FISHER INVESTMENTS AUSTRALASIA™

THIRD QUARTER 2019

MARKET PERSPECTIVES

THIRD QUARTER 2019 REVIEW AND OUTLOOK
MARKET PERSPECTIVES

The below table of contents contains hyperlinks allowing the reader to quickly navigate to the desired section.

THIRD QUARTER 2019 REVIEW AND OUTLOOK EXECUTIVE SUMMARY

03 October 2019

Portfolio Themes

- **Quality Tilt:** We prefer equities with stronger balance sheets and consistent margins.
- **Overweight to Information Technology:** The Information Technology sector is heavily skewed toward large, high-quality firms. The sector should benefit from robust global IT spending driven by the growing demand for products and services related to mobile, cloud computing and the "Internet of Things."
- **Overweight to Energy:** Energy demand remains robust and the sector often outperforms late-cycle, with tailwinds from physical demand via economic growth and financial demand via inflation.

Market Outlook

- **Expect the Bull Market to Continue:** We expect global markets will continue climbing though likely at a slower pace and with increased volatility than earlier in the year.
- **Strength in Services is Underappreciated:** In both developed and emerging markets, a strong services sector more than offsets weakness in global manufacturing that should prove temporary.
- **Dour Sentiment has Potential for Upside Surprise:** Tail-risk political events, like Brexit, populism, impeachment and trade wars have dragged sentiment to unreasonable levels.

After rising 16.2% in 2019's torrid first half, global equities took a breather in Q3—finishing flat for the quarter.[i] As we anticipated, equities had more short-term volatility than earlier in the year, which slowed gains. Moreover, the increased market fluctuation is consistent with the typical back half of a US president's third year. Returns may continue to be sideways in the near term, but we see little reason to think a bear market is underway. As such, we remain optimistic and expect the bull market to persist into next year, reaccelerating as election uncertainty starts falling.

Emerging Markets (EM) equities were down -4.3% during the quarter, but remain 5.9% positive for the year.[ii] In Q3, downside EM volatility was more prevalent in July and August on renewed trade and global growth concerns before partially recovering in September. Despite the pullback in the middle of Q3, we believe EM countries are in better shape than widely appreciated.

Volatility and flattish quarterly returns have some investors feeling fatigued and sensitive to any negative news flow. Many seek reasons to be bullish but find few amongst stories of slow growth, tariffs and political uncertainty. However, equities rise much more often than not, even when fundamentals are mixed. Unless there is a good reason to be bearish, we believe long-term investors should default to being bullish. Further, we don't see a good reason to be bearish now. In our view, bull markets die one of two ways: atop the wall of worry in euphoria, or when a multi-trillion dollar negative surprise wallops them. Euphoria looks distant, and we don't see an unappreciated wallop-sized negative lurking.

Rather, we see a widespread misunderstanding of false fears. Sentiment is overall dour. Investors have overreacted to small market movements in both directions. It didn't take much to flip sentiment from optimism to scepticism this summer. Therefore, it probably won't take much positivity to swing sentiment more towards optimism. Periods of fluctuating returns are normal, not grounds for pessimism and bull market returns tend to come in clumps.

i Source: FactSet, as of 01/10/2019. MSCI All County World Index return with net dividends, 31/12/2018 – 30/06/2019 and 30/06/2019 – 30/09/2019.
ii Source: FactSet, as of 01/10/2019. MSCI Emerging Markets Index return with net dividends, 31/12/2018 – 30/09/2019 and 30/06/2019 – 30/09/2019.

The inverted US yield curve and weak economic data preoccupied investors throughout the quarter. Many fear recession. But to us, this looks like a mid-cycle economic slowdown, echoing 2015 – 2016. Then, as now, manufacturing activity fell worldwide, and global trade stumbled. Yet services industries—the vast majority of developed-world economic output—continued growing, powering the global economy. Equities endured a correction from late-May 2015 to mid-February 2016, and then moved sharply higher.

Beyond economic worries, unique political events also dominate headlines globally. In the US, impeachment chatter is everywhere. House Speaker Nancy Pelosi formally opened an impeachment inquiry 24 September, alleging President Trump improperly solicited foreign interference in next year's election. Her move came in response to reports President Trump pressured Ukraine's president to investigate potentially corrupt business dealings in the country involving Hunter Biden—the son of former Vice President and 2020 presidential candidate Joe Biden. Impeachment isn't a foregone conclusion. At this stage, it is only an inquiry, which likely means several weeks (and perhaps months) of subpoenas, testimonies and hearings before—and if—the House schedules a vote.

In the UK, Brexit continues dominating the discourse. While little has changed in terms of Brexit resolution, uncertainty is as high as ever—a persistent headwind for businesses and markets. Our view remains unchanged: Any kind of clarity would benefit markets since it would allow everyone to move on. Repeatedly delaying deadlines fosters short-term thinking from businesses, delaying risk-taking. Getting past Brexit would restore a long-term mindset, likely encouraging investment.

While impeachment and Brexit are unusual, flattish returns are typical as the US president's third year winds down and the election approaches. This sets up falling uncertainty—and big returns—later in the election year as the candidate field narrows. 2016's correction recovery started as the Republican primaries thinned the herd from many to President Trump—reducing uncertainty.

In Emerging Markets, trade tensions remain at the forefront of investors' minds and few seem to recognise that these headwinds are too small to cause a broad downturn, in our view. Even modestly positive news on trade is likely supportive to markets. Stimulus in China, an underappreciated driver, likely continues to have a positive impact globally. Tax cuts in India made headlines, but likely aren't substantial enough to make a large impact on the region. In Latin America, we believe Brazil and President Bolsonaro's reform oriented agenda should be supportive for Brazilian equities. On the contrary, Argentina's markets, a new EM country, were shocked by the surprise defeat of President Mauricio Macri by Alberto Fernández in the August primary elections.

With near-term volatility always possible, we think reality doesn't have a high bar to clear to beat investors' low expectations—a reason to be bullish, in our view.

GLOBAL UPDATE AND MARKET OUTLOOK

5 November 2019

Q3 RECAP

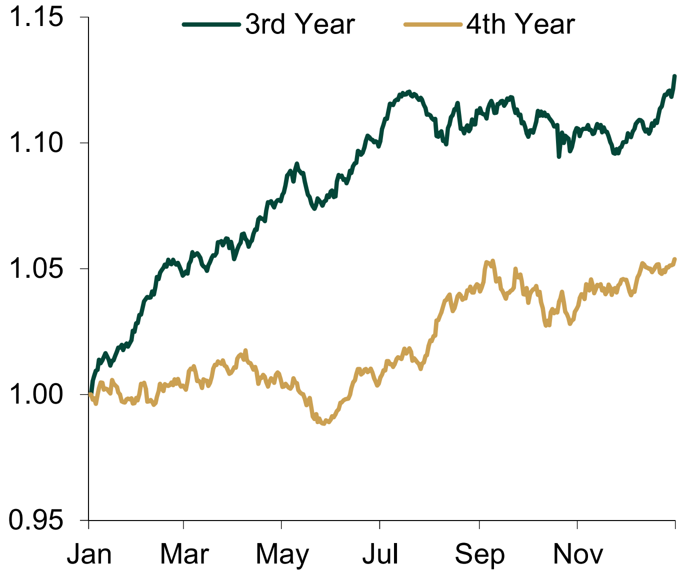
After 2019's strong first half, Q3's unsteady returns caught many investors off guard. Volatility in early-to-mid August rekindled fears of the bull's end, and worries lingered long after equities rebounded. Yet the overall flattish return is typical of the second half of a US president's third year. While year three is the four-year presidential cycle's best, it is usually front-end loaded. The back half normally has unsteady and lower returns. This often continues into the election year, before equities regain momentum as election uncertainty slowly fades.

Exhibit 1 shows equities' average path during the third and fourth years. If the trajectory is similar for this cycle, fluctuating returns could continue until the primary process starts filtering out Democratic candidates, bringing clarity on the nominee. However, averages are not predictive. Unexpected outperformance could come earlier and positioning to capture it is key.

Global equities experienced similar flattish stretches in 2011 – 2012 and 2015 – 2016. Corrections struck both times, slowing returns. However global equities enjoyed double-digit returns in the subsequent year (Exhibit 2).

While past performance doesn't predict future returns, flat stretches aren't unusual. More importantly, they don't necessarily develop into extended downturns or further flatness—reacceleration often follows (Exhibit 3).

Exhibit 1: Average Returns in a President's Third and Fourth Years



Source: Global Financial Data, Inc., as of 12/03/2019. S&P 500 Index daily price returns, 31/12/1928 – 31/12/2018. Indexed to 1.

Exhibit 2: Subsequent Year Returns After a Flat Stretch

	Flat Stretch Return	Subsequent Year Return
2011 - 2012	9.4%	26.7%
2015 - 2016	6.6%	22.4%

Source: FactSet, as of 17/10/2019. MSCI World Index return with net dividends, 31/12/2010 – 31/12/2012, 31/12/2012 – 31/12/2013, 31/12/2014 – 31/12/2016 and 31/12/2016 – 31/12/2017.

Exhibit 3: MSCI World Returns After Flat Periods

			MSCI World Return After Crossing Previous High		
Start	**End**	**Duration**	**12 Months**	**18 Months**	**24 Months**
30/04/1971	30/11/1971	214	28.4%	24.4%	9.4%
04/02/1976	20/09/1976	229	-2.7%	-1.6%	14.7%
31/12/1976	14/04/1978	469	14.3%	17.0%	13.5%
11/10/1978	06/08/1979	299	13.8%	20.4%	18.5%
02/05/1984	17/01/1985	260	34.7%	70.1%	103.8%
17/04/1991	27/12/1991	254	-3.4%	7.5%	14.4%
06/01/1992	01/04/1993	451	10.4%	15.5%	19.0%
01/02/1994	26/08/1994	206	7.0%	18.2%	20.6%
02/09/1994	30/03/1995	209	19.5%	23.6%	30.0%
17/02/2004	02/11/2004	259	11.8%	28.4%	31.3%
15/04/2010	03/11/2010	202	-2.2%	4.1%	5.8%
02/05/2011	21/01/2013	630	19.4%	25.2%	21.9%
03/07/2014	19/02/2015	231	-12.6%	-1.6%	4.3%
21/05/2015	09/02/2017	630	13.5%	19.7%	11.8%
26/01/2018	--	--	--	--	--
Average		324.5	10.8%	19.4%	22.8%
Median		256.5	12.6%	18.9%	16.6%
Positive Frequency		--	71.4%	85.7%	100.0%

Source: Global Financial Data, Inc., as of 27/08/2019. MSCI World Price Index flat periods exceeding 200 days, 31/12/1969 – 27/08/2019.

MID-CYCLE SLOWDOWN

We think this flat period, like the past two, is a mid-cycle slowdown, not the start of a bear market. Yet recession fears loom as many surveys show respondents expect one in the next year. Further, headlines are claiming that weakness in manufacturing is just the start.

We see little evidence to support this. Manufacturing was also weak in the 2015 – 2016 slowdown, contracting in the US and other major nations. However, recession did not follow. Services (the vast majority of advanced economies' GDP) still grew, identical to the current market environment. Exhibit 4 shows the latest purchasing managers' indexes (PMIs) in the world's largest economies. PMIs are surveys showing the percentage of businesses reporting growth in a given month. Readings over 50 indicate expansion. Outside of the UK, where Brexit uncertainty dominates, services are growing nicely.

Exhibit 4: Services Outshines Manufacturing

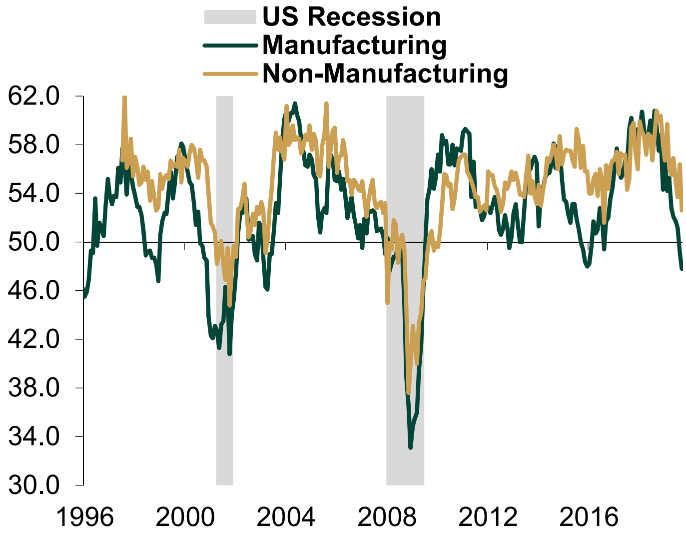
	Manufacturing PMI	Services PMI	Manufacturing Share of GDP	Services Share of GDP
Japan	48.9	52.8	20.7%	69.1%
Eurozone	45.7	51.6	25.3%	73.0%
US	47.8	52.6	11.2%	70.0%
UK	48.3	49.5	10.0%	79.2%
China	51.4	51.3	33.9%	51.6%

Source: FactSet, ECB, US Bureau of Economic Analysis, UK Office for National Statistics, National Bureau of Statistics of China, Economic and Japanese Cabinet Office, as of 21/10/2019. Eurozone manufacturing share of GDP includes construction. All PMI data are from September 2019 and cite Markit PMIs except the US, which uses the Institute for Supply Management's (ISM's) data.

This does not guarantee GDP will grow in all of these nations, of course. Manufacturing could contract deeply enough to offset services' growth, as it did in Germany in Q2 2019. However, look beyond GDP, as equities do. If the sector representing the vast majority of the economy is growing at a decent rate, then things are likely fine regardless of a weak pocket.

Contrary to many pundits' theories, we do not buy the notion of weak manufacturing infecting services. As Exhibit 5 shows, manufacturing has long been more volatile than services. It is normal for smaller, less-diverse gauges to fluctuate more than larger ones. Additionally, manufacturing is more sensitive to the global economy's ebbs and flows. Eventually, a recession will come, and both services and manufacturing will shrink. However, manufacturing PMIs aren't a timing tool for this.

Exhibit 5: Manufacturing & Non-Manufacturing PMIs



Source: FactSet, as of 09/10/2019. US ISM PMIs, January 1996 – September 2019.

As previously mentioned, we think this is another slowdown—a pause that refreshes. If so, then stabilisation or an economic reacceleration will follow—a bullish positive surprise given widespread global recession fear. While select nations may contract or even enter recession, that isn't unusual during slowdowns. The 2011 – 2012 global slowdown occurred while the eurozone was in recession. In 2015 – 2016, select oil-heavy nations contracted while the world grew.

Eventually, a recession will come, and both services and manufacturing will shrink. However, manufacturing PMIs aren't a timing tool for this.

Flat stretches test investors' patience, but they aren't abnormal. This bull market has had two prior long, flat periods. Strong returns followed them, as they often do, and equities' gains frequently come in bursts. In a bull market, enduring some fluctuating periods is often necessary to enjoy the good.

An Update on the Yield Curve

The US yield curve remained modestly inverted throughout Q3, along with several major European yield curves.

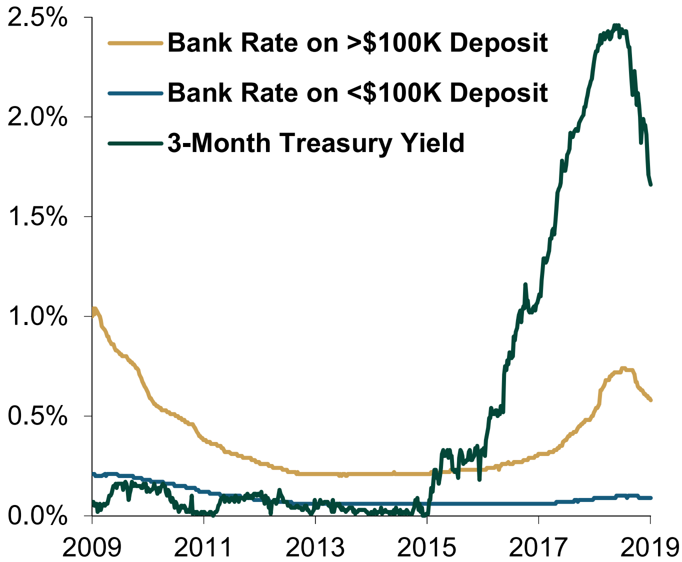
In principle, investors are right to watch the yield curve. It is a reliable economic indicator, and it has inverted before all recessions since World War II. Yet it has also inverted temporarily during economic expansions. Even when the inversion correctly signals a recession, it isn't a timing tool. There is usually a lengthy lag between inversion and a bear market's onset.

This inversion has an interesting cause: It came from falling long rates globally, a product of weak inflation and central bank intervention. Historically, pre-recession inversions happened when central banks increased interest rates while battling inflation and overshot.

> Even when the [yield curve] inversion correctly signals a recession, it isn't a timing tool. There is usually a lengthy lag between inversion and a bear market's onset.

We are not saying the unique cause of this inversion means anything. There is little historical precedent. As Sir John Templeton preached, "this time is different" are the four most dangerous words in investing. With that said, long rates are subject to market volatility. They have also risen a bit in recent weeks, with the yield curve positive as of mid-October. However, there is fundamentally no difference between a slightly inverted and slightly positive yield curve. Banks don't lend at government rates. Most US banks' cost of funding is well below short-term government rates, and prime loan rates exceed long-term Treasury rates (Exhibit 6). Global interest rate arbitrage is also alive and well, enabling banks to borrow in Europe and Japan very cheaply and lend profitably in the US.

Exhibit 6: Bank Funding Costs Are Far Below Short-Term Treasury Yields



Source: FactSet, as of 21/10/2019. Three-month Treasury yield (constant maturity), national jumbo and non-jumbo deposit rates, 16/10/2009 – 18/10/2019.

Mostly, we see the recent inversions as evidence central banks still don't see things correctly. The Fed has been cutting short rates, which helps address inversion but misses its cause. The European Central Bank also cut short rates and announced it will restart quantitative easing (QE). QE reduces long rates—making things worse, not better. In our view, the real solution would be for central banks to end QE everywhere and sell all the long-term bonds accumulated over the past decade. This would let long rates rise, steepening yield curves.

Unfortunately, we doubt that happens anytime soon. Fathoming the benefits of higher long-term rates requires thinking like a banker. However, bankers are shunned in monetary policy circles now. Most central bankers are economists, lawyers or politicians, with minimal real-world business or banking experience. Some argue this is commendable, given central banks' expanded regulatory authority. In contrast, we think this cycle's poor monetary policy speaks to the value of getting back to basics and empowering people who understand what makes banks function.

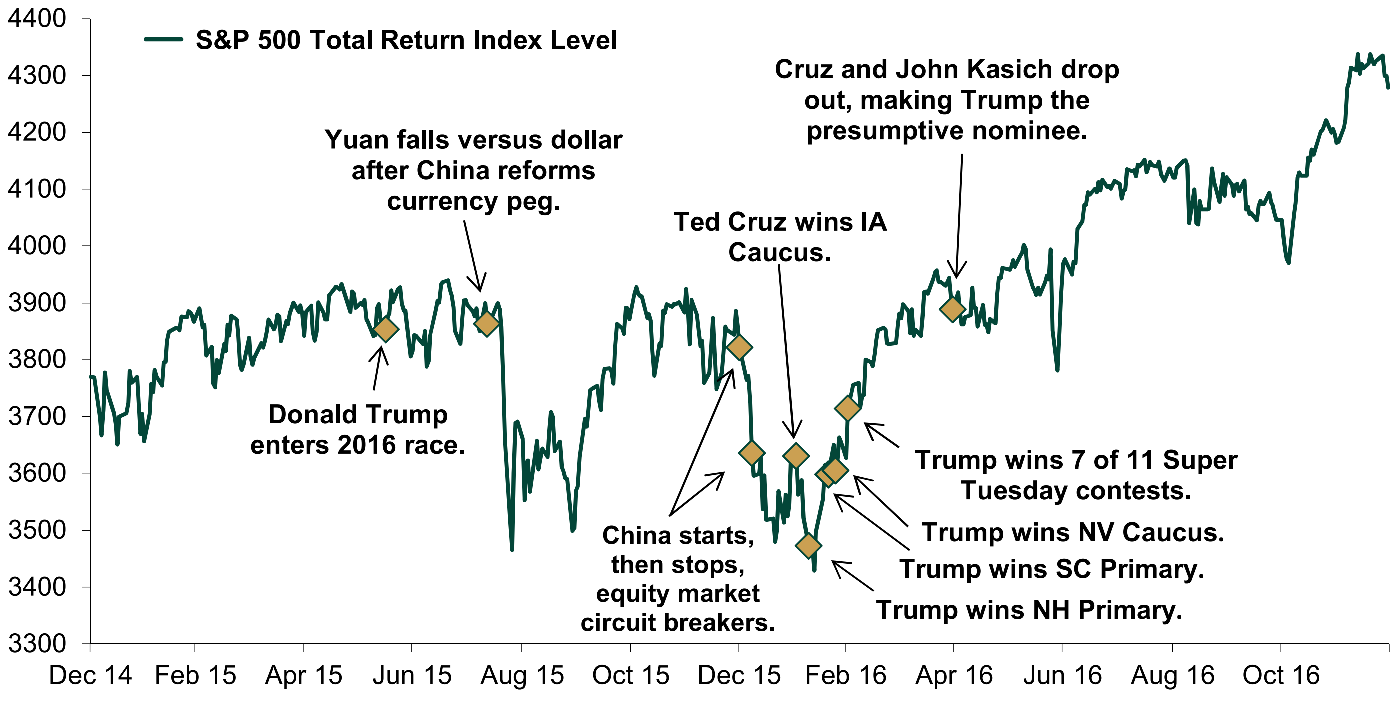
US Commentary

US Commentary

A Rerun of 2016

US equities' last lengthy flat stretch occurred in 2015 and early 2016. Similarly, it included a correction (sharp, sentiment-driven drop of -10% to -20%). Equities bottomed in February 2016, as President Trump's victories in early GOP primaries reinforced his front-runner status (Exhibit 7). Returns improved throughout the year and expanded after the election. We do not think this was about anything specific to President Trump—it was falling uncertainty. For this market cycle, it would not shock us if returns move sharply higher in 2020's second half, as we get closer to having a presidential victor. In addition to political factors, sentiment and economic trends matter to equities' direction as well. President Trump's potential impeachment also adds a layer of uncertainty 2016 didn't have. However, this isn't automatically negative.

Exhibit 7: Election Uncertainty and Equities in 2015 – 2016



Source: FactSet, as of 21/10/2019. S&P 500 Total Return Index, 31/12/2014 – 31/12/2016.

An Early Look at US Politics

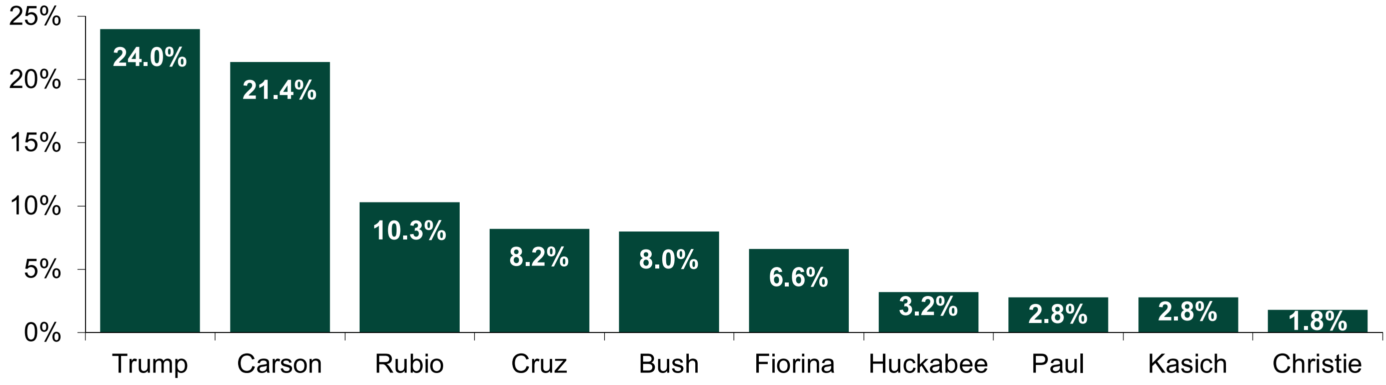
US politics gathered momentum in Q3 as election season accelerated—likely to stir sentiment. Many speculate about various candidates, their plans and potential market impact. In our view, it is too early to worry much about such specifics. No one can assess the election's probable outcome at this point.

Even after a few dropouts, 17 candidates are vying for the Democratic nomination. Former Vice President Joe Biden and Senator Elizabeth Warren top polls, but whether either of them or a new candidate takes the nomination is unclear. Even less clear is whether any campaign pledge can become law.

Think back to how unpredictable the US political landscape was at this time in 2015. President Trump led the Republican race in most polls, but narrowly (Exhibit 8). Moreover, his inexperience and unconventional style blinded almost everyone to the possibility of his winning.

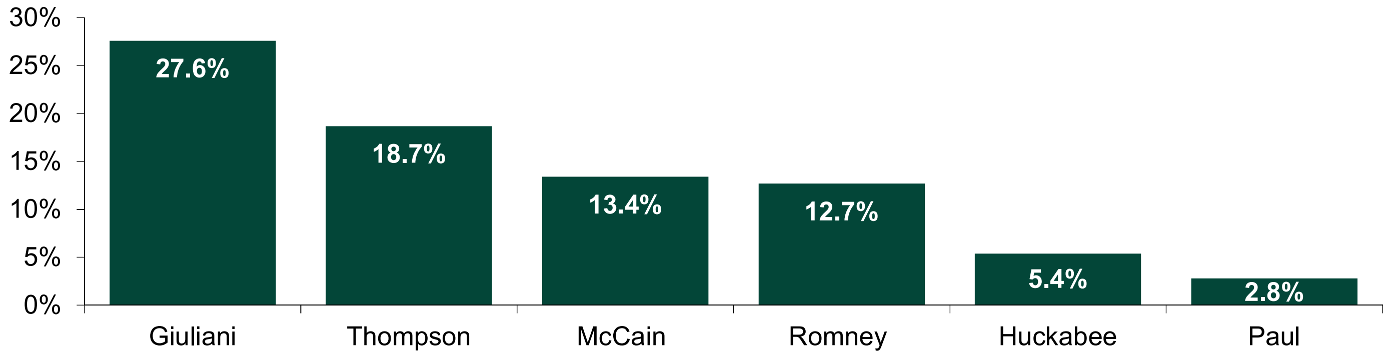
Only after President Trump took most early primaries in 2016 did he emerge as the clear front-runner. Likewise in 2012's campaign, eventual GOP nominee (and now Senator) Mitt Romney and Herman Cain were polling similarly in mid-October 2011. Mr. Cain took the lead days later, but was out of the race in two months.[iii] Whereas, in mid-October 2007, Rudy Giuliani led the GOP race, with his closest opponent—Senator Fred Thompson—10 points back. The eventual nominee, John McCain, was third—five points behind Thompson (Exhibit 9).[iv]

Exhibit 8: Top Ten GOP Primary Candidates' Poll Standings on 18 October 2015



Source: RealClearPolitics, as of 18/10/2019. GOP primary poll averages on 18/10/2015.

Exhibit 9: GOP Primary Candidates' Poll Standings on 18 October 2007



Source: RealClearPolitics, as of 18/10/2019. GOP primary poll averages on 18/10/2007.

iii Source: Real Clear Politics, as of 18/10/2019. Republican primary poll averages on 18/10/2012. https://www.realclearpolitics.com/epolls/2012/president/us/republican_presidential_nomination-1452.html

iv Source: Real Clear Politics, as of 11/10/2019. Republican primary poll averages on 15/10/2007. https://www.realclearpolitics.com/epolls/2008/president/us/2008_republican_presidential_nomination-2741.html

On the Democratic side, Hillary Clinton wasn't just leading Barack Obama in October 2007—she was well in the lead, nearly 26 percentage points ahead.[v] President Obama didn't overtake her until February 2008, after he focused his campaigning on Iowa and New Hampshire—a high-risk approach. His success in these early primaries catapulted him to the nomination.

Today, most presume Joe Biden or Elizabeth Warren will be the Democratic nominee. But could a lower-polling Democrat employ Obama's strategy with similar results? It will be interesting to watch—but for now, it is unknowable.

THE IMPEACHMENT INQUIRY

This election season features an added element of uncertainty: President Trump's potential impeachment. In September, news broke that Trump asked Ukrainian President Volodymyr Zelensky to investigate Joe Biden's son Hunter's involvement in Ukraine's oil and gas industry. House Democrats responded by opening a formal impeachment inquiry, alleging this amounted to courting foreign influence in 2020's election. On 31 October, the House of Representatives passed a resolution as another step in formalising the impeachment inquiry into President Trump. Presently, we have a broad outline of the events under investigation, but many details remain unknown. They will likely emerge over time, as will a wide array of opinions on whether they justify impeachment or not. We won't opine on that debate. Rather, we will simply note impeachment could elevate uncertainty and cause short-term volatility as a result. However, the ongoing investigation doesn't increase the likelihood of a bear market, in our view.

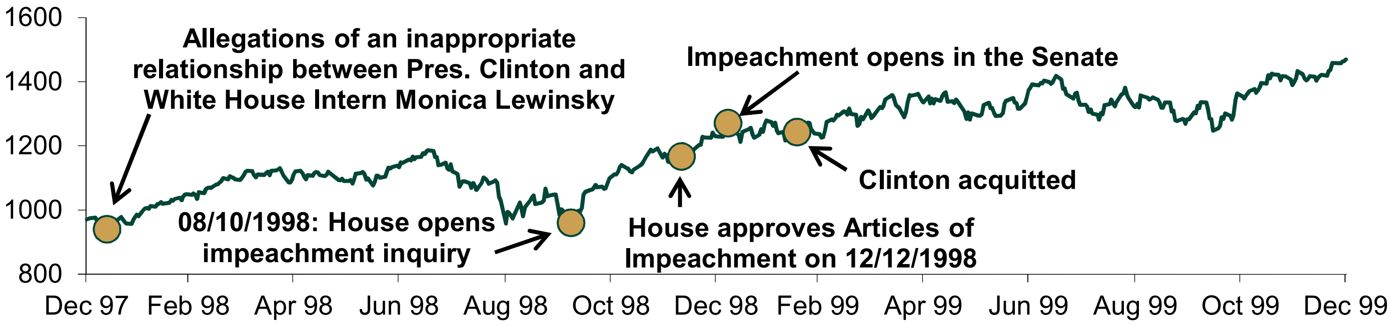
For one, whether the House even impeaches Trump isn't clear. An investigation doesn't mean Articles of Impeachment are assured. Impeaching Trump would require a majority vote in the House—218 votes of 435. The Democrats have 234 seats, sufficient to impeach without GOP help. However, this would be a risky move—particularly for Democratic lawmakers seeking re-election in contentious districts. Impeachment may play well with Democrats' base, but it is a divisive issue more broadly.

If the House does impeach Trump, it would open a trial on charges of high crimes and misdemeanors (a vaguely defined constitutional term) in the Senate. The burden of proof will likely be exorbitant. A two-thirds majority—67 votes—is required to oust the president. Republicans hold 53 seats to the Democrats' 47.[vi] If all Democrats voted to convict Trump, they would still need 20 GOP senators to join them. During 1998 – 1999's impeachment trial of President Bill Clinton, the GOP held a 55 – 45 Senate majority. Despite the party tilt against Clinton, he was easily acquitted—55 senators found him "not guilty" of perjury.[vii]

IMPEACHMENT ISN'T AUTOMATICALLY BEARISH

Impeachment would likely add to the uncertainty in early presidential races. Yet the limited historical evidence shows impeachment isn't inherently bearish. For example, only two presidents have faced impeachment since reliable equity market data begin—Bill Clinton and Richard Nixon. Four months passed between the House voting to open President Clinton's impeachment inquiry and the Senate's acquittal. During that span, the S&P 500 soared 28.2% (Exhibit 10).[viii]

Exhibit 10: S&P 500 During President Clinton Impeachment



Source: Global Financial Data, Inc., as of 10/05/2017. S&P 500 Price Index level, 31/12/1997 – 31/12/1999.

v Source: Real Clear Politics, as of 18/10/2019. Democratic primary poll averages on 18/10/2007. https://www.realclearpolitics.com/epolls/2008/president/us/democratic_presidential_nomination-191.html#polls

vi Source: US Senate, "Party Division," accessed 16/10/2019. https://www.senate.gov/history/partydiv.htm

vii Source: CNN and US Senate, as of 18/10/2019. "How the Senators Voted on Impeachment," Staff, CNN, 12/02/1999. https://www.cnn.com/ALLPOLITICS/stories/1999/02/12/senate.vote/ "Party Division," accessed 16/10/2019. https://www.senate.gov/history/partydiv.htm

viii Source: FactSet, as of 18/10/2019. S&P 500 total return, 08/10/1998 – 12/02/1999.

President Nixon resigned in 1974 before the House voted on impeachment. This example may seem bearish, as the market declined during most of the Watergate investigation and impeachment inquiry (Exhibit 11).

However, just as the market's torrid rise wasn't attributable to Clinton's impeachment, Watergate alone likely didn't drive 1973 – 1974's deep bear market. Nixon's price controls and the Arab oil embargo, which combined to stoke high inflation and economic contraction, likely had a major impact.

How impeachment might affect Trump's 2020 chances is also unclear. An official impeachment could damage his chances of re-election. It could also help him, in the sense that he may see Joe Biden as his stiffest competition. If he can successfully use Hunter Biden's Ukraine connection (whether appropriate or not) to imply the Biden family has corruption issues, it could eliminate Mr. Biden before the general election. Trump may think this matches him against Elizabeth Warren, whom he sees as more politically extreme and easier to beat. He may not be correct about that, but this could be his strategy. At this point, though, any statements about this must be hedged with "may," "could," "might" or "possibly." We cannot assign probabilities to these possible outcomes. Hence, we don't think impeachment's impact on 2020 should factor into investment decision-making now.

Even More Uncertainty in the US House and Senate Elections

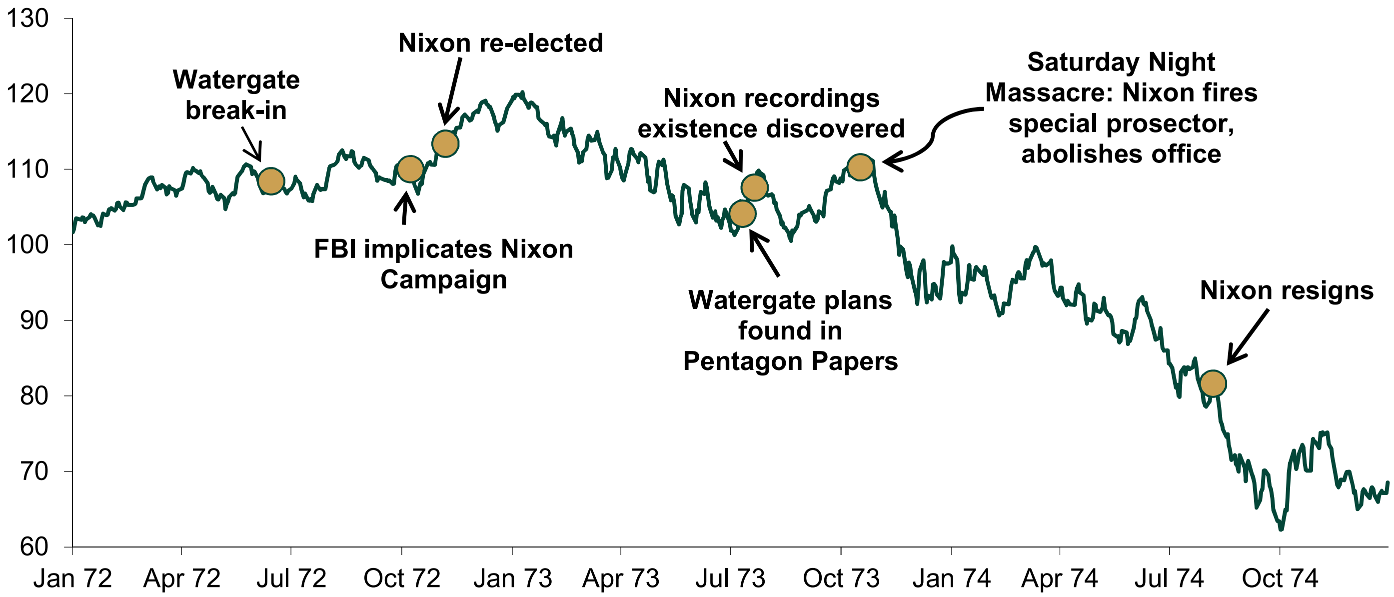
Even if we could be 100% sure about the US presidential race, the market implications still wouldn't be clear. Equities care far less about specific candidates than a president's ability to enact big legislative changes affecting property rights, taxation or other economically significant factors. That requires knowing not only who will take the White House, but how the House and Senate will change.

Similar to last quarter, most incumbents' challengers are still undetermined. We may not even know all the seats up for re-election. Retirement could open Senate seats that otherwise wouldn't be contested this year. For example, Georgia Sen. Johnny Isakson's seat wasn't available until 2022. Yet health issues recently forced his retirement, so both Georgia Senate seats are up for election in 2020.

Hence, we can't know if November 2020's vote will bring a GOP majority, Democratic majority or divided government. Absent this knowledge, determining the likelihood of significant legislation passing is impossible—regardless of who becomes president.

The inability to frame probabilities is why political uncertainty should be high through early 2020. As a result, this may potentially slow returns in the short term. However, once a Democratic front-runner emerges, the general election will come into focus. By then, Congressional races will also take shape. At that point, likely in mid-2020, equities should enjoy falling uncertainty's powerful drive.

Exhibit 11: S&P 500 During Watergate Investigation

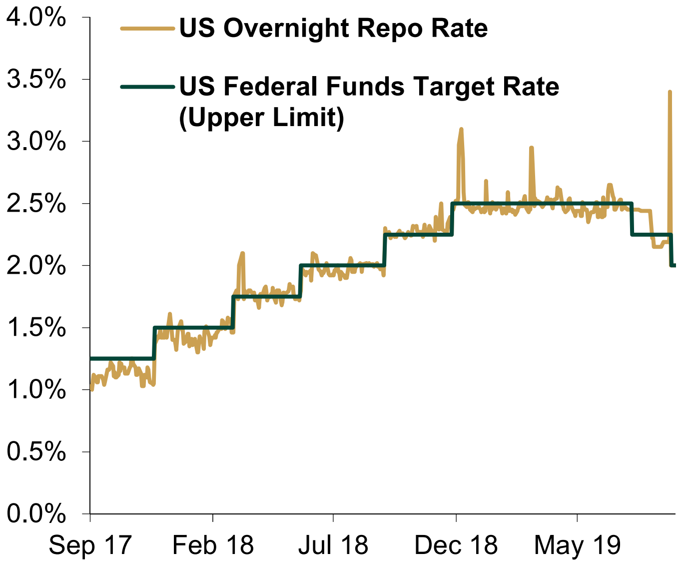


Source: Global Financial Data, Inc., as of 10/05/2017. S&P 500 Price Index level, 31/12/1972 – 31/12/1974.

Recent Volatility in the Repo Market

At the end of September, the US financial system experienced unusual volatility in the repo market, triggering a multitude of effects across financial institutions (Exhibit 12). The recent volatility in the repo market seemingly stemmed from a combination of small technical factors the Fed did not anticipate and responded to at a lag. In our view, this is temporary and does not signal trouble for equity markets.

Exhibit 12: Repo's Unusual Spike



Source: FactSet, as of September 2019. US overnight repo rate and fed-funds target (upper limit), September 2017 – September 2019.

Historically, similar-yet-smaller spikes typically clustered around quarter end, as corporations close the books. That seems to be one contributing factor for late September's volatility, as well as outflows from corporate tax payments. Further, the Japanese market was recently closed for a holiday, implying a major source of funding that was not active in the market. Finally, the US government sold bonds recently, which may have further drained cash from money market funds and other liquidity sources. These are the technical factors investors generally cite for the recent volatility—and seem more or less correct in our view. In response to this, the Federal Reserve (Fed) stepped in as a source of liquidity, pushing rates back down toward the target.

The recent volatility in the repo market seemingly stemmed from a combination of small technical factors the Fed did not anticipate and responded to at a lag. In our view, this is temporary and does not signal trouble for equity markets.

Beyond these technical factors, Fed policy is likely a contributing factor. In our view, the Fed was poorly prepared for this volatility given their lag response. However, in the subsequent days, it seemingly regained control over short-term funding markets. Many investors talk about creating a permanent facility to intervene in the repo market, which is interesting given the Fed's role in intervening was commonplace before 2008. Overall, this looks like a return to normal policy (pre-financial crisis).

Global Developed ex-US Commentary

Tech Impact on EU Performance

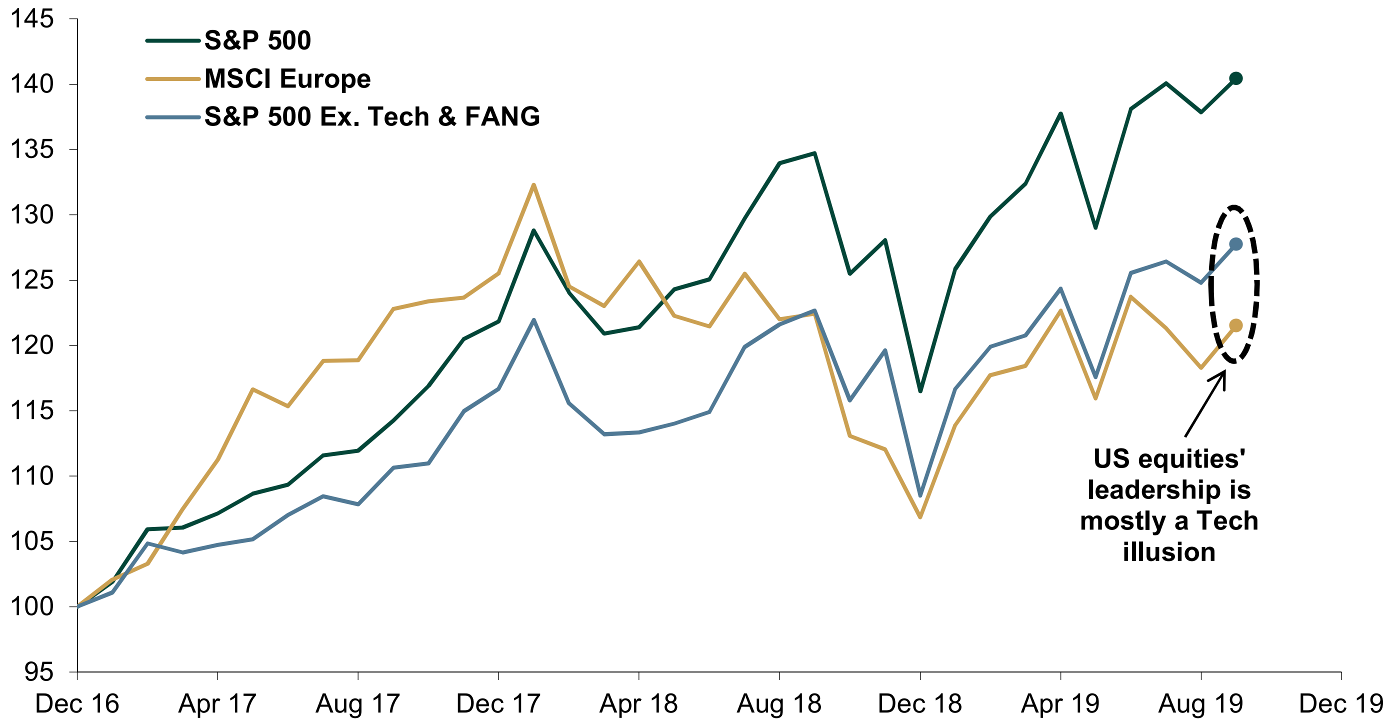
Despite Europe's underperformance and weak economic data, European equities are not as weak as many seemingly presume. Similarly, we think that value equities' recent outperformance, hyped in headlines, is likely a brief countertrend. Our emphasis on the world's biggest, high-quality firms should continue paying off as the bull market reasserts itself.

US outperformance is primarily from America's heavier exposure to Tech and Tech-like equities. At quarter-end, Technology was 21.9% of the S&P 500.[ix] The Interactive Media industry within Communication Services (current sector for Facebook and Google) added another 4.5%.[x] Tech-like Amazon, categorised as Consumer Discretionary, adds another 2.9%.[xi] Combined, these equities are 29.3% of the total index.

Europe's Technology weighting is much smaller, only 7.5% of the MSCI Europe Ex. UK Index.[xii] The Communication Services sector is 4.5% of the index, but this is concentrated in the Telecom industry—defensive equities that often don't behave like Technology companies.[xiii] Europe also does not have an Amazon-style e-commerce giant.

Remove Tech and Tech-like equities from the equation, and US and European returns are much closer (Exhibit 13). Analysed this way, we think it is clear Europe isn't weak. Rather, it is doing about as well as the non-Tech US. For global strategies, our positioning considers this discrepancy.

Exhibit 13: US Outperformance Is Mostly a Tech Mirage



Source: FactSet, as of 16/10/2019. S&P 500 Total Return Index and MSCI Europe Index with net dividends, 30/12/2016 – 30/09/2019. S&P 500 Ex. Tech & FANG is the S&P 500 excluding the Information Technology sector, Facebook, Netflix, Amazon and Alphabet. Indexed to 100.

ix Source: FactSet, as of 15/10/2019. S&P 500 Information Technology sector share of total index market capitalisation on 30/09/2019.

x Ibid. S&P 500 Interactive Media & Services industry share of total index market capitalisation on 30/09/2019.

xi Ibid. Amazon share of S&P 500 total index market capitalisation on 30/09/2019.

xii Ibid. MSCI Europe x. UK Information Technology sector share of total index market capitalisation on 30/09/2019.

xiii Ibid. MSCI Europe x. UK Communication Services sector share of total index market capitalisation on 30/09/2019.

Brexit—Still in Limbo

As we write, Brexit is in legislative limbo, extending the uncertainty that has loomed over UK equities. The EU has granted the UK an extension, moving the Brexit date again—from 31 October to 31 January (or sooner, if Parliament passes a Brexit deal before January's end), with a general election scheduled for 12 December. The outcome of this vote should begin alleviating the uncertainty that has weighed on the UK's markets and economy for well over a year.

At the moment, businesses and investors have no clarity. They came close to getting some when Prime Minister Boris Johnson's modified withdrawal agreement passed its second reading in the House of Commons on 22 October. However, MPs rejected the motion to shorten the remaining legislative process into just three days, arguing that wasn't sufficient time to review the bill and table amendments. In response, Johnson paused the bill and made one final attempt at calling a general election, which requires a two-thirds majority under the Fixed-Term Parliaments Act. This effort succeeded on 29 October. MPs' final major order of business will be to elect a new Speaker, and then the legislative session will close on 6 November.

As the election looms, investors have numerous questions. Will Brexit happen? If so, will it follow Johnson's deal? Will there be a second referendum? Will Brexit be revoked entirely? Will Johnson or Labour leader Jeremy Corbyn win an outright majority? Or will the next government be a fractured Remain alliance or Brexit alliance?

The answer is impossible to know now. The most recent polls give the Conservatives a 10-point edge, with Labour and the Liberal Democrats tied. Yet this is just the starting position. Theresa May had a similar lead when the campaign for 2017's snap election began and ended up losing her majority. Plus, national polls aren't very revealing in a first-past-the-post system like the UK's. Brexit adds further complexity, moving the vote away from traditional party lines. The Liberal-Democrats parties, Plaid Cymru and Scottish National Party have discussed fielding joint "stop Brexit" candidates, while Labour appears set to campaign for a second referendum. In doing this, they could very well split the "Remain" vote. On the other side, the Brexit party could steal Tory support, splitting the vote of those who support Brexit or otherwise prefer implementing the results of 2016's referendum. Whether Prime Minister Johnson or Mr. Corbyn wins a majority—or whether the House of Commons emerges even more fragmented than it is today—is unknowable. However, once the results are in, investors can begin assigning probabilities to all the potential Brexit outcomes.

Falling uncertainty after the election is highly likely—but not guaranteed. While we have no opinion on the political merits of the matter, we think it is fair to say a second referendum would prolong uncertainty, especially if its results conflicted with 2016, opening up contentious constitutional questions. On the other end of the spectrum, if the Tories and Brexit Party somehow combined for a majority, dispute over the terms of Brexit would likely resume, erasing the clarity provided with Johnson's deal. At the same time, even being able to eliminate possible outcomes would give business owners more to work with than they presently have.

The combination of very low expectations along with the benefits of finally having clarity should be supportive for the UK and, to a lesser extent, Continental European markets.

While we are not pro- or anti-Brexit, we still believe simply getting Brexit over with is the fastest way to end uncertainty—and therefore likely the most beneficial for the UK economy and equities. Markets move most on the gap between reality and expectations. Expectations for Brexit mostly range from bad to disaster. A less-bad-than-feared Brexit should be a positive surprise. The combination of very low expectations along with the benefits of finally having clarity should be supportive for the UK and, to a lesser extent, Continental European markets.

Markets Don't Care About Political Personalities

With the election now planned, investors' attention is returning to another alleged political risk: the possibility of Mr. Corbyn becoming prime minister. Under his leadership, the Labour Party has made a clean break with the "New Labour" policies championed by Tony Blair and Gordon Brown, leading investors to fear a hard left turn and an assault on property rights. Mr. Corbyn has pledged to nationalise railroads and utilities, while grassroots campaigners have called for the seizure of private schools and their property (something Labour leadership doesn't publicly support). Mr. Corbyn's speech at the Labour's party conference also alluded to creating a state-owned generic drugs company. His shadow chancellor, John McDonnell, favours transferring one-tenth of every listed UK company's shares into a fund that would split dividends between workers and the state.

t is always vital for investors to set aside their own feelings—good or bad—about any political party and candidate. Separate hype from reality and remember markets care about policies, not personalities. UK shares have done well during Labour and Conservative governments alike—and under moderate as well as more left-leaning Labour governments. Markets are overall blind to political parties.

For investors, should Mr. Corbyn become prime minister, the question is whether all of his pledges would be likely to take effect in the exact manner people fear today. Will his majority be large enough? Will the Parliamentary Labour Party have equally radical preferences? Many Labour MPs don't support his agenda but have avoided opposing him outright in order to avoid deselection. If they return in a Labour majority, they may feel more empowered to water down or reject contentious legislation. If that were to happen, and investors' worst fears for a Mr. Corbyn government were priced in, the result could be a positive surprise for markets.

Similarly, we think it is a mistake to presume a Conservative government with a strong majority would automatically be bullish. Bear markets have begun when both parties were in power, and both are capable of passing legislation with unintended side effects. Investors often see the Tories as pro-market, but it was Theresa May who pushed through energy price caps. The Tories, in recent years, have also floated changes to corporate governance that could lead to corporate boards' making decisions that don't benefit shareholders.

It is always vital for investors to set aside their own feelings—good or bad—about any political party and candidate. Separate hype from reality and remember markets care about policies, not personalities.

We think investors are best off being patient and measured. See who wins, see what their majority is, assess their manifesto, and weigh the likelihood any policy that seems terrible or wonderful actually becomes law as outlined. If a hung Parliament or very slim majority emerge, this situation likely points to political gridlock and reduced legislative risk.

Spain & Italy's Political Gridlock

In Spain, political gridlock reigns. With Prime Minister Pedro Sánchez's centre-left Spanish Workers Socialist Party unable to form a government following April's elections, voters return to the polls on 10 November —the fourth national election in four years. An added layer of complication is the recent violent protests following the sentencing of nine Catalan separatist leaders convicted of leading 2017's secession attempt. The inflamed tensions likely make government formation even more difficult for Prime Minister Sánchez, who historically relied on separatist groups to govern. Whatever government eventually forms will likely be gridlocked—incapable of passing anything material. While frustrating for voters, gridlock is generally good for equities. It means low risk of new legislation undoing reforms that helped recharge Spain's economy following the country's debt crisis and recession.

Similarly, Italy's political tumult has left it gridlocked as well. In August, the country's divided government collapsed when the nationalist populist party, The League, withdrew its support from Prime Minister Giuseppe Conte. The League's leader, Matteo Salvini, hoped to force new elections to capitalise on his party's strong poll numbers. Matteo failed and the anti-establishment Five Star Movement along with centre-left Democratic Party overcame long-standing differences to form a government without elections. For the moment, the coalition is tenuous but holding. However, a government of political adversaries probably cannot pass significant legislation—a fine outcome for equities.

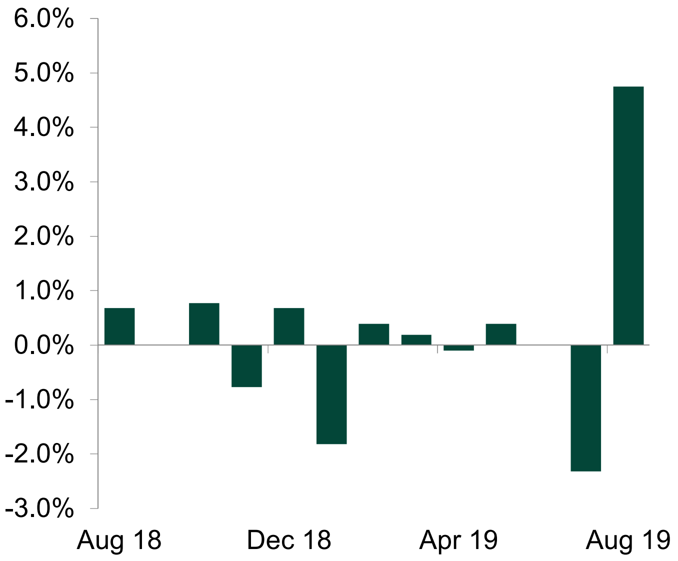
JAPAN'S CONSUMPTION TAX

On 1 October, Japan's twice-delayed consumption tax hike—from 8% to 10%—took effect. Japanese markets declined in the days leading up to the hike, and headlines speculated the impact on domestic demand. Slow demand would be a headwind since exports, the backbone of Japan's economy, have weakened this year. While the hike may skew Japanese economic data and weigh on Japanese relative returns in the short term, it doesn't materially alter the outlook for global markets or the economy, in our view.

Recent history inspires concern over the consumption duty's economic effect. After Japan's last consumption tax hike in April 2014, household expenditures decreased -17.7% annualised—driving a -7.3% annualised Q2 2014 GDP contraction (Exhibit 14).[xiv]

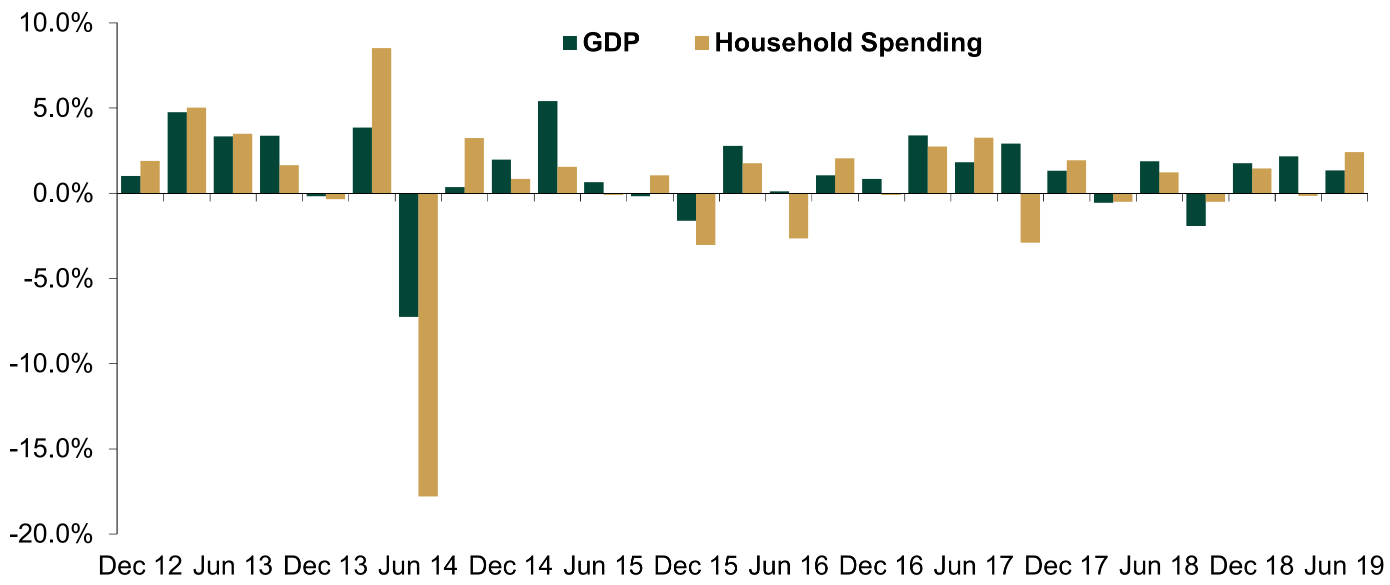
However, household spending increased in Q1 and recovered slightly in Q3. This illustrates how tax changes in fact enhance consumption rather than impair it. If consumers know of an upcoming sales tax increase, they will often speed up big purchases or stockpile beforehand. This occurred in 2014 to such an extent that consumption remains below Q1 2014's inflated levels even five-plus years later. Consumers appear to be doing something similar this year, as August retail sales increased 4.8% m/m, driven by spending on big-ticket items (Exhibit 15).[xv]

Exhibit 15: Japanese Retail Sales, August 2018 – August 2019



Source: FactSet, as of 07/10/2019. Month-over-month percentage change in Japanese retail sales, seasonally adjusted, August 2018 – August 2019.

Exhibit 14: Japanese GDP and Household Spending, Q4 2014 – Q2 2019



Source: FactSet, as of 07/10/2019. Seasonally adjusted annualised Japan GDP growth rate and household expenditure growth rate, Q4 2014 – Q2 2019.

xiv Source: FactSet, as of 19/09/2019. Quarter-over-quarter annualised Japan GDP growth and household expenditure growth, Q2 2014.

xv Source: FactSet, as of 07/10/2019.

Considering this for future Japanese economic data releases, as household expenditures' showing a Q3 pickup—and Q4 pullback—wouldn't be shocking. In anticipation for this, Prime Minister Shinzo Abe's government has taken steps to mitigate the impact this time, including cutting auto taxes, maintaining an 8% sales tax rate for food and other "daily necessities" and providing subsidies to essentially offset the hike.

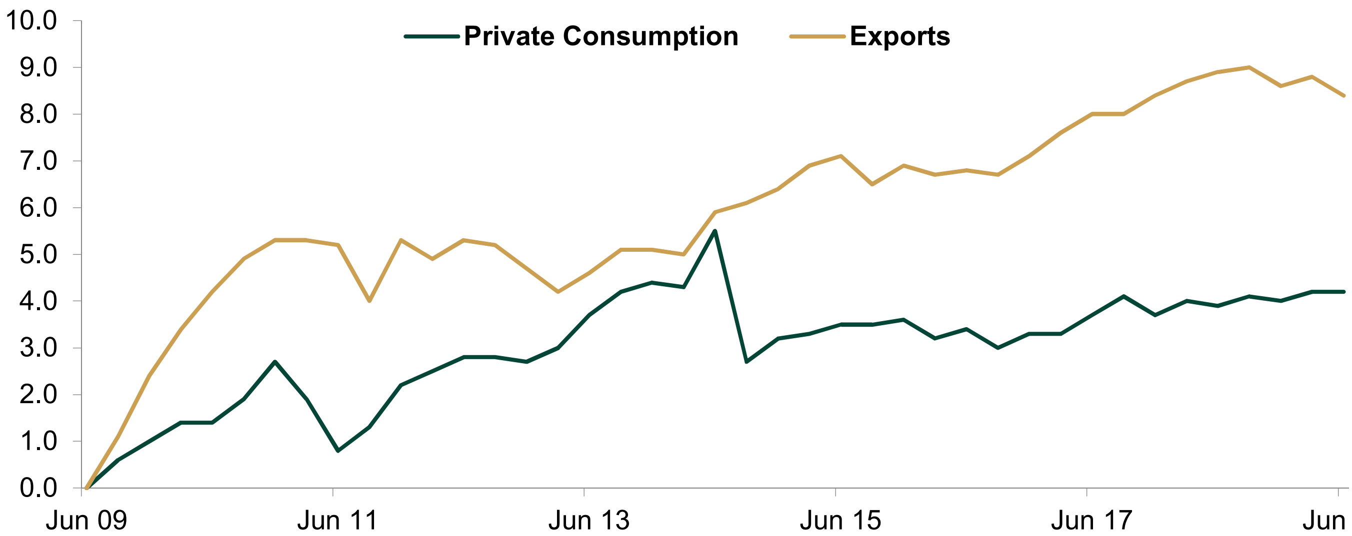
As for the broader global impact, the consumption tax hike shouldn't derail the global economy or bull market. Japan's 2014 sales tax hike and associated GDP contraction didn't reverse the global expansion. World GDP growth actually accelerated to 2.8% from 2013's 2.6%—a reminder pullbacks in even large economies needn't derail the global economy.[xvi]

OUTLOOK FOR JAPANESE MARKET

The tax increase doesn't alter our views on Japanese markets. We already expected Japan to lag global markets due to slowing domestic demand and its small-cap dominated markets. The consumption tax hike adds to headwinds temporarily—as it did in 2014, when Japanese equities lagged the world. That said, though private consumption remains in an unstable uptrend, external demand drives Japanese economic growth. Over the past 10 years, exports' contribution to Japanese GDP has doubled private consumption's (Exhibit 16). That divergence doesn't look likely to reverse any time soon, as long-running domestic headwinds—like an inflexible labour market and counterproductive monetary policy—remain in place.

Accordingly, we favour large Japanese exporters. Japanese exports have contracted for most of 2019, but these major multinationals' global supply chains and offshore manufacturing hubs highlight their more diversified businesses. These firms aren't as dependent on domestic growth, as their prospects rely more on the global economy. While the expansion has slowed this year, driven primarily by a worldwide manufacturing soft patch, we believe growth will reaccelerate. External demand recovery should benefit globally focused firms, including big Japanese exporters.

Exhibit 16: Japanese Exports Versus Private Consumption Since Q2 2009



Source: FactSet, as of 28/10/2019. Private consumption's and exports' cumulative contributions to Japanese quarter-over-quarter GDP growth, Q2 2009 – Q2 2019.

xvi Source: International Monetary Fund, as of 19/09/2019. Annual percentage change in global GDP, 2013 – 2014.

Canada's Election

After a contentious and tight campaign, Canadians headed to the polls 21 October and handed incumbent Prime Minister Justin Trudeau a victory. Trudeau did overcome a series of scandals on the campaign trail that had put his party's chances of retaining power in jeopardy. In the end, the Liberals took 157 of 338 House of Commons seats. That is down from 177 in the outgoing government, and below the 170 needed for a majority. Trudeau is now likely poised to head a minority government, perhaps with the occasional support of the left-leaning New Democratic Party. This has resulted in gridlock and falling uncertainty, which are typically bullish. However, we expect the impact to be muted in Canada, as its equity market is heavily tilted to out-of-favour categories.

Gridlock's impact is bullish in our view because it blocks sweeping legislation that could derail markets. Government actions usually create winners and losers, change the rules businesses operate under and very often create unintended consequences. Gridlock decreases this risk. Early in election years, big campaign promises tend to raise fears of sweeping legislation. Uncertainty over which policies will become law weighs on equites. However, as the election approaches, equities get more clarity over the makeup of government and the likelihood major changes comes.

In Canada's case this year, polls suggested a tight race throughout. That raised the chances of a minority government, which likely relieved markets some. However, we suspect any positive impact from this will prove fleeting.

Canadian Concentration

Canada's markets tilt heavily toward three sectors: Financials, Energy and Materials. These three sectors total 65% of the MSCI Canada Investible Market Index.[xvii] By contrast, the three amount to 25% of global equities by market capitalisation.[xviii] Canada's Energy and Materials industries are dominated by smaller, high-cost firms that typically aren't in favour in later-stage bull markets. As for Financials, the aforementioned inverted yield curves present fundamental and sentiment headwinds.

This three-sector concentration has benefited Canadian equities thus far in 2019, tied to a simple post-correction phenomenon: What fell the furthest usually bounces the highest. Last year, Canadian equities fell further than the MSCI All Country World Index, driven by a -26.0% full-year decline in its huge Energy sector.[xix] However, as recession fears faded in early 2019, the relief disproportionately benefited Canada. That said, this impact is typically temporary—we don't expect Canada's outperformance to last.

xvii Source: FactSet, as of 29/10/2019. MSCI Canada IMI Index sector weights on 30/09/2019.

xviii Ibid. MSCI World IMI sector weights on 30/09/2019.

xix Source: FactSet, as of 29/10/2019. MSCI Canada IMI Energy sector return with net dividends, in USD, 31/12/2017 – 31/12/2018.

Emerging Markets Commentary

Emerging Markets Commentary

Tariffs Are Still Small Compared to Global GDP

August's volatility coincided with another round in President Trump's trade dispute with China. It began on 1 August, when President Trump announced tariffs on almost all previously untaxed imports from China would take effect 1 September. Headlines bemoaned a material escalation, missing some crucial facts. Firstly, President Trump had threatened similar tariffs a year prior. Secondly, the tariff rate he announced, 10%, was less than the 25% rate previously threatened. Technically, this was a softening of threats, and largely went unnoticed.

Two weeks later, President Trump announced these tariffs would take effect in two rounds—one on 1 September, and one on 15 December. Delaying the second round to mid-December looks like a move designed to ease American holiday shoppers' pain. It targets mostly consumer goods, and imported items supplying inventory for the holiday season that would likely have arrived before mid-December. China retaliated soon after with a 10% tariff on $75 billion in goods that would also take effect in two stages, on the same dates. Then they went one step further, increasing tariffs on US auto imports. In response, President Trump announced the tariff taking effect on 1 September would now be 15%, and the $250 billion of Chinese goods previously subject to a 25% tariff would face a 30% tariff from 1 October onward.

> All of the new tariffs, including retaliatory measures from other countries, are too small to derail the global economy.

In September, however, tensions eased as China announced it would exempt some products from tariffs. President Trump then delayed the 1 October tariff hike by two weeks, extending the negotiation window. In mid-October, negotiators reached "phase one" of a trade deal involving China buying more agricultural goods and America agreeing to suspend the delayed 1 October tariffs indefinitely.

Overall, our view is unchanged. All of the new tariffs, including retaliatory measures from other countries, are too small to derail the global economy. Even assuming an exaggerated 30% tariff rate across the board, tariff payments would total only 0.4% of GDP.[xx] Even that estimate seems high, given the mounting evidence companies are avoiding tariffs by shifting supply chains and shipping through third-party nations like Taiwan and Vietnam.

Putting the Japan and South Korea Export Dispute in Perspective

Elsewhere in trade conflicts, Japan enacted restrictions that would slow South Korea-bound exports of certain materials used in semiconductor production—a major South Korean industry that accounts for about 20% of South Korean exports.[xxi] Then on 2 August, Japan announced more sweeping restrictions that would require Korean firms to apply for permission before importing any of about 1,100 high-tech materials and products from Japan. South Korea has retaliated by removing Japan from its own preferential trade list.

Many fear the potential ramifications, but we think the economic fallout in South Korea is likely limited. While 2 August's move will add administrative burdens to Japan/South Korea trade, it doesn't actually ban shipments. Many of Japan's large trading partners—including China, Taiwan and Singapore—operate under similar rules. While a long-lasting dispute could weigh on South Korean semiconductor manufacturers' earnings and impact exports, they likely have enough inventory on hand presently to sustain production in the short term. Additionally, they probably won't wait to adapt if the regulatory environment darkens further. Many are likely already evaluating supply chains and considering workarounds should restrictions continue.

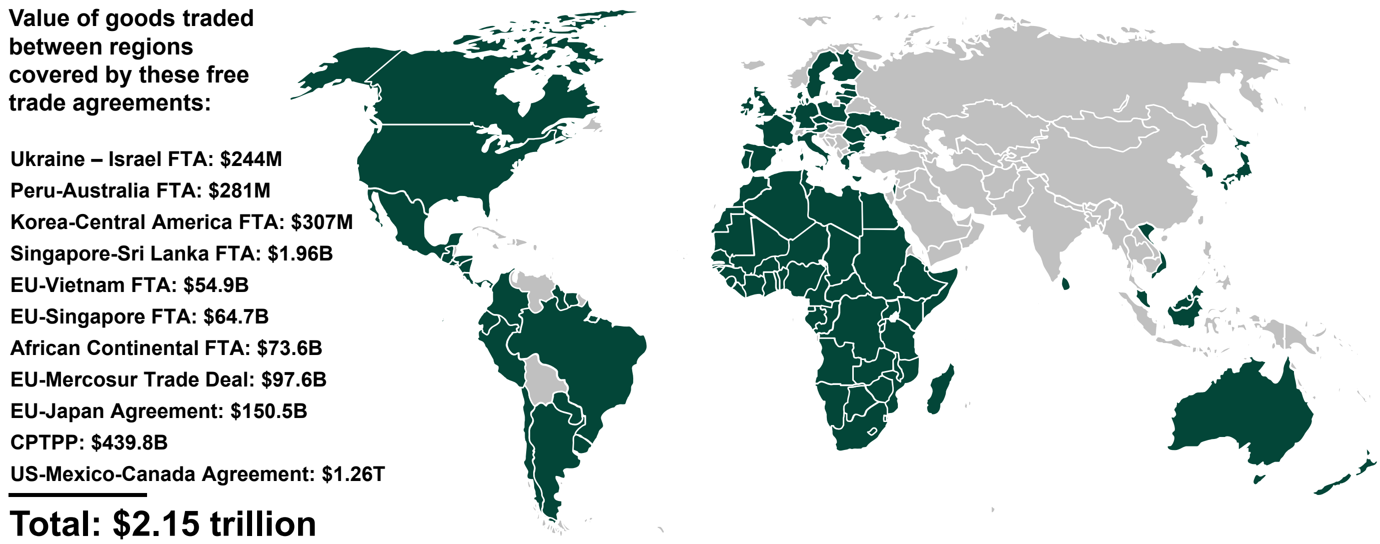
xx Source: US International Trade Commission, IMF and Fisher Investments Research, as of 06/09/2019.

xxi Source: "Memory Chip Prices Soar as South Korea-Japan Dispute Escalates," by Edward White, Song Jung-a, and Robin Harding, Financial Times, 16/07/2019. https://www.ft.com/content/f9f6a460-a7a4-11e9-b6ee-3cdf3174eb89

Globalisation Isn't in Retreat

While tariffs dominate headlines, positive trade-related news gets minimal coverage. For instance, a number of countries have signed free-trade agreements covering a far larger volume of goods than those caught in new tariffs (Exhibit 17). Of course, free-trade agreements aren't a perfect economic offset for tariffs, as their economic effects occur slowly. They are more long-term structural factors than near-term economic drivers. Tariffs have a nearer-term impact because they can disrupt extant supply chains. However, we find it interesting that the world is still tilting toward freer trade, not protectionism, despite headlines' portrayal. That tendency is an overlooked positive, in our view.

Exhibit 17: Free-Trade Agreements That Advanced in 2018 and 2019



Source: FactSet, World Bank and European Commission, as of 29/07/2019. Bilateral goods trade and global ratified or signed free-trade agreements, 2018 – 2019. (Values may be as of 2017 due to data availability.)

India's Corporate Tax Cut in Perspective

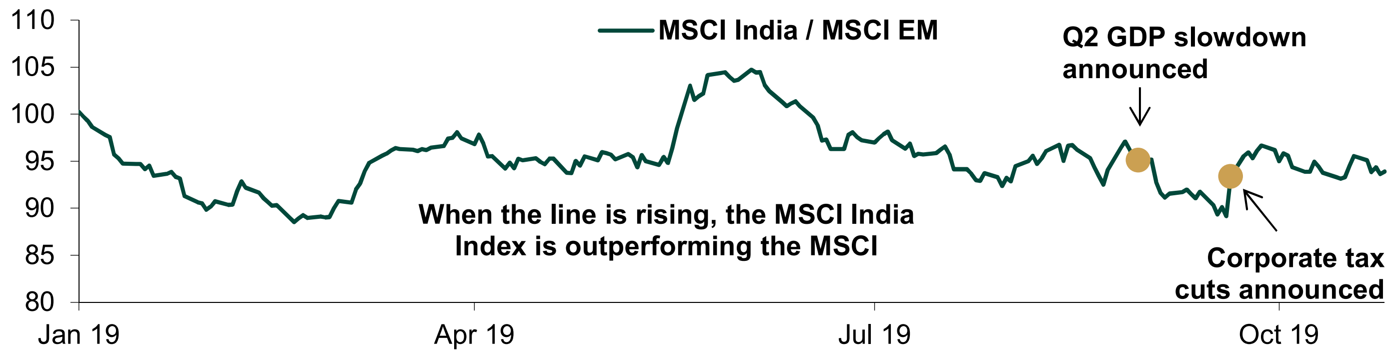
Indian Prime Minister Narendra Modi entered Q3 confidently after his re-election this past May. Many investors seemingly greeted this optimistically, convinced his large majority in the Lok Sabha would enable a renewed focus on needed economic reform. Yet as we expected, three months in, Prime Minister Modi looks focused on passing popularity-boosting measures rather than difficult ones. Hence, he responded to the decelerating economic growth with corporate tax cuts. Further, he revoked Jammu and Kashmir's political autonomy—a move building on anti-Pakistan rhetoric in the campaign. Unless Prime Minister Modi regains his focus on reform—which seems unlikely any time soon, in our view—Indian equities seem poorly positioned relative to Emerging Markets generally.

At August's end, India announced Q2 GDP slowed to 5.0% y/y from 5.8% in Q1—its slowest growth since Q1 2013.[xxii] Private consumption growth's deceleration to just 3.1% y/y from Q1's 7.2% drove GDP's slowdown.[xxiii] In response, the government announced a series of policy measures aimed at stimulating growth. It plans to merge 10 state banks into 4 and recapitalise them with nearly $10 billion to encourage lending. Following government pressure, the Reserve Bank of India made a $24 billion windfall payment to the government. The government also reversed its recent decision to tax foreign investment and lowered vehicle taxes as passenger car sales neared their lowest in a decade. While the reversal of foreign investment taxes is a plus, they largely amount to undoing a self-inflicted wound. Meanwhile, given India's $2.7 trillion GDP, most of these measures look too incremental to change India's growth trajectory.[xxiv]

Recently announced corporate tax cuts probably will have minimal impact as well. In September, Modi's government unexpectedly announced plans to lower overall corporate taxes to 22% from 30%, bringing them more in line with other Asian countries. New manufacturing companies created before March 2023 will get a special 15% tax rate. The tax reduction's estimated $20 billion impact amounts to only about 0.7% of GDP. Combined with the aforementioned measures, recent stimulus likely totals around 1.5% of GDP. Further, the efficacy of tax cuts is questionable. While businesses would probably enjoy the profit-boosting windfall, the likelihood the tax cuts achieve the policy's aim—boosting business investment—seems low. Businesses could use the added earnings boost to retire debt, hoard cash or take many other actions. Hence, these cuts' economic impact should prove even smaller than the directly observable impact. Moreover, tax cuts don't impact markets much longer term, in our view. Equities generally price in tax cuts and move on.

While these measures may modestly help support growth, they seem reactionary to us. Corporate tax reform wasn't part of Prime Minister Modi's reelection campaign. This looks more like one-off stimulus rather than broad and deep-seated structural reforms that provide lasting benefits. Accordingly, Indian equities enjoyed brief outperformance surrounding the tax cuts' announcement, but returns relative to Emerging Markets have since tapered off (Exhibit 18).

Exhibit 18: Indian Equities' Relative Returns



Source: FactSet, as of 28/10/2019. MSCI India Index and MSCI Emerging Markets Index returns with net dividends in USD, 31/12/2018 – 25/10/2019.

xxii Source: FactSet, as of 17/10/2019. Real GDP, Q1 2019 – Q2 2019.

xxiii Ibid. Private consumption expenditures, Q1 2019 – Q2 2019.

xxiv Ibid. Nominal GDP, Q2 2019.

The government's incorporation of formerly autonomous Jammu and Kashmir speaks more to its policy focus, in our view. Hindu nationalists have long sought to quell insurgency in the restive region, which has proved politically popular at the ballot box. Jammu and Kashmir is part of the larger Kashmir region, whose territory India disputes with Pakistan. In August, India's Parliament revoked Article 370 of the Constitution, which granted Jammu and Kashmir regional autonomy. It then passed the Jammu and Kashmir Reorganisation Act. Effective 31 October, this splits the state into two federally administered territories—Jammu and Kashmir in the west and (mainly Buddhist) Ladakh in the east. While the Bharatiya Janata Party's removal of Article 370 has reignited simmering tensions and critical international reaction—not least from Pakistan—domestically, this policy follows Modi's campaign promises. That said, it has minimal impact for markets and the economy except to introduce additional uncertainty over a potential regional conflict.

Prime Minster Modi's government has made little to no headway in reform since his re-election—a headwind for equities. When first elected in 2014, Prime Minister Modi initially seemed to take on the mantle of economic reformer, adopting policies to cut bureaucracy, tackle corruption and improve tax efficiency. However, a damaging and disorganised demonetisation—forcing everyone to declare their cash and exchange it with new notes—seemingly failed to expose and curb corruption. Further, a rocky goods and services tax rollout, unpopular with the nation's merchants, drained Prime Minster Modi's political capital further. Many viewed these as disrupting economic activity and achieving little else.

In his second term, Prime Minister Modi's appetite for economic reform has weakened. He has deprioritised making India more attractive to foreign investment and capital. Reform of land-use and labour regulations appear to have stalled. Privatising state-owned enterprises is off the agenda. Rather, he has pushed the central bank to ease credit—and help fund budget deficits—and boosted cash handouts to farmers to gain political favour. To incite his base, he used religious nationalism with sectarian policies—like in Jammu and Kashmir.

In our view, piecemeal and modest stimulus, which is all Prime Minister Modi seems to offer thus far, probably won't significantly alter India's increasingly sluggish economic course. We think markets recognise this. The temporary bounce Indian markets enjoyed after Prime Minister Modi's re-election seems distant already, and we suspect the country will continue to lag as it becomes increasingly clear he isn't aiming for reform.

Brazil's Pension Reform Provides Tailwind for Equities

In Q3, the MSCI Brazil Index fell -4.5%, slightly underperforming the MSCI Emerging Markets Index's -4.1%.[xxv] However, year to date through October, Brazil is up 17.6% and outperforming EM's 10.4%.[xxvi] Behind this outperformance, in our view, is President Jair President Bolsonaro's election that triggered falling political uncertainty, allowing markets to price in advancing economic reforms. Recently completed pension reforms are one such example. While the prior two administrations tried unsuccessfully to pass reforms, most investors expected the bill to advance this time. This is why we think markets priced in the reform. Overall, we think further reform progress should continue providing a tailwind for Brazilian equities.

In addition to boosting sentiment, the pension reforms should prove beneficial for the country's finances. Brazil was spending 13% of GDP on social security—over half of that on pensions.[xxvii] This was likely unsustainable, with analysts expecting pension spending—and taxes to pay for it—to balloon unless lawmakers addressed the issue. Pension reform should place Brazil on firmer fiscal footing with estimated savings around $200 billion over the next decade.[xxviii] The legislation raises the minimum retirement age to 65 for men and 62 for women. To qualify, urban workers must contribute 20 years for men and 15 for women. This is stricter than the prior system, which allowed people to claim benefits in their 50s.

xxv Source: FactSet, as of 21/10/2019. MSCI Brazil Index and MSCI Emerging Markets Index returns with net dividends in USD, 28/06/2019 – 30/09/2019.

xxvi Ibid. MSCI Brazil Index and MSCI Emerging Markets Index returns with net dividends in USD, 31/12/2018 – 31/10/2019.

xxvii "Why the Future of Brazil's Economy Rides on Pensions," Rachel Gamarski, Simone Iglesias and Mario Sergio Lima, Bloomberg, 28/10/2019. https://www.washingtonpost.com/business/why-the-future-of-brazils-economy-rides-on-pensions/2019/10/25/477a664c-f73f-11e9-b2d2-1f37c9d82dbb_story.html

xxviii "Brazil's Pension Overhaul Is Just a Start," Julia Leite, Bloomberg, 25/10/2019. https://www.bloomberg.com/news/articles/2019-10-25/brazil-s-pension-overhaul-is-just-a-start

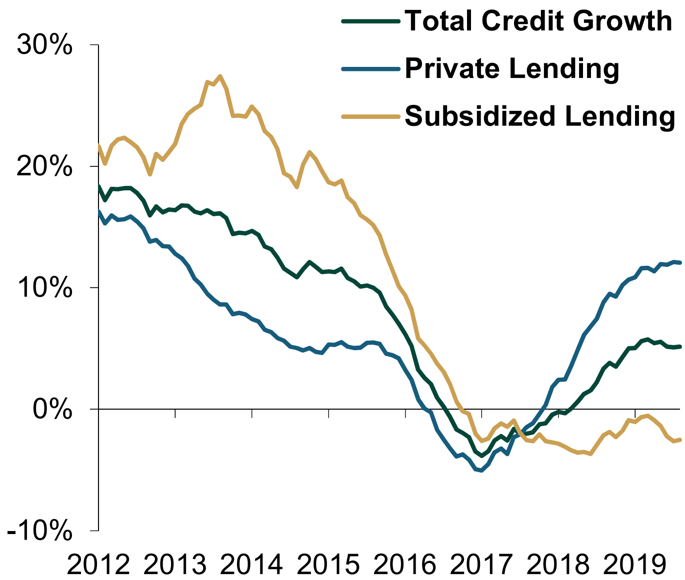
Further reforms are in progress. President Bolsonaro's administration is negotiating several trade deals, implementing a privatisation plan and moving to overhaul Brazil's tax code. The EU and Mercosur—a South American trade bloc whose members include Brazil, Argentina, Uruguay and Paraguay—announced a comprehensive free trade agreement at June's end, 20 years after talks first began. The countries involved still need to ratify the deal for it to take effect. However, if enacted, the prospective agreement would be the world's largest—spanning 780 million people and covering $21 trillion in economic activity.[xxix] It would eliminate tariffs on over 90% of trade between the blocs.[xxx] Moreover, Mercosur is seeking deals in Asia, including with Singapore, South Korea, Vietnam, Indonesia, Japan and India. Brazil is also pursuing bilateral trade talks with China, the US and Mexico.

Trade talks can take years, as the EU-Mercosur deal shows. Even with a deal, ratification can take years more, and long phase-ins can delay the full effects for a decade or longer. Yet Brazil's shift to a more open economy marks a change highlighting the country's commitment to raising its global competitiveness. Notably, to underscore this, President Bolsonaro's administration unilaterally reduced tariffs on more than 2,300 products.[xxxi]

Meanwhile, privatisation is underway. Brazil's government has sold more than $20 billion in assets through Q3, including natural resources—mainly Petrobras oil exploration areas—and infrastructure operation rights.[xxxii] More is on the way with plans to cut 134 state-owned companies (the most in the Americas) down to 12, raising $323 billion in proceeds—including crown jewel Petrobras.[xxxiii]

With benign inflationary expectations, the Banco Central do Brasil loosened monetary policy significantly, bringing rates to an all-time low of 5.5%. This policy has helped narrow the spread between state owned bank and private sector bank lending rates, allowing private sector banks to regain market share (Exhibit 19).

Exhibit 19: Increasing Private Credit Availability



Source: Central Bank of Brazil, year-over-year credit growth as of August 2019.

Tax reform is next on the agenda. By the World Bank's measure, Brazil has the world's most complicated tax system, with average midsized companies taking 2,000 hours to prepare taxes.[xxxiv] Streamlining the tax system, making it easier to pay taxes, could raise revenue and boost economic activity.

xxix "EU, Mercosur Reach Agreement on Trade," Emre Peker and Jeffrey T. Lewis, The Wall Street Journal, 28/06/2019. https://www.wsj.com/articles/eu-mercosur-reach-agreement-on-trade-11561745957

xxx "EU-Mercosur Free Trade Deal — What You Need to Know," Alexander Pearson, Deutsche Welle, 29/06/2019. https://www.dw.com/en/eu-mercosur-free-trade-deal-what-you-need-to-know/a-49414103

xxxi "Brazil Opens Up an Economy Long Shielded From Competition," Paulo Trevisani, The Wall Street Journal, 23/09/2019. https://www.wsj.com/articles/brazil-opens-up-an-economy-long-shielded-from-competition-11569244957

xxxii "Brazil Surpasses 2019 Target of $20 Billion in Privatizations," Marcela Ayres and Jamie McGeever, Reuters, 03/10/2019. https://www.reuters.com/article/us-brazil-economy-privatization/brazil-surpasses-2019-target-of-20-billion-in-privatizations-idUSKBN1WI2HY

xxxiii "Brazil's Bolsonaro Wants to Privatize Petrobras by End of His Term: Report," Staff, Reuters, 21/08/2019. https://www.reuters.com/article/us-petrobras-privatization/brazils-bolsonaro-wants-to-privatize-petrobras-by-end-of-his-term-report-idUSKCN1VB2CW

xxxiv "Investor Hopes Rise as Brazil Pension Reforms Pass Congress Hurdle," Bryan Harris and Carolina Unzelte, Financial Times, 11/07/2019. https://www.ft.com/content/51676296-a18a-11e9-974c-ad1c6ab5efd1

During August's wildfires in the Amazon, it looked like President Bolsonaro's political capital might be impacted, potentially complicating his reform drive. While the fires aren't a major market driver, in our view, President Bolsonaro's approval rating fell to 41% from February's 57.5%, tied partly to his public downplaying of the incident.[xxxv] Some saw this as evidence of an anti-environmental stance and support of slash-and-burn clear cutting, with potential implications for policymaking. In September, Austria voted to reject the draft EU-Mercosur trade agreement over Amazonian forest fire concerns. Despite the negative attention, Brazil's government sought to contain the fires—now under control—and launched initiatives to prevent new ones. These actions received less notice, but they counter the popular narrative that President Bolsonaro is actively removing Brazil's environmental protections. This also suggests he is willing to respond as needed to repair any damage to his trade agenda. In our view, this looks more like a short-term setback for President Bolsonaro's economic policies. For his big initiatives, it doesn't seem to be affecting his ability to pass reforms longer term.

Pension reform passage, progress on tax reform and privatisation against an improving economic backdrop—e.g., falling inflation and accelerating private loan growth—allow room for warming sentiment as reality likely exceeds expectations.

Politics Dominate Argentina's Markets

Argentina's presidential election—which has contributed to wild fluctuations in the country's markets over the last two years—reached its culmination in Q3, before concluding in late October. While uncertainty over who would win ended on 27 October, the return of a Peronist administration raises many questions over potential economic and fiscal policy. In our view, Argentina's equity market faces significant political headwinds in the next 12 – 18 months.

Politics have had an unusually large influence over markets in Argentina over the past five years, as two radically different economic ideologies are involved. On one end, the leftist Peronist politicians that have dominated Argentina for most of the last few decades argue for vast government intervention in the economy, nationalising select businesses, managing prices and spending significantly on social programmes. On the other, reformists argue these policies are inherently unsustainable and that Argentina must open markets to competition and free movement of capital in order to advance.

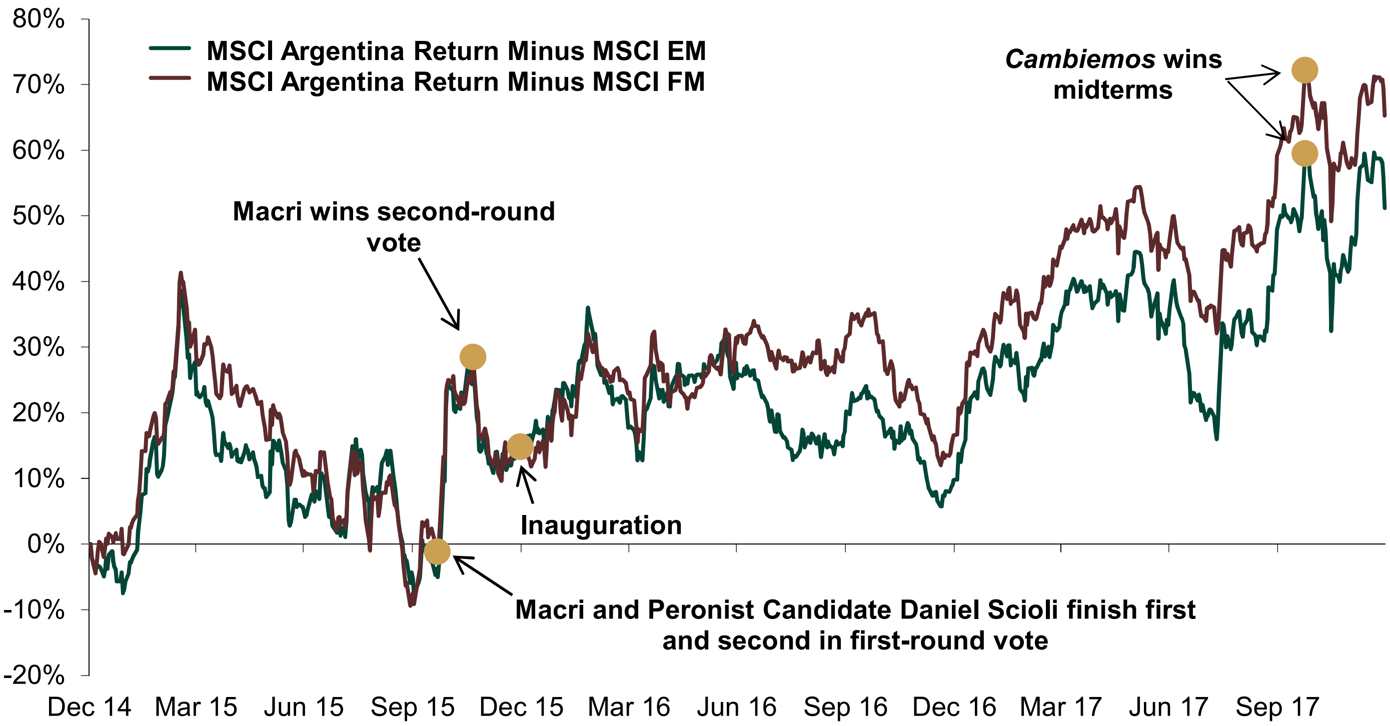
Four years ago, in 2015's election, President Mauricio Macri successfully campaigned on a reform-oriented platform, benefiting from divisions among various Peronist factions. After winning election in a head-to-head runoff on 22 November 2015, Mauricio Macri assumed the presidency on 10 December 2015. Within days, he attempted to launch reforms by targeting easy but unpopular measures introduced by the preceding Peronist government of Cristina Fernández de Kirchner. On 16 December, he issued a decree reversing Kirchner's ban on agricultural exports. Later that month, he eliminated a vast array of non-tariff import barriers, including selected capital controls. By the following March, President Macri had negotiated and settled with creditors who held out from the settlement of Argentina's 2001 sovereign default, restoring the country's access to international debt markets. Over the next two years, he enacted a series of other measures, including corporate tax reform and lifting costly energy subsidies, which vastly liberalised Argentina's economy.

xxxv *"Brazil Poll Shows Bolsonaro Government Approval Sinks," Staff, Reuters, 26/08/2019. https://www.reuters.com/article/us-brazil-poll/brazil-poll-shows-bolsonaro-government-approval-sinks-idUSKCN1VG1KR*

Yet such measures were never likely to prove pain-free. For example, energy subsidies, which are measures capping or otherwise controlling consumers' basic costs of fuel, transport and electricity, are common across many developing economies. However, they also have a long history of draining government coffers, particularly as countries modernise and energy consumption rises. Lifting them is fiscally and economically wise in the medium to long term, but it can be politically—and economically—painful in the short run.

President Macri's efforts to roll back subsidies proved politically contentious—far more challenging than simply repealing a Kirchner-era decree. Courts ruled he had to hold public hearings on utility subsidy reform, which slowed the process and forced him to moderate. That said, he made some progress on reform throughout 2016 and most of 2017, with Argentina's equities overall outperforming Emerging Markets & Frontier Markets (Exhibit 20). Then, in late 2017, his Cambiemos Party gained ground in October's widely watched midterm elections, seen as a referendum on Macri's reforms. From his solid showing in 2015's first-round election through 2017's close, the MSCI Argentina increased 97.7%.[xxxvi]

Exhibit 20: MSCI Argentina Outperformance Amid Reformist Policies



Source: FactSet, as of 28/10/2019. MSCI Argentina returns minus MSCI Emerging Markets & MSCI Frontier Markets returns, both with net dividends and denominated in USD, 31/12/2014 – 31/12/2017. Argentina reclassified from Frontier Markets to Emerging Markets status in May 2019.

xxxvi *Source: FactSet, as of 10/28/2019. MSCI Argentina Index return with net dividends, in USD, 10/23/2015 – 12/31/2017.*

However, MSCI Argentina's outperformance didn't last. In December 2017, Macri pushed for pension reforms to further guard the government's finances, spurring big protests among unions who rallied Peronist politicians to their side. This move led President Macri to slow the pension changes—and the pace of other reforms. Also, the Banco de la República Argentina (BCRA) surprisingly cut interest rates and increased its inflation target in January 2018—both moves coming despite inflation rates exceeding 20% y/y. This led many to suspect President Macri was interfering with policy, aiming for an economic boost to his popularity.

Instead, sentiment weakened and the peso declined, forcing the central bank to reverse course and hike short-term rates dramatically—from 29% in December 2017 to 68% now.[xxxvii] The government re-imposed capital controls to stem the pressure on the peso. In May 2018, President Macri requested an International Monetary Fund (IMF) bailout to avert a default. The poor economic results—and IMF bailout, which reminded voters of the 2000 bailout many blame for Argentina's default—damaged his popularity. Seeing this, investors began fearing a Peronist return to power in 2019's vote. As polls showed rising popularity for Peronist candidates, markets declined (Exhibit 21).

Exhibit 21: MSCI Argentina's Decline

Source: FactSet, as of 28/10/2019. MSCI Argentina returns minus MSCI Emerging Markets & MSCI Frontier Markets returns, both with net dividends and denominated in USD, 31/12/2017 – 25/10/2019. Argentina reclassified from Frontier Markets to Emerging Markets status in May 2019.

xxxvii *Source: FactSet, as of 10/30/2019. Argentina main short-term policy rate, 12/31/2017 – 10/30/2019. Note that the BCRA shifted from using the 7-day Repo Rate as its main policy tool to using the Rate on Liquidity Bills—the LELIQ rate—in August 2018.*

As 2018 progressed and 2019 dawned, polls repeatedly showed Macri tied with various Peronist candidates, including the former president he replaced—Cristina Fernández de Kirchner. On 18 May, Kirchner shocked many by announcing she wouldn't seek the presidency, targeting the role of vice president instead. For president, she supported long-time lieutenant Alberto Fernández (no relation)—widely seen as a more moderate candidate. Argentine equities rallied on the news.

They extended their gains in June, after President Macri announced Senator Manuel Pichetto as his running mate. Pichetto belongs to Kirchner's Peronist Justicialist Party, but he is a frequent critic of her policies, favouring a more moderate approach. Most observers saw President Macri's courting moderate Peronist voters who had split with Justicialist candidates as an attempt to boost his re-election chances. President Macri's standing in the polls improved after the move. The final poll ahead of August's primary election showed President Macri trailing Fernández by 2%—but neither candidate getting a majority share to avoid a head-to-head runoff. Polls placing the two against each other directly showed President Macri narrowly winning re-election.

However, 11 August's primary vote—widely seen as a preview of the general election—refuted Macri's lead, sending markets reeling. In the vote, Fernández took 47% of the vote, far exceeding Macri's 32%. That suggested he would win easily in October. Further, since Fernández took more than 45% of the vote, it would eliminate the need for a runoff under Argentine election law. Fear of extreme Peronist policies returning sent the MSCI Argentina tumbling -26.8% on 12 August in peso terms.[xxxviii] The peso also plummeted, bringing returns to -40.0% in US dollars.[xxxix]

The currency's plunge forced the BCRA to further tighten capital controls. President Macri explored restructuring Argentina's debt. He froze consumer prices, including fuel and utilities, reversing earlier reforms. However, he was still far behind in the polls. On the election's eve, the Fernández/Kirchner ticket was polling at 54%, 22.5 percentage points ahead of Macri/Pichetto.[xl]

Hence, Fernández's eventual victory in the 27 October vote was widely expected. The only surprise is the margin of victory—48% to 40%—which was smaller than most anticipated. That said, it was still sufficient to avoid a head-to-head runoff between the top two candidates.

Argentine equities' huge decline alongside political developments suggest markets have priced in Fernández's potential reversal of many of President Macri's reforms—and potentially taking a very anti-market stance. The likelihood of default, already rising significantly throughout 2018 and 2019, seems further elevated. In the run up to October's vote, Fernández said he would seek a debt "reprofiling" along the lines of Uruguay's 2003 default, under which bondholders were forced to take a 20% haircut. Markets do not seem to buy this presently, as Argentina's 5.9% 10-year US dollar bonds issued in January 2018 are presently trading at just 38% of par value.[xli]

Argentine equities' huge decline alongside political developments suggest markets have priced in Fernández's potential reversal of many of President Macri's reforms—and potentially taking a very anti-market stance.

This introduces the possibility that markets have overshot reality. This is perhaps doubly true considering the make-up of the Argentine National Congress. Parties affiliated with Peronism have a majority in the lower house of Congress, the Chamber of Deputies. However, right-leaning parties control the Senate, which could impede progress.

If either this gridlock or potential moderation by Fernández's means he reverses relatively few of President Macri's reforms, it could trigger relief—and send equities rallying. Yet there is little way to assess this presently, particularly given the country's history.

xxxviii Source: FactSet, as of 29/10/2019. MSCI Argentina Index return with net dividends, in Argentine pesos, 09/08/2019 – 12/08/2019.

xxxix Ibid. MSCI Argentina Index return with net dividends, in USD, 09/08/2019 – 12/08/2019. The Argentine peso declined -18.1% against the dollar on 12/08/2019.

xl Source: Federico González and Associates, as of 25/10/2019.

xli Source: FactSet, as of 30/10/2019. Government of Argentina 5.875% 10-year bond dated 11 January 2018, SEDOL BYZPWF6; ISIN US040114HQ6.

Should you have any questions about any of the information provided, please contact FIA at:
Email: Australia@Fisher-Investments.com.au
Phone:+61 2 8211 0625
Mail: Level 25, Aurora Place, 88 Phillip St, Sydney NSW 2000

For clients in Australia, Fisher Investment's (FI) wholly-owned subsidiary, Fisher Investments Australasia Pty Ltd (FIA), which holds an Australian Financial Services Licence (#433312) with the Australian Securities and Investment Commission (ASIC), serves as the investment manager. In this arrangement, FIA delegates portfolio management to its parent company, FI. FI is an investment adviser registered with the United States Securities and Exchange Commission (US SEC). As of 30 September 2019, FI managed assets valued over $163 billion AUD. FI maintains two principal business units – Fisher Investments Institutional Group (Fisher) and Fisher Investments Private Client Group (FIPCG). FIPCG manages and serves a variety of equity, fixed income, and balanced assets for significantly all of FI's private client accounts. FIIG services significantly all of FI's institutional accounts. FI's Investment Policy Committee (the IPC) has ultimate decision-making authority and accountability for the firm's strategies.

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

The foregoing information constitutes the general views of FI and should not be regarded as personalised investment advice or a reflection of the performance of FI managed strategies. There can be no assurances that they will continue to hold this view; FI may change its views at any time based on new information, analysis, or reconsideration. This analysis is for informational purposes only. It has been formulated with data provided to FI and is assumed to be reliable. FI makes no claim to its accuracy. Investing insecurities involves the risk of loss.

This material is designed for use with wholesale prospects and clients.