Fisher Investments Australasia™

MARKET PERSPECTIVES
REVIEW & OUTLOOK

FIRST QUARTER 2021

FIRST QUARTER 2021 REVIEW & OUTLOOK

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FIRST QUARTER 2021 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

12 April 2021

PORTFOLIO THEMES

- We continue to favour larger, high-quality companies as our assessment is that we remain in a late bull market cycle despite the technical bear in 2020.
- The recent relative strength in smaller and more value-oriented companies is likely a typical countertrend in a longer growth-led cycle.
- Measures of economic growth and inflation likely moderate once last year's deeply depressed base levels are passed, supporting our preference for growth-oriented equities.

MARKET OUTLOOK

- **Expect an Above-Average Year for Global Equities:** We anticipate a strong year for global markets tied to equities' resilience, political clarity and continued vaccine development and distribution.
- **We Believe We are Late in the Market Cycle:** The 2020 downturn behaved more like an outsized correction than a traditional bear so the market cycle did not reset. The vast majority of our sentiment and market indicators point to this being a late cycle bull market, yet many forecasters expect early-cycle leadership.
- **Investor Sentiment is Elevated but not Euphoric and can Remain High for a Long Time:** Positive sentiment can reign for a while before equities reach a euphoric peak, with strong returns along the way. Monitoring sentiment will be key for investors in 2021.

Global markets extended their climb in Q1, rising 4.6%.[i] Value equities led growth with Tech and Tech-like equities lagging, however we believe this to be a temporary countertrend. We are monitoring this carefully with the understanding that style volatility is normal. Crucially, our outlook hasn't changed. We still think equities should have a good year, with growth regaining its leadership as markets climb alongside sentiment.

As detailed in past Reviews, 2020's bear market acted like an oversized correction. There was little to no excess before governments shut down the global economy to restrain Covid-19's spread, triggering a contraction unlike normal recessions. Markets priced this rapidly—too fast to reset the market cycle, in our view. As a result, equities are behaving like they are in the late stages of the bull market that began in 2009—a point when returns are usually strong with growth leading despite irregular value countertrend rallies. Overwhelmingly, most observers now envision a young bull market with years to run amid extended value leadership. Global markets efficiently price in broad expectations and we believe there are fundamental reasons for our current contrarian view. While we believe this bull market has room to run now, it is likely closer to its end than most expect.

Value's leadership dominated headlines globally in Q1—a big sign this is a temporary and fleeting leadership reversal, in our view. Long-term interest rates rose swiftly—which inflated expectations for inflation and fast economic growth to benefit the industries that suffered most during lockdowns—all value categories. The steeper yield curve also heightened expectations for bank earnings, another big value component.

i Source: FactSet, as of 01/04/2021. MSCI ACWI Index return with net dividends, 31/12/2020 – 31/03/2021.

Fund managers are now more optimistic on value than they have been in many years with retail investors following suit. After a brief bump tied to reopening, economic growth will likely be slower than headlines expect. Inflation probably won't spike, anchoring long-term interest rates—a backdrop favouring growth equities over value. Further, value equities, especially illiquid small ones, are generally lower quality and usually fare worst in bear markets. While we don't think a bear market is imminent, investors shifting heavily to value and not appreciating this bull market's late-cycle traits could be setting themselves up for disappointment.

Sentiment today is classically late-cycle. Optimism abounds. Pockets of euphoria exist in areas such as cryptocurrencies, digital assets called non-fungible tokens (NFTs) and so-called blank check companies (Special-Purpose Acquisition Companies, or SPACs). These fads wouldn't happen in a typical new bull market, when pessimism dominates.

Pockets of skepticism exist though, and politics underpins much of it. Many investors are concerned about spending and potential tax increases. This is understandable, and in the US more legislation may pass early in President Biden's term than we initially envisioned. But plenty of historical data show markets pre-price widely watched bills like taxes and spending, limiting their power over equities—positively or negatively. For example, major tax and spending hikes dominated last year's US presidential campaign and the vast majority of investors expected them in some form. Therefore, efficient markets dealt with all of this by the time President Biden was elected. Also, his "honeymoon" period with lawmakers and voters is nearly over. Gridlock— tied to the Democratic Party's narrow edge in the House and Senate as well as internal divisions—should result in any proposed legislation, such as a tax bill, getting watered down. Pushing bills through repeatedly would likely wear out fast, as many in Congress look ahead to 2022's midterms. As 2021 passes, gridlock's realities should grip tighter.

In European politics, Netherlands Prime Minister Mark Rutte's People's Party for Freedom and Democracy (VVD) won the most votes in mid-March's general election. Yet at the month's end, Prime Minister Rutte became entangled in a long-running childcare scandal, as allegations he tried to silence a whistleblower emerged. Italy has a new government, led by former ECB President Mario Draghi. Some observers think Prime Minister Draghi's popularity and reputation for competence bolster his ability to pass major changes, including overhauling Italy's bureaucracy and implementing sweeping tax reforms. However, we doubt Prime Minister Draghi's government will be much more active than its predecessors. Additionally, two widely watched German regional elections saw outgoing Chancellor Angela Merkel's Christian Democratic Union (CDU) suffer historic losses. Some observers see the results as a precursor for September's federal election, though that seems unlikely to us. No one party looks likely to run away with September's vote, and no politician currently has Chancellor Merkel's popularity. It appears another do-little German coalition government is likely, which should prevent extreme legislation—a positive for equities.

Emerging Markets (EM) also rose in Q1, rising in accordance with Covid-19 vaccine optimism and the value countertrend—helping EM heavy sectors such as Energy and Materials. However, Emerging Markets fell in March, with the biggest detractor a sharp fall in Chinese equities, which account for over 35% of the MSCI EM's market capitalisation.[ii] Chinese volatility, stemmed primarily from fears over the new enforcement of the Holding Foreign Companies Accountable Act—which raises the possibility of Chinese ADRs being delisted from US exchanges—and regulatory rumblings from Beijing. The People's Bank of China (PBOC) is reportedly planning to toughen oversight of digital commerce and payments—putting some large Tech and Tech-like names in its sights—and financial regulators are also considering measures that would further tighten private credit. While these issues are worth watching, we think the sentiment reaction to them is excessive.

ii Source: FactSet, as of 01/04/2021. MSCI Emerging Markets and constituent countries' market capitalisation on 31/03/2021

Once the sentiment reaction passes, we think the country's favourable economic fundaments should regain primacy, boosting Tech and e-commerce in particular. We think China's recent decline is a correction, not the start of something much worse, and we still think EM equities are likely to have a good to great year, with growth equities leading.

Markets' ability to pre-price major, widely discussed developments was one of last year's biggest lessons. It won't surprise us if the major economic data swings likely ahead push sentiment up and down. Economic data series are often calculated on a year-over-year basis. Last year's deeply depressed figures will be the base for forthcoming reporting, which will yield huge growth rates even if activity is static month to month. As we move through the second quarter, and last year's sharp rebound becomes the new base, we believe it could drive big slowdowns or even drops for the same reason. We expect to see plenty of headline volatility tied to this dynamic.

This "base effect" will also boost inflation briefly. This looks temporary to us, as inflation and interest rates move globally, not nationally. Global forces are relatively benign. On the economic front, many envision a big, stimulus-fueled boom in the coming months. Economic growth may spike temporarily, but we don't think a huge, lasting surge is ahead. We aren't pessimistic, but late in bull markets, high expectations and greed can drive some investors to make risky, overly optimistic decisions.

While we don't see a bear market as imminent, we are vigilant for what could cause one and we diligently monitor widespread signs which could affect equities broadly. But overall, this looks like a very good, late bull market year to us.

GLOBAL UPDATE AND MARKET OUTLOOK

07 May 2020

Q1 MARKET RECAP

OPTIMISM—RATIONAL VERSUS OVERSTATED

As 2021 began, optimism was only beginning to surface. Now it is broadly evident. Vaccines are rolling out across the globe. Economies are increasingly, if irregularly (e.g., Europe) reopening. More and more people see a return to near-normal as close by. Positive economic forecasts of robust growth abound, with many envisioning a lasting expansion. While partisanship persists, the 2020 US election's wild political backdrop and aftermath has calmed and European politics are mostly gridlocked. Forecasters, already bullish at the year's start, seem more so now.

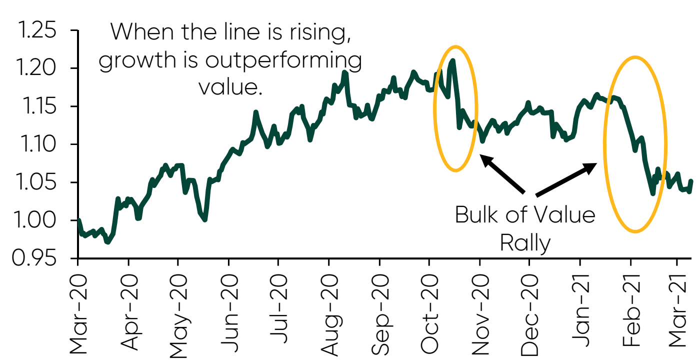
Feeding on this optimism, global equities rose, extending gains as the bull market completed its first year.[iii] We think this is the start of strong full-year returns. For one, stirring animal spirits are usually a powerful tailwind. It takes a while for optimism to become full-blown euphoria, and even that transformation isn't necessarily bearish. All the while, positive sentiment drives powerful returns.

Fundamentals are bright. The US political stage is set for what we call the perverse inverse: equities' overwhelming tendency to deliver robust returns in Democratic presidents' inaugural years. Abundant fear over tax hikes and contentious sociological measures feeds this, as they keep expectations low. That sets up big positive surprise as legislation proves more moderate than the radical change markets contemplated during the campaign. Meanwhile, the global economic recovery from lockdowns continues as vaccines roll out and businesses reopen, powering a big rebound in corporate earnings. These factors are well-known, but economic drivers are improving, not worsening—a great backdrop for equities. Economic growth from 2022 onward may not be as positive as everyone expects, but this isn't bearish—at least, not for now. Rather, we think it benefits growth equities, defying the many who expect value to lead tied to a big, lasting acceleration.

THE VALUE COUNTERTREND

Our expectations for growth to beat value are uncommon, especially after value's Q1 outperformance. Brent oil prices rose 24.1% in Q1 as expectations for resurgent demand rose, driving value-oriented Energy equities up 17.7%—the best-performing sector.[iv] Similarly, expectations for accelerating inflation sent US interest rates up from 0.93% at 2020's close to 1.74%.[v] That climb further aided value—especially Financials, which outperformed markedly in Q1 as hopes for rising loan profits grew. Meanwhile, Tech equities rose, but only by 1.8% as less economically sensitive growth equities trailed.[vi] In our view, though, value's Q1 leadership doesn't look lasting. For one, most of the outperformance during the quarter occurred in a short timeframe, similar to the brief spurt last November. (Exhibit 1)

EXHIBIT 1: VALUE'S BURST



Source: FactSet, as of 04/04/2021. MSCI ACWI Growth Index divided by MSCI ACWI Value Index, both with net dividends, 23/03/2020 – 31/03/2021. Indexed to 1 at 23/03/2020.

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iii Source: FactSet, as of 01/04/2021. MSCI ACWI Index return with net dividends, 23/03/2020 – 31/03/2021.

iv Source: FactSet, as of 06/04/2021. Brent crude oil price percentage change, 31/12/2020 – 31/03/2021 and MSCI ACWI Energy sector return with net dividends, 31/12/2020 – 31/03/2021.

v Source: FactSet, as of 06/04/2021. US 10-Year Treasury Constant Maturity yield, 31/12/2020 and 31/03/2021.

vi Source: FactSet, as of 06/04/2021. MSCI ACWI Information Technology sector return with net dividends, 31/12/2020 – 31/03/2021.

Value bulls cite the category's typical outperformance early in bull markets, as equities anticipate a sharp economic acceleration. Today, many see this bull market as young, with vaccines and government "stimulus" set to power years of fast economic growth. But we see many problems with this thesis. Most important among them: There are many signs this bull market is late-stage, not early.

THE BEAR MARKET THAT ACTED LIKE A CORRECTION

As past Reviews detailed, 2020's sharp downturn was technically a bear market—it breeched-20% from a peak and had a fundamental cause. Yet in many ways, it acted like a hugely oversized correction.

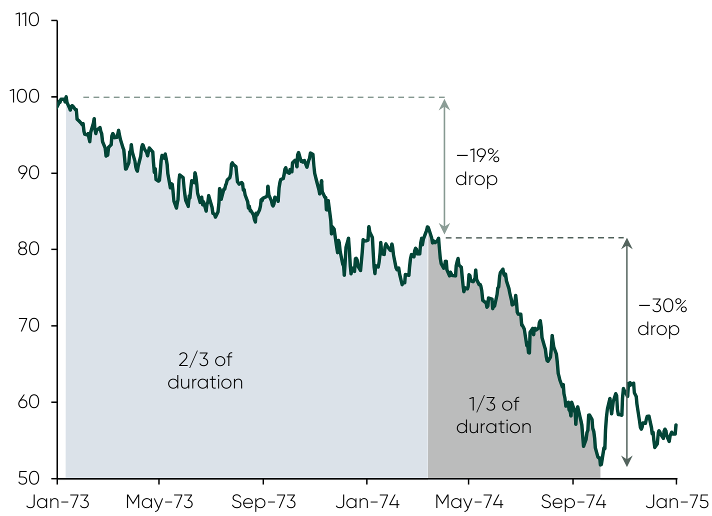
Today's optimistic sentiment would be highly unusual early in a bull market, when the downturn's painful impact is fresh. As Sir John Templeton put it, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." The prevalence of speculation driven offerings like special-purpose acquisition companies (SPACs), cryptocurrencies, "meme" equities and more shows sentiment is far from pessimistic. This warming sentiment—likely due to the bear market's correction-like speed—is a key sign we are late, not early, in this bull market.

SPEED DEFINES THIS CYCLE'S EVOLUTION

Speed was arguably the 2020 bear market's defining feature. Global equities tumbled from record highs in mid-February to bear market lows in mere weeks—the fastest ever. That speed typifies corrections, not bear markets.

Bear markets normally begin with a whimper, not a bang. They first slowly move lower, as investors dismiss declines as buying opportunities while overlooking the bear market's fundamental cause. Only late, when people realise the negatives driving weakness are fundamental, do the violent swings arise. We think this is why bull markets typically begin with a long, rolling top and gradual declines. 2020 aside, about a third of bear markets' peak-to-trough declines comes in the first two-thirds of its lifespan. The worst drops come late. We call this the two-thirds, one-third rule. Exhibit 2 shows this, using the 1973 – 1974 bear market.

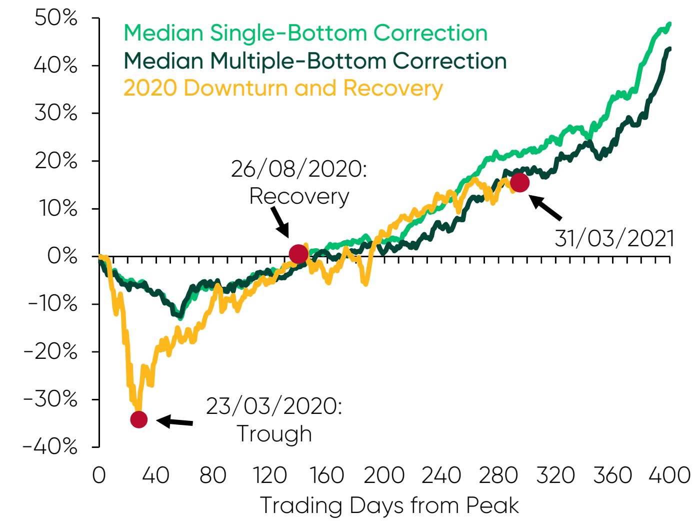
EXHIBIT 2: THE TWO-THIRDS, ONE-THIRD RULE IN 1973 – 1974



Source: FactSet, as of 12/03/2019. S&P 500 price index, indexed to 100 at pre-bear market peak on 11/01/1973. 11/01/1973 – 31/03/1975.

It would be senseless to recreate this graph for 2020, given the decline's speed. But that is the point: That pace resembles a correction much more than a bear market—on the way down and up. Exhibit 3 shows this, plotting the MSCI World Index during 2020's bear market against the median single- and double-bottom correction (we differentiated the two to highlight how similar typical correction recoveries look despite swings around the low). The similarities are striking.

EXHIBIT 3: 2020'S CORRECTION-LIKE BEAR MARKET AND RECOVERY



Source: FactSet and Global Financial Data, Inc., as of 31/03/2021. MSCI World Index price returns. Data are monthly from 06/06/1975 – 31/12/1975 and daily thereafter. Chart data shows MSCI World cumulative return.

WHY SPEED MATTERS

A bear market's speed drives its effect on sentiment—which influences the market cycle's evolution. Typically, fear builds slowly until the panicky final third. Bear markets end with capitulation, when all but the most enthusiastic investors have given up.

Late in bear markets, value equities—more economically sensitive and credit-reliant—are usually hit hardest. Tied partly to the credit cycle and value firms' lower quality, many investors fear for their survival. Banks restrict credit to them, threatening their viability and causing some to fail. In a bear market's final throes, fear towards value firms is usually at its height.

But, as Ken Fisher wrote in his 1 March LinkedIn post:

> *Inevitably, but after a long time, panic goes too far. Central banks cut short rates, long rates hold steady and yield curves steepen. Markets, foreseeing a lending boost, pre-price that effect so value stocks lead the rebound. Value's early leadership is historically and primarily a relief rally from prior credit tightening reversing.*[vii]

While value trailed during last year's downturn, its speed didn't let the sentiment and credit effects unfold, in our view. There was no extreme, disproportionate credit tightening. While some pundits deterred from value, we never reached typical bear market extremes. Rather, most looked to the historical record, saw their typical early outperformance in new bull markets and assumed it would repeat. But without investors giving up on value, relief—value's traditional fuel—was absent. Hence, growth led before, during and after the downturn. That last part is highly unusual following a bear market, but is entirely normal following a correction.

VALUE: SENTIMENT IS OVERLY OPTIMISTIC

The bullish case for value is widely known—unlikely to sway markets for long. Rampant enthusiasm partly reflects vaccinations and quick reopening expectations, and partly reflects popular expectations for "stimulus" plans' effects.

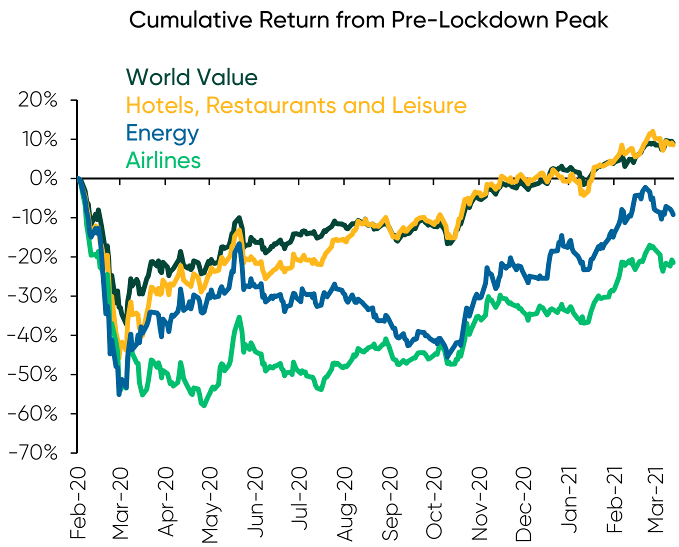
Throughout 2020, pundits dissected every emerging vaccine development. When successes emerged in early November, focus turned to distribution. Now headlines focus on daily inoculation counts, distribution issues and successes, and more.

vii "'Why' Is Always Crucial. Why It's Not Time For Value Stocks," Ken Fisher, LinkedIn, 01/03/2021.

Nearly everyone now anticipates near-term economic reopening. So do economic forecasts. The IMF sees US GDP growing 6.4% this year, a hair behind the Fed's 6.5% forecast.[viii] The median of 67 brokerage forecasts puts 2021 US GDP growth at 5.8%.[ix] Any would be the fastest annual growth since 1984, a widely discussed comparison.[x] Expectations overseas are similarly robust. The IMF expects a 5.3% surge in UK GDP this year.[xi] The eurozone, much criticised for its slow vaccine rollout, is still expected to grow 4.4%.

The vaccine-driven boom is, and has been, the common forecast globally. Markets are efficient, pre-pricing common opinions, views and forecasts. As Exhibit 4 shows, returns for airlines, leisure firms, Energy and value—areas most reopening-exposed—seemingly pre-priced it.

EXHIBIT 4: THE REOPENING TRADE IS CLOSED



Source: FactSet, as of 07/04/2021. MSCI World Value, Energy, Airlines and Hotels, Restaurants and Leisure returns with net dividends, 19/02/2020 – 31/03/2021.

Saying reopening and vaccines support value means arguing markets are near-totally inefficient. Yet one of the last year's most important investing lessons is this very pre-pricing function. Equities began climbing before data registered the extent of the lockdowns' economic damage. They were already done dealing with the widely expected contraction—and looking ahead to recovery.

Last year, we saw several value countertrends many pundits thought were real, but none of them led to a lasting leadership shift. Early last June, after two weeks of value outperformance, pundits claimed big growth was losing its "mojo" as "an extreme confluence of various technical factors ... are set to drive a significant upswing in traditional value stocks."[xii] Last September, another two-week countertrend had many arguing reopening would drive cyclical value equities' outperformance.

Looking further back, longer countertrend rallies are easy to find. In Tech- and growth-dominated 1999, value led from February to May. Pundits were certain "overvalued" Tech was spent. "The abandonment of technology stocks, until recently the backbone of the Wall Street bull market, began last week as investors developed a new fervour for cyclical stocks—shares of companies that do well when the economy is strong."[xiii] Yet by yearend, growth had again led significantly in the run up to the Tech bubble's top. In the 2009 – 2020 bull market, value had extended countertrend rallies in 2012, 2016 and 2018. Yet overall, growth dominated.

viii "IMF Lifts Outlook for Global and US Growth," Greg Robb, MarketWatch, 06/04/2021.

ix Source: FactSet, as of 07/04/2021.

x Source: US Bureau of Economic Analysis, as of 07/04/2021.

xi Source: IMF April 2021 World Economic Outlook, as of 07/04/2021.

xii "Value Stocks Are Coming Back as Momentum Shares Lose Their Mojo," Evie Liu, Barron's, 09 June 2020.

xiii "Nasdaq Meltdown Sinks Dow," Malina Poshtova Zang and Robert Scott Martin, CNN Money, 19/04/1999

RATIONAL OPTIMISM FOR NOW

The world is gradually returning toward normal economically—and that is a sound reason for optimism about the immediate future. But as an investment thesis, we think it falters. Any investment rationale must look beyond reopening, vaccines and the pandemic. As we will discuss more throughout this Review, we think a look at that timeframe reveals a 2021 economic acceleration that proves temporary, inflation that never meaningfully materialises and value leadership that gives way to growth before long.

Furthermore, some pandemic-era changes may never reverse fully—like the drop in business travel. The exact permanent changes defy prediction. But markets will see them before the crowd and pre-price it efficiently—and have probably already begun to. Many of these trends benefit Tech and growth equities, which could be a positive surprise value bulls aren't considering.

ECONOMIC REOPENING AND BEYOND

Pundits everywhere see vaccines, reopenings and "stimulus" supporting years of robust growth, fueling enthusiasm for value equities. While we probably will see strong economic growth as more businesses reopen, we don't think it will last. Economic growth probably slows towards the pre-pandemic trend after an initial bounce. Today's popular forecasts underrate how much of the recovery already occurred and overrate fiscal stimulus's impact.

EQUITIES ALREADY REFLECT THE REOPENING BOOM

Reopening is a powerful economic force as we saw mid to late last year, when businesses returned from the first Covid-19 wave shutdowns. Many indicators recovered most of that lost ground and some even hit new highs. The second Covid-19 wave brought new shutdowns, but the economic impact wasn't nearly as severe as last year's. Factories remained open and many services businesses, while still hit by restrictions, found workarounds to cushion the impact. Equities moved ahead of last year's reopening boom and have likely already priced vaccines and the removal of lingering restrictions.

Exhibits 5 and 6 show how far the US economy has already come. Retail sales are at record highs. Industrial production (IP) is near pre-pandemic levels and GDP is nearing its Q4 2019 high.

EXHIBIT 5: RETAIL SALES & IP

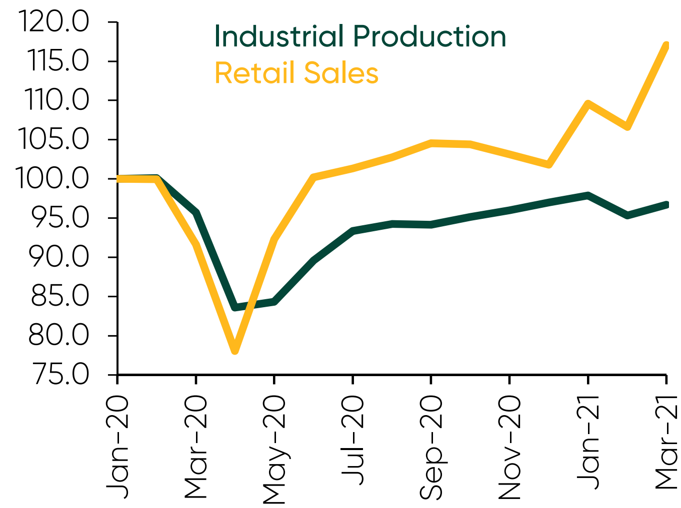


EXHIBIT 6: GDP

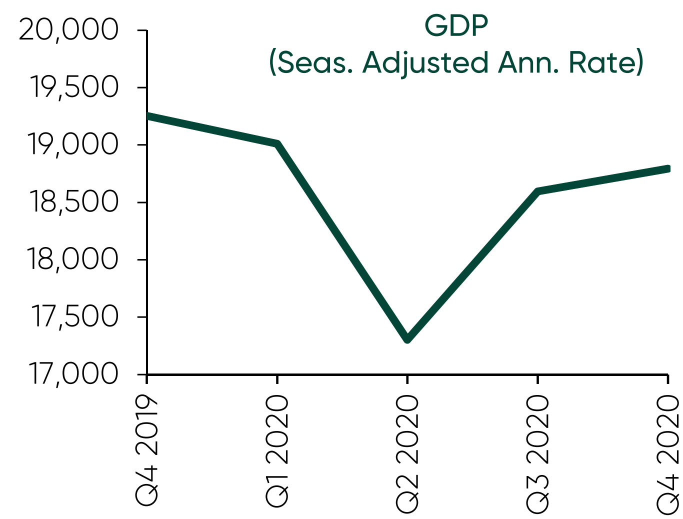


Exhibit 5 & 6 Source: Federal Reserve Bank of St. Louis and US Bureau of Economic Analysis, as of 19/04/2021. Exhibit 5 indexed to 100 at January 2020. Exhibit 6 shows GDP in billions of 2012 USD.

These gauges aren't perfect—and retail sales and IP highlight the "goods" segment of the economy, which was hit less than America's huge services sector. Regardless, these charts show the economy's resilience, which equities have pre-priced for the past year. The S&P 500's "V"-shaped recovery preceded the economy's by several months—efficient markets at work.

But they also show most of the initial boom is over. Yes, pockets of weakness linger in leisure and hospitality, and those will enjoy a long-delayed recovery as recreational travel and indoor dining return in earnest. However, last year's rebound was sharp and short, and any visible impact on data as the remaining businesses come back to life is likely equally fleeting. Overall, the post-Covid-19 trend should eventually look like the pre-Covid-19 trend of slow-but-steady GDP growth.

EUROPE ISN'T FAR BEHIND

Most European nations are behind the US due to their tougher, longer-lasting lockdowns and well-documented difficulties with vaccine distribution. Yet they, too, are largely following the same trajectory as the US: big "Vs" in economic data last April through August, followed by small contractions from October through January 2021. But markets know all of this, including the course the US has charted for the rest of the developed world. To us, that suggests strongly the rebound immediately ahead is priced there, too, which is a particular headwind for the value-heavy UK and European equity markets.

EXHIBIT 7: UK REBOUND

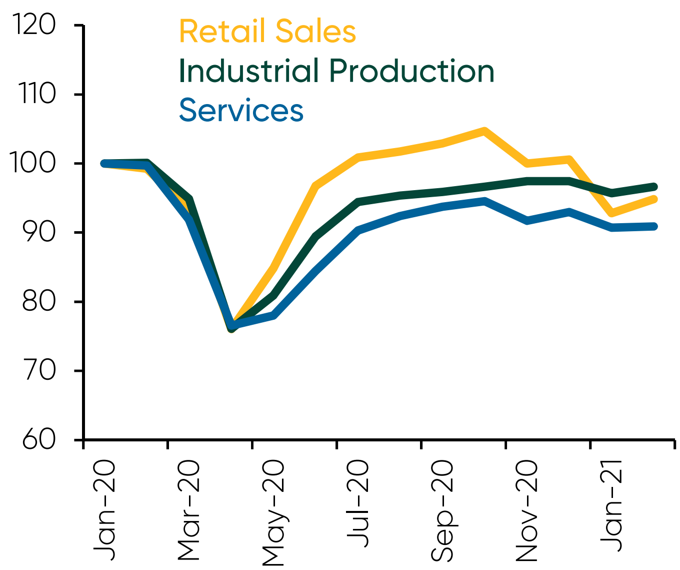


EXHIBIT 8: THE EUROZONE'S V

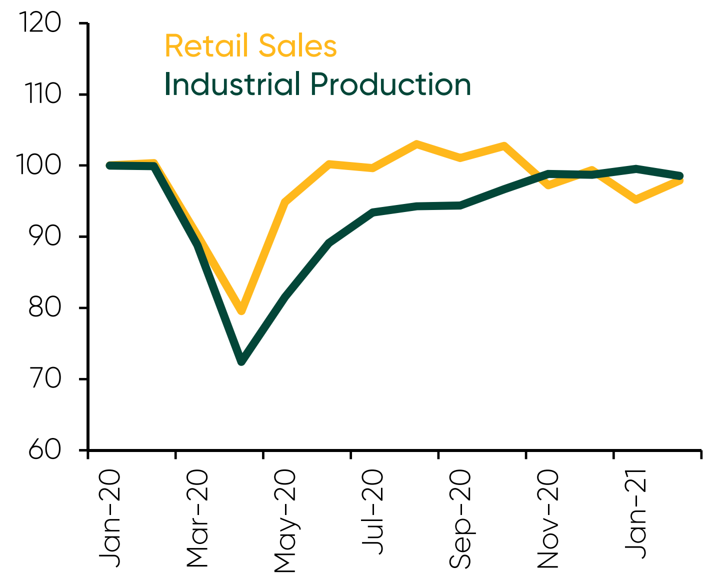


Exhibit 7 & 8 Source: FactSet and UK Office for National Statistics, as of 19/04/2021. Both charts indexed to 100 at January 2020.

BASE EFFECTS WILL IMPACT FORTHCOMING DATA

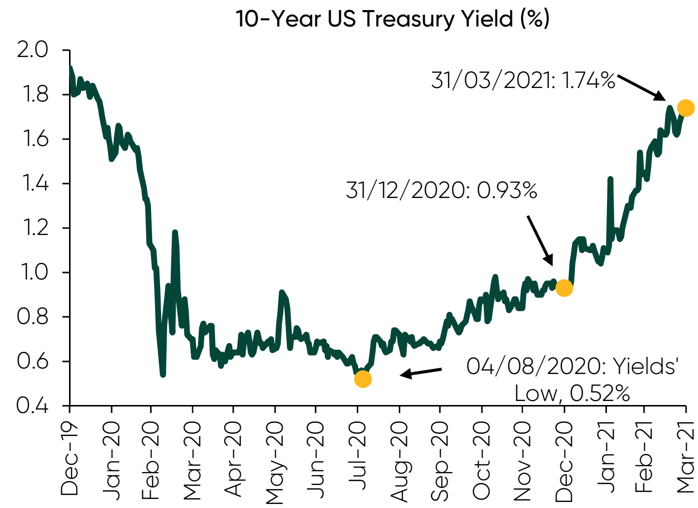
Some indicators over the next few months might seem to counter everything already discussed. This is because many data series—perhaps most notably US inflation—are calculated on a year-over-year basis. In normal times, this helps smooth volatility in month-over-month calculations, especially in emerging markets where data aren't seasonally adjusted. This year, however, the year-over-year calculations will have the opposite effect. The base—last year's results in March and April—will be deeply depressed from lockdowns, which will massively inflate results this year. As a result, year-over-year growth rates will likely show huge increases immediately ahead, followed by sharp slowdowns or even contractions, even if data are static from month to month.

In Emerging Asia, which took the economic hit from lockdowns before the US and Europe, these results are already materialising. In China, which combines January and February to remove skew from the Lunar New Year, that two-month stretch saw retail sales jumping 33.8% y/y, industrial production surging 35.1%, exports up 50.1% and imports a whopping 14.5%.[xiv] Additionally, Q1 GDP soared 18.3% y/y.[xv] In South Korea and Taiwan, March exports surged 20.1% y/y and 29.1%, respectively.[xvi]

INTEREST RATES AND INFLATION

As previously mentioned, long-term interest rates jumped in Q1—a global trend seemingly underpinned by US Treasury yields. (Exhibit 9)

EXHIBIT 9: THE TREASURY YIELD JUMP



Source: FactSet, as of 08/04/2021. 10-year US Treasury yields, 31/12/2019 – 31/03/2021.

Some saw this as fuel for value equities. For others, the rise spurred fears (or hopes) of faster inflation. Still others saw it as the beginning of a bond bear market, with a persistent rise causing debt troubles worldwide. But to us, like the value countertrend, this move seems much more about sentiment than fundamentals. Despite the upswing, we still expect the full year's rate moves to be benign in hindsight. From here, rates are likelier to fall than rise.

xiv Source: FactSet and China Customs Bureau, as of 09/04/2021.

xv Source: FactSet, as of 19/04/2021.

xvi Source: FactSet, as of 09/04/2021.

BOND MARKET FUNDAMENTALS

Bonds, like equities, move on supply and demand—factors set globally, not nationally. As most everyone knows, increased debt issuance tied to global governments' Covid-19 responses has sent supply surging. Yet demand is similarly strong.

Central bank quantitative easing (QE) programmes absorb trillions' worth of bonds. Entering 2020, the Fed held just over $2 trillion in US Treasury notes and bonds (securities with greater than a 1-year maturity). Now it holds over $4.2 trillion.[xvii] Other major central banks are purchasing similarly vast quantities of assets under QE. While we don't think it is terribly sensible, QE adds to demand for bonds and takes vast quantities off the market.

Even beyond this, Treasury demand is healthy. US yields are higher than almost anywhere else in the developed world, luring investors. Much of Europe, including Germany, France and Switzerland, have negative 10-year yields.[xviii] British, Spanish and Italian yields are under 1%. Japanese 10-year yields are pinned near 0%.

Inflation expectations are a key demand driver. With QE running globally, it would likely require runaway inflation to send yields surging—improbable any time soon. More likely: After a brief, base-effect driven bump, inflation slows—dampening interest rates.

WHY INFLATION ISN'T LIKELY TO SPIKE

Interest rates' Q1 rise has many watching for hot inflation. Some cite rising commodity prices, like oil or lumber. But isolated price jumps are normal—functions of supply and demand. Inflation is different however, as it entails prices rising across the global economy. Today, despite pockets of price pressures, inflation signs are sparse worldwide.

In the developed world, inflation rates—and therefore interest rates—are tightly correlated and there are few barriers to moving money across borders. Exhibit 10 shows you this, plotting the core consumer price index in the US and the rest of the developed world (weighted by GDP). Exhibit 11 echoes the point, plotting the producer price index—a measure of input costs—for the same regions (also GDP-weighted).

EXHIBIT 10: CORE CONSUMER PRICES

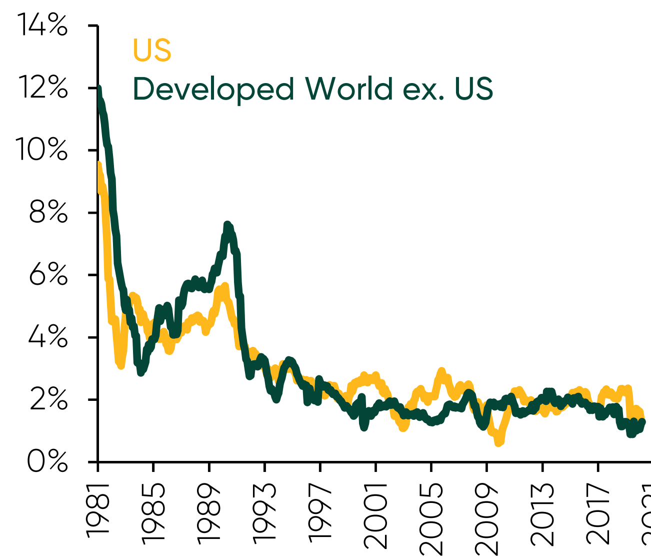


EXHIBIT 11: PRODUCER PRICES

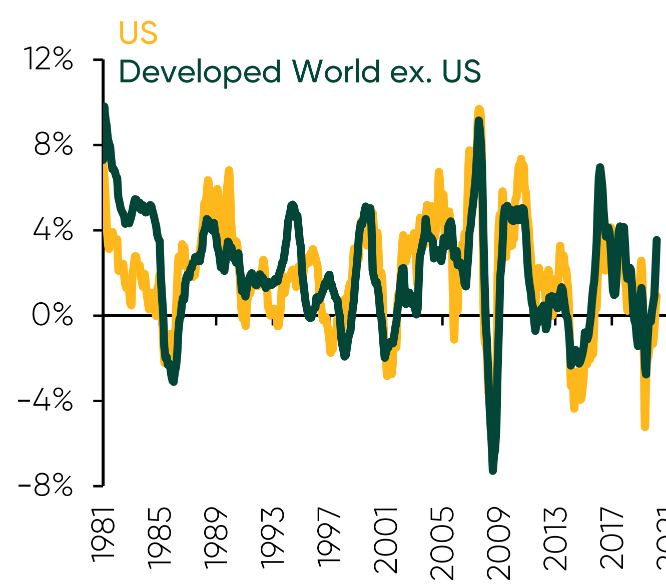


Exhibit 10 & 11 Source: FactSet, as of 09/04/2021. Data shows Y/Y change.

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xvii Source: Federal Reserve Bank of St. Louis, as of 08/04/2021. Securities held outright by the US Federal Reserve, US Treasury notes and bonds.

xviii Source: FactSet, as of 13/04/2021. 10-year government bonds yields for Germany, France and Switzerland on 31/03/2021.

Sixty years ago, Milton Friedman said inflation is always and everywhere a monetary phenomenon: Too much money chasing too few goods. We think there was plenty of evidence supporting his theory, and logically it holds up. But a year has passed since central banks exploded money supply while production capacity remained constrained. Based on Mr. Friedman's logic and analysis, we should see signs of inflation now, yet we aren't. In our view, this raises important questions about the measurement of money supply and velocity (how often money changes hands—the "chasing"). The financial system has evolved dramatically since Mr. Friedman's day. It wouldn't surprise us if money supply measures are out of date, including many things that aren't really money (a medium of exchange).

WHAT IS MONEY SUPPLY?

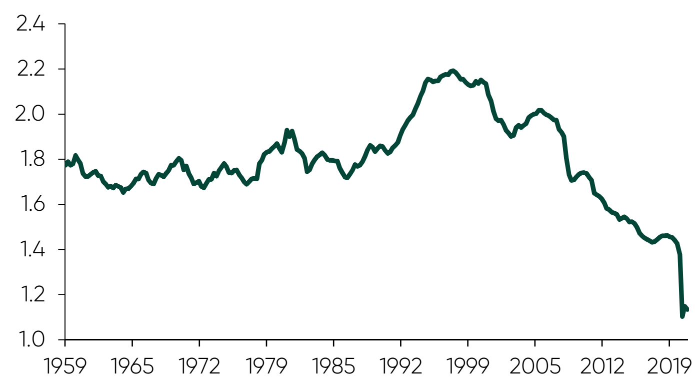
There are five main money supply measures: M0, M1, M2, M3 and M4.

- M0, or the monetary base, is hard currency in circulation plus bank reserves—money created by the Fed that doesn't circulate. (Relatedly, it is a myth that the Fed "prints money." It does no such thing, controlling money supply mostly by expanding or contracting reserves, which underpin bank lending.)
- M1 is M0 plus checking and demand deposits held at banks and credit unions.
- M2 adds savings accounts, small, short-term CDs and money market funds.
- M3, which the Fed no longer publishes but is tracked elsewhere globally, adds large CDs, institutional money funds (including repurchase agreements—effectively IOUs exchanged for short-term bonds, usually between financial firms).
- M4, the broadest measure, adds commercial paper and government debt with less than a year to maturity. In the US, the Center for Financial Stability publishes these data. Elsewhere globally, some central banks, like the Bank of England, do.

In Milton Friedman's world, M1 and M2 predicted inflation, but today there are far more tools one could see as money, like those lumped into M4. However, it isn't clear all the ingredients of M3 or M4 are actually used in transactions. M4 rose almost 30% last year.[xix] Monetary policy's economic effect usually hits at a lag - yet a year after the increase, few signs of inflation exist.

Money supply alone won't determine inflation. It must change hands, chasing goods and services. To gauge this, one would look to velocity measures. For example, perhaps M4 velocity slowed markedly, offsetting the supply increase. That would surprise most economists, given longstanding theory held that velocity was relatively stable. Regardless, there is no way to know as there is no M4 velocity measurement. M2 velocity is all we have and it is near all-time lows, suggesting perhaps velocity did drop significantly. (Exhibit 12)

EXHIBIT 12: M2 VELOCITY NEAR ALL-TIME LOWS



Source: Federal Reserve Bank of St. Louis, as of 08/04/2021. Q1 1959 – Q4 2020. Calculated as the ratio of quarterly nominal GDP to the quarterly average of M2 money stock.

Considering another scenario - we lost significant velocity to lockdowns a year ago and the added supply merely filled the void temporarily. It would be a mistake to call this "money supply growth"—a strange twist on Frederic Bastiat's legendary "Broken Windows Fallacy." Replacing something destroyed doesn't equal actual growth.

xix Source: Center for Financial Stability, as of 08/04/2021. Divisa M4 year-over-year growth in December 2020.

Either way, something is happening that is different from what Mr. Friedman observed 60 years ago, when money supply and velocity were easily measured and widely watched. Hence, basing big inflation expectations solely on increases to the money supply is flawed. The good news: Inflation is generally slow-moving, so you don't need an abundance of hints about where it is headed.

SENTIMENT WARMS FURTHER

Today's optimism is classically late-cycle and mostly rational, but there are signs of widespread optimism. Some pundits have started projecting years-long economic and market booms. Pockets of euphoria exist in niche markets and greed is overtaking fear as the dominant emotion. Optimism can last a while and is a great backdrop for equities—as is early euphoria, but sentiment usually overshoots eventually. We don't think we are there yet, but we are watching for widespread signs which could affect equities broadly.

WIDESPREAD OPTIMISM, POCKETS OF EUPHORIA

There is no single, perfect way to measure sentiment. Hence, we track several measures that we think, combined, indicate the prevailing mood. These include merger & acquisition activity, initial public offering (IPO) performance and other market-based indicators. They also include public sentiment surveys as well as our proprietary gauges. Some have flashed froth recently, including a jump in margin debt—a potential sign of greed as investors lever up to take more risk. Yet others—including consumer and business sentiment surveys—remain muted. That tells us that despite broadening optimism, equities have some "wall of worry" to climb.

CRYPTOCURRENCIES

Currently, there are isolated pockets of euphoria, including cryptocurrencies. Excitement returned as bitcoin and others spiked in recent months. Proponents argue now is different than 2017/2018's boom and bust, saying cryptocurrencies' moment as the future of money has arrived. They cite banks' letting clients hold cryptocurrencies, a few public companies investing in them and some firms accepting bitcoin as payment. All of this strikes us as following the crowd. For example, a few, select companies hold bitcoin on their balance sheets—with one arguing it is superior to cash as a corporate treasury asset. We disagree, as corporate treasury assets should be stable and liquid, like cash—not hugely volatile like bitcoin.

Further illustrating crypto enthusiasm's irrationality is Dogecoin, a joke cryptocurrency launched in 2013 based on an Internet meme about a Japanese dog breed. Dogecoin serves primarily as an online gratuity to reward content creators. Aside from a boom and bust alongside bitcoin in 2017 and 2018, it has mostly traded flat versus the dollar. But in late January, Dogecoin jumped over 800% in 24 hours, driven by a group of Reddit investors—who were perhaps inspired partially by Tesla founder Elon Musk's tongue-in-cheek tweet about the coin.[xx] When a mock cryptocurrency climbs eightfold because of memes and tweets, sensibility seems absent.

In our view, cryptocurrencies remain speculative and most aren't a viable medium of exchange due to their extreme volatility. If crypto actually was money, it wouldn't generate a return—and few would clamor to own it.

xx "Reddit frenzy pumps up Dogecoin, a cryptocurrency started as a joke," Arjun Kharpal, CNBC, 29/01/2021. https://www.msn.com/en-us/money/companies/reddit-frenzy-pumps-up-dogecoin-a-cryptocurrency-started-as-a-joke-by-over-800/ar-BB1dc4sw?ocid=uxbndlbing

NON-FUNGIBLE TOKENS (NFTS)

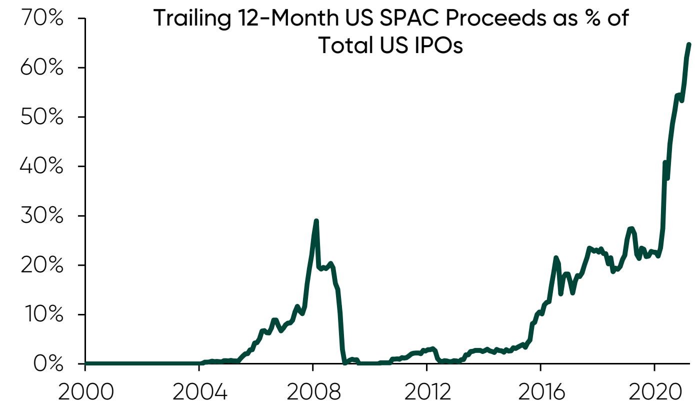
NFTs—basically digital collectibles—are files that the creator certifies and stamps as unique. They are used primarily for art, Internet memes and sports highlight clips. One New York Times writer auctioned a column as an NFT, raking in $560,000 for charity.[xxi] Twitter co-founder and CEO Jack Dorsey sold an NFT of the first tweet for $2.9 million.[xxii] While these can theoretically be reproduced infinitely, only one has the NFT stamp, which creates scarcity and hype.

SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS)

SPACs are a way for companies to go public with less regulatory scrutiny than traditional IPOs. The SPAC is a holding company with a single mission: to acquire a private firm within a given timeframe (usually two years), making it a publicly traded company. It starts with high-profile backers, then it raises money from investors in an IPO. Ideally, it then completes the merger and delivers a big payout to its investors. Big names from the investment and celebrity worlds, along with some sharp initial returns, have generated buzz. Some SPACs have bought startups in widely hyped areas such as hydrogen and electric vehicles—giving the impression of being a ground-floor entry point to these popular new technologies. That is enticing, considering how many firms have stayed private for ages, IPOing only after becoming bloated and diluted.

SPACs seem to us like a market-based solution for firms looking to go public without the IPO paperwork and costs—a legacy of 2002's Sarbanes-Oxley Act. They aren't new, but they are increasingly widespread. SPACS have jumped from generating just over 20% of US IPO proceeds a year ago to 65% over the past 12 months (Exhibit 13)—perhaps signaling excess.

EXHIBIT 13: SPACS LEAD US ISSUANCE



Source: Refinitiv, as of 30/03/2021. Trailing 12-month inflation-adjusted US SPAC Proceeds, January 2000 – March 2021. Calculated based on the IPOs' end-of-month value.

Cryptocurrencies, NFTs and SPACs are faddish and speculative, like the headlines' recent obsession with GameStop and other "meme stocks." This intersection of fads early in a bull market is unlikely. Investors would be too fearful of risky ventures and huge associated volatility. Pundits would warn about these assets, too, not celebrate them. But this typifies late bull markets. To us, this plethora of fads—and common praise of them—typifies late bull markets and indicates this bull market is closer to its end than many think.

xxi "Why Did Someone Pay $560,000 for a Picture of My Column?" Kevin Roose, The New York Times, 26/03/2021. https://www.nytimes.com/2021/03/26/technology/nft-sale.html

xxii "Jack Dorsey sells his first tweet ever as an NFT for over $2.9 million," Taylor Locke, CNBC, 22/03/2021. https://www.cnbc.com/2021/03/22/jack-dorsey-sells-his-first-tweet-ever-as-an-nft-for-over-2point9-million.html

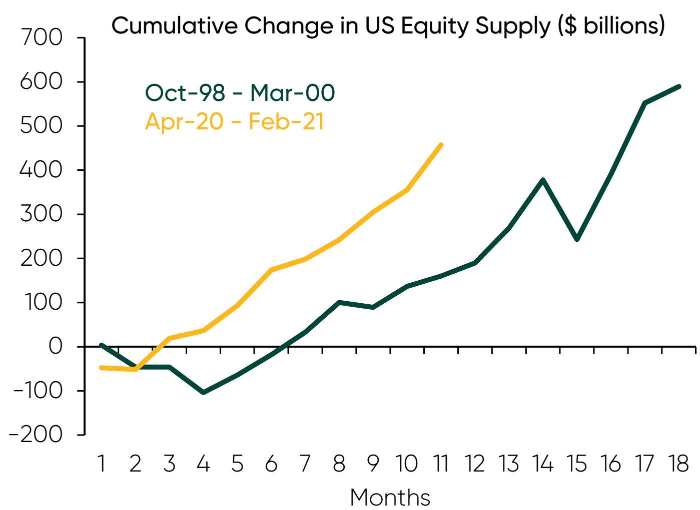
MONITORING EQUITY SUPPLY

Unless they are walloped prematurely, bull markets generally peak when equity supply exceeds demand. That usually comes when sentiment is overly euphoric. Since April 2020, US net equity supply (initial and secondary offerings minus buybacks, buyouts and delistings) has traced a path similar to the 18 months prior March 2000—reminiscent of the early stages of the Tech bubble. (Exhibit 14) Global issuance is also up.

> "UNLESS THEY ARE WALLOPED PREMATURELY, BULL MARKETS GENERALLY PEAK WHEN EQUITY SUPPLY EXCEEDS DEMAND."

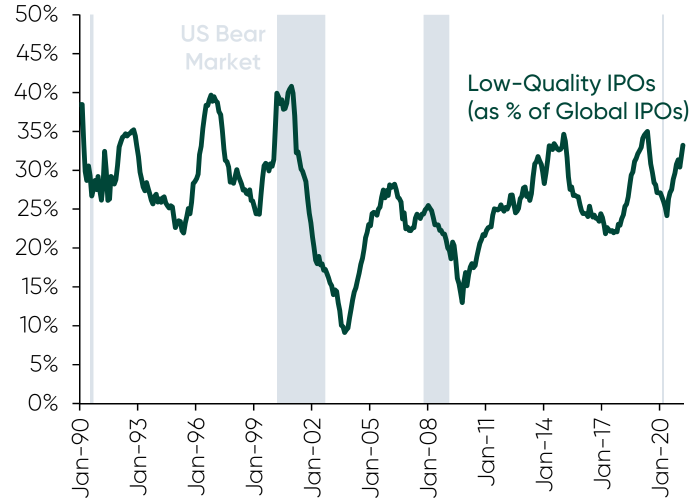
However, rising supply alone isn't necessarily bearish - IPO quality is crucial. We gauge this by tracking the percentage of "low-quality" IPOs—i.e., IPOs with negative earnings per share (EPS) or net income. (Exhibit 15) Globally, IPO quality has worsened, but it still better than at the Tech bubble's peak.

EXHIBIT 14: COMPARING LATE 1990S EQUITY SUPPLY TO TODAY



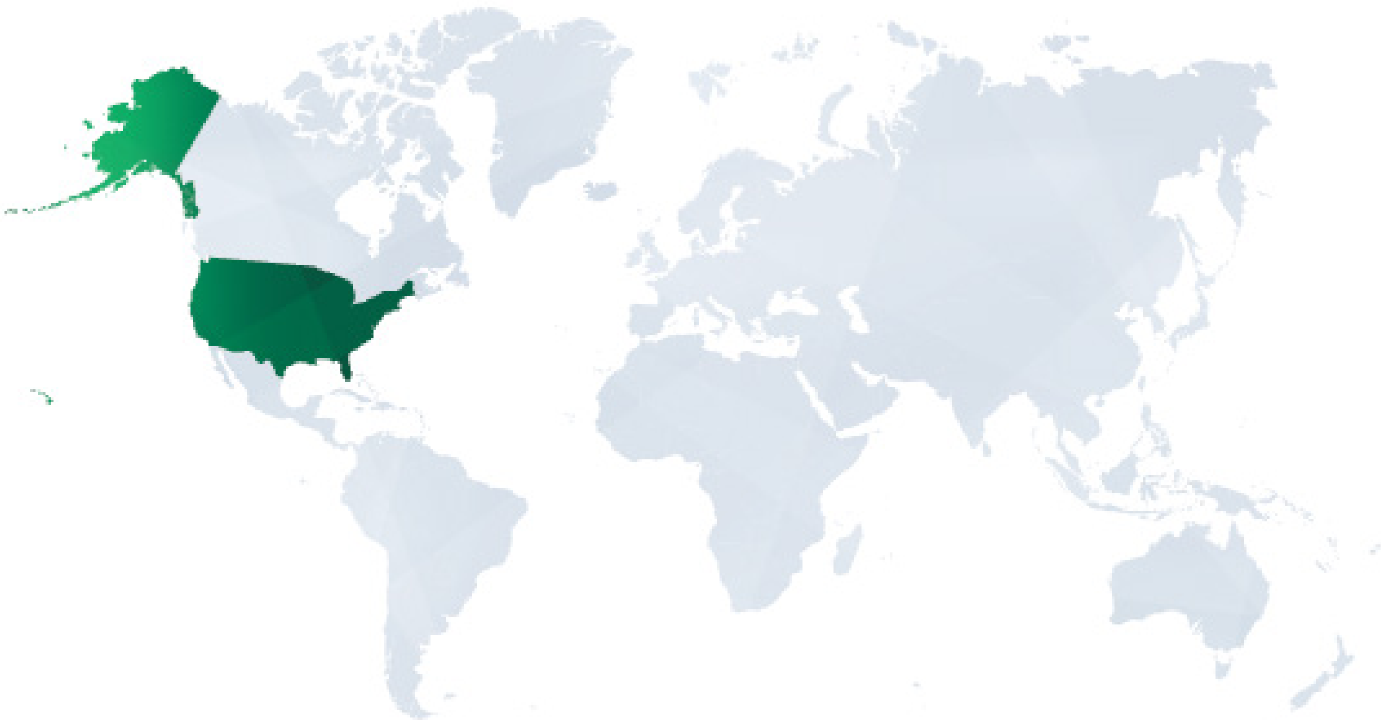
Source: Refinitiv and FactSet, as of 05/03/2021. Cumulative change in US equity supply, adjusted for inflation, October 1998 – March 2000 and April 2020 – February 2021.

EXHIBIT 15: A LOOK AT GLOBAL IPO QUALITY



Source: Refinitiv, as of 30/03/2021. Trailing 12-month inflation-adjusted global IPO proceeds, January 1990 – March 2021. SPACs aren't included as they don't have net income or EPS figures.

UNITED STATES **COMMENTARY**



APPRECIATING THE GRIDLOCK AHEAD

President Joe Biden's first 100 days were busy. Between the $1.9 trillion Covid-19 relief bill and big infrastructure spending and tax proposals, Congress may not feel gridlocked. It may feel like Democrats can push through whatever they want unilaterally. However, there are far more procedural roadblocks and intraparty gridlock than most coverage suggests. As 2021 unfolds and President Biden's honeymoon period ends, the feeling and reality of gridlock should grow, fueling the big returns typical of Democratic presidents' inaugural years.

Gridlock doesn't mean nothing passes, and more could pass early in President Biden's term than we initially envisioned. But gridlock frequently waters down legislation, as we have already seen. Plus, everything on President Biden's agenda was discussed excessively on the campaign trail last year. Markets likely already priced ideas like Covid-19 relief, tax hikes, infrastructure plans and the like.

ON COURSE FOR A TYPICALLY BIG DEMOCRATIC INAUGURAL YEAR

Past reviews have detailed equities' generally robust returns in a Democratic president's inaugural year—16.2%, on average, since 1925[xxiii]. The reason is simple: In the election year, when returns trend below-average if a Democrat wins, markets pre-price widespread fears of the new president passing everything discussed

xxiii Source: Global Financial Data, Inc., as of 12/01/2021. S&P 500 total return average in Democratic presidents inaugural years, 1925 – 2020.

during the campaign—typically, in Democrats' case, higher taxes, big public spending, tough regulation and redistribution. That rhetoric creates the illusion that the party is inherently anti-business. It also means markets pre-price any legislation that actually passes, setting up big relief rallies as gridlock and congress member's increased focus on re-election waters down most big bills from initial proposals.

The Covid-19 lockdowns, and the steep recovery from them, skewed last year's returns from this trend. Talk of tax hikes and big spending looms but, as we will show, is already priced in. Meanwhile, gridlock among Democrats is becoming more evident. Most major proposals today have long been discussed and seem likely to be watered down—limiting their ability to surprise markets. As investors fathom this, returns should strengthen throughout the year.

THE INS AND OUTS OF BUDGET RECONCILIATION

Those anticipating a large amount of legislation cite budget reconciliation as the key. This process lets a party pass legislation with a simple Senate majority—avoiding the 60 votes needed to avoid a filibuster. This is critical now, tied to the Senate's 50/50 partisan split.

We have already seen reconciliation in action once this year. The $1.9 trillion Covid-19 relief bill, named the American Rescue Plan (ARP), passed via reconciliation with unanimous Democratic approval in the Senate. But the path to that approval shows reconciliation's limitations. The ARP's initially included a measure raising the federal minimum wage to $15 per hour. This attracted fierce Senate opposition from states with relatively lower incomes and cost of living, where a higher statutory wage could threaten many small businesses' existence. That opposition included a number of Democrats. But it never came up for formal debate, as Senate Parliamentarian MacDonough ruled it ineligible for reconciliation. Attempts to bypass her ruling didn't muster anywhere near a majority amid opposition from several swing-state Democratic senators. We think this previews what to expect as the party engages in budget reconciliation later this year.

Because Congress didn't pass a budget for fiscal 2021 before former President Donald Trump left office, President Biden's term began with two chances at reconciliation in each category this calendar year: once for fiscal 2021 and once for fiscal 2022, which begins on 1 October.

But in early April, Senators petitioned Parliamentarian MacDonough to let additional bills pass via reconciliation as long as they merely amended earlier budget bills. Theoretically, this gives the party additional chances at changing spending and taxes via reconciliation, under the guise of updating prior bills. This stoked fear, but we don't think it changes much. The general limits still apply and taking multiple attempts at spending and tax rates doesn't change the basic incentives for swing-state Democrats to moderate—especially those facing uphill re-election battles in 2022. West Virginia Senator Joe Manchin, who isn't even up for re-election until 2024, stated his opposition to repeatedly using reconciliation in an 8 April Washington Post op-ed. The further we get from the inauguration, the more President Biden's honeymoon period will wane. As it does, gridlock within the Democratic Party likely escalates as senators' self-interests gain primacy.

BEYOND THE FILIBUSTER

As the abandoned federal minimum wage increase shows, there are strict limits to what can pass via reconciliation. That is bad news for those pressing big bills on non-budget topics. Their proposed solution: removing or weakening the filibuster so all bills can pass with a simple majority. This elevated fears among many right-leaning investors, but it faces two obstacles. For one, intraparty divides likely mean the filibuster isn't going anywhere. West Virginia Senator Manchin and Arizona Senator Kyrsten Sinema have publicly rejected calls to remove it. Senator Manchin said it succinctly in the aforementioned op-ed: "There is no circumstance in which I will vote to eliminate or weaken the filibuster."[xxiv] Secondly, fears of the filibuster's elimination overstate its importance as to checking power.

xxiv "I Will Not Vote to Eliminate or Weaken the Filibuster," Senator Joe Manchin, The Washington Post, 08/04/2021.

As The Wall Street Journal's Kim Strassel highlighted in her 19 March column, it is merely 1 of 44 standing rules in the Senate, most of which the opposition can use to slow down the process.

The US Senate's existing rules serve to differentiate it from the House of Representatives, making it a more deliberative body. It was never meant to be a rubber-stamp parliament—its purpose is to be a check on the House. As Strassel explained, many of the existing rules "are designed to enhance 'the rights of individual senators' at the expense of 'the powers of the majority.'"[xxv] Even the most mundane can halt Senate business. One rule requires unanimous consent for simple actions like opening the chamber in the morning, moving to the day's business, and skipping recitation of every bill and amendment. One objecting Senator could obstruct any of this, and it would require a majority to overcome the objection—requiring all Democratic senators present at all times. Senators could also issue "quorum calls" to verify there were 51 members present, then vacate the premises to ensure they wouldn't pass. Together, these moves could eat up an entire day.

Senator Manchin wrote that, "Every time the Senate voted to weaken the filibuster in the past decade, the political dysfunction and gridlock have grown more severe."[xxvi] The only thing preventing this now is comity, which won't last long if Democrats try to ram multiple bills through. The more they try to do after the honeymoon period, the more hostility will replace graciousness, and gridlock's grip will tighten.

WHAT GRIDLOCK DOES (AND DOESN'T DO)

Gridlock doesn't mean nothing happens. It often means legislation that squeaks through is watered down versus initial proposals, as we saw with the ARP's minimum wage provision. Even for measures that can pass with a simple majority vote, swing-state Democrats' incentives to moderate support intraparty gridlock.

But moderation may not mean "no." A bipartisan House vote approved the return of earmarks, now known as "community project funding requests," with new transparency guidelines aimed at preventing corruption and waste. Republican Senators may follow in hopes of securing funding for their states from the upcoming infrastructure bill. If this happens, it isn't hard to imagine Senate majority leader Chuck Schumer bargaining to win over moderates from either party. In exchange for community funding, swing-state senators may support smaller-than-advertised tax hikes or minimum wage increases—basically, normal politics at work.

MARKETS EFFECTIVELY DISCOUNT TAX PROPOSALS

Democrats could push through higher taxes, unnerving many investors. This is understandable to some extent, as taxes are perhaps the most direct way government impacts the public. But there is ample history and theory showing that tax increases aren't likely to drive a bear market—neither are tax cuts fuel for a bull market.

Taxes are a classic case of investors believing events have predetermined outcomes. But we have a very long history of tax changes and market returns, making this theory easy to test. Tax hikes usually don't coincide with negative returns. The reason is simple: Markets move most on surprises, and there is no such thing as a surprising tax change—especially now, as the entire country has discussed potential Democratic tax hikes since the primaries.

The data support this. Consider corporate taxes, which Biden's infrastructure plan would raise from 21% to 28%. The US government has hiked corporate tax rates 13 times since good market data begin in 1925. In the ensuing 12 months, equities rose 9 times, averaging 11.1%.[xxvii] A similar story is told in regards to personal income taxes. The government has hiked the top bracket rate 14 times, and the S&P 500 rose in the next 12 months after 10 of them, averaging 16.8%. Similar positivity holds after capital gains tax hikes. Ironically, average returns after tax cuts are lower.

xxv "A Day in a Scorched-Earth Senate," Kimberley A. Strassel, The Wall Street Journal, 18/03/2021.

xxvi See note 24.

xxvii Source: Global Financial Data, Inc., as of 19/10/2020. Average S&P 500 price returns.

Many naysayers point to the fact that more than one tax type may rise this year, but it makes little difference. Exhibits 16 and 17 show returns before and after two of the three main taxes (income, capital gains and corporate) were hiked or cut simultaneously. In the 12 months before such sweeping hikes, returns are varied and average -0.5% as markets discount the likelihood of change. But in the 12 months after, equities were overwhelmingly positive—much more than after tax cuts. The S&P 500 rose 9 of 11 times, averaging 16.7%.

Of course, this average—and the pre-hike average—are skewed by 1932's huge drop before the cut and enormous rise after, which weren't related to that single percentage point hike to the top marginal rate. Coincidentally, that hike fell near the Great Depression's June 1932 trough, skewing results. Regardless, the median return shows you a similar, if less extreme, effect. Equities' median pre-hike return was a tepid 7.2%, which jumped to 11.8% after. To us, that illustrates equities' pre-pricing mechanism near-perfectly.

EXHIBIT 16: RETURNS AFTER SIMULTANEOUS TAX HIKES

		Changed?		S&P 500 Price Return	
Effective Date	Personal	Corporate	Cap'l Gains	12 Months Before	12 Months After
01/01/1930	X	X		-11.9%	-28.5%
06/06/1932	X	X		-61.1%	98.0%
21/10/1942	X	X		-3.5%	25.2%
23/09/1950	X	X		24.8%	20.4%
20/10/1951	X	X		15.9%	4.3%
01/01/1952	X	X		16.5%	11.8%
28/06/1968	X	X	X	9.1%	-2.3%
01/01/1969	X		X	-11.8%	0.7%
01/01/1991	X		X	-6.6%	26.3%
10/08/1993	X	X	X	7.2%	2.4%
02/01/2013	X		X	16.3%	25.3%
			Average	-0.5%	16.7%
			Median	7.2%	11.8%
			% Positive	55%	82%

Source: FactSet, US House of Representatives Archives, US Senate Archives, Tax Policy Center, as of 19/03/2021. S&P 500 price returns 01/01/1929 – 31/12/2020.

EXHIBIT 17: RETURNS AFTER SIMULTANEOUS TAX CUTS

		Changed?		S&P 500 Price Return	
Effective Date	Personal	Corporate	Cap'l Gains	12 Months Before	12 Months After
01/01/1946	X	X		30.7%	-11.9%
26/02/1964	X	X		18.9%	12.3%
01/01/1965	X	X		13.0%	9.1%
01/01/1970	X	X	X	-11.4%	0.1%
01/01/1971	X	X	X	0.1%	10.8%
01/01/1979		X	X	1.1%	12.3%
13/08/1981	X		X	8.3%	-22.2%
01/01/1987	X	X	X	14.6%	2.0%
01/01/1988	X	X		2.0%	12.4%
28/05/2003	X		X	-11.3%	17.6%
01/01/2018	X	X	X	19.4%	-6.2%
			Average	7.8%	3.3%
			Median	8.3%	9.1%
			% Positive	82%	73%

Source: FactSet, US House of Representatives Archives, US Senate Archives, Tax Policy Center, as of 19/03/2021. S&P 500 price returns 01/01/1929 – 31/12/2020.

Nothing in this history suggests a potential tax hike is predictive for equities. However, none of this means tax hikes are a positive or somehow bullish. But markets priced tax-hike fears during the presidential campaign, and over the past year, little has been widely discussed more than big tax changes and public spending. If changes get through Congress, it is highly unlikely to shock equities.

US GOVERNMENT DEBT CONCERNS

While many economists cheered the Biden administration's big Covid-19 relief spending plans, some voiced concern. The nonpartisan Congressional Budget Office (CBO) projected a $2.3 trillion federal deficit for fiscal year 2021—10.3% of estimated GDP.[xxviii] That comes on the heels of the postwar-record $3.1 trillion in fiscal year 2020. The deficit drove net public debt, which removes intragovernmental holdings, to $21.6 trillion at 2020's end—100.1% of GDP.[xxix] The CBO sees the federal deficit exceeding its historical average even after the pandemic's impact wanes.

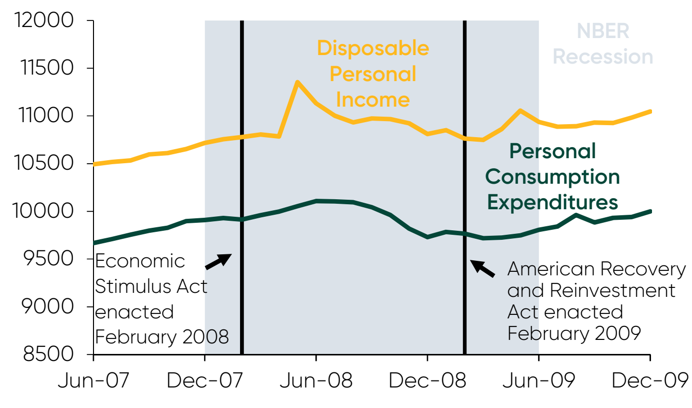
That stirred fears of soaring debt increasing borrowing costs—and creating a debt crisis. However, we think the government can afford the interest payments. As of fiscal year 2020, US interest payments were 10.1% of tax revenues.[xxx] This figure has been rising since 2011, but it remains well below the 15% – 18% range from the 1980s – 1990s—a great period for the US economy.[xxxi] Moreover, today's low yields let the Treasury refinance maturing debt at a cheaper rate. In March 2011, the Treasury sold $21 billion in 10-year notes at a 3.48% median yield.[xxxii] A decade later, $38 billion in 10-year notes fetched a much-cheaper 1.47% median interest rate.[xxxiii] US debt's weighted-average maturity is over 64 months.[xxxiv] Interest rates would have to skyrocket and remain high for years before debt affordability became problematic.

We don't think the government can borrow and spend indefinitely without consequence. But debt was a long-running concern even before Covid-19—and remains a false fear, in our view.

FISCAL STIMULUS IS UNLIKELY TO HAVE MEANINGFUL ECONOMIC IMPACT

Most think a huge fiscal stimulus boom is coming. This stems partly from the multiple rounds of checks sent to many US households. Altogether, qualifying individuals have received up to $3,200 each, which pundits characterise as several hundred billion dollars' worth of pent-up demand waiting to be spent once businesses reopen. We think this is a stretch. As Exhibit 18 shows, similar payments in 2008 – 2009 didn't really have a significant impact - nor did similar payments sent in 2001.

EXHIBIT 18: STIMULUS CHECKS DIDN'T DO MUCH IN 2008 – 2009



Source: Federal Reserve Bank of St. Louis, as of 12/04/2021. June 2007 – December 2009. Chart shows data in billions of dollars.

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xxviii "The Budget and Economic Outlook: 2021 to 2031," Congressional Budget Office, 11/02/2021. Date accessed: 09 April 2021.

xxix "The 2021 Long-Term Budget Outlook," Congressional Budget Office, 04/03/2021. Date accessed: 09/04/2021

xxx Source: St. Louis Federal Reserve, as of 09/04/2021. Annual federal outlays of interest divided by annual federal receipts for fiscal year 2020.

xxxi Ibid. Statement based on annual federal outlays of interest divided by annual federal receipts, 1980 – 1999.

xxxii Source: TreasuryDirect, as of 09/04/2021.

xxxiii Ibid.

xxxiv Source: Treasury Department, as of 09/04/2021. Historical weighted average maturity of marketable debt outstanding as of 31/12/2020.

Several surveys suggest consumers aren't itching to spend. Saving and paying down debt were among the top uses for the first round of checks, according to the National Bureau of Economic Research and Philly Fed. The same was true for the second round of checks, according to the Census Bureau's Household Pulse Survey. These findings suggest relief payments won't turn immediately into new spending or propel consumption to a higher level.

PRESIDENT BIDEN'S PROPOSED INFRASTRUCTURE PLAN

Also fueling high expectations is President Biden administration's $2.3 trillion infrastructure proposal. Even the measures within the proposal that do entail direct spending and investment in infrastructure and technology won't pack a big punch, for a simple reason: Many probably won't ever happen, and those that do will trickle out over many years.

The plan, released at March's end, directs federal money to bridges, rail, green energy and more. But it all happens over the next eight and a half years. These are not former-President Barack Obama's "shovel-ready" products, which is telling. Even those proved imaginary a decade ago, when the American Recovery and Reinvestment Act failed to juice GDP. As President Obama acknowledged in an October 2010 New York Times interview after local governments struggled to spend money allocated to them: "There's no such thing as a shovel-ready projects."[xxxv] If there were, they would already be in progress and politicians from both parties wouldn't still be whining about infrastructure. Funding has never been the issue - the real stumbling block is permitting. Getting even simple projects approved is a difficult, costly feat. Small projects generally need town, city or tribal approval, and usually county, too. Those spanning multiple counties need double that, plus state. A road or bridge connecting two states adds more complexity, including federal approval. At each level, there are multiple agencies weighing in—all possibly stopping or delaying potential projects.

President Biden's plan advertises everything he would like to accomplish. It is a wish list and not ironclad. Even if it does pass in its present form, eight years is a long time. Midterms loom next year. We could have a Republican Congress in 2023, and they could supersede President Biden's plan with their own budget—which another Congress could supersede in 2025, and so on. One big reason for this, discussed at length in our Q4 Review, is redistricting. Several traditionally Republican states stand to gain seats, while several Democratic strongholds stand to lose. Given the Democrats' majority is historically slim, and the president's party tends to lose relative power at midterms, a shift is plausible—although it is much too early to forecast this now.

xxxv "Education of a President," Peter Baker, The New York Times, 12/10/2010.

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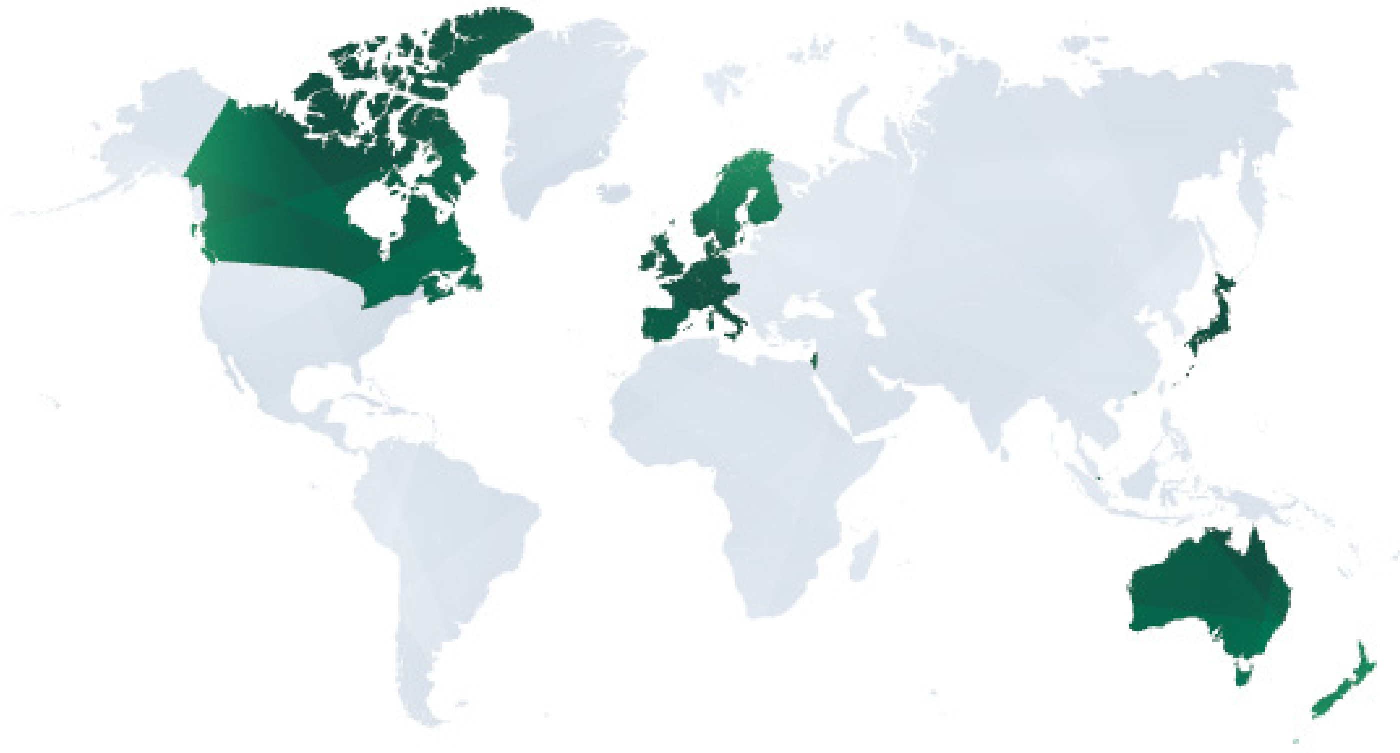
COMMENTARY



UK TAX HIKES

Similar to concerns we mentioned in the US section, potential tax increases also dominated headlines in the UK in Q1, courtesy of Chancellor Rishi Sunak's proposed budget and its focus on deficit reduction. On the individual side, while tax rates won't increase, Chancellor Sunak proposed freezing the income thresholds for the higher-rate and additional-rate tax bands after next year, which would bring more people into income to higher tax bands as wages and salaries rise. On the business side, the proposed tax increase is outright: Chancellor Sunak proposed an increase to the corporation tax rate from 19% to 25% in 2023. We have seen many argue this is a fundamentally negative development for UK markets, but we think that conclusion is premature.

For one, two years is a long time, and financial conditions could change considerably in that window. Already, economic data are running ahead of official projections, and the forecasts underlying Chancellor Sunak's tax plans could well prove too pessimistic. If faster-than-expected economic growth brings higher-than-expected tax revenues, it could lessen the need for increases. Plus, in our view, that "need" is debatable. While the Treasury has added £400 billion worth of debt over the past year, it carries historically low interest rates.[xxxvi]

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xxxvi "Budget 2021: Protecting the Jobs and Livelihoods of the British People," HM Treasury, March 2021.

Even with rates' recent increase, the benchmark 10-year gilt yield is at just 0.75%, enabling the Treasury to refinance maturing debt at a discount.[xxxvii] This should help keep debt service costs overall affordable, buying the nation time to grow into its higher debt load—much as Britain and the US alike did after the second World War. Notably, even five years from now, the Office for Budget Responsibility (OBR) projects interest costs remaining below fiscal 2019 – 2020's pre-pandemic burden.[xxxviii]

"IF THE CORPORATION TAX DOES RISE, WE DON'T VIEW IT AS AN AUTOMATIC NEGATIVE"

Political considerations perhaps add incentive to abandon these planned increases as they approach. The next election is due in 2024, and Labour leader Keir Starmer has already hinted at his opposition to corporation tax increases. In our view, cancelling planned tax increases would be an easy way for the Conservative Party to steal some of his talking points ahead of the campaign, much as David Cameron's Conservative government backed off of its "austerity" ahead of 2015's UK election.

If the corporation tax does rise, we don't view it as an automatic negative. The UK's history of market returns and corporation tax rises isn't as robust as the US history, as there have been only two rate increases since the Treasury created a dedicated corporation tax rate in 1965. Those took effect on April 1969 and April 1973, both during global bear markets. In our view, the negative UK market returns following both tax rises stemmed from those global factors (the implosion of the so-called Nifty Fifty bubble in 1969 and the oil shock in 1973), not the tax increases. Similarly, while returns were positive following all but two of the corporation tax rate decreases, those all coincided with global bull markets.

The two negative instances were 2008, during the global financial crisis, and 2015, when uncertainty over the Brexit referendum and a global correction dragged on returns. Further, Parliament tended to pass corporation tax cuts that took effect gradually over many years, including phased cuts from 2011 – 2017. Markets are forward-looking and efficient and don't wait for tax changes to become effective before pricing them in.

Therefore, we think it is more helpful to simply consider the proposed change in its historical context. The corporation tax exceeded 25% for the entirety of its history until April 2012. It spent 11 years above 50% and exceeded 40% until April 1986. Raising the rate back to where it was a decade ago won't undo the vast gains in competitiveness gained in the decades beforehand. The UK had a robust economy and was widely seen as a great place to do business before former Prime Minister Cameron's tax cuts, and rolling them back won't much change that. Several nations would still have higher rates than the UK, including Japan, Germany and, if US President Biden's tax plan passes, the US. That argues against an increase hurting UK equities, in our view.

GERMANY ELECTION PREVIEW

In Germany, the race to September's federal election is taking shape. While speculation over outgoing Chancellor Angela Merkel's replacement abounds, whoever replaces her likely faces a continuation of the gridlocked legislature that has dominated the last few years—a favourable outcome for German equities.

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xxxvii Source: FactSet, as of 19/04/2021.

xxxviii Ibid

THE REGIONAL VOTES' TAKEAWAYS

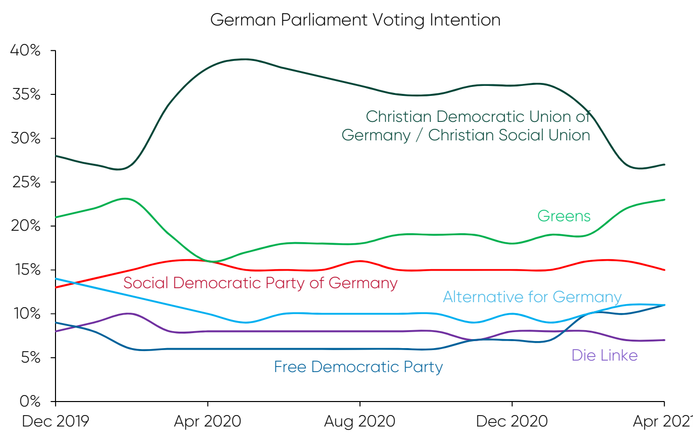
In March, the Christian Democratic Union (CDU) suffered big losses in regional votes in Baden-Württemberg and Rhineland-Palatinate. In Baden-Württemberg, the CDU took 27% of the vote, behind the Greens' 30%; in Rhineland-Palatinate, the CDU won 32% while the Social Democratic Party's (SPD) took 36%. Some treated the results as a precursor to the federal vote, but we think that is premature. The poor performance likely reflected voter frustration over a CDU corruption scandal and slow vaccination rollouts—issues that could radically shift by September. Moreover, the Greens' and the SPD's respective state premier candidates were both popular incumbents expected to win.

That said, given the results were the first widely watched vote after Armin Laschet became the CDU's leader, many viewed the weak showing as reason to doubt his prospects of becoming the party's chancellor candidate. Some favoured the more popular Markus Söder, head of Bavaria's Christian Social Union (CSU), the CDU's sister party. After considerable debate and Mr. Laschet's victory in an April secret party ballot, though, Mr. Söder withdrew his name from consideration. While Mr. Laschet has cemented his position as the CDU/CSU's chancellor candidate, the drawn-out debate exposed the deep rifts within Germany's centre-right—a sign there likely isn't a candidate with the popularity to deliver a majority. This means Germany will likely have some sort of coalition government after September's vote.

THE GREEN FACTOR

The Greens have replaced the SPD as the CDU/CSU's main competition (Exhibit 19), as the SPD has suffered since becoming the junior partner in the "Grand Coalition" atop Germany's government. Many of the SPD's traditional voters think the party gave too many concessions to be a part of the current governing coalition with the CDU/CSU, and the Greens have emerged as the main centre-left alternative. Most polls currently put the Greens second to the CDU/CSU, but one projects them as the top vote-getter.[xxxix] While much can change over the next several months, most political observers think the Greens' rising support will at least make them a member of the coalition government most expect to lead Germany after the election.

EXHIBIT 19: GERMAN FEDERAL ELECTIONS PREVIEW



Source: Politico EU poll of polls, accessed 23/04/2021.

In a sign of the party's rising prominence on the national political stage, the Greens chose co-party leader Annalena Baerbock as its first-ever chancellor candidate. Ms. Baerbock is seen as part of the Greens' more moderate wing who could appeal to centrist voters looking for change in a government historically dominated by the CDU and SPD.

xxxix "Germany: The Green Party's economic plans," Nik Martin, Deutsche Welle, 21/04/2021.

The Greens' ascendance has spurred discussions about the prospect of a major shift in usual legislative priorities, from increasing spending on green technologies to relaxing Germany's "debt brake" to pay for its initiatives. However, we caution against speculating about future potential policy. If another coalition runs Germany, policy divides could very well stymie any individual party's influence. Furthermore, the Greens have already shown signs of moderation. Besides their efforts to appeal to a broader constituency, including rural communities and industrial workers, they have also softened their rhetoric on national climate policy. For example, rather than insist Germany fulfill the Paris climate deal's recommendations, they have said the country should try to "get on the path" of doing so.[xl]

> WE CAUTION AGAINST SPECULATING ABOUT FUTURE POTENTIAL POLICY

Note, too, that a Green-led coalition won't necessarily mark a large change in policy. Take Baden-Württemberg, where the Greens and CDU formed a coalition government in 2016. Compromise and typical politicking marked the term. For example, popular Green state premier Winifried Kretschmann proposed a plan to incentivise the purchase of new diesel and gasoline cars to help auto companies struggling during the pandemic. While orthodox Green members criticised the move, it was sensible from a political perspective—Baden-Württemberg is Germany's auto hub. Whatever their ideology, politicians seek to retain power—and that requires compromise and not upsetting their constituents.

Political rhetoric may increase in the coming months, but all the debates and discussions about potential new policy will give markets plenty to process and pre-price. While we won't know the exact composition of Germany's next government for several months, a coalition government comprised of multiple parties will likely be the result—a recipe for bullish gridlock that decreases the likelihood of major legislative change.

ITALY - STATUS QUO VS. MARIO DRAGHI

On 23 January, Italian Prime Minister Giuseppe Conte resigned following a breakdown in Italy's coalition government over the allocation of funds from the European Recovery Fund, the EU's Covid-19 fiscal response plan. While many expected a new vote, on 12 February, President Sergio Mattarella undercut those expectations and named former ECB head Mario Draghi as Italy's next prime minister, charging him with forming a new coalition government. Pundits were generally very optimistic over Draghi's appointment, commending his term at the ECB and noting it may be game changing for Italy. We think these expectations are perhaps overly optimistic.

An important first mandate for Prime Minister Draghi is to work with finance minister Daniele Franco on plans to allocate €209 billion in funding from the European Recovery Fund, and Italy submitted its Recovery plan to the EU just before the 30 April deadline. However, the benefits of this plan are limited to say the least. If the EU plan officially becomes a reality, it still deploys funds over a multi-year period—too slow to mean much to markets now, in our view.

xl "German Greens hope regional win will bolster claim to national power," Erika Solomon, Financial Times, 06/03/2021.

Beyond this, while Prime Minister Draghi's appointment lifted a cloud of uncertainty over Italy's political landscape, the parties in his coalition have quite contrasting views of reform measures. As a result, achieving consensus or passing meaningful legislation has proven extraordinarily difficult in Italy, a fact that Prime Minister Draghi's appointment hasn't changed. Beyond Covid-19 aid decisions, Italy's coalition will probably return to infighting, in our view. The fragility of the country's governments in recent years aligns with that view. Hence, Italy is yet another nation that should face gridlock for the foreseeable future, an underrated positive in the country.

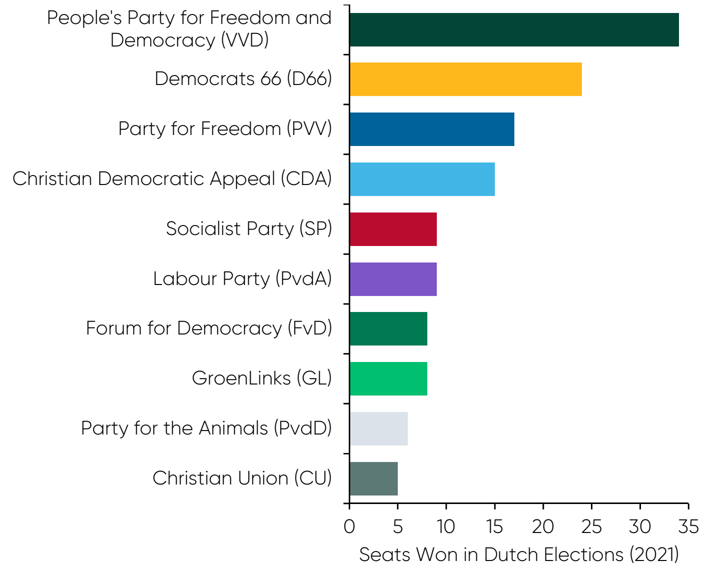
THE NETHERLANDS' ELECTIONS

After four years of an inactive, multiparty government, The Netherlands held parliamentary elections on 17 March against the backdrop of an ongoing childcare benefits scandal embroiling Prime Minister Mark Rutte and his Party for Freedom and Democracy (VVD). As we expected, the results seem set to return another government comprised of at least four parties—resulting in gridlock. For equities, we think this scenario is positive, implying little legislation of consequence will pass, reducing political uncertainty.

The childcare benefits scandal dominated the run up to the vote, as it emerged that Dutch tax authorities had falsely accused over 20,000 families of fraudulently filing for education credits. This erroneously forced many to repay benefits amounting, in some cases, to thousands of euros. Prime Minister Rutte's government was charged with covering up the errors—and not adequately protecting the Dutch citizenry. This led to his government's resignation in January, two months before the vote.

The scandal notwithstanding, Prime Minister Rutte's VVD still managed to win a plurality, capturing 34 seats—a gain of 1 from the prior government. The Democrats 66 (D66), Geert Wilders' far-right Party for Freedom (PVV) and the Christian Democratic Appeal (CDA) also fared relatively well. (Exhibit 20)

EXHIBIT 20: TOP 10 PARTIES IN THE NETHERLANDS' 17 MARCH ELECTIONS.



Source: Dutch Electoral Council, as of 27/04/2021.

However, no party came close to the 76 seats needed for a majority—it will take four parties to do so. Hence, Prime Minister Rutte and VVD must now negotiate with other parties to form a coalition government. As with the last two Dutch governments, hopes for swift progress in coalition-building look likely to prove false. That is perhaps doubly true now, given post-vote twists in the childcare benefits scandal. In early April, allegations surfaced that Prime Minister Rutte tried to sideline a political opponent when forming a new coalition, which he falsely denied engaging in. Two parties considered indispensable for the VVD—the Christian Democrats and pro-EU D66—promptly filed a motion of disapproval, triggering a confidence vote. Prime Minister Rutte narrowly survived that vote on 2 April, but Parliament did vote to censure him.

Yet Prime Minister Rutte's prospects of building a coalition are now dimming once again because the prime minister needs support from the very same party leaders who voted to censure him. Returning to the negotiating table will be difficult, and some are calling for Prime Minister Rutte to step away altogether. If so, VVD might put forth a different candidate to lead the administration. If no coalition can be formed, new elections could follow.

While many see the political dilemma as problematic, equities are well used to long coalition talks. Four years ago, it took Prime Minister Rutte 225 days and after his first win in 2010's snap election, it took 127 days. Now the government looks to remain as gridlocked as ever and there seems to be little potential for the type of meaningful legislation. Legislation has a tendency to create winners and losers, stoking uncertainty in the process.

ISRAEL'S ENDLESS ELECTIONS

On 23 March, Israel's fourth general election in two years proved just as inconclusive as the prior three. Prime Minister Benjamin Netanyahu's Likud party and its allies easily won the most votes, taking 52 seats. Yet this is still 9 seats short of the 61 needed to form a majority in the 120-seat Knesset. The anti-Netanyahu parties are at odds, suggesting they will struggle to form a cohesive coalition.

Two weeks after the election, Israel's President Reuven Rivlin asked Prime Minister Netanyahu to form a coalition government to mend a deeply fractured Knesset. Still, as President Rivlin noted, while Prime Minister Netanyahu has a slightly higher chance of success compared to others in parliament, asking him to form the coalition was not an "easy decision" because of Netanyahu's ongoing breach of trust, bribery and fraud charges.

On 19 April, Likud's efforts to form a coalition hit more turbulence. The party suffered a surprising defeat in attempting to form an Arrangements Committee, the group that determines committee memberships within the Knesset. The party's proposal for the committee's makeup was rejected in favour of a counter-proposal from a group of anti-Netanyahu parties that gives Likud just one of four seats on the committee. As Prime Minister Netanyahu's hopes for forming a coalition government faded, he has continued to explore unique ways to form a new coalition controlled by the right.

Hence, uncertainty over Israel's government lingers well after the general election. A fifth election may even loom, although it isn't clear this would prove more decisive. That said, this is only a minor source of uncertainty, especially since the country represents a tiny 0.60% of MSCI EAFE market capitalisation.[xli]

xli Source: FactSet, as of 25/04/2021.

EMERGING MARKETS **COMMENTARY**

CHINA'S CORRECTION IN PERSPECTIVE

The MSCI China Index finished Q1 relatively unchanged, but the flat quarterly return obscures a more volatile reality. After an initial run up, Chinese equities dropped -18.5% from their 17 February peak to their 25 March low—a deep correction.[xlii] Most coverage we see associates the decline with escalating US and Chinese regulatory crackdowns on China's Tech and Tech-like sectors, hurting recent outperformers. It also supposes worse to come. But regulatory risk likely carries little forward-looking surprise, and it isn't a shift from the long-running status quo. Meanwhile, we think China's fundamental drivers are underappreciated, which should make this setback brief.

While the MSCI China includes Chinese shares listed in the mainland and Hong Kong, its biggest companies by market cap are US-listed ADRs of Chinese internet platforms. Although China's Tech sector is relatively small, Tech-like companies in Consumer Discretionary and Communication Services (particularly Alibaba, Baidu and Tencent) constitute over 40% of the index.[xliii]

xlii Source: FactSet, as of 26/04/2021. MSCI China Index returns with net dividends, 31/12/2020 – 31/03/2021 and 17/02/2021 – 25/03/2021.

xliii Ibid. MSCI China constituents' index weights, 23/04/2021.

These mega-cap firms, which dominate their industries in China, have long faced regulatory headwinds—part of the long-term policy backdrop they have navigated successfully for years. In the latest bout, the State Administration of Market Regulation imposed a range of antitrust fines on them, from 500,000 yuan (about $77,000) penalties against Tencent and Baidu to a larger 18.2 billion yuan (roughly $2.8 billion) for Alibaba. Moreover, the People's Bank of China is implementing stricter supervision and regulation of the financial services these firms provide. This includes higher capital requirements, oversight of all digital commerce and forced restructuring to separate payments and lending divisions. But these actions aren't coming out of nowhere. They are part of financial authorities' long-running efforts to rein in unofficial "shadow banking" activities - financial services increasingly undertaken by non-bank actors.

While we don't think this increasing regulation is great for these firms, it isn't surprising and doesn't fundamentally impede their growth, in our view. The increased regulation could help formalise the sector as part of China's regulated economy. From a macroeconomic perspective, restricting credit looks likely to slow China's overall GDP growth. This appears intentional, as policymakers seek to constrain excess to better ensure social stability and longer-term expansion. After the post-lockdown bounce, a slowdown would also be a return to normal, resuming a long-term trend toward decreasing single-digit growth—a decline led mostly by heavy industry and value-oriented, cyclical companies. Despite China's slowing growth, consumer spending and services—driven by ever-increasing activity on mobile and online platforms—are becoming a bigger part of the economy. Demand for gaming, social media, digital commerce and cloud services is set to strengthen, not wane.

We think this underscores Tech-like platforms' growing market share and dominance. This may draw extra regulatory scrutiny, but that should actually help cement their leadership, in our view. Their experience in navigating China's regulatory structure helps gives these big Tech-like firms an edge, heightening barriers to competitors entering. Then, once the regulatory regime is established, uncertainty largely clears. Without the regulatory overhang, companies can move on.

US REGULATORY SHIFTS

Many also see delisting threats from US exchanges sparking volatility and weakness for Chinese ADRs. Last December, former US President Donald Trump signed the Holding Foreign Companies Accountable (HFCA) Act, which the SEC began to implement in March under current US President Biden's administration. The HFCA requires US-listed firms to verify they aren't owned or controlled by a foreign government, and that their books are audited by firms subject to inspection by the US Public Company Accounting Oversight Board. Otherwise, they could face delisting. While the US perspective on this is somewhat understandable, considering that US firms face strict audit requirements under 2002's Sarbanes-Oxley Act, it is a particular problem for US-listed Chinese firms because China's national security laws seemingly prevent Chinese auditors from disclosing their records to US regulators.

However, there are mitigating factors worth considering. For one, the HFCA allows a three-year grace period for compliance—there are no immediate repercussions. In the meantime, potentially affected Chinese companies could obtain a dual listing in Hong Kong, as some already have. Doing so would ensure global investors' ability to trade the security, suggesting US delisting wouldn't be a key issue. Then too, China has been gradually increasing global investors' access to its domestic equities for years. A US ban wouldn't be an insurmountable obstacle.

There was a clear demonstration of this in January following an executive order President Trump issued banning trades in companies linked to China's military. After some initial confusion, the NYSE delisted three Chinese companies—China Telecom, China Unicom and China Mobile—effective 11 January. Owners of the old ADRs have until November to sell them or convert them to Hong Kong-listed shares. Since then, the companies' shares have traded in Hong Kong without incident. Trading in one liquid exchange over another hasn't harmed share prices. While the delisted firms' Hong Kong shares fell ahead of the ban, they rallied afterward. Two of the three are up nicely since the NYSE's initial announcement—the other is flat.[xliv] Similarly, two are outperforming the MSCI China and the third is in line year to date. This illustrates the fact that delisting isn't necessarily damaging and that fundamental strength can overcome these concerns. In addition, the Chinese firms listed on the Office of Foreign Assets Control (OFAC) & US Department of Defense sanctions list represent less than 5% of the MSCI China IMI and around one and a half percent of the MSCI EM IMI. (Exhibit 21)

EXHIBIT 21: SANCTIONS ON CHINESE PUBLICLY LISTED FIRMS

Source: FactSet, Office of Foreign Assets Control as of 31/03/2021. Shows % of equities present in the respective MSCI indices which are included in the 8 January OFAC NS-CCMC Sanctions and US Department of Defense lists. Index constituents shown as of 31/12/2020 as MSCI has since removed some of the impacted equities from their indices.

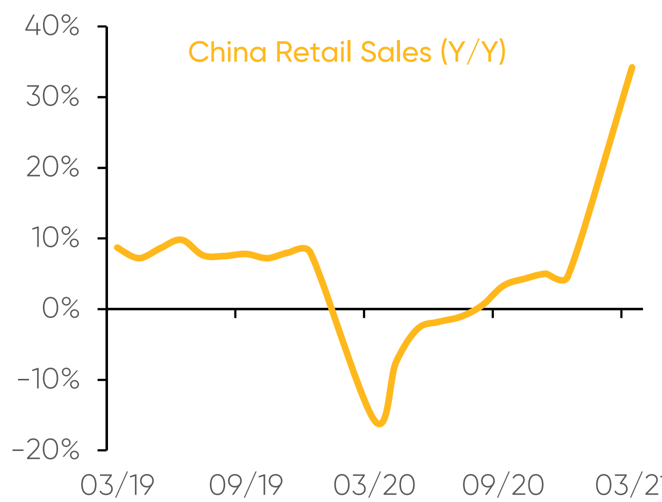
While Chinese regulation and US-China policy disputes are sources of uncertainty, we expect them to fade into the background with time. In our view, China's swift recovery from the Covid-19 downturn and the government's return to emphasising market-oriented reforms (like allowing bond defaults to encourage market discipline) suggest the future is brighter than many appreciate for the country's equities.

CHINA'S QUICK RECOVERY

Q4 GDP results released in January show Emerging Asian nations continue weathering the Covid-19 storm. China's 6.5% y/y growth helped GDP grow 2.5% for the full year of 2020. In addition, Q1 2021 GDP growth for china was 18.3% y/y and retail sales grew 34.2% y/y. (Exhibit 22 and 23) While the Q1 data got an artificial bump from the base effect, this data as a whole reflects the country's Covid-19 trajectory running a couple of months ahead of the world's as well as the government's efforts to boost the economic recovery.

EXHIBIT 22: CHINA GDP

EXHIBIT 23: CHINA RETAIL SALES



Source: FactSet, National Bureau of Statistics as of 31/03/2021. Shown as a year-over-year % change. GDP is shown as a quarterly year-over-year change.

xliv Ibid. China Telecom, China Mobile and China share prices in HKD, 31/12/2020 – 23/04/2021.

We expect growth there to continue, but as the quarters progressed, there were signs the government is shifting its focus back to reining in the shadow banking system. 2021 lending data showed slowing credit growth—resuming the pre-Covid-19 trend—and the central bank chose not to inject massive liquidity into the banking system ahead of the Lunar New Year holiday as it typically does, allowing short-term interest rates to jump. However, in our view, China's swift recovery from the Covid-19 downturn and the government's return to emphasising market-oriented reforms (like allowing bond defaults to encourage market discipline) suggest the future is brighter than many appreciate for the country's equities.

> "THE GOVERNMENT'S RETURN TO EMPHASISING MARKET-ORIENTED REFORMS...SUGGEST THE FUTURE IS BRIGHTER THAN MANY APPRECIATE"

KOREAN POLITICAL SCANDALS

Korean equities were slightly positive during the Q1 as attention began turning to the presidential election in March 2022.[xlv] First, President Moon Jae-in removed one of his top economic advisors over a property management scandal. The advisor, Kim Sang-jo, front-ran a rent control measure two days before it took effect, raising rents in an apartment building he owns by 14%. Second, the state-run development agency stands accused of using inside information to purchase farmland slated for public housing development, which has triggered investigations of multiple agencies and the presidential administration itself. Neither of these scandals has huge implications for Korean equities, in our view. However, they have further eroded support for President Moon's Democratic Party, displayed by the conservative People Power Party winning the mayoral elections in both Seoul and Busan. These victories heighten expectations for the party to retake the presidency in a year. However, in our view, it is still too early to project that contest, but we do expect markets to price it in as the year rolls on.

BRAZIL'S RECENT STRUGGLES

Brazilian equities fell in Q1 as the Covid-19 outbreak disproportionally affected the commodity sensitive country through 2020 and into 2021. Congress showed its commitment to maintaining compliance with the spending cap with the recently passed 2021 budget, while also allowing for more direct fiscal stimulus outside the spending cap in response to the virus continuing to surge. The country's dual deficit and continued political uncertainty leave the country vulnerable to negative shocks, but this austerity-focused legislation is in line with Brazil's history of implementing reform efforts and showing better fiscal management in the wake of recessions. Domestic economic growth and credit availability are improving and economic data have been surprising to the upside relative to overly dour expectations.

On the political front, President Bolsonaro has been gaining more centralised support in Congress, but an investigation into his handling of the country's Covid-19 response and the news of a potential challenge from popular former President Lula da Silva are increasing political tensions. The government's economic agenda has the potential to provide a positive catalyst if Congress can successfully resume reform efforts to overhaul the country's tax system and improve the fiscal situation in Brazil by keeping the budget constrained within the spending ceiling. The ousting of Petrobras' CEO Roberto Castello Branco weighs on investor confidence, but President Bolsonaro has a history of introducing extreme rhetoric to improve his popularity, but often reverses course to realign with the reform agenda of Paulo Guedes, the Economy Minister. The severity of the market reaction indicates investors are pricing in a very bad if not worst-case scenario, which often overshoots reality in Brazil.

Equities in Brazil have a long history of bouncing following EM bear markets, as recession tends to drive reform efforts and better fiscal management in the subsequent recovery. Current sentiment is overly dour tied to geopolitical risk, the country's dual deficit and budget issues, and Brazil's status as a Covid-19 hotspot. These fears are likely to abate in the months ahead, potentially providing a tailwind to equities.

xlv Source: FactSet, as of 01/04/2021. MSCI South Korea return with net dividends, 28/02/2021 – 31/03/2021.

TURKEY: CENTRAL BANK VOLATILITY

Turkey finished Q1 as the MSCI Emerging Markets (EM) Index's worst performer, falling -20.4% as EM equities rose 2.3% overall.[xlvi] However, most of that divergence—as well as the vast majority of Turkey's decline—occurred on one day, 22 March. That was the first trading day after Turkish President Recep Tayyip Erdogan fired central bank head Naci Agbal and replaced him with economist Sahap Kavcioglu, widely seen as a regime loyalist—stoking fears that the central bank will cease trying to fight inflation with high interest rates. Governor Kavcioglu sought to dismiss those fears after he was hired, and he decided to keep interest rates steady at his first meeting in April. What happens from here is unknowable, as monetary policy decisions always defy prediction, but we think events in the quarter highlight how the reforms Turkey desperately needs remain distant—a fact that continues to disappoint investors.

> "MONETARY POLICY DECISIONS ALWAYS DEFY PREDICTION"

Turkey has battled high inflation for years, due largely to years of economic mismanagement. That includes President Erdogan's long history of interfering in monetary policy, which stems in part from his unorthodox belief that high interest rates cause inflation. As a result, Governor Agbal—whom Erdogan appointed in November 2020—was probably always on close control, as he hiked interest rates significantly during his short tenure. The last straw appeared to be with Agbal's decision to hike the policy rate from 17% to 19% on 18 March (bringing the total magnitude of his rate hikes to 8.75 percentage points). President Erdogan dismissed him after market hours on the following day.

Markets' swift drop on 22 March, in our view, was equities' way of discounting two primary fears. The first—the potential for inappropriate monetary loosening—likely stems from Governor Kavcioglu having, in past writings, echoed President Erdogan's view of high interest rates. Turkish inflation, though down from October 2018's 25.2% y/y, has ticked up lately, rising to 16.2% y/y in March.[xlvii] That isn't necessarily surprising, as it takes time for monetary policy moves like Governor Agbal's rate hikes to affect the real economy, and a quick reversal likely wouldn't help matters. Yet Governor Kavcioglu eased this rhetoric in initial interviews and chose not to loosen at April's meeting, which pundits widely viewed as a test. That doesn't automatically render policy mistakes less likely, but in our view, it does show why presuming past rhetoric dictates central bankers' decisions is an error.

The other main fear here is political. During his term, Governor Agbal launched a review of his predecessor Berat Albayrak's policy of defending the lira in forex markets, which drained the country's reserves considerably during the Covid-19 panic last year. That reportedly upset President Erdogan, who had recently been rallying public support for Mr. Albayrak—who is also President Erdogan's son-in-law. Governor Agbal's removal raised the potential of Mr. Albayrak's return to frontline politics, dashing many investors' reform hopes. Now, we always thought President Erdogan's pledges of reform were mostly empty talk, so nothing here surprises us, but it does illustrate the perilous state of Turkey's political drivers.

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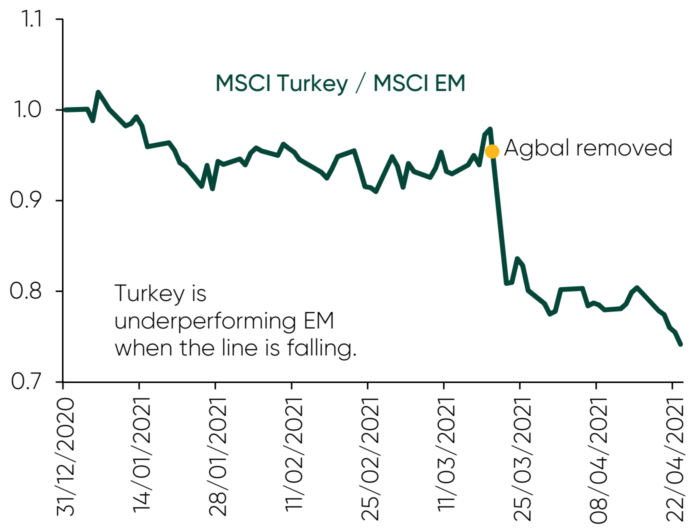
xlvi Source: FactSet, as of 01/04/2021. MSCI Turkey and MSCI EM Index returns in USD with net dividends, 31/12/2020 – 31/03/2021.

xlvii Source: FactSet, as of 26/04/2021. Year-over-year percentage change in Turkish CPI, October 2018 and March 2021.

While equities are very used to Turkey's political instability and the regime interfering in monetary policy—and priced much of Q1's negative developments rapidly—the events seemingly reminded investors of the risks posed by a dictatorial regime. (Exhibit 24) These events also represent a disappointment to investors who thought sentiment towards Turkey had reached its lowest point.

EXHIBIT 24: THE SHORT-LIVED REACTION TO GOVERNOR AGBAL'S REMOVAL



Source: FactSet, as of 23/04/2021. MSCI Turkey and MSCI EM Index returns with net dividends, 31/12/2020 – 23/04/2021. Indexed to 1 at 31/12/2020.

While we think the surprise power from Q1's events is spent, we are pessimistic on Turkey's prospects overall, as the political scene remains volatile and economic fundamentals are weak. At some point, it is possible expectations will overshoot to the downside and make positive surprise easily attainable. But we don't think that is now.

MORE EM POLITICS: PAKISTANI AND PERU

Recent election results in Pakistan and Peru suggest ongoing gridlock, but with differing investment implications, in our view—negative for the former, but positive for the latter.

PAKISTAN: NEEDED STRUCTURAL REFORMS UNLIKELY AFTER SENATE ELECTIONS

Pakistan's ruling party suffered a surprise setback in early March. While Prime Minister Imran Khan's Tehreek-e-Insaf party gained seats in 3 March elections, its governing coalition unexpectedly failed to achieve a majority in the 100-member Senate. The most surprising individual result was Finance Minister Abdul Hafeez Shaikh's defeat in his Senate re-election bid. This prompted a confidence vote on 6 March in the National Assembly, the lower house of Parliament. The government survived, but without Mr. Shaikh and lacking Senate control, its structural reform agenda may stall.

Prime Minister Khan had previously tasked Mr. Shaikh with implementing the International Monetary Fund's $6 billion bailout programme, including introducing legislation like the State Bank Amendment Bill to make Pakistan's central bank independent. The future of important reforms like this is now in question. If the opposition parties that control 51 Senate seats block such reforms, the government can still advance them in joint parliamentary proceedings. However, it can't count on its coalition to hold, particularly for unpopular austerity or constitutional changes centralising power in Islamabad. Hence, major legislation faces increased headwinds post-vote. More broadly, the opposition parties holding the Senate are emboldened, but not unified—and the military-backed government still holds sway. Meanwhile, nationwide unrest from anti-France protests surrounding French cartoons some deem blasphemous is adding to uncertainty. Pakistan banned the opposition Islamist Tehrik-e-Labaik Pakistan (TLP) party in mid-April and arrested its leader after members took 11 police officers hostage and killed 4 other officers in clashes. The TLP has since called off protests after the government agreed to hold a vote expelling France's ambassador to Pakistan and withdraw criminal cases against it, but the party's ban and leader's arrest remain in effect as of this writing.

While political unrest is nothing new for Pakistan's markets, the MSCI Pakistan Index was volatile in March and underperformed the MSCI Emerging Markets (EM) Index in Q1—extending its years-long overall relative weakness.[xlviii] For this to change, we think major reform is needed, but this seems unlikely anytime soon. In Pakistan, the military's influence obscures economic control and encroaches frequently into the private sector, which we think presents an ongoing headwind.

PERU: GRIDLOCKED CONGRESS SHOULD KEEP NATIONALISATION THREATS AT BAY

Following the 11 April general election that gave no one a majority, Peru's presidential race is headed to a 6 June runoff between a relatively unknown far-left candidate, Pedro Castillo and Keiko Fujimori, the daughter of the authoritarian former Prime Minister, Alberto Fujimori, who led the political dynasty that ruled in the 1990s. The race is giving rise to fears of more interventionist economic policy, although we think these fears overstate the likely reality.

The Castillo-Fujimori faceoff follows an unstable stretch in Peruvian politics, which saw Congress impeach and oust President Martin Vizcarra last November on alleged corruption. Many describe the removal as a coup based on made-up charges. His successor, President Manuel Merino, resigned after just five days in office, following two deaths during protests against President Vizcarra's impeachment. Congress then elected Francisco Sagasti to the presidency in a caretaker capacity until the vote.

The political commotion doesn't seem to have fazed Peru's markets as much as expected though. Since initial impeachment proceedings began 9 November last year, the MSCI Peru Index has experienced what we consider normal volatility relative to other emerging markets. Peru outperformed and rose sharply at the end of 2020 and has underperformed so far in 2021.[xlix] In our view, this suggests markets don't anticipate a radical shift from Peru's overall free-market policy stance, which seems to us like a rational assessment despite some jitters otherwise.

Pedro Castillo is running his presidential campaign on rewriting Peru's constitution—which a committee convened by Alberto Fujimori drafted after his 1992 "self-coup." A major part of his socialist Peru Libre party's platform is nationalising key industries, like mining. However, Mr. Castillo has more recently said nationalisation isn't his objective. He says he simply aims to renegotiate contracts with miners to get a larger share of profits to redistribute to Peruvians. It remains to be seen whether that is true.

Allegations of corruption connected to Brazil's Operation Car Wash investigation have bogged down Fujimori's campaign, likely contributing to Castillo's sizable lead in recent polls. This has raised fears over a leftist regime taking power. But regardless of the eventual presidential winner, Peru looks set for gridlock. Congressional election results saw 10 parties meeting the threshold for representation in Peru's single 130-member legislative body, with none close to a majority. We doubt the new government will be stable, and it is unlikely to have sufficient influence to enact sweeping policy change. Whatever aims Castillo has toward the mining industry, nationalisation probably won't materialise. Fear over him winning could stoke short-term volatility around June's vote, but as he proves unable or unwilling to press extreme policies forward, we think Peruvian equities will likely rally in relief.

xlviii Source: FactSet, as of 04/20/2021. MSCI Pakistan and MSCI Emerging Markets, both with net dividends, 31/12/2020 – 31/03/2021.

xlix Source: FactSet, as of 04/20/2021. MSCI Peru and MSCI Emerging Markets, both with net dividends, 11/10/2020 – 31/03/2021.

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