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SECOND QUARTER 2014

MARKET PERSPECTIVES

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SECOND QUARTER 2014 REVIEW AND OUTLOOK
MARKET PERSPECTIVES

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SECOND QUARTER 2014 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Global equities gained steadily in Q2, bolstered by economic data affirming the economic expansion remains on track despite Q1 weather-related weakness. Each new market high is met with disbelief—in our view, a sign investors have yet to embrace optimism, leaving plenty of room for sentiment improvement ahead. Improving sentiment against a better economic and political backdrop than most appreciate should continue pushing equities higher in the second half of the year.

Size leadership has been shifting. The smallest equities have lagged, but so have large caps. Such fluctuation is not uncommon in the middle stages of bull markets. Historically, large cap equities have been the better performers in bull markets' back halves—yet sometimes only in erratic or large swings. While it is possible smaller firms could lead through the end of this bull, it would be quite unusual. Over the last dozen bull markets, small cap leadership has been almost uniformly concentrated in the first few years. Successful investing rests on probabilities, not possibilities. That large caps have yet to lead consistently in this market cycle strongly suggests this will be a long bull market, with a sustained period of large cap leadership still ahead.

Market Outlook

Our forecast remains for equities to finish 2014 up a lot, with the strongest push coming in the back of the year and extending into 2015. 2014 is a US midterm election year, which are historically back-end loaded. Midterm elections usually result in gridlock. Since 1932, only twice—in Franklin Delano Roosevelt's and George W. Bush's first terms—has the President's party gained seats in both houses during a midterm contest. All other times, the President has lost relative power, reducing the risk of sweeping legislation interfering with property rights or distribution of wealth and income. Less political risk is a big positive for markets. However, investors are slow to realise this. Most investors get caught up in the campaign's rhetoric and polarisation, increasing fears that loud campaign pledges might actually come to fruition. After the election, however, the noise dies down, Congress continues doing next to nothing, and investors eventually realise most promises cannot pass. This is a powerful force for markets in midterm years' second halves, particularly fourth quarters, which have been positive 86.4% of the time since 1925—significantly higher than equities' historical 68% frequency of positive quarterly returns.[i] This effect extends over the following quarters—the first and second quarters of post-midterm years are also positive 86.4% of the time.

As investors look out over the next year, few realise how strong it can be. Many remain wary of this bull market, continually checking for signs of a top. While there is always a chance some unseen risk could materialise and knock the bull off course—and we always watch for this—we do not see anything material enough to derail the many positives supporting equities. Investors' lingering scepticism combined with the underappreciated midterm effect and positive economic fundamentals tells us this is not the time to brace for a peak or wait for a pullback. Underestimating markets can carry significant opportunity cost.

As equities clocked new highs while tensions flared in Iraq, eurozone growth slowed and new data revealed the US economy contracted at a -2.9% seasonally adjusted annual rate in Q1, headlines warned of equities' apparent complacency, saying returns were too detached from reality. Yet equities have a long, long history of shrugging off regional conflicts and rough economic data. Many claimed equities' resiliency this time was a result of US Fed policy masking their underlying vulnerability, but this ignores decades of market history. It is normal for equities to rise when the world looks weak—geopolitical conflict and patches of sluggish (and occasionally negative) growth are often part of the proverbial wall of worry bull markets love to climb. While there are always risks, the time to worry most, in our view, is when headlines stop highlighting negatives and start ignoring them.

Today, headlines continue ignoring the positives. Even with the US's GDP contraction, S&P 500 corporate earnings rose 2.1% y/y in Q1—beating expectations for a small decline—and revenues rose 2.7%, illustrating the private sector's continued strength.[ii] Nor was economic weakness universal. The global economy grew 3% y/y in Q1 as Emerging Markets surged and the UK led the developed world.[iii] Publicly traded firms appear poised to continue doing well, with most US indicators showing growth resuming in Q2 as the impact of severe winter weather faded and loan growth continued its post-taper rebound. The Conference Board's Leading Economic Index—one of the most reliable predictors of future economic trends—continued rising, fueled by the relatively steeper yield curve and credit conditions. In our view, there is simply too much driving this bull forward for it to derail.

THEMATIC UPDATE & MARKET OUTLOOK

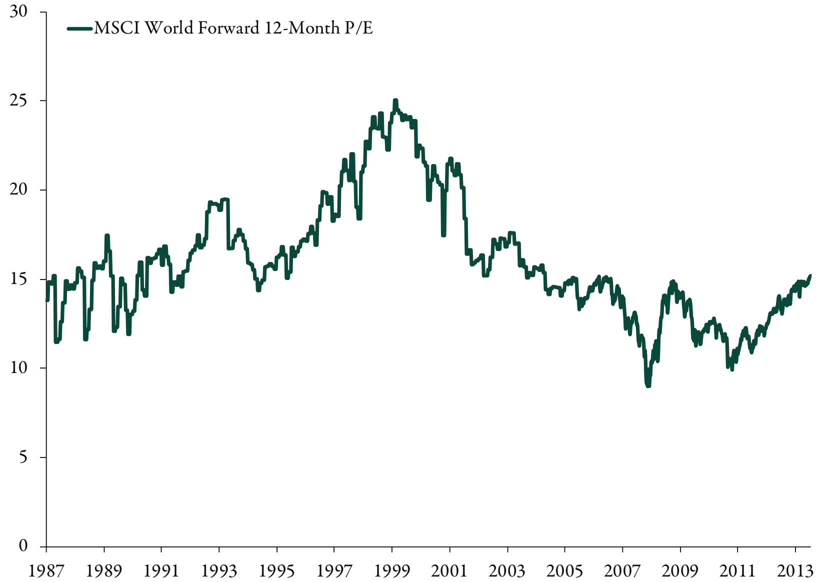
A Look Back and a Look Ahead

After performance in April and early May remained flat, global equities drifted higher with the MSCI World Index closing at multiple all-time highs. Global equities' rose 4.9% in Q2 featuring historically low volatility. The S&P 500 went 58 trading days in Q2 with less than 1% daily moves up or down.[iv] Only 16 days this year had 1% moves, below the long-term average of one every four trading days.[v]

Many find markets too calm. With United States (US) Q1 GDP dipping and Iraq and Ukraine in turmoil, many thought equities should drop. Some claimed monetary policy was propping prices, but believed they would fall when the support stopped. To others, rising bond prices warned that equities would fall soon after. However, none of these theories holds. Equities often rise when the world looks weak, and volatility varies. Bull markets climb a wall of worry. Sentiment can slip as a result of one-off economic dips and geopolitical tensions. Equities also often defy expectations. If most expect markets to react one way to an event and act accordingly, their expectations already had their effect. Equities usually do something else.

Worries and doubts show investors' lasting scepticism. Investors have warmed some to this bull market, but there is ample room for confidence and prices to rise before reaching the euphoria typical of market peaks. This can be observed in equity valuations. While valuations do not predict direction, they help measure sentiment. Today's price-to-earnings ratios (P/Es) and other measures are not extreme—they are average. This supports our view investor sentiment is not as bleak as this bull market's early stages but remains far from euphoric. We expect improving sentiment, supported by positive fundamentals, to move this bull market higher.

Exhibit 1: MSCI World P/E



Source: FactSet, S&P Capital IQ, as of 18/07/2014. MSCI World Index Forward 12-Month P/E, 17/12/1987-03/07/2014.

Many pundits underestimate the economy's strength. For example, below-average wage and income growth leads the media to suggest American consumers are cash-strapped. Data tell a different story. American households—individual investors—have plenty of savings. US Federal Reserve (the Fed) data show consumers have $10.8 trillion in cash and cash-like holdings—ample cash to consume or invest.[vi]

Market Drivers

We are often asked what risks could derail the bull—a sign fear still remains. No bull market lacks risks. However, in our view, now is not the time to contemplate negatives or look for a bull market top. Bull markets usually end when few expect them to—either losing steam amid widespread euphoria or stopped early by a large, overwhelming shock. To us, investors' foresight for the end is a sign the end is not near. Too much is driving equities higher for a collapse to occur in the foreseeable future. In our view, now is the time global equities move higher.

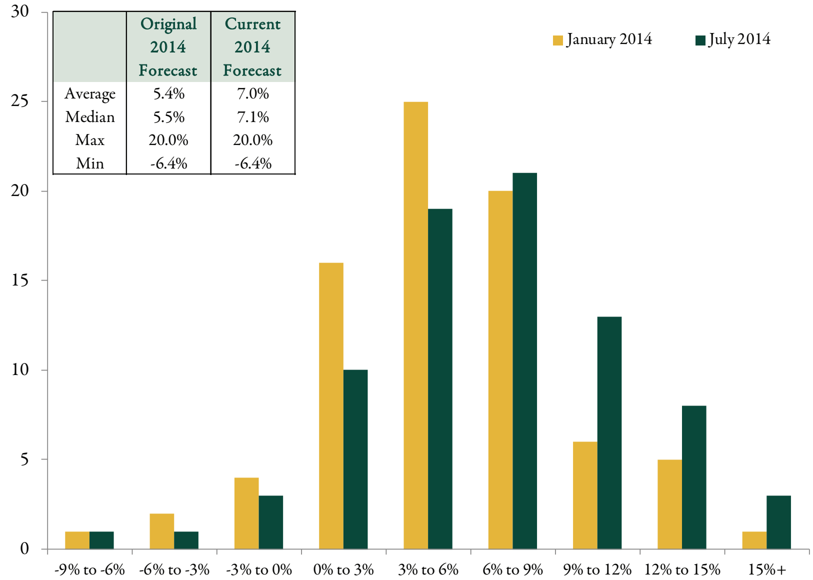
We group market drivers into three categories—economics, politics and sentiment. Sentiment remains sceptical. Optimism is growing—like those who shrugged off poor Q1 US GDP as a weather related incident—but positivity is not universal. Few expect great equity returns.

Equities tend to discount pundits' projections, surprising investors with actual returns differing from Wall Street's forecasts. Last year was a near-perfect example of the average pundit's forecasting woes. In 2013, most professionals' S&P 500 forecasts clustered in the mid-to-high single digits, yet the index finished the year up more than 30%. Again this year, forecasts were muted, with the median S&P 500 forecasted return at just 5.5%.

These muted forecasts were one of several factors driving our 2014 forecast in January. Very few believed equities could follow a huge 2013 with another above-average year, making up-a-lot full-year returns most likely. Over halfway in, muted expectations remain. For example, Barron's recent "Midyear Roundtable" gave professionals a chance to update their 2014 S&P 500 forecasts. Despite the S&P's 7.1% first-half return's topping their meager full-year expectations, few called for a significantly bigger rise.[vii] "The bulls in the bunch see a meager 5% gain in the Standard and Poor's 500 in the months ahead, while the rest see a volatile rout in late summer that could leave equities 10% lower, at least."[viii]

Barron's pundits are not the only professionals expecting little from 2014's back half. As Exhibit 2 shows, few gurus have upped their forecasts much. These guarded expectations imply equities would surprise the most people by closing 2014 up-a-lot or down-a-lot. Up-a-lot is most likely, in our view.

Exhibit 2: Professional Forecasts Are Still Muted



	Original 2014 Forecast	Current 2014 Forecast
Average	5.4%	7.0%
Median	5.5%	7.1%
Max	20.0%	20.0%
Min	-6.4%	-6.4%

Source: Fisher Investments Research, as of 24/07/2014. S&P 500 Total Return Index forecasts by 79 analysts as of January and July 2014.

Economic and political drivers favour up-a-lot. The world economy is stronger than most perceive, and earnings are still beating expectations. Politically, this is a US midterm election year—typically back-end loaded. Historically, midterm years' fourth quarters are positive 86.4% of the time—well above the long-term average.[ix]

This is no coincidence, in our view. Midterms usually mean more gridlock—great for equities. The outcome should not differ this time. Gridlock reduces the likelihood radical legislation, such as altering property rights or the distribution of resources and capital, passes. Investors only gradually realise this as the vote nears. As shown in Exhibit 3, this feature tends to last, with the following Q1 and Q2 each positive 86.4% of the time (a coincidence that this matches Q4).[x] The new Congress does not convene until January, giving markets more time to realise candidates probably cannot keep their promises—easing campaign-season fears.

Exhibit 3: Returns After Midterms Are Overwhelmingly Positive

Midterm Year	Midterm Q1	Midterm Q2	Midterm Q3	Midterm Q4	Subsequent Q1	Subsequent Q2	Subsequent Q3	Subsequent Q4
1926	-9.1%	8.9%	10.1%	2.0%	4.6%	7.3%	16.1%	5.2%
1930	18.4%	-17.8%	-8.2%	-16.4%	10.2%	-9.9%	-33.6%	-14.8%
1934	7.4%	-8.0%	-6.2%	5.4%	-9.9%	22.1%	14.4%	17.0%
1938	-17.8%	38.5%	7.3%	9.0%	-16.0%	0.0%	21.4%	-2.9%
1942	-5.9%	5.8%	8.5%	12.1%	20.1%	8.0%	-0.9%	-2.1%
1946	5.1%	2.9%	-18.0%	3.5%	0.3%	1.5%	0.5%	2.7%
1950	4.9%	4.0%	11.9%	6.9%	6.7%	-0.3%	12.8%	3.8%
1954	10.1%	9.8%	11.9%	12.6%	2.8%	13.3%	7.5%	5.1%
1958	6.4%	8.5%	11.6%	11.2%	1.2%	6.3%	-2.0%	6.1%
1962	-2.1%	-20.6%	3.7%	13.1%	6.4%	5.0%	4.2%	5.4%
1966	-2.7%	-4.3%	-8.8%	5.9%	13.2%	1.3%	7.5%	0.5%
1970	-1.8%	-18.0%	17.1%	10.3%	9.7%	0.2%	-0.6%	4.6%
1974	-2.8%	-7.6%	-25.2%	9.3%	23.0%	15.4%	-10.9%	8.6%
1978	-4.9%	8.5%	8.7%	-5.0%	7.1%	2.6%	7.6%	0.1%
1982	-7.3%	-0.6%	11.5%	18.3%	10.0%	11.1%	-0.2%	0.4%
1986	14.1%	5.9%	-7.0%	5.6%	21.3%	5.0%	6.6%	-22.5%
1990	-3.0%	6.3%	-13.7%	9.0%	14.5%	-0.2%	5.3%	8.4%
1994	-3.8%	0.4%	4.9%	0.0%	9.7%	9.5%	7.9%	6.0%
1998	13.9%	3.3%	-9.9%	21.3%	5.0%	7.0%	-6.2%	14.9%
2002	0.3%	-13.4%	-17.3%	8.4%	-3.1%	15.4%	2.6%	12.2%
2006	4.2%	-1.4%	5.7%	6.7%	0.6%	6.3%	2.0%	-3.3%
2010	5.4%	-11.4%	11.3%	10.8%	5.9%	0.1%	-13.9%	11.8%
2014	1.8%	5.2%	?	?	?	?	?	?
Average Return	1.3%	0.2%	0.5%	7.3%	6.5%	5.8%	2.2%	3.1%
Average Positive	7.7%	8.3%	9.6%	9.5%	9.1%	7.2%	8.3%	6.6%
Average Negative	-5.6%	-10.3%	-12.7%	-7.1%	-9.7%	-3.5%	-8.5%	-9.1%
% Positive	52.2%	56.5%	59.1%	86.4%	86.4%	86.4%	63.6%	77.3%

Source: Global Financial Data, as of 23/07/2014. S&P 500 Total Return Index from 31/12/1925-30/06/2014.

While we expect the biggest bounce after the election, this is not a timing tool. Returns are more variable during Q3 of midterm years, but they are positive 59.1% of the time. Investors desire clear signals before dipping into the market, but equities do not function on clear signals. Short-term timing is frequently a losing strategy.

This is also true for corrections—short, steep drops of -10% or greater. A correction is always possible. However, corrections are impossible to repeatedly predict and time—they begin and end without warning. Some think a correction must lurk since 25 months have passed since the last one ended—above the 18-month average between bull market corrections since 1974.[xi] Yet corrections do not run on schedules—equities will not correct just because they have not lately. There were no corrections between 8 April 1992, and 20 July 1998.[xii] The 2002-2007 bull's first correction began 13 June 2006.[xiii] The next occurred the following summer.[xiv] The short bull market from 1987-1990 had zero corrections.[xv] Corrections are unpredictable. The "better buying opportunity" many investors await may not come, or may come when equity prices are much higher.

Global Political Climate

As always, our political commentary is intended to be nonpartisan and approach issues solely to assess potential market impact (or lack thereof). Political bias is blinding.

The political landscape in Developed and Emerging Markets was active in Q2, with several notable events. The US Congress continued to be gridlocked as law makers prepared for midterm elections. Countries in the eurozone elected a new Parliament in May and Japanese Prime Minister Shinzo Abe pursued his "Third Arrow" of reforms.

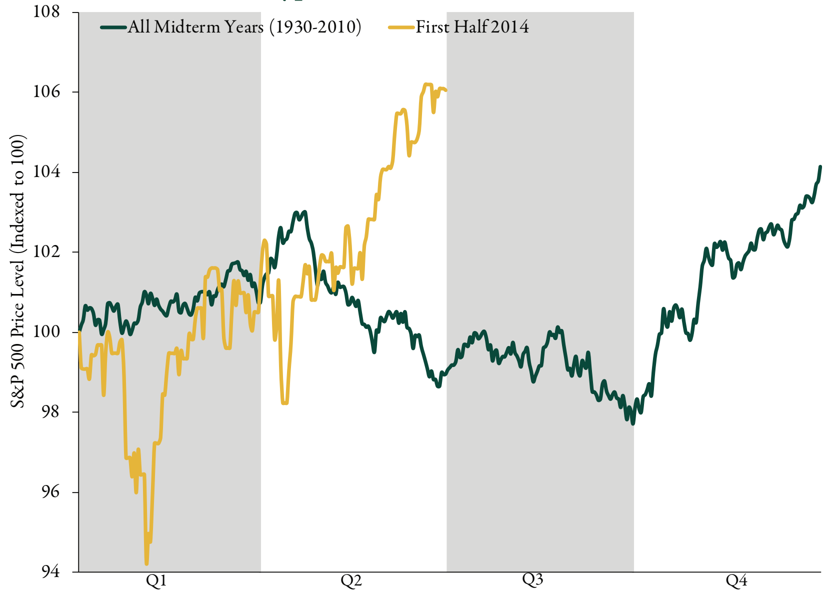
Mexico continued implementing some of the sweeping reforms passed last year, with its law makers passing some of the secondary legislation necessary to end the monopoly stranglehold over its Telecom sector. Brazil heated up for this October's Presidential election while China continued to pursue reforms and other countries in Asia saw several big developments.

The Bullish US Midterm Election Effect

As midterms approach, few understand their bullish impact on equities. As shown in Exhibit 3 previously, equities have risen in 86.4% of midterm Q4s and the following two quarters—well above the 67.4% frequency of positive quarterly returns.[xvi] We believe this will be a boon for equities through the end of 2014 and into 2015. Equities are primed for a midterm election party.

Halfway through, this year may seem to veer from the midterm pattern as returns so far are above the average midterm year. Exhibit 4 compares 2014's first half to average midterm years' results since 1930.

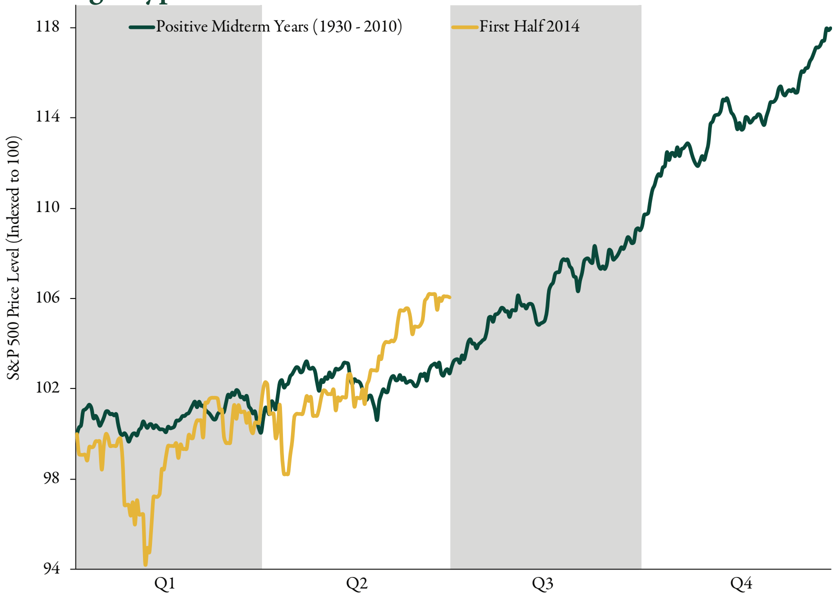
Exhibit 4: 2014 Year-to-Date Returns Versus a Typical Midterm Year



Source: FactSet, as of 23/07/2014. S&P 500 Price Index, 31/12/1929-30/06/2014. All Midterm Years consists of the average daily return of US midterm election years: 1930, 1934, 1938, 1942, 1946, 1950, 1954, 1958, 1962, 1966, 1970, 1974, 1978, 1982, 1986, 1990, 1994, 1998, 2002, 2006 and 2010.

However a more granular look displays 2014's first half looks a lot like the average positive midterm year. The deviation in Exhibit 4 is normal for a positive midterm year.

Exhibit 5: Equities Tracking a Typical Positive Midterm Year



Source: FactSet, as of 23/07/2014. S&P 500 Price Index, 31/12/1929-30/06/2014. All Midterm Years consists of the average daily return of US midterm election years when the S&P 500 Total Return Index had a positive annual return: 1938, 1942, 1950, 1954, 1958, 1970, 1978, 1982, 1986, 1994, 1998, 2002, 2006 and 2010.

This pattern could break down—charts alone are not predictive. However, there is a fundamental reason midterm years tend to be back-end loaded, and this year has all the ingredients.

Get Ready for US Gridlock

Midterm elections are bullish because they tend to bring gridlock—a large positive for equities. Yet markets usually get caught up in campaign bluster and do not see gridlock until it is close by. This is why returns tend to vary pre-election, then pop in Q4 and into the next year. This year's midterm campaigns have all the usual distractions, but when the elections are over, gridlock should remain. Neither party likely gains a supermajority in both houses.

History favours the Republicans' gaining some seats, as the president's party has lost seats in the vast majority of modern midterms. The president is widely seen as his party's standard-bearer, but by midterms, his allure has worn off—voters see he's just a politician, and independents eschew legislators who leveraged his platform. This year, senators initially elected as President Barack Obama won in 2008 face voters for the first time since.

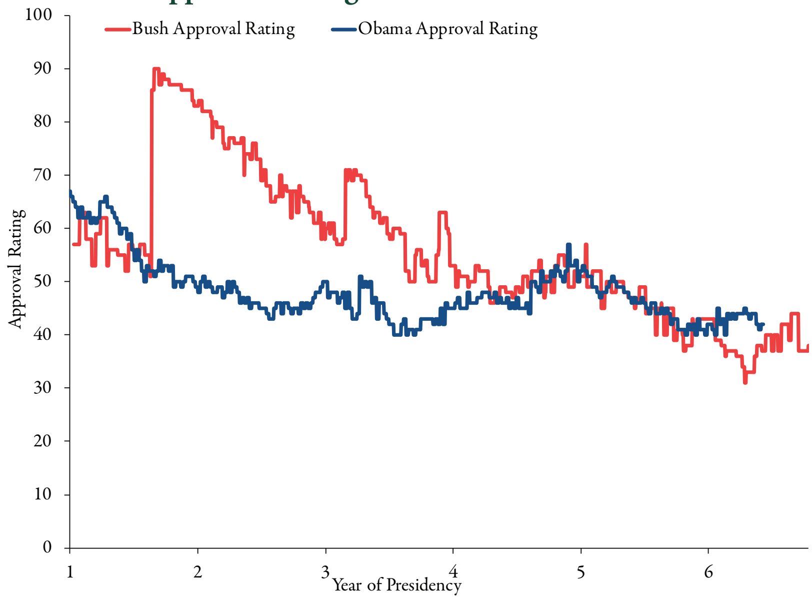
Republicans also have a small structural edge. In the House, they have more incumbents. However, they also have more open seats—half in traditionally Democratic territory—an opening for Democrats to win seats. In the Senate, Republicans must defend fewer seats in traditionally Democratic states, but taking control will be challenging. It would take flawless campaigning—like 1994's "Contract with America"—for a Republican sweep, and flawless campaigning takes perfect luck and lots of money.

Playing the Popularity Contest

President Obama's poll ratings are another indicator. As we wrote last quarter, his declining approval rating largely tracked G.W. Bush's at similar points during his second term. Bush's falling popularity preceded a Republican drubbing in 2006's midterms. Obama's numbers following a near identical course could signal Democratic misfortunes.

As Exhibit 6 shows, Obama's ratings did diverge from Bush's briefly in Q2. However, in early May, they fell again, likely tied to the VA scandal, the controversial trade for former prisoner of war Bowe Bergdahl and Iraq's descent into chaos. At quarter end, Obama's approval was only two points above Bush's at the same point in his second term.

Exhibit 6: G.W. Bush and Obama Approval Raitings



Source: Gallup, as of 01/07/2014

Obama's flagging popularity is apparent elsewhere. A recent Wall Street Journal poll put his approval rating at 41%—matching his series low.[xvii] 54% of respondents said they believe he cannot lead. His falling support has Democratic congressional candidates breaking with the administration—a sign of electoral sentiment. In early June, for example, several coal-state Democrats labeled Obama's new CO2 emissions targets stealth taxes and jobs-killers.[xviii]

Gridlock is Great for Equities

Our view of gridlock's benefits is rare. Media seldom says a largely inactive legislature is good. The same Wall Street Journal poll put the US Congress's approval rating at 7%—an all-time low—largely because voters see legislators as complainers who fail to act.[xix] This is powerful: It sets sentiment low, which markets like.

Getting stuck in ideology is human nature. Partisans see their party's proposals as best and the opposition's as worst. More independent-minded voters want bipartisanship—few believe doing nothing is desirable.

Compromise sounds good, and some beneficial laws have resulted. However, bipartisan legislation can be bad. 2002's Sarbanes-Oxley was a bipartisan failure. The Tariff Act of 1930 (Smoot-Hawley) had broad bipartisan support. So did the Humphrey-Hawkins Act of 1978, responsible for the Fed's dual mandate tying US monetary policy to antiquated (and long-ago debunked) economic theory. The Merchant Marine Act of 1920 (the Jones Act) still creates bottlenecks in US crude oil transportation. Just because both parties agree on something does not make it good, it makes it popular—entirely different.

Additionally, equities dislike legislative risk. More laws means more negatives could be introduced, perhaps interfering with property rights or otherwise creating winners and losers. We often mention Prospect Theory—individuals' feeling the pain of losses more than the joy of gains—when we discuss market volatility, but it applies here, too. If a new law shifts resources from one group to another, the losers hate it far more than the winners love it—the net negativity can weigh on equities. This potential pain is why markets hate active legislatures and love gridlock. Gridlock makes extreme legislation far less likely. Few individuals enjoy the heated debate, but slow-moving or stagnant legislatures give businesses and investors more time to adapt to the few laws that pass.

That few see gridlock's benefits is the key to the midterm effect's power. During campaign season, investors fear radical campaign pledges will become law. Measures that are usually approved—like extensions of dozens of longstanding "temporary tax cuts"—stall as candidates use them to aggravate voters. All of this drives investor fear.

After the election, extreme rhetoric fades while campaign pledges fail to develop. Expired temporary tax cuts are renewed and applied retroactively. As time passes, once-raucous, extreme candidates go back to being the same boring politicians with whom 93% of Americans are disappointed with.[xx] As months pass without extreme proposals becoming law, relief sets in. Even if investors do not consciously see this as a huge positive, equities do, and gridlock propels them higher in the contest's aftermath.

Europe Picks a New Parliament

EU nations elected a new union-wide Parliament in May, and the vote went largely as expected. While anti-euro (also described as "euroskeptic" in the EU) parties picked up seats, the traditional pro-euro parties maintain a majority.

Exhibit 7: European Parliamentary Election Results

		2009 Seats		2014 Results	
		# of Seats	% of Seats	# of Seats	% of Seats
Pro-Euro	European People's Party	274	35.8%	221	29.4%
	Progressive Alliance of Socialists and Democrats	196	25.6%	191	25.4%
	Alliance of Liberals and Democrats for Europe	83	10.8%	67	8.9%
	The Greens-European Free Alliance	57	7.4%	50	6.7%
Euroskeptic	European Conservatives and Reformists	57	7.4%	70	9.3%
	Europeans United Left-Nordic Green Left	35	4.6%	52	6.9%
	Europe of Freedom and Democracy	31	4.1%	48	6.4%
	Non-Attached	33	4.3%	52	6.9%

Source: European Parliament, as of 25/07/2014.

While euroskeptic groups won the most seats of any party in France, the United Kingdom (UK), Greece and Denmark, we do not believe this is a bellwether for national elections in these states. Voters tend to treat EU elections differently than national contests. Overall turnout tends to be lower at EU contests, but turnout among euroskeptics often does not drop off, as many see a vote for an anti-EU candidate as a way to protest against the EU establishment. In national elections, turnout is higher, and voters tend to focus more on domestic issues. This is evident in recent UK poll numbers, for example, where the main Conservative and Labour parties outpoll the euroskeptic UK Independence Party—even though UKIP beat both at the EU election.

The impact on EU policy should be limited, as well, given the strong pro-euro majority. Several leaders, like French President François Hollande, said the EU election should propel leaders to focus on growth initiatives, and a growth-oriented policy slant would not surprise. As Q2 progressed, many leaders urged a more relaxed interpretation of EU treaty deficit limits to give countries more flexibility to encourage growth through fiscal stimulus. Longtime austerity champions like German Chancellor Angela Merkel even appeared open to the idea. Beyond this, however, the euroskeptics likely carry little influence.

The European Council (national leaders) did nominate a new European Commission President at Q2's close, tapping former Luxembourg Prime Minister Jean-Claude Juncker. Juncker favours tighter political integration, and the choice irritated the UK, which opposed the nomination. However, we do not believe this materially increases the likelihood the UK leaves the EU. Juncker has already made overtures to Prime Minister David Cameron, pledging support for the UK's broad push to reform Europe's single market and expressing willingness to allow the UK to reclaim some powers from Brussels.

Overall, we believe the EU political developments largely maintain the status quo. Leaders likely continue doing what is needed to preserve and strengthen the currency union, with any structural changes occurring at a gradual pace—with plenty of debate and politicking along the way.

Japan's Third Arrow Quivers

Japanese politics had an eventful Q2 as Prime Minister Shinzo Abe continued pushing his biggest policy goals: economic reform and restoring Japan's military prowess. Expectations remain high for structural economic reforms—the so-called Third Arrow of "Abenomics," but Abe made significantly more progress on military matters. While these two goals might seem unrelated, his focus is indicative of his priorities and spending political capital on the military risks the politically difficult economic reforms which are necessary to restore Japan's dynamism.

Abe did make another attempt—his third so far—at advancing his economic agenda. In a widely anticipated June speech, he announced many new reform plans and targets. However, like his previous two attempts for positive reform, most of his proposals were general and open-ended. The "aggressive agricultural policy" made no mention of reducing or eliminating tariffs, even though Abe touted the Trans-Pacific Partnership (TPP) trade agreement—which could mandate scrapping agricultural tariffs—as key to his agenda's success. Immigration reform was limited and largely confined to specific industries and special economic zones. Corporate governance reform was inconclusive, stating officials would work with the Tokyo Stock Exchange to draft a governance code for listed firms. Furthermore, labour market reforms were absent.

While the broad goals Abe outlined are largely beneficial, the lack of specifics is problematic. Only one of these broad goals has been clarified since—on 31 July, the government detailed Abe's corporate tax cut plan, which aims to reduce the 35% rate by six percentage points through fiscal 2019. Yet even this plus may be diluted, as the government is debating increasing other business taxes and closing loopholes to fund the cut.

Goals are different from tangible progress—completed legislation—and actual policy plans are few and far between. While these broad plans may yet yield specific legislation, recent history suggests it is highly unlikely. Abe's presentation also included highlights of Third-Arrow legislation passed so far, and the list is not long. There are some beneficial changes, but they are small and mostly non-contentious, like establishing a legal framework for crowdfunding, expanding the use of the national power grid, establishing a market-driven electricity system and enabling online sales of nonprescription drugs. A free-trade deal with Australia was finalised in Q2, but it did not eliminate agricultural tariffs—they were reduced, but the phase-in period is long. Beef tariffs, for example, were cut in half from 38% to 19%, but over an 18-year period—hardly encouraging for the TPP, which aims for total tariff reduction.

The issue remains political opposition—the most significant items, like corporate tax cuts, corporate governance, labour and agricultural reforms face stiff resistance from vested interests. Abe's Liberal Democratic Party's (LDP) traditional base is in Japan's farming sector, which prizes the tariffs Abe will have to eradicate to finalise TPP. The Japan Business Federation—known locally as keidanren—is not enamored of reforms that would end the elaborate cross-shareholdings among many Japanese firms. Keidanren would welcome the corporate tax cut, but fiscal hawks in Parliament refuse to pass these without offsetting tax hikes. Additionally, workers—who are also the majority of voters—are not keen to see the traditional lifetime employment system scrapped.

Compounding matters is Abe's other political pursuit: restoring Japan's military prominence. Abe has actively pursued amending or removing Article Nine of Japan's Constitution, the anti-war clause, which forever renounces war as a sovereign right. His attempts to rewrite this passage failed last year, but he persisted. Since he lacked enough Parliamentary votes to ratify an amendment, he chose to reinterpret the clause instead. In Q2, his cabinet—a coalition between the LDP and traditionally pacifist New Komeito party—agreed to interpret the clause as permitting the use of force for collective self-defense and participating in UN peacekeeping operations and "grey zone" incidents.

The move was hugely unpopular with citizens, who saw it as an end-run around the constitutional amendment process and a violation of Japan's democratic foundations. Protests raged in Tokyo in the aftermath, with one citizen self-immolating in a busy intersection—a horrific display. Abe's poll ratings fell below 50% for the first time since the December 2012 election, and early in Q3, the LDP candidate for governor of Shiga prefecture lost the election—a contest widely seen as a referendum on the security issue.

This episode has severely dented Abe's political capital. The less popular he is, the less incentive interest groups and rival politicians have to support his policy aims. Rivals likely see an opening to seize favour with voters by opposing the more unpopular measures, with hopes of unseating Abe and turning Japan's revolving political door once again.

In our view, the chain of events recalls Abe's first turn as Prime Minister in 2006, when he succeeded champion Junichiro Koizumi, inheriting a mandate to continue Koizumi's ambitious economic reform agenda. However, Abe focused on nationalistic pursuits instead, including rewriting school curriculum to be more "patriotic" and exploring an Article Nine rewrite. Meanwhile, Japan's economy floundered, Abe's popularity suffered, and he stepped down for health reasons after only a year. While he has undoubtedly made more progress this time around, it seems old habits have resurfaced. Absent a radical shift in course, we continue to believe reality will fall short of investors' still-lofty expectations.

Brazil Heats Up

Ten challengers have lined up to take on Brazilian President Dilma Rousseff in October's election, though the race is primarily between her and the Brazilian Social Democracy Party's Aécio Neves. Most of the campaign's early rhetoric is largely noise. Pundits sought clues in everything from poll numbers to the World Cup, but in our view, none of this is particularly telling. Poll numbers this early are usually variable, and by the time Brazilians hit the polls, both Brazil's World Cup defeat and fans' audible displeasure of Rousseff at several matches will be a distant memory. In our view, it is too early to handicap the results.

However, the campaign has influenced equities. Throughout her Presidency, Rousseff has proven much less business-friendly than her predecessor, Luiz Inacio Lula da Silva, which has contributed to Brazil underperforming the MSCI Emerging Markets index since she took office. Any indication she is losing ground in the polls tended to send Brazilian equities higher, as Neves is widely seen as more pro-business and therefore less apt to meddle with state-owned enterprises. This would be a direct contrast with Rousseff, who has manipulated state-owned banks and energy firms quite a bit in an effort to boost economic growth.

Rousseff does still lead Neves, though her advantage is now marginal. How Brazil's economy fares between now and October will likely influence the outcome, as Rousseff's eroding support has largely coincided with weaker economic data. For now, though, the ultimate outcome is to be determined.

High Expectations in India

Indian equities rallied as Narendra Modi and his Bharatiya Janata Party (BJP) swept to power in May, winning 282 of the Lok Sabha's 543 seats. His broader coalition, the National Democratic Alliance (NDA), took 336 seats overall, giving it the biggest majority in India's parliament since 1984, when the Indian National Congress took 404 seats amid a rush of support following the assassination of Indira Gandhi.

Modi, the prior Chief Minister of Gujarat, campaigned on a platform of economic and political reform, pledging to eradicate corruption and revitalise India's increasingly antiquated economy and infrastructure. Markets appeared to cheer an administration with a firm mandate for reform, but this is not the first time expectations have surged following the election of an Indian Prime Minister with an economic agenda and strong support. Given the decentralised structure of India's government—and the political roadblocks against some of the more radical changes necessary to modernise India's economy and attract investment—it remains premature to say whether Modi's policies will be able to meet current expectations.

The prior administration provides a useful illustration. During his first term, former Prime Minister Manmohan Singh pushed through modest reforms, building up support for his re-election campaign. Indian equities rallied as he cruised to a landslide victory on a platform of economic reform, infrastructure investment and cutting through India's concentration of red tape. However, his actual successes were limited. He made a number of sweeping proposals, including multiple attempts to create a national tax and trade permit system, remove barriers to foreign investment and boost private investment in infrastructure, but a series of corruption scandals weakened his political support, making passage difficult. Rare legislative successes like the measure allowing foreign ownership of retailers to exceed 50% went largely nowhere as implementation was left to regional governments, who have the right to decide whether or not to allow foreign majority stakes.

In our view, this political inertia is a large reason why Indian equities struggled to match the MSCI Emerging Markets Index for much of Singh's second term. Reform likely remains a swing factor for Indian equities looking forward, and it is an open question whether Modi will deliver.

Early signs are mixed. When Modi revealed his cabinet in late May, he trimmed the number of ministers from 71 to 45 in an effort to reduce government bloat and streamline decision-making. The role of Finance Minister went to Arun Jaitley, a NDA veteran who served as Minister of Commerce and Industry from 1998 to 2004. In his initial interviews, Jaitley highlighted several areas of low-hanging fruit to help restore confidence in India's economy, including accelerating project clearances and easing other administrative hurdles to doing business.

Modi kept expectations high after laying out his specific reform agenda in a June Parliamentary address. He cited containing inflation as the government's top priority, with a focus on addressing supply-side factors. Plans include investments in agriculture, irrigation, cold storage and reform of the Public Distribution System to tackle hoarding and black market sales—all of which, if seen through, would also help India combat its chronic malnutrition problems. Modi also pledged to introduce a national sales tax, resurrecting memories of Singh's failed attempts, and encourage foreign investment—but the only specific measure proposed was raising the foreign investment limit in the defense industry from 49% to 100%. Echoing Jaitley, he promised to speed approvals for business projects and infrastructure, with spending focused on road, rail and airports. Further, he pledged all homes will have uninterrupted electricity by 2022, implying an effort to take on India's byzantine power grid.

While the new government says all the right things, however, for now, action appears to be limited. As Q3 opened, the administration announced its first budget, and it did not quite match the prior rhetoric. It did include measures to cut income and investment taxes for low earners and boost infrastructure spending and financing, and they made good on the pledge to raise the foreign investment cap in the defense industry, but subsidies were left unchanged. In the surrounding days, Jaitley admitted the government was pursuing only the most politically expedient measures and deliberately taking a more gradual approach with the more challenging ones in order to avoid losing support. While this is encouraging in the sense that it suggests more contentious measures are not off the agenda, he also implied some of these—particularly labour market reforms—should be left to state governments.[xxi]

For now, markets appear to be taking these developments as in line with expectations. Looking forward, however, whether Modi can retain his momentum will be a key factor for Indian equities.

Chinese Reform Continues

China's leaders continued the slow progression to a more consumption-based, market-oriented economy throughout Q2, helping ease fears slowing growth would derail reforms.

Q2's first reform came on its first day, when China's National Development and Reform Commission (NDRC) announced plans to deregulate rail pricing on one new railway line, Zunchi Rail, which transports coal between Inner Mongolia and Shanxi Province. Freight rates will be determined by the market, which officials believe will attract private capital, helping ease the sector's funding constraints. While this was a small change, it has symbolic importance: Railway pricing has been strictly regulated, and while officials have spoken about deregulation in the past, they are finally acting, which could give investors confidence.

The reform push continued as April progressed, with the Chinese Securities Regulatory Commission (CSRC) and Hong Kong Futures Commission launching a pilot programme to allow mainland A-shares to be traded on the Hong Kong exchange and vice versa. Through July, this was the most meaningful example of the government's push to liberalise the capital account.

The new programme is similar to the "through-train" programme announced in 2007, which was quickly quelled by the Global Financial Crisis. The programme will allow Hong Kong investors to move up to RMB 300 billion ($48 billion) in mainland securities daily, while mainland investors can move up to RMB 250 billion ($40 billion) into Hong Kong shares each day. Investors with a minimum of RMB 500,000 ($8,000) can participate. The investment procedure will likely be simpler than the current Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) schemes, which impose qualification approval, holding period requirements and restrictions on remittances. The new system will establish direct cross-boundary clearing and allow investors to trade through their local brokers—all of which demonstrate the government's commitment to pursuing meaningful financial reform.

Officials also took steps to restart the IPO process in April, as the CSRC resumed its review of IPO applications. The CSRC approved 50 listings in January, but the programme stalled as the CSRC identified a need to modify disclosure requirements. As a result, no IPOs had priced since 22 January, disappointing the many investors who expected a more meaningful resumption of new issuances after the 14-month ban that ran through December 2013 created a queue of over 600 companies waiting to go public. While the delay is a setback for the companies awaiting financing, it does illustrate officials' desire to create a more transparent, investor-friendly system—a positive. Moreover, it helps temper investors' expectations, providing a timely reminder the road to reform will not be quick and easy—there will be the occasional speed bump. What matters, however, is that officials show the resolve to clear whatever hurdles arise, and in this case, the results are encouraging.

Another encouraging development occurred in May, when the State Council—the ruling cabinet—announced its capital markets reform agenda. While most of the goals were well-known following last year's Third Plenum, the Council provided more detailed instructions and signals the actual policymakers' intent to push through the Party's desired agenda.

Specifics included plans to expand the QFII and QDII programmes, raise foreign shareholder limits, open domestic capital markets to foreign individual investors and allow domestic individuals to invest more in foreign markets—all of which would further open the capital account. Several other measures target corporate financing, continuing the longer-term effort to diversify away from traditional bank channels. To expand bond markets, officials plan to develop a scheme for local government bond issuance, increase the amount of bond types available and promote securitisation. On the equity front, the Council reiterated its commitment to move to a registration-based IPO system, similar to the US. Officials also removed some hurdles to venture capital and private equity financing, including the requirement for placements to receive administrative approval. Additionally, state-owned enterprises were once again called out for needing improvement, with the government pledging to actively develop a mixed ownership economy and allow more private investors to become minority shareholders. In the weeks that followed, regulatory agencies announced further steps toward many of these goals, suggesting reforms should remain at the forefront looking ahead.

Economic Fundamentals Still Strong

Global growth jitters persisted as Q1 results showed US GDP contracting, China slowing and the eurozone drifting. Most outlets excused the US GDP drop as a winter weather side-effect—rightly so, as Q2 GDP bounced back positively. However, a loud minority argued a stronger economy would have grown despite the extreme weather conditions. Most monthly indicators improved throughout Q2, but headlines latched on to any hint of faltering output as signs of a fragile world.

The media's scepticism did not match reality—data overwhelmingly point to global growth. Expansions are not smooth—all see occasional slowing or even brief dips. Additionally, most economic data—GDP, retail sales, industrial production and the like—look backward. They tell you what happened, but the past does not predict the future nor are equities propelled by current economic activity. Equities look forward — growth a quarter, two or three from now is what matters. Once a report confirms activity, equities already lived it.

The Overlooked Indicator

To see where the world is going, you can simply look at the longer-term trends of The Conference Board's Leading Economic Index (LEI). The Conference Board maintains LEIs for 12 major countries and the eurozone.

Each LEI collects the country's forward-looking economic indicators. These vary—for example, China's LEI omits the interest rate spread since the government controls lending and capital markets. However, most countries include some combination of equity prices, interest rates or yield curve spreads, factory orders (which become tomorrow's production), credit availability and others. No factor perfectly captures or predicts the entire economy. The combination, however, gives a fairly reliable gauge of future economic direction. If major countries' LEIs are high and rising, a recession is unlikely to follow closely—no US recession in LEI's 55-year published history started with LEI rising.

Few observers cover non-US LEIs, following PMIs instead. PMIs are useful, as their new orders sub-indexes give a timely read of demand and future production, but they are not perfect. PMIs are surveys—subject to error—and estimate only how many firms saw more activity. They don't reveal the magnitude of growth. If a minority of businesses grow, PMIs would show contraction. But if that minority grew faster than the majority shrank, actual output would grow. LEIs include PMIs' new orders and several other variables—more complete and usually more reliable.

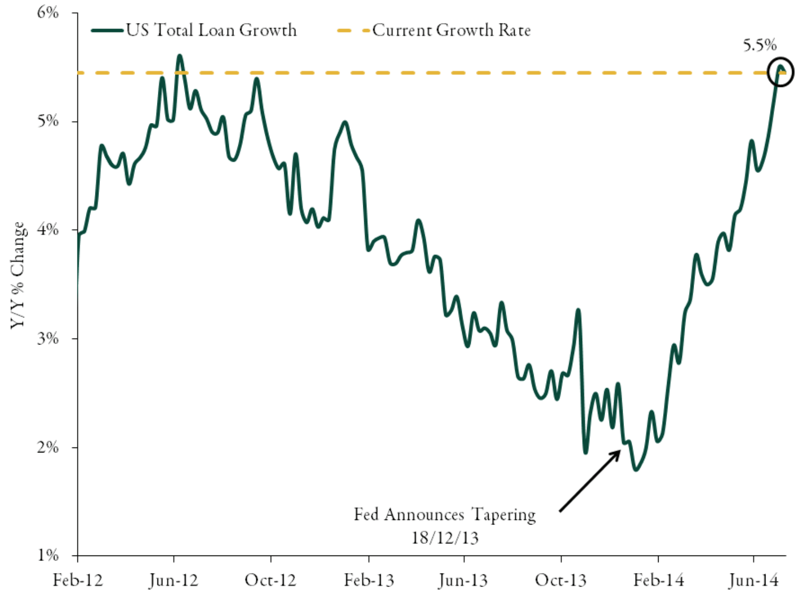
The LEI, unlike GDP, is able to capture drivers like money supply and loan growth through measuring the interest rate spread (yield curve spread) and credit availability (the Leading Credit Index). These components are the most consistent with the LEI's broader direction—and have been since 1991, the earliest detailed data available for the current series. Others (factory orders, employment, building permits, sentiment) are frequently volatile, driving occasional LEI shakiness. However, if the rate spread and Leading Credit Index are positive—as they have been for a long while—it indicates businesses can get funding to invest and grow.

Despite being a more complete and reliable indicator, LEI does not predict future returns. Equities are part of most LEIs, and past performance does not dictate future returns. Thus, LEI is not a pure market forecasting tool. However, recessionless bears are rare, and since LEIs help show the economy's path, they help an investor see if growth will support equities. The current environment of rising global LEIs is certainly an encouraging sign and underscores our bullish forecast.

The Post-Taper Renaissance Continues

Loan growth in the US improved again in Q2 as the Fed reduced ("tapered") monthly asset purchases (quantitative easing, or QE) by another $20 billion. Additionally, global concerns over negative effects of the taper largely did not play out. Most Asian economies stayed strong throughout Q2, providing further proof the region's economic performance is not tied to the Fed's QE programme and helping sentiment move further past these false fears.

Exhibit 8: Loan Growth Continues Rising



Source: FactSet, as of 24/07/2014. Year-over-year percent change in total loans and leases at all US commercial banks, 31/01/2012-04/07/2014.

We expect lending to accelerate more as QE gradually ends. So far, tapering has gone largely as we expected. After speeding up in Q1, business and household lending stayed firm through Q2. Fed surveys show improved loan supply, and borrowers and banks report looser lending standards. Long-term interest rates are higher than before May 2013, when former Fed chairman Ben Bernanke alluded to slowing QE, but loan demand did not fall. A drop in refinancing pushed overall mortgage originations down—but issuance for new home purchases is steady. The housing recovery continued in Q2, with May new and existing home sales up 18.6% m/m and 4.9% m/m, respectively, after rising 3.7% m/m and 1.5% m/m in April.[xxii]

Unsurprisingly, banks' net interest margins (NIM), a measure of loan profits, have not grown yet. Monetary policy changes usually show in the economy at a considerable lag. It would be unusual for banks' margins and long-term rates to rise simultaneously, considering NIM expansion requires issuance of enough higher interest-rate loans to boost the average. Looking ahead, we still expect NIM to expand (supporting our optimism for US and UK banks), even though long-term US Treasury rates are down this year. As detailed earlier, interest rate volatility is normal. Even with recent declines, the yield curve is steeper today than before taper talk began last May.

Rate Hike Speculation

Inflation in the US is also rising. CPI sped from 1.1% y/y in February to 2.1% in May.[xxiii] The Personal Consumption Expenditures (PCE) price index—the Fed's preferred gauge—jumped from 0.8% to 1.8% over this span, and core PCE, which excludes volatile food and energy prices, hit 1.5% in May.[xxiv] March's slow-inflation fears morphed into hot inflation fears, yet the PCE annual rate is below the Fed's 2% target—itself not a ceiling. Some claim rising food prices signal problematic inflation, but increases in certain goods are not a monetary issue. Rising food prices often stem from non-monetary factors like weather—Q2's rising prices were largely tied to California's drought and other fleeting factors.

Core inflation figures exclude food and energy prices to remove volatility caused by factors like weather. Food prices could rise as California's drought continues. However, the Fed lacks tools to target the drivers behind this. No rate hike can spur rainfall in Central California. Basing monetary policy on unpredictable, uncontrollable factors like weather would be a very real risk.

Higher inflation spurs speculation about a short-term rate hike. This reached a furor in the UK, where markets hang on Bank of England (BoE) Governor Mark Carney's every word as the economy continues recovering. Shortly after becoming Governor at the BoE in July 2013, Carney adopted "forward guidance," mimicking former Fed Chairman Ben Bernanke's strategy of tying future policy moves to certain economic conditions. At the time, Carney said the BoE would not consider a rate hike until the unemployment rate—then at 7.7%—improved to 7%. The official BoE forecasts predicted that improvement would not come until late 2016, suggesting this guidance was Carney's attempt to quell speculation over a potentially premature hike.

Since then, however, things have improved quicker than the BoE expected. GDP growth held steady at a 3.2% annual rate in Q1, and most indicators showed considerable strength throughout Q2—including business investment, which grew a fifth straight quarter.[xxv] With an improving economy came improving unemployment, which hit 6.9% in February—over two and a half years ahead of the bank's forecasts—forcing BoE Governor Mark Carney to retract his earlier guidance.[xxvi] Markets took him at his word, and interest rate futures indicated expectations for a mid-2015 hike. However, in a June speech he indicated markets were looking too far out, raising the risk they would be blindsided when the BoE acted earlier. The change in opinion drove investors to parse every ensuing comment from Carney or BoE release for clues about the exact timing of a hike, with several pundits attempting to diagnose the move to a specific month, but in our view, this effort is misplaced. Central bank decisions are not predictable market functions. They are based on human inputs and judgment, including the interpretation of volatile short-term economic data. As Carney's U-turn showed, these thoughts are subject to change.

Rate-hike fears, too, are misplaced in our view. They stem from the long-standing belief rising rates are bad for equities, but there is no evidence this is true historically. Exhibits 9 and 10 show global equity returns before and after the initial rate hike in each of the Fed's and BoE's tightening cycles since 1970.

Exhibit 9: Initial Fed Rate Hikes and Trailing/Forward Returns

Date of First Rate Hike	Percent Change Prior 12 Months	Percent Change Next 12 Months	Percent Change Next 24 Months
16/07/1971	31.2%	13.5%	19.0%
16/08/1977	-1.5%	15.0%	19.8%
21/10/1980	18.9%	-13.6%	-8.0%
27/03/1984	11.8%	8.0%	62.6%
16/12/1986	40.8%	14.1%	37.6%
29/03/1988	0.9%	11.7%	9.8%
04/02/1994	27.2%	-3.9%	17.4%
30/06/1999	14.0%	10.7%	-12.1%
30/06/2004	21.4%	8.7%	22.4%
Average	**18%**	**7%**	**19%**

Source: FactSet, as of 04/08/2014. MSCI World Price returns before and after the announcement of the initial rate hike in the past nine Fed tightening cycles. Returns before 1980 are monthly, daily thereafter. Data in USD

Exhibit 10: Initial BoE Rate Hikes and Trailing/Forward Returns

Date of First Rate Hike	Percent Change Prior 12 Months	Percent Change Next 12 Months	Percent Change Next 24 Months
28/11/1977	-8.2%	3.6%	-0.8%
06/07/1984	11.5%	25.7%	64.2%
10/06/1988	-11.1%	25.6%	20.7%
12/09/1994	6.0%	9.5%	20.0%
30/10/1996	12.2%	12.2%	24.5%
08/09/1999	30.4%	21.5%	-15.2%
06/11/2003	8.9%	4.7%	20.4%
Average	**7.1%**	**14.7%**	**19.1%**

Source: FactSet, as of 04/08/2014. MSCI World Price returns before and after the announcement of the initial rate hike in the past eight BoE tightening cycles. Returns before 1980 are monthly, daily thereafter. Data in GBP.

In our view, the larger issue here is a potential credibility deficit for Mark Carney—something the UK press has alluded to as well. While he has not lost this key asset yet, as most outlets appear willing to extend some grace for his recent verbal missteps and take a "wait and see" approach to his actual decisions, there is a critical lesson in this saga for him. If central bankers are too clear, investors will try to front-run them, as UK investors did with Carney's guidance. This is why central bankers have historically sought to be vague. Former Fed Chair Alan Greenspan epitomised this vagueness, eschewing formal policy announcements for much of his tenure and delivering his semiannual Congressional testimony in riddles and opaque, long-winded phrasing—a dialect that came to be known as "Fedspeak." He once remarked, "Since I have become a central banker, I have learned to mumble with great incoherence. . . . If I seem unduly clear to you, you must have misunderstood what I said."[xxvii] In our view, the most beneficial strategy for Carney would be to adopt Greenspan-style mumbling and help markets resist the temptation to overthink policy statements and every piece of economic data for clues on his next move.

As for current Fed chair Janet Yellen's next move so far, she is resisting pressure to react to food prices and rising core prices—appropriate, in our view. It would not surprise us if she continues her gradual approach. Fed transcripts from her time as San Francisco Fed President show she is not a great forecaster, and she seems to know this. Throughout 2008, her economic outlook was non-committal, based on past results, not expectations for the future. She has stayed course in recent press conferences, speeches and Congressional testimonies.

While we cannot know what she will do and when, thus far Yellen seems more prone to gradual moves—and more humble—than Bernanke. Bernanke was a hammer looking for a nail, eager to test grand policy tricks he theorised the Fed should have used during the Great Depression. Yellen shows no such tendencies. Seven years older than Bernanke, perhaps more moderated, and dissimilar to him, she tends to wait for confirmation and consensus. Thus, she seems likelier to move slowly and abide with traditional monetary policy, not QE-style experiments. If this proves true, the US economy would likely benefit from the simplicity, but only time will tell how this plays out.

Much of the inflation fear and effort to read central bankers' minds seems to rest on the myth a rate hike is bad for equities. History does not support this—equities tend to rise before and after an initial rate hike.

US Still Poised for Growth

The first estimate of Q1 GDP showed a 0.1% seasonally adjusted annual growth rate (SAAR), but the third reading revealed a -2.9% drop.[xxviii] While many claimed the dip was caused by severe winter, a loud minority claimed a firmer economy would have overcome the weather. Even as data improved in spring, any lackluster report brought out the naysayers. When jobs passed their pre-recession peak in May, conditional arguments about still-weak growth ensued (oddly flipping the "jobless recovery" talk from the bull's first few years). Meanwhile, Q2 GDP was up 4.0% SAAR and LEI rose in five straight months through June and 13 of the last 14, discrediting arguments around faltering growth.[xxix]

Looking ahead, we expect LEI to prove correct. GDP dipping in an expansion is not unprecedented—Q1 2011 GDP fell -1.3% SAAR.[xxx] Q1 2014's drop was bigger, yet it contained few signs of weakness. Consumer spending—the economy's biggest segment—grew 1.0%, with spending on durable goods (big-ticket items) and services up 1.2% and 1.5%, respectively.[xxxi] Healthcare spending hurt consumption, thanks largely to the Affordable Care Act's delayed rollout—premium payments expected to register in Q1 were delayed, preventing some from seeking non-emergency medical care until their new plan kicked in.

Other areas fared better than headline GDP suggested. While overall business investment fell -1.2%, intellectual property investment—including software and R&D—rose 6.3%.[xxxii] Businesses usually do not invest in long-term projects if the outlook is shaky. Private inventories fell, shaving 1.7 percentage points off total growth, but this is due to the weather—with factories offline and shipping routes blocked, firms couldn't restock—shelves grew bare.[xxxiii] Imports rose 1.8%, signaling healthy demand. Rising imports detract from GDP, a calculation quirk.[xxxiv]

GDP is useful, but any indicator that falls nearly 3% when demand does not crater, in our view, does not perfectly measure the real economy. Similarly, it does not indicate private-sector health—more meaningful for investors. When investors own equities, they do not own slices of national economic output. They instead own slices of corporate earnings. Q1 S&P 500 earnings per share rose 2.1% y/y—beating an expected decline—and revenues advanced 2.7% y/y.[xxxv] In other words, corporate America is growing.

The Eurozone's Ongoing Struggles

Mixed eurozone economic data drove sentiment lower as analysts fretted past results, ignoring forward looking indicators. Q1 eurozone GDP grew 0.2% q/q, but it was mostly driven by Germany—several countries were flat or fell.[xxxvi] Uneven growth persisted in Q2, yet eurozone LEI marched up, highlighting a disconnect between the two readings. Yet this is not all that uncommon. France exemplifies this disconnect. GDP stagnated in Q1, and services and manufacturing Purchasing Managers' Indexes (PMI) were below 50, signaling contraction, all quarter. Yet French LEI kept rising. This resembled Q4 2013, when contracting PMIs drove double-dip recession fears while LEI rose. LEI proved correct—Q4 GDP grew 0.2% q/q.[xxxvii]

Eurozone, French, German and Spanish LEIs are all in longer-term uptrends. However, the perception of a fragile Europe persists. This seems largely due to the International Monetary Fund (IMF) and its counterpart, the World Bank. For months, they have misinterpreted slowing inflation as evidence the region has not grown stably, risking renewed recession and deflation (a false fear, in our view). Fears surrounding low inflation and slow-growth drove calls for ECB chief Mario Draghi to introduce QE. So far, he has not—and the eurozone should benefit if this holds true—but he has tried to address the long-lived fall in lending that is weighing on inflation. In June, the ECB launched two new long-term refinancing operations—one aimed at lending for small businesses, the largest piece of Europe's corporate sector. They also cut the primary bank rate to 0.15% and the central bank deposit rate to -0.1%.

Many feared negative rates. Europeans worried they would hurt savers — stifling spending and living standards — while some US investors worried the move was a monetary policy error potentially bucking the bull. We do not believe it is a negative, but it probably will not improve lending much. Charging banks to hold central bank reserves is designed to punish banks hoarding cash, but it does not ensure banks lend excess funds—which total only €8.3 billion.[xxxviii] Most evidence suggests banks are holding extra cash as a stress-test cushion, so they are more likely to purchase high-quality, liquid bonds, like UK gilts, German bunds or US Treasuries.

Slow eurozone loan growth is not a monetary policy issue—it is regulatory. The ECB soon becomes regulator of the eurozone's largest banks, and its powers are broad. Officials gave it power to supervise failing or near-failing banks, a process potentially forcing losses on creditors and large depositors. A prime example of such loss is Cyprus's banking crisis, which wiped out significant savings. However, the legislation and regulatory framework does not state what would trigger this, driving uncertainty. Draghi and others have implied failing a stress test—an exercise designed to determine a bank's ability to withstand a potential crisis—could force these "bail-ins." This incentivises banks to slash balance sheet risk before this autumn's tests. Until the results are announced and the ECB's bail-in triggers are clarified, lending probably stays weak.

While this is a headwind, the eurozone has ample positives, too. Fiscal policy is largely pro-growth. France's Socialist leaders are acting like free-market reformers, proposing tax cuts, incentives for investment and some deregulation. Spain and Italy have proposed or enacted tax cuts, easing the three-year austerity burden on households and firms. There is clamor for more flexible Maastricht Treaty deficit limits to allow nations to launch fiscal stimulus, with even Germany supporting this stance. All are positive for the eurozone over the mid to longer term.

Still No Hard Landing in China

Fears of a crash in the world's second-largest economy persisted throughout Q2. Official data revealed Q1 GDP growth slowed to 7.4% y/y, property markets weakened, retail sales and industrial production slowed and manufacturing PMIs showed considerable choppiness.[xxxix] Yet China's LEI has been on a tear, outpacing most of the world, suggesting the long-feared hard landing is as unlikely as ever.

The media's take on China data reveals just how out of step with reality sentiment is. When HSBC's manufacturing PMI, which focuses on small private firms, rose above 50 in June and signaled expansion for the first time in seven months, headlines reacted as if China were coming out of a recession. In reality, China had never stopped growing. Slower growth in retail sales and industrial production meant 9.6% y/y and 8.7% y/y rises in April, respectively, enviable by any other standard.[xl] The official manufacturing PMI, which includes state-owned enterprises and thus provides a broader look than HSBC's measure, never fell below 50. Neither did the official services PMI, which has been far above the manufacturing gauge all year. Services now represent the largest segment of China's economy, and growth there is clearly broad-based.

While growth has slowed, retail sales, industrial production, trade and other indicators appeared to stabilise in May and June as targeted fiscal and monetary stimulus measures began to take effect. Keeping with the approach they took in 2012 and 2013 after early economic readings wobbled, officials announced several measures throughout Q2. The measures were small and largely consistent with the government's stated goal of supporting growth enough to meet annual targets without deviating from longer-term plans to reengineer their growth model to a service and consumption-based economy with more market influences. Included were measures to attract private investment in railroads, accelerated infrastructure spending, tax cuts for small businesses, and reserve requirement cuts for the smaller banks that lend to the private sector.

None of these will restore China's double-digit growth, but they do not need to—significant economic reacceleration is not necessary for Chinese equities to perform well. As ever, the gap between reality and expectations is what matters, and with most investors still expecting the economy to weaken, mere stability should prove a positive surprise. Furthermore, all evidence suggests a stable-growing China is what we have today. The first estimate of Q2 GDP put growth at 7.5% y/y, with one of the biggest headwinds—the decline in property sales—leveling off somewhat.[xli] While the property sector still faces challenges, recent data suggest fears of a broad collapse are overstated. With stable domestic and improving external demand, continued fiscal and monetary policy support and property markets quietly improving, China's macroeconomic picture is quite better than most perceive.

Growth Continues Throughout Asia

In Indonesia—widely feared last year as one of the most vulnerable to QE's end—monthly data suggest growth held steady after Q1's 5.2% y/y GDP rise.[xlii] Industrial production continued advancing at 4% y/y and 2.9% y/y in April and May, respectively.[xliii] Retail sales jumped 15.9% y/y in April, 15% y/y in May and 11.9% y/y in June.[xliv] Trade was noticeably volatile, but this has been the case for the past year, and choppy import and export figures have not derailed overall growth.

The Philippines held steady as well, with data confirming GDP grew 5.7% y/y in Q1 as the country recovered from Typhoon Haiyan.[xlv] Manufacturing—lackluster in Q1—snapped back with 13.1% y/y and 21.2% y/y growth in April and May, respectively.[xlvi] Retail sales saw minor improvement too , rising 2.3% y/y in April and 2.6% y/y in May.[xlvii] Trade slowed some in April but remained positive, with exports growing 0.8% y/y and imports up 3% y/y. The country's yield curve is also the steepest in Emerging Asia, which bodes well looking ahead.

Indian growth also appeared to remain relatively firm. Industrial production—down slightly in February and March—rebounded to 3.4% y/y in April and 4.7% y/y in May.[xlviii] Exports, also down in February and March, bounced back strong at 9.64% y/y in April, 12.4% y/y in May and 10.2% y/y in June.[xlix] Imports were shakier—down double digits in April and May—but seemed to stabilise in June with 8.3% y/y growth.[l] Perhaps most telling, though, India's LEI rose all quarter, culminating with a 0.8% rise in June.[li] It would be unusual for a soft patch to occur after an LEI upswing.

Monthly indicators in Thailand were noticeably weaker than the rest of the region, but these seemingly lackluster results actually represented broad improvement. GDP contracted -0.6% y/y in Q1 as political protests disrupted commerce in the capital, Bangkok, but both the political landscape and economy appeared to stabilise in Q2.[lii] Retail sales' declines eased to -0.8% y/y and -0.3% y/y in April and May, and Industrial Production retuned to growth, rising 1.2% y/y in April and 1.2% y/y in May.[liii] Growth might not resume for a while longer but it does appear fears of a prolonged economic impact from political disruptions were overwrought.

Korea also experienced some volatility as April's Sewol ferry tragedy shook sentiment. Nationwide mourning was widely blamed for a lack of retail sales growth in April, though consumers bounced back in May, sending sales up 1% y/y and easing fears of a prolonged economic impact from the disaster.[liv] Industrial production did fall -2.1% y/y in May after growing 2.5% y/y in April, but this appeared tied more to the placement of two holidays close together, which prompted workers to take more time off—not a sign of a weakening economy.[lv] With imports up all quarter, it seems clear Korean demand is growing, not falling.[lvi]

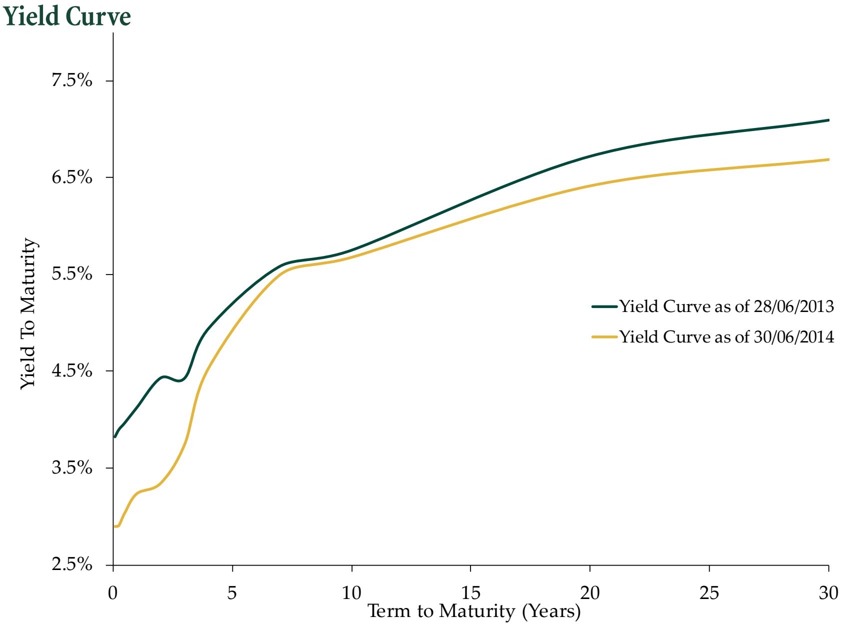
Finally, Taiwan continued marching forward, with Q2 GDP growing 2.8% y/y. Household spending led the charge, growing 2.7% y/y, but private business investment was also positive at 2.2% y/y, the seventh straight quarter of growth. Exports rose 3.9% for the quarter, and looking ahead, we expect trade to stay strong as continued growth in enterprise technology spending throughout the developed world drives demand for the many components manufactured in Taiwan.

Mixed Growth in Latin America

Across the Pacific, growth was not quite as robust. Brazil—Latin America's largest economy—endured a continued slowdown in Industrial Production, which fell -0.5% y/y in April and -0.6% in May.[lvii] Trade, too, was weak, with exports and imports falling throughout the quarter. Yet retail sales were stronger, rebounding from March's contraction with growth of 6.7% y/y in April and 4.8% in May.[lviii] A relatively healthy Brazilian consumer might not be sufficient to drive a meaningful economic reacceleration, but Brazil's economic issues are well-known. Brazilian equities have demonstrated an ability to overcome them in recent months, though Brazilian outperformance seems to have been driven by politics more than economics of late.

The story is much the same in Mexico. While Mexico has more structural factors in its favour than Brazil, thanks to the ongoing raft of economic reforms, those are not meaningful near-term drivers—reforms tend to impact the real economy at a substantial lag. However, while growth has remained slow, there are some encouraging signs. Mexico's strong trade relationship with the US remains a positive, helping boost export growth above 4% y/y during each month of Q2.[lix] Mexico's yield curve has also steepened significantly over the past 12 months, as shown in Exhibit 11 which should support lending and investment over the foreseeable future.

Exhibit 11: Mexican Yield Curve



Source: FactSet, as of 8/8/2014.

Fears, Risks and the Wall of Worry

Though we believe major economic, political and sentiment drivers point to continued bull market, this does not mean risks are absent. No bull market—no matter how strong—lacks negatives, and this bull has plenty.

Most negatives existing today lack power to hit corporate profits enough to disrupt markets. Many persist in headlines, sapping surprise power (Ukraine, Iraq). Other negatives rest on fearful feelings, not hard evidence (equities at all-time highs). Rarely discussed risks posing actual market threats are extremely low-probability. Yet investors seem more prone to search for negatives than appreciate the strong bull market and global economic expansion—a sign record highs are likely to continue.

While negatives arise and may persist, a $70 trillion global GDP growing at 2% a year with 2% inflation would take $2.8 trillion of new negatives to turn an expansion into recession. A few new, minor negatives will not do it. However, sentiment mostly wavers around much smaller phenomena.

Acrophobia

With each new high, pundits ask whether the level is justified, or if a crash is forthcoming. After the Dow Jones Industrial Average (Dow)—a widely watched but faulty index—reached 17,000 just after quarter-end, sceptical headlines erupted. In May, a well-known hedge fund manager's vibrant comment that he would not own too many equities sent sceptical shockwaves.[lx] June unearthed skeptics clamoring that investors were unaware of risks associated with market complacency.

All-time highs are not predictive—index levels, round numbers and records reflect past market movement, which does not dictate the future. As Exhibit 12 shows, the 1990s bull set over 300 new daily closing highs, with expansive returns between the early highs and peak. The 1980s surged through many records. The S&P 500 set 48 new record highs in 2002 – 2007's bull, the first in late 2006.[lxi] A record high should not affect an investor's strategy or expectations of market direction.

Exhibit 12: S&P 500 Total Returns After Record Highs Attained, 1990s Bull Market

Record High Number	Date Attained	Forward Return Through 24th of March 2000 Peak	Hypothetical Value of $1,000,000 Invested
1	11/02/1991	411.4%	$5,114,013
100	20/03/1995	236.8%	$3,368,145
200	18/10/1996	127.7%	$2,276,861
300	16/07/1998	31.9%	$1,319,227

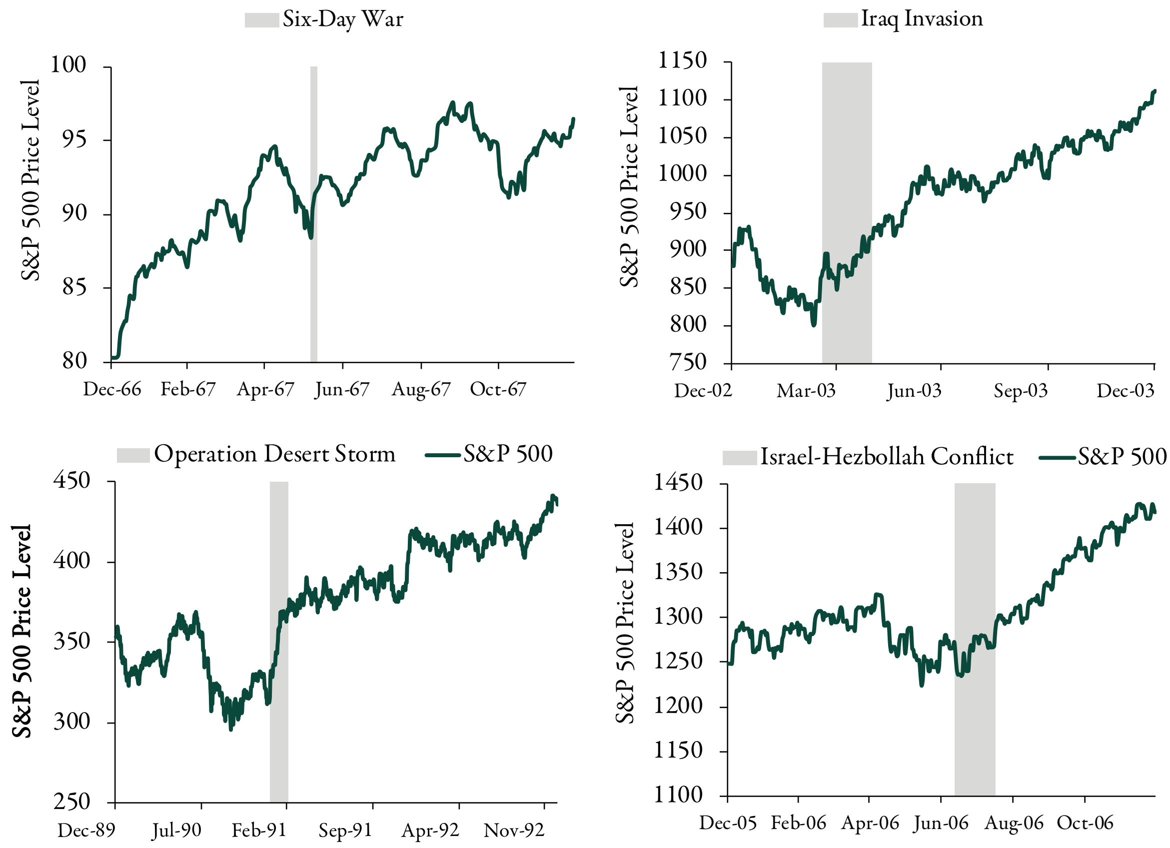
Source: Factset, as of 18/07/2014. S&P 500 Total Returns and hypothetical value on 24/03/2000 of $1,000,000 invested on the date indicated.

An Overstated Risk—Geopolitical Worries

Many skeptics consider how equities remain rising in a world torn by conflicts, namely in Ukraine and Iraq. However, most bull markets advance amid regional conflicts and, barring major (and very unlikely) escalation, Iraq and Ukraine seem like the latest examples.

This is an uncommon view, but consider the historical events. In this bull market, tensions have flared in Iran, Syria, Egypt, Libya, Tunisia, Sudan/South Sudan, Israel, Afghanistan, Iraq and more. Equities may react slightly at first, but none ended the bull. This is the historical norm. Exhibit 13 shows S&P 500 returns during the Six Day War between Israel and several Arab states, two US/Iraq wars and 2006's Israel/Hezbollah fighting. These are a few of many such examples.

Exhibit 13: Regional Conflicts Tend Not to Knock Equities



Source: FactSet, as of 21/07/2014. S&P 500 Price Index, 31/12/1966-31/12/2006.

Russia & Ukraine

The Ukrainian conflict continued in Q2, with a slightly different setting. Tensions today are centred in eastern Ukraine—around the cities of Donetsk and Slovyansk—but otherwise resemble the situation in Crimea. Pro-Russian rebels who spoke with Russian accents, wore Russian-style uniforms and seemed new to the region stormed government buildings. After seising control, rebels in Donetsk and the neighboring Luhansk region held referendums on secession from Ukraine. Turnout was suspiciously low, but the measures passed by a wide margin, and rebels declared independence—similar to Crimea, though the Kremlin made no moves to annex these areas.

In May, Ukrainian voters elected lawmaker and chocolate magnate Petro Poroshenko president. Poroshenko is anti-Kremlin—Russian trade restrictions targeted his business in late 2013, and he supported protests against the pro-Russian government in early 2014. A week after he took office, rebels in Luhansk downed a Ukrainian transport plane, killing 49. Poroshenko soon offered a ceasefire, but the rebels reportedly never stopped firing. Poroshenko responded by invading rebel-held areas, and the Ukrainian military pushed rebel forces back to major strongholds.

After quarter end, Russian separatists downed Malaysian Airlines flight MH17 from Amsterdam to Kuala Lumpur, killing 298 civilians—an unfortunate tragedy. The US and EU responded with stiffer sanctions, but as of this writing, it appears Russian banks and businesses will not be barred fully from trading with the West, limiting the potential economic and market impact.

It would take extreme escalation—likely involving many more nations—for equities to see a lasting, negative impact. Many fear economic measures—Russia exerting influence through its Energy industry, as many pipelines cross Ukraine. If Russia shut the flow, some argue, Europe's economy would lack energy. However, this would hurt Russia more than it helps. Russia's Energy sector is its economy's lifeblood. It cannot afford to cut off the West. Some suggested a Q2 energy deal with China gives Russia an alternate customer, but gas will not flow there for years. Though Russian state-run gas giant Gazprom stopped supplying Ukraine with natural gas in June due to disputed overdue bills, gas still flows through Ukraine to Europe.

It is highly improbable a money manager perfectly predicts how the conflict plays out. In our view, unless this escalates into a global conflict—an unlikely scenario—the proceedings should not have a material impact on equities.

ISIS & Iraq

In mid-June, the Islamic State of Iraq and al-Sham (ISIS)—an al Qaeda-affiliated terrorist group—swept from Syria into northwestern Iraq, taking Mosul, Tikrit and Tal Afar and threatening Baghdad. The Iraqi army mounted a resistance, which was largely ineffective until being reinforced by the Kurdish and Iranian armies. A battle between Sunni and Shiite Islamic forces ensued.

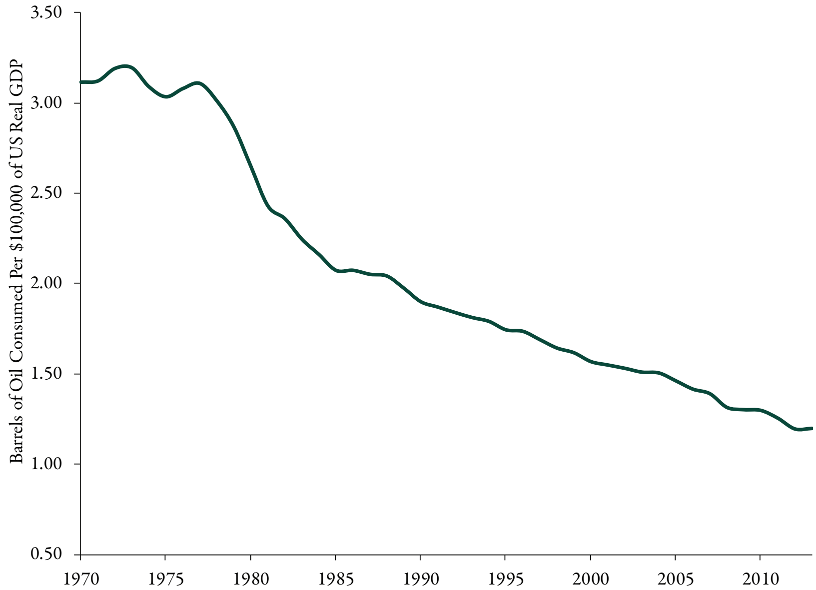
The turmoil triggered fears of market and economic impact, but in our view, these are misplaced. Annual Iraqi GDP ($229 billion in 2013) is roughly equivalent to the US states Louisiana or Connecticut, about 0.3% of global GDP.[lxii] Trade ties are also limited. In 2013, Iraq made up 0.3% of EU exports and 0.6% of EU imports and only 0.1% of US exports and 0.6% of US imports.[lxiii]

The major concern seems to be oil. Iraq is OPEC's second-largest producer, with output of 3.1 million barrels per day (MMbpd). Brent crude oil prices—a global benchmark—rose from about $109 per barrel to over $115 after fighting began (US benchmark prices rose less).[lxiv] This, however, should not last. The fighting has largely missed oil infrastructure. Most Iraqi oil fields and export terminals are in the southeast—some analysts claim only 10-15% of Iraqi output is near the conflict zone.[lxv] After mid-June, Brent prices fell to about $110, near the same level prior to the beginning of the turmoil.

If the conflict does hurt oil output, Saudi Arabia said they are willing and able to boost output enough to compensate. Also, Libya—largely an energy nonfactor since 2011—recently brought two key oil export terminals back online.

Additionally, today's US is not like the 1970s. US oil output is not falling. In March 2014, the US produced 8.2 MMbpd, 3.0 MMbpd more than the monthly average from 2005-2010, before the shale boom hit full stride—a nearly Iraq-sized increase. This helped US oil imports fall to mid-1990s levels. The US economy is also far less energy intensive than 40 years ago.

Exhibit 14: The US Economy's Increasing Oil-Efficiency



Source: US Department of Energy, US Bureau of Economic Analysis, as of 18/07/2014. Annual petroleum consumption (thousands of barrels per day) and US real GDP in 2009 dollars, 1970 – 2013.

This output boom is also why we are not currently emphasising Energy equities. Energy earnings tend to be more sensitive to prices than volumes. Recently rising production has outstripped demand, weighing on prices—and Energy firms' revenues and profits. June's Iraq-driven volatility is neither big nor expansive enough to benefit Energy firms' top and bottom lines much.

The Foreign Account Tax Compliance Act, FATCA

One of Q2's most-discussed false fears was the Foreign Account Tax Compliance Act, or FATCA for short. It is also often referred to by its bill number, HR 2847. FATCA is a provision added to March 2010's Hiring Incentives to Restore Employment Act. It aims to reduce tax evasion by requiring non-US banks to disclose US citizens' offshore accounts and holdings to the IRS, which seeks to tax activities according to US law. Final rules, released in February 2012, require non-US nations and banks to sign disclosure deals where non-US firms would report any US citizens' or green-card holders' taxable accounts exceeding $50,000. Banks in nations that do not sign on are subject to a 30% withholding on any US-related business—a big incentive to comply.

Four years after passage and two years since the final rules were set, it seems most of FATCA's direct impacts already happened. Most major banks are in compliance, and some simply refuse to serve overseas Americans due to high compliance costs—a clear negative for these individuals. This drove a sharp increase in expatriates renouncing US citizenship in 2013, but the 221% rise put the total number at 2,999—a curiosity, not an economic issue. The direct economic and financial effects seem to lack market-moving power.

Some see this as protectionism, and we do not disagree. However, a trade war requires two or more parties raising barriers, and major trade partners do not appear to be reacting to FATCA. Nearly all big banking nations (Switzerland, the UK, the Cayman Islands, Hong Kong and Bermuda) signed agreements. Similarly, over 100 countries and territories have signed on.[lxvi] Barring a major and unlikely shift, FATCA should have little impact moving forward.

Less Discussed Risks Worth Monitoring

While we do not believe any existing negative is big or surprising enough to trigger a bear market, we always aim to see powerful risks the investing public and media overlook. Here are a few examples we monitor, though these do not look probable presently.

Regulatory Reshuffling

While gridlock mitigates the risk new US legislation passes, it does not mean Washington has no potential impact. Many rules are fine-tuned or written by regulators, often years after legislation passes. Sometimes, a new rule's impact can change as it interacts with existing rules—2002's Sarbanes-Oxley Act's criminal penalties for accounting fraud led bank executives to take aggressive write-downs upon implementation of 2007's FAS 157 (the mark-to-market accounting rule). This, in our view, played a large role in 2008's financial panic.

We do not see anything similar today, but unknowns exist. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 left most rule-writing to regulators. As Q3 begins—four years since the law passed—only 52% (208 of 398) of required rules are final.[lxvii] As rules emerge, they cause disruptions. One minor example targets the accounting method for collateralised debt obligations backed by Trust-Preferred Securities, which small banks have long held for income. An obscure Volcker Rule provision initially banned this as proprietary trading, requiring banks to write-down these assets and liquidate them by July 2015. Though the rule was eased and the initial estimated impact was a minimal $600 million, it illustrates the broader point.

More recently, the Volcker Rule would have required banks to liquidate nearly $130 billion of Collateralized Loan Obligations (CLOs)—securitised corporate loans and illiquid bonds—by June 2015. Roughly 70% of CLO buyers are banks, so the rule could threaten CLOs' existence. In April, the Fed granted banks two more years to comply. In the meantime, European and US regulators' attitudes toward securitisation have warmed. The practice was blamed (excessively, in our view) for being "toxic" and taking down banks in 2008, but some regulators now realise blanket opposition is inappropriate and impairs credit creation. It remains to be seen whether the CLO regulation changes in light of this, though.

No one can know what specific, potentially harmful regulations emerge from Dodd-Frank's rule making. Rules written by unelected officials out of public view, by definition, cannot be forecast. Investors can only watch carefully as rules are written.

Monetary Policy Errors—Including "Macroprudential" Regulation

Erroneous monetary policy is a near-constant risk. It, too, played a role in 2008 when the Fed leaned on the Treasury for crisis management. Wrongheaded policy could always cause overheating or a sharp deflation—history has several examples, including the Great Depression. We report on standard monetary policy regularly. However, central bankers now pose other risks—like wrongly trying to deflate a perceived bubble (an effort most see as positive).

Post 2008, central bankers' roles include more regulatory responsibility than ever. One such example is the increasing use of "macroprudential policy"—an attempt to preemptively spot and address possible bubbles —to avoid excess in certain financial areas. This is not raising the fed-funds target rate, for example, to cool inflation. It is creating rules targeting specific economic areas where officials believe valuations are out of line with fundamentals. Fed chairwoman Janet Yellen differentiated the two areas of policy in a July speech.

The UK has gone one step further and put it to practice. In June, BoE Governor Mark Carney announced a cap on mortgages exceeding 4.5-to-1 principal to borrower income ratios at 15% of new loans to ostensibly cool London housing. Lenders must now also decline borrowers who fail an interest rate affordability "stress test," which aims to gauge whether they can afford mortgage payments in the event interest rates rise three percentage points from the prevailing rate at origination.

Notably, this is not a significant change. In the country as a whole, loan-to-income ratios exceeding 4.5-to-1 on new mortgage originations are currently 11%, leaving plenty of room under the cap. Moreover, the BoE's broader assessment of the housing sector indicates these measures are not designed to put a brake on mortgage issuance in the here and now—they are preemptive actions to limit the future risk of households defaulting and limit banks' exposure in the event defaults do ramp up. By cooling London a bit today, they believe they can help prevent the broader market from getting out of hand later.

While this gradual approach is better than the alternative, we question the need for intervention. London's swiftly rising home prices are largely tied to extremely tight supply, which is a regulatory issue. Now, to Carney's credit, the BoE's announcement did not indicate policymakers believe London's issues are indicative of a UK-wide housing bubble. However, intervention is a slippery slope, and there is no evidence central bankers can spot a bubble, much less let only some air out. They also operate largely outside democratic checks and balances. That is a plus most of the time, but macroprudential policies seem far removed from central banks' primary purpose and introduce additional potential policy errors. We have not seen anything problematic yet, but we do not share the faith many place in central bankers' ability to deflate bubbles without collateral damage. As we know from the past, central bankers' record is far from clean.

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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lviii. FactSet, as of 07/16/2014. Year-over-year percent change in Brazil's Retail Sales, April-May 2014.
lix. FactSet, as of 07/16/2014. Year-over-year percent change in Mexico's Exports, April-June 2014.
lx. "Tepper: 'Have Cut Equity Exposure to 60% From 100% 6 Months Ago," Jeff Cox, CNBC, May 14, 2014.
lxi. Factset, as of 07/21/2014. S&P 500 Total Return Index, 10/09/2002 – 10/15/2007.
lxii. IMF (Iraq and Global GDP) and the US Bureau of Economic Analysis (Connecticut and Louisiana GDP), as of 12/31/2013.
lxiii. US Census Bureau and Eurostat, as of 07/15/2014.
lxiv. FactSet, as of 07/08/2014. West Texas Intermediate and Brent crude prices, 12/31/2013 – 07/07/2014.
lxv. "Iraq Fighting Doesn't Raise Oil Prices, Yet," Jennifer Collins, Gilgamesh Nabeel and Ammar Al Shamary, USA Today, July 6, 2014.
lxvi. US Department of the Treasury, as of 07/08/2014.
lxvii. "Dodd-Frank Progress Report, July 2014," Davis Polk & Wardwell, LLP.

Terms of Business

1. *Fisher Investments Europe*
   Fisher Investments Europe Limited is registered in England and authorised and regulated by the Financial Conduct Authority (FCA). Fisher Investments Europe's FCA reference number is 191609. Fisher Investments Europe's permitted business is advising on investments, advising on pension transfers and pension opt outs, agreeing to carry on a regulated activity, arranging deals in investments, dealing in investments as agent, making arrangements with a view to transactions in investments, and managing investments.
   You can check this on the FCA's online financial services register: www.fca.org.uk or by contacting the FCA on +44 20 7066 1000.
2. *Communications*
   Fisher Investments Europe can be contacted by mail at 6-10 Whitfield Street, London W1T 2RE, or by telephone on 0800 144 4731. All communications with Fisher Investments Europe will be in English only.
3. *Services*
   These Terms of Business explain the services offered to professional clients and will apply from when Fisher Investments Europe begins to advise you. As part of its services, Fisher Investments Europe seeks to:
   a) Reasonably determine your client categorisation;
   b) Understand your financial circumstances and investment aims to determine whether a full discretionary service and the proposed investment mandate and accompanying benchmark(s) are suitable for you;
   c) Explain features of the investment approach;
   d) Describe investment performance as it relates to your investment mandate;
   e) Provide a full explanation of costs;
   f) Assist in the completion of documentation;
   g) Where specifically agreed, review your position periodically and suggest adjustments where appropriate.
4. *Discretionary Investment Management Service and Investments*
   To help you achieve your financial goals, Fisher Investments Europe may offer its discretionary investment management services. In such case, Fisher Investments Europe will delegate the investment management function, as well as certain ancillary services, to its parent company, Fisher Asset Management, LLC, trading as Fisher Investments, which has its headquarters in the USA and is regulated by the US Securities and Exchange Commission. Where appropriate, Fisher Investments Europe may recommend that you establish a discretionary investment management relationship directly with Fisher Investments. In such case, Fisher Investments Europe acts as an introducing firm. A separate investment management agreement will govern any discretionary investment management relationship whether with Fisher Investments Europe or with Fisher Investments.
   Subject to applicable regulations, for qualified investors Fisher Investments Europe may recommend an investment in an Undertaking for Collective Investment in Transferable Securities (UCITS) regulated by the Central Bank of Ireland and managed by Fisher Investments.
5. *Client Categorisation*
   Fisher Investments Europe deals with both retail clients and professional clients. As a user of Fisher Investments Europe's institutional services, you have been categorised as a professional client. You have the right to request re-categorisation as a retail client which offers a higher degree of regulatory protection, but Fisher Investments Europe does not normally agree to requests of this kind.
6. *Financial Services Compensation Scheme (FSCS)*
   The activities of Fisher Investments Europe are covered by the FSCS and therefore if (i) you are eligible to claim under the FSCS, (ii) you have a valid claim against us and (iii) we are unable to meet our liability towards you because of our financial circumstances, the FSCS will be able to compensate you for the full amount of your claim up to £50,000. However, since you have been categorised as a professional client, you are unlikely to be eligible. You can contact us or the FSCS in order to obtain more information regarding the conditions governing compensation and the formalities which must be completed to obtain compensation. Please note that the protections of the FSCS do not apply in relation to any services provided by Fisher Investments.
7. *Custody and Execution*
   Neither Fisher Investments Europe nor Fisher Investments is authorised to hold client money. This means neither Fisher Investments Europe nor Fisher Investments can accept cheques made out to Fisher in respect of investments, nor can they handle cash. All client assets are held at external custodians where each client has a direct account in their own name.
   If you appoint Fisher Investments Europe or Fisher Investments as your discretionary asset manager, execution of transactions will be arranged through such custodians and brokers and at such prices and commissions that Fisher Investments determines in good faith to be in your best interests. Further information regarding selection of brokers is set out in Fisher Investments' Form ADV Part 2.
8. *Risks*
   Investments in securities present numerous risks, including various market, currency, economic, political, business and other risks, and can be very volatile. Investing in securities can result in a loss, including a loss of principal. Using leverage to purchase and maintain larger security positions will increase exposure to market volatility and is not recommended.
9. *Data Protection*
   To advise you on financial matters, Fisher Investments Europe may collect personal and sensitive information subject to the Data Protection Act 1998. By engaging in business with Fisher Investments Europe, you consent to Fisher Investments Europe processing your data, both manually and electronically, including transferring data outside the European Economic Area, including to its parent, Fisher Investments, in the United States, for the purposes of providing services and enabling Fisher Investments to provide services, maintaining records, analysing your financial situation, providing information to regulatory bodies and service providers assisting Fisher Investments Europe and/or Fisher Investments in providing services.
10. *Conflicts of Interest*
    Fisher Investments Europe has a conflicts of interest policy to identify, manage and disclose conflicts of interest Fisher Investments Europe, Fisher Investments or any of their employees or representatives may have with a client of Fisher Investments Europe, or that may exist between two clients of Fisher Investments Europe. Fisher Investments Europe's conflicts of interest policy covers gifts and favours, outside employment, client privacy, inadvertent custody, marketing and sales activities, recommendations and advice, and portfolio management. In addition, Fisher Investments Europe provides a copy of Fisher Investments' Form ADV Parts 2A and 2B to all clients.
11. *Fees*
    If you appoint Fisher Investments Europe as your discretionary investment manager, you will pay management fees to Fisher Investments Europe as detailed in the investment management agreement. Fisher Investments Europe will pay a portion of such management fees to Fisher Investments as the sub-manager.
    If you appoint Fisher Investments directly as your discretionary investment manager, you will pay management fees directly to Fisher Investments as detailed in the investment management agreement. If you invest in a UCITS fund managed by Fisher Investments, Fisher Investments will receive its management fee indirectly through the UCITS. Fisher Investments Europe does not charge a separate fee for its introducing or distribution services.
    You will also incur transaction and custody fees charged by brokers and custodians. However, any such additional fees will be payable directly to brokers/custodians, and neither Fisher Investments Europe nor Fisher Investments will share in any commission or other remuneration.
12. *Termination*
    If you wish to cease using the services of Fisher Investments Europe or Fisher Investments at any time, then send notification and the arrangement will cease in accordance with the investment management agreement. However, if a transaction is in the middle of being arranged on your behalf at that time and it is too late to unwind it, then the transaction may need to be completed first.
13. *Governing Law*
    These Terms of Business are governed by English law.