FISHER INVESTMENTS EUROPE™

FIRST QUARTER 2013

MARKET PERSPECTIVES

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FIRST QUARTER 2013 REVIEW AND OUTLOOK
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FIRST QUARTER 2013 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Strong global bull market returns continued in Q1. Fisher Investments (FI) continues to expect strong overall equity returns throughout 2013 led by the world's largest stocks.

Market Recap

While most global indices are off their previous high levels, headlines globally touted the US S&P 500 Price Index's all-time high—a nice, but meaningless milestone. Index levels—whether new highs, round numbers or past high-water marks, say nothing about future direction. Many fear new highs signal a long-in-the-tooth bull market. Bull markets die for many reasons, but age and magnitude alone are not among them. Many bull markets have run on for many years after surpassing a prior high. This "fear of heights" is bullish. It indicates sentiment remains mixed—such fears do not align with typically euphoric bull market zeniths. There is ample fundamental support for prices at present levels, which FI details in the full Review & Outlook.

Q4 US GDP growth was revised up to a still-tepid 0.4%. However, Q4 US revenues and earnings—a more direct reflection of economic health—were both nicely positive and better than expected. Through this bull market, earnings have overall risen with stock prices. Strong revenue growth shows firms are not relying solely on cost-cutting to boost profits. Most indicators broadly point to ongoing US and global expansion, and forward-looking indicators allude to continuing growth ahead. Positively, sentiment remains sceptical tied largely to many misunderstood or overwrought concerns like inflation, a eurozone implosion, high unemployment, too-slow growth, US debt and political discord. Such fears have failed to derail the bull market and their existence implies future economic and earnings growth simply are not fully reflected in stock prices yet.

Japanese shares rallied as new Prime Minister Shinzo Abe kicked off his economic agenda in earnest in Q1, passing fiscal stimulus worth 2% of GDP and appointing a new Bank of Japan Governor, Haruhiko Kuroda, who vowed to do "whatever it takes" to end 15 years of deflation. Abe's approval ratings soared above 70% in response, but unless Abe pursues deep economic reform, it appears the economy likely will not meet voters' lofty expectations—fiscal and monetary stimulus alone should not break Japan out of its long-running funk, as they do not address the causes. Abe did launch a reform push late in Q1, joining talks for three ambitious free trade deals, approving cabinet proposals to reform energy markets and proposing tax breaks for businesses offloading unprofitable subsidiaries. These are encouraging steps, but they must still pass through Japan's parliament, and they are far from cure-alls. Abe has spoken vaguely of further reforms, but for now, the extent of his appetite for change is unclear.

Moody's downgraded the UK's credit rating one notch from AAA to Aa1 in February with minimal market reaction. Sovereign yields fell over 30 basis points in the aftermath, closing Q1 at 1.77%—among the world's lowest. Markets seemed to understand Moody's decision was backward-looking and did not reflect the UK's forward-looking creditworthiness. Meanwhile, European political uncertainty grew in the wake of Italy's inconclusive election, but Italy's sovereign yields remained manageable. Cyprus became the latest eurozone nation to secure a bailout, wiping out a large portion of "uninsured" (greater than €100,000) bank deposits. While this is an ill-advised strategy, the global fallout is likely limited. FI will detail these topics and more in the full Review & Outlook.

China's political transition concluded as planned at March's National People's Congress, when Xi Jinping and Li Keqiang were named President and Premier, respectively. The new administration's policy plans appear to continue the previous regime's agenda—financial liberalisation remains a goal, and several measures to continue opening the economy were announced. However, there was some give and take on the policy front, as officials also announced anti-capitalist measures like new wealth taxes and forced disbursement of state-owned firms' profits. Looking ahead, reform likely continues, but with similar fits and starts. Economic data continued reaccelerating, though officials announced some tightening measures to cool property markets. A material slowdown appears unlikely. The official growth target remains 7.5%, and China has historically exceeded these benchmarks.

Mexico remained a bright spot in Emerging Markets as new President Enrique Peña Nieto's ambitious reform agenda took shape. Making good on promises to break with his Institutional Revolutionary Party's (PRI) monopoly-friendly past, Peña Nieto introduced legislation to introduce competition in telecom and media markets, and the PRI officially dropped its longstanding opposition to private investments in energy markets. Private investment and competition are needed badly throughout Mexico's economy, long dominated by the inefficient monopolies. With broad political support for these plans within the PRI and opposition parties, Mexico has its best shot at economic liberalisation on decades.

Other Emerging Markets weakened a bit as Brazil's economy slowed, Indian political uncertainty increased and Russia introduced tighter financial regulations. It is not unusual for Emerging Markets nations to contract amid a longer-term expansion. Overall and on average, FI expects Emerging Market economies to continue growing at a healthy pace, helping offset European weakness and buoying global growth.

While political uncertainty and economic malaise remain in Europe, FI believes global growth should continue against of tame global inflation and dour sentiment, with stronger areas buoying the rest of the world, even if at a slightly slower overall rate. As global equities continue to shrug off the political theatrics and mild uncertainty in favour of better global fundamentals like accelerating earnings growth—still underappreciated—FI maintains an optimistic outlook for 2013.

THEMATIC UPDATE & MARKET OUTLOOK

The Bull Continues

Q1 featured strongly positive bull market returns, which FI believes are a down payment on very positive full-year 2013 returns. A correction is always possible. However, since the last three years featured sizable corrections, many investors may expect one this year. In investing, when everyone strongly expects something to happen, it rarely happens as expected. Therefore, a full-blown correction may be somewhat less likely this year, but by their sentiment-based nature, corrections are impossible to predict.

Risks to the bull market exist, as they always do. However, in FI's view, today's material risks are so well known, they lack material market-moving power.

A Mix of Scepticism and Optimism

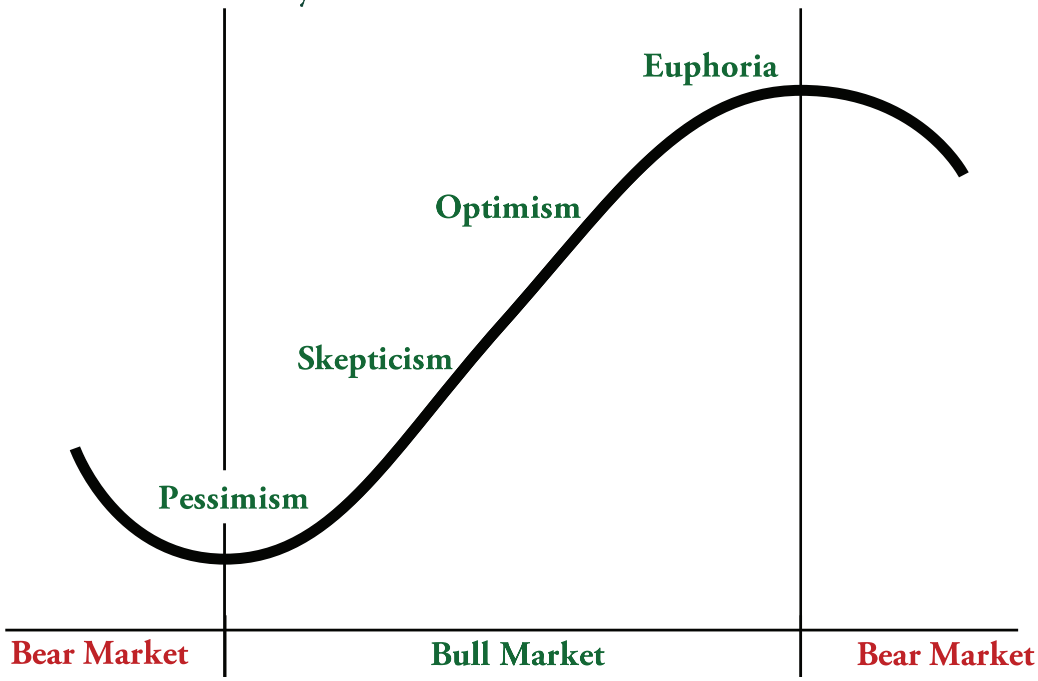
Despite increasing signs of optimism, sentiment remains mixed. The US fiscal cliff, mostly resolved as this quarter began, was not the disaster widely advertised. Nor was the sequester, which went into effect to much political uproar but very little fiscal fallout. Q4 GDP growth was revised up to a tepid but expansionary 0.4% annualised. The eurozone remains in recession, yet economic trouble seems largely isolated to that region and stocks have risen through it all. The failure of long-expected disaster to appear has melted some doggedly dour sentiment.

While not broadly so—plenty of scepticism remains. Yet, bad news does not signal the end of a bull. No bull market is pristine, and bad news is a constant. However, if bad news is widely known—as many prominent market fears are—then its market-moving power is likely diminished.

The mix of optimism and scepticism is consistent with FI's view we are at the bull market's midpoint, with much more bull market yet to come. As legendary investor Sir John Templeton said, "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." (Exhibit 1 illustrates this market sentiment life cycle.) In FI's view, investors still have one foot in scepticism and one in optimism. As FI has written in past Review & Outlooks, this is also the stage when category leaderships rotates to the world's largest stocks—a theme which typically persists for the remainder of the bull and through the peak. Beyond sentiment, global fundamentals also support ongoing bullishness.

Some categories of global stock indexes have reached or are approaching all-time highs (e.g. US stocks). Such milestones often engender "fear of heights"—the belief the bull market has run long enough and a new bear market is in the fore. However, index levels are meaningless to stocks. Bull markets often surpass a prior peak and run for some time. There is neither a right duration nor magnitude for a bull market. Bull markets can run on as long as fundamentals support rising prices. Further, fear of an impending market top actually diminishes the risk one is immediately in the fore.

Exhibit 1: Market Sentiment Life Cycle



Note: This hypothetical graph is illustrative and not indicative of actual returns or market behaviour.

How much longer the bull has to run FI cannot say with any precision. Forecasts out more than about 12 to 18 months are fraught with peril because they require a forecast of future stock supply—which is near impossible. FI is not aware of anyone who forecasts stock supply successfully or even attempts it. FI does continue to believe we are at or just past the mid-point of this bull market. However, FI monitors constantly for materially negative fundamentals few are considering that could potentially cause a bear market.

Every bull dies for different reasons (and age is not one of them). Some general features FI look for in an aging bull are near uniform euphoric sentiment, huge increases in IPOs, firms spending down cash, excessive equity-based (as opposed to cash or cash-and-equity-based) mergers and acquisitions, and at least a few long-established, notable bear market gurus capitulating. The appearances of one or a few of these are not enough to cause a bear market (or be signs of a bear market). There also needs to be a materially negative fundamental feature that is little appreciated.

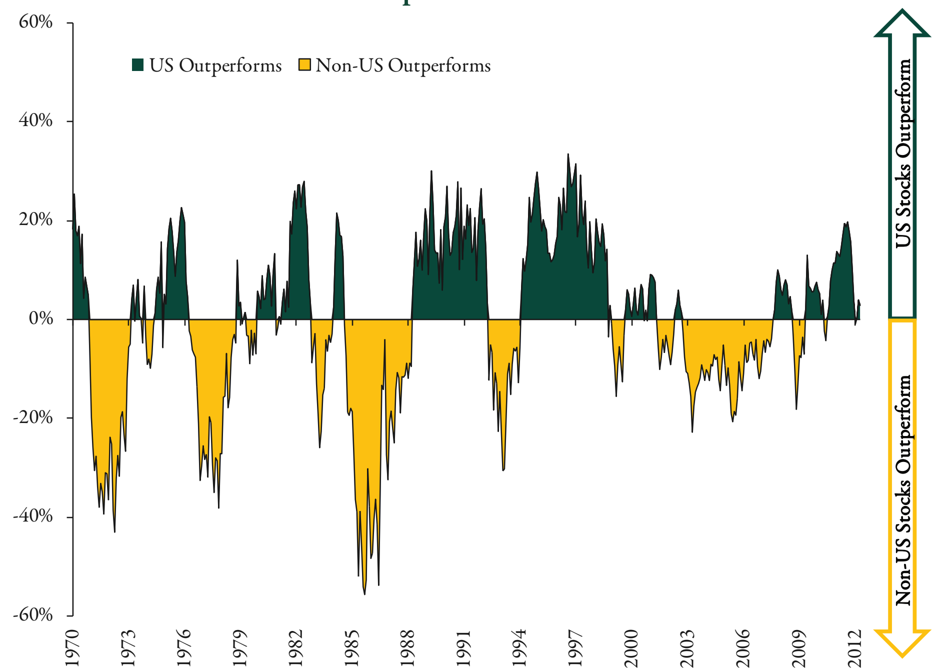
It is important to note not every bull market experiences the entirety of this sentiment progression—it is possible for something unforeseen by most to knock a bull market off course before sentiment becomes euphoric. For example, the last bear market did not feature a surfeit of euphoria at the top as the financial crisis truncated a bull that otherwise may have had a ways to run. Because of that, and the typical investor behaviour of fighting the last war, investors may expect the next bull market top to be similar to the last. Most likely, it will not be, postulating a return to a more "typical" bull market top (which is still tough to spot ahead of time) marked by widespread euphoria. FI is constantly looking out for significant yet overlooked risk factors, which may prematurely derail this bull market. Presently FI does not see any with a high probability of occurring. Should that change, FI would not hesitate to change FI's bullish forecast.

US Versus Global

On a cumulative basis, non-US stocks led the bull market that began on March 9, 2009 for its first two years. However, performance leadership often shifts, and since June 2011, US stocks have been outperforming the broader market. Cumulative US outperformance becomes more noticeable in August 2011—ironically, the same month Standard and Poor's downgraded the US's credit rating. US investors incorrectly tend to have too much US focus, and recent US outperformance has only exacerbated this domestic bias. FI expects US stocks to outperform in 2013 and possibly for the balance of the bull market thanks in part to the heavy concentration of mega cap stocks in the US, but the benefits of a global approach are myriad, outweighing near-term outperformance of any narrower category.

Finance theory tells us, over longer periods, no well-constructed equity category should yield superior returns over any other. Though the S&P 500 has outperformed recently, US stocks have lagged the non-US developed world over the past 10 years. Category leadership rotates irregularly. (See Exhibit 2)

Exhibit 2: Rotation of US and Non-US Leadership



Source: Thomson Reuters, as of 19/4/2013; MSCI USA Total Return Index from 1/1/1970 to 31/3/2013. Based in USD.

If no category is inherently better, then it is better to consider the benefits of diversification. The broader the benchmark, the more opportunities to manage risk and add value. Global stocks will always lag some narrower categories and lead others. However, the same is true for all-US stocks, all non-US or all-any-other-narrower-category—no one category of stocks is best for all time.

US Federal Reserve Update

Looking ahead, FI anticipates US Fed policy will keep short-term interest rates near generational lows for some time. The Fed has been exceptionally transparent about their plans moving forward, and unless the US economy reaccelerates sharply – causing materially higher inflation expectations – it is unlikely the Fed will alter its near-zero, short-term interest rate target soon. Of course, Ben Bernanke may be replaced as Fed head in January 2014, and it is possible, though unlikely, his sucessor changes the course of monetary policy. But there's no way for us to forecast that now.

Long-term rate moves are also likely to be modest and tied to tame inflation expectations. Even as bond investor risk appetite increases with improving equity sentiment, global central banks appear likely to continue acting as a source of demand, putting some downward pressure on longer rates.

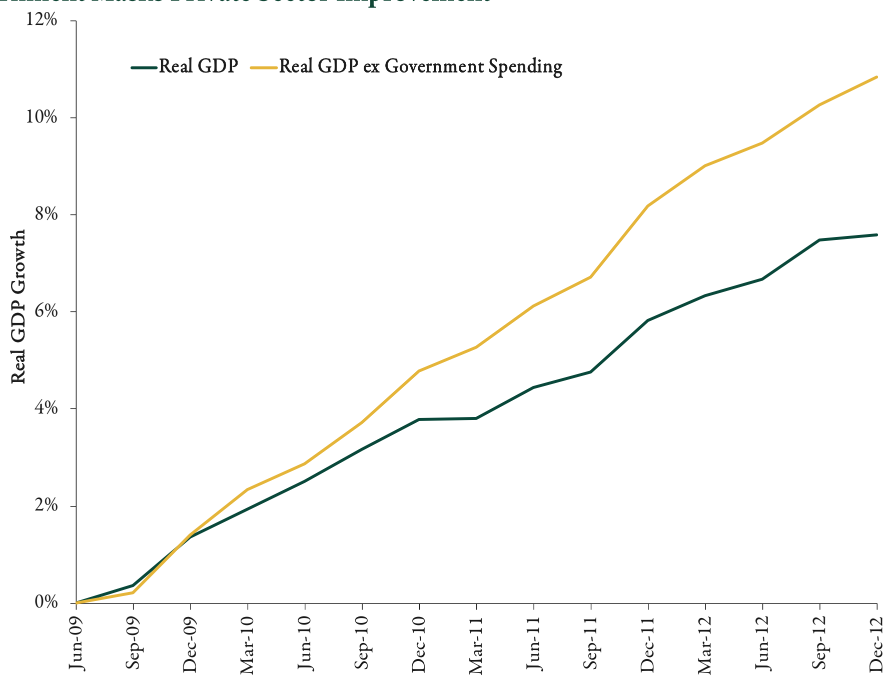
A risk factor less recognised—one FI believes bears close watching—is the monetary policies enacted by the Fed. QE-infinity, a widely known factor, is nearly ubiquitously misperceived in FI's view. Most fear higher inflation or what happens if the "Fed pulls the punchbowl"—a theory that implies the Fed is supporting growth. This is backwards in FI's opinion. There is no punchbowl; the money created under QE is largely on deposit at the Fed in the form of excess reserves, earning a small but competitive interest rate (relative to prevailing short-term rates). As FI wrote in FI's Q4 2012 Review & Outlook, FI believes the Fed's policy of seeking to depress long rates is contractionary and disin- or deflationary. Despite these policies however, the economy's continued growth is a testament to the resilience of the US private economy.

Fine Global Growth

Against ongoing fears of too-slow growth and an impending recession, US GDP tacked on another quarter of growth in Q4, and the expansion likely continued into Q1. Pockets of weakness exist (the eurozone, Japan, the UK, etc.), but much of the world's growth is either adequate (the US, Australia) or even rapid (much of the Emerging Markets)—with the larger, stronger economies pulling along smaller, weaker ones, not the reverse. FI anticipates overall fine global growth to continue through 2013.

US GDP growth rates have not been large, but headline GDP has been depressed in part by government spending, which detracted from growth in 10 of the last 14 quarters[i]. The government spending component of GDP has declined, which might seem odd since overall government spending is up. However, much of the increase in government spending was due to transfer payments (e.g., unemployment benefits), not direct spending or investment—transfer payments are not captured in GDP's calculation. Stripping out government spending, the US economy has annualised adequate 3% growth in the current expansion. (See Exhibit 3)

Exhibit 3: Government Masks Private Sector Improvement



Source: US Bureau of Economic Analysis, Thomson Reuters; as of 31/12/2012. Based in USD.

Fed policy, more contractionary than expansionary in recent years, has also somewhat dampened US growth. Until lending activity and the velocity of money picks up, inflation will likely remain tame. Even then, it can take some time to work through slack in the economy (unemployment, capacity utilisation, etc.) before inflation moves to troublesome levels.

While many would prefer quicker economic growth and job creation overall, moderate growth with low inflation have historically proven to be a very favourable environment for stocks.

Revenue and Earnings Strength

Many focus on GDP figures in gauging economic health, but GDP is an imperfect calculation and is not a direct reflection of the economy, nor is it intended to be. GDP is a government produced metric of domestic output, partially derived from surveys and assumptions. Its calculation allows for reasonable apples-to-apples output comparisons across time and countries. However, it has weaknesses. For example, if government spending radically increased and imports cratered relative to exports, that could result in big GDP increases. However, imports crashing could be a sign of trouble now, and radically higher government spending could set up bigger problems down the road.

Instead, FI believes better measures of global economic conditions are corporate earnings and revenue growth—both were nicely positive and better than expected in Q4. Q4 US earnings grew 6.3% year-over-year—the 12th consecutive quarter of growth—and a huge improvement over 2.8% beginning-of-quarter expectations and a new all-time high[ii]. (See Exhibit 4.) That is certainly not as fast as double-digit earnings growth earlier in this expansion, but as expansions mature, comparisons get tougher and earnings growth normally decelerates. The key factor now is earnings continue an upward trend and continue to best too-dour expectations. Further, an occasional quarter of negative earnings does not indicate the bull market's end. Rather, earnings growth deceleration prompts investors to seek stocks they believe will best withstand that environment—typically mega cap—warranting FI's current portfolio positioning.

Exhibit 4: Corporate Profits Hit All Time Highs

Source: Thomson Reuters, IBES Global Aggregates; as of 31/1/1985 - 29/3/2013. Trailing 12-month EPS shown through as-of date. Forward calendar 2013 EPS used for estimate. 2013 growth forecast from 29/3/2013 - 31/12/2013. Based in USD.

Top-line sales growth—a direct reflection of demand—was also more robust than expected in Q4, growing 3.6% y/y and besting estimates of just 1.9% y/y[iii]. Strong revenue growth shows firms are not relying solely on cost-cutting to boost profits, but are instead finding new ways to increase sales. Taken together, ongoing earnings and revenue growth illustrate a better-than-widely appreciated economic reality.

Another sign of ongoing economic growth: the US Leading Economic Index (LEI). LEI, a composite of 10 indicators is another a good (although not perfect) measure of future economic health. Right now, LEI is high and trending higher. In the last 50 years, recessions have not tended to follow shortly after a rising LEI trend. Instead, recessions tend to follow after LEI has fallen for some time already.

An Incremental Housing Tailwind

Housing data continues to improve—a small economic positive. When housing was weak, many investors feared it was a major negative, such that the economy would not recover without a strong housing rebound. However, housing in the US has always been of relatively minimal significance in the economy (6.3% at its Q4 2005 peak contribution, but only 2.6% in Q4 2012) and is not as impactful as many feared[iv]. In fact, housing continued weakening through much of the current expansion—too small to hold back growth.

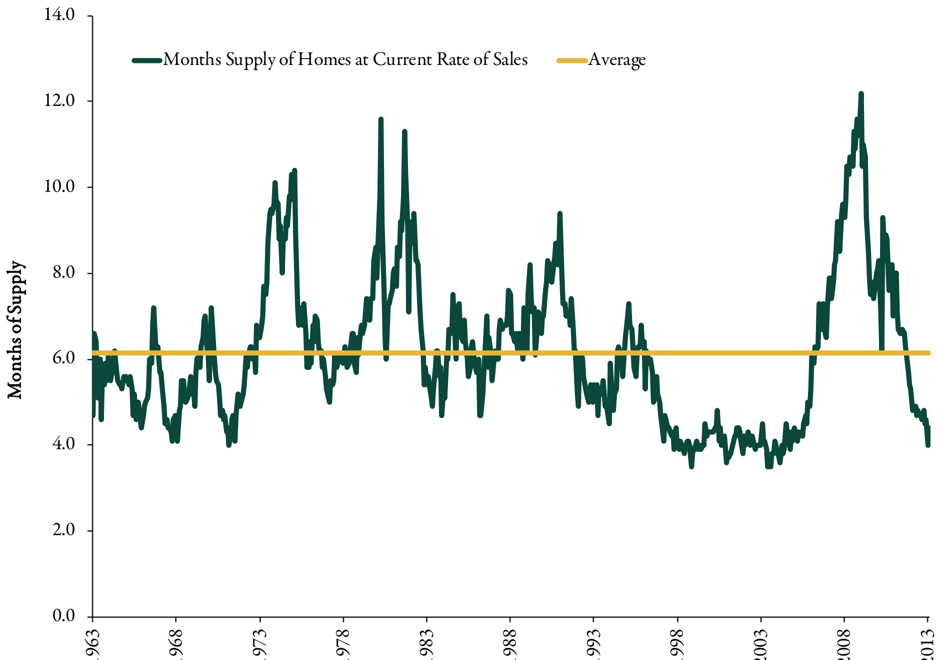
However, now that housing is in a legitimate and seemingly sustained rebound, there is not much (if any) talk about it being a huge positive. FI agrees! It is still too small. However, those who wrongly believed the economy could never recover while housing remained weak should view today's housing improvement as a huge economic positive. Yet they do not. They cannot have it both ways. Today, housing starts are at pre-Lehman levels and seem to be trending positively. For example, February starts were up a big 34.8% from a year earlier, or 968,000 new homes annualised. However, there is still plenty of room for improvement. March's new home starts were above a 1 million at an annualised pace—still below the 1.5 million average annual new homes built since 1959, but a big increase from recent years[v].

New home construction peaked in January 2006 at an annual pace just above 2.2 million starts. That figure had halved 19 months later and continued falling until hitting a 490,000-start trough in January 2009. (The lowest figure since records begin in 1959.) However, even after bottoming, growth was middling until mid-2011. This long period of relatively low construction activity pinches housing supply today. At the current sales rate, only 4.4 months of housing inventory is available in the US (new and existing housing) [iv]. This compares to an average 6.2 months since 1963[vii]. (See Exhibit 5.) Note how far supply has fallen since its 2009 peak. Meanwhile, lower home prices, extremely low mortgage rates and modestly rising incomes have housing affordability near all-time highs [viii]. (Exhibit 6)

Furthermore, when demand rises against low supply, all else equal, prices should rise. That is exactly what happened in 2012. Median US home prices were up 6.4% in 2012 on a 9.4% increase in existing homes sales[v]. (Exhibit 7)

These rising prices incentivise new construction starts, which in FI's view, should be a slight economic tailwind moving forward. For example, historically, the National Association of Home Builders Index (NAHB) tracks residential investment as a percent of GDP quite closely. Looking at the index today suggests residential investment as a percent of GDP is set to jump. (Exhibit 8)

Exhibit 5: Monthly Supply of Homes at Current Rate of Sales

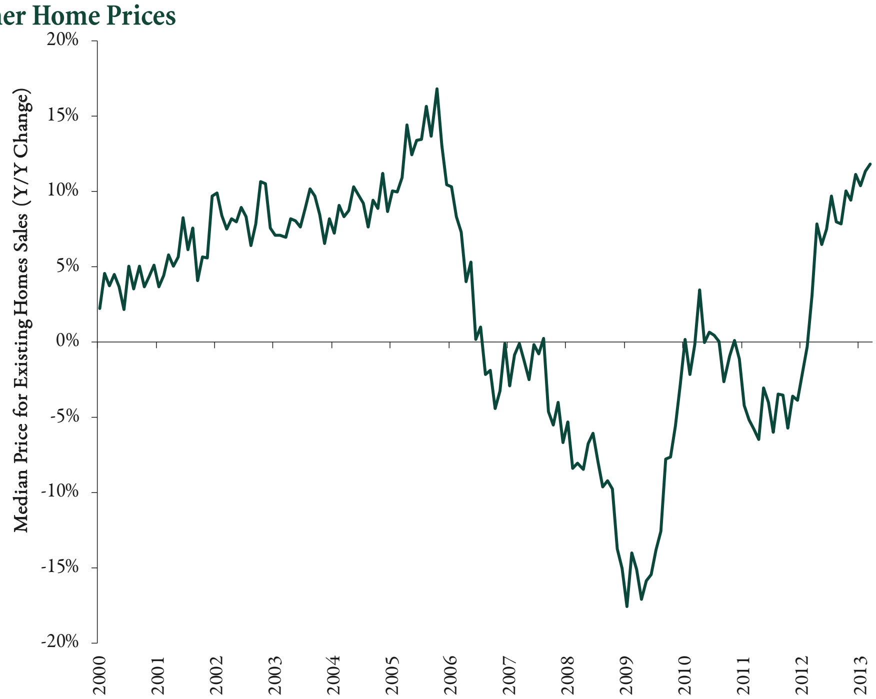


Source: Thomson Reuters,US Census Bureau as of 18/4/2013; 15/1/1963 - 15/2/2013 United States, New Home Sales, Ratio of houses for sale to houses sold (months supply), SA. Based in USD.

Exhibit 6: Housing Affordability Near All-Time Highs

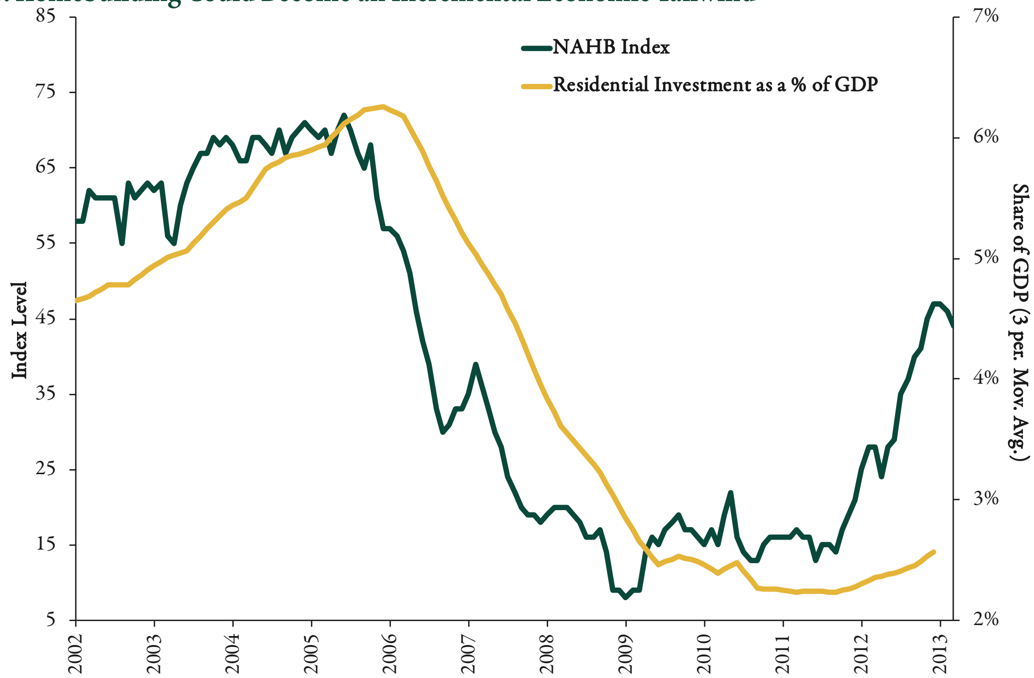
Source: National Association of Realtors, Thomson Reuters; as of 15/2/1981 - 15/11/2012. Based in USD.

Exhibit 7: Higher Home Prices



Source: National Association of Realtors, Thomson Reuters; as of 15/3/2013. Based in USD.

Exhibit 8: Homebuilding Could Become an Incremental Economic Tailwind



Source: US Bureau of Economic Analysis, National Association of Homebuilders, Thomson Reuters; Housing Market Index as of 15/1/2001 is shifted forward 1 year and based on a monthly survey of builders estimating sales expectations for single-family homes. From 15/1/2001 - 15/3/2013. NAHB Index as of 15/3/2013. Share of 3 month GDP as of 31/12/2012. Based in USD.

Again, while an improved housing market is indeed a minor plus economically, in FI's view, it is more valuable as a sentiment marker. Housing's rebound seems to get less positive attention compared to the negative attention witnessed on the way down—and, when mentioned, it is often considered illusory rather than being the real product of rising demand and tightening supply. The lack of realistic appreciation of housing's improvement provides a good example of sceptical sentiment—explaining FI's current positioning which stands to benefit from an improving housing market.

Rehashed Fears

Possible risks are omnipresent in investing—a fact of life. Their mere existence, however, tells you little. The key is assessing not the possibility, but the probability of sufficiently sized, fundamental and surprising (i.e., not widely known) negative factors potentially derailing a bull market.

In his January 2013 Forbes column, Ken introduced the concept of cud chewing—when the same fears get rehashed over and over. In FI's view, that is what has largely happened during the duration of this bull market. Investors broadly discuss many fears—but because they are so widely known and long gone over, their material market-moving power has been sapped. Some, like the eurozone's ongoing drama, had a new wrinkle in Q1 (the Cyprus bailout structure), but the overarching story is common knowledge and remains largely unchanged. Others, like the fiscal cliff, were merely overhyped and wrongly perceived from the start. Besides these well-known risks, FI sees few big enough to derail the bull market in 2013.

The Fungible Cliff

Through the back half of 2012, a near universal concern was the so-called US fiscal cliff—a political invention composed of the scheduled expiration of the "Bush tax cuts," automatic budget cuts (sequestration), the end of the temporary payroll tax holiday and other minor changes. Fears the fiscal cliff would near-automatically trigger a recession were widespread. Compounding those fears was a gridlocked government that seemed incapable of accord.

The fiscal fears were based on two broad misperceptions—which FI wrote on during much of 2012. First, the potential impact of tax code changes and government spending on the overall economy were overestimated. There's no convincing evidence that tax hikes lead to poor market returns—overwhelmingly and on average, stock returns are strongly positive in the 12 months following tax hikes. (In fact, average stock market returns are superior following tax hikes—which doesn't prove tax hikes are good or cuts are bad. Rather, neither on its own particularly impacts stocks much.) But perhaps more significant, the theory the US was headed off the fiscal cliff missed its political purpose—it was a wedge issue, useful for fundraising and garnering political capital with constituents. Hence, politicians blustered until the very last minute, then compromised (as FI expected).

The deal, signed literally hours before the first trading session of 2013, created a new tax bracket for high earners but extended the Bush tax cuts for the majority of Americans. The payroll tax holiday was allowed to lapse—as was widely expected. In totality, the changes are unlikely to have much macroeconomic impact—a molehill, not a cliff. Finally, the sequestration was can-kicked to 1 March setting up another Q1 inside-the-Beltway pseudo-crisis.

The Spending-Growth-Slowing Sequester

With the US fiscal cliff resolved, focus shifted to the sequestration—another rehashed concern. Sequester opponents argued the broad and indiscriminate "cuts," estimated at $1.2 trillion over 10 years, would wreak havoc. Some Republicans wanted to avert cuts to defense programmes but have flexibility to cut other spending. Democrats largely wanted to offset the cuts with tax increases—a point Republicans opposed.

What was lost in this political finger-pointing was, in its final form, the sequester was not a package of year-over-year spending cuts (a critical point FI made throughout the quarter in other writings). The often alluded-to cuts were actually a reduction in the rate of on-budget spending growth. While there are actual cuts in 2013 to some discretionary programmes and defense, they are more than offset by increased spending on so-called mandatory programmes like Social Security and Medicare. (FI says "so-called mandatory" because they are legislative constructs like any other government programme.) In calendar-year 2013, total US government spending is projected to grow—and spending is projected to grow every year thereafter. Sequestration, in FI's opinion, has minimal short-term impact (mostly sentiment based) and even less long-term implications on equity markets.

Europe

Eurozone fears have been an ongoing concern for over three years. Eurozone economic weakness and some political pressures remain, but the risks of a sudden eurozone dissolution—in FI's view, the primary factor giving eurozone issues more global reach in the past few years—have continued to dissipate.

For all the critiques of eurozone leaders—some deserved—their resolve to hold the eurozone together has been consistently underestimated. FI sees little reason to believe their resolve would suddenly weaken after spending tremendous political capital for three full years.

Germany

Germany holds federal elections in September, which could drive some modest uncertainty. But as vilified as she is in some parts of Europe, German Chancellor Angela Merkel remains very popular at home. Throughout the eurozone's crisis, she has consistently balanced two audiences: fellow EU leaders and her constituency. Her strategy seems to hinge on maintaining a hard-line "austere" public image, while softening out of the public's eye. Consider, few if any of the bailed out nations have met budget targets. Under original bailout agreements, this would have required additional austerity. Yet that is rarely enforced—the kinder, softer, deal-maker Merkel emerges when the spotlight is not shining.

This strategy has paid dividends. In a March poll, Merkel received a 68% approval rating for her job as Chancellor—making her easily Germany's most popular politician currently[ix]. A separate poll showed Merkel with a massive 62% to 27% lead over the Social Democrat challenger, Peer Steinbrück[x]. It is very early, so those figures will change, but Merkel seems off to a strong start.

Beyond the election, it seems Germany has too much at stake to reverse course and cease backing the euro: Money that has been lent via bailout vehicles or promised between euro-system central banks under Target2, the real time gross settlement system, and simple economic risk tied to crossborder trade and contracts associated with a sudden reversion to deutschemark.

Cyprus

Q1's eurozone wrinkle centreed on tiny Cyprus (less than 1% of eurozone GDP). Cyprus's debt woes were not new—a bailout request came in late 2012 after the two Greek sovereign bondholder haircuts greatly hurt Cypriot banks, which were hugely (and misguidedly) concentrated in Greek debt holdings. (Also serving as a potent reminder about the perils of not diversifying.) Cyprus's economy is dominated by these banks (swollen by large foreign depositors)—and banks' balance sheets in aggregate greatly exceed Cypriot GDP.

Cyprus turned to the International Monetary Fund (IMF), European Union (EU) and European Central Bank (ECB)—the troika—for aid, requesting a €15.8 billion bailout, an amount nearly equal to Cyprus's GDP. The IMF demanded Cyprus contribute €5.8 billion, suggesting a "solidarity tax" assessed on bank depositors. This is generally considered taboo in developed nations—it is effectively a seizure of previously off-limits and protected private property. What is more, under EU law, banks must insure deposits under €100,000, similar to US Federal Deposit Insurance Corporation (FDIC) protections. In short, it was a terrible idea. That plan got nary a single vote in the Cypriot parliament. Ultimately, the final plan protects deposits under €100,000 but subjects larger depositors to a far larger haircut. Most investors realised Cyprus's bailout was unique but feared it established a new precedent—a new "blueprint" for bailouts going forward—and worried about bank runs not just in Cyprus but elsewhere in Europe's periphery.

FI doubts it is a blueprint. All of the PIIGS (now, including a C) are (or have been) experiencing their own brand of weakness. Some of that extended to banks—like in Cyprus, Ireland and Spain. In Italy and Portugal, there was little bank weakness. And in each nation, bailouts were handled differently—as is appropriate. Should another tiny, Greek satellite with bank deposits four times the size of its GDP seem on the brink of bankruptcy, Cyprus indeed might be the model. But there is exceptionally tiny risk that Irish deposits, for example, will experience haircuts to collateralise Ireland's bailout.

Italian Elections

February's Italian Parliamentary elections ended in deadlock, with no party winning enough votes in both chambers to form a government. The three parties that won the most votes were Pier Luigi Bersani's centre-left Democratic Party, former (and seemingly perpetually embattled) Prime Minister Silvio Berlusconi's centre-right People of Freedom and comedian (no joke) Beppe Grillo's anti-establishment Five Star Movement. Efforts to form a grand coalition bridging the gap between these groups (or by cobbling together support from several smaller parties) failed. The resulting stalemate led some to fear the Italian election would drive volatility akin to Greece's contested elections last year—widely considered a source of the fear behind 2012's global market correction.

Yet the market reaction was fleeting at best in both bond and stock markets. In FI's view, Italian political fears are another example of a rehashed fear. Simply, markets have dealt with European political upheaval for some time now. Belgium went 18 months—much of the crisis—without a government. While Greece had a contentious election, it did not end disastrously. Spain and Portugal have both had significant turnover in their political leadership, and Portugal's Pedro Passos Coelho has survived four no-confidence votes in parliament since 2011.

Italy's path to forming a government is complicated due to unique quirks in its electoral system. There are a few options, but the two primary ones now are either, Italy's president calling new elections, or two of the major parties overcoming their differences and forming a grand coalition. Yet the first option was procedurally delayed—by law, Italy's president cannot call new elections in the last six months of his or her term. Current President Giorgio Napolitano's term was due to expire in May, with voting taking place in April.

Over the April 20-21 weekend, the situation became clearer. First, Bersani stepped down from the leadership post of his party, perhaps allowing a reset of coalition talks. Second, after a few rounds of voting, Napolitano became Italy's first president to win a second seven-year term. The 87-year-old Napolitano had previously stated he was not interested in a second tour in the mostly ceremonial role, but it appears he will serve. He has stated plans to work with the centre-left and centre-right parties in an effort to form a coalition. This is a developing situation, but it appears to us unlikely to merit altering FI's bullish outlook as of this writing.

Currency Wars

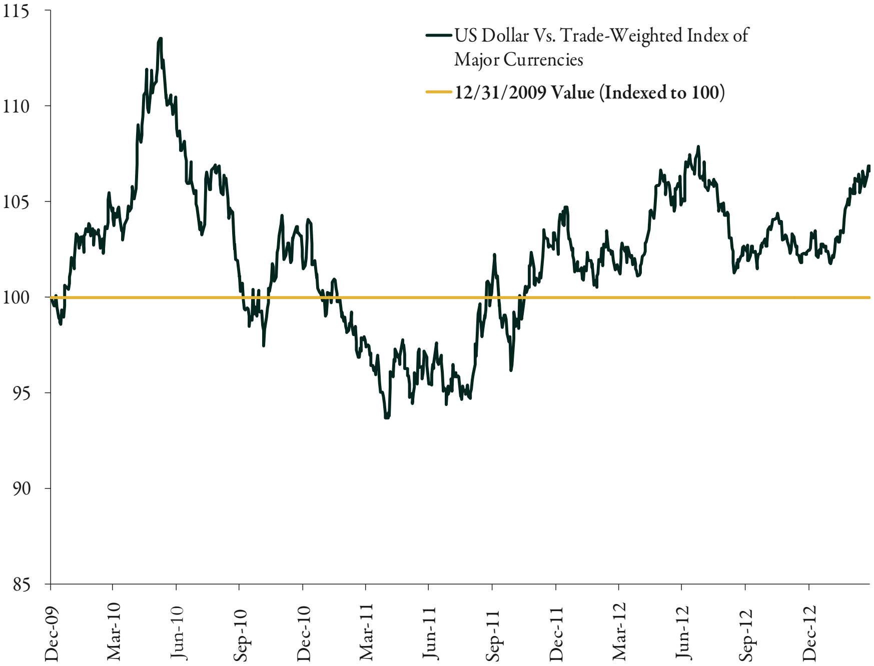
A recurring fear that came to the forefront again in Q1 was whether nations are "playing fair" with their currencies. Central banks have taken on ever-more activist roles in enacting unconventional—and often misguided—policies over the past few years. Some politicians have encouraged efforts by central banks to force down currency exchange rates relative to heavy trade partners, making exported goods cheaper and, hence, more attractive. In some corners, this is called the academic-sounding "competitive devaluation." Others use a more bellicose term: currency wars.

However, this is all based on two faulty premises—that cheaper exports are economically preferable and that currency exchange rates are a big driver of export growth. Yes, devaluing currency might increase demand for exports, however, it also makes imports more expensive. In today's globalised world, few exports are wholly produced by the exporting country. Japan, for example, which is currently targeting a weaker yen, has to import huge quantities of liquefied natural gas due to the shutdown of many nuclear power plants. A weaker yen makes this necessity more expensive. A weaker currency is not necessarily a net benefit.

Since the US went off the gold standard in 1973, the movements of the US dollar relative to a trade-weighted basket of currencies (weakening or strengthening) explain only about 15% of exports' movements. Other factors simply contribute more. During recessions, there are higher negative correlations between export growth and the dollar. However, FI believes this relationship is caused by recessions, not the other way around. Historically, investors tend to seek the dollar's liquidity and relative safety during recessions, while the same recessions zap global demand for US exports. The primary causal factor is not currency values—it is global macroeconomic conditions.

Furthermore, there is no evidence that efforts to weaken a currency work consistently. For example, US Fed policy in recent years has served to lower key US central bank rates and increase monetary reserves—two common currency-weakening tactics. Yet overall, the dollar has wiggled some, but no consistent pattern exists. (Exhibit 9) That is probably in part due to quantitative easing (QE) in other nations (currencies are only priced relative to one another). Additionally, most of the effect on exchange rates—to the extent there is one—is often generated up front, losing power over time. While currency fluctuations can affect returns, FI incorporates currency expectations into FI's allocation and selection decisions. Similarly, expected currency volatility contributes to FI's assessment of risk in FI's decisions for each portfolio respectively.

Exhibit 9: US Dollar Vs. Trade-Weighted Currency Basket



Source: Global Financial Data, Inc., as of 23/4/2013, Trade-weighted Index of the United States Dollar against a Basket of Multiple Currencies from 31/12/2009 to 22/4/2013; Federal Reserve. Based in USD.

US Politics

Many investors feared US President, Barack Obama's re-election would be toxic for stocks. However, as FI showed in FI's Q4 2012 Review & Outlook, there is simply no basis for that fear—since World War II, stock returns during Democratic presidents' first years (whether first or second term) are nearly always double-digit positive. Moreover, Obama fears have been debated by investors for over four years—but the bull market persists.

Gridlock—a generally positive feature for markets, which hate the redistribution and unintended consequences inherent in new major legislation—should only increase through 2013. Congress is mixed, which results in gridlock. But an additional contributing factor to still more inaction is the structure of the 2014 elections, which strongly favour Republicans.

There are 21 Democrat-held seats up for election in 2014 to just 14 Republican—alone a significant Republican advantage. Of the 14 Republican races, 13 are in states Romney carried (including two seats in South Carolina). Just Susan Collins (Maine) is running in a traditionally blue state. But as a three-termer and with solid moderate bona fides, that seat does not seem imperiled at the moment. Saxby Chambliss and Mike Johanns are retiring, leaving two open seats in reliably red Georgia and Nebraska. Of the Democrats' 21 races, seven are in states Romney carried, with six seats open (tougher to defend). Three open seats are in states that went to Romney—especially vulnerable.

Vulnerable Democrats will likely moderate to improve their odds. And FI sees evidence of it already. In March's continuing resolution funding government until September, Democrats intentionally did not include funding for the Affordable Care Act (ACA) or Dodd-Frank's scheduled expansion—they thought it might prove too contentious. Near simultaneously, the Senate voted to repeal the ACA's 2.3% medical-device tax and approve the politically contentious Keystone XL pipeline in amendments to its budget proposal. The Senate's budget stands little chance of passing, but the symbolism in the Democrat-controlled Senate approving these measures is meaningful. Also, note how the gun control debate played out. Gun control has zero to do with stocks—but many vulnerable Democrats sided with Republicans, shooting down the proposed legislation. For example, Mark Begich, a freshman Democratic senator from Alaska up for re-election in 2014, could not afford to appear anti-gun—hence his vote against gun control. Pragmatism outweighed partisan loyalty.

Gridlock does not mean nothing can happen—as evidenced by the recent continuing resolution, the fiscal cliff deal and the aforementioned symbolic votes. Gridlock simply suggests a minimal change of passing extreme legislation—a bullish factor.

Japan

Inside Japan's Rally

Since this bull market began on 9 March 2009, global stocks have more than doubled, and many indexes have reached or surpassed previous highs. However, until recently, one nation has not enjoyed such robust returns: Through year-end 2012, Japanese stocks were up only 51% since the low (in US dollar terms), and Japan has endured two recessions during the broader global expansion[xi]. In Q1, however, a Japanese rally that began in mid-November gained strength, and Japanese stocks surged—but only Japanese investors enjoyed most of the gain. Investors in non-yen currencies did not capture anywhere near as much as the weakening yen severely dampened returns denominated in stronger foreign currencies, including the dollar. In US dollar terms, Japanese stocks only outpaced the MSCI World by less than four percent in Q1[xii].

This currency headwind is but one reason FI does not share much of the world's newfound Japanese enthusiasm. Japan has deep economic issues, and FI is sceptical of officials' ability to effect needed change in the period ahead.

Cheering Abenomics

Japan's rally seems based on one big driver: Abenomics, the term for Prime Minister Shinzo Abe's economic policy.

On 15 November former Prime Minister Yoshihiko Noda called a snap election. Noda and his Democratic Party of Japan (DPJ) were deeply unpopular, and Liberal Democratic Party (LDP) leader Abe—who had a yearlong stint as prime minister in 2006-2007—looked destined to recapture the premiership. Abe wooed voters and investors with promises to combat chronic deflation and economic malaise with the "three arrows" of Abenomics: aggressive monetary easing, massive fiscal stimulus and economic reform. Japan's political revolving door had prevented meaningful change since 2006, and investors cheered the prospect of a decisive leader.

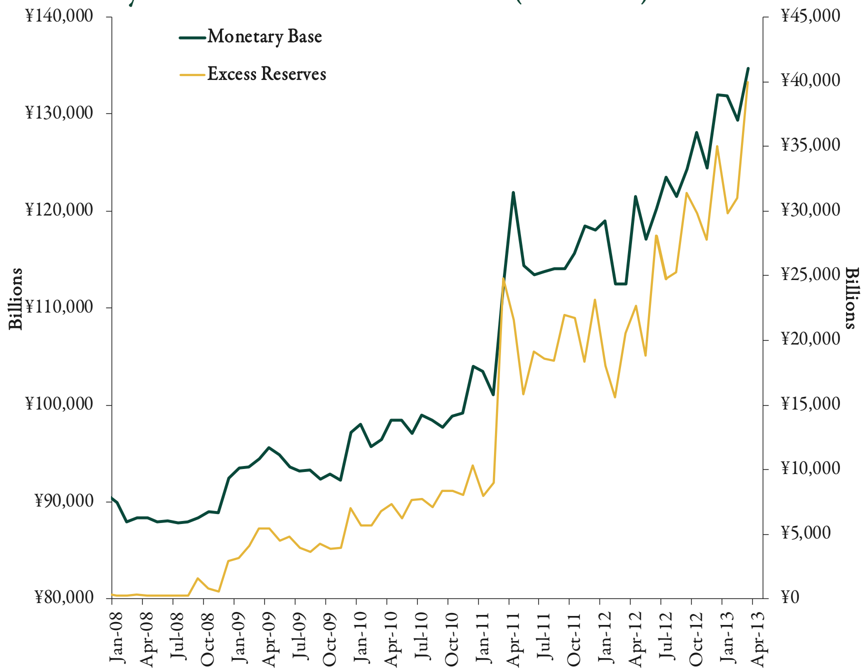
Once Abe took office, he did not disappoint—he quickly loosed arrows one and two. He announced a stimulus package worth 2% of GDP in January, including public spending on earthquake recovery and seismic retrofitting projects, a rare defense spending increase and loan guarantees for small businesses. One week later, his government and the Bank of Japan (BoJ) agreed to raise the bank's inflation target to 2% and expand the current quantitative easing programme indefinitely. Soon after, Abe appointed Asian Development Bank chief Haruhiko Kuroda to replace outgoing BoJ Governor Masaaki Shirakawa. Kuroda has long blamed BoJ's cautiousness for Japan's persistent deflation. In his confirmation hearings, he vowed to do "whatever it takes" to reflate the economy, and in his first meeting as chief, he announced plans to double the monetary base in two years.

The Shortcomings of Fiscal and Monetary Stimulus

Investors largely welcomed these events, as did Japanese voters. Abe's approval ratings topped 70%. However, fiscal and monetary stimulus alone will not make Japan's economy more viable. Successive fiscal stimulus efforts under previous governments have occasionally provided a short-term boost, but Japan has still had 5 recessions in 15 years. Nominal GDP remains well off its 1997 peak, with real GDP advancing only 8.97%[xiii]. Government spending increased during this period, while business investment—the key economic engine of any advanced economy—has steadily declined.

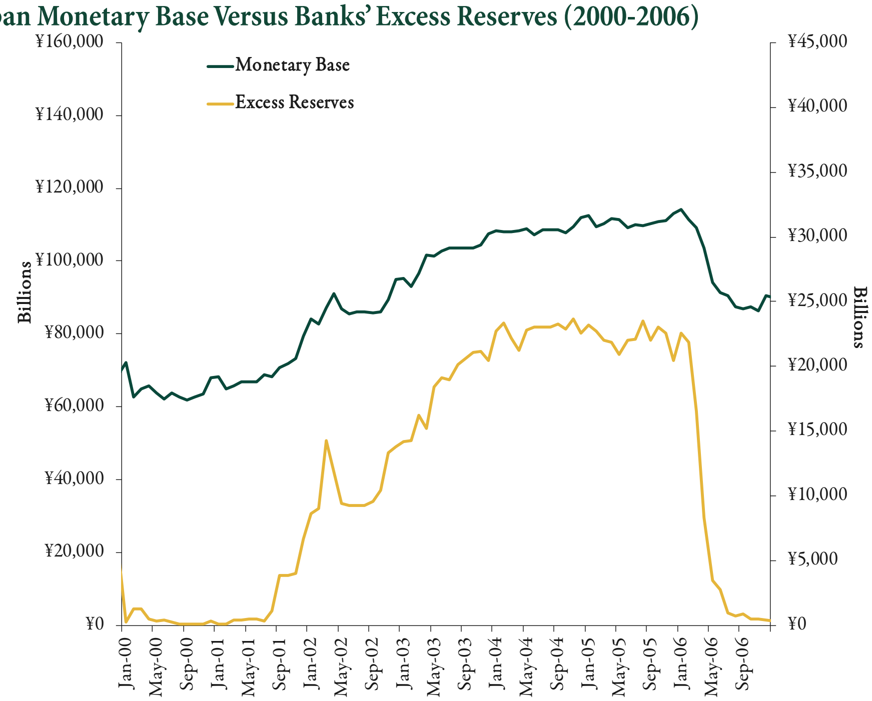
Meanwhile, 12 years of on-and-off QE have yielded few results—deflation persists even though the BoJ has roughly tripled the monetary base since 1999[xiv]. Like their US and UK counterparts, Japanese banks have opted to park much of the QE money at the BoJ as excess reserves. As shown in Exhibit 10, the monetary base and excess reserves rose in tandem during Japan's first QE programme, which ran from 2001 until 2006. Moreover, as Exhibit 10 shows, the same pattern has emerged during the current QE programme, which began in late 2010. The QE money is not flowing through to the broader economy. Bank lending, meanwhile, has shrunk substantially. (Exhibit 11) As a result, M2—the amount of money circulating in the broad economy—has not risen in sympathy with the monetary base. (Exhibit 12)

Exhibit 10: Japan Monetary Base Vs. Banks' Excess Reserves (2008-2013)



Source: Thomson Reuters, as of 23/4/2013. Bank of Japan: Monetary Base 15/1/2008-15/3/2013, Excess reserves calculated as total reserves - Required Reserves.

Exhibit 11: Japan Monetary Base Versus Banks' Excess Reserves (2000-2006)

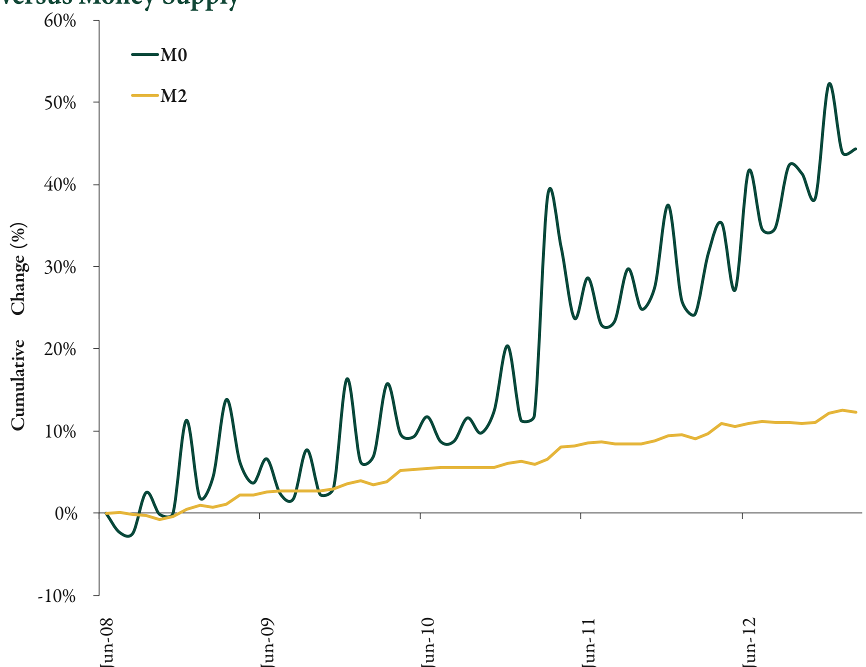


Source: Thomson Reuters, as of 23/4/2013. Bank of Japan: Monetary Base 15/1/2001-15/12/2006, Excess reserves calculated as Total reserves - Required Reserves.

Exhibit 12: Japanese Outstanding Bank Loans

Source: Thomson Reuters, as of 23/4/2013. Japan, Aggregate Bank Lending (excl. Shinkin Banks), JPY; 15/1/1992 - 15/3/2013.

Exhibit 13: M2 Versus Money Supply



Source: Thomson Reuters, as of 23/4/2013. Bank of Japan, Central Bank Liability: Monetary Base - Total, Money Supply: M2, JPY; 30/6/2008 - 28/2/2013.

Hence, QE has not done much for Japan, just as it has not done much for other economies globally. Prices and lending rose somewhat toward the end of the first round of QE, from 2001 until 2006, but soon reversed. While lending has improved somewhat during the current QE programme, which began in November 2010, it is rising off a very low base.

Policymakers claimed victory when jawboning by Abe and the BoJ helped weaken the yen, theoretically aiding Japanese exporters—but this is a dubious goal. A weaker yen makes imports more expensive—an acute problem as Japan relies on foreign energy imports in the wake of Fukushima. Expensive energy has been a headwind for businesses since 2011.

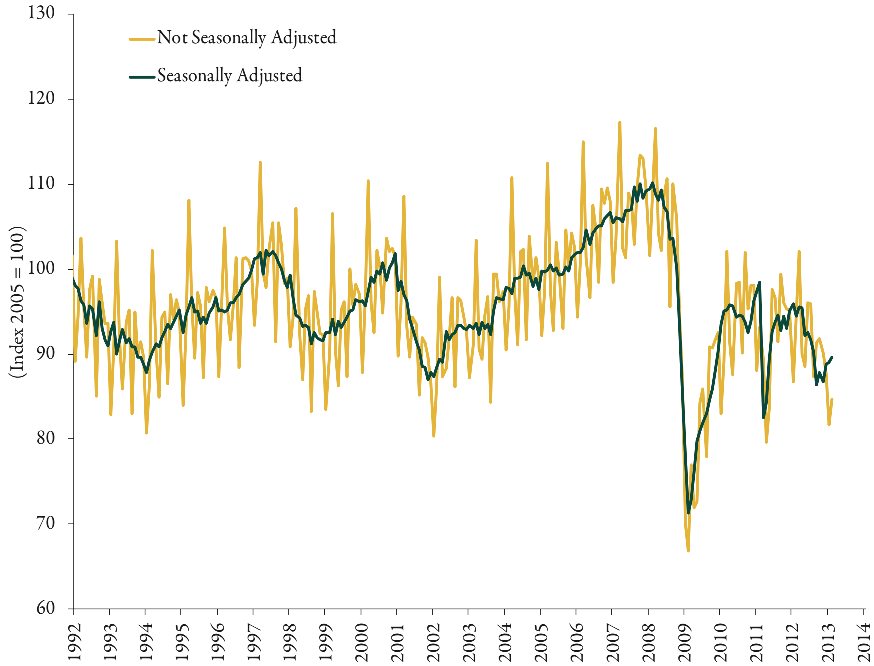
In short, while fiscal and monetary stimulus may be like candy to voters and some investors, they do not address the real issues plaguing Japan.

What Japan Really Needs

For capital and economic activity to start flowing more quickly, and for businesses to resume investing in earnest, Japan needs deep economic reform. Its ongoing funk stems from long-running structural issues like waning productivity, a shrinking workforce, high trade barriers and a lack of dynamism in the corporate sector.

Japan's working-age population is at all-time highs, but the labour force participation rate has declined since the early 1990s, and women's participation rate is well below the developed-world average—it finished 2011 at 47.7%, compared to the US's 58.1%, Canada's 62.2% and the UK's 56.9%[xv]. Ideally, firms would compensate with productivity gains, but this has not really happened in Japan. Industrial output has stagnated. (Exhibit 14)

Exhibit 14: Japanese Industrial Production



Source: Thomson Reuters, as of 23/4/2013. Ministry of Economy, Trade and Industry, Industrial Production – Manufacturing.

One big reason is the ongoing weakening of Japan's mega-conglomerates, known as keiretsu. There are two kinds of keiretsu—the vertically integrated (think any major Japanese automaker) and the horizontally integrated. In the latter, subsidiaries are centreed around a bank holding company, and the bank and subsidiaries maintain cross shareholdings in each other. This gives subsidiaries an easy financing lifeline, reducing their incentive to offload unprofitable operations—hence the lack of productivity gains. It also gives banks a stake in keeping unprofitable subsidiaries afloat, creating high barriers to entry throughout the economy and, thus, limiting competition. New firms would arguably be more innovative than the stagnant keiretsu have been in recent years, bringing some much-needed dynamism back to Japan. Competition breeds growth.

Additionally, for an export powerhouse, Japan's economy remains remarkably closed to the rest of the world. Protectionism has long been politically popular, especially in agriculture, where tariffs are 777.8% for rice, 50% for beef, 220% for wheat and 210% for barley, to name a few[xvi]. These, as well as outdated procurement policies and other restrictions, have been obstacles in Japan's free-trade negotiations with major partners. Japan's exporters are thus at a relative disadvantage to South Korea, which trades freely with the US and EU.

The Revolving Door and Economic Reform

Japanese policymakers have long been aware of the need for deep reform. However, Japan has seen few meaningful reforms since 2000—and perhaps the most noteworthy, the 2006 bill to privatise the Japan Post behemoth, has not come to fruition. Japan Post is not your average post office—it is a postal service, bank and insurance company wrapped into one. Under the privatisation law, spearheaded by reform champion Junichiro Koizumi (Prime Minister [PM] from 2001 to 2006—an eternity relative to recent PMs), the government was to split Japan Post into five entities under the umbrella of Japan Post Holdings, privatise the bank and insurance subsidiaries by 2010 and sell two-thirds of its stake in the holding company by 2017. (This is as close as most former state-owned enterprises ever get to full privatisation in Japan). However, privatisation was unpopular with voters and interest groups, and later governments dismantled the legislation after Koizumi stepped down. They let the 2010 deadline lapse, and in 2012, Parliament officially scrapped the 2017 deadline, offering no timetable for privatising either the holding company or the bank and insurance companies. Proposals to tender two-thirds of the holding company in 2015 circulated last October, when Noda was investigating selling state-owned assets to fund earthquake recovery, but firm plans have not materialised.

Not only has Japan lost its key legislative achievement of the past decade, but since Koizumi, no PM has had the clout or longevity to pass further reforms. Japan has had eight PMs in eight years, and leaders have largely operated in fear of the revolving door. True reform requires taking on stakes and a willingness to make unpopular decisions, and Japan's PMs have not been willing to spend the necessary political capital, to the extent they have even had it. Abe—ironically, Koizumi's hand-picked successor—was no different during his first term. Koizumi intended for Abe to carry the torch of reform. Instead, Abe pursued more nationalist aims, like making school curriculum more "patriotic", while the economy floundered. His ratings plummeted, LDP leaders lost patience when the DPJ won the upper house, and he soon stepped down.

How Likely Is Reform?

Given Abe's record, hopes for true reform remain muted. Though economic reform is the third arrow of Abenomics, he speaks of it in vague terms and has offered few policy specifics. It is simply unclear whether he is willing to spend his political capital on deep economic reforms. For example, he tasked two committees with making recommendations for deregulation and structural reform. But these committees are divided between the keiretsu old guard, which likely has a vested interest in the status quo (creative destruction can be painful for those directly impacted), and the younger crowd, which understands the need to tear down barriers to entrepreneurship and competition. Findings are not due until June, and it is far from certain credible proposals will emerge.

The administration did take a few tentative steps toward reform in March, but they picked only the lowest hanging fruit, including free trade deals, utilities deregulation and small corporate tax changes. Voters have remained supportive thus far, but the much deeper changes Japan needs may not be as popular and will require taking on more powerful political interests. Abe has already made concessions to the agricultural lobby during free trade talks, suggesting he may not quite have the desire or clout to push deeper changes through. Lawmakers may also resist, potentially blocking or watering down reforms submitted to Parliament. July's upper house elections are also a key question mark. Additionally, political winds are fickle. Recent Japanese economic data have stabilised a bit, but if the situation deteriorates, Abe may find himself on a much shorter leash from voters—and through the revolving door once more.

Headwinds for Investors

This ongoing uncertainty is a key reason FI remains underweight to Japan despite the rally and tentative reform plans. It will take much more than aggressive stimulus for Japanese shares to sustain strong returns—and stimulus without reform could lead to greater problems down the road. Moreover, Japan has one mega-cap stock—even if Japanese fundamentals continue improving, FI would expect its smaller-than-market-average firms to lag much bigger peers globally as investors flock to the world's largest companies. Moreover, as mentioned earlier, the weak yen dampens returns for US investors, and policymakers seem set on allowing the currency to weaken further. For US investors, better opportunities likely exist elsewhere over the period ahead.

Should you have any questions about any of the information in the First Quarter 2013 Review and Outlook, 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. Thomson Reuters Analytics, as of 4/12/2013.
ii. Thomson Reuters I/B/E/S, as of 4/12/2013.
iii. Thomson Reuters I/B/E/S, as of 4/12/2013.
iv. The US Bureau of Economic Analysis, as of 4/18/2013.
v. The US Census Bureau, as of 4/18/2013.
vi. The US Census Bureau.
vii. The US Census Bureau, as of 4/18/2013.
viii. National Association of Realtors, as of 4/18/2013.
ix. Source: "Merkel's Hard Line, Vilified in Nicosia, Cheers Germany," Matthew Karnitschnig, The Wall Street Journal, March 21, 2013. http://online.wsj.com/article/SB10001424127887324103504578372461781539472.html
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xi. Thomson Reuters, as of 04/18/2013; MSCI Japan Net Return Index from 3/9/2009 to 12/31/2012, market low defined as the 3/9/2009 low of the MSCI World Net Return Index.
xii. Thomson Reuters, MSCI Japan with net dividends, MSCI World with net dividends, from 12/31/2012 to 03/31/2013.
xiii. Thomson Reuters, as of 4/23/2013. Japan Cabinet Office, Expenditure Approach, Gross Domestic Product, Seasonally Adjusted, JPY; 2/15/1994 - 11/15/2012.
xiv. Thomson Reuters, Inc., as of 4/23/2013, Japan's Consumer Price Index National Measure from 1/15/1999 to 2/15/2013; Statistics Bureau (MIC) Japan. Thomson Reuters, Inc., as of 4/23/2013, Japan's Monetary Base (Reserve Requirement Rate Change Unadj.) from 1/15/1999 to 3/15/2013; Bank of Japan.
xv, Federal Reserve Bank of St. Louis.

xvi. Japan Customs, 4/24/2013, Japan's Tariff Schedule as of April 1, 2013.