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INSTITUTIONAL GROUP

FIRST QUARTER 2019

MARKET PERSPECTIVES

**FIRST QUARTER 2019 REVIEW AND OUTLOOK
MARKET PERSPECTIVES**

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

FIRST QUARTER 2019 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:** Following equities’ steep Q1 ascent, we expect equities to keep climbing, though the pace likely slows in the year’s second half.
- **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.

Global equities are up 16.9% since the December 25 low and 12.2% in Q1.ⁱ The MSCI All Country World Index has enjoyed the V-shaped recovery we expected following the sharp sell-off in December.ⁱⁱ Overall, this should be only the beginning of a great year for global markets.

We expect equities to keep climbing, though the pace likely will be more gradual in the year’s second half. The third year of a US president’s term is far stronger and more consistently positive than years one and two. It is also usually front-end loaded. We think the early expansion comes as markets celebrate reduced legislative risk post-midterms. This becomes more widely known later in the year, while political uncertainty starts drifting higher as election year campaigning heats up. Equities should still do well, but with more volatility than we have seen thus far.

While it is premature to assess 2020 market drivers, US election years are usually good for equities, too. Although, unlike third years, fourth years tend to be back-end loaded. Election uncertainty weighs early. However as primaries narrow the field of political candidates, conventions pass and nominees are selected, equity returns typically improve with falling uncertainty.

Global economic fundamentals are far better than appreciated. While the media was highly focused on weak manufacturing surveys and the US yield curve’s slight inversion in late March, we believe the extensive coverage is a bullish sign. Media attention weakens the negative surprise power as speculation of a potential inversion occurred months before. Markets are efficient and quickly price in broad based fears. Rather than being dangerous, the inverted yield curve sets expectations low, extending the wall of worry. The real time to worry about an inverted yield curve is when no one else does, raising the risk of negative surprise.

We believe what really matters is the global yield curve. Today a big multinational bank can easily borrow very cheaply in most of Europe and Japan, hedge for currency risk and lend profitably in the US. Globalization and interest rate arbitrage render any one country’s yield curve largely meaningless—even a country as big as the United States. The difference between a slightly inverted US curve and the preceding months’ slightly positive curve is a distinction without meaning. Despite the recently flat curve, US loan growth still rose — demonstrating that interest rate arbitrage is still in action. Further, as the yield curve’s return to positive territory on March 29 shows, shallow inversions can reverse fast.ⁱⁱⁱ

ⁱ Source: FactSet, as of 04/01/2019. MSCI All Country World Index returns with net dividends, 12/25/2018 – 03/31/2019 and 12/31/2018 – 03/31/2019.

ⁱⁱ Source: FactSet, as of 04/01/2019. MSCI All Country World Index returns with net dividends, 12/25/2018 – 03/31/2019.

ⁱⁱⁱ Source: FactSet, as of 04/01/2019. US 10-year Treasury yield minus 3-month Treasury yield on 03/29/2019.

Widespread manufacturing worries are similarly bullish. The concerns center on surveys called purchasing managers' indexes (PMIs), which loosely measure the percentage of businesses growing in a given country. They showed eurozone manufacturing contraction in March, with Germany especially weak. Yet manufacturing is just 25% of eurozone GDP and 23.1% of Germany.^{iv} Services are much larger (73.0% in the eurozone and 68.2% in Germany) and they are nicely positive.^v Meanwhile, most evidence suggests manufacturing's worries should soon fade. For one, EU auto emissions rules' impact looks to be diminishing. Additionally, Chinese stimulus taking effect should boost private sector demand for European exports. Other indicators also point positively, including US and eurozone Leading Economic Indexes—high and rising, inconsistent with a looming recession.

Emerging Markets (EM) equities were also up sharply in Q1 2019 and currently are 13.3% higher than the recent low on October 29.^{vi} Following Q4's global volatility, many remain skeptical of the rally's staying power. However in our view, similar to developed equities, this year's sharp early jump is likely the V-shaped beginning to a longer, if more gradual, ascent.

Chinese government stimulus is starting to take its effect in lending and manufacturing PMI data.^{vii} Meanwhile, following elections in Thailand and Brazil, both countries' purchasing managers' indexes are showing expansion, suggesting both economies are weathering the political drama well enough. South Africa has faced challenges with political uncertainty and the insolvency of Eskom, South Africa's state-owned power giant leading to widespread blackouts. We continue to monitor tensions between India and Pakistan following a terrorist attack in the Indian-controlled portion of Kashmir by Pakistani militants on February 14. With India's upcoming elections, it is likely that campaign rhetoric will be high, but we don't believe that the dispute will escalate. In our view, headwinds in some EMs don't negate more powerful positives—like steady global growth and a potential nascent recovery in Chinese demand. As economic fundamentals remain sound overall and political turmoil limited to a select few countries, we believe EM equities should continue to move higher in 2019.

Overall, we expect the 10-year-old bull to resume its climb. Bull markets do not die of old age, instead they die when they finish climbing the wall of worry and euphoric investors ignore weakness—or when some huge unexpected wallop knocks trillions off global GDP. Euphoria is absent today. Instead, a surprising amount of skepticism persists despite global equities being just 5.3% below all-time highs as December's volatility weighs on sentiment.^{viii} Investors overemphasize small negatives and ignore good news. They seek wallops in China, Brexit and tariffs, not fathoming that all are too small, misunderstood or unlikely to unfold disastrously. In our view, many of the current market concerns are widely reported, limiting their surprise power. Rather than looming disasters, we believe many of these concerns represent opportunities as uncertainty diminishes.

^{iv} Source: Eurostat and DeStatis, as of 03/26/2019.

^v Ibid.

^{vi} Source: FactSet, as of 04/02/2019. MSCI Emerging Markets Index return with net dividends in USD, 10/29/2018 – 03/31/2019.

^{vii} Source: FactSet, as of 04/01/2019.

^{viii} Source: FactSet, as of 04/01/2019. MSCI All Country World Index return with net dividends, 01/26/2018 – 03/31/2019.

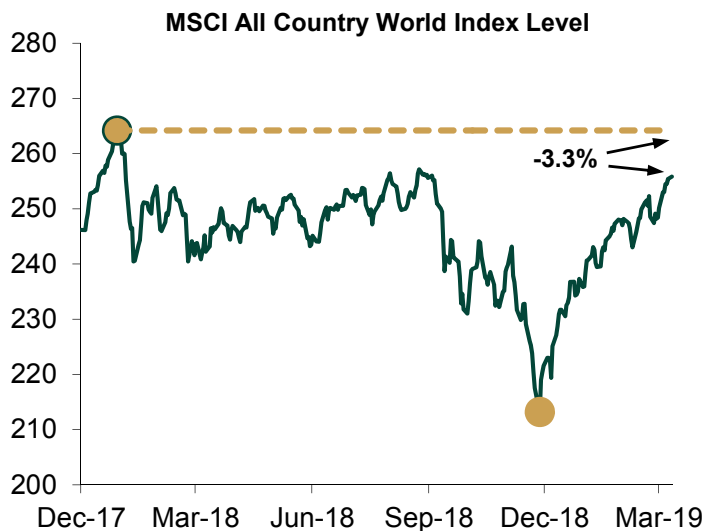
GLOBAL UPDATE AND MARKET OUTLOOK

Q1 RECAP

THE V-SHAPED REBOUND AND BEYOND

As mentioned earlier, global equity markets rose in Q1, driven by the “V”-shaped rebound we expected following Q4 2018’s steep correction. Gains continued in early April, bring equities up from their December low and just -3.3% below all-time highs.^{ix} In just over three short months, equities reversed steep negativity many professionals warned would spiral into a bear market—a typical recovery (Exhibit 1).

Exhibit 1: The V-Bounce Erased Most of Last Year’s Decline



Source: FactSet, as of 04/09/2019. MSCI All Country World Index with net dividends, 12/31/2017 – 04/08/2019.

Following this swift rebound, we expect gains to continue, albeit at a slower pace. The renewed investor skepticism—amplified by Q4’s decline—is fueling rising equity markets. Coupled with brighter-than-appreciated economic fundamentals and bullish political drivers, we believe our sentiment is expected to set up a positive surprise.

Categories which declined the most in Q4 (Energy and Technology) rebounded strongest in Q1, largely erasing Q4’s underperformance.^x Short swings and corrections tend to recover quickly—it is near impossible to perfectly time markets’ eventual rebound. Overall, equities should keep climbing this year, but likely with volatility.

THE TRUTH ABOUT SLOWER GLOBAL GROWTH AND EQUITIES

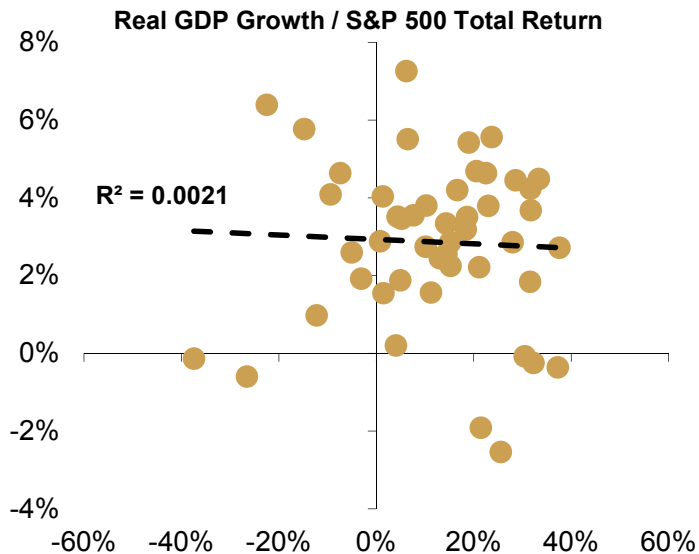
With manufacturing surveys and other indicators softening, many investors are worried about slower growth. The consensus seems to assume that without faster expansion equities will slow down, ultimately ending this bull market. Yet slower economic growth should be a fine backdrop for equities. Equities have done well throughout this bull market, despite not seeing consistent rapid growth. Markets do not move in tandem with GDP. Rather, equities focus on one aspect of GDP—the private sector—and how its future profitability aligns with expectations. Slow growth expectations dampen sentiment, raising the potential of positive surprise.

^{ix} Source: FactSet, as of 04/01/2019. MSCI All Country World Index return with net dividends, 12/31/2018 – 03/31/2019, 12/25/2018 – 04/08/2019 and 01/26/2018 – 04/08/2019.

^x Source: FactSet, as of 04/11/2019. MSCI World, MSCI World Information Technology sector and MSCI World Energy sector returns with net dividends, 09/30/2018 – 12/31/2018 and 12/31/2018 – 03/31/2019.

As Exhibit 2 shows, there is virtually no statistical relationship between a given year's GDP growth and equity returns. The scatterplot's R-squared—which measures how much one variable's movement influences another's—rounds to zero.

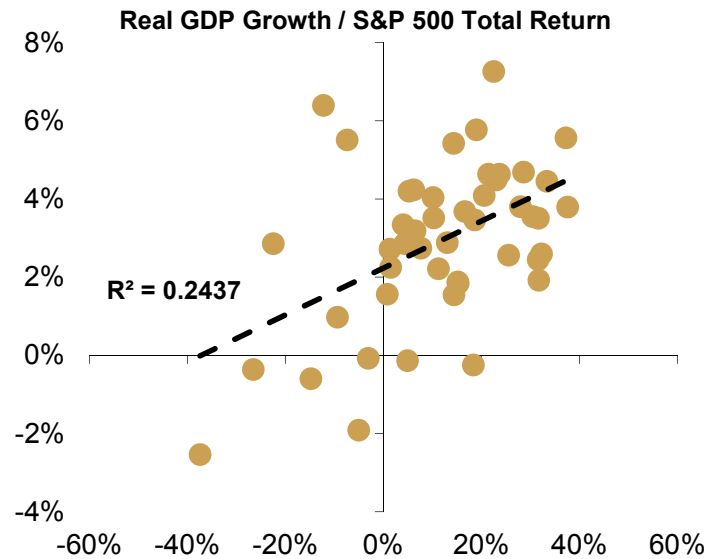
Exhibit 2: Equities and GDP Don't Move in Tandem...



Source: Global Financial Data, Inc. and FactSet, as of 03/22/2019. Annual real GDP percentage change and S&P 500 total return, 1970 – 2018. Each dot represents a single year's equity returns and GDP growth.

There is, however, a positive relationship between one year's equity returns and the following year's GDP growth, as Exhibit 3 shows, but that is not useful for equity forecasting. Rather, it shows equities move ahead of the economy, as we would expect. Hence, they have likely already priced economic slowdown fears.

Exhibit 3: ...but Equities Do Predict GDP



Source: Global Financial Data, Inc. and FactSet, as of 03/22/2019. Annual real GDP percentage change and S&P 500 total return, 1970 – 2018. Each dot represents one year's equity returns and the following year's GDP growth.

FALSE FEARS: INDUSTRIAL RECESSION

Global growth fears center on manufacturing—particularly, purchasing managers' index (PMI) surveys. These report the percentage of businesses growing in a given month, with readings over 50 indicating economic expansion. As such, they measure the breadth of growth, not its magnitude or growth rate. PMIs showed manufacturing in Europe and Japan weakening throughout Q1, with several nations contracting. Germany, widely considered Europe's economic and industrial powerhouse, was notably weak. As more data rolled in, falling exports and factory orders seemed to confirm the worst fears.

Factories throughout Europe and Japan are meaningfully impacted by weaker private sector demand in China, and thus, we expect a stronger recovery to emerge as Chinese stimulus begins to take effect. However, the recovery will take time to manifest in stronger demand for European and Japanese products. Yet for the global economy—and equities—tepid manufacturing lacks power to impact markets because it is widely covered and, hence, likely reflected in equity values. Further, the economies of Europe and Japan are predominantly services-based similar to the US economy. Focusing only on manufacturing ignores the vast majority of developed-world output. Similarly in China, services represent the majority of GDP.

WHAT TO WATCH INSTEAD OF MANUFACTURING

Other economic indicators point positively, including The Conference Board's Leading Economic Indexes (LEIs) for the US and eurozone. The US LEI has the longest published history, dating to 1959. Since then, no recession has begun while LEI was in an uptrend. LEIs usually fall for several months before recession begins. High and rising LEIs in the US and eurozone suggest recession isn't imminent.

LEIs—while very good indicators—underrate the impact of services, which is a common problem in economic data. Equities, the best leading indicator in the world, also suggest growth will be decent. Efficient markets have already priced in weak PMIs, in our view. If Europe's economy were as weak as feared, European equities should be dramatically trailing US equities. Overall, the data suggests Europe's outlook isn't bad.

Chinese government stimulus is starting to take its effect in lending and manufacturing PMI data as well. The actions of the Chinese government indicate that the slowdown that some fear is priced into markets. Yet people still have little faith in a turnaround. Most presume the stimulus isn't working because they don't see immediate improvement in monthly output data. However, monetary and fiscal stimulus usually works at a bit of a lag.

THE LONGEST BULL MARKET IN HISTORY

This bull market, now history's longest, turned 10 years old in early March. The economic expansion will similarly turn 10 years old in June, matching the 1990s for the US's longest expansion. The length of this bull market has caused some investors to wonder if the bull's days are numbered. Overall, we expect the 10-year-old bull to resume its climb. Bull markets do not die of old age, instead they die when they finish climbing the wall of worry and euphoric investors ignore weakness—or when some huge unexpected wallop knocks trillions off global GDP.



US COMMENTARY

OUR VIEW ON THE US YIELD CURVE INVERSION

In Q1's final week, the inversion of the US 10-year minus the 3-month Treasury yield curve dominated headlines. Based on our forecast for flat to slightly lower long-term interest rates, we anticipated a flattening yield curve—and possible inversion—this year. Yet the media sees this inversion as a potential bear market sign. We think there are big reasons to see it as the opposite: a sign more bull market awaits.

Inverted yield curves indicate that bank lending may be unprofitable. Historically, yield curve inversions have been fair indicators of troubled credit markets. Inversion preceded each of the last seven US recessions.^{xi} However, we do not believe it is a timing tool. Inversion's impact hits the real economy at a lag, as Exhibit 4 shows.

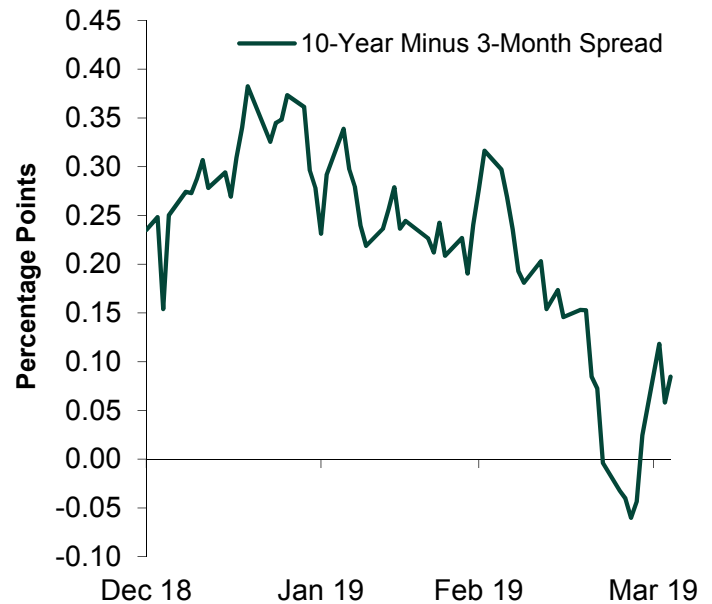
Exhibit 4: Exhibit 4: Yield Curve Inversion Isn't a Timing Tool

S&P 500 Bear Market			
Start Date	End Date	S&P 500 Bear	US Recession
8/2/1956	10/22/1957	-7	6
12/12/1961	6/26/1962	No Inversion*	No Inversion*
2/9/1966	10/7/1966	1	No Recession
11/29/1968	5/26/1970	-1	13
1/11/1973	10/3/1974	-5	6
11/28/1980	8/12/1982	25	15
8/25/1987	12/4/1987	No Inversion	No Recession
7/16/1990	10/11/1990	16	16
3/24/2000	10/9/2002	19	31
10/9/2007	3/9/2009	21	24
Average		9	16
Median		9	15

Source: Global Financial Data, Inc. and FactSet, as of 03/26/2019. *The yield curve nearly inverted on 01/06/1960 (23 months before the bear began), hitting 0.03 percentage point.

Further, March's inversion was a shallow -0.06 percentage point at its deepest.^{xii} The difference between a slightly positive yield curve and an inversion this small is immaterial. Banks may base loan pricing on government yields, but they don't match them—they add a premium, which could easily mean positive spreads. In our view, this is why lending rose despite the flat yield curve in the months before March's inversion. Further, yield curve inversion must persist to cause problems and March's inversion quickly reverted (Exhibit 5).

Exhibit 5: The Yield Curve's Shallow Q1 Inversion



Source: FactSet, as of 04/09/2019. US 10-year Treasury yield minus 3-month Treasury yield, 12/31/2018 – 04/08/2019.

The US yield curve inversion was widely reported as the media fearfully anticipated the yield curve inverting for months. This situation was similar to a relatively meaningless inversion of the 5-year minus 2-year curve in early December. This extensive media coverage means equities likely priced the inversion into markets—limiting its potential surprise power.

While the media focused on the US yield curve, the global yield curve is still positively sloped – validating that interest rate arbitrage opportunities are available. The time to worry about an inverted yield curve, in our view, is when it is sustained and global—and when most investors are convinced it is not a threat.

^{xi} Source: Global Financial Data and FactSet, as of 04/02/2019.

^{xii} Source: FactSet, as of 4/9/2019. US 10-year Treasury yield minus US 3-month Treasury yield, 03/22/2019 – 04/08/2019.

THINK GLOBALLY WHEN CONSIDERING IMPLICATIONS OF US YIELD INVERSION

Major banks can obtain funding from anywhere in the developed world, borrowing at overnight rates abroad, hedging for currency risk and lending to American households and businesses. Presently, the US 3-month yield is the developed world's highest. Rates are negative in the eurozone, Sweden, Switzerland and Japan. British short-term yields, while above zero, are far below the US (Exhibit 6). These negative global rates are all cheap funding sources for US banks.

This global interest rate arbitrage opportunity is largely ignored by investors which is a strong bullish reality...

The US 10-year Treasury yield is second only to Italy's presently—and only barely below it. Banks borrowing cheaply abroad and lending profitably to US borrowers should keep credit flowing, fueling growth. This global interest rate arbitrage opportunity is largely ignored by investors which is a strong bullish reality considering the recession fears of the inverted yield curve is priced in.

Exhibit 6: Cheap Funding Globally Can Fuel Profitable US Lending

3-Month Government Bond Yields		10 Year Government Bond Yields	
Country	Yield	Country	Yield
United States	2.40%	Italy	2.49%
Singapore	1.87%	United States	2.41%
New Zealand	1.85%	Singapore	2.07%
Australia	1.77%	New Zealand	1.81%
Canada	1.66%	Israel	1.80%
Hong Kong	1.27%	Australia	1.77%
Norway	1.09%	Canada	1.65%
United Kingdom	0.75%	Norway	1.61%
Israel	0.30%	Hong Kong	1.41%
Japan	-0.18%	Portugal	1.25%
Italy	-0.21%	Spain	1.09%
Portugal	-0.36%	United Kingdom	1.00%
Sweden	-0.40%	Ireland	0.55%
Spain	-0.49%	Belgium	0.42%
France	-0.51%	France	0.32%
Germany	-0.53%	Finland	0.27%
Austria	-0.57%	Austria	0.23%
Finland	-0.60%	Sweden	0.17%
Ireland	-0.73%	Netherlands	0.03%
Switzerland	-0.85%	Denmark	-0.01%
Belgium	-0.85%	Germany	-0.07%
Denmark	-0.85%	Japan	-0.09%
Netherlands	-0.91%	Switzerland	-0.38%

Source: FactSet, as of 04/18/2019. Respective 3-month and 10-year sovereign yield for all MSCI World constituent nations on 03/29/2019. US yields are constant maturity rates.

US POLITICAL GRIDLOCK IS A MARKET POSITIVE

With Q2 underway, we are in the middle of the US presidential cycle's third year. As Exhibit 7 shows, year three is the presidential term's most consistently positive—with the highest average return. It has been negative just twice—the last in 1939, World War II's outbreak in Europe.

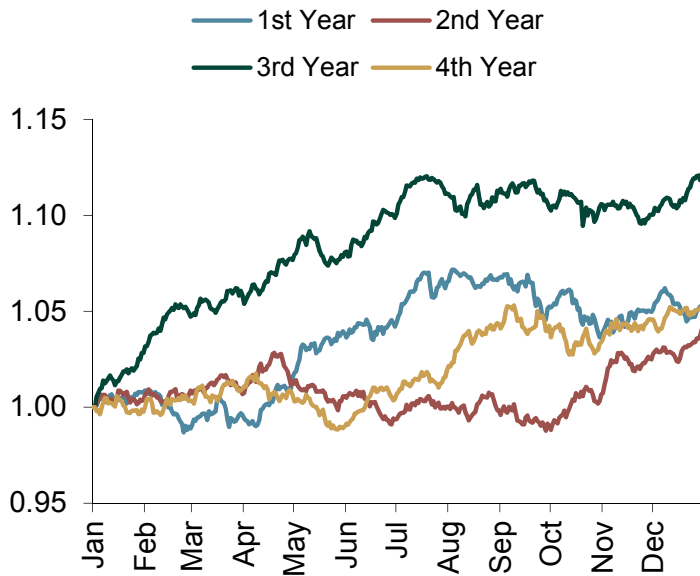
Exhibit 7: The Presidential Term Anomaly

S&P 500 Total Returns by Presidential Year, 1925 - 2018								
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%
Roosevelt -- 1st	1933	52.9%	1934	-2.3%	1935	47.2%	1936	32.8%
Roosevelt -- 2nd	1937	-35.3%	1938	33.2%	1939	-0.9%	1940	-10.1%
Roosevelt -- 3rd	1941	-11.8%	1942	21.1%	1943	25.8%	1944	19.7%
Roosevelt / 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	-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, Inc. and FactSet, as of 01/14/2019. S&P 500 Index annual total returns, 1925 – 2018.

Additionally, as Exhibit 8 and 9 shows, the average returns in the third presidential year are typically front-end loaded.

Exhibit 8: Average Returns in the Presidential Cycle



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

Exhibit 9: Average Returns in Years Three and Four



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

In our view, the driving force behind strong early-year returns is investors' gradually appreciating US midterm-driven gridlock. Similar to last November, midterms usually increase gridlock, reducing legislative risk. The surprise of legislative calm after a campaign is a relief for equities. As the markets gradually appreciate political gridlock in the ensuing months, equities typically deliver big returns—as in Q1.

In an average third year, this tailwind wanes in the second half, slowing gains. Averages aren't predictive, of course. They are made up of extremes. But if returns slow, remember: This is typical—nothing to fear. The same holds if a slow patch extends to year four. Election years are also more consistently positive than years one and two, with above-average returns. But they tend to start slowly, as building election noise stokes uncertainty. Returns typically improve late, as a narrowing field gives markets more clarity about the outcome and likely policy direction.

TOO EARLY TO PREDICT THE 2020 US PRESIDENTIAL ELECTION

Politics are just one market driver, and we think it is too early to forecast returns in 2020 and beyond. Yet the stage seems set for a typical fourth year. Uncertainty from the crowded field of Democratic candidates is growing. When over a dozen candidates from either party try to outdo each other with extreme campaign pledges, it can create uncertainty for equities as the primaries approach—a headwind early in the election year. However as primaries begin the presidential candidates should start to narrow. By mid-summer, nominees will have been selected and uncertainty starts to fall, boosting returns. While negative election years have happened, four times since 1925, we currently do not see drivers for this.

As a result, we think it is far too early to start speculating on the campaign. The impact of the 2020 election on the market will not be taking effect for a long while. Media coverage will be extensive, publicizing every poll, debate and town hall. However it is way too soon for the Democratic field to narrow, enabling equities to start pricing the outcome.



GLOBAL DEVELOPED EX-US COMMENTARY

EUROPE TAKES THE STAGE

The European Parliament, which holds elections in May, has a fixed five-year cycle and shows a trend of boosting equities as election uncertainty falls. European equity returns typically slow before the election and accelerate afterward. 2014 was the only time equities were negative in the 6 and 12 months after the contest (Exhibit 10). We believe the European Central Bank's instituting its negative interest rate policy weeks after the election, with quantitative easing following shortly thereafter, explains the outlier.

Exhibit 10: MSCI Europe Ex. UK Returns Pre & Post Election

European Parliament Election Date	Months Prior to Vote	Six Months Post-Vote	12 Months Post-Vote
June 10, 1979	(0.9%)	5.8%	6.2%
June 14, 1984	(1.4%)	(3.8%)	20.5%
June 15, 1989	4.2%	24.6%	32.3%
June 09, 1994	(0.1%)	3.1%	16.6%
June 13, 1999	(5.2%)	22.3%	22.2%
June 13, 2004	1.2%	17.8%	14.3%
June 07, 2009	13.9%	22.1%	(0.6%)
May 22, 2014	6.3%	(7.6%)	(7.0%)
May 27, 2019	??	??	??
Average	2.3%	10.5%	13.1%
Median	0.6%	11.8%	15.5%
% Positive	50%	75%	75%

Source: FactSet, as of 03/19/2019. MSCI Europe Ex. UK Index return with net dividends. "% positive" is the frequency of positive returns for the periods depicted.

POLITICAL FEAR IN EUROPE HIDES BULLISH REALITY

The potential for strong returns and falling uncertainty is difficult to see. Fear of populist and anti-EU politicians abound, with many worried about surging populists in the European Parliament. Similar fears surround Finland, Denmark and Spain. However, populists' rise in recent years has bullishly put most of Europe into gridlock.

This is easy to see if you envision the political spectrum as a bell curve. Historically, parliaments in western developed nations had a majority towards the center-left and center-right, with a small minority in the fringe parties. Most governments were either grand centrist coalitions or center-left or center-right unions with relative ideological alignment.

The rise in populist parties changed this structure. These parties carved support away from centrist parties, flattening the bell curve. As the middle loses its power, Europe gets more fractured coalitions that cannot agree on issues. For example, in Italy, the center of populist fears, its "populist" government is a tenuous coalition between the far right and leftists. They agree on little and have accomplished even less, defying fears of instant radical change when they took office last summer. Sweden is another recent example; it went 133 days without a government after last September's election.^{xiii} The stalemate broke only when the center-left prime minister formed a minority coalition with other left-leaning and center-right groups. Even then, they lacked a majority, assuming power only when the former communist party abstained from objecting.

The Spanish election in April occurred because a minority center-left government couldn't get Catalan separatists to support a budget. Britain's minority government can't agree on Brexit and France is engaged with the "Yellow Vests" protests. While Germany maintained their grand coalition, populist's movements are gaining ground there as well. Overall, political gridlock is powerful and a positive market driver in Europe.

Many investors fear that populism will shatter their country's politics. However many fail to recognize the actual effect it has in the developed western world. Voters are tired of the establishment. They see it hasn't accomplished anything in decades and they want new leaders. So they elect populists, who then align with each other or the establishment to govern coalitions of people who agree on nothing. Again, in our view, this political gridlock is great for equities.

^{xiii} "Sweden Forms a Government After 133 Days, but It's a Shaky One," Christina Anderson, *The New York Times*, 01/18/2019. <https://www.nytimes.com/2019/01/18/world/europe/sweden-government.html>

JAPAN

JAPAN'S SUBPAR START TO 2019

Japanese equities rose 6.7% in Q1, lagging global markets' gain and remaining -14.3% below their January 24, 2018 peak.^{xiv} While we think an improving global economy and recovering Chinese demand should lift the Japanese economy and equities in 2019, structural headwinds likely weigh on both. In short, we expect Japanese market underperformance to persist this year.

Recent data set the scene. Q4 GDP rose 1.9% annualized, rebounding from Q3's natural disaster-driven -2.4% contraction.^{xv} However, Q1 data released thus far have been mixed. Machinery orders—which many consider a leading indicator of business investment—rose 5.4% m/m in February, ending a streak of three contractionary months.^{xvi} Core machinery orders—which exclude the volatile categories of ships and electric utility orders—rose 1.8% m/m, its first positive reading in four months.^{xvii} New orders from overseas increased 19.0% m/m in February.^{xviii}

BEHIND THE NUMBERS

Pundits point to a couple culprits—such as annual Lunar New Year celebrations, when factory shutdowns and worker holidays typically dent demand across Asia. At a minimum, its shifting timing muddies the waters by distorting year-over-year comparisons. Tariffs, though, seem to be pundits' primary suspect. Some argue that a US/China trade war saps Chinese demand and crimps global and Japanese growth. In our view, this may have merit but is frequently overstated. The scope of US/China tariffs, as we have written in past Reviews, is likely too small to materially impede trade.

CHINA'S IMPACT ON JAPAN

We believe the most important factor underlying Japan's recent woes is China's 2018 crackdown on “shadow banking”—lending outside the formal financial system. This is the primary source of credit for China's vast private sector, as large state-owned banks are reluctant to lend to its riskier (not government-backed) small and mid-sized enterprises (SMEs). When regulators moved to curtail shadow banking activity last year, credit dried up for large swaths of the economy. The resulting decline in Chinese demand appears to have crimped growth as far away as Europe.

However, we believe the pain is likely short-lived. In an effort to ease private firms' transition to traditional banks, Chinese policymakers have been rolling out substantial fiscal and monetary stimulus. The former includes \$370 billion in local government bond issuance (mostly to fund infrastructure) and \$283 billion in personal and business tax cuts.^{xix} The monetary measures—including sharp bank reserve requirement cuts and incentives to lend to SMEs—probably make a larger impact, but not right away. Monetary policy typically takes effect at a lag, as more available financing gradually feeds into borrowing, business investment, hiring and the like.

DOMESTIC DEMAND IN SHORT SUPPLY

Recent upticks in Chinese credit data—including new yuan loans, outstanding yuan loans and money supply—suggest this process may be underway. China's Purchasing Managers' Indexes—both the government-produced “official” measure and Caixin's privately produced one—ticked up in March, with manufacturing gauges flipping from contraction to expansion. While this is nascent—and rebounding credit and stimulus haven't shown in many Chinese or Japanese economic data series yet—this isn't a surprise. Monetary shifts typically impact the real economy at a lag. Hence, Chinese stimulus's full effects might not impact growth for months. Japan's 10-day national holiday in April and May could also skew results in the near term. But as stimulus slowly takes effect, Japanese growth may pick up—but the benefits could be concentrated among the country's big exporters, which are better insulated from domestic demand weakness.

^{xiv} Source: FactSet, as of 04/18/2019. MSCI World Index and MSCI Japan Index, both with net dividends, 12/31/2018 – 03/29/2019 and 01/24/2018 – 03/29/2019.

^{xv} Source: Japan Cabinet Office, as of 04/17/2019.

^{xvi} Ibid.

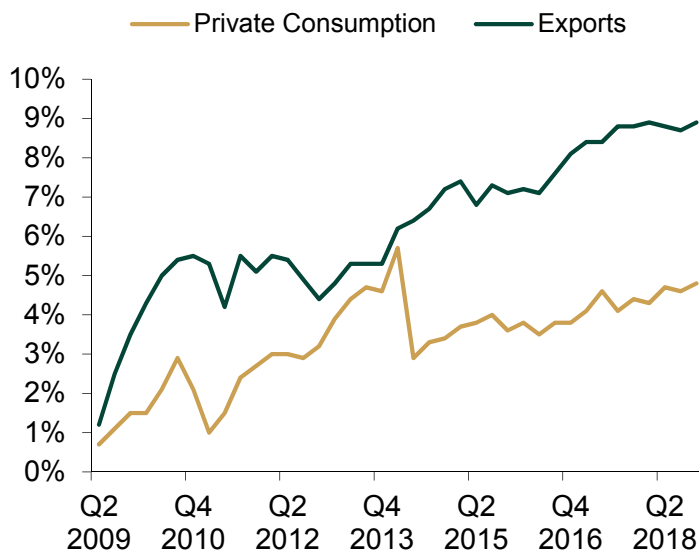
^{xvii} Ibid.

^{xviii} Ibid.

^{xix} Source: Fisher Investments Research, as of 04/16/2019.

This weakness is one of the Japanese economy's main vulnerabilities. Exports comprised 17.4% of Japan's GDP in 2018.^{xx} This isn't especially high by global standards, but a prolonged malaise in business and consumer spending has turned exports into Japan's main growth engine. As Exhibit 11 shows, exports' contributions to GDP growth have far outstripped private consumption's during this global expansion. Hence, when exports falter, Japan's economy typically suffers. October's planned consumption tax hike may weigh further on domestic demand—the sharp drop in private consumption below indicates the damage from the last hike in Q2 2014. This, plus persistence of Japan's misguided monetary policy, are fundamental headwinds that likely continue weighing on its economy.

Exhibit 11: Japanese Exports Versus Private Consumption



Source: FactSet, as of 04/25/2019. Cumulative contribution to Japanese quarter-over-quarter GDP growth of private consumption and exports, Q2 2009 – Q4 2018.

That said, these factors are increasingly well known. Sentiment towards Japan seems to be gradually souring. If worries intensify, this increases the odds sentiment becomes unrealistically dour—making a positive surprise and rebound in Japanese relative performance more likely. This is a factor we are watching, however, we don't believe pessimism has increased enough relative to reality to merit ramping up Japanese exposure.

CANADA

TRUDEAU'S POLITICAL ISSUES AND THE IMPACT ON OCTOBER'S ELECTION

Canadian voters head to the polls in October to decide whether to give Prime Minister Justin Trudeau and his Liberal Party's government another term. While reelection seemed likely just months ago, Prime Minister Trudeau has since become embroiled in a political firestorm. The scandal with Canadian construction company SNC-Lavalin, dominated headlines for months, hurt the prime minister's approval rating and is a black eye for the Liberal Party—jeopardizing his chances for reelection and raising uncertainty before the vote. While the scandal swamps Canadian airwaves, the upshot for markets is gridlock, as Prime Minister Trudeau likely seeks to avoid further alienating voters with major, controversial new legislation. Further, resolution to the election—however it goes—should clear some uncertainty.

LINGERING POLITICAL SCANDAL

Last year, SNC-Lavalin faced allegations of fraud and corruption, including charges of bribing Libyan government officials to the tune of nearly \$50 million from 2001 – 2011.^{xxi} If found guilty, SNC-Lavalin would be banned from bidding on Canadian federal contracts for 10 years. The heart of the current controversy hurting Trudeau's standing: Former Attorney General Jody Wilson-Raybould alleged his office pressured her to treat SNC-Lavalin leniently. She also claimed a January demotion stemmed from her decision to continue criminal prosecution against the company.

Since breaking in February, this story has dominated Canadian politics, with several senior cabinet officials resigning in its wake. While it is unclear whether Prime Minister Trudeau himself directly intervened, his rivals have used the controversy to batter the prime minister. Conservative Party Leader Andrew Scheer recently announced Prime Minister Trudeau's lawyer threatened to sue him over SNC-Lavalin-related comments—another embarrassment for the Prime Minister's office, which can't seem to shake the story.^{xxii}

xx Source: Fisher Investments Research, as of 04/25/2019.

xxi Source: "What You Need to Know About the SNC-Lavalin Affair," Mark Gollom, CBC News, 03/08/2019. <https://www.cbc.ca/news/politics/trudeau-wilson-raybould-attorney-general-snc-lavalin-1.5014271>

xxii https://www.washingtonpost.com/world/2019/04/08/justin-trudeau-just-cant-quit-snc-lavalin-scandal/?utm_term=.8fa4c272e068

PRIME MINISTER TRUDEAU'S POPULARITY FALLOUT

Though Prime Minister Trudeau's popularity has declined since 2015's election—natural for almost any government official in power—most still expected him to win a second term. However, recent polls show October's race looks tight. The SNC-Lavalin affair, should it persist, could swing the election. Some political experts believe Trudeau's reelection chances depend on the provinces of Ontario and Québec—the latter being Prime Minister Trudeau's home province, a stronghold for his support and also the base of SNC-Lavalin.

According to the latest CBC national poll data, the Conservatives currently lead the Liberals by almost three percentage points: 35.2% to 32.7%.^{xxiii} The Liberals still hold a firm lead in Québec (35.1% to 22.0%), where the scandal seemingly is less politically poisonous due to the company's ties to the province—also why many allege Prime Minister Trudeau may have interfered in the prosecution of SNC-Lavalin. However, the Conservatives have made headway in Ontario.^{xxiv} After Prime Minister Trudeau won the province with about 45% of the popular vote in 2015, the Liberals now trail the Conservatives there by a closely (36.6% to 35.8%).^{xxv}

As pundits weigh in and update their election forecasts based on national polls and upcoming provincial votes, we don't recommend trying to game October's result today. Too much can change in the next six months. However, we do believe the controversy will sap Trudeau's political capital, rendering him unable, and likely unwilling, to pursue major legislative changes. Politicians gearing up for reelection bids often avoid championing contentious legislation. Such sweeping laws typically create winners and losers, potentially roiling part of the electorate. Moreover, campaign strategy often involves candidates talking up what they will do on key issues if victorious in October to motivate their supporters.

In our view, a hamstrung government is a positive for markets, which dislike the uncertainty big new laws can bring. This gridlock is persistent throughout developed market economies—a major reason we are bullish about equities this year. That said, in Canada, other factors likely outweigh negatives. Canadian markets' heavy Energy and Materials skew makes them extremely subject to industry-specific factors. Specifically, the issues we discussed last quarter involving Canadian oil producers struggling amid a glut created by transport issues remain. For the time being, while the election's falling uncertainty and inactive government are appealing to us, we see more attractive investment opportunities beyond Canadian borders.

BREXIT UNCERTAINTY LINGERS

Brexit dominated headlines all quarter, with Parliamentary votes, negotiations, renegotiations and deadlines. Yet little concrete decisions have been made, aside from the Brexit date (which is now slated to occur by then end of October). However no one knows what the outcome may be, and uncertainty drags on the economy. The situation with Brexit changes constantly. While uncertain of the result, we believe it will end in either: a “no-deal” Brexit or a “soft” Brexit. Either way, uncertainty falls. It is simply a matter of when, not if—and whenever it happens, it should be a big relief for UK, European and global equities.

While uncertain of the result, we believe it will end in either: a “no-deal” Brexit or a “soft” Brexit.

^{xxiii} Source: CBC Poll Tracker, as of 04/22/2019. Polls and projections last updated on 04/16/2019. <https://newsinteractives.cbc.ca/elections/poll-tracker/canada/>

^{xxiv} *Ibid.*

^{xxv} *Ibid.*



EMERGING MARKETS COMMENTARY

EMERGING MARKETS COMMENTARY

While late-2018 volatility affected Emerging Market (EM) equities, EM rebounded sharply in Q1 2019 rising 9.9%—a bounce we believe is a typical surge off a correction or bear market's low. We believe EM equities should do well looking forward as the downstream impact of China's economic slowdown likely proves less severe than many fear.

INDIA

INDIAN ELECTIONS

Prime Minister Narendra Modi is the frontrunner in India's ongoing elections, which began April 11, but results likely won't be final until May 23. While optimism toward Indian equities seemed to perk early this year ahead of the vote, we expect a stalled reform agenda to offset this—likely weighing on Indian equities this year.

Polls heading into the election indicate Prime Minister Modi's Bharatiya Janata Party (BJP) and allied parties in its National Democratic Alliance (NDA) coalition taking a slim majority. With 543 lower house—"Lok Sabha"—seats contested, polls indicate the NDA seems poised win around 273.^{xxvi} If this holds, it would give the BJP a razor-thin majority—well below the commanding 330 seats they won in 2014.

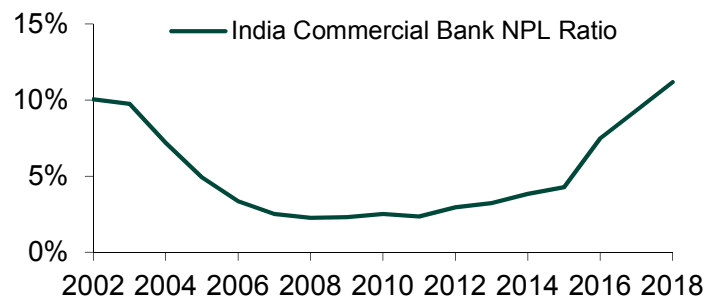
If re-elected, we think Prime Minister Modi will likely fail to enact significant reform many investors expect—an unfortunate situation. Bold earlier reforms like demonetization and a major tax system overhaul, while net positive for the economy in our view, haven't raised enthusiasm for further action. Rather, they drained Prime Minister Modi's political capital and approval ratings, hampering his ability to deliver more difficult—and much-needed—reforms increasing labor market flexibility and privatizations, particularly in the state-owned banking sector.

BJP'S REFORM PUSH—AND INDIA'S BANKS—SLOWED

State banks control about two-thirds of banking assets and also account for about 90% of non-performing loans (NPLs).^{xxvii} As a percentage of total commercial bank loans, NPLs soared to 11.2% in 2018 from 3.8% when Prime Minister Modi took office in 2014

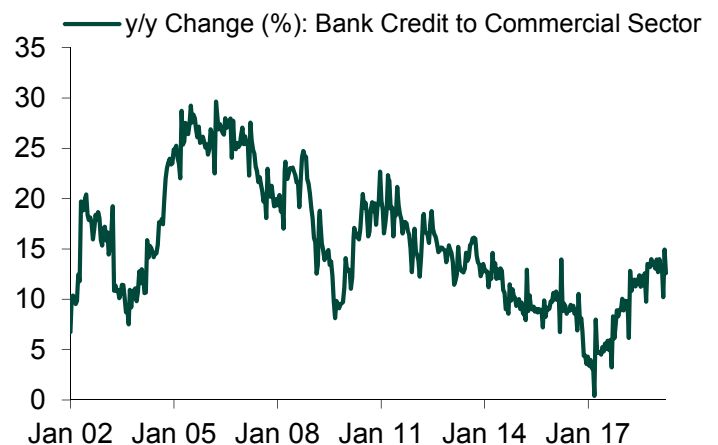
(Exhibit 12).^{xxviii} Until recently, this crimped lending. But after government capital infusions into state lenders in February, lending has jumped.^{xxix} Bank credit to the commercial sector accelerated to 15% y/y at quarter's end (Exhibit 13). While positive on the surface, we think this mostly demonstrates Modi's increased economic meddling. Rising political favoritism and government intervention raises uncertainty and could potentially harm India's economic development, watering down or reversing positive structural reforms undertaken during Prime Minister Modi's first term.

Exhibit 12: Non Performing Loans Rising



Source: FactSet, as of 04/30/2019. Banking & Credit, NPL, All Scheduled Commercial Bank, Percent - India, 2002 - 2018.

Exhibit 13: Credit Growth Rebounding



Source: FactSet, as of 04/30/2019. Monetary Aggregates, Bank Credit to Commercial Sector - India, bi-monthly, 01/11/2002 - 04/12/2019.

xxvi "Modi's Alliance to Win Slim Majority in Indian Election, Poll Shows," Subrat Patnaik, Reuters, 04/09/2019.

xxvii "Who's to Blame for India's Slowdown?" Neelkanth Mishra, Bloomberg, 04/21/2019. <https://www.bloomberg.com/opinion/articles/2019-04-21/india-s-banks-are-dragging-down-its-economy>

xxviii Source: FactSet, as of 04/30/2019. Banking & Credit, NPL, All Scheduled Commercial Bank, Percent - India, 2014 - 2018.

xxix "India Banks Jump as Record Capital Infusion Set to Boost Loans," Rahul Satija, Bloomberg, 02/20/2019. <https://www.bloomberg.com/news/articles/2019-02-21/india-banks-jump-as-record-capital-infusion-set-to-boost-loans>

With momentum on the economic policy front stalling, Modi's campaign largely avoids focusing on future reform efforts. Many observers claim his campaign hinges on fear—particularly, fear of how the government would handle tensions with Pakistan if he isn't re-elected. While tensions are longstanding between India and Pakistan, Q1 brought another iteration Prime Minister Modi seeks to capitalize on. In February, Pakistan-based terrorists attacked Indian soldiers in India's portion of the disputed Kashmir region. Prime Minister Modi promised a meaningful response and launched airstrikes against several Pakistani targets, which seemingly boosted his popularity. Additionally, Prime Minister Modi cited Sri Lanka's tragic Easter bombings as further evidence India's security is threatened by terrorism. Reuters recently reported Modi asked an election-rally audience, "Should terrorism be finished or not? Who can do this? Can you think of any name but Prime Minister Modi?"^{xxx} We think that line of logic is illustrative of his election platform.

Economically, Prime Minister Modi is championing the farmer subsidies as a key provision—an effort to shore up rural support. But the messy implementation of economic reforms may have already done significant damage. The BJP lost control of three state legislatures to the opposition Congress Party last December. All this adds up to a scenario where the BJP holds a slimmer majority or loses the election—either way, a recipe for less reform.

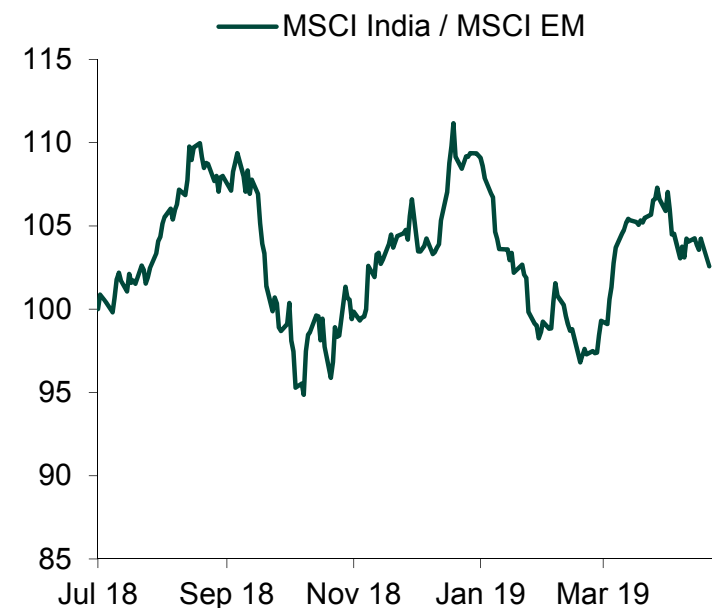
CONGRESS PARTY TROUBLES

The Congress Party—the BJP's main opposition—probably wouldn't deliver much pro-market reforms either. Congress's campaign hinges mostly on matters removed from markets: Leader Rahul Gandhi has promised annual 72,000 rupee handouts to poor Indian households, a 2.2 million government job hiring spree, legislation guaranteeing women a third of seats in national and state assemblies, doubling healthcare spending to 3% of GDP and more than doubling education spending to 6% of GDP.^{xxxii}

As for more business friendly measures, Gandhi offered to cut red tape for new business formation and simplify the goods and services tax Modi implemented. But we doubt he can deliver on this promise. Even when the BJP won with a large majority in 2014, passing the tax measure required watering down reform. If Congress does manage to win, it is unlikely they would have anywhere near enough seats to enact such a reform. This seems like a case where, if Congress wins, investors expecting such a move may be disappointed.

Leading up to the vote, Indian markets have been overall lackluster. Despite a February 27 – March 28 jump, Indian equities trailed EM during the quarter overall, 7.2% to 9.9%, respectively.^{xxxii} Since last June—with elections coming into focus—Indian equities' performance relative to EM has waffled (Exhibit 14). A promising initial reform push has seemingly run aground, which elections don't seem likely to change. With policy uncertainty weighing on Indian equities for the foreseeable future, we remain underweight.

Exhibit 14: Indian Equities' Relative Returns



Source: FactSet, as of 04/30/2019. MSCI India Index divided by the MSCI Emerging Markets Index. All returns in USD with net dividends, 07/01/2018 – 04/30/2019.

xxx "India's Modi Condemns Sri Lanka Attacks, Says He Can Defeat 'The Terrorists,'" Staff, Reuters, 04/21/2019. <https://www.reuters.com/article/us-india-election-modi/indias-modi-condemns-sri-lanka-attacks-says-he-can-defeat-the-terrorists-idUSKCN1RX0IW>

xxxii "Factbox: Congress's Many Promises to Take on Modi in Indian Election," Staff, Reuters, 04/01/2019. <https://www.reuters.com/article/us-india-election-factbox/factbox-congresss-many-promises-to-take-on-modi-in-indian-election-idUSKCN1RD2UP>

xxxii Source: FactSet, as of 04/23/2019. MSCI India Index and MSCI Emerging Markets Index returns with net dividends, 12/31/2018 – 03/29/2019.

SOUTH AFRICA

STATE-OWNED UTILITY TROUBLE

South African state-owned power company Eskom's financial woes mounted in Q1, with frequent blackouts weighing on the country's economy. Both predicaments were long in the making and seem far from a resolution—likely continuing to hang over South African equities. Eskom, which provides about 95% of South Africa's power, is suffering from years of mismanagement and corruption. The state-backed monopoly has long been a popular way for government officials and politicians to divert money, jobs and contracts to favored groups. As politicians rewarded supporters with jobs, Eskom's workforce ballooned by 50% between 2003 and 2017.^{xxxiii} Meanwhile, expertise fled as managers hoping to cash in replaced competent professionals. Since 2007, employee costs have tripled and coal costs quintupled—tied in part to controls propping up coal prices for black-owned mining companies.^{xxxiv} Couple this with subsidized low electricity rates for low-income households, and it is no surprise Eskom's balance sheet is under pressure.

The result: Load shedding—blackouts—began as early as 2008 after the government neglected to build more plants to keep up with growing demand and company insiders allegedly sabotaged capacity in order to steer lucrative coal contracts to cronies. Eskom then borrowed heavily to build new coal-fired plants. But these projects are years behind schedule and face massive cost overruns, exacerbating Eskom's debt burden. Moreover, their output is meager and breakdowns are common.

Today, already inadequate power provision is slipping further. About a third of Eskom's power stations are non-functioning or closed for maintenance.^{xxxv} Blackouts reached record levels in March, with Eskom routinely taking about 9% of its capacity—enough to power 3 million homes—offline.^{xxxvi} The economic toll appears substantial. Factories must rely on generators or halt production. Many small businesses must close their doors when the lights go out. Without working traffic signals, transportation often grinds to a halt. Goldman Sachs estimates the outages could slash 2019 GDP growth by 0.9 percentage point, while the South African Reserve Bank estimates a bigger impact: 1.1 percentage point.^{xxxvii} The longer power cuts persist, the worse this likely gets.

BAILOUTS AND REFORM PLANS

Making matters worse, Eskom's finances look dire. Its debt—60% of which is state-backed—has risen over tenfold since 2007 and now stands at \$30 billion.^{xxxviii} With sales at decade lows, revenues aren't enough to cover interest payments, rendering the company functionally insolvent. Financial pressure seems unlikely to abate anytime soon. According to South Africa's finance minister, Eskom “does not anticipate to generate sufficient internal cash to pay all of its maturing obligations at any point in time over the next five years.”^{xxxix} In February, the government announced it would give Eskom a \$5 billion cash infusion, to be paid out over the next three years—though the Treasury recently revealed it had secretly advanced Eskom \$355 million of that sum in order to prevent an imminent default.^{xl}

Additional support is ostensibly contingent on the company restructuring and the country reaching certain growth targets, though these benchmarks could shift if politicians deem additional rescue efforts necessary.

xxxiii “South Africa Crippled by Rolling Blackouts, Weeks Before an Election,” by Norimitsu Onishi, *The New York Times*, 04/06/2019.

xxxiv “How to solve South Africa's energy crisis,” Staff, *The Economist*, 04/17/2019.

xxxv *Ibid.*

xxxvi *Ibid.*

xxxvii Sources: “Eskom power cuts to hit South Africa GDP -Goldman Sachs,” Staff, Reuters, 03/21/2019. “South Africa Blackouts May Cut Growth Close to Zero, Central Bank Says,” Rene Vollgraaff and Londell Phumi Ramalepe, Bloomberg, 04/17/2019.

xxxviii Sources: “Eskom's debt is draining South African growth,” Pavel Mamai, *Financial Times*, 12/12/2018. “How to solve South Africa's energy crisis,” Staff, *The Economist*, 04/17/2019.

xxxix “South Africa reveals \$355m Eskom emergency bailout,” Joseph Cotterill, *Financial Times*, 04/19/2019.

xl *Ibid.*

The amounts paid or promised to date aren't near enough to erase Eskom's \$30 billion in outstanding debt. But they should delay collapse and buy the company time.^{xli} Similar to his predecessors, President Cyril Ramaphosa says he will use this time to split the company up into three businesses—power generation, transmission and distribution. The aim is to improve competition and make it easier for private producers to sell their power over the national grid. But labor unions—a key constituency—oppose the move. With elections on May 8th, the government may not wish to pick a fight.

In our view, therefore, South African equities should continue to lag broader EMs for the foreseeable future—at least until sentiment materially sinks.

For all its troubles, Eskom doesn't appear on the brink of collapse. The government has a big incentive to keep it running, as failure would likely create economic disruption well beyond today's levels. However, the status quo isn't great. Periodic blackouts will probably persist, hampering businesses already struggling with high electricity costs. More demands on state coffers likely loom, as well. Meanwhile, the ruling party's ongoing push for a constitutional amendment permitting land expropriation fuels uncertainty, likely scaring off investment.

South African markets are seemingly pricing in these problems to an extent. The country's equities market rose 4.6% in Q1, lagging broader EM 9.9% rise.^{xlii} However, we think South Africa's equities don't fully reflect the tough road ahead for Eskom and the economy generally. In our view, therefore, South African equities should continue to lag broader EMs for the foreseeable future—at least until sentiment materially sinks.

THAILAND

THAI ELECTION

Thailand's long-delayed parliamentary election finally took place on the 24th of March. But the results were inconclusive. Ruling junta leader and current Prime Minister Prayuth Chan-ocha probably remains in power, but election-rigging claims, subsequent by-elections and vote recounts raise uncertainty ahead of the Election Commission's official tally release, which is scheduled for May 9 (but may be pushed back).^{xliii} Regardless, we think either of two outcomes is likely: 1) a military-backed government lacking a House majority or 2) an anti-military coalition-led House with a pro-military Senate. Both scenarios probably deliver divided government and gridlock, preventing market-opening reform and sustaining political uncertainty. We think this is a modest headwind for Thai markets in the foreseeable future.

Prayuth—Prime minister and former Commander in Chief of the Royal Thai Army—assumed office in 2014, after he staged a successful coup following a constitutional crisis. At the time, Prime Minister Yingluck Shinawatra's Pheu Thai party (For Thais) proposed constitutional amendments intended to pardon her brother, former Prime Minister Thaksin Shinawatra, who was also deposed in a 2006 coup. Mass protests against the government ensued, leading to a disputed election and Prayuth's coup. After consolidating his power, he drafted a new constitution that took effect in 2017 giving the military a large say in government affairs.

^{xli} *Ibid.*

^{xlii} Source: FactSet, as of 04/18/2019. MSCI South Africa Index and MSCI Emerging Markets Index, both with net dividends, 12/31/2018 – 03/31/2019.

^{xliii} "Thailand Constitutional Court Tells Election Commission to Do Its Job of Calculating, Allocating Party Seats," Staff, *The Nation/Asia News Network*, 04/25/2019. <https://www.straitstimes.com/asia/se-asia/thailand-constitutional-court-tells-election-commission-to-do-its-job-of-calculating>

GOVERNMENT STRUCTURE

Thailand's 2017 constitution assigns the military's National Council for Peace and Order with wide-ranging powers. It appoints all 250 members of the Senate and controls the judiciary. The Senate and the 500-seat House elect the prime minister. Within the House, 350 "constituent seats" are elected from local districts. These are akin to the U.S. House districts, electing one representative. The remaining 150—known as "party-list seats"—are determined by parties' final share of the national popular vote. Following March's preliminary election results, both Prayuth's Palang Pracharath (People's State Power) party and the Pheu Thai party claim this structure supports their parliamentary control.

Unofficial results suggest Palang Pracharath won 97 of 350 constituencies and its likely coalition partner—the Democratic Party—won 32 seats.^{xliv} 129 House votes plus 250 from the Senate would allow them to form a government—returning Prayuth as prime minister. Additionally, Palang Pracharath is leading popular vote totals with about 8.4 million versus Pheu Thai's 7.9 million, giving them the edge on party-list seats and potentially increasing their House advantage.^{xlv} However, based on preliminary results, Palang Pracharath won't have a House majority, falling short of the 251 needed.

CONTESTED VOTE

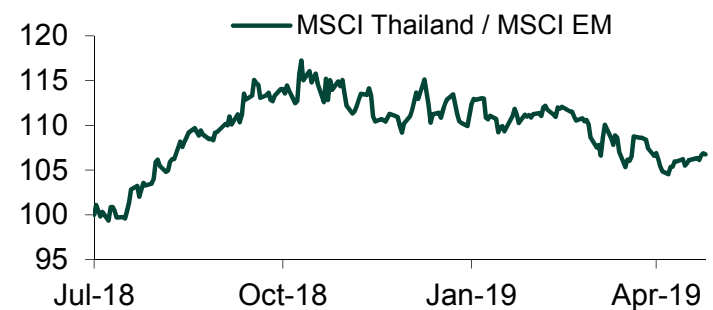
Contesting Palang Pracharath's claim it has a mandate, Pheu Thai argues it has enough seats to form the new government. Pheu Thai won 137 constituent seats and formed a 7-party coalition that claims to have a House majority. Pheu Thai's biggest coalition partner is Future Forward—a center-left party led by former business tycoon Thanathorn Juangroongruangkit—which took the third-largest share of the popular vote. The junta-appointed Election Commission is currently pressing charges against Thanathorn, alleging campaign violations that disqualify him. In turn, Thanathorn accuses the Election Committee—and the military regime—of "trying everything to destroy us."^{xlvi}

The Election Commission could also disband another coalition partner—the New Economics Party—led by former Pheu Thai politician Mingkwan Saengsuwan, throwing the multi-party coalition's bid in further doubt.^{xlvii} Further, though Pheu Thai say they have enough votes to control 255 House seats, this was based on Pheu Thai's own calculation of the party-list allocation. That may not match the Election Commission's tabulation.

The tensions between pro- and anti-military parties are unlikely to dissipate even after the Election Commission announces official election results and the winner forms a government. Gridlock is likely to persist given the disparate views of the two camps, with neither side likely able to advance significant legislation. In economically competitive nations, we generally see such gridlock as a positive, as legislation risks doing more harm than good. But in EMs like Thailand, the need for reform outweighs this risk. Given the backdrop, Thailand looks unlikely to enact many meaningful reforms. Even with a victory for a pro-military government, sentiment for anti-military rule should run high and could disturb sentiment in the near term.

Either case suggests political uncertainty lasts longer than expected. The lack of a clear outcome is likely behind recent weakness in Thai shares, which have underperformed since the election. Thai equities rose 7.4% in Q1, trailing MSCI EM's 9.9%, part of a longer-term relative downtrend since October last year (Exhibit 15).^{xlviii}

Exhibit 15: Thai Equities' Relative Returns



Source: FactSet, as of 04/29/2019. MSCI Thailand Index divided by the MSCI Emerging Markets Index. All returns in USD with net dividends, 07/01/2018 – 04/26/2019.

^{xliv} "Thailand's Pro-Army Party Wins Popular Vote: Election Commission," Patpicha Tanakasempipat and Panu Wongcha-um, Reuters, 03/28/2019. <https://www.reuters.com/article/us-thailand-election/thailands-pro-army-party-wins-popular-vote-election-commission-idUSKCN1R90S8>

^{xlv} Ibid.

^{xlvi} "Thai Opposition Leader Accuses Junta of Trying to 'Destroy' Party," John Reed, Financial Times, 04/28/2019. <https://www.ft.com/content/26e6aa6a-6a2e-11e9-80c7-60ee53e6681d>

^{xlvii} "New Economics Members Seek to Disband Own Party," Staff, Bangkok Post, 04/18/2019. <https://www.bangkokpost.com/news/politics/1663372/new-economics-members-seek-to-disband-own-party>

^{xlviii} Source: FactSet, as of 04/29/2019. MSCI Thailand Index divided by the MSCI Emerging Markets Index. All returns in USD with net dividends, 12/31/2018 – 03/29/2019.

BRAZIL

In Brazil, after taking office in January, President Jair Bolsonaro's administration seems to be preparing bold economic reforms, including privatizations, less stringent business regulations, freer trade, spending cuts, a corruption crackdown and pension reforms. In late March, the lower house president—whose aid is key to marshaling support for bills in Brazil's fragmented legislature—stopped trying to muster votes for pension reform after the president's son and Justice Minister antagonized him on social media. Meanwhile, flagging poll numbers and cabinet infighting indicate President Bolsonaro's political capital has diminished since he took office in January. Getting controversial reforms through Brazil's Congress was always going to be a difficult. If President Bolsonaro—still new to the office—is able to mend fences, hopes for reform progress should give Brazilian equities a boost.

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give Brazilian equities a boost.

Recent expansionary purchasing managers' indexes suggest the country's economy is weathering the political drama well enough. Should commodity prices remain firm—likely, given well-balanced supply and demand presently—we expect Brazil's economy to benefit. Though it is still early, markets seem to view the prospect of a relatively stable government as an improvement from Brazil's recent history of chaotic politics. President Bolsonaro's three predecessors were jailed, impeached and left office with rock-bottom approval ratings, respectively.

Additionally, Brazil is emerging from one of its worst recessions in history, contracting for 11 consecutive quarters. While GDP growth is only modestly positive, recovery in investment and consumption is gaining momentum.

Should you have any questions about any of the information in the First Quarter 2019 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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