FISHER INVESTMENTS EUROPE™

MARKET PERSPECTIVES
REVIEW & OUTLOOK

SECOND QUARTER 2021

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SECOND QUARTER 2021 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

12 July 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.
- As growth resumed leadership late in Q2, we believe the relative strength in value-oriented companies was likely a countertrend in a longer growth-led cycle.
- Economic growth and inflation expectations likely continue to moderate as global economies reopen supporting our preference for growth equities.

MARKET OUTLOOK

- **Expect an Above-Average Year for Global Equities:** After a solid first half of 2021, global markets are on track for a strong year 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 equities enjoyed another good quarter rising 7.4% and seem on course for robust full-year returns.[i] Much in line with our expectations, growth outperformed value in Q2, displaying characteristics typical of a late stage bull market.[ii]

While market leadership will inevitably change, we believe growth will maintain leadership in the near future. While last year's downturn was a bear market by magnitude and cause, it behaved like a correction. The downturn didn't last long enough to reset the market cycle and usher in long-running value leadership. Accordingly, equities are behaving as if we are in the late stages of the bull market that began in 2009.

Growth has led overall since March 2020's recovery started and continues to do so despite several value countertrends along the way. We are choosing to maintain our growth emphasis with select value exposure for diversification. This positioning helped mitigate the impact of the year's early countertrend.

Consistent with our outlook earlier in the year, we maintain the view that recent jumps in economic growth and inflation will likely be temporary. As opposed to previously, the consensus view now seems more in line with ours, which is normally concerning. But the facts and logic supporting our view still hold.

i Source: FactSet, as of 01/07/2021. MSCI ACWI returns with net dividends, 31/03/2021 – 30/06/2021.

ii Source: FactSet, as of 01/07/2021. Statement based on the MSCI ACWI Growth and Value Index returns with net dividends, 31/03/2021 – 30/06/2021.

Specifically, pundits now cite the declines in lumber prices and long-term interest rates as signs inflation pressures are temporary. They also note the base effect from last year's pandemic-induced deflation in April and May. These are correct observations, if incomplete. Spiking resource prices due to supply shortages don't represent lasting inflation. We see this more as a false fear resolving and people realising what the market already knew. While broad measures of money supply soared, most of the components aren't actually mediums of exchange. Note, we aren't arguing there is no inflation. Just that there is a big difference between the 1970s-style inflation many fear and the slow, pre-pandemic inflation rates we expect.

Pundits are also moderating on infrastructure spending as stimulus, noting the slow rollout. Instead of overheating and a new Roaring Twenties, many now anticipate slow growth. We largely agree. After a temporary surge tied to reopening, we have long said pre-pandemic slow growth was likely to return. "Stimulus" was never likely to have the anticipated effect, considering shovel-ready infrastructure projects are largely a myth and households spent only a portion of their Covid-19 relief money. Regardless, government spending can aid growth when the conditions are right, but that isn't now. Most economic data are near or even above pre-pandemic levels. The notion the economy needs support from here strains credulity.

While some US legislation has passed under President Biden and other proposals could come to fruition, overall, we expect the Democratic Party's narrow edge in the House and Senate, alongside internal division, to make passing legislation difficult. Gridlock is blocking some ideas and diluting others. Tax hikes have already fizzled. The G7's vaunted global minimum corporate tax rate agreement will likely do the same. Further, we are three months away from the traditional start of US midterm campaigning. Politicians are already shifting gears. The rhetoric around a bipartisan infrastructure deal looks more like campaign talk than serious progress on legislation. Moreover, markets are familiar with all this. If major legislative disruption were likely, equities would show it.

Political risk remains benign in global developed markets, but several meaningful elections will draw attention in the second half of 2021. Germany will go to the polls in September and will replace Prime Minister Angela Merkel. We don't envision a successor with her political influence and believe it is unlikely for any single party to win a majority resulting in an inactive coalition government—positive for equities.

In Japan, Prime Minister Yoshihide Suga survived a no-confidence vote—an unsurprising outcome as his Liberal Democratic Party (LDP) and its coalition partner, Komeito, wield a huge majority in the lower house. Some speculate Prime Minister Suga may call a snap general election—a vote is due by 22 October —following the Tokyo Olympics' conclusion in early August. A fresh mandate from voters may help Prime Minister Suga shore up support within his own party.

Additionally, rumours speculate that Canadian Prime Minister Justin Trudeau may also call an early election attempting to capitalise on his vaccination campaign success and fiscal response. If he moves forward, it is too early to predict whether this will result in a majority government led by Prime Minister Trudeau.

Emerging Markets (EM) also rose in Q2, adding to a positive first half of 2021. Unlike global developed markets, growth narrowly trailed value over the quarter.[iii] However, that trend reversed in June as growth in EM led alongside developed markets, a sign of things to come in our view.

Brazil was EM's best performer in Q2. The likely reason why, in our view, is simple: The country is beating exceedingly low expectations. Between political uncertainty, slow vaccine progress and the reduction of direct aid payments in April, most observers expected Brazil to struggle for the foreseeable future. However, reality has proven better than feared.

iii Source: FactSet, as of 01/07/2021. Statement based on the MSCI EM Growth and Value Index returns with net dividends, 31/03/2021 – 30/06/2021.

China got a respite from its deep February – March correction as the MSCI China rose during the quarter. On the economic front, not much has changed. Data, while still showing recovery from last year's lockdowns, remain skewed by the base effect, making year-over-year measures of little use for investors right now. Most major economic indicators have been slowing in Q1, part of the broader slowdown likely attributable to the base effect, as China's recovery was accelerating last year.

Further, markets have been reacting to recent news that Chinese government agencies are considering revising rules on overseas listings as part of broader capital markets reform. With this news, investor sentiment turned negative overlooking strong fundamentals, in our view. Potential regulatory changes appear aimed at strengthening domestic capital markets rather than a draconian move against foreign listed companies.

Halfway into 2021, global markets are well familiar with the pandemic's issues and setbacks—and are looking beyond them. We think they are pricing in the return to pre-pandemic growth trends. This still leaves further room for the bull market to rise this year, but rising optimism makes monitoring for euphoria and areas of excess paramount, in our view.

GLOBAL UPDATE AND MARKET OUTLOOK

09 August, 2021

Q2 MARKET RECAP

SHUN MYOPIA AND LOOK AHEAD

Global equities climb accelerated in Q2 bringing year-to-date returns to 12.3%[iii]. As mentioned in the Executive Summary, growth reclaimed leadership from value in mid-May surprising many investors. In Q2, US equities beat other developed market and EM equities, with Tech leading all sectors.[iv] Communication Services, which includes several Tech-like giants, rose 8.0%.[v]

Value-heavy sectors including Financials and Materials lagged, as we would expect, but Energy continued outperforming as oil prices rose. Pundits continue hyping Energy equities' alleged opportunities as demand resurges alongside tight supply. But efficient markets are well aware—and equity prices likely reflect this by now. We don't see dark times in store for Energy, as relatively higher oil prices do support producers' earnings. But we don't expect value categories like Energy to lead markets looking forward.

GROWTH, VALUE AND THE CORRECTION-LIKE BEAR

Overall, we see Q2 as a near-perfect microcosm of a typical late-stage bull market. Last year's downturn was indeed a bear market, ending the bull market that began in March 2009. Equity markets fell much more than -20% and global lockdowns' severe economic impact gave it a fundamental cause—meeting the definition of a bear market. Yet in its speed and shape, it acted like a correction. It didn't grind slowly lower over many months (or years) before plunging late, unlike most past bear markets. Instead, it was a panicky plunge from start to finish, lasting just 28 trading days from beginning to end.[vi]

> "WHAT GETS HIT DISPROPORTIONATELY ON THE WAY DOWN BOUNCES HIGHEST AND FASTEST ON THE WAY UP."

Duration matters. In a normal bull market, value equities lead in the initial recovery, then gradually give way to growth, which leads as the bull market matures. Towards the end of a normal bear market, value usually takes its worst hit in the panicky final throes, when credit is usually tightest and investors avoid small, illiquid companies they fear won't survive the recession that bear markets usually anticipate. That panic, in our view, is what sets up value's early leadership in a new bull market. What gets hit disproportionately on the way down bounces highest and fastest on the way up.

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iii Source: FactSet, as of 01/07/2021. MSCI ACWI Index returns with net dividends, 31/12/2020 – 30/06/2021.

iv Ibid. MSCI ACWI Information Technology Index return with net dividends, 31/03/2021 – 30/06/2021.

v Ibid. MSCI ACWI Communication Services Index return with net dividends, 31/03/2021 – 30/06/2021.

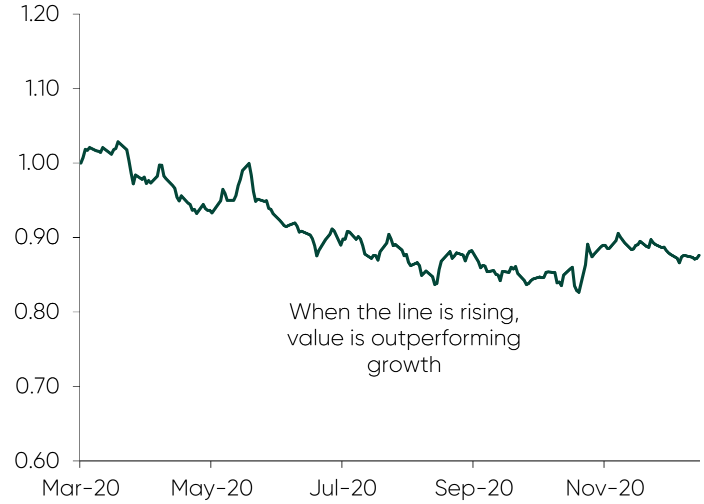
vi Source: FactSet, as of 07/07/2021. Day count is global trading days based on the MSCI World Index, 12/02/2020 – 23/03/2020.

Last year's bear market wasn't long enough for that value reset to happen. While value equities trailed growth during the bear market, it was a steady trend from start to finish. Contrast this with the bear market that accompanied the financial crisis in October 2007 – March 2009. Nearly all of value's deep cumulative lag occurred in the final stage of that bear market. That stretch of severe underperformance set up for a big value rally after the bear market bottomed in 2009, an event that didn't repeat last year. (Exhibits 1 & 2)

EXHIBIT 1: VALUE SURGED OUT OF THE GATE IN 2009 ...

Source: FactSet, as of 06/07/2021. MSCI ACWI Value and Growth returns with net dividends, 09/03/2009 – 31/12/2009. Indexed to 1 at 09/03/2009.

EXHIBIT 2: ... BUT NOT IN 2020



Source: FactSet, as of 06/07/2021. MSCI ACWI Value and Growth returns with net dividends, 23/03/2020 – 31/12/2020. Indexed to 1 at 23/03/2020.

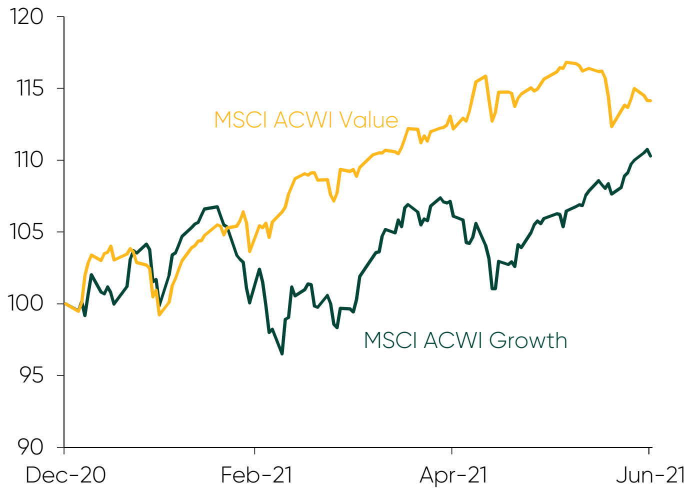
To be clear, equities are officially and technically in a bull market that began in March 2020. But in our view, because last year's bear market was so short, equities are acting like it was a correction. It didn't reset the value versus growth cycle. Equities are therefore behaving as they normally would in a late-stage bull market, with growth equities leading during—and cumulatively—since the short bear market.

As Exhibit 2 hints at, growth's leadership since March 2020 hasn't been steady. Value had several short bursts, including November 2020 (tied to vaccine excitement). It also led in Q1 as enthusiasm over global reopening boosted travel and leisure. But value fizzled in mid-May, rising just 1.3% from 13 May through quarter-end. In that same window, global growth equities leapt 9.1%, driving their big Q2 leadership.[vii]

Interestingly, most pundits and financial news outlets missed this. Much of the commentary we encountered focused on year-to-date returns, which still showed value leading, seemingly not realising the trend had faltered. Pundits are still pounding the table early in Q3, despite the fact growth has been leading since mid-May (Exhibit 3.) Shifting into value equities based on this rhetoric would have been a mistake.

vii Source: FactSet, as of 07/07/2021. Day count is global trading days based on the MSCI World Index, 12/02/2020 – 23/03/2020.

EXHIBIT 3: GROWTH AND VALUE DIVERGENCE IN 2021



Source: FactSet, as of 01/07/2021. MSCI ACWI Growth and Value Index returns with net dividends, 31/12/2020 – 30/06/2021. Indexed to 100 at 31/12/2020.

ECONOMIC CONDITIONS FAVOUR GROWTH OVER VALUE

The National Bureau of Economic Research (NBER) only recently declared an end to the recession that accompanied last year's lockdowns, so this next statement might sound strange: The economic environment looks increasingly like a late-stage expansion, matching our expectations.

This, too, stems from the unique nature of last year's downturn. As past Reviews detailed, society (and NBER) call the economic contraction a recession because there is no other word. But ordinary recessions don't start without warning because governments shut down economic activity. Rather, they usually arise when over-extended businesses meet tightening credit. An inverted yield curve usually provides an early warning sign, eventually leading banks to restrict lending as their net interest margins shrink.

As access to credit deteriorates, businesses run down inventories and cut capital expenditures in an effort to trim costs and survive lean times. Output falls accordingly, as do certain categories of consumer spending as households cut discretionary purchases. The pain can last several months or quarters, until the yield curve steepens again, restarting the flow of capital. By then, businesses are usually lean and mean. GDP jumps off the bottom as companies grow swiftly through productivity gains made during the recession. Eventually, this catch-up phase expires and businesses reach the limits of doing more with less, slowing GDP growth as expansion depends more on new investments.

None of that happened last year. Instead, governments flipped a switch, curtailing economic activity for several weeks—in some cases, two or three times. It was a sharp economic contraction without many of a recession's traditional defining features. Entering lockdowns, businesses didn't have excess to work off. Restrictions didn't last long enough for most to start shedding unproductive assets in order to survive. Because lockdowns created pent-up demand, there was always going to be a short economic boom upon reopening. But the short-lived downturn didn't require firms to get lean and mean. Absent the typical productivity gains stemming from a recession, lasting fast growth was never likely. Plus, as several industrial areas demonstrate, it is much easier to turn activity off than turn it on, which also supports slower growth. Slow growth and slow inflation are hallmarks of late-stage expansions.

Yes, slow inflation. The US CPI inflation rate hit 5.0% y/y in May and 5.4% in June, a 13-year high, but these are figments of math and one-offs.[viii] Meanwhile, supply is already recovering in some of the categories that fueled this March's inflation fears. Lumber, perhaps the poster child for the alleged risk of "cost-push inflation," is now down about 57.5% since its surge to a May peak fueled inflation dread.[ix]

viii Source: FactSet, as of 06/07/2021.

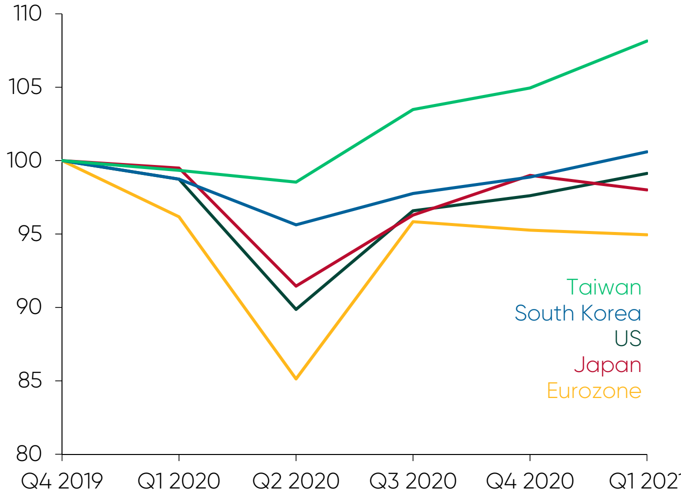
ix Source: FactSet, as of 09/07/2021.

When prices spiked, some consumers delayed purchases while sawmills across the US—which had cut production during lockdowns, anticipating reduced construction—reopened and added shifts. Output rose, prices fell. Soon we will see this in metals and other resources as suppliers respond to prices' incentives.

Meanwhile, many economic data series are near or above pre-pandemic levels. US GDP finished Q1 just 0.9% below its pre-pandemic peak.[x] Industrial production is only 1.4% off its prior high.[xi] Retail sales eclipsed their prior peak months ago.

In other parts of the developed world, recoveries are behind due to lingering lockdowns, but they have made more progress than you might think. (Exhibit 4) In the UK's first lockdown, services output dropped -23.4% peak-to-trough.[xii] As of May 2021, it had clawed back most of that—despite the third lockdown continuing—and was just 3.7% below pre-pandemic levels.[xiii] Monthly GDP stood 3.4% below January 2020's pre-pandemic level in May 2021.[xiv] There, too, retail sales have already clocked new highs. So have retail sales in the eurozone, while eurozone GDP has 5.1% worth of lost ground to make up.[xv] Even in Japan, whose continued Covid-19 struggles and slow vaccine rollout are well-documented, GDP finished Q1 just 3.9% off its peak.[xvi] Now, across the developed world, several monthly indicators are slowing, suggesting the reopening surge is fading. Pundits have stopped hyping a new Roaring Twenties. Between slowing growth and the prospect of slower inflation, the thesis underpinning value's Q1 run seems to be disintegrating.

EXHIBIT 4: GDP'S RAPID WORLDWIDE RECOVERY



Source: FactSet, as of 08/07/2021. Seasonally Adjusted Quarterly Real GDP for the listed countries, Q4 2019 – Q1 2021. Indexed to 100 at Q4 2019. Japanese GDP peaked in Q3 2019 when a scheduled October 2019 sales tax hike pulled consumption into mid-year.

In our view, this primes growth equities to shine for the rest of this expansion. In part, growth normally outperforms late in bull markets because of slower economic growth rates. Investors, seeing output slowing, gravitate to companies with a proven ability to make profits in tougher environments. They seek businesses with strong gross operating profit margins, product lines that are in demand through thick and thin, geographically diverse revenues and strong brand names. These high-quality features are all hallmarks of growth-oriented companies.

x Ibid. US GDP, Q4 2019 – Q1 2021.

xi Ibid. US Industrial Production, February 2020 – May 2021.

xii Ibid. UK Index of Services, January 2020 – April 2020.

xiii Ibid. UK Index of Services, January 2020 – May 2021.

xiv Source: FactSet, as of 09/07/2021. UK GDP by Industry, Gross Value Added, January 2020 – May 2021.

xv Ibid. Eurozone GDP, Q4 2019 – Q1 2021.

xvi Ibid. Japan GDP, Q3 2019 – Q1 2021.

MARKETS CALMER IN Q2 THAN HEADLINES SUGGEST

Not much happened in Q2. But you wouldn't know it from headlines, which spun small things into huge events. This refusal to contextualise current events is myopic, which is one of the most striking features of today's world. From our vantage point, the record-fast bear market and round trip to new all-time highs has many investors and pundits exceedingly near-term focused.

For instance, markets were quite calm in Q2, extending the year's low volatility. For example, in the US daily market moves are much calmer than average, and as several outlets have noted, the S&P 500 hasn't fallen -5% since late last year. So when US equities fell -2.1% in June's third week, pundits hyped it as huge.[xvii] Yet in reality, it was perfectly normal volatility. The S&P 500 erased it by 24 June.

> "...THE RECORD-FAST BEAR MARKET AND ROUND TRIP TO NEW ALL-TIME HIGHS HAS MANY INVESTORS AND PUNDITS EXCEEDINGLY NEAR-TERM FOCUSED."

Pundits' jitters extended to short-term events. Consider the attention heaped on the minimum global corporate tax rate agreement, which is a loose political pact that will take years (if ever) to become tax law, thanks to gridlock in participating nations and key European holdouts. Other examples of gridlock includes the continued headlines surrounding efforts to regulate big Tech and Tech-like firms and the supposed bipartisan compromise on infrastructure in the US. Other widely scrutinised short-term events abound. The frenzy over family investment office Archegos' collapse. GameStop and other meme stocks' booms and crashes. The UK and EU's disagreements over the finer points of Brexit. All fizzled so quickly that we doubt many investors remembered them even two weeks later.

Myopia isn't confined to fear. Witness the early-year enthusiasm over cryptocurrencies, electric vehicles and special-purpose acquisition companies (SPACs). These categories' Q2 woes show the danger of falling for myopic frenzies. So many people wanted to chase these categories in Q1. Many of our individual private clients asked us why we weren't adding bitcoin, hot electric-vehicle startups or SPACs to client portfolios. Now, those questions have dried up, for a simple reason: These categories imploded. Bitcoin finished Q2 down -44.8% from its 13 April high.[xviii] SPAC issuance has slowed following SEC orders to adjust financial reporting. One infamous SPAC acquisition, Lordstown Motors, admitted it might not be able to continue as a going concern and that its initial projections were far too lofty. It is down -41.2% since merging with a SPAC on 3 August, 2020 and -76.8% from its high.[xix]

On the bright side, these implosions indicate the market is overall quite healthy, with froth relegated to the fringes. As these categories underperformed, broader indexes kept hitting new highs, suggesting euphoria hadn't infected equities broadly. (Exhibit 5) If it were more pervasive, broad indexes probably would have tumbled with prior highfliers. In our view, this suggests we aren't at a market peak despite continued record highs.

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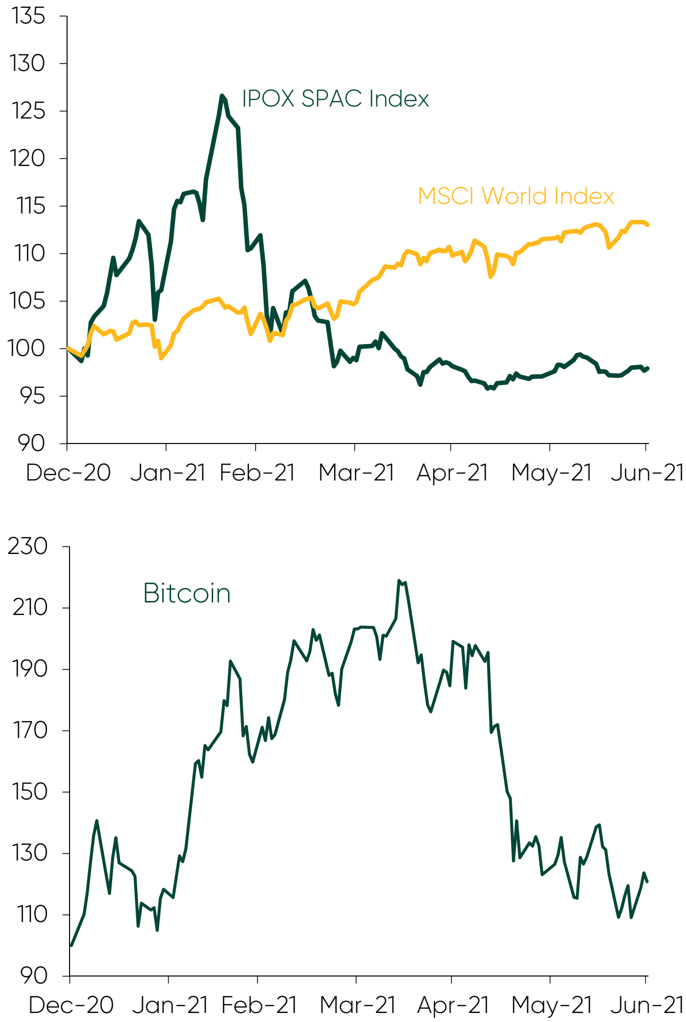
xvii Source: FactSet, as of 06/07/2021. S&P 500 total return, 14/06/2021 – 18/06/2021.

xviii Source: CoinMarketCap.com, as of 08/07/2021. Bitcoin price, 13/04/2021 – 30/06/2021.

xix Source: FactSet, as of 26/07/2021. Lordstown Motors Corp. price return, 08/03/2020 – 26/07/2020.

EXHIBIT 5: BITCOIN AND SPACS DOWN IN Q2, EQUITIES UP



Source: Refinitiv, FactSet and CoinMarketCap.com, as of 08/07/2021. IPOX SPAC ETF price, MSCI World Index return with net dividends and Bitcoin price in USD, 31/12/2020 – 30/06/2021. All series indexed to 100 at 31/12/2020.

CHECKING IN ON INFLATION AND INTEREST RATES

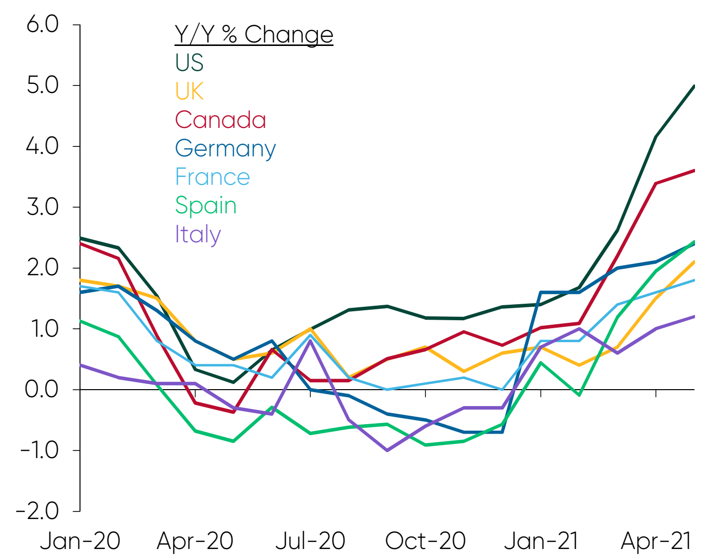
The chief fear entering Q2: inflation. Pundits pointed to rising price indexes and commodity and component shortages—and claimed high inflation loomed. Some warned government "stimulus" risks overheating the economy. Many still do. But we don't think high inflation is at hand.

In our Q1 Review we discussed how near term economic data would likely be heavily skewed due to the year over year comparisons—especially inflation gauges. As we explained, most of this would likely prove temporary, fleeting effects of last year's lockdowns and more recent reopenings. Inflation fears spiraled in Q2's first half as select natural resources prices soared and long-term Treasury yields ticked higher. But more recently, the consensus viewpoint seems to have fallen in line with ours. That is often reason for pause, but the logic behind our inflation views hasn't changed. The latest data suggest inflation's recent jump will likely be fleeting, not the start of 1970s-style inflation.

THE WIDELY ANTICIPATED BASE EFFECT

Entering 2021, nearly everyone forecast higher inflation rates. Consumer Price Indexes (CPIs) in the first half of the year confirmed those projections, albeit with a notable divide between the US and elsewhere (Exhibit 6.) Pundits credit larger stimulus efforts in the US for faster-rising prices—a misperception, in our view. Rather, we think economic reopening progress—quicker in the US than other developed nations—has played a much bigger role.

EXHIBIT 6: INFLATION HAS PICKED UP IN 2021



Source: FactSet, as of 19/07/2021. CPI for US and UK; HCPI for Germany, France, Spain and Italy, year-over-year percent change, January 2020 – June 2021. Canada CPI data is through May due to data availability.

As we wrote last quarter, inflation gauges were subject to the impact of the base effect. Many countries report CPI on a year-over-year basis—i.e., the percentage difference between a given month and the same month a year prior. Lockdowns weighed on the base (in this case, March, April and May 2020), which inflated this year's figures, resulting in distorted, unreliable readings. These effects will fall out of the calculation as 2021 progresses, though it won't happen uniformly—especially since many European nations' reopening plans lag the US'. Fed chair Jerome Powell also warned about transitory effects on prices in early March. Several other central bankers, including the BoE's Andrew Bailey and the ECB's Christine Lagarde, echoed the sentiment.

TRUE INFLATION IMPACTS PRICES BROADLY

Some have pointed to rising commodity prices—e.g., lumber prices skyrocketing to record highs—as precursors to hot inflation. Worries tied to surging prices hit a crescendo in mid-May, perhaps even contributing to a few days' negative market volatility.

However, in our view, rising raw materials prices aren't a leading inflation indicator. Rather, they reflected temporary shortages amid unleashed demand as economies reopened. Those shortages stemmed partly from producers' underestimating the fast economic rebound. They shuttered capacity last year, likely anticipating a far slower recovery. Cutting capacity is faster than bringing it back online or adding more.

But prices are a signal, and higher prices incentivise producers to boost supply. This appears to be happening. Lumber producers announced investment of $340 million in new sawmill capacity as of mid-June.[xx] The market already seems to reflect the news of incoming supply.

After hitting May record highs, lumber prices fell -57.5% by early July.[xxi] Semiconductor manufacturers are also pouring money into production. Taiwan Semiconductor Manufacturing—one of the world's most important producers—plans to spend $100 billion on expansion over the next three years.[xxii] Intel announced a $20 billion investment to build two US chip factories, while GlobalFoundries will build a $4 billion plant in Singapore, with production slated to start in 2023.[xxiii]

While supply won't increase overnight, shortages appear to be more short lived than many feared. But also, as we noted in the Q1 Review, inflation entails prices rising across the economy—a global monetary phenomenon—not isolated price pressures for certain goods or services.

RECENT INFLATION NUMBERS BROKEN DOWN

Month-over-month readings—which remove the base effect skew—highlight reopening's significant impact. Take April CPI, which rose 0.8% m/m—then the fastest since June 2009.[xxiv] Five categories—used cars, car and truck rental, airline fares, admissions (to theaters and sports events) and lodging away from home (hotels/motels)—contributed half the monthly gain despite comprising just 5% of the overall CPI basket.[xxv] Most of these categories have clear ties to reopening—and May and June's readings suggest some of that initial jump may be fading. (Exhibit 7)

xx Source: Fisher Investments Research, as of 16/06/2021.

xxi Source: FactSet, as of 09/07/2021.

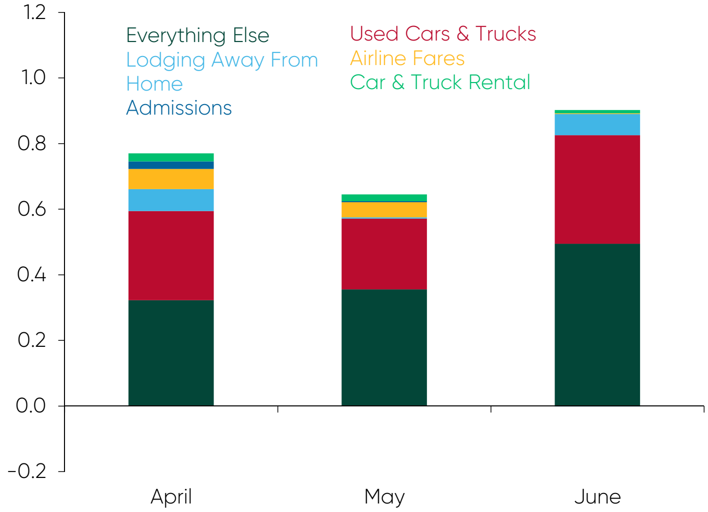
xxii "The World Relies on One Chip Maker in Taiwan, Leaving Everyone Vulnerable," Yang Jie, Stephanie Yang and Asa Fitch, The Wall Street Journal, 19 June, 2021.

xxiii Ibid. and "U.S. Firm GlobalFoundries Invests $4 Billion in Singapore Chip Plant," Debby Wu, Bloomberg, 22 June, 2021.

xxiv Source: FactSet, as of 09/07/2021.

xxv Source: Bureau of Labour Statistics, as of 17/05/2021.

EXHIBIT 7: REOPENING'S IMPACT ON US CPI



Source: US Bureau of Labour Statistics, as of 13/07/2021.

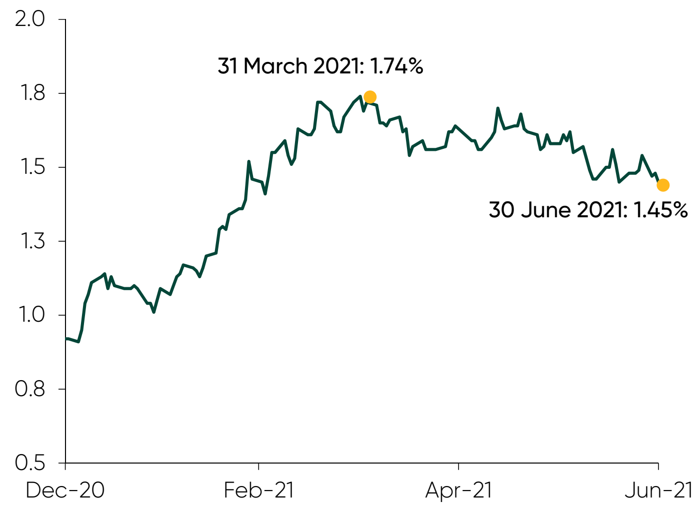
The exception is used cars, which remained the biggest-contributing subcategory through June. It rose 10.5% m/m, its largest monthly increase on record, accounting for more than a third of the headline gain.[xxvi] Several factors may be at work, including rental car companies rebuilding inventory and semiconductor shortages hampering new vehicle production, but it seems unlikely to us that used car prices will keep shooting higher indefinitely. Volatile energy prices also contributed strongly to June's monthly uptick. In our view, CPI's rise will slow before long, as reopening-impacted categories fade.

WHAT A STRONG US DOLLAR AND TREASURY YIELDS SAY ABOUT INFLATION

Despite a few bumps, the dollar has been relatively strong this year against a trade-weighted basket of major trade partners' currencies. As inflation fears spiraled, the dollar slipped -3.6% from March's end to mid-May—weakness loosely consistent with rising inflation expectations.[xxvii] But, as data indicated the acceleration was temporary, the dollar rallied back, finishing Q2 almost flat at -0.7%. On the year, the dollar is actually up 1.8%. That relative strength is inconsistent with looming inflation problems.

Other similarly liquid markets echo that message—including the bond market. Few assets are more sensitive to inflation than long-term Treasurys. If bond investors broadly expect higher inflation to erode interest payments' purchasing power, they will normally demand higher yields. After rising from 0.93% to 1.74% in Q1, 10-year Treasury yields drifted lower in Q2—settling at 1.45% on 30 June.[xxviii] (Exhibit 8) They fell more in July.

EXHIBIT 8: US 10-YEAR TREASURY YIELD IN 2021



Source: FactSet, as of 07/07/2021. US 10-Year Treasury Yield, 31/12/2020 – 30/06/2021.

In our view, the market is signaling a simple message: The uptick in inflation is fleeting. The market isn't perfect, but it is the most efficient pricing mechanism in town, in our view. If inflation was truly a big risk, forex, bonds and other similarly deep, liquid capital markets would show it in their prices. They have heard the dire projections, priced them in and moved on.

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xxvi Ibid., as of 13/07/2021.

xxvii Source: FactSet, as of 06/07/2021. Nominal USD Trade-Weighted Exchange Index, Major Currencies, 31/03/2021 – 20/05/2021.

xxviii Source: FactSet, as of 07/06/2021. 10-Year US Treasury Yield, 31/12/2020 – 31/03/2021 and on 30/06/2021.

EXPECT MINIMAL ACTION ON THE GLOBAL MINIMUM CORPORATE TAX

Perhaps the best microcosm of investors' myopia over politics and gridlock: the G7's agreement on a Biden-brokered global minimum corporate tax.

When the administration rolled out its domestic corporate tax hike, it accepted one key thing: People respond to incentives. The higher rate would encourage US companies to domicile elsewhere to take advantage of lower rates. As such, President Biden pitched a global minimum corporate tax rate—one applying to all firms—of 21%. Most coverage around this highlights things like the G7 agreeing to the plan, but this reception misses some major complications suggesting any global minimum corporate tax would take many years to complete, if one ever happens.

President Biden's initial ask of 21% met immediate resistance from many countries. So to gain G7 approval, he watered it down to 15%. But even this isn't a done deal. Nor is the Organisation for Economic Cooperation and Development's (OECD's) broader agreement among 131 nations, cemented as July dawned. Many tax havens—including Ireland (12.5% corporate tax rate) and Hungary (9%) haven't signed on. Getting the likes of France, Japan and Germany to agree is irrelevant, as their tax rates are relatively high. Instead, the smaller nations that use tax rates to lure companies must agree to the plan.

Few seem on board. Hungarian President Viktor Orban labeled the plan "absurd" in June.[xxix] Irish Finance Minister Paschal Donohoe has repeatedly expressed reservations about any policy that would limit small nations' ability to attract business. Those two aren't alone.

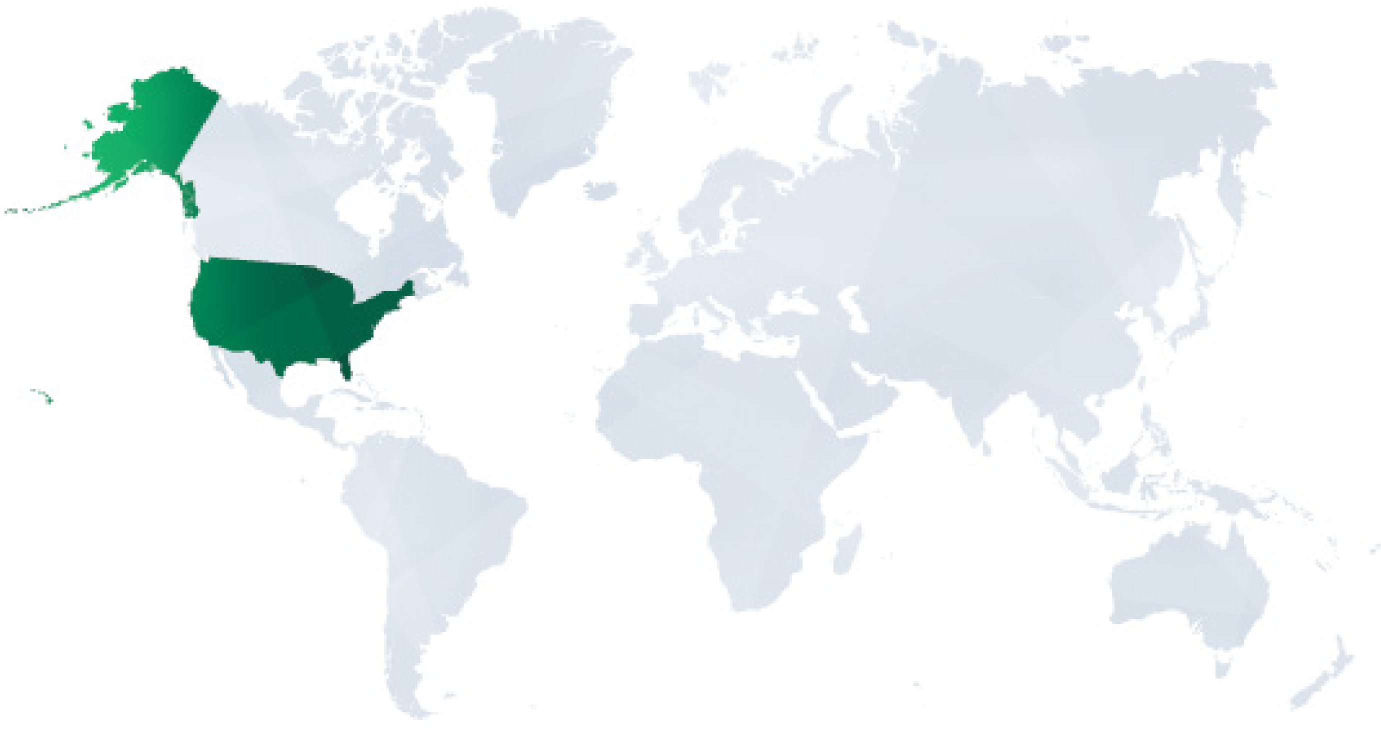
BEYOND THE RATE

These negotiations are merely the tip of the iceberg. Agreeing to a global rate is the easy part. Few have broached how to define the revenue subject to tax, an issue that has stymied international digital taxation efforts for a decade. Then there is the matter of industry exclusions. Many countries talk up seeking exclusions for certain national champions (e.g., UK officials and London's huge banking sector). Several nations also say they would compensate firms hit by the tax via national tax credits and other handouts. Negotiations on these measures haven't started.

If and when they get to a final deal, remember: The G7 and OECD can't enact tax rules on their own. Each and every nation must pass a law to enact a global tax. US Treasury Secretary Janet Yellen said the actual legislation won't be ready until early next year—the heart of midterm campaigning. Then too, ratifying a treaty takes a two-thirds Senate majority. The upshot: Don't overrate the chances this ever happens.

xxix "Hungary's Orban Calls Global Minimum Corporate Tax Plan 'Absurd'," Zoltan Simon, Bloomberg, 09/06/2021.

UNITED STATES COMMENTARY



NEGLIGIBLE IMPACT OF US 'FISCAL STIMULUS'

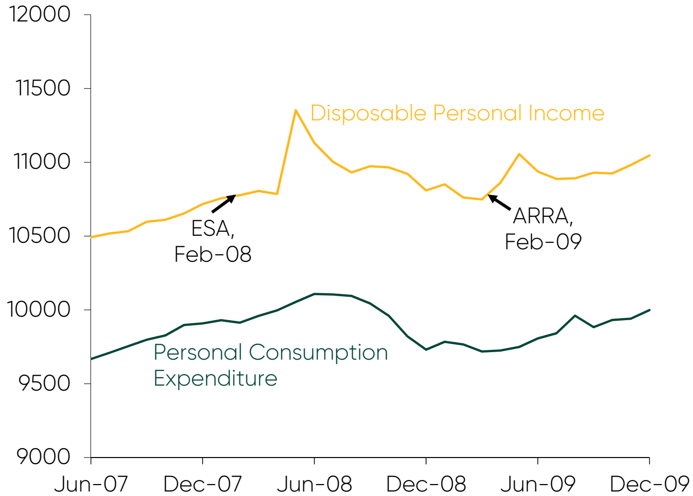
With $4.5 trillion in approved Covid-19 relief since last year—and possibly up to $4 trillion more to come—many thought a wave of new cash circulating through the economy would inevitably lead to rising prices.[xxx] Yet all this is moving slowly—a reminder fiscal stimulus's powers are vastly overrated. Of that $4.5 trillion, about $3 trillion has actually been spent, with about $340 billion on Covid-19 relief checks.[xxxi]

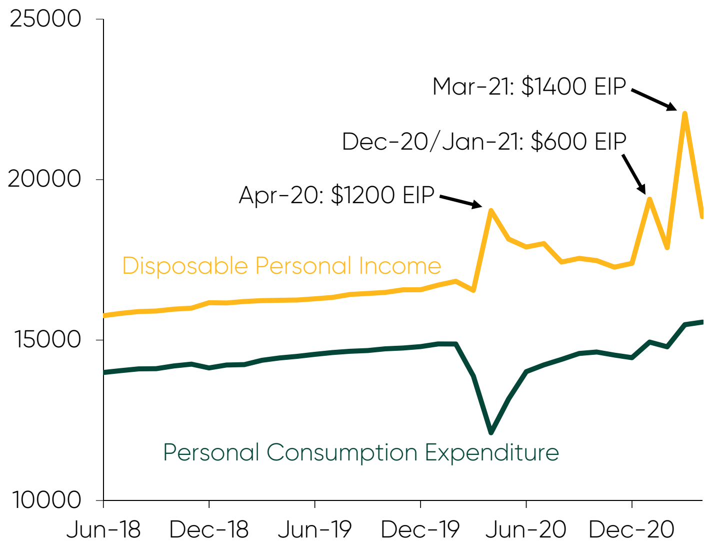
Those were supposed to drive a big US household spending boom, with many seeing higher prices resulting. But as we have previously written, past one-time payments didn't turbocharge spending. That appears true with Covid-19 payments, too.

xxx Source: USASpending.gov, as of 08/07/2021. "The Federal Response to COVID-19." Data cited are through 31 May, 2021.

xxxi Ibid.

EXHIBIT 9: DIRECT PAYMENTS DON'T BOOST SPENDING





Source: St. Louis Federal Reserve, as of 21/06/2021. Personal consumption expenditures (PCE) and disposable personal income (DPI), billions of dollars, monthly, June 2007 – December 2009 and January 2018 – April 2021. ESA is Economic Stimulus Act, ARRA is American Recovery and Reinvestment Act, and EIP is Economic Impact Payment.

Households spent some—but not all—of their windfalls. In a New York Fed survey, recipients reported spending about 27% of funds, on average, across the three rounds of payments.[xxxii] They saved or repaid debt with the rest.[xxxiii] Hard data back this up. The Fed's quarterly household wealth report showed balances in cash, checking accounts and savings deposits rose by $848.5 billion in Q1—hitting a record $14.5 trillion.[xxxiv] The New York Fed reported US credit card balances fell -13.8% y/y in Q1—illustrating debt repayment, too.[xxxv]

Government spending plans are also miscast as stimulus. It is possible government spending can spur demand if the conditions are right. But it seems odd to spend all this proposed money when the economy is already back to pre-pandemic levels.

Moreover, calling this spending "stimulus" seems like a marketing label for normal government spending and investment. Even if it passes, President Biden's infrastructure proposal won't have a powerful effect for a simple reason: Most direct spending and investment will trickle out over many years. Future Congresses may also re-appropriate unused funds for other things, which happens frequently. Ironically, this is precisely how some are suggesting to pay for this infrastructure bill: by reallocating unspent Covid-19 relief funds.

History confirms US stimulus efforts don't materially impact growth. Since 1971, the US has passed 16 major stimulus plans, which run the gamut from supply-side measures to demand-side ones.[xxxvi] GDP grew on a year-over-year basis in 81% of the quarters those plans passed, with a median growth rate of 2.3% y/y.[xxxvii] Four quarters after passage, the median growth rate slowed to 1.7%—not what you would expect after a purported economic boost.[xxxviii]

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xxxii "An Update on How Households Are Using Stimulus Checks," Olivier Armantier, Leo Goldman, Gizem Koşar, and Wilbert van der Klaauw, Liberty Street Economics, 7 April, 2021.

xxxiii Ibid.

xxxiv Source: US Federal Reserve, as of 08/07/2021. "Financial Accounts of the United States, Flow of Funds Balance Sheets and Integrated Macroeconomic Accounts: First Quarter 2021."

xxxv Source: New York Federal Reserve, as of 08/07/2021. Household Debt and Credit Report Q1 2021.

xxxvi Source: Federal Reserve Bank of St. Louis and Fisher Investments Research, as of 31/03/2021.

xxxvii Ibid. Frequency of positive year-over-year GDP growth and median year-over-year real GDP growth rate in quarter stimulus bills enacted, 1971 - 2020.

xxxviii Ibid. Median year-over-year real GDP growth rate in the fourth quarter after stimulus bills were enacted, 1971 – 2020.

The two most recent efforts echoed this. After implementation of December 2017's Tax Cuts and Jobs Act, GDP grew 2.5% y/y in Q4 2018—trailing Q4 2017's 2.7%.[xxxix] Similarly, in the year after 2009's $787 billion American Recovery and Reinvestment Act passed, GDP grew just 1.7% in Q1 2010.[xl] Indeed, that is skewed by the recession's continuing for four and a half months after the bill's passage, and perhaps growth would have been weaker without the spending—but it could also have been higher. With no counterfactual, there is no way to know.

> "...THE FEARS OF EXTREME ACTION THAT HIT SENTIMENT EARLIER SHOULD GRADUALLY, UNCONSCIOUSLY FADE... THE ENSUING RELIEF SHOULD PROPEL MARKETS HIGHER."

MONETARY STIMULUS ISN'T STIMULATING, EITHER

On the money supply side, the Fed and other central banks' "stimulus" efforts drastically increased broad measures like M4. But as we wrote last quarter, money supply measures have broadened in the last 50 years, including many things that aren't money—i.e., a medium of exchange. For example, Treasurys and commercial paper—included in M4—aren't money. You use money to buy them.

M2 money velocity—a gauge of how often money supply changes hands—remains near all-time lows while bank lending has been slow due to a flat yield curve.[xli] That suggests money isn't "chasing" goods and services swiftly. All that monetary "stimulus" just isn't doing much stimulating at all.

GRIDLOCK'S GRIP TIGHTENS

Our political analysis is intentionally nonpartisan. We favour no politician nor any party and assess developments solely for their influence on markets and personal finance.

After President Biden notched some legislative successes in Q1—like the $1.7 trillion American Rescue Plan—many investors presumed much more would follow. So when he unveiled multifaceted tax hikes to finance up to $4 trillion more in spending, fear of everything from the tax hikes crushing equities to fiscal stimulus overheating the economy surged. But, as Q2 progressed, the Democrats' historically slim margins in Congress and intraparty squabbling—gridlock—squeezed tighter. As this year progresses, we think gridlock's effect will increasingly sink in—helping propel equities to the typically strong returns characteristic of newly elected Democratic presidents' inaugural years.

THE US GOVERNMENT IS GRIDLOCKED

Too many investors think gridlock requires split party control of the presidency, House and Senate. Hence, when 5 January's Georgia Senate runoff gave the Democrats "control" of all three, many surmised gridlock was gone, paving the way for a rush of legislation. Democrats cheered this; Republicans feared it.

But, as we have argued since November's election results became clear, this view of gridlock is superficial. The party's margin of control in Congress matters. US political parties, including today's Democratic Party, aren't unified on all key issues. So the Senate's 50 – 50 split complicates legislating. Furthermore, the Democrats' House edge is the smallest confronting any new Democratic president since Grover Cleveland—who was in office in the late 1800's. Passing legislation requires virtual unanimity.

This doesn't mean nothing will pass. But it complicates passing anything divisive. It means delays in legislating, affording markets extra time to pre-price a bill's likely impact.

xxxix Ibid. Year-over-year growth rate in US real GDP, Q4 2018 and Q4 2017.

xl Ibid. Year-over-year growth rate in US real GDP, Q1 2010.

xli Source: Federal Reserve Bank of St. Louis, as of 09/07/2021.

It means almost anything that passes will be significantly watered down. It means the fears of extreme action that hit sentiment earlier should gradually, unconsciously fade from here. The ensuing relief should propel markets higher.

THE INFRASTRUCTURE AND TAX HIKE PLANS

A perfect example of this: Q2's chatter over trillions in tax-hike funded infrastructure spending. President Biden initially unveiled two separate spending plans totaling near $4 trillion, with $2.3 trillion allocated to the American Jobs Plan, his infrastructure proposal. To fund this, he pitched raising corporate taxes from 21% to 28%. Additionally, President Biden planned to tax high earners' capital gains at ordinary income tax rates and end the cost basis step-up at death that let many investors bequeath taxable portfolios with no embedded gains.

But by quarter end, President Biden was backtracking. While the debate shifts nearly daily, the corporate tax hike seems mostly sidelined, based on the bipartisan infrastructure plan we will discuss momentarily. Capital gains tax changes, including the elimination of the cost basis step-up, seemingly face opposition from multiple Democratic Senators, including Montana's Jon Tester and New Jersey's Robert Menendez. Politicians now talk of reallocating unspent Covid-19 response funds to "pay" for infrastructure, a far cry from new spending funded by new taxes. As we detailed last quarter, tax hikes don't typically have the negative effect on markets many investors assume—they move too slowly and publicly to shock anyone. But the hikes' disappearance should relieve investors' worries, buoying sentiment.

Those excited or worried over infrastructure spending should find further comfort in the bipartisan plan that emerged in late June. It shrank President Biden's plan from $2.3 trillion to $974 billion. But of that $974 billion, just $579 billion is new spending. The rest was already budgeted—dilution in action. That $579 billion targets only physical infrastructure. Around $312 billion funds road, bridge, rail and public transportation upgrades. The balance funds broadband, water and power improvements.

While this bipartisan plan seems like traditional, nonpartisan infrastructure spending even, it now confronts gridlock and could morph—or die. The Democratic Party's progressive wing says it undercuts earlier promises. Some demand the administration advance its initial, multi-trillion dollar package under budget reconciliation rules that require only a simple majority to pass. As of July, House Speaker Nancy Pelosi has said the bipartisan infrastructure plan can't be separated from the broader push. Senator Elizabeth Warren called the two plans part of one whole. Yet Republicans have already expressed opposition to this two-pronged approach, jeopardising the entire effort.

President Biden first said he would advance the two measures concurrently. But then, facing opposition from Republicans and moderate Democrats, he waffled. Regardless, President Biden's early statement showed the process's true nature: a political effort targeting midterms. He must motivate progressive voters and avoid alienating voters in red states that elected Democrats in 2020. That fine balance illustrates the extreme gridlock his administration confronts.

THE PERVERSE INVERSE

The gap between President Biden's talk of big measures and the political reality confronting them illustrates how the phenomenon we call "The Perverse Inverse" works. Democrats often campaign on tax hikes, regulation and many other measures investors broadly consider "anti-business." Republicans usually spout the opposite, giving the impression they are "pro-business." We aren't saying either perception is accurate, just common—and they influence sentiment in election and inaugural years.

Democrats' campaign rhetoric fuels investor fears that they will be bad for equities, weighing on returns in years a Democrat wins the White House—especially newly elected Democrats, as their newness heightens uncertainty. But few presidents can fulfill all their campaign talk—if they ever intended to. As this unfolds, fears over what the government may do fall unconsciously. The ensuing relief is a tailwind for markets. Hence, newly elected Democratic presidents average lofty inaugural-year returns.

The reverse holds for Republican presidents. Their rhetoric raises expectations in the election year—buoying returns. But when the new GOP president's campaign pledges fail to materialise, disappointment weighs on returns.

EXHIBIT 10: THE PERVERSE INVERSE

	Election Year	Inaugural Year
Democrat	8.2%	16.2%
Republican	15.2%	2.6%
Newly Elected Democrat	0.7%	21.8%

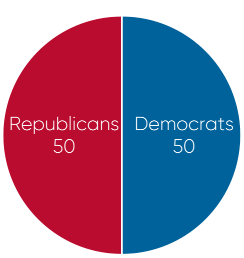
Source: Global Financial Data, Inc., as of 29/06/2021. Average annual S&P 500 total returns in election and inaugural years, 1925 – 2020. Democratic averages include 2020 but omit 2021's year-to-date result.

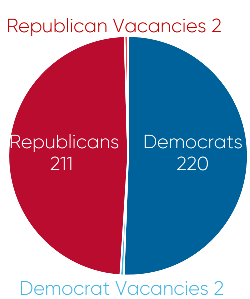
THE GREAT MODERATION IS APPROACHING

By the time Q3 ends, politicians' focus will have shifted squarely to next year's midterm elections. This shift has already begun. Between June's end and Q3's close, the Senate will be in session for only a little over 20 days, with the balance of time allocated to members working in their states. That isn't much time to introduce bills, move them through committee to the floor, debate and pass them.

The president's party nearly always loses seats in midterms. This time, that could prove a death knell for any big legislation, given the tight margins in Congress. (Exhibit 11) Both parties will be very invested in trying to retain and gain seats next November. Passing contentious bills could jeopardise seats in purple districts, making politicians unlikely to act on such measures once the midterm campaigns kick off.

EXHIBIT 11: SLIM LEAD IN CONGRESS MEANS GRIDLOCK





Source: US Senate & House of Representatives Party Divisions, as of 29/07/2021.

As shown in our Q4 2020 Review, once-a-decade redistricting compounds midterm-generated gridlock. Congresspeople seeking re-election in redrawn districts don't know yet exactly whom they will represent—injecting uncertainty into their campaign. That should increase legislators' risk aversion, dissuading them from passing sweeping bills.

BIG TECH LEGISLATION

Beyond taxes and spending, arguably the major legislative news in Q2 was the push to pass multiple antitrust-related bills targeting big Tech. But here, too, gridlock should slow progress and water down any eventual bill, relieving investors' worries.

In late June, the House Judiciary committee advanced a handful of bills targeting Amazon, Apple, Facebook, Google and more. The bills would enhance antitrust law and beef up regulators, limit these firms' ability to acquire competitors and prevent some that operate platforms offering third-party goods from selling their own products.

Aspects of these bills have bipartisan support. But gridlock is already attacking. California Congresspeople, for example, argued the bills threaten major employers and a key source of state tax revenue. Others claimed they would unwittingly hit small firms or make Tech products more susceptible to data breaches and hacks. It isn't clear there are enough votes in the full House, to say nothing of the Senate, where this legislation would require 60 votes to avoid a filibuster.

LARGE COMPANIES AND THE INVISIBLE HAND

The legislation seemingly operates on the idea only government can keep these big firms from forever dominating the US economy. That is a popular position, and one lawmakers from both parties champion. But it is wrong. Adam Smith's legendary invisible hand—profit-seeking innovation and competition—is usually what erodes the biggest companies over time.

To see this requires setting aside the myopia of politics. Instead, look to markets—specifically, at the amazing churn in the 10 biggest firms over time. Exhibit 12 shows this, listing the world's biggest companies by market cap in 1973 (the earliest year data were available), 1980, 1990, 2000, 2010 and 2020.

EXHIBIT 12: CHURN AT THE TOP

1973	1980	1990
IBM	IBM	Nippon Telephone
AT&T	AT&T	IBM
Exxon Mobil	Exxon Mobil	Exxon Mobil
Saab Scania A	Saab Scania A	Industrial Bank Japan
Eastman Kodak	Schlumberger	Fuji Bank
GM	Shell Oil	GE
Sears Roebuck	Standard Oil (Amoco)	Altria Group (Philip Morris)
GE	Chevron	Sumitomo Mitsui Fin.
Xerox	BP	Bank of Tokyo-Mitsubishi
3M	Atlantic Richfield	Toyota Motors
2000	**2010**	**2020**
GE	Exxon Mobil	Apple
Royal Dutch Petroleum	PetroChina	Saudi Aramco
Exxon Mobil	Apple	Microsoft
Pfizer	BHP Group	Amazon
Cisco Systems	Microsoft	Alphabet (Google)
Walmart	I&C Bank of China	Facebook
Vodafone	Petroleo Brasileiro SA	Tencent
Microsoft	China Construction Bank	Tesla Inc
Citigroup	Royal Dutch Shell	Alibaba
AIG	Nestle S.A.	Berkshire Hathaway

Source: FactSet and Refinitiv, as of 07/07/2021. Top ten MSCI All Country World Index constituents by market capitalisation at the end of each calendar year referenced.

IBM once dominated. Now it is the 82nd largest.[xlii] Cisco, the biggest Tech name in 2000, is still a large company. But it is now 33rd in the world. Why? Competition. We suspect that, in 10 or 20 years' time, there will be continued churn, antitrust action or no.

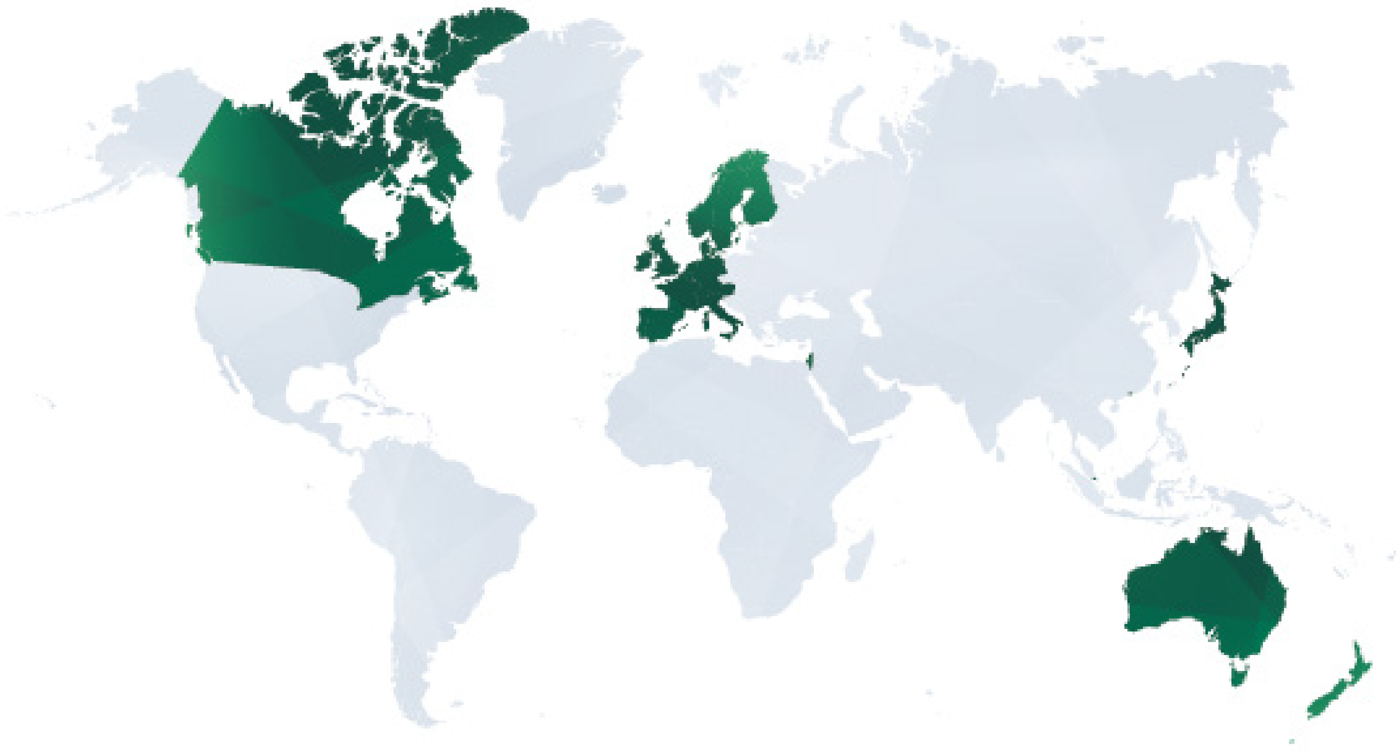
One firm once targeted by antitrust suits remains on the list 20 years later: Microsoft. That illustrates the fact this legislation alone—or any potential further antitrust action—isn't automatically negative for the companies affected, in the short or long term. Indeed, Facebook jumped 4.2% on 28 June, the day a Federal judge dismissed state and Federal antitrust lawsuits against it.[xliii] But even before that, all four of the new legislation's chief targets were up more than the market in Q2.[xliv] Facebook itself was up 15.9% before the ruling. While markets aren't perfectly efficient discounters of widely known information, they are closer to perfect than most humans. The market is saying not to worry about antitrust issues.

xlii Source: FactSet, as of 28/06/2021. IBM rank by market capitalisation in the MSCI All Country World Index.

xliii Source: FactSet, as of 07/07/2021.

xliv Source: FactSet, as of 29/06/2021. Amazon, Apple, Facebook and Google returns, 31/12/2020 – 28/06/2021.

GLOBAL DEVELOPED EX-US COMMENTARY



Economic recoveries continued in Q2 across the developed world. However, many nations' reopening progress has sputtered due to slow vaccine rollouts and the rise in Covid-19 variant cases in certain regions—even leading to renewed restrictions in some countries. These setbacks have stirred concerns about the global economy's near-term prospects. In our view, though, markets are well aware the return to normal would happen in fits and starts. We think they are looking beyond these immediate developments and pricing in the return to pre-pandemic trends of slower economic growth.

A BETTER-THAN-APPRECIATED REALITY

In contrast to the US and China, many developed nations have maintained lockdowns for longer—weighing on their economic recoveries. Still, though, their economic recoveries are far further along than many appreciate, with some nations even back to pre-pandemic output levels. (Exhibit 13)

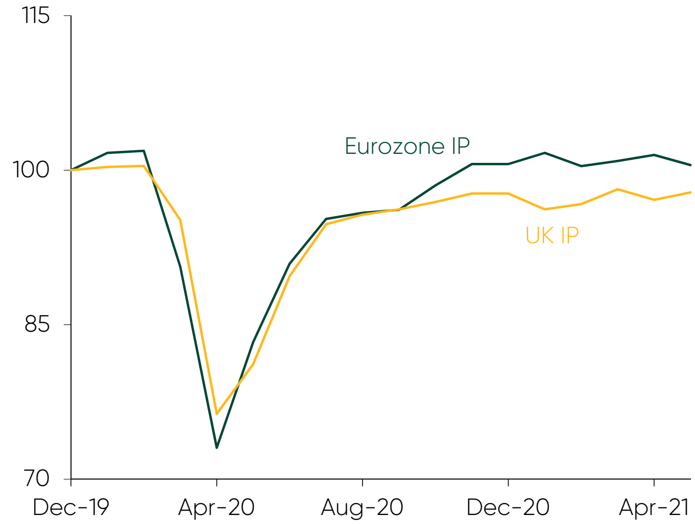
EXHIBIT 13: DEVELOPED NATIONS' ECONOMIC RECOVERY

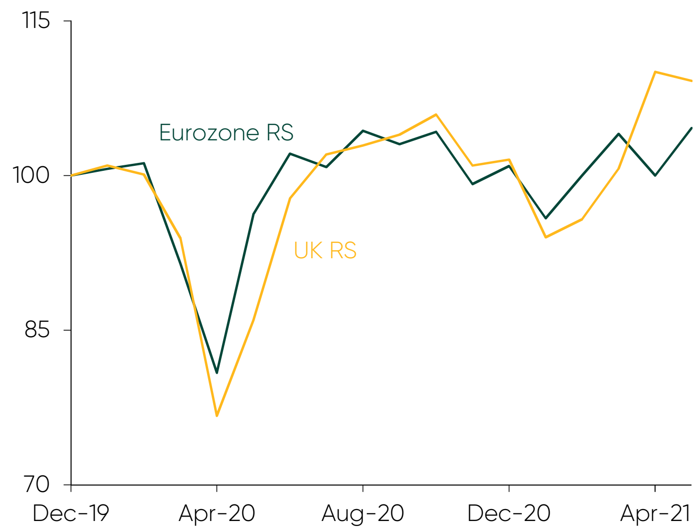
	Pre-Pandemic GDP Level	Latest GDP Level	Difference
Australia	497.0	501.1	0.8%
Austria	93.3	86.8	-6.9%
Belgium	111.9	107.6	-3.9%
Canada	2002.2	1979.0	-1.2%
Denmark	535.6	526.6	-1.7%
Finland	57.3	56.3	-1.8%
France	583.2	555.6	-4.7%
Germany	809.5	768.8	-5.0%
Hong Kong	719.6	697.2	-3.1%
Ireland	70.2	72.7	3.6%
Israel	340.5	333.2	-2.1%
Italy	430.5	402.9	-6.4%
Japan	546999.5	536089.7	-2.0%
Netherlands	190.5	183.2	-3.9%
New Zealand	66.1	67.8	2.5%
Norway	910.8	895.3	-1.7%
Portugal	51.3	46.7	-9.1%
Singapore	120.2	121.1	0.7%
Spain	111.4	101.1	-9.3%
Sweden	1286.7	1273.6	-1.0%
Switzerland	183.7	179.7	-2.2%
UK	101.3	98.1	-3.2%

Source: FactSet, Statistics Canada, Office for National Statistics, and Central Statistics Office of Ireland, as of 22/07/2021. Seasonally Adjusted Quarterly Real GDP, in billions of local currency for listed countries (except Spain, Canada and the UK), Q4 2019 and Q1 2021. Seasonally Adjusted Quarterly Real GDP Index Level for Spain, Q4 2019 and Q1 2021. Seasonally Adjusted Monthly Real GDP, in billions of CAD, for Canada, February 2020 and April 2021. Seasonally Adjusted Monthly Real GDP Index Level for UK, February 2020 and May 2021. For Ireland, GNP is used to avoid tax-related distortions.

Narrower datasets tell a similar story. Industrial production in the eurozone and UK is nearing pre-pandemic levels while retail sales have already surpassed them. (Exhibit 14)

EXHIBIT 14: EUROZONE AND UK INDUSTRIAL PRODUCTION AND RETAIL SALES





Source: FactSet, as of 19/07/2021. Eurozone and UK retail sales and industrial production index levels, indexed to 100 at December 2019 level, December 2019 – May 2021.

The UK also monitors monthly production and services output. Both are close to breakeven—production is -2.6% below February 2020 levels while services is -3.4% away—and their rebounds track the UK's reopening progress.[xlv] While both recoveries began in May 2020, production output held up better than services through subsequent lockdowns. For example, after England's November national lockdown, services output fell -3.0% m/m while production ticked up 0.8%.[xlvi]

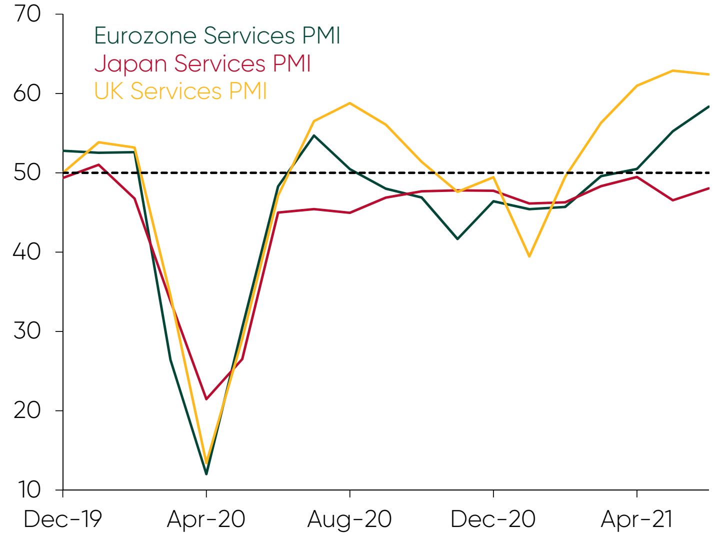
xlv Source: ONS as of 23/07/2021. Index of Production and Index of Services, percent change, February 2020 – May 2021.

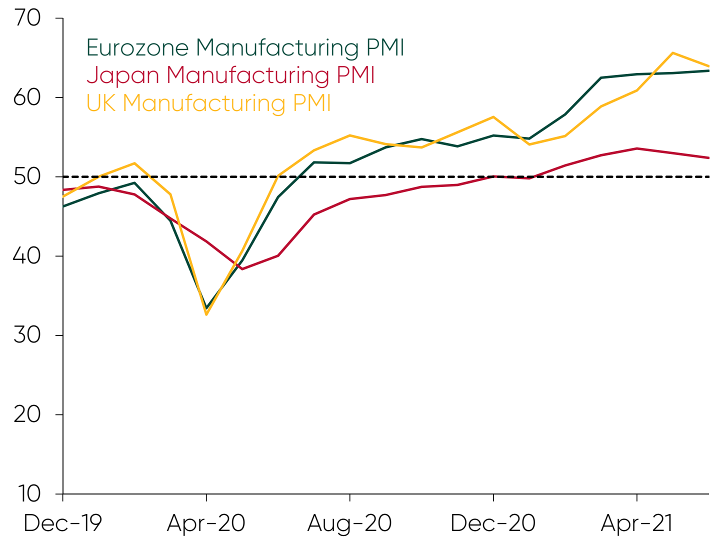
xlvi Ibid. November 2020.

In our view, this illustrates a broader trend: Covid-19 restrictions disproportionately knocked services businesses, many of which are people-facing, while production industries largely stayed open after the UK's first lockdown ended. As restrictions eased this year, services output has climbed 3.5% while production is up a flattish 0.1%.[xlvii] Part of the reason for production's relative lag: The global semiconductor shortage has weighed on the manufacturing subsector—especially transport equipment.[xlviii] In our view, those headwinds are likely temporary and will subside as producers address supply shortages.

Business surveys provide another snapshot of growth's return, particularly in services. (Exhibit 15)

EXHIBIT 15: MANUFACTURING AND SERVICES PMIS FOR EUROZONE, JAPAN AND UK





Source: FactSet, as of 20/07/2021. Eurozone, Japan and UK Manufacturing and Services PMIs, December 2019 – June 2021. Dashed line at 50 is dividing mark between growth and contraction.

xlvii Ibid. December 2020 – May 2021.

xlviii "Coronavirus and the Impact on Output in the UK Economy: May 2021," Staff, ONS, 9 July, 2021.

These recoveries have occurred despite lagging reopening progress. In the UK, England's long-awaited "Freedom Day" of 19 July was a disappointment after thousands of people had to self-isolate for coming into contact with a person who tested positive with Covid-19—triggering what headlines called a "pingdemic." Canada has maintained one of the developed world's longest-lasting lockdowns, exemplified by Ontario's restrictions on indoor restaurant dining lasting over a year—easing finally in mid-July. Japan implemented another state of emergency in Tokyo as it prepared to host the Olympics, which will have no spectators—a potentially major blow in terms of lost expected tourism and consumption. In Australia, Sydney re-entered lockdown at the end of June, with Melbourne following suit a couple weeks later. The Netherlands also brought back containment measures 10 July due to rising cases. Restrictions planned to remain until 13 August.

> "WE THINK MARKETS ARE LOOKING BEYOND THESE SPEED BUMPS AND AHEAD TO A RETURN TO NORMAL."

These setbacks may weigh on developed world growth in the near term, but markets are looking forward. Ever since governments first eased Covid-19 restrictions last year, pundits, experts and politicians have discussed their prospective return—allowing equities to pre-price them and move on. Despite their negative economic impact, restrictions increasingly lack surprise power, which moves equity prices most, in our view. We think markets are looking beyond these speed bumps and ahead to a return to normal.

In our view, that normal likely isn't lasting, fast growth. Many pundits have promoted government stimulus and reopening as fuel for a new "Roaring Twenties" and a value rally. But the reopening acceleration in growth rates is widely known—and likely to prove fleeting. Markets probably already reflect this, which speaks to why interest rates have fallen of late. Contrary to many fears, this isn't bearish, in our view. It simply shows we are likely much later in this bull market than many presumed.

Growth normally lead late—as it has since mid-May and overall since last year's bear market ended. We think the slower growth ahead should pave the way for less economically sensitive growth categories to lead overall through this bull market's peak.

DEVELOPED MARKETS POLITICAL UPDATE

While political chatter can always grab headlines at any moment, based on what we see today, there isn't a whole lot of near-term political uncertainty in much of the developed world. Gridlocked governments are prevalent. Developments in Q2 did little to change that, mitigating the risk of market-roiling legislation passing.

UNITED KINGDOM

Prime Minister Boris Johnson's Conservative Party lost a by-election in Chesham and Amersham, a traditional Tory territory stronghold, to the Liberal Democrats in mid-June, leading some pundits to view the outcome as a precursor of the UK's next national election. That presently isn't planned to occur until May 2024, an eternity in politics. However, there is significant support for legislation repealing 2011's Fixed-Term Parliaments Act, which could lead to a much earlier vote. Regardless, we don't think by-elections are useful in foretelling national election results.

The Tories won 2019's general election by making strong gains in the so-called "Red Wall"—traditional Labour strongholds in Northern England. By contrast, Chesham and Amersham is part of the "Blue Wall" of reliable Conservative seats in rural Southern England. The Tories held the seat since the mid-1970s, leading pundits to speculate the by-election result shows the opposition chipping away at the Blue Wall, potentially signaling a landslide defeat in the next national contest.

While that is possible, we think it ignores the unique factors at work. For one, the Tories had no incumbent. It was a vote to replace the constituency's long-serving Member of Parliament, Cheryl Gillan, who had passed away. The Tory candidate lacked her popularity. There is also some evidence this was a protest vote over Johnson's proposed housing policy, which would remove planning from local control, prompting fears of rapid development in rural areas.

Forcing a policy U-turn appeared to be the goal, and there are now indications that the Conservatives are reconsidering policies that might cost them traditional support, surprising those who presumed the Tories' 85-seat majority made passing everything in their manifesto a foregone conclusion.

In our view, the outcome demonstrates how, even in nations where governments have enough seats to push big legislation, they may elect to moderate in order to win re-election, preventing sweeping legislation from impacting equities.

FRANCE

Similar to the UK, the results of France's 20 June regional elections—in which President Emmanuel Macron's La République en Marche (LREM) party flopped—don't automatically predict next year's presidential election. In the vote, the centre-right Republicans strengthened their grip across several regions, exceeding expectations, while Marine Le Pen's National Rally won only in Provence. Xavier Bertrand, the Republicans' presumptive presidential candidate, won by a landslide in Hauts-de-France, sparking chatter that he—not Le Pen—may be Macron's main competition next year.

Regional elections often aren't predictive, however. For example, 2015's regional vote correctly presaged then-president François Hollande and his Socialist Party's eventual defeat, but it also showed momentum shifting towards the Republicans. Yet their presidential candidate, François Fillon, eventually finished third in the first round, while Macron—whose movement didn't even exist during 2015's elections—won the runoff against Le Pen.

His party's newness was likely at play this time as well, as LREM still lacks ground game necessary to contest all regions. Turnout was also far lower than in a typical national election, at just 33%.[xlix] Two-thirds of voters turned up for France's 2017 presidential elections.[l] Low turnout suggests a relatively small number of voters felt strongly enough about their dissatisfaction with the government to register it at the ballot box.

In the meantime, these results are more indication that President Macron's political capital is drained, likely leading to gridlock on non-Covid-related legislation. He basically admitted as much earlier this year, stating his administration wouldn't pursue its pension reforms until its (potential) second term. Those changes, long seen as necessary to adding flexibility to labour markets, derailed in the wake of the gilets jaunes (yellow vests) protests.

More recently, LREM's decision to ram through effective Covid-19 vaccine mandates over the objection of over 150,000 protestors nationally followed Macron's warning he was about to pursue actions that risked torpedoing his re-election chances. To us, that seems like a tacit admission gridlock is here for the remainder of his term. While that forestalls reforms that might be beneficial, even changes that appear market-friendly can create winners and losers, likely making gridlock a net benefit here, too.

NETHERLANDS

Gridlock also persists in the Netherlands. As noted last quarter, after a childcare benefits scandal brought down Prime Minister Mark Rutte's government in Q1, March's election failed to deliver anything close to a majority. Rutte's VVD won a plurality, but it would need at least three coalition partners to form a working majority in the 150-seat legislature, leading to a long stalemate.

xlix "Far-Right Party Wins No Regions in Second Round of French Regional Elections Results," Lauren Chadwick, Euronews, 28/06/2021.

l "French Election Turnout Worst in Modern History as Emmanuel Macron Heads for Landslide Victory in Parliament," Will Worley, The Independent, 12/06/2017.

In May, Parliament tapped Labour Party member Mariëtte Hamer to lead coalition negotiations, but nothing changed materially until a month later, when Pieter Omtzigt left the Christian Democrats (CDA). The CDA is the natural coalition partner and a long-time ally of Rutte's VVD, and Omtzigt, while not party leader, was an influential member. He was also among Rutte's chief rivals and was instrumental in the vote to censure him in the wake of the childcare benefits scandal. His departure could clear the way for VVD and CDA to renew their partnership. It also has little effect on coalition math. VVD currently holds 34 seats, CDA has 14, and former coalition-partner Democrats 66 (D66) 24. Together they are four seats shy of a majority, versus three before Omtzigt's departure.

Whatever government eventually results from this—or if there are new elections—a deeply fractured coalition with little ideological overlap should stymie any effort to pass major, contentious legislation—as we saw following 2017's election. It wouldn't surprise us to see agreement around the disbursement of EU Covid-relief funds, but not much else, in the near future.

ISRAEL

Israel finally formed a new government in mid-June. The Knesset approved a new coalition government led by Naftali Bennett of the right-wing Yamina Party, ending Benjamin Netanyahu's 12-year tenure as Prime Minister. The coalition includes eight parties ranging from far left to far right, as well as an Arab party.[li] As part of the coalition agreement, Bennett switches place with Yair Lapid, leader of the centrist Yesh Atid party, in two years. Yamina has just six seats, and Bennett seems focused on winning small victories in areas where multiple parties agree, including education and transportation, while staying away from hot-button sociological issues.

Already, there are questions about how long the government will last, given the participating parties have little in common other than their opposition to former Prime Minister Netanyahu. If they can't agree on budgets or other major legislation, it could bring yet another snap election.

For now, however, the combination of gridlock and falling uncertainty should benefit Israeli equities, which should also benefit from a heavy Tech weighting in this maturing bull market.

SWEDEN

A dramatic June capped off Sweden's Q2, but for all the fireworks, little looks changed today. Sweden's government collapsed when the Riksdag ousted Prime Minister Stefan Löfven in a no-confidence vote on 21 June, called after the Left Party—which had been propping up Löfven's minority government by agreeing to abstain from key legislation—dropped its implicit support over rent control reforms. That gave Löfven one week to decide whether to resign or call a snap election. He chose the former, paving the way for Moderate Party leader Ulf Kristersson to try his hand at forming a new coalition. Those efforts collapsed on 1 July, giving Löfven a new window to try again. That effort succeeded, and he announced a new minority coalition with the Greens on 5 July. They narrowly won a confidence vote two days later, with the Left and Centre Party abstaining.

While this resolves the immediate crisis, it doesn't change the underlying political driver: gridlock. It also doesn't resolve all political uncertainty, as Löfven has vowed to resign again if he fails to pass budget legislation in the fall, possibly sparking Sweden's first snap elections since 1958. The Centre Party has already stated it wouldn't back a budget negotiated with the Left, likely previewing the difficulty at hand.

We won't venture to guess whether the government survives through the fall, but, for now, gridlock and the status quo remain in Sweden. Sweeping legislation that would rattle financial markets is unlikely.

li "Explainer: Who's Who in Israel's New Patchwork Coalition Government," Ari Rabinovitch, Reuters, 14/06/2021.

GLOBAL ELECTIONS FORTHCOMING IN 2021

Outside the US, several elections are approaching. However, few seem likely to drive dramatic change or upend the gridlock reigning in most of the world.

NORWAY VOTES

Norwegians will hit the polls in mid-September to elect a new parliament. Currently, Prime Minister Erna Solberg and her Conservative Party are trailing in polls, likely tied to Covid-19 response missteps (including Solberg violating social-distancing rules at her birthday party in April). But polls suggest the result will look like the long-splintered government requiring complicated coalitions to reach a majority. Prime Minister Solberg's Conservatives have rotated coalition partners multiple times since she took office in 2013. This instability is a recipe for more gridlock, although the parties atop any coalition may shift.

GERMANY'S FEDERAL ELECTION

A couple weeks after Norway's vote comes the chief European election on the calendar now: Germany's Federal Election, scheduled for late September. While the personalities will change and the parties in government could, too, the broad picture looks unlikely to shift materially: Germany's current government is an unwieldy "Grand Coalition" between outgoing Chancellor Angela Merkel's centre-right Christian Democratic Union (CDU/CSU) and Vice Chancellor Olaf Scholz's centre-left Social Democratic Party (SPD). The partnering parties have little ideological overlap, driving inactivity.

Polling suggests no party is likely to win a majority. While the CDU is polling first, Chancellor Merkel's replacement—party chief Armin Laschet—lacks anything close to her popularity and name recognition. It would take a very surprising result for the CDU to garner a majority. The SPD has been hurt badly by taking the junior post in Merkel's coalition. Their support has cratered versus 2017. (Exhibit 16) The SPD's loss seems to be the Green Party's gain, if polls are any indication.

Hence, it appears either the CDU will form another, even grander, coalition involving the SPD and another party or the Greens could enter government for the first time. Perhaps they form a coalition with the CDU/CSU or some broad, multiparty grouping involving the SPD and others. To many, this looks like a political earthquake. But we think this overrates things.

While the Greens' entering government would be noteworthy, their policy stance doesn't have much in common with many other parties. This suggests another unstable, inactive coalition.

EXHIBIT 16: 2017 GERMAN ELECTION RESULTS AND 2021 POLLING, MAJOR PARTIES

Party	% of 2017 Vote	June 28 Polling
CDU/CSU	32.9	28
SPD	20.5	16
The Left	9.2	7
Greens	8.9	20
Free Democratic Party	10.7	12
Alternative for Germany	12.6	11

Source: Politico and Federal Returning Officer of Germany, as of 29/06/2021.

JAPAN

Japan will vote by October, perhaps sooner if rumors prove true and Prime Minister Yoshihide Suga calls a snap election in August. Regardless of the timing, his Liberal Democratic Party (LDP) and coalition partner, New Komeito, seemingly have a huge edge heading into the vote. The only real question is whether Suga returns as Prime Minister.

Prime Minister Suga, who took office in September 2020 after Shinzo Abe resigned for health reasons, has been hurt by what many see as an inadequate Covid-19 response and Olympics uncertainty. He survived a no-confidence vote in June. But the LDP holds its leadership vote in September. Many speculate the party will abandon Prime Minister Suga for a fresher face then. Hence, there is speculation Prime Minister Suga may call the national election early. A decisive LDP win may strengthen his hand enough to remain in power.

WILL CANADA VOTE?

Canada isn't scheduled to vote until 2023. But there are rumors Prime Minister Justin Trudeau will call early elections—albeit for different reasons than Prime Minister Suga in Japan.

Trudeau heads a minority government presiding over one of the developed world's longest-lasting lockdowns. But polls show his Liberal Party's popularity is up tied to positive perceptions of the Covid-19 vaccination campaign and fiscal response. Many observers suspect he will try to capitalise by calling for a September election after a five-week campaign starting in August.

It isn't clear if the polls showing higher popularity will translate into seats in Parliament. After all, polling has been pretty notorious for inaccurate projections in recent years. But if he does call for early elections and gains enough seats to win a majority, it could upend gridlock and stir some uncertainty. That said, Canadian equities are tilted heavily to Energy, Materials and Financials. We expect these value categories to underperform without even considering politics.

EMERGING MARKETS COMMENTARY

EMERGING MARKETS GROWTH DRIVEN BY REOPENING

Like in the rest of the world, progress on reopening is largely driving Emerging Markets (EM) economic growth. We suspect markets are well aware of this, which has important implications for leadership trends, as reopening-related economic accelerations are unlikely to prove lasting. With EM economic growth likely slowing back to rates seen during the late 2010s, we think EM growth equities should continue leading like they did pre-pandemic.

EAST ASIA

Chinese, Taiwanese and South Korean GDP have all surpassed their pre-pandemic levels.[lii] China's GDP hit new highs in Q4 2020. In Taiwan and South Korea, this occurred in Q3 2020 and Q1 2021, respectively. For China and South Korea, beyond the milestone the return to expansion represents, we think this demonstrates their economies have sufficiently adapted so that ongoing Covid-19 challenges and restrictions—sporadic outbreaks, strict social distancing (in Seoul now, for example) and lagging vaccination rates—aren't the roadblocks they once were. Taiwan re-imposed restrictions in mid-May after a case spike and only began easing them in late July.

lii Source: FactSet, as of 26/07/2021. China, Taiwan and South Korea GDP, Q4 2019 – Q1 2021.

While this seems to have dampened retail trade in June and will likely affect output data released in the coming weeks, it doesn't seem to have affected industrial production much.[liii] For example, Taiwan's June factory output hit fresh new highs after hitting record levels in May.[liv] Now, with restrictions starting to roll back, consumer activity should recover swiftly.

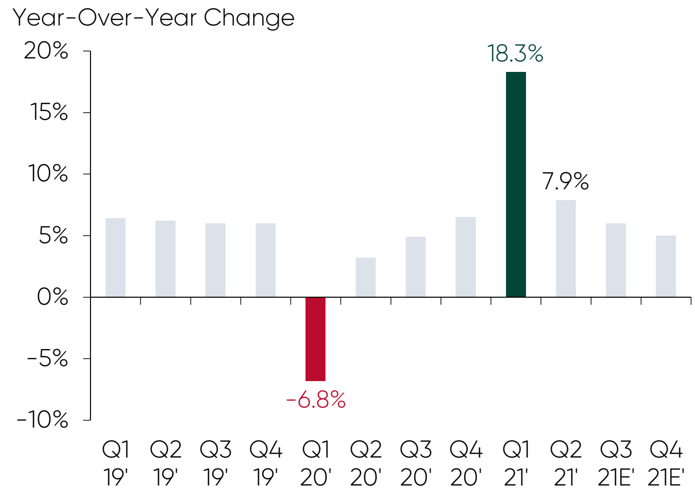
Full reopening may take time, and perhaps progress toward it will be uneven. However, these three nations have reopened enough that the overall trend in economic activity seems to be upward. Of course, their global export orientation is spurring some of this activity. China, among the first countries to reopen globally, initially benefited from strong global demand for personal protective equipment. More recently, though, it has benefited from developed markets' reopening. Global Tech demand has similarly bolstered Taiwan and South Korea. We think this just reinforces long-standing trends.

Markets reflect this, in our view. The MSCI Taiwan Index hit new highs in Q2 and has since moved higher, outperforming EM and apparently unbothered by short-term Covid restrictions.[lv] The MSCI Korea Index has been hovering just below its all-time high set in January, also beating the benchmark quarter and year to date.[lvi] The MSCI China Index, seemingly beset by regulatory uncertainty at home and abroad, remains well off its February peak, but those factors are post-Covid-19, illustrating the broader point.[lvii]

Forward-looking markets appear to be looking at the economic and earnings landscape beyond the reopening bounce. China is already decelerating, with Q2 GDP growth more than halving to 7.9% y/y from Q1's base-effect-boosted 18.3%.[lviii] (Exhibit 17)

After lockdown skew, slowing is natural and shouldn't be surprising. We see this as a return to normal—which other countries later in the lockdown-reopening cycle will likely resemble.

EXHIBIT 17: CHINESE GDP, YEAR OVER YEAR



Source: FactSet, as of 02/08/2021. Chinese Real GDP, year-over-year percentage change, quarterly, Q1-2019-Q2 2021. China Real GDP year-over-year percentage change estimates, quarterly Q3 2021-Q4 2021.

As global growth rates revert to pre-pandemic trends, we expect East Asian EM equities' less-economically sensitive growth characteristics to be a net benefit. Such traits are normally in favour later in bull markets, which is where we think we are today. As markets look beyond the economic reopening-related surge in economic activity, we expect growth equities to lead.

INDIA

In Q1, India's GDP also exceeded its Q1 2020 pre-pandemic peak—despite a tragic second-wave Covid-19 surge.[lix] While there was no accompanying national lockdown, regional governments imposed strict restrictions in April.

liii Ibid. Taiwan retail trade, June 2021.

liv Ibid. Taiwan industrial production, May 2021 – June 2021.

lv Ibid. MSCI Taiwan and EM returns with net dividends, 31/12/2020 – 30/06/2021.

lvi Ibid. MSCI Korea and EM returns with net dividends, 31/12/2020 – 30/06/2021.

lvii Ibid. MSCI China returns with net dividends, 31/12/2020 – 30/06/2021.

lviii Ibid. China GDP, Q2 2021.

lix Ibid. India GDP, Q1 2021.

These seem to have hit monthly data, like industrial production, which in May fell to levels seen last June—when there was a national lockdown. But as falling Covid-19 rates enable regional restrictions to ease—as they are now—we expect economic activity to resume.

Again, equities appear to be looking through short-term disruptions. The MSCI India Index outperformed EM in Q2 and year to date.[lx] Given India's Financials-heavy value orientation, we don't expect this to last. But, in our view, the upturn does illustrate markets are forward-looking and efficient. They saw the rising caseloads and crisis developing and weren't surprised by strict regional restrictions. Hence, they looked beyond them, to a time when reopening would progress more. To the extent reopening would buoy India's economy, equities likely already reflect it.

BRAZIL

Meanwhile, rounding out major EM countries, Brazil's GDP is on the cusp of exceeding its Q4 2019 pre-pandemic level. Its Q1 GDP was almost even with the prior peak.[lxi] Like India, this occurred against escalating infections, which don't seem to have hindered growth as, notably, Brazil never instituted a national lockdown. Although some states like Sao Paulo have implemented Covid-19 restrictions, enforcement has been spotty.

The MSCI Brazil Index has also outperformed EM in Q2 and year to date, but this has been driven mostly by rising commodity prices, in our view, especially in metals.[lxii] They pre-priced the economic reopening. But it appears this boost is already subsiding. Copper prices, for instance, peaked 11 May and fell -9.9% by quarter end.[lxiii] As global growth moderates, we expect short-term supply issues to fade, which we think commodity-driven sectors and markets recognise.

The case for value-oriented equities, sectors and EM countries hinges on accelerating economic growth. But a look at what is happening across EM shows that after an initial reopening surge, fast growth probably won't last. This is an argument for growth leadership, potential short-term countertrends notwithstanding.

CHINA – UPDATE ON DEBT AND DEFAULTS

For much of 2021, pundits have focused on China's corporate bond market, as several high-profile issuers have come under pressure. This, following two widely publicised defaults, has many speculating many more may lie ahead, with a debt crisis set to derail China's expansion—and impact the global economy. In our view, though, such worries are mistaken. Indeed, China is allowing more troubled firms to default, but this is a long-term positive for its economy and one policymakers are managing carefully.

For years, defaults—especially of state-owned enterprises (SOEs)—were a rarity in China. The government, seeing failures as a source of economic risk and social stability, preferred to bail out even the most untenable businesses. However, in the mid-2010s, China began to allow more failures. They did so gradually and selectively, occasionally making investors whole on the back, in an effort to slowly introduce market forces into credit allocation in China. For years, analysts saw this as a source of risk, fearing contagion would spur a financial crisis. These worries quieted for a period during the pandemic, only to re-emerge last November when SOE Yongcheng Coal suddenly defaulted.

This year, most focus is on China Evergrande Group and China Huarong Asset Management. Evergrande, China's largest property developer, has long been feared to be over indebted. Towards the end of last year, right around when Yongcheng failed, rumors emerged of Evergrande not being able to service its debt and seeking—and receiving—a bailout from Guangdong's provincial government and officials in Shenzhen.

lx Ibid. MSCI India and EM returns with net dividends, 31/12/2020 – 30/06/2021.

lxi Ibid. Brazil GDP, Q4 2019 – Q1 2021.

lxii Ibid. MSCI Brazil and EM returns with net dividends, 31/12/2020 – 30/06/2021.

lxiii Ibid. Copper price, 11/05/2021 – 30/06/2021.

Fears over it have simmered all throughout 2021, as Chinese authorities urged the company to sell assets and repay debt. The company's bonds are presently trading at about 50% of par value.[lxiv] Many wonder if Evergrande still has state-backing which helped it skirt insolvency in the past.

Meanwhile, Huarong Asset Management was in the spotlight all year. The company, a distressed-debt SOE set up to clean up bad debt from the Asian Financial Crisis in the late 1990s, entered 2021 dealing with the aftermath of a bribery case involving former chairman Lai Xiaomin, who was found guilty, sentenced to death and executed in January. On 1 April, Huarong delayed releasing its financial results, prompting rating downgrades and a suspension of trading of the company's shares in Hong Kong. But these high-profile stories obscure a more benign reality. The number of defaults in 2021 is roughly on pace with 2020. A total of 16 private enterprises and 7 SOEs defaulted last year; 16 private enterprises and just 1 state-owned company have defaulted in 2021.[lxv] In addition, this year's defaults are concentrated in a smaller number of companies, as just two—HNA Group and Fortune Land—account for 90% of defaults so far this year.[lxvi]

> EMBRACING LIBERALISATION AND MARKET FORCES SIGNALS PROGRESS FOR POLICYMAKERS IN ASIA'S LARGEST ECONOMY

While additional defaults are possible, they are also an essential part of China's long journey toward more liberalised capital markets. The more market forces you have in bond markets, the more firms will fail. But in developed and Emerging Markets alike, this tends to be an after-effect of economic weak patches, not a cause.

We still don't think China will allow substantial defaults or allow firms they see as systemic risks to fail, but continued defaults this year and last indicate policymakers are gradually walking back implicit government support. This change of stance is a long-term positive people often see incorrectly. Propping up failing companies creates a moral hazard (which happens when investors believe the state will bail out a company when it runs into trouble). Moreover, removing implicit government guarantee improves price discovery. State support allows weaker firms—companies that would have otherwise defaulted—to continue operating and secure financing. The implicit government backing meant interest rates were unnaturally low for riskier firms, too, as it distorted credit risk.

Greater risk of default allows markets to more clearly price companies for the likelihood they survive on their own merit and, in the long run, should help investors allocate capital much more efficiently. Successful reform like this is key to leadership in Emerging Markets now, in our view. Embracing liberalisation and market forces signals progress for policymakers in Asia's largest economy. China certainly needs a lot more liberalisation on many fronts, and some limited pain likely lies ahead, but the changes are something to cheer; not fear. At a time when everyone is watching seemingly heavy-handed regulation of the largest Chinese Tech and Tech-like companies (particularly those lifted offshore), allowing more defaults is an underappreciated sign that market-oriented change continues.

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lxiv "Evergrande Bonds Pledged at 53% Discount in China Funding Market," Bloomberg, 20 July, 2021.

lxv Source: Fisher Investments, Goldman Sachs, as of 15/06/2021. Number of defaults is entities in technical default (missed payments). Offshore defaults not included.

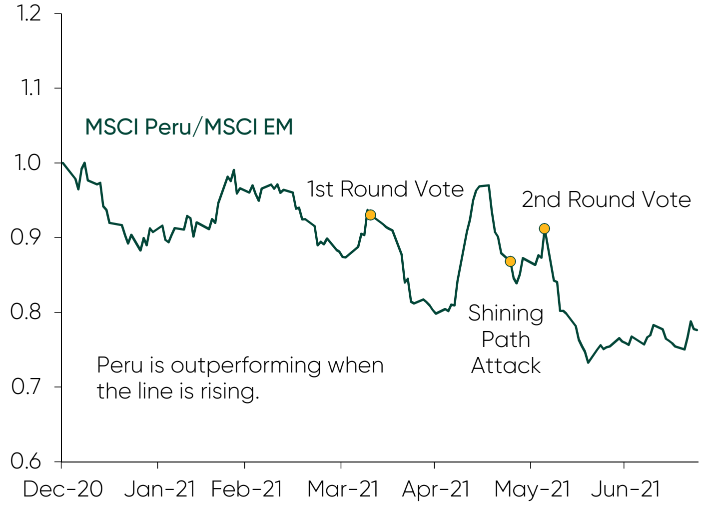
lxvi Source: Fisher Investments, Goldman Sachs, as of 15/06/2021. Notional value of all bonds outstanding entities in technical default (missed payments) for onshore/domestic bonds. Offshore defaults not included.

PERU

Political uncertainty tied to the presidential election was the defining feature of Peru's equity market drivers in Q2, leading the country to underperform the MSCI EM benchmark by a wide margin even as other commodity-heavy nations outperformed. Yet with doubts over the election's outcome now resolved and legislative elections pointing to gridlock, Q2's tailwinds should fade. The value-heavy nation may not outperform as growth equities lead globally, but a repeat of the first half's -18.5% slide (compared to EMs' 7.4% rise) seems unlikely.[lxvii]

All year, pundits have pointed to leftist candidate Pedro Castillo's ascendance as a potential negative for Peru's markets. Fears escalated as he led in polls throughout Q1 and spiked after he won 11 April's first round, edging out the right-leaning Keiko Fujimori and setting up a 6 June runoff between the two. A terrorist attack by the militant left-wing Shining Path in late May added to investors' skittishness. Yet Peru's markets rallied in the days leading up to that contest, even as most observers presumed a Castillo victory was a foregone conclusion, implying investors were getting over their fears as Castillo watered down his party's rhetoric on nationalising mining companies. The calm didn't last, as the tight runoff and messy aftermath triggered a new bout of uncertainty.

EXHIBIT 18: POLITICAL UNCERTAINTY WEIGHED ON PERU'S MARKETS



Source: FactSet, as of 26/07/2021. MSCI Peru and MSCI EM Index returns with net dividends, 31/12/2020 – 23/07/2021.

The day after the contest, while officials were still counting the ballots, Fujimori made public allegations of irregularities at polling stations. On 9 June, when Castillo had a slight lead with 99% of ballots counted, Fujimori formally asked the National Electoral Tribunal to annul 200,000 votes and review 300,000 others, alleging voter fraud at hundreds of polling locations. That prompted a formal investigation by the National Electoral Jury, dragging out the process of declaring a winner for several weeks. Eventually, on 19 July, officials announced they found no evidence of fraud and confirmed Castillo as the winner, 50.1% to 49.9%.

Peruvian equities rallied a bit on the news, but whether that was the result of falling uncertainty or rallying copper prices, isn't clear. We do think the resolution of this controversy is a positive, however, as it allows investors to refocus on fundamentals. On the political front, those fundamentals are shaping up better than feared. Firstly, Castillo has continued backing further away from prior pledges to nationalise the mining industry. Instead, redistributing profits via greater taxation and social spending appears to be his focus. Whether or not this is ideal from a socioeconomic standpoint, it doesn't jeopardise property rights or discourage foreign investment to the extent the risk of expropriation would.

lxvii Source: FactSet, as of 26/07/2021. MSCI Peru and MSCI Emerging Markets (EM) Index returns with net dividends in USD, 31/12/2020 – 30/06/2021.

Secondly, there are limits on what Castillo can accomplish with Peru's legislature so fractured. The 130-seat legislature has members from 10 parties, and Castillo's Free Peru holds only 27 seats. Furthermore, on 26 July, a right-leaning opposition coalition cemented control in the legislature, electing centrist María del Carmen Alva as president of the legislature. She has support from Fujimori's Popular Force party. Meanwhile, lawmakers rejected Free Peru candidates in all key posts, illustrating the challenges Castillo will likely have in attempting to enact his agenda. That further reduces the likelihood of severe tax hikes and anti-market constitutional change, which should remove some of the political uncertainty hanging over local markets as gridlock becomes more apparent.

MSCI RECLASSIFICATIONS

In Q1, MSCI reclassified Argentina from EM to a standalone index, added Iceland to its Frontier Markets (FM) Index and proposed shifting Pakistan from EM to FM. We discuss what those changes entail below, but at a high level, we think these reclassifications' market implications are minimal.

ARGENTINA

Starting November, MSCI will remove Argentina from its EM Index, where it is currently a 0.1% weight, to Standalone Market status.[lxviii] This means the MSCI Argentina won't belong to MSCI's broader index groupings based on its classification of countries' market development. It will join Ukraine, Zimbabwe and Lebanon as standalone categories, a designation usually featuring greatly troubled economies and countries.

In Argentina's defense, the move has less to do with endemic instability and more to do with market access. In September 2019, MSCI announced a review of Argentina's EM status following the imposition of capital controls, which remain in place today.

MSCI acknowledges Argentina's capital controls don't necessarily make it more difficult to invest in practice. The controls primarily target the foreign exchange market, and the bulk of investors use ADRs. MSCI also included only ADRs in its EM benchmark. But the lack of guidance as to when Argentina will lift capital controls technically violates MSCI's Market Accessibility criteria for the EM index.

MSCI made the official announcement 24 June, but it doesn't seem to have affected Argentina's equities much. The MSCI Argentina Index dropped -7.7% from the decision through 8 July, but it has since recovered most of that.[lxix] Relative to EM, Argentina is about even since its reclassification. We wouldn't read too much into such short-term moves—reclassification could have driven volatility, but in any event, it is also normal for an individual country index to be more volatile than a broader benchmark. Going back further, Argentina has remained more or less range bound versus EM since its big late-2019 breakdown tied to capital controls' imposition. This speaks to a key point: Markets reacted to fundamental surprises—new capital controls were a big shift in economic policy then. Argentina's reclassification much later is motivated by factors markets already dealt with.

lxviii Source: FactSet, as of 22/07/2021. Argentina's MSCI EM Index weighting, 21/07/2021.

lxix Ibid. MSCI Argentina return with net dividends, 24/06/2021 – 08/07/2021 and 08/07/2021 – 20/07/2021.

ICELAND

At May's end, MSCI moved Iceland to FM from standalone status, adding three constituents to the FM benchmark with a combined weight of 8%.[lxx] This makes Iceland the third-largest FM weight behind Vietnam (29%) and Morocco (12%).[lxxi] On a sector basis within the MSCI Iceland Index, its constituents are in Industrials (55%), Financials (23%) and Health Care (22%).[lxxii]

Iceland's addition prompted a big shift in FM country and sector weightings, but those come with the territory. Many FM nations have only a few constituents that dominate their markets. When added to a broader benchmark, they can boost diversification—though they should also be considered on their own merits along with the investment role they play. In Iceland's case, we find it behaves defensively relative to FM. Given our view growth is likely to lead globally, we think an underweight to Iceland is appropriate with its defensive, value tilt.

PAKISTAN

In addition to MSCI's 24 June removal of Argentina from EM, it also announced Pakistan's potential reclassification to FM, given the small size of the country's equity market. MSCI initiated its standard consultation process and will announce its decision by 7 September. Due to shrinking market capitalisations of Pakistan's index constituents, it no longer meets the minimum for EM. Since late 2019, all securities in the MSCI Pakistan Index have fallen below EM's required size and liquidity criteria. Pakistan now represents just 0.02% of the MSCI EM index.[lxxiii]

While its absence would probably have little impact on EM, its representation in FM would be more noticeable, with around a 2% weight prospectively. But we doubt any reclassification would have lasting effects. As noted, Pakistan's dwindling market capitalisation is independent of how MSCI classifies it.

Also, it isn't a secret Pakistan hasn't met EM size and liquidity requirements for nearly two years. Fundamental factors are much more likely to dictate where Pakistani equities head than whether it is 0.02% of EM or 2.00% of FM.

SUMMARY

Halfway into 2021, markets are well familiar with the pandemic's issues and setbacks—and are looking beyond them. We think they are pricing in the return to pre-pandemic growth trends, an environment that favours growth equities over value. In our view, that most benefits the countries and sectors with growth characteristics, though we think maintaining exposure to high-growth value areas makes sense for diversification.

In our view, EM's modest first-half returns are likely the beginning of a good full year. Potential countertrends aside, we still expect growth to outperform value over the foreseeable future. We still view global Emerging and developed markets' bull market as a continuation of the long expansion that began back in March 2009. Such late-stage expansions are usually when big growth equities excel, benefiting countries with heavy growth exposure. Countries rich in Tech and Tech-like equities should benefit accordingly, but in the event value surprises us, our exposure to Brazil and other areas should provide stability to portfolios, as it has year to date.

lxx Ibid. Iceland's MSCI FM Index weighting.

lxxi Ibid. Vietnam and Morocco's MSCI FM Index weightings, 21/07/2021.

lxxii Ibid. Industrials, Financials and Health Care's MSCI Iceland weightings.

lxxiii Ibid. Pakistan's MSCI EM Index weighting, 21/07/2021.

Should you have any questions about any of the information provided above, you can find Fisher Investments Ireland Limited contact info at the below website.

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