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INSTITUTIONAL GROUP

FOURTH QUARTER 2017

MARKET PERSPECTIVES

FOURTH QUARTER 2017 REVIEW AND OUTLOOK
US SMALL CAP OPPORTUNITIES

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FOURTH QUARTER 2017 REVIEW AND OUTLOOK

EXECUTIVE SUMMARY

Portfolio Themes

- **Quality Tilt:** As the bull market progresses, we favor stocks with stronger balance sheets and consistent margins.
- **Overweight to Information Technology:** The Information Technology sector is heavily skewed toward large, high-quality firms—a segment we expect to outperform in the later stages of a bull market. The sector should also 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.”
- **Underweight to Commodity-Oriented Sectors:** The Energy and Materials sectors likely continue to struggle as supply growth constrains commodity prices.

Market Outlook

- **Growing Investor Confidence:** Investor optimism typically increases as a bull market matures. US sentiment has improved but is not yet euphoric. Meanwhile, growing optimism in the US remains unmatched by European investors.
- **Strong Economic Drivers:** In both developed and emerging markets, economic drivers remain strong. We believe these fundamentals will come to the forefront as sentiment improves.
- **European Leadership:** As euroskeptic fears fizzle and renewed gridlock reduces legislative risk, Europe should continue to outperform in 2018.

This bull market has powered into its final third, with the MSCI All Country World Index (ACWI) adding another 5.7%, bringing calendar year 2017 gains to 24.0%.ⁱ We remain bullish and expect markets to deliver strong returns in 2018.

Outsized annual returns are common in bull markets' final thirds. Huge years like 1999, 1998, 1997, 1989 and 1980 all occurred as bull markets neared their peaks. As bulls age, investors generally become more optimistic. Accordingly, as equities climb further up the Wall of Worry, greed gradually replaces fear. Worries about the next downturn give way to fear of missing potential gains, and investors see less risk and more opportunity. The more these emotions percolate, the higher investors bid equities.

We have not yet seen the huge returns typical of a bull's final third. Those celebrating 2017's greatness or calling it unrepeatable large

miss the fact that global stocks have averaged 18% in bull markets since 1926.ⁱⁱ The fact that investors see a modestly above-average bull market year in 2017 as an outlier speaks to how much they underestimate stocks' potential.

Eurozone stocks led in 2017, despite a Q4 pause that had all the hallmarks of a brief countertrend. In our view, even after a stellar 2017, positive surprise potential is greater in the eurozone than in the United States and elsewhere. Currency factors helped depress European sentiment, as the MSCI ACWI rose just 8.9% in euros.ⁱⁱⁱ While larger returns stirred Americans' animal spirits, this sentiment is unmatched by European investors. Add in lingering fears of weak economies, ECB policy and regional politics, and expectations for eurozone stocks remain low. There is ample room for continued economic growth and strong earnings to surprise markets—a key reason we expect eurozone stocks to lead again in 2018.

ⁱ Source: FactSet, as of 1/5/2018. MSCI ACWI Index return with net dividends, 12/31/2016 – 12/31/2017.

ⁱⁱ Source: Global Financial Data, Inc. and FactSet, as of 12/28/2017. Annualized price returns in USD for bull markets from 1926 to 2007. The current is omitted as it is incomplete. GFD World Index used for bull markets from 1926 – 1970; MSCI World Index from 1970 – 2007. The World Index's 2017 price return in USD was 20.1%.

ⁱⁱⁱ FactSet, as of 1/5/2018. MSCI ACWI Index return with net dividends in EUR, 12/31/2016 – 12/31/2017.

In Emerging Markets (EM), sentiment has improved, though doubts persist. Some experts attribute strong EM equity performance to accommodative monetary policies in developed economies like the US and eurozone, arguing that as these central banks tighten, it would remove the alleged support stimulating EM. However, in our view, many EM economies are doing better than appreciated and aren't reliant on outside help. Though many view EM as a cohesive bloc, individual nations' economic and political drivers vary. Economies that are trade-oriented and have growing services sectors and consumer classes are doing better than those reliant on commodity prices. While political drivers can be mixed—sudden shifts in regulatory or legislative landscapes aren't uncommon and can drive market uncertainty—we don't see this as problematic for the entire category. Overall, we believe EM should continue doing well, albeit with dispersion among country-level returns.

Along with non-US outperformance, we expect 2017's other big trends to persist in 2018 and believe portfolios are well positioned. Information Technology—our largest sector overweight—led in 2017 and should repeat. Robust IT-related capex, mobile adoption and cloud computing are powering demand for hardware, components and software. However, Energy—a primary underweight and 2017's worst sector—likely continues to struggle as lasting supply gluts pressure oil prices.

As for interest rates, we expect long-term US Treasury yields to remain benign in 2018. Most pundits anticipate rising rates, believing long rates are overdue to react to the US Federal Reserve's three rate hikes in 2017. However, long rates don't typically move in tandem with short rates. While the Fed controls short-term interest rates, long-term rates are market-driven—a function of real interest rates plus some inflation premium. Fed rate hikes amid low inflation are anti-inflationary, leading to a flattening yield curve, weighing on lending and money supply growth. Should the Fed hike rates further in 2018, we expect similar results. Moreover, long rates globally are highly correlated, and global monetary policy shifts have been glacial, giving markets ample time to digest moves.

While sentiment in the United States has improved, it isn't euphoric. Professional forecasters again project single-digit S&P 500 returns. Stocks usually don't do what the consensus expects. That doesn't mean they automatically do the opposite—returns could be more or less positive than widely expected, too. While a negative year would surprise, this seems unlikely—fundamentals are strong, and extant risks appear too small or unlikely to strike and wallop markets. With the global economy on an upswing, world trade humming, European yield curves steeper and earnings growing nicely, surprisingly strong returns seem much more probable.

Because the last bull market ended prematurely, investors haven't seen rational optimism since the late 1990s. As a result, many have trouble discerning optimism from genuine euphoria. For a windowpane into future euphoria stocks may encounter, see bitcoin. Not only is it a sign investors can still muster animal spirits (versus being permanently scarred by the financial crisis), it shows what to watch for as sentiment improves. Newfangled technologies and new paradigms often emerge near the end of bull markets, driving normally rational people to shun reason and make speculative bets. What matters is the moment when such irrational exuberance spills into broader markets. We are watching closely for this but don't believe it is here yet.

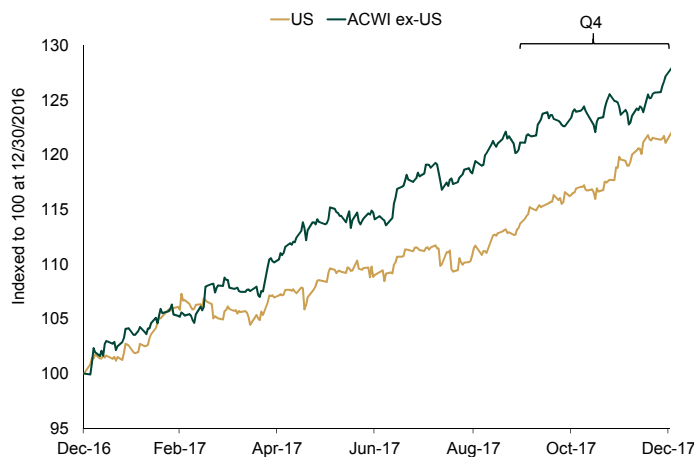
That said, this bull market will end one day. In this later bull market phase, one of our most important research efforts is looking for indications the next bear is approaching. For now, we don't see a bear market forming. However, it wouldn't surprise us if we saw a correction (-10% to -20%) this year. Corrections are impossible to predict and time consistently. We believe it is optimal to wait it out if one occurs and look forward to the gains on the other side.

THEMATIC UPDATE AND MARKET OUTLOOK

Q4 RECAP

The global economy is expanding, with widespread growth supported by broadly positive economic data to ultimately help boost sentiment. Non-US leadership slowed in Q4, though as shown in Exhibit 1, this is most likely a brief counter trend already showing signs of reversal as the quarter concluded.

Exhibit 1: Non-US Leadership Picks Up



Source: FactSet, as of 02/01/2018 in USD.

US economic growth accelerated in 2017, particularly in Q4, boosting investor optimism. While many assess US growth through a political lens, the President's administration does not significantly impact economic results. The nation's vast private sector remains the driving force. In Europe, the UK expansion continued despite Brexit-related fears and accelerated as 2017 waned. The eurozone also held firm, with growth accelerating from 2016. Likewise, Emerging Markets with strong exposure to the Technology sector's supply chain—particularly China and Taiwan—benefited from a pickup in global demand.

Despite lingering fears over euroskeptics and President Trump, politics in the developed world look benign for markets. Most governments remain gridlocked, preventing sweeping change. In the US, November's midterms aren't as important to markets as people think. After spending its political capital on tax reform, Congress probably does little, especially with campaign season approaching. Moreover, intraparty gridlock persists, preventing the GOP-held Congress from accomplishing much.

Politics abroad are similarly positive. Political uncertainty still has some room to fall in Europe, tied to Catalonia's separatist movement

and March's Italian election. Brexit talks remain glacial, with both sides seemingly grinding toward a Brexit in name only. The result: few material near-term changes, particularly where trade is concerned. That said, we don't expect falling uncertainty to play as big a role this year as it did in 2016 and 2017.

STRONG RETURNS IN THE FINAL THIRD

As mentioned in the Executive Summary, we believe this bull market to have emphatically entered its final third, marked by strong returns, which should continue in 2018. The large later years of a bull market feed the euphoria typifying market peaks. Historically, a large share of a bull market's return usually comes late as investor sentiment evolves to optimism and then euphoria, drawing those who were formerly on the sidelines to enter the market—propelling equity prices higher. Exhibit 2 dissects historical bull markets into thirds, revealing, on average, almost 40% of a bull's return can come in the final third of its life.

Exhibit 2: Bull Market Returns by Thirds

Bull Start	Bull End	Bull Length (Years)	% of Bull Return by Third of Lifespan		
			First Third	Second Third	Final Third
06/01/1932	03/06/1937	4.8	62%	4%	34%
04/28/1942	05/29/1946	4.1	51%	12%	37%
06/13/1949	08/02/1956	7.1	39%	10%	51%
10/22/1957	12/12/1961	4.1	60%	-4%	45%
06/26/1962	02/09/1966	3.6	59%	26%	15%
10/07/1966	11/29/1968	2.1	59%	-4%	46%
05/26/1970	01/11/1973	2.6	73%	6%	21%
10/03/1974	11/28/1980	6.2	59%	-6%	47%
08/12/1982	08/25/1987	5.0	37%	23%	40%
12/04/1987	07/16/1990	2.6	42%	49%	9%
10/11/1990	03/24/2000	9.5	26%	29%	45%
10/09/2002	10/09/2007	5.0	58%	12%	30%
Median ex Current		4.5	51%	12%	37%

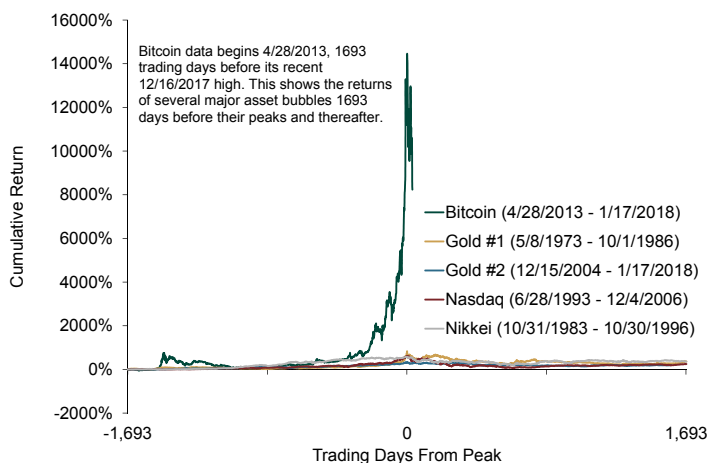
Source: Global Financial Data, Inc., as of 11/21/2017. Calculations are based on S&P 500 price returns for the periods shown.

BITCOIN AS A WINDOWPANE TO EUPHORIA

Since the last bull market ended prematurely, investors haven't seen stock market euphoria for nearly 20 years, since the late-1990s' Tech bubble inflated. As a result, many mistake rational positivity for euphoria. What will euphoria look like when it arrives? The frenzy over bitcoin and cryptocurrencies is a classic preview.

The bitcoin spike dwarfs most major historical bubbles. Exhibit 3 compares bitcoin to other recent frenzies, including gold in the late-1970s, the Nasdaq in the late-1990s and Japanese stocks in the late-1980s. It is impossible to know whether December 16, 2017 was bitcoin's peak, making the methodology imperfect. But the initial bubble inflation isn't knowable, so this is the fairest comparison we can create. And it is illustrative, showing bitcoin's astronomical relative magnitude. When you consider that bitcoin's supply increases at a steady fixed rate, it takes astounding demand to drive something up so high in such a short amount of time. That demand is driven by sentiment—euphoria.

Exhibit 3: Is Bitcoin A Bubble?



Source: Fisher Investments Research, FactSet, Global Financial Data and CoinMarketCap.com, as of 1/18/2018. All periods are 1,693 days before and after the peak, except bitcoin (1,693 before and 32 after) and Gold #2 (1,693 before and 1,601 after), as this is all the time elapsed.

The tone and content of the bitcoin debate was also telling. Those urging caution offered well-supported and rational arguments centering on the lack of fundamental reasons for long-term growth. The pro-bitcoin arguments, meanwhile, were based on the speculation of assumed scenarios in the future, and a lack of examining the broader picture of cryptocurrencies beyond Bitcoin. For example, one misconception fueling Bitcoin's euphoria is that its long term supply is fixed at 21 million, with 16.8 million currently in circulation.^{iv} The claim is that with a continually growing economy and a fixed supply of currency to match, the value of the currency must rise. The glaring error here is that Bitcoin is not the only cryptocurrency – there are over 1,400 other cryptocurrencies, with new Initial Coin Offerings (ICOs) happening all the time.

Another signature sign of euphoric speculation were the wild rallies taking place in companies who changed their name to cryptocurrency based titles. For example, the Long Island Iced Tea Corp, a drink producer, soared 500% after the firm announced it would become "Long Blockchain Corp" ^v – starkly reminiscent of the plethora of tech titles hitting the markets during the Tech bubble.

Evidence of a bubble and the implied burst raises the concern of the potential effect on markets. However, the market cap of all cryptocurrencies was about \$759 billion as of 1/3/2018.^{vi} For perspective, the entire crypto market is just 0.6% of global GDP.^{vii} A bear market wallop requires an event to shave trillions of dollars of global GDP – a feat which cryptocurrencies do not currently have the size to provide.

^{iv} Source: CoinMarketCap.com, as of 1/3/2018.

^v Sophie Christie, "Want Your Company's Share Price to Rocket? Simply Add 'Blockchain' to Its Name," *The Telegraph*, December 21, 2017.

^{vi} Source: CoinMarketCap.com, as of 1/18/2018.

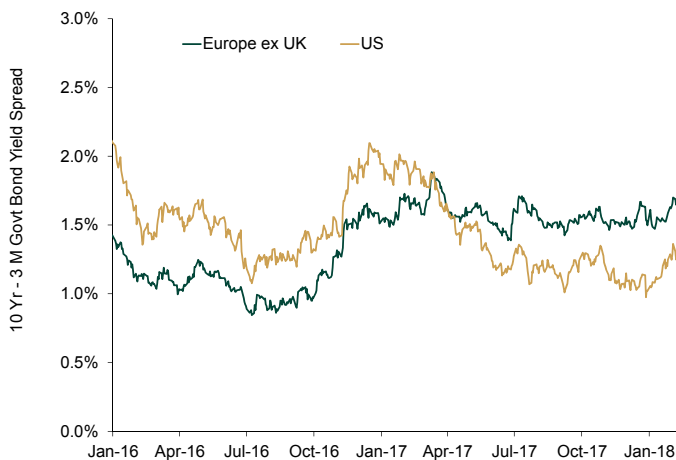
^{vii} Source: CoinMarketCap.com and IMF, as of 1/25/2018. Market capitalization of all cryptocurrencies on 1/24/2018 as a percentage of 2016 global GDP.

2018 FORECAST

2017's sector and country winners should repeat in 2018. High quality firms displaying healthy profit margins and strong growth prospects, characteristic of consumer oriented sectors including Health Care, Consumer Staples, and Information Technology should outperform. Their profitability attracts investors seeking more stable investments in a maturing bull market. Conversely, commodity dependent sectors such as Energy should underperform given the industry's quickening supply response to price changes, keeping prices range-bound.

Despite last year's leadership and falling uncertainty, the gap between sentiment and reality is still wider in Europe than most places. People see the expansion as fragile. Few notice the loan growth pickup and steeper yield curves, which should boost European banks (Exhibit 4). With robust balance sheets, they are well positioned to take advantage. Many fear the end of the European Central Bank's (ECB) quantitative easing (QE), not realizing the ECB slowed bond purchases throughout 2017—and eurozone stocks led. The end of QE was bullish in the US and Britain, and we see no reason why the eurozone would be different.

Exhibit 4: Favorable European Yield Spread Signals Growth Prospects in Europe

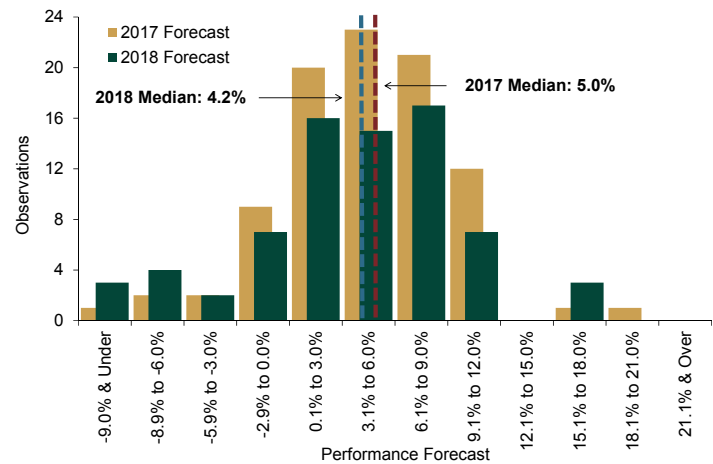


Source: FactSet, as of 2/9/2018.

U.S. investors broadly see 2017's returns as great, even though they were in line with the S&P 500's long-term average return during bull markets. This suggests to us investors don't fathom the potential for robust returns in a maturing bull market, a sign sentiment remains in check as 2018 kicks off. Even so, doubts still linger. People seek catalysts to drive stocks higher and perceive few. Many see old stand-bys like rising valuations and all-time highs as signs of trouble. Euphoria arrives when investors run out of doubts. At that point,

professional forecasts will probably call for much higher returns than they are now. Entering 2018, the median S&P 500 forecast for the year was 4.2%—lower than 2017's 5.0% (Exhibit 5).

Exhibit 5: Professional Forecasts Remain Cautious



Source: Fisher Investments, Research, as of 12/29/2017. S&P 500 price level forecasts are made by equity strategists from a variety of firms within the investment industry.

As always, we remain vigilant for signs of the inevitable bear, but do not believe any catalysts loom today. Today's risks are either too well-known, too small to destroy trillions of dollars of global GDP, or simply false. That's not to say a correction isn't possible. Unlike a bear market, corrections can happen for a number of reasons or no reason at all, often vanishing as soon as they appear. But corrections are a healthy feature of bull markets. Without the occasional worry, investors can become overly euphoric, resulting in a risky environment for equities. In fact, as of the date of this writing, global markets had either entered or were approaching correction territory. However, it exhibits the classic characteristics of a correction: a sharp, sentiment-driven market drop. We do not believe this reflects a shift in global fundamentals or the beginning of a bear market.



US COMMENTARY

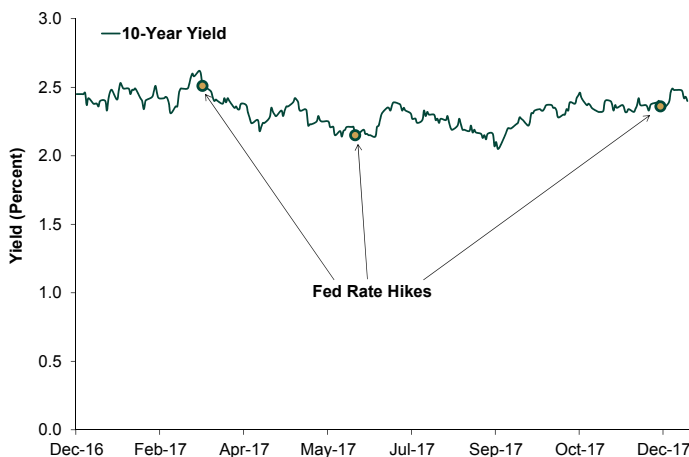
US COMMENTARY

As expected, U.S. stocks performed well in 2017 with the S&P 500 completing its full-year streak of positive monthly returns in December, rising 1.1%, to bring full-year returns to 21.8%.^{viii} President Trump marked his first major legislative achievement in December, as Congress capped months of debate by passing tax reform. Meanwhile, Fed Board member Jerome Powell was selected to replace Janet Yellen as Fed Chair. On the trade front, NAFTA negotiations concluded their fifth round mid-way through the quarter. The negotiations failed to resolve numerous issues. In our view, this is to be expected as trade talks are known to be contentious, however, all parties still have a vested interest in compromise. Overall, economic fundamentals remain strong, political gridlock continues, and sentiment is rising, all leading to expectations of a great year for US stocks in 2018. However, we still expect US equities to underperform Non-US, as economic drivers in Europe outpace the US.

FED POLICY IMPACT ON LONG RATES

Entering 2017, most expected long-term interest rates to rise as the Fed escalated short-term rate hikes. But the market had other ideas. Even as the Fed raised overnight rates three times and economic growth accelerated, 10-year yields finished 2017 five basis points below where they began (Exhibit 6). We expect long rates to repeat the feat this year, finishing 2018 little changed.

Exhibit 6: Long Rates in 2017



Source: FactSet, as of 1/9/2018. 10-year US Treasury yield, constant maturity, 12/31/2016 – 12/31/2017.

^{viii} Source: FactSet, as of 2/8/2018.

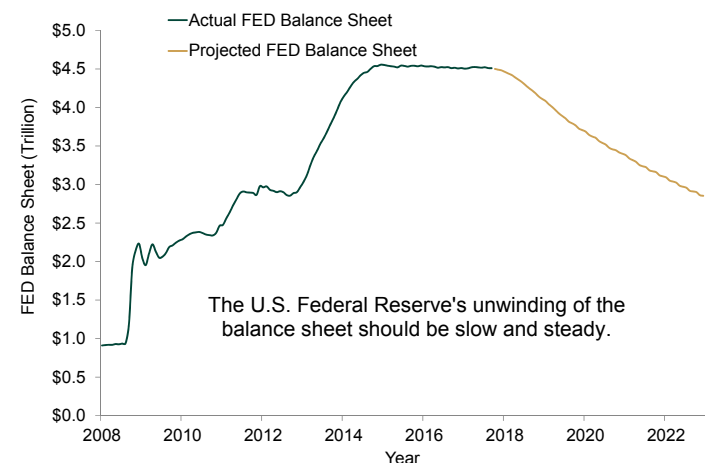
^{ix} Friedman, M. (1983). *The counter-revolution in monetary theory: first Wincott memorial lecture, delivered at the Senate House, University of London, 16 September, 1970.* London: Institute of Economic Affairs.

While the Fed controls overnight rates, the market determines long rates. Like all assets, they move on supply and demand, and the chief demand driver is inflation expectations. The long-term interest rate is basically the real interest rate plus (or minus) some premium for inflation, and real rates are largely the cumulative growth rate of the developed world (with some variance by country).

When the Fed hikes rates amid low inflation, as it did last year, it is anti-inflationary. People saw inflation rates slow as the year progressed and figured the Fed did its job, successfully containing prices. Hence long rates fell as investors did not demand as much of an inflation premium. This flattened the yield curve, weighing on loan growth and broad money supply. As Milton Friedman preached, "Inflation is always and everywhere a monetary phenomenon..."^{ix}

Beyond fed-funds rate hikes, the Fed began allowing its balance sheet to contract in October, prompting further fears of higher rates, but given the early foresight provided by the Fed last summer, the market has had plenty of time to discount the news. Further, the Fed isn't selling bonds; rather, it will discontinue reinvesting a small amount of maturing bonds each month. As Exhibit 7 displays, if the Fed sticks to the current plan, its balance sheet won't return to pre-2008 levels until 2024.

Exhibit 7: Projected FED Balance Sheet



Source: Federal Reserve, actuals as of October 2017, projected from November 2017 to December 2022.

Long-term interest rates throughout the developed world are highly correlated. While monetary policy abroad is shifting some, the pace is slow and widely telegraphed—unlikely to move markets materially. The ECB and Bank of Japan continue buying long-term bonds, albeit fewer of them, pressuring long-term interest rates. The Bank of England reacted to higher inflation by hiking overnight rates in November, but this merely reversed August 2016's post-Brexit rate cut. After the hike, UK long rates fell, flattening the yield curve—another example of hikes' anti-inflationary, rate-lowering impact.

The low inflation seen in recent years has peaked the curiosity of policymakers and investors, who cannot reconcile low inflation with accelerating GDP and low unemployment. With regards to understanding inflation, many believe in the Phillips Curve model, which links unemployment to inflation by the logic that when unemployment is low, businesses must raise wages to attract workers, creating a wage-price spiral. In our view, however, there is over a century's worth of data showing money supply growth, not unemployment, drives prices. In our fractional reserve banking system, banks create most new money through lending, which depends on potential profits, which stem from the yield curve. Banks borrow at short rates, lend at long rates and profit off the spread—known as their net interest margin. Flatter yield curves shrink that spread and banks' potential profits, driving them to lend less. That slows money supply growth, with a downstream effect on prices.

TAX REFORM AND OTHER POLITICAL DEVELOPMENTS

Eleven months after his inauguration, President Donald Trump achieved his first major legislative accomplishment, signing tax reform into law. The debate and eventual passage sparked headlines and politicized speculation. While there are many impacts at the individual and company-specific level, the macroeconomic and stock market impact is vastly overestimated by most commentators.

Conventional wisdom argues tax cuts help stocks and hikes hurt. Exhibits 8 – 9 display a historical analysis of both. Specifically, they display the 12-month return after every policy adjustment to top tax rates since 1926.^x Ultimately, the conclusion is that tax changes have no material impact on stocks.

Exhibit 8: Corporate Income Tax Rate Shifts

Corporate Tax Hikes			Corporate Tax Cuts		
Effective Date	New Tax Rate	Fwd 12-Month Return	Effective Date	New Tax Rate	Fwd 12-Month Return
Feb. 26, 1926	13.5%	8.6%	May. 29, 1928	12.0%	24.2%
Jan. 1, 1930	12.0%	-28.5%	Dec. 17, 1929	11.0%	-29.9%
Jun. 6, 1932	13.8%	98.0%	Jan. 1, 1946	38.0%	-11.9%
Jun. 22, 1936	15.0%	2.1%	Feb. 26, 1964	50.0%	12.3%
May. 28, 1938	19.0%	23.8%	Jan. 1, 1965	48.0%	9.1%
Oct. 8, 1940	24.0%	-5.3%	Jan. 1, 1970	49.2%	-0.1%
Sep. 20, 1941	31.0%	-15.8%	Jan. 1, 1971	48.0%	10.8%
Oct. 21, 1942	40.0%	25.2%	Jan. 1, 1979	46.0%	12.3%
Sep. 23, 1950	42.0%	20.4%	Jan. 1, 1987	40.0%	2.0%
Oct. 20, 1951	50.8%	3.5%	Jan. 1, 1988	34.0%	12.4%
Jan. 1, 1952	52.0%	11.8%			
Jun. 28, 1968	52.8%	-2.3%			
Aug. 10, 1993	35.0%	2.4%			
Average		11.1%	Average		4.1%
Median		3.5%	Median		9.9%

Source: Tax Policy Center and Global Financial Data, Inc., as of 10/27/2017. S&P 500 price returns for the periods indicated.

Exhibit 9: Personal Income Tax Rate Shifts

Income Tax Hikes			Income Tax Cuts		
Effective Date	New Tax Rate	Fwd 12-Month Return	Effective Date	New Tax Rate	Fwd 12-Month Return
Jan. 1, 1930	25.0%	-28.5%	Dec. 17, 1929	24.0%	-29.9%
Jun. 6, 1932	63.0%	98.0%	Jan. 1, 1946	86.5%	-11.9%
Jan. 1, 1936	79.0%	27.9%	Apr. 2, 1948	82.1%	-1.4%
Jun. 25, 1940	81.1%	0.9%	Aug. 16, 1954	91.0%	34.8%
Oct. 21, 1942	88.0%	25.2%	Feb. 26, 1964	77.0%	12.3%
May. 29, 1944	94.0%	23.1%	Jan. 1, 1965	70.0%	9.1%
Sep. 23, 1950	84.4%	20.4%	Jan. 1, 1970	71.8%	-0.1%
Oct. 20, 1951	91.0%	3.5%	Jan. 1, 1971	70.0%	10.8%
Jan. 1, 1952	92.0%	11.8%	Aug. 13, 1981	69.1%	-22.2%
Jun. 28, 1968	75.3%	-2.3%	Jan. 1, 1982	50.0%	14.8%
Dec. 30, 1969	77.0%	0.7%	Jan. 1, 1987	38.5%	2.0%
Jan. 1, 1991	31.0%	26.3%	Jan. 1, 1988	28.0%	12.4%
Aug. 10, 1993	39.6%	2.4%	Jun. 7, 2001	39.1%	-19.5%
Jan. 2, 2013	39.6%	25.3%	Jan. 1, 2002	38.6%	-23.4%
			May. 28, 2003	35.0%	17.6%
Average		16.8%	Average		0.4%
Median		16.1%	Median		2.0%

Source: Tax Policy Center and Global Financial Data, Inc., as of 10/27/2017. S&P 500 price returns for the periods indicated.

We see several reasons tax cuts lack power to sway stocks. For one, much of the discussion about tax cuts' market impact presumes they still are not priced into stocks, but tax changes play out in broad daylight and take significant time to enact—affording markets ample time to discount potential effects.

Economically, we don't expect the tax cut to provide a huge growth boost. Business investment is already at record highs (16% above Q1 2008's pre-recession peak) and is not a primary factor in this expansion's slow GDP growth.^{xi} Moreover, the US economy is growing steadily.

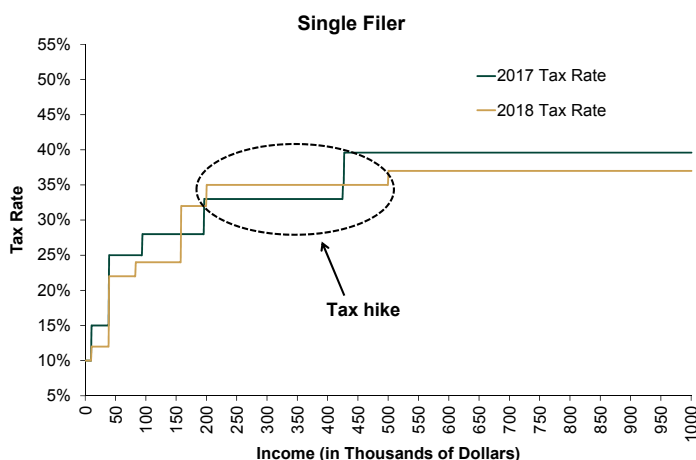
^x Source: Global Financial Data, Inc. and FactSet, as of 1/2/2018. Annualized price returns in USD for bull markets from 1926 to 2007. The current is omitted as it is incomplete. GFD World Index used for bull markets from 1926 – 1970; MSCI World Index from 1970 – 2007. The MSCI World Index's 2017 price return in USD was 20.1%.

^{xi} Source: US Bureau of Economic Analysis, as of 1/22/2018. Real private nonresidential fixed investment, Q1 2008 – Q3 2017.

A second reason tax changes lack a preset impact: They often create broad categories of winners and losers. While many taxpayers will pay lower rates, some will pay more, because the law reduced income thresholds for some of the higher income bands. All else equal, many single filers earning between \$157,000 and \$427,000 will see higher taxes (Exhibit 10). Heads of household lose most of their filing advantages with a similar tax hike in the mid/upper income range. Joint filers get tax cuts unless they make between \$400,000 and \$424,000 (Exhibit 11).^{xii}

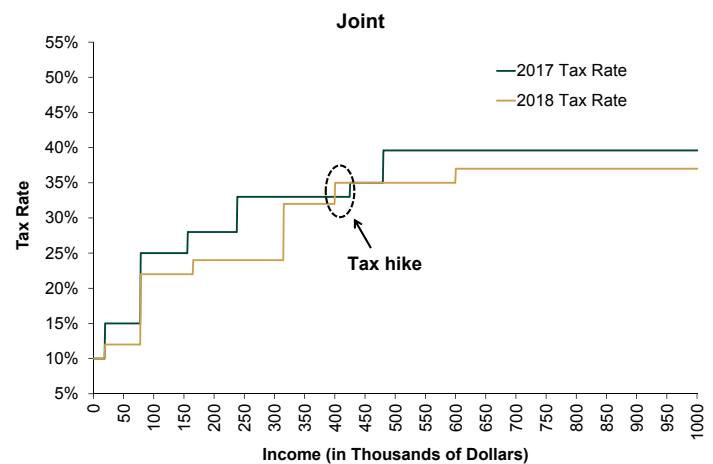
The legislation also strikes many deductions. It caps state and local tax (property or income) deductibility at \$10,000 and limits mortgage interest deductions. It further eliminates deductions for miscellaneous expenses like tax preparation, legal and investment management fees. To compensate, it doubles the standard deduction, likely helping most taxpayers. But those benefiting from specific itemized deductions will lose.

Exhibit 10: The Single Hike within the Cut



Source: Tax Foundation, as of 12/19/2017.

Exhibit 11: The Joint Hike within the Cut



Source: Tax Foundation, as of 12/19/2017.

The bill has positive and negative effects for corporations. While the headline rate cut from 35% to 21% is a plus, many major American businesses weren't paying anything near 35%. The law also changes America's system of taxing profits earned abroad to eliminate blanket double taxation—probably cheering many businesses. Still, it strikes many deductions, and a new base-erosion anti-abuse tax penalizes firms who use transactions between foreign subsidiaries to reduce taxable income.

^{xii} "Details of the Conference Report for the Tax Cuts and Jobs Act," Jared Walczak, Joseph Bishop-Henchman and Nicole Kaeding, Tax Foundation, 12/15/2017. <https://taxfoundation.org/conference-report-tax-cuts-and-jobs-act/>

MIDTERM ELECTIONS

While the media expect big shifts in the coming midterm elections, we suspect small shifts are likelier. Predicting those shifts is premature, but it should gain clarity later on. It is possible, however, to survey the structural factors for November, particularly in the Senate.

The GOP's one-seat edge implies the Democrats could win Senate control without a huge shift. But it is also possible Republicans strengthen their hand. The Democrats have many more seats up for

grabs and will likely have to devote significant campaign resources to defending them (Exhibit 12). The Republicans' House edge is larger, with Democrats needing to win 24 seats to take it.

If Democrats did win the Senate and the House, the market impact should not be significant as gridlock would still persist, reducing the probability of sweeping legislation with the power to roil markets to pass – a bullish sign.

Exhibit 12: 2018 Senate Races

Senator	Party	State	Percent of Vote for Trump in 2016	Percent of Vote for Romney in 2012	Percent of Vote for McCain in 2008	Percent of Vote for Bush in 2004	Percent of Vote for Bush in 2000
Barrasso, John	R	WY	70%	69%	65%	69%	68%
Manchin, Joe, III	D	WV	69%	62%	56%	56%	52%
Heitkamp, Heidi	D	ND	64%	58%	53%	63%	61%
Corker, Bob*	R	TN	61%	59%	57%	57%	51%
Fischer, Deb	R	NE	60%	60%	57%	66%	62%
Wicker, Roger F.	R	MS	58%	55%	56%	59%	58%
Tester, Jon	D	MT	57%	55%	50%	59%	58%
Donnelly, Joe	D	IN	57%	54%	49%	60%	57%
McCaskey, Claire	D	MO	57%	54%	49%	53%	50%
Cruz, Ted	R	TX	53%	57%	55%	61%	59%
Brown, Sherrod	D	OH	52%	48%	47%	51%	50%
Flake, Jeff*	R	AZ	50%	54%	54%	55%	51%
Nelson, Bill	D	FL	49%	49%	48%	52%	49%
Casey, Robert P., Jr.	D	PA	49%	47%	44%	48%	46%
Baldwin, Tammy	D	WI	48%	46%	42%	49%	48%
Stabenow, Debbie	D	MI	48%	45%	41%	48%	46%
Hatch, Orrin G.*	R	UT	46%	73%	63%	72%	67%
Heller, Dean	R	NV	46%	46%	43%	50%	50%
Klobuchar, Amy	D	MN	45%	45%	44%	48%	46%
Kaine, Tim	D	VA	45%	47%	46%	54%	52%
King, Angus S., Jr.	I	ME	45%	41%	40%	45%	44%
Menendez, Robert	D	NJ	42%	41%	42%	46%	40%
Carper, Thomas R.	D	DE	42%	40%	37%	46%	42%
Murphy, Christopher	D	CT	42%	41%	38%	44%	38%
Whitehouse, Sheldon	D	RI	40%	35%	35%	39%	32%
Heinrich, Martin	D	NM	40%	43%	42%	50%	48%
Cantwell, Maria	D	WA	38%	41%	40%	46%	45%
Gillibrand, Kirsten E.	D	NY	37%	35%	36%	40%	35%
Cardin, Benjamin L.	D	MD	35%	36%	36%	43%	40%
Warren, Elizabeth	D	MA	34%	38%	36%	37%	33%
Feinstein, Dianne	D	CA	33%	37%	37%	44%	42%
Sanders, Bernard	I	VT	33%	31%	30%	39%	41%
Hirono, Mazie K.	D	HI	30%	28%	27%	45%	37%

Source: US Senate, Fisher Investments Research. Senators up for re-election in 2018 as of 12/27/2017. Sanders and King caucus with the Democrats. *Senators not seeking re-election.



Non-US DEVELOPED COMMENTARY

NON-US DEVELOPED COMMENTARY

Initially, 2018's political calendar may appear eventful and volatile. Brexit negotiations continue, rumored leadership challenges continue affecting Prime Minister Theresa May, and the anti-establishment Five Star Movement tops polls ahead of Italy's March election. Yet the common thread amongst all of this is political gridlock, which should keep legislative risk low throughout the developed world. This has been a positive force for global markets in recent years and should remain so in 2018.

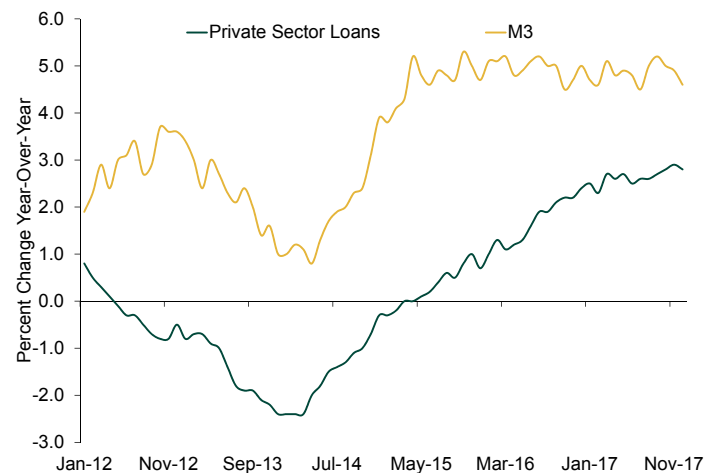
EUROZONE: EXPANSION STRONG AND WIDESPREAD

The eurozone's expansion is ongoing, with GDP growing for the 19th consecutive quarter in Q4 2017. IHS Markit's December eurozone composite purchasing managers' index (PMI)—a survey tallying the breadth of growth—hit 58.1. Readings above 50 indicate expansion and December's read is near a seven-year high.^{xiii} All four of the largest economies' (Germany, France, Italy, Spain) composite PMIs remain in the high-50s, indicating widespread services and manufacturing expansion.

The outlook also looks positive, with The Conference Board's Leading Economic Index (LEI) for the eurozone up 0.8% m/m in November, its 15th consecutive monthly rise, with all eight components positively contributing. The yield spread—one of the LEI's most forward-looking components—was a primary contributor to the increase. A good proxy for loan profitability, it suggests healthy loan and money supply growth should continue underpinning the expansion.

Meanwhile, broad M3 money supply has steadily risen for three years, remaining robust after the ECB first slowed the pace of bond purchases—"tapered" its quantitative easing (QE) program—in January 2017. Reducing QE last January eased some of the pressure on long rates, contributing to the yield curve's steepening—which we believe drove the acceleration in loan growth (Exhibit 13). We expect similar as the ECB again tapers its asset purchases this year, defying widespread fears to the contrary. As investors gradually realize the ECB isn't responsible for the continued expansion, we believe sentiment should improve, helping lift eurozone stocks.

Exhibit 13: Loan Growth is Rising and Money Supply Growth is Steady



Source: European Central Bank, as of 1/18/2018. January 2012 – December 2018.

THERESA MAY'S TENUOUS GRIP

May's struggles continued in Q4 despite the Phase One agreement, as Labour regularly outpolled the Conservatives. Further weakening her hand, she suffered a legislative defeat over amendments to the EU withdrawal bill and had to U-turn on plans to enshrine the Brexit date into UK law in order to avoid a second loss. An early-January cabinet reshuffle did little to shore up her position, especially with some high-profile MPs refusing ministerial posts. By month's end, after Chancellor Philip Hammond publicly advocated a soft Brexit with only "very modest" changes to the UK's relationship with the EU, the eurosceptic wing of the Conservative Party was threatening a leadership challenge.

To the casual observer, this might look like political instability. However, for markets, the upshot is political gridlock. Even if the Tories were united, May's minority government would prevent most radical legislation from passing. Internal divisions and Brexit distractions throw further sand in the gears. Although the infighting and inaction might be frustrating for voters, for markets, it means little risk to property rights and regulations. When businesses and investors can be reasonably confident that the rules won't change for the foreseeable future, they are generally less risk-averse—a positive force for markets.

^{xiii} Source: IHS Markit, as of 1/11/2018.

As Labour's poll numbers ascended, the financial community started considering the possibility of Jeremy Corbyn becoming PM, fearing markets could take a hit if a leftist government took power. We believe this is far too speculative. For one, the next general election isn't scheduled until 2022—anything could happen between then and now. A snap election is possible but impossible to forecast. Plus, as 2017's election showed, polls can change radically over the course of a campaign. Should a change in government become more likely, we will analyze the potential outcomes and market impact. Note, though, that eliminating political bias is critical when doing this. No politician or political party is inherently bad or good for markets, and UK shares have done well with governments at both ends of the political spectrum. Markets care about policies, not personalities, and it is too early to know which policies the next government will pursue, much less pass, regardless of who heads it.

THE REALITY OF BREXIT PHASE ONE

In early December, negotiators concluded the first round of Brexit talks, setting the stage for trade discussions to take center stage in 2018. Many hailed the agreement as a breakthrough, but in reality this simply removed most of the provisions, with much remaining unknown. The negotiation process remains glacial—part of the long-term structural backdrop, in our view, and not a cyclical driver of UK markets.

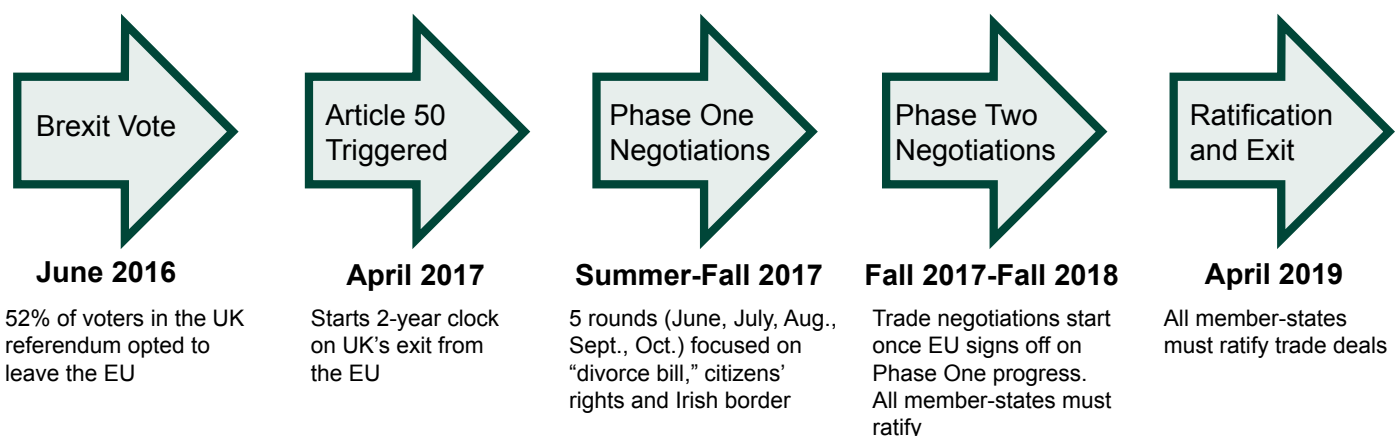
Exhibit 14 shows the Brexit timeline, presuming they stick to the two-year window stipulated in Article 50 of the EU Treaty. Phase One talks focused on citizens' rights, payment to settle the UK's previously agreed EU budget and pension commitments, the European Court of Justice's jurisdiction, and the Irish border. When announcing the Phase One breakthrough, politicians hailed it as a broad agreement. Yet a closer read shows they left much to be decided

later. For instance, headlines said the UK and EU agreed on a £39 billion "divorce bill," referring to how much the UK will contribute to the EU budget after Brexit. However, this figure comes from the UK government's "conservative" estimates of expected future payments, which the EU allowed them to use when presenting the agreement. EU officials believe the bill will be closer to £60 billion. The actual amount remains unknown, as it was before the alleged breakthrough.

Notably for markets, both sides seem determined to grind toward a Brexit in name only. Even Boris Johnson, an arch Brexit campaigner in 2016, advocates strong trade links between the UK and EU (including fanciful talk of a cross-Channel bridge). All involved remain in favor of a post-Brexit "transition period," which would phase Brexit in slowly after the official exit date. May publicly says she envisages a two-year transition, but we wouldn't be surprised if a longer period ultimately wins out. In late January, The Telegraph reported UK officials were discussing a three-year transition. And, for its part, EU leaders think the final accord might not take effect until 2025.

Equity markets generally look 3 – 30 months ahead, pricing in the likely reality during that span. Accounting for the transition period, Brexit is likely far outside that realm. Over the foreseeable future, which markets care most about, it looks increasingly likely that the rules of UK – EU commerce won't change much. Changes taking place afterward should be well-known long beforehand, giving markets ample time to adapt. There is very little room for sudden, sweeping change to take place the day after people discover it, and surprises are what move stocks most.

Exhibit 14: Brexit Timeline



ITALY'S ELECTION

Italy's election, scheduled for March 4th, continues making investors nervous. The anti-establishment Five-Star Movement (M5S) leads current polling, renewing last year's fears of populism splintering the euro. Whether or not M5S takes the most seats, we believe these fears are overwrought.

As Exhibit 15 shows, although M5S leads polls, the top three parties are polling similarly, making it unlikely one group pulls away. Moreover, recent changes to Italy's electoral laws removed the automatic majority awarded to any party that managed to win at least 40% of the vote. Instead, about 40% of parliamentary seats will be chosen on a "first-past-the-post" basis (i.e., "winner takes all") and proportional representation (via party list) decides the rest. Hence, a divided government looks like the most likely outcome.

Moreover, M5S has already walked back its earlier anti-euro rhetoric, calling a pledge to hold an "Italexit" referendum merely a negotiating ploy. They have also pledged to abide by the eurozone's deficit targets, placing very little daylight between their and mainstream parties' policies. Thus, even if they gain some seats, it isn't clear what their influence would actually be.

Exhibit 15: Italian Election Polling

Party	Polling on January 9
Five-Star Movement	28.1%
Democratic Party (Centre-Left)	20.7%
Forza Italia (Centre-Right)	18.0%
Northern League (Anti-EU Centre-Right)	12.6%
Free & Equal (Left)	6.7%
Brothers of Italy (Anti-EU Right)	5.3%
Others	8.6%

Source: Matrix, as of 26/1/2018.

JAPAN

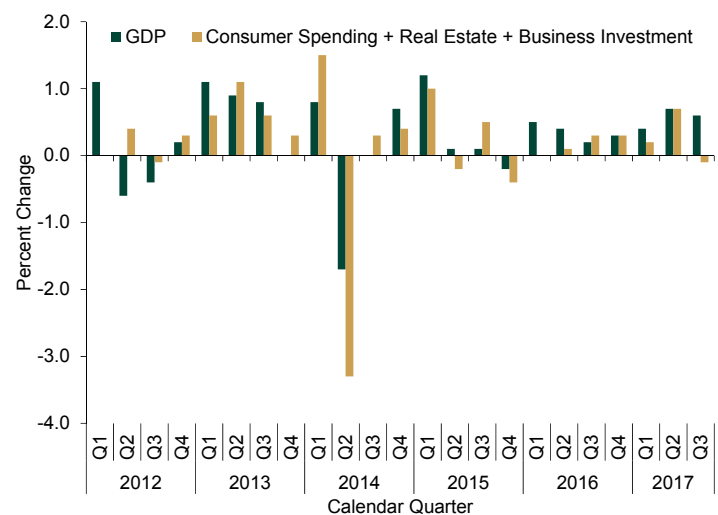
In Japan, Prime Minister Shinzo Abe's Liberal Democratic Party (LDP) emerged triumphant in snap parliamentary elections. The LDP and its coalition partner, Komeito, won a combined 312 seats, maintaining its supermajority. Despite some initial momentum for the opposition—in particular the upstart Party of Hope, led by popular Tokyo governor Yuriko Koike—voters opted for the status quo.

Later in the quarter, Japan and 10 other nations made headlines after agreeing in principle on a multilateral trade pact, known as

the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Similar to the Trans-Pacific Partnership that included the US, CPTPP would eliminate tariffs on industrial and farm products. Other provisions include regulating online commerce and intellectual property. While the deal is far from being finalized—some details need finalizing and all individual countries' governments must approve—it counters worries about global trade.

Exports continue driving Japanese expansion while domestic demand lags, which we think speaks to better conditions elsewhere. November export values rose 16.2% y/y, accelerating from October's 14.0%.^{xiv} Import values were up 18.9%, slowing slightly from October's 19.2%, which was its fastest growth rate in four years.^{xv} However, trade gains were largely due to currency translation. In volume terms, November exports rose 5.5% y/y and imports rose just 2.6%—one way to see Japanese domestic demand remains unexceptional.^{xvi} Other figures confirm this as pure private sector growth (the sum of private consumption, business investment and real estate investment) was negative (Exhibit 16).

Exhibit 16: GDP and Its Private Sector Components



Source: Japan Cabinet Office, as of 1/18/2017. Q1 2012 – Q3 2017.

^{xiv} Japan Customs, as of 12/19/2018

^{xv} Ibid.

^{xvi} Ibid.

More recent data suggest consumer spending remained weak in Q4. November retail sales rose 1.9% m/m, rebounding from October's -0.1% dip, but year-over-year, the series mostly hovered around 2% in 2017.^{xvii} The same holds for broader household spending, of which retail is only a slice. November consumption expenditures rose 1.7% y/y, up from October's -0.3% decline, but that was just its third month since April 2016 in positive territory.^{xviii}

Absent major structural reform, robust growth isn't likely. We don't see Prime Minister Shinzō Abe's October snap election victory as much of a game changer on that front. Abe's government has repeatedly shied away from major overhauls to Japan's labor markets or other deep-seated issues. Even low-hanging fruit like corporate tax cuts—first mooted years ago—remains slow-going. The latest proposal, passed by the cabinet in late December, would cut tax rates from 30% to around 20%, but only for firms that raise wages by 3% and ramp up domestic investment. And the measure would last only three years. Status quo economic policies that leave Japan's

growth moribund should continue, especially if Abe spends his political capital on rewriting Article 9 of Japan's Constitution—which currently forfeits the sovereign right of belligerency—as this remains his government's top priority.

On the monetary policy side, the Bank of Japan has trimmed its asset purchases since August 2016, helping loan growth improve earlier in 2017, but QE remains a headwind. December Japanese loan growth slowed to 2.5% y/y, continuing the deceleration from July's 3.4% peak growth rate.^{xix} Japan's flattest-among-G7 nations' yield curve continues hampering lending and holding back economic growth. While Japan's biggest Tech firms likely benefit from the upturn in global growth, domestically focused firms likely face a tougher road.

Overall, Japan's situation has not materially changed, so how sentiment develops is worth monitoring. If sentiment continues falling, mediocre results could easily exceed expectations—setting up potential upside risk. However, sentiment has perked up some in recent weeks, so we will be watching the evolution closely.

^{xvii} Ministry of Economy, Trade and Industry, as of 1/12/2018.

^{xviii} Ministry of Internal Affairs and Communications, as of 1/12/2018.

^{xix} Bank of Japan, as of 1/12/2018.



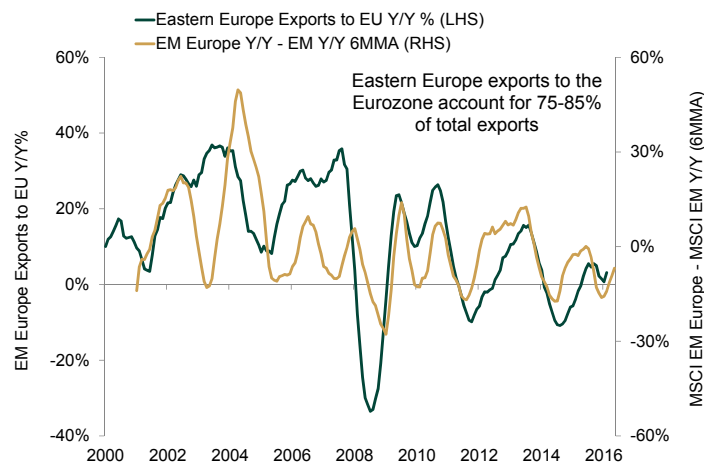
EMERGING MARKETS COMMENTARY

EMERGING MARKETS COMMENTARY

EASTERN EUROPE'S BENEFITS OF PROXIMITY

Emerging Eastern Europe excluding Russia—Poland, Hungary and the Czech Republic—continues to see strong economic growth tied to their proximity to the eurozone's ongoing expansion (Exhibit 17). Throughout 2017, these countries experienced consistently strong growth amid the eurozone's highest GDP growth rate in 10 years.

Exhibit 17: EM Europe is Heavily Linked to Developed Europe Demand Growth



Source: FactSet, as of 2/9/2018.

Politically, the region has seen a rise in nationalism. The Czech Republic just concluded its presidential elections which saw the populist incumbent emerge victorious. Meanwhile, Hungary will hold parliamentary elections later this year, with the populist leaning incumbent party holding a comfortable lead in the polls. In Poland, the populist Law and Justice party (PiS) recently challenged the Judiciary's independence. Poland in particular has been the most combative with the European Commission as the PiS party asserts its domestic agenda despite pushback from Brussels.

However, unlike developed Europe's upstart populist parties that spooked investors in 2017, these parties have governed for at least several years—a period which has seen increased integration with the EU and the benefits thereof. As such, we expect the strong economic linkages between developed and emerging Europe to prevail over political rhetoric.

xx Source: The Bank of Korea, as of 1/26/2018.

xxi Ibid.

xxii Ibid.

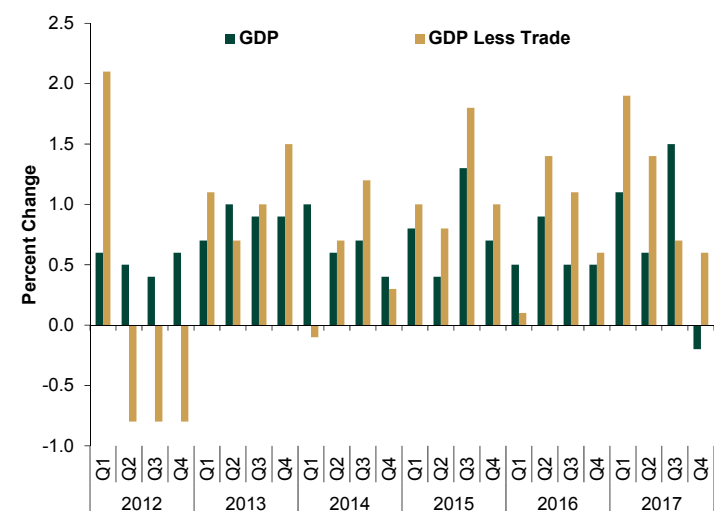
xxiii Ibid.

SOUTH KOREA: UNDERLYING GROWTH TRENDS INTACT

While tensions with North Korea and what seems like a one-off dip in South Korean GDP drew headlines, data actually reveal the economy's underlying strength. Strong export growth led South Korean GDP to rise 1.5% q/q in Q3, but this reversed last quarter (Exhibit 18). That—plus an irregular 10-day autumn holiday—caused Q4 GDP to contract -0.2%.^{xx}

For the year, Korea grew 3.1%, accelerating from 2016's 2.8%. Despite all the saber-rattling from North Korea, South Korea continues benefiting from global Tech demand and its flourishing trade linkages with the rest of Asia and the world.

Exhibit 18: Solid Ex. Trade Growth



Source: The Bank of Korea, as of 1/25/2018.

INDIA: GROWTH REACCELERATES

Economic impacts on India from late 2016's demonetization and last July's goods and services tax (GST) appear to be waning. Private consumption grew, while government spending growth slowed—expected given the government's stated goal of meeting deficit targets.^{xxi}

On a sector basis, growth was uniform. India's largest economic sector—financial and business services—rose 5.7% y/y.^{xxii} Meanwhile, trade, hotel, transport & communication services rose 9.9% y/y, utilities 7.6% and manufacturing 7.0%.^{xxiii}

From industrial production to trade, monthly data suggest growth continued into Q4. October and November industrial production rose 8.4% y/y and 2.0% y/y, respectively. December's manufacturing PMI rose 2.1 points to 54.7, while the services PMI rose 2.4 points to 50.9. Both are above 50, indicating expansion. Although services struggled in 2017's second half, three of the last four months were above 50, suggesting the worst is probably behind.

Forward-looking indicators suggest growth should persist. Loan growth accelerated from 6.9% y/y at Q4's start to 9.8% in the two weeks to December 22 (and 11.1% through January 5).^{xxiv} India's ₹2.1 trillion (\$33 billion) state bank recapitalization in October—its largest ever—seems to have provided a shot in the arm for state lenders saddled with non-performing loans. This, along with the Reserve Bank of India's orders to resolve them, should help clear uncertainty and boost lending.

Money supply is growing^{xxv} and finding its way to India's households and businesses, which are spending and investing despite perceived disruptions from major economic reforms. A stronger underlying reality than widely appreciated is a bullish positive for Indian stocks, in our view.

MEXICAN ELECTION IN FOCUS MIDYEAR

Political uncertainty from Mexico's July 1 general election is running high, weighing on sentiment, but markets should benefit from increased clarity as the results and next president's relative clout become more evident. Three-time leftist candidate Andrés Manuel López Obrador (AMLO, as he is commonly known) currently leads polls, and many fear he will enact anti-market policies—torpedoing NAFTA and repealing landmark energy reform—if he reaches office. However, reality is likely to prove less painful than the rhetoric.

Although current NAFTA negotiators are trying to reach a deal before Mexico's elections, AMLO is vying to delay talks for a seat at the table and a hand at reworking the trade pact. Most see him as anti-free trade and—much like how President Donald Trump campaigned—he promises to get the best deal for the Mexican people. We can't say whether or when NAFTA will be renegotiated—or if AMLO will have

a say in its outcome—but politicians have a tendency to moderate on trade once in office. Indeed, Graciela Marquez—AMLO's NAFTA Chief—recently explained they “support the continuation of NAFTA ... It's very important for the well-being of Mexicans.”^{xxvi} Moreover, AMLO has also walked back his hardline position against energy reform, which has increased foreign investment in—and the competitiveness of—Mexico's oil sector. When presenting his party's—the National Regeneration Movement's (MORENA's)—2018 platform, he promised to uphold existing contracts and only proposed reforms to ensure existing goals are met.

While recent polls have AMLO as the favorite, his victory is not a foregone conclusion and the race is still too early to handicap. Some polls put center-right National Action Party (PAN) candidate Ricardo Anaya Cortés either ahead or a close second as of December. A January poll suggests AMLO's lead is now around 32% versus Anaya's 26%, and the incumbent Institutional Revolutionary Party's (PRI's) presumptive nominee, Jose Antonio Meade, trailing at 16%.^{xxvii} But with 20% undecided, AMLO isn't unassailable. Markets should gain more clarity as elections approach, but for now uncertainty clouds the outlook.

In addition to the presidency, the entire federal Senate and Chamber of Deputies is up for grabs July 1.^{xxviii} Currently, Mexico's entrenched traditional parties, PRI and PAN, hold 92 out of 128 Senate seats. MORENA has none, although its Labor Party (PT) coalition partner has 15. In the 500 seat lower house, PRI and PAN hold a combined 315, while MORENA and its coalition partners have 58. MORENA could boost their representation, but it would take a landmark shift to swing all bodies of government in MORENA—and AMLO's—favor. Absent that, it is likely AMLO would face gridlock if he wins, preventing sweeping reform.

As investors gain more clarity on both NAFTA talks and the election this year, the decline in overall uncertainty should be a tailwind to equities. Fears over both the candidates and NAFTA talks seem to exceed reality by quite a distance, allowing significant room for positive surprise.

^{xxiv} Source: Reserve Bank of India, as of 1/23/2018.

^{xxv} *Ibid.*

^{xxvi} “Lopez Obrador's Nafta Chief Intends to Keep Mexico in Agreement,” Eric Martin, Bloomberg, 2/1/2018. <https://www.bloomberg.com/news/articles/2018-02-01/lopez-obrador-s-nafta-chief-intends-to-keep-mexico-in-agreement>

^{xxvii} “Mexico Presidency Race Tightens; Leftist Stays out Front: Poll,” Staff, Reuters, 1/29/2018. <https://www.reuters.com/article/us-mexico-election/mexico-presidency-race-tightens-leftist-stays-out-front-poll-idUSKBN1F11MQ>

^{xxviii} Source: Wilson Center, as of 2/5/2018. The Mexico Institute's 2018 Elections Guide Electoral Map. <https://mexicoelectionsblog.weebly.com/electoral-map.html>

CHINA: GROWTH STEADY

The quarter began as China wrapped up its 19th Party Congress, with President Xi Jinping consolidating his hold on power. Many China experts noted Xi seemingly positioned himself to wield power beyond his second term in office—a shift in the post-Mao era, and one with potential long-term political ramifications. However, Xi's consolidation of power should not radically alter the status quo for the foreseeable future—the timeframe markets care about most. While promising more free-market reform, the government's primary focus continues to be social stability above all else. Therefore big, radical changes are unlikely.

After the Congress, China's government announced it would remove foreign ownership caps on Chinese banks and financial asset management companies. Before, foreign companies couldn't own more than 20% of a Chinese financial institution (and foreign ownership of total holdings couldn't exceed 25%). Granted, the government isn't completely relinquishing control: Any foreign entity seeking more than a 5% stake in a bank will require the China Banking Regulatory Commission's approval. However, beyond some potential positive developments (e.g., Chinese banks improving their capital allocation), the more immediate impact may be on sentiment. Many experts worried President Xi Jinping would increase the government's influence in specific sectors following the Party Congress. While developments could always change, this move runs counter to those expectations.

Chinese economic data remained steady at year-end and once again proved hard-landing fears hollow. Q4 GDP rose 6.8% y/y, matching Q3's pace and bringing full-year growth to 6.9%—accelerating from 2016's 6.7%.^{xxix} This was its first annual acceleration in seven years and above the government's 6.5% growth target.

Although monthly data released during Q4 were somewhat mixed, the overall picture remains generally solid. December's official purchasing managers' indexes (PMIs)—which include large, state-owned enterprises—stayed above 50, indicating more surveyed firms expanded than contracted.^{xxx} PMIs indicate only growth's

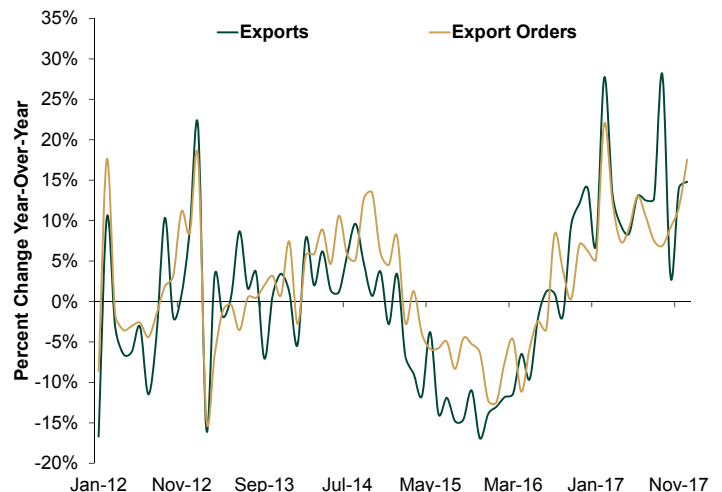
breadth—not its magnitude—but China's stats remain consistent with their longer-term trend of slower but steady expansion, far from the common expectation of an economic hard landing.

TAIWAN: TRADE POWERS GROWTH

Trade also continues fueling Taiwanese GDP, which grew 1.0% q/q (3.3% y/y) in Q4.^{xxxi} As in Q3, the primary positive contributors were private consumption, which rose 2.9% y/y, and exports, up 6.0% y/y (Exhibit 19).^{xxxii} Meanwhile, gross fixed capital formation fell for the second consecutive quarter, slipping -4.8% y/y.^{xxxiii} While a more detailed breakdown isn't available to show whether the decline spanned the public and private sectors, commentary from Taiwan's statistics bureau pinned it on a drop in machinery and equipment investment. As always, it is too soon to know whether the double dip is a hiccup or the start of a deeper investment pullback, particularly without a seasonally adjusted quarterly breakdown of GDP's components.

While Taiwan experiences positive growth, its market is heavily weighted toward commoditized Technology firms and less leveraged to mobile and cloud computing, which we currently favor.

Exhibit 19: Strong Export and Export Orders Growth



Source: Ministry of Economic Affairs, Republic of China (Taiwan), as of 1/26/2018.

^{xxix} Source: National Bureau of Statistics of China, as of 1/19/2018.

^{xxx} Ibid.

^{xxxi} Source: Directorate General of Budget, Accounting and Statistics, as of 2/1/2018.

^{xxxii} Ibid.

^{xxxiii} Ibid.

GREECE: A BULLISH SIGNAL FOR EMERGING EUROPE

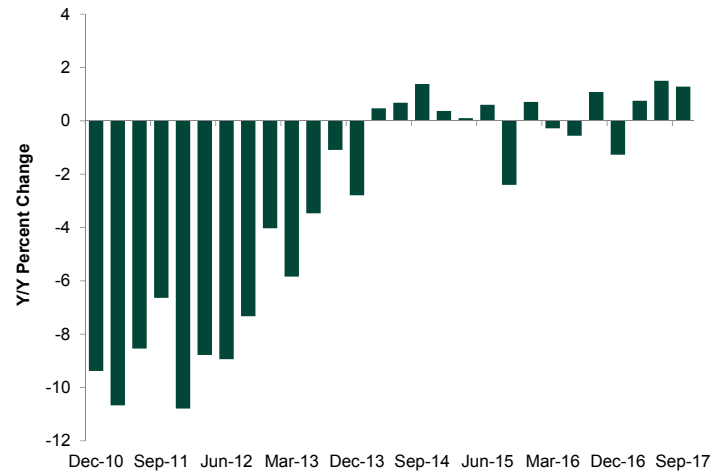
Positive developments in Greece, one of the world's most troubled economies in recent years, show the breadth of the present expansion. Investors now appreciating these developments more also shows improved sentiment, which bodes well for Emerging Europe beyond Greek borders.

For the vast majority of this bull market, the Greek economy has been troubled. In late 2009, Greece unveiled deficits far in excess of prior reports, the first step in a debt crisis that led to three bailouts, two defaults and a catastrophic recession. Between 2010 and 2016, a period of continuous global GDP growth, Greek annual GDP shrank a massive 23%.^{xxxiv} Negotiations over bailouts and associated austerity measures between Greek and EU officials have often been fraught, leading many to fear a “Grexit”—the Hellenic Republic crashing out of the eurozone. However, Greece's situation started to improve last year: The economy is growing, politics have stabilized and foreign capital is returning. Athens now appears on track with its bailout requirements. While these improvements are nascent, Greece's progress symbolizes how far the eurozone has come since its crisis—and how sentiment toward Europe broadly has evolved.

Last July, Greece returned to the international bond market for the first time since 2013—a major sign of improvement. This comes only two years after the country was in near-total disarray. Firebrand Alexis Tsipras and his far-left upstart Syriza party stormed into Parliament in 2015, ignored prior reform commitments and nearly took Greece out of the eurozone by calling a referendum on the third bailout. Though the bailout ultimately went through, there was plenty of drama: Greek leaders adopted capital controls, voters rejected the aid package due to its tough conditions, and Prime Minister Tsipras ended up making major concessions to reach a deal.

Since that turbulent time, Greece's situation has brightened. For one, the economy seems to be recovering, as GDP has grown in four of the past five quarters. (Exhibit 20)

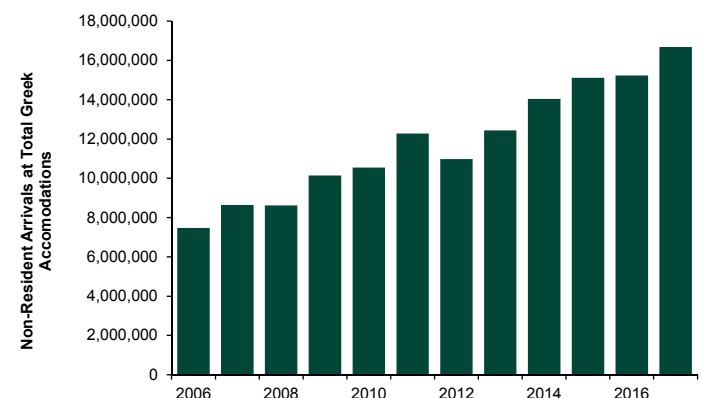
Exhibit 20: Greece's GDP Shows Steady Improvement



Source: FactSet, as of 1/18/2018. Greek GDP, year-over-year percent change, from 12/31/2010 – 9/30/2017.

Industrial production has risen 14 straight months through November 2017.^{xxxv} The manufacturing subsector has been growing, too, and IHS Markit's Greece Manufacturing December PMI showed new orders enjoyed their sharpest rise in more than nine-and-a-half years—a positive sign for growth in early 2018.^{xxxvi} Tourism, an important driver of the Greek economy, picked up in 2017, too. The Accommodation and Food Service Activities Sector, which covers groups like hotels and holiday and short-stay accommodation, rose 13.9% y/y in Q3 2017—accelerating from Q2's 7.2% and massively improving from Q1's 0.9%.^{xxxvii} Exhibit 21 compares total non-resident arrivals at Greek accommodations through each year's first 10 months.

Exhibit 21: Non-Resident Arrivals at Greek Accommodations



Source: Eurostat, as of 1/26/2018. Cumulative visitors through October of each year, 2006 – 2017.

^{xxxiv} Source: FactSet, as of 1/26/2018. Greek annual GDP, 2010 – 2016.

^{xxxv} Ibid.

^{xxxvi} IHS Markit, as of 1/26/2018.

^{xxxvii} Source: Hellenic Statistical Authority, as of 1/28/2018.

Furthermore, chronically high Greek unemployment has been trending downward, with the unemployment rate down from 21.1% in Q2 2017 to 20.2% in Q3 2017.^{xxxviii} Though backward-looking, steady jobs improvement confirms the ongoing economic recovery.

In the political realm, Tsipras has held onto power—an unlikely source of stability who has pushed through some needed reforms. Investors have taken notice. Last November, the Treasury held a successful €30 billion voluntary debt swap—an exchange of higher yielding bonds (e.g., ~20%) for lower yielding bonds (e.g., 3.5 – 4.2%). This cheaper financing relieves some immediate pressure on Greece, and it indicates investors are much more confident about Greece’s creditworthiness. 10-year Greek yields have been falling overall since Greek markets reopened in August 2015 following a five-week closure due to bailout talks (Exhibit 22).

Exhibit 22: Greek 10-Year Yields Since 2015 Political Turmoil



Source: FactSet, as of 1/18/2018. Greek 10-Year Yield, 8/3/2015 – 1/11/2018.

Another example of Greece’s overall progress: an increase in privatizations. One of creditors’ primary bailout conditions was for Greece to privatize state-owned property and assets. From 2011 – 2015, the Hellenic Republic Asset Development Fund (HRADF) privatized only about €3.5 billion worth of assets. But in 2016 and 2017, the Hellenic Corporation of Assets and Participations (HCAP, HRADF’s successor) started making big deals, selling off stakes in major ports and leasing out regional airports. In 2017 alone, Greece privatized about €2 billion worth of assets. HCAP has set its sights higher in 2018, seeking to raise at least €3.5 billion. The more the Greek economy recovers, the better price HCAP can fetch for valuable assets.

BAILING FROM THE BAILOUT

In January, eurozone creditors tentatively signed off on Greece’s latest spate of reforms, which included some controversial labor changes—like making it more difficult for workers to strike. Greece is now set to receive its next bailout tranche in February. Barring any unforeseen changes, the country also looks poised to exit its bailout program in August. Currently, creditors are debating the appropriate way to monitor Greece once their direct oversight ends. There are also questions of whether Greece will have enough cash on hand to service its debt and what debt relief (if provided) could look like. However, those longer-term issues aren’t causing investors angst like they used to—a sign of sentiment’s progress.

While Greece’s general prospects look brighter, this doesn’t mean it is time to overweight Greek stocks. Though Greek price-to-earnings (P/E) ratios are low relative to other stocks, valuations aren’t predictive. If they were, Greek stocks should be outperforming massively since 2011. Yet consider: From 2011 to today, Greek stocks are down -82.6%, while Emerging Markets returned 30.1%.^{xxxix} Moreover, Greek markets skew toward Financials, which still face problems like heavy government involvement and record levels of bad loans. So even though Greece is slowly emerging from the abyss, better investment opportunities likely exist in other Emerging Markets.

^{xxxviii} *Ibid.*

^{xxxix} Source: FactSet, as of 1/26/2018. MSCI Greece with net dividends in US dollars and MSCI Emerging Markets Index with net dividends in US dollars, 12/31/2010 – 1/25/2018.

SOUTH AFRICA

President Jacob Zuma remains in the spotlight as investors keep a lookout for his removal from office well before his term ends in 2019. He has lost significant clout within the African National Congress (ANC). Rumors swirl of Zuma's impending departure, and ANC leadership agreed he should step down ahead of February 8's State of the Nation Address, but Zuma remains quiet on his plans. His struggles have weighed on South African stocks' relative returns for over 18 months. He has survived numerous calls for his resignation, including seven no-confidence motions, making it far from guaranteed that the next motion, scheduled for February 22, will bring the end of his presidency.

Yet many believe the mood is different now, making his early removal more likely. Ramaphosa won the ANC leadership contest by running on an anti-corruption platform, and he has already begun taking steps to shore up party support ahead of 2019's elections. His anti-corruption drive has already shaken up the board and management of Eskom, the state-power utility, as he removed any executives currently facing allegations of serious corruption. Ramaphosa's supporters see removing Zuma as critical to attracting voters in 2019. That could inspire more ANC lawmakers to side with the opposition Economic

Freedom Fighters, which called the no-confidence motion. That said, Zuma's ability to overcome long political odds is remarkable, and he still has plenty of staunch supporters within the ANC.

Many worry about violence and unrest if he is removed early, as some factions supporting him have warned this could lead to civil war, raising the spectre of Kenyan violence in 2007. Yet to us, this seems premature. South Africa has relatively strong political institutions, and Zuma is nowhere near as popular with voters as Raila Odinga was in Kenya a decade ago (and remains today). His approval rating hit an all-time-low 18% in September 2017. While threatening violence might work as a negotiating tactic, ultimately, there is no reason a carefully managed transition should incite bloodshed.

Ultimately, a resolution to this saga could boost sentiment toward South African stocks, particularly if Ramaphosa makes continued progress on addressing corruption. It is possible South African stocks could greet Zuma's removal much as Brazilian stocks cheered the impeachment and removal of Dilma Rousseff and South Korean stocks welcomed the early departure of Park Geun-hye. However, we think acting on these hopes is premature at this point, given Zuma's apparent resistance to removal. If and when he is removed, there should be sufficient time to assess all of South Africa's drivers—economic and sentiment as well as political—as well as the influence of global commodity prices, which remain key to South Africa's economic fortunes.

Should you have any questions about any of the information in the Fourth Quarter 2017 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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