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INSTITUTIONAL GROUP

SECOND QUARTER 2018

MARKET PERSPECTIVES

SECOND QUARTER 2018 REVIEW AND OUTLOOK
MARKET PERSPECTIVES

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Investment in securities involves the risk of loss. Past performance is no guarantee of future returns. Other methods may produce different results, and the results for individual portfolios and for different periods may vary depending on market conditions and the composition of the portfolio.

SECOND QUARTER 2018 REVIEW AND OUTLOOK

EXECUTIVE SUMMARY

Portfolio Themes

- **Quality Tilt:** As the bull market progresses, 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—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.”
- **Overweight to Health Care:** Health Care should benefit from increasing investor preferences for larger, higher quality companies with long term growth prospects. Within the sector, larger Pharmaceutical firms are offsetting key patent expirations through pipeline development, M&A, licensing and rapid Emerging Markets growth.

Market Outlook

- **Growing Investor Confidence:** Investor optimism typically increases as a bull market matures. Recent correction angst notwithstanding, 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 outperform for the remainder of 2018.

The MSCI All Country World Index finished the second quarter up slightlyⁱ amid evolving fears. Concerns over rising yields, tariffs, slower economic growth and politics took turns starring in headlines as this correction's alleged cause. Fluctuating fear is a classic correction trait, as investors anxious about volatility seek to justify drops and rationalize taking action. In a bear market, the opposite occurs where investors cling to positives and dismiss reasons more downside awaits. This sentiment backdrop, combined with underappreciated positive political and economic drivers, suggests that a bear market isn't likely. Where equities go immediately from here is difficult to predict, but we continue to believe the bull market should eventually resume with intensity, delivering strong returns.

At the end of Q2, headlines returned to tariffs as a threat to equities. While tariffs are generally bad, we believe those discussed to date lack the size and surprise to derail global growth. President Trump has recently approved tariffs on approximately \$85 billion in imported goods, and his administration is investigating \$408 billion more.

With tariff rates ranging from 10% to 25%, the maximum annual impact if Trump enacts all tariffs currently under investigation would be \$81.5 billion—approximately 0.4% of the US's \$19.4 trillion GDP.ⁱⁱ (On July 20, President Trump threatened tariffs on \$500 billion in Chinese goods. Yet that isn't under investigation and would encompass virtually all Chinese imports – putting the statement in conflict with earlier announcements.) However, this is an unlikely scenario. Unilateral tariffs are easy for exporters to avoid because brokers can reroute goods through third-party nations for a small fee. Hence their impact is likely small. Additionally, the tariffs could also be the president's way of rallying his supporters before the US midterm elections—threats he can walk back, perhaps after “winning” apparent concessions from trading partners. It seems this may already be underway after Trump and European Commission President Jean-Claude Juncker emerged from late July talks with promises to dial down tensions and lower trade barriers between the two.

ⁱ Source FactSet, as of 07/02/2018. MSCI All Country World Index return with net dividends, 03/31/2018 – 06/29/2018.

ⁱⁱ Source: Office of US Trade Representative, White House and US Bureau of Economic Analysis, as of 06/28/2018.

Amid concerns about tariffs, some investors disregard a strong global economy. GDP grew in Q1 in the US, UK and eurozone. US loan growth has accelerated, funneling more capital to businesses and households to spend and invest. Business surveys in the US, Britain and the eurozone show output and new business are rising. While rising slightly, inflation and inflation expectations remain moderate, extending a Goldilocks-style economy globally. The European Central Bank announced plans to end quantitative easing (QE), an unheralded positive that should spur loan growth. If markets were zooming, we suspect pundits would cheer an echo of the mid-to-late 1990s, when stocks enjoyed years of solid returns before Tech Bubble euphoria took hold. However, in our opinion, sideways volatile markets and fearful headlines blind some investors, creating room for positive surprise—bullish.

Global politics also remain favorable, with gridlock entrenched throughout the developed world. Despite high-profile political turnover in Spain and Italy, which we will discuss in the Global Developed ex-US Commentary section, these countries still have a minority government and weak coalition, respectively—a climate for inaction. German Chancellor Angela Merkel's coalition is unstable, as is UK Prime Minister Theresa May's minority government. The twin issues of Brexit and migration monopolize politicians' attention on both sides of the English Channel, crowding out major legislation. About the only significant measure passed in Q2 was Britain's bill to add a third runway at Heathrow airport. Overall, legislative risk seems low.

Meanwhile, US politicians are preoccupied with midterm campaigning. Though Supreme Court Justice Anthony Kennedy's pending retirement could add fuel to already hot campaign rhetoric, we expect the election's outcome to prove duller than today's sensational headlines suggest. In short, whether we end up with a small Democratic majority, small Republican majority or split Congress, gridlock should prevail. This should usher in the US political cycle's sweet spot: the 87% Miracle. As we will detail in the US Commentary section, US equities have historically been positive 87% of the time in each of the three post-midterm quarters which is well above the average quarter.ⁱⁱⁱ The tailwinds of gridlock and falling uncertainty are powerful.

In Emerging Markets, mainland Chinese stocks tumbled as Trump's harsh new tariff threats alarmed investors. Consistent with our view for the US, we don't believe the impact of proposed tariffs is large enough to spark an actual hard landing in the second largest global economy.^{iv} Not only would the actual tariff payments amount to a sliver of annual GDP if enacted, but also we believe they are easily avoidable. For example, consider the tariff on US soybean imports. It is highly unlikely Chinese importers end up paying this, as they can easily buy from other nations, like Brazil, where tariffs don't apply.

Furthermore, with recent strength of the US dollar driving volatility in some EM currencies, higher oil prices and US 10-year treasury yields close to 3%, concerns around emerging markets have been reignited. Though some countries, like Turkey, face challenges specific to their underlying markets, we don't believe the structural conditions of EM as a whole suggest a broader contagion effect. Still-strong economic fundamentals coupled with cooler investor sentiment suggest EM countries probably don't face significant downside from here as broad global growth continues pulling along most EM economies, defying fears of a slowdown.

We still believe global equities should have a strong year. Returns during US midterm-year Q3s are more variable, and we believe volatility will persist before the 87% Miracle starts. Crucially, however, we don't believe this is a bear market. As we will discuss more in the US Commentary section, we continue scouring for reasons we could be wrong—surprising, fundamental negatives with the power to erase a few trillion from global GDP and turn this correction into a bear market. We currently don't see any. Rather, we believe fundamentals favor a strong second half and beyond.

ⁱⁱⁱ Source: Global Financial Data, Inc., as of 06/15/2018. S&P 500 Index total return, 12/31/1925 – 03/31/2018.

^{iv} Source: IMF, based on nominal gross domestic product, as of 04/30/2018.

GLOBAL UPDATE AND MARKET OUTLOOK

Q2 RECAP

Global equities had a volatile first half of 2018, ending June down -0.4% for the year (Exhibit 1).^v Myriad fears, including eurozone political uncertainty and interest rates, rotated through headlines. As June gave way to July, investors fixated on trade tariffs, with most expecting weak returns ahead. In our view, this speaks to a growing gap between our sentiment and positive fundamentals. We believe this—plus the bullish force of US midterm elections and false eurozone political fears—sets the stage for a strong second half.

Although investors are wary of the headline events that persistently arise, we believe the bull market's drivers remain intact. Global economic expansion continues, powering strong corporate earnings growth. With the European Central Bank (ECB) unveiling a planned end to its QE program and the Fed gradually reducing its balance sheet, monetary policy is getting saner. Most major governments are gridlocked, decreasing the likelihood of sweeping new laws equities typically dislike.

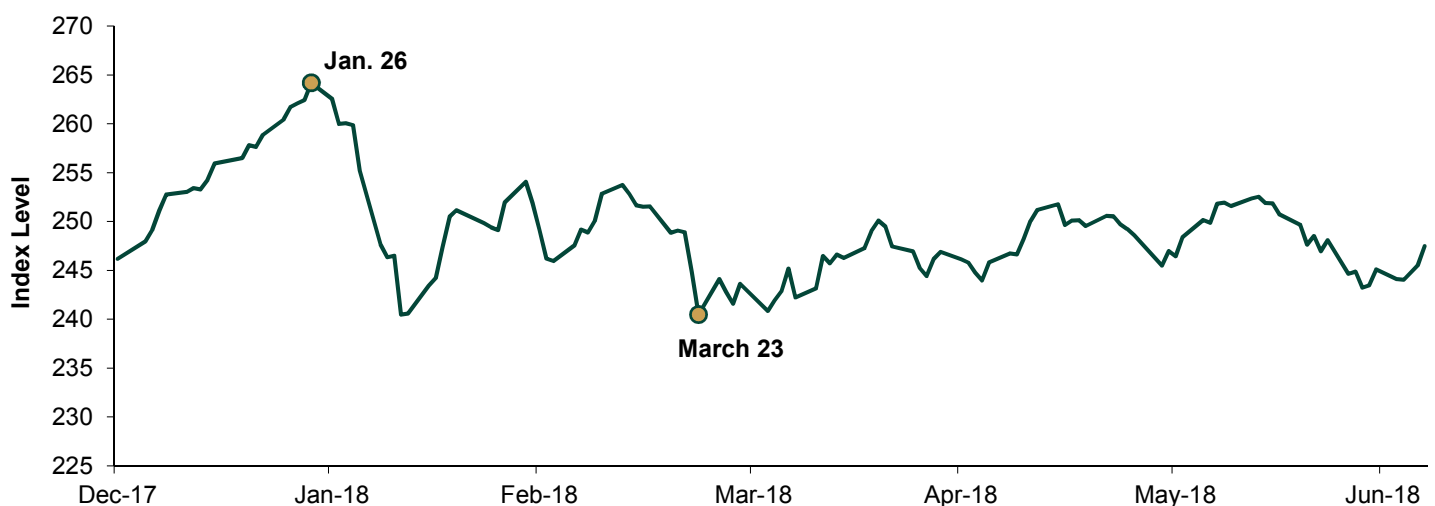
QUARTERLY UPDATE ON THE PEAK

We still believe 2018's pullback is a correction—not a bear market. Global equities finished Q2 -7.2% below the January 26 peak, putting two of our bear market rules in focus: the three-month rule and the

2% rule.^{vi} According to our three-month rule, we won't shift to a more defensive strategy until at least three months after a peak. The 2% rule is more about identification: Bear markets typically average roughly -2% monthly declines from peak to trough—a gradual grind. If the drop is fast and sharp, it is most likely a correction. Presently, equities are more than three months from their peak. But these rules aren't triggers. They are meant to instill discipline to prevent short-term volatility from deceiving us. They also provide time to research whether a fundamental negative driver sufficient to create a bear exists.

This correction was typical on the downside, characterized by its quick plunge from late January through early February. After a short recovery, volatility resumed, with equities hitting a second bottom on March 23. However, rather than bouncing quickly, they have been grinding higher in fits and starts. Yet this isn't abnormal. Double-bottom corrections can take longer to rebound—especially with a constant fear-morph weighing on sentiment. While no two corrections are identical, this one resembles 2010's April 15 – July 1 correction, which double-bottomed and endured a grind before jumping higher (Exhibit 2 on the next page). Corrections' ends are as unpredictable as their beginnings. As uncomfortable as they are, we believe discipline will reward investors when the bull resumes its charge.

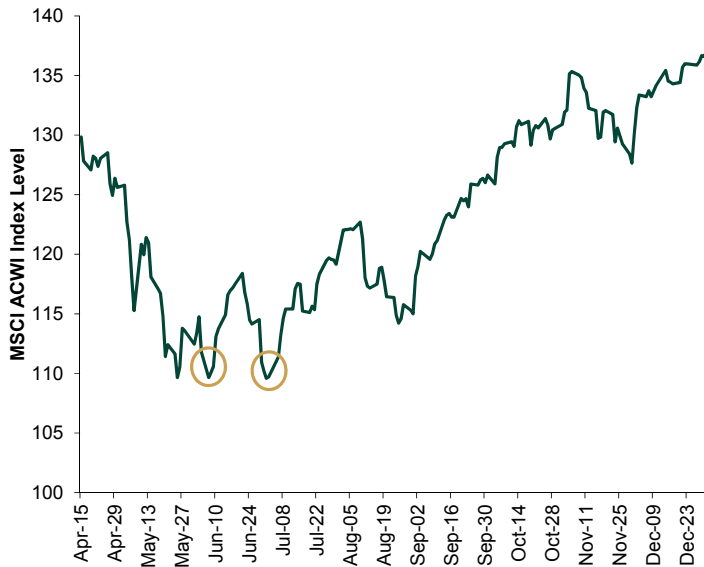
Exhibit 1: Global Equities' Volatile Six Months



Source: FactSet, as of 07/16/2018. MSCI ACWI Index with net dividends, 12/31/2017 – 06/30/2018.

^v Source: MSCI ACWI Index return with net dividends, 12/31/2017 – 06/30/2018.

^{vi} Source: MSCI ACWI Index return with net dividends, 01/26/2017 – 06/30/2018.

Exhibit 2: This Year's Correction Resembles that of 2010

Source: FactSet, as of 07/17/2018. MSCI ACWI Index with net dividends, 04/15/2010 – 12/31/2010.

SCALING PRESIDENT TRUMP'S TARIFFS

The trade tariffs dominated financial media and investor sentiment throughout Q2, with fear (and market volatility) spiking as President Trump's spats with China and the EU escalated at June's end. Yet most of the hype rested on media playing fast and loose with language, describing tariffs on \$50 billion in goods as "\$50 billion in tariffs." Once you scale them and consider how benign unilateral tariffs typically are, the potential impact becomes far less significant than advertised.

UPDATES ON PRESIDENT TRUMP'S NEW TARIFFS

While protectionism was featured heavily in President Trump's campaign rhetoric, he didn't launch tariffs immediately upon taking office. He started slowly, opening investigations into potential tariffs on washing machines and solar panels in summer 2016. The first concrete proposal, in September 2017, was a 300% tariff on Canadian-made jetliners—effectively targeting Bombardier. The US International Trade Commission rejected the proposal, making November 2017's 21% tariff on Canadian softwood lumber the Trump administration's first official action. Tariffs on washing machines and solar panels followed in February, with steel and aluminum tariffs arriving in March. South Korea, Australia, Brazil and Argentina

attained permanent reprieves, but the EU, Canada and Mexico's grace period ran out in June, prompting all three to retaliate. Meanwhile, the White House announced multiple rounds of tariffs on Chinese imports, with China retaliating at each step, and threatened tariffs on imported autos—a measure seemingly aimed at Germany.

On July 6, the first round of Chinese tariffs (and counter-tariffs) took effect. While the Trump administration initially billed these as tariffs on \$50 billion worth of goods, they eventually split it in two tranches. The first, targeting \$34 billion worth of goods, is now in force. The second is forthcoming, pending further review, and will likely target \$16 billion worth of high-tech imports if it takes effect. The administration has threatened tariffs on an additional \$200 billion worth of Chinese imports, but these are only in the exploratory stage.

Exhibit 3 on the next page compiles all tariffs announced, enacted or threatened thus far, along with an estimate of the maximum payment. Exhibit 4 on the next page illustrates the total in dollars and as a percentage of global GDP. (Note, it excludes some high-profile events that occurred just before we went to press. For instance, President Trump has recently discussed slapping a 10% tariff on \$500 billion of Chinese goods imports. This isn't included in Exhibit 4, as it isn't presently under investigation. Moreover, the US imported a total of \$505 billion from China in 2017—it isn't clear how this 10% tax would relate to the other tariffs announced.)^{vii} Additionally, as July neared its end, President Trump met with European Commission President Jean-Claude Juncker to discuss a new trade agreement, with the EU delegation and White House reportedly agreeing to reduce "industrial tariffs" on both sides, according to a Wall Street Journal report published just before this commentary was finalized.^{viii} This would forestall auto tariffs and roll back the steel and aluminum tariffs on the EU. But, since this isn't concrete, we have kept them in our analysis.

For something to wallop a bull market when economic and political fundamentals seem otherwise fine, it must be capable of knocking a few trillion dollars off of global GDP. This is the amount necessary to cause a recession in an \$87.5 trillion world economy.^{ix} At just 0.12% of this, the impact of all current and threatened tariffs fails to reach comparable levels, and is a fraction of this year's \$2 - \$3 trillion in global GDP growth.

^{vii} Source: US Census Bureau, as of 07/23/2018. Total US goods imports from China in 2017.

^{viii} Source: "Europeans Agree to Consider Changes on Trade, EU Official Says," Vivan Salama and Valentina Pop, *The Wall Street Journal*, 25 July 2018.

^{ix} Source: IMF, as of 07/10/2018. Estimate comes from the April 2018 World Economic Outlook.

Exhibit 3: Diary of a Trade Spat

US Tariffs Enacted or Proposed During the Trump Administration			
Category	Dollar Amount Subject to Tariffs	Tariff Rate	Maximum Tariff Payment
Solar Panels	\$4.5 billion	30%	\$1.35 billion
Washing Machines	\$1 billion	20% - 50%	\$500 million
Canadian Lumber	\$5.6 billion	21%	\$1.2 billion
Steel & Aluminum	\$40 billion	15% - 25%	\$7.5 billion
China Round 1.1	\$34 billion	25%	\$8.5 billion
China Round 1.2	\$16 billion	25%	\$4 billion
China Round 2	\$200 billion	10%	\$20 billion
Autos	\$192 billion	20%*	\$38.4 billion*
Total in Effect by July 6	\$85.1 billion		\$19.1 billion
Total Including Future Threats	\$493 billion		\$81.5 billion

*The 20% figure comes from President Trump's off-hand remarks about the size of a potential tariff on EU auto imports. At present, the administration has not made an official proposal. Payment calculation based on hypothetical 20% tariff rate.

Chinese Retaliatory Measures Enacted or Proposed			
Category	Dollar Amount Subject to Tariffs	Tariff Rate	Maximum Tariff Payment
Food Products (Steel Retaliation)	\$3 billion	15% - 25%	\$0.75 billion
Retaliation to Round 1.1	\$29.6 billion	25%	\$7.4 billion
Retaliation to Round 1.2	\$15.4 billion	25%	\$3.85 billion
Retaliation to Round 2	\$82 billion maximum**	10%	\$8.2 billion
Total in Effect by July 6	\$32.6 billion		\$8.15 billion
Total Including Future Threats	\$130 billion		\$20.2 billion

**The US exports only about \$130 billion worth of merchandise to China annually, so like-for-like retaliation would likely include additional non-tariff measures.

Other Retaliatory Measures			
Country	Dollar Amount Subject to Tariffs	Tariff Rate	Maximum Tariff Payment
Canada	\$13 billion	25%	\$3.25 billion
Mexico	\$3 billion	15% - 25%	\$0.75 billion
EU	\$3.3 billion	25%	\$0.83 billion
Total	\$19.6 billion		\$4.83 billion

Source: US Trade Representative, China Ministry of Commerce, the American Action Forum, CNN, Politico and the Peterson Institute for International Economics, as of 07/10/2018.

Exhibit 4: Total Tariff Payments Relative to Global GDP

	Dollar Amount Subject to Tariffs	Maximum Tariff Payment	Percentage of Global GDP
Total in Effect by July 6	\$137.3 billion	\$32.08 billion	0.037%
Total Including Future Threats	\$642.6 billion	\$106.5 billion	0.122%

Source: IMF, US Trade Representative, China Ministry of Commerce, the American Action Forum, CNN, Politico and the Peterson Institute for International Economics, as of 07/10/2018. The IMF's estimate of nominal global GDP, in US dollars, is \$87.5 trillion as of April 2018.

UNILATERAL TARIFFS ARE EASY TO AVOID

Even 0.12% is likely an overestimate. Most of these tariffs won't be paid. While global tariffs can impede trade and raise costs, single-country measures have countless workarounds. Like embargoes and sanctions, they are avoidable and rarely work.

As mentioned in the Executive Summary, headlines decry individual measures' impact on local producers, warning tariffs render them unable to compete. The media presents numerous warnings about US soybean producers flailing now that China's new tariff is in effect. However, this is overwrought. US soybean farmers don't sell directly to Chinese firms. They sell to commodity brokers, who shop globally for the highest bidder. US commodity brokers might not sell directly into China now that tariffs apply. But they can sell to a German broker, who can flip them to China for possibly a 1% cut. The farmers still receive market prices. The middlemen receive a profit. Chinese buyers pay a 1% fee instead of a 25% tariff.

Since the majority of the tariffed goods are substitutable, it is possible to envision this scenario unfolding broadly. For instance, instead of paying \$106.5 billion worth of tariffs on \$642.6 billion worth of traded goods, buyers would effectively pay a 1% brokerage fee—\$6.426 billion. This would amount to just 0.0073% of global GDP. Alternatively, China may simply buy more beans from Brazil and fewer from the US—and brokers sell more US beans to Brazil's non-Chinese customers.

While potential auto tariffs monopolized media attention at quarter-end, they too are easily evaded. Lost in most coverage was the fact most major European automakers manufacture cars in the US, primarily at plants scattered throughout the South. According to one German industry group, while German automakers shipped 494,000 cars to the US last year, they built 804,000 in the US—exporting over half to Canada, Mexico and China.^x Thus, if President Trump taxes European cars, European automakers can leverage their US factories and adjust global supply lines. As opposed to shipping vehicles made in the US abroad, they can sell them all in the US, while their European and Mexican factories sell to Canada, Mexico and China. When US plants need steel and aluminum, they can buy from producers in South Korea, which is an exempt country. Alternatively, South Korea can broker German steel to US auto factories.

THREATS MAY NOT BECOME REALITY

It isn't assured the threatened tariffs will take effect—for now, they are just proposals. Similarly, like prior administrations' tariffs, those that are already in force might not last long. This could be part of President Trump's midterm strategy. As he learned while campaigning, tariff talk plays well with his base. Large threats could be his way of getting GOP voters enthusiastic about November's US elections. After the contest, he could easily back down—and boast a win if he gets small concessions from China and the EU. This supports the evidence that returns before midterm elections are often more variable. Politicians scare investors with tough campaign rhetoric prior to the contest, but the threats subsequently fade into gridlock.

Beginning with big threats is a classic negotiating strategy of President Trump. After President Trump threatened the auto tariffs, the discussion turned to Europe and the US slashing auto tariffs to zero—an option proposed by the German ambassador of the US and tentatively endorsed by German Chancellor Angela Merkel. President Trump and Juncker's late-July accord further underscores this viewpoint. While the deal is not yet complete, it reflects the possibility of multiple outcomes unfolding.

ECB TAPER TERROR

In June, ECB President Mario Draghi announced the potential end of QE. We believe this is an underappreciated positive in global equities, as we will discuss more extensively later on. The central bank plans to reduce its monthly asset purchases from €30 billion to €15 billion in October and to €0 in December—provided incoming data match the bank's outlook. Financial media have debated the potential fallout, and some fret the removal of the ECB's "accommodative" monetary support—allegedly one of the drivers of the eurozone's economic expansion. ECB policymakers recently argued QE aided struggling eurozone citizens by boosting economic growth, which added jobs. However, in our view, QE hinders, rather than stimulates, growth. We believe the sooner the ECB ends QE, the better.

^x Source: "VDA President Bernhard Mattes on Import Tariffs Imposed by the US Administration," Verband der Automobilindustrie, May 24, 2018.



US COMMENTARY

87% MIRACLE

A widely overlooked phenomenon is set to take place soon: The 87% Miracle. The 87% Miracle refers to equities' overwhelming tendency to rise after US midterm elections. Since 1926, US equities have risen in 68.6% of all calendar quarters.^{xi} However, following US midterm elections, the frequency of positivity escalates. Since 1926, the S&P 500 has risen in midterm Q4s—and the following Q1 and Q2—87% of the time (Exhibit 5).^{xii} In all other quarters, it has been positive only 64.5% of the time.^{xiii}

We always caution investors against buying into correlation without causation, but in our view, there is an identifiable cause. Midterms typically reduce uncertainty. Markets generally react poorly to rising uncertainty and respond positively to falling uncertainty. US Midterms' run-ups feature wild speculation, pushing uncertainty to its highest. Hence, stocks rise less frequently in midterm years' first three quarters. As Congressional races develop and outlandish possibilities dissipate, equity markets gradually discount the eventual outcome. Midterms routinely raise gridlock, reducing uncertainty. Markets celebrate in relief.

Exhibit 5: Returns After Midterms Are Overwhelmingly Positive

Midterm Year	Midterm Q1	Midterm Q2	Midterm Q3	Midterm Q4	Following Q1	Following Q2	Following Q3	Following Q4
1926	-9.1%	8.9%	10.1%	2.0%	4.6%	7.3%	16.1%	5.2%
1930	18.4%	-17.8%	-8.2%	-16.4%	10.2%	-9.9%	-33.6%	-14.8%
1934	7.4%	-8.0%	-6.2%	5.4%	-9.9%	22.1%	14.4%	17.0%
1938	-17.8%	38.5%	7.3%	9.0%	-16.0%	0.0%	21.4%	-2.9%
1942	-5.9%	5.8%	8.5%	12.1%	20.1%	8.0%	-0.9%	-2.1%
1946	5.1%	2.9%	-18.0%	3.5%	0.3%	1.5%	0.5%	2.7%
1950	4.9%	4.0%	11.9%	6.9%	6.7%	-0.3%	12.8%	3.8%
1954	10.1%	9.8%	11.9%	12.6%	2.8%	13.3%	7.5%	5.1%
1958	6.4%	8.5%	11.6%	11.2%	1.2%	6.3%	-2.0%	6.1%
1962	-2.1%	-20.6%	3.7%	13.1%	6.4%	5.0%	4.2%	5.4%
1966	-2.7%	-4.3%	-8.8%	5.9%	13.2%	1.3%	7.5%	0.5%
1970	-1.8%	-18.0%	17.1%	10.3%	9.7%	0.2%	-0.6%	4.6%
1974	-2.8%	-7.6%	-25.2%	9.3%	23.0%	15.4%	-10.9%	8.6%
1978	-4.9%	8.5%	8.7%	-5.0%	7.1%	2.6%	7.6%	0.1%
1982	-7.3%	-0.6%	11.5%	18.3%	10.0%	11.1%	-0.2%	0.4%
1986	14.1%	5.9%	-7.0%	5.6%	21.3%	5.0%	6.6%	-22.5%
1990	-3.0%	6.3%	-13.7%	9.0%	14.5%	-0.2%	5.3%	8.4%
1994	-3.8%	0.4%	4.9%	0.0%	9.7%	9.5%	7.9%	6.0%
1998	13.9%	3.3%	-9.9%	21.3%	5.0%	7.0%	-6.2%	14.9%
2002	0.3%	-13.4%	-17.3%	8.4%	-3.1%	15.4%	2.6%	12.2%
2006	4.2%	-1.4%	5.7%	6.7%	0.6%	6.3%	2.0%	-3.3%
2010	5.4%	-11.4%	11.3%	10.8%	5.9%	0.1%	-13.9%	11.8%
2014	1.8%	5.2%	1.1%	4.9%	1.0%	0.3%	-6.4%	7.0%
2018	-0.8%	3.4%	?	?	?	?	?	?
Avg. Return	1.3%	0.3%	0.5%	7.2%	6.3%	5.5%	1.8%	3.2%
Avg. Positive	7.7%	8.0%	9.0%	9.3%	8.7%	6.9%	8.3%	6.7%
Avg. Negative	-5.2%	-10.3%	-12.7%	-7.1%	-9.7%	-3.5%	-8.3%	-9.1%
% Positive	50.0%	58.3%	60.9%	87.0%	87.0%	87.0%	60.9%	78.3%

Source: Global Financial Data, Inc. and FactSet, as of 07/13/2018. S&P 500 Total Return Index, 12/31/1925 – 06/30/2018.

^{xi} Source: Global Financial Data, Inc. and FactSet, as of 07/9/2018. S&P 500 Total Return Index, calendar quarters, Q1 1926 – Q2 2018.

^{xii} Source: Global Financial Data, Inc., as of 06/15/2018. S&P 500 Index total return, 12/31/1925 – 03/31/2018

^{xiii} Ibid.

The 87% Miracle is not a timing tool or indicative of returns' magnitude. It also is not a statement about Q3. The current correction—which may or may not have reached its trough on March 23—could persist. Though equities rose in 60.9% of historical midterm Q3s, returns are more variable—the spread between average negative and positive returns is wider than other midterm quarters.^{xiv} We suspect this stems from hotter campaign rhetoric as November nears.

However, variable isn't negative. Short-term market timing is often a losing proposition—a huge risk during a bull market for those who need equity-like returns to reach their goals. In our view, now is the time to be positioned for the three quarters afterward. The 87% Miracle, combined with the impact of ECB QE ending and Italian false fears fading, forms a bullish trifecta. We believe portfolios are well-positioned to capitalize on this outlook.

INTEREST RATE UPDATE

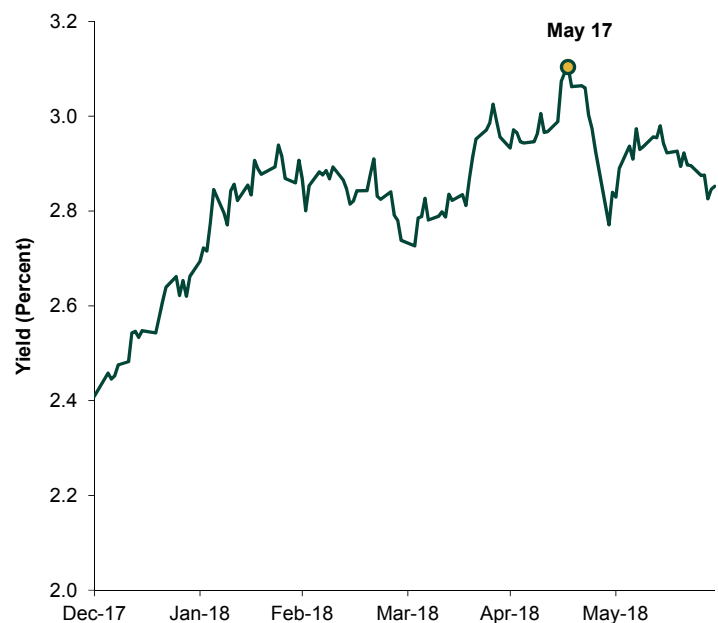
As was explained in our Q4 2017 Review & Outlook, we expect long rates to repeat their 2017 performance—finishing 2018 little changed. That may seem surprising, given recent noise over rising long rates, but the 10-year US Treasury yield has already retreated from its Q2 peak (Exhibit 6).

After 10-year yields rose about 50 basis points in two months—from 2.4% at 2018's start to 2.9% near February's end—pundits hyped concerns about crossing 3%.^{xv} Long rates then moderated for the next two months before picking up once again, peaking at 3.1% in mid-May.^{xvi}

Crossing the 3% mark had investors fearing interest rates were off to the races, with a bond bear market underway. Yet long rates' year-to-date move now appears smaller than feared—and more aligned with our expectations. In our view, fundamentals still favor benign long-term interest rates.

For one, inflation is tame. As Milton Friedman taught, inflation is always and everywhere a monetary phenomenon. Broad US money supply and lending are growing steadily, but neither looks likely to zoom in the near term—especially with a flatter yield curve. Demand for US debt is healthy since US rates are among the developed world's highest. Unless US Treasury market supply and demand drivers change radically, we don't expect a major move up—or down—in bond yields.

Exhibit 6: The 10-Year Treasury's First Half



Source: FactSet, as of 07/13/2018. US 10-Year Treasury Yield, 12/29/2017 – 06/29/2018.

MEDIA WOES OVER FLATTENING YIELD CURVE

Financial media make much of the flattening US yield curve, warning it foretells concern. This seems premature. We agree the yield curve is a key forward-looking indicator. Banks typically borrow short term to fund long-term loans, and the spread between them influences loan profitability. When long rates substantially exceed short rates, banks have ample incentive to lend, fueling growth. When flat, those incentives decline. When yield curves invert, it signals troubled credit markets. An inverted yield curve has preceded every US recession since the Great Depression.

^{xiv} Source: Global Financial Data, Inc. and FactSet, as of 7/9/2018. S&P 500 Total Return Index, calendar quarters, Q1 1926 – Q2 2018.

^{xv} Source: FactSet, as of 07/09/2018. US 10-Year Treasury Yield on 12/29/2017 and 02/22/2018.

^{xvi} Ibid. US 10-Year Treasury Yield on 05/17/2018.

Flat doesn't mean inverted. US yield curves may be flatter, but they aren't inverted. Banks still have incentive to lend, perhaps more judiciously than when the interest rate spread is wider. Additionally, most coverage dwells on the spread between 10-year and 2-year Treasury rates (currently 0.24 percentage point).^{xvii} But we believe this is a less-telling measure than the 10-year minus 3-month spread or the 10-year minus fed-funds spread—0.85 and 0.92 percentage point, respectively. Few banks fund themselves with 2-year borrowings.^{xviii} They typically do so via deposit accounts or by borrowing from each other at the overnight rate.

Moreover, as telling as the US yield curve is, the global yield curve trumps it. Today's modern, global capital markets make it easy for multinational banks to borrow in one country, hedge for currency swings and lend in another. Therefore, no single country's yield curve—not even the US—matters more than the global one. The global GDP-weighted yield curve remains upward sloping, with the 10-year minus 3-month spread at 0.9 percentage point.^{xix} GDP weighting uses quarterly real GDP as of Q1 2018. Finally, as we have shown in past quarters, even when the yield curve does flatten and invert, it isn't a timing tool—bear markets do not usually commence immediately.

MIDTERM MADNESS

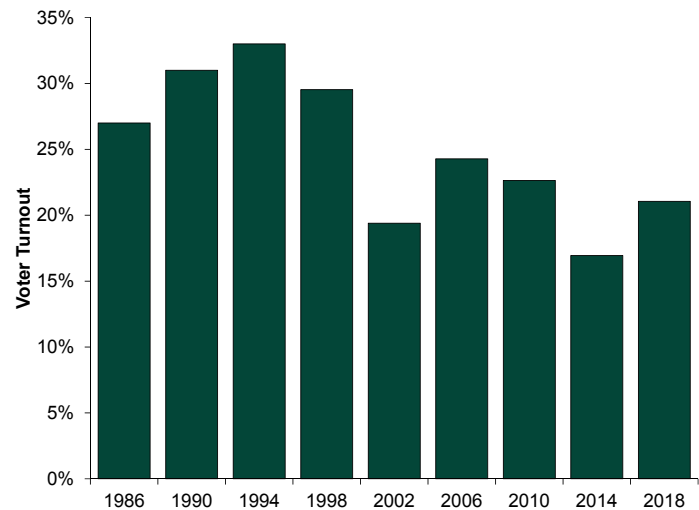
As always, our political analysis favors neither party nor any politician and is limited to assessing how developments are likely to impact the economy and markets.

Media claims of a sweeping shift to Democratic momentum, also known as a “blue wave” set to flood Congress grew in Q2, with rhetoric ramping up after Supreme Court Justice Anthony Kennedy announced his retirement. But despite breathless headlines, we expect this year's election to shock many by being radically dull. Shifts should be small. The two most likely outcomes: a continued small Republican majority in the House and Senate or a split Congress. A slim Democratic majority in both chambers is possible but less likely. For equities, any of these would extend gridlock, ushering in the 87% Miracle—bullish.

Small shifts may seem outlandish, given coverage describes eager voters boosting Democrats' chances of taking Congress, similar to 1994's “Republican Revolution.” Most blue wave arguments hinge on

fundraising and special elections like the Alabama and Pennsylvania votes discussed last quarter. But special elections don't considerably indicate national trends. Parties focus funding and attention on one race at a time. A blue wave sweeping both chambers likely requires widespread enthusiasm. Q2's primaries don't show that. For example, swing-state Ohio's gubernatorial primary featured low turnout on both sides (Exhibit 7). This typically favors incumbents.

Exhibit 7: Ohio Voter Turnout in Midterm Primaries



Source: Ohio Secretary of State, Election Results and Data, as of 07/13/2018.

Similarly, many claim newcomer Alexandria Ocasio-Cortez's Democratic primary win over 10-term Congressman Joe Crowley in New York's Queens borough signals enthusiasm. But here, too, turnout was low. To us, this seems like Virginia Republican (then-House Majority Leader) Eric Cantor's 2014 primary loss. In both, voters rejected powerful incumbents. The common slogan, “I am the established leader, able to bring home the bacon in ways a new face can't,” seems exhausted. It doesn't resonate. We aren't convinced this is foretelling for November. Further, her win doesn't change the likely House balance, as Queens is staunchly Democratic.

Media highlight the Democrats' fundraising edge, but this isn't what it seems. In many cases, the edge stems from multiple Democratic candidates in one primary, which differs from November. At the committee level, the Democrats are having success mostly with special interests—big funders like Tom Steyer. The GOP is the reverse, doing well at the committee level despite little interest from big donors like the Koch brothers and Sheldon Adelson.

^{xvii} Source: Federal Reserve Bank of St. Louis, as of 07/17/2018. 10-year Treasury rate minus 2-year Treasury rate on 07/13/2018.

^{xviii} Ibid. 10-year Treasury rate minus three-month Treasury rate and 10-year Treasury rate minus effective fed-funds rate on 07/13/2018.

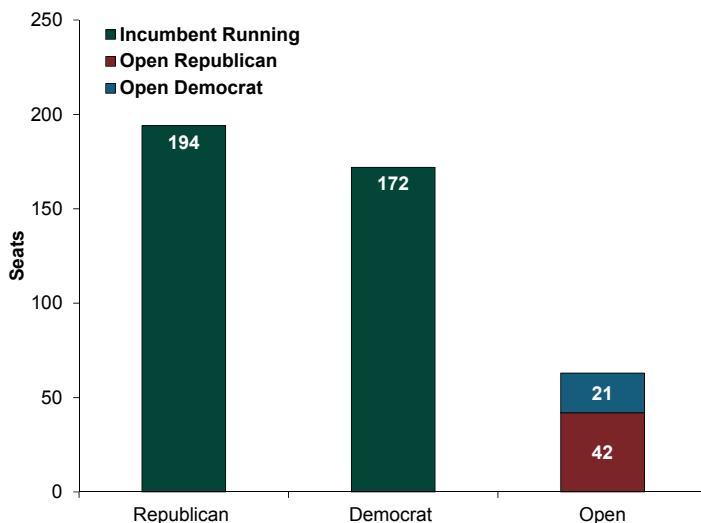
^{xix} Source: FactSet, Global Financial Data, Inc., Bloomberg and Thomson Reuters, as of 07/16/2018. MSCI World Index constituent countries' 10-year and 3-month yields on 07/16/2018.

THE DEMOCRATS' EDGE IN THE HOUSE

While we don't expect an extreme shift, history and this year's structure favor the Democrats gaining House seats—possibly enough to take control. The president's party usually loses seats in midterms. In the 26 midterms since 1912 (when the House became a 435-seat body), the president's party lost seats 23 times.^{xx} The exceptions were small gains in 1934, 1998 and 2002. The average decline: 30 seats. Even if the Democrats trail this slightly, they could take control. They need just 25 seats.

Incumbency is crucial in House contests, especially low-turnout votes. That favors Republicans—the majority. But the edge is small, as more GOP lawmakers retired or resigned than Democrats. As of July 10, 42 previously Republican seats will be open on Election Day versus 21 Democratic (Exhibit 8). So while enthusiasm is unlikely to drive a huge swing, Democrats should add some seats, either taking narrow control or cutting Republicans' majority.

Exhibit 8: Open Seats in 2018 Midterms by Party



Source: House of Representatives Press Gallery, as of 07/10/2018.

SENATE UPDATE

While structure favors the Democrats in the House, the opposite is true in the Senate. Republicans' Senate edge is just one seat. But the Democrats have many more seats to defend this year, 26 versus 9 (Exhibit 9).

Exhibit 9: Democrats Have More Seats at Risk in November

Senator	Party	State	Percent of Vote for Trump in 2016	Percent of Vote for Clinton in 2016	
Barrasso, John	R	WY	70%	22%	States Trump Won in 2016
Manchin, Joe, III	D	WV	69%	26%	
Heitkamp, Heidi	D	ND	64%	28%	
Corker, Bob*	R	TN	61%	35%	
Fischer, Deb	R	NE	60%	34%	
Wicker, Roger F.	R	MS	58%	40%	
Cochran, Thad**	R	MS	58%	40%	
Tester, Jon	D	MT	57%	35%	
Donnelly, Joe	D	IN	57%	38%	
McCaskill, Claire	D	MO	57%	38%	
Cruz, Ted	R	TX	53%	43%	
Brown, Sherrod	D	OH	52%	44%	
Flake, Jeff*	R	AZ	50%	45%	
Nelson, Bill	D	FL	49%	48%	
Casey, Robert P., Jr.	D	PA	49%	48%	
Baldwin, Tammy	D	WI	48%	47%	
Stabenow, Debbie	D	MI	48%	47%	
Hatch, Orrin G.*	R	UT	46%	28%	
Heller, Dean	R	NV	46%	48%	States Clinton Won in 2016
Klobuchar, Amy	D	MN	45%	47%	
Smith, Tina**	D	MN	45%	47%	
Kaine, Tim	D	VA	45%	50%	
King, Angus S., Jr.	I	ME	45%	48%	
Menendez, Robert	D	NJ	42%	55%	
Carper, Thomas R.	D	DE	42%	53%	
Murphy, Christopher	D	CT	42%	54%	
Whitehouse, Sheldon	D	RI	40%	55%	
Heinrich, Martin	D	NM	40%	48%	
Cantwell, Maria	D	WA	38%	56%	
Gillibrand, Kirsten E.	D	NY	37%	59%	
Cardin, Benjamin L.	D	MD	35%	61%	
Warren, Elizabeth	D	MA	34%	61%	
Feinstein, Dianne	D	CA	33%	61%	
Sanders, Bernard	I	VT	33%	61%	
Hirono, Mazie K.	D	HI	30%	62%	

Source: US Senate, Fisher Investments Research, as of 07/16/2018. Senators King and Sanders are categorized with the Democrats based on voting tendency. *Senator not running for re-election. **Seat open in 2018 due to resignation, with regular election in 2020.

That strains resources, especially because 10 seats are in states President Trump won in 2016. Only one GOP seat is in a state taken by Clinton. Those seats arguably became more vulnerable with the Supreme Court opening, as these senators must don a moderate face to win re-election. That conflicts Senate Minority Leader Chuck Schumer's call to oppose Brett Kavanaugh's nomination at all costs, complicating their posture for November. We believe this favors the Republicans adding a Senate seat or two. The chief risk for Republicans is a 2006 repeat, when late-breaking scandals rocked the party shortly before the vote.

^{xx} Source: US House of Representatives, as of 07/13/2018. <http://history.house.gov/Institution/Party-Divisions/Party-Divisions>

THE GOLDEN GOOSE: GRIDLOCK

Regardless of whether the Republicans hold both chambers, lose one or even both, gridlock should remain—supporting equities. If the Republicans retain control, their edge will likely shrink in the House and remain slim in the Senate. This would further stall major legislation. They spent colossal amounts of political capital passing tax cuts late last year, and lacking a large Congressional edge should stymie future efforts. Moreover, 2019 is the third year of President Trump's first term—a time presidents typically look to set up a re-election bid. Combined, these factors should mean little sweeping legislation passes, if attempted. We believe this is why the third year of a president's term is the most frequently positive, with the highest average returns. The third year celebrates inactivity as the 87% Miracle blossoms.

As we mentioned last quarter, if the Democrats take the House, they could advance impeachment proceedings. However, with a Republican Senate as the jury, it would likely take substantial evidence of high crimes to convict and remove President Trump from office. Such evidence may emerge, but to date, we haven't seen anything significant enough.

A WORD ON THE SUPREME COURT

Justice Anthony Kennedy's retirement announcement—and President Trump's subsequent nomination of Brett Kavanaugh—drove huge noise on both sides. This is understandable, as the court wields significant power. For markets, however, this is less consequential than many investors fear.

Supreme Court rulings rarely carry broad market impact—they are most often sociological. Perhaps, as many argue, Kennedy's retirement shifts the ideological balance to the right. Yet talk of the court losing the centrist "swing vote" seems overstated.

Regardless, relatively few decisions are 5 – 4. In the current term, just 19 of 71 decisions were 5 – 4.^{xxi} At 27%, this is above average. Only 20% of the last decade's decisions were 5 – 4. And of this year's 19, only 14 were along ideological lines. It is dull, but most court rulings are legal technicalities yielding much more uniformity. In this term, there have been 28 unanimous rulings—which isn't uncommon historically. Finally, while many talk up controversial court rulings being revisited, the court cannot randomly revisit a case without cause. They must be faced with a valid legal challenge that works its way through the appellate court system. They don't have the authority to act however they please, despite the frequent depiction in the press.

xxi Source: SCOTUS Blog Stat Pack, as of 07/13/2018. http://www.scotusblog.com/wp-content/uploads/2018/06/SB_5-4cases_20180629.pdf



GLOBAL DEVELOPED EX-US COMMENTARY

EUROZONE

INSIDE THE EUROZONE'S TWIN FALSE FEARS

After outperforming through late April, eurozone equities have trailed the world as investors wrestled with Italian politics and fear of the ECB ending its QE program. We believe investors see both issues backward, creating a bullish disconnect between sentiment and reality that should benefit eurozone equities for the foreseeable future.

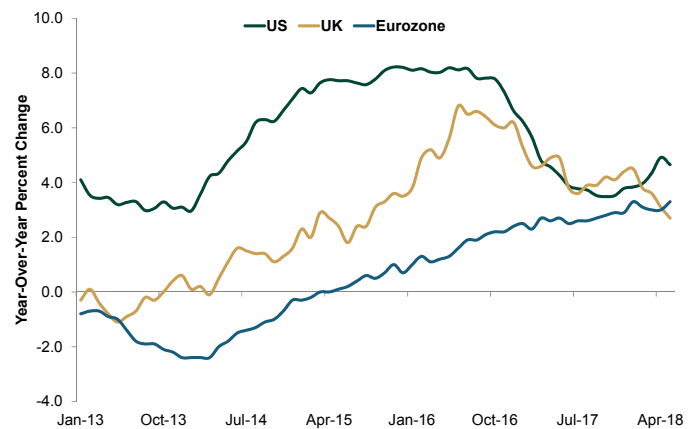
AN UNRECOGNIZED POSITIVE: THE
(POTENTIAL) END OF EUROZONE QE

In mid-June, ECB chief Mario Draghi announced the central bank's intention to reduce monthly bond purchases (QE) from the current €30 billion to €15 billion in October and, if all goes as planned, end QE in December. To no surprise, this renewed investors' long-running fear of QE's end—especially since the announcement followed a stretch of softer economic data.

Despite the common view that QE is a stimulus, we believe it is a negative. In our view, the eurozone—like the US and UK before it—has grown despite QE, not as a result of it.

Conventional wisdom says QE stimulates by flooding banks with new reserves and driving rapid loan growth as lower long-term interest rates—the result of the ECB's asset purchases—make credit more affordable and entice borrowers to take out more loans. Yet this did not occur (Exhibit 10). By reducing long-term rates while fixing short-term rates just below zero, the ECB flattened yield curves across the eurozone. Much of the €2.4 trillion of new reserves created through QE ended up on deposit at central banks, instead of backing new loans. Stronger nations with healthier bank balance sheets experienced positive loan growth regardless. But in weaker nations, banks used QE to rebuild balance sheets instead of lending a significant portion. Consequently, in aggregate and on average, loan growth crawled.

Exhibit 10: Loan Growth in the US, UK and Eurozone since 2013



Source: St. Louis Federal Reserve, ECB, and BoE, as of 7/25/2018. Year-over-year percent change for loans and leases in bank credit for all commercial banks (US), lending to households, non-financial corporations and non-intermediating financial companies (UK), and adjusted loans excluding reverse repos with CCPs to euro area non-MFIs excluding general government reported by MFI in the euro area (eurozone), January 2013 – May 2018.

We believe QE's end should have a positive impact, with eurozone bank equities the prime beneficiaries. As the ECB continues tapering and eventually ceases monthly bond purchases, it should remove some of the pressure on long-term interest rates, helping yield curves steepen. As lending becomes more profitable, banks will be in a prime position to increase lending. While many investors fear constrained bank balance sheets—especially in Italy and Spain—in reality, these institutions are healthier than they have been in years. Non-performing loans are down and capital ratios are up. The only components lacking are steeper yield curves. The end of QE should benefit this situation.

Investors currently overlook this detail—just as they overlook the possibility that Italian relief can benefit the rest of the eurozone. Investor sentiment has been especially dour on Italian banks recently, as investors fear they are most vulnerable to debt issues. As these twin false fears fade and a steeper yield curve boosts lending, we believe a large relief rally awaits.

ITALY

ITALY'S POPULISTS: DISCUSSED PLANS YIELD LITTLE ACTION

On April 19, Italy was effectively even with Finland as the MSCI World Index's best-performing nation year-to-date and beating the world by a mile.^{xxii}

By quarter-end, Italy was trailing the world's slight gain.^{xxiii} MSCI Italy return with net dividends, 12/31/2017 – 06/30/2018. In between came a political circus and renewed fears of Italy leaving the eurozone—"Quitaly"—and imploding under the weight of its supposedly astronomical debt. We believe both fears are misplaced.

On March 4, Italy held parliamentary elections, and the results were inconclusive. The anti-establishment Five Star Movement (M5S) won the most seats but not a majority. A right-leaning coalition led by former premier Silvio Berlusconi beat all other blocs but didn't get enough seats to take power. In addition, the junior coalition partner—the anti-immigrant League—won more seats than Berlusconi's more traditionally center-right Forza Italia. So the two widely feared "populist" parties—M5S and the League—finished first and second, with many fearing a "nightmare" scenario of them joining forces for a radical, populist government.

After nearly three months of deadlock and failed negotiations, this widely feared populist coalition developed. Little-known law professor Giuseppe Conte became Prime Minister, heading a cabinet of M5S and League ministers. M5S leader Luigi di Maio became Labor Minister, while League Leader Matteo Salvini assumed the role of Interior Minister, with both appointed deputy Prime Ministers. In their governing platform, the parties pledged to slash tax rates while moving to a flat-tax system, reduce the retirement age, adopt a universal basic income for the poor, curb immigration and improve relations with Russia. Missing were two items that spooked investors throughout the campaign and coalition talks: a referendum on eurozone membership and plans to introduce a shadow parallel currency. Quitaly wasn't on the agenda.

This shouldn't be a surprise—even strident populists tend to moderate. Italy's populists started backing off Quitaly rhetoric while campaigning, claiming prior threats were merely negotiating tactics aimed at extracting budgetary and immigration concessions from eurozone and EU officials. In backing off, M5S and the League followed in the footsteps of Greece's radical leftist government and Portugal's socialist administration. Both took power in recent years with pledges to ignore eurozone budget treaties. Yet both moderated, met austerity commitments, implemented or preserved economic reforms and ran budget surpluses. We see no reason Italy should differ.

Moreover, even if some individuals in Italy's government want to pursue radical policies, the risk of anything passing appears quite low. Populism isn't a uniform ideology. This coalition's two parties share little common ground. M5S is a combination of leftists and "techno-libertarians," while the League is hard right. The likelihood they agree on sweeping fiscal policy changes is low, and with only a combined 53% of seats in Italy's lower house, it would take only a few defectors to terminate contentious legislation. This makes Quitaly effectively impossible, even if politicians wanted to pursue it: Leaving the eurozone would require a two-thirds majority vote.

The alliance seems to already be impaired, as many in M5S decry Salvini's recent pledges to create a registry of the Roma population and possibly expel all who aren't Italian citizens. In our view, despite the populist angle, this administration resembles most of Italy's governments in recent years: a deeply divided, ideologically ingrained group uninclined to compromise. We believe it is highly unlikely the coalition has staying power—normal in a country that has had 66 prime ministers since Mussolini.

ITALIAN DEBT FEARS

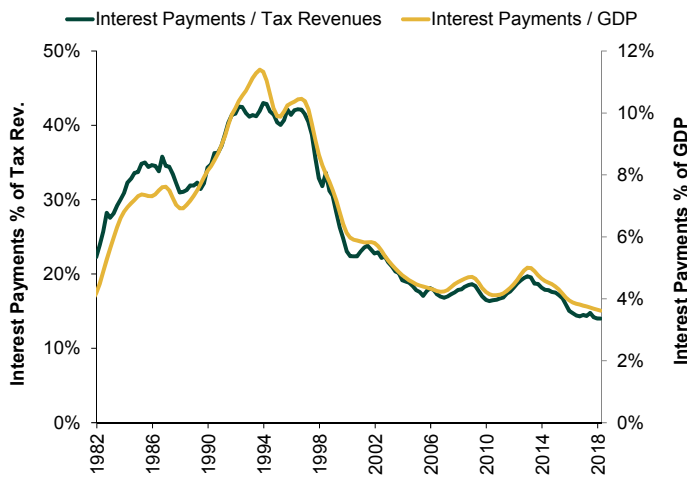
Quitaly wasn't the only fear surrounding Italy's populists. Their budgetary plans raised debt fears. Echoing this was a (since debunked) rumor that they would push the ECB to retire all Italian bonds bought through QE—effectively a debt "haircut" or default. Italian debt dread spiked. In our opinion, however, the fear seemed unnecessary, and not just because gridlock renders sweeping fiscal policy changes unlikely. Italy's public finances are in their best shape in decades. While debt-to-GDP may be elevated, this is not directly reflective of a country's solvency.

^{xxii} Source: FactSet as of 07/11/2018. MSCI Italy and MSCI World Index returns with net dividends, 12/31/2017 – 04/19/2018.

^{xxiii} Ibid.

The crucial matter is whether a country can service its debt. Principal payments are easy to service, as the treasury can issue new debt to refinance old debt—standard practice. Despite the ease of servicing principal payments, servicing interest payments can present challenges. However, Italy’s ability to meet these is quite strong. Annual interest payments tumbled from 11.4% of GDP in 1992 to 3.6% now. As a percentage of tax revenues—the most meaningful measure—interest costs are down from 43% in 1992 to 14% today, the lowest in Italian modern history (Exhibit 11).

Exhibit 11: Italian Interest Payments as a Share of GDP and Tax Revenue



Source: FactSet, Bank of Italy and Oxford Economics, as of 05/23/2018. Government debt interest payments as a percentage of GDP and tax revenue, Q1 1982 – Q1 2018.

Some investors fret the recent uptick in Italian long-term interest rates will make debt unsustainable in the near future, although this seems unlikely. As illustrated by Exhibit 12, although elevated in recent weeks, 10-year Italian yields remain near their lowest levels in decades. Due to the Treasury’s efforts to extend the debt’s weighted-average maturity from about three years in 1993 to more than seven today, rates must soar to nosebleed levels and stay there for years to materially raise carrying costs (Exhibit 13). Years of double-digit interest rates in the 1980s and 1990s were not enough to cause a material impact, even though the average debt maturity was short. Meanwhile, even at today’s slightly elevated rates, the Treasury is refinancing maturing debt at a discount. In June, for example, they sold 5-year debt at 1.8% and 10-year debt at 2.8%.^{xxiv} The 5-year notes replaced a maturing bond, issued in June 2013, that yielded 3.5%.^{xxv}

^{xxiv} Source: Italian Treasury Department, as of 07/11/2018.

^{xxv} Ibid.

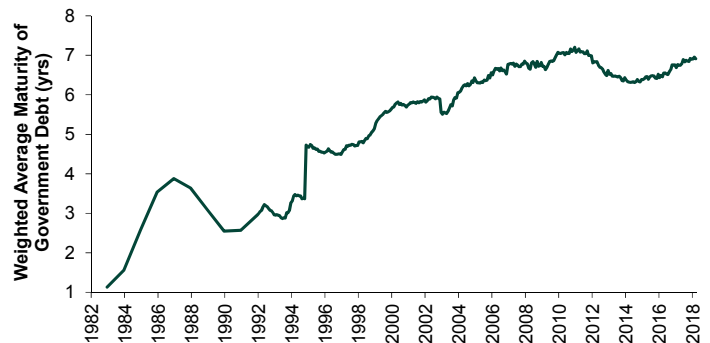
^{xxvi} Ibid.

Exhibit 12: Italian 10-Year Yields Near Generational Lows



Source: FactSet, as of 07/10/2018. Italian 10-year government bond yields, 02/01/1980 – 07/10/2018.

Exhibit 13: Weighted-Average Maturity of Italian Government Debt



Source: Italian Treasury Department, as of 05/23/2018. Weighted-average maturity of government debt, January 1982 – March 2018. Data are yearly through 1991 and monthly thereafter.

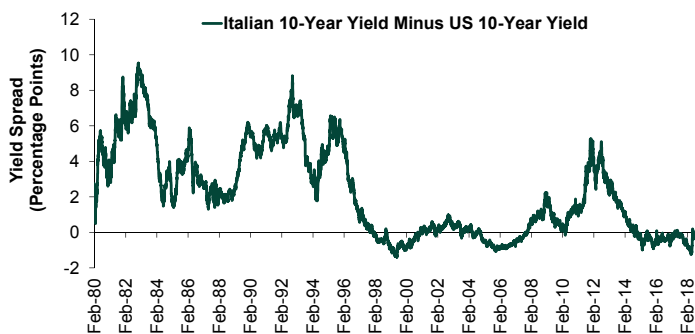
The new 10-year notes replaced a June 2008 bond carrying a 5.1% rate.^{xxvi} Italy’s debt continues becoming cheaper—an observance overlooked by many.

We suspect the source of investors seeing Italy’s debt incorrectly is because they use a misguided measure of risk. In bond markets, investors weigh risk in one area by comparing yields to a benchmark widely seen as risk-free. In Italy’s situation, most benchmark to German bund yields—becoming alarmed as the spread reached its widest level in five years. This might seem logical, since both are European, and many cast Germany as Europe’s strong nation. But there are problems. For one, Germany is cutting debt, reducing long-term yields and distorting the comparison. Moreover, since both

nations use the euro, benchmarking Italian bonds to German bunds ignores currency flows. An investor fearing that Italy will destroy the euro is not likely to use another euro nation as a safe haven. Instead, they would likely turn to the US dollar, as is the crisis norm. In nearly every crisis, the dollar rises against a broad currency basket, as only US bond markets possess the size and liquidity to absorb the extent of extra demand.

Therefore, Italy's proper "risk-free" reference points are US Treasury yields. Throughout Italy's political upheaval, Italian yields remained below or effectively even with US yields, depending on daily volatility. While creditworthiness is not the only driver of yields, if investors saw Italy as significantly risky, they would likely demand a large premium to lend in the nation. During the eurozone's sovereign debt crisis, for example, Italy's premium was over 500 basis points (Exhibit 14). Benign spreads, coupled with equity market volatility, are a good indication markets have already priced in widespread fears of Italian turmoil and debt doom—and a sign these are false fears.

Exhibit 14: Italian 10-Year Yields Minus US 10-Year Yields



Source: FactSet, as of 07/11/2018. Italian and US 10-year government bond yields, 02/01/1980 – 07/10/2018.

SPAIN

GRIDLOCK PREVAILS DESPITE NEW LEADERSHIP

Italy wasn't the only eurozone country to get a new government in Q2—Spain also ushered in new leadership in early June. However, though the faces and party in charge have changed, gridlock remains—a positive aspect for Spanish and eurozone equities. While some fear the new government may undo beneficial reforms, we believe this is overblown. In our view, the turnover doesn't change Spain's bullish mix of a strong economy, benign politics and skeptical sentiment.

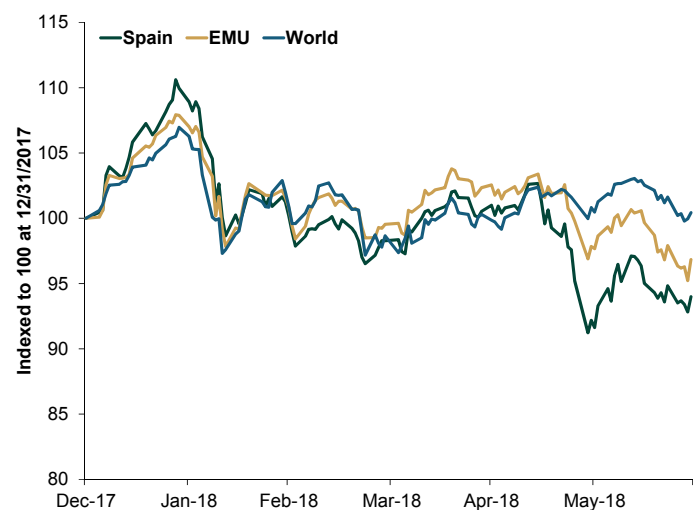
Mariano Rajoy, prime minister since 2011, became Spain's first-ever leader ousted in a no confidence vote after a long-running

corruption scandal came to a head in late May. While Prime Minister Rajoy wasn't implicated, the scandal involved several high-ranking officials in his Popular Party, including party's former treasurer, Luis Bárcenas. Bárcenas and others were found guilty on May 24 of funding local campaigns in two towns with illegally sourced money, and the party itself paid a nominal fine.

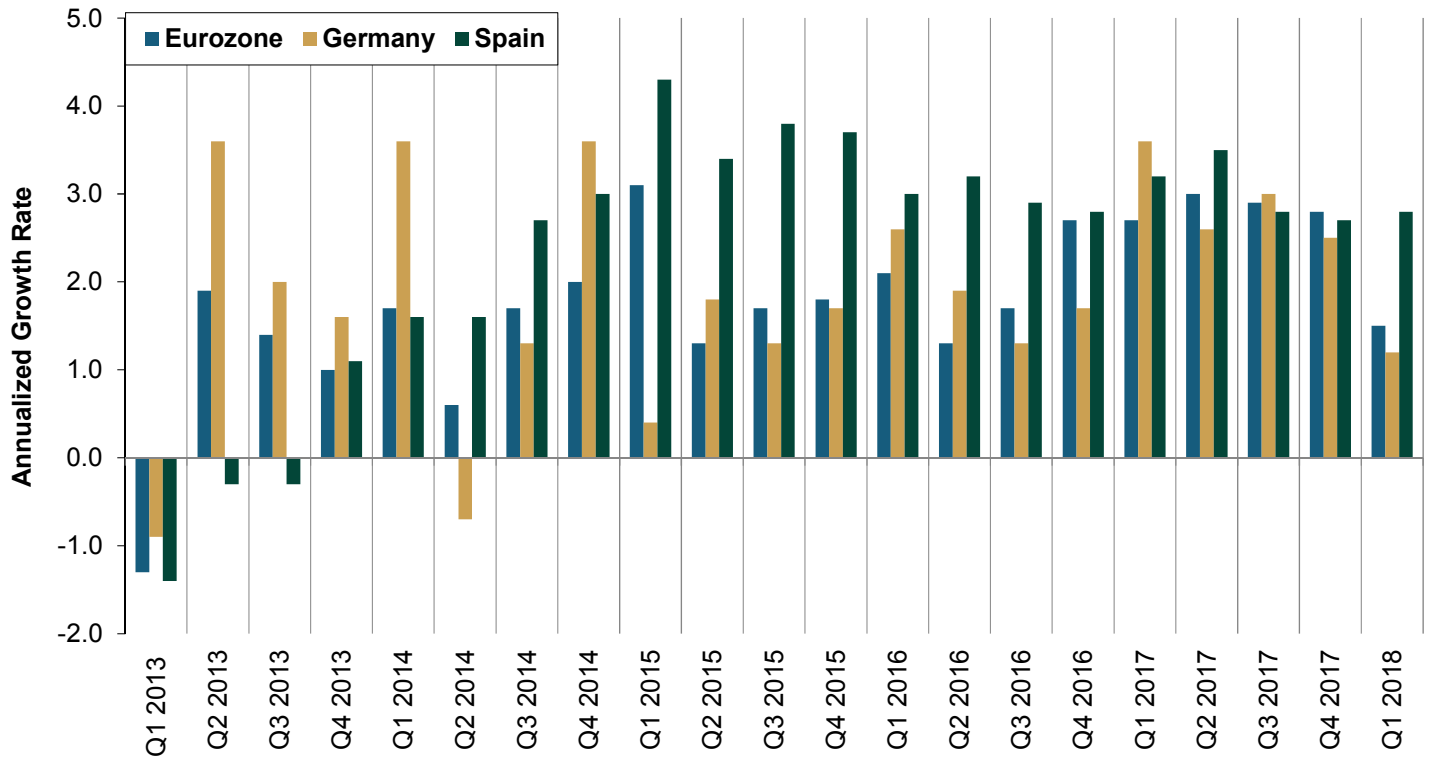
Socialist Party head—now Prime Minister—Pedro Sánchez appears to have seen the guilty verdict as his opportunity to challenge Prime Minister Rajoy. Prime Minister Rajoy had been losing popularity for years, in part tied to the scandal and in part due to enacting difficult, but beneficial reforms, such as relaxing labor market laws to give employers added flexibility. Since 2016, Prime Minister Rajoy headed a tenuous minority government that controlled just 123 seats of 350 in Parliament's lower chamber, serving as Prime Minister merely because the Socialists abstained from challenging him. This minority government led to extreme gridlock in which little meaningful legislation passed. While that prevented additional reforms, it also preserved those enacted under Prime Minister Rajoy.

Sánchez reversed course in June, calling for a confidence vote. With the support of several nationalist parties and the far-left Podemos, the Socialists were able to garner enough support to oust Prime Minister Rajoy—and take power—on June 1. The turmoil likely contributed to Spanish equity market volatility around the turn of May/June (Exhibit 15). Investors feared potential reversal of reforms—particularly against the backdrop of populist parties taking power in nearby Italy.

Exhibit 15: Political Turmoil Stokes Fear in Spain



Source: FactSet, as of 07/19/2018. MSCI Spain, MSCI EMU and MSCI World with net dividends in USD, indexed to 100 at 12/31/2017. 12/31/2017 – 06/30/2018.

Exhibit 16: Spain Economy's Recent Outperformance of Eurozone and Germany

Source: Eurostat, as of 07/19/2018. Annualized real GDP growth rates, Q1 2013 – Q1 2018.

However, the Socialist Party has lost even more popularity than Prime Minister Rajoy's in recent years—many analysts believe fear of further declines motivated him to push the confidence vote now. Sánchez steps into power with just 84 seats in Parliament's lower chamber—a markedly weaker minority government than that of Prime Minister Rajoy. Further, to get fringe parties' support and take control, Sánchez had to promise to hold elections before the scheduled 2020 vote.

This likely amounts to a very inactive government unable to pass material legislation—bullish for equities. So far, most of the new government's attention seems trained on exhuming and removing former dictator Francisco Franco's remains from a church in the famous Valley of the Fallen. That is a sensitive topic in the country, but it bears no relationship to markets.

This inactivity is favorable for Spain, as its economy doesn't need stimulus or reform at this juncture. Since 2014, Spain has averaged 3.0% annualized GDP growth per quarter.^{xxvii} That is a full percentage point above both the eurozone and widely perceived powerhouse Germany over that time span (Exhibit 16). Hence, in our view, fears over what Spain's new government may do seem overblown and disconnected from a much more positive reality.

^{xxvii} Source: Eurostat, as of 07/19/2018. Average annualized real GDP growth rate, Q1 2014 – Q1 2018.

BRITAIN

UK: POLITICAL DISORDER WEIGHS ON SENTIMENT

The UK's political theatrics seemingly escalated in Q2 and early Q3, as the Brexit backlash mounted, Parliament battled over the EU Withdrawal Bill and PM Theresa May's cabinet split further into "hard" and "soft" Brexit camps. In early July, Boris Johnson and David Davis resigned their cabinet posts of foreign and Brexit minister, respectively, fueling speculation that May's days were numbered. But she managed to persevere, entering Parliament's summer holiday with her job intact, new ministers and a new status as Brexit negotiator-in-chief. Despite the turnover and new responsibilities, however, not much has functionally changed: May still heads up a tenuous minority government that is divided over Brexit and has difficulty passing substantive legislation. The resulting political gridlock should remain positive for UK equities, which outperformed global markets in Q2.^{xxviii}

Headlines continue speculating about a Conservative Party leadership change, but we don't view this as a likely outcome. While anything is possible, the backlash against May is strongest among euroskeptic MPs, and this is not an optimal time for anyone favoring a "hard" Brexit to helm the government. A new Conservative PM attempting to stay in power without holding a snap election would likely have to retain the Democratic Unionist Party's (DUP) support for a minority government. The DUP's primary Brexit concern is keeping the Irish border open and frictionless, placing the party in the "soft Brexit" camp. The likelihood a new government could pursue a harder Brexit and retain the DUP's support appears quite distant, likely rendering the move political suicide for Johnson or any other staunch Brexiteer rumored to have an eye on the prize. If opinion polls strongly favored the Conservatives, we could foresee a new leader calling a snap election in an attempt to win a majority, but all four polls using fieldwork conducted after Johnson's resignation depict Labour pulling ahead.^{xxix} This does not appear to be an opportune time to mount a challenge. Meanwhile, May is pressing on. After appointing Dominic Raab to succeed Davis as Brexit minister, she announced in late July that she is assuming full responsibility for all Brexit negotiations, with Raab responsible for domestic planning and implementation. This seems more political than anything else, as concern about a potential "no deal" Brexit has become Tory rebels' latest *cri de cœur*. Reversing the decision to delegate negotiations to the Brexit minister enables May to project an assertive persona, perhaps an attempt to

inspire lawmakers' confidence that her government will eventually reach a trade agreement with Brussels. However, we doubt it results in concrete changes to the UK's negotiating strategy, which May and the cabinet mandate regardless of who haggles with EU negotiator Michel Barnier.

Therefore, beneath the surface, we don't believe much has functionally changed. Prior to the summer's events, May headed a divided cabinet preoccupied by Brexit. Today, she does the same. Brexit negotiations moved in fits and starts before and continue to today—and they remain just as public and widely dissected by the media as before. The controversial Chequers agreement and Brexit White Paper stake out the government's negotiating positions, but the outcome still depends on how these negotiations go and what concessions the EU is willing to offer in order to secure a free-trade deal. This matter will likely continue monopolizing most of politicians' attention in the months ahead.

As a result, Parliament should continue struggling to pass major legislation—generally an advantage to equities, which typically react poorly to sweeping changes. The latest round of energy price caps, passed in late July, might appear to run counter to this viewpoint, but the bill should have limited reach—just as last year's caps on households using prepayment meters didn't upend the market. The new caps, which take effect this winter, will apply only to households on standard variable tariffs—fewer than half of UK households. Furthermore, the "big six" energy suppliers have already moved to phase in rate hikes before the caps—which only run through 2020—take effect. Though price caps are generally negative for markets, and history shows they typically lead to higher inflation in the end, these are not the sort of sweeping measures that could trigger a broad economic impact. Niche measures could adversely impact individual companies, and energy providers like Centrica have experienced volatility in recent weeks, but we believe investors shouldn't mistake this for a broad, negative market reaction. Moreover, this is solely one area where Labour and the Conservatives happen to agree (and despite their agreement, it took over a year to pin down). In addition to energy prices, they have very little common ground, likely making this bipartisan compromise the exception—not the rule.

^{xxviii} Source: FactSet as of 06/30/2018.

^{xxix} Source: UK Polling Report, as of 07/17/2018.



EMERGING MARKETS COMMENTARY

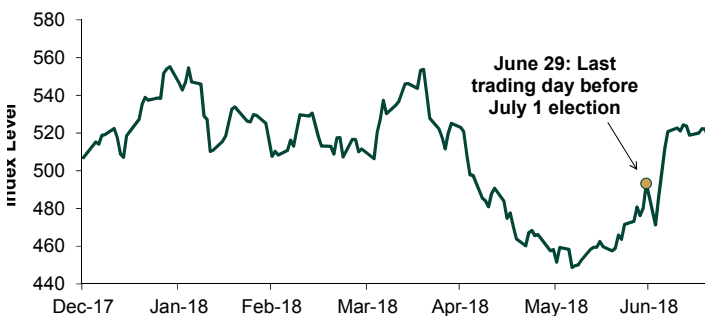
EMERGING MARKETS COMMENTARY

POLITICAL UNCERTAINTY FALLS IN MEXICO

After a month of buildup to Mexico's July 1 election—with investors fretting over the consequences—left-leaning populist Andrés Manuel López Obrador (AMLO) won 53% of the vote, crushing candidates from traditional parties. Taking over 50% of the vote hasn't happened since the 1980s when Mexican politics was effectively a one-party system, which is noteworthy considering Mexico's current multi-party system. Moreover, AMLO seems to have had long coattails—his win swept in his National Regeneration Movement (MORENA) party and its allies to a legislative majority. Many presume AMLO's leadership will negatively affect equities, given anti-business campaign rhetoric, with some making—unwarranted, in our view—comparisons to the late Venezuelan dictator Hugo Chavez. However, in our opinion, the widespread speculation and polls showing AMLO had a trivial lead in the election run up likely mean equities already reflected elevated levels of fear and uncertainty prior to the vote. If he moderates—as most politicians tend to, once in office—that would be bullish.

While we don't suggest that the short-term market movements are a large concern, it is worth noting Mexican equities rose 5.3% in the three weeks after the vote following volatility during the run up (Exhibit 17).^{xxx}

Exhibit 17: Mexican Election Fears Fade After Vote



Source: FactSet, as of 07/20/2018. MSCI Mexico Index with net dividends in USD, 12/31/2017 – 07/20/2018. Mexican general election held Sunday, 07/01/2018.

This speaks to a fairly typical scenario where heated campaign rhetoric and fear of personalities impact equities before an election, likely pre-pricing investors' worst fears. But it also creates room for reality to positively surprise.

NEW ADMINISTRATION TACKS TO CENTER

AMLO began moderating on the campaign trail—and has continued to do so as president-elect. AMLO's campaign focused mostly on ending political corruption and violent crime—potentially bullish—but investors honed in on his past anti-NAFTA rhetoric and statements he would repeal 2013's energy reforms. Despite this, he has changed his tune on both accounts.

Early in AMLO's campaign, many presumed he took a dim view of NAFTA when he called for suspending trade talks and claimed outgoing President Enrique Peña Nieto would cave to American demands. Some negotiators pushed to seal a deal ahead of Mexico's election, warning AMLO's administration might scrap it. Now, however, AMLO says he supports NAFTA and backs the outgoing government's approach. Incoming economy minister Graciela Márquez—who would lead Mexican trade talks—and finance minister appointee Carlos Urzua have expressed their desire to preserve and expand NAFTA.^{xxxi} AMLO may be more open to US demands for higher manufacturing wages. While coming from the left, AMLO's nationalism could mesh well with President Donald Trump. Meanwhile, US border state and farm belt politicians—key supporters of President Trump—are keen on staying in NAFTA. American automakers—and workers—are also vested in maintaining their global competitiveness and trade advantages. Prospects for Mexico's economic relationship with the US breaking down seem overwrought, in our view.

Regarding energy reforms, the AMLO administration also looks more market-friendly than advertised. When campaigning, AMLO spoke against constitutional changes that allowed greater private control and foreign investment in Mexico's aging energy sector. Investors fear a much-needed state production overhaul will stall for lack of capital and expertise if AMLO suspends oil-block auctions and dismantles private exploration partnerships. On MORENA's official platform however, there are no policies reversing reforms. AMLO's incoming chief of staff, Alfonso Romo, said they won't pursue changes to energy reforms or existing contracts, although the administration would review contracts for graft.^{xxxii}

^{xxx} Source: FactSet as of 07/23/2018. MSCI Mexico Index return with net dividends in USD, 06/29/2018 – 07/20/2018

^{xxxi} Source: "Mexican Election Favorite Is 'Really Not Leftist,' Adviser Tells Investors," Jean Yoon and Paritosh Bansal, Reuters, 06/06/2018. <https://www.reuters.com/article/us-mexico-election-economy/mexican-election-favorite-is-really-not-leftist-adviser-tells-investors-idUSKCN1J22S2>

^{xxxii} Source: "Landmark Mexico Oil Reform Is Set to Stay: AMLO's Chief of Staff," Nacha Cattani and Daniel Cancel, Bloomberg, 07/05/2018. <https://www.bloomberg.com/news/articles/2018-07-05/landmark-mexico-oil-reform-is-set-to-stay-amlo-s-chief-of-staff>

Indeed, it appears that AMLO has made an effort to placate foreign investors, meeting with several large institutional investment funds to relieve their fears. Urzua sought to calm markets by telling investors AMLO remains committed to NAFTA, free trade, a free-floating currency, central bank independence and a primary budget surplus. Romo has emphasized the private sector's role in driving growth, floating bank deregulation and more flexible pension investment rules for diversification outside government bonds. Of course, we do not know if what has been stated will come to fruition, and AMLO could still run Mexico like the radical leftist his critics portray him as, but the pessimism thus far doesn't seem warranted.

POLITICAL CONSTRAINTS BIND SWEEPING LEGISLATION

Aside from AMLO's moderating rhetoric and conciliatory pro-investment administration, Mexico's political realities make enacting an anti-capitalist agenda unlikely. MORENA and its political allies—the Labor Party (PT) and the religious conservative Social Encounter Party (PES)—captured three-fifths majorities in both legislative houses. However, they don't have the two-thirds of seats or the majority of state legislatures needed to amend Mexico's Constitution. Peña Nieto's major economic reforms—including energy liberalization—won't be easily overturned. Moreover, MORENA's electoral pact with the PES, which almost always voted against MORENA in the current Congress, could stymie sweeping legislation that might upset markets. MORENA itself is cobbled together with members from the traditional center-right National Action Party (PAN) and long dominant Institutional Revolutionary Party (PRI)—it isn't ideologically monolithic.^{xxxiii}

Further, the Peña Nieto administration passed constitutional reform to allow reelection for legislators, which also exerts a moderating influence. Under the old rules, the Constitution banned Mexican legislators from seeking reelection, so all legislators elected July 1 are new. But moving forward, they will be allowed to seek reelection. The lower house can serve up to four three-year terms and Senators can serve two six-year terms. The president will remain limited to one six-year term. Confronted with reelection, politicians' incentives are likely more aligned with—and accountable to—the public. Rather than do as much as they can—for good or ill—once in office, legislators may focus more on not harming their reelection chances, which usually points to inertia and moderation. It doesn't take radical legislation off the table, but accountability at least adds some friction.

It is too early to conclude how AMLO and his congressional majority will govern and what NAFTA negotiations will bring, but in our view, reality is likely to positively surprise. Political constraints and the AMLO administration's investor outreach suggest it is unlikely a new Latin American strongman is coming to power and ready to run the country into the ground for personal gain under a socialist guise. As fears fade, we think investor relief should lift sentiment and Mexican equities.

TURKEY'S CURRENCY AND FISCAL WOES

Turkey had a turbulent quarter, with the MSCI Turkey falling -25.8%.^{xxxiv} This brought year-to-date returns to -29.6%—far underperforming the MSCI Emerging Markets' -6.6% return in 2018 through Q2.^{xxxv} While some pundits argue weak returns in Turkey (and Frontier Markets behemoth Argentina) foretell broader EM weakness, we believe the decline is principally due to country-specific factors—hence the outsized drop. The combination of quasi-dictator Recep Tayyip Erdoğan's consolidating power via a snap election and poor fiscal and monetary policy—seemingly tied to that election—caused weakness early. Then, when President Erdoğan seemed to threaten the central bank's independence, a currency crisis ensued, spooking investors.

In mid-April, President Erdoğan called snap elections for June 24—well before their original November 2019 date. President Erdoğan argued an early vote would remove political uncertainty and allow Turkey to focus on more pressing matters—like instability in nearby Syria. However, many believe President Erdoğan was trying to consolidate presidential power. A referendum last April transferred authority from the premiership to the presidency, granting unprecedented executive power to this election's winner. The president is now able to issue decrees without Parliamentary input or veto, as well as handpick many of the judges and other officials tasked with reviewing executive decisions. That said, President Erdoğan already held substantial power ever since imposing “emergency rule” following a failed coup attempt in 2016. This form of martial law allowed President Erdoğan to suppress opposition and exert substantial influence on all branches of the Turkish government.

^{xxxiii} Source: “Mexico Leftist's Motley Coalition Augurs Post-Election Balancing Act,” Dave Graham, Reuters, 06/22/2018. <https://www.reuters.com/article/us-mexico-election-analysis/mexico-leftists-motley-coalition-augurs-post-election-balancing-act-idUSKBN1J119G>

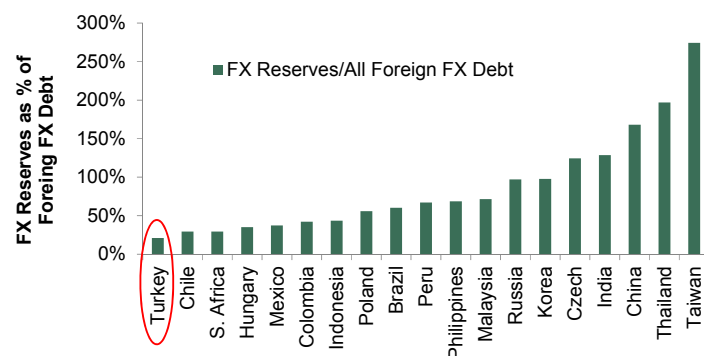
^{xxxiv} Source: FactSet, as of 07/23/2018. MSCI Turkey return with net dividends in USD, 03/30/2018 – 06/29/2018.

^{xxxv} Ibid. MSCI Turkey and MSCI Emerging Markets returns with net dividends in USD, 12/31/2017 – 06/29/2018.

Thus, aided by his iron grip on the media and jailing of many opposition political figures and dissenters, President Erdoğan eked out a narrow victory in the June vote.^{xxxvi} Many investors fear he will use his new authority to Turkey's detriment—and indeed, things may worsen from a civil and human rights perspective. But markets are callous—and from their perspective, we believe the election likely changed little. President Erdoğan already exercised significant control over Turkish politics, operating largely without checks from Parliament well before the referendum took effect. For example, he has led cabinet meetings—officially the prime minister's purview—since 2015, and judges are loath to rule against him given his firing of about a quarter of the judiciary since 2016.^{xxxvii}

That said, the election seemingly heightened economic pressures. Among larger EM countries, Turkey has the lowest foreign exchange reserves relative to foreign currency debt (Exhibit 18), the highest current account deficit as a percentage of GDP and the biggest post-2010 increase in lending as a percentage of GDP, which could reflect inefficient credit growth.^{xxxviii} Large fiscal and monetary stimulus programs ahead of 2017's referendum—and in the lead-up to the snap election—drove much of this spending. This was likely intended to raise President Erdoğan's odds of victory in both. The strategy seemingly worked, but at the cost of rising inflation, surging foreign currency-denominated debt and a weak lira.

Exhibit 18: Turkey's Forex Reserves are the Lowest Relative to Foreign Currency Debt Among Major Emerging Markets



Source: FactSet, as of 7/19/2018. Turkey 1-Week Repo Rate and USD per lira spot exchange rate, 3/30/2018 – 6/29/2018.

xxxvi Source: Turkey election: Erdogan wins re-election as president,” Staff, BBC, 06/25/2018. <https://www.bbc.com/news/world-europe-44596072>

xxxvii Source: “Five Takeaways From Turkey’s Election,” Palko Karasz, The New York Times, 06/26/2018. <https://www.nytimes.com/2018/06/25/world/europe/erdogan-turkey-election.html>

xxxviii Sources: Bank for International Settlements and IMF, as of 05/23/2018.

xxxix Source: “Turkey’s lira hammered after Erdogan says wants greater economic control,” Daren Butler and Nevzat Devranoglu, Reuters, 05/14/2018. <https://www.reuters.com/article/us-turkey-economy-erdogan/turkeys-lira-slides-after-erdogan-says-wants-greater-economic-control-idUSKCN11G0F0>

xl Source: FactSet, as of 07/19/2018.

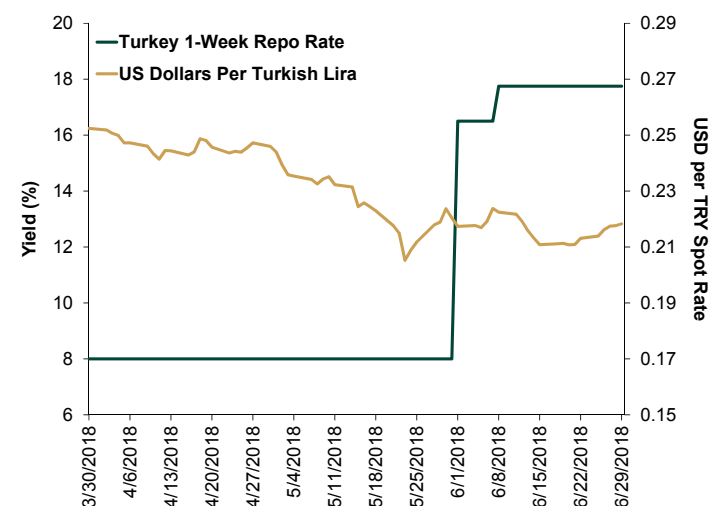
xli Ibid.

xlII Source: FactSet, as of 07/19/2018. Turkey 1-Week Repo Rate, 05/30/2018 – 06/08/2018.

Against this backdrop, many investors expected the Turkish Central Bank to respond with rate hikes—the typical way to stabilize a volatile currency. Yet they initially didn’t. Meanwhile, President Erdoğan vocally opposed higher rates. Despite having no official power over the central bank, he publicly declared he would assume responsibility for its decisions, claiming he would be credited or blamed for the outcome regardless.^{xxxix}

This threat to the bank’s independence caused sentiment to deteriorate rapidly, exacerbating the lira’s decline. Tied to currency weakness and excess fiscal stimulus, CPI jumped from 10.8% y/y in April to 12.1% in May, finishing the quarter at 15.4%.^{xl} June’s 14.7% y/y core CPI reading (excluding Energy, Food, Alcohol and Tobacco) was the highest on record.^{xli} The spiraling situation essentially forced the central bank to take action. It raised the one-week repo rate three times between May 31 and June 8—from 8.00% to 17.75% (Exhibit 19).^{xlII} This seemed to temporarily slow the lira’s slide, but it didn’t reverse it. Moreover, volatility resumed in late July after the central bank held rates steady versus an expected 1.0% hike.

Exhibit 19: Rate Hikes Stanch the Lira’s Bleeding



Source: FactSet, as of 7/19/2018. Turkey 1-Week Repo Rate and USD per lira spot exchange rate, 3/30/2018 – 6/29/2018.

Markets remain uneasy tied to political developments. Since his re-election, President Erdoğan has jailed an additional 18,000 civil servicemen, tapped his son-in-law to lead the newly combined Treasury and Finance ministries (which would oversee the central bank), given himself the authority to appoint the central bank governor and removed term limits on central bank governors.^{xliii} President Erdoğan's penchant for commenting on monetary matters hasn't subsided either—he “predicted” rates falling in the near future, which may renew concerns over the central bank's policy direction and independence.

Meanwhile, although the government recently lifted the aforementioned state of emergency, Parliament swiftly extended similar powers to the presidency and local governments. Under the new plan, city officials may ban citizens from assembling in public places if they deem it a threat to safety or order. Government ministers will still be able to dismiss judges and other public officials. In effect, emergency rule will go on.

President Erdoğan's haphazard, arbitrary antics are a net negative, deepening political risk in Turkey—but we don't believe the country's governance and economic issues threaten broader EM stocks. Turkey's issues are Turkey-specific—a fact its underperformance relative to broader EM stocks reflects. Most other EMs aren't spending like crazy while threatening their central banks' independence. Hence, we don't believe Turkey's challenges are likely to spill over and negatively impact other EM economies.

CHINESE MARKET VOLATILITY

As mentioned, President Trump's tariffs weighed on select Emerging Markets, including China. While new tariffs are indeed a negative, we don't believe the impact is at all large enough to spark an actual hard landing in the largest EM economy. The actual tariff payments amount to an insignificant percentage of GDP, if enacted, and we believe they are easily avoidable, as discussed throughout this review. Further, the Chinese Yuan depreciated -5.0% versus the US dollar throughout the quarter.^{xliv}

CHINESE FINANCIAL LIBERALIZATION AND IMPROVED REGULATION

While media headlines fixated upon China's trade negotiations with President Trump, China continued taking incremental steps toward greater capital market liberalization, consistent with recent moves to permit greater foreign ownership of Chinese financial institutions. China announced minor market liberalizations in April. Companies seeking to list on domestic markets now have the option to issue Chinese Depositary Receipts (CDRs) as well as A-share initial public offerings (IPOs). The Securities Regulatory Commission also announced an increase in the daily purchases quota from around \$2 billion to \$8.3 billion for Hong Kong's connect programs.

Moreover, on June 1, index provider MSCI started including select Chinese A-shares in its Emerging Markets index, a widely anticipated move we believe has few implications for Chinese markets or investors. For years, China has been pushing for the inclusion of Chinese A-shares in MSCI, and was able to accomplish this on a small scale last summer. The MSCI Emerging Markets Index is adding merely 234 of the roughly 3000 A-share companies, making up about 0.8% of the index – a rounding error that is insignificant in comparison to Chinese H-shares' roughly 30% weight.^{xlv} A-shares will likely remain a small weight until China's government further opens up its domestic market. Despite sentiment impacts surrounding the announcement, markets pre-price in these factors, minimizing the probability of significant effects upon eventual inclusion.

Further, on April 27, Chinese authorities announced new asset management rules aimed at tightening the shadow banking sector. Officials have begun unwinding the sector, moving the ever-complex activities back into traditional financial markets. This supports the Chinese government's two long-running goals: to control economic activity and minimize the risk of financial crisis, which could disrupt social stability. The aim of deleveraging the shadow banking sector is fostering stability, which was re-emphasized with the government's recent decision to extend the deadline of compliance from June 2019 to December 2020.

^{xliii} “Turkey purges more workers ahead of Erdogan swearing-in,” Staff, BBC, 07/08/2018. <https://www.bbc.com/news/world-europe-44756374>.

^{xliv} Source: FactSet as of 06/30/2018.

^{xlv} Source: MSCI's May 2018 Semi-Annual Index Review, Based on 5% Chinese A-shares Inclusion.

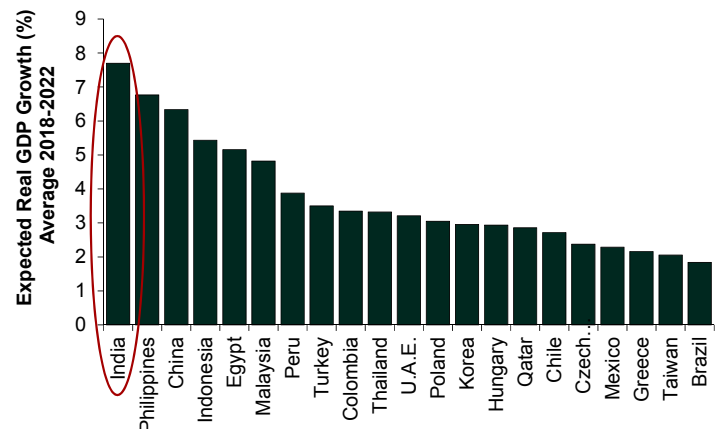
GEOPOLITICAL RISKS WEIGH ON SOUTH KOREAN SENTIMENT

South Korea was brought into the spotlight during April's high-profile summit between South Korean President Moon Jae-in and North Korean leader Kim Jong-un. This was followed by another widely watched summit with US President Donald Trump in Singapore. Whether the summit paves the way for denuclearization and investment, neither Korean stocks nor the economy are dependent on de-escalating tensions. May industrial production grew 0.3% m/m (1.7% y/y), decelerating from 1.5% m/m in April, while retail sales contracted -1.0% m/m (4.6% y/y). While not great, these data don't suggest Korean firms need a boost from their neighbor to the north.

NEGATIVE DRIVERS OVERCAST POSITIVE INDIAN ECONOMIC GROWTH

The Indian economy continues to be one of the fastest growing major economies (Exhibit 20). Aside from India's positive economic drivers, political and sentiment drivers are currently mixed. Negative drivers, such as India's vulnerability to external shocks and haphazard approach to foreign investment outweigh the nation's robust economic growth. As a result, we have shifted our positioning to a modest underweight in India. While their reform progress seems to be stalling, they have mostly moved past the effects of 2016's demonetization program and last year's goods and services tax rollout. As the unprecedented reforms of Prime Minister Modi have largely already been implemented, optimism surrounding his agenda may have run its course. Further, the reforms in India have experienced patterns consistent with the "Honeymoon Effect," the process in which optimism surrounding a political candidate's reform agenda drives markets higher, while the introduction and ensuing execution of reform tends to fall short of elevated expectations. India's recent reform successes initially buoyed sentiment and helped improve India's underlying fundamentals, driving significant outperformance for Indian shares. However, India's relative performance moved mostly sideways as these reforms were implemented, as compromises watered down the intended reform.

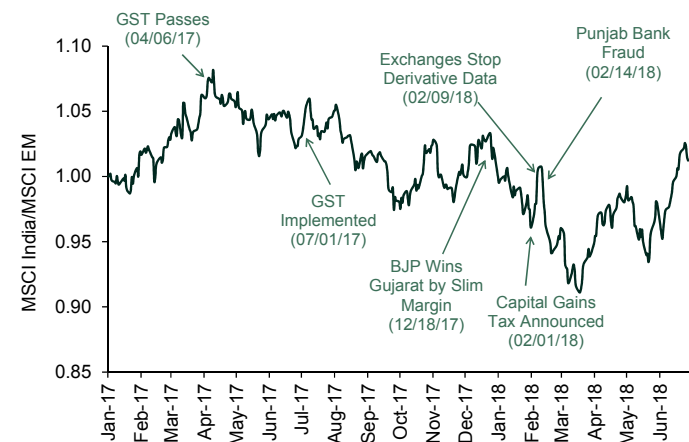
Exhibit 20: India Expected to Be the Fastest-Growing Economy



Source: IMF World Economic Outlook 2018-2022 as of 2017.

Following Q1's dented sentiment tied to the Punjab Bank fraud scandal, as well as announcement to discontinue releasing foreign exchange data for the creation of derivative products, India has slightly lagged on a year-to-date basis (Exhibit 21).

Exhibit 21: MSCI India Relative Performance



Source: FactSet, Fisher Investments Research. MSCI India and MSCI Emerging Markets Index returns with net dividends, 01/01/2017 – 06/30/2018.

The Indian government recently announced additional changes to the way foreigners can trade in local securities. These changes make it significantly more challenging and costly to trade in local markets. Currently, foreigners can trade shares on a "foreign board." When a security has reached its foreign ownership limit, investors can wait for room to become available, buy from another foreigner on the board, or buy (but not create) a depository receipt (DR). The new rules discontinue the foreign board, leaving investors to either wait for room or buy a DR for any security that has reached its limit.

GREEK BAILOUT EXIT

In late June, Greece and its creditors agreed to a debt-relief deal, giving the country some wiggle room as its recovery continues. Though the agreement has its detractors—and potential issues—the exit does seemingly pave the way for the closure of another chapter from the eurozone's debt crisis saga.

DEBT RELIEF DETAILS

The agreement gives Greece an extra 10 years to pay back about €96 billion of loans, approximately 40% of what it owes. Creditors deferred interest payments and amortizations for another decade—changing the earliest repayment deadline to 2033—and will also lend Greece €15 billion for its IMF loans and to add to its cash reserves. This provides the country about €24 billion to meet its financing needs for the next two years.

In Greece, the Syriza-led government hailed the agreement, with finance minister Euclid Tsakalotos saying, “I think this is the end of the Greek crisis.”^{xlvi}

Prime Minister Alexis Tsipras symbolically put on a tie, which he'd promised not to do until Greece got debt relief. But the opposition wasn't as optimistic, arguing the deal didn't significantly improve the country's situation. One official from the New Democracy party said Greece was in a “fish bowl” for the next several years—it could pay off maturing debt but would face difficulty borrowing privately.^{xlvi}

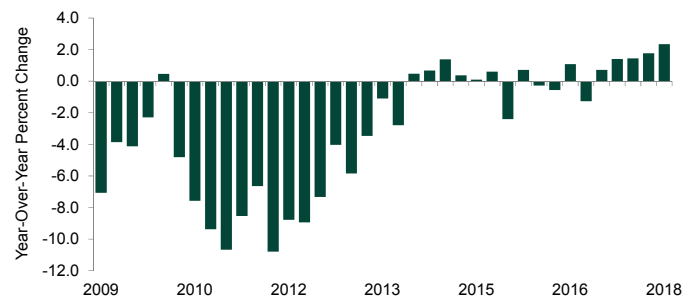
Still others fretted Greece was surrendering sovereignty in exchange for debt relief—even if they could borrow privately, the exit terms resemble an extension of bailout terms nonetheless. Further, the deal didn't cut Greece's debt load. Rather, it merely extended the maturities. That is a popular sticking point among the eurozone's developed nations and Greece's creditors (notably, Germany). Bailing Greece out for years—only to write debt off—would be a difficult political stance for creditor countries to take to their voters. However, some experts and supranational organizations like the IMF voiced concerns about Greece's future—namely the sustainability of its long-term debt. Many deadlines were pushed off years, even decades, into the future, meaning potential issues would be future finance ministers' problems.

Questions about Greece's mid- to long-term prospects remain. Future leaders could implement changes that set the Hellenic Republic back. Some worry a Greek government with a more acrimonious stance toward the deal could come sooner than anticipated given the exit deal's lack of domestic popularity. But that is speculation today. Markets look no further than 30 or so months ahead and focus most on the next 12 – 18 months. Anything beyond that timeframe is unknowable, in our view—leaving little for markets to price in.

SIGNIFICANCE OF DEBT DEAL

That said, it does appear the path to a Greek bailout exit in August was accomplished with minimal noise and rancor—the opposite of how talks largely went since 2010. In our view, the agreement is another sign of Greece's return from the abyss. Economic growth has returned (Exhibit 22). In February, Greece raised new money on capital markets for the first time since 2014. Structural reforms—e.g., privatizations—have progressed slowly but are moving forward.

Exhibit 22: Greek GDP Since 2009



Source: FactSet, as of 07/25/2018. Greek GDP, year-over-year percent change, Q1 2009 – Q1 2018.

Some headwinds still persist, and robust Greek growth doesn't seem likely in the near term. However, the worst of its pain has likely passed. Like other Emerging Markets, Greece is contributing to the broader global expansion—seemingly inconceivable just a couple years ago.

While the improvements are notable, we believe there are reasons to be cautious about investing in Greece. Greece represents merely 0.31% of the MSCI Emerging Markets Index, and the most prominent equities in the country are banks and Financials, which are shaky at best.^{xlvi} Ultimately we see this deal as paving the way for the closure of a long-running chapter in the eurozone's debt crisis—and perhaps a story that could bolster sentiment slightly.

^{xlvi} Source: “Debt relief deal gives Greece hope after years of austerity,” by Mehreen Khan, Jim Brunsten, Kerin Hope, *Financial Times*, 06/22/2018. Date accessed: 07/20/2018. <https://www.ft.com/content/bee7ec5a-7625-11e8-b326-75a27d27ea5f>

^{xlvi} Source: “Greece Will Be Stuck in Its Bailout for years to come,” by Leonid Bershidsky, *Bloomberg*, 6/22/2018. Date accessed: 06/22/2018. <https://www.bloomberg.com/view/articles/2018-06-22/greece-will-be-stuck-in-its-bailout-for-years-to-come>

^{xlvi} Source: FactSet as of 06/30/2018.

Should you have any questions about any of the information in the Second Quarter 2018 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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