Fisher Investments™

Institutional Group

FOURTH QUARTER 2018

MARKET PERSPECTIVES

FOURTH QUARTER 2018 REVIEW AND OUTLOOK
MARKET PERSPECTIVES

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FOURTH QUARTER 2018 REVIEW AND OUTLOOK EXECUTIVE SUMMARY

Portfolio Themes

- **Quality Tilt:** We prefer equities with stronger balance sheets and consistent margins.
- **Overweight to Information Technology:** The Information Technology sector is heavily skewed toward large, high-quality firms. The sector should benefit from robust global IT spending driven by the growing demand for products and services related to mobile, cloud computing and the "Internet of Things."
- **Overweight to 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 and rapid EM growth as well as strong research and development pipelines are leading to record drug approvals along with healthy sales growth.

Market Outlook

- **Expect the Bull Market to Resume:** Late 2018 selling pressure likely continues to abate throughout 2019 leading to strong equity returns globally.
- **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 that sweeping legislation, potentially hurting equities, passes. This gridlock tempers current political volatility.

2018 was a difficult year—downside volatility returned and the year concluded with the second worst December on record. Global equities declined -9.4% last year[i] and returns didn't meet our optimistic expectations. Yet, looking forward (as markets do), evidence we will detail overwhelmingly argues against being bearish now. Global equities' 12.4% jump off Christmas Eve's low now looks like an early V-shaped rebound typical of market recoveries.[ii] We expect the recent upward trend to be only the beginning of a brighter 2019—with December proving the adage it is always darkest before dawn.

Consider the backdrop, using the S&P 500, which has a much longer published record than the MSCI All Country World Index. Following all corrections (sharp, sentiment-driven drops of 10% – 20%), returns in the 12 months after the bottom average 34% before dividends.[iii]

Late-2018's pullback appears to be a correction that ended on Christmas Eve. Assuming so, it will have ended closer to calendar yearend than any preceding S&P 500 correction or bear market. That means timing-wise calendar-year 2019 will align very closely to the 12 months following a correction low. Therefore, simply achieving average post-correction 12-month returns implies an outstanding year ahead. Outside global recessions and world wars, US equities have never fallen two years in a row.[iv] The vast majority of economic indicators suggest a recession isn't likely. Pockets of weakness exist—always do. However most of the world is growing fine.

Many tried pinning December's mayhem on recycled fears like Brexit, trade tensions, Fed policy, White House chaos, China and signs of slowing growth. To an extent, all these factors likely influenced sentiment, contributing to the volatility, but these don't explain US equities' -15.6% and MSCI ACWI's -10.8% decline between December 3 and December 24.[v] Our hypothesis, which we will detail in the full review, is that hundreds of hedge funds, maybe over 500, were silently preparing to close by yearend, requiring them to liquidate in December. Additionally, many others raised mountains of cash to meet a flood of early-January redemption requests they anticipated

i Source: FactSet, as of 01/16/2019. MSCI All Country World Index return with net dividends, 12/31/2017 – 12/31/2018.

ii Source: FactSet, as of 02/14/2019. MSCI All Country World Index return with net dividends, 12/25/2018 – 01/31/2019.

iii Source: FactSet, as of 12/07/2018. S&P 500 price returns 12 months after correction troughs, 05/14/1928 – 02/11/2017.

iv Source: Global Financial Data, Inc., as of 01/25/2019. S&P 500 annual total return, 1925 – 2018.

v Source: FactSet, as of 01/16/2019. S&P 500 Index and MSCI ACWI returns with net dividends, 12/03/2018 – 12/24/2018.

after years of poor performance. Because most hedge funds are unregistered and announce closures only to their investors, there is not good data on how many shut down. Nevertheless based on our interactions with other institutional investors and market makers and our observations of market movement we believe they collided against each other as the month proceeded, cascading prices lower as they prioritized speed over price with no incentive to optimize trade results. With this increase in downside volatility, many retail investors also panicked. Liquidity dropped as markets fluctuated. A typical day would see markets rise or dip early on, but later mass selling would resume and markets often finished down -1% or more.

All evidence suggests this forced selling ended after Christmas. Market action on December 26 and 27 was consistent with short-sellers being squeezed and scrambling to cover open positions. The lack of wild intraday volatility since suggests the hedge funds finished their liquidations. The past four weeks appear to be the right side of the V-shaped recovery. We anticipate more gains ahead, although the path could be jagged, moving more slowly now.

Political drivers should also provide a tailwind in 2019, with this being year three in President Trump's first term—the best of the four-year presidential cycle. Third years average 17.8% since 1925 and haven't been negative since World War II's 1939 onset—and only down -0.9% then.[vi] That positivity stems from gridlock, which is alive and well after midterms returned traditional partisan gridlock to Washington D.C., replacing the intraparty variety existing since 2016. Gridlock also reigns globally, with most European governments either minority administrations or weak coalitions that cannot do much. The major political question mark—Brexit—should sunset soon, delivering investors much-needed clarity whatever the outcome.

Economic fundamentals are also far better than most suspect. Leading Economic Indexes (LEI) for the US and eurozone remain in long uptrends—high and rising. Modern recessions haven't begun until LEIs have fallen for several months. China's government has launched a large stimulus program—underappreciated by many—which so far seems to be keeping the long-dreaded hard landing at bay. Britain's continued GDP growth keeps defying Brexit dread. Very few nations of significance have experienced contracting GDP recently (there are almost always some), and they appear to be minor—stemming from unique, one-off, temporary situations.

Little noticed amid the gloom, valuations contracted last year as equities fell while earnings soared. There is only one aspect related to valuations that helps with timing markets: When valuations contract one year, they usually expand the next—even if there is a recession. With MSCI All Country World and S&P 500 earnings projected to grow this year—and since earnings almost always top analysts' consensus estimates—expanding valuations on top of strong earnings implies big equity price increases.

Emerging Markets (EM) also struggled in Q4 2018, but performed better than developed equities in the quarter. In our view, the evolution of sentiment toward EM equities in Q4 resembles a classic correction-style fear morph. Some of 2018's big EM-related fears—such as weakening currencies, Turkish Prime Minister Recep Tayyip Erdoğan's power grab and troubles in Frontier Market Argentina—have faded. However, instead of acknowledging apparent positives investors have mostly moved on to other worries, such as China's worsening economic data.

Despite a difficult year for EM equities, we believe fundamentals are better than present dour headlines suggest. Emerging Markets economic growth should continue outpacing the developed world boosting per capita income and consumption. This trend continues pushing millions of EM households into the middle class. Infrastructure growth broadly and accommodative fiscal policy in large economies like China are underappreciated. Low valuations reflect overly pessimistic sentiment and as uncertainty fades in the developed world, EM equities will likely benefit with a strong recovery throughout 2019.

Volatility is a two-way street. Downside volatility dominated Q4. We have seen a more positive trend so far in 2019, but another correction is always possible, for any or no reason. But overall, we expect 2019 to be the payoff for discipline and patience in 2018.

vi Source: Global Financial Data, Inc., as of 01/14/2019. S&P 500 annual total returns, 1925 – 2018.

GLOBAL UPDATE AND MARKET OUTLOOK

Q4 RECAP

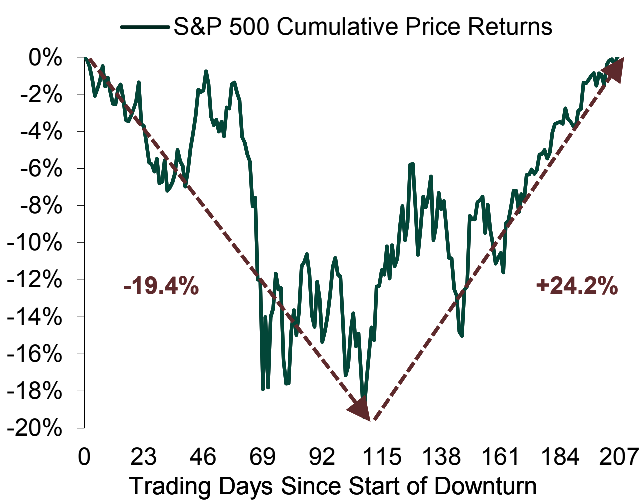
The V-Shaped Rebound and Beyond

2018's rocky close challenged investors. Most often, barring a major recession or world war—neither of which appears likely now—equities rebound from down years. More volatility may lie ahead—and gains likely slow relative to this torrid start—but strong fundamentals and extensive historical data argue for strong full-year returns in 2019.

2018 reminds us of 2011, when equities also endured a large correction. Then, the S&P 500 dipped below -20% intraday but never closed below that mark.[vii] The same happened in 2018. Using intraday highs and lows, US equities breached -20% on Christmas Eve. However using closing prices, they didn't.

Similar to the aftermath of 2011's correction, the market's move since December has been a V-shaped recovery. By mid-February 2012, equities were back at pre-correction highs. The bounce included occasional negativity, but overall, equities rebounded sharply and kept climbing—enjoying double-digit gains in 2012 and a stellar 2013 (Exhibit 1).

Exhibit 1: 2011 Correction



Source: FactSet, as of 12/24/2018. S&P 500 price index daily, 04/29/2011 –02/24/2012.

2019: The Year of the Bounce

Using the S&P 500, we can identify 32 prior corrections since 1925. Some lasted a few weeks, others over a year. The average return in the 12 months after the bottom is 34.0%, with the biggest rebounds following the worst declines overall and on average.[viii] 2018's correction low is closer to December 31 than any correction or bear market since 1925.[ix] Timing-wise, that closely aligns the 12-month rebound window with 2019. Just getting the average correction aftermath implies a very good year for equities.

Extrapolating this to the developed world, the MSCI World shows a similar pattern, despite a shorter history. Returns following the MSCI World's 13 prior corrections averaged 24% over the next 12 months (Exhibit 2).

Exhibit 2: MSCI World Index Returns After Corrections

Correction	Duration (Months)	Magnitude	6M Fwd	12M Fwd	24M Fwd
02/13/1980 - 03/27/1980	1.4	-16%	28%	31%	9%
05/02/1984 - 07/24/1984	2.7	-14%	18%	34%	100%
04/17/1991 - 08/19/1991	4.1	-11%	7%	2%	27%
01/06/1992 - 04/08/1992	3.0	-14%	4%	17%	29%
07/20/1998 - 10/05/1998	2.5	-21%	33%	36%	44%
11/28/2002 - 03/12/2003	3.4	-14%	30%	47%	66%
05/09/2006 - 06/13/2006	1.1	-12%	19%	28%	17%
07/19/2007 - 08/16/2007	0.9	-11%	-2%	-9%	-28%
04/15/2010 - 07/02/2010	2.7	-17%	24%	30%	20%
05/02/2011 - 10/04/2011	5.1	-23%	20%	24%	44%
10/28/2011 - 11/25/2011	0.9	-12%	8%	19%	48%
03/19/2012 - 06/04/2012	2.5	-13%	14%	28%	49%
05/21/2015 - 02/11/2016	8.7	-19%	18%	24%	40%
Average	3.0	-15%	17%	24%	36%
Median	2.7	-14%	18%	28%	40%

Source: FactSet, as of 12/07/2018. MSCI World Index price returns 6, 12 and 24 months after correction troughs, 02/13/1980 – 02/11/2018.

A Word on Emerging Markets

Emerging Market (EM) equities struggled in 2018, falling -14.6%.[x] This decline brought EM equities into shallow bear market territory from January 26, 2018 highs. While further declines are possible—short-term volatility is impossible to forecast—we believe the decline is primarily sentiment-driven, and EM equities should do well looking forward as the downstream impact of China's economic slowdown likely proves less severe than many fear.

vii Source: Global Financial Data, Inc., as of 02/14/2019. Based on S&P 500 price return using intraday lows, 04/29/2011 – 10/03/2011.

viii Source: FactSet, as of 12/07/2018. S&P 500 price returns 12 months after correction troughs, 05/14/1928 – 02/11/2018.

ix Source: FactSet, as of 12/31/2018. Based on S&P 500 daily closing prices, 12/31/1925 – 12/31/2018.

x Source: FactSet, MSCI Emerging Markets Index return with net dividends, 12/31/2017 – 12/31/2018.

As seen in Exhibit 3, EM equities tend to rebound sharply from large declines like the one seen in 2018—mimicking the V pattern discussed previously for developed markets. 2018's decline was fairly typical in length and magnitude compared to other large drops, and should feature a similarly robust rebound.

Exhibit 3: MSCI Emerging Markets Index Returns After Downturns Larger than 15%

Returns Following EM Downturns Greater than -15%					
Peak to Trough			Forward Returns After Trough		
Period	Duration (M)	Return	6mo	12mo	18mo
Jun 1989 - Jul 1989	1.0	-17.0%	39.5%	51.0%	16.2%
Feb 1990 - Apr 1990	1.3	-18.1%	2.1%	23.7%	31.0%
Aug 1990 - Jan 1991	5.5	-31.9%	42.4%	74.8%	83.9%
Apr 1992 - Aug 1992	4.1	-18.8%	12.1%	36.1%	89.9%
Feb 1994 - May 1994	2.9	-19.5%	24.1%	2.9%	-3.8%
Sep 1994 - Mar 1995	5.7	-32.6%	19.4%	18.9%	20.2%
Jul 1995 - Sep 1998	37.9	-52.3%	34.6%	73.7%	119.6%
Feb 2000 - Sep 2001	19.3	-53.7%	42.5%	11.8%	14.9%
Apr 2002 - Mar 2003	10.9	-25.9%	41.0%	74.2%	70.7%
Apr 2004 - May 2004	1.1	-20.4%	28.3%	35.3%	65.4%
May 2006 - Jun 2006	1.2	-24.5%	31.7%	52.6%	86.7%
Jul 2007 - Aug 2007	0.8	-17.7%	20.6%	1.6%	-45.6%
Oct 2007 - Oct 2008	11.9	-66.1%	39.4%	108.4%	124.6%
Nov 2008 - Nov 2008	0.5	-23.0%	62.8%	107.9%	90.0%
Jan 2009 - Mar 2009	1.8	-21.8%	74.9%	102.0%	109.5%
Apr 2010 - May 2010	1.3	-18.3%	26.4%	30.7%	2.6%
Mar 2012 - Jun 2012	3.1	-18.3%	14.1%	13.8%	12.8%
Jan 2013 - Jun 2013	5.7	-18.4%	12.7%	18.7%	7.7%
Sep 2014 - Dec 2014	3.4	-17.3%	6.1%	-13.1%	-12.1%
Feb 2015 - Jan 2016	10.8	-30.7%	26.5%	31.0%	54.0%
Jan 2018 - Oct 2018	9.1	-26.6%	?	?	?
Average	**7.2**	**-27.3%**	**30.1%**	**42.8%**	**46.9%**

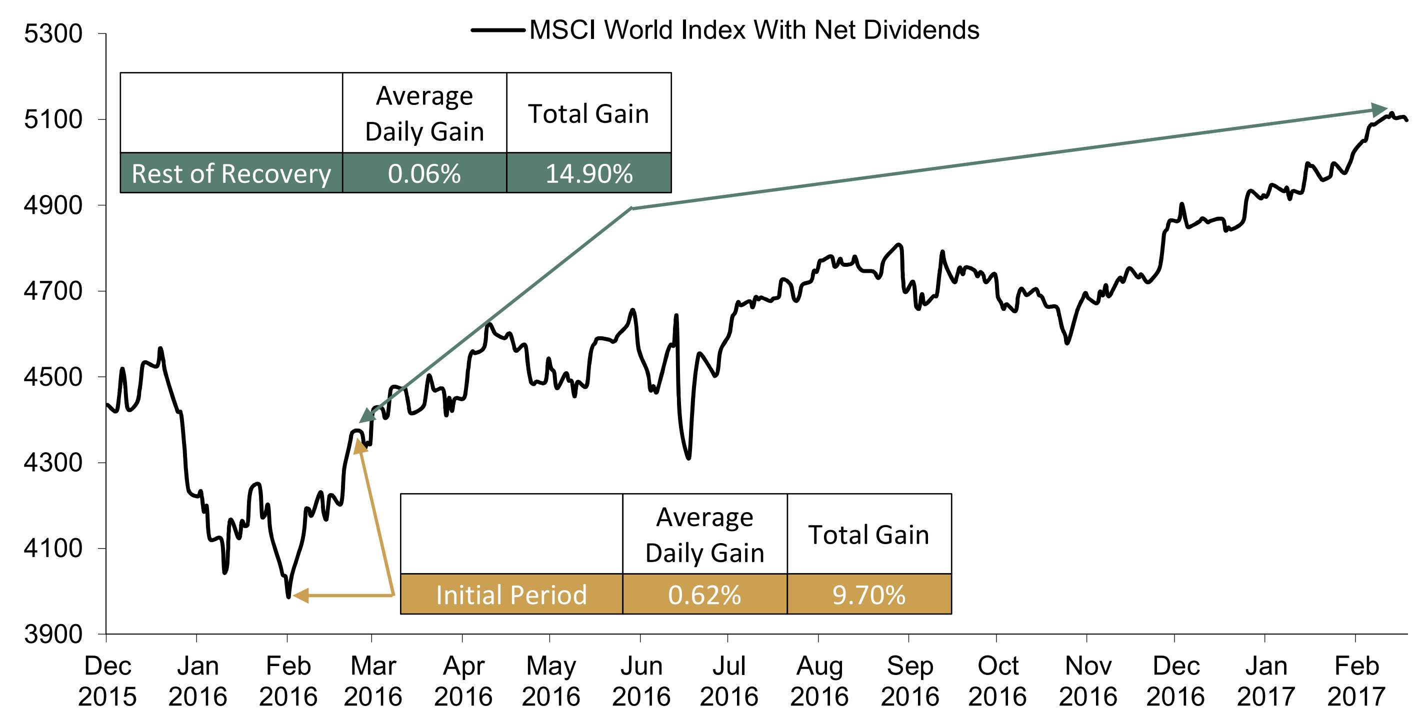
Source: FactSet as of December 2018. MSCI Emerging Markets price index, daily, December 1987 to December 2018.

Despite a difficult year in 2018 for EM equities, we believe fundamentals are mostly better than dour headlines suggest. Further volatility wouldn't be surprising from here. However, unless fundamentals take a major turn for the worse—and few notice—we believe EMs should bounce back alongside developed markets.

A Slower Rebound From Here Is Ok

The steep jump off December 24's low, which appears to be the initial rebound and steepest portion of the V, is likely either over now or will soon be. We expect equities to continue rising, but with more chop—recoveries aren't smooth. The result: an ultimately powerful, yet less steep, climb. The initial bounce should retrace much of December's steep negativity, and the near future will likely better resemble October or November's more mixed market conditions. This is typical of correction and bear market recoveries. A sharp initial bounce usually gives way to a slower, more jagged climb. Yet a slower pace can still bring very nice returns overall. The year after the 2015 – 2016 correction ended is a striking example, as Exhibit 4 shows.

Exhibit 4: The 2015 – 2016 Correction's Aftermath



Source: FactSet, as of 02/04/2019. MSCI World Index return with net dividends, 12/11/2015 – 02/28/2017. Includes average daily gain and total gain from 02/11/2016 – 03/04/2016 and 03/04/2016 – 02/11/2017.

The Ins and Outs of Forced Selling

The Late-Year Sell-Off

Until early December, market volatility looked like a common correction. Fearful headlines about tariffs, China, Brexit, Italy and slowing growth spooked investors. The S&P 500 went from an all-time high on September 20 to flat on the year by late November. A recovery seemed underway by early December, but then markets sold off. The S&P 500 fell -15.6% from December 3 through Christmas Eve, with US markets lagging global markets.[xi] We believe the downturn stemmed from hedge funds scrambling to liquidate by yearend.

Why Did So Many Hedge Funds Close?

Hedge funds aren't legally required to publically disclose performance data or information on redemptions and closures. However, based on media reporting, our interactions with market makers and our experience, we think several hundred funds decided in early December to close at yearend, requiring rapid liquidation.

> ...The S&P 500 fell -15.6% from December 3 through Christmas Eve, with US markets lagging global markets.[xii] We believe the downturn stemmed from hedge funds scrambling to liquidate by yearend.

To fathom why hedge funds and other private investment funds would fold en masse, it is important to understand their fee structure. In our view, this decision revolves around the 2&20 fee structure many of these funds employ. When performance lags for a couple of years, it becomes even harder for the fund to surpass its high-water mark (which does not reset annually) and earn incentive fees on outperformance. If underperformance persists, it often becomes easier and less costly for the fund to close and begin anew.

We believe hundreds of hedge funds were in this position as December dawned. Their performance appears to have been dismal overall in recent years. Many managers were bearish after President Trump's election. Funds with minimal equity exposure, or designed to move opposite equities, missed the S&P 500's 27.9% rise between Election Day 2016 and yearend 2017.[xiii] Many then flipped bullish for 2018, only to lose out again as equities struggled. We suspect this put performance-based fees out of reach for many, incentivizing their closure.

By December 6, we believe hundreds of hedge funds told clients they were closing. While thousands more survived, their road ahead wasn't smooth. After an awful 2018, managers likely anticipated client redemptions in January and decided to raise cash while closing fund managers liquidated everything.

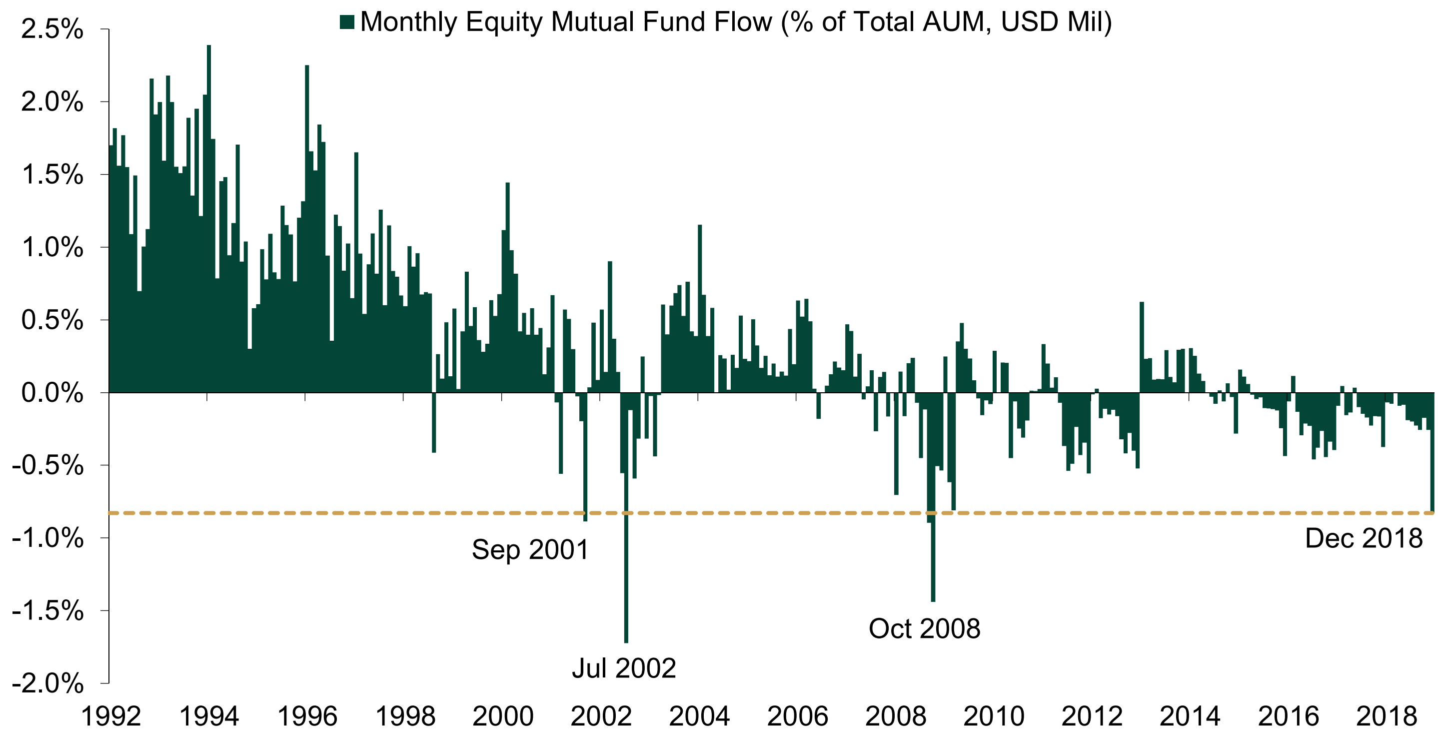
Hence, hedge funds' powerful selling began. The subsequent market declines had a knock-on effect as more investors began to sell and eventually, everyone—hedge fund managers and normal folks—was hastening to get out of the market. The effect on retail investors is evident in mutual fund flows, which spiked in December (Exhibit 5 on next page) as outflows reached their highest level (as a percentage of AUM) since march 2009, the bottom of the last bear. The four larger outflows were all during historically large bear markets. As Exhibit 6 on the next page shows, weekly equity fund outflows—including ETFs—escalated in December, peaking in its final week.

xi Source: FactSet, as of 01/23/2019. MSCI World Index return with net dividends, 12/24/2018 - 01/22/2019

xii Source: FactSet, as of 01/23/2019. MSCI World Index return with net dividends, 12/24/2018 - 01/22/2019

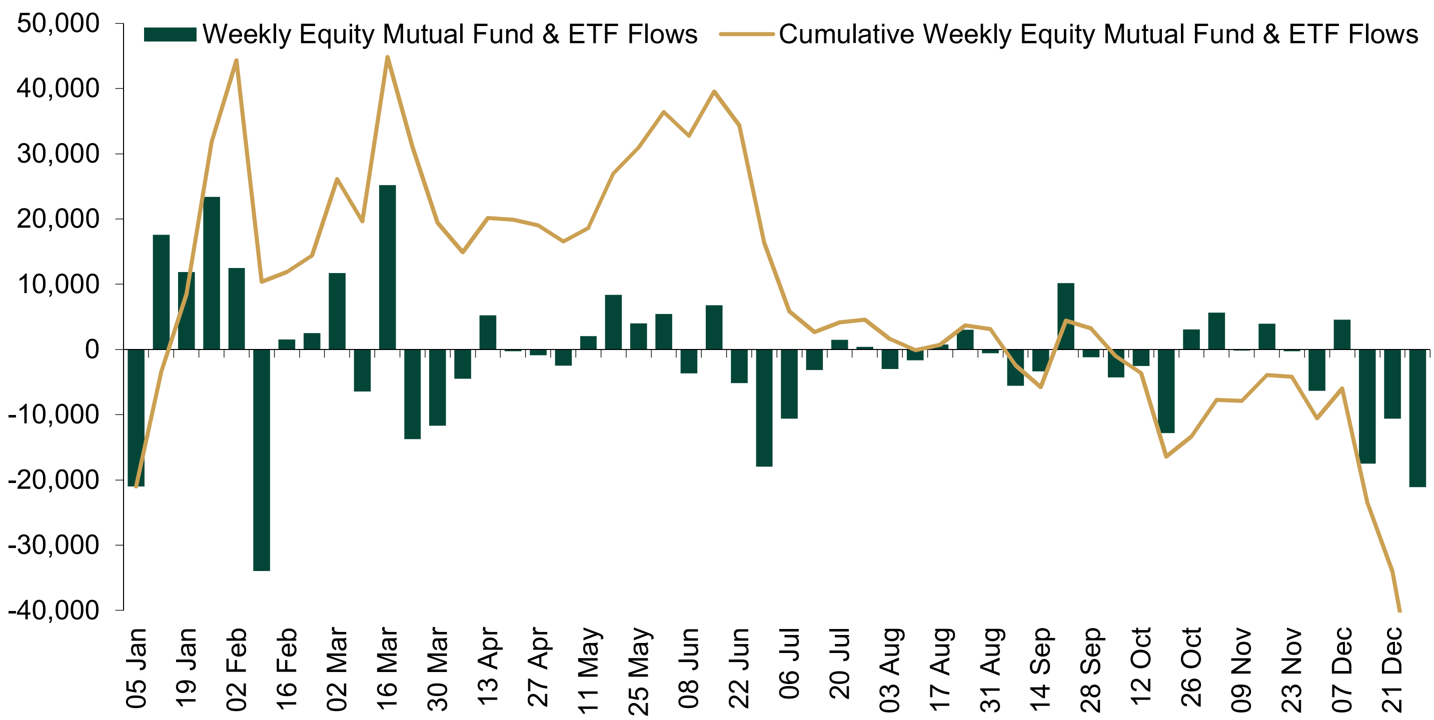
xiii Source: FactSet, as of 1/22/2019. S&P 500 total return, 11/08/2016 – 12/31/2017.

Exhibit 5: Mutual Fund Investors' Exodus



Source: FactSet and Thomson Reuters, as of 12/31/2018. Monthly ICI Equity Mutual Fund Net New Cash Flows and Monthly ICI Equity Mutual Fund Total Asset Values, 12/31/1991 – 11/30/2018; December 2018 net flows calculated using weekly ICI Equity Mutual Fund Net New Cash Flow estimates through 12/28/2018.

Exhibit 6: Weekly Equity Mutual Fund and ETF Net Flows



Source: FactSet, as of 01/11/2019. ICI Equity Mutual Fund and ETF Net Flows, weekly, 01/05/2018 – 01/04/2019.

Unusual Intraday Performance

From December's second week onward, market movement wasn't normal. Almost every day, markets would either start a bit lower or rise in the morning, then sell off sharply and finish down -1% or worse. Most of December's drop came in the 7 trading days from December 14 – 24.[xiv] To us, it looks like frantic selling by fund managers who didn't care about trade execution. Normally, large funds would take care to minimize their market impact and achieve a good price. That doesn't appear to have happened in December, consistent with mass fund closures.

Exhibit 7 shows the S&P 500's opening, high, low and closing prices every day during December. The shaded lines exemplify heavy hedge-fund selling, in our view. Note, also, most of these funds reside in the US. US equities were among the hardest hit in December, and big intraday selling was nearly exclusive to the US—all consistent with forced selling by US funds.

Exhibit 7: S&P 500 Pricing in December

Date	Open	High	Low	Close	% Change
12/03/2018	2,791	2,800	2,773	2,790	1.1%
12/04/2018	2,782	2,786	2,697	2,700	-3.2%
12/06/2018	2,664	2,696	2,622	2,696	-0.2%
12/07/2018	2,691	2,709	2,623	2,633	-2.3%
12/10/2018	2,631	2,648	2,583	2,638	0.2%
12/11/2018	2,664	2,674	2,621	2,637	0.0%
12/12/2018	2,658	2,685	2,650	2,651	0.5%
12/13/2018	2,659	2,670	2,637	2,651	0.0%
12/14/2018	2,630	2,635	2,594	2,600	-1.9%
12/17/2018	2,591	2,601	2,531	2,546	-2.1%
12/18/2018	2,560	2,574	2,529	2,546	0.0%
12/19/2018	2,547	2,585	2,489	2,507	-1.5%
12/20/2018	2,497	2,510	2,441	2,467	-1.6%
12/21/2018	2,465	2,504	2,409	2,417	-2.1%
12/24/2018	2,401	2,410	2,351	2,351	-2.7%
12/26/2018	2,363	2,468	2,347	2,468	5.0%
12/27/2018	2,443	2,489	2,398	2,489	0.9%
12/28/2018	2,499	2,520	2,473	2,486	-0.1%
12/31/2018	2,499	2,509	2,483	2,507	0.8%

Source: FactSet, as of 01/10/2019. S&P 500 opening, high, low and closing prices and daily percentage change, 12/03/2018 – 12/31/2018.

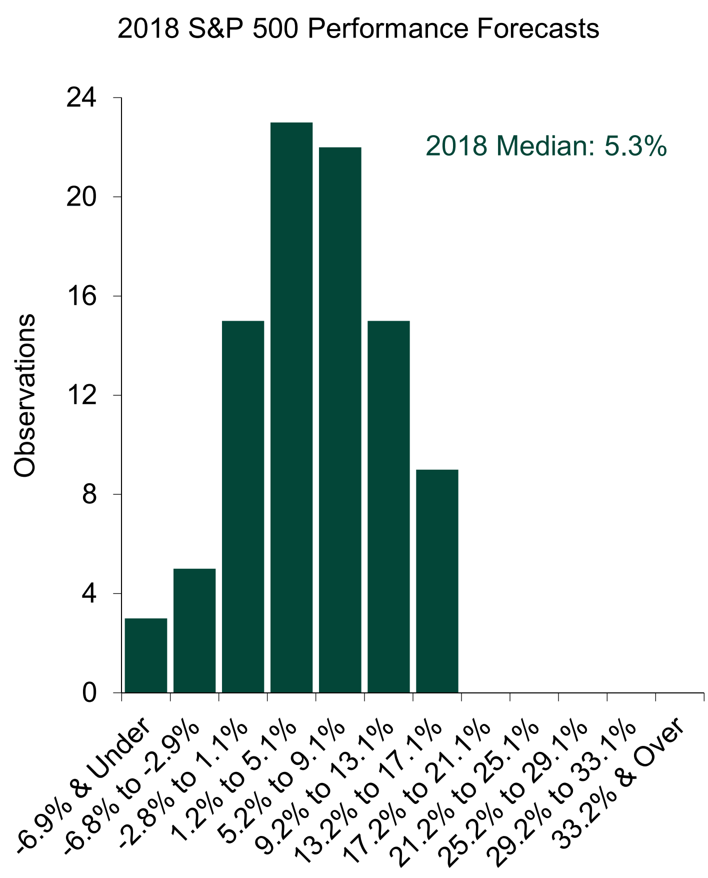
xiv *Source: Global Financial Data, Inc., as of 02/06/2019. Statement based on S&P 500 index total returns.*

What Sentiment Bell Curves Imply for 2019

Professional forecasts are another tool we use. As Exhibits 8 and 9 show, when graphed, professional forecasts usually cluster in the middle, forming a bell curve. Markets price in all widely known information and opinions, including popular forecasts—then tend to do what few expect. Thus, actual returns typically end up better or worse than most predictions, not in the middle of the bell curve.

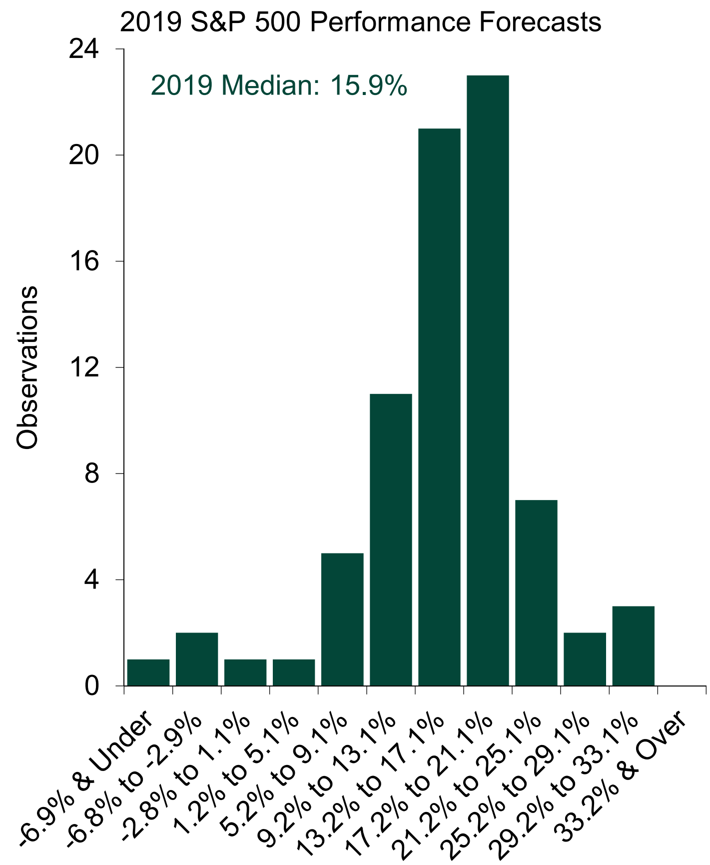
This indicator worked in 2018, but not how we expected. The median forecast was for a 5.3% full-year return. In our Q4 2017 Review & Outlook, we said either a large positive or slight negative year would surprise the herd. We thought big gains were more likely due to overwhelmingly positive economic and political fundamentals. When Q3 2018 ended, calendar-year returns seemed set to surprise to the upside, as we expected. However, Q4's swoon moved equities into the red for the year, with the S&P 500 falling -4.4%—a downside surprise. We picked the wrong end of the curve.

Exhibit 8: The 2018 Sentiment Bell Curve



Source: FactSet and Fisher Investments Research, as of 02/05/2019. S&P 500 price index and professional forecasts.

Exhibit 9: The 2019 Sentiment Bell Curve



Source: FactSet and Fisher Investments Research, as of 02/05/2019. S&P 500 price index and professional forecasts.

This year's median S&P 500 forecast is a 15.9% gain. This is not as optimistic as it might look, as a 15.9% rise wouldn't even put the S&P 500 at new highs. Regardless, the average post-correction recovery would put equities well on the right side of the curve.

US Commentary

US COMMENTARY

UNITED STATES' POLITICAL SWEET SPOT

Global gridlock persists, especially in the US—forestalling extreme legislation. Last quarter, we noted the high frequency of positivity in US markets after midterm elections. Entering Q4 2018 US equities had risen in 87% of midterm year Q4s—and the subsequent Q1 and Q2—since 1925.[xv] In totality, the three-quarter stretch rose 91.3% of the time.[xvi] Q4 2018's steep decline obviously cuts against this historical pattern, but the fact all three post-midterm quarters matched was largely a coincidence. The full nine-month stretch means much more, and one negative quarter doesn't necessarily derail it.

The post-midterm period we are currently in is a gateway to the presidential cycle's most bullish stage: the third year of a term. It is historically the highest returning and most often positive of a President's four year term (Exhibit 10).

Exhibit 10: The Presidential Term Anomaly

President	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%
Ike -- 1st	1953	-1.1%	1954	52.4%	1955	31.4%	1956	6.6%
Ike -- 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	-4.4%	2019		2020	
Percent Positive		58.3%		62.5%		91.3%		82.6%
All (Avg)		10.5%		8.6%		17.8%		11.1%
Positive Years (Avg)		26.3%		21.1%		21.6%		16.9%

Source: Global Financial Data and FactSet, as of 01/14/2019. S&P 500 total return, 1925 – 2018.

In our view, there are two keys to bullishness in the third year of presidential terms. First, midterms bring gridlock, which typically keeps extreme legislation from roiling equities. Second, in the third year, the president—and would-be challengers—start looking to the election year. Posturing and fundraising distract them from legislating. Campaining discourages material new laws as passing bills can roil voters. Hence, the third year tends to be benign politically, letting markets focus elsewhere. We expect this—plus solid economic drivers—to boost equities in 2019.

EARNINGS AND EXPANSION

S&P 500 earnings are estimated to have grown 20.2% in 2018, a big acceleration from 2017.[xvii] Many fear this is unrepeatable, triggered by America's corporate tax cut.

It is true tax cuts inflated last year's profit growth. But these weren't the sole driver. Sales—largely untouched by tax cuts—are estimated to have grown a solid 8.9% last year.[xviii] Moreover, tax cuts' impact—boosting 2018 profits and then vanishing—isn't sneaking up on anyone. This is one large reason analysts expect 5.0% growth in 2019.[xix] Even these estimates might be too low. Companies typically guide expectations lower before their earnings announcements to increase the likelihood they beat, garnering favorable coverage. It is normal in a given quarter for most firms to top low estimates.

Profits' fast 2018 growth plus falling equity prices compressed valuations. Since 1996, US valuations have never fallen two straight years—even during the dot-com bear market from 2000 – 2002. The dip implies multiple expansion this year. Adding even slow earnings growth should yield a good-to-great year.

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

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

xvii Source: FactSet Earnings Insight, as of 02/08/2019.

xviii Ibid.

xix Ibid.

Seeing Through the US Government Shutdown

Usually, we would know by now whether US GDP grew in Q4. However, because the government shutdown furloughed the Commerce Department's statisticians, many flagship reports were delayed. Q4 GDP will now come out at February's end. Releases of additional economic data, including retail sales, trade and factory orders for December and January are similarly delayed. Yet the Commerce Department doesn't have the monopoly on data. The Fed, Labor Department and private entities like the Institute for Supply Management (ISM) also release economic reports. Their latest releases suggest growth continued through Q4 and into January.

ISM's main gauges are purchasing managers' indexes (PMIs)—surveys estimating what percentage of companies grew. Manufacturing and non-manufacturing PMIs stayed well above 50 all quarter. Manufacturing's drop to 54.3 in December sparked some handwringing, but it doesn't imply broad weakness.[xx] PMIs measure how many firms grew, but not by how much, so reading into short-term movements is fruitless. Moreover, January 2019's rebound put manufacturing PMI at 56.6, with forward-looking new orders bouncing back strongly.[xxi] The Fed's industrial production gauge, which grew all quarter, echoes this. Manufacturing—the largest component—rose in two of three months, jumping 1.1% m/m in December.[xxii]

GDP "Nowcasts" also signal continued growth in Q4. These indexes, published by three Federal Reserve Banks (New York, Atlanta and St. Louis) combine economic releases and economists' estimates into an unofficial early reading of US GDP. While Nowcasts sometimes vary from reported GDP, they are decent ballpark estimates. Presently, the three gauges point to Q4 GDP growth between 1.5% and 2.6%.[xxiii] Slower, perhaps, but still growing.

...PMIs measure how many firms grew, but not by how much, so reading into short-term movements is fruitless...

The government shutdown, which ran from December 21 through January 25, likely won't impact Q1 GDP growth much. Federal spending hit by the shutdown is typically delayed, not canceled. Workers who were furloughed or working unpaid usually receive backpay. Businesses which rely on government workers likely felt a pinch as their clientele dealt with delayed paychecks. Only 800,000 government workers were affected by the shutdown, or 0.5% of all US nonfarm payrolls, but this likely isn't enough to move the needle.[xxiv] The Congressional Budget Office estimated $11 billion of economic output was lost during the shutdown but projects $8 billion of it to be recovered, leaving the total cost at $3 billion, or 0.01% of GDP.[xxv]

xx Source: FactSet, as of 01/11/2019. ISM Manufacturing level and point change, December 2018.

xxi Source: Institute for Supply Management, as of 02/05/2019.

xxii Source: US Bureau of Economic Analysis. Figure combines Mining, Utilities and Manufacturing's share of 2017 GDP to replicate the data included in the Federal Reserve's monthly report on industrial output.

xxiii Source: Federal Reserve Banks of New York, Atlanta and St. Louis, as of 02/14/2019. Readings were 2.4%, 1.5% and 2.6%, respectively.

xxiv Source: St. Louis Fed, as of 02/07/2019. Based on total January nonfarm payrolls.

xxv Ibid. Based on annualized nominal GDP in Q3 2018.

Exhibit 11: Returns Before & After False Inversions

	Inversion Cause		Returns Before Inversion		Returns Following Inversion			
Inversion Date	Rising short rates?	Fallling long rates?	-6M	-3M	+6M	+12M	To Mkt Peak	# Months Before Bear
11/01/1978	X		-0.8%	-3.8%	5.0%	5.9%	45.1%	25
05/31/1989	X		17.1%	11.0%	7.9%	12.7%	15.1%	14
09/10/1998		X	-7.9%	-11.9%	31.3%	37.9%	55.8%	19
02/28/2006	X		6.3%	1.8%	1.6%	9.9%	22.2%	20
		Average	**3.7%**	**-0.7%**	**11.5%**	**16.6%**	**34.6%**	**19**
		% Freq. Positive	**50%**	**50%**	**100%**	**100%**	**100%**	

Source: FactSet, Global Financial Data, Inc. and St. Louis Federal Reserve, as of 01/04/2019. S&P 500 price index, 10-year US Treasury yield and 3-month US Treasury Bill yield, daily, 04/30/1978 – 12/31/2008.

INTEREST RATE UPDATE

10-year US Treasury yields' 29-basis point rise last year was far smaller than many anticipated.[xxvi] When the 10-year yield neared 3% in February and April, many feared it would jump to 4% or higher. Yet the highest point reached during the year was just 3.24% on November 8.[xxvii] By January's end, the 10-year yield was back down to 2.63%.[xxviii]

We don't expect big moves in 2019, for much the same reason as 2018. As 2019 opened, the yield curve was flattening. This points to restrained loan and money supply growth—both disinflationary phenomena. Long-term rates depend largely on inflation expectations, making a rapid rise in yields unlikely when inflation is tame like it is now.

While Fed moves aren't predictable, this backdrop isn't consistent with hiking rates. Doing so amid widespread slow-growth fears and a flatter yield curve would be odd. However, if they do hike, it would dampen inflation expectations even more, weighing further on long rates. With people still fearing higher interest rates, a more benign move should be bullish for equities.

Potential yield curve inversion (short rates exceeding long rates) is something we watch closely for. Yet US yield curve inversion, though important, isn't a market timing tool. As Exhibit 11 shows, there are four occurrences when the US yield curve inverted without a recession or bear market starting in the next 12 months. Even when inversion does precede recession, the lag between the two can be significant—equities can rise for months thereafter.

xxvi Source: FactSet, as of 01/10/2019. 10-year US Treasury yield, constant maturity, 12/31/2017 – 12/31/2018.

xxvii Source: FactSet, as of 01/10/2019. 10-year US Treasury yield on 11/08/2018.

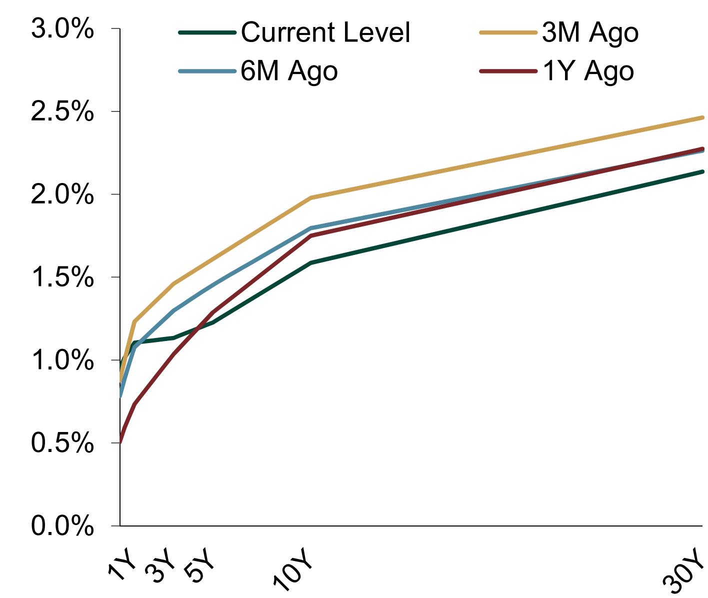
xxviii Source: FactSet, as of 02/07/2019. 10-year US Treasury yield on 01/31/2019.

In December, many pundits claimed the yield curve inverted, warning of trouble. But they looked at two largely irrelevant yield spreads: the 5-year minus 3-year and 5-year minus 2-year. In our view, focusing on these segments of the yield curve ignores why the curve matters to begin with—the yield curve drives banks' profits. When the yield curve inverts, potential costs outweigh revenue, making lending unprofitable and unattractive. If the curve remains inverted, credit freezes, sapping economic growth.

Using 2- or 3-year yields as the curve's short end doesn't match banks' typical funding. Banks get most funding from customer deposits or wholesale funding, which makes overnight and 3-month interest rates better snapshots of borrowing costs. Similarly, 5-year yields aren't long-term enough to represent loan revenues. This is why we monitor the 10-year minus fed-funds and 10-year minus 3-month yield curve spreads most closely. Both have flattened but aren't inverted.

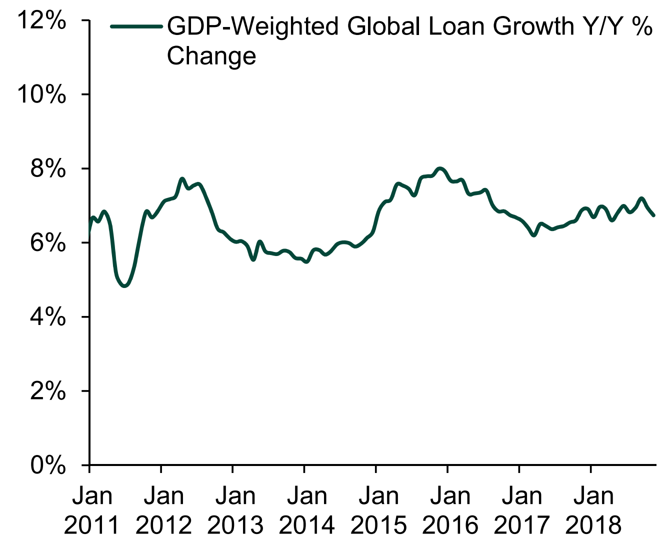
Moreover, in a world where banks can easily borrow in one country and lend in another, the global yield curve matters most. It influences global loan growth and money supply, which matter more than local readings. The global curve is currently positive, helping support loan and money supply growth worldwide (Exhibit 12-14).

Exhibit 12: Global Yield Curve



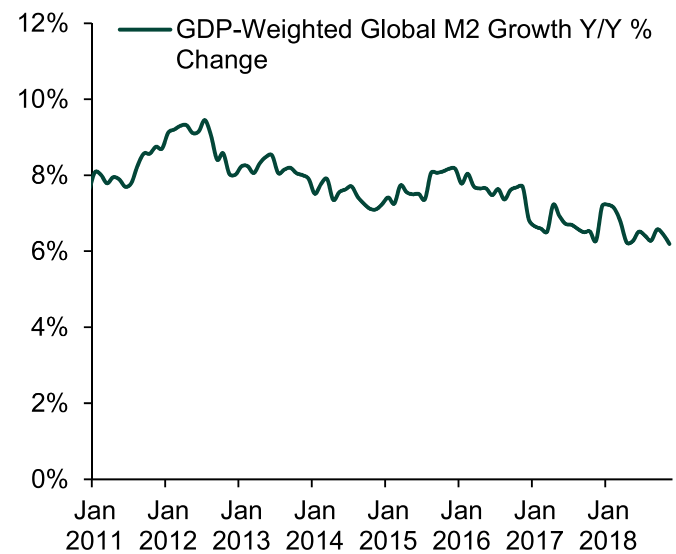
Source: FactSet, as of 02/06/2019. Global (excluding Emerging Markets) GDP-weighted yield curve on 02/05/2019. Weighted M2 and loan growth of top 30 economies weighted by GDP, January 2011 – November 2018.

Exhibit 13: Global Lending



Source: FactSet, as of 02/06/2019. Global (excluding Emerging Markets) GDP-weighted yield curve on 02/05/2019. Weighted M2 and loan growth of top 30 economies weighted by GDP, January 2011 – November 2018.

Exhibit 14: Global Money Supply



Source: FactSet, as of 02/06/2019. Global (excluding Emerging Markets) GDP-weighted yield curve on 02/05/2019. Weighted M2 and loan growth of top 30 economies weighted by GDP, January 2011 – November 2018.

Global Developed ex-US Commentary

United Kingdom

Brexit: Keep Calm and Get On With It!

The UK is slated to leave the EU in less than two months, with headlines shrieking over the many remaining unknowns and warning of disaster. However, our view remains unchanged: Brexit's biggest negative—uncertainty over how the UK/EU relationship will look—should fall thereafter, allowing everyone to move on. Even the widely feared "no-deal" Brexit likely won't be as disruptive as media project—a potentially big positive surprise.

Brexit's ultimate shape and even its timing remain unknown. As we write, it is scheduled for March 29, but members of Parliament (MPs) are in discussions about requesting an extension. Their motivation is the government's failure to win a vote on the exit terms Prime Minister Theresa May agreed to with EU negotiators in November. That agreement included a post-Brexit transition period running through 2020, with the UK free to sign its own trade agreements. However, it also included a "backstop" solution for the Irish border, which still lacks a permanent fix. Brexit complicates the Good Friday Accords outlining the peace agreement between Northern Ireland and Irish Republic which require a "frictionless" land border with no manned checkpoints. Once the UK leaves the EU's customs union and single market, goods crossing the border become subject to customs checks and, potentially, tariffs.

> This reminds us of the turn of the century's Y2K scare, which ended up benign. We believe Brexit will similarly surprise.

This is the biggest obstacle in Brexit talks, so negotiators included the backstop in the withdrawal agreement in order to buy more time. The backstop would keep the entire UK in the EU's customs union with Northern Ireland staying in the single market indefinitely to avoid border checks. To pro-Brexit MPs, this defeated Brexit's purpose. Pro-EU MPs also disliked it, arguing it stripped more benefits of EU membership than costs. The result: MPs rejected the deal by more than 200 votes in January, the biggest Parliamentary defeat for a UK prime minister in decades. However, Prime Minister May won a no-confidence motion tabled by Labour Party leader Jeremy Corbyn the next day. The upshot: Prime Minister May was forced to return to the EU to tryand secure a "Plan B" more amenable to MPs. When she presented this plan in late January—which looked little different from Plan A—MPs responding by passing two small, nonbinding amendments instructing her to negotiate "alternative arrangements" to replace the Irish backstop. She is now negotiating with EU officials and is due to report back to Parliament soon.

However this ends, we think it is highly unlikely Brexit goes as badly as feared. Financial media warn constantly of a "hard" or "no-deal" Brexit's disastrous fallout. Many predictions center on government-issued white papers or analyses from the Bank of England (BoE) or Treasury. This dour sentiment has heavily impacted popular interpretations.

For example, in late November, the BoE tested banks' preparedness for Brexit using a hypothetical worst-case scenario hinging on an -8% GDP contraction in the event Brexit happened with no deal, no transition period and no policy response. This means no fiscal stimulus, monetary stimulus or patchwork measures to ensure continued trade and minimize supply chain disruptions. This scenario is highly unrealistic. It also wasn't a forecast. The central bank said it was a thought experiment to aid stress tests. Yet media reaction was hysterical, with many claiming the BoE thought a no-deal Brexit could rival America's Great Depression. This is the sort of fear markets have priced in.

Obviously, a soft Brexit with a transition period would beat these expectations. So would a "hard" Brexit that makes a cleaner break but still includes some broad agreements with the EU. Yet even the dreaded "no-deal" scenario shouldn't be as bad as feared. The UK-EU trading relationship would revert to World Trade Organization (WTO) rules. Both have most favored nation status, minimizing tariffs. Though new customs checks would take effect, European and British ports have hired thousands of workers for this scenario. Moreover, businesses have had plenty of time to plan and prepare. Anecdotal evidence from companies' earnings calls and CEO interviews suggests firms have made preparations. Recent manufacturing surveys show factories are stockpiling goods and supplies. Both sides aim to implement stopgap measures keeping the Irish border frictionless.

Brexit's main negative, in our view, is the associated uncertainty. Not knowing the future rules prevents businesses from unleashing new investments and other long-term plans. Knowing the outcome will allow businesses—and markets—to move on, relieving equities.

European Politics ex. Brexit

While the UK's Brexit negotiations and Italy's budget standoff with the EU grabbed the most attention during Q4 2018, other European nations dealt with their own political issues. Whether they made global news or just local, these stories largely speak to the same trend: political gridlock reigns. While many bemoan governments that can't, or don't, accomplish much, equities enjoy a lack of sweeping legislation that would potentially impact property rights, taxes and more. Further, keeping the status quo means businesses do not have to deal with external shifts to the playing field beyond their control. So it is across most of Europe—an underappreciated positive for equities.

Italy

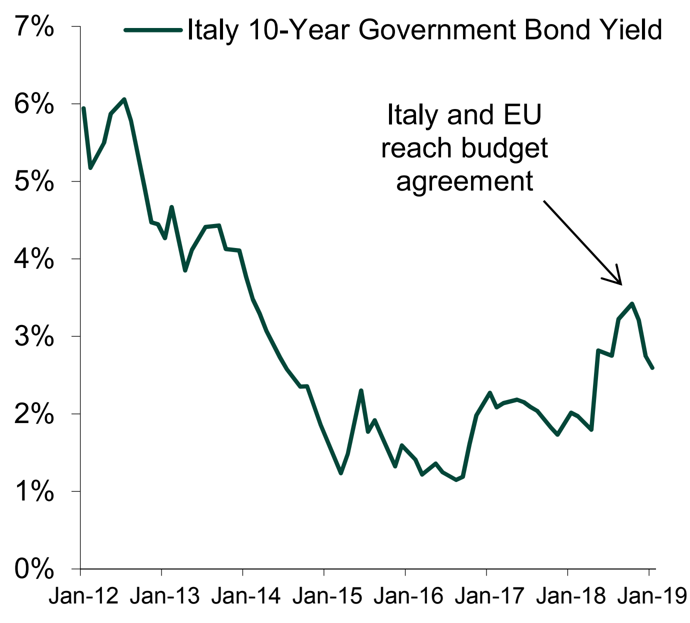
Italy and the EU ended their months-long budget stalemate in December, to little fanfare. Throughout the autumn, Rome and Brussels battled over Italy's spending plans. As EU officials rejected Italy's initial deficit proposal, 2.4% of GDP, Italian yields spiked. Some worried this put Italian debt at risk of default. However, as discussed in the Q2 and Q3 2018 Review & Outlooks, and shown in Exhibit 15, interest payments' share of Italian tax revenue is near generational lows. Italian debt is affordable.

After months of negotiating, both sides met in the middle—ending the episode quietly. As a result yields fell. (Exhibit 16) Italy's bond auctions went seamlessly, with demand exceeding supply. Yet few cared. Fears morphed to the next scary topic—a reminder of how prevalent dour sentiment is today.

Exhibit 15: Italian Interest Payments Relative to Tax Revenues

Source: FactSet, Bank of Italy and Oxford Economics as of 09/30/2018. Italian government interest payments and tax revenues, quarterly, 12/31/1981 – 09/30/2018.

Exhibit 16: Falling Italian Yields Following Budget Agreement



Source: FactSet as of 01/31/2019. 10-year Italian government bond yield, daily, 01/02/1980 – 01/31/2019.

France

In France, the "Yellow Vest" protests against President Emmanuel Macron's new fuel tax dominated headlines. After President Macron unveiled this tax, many commuters took to the streets to protest donning safety vests—earning the movement its moniker. In the process, the protests stymied business, clogged thoroughfares and halted economic activity. Though the broad market impact is likely limited, economic data show the protests' effects—November industrial production slipped -1.3% m/m, and manufacturing dropped -1.4%.[xxix] IHS Markit's December purchasing managers' indexes (PMI) fell below 50—Manufacturing registered 49.7 while Services dipped to 49.0—signaling more surveyed businesses contracted than expanded.[xxx] While January's flash PMI showed a Manufacturing rebound, Services slipped further into contraction.[xxxi]

Beyond the passing hit on economic growth, tax debates are largely sociological and therefore not meaningful for markets.

Though protests may weigh on Q4 2018 GDP—potentially even causing contraction—the economic fallout is likely temporary and well known—markets typically look past such events. France's economy and markets have weathered protests plenty of other times in recent memory, including truckers' strikes in 1996, 1997, 2009 and 2017. Recent protests received more international attention, but strikes aren't unusual for France. The added attention may make it more likely markets already reflect this labor disruption's impact.

Beyond the passing hit on economic growth, tax debates are largely sociological and therefore not meaningful for markets. In our view, the current strife highlights President Macron's falling popularity. His political capital has steadily declined since taking office in 2016. Though some worry this will imperil Macron's ability to pass future reform—both domestically and for the broader eurozone—equities shouldn't suffer from it, in our view. French and eurozone equities don't need reform as fuel. New legislation in developed nations tends to create winners and losers. Even allegedly "business friendly" policies can result in unintended consequences that introduce uncertainty and knock sentiment—which equities often dislike.

The recently announced "Grand Debate"—President Macron's outreach to the French populace for their opinion and ideas—may take over the discourse next, but it doesn't mean big political change is forthcoming. Large national debates perpetuate gridlock, making it more difficult to pass any major, sweeping new laws, and further entrenching the status quo which has been fine for equities. Gridlocked French governments haven't derailed eurozone or French markets in the recent past, and we don't see that changing now.

Germany

In late October, Christian Democratic Union (CDU) leader and current Chancellor Angela Merkel announced she wouldn't seek reelection as party chair—setting up a leadership contest at the December party conference between Annegret Kramp-Karrenbauer and Friedrich Merz. The vote was hotly contested and exposed some CDU divisions. Kramp-Karrenbauer is a pro-EU centrist and Merkel's protégé, while Merz postured as the option for voters who are against what he presented as the center-right party's leftward shift. CDU members selected Kramp-Karrenbauer, who is now in the process of cementing her party leadership. The CDU's story is similar to Germany's other establishment parties. The Christian Social Union (CSU), CDU's Bavarian sister party, and the center-left Social Democrats (SPD) have also been undergoing leadership changes.

Couple these transitions with Chancellor Merkel's lame-duck status for the rest of her term as chancellor, and the upshot: gridlocked German politics. The country's "Grand Coalition" government—which the CDU/CSU and SPD renewed in 2018—doesn't have much common ground. The CDU and CSU are reviewing their long-running alliance, and the SPD—which faces challenges from smaller, far-left parties—has little political incentive to work closely with its center-right counterpart. These tensions decrease the likelihood the Bundestag passes any major change. The low likelihood of legislative uncertainty is a positive for equities.

xxix Source: FactSet, as of 01/22/2019.

xxx Source: IHS Markit, as of 01/22/2019.

xxxi Source: IHS Markit, as of 01/25/2019.

Spain

In Spain, a coalition of the political right and center took power in Andalusia—likely adding to the country's overall gridlock. In December, Spain's most populous region—historically a stronghold for Prime Minister Pedro Sánchez's center-left Socialist (PSOE) party—had a surprising regional election outcome. Vox, a far-right populist party, unexpectedly surged and won 12 seats—giving it kingmaker power. Though the Socialists won the most votes, they failed to get a majority. That gave the center-right Popular Party's (PP) local leader, Juan Manuel Moreno, an opportunity to break through, and he formed a government with the support of Vox and the centrist Ciudadanos.

...budget negotiations dampen the likelihood of major legislative change, which can yield uncertainty and gridlock.

This right-leaning coalition brought an end to the PSOE's 36-year run atop Andalusia's government, putting Prime Minister Sánchez and his minority government in Madrid on notice. Before the Andalusian election, there were murmurs Prime Minister Sánchez was maneuvering for a snap election. The PSOE had been polling better than the PP, giving Prime Minister Sánchez reason to think he could strengthen his hand. The Andalusian outcome dampened that speculation for now.

Currently, the Spanish government is attempting to get its budget through parliament. Prime Minister Sánchez will need the support of several smaller parties, including Catalan separatists, in order to pass his plan—a tall order. Already, the PSOE suffered a setback in late January, as far-left party Podemos voted against housing regulation change. Minority governments such as Prime Minister Sánchez's usually struggle to pass consequential legislation. But now as Sánchez attempts to find compromises, budget negotiations dampen the likelihood of major legislative change, which can yield uncertainty and gridlock.

Belgium

In December, the Belgian government collapsed after the right-wing nationalist N-VA Flemish party—the biggest coalition partner—exited the government over Prime Minister Charles Michel's push to join the UN's nonbinding pact regarding migration. Migration is a hot-button topic—and has been since 2015's European migration crisis. But it is also a sociological issue—and as stated previously, we don't believe sociology drives markets. While the Michel government's fall could stoke some local uncertainty, this doesn't mean looming trouble for Belgian markets or the eurozone. Belgium went without a government for 589 days in 2010 – 2011. That period coincided with the eurozone debt crisis and accompanying regional bear market. While Belgian equities dropped -9.5% during that stretch, eurozone equities fared even worse at -13.7%—a sign not having a government isn't automatically bad for markets.[xxxii]

Sweden

Following more than four months without a government, Swedish Prime Minister Stefan Löfven won a second term in office. After September 9's election yielded a hung parliament, both the center-left and center-right blocs tried and failed to win lawmaker's support. Since neither wished to work with the far right, anti-immigration Sweden Democrats (Sweden's third-largest party), both blocs faced a difficult path.

But on January 18, Prime Minister Löfven "won" sufficient support from the 349-seat Riksdag. Under Swedish law, a prime minister can enter power if a majority of legislators don't oppose. Though only 115 MPs voted in favor of Prime Minister Löfven, 77 abstained—primarily those from the Left Party. Prime Minister Löfven did have to make big concessions to the center-right's Center and Liberal parties, including pledges to cut taxes, reform housing law and relax some labor laws. Additionally, though the Left Party abstained from the final vote, they threatened to vote against Prime Minister Löfven's government should it attempt to make good on pledged compromises it considers too far to the right. The result: a weak minority government that could easily collapse should a member of the fragile coalition, or an abstaining party, voice its opposition. Gridlock also persists in Scandinavia.

xxxii Source: FactSet, as of 01/22/2019. MSCI Belgium Index with net dividends and MSCI European Economic and Monetary Union Index with net dividends, USD, 04/26/2010 – 12/06/2011.

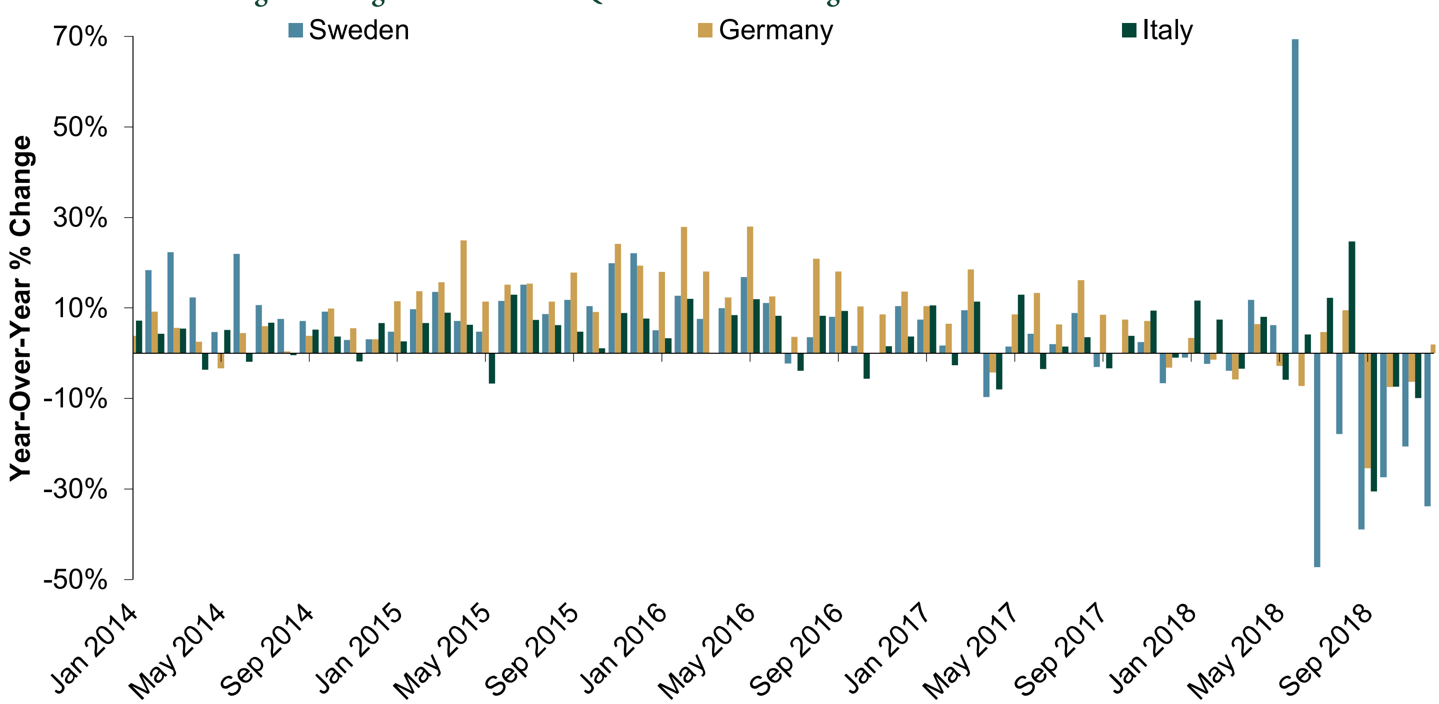
Continental Europe's Economic Growth

Eurozone GDP grew 0.9% annualized in Q4, defying fears that weak trade and industrial production would drive contraction.[xxxiii] The initial estimate contained few details, though it did show France growing 1.1% annualized despite widespread protests many thought would hurt output.[xxxiv] Spain accelerated to 2.8%.[xxxv] German Q4 GDP rebounded from a small Q3 contraction, although growth remained slow.[xxxvi]

Although eurozone GDP's breakdown isn't out yet, monthly data suggest weakness came from heavy industry and trade. Trade weakness likely stems from weaker Chinese private sector demand. As Chinese stimulus measures take effect, we expect recovering there to rekindle trade, helping the eurozone. Weakness in industrial production appears tied to new EU emissions standards disrupting the auto industry. For example, Volkswagen estimated the standards would interrupt production of 200,000 – 250,000 vehicles in 2018's second half.[xxxvii] Italy's auto industry and supporting manufacturers are also likely struggling with these new rules, weighing on factory output.

Auto sales also demonstrate the rules' impact. When new taxes or regulations take effect, it is normal for consumers to front-run them. Usually, sales spike before the change, then fall for a spell. As Exhibit 17 shows, this seemingly happened in Europe. German and Italian new passenger car registrations jumped in late summer, as consumers raced to buy before the new rules took effect September 1, then plummeted. Sweden, though not a eurozone member-state, is also illustrative. Auto registrations there were more extreme, as tighter emissions restrictions and a new tax on non-electric cars likely contributed to Sweden's small Q3 GDP contraction.

Exhibit 17: New Passenger Car Registrations Hint at Q3 Contractions Being One-Offs



Source: FactSet, as of 01/18/2019. Year-over-year percentage change in new passenger car registrations. January 2014 – December 2018.

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xxxiii Source: FactSet, as of 02/07/2019.

xxxiv Ibid.

xxxv Ibid.

xxxvi Ibid.

xxxvii "VW Says 250,000 Cars Could Be Delayed by New Testing Rules," Andreas Cremer and Jan Schwartz, Reuters, 06/08/2018. https://www.reuters.com/article/us-volkswagen-emissions-production/vw-says-250000-cars-could-be-delayed-by-new-testing-rules-idUSKCN1J42A4.

Italian GDP contracted -0.9% annualized, worsening from Q3's -0.5% decline.[xxxviii] The two consecutive quarters of negative GDP meet one popular definition of a recession. Some fear this spells trouble for the eurozone, but a look under the hood shows Italy's issues should be temporary. While it, too, felt a pinch from slowing Chinese private sector demand and the new EU emissions testing rules, weak fixed investment seemingly tipped the scales negative. This likely stems from spiking Italian long-term interest rates, which ran up through November. Rates were never excessive, but a quick spike can deter borrowing if firms think it is temporary. They likely wait for it to reverse, rather than lock in years of higher interest payments. This appears to have happened in Italy, causing firms to delay borrowing and investment. Rates have since fallen from 3.6% in late-November to 2.6% at January's end.[xxxix] That should help boost corporate demand for credit, leading to a recovery in lending and investment.

UK economic data are a mixed bag. Overall, growth continues. Quarterly GDP accelerated in 2018's first three quarters—despite falling business investment. However, Q4 growth slowed notably from 2.5% annualized to 0.7%.[xl] Many commentators cited contraction in December, particularly blaming weak manufacturing output. We see this mostly as a byproduct of Brexit uncertainty, which should dissipate soon. Moreover, we caution against extrapolating one wobble in a new monthly series—which exacerbates data volatility.

PMIs also hint at Brexit uncertainty taking a toll. Manufacturing PMI ticked down from 54.2 in December to 52.8 in January.[xli] While this suggests growth, production and forward-looking new orders weakened. Most of the headline positivity came from fast-rising inventories as firms stockpiled ahead of Brexit, which also accounted for most new business. Overall, uncertainty appears to be discouraging long-term moves.

The services PMI was even weaker, crawling to 50.1 in January as new orders fell for the first time since July 2016.[xlii] Here, too, firms reported Brexit uncertainty sapping demand. However, this isn't the first time sentiment has derailed the UK services PMI—it happened after the Brexit vote, too. That downturn was fleeting, as businesses digested the vote and moved on. We suspect they will do the same once Brexit's ins and outs are no longer a mystery.

A Final Word on QE

One reason many doubt equities' potential is the end of central banks' quantitative easing (QE) programs, supposedly one of few supports for economic growth and equities since 2008. We think this view is faulty: A clear-eyed look shows equities and the economy grew despite QE, not because of it.

For much of the last decade, central banks globally used massive QE programs. Central bankers claimed they would boost lending by lowering long-term interest rates and pumping banks with capital. This meant buying trillions of dollars in long-term bonds and other assets from banks, flooding them with reserves while also lowering long-term interest rates. In addition to the alleged economic benefits, some claim this drove investors from low-yielding bonds to equities, lifting prices.

QE's market-friendly reputation also benefits from timing. The Bank of Japan's (BoJ) first QE program ran from 2001 – 2006, partly overlapping 2002 – 2007's global bull market. The US Federal Reserve (Fed) unveiled QE in November 2008, and the bull market began the following March. The Fed, BoJ, Bank of England (BoE) and European Central Bank (ECB) all used QE at times during the next nine years, while equities rose.

The ECB ended QE in December, leaving only the BoJ with active QE. The Fed is letting its bond holdings mature, shrinking its balance sheet in what some call "quantitative tightening," or "QT." Many believe this enabled 2018's volatility—thus dooming equities to more downside absent new "stimulus."

Ending QE Wasn't Bearish

We see abundant evidence contradicting this. Japan underperformed in the last two bull markets despite having the only QE program in the mid-2000s bull and the largest relative to GDP in this one. The Fed began discussing "tapering" US QE in 2013, a banner year for equities. It announced its first QE reduction that December—no calamity followed. QE finally ended before the 2015 – 2016 correction. Its absence didn't prevent a huge rally thereafter.

xxxviii Source: FactSet, as of 02/04/2019.

xxxix Source: FactSet, as of 02/04/2019. Italian 10-year benchmark government bond yield, 11/20/2018 – 01/31/2019.

xl Source: Office for National Statistics, as of 02/11//2019. UK GDP, Q1 2018 – Q4 2018.

xli Source: IHS Markit, as of 02/07/2019.

xlii Ibid.

UK QE ended in November 2012—yet UK equities had a fine 2013 and the bull marched on. GDP growth accelerated. After the eurozone's sovereign debt crisis, equities there resumed rising in 2012. Economic growth returned in Q2 2013. But the ECB didn't launch QE until March 2015. It announced its first QE taper in December 2016. Yet eurozone equities outperformed in 2017 as economic growth improved.

Eurozone QE's end was widely telegraphed beforehand and the subject of media fodder for months. Efficient markets don't wait for widely anticipated events to happen before pricing them in. Even if QE's conclusion was negative, it wouldn't be a forward-looking factor, in our view.

Why QE Is Counterproductive

QE presumed reducing long-term interest rates would spur lending. We think it did the opposite. As noted previously, banks' core business model is borrowing at short-term rates—usually via deposits and overnight loans from other banks—and lending at long-term rates. The difference determines profit margins on new loans. If the difference is too narrow, there isn't much incentive to lend—particularly to borrowers without excellent credit. Thus, by reducing long-term rates while short rates were fixed near zero, QE made lending less attractive.

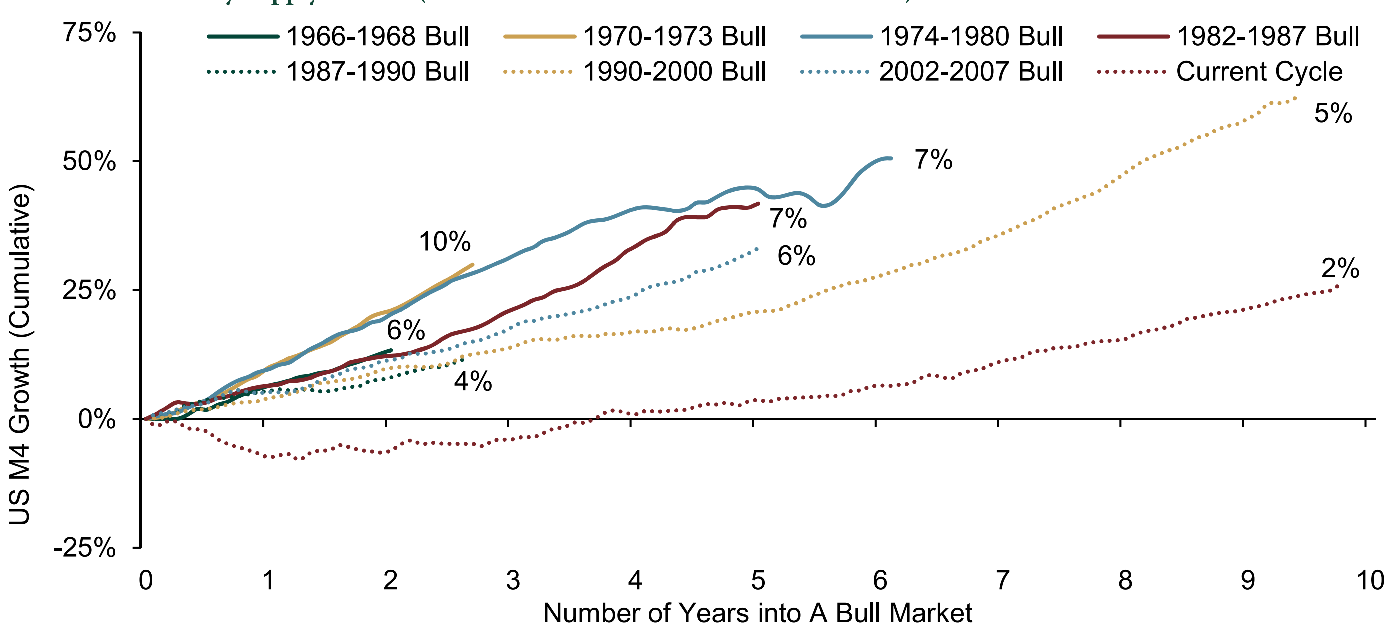
QE has another little-noticed flaw. Many call it "printing money." This is wrong. Under QE, banks exchanged bonds for central bank reserves. These reserves could have backed new loans, which is how most new money originates. However, absent worthwhile profits, banks likely won't lend. So even if the monetary base rises, broad money supply (M4), doesn't.

This is what happened during QE. Excess reserves—those exceeding regulatory minimums—skyrocketed as lending crawled. Banks used new reserves to build capital buffers, not to support lending. If they lent more, new reserves would have been "required," not "excess." US banks' excess reserves ballooned from negligible levels in August 2008 to $2.7 trillion in August 2014.[xliii] Eurozone excess reserves rose from just above zero in July 2012 to €1.3 trillion n December 2018.[xliv]

QE wasn't stimulus, as money supply and lending data show. It is more accurate to call it a backdoor bank recapitalization. US M4 money supply has grown at the slowest pace on record during this expansion (Exhibit 18).

Similarly, UK and US loan growth crawled during QE but accelerated after tapering began. GDP growth picked up, too. Eurozone loan growth began recovering before QE. It accelerated while the program ran but sped further while the ECB tapered. With QE ending, lending likely continues apace.

Exhibit 18: US Money Supply Growth (Cumulative and Annualized Growth Rates)



Source: FactSet and the Center for Financial Stability, as of 01/16/2019. US M4 Growth during S&P 500 bull markets, monthly, October 1966 – November 2018.

xliii Source: Federal Reserve Bank of St. Louis, as of 1/11/2019. Excess Reserves of Depository Institutions, August 2008 – August 2014.

xliv Source: Eurostat, as of 1/11/2019. Total excess reserves of credit institutions subject to minimum reserve requirements in the euro area, July 2012 – December 2018.

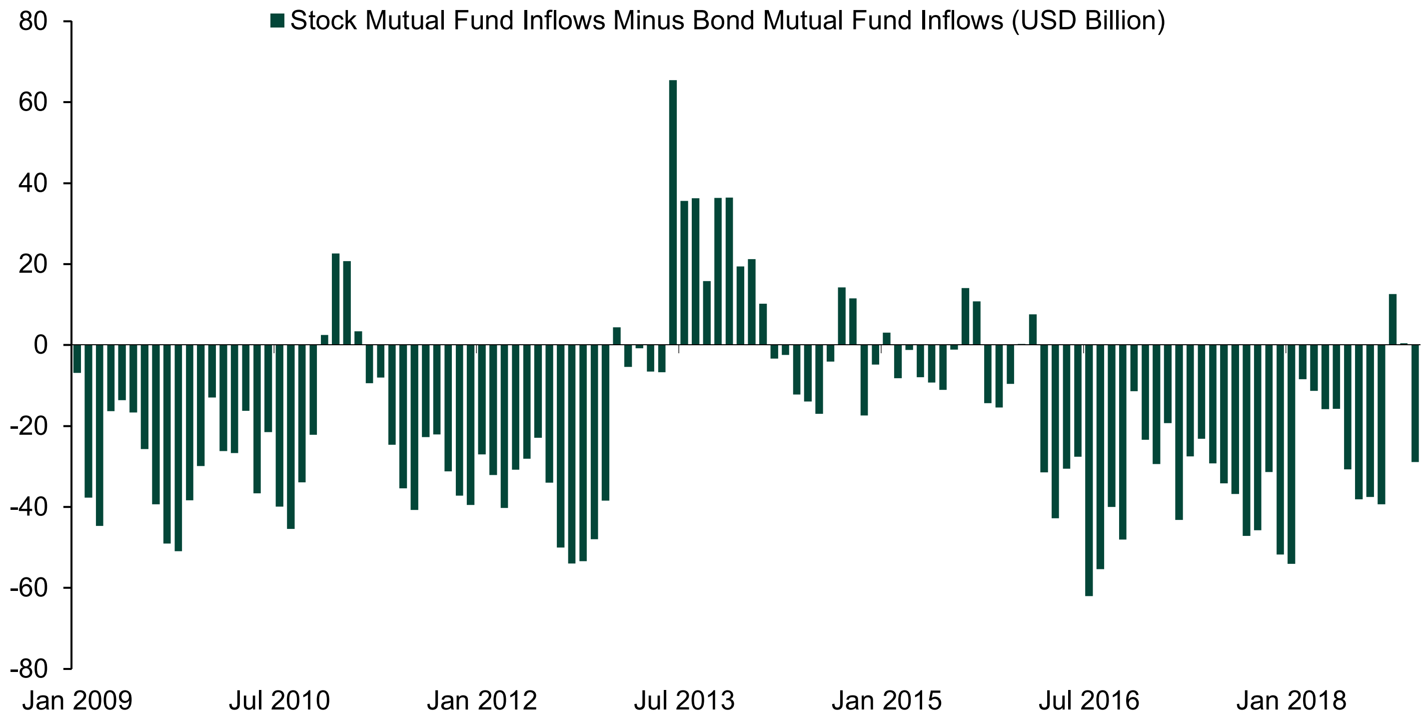
QE Didn't Fuel the Bull

There isn't much evidence QE drove investors from low-yielding bonds to higher-returning equities, supercharging the bull. Institutional investors generally have asset allocation mandates. Most can't just flip from bonds to equities because yields are low. Retail investors could, but fund flows don't suggest this happened (Exhibit 19). These data aren't ironclad, as they miss what investors do with the proceeds of a sale. But if there were a QE-induced stampede from bonds, fund flows would probably show it.

Finally, the US bull's annualized return is below the long-term average—14% versus 21%. Not what you would expect if QE were supporting equities.[xlv]

We think the evidence is conclusive: QE hasn't powered this bull market or economic expansion. Instead, it sapped lending, money supply and economic growth. We believe its gradual disappearance is an underappreciated positive.

Exhibit 19: Fund Flows Don't Show Flight to Equities



Source: FactSet, as of 01/11/2019. Monthly ICI Equity Mutual Fund Net New Cash Flows and Monthly ICI Bond Mutual Fund Net New Cash Flows, January 2009 – November 2018. December 2018 net flows calculated using weekly ICI Equity and Bond Mutual Fund Net New Cash Flow estimates through 12/28/2018.

xlv *Source: FactSet, as of 01/16/2019. S&P 500 Price Index, annualized returns during bull markets, 06/01/1932 – 12/31/2018.*

Emerging Markets Commentary

Emerging Markets Commentary

Still No Chinese Hard Landing

China's economy slowed further in 2018, renewing years-old "hard landing" talk (Exhibit 20). But slower growth isn't a crash, nor is it new.

Some fear Chinese GDP is government-manipulated, masking deep issues. They cite anecdotes like Beijing ceasing provincial governments' data collection efforts, arguing officials are whitewashing US tariffs' impact. In our view, skepticism is always healthy as all datasets have limitations. Moreover, data from private entities and public entities outside China indicate tariffs aren't a big drag.

Nor should they be. As we showed in the Q2 2018 Review & Outlook, tariff payments are less than half a percent of world GDP.[xlvi] Even if all threatened tariffs take effect—at an exaggerated 25% rate—the new payments would be about 0.3% of global GDP.[xlvii]

In recent earnings calls, many multinational firms doing business in China reported solid demand. This is true in consumer-oriented sectors as well as several Technology and Materials firms directly exposed to the new tariffs. Negative statements like Apple's reduced revenue estimates, which they pinned on weaker-than-expected Chinese sales, get all the attention.

Exhibit 20: Chinese Hard Landing Not Likely

Source: FactSet, Inc, y/y change in real Chinese GDP from March 1997 to September 2018. Based on quarterly data points.

xlvi *Source: IMF, as of 07/10/2018. Estimate comes from the October 2018 World Economic Outlook.*
xlvii *Ibid.*

The Answer Lies in the Shadow…

Chinese private sector demand did weaken last year. But we don't think the "trade war" is to blame. Rather, we believe the weakness stems from the government's efforts to rein in shadow banking.

"Shadow banking" refers to borrowing and lending outside the traditional banking system. All nations have shadow banking systems to fill the gaps in mainstream banking systems. China's is larger than most because strict official loan quotas govern the traditional, state-run banks which lend predominantly to large state-run firms. This forces many small and midsized private firms to borrow from shadow lenders.

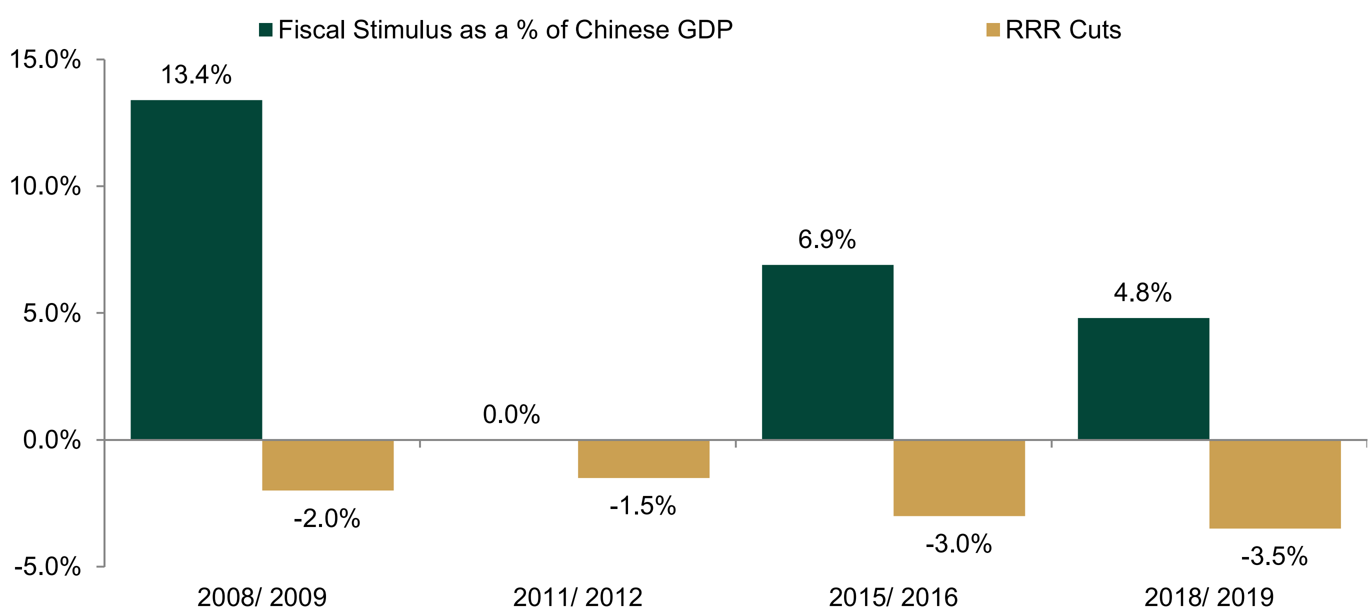
Shadow banking ballooned in China as the government encouraged fast growth in the service sector. Their goal was to shift from manufacturing and export-led growth to a consumption and services-based economy, and they seem to have been successful. But off-balance-sheet debt grew, creating worries about economic stability. Last year, Beijing prioritized unwinding much of the shadow banking space in hopes of moving that activity to the traditional banking system, where they could better monitor debt buildups.

Once private firms' shadow funding was cut off, traditional banks didn't fill the void. Instead, they lent mainly to big state-owned enterprises. They got capital they largely didn't need, while the private sector was starved. Private firms are China's main growth engine. When they couldn't get funding, it triggered a surprisingly sharp slowdown.

To soften the blow, regulators stepped in with stimulus and measures to funnel more credit to the private sector. One program subsidizes loans to small businesses. The central bank also cut reserve requirements several times to incentivize lending. These moves free significant capital to back bank loans. Officials also relaxed corporate bond issuance rules for companies with reasonably low debt and no defaults in the last three years. Fiscal stimulus included $200 billion in local government bond issuance and tax cuts aimed at small businesses and manufacturing (Exhibit 21).

These measures may be slower-acting than China's fiscal stimulus during prior slowdowns, which centered on infrastructure projects. They may not boost economic data right away. Yet as they kick in, private sector demand should recover, helping global trade rebound from its late-2018 pullback.

Exhibit 21: Scaling Chinese Stimulus



Source: FactSet, World Bank as of 02/01/2019. Chinese fiscal stimulus (defined as infrastructure and tax cuts) and reserve requirement ratio (the minimum amount of cash a bank holds in reserve as a percentage of liabilities), 2008 – 2019.

INDIA'S ELECTION BOOSTS UNCERTAINTY

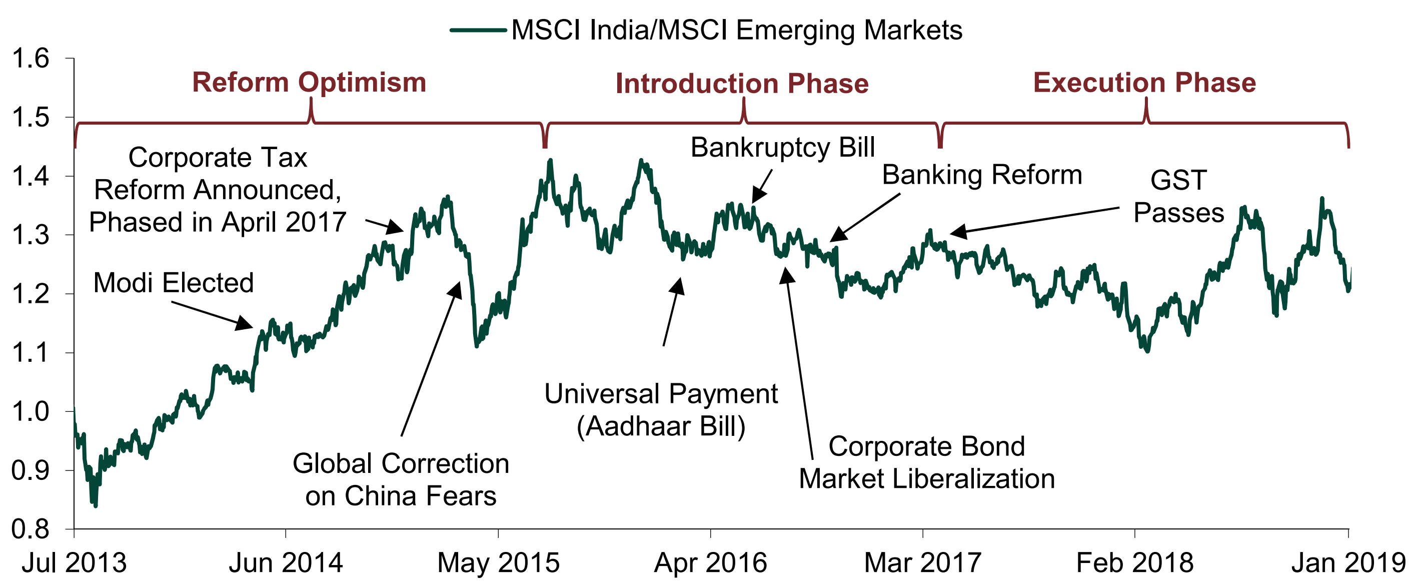
Indian equities held up well relative to Emerging Market peers in 2018, with the MSCI India falling -7.3% versus EM's -14.6% drop.[xlviii] However, we believe 2018's outperformance masks developing political uncertainty which we expect to hamper Indian equities in 2019's first half, if not longer. As India's general election—due by May—has drawn closer, Prime Minister Narendra Modi's Bharatiya Janata Party (BJP) has suffered several setbacks, leading many to think his re-election is much less likely than it was a year ago. In response, Prime Minister Modi has increasingly stepped away from reforms and adopted policies carrying economic risks in the name of winning votes. In our view, this is likely to weigh on Indian equities.

In 2016 and 2017 respectively, the government enacted a demonetization program and a goods and services tax (GST)—both landmark economic reforms. Demonetization replaced 86% of India's currency in circulation over two months in late 2016.[xlix] The stated aim was to force cash holders to declare their notes, moving India's large informal economy out of the shadows. The government estimated a third of circulating currency wouldn't be declared, presuming it ill-gotten "black money" which they could then cancel, dealing a blow to India's sprawling black market.

Although demonetization helped bring millions of previously unbanked Indian citizens into the banking system, implementation was messy. The move acted like a brief monetary shock, shrinking money supply rapidly. Currency shortages squeezed liquidity which created widespread—albeit temporary—business interruptions without the currency to conduct commerce. Indians replaced 97% of notes—far more than the government anticipated—leaving many to wonder whether significant economic disruption caused by the program was worth it.[l] Prime Minister Modi's political capital fell as a result.

The government's second major economic reform—GST overhaul—occurred mid-2017 and has yielded mixed results thus far (Exhibit 22). The stated aim of GST reform was to simplify byzantine tax laws, reduce tax avoidance and raise compliance. A rocky rollout, still-cumbersome tax system and disappointing revenue impact has underwhelmed markets and voters. Small and medium-sized enterprises (SMEs) have borne the brunt of headaches, struggling with compliance costs, higher taxes and poorer sales. They were previously exempt from excise taxes and, under the GST, their effective tax rates rose to 18% from a range of 5% – 12.5% under the prior value-added-tax regime.[li]

Exhibit 22: India's Reform Optimism Fading



Source: FactSet as of 01/31/2019. MSCI India & MSCI Emerging Markets total return level.

xlviii Source: FactSet, as of 01/14/2019. MSCI India and MSCI EM returns with net dividends, in USD, 12/31/2017 – 12/31/2018.
xlix "India's Bold Experiment With Cash," Martin Wolf, Financial Times, 02/21/2017.
l "India Said to Get 97% Banned Notes in Setback to Graft Crackdown," Siddhartha Singh and Bibhudatta Pradhan, Bloomberg, 01/04/2017.
li "A Year After GST, Small Businesses Report Huge Drop in Sales, Struggle With High Costs of Compliance," Alisha Sachdev, Hindustan Times, 07/04/2018.

These reforms were a net plus for markets, in our view, but poor implementation seems to be hitting the BJP at the ballot box. Prime Minister Modi's increasingly interventionist economic policy stance seems to underscore the changing polls. A year ago it appeared the BJP would cruise to victory, today it seems otherwise. In December's five state elections—representing 15% of Lok Sahba (lower house) seats—the BJP lost control of three state legislative assemblies to the opposition Congress Party. Now, the BJP faces falling poll numbers ahead of national elections this spring, raising the chances it loses—which increases uncertainty about future policy direction.

To combat this, Prime Minister Modi is seemingly putting political gain over economic reform. For example, he imposed price controls on medical devices to benefit manufacturers in his home state (Gujarat), implemented wide-ranging tariff hikes and backtracked on state-owned enterprise privatization. The most prominent heavy-handed tactic on display was Prime Minister Modi's squabble with the Reserve Bank of India (RBI)—India's central bank. Prime Minister Modi has sought greater control over the RBI for years, and members of the BJP clashed repeatedly with former RBI Governor Raghuram Rajan (appointed by Prime Minster Modi's predecessor, Manmohan Singh). Rajan resigned in 2016 after one three-year term—rare among RBI governors.

The RBI's fraught relations with the government grew more rancorous under Rajan's successor, Urjit Patel. Patel's main emphasis at the RBI was cleaning up Indian public sector banks' double-digit non-performing loans. Part of this took the form of severely restricting some new lending, mostly at the expense of loan availability to SMEs.

In October, to counter the RBI, the government sought to invoke Section 7 of the RBI Act—never used in the bank's 84-year history—empowering it to override central bank decisions. Although the government hasn't followed through on this threat, it remains a risk. Patel resigned on December 10, after mounting government criticism of the RBI unnecessarily restricting growth. He claimed his resignation was for "personal reasons," but we—and most observers, it seems—think it was much more a response to the government's pressure and threats.

Prime Minister Modi replaced Patel with Shaktikanta Das—a Finance Ministry bureaucrat who oversaw demonetization. Many believe he will implement Prime Minister Modi's preferred easy-lending policies, sparking renewed concerns over the RBI's independence. So far, there is no apparent sign those fears are accurate, but Emerging Markets have a long history of governmental meddling with monetary policy. Markets often frown on such concepts. We think India may prove the latest.

Prime Minister Modi is also tilting the playing field against foreign investors. India's trade ministry is implementing new e-commerce rules designed to shield local merchants—a key BJP voting bloc. After previously opening up to foreign competition, Prime Minster Modi is now implementing restrictions on foreigners' ability to compete with local firms. Current regulations prohibit foreign retailers from selling anything except food directly to consumers. However, they have worked around this by forming joint ventures with local businesses. Starting February 1, 2019, new rules will discourage this practice. Foreign companies must allow any local firm to buy inventory from them on the same terms as their joint ventures. This will bar foreign online retailers from offering exclusive products or discounts through their Indian affiliates. For example, Amazon's Indian storefront Cloudtail offers Alexa-enabled smart speakers at discounted prices.[lii] Under the new regulation, local Indian retailers will be able to buy them wholesale from Amazon, potentially matching prices Cloudtail receives. Effectively, foreign firms operating in India won't be able to compete on merchandise selection or price. This may help shore up support for the government, but in our view it is a headwind for markets.

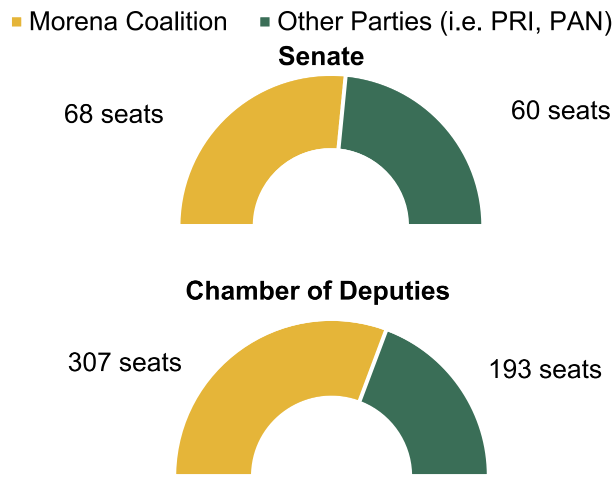
Meanwhile, government largesse is extending to farm aid ahead of elections. In another bid to boost voter support, the government is reportedly working on a farm-relief bill involving cash handouts to as many as 150 million households. Estimated costs run to a few trillion rupees. With revenue projections from the newly-installed GST 1 trillion rupees short of its 2018 – 2019 fiscal year target, rising deficits undermine confidence in the government's fiscal discipline. On its own, this isn't too significant. But when combined with the aforementioned policy intervention, it appears to be part of a broad trend of subjugating economics to perceived political need. That is a dangerous track. A key positive for India over the last few years has been Prime Minister Modi's apparent willingness to reform. Signs this isn't the case any longer stir uncertainty and could disappoint investors.

lii "Amazon Slashes the Price of Its Echo Smart Speakers in India Again," Shweta Ganjoo, India Today, 08/14/2018.

AMLO's Early Days

When leftist candidate Andrés Manuel López Obrador (also known as "AMLO") won Mexico's presidential election in July, worries abounded of ballooning budgets, nationalizations and the reversal of his predecessor's market-friendly reforms. Moreover, his MORENA party holds a legislative majority (Exhibit 23), seemingly giving him latitude to push through big changes. In our view, however, these fears are overwrought. Thus far, AMLO has shown signs of moderating—and some of the policies his administration has announced so far may even be beneficial.

Exhibit 23: Morena Holds Legislative Majority



Source: Source: Instituto Nacional Electoral as of July 2nd, 2018. Based on 92% of votes counted.

Some of his early executive actions raised eyebrows. Perhaps the biggest: In November, shortly before AMLO took office, bank equities sold off on news the country's antitrust agency, Cofece, asked the Senate to review AMLO's proposal mandating the elimination of select bank fees—such as ATM and transfer fees. Many considered removal of these fees a major negative for Mexican banks' profits, heralding an interventionist, populist economic policy stance. However, the government quickly reversed course after markets reacted with sharp negativity.

On the campaign trail, AMLO railed against the construction of a new Mexico City airport as an example of corruption. Proponents argued it was a much-needed infrastructure improvement—scrapping it would squander large investments already made while spooking investors about the government's willingness to follow through on contracts. In October, the government conducted a hasty referendum on whether to continue building the new airport or renovate an existing one instead. A mere 1.2% of registered voters participated, and when over two thirds of them voted in favor of renovation, AMLO cancelled construction of the new airport.. This sparked concerns of arbitrary policymaking—particularly after a subsequent batch of referendums seemingly suggested this was one of the new government's preferred reform tools. In our view, they seem more like an eye-catching way to show AMLO's responsiveness to voters than the dawn of a new era of radical change.

AMLO's proposals thus far don't reflect a huge leftward shift. During the campaign, his apparent protectionist leanings stirred worries he would torpedo then-ongoing NAFTA negotiations, potentially hampering North American trade. Post-victory, however, AMLO's incoming administration worked with the prior government to finalize the USMCA (NAFTA's replacement). His initial 2019 budget isn't spendthrift—it targets a 1% of GDP surplus. In early January, his administration proposed a range of benign financial reforms, including tax credits that eliminate withholding taxes on foreigners' purchases of Mexican peso-denominated corporate debt, allowing more entities to engage in interbank repurchase agreements and securities lending (including the state pension managers), and a tax cut (from 35% to 10%) on funds companies raise in IPOs.[liii] Even some of the maligned referendums may prove slight economic positives, in our view. One upgrades a state-owned oil refinery, potentially allowing it to process heavier (and more profitable) types of oil; another authorizes a rail line that could boost tourism.

liii "Mexico launches major initiative to boost financial sector," James Young, BNAmericas, 01/09/2019.

Most importantly, there has been no sign of nationalizations or an economic reform rollback to date. Key among these is a 2014 constitutional amendment allowing foreign competition in Mexico's state-dominated energy industry. Despite opposing the amendment for years, AMLO has backed off talk of canceling contracts with foreign energy firms—a classic case of post-election moderation. As concerns of radical, economy-stifling change fade, Mexican equities likely benefit.

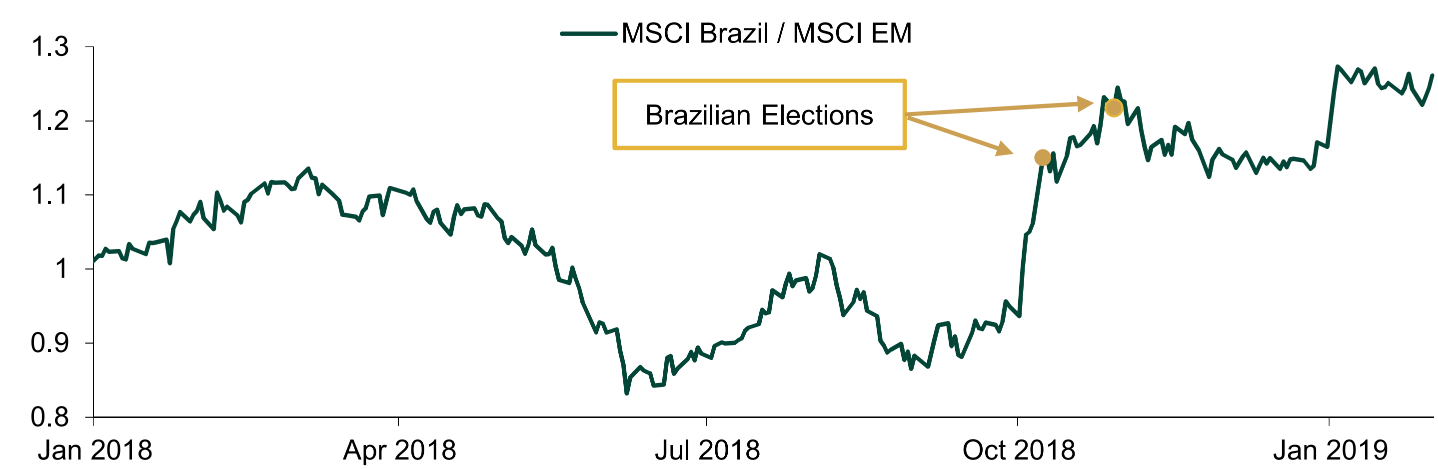
Perhaps the biggest move to date is an ongoing crackdown on rampant fuel theft, which drains state oil company Pemex's revenues and funds criminal organizations. Since thieves usually tap vulnerable fuel transport pipelines, AMLO ordered many shut down in favor of transporting gas via tanker trucks. An initial shortage of trucks delayed deliveries, leading to long lines at gas stations and worries of broader economic trouble. Despite the crackdown's visible disruptions, its impact is likely minor and fleeting. As more Pemex-owned trucks become available, gas sellers find alternative carriers (like private truckers, cargo trains and ships) and pipelines gradually reopen, the pain should lessen. Longer term, reducing fuel theft and combatting corruption would be positives. We see few acknowledging this possibility presently, supporting our view that Mexico's outlook is brighter than most appreciate.

Bolsonaro Takes the Reins in Brazil

New Brazilian president Jair Bolsonaro took office in January touting an array of economic reforms—including a corruption crackdown, privatizations, an overhaul of the country's bloated pension system, lighter regulation, fewer barriers to trade and lower spending. While hopes for transformative change could prove too sunny, Brazilian equities may still ride those hopes higher in the near term—particularly given the administration's apparent resolve. Moreover, we believe rising commodity prices and a more stable political climate after years of scandal represent underappreciated tailwinds for Brazil (Exhibit 24).

Like AMLO, President Bolsonaro initially seemed inclined to moderate. Late in the campaign, he soft-pedaled earlier plans to privatize Eletrobras & Petrobras, the two state-run giants. Post-election, administration officials had to walk back statements suggesting he favored watered-down pension and tax changes. Nonetheless, there is evidence his administration is positioning for a major policy push. For example, his cabinet appears stocked with serious reformists. Justice Minister Sergio Moro, a former federal judge who oversaw the Operation Car Wash trials, is considered an anticorruption hawk. Free-market economist Paulo Guedes, who crafted Bolsonaro's economic policy agenda, heads up a powerful new department comprised of the Finance, Labor, Planning, Commerce and Industry Ministries.

Exhibit 24: Pre-Election Optimism Follows President Bolsonaro into Office



Source: FactSet as of 01/31/2019. Based on MSCI Brazil, and MSCI Emerging Markets index price returns in USD. Indexed to 1 on 12/31/2017.

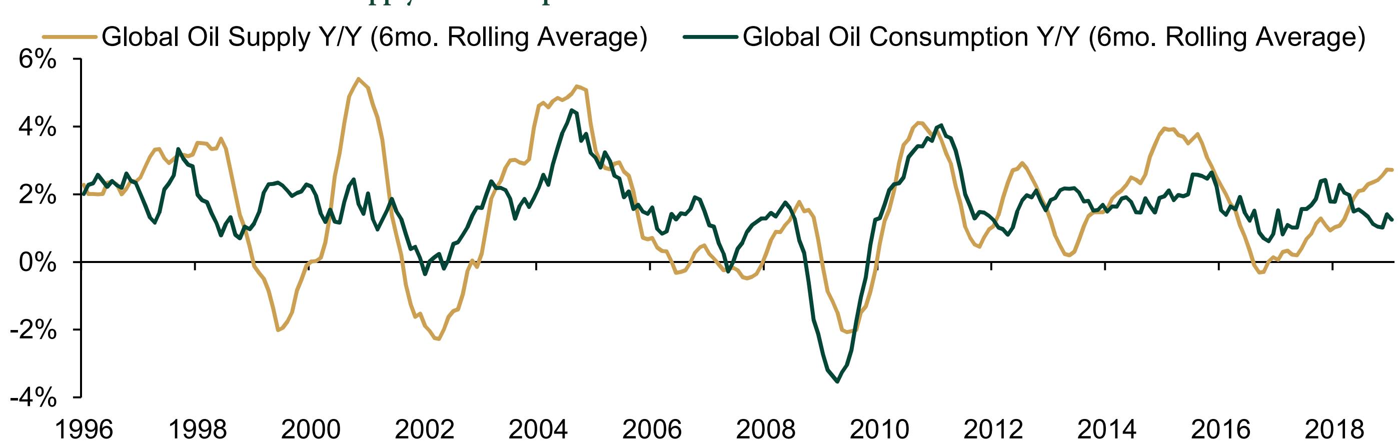
In recent speeches and interviews, Guedes and President Bolsonaro have reaffirmed the government's commitment to bold changes. In a January 23 Bloomberg interview, Guedes mooted plans to eliminate the country's budget deficit (7% of GDP) through pension cuts and privatizations.[liv] He has also suggested slashing corporate taxes to 15% from 34%. For his part, President Bolsonaro has noted his desire to make it easier to do business in Brazil by simplifying taxes, reducing regulatory compliance costs and further opening the economy to international trade. To that end, he advocated modernizing the Mercosur trade bloc and permitting member countries to forge trade deals outside it.

Pushing major bills through Brazil's Congress—home to 30 parties—may be difficult. President Bolsonaro's Social Liberal Party is the second largest in the Chamber of Deputies (Brazil's lower house), but it holds just 52 of 513 seats. While the jury is out on how much President Bolsonaro's administration will achieve, investor optimism surrounding his presidency might buoy Brazilian equities in the near term. This "honeymoon effect" could persist until reforms appear too tentative or ineffective. If the government seems to make meaningful progress on pension reform or privatization, it might last longer. This played out in India following Prime Minister Narendra Modi's election in May 2014. Anticipating a beneficial reform push, investors bid up India's equities relative to Emerging Markets in the months surrounding his election. India's outperformance persisted until early 2016's global equity correction and aftermath, when a messy demonetization and sloppy tax reform hurt sentiment. A similar honeymoon rally followed Enrique Peña Nieto's 2012 win in Mexico, bolstered by hopes for reform, culminating in Energy and Finance industry liberalizations.

Overall, we believe there is ample room for political uncertainty to fall in Brazil, benefiting equities. Brazilian politics have been chaotic for years. The Car Wash scandal took center stage in 2014, eventually ensnaring dozens of politicians and businessmen—among them former Presidents Luiz Inácio Lula da Silva and his successor, Dilma Rousseff. Lula is currently serving a 12-year prison sentence, while Rousseff was impeached in August 2016 on charges of manipulating budget figures. Her unelected successor, Michel Temer, also battled corruption allegations while sporting single-digit approval ratings during much of his term. After years of seemingly nonstop scandal and political upheaval, the bar is low for Bolsonaro's presidency to prove more stable.

Lastly, Brazil's commodity-heavy economy may get a boost from higher commodity prices. Global oil supply and demand appear roughly balanced as seen in Exhibit 25, with the long-running supply overhang largely diminished. To us, this suggests Q4 2018's oil price decline was primarily sentiment-driven, meaning early 2019's rebound probably isn't just a flash in the pan. We think Brazil stands to gain as a result.

Exhibit 25: Balanced Global Oil Supply & Consumption



Source: FactSet as of 01/31/2019.

liv *"Bolsonaro Says Brazil Must Reform or Become Next Venezuela," Raymond Colitt and Eric Martin, Bloomberg, 01/23/2019.*

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

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