FISHER INVESTMENTS EUROPE™

MARKET PERSPECTIVES
REVIEW & OUTLOOK

FOURTH
QUARTER
2022

FOURTH QUARTER 2022 REVIEW & OUTLOOK

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FOURTH QUARTER 2022 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

12 January 2023

PORTFOLIO THEMES

- We believe a new bull market cycle is close, if not already underway. We expect the equities that fell the most during the downturn likely lead in the recovery.
- Widespread pessimism over inflation, central banks and recession likely creates an environment that supports positive returns in 2023.
- Underappreciated economic fundamentals such as strong loan growth, robust corporate balance sheets and continued strength in labour markets are largely incongruous with recession fears.

MARKET OUTLOOK

- **Global Market Recovery is Near or Underway:** Global equities' Q4 rebound demonstrates how a better than expected reality can quickly reverse market drawdowns. This also creates a path for material upside where growth likely proves more resilient and enduring than the current, dour forecasts expect.
- **Overly Depressed Investor Sentiment Supports Coming Rebound:** Universally dour sentiment, driven by concerns on inflation, energy crunches, the Russia-Ukraine War and a variety of other factors has significantly lowered investor expectations, allowing room for the new bull market to grow.
- **US Politics Provides Clear Path Forward for Markets:** Divided US government historically fuels a positive three-quarter stretch for equities—the three quarters starting 1 October in a midterm year were positive 92% of the time, with average returns of 20%. Similarly, the third year of a US president's term historically has the highest frequency of positive returns of the four-year cycle.

Q4 brought some relief from 2022's downturn with a 9.8% return for the MSCI ACWI Index—extending the long history of post-US midterm positivity.[i] Emerging Markets (EM) also rebounded and finished the quarter with a 9.7% gain.[ii] Turning points are impossible to predict and clear only in hindsight, and thus it is still too soon to know if October's low marked the bear market's end. However, whether the new bull market began in Q4 or arrives this year, we think equities are most likely to end 2023 higher.

In 2022, we expected early volatility with a late year rally, but the tragic Russia-Ukraine war, high inflation, interest rate hikes, political rancor and more dragged equities down into a shallow bear market. Usually, equities move past such widely known factors quickly. However, last year's constant stream of negative headlines, created yearlong uncertainty. Even when reality turned out better than feared—like second-half economic data—pessimists dismissed it, warning worse was still ahead, a classic sign of "the pessimism of disbelief" as we have often noted.

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i Source: FactSet, as of 03/01/2023. MSCI ACWI Index return with net dividends, 01/10/2022 – 30/12/2022.

ii Source: FactSet, as of 03/01/2023. MSCI EM Index return with net dividends, 101/10/2022 – 30/12/2022.

Nevertheless, markets now appear to have reckoned with many of these concerns, and improvement on some—like inflation—should make 2023 a year of positive surprise, relief and recovery. In fact, we think the new bull market should bring sizable early gains where average S&P 500 returns in the 6 and 12 months off bear market lows since 1925 are 29.0% and 48.7%, respectively.[iii]

Positioning portfolios for a new bull market in 2023 is paramount now, even given the possibility of the long-feared recession. Surveys show business leaders, economists and almost everyone else expect an economic downturn, making this perhaps the most widely and longest-anticipated recession in US market history.[iv] That has given businesses time to prepare—and markets time to weigh the impact, muting the effects if recession arrives. As Ken has said, "anticipation is mitigation." Equities look forward, pre-pricing downturns. That may have been happening in 2022. If we don't get a severe 2023 recession, positive surprise would gradually replace fear as pessimists surrender, buoying equities.

Even if a recession occurs, it would be extraordinary for equities to decline from January 2022 to January 2024. Counterintuitively, a recession could grant clarity—ending the pessimistic cycle of waiting on negatives. To get a second down year would likely require something new and completely unexpected—not just a recession. While a true "black swan" event is possible, positioning for remote possibilities is unwise. Additionally, many say we need "capitulation" first. But that doesn't always happen and many factors, including weakness in most "safe haven" assets, suggest it won't now.

The overwhelming probability is the world looks much better at 2023's end than almost anyone perceives today. US politics is one reason. As we expected, the Republicans didn't get a landslide victory in November's midterms. But they won enough to deliver gridlock, kicking off the "Midterm Miracle"—history's most positive nine-month stretch starting in midterm year Q4s. 2022's was an almost perfectly average midterm Q4 return. A year from now, the reality of partisan gridlock will likely have dawned on all, with few major bills likely to pass. Inflation should keep slowing and Fed rate hikes will likely 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 relief.

Across the globe, Europe looks to have weathered feared winter energy shortages better than almost anyone envisioned. In the UK, many worried mid-December severe weather conditions would pressure the National Grid. But the public was able to use energy as normal, and the National Grid didn't have to resort to its emergency contingency plan of restarting two coal-fired power stations.

Another looming concern amongst global investors in Q4 is the continued possibility of a recession in Europe. Q3 UK GDP contracted -0.3% q/q, with the Bank of England presuming a downturn is already underway.[v] We have seen similar forecasts for the eurozone. The consensus views suggest baseline expectations for Western Europe's economic growth are dour, so if a downturn occurs, it wouldn't have much surprise power, in our view. Rather, it would confirm what most already anticipate and may actually reduce uncertainty. If the UK or eurozone grow at even a tepid rate this year, that could surprise to the upside—potentially lifting markets.

iii Source: FactSet, as of 30/12/2022. S&P 500 average price return in the first 6 and 12 months of bull markets, 01/06/1932 – 30-/12/2022.

iv Source: Federal Reserve Bank of Dallas, The Wall Street Journal, Bank of America, Bloomberg, Barron's, Federal Reserve, PwC, AICPA and The Conference Board, as of 29/12/2022.

v Source: FactSet. Quarterly change in UK Q3 GDP.

In EM, China is reopening which should boost growth across Asian countries in time. After easing some restrictions in November, officials ended the requirement for people with mild or asymptomatic cases to quarantine in centralised facilities. People who have close contact with those who test positive may also quarantine at home from now on, and testing requirements for domestic travel have ended. While the government declined to downgrade the virus from a Category A to Category B infectious disease, which would have ended local authorities' ability to implement lockdowns, the overall acceleration of the end of Zero-COVID was seemingly enough to help investors price in the end of restrictions within the foreseeable future.

In the Latin American political landscape, Brazilian President Luiz Inácio "Lula" da Silva won the second round of October's presidential election against incumbent former President Jair Bolsonaro. However, right-leaning parties gained ground in October's election, which would give President Lula's allies less power when the new legislature convenes in February. Despite the rioting that has persisted well past the election, we think gridlock under the new administration will be stronger than many seem to anticipate today.

Peru also experienced a jolt from political uncertainty. Early in December, now-former President Pedro Castillo attempted to suspend the legislature, rule by decree, reorganise the judiciary and impose a nationwide curfew—a move widely condemned as an attempted coup. Congress impeached him in response, with the move earning broad support—even within former President Castillo's leftist party. The measure to remove him passed easily and Vice President Dina Boluarte assumed the presidency. While the political uncertainty for both countries remains tense and unclear for now, the potential for falling uncertainty in 2023 appears high.

On the sentiment front, US consumer confidence surveys hover near historical lows, yet consumer spending—adjusted for inflation—rose throughout the year. Bank executives talk up recession but aren't provisioning extra for loan losses. On the contrary, banks are lending freely despite the inverted yield curve. Traditionally, the inverted curve signaled recession because it meant banks' funding costs exceeded potential loan revenues, drying up credit. However, with deposits costing near-zero and loan interest rates up with long-term Treasury yields, lending has become even more profitable—hence, the fast loan growth. People rarely sit on borrowed money. They typically spend and invest it, fueling growth.

An abnormal 2022 feature was equities and bonds moving in parallel. That should continue in 2023—but positively this time—as it did in Q4 2022. US 10-year Treasury yields are already down nicely from recent highs, helped by easing inflation. Commodity prices are down, supply chains are evening out and money supply growth globally has cooled dramatically. In the US, it has flatlined. With this, the dollar should continue weakening from its relative high, easing false fears of it hampering multinational equities.

By yearend 2023, a new bull market cycle should be well underway, but the path won't be placid. Volatility and pullbacks have struck early in bull markets without derailing them. At this stage in the market cycle, patience is best and should be rewarded over time. Our priority is to best position portfolios to capture returns from the upcoming, or ongoing, recovery while many still can't fathom a positive 2023.

GLOBAL UPDATE AND MARKET OUTLOOK

31 January 2023

MARKET RECAP

A NEW BULL MARKET

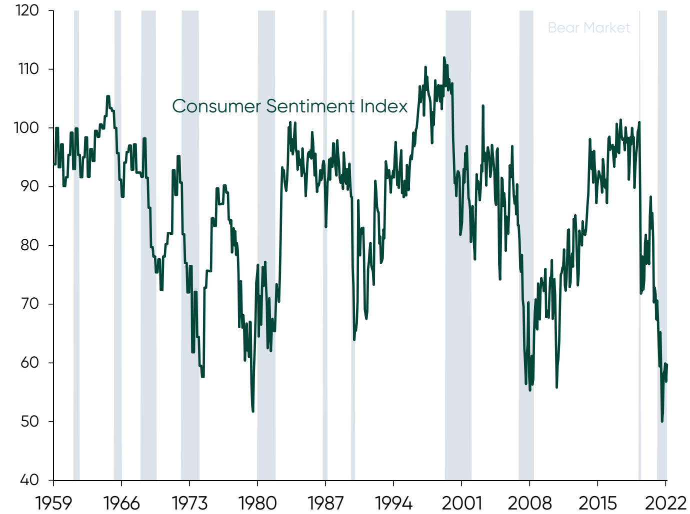
Given global markets' dismal 2022 performance, investors are fatigued and discouraged. Most economists anticipate recession and many expect more rate hikes, weighing on economic growth and equity markets. However, we believe this broad pessimism entering 2023 provides the perfect backdrop for an emerging bull market—delivering a year of recovery.

THE STAGE IS SET

Sir John Templeton famously said: "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." That foundational pessimism abounds today. Markets move most on the gaps between expectations and subsequent reality. The gap appears very wide. If the global economy grows slightly, is flat or even shrinks modestly, it should be a positive surprise versus universally grim projections of recession. The wall of worry is high.

There is no perfect sentiment measure. But many measures suggest pessimism reigns. Consider: The University of Michigan's Consumer Sentiment Index, which began in 1952, hit a record low in June and hovers near it now. (Exhibit 1)

EXHIBIT 1: US CONSUMER SENTIMENT DROPS TO RECORD LOWS



Source: FactSet, as of 09/01/2023. Index level data is quarterly from November 1959 – January 1978; monthly thereafter. Bear market shading is based on S&P 500 cycle dates.

It isn't just the United States. GfK's UK Consumer Confidence Index, dating to January 1974, hit a record-low -49 in September.[vi] Their German gauge, starting in 1995, also hovers near October's record lows. ZEW's gauge of financial professionals' economic confidence—starting around 1991's reunification—hit -61.9 in September, a whisker from record lows. ZEW's eurozone measure parallels this. Such deep, widespread negativity is inconsistent with equities falling much further. It would take something large, new and unexpected—a huge, negative shock.

Whether the bull market began climbing the wall of worry in October or investors must process more uncertainty and fear before a 2023 bottom isn't knowable. Regardless, there is ample reason to believe the typically big, new bull market rally is close, if not here, as we will explain.

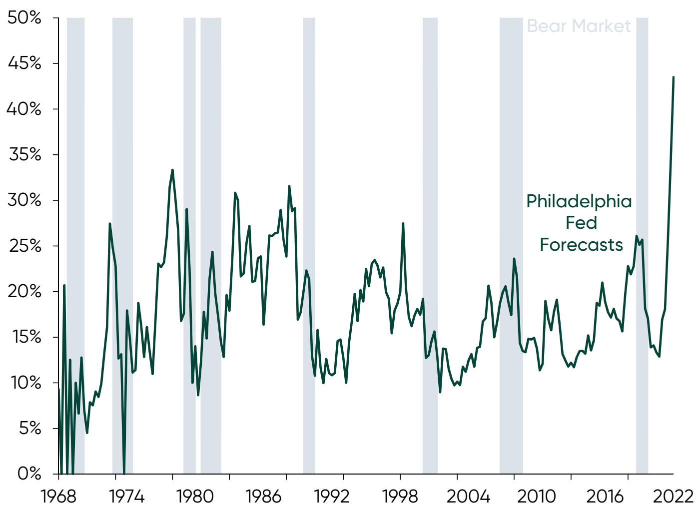
vi Source: FactSet, as of 12/01/2023.

RECESSION IS WIDELY ANTICIPATED

The US and world ended 2022 with several economic indicators dipping or slowing. Yet equities don't need a thriving economy in order to create an equity environment ripe for growth. Absolute "good" or "bad" isn't what moves markets materially. Markets react to surprise. A modestly better than expected reality is enough to be bullish.

Multiple surveys show business leaders expect recession. The Dallas Fed reported 54% of firms cited recession concerns in December. Three separate media surveys—from *The Wall Street Journal, Barron's and Bloomberg*—show between 68% and 78% of respondents expect a 2023 recession. Two Q4 surveys—from PwC and the American Institute of Certified Public Accountants—showed 81% and 91% of CEOs, CFOs and controllers expecting one. The Conference Board's CEO survey went further: 98% of respondents foresee a US recession in 2023—99% expect a European one.[vii] The Philadelphia Fed's Recession Expectation Survey hit an all-time high. (Exhibit 2) A recession now would arguably be history's most expected downturn.

EXHIBIT 2: PHILADELPHIA FED'S PROBABILITY OF RECESSION IN THE NEXT 12 MONTHS



Source: Philadelphia Fed, mean probability of a decline in real GDP (real GNP prior to 1992:Q1) in the current quarter and the following 4 quarters. Data as of 12/29/2022.

With expectations so dim, negative surprise is much harder to achieve than positive. Even a mild recession shouldn't have sway over equities. But if the global economy avoids recession, that would be a powerful upside surprise.

If a recession does materialise, it is likely short and shallow, unlike the deep 2020 downturn or 2007 – 2009's protracted, powerful one. Businesses aren't irrational. With so many expecting recession, they have been preparing. Anticipation is mitigation. Steadily, firms are cutting costs. Some have laid employees off. Many have pared investment and expansion plans.

Wringing out excesses created in the prior expansion is a recession's main purpose. But the more done beforehand, the more mild the recession, if it comes at all.

RECESSION WATCH 2023

It is impossible to say if a recession is underway, but some US data suggest so while others don't. The Conference Board's Leading Economic Index (LEI) is dropping. US 3-month Treasury rates are above 10-year—an "inverted" yield curve many see as a recession harbinger. Services and manufacturing purchasing managers' indexes (PMIs) are under 50, implying contraction.

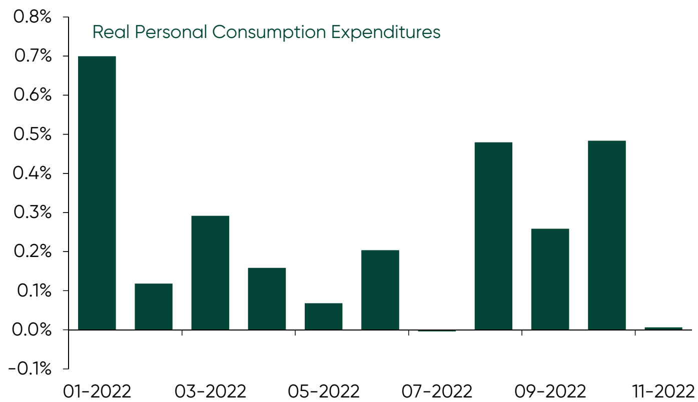
Industrial production struggles, down most of the past eight months, but this is primarily due to automobile output and the overall decline is small.[viii] High-tech consumer and business products have been more resilient. Overall, there is no clear signal from industrial output. On the positive side, consumer spending keeps growing. (Exhibit 3) Spending on goods was weak, but services was not. Perhaps the split between goods and services signals high prices are forcing people to cut back. However, services are the bulk of consumer spending, and its continued growth was enough to keep overall spending positive—inconsistent with normal recessions.

vii Source: Federal Reserve Bank of Dallas, The Wall Street Journal, Bank of America, Bloomberg, Barron's, Federal Reserve, PwC, AICPA and The Conference Board, as of 29/12/2022.

viii Source: US Federal Reserve, as of 18/01/2023.

Furthermore, lending keeps growing in the double digits—historically fast—also inconsistent with a recession. Usually, recessions erupt when tight credit forces lending negative, forcing firms to cut back. Abundant lending usually brings more spending and investment, as borrowers don't sit on borrowed funds. This doesn't make recession impossible, but unlikely. Even if lending slows from early January's 11.3% y/y, it should foster growth.[ix]

EXHIBIT 3: ADJUSTED FOR INFLATION, CONSUMER SPENDING HAD A GOOD YEAR

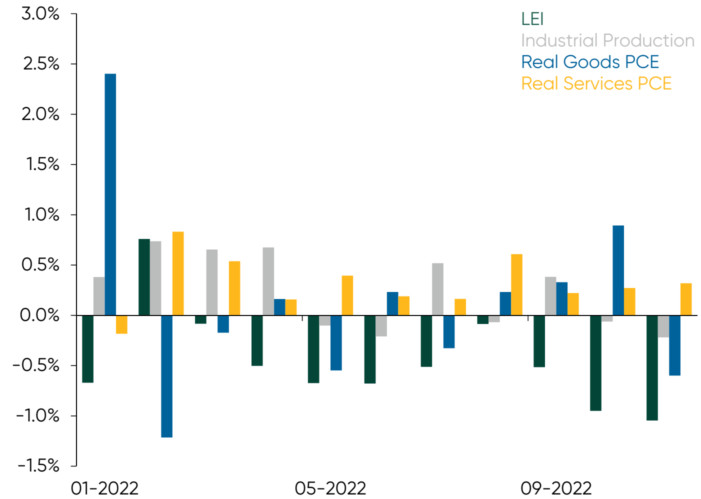


Source: Bureau of Economic Analysis, month-over-month change as of 11/01/2023.

WHY LEI AND THE YIELD CURVE AREN'T REASON TO BE BEARISH NOW

The now-legendary LEI and yield curve may be giving false recessionary signals. Take LEI. It links 10 mostly forward-looking indicators, including three sets of factory orders, the yield curve spread and a credit gauge. But it features goods production over services, despite services representing nearly 70% of US GDP. Building permits are among the biggest recent detractors. Yet residential and commercial real estate investment generate just 6.8% of GDP.[x] Its factory order components, while forward-looking, represent under 20% of GDP.[xi] In falling 10 straight months through November, the LEI's recessionary tilt doesn't square with services spending's consistent growth or private spending and investment's combined growth.

EXHIBIT 4: LEI PREDICTS GOODS BETTER THAN SERVICES



Source: FactSet and BEA, month-over-month percent change as of 11/01/2023.

As for the yield curve, it garnered significant media attention since short-term interest rates exceeding long-term rates often precedes recession. But the angst doesn't explore *why* that is and whether it holds now. The yield curve matters only if it influences bank lending—something it likely isn't doing now. Usually, the yield curve influences banks' future profit margins. Banks borrow at short-term rates to finance lending at long-term rates, profiting off the spread between them. Their borrowing costs typically track 3-month US Treasury yields, while 10-year US Treasury yields are a proxy for most long-term individual and business loans. So when 3-month rates top 10-year rates, it usually means banks' lending profitability is about to drop, causing lending to dry up and forcing firms and households to cut back.

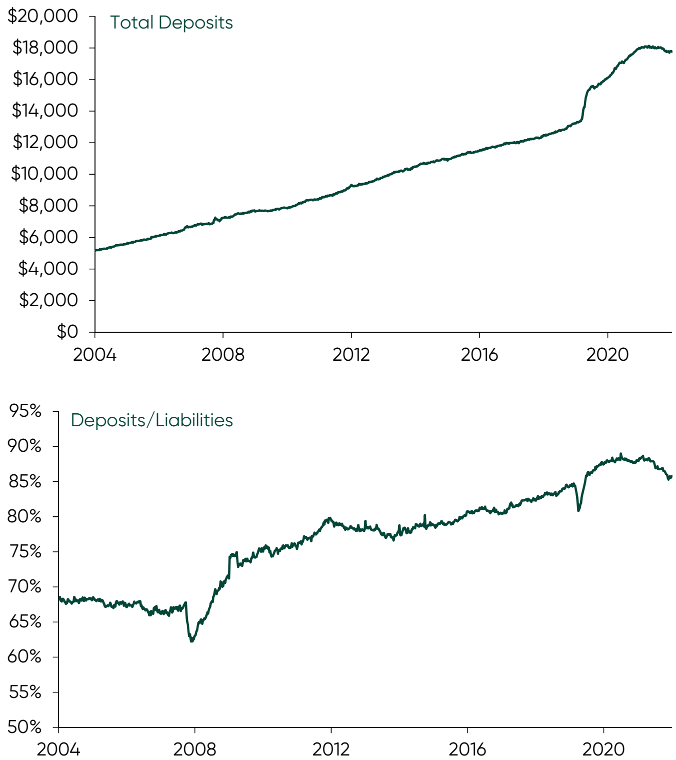
ix Source: St. Louis Federal Reserve, as of 18/01/2023. Year-over-year percent change in loans and leases in bank credit (all commercial banks) for the week of 04/01/2023.

x Source: FactSet, as of 03/01/2023.

xi Ibid.

But now, short-term rates—and therefore the yield curve—are detached from lending. While short-term rates reflect what banks would pay to borrow from one another to finance lending, few are relying on that. Banks' deposit bases are historically huge on an absolute basis and as a percentage of total funding. (Exhibit 5) They cost nearly nothing, with savings accounts averaging 0.24%.[xii] Meanwhile, 10-year Treasury yields are up. This makes lending more profitable despite Fed hikes—boosting incentives to lend and disarming the inverted yield curve.

EXHIBIT 5: BANKS ARE FLUSH WITH DEPOSITS



Source: FactSet, Federal Reserve System. Liabilities and total deposits of commercial banks as of 11/01/2023. USD Billions.

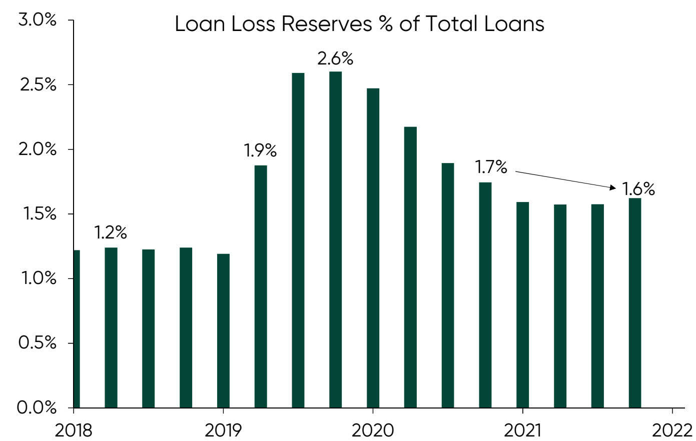
Furthermore, today LEI and yield curves can be accessed on your smartphone. They built their legendary forecasting prowess in decades past, when few could find them easily. Given their widespread attention, many heed them. Widespread attention makes them largely pre-priced. Hence, we don't think the inverted yield curve or LEI indicate much now that markets haven't seen.

WATCH WHAT PEOPLE DO, NOT WHAT THEY SAY—BANKERS, TOO

Many businesses whose equities declined deeply have cut costs in anticipation of recession. Seemingly similarly, questions in the Fed's October Senior Loan Officer Opinion Survey showed 15 of 19 banks say they see an over 40% chance of 2023 recession—9 said greater than 60%. Some prominent CEOs like JPMorgan Chase CEO Jamie Dimon made waves in mid-2022 by suggesting a "financial hurricane" looms. If true, banks would presumably set aside extra reserves for loan losses—preparing for ugliness like their non-financial peers. This is doubly true as a relatively new accounting rule—the Current Expected Credit Loss rule—requires them to reserve cash for expected loan losses over the loan's lifespan, not when the loss actually hits.

Reserves are rising, as many pundits note. But, as Exhibit 6 shows, they barely budged relative to outstanding loans, showing their rise is more about lending increases than caution. Even JPMorgan Chase isn't provisioning for a financial hurricane, as Mr. Dimon acknowledged on the bank's Q3 earnings call. This—plus fast global loan growth—may seem to contradict the idea of firms preparing for recession. But low funding costs and higher interest revenues boost lending profitability—likely explaining the contradictory behavior.

EXHIBIT 6: BANK LOAN LOSS RESERVES RELATIVE TO TOTAL LOANS MOVED MARGINALLY IN 2022



Source: FactSet, as of 19/12/2022. Quarterly earnings for 15 largest US banks through 3Q 2022, weighted by loan book size.

xii Source: St. Louis Federal Reserve and FactSet, as of 03/01/2022. Average national deposit rate: savings, December 2022 and 3-month US Treasury yield on 30/12/2022.

IMPROVEMENTS PESSIMISTS MISS

The many worries of 2022 created vast and increasing worrisome fears amongst investors. But in time, the bear market, brought the "Pessimism of Disbelief"—the tendency to dismiss or even fear positive news. As some of 2022's worries fade, it should help deliver positive surprise to fuel the new bull market.

INFLATION

Inflation is slowing. That cooling should continue. Inflation is typically too much newly created money chasing too few goods or services. When they come into better balance, input prices cool. These input prices feed into businesses' costs. Later, they slow inflation and may, sometimes, cause falling prices. We likely won't see 2020-level prices return. That would require deep deflation. But a return toward lower, more normal inflation rates is well underway now.

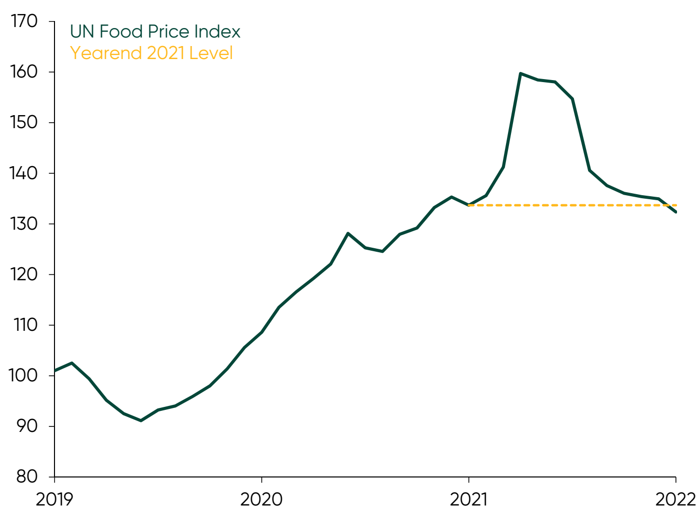
Last quarter's Review highlighted input costs and early inflation drivers that are down already. Importantly: Broad money supply growth has slowed significantly. The US's broadest measure was roughly flat year-over-year in October and November.[xiii] So the "too much new money" improved dramatically in 2022's back half.

Input prices also show vast improvement. While the Ukraine war tragically persists, people are much less concerned about the economic effects. Consider oil prices for example. Early in 2022, they rose as Russian sabre rattling roared. When Russia invaded Ukraine, prices surged to $133 per barrel, reacting to West's sanctions.[xiv] Forecasters, fearing worse, feared prices spiking over above $200. Instead, Brent Crude fell—ending 2022 at $82, a nominal $5 full-year rise.[xv]

The UN's World Food Price Index surged with the war, primarily on fears of grain trade disruptions. But by December it had reversed, finishing below 2021 yearend levels. (Exhibit 7) Outside the war's effects, home prices are cooling. These usually lead rents by about 15 months. So shelter costs—the biggest consumer price index component—should ebb soon.

These improvements are now slowing inflation. The US Consumer Price Index eased from 9.1% y/y in June to 6.5% in December.[xvi] In fact, rarely reported, the annualised US CPI in 2022's second half averaged below 2%.[xvii] While headline inflation remains higher due to energy costs, European inflation is also improving. (Exhibit 8) The cooling is nascent and uneven, implying further room for improvement to buoy sentiment.

EXHIBIT 7: GLOBAL FOOD PRICES ERASED THE UKRAINE WAR INCREASE



Source: UN Food and Agriculture Organisation, index level as of 09/01/2023. December 2019 – December 2022.

xiii Source: Center for Financial Stability, as of 10/01/2023. November Divisa M4 including Treasurys, year-over-year percentage change.

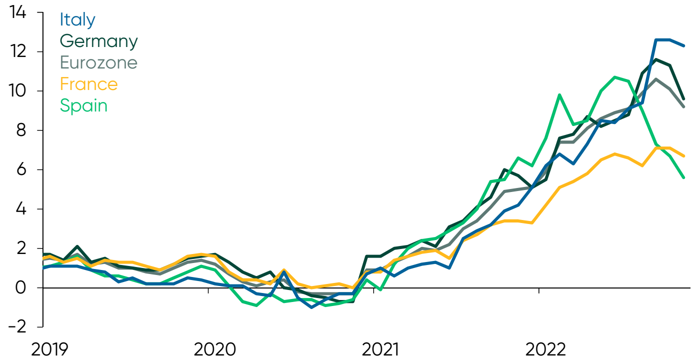
xiv Source: FactSet, as of 09/01/2023. Brent crude oil price on 08/03/2022.

xv Ibid. Brent crude oil prices on 31/12/2021 and 30/12/2022.

xvi Source: FactSet, as of 12/01/2023.

xvii Source: FactSet, as of 18/01/2023. US Consumer Price Index, average annualised rate of change, July 2022 – December 2022.

EXHIBIT 8: EUROZONE INFLATION SEEMS TO HAVE PEAKED

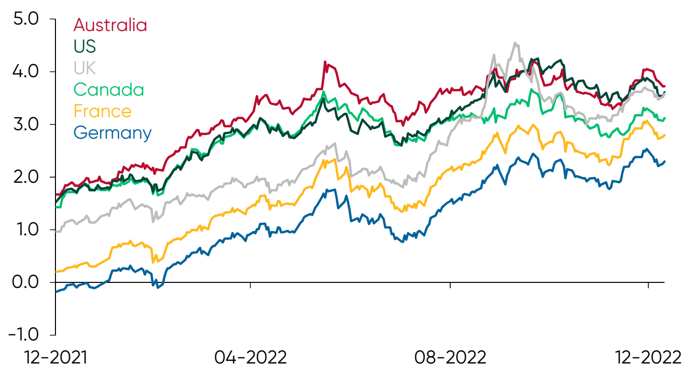


Source: Eurostat, year-over-year percent change as of 09/01/2023. December 2019 – December 2022. December 2022 data are preliminary estimates.

BOND INVESTORS SHOULD GET RELIEF, TOO

Inflation expectations are a key driver for long-term interest rates, so as inflation cools, yields should fall—buoying bond prices. In 2022, rising inflation and inflation fears caused 10-year government bonds rates to surge globally. (Exhibit 9) Since bond yields and prices move inversely, that contributed to bonds falling alongside equities. Late in 2022, long-term interest rates' rises reversed. That should continue. After 20 October's peak at 4.24%, 10-year US Treasury yields fell, finishing 2022 at 3.88%.[xviii] By mid-January they were 3.41%.

EXHIBIT 9: GLOBAL LONG RATES IN 2022



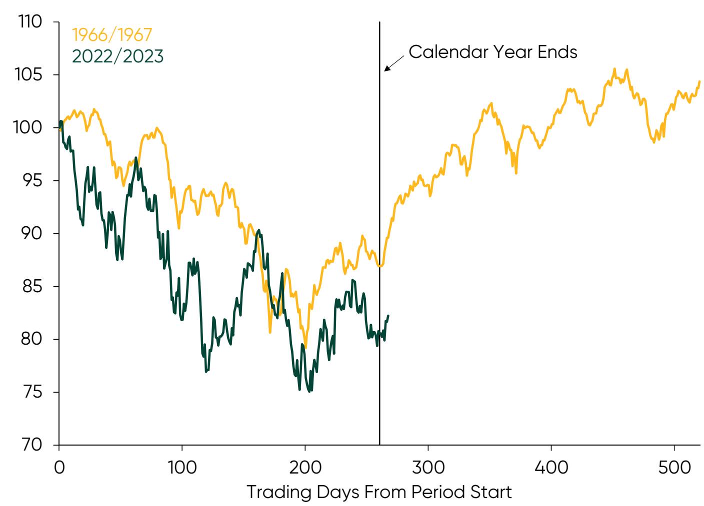
Source: FactSet, as of 11/01/2023. 10-year government bond yields, yield percent, 31/12/2021 – 10/01/2023.

1967, REVISITED

Last quarter's Review showed how 2022 resembled 1966—midterm election years with wars, tense political backdrops, shallow bear markets, Fed rate hikes and recession fear. Parallels likely continue through 2023. 1967 brought a new bull market as economic fears eased.

If 12 October proves the low, it would also resemble 1966's bear market, which didn't end with capitulation. Yet equities still enjoyed a typical rebound. The S&P 500 rose 5.9% in Q4 1966 and added another 23.9% in 1967.[xix] While the yield curve inverted in late 1966, like 2022, recession never came. GDP growth slowed in 1967 but stayed positive, defying widespread recession expectations—a relief that helped power equities' big 1967. The inflation rate, which doubled by October 1966, was down sharply by May 1967—another relief.[xx] Overall, we believe 2023 will bring portfolio relief now as 1967 did then.

EXHIBIT 10: JUST LIKE 1967?



Source: FactSet, via 11/01/2023. S&P 500 Prices, indexed to 100 at period start, 31/12/1965 – 31/12/1967 & 31/12/2021 – 10/01/2023.

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xviii Source: FactSet, as of 03/01/2023. 10-year US Treasury yield (constant maturity), 20/10/2022 and 30/12/2022.

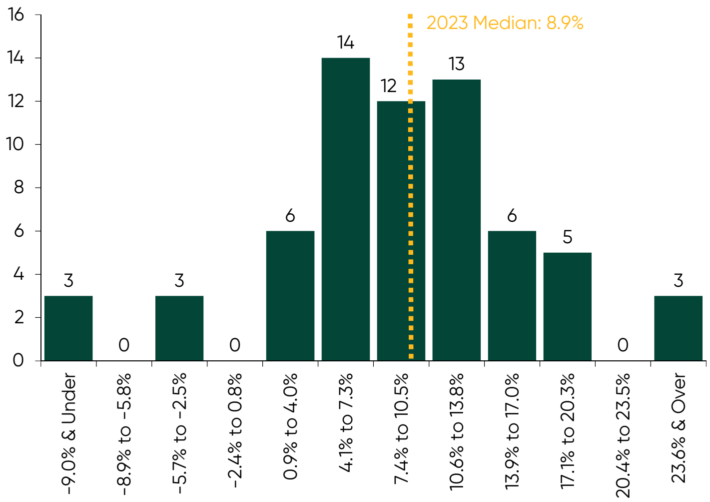
xix Source: Global Financial Data, Inc., as of 30/12/2022. S&P 500 total returns, 30/09/1966 – 31/12/1966 and 31/12/1966 – 31/12/1967.

xx Source: St. Louis Federal Reserve, as of 30/12/2022.

THE 2023 PROFESSIONAL FORECASTER SENTIMENT BELL CURVE

One of our forecasting methods is to understand Wall Street's common expectations. They are generally pre-priced and don't come to fruition. We take forecasters' projected yearend for broad market indexes such as the S&P 500, impute the implied return, then plot these forecast returns on a bell curve. Wherever forecasts cluster typically doesn't happen. Where there are few or no forecasts—whether to the left, right or points in between—more commonly occurs. Exhibit 11 shows you this for 2023.

EXHIBIT 11: 2023 SENTIMENT BELL CURVE OF S&P 500 FORECASTS

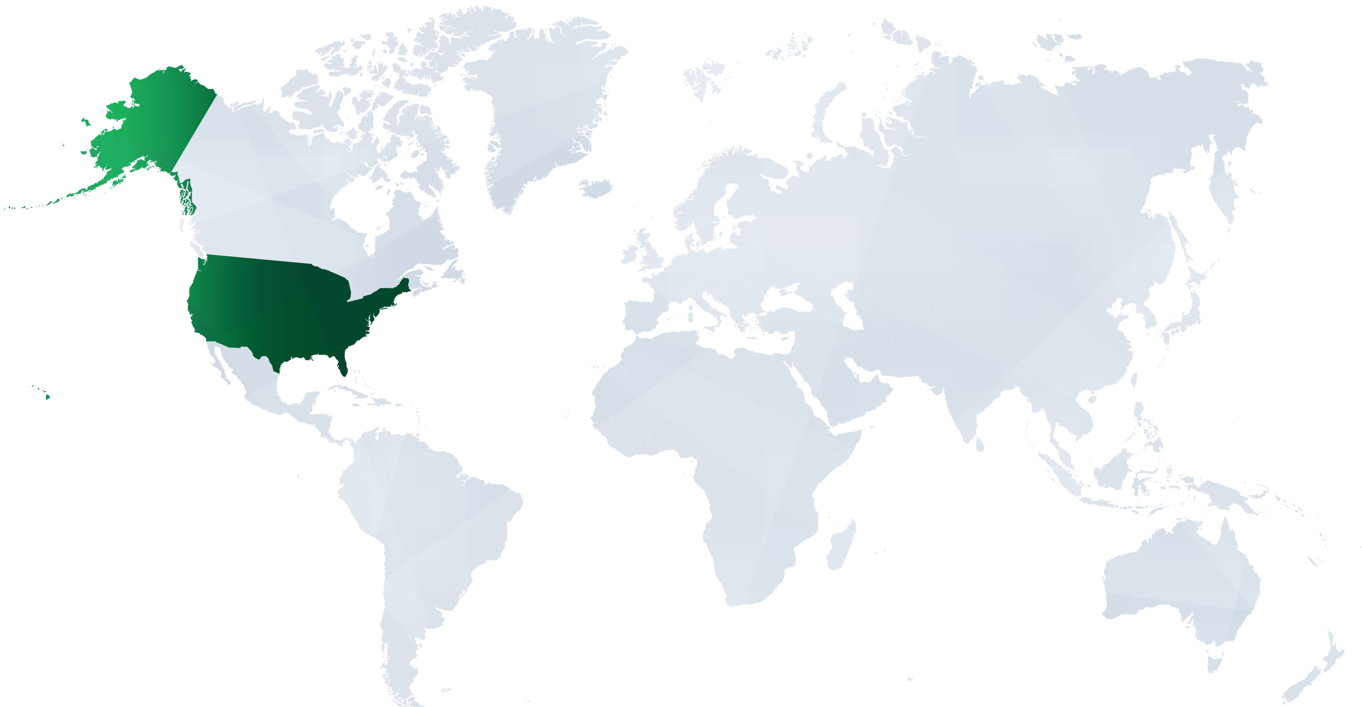


Source: Fisher Investments Research and Bloomberg, number of observations per forecast as of 10/01/2023.

These forecasts aren't uniformly pessimistic—they are varied. Still, most forecasts cluster in the two columns spanning 6.1% to 10.0% and 10.1% to 14.0%—with the median being 8.9%. This isn't overly bullish, considering the annualised bull market average is 23%.[xxi] That average is in a range no one forecasted. Maybe it happens this year. Or maybe we get bigger returns than anyone forecasts. While we cannot definitively say whether markets will face another leg down or not, we think politics, economics and dour sentiment imply a bull market is much more likely than a very negative scenario in 2023.

xxi Source: Global Financial Data and FactSet, as of 10/01/2023. S&P 500 average annualised price return in bull markets, 01/06/1932 – 03/01/2023.

UNITED STATES COMMENTARY



THE US MIDTERM MIRACLE IS OFF AND RUNNING

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

November's US midterms flipped the House of Representatives from a slight Democratic majority to a slim Republican one, delivering the increased gridlock we expected. Republicans will control which legislation is voted upon—virtually guaranteeing partisan Senate legislation goes nowhere. Meanwhile, the Democrats control all Senate committees, virtually assuring partisan House legislation dies. It should bring a calming legislative environment, with only moderate, consensus or essential (e.g., debt ceiling) bills passing.

Markets love gridlock because they dislike big change. Large bills drive uncertainty, creating winners and losers. Prospect Theory teaches us losers hate it much more than the winners love it, and their negativity overwhelms market outlooks. This can weigh heavily on equities. Even watered down large bills, as in 2022, can weigh on sentiment and returns by creating winners and losers. Gridlock ends this. Even if people don't notice gridlock's benefits, the mere absence of contentious new laws can give equities relief.

The nine months starting in the pre-midterm October are history's strongest nine-month string, and despite December's dip, the Midterm Miracle delivered in Q4, bringing a 7.6% S&P 500 return—a normal midterm Q4.[xxii] This historically positive stretch starts the president's third year. As Exhibit 12 shows, the third year of a president's term has the electoral cycle's highest average return, 18.4%, and has been positive in 91.7% of history. No third year was negative since 1939—as WWII started—which was down just -0.9%.[xxiii] 1931's decline was huge—in the Great Depression's depths—nothing like today.

Furthermore, despite elevated fear after 2022, negative second years of president's terms led to even stronger third years. Since accurate data begin in 1925, there were nine negative second years—leading to average third years with 28.7% median return, with only one down year, again, 1931.

THE STRONG DOLLAR

The US dollar, which also moved with long rates in 2022, should weaken into 2023—assuaging fears. Currencies usually move with relative interest rates, strengthening as yields rise versus other nations', weakening as they fall. US rates rose faster than most nations in 2022. So, relative to a broad trade-weighted currency basket, the dollar strengthened most of the year—hitting a 20-plus-year high on 25 September. As the dollar rose, fear grew of its strength hurting US firms' overseas revenues and profits. This is incorrect in our opinion. Currency swings bring largely offsetting benefits and detractions. But the strong dollar hurt sentiment—especially for Tech and Tech-like firms. That fear should ease as 2023 evolves. The dollar is weakening as inflation cools and long-term interest rates fall.

EXHIBIT 12: YEAR THREE—THE PRESIDENTIAL TERM'S SWEET SPOT

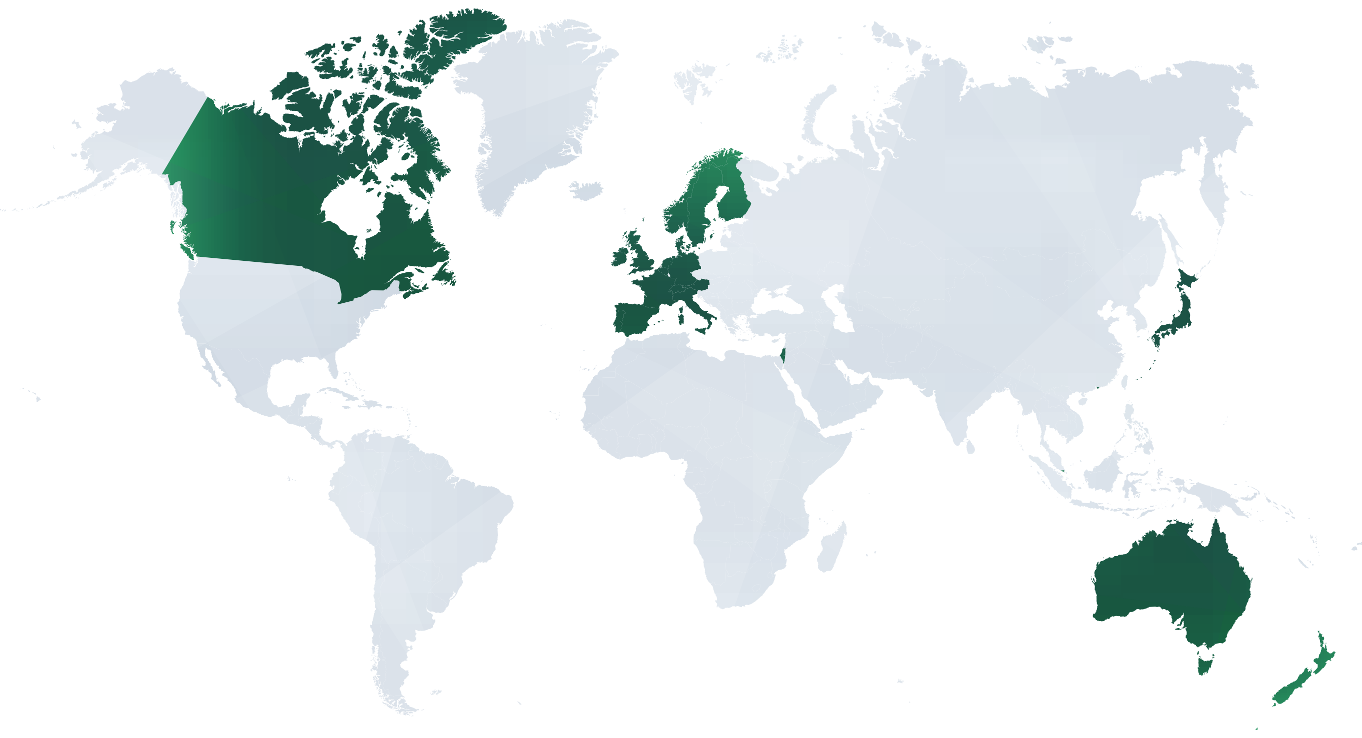
Party	President	First Year		Second Year		Third Year		Fourth Year	
R	Coolidge	1925	29.5%	1926	11.1%	1927	37.1%	1928	43.3%
R	Hoover	1929	-8.9%	1930	-25.3%	1931	-43.9%	1932	-8.9%
D	FDR -- 1st	1933	52.9%	1934	-2.3%	1935	47.2%	1936	32.8%
D	FDR -- 2nd	1937	-35.3%	1938	33.2%	1939	-0.9%	1940	-10.1%
D	FDR -- 3rd	1941	-11.8%	1942	21.1%	1943	25.8%	1944	19.7%
D	FDR / Truman	1945	36.5%	1946	-8.2%	1947	5.2%	1948	5.1%
D	Truman	1949	18.1%	1950	30.6%	1951	24.6%	1952	18.5%
R	Ike -- 1st	1953	-1.1%	1954	52.4%	1955	31.4%	1956	6.6%
R	Ike -- 2nd	1957	-10.9%	1958	43.3%	1959	11.9%	1960	0.5%
D	Kennedy / Johnson	1961	26.8%	1962	-8.8%	1963	22.7%	1964	16.4%
D	Johnson	1965	12.4%	1966	-10.1%	1967	23.9%	1968	11.0%
R	Nixon	1969	-8.5%	1970	4.0%	1971	14.3%	1972	18.9%
R	Nixon / Ford	1973	-14.8%	1974	-26.5%	1975	37.3%	1976	23.7%
D	Carter	1977	-7.4%	1978	6.4%	1979	18.4%	1980	32.3%
R	Reagan -- 1st	1981	-5.1%	1982	21.5%	1983	22.5%	1984	6.2%
R	Reagan -- 2nd	1985	31.6%	1986	18.6%	1987	5.2%	1988	16.6%
R	Bush	1989	31.7%	1990	-3.1%	1991	30.5%	1992	7.6%
D	Clinton -- 1st	1993	10.1%	1994	1.3%	1995	37.6%	1996	23.0%
D	Clinton -- 2nd	1997	33.4%	1998	28.6%	1999	21.0%	2000	-9.1%
R	Bush, G.W.-- 1st	2001	-11.9%	2002	-22.1%	2003	28.7%	2004	10.9%
R	Bush, G.W.-- 2nd	2005	4.9%	2006	15.8%	2007	5.5%	2008	-37.0%
D	Obama -- 1st	2009	26.5%	2010	15.1%	2011	2.1%	2012	16.0%
D	Obama -- 2nd	2013	32.4%	2014	13.7%	2015	1.4%	2016	12.0%
R	Trump	2017	21.8%	2018	-4.4%	2019	31.5%	2020	18.4%
D	Biden	2021	28.7%	2022	-18.1%	2023		2024	
Frequency of Positive Returns			60.0%		60.0%		91.7%		83.3%
Average Return for Republicans			4.9%		7.1%		17.7%		8.9%
Average Return for Democrats			17.2%		7.9%		19.1%		14.0%
Average Return for All Periods			11.3%		7.5%		18.4%		11.4%

Source: Global Financial Data, Inc., and FactSet, as of 10/01/2023. S&P 500 total return, 1925 – 2022.

xxii Source: FactSet, as of 10/01/2023.

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

GLOBAL DEVELOPED EX-US COMMENTARY



GLOBAL POLITICS

Better than feared economic realities across the global developed landscape, as well as falling uncertainty from political gridlock, should prove to alleviate many investor fears from Q4 and buoy equity markets in 2023.

THE UK POLITICAL SCENE

Political uncertainty is also easing in the UK, where new Prime Minister Rishi Sunak appears focused most on rebuilding the Conservative Party's popularity and reputation for fiscal probity following former Prime Minister Liz Truss's brief premiership. On the fiscal front, Prime Minister Sunak and Chancellor of the Exchequer Jeremy Hunt appear to be having some success: Their decision to abandon former Prime Minister Truss's tax cutting agenda—and instead extend recent stealth tax hikes—whilst decreasing support for household business and energy costs seems to have quieted economists' deficit concerns. However, Prime Minister Sunak and the Conservative Party's poll ratings are down, and divisions within the party have surfaced again, suggesting to us he will have little political capital to push through major economic measures from here. The resulting political gridlock should keep legislative risk low, adding to global political tailwinds.

Chancellor Hunt's Autumn Statement, released in November, confirmed broad tax cuts are now off. Instead, he extended Prime Minister Sunak's earlier tax band freeze from 2026 to 2028, which will increase tax take (and households' income tax burdens) as wages and salaries rise with inflation. Additionally, the government is reducing the threshold for the 45% rate from annual income of £150,000 to £125,145, exposing many more households to the Additional Rate. The dividend allowance will drop from £2,000 to £1,000 in April 2023 and £500 in April 2024, whilst the capital gains tax's annual exemption will drop from £12,300 to £6,000 in April 2023 and £3,000 in April 2024. The corporation tax increase from 19% to 25% will take effect in April as previously scheduled, but the business rate multipliers will freeze, effectively cutting those rates. Meanwhile, the energy windfall profits tax will both rise from 25% to 35% for North Sea oil and gas production and widen to low-carbon electricity generators, whose rate will be 45%. The tax will also be extended for two years and is now scheduled to sunset in March 2028.

On the spending side, the Autumn Statement projects departmental spending will rise 1% annually in real terms—slower than initially planned, but still growth (recalling the "austerity" of the 2010s). Energy bill assistance will continue, but it will be less generous. For households, the energy price guarantee's end date will be extended from April 2023 to April 2024, but the amount will rise from £2,500 to £3,000—meaning the typical household's average annual amount paid will rise to £3,000. For businesses, the system of fixed unit energy costs, which began in October, will end in March, with a 12-month programme of "transitional support" taking its place in April. Under that plan, in which the government estimates it will provide £5.5 billion worth of assistance, businesses will receive wholesale price discounts instead of fixed rates. With wholesale power prices now down considerably, businesses and households alike should soon feel some much-needed relief.

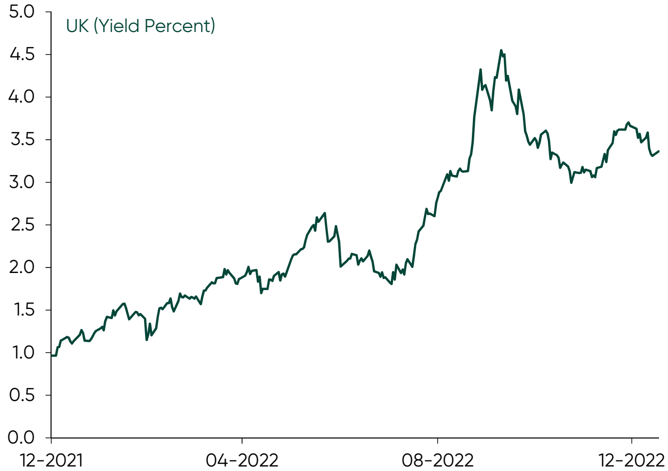
Markets generally took the new fiscal measures in stride, looking past the inevitable handwringing about "austerity." Long-term interest rates continued falling, and as we write, UK equities are flirting with new record highs and have basically erased 2022's decline. We don't think this reaction is outlandish, considering the tax measures either extended the status quo—or were too small to create huge amounts of winners and losers. Markets are adaptable and don't need perfection. Just the lack of a big negative surprise is often enough, and we think the Autumn Statement satisfied in that regard.

From here, we doubt Prime Minister Sunak and Chancellor Hunt do much to raise political and economic uncertainty. The party remains divided over the implementation of Brexit, with the dust-up over repealing EU legislation, the latest economic split to come to the fore. Internal divisions over more sociological matters are also erupting. Combined with recent verbal and social media gaffes on Prime Minister Sunak's part, the government's political capital appears to be on the wane. Typically, when this happens, the party in power focuses on rebuilding its reputation ahead of the next election, which usually brings incremental change at most. That may perhaps disappoint those hoping for a larger move toward tax cuts before the next contest, which is presently due by late January 2025, but the UK has shown for many years that deep tax cuts and nominally pro-growth measures aren't necessary for UK equities and the economy to do fine.

EUROPEAN LONG RATES AND INFLATION

UK yields have fallen even more than US since October's peak, dropping over a full percentage point (Exhibit 13). Yet inflation hasn't eased much, suggesting the drop in yields is mostly about easing pension fund turmoil. As last quarter's Review discussed, when bond markets overreacted to the previous government's fiscal policy plans, it spurred margin calls at leveraged pension funds, forcing them to sell their most liquid assets—Gilts—to raise collateral. These forced sales drove yields higher still, prompting the Bank of England to intervene with temporary liquidity facilities and offers to purchase Gilts directly from pension funds. That helped ease the simmering panic and—notably—yields remain lower even now that the BoE has sold the Gilts purchased via these emergency programmes.

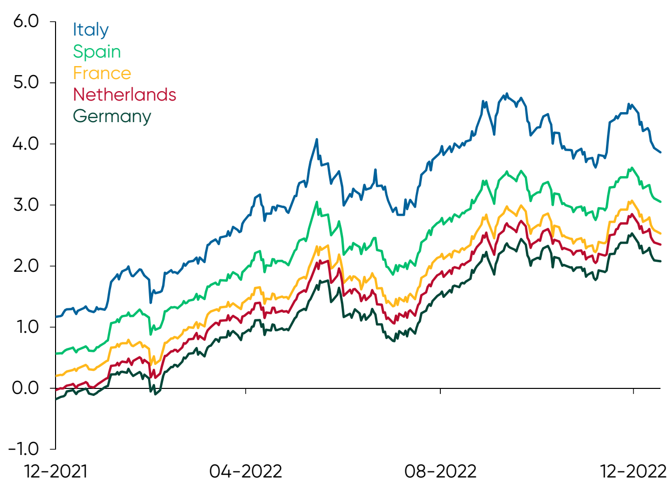
EXHIBIT 13: UK 10-YEAR YIELDS



Source: FactSet, as of 18/01/2023. UK benchmark 10-year government bond yields, 31/12/2021 – 17/01/2023.

In our view, had the pension dust-up not occurred, UK yields likely would have hewed closer to eurozone yields, most of which—unlike US yields—rose to near new highs at yearend. (Exhibit 14) We think there is a simple reason for this—and it is the same reason they should follow US yields' general trajectory lower this year: Inflation has taken longer to ease in the UK and Continental Europe. But it is easing, which should help long rates on both sides of the English Channel extend January's slide.

EXHIBIT 14: EUROZONE 10-YEAR YIELDS

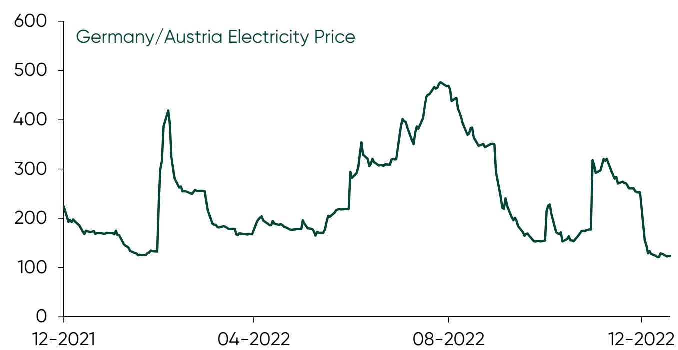


Source: FactSet, as of 18/01/2023. Germany, France, Italy, Spain and Netherlands benchmark 10-year government bond yields, 31/12/2021 – 17/01/2023.

While US Consumer Price Index (CPI) inflation peaked in June at 9.1%—and has since eased to 6.5% in December—eurozone inflation kept rising, eventually hitting a high of 10.6% y/y in October as European natural gas prices' summertime spike continued filtering through to consumer prices.[xxiv] Since then eurozone CPI has slowed, but it remained quite elevated at 9.2% in December.[xxv] UK inflation has followed a similar path, peaking at 11.1% in October and slowing modestly to 10.5% in December.[xxvi] All should improve much further in 2023, reducing the inflation premium in eurozone bond yields.

For one, energy prices were the biggest contributor to spiking inflation, and as we will show later, oil and benchmark European natural gas prices are now back below pre-Ukraine invasion levels. While those levels are still elevated relative to the region's history, as natural gas prices rose during autumn 2021's wind power shortage and spiking global demand, those higher levels are now in the year-over-year calculation base. That math, coupled with the drop in natural gas prices since autumn, points to rapidly slowing year-over-year energy price rates from here. This is also present in eurozone and UK power prices, which follow natural gas. Input prices don't immediately show in consumer prices—particularly in the UK, where household energy price caps add considerable distortions—but time should alleviate these issues.

EXHIBIT 15: CENTRAL EUROPEAN POWER PRICES



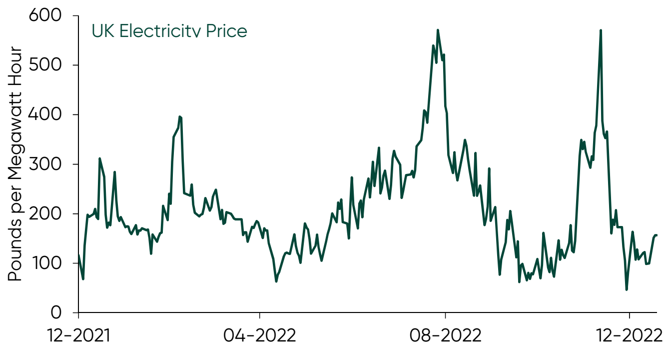
Source: FactSet, as of 18/01/2023. Germany/Austria Power Base Near Term, euros per megawatt hour, 31/12/2021 – 17/01/2023.

xxiv Source: FactSet, as of 18/01/2023.

xxv Ibid.

xxvi Ibid.

EXHIBIT 16: UK POWER PRICES



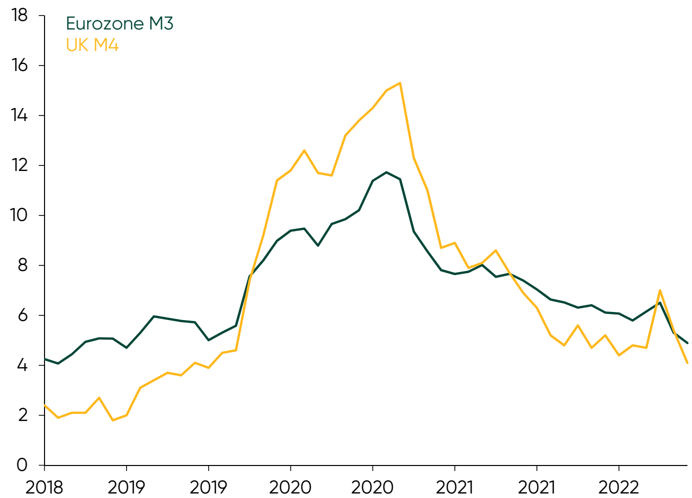
Source: FactSet, as of 18/01/2023. NORX UK Power Daily Average, pounds per megawatt hour, 31/12/2021 – 17/01/2023.

Broader CPI should also soon benefit from base effects. In March, the disruptions from the war in Ukraine will move from the numerator to the denominator. Consider that December 2022's eurozone consumer prices were 9.2% higher than December 2021's but only 5.2% above March 2022's.[xxvii] While we don't expect prices to be flat in the foreseeable future, we think the calculation illustrates how quickly base effects can alter the year-over-year rate.

Energy prices aren't the only way falling crude oil and natural gas prices should help consumer price increases slow. Both are feedstock for a wide array of consumer products from plastics and synthetic rubber to cleaning products. Higher input costs drove these goods prices higher throughout 2022, but that should be in the rearview mirror. So should the impact of higher metals prices last year, as those are also now at pre-invasion levels. Food prices, meanwhile, are benefiting from lower agricultural commodity prices.

Input costs and easing shortages aren't the only support for easing inflation. Monetary factors also favour it. On a seasonally adjusted month-over-month basis, eurozone M3 money supply has stalled, falling -0.5% in October—its first drop since before the pandemic—and staying flat in November.[xxviii] Year-over year, M3 is back at pre-pandemic growth rates. The UK's broadest measure, M4, has followed a similar trajectory. (Exhibit 17) Those rates didn't translate to fast inflation in the late 2010s, and they should support milder price increases now.

EXHIBIT 17: MONEY SUPPLY HAS SLOWED



Source: FactSet and Bank of England, as of 18/01/2023. Eurozone M4 and UK M4 (Excluding Intermediate OFCs), year-over-year growth rate percent change, 31/12/2018 – 30/11/2022.

THE EU'S ENERGY SITUATION—BETTER THAN FEARED

Another area where reality will likely top dire fears: Europe's energy scenario. When Russia invaded Ukraine, fear of global energy supply shortages surged. Oil and natural gas prices soared. Fears grew of Europe, dependent on Russian oil and natural gas, getting hit hard. The retaliatory sanctions increased those fears, conjuring shortage fears like 1970s-style gas lines and car-free days common in Europe then. Wintertime, when gas demand spikes, was a chief concern, as many presumed rationing would destroy GDP. But with winter underway, Europe is faring far better than feared. It isn't short of natural gas or oil. With energy infrastructure construction progressing, Russia has lost energy leverage over Europe.

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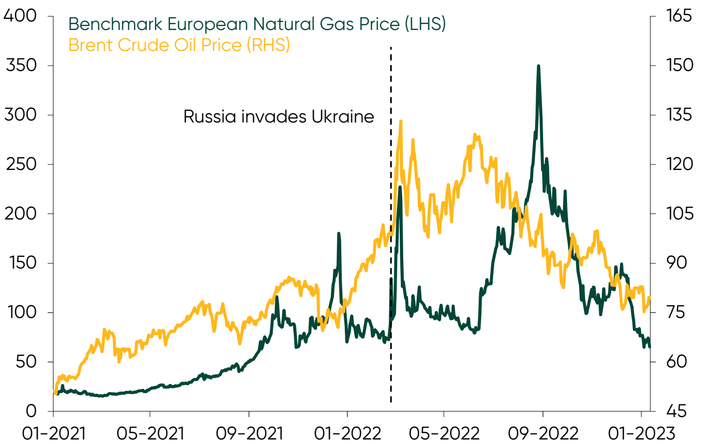
xxvii Ibid.

xxviii Ibid.

THE INVASION PREMIUM IS GONE

Markets reflect this falling uncertainty. European equities have jumped since October, widely outperforming global markets.[xxix] Benchmark European natural gas prices, while high by historical standards, are below February's pre-invasion prices. Oil prices also sank to pre-invasion levels, via higher production while China and India—unaffected by Western sanctions—purchased discounted Russian crude, leaving more non-Russian oil for Europe.

EXHIBIT 18: ENERGY BENCHMARKS SUGGEST FALLING SUPPLY RISKS



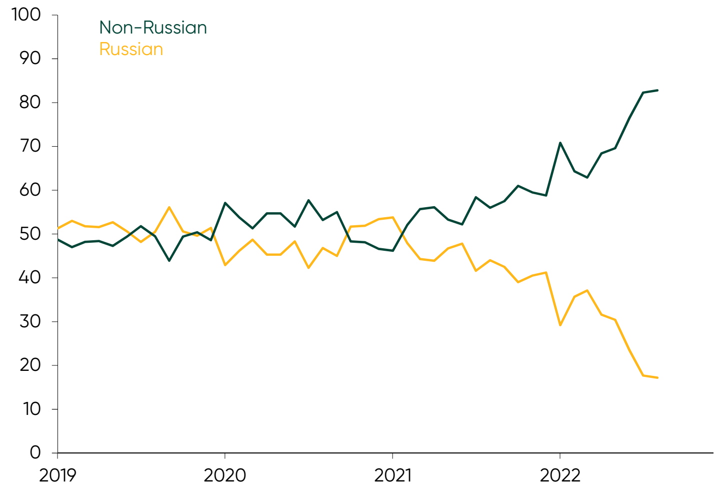
Source: FactSet, as of 11/01/2023. Dutch TTF natural gas price in euros and Brent crude oil price in US dollars, euros per megawatt hour (LHS), dollars per barrel (RHS), 01/01/2021 – 11/01/2023.

EUROPE'S FALLING RUSSIAN DEPENDENCE

Last quarter, we showed that Europe was filling gas reserves early despite Russia stopping most European flows. At yearend, EU gas storage was 83.5% full, down from mid-November's 95.5% peak, but still above its 80% 1 November target.[xxx] A cold snap forced a December dip, but they have since resumed *filling* coffers—unusual for January—amid warm weather.

With Russia shipping to China and India, other supplies are free for Europe. In 2022's first 11 months, American liquefied natural gas (LNG) exports to Europe rose 137% versus 2021.[xxxi] LNG shipments from the US, Qatar and elsewhere have replaced most Russian gas. Non-Russian gas is now over 80% and trending up. Some think Russia won't supply any EU gas by next winter.

EXHIBIT 19: EU DIVERSIFYING AWAY FROM RUSSIAN GAS



Source: European Commission, as of 07/11/2022. Share of gas delivered to the EU by Russia and other countries, EU natural gas imports, percent of total, January 2019 – August 2022.

Europe is rapidly building infrastructure to sustain its new, non-Russian supplies. Germany (where Russian gas flows shrunk to zero from 55% of 2021 imports) completed a new North Sea floating LNG terminal—usually a five year project—in 200 days by November.[xxxii] A second one will likely open before yearend. A new Baltic Sea terminal opened and began receiving LNG in December. Three more terminals are expected to open by yearend. New terminals will then be able to import about a third of Germany's 2021 gas demand.[xxxiii] Meanwhile Germany has inked long-term supply contracts from non-Russian sources.

xxix Source: FactSet, as of 12/01/2023. Statement based on Q4 returns for the MSCI EMU Index with net dividends versus the MSCI World Index with net dividends.

xxx "How Much of Europe's Gas Storage Is Full," Staff, Reuters, 31/12/2022.

xxxi "US LNG Exports Both a Lifeline and a Drain for Europe in 2023," Gavin Maguire, Reuters, 20/12/2022.

xxxii "The Five-Year Engineering Feat Germany Pulled off in Months," Georgi Kantchev, *The Wall Street Journal*, 09/12/2022.

xxxiii "Germany Finishes Construction of Its First LNG Import Terminal," Guy Chazan, David Sheppard and Camilla Hodgson, *Financial Times*, 15/11/2022.

Dozens more European LNG terminals are planned and under construction while existing terminals are expanding to make Europe energy flexible.[xxxiv] Its energy infrastructure buildout not only helps mitigate Russian influence, but its quick response is cushioning economic effects. Amid all this, the eurozone has—so far—defied recession expectations. With energy supplies brimming and rationing remote, worst-case scenarios hinged on shortfalls look unlikely.

RETHINK RUSSIAN OIL PRICE CAPS

In late 2022, the EU agreed to a long-mooted price cap on imported Russian oil—and natural gas imported from anywhere. These could introduce risk by backfiring via meddling with market functioning and interfering with price signals that incentivise conservation and increased supply. However the details matter and they largely render recent moves symbolic, with little market impact.

On 5 December, the EU, G7 and Australia enacted a price cap on seabourne Russian oil after finally agreeing to a $60 per barrel limit. The cap's aim is to sap Russia's oil revenue *without* destabilising markets. It bars firms in complying nations from insuring, financing or shipping Russian oil bought above the cap. Now, the EU, US and UK already banned Russian oil. These caps seek a wider reach, as Western revinsurers historically covered most global oil transport. The cap is subject to change every two months, intending it to be 5% below average Russian crude oil prices as tabulated by the International Energy Agency. Crucially, however, any adjustment requires unanimous agreement.

This appears disruptive—as headlines claimed. But there are some important mitigating factors. First, the initial cap was set above discounted Russian crude's current price, rendering it toothless presently. That may change, but the months-long struggle to get any price-level agreement suggests unanimity isn't likely. Then, the cap doesn't apply to Russia's main buyers—China and India. There, Russian insurers replaced Western ones. There is also a growing fleet of so-called "shadow" tankers that circumvent restrictions by painting over ship names, changing flags, turning off transmitters, using decoy signals and swapping oil at sea. So Russian seabourne oil exports haven't changed much. In the four weeks to yearend, shipments averaged a hair below the 2.86 million average in the four weeks before February's invasion.[xxxv]

ON NATURAL GAS CAPS

The EU's December deployment of LNG price caps changes little. While long debated amid fears of discouraging conservation and causing shortages, it, too, packs little punch.

Effective one year from 15 February, this cap triggers only if two conditions are met:

1. Benchmark European natural gas prices—the Dutch Title Transfer Facility (TTF) gas hub's front-month contracts—rise above €180 per megawatt hour (MW/h) for three days.

2. TTF prices are €35 higher than a reference price based on an international basket of LNG transaction hubs for the same three days.

xxxiv "Liquefied Natural Gas Infrastructure in the EU," Staff, European Commission, 20/12/2022.

xxxv "Russia's Oil Flows Slump to 2022-Low as Sanctions Squeeze Moscow," Julian Lee, Bloomberg, 03/01/2023.

€180 per MW/h isn't the cap itself. If triggered, the cap would be €35 per MW/h *above* the LNG reference price. This alone helps mitigate the supply disruptions hard caps can bring. It means EU prices would still exceed global prices, incenting suppliers to bring cargoes. In 2022, the cap wouldn't have triggered in March's natural gas price spike. The gap between TTF and global prices was too small. It would have in August, but because the likely reference prices also surged, the gap wasn't much. This is poor policy, but isn't disastrous, either. TTF prices are now about €65 per MW/h—a third of the trigger price. So the issue of the cap distorting market incentives is moot. For the foreseeable future, it should stay that way with European gas reserves high and new supply lines coming online. For now, the natural gas price cap poses little risk.

JAPAN PIVOTS ON YIELD-CURVE CONTROL PROGRAMME

In December the Bank of Japan (BoJ) announced a change to its yield-curve control (YCC) programme, surprising observers—and spurring speculation about the move's global implications. But in our view, the BoJ's shift isn't as consequential as many think, and the market has confirmed as much.

YCC sets targets for 10-year Japanese Government Bond (JGB) yields. When implementing YCC in September 2016, the BoJ targeted a 0% 10-year yield, with officials allowing for fluctuations within a trading bandwidth of +/- 0.1 percentage point (10 basis points). This programme sought to keep the yield curve positively sloped at a time when long rates globally were going into negative territory. At that time, market action was pulling Japanese yields down. Now, the market is tugging them higher in sympathy with other rates globally.

Effectively, the BoJ's target is an interest rate peg—which is inherently unstable. It works as long as the target isn't far off the market rate. But when the market moves, officials must intervene to preserve the peg. That appears to be what happened last year. As bond yields rose globally, they pushed JGB yields higher, hitting the BoJ's then 0.25% target.

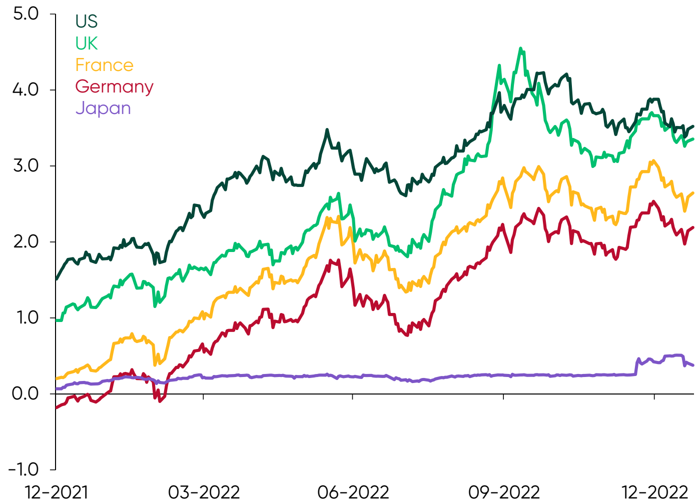
After long rates fell globally in December, BoJ announced it was raising its targeted trading bandwidth to 0% +/- 0.5 percentage point, moving the 10-year yield's effective ceiling from 0.25% to 0.50%. From a marketing perspective, the BoJ can claim a successful defence of its peg, though continuing to do so would invite more risks (e.g., speculative attacks)—thus, requiring a target hike. The update perhaps helps the BoJ avoid the perception of capitulation to the market, but it also addresses self-created yield curve distortions. For example, last year 8- and 9-year yields slightly exceeded JGB 10-year yields while longer maturities were much higher—a kink suggesting the 10-year yield would be higher if market forces were unhindered.

JGB yields rose in response to the BoJ's tweak, and many pundits posited Japanese investors would buy up JGBs—causing other developed market yields to rise and perhaps motivating investors to leave equities for sovereign debt. But we don't think the BoJ's minor move is a sea change. Yes, immediately following the move, 10-year JGB yields jumped from 0.26% to 0.41%.[xxxvi] They ticked higher and hovered around 0.5% in early January, but they have since retreated to 0.38%.[xxxvii] In our view, markets recognise this isn't a game-changing shift. Though the BoJ updated its 10-year JGB target, quantitative easing and the negative rate policy remain in place. Additionally, when the BoJ raised the 10-year yield's bandwidth, it simultaneously *increased* its monthly JGB purchases from $55 billion to $67 billion. In our view, these policies aren't stimulative because they discourage banks from lending, and we think they have flattened and distorted Japan's yield curve—banks don't have much incentive to take risk or lend to anyone but the most creditworthy borrowers.

xxxvi Source: FactSet, as of 24/01/2023. 10-year Japanese Government Bond Yield on 19/12/2022 and 20/12/2022.
xxxvii Ibid. 10-year Japanese Government Bond Yield, 31/12/2022 –23/01/2023.

Western sovereign debt yields rose in sympathy with JGB yields after the BoJ's announcement—but that stopped the next day. JGB yields' January rise also appears to echo other sovereign yields—a global move, not a Japanese-specific one. Moreover, while Japanese yields may be up a smidge from ultra-low levels, other developed economies' 10-year government bond yields remain far higher. (Exhibit 20) In our view, it seems unlikely the BoJ's move will drive a significant shift to JGBs. Note, too, the MSCI EAFE is up 8.1% since the BoJ's announcement—countering concerns investors would sell equities en masse for JGBs.[xxxviii]

EXHIBIT 20: JAPANESE BOND YIELDS ARE MUCH LOWER THAN DEVELOPED WORLD COUNTERPARTS



Source: FactSet, as of 24/01/2023. 10-year US Treasury, UK Gilt, German Bund, French Treasury and JGB yields, 31/12/2021 – 23/01/2023.

Now, the yield curve remains distorted as 8- and 9-year yields remain around 10-year levels, and the BoJ has continued intervening to iron out the kinks. In late January, the BoJ injected ¥1 trillion via money market operations to financial institutions to spur demand for five-year JGBs after their yields spiked mid-month. In our view, ongoing interventions are counterproductive and lead to odd outcomes. For example, in some cases, the BoJ now owns more than 100% of specific issues outstanding (by buying issues, lending them to banks and buying them back from the banks). Continuing bizarre monetary policy probably extends long-running domestic headwinds—a reason we prefer globally focused Japanese multinationals whose revenues aren't reliant on Japanese demand—while we think ending these programmes would be a net benefit.

But as with any central bank, the BoJ's decisions are unknowable. Moreover, current BoJ Governor Haruhiko Kuroda's term is set to end on April 8. Prime Minister Fumio Kishida plans to nominate a new BoJ governor in February, and with the terms of two Kuroda deputies ending in March, at least three new faces are coming to the BoJ. Many wonder whom PM Kishida will choose—and what that means for future BoJ monetary policy. We can't know that now. Whoever the new governor is, central bankers' moves defy prediction, as their decisions derive from their own biases and interpretations of economic data. Watch what they do, but for now, current BoJ monetary policy remains more of a headwind than help to economy, in our view.

xxxviii Ibid. MSCI EAFE Index returns with net dividends, in USD, 20/12/2022 – 23/01/2023.

EMERGING MARKETS COMMENTARY

CHINA RECAP: LOCKDOWNS FADING AND GROWTH AHEAD

After a difficult 2022 that saw the MSCI China Index tumble -31.2% through Q3, Chinese officials have changed tack dramatically on most of the issues that roiled sentiment.[xxxix] More relaxed COVID measures, alongside China's recent efforts to end a two-year Tech crackdown, support property markets and stimulate demand, have Chinese equities pricing in the likelihood of improved growth. From 31 October to yearend, the MSCI China Index rose 36.5%, vastly outperforming the MSCI Emerging Markets Index's 13.3%.[xl] We see room for further recovery as reality exceeds expectations.

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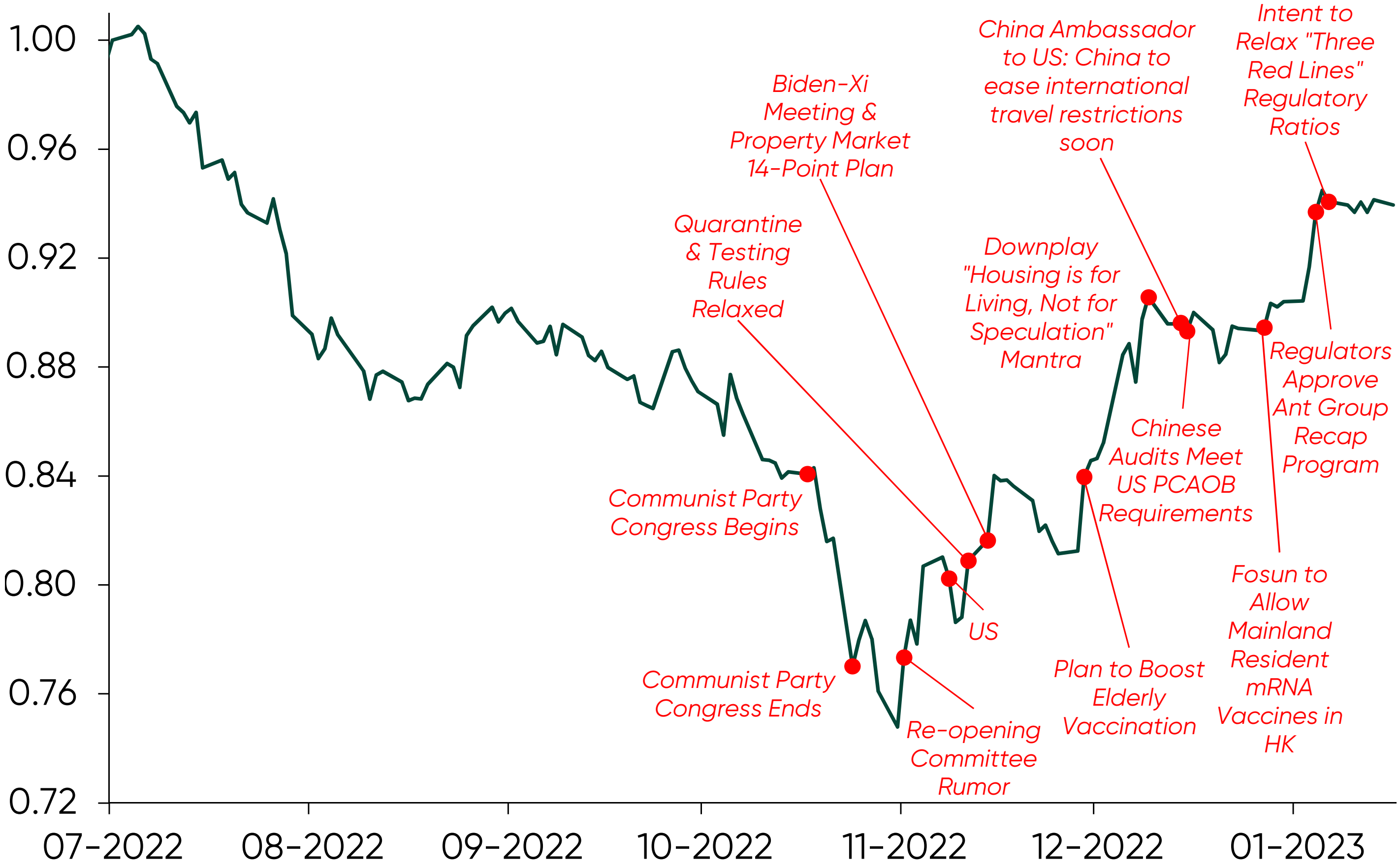
xxxix Source: FactSet, as of 19/10/2023. MSCI China Index returns with net dividends in USD, 31/12/2021 – 30/09/2022.

xl Ibid. MSCI China and Emerging Markets Indexes returns with net dividends in USD, 31/10/2022 – 31/12/2022.

EXHIBIT 21: CHINA TIMELINE AND MSCI EM PERFORMANCE



Source: Fisher Investments Research & FactSet, daily, USD, 01/07/2022 – 16/01/2023, USD. Performance is based on respective index relative to MSCI EM Index.

China started easing its zero-COVID policies in November, reducing quarantine times and making both domestic and international travel easier. Most expected a continued gradual easing from there, but on 7 December, authorities abruptly ended the practice of mass testing and strict measures that had prevailed the last three years. COVID infections are reportedly surging, creating near-term economic headwinds. But like previous reopenings in China and elsewhere, we expect economic activity to pick up before long, with firms better able to conduct business and restrictions on movement lifting.

Notably, while authorities have rolled back zero-COVID measures, restrictions haven't officially ended. However, they have lightened considerably, ending zero-COVID in practice if not in name. Exhibit 21 rounds up changes since last summer, but most importantly, in our view:

1. Negative tests are no longer required to travel or enter establishments that aren't designated high-risk (e.g., schools, retirement homes and health clinics).

2. Officials will likely disallow work stoppages unless an area is deemed high-risk.

After China reopened nationally in 2021, administrative regions still imposed restrictions when outbreaks flared, causing intermittent economic disruptions.

EXHIBIT 22: A SUMMARY OF EASING COVID GUIDELINES

Guideline Category	June 2022 COVID Guidelines	November 2022 COVID Guidelines	December 2022 COVID Guidelines
Quarantine - COVID cases	Centralized quarantine & treatment for all cases	Centralized quarantine & treatment for all cases	Home quarantine allowed for asymptomatic & mild cases
Quarantine - close contact with COVID-positive people	Centralized quarantine for 7 days + 3 days at home	Centralized quarantine for 5 days + 3 days at home	Home quarantine, with restrictions lifted for negative PCR test after 5 days
Quarantine - close contact with people who have had close contact with COVID-positive people	Home quarantine for 7 days	Close contacts of close contacts no longer identified and traced	Close contacts of close contacts no longer identified and traced
Classification for designating COVID risk in a given district	Applying high/mid/low-risk districts nationwide	Applying high/mid/low-risk districts nationwide	Applying high/mid/low-risk districts nationwide
Criteria for downgrading a district's risk level	Downgrade from high to mid-risk if no local cases for 7 days. Downgrade from mid to low-risk if no local cases for an additional 3 days.	Downgrade from high to low-risk if no local cases for 5 days	Downgrade from high to low-risk if no local cases for 5 days
Guidelines for international flights	International flight "circuit breaker" mechanism in place	No international flight "circuit breaker" mechanism in place	No international flight "circuit breaker" mechanism in place
Intra-China travel	Negative PCR test within 48 hours and 2 PCR tests in 3 days	2 PCR tests in 3 days	No PCR test requirement

Source: Government announcements. Shaded areas represent easing from prior guidelines.

Another way China appears to be prioritising growth in 2023: Easing the regulatory push aimed at bringing Tech and Tech-like firms in line with President Xi Jinping's 2021 "Common Prosperity" agenda. As Chinese Communist Party (CCP) secretary of the People's Bank of China (PBoC), Guo Shuqing, remarked recently, its regulatory crackdown "has been basically completed."[xli] While that is mere talk, there are early hints regulators are following their words with actions: approving games and allowing new user registrations and capital expansion.

For example, as 2022 closed, the China Banking and Insurance Regulatory Commission granted Ant Group the ability to more than double its registered capital after a restructuring that saw founder Jack Ma relinquish control. This comes after the company's late-2020 IPO was suspended abruptly. It appears one of the first firms to face increased scrutiny has now completed the process. Many outlets note the apparent symbolism and suggest authorities are sending a message. That doesn't mean regulations in place will reverse, but it suggests draconian new ones are unlikely, reducing uncertainty.

xli "Beijing Official Says Crackdown on Tech Companies Is Over," Laura Dobberstein, The Register, 10/01/2023.

However, we do see a caveat: The Chinese government is taking "golden shares" in some of its Internet giants. While they are small stakes, about 1%, they endow holders with special rights over management decisions, possibly giving them outsized influence and control. This particular arrangement appears unique to China's online platform companies, but the practice—proposed in 2016 and started in 2017—doesn't necessarily weigh on them or Chinese equities generally. They rose in both of those years. We also don't find golden share arrangements much different than the CCP establishing advisory committees on key companies' boards in other sectors like Financials and Energy. In our view, it mostly makes CCP influence more explicit. If that is the tradeoff for easing the broad regulatory crackdown, we think it is probably a net improvement.

On China's real estate front, officials plan to ease the "Three Red Lines" regulation introduced in August 2020 aimed at deleveraging China's property sector. The policy mandated: 1) property developers' liabilities below 70% of assets; 2) net debt below equity; and 3) money reserves greater than short-term debt. The proposed relaxation may ease some of these borrowing caps and extend the grace period for meeting targets, although the plans are still in deliberation and subject to change.

This comes on the heels of a host of measures aimed at helping illiquid but solvent developers. These include policy support to raise new funds through bond and equity issuance and access bank lending, loan repayment extensions, property funds to buy up units for rental conversion and homebuyer assistance—e.g., lowering mortgage rates until they are affordable for first-time homebuyers. Regulators' objective: prioritising the completion of unfinished pre-sold units and shoring up property firms' finances. More generally, President Xi's top economic adviser, Vice Premier Liu He, recently started calling China's property sector a "pillar" of the economy, hinting at the change in policy direction toward backstopping the market.

Property support is showing up in new lending. The PBoC cut banks' reserve requirement ratio 25 basis points 5 December, following April's 25 basis point cut, freeing up an estimated 500 billion yuan ($70 billion), which seems to have helped boost lending. Although aggregate financing decelerated further in December, new bank lending picked up. Corporate loan growth in particular jumped from 737 billion yuan in November to 1.21 trillion yuan in December, which was four times the amount a year ago.[xlii] Credit appears directed to state-owned enterprises to finance infrastructure development, but we think this shows authorities are ready and willing to stimulate growth as needed, in line with the government's recent rhetoric of growth as this year's top priority.

While Chinese policymaking remains opaque, with expectations low, we think regulatory authorities' shift to emphasise growth constitutes positive surprise. That could always change, but on its present course, we see further opportunity for China to deliver more upside.

THE POLITICAL SITUATION IN BRAZIL, PERU AND SOUTH AFRICA

In Materials-heavy Emerging Markets (EM), we see political uncertainty falling after Brazil's recent elections, Peru's government upheaval and South Africa's presidential scandal. However, we don't see this changing how their markets act longer-term, which key mainly off their respective commodity exposure.

BRAZIL'S UNAPPRECIATED GRIDLOCK

Brazilian President Luiz Inácio "Lula" da Silva defeated incumbent former President Jair Bolsonaro in October 30's second-round presidential runoff, returning him to office 12 years after he last held the post. The MSCI Brazil Index rallied ahead of elections and in the immediate aftermath, seemingly expecting political moderation from leftist Lula. For example, during campaigning, he went out of his way to court Brazilian business leaders, emphassing the pragmatism he exhibited during his earlier administration. He also brought on ex-rival Geraldo Alckmin as his centrist running mate (now vice president) and pledged support for the Banco Central do Brasil's independence, which it gained in 2021.

xlii "China's Corporate Loan Growth Picks Up on Rising Property Aid," Staff, Bloomberg, 10/01/2023.

Some also expected a contested election and the potential for civil unrest, but the vote went smoothly, protests didn't bring the nation to a standstill, and equities rallied as political uncertainty faded. That process continues in the aftermath of 8 January, when some of former President Bolsonaro's supporters stormed the presidential palace and other government institutions a week after the New Year handover. Fears of a power struggle engulfing the country haven't bourne out, and the political truce between Mr. Bolsonaro and President Lula appears to be holding.

However, since the election there has been growing concern over President Lula's fiscal policies and commitment to privatisation, which we think contributed to the MSCI Brazil's 2.4% return trailing EM's 9.7% in Q4.[xliii] In November, he proposed exempting social spending worth about 2% of GDP from the constitutional spending cap without indicating where the funding would come from, resurrecting deficit fears. The next month, he appointed leftist former Sao Paolo Mayor Fernando Haddad as finance minister, dashing hopes for a centrist choice. While nodding to fiscal responsibility, Finance Minister Haddad supported replacing the constitutional spending cap, perhaps signaling the administration's priorities.

Seemingly underscoring this fear, in December, Brazil's outgoing legislature approved an amendment to increase the cap by 1.6% of GDP for two years. Yet this was less than Lula requested and milder than an initial proposal for four years. Meanwhile, since assuming office in January, President Lula has called fiscal rules "stupidity," backtracked on ending a fuel tax exemption, revoked a late-term former President Bolsonaro corporate tax break and stopped privatisation studies of state-owned enterprises, including Petrobras, while nominating a political ally as CEO of the company.

In our view, though, all this recalls President Lula's first term. Debt and deficit concerns soared upon his election, only to fade later as he cut spending, serviced Brazil's debt, ran a primary budget surplus (adhering to an IMF programme and paying it off two years ahead of time) and made unpopular pension cuts to do so. Brazilian equities then traded with commodity markets, which boomed in President Lula's first term tied to burgeoning Chinese demand. They should return to trading with commodities before long this time, too, although we doubt it would be such a boom. Chinese iron ore demand isn't expected to resurge and commodity prices overall face some headwinds.

Fears should also subside as more realise bills face tougher passage in Brazil's new legislature, largely leaving the status quo unchanged. President Lula's Workers Party and its allies hold only 27% of the lower house and 17% of the Senate following the election, as right-leaning groups gained seats. This keeps his supporters short of a majority, likely forcing him to water down legislation and compromise with centrist Senators. Thus, the likelihood that any budget changes are as radical as proposed seems slim. We think the growing realisation gridlock reigns—and reins in legislative risks—should allow markets to better appreciate Brazil's positive fundamentals, particularly as falling inflation proves a stronger driver than political uncertainty.

PERU'S MARKETS MOVE ON FROM POLITICAL TURMOIL

After a tumultuous but legislatively inactive first year facing stiff opposition, Peru's leftist former President Pedro Castillo attempted to suspend Congress 7 December, rule by decree and convene an assembly to write a new constitution. But the plan backfired. The military and police didn't back him, his cabinet quit, the constitutional court deemed it a coup, lawmakers—including from his Peru Libre party—impeached him, and then he was arrested. Consequently, former President Castillo's Vice President Dina Boluarte assumed the presidency—with backing from parties that form Peru's right-leaning congressional majority—and appointed a centrist cabinet.

xliii Source: FactSet, as of 19/01/2023. MSCI Brazil and EM Indexes returns with net dividends, 30/09/2022 – 31/12/2022.

In response, former President Castillo's mainly rural indigenous supporters launched protests blocking roads, rails, airports and mining operations. President Boluarte declared a state of emergency and sent the military to confront protestors, killing dozens. Meanwhile, Congress granted the President's request to move elections to 2024 from 2026. But that didn't appease protesters, who are now marching on Lima to oust her.

While the situation remains tense, political chaos isn't new to Peru. President Boluarte is Peru's fifth president in three years. Moreover, all elected Peruvian presidents since 1985 have been in jail or faced arrest warrants. Insofar as a presidential takeover didn't happen, we think the initial resolution is likely a relief. But continued protests and an upcoming election—now moved up—add to lingering uncertainty.

Peruvian equities initially fell in the attempted coup's wake, but they have since soared in the New Year likely tied to falling political uncertainty and, importantly, rising copper prices—a heavy influence on Peruvian markets. Copper rose from $7,647 per ton at Q4's start to $8,387 at yearend, then further to $9,436 on 18 January as we write.[xliv] The MSCI Peru Index rose 17.4% last quarter, outperforming EM, and has notched another 11.7% gain to start the year so far versus EM's 7.7%.[xlv] That said, we don't expect copper and commodity prices to rise much, if at all, this year. That should cool Peruvian equities.

SOUTH AFRICA'S "FARMGATE" SCANDAL LEAVES STATUS QUO INTACT

With its 230 of 400 seat parliamentary majority, the governing African National Congress (ANC) blocked impeachment proceedings on 13 December against ANC leader and South African President Cyril Ramaphosa. The attempted impeachment stemmed from the "Farmgate" scandal, which involves an alleged theft ranging from $580,000 to upwards of $4 million hidden in a couch on President Ramaphosa's private game farm. He claims the cash was from selling buffalo, but instead of reporting the theft to police, he used his presidential bodyguard to track down the money. An independent parliamentary panel found preliminary evidence President Ramaphosa could have violated anti-corruption laws, leading to calls for impeachment.

Less than a week after surviving potential impeachment, he won the ANC's party leadership contest for a second term, as expected, keeping the presidency despite his—and the party's—rising unpopularity. His close allies within the ANC also won four of the other six top leadership positions, gaining one more spot than before. Although President Ramaphosa has consolidated party support, many are skeptical that will translate into policies addressing myriad problems plaguing South Africa's economy. These include record levels of daily power outages, which cripple business, and a decrepit rail system preventing key exports from reaching ports.

Meanwhile, following the ANC's national party conference in early January, it continues aiming to broaden the South African Reserve Bank's remit beyond inflation-targeting to support growth and employment objectives, which could threaten the central bank's independence. While worth monitoring, it is also a long-standing issue that has gone nowhere over the years. The factional party infighting hindering beneficial reforms also thwarts potentially harmful ones.

xliv Source: FactSet, as of 19/01/2023. LME copper price per ton, 30/09/2022 – 18/01/2023.

xlv Source: FactSet, as of 19/01/2023. MSCI Peru and EM Indexes returns with net dividends, 30/09/2022 – 31/12/2022 and 31/12/2022 – 18/01/2023.

The ANC is also pursuing land expropriation, extending fears about the sanctity of property rights from a market perspective (which sets aside the sociological considerations tied to South Africa's apartheid history). The National Assembly passed a long-stalled expropriation bill on 28 September, which now awaits the upper house National Council of Provinces' concurrence—where the ANC holds 54 of 90 seats. President Ramaphosa is urging its enactment, eyeing 2024 general elections, but legal challenges likely blunt land reform efforts if adopted.

Like other Materials-oriented EMs, South Africa moves mainly on the underlying commodity prices it is geared to—while politics generally take a backseat. We see President Ramaphosa remaining in power mostly entrenching a status quo markets are used to. In Q4, the MSCI South Africa Index rose 18.3%, reflecting the S&P GSCI All Metals Index's rise.[xlvi]

xlvi Source: FactSet, as of 19/01/2023. MSCI South Africa returns with net dividends, 30/09/2022 – 31/12/2022

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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