (Exhibit 24)

EXHIBIT 24: BRAZILIAN INFLATION AND PMIS



Sources: FactSet, as of 22/07/2022. Left Chart: Year-over-year change in Extended National Consumer Price Index (IPCA), June 2020 – June 2022. Right Chart: Brazilian Purchasing Managers Index, readings above 50 imply expansion.

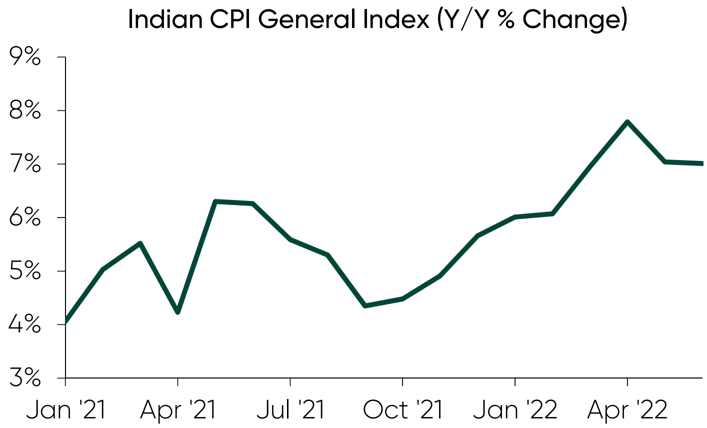
xli FactSet, as of 22/07/2022.

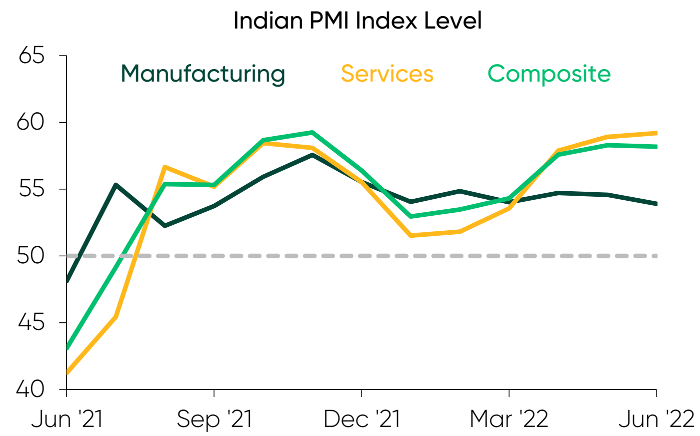
xlii Ibid.

In India, inflation has picked up over the past year and a half. (Exhibit 25) However, despite the acceleration, data point to ongoing economic activity, with Q1 GDP rising 4.1% y/y.[xliii] Though this was a third-straight quarterly deceleration, a slowdown seemed a foregone conclusion given Q2 2021's 20.3% jump was skewed by the base effect and the country's economic reopening.

Monthly PMIs have exceeded 50—implying expansion—since July 2021, indicating continued growth in India's manufacturing and services sectors. (Exhibit 25)

EXHIBIT 25: INDIAN INFLATION AND PMIS





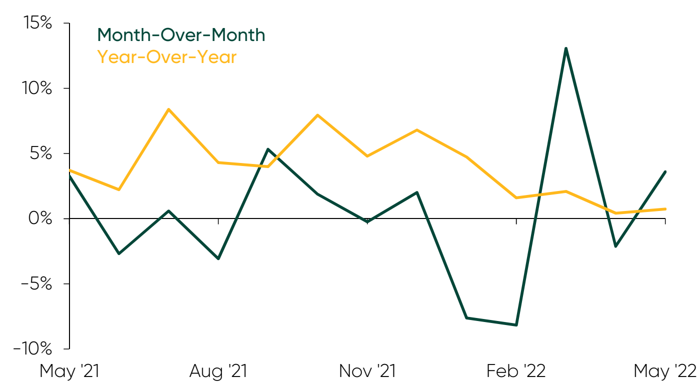
Sources: FactSet, as of 22/07/2022. Left Chart: Year-over-year change in CPI General Index, January 2021 – June 2022. Right Chart: Indian Purchasing Managers Index, readings above 50 imply expansion.

SOUTH KOREA: ONGOING GROWTH DESPITE SUPPLY CHAIN ISSUES

Though supply chain issues have dominated headlines over the past year and a half, they haven't upended growth. See South Korea, where exports have been robust due to strong semiconductor and electronic goods demand. Exports grew at double-digit rates from February 2021 through May 2022 before slowing to 5.2% y/y in June.[xliv] That slowdown appears tied to short-term developments, including an eight-day truckers' strike that interrupted industrial production and delayed shipments as well as disruptions from COVID-19 lockdowns in China—South Korea's largest trading partner.

Other South Korean data point positively, too. Q2 GDP rose 0.7% q/q—the eighth straight quarter of growth—ticking up from Q1's 0.6% rate.[xlv] Monthly retail sales have bounced around, and though the measure appears to be slowing on a year-over-year basis, the month-over-month change highlights some volatility—tied, in part, to reopening trends. (Exhibit 26)

EXHIBIT 26: KOREAN RETAIL SALES



Sources: FactSet, as of 22/07/2022.

xliii Ibid.

xliv Ibid.

xlv Source: FactSet, as of 27/07/2022.

However, reopening has overall been a boon since March, and continued normalisation would likely be a positive. On the heavy industry side, industrial production is up on a monthly basis in 10 of the past 12 months while Korea's manufacturing PMI has been expansionary since September 2020.[xlvi] Many experts forecast South Korea, along with other major economies, entering recession at some point in near future. We don't dismiss that possibility, but extrapolating slowing growth into an imminent recession is a mistake, in our view.

TAIWAN: BENEFITTING FROM RESILIENT GLOBAL DEMAND

As economically influential as China is, its struggles haven't derailed EMs with close economic ties to them. Take Taiwan, a key link in the global tech supply chain thanks to its semiconductor industry. Taiwanese exports registered double-digit growth on a year-over-year basis throughout Q2, rising 15.2% y/y in June.[xlvii] Interestingly, June exports to China, Taiwan's largest trading partner, fell -4.5% y/y due in part to lockdown-related disruptions—with exports to the mainland down -15.8%.[xlviii] However, growth elsewhere offset that weakness (e.g., exports to America rose 27.9% y/y).[xlix] In our view, Taiwan's export growth reflects the robust appetite for tech goods worldwide. Even with the long-running global chip shortage showing signs of easing, semiconductor producers still forecast strong demand for the foreseeable future—a tailwind for the Taiwanese economy.

THE WAR IN UKRAINE

The Russia – Ukraine war tragically continues. We have sympathy for all those affected in Ukraine, the region and worldwide. While this war of attrition has no end in sight, we think markets are getting clarity on some important fronts.

Fears of Russia invading NATO countries have vanished amid the Russian army's struggles. That lowers the probability of NATO retaliation expanding the conflict. So far, there have been no tactical nuclear strikes—a horrid possibility that could widen the war.

Economic sanctions aren't deterring Russian President Vladimir Putin, yet neither are they causing a broader disaster. Russia is feeling economic pain, but it is still selling its oil (albeit cheaply) to non-sanctioning countries and obtaining hard currency. Even Russia's recent "default" on dollar- and euro-denominated bonds wasn't a bond market disaster. Unsurprisingly, the default occurred not because Russia lacks money—but because Western sanctions blocked Russia's interest payment. The outcome was a non-event that mostly amounts to a legal and academic curiosity.

xlvi Ibid.

xlvii Source: FactSet, as of 22/07/2022.

xlviii Ibid.

xlix Ibid.

Should you have any questions about any of the information provided above, please contact FIE by mail at Level 18, One Canada Square, Canary Wharf, London, E14 5AX or by telephone at +44 (0)207 299 6848.