Fisher Investments™

Institutional Group

FOURTH QUARTER 2016

FISHER MARKET PERSPECTIVES

FOURTH QUARTER 2016 REVIEW AND OUTLOOK
FISHER MARKET PERSPECTIVES

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FOURTH QUARTER 2016 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Portfolio Themes

- **Underweight to Commodity-Oriented Categories:** Companies with significant commodity exposure should underperform.
- **Quality Tilt:** As the bull market progresses, we favor equities with stronger balance sheets and consistent profit margins.
- **Overweight to Technology:** As an economically cyclical sector that is heavily skewed toward high-quality firms—we expect Information Technology companies to outperform in the later stages of a bull market.

Market Outlook

- **Positive Inaugural-Year:** We expect markets to receive Trump as they typically receive ***Democrats***, with big inaugural-year returns as the incoming administration does less than feared.
- **Falling Uncertainty in Europe:** We expect the bull market will continue as concerns over European elections, a European banking crisis and Brexit slowly fade.
- **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.

2016 ended on an upbeat note, bringing the MSCI All Country World Index's (ACWI) full-year return to 7.9%.[i] Entering last year, we believed global stocks would do fine, steadily gaining steam as uncertainty ebbed. 2017 should be even better—a great year, rewarding equity investors.

As we expected, 2016 was a year of falling uncertainty. Global stock returns weren't as lackluster as in 2015, but still weren't big. After markets spent nearly three years grinding, a big bull market year is unfathomable to most. Yet bull markets typically surge out of dull periods. Expect an unexpectedly great year as sentiment improves, growth persists and political fears fade. US stocks outperformed for the fourth consecutive year. However, the historically long stretch of US outperformance and underappreciated non-US fundamentals indicate a period of non-US leadership may be ahead.

Last year's big news was Donald Trump winning the White House. While this shocked many, we understood that if states voted according to their legislatures' partisan composition, Trump had a clear path. Throughout last year, in noting that we favored no party or candidate, we warned of political bias's blinding influence on investors—clearly visible today. No one knows what Trump will do in office, but everyone has opinions adding to the wide range of hopes and fears surrounding his presidency. The media, surprised by Trump's victory, continues to dissect each of his statements for policy clues. Investors outside America cannot understand how Trump won and what the fearful media rhetoric means. Professional sentiment is also cautious: Most Wall Street forecasts are barely positive, the most muted outlook since 2010. If Trump turns out to be more moderate, diminishing fear should support surging stocks. If he does more than we expect, depending on economic and sentiment factors, the probability stocks fall increases.

US president's inaugural years tend to be very positive or down, not middling. Most positive years happen under Democrats—investors fear anti-business policies in the election year, then are positively surprised as the new administration does less than imagined. This time, we see it a little differently: Markets should receive Trump as they typically receive ***Democrats***, with big inaugural-year returns. As Ken Fisher explained in Forbes' November 8 issue: "Why? Because so many conventional Republican investor types fear him as well… Never has so much of the GOP firmament so opposed its nominee, including three of the last five presidential nominees, a slice of Congress, big global-trade firms and Wall Street, and its same-name journal." Combine this intraparty opposition with the tiny Republican edge in the US Senate, and Trump will face difficulty moving forward with his more controversial plans.

i FactSet, as of 1/3/2017. MSCI All Country World Index return with net dividends, 12/31/2015 – 12/31/2016.

Some argue stocks' post-election rise signals investors' high hopes for tax cuts, fiscal stimulus and faster growth, but we believe those counting on significant changes in policy will be disappointed. Fear of Trump still outweighs isolated optimism of Trump. Despite talk of the "Trump Rally", stocks didn't have a huge US election year—just mildly positive, nearly matching the election year average since 1928. Most pre-election trends continued post-election. Meanwhile, Trump's escalating protectionist rhetoric and jawboning against the likes of Ford, Boeing, Lockheed and Carrier frighten much of Corporate America. All signs point to markets receiving Trump as they would a Democrat, with a great year most likely.

The rise of populist politicians is a big story across the rest of the developed world as well. This narrative will likely continue as France and Germany hold big elections in 2017. However, reality eventually overcomes popular perception. For every major populist "victory" (e.g., Brexit), there is a less-acknowledged establishment win (e.g., Spain's Popular Party finally forming a government). As investors look beyond the political noise, they should gain a clearer view of better-than-appreciated global economic growth. Corporate earnings have beaten expectations and are projected to accelerate, yield curves are positively sloped and leading economic indicators are expansionary.

India's Prime Minister Narendra Modi surprised the country in November by voiding 500- and 1000-rupee notes as legal tender. This temporary money supply crunch will likely affect near-term economic data. However, the country is still among the world's fastest-growing, and Modi's incremental reforms are having generally positive results. In China, bond market concerns received attention and perpetuated economic "hard landing" fears—obscuring better-than-appreciated reality. However, short-term volatility isn't surprising in bond markets, and rising yields were global—not China-specific. With the economy steady and the government voicing its comfort with modestly slower growth, China is on solid footing going into 2017. Most Emerging Markets continue to grow nicely, yet many investors still fail to fully appreciate persistent growth and escalating economic reforms throughout Latin America and Southeast Asia.

One of our more contrarian 2017 forecasts is for falling long-term interest rates. Our expectations for little action by the US Federal Reserve and sideways long-term interest rates proved correct in 2016, with the Fed hiking once (in December) and 10-year US Treasury yields rising just 18 basis points.[ii] With long-term yields ending 2016 on an upswing, most expect them to continue rising, increasing the likelihood markets have already priced the consensus view and will do something different.

While we expect strength for global markets, 2017 is a year for vigilance. The likelihood of a down year is higher than in recent years. We don't believe this warrants immediate action, however it may eventually. Beyond this, we must also watch for changing leadership: Non-US stocks often begin outperforming in the years following a US presidential election. Sentiment has progressed much more slowly in Europe than America, and uncertainty in the region will likely fade throughout the year as it did in the US in 2016. A leadership shift isn't certain in 2017—but we are watching for it.

ii Ibid. 10-Year US Treasury yield, 12/31/2015 – 12/31/2016.

THEMATIC UPDATE AND MARKET OUTLOOK

Q4 RECAP

After years of modest global market returns, a big up year is the last thing most investors expect. Yet we believe 2017 will substantially reward investors' discipline.

As 2016 progressed and uncertainty fell, investors viewed the global economy more clearly. The fine growth they saw seems to have bolstered animal spirits, a delayed reaction to long-running trends. America and Britain, propelled by mighty service sectors, are at the forefront of the developed world. As noted later in the Review & Outlook, the eurozone is broadly growing. Many Emerging Markets, from China to Mexico, continue defying fears over perceived fragility. As uncertainty continues falling in 2017, investors should gain confidence in a global economy that has long exceeded most expectations.

Flat to Positive—the Shift Continues

In past Review & Outlooks, we have discussed a phenomenon where stocks tend to follow lackluster stretches with robust returns. 2015 was relatively flat, with a correction beginning mid-year and lasting through early 2016. Last year was better, with a nice recovery after the correction's February low, but not quite sensational. We see more robust returns ahead.

Exhibit 1: S&P 500 Returns After Bull Market Flat Periods

S&P 500 Sideways Streak > 300 Days			S&P 500 Return After Crossing Previous High		
Start	End	Duration	12 Months	18 Months	24 Months
7/18/1933	10/21/1935	825	40.4%	42.8%	-2.2%
7/14/1943	6/13/1944	335	18.6%	36.8%	48.7%
1/5/1953	3/10/1954	429	37.2%	65.2%	75.8%
8/3/1959	1/26/1961	542	12.4%	-5.6%	8.7%
9/21/1976	8/14/1979	1057	14.7%	18.6%	24.2%
10/10/1983	1/18/1985	466	21.7%	38.0%	55.4%
2/2/1994	2/13/1995	376	37.1%	37.5%	66.7%
4/29/2011	2/23/2012	300	11.2%	22.0%	34.7%
5/21/2015	7/8/2016	414	?	?	?
Average		541	24.1%	31.9%	39.0%
Median		448	20.1%	37.1%	41.7%

Source: Global Financial Data, Inc., as of 7/12/2016. S&P 500 price returns for periods shown. Duration count is in calendar days. Sideways streak is defined as a period between record highs.

After muted periods, history suggests an upswing is more likely than a slump. As Exhibit 1 shows, the S&P 500 endured eight other 300-plus-day point-to-point sideways streaks since the 1920s. Returns over subsequent 12, 18 and 24 months are overwhelmingly positive and typically up big. Stocks' strong Q4 returns seem like the beginning of a classic upturn.

Earnings' Emergence

Corporate earnings should strengthen in 2017. S&P 500 earnings were negative for five straight quarters, with the streak ending in Q3 2016.[i] However, this "earnings recession" primarily reflected one sector's struggles—Energy—rather than broad weakness. Oil prices' plunge, which started in mid-2014 and persisted throughout 2015, crushed profits. However, other sectors largely held up fine.

Exhibit 2: Energy's Impact on S&P 500 Earnings Growth

Quarter	Energy	S&P 500 Ex-Energy	S&P 500 Earnings Growth
Q4 2014	-2.4	7.0	4.6
Q1 2015	-6.8	7.4	0.5
Q2 2015	-6.1	5.8	-0.3
Q3 2015	-6.4	4.6	-1.8
Q4 2015	-5.8	1.7	-4.1
Q1 2016	-5.4	-0.2	-5.6
Q2 2016	-3.9	0.5	-3.5
Q3 2016	-3.0	6.2	3.1

Source: FactSet, as of 1/10/2017. Percentage-point contributions to S&P 500 year-over-year earnings growth. May not sum due to rounding.

Soon this skew will fall out of the year-over-year calculation, and Energy will be less of a drag. Oil prices bounced and stabilized in 2016, which should eventually flip Energy from a minus to a plus. That likely raises broader earnings' growth rate and could boost investor sentiment.

Rise and Shine, Animal Spirits!

This bull market turns eight in March and shows no sign of stopping. Unless a huge negative surprise emerges and ends it, this should surpass the 1990s and become history's longest bull.

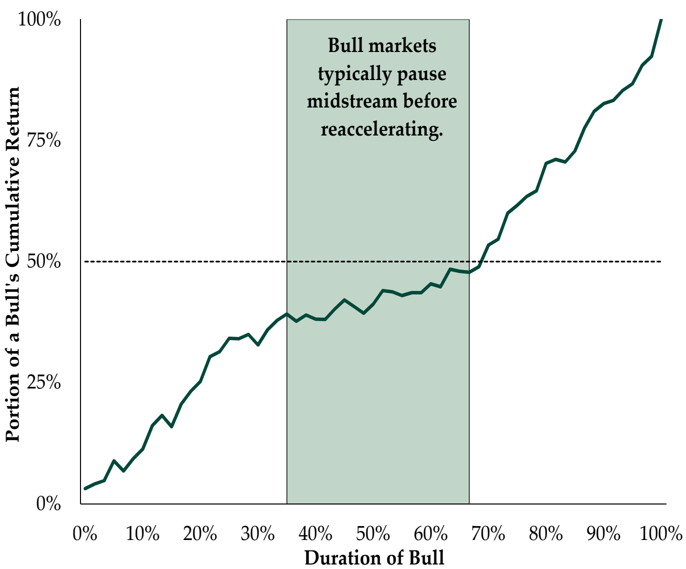
We often share Sir John Templeton's famous quote about sentiment's evolution during a market cycle: "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Investors in the United States are only just hitting optimism, and Europe is stuck in skepticism. Once sentiment reaches optimism, it usually stays there a long while before hitting euphoric peaks. In his

i Source: FactSet, as of 1/12/2017.

classic work, *The General Theory of Employment, Interest and Money*, economist John Maynard Keynes referred to the "spontaneous optimism" he called animal spirits: "Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction..." In markets, animal spirits represent the rising confidence that spurs investors to bid up earnings as bull markets mature. Animal spirits just began percolating and should bubble for a long while before boiling over.

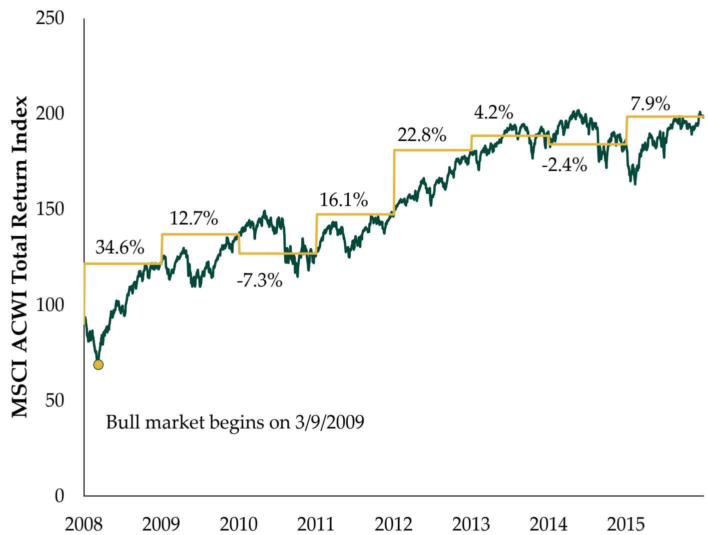
Stocks have plenty of room to climb on the proverbial "wall of worry." Mere months after the S&P 500 emerged from its flat stretch, people fear stocks have come too far too fast and cannot fathom big returns. Yet bull markets don't move at a steady, predictable pace. Returns come in clumps. Bulls markets often slow somewhere in the middle, before reaccelerating for their final third (Exhibit 3). Even that depiction, which averages the 12 complete bull markets since 1926, is far smoother than any one cycle. Most bulls resemble a long, uneven staircase—some big steps, some small and even the occasional step down. This bull market is no different. (Exhibit 4)

Exhibit 3: Bull Market Pauses Are Normal



Source: Global Financial Data, Inc., as of 11/9/2016. Depicts bull markets from 6/1/1932 – 10/9/2007. Bull markets before 1990 rounded to nearest month to match GFD's S&P 500 Total Return extended data.

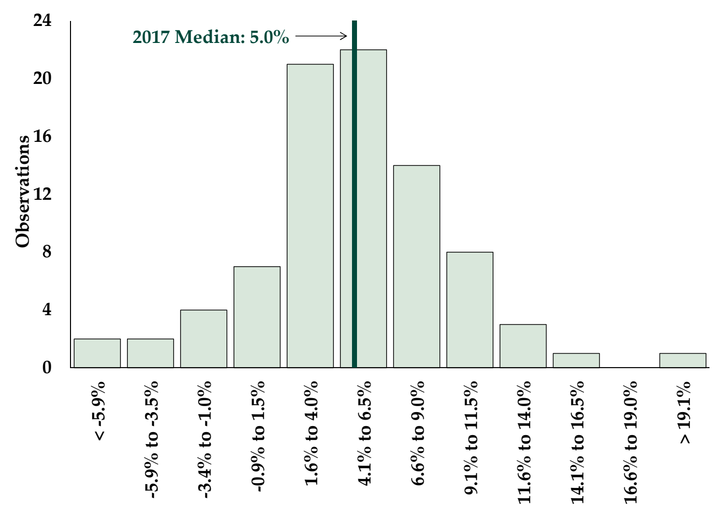
Exhibit 4: The Uneven Staircase



Source: FactSet, as of 2/7/2017. MSCI ACWI total return index with net dividends (daily index level and annual return), 12/31/2008 – 12/31/2016.

Investors should not let recent years' small movements dictate their outlooks. Setting expectations based on what just occurred is a behavioral error called recency bias. It causes many investing errors, and we see this happening to many Wall Street professionals. Their forecasts are barely positive, the most muted since 2010 (Exhibit 5). They seem poised to miss a 2017 year that is far better than they expect.

Exhibit 5: Professional S&P 500 Forecasts



Source: Fisher Investments Research, as of 1/17/2017.

Early in 2016, Ken called this the most joyless bull market in history because investors have just now begun emerging from their dour state of mind. But, memories of the last global bear market remain forefront for many investors. People forget how bull markets normally behave as confidence ascends. Few realize the S&P 500's average annual return during bull markets was 21% before this bull market, which is annualizing 19%.[ii] The late 1990s, when the S&P 500 topped 20% three years running, is a distant memory. After Alan Greenspan warned of "irrational exuberance" in December 1996, the bull market ran 39 more months, including those three straight 20%-plus years. Recent returns pale by comparison. Today's collective shift in outlook seems like the normal warming of sentiment that coincides with strong, maturing bull markets.

Expect the Unexpected

We think 2017 is a year to expect the unexpected. But, in a positive way. Even the most optimistic forecasters see average returns ahead. But average returns aren't normal. History shows stocks return between 0 and 10% just 16% of the time. Most often—in 36% of all years since 1926—they top 20%. Half of these years occurred during a bull market's second half.

History and sentiment aren't the only reasons we expect big returns. The world is growing, with most major regions beating expectations. Even the long-derided eurozone keeps generating positive economic surprises, and few realize it. With Leading Economic Indexes pointing positively and yield curves still adequately steep, growth looks poised to continue in 2017. Politics should also go better than feared, as the Trump administration does less than imagined and euroskeptic populists hit roadblocks at the ballot box or, if they enter government, in gridlocked parliaments.

While it is impossible to know exactly how global events will unfold, changes in our forecasts related to macro events may lead to some portfolio repositioning.

ii Source: Global Financial Data, Inc. for bull markets before 3/9/2009, as of 3/18/2015. FactSet for the period 3/9/2009 – 12/31/2016, as of 1/27/2017.

US Commentary

The Case for a Surprising Drop in Interest Rates

Our most contrarian—and perhaps most controversial—forecast is for long-term interest rates to fall in 2017.

Entering 2016, we believed the US Federal Reserve (Fed) would do little and long rates would bounce around but finish the year near where they started. This, too, contradicted the popular view because Fed members' dot plot of forecasts, a visual depiction of where each Fed official expects the rate to be by calendar year end, showed an average projection of four rate hikes in 2016. Most expected an active Fed, with rising long-term interest rates pricking an alleged "bond bubble." However, we noted that barring runaway inflation or a crisis, the Fed usually does little or nothing ahead of presidential elections, lest they appear politically motivated. As we expected, the Fed made no moves before the election, finding all manner of excuses to delay.

In our Q3 2016 Review & Outlook, we said the Fed was finally free to act in December, which seemed as good a time as any to raise rates. As expected, they hiked the fed-funds target range by 25 basis points, the second rate hike of this bull market to a still very accommodative 0.50% - 0.75%. Meanwhile, long rates charted a wild course throughout the year, first falling near historic lows after the Brexit vote, then rising as economic results improved and inflation picked up. Yet on December 31, the 10-year US Treasury yield was only 18 basis points higher than where it began 2016. [iii]

iii Source: FactSet, as of 1/3/2016. Change in 10-Year US Treasury yields, 12/31/2015 – 12/31/2016.

What's next? No one can be certain exactly how Fed members will interpret data and events. These 10 people each have their own biases and opinions. Yet when you consider that Fed Chair Janet Yellen's term will be up soon and her viewpoints, as well as those of her colleagues, it is clear they have no reason to be friendly to Trump—no reason to keep rates lower for longer. Trump is unlikely to reappoint the members of the Fed. Raising rates seems like an obvious way to make Trump's job more difficult in response to his occasionally harsh critiques of their record. Hence, they might as well raise rates several times.

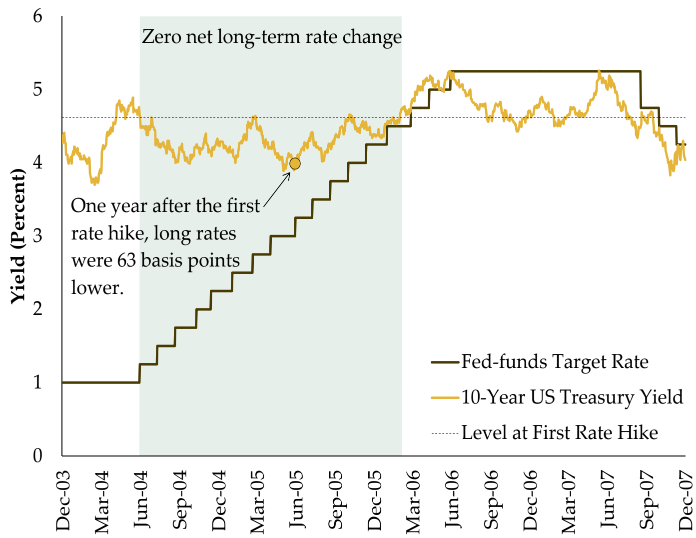
> The more hawkish Fed members are, the less reason there is for long rates to rise due to inflation fears.

People think rising short-term rates certainly lead to rising long-term rates. Recency bias also makes most analysts expect long-term rates to rise. Given markets often do what few expect, this argues for flat or falling rates. Moreover, the more the Fed raises rates, the more reason there is for long rates not to rise. All else equal, rate hikes reduce inflation expectations, prompting creditors to demand less compensation to lend long-term. When long rates don't rise alongside short rates, it flattens the yield curve and bank lending, creating further disinflation. The more hawkish Fed members are, the less reason there is for long rates to rise due to inflation fears. Moreover, bond markets are global, and yields in major developed nations tend to be highly correlated. Central banks in Japan and

Europe continue buying long-term debt, lowering long rates there and driving demand for higher-yielding US Treasuries. This should reduce long-term Treasury yields.

There is precedent for long rates to fall while the Fed tightens: From 2004 to 2006, the Fed hiked at 17 straight meetings (Exhibit 6), one of the sharpest tightening cycles in recent history. Yet long-term rates had zero net change from June 30, 2004—when the Fed first hiked—to March 6, 2006. All of long rates' net change during this tightening cycle came in the final three and a half months.

Exhibit 6: Rising Short Rates Don't Always Mean Rising Long Rates



Source: FactSet, as of 1/9/2017. Fed-funds target rate and 10-Year US Treasury Yield, 12/31/2003 – 12/31/2007.

ALL ABOUT TRUMP

As always, our political commentary is non-partisan and non-ideological. We favor no politician, elected official or party, and we believe political bias is a blinding investment error. We assess politics solely for its potential market impact.

Our take on this election and the Trump administration is unique—and has been from the get-go. When poll-obsessed pundits penciled in a Clinton victory last summer, we painted a scenario for Trump to win if states voted according to their legislatures' partisan makeup. We said not to fear either candidate, as markets would benefit from falling uncertainty no matter who won. Now, we think a pleasant surprise awaits as markets greet Trump like they normally greet new Democratic presidents, with strong inaugural-year returns.

THE TRUMP TWIST ON MARKET HISTORY

US stock returns during inaugural years are usually up big or down, not middling. Big years usually accompany new Democrats, while new Republicans often see disappointing numbers. (Exhibit 7)

Exhibit 7: S&P 500 Returns in Inaugural Years

Party	President	First Year		Party	President	First Year	
R	Coolidge	1925	N/A	R	Nixon / Ford	1973	-14.8%
R	Hoover	1929	-8.9%	D	Carter	1977	-7.4%
D	FDR - 1st	1933	52.9%	R	Reagan - 1st	1981	-5.1%
D	FDR - 2nd	1937	-35.3%	R	Reagan - 2nd	1985	31.6%
D	FDR - 3rd	1941	-11.8%	R	Bush	1989	31.7%
D	FDR / Truman	1945	36.5%	D	Clinton - 1st	1993	10.1%
D	Truman	1949	18.1%	D	Clinton - 2nd	1997	33.4%
R	Eisenshower - 1st	1953	-1.1%	R	Bush, GW - 1st	2001	-11.9%
R	Eisenshower - 2nd	1957	-10.9%	R	Bush, GW - 2nd	2005	4.9%
D	Kennedy / Johnson	1961	26.8%	D	Obama - 1st	2009	26.5%
D	Johnson	1965	12.4%	D	Obama - 2nd	2013	32.4%
R	Nixon - 1st	1969	-8.5%	R	Trump	2017	?
	Republican Average				0.7%		
	Democratic Average				16.2%		
	Overall Average				9.2%		

Source: Global Financial Data, Inc., as of 1/12/2017. S&P 500 annual total return in inaugural years, 1925 – 2013.

Since Truman, inaugural-year returns under Democrats topped 10% all but once. We believe sentiment and investors' political biases explain this. Markets move most on surprises. They price in investors' expectations, then usually do something different as expectations prove wrong. Investors usually have high hopes for new Republican presidents thanks to their market-friendly talk and the party's pro-business reputation. Then the new president moderates (not wanting to alienate centrist voters) or encounters gridlock, and does less than hoped. Investors realize he was just another politician, and their disappointment dampens returns.

Under Democrats, it is the opposite. Democratic candidates usually promise things markets fear, like protectionism, stiffer regulation and redistribution. That reduces investors' expectations, setting up powerful positive surprise potential when they, too, do less than envisioned.

Trump ran as a Republican, but his rhetoric wasn't business friendly. Investors seem to fear him as they usually do a new Democrat. The media, typically skeptical toward free trade, warns daily that ending North American Free-Trade Agreement (NAFTA) and adopting new tariffs will hurt consumers and domestic manufacturers who import components. They estimate cost increases for iPhones and cars and worry over the likely impact on profits at companies like Wal-Mart. When Carrier decided—at Trump's urging—to delay a new factory in Mexico and keep 800 jobs in Indiana, pundits said it reeked of

Mussolini's industrial policy. For every investor who cheers his proposed tax cuts, many more fear they will blow a huge hole in the Federal budget. Trump frightens Democrats by talking up financial deregulation, then alarms Republicans by targeting prescription drug prices.

The perception of Trump as a non-traditional Republican extends beyond policies. No Fortune 100 CEO endorsed him. Nor did 11 Republican senators or three of the last five Republican Party (GOP) presidential nominees. The Wall Street Journal and Investors' Business Daily—normally friendly to Republicans—attacked him regularly. Trump-phobia is everywhere.

Hence, positive surprise potential is high. Those 11 #NeverTrump GOP senators should bring intraparty gridlock. Only three would need to join with the 48 Democratic senators to block radical legislation. Ken recalls Ronald Reagan saying even the best presidents, with the most political capital, win only two or three major initiatives. Trump, who takes office as the most disliked president in modern times, lacks political capital. His transition approval rating, 40%, lags the past three presidents widely and is below any president's initial approval rating since Truman (Exhibit 8). As he accomplishes less than imagined, markets should rally in relief.

Exhibit 8: Trump Approval Is Low

Initial Job Approval	
Truman	87%
Eisenhower	68%
Kennedy	72%
Johnson	78%
Nixon	60%
Ford	71%
Carter	66%
Reagan	51%
Bush I	51%
Clinton	58%
Bush II	57%
Obama	68%

Transition Approval (Early/Mid- January)	
Clinton	66%
Bush II	62%
Obama	78%
Trump	40%

Source: Gallup, as of 1/23/2017.

Trump-phobia Should Fade

Uncertainty has fallen since the election, to an extent, as we thought it would. While fear lingers, now that business leaders know the new president and his cabinet, they can start planning. Knowing the political landscape for the next four years, all else equal, enables businesses to make long-term investments.

Yet there is plenty of room for uncertainty to fall, as extant Trump-phobia indicates. Trump is not a conventional president. His willingness to break tradition and shun political conformity raises doubts. People don't know what he will do but many are sure it will be bad. Most conservatives waffle between hope for greatness and fear of the unpredictable. Liberals are even more fearful, but still sure he is haphazard and disrespectful.

By year end, investors should see Trump falls somewhere in between polarized expectations—not as good as supporters hope, not as bad as detractors fear. Much was made of the executive actions issued during Trump's first week, but such a flurry isn't unusual for a new President. Obama also issued several. While Trump's actions stirred headlines, they lack broad market or economic impact. Most are pure sociology, which markets look past. Those with economic relevance are too small to make an impact and, in the case of those related to a border wall and the Affordable Care Act, are powerless without legislation. Withdrawing the US from the Trans-Pacific Partnership (TPP) stole headlines, but markets have known for nearly a year that TPP was dead on arrival. Meanwhile, as the swift judicial response to the most recent immigration order shows, the courts will continue curbing presidential attempts to act outside the law, as they were designed to do.

Love or loathe Trump, he won't be able to do much—just like a typical new Democratic president. Hence markets should react as they always do when concerned about how a new Democratic president treats business, and climb the wall of worry.

What Trump Rally?

That last section might seem odd if you have seen articles heralding the supposed Trump Rally, which imply markets are out-of-control positive and ignoring risks galore. This perception is off. The rally started long before Trump and isn't that large. Rather, it is an extension of the post-Brexit rally, which built off the post-correction recovery. The S&P 500's 2016 return nearly matches the average election year since 1928. The post-election run amounts to a 4.64% price return between Election Day and year end—a 37 trading-day stretch. Since 1928, 26.1% of rolling 37-day periods have topped it. Only one year-long period since 1928 lacked a 37-day stretch that reached 4.64%.[iv] Most years have a few, as last year did. When viewed from this perspective, the Trump Rally was ordinary.

iv FactSet, as of 1/5/2017.

Further, if Trump cheer were the driving force, you would expect the US to be one of the best-performing countries after the election. Instead, it was the middle of the range (Exhibit 9). We daresay investors weren't bidding up Greece, Egypt or Italy because of Trump. Even Russia was the continuation of a pre-election trend.

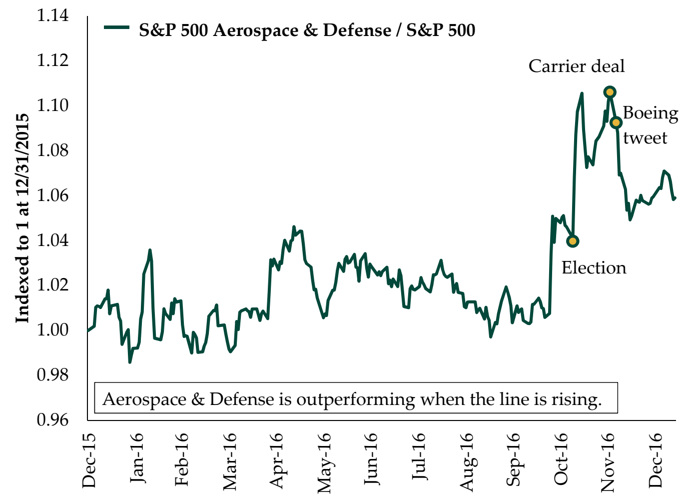
Exhibit 9: The Post-Election Rally in Context

Countries Beating the MSCI ACWI		Countries Lagging MSCI ACWI	
Country	**Return in Local Currency Since US Election**	**Country**	**Return in Local Currency Since US Election**
Greece	17.34	UK	4.93
Russia	15.94	USA	4.84
Egypt	15.87	Netherlands	4.81
Italy	14.98	Qatar	4.47
Japan	11.83	Portugal	4.27
Australia	9.20	Korea	4.00
Germany	8.99	UAE	3.53
France	8.67	Singapore	3.20
Austria	8.44	Thailand	2.10
Poland	8.14	Belgium	2.08
Finland	8.14	Turkey	1.48
Norway	7.81	Colombia	0.08
Denmark	7.47	Israel	-0.72
Ireland	7.33	Taiwan	-0.87
Sweden	6.05	Malaysia	-1.28
Hungary	5.49	Peru	-1.34
Switzerland	5.48	South Africa	-1.37
Spain	5.20	New Zealand	-1.63
Canada	5.05	Chile	-3.09
MSCI ACWI	*4.98*	Czech Rep.	-3.20
		India	-4.40
		Mexico	-4.83
		Indonesia	-5.14
		China	-5.45
		Hong Kong	-6.50
		Brazil	-6.61
		Philippines	-6.61

Source: FactSet, as of 1/6/2017. Returns are in local currency to remove skew from the dollar's fluctuations. 11/8/2016 – 12/31/2016.

It is futile to base trades on speculation over what Trump might do—unknowable today, no matter how many argue otherwise. US Aerospace & Defense's travails show why. The industry surged after Trump's win, boosted by hopes for higher defense spending. Rationale being that it was a Trump industry. But then came the strong-arming of Carrier (a subsidiary of United Technologies) and tweets against Boeing and Lockheed Martin. Investors flipped from cheering Defense to fearing cuts and intrusion. As such, the industry gave up most of its post-election relative gains (Exhibit 10). That doesn't make Defense's outlook dismal—far from it—but it does show short-term reactions to Trump's win didn't represent a shift in market direction or necessitate strategy changes.

Exhibit 10: S&P 500 Aerospace & Defense Relative Performance



Source: Twitter, FactSet, as of 1/17/2017. S&P 500 and S&P 500 Aerospace & Defense Total Return Indexes, 12/31/2015 – 1/13/2017. Indexed to 1 at 12/31/2015.

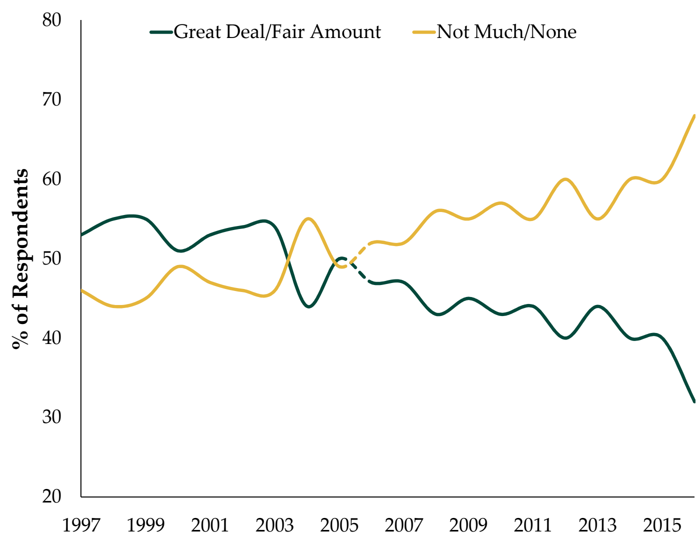
The world is not now a fundamentally different place simply because Trump is in office. Hence investors shouldn't be hugely fearful or excited. Moreover, no one can know what Trump will do. He said so much during the campaign, much of it contradictory. It is impossible to identify which items he will push with Congress. There is no clarity and no way to assign probabilities. Hearsay and speculation aren't valid evidence. We suspect he consciously sends signals to headfake the world, with his contradictory messaging planfully and cunningly conceived to throw people off. He is the negotiator who literally wrote the book on the art of dealmaking.

Trump himself may not even know what to focus on until he has been in the Oval Office for a while. Nothing adequately prepares you for the challenge of being president. Pundits saying otherwise, claiming to know what he will do, are largely the same ones who couldn't foresee his nomination, much less his victory. They are no more credible now.

The Real Loser in 2016

Hence 2016's biggest loser wasn't any politician or school of thought—it was the media. Regardless of an investor's political leanings, their opinion of media probably fell. A September Gallup poll pegged Americans' trust in mass media at an all-time low. Only 32% claimed at least a "fair amount" of confidence media is "reporting the news fully, accurate and fairly."[v] That is down from 53% twenty years ago (Exhibit 11). Next year's figures likely worsen, as this survey was done before the election. People who aren't Trump fans likely lose confidence because no major media outlets foresaw his win. Republicans' confidence is already near rock bottom, at only 14%, but it likely ebbs further due to conventional Republican-leaning outlets' #NeverTrumpism.

Exhibit 11: Americans Are Losing Faith in Media



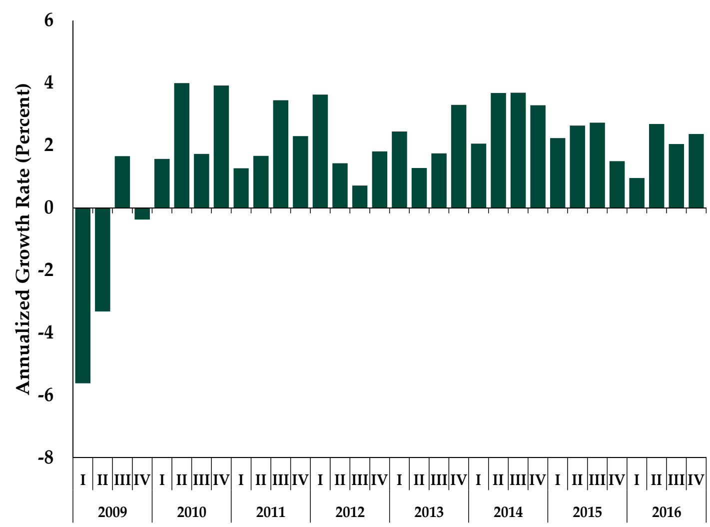
Source: Gallup, as of 1/30/2017. "Confidence in Mass Media," poll conduted Sept. 7-11, 2016. Dashed line indicates 2006, when no poll was conducted.

Investors are starting to see through the media. They realize pundits didn't get Trump during the election, and they will slowly see the media still doesn't understand him. Trump won because he ran against the media, and they couldn't see what he was doing. We expect that investor skepticism should foster animal spirits as they pay ever-less attention to distractions and focus on what actually happens. As investors increasingly ignore the noise and see Trump's administration is rather benign, doing little, optimism should perk.

US Economy on Fine Footing

The US economy remains surefooted. While recession fears lingered in 2016, America showed few signs of weakness. After a GDP averaged slowish 1.1% annualized growth in the first half, it sped, averaging 2.7% in the second half.[vi] However, analyzing GDP's components tells a more lasting tale and suggests recession fears were overblown from the beginning. Erratic components like inventory change, trade and government spending—all subject to noise and open to interpretation—dragged down first half figures, boosted Q3 and resumed dragging in Q4. Omitting these and viewing pure private sector components (consumer spending, business investment and real estate) shows growth wasn't abysmally slow in early 2016—it was healthy all along, in keeping with long-running trends. (Exhibit 12)

Exhibit 12: Pure Private Sector GDP



Source: US Bureau of Economic Analysis, as of 1/27/2017. Q1 2009 – Q4 2016.

Growth should continue. Broad money supply continues rising steadily. Though loan growth slowed in Q4 (particularly business lending), it rose decently in 2016 overall.[vii] The yield curve spread finished 2016 at 190 basis points—plenty wide to support lending.[viii] While we expect it to flatten, flatter-but-positive yield curves don't mean recession looms. Inverted curves do. The Conference Board's Leading Economic Index (LEI) remains in a long uptrend, bolstered by the yield curve and Leading Credit Index—the most telling components.[ix] Chatter centers on potential fiscal stimulus, but the US economy doesn't need help. For stocks, growth has been fine absent a fiscal stimulus or infrastructure plan, and likely remains so either way.

v Gallup, as of 1/11/2017. "Americans' Trust in Mass Media Sinks to New Low," Art Swift, Gallup, September 14, 2016.

vi Source: Bureau of Economic Analysis, as of 1/27/2017.

vii Source: Federal Reserve Board, as of 1/13/2017.

viii Source: St. Louis Federal Reserve, as of 1/13/2017.

ix Source: The Conference Board, as of 1/26/2017.

Non-US Developed Commentary

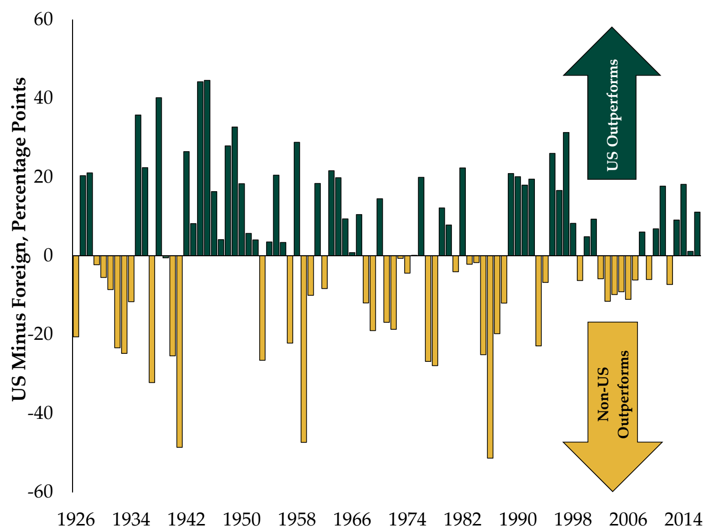
The Case for a Rotation to Non-US Leadership

The focal point of 2016's falling uncertainty was the US, where the presidential election combined with fears over Fed rate hikes and falling oil prices concerned even the most sophisticated investors. As the year progressed, uncertainty cleared—a tailwind to US stocks, which beat non-US stocks for the fourth straight year. Yet we believe a turning point may be approaching, with Europe the prime beneficiary.

Four years of US leadership is long by historical standards. Since 1970—the inception of the MSCI indexes—US stocks never outperformed in five straight calendar years. A longer series Global Financial Data constructed using historical data shows only two periods longer than four years—a five-year stretch in the mid-1960s and the 11 years from 1942 through 1952, when World War II devastated much of the world outside America and the Iron Curtain fell in Europe. (Exhibit 13)

While that mostly shows leadership rotating between US and non-US, there are ample fundamental and political reasons non-US may gain primacy this year.

Exhibit 13: US Versus Non-US Since 1926

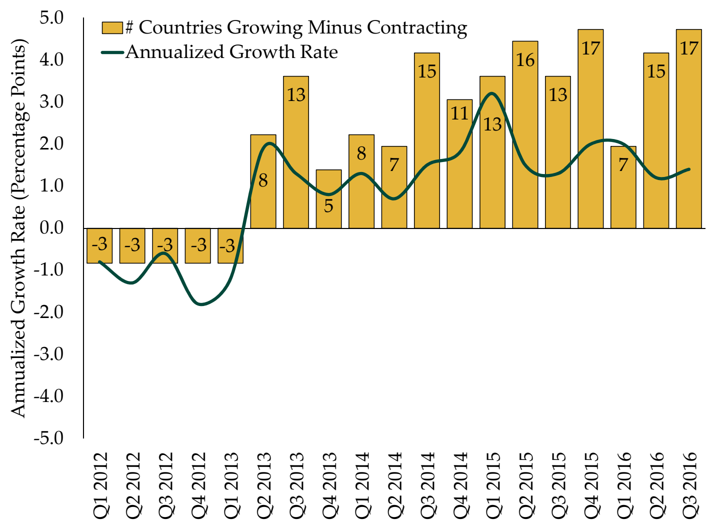


Source: Global Financial Data, as of 1/10/2017. Annual S&P 500 price returns minus GFD World Ex. US Index price returns, 1926 – 2016. Price returns used in lieu of total due to data availability.

Eurozone Fundamentals Are Fine

The eurozone's economy is stronger than most give it credit for. In Q4 2016, eurozone GDP grew 0.5% q/q (2.0% annualized)—the 15th straight quarter of growth.[x] While Q4's country breakdown isn't available yet, growth has been increasingly broad-based recently. Of the 19 member nations reported in Q3, only one—Luxembourg—contracted, down -0.2% annualized.[xi] While headline rates aren't fast, growth is consistent. (Exhibit 14)

Exhibit 14: Eurozone GDP Growth Is Consistent and Broad-Based



Source: Eurostat, as of 2/07/2017. Eurozone GDP and number of member countries posting positive annualized growth, Q1 2012 – Q3 2016.

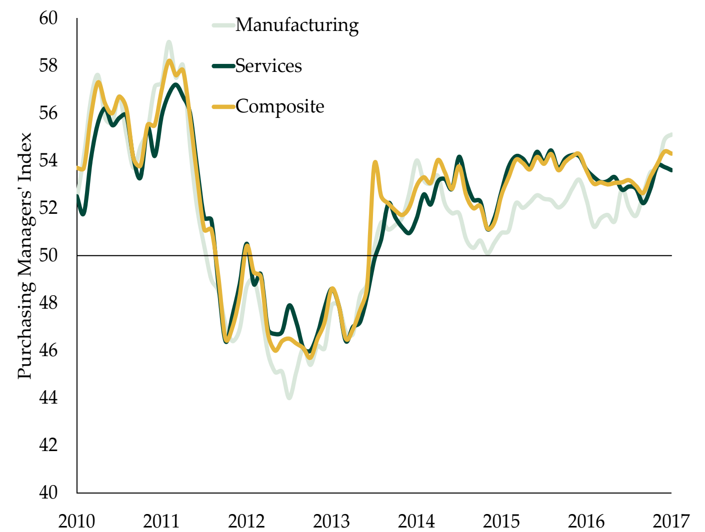
Eurozone economic growth doesn't outpace America's, but the gap isn't nearly so big as many presume.

Purchasing managers' indexes (PMIs)—monthly surveys tallying the breadth of growth—suggest this trend continued in Q4 2016. All four major eurozone economies—Italy, France, Spain and Germany—topped 50, indicating more firms grew than contracted (Exhibit 15). Additionally, inflation has accelerated, easing deflation fears and potentially driving the European Central Bank to taper its bond purchases, a potential positive for eurozone banks and future growth generally. Should money supply and loan growth continue rising, tapering is increasingly likely. (Exhibit 16)

x Source: Eurostat, as of 1/12/2017.

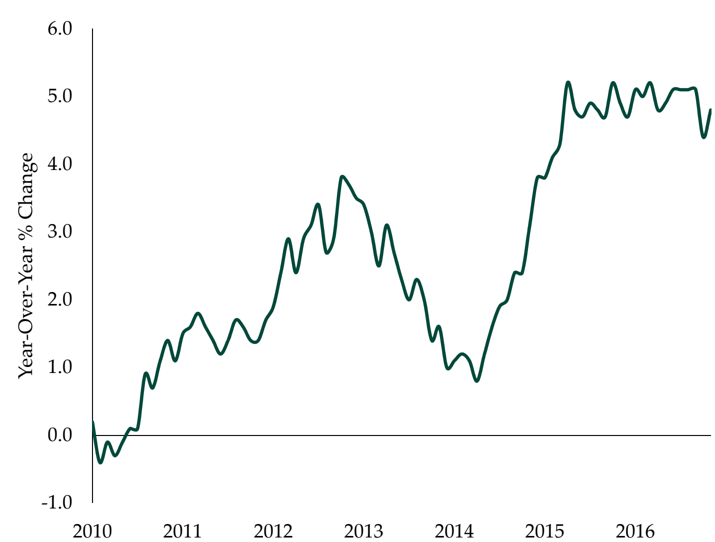
xi Ibid.

Exhibit 15: Eurozone PMIs



Source: Bloomberg, FactSet as of 1/27/2017. Eurozone manufacturing, services and composite PMIs, Jan. 2010 – (preliminary) Jan. 2017.

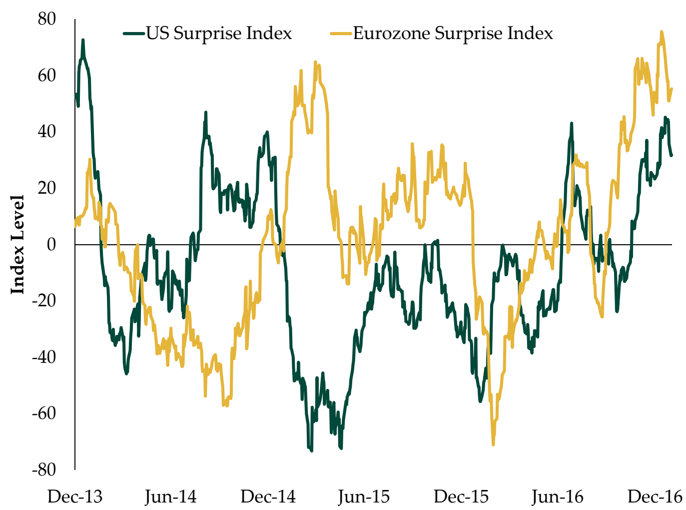
Exhibit 16: Eurozone M3 Money Supply Growth



Source: FactSet, as of 1/27/2017. Eurozone M3 Money Supply, 1/31/2010 – 12/31/2016.

Eurozone economic growth doesn't outpace America's, but the gap isn't nearly so big as many presume. Moreover, for stocks, growth rates aren't as important as how the data relate to expectations. Eurozone data have much more consistently beaten professionals' expectations lately as shown by Citigroup's Economic Surprise Indexes for the US and Eurozone (Exhibit 17 on next page). These gauges attempt to measure data against forecasts. While imperfect, as investor sentiment extends far beyond professional analysts, they illustrate relatively lower expectations for Europe.

Exhibit 17: The Eurozone Is Surprising Analysts Positively More Than America

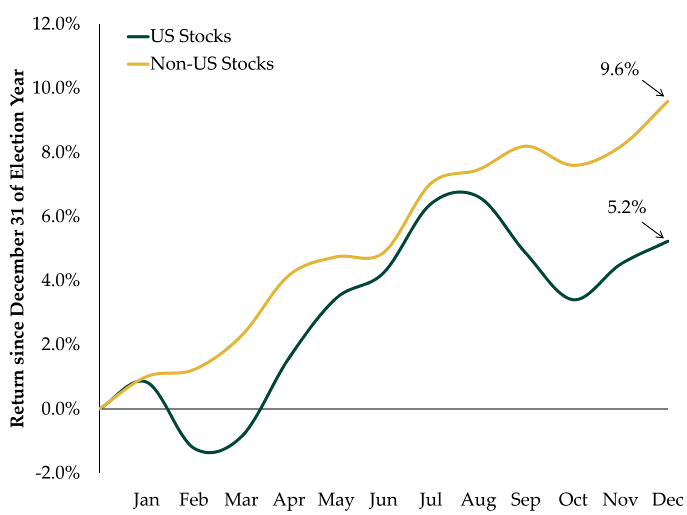


Source: FactSet, as of 2/07/2017. Citi Surprise Indexes for the eurozone and US, 12/31/2013 – 1/31/2017.

Inaugurating Non-US Leadership

Inaugural years tend to be either up big or down for US equities, with little in between. They also tend to favor non-US equities, as investors struggle to size up the incoming US administration's policy priorities and ability to enact law. (Exhibit 18)

Exhibit 18: Non-US Stocks Typically Lead in Inaugural Years



Source: Global Financial Data, 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.

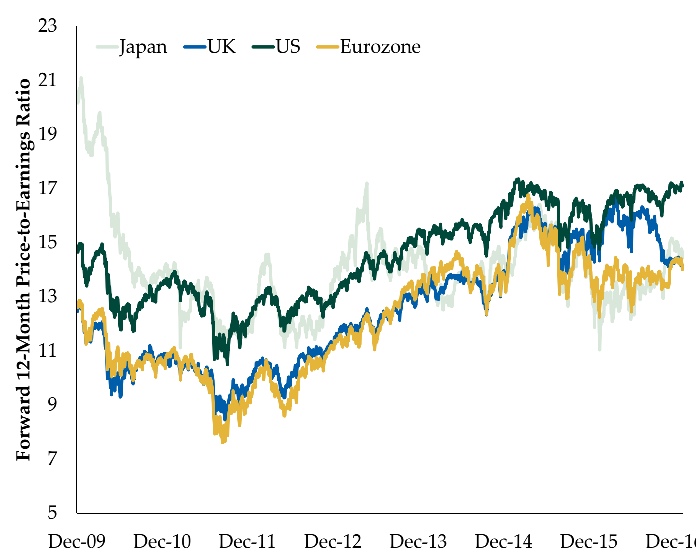
Contrary to this point, some supporters suggest Trump's policies should fundamentally favor US stocks. But Trump enters office with only a narrow (52-48) Senate majority, and the Republicans' internal Trump divide could complicate major economic legislation. Even so, tax reform and fiscal stimulus rarely have the forecasted market impact, frequently amounting to much less. The failure of Obama's "shovel ready" fiscal stimulus and George W. Bush's tax cuts to deliver faster growth isn't abnormal. There is little reason to believe it will be different this time with Trump.

Non-US investors' polarized view of Donald Trump could exacerbate this trend in 2017 as uncertainty surrounding his administration remains. The anti-Trump sentiment is more hostile outside America as some Europeans seem convinced he is a fascist. It is likely that not all European investors view him with such hostility. But, the majority view is very negative and fearful, creating ample room for uncertainty to fall and sentiment to increase as the year progresses.

Europe's Sour Sentiment

Europe and the US are at different stages of this bull market's sentiment curve. While animal spirits are stirring in America, breaking investors out of persistent skepticism, European investors only recently emerged from pessimism. Valuation measures like forward price-to-earnings ratios illustrate this gap. Many non-US markets—especially Europe—trade at a discount to American stocks, as investors remain reluctant to bid them up. (Exhibit 19)

Exhibit 19: Relative Valuations Illustrate Skeptical Sentiment Overseas



Source: FactSet, as of 2/07/2017. 12-Month Forward Price-to-Earnings ratios of the S&P 500, MSCI Japan, MSCI UK and MSCI EMU Indexes, 1/11/2010 – 1/31/2017.

While America had one deep recession and a bear market before 2009's bull market began, Europe endured the same as well as the eurozone debt crisis-driven recession from 2011 to 2013. While fears over the European periphery—Greece, Spain, Portugal, Italy and Ireland—were global, they generated only corrections in the US while Europe suffered a regional bear market. These sovereign debt issues magnified the eurozone banking sector's crisis-related problems as banks own many government bonds. Consequently, the eurozone has been much slower to address its banking sector's crisis-related problems. Similar fears over Italy and Greece still linger today and the media continues to overhype their global impact, making dour Eurozone sentiment easy to understand.

Europe's Year of Falling Uncertainty

In 2016, Europe lagged the US—both in terms of returns and clearing uncertainty. While the Brexit vote cleared up some uncertainty, talks still haven't begun—causing uncertainty to linger. But clarity is slowly coming. UK Prime Minister Theresa May clarified her aims in January, sketching her vision of a post-Brexit Britain. On January 24, the UK Supreme Court ruled Parliament must approve the triggering of Article 50—the EU Treaty's exit clause—and anticipating an unfavorable ruling, the May administration had a bill ready for Parliament's consideration mere days after the court's decision. Many lawmakers do not oppose the Prime Minister as doing so would go against the will of the people, and on February 1st Parliament voted in support of the government's bill. The House of Lords, which isn't accountable to voters, is yet to rule on the bill and while this could delay or set aside the referendum's result, doing so could trigger a constitutional crisis. Regardless of what happens, Brexit's developments continue playing out slowly and publicly, gradually reducing surprise potential.

While there is less clarity in the UK, there are signs sentiment is starting to warm up. Italy's referendum on constitutional reforms, considered necessary to trim bureaucracy and enact economic reforms, didn't occur until December, driving Brexit-like concern over its potential failure for much of the year. When it failed as expected, Prime Minister Matteo Renzi resigned with it. Meanwhile, Italy's third-largest bank—Monte dei Paschi di Siena—failed to recapitalize via private markets, triggering a government bailout. If this happened in 2012, stocks would likely have fallen. As recently as September 2016, fears over eurozone banks (Germany's Deutsche Bank, in particular) spurred sharp sell offs. But this time markets surged—a shift hinting at European sentiment beginning to move beyond pessimism.

Sentiment should continue warming, with Europe enjoying its own year of falling uncertainty. Political anxiety is high as elections loom in the Netherlands, France and Germany. Greece may vote, as Prime Minister Alexis Tsipras has threatened to resign. Italy, on its fourth straight unelected government (and 64th government since Mussolini), might call snap elections. While elections are regular in democracies, populist euroskeptic parties' ascendance raises fears of anti-EU or anti-euro governments, rekindling fear over either union's longevity. However these votes go, just knowing should reduce uncertainty, a tailwind for stocks.

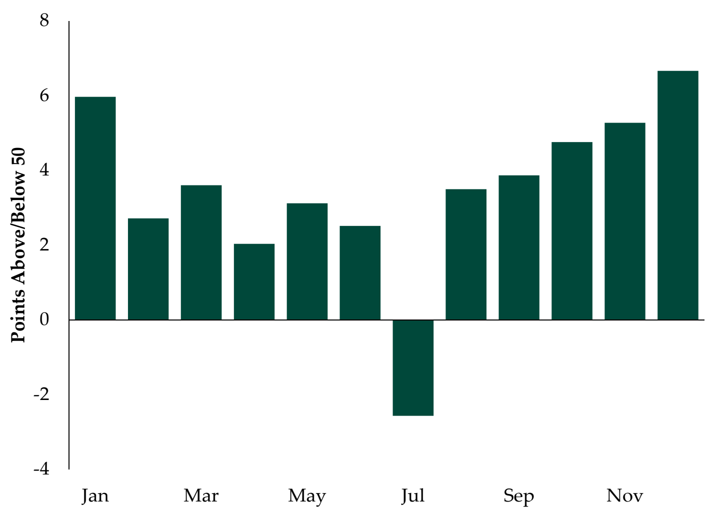
Sentiment should continue warming, with Europe enjoying its own year of falling uncertainty.

Radical political change is unlikely. Europe's rising populism has stoked fears for years. Populist parties have occasionally done well in local and EU elections, but not in national contests. Last year, many feared Spain would elect the euroskeptic Podemos, but mainstream parties won out. Austria's far-right, anti-euro presidential candidate lost to an establishment figure in December. Many fear euroskeptic Front National (FN) leader Marine Le Pen will win France's presidency this spring, but the FN has never taken a major national post and her likely opponent, François Fillon, is a formidable former Prime Minister. While a scandal threatens to ensnare Fillon, the next-closest opponent, independent centrist Emmanuel Macron, is a well-respected former Finance Minister. Le Pen reportedly leads polling for April's first round of voting, but this seems like a quirk of France's election structure, which would split the opposition to Le Pen in the first round, but not in the decisive second round. Polls suggest a more than 20-point edge for Fillon or Macron in a head-to-head match. Chancellor Angela Merkel is seeking a fourth term in Germany's federal election on September 24. While many fear the rise of the euroskeptic Alternative for Deutschland party, her opponents are largely unknown nationally. Greece already elected a euroskeptic leader—Tsipras—but he acquiesed to EU, IMF and ECB demands. As all these elections come and go, they should bring clarity to European stocks.

UK Growth Persists

No major economic gauges show Britain suffering Brexit-related fallout. Q3 and Q4 GDP, the first two full quarters after June's referendum, grew 0.6% q/q each (or 2.3% annualized and 2.4% annualized, respectively).[xii] The services sector, 80% of GDP, grew fastest, expanding 0.8% in Q4.[xiii] Other recent data were also positive. The December composite purchasing managers' index (PMI), which includes services and manufacturing, hit 56.7—readings above 50 indicate a majority of surveyed firms grew.[xiv] December also marks PMI's 2016 highpoint, continuing the impressive rebound after July's downturn (Exhibit 20), a byproduct of the temporary shock.

Exhibit 20: Markit/CIPS UK Composite PMI in 2016



Source: FactSet, as of 1/12/2017.

While retail sales fell in November and December, this followed a 1.9% m/m jump in October—volatility in these narrow series is normal, and there is little evidence Brexit hit consumers.[xv] Industrial production also surged in November (2.1% m/m) as mining and manufacturing led.[xvi] Production is a sliver of UK output and has been choppy for years, but recent data provide more evidence growth isn't suffering. Yet Brexit fears persist, centering on the weaker pound driving inflation and knocking consumer spending—and thus, growth. However, people regularly overestimate currencies' impact on prices in diverse economies, and Britain has done fine through past periods of higher inflation.

xii Source: Office for National Statistics, as of 1/27/2017.

xiii Ibid.

xiv Source: Markit, as of 1/13/2017.

xv Source: Office for National Statistics, as of 1/27/2017.

xvi Source: Office for National Statistics, as of 1/13/2017.

Growth in Japan?

Economic data confirm Japanese growth remains tepid. Most data released in January don't deviate from their trends. December inflation hovered around flattish, regardless of the gauge used: National CPI inched up 0.3% y/y, Core CPI (exclude fresh food) slipped -0.2%, and "Core-Core" CPI (exclude fresh food and energy) was flat.[xvii] All show the Bank of Japan's much-lauded efforts to stoke inflation have fallen short. Couple these weak data with the US's pulling out of the Trans-Pacific Partnership—which Prime Minister Shinzo Abe spent a good deal of political capital on—and sentiment toward Japan is plunging. While Japan's near-term prospects don't seem particularly bright, Japanese stock valuations have declined and foreign capital is leaving—signs investors have turned.

xvii Source: FactSet, as of 1/31/2017.

Emerging Markets Commentary

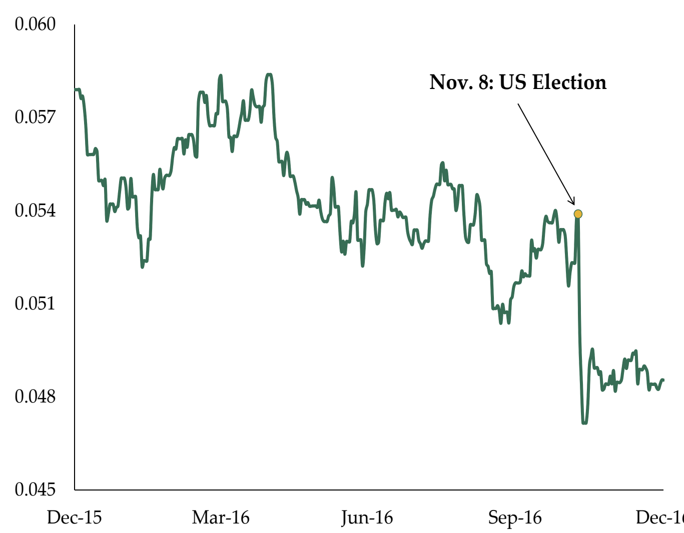
Mexico

Mexico Underappreciated Under Trump

2016 closed on a highly eventful note for Mexican markets. Donald Trump's victory in the US presidential election triggered widespread concerns his campaign trail threats to renegotiate or withdraw from the NAFTA would become policy and damage Mexican exports. Meanwhile, gasoline price deregulation tied to 2013's Energy sector reforms unfolded in January, and the resulting fuel price spike led to protests. Most pundits and media attention fixated on these developments, depressing sentiment—and overlooking continued economic growth. This sets the stage for a positive surprise boosting Mexican stocks. We anticipate Trump's protectionism, to the extent it even materializes, to be far less sweeping than feared as we discussed earlier. Gas price reforms are a longer-term positive, which should bolster private sector interest in investing in Mexico. As reality proves these fears false, we expect Mexican markets to benefit from relief.

In pesos, the MSCI Mexico fared reasonably well in 2016, rising 8.6%, a shade under the MSCI Emerging Markets' (EM's) 9.7% in local currencies.[xviii] However, in US dollar terms, it fell -9.2%, badly lagging EM, as peso fell -16.1% against the dollar. In Q4, Mexico dropped -7.9% while Emerging Markets were down -4.2%, with peso declines accelerating after President Trump's surprise election[xix] (Exhibit 21, 22 on next page). This acceleration seems like a sentiment reaction, which we anticipate will prove fleeting in time.

Exhibit 21: The Peso's Weakness Against The Dollar

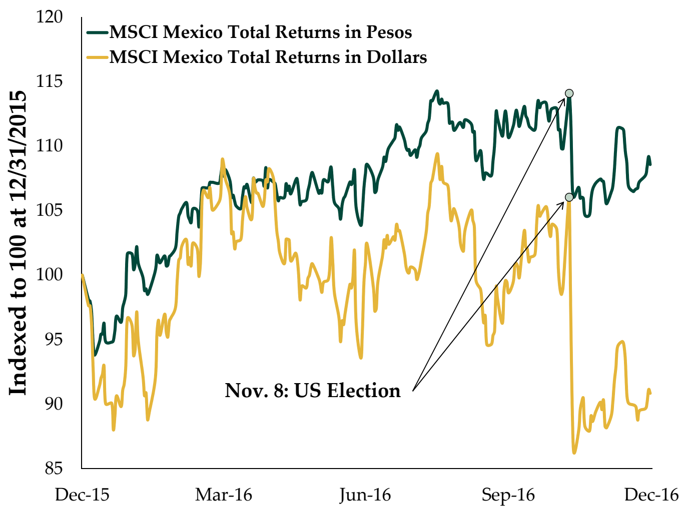


Source: FactSet, as of 1/24/2017. US dollar per Mexican peso exchange rate. 12/31/2015 – 12/31/2016.

xviii Source: FactSet, as of 1/24/2017. MSCI Mexico and MSCI Emerging Markets Index returns with net dividends, 12/31/2015 – 12/30/2016.

xix Source: FactSet, as of 1/24/2017. MSCI Mexico and MSCI Emerging Markets Index returns with net dividends, 9/30/2016 – 12/30/2016.

Exhibit 22: MSCI Mexico Returns in Pesos vs. Dollars



Source: FactSet, as of 1/24/2017. MSCI Mexico returns with net dividends in US dollars and returns with gross dividends in Mexican pesos. 12/31/2015 – 12/31/2016, rebased to 100 on 12/31/2015.

The dour sentiment overlooks Mexico's resilient fundamentals. When oil prices collapsed in 2014, many assumed this meant future problems for Mexico—even a possible recession—given the country's large oil and commodities exposure. Yet the economy hasn't contracted in any quarter since. Q3 data showed GDP growth accelerated to 1.0% q/q (4.0% annualized), rebounding from 0.1% growth the prior quarter and continuing its three-plus-year growth string.

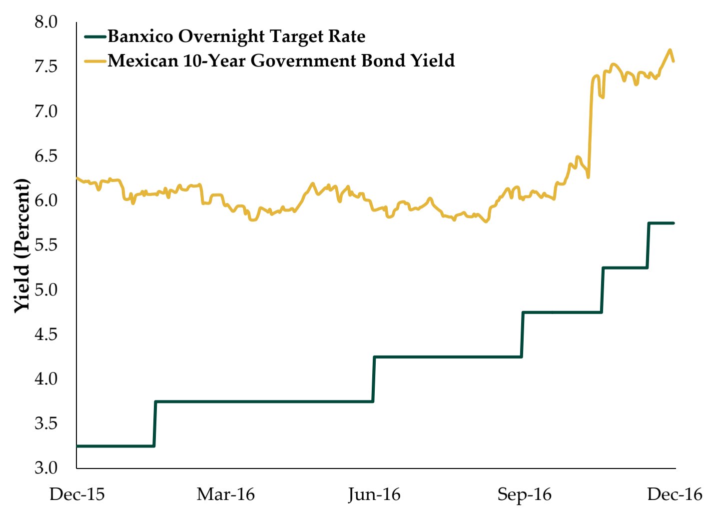
It is true annual growth rates are down from 4%+ post-2009 rates, with commodities a key factor. Mining production has been declining since 2014 with the slump in oil prices, and has yet to recover despite oil prices' rebound last year. Meanwhile, to help combat peso depreciation, Banco de México (Banxico) hiked short-term policy rates five times last year for a combined 2.5 percentage point increase to 5.75%.[xx] Despite this, private consumption and industrial production outside mining helped keep growth afloat.

> The dour sentiment overlooks Mexico's resilient fundamentals.

While Mexico gets tarnished as a low-skill, low-wage *maquiladora* outsourcing destination, its integration with—and steady move up—the global supply chain has quietly increased its value-added exports and supplanted its reliance on crude oil production. Combined, Mexico's auto exports are larger than its petroleum-based industries', while machinery and electrical equipment exports exceed those. From this perspective, Mexico's expansion amid severe commodity headwinds highlights its increased economic diversity and stability in recent years.

Looking forward, even with overnight rates at their highest since 2009, the yield curve remains positively sloped (Exhibit 23), suggesting credit markets are healthy and hinting at growth ahead. Instead of retrenching, consumer and private sector credit growth has accelerated,[xxi] which we view as a healthy sign, rather than a potential vulnerability.

Exhibit 23: Despite Rate Hikes, Yield Curve Still Positive



Source: FactSet, as of 1/24/2017. Banco de México overnight interbank funding rate and Mexico 10-year government bond yield, 12/31/2015 – 12/30/2016.

Trump's Bluff

Most analysts and pundits, however, aren't looking at fundamentals, but rather, speculating about whether President Trump will proceed with exiting NAFTA and erecting trade barriers between the US and Mexico. If Trump's tough trade rhetoric becomes reality, there is potential for Mexico's economy to be harmed badly, given 80% of Mexican exports go to America.

However, markets have been digesting this ever since Election Day, and to some extent, before—markets had months to weigh his protectionist rhetoric before the vote, a process that accelerated post-vote. Given the level of fear, anything less than the reintroduction of steep tariffs or a complete renouncing of NAFTA, should be a tailwind for Mexican markets. While a renegotiation seems set to begin soon, renegotiation is a far cry from exiting the treaty. It could actually mean deepening it, reforming outdated provisions or otherwise improving the deal for all three nations. And, even if NAFTA doesn't

xx Source: FactSet, as of 1/24/2017.

xxi Source: Banco de México, as of 1/26/2017.

survive, the Trump administration has expressed a preference for bilateral deals, so the landscape isn't assured to change—bilaterals could replace NAFTA. But also, renegotiation isn't likely to move fast. Talks this big are likely to take significant time, years even.

A trade war would be costly, reduce economic growth and destroy jobs. But we don't believe it is likely.

Some say Trump will follow through on campaign rhetoric and pull America out. But there are many reasons to think moderation is more likely. Five million American jobs depend on NAFTA, many of them in politically influential Texas. Mexico is an integral part of US businesses' supply chains—for produce, appliances, aircraft parts, medical equipment and cars. 40% of Mexico's export value is sourced from the US.[xxii] Moreover, 59% of all US gasoline exports go to Mexico[xxiii] as well as 14% of US agricultural exports,[xxiv] to which Corn Belt states are particularly sensitive. A trade war would be costly, reduce economic growth and destroy jobs. But we don't believe it is likely.

A vibrant Mexico is much better for America—from an economic and security perspective—than a wounded one in recession. We can't know for certain Trump sees it that way, but as an investor, if he does anything less than feared toward Mexico, markets there should do fine.

Mexican Energy Reforms

January 1 saw popular fuel subsidies partially lifted with less than a week's warning. Dubbed *el Gasolinazo*, fuel prices rose 14 – 20% and caused widespread protests. Further fuel price liberalization is progressively scheduled the rest of the year with full liberalization slated for 2018.

This is the latest in Mexico's ambitious energy reforms, dating back to 2013 when the government ended its 75-year oil monopoly through constitutional amendment. Bidding for exploration and production was opened to private companies in 2015 and reforms have now started to head downstream to refining, distribution and consumption.

While opening up the Energy sector to non-Mexican investment and private competition is welcome, reforms have yielded little so far, largely due to the oil oversupply. Removing gas subsidies and price caps is a critical step in this process, as few private firms would invest heavily in a controlled environment like this. While it likely won't have an immediate effect, this should help clear the way longer term for investment in rebuilding Mexican energy production. Reform proponents billed price liberalization as lowering costs. It should lower cost, eventually, with more supply and efficient delivery. But in the short term, it can cause temporary dislocations, which seems to be the case now.

Fuel price liberalization has been politically damaging to President Enrique Peña Nieto—who has the lowest approval ratings of any Mexican president in two decades—and opens the 2018 election door for the leftist opposition led by Andrés Manuel López Obrador. This has raised fears that a new government could undermine energy reform. Despite elevated political uncertainty, there is no concerted effort to roll back reforms, which would prove difficult given their constitutional enshrinement. That said, 2018 is far off and the impact of gas price subsidy reform could be long gone by then.

India

Demonetization—Fine Idea, Poorly Executed

Although Prime Minister Narendra Modi's Q4 currency reform likely impacted India's economy and stocks, we believe markets have seen its worst effects. As investors digest the poor implementation, they should see this as a medium-term positive. We expect Indian stocks to move higher, supported by India's fundamentally sound economy and continued reform progress.

The idea is controversial one, but it is primarily an effort to reduce corruption and tax evasion.

On November 8 Modi surprisingly announced 500- and 1000-rupee banknotes (comprising 86% of circulating currency) were no longer legal tender, with new 500- and 2000-rupee notes taking their place. Indian citizens holding them had until December 30 to swap old currency for new, requiring them to formally declare all cash on hand.

The idea is controversial one, but it is primarily an effort to reduce corruption and tax evasion. Many Indian citizens forego bank accounts in favor of keeping savings at home, partly because rural areas—where over two-thirds of India's population lives—are

xxii Source: The Economist, 1/14/2017.

xxiii Source: US Energy Information Administration, as of 1/26/2017.

xxiv Source: US Department of Agriculture, as of 1/27/2017, US Agricultural Exports, FY 2016, 11/29/2016.

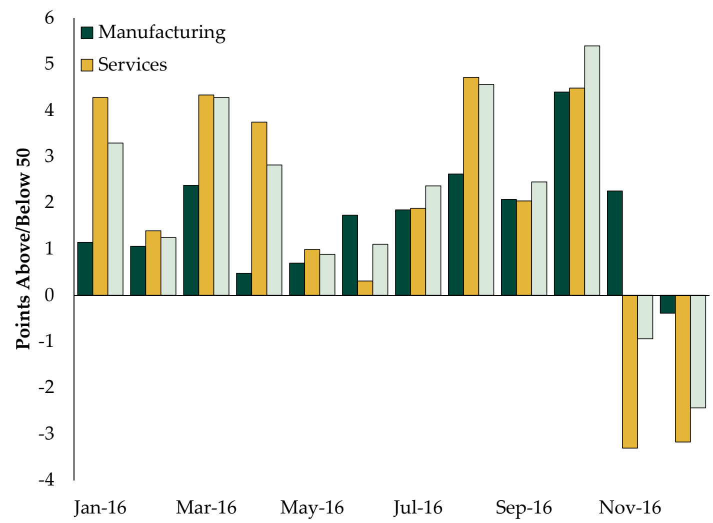
underbanked, and partly because few trust India's banks, which have a history of corruption and poor investments. Hence, few Indian citizens have debit or credit cards. Commerce is predominantly cash-based, resulting in rampant tax evasion and a huge underground economy (estimated at 20 – 50% of GDP).[xxv] The informal sector's size contributes to endemic corruption and a large sum of "black money." In conjunction with the Goods and Services Tax passed in September, Modi's "demonetization" reform sought to ease doing business nationwide and bring transactions out of the shadows. People depositing vast sums would be subject to investigation into whether their wealth was ill-gotten.

Well intended, but implementation was clumsy, jarring business and disrupting the lives of millions of law-abiding citizens. Because Modi declared the old notes would soon cease to be legal tender, businesses stopped accepting them immediately. Yet there weren't nearly enough new notes ready, so banks couldn't cope with huge demand. Huge lines formed at bank branches around the country—demand they were ill-equipped to meet. Even ATMs couldn't dispense the new bills, because they were a different size. As a result, many couldn't even purchase basic goods and services. Commerce stalled; employers couldn't pay workers; nearly 90% of India's trucks waited for days at toll crossings, gas stations and delivery locations, waiting to pay or be paid in new currency.[xxvi] There were also anecdotal reports that real estate sales, construction activity and consumer credit demand pulled back. It all had the effect of a miniature shock to money supply.

Indian Economy, Stocks Hit

Early national data was negative. Nikkei's Manufacturing Purchasing Managers' Index (PMI) fell to 49.6 in December—readings under 50 indicate contraction—with new orders also falling.[xxvii] The Services PMI fared even worse, falling to 46.7 in November and contracting again in December, at 46.8[xxviii] (Exhibit 24). Across the entire economy, new business fell at its fastest pace since 2013. Meanwhile, order backlogs rose for the seventh straight month as cash flow problems prevented firms from completing outstanding business.

Exhibit 24: India PMIs



Source: FactSet, as of 1/25/2017.

None of this means India's economy contracted in Q4—current consensus estimates call for 6.0% y/y growth.[xxix] But this would be a significant slowdown from Q3's 7.3% y/y, and it is abundantly clear the economy took a hit.[xxx]

Indian stocks, however, are already moving on. A pullback that began on September 8 accelerated after Modi's announcement. The MSCI India entered correction territory on November 11 falling 15.0% through November 21's low. Since then, though, the index is up 7.6%, albeit with plenty of volatility along the way, even as economic data has gotten worse.[xxxi]

xxv "The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2008," Dev Kar, Global Financial Integrity, 11/17/2010. http://www.gfintegrity.org/storage/gfip/documents/reports/india/gfi_india.pdf

xxvi "Demonetization Effect: Now, Petrol Pumps, Toll Plazas Refuse Rs 500, Rs 1000 Notes," Staff, The Financial Express, 11/14/2016. http://www.financialexpress.com/economy/demonetization-effect-now-petrol-pumps-toll-plazas-refuse-rs-500-rs-1000-notes/445462/

xxvii Source: IHS Markit, as of 1/25/2017.

xxviii Ibid.

xxix FactSet, as of 1/25/2017.

xxx Ibid.

xxxi Ibid. MSCI India return with net dividends, 11/21/2016 – 1/24/2017.

China

China's stock market volatility and yuan devaluation dominated headlines to start 2016. Following that early year turbulence, news was relatively quiet as economic growth remained steady. GDP grew 6.7% y/y in 2016 (6.8% y/y in Q4), falling in the middle of the government's targeted 6.5%-7% range.[xxxii] However, by year's end, Chinese hard landing concerns returned as corporate debt and higher interest rates angst rekindled fear. While we continue to believe these hard landing fears are overwrought, more investors seem to appreciate this point now—sentiment is catching on. A key swing factor for Chinese stocks—enactment of market-oriented reforms—also now seems to be on the backburner as China's Communist government aims for "stability." Therefore, in our view, China seems unlikely to cause a crisis or markedly outperform.

A Looming Debt Crisis?

Worries about Chinese debt have persisted since "hard landing" concerns surfaced in 2011. The fear centers on China's opaque corporate bond market, which some estimates peg at $3 trillion.[xxxiii] Many fear some businesses and sectors recklessly overextending themselves, inflating a bubble that will eventually pop, bringing down the broader economy. However, that detrimental hypothetical hasn't become reality. While struggling firms have defaulted on interest payments in the past—see Chaori Solar in 2014—this didn't cause broader problems, especially since the government served as a backstop in the event of negative fallout. However, concerns about struggling corporations still linger, particularly in light of capital outflows for much of 2016 and pressure on the yuan that led the People's Bank of China to sell reserve assets. When interest rates rose sharply in late 2016, many feared China's debt crisis was about to begin.

Rising Yields Aren't Reason to Worry

After the US Federal Reserve hiked interest rates in mid-December, China's 10-year bond yield rose to a 16-month high. Because rising yields mean higher borrowing costs for companies, struggling firms could feel interest rate pressure, and the weakest may end up defaulting on interest payments. If a multitude of defaults agitates the corporate debt market, China will suffer, and many speculate on possible global ramifications.

However, rising bond yields don't seem problematic, especially since they aren't unique to China. Compare sovereign yields since China's 10-year hit a low on October 24. (Exhibit 25)

Exhibit 25: 10-Year Yields on Sovereign Debt

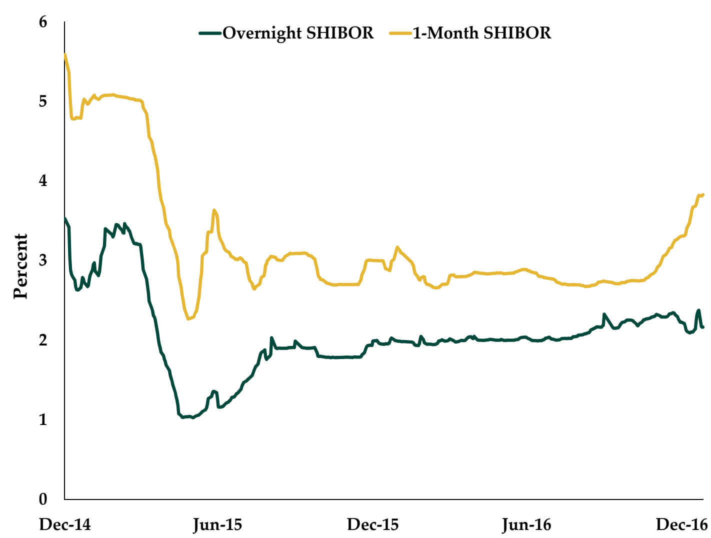
	October 24 (China's Low)	January 26	Change (percentage point)
China	2.63	3.27	0.64
US	1.77	2.46	0.70
UK	0.98	1.40	0.43
Australia	2.24	2.69	0.45
Germany	0.02	0.41	0.39
Japan	-0.06	0.04	0.10
South Korea	1.60	2.10	0.50
Taiwan	0.86	1.15	0.29

Source: FactSet, as of 1/26/2017. Yields are in percent.

From major Western economies to non-commodity heavy Emerging Markets, yields have been climbing globally. Fixed income markets, like equity markets, also experience bouts of short-term volatility, and when compared to peers, China's rising yields don't seem unique or worrisome.

Elsewhere, an uptick in bank funding rates (specifically, the Shanghai Interbank Offered Rate, or SHIBOR) was allegedly evidence of building stress in China's financial system. Yet this rise was small by even recent historical standards. (Exhibit 26)

Exhibit 26: Overnight and One-Month SHIBOR in Perspective



Source: FactSet, as of 1/26/2017. From 12/31/2014 – 1/25/2017.

xxxii Source: National Bureau of Statistics, as of 1/20/2017.

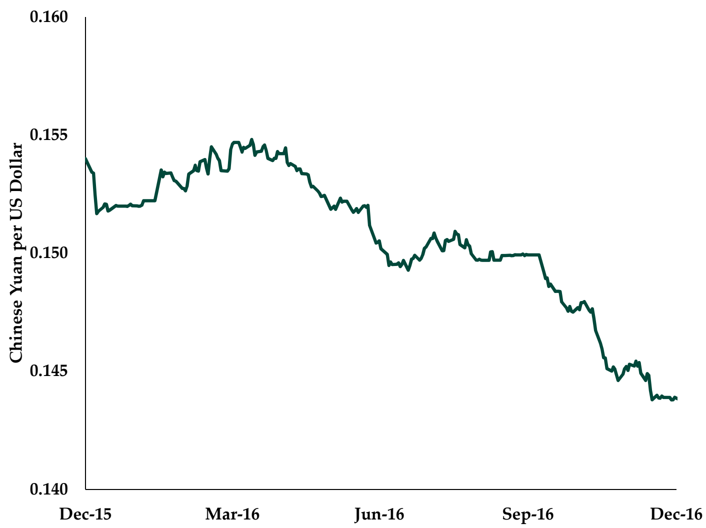
xxxiii Source: "It's All Suddenly Going Wrong in China's $3 Trillion Bond Market," Bloomberg News, as of 4/18/2016. Article accessed 1/20/2017.

Moreover, the government has the means—and willingness—to intervene and recapitalize banks should troubles arise. For instance, the People's Bank of China injected a net $6.5 billion into the interbank market in December to address potential liquidity issues. The government's tendency to intervene in markets stems from its desire for stability—and this is particularly evident with the yuan.

The Government's Yuan Forays

After peaking in April, the Chinese yuan weakened versus the dollar throughout the rest of 2016. (Exhibit 27)

Exhibit 27: The Yuan's Weak 2016



Source: FactSet, as of 1/23/2017.

This contributed to the aforementioned corporate debt fears, as a weaker yuan could hurt Chinese companies' ability to repay dollar-denominated debt. The yuan also made headlines as now-US President Donald Trump frequently charged China with devaluing intentionally to increase export attractiveness.

> The government's top commitment remains preserving overall stability, which means softening any potential shocks to the system.

However, while China was meddling with the yuan, it was to prop the currency up—not artificially push it down, as Trump argued. While some were expecting capital outflows to drive the yuan down at 2017's start, the renminbi actually jumped to its strongest level since early November. Most observers believe the government stepped in to absorb liquidity and spiked the overnight deposit rate to prop up the currency. China has ample tools to prevent the yuan from falling sharply. Even after selling nearly $1 trillion of its foreign exchange reserves to prop up the yuan from mid-2014 to November 2016, China still holds a robust $3 trillion. The government's top commitment remains preserving overall stability, which means softening any potential shocks to the system.

This suggests emphasis on economic liberalizations may be a lower priority today—officials admitted as much at its recent annual Central Economic Work Conference. While disappointing, as Chinese markets would likely have benefited from increased openness, the de-emphasizing of reform doesn't mean trouble looms. Rather, it suggests the status quo will largely persist for the foreseeable future. China's status quo has continually defied hard landing worries, and nothing suggests this will change in the foreseeable future.

Korea

Korea's big news in Q4 was the influence-peddling scandal surrounding President Park Geun-hye, which led to her impeachment in December. Her trial began in January, and the Constitutional Court must decide by June whether to remove her from office permanently, with new elections following two months later. Korean markets wobbled as the scandal unfolded in October and November, but their December rebound illustrates the power of falling uncertainty—a theme that likely continues this year as Park's fate gradually becomes clear.

The scandal revolved around Choi Soon-sil, a close confidant of Park's and daughter of Park's late shaman, Choi Tae-min, who won Park's favor in her youth by claiming to be able to contact her late mother. Allegations against Choi are myriad, but the impeachment centers around Park allegedly enabling Choi to embezzle tens of millions of dollars from the Federal government and several of Korea's largest firms. Samsung and its heir apparent, Samsung Electronics Vice Chairman Jay Y. Lee, are also ensnared in the scandal, as prosecutors allege he gave Choi embezzled funds in exchange for Park's directing Korea's National Pension Service to approve the merger that placed him in de facto control of Samsung Group.[xxxiv]

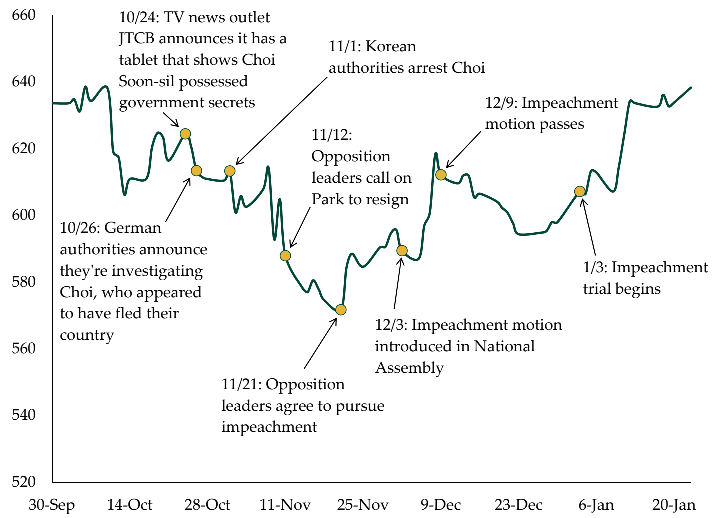
xxxiv *"South Korea Court Rejects Arrest of Samsung Heir Jay Y. Lee," Jungah Lee and Kanga Kong, Bloomberg, January 18, 2017. https://www.bloomberg.com/news/articles/2017-01-18/south-korea-court-denies-arrest-of-samsung-heir-jay-y-lee*

The public first caught wind of these affairs in late October, when investigators began pursuing Choi. At the time, Park appeared to be insulated, but the more information leaked, the more public opinion turned. Over one million Koreans held weekly candlelight vigils outside Park's official residence, and as the weeks passed, investigators unearthed more and more evidence suggesting Park was complicit in Choi's wrongdoings. As her approval plunged to a record-low 5%, calls for her to resign grew louder, and lawmakers began discussing whether to impeach her.[xxxv] At first, Park resisted, but by early December she offered to resign. Rather than accept, however, the National Assembly voted on December 8 to impeach her, with dozens of members of her Saenuri Party siding with the opposition.

Upon the impeachment, Park was removed from office temporarily, with Prime Minister Hwang Kyo-ahn serving as acting president. Park thus far has refused to testify or appear at her impeachment trial, which isn't unusual—former President Roh Moo-hyun also avoided his own impeachment proceedings, and he was eventually acquitted.[xxxvi] As this Review & Outlook is released, it is impossible to know whether Park will be reinstated or convicted. While public opinion is strongly against her, she is not being tried in the court of public opinion, but in the Constitutional Court. Six of the court's nine justices must vote to remove her from office, but two of those justices' terms expire before June, including Chief Justice Park Han-chul, and replacements are unlikely to be appointed while an impeachment trial is ongoing.[xxxvii] Of the remaining justices, only two would need to vote to acquit Park for her to be reinstated.

As a result, uncertainty likely lingers over Korean stocks for the time being. However, that doesn't mean the scandal is bearish. The MSCI Korea fell for a month after the scandal broke, then rebounded despite the impeachment (Exhibit 28)—simply knowing whether Park would stand trial offered some measure of relief. They now sit above pre-scandal levels.

Exhibit 28: MSCI Korea as the Scandal Unfolded



Source: FactSet, The Telegraph, The Diplomat, JTCB and The New York Times, as of 1/24/2017. MSCI Korea Index with net dividends, 9/30/2016 – 1/23/2017.

Thanks to the scandal, sentiment toward Korea plummeted—unnecessarily so, in our view. Korea's economy continues growing at a decent clip, and the country is getting a boost from the nascent recovery in global trade. If that trend continues, and China keeps modestly growing while the Western world remains fundamentally healthy, Korea should easily beat low expectations. Falling uncertainty as the political situation clarifies should also be a modest tailwind—similar to the lift America and Britain received in 2016 as uncertainty related to the election and Brexit, respectively, gradually dissipated.

xxxv "Park's Approval Rating Hits Record-Low of 5%," Rachel Lee, The Korea Times, November 4, 2016. http://www.koreatimes.co.kr/www/news/nation/2016/11/116_217549.html

xxxvi "Park Geun-hye, South Korean President, Is a No-Show at Impeachment Trial," Choe Sang-hun, The New York Times, January 3, 2017. https://www.nytimes.com/2017/01/03/world/asia/south-korea-president-impeachment-trial.html

xxxvii "Park's Lawyers Spring 39 More Witnesses on Constitutional Court," Staff writers, The Chosunilbo, January 24, 2017. http://english.chosun.com/site/data/html_dir/2017/01/24/2017012401147.html

Should you have any questions about any of the information in the Fourth Quarter 2016 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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