

FISHER INVESTMENTS™
INSTITUTIONAL GROUP

THIRD QUARTER 2018

MARKET PERSPECTIVES

THIRD QUARTER 2018 REVIEW AND OUTLOOK
MARKET PERSPECTIVES

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

EXECUTIVE SUMMARY 1

GLOBAL UPDATE AND MARKET OUTLOOK 3

Q3 RECAP..... 3

US COMMENTARY 5

GLOBAL DEVELOPED EX-US COMMENTARY 11

EMERGING MARKETS COMMENTARY 19

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.

THIRD 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 larger, 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, M&A, rapid EM growth and strong research and development pipelines are leading to record drug approvals and healthy sales 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.
- **Global Political Gridlock:** In much of the developed world political gridlock persists decreasing the likelihood sweeping legislation potentially hurting equities passes. With US midterms in Q4 the president’s party typically loses power increasing gridlock. US equities have risen in 87% of midterm year Q4s—and each of the two subsequent quarters.

Global equities continued rebounding in Q3, with the MSCI All Country World Index rising 4.3% and finishing near all-time highs.ⁱ In Q3, Brexit negotiations, volatile commodity prices, tariffs, widening Italian budget deficits, interest rates, currency swings and corporate earnings drove headlines and spurred fears within developed economies.

Within the United States, focus shifts to midterm elections and equities’ overwhelming tendency to rise in the surrounding quarters—as well as the third year of a president’s term. Overall, gridlock dominates the developed world. This decreases the likelihood that sweeping legislation –which could hurt equities – passes. As investors gradually appreciate this, we believe it will allow them to refocus on positive economic fundamentals in most of the world, warming sentiment. In short, we believe equities still have plenty of fuel to rise for the foreseeable future.

Since 1926, US equities have risen in 87% of midterm year Q4s and each of the subsequent two quarters individually—far more frequent gains than the typical quarter.ⁱⁱ Better still: Even in the eight instances when at least one of the three quarters was negative, cumulative returns were still positive for six of these nine-month periods. Only twice have equities fallen cumulatively between the midterm year Q4’s start and the following Q2’s end: Q4 1930 – Q2 1931, during the Great Depression, and Q4 1938 – Q2 1939, as Hitler’s territorial ambitions grew. All the other nine-month periods were up, an overall 91.3% frequency of positive returns.ⁱⁱⁱ

We believe midterm elections drive this positivity for a simple, underappreciated reason: They tend to increase political gridlock, deterring radical legislation. As we will discuss in the full Review & Outlook, whether Democratic or Republican, the president’s party tends to lose relative power in midterms, hindering controversial

ⁱ Source: FactSet, as of 09/28/2018. MSCI All Country World Index Return with net dividends, 06/29/2018 – 09/28/2018.

ⁱⁱ Source: Global Financial Data, Inc., as of 09/20/2018. S&P 500 Total Return Index, 01/01/1926 – 12/31/2017.

ⁱⁱⁱ Source: Ibid.

legislation and reducing political risk. The absence of this negative is positive. Yet investors often fail to appreciate this, frustrated by the lack of action justifying their vote.

While US political gridlock typically acts as a catalyst for positive returns within US equities, it is bullish for the world as well. As we will show in the full Review & Outlook, US and global equities have been highly correlated during this bull market. Europe moves nearly in lockstep with the US. Though correlations measure only direction, this shows good times for US equities are generally good times for the developed world overall, extending the 87% positive effect globally.

Looking ahead, we expect a European resurgence. False fears and political uncertainty obscure strong fundamentals. Monthly economic data, like IHS Markit's purchasing managers' indexes, continue to suggest expansion. Italian budget worries, Brexit bickering, ascendant populists and other forces have dampened sentiment, along with fears of more European Central Bank (ECB) quantitative easing (QE) "tapering." We think the end of QE is bullish. Last quarter, we showed why ending QE should help, rather than hurt the eurozone. We are surprised markets haven't yet seen this. Data released during Q3 further prove the point, as we will detail in the full Review & Outlook. From ending QE to Brexit, we anticipate widespread relief as these commonly feared issues finally resolve without disaster—a pattern that has played out in the US as the US Federal Reserve (Fed) has continued rate hikes in the face of unwarranted fear. The more they get on with it, the more investors can get over it, freeing equities from uncertainty.

Overall, there is much for investors to like these days. Double-digit earnings growth continues, powered by robust revenues—a sign tax cuts alone aren't responsible for rising corporate profits. Positively, the US and most developed nations are politically gridlocked. The "Goldilocks" economy persists, with moderate growth and mild inflation across the globe. Troubles in Argentina and Turkey steal headlines, but Frontier and Emerging Markets overall are growing, boosting demand for goods and services from the developed world. The US and Chinese economies are shrugging off tariffs, with most indicators showing growth. Several new trade agreements are in progress, including some involving the US—defying protectionism fears.

In short, we expect positive returns to continue through 2019's first half at least. The third year of a US president's term is historically the most consistently positive, with the highest average return. A correction (a sharp, sentiment-fueled drop of -10% or worse) is always possible, but large corrections typically don't occur during US presidents' third years or after US midterms. Any declines seem likely to be small and short-lived.

GLOBAL UPDATE AND MARKET OUTLOOK

Q3 RECAP

NEGATIVE HEADLINES, CONTRARIAN INDICATORS

Negative headlines were prevalent in Q3. Slowing Chinese economic data, combined with a bear market in the Shanghai Composite, prompted worries that tariffs were causing the long-dreaded Chinese hard landing. Italy's budget battles with the EU rekindled eurozone debt and banking fears. Currency crises in Turkey and Argentina caused many to fear contagion in Emerging and Frontier Markets. These issues have one crucial thing in common: All are widely discussed, and in our view, overly feared. We believe this sentiment makes them powerful *positive* contrarian indicators.

These examples appear to be cases of investors broadly fearing distant, complex topics they don't fully understand. As Ken wrote in USA Today at September's end, the word "contagion" is usually "applied when financial folk and journalists express heavy fear about financial flows they don't understand. When they understand things correctly, they express them more definitively and specifically."

THE RETURN OF VOLATILITY

Entering Q4, it looked like equities had finally shaken off the early-year correction. The S&P 500 hit all-time highs throughout September, and the MSCI All Country World Index was close behind. Then volatility returned, with a sharp selloff in October's second week, flattening returns on the year. Investor concerns over a flattening yield curve and tariffs have driven volatility. However, we expect this negativity will prove fleeting.

QUARTERLY UPDATE ON THE PEAK

The S&P 500 hit its most recent all-time high on September 20, but then fell -9.8% through October 29.^{iv} The All Country World Index, which was near its January 26 high when the volatility struck on September 21, dropped -10.2% through October 29.^v

Like early 2018's volatility, we think this pullback looks correction-like. It has been sharp, swift and seemingly came out of nowhere while economic data and corporate earnings were strong. It also

appears driven by sentiment, not weakening economic fundamentals. The fears circulating since September 20 are all in that category of contrarian "tells"—rising interest rate fears and China trade worries. Meanwhile, investors are overlooking positive signs, including a healthy global yield curve and rising Leading Economic Indexes in most major regions.

We don't believe this is the beginning of a bear market (a deeper, longer, fundamentally driven decline). As written in past quarterly Review & Outlooks, while corrections usually start with a bang, bear markets usually roll over gradually—a whimper. Moreover, we don't see a fundamental reason for a bear market to be underway today. Bear markets usually begin when euphoric or complacent investors overlook signs of weakness. Today, we have the opposite.

Our approach, focuses on the impact of economic, political and sentiment drivers on our portfolio positioning. We are constantly monitoring for signs the bull market may be ending while employing our standard bear market "rules":

- **The 2% Rule:** Bear markets' average peak-to-trough decline is around -2% monthly.
- **The 3-Month Rule:** Never go defensive for at least three months after a peak, in order to avoid being fooled by a correction.
- **The 2/3 – 1/3 Rule:** Approximately two-thirds of a bear market's decline comes during the final one-third of its life.

These rules don't override fundamental analysis, but complement it. The key to identifying a bear market is finding a multi-trillion dollar fundamental driver that others have missed. These "rules" contribute to our disciplined approach and help us avoid getting sidetracked by short-term volatility. These rules remind us that perfect market timing is an unnecessary and risky goal when maintaining a fundamentally disciplined approach.

LEADERSHIP ROTATES

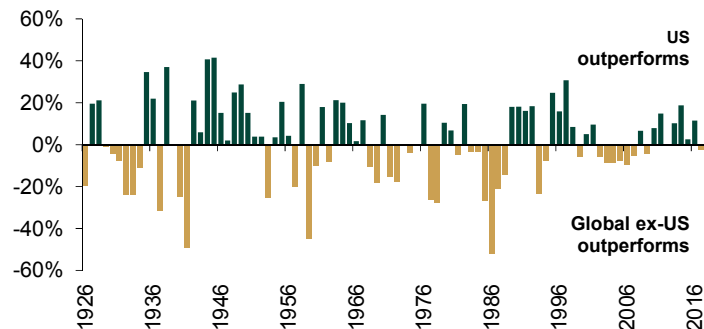
Many investors have no doubt noticed US equities outperforming equities outside of the US—not just this year, but throughout this bull market. Global markets are highly correlated—but leadership rotates, often unpredictably. US leadership has persisted for most of this bull market. However, that lead hasn't been smooth and steady. A more granular view of the past nine years shows spurts of global

^{iv} Source: FactSet, as of 10/30/2018. S&P 500 Total Return Index, 09/20/2018 – 10/29/2018.

^v Ibid. MSCI All Country World Index return with net dividends, 09/21/2018 – 10/29/2018.

ex-US outperformance. Many now forget global ex-US markets led in this bull market's first two years. Similarly, last year Europe drove global ex-US markets' outperformance.

Exhibit 1: No Country Leads Forever



Source: Global Financial Data, as of 04/13/2018. Annual S&P 500 price returns minus GFD World Ex. USA Index price returns, 1926 – 2017. Price returns used in lieu of total due to data availability.

Beyond this bull market, recent US outperformance makes many forget past stretches when global ex-US equities led; like the last bull market, when the US lagged for six straight years or 1968 – 1974. Even during the 1982 – 1987 bull market—a period many US investors recall as hugely bullish for US equities—global ex-US equities vastly outperformed.

Even during the 2009 burst of global ex-US leadership—many feared US equities would underperform in this bull market. However, relatively consistent US leadership in this bull market didn't begin until August 2011—days after Standard and Poor's downgraded the US's credit rating, which most thought bearish.

That so many underestimate the strong fundamentals of global ex-US equities is telling about the current state of sentiment. The extreme preference for US equities is reason to be bullish about Europe. Unloved categories often perform well looking forward, especially if they are unloved for no fundamental reason. We believe that is true of Europe today.

A NEW TRADE DEAL

Canadian and US negotiators reached a last minute deal on September 30, bringing Canada into the trade agreement the US and Mexico reached in August. The newly revised agreement, dubbed the United States-Mexico-Canada Agreement (USMCA), will replace the North American Free Trade Agreement (NAFTA) if and when national legislatures approve it. Meeting the deadline allows US President Trump, Mexican President Enrique Peña Nieto and Canadian Prime Minister Justin Trudeau to sign the deal on November 30, one day

before Mexico's president-elect Andrés Manuel López Obrador takes office. The new agreement doesn't represent a major shift from NAFTA overall – Canada gave some ground in reducing protections for its dairy industry, and the new agreement includes a 16-year sunset clause.

TARIFFS UNLIKELY TO DERAIL ECONOMIC EXPANSION

Tariff issues with China escalated in September, as the US imposed long-discussed tariffs on \$200 billion in Chinese goods on September 24. Not only is there little new here—officials telegraphed these tariffs months ago—but in our view, the tariffs' size and likely effects are too small to significantly dent growth. The latest Chinese import tariffs start at 10% but rise to 25% at year end, buying more time for negotiations. Even if it hits 25%—and China responded proportionally—total tariffs enacted amount to only a tiny fraction of global GDP, unlikely to derail the expansion.

COMMUNICATION SERVICES REPLACES TELECOM IN MSCI AND S&P INDICES

At the close of Q3, Index providers S&P Dow Jones Indices and MSCI crafted a new sector called Communication Services. This new sector combined the old Telecommunication Services sector with Media and Entertainment firms. As a result, it pulled in some former Consumer Discretionary firms and even some former Technology firms, including Alphabet (Google's parent company) and Facebook. Though thought of as Information Technology due to their ubiquitous online presences, both companies earn the majority of their revenue from advertising, making them very media-like.

Sector changes don't alter our outlook for the affected companies. Rather, reclassifications are typically backward-looking formalities—official recognition of trends and developments the market priced in long ago. The trends S&P and MSCI recognized when making the change are issues we have long incorporated into our security analysis. Even the shift was long communicated, as the index providers announced they were considering it over a year ago.

Some observers lamented the loss of the Telecom sector, as Telecom has long been considered “defensive.” While the broader Communication Services sector may be more cyclical, Telecom will remain an industry group within that sector and likely retain its defensive characteristics. If anything, the change highlights the need to consider industry groups as well as broad sectors—again, a normal part of our analysis.



US COMMENTARY

THE S&P 500 TENDS TO RISE SUBSEQUENT TO THE MIDTERMS

We have now entered equities' overwhelming historical positive period during a midterm election year's Q4 and the following two quarters. As we showed last quarter, since 1926, S&P 500 returns during each of these quarters have been positive 87% of the time—far above equities' non-midterm 64.6% quarterly frequency of positivity.^{vi}

Q4's rocky start doesn't negate this phenomenon, in our view. First, consider the following: We are only a few weeks into a three-quarter stretch. Nothing about a negative start implies a poor period in total. Of the 23 midterm-year Octobers since 1926, the S&P 500 fell in eight of them. In only two (1930 and 1978) did this contribute to a down Q4. And in only one (1930) was the full nine-month period down. There were eight instances when at least one of the quarters over the full three-quarter period was negative. But in five of those, cumulative returns were still positive. Notably, in 1978, the midterm-year Q4 fell -5.0%, but the next two quarters were positive, bringing cumulative returns to 4.4% during these nine months. Simply, we are entering a stretch that hasn't been negative since the dawn of World War II. Overall, returns during the full nine months were positive 91.3% of the time since 1926. Being bearish today seems unwise. Exhibit 2 shows this history, with returns in each quarter as well as the cumulative return over the full nine months.

The midterm is the gateway to year three of the president's term—historically, the most consistently positive, with the highest average return. As referenced in the Executive Summary and in Exhibit 3 on the next page, year three has also been negative just twice in history—1931, during the Great Depression, and 1939, as World War II's storm clouds gathered over Europe. Average returns in year three are 17.8%, dwarfing all other years. Politically, we are entering a very positive stretch.

Exhibit 2: Historical US Midterm Returns – Being Bearish Seems Unwise

Midterm Year	Midterm Year Q4	Subsequent Year Q1	Subsequent Year Q2	9-Month Cumulative Return
1926	2.0%	4.6%	7.3%	14.4%
1930	-16.4%	10.2%	-9.9%	-17.0%
1934	5.4%	-9.9%	22.1%	15.9%
1938	9.0%	-16.0%	0.0%	-8.4%
1942	12.1%	20.1%	8.0%	45.4%
1946	3.5%	0.3%	1.5%	5.5%
1950	6.9%	6.7%	-0.3%	13.7%
1954	12.6%	2.8%	13.3%	31.1%
1958	11.2%	1.2%	6.3%	19.6%
1962	13.1%	6.4%	5.0%	26.4%
1966	5.9%	13.2%	1.3%	21.4%
1970	10.3%	9.7%	0.2%	21.2%
1974	9.3%	23.0%	15.4%	55.0%
1978	-5.0%	7.1%	2.6%	4.4%
1982	18.3%	10.0%	11.1%	44.5%
1986	5.6%	21.3%	5.0%	34.5%
1990	9.0%	14.5%	-0.2%	24.5%
1994	0.0%	9.7%	9.5%	20.2%
1998	21.3%	5.0%	7.0%	36.3%
2002	8.4%	-3.1%	15.4%	21.2%
2006	6.7%	0.6%	6.3%	14.1%
2010	10.8%	5.9%	0.1%	17.4%
2014	4.9%	1.0%	0.3%	6.2%
2018	-	-	-	-
Average Return	7.2%	6.3%	5.5%	20.3%
Average if (+)	9.3%	8.7%	6.9%	23.5%
Average if (-)	-7.1%	-9.7%	-3.5%	-12.7%
Freq. Positive	87.0%	87.0%	87.0%	91.3%

Source: Global Financial Data, Inc., as of 09/20/2018. S&P 500 Total Return Index, 01/01/1926 – 06/30/2015.

^{vi} Source: Global Financial Data, as of 10/16/2018. S&P 500 total return frequency of quarterly positivity in non-midterm miracle periods, Q1 1926 – Q3 2018.

Exhibit 3: The Presidential Term Anomaly

Winner	Inaugural Year		Second Year		Third Year		Fourth Year	
Coolidge	1925	29.5%	1926	11.1%	1927	37.1%	1928	43.3%
Hoover	1929	-8.9%	1930	-25.3%	1931	-43.9%	1932	-8.9%
FDR - 1st	1933	52.9%	1934	-2.3%	1935	47.2%	1936	32.8%
FDR - 2nd	1937	-35.3%	1938	33.2%	1939	-0.9%	1940	-10.1%
FDR - 3rd	1941	-11.8%	1942	21.1%	1943	25.8%	1944	19.7%
FDR / Truman	1945	36.5%	1946	-8.2%	1947	5.2%	1948	5.1%
Truman	1949	18.1%	1950	30.6%	1951	24.6%	1952	18.5%
Eisenhower - 1st	1953	-1.1%	1954	52.4%	1955	31.4%	1956	6.6%
Eisenhower - 2nd	1957	-10.9%	1958	43.3%	1959	11.9%	1960	0.5%
Kennedy / Johnson	1961	26.8%	1962	-8.8%	1963	22.7%	1964	16.4%
Johnson	1965	12.4%	1966	-10.1%	1967	23.9%	1968	11.0%
Nixon	1969	-8.5%	1970	4.0%	1971	14.3%	1972	18.9%
Nixon / Ford	1973	-14.8%	1974	-26.5%	1975	37.3%	1976	23.7%
Carter	1977	-7.4%	1978	6.4%	1979	18.4%	1980	32.3%
Reagan - 1st	1981	-5.1%	1982	21.5%	1983	22.5%	1984	6.2%
Reagan - 2nd	1985	31.6%	1986	18.6%	1987	5.2%	1988	16.6%
Bush	1989	31.7%	1990	-3.1%	1991	30.5%	1992	7.6%
Clinton - 1st	1993	10.1%	1994	1.3%	1995	37.6%	1996	23.0%
Clinton - 2nd	1997	33.4%	1998	28.6%	1999	21.0%	2000	-9.1%
Bush, G.W. - 1st	2001	-11.9%	2002	-22.1%	2003	28.7%	2004	10.9%
Bush, G.W. - 2nd	2005	4.9%	2006	15.8%	2007	5.5%	2008	-37.0%
Obama - 1st	2009	26.5%	2010	15.1%	2011	2.1%	2012	16.0%
Obama - 2nd	2013	32.4%	2014	13.7%	2015	1.4%	2016	12.0%
Trump	2017	21.8%	2018		2019		2020	
Percent Positive	58.3%		65.2%		91.3%		82.6%	
All (Avg)	10.5%		9.1%		17.8%		11.1%	
Positive Years (Avg)	26.3%		21.1%		21.6%		16.9%	

Source: Global Financial Data, Inc., as of 09/20/2018. S&P 500 Total Return Index, 01/01/1926 – 12/31/2017.

Midterms routinely increase gridlock as the president's party loses relative power. Once midterms end, focus shifts to the next presidential election, and both sides start campaigning. Would-be presidential challengers focus more on making names for themselves than advancing legislation. Meanwhile, the president typically moderates in order to avoid rocking the boat and alienating the centrist voters necessary to secure re-election. We think President Trump's decision to back down from border wall funding demands in order to avoid a government shutdown before midterms is a sneak preview of this gridlock.

Overall, the run-up to campaigning typically amounts to a relatively light legislative calendar, with little of consequence passing through congress. Midterms' tendency to raise gridlock is also why presidents

tend to frontload major legislation in their first two years. We think this explains equities returns' far higher variability in years one and two. It is when their political capital is highest—and when they have the most time to repair the electoral damage contentious legislation can cause.

Bullishly, midterms are upon us. The widely watched election will be over and we will know the makeup of the US government through 2020. Volunteer calls, yard signs and television spots soon will vanish, providing some relief before presidential campaigns kick off. Our view of midterms is unchanged: We expect a far smaller shift than many pundits. The most likely scenarios: Either the Republicans narrowly hold the House and Senate or the Democrats narrowly win one or both chambers. Either of these scenarios would bring gridlock.

THE BATTLE FOR THE US HOUSE OF REPRESENTATIVES

Since the House of Representatives became a 435-seat body in 1912, the president's party lost seats in 23 of 26 midterms.^{vii} On average, a net 30 seats flipped—above the 23 Democrats must win to gain control. Incumbency is crucial in House races, which is an edge for Republicans, to an extent. But this is mitigated by a far larger number of open GOP seats this year. In sum, we think the Democrats have a slightly higher chance of taking control by a small margin.

Yet this won't be easy. Redistricting rendered only about 36 truly toss-up seats. This means Democrats would have to perform very well in the toss-up races and/or steal a few upsets to take control. While we think the House is leaning Democratic, it would not shock us if Republicans held on by a small margin.

AS FOR THE SENATE...

We still believe the Republicans are most likely to retain slim control of the Senate, perhaps even add a seat or two. Much of this is driven by structure. As noted in past Review & Outlooks, Democrats have far more seats contested this year (26) than Republicans (9). Moreover, of those 26 Democratic seats, 10 are in states Trump won in 2016. Trump took a majority in six—implying incumbents' seats are at risk. (Exhibit 4) By contrast, just one Republican seat is in a state Hillary Clinton took—Dean Heller's Nevada seat, a state Clinton won by a narrow, 48% – 46% margin.

RACES TO WATCH

The Senate likely hinges on a few key races. Republicans aim to flip Indiana, North Dakota, Missouri and possibly Florida. If current polls hold, North Dakota looks likely to shift Republican, as Kevin Cramer leads incumbent Sen. Heidi Heitkamp by double-digits in the NBC News and Fox News polls.^{viii} In Indiana, Democratic Sen. Joe Donnelly's narrow lead over Mike Braun is well within the margin of error.^{ix} Races in Florida and Montana show Democratic incumbent Senators Bill Nelson and Jon Tester similarly lead by slim margins. Meanwhile, Josh Hawley is in a virtual dead heat with Missouri Sen. Claire McCaskill.

Democrats are targeting Dean Heller's seat in Nevada, Sen. Bob Corker's open Tennessee seat and retiring Sen. Jeff Flake's Arizona seat. In all three races, GOP candidates are currently out-polling Democratic challengers, although Arizona's race between Republican Martha McSally and Democrat Kyrsten Sinema has gone back and forth with no clear frontrunner. This ultimately looks like a scenario where the Republicans gain one or two seats, expanding their majority—but not nearly enough to push through legislation.

Exhibit 4: 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%	States Clinton Won in 2016
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%	
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. ***Sen. Feinstein's challenger is also a Democrat due to California's primary system, which pits the top two finishers against one another regardless of party affiliation.

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

viii Source: Real Clear Politics, as of 10/16/2018.

ix Source: Ibid.

SWING FACTORS?

Ultimately, results depend in large part to resource allocation and individual campaigning. From a fundraising perspective, there isn't a huge divide between the two parties. This is more evidence the ability of Democrats to turn the House of Representatives and the Senate, which many pundits hyped throughout 2018, may not arrive.

Through October 15, Democratic House and Senate candidates are outraising Republicans, \$1.13 billion to \$827 million.^x However, the Republicans are outraising Democrats at the national committee level, resulting in total funding (individual House and Senate candidates plus national committee) of \$1.25 billion for the Democratic Party versus \$1.07 billion for the GOP.^{xi}

GRIDLOCK REIGNS

If Republicans hold both chambers, the intraparty gridlock existing since 2016's vote likely persists and probably even deepens as Trump likely focuses more on re-election and campaigning. This reduces the likelihood of major legislation, in our view.

If the Democrats take one or both chambers, this returns the traditional party vs. party gridlock that existed from 2010 – 2016, a great period for equities. Further, while the Democrats may take the House and/or Senate, the chances they win a huge margin in either are remote. This is especially true—and meaningful—in the Senate. As written in our Q1 2018 Client Review & Outlook, if the Democrats take the House, they can introduce articles of impeachment—perhaps even advance them to a trial in the Senate. Yet conviction takes a two-thirds Senate vote. Barring huge revelations yet to emerge, reaching 67 votes to oust Trump looks like a stretch. A Republican Senate didn't vote to oust Bill Clinton in 1998. The threshold for conviction is high.

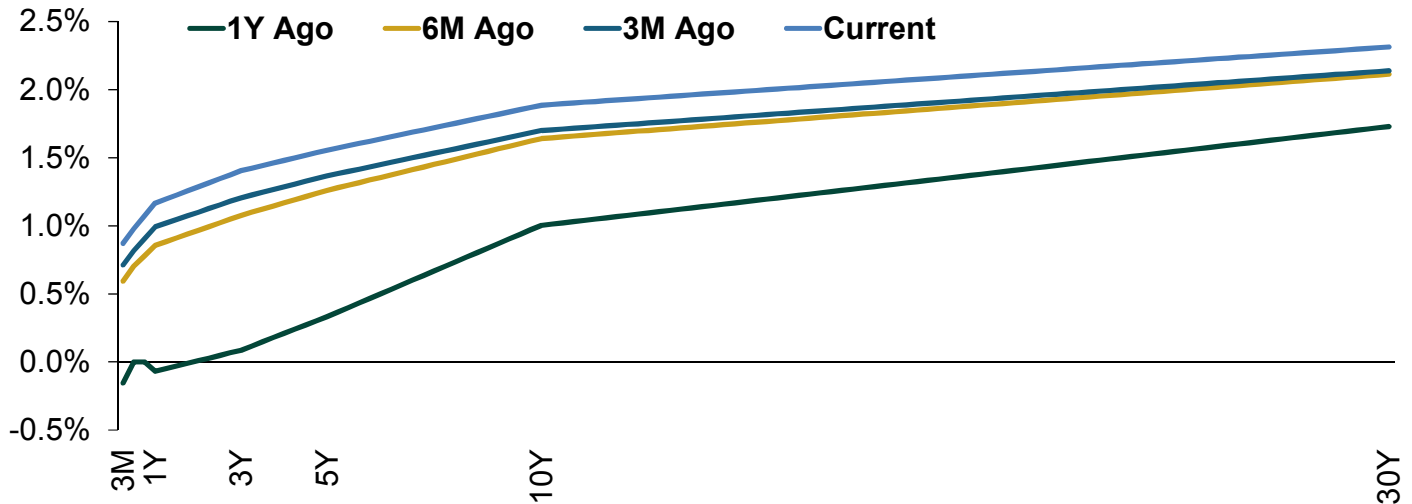
Though these political drivers center on the US, they apply to global markets. Global developed markets don't move in lockstep, but they generally head in similar directions. Usually, what is good or bad for US equities impacts global ex-US equities similarly (and vice versa). Statistically, high correlation coefficients between the US and global ex-US markets show this. The correlation coefficient between the US and MSCI EAFE Index during this bull market is 0.84.^{xii}

We expect this relationship to persist in this election cycle. In our view, US political angst at least partially explains the performance of non-US equities recently—possibly even more in Europe and China, where recent tariff concerns have weighed heavily. To the extent midterms reduce US political risk, non-US equities could be even bigger beneficiaries.

^x Source: Federal Election Commission, as of 10/16/2018. Total Democratic and Republican House and Senate candidate receipts in 2018 election cycle.

^{xi} Source: Ibid. Total Democratic House and Senate candidate receipts in 2018 election cycle plus DNC Services Corporation receipts and total Republican House and Senate candidate receipts in 2018 election cycle plus Republican National Committee receipts.

^{xii} Source: FactSet, as of 09/26/2018. Based on weekly price returns of the S&P 500 Index and MSCI EAFE Index in local currency terms, 03/09/2009 – 09/21/2018.

Exhibit 5: Global Yield Curve

Source: FactSet, Global Financial Data, Inc., Bloomberg and Thomson Reuters, as of 10/08/2018. MSCI World Index countries' 10-year and 3-month yields weighted by quarterly real GDP as of 09/30/2018.

INTEREST RATES AREN'T PROBLEMATIC

Interest rates have dominated investors' attention lately. At first, many feared a flattening yield curve, wrongly emphasizing the gap between 2-year and 10-year US Treasury yields, as discussed in Q2's Review & Outlook. Then, as long rates rose throughout September and early October, many worried rising rates would kill the bull—ignoring that rising long rates steepen the yield curve, easing the issue they feared earlier in the year.

In reality, the global yield curve hasn't budged much over the past year, as Exhibit 5 shows. Long rates are up a bit, but not by much, despite widespread expectations for a large move. Year to date through September 30, US Treasury yields are up 65 basis points—only 11 basis points above the median nine-month move since 1962.^{xiii} Actually, despite the fear over recent rate jumps, the US 10-year Treasury yield's year-to-date high on October 5 is just 12 basis points above the prior year-to-date high notched in April.^{xiv} The high prior to October 5 was set on May 17 at 3.11%.

Looking ahead, we expect rates to stay benign. The US Federal Reserve may continue raising its short-term interest rate target gradually, but it is difficult to envision monetary policymakers raising rates more than expected with all that is going on in the world (including Brexit uncertainty, China wobbles and more political theatrics around the world).

^{xiii} Source: Federal Reserve Bank of St. Louis, as of 10/16/2018. Median rolling nine-month change in US Treasury yields (up or down), January 1962 – September 2018.

^{xiv} Source: Federal Reserve Bank of St. Louis, as of 10/16/2018. US 10-year Treasury yield, 12/31/2017 – 10/15/2018.



GLOBAL DEVELOPED EX-US COMMENTARY

EUROZONE

UNLOVED EUROPE

In our view, renewed political uncertainty has hindered European equities this year. However, we remain optimistic our Europe overweight (in global portfolios) should lead moving forward as uncertainty falls, revealing underappreciated fundamental strength.

BREXIT BICKERING

With about five months to go until Brexit is scheduled to become official, the final deal remains unknown. After a mid-October EU summit, Prime Minister Theresa May claimed 95% of the withdrawal deal was agreed to, but major question marks surround the Irish border and the UK's trade relationship with the EU. Specifically, the EU wants a "backstop" solution to the Irish border in the event that a long-term trade deal fails to address the issue. Their top two solutions are keeping the UK in the EU's customs union or using the Irish Sea as the border for customs checks, but Prime Minister May likely can't get either option through Parliament. Members of Parliament from the Democratic Unionist Party, which supports her minority government, have even put forth legislation that would make it illegal to carve the UK into two separate regulatory and customs territories. Meanwhile, Prime Minister May's government is considering extending the post-Brexit transition period beyond December 31, 2020 in order to win more time to solve the border question.

At this point, we have a very hard time envisioning any possible negative outcome that markets haven't already considered.

The outcome is impossible to predict, though the probability of a "kick the can" solution appears high, especially with the government now warming to a longer transition. The EU has already offered to extend the transition period through early 2022, and accepting a longer phase-in would give both parties an escape from the current deadlock. It wouldn't be difficult. The UK and EU could issue a joint political statement outlining vague future trade principles without making a binding legal commitment. That would buy them time to ensure a deal, thereby kicking the real Brexit date a little further down the road and buying more time to reach a compromise on the border.

Though this might seem beneficial as it avoids the cliff-edge "no deal" Brexit scenario so many fear, we believe markets would likely benefit most from simply getting on with Brexit—regardless of whether it is "soft," "hard" or "no-deal." Many analysts focus on the particulars of any exit, trying to assess whether various trade arrangements would be beneficial or harmful for the UK economy and markets. However, in our view, this misses a key point: markets are forward-looking and dislike uncertainty. They price widely discussed information and expected events before they occur, and Brexit's possible endgames have been discussed far and wide for over a year now. No-deal chatter has preoccupied investors for months, making speculation about markets' reaction to various outcomes too backward-looking.

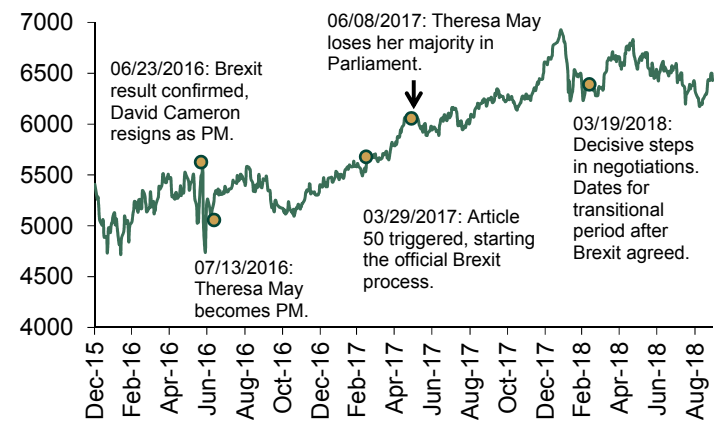
At this point, we have a very hard time envisioning any possible negative outcome that markets haven't already considered. The government's comprehensive no-deal whitepapers left no stone unturned. Industry groups have warned of food and drug shortages and intolerable backlogs at ports. Several think tanks have estimated a large, negative impact from new tariffs. Companies have warned of the potential need to relocate factories and offices. In our view, saying markets haven't yet priced in all the potential negatives is to say markets aren't efficient at all. It all rather reminds us of the Millennium Bug ("Y2K") nearly two decades ago.

Meanwhile, there is mounting evidence prolonged Brexit uncertainty has hurt investment and risk-taking. For one, we suspect it is a large contributor to the correction in UK shares that began in late May. It also appears to have affected businesses' decision-making capabilities. Business investment fell consecutively in Q1 and Q2.^{xv} In a recent survey, only 12% of UK businesses' Chief Financial Officers called today a good time to take risk, while 44% said they expect to cut investment over the next three years.^{xvi} A separate survey, from the Confederation of British Industry, showed 80% of firms reporting reduced investment due to political uncertainty—up from 36% a year ago.^{xvii} In CIPS and IHS Markit's purchasing manager surveys, businesses routinely blame Brexit worries for muting growth.^{xviii}

In our view, businesses would benefit from an end to the uncertainty. We suspect it isn't the sheer prospect of a no-deal Brexit that is delaying risk-taking. Companies have made contingency plans for that potential outcome. But without knowing what the rules will be after Brexit, it is basically impossible to know which plan to execute. Even seemingly simple decisions, like deciding where to locate a new factory, become difficult and fraught with risk when future trade arrangements aren't clear. Is it better for a UK firm to open a new facility in Wales and risk new tariffs and customs checks on shipments into the EU? Or should it locate the new factory in Ireland, inside the customs union? While this might seem like a no-brainer, consider that if the UK leaves the customs union, it can sign new free-trade agreements with the US, Korea, Japan and many others, which a factory in the EU wouldn't benefit from. Only after a Brexit deal is final will businesses know all the variables, enabling them to launch long-term investment plans.

Equities should also benefit from an end to Brexit uncertainty. When issues like Brexit weigh on sentiment, relief typically comes when the thing everyone fears finally happens—and life goes on anyway. For instance, the only thing that enabled US investors to get over fears of the Federal Reserve raising short-term interest rates three years ago was for the Fed to actually hike rates. 2012's widely feared US "Fiscal Cliff" of tax hikes and spending cuts weighed on sentiment until it passed without harm. In both cases, after the event, investors realized their fears were overblown. The same thing happened surrounding the Brexit vote—equities were rocky in the run-up to the referendum and fell sharply in the initial aftermath, but UK equities have been gradually increasing since.

Exhibit 6: Stable UK Equity Performance Despite Brexit Uncertainty



Source: FactSet, as of 10/30/2018. MSCI United Kingdom Index Return with net dividends in USD, 12/31/2015 – 09/30/2018.

Markets move most on surprises. In our view, based on all the dire forecasts circulating, anything short of a Brexit disaster would be a pleasant surprise for equities. We believe this is true whether Brexit goes well, just ok or even rather badly. Any would be an improvement over the all-out mayhem many predict, enabling UK and European equities alike to enjoy a relief rally.

ITALIAN INDECISIVENESS

Italy is another sentiment roadblock. After all the theatrics and threats, Italy's populist coalition agreed on a larger budget deficit than many expected—missing an opportunity to moderate, and prolonging uncertainty. While some fret the higher spending, we don't think this will prove to be a significant drag on the Italian economy. The preeminent Italy fear remains a "Quitaly"—a disorderly euro exit, in which Italy repays debt in devalued lira. Quitaly jitters drive up Italian sovereign debt yields—as they have at various points this year. However, an actual Quitaly remains highly unlikely.

As we highlighted in last quarter's Review & Outlook, Italian debt doesn't seem hugely problematic. Interest payments' share of tax revenue is near generational lows. Bond maturities are long, too—averaging just under seven years—so short-term rate swings won't immediately widen the deficit. To harm Italian debt affordability, rates would have to rise and stay high for years while Italy gradually refinances. Moreover, both Five Star Movement (M5S) and The

^{xv} Source: Office for National Statistics, as of 10/22/2018.

^{xvi} Source: "Brexit Anxiety for Businesses 'at Highest Since Referendum,'" Graeme Wearden, *The Guardian*, 10/08/2018.

^{xvii} Source: "Bosses to Activate Brexit Panic Button by Christmas," Anna Isaac, *The Telegraph*, 10/21/2018.

^{xviii} Source: IHS Markit, as of 10/22/2018.

League leaders have muted their Quitaly rhetoric—especially since polls indicate a majority of Italians don't support it. It is very unlikely they could get the two-thirds vote necessary to pass euro-exit legislation. With both parties jockeying for primacy, pushing an unpopular, likely unattainable policy right now seems unwise.

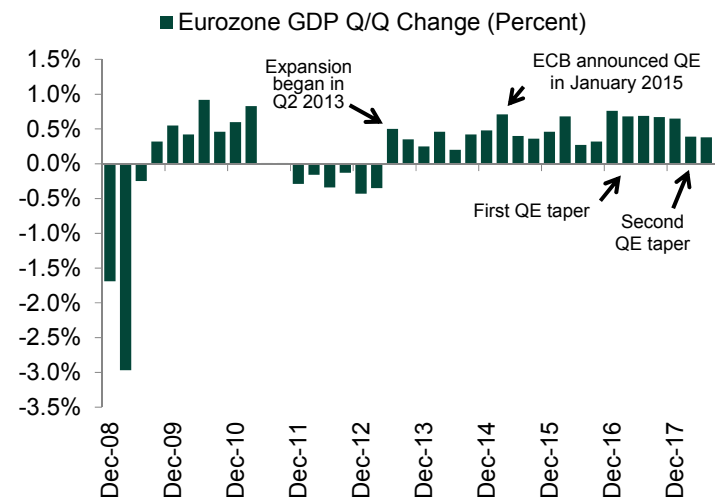
However, it is hard to say when markets will move past this noise. Will it happen if a drama-free reality plays out under a supposedly spendthrift budget? Or will the coalition implode, bringing snap elections and a new government—and perhaps a more certain outcome? Or could tax reform leading to higher revenues do the trick? (The latter isn't a far-fetched idea, as many economists note a flatter, simpler tax could reduce avoidance and the gray market—huge issues in Italy relative to other developed nations.) We can't game the likelihood of any of these scenarios right now. However, we believe investors should eventually get used to Italy's antics and realize the new government is no more adverse than past Italian governments.

THE OVERLOOKED ECONOMIC DRIVER: POTENTIAL END OF QE IN EUROPE

Meanwhile, the eurozone economy continues expanding—and tailwinds are gathering. One is the ECB's winding down its quantitative easing (QE) program. The ECB tapered once again in October and plans to end QE in December unless the economic outlook goes south. Some still fear this, believing monetary stimulus alone propped up growth. We have long argued this view is misperceived—QE has been more of an economic depressant than a stimulant.

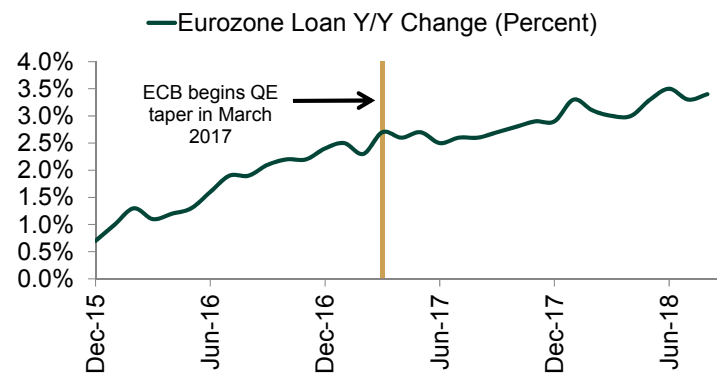
Pundits fearing tapering miss the fact eurozone economic growth preceded QE by two years. (Exhibit 7) They overlook lending's acceleration after the ECB tapered QE in 2017. (Exhibit 8)

Exhibit 7: The Eurozone Economy Didn't Need QE



Source: FactSet, as of 10/10/2018. Eurozone GDP, quarter-over-quarter percent change, Q4 2008 – Q2 2018.

Exhibit 8: Less QE, More Lending



Source: ECB, as of 10/10/2018. Year-over-year percent change for adjusted loans excluding reverse repos with central counterparties to euro area non-monetary financial institutions excluding general government reported by MFI in the euro area, December 2015 – August 2018.

The ECB's latest bank lending survey indicates banks have been easing credit standards this year and are optimistic about the future.^{xix} Non-performing loans are weighing less and demand remains solid. Good news is staring us in the face, but people can't see it yet. The ECB hurrying up and ending QE would allow everyone to move on and recognize the positive fundamentals that have been there all along.

^{xix} Source: ECB, as of 10/24/2018. Q3 Euro Area Bank Lending Survey Credit Standards.

It isn't just eurozone banks, either. Broader economic data paint a similar portrait. Eurozone purchasing managers' indexes (PMIs) have been expansionary for the past several years. These gauges indicate persistent growth despite rising fears of a slowdown.

In our view, this highlights the bigger gap between sentiment and reality—more reason to be bullish about eurozone equities. As the events stoking uncertainty pass and folks realize media warnings of trouble are far overblown, we expect investors' animal spirits to stir—similar to the US more recently and in Europe in 2017.

OVERLOOKED POSITIVE TRADE DEVELOPMENTS

Headline trade war fears remain prevalent, but beneath the surface there is mounting evidence of positive trade developments—particularly those initiated by the EU—an underappreciated positive for European equities. The EU has signed several new trade deals this year with more in the works and nearing completion, underscoring what we think is a wide and bullish gap between sentiment and reality on trade.

Most media focus on trade disputes between the US and China and, to a lesser extent, widespread fears of US global auto tariffs, which could harm the EU. Far fewer notice the EU advancing global free trade and investment. Recent EU trade agreements signed with Canada and Japan illustrate Europe's expanding economic opportunities. The EU and Canada signed the Comprehensive Economic and Trade Agreement (CETA) in October 2016 after seven years negotiating the pact. It is still pending full EU ratification, but it has been provisionally in force since September 2017. CETA removed 98% of all tariffs between the EU and Canada, which should buoy transatlantic trade between the two in the coming years.^{xx}

While the Canada deal is relatively small, in July 2017, the EU followed CETA by creating the world's largest trading bloc with Japan—the Japan-EU Economic Partnership Agreement (JEEPA)—after four years of negotiations. Although JEEPA isn't operational yet—it is still awaiting European Council and Parliamentary approval—it is scheduled to take effect in March 2019. If approved, the EU will eliminate 99% of tariffs on Japanese products and Japan will erase

94% of duties on EU products (maintaining some agricultural protections), easing trade across countries accounting for 28% of world GDP and 40% of world trade by volume.^{xxi}

If the EU's trade agreement with South Korea, which provisionally took effect in July 2011 and became fully effective in December 2015, is any indication European exporters could see substantial gains. From 2010 (the last full year before the agreement) to 2017, the EU's annual South Korean goods exports rose from \$32 billion to \$57 billion (almost 80%), and services exports from 2010 to 2016—the latest annual data available—rose from about \$10 billion to almost \$15 billion (over 43%).^{xxii} We don't think this can all be attributed to the trade deal, but it likely played a role, in concert with ongoing global economic expansion. When and if JEEPA becomes operational, EU and Japanese tariff reductions will gradually phase in over several years. So while the initial impact is likely small, it should provide a growing economic tailwind and counter prevailing protectionist pessimism.

Further, in April, the EU reached a deal to expand its two-decade old pact with Mexico. Technical details remain in flux, but both sides expect finalization for approval by yearend after two years of talks. If it is approved, the new agreement would include digital trade, financial services and investment protections. This means roughly \$88 billion in annual goods and services trade will face fewer restrictions and tariffs—likely boosting bilateral commerce.^{xxiii}

Moreover, the EU and Singapore signed their trade and investment agreement in October, which like JEEPA now awaits European Council and Parliamentary approval and member-state ratification before entering into force. Combined trade in goods and services stands around \$111 billion annually, which we expect to rise if the deal is approved, considering it scraps nearly all customs duties and overlapping bureaucracy.^{xxiv} The same week, the EU and Vietnam signed their deals. If enacted, the deal will eliminate over 99% of tariffs over the next decade.^{xxv} The deal also reduces regulatory and other non-tariff barriers in the automotive sector and strengthens rules encouraging foreign investment.

xx Source: "EU-Canada Comprehensive Economic and Trade Agreement (CETA)," European Commission, September 2017.

xxi Source: "A New EU Trade Agreement with Japan," European Commission, July 2018.

xxii Source: "South Korea - Trade," European Commission, 04/16/2018.

xxiii Source: "EU-Mexico Trade Agreement," European Commission, April 2018.

xxiv Source: "EU-Singapore Free Trade and Investment Protection Agreements," European Commission, April 2018.

xxv Source: "EU and Vietnam Finalise Trade and Investment Discussions," European Commission, 06/26/2018.

The EU is currently seeking to open trade in other areas around the world. Elsewhere in the Asia-Pacific region, talks are progressing with other Southeast Asian nations, Australia, New Zealand and China. In Latin America, discussions are underway with Mercosur (the regional trade association between Argentina, Brazil, Paraguay and Uruguay) and Chile. And, leaving few corners of the world untouched, the EU is also pursuing deals in Africa, the Middle East and the rest of Europe.

Finally, while many fear a potential rise in EU/US tariffs, trade talks with the US are also moving forward. These are further from a final deal than the aforementioned agreements. But the progress is worth noting. The EU and US issued a joint statement in July announcing their intent to lower trade barriers. The US agreed not to advance auto tariffs for the time being, and there are hints at a broader agreement in November. Trade negotiators are aiming to zero out tariffs, non-tariff barriers and subsidies on non-auto industrial goods. Meanwhile, frosty relations appear to be melting as Germany prepares to buy more American liquefied natural gas. While far from the now-abandoned EU/US free trade deal—the Transatlantic Trade and Investment Partnership (TTIP)—negotiators once hoped for, a series of smaller deals that gets to much of TTIP may be easier to tackle.

Against a backdrop of near-ubiquitous trade war fears, these major steps toward a world of increasing free trade seem like a very bullish surprise indeed.

Besides the EU's trade advancement efforts, the US just inked revised trade agreements with South Korea and its North American partners, Canada and Mexico. These still require congressional approval, but they hint at policy direction, in our view. US trade officials are presently pursuing deals with the EU, UK, Japan and other Asia-Pacific nations, too. Despite the US's tough trade rhetoric—and tariff threats—these actions suggest to us protectionism isn't the end. Rather, it seems to us it is a means to both a political end (US President Trump currying favor with his voter base) and an economic one (tough talk spurring expanded free-trade pacts). Against a backdrop of near-ubiquitous trade war fears, these major steps toward a world of increasing free trade seem like a very bullish surprise indeed.

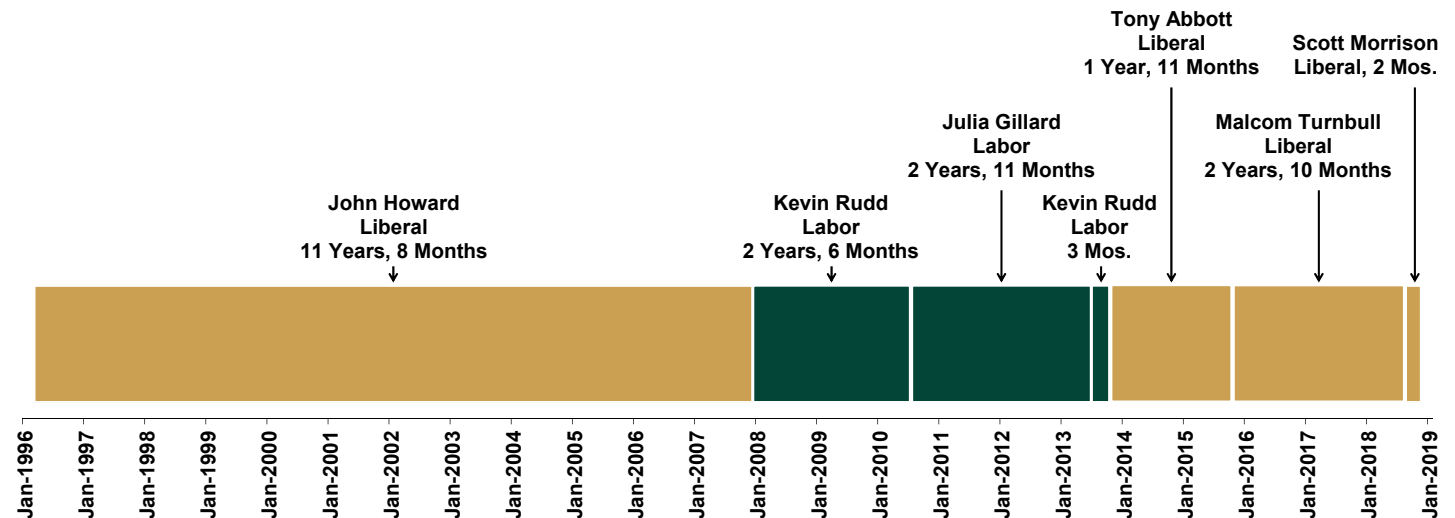
POPULIST FEARS ARE OVERBLOWN IN SWEDEN

Sweden dealt with its own case of populist fears leading up to its general election. Polls projected the far-right Swedish Democrats—buoyed by their tough migration stance—taking the second-highest vote share of any party. However, the Swedish Democrats took only 17.6% of the vote on election day—better than 2014's contest but not nearly enough to gain any real political influence. The traditional center-left and center-right parties each took about 40% of the vote and are left with the likely long process of forming a government. In our view, Sweden is the latest example of European populist fears falling flat—similar to the Dutch election last year.

BANK OF JAPAN STEALTH TAPERING

In Japan, a weak domestic economy resulting from poor monetary policy and a lack of growth-enhancing reforms leaves Japan largely dependent on external demand. The Bank of Japan (BoJ) implemented a stealth taper in July by allowing JGB yields to tick up while the BoJ buys fewer bonds. Though tapering is an incremental positive, the scope is extremely limited relative to the BoJ's massive asset purchases. In September, Prime Minister Shinzo Abe won reelection as president of the Liberal Democratic Party (LDP) although his priority still appears to be amending the Constitution's anti-war clause—a symbolic but controversial issue that would require most of Abe's political capital and dominate Japan's National Diet's attention. This likely means he won't advance meaningful economic or structural reforms to target reinvigorating the economy. The lack of reform, in our view, leaves Japanese growth heavily dependent on the broader global expansion.

Exhibit 9: Since Howard, Australia's Prime Minister Turnover Has Been High



Source: National Archives of Australia, as of 10/26/2018. Australian Prime Ministers, their party affiliation and tenure.

AUSTRALIA'S NEW PRIME MINISTER AND BANKING COMMISSION

Like much of the world, politics garnered significant attention in Australia in Q3, with two stories dominating. First, once again Australia has a new prime minister—Scott Morrison, highlighting the extreme form of political gridlock practiced Down Under. And, second, as it has for much of the last year, Australia's Banking Royal Commission (BRC)—a wide-ranging investigation into the financial services industry—garnered significant headlines. In our view, while much of the focus fell on the first, the second is far more significant for Australian equities, given the country's large Financials weighting. We expect the ongoing BRC to weigh on sentiment, a headwind not only to Australian Financials, but Australian equities altogether.

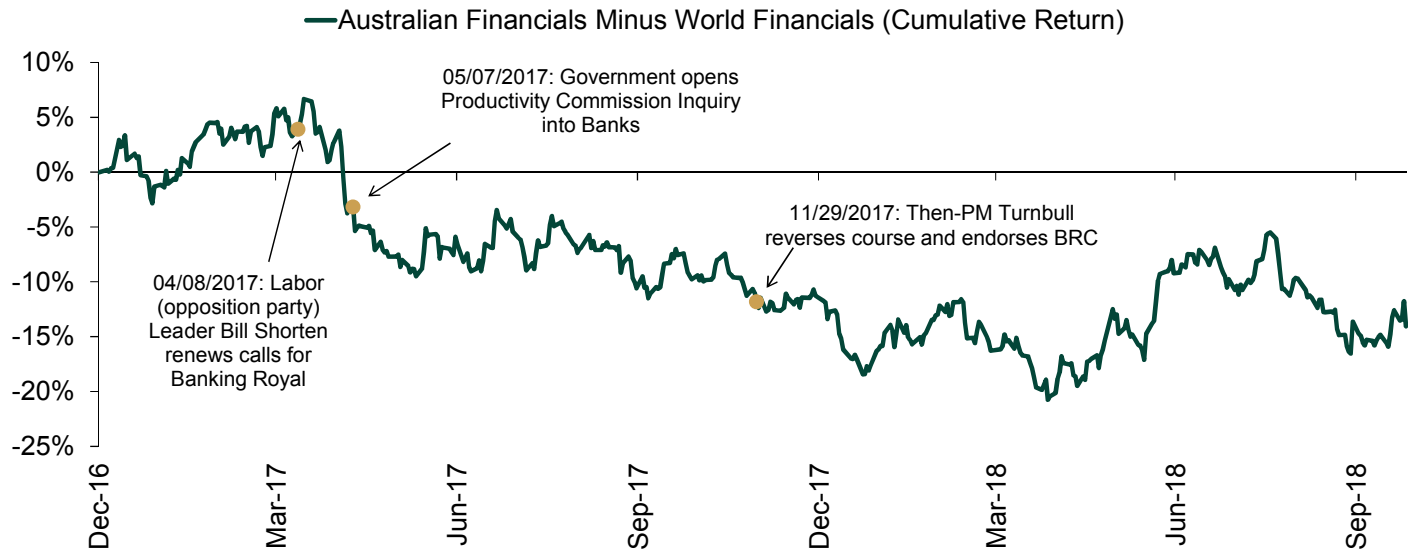
TURNBULL'S OUT, MORRISON'S IN

Since former PM John Howard left office in December 2007, the prime ministerial post has been something of a revolving door, with no one serving an entire three-year term. Malcolm Turnbull, who became PM in October 2015, became the latest victim, as the Liberal/Nationals coalition government ousted him in a leadership spill in August. This is merely the latest such ouster, deepening the gridlock both within and outside the coalition (Exhibit 9). Already, talk of further shakeups within Morrison's administration is causing many to question its staying power and stability.

Due to this gridlock, little legislation of consequence is passing. Which, combined with the frequent turnover, frustrates many Australians. The government has yet to pass a long-awaited comprehensive energy policy. But for equities, this gridlock is a benefit to Australia—it blocks most extreme legislation that could roil sentiment and shake markets. The major exception? The ongoing Banking Royal Commission (BRC).

THE BRC HAMPERS AUSSIE FINANCIALS

Following a series of scandals including mortgage and loan pricing, misdeeds involving financial advice, sales of poor financial products and more, many politicians called for investigations into banks' practices. Throughout 2016, the government rebuffed the opposition Labor Party's efforts to launch a Royal Commission—a panel with sweeping authority to call witnesses and enact penalties over misdeeds. This continued into early 2017, when Labor Leader Bill Shorten made an official Labor policy thrust. The coalition attempted to undercut this increasingly popular idea by having the Productivity Commission—another arm of government with far less power—look into it. However, this assuaged few. And, as stories of further scandal emerged, then-PM Turnbull reversed course and announced the government would invoke a BRC in November 2017.

Exhibit 10: BRC Weighs on Australian Financials

Source: FactSet, as of 10/26/2018. MSCI Australia Financials sector cumulative return minus MSCI World Financials sector cumulative return, 12/31/2016 – 10/25/2018.

IMPACT ON BANKS

The BRC's hearings were filled with fireworks, as many well-known financial practitioners and leaders from insurers, wealth managers and banks admitted to error and wrongdoing under oath. These hearings extend into their seventh round later this fall, with a final report due in February 2019.

While many are skeptical the BRC will have much lasting impact on policy or bank behavior—or even that punishments will be severe—the impact on investor sentiment toward Australian Financials is fairly apparent, in our view. As Exhibit 10 shows, Australian Financials have lagged World Financials basically throughout this saga—and by fairly large margins. While we anticipate markets will eventually discount the impact—pre-pricing the fallout—that doesn't seem to have happened yet.

The impact of this isn't limited to just sector decisions within one country. Financials represent over one-third of the MSCI Australia's market capitalization. It is no surprise that Australia has underperformed global equities, in part tied to this.



EMERGING MARKETS COMMENTARY

EMERGING MARKETS COMMENTARY

EM: EQUITIES' SLIDE INTO BEAR TERRITORY, YET STRONG FUNDAMENTALS PERSIST

After a flat Q3, the MSCI Emerging Markets (EM) Index dropped again in October, bringing its decline to -24.6% since its January 26 high.^{xxvi} With EM equities now 20% below their peak, many pundits now note they are technically in bear market territory. However, that distinction lacks forward-looking significance. Moreover, magnitude alone doesn't determine whether a market decline is a correction or bear market. Bear markets, which have identifiable fundamental causes, typically spend significant time below -20%. In EM, bear market declines typically average -40%.^{xxvii} So the question is, are there fundamental reasons for EM equities to fall much further from here, or is this a deep but sentiment-fueled correction, with more downside behind us than ahead?

We believe most evidence points to a deep correction. For much of the year, investors feared a strong US dollar harming EM economies and causing a currency crisis reminiscent of 1998. Many pointed to China, Turkey, South Africa and Argentina as signs of worse things to come in other EMs—in our view, failing to properly see these nations' problems as unique, local issues. Chinese markets are mostly walled off from the world and lack a direct tie to its domestic economy, much less the world economy. In Turkey, markets have been dealing with an increasingly authoritarian president with a history of meddling with monetary policy. In Argentina, policymakers' attempts to clean up an economic mess—a legacy of the prior administration—resulted in an IMF bailout. And in South Africa, the new government pursued uncompensated land acquisition, destroying investors' confidence in property rights. Simply, none of these seem like evidence of categorical problems in all or even most EM nations.

While much of this year's downside stemmed from investors' overreaction to fearful headlines about contagion, October's slide appears more related to fear of newly enacted tariffs' global fallout. The Trump administration's tariffs primarily target China, heightening fears of an economic hard landing in the world's second-largest economy rippling through EM and the entire world. Yet as we have long argued, this mentality fails to properly scale tariffs. If all tariffs currently under discussion were to take effect, the total annual tariff payments would be less than 0.3% of global GDP, based on the IMF's most recent estimate of global output.^{xxviii} Moreover, while China's economy has slowed this year, the major headwind is the government's stepped-up efforts to contain the shadow-banking sector. This has resulted in very weak total social financing growth this year, and recent stimulus measures aimed at cushioning the blow haven't taken full effect yet. Meanwhile, Chinese trade data—as well as cross reads from its trading partners—suggest tariffs aren't having an outsized impact on Chinese exporters or domestic demand for imported goods. Chinese exports and imports continue growing at a healthy pace.

As false fears of tariffs and contagion fades, markets should be able to better see this largely positive reality, creating plenty of room for positive surprise to push EM equities higher.

While sentiment has become more dour this year, EM fundamentals remain largely positive, with economic growth continuing in most nations. The rebound in oil and other commodity prices should add tailwinds to the commodity-dependent EMs. Falling political uncertainty in the wake of elections in Mexico and Brazil has provided some relief for equities. In Asia, continued demand for high-tech goods should benefit EM nations with key roles in those supply chains, including South Korea and Taiwan. As false fears of tariffs and contagion fades, markets should be able to better see this largely positive reality, creating plenty of room for positive surprise to push EM equities higher.

^{xxvi} Source: FactSet, as of 10/26/2018. MSCI EM Index return with net dividends, 01/26/2018 – 10/26/2018.

^{xxvii} Source: FactSet, as of 10/04/2018. Based on MSCI EM Index bear markets, 1990 – 2018.

^{xxviii} Source: International Monetary Fund, US Trade Representative, China Ministry of Commerce, the American Action Forum, CNN, Politico and the Peterson Institute for International Economics, as of 10/26/2018.

MEXICO: COMPROMISE AND MODERATION

Trade and political uncertainty dominated headlines throughout the summer in Mexico. Nationalist Andrés Manuel López Obrador (AMLO) of the National Regeneration Movement (MORENA) party enjoyed a resounding victory in July's presidential election, and his brand of populism drove fears about potential protectionist changes to come. AMLO's win also stirred worries about the fate of North American Free Trade Agreement (NAFTA) renegotiation talks, which were already fraught with disagreement. However, talks progressed throughout Q3, and US and Mexican negotiators reached a tentative deal in August—one Canada joined at October's start. The upshot: The Mexican economy likely won't face significant disruptions as new trade agreements largely maintain the status quo. Moreover, concerns about AMLO's nationalist agenda seem overstated, as signs of his moderating are already emerging.

MEET THE USMCA

The renegotiated trade deal has a new name—the US-Mexico-Canada Agreement (USMCA)—though the pact isn't terribly different from its predecessor. Canada agreed to cut protections for its dairy industry, a widely watched and contentious point. The USMCA also updates some auto industry standards—a contentious issue between Mexico and the US. The North American content requirement was raised from 62.5% to 75%, and USMCA adds another caveat: 45% of autos imported duty-free must be made by workers earning \$16/hour or more. The US pushed for this, arguing cheaper Mexican labor undercut American workers.

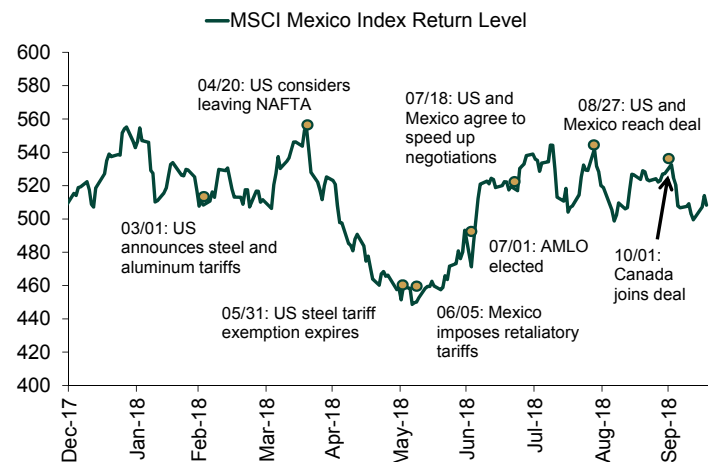
Though these changes may seem big, a Bloomberg estimate said only three models currently violate the new rules of origin.^{xxix} Moreover, since most non-USMCA content in cars that Mexico exports to the US comes from high-wage countries like Japan, South Korea and Germany, the wage requirement likely won't impose a huge new burden. While the USMCA adds several chapters that weren't in NAFTA—like new e-commerce and intellectual property rules—the upshot is it likely drives incrementally freer trade among the US, Mexico and Canada.

Some see the new pact's 16-year sunset clause as a negative potentially stoking uncertainty down the line. However, this does provide the opportunity to update the pact periodically for shifts in the economy.

If NAFTA had included such a clause, it is possible e-commerce—which many saw as a key missing piece to the deal—would have been included years ago.

That said, USMCA's changes won't go into effect immediately—the effective date is 2020, and some provisions are pushed out even further. Each country's legislature must also ratify the agreement, which probably won't be quick. The pact could face further revisions, tweaks and delays as politicians assess the details. However, for markets, the high-level agreement likely decreases uncertainty to an extent. Leading up to the agreement, fears of a complete breakdown in North American trade were prevalent, and we think that uncertainty likely weighed on Mexican markets this year. (Exhibit 11) Now investors can plan on some form of a trade deal likely being in place, whether it is the new USMCA or a return to NAFTA. Simply knowing that is a positive.

Exhibit 11: Uncertainty Has Weighed on Mexican Equities



Source: FactSet, as of 10/18/2018. MSCI Mexico Index Return with net dividends in USD, 12/31/2017 – 10/17/2018.

AMLO's MODERATION

Mexico's other big source of uncertainty—national politics—continues falling following July's presidential election. Some feared AMLO would pursue a nationalist agenda upon entering office, undoing current President Enrique Peña Nieto's market friendly reforms—particularly Peña Nieto's constitutional reform opening the Energy industry to players beyond Mexico's national oil firm, PEMEX. Yet this concern seems overwrought.

Though he presents himself as a maverick, AMLO has already started moderating. After winning the election, AMLO stressed his government would respect central bank autonomy and existing

xxix Source: "Trump's Mexico Trade Deal Looks Like a Lemon," David Fickling and Anjani Trivedi, Bloomberg, 08/28/2018.

contracts while staying fiscally responsible. He has also backed off talk of undoing the oil market opening, instead targeting minor changes on the fringe—like reviewing drilling license awards. While these actions may spur new concerns, they seem mostly like a moderation of campaign talk, in our view. Though politicians' words must always be critically evaluated, AMLO has followed a well-worn path: Start on the campaign trail with strong conviction before eventually toning down the harsh rhetoric.

AMLO's actions highlight this moderation. While many analysts believed the US wanted to speed up trade talks to avoid the uncertainty associated with Mexico's new executive come December 1, AMLO had representation at USMCA talks—and they didn't hold up any deal. Rather than significant foreign policy change, AMLO seems more focused on pursuing domestic reform. While it is always possible a new executive with major legislative support (which AMLO will enjoy) can implement big, sweeping change, we caution investors against presuming a major shift is coming.

Consider a recent example in developed markets: French President Emmanuel Macron. He and his centrist En Marche party rode a wave of support to power in 2017. While Macron has passed some minor reforms, he hasn't implemented a radical new program—despite having legislative support. Plus, Macron's popularity has been draining quickly, giving him even less sway to pass big change. This doesn't mean Macron's current situation is AMLO's future. But democratically elected politicians' political capital is a finite resource—often limiting the amount of major change they can pass.

INDIA: FINANCIAL FRAGILITY AND BIOMETRIC IDENTIFICATION

Indian equities sold off as fears over the non-bank financial sector swirled following the default of Infrastructure Leasing & Financial Services' (IL&FS), a distressed Indian lender. After the Indian government took control of IL&FS, some even claimed the default was a "Lehman moment" for the country's financial sector. We believe this comparison is off. While ILFS's default could lead non-bank lenders responsible for about 20% of India's total financing to tighten credit, the scale seems too small to spark a financial panic. Moreover, last year's bank recapitalization program should backstop the bank sector. We expect the country's economy to continue growing at a fine pace despite worries over financial system fragility.

WATERED DOWN BIOMETRIC IDENTIFICATION LEGISLATION

Outside Financials, India's highest court partially affirmed the government's nationwide biometric ID program intended to help modernize the Indian economy. However, the ruling greatly waters down the proposal. Per the court, while the government may still demand biometric proof of identity to access public benefits, private companies—such as banks—may not require it to purchase their services. Overall, there are still some unknowns surrounding how the private sector can use the system, but it isn't unusual for sweeping reforms to take two steps forward and one step back. Moreover, the ramifications of this decision—and of the law itself—will likely play out over many years, which should sap any influence over markets.

TURKEY'S TOUGH QUARTER

Turkish markets tumbled another -20.5% in Q3, bringing year-to-date returns to -44.1%.^{xxx} However, the weak quarterly results obscure a sharp, 20.6% September rebound.^{xxxi} While it is likely premature to declare Turkey's problems over, we don't believe its issues reflect broader Emerging Markets weakness. Rather, we think they speak to domestic economic and political issues.

After a snap election in June—seemingly to quell political uncertainty and allow the government to focus on important issues—President Recep Tayyip Erdoğan consolidated his already significant power. Following a vast increase in debt-financed stimulus spending, the country's increasing authoritarian stance—which accompanied rhetoric and personnel decisions challenging the central bank's independence—seemingly caused fear to spike. When sagging investor confidence sent the lira sliding and inflation spiking earlier this year, these debts became far more taxing. Making matters worse, as part of its ongoing crackdown on suspected dissidents and opposition figures, the government proceeded with the prosecution of an American pastor accused of spying. This drew criticism from the White House—then sanctions and double-strength tariffs on steel and aluminum, causing the lira to sink once again.^{xxxii}

The declining lira sent inflation soaring, which the central bank did little about—likely tied to Erdoğan's rhetoric. However, that changed to an extent in September. On September 13, the Central Bank of Turkey hiked its benchmark 1-week repo rate by 6.25 percentage

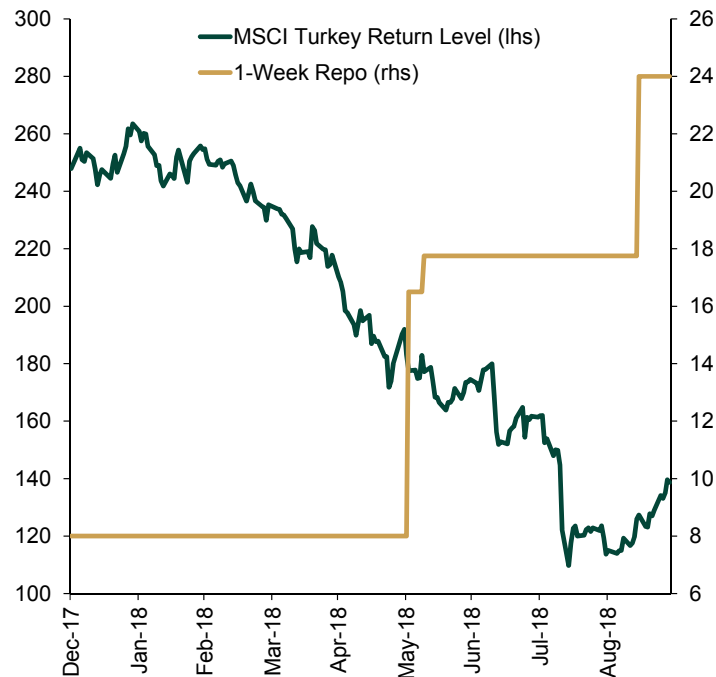
^{xxx} Source: FactSet, as of 10/22/2018. MSCI Turkey return with net dividends in USD, 06/29/2018 – 09/28/2018.

^{xxxi} Ibid. MSCI Turkey return with net dividends in USD, 08/31/2018 – 09/30/2018.

^{xxxii} Source: "U.S. Imposes Sanctions on Turkish Officials Over Detained American Pastor," Adam Goldman and Gardiner Harris, *The New York Times*, 08/01/2018.

points, putting it at 24%.^{xxxiii} This move far exceeded expectations and put rates closer to inflation. As Exhibit 12 shows, the hike coincides with Turkey's equity market bouncing higher. We think the hike alleviated fears of central banks not taking appropriate action to quell inflation. Whether this lasts remains to be seen, but at least in the short run it appears to have been a positive factor.

Exhibit 12: Turkey's September Rate Hike Arrests Fears



Source: FactSet, as of 10/25/2018. MSCI Turkey return with net dividends in USD and Turkish 1-Week Repo Rate, 12/31/2017 – 09/30/2018.

MORE CHALLENGES AHEAD

Significant problems remain, however the lira has recovered against the dollar since its August 13 low, rising 23.2%, but it is still -33.0% below where it started the year.^{xxxiv} Turkey's external debt—money owed to foreign lenders, typically in foreign currency—is about half of GDP.^{xxxv}

While private firms owe much of this, many of the loans are state-backed, making them the government's problem. Second, Erdoğan's grip remains tight and his interventions arbitrary—a notable political risk. Third, despite the release of the jailed American pastor in October, US sanctions are still in place, as the Trump administration is demanding the release of other US citizens the Turkish government is currently detaining.

Some in the Turkish government seemingly recognize the country's challenges. Treasury and Finance Minister Berat Albayrak touted “fiscal discipline” in a September 20 speech, noting that public infrastructure projects are now on hold absent foreign investment.^{xxxvi} There were also murmurs of a potential IMF bailout. But Erdoğan isn't having it—and the US could very well veto it anyway. This speaks to one of Turkey's biggest problems currently—Erdoğan's willingness to meddle with its institutions, especially the central bank. While they resisted pressure recently, Erdoğan is still publicly calling for lower rates—and although he has no official power over the bank's policies or personnel, he has shown little regard for such rules elsewhere. Given significant unresolved economic issues and heightened political risk, we think Turkey still faces major headwinds.

TURKEY'S ISSUES ARE ITS OWN

But while many paint Turkey's woes as representative—or potentially a cause—of EM-wide risks, we believe “contagion” fears are way overblown. While institutional strength and independence varies among EMs, few have as many concurrent issues as Turkey. Most do not have huge piles of dollar-denominated debt. Few have leaders who threaten central banks' independence and oddly claim high interest rates spur inflation. Fewer still just finished rewriting the constitution and flooding the country with debt-fueled stimulus spending to placate the public. These are Turkey's problems, and we don't think they are emblematic of EMs broadly. Overall, Turkey's \$850 billion GDP barely represents 1% of world's, according to World Bank data—likely too small to wallop world markets or drive global recession.

^{xxxiii} Source: Central Bank of Turkey, as of 10/25/2018.

^{xxxiv} Source: FactSet, as of 10/25/2018. Lira per dollar, 12/31/2017 – 10/24/2018.

^{xxxv} Source: “Turkey returns to international debt market with new \$2bn bond,” Adam Samson and Pan Kwan Yuk, *The Financial Times*, 10/17/2018.

^{xxxvi} Source: “Turkey revises down growth forecasts in new economic program,” Staff, *Hurriyet Daily News*, 09/20/2018.

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

Commentary in this summary constitutes the global views of Fisher Investments and should not be regarded as personal investment advice. No assurances are made we will continue to hold these views, which may change at any time based on new information, analysis or reconsideration. In addition, no assurances are made regarding the accuracy of any forecast made herein. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customizations and start dates may preclude certain elements of this strategy from being implemented.