Fisher Investments Europe™

FOURTH QUARTER 2013

MARKET PERSPECTIVES

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FOURTH QUARTER 2013 REVIEW AND OUTLOOK MARKET PERSPECTIVES

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FOURTH QUARTER 2013 REVIEW AND OUTLOOK: EXECUTIVE SUMMARY

Global equities surged in Q4 and for all of 2013 as the bull routinely marched past new highs. Global equities were nicely positive for the year, finishing the year on a decidedly high note.

Market Outlook

Looking ahead, Fisher Investments (FI) believes equities are likeliest to follow 2013's strong returns with another up-a-lot year in 2014. Like last year, most market prognosticators' forecasts are muted for 2014, with the average forecast in the mid-single digit range and almost none that are very positive or negative. Many bears are only just now starting to shed their scepticism, but they still forecast timid positive returns, while fear of heights has dampened the bulls' enthusiasm. Typically, when the bears become less bearish and the bulls less bullish, markets will surprise both parties, finishing the year up a lot or down a lot. This also implies a down-a-lot scenario is more likely than last year. However, FI does not see any risks big, surprising or likely enough to upend the many positive drivers at work.

Many still cite the tepid pace of economic growth as an impediment to strong equity market gains. Though exceptional growth is not a requirement for strong equity market returns—as 2013 demonstrated—accelerating global economic growth and corporate earnings in 2014 should keep the bull market going. Leading Economic Indexes in most countries are high and rising thanks largely to steepening yield curves globally. The US and UK are gaining steam, and the eurozone continues recovering.

While numerous positive fundamentals exist, expectations remain low—few investors are aware of the world's strength. As Sir John Templeton said, "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." As the bull market approaches its fifth birthday in March, investor sentiment is a mix of scepticism and optimism. 2014 could be the year optimism gains a firm foothold. However, just because optimism is growing does not mean pessimism is warranted—persistent contrarianism is not a winning investment strategy. Investors are just now waking up to the reality the world is fine—and still far from the euphoric heights typical of market peaks. In FI's view, their growing optimism is a powerful force for equities.

Difficult as this is for some to believe, a correction could aid the process. We did not have a correction in 2013 but could see one in 2014. It is rare—and difficult—for dour investors to shake off their scepticism by simply noticing the world is better than they believed. However, if equities were to experience a meaningful correction over a few weeks or months, the pessimists may believe they were proven correct—becoming more convinced markets have finally dealt with their concern leaving more room for the bull to run.

The US Federal Reserve (Fed) began tapering its quantitative easing (QE) in January 2014, slowing monthly asset purchases from $85 billion to $75 billion (and in February the rate slows to $65 billion[i])—a step in the right direction, but slower than FI would like. As FI has written in previous Review & Outlooks the end of QE will be a positive economic surprise. Most see this backward, recalling former Fed Chairman William McChesney Martin's famous quote that the Fed's job is to "pull the punchbowl" before the party gets going. Yet QE has been a sedative to economic growth. QE reduced the spread between short- and long-term interest rates, discouraging bank lending, loan growth and money supply while building only the monetary base and bank balance sheets. Finally ending QE will allow the rate spread to normalise, encouraging banks to lend more and enabling faster money supply growth, which time-honored evidence shows is the fuel for faster economic growth. Consider the UK: One year after its QE programme ended, Britain has emerged from its sluggish growth and enters 2014 as one of the developed world's strongest economies.

The political climate remains favourable, with gridlock persisting in the most competitive advanced economies and free-market reforms continuing in many Emerging Markets. The US Congress set a new record for inactivity in 2013, and legislation should be similarly rare in 2014 as lawmakers gear up for November's midterm elections. Some fret Congressional gridlock, but as FI has written in previous Review & Outlooks, markets prefer an inactive Congress. As we saw repeatedly in 2013, gridlock does not mean nothing happens—a split, polarised legislature can still compromise on measures requiring action, like the debt ceiling. However, gridlock dramatically reduces the likelihood of big, controversial legislation that tends to scare investors.

THEMATIC UPDATE & MARKET OUTLOOK

Another Good Year in 2014

The bull market stormed ahead in 2013, with developed markets up-a-lot. As markets soared, some longtime sceptics warmed to equities, but many investors remain sceptical the bull market will maintain its strength. In prior Review & Outlooks, FI has quoted Sir John Templeton, who said, "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." Current sentiment appears trapped between scepticism and optimism. FI thinks investors will embrace optimism in 2014, pushing equities higher as they do.

This is one reason FI believes the bull market should continue to strengthen in 2014, with equities likeliest to finish up-a-lot. Like last year, most professionals expect equities to rise in the mid-single digit range, but the more extreme forecasts, both positive and negative have been reined in. Bears are fatiguing. Their fears persist, but they are tiring of being wrong. However, they expect only timid gains—this is not the capitulation typical of a bull's euphoric peaks. Meanwhile, many bulls fear an end to strong returns.

When the bulls are less bullish and the bears less bearish, markets usually surprise both, finishing the year up big or down-a-lot. While FI expects up-a-lot, this also implies the start of a bear market is more likely than last year. However, new bear markets typically require weakening fundamentals, little-seen risks, and euphoric investors blind to the first two. Today, we have the opposite—investors are not euphoric and do not grasp how strong fundamentals are. While risks exist, most are widely discussed and lack much market-moving power. Among less-frequently discussed risks, none appear big or probable enough to upend the many positive forces keeping the bull market going.

This does not mean 2014 will be a straight shot up—volatility is ever-present and corrections always possible. However, FI does not believe it is possible to predict and time corrections with any precision. Corrections are short, sharp down moves of roughly 10% to 20%, driven by sentiment and typically tied to a prominent, fear-inducing story. They tend to be steep and quick. By the time a correction has been identified, the downside could be mostly over, making allocation shifts misguided. The potential short-term gains from timing a correction do not outweigh the long-term risks of repositioning. Therefore, changes for this reason are not advisable for long-term investors.

Enduring some short-term volatility is a necessary trade-off for achieving long-term growth. While corrections can be unsettling, FI does not believe it is in long-term investors' best interests to try to trade around them. In this bull market alone, five corrections have occurred—investors trying to time them could have missed significant gains.

Why FI is Bullish

Many investors cite tepid growth as a barrier to big equity gains, but exceptional economic growth is not needed for robust returns—just an economic and political backdrop better than most perceive.

An Accelerating Global Economy

Economic reality, though not stellar, is better than most believe. Developed-world growth accelerated as 2013 advanced, led by the US and UK, and the eurozone emerged from its 18-month recession. China continues meeting growth targets and adding big sums to global GDP. On balance, Emerging Markets continue growing at a decent clip. Forward-looking indicators suggest global growth and corporate earnings should speed further in 2014. Yield curves are steepening, which makes lending more profitable and is fuel for faster growth. Steep yield curves are also helping Leading Economic Indexes (LEI) rise globally, implying economic expansion should continue. The new orders sub-indexes of most services and manufacturing Purchasing Managers' Indexes show growth, implying continued business investment and activity up and down the global supply chain.

Favourable Political Climate

Gridlock persists in some of the world's most competitive economies, creating a benign legislative environment for equities. Some individuals are cautious of political inactivity, but for markets, it is good. Gridlock reduces the likelihood of radical change to property rights or other big, controversial measures that tend to worry investors. In some nations, like the UK, some suggest growth cannot continue without policies to boost a flagging section of the economy. However, in free, competitive nations, such adjustments can carry more downside than upside—creating winners in one area, but losers in others and unintended consequences. No country is structurally perfect, but economic cycles are regularly strong enough to overcome small structural issues.

Sentiment Still Stuck

Negative sentiment is starting to thaw, but scepticism lingers. Equity mutual fund net inflows were positive in 2013 for the first time in this bull market, suggesting at least some investors who exited the equity market after 2008 are starting to return. [ii] However, in FI's view this renewed interest in equities is in its early stages. IPO activity picked up, with some offerings earning a positive clip, indicating investors are more willing to pay for potential. Conversely, many see rising fund flows and IPOs as signs of euphoria—sentiment detached from what they see as a subdued reality. Headlines still report good news with cautious foresight that it will not continue much longer.

Optimism could gain a firm hold this year as investors slowly overcome long-held fears. Some might question whether budding optimism is negative. What matters more than the level of sentiment is how sentiment relates to reality. Favourable fundamentals suggest optimism is rational. Nascent optimism is far from euphoria, and rising confidence drives demand for equities—a powerful force pushing markets higher

Fundamentals and Perceptions

Nearly five years into this bull market, many investors still believe it lacks fundamental support. Many remain perplexed about why equities were up big in 2013 amid slow economic growth, US spending cuts, eurozone austerity and slowing Emerging Markets—and now wonder how equities can do great in 2014. However, positive fundamentals have complemented the bull since it began in March 2009, and the backdrop remains favourable: an economic and political landscape better than most perceive.

Another Quarter of Earnings and Revenue Growth

With each passing quarter and year, the financial press questions sluggish economic growth. However, this bull market's slow headline growth is a great backdrop for equities. Behind the scenes, conditions are significantly stronger than they might outwardly appear.

US corporate earnings fit this description near perfectly. Aggregate S&P 500 earnings per share grew 3.5% y/y in Q3 2013. [iii] Yet the 16th straight quarter rising profits was generally met with fears slower growth imply the bull's end is near. As FI has written in previous Review & Outlooks, earnings typically slow as bull markets progress and year-over-year comparisons become harder to beat. Furthermore, index-level earnings data does not reveal much—growth varied by sector.

Consumer Discretionary and Information Technology saw earnings grow over 9% y/y. [iv] Energy saw earnings fall -8.2% y/y—skewing the overall average—as high fixed costs and stable oil and natural gas prices pinched margins.[v] Financials earnings were flat, but this was tied to a large, one-off loss at JP Morgan Chase, which settled long-expected regulatory and legal costs—not a sign of fundamental weakness at the bank, nor the sector.

Some believe earnings are growing only because firms are cutting costs, so growth will not last. Yet after the recession, revenues began rising again in Q4 2009 and have increased in all but two quarters since.[vi] In Q3 2013, sales rose in all sectors, and aggregate S&P 500 revenues per share accelerated from Q2 2013, growing 2.9% y/y.[vii] Health Care and Consumer Discretionary revenues were a healthy 5.7% and 5.3% y/y, respectively, and while Tech revenue growth appeared slow, the 2.8% growth is a nice acceleration from Q2's 0.4% y/y.[viii]

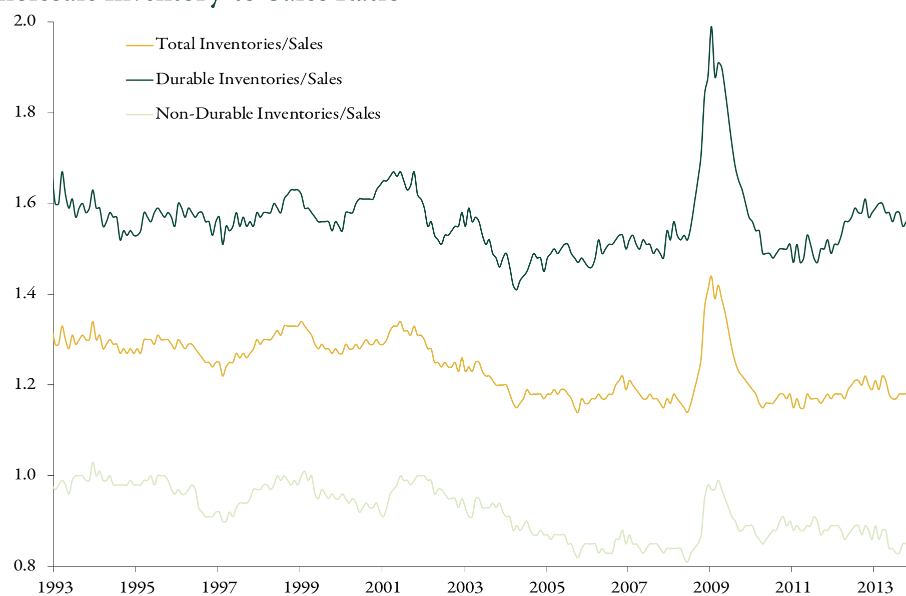
A Strengthening Global Economy

Many similarly complain about slow GDP growth, but equities are not GDP—they are shares in publicly traded companies. After-tax US corporate profits hit a record-high $1.7 trillion in Q3, enabling businesses to drive investment to a cyclical high of $1.99 trillion and execute $131 billion in share buybacks.[viii] Yet corporate cash balances grew, hitting $1.93 trillion.[ix] Firms are healthy and growing, and the money they spend and invest helps fuel growth throughout the entire economy.

Broader economic growth is healthier than most perceive. For example, as US Q3 GDP was revised up from a 2.8% seasonally adjusted annual rate to 4.1%, many claimed the doubling of inventories' contribution signals fading growth.[x] Yet total private demand—consumer spending and business investment combined—contributed even more than inventories. Imports, too, were revised up, detracting from headline GDP. Economically, however, rising imports imply increased demand—a plus. This is one more reason GDP is not a perfect picture of the real economy.

Rising inventories by no means imply an automatic reversal ahead. The inventory-to-sales ratio is not high, so it is no shock reports suggest inventories continued growing in Q4.

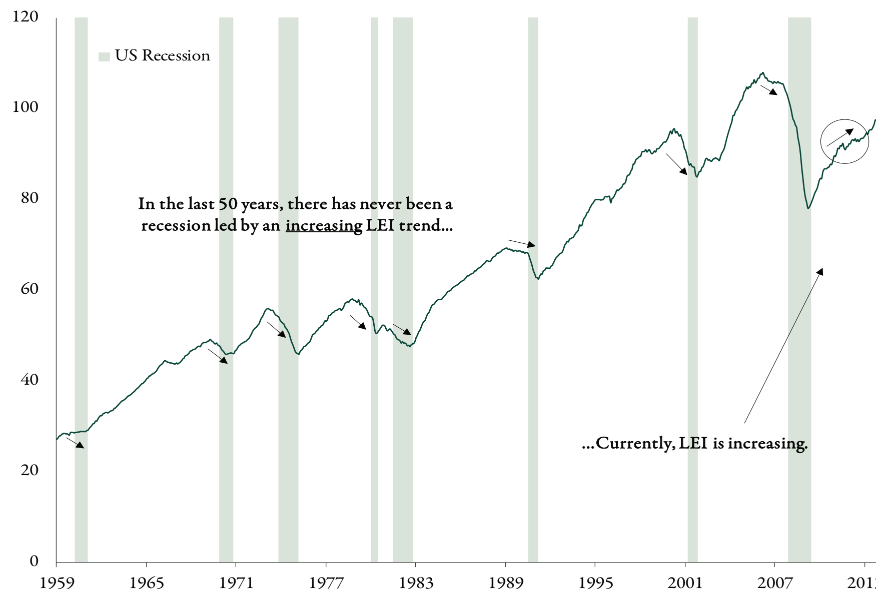
Exhibit 1: US Wholesale Inventory-to-Sales Ratio



Source: FactSet, as of 14/1/2014; Monthly Inventories-to-Sales Ratio of Merchant Wholesalers (seasonally adjusted) 31/12/1992-31/12/2013; U.S. Census Bureau.

The US Leading Economic Index (LEI) also implies further growth. As shown in Exhibit 2, LEI continued rising in Q4, led by the wider interest rate spread. No US recession in 50 years has started while LEI was rising.

Exhibit 2: US LEI and Recessions



Source: FactSet, as of 22/1/2014. Conference Board Leading Economic Index and NBER Recessions, 31/1/1959-30/11/2013.

Additionally, growth is picking up globally. UK GDP accelerated all year, and monthly data throughout Q4 remained strong, as did the LEI trend—also driven by a wider rate spread.[xi] The eurozone's uneven recovery also continues. Many feared a double-dip after GDP growth slowed to 0.1% y/y in Q3 (from Q2's 0.3%), but more forward-looking readings suggest growth should continue.[xii] Eurozone Purchasing Managers Index (PMI) surveys rose in Q4, and eurozone LEI is up six months straight.[xiii] The three member-states with LEIs—Germany, France and Spain—also show rising trends. PMI surveys, factory orders and industrial production data indicate Germany grew in Q4, and eurozone retail sales notched their strongest growth since 2009 in November.[xiv] Data do not suggest a double-dip.

Emerging Markets growth is overall solid. Chinese GDP grew 7.7% in 2014, exceeding consensus expectations and the government's official target.[xv] Though China's growth rate has slowed, its contribution in dollars to global GDP growth is on par with years when GDP grew at a double-digit pace. South Korea continues recovering from recent tepid growth, with Q3 GDP growing 3.3% y/y, up from Q2's 2.3%. Mexico's GDP rose 1.3% y/y in Q3, ahead of expectations. Malaysia's Q3 GDP growth accelerated to 5% y/y, Thailand's hit 2.7% y/y, and India rebounded to 4.8% y/y.[xvi] Not every Emerging Market grew—Brazil contracted in Q3, falling 0.5% y/y—but growth need not be uniformly positive for developing countries to continue contributing mightily to global demand.[xviii] Additionally, LEIs—particularly for China and South Korea—suggest this should continue.[xviii]

US QE's eventual end should be an additional positive for developing economies. Flatter rate spreads have weighed on growth in recent years, but rising long-term US Treasury rates should lift long-term rates in developing countries—and, thus, widen yield spreads. This should provide fuel for faster growth—and a bigger contribution from the category to global GDP.

Lingering Scepticism

Sentiment does not reflect a full appreciation of these factors. Still-sceptical investors fixate on the negative and assume it will worsen. Positive factors are generally acknowledged but presumed to be rarities or passing phenomena. Yet, as detailed, the US and global economies are growing—fuel for continued profit growth. Politics are largely inactive, presenting few unexpected, powerful surprises to derail equities or cause economic dislocations. As economic growth and the bull market continue, sceptics likely become optimists, and are more willing to pay up for future corporate earnings. The resulting valuation expansion is typical of maturing bull markets, and P/E multiples have expanded only modestly thus far.

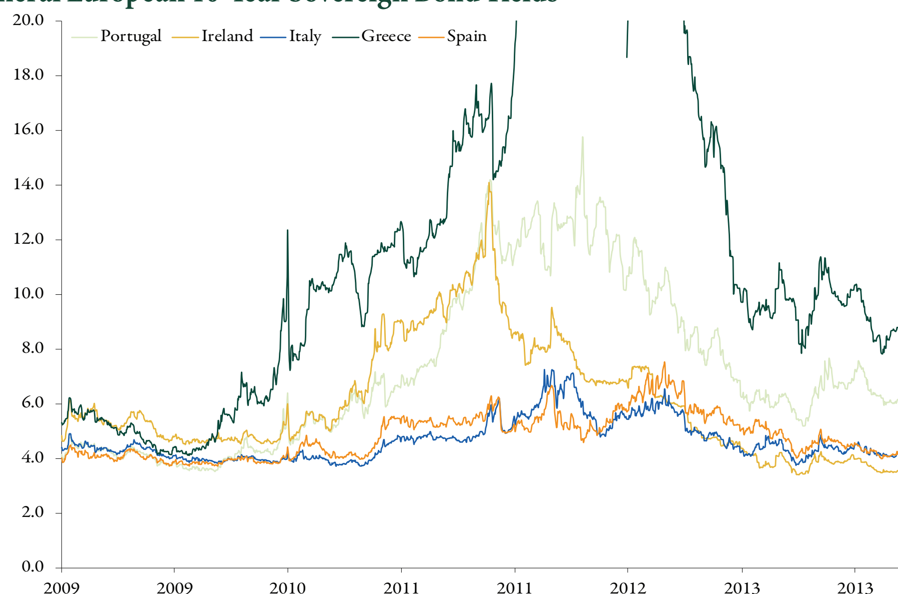
The eurozone is a microcosm of still-sceptical sentiment. The 18-nation bloc's uneven growth has some fixated on laggards—namely, France. Recent Purchasing Managers' Index (PMI) readings have disappointed, and France was a drag on Q2 and Q3 eurozone GDP. These developments overwhelm media attention. Bloomberg, for example, posits, "Is France the 'Sick Man of Europe?" Businessweek responds with, "More Evidence France Is the New Sick Man of Europe." The Daily Mail and Independent report France is indeed "Europe's Sick Man," though The New York Times suggests the moniker is "under debate."[xix] Contrarily, France's Leading Economic Index continues to rise. The MSCI France performed basically in line with the MSCI European Economic and Monetary Union Index throughout this time period.[xx]

The debate over France's health masks improvements in more previously troubled areas: the periphery. In December, Ireland officially exited its bailout, and an early-January sale of 10-year sovereign bonds saw sky-high demand at pre-crisis rates. Irish GDP grew a fast 1.5% q/q—6.1% annualised—in Q3 2013, led by a 10.9% rise in private investment.[xxi] Fiscal year 2013 tax revenue rose 3.2%, led by corporate taxes—alluding to healthy private sector-led growth.[xxii]

While headlines focused on France's contractionary 47.8 December Services PMI, Spain's surged well beyond expectations to 54.2, among the fastest reads in the eurozone.[xxiii] This comes as Spain exits the EU/IMF/ECB Financial sector aid programme entered into in 2012 and private investors hurry to gain exposure in the once-troubled banks. In Portugal, most media focus on the Constitutional Court's rejection of some austerity measures targeting government workers. Fewer notice its second straight quarter growth in Q3, led by a 4.8% q/q surge in business investment. Domestic demand in total rose 1.4% q/q in Q3.[xxiv]

As seen in Exhibit 3, three of five peripheral European sovereigns' benchmark bond yields are now at levels not seen since early 2010—before Greece's first bailout. In early January, Spain auctioned five-year debt priced to yield 2.41%—the lowest paid on five-year debt since joining the euro.

Exhibit 3: Peripheral European 10-Year Sovereign Bond Yields



Source: FactSet, as of 8/1/2013. 31/12/2008-31/12/2013.

Some claim recent select strong IPO performance—Twitter, for example—suggests euphoria lurks. Yet the occasionally high-performing IPO is a relative rarity. There were 156 US IPOs in 2013 (excluding closed-end funds, REITs and ADRs).[xxv] While the number reaching market is up from recent years, consider the depressed base offerings build from today: The post-Sarbanes-Oxley period (2003 – 2013) has seen only 1,199 IPOs, or 119 per year—the largest year being 2004's 174. 1999 and 2000 had 858 combined. Even prior to the tech bubble's 1999 – 2000 inflation and collapse, there were 3,614 offerings from 1990 – 1998, or 451 per year. 1999 was the last year issuance exceeded or reached that mark. In the 1980s, an average 205 firms went public annually.[xxvi]

While the number of unprofitable 2013 IPOs was up from recent past years, it was not alarmingly so. In addition, arguably more significantly, 63% of firms issuing shares had trailing 12-month earnings exceeding $50 million—significantly exceeding the average of 48%.[xxvii]

Issuance has been very low in recent years—seeing an uptick and some celebrating of high-profile offerings is not a sign of euphoria but optimism.

Global Politics Still Positive

Politics is an important driver of equity returns. Regulations, fiscal policy and economic policy are often born in politics.

More Gridlock Ahead

In economically competitive nations like the US, UK and Germany, gridlock persists. While media often decries gridlock, an economy with a robust private sector, ample private property protections and growth should be more wary of negative unintended consequences stemming from supposedly growth-enhancing legislation.

The alternative—single-party legislative domination or rampant bipartisanship—has not historically matched the utopic vision politicians often proffer. For example, 2002's Sarbanes-Oxley Act, which raised US-listed firms' compliance costs greatly, was a well-intended, hugely bipartisan bill aiming to eliminate accounting fraud. The Tariff Act of 1930, responsible for deepening the Great Depression, was popular with Republicans and Democrats. Nixon's early 1970s price controls had bipartisan support. Bipartisan law does not mean sensible law.

Some criticise the recent US budget deal as lacking significant growth-enhancing measures and/or entitlement reforms. Similarly, the UK government has been (rather baselessly) blasted for spending cuts it has not enacted—and for agreeing to budgets with meager economic measures. However, these nations enter 2014 near the top of developed-world economic growth rates. There is little reason to think governments can successfully build upon this while bringing zero unintended effects. More often, government reforms create winners and losers.

Free Market Reforms Continue

Mexico, a nation needing reforms, passed a number of major changes including labour, tax, banking sector and Energy liberalisations.

Banking targets businesses and consumers' credit access. For decades, Mexico has been "underbanked"—total commercial credit outstanding to nonfinancial private firms is only 15% of GDP. For some perspective, Brazil and Chile—similarly developing nations—tally roughly 50% and 70%, respectively.[xxviii] Mexico's poor credit penetration stems from regulation. Collecting collateral when borrowers default has long been arduous, driving banks to lend to only exceptionally creditworthy borrowers—large businesses and wealthy individuals—undermining small and mid-sized firms. Individuals with less stellar credit also found cautious lenders outside the informal economy. Reforms passed in December ease standards and the collateral collection process. This should increase banks' willingness to lend, spurring competition and growth.

The opening of Mexico's Energy sector garnered more headlines. Mexican Energy has long been dominated by a single company—state-owned Petroleos Mexicanos had a monopoly over the nation's vast proven reserves of oil. However, Pemex lacks advanced techniques and expertise in deepwater drilling and hydraulic fracturing needed to boost output meaningfully. Substantial investment is needed to modernise the firm's extraction capabilities. 2013 was Pemex's ninth straight year of declining output. Output has fallen 25% since 2004 and was below 2.5 million barrels per day in July 2013 for the first time since 1995.[xxix] By contrast, US output has surged over 35% in the same period.[xxx]

This North American Energy paradox is not due to Mexican oil fields running dry. Pemex estimates Mexico has nearly 14 billion barrels of oil and huge shale gas reserves. Developing them will require capital and knowledge from non-Mexican Energy firms, which is now possible. In December, Mexico's Congress passed—and all states ratified—a constitutional amendment allowing private firms to share in Mexican production and profits for the first time in 75 years. Expanding production in Mexico gives firms access to greater reserves long-term, but it does little if anything to improve their profitability in the next 12-18 months.

In China, the 18th Central Committee of the Communist Party unveiled the policy platform agreed to under its Third Plenum. Chinese President Xi Jinping and Premier Li Keqiang set expectations rather high for the announcement of market-opening reforms, drawing comparisons to 1978, when Deng Xiaoping used the 11th Central Committee's Third Plenum as the coming-out party for his plan to gradually open China's economy.

In the current version, Xi and Li proclaimed the private sector would play a "decisive" role in the Chinese economy, with an emphasis on the financial sector. They also announced plans to allow much greater foreign investment, based on results in Shanghai's Free-Trade Zone. There is, however, a ten-page list of excluded industries, but the step is noteworthy. Additionally, China's "one-child policy"—Malthusian population controls penalising citizens for having more than one child—was relaxed.

While many provisions of the Third Plenum focused on social reform, this makes sense from the standpoint that China seeks to minimise dissent in order maintain political—and economic—stability. One of the less-publicised issues facing China's leadership is a rebellious fringe—like Chinese farmers, for instance, who have been actively rebelling against forced relocation and government fees. Relaxing the one-child rule, to the extent it actually follows the statement, would be a politically popular move indeed. So, too, would strengthening the social safety net and reforming the hukou urban migration registration system, allowing more rural citizens to move to the cities and improving benefits for migrant workers—a necessary step as leaders seek to modernise agricultural production and consolidate small farms.

While these and other social reforms occupy significant government attention, financial liberalisation seems poised to continue, though perhaps not at an exceptional pace. Most of the plans announced in December were generalised, including pledges to increase private sector involvement in banking and the broader economy and promote domestic consumption. However, some specific measures have been announced. In December, the People's Bank of China announced it would create something of an interbank deposit market—allowing banks to trade deposits at market-determined prices—and in early January officials announced plans to grant a handful of private banking licenses this year. Securities regulators also restarted IPOs, announcing a more streamlined, transparent process, and there is mounting discussion of permitting wider yuan use in international trade settlement.

While the eventual degree to which China's economy ultimately becomes more market-driven remains an open question, in Communist China, some modest reform is likely more than what many investors anticipate occurring. In some ways, FI finds the notion of gradual financial reform preferable for equities. China's communist leadership experimenting with sweeping and sudden reforms could easily bring unintended consequences.

Reviewing the US Midterm Elections

As always, FI's political commentary is intended to be nonpartisan and approach issues solely to assess potential market impact (or lack thereof), as political bias blinds.

Though it is still very early to forecast this year's US midterm results, FI believes November midterms likely bring continued gridlock as both history and structure favour a continued Republican House majority and a smaller Democratic Senate majority.

According to the Cook Political Report, in the US Senate, the Democrats hold a 53-45 advantage, with an additional two independents, Bernie Sanders (NH) and Angust King (ME), that caucus with the Democrats. The Senatorial election's structure more solidly favours Republicans' gaining relative power, though it would take near-flawless campaign execution for them to win a majority. The Republicans have 14 seats up for reelection compared to the 21 Democratic seats. Defending their seats looks easy compared to Democrats, considering the GOP-incumbent races are predominantly in ironclad Republican states like South Carolina, Mississippi and Alabama. There are two principal exceptions: Kentucky's Mitch McConnell's seat and the seat vacated by Georgia's Saxby Chambliss. The Cook Report does classify Kentucky as a "toss-up" state, though this seems odd to us considering the state has voted Republican in the past four Presidential contests.

However, even if the Republicans successfully defend all their seats up for election, they still must win six from Democrats to control the Senate. It is not impossible, but this would require repeating their performances from 2010 or 1994. There are three open seats currently held by Democrats in traditionally Republican states—these are the most vulnerable. Beyond these, Republicans' winning the additional three needed for control is possible, but difficult, and requires losing no seats. At this juncture, the most likely outcome is a slim Democratic majority in the Senate, though this could change as campaign season heats up.

In the House, several structural factors lean in Republicans' favour. For one, incumbents are difficult to defeat. In 2012, only 23 incumbent Congressmen lost their seats—13 Republicans and 10 Democrats.[xxxi] A key, therefore, is to look to open seats where the incumbent is not seeking reelection. As of 7 January, 2014, 25 House seats are open in 2014's elections—18 Republican and 7 Democratic seats.[xxxii]

On the surface, this would seem to favour Democrats. All else equal, an unlikely sweep of all open seats would give Democrats a slim edge. However, of the 18 Republican-held open seats, about half are in traditional Republican strongholds and unlikely to swing Democratic. This effectively implies Democrats will have to win eight incumbent seats and defend all their own, contradicting both the historical trend of the President's party weakening in midterms and the recent popularity hit many Democrats have suffered, principally due to the Affordable Care Act's (ACA) chaotic rollout. Now, there is sufficient time for ACA-related negativity to diminish, perhaps if enrollment improves and highly publicised technology issues abate. The likelihood they take the House is extremely low, though a slightly reduced Republican advantage would not be surprising.

A Look at 2016

The 2016 US Presidential election has already entered the national conversation. Polls show New Jersey Governor Chris Christie with a two-point lead over Hillary Clinton, but Clinton trouncing Representative Paul Ryan, Senators Ted Cruz and Rand Paul and former Florida Governor Jeb Bush. FI believes January 2014 is too early to handicap the full roster of candidates in 2016, let alone the nominees or victor. Polls this early are based on name recognition suggesting the output is mostly noise.

Yet history suggests one thing is likely: It will take an unusual turn of events for Hillary Clinton to win the Democratic nomination. Democrats typically do not nominate campaign trail veterans. They prefer someone whose issues have not been exposed by journalists and opponents. They make exceptions for Vice Presidents like Al Gore, Walter Mondale and Hubert Humphrey, but all other nominees from John F. Kennedy on have had little national exposure. They also have not been the initial front-runners. Barack Obama was a second-term Senator with minutes on the national stage. Howard Dean led in fundraising and endorsements when 2004 primaries began, but his oft-parodied Iowa caucus concession speech drove Democrats to, instead, advocate for John Kerry. Bill Clinton was supposed to lose to Paul Tsongas in 1992, and Michael Dukakis to Gary Hart in 1988. Jimmy Carter came from nowhere in 1976, winning primaries most assumed George Wallace would carry. George McGovern polled fifth when the 1972 campaign kicked off, badly trailing Edward Muskie. Democrats choose the dark horse.

Hillary Clinton is not a dark horse—she is a war horse. She entered the 2008 campaign as the front-runner, but voters picked Obama. Picking Clinton now would imply a declaration they erred in 2008 and defy over 50 years of electoral history—not impossible, but highly improbable.

Vice President Joe Biden, too, is an unlikely nominee, though if he runs with Obama's endorsement, he might stand a better chance than Clinton. Biden is the archetypical Democratic Party also-ran. His first foray, in 1988, collapsed when it was revealed he lifted campaign speeches from Welsh politician Neil Kinnock, the Labour Party challenger to Margaret Thatcher in 1987. Biden tried again in 2008, losing badly in early primaries. His tenure as Vice President has earned respect, yet voters might focus more on well-publicised gaffes. Still, an endorsement from a sitting President is powerful with delegates and could propel him—though it is far from certain President Obama would tap his Vice President over his former Secretary of State.

Among the newcomers, it is impossible to say who Democratic delegates would choose. Assumedly, they are most likely to go for a current or former governor who is untested on the national scene, like former Montana Governor Brian Schweitzer or Maryland Governor Martin O'Malley—both of whom have been active in bellwether states. Well-known governors, like New York's Andrew Cuomo, do not fit the mold. Congressmen with success in Republican states—someone like West Virginia's Joe Manchin—could also fit the bill, though a record of moderate decision making to gain constituents votes does not always play well in a Presidential primary.

Europe Hits the Polls

In May, EU voters elect the next European Parliament—the third leg of the EU's inefficient rulemaking process. Typically, EU-wide financial policy follows a twisted path. After the European Commission—the bloc's appointed institutional leadership—proposes new laws, member-states' finance ministers hash out the details. The European Council—the heads of each member state—then steps in, often renegotiating various provisions before approving the final package. Separately, the European Parliament drafts, debates, amends and passes its own version. If what Parliament approves does not match the Council's version, they try to reconcile the differences and eventually approve identical bills.

Parliament contains 766 members (MEP) from 28 countries and dozens of political parties. Within the chamber, national parties form broad caucuses along rough ideological lines. The centre-right European People's Party currently holds the most seats (274). Its constituent parties include Germany's Christian Democrats (Angela Merkel's party), France's Union for a Popular Movement (former President Nicolas Sarkozy's party) and Spain's ruling Popular Party. The centre-left Progressive Alliance of Socialists and Democrats is second-largest (185 seats), with constituents including the UK's Labour Party, France's ruling Socialist Party and Italian Prime Minister Enrico Letta's Democratic Party. The centrist caucus is third-largest with 85 seats, followed by the Green parties with 58 and a smaller centre-right coalition (which includes the UK's Conservative Party) with 56 seats. At the bottom is a collection of "eurosceptics."

Currently, eurosceptic parties control 12% of seats. However, they are expected to make great strides in May, capitalising on a rising surge of anti-union sentiment. While capturing one third of the chamber might not give them a strong enough presence to forestall all legislation—especially considering the major caucuses tend to share pro-European values and a general willingness to move the union forward—there is a caveat.

This October, Parliament will "elect" the President of the European Commission for the first time. Whichever caucus wins in May receives a mandate to nominate its preferred candidate for confirmation by a simple majority of MEPs. With the major caucuses equally passionate about controlling the top spot, this process is likely contentious—and if eurosceptics take more seats, it gets even more complicated. Securing a majority likely requires several rounds of negotiating, with key Commission positions and even the European Council presidency potentially awarded as bargaining chips—resulting in a conflict-prone, bureaucratic morass.

The timing is not good, as the bloc is trying to agree on the architecture of the eurozone's banking union, which establishes a central bank regulator (the European Central Bank), a bank deposit insurance system and a preset course for resolving failing banks—including forced losses on investors and large depositors, also known as bail-ins. The Council approved a plan in December, but Parliament did not open debate until January, and the two proposals are far apart. Key questions also remain, including when a bank would be declared insolvent, triggering investor losses. Some statements suggest banks failing the ECB's upcoming stress tests could be subject to bail-ins. This drives uncertainty for eurozone Financials, and a difficult electoral process could compound the issue.

Considering Bull Market Risks

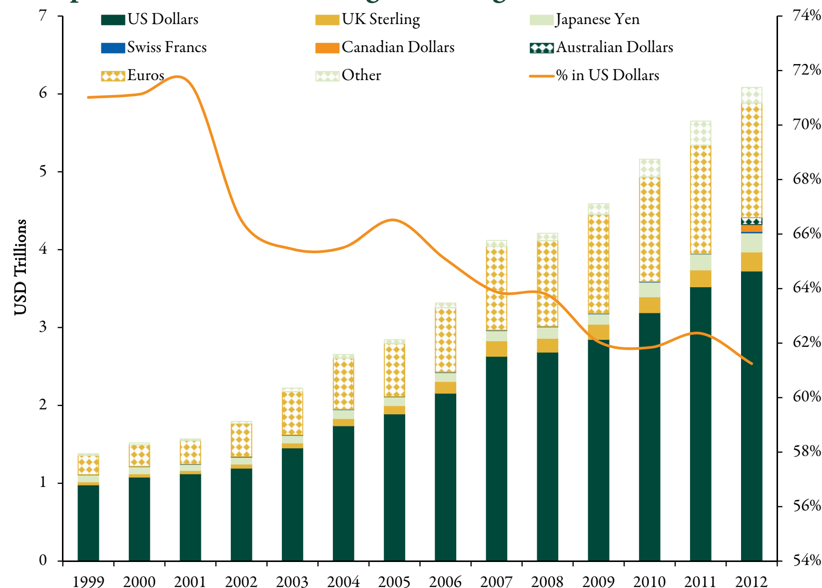
No bull market is devoid of risks, and this bull has plenty. In FI's view, however, none are sweeping, probable and underappreciated enough to cause a bear market in the foreseeable future. Most of today's risks are widely known, long-running fears.

Widely Discussed Risks

The US Dollar's Demise

One example is the chronic fear the US dollar will no longer be the world's reserve currency as nations diversify their foreign exchange (forex) reserves. Few investors realise the dollar has already lost significant market share, without any discernable impact on the economy or public finances. In 1999, the dollar accounted for 71% of all allocated forex reserves.[xxxiii] Today, it accounts for 61%—yet the total dollars in forex reserves are an all-time-high $3.72 trillion.[xxxiv]

Exhibit 4: Currency Composition of Official Foreign Exchange Reserves



Source: International Monetary Fund, as of 31/12/2013.

Even with a smaller market share, which is largely due to the euro's rise, the dollar is in more demand than ever before, thanks to the vast growth in total global reserves. As reserves continue growing, so should dollar demand. To fill their reserves, countries need liquid, easily convertible currencies from deep markets—the dollar is unmatched. There are over $16 trillion in US Treasurys outstanding—the biggest market by far and the most liquid and convertible. There is not a viable substitute—the UK gilt market is not big enough, the eurozone is not stable enough, currency intervention makes the yen less attractive, and China's yuan is too restricted. It would take something overwhelming and unprecedented to cause a wholesale shift away from the dollar. S&P's US credit rating downgrade in 2011 did not do it. Foreign demand for US Treasurys remained firm throughout last year's debt ceiling debate. 2000's and 2008's bear markets and recessions did not kill greenback demand. Some suggest rising debt may be the catalyst, but Japan's gross public debt is about 210% of GDP, and international yen holdings are rising.[xxxv]

The US Debt Ceiling

The 108th US debt ceiling increase, passed in October, suspended the limit until 7 February. On that day, the ceiling automatically resets to the current US gross public debt level, and—unless Congress acts—the Treasury begins taking "extraordinary measures" to fund the government.

Investors habitually fret the negative ramifications should Congress stall, but it is a virtual certainty Congress will raise the limit, whether before 7 February, while extraordinary measures are in force, or at the last moment. Delay is not disaster, however, or—more importantly—default. Debt default is a specific thing—failure to pay principal or interest. Congress can still refinance maturing debt, leaving interest payments the primary concern. However, tax revenue covers interest payments and other major obligations fairy easily. Fiscal year 2013 tax revenue of $2.77 trillion dwarfed the $221.2 billion in interest payments.

Too Far, Too Fast

All-time highs do not predict future movement, up or down. During the 1990s bull market, the S&P Total Return Index hit 347 new highs. This time around, it has already hit 82 (through year-end 2013).[xxxvi]

Selling—or not buying—because equities are at all-time highs has a major theoretical flaw, too. Investing is a decision about the future—a equity is ownership of a company's future earnings. Past price movement does not determine future returns. Fundamental factors, like the direction of earnings and the economy—and the degree to which these factors are already reflected in equity prices—rule. As detailed earlier, FI believes economic, political and sentiment drivers point to many more new highs ahead.

Less Discussed Risks Worth Monitoring

What matters more for markets are the risks few discuss. FI details some below, and you will likely notice they are worlds away from what most other outlets perceive as risks. The less talked-about a risk factor is, the greater its ability to surprise markets. Though FI does not believe any of these are likely to hinder the bull market in the foreseeable future, FI believes they merit close attention.

Unintended Consequences From Regulatory Changes

Regulatory change is always a risk—new rules can create uncertainty and negative unintended consequences. These are not always apparent when a law is first passed. Sometimes, a law can influence the impact of rules written years in the future. For example, the strict penalties for accounting fraud contained in 2002's Sarbanes-Oxley act incentivised many banks to apply a hyper-aggressive definition of 2007's FAS 157 (the mark-to-market accounting rule), triggering nearly $2 trillion in largely unnecessary writedowns throughout 2008, a key to the financial panic.

Other times, the US Congress leaves placeholders for regulatory agencies to write the actual rules, which are then adopted without additional legislative debate. Theoretically, this leaves rule-making to "experts," not politicians. However, it opens the door to new rules that are not widely discussed (courtesy of Congress) before implementation. Exhibit A is 2010's Dodd-Frank Wall Street Reform and Consumer Protection Act, which left 398 rules to be written by regulators.[xxxvii] As of 2 January, only 201 of these rules have been finalised; 110 have not even been proposed.[xxxviii]

The risk here is if any of these rules has a levered impact on the Financial sector, such as FAS 157—something where the fallout becomes apparent only when firms start applying the rule. This happened, though on a small scale, in late December, courtesy of the Volcker Rule, a Dodd-Frank provision banning banks from trading in their own accounts for a profit. Buried in the rule's 964 pages was a provision prohibiting "ownership interest" in certain funds. The definition of "ownership interest," which was significantly expanded between the preliminary and final drafts, included community banks' holdings in Collateralised Debt Obligations backed by Trust-Preferred Securities (TruPS-backed CDOs). Small banks have long owned these securities for their favourable tax and regulatory treatment, holding them to maturity and collecting income.

According to the American Banking Association (ABA), which filed suit to suspend this provision, the Volcker Rule will force banks to reclassify the securities as "available for sale," mark them to market, and sell them by July 2015. The ABA estimates community banks will take a resulting $600 million capital hit, and one bank, Utah's Zions Bancorporation, announced a $387 million writedown late in Q4. However, on 14 January, regulators approved an interim rule allowing community banks to continue owning most TruPS-backed CDOs, and Zions subsequently adjusted its related writedown to between $135 million and $145 million.

$600 million is infinitesimal relative to the over $14 trillion US banking system—it would take far more to trigger panic.[xxxix] However, this saga illustrates how a rule written in the shadows, with provisions added after the public comment period, can swiftly catch banks and investors off guard. There is no way to know which, if any, of Dodd-Frank's 101 unwritten rules could trigger losses sweeping enough to damage the sector—it is impossible to know what regulators write before they write it—but in FI's view, the rulemaking process deserves close scrutiny.

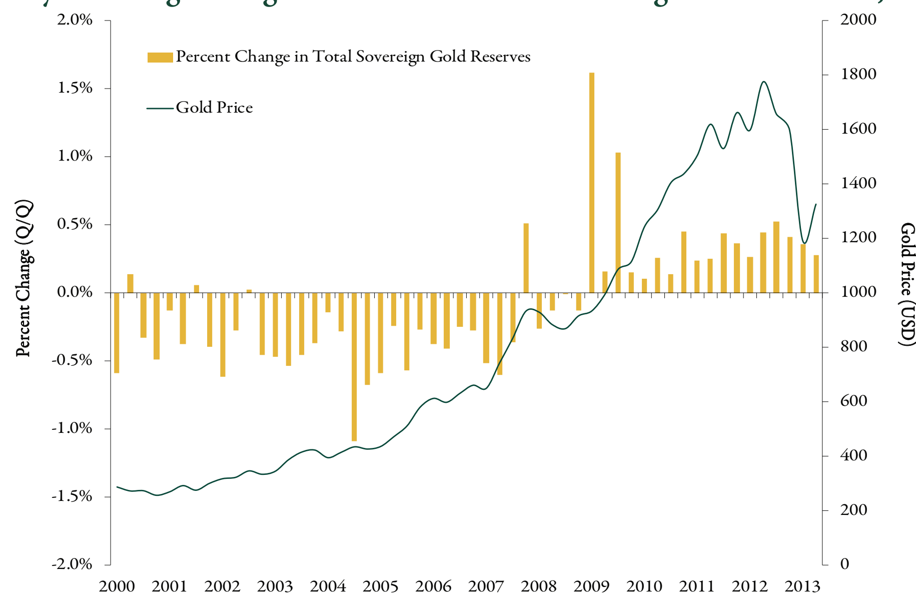
A Gold-Induced Panic

Another underappreciated risk is a gold-induced panic. From gold's peak in September 2011, gold prices fell 36.5% through 2013's close—qualifying by magnitude, duration (and typically euphoric top) as a bear market.[xl] This alone is not meaningful to equities, but there is the possibility an acceleration of gold's bear market could incite some degree of panic as some investors wrongly view gold as an economic barometer, which it is not.

In 2000-2001, global sovereigns began selling gold reserves. They liquidated gold holdings over the next nine years, reducing holdings by more than 3,000 tons before they began rebuilding gold reserves. Interestingly, official sector net liquidations of gold began shortly before gold prices bottomed in 2001. Governments' liquidating at the bottom of a gold bear market is a cautionary story for gold bulls clinging to the belief official sector buying will spark a gold uptrend.

The official sector did not resume net gold purchases until 2009, consistently adding to gold reserves since. However, notice the green line in Exhibit 5—while official sector holdings rose, the gold bubble burst. Governments bought gold late in its uptrend.

Exhibit 5: Quarterly Percentage Change in Official Sector Gold Holdings and Gold Prices, 2000 – 2013.



Source: World Gold Council, www.Gold.org, as of 8/1/2014.

How governments globally react to holding increased quantities of a rapidly depreciating reserve asset is the question. Particularly in Emerging Markets, decisions involving precious metals, currencies and monetary policy are frequently perplexing. India, for example, has a long history of rather careless policy enacted in response to relatively irrational fears. They have also enacted taxes on imported gold to try to stem the trade deficit. Governments in many parts of the world are not necessarily rational actors.

Should a major holder of gold, like Russia, decide to suddenly liquidate, it could prompt other nations to follow. While a central bank selloff does not appear likely at the moment, if it were to happen, it could unsettle investors, potentially altering investor behaviour in other asset classes, including equities. How this would play out is impossible to forecast with precision, but FI believes it is worth bearing in mind.

Monetary Policy Errors

Global monetary policy has already been a headwind capitalism has been forced to overcome. Yet many do not see it this way—some see the end of US QE as deflationary in the US and catastrophic in the developing world, while others believe the eurozone is headed for a deflationary spiral.

None are true, in FI's view. US money supply growth should accelerate when QE ends, as it did in the UK. The risks to Emerging Markets, too, are overstated—while foreign portfolio investment capital flows increased after QE began, this was simply a reversal of the outflows occurring during the financial panic, not a flood of "hot money." Capital flows slowed and even turned negative throughout subsequent rounds of QE. In the eurozone, while inflation is falling, M3 money supply is still growing, and long-term government bond rates do not suggest deep deflation is in the offing.

However, if central bankers see these factors differently and respond to ghost stories with policy changes, the door for sweeping errors opens. In the eurozone, the reason for falling inflation is simple: Banks are deleveraging, largely due to the regulatory environment. ECB stress tests near, and those who fail face a tough future. Officials are debating whether failing a stress test should trigger newly agreed-to "bail-in" procedures, which force creditors and large depositors to take losses when a bank is on the brink. This encourages banks to slash lending. The solution, in FI's view, is a less punitive regulatory environment, giving banks more freedom to lend. However, the continued anti-bank backlash makes the ECB more apt to pursue unconventional monetary solutions, like massive cash infusions, attempts to radically reduce long-term interest rates or negative deposit rates. Though the risk this triggers a global bear market is slim, it could cast doubt on the region's economic recovery and weigh on eurozone equities.

In Emerging Markets, India's recent monetary policy mistakes illustrate the potential for things to go wrong. Last July, when fears of QE-related capital flight peaked, the central bank hiked short-term interest rates twice—believing this would attract rate-seeking foreign investors, inverting the yield curve in the process. Shortly thereafter, RBI officials feared a liquidity shortage and implemented a small QE programme, placing further pressure on the inverted curve. The wrong prescription for a misdiagnosed problem, which markets tend not to like. The RBI has since corrected course, but the risk of similar errors remains. If multiple large Emerging Markets make similarly perplexing moves, there could be global fallout.

A Trade War With China

Following the Edward Snowden leaks, many non-US countries have become wary of NSA surveillance, believing using US-made devices could enable spying. One example is China, which appears increasingly focused on limiting NSA encroachment. In a September speech, Vice Premier Ma Kai stressed the importance of China developing its own Information Technology sector, calling the industry an "important guarantee" for national security.[xli]

Historically, Chinese firms have had only a small share of the local semiconductor market—the US and Korea dominate. A government push toward Chinese manufacturers under the guise of national security would threaten foreign firms' market share and appears to have started in Q4. In December, the government announced fresh subsidies for domestic microchip producers. US firms reported a fall in Chinese sales, particularly among firms with government ties. Cisco and Qualcomm both cited NSA surveillance as a headwind to their Chinese businesses.

In 2012, China made up 14% of US total trade in goods—no small amount.[xlii] The broader risk, however, is if this escalates into a full-blown trade war. So far, evidence is anecdotal. However, it follows US accusations of China spying through Chinese-made computers and network providers. Last year, the US government made approval of the Sprint/Softbank merger contingent on Softbank agreeing not to source material for its core business from Chinese firms.[xliii] Mutual distrust frequently impacts US/China trade. If China uses NSA concerns as a cover for new trade barriers—and the US retaliates—it could hit both countries' economies and affect global markets. The US-China trade relationship is a key link in the global supply chain. Components of many goods pass between China and the US before they enter the market. Import restrictions, high tariffs and other trade barriers could alter trade routes, make goods more expensive or even create supply shortages.

Markets typically dislike protectionism for this very reason—it interferes with global commerce and, in the worst cases, can hamper world trade flows. Currently, the balance of global trade is getting freer. However, a trade war between the world's two biggest economies could tilt the balance of the world into protectionism, potentially threatening the bull market.

The Beginning of Quantitative Easing's End

In December, the US Fed announced the long-awaited "tapering" of its QE programme. In January, monthly asset purchases slowed from $85 billion to $75 billion and in February will slow to $65 billion. As written in previous Review & Outlooks, FI is not an advocate of QE—it is a drag on bank lending and economic growth. The reduction is a positive step, but small. FI believes ending the programme would provide a much bigger economic boost.

Why Quantitative Easing Is a Negative

QE's explicit goal is to stimulate the economy by promoting borrowing. There are two main ways to stimulate the sales of any good or service, including a loan—boosting supply or boosting demand.

For decades, the Fed targeted supply—banks' willingness to lend. Banks' core business is taking deposits and lending to households and businesses. Their costs are short-term interest rates, their revenues are long-term interest rates, and their gross operating profit margin is the spread between the two. When the rate spread is wide, profits are bigger, which makes banks more eager to lend. When the rate spread is slim, profits are smaller, which discourages lending—unless a borrower is excessively solvent, there is not enough reward to make the added risk advisable.

Historically, the Fed has controlled short-term rates while long-term rates were market driven. If the Fed wanted the money supply to grow faster, it would widen the rate spread by lowering short-term rates, encouraging banks to lend more. If it needed the money supply to grow slower to fend off inflation, it would shrink the spread by raising short-term rates.

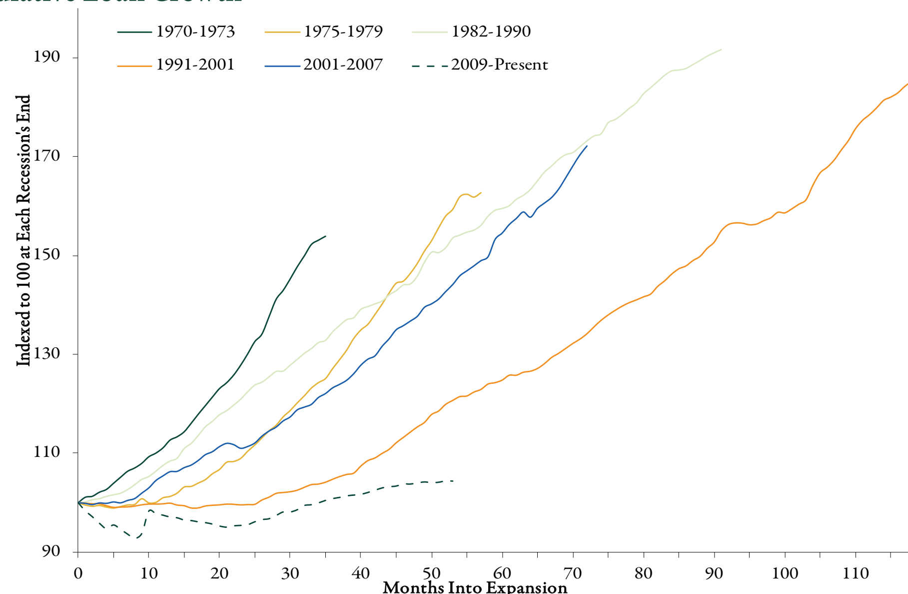
QE takes the opposite approach—attempting to stimulate demand by artificially keeping long-term rates low to encourage borrowing by consumers and businesses. Fed surveys show this held true—demand is high! Supply is not, however, thanks to QE. In buying over $3 trillion in bonds to reduce long-term interest rates, the Fed shrank the interest rate spread, inhibiting bank lending.[xliv] The result has been the slowest pace of loan growth ever this far into an economic expansion, and the slowest pace of money supply growth in modern history.

The Weakest US Growth in Post-War History

Four and a half years into expansion, US loan growth is anemic, giving us the weakest broad money supply growth—and economic growth—in modern history. There is some point to falling government spending as a drag on headline GDP growth. Regardless, if you remove the government component of GDP, the current expansion is still the third-slowest since World War II, suggesting there is another inhibitor.

In FI's view, that inhibitor is QE. Over 100 years of academic theory and evidence holds that a faster-growing money supply fuels faster growth. Banks are the lynchpin in all this—the government creates only a fraction of the total money supply. It controls the monetary base (M0)—the total coins, notes and reserves. Banks create the rest, primarily through lending. If the rate spread is small, banks typically create less money, weighing on overall growth. As Exhibit 6 shows, even with the data skewed by a small accounting rule change, which caused an abrupt increase nine months in, loan growth during this expansion is the weakest of the last six by a significant margin—and it is growing off a low, crisis-born 2009 base.

Exhibit 6: Cumulative Loan Growth

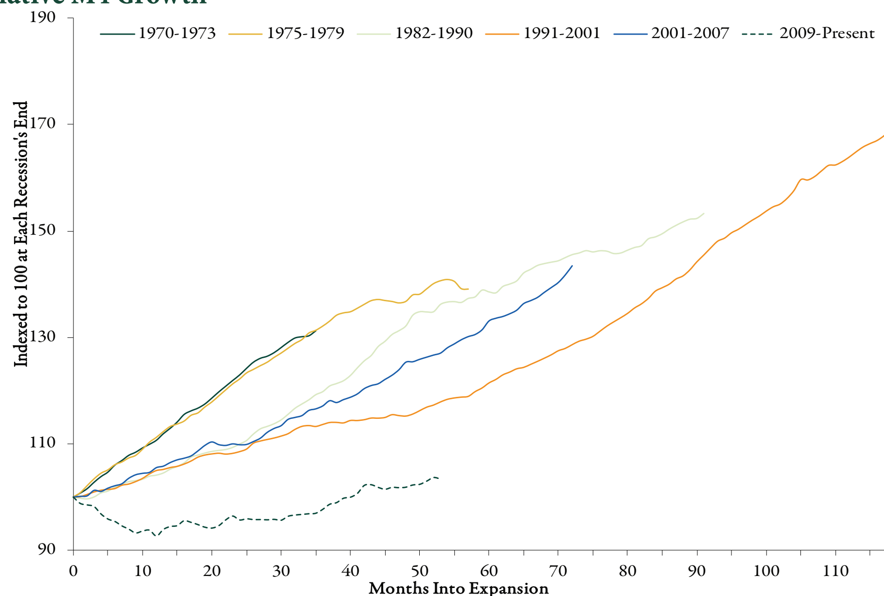


Source: FactSet Inc., as of 17/1/014; Federal Reserve H.8 Assets of Commercial Banks - Loans and Leases and NBER Recessions from 30/11/70 to 31/12/13.

As a result, this expansion has seen extraordinarily weak broad money supply growth. There are a few ways to measure this. The Fed uses M2, which includes currency, checkable deposits, household savings deposits, minor deposits and money market funds. This metric is up 37% since QE began—average when compared to previous expansions, but far below M0's 145% rise.[xlv] However, M2 does not capture all capital. A better gauge is M4, which includes M2 plus other highly liquid instruments that substitute for money: institutional money market funds, large time deposits, repurchase agreements, commercial paper and Treasury bills. M4 is the Bank of England's preferred monetary aggregate.

The Fed does not publish M4, but the nonpartisan Center for Financial Stability does. Their dataset goes back to 1967, covering the past six expansions. Exhibit 7 shows this is the first observation where M4 spent significant time in contraction.

Exhibit 7: Cumulative M4 Growth



Source: Center for Financial Stability, as of 16/1/2014; Divisia M4 Level from 1/1/1967 to 1/11/2013; NBER Economic Cycles from 1/1/1967 to 1/11/2013

What Happens When Rates Rise?

Long-term rates have risen since Ben Bernanke suggested QE could end soon, and excluding a brief period in early 2011 before the Fed launched Operation Twist, rate spreads are the widest since 2010.[xlvi] The Fed was still buying $85 billion in bonds monthly, but forward-looking markets began discounting the reduction. As detailed previously, rates could rise if bond purchases slow materially or cease all together, but a sudden spike is unlikely.

Wider US rate spreads should be a powerful force globally. Long-term interest rates in advanced and emerging economies are highly correlated. Rate spreads worldwide shrank while QE was in force and have widened along with US spreads in recent months.

In the US, wide rate spreads have not yet fostered a meaningful rise in loan growth, but this should not surprise—net interest margins typically lag changes in the rate spread by several months. Many fear higher rates will diminish demand for loans. However, FI believes demand should remain healthy while supply increases substantially, boosting overall loan growth.

Consider a rate rise from a bank's point of view. When 2012 ended, the rate spread was 1.73 percentage points. Today, it is 2.97. If rates rise another half a point, the spread will have doubled since 2012—a 100% increase in a bank's lending profit. This allows banks to take on additional risk and lend to the many businesses and households that have not qualified for years.

Now, consider a business's point of view. For example, consider a shop owner with good credit and an average return on investment (ROI) of 7%.—current after-tax borrowing cost would be about 3%. When borrowing to fund a long-term project, the total profit matters most. If borrowing costs rise half a point, total profit will still be 50% (3.5 divided by 7) if revenues hold steady. Thus, the decision becomes more about the long-term outlook. If there is confidence in the economy, the order books are growing and demand is expected to remain high, consumers will still take the loan. If consumers decide not to borrow, chances are the project was speculative enough that they would not have borrowed at lower rates, either.

Lastly, consider the homebuyer's perspective. Highly rated US borrowers can get a 30-year fixed loan for 4.5%.[xlvii] For a $500,000 home, that is a monthly principal and interest payment of $2,533. If rates rise half a point to 5%, the monthly payment would rise to $2,684—a $151 increase, or $1,812 per year. If potential homebuyers are confident in their employment and earning prospects, they will likely decide the added cost are more than manageable.

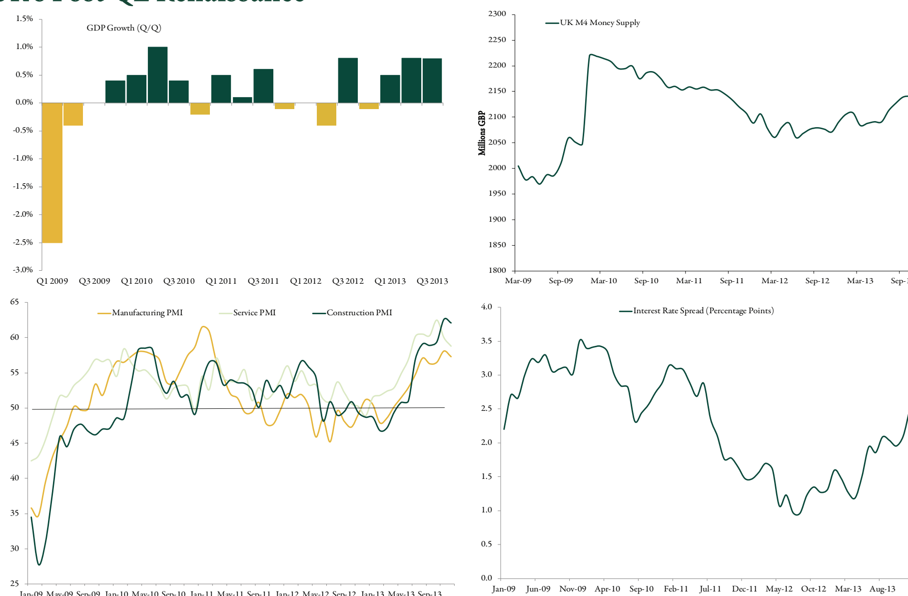
Simply, borrowers like ultra-low rates, but they do not need them. Banks' core business relies on rate spreads. Currently, with the US economy growing, disposable incomes rising and manufacturing new orders strong, businesses and households should remain motivated to borrow. With lending becoming more profitable, banks should have motivation to lend more.

The UK Precedent

The result should be faster M4 money supply growth, which should fuel faster growth overall. This is exactly what happened in the UK, where QE ended in late 2012—a powerful, underappreciated precedent. As written in previous Review & Outlooks, the UK economy struggled during its QE programme, which ran from March 2009 through November 2012. GDP contracted in 6 of 16 quarters, and real output rose by only £11.11 billion.[xlviii] M4 money supply rose swiftly at first, but it fell by £153 billion between March 2010 and March 2012.[xlix]

Since then, things have improved dramatically. After contracting in Q4 2012, GDP grew 0.5% q/q in Q1 2013 and 0.8% in Q2 and Q3—a total rise of £7.76 billion and much faster than growth during the entirety of QE.[l] PMI surveys showed rapid expansion in Services, Manufacturing and Construction, with new orders particularly strong.[li] M4 money supply also accelerated.[lii]

Exhibit 8: The UK's Post-QE Renaissance



Source: FactSet, as of 22/1/2014; Q/Q percentage change in UK GDP, 31/12/2008-30/9/2013. Monthly amounts outstanding of M4 Money Supply, 31/3/2009-31/12/2013. Markit UK Manufacturing, Service and Construction PMI Surveys, 1/1/2009-31/12/2013 (50 is considered the dividing line between contraction and growth). Spread between 10-year benchmark gilt yields and UK bank rate, 31/12/2008-31/12/2013.

We expect similar results once QE ends in the US, if not better. Even with QE over, regulatory uncertainty weighed on UK lending—particularly to small and medium businesses—as the Bank of England threatened to adopt higher regulatory capital requirements six years before 2019, the international deadline set in 2010's Basel III accords. Additionally, UK regulatory reform is over two years behind the US, with Parliament passing its equivalent of Dodd-Frank in December. The US regulatory landscape is clearer, and the Fed's timeline for implementing the Basel III capital requirements is more in line with international norms, which should support faster loan growth than the UK experienced last year.

What About Janet Yellen?

Janet Yellen succeeded Ben Bernanke as Fed Chair in January. As FI wrote in FI's Q3 2013 Review & Outlook, it is impossible to forecast the Yellen Fed's actions. Fed moves are voted on by 12 people—human decisions are not market functions.

Many try to divine Yellen's approach from the many speeches and papers she has delivered over the years, including the Nobel Prize-winning paper she co-authored. However, FI does not believe these contain meaningful clues. Fed chairpersons frequently behave differently than expected once in office. Bernanke, for example, took office in 2006 with a reputation as an expert on the Great Depression. Most assumed he would provide a safe pair of hands during the financial crisis in 2008, yet he struggled to perform the Fed's two core functions—serving as lender of last resort and boosting liquidity. He created numerous swap lines, public-private investment partnerships and borrowing facilities as more and more firms took writedowns and credit markets seized, but this did not provide much relief. He also skipped proven methods a scholar of Fed crisis management should have used, like dropping the discount rate below the Fed funds rate, which would have let banks borrow cheaply from the Fed and lend to each other at higher rates, moving more money through the system. Then, when trying to battle deflationary conditions, he skipped tools like lowering the reserve requirement and went straight to deflationary QE, defying decades of Fed wisdom and economic theory.

Some investors analysed Yellen's congressional testimony for hints of her agenda, but confirmation hearings are political exercises. The goal is to win politicians' votes, and Fed candidates are extraordinarily good at saying what certain Senators want to hear. In FI's view, Yellen's testimony simply demonstrated meticulous preparation and awareness of her inquisitors—nothing more.

Once Yellen begins making decisions and issuing statements on behalf of the Fed, FI can weigh her actions. Until then, however, FI believes speculation is unnecessary.

Should you have any questions about any of the information in the Fourth Quarter 2013 Review and Outlook, please contact FIE by mail at 2nd Floor 6-10 Whitfield Street, London W1T 2RE or by telephone at +44 (0)800 144-4731.

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iii. FactSet, as of 12/31/2013. "Earnings Insight" for the week ending 27/12/2013.
iv. Ibid.
v. Ibid.
vi. Source: FactSet, as of 10/1/2014. S&P 500 year-over-year revenues per share. Two quarters of decline were Q3 2012 (-0.54%) and Q1 2013 (-0.21%).
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viii. FactSet, as of 31/12/2013. "Earnings Insight" for the weeks ending 27/12/2013 and 27/09/2013.
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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, making arrangements with a view to transactions in investments, arranging investments, managing investments, and advising on pension transfers and pension opt-outs. 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 is based in the USA and 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 FI's liability towards you because of FI's 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.