FISHER INVESTMENTS EUROPE™

MARKET PERSPECTIVES
REVIEW & OUTLOOK

FIRST QUARTER
2023

FIRST QUARTER 2023 REVIEW & OUTLOOK

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FIRST QUARTER 2023 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

14 April 2023

PORTFOLIO THEMES

- We believe a new bull market cycle is close, if not already underway. Equities that fell the most during the downturn likely lead in the recovery.
- Negative volatility tied to inflation, central bank policy fears and isolated banking instability indicate overly dour pessimism still abounds—likely setting the stage for positive surprise in 2023.
- The categories that were hardest-hit during the bear market are disproportionately weighted toward growth equities, which should outperform during the initial phase of a new bull market, but cyclical value categories may outperform by yearend.

MARKET OUTLOOK

- **A New Bull Market is Near or Underway:** While volatility in any sector or region can temporarily impair returns, we believe a new bull market cycle is imminent.
- **Excessive Investor Fear Supports New Bull:** Universally dour sentiment, driven by concerns on inflation, labour markets, energy crunches, the Russia-Ukraine war, banking sector uncertainty and a variety of other factors has significantly lowered investor expectations, creating space for the new bull market to grow.
- **US President's Third Year is a Tailwind for Global Markets:** The third year of a US president's term historically has the highest frequency of positive returns of the four-year cycle. S&P 500 returns have been positive 91.7% of the time since 1925. No third year was negative since 1939, in the Great Depression's depths, which is nothing like today.

Global equities rose 7.3% in Q1, bringing MSCI ACWI Index returns to 18.4% since last October's low.[i] Emerging Markets (EM) also performed well, returning 4.0% in the quarter. Market movement is increasingly looking like the new bull market we have described previously, with the backdrop unfolding, as we would expect.[ii] Pessimism remains rampant, especially after several small or long-troubled banks failed in mid-March, igniting fears of a 2008 redux. Such worries overlook the unique nature of these banks' issues and the financial system's robust overall health. Meanwhile, bullish political gridlock goes unnoticed and economic results quietly beat meager expectations. As always, volatility is possible and we cannot rule out the possibility of more downside. However, this rally looks ever more like a classic early bull market, leading us to believe 2023 will be a positive year for global markets.

Thus far in 2023, growth equities, like Tech and Tech-like firms, have performed well despite growth leadership being unusual early in a bull market. The outperformance follows a simple-yet-unseen reality: In early bull markets, the categories of equities hit hardest in the preceding bear market usually lead early in the rebound. Normally that is economically sensitive value equities as they are typically punished the most in a recession. However, the most widely anticipated recession in modern history has failed to materialise yet.

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i Source: FactSet, as of 05/04/2023. MSCI ACWI Index return with net dividends, 31/12/2022 – 31/03/2023 and 12/10/2022 – 31/03/2023.

ii Source: FactSet, as of 05/04/2023. MSCI EM Index return with net dividends, 31/12/2022 – 31/03/2023.

Value could lead later if a recession does strike, but the category would likely be punished first. We carefully watch markets for such signs, but we ultimately think it is best to maximise the likelihood of participating in the bull market bounce by overweighting previously hard-hit growth equities.

Entering the new year, we said that whether the bull market started last October or began this year, we believed global equities would most likely end 2023 far higher than where they began it, fueled by big early bull market returns. We still think so. As we wrote in Q4 2022's Review and Outlook: "A year from now, the reality of partisan gridlock will have dawned on all, with few major bills to rock the boat. Inflation should keep slowing. And Fed rate hikes will have proven feckless, as banks' high deposit bases mute the fed-funds rate's impact on loan profitability and enable banks to lend enthusiastically at big profits. On all fronts, we believe 2023 should bring sweet relief."

That is playing out extraordinarily well. While US headlines dwell on Congressional uproar over TikTok and the debt ceiling, the simple reality is no major economic bills are in the works. Gridlock is supporting positive market performance, unnoticed as usual. The S&P 500's 7.6% Q4 rise started a typical "Midterm Miracle," topping the average 6.3% midterm Q4 rise prior to last year.[iii] Q1 2023 was similarly impressive, as US equities rose 7.5% versus the average post-midterm Q1's 6.6%.[iv] The positivity extends into Q2 and the entirety of the president's third year—historically the strongest of the four. Recall, there hasn't been a negative third year of a president's term since 1939, which was down only -0.9%.[v] Better still, gridlock now reigns globally, keeping legislative risk low almost everywhere. Although not definitively or overwhelmingly positive, global economic data are beating expectations, inflation is slowing and market drivers are bright.

The regional bank scare in the United States grabbed attention globally, particularly in Europe. Despite little fundamental connection to European banks, the fear spread over to the Continent—and targeted Switzerland's long-maligned Credit Suisse in particular. After the bank released its delayed annual report, which contained dismal results, some prominent shareholders shared concerns publicly. That sent shares careening and panicked depositors who withdrew their funds, fearing US domestic banking issues were going global. Overall, the limited broad market impact—not to mention the rebounds in hard-hit Financials and Energy—suggests to us the larger selloff was sentiment-driven, and fundamentals aren't as bad as some fear.

That said, we are closely monitoring lending data. It is possible fear of further panic persuades banks to hold more in reserves instead of lend—making it harder for households and businesses to access capital, which could weigh on economic growth. Even before March's banking scare, lending in Europe was weakening. UK total lending fell -0.3% y/y in February, its first year-over-year decline since 2014.[vi] In the eurozone, loan growth has been decelerating since last September—from 7.1% y/y to February's 4.3%.[vii] Now, recession isn't inevitable, but the global banking scare could discourage banks from lending as enthusiastically as last year, which could weigh on growth in developed world—worth watching. Or a sharp regulatory change could have similar results—always a concern we monitor.

iii Source: FactSet and Global Financial Data, Inc., as of 05/04/2023. S&P 500 total return, 30/09/2022 – 31/12/2022 and average in midterm year Q4s, 1926 – 2023.

iv Source: FactSet and Global Financial Data, Inc., as of 04/05/2023. S&P 500 total return, 31/12/2022 – 31/03/2023 and average in midterm year Q1s, 1926 – 2023.

v Source: Global Financial Data, Inc., as of 30/12/2022. S&P 500 total return, 31/12/1938 – 31/12/1939.

vi Source: Bank of England, as of 29/03/2023.

vii Source: European Central Bank, as of 03/04/2023.

In EM, China had an eventful Q1—first with the National People's Congress (NPC), which opened the five-year legislative session, then with the release of combined January and February economic data. As with October's Communist Party Congress, the NPC brought volatility initially, likely tied to heightened geopolitical chatter. However, the uncertainty faded quickly, and economic drivers seemingly regained investors' focus. At the NPC, officials set this year's GDP growth target at 5.0%, below consensus expectations for 5.3% and below last year's 5.5% target. That seemed to disappoint investors initially, but 5.0% growth would be a meaningful acceleration from last year's 3.0% full-year growth.[viii] Additionally, the policy plans outlined at the meeting were largely pro-growth. The monetary policy statement called for policy to be "prudent, targeted and forceful" such that financing growth generally matches nominal GDP growth—which seems consistent with the decision later in the month to cut the reserve requirement by another 25 basis points to entice continued infrastructure and manufacturing investment. Meanwhile, officials plan to intensify efforts to attract foreign investment, including continuing to open access to the services sector, and raise defense spending to its fastest pace in four years—which should provide a public investment economic boost.

Brazil underperformed in Q1 as the central bank discussed continuing interest rate hikes. While the Monetary Policy Committee (Copom) held the benchmark Selic rate at 13.73% at its March meeting, its statement raised the prospect of further rate hikes, allegedly disappointing investors who believed rate cuts were nearby. As ever, we counsel against taking central banks' forward guidance as a policy blueprint—monetary policy moves defy prediction, in our view. Moreover, there is a silver lining in the hawkish comments, as they should help diminish concerns about the central bank's independence. Cutting rates would have given the impression that Copom is yielding to President Lula's demands for lower rates, so a more hawkish statement may simply be the central bank's attempt to signal its credibility and independence. Meanwhile, falling inflation and strong exports—which should get a boost from China's reopening—should offset lingering fears of political uncertainty.

Unlike the rebound in global equities, sentiment is not experiencing a similar rally. One recent survey of investment professionals showed 70% think the upturn is a mirage and equities will soon tumble.[ix] Analysts hunt for bearish basics, citing everything from the Fed and banks to technical indicators. In bear market rallies, that doesn't happen. People seek reasons to be bullish. When they instead seek reasons to be bearish, however far-fetched, it shows the pessimism of disbelief reigns.

This is typical in recession fears. At 2023's start, they were everywhere. Then a run of solid data seemingly lifted the world's spirits. Several outlets raised economic forecasts. Many cheered the prospect of enduring only a "soft landing" of slow growth. But March's banking woes reignited pessimism. Now people envision a shaky economy vulnerable to any little shock. Even China's reopening tailwinds, progressing nicely, are beheld as too weak to help. These seem like classic bricks in a young bull market's wall of worry.

We observe central bank rate hikes similarly. Pundits continue interpreting every economic data release in light of what it means for monetary policy. But the widespread fear has lost its market effect. For example, in the US the S&P 500 is down modestly since the Fed scrapped its prior rate guidance and inflation outlook to begin hiking on 16 March 2022.[x] Although, it is up since the Fed started its aggressive 0.75 percentage-point hikes in June, extending equities' long history of doing fine in various interest rate environments. Furthermore, many said Tech was most vulnerable to higher rates, yet it is leading in the recovery despite much higher rates now. The Fed's early-2022 reversal is spent.

viii Source: FactSet, as of 31/03/2023.

ix Source: "Investors Believe the Stock Market Is Set for Losses, and Cash Is Best Safe Haven, CNBC Survey Shows," Yun Li and Patricia Martell, *CNBC*, 31/03/2023.

x Source: FactSet, as of 05/04/2023. S&P 500 total return, 16/03/2022 – 31/03/2023.

Conclusively, we don't think the various negative headlines in the global media apparatus are likely to derail equities now, but they are important to watch and weigh. Currently, most widely perceived "risks" are either false, too small or too widely known to send equities spiraling. Markets move most on probabilities, and we think the highest probability is a widely unexpected 2023 bull market.

GLOBAL UPDATE AND MARKET OUTLOOK

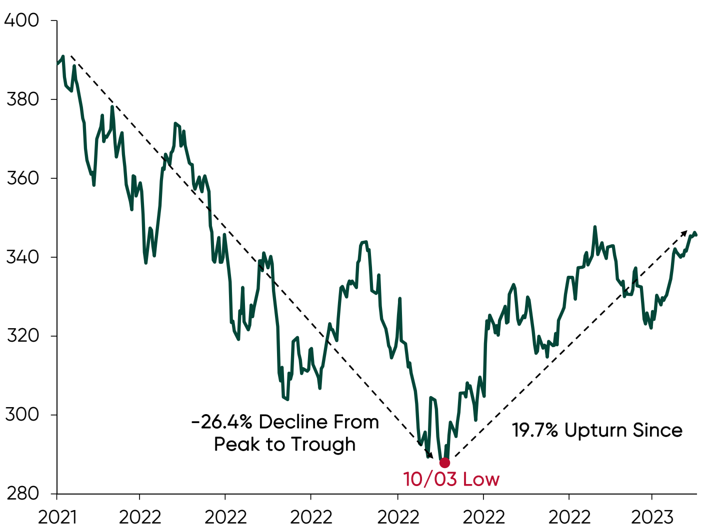
30 April 2023

MARKET RECAP

A STRIKING BACKDROP FOR A BULL MARKET

Entering this year, we expected the combination of deep pessimism, United States' post-midterm political sweet spot and resilient economic conditions to deliver a new bull market. The upturn since October's low increasingly looks like that, with two straight strong quarters and the downturn's hardest-hit categories leading. Despite the recovery, few believe this to be the beginning of an early bull cycle. To us, that suggests this recovery is real and the central force behind this rally is that the economic reality has far exceeded fears.

EXHIBIT 1: GLOBAL EQUITIES REBOUND FROM OCTOBER'S LOW



Source: FactSet, as of 06/04/2023. MSCI ACWI with net dividends, 31/12/2021 – 31/03/2023.

THE WIDELY EXPECTED RECESSION THAT HASN'T ARRIVED

Entering this year, sentiment gauges like Bank of America's Global Fund Manager Survey showed pervasive, deep pessimism. Public and private sector surveys ranging from the Philadelphia Fed's to The Conference Board's to KPMG's showed widespread expectations for a 2023 recession. This was true globally, but especially in Europe, where surveys showed executives thought a deep recession was virtually certain.

Yet global economic data throughout Q1 didn't support the fear. They weren't great. But they weren't deeply contractionary, either—with most suggesting growth was muddling along. Exhibit 2 illustrates this using GDP.

EXHIBIT 2: GDP GROWTH IS MIXED, NOT CRATERING

	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Full Year
US	-1.6%	-0.6%	3.2%	2.6%	2.1%
Eurozone	2.5%	3.6%	1.5%	-0.1%	3.5%
Germany	3.2%	0.4%	1.9%	-1.7%	1.8%
France	-0.9%	2.0%	0.7%	0.3%	2.6%
UK	2.0%	0.2%	-0.4%	0.5%	4.1%
Japan	-1.8%	4.7%	-1.1%	0.1%	1.0%
China (y/y)	*4.8%*	*0.4%*	*3.9%*	*2.9%*	*3.0%*

Source: FactSet and Eurostat, as of 06/04/2023. All quarterly figures are annualised rates except China, which is year-over-year due to data availability. Full year column is 2022 versus 2021.

The underlying data are just as mixed. US Q1 and Q2 contractions were driven by volatile categories like inventory change and government spending—both open to interpretation. The only clear, consistent detractor of any note was residential real estate investment. It fell -3.1%, -17.8%, -27.1% and -25.1% annualised in 2022's four quarters, respectively.[xi] Yet even these huge drops didn't drive recession. And now, there are emerging signs US housing is stabilising. So even this rare, consistent headwind may be fading.

A persistent divide between manufacturing and services results also underlies the mixed data. During COVID restrictions, services faltered while manufacturing boomed. That trend reversed last year and into 2023, as demonstrated by broad-based growth in Purchasing Managers' Indexes (PMIs).

xi Source: US Bureau of Economic Analysis, as of 06/04/2023. Annualised change in residential real estate investment.

EXHIBIT 3: THE GLOBAL PMI DIVIDE

	Composite	Services	Manufacturing
US	52.3	52.6	49.2
UK	52.2	53.5	47.9
Eurozone	53.7	55.0	47.3
Germany	52.6	53.7	44.7
France	52.7	53.9	47.3
Japan	52.9	55.0	49.2

Source: FactSet, as of 10/04/2023. March S&P Global PMIs. Readings above 50 are expansionary.

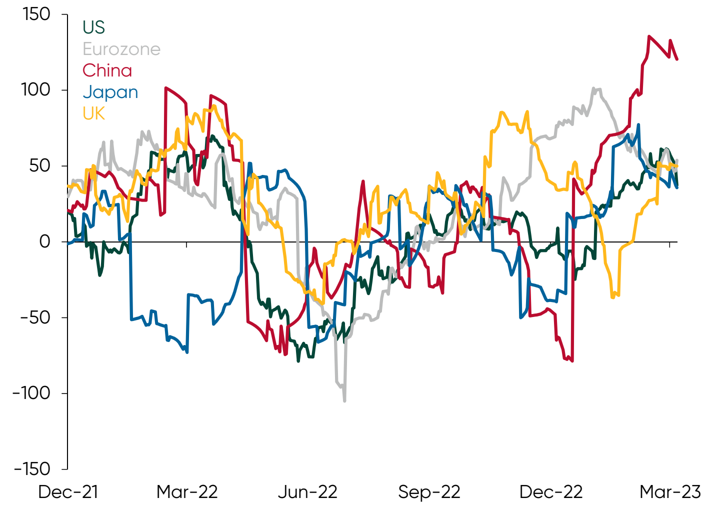
PESSIMISM DELIVERS POSITIVE SURPRISE

We aren't arguing economic data are tremendously expansionary. But with almost everyone expecting an economic downturn entering this year—the most widely expected recession ever—they are material and positive enough to surprise to the upside.

One way to see this: Citigroup's Economic Surprise Indexes. These compare how incoming data relate to market analysts' expectations. When they are above zero, more data is beating expectations than missing. They aren't perfect or all-inclusive—no sentiment metric is. But as Exhibit 4 shows, they help show that positive surprise has been plentiful lately.

Of course, a recession could still come. We are watching for one. Crucially, so is just about everyone else. This suggests the equity market impact would be muted—markets pre-price widely expected events. A recession could spur value to lead eventually. But we don't think that is today. Growth has led thus far, as we would expect following a historically small bear market with no recession. What gets hit hardest typically bounces highest, and absent a recession that hurts value, that was growth.

EXHIBIT 4: CITI ECONOMIC SURPRISE INDEXES SHOW GLOBAL RELIEF



Source: FactSet, Economic Surprise Index Level as of 06/04/2023. 31/12/2021 – 31/03/2023.

EXCESSIVE PESSIMISM STILL REIGNS

The pessimism of disbelief, sour sentiment despite better-than-expected economic results, is alive and well at Q1's close, keeping economic and political expectations low.

Sentiment seemingly warmed in early Q1, as data topped fears and equities climbed. In *Bloomberg*'s December survey, 70% of economists expected recession. That ticked down to a still-high 60% by February. Many talked of the Fed avoiding a dreaded "hard landing" of steep economic decline in favour of merely slowing growth.

But March's bank failures hit sentiment anew. Now 65% of economists expect recession.[xii] Despite little evidence supporting the view, many fear a systemic financial panic is forthcoming. They argue it proves the Fed has already gone too far, again proclaiming recession a near-certainty. Bearishness abounds. At quarter end, a CNBC poll found 70% of the "chief investment officers, equity strategists, portfolio managers and CNBC contributors who manage money" expect equities to fall.[xiii]

xii Source: "Economists Boost US Recession Odds on Higher Rates and Banking Woes," Augusta Saraiva and Kyungjin Yoo, *Bloomberg*, 28/03/2023.

xiii Source: "Investors Believe the Stock Market Is Set for Losses, and Cash Is Best Safe Haven, CNBC Survey Shows," Yun Li and Patricia Martell, CNBC, 31/03/2023.

Elsewhere, headlines in *The Wall Street Journal* claimed equities "haven't been this unattractive since 2007" based on gaps between bond yields and earnings yields (the inverse of the price-to-earnings ratio expressed as a percentage) or the contorted cyclically adjusted price-to-earnings ratio.[xiv] Neither reliably predicts markets, but that doesn't stop the hunt for negativity. An early April *Bloomberg* report argued that allegedly contradictory movement in gold, bonds and equities showed markets are "confused" about the economy's health and trajectory.[xv]

But it doesn't seem very confusing to us. Quite the contrary—we think it is great. In early bull markets, folks often see disconnects between markets and the economy, or Wall Street and Main Street, in the parlance often used. Valuation metrics, too backward-looking, are often skewed as equities jump before earnings recover—normal. Today's headlines are archetypal of new bull markets. Equities move most on the gap between sentiment and reality, as Q4 and Q1 illustrate. Their climb amid dug-in bearishness suggests positive surprise remains the most likely outcome.

RISKS WE ARE WATCHING

While we are bullish, we always watch for risks to our forecast—and to equities. Doing so requires looking past the fears churning in headlines, which are usually too widely discussed to significantly derail markets. Lately, most recycle issues markets dealt with months or even years ago. These may stir sentiment, but the likely effect is small. In our view, the real risks are those potential negatives, largely unseen, that could deliver a multitrillion dollar shock if they manifested. Right now, investors are busy fighting the last war, a classic early bull market sentiment indicator, which diverts attention from key risks we are watching closely.

FIGHTING OLD WARS

Beyond banking concerns, headline fears morph from one faulty concern to another. When OPEC+ cut oil production targets in April, headlines extrapolated a couple days' jump to much higher oil prices and resurgent inflation ahead. They forget that OPEC+ cut targets six months earlier… and oil prices fell. The cartel simply does not have the power to sway markets like they once did—many members can't even reach production targets to begin with. The focus on targets over actual production is out of touch.

The US debt ceiling, a false fear so prominently discussed early this year, now simmers on the backburner. Taking its place: False fears of the dollar losing its status as the world's primary reserve currency, as the currency weakened against a trade-weighted basket in Q4 and Q1.

This fear has floated around for decades, with many arguing its heavy use in world trade, financial transactions and as a central bank reserve holding is the sole factor allowing the US to finance its debt—its "exorbitant privilege." Today, the fear crops up tied to the Ukraine war, as sanctions drove Russia and other nations to seek alternatives to it. Hence, many fear China and Russia will conduct trade—including the oil trade—in yuan.

We have discussed de-dollarisation fears many times, but there is no real evidence the world is set to abandon the dollar—or that it would matter if they did. The US doesn't collect a fee any time someone trades in or out of the US dollar. While the dollar's share of global central bank reserves has fallen the last couple decades, it remains well over half—no other alternatives are close.[xvi] Moreover, because overall central bank reserves have risen substantially in the last two decades, the absolute amount of dollar assets they hold is up.

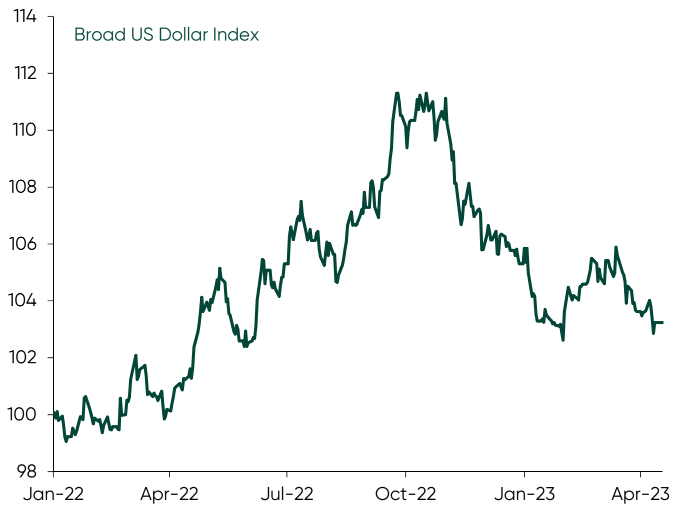
xiv Source: "Stocks Haven't Looked This Unattractive Since 2007," Eric Wallerstein, *The Wall Street Journal*, 06/04/2023.

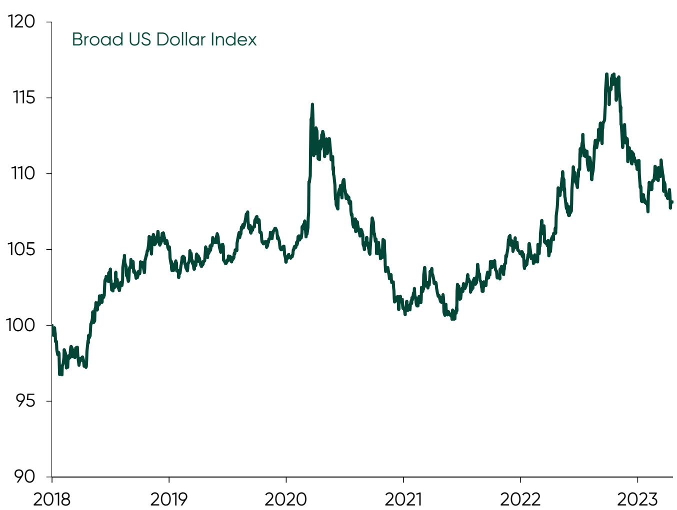
xv Source: "Mixed-Up Markets Can't Get Story Straight as Bank Drama Smolders," Denitsa Tsekova, *Bloomberg*, 06/04/2023.

xvi Source: IMF, as of 11/04/2023.

The dollar is dominant because it is convenient to use, not because the US is forcing anyone to do so. Until another country—or currency bloc—matches the US's market depth, liquidity, accessibility and legal structure, we don't see that changing. To counter the latest myopia, Exhibit 5 shows the US dollar against a broad range of currencies over the last year and five years. Currencies fluctuate, but the recent weakness is the dollar retracing some of the panic-driven spike last year. This is normal in new bull markets, in our experience.

EXHIBIT 5: DOLLAR "WEAKNESS" IN PERSPECTIVE





Source: FactSet, as of 11/04/2023. Fed Broad US Dollar Index, 31/12/2021 – 11/04/2023 and 31/12/2017 – 11/04/2023. Index levels rebased to 100 at series' starts.

Fixation on false fears—e.g., oil and the dollar—is the standard backdrop for new bull markets and contrasts with what sentiment would be like in a bear market rally. Then, people grasp at every seemingly positive straw and ignore all the bad. Now they reach for negatives and ignore the positives. Classic and bullish.

GEOPOLITICS

While everyone watches Russia-Ukraine, that regional red flag has been raised high for over a year. It is now clear the conflict is highly unlikely to spread west into EU or NATO territory, and markets know how to handle a war of attrition concentrated in a small pocket of the global economy. The initial scare sent commodity markets reeling, but those fear-based disruptions have long since settled, with most metals, food and energy commodities now trading below pre-invasion levels. The human toll is tragic, but markets have moved on.

However, stealthy geopolitical risk lurks in India and Pakistan. Conflict between the neighbouring nuclear powers has simmered for decades—and faded into the subcontinental backdrop. But it has the potential to reignite with Pakistan currently facing severe economic strain and a debt crisis. Alone, this doesn't present a global economic threat, but financial upheaval is breeding political instability. Pakistan has seen plenty of that in recent years, mostly manifesting in internal power struggles. But if directed outward, the situation could escalate.

For instance, Pakistan has begun competing with India by buying discounted Russian oil, which could antagonise its rival. Add that to a long list of grievances between them—alongside wider politics as South Asia's influence grows on the world stage—and circumstances bear watching, particularly since they could embroil China. Pakistan and China each claim territory in India's northern Himalayan states. In India's Arunachal Pradesh—which China recently renamed "Zangnan"—both countries are building settlements on disputed land. Incursions and border clashes there have the potential to heat up quickly. This is just one area of major possible conflict, but with all eyes on well-known tensions, don't overlook others flying under the radar.

CREDIT FREEZE

Global loan growth led by the US has been an unappreciated bright spot. Though few notice, it nonetheless spurs spending and investment, which then surprises many with upside outcomes. However, a lending slump could sap credit supporting economic activity worldwide. A couple potential causes: Regulatory uncertainty or bank funding cost pressures. In the wake of recent failures, even if the regulatory landscape *doesn't* end up shifting much, banks could still become risk averse. Most acknowledge this right now and are on high alert for a prolonged lending contraction. Yet lending wouldn't necessarily have to fall to make trouble, which is where the stealth factor appears. Growth slipping below inflation could signal a contraction in real terms, which could knock real spending, investment and GDP. Currently, loan growth in the US exceeds inflation, Japan's matches, while the UK and eurozone's are below. Given the UK and eurozone are at the center of recession talk, we don't think headwinds are going unnoticed, but a broader decline would be another story.

We haven't seen it on a large-enough scale yet, but if banks broadly began competing for deposits, it could erode the cheap funding base shown in last quarter's Review and further discourage lending. While perhaps good news for depositors, it would be less so for banks' loan margins—and incentive to lend. Banks' actual funding costs inching towards the fed-funds target rate could yield the long-rumored, but thus far unseen, credit crunch.

RESERVE REQUIREMENTS

Relatedly, the US Federal Reserve could reinstate reserve requirements scrapped in 2020, potentially freezing lending. Post-pandemic, monetary policy is gradually returning to "normal"—zero interest rate policy and quantitative easing are fading into the rearview. Yet some less-heralded emergency measures remain. If the Fed suddenly reinstated reserve requirements at high levels, forcing banks to set aside funds to back lending (just as their deposit bases have begun to erode), they may prefer to rein in credit. This happened in 1937. Climbing out of the Great Depression and eager to restore "normal" bank operations, the Fed increased reserve requirements. Bank lending shriveled, sending the economy back into a tailspin and truncating the 1932 – 1937 bull market.

CRYPTO REGULATION

The US Treasury sees decentralised cryptocurrency markets as increasingly threatening—partly to financial stability, but mostly to national security through money laundering, terrorist financing and sanctions-evasion. Although the crypto-booms (and busts) over the years haven't had many wider ramifications for financial markets—largely because their isolation from the banking system limits transition—new regulations or legislation could change that. Regulations have yet to take shape. But well-intended policies often have unintended consequences.

In the wake of early century accounting scandals (Enron and WorldCom), the swift passage of Sarbanes-Oxley's stepped-up compliance costs and criminal liabilities halted what we think was a nascent recovery from the dot-com bear market, pushing equities to their ultimate low in October 2002. Stricter "fair value" accounting rules in the form of 2007's FAS 157—stemming from the 1980s' Savings & Loan Crisis—led to the 2007 – 2009 global financial crisis and bear market. It forced sound banks to mark illiquid and hard-to-value assets they never intended to sell to the fire-sale prices of comparable assets other distressed institutions were unloading—destroying bank capital and bankrupting several major institutions.

MARK-TO-MARKET ACCOUNTING

Speaking of FAS 157, some have suggested re-imposing mark-to-market. Banks' ability to carry assets classified as hold-to-maturity at cost is under fire. Some see this hiding (paper) losses and obscuring banks' risks with questionable capital. But this misses the point: It fixed misapplied mark-to-market accounting rules that precipitated 2007 – 2008's global financial crisis. $200 billion in mostly subprime loan losses, which banks could have absorbed otherwise, spiraled into $2 trillion in exaggerated and unnecessary writedowns because paper losses were treated as real, wiping out bank capital.[xvii]

Markets, in our view, are more than capable of valuing bank assets—and assessing any risks—regardless of the accounting conventions used to classify them. They could have a harder time navigating mark-to-market rules that may have direct—but arbitrary—consequences for bank balance sheets. If revived, the imposition of "fair value" accounting could enable the 2008 repeat everyone says they seek to avoid.

Nothing here is assured to happen and negatively surprise markets. But we find it good exercise to track events most ignore and weigh developing scenarios' bearish potential—just in case. Looking for problems others may miss may seem a bit counterintuitive, because it goes against instinct. But in our view, shocks move equities most—and something everyone watches likely isn't a shock.

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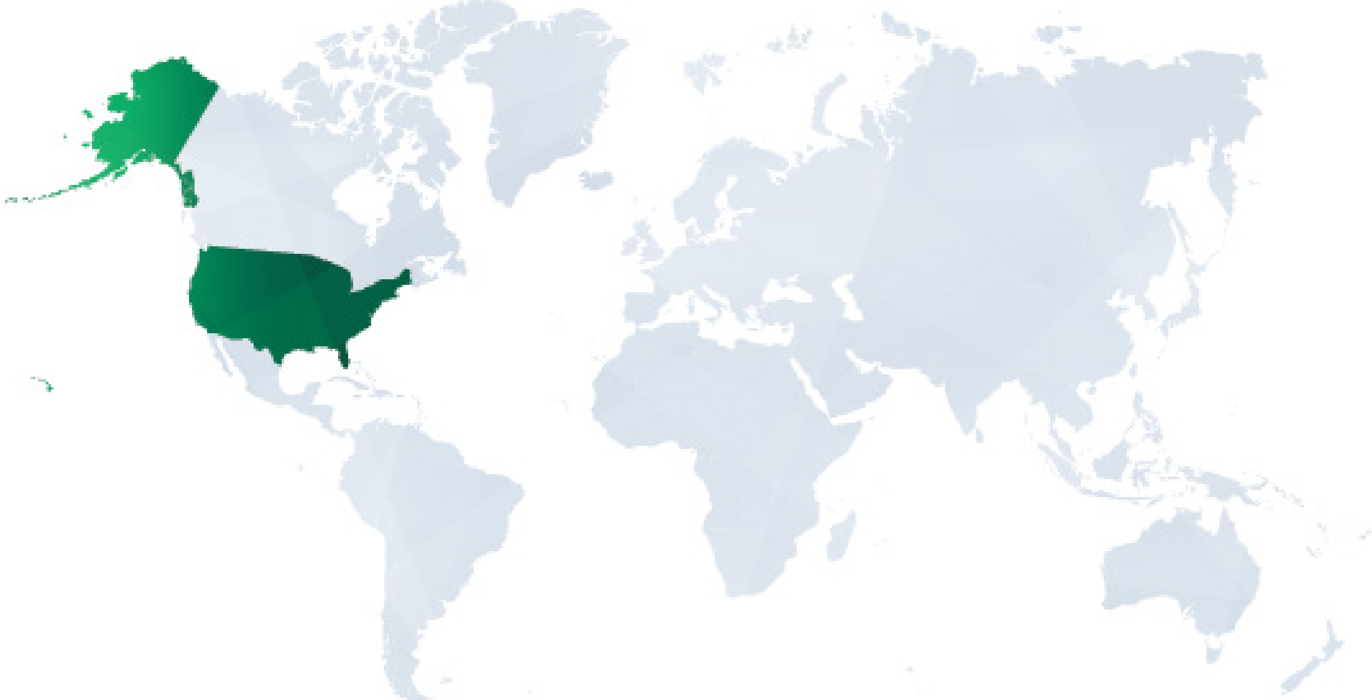
xvii Source: *Senseless Panic*, William Isaac, Wiley, 2012.

UNITED STATES COMMENTARY



THE MIDTERM MIRACLE IS IN FULL SWING

Our political commentary is intentionally non-partisan. We favour no politician nor any party, assessing developments solely for potential market impact.

US midterm elections, which routinely increase political gridlock, ignite market rallies. As our Q3 2022 Review showed, the tense run up to midterm elections typically weighs on sentiment and returns. In the three pre-vote quarters, equities have averaged just 1.0%, -0.3% and 0.6% returns, respectively.[xviii] They rose just 48%, 56% and 60% of the time.

But as the election comes and goes, the reality of gridlock sets in. Political rhetoric doesn't subside, but little legislation squeaks through, which reduces the threat of government action creating winners and losers. Therefore, allowing businesses to better plan investment and mitigates an external factor beyond their control. Prior to the 2022/2023 period, the three quarters starting in the midterm year's Q4 average 6.3%, 6.6% and 5.5% gains, respectively, rising 83.3%, 87.5% and 87.5% of the time.[xix] Exhibit 6 shows Q4 2022 and Q1 2023 have proven no exception, rising 7.6% and 7.5%.

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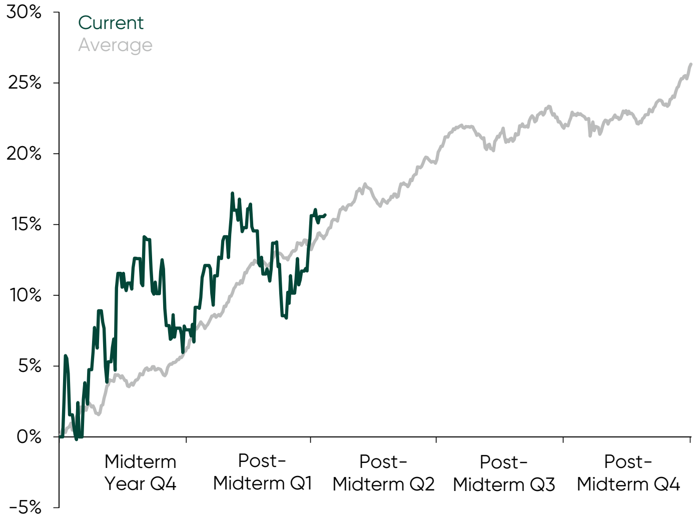
xviii Source: Global Financial Data, Inc., as of 11/04/2023. S&P 500 average total return and frequency of positive returns by midterm quarter. 1925 – 2023.

xix Source: Global Financial Data, Inc., as of 11/04/2023. S&P 500 average total return and frequency of positive returns by midterm quarter. 1925 – 2023.

EXHIBIT 6: THE MIDTERM MIRACLE, ILLUSTRATED



Source: Global Financial Data and Fisher Investments Research, as of 11/04/2023. Average S&P 500 total return from 30 September of midterm year to 31 December of following year (returns daily, interpolated from monthly) and S&P 500 total return, 30/09/2022 – 10/04/2023.

Yet few credit gridlock now—they are too distracted by potential TikTok bans, debt ceiling negotiations, military leaks or bank failures. Investors might subconsciously *know* few major laws are passing but they don't actively consider the bullish impact—key to the Midterm Miracle's repeat power. Moreover, the Midterm Miracle starts the president's third year—the best of the four-year presidential cycle—with material gains. It averages 18.4% with no down years since 1939's -0.9%.[xx] The tailwind of gridlock should be behind equities all year.

As is typical, many already eye 2024. This is premature. While the field will begin taking shape in this year's third quarter, it isn't worth over-analysing yet. At this point, the political conversation is largely speculation. We would say the same over former President Donald Trump's indictment. The flood of headlines largely proves the lack of more substantive political activity and news, in our view.

THE FED'S SURPRISE POWER IS FADING

The Fed's hikes continued into Q1, although March's was only 0.25 percentage point—far smaller than last year's frequent 0.50 or 0.75 ppt hikes. Investors now expect only a few more rate hikes amounting to a fraction of a percentage point. This time last year, after the Fed's big U-turn—admitting they missed the mark on inflation—investors expected several percentage points of hikes. We have come a long way.

With this journey, Fed moves' surprise power has fallen. Today, the S&P 500 sits just 4% below its level before the Fed's first hike.[xxi] Equities are up since it launched hikes in mid-2022. They have risen amid rate hikes since October, an unspoken truth. Also underappreciated: For years, very low short- and long-term interest rates had many fearing the Fed was powerless if economic trouble struck. As March's banking fears illustrated, you can't say that now. The Fed could cut rates if it so desired—not that this is a cure-all.

As for long-term interest rates, they have fallen lately, but that seems mostly tied to March's banking fears. As that force abates, we expect rates to be range-bound, perhaps drifting up slightly by yearend.

MARCH'S BANKING FEARS IN PERSPECTIVE

Silicon Valley Bank (SVB) and Signature Bank's failures sparked fears of a system-wide meltdown. US regional bank equities tumbled. Meanwhile, SVB's UK subsidiary suffered a run, as did Switzerland's long-suffering Credit Suisse. Since then, however, the frenzy has subsided. Regional bank equities have stabilised, and the MSCI ACWI Index is up 5.1% since 10 March, the day SVB failed.[xxii] Equities usually get over failing financial institutions faster than most can fathom—this time, so far, is no different.

xx Source: Global Financial Data, Inc., as of 11/04/2023. Average S&P 500 total return in US presidents' third years, 1927 – 2019.

xxi Source: FactSet, as of 11/04/2023. S&P 500 total return, 16/03/2022 – 31/03/2023.

xxii Source: FactSet, as of 11/04/2023. MSCI ACWI returns, 10/03/2023 – 31/03/2023.

SVB AND SIGNATURE HAD UNIQUE PROBLEMS

SVB wasn't like other banks. It was a creation and tool of the Venture Capital (VC) world. Yes, like most regional banks, it served local businesses, their employees and customers. But most regional banks' business client base is diverse, mitigating industry concentration risk in their balance sheet. SVB, however, served VC firms, their portfolio companies (mainly startups and even some publicly traded Tech and Tech-like firms) and their employees, families and friends. Several VC funding deals required the companies to bank with SVB. Around 90% of its deposit base was above the FDIC's normal $250,000 insurance limit, and much of that was startups' cash reserves and working capital.[xxiii] According to Congressional testimony, its top 10 depositors held some $13 billion—vast concentration. Meanwhile, it also owned a high concentration of longer-term US Treasury bonds, whose value declined as interest rates rose in 2022. This reduced SVB's liquidity just as VCs hit a rough patch, causing business depositors to burn through cash quickly.

SVB's bank run was also atypical. It spiraled on social media as VC firms publicly urged their portfolio companies to withdraw their money. This sparked panic with depositors, which escalated on 8 March when SVB disclosed hefty losses and plans to raise capital. The escalating run caused those plans to fall through, leading to its seizure by the FDIC two days later.

New York-based Signature also had a concentrated deposit base—in cryptocurrency companies. Crypto fueled a 68% increase in Signature's deposits in 2021, making it vulnerable as crypto crashed last year.[xxiv] There, too, uninsured deposits represented about 90% of its base, heightening the incentive to flee as crypto imploded. That its run happened parallel to SVB's is no surprise.

WHAT THE REGULATORS DID

Initially, SVB and Signature were set to follow the standard bank failure playbook. Under FDIC receivership, insured deposits would be available immediately, while those holding uninsured deposits would receive a claim on the bank's assets and likely receive part of their funds later. But the Fed and Treasury quickly caved to a social media campaign that portrayed SVB's business clients not as startups whose founders and early investors didn't want their holdings diluted by an emergency funding round, but as small mom-and-pop businesses just trying to make next week's payroll. They warned of national economic calamity if this happened, claiming it would spark a run on all regional banks nationally as small businesses pulled uninsured deposits. The pressure worked. On Sunday, 12 March, the Fed and Treasury jointly guaranteed all uninsured deposits at SVB and Signature, and the Fed created a new liquidity facility—the Bank Term Funding Program (BTFP) for regional banks.

RUMORS OF A SYSTEM-WIDE RUN SEEM GREATLY EXAGGERATED

Data clearly show the bank run didn't spread. If it had, banks nationally would have tapped emergency Fed funding via the discount window or BTFP. To ease the associated stigma, the institutions that did aren't yet public. But banks borrow through their district's Federal Reserve branch—and all publish weekly lending data. While total borrowing jumped, it concentrated in San Francisco and New York—home to SVB and Signature. This includes credit extended to the FDIC in those firms' resolutions. Elsewhere, borrowings were immaterial.

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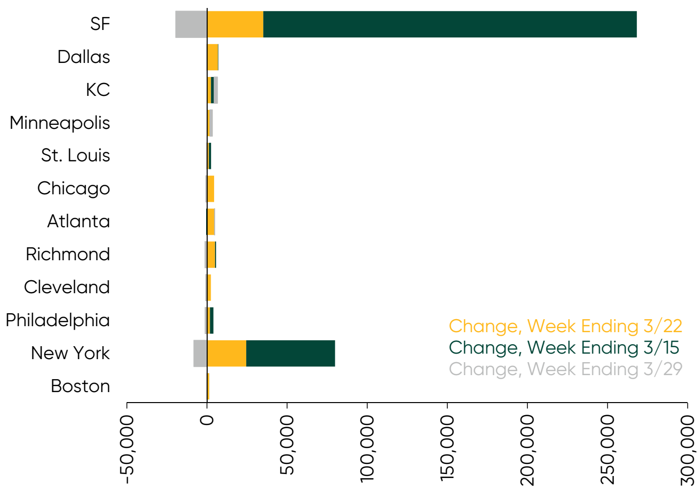
xxiii Source: Congressional Research Service, as of 10/04/2023.

xxiv Source: "Signature Bank Insiders Sold $100 Million in Stock During Crypto Surge," Tom McGinty and Ben Foldy, *The Wall Street Journal*, 04/04/2023.

EXHIBIT 7: NOT A NATIONAL EMERGENCY



Source: Federal Reserve, change in Federal Reserve Branch Assets, Securities, Unamortised Premiums, Discounts, Repo and Loans, in Millions. Data as of 10/04/2023. USD.

GLOBAL SPILLOVER?

As SVB failed, depositors at its UK subsidiary fled. On paper, SVB UK should have been immune to whatever balance sheet problems befell the parent company. It was "ringfenced" in accordance with UK bank regulations. But bank runs breed indiscriminate panic, and the day after SVB failed, the Bank of England sold what was left of SVB UK to HSBC for £1. Yet small and large UK lenders alike carried on as usual, and a national bank run didn't happen.

Later that week, Credit Suisse released its delayed 2022 annual report, and the results were grim. In response, one major institutional investor stated his firm would infuse no more capital into the bank, sending its already depressed equity price sharply lower—and sparking a run. The Swiss National Bank (SNB) announced on 15 March that it would backstop Credit Suisse if needed, but that seemingly just enflamed fear. By the weekend, the SNB was brokering an emergency rescue from UBS, which purchased Credit Suisse for 3 billion Swiss francs. Unusually for a failing bank, some subordinated bondholders took total losses while shareholders received partial compensation, sparking uncertainty over the pecking order if more European banks failed. But Swiss regulations are unique in imposing losses on certain bondholders first under certain conditions, and that possibility was written into the bond prospectus. As this fact dawned on markets—and the Bank of England and European Central Bank affirmed the Swiss decision would have no bearing on their bank resolution procedures—panic subsided.

CREDIT SUISSE'S TAKEOVER DOESN'T UPEND EU BANKS' CAPITAL STRUCTURE

The Swiss government-backed mid-March emergency takeover of Credit Suisse by UBS included a wrinkle that stirred some uncertainty across Europe: While equity holders got 3 billion francs in compensation (taking the form of 1 UBS share for every 22.5 of Credit Suisse's), holders of contingent-convertible bonds—co-cos—were wiped out. Some saw this as dangerously upending tradition, which put bondholders ahead of equity holders, with repercussions across the EU, given banks' heavy use of co-cos to raise capital. We think this is overwrought. The issues in Switzerland were unique to Swiss banks, as law elsewhere, officials' announcements and the prospectuses make clear.

Co-cos qualify as additional tier-one (AT1) capital, one step below common equity tier one (CET1) in the capital pecking order. Typically, if a bank fails, conventional wisdom suggests CET1 absorbs the first loss and, as further losses mount, co-cos would convert to equity to shore up capital if necessary. This is how it works in the EU. Shareholders' equity is written down to zero before AT1 assets take a hit. While CET1 faces a higher likelihood of loss in times of stress, AT1 capital—next in line on the chopping block—remains relatively risky.

In our view, co-cos were never low-risk investments. They very often trade like equities. Yet it appears many considered them fairly safe, perhaps blinded by relatively high yields. Hence, Credit Suisse co-co holders seem largely shocked by the government's supposedly unorthodox move—and extend the fear to other locales in Europe.

That said, there are different kinds of co-cos, and Swiss rules differ from the EU's. Credit Suisse's co-co prospectus allowed for its AT1 instruments going to zero in a "viability event," even if equity holders receive compensation. It states: "In the case of any such cancellation, FINMA may not be required to follow any order of priority, which means, among other things, that the Notes could be cancelled in whole or in part prior to the cancellation of any or all of CSG's [Credit Suisse Group's] equity capital."[xxv]

After Credit Suisse took a loan from the Swiss National Bank—backed by the federal government—Switzerland's Financial Market Supervisory Authority (FINMA) determined that a viability event had indeed occurred. It instructed Credit Suisse to zero out its co-cos. While Credit Suisse's AT1 creditors are appealing FINMA's decision, we think it is pretty clear its co-cos were meant to absorb loss. So it doesn't seem to us this should have been a shock.

In any event, the Swiss decision isn't relevant elsewhere in Europe. The country isn't part of the EU or eurozone, and its moves have no bearing or legal weight on the EU's formal "bail in" resolution process, created in the mid-2010s to avoid government bailouts of troubled banks. It stipulates that shareholders take the first losses, followed by junior (subordinated) creditors—including AT1 bonds like co-cos—and then senior bondholders. If all those capital tiers are wiped out, next on the hook are uninsured depositors, starting with large corporations holding deposits over €100,000 and then small and midsized business and individual deposits over €100,000. It is only when the hierarchy of "bail ins" reach 8% of a banks' liabilities that it can qualify for an infusion of state capital—and if that requires capital more than 5% of liabilities, then all bank creditors face total loss. While policymakers may always deviate from script, it is notable that, in Credit Suisse's wake, the ECB has clarified it stands by its official mechanism. Regulators in the UK, Hong Kong and Singapore did the same for their resolution rules.

Non-Swiss co-co bonds have since rallied to around pre-acquisition levels. Bloomberg's global co-co bond index has rebounded substantially from its 20 March low to where it was trading before UBS's takeover of Credit Suisse.[xxvi] That doesn't mean banking uncertainty has cleared completely. Banks seem reticent to issue co-cos currently, much less equity. That may pass in time, since such moves are commonplace after a downturn, as issuers are reluctant to sell when demand may suffer from fear. Also, given ongoing capital and regulatory concerns, banks could retrench. We are closely watching bank lending for evidence of widespread and sustained credit constriction. But as for unintended policy ramifications from Switzerland's unique bank merger, we don't see much risk. A global bear stemming from Swiss authorities' unusual co-co treatment doesn't look likely to us.

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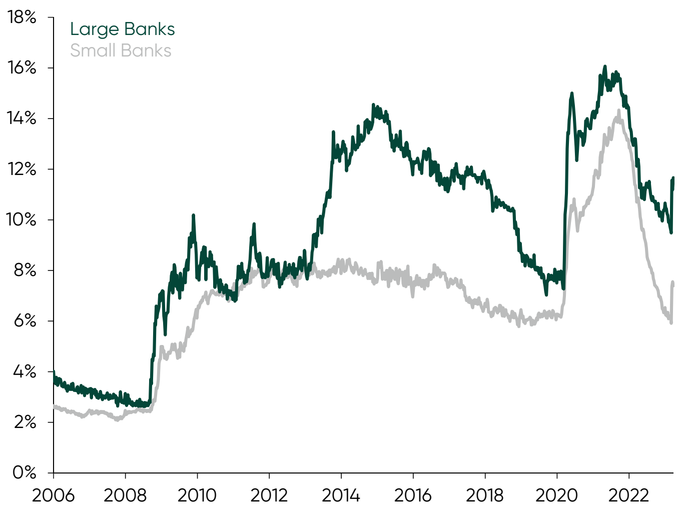
xxv Source: "UBS Got Credit Suisse for Almost Nothing," Matt Levine, *Bloomberg*, 20/03/2023.

xxvi Source: "Risky AT1 Bonds Rebound From Plunge After Credit Suisse Wipeout," Nikou Asgari, *Financial Times*, 05/04/2023.

BANKS ARE HEALTHY

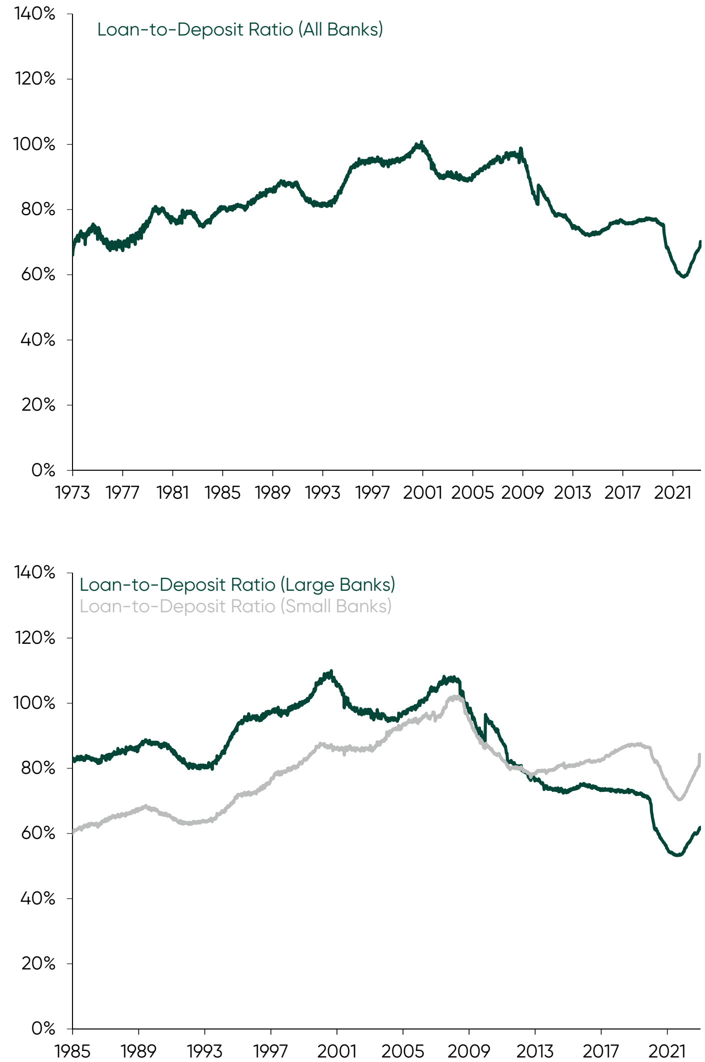
The lack of contagion shouldn't shock. Banks are overall very healthy. Exhibit 8 illustrates that they have healthy capital buffers and cash as a percent of total assets is far above pre-2008 levels. System-wide, the loan-to-deposit ratio—a simple measure of risk—is near its lowest levels in 50 years. While large banks hold more than small, the latter are well below levels seen throughout the 1990s and 2000s, shown in Exhibit 9.

EXHIBIT 8: BANK BALANCE SHEETS HAVE PLENTY OF CASH



Source: Federal Reserve, as of 10/04/2023. Cash as a percent of total assets for large and small domestically chartered commercial banks, weekly, 04/01/2006 – 29/03/2023.

EXHIBIT 9: LOAN-TO-DEPOSIT RATIOS ARE LOW



Source: St. Louis Federal Reserve, as of 10/04/2023. Loan-to-deposit ratio for all commercial banks, weekly, 03/01/1973 – 29/03/2023; and loan-to-deposit ratio for small and large domestically chartered commercial banks, weekly, 03/04/1985 – 29/03/2023.

Accounting rules offer most banks additional bandwidth—and explain why SVB was hit hardest when Treasurys fell. There are two primary asset buckets on a bank's balance sheet: *available for sale* (AFS) and *hold to maturity* (HTM). AFS assets, as the name implies, are typically liquid assets the bank can sell to meet short-term cash needs. These assets are marked to market, meaning banks had to write down Treasurys held in their AFS buckets as interest rates rose. HTM assets are typically illiquid, harder-to-value assets banks have no intention of selling—they will simply hold the loan or security for its entire life, collecting interest and principal. When held at an unrealised loss, banks need not write them down for regulatory capital purposes.

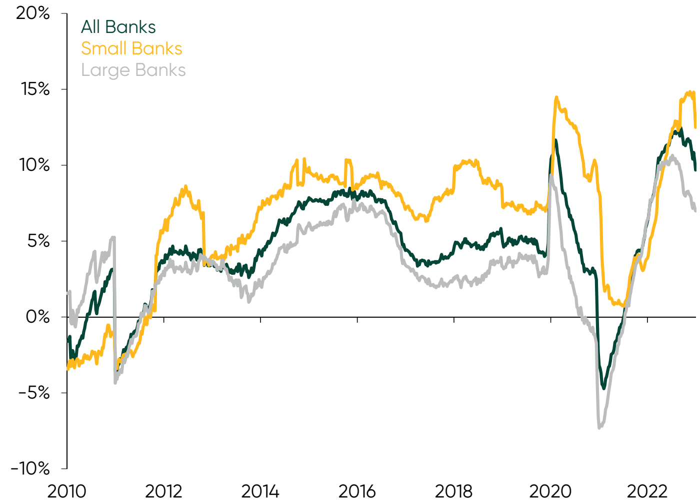
When Treasurys fell, many banks could preserve capital by moving some Treasury holdings from AFS to HTM.[xxvii] This sacrifices some liquidity that may be needed to meet withdrawals. Yet most banks are liquid enough to do it. SVB wasn't, due to its customer base, so it had to raise capital and dump its AFS security portfolio. This has led to some chatter about revising mark-to-market regulations, which we are watching closely. But the added flexibility was beneficial and explains why falling bond prices haven't hurt balance sheets overall.

ECONOMIC IMPACT MUTED SO FAR

While SVB and Signature were too small to wallop the economy and markets, there was a risk that banks would throttle lending. Worried about losing uninsured depositors to money market funds and other cash vehicles, they could decide to hoard cash. A sharp lending slowdown would choke a key economic input.

So far, this hasn't happened. In the three weeks' worth of post-SVB bank lending data, year-over-year growth remains strong, shown in Exhibit 10. Some claim a two-week drop in late March is a warning sign, but much of this is again related to FDIC bank resolutions and, likely, seasonal adjustment quirks. The data are worth watching, but little sign of trouble has emerged yet.

EXHIBIT 10: LOAN GROWTH SLOWER BUT STILL ROBUST



Source: St. Louis Fed, as of 10/04/2023. Loans and leases in bank credit, Year-Over-Year Loan Growth Rate, 31/03/2010 – 29/03/2023.

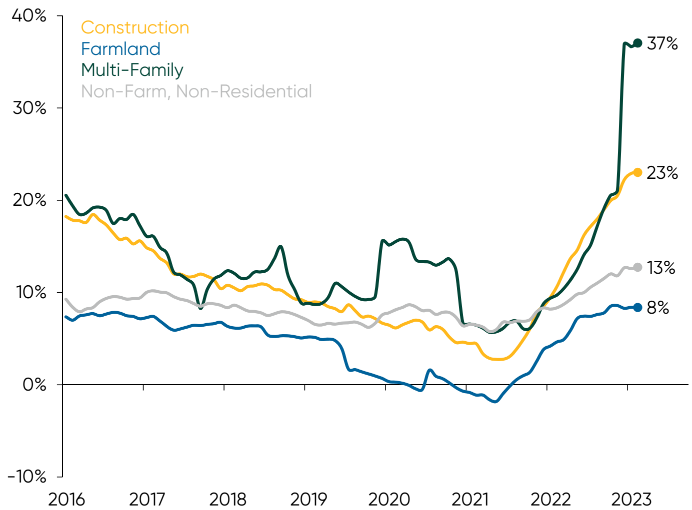
WHAT ABOUT COMMERCIAL REAL ESTATE?

Some argue March's events previewed larger problems to come if commercial real estate crashes. The logic: With office use down as more companies offer remote work and rising interest rates making loans harder to refinance, a chain reaction of defaults and falling building values will destroy bank balance sheets.

xxvii Source: "As Interest Rates Rose, Banks Did a Balance-Sheet Switcheroo," Jonathan Weil, *The Wall Street Journal*, 29/03/2023.

We doubt it. Very few banks exceed regulatory commercial real estate exposure guidelines. Small banks have relatively higher exposure, with commercial real estate at 43% of their total loans, but most of that is multi-family properties.[xxviii] Regional banks' exposure to office loans maturing this year is less than $50 billion.[xxix] Less than $100 billion matures in the next two years. The small handful of over-exposed banks might have hiccups, but with this representing under 2% of publicly traded bank assets, we don't think it is a systemic risk.[xxx]

EXHIBIT 11: SMALL BANK CRE LOAN GROWTH BY CATEGORY



Source: Federal Reserve, Year-Over-Year Percentage Change as of 30/03/2023. 01/01/2016 – 28/02/2023.

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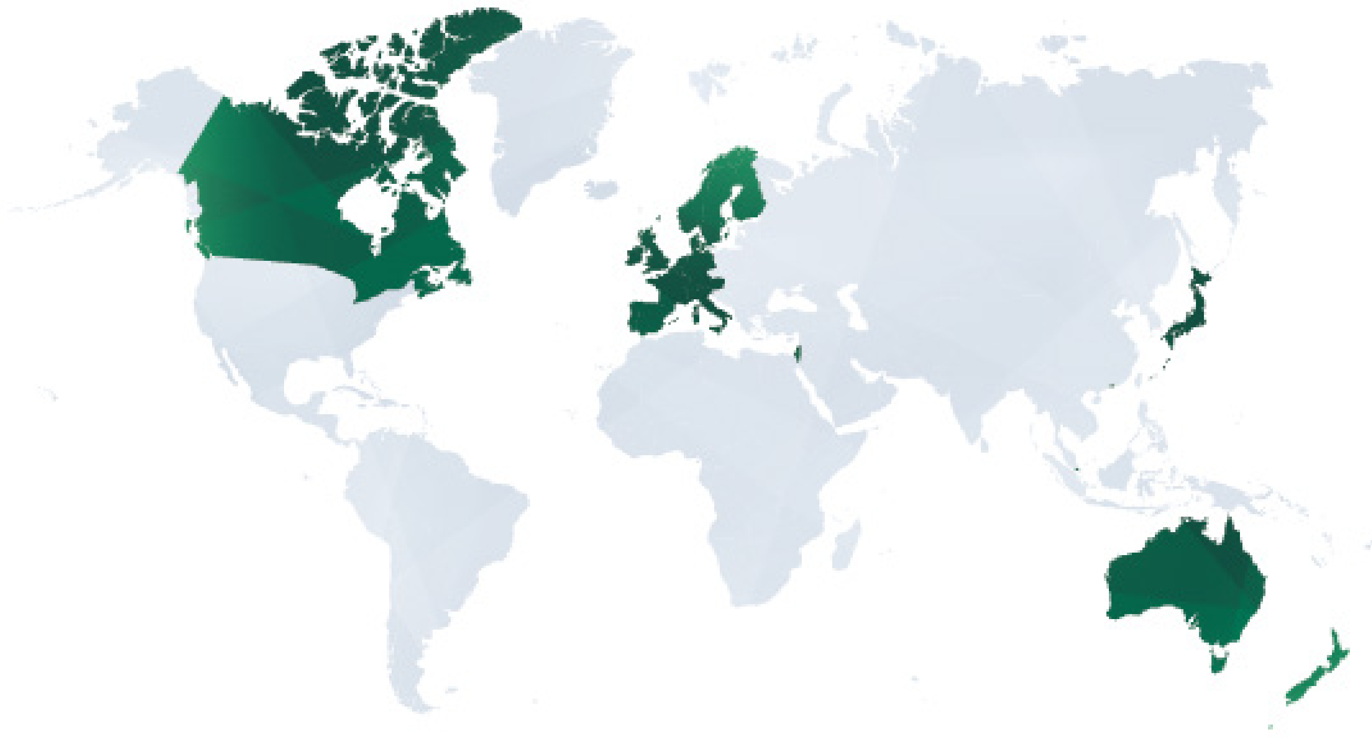
xxviii Source: Federal Reserve, as of 10/04/2023.

xxix Source: CBRE, as of 31/01/2023.

xxx Source: FactSet and US Federal Reserve Bank of St. Louis, as of 30/03/2023.

GLOBAL DEVELOPED EX-US **COMMENTARY**



GLOBAL POLITICS

2022 was a volatile year for global politics, but 2023 should be much calmer—providing a more stable legislative environment for markets to continue their rally throughout the year.

GLOBALLY, A QUIETER YEAR IN POLITICS

Consider last year: The UK had three governments after two prime ministers resigned in rapid succession. France held a widely watched presidential contest, with President Emmanuel Macron narrowly winning re-election. In Italy, former ECB head and Prime Minister Mario Draghi resigned his post, triggering snap elections, which Giorgia Meloni's populist Brothers of Italy party won, spurring fear of extreme policy—that never materialised.

By contrast, Spain's late-2023 vote is arguably the year's biggest developed-world election. While French protests rage over pension reform, the government avoided snap elections, easing uncertainty. Outside this, most elections are local or provincial. Politics should be blissfully quiet.

Most of the UK political scene focused on sociological issues in Q1—matters that are important for society and culture but outside markets' purview. Yet two economically significant developments occurred: March's Spring Budget gave markets more clarity over the government's tax plans, and the UK joined the Indo-Pacific trade bloc called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). On both fronts, we think pundits have overplayed the economic significance.

Most of the Budget chatter dwelled on taxes, which are set to continue rising. Ahead of the announcement, many observers and analysts lobbied for the reversal of the corporation tax hike, passed in 2021 and scheduled to take effect in April. That didn't happen, and corporation tax has now risen from 19% to 25%. To soften the blow, Chancellor of the Exchequer Jeremy Hunt announced new investment deductions and other incentives. He also seemingly sought to ease the effect of the continued stealth tax hikes on individuals, which come from tax bands being frozen rather than indexed to inflation—exposing more income to higher rates as wages rise to compensate for higher consumer prices. Household energy subsidies will now drop in July instead of April, in hopes of wholesale electricity costs falling below the subsidy ceiling by then. Additionally, the government claims new spending on childcare and other social initiatives will leave households better off. That programme, along with pension changes, aims to get more people in the labour force, on the (in our view, flawed) theory that this will raise economic growth.

While Mr. Hunt claimed the Budget was "the most pro-business, pro-enterprise regime anywhere," many critics quickly pointed out that the tax burden, by some measures, will be the highest since World War II. Analysts warned the corporation tax changes making it harder for the UK to avoid recession this year. After all, the more you tax something, the less you get of it—in this case, profits, which are the fruit of investment. Hence, many warn the higher rates will discourage investment, dooming the country to slow growth indefinitely.

In our view, it is questionable whether the new investment incentives will combat this. Presuming the Budget passes Parliament as written, for the next three years businesses should be able to write off every pound of investment against their tax bill. "Research-intensive" businesses will also get an "enhanced credit" of £27 for every £100 invested. Lastly, the Budget creates 12 new "investment zones" where businesses can compete for grants and subsidies to build new research hubs and other facilities centered around universities.

Time will tell whether these are sufficient to offset the effect of higher taxes, but there is precedent for them being too small. Consider the aftermath of last year's windfall profits tax on oil and gas producers. The tax scheme allowed producers to write off 91 pence of every £1 invested in new oil and gas well drilling. But several major drillers cut UK investment anyway. It seems the prospect of sudden tax changes was just too much. Yet we also hesitate to use this as a blueprint for UK business overall, given new wells have high up-front costs, and their eventual revenues are hard to predict since prices fluctuate on the market. We doubt the windfall tax was the only variable affecting companies' decisions to scale back.

THE UK CORPORATE TAX RATE IN CONTEXT

Then again, it is important to put the corporation tax rise in its historical context. At 25%, the corporation tax rate will still be lower than at any point before David Cameron's coalition government started cutting it from 28% in 2010.[xxxi] The lower rates since, plus prior efforts to boost business spending with "super deductions" and "levelling up" plans for Northern England, didn't really bear fruit, suggesting tax rates and incentives aren't a major investment decision swing factor.

As Exhibit 12 shows, business investment didn't surge in the era of lower taxes and greater investment incentives. Post-2010 trends didn't look much different than pre-2010 trends, perhaps because businesses know that what governments giveth, governments can taketh away. We suspect businesses have long presumed they were just one change in government away from higher rates.

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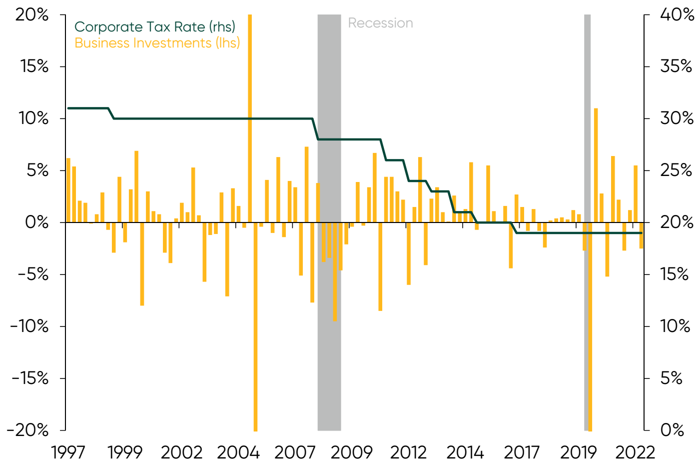
xxxi ....Source: HMRC, as of 15/03/2023.

EXHIBIT 12: CORPORATION TAX RATES DIDN'T MUCH INFLUENCE INVESTMENT



Source: FactSet and HMRC, Quarter-Over-Quarter Percent Change (lhs), Tax Rate (rhs). Data as of 15/03/2023. Investment y-axis truncated for visibility so that one-time events wouldn't skew the picture.

In our view, this illustrates why equities prefer gridlock. Inactive legislatures tend to keep fiscal policy relatively static, making it easier for businesses to calculate return on investment. In the UK, it is a moving target, which we think helps explain why, regardless of whether business taxes rise or fall, investment growth's long-term trend doesn't change much.

Mostly, we think the sheer complexity and ever-changing nature of the UK's tax system is probably a headwind. To navigate and keep up with it costs significant resources—resources that could probably be deployed more productively elsewhere. Yet it is a status quo that the UK economy and equities have learned to live with, so we doubt another round is a material negative, especially when there were no big, sudden surprises. The corporate tax hike has been scheduled for nearly two years now, making it very unlikely equities have yet to price it in. This is likely also why the MSCI UK IMI Index hasn't radically underperformed this year as the hike drew near.

CPTPP PROBABLY ISN'T A GAME CHANGER

As for CPTPP, we think most coverage has largely been too optimistic—as it typically is whenever a country joins a big trade bloc. Think tanks and politicians, knowing that free trade is often a tough political sell, tout big long-term economic projections aiming to show how the pact will turbocharge exports and growth. In the UK's case, several pro-Brexit outlets cheered that, by joining CPTPP, the UK has officially shut the door on ever rejoining the EU by pulling away from Continental customs rules. Others tout its economic benefits, giving the UK access to a big trade bloc that rivals the EU in economic size and is faster-growing to boot—essentially arguing CPTPP membership will offset any trade losses from Brexit. Perhaps, although businesses—particularly small businesses—must still factor in higher shipping costs and the like. Proximity still counts.

We do see some potential long-term benefits, but they will likely accrue too far in the future to matter to equities today. The UK's trade with the non-EU world grew faster than trade with the EU for years pre-Brexit, and Asia is a key factor here. CPTPP includes Japan, Singapore, Australia, New Zealand and a couple other Asian nations, and reducing friction here could unleash potential. However, given the US left CPTPP talks before the agreement became final, CPTPP doesn't address trade with Britain's single-largest trading partner. More importantly, trade deals are usually too slow-moving to be big near-term economic drivers. CPTPP's scheduled tariff reductions happen gradually over the 30 years after it came into force.

Accordingly, it will be about 25 years before the treaty is fully implemented. So while it probably helps the structural backdrop for the UK's economy to a degree, it is probably well outside the scope of economic drivers markets will look to in the next 3 – 30 months.

A DRAMATIC QUARTER FOR FRENCH POLITICS

Following weeks of protest and debate, French President Emmanuel Macron and Prime Minister Elisabeth Borne enacted a measure raising the retirement age without a vote in the National Assembly in mid-March. This triggered two no-confidence motions, the first of which failed by only nine votes. Protests have raged ever since, with public dissent broadening beyond the government and embroiling several major corporations. In the past, widespread actions like this haven't had an outsized economic impact, and we doubt this time is different. More broadly, while uncertainty is high for now, the likely outcome is political gridlock, which should benefit French equities as the dust settles.

Raising the retirement age from 62 to 64 by 2030 has topped President Macron's agenda since his first term. Then, the Yellow Vest protests over fuel tax measures and the pandemic jointly took pensions off the agenda. But pension reforms were among his campaign pledges when he ran for re-election last year, and even when his coalition lost its majority in the National Assembly, he pledged to push them through.

While President Macron and his party argue raising the retirement age is necessary to extend the state pension without runaway budget deficits, the measure is highly unpopular—hence the protests. Public sentiment placed the center-right Les Republicains Party in a tricky predicament. President Macron's centrist Renaissance Party relies on Les Republicains in the National Assembly, and party leader Eric Ciotti has supported the measure. But President Macron and PM Borne couldn't secure enough votes to pass the pension measure, so they resorted to Article 49 of France's constitution to bypass the chamber and enact the measure.

In response, the opposition submitted two no-confidence motions—one by a group of centrist dissenters and one by Marine Le Pen's National Rally party. Had either passed, cabinet ministers indicated Macron would dissolve the National Assembly and call a snap election. This outcome likely wasn't very attractive to centrist legislators given the popular unrest. Moreover, this saga was unfolding just as the Dutch Farmer-Citizen Movement won a plurality in Holland's provincial elections, making them the largest single party in the Dutch Senate, amidst the ongoing protests over farm closures and forced sales. Hence, it isn't terribly surprising that as unpopular as President Macron is with the public and many in Parliament, the no-confidence motion didn't pass.

President Macron has emerged wounded politically from these events, with little to no political capital left—rendering big legislation unlikely for the rest of his term. This may be hard to see in the immediate future, with protests grabbing headlines internationally and corporations increasingly amongst the targets. The unrest likely keeps uncertainty elevated for the foreseeable future. Yet prior disruptive protests haven't been bearish for France, including 2019's Yellow Vest movement. Nor did those events or protests in the mid-1990s induce French recessions, and according to a recent estimate by France's national statistics agency, both reduced quarterly GDP by merely 0.2 percentage point.[xxxii] The agency estimates the effect could be milder today given increased teleworking, although duration will likely also be a factor.

While the uncertainty could weigh on French equities near-term, we think gridlock should be a positive over the foreseeable future. While some view French economic policy as less competitive than other developed nations, such things tend to fade into the long-term structural backdrop and haven't prevented the country from growing nicely and delivering very nice equity returns in the long run. Reforms, however beneficial they might seem on paper, tend to create winners and losers and stoke uncertainty. Gridlock, however frustrating for voters, reduces uncertainty and enables risk-taking.

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xxxii .... Source: FactSet, as of 18/18/04/2023. China Q1 2023 and full-year 2022 real GDP growth rates.

Markets may not see this immediately amidst the protests and wait for the constitutional court to decide whether to allow a referendum on overturning the pension measures. But as the outcome becomes apparent and uncertainty eases, the reality of gridlock should become more clear. Politics are just one driver, but on that front, we see tailwinds for France—not to mention the broader eurozone, where gridlock similarly reigns.

EMERGING MARKETS **COMMENTARY**

CHINA'S REOPENING

China's lifting of COVID restrictions in late-2022 adds a global economic tailwind. While it likely won't be as big a surge in activity as 2020's initial reopening—the economy wasn't as restricted—the world's second-biggest economy is rebounding, which buoys activity worldwide. Furthermore, China's government has slowed its regulatory push targeting property developers and the Tech industry.

You can see the effects now in the country's PMIs, real estate data and more. As Exhibit 13 shows, Chinese PMIs—especially reopening-boosted services-industry measures—have improved since late-2022 as the range of measures took root.

EXHIBIT 13: CHINA PMI

	National Bureau of Statistics PMIs		Caixin PMIs	
	Manufacturing	Non-Manufacturing	Manufacturing	Services
Oct-22	49.2	48.7	49.2	48.4
Nov-22	48.0	46.7	49.4	46.7
Dec-22	47.0	41.6	49.0	48.0
Jan-23	50.1	54.4	49.2	52.9
Feb-23	52.6	56.3	51.6	55.0
Mar-23	51.9	58.2	50.0	57.8

Source: FactSet, as of 10/04/2023. National Bureau of Statistics are "Official" government PMIs; Caixin are conducted by S&P Global.

REVIEWING CHINA'S Q1 GROWTH

GDP growth is already reaccelerating from last year's historically low growth.[xxxiii] Q1 GDP accelerated to 4.5% y/y from Q4 2022's 2.9%—beating consensus estimates of 3.4%—with agriculture (3.7%), heavy industry (3.3%) and services (5.4%) all expanding.[xxxiv] Services' leadership is notable, in our view, since the sector is the economy's largest. Moreover, growth there is in line with the government's long-term desire of transitioning from industrial, export-driven growth to a services- and consumption-based model. March data are also consistent with resurgent domestic demand: Industrial production rose 3.9% y/y (Jan-Feb: 2.4%) while retail sales jumped 10.6% (Jan-Feb: 5.8%).[xxxv] (January and February data are combined to account for Lunar New Year skew.)

On real estate, declines in Chinese property investment and construction starts slowed markedly in January/February versus a year earlier. In yuan terms, property sales by floor area rose 3.5% y/y in the same period, a vast improvement from last April's -48.6%, the biggest decline all year.[xxxvi] Home prices rose in 65 of 70 cities in March suggesting a nascent, broad-based real estate recovery and improving from 55 in the January-February period.[xxxvii] Per Q1 GDP, real estate output was up 1.3% y/y while construction rose 6.7%.[xxxviii] In our view, that growth suggests property developers have regained some liquidity and are working through their backlog of sold-but-uncompleted housing units—a high-profile sore spot for some Chinese consumers that garnered headlines last year. After real estate's struggles over past couple years, the industry may be shifting from a modest headwind to a slight tailwind to overall growth.

Now, we don't think Chinese GDP growth will be overly robust. Restrictions weren't as onerous in 2022 as 2020, so the corresponding reopening boost shouldn't be huge. The government expects as much after setting its 2023 growth expectations at around 5%. Still, some say a weaker world outside China is a headwind. But the data don't show this, as recession signs are scant globally. In addition to prior comments in the Market Recap section, consider: Chinese March exports jumped 14.8% y/y, snapping five months of declines—partially reflecting better-than-feared demand, in our view.[xxxix]

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xxxiii Source: FactSet, as of 18/04/2023. China Q1 2023 and full-year 2022 real GDP growth rates.

xxxiv Source: National Bureau of Statistics of China, as of 20/04/2023.

xxxv Source: National Bureau of Statistics of China, as of 20/04/2023.

xxxvi Source: "China's Property Sector Draws Closer to Exit From Protracted Slump," Liangping Gao and Ryan Woo, *Reuters*, 14/03/2023.

xxxvii Source: National Bureau of Statistics of China, as of 20/04/2023.

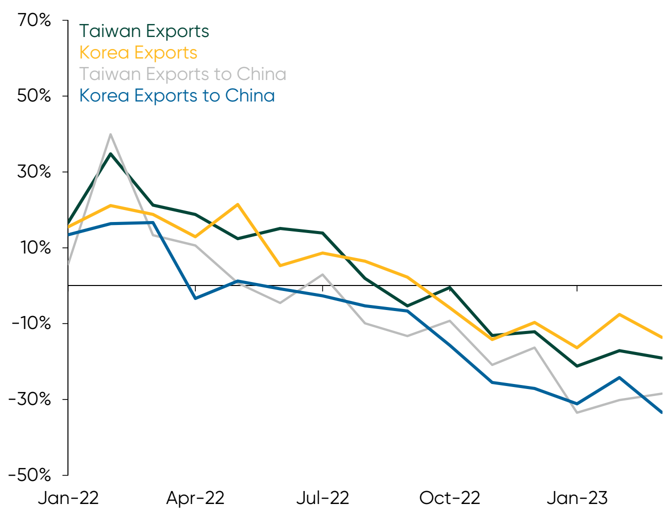
xxxviii Source: National Bureau of Statistics of China, as of 20/04/2023.

xxxix Source: FactSet, as of 20/04/2023.

THE PERIPHERY EFFECT

China's COVID restrictions also weighed on neighbouring economies with strong trade ties to China. Frontier Market Vietnam, whose largest trading partner is China, exhibited some of these ripples: Q1 GDP growth slowed to 3.3% y/y from Q4 2022's 5.9% rate, with exports falling -11.9%.[xl] China's impact also manifested in the trade data for some notable EMs. The world's second-largest economy is a huge source of demand for semiconductor chips and electronic goods—major exports for Taiwan and South Korea, respectively. For the former, March exports (-19.1% y/y) fell a seventh-straight month, with trade to mainland China down -28.5% y/y.[xli] Taiwan's export orders also tumbled -25.7% y/y, with China a big detractor.[xlii] As Exhibit 14 shows, it was a similar story in South Korea: Exports (-13.6% y/y in March) have fallen 6 straight months, with goods to China (-33.4%) down 10 consecutive months.[xliii]

EXHIBIT 14: CHINA HAS WEIGHED ON TAIWANESE AND SOUTH KOREAN EXPORTS



Source: FactSet, as of 04/21/2023. Taiwan and South Korea exports and exports to mainland China, year-over-year change in percent, January 2022 – March 2023.

China's reopening will likely benefit nearby regional economies, though it may take time to show up in output data. But some indicators are hinting at the benefits already—e.g., developed market Japan's services purchasing managers index (PMI) noted the return of Chinese tourism contributed to March growth.[xliv] Moreover, China's reopening spreads benefits beyond the Asia-Pacific region. For example, China is Brazil's top export destination for many commodities, including iron ore, soybeans and oil—so improving demand in the former is a tailwind for Latin America's largest economy. China is one of the global economy's biggest drivers, and we think its improvement is an overlooked positive this year.

BRAZIL'S POLITICAL CLIMATE

With last year's tight general election and related unrest in the rearview, Luiz Inácio "Lula" da Silva—back for a second stint as president after a prison term—took office in January. Lula's return to national politics seemingly weighed on investor sentiment, tied to chatter about "anti-business" fiscal policy, including higher government spending, the reintroduction of fuel taxes and his complaints about the Central Bank of Brazil's decision-making. Lost in the noise: The new president will likely struggle to pass major legislation, an underappreciated positive for Brazilian markets.

BLUSTER OVERSHADOWS GRIDLOCK

Throughout Q1, political and sociological developments dominated headlines. In Lula's first week on the job, supporters of former president Jair Bolsonaro stormed into the nation's Congress, Supreme Court and Presidential Palace—driving fears of unrest. Investors also fretted Lula's spending plans and the prospect of new taxes. However, although the president's bluster grabs attention, Congress's composition implies a do-little legislature.

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xl Source: "Vietnam Q1 GDP growth slows as weak demand hits exports," Khanh Vu, *Reuters*, 28/03/2023.

xli Source: FactSet, as of 20/04/2023.

xlii Source: FactSet, as of 20/04/2023.

xliii Source: FactSet, as of 20/04/2023.

xliv Source: S&P Global, as of 23/03/2023.

While Lula won the presidency, Bolsonaro's right-wing Liberal Party (PL) took 99 seats in the 513-member Chamber of Deputies, making it the lower house's biggest individual party. Along with its allies, the PL controls half the chamber. In the 81-member Senate, the PL and PL-aligned parties have 23 seats to Lula's Workers Party and its allies' 14. In Brazil, major reforms (e.g., changing the tax system) need constitutional amendments—which require a three-fifths majority in both houses to pass. The Workers Party's lack of congressional majority will likely force Lula to work with politicians that aren't ideologically aligned with him to pass legislation—notably, former Bolsonaro ally and recently reelected Chamber of Deputies speaker Arthur Lira of the center-right Popular Party. Lira is also the head of the Centrão, a 235-member centrist bloc with big influence in the lower house.[xlv]

The impact of this gridlock is starting to become apparent. Consider another concern arising with Lula's victory: land reform. Lula has long-running ties to the Landless Workers' Movement (MST), a Marxist group that occupies land unlawfully and is a core part of his political base. MST anticipated more support for its mission after Lula's victory. But once politicians are in power, they often moderate from strong campaign rhetoric—accepting the political realities they have to work with. So it is now with land reform. Despite Lula's reputed sympathy to the cause, the government has condemned land invasions and signaled it wouldn't tolerate occupations of productive land—frustrating MST leadership.[xlvi] In our view, this is a reminder politicians' personalities don't automatically translate into legislative change.

CENTRAL BANK INDEPENDENCE IN TROUBLE?

Lula's criticism of the Central Bank of Brazil also worried investors in Q1. The president has taken umbrage with monetary policy, arguing high interest rates are stunting economic growth and the bank's inflation target of around 3% is too low. Lula also questioned the central bank's need to set monetary policy autonomously—a power enshrined by a 2021 law.

These public attacks stirred concerns the central bank's independence was in jeopardy—an alleged negative. According to conventional wisdom, shielding monetary officials from day-to-day politics empowers them to make politically unpopular decisions for the good of the economy. Without this perceived safeguard, politicians would hijack monetary policy and keep interest rates low to boost economic growth—ignoring the potential longer-term negative consequences of higher money supply fuelling inflation. A popular example showcasing the trouble of mixing politics and monetary policy: Turkey, where President Recep Tayyip Erdogan has routinely replaced central bank governors who challenge his unorthodox monetary policy views. His frequent meddling has contributed to the country's long-running, sky-high inflation.

In March, Copom, the Central Bank of Brazil's rate-setting committee, maintained its Selic benchmark interest rate at 13.75%—and some interpreted the decision as a signal affirming the bank's independence. We don't know what, if any, changes are coming, though we think it is counterproductive to speculate about how Lula's talk may impact monetary policy. Political pressure isn't uncommon globally and doesn't necessarily lead to changes. Last year, some elected officials in developed markets, including Australia, the UK and the US, wanted to review and rein in the powers of their countries' respective central banks. Despite all the bluster, that didn't happen. It takes more than talk to impinge on central bank independence—and in Brazil's case, it takes legislation. Given the aforementioned gridlock, that is highly unlikely to pass.

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xlv Source: "'Radical Changes Are Not Going to Fly': Brazil's Divided Congress Reassures Investors," Bryan Harris and Carolina Ingizza, *Financial Times*, 10/04/2022.

xlvi Source: "Brazil Workers' Movement Steps Up Land Invasions Under Lula Government," Bryan Harris and Carolina Ingizza, *Financial Times*, 09/04/2023.

WE HAVE SEEN THIS BEFORE

Concerns over a Lula presidency aren't new. Lula served as president from 2003 – 2010, and upon his election in 2002, many thought he would drive a default through massive social spending—especially after his calls to renegotiate Brazil's debt with foreign investors. Yet that worst-case scenario didn't materialise. Six months into the job, Brazil paid its interest on time, and Lula's government cut some spending and even proposed scaling back social security pensions.[xlvii] After winning reelection in 2006, Lula entered his second term with a broad-based coalition that included far-left and center-right parties—illustrative of how politicians moderate to stay in power.[xlviii]

From a market perspective, Brazilian equities soared 1,164.9% from 2003 – 2010, vastly outperforming the MSCI Emerging Markets' 378.3% over the same period.[xlix] Now, we wouldn't attribute all of that performance to politics or Lula. Some of it is a function of timing—a global and EM bull market began in late 2002, right before Lula entered office.[l] But more significantly for Brazilian markets, the 2000s global commodity supercycle buoyed the country's commodity-heavy economy. This doesn't look likely to repeat today, as there isn't a commodity supercycle underway. But Lula's previous stint in office suggests domestic politics needn't doom equities.

In our view, Brazilian politics could add some short-term uncertainty as it did in Q1. But political reality isn't likely to be as radical as feared. Moreover, some underappreciated economic tailwinds (e.g., moderating inflation and a boost tied to China's reopening) could offset politics' headwinds—a positive for Brazilian equities.

ELSEWHERE IN LATIN AMERICA

Mexico was the second-best performing constituent in Q1 returning 20.3%.[li] This extends last year's big outperformance, which stemmed from its more defensive sector makeup as well as US companies pursuing "nearshoring" to reduce supply chain distance. In January, Mexico seemed to benefit more from political drivers, in particular the 2 January election of Justice Norma Lucía Piña Hernández as Supreme Court President. Supreme Court Justice Piña has previously opposed the President Andres Manual Lopez Obrador (AMLO)'s stance on energy policy and judicial independence. Her leadership of the Supreme Court likely limits the scope of AMLO's attempts to nationalise electricity production, install food price controls and assert more political influence over the electoral process by weakening the independent National Electoral Institute. While we think the political risks here have long been overstated, the court change likely makes the institutional checks and balances more visible, helping political sentiment improve.

Returns were more mixed across South and Latin America. Peru outperformed, returning 8.3% in Q1, rallying as markets continued moving on from the recent political upheaval and protests.[lii] Chile slightly outperformed in Q1 despite a pullback in March as contagion fears hit some local banks.[liii] These developments contradicted continued positivity on the political front: The legislature rejected President Gabriel Boric's sweeping tax hikes, which included a new wealth tax and increased levies on high earners. While we think investors have often overrated the impact of such tax changes, the failure to push them through shows that for all the fears of President Boric's leftist administration when it took office, gridlock is likely to block radical legislation. Overall, we think reality on this front is going far better than investors expected.

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xlvii Source: "Lula's Pragmatic Approach Helps Brazil Find Balance," Jon Jeter, *Washington Post*, 19/06/2003.

xlviii Source: "Brazil Lula's Coalition Divided in Congress Vote," Raymond Colitt, *Reuters*, 31/01/2007.

xlix Source: FactSet, as of 19/04/2023. MSCI Brazil Index returns with net dividends and MSCI Emerging Markets Index returns with net dividends, in USD, 31/12/2002 – 31/12/2010.

l Ibid. MSCI Emerging Markets Index returns with net dividends, in USD, 10/10/2002 – 29/10/2007.

li Source: FactSet MSCI Mexico Index return with net dividends, 31/12/2022 – 31/03/2023.

lii Ibid. MSCI Peru return with net dividends in USD, 31/12/2022 – 31/03/2023.

liii Ibid. MSCI Chile return with net dividends in USD, 28/02/2023 – 31/03/2023.

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

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