# FISHER INVESTMENTS EUROPE™

THIRD QUARTER 2015

# FISHER EMERGING MARKETS EQUITY

# THIRD QUARTER 2015 REVIEW AND OUTLOOK
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## THIRD QUARTER 2015 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Volatility increased in Q3 as global markets entered their first correction since 2012 led by a downturn in Emerging Markets (EM). Corrections (short, sharp, sentiment-driven drops exceeding -10%) are normal in bull markets. These unpredictable mass sentiment swings do not reflect meaningful shifts in fundamentals. While the volatility is uncomfortable, corrections tend to come and go relatively quickly—temporary setbacks in a broader bull market.

The present correction, at its lowest point to date, reached -14.9%—middling by historical standards.[i] In the quarter, the MSCI All Country World Index (ACWI) fell -9.5%, bringing full-year returns to -7.0%.[ii] Developed nations outside the US experienced similar volatility during the quarter, entering correction territory and breaching 25 August's low in September's final days. The MSCI AC World ex-US fell as far as -18.9%[iii] by 29 September from its 27 April high. However, typical client portfolios fared better, bolstered by our underweights to Energy and Materials and overweight to larger firms.

### Composite Performance

| | Q3 2015 | YTD (as of 30/09/2015) |
|---|---|---|
| Fisher Emerging Markets Equity (Gross of Fees) | -17.0% | -14.9% |
| Fisher Emerging Markets Equity (Net of Fees) | -17.1% | -15.3% |
| MSCI Emerging Markets Index | -17.9% | -15.5% |

*Source: Eagle Investment Systems. Performance is preliminary, as of 05/10/2015 and is subject to final reconciliation of accounts. Please see performance disclosures on the final page.*

### Porfolio Themes

- **Underweight to Commodity-Oriented Companies:** Companies that have significant commodity exposure (metals, oil and agricultural) should underperform.
- **Quality Tilt:** As the bull market progresses, we favour equities with strong balance sheets and consistent profit margins.
- **Overweight to Health Care:** Health Care companies typically offer reliable sources of revenue and often have power to pass higher costs to consumers, giving them stable longer-term growth prospects.

### Market Outlook

- **Sentiment Driven Global Equity Correction:** Fundamentals are still strong and recency bias leads investors to misperceive the magnitude of volatility in respect to historical norms.
- **Earnings Growth:** Corporate earnings and revenues beat analyst expectations (when excluding energy) and continue to grow alongside the global economy.
- **Underappreciated Developed Market Strength:** Developed nations' economies continue to grow and the Chinese slowdown is not as negative as many investors believe.

While the global correction is not unusually large, after years of relatively calm markets, it feels severe to many. Recency bias—investors' tendency to place greater importance on the recent past—might make the low volatility, correction-free stretch in the three years before Q3 feel standard. This is the sixth correction since the global bull market began in 2009. Pullbacks in 2010 and 2011 were larger than the present one, yet equities rebounded swiftly and the global bull market continued. The current global correction may have already ended, or more downside may lie ahead—impossible to know. That being said, corrections rarely end without fear peaking, and we have yet to see this.

As often happens during corrections, frightening headlines captured investors' attention—namely, false fears over China's slowdown and a US Federal Reserve (Fed) rate hike. Yet for all the noise, remarkably little happened in Q3. A much-hyped Chinese currency "devaluation" amounted to a -3% move, and Chinese authorities have continued propping up the currency ever since. After much talk, the Fed did not hike rates. US politics took centre stage, but this is not the time for investors to analyse 2016's elections—too early, too much variability. Economically, little changed from Q2 as most measures continue showing growth in the US, Europe and non-commodity-dependent EM. Q2 S&P 500 earnings contracted slightly, but excluding the Energy sector, profits grew nicely—a repeat of Q1. The global bull market's positive fundamentals remain intact.

Amid the volatility, eurozone data suggest the 19-member bloc's streak of underappreciated economic growth continued throughout the quarter. The second estimate of eurozone GDP was revised up to 0.4% q/q from 0.3%.[iv] The report also reveals the increasing breadth of that growth. Including Ireland's later-reported 6.7% y/y growth, 18 of the eurozone's 19 member nations expanded on a quarter-over-quarter basis in Q2, with Luxembourg the sole exception.[v] There are some caveats however as Greece was revised up to 0.9% q/q, but most of this activity occurred before capital controls took effect in Q2's final days. We expect future reports to contract, reflecting the negative fallout. However, Greece's lack of growth does not represent the broader region.

EM remain in better shape than many investors believe. While many view the entire category as vulnerable to weak commodity prices, this is not true. Many nations—most notably India, Korea, Indonesia and Taiwan—receive a net benefit from falling commodity prices. Commodity-dependent nations simply receive more attention, keeping expectations for other EM nations overly low. For example, many remain focused on Russia's Energy-heavy economy, which is feeling significant pressure from low oil prices and Western economic sanctions. Similarly, Brazil continues to struggle due to low commodity prices and high inflation (in addition to ongoing political headwinds and a recent credit rating downgrade to junk status). Contrarily, Mexico and Indonesia both have large commodities sectors yet reported growth during Q2 due to greater diversification within their individual economies, expanding 2.2% y/y and 4.7% y/y respectively. [vi]

While fears of a Chinese hard landing persist, the data remain in line with longstanding trends—slower growth, not a hard landing. For example, fixed asset investment in August rose 10.9% y/y versus 16.5% over the same period in 2014.[vii] While many doubt the accuracy of China's economic numbers, with some suggesting growth is closer to 4% or 5% rather than 7%, we view this issue as overwrought. If this were the case, China's many trade partners would note the slowdown in their numbers. Yet many executives have indicated at earning calls that Chinese growth, while slowing, is overall fine.

**Portfolio Attribution**

The *Fisher Emerging Markets Equity* portfolio outperformed the MSCI Emerging Markets index during Q3 2015. Country and sector allocation contributed to relative return while equity selection detracted. An overweight to and selection within Indian Healthcare was the largest contributor driven by pharmaceuticals company Dr. Reddy's Laboratories Additionally, an underweight to Brazil contributed as the country underperformed the broader benchmark. Conversely, an overweight to and selection within China detracted driven by capital markets firm Citic Securities, mobile & computer technologies manufacturer Lenovo and insurance provider Ping An Insurance. Further, selection within Consumer Discretionary detracted as media provider Grupo Televisa and automobile maker Tata Motors underperformed.

## THEMATIC UPDATE AND MARKET OUTLOOK

### A Q3 Recap

Q3's correction led many to fret an economic slowdown, despite the fact global data largely show growth trends continuing from recent quarters and years. Manufacturing data from developed and Emerging Markets (EM) overall slowed, but strong service sector data suggests it—the dominant sector in the US, UK, eurozone and even China—is propelling growth. Commodities are also a major story economically, as falling oil and raw materials prices weigh on commodity-heavy economies and skew earnings, trade, inflation and retail sales data globally. Overall, we continue to believe the world economy is on solid footing, led by the US, UK, eurozone and non-commodity reliant EMs.

Beyond the volatility, elections and political machinations highlighted the quarter, which we will discuss in depth in this review. Noteworthy elections took place in several developed nations, and in the US, the 2016 presidential campaign garnered attention from the media before the primaries get underway early next year. We expect the campaign landscape to evolve in the coming months; however, it is too early to give credence to headlines.

## US COMMENTARY

### US Economic Growth Is Sound

US Q2 GDP growth, initially reported at 2.3% (seasonally adjusted annual rate), was revised up to 3.9% as consumer spending and construction activity accelerated. While GDP itself does not have many implications for forward-looking equites, it does reaffirm economic trends. In Q2, it confirmed America's expansion reaccelerated sharply in Q2 after Q1's slowdown.

Data released during Q3 similarly show continuing growth, not a material slowdown. While many decry "sluggish" retail sales like September's 0.1% m/m rise, this narrow gauge comes with an asterisk. For one, headline retail sales figures omit much of the services sector beyond restaurants and bars. Health care, housing, financial services, transportation and other services are absent, causing retail sales to measure only about half of the actual spending constituting GDP.

Personal consumption expenditures (PCE) data are far broader and rose in six of the past seven months through August, when they logged a 3.2% y/y gain.[viii] Moreover, both PCE and retail sales are impacted by commodity prices. Exhibits 1 and 2 show this effect by comparing headline sales and sales excluding energy goods and gasoline station sales, respectively. Excluding energy's skew, September retail sales rose 0.4% m/m while PCE rose 4.4% y/y.

**Exhibit 1: Personal Consumption Expenditures**

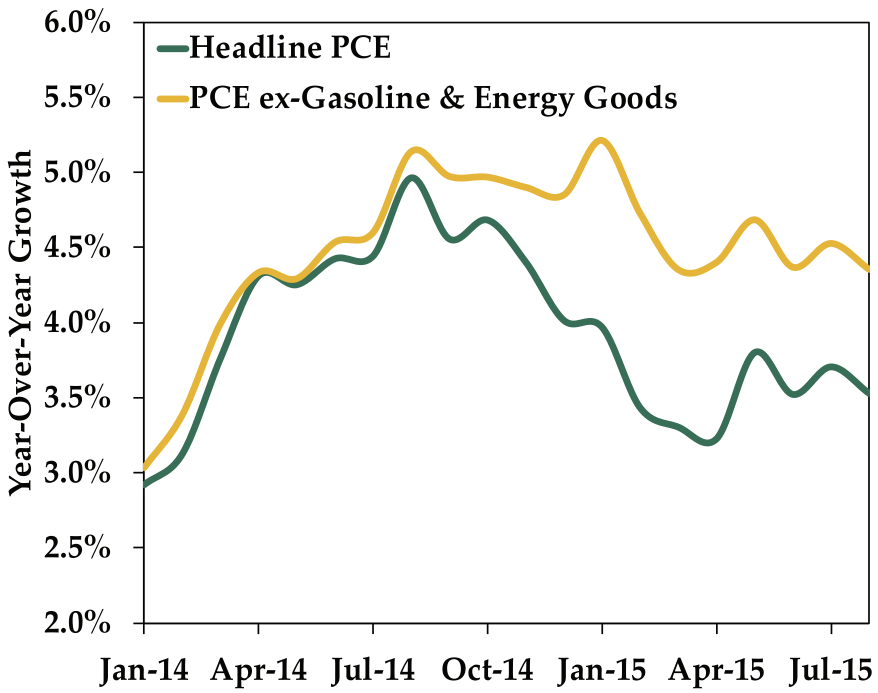
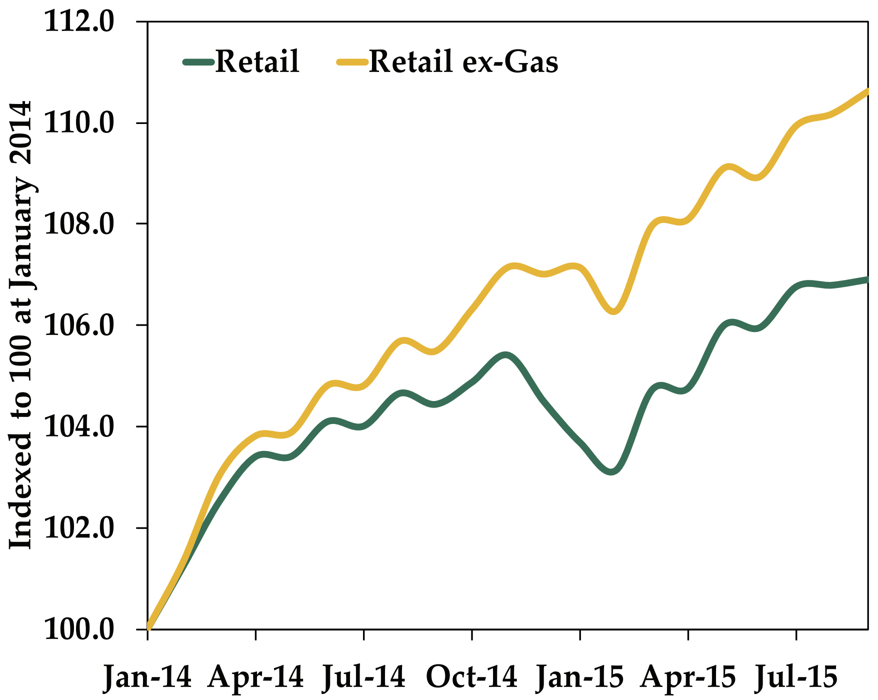


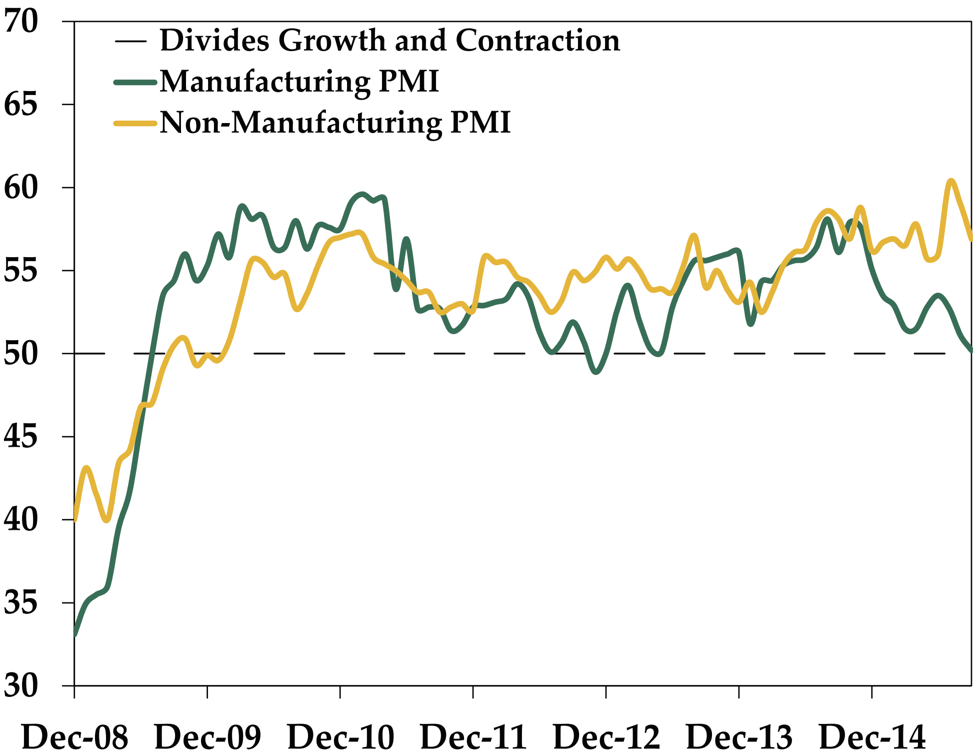

**Exhibit 2: Retail Sales**

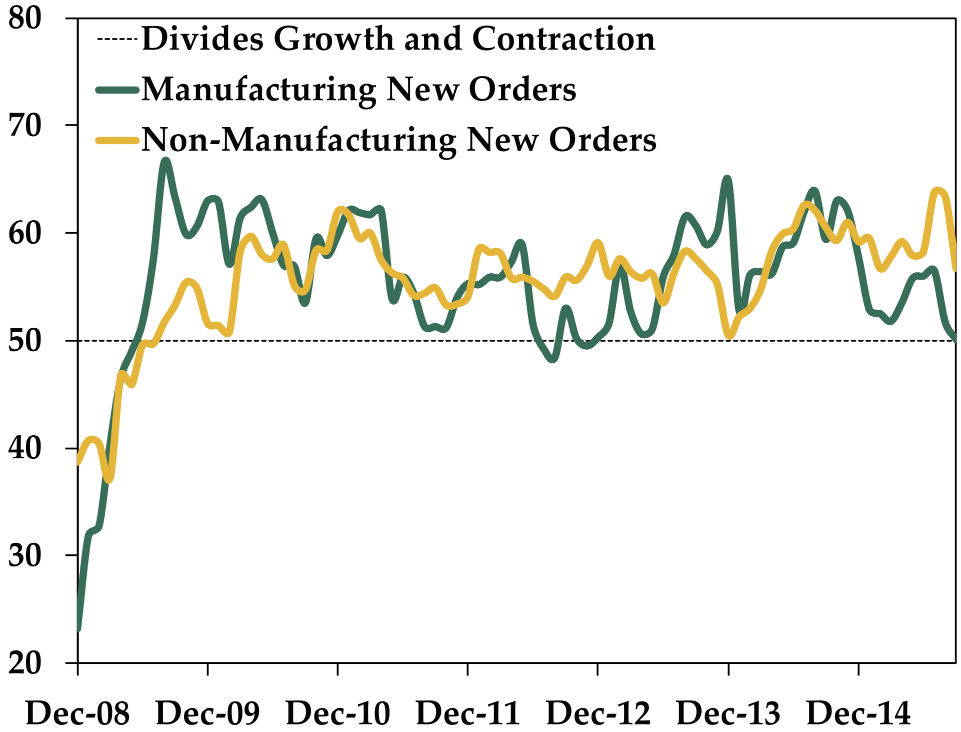



*Sources: US Census Bureau and US Bureau of Economic Analysis, as of 15/10/2015.*

Throughout Q3, the Institute for Supply Management's manufacturing and non-manufacturing (predominantly services) Purchasing Managers' Indexes (PMIs) remained above 50—indicating more firms grew than contracted—as they have for most of this expansion. Both surveys' New Orders Indexes—today's demand, tomorrow's production—show growth. (Exhibit 3) Note that in both output and new orders, non-manufacturing posted broader growth than manufacturing, a sign the 78% of US GDP comprised by the services industry is healthy.

**Exhibit 3: ISM Manufacturing and Non-Manufacturing PMIs and New Orders**

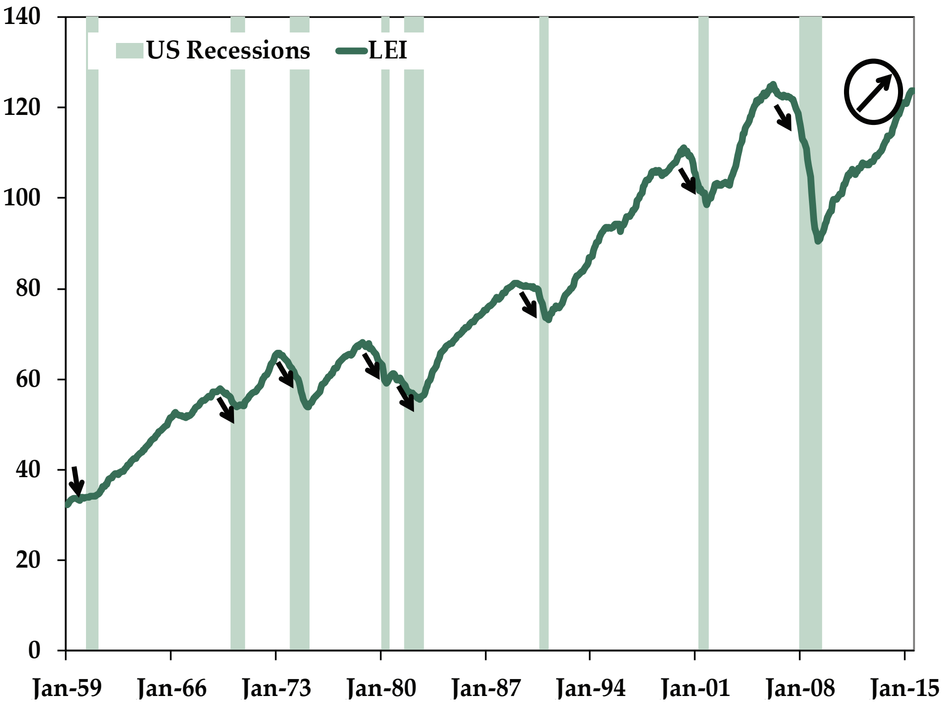



*Source: FactSet, as of 22/10/2015. December 2008 – August 2015.*

Looking ahead, growth likely continues. While The Conference Board's September US Leading Economic Index fell -0.2% m/m, this seems likely to prove a one-off. The dip was driven most by equity prices, tied to the correction retesting the lows, and at the time of writing, we have already seen significant recovery in global equity markets. Building permits were the next biggest detractor, which have been subject to volatility all summer tied local government policy changes in New York and Florida. The most reliable components in the series, the yield spread and Leading Credit Index, positively contributed. The Conference Board's US Leading Economic Index (LEI) has risen in 18 of 20 months, underpinned by a steep yield curve. In LEI's 55-year history, no US recession has started while the index was high and rising (Exhibit 4).

**Exhibit 4: The Conference Board's US LEI**




*Source: FactSet, as of 24/07/2015. January 1959 – August 2015.*

**Not an Earnings Recession—An *Energy* Earnings Recession**

Similar to Q1, as Q2 earnings season began analysts expected aggregate S&P 500 earnings to fall -4.5% y/y, blaming the strong dollar—which makes exports more expensive when purchased in weaker currencies and reduces revenue earned overseas when converted back to US dollars. Yet in a near repeat of Q1, earnings surpassed dour expectations, falling just -0.7% y/y. Excluding the Energy sector's –55.4% earnings decline, profits rose 5.9% y/y [ix].

What analysts seem to persistently overlook is the fact a strong dollar is not a categorical negative for US multinationals. It may dampen revenues some after conversion—and perhaps impair price-competitiveness to the extent US firms try to mark prices up abroad to cover the rising dollar. However, that is not the only impact: the strong dollar also reduces costs for foreign-sourced components, raw materials and labour. Hence, the overall impact to profits is often zero-sum or close to it.

Entering Q3, analysts once again project a decline—the second straight quarter, which some have been quick to label an "earnings recession," fretting the potential impact on equities and once again accusing the dollar. As of the 2nd of October, analysts expected a -4.2% y/y Q3 earnings dip, nearly matching their Q1 and Q2 preseason projections. However, analysts' forecasts also pin most weakness again on Energy earnings—this time projected to fall -65.9%. It remains to be seen if their forecast will come to fruition, but it seems to us this is less an earnings recession and more an Energy earnings recession resulting from the widely known fall in oil prices.

## US Politics

*Political Disclosure: As always, we favour no candidate or party and assess politics solely from the perspective of how legislation, regulation or plans may impact markets. We believe political ideology is blinding and dangerous for investors.*

Summer was full of political news. We had two Republican debates, two candidate dropouts (as of this writing) and plenty of headline fodder. It is still too early, by any historical standard, to handicap the primaries, much less who wins next November. We are still in what journalists call "the silly season." The serious race typically starts much closer to the first primaries. In recent cycles, these have occurred in early January, but the Iowa caucus (February 1st) and New Hampshire primary (February 9th) are later this round, delaying serious campaigning. It might be December or early January before the serious campaigning begins. For now, it is too early to fear or cheer potential market impact.

### Same Old Story

The Republicans have whittled their field down to 15 candidates. Polls show candidates with nontraditonal political backgrounds leading, but polls this early are primarily based on name recognition and have little predictive power. Consider the polls in November 2007, a year before John McCain and Barack Obama faced off. Leading the Republican field were a nationally famous New York City mayor (Rudy Giuliani) and a Senator-and long-time television star (Fred Thompson). Neither made much noise in the primaries (Exhibit 5).

### Exhibit 5: November 2007 Presidential Primary Polling

| Republican Candidate | % Support | Democratic Candidate | % Support |
|---|---|---|---|
| Rudy Giuliani | 28% | Hilary Clinton | 48% |
| Fred Thompson | 19% | **Barack Obama** | **21%** |
| **John McCain** | **13%** | John Edwards | 12% |
| Mitt Romney | 12% | Dennis Kucinich | 4% |
| Mike Huckabee | 10% | Joe Biden | 2% |
| Ron Paul | 5% | Bill Richardson | 2% |
| Tom Tancredo | 1% | Christopher Dodd | 1% |
| Duncan Hunter | 1% | Mike Gravel | 1% |
| Other | * | Other | * |
| None/No Opinion | 9% | None/No Opinion | 9% |

*Source: Gallup, as of 06/10/2015. Both polls taken 11-14 November 2007. Boldface indicates eventual nominee. *Indicates less than 0.5%.*

Hillary Clinton remains in pole position among Democrats (Exhibit 6), but she is not your typical Democratic nominee or successful candidate. As Ken wrote in his June 29 Forbes column, "Since the Civil War we've elected Democrats who were either (1) already President or (2) a fresh new face (Obama, Clinton, Carter, Kennedy, FDR, Woodrow Wilson, etc.) … Democratic coalitions require emotional legs to get marginal voters out—and old dogs have fewer new tricks, and known negatives undermine hope." Clinton does not match those two requirements. She has spent almost 25 years in the nation's eye. She is a political war horse with well-known blemishes—not the prototypical "blank canvas" candidate Democrats prefer.

Democrats would likely fare better nominating a current or former governor with a roughly three-to-six year tenure. Options abound, and the fresh face would let them project whatever image they want to cultivate enthusiasm and build the broad coalition needed to mobilise turnout. However, the longer a dark horse takes to emerge, the lower the likelihood it happens. It is not impossible, and former Maryland Governor Martin O'Malley fits the profile, to an extent. However, we must wait and see how things turn out when he begins campaigning in earnest.

**Exhibit 6: Current Presidential Primary Polling**

| Republican Candidate | % Support | Democratic Candidate | % Support |
|---|---|---|---|
| Donald Trump | 23% | Hilary Clinton | 42% |
| Ben Carson | 17% | Bernie Sanders | 25% |
| Carly Fiorina | 10% | Joe Biden | 19% |
| Marco Rubio | 10% | Jim Webb | 1% |
| Jeb Bush | 8% | Martin O'Malley | 1% |
| Ted Cruz | 6% | Lincoln Chaffee | 0% |
| John Kasich | 3% | | |
| Mike Huckabee | 3% | | |
| Chris Christie | 3% | | |
| Rand Paul | 2% | | |
| Rick Santorum | 1% | | |
| Bobby Jindal | 1% | | |
| Lindsey Graham | 0% | | |
| George Pataki | 0% | | |
| Jim Gilmore | 0% | | |

*Source: Real Clear Politics, as of 06/10/2015. Average of polls for 17/09/2015 to 04/10/2015. Webb dropped his bid for the Democratic nomination on 20th of October but may run as an independent. Biden announced he will not run on 21st of October.*

Further, as we discussed last quarter, poll accuracy has been questionable lately—even near election day. Leading up to the UK's May general election, polls predicted no party would win outright, leading to a coalition or minority government. Yet the Conservatives won an outright (albeit slim) majority. Polls also indicated a tight race in Canada's 19th October contest, yet the Liberal Party won handily.

The GOP fracas will sort itself out in time. It has already eliminated two candidates: Wisconsin Governor Scott Walker and former Texas Governor Rick Perry. A more tactically minded candidate probably would not announce his or her intention to run until after campaigning begins in earnest, thus avoiding the tendency to flame out early. By declaring later, a candidate can skip the debates, giving rivals fewer soundbites to twist. Debates have little to do with governing, and there are other ways to broadcast one's views and resumé: traditional media, social media and other public forums. Walker is a perfect example of this. Considered an early favourite after declaring in July, he peaked too early. His performance in the two Republican debates hurt him, resulting in an early exit.

**What to Make of Proposals**

Several candidates have already announced policy proposals. Clinton offered one on capital gains taxes and another targeting prescription drug prices. Jeb Bush and Donald Trump introduced tax plans. Still others have made vague references to taxes and trade. However, at this point, this is a meaningless exercise. Proposals and campaign lines this early will not meaningfully influence markets. There is too much noise, too many conflicting proposals and opinions.

It is easy to pick a controversial agenda item and argue it hurts markets—e.g., Clinton's proposed intervention in Pharmaceuticals or Trump's vows to raise trade barriers with China and Mexico—but there is no way to isolate its impact. Moreover, markets do not have enough information to form probabilities—and equities move on probabilities, not possibilities. Equities will eventually begin discounting campaign rhetoric and the likely winner's proposals, but not until the field narrows further and it becomes possible to assess the likelihood of various outcomes—both for the White House and Congress.

Looking ahead, Republicans currently hold an edge for 2016's Congressional elections. Though Democrats must defend fewer Senate seats in opposition territory, strong Republican incumbents stand in their way of gaining ground. Winning a majority would require Democrats to virtually sweep toss-up seats. Though possible, this will depend on where both parties direct resources and the campaigns' strength. Meanwhile, the Republican presidential candidate will likely have an edge if the Democrats nominate Clinton, due to the aforementioned reasons.

If the GOP swept, it would set up the "perverse inverse," markets' tendency to rally in election years when new Republicans win the presidency, then falter the next—and vice versa when a new Democrat is elected. It would also end gridlock, raising legislative risk, which markets generally dislike. These are considerations we will weigh as the campaigns get more serious—and we will share our thoughts when appropriate.

## NON-US DEVELOPED MARKET COMMENTARY

### Unfounded Market Volatility

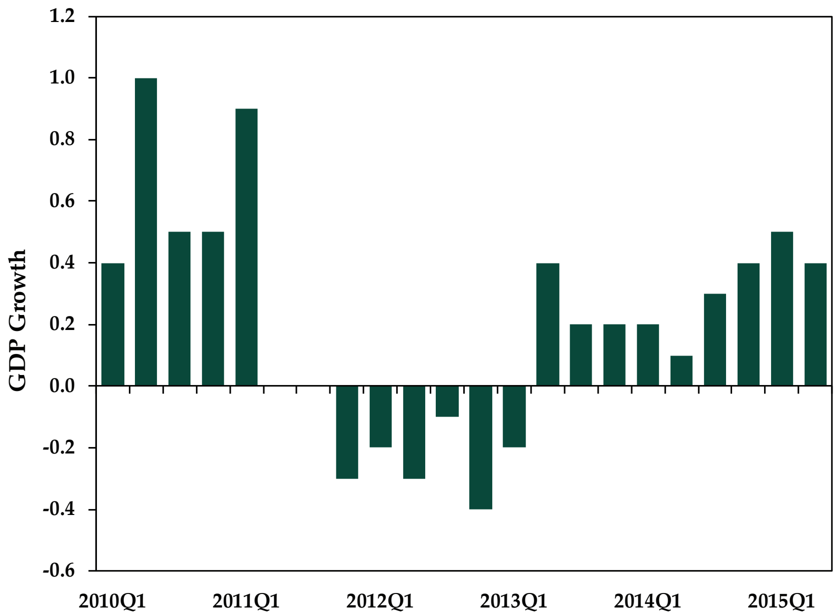
Non-US developed equities officially entered correction territory in August, with the MSCI World ex-US falling as much as -13.1% between its 21 May high and 25 August low, before rising to finish the month of August down -10.8% from all-time highs. [x] Most of the negativity hit in August's final two weeks. The index finished the quarter down -10.6% from Q2's close. [xi]

Many pundits attributed the volatility to China, claiming its economic slowdown had taken a new turn. However, we do not believe conditions in China have fundamentally shifted from the long-established trend of gradual economic slowdown amid intermittent economic reforms. Further, developed market fundamentals generally continued to improve in Q3, and thus, we see this as normal bull market volatility driven by sentiment—typical characteristics of corrections, not the beginning of a bear market.

### Eurozone: Underappreciated Growth

Q2 eurozone GDP was revised up to 0.4% q/q (1.5% annualised) growth, and Q1 was similarly bumped to 0.5% q/q. While many were quick to laud the ECB's quantitative easing programme, growth predates the launch of bond buying by about two years—the eurozone has grown nine straight quarters (Exhibit 7). Further, it is increasingly broad-based. Out of the 19 eurozone nations, only Luxembourg reported contraction—evidence growth is increasingly widespread and, in light of the negative volatility, largely underappreciated.[xii]

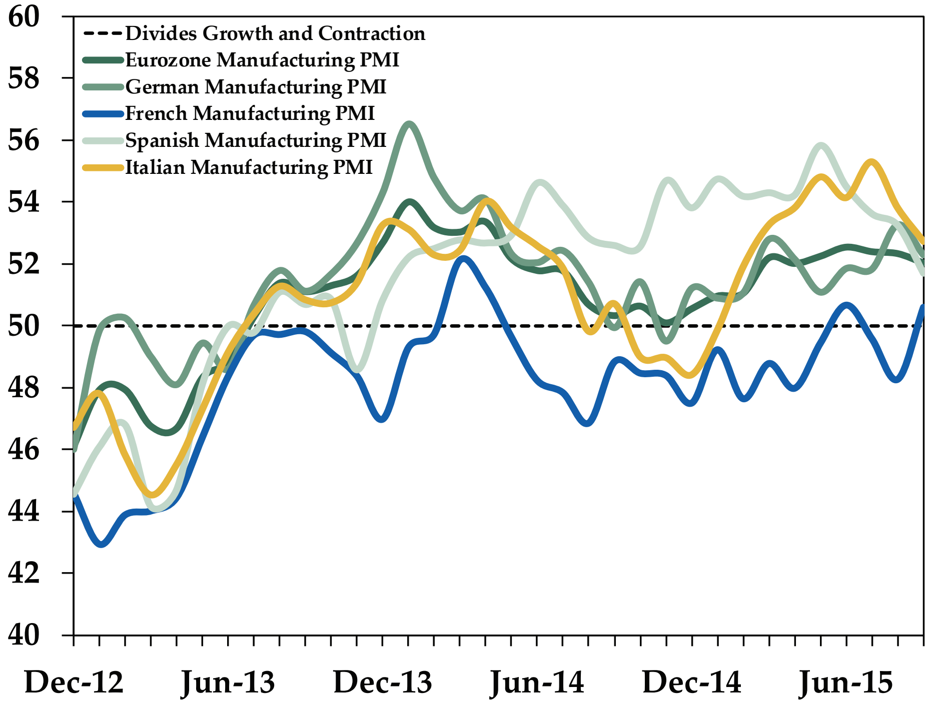
**Exhibit 7: Eurozone Quarter-Over Quarter GDP Growth**

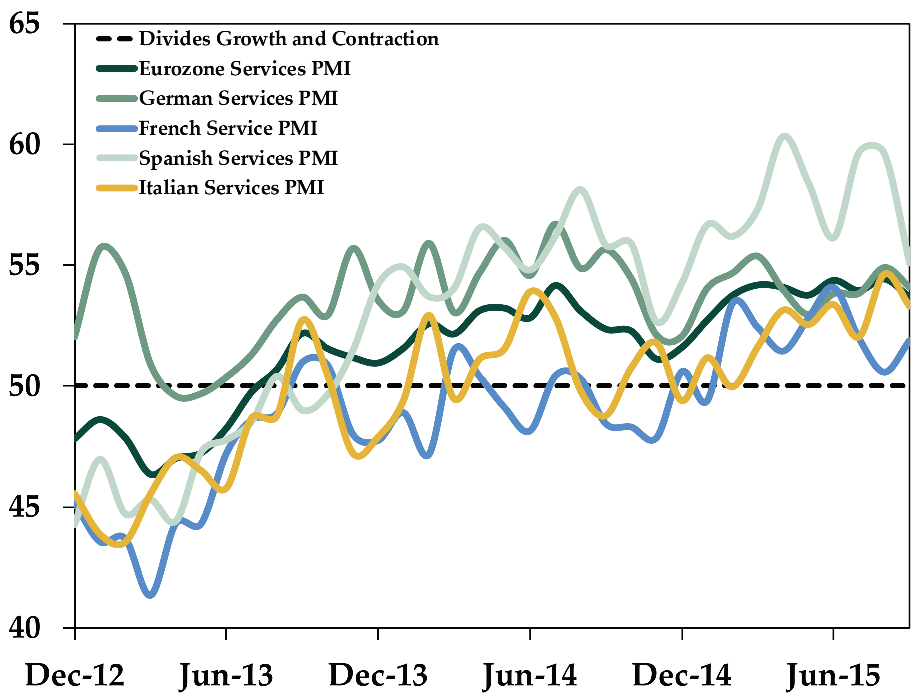



*Source: Eurostat, as of 20/10/2015. Eurozone GDP growth, Q1 2010 – Q2 2015.*

Eurozone PMIs also illustrate growth's breadth. The bloc's composite PMI (services plus manufacturing) stayed in expansion all quarter, as did German, French, Spanish and Italian composite PMIs. Here, like the US, services PMI show much broader growth than manufacturing—but both measures are overall indicating growth (Exhibit 8).

**Exhibit 8: Eurozone Manufacturing PMI and Services PMI**




*Source: FactSet, as of 21/10/2015. Markit PMI, December 2012 – September 2015.*

Yield curves in the eurozone are positively sloped and The Conference Board's Eurozone LEI rose a 10th straight month in August (0.2% m/m).[xiii] However, September's LEI was unchanged m/m at 108.0. We remain confident growth should continue in the region.

## European Politics

Nonstop coverage of Greece fell silent in Q3. Now the media is primarily focusing on the refugee crisis, and to a lesser extent China. We do not believe any of these present a material risk to the bull market. The Syrian War and refugee crisis is a major humanitarian tragedy, but the economic impact is small. These issues have the power to scare investors—and potentially swing short-term sentiment—but they should not have the power to materially sway markets for long.

## Portuguese Election

Portugal voted in early October, a contest widely considered a referendum on incumbent Prime Minister Pedro Passos Coelho's stewardship during the debt crisis, bailout and subsequent recovery. While Portugal's economy is recovering, led by private consumption and investment, voters are fatigued with austerity, and the centre-left Socialist Party sought to capitalise.

Passos Coelho's central-right alliance won the most votes but lost its Parliamentary majority, taking just 107 of the 230 seats. Initially, Socialist leader Antonio Costa said he would not block a minority centre-right government, and he and Passos Coelho began negotiations for his support. However, Costa left open the possibility of a coalition between the Socialists and smaller leftist groupings. Together, the Socialists, Left Bloc and Communist/Green alliance hold 122 seats, and as talks with Passos Coelho broke down, Costa announced he had secured enough support for a leftist majority government. Yet the decision rested with President Aníbal Cavaco Silva, and on the 22nd of October he named Passos Coelho Prime Minister and asked him to form a government, citing his concern over the Communists' and Left Bloc's euro scepticism. The Socialists have already threatened to block Parliamentary ratification of Passos Coelho's minority government, raising the likelihood of new elections next year.

Whilst this saga raises political uncertainty for Portuguese markets, its actual impact should be limited—a point underscored by Portuguese interest rates, which remain near euro-area lows. Portugal has already implemented several reforms, and though a stalemate stalls further progress, it also prevents past measures from being undone. Moreover, Portugal is only 1% of eurozone GDP, smaller than even Greece.

## Up Next: Spain

Spain's general election is scheduled for the 20th of December, and polls show a tight race might yield the first coalition government since Spain's return to democracy in 1978.

The centre-right Popular Party (PP)—led by current Prime Minister Mariano Rajoy—and centre-left Socialist Party (PSOE) have dominated Spanish politics since Franco's fall, but two upstart parties are challenging their dominance. One, Ciudadanos, was formed in 2005 with a platform based on individual freedoms and tackling corruption. Many of their economic policies overlap with PP's, leading many to label them as centre-right, and the two parties have formed coalitions in regional governments. The other newcomer, Podemos, is an anti-austerity populist party formed in 2014 by Pablo Iglesias, a young political science professor. Their ideology has much in common with Greece's radical-left Syriza.

Current polls show PP and PSOE on top, followed by Ciudadanos, with Podemos in last. While Podemos enjoyed strong polling gains and local election victories in Madrid and Barcelona earlier this year, Syriza's many setbacks and failure to win many concessions from Brussels dented much of the enthusiasm for Podemos, reducing their support. However, we caution against reading too much into these standings, as pre-election polling has been wildly inaccurate throughout Europe this year.

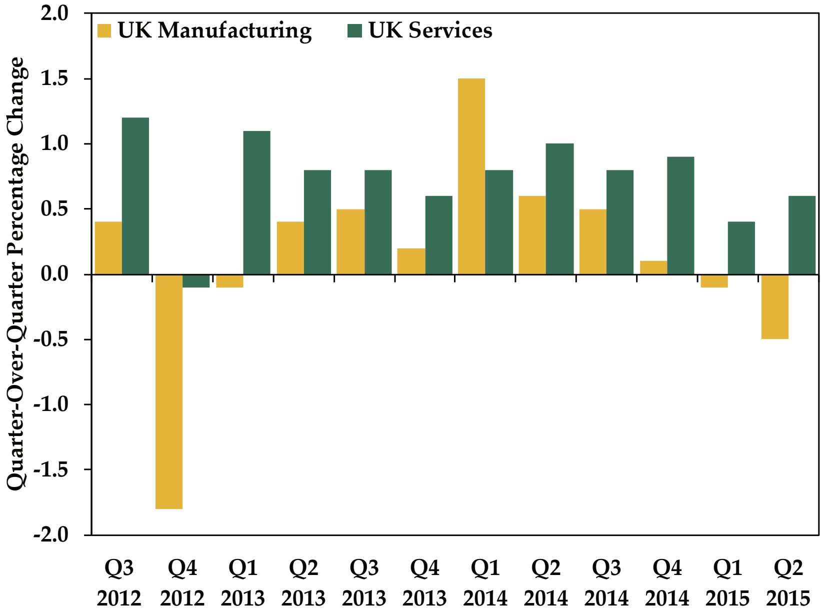
Regardless of how the vote breaks down, we do not expect much to change in Spain. PP has already made coalition overtures toward Ciudadanos, and should they form a government, their agenda would probably uphold the status quo. Podemos has ruled out being a junior partner in a PSOE coalition, raising the likelihood of a unity government should PSOE win the most votes. Overall, whoever ends up in power will likely have a weak mandate, making it difficult to pass much substantial legislation. Spain has already passed several economic reforms in recent years, and gridlock reduces the likelihood of unwinding them—a positive.

## UK Economics

The UK economy remains among the developed world's strongest. Q1 and Q2 GDP both rose 0.7% q/q (2.6% annualised), led once again by services. While soft patches remain, the foundation is strong.

Business investment continued rebounding from its brief 2014 autumn dip in Q2, growing 2.9% q/q and 5.0% y/y. Though many believe UK growth is not "stable" until components like business investment and exports pick up, consider: Quarterly business investment hit an annual all-time high in 2014.[xiv] While trade remains choppy, it also has not prevented growth. Plus, the UK is a services- and consumption-oriented economy. Though Manufacturing PMI slowed in September, Services PMI remained firmly in expansion territory. Sectoral GDP breakdowns show fairly steady services growth, while manufacturing is weaker(Exhibit 9). Given services comprise about 79% of UK GDP, a healthy services sector can drive growth.

### Exhibit 9: UK GDP Sectoral Breakdown: Manufacturing Vs. Services




*Source: FactSet, as of 21/10/2015. UK GDP by Industry, Q3 2012 – Q2 2015*

## The UK's Labour Party Gets a New Leader

After the Conservative Party won an unexpected majority in May, Labour Party Leader Ed Miliband stepped down, triggering a wild leadership contest. Initially, it looked like supporters would choose from three shadow cabinet members: Yvette Cooper, Andy Burnham and Liz Kendall. However, party members worried the debate was too narrow, as all three had close ties with the Blair and Brown administrations, so they drafted leftist Jeremy Corbyn to widen the debate. Corbyn, an MP since 1983 with no ministerial experience and a history of voting against Labour Party leadership (he has rebelled on more than 500 votes since 1997), was not expected to win many votes. Yet he captured the national attention and won in a landslide. His economic platform includes re-nationalising railways, hiking taxes on business and high earners, upping infrastructure and public investment and launching "people's quantitative easing," through which the Bank of England would use new reserves to purchase bonds issued by a public development bank.

Corbyn's success and radical agenda triggered much chatter among the punditry and investors, but it is largely a non-issue for markets at this point. The Conservatives have a Parliamentary majority, and the next general election is not until May 2020—much too far out to handicap. Markets move on probabilities, not possibilities, and equities generally do not discount events beyond the next 30 months or so.

Moreover, it is far from certain Corbyn will lead the Labour Party in the next election. Most Labour MPs voted for Cooper, Burnham or Kendall, and many refused to join Corbyn's shadow cabinet. At the Labour Party Conference in October, several shadow cabinet members openly criticised Corbyn's national defense stance. Corbyn faced another rebellion two weeks later, over Chancellor George Osborne's fiscal charter, which sets stricter budget targets. Several senior MPs threatened to vote for the bill or abstain, defying party whips, forcing Corbyn to allow abstentions at the last minute. Over a dozen took advantage, raising big questions about Corbyn's authority.

Corbyn could easily survive these early scrapes and lead Labour for a while longer, but his dismal polling and lack of control could very well prompt the party to replace him before the next election. Either way, in the meantime, the Conservatives' slim majority should keep Parliament gridlocked, bringing bullish political stability to UK equities.

**Japan: Still Weak**

Japanese equities fell -11.8% in Q3, underperforming the MSCI ACWI by more than two percentage points. While we would expect Japan to participate in the rebound we are beginning to see from Q3's correction, we continue to believe Japan has not enacted the structural economic reforms necessary to unshackle the economy and support equity outperformance.

Japan's economy is showing persistent signs of weakness. While export values rose slightly in Q3, export volumes have declined in five straight months—gains are solely the result of currency translation, while the actual units shipped is down. Meanwhile, domestic data remain torpid. Retail sales closed the quarter by decelerating markedly to 0.8% y/y growth in September, showing the post-sales tax hike upswing in April was merely a function of low year-over-year comparisons, not a sustained rebound. Industrial production contracted in July and August. Most analysts believe Japan's GDP contracted in Q3, and if so, this would mark the second straight quarter of contraction—putting Japan back in a recession by one common definition. All this stands as a stark reminder that Abe's economic strategy is long on misguided quantitative easing (QE) and short on the structural reforms Japan needs. However, many pundits continue to see any renewed sign of weakness as a call for an extra budget or more QE. These persistent calls show sentiment still does not appreciate the actual issues on the ground in Japan.

In early September, Japanese Prime Minister Shinzo Abe was re-elected as leader of Japan's governing Liberal Democratic Party, after running unopposed. Optimists may suggest this means Abe has renewed clout to push through contentious reforms—and they point to his claims he will refocus on Abenomics after passing defense reforms in the summer. However, this overlooks the fact he is now a lame duck. The LDP has term limits on its leadership, and Abe will term out at the end of this three-year term. That means Japan will get a new Prime Minister, and this could set up more intraparty disputes, as would-be successors attempt to position themselves.

Abe followed the re-election by reiterating a number of well-known initiatives, like cutting corporate taxes by 3.3 percentage points, a measure already passed. He also reiterated his focus on the Trans-Pacific Partnership free-trade deal as a key policy aim and an agreement was reached, but it still must be ratified by the 12-negotiating nation's legislatures, which will be difficult.

**Australia Gets a New Prime Minister …**

Malcolm Turnbull became Australia's fifth Prime Minister since 2007 in September, as the Liberal Party deposed Tony Abbott in a backroom leadership vote. This is Australia's third interparty coup since 2010, and no Prime Minister has served a full term since John Howard from 2004 to 2007.

This time around, Australia's weakening economy turned the revolving door. While Australia has not endured a recession in 24 years, its commodity-heavy economy faces big headwinds from the global supply glut and low prices, and GDP growth slowed to just 0.2% q/q in Q2. Rivals seized on this, and the opposition Labour Party surged ahead of the Liberals in polling for next year's national elections. Abbott's personal polling was down as well, and the Liberals replaced him in hopes of energising voters with a fresh face.

Some investors are encouraged by Turnbull's private-sector history and strong business contacts, but this seems a touch optimistic and could overly inflate sentiment toward Australian equities. Despite Turnbull's "market-friendly" reputation, Australia's economy and markets face a substantial headwind from weak commodity prices. Though its economy has a strong financial system and relatively healthy consumers, the commodity pinch restricts growth. This could drive continued political upheaval, but Australian markets are quite used to this by now.

### … And So Does Canada

Canadians hit the polls on 19 October, faced with a choice between incumbent Prime Minister Stephen Harper and his Conservative Party—in power nearly 10 years—the centre-left Liberal Party and the upstart New Democratic Party. Though Harper argued his stewardship and fiscal conservatism was necessary to guide Canada out of its ongoing recession, Liberal leader Justin Trudeau's youth and platform of change and fiscal stimulus resonated most with voters. The Liberals won handily, taking 184 of Parliament's 338 seats—a 30-seat majority.

Trudeau, the son of long-serving Prime Minister Pierre Trudeau, has pledged to raise taxes on the highest earners, cut taxes for middle-income folks and run deficits for the next three years as he battles a struggling economy with C$60 billion in new infrastructure spending. The strong majority means Canada will not enjoy bullish gridlock, and a more active government may be at hand, raising the risk of sweeping legislation—something equities typically dislike.

However, Trudeau's election does not really alter investment opportunities within Canada, which faces economic headwinds similar to Australia's. Though his tax changes do appear likely to pass, a four-point hike in income taxes for the top one percent of Canadian earners should not have much market impact. Nor should the tax cut for middle earners. Small tax changes are usually not a huge factor for markets, as US history has proven time and again. As for the spending, fiscal stimulus can help when there is a dearth of demand, but we are sceptical that it will help much in Canada, whose recession stems from the well-known troubles in Energy and Mining. Canadian growth does not depend as heavily on commodities as other countries like Russia, but they do represent a fair chunk of GDP, and falling prices hurt them enough to offset growth in other sectors. This is even more apparent in Canada's equity market, where Energy and Materials account for 30% of total market capitalisation

The Trans-Pacific Partnership (TPP)—a trade agreement between Canada, the US and 10 other nations—was another central campaign issue. The agreement, negotiated by Harper's administration, was finalised in October but must be ratified by all 12 nations before taking effect. Trudeau and the Liberal Party say they strongly support free trade, but they are non-committal on the TPP, claiming they cannot say which way they lean until they assess the entire agreement and its impact on "supply management, [the] auto sector, and Canadian manufacturers." [xv] Compounding matters, Trudeau has not decided whether to grant Liberal MPs a free vote on the deal, which could impact its chances of passing. This is one of many hurdles TPP faces before taking effect, along with the US's 2016 elections, and the road will be difficult. However, while TPP would be a long-term positive, its absence is not a negative—it just extends the status quo.

## EMERGING MARKETS COMMENTARY

Throughout the quarter, the media blamed several major fears for the global equity markets correction, but China seems to bear the brunt, with many supposing a sharp economic slowdown has now arrived. Pundits argue recent Chinese government moves are acts of desperation—flailing efforts to stanch the bleeding. While these fears run rampant, economic data, announced reforms and commentary from Western executives suggest the long-existing trend of gradually slowing, but still-strong growth continues amid a backdrop of incremental reform.

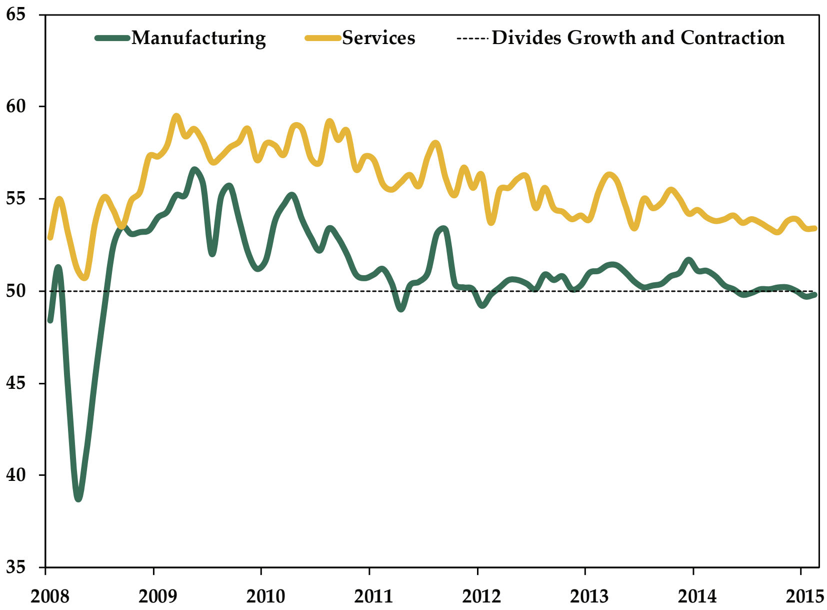
### China's Gradual, Engineered Slowdown

To be sure, China's economy is not growing at double-digit rates like it was in 2010. Nor are manufacturing and trade skyrocketing. Far from being a surprising new negative, this has been the general trend in Chinese data for nearly four years. In addition, it is the government's stated objective to shift the emphasis of growth from export- and infrastructure-development driven to domestic consumption and services-led. Recent data suggest this trend continued.

Now, many are sceptical of Chinese data, partly because of the government's opacity and partly because of a 2010 Wikileaks release in which current Chinese Premier Li Keqiang called China's GDP "manmade" and urged observers to use alternate statistics. However, the IMF's in-house estimates largely echo China's official figures and some data (like the aforementioned trade data) can be cross-checked against major trade partners. Moreover, while it may not yield a quantitative picture of China's economy, commentary from non-Chinese firms doing business domestically suggests the economy is largely in fine shape—high absolute levels of growth, but slower than earlier years in this global expansion.

As for economic data, Purchasing Managers' Indexes garnered a great deal of attention in Q3. Headlines frequently decry the Official and Caixin/Markit manufacturing gauges being slightly in contractionary (sub-50) territory, although both measures have spent much of the last few years below 50. The latter gauge, a private-sector survey tilted towards smaller, private manufacturers, has contracted far more often than it has grown since 2011, as these smaller firms struggle to obtain credit. Meanwhile, services gauges are outpacing manufacturing and remain expansionary in both series (Exhibit 10).

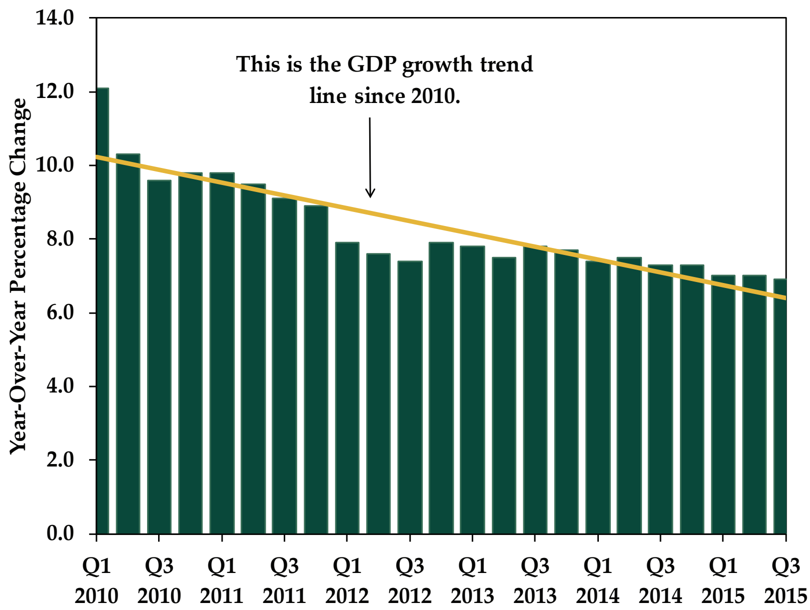
**Exhibit 10: China Official PMI—Services and Manufacturing**




*Source: FactSet, as of 22/10/2015.*

In Q3, GDP slowed to 6.9% y/y from 7.0%, again in keeping with a long-running trend. Exhibit 11 shows the trend in Chinese year-over-year real GDP growth since 2010.

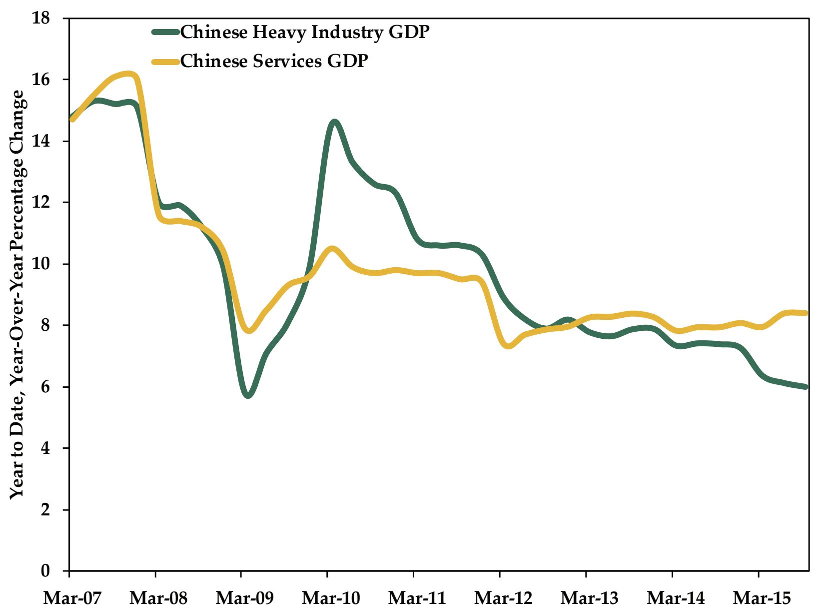
**Exhibit 11: China Real GDP Growth (Year-Over-Year)**




*Source: FactSet, as of 22/10/2015.*

Under the surface, GDP data show the same rotation from manufacturing to services. As Exhibit 12 shows, service sector growth eclipsed heavy industry in Q1 2013 and has led ever since. Through Q3, the service sector grew 8.4% year to date from 2014's first three quarters, compared to just 6.0% for heavy industry.

**Exhibit 12: China GDP, Heavy Industry v. Services**




*Source: FactSet, as of 19/10/2015. China Secondary and Tertiary Industry GDP growth, Q1 2007 – Q3 2015.*

Some suggested the equity market decline would act as a reverse "wealth effect" and hurt Chinese consumer spending. Less than 10% of Chinese actually own equities, suggesting that the impact is not broadly felt. And even with that, consumption is not hugely swayed by a "wealth effect" or other sentiment features. In our view, real wage growth, which continues apace in China, has far more influence over consumers' actions.

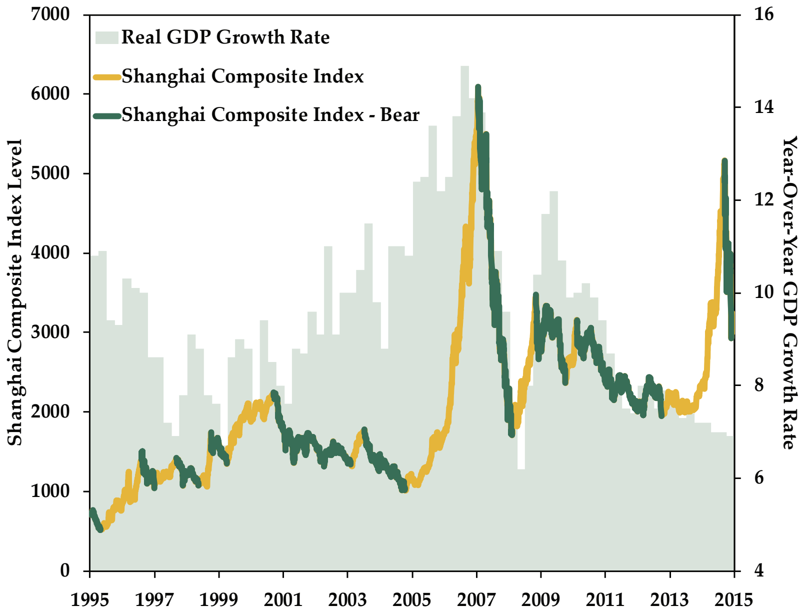
Economic data from China's October 1 - 7 "Golden Week" national holiday showed strength, refuting the reverse "wealth effect" claims. Sales at restaurants and retailers rose 1.082 trillion yuan ($170 billion), an 11% y/y increase.[xvi] In the week, about 11.5 million tourists visited Beijing and another 4 million Chinese tourists traveled abroad.[xvii] While many fret trade data showing weak imports suggests all is not well with Chinese consumers, weak numbers like September's -20.5% y/y drop in imports were a function of commodity prices, not slumping demand. Australia's commodity export hub, Port Hedland, reported record iron ore export volumes to China in August. There are few signs China's economy is markedly weakening, much less approaching the long-rumored "hard landing."

## Economic Slowdown Fears

China economic slowdown fears seemingly build on Q2's concerns over a steep drop in Chinese domestic A-shares. After surging 152% in the preceding 12 months, the Shanghai Composite Index fell -43.3% from its June 12 high to the lowest point seen to date (26 August) [xviii]. Last quarter, we discussed the fact moves in A-share markets are largely limited to domestic investors, due to restrictions on foreign investment. As volatility continued, many assumed the bear market foretold big trouble in China's economy. However, while equity markets are frequently good forward-looking gauges, China's domestic markets are not liquid and open enough to function as a reliable leading indicator.

As Exhibit 13 shows, the Shanghai Index has had nine bear markets since 1995. While some have correlated with global recessions and bear markets—like 2008's—most did not.

**Exhibit 13: China's Domestic Markets Aren't a Reliable Leading Indicator**




*Source: FactSet, as of 22/10/2015. Shanghai Composite Index and year-over-year Real GDP growth rate, Q3 1995 – Q3 2015.*

Despite the nine bears, there were no Chinese recessions during the period. Quite the contrary: From 2001 through 2005, the Shanghai had two -40% drops, yet the economy accelerated from 7% y/y GDP growth to over 10%. Similarly, the Shanghai fell 32% between August 2009 and July 2010, yet growth accelerated markedly into double-digit territory.

## Intervention and Reform

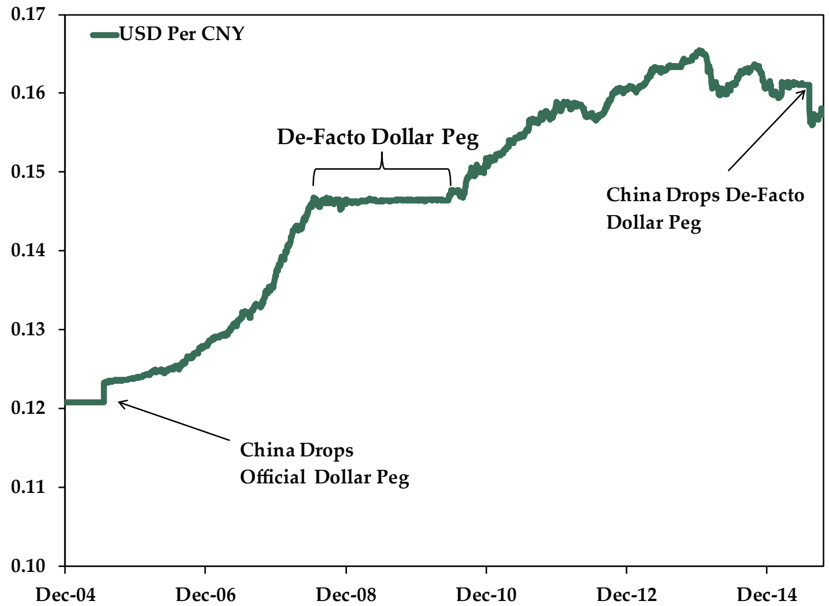
In July and early August, China's government frequently intervened in the A-share markets with short selling and IPO bans, public cajoling via state-run media, and outright purchases of equities by government-directed Financials. Of course, this runs counter to the market-oriented reforms enacted in recent years, highlighted in the equity markets by China's opening the Shanghai-Hong Kong Stock Connect last year. We have noticed China's reforms often come in two-steps forward, one-step back manner, which seems to be the case here.

## The Commonly Misperceived Devaluation

While much of the world saw it as a sign of economic desperation, China enacted yet another market-based reform in August. On 11 August, the government reset the yuan's official value 1.9% lower against the dollar and announced a new method of determining the exchange rate. The result was the yuan's biggest decline against the dollar in two decades and a slew of claims the government was desperate and trying to "steal growth" from trading partners via a competitive devaluation to boost exports.

However, a little perspective is in order. A -1.9% decline would be considered relatively normal volatility in markets less controlled than China's. The new exchange rate regime, too, was ostensibly meant to be more market-oriented than its predecessor. Before August 11, China used a managed float in which exchange rates were determined by fiat and then allowed to trade in a 2% bandwidth (up or down). The next day, the government would set a new rate that may or may not be influenced by the prior close. A number of times, this system has amounted to a de-facto peg against the dollar (Exhibit 14).

**Exhibit 14: US Dollar Per Chinese Yuan**




*Source: FactSet, as of 22/10/2015.*

The new methodology bases the daily rate on the prior day's close and market makers' quotes. While this is not perfectly market-set and the 2% bandwidth remains, rates are much more market-like than before. What is more, the devaluation was an acknowledgement the government had been propping up the yuan against the dollar for some time. In essence, the yuan was de-facto pegged to the dollar because the government was preventing it from falling, a stark contrast to US politicians' continuing claims the yuan should rise.

Since the new exchange-rate regime's announcement, most reports indicate China has intervened to prevent the yuan from falling further. At Q3's close the yuan was down a mere -2.1% against the dollar—a tiny move relative to the media firestorm it triggered.

A related issue is the IMF's Q4 vote on including the yuan in its reserve-currency basket, the special-drawing right (SDR). The SDR, designed in 1969, is an accounting unit presently comprised of the US dollar, British pound, Japanese yen and euro. It is not a currency in itself nor a claim on the IMF for the underlying currencies. A central bank seeking to redeem its SDRs must exchange them with other IMF members for the underlying currency. China has long expressed a desire for the yuan to be the fifth currency in the basket, and leaks in October suggested the IMF is leaning that way, seeing August's moves as steps toward a freer yuan. That being said, there is little fundamental benefit to inclusion in the SDR. Inclusion does not give an issuing country rights, fee revenue or lower bond interest rates, contrary to some popular notions. This is a symbolic matter—a sign of China's advance and reform.

**The rest of EM…**

Credit ratings agency Standard & Poor's downgraded Brazilian debt to BB+—junk status—late-lagging confirmation of Brazil's longstanding economic struggles. While headlines focused on the debt downgrade, Brazil's data have long shown the country's weakness. Q2 GDP fell -1.9% q/q, pushing the country into what most economists consider a recession—two consecutive quarters of contraction. Brazil's mid-September National Wide Consumer Price Index (IPCA CPI) remained at 9.57% y/y, matching August's 11-year high. Along with a stagnant economy, Brazil's political scene remains unsettled as the "Car Wash" corruption scandal continues to incriminate high-ranking officials. Talks of impeaching President Dilma Rousseff have strengthened, and while the likelihood is low, the political uncertainty is another headwind. With forward-looking indicators like The Conference Board's Brazil Leading Economic Index (LEI) falling -1.5% m/m in August—its 10th straight monthly decline—Brazil's near-term prospects look unattractive.

While many commodity-heavy Emerging Markets (EM) economies struggle, the category is not uniformly affected. Many nations—most notably India, Korea, Indonesia and Taiwan—receive a net benefit from falling commodity prices. India, for example, has remained positive, evidence EM are not a cohesive bloc and remain attractive on a selective basis. Services growth led India's calendar Q2 7.0% y/y GDP growth rate, particularly transportation and financial services. Tax revenues have risen 35% y/y year to date due to improvements in tax collection. August CPI slowed to 3.66% y/y compared to July's 3.69% y/y. While energy prices figure into that lower number, it is a marked improvement compared to the double digit levels of 2013. Given weaker-than-expected inflation, the Reserve Bank of India cut its policy repo rate by 50 basis points to 6.75%—more than most economists forecasted. With accommodative monetary policy, less dependency on China for growth and a tailwind from low energy prices, India appears to be gradually improving economically. Politically, while some are frustrated with the slow pace of reform, Prime Minister Narendra Modi has made progress on this front during his time in office and his government has pulled back from some potential market negatives. On September 1, Finance Minister Arun Jaitley reversed earlier statements, saying India will not apply the controversial alternate minimum tax to foreign institutional investors.

Many fret the struggles of EM overall—emphasising poor exports figures—while overlooking steady domestic demand. Taiwan GDP missed expectations of 2.5% y/y, growing just 0.6% y/y in Q2, though this is primarily due to weakness in the tech trade. However, domestic demand grew—private spending rose 2.8% y/y and imports were up 1.9% y/y. Indonesia grew 4.7% y/y in Q2—meeting expectations—driven by private consumption (5.0% y/y). Mexico also expanded resulting from Services industry growth. Q2 GDP rose 2.2% y/y (0.5% q/q) as services rose 3.1% y/y. Though countries like Indonesia and Mexico have large commodity sectors, they are also more diversified. While growth is by no means substantial, it shows not all EM are dependent on commodity prices (like Brazil or Russia) or robust Chinese economic growth. For better-diversified economies, the pain has not been as severe. Countries with solid consumer demand like Mexico and South Korea benefit from low energy costs. They also have large service sectors that can help offset some weakness in trade (and Energy in Mexico's case). In our view, it is not accurate to suggest a slowing Chinese economy will bring down all EM with it.

## PORTFOLIO PROFILE

### Summary of Portfolio Themes & Positioning

### Country Positioning

### Overweight India

With large weights to generic pharmaceuticals and IT-services companies, India's equity market composition is particularly desirable in the current stage of the market cycle. Politically, monetary policy credibility has been restored under new Reserve Bank of India (RBI) head Rajan Raguram, and National Democratic Alliance (NDA) coalition's rise to power, led by Prime Minister Narendra Modi, raises the probability of pro-market reform .

#### Economic Drivers

+ **Favourable Market Composition:** India has the largest Health Care and fourth-largest Technology sectors among Emerging Markets (EM), with industry exposure concentrated in desirable generic pharmaceuticals and IT-services firms that benefit from robust developed-market end demand and nascent Emerging Markets consumption trends.
+ **Underappreciated Economic Potential:** Investor focus on current account deficit worries and political drivers ignores that India is expected to be one of the fastest-growing economies in the world over the next several years.
+ **Monetary Policy Turning Dovish:** Inflation has fallen considerably in the past several months, led by declines in food and fuel, and the RBI embarked on a new easing cycle, again cutting rates twice by 25 basis points to 7.25%.
+ **Falling Commodity Prices Leading Positive Fiscal Reform:** With net oil and minerals imports accounting for roughly 6% of GDP, trade deficit concerns should ease as commodity prices remain weak. Moreover, falling prices motivated the government to end diesel fuel subsidies, which have accounted for as much as 10% of India's public spending in recent years.
- **Vulnerable to External Shocks:** Despite positive reform momentum, India's budget remains laden with subsidies and transfer payments, keeping the fiscal deficit elevated and diverting funds from productive investment. Much of the recent improvement in its current account deficit comes from lower energy prices and gold import restrictions—leaving the country more vulnerable to external shocks than other Emerging Markets.
+ **Infrastructure Growth Accelerating:** Infrastructure growth has accelerated since the 2005 reform allowing public-private joint ventures, which decreased government involvement in infrastructure investments. In addition, Modi's "Made in India" campaign, which seeks to boost economic potential through manufacturing and infrastructure investment, led to a 25% y/y increase in budgeted infrastructure spending in 2016—roughly double the long-term growth rate.

#### Political Drivers

+ **Monetary Policy Credibility:** Upon his appointment, RBI head Rajan Raguram quickly restored monetary policy credibility by raising rates despite political pressure for easing given economic weakness. Moreover, the government formally adopted inflation targeting, pledging to keep inflation below 6%. Inflation-targeting regimes have historically precipitated a structural decline in price volatility in other Emerging Markets, providing a more consistent backdrop for economic policymaking.

± **Reform Expectations:** Narendra Modi's emergence has increased optimism for reform given his track record and strong mandate, but reviews of his first year in office disappointed. Investor expectations were likely too high as modest progress has been made, such as corporate tax cuts and the introduction of a comprehensive bankruptcy code. Moderate additional reform headway is likely a positive surprise.

- **Hostile to Foreign Investment:** Despite modest progress, India remains relatively hostile to foreign investment. The Finance Ministry announced plans late April to collect retroactive taxes on select foreign companies. While the government eventually dropped the idea, the move suggested not much had changed politically and likely drove the correction in Indian shares in April and May.
- **Corruption:** The inherent coalition-building of Indian politics has led to significant corruption scandals, which historically have impeded business and political reform.

## Sentiment Drivers

± **Elevated Valuations:** Optimism for Indian shares drove the forward price-to-earnings ratio to 18x—above its 10-year average but still not at extreme levels seen in 2007. Positive economic growth expectations and steady political progress suggest the premium to recent years is justified.

## Overweight China

Sentiment on China's economic growth potential and recent market gyrations remains overly dour. Credit growth is likely to slow along with infrastructure investment growth, but an unprecedented reform agenda of the Xi-Li regime should help promote consumption, financial liberalisation and more efficient allocation of resources. These measures should stabilise economic growth and have a positive impact on Chinese equities as fears of a "hard landing" subside.

### Economic Drivers

+ **Economic Reform Gaining Momentum:** New leadership is promoting economic reform to boost return on capital. With industrial activity expected to contribute less to growth, policy is likely to focus on increasing capital efficiency and the private sector's role in the economy. The government recently announced an overhaul to state-owned enterprises (SOEs), attempting to attract private capital and focus more on profitable investment.
+ **Property Prices Stabilising:** Property markets matter more than equities, accounting for approximately half of household wealth. A slowdown in both construction and prices has previously been a headwind to economic growth, but prices bottomed in 2014 and are growing again.
± **A-Share Market Limited Impact to Economy:** Chinese equity ownership is low by global standards, with only one fifth of household wealth in equities. Moreover, only 1% of banking assets are leveraged to the equity market, suggesting limited economic impact from recent market turmoil.
- **Credit Growth:** The government is actively deleveraging and shifting from fixed asset investment toward consumption. With the fixed asset side larger than consumption, the aggregate economy is slowing modestly.
+ **Well Insulated Capital Markets:** Current market turmoil elicits comparisons to Southeast Asia in the late-1990s prior to the Asian Financial Crisis, but with nearly $4 trillion in foreign currency reserves, a closed capital account and little foreign debt, Chinese markets are less vulnerable to external shocks.
+ **Monetary Policy Easing Supports Credit Growth:** The People's Bank of China cut rates a fifth time since November and has lowered the reserve rate requirement for banks three times this year.

### Political Drivers

+ **Financial System Liberalisation:** The Chinese government is gradually opening the financial system to market influences, including increasing loan and deposit rate flexibility, growing domestic and offshore bond markets, widening renminbi use in global trade, instating deposit insurance for the first time and removing the loan-to-deposit cap for banks.
- **Market Interventions Undermine Policy Credibility:** The government's heavy-handed and poorly-timed interventions to support equity markets and the ensuing decision to devalue the yuan has undermined confidence in policymaking.
- **Anti-Corruption Drive:** The government's anti-corruption drive has reached farther than expected and has begun to have a negative impact on sentiment and consumption by the political and wealthy elite.

### Sentiment Drivers

± **Fears of Economic Slowdown Overwrought:** Recent economic data has been weaker than expected, revitalising calls for a hard landing and drawing comparisons to Southeast Asia prior to the Asian Financial Crisis. However, while industrial-related activity has slowed as expected, services are growing and private consumption remains steady. Other non-traditional measures, such as multinational corporations' sales into China, suggest the economy is holding up.
+ **Cheap Valuations:** H-share equity valuations are well below historic norms, suggesting dour sentiment remains despite the rally in mainland shares. As low economic expectations subside and reform progresses, valuations are likely to expand.
- **Equity Supply Influences Returns:** With the Chinese government owning roughly two-thirds of shares, significant supply overhangs exist. After a period where the government blocked all new IPOs, share issuance surged in 2014 and 2015. IPOs are again banned given recent market turmoil.

## Overweight Mexico

Tied to strong economic linkages with the US and pro-growth domestic reforms, we expect Mexican equities to outperform.

### Economic Drivers

+ **US Trade Relations:** Over 70% of Mexico's exports are directed to the US. If the US economy outperforms most developed regions—likely, in our view—Mexico should benefit relatively.
+ **Monetary Policy:** Mexico's inflation remains benign, and monetary policy remains accommodative—a tailwind for Mexican bank lending.
+ **Competitive Labour:** Mexican labour costs (e.g., manufacturing wages) have been fairly stagnant over the past decade, while labour costs for competing exporters such as China and Brazil have risen sharply—increasing Mexico's attractiveness for foreign investment.

± **Limited Commodity Price Exposure:** Over the past several decades, Mexico's economy diversified away from oil export dependence. Net oil exports are less than 3% of GDP, so Mexican equities have limited exposure to the negative price effects of the recent surge in global supply.

+ **Leading Economic Indicators:** After decelerating from 2010-13, Mexico's LEI index is now accelerating—implying continued growth.

### Political Drivers

± **Major Political Reforms:** President Enrique Peña Nieto has already pushed sweeping reforms through Congress. However, these favourable reforms are now well known, and moving forward, implementation risk is elevated.

± **Energy Reform:** President Peña Nieto is opening the state-controlled Energy sector to private investment, which should help reverse recent production declines and drive foreign direct investment in the sector. However, the fall in oil prices may limit the near-term investment previously expected from these reforms.

+ **Financial Reform:** Recent financial reforms increase lender protections and collateral claims, which should help spur credit growth.
+ **Labour Reform:** The liberalisation of hiring and firing should improve Mexican firms' competitiveness and draw more workers into the formal economy.

± **Anti-Monopoly Laws:** Strong anti-monopoly laws, particularly in telecom and broadcast media, threaten entrenched market leaders by opening up competition. However, these reforms should promote supply development, lowering costs for the economy.

### Sentiment Drivers

- **High Valuations:** Mexican shares trade at a valuation premium versus most EM peers—implying shares may largely already reflect Mexico's relative strength.

+ **Consumer Confidence:** The Mexican consumer is showing few signs of exuberance as the confidence index remains below 2006 and 2013 peaks.

## Overweight Indonesia

Since the fall of its military dictatorship in 1998, Indonesia has accelerated supply-side reforms. Today, relatively healthy credit growth, improving infrastructure, expanded free trade and increased political stability are driving investment and productivity gains.

### Economic Drivers

+ **Labour Costs:** Huge supply of labour resulting in labour costs among Asia's lowest.
± **Credit Growth and Low Penetration:** An underpenetrated credit market led to a surge in credit and booming domestic economy. Growth has slowed some, though it remains among the highest in major Emerging Markets and relatively strong globally.
- **Inflation Remains Elevated:** Inflation remains stubbornly high, limiting Bank Indonesia's ability to support the economy. The central bank is expected to remain on hold through the second half of 2015.
± **Perceived Vulnerability to External Shocks:** The rupiah was one of the worst performing Emerging Markets currencies in 2013 as elevated deficits and the US's end to quantitative easing sparked capital flight fears. However, expectations for economic reform under President Widodo's administration as well as the positive fiscal impact from further fuel price increases should calm fears of the country's external position.
+ **Favourable Demographics:** Indonesia's population is the world's fourth-largest—77% are between 15 and 45 years old—providing a significant pool of productive labour. A younger population promotes favourable trends in labour and consumption.

### Political Drivers

+ **Rising Infrastructure Investments:** The government has called for $450 billion in new infrastructure by 2019 and for the first time ordered ministries to give the private sector priority on projects over state agencies. Expected projects include 24 seaports, 15 airports, a 50% increase in refinery capacity and a 65% increase in electricity generation. President Widodo has also accelerated the pace of public tenders – in May alone, nearly 40% of project tenders for the full-year were issued, suggesting investment should help drive second half growth. Infrastructure bottlenecks and inadequate supply-side reforms have been chief growth impediments in recent years—a key area of focus for President Widodo.
+ **Market-Oriented Reform:** After initial difficulties following a weaker-than-expected showing in parliamentary elections and a cabinet reshuffle, President Widodo is making progress on market-friendly reform. His government lowered required down payments for first-time home purchases by 10 percentage points to 20%, announced plans to cut corporate taxes from 25% to 18% over next few years to become more competitive with regional neighbours, gave tax holidays to businesses and pledged more measures to revive economic activity.
- **Government Interference in Resource Sector:** The government instituted an export ban on nickel and bauxite to capture a bigger share of domestic resource processing as Indonesia lacks the ability to fully process the minerals. Other minerals, such as copper, zinc and iron ore, will face increased export taxes from 20% to 60% in 2016 before exports are fully banned by 2017.
+ **Subsidy Reform:** In November 2014, President Widodo announced an additional, much-anticipated fuel price increase, nearly halving the fuel subsidy bill to 1.6% of GDP this year. The government is now proposing to remove electricity subsidies in 2015.
+ **Eminent Domain Reforms:** Government departments can now seize land for infrastructure projects with compensation and relocation expenses determined by an independent auditor—similar to US eminent domain laws—driving a strong increase in investment.
- **Restrictive Labour Laws Hurt Employment:** Indonesia's severance laws are among the world's most restrictive, requiring 108 weeks of severance pay even if an employee is fired for justifiable cause—including stealing.

### Sentiment Drivers

± **Valuations:** Until recently, relative valuations hovered around the highest levels compared to Emerging Markets peers since 1999. But summer 2013 tapering fears brought the price-to-earnings ratio below the 10-year average.
+ **Overblown Tapering Fears:** Indonesia and other countries in the "Fragile Five" were disproportionately and adversely impacted by unfounded "tapering" fears and should continue to see relief in the coming quarters.

## Overweight South Korea

Continued recovery in developed-market demand should support export-oriented countries like South Korea, but recent currency strength has offset an otherwise positive backdrop. Domestically, accommodative monetary and fiscal policy support economic fundamentals. The relative portfolio weight is primarily a residual of sector and equity-specific decisions.

### Economic Drivers

- \- **Loose Japanese Monetary Policy:** Ongoing loose monetary policy from Japanese Prime Minister Shinzo Abe's administration significantly weakened the Japanese yen relative to the South Korean won to the detriment of South Korean exporting competitors.
- \+ **Exports Leveraged to Developed-Market Recovery:** With signifigant exports to the US and Europe, the South Korean economy should benefit from improving developed-world economic fundamentals. Rising exports historically coincide with higher equity prices.
- \+ **Rising Free Trade:** Since 2010, Korea has signed or implemented free-trade agreements with countries representing over 40% of total exports, including the Association of Southeast Asian Nations (ASEAN), India, Colombia, Peru, the European Union and the United States. Negotiations with China and Japan are ongoing.
- \+ **Low Commodity Prices:** South Korea imports nearly all of its energy needs and is one of the biggest beneficiaries of lower oil prices in Emerging Markets.
- \+ **Steepening Yield Curve:** Muted inflation and recovering domestic economic fundamentals likely keep monetary policy loose, while tapering and quantitative easing's end in the US and eventually elsewhere should push long rates higher. With more than 90% of loans variable rate, commercial banks are poised to benefit from a steeper yield curve. Banks should benefit further from stronger developed-market demand through SME customers focusing on exports.
- ± **Consumer Debt Levels:** In 2011, regulators threatened to cap consumer loan growth rates at the level of nominal GDP growth if banks didn't voluntarily comply with reduced debt level goals, leading to a significant bank-lending slowdown. While consumer debt levels remain elevated (~90%/GDP), debt servicing costs have since eased, and the government introduced measures to increase affordability and cut property taxes that should support a nascent housing recovery.

### Political Drivers

- \+ **Government Policy Supportive of Growth:** In response to MERS and weaker-than-expected trade, the government announced another fiscal stimulus package for the second half of 2015 of KRW15 trillion (~1.5% of GDP). It also introduced a financial investment promotion programme, including liberalising overseas M&A and raised investment caps for insurance companies. Monetary policy also remains accommodative, with rates at an all-time low of 1.5%.
- ± **Tax Changes to Promote Investment:** New tax law provides tax benefits to incentivise wage hikes, taxes "idle" corporate cash to promote investment or shareholder payout and cuts taxes on dividend income for both large and small shareholders.
- \- **North Korea Overhang:** North Korean dictator Kim Jong-un has conducted several missile launches and nuclear tests since taking power, raising tensions on the peninsula. While South Korea's President Park Geun-hye has pledged to increase engagement with Kim's regime, many attempts to do so have quickly proven unsuccessful.

### Sentiment Drivers

- ± **Business Sentiment:** President Park Geun-hye, a member of the pro-business Saenuri party, is sympathetic to Korea's mega-conglomerates, and large firms likely view the pro-business status quo as positive. However, she campaigned on gradual business reform, and though she watered down some pledges throughout the campaign, firms may remain wary of corporate reforms.

## Underweight South Africa

We expect South Africa to underperform as commodity supply continues to outpace demand and insufficient infrastructure constrains growth.

### Economic Drivers

- **Relative Performance Highly Correlated to Metals:** Approximately 10% of the MSCI South Africa is comprised of gold and precious metal firms, compared to just 2% for the MSCI EM. We expect metals to underperform in the period ahead, which likely drags on South Africa's overall performance.
- **Vulnerable to External Shocks:** Unlike the other perceived EM "Fragile Five" countries, South Africa is legitimately at risk to external shocks given the size of its dual deficit (current account and budget), minimal foreign currency reserves and economic reliance upon precious metal exports.
- **Commodity Exporter:** As a major precious metals exporter, South Africa's exports are hurt by falling prices and weaker global demand, which also impact local spending trends as fewer imported dollars weaken local producers' consumption.
- **Power Shortages:** South African state-owned utility Eskom (produces 95% of the nation's power), continues struggling to efficiently produce and distribute South Africa's electricity. Until power is delivered reliably, ongoing investment remains questionable—particularly in energy-dependent sectors like Metals & Mining and heavy manufacturing.
- **Tightening Monetary Policy:** The central bank has caved to the pressures of a declining rand, hiking short-term rates at a time when economic growth is weakening, compressing the yield curve and further pressuring economic growth prospects.

### Political Drivers

- **Labour Unrest:** The country's dominant mining industry faces consistent labour unrest. Strikes in August 2012 caused the deadliest labour unrest in the country's history, leading to significant strike-related production stoppages. There was significant upheaval again in 2014, with production stoppages at major platinum and gold mines, followed by the manufacturing sector.
- **Elevated Deficit Leading to Fiscal Consolidation:** The budget deficit is perpetually above target, and the government aims to reduce the deficit to 3.1% of GDP in 2015/16. Therefore, policymakers face tight spending limits amid a frail economic recovery, raising the probability of tax increases.
- **Lack of Political Checks and Balances:** South Africa essentially has a one-party system, with the African National Congress (ANC) currently holding 66% of Parliament—increasing the risk of extreme legislation and implying little challenge to the ongoing implementation of controversial legislation, including Black Economic Empowerment (BEE) and greater state control of strategic sectors.

\+ **Strongest Property Rights in Africa:** Relatively strong property rights compared to the rest of Africa provide a starting point for most firms expanding into sub-Saharan Africa.

### Sentiment Drivers

± **Currency Correlation:** Movement in the rand/US dollar exchange rate is highly correlated with South Africa's relative performance, demonstrating the impact of foreign capital flows on performance.

- **Valuations:** Forward P/E is above historical averages and well above EM peers, implying investors may be overly optimistic relative to reality.

## Underweight Taiwan

Taiwan's equity markets are heavily weighted toward commoditised Technology firms—a category less likely to benefit from growth trends in mobile and cloud computing. The relative portfolio weight is primarily a residual of sector and equity-specific decisions.

### Economic Drivers

- **Commoditised IT Hardware Exposure:** Exports are heavily weighted to increasingly commoditised technology components (i.e., production and hardware focused) and less leveraged to key industry trends such as mobile and cloud computing, which we currently favour.
- **Hawkish Monetary Policy:** While Taiwan's interest rates have been stable since 2011, they are relatively high by global standards, and policymakers have shown little indication they intend to reverse the five rate hikes enacted since mid-2010 in any effort to spur growth.
- **Strong Taiwanese Dollar:** With nearly 75% of its economy based on exports, Taiwan's strong dollar poses an obstacle to growth and erodes profit margins for technology exporters. A weakening Japanese yen or Korean Won could further hurt commoditised exporters.

± **Moderating Loan Growth:** Bank lending growth remains soft but positive, averaging+3.5% y/y in 2015, while non-performing loan ratios remain exceptionally low at 0.27%.

### Political Drivers

± **Cross-Strait Relations:** Recent scandals, including the China trade pact protests (Sunflower Movement), have increased tensions between the more China-friendly ruling party (KMT) and minority parties. Such scandals have swayed public opinion towards the minority party who lead in national polling. A win by the progressive party (DPP) in national elections, scheduled for early 2016, could put closer Chinese ties at risk.

± **Mixed Fiscal Policy:** Taiwan's corporate tax rates dropped from 25% to 17% in 2010 and remain among the most competitive both regionally and globally. However, a recent increase in the capital gains rate and the banking sector tax, both meant to help close the country's persistent fiscal imbalance, likely create a small ongoing fiscal drag.

### Sentiment Drivers

± **Softening Macroeconomic Expectations:** Investor sentiment around Taiwan ebbs and flows with global GDP expectations because it's a heavy exporter. Taiwan growth expectations have softened somewhat for 2015 despite expectations for global GDP reacceleration in the second half of the year.

## Underweight Russia

Russia's weak private property rights and President Vladimir Putin's willingness to geopolitically isolate Russia deter foreign investment and weaken sentiment. Substantial economic dependence on oil and natural gas revenues leaves the country exposed to changes in commodity prices.

### Economic Drivers

- **Market Overweight to Natural Resources:** With a majority weight to Energy and Materials, the performance of the MSCI Russia is largely determined by commodities—specifically, MSCI Russia is highly correlated to the global Energy sector.
- **Stagflation:** Russia is officially in recession, yet inflation has spiked above 15%, meaning stagflation is in effect. This was accomplished through a combination of poor geopolitical, monetary policy, and economic decisions. While inflation may have already peaked , economic contraction likely continues.
- **Weak Private Property Rights:** The government has a history of appropriating firms (e.g., Yukos, 2003 and recent event with Bashneft), effectively revoking licenses (e.g., Royal Dutch Shell, 2006) or changing tax royalties (e.g., Mechel, 2008)—a drag on sentiment and large deterrent to Foreign Direct Investment.

± **Low Credit Penetration:** Credit penetration remains relatively low compared to other EM countries. Russian individuals and small businesses outside the major cities are rapidly gaining access to traditional banking operations, helping spur economic growth. However, recent massive short-term rate hikes to protect the currency sharply inverted Russia's yield curve, reducing the likelihood Russia realises the benefits of low credit penetration, at least for the immediate future.

### Political Drivers

- **Geopolitical Isolation:** Russia's annexation of Crimea in Ukraine—against international claims of validity—led to international sanctions with potentially significant economic isolation from Europe and the United States.
- **Putin's Grip on Power:** Putin can remain president through 2024 (two consecutive six-year terms)—which would make him Russia's longest-serving leader since Stalin. Combined with his willingness to confront western powers, his reign is likely to continue scaring away long-term capital investment.
- **Western Capital Markets Sanctions:** Russia's private sector—particularly its banks and energy companies—are effectively blocked from raising debt or issuing new equity offerings in every major developed market, pressuring the cost of capital.
- **Monetary Policy Guided by Currency Protection:** The central bank was forced to intervene multiple times in the currency market as the ruble lost half its value in 2014. While 2015 has seen a recovery, currency risks remain high given pervasive inflation risks, sanctions and geopolitics.

± **Oil Drives Government Budget:** With roughly 50% of total government revenues tied directly to the Energy sector, a $10 move in Brent oil prices is estimated to adjust government revenues by 1.5% of GDP. Based on its tax dependence, marginal tax rates on oil production amount to roughly 90%.

### Sentiment Drivers

- **Putin's Record:** Putin's history of meddling with private enterprise exacerbates fears of government intervention in the private sector, likely keeping investors away. After a brief period of moderation pre-Sochi Olympics, Putin's nationalistic streak has reached post-Cold War highs with the Crimea annexation.

\+ **Cheap Relative Valuations:** MSCI Russia's Price-to-Earnings ratio trades at a substantial discount to its 10 year average, MSCI ACWI Energy and MSCI Emerging Markets, ranging from a 40-60% discount—indicating sentiment on Russian equities is quite dour, leaving room for upside surprise versus weak expectations.

## Underweight Brazil

We expect Brazil to underperform as weak commodity prices, poor domestic policies and tight monetary policy constrain growth.

### Economic Drivers

- **High Inflation:** State-subsidised lending, falling commodity export prices and price controls have driven inflation well above the target rate.
- **Tight Monetary Policy:** In response to problematic inflation, Brazil's central bank has waged an aggressive tightening campaign, contributing to the current recession and likely weighing on future consumption.
- **Current Recession:** High interest rates and a weak labour market are crimping domestic demand, while government spending slows amid fiscal imbalances, leading to the country's worst recession in decades.
- **Commodity Oversupply:** Brazil is the world's second-largest iron ore exporter, and the past decade's surge of Australian iron ore capex threatens iron ore prices.

### Political Drivers

± **"Car Wash" Scandal:** The Brazilian Energy sector bribery scandal has weighed heavily on Brazilian equities. While arrests continue and the wave of countrywide protests creates uncertainty for investors, much of the shock value from this event is likely past.

- **Weakened Leadership:** President Dilma Rousseff's popularity has fallen dramatically – among both the general public and Congress – amid the "Car Wash" and other campaign investigations, stymying attempts to close the fiscal deficit through spending cuts.

± **New Taxes:** Since the beginning of 2015, Brazil has implemented or weighed new taxes targeting imports and the mining and financial sectors. However, since fuel price regulations force the Brazilian oil industry to sell imported fuel at a loss, the fuel taxes should be a tailwind for Brazilian Energy as fuel imports weaken.

- **Protectionism:** Protectionist lobbies from Brazil and Argentina continue holding back progress on the EU-Mercosur free-trade agreement. Further, the emerging and more open Pacific Alliance poses a competitive threat that could further weaken Mercosur exports.

### Sentiment Drivers

± **Neutral Valuations:** Recent underperformance appears more driven by fundamentals than sentiment: Multiples have not significantly changed versus peers.

*Country positioning is based on a representative Fisher Emerging Markets Equity portfolio as of 30/09/2015.*

**Exhibit 15: Portfolio Country Weights vs. MSCI Emerging Markets Index, as of 30/09/2015**

| Country | Relative Weight | Fisher EM | MSCI EM |
|---|---|---|---|
| India | 9.0% | 17.9% | 8.9% |
| Mexico | 2.2% | 7.0 | 4.8 |
| China | 2.0% | 25.4 | 23.4 |
| Indonesia | 2.0% | 4.1 | 2.1 |
| South Korea | 1.7% | 17.2 | 15.5 |
| Thailand | 1.4% | 3.6 | 2.2 |
| Philippines | 0.9% | 2.4 | 1.5 |
| Peru | 0.7% | 1.1 | 0.4 |
| Turkey | 0.0% | 1.4 | 1.4 |
| Czech Republic | 0.2% | 0.0 | 0.2 |
| Egypt | -0.2% | 0.0 | 0.2 |
| Hungary | -0.2% | 0.0 | 0.2 |
| Greece | -0.3% | 0.0 | 0.3 |
| Colombia | -0.5% | 0.0 | 0.5 |
| Poland | -0.6% | 1.0 | 1.6 |
| United Arab Emirates | -0.8% | 0.0 | 0.8 |
| Qatar | -1.1% | 0.0 | 1.1 |
| Malaysia | -1.1% | 2.0 | 3.1 |
| Chile | -1.3% | 0.0 | 1.3 |
| Brazil | -1.4% | 4.7 | 6.1 |
| Russia | -2.4% | 1.4 | 3.8 |
| Taiwan | -2.9% | 9.6 | 12.5 |
| South Africa | -6.6% | 1.2 | 7.8 |

*Excludes cash. Source: Eagle Investment Systems LLC. China includes an opportunistic weight to Hong Kong via the company, Sands China Ltd., which derives all of its revenues from China.*

## Sector Positioning

### Overweight Information Technology

The Information Technology sector is heavily skewed toward large, high-quality firms, a segment we expect to outperform in the later stages of a bull market. The sector should also benefit from a reacceleration of global IT spending driven by the growing demand for products and services related to mobile, cloud computing, and the "Internet of Things".

#### Economic Drivers

+ **Strong Corporate Fundamentals:** Strong corporate profitability, healthy balance sheets and low financing costs should support increased technology expenditures. 2015 global IT services and enterprise software spending is expected to grow in excess of global GDP, driven primarily by trends in cloud computing as well as an aging equipment replacement cycle.
+ **Mobile Technology Boom:** Rapid adoption of mobile technology is altering consumer spending habits on electronic hardware—increasing spending on smartphones, tablets, and wearables as well as the infrastructure needed to support the mobile computing ecosystem.
+ **The Internet of Things (IoT):** The burgeoning trend toward adding communication capabilities to a large swath of previously unconnected consumer electronics and industrial devices should drive a wave of activity and broadly benefit the Technology sector beyond component makers.

± **Cloud Computing Productivity Gains:** Cloud computing can potentially reduce cost burdens for businesses of all sizes, increasing technology capacity utilisation, reducing IT staffing needs and increasing productivity of a more mobile workforce. Cloud investments should benefit enterprise software and hardware providers across the sector.

- **Traditional Computing Stagnating:** As a long-term trend, high computer penetration, and the shift toward mobile computing are eroding demand for traditional devices like desktops and laptops.

#### Political Drivers

- **Government Austerity:** Nearly 15% of global IT spending comes from local, regional and national governments, which continue to operate with fiscal restraint.

#### Sentiment Drivers

+ **"Growth" Characteristics:** Technology shares tend to be more growth than value oriented, a style we favour in the period ahead. As the market matures, investors will increasingly prefer Technology companies with stable and higher margins.
+ **Mega-Cap Equities:** The Technology sector contains some of the world's largest companies by market capitalisation. As the equity bull market matures, investors are likely to favour high quality companies with stable balance sheets and geographically diverse revenue streams.

- **High Expectations:** Expectations of certain high growth areas within Technology such as the Internet-of-things, big data, virtualisation, and software-as-a-service are quite ambitious, setting the bar high, not to be easily exceeded.

+ **Low Valuations:** As a whole, the Technology sector is trading at steeply discounted valuations relative to the market in recent history. We expect this gap to narrow in the future, providing a tailwind to Technology shares.

## Overweight Health Care

Health Care should benefit from increasing investor preferences for larger , higher quality companies with long term growth prospects. Within the sector, larger Pharmaceutical firms are offsetting key patent expirations through pipeline development, M&A, licensing and rapid Emerging Markets growth.

### Economic Drivers

+ **Emerging Markets Health Care Demand:** Huge swaths of Emerging Markets populations are breaching key income thresholds, allowing for the purchase of pharmaceuticals and medical devices for the first time.
+ **Balance Sheet Strength:** Financial flexibility of large Pharmaceuticals firms allows for increased research and development, share buybacks, dividends and strategic acquisitions.
+ **Favourable Developed World Demographics:** Aging and longer-living developed world populations should increase total health care expenditures.
+ **Robust Pipelines:** A rapid decline in patent expirations and positive pipeline development are broadly underappreciated.

± **BioSimilar Competition:** The FDA's approval of generic biotechnology drugs will introduce new competition yet minimal discounting, manufacturing challenges and regulatory hurdles likely limit the severity of competition relative to generic pharmaceuticals.

± **Labour Markets and Improving Demand:** High unemployment rates and the associated loss of insurance coverage earlier in the economic cycle have put negative pressure on medical spending, but improving economic conditions should increase patient utilisation rates and hospital capital expenditures.

- **Regional Austerity:** Budget-conscious governments in the developed world are attempting to slow the growth rate of health care spending.

### Political Drivers

+ **Uncertainty Dissipating:** With the majority of uncertainty surrounding implementation of US health care legislation seemingly past, regulatory risk likely declines moving forward, boosting sentiment.

± **Drug and Device Approval:** Pipelines and new product approvals are improving despite a relatively tight regulatory environment.

### Sentiment Drivers

+ **Preference Shift to Growth:** We expect Health Care to benefit from investors' preference shifting to larger companies with higher quality growth opportunities. Additionally, large pharmaceutical firms possess many mega cap characteristics that we believe investors favour in the latter stages of a bull market, such as higher profit margins, diversified revenues, strong cash flow & balance sheet and brand recognition.

± **Premium Valuations:** Valuations are no longer at a deep discount to the broad market, suggesting today's positive fundamentals are only modestly underappreciated.

## Overweight Financials

Positively sloped global yield curves, healthy balance sheets and improving capital market conditions surpass ongoing regulatory headwinds.

### Economic Drivers

+ **Positively Sloped Yield Curves:** In most developed countries, the yield spread remains wide, with short rates remaining low and long rates above levels seen at the beginning of this cycle, providing positive earnings spread. This gives well-capitalised banks an incentive to accelerate loan growth. This is particularly true in the US and UK, while Japan and the eurozone continue to see tighter yield curves.
+ **Credit Quality Is Improving:** The credit cycle is favourable outside of the eurozone, and banks are benefitting from a release in loan-loss reserves and improved asset quality.
+ **Banks Deploying Capital:** Well-capitalised institutions are deploying capital via dividends, share repurchases and acquisitions, despite regulatory constraints.
+ **Capital Markets Activity Beginning to Accelerate:** IPOs of profitable and quality companies is gaining momentum, similarly, M&A activity is gaining traction, with predominantly cash deals (rather than speculative LBOs). Both are highly profitable endeavours for investment bank underwriters & advisors.
+ **US & UK Housing Market Recovery:** The ongoing US & UK housing recovery helps support bank balance sheets and should drive future mortgage origination.
- **Rebuilding Balance Sheets Reduces Profitability:** Financials firms are subject to far more stringent capital requirements and threats of modified business structures than in previous cycles. While its impact is less dramatic than it was earlier in the cycle, it will remain a headwind to bank profitability and syphon funds away from more innovative projects towards compliance for the immediate future
- **Banks Not Lending Aggressively:** In most countries, while modestly positive and accelerating, loan growth remains well below pre-crisis levels, as credit standards remain conservative with management still giving strong capital ratios priority over loan growth. The US seems to be an exception, since its large banks recapitalised more quickly than peers in other developed countries.

### Political Drivers

+ **Federal Reserve 1st Rate Hike:** US Banks are uniformly well positioned for the pending rate hike cycle, with short duration assets easily rolled over at higher yields when the cycle commences.

± **Regulatory Interference:** Regulatory uncertainty surrounding Dodd-Frank, Basel III, Solvency II, financial transaction taxes and other regulatory measures continues to pressure core lending and investment banking activity. While the impact has waned as measures have been diluted and visibility has improved, uncertainty remains.

- **High Capital Requirements:** Globally, more stringent rules were proposed on Basel III's Leverage Ratio, with the US and UK both requiring ratios above international guidance.
- **Ongoing Litigation:** Expensive litigation seems to have shifted geographic focus, from the ongoing and very expensive fines of large US Banks across the Atlantic to Large European Banks.
- **Unwinding of Extreme Monetary Policy:** The Fed has created $2.6T in excess reserves that is parked on bank balance sheets, as they begin to raise interest rates the Fed needs to effectively soak up this excess liquidity to establish a floor on short interest rates. The ON RRP programme should accommodate their needs, but it's a new, never before used programme and may have unintended consequences.

### Sentiment Drivers

+ **Valuations:** The Financials sector is trading at a discount relative to other sectors and itself historically, suggesting room for investors to bid up shares as fundamentals improve—particularly in the later stages of a bull market.
+ **Maturing Equity Bull Market:** Improving long-term equity market trends should bolster asset management and investment banking activity as investors gain confidence in a maturing bull market.

## Neutral Consumer Discretionary

The economically-sensitive sector should benefit from better-than-expected global growth, minimal inflation and improving credit access. The relative portfolio weight is primarily a residual of country and equity-specific decisions.

### Economic Drivers

+ **Global Growth:** We expect global growth to outperform low expectations – a tailwind to the economically-sensitive sector.
+ **Yield Curve:** A steep yield curve has historically been a forward-looking indicator of Discretionary outperformance, and the 10Y-3M US Treasury yield spread is currently wider than the long-term average.
± **Favour Online Consumption:** Online retail sales, which have consistently grown 10-15 percentage points faster than brick-and-mortar sales, are likely to continue taking brick-and-mortar market share.
+ **US Housing Recovery:** US home prices should benefit from relatively tight supply, relaxed lending standards, fewer non-performing loans and a modestly steep yield curve to stimulate mortgage lending.
+ **Low Inflation Risk:** Consumer Discretionary equities typically underperform in the later stages of bull markets when inflation accelerates. While the risk of inflation tends to increase as bull markets mature, we still believe it is too early for inflation to significantly increase.
± **Emerging Markets Differentiation:** We expect Emerging Markets consumption to grow faster in countries undergoing structural reforms and with less dependence on commodity exports. Further, we favour exporters that should benefit from an economic recovery in the Developed World.

### Political Drivers

± **Net Neutrality:** The FCC announced new regulations regarding how Internet Service Providers (ISPs) manage network traffic. ISPs may be marginally hurt by more stringent rules while content providers may benefit.
+ **China Consumption Shift:** China's political strategy of reducing investment-led in favour of consumption-led growth should be a tailwind for Chinese consumption equities relative to equities exposed to Chinese investment.
- **Chinese Conspicuous Consumption:** However, some Chinese luxury products consumption and VIP gaming may continue facing headwinds tied to political reform discouraging conspicuous consumption.
- **Japanese Consumption Tax:** Japan increased the consumption tax from 5% to 8%, a negative driver for Japanese consumption equities. However, the second phase of the tax hike – increasing the rate to 10% – was delayed from October 2015 to April 2017.

### Sentiment Drivers

± **Moderate Valuations:** Relative sector valuations are neutral versus earnings and sales but expensive versus book values.

## Neutral Consumer Staples

While the Consumer Staples sector has above-average gross margins and quality earnings growth—features we prefer late in bull markets—the sector's defensive characteristics may present a performance headwind amid growth in global economic activity. The relative portfolio weight is primarily a residual of country and equity-specific decisions.

### Economic Drivers

- \- **Yield Curve:** Historically, the steeper the yield curve, the weaker the forward relative returns of the more defensive Staples sector, and the 10Y-3M US Treasury yield spread is currently wider than the long-term average.
- \+ **Gross Margins:** Firms with large gross margins tend to outperform later in bull markets. On average, Staples firms have larger gross margins than market peers.
- \+ **Quality:** Firms with more stable, high-quality earnings growth, such as Consumer Staples, tend to outperform later in bull markets.
- \- **Global Growth:** We expect global growth to outperform low expectations – a headwind to the traditionally defensive Staples sector.
- \+ **Many of the World's Largest Firms:** Consumer Staples has a large number of above-average equities by market capitalisation. In maturing bull markets, such larger firms tend to outperform.
- \- **E-Commerce:** The growth of e-commerce retailing, which is more concentrated in the Consumer Discretionary sector, is likely to continue taking market share from brick-and-mortar Food & Staples Retailing.
- ± **Emerging Markets Differentiation:** We expect Emerging Markets consumption to grow faster in developing regions with less dependence on commodity exports, and we favour Mexican firms due to a combination of structural reforms and linkages to the recovering US economy.
- ± **Tobacco:** Tobacco is an unattractive way to benefit from strengthening US and European economies since cigarette usage is in long-term decline. However, tobacco remains a growth industry within the Emerging Markets.

### Political Drivers

- \- **Chinese Political Reform:** Chinese political reforms discouraging conspicuous consumption are likely to remain a headwind for the Beverages industry.
- \- **Japan Consumption Tax:** In 2014, Japan increased the consumption tax from 5% to 8%, a negative driver for Japanese consumption equities. However, the second phase of the tax hike taking the rate to 10% was delayed from October 2015 until April 2017.
- ± **Mexican Reforms:** Mexico recently implemented new taxes on sugary beverages and high-caloric foods in an effort to reduce obesity, but we believe the positive effects on Mexican growth from the broad reform agenda for Energy, Banking and Telecom more than offset the tax headwind.
- \- **Tobacco Regulations:** Several Emerging Markets governments such as Korea and Indonesia have recently increased tobacco regulations including smoking bans in public places and mandated graphic warnings on packaging.

### Sentiment Drivers

- \- **Emerging Markets Valuations:** Sentiment towards Consumer Staples in Emerging Markets is high, driving premium relative valuations.
- ± **Developed Markets Valuations:** Developed World Staples valuations are within historical norms, providing evidence of neither bullish nor bearish sentiment.

## Underweight Energy

Years of global oilfield investment should continue driving production capacity growth faster than demand growth, increasing the odds of weak oil prices. Consequently, profit growth in the Energy sector will likely lag the broad market.

### Economic Drivers

- **US Oil Investment and Innovation:** A decade of intense oil industry investment and new innovation has dramatically enhanced oil companies' ability to extract oil from previously unreachable resources. We expect oil prices to remain low, reflecting the oil industry's enhanced ability to meet global demand growth.
- **OPEC Production:** OPEC's policy of increased production, targeting market share in competition with North American oil producers, should keep oil prices relatively low.

± **Falling US Oil Rig Count:** The oil price plunge has forced US oil companies to reduce drilling in high-cost regions. While this should marginally support prices, many investors argue (we believe falsely) this will cause oil prices to rise swiftly again. However, past oil booms also witnessed falling rig counts, and oil prices remained low afterward for some time.

- **Thin Gross Profit Margins:** Late-stage bull markets typically favour firms with large gross profit magins as they afford firms greater flexibility and often result in more reliable and stable future earnings. The Energy sector has thin profit margins, which should result in underperformance relative to other sectors.
- **Low Energy Intensity of Developed Markets (DM) Growth:** Relative to Emerging Markets (EM) peers, DM countries use less energy per unit of GDP growth. We expect oil demand to lag strong aggregate global demand growth as DM GDP accelerates, while EM growth decelerates.

### Political Drivers

- **Chinese Rebalancing:** China's policy of promoting consumption versus investment growth should reduce the energy intensity of Chinese GDP growth.
- **EM Fuel Subsidy Cuts:** In an effort to improve competitiveness, several EM countries have begun cutting fuel subsidies. While we believe these cuts are sound policy that ultimately strengthen public finances and promote aggregate growth, they incrementally reduce oil demand growth.

± **Geopolitical Supply Disruptions:** The global oil market remains exposed to supply shock risks in Russia, the Middle East and North Africa. A significant increase in social unrest or outright conflict has potential to drive oil price spikes. However, these risks are frequently present, difficult to time and often short-term.

± **US Crude Oil Export Ban:** Political will may be shifting toward easing and/or lifting altogether the US crude oil export ban. A full lifting of the ban would help North American exploration and production companies, hurt US Gulf Coast refiners, and moderately hurt the overall sector by adding to downward pressure on global oil prices.

### Sentiment Drivers

- **Today's Costs Not a Future Price Floor:** We believe many investors have false confidence oil prices can't remain low because today's costs represent a price floor. However, as oil prices fall, operators in the highest-cost areas slow drilling, causing marginal production costs to fall. These drilling cuts lead to idle equipment, driving costs lower elsewhere. This mechanism is capable of keeping oil prices weak moving forward.

## Underweight Industrials

Industrial categories most heavily reliant on resources pricing for profits face headwinds, but other categories should benefit from global economic acceleration and improving credit availability. The relative portfolio weight is primarily a residual of country and equity-specific decisions.

### Economic Drivers

+ **Automation Equipment:** Lack of qualified labour and rising wages in Emerging Markets along with improving productivity in Developed Markets are contributing to increased demand for factory automation equipment.
+ **Global Trade Rebound:** Much of the sector directly benefits from a likely positive surprise from reaccelerating global trade. We expect global trade to beat today's modest expectations.

± **Global Credit Availability:** Industrial customers' access to credit continues to improve in the US and UK as a wide yield curve increases banks' incentive to lend, likely fueling stronger-than-expected capital expenditures growth in those regions. However, loan growth is expected to decelerate in China.

- **Weak Resource Pricing:** Low resource prices are a significant headwind for future extraction equipment demand.
- **Slowing Order Rates:** As orders shift from short (quickly filled orders) to long cycle (multi-year products), order rates likely slow, impacting revenues.

### Political Drivers

+ **Chinese Minimum Wage Growth:** The Chinese government is targeting an annual 13% minimum wage increase through 2015, supporting the need for labour-saving machinery, and making manufacturing labour costs elsewhere more competitive.
+ **Government Infrastructure Spending:** Developing countries are expected to spend about $1.5 trillion a year through 2020 to meet infrastructure demand.

### Sentiment Drivers

- **Size Preference Shift:** As bull markets mature, investors tend to seek firms with high earnings stability, brand recognition, pricing power and better credit access. Such firms tend to have larger-than-average market capitalisations—a headwind for Industrials as the sector has relatively few very large firms.

## Underweight Utilities

Utilities should underperform given our forecast for an ongoing bull market, weak power price fundamentals and the sector's thin gross profit margins.

### Economic Drivers

- **Thin Gross Profit Margins:** Late stage bull markets typically favour firms with large gross profit margins as they afford firms greater flexibility and often result in more reliable and stable future earnings. The Utilities sector historically has thin profit margins, which should result in underperformance relative to other sectors.

± **Interest Rates:** We expect neutral long-term interest rates over the next 12 months, which should have a neutral impact on the yield-sensitive Utilities sector. Expectations for the Federal Reserve to hike short-term interest rates should make US Utilities' dividend yields less attractive as bond substitutes.

± **Structural Growth:** Strong efficiency gains limit structural growth potential in developed markets. Conversely, inadequate infrastructure makes Utilities a growth industry within Emerging Markets.

\+ **Gas over Electric:** Low natural gas prices and EPA coal regulations should promote volume growth for gas Utilities.

- **Power Prices:** Gas-fired power plants usually provide peak load power, so power prices are heavily influenced by natural gas prices. Since the shale boom is boosting US natural gas supplies, prices should remain low, limiting the relative performance of US independent power producers. Gas prices are higher outside the US, but we believe risk is to the downside due to high levels of international gas investment.

### Political Drivers

- **German Regulations:** Following Japan's nuclear disaster, German regulators increased focus on renewable energy sources, which lowers overall utilisation by requiring high-cost, flexible reserves to be maintained for periods when renewable power is unavailable.

± **US Regulations:** Environmental Protection Agency coal regulations create winners and losers, as do the costs of coal to natural gas conversions and closures of some coal-fired plants. Regulated utilities are best positioned to pass regulated costs along to customers.

\+ **Japanese Regulations:** While public support remains mixed, Japanese regulators have begun bringing some nuclear capacity back online. The pace of the restarts is likely gradual and eased by the low prices of imported fossil fuels.

- **Brazilian Regulations:** Following major tariff reductions several years ago, the Brazilian government is now backtracking, allowing power prices for consumers to rise. However, as part of this deal, the state will provide fewer subsidies to the Utilities at a time when customers are already struggling to pay their bills. Brazil's drought has raised electricity prices, by stifling hydroelectric power production and forcing Utilities to use higher-cost sources of power.

### Sentiment Drivers

± **Valuations:** Most relative valuation metrics fall within historical norms, indicating neutral sentiment toward Utilities.

## Underweight Materials

Metals prices – a key driver of sector returns – continue to fall as infrastructure led growth in metal demand from Emerging Markets is slowing while supply growth continues accelerating.

### Economic Drivers

± **Commodity Supply Growth:** Capital expenditures on new production capacity resulted in rapid increases in the global supply of both copper and iron ore, among others. However, a recent decline in planned capital expenditures in response to lower prices has reduced expected supply growth rates over next couple of years.

- **Changing Chinese Consumption:** Despite minor stimulus programmes used to buoy GDP growth, China's government is no longer using infrastructure spending as its primary mechanism to boost economic output — key to Materials as China is the primary driver of global demand growth for many industrial commodities. Meanwhile demand for other commodity consuming goods (i.e. autos) hasn't offset declining infrastructure spending.
- **Industry Cyclicality:** Cycles of outperformance tend to be followed by cycles of underperformance of similar magnitude, due in part to the industry's supply response to changing commodity prices. The current underperformance cycle began in 2011 but is following a historic outperformance cycle.

± **Commodity Arbitrage Deals:** Low borrowing costs and high interest rate spreads between US and Chinese bonds create commodity arbitrage opportunities that lock up metals in warehouses, creating a new source of demand. These financing deals increase both the amount of metals stored in warehouses and the price of the metals, whereas historically the two moved inversely. Should these deals unwind there would be a surge in global metal supplies and a drop in demand at a time when supplies are already growing faster than demand.

± **Specialised vs. Commoditised:** Global economic growth continues to drive demand for many end markets within the sector. However, in a moderate growth environment, specialised products likely have better pricing power than more commoditised products, favouring downstream firms over upstream producers.

± **Falling Input Costs:** The recent decline in oil price and continued low natural gas prices reduce input costs for many Chemicals companies, driving margin expansion as input costs fall faster than selling costs. Lower oil prices also reduce costs for most commodity producers, thereby pulling down cost curves. This in turn creates a headwind for prices of fungible commoditised chemicals and metals as producers compete mostly on price, limiting revenue growth for many producers.

### Political Drivers

± **Resource Nationalism Raises Production Costs and Limits Supply:** Government intervention within commodity producing companies can lead to increased taxes, decreased exports or even outright expropriation of resources. Just this year, new legislation in Canada, Indonesia, Australia, among others, is expected to increase production costs in key commodity producing countries, hurting company profitability.

### Sentiment Drivers

- **Valuations:** Valuations for global Materials are in line with their 10 year averages and the broader indices. However, with weaker fundamentals, these valuations are likely too lofty.
- **Preference Shift from Cyclical Growth to Secular Growth:** Historically, cyclical industries lead in the early parts of a bull market but begin to lag as the bull market matures, unless inflationary pressures start driving commodity prices higher. With the current bull market past the halfway point and subdued inflationary pressures, it seems unlikely cyclical commodity producers will outperform.

## Underweight Telecom Services

The defensive nature of the sector and historically high political and regulatory influences are risks to sector outperformance.

### Economic Drivers

- **Developed Wireless Markets Saturated:** Most of developed Europe, the US and developed Asia have mature markets with penetration rates near or above 100%. Opportunities still exist, particularly with respect to rising smartphone penetration. However, broader wireless market saturation limits subscriber growth in developed markets.
- **Price Competition Intensifying:** Pricing competition remains high and increasing as penetration rates among premium (smartphone) users increase and as a lack of product differentiation among incumbents increasingly forces them to compete on price.

± **Rising Emerging Markets Middle Class:** Low saturation rates of wireless service and wire-line Internet in Emerging Markets provide significant growth opportunities for local service providers as well as carriers from those developed markets still expanding. However, Emerging Markets subscribers generally have lower margins. Further, high competition limits potential average revenue-per-user growth.

± **Mobile Data Usage Rising Globally:** Increasing demand for wireless data services is a positive revenue driver for firms globally. However, companies' ability to convert higher revenues into increased profits is limited by increased handset subsidies (for smartphones) as well as high infrastructure investments required to cope with increasing data demand.

\+ **Telecom Growth Trends:** Telecom firms benefit as enterprises increasingly demand cloud-based, infrastructure-as-a-service offerings.

### Political Drivers

- **Heavy Regulation and Political Influence:** Recent proposals by the European Parliament to enshrine Net Neutrality into law as well as actions by the FCC in the United States to regulate broadband providers add uncertainty to the sector's prospects.

± **State-Sponsored Oligopolies:** Many companies enjoy state-sponsored oligopoly status as large domestic telecommunications networks are deemed critical to national security. Such designation can be a fickle benefit as such companies are at the whims of governments and regulators who may ultimately look to break up such oligopolies as in the case of Mexico and America Movil.

### Sentiment Drivers

- **Traditionally Defensive Sector:** Telecom is historically a defensive sector and more likely to underperform during bull markets and outperform during bear markets due to investor perception of Telecom as a sector with stable cash flows.

*Sector positioning is based on a representative Fisher Emerging Markets Equity portfolio as of 30/09/2015.*

**Exhibit 16: Portfolio Sector Weights vs. MSCI Emerging Markets Index, as of 30/09/2015**

| Sector | Relative Weight | Fisher Emerging Markets | MSCI Emerging Markets |
|---|---|---|---|
| Information Technology | 11.6% | 29.7% | 18.1% |
| Health Care | 6.6% | 9.5 | 2.9 |
| Financials | 1.9% | 30.5 | 28.6 |
| Consumer Discretionary | 0.8% | 10.2 | 9.4 |
| Consumer Staples | -1.0% | 7.8 | 8.8 |
| Telecom Services | -3.2% | 4.2 | 7.4 |
| Materials | -3.3% | 3.3 | 6.6 |
| Utilities | -3.4% | 0.0 | 3.4 |
| Industrials | -4.7% | 2.8 | 7.5 |
| Energy | -5.7% | 1.8 | 7.5 |

*Excludes cash. Source: Eagle Investment Systems LLC.*

## Portfolio Holdings & Characteristics

### Top Ten Holdings

**Exhibit 17: Top Ten Holdings, as of 30/09/2015**

| | Name | Equity Weight (%) | Country | Sector |
|---|---|---|---|---|
| 1 | TENCENT | 4.7% | China | Information Technology |
| 2 | DR REDDY'S LABORATORIES | 4.7% | India | Health Care |
| 3 | HDFC | 4.4% | India | Financials |
| 4 | TAIWAN SEMICONDUCTOR | 4.0% | Taiwan | Information Technology |
| 5 | TATA CONSULTANCY | 3.0% | India | Information Technology |
| 6 | PING INSURANCE | 2.9% | China | Financials |
| 7 | SAMSUNG ELECTRONIC | 2.9% | South Korea | Information Technology |
| 8 | NAVER | 2.3% | South Korea | Information Technology |
| 9 | CIPLA | 2.3% | India | Health Care |
| 10 | CHINA MOBILE | 2.2% | China | Telecommunication Services |

*Based on a representative Fisher Emerging Markets Equity portfolio, excluding cash. Source: Eagle Investment Systems LLC.*

### Buys and Sells

**Exhibit 18: Buys, Q3 2015**

| Equity | Country | Sector |
|---|---|---|
| There were no new buys during the quarter. | | |

*Based on a representative Fisher Emerging Markets Equity portfolio, excluding cash. It should not be assumed recommendations made in the future will be profitable or will equal the performance of securities in this review.*

**Exhibit 19: Sells, Q3 2015**

| Equity | Country | Sector |
|---|---|---|
| **ROSNEFT** | **Russia** | **Energy** |
| Russian integrated oil company, Rosneft, was sold to further reduce exposure to the Energy sector. Increased global production and tepid global demand growth should continue to depress oil prices, reducing the likelihood of future share outperformance. | | |

*Based on a representative Fisher Emerging Markets Equity portfolio, excluding cash. It should not be assumed recommendations made in the future will be profitable or will equal the performance of securities in this review.*

## Best and Worst Performing Issues

### Exhibit 20: Best Performers, Q3 2015

| Equity | Country | Sector |
|---|---|---|
| **DR. REDDY'S LABORATORIES** | **India** | **Health Care** |
| Indian generic pharmaceutical company Dr. Reddy's Laboratories outperformed due to a handful of FDA drug approvals. This alleviated fears that the current FDA hold on one of its manufacturing plants would slow FDA approvals. Additionally, strong results from India and the US coupled with Dr. Reddy's Q2 earnings gave further confidence to the market the manufacturing issue was not overly problematic. | | |
| **INFOSYS** | **India** | **Information Technology** |
| Indian IT services company Infosys outperformed as higher enterprise technology spending drove strong revenue gains in Financial Services (+11% y/y) and Manufacturing (+16% y/y). North America (+16% y/y) continued to accelerate, and sequential revenue growth was the strongest in the last 15 quarters. Additionally, attrition decreased to 21% vs. 23% in the year-ago quarter, utilisation crossed the 80% threshold and headcount growth was the highest since Q2 2012. | | |
| **HYUNDAI MOTOR** | **South Korea** | **Consumer Discretionary** |
| Korean auto manufacturer Hyundai Motor outperformed as Hyundai's auto sales and profits beat expectations on better than anticipated global sales volumes. This was due to healthy consumer demand for refreshed car models in its key sedan segment. Notably, Korean (Hyundai's largest geographic end market) sales volumes increased at a relatively faster pace versus the rest of the world, tied to an improving Korean economy. Management's proven track record for developing well received brands globally should continue to drive demand for its new and refreshed line of cars through the remainder of 2015. | | |
| **KT&G** | **South Korea** | **Consumer Staples** |
| Korean tobacco manufacturer KT&G outperformed as a 21% domestic price increase offset declining volumes attributed to a tobacco tax hike in January. Additionally, Ginseng sales rose 14% y/y given its perceived health benefits as fears of MERS contagion spread. Further, exports grew 44% y/y due to high Duty Free sales demand from Chinese tourists. | | |
| **HDFC BANK** | **India** | **Financials** |
| India's largest bank HDFC outperformed as investors sought refuge in higher quality banks with lower credit risk during recent Emerging Markets equity volatility. HDFC is also gaining market share domestically, supported by its low cost funding base and prior growth investments. | | |

*Based on securities' total contribution (i.e., their weighted absolute return), gross of fees, to a representative Fisher Emerging Markets Equity portfolio over the time period specified above, excluding cash. It should not be assumed recommendations made in the future will be profitable or will equal the performance of securities in this review.*

**Exhibit 21: Worst Performers, Q3 2015**

| Equity | Country | Sector |
|---|---|---|
| **CITIC SECURITIES** | **China** | **Financials** |
| China's largest investment bank Citic Securities underperformed due to a sharp correction in Chinese A shares, which negatively impacted trading activity and investment banking fees. We expect China to continue supporting capital markets reform that should benefit the company. | | |
| **LENOVO** | **China** | **Information Technology** |
| Mobile & computer technologies manufacturer Lenovo underperformed due to growth concerns about China. The company experienced weakening mobile device sales in China due to a maturing smartphone market and increasing competition. However, we believe Lenovo should benefit from enterprise technology spending and market share gains in Personal Computers, tablets and mobile. | | |
| **PING AN INSURANCE** | **China** | **Financials** |
| China's second largest insurer and retail bank Ping An Insurance underperformed as Chinese equities fell considerably, impacting Ping An's 15% equity allocation. Going forward, we expect sentiment on China to improve as growth remains positive and China avoids a "hard landing". Additionally, fundamentals for Chinese insurers remain strong with overall premium growth in high double-digits, driven by increasing insurance adoption rates amongst a rising middle class. | | |
| **CIELO** | **Brazil** | **Information Technology** |
| Leading Brazilian merchant acquirer and payment processor Cielo underperformed as Brazilian economic weakness overshadowed credit penetration and cashless payments growth. Credit (+2% y/y) and debit (+6% y/y) volumes decelerated while the average credit transaction size dropped 3% y/y. On the positive side, pricing improved as less attractive customers were dropped and point-of-sale rental fees were strong. Additionally, growth in operating expenses to support new initiatives appears to be slowing down, indicating potential for higher margins as transaction volumes grow. | | |
| **TENCENT** | **China** | **Information Technology** |
| Leading Chinese internet services provider Tencent underperformed on concerns over the impact of macroeconomic weakness. Advertising sales (+97% y/y) slowed despite growth in mobile advertisements, inventory, number of advertisers, better click-through rates and higher pricing. Mobile game revenue disappointed (+11% y/y vs. +82% last quarter) in the absence of major new title launches, while ecommerce related to physical goods continued to deteriorate as traffic is shifted to JD.com. Positively, the Tencent ecosystem continued to expand (WeChat +37% y/y to 600 million users, Qzone mobile +15% to 574 million users) and video advertisements doubled over the last year. | | |

*Based on securities' total contribution (i.e., their weighted absolute return), gross of fees, to a representative Fisher Emerging Markets Equity portfolio over the time period specified above, excluding cash. It should not be assumed recommendations made in the future will be profitable or will equal the performance of securities in this review.*

## Valuations

**Exhibit 22: Portfolio Characteristics vs. MSCI Emerging Markets Index, as of 30/09/2015**

| | P/E | P/B | Dividend Yield (%) | Weighted Average Market Cap ($ Mil) |
|---|---|---|---|---|
| Fisher Emerging Markets Equity | 12.3 | 1.9 | 2.0 | $40,897 |
| MSCI Emerging Markets Index | 10.7 | 1.6 | 2.7 | $34,113 |

*Based on a representative Fisher Emerging Markets Equity portfolio, excluding cash. Source: Eagle Investment Systems LLC.*

## Q3 2015 MARKET RECAP

### Country

Please see the table below for a list of major regional and country returns.

**Exhibit 23: Regional and Country Performance, as of 30/09/2015**

| Country/Region | Q3 2015 |
|---|---|
| MSCI India | -6.7% |
| MSCI Korea | -11.8% |
| MSCI Mexico | -12.0% |
| MSCI Russia | -14.8% |
| MSCI Taiwan | -16.9% |
| **MSCI Emerging Markets** | **-17.9%** |
| MSCI South Africa | -18.6% |
| MSCI China | -22.7% |
| MSCI Indonesia | -24.2% |
| MSCI Brazil | -33.6% |

*Source: FactSet.*

### India

India outperformed  with its large Technology and Healthcare sectors leading the way. These high margin industries continued to benefit relative to peers during a period of low global inflation, where pricing power is at a premium. The decision by the government to not apply a minimum alternative tax retroactively to foreign institutional investors also supported returns. Equities had significantly sold off earlier in the year when the government first announced it would be targeting foreign institutional investors before slowly recovering as the government reduced the potential scope of the tax and then finally removed its retroactive enforcement as a risk.

### South Korea

Korea outperformed as it bounced back from fears earlier in the year of Middle East Respiratory Syndrome (MERS) negatively impacting the country. Its ongoing monetary stimulus, with four rate cuts since the middle of 2014, along with a modest fiscal stimulus package announced at the end of Q2 appear to have helped stabilise the country during a period of heightened global economic fear.

### Brazil

Brazil underperformed amid a deteriorating economic and political environment. Estimates for economic contraction continue to grow, due in part to rising interest rates, high inflation, and a weakening employment environment. Political headwinds remain severe, with the embattled Rousseff administration unable to pass measures intended to restore the country's finances. Additionally, sentiment remains strongly negative due to the above-mentioned headwinds and the downgrade of the country's debt to junk status.

### Indonesia

Indonesia underperformed due to fears of a rapid slowdown in China, its largest trading partner. As a net commodity exporter with a current account deficit, Indonesia was also hurt by weakness in commodities and fears of capital outflows due to the start of interest rate increases in the US. The government announced a stimulus package in September focusing on deregulation of bureaucracy, with promises of more stimulus packages to come. However, investors remained sceptical due to previous pledges to simplify business regulations and increase infrastructure spending, which have been slow to come to fruition.

## Sector

Please see the table below for a list of MSCI Emerging Markets sector index returns.

**Exhibit 24: MSCI Emerging Markets Index Sector Returns, as of 30/09/2015**

| Sector | Q3 2015 |
|---|---|
| Health Care | -9.5% |
| Consumer Staples | -11.3% |
| Consumer Discretionary | -13.8% |
| Telecom Services | -15.6% |
| Information Technology | -16.0% |
| Industrials | -16.0% |
| Utilities | -16.8% |
| **MSCI Emerging Markets** | **-17.9%** |
| Materials | -19.4% |
| Financials | -21.4% |
| Energy | -25.3% |

*Source: FactSet.*

### Health Care

Health Care outperformed, driven by Pharmaceuticals, as investors rewarded the industry's defensive characteristics in a period of heightened global market volatility. The broader sector continues to gain investor favour on relatively attractive valuations, improving health care utilisation and a new innovative drug cycle.

### Consumer Staples

Consumer Staples outperformed as market weakness helped drive a flight-to-quality into the higher margin sector with more predictable earnings. Further, high M&A activity continued in Q3, further restricting Staples equity supply.

### Energy

Energy underperformed, moving lower with oil prices and commodities broadly. Buoyant production globally kept oversupply fears top of mind for investors, while periodic concerns over demand drove volatility. Additionally, weaker companies in the sector faced solvency concerns as a result of lower oil prices, weighing on sentiment for the group.

### Financials

Chinese and other EM Financials associated with Chinese growth were underperformers as the market digested the A-share bear market and future policy risk, proving the catalyst for a global correction. A further drag came from Financials in commodity exporting countries, as the high correlation between the banking sectors in net commodity exporting countries and commodity prices continued to hold up well.

**Should you have any questions about any of the information provided above, please contact FIE by mail at 2nd Floor 6-10 Whitfield Street, London W1T 2RE or by telephone at +44 (0)800 144-4731.**

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*i. FactSet, as of 10/06/2015. MSCI AC World Index returns with net dividends, 21/5/2015 – 29/09/2015.*
*ii. Ibid. MSCI AC World Index returns with net dividends, 30/06/2015 – 30/09/2015 and 31/12/2014 – 30/09/2015.*
*iii. FactSet, as of 06/10/2015. MSCI AC World ex-USA Index returns with net dividends, 27/04/2015 – 29/09/2015*
*iv. Eurostat, as of 02/10/2015*
*v. Irish Central Statistics Office, as of 10/09/2015*
*vi. Ibid.*
*vii. China National Statistics Burea, as of 01/10/2015*
*viii. FactSet, US Real Personal Consumption Expenditures, May 2015.*
*ix. Source: FactSet, as of 21/10/2015.*
*x. Source: FactSet, as of 28/09/2015.*
*xi. Source: FactSet, as of 02/11/2015.*
*xii. Eurostat, as of 27/7/2015.*
*xiii. The Conference Board, as of 4/11/2015.*
*xiv. Bloomberg, UK Office for National Statistics, as of 20/7/2015. Real Business Investment, 31/3/2004 - 31/3/2015.*
*xv. "Statement by Liberal Party of Canada Leader Justin Trudeau on the Trans-Pacific Partnership," 5 October, 2015. https://www.liberal.ca/statement-by-liberal-party-of-canada-leader-justin-trudeau-on-the-trans-pacific-partnership/*
*xvi. FactSet, China Ministry of Commerce, as of 8/10/2015. RMB/USD exchange rate as of 7/10/2015.*
*xvii. Beijing Municipal Tourism Commission and Tuniu Corporation, as of 16/10/2015.*
*xviii. FactSet, as of 22/10/2015. Shanghai Composite Index price returns, 12/6/2014 – 12/6/2015 and 12/6/2015 – 26/8/2015.*

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    d) Describe investment performance as it relates to your investment mandate;
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## Fisher Investments Institutional Group *Emerging Markets Equity* Composite Performance Disclosures

Fisher Investments Institutional Group claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. The firm has been independently verified for the periods January 01, 1990 through December 31, 2013. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Fisher Investments Institutional Group Emerging Markets Equity Composite has been examined for the periods April 01, 2006 through December 31, 2013. The verification and performance examination reports are available upon request. Performance is preliminary as of October 05, 2015.

1. Fisher Asset Management, LLC, doing business as Fisher Investments (FI), is an investment adviser registered with the US Securities and Exchange Commission. As of September 30, 2015 FI managed assets valued over $60 Billion. FI maintains two principal business units – Fisher Investments Institutional Group (FIIG) and Fisher Investments Private Client Group (FIPCG). FIPCG services substantially all private client accounts managed by FI and FIIG services substantially all institutional accounts managed by FI (including those accounts sub-managed for Fisher Investments Europe and Fisher Investments Australasia). The Investment Policy Committee is responsible for all strategic investment decisions for both business units.
2. The FIIG Emerging Markets Equity composite consists of accounts managed against the MSCI Emerging Markets Index (MSCI EM) with a view towards capital appreciation.
3. The MSCI EM Index measures the performance of selected stocks in 23 countries and is presented net of dividend withholding taxes and uses a Luxembourg tax basis.
4. For the period from April 1, 2006 through September 30, 2007, performance for this composite was determined using time-weighted rates of return, with valuation on at least a monthly basis and geometric linking of periodic returns. On October 1, 2007, Fisher Investments adopted a new performance calculation system using time-weighted rates of return, with valuation on a daily basis and geometric linking of periodic returns. Valuations are based on trade date. Neither leverage nor derivatives have been used in obtaining performance. Returns reflect the reinvestment of dividends, royalties, interest and other forms of accrued income. Composite performance is presented net of foreign withholding taxes on dividends, interest income and capital gains. Withholding taxes may vary according to each investor's domicile. Net performance figures are presented after deduction of actual management fees and are inclusive of performance based fees where applicable.
5. Valuations and returns are computed and stated in US Dollars.
6. The dispersion of annual returns is measured by the asset-weighted standard deviation across portfolio returns gross of fees represented within the composite for the full year. The composite dispersion is shown as N/A when there is 1 or fewer accounts in the composite for the full calendar year.
7. Fisher Investments Institutional Group standard fee schedule for Emerging Markets Equity (also listed in Part 2A of Fisher Investments' Form ADV) is: 1.00% on the first $25 million, 0.95% on the next $25 million, 0.90% on the next $50 million, 0.85% on the next $50 million, and negotiable beyond $150 million.
8. This composite was created in April 2006
9. A list of FIIG composite descriptions is available upon request.
10. The policies regarding valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
11. From March 2014 to September 2014, individual portfolio cash flows (either cash or in-kind legacy holdings) greater than 50% of portfolio assets were placed in temporary accounts until the assets were implemented or disbursed, and performance of these temporary accounts were excluded from the composite. Effective October 2014, the cash flow criteria was updated to either 50% of portfolio assets or $500 Million USD.
12. Three year annualized ex-post standard deviation is measured using asset-weighted monthly composite returns gross of fees.
13. Investment in securities involves the risk of loss. Past performance is no guarantee of future returns. Other methods may produce different results, and the results for individual portfolios and for different periods may vary depending on market conditions and the composition of the portfolio.