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SECOND QUARTER 2017

MARKET PERSPECTIVES

SECOND QUARTER 2017 REVIEW AND OUTLOOK  
MARKET PERSPECTIVES

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## SECOND QUARTER 2017 REVIEW AND OUTLOOK

### EXECUTIVE SUMMARY

#### Portfolio Themes

- **Overweight to Information Technology:** The Information Technology sector is heavily skewed toward large, high-quality firms—a segment we expect to outperform in the later stages of a bull market. The sector should also benefit from robust global IT spending driven by the growing demand for products and services related to mobile, cloud computing and the “Internet of Things.”
- **Quality Tilt:** As the bull market progresses, we favor stocks with stronger balance sheets and consistent margins.
- **Underweight to Defensive Categories:** Defensive categories should underperform given our forecast for an ongoing bull market.

#### Market Outlook

- **European Leadership:** As euroskeptic fears fizzle and renewed gridlock reduces legislative risk, Europe should outperform in the second half of 2017.
- **Falling Uncertainty:** Investor sentiment should continue rising as gridlocked governments elsewhere around the world reduce the likelihood of sweeping legislation.
- **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 markets continued their rise in Q2, with the MSCI All Country World Index (ACWI) adding another 4.3% — bringing year to date returns to 11.5%.<sup>i</sup> Non-US stocks again outperformed, with European stocks faring particularly well. We see 2017's back half as amplifying early-year trends, and all seems on track for a great 2017 led by non-US stocks.

While Q2 was strong, stocks didn't move straight up. European and Technology shares outperformed in Q2 but experienced some volatility mid-quarter, leading investors to think the year's great start may be unraveling — a myopic viewpoint, in our view. Recent developments look quite typical of US presidents' inaugural years, as we will detail in the full Review & Outlook. Since 1970, when good sector-level data began, the non-US sectors and countries leading in inaugural-year first quarters have outperformed for the full year the majority of the time, frequently gaining steam in the second half. Yet leadership often fluctuates in Q2. In his April 24 column for Britain's Financial Times, Ken called inaugural years' second quarters

“relatively quiet compared to the year's back half.” History strongly argues Q1 is the guide, suggesting a bright second half awaits the year's early leaders.

The volatility in big Tech companies such as Facebook, Amazon, Netflix and Google — the so-called FANG or FAAMG stocks—looks typical of a quick reversal or countertrend. FANG was mostly a CNBC curiosity until they plunged on June 9, rendering it front-page news on almost every media outlet. Such fast, universal media coverage is typical of short-term moves, not longer-term, lasting negatives. To us, it recalls 2013's short-lived “taper tantrum” over quantitative easing's potential end, 2010's “Flash Crash” and other short lived stories.

In our view, FANG hype is distracting from other, more meaningful developments—chiefly, another year of falling uncertainty, which is right on track. President Trump is filling out his administration to little excitement while accomplishing much less than hoped or feared. Meanwhile, media is overselling the James Comey and Jeff Sessions hearings (which under-delivered), burying more important considerations for investors: After President Trump's five-plus

<sup>i</sup> Source: FactSet as of 07/07/2017. MSCI All Country World Index return with net dividends, 03/31/2017 – 06/30/2017 and 12/30/2016 – 06/30/2017.

months in office, we have a good sense of his relative political muscle. Businesses and investors largely know what they are dealing with, enabling risk-taking.

While uncertainty is falling somewhat in America, the real nexus is Europe, where euroskeptic fears fizzled. Three months ago, investors were concerned about far-right, anti-euro French presidential candidate Marine Le Pen and her Front National party. But she lost decisively to centrist Emmanuel Macron, whose En Marche party then took a solid majority in June's Parliamentary contest while voters relegated Le Pen to the fringes. Euroskepticism's decline in France and Holland bolstered sentiment, easing fears over radicalism in Italy and Germany. UK political uncertainty ticked up when Prime Minister Theresa May lost her majority in June's snap election, but renewed gridlock should reduce legislative risk, helping clear the fog as the year progresses.

In Emerging Markets, China's recent economic data suggests continued growth, with consumer-related and industrial segments of the economy looking strong. Additionally, index provider MSCI announced it will include mainland Chinese stocks (known as A-shares and traded in Shanghai and Shenzhen) in its Emerging Markets index starting in May 2018. To us, this is largely a symbolic change. While the addition is recognition that China has made some progress in opening up its capital markets, it still has ways to go. India will implement its long-awaited Goods and Services Tax (GST) at the start of July. While it will likely be painful in the short term, the GST would likely have a beneficial long-term impact – a more streamlined tax system should help the government's ability to collect taxes. In

Brazil, Michel Temer is now even more deeply embroiled in political scandal. While Temer likely has enough congressional support to block a trial, the scandal is damaging his ability to enact reforms.

While a correction—a short, sharp, sentiment-driven decline exceeding -10%—is always possible and unforeseeable, overall we see lots of potential for the second half to mimic and amplify Q1. Animal spirits are stirring in Europe, where economic data keep improving and beating expectations. Corporate earnings, up in America, are soaring even higher abroad. Strong Emerging Markets growth is boosting export-oriented Asia, especially big Asian Technology companies. Meanwhile, sentiment is still relatively warmer toward America, creating more room for positive surprise elsewhere. As uncertainty melts away and investors appreciate these positives, we believe stocks should enjoy a strong run.

# THEMATIC UPDATE AND MARKET OUTLOOK

## Q2 RECAP

Halfway through the year, 2017 is largely unfolding as we expected. Europe is leading the world, political uncertainty is fading, earnings are up and gridlocked governments are doing little — keeping legislative risk low. Global stocks are rallying, with sentiment warming. Yet midway through June, brief weakness in Europe and Tech—and a burst of US outperformance—had media warning of reversals. However, everything we have seen so far is normal for US presidents' inaugural years. Usually, Q1's trends are amplified in inaugural years' back halves, with some leadership changes in between. We believe the media frenzy over Q2's final six weeks is bullish: It suggests a quick countertrend reset sentiment, setting up a strong second half.

## IN INAUGURAL YEARS, FOLLOW THE LEADERS

Non-US stocks have beaten US in 14 of 22 inaugural years since 1929, averaging 9.6% annualized versus America's 5.2%.<sup>i</sup> If we narrow our sample to inaugural years when non-US led in Q1, it leads for the full year in 10 of 11 inaugural years—every time except 1973. In the other 10 years, non-US's lead widened after Q1 all but once. We believe this is primarily tied to political uncertainty.

### Exhibit 1: Q1 Outperformance in Inaugural Years

	Non-US Returns Minus US Returns (Percentage Points)		
	Q1	Q2	Second Half
1933	17.1	-55.4	34.8
1937	0.5	11.0	22.8
1941	14.3	12.4	20.6
1953	10.7	2.4	11.9
1957	14.1	1.8	4.9
1969	9.1	0.3	9.2
1973	22.7	2.0	-16.2
1977	8.9	1.1	14.0
1985	0.8	-0.8	18.5
1993	7.7	9.7	3.2
2005	2.1	-2.6	9.6

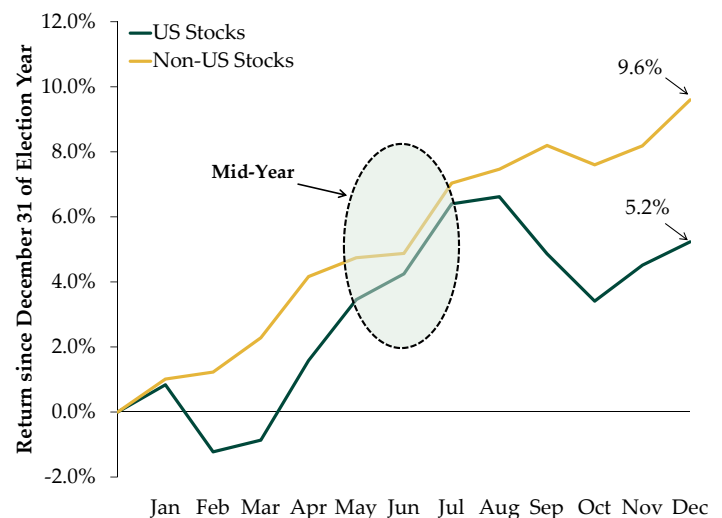
Source: FactSet and Global Financial Data, Inc., as of 6/28/2017. 1933's huge swings are tied to large currency swings as the US left the gold standard.

<sup>i</sup> Source: Global Financial Data, Inc., as of 1/10/2017. S&P 500 and GFD World Ex. US Index price returns in inaugural years, 1929 – 2013. Price returns used in lieu of total due to data availability.

While the US outperformed from late-May through June's end, leadership often changes in the second quarter of inaugural year. In 7 of the 10 years in Exhibit 1, non-US's margin over US narrowed or flipped in Q2 before widening again in the second half. As Exhibit 2 shows, most of non-US's historical inaugural-year outperformance came in the back half, after US stocks attempted a mid-year catchup.

While absolute returns don't always accelerate in the second half, history strongly suggests the relative trends—on a region, country and sector basis—should strengthen.

### Exhibit 2: Non-US Dominates in Inaugural Years' Second Halves



Source: Global Financial Data, Inc., as of 1/10/2017. S&P 500 and GFD World Ex. US Index price returns in inaugural years, 1929 – 2013. Price returns used in lieu of total due to data availability.

Sector and country leadership trends often follow a similar pattern in inaugural years, with early-year leaders outperforming for the full year more often than not. As Ken Fisher wrote in his May 31 *Financial Times* column:

*Since 1970—when good sector data begin—non-US sectors that led in the first quarter of inaugural years led for the rest of the year. The first quarter's top three non-US sectors led 61% of the time, by a median 3.4%. Meanwhile, the three worst sectors trailed the rest of the year 76% of the time by 4.8%.*

*Country leadership also persists. Similarly, the first quarter's top country or region led the rest of the year 80% of the time, by a median 5.6%. The second best kept leading 60 per cent of the time, with a 2.2% spread. The worst kept lagging 60% of the time, and by 6.2%.*

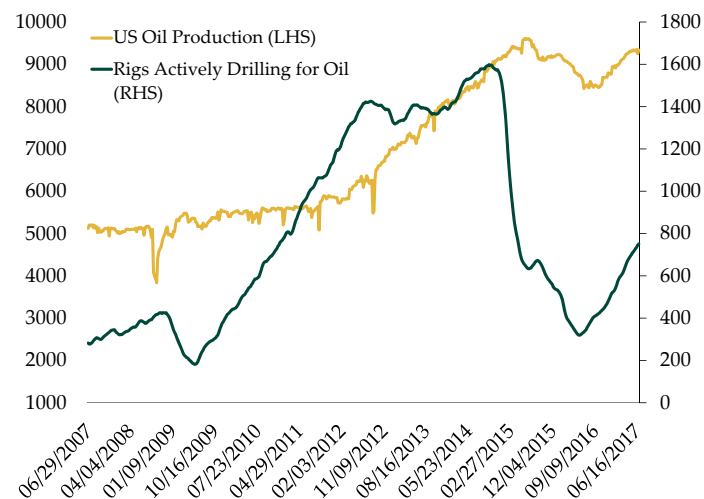
Therefore, we view eurozone stocks' temporary lag in late May and June as a good sign. Same for the media's continued frenzy. Talk of "crowded trades" gone bust renews skepticism, extending the wall of worry for eurozone stocks. Everything we have seen so far fits the pattern.

### ENERGY BACK IN THE DOLDRUMS

Last year, Energy was the best performing sector in the MSCI ACWI index. However, we believed Energy's run was likely a counter-trend, fueled by unfounded optimism over OPEC supply cuts that would ultimately do little to reduce global output.

Sure enough, even as OPEC announced small production cuts—and largely complied with them—US production surged. As prices stabilized in 2016, shale oil producers' efficiency gains made during the last few years radically lowered breakeven oil prices. Investment in new wells resumed rising in Q3 2016.<sup>ii</sup> Oil rig count soon followed, and before long US oil output was flirting with prior highs (Exhibit 3). As the world fathomed the enduring global supply glut, oil prices tumbled, and Energy stocks fell—surrendering last year's outperformance.

### Exhibit 3: Rig Count and Output



Source: FactSet, as of 7/14/2017. US Weekly Field Production of Crude Oil (four-week average) and Baker Hughes count of active oil rigs, 06/29/2007 – 06/30/2017.

Even with US oil output's resurgence, many pundits still believe oil output is a function of reserves—it isn't. Rather, it is about technology: How easy and cheaply can producers access what is in the ground? US shale oil was always there, but until recently, it was too

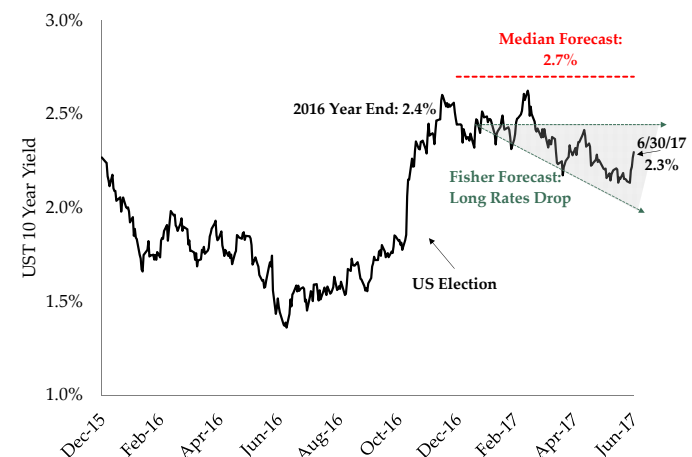
difficult to tap. Years of investment and technological development changed that, enabling firms in some shale fields to profit with oil between \$15 and \$40 per barrel. In our view, the world still doesn't appreciate how much technology has transformed the industry, or that innovation is still advancing.

This technological advancement can become a big positive in the future, boosting US producers' margins. However, with current profits still price-sensitive and supply growth exceeding demand growth, we maintain our underweight to the Energy sector.

### INTEREST RATES

At 2017's outset, nearly everyone thought long-term interest rates would rise. However, we believed rates were more likely to finish the year a little lower than they began. Our rationale was based on the following factors: overblown reflation expectations, low US Treasury (UST) supply creation and foreign demand for UST (Exhibit 4).

### Exhibit 4: UST 10 Year Yield and Forecasts



Source: FactSet as of 06/30/2017. Fisher Investments Research & Guru Forecasts as of 01/03/2017.

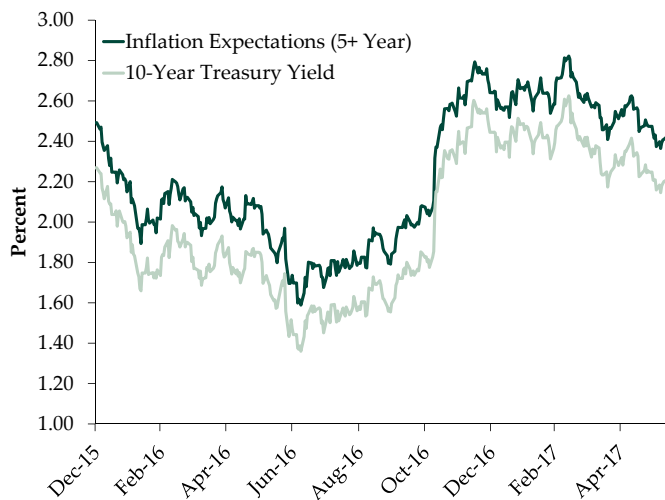
Indeed, with bond demand sky-high globally and the US Federal Reserve (Fed) rate hikes tamping down inflation expectations—10-year US Treasury yields are down from 2.44% the beginning of the year to 2.30% as of 06/30/17.<sup>iii</sup> Additionally, They have almost perfectly tracked inflation expectations (Exhibit 5 on the next page). The Fed has done its part. So far Fed has hiked rates twice, in March and June—a big reason inflation expectations are down. Continued

<sup>ii</sup> Source: US Bureau of Economic Analysis, as of 6/28/2017.

<sup>iii</sup> Source: FactSet, as of 7/14/2017.

growth and falling inflation expectations have helped reduce corporate bond yields, narrowing credit spreads—particularly in high-yield bonds.

#### Exhibit 5: Interest Rates & Inflation Expectations



Source: FactSet, as of 7/14/2017. Bloomberg Barclays' US Government Breakeven Index (5+ Year) and US 10-Year Treasury Yields, 12/31/2015 – 06/30/2017.

#### CURRENT FEARS

We are bullish and believe the foreseeable future should be great for stocks. The fact that many investors remain preoccupied with potential risks suggests investor sentiment, while warmer than years past, is far from euphoric. Below we discuss a few common fears that we believe are exaggerated.

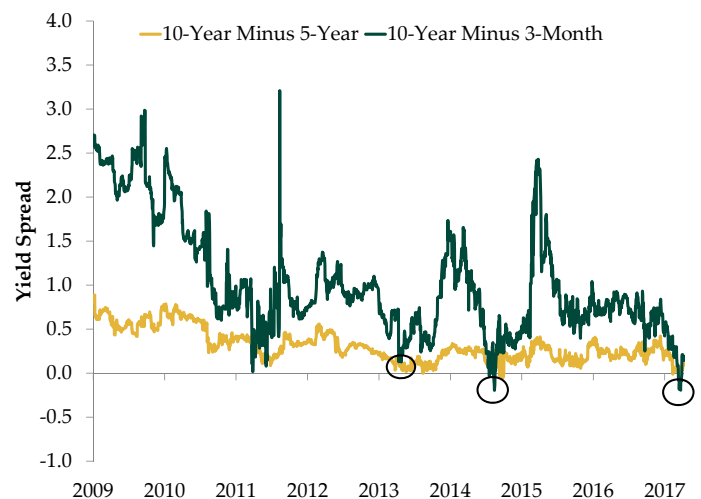
#### CHINESE DEBT AND INVERTED YIELD CURVE

The Chinese economy is slowing, but that has been the case for a long time. The debt issue isn't new, either, having circulated since 2011. In May, credit ratings agency Moody's spurred headlines after downgrading Chinese debt for the first time since 1989, but ratings agencies' decisions are usually late confirmation of commonly held theories, and that seems true here. China's issues are well known, widely overestimated and quite manageable. Government officials have taken several steps to reduce financial risk, including discouraging certain types of bank lending. Moreover, as the government undergoes a major leadership transition this year, it will likely use all tools necessary to ensure overall economic stability—as officials have during past transitions.

The Chinese yield curve is another source of concern for investors. China's 5-year bond yield climbed above the 10-year in May—is that reason to be bearish? Not in our view. Though China's inverting yield curve has coincided with trouble in the past, we never established any sort of causal link between the inversion and past troubles.

China's yield curve doesn't necessarily signal trouble in financial markets because China works differently than developed economies. The government sets loan quotas and controls the banking system, and capital markets are relatively closed. In a closed, mercantilist economy, the yield curve is less relevant. During the handful of times when China's yield curve inverted, it didn't coincide with a global bear market. Nor did Chinese loan growth tumble.

#### Exhibit 6: Chinese Yield Spreads Since 2009



Source: FactSet, as of 7/10/2017.

#### NORTH KOREA

Another common fear right now: Kim Jong-un and North Korea. While World War III would be bad for markets—as World War II's onset was—it is unlikely North Korean tensions reach that level. Though Pyongyang's intercontinental ballistic missile tests are concerning—they aren't a new development. North Korea has made scores of threats toward the international community in recent decades. Usually the goal behind the posturing is to receive aid for its suffering populace—like after 2016's major flood—or to attempt to force concessions (e.g., remove sanctions). While it is possible North Korea decides to attack without provocation, markets move on probabilities, not possibilities – and the likelihood of further escalation seems low for now.





## UNCERTAINTY CONTINUES FALLING

The S&P 500 rose 3.1% in the second quarter, shaking off political theatrics and June's infamous FANG wobble to bring year-to-date gains to 9.3%.<sup>iv</sup> Thus far, markets are behaving as we would expect in inaugural years that start amid relatively high political uncertainty: melting up as the fog clears and investors gain a better view of the strong economic fundamentals around them. We expect this to continue as 2017's second half unfolds.

Six-plus months into the Trump presidency, it is increasingly clear the risk of radical policy change is low, which should encourage more risk-taking among businesses and investors alike. Though we don't believe health care reform efforts are a broad market driver, Congress's ill-fated attempt to repeal and replace the Affordable Care Act is a great example of intra-party gridlock at work. The GOP-controlled Senate easily passed repeal bills when President Obama was in the White House, acting "decisively" when they knew the legislation would never take effect—a symbolic, no-risk affair. However, when a bill actually has a chance of becoming law, politicians' interests change radically, as upsetting the apple cart can result in voter backlash during midterm elections. Even though Republican Senators broadly claim to dislike the ACA, they had competing opinions on what to do with it. Swing-state GOP Senators had every incentive to do nothing. By the end of July, three different measures aiming to end the ACA failed, and the effort was all but dead.

### ...Congress's ill-fated attempt to repeal and replace the Affordable Care Act is a great example of intra-party gridlock at work.

While the Senate debated health care, the House moved on to tax reform and made some noteworthy progress as July wound down: GOP leadership agreed to abandon plans for a border adjustment tax. However, other details still aren't clear, including the income thresholds for each tax rate and which deductions will survive the overhaul. Any plan likely creates winners and losers, and potential losers likely lobby their Representatives and Senators hard to preserve their favorite loophole. Even if the House passes something, it is unclear whether the Senate can, given the GOP's much smaller majority there—especially if attention shifts to debt and deficits as the debt ceiling takes the stage this fall. While inaction might

frustrate investors, markets should be happy with it here, too, as gridlock reduces the risk of sweeping change and the resulting unintended consequences.

## US ECONOMIC GROWTH STILL ROBUST

While politicians keep debating, the US economy keeps growing. Q2 GDP grew 2.6% annualized in the first estimate, accelerating from Q1's revised 1.2%. Residential investment dipped -6.8% after a strong Q1—detracting -0.27 percentage point from Q2 GDP—but other pure private sector components compensated. Personal consumption expenditures (PCE) accelerated to 2.8%, adding 1.93 percentage points and business investment increased 5.2%, contributing another 0.64 percentage point, led by a 116.7% jump in mining and oilfield investment. All told, "core" GDP—PCE, business and residential investment—rose 2.3%, in the upper end of its range since 2014. While Q2 GDP is backward-looking, it shows the economy remained strong heading into the second half.

More forward-looking data suggests Q3 is off to a good start. The Institute for Supply Management's June manufacturing purchasing managers' index (PMI) rose 2.9 points to 57.8, indicating broadening expansion. New Orders rose 4.0 points to 63.5—today's orders are tomorrow's production. June's ISM non-manufacturing PMI rose half a point to 57.4, with New Orders rising 2.8 points to 60.5. The Conference Board's June Leading Economic Index (LEI) accelerated to 0.6% m/m from 0.2% previously, marking its 10th straight rise. Not only are US economic fundamentals likely to remain firm, but since LEI's 1959 inception, no recession has begun while the index was high and rising. Some have noted yield curve flattening as a concern, noting slower loan growth and money supply, but this is typical heading into the latter stages of the market's cycle. While these might point to slower growth, they aren't contractionary.

With 286 S&P 500 companies reporting, Q2 earnings growth is expected to be 9.1% y/y—another solid increase and ahead of expectations. Mid-June estimates, before Q2 reporting season began, were for 6.5%. Energy's 322.8% growth skewed headline earnings, but even without it, Q2 earnings excluding Energy still rose 6.8%, up from 3.5% in mid-June. Moreover, 10 of 11 sectors' earnings grew (Consumer Discretionary's fell 1.0% y/y). Corporate America's health is broad-based.

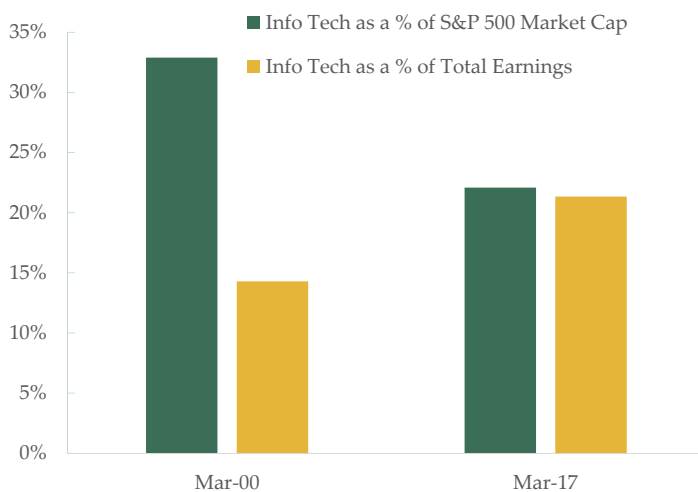
<sup>iv</sup> Source: FactSet, as of 6/30/2017. S&P 500 total return, 6/30/2017 – 7/31/2017 and 12/30/2016 – 7/31/2017.

## FACEBOOK AND GOOGLE AND “FANGS”

When media outlets are quick to sound an alarm, it usually signals a very short-term trend. When Jim Cramer first dubbed Facebook, Amazon, Netflix and Google the “FANG” stocks in 2013, the world barely noticed. “FANG” occasionally popped up on CNBC or niche websites like Seeking Alpha afterward. However, that all changed on June 9, when US Tech stocks had a rough day and those four led the way down. Two days later, when Netflix subbed out for Microsoft and Apple, the chatter jumped from CNBC to local newspapers and USA Today’s Money page in a blink. We find these quick sentiment swings reassuring. The faster media reports on this, the faster it all gets priced in.

We are still bullish on big Tech—both US and non-US. Unlike the Dot Com era, Tech performance has been supported by strong earnings (Exhibit 7). Additionally, Tech was among Q1’s top sectors, positioning it for a big inaugural-year second half. The world’s biggest Tech firms are solid mega-caps, with strong balance sheets, a global customer base, well-known brands and diverse revenue streams — all the qualities investors typically prefer in maturing bull markets.

### Exhibit 7: Info Tech Has Been Supported By Strong Earnings



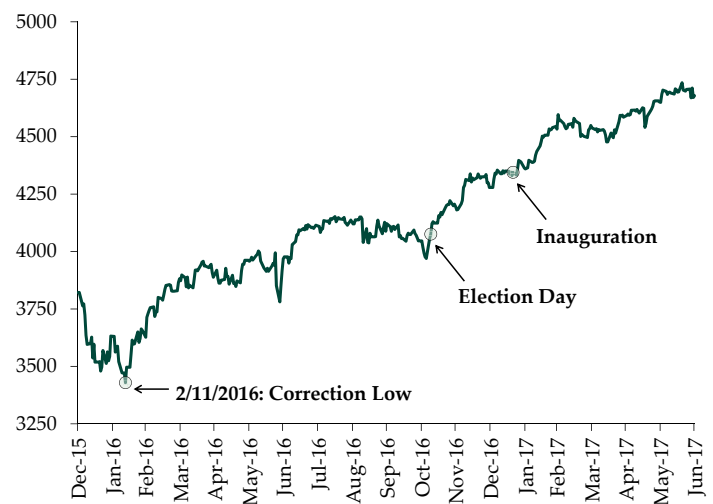
Source: FactSet as of 3/31/2017. Calculated as weighted average market cap of all S&P 500 companies vs weighted average market cap of S&P 500 companies in the Information Technology sector, and last twelve months net income of all S&P 500 companies vs. last twelve months net income of S&P 500 companies in the Information Technology sector.

## THE NOT-A-TRUMP RALLY

As we discussed in our Q1 2017 Reviews, we never believed there was a Trump Rally. Rather, we expected falling uncertainty to boost stocks after the election regardless of who won.

Trump Rally discussion misses a simple point: The rally began in February 2016, when the correction ended (Exhibit 8). The phrase “Trump Rally” was largely coined by the media – as they needed a new narrative to explain markets’ post-election performance. Additionally, a Trump Rally would not be able to explain the outperformance of non-US stocks.

### Exhibit 8: Not a Trump Rally



Source: FactSet, as of 7/14/2017. S&P 500 Total Return Index, 12/31/2015 – 6/30/2017.

## MEDIA KEEPS LOSING CREDIBILITY

The media is clearly aiming for short-term impact, and it is working. Ratings and readership are up. However, we suspect it isn’t a great long-term strategy, as their success comes at the expense of trustworthiness.

Media is an entertainment business. Trump’s cabinet appointees received plenty of attention for occasional confirmation hearing slip-ups, but does anyone know what they have actually done? The information is readily available, but news outlets don’t report it — Policy reporting isn’t entertainment.

We don’t mean to attack media for this—they are clearly just playing to their chosen audience, as any entertainment business might. However, as we wrote last quarter, falling media credibility is bullish. Without the drag of political angst, animal spirits can thrive.



# Non-US DEVELOPED COMMENTARY

## EUROPEAN LEADERSHIP

Six months in, the leadership rotation we expected entering 2017 has materialized, with non-US stocks leading. While many seemingly presume this will prove fleeting, we expect non-US leadership to last.

While uncertainty is falling in the US, it fell more in Europe, where fears of euroskeptic populists gaining power and splintering the eurozone or EU have largely faded. After Dutch voters rejected nationalist firebrand Geert Wilders and his Freedom Party in March, French voters rejected far-right Marine Le Pen and her Front National party—first in April and May’s presidential contest, then in June’s parliamentary vote. Instead, they elected pro-euro centrist Emmanuel Macron president and gave his En Marche movement a majority in the National Assembly. The Front National won just eight seats, too little to influence legislation.

Germany’s elections loom in September, Austria’s occur in October and Italy must vote by next May, however, associated uncertainty is already fading. In key German regional elections, Chancellor Angela Merkel’s Christian Democratic Union won handily, while the anti-euro Alternative for Deutschland (AfD) fizzled. The CDU’s former coalition partner, the pro-business Free Democrats, have also rebounded and could re-enter the Bundestag in September. With their fortunes rising and AfD fading, investors have overcome fears of German euroskepticism.

Austria’s coalition government collapsed in mid-May, putting elections there on the docket this year as well. After a tight Presidential election last year between a pro-euro and euroskeptic candidate, some fear an anti-euro government may yet attain power there. However, all three leading parties—even the far-right Freedom Party, whose anti-euro presidential candidate ran last fall—recently stated support for both the EU and euro. Moreover, the election is likely to yield a multi-party coalition with questionable stability and little ability to enact radical legislation.

Italy’s anti-establishment Five Star Movement also hit speedbumps, failing to make much headway in recent local elections. Perhaps reading the tea leaves from France, the Netherlands and Germany, party leadership backed off their pledge to hold a nonbinding referendum on euro membership, saying instead the threat was always just a bargaining chip to get less austerity. Either way, investors aren’t panicking anymore. Things could change by the time Italy schedules a vote, but for now the uncertainty is diminishing and euroskeptic politicians are out of fashion.

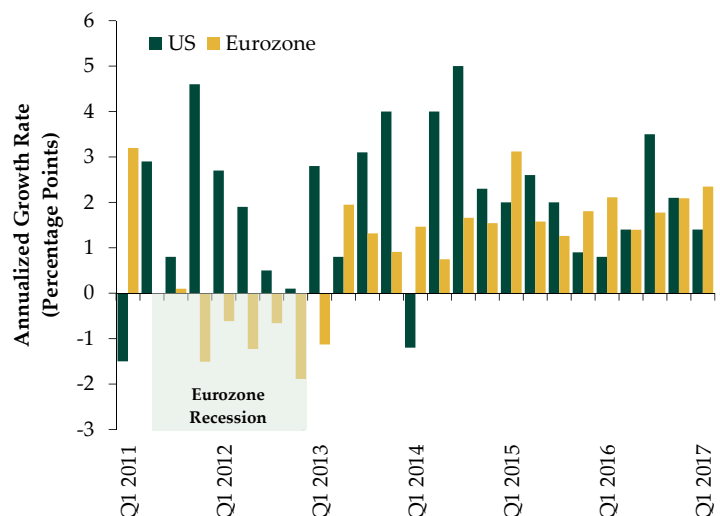
## ECONOMIC GROWTH IS ACCELERATING IN THE EUROZONE

With political uncertainty in Europe falling further in Q2, observers increasingly see the eurozone’s fundamental economic health. As a result, investors are already asking when will the ECB follow the Fed’s lead – dialing back Quantitative Easing and/or hiking rates. This speaks to warming sentiment and less nervousness—an unconscious understanding Europe’s economy is improving.

While sentiment is warmer, investors and pundits still underestimate the eurozone. As we wrote in our Q4 2016 Review & Outlook, this seems mostly tied to 2011 – 2013’s sovereign debt crisis. Unlike America and the UK, the eurozone had two recessions between 2008 and 2013. Sentiment’s typical bull market evolution—from pessimism to skepticism, skepticism to optimism and optimism to a euphoric peak—was therefore stunted in the eurozone relative to the United States. In the US today, fears of a new 2008 have faded into the background. After eight years of growth, few think any weak data point or widespread fear is a crisis in the making. But in the eurozone, even factors that aren’t necessarily bad—like low inflation—are commonly viewed as problematic. European sentiment is now where the US was in this bull market’s earlier years.

But investors’ fear underrates the eurozone’s economic reality. As of Q1 2017’s close, eurozone GDP had grown in 16 straight quarters. In the last eight, it matched the US’s 1.8% average annualized growth rate.

### Exhibit 9: Eurozone and US Annualized GDP Growth



Source: FactSet, as of 6/29/2017. Annualized GDP growth rates, Q1 2011 – Q1 2017.

Furthermore, while media has made much of the rebound in US earnings in recent quarters, far less noticed is the faster growth in European earnings. MSCI Europe Q1 earnings rose 30.7% y/y and are expected to rise 23.5% in 2017—both topping US growth rates.<sup>v</sup>

Looking ahead, European economic growth seems likely to persist, underpinning earnings growth. Eurozone purchasing managers' indexes—surveys tallying the breadth of growth—remain near six-year highs, buoyed by forward-looking new orders. Moreover, The Conference Board's Eurozone Leading Economic Index (LEI) is in a strong uptrend, showing broad growth.

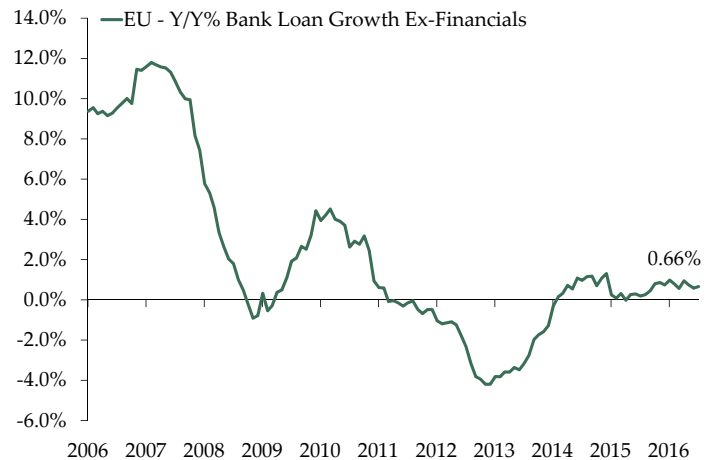
Eurozone LEI's strong rise is due partly to a widening yield curve spread, the difference between short- and long-term interest rates. The spread signifies lending profitability, and over a century of economic theory and data shows it is a very reliable forward-looking indicator. A steep yield curve encourages lending, boosting economic growth.

### THE CASE FOR EUROZONE FINANCIALS

While yield curve spreads in the five major eurozone nations (Germany, France, Italy, Spain and the Netherlands) are unchanged to up slightly this year, the US spread has flattened from 1.70 percentage points to 1.05.<sup>vi</sup> A flatter US yield curve doesn't mean economic problems loom, but it does suggest less profitable lending, making banks less likely to lend more.

Hence, we aren't surprised US loan growth has slowed. This time last year, it hovered between 7.5% and 8% y/y.<sup>vii</sup> This year, in the four weeks ended June 28, it averaged just 3.6% y/y.<sup>viii</sup> Eurozone loan growth is slower but accelerating, boosting money supply (Exhibit 10).

### Exhibit 10: Stabilizing and Positive Loan Growth



FactSet as of 6/30/2017.

One reason for this divergence: European banks are getting more comfortable with regulatory change, capital levels and rising yield spreads. Hence, senior loan officer surveys—measures of banks' willingness to extend credit—show EU banks loosening lately while US banks are tightening. Historically, differences in banks' willingness to lend correspond with regional leadership—sensible, given rising lending boosts money supply and future economic growth.

Exhibit 11 on the next page illustrates this. The yellow line shows eurozone stocks' relative returns against US stocks on a forward three-month average basis. The green columns show the percentage of eurozone banks reporting looser credit standards minus US banks reporting looser credit standards. When both are rising, eurozone banks are loosening standards more than US banks and eurozone stocks are outperforming. When both are falling, US banks are loosening more and US stocks are outperforming. As shown, a sizable and unusual gap developed in recent years. We think this is bullish for eurozone stocks—and banks specifically.

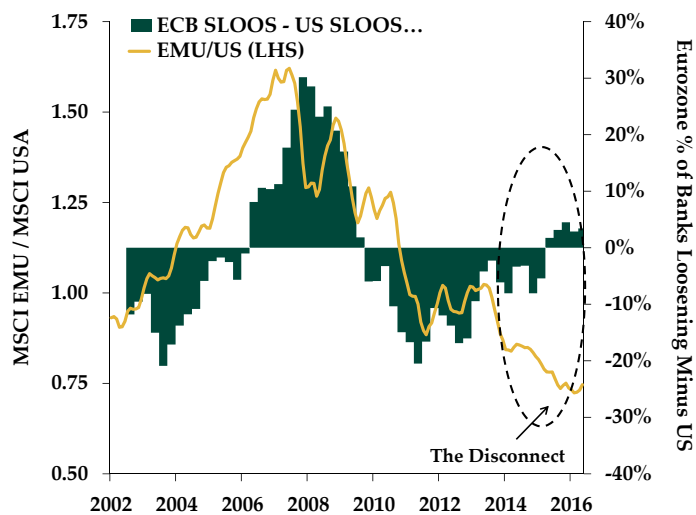
<sup>v</sup> Source: FactSet, as of 7/17/2017.

<sup>vi</sup> Source: FactSet, as of 6/29/2017.

<sup>vii</sup> Source: Federal Reserve Bank of St. Louis, as of 7/10/2017.  
US total loan growth at year-over-year rates, four-week moving average, 12/31/2015 – 6/28/2017.

<sup>viii</sup> Ibid.



**Exhibit 11: Banks' Willingness to Lend Correlates with Outperformance**

Source: ECB, Federal Reserve, FactSet, as of 5/10/2017.

More importantly, there is still room for uncertainty to fall around eurozone banks. Investors have long feared big regulatory shifts and weaker capital ratios. Yet those features are vestiges of 2008 and the sovereign debt crisis, and are long known now. The time to buy is when the sentiment on a category is overly dour, and we think that is true of eurozone banks today.

Many large, well-capitalized eurozone banks dominate their country of domicile. Italy is a good example. Banca Intesa in Italy, which just got a great deal from the Italian government to take the viable loans of two troubled Venetian lenders at basically no cost. In Spain, Banco Santander, which had €1.5 trillion in assets before it raised capital and bought failing Banco Popular's €147 billion in good assets.<sup>ix</sup> These big banks are in sound shape and are part of national oligopolies—these mergers boost their positions even more. That is bad for competition but great for shareholders, as these firms have more pricing power, better cost structures and more diverse revenue streams. Legacy issues at smaller banks in Italy and Spain that policymakers would like to clean up are opportunities for these firms. That investors still mostly see them as risks shows the wide gap between sentiment and reality.

<sup>ix</sup> Source: 1st Quarter 2017 Quarterly Report, Grupo Banco Popular. <http://www.grupobancopopular.com/ES/AccionistasInversores/Documents/Quarterly%20Report%201Q17.pdf>

**UK POLITICAL UNCERTAINTY HAS ROOM TO FALL**

Political uncertainty temporarily rose in the UK in Q2, but should fall over the foreseeable future as the post-election dust settles and politicians get on with Brexit negotiations.

When Prime Minister Theresa May called the snap election in April, her goal was to increase her majority to strengthen her hand in Brexit negotiations, and the Tories' wide polling lead seemed to support her decision. When she instead lost her majority, forcing her to form a minority government with the support of Northern Ireland's Democratic Unionist Party (DUP), it raised a myriad of questions. Would the government's Brexit negotiation tactics change? Did a so-called hard or soft Brexit become more likely? What would become of key campaign pledges, including energy price caps?

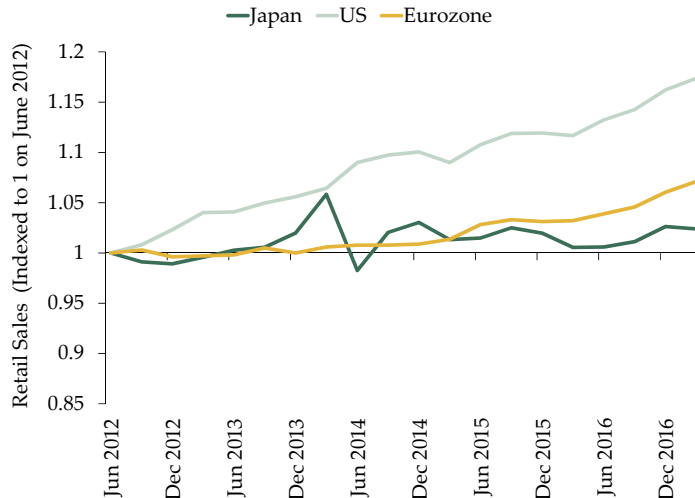
In the furor, we think investors ignored the elephant in the room: political gridlock. May needs her entire party's support—not to mention the DUP's—to pass major legislation, and the Tories are far from united. With both backbench and cabinet rebellions increasingly commonplace under her leadership, the likelihood of Parliament passing radical legislation that could alter property rights or otherwise create winners and losers—which markets generally dislike—is far lower. Already, May has climbed down from some of her more aggressive proposals, including energy price caps, the so-called dementia tax and the end of the pension triple lock. Investors might not consciously fathom political gridlock's benefits, but markets usually feel relief from lower legislative risk and should rally from the subconscious realisation that the risk of major change is low.

In regards to Brexit, May invoked Article 50 of the Lisbon Treaty—launching the formal EU withdrawal process—in March. Whilst the elections delayed official negotiations, both sides made their starting positions clear. May announced her willingness to withdraw from the EU's single market in order to limit immigration, while European leaders signaled their commitment to preserving EU citizens' rights in the UK and pressured several financial functions to move from London to the EU. Our views are unchanged: It is far too early to assess whether Brexit will prove a net positive, negative or neutral for the UK economy. For markets, what matters most is that the negotiations are slow and public, reducing potential surprise power. The more public the debate is—and the more politicians and pundits discuss all potential scenarios, however far-fetched—the less likely it is for Brexit to produce a negative shock.

## JAPAN GROWTH REMAINS WEAK

In Japan, growth remains weak. While exports have shown some recent improvement, domestic demand has remained muted, consistently lagging developed peers since early 2015 (Exhibit 12). Needed economic reforms haven't materialized, and monetary policy remains questionable. However, sentiment toward Japan has deteriorated, suggesting expectations are approaching this reality.

### Exhibit 12: Domestic Demand Remains Muted



Source: FactSet as of March 2017.

In years past, pundits presumed the Bank of Japan's huge quantitative easing program and the government's fiscal policy would cause growth on their own. Foreign investors rushed to buy in 2012 and 2013 with high hopes based on these and Prime Minister Shinzo Abe's economic reform talk. Meanwhile, Abe's popularity has been hit by a favoritism scandal involving government funding for a private school. Partly as a result, the Liberal Democratic Party performed poorly in early July's Tokyo elections, leading many investors to question whether Abe's political capital is falling. This is depressing sentiment, which increases the risk even weak economic data or small reforms positively surprise, boosting Japanese stocks.

As we believe the sentiment is catching up with the reality, we slightly pared our significant underweight to mitigate the risk of Japan outperforming, adding export-oriented firms we expect to benefit from rebounding global trade.



# EMERGING MARKETS COMMENTARY



## CHINESE MAINLAND SHARES GET SYMBOLIC BOOST

On June 20, MSCI announced plans to include mainland Chinese stocks—A-shares—in its Emerging Markets (EM) and All-Country World Indexes (ACWI) starting in May 2018. This was the fourth time MSCI considered adding A-shares to the indexes, with many in the financial press watching the announcement closely. When it came, some presumed this was a critical move. Perhaps many years from now, we will look back on it as a key step in the internationalization of China's domestic equity markets. But for now, the change is small and mostly symbolic—it doesn't render China's prospects more or less attractive in the next 12 – 18 months.

**...China lobbied for EM classification for years on the hope mainland shares' inclusion would attract capital from fund managers and institutional investors with MSCI EM-based mandates.**

Chinese stocks have been in the MSCI Indexes for roughly two decades, but most stocks listed in mainland China haven't been included. Because of China's capital controls, large Chinese companies have three main share classes: H-shares (traded in Hong Kong), A-shares (traded in Shanghai and Shenzhen) and B-shares (traded in foreign currency in Shanghai and Shenzhen, and far less common). Foreigners have long had access to H- and B-shares, and MSCI has included these in its indexes. However, these share classes represent only a fraction of China's equity market capitalization. There are only 222 H-shares (with a market cap of \$745 billion)<sup>x</sup> versus 3261 A-shares (with a market cap around \$7 trillion).<sup>xi</sup> Considering A-shares' total market cap, many thought A-shares' inclusion would be a significant development for all managers and index funds benchmarked against the MSCI EM, driving a vastly increased role for China in MSCI's heavily used indexes.

For its part, China lobbied for EM classification for years on the hope mainland shares' inclusion would attract capital from fund managers and institutional investors with MSCI EM-based mandates. Moreover, the inclusion would serve as international recognition of its market liberalizations in recent years—much like last year's decision by

the IMF to include the yuan in its Special Drawing Right currency basket. Until now, MSCI declined, citing restrictions on investment, regulators' tendency to arbitrarily halt trading of volatile stocks for long stretches, and rules limiting index funds' stock sales.<sup>xii</sup> Now, however, it seems China has done enough to win entry.

## STOCK CONNECT

In recent years, China has allowed many more foreign investors to purchase domestic stocks via the Shanghai Stock Connect. This program, launched in November 2014, allows global investors to access select A-shares via a clearing and order-routing connection with the Hong Kong Exchange. After MSCI declined to add A-shares last June, China's securities regulators announced the sister access channel—the Shenzhen Stock Connect—would launch in November, greatly increasing the number of eligible stocks. That said, the stock connect still has quotas that cap the amount of in-and-outflows from Shenzhen and Shanghai. Moreover, trading halts and suspensions are common—about 8% of A-shares were halted as of May.<sup>xiii</sup>

## MINOR CHANGE

Hence, MSCI added only 222 Chinese A-shares to the gauge, a fraction of the total. China was already 28% of the MSCI EM Index; after the change takes effect, it will rise to 28.73%. China was 3.14% of the ACWI. A-shares will boost this by a microscopic 0.1%. Moreover, because of the stock connect's strict caps, MSCI is using a very gradual, two-pronged implementation approach that is scheduled to complete next year. However, it is conceivable that if China lifted the stock connect's quotas, MSCI could speed up implementation and possibly consider upping China's weight.

Because of the move's small scope, we don't expect A-shares to gain much from the change. In addition, index reclassifications usually don't have a meaningful impact. MSCI moves slowly, announcing its decisions a year before they take effect, giving markets plenty of time to price in the change before index funds and other managers start buying. Markets discount all widely known information, and MSCI's move is widely known.

<sup>x</sup> “List of H Share Companies (Main Board),” Hong Kong Exchanges and Clearing, updated 6/30/2017. [https://www.hkex.com.hk/eng/stat/smstat/chidimen/cd\\_hmb.htm](https://www.hkex.com.hk/eng/stat/smstat/chidimen/cd_hmb.htm)

<sup>xi</sup> “Your ETF Isn't What You Think It Is,” James Mackintosh, Wall Street Journal, 6/19/2017. <https://www.wsj.com/articles/your-etf-isnt-what-you-think-it-is-1497889558>

<sup>xii</sup> “MSCI Forgets Its Doubts About China,” Christopher Balding, Bloomberg, 6/21/2017. <https://www.bloomberg.com/view/articles/2017-06-21/msci-forgets-its-doubts-about-china>

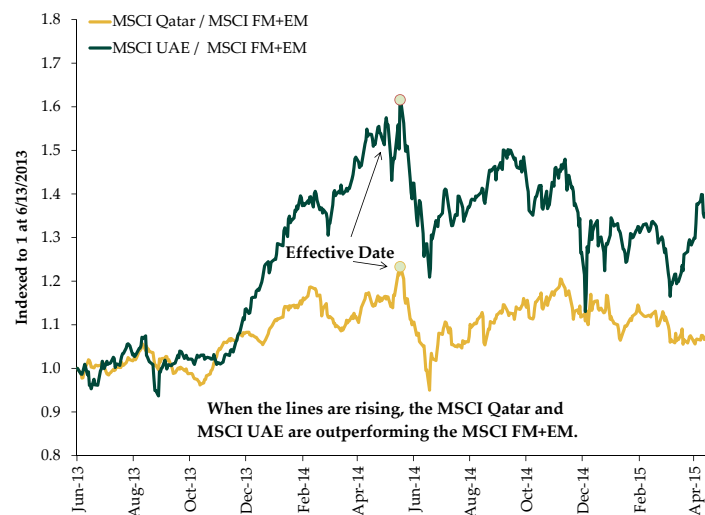
<sup>xiii</sup> “MSCI China Bulls, Prepare to Be Disappointed,” Nisha Gopalan, Bloomberg, 6/15/2017. <https://www.bloomberg.com/news/articles/2017-06-15/msci-china-bulls-prepare-to-be-disappointed>

## INDEX MOVES AND STOCKS

MSCI announced the United Arab Emirates (UAE) and Qatar's upgrade from Frontier to Emerging markets in June 2013. Between then and May 2014, when the change took effect, both outperformed the MSCI Frontier Emerging Markets Index, which combines their past and present benchmarks. But after reclassification, they lagged. Israel, tapped for an upgrade to Developed in 2009 and officially added to the MSCI World Index in 2010, led the ACWI before the effective date and lagged after. Recent MSCI EM inductee Pakistan outperformed the MSCI Frontier Emerging Markets Index after MSCI announced the upgrade on June 14, 2016, but has lagged since the change took effect in June.

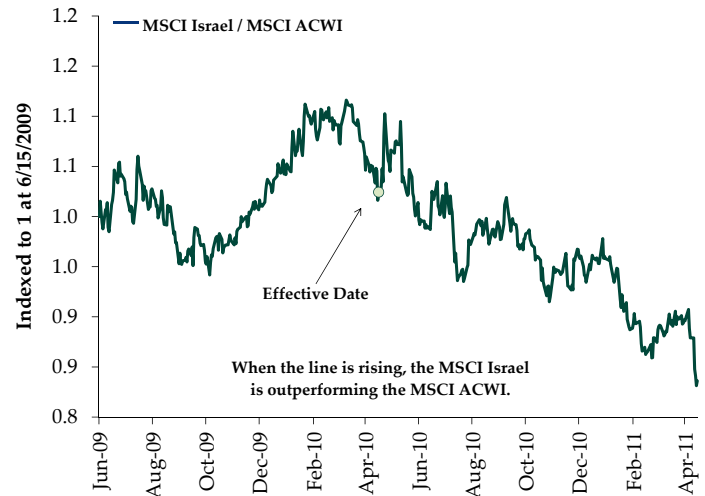
All this suggests investors tend to bid up shares in upgraded countries before they are in new indexes, front-running the index funds. However, as Exhibits 13-15 show, this isn't a timing tool. Reclassified countries don't uniformly start outperforming as soon as MSCI announces its decision, lead all the way until the change takes effect, then lag. It is much more nuanced, and the timing of their leadership shifts is inconsistent. Since forthcoming index changes are only one small variable influencing demand, unpredictable reactions shouldn't surprise. Thus, MSCI's A-share announcement isn't a reason to try to front-run the change. Political and regulatory risks persist, and A-shares tend to be lower-quality and more value-oriented, which typically underperform in maturing bull markets.

### Exhibit 13: MSCI UAE and MSCI Qatar vs MSCI Frontier Emerging Markets



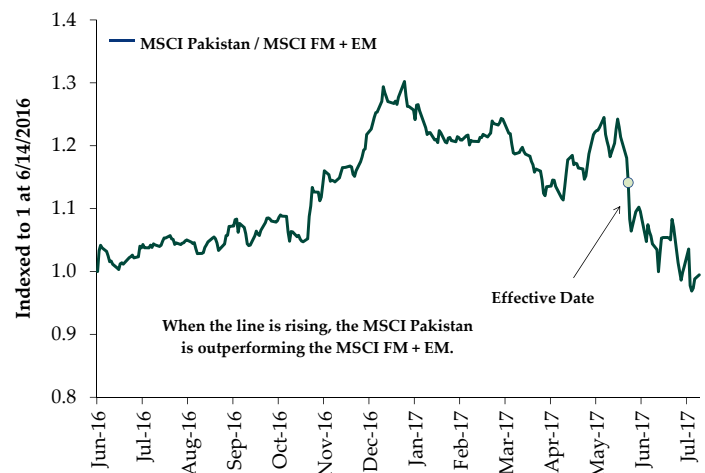
Source: FactSet, as of 6/23/2017. MSCI UAE, MSCI Qatar and MSCI Frontier Emerging Market Index returns with net dividends, (in USD) 6/13/2013 – 4/30/2015.

### Exhibit 14: MSCI Israel vs MSCI All Country World Index



Source: FactSet, as of 6/23/2017. MSCI Israel and MSCI All Country World Index returns with net dividends, (in USD) 6/15/2009 – 4/30/2011.

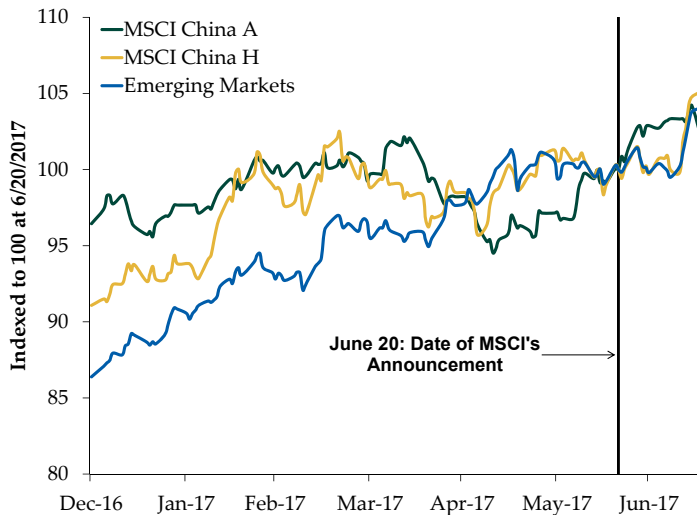
### Exhibit 15: MSCI Pakistan vs MSCI Frontier Emerging Markets



Source: FactSet, as of 6/23/2017. MSCI Pakistan and MSCI Frontier Emerging Market Index returns with net dividends, (in USD) 6/14/2016 – 7/17/2017.

While it has been only over a month since the announcement as of this writing (August 9), it is worth noting markets have barely reacted to the news thus far. Both the MSCI Emerging Markets and MSCI China H-Share Index have outperformed the MSCI China A-Share Index since the announcement (Exhibit 16).

#### Exhibit 16: No Big Bang From MSCI Inclusion



Source: FactSet, as of 7/18/2017. MSCI China A and MSCI China H Indexes with gross dividends and MSCI Emerging Markets Indexes with net dividends (in RMB).

More fundamentally, the idea that more index funds purchasing mainland stocks will boost returns misses a crucial feature of markets. In an auction marketplace, price movement varies with buyers' eagerness to bid up shares, not how many are bidding. Moreover, MSCI's move affects so few Chinese companies that even if adding participants mattered, little additional buying would occur. MSCI's decision is backward-looking—a reaction to (mostly incremental) reforms markets were already aware of. While China still has a strong economy with growing investment opportunities, EM classification doesn't alter the backdrop.

#### BRAZIL - POLITICAL SCANDAL AND COMMODITY DEPENDENCE LIMIT PERFORMANCE

Brazilian stocks participated in the Emerging Markets surge that began 2017, rising 10.4% in Q1—just slightly trailing the MSCI Emerging Markets' (EM) 11.4%. Yet Q2 was a different story, as the Car Wash corruption investigation ensnared still more politicians—including sitting President Michel Temer—and the commodity countertrend that aided Brazil in Q1 seemingly died out. Hence, the MSCI Brazil fell -6.7% in Q2—trailing the MSCI EM by 12.9 percentage points.<sup>xiv</sup> While underperformance of this magnitude may not repeat in the immediate future, we expect commodity price headwinds to continue negatively affecting Brazil. Meanwhile, political turmoil likely limits needed economic reforms. Brazilian markets look poised to underperform, in our view.

Operation Car Wash—the more than three-year old investigation into Brazilian political corruption—continues to dominate Brazil. The investigation toppled Rousseff last year, and shortly after quarter end, Judge Sérgio Moro convicted Rousseff's mentor and predecessor, Luiz Inácio "Lula" da Silva, of accepting bribes. (Lula is out of jail, pending appeal.) Lula is a huge political figure in Brazil and early polls had him leading in next year's presidential elections. But Lula wasn't the most significant person embroiled in scandal in Q2. Current President Michel Temer was.

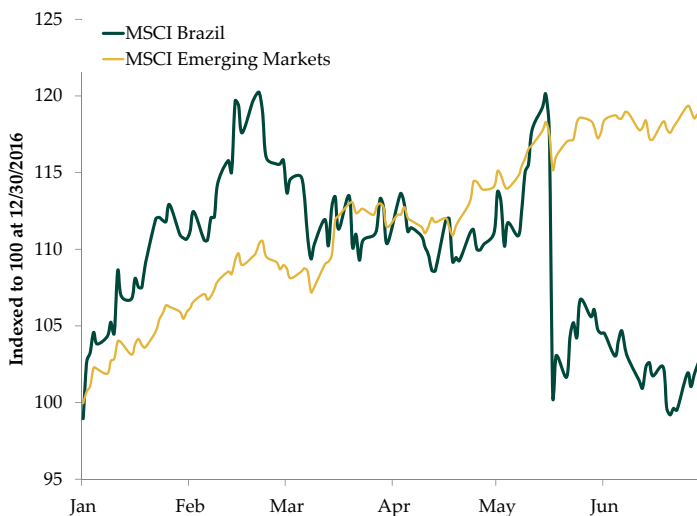
<sup>xiv</sup> Source: FactSet, as of 7/17/2017. MSCI Brazil returns with net dividends (in USD), 3/31/2017 – 6/30/2017.

## REFORM AGENDA BOGGED DOWN

In May, Brazilian newspaper *O Globo* reported Joesley Batista—the head of JBS, the world’s largest meatpacking firm—secretly recorded Temer endorsing a 5 million reais (approximately \$1.5 million USD) bribe to former Lower House Speaker Eduardo Cunha in exchange for Cunha’s silence on other politicians’ corruption. Besides this, Temer allegedly accepted \$152,000 in bribes from Batista, with the promise of \$11 million more to come. Investigators also accuse Temer of arranging millions in illicit donations to his Brazilian Democratic Movement Party and more charges may be forthcoming.

This all contributed to Brazil’s big underperformance, as investors’ hopes for economic reforms seem to rest on shaky ground. After newspapers reported initial allegations against Temer, Brazilian stocks fell -14.7% on May 18.<sup>xv</sup> While markets rebounded some thereafter, at quarter-end the MSCI Brazil was up only 3.0%—far behind the MSCI Emerging Markets’ 18.4% rise.<sup>xvi</sup> (Exhibit 17 on the next page) To cap it all off, Brazil’s prosecutor-general filed charges against Temer in late June, citing the taped conversation between him and Batista.

## Exhibit 17: Brazil’s Wild Ride



Source: FactSet, as of 7/17/2017. MSCI Brazil and Emerging Markets returns with net dividends in US dollars, 12/30/2016 – 6/30/2017, rebased to 100 on 12/30/2016.

However, Car Wash hasn’t drowned Temer’s political fortunes. The case could only go to trial only if a two-thirds majority of Congress’ 513-seat Lower House approves. Only 227 votes were ultimately cast

<sup>xv</sup> Source: FactSet, as of 7/25/2017.

<sup>xvi</sup> Source: FactSet, as of 7/17/2017. MSCI Brazil and MSCI EM returns with net dividends (in USD), 12/30/2016 – 6/30/2017.

against him in early August, well short of the two-thirds majority required, allowing him to skirt trial and remain in office for the time being.<sup>xvii</sup>

Many still have high hopes political change will boost Brazil’s economy. Although Temer’s troubles render structural reforms difficult, recent labor reform enactment suggests some progress. In July, Brazil’s Congress overhauled 70-year-old labor laws to allow a more flexible workforce, easing hiring conditions and reducing union power. While encouraging, labor reform was supposed to be a small victory before the bigger fight over social security. It is unclear whether Congress and Temer can advance such contentious legislation given his unpopularity and the continued political turmoil Car Wash seems to churn up near daily. Although Temer likely has the votes to stay in power for now, more charges from the prosecutor-general could bog him down in myriad votes, draining what is left of his political capital.

## ECONOMIC HEADWINDS

Regardless of Temer’s status and Congressional ability to advance reform, Brazil’s commodity-heavy economy is suffering amid the global commodity downturn. While Brazil’s GDP grew 1.0% annualized in Q1, this was the first positive reading after eight straight quarters of contraction.<sup>xviii</sup> The growth was driven by record soybean and corn harvests, as well as rising inventories. Agricultural output rose 13.4%, its fastest rate in over two decades, contributing three-quarters of Q1’s GDP growth. This is unlikely to prove sustainable. Industrial output provided the rest, but that was due mostly to utilities. Services were flat. Consumption fell -0.1% and business investment dropped -1.6%, showing domestic demand remains quite weak.

Business surveys point to a still struggling economy. The composite PMI—combining manufacturing and services sectors—fell to 48.5 in June after managing to stay barely above 50 the prior two months.<sup>xix</sup> Levels below 50 indicate contracting business activity. Banks are cautious over lending after non-earmarked (not government-

<sup>xvii</sup> “Brazil’s Temer Has the Votes to Crush Corruption Charges,” Simone Preissler Iglesias, Bloomberg, 7/12/2017. <https://www.bloomberg.com/news/articles/2017-07-12/brazil-s-temer-said-to-have-votes-to-crush-corruption-charges-j517bii9>

<sup>xviii</sup> Source: Trading Economics, as of 7/25/2017.

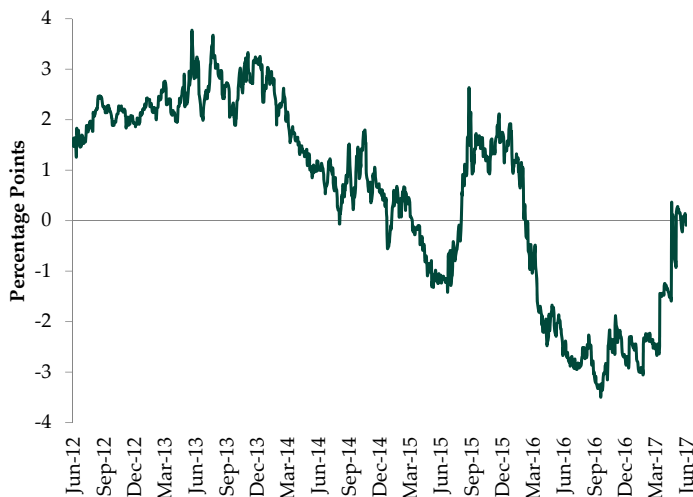
<sup>xix</sup> “Brazil defaults hit record in May as corporate woes linger,” Guillermo Parra-Bernal and Marcela Ayres, Reuters, 6/28/2017. <http://www.reuters.com/article/brazil-economy-lending-idUSL1N1JP0LZ>



directed and unsubsidized) loans in default over 90 days rose to 5.9% in May. This is one factor driving weak private sector lending, which has fallen -12% through May since a recent high in December 2015.<sup>xx</sup>

On the positive side, inflation has fallen from 10.7% in January 2016 to 3.0% in June, which allowed Brazil's central bank to aggressively cut interest rates. The last rate cut on July 26th brought interest rates down to 9.25% - the lowest in recent years. While a significant economic recovery is still a ways off, decreasing inflationary expectations and potentially deeper than previously expected interest rate cut cycle should provide relief for Brazil's banking system (Exhibit 18).

#### Exhibit 18: Brazil Yield Curve Spread



Source: FactSet, as of 7/17/2017. Brazil 10-Year Sovereign Bond Yield minus Brazil Overnight Target Selic Rate, 6/29/2012 – 6/30/2017.

#### BRAZIL LIKELY CONTINUES UNDERPERFORMING

Underlying Brazil's weak economy and markets are stagnant commodity prices. Brazil is pumping record amounts of oil—1.5 million barrels a day, 26% higher than its previous 2010 peak—and is now the second largest non-OPEC supplier after the US.<sup>xxi</sup> But rising supply is undermining oil prices and profits. With the global oil glut unlikely to end soon, a sustained rally in Brazil's commodity-heavy stock market is unlikely. Similarly, iron ore production in Brazil and Australia—which together control around 80% of world iron

trade—is rising, keeping prices in check.<sup>xxii</sup> Australian shipments by volume are up 12% y/y and while Brazil's shipments are down from last year, Brazil's largest miner Vale is ramping up the world's largest iron ore mine this year; export growth is likely to follow.<sup>xxiii</sup> China is on track to import record amounts this year—breaking last year's record, topping one billion tons—but Chinese inventories are also reaching record levels, which could spell trouble down the road if steel demand moderates.<sup>xxiv</sup> Given Brazilian stocks' commodity price sensitivity and supply overhangs in key markets, we don't expect outperformance anytime soon.

Brazil is simultaneously undergoing historic recession and political upheaval, which entails great risk, but also has the potential to be transformative. If Brazil is able to clean house politically and persist in structural economic reform, the nation might well finally live up to its promise as the "Country of the Future." However, we still see this as a distant prospect with many obstacles ahead. For investors in the here and now, the political uncertainty, unfavorable fundamental economic backdrop and commodity orientation outweigh the likelihood that Brazil soon emerges as an Emerging Market powerhouse.

#### SOUTH AFRICA RECESSION AND POLITICS

South Africa officially entered recession in Q1, though its economy has struggled for the past couple years. Political uncertainty has also gripped the country, with President Jacob Zuma currently involved in a corruption scandal. Given a struggling, commodity-reliant economy and political instability, South Africa's near-term prospects look dim.

Q1 GDP contracted -0.7% annualized after falling -0.3% in Q4.<sup>xxv</sup> While this fits one technical definition of recession—two consecutive quarters of economic contraction—the economy has been weak for

<sup>xxii</sup> "Fact check: Andrew Forrest exaggerating big miner influence over iron ore," Staff, Australian Broadcasting Corporation, 6/3/2015. <http://www.abc.net.au/news/factcheck/2015-06-03/fact-check-australia-share-iron-ore/6483632>

<sup>xxiii</sup> Source: "Bearish Outlook despite Australia's Iron Ore Export Record," Annie Gilroy, Market Realist, 6/29/2017. <http://marketrealist.com/2017/06/australias-iron-ore-exports-set-another-record-price-outlook-remains-bearish/>

<sup>xxiv</sup> "One Billion Tons of Iron Ore Headed for China as Miners Jump," Jasmine Ng, Bloomberg, 7/13/2017. <https://www.bloomberg.com/news/articles/2017-07-13/one-billion-tons-of-iron-ore-are-headed-to-china-s-mills-in-2017>

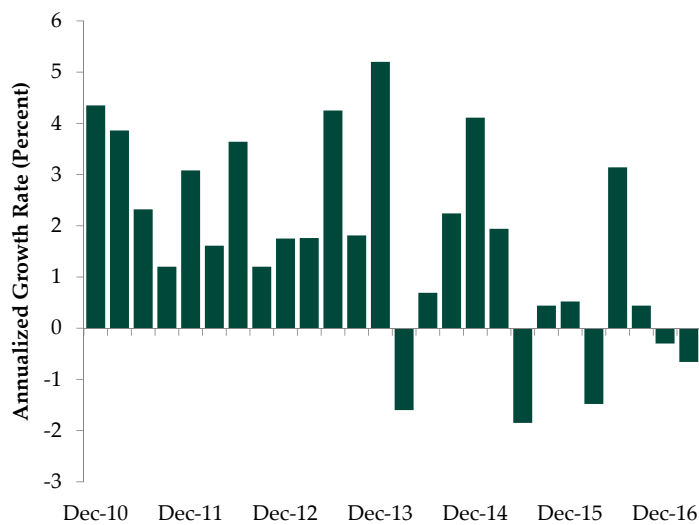
<sup>xxv</sup> Source: FactSet, as of 7/24/2017.

<sup>xx</sup> Source: Trading Economics, as of 7/25/2017.

<sup>xxi</sup> "OPEC Gets Another Supply Headache From Surging Brazilian Exports," Sabrina Valle, Bloomberg, 6/23/2017. <https://www.bloomberg.com/news/articles/2017-06-23/opec-gets-another-supply-headache-from-surging-brazilian-exports>

a while. GDP declined in four of the past eight quarters and growth has slowed dramatically since 2010 – 2012, when commodity prices were far stronger (Exhibit 19).

**Exhibit 19: South African GDP Since Q4 2010**



Source: FactSet, as of 7/24/2017.

In Q1, household (-2.3%) and government (-1.0%) spending contracted, as did most sectors.<sup>xxvi</sup> Only agriculture and mining grew—and both fell in Q4 2016.<sup>xxvii</sup>

More recent data highlight the economy's struggles. May manufacturing production dropped -0.3% m/m (-0.6% y/y), the fourth monthly contraction of the year.<sup>xxviii</sup> Mining production also slipped -0.2% m/m in May, compounding April's -1.4% slide.<sup>xxix</sup> The Standard Bank South Africa PMI, which reports on South African private sector business conditions, fell to 49.0 in June—implying a majority of responding firms contracted.<sup>xxx</sup> While just the first contraction since August 2016, South African PMI has hovered around 50 for the past several months, suggesting growth is broadly tepid. Heavy industry sectors like Manufacturing and Mining aren't the biggest parts of the South African economy—they are 13% and 8% of GDP, respectively—they are still sizable segments overall.<sup>xxxi</sup> Mining alone employs almost half a million individuals—nearly 5%

of total South Africans with formal, non-agricultural jobs.<sup>xxxii</sup> With headwinds from the global commodity supply glut still present, South Africa's struggles probably aren't going away. Even if its recession is short-lived, robust growth isn't likely ahead, barring a major recovery in the mining industry.

## POLITICS

President Zuma remains wrapped up in a scandal involving his ties with the Gupta business family, which has interests in air travel, energy, technology and media.<sup>xxxiii</sup> This has hampered the government's efforts to push through reform and make personnel appointments. However, Zuma has proven resilient to damaging political controversy, and he currently looks unlikely to be ousted from power for the foreseeable future.

To appease political allies—particularly after the controversial dismissal of former Finance Minister Pravin Gordhan—the Zuma administration recently announced a new mine ownership charter. This will force mining companies to restructure their firms so black ownership share—through the Black Economic Empowerment (BEE) program— from 26% to 30% within 12 months. The government also announced requirements on employment equity—i.e., racial and gender quotas for management. While the charter has subsequently been suspended until it is ruled on by the courts, the haphazard government actions aren't a positive for mining firms working in South Africa or the country at large. Another recent example of such haphazard policy making is the country's anti-corruption watchdog—the public protector's office—proposing changing the central bank's mandate to include “balanced and sustainable economic growth” and come under the government's power rather than remaining largely independent and focused solely on inflation. Thankfully, the central bank's mandate doesn't seem likely to change at this point, but future populist actions could be in the works as Zuma attempts to maintain his grip on power, and the rampant political uncertainty is another reason to be pessimistic about South Africa's prospects.

<sup>xxvi</sup> Source: *Ibid.*

<sup>xxvii</sup> Source: *Ibid.*

<sup>xxviii</sup> Source: *Ibid.*

<sup>xxix</sup> Source: *Ibid.*

<sup>xxx</sup> Source: Standard Bank and IHS Markit, as of 7/24/2017.

<sup>xxxi</sup> Source: Statistics South Africa, as of 7/12/2017. “Gross Domestic Product (GDP), 4th Quarter 2016.”

<sup>xxxii</sup> Source: Statistics South Africa, as of 7/12/2017. “Mining Industry, 2015 (Report No. 20-01-02)”

<sup>xxxiii</sup> Source: BBC News, accessed on 7/13/2017. “The Guptas and Their Links to South Africa's Jacob Zuma,” published 11/2/2016. <http://www.bbc.com/news/world-africa-22513410>

**QATAR - BLOCKADE EXPOSES REGIONAL TENSIONS,  
BUT MARKET IMPACT LIKELY LIMITED**

A Saudi-led blockade on Qatar exposed escalating Middle East tensions in late Q2, but this is unlikely to have wider impact on markets. Saudi Arabia, Egypt, the United Arab Emirates and Bahrain cut diplomatic ties with Qatar June 5, expelling Qatari diplomats and citizens. The nations also implemented an embargo blocking air and land traffic, movement of people and goods, and commercial and financial relations, ratcheting up Mideast geopolitical pressure. The Saudi bloc issued Qatar an ultimatum with 13 demands for sanctions to be lifted, including curbing Iranian ties, ending support for the Muslim Brotherhood, closing a Turkish military base and shutting down the Al-Jazeera news network.<sup>xxxiv</sup> Qatar has yet to comply, while both Iran and Turkey—often at odds with the Saudi coalition’s regional aims—have lent support.

The goal of the blockade is to bring Qatar’s foreign policy in line with its traditional Mideast Sunni Islam allies’. Recently, Qatar has been inclined to play the role of a neutral intermediary among Persian Gulf nations. This has caused rifts with fellow Sunni nations, notably on matters related to Shia Muslim-majority Iran—Qatar and Iran share ownership of vast natural gas fields, making them commercial partners to some extent, while the remainder of the Sunni-led Gulf views Shiite Iran as a leading source of instability in the region.

**QATAR’S GLOBAL MARKET HEFT IS RELATIVELY SMALL**

The market impact so far has been largely limited. Qatar is down -8.5% since the announcement, versus the MSCI Emerging Markets’ flat returns.<sup>xxxv</sup> Most other regional indices were down only modestly. Oil rallied briefly though it quickly moved lower, potentially on investors’ thinking instability could lead to OPEC disagreements that may disrupt a coordinated production cut- the impact of which is overrated, in our opinion.

Qatar is small in Emerging Markets and world Energy markets. It is only 0.7% of the MSCI Emerging Markets Index and is a small Energy producer, amounting to 2% of global petroleum and other

liquids production.<sup>xxxvi</sup> Any ratcheting up of tensions is therefore likely to have only limited impact on global stock markets and Energy trading. Qatar is the world’s leading liquid natural gas (LNG) exporter, supplying 30% of global volumes.<sup>xxxvii</sup> But while global LNG trade is rising rapidly—thanks in part to US shale gas production and infrastructure buildout—it is still small relative to world Energy trade. LNG trade is 14.7% of crude oil exports when converted to British thermal units (BTUs).<sup>xxxviii</sup> And Qatar is less than a third of that.

On the other hand, the US has 11,000 troops stationed in Qatar’s Al Udeid Air Base, the US’s largest in the Mideast.<sup>xxxix</sup> If a crisis were to escalate, it could jeopardize US strategic operations there, including combat sorties against the Islamic State in Iraq and Syria. But by the same token, the US has every incentive to keep the situation from getting out of hand. US Secretary of State Rex Tillerson is now in direct talks with the parties to resolve the impasse.<sup>xl</sup> Besides LNG and the US’s Mideast military operations, Qatar is also critical to the world’s helium supply—25% of production in 2016—used in birthday balloons, but also needed for cooling MRI machine magnets and for making semiconductors, computer hard drives and rocket fuel.<sup>xli</sup> Production was temporarily disrupted in June but is back online again, albeit through a indirect and more expensive route to market via Oman.

<sup>xxxvi</sup> Source: US Energy Information Administration, *International Energy Statistics*, “Total Petroleum and Other Liquids Production 2017.” <https://www.eia.gov/beta/international/rankings/>

<sup>xxxvii</sup> Source: GIIGNL Annual Report 2017. [http://www.giignl.org/sites/default/files/PUBLIC\\_AREA/Publications/giignl\\_2017\\_annual\\_report\\_0.pdf](http://www.giignl.org/sites/default/files/PUBLIC_AREA/Publications/giignl_2017_annual_report_0.pdf)

<sup>xxxviii</sup> Source: BP Statistical Review of World Energy. <http://www.bp.com/en/global/corporate/energy-economics/statistical-review-of-world-energy.html>

<sup>xxxix</sup> “Qatar hosts largest US military base in Mideast,” Brad Lendon, CNN, 6/6/2017. <http://www.cnn.com/2017/06/05/middleeast/qatar-us-largest-base-in-mideast/index.html>

<sup>xl</sup> “U.S. foreign chief Tillerson arrives in Gulf for talks on Qatar crisis,” Jonathan Landay and Tom Finn, Reuters, 7/10/2017. <http://www.reuters.com/article/us-gulf-qatar-usa-idUSKBN19V0SU>

<sup>xli</sup> “How the Qatar Crisis Shook Up the World’s Supply of Helium,” Sarah Zhang, *The Atlantic*, 7/8/2017. <https://www.theatlantic.com/science/archive/2017/07/qatar-helium-production/532788/>

<sup>xxxiv</sup> “Gulf diplomatic crisis: Here are the 13 demands Arab nations have made of Qatar,” Staff, AP, 6/23/2017. <http://www.firstpost.com/world/gulf-diplomatic-crisis-arab-nations-send-list-of-13-demands-to-qatar-to-be-fulfilled-within-10-days-3736801.html>

<sup>xxxv</sup> Source: FactSet, as of 7/17/2017. MSCI Qatar, MSCI Emerging Market Index and MSCI World Index returns with net dividends, 6/6/2017 – 7/17/2017.

## POTENTIALLY NEGATIVE FOR ENERGY

Not too long ago, escalating Gulf geopolitical risks would have raised supply disruption fears and Energy prices. Now, because of strained government budgets among oil- and gas-dependent nations, instability could lead to looser adherence to recently extended OPEC-led production cuts.<sup>xlii</sup> OPEC infighting may weaken coordination and boost supply as member countries attempt to bolster regional standing, maintain independence and exert influence. For Qatar's part, playing to its natural gas strengths, the nation is planning to boost its LNG output by 30% over the next five to seven years, aided by Western Energy giants ExxonMobil, Royal Dutch Shell and Total.<sup>xliii</sup> Qatar is also somewhat financially insulated from the boycott with an amassed \$340 billion in foreign exchange reserves split between its central bank and sovereign wealth fund.<sup>xliv</sup> Qatar's nominal currency peg to the US dollar initially weakened following the blockade's announcement, but has since stabilized with government backing.<sup>xlvi</sup> Besides meeting any capital outflow calls, current reserves could also cover imports for over a decade.

A quick resolution may not be forthcoming if Qatar maintains its position with Iranian and Turkish backing, and some diplomatic cover from the US—Secretary Tillerson recently called the Qatari position “reasonable.”<sup>xlvi</sup> That said, Qatar could still concede to its neighbors' demands, as it did in 2014 when a similar diplomatic dispute arose. Despite its wealth, Qatar remains reliant on Saudi Arabia, specifically for food, 40% of which is imported. Either way—or if some compromise is eventually reached—the situation is having little effect on global equity or Energy markets.

xlii “Which oil exporters are most desperate for higher prices?” Matthew C Klein, *Financial Times*, 7/11/2017. <https://ftalphaville.ft.com/2017/07/11/2190877/which-oil-exporters-are-most-desperate-for-higher-prices/>

xliii “Exclusive: Energy giants court Qatar for gas expansion role despite crisis,” Ron Bousso and Dmitry Zhdannikov, *Reuters*, 7/6/2017. <http://www.reuters.com/article/us-gulf-qatar-lng-exclusive-idUSKBN19Q2HA>

xliv “Qatar's central banker boasts \$340B in reserves, says country not worried about the current boycott,” Willem Marx and Matt Clinch, *CNBC*, 7/9/2017. <http://www.cnbc.com/2017/07/09/qatar-hoard-of-340-billion-and-gold-bullion-means-its-not-worrying-about-the-current-boycott.html>

xlvi “Qatar riyal back near peg as local banks assert control, cool speculation,” Andrew Torchia, *Reuters*, 7/3/2017. <http://www.reuters.com/article/us-gulf-qatar-currency-idUSKBN19O1IE>

xlvi “Visiting Doha, Tillerson calls Qatari position ‘reasonable,’” Staff, *Reuters*, 7/11/2017. <http://www.reuters.com/article/us-gulf-qatar-usa-idUSKBN19W140>

## ELSEWHERE IN EM

In India, Parliament's lower house passed the goods-and-services (GST) tax, beginning the long and arduous implementation process. The GST has been in the works for years and aims to simplify India's tax system. Previously, businesses and individuals had to deal with various indirect taxes applied at both the national and state level. The GST establishes five different tax rate brackets, and many goods and services will be taxed at a rate lower than currently levied (e.g., capital goods and consumer goods). The GST also makes exemptions for certain services like healthcare and education. While it will likely be painful in the short term as businesses and local governments adjust—already, some workers are planning to strike in protest—a more streamlined tax system is an improvement over the current byzantine system that has hamstrung the government's ability to collect taxes. The GST would likely have a beneficial long-term impact should it be implemented fully, and reforms like this have been Modi's M.O: He has been successful in carrying through with smaller, more incremental reforms, like the government's current attempt to privatize the national airline.

In Korea, voters elected Moon Jae-in of the center-left Democratic Party as president, replacing the recently impeached Park Geun-hye. Moon's victory was not a surprise as he had long been leading polls. Gridlock, however, will likely hinder his ability to pass new laws. There are high hopes Moon can introduce and implement meaningful chaebol reform to loosen the grip Korea's huge, family-run mega conglomerates hold over the economy and policies. Even though public opinion seems to be in favor of reform—evidenced by the recent arrests of major chaebol leaders—the chaebol, which comprise nearly 60% of South Korean GDP, still wield tremendous political influence. Whether Moon's efforts are successful or not, the passing of this political uncertainty is a positive as it allows investors to see Korea's other solid drivers. While tensions on the Korean peninsula have intensified some after North Korea's recent sabre-rattling, provocations from North Korea aren't new—South Korea's economy has grown just fine through similar periods of hot rhetoric, and South Korean stocks have taken this year's tensions in stride.



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

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