FISHER INVESTMENTS EUROPE™

MARKET PERSPECTIVES
REVIEW & OUTLOOK

THIRD QUARTER 2023

THIRD QUARTER 2023 REVIEW & OUTLOOK

TABLE OF CONTENTS

The below table of contents contains hyperlinks allowing the reader to quickly navigate to the desired section.

THIRD QUARTER 2023 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

3 November 2023

PORTFOLIO THEMES

- We believe this young bull market cycle will continue.
- Economic conditions, while slow, remain better than resurgent negative sentiment implies.
- In a slow-growth economy, high-quality, all-weather growth equities should lead markets.

MARKET OUTLOOK

- **Sentiment is behaving typical of an early bull:** Recirculated fears over inflation, US politics, a pending recession and narrow market breadth have dragged expectations lower. Yet the economic reality is brighter than these fears imply—providing room for upside surprise.
- **Anticipation is mitigation:** Widespread recession forecasts thus far haven't been realised and businesses have already taken cautionary measures to mute a potential recession if one comes.
- **Fourth year of a US president's term is a tailwind:** Global political gridlock will continue to sap legislative risk for the rest of this year and into next, an underappreciated positive.

Volatility cut both ways in Q3, lifting global equities to new year-to-date highs at July's end before a late-quarter pullback set in. The back-and-forth finished in a -3.4% decline for global markets on the quarter, although year-to-date returns remain nicely positive at 10.1%.[i] Emerging Markets (EM) also fell, down -2.9% in the third quarter and up a modestly positive 1.8% year-to-date at quarter's end.[ii] While negative sentiment could keep weighing on equities in the near future, we think the bull market's backdrop looks bright. Economic conditions appear better than most everyone expected, gridlock continues sapping legislative risk, and broader EM data has shown resilience. Better still, year four of the US presidential cycle lies ahead, extending political tailwinds globally through 2024 at least. With politics largely gridlocked throughout the developed world and sentiment broadly dour, reality has a low bar to clear to beat expectations.

Pullbacks similar to what we saw late in Q3 are normal in bull markets—even early bull markets. Equities endure a pullback of -8% or worse about once every two years, on average, since daily data begin in 1928.[iii] Larger bull market corrections of -10% to -20% are also frequent, with 34 occurring in the same span.[iv] While these pullbacks and corrections often rehash old fears and energise bearish media outlets, they fade into meaninglessness quicker than many investors think.

Since this bull market began last October, high-quality growth equities have led global markets, unusual for a young bull market. Absent a recession, investors are acting as they normally would later in the cycle when economic growth slows—rewarding the companies best able to maintain earnings in a torpid global economy. High-quality growth equities, with their large global footprint, diverse revenue streams and exposure to long-term trends, fit the bill. While this trend has persisted since the beginning of this cycle, returns were mixed in Q3. When equities' climb resumes, we expect high-quality growth to continue leading, though we remain flexible and we are continually monitoring this trend across markets and strategies.

While it is impossible to know when the rally will resume, it should have ample fuel when it does. US economic growth remains resilient, with all signs pointing to a mid-year acceleration—very different from the recession most pundits forecasted when the year began. Higher interest rates haven't deterred spending and investment, and continued loan growth adds economic support. In developed Europe, despite fears to the contrary, most countries continue notching slow growth. Even China, the subject of so many fears, is growing at prepandemic rates.

---

i Source: FactSet, as of 03/10/2023. MSCI ACWI Index returns with net dividends, 30/06/2023 – 30/09/2023 and 31/12/2022 – 30/09/2023.

ii Source: FactSet, as of 02/10/2023. MSCI EM return with net dividends, 30/06/2023 – 30/09/2023 and 31/12/2022 – 30/09/2023.

iii Source: FactSet, as of 05/01/2023. S&P 500 price returns,14/05/1928 to 04/01/2023.

iv Source: FactSet, as of 05/01/2023. S&P 500 price returns, 14/05/1928 to 04/01/2023.

Yet even as fundamentals remain stable, sentiment went backward in Q3. In the US, the debt ceiling standoff and Fitch's subsequent downgrade of the US's credit rating, the rising deficit, September's government shutdown worries, seemingly widespread strikes, resurgent oil and gas prices, the resumption of student loan payments and Fed forecasts of higher for longer interest rates all weighed on investors in the second half of Q3.

Rising European natural gas prices—with massive daily volatility—rekindled concerns of a brewing winter energy crisis, weighing on sentiment. Threatened strikes at two Australian liquefied natural gas (LNG) facilities further drove fears of production disruptions leading to a LNG shortfall and increased competition for global supply—causing prices to skyrocket like last year. However, disruptions aren't likely to be as severe as initially thought, prices are nowhere near last year's and workers at one export plant have already reached a deal. In our view, energy shortage warnings illustrate persistent skeptical sentiment in Europe—worth keeping in mind when weighing how expectations align with reality.

In Asia, Japanese economic growth continued to moderate. August retail sales and industrial production were flattish month-over-month, stoking further concerns about tepid domestic demand.[v] In our view, those contractions undercut the common narrative a weak yen boosts exports and Japanese markets. That thinking was always overstated, in our view, as currency swings bring both benefits and costs.

In EM, China's local government debt fears and hard landing worries have weighed heavily, though recent economic data has shown better-than-expected improvement. Their property sector woes continue drawing attention—particularly with Evergrande, the country's second-largest real estate developer, facing bankruptcy—this comes after more than two years of default warnings from Evergrande (and others). While these stories dominated headlines, the shock power appears very low. Meanwhile, although it garners less coverage, authorities continue taking steps to contain credit risks, such as the one trillion yuan local government debt swap program that began last month to refinance off-balance sheet financing vehicles under more favorable terms. Although there are real issues in China and growth is slowing, we think China's ability and efforts to avert a hard landing remain underappreciated.

Spanish politics provided an example of the political gridlock we have seen throughout developed markets as Popular Party leader Alberto Núñez Feijóo failed to secure the votes needed to become prime minister—opening the door for incumbent Prime Minister Pedro Sánchez of the center-left Socialist Party to form a government. PM Sánchez must win the support of pro-Catalan independence parties, which isn't a given and will likely require many concessions. If he fails, new elections likely follow in late 2023 or early 2024. Though that could stoke some uncertainty, the current struggle to put together a government highlights the fractures in Spanish politics—a recipe for gridlock, which bullishly decreases the likelihood of major legislative change.

Political uncertainty and fear over Brazilian President Luiz Inácio "Lula" da Silva's left-leaning government enacting vast spending and/or anti-market legislation remains high, also souring sentiment. However, with upcoming tax reform debates this fall, we should get clarity on aspects of this soon, which should help uncertainty start to fall—a plus, in our view. We think this and a backdrop of slowing inflation and an economy benefiting from resilient commodity prices are tailwinds for Brazil.

v Source: FactSet, as of 02/10/2023.

Finally, US political uncertainly is an increasingly large concern for investors as next year's election nears. Congress's six-week delay on a government shutdown will expire mid-November, almost certainly setting up another standoff. The US House of Representatives ousted Speaker Kevin McCarthy in a surprise vote in early October. Meanwhile, the public seems disenchanted with the prospect of a 2020 presidential rematch between President Biden and former President Trump, with a majority of voters on both sides preferring fresh choices. The longer the status quo drags on and the likelier a rematch becomes, the more discontent we expect. Yet underneath it all is the simple, bullish reality of gridlock. This divided Congress can grind out a compromise when absolutely necessary, as we saw with the debt ceiling and shutdown. But beyond that they are accomplishing little and should attempt even less as politicians focus on winning voters in next year's elections, helping calm the waters for equities and bonds alike. Absent major legislation affecting property rights, taxes and regulations, businesses can take risk and invest with confidence—a consistent yet underappreciated tailwind.

We will detail many of these topics in the full Review, but most are old fears that investors have already processed. These anxieties are a bull market hallmark, and a normal and healthy part of equities' climbing the wall of worry.

GLOBAL UPDATE AND MARKET OUTLOOK

3 November 2023

MARKET RECAP

THE BULL MARKET STALLS

Entering 2023, we forecast a year of recovery as post-Midterm gridlock brought legislative calm, economic conditions proved better than expected and sentiment—soured by 2022's bear market—proved too dour. Along the way, we expected occasional negativity, and it arrived in Q3. We see Q3's modest decline as a temporary pause in the bull market before a more lasting uptrend resumes.

Thus far, growth-oriented equities, including Tech, have led this bull market. These equities have twin tailwinds at their backs: One, as recent quarterly Reviews detail, equities that fall the most in a bear market typically bounce highest in the ensuing bull market. That favours growth and Tech after 2022's disappointment. But also, the absence of a global recession—and moderating growth rates—favour growth-oriented companies over value. Value firms, which centre in sectors like Energy, Industrials and Financials, tend to rely on economic activity to deliver earnings and sales growth more than Tech, which rides long-lasting trends. This isn't to say Tech has *no* exposure to economic conditions—it clearly does. It is a matter of degree.

These factors, in our view, largely underpin Tech and growth leadership in this bull market. When equities are up, Tech and growth usually lead. When broad markets are down, they lag and value leads. As Exhibit 1 shows, since the 12 October 2022 low, Tech and growth have outperformed on roughly 70% of up days. While that trend could change or break down, our Tech and growth emphasis has helped portfolios in this bull market. We expect that to resume once markets resume rising.

EXHIBIT 1: TECH AND GROWTH LEAD THE WAY HIGHER

	Tech Outperformed	Tech Underperformed
MSCI ACWI Up	71.5%	28.5%
MSCI ACWI Down	39.4%	60.6%
	Growth Outperformed	**Growth Underperformed**
MSCI ACWI Up	67.7%	32.3%
MSCI ACWI Down	42.5%	57.5%
	Value Outperformed	**Value Underperformed**
MSCI ACWI Up	32.3%	67.7%
MSCI ACWI Down	65.4%	34.6%

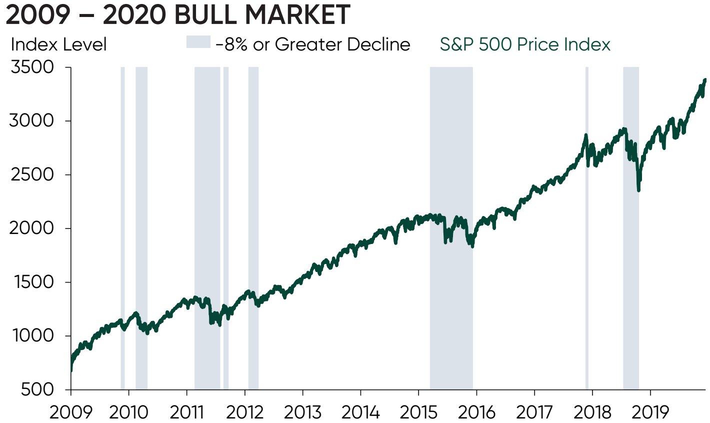
Source: FactSet, as of 09/10/2023. Frequency of MSCI ACWI Information Technology sector, MSCI ACWI Growth Index and MSCI ACWI Value Index daily returns exceeding or trailing the MSCI ACWI, 12/10/2022 – 06/10/2023.

Q3'S DECLINE: THE START OF A CORRECTION?

Many question whether equities have further to fall. Perhaps—it could be this bull market's first correction. Or it may be a soon-forgotten blip. Bull markets are jagged. Using the S&P 500's long history, only the 2020 – 2022 bull market saw zero negative quarters, and it was historically brief.[vi] Even declines of -8% from a high aren't unusual, and the current doesn't appear materially different from past pullbacks.

The 2009 – 2020 bull market had 8 pullbacks of -8% or greater. As Exhibit 2 shows, they were calls for patience—not signals of something far worse. Mini-corrections or corrections later may look bigger, but this is merely because an 8% move off a higher high is more in points.

EXHIBIT 2: PULLBACKS AND CORRECTIONS IN THE 2009 – 2020 BULL MARKET



Source: FactSet, as of 10/10/2023. S&P 500 Price Index, 09/03/2009 – 19/02/2020.

vi Source: Global Financial Data, Inc., as of 09/10/2023. S&P 500 quarterly total return in bull markets, Q4 1925 – Q3 2023.

If we identified a material negative few others saw with the magnitude to dent the massive global economy by trillions of dollars and therefore looked set to drive a bear market, taking defensive action may make sense. However, sentiment-driven moves start and end without warning and early volatility isn't uncommon—the 2002 – 2007 and 2009 – 2020 bull markets saw corrections or mini-corrections in the first year.

THE POWER IN THINKING LONG TERM

Breakevenitis—the temptation to exit markets, or materially alter a target asset allocation, at or near the pre-downturn high—is something we observe broadly and sometimes within our retail client base. To many, doing so makes sense: they didn't lock in big bear market losses by selling near the lows, and they seek to avoid a renewed downturn many investors, burnt by the prior drop, are convinced is likely.

Over long periods, breakevenitis' issues are even clearer. Exhibit 3 shows the 10-, 15-, 20- and 30-year annualised S&P 500 total return following the peak of every historical bull market. This presumes investment at the worst historical moments possible, tabulating returns from there.

EXHIBIT 3: HISTORICAL ANNUALISED RETURNS FROM BULL MARKET PEAKS

Market Peak	10-Year Annualized Return	15-Year Annualized Return	20-Year Annualized Return	30-Year Annualized Return
1929	-5.4%	-0.7%	1.6%	7.5%
1937	4.0%	7.8%	10.4%	10.5%
1946	15.2%	14.1%	12.7%	10.1%
1956	9.0%	8.0%	7.3%	9.5%
1962	7.0%	6.3%	6.7%	10.2%
1966	4.4%	6.3%	8.6%	10.7%
1968	2.5%	7.3%	9.1%	12.3%
1973	6.6%	9.8%	11.3%	10.6%
1980	13.2%	14.4%	15.4%	10.3%
1987	13.9%	9.7%	10.3%	9.4%
1990	16.5%	9.9%	9.2%	8.7%
2000	-1.8%	3.8%	6.3%	--
2007	7.5%	8.5%	--	--
2020	--	--	--	--
2022	--	--	--	--

Source: Global Financial Data, Inc., as of 10/10/2023. S&P 500 total return, calculated using monthly returns starting the peak month before the bear market, August 1929 – September 2023.

Volatility is one of market's favourite tools to trick investors out of equities. Today, many wonder why they should take equity market risks when Treasurys yield near 5%. For investors who desire only 5% nominal returns, the increase in yield is likely welcome, however equities annualise nearly double that in the long run. Particularly when accounting for inflation, the opportunity cost in the gap between equities' roughly 10% annualised long-term return and 5% is massive when compounded over 10, 20 or 30 years.

SENTIMENT REMAINS BULLISHLY DOUR

This bull market turned one year old on 12 October. While we do not yet have a formal 2024 forecast, the gap between sentiment and fundamentals suggests equities are likely to post more gains in year two—in keeping with history. No S&P 500 bull market has posted negative returns in its second year since 1932 – 1937's.[vii] And that bull market's second year was just -4%. Bull markets are much harder to stifle than almost anyone presumes. Looking forward, we see many reasons to believe Q3's dip was a pause in this bull market—which should resume climbing before long.

Pundits' focus on volatility, cash's increasing allure and more speaks to renewed negative sentiment. The wall of worry grew as worries over interest rates, the federal budget deficit, strong US dollar, government shutdown, strikes, continued bank worries, tapped out consumers (*e.g.*, student debt), China and more swirled. But all speak to sentiment remaining skeptical. As Sir John Templeton famously stated, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." The backdrop we see on Q3's heels isn't close to optimism. That leaves lots of room for reality to surprise positively, which is the lifeblood of bull markets.

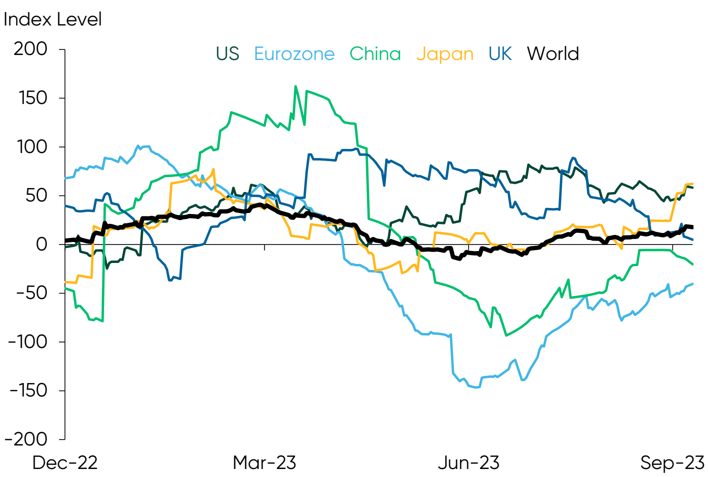
vii Source: Global Financial Data, Inc., as of 16/10/2023.

EXPECTATIONS RELATIVE TO FUNDAMENTALS

Economic and political factors suggest the likelihood of positive surprise is high. The global economy has defied widespread recession expectations, shifting ever-more forecasts toward the "soft landing" of slowing growth. Yet data suggest US consumers are alive and well while businesses are investing.

Incoming data are broadly beating expectations. Consider Citigroup's economic surprise indexes, which compare data releases to analysts' forecasts. When above zero, more data are beating expectations than missing. While some soft spots remain (*e.g.*, China and the eurozone), most regions are beating estimates. (Exhibit 4)

EXHIBIT 4: CITI ECONOMIC SURPRISE INDEXES



Source: FactSet, as of 10/10/2023. 31/12/2022 – 29/09/2023.

US loan growth has cooled but remains positive at 4.2% y/y in the week ended 27 September.[viii] Profits, too, are better than feared. In early July, analysts saw S&P 500 earnings falling -6.4% y/y.[ix] By the reporting season's end, though, they had fallen just -2.8%. Now analysts expect 1.3% growth in Q3 and double-digit earnings growth by mid-2024. If history holds, these estimates will likely prove low.

The Conference Board's Leading Economic Index (LEI) is the exception, but LEI tilts toward manufacturing. Data have long showed this sector to be weaker. Services—underrepresented in LEI—remain much stronger and are a far bigger portion of US GDP.

Politics are also playing out as we expected, with lots of talk and little happening since last year's midterms delivered great gridlock. As we noted last quarter, the period after the Midterm Miracle is generally still positive, but it isn't uncommon for gains to pause. However, that negativity usually doesn't last, and fourth years—election years like 2024—are typically good for markets. While many fear the tense chatter and environment elections bring, they usually don't see much material legislation—which is what equities focus on most.

THE WALL OF WORRY REBUILT

Q3 brought no shortage of worries, some retreads from bull markets past. In the US, these included the debt ceiling, a debt downgrade, consumer debt doom and a government shutdown standoff. Overseas, Chinese "hard landing" chatter persisted and fears of European wintertime energy shortages returned. While these fears weighed on equities in the short term, we think they are overstated—adding bricks to the bull market's "wall of worry."

THE PESSIMISM OF DISBELIEF PERSISTS

Economic sentiment remains skeptical. Consensus expectations shifted from an economic "hard landing" to a soft landing in Q3. Yet many seem convinced the stay is temporary, making it only a matter of time before monetary policy's famous long and variable lag spurs the long-awaited downturn—classic pessimism of disbelief.

viii Source: Federal Reserve Bank of St. Louis, as of 10/10/2023.

ix "Profits Are Making a Comeback," Justin Lahart, *The Wall Street Journal*, 11/10/2023.

But recession projections spur action—anticipation is mitigation. Businesses cut costs and slowed growth endeavours as if recession were already here. Some companies laid off workers; many others froze hiring. Firms slashed marketing budgets and squeezed operations to maximise output with their existing workforce. The upshot: Many businesses already prepared for a downturn. If or when recession arrives, companies won't have much excess to wring out.

Consider how businesses handled rising interest rates. Rates were low for decades before 2022. Businesses aren't irrational—they took advantage by building liquidity buffers and extending maturities on outstanding debt to lock in those low rates. Thus, today's rising rates aren't skyrocketing funding costs, especially for larger firms.[x] As a bonus, they boost returns for companies with high cash balances.

AI ENTHUSIASM

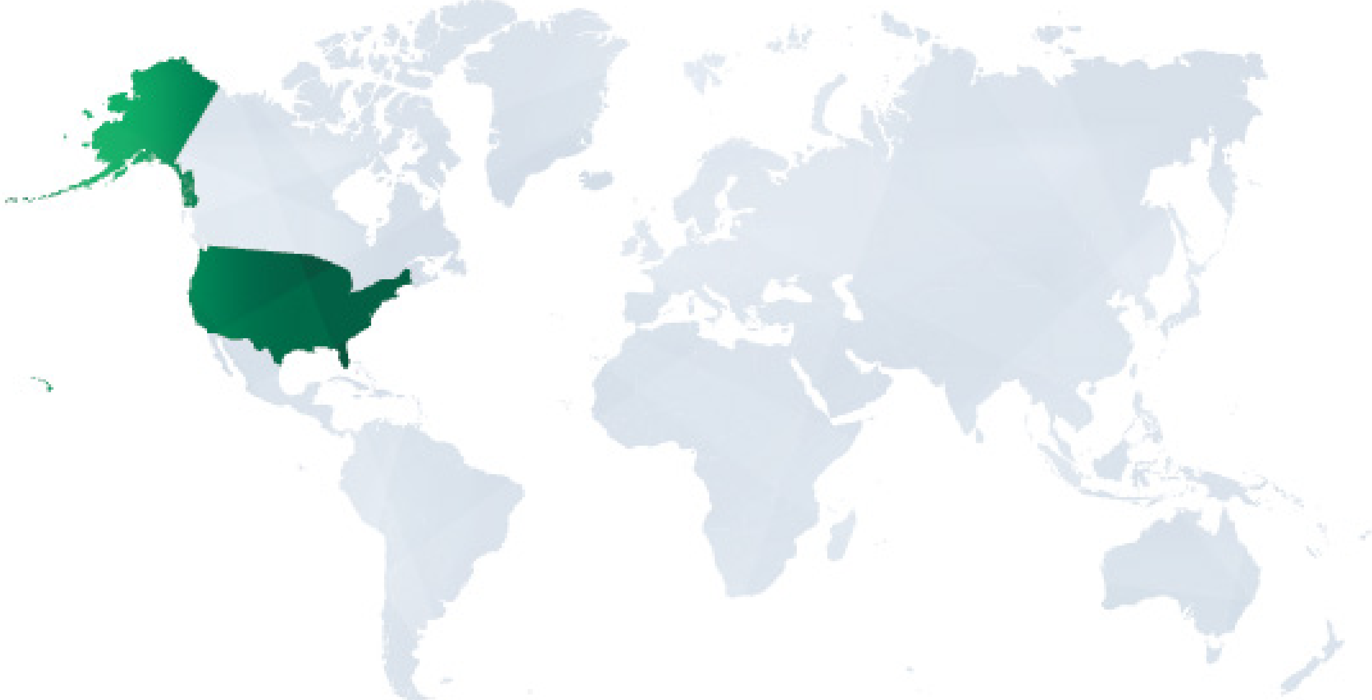
One area where enthusiasm remains: artificial intelligence (AI). Hype and hope remain hot as investors seek potential opportunities, from chip producers to cloud computing service providers. Many Tech and Tech-like holdings that we favour are leading development of AI technologies. We would also warn that trying to find the next big long-term winner is risky speculation—unwise.

We see many hopeful forecasts of AI-driven paradigm shifts, from revolutionizing health care to solving equity markets. (On the latter, there has been predictably little success.[xi]) It may be possible to identify which fields AI will likely impact, but we can't know when it will come to fruition (if at all). In our view, trying to determine AI's winners years down the line isn't possible—nor necessary for investors, as markets tend not to look beyond 30 months out. Today's media coverage is just sensationalism, with pundits milking the same old stories—with a tweak here or there—for as long as they can.

x "BIS Quarterly Review: International Banking and Financial Market Developments," Bank for International Settlements, September 2023.

xi "Can AI Beat the Market? Wall Street Is Desperate to Try," Justina Lee, *Bloomberg*, 02/10/2023.

UNITED STATES COMMENTARY



GOVERNMENT DEBT WORRIES

Debt ceiling chatter brought the usual faulty warnings of "default" if Washington didn't act. As ever, we noted politicians were very likely to reach a last-minute deal—and default wasn't really on the table. Incoming revenue more than covers debt interest, and the Treasury can issue to refinance maturing bonds—and the Constitution requires servicing debt before other expenses. Regardless, as we expected, Congress struck a last-minute deal in early June.

The theatrics didn't end there. In August, credit ratings agency Fitch downgraded America's credit rating from AAA to AA+, citing debt ceiling standoffs, partisanship and Social Security funding—perhaps spurring some market volatility. But history shows downgrades have little impact on markets. S&P's 2011 downgrade didn't end the 2009 – 2020 bull market. Yields fell after the move. Fitch's and Moody's 2013 British debt downgrades didn't tank UK markets or spike Gilt yields, either. Short-term volatility aside, downgrades don't doom markets.

Q3 closed with a government shutdown battle over discretionary spending for fiscal 2024. More threats and drama ensued before Congress delayed the decision to mid-November with a bipartisan deal hours before the deadline. This cost Republican Kevin McCarthy his House speakership.

Don't be shocked if shutdown worries spike as the November deadline nears, possibly weighing on markets. But government shutdowns don't punish equities (Exhibit 5), and none has ever caused a bear market or recession.

EXHIBIT 5: A HISTORY OF GOVERNMENT SHUTDOWNS

Shutdown at Midnight	Govt. Reopened	Days	S&P 500 Price Returns					
			Week Before Shutdown	During Shutdown (*periods vary*)	After Shutdown: 1M	3M	6M	12M
9/30/1976	10/11/1976	10	-1.6%	-2.5%	-3.2%	2.4%	-4.1%	-6.6%
9/30/1977	10/13/1977	12	1.6%	-2.6%	2.1%	-4.6%	-4.2%	11.5%
10/31/1977	11/9/1977	8	0.8%	0.1%	0.5%	-2.3%	3.7%	2.2%
11/30/1977	12/9/1977	8	-1.7%	-2.0%	-1.4%	-5.5%	7.8%	3.9%
9/30/1978	10/18/1978	17	0.7%	-1.2%	-7.5%	-1.8%	0.0%	2.1%
9/30/1979	10/12/1979	11	-1.0%	-3.9%	-3.4%	4.6%	-0.9%	24.0%
11/20/1981	11/23/1981	2	0.0%	0.0%	1.0%	-7.0%	-5.6%	10.3%
9/30/1982	10/2/1982	1	-2.7%	1.3%	9.6%	15.3%	25.4%	36.2%
12/17/1982	12/21/1982	3	-1.5%	-0.9%	6.6%	11.5%	24.0%	18.9%
11/10/1983	11/14/1983	3	0.6%	1.1%	-0.8%	-6.0%	-4.7%	0.6%
9/30/1984	10/3/1984	2	0.3%	-1.5%	2.4%	2.2%	10.4%	12.5%
10/3/1984	10/5/1984	1	-2.3%	0.3%	2.8%	1.0%	9.9%	12.3%
10/16/1986	10/18/1986	1	1.6%	-0.3%	2.4%	11.5%	20.1%	18.4%
12/18/1987	12/20/1987	1	5.9%	0.0%	1.1%	8.8%	8.6%	10.9%
10/5/1990	10/9/1990	3	1.8%	0.6%	-2.4%	0.6%	20.8%	21.4%
11/13/1995	11/19/1995	5	0.7%	1.3%	1.1%	8.0%	11.5%	22.9%
12/15/1995	1/6/1996	21	-0.2%	0.1%	3.1%	6.3%	6.6%	21.3%
9/30/2013	10/17/2013	16	-1.2%	2.4%	4.5%	7.4%	8.2%	8.2%
1/20/2018	1/22/2018	2	0.9%	0.8%	-3.3%	-5.0%	-0.3%	-5.0%
2/9/2018	2/10/2018	1	-5.2%	*N/A*	6.4%	3.0%	8.9%	3.4%
12/21/2018	1/25/2019	34	-7.1%	9.3%	5.7%	10.7%	13.7%	24.7%
Mean		**8**	**-0.5%**	**0.1%**	**1.3%**	**2.9%**	**7.6%**	**12.1%**

Source: FactSet, as of 23/09/2021. S&P 500 price returns, 30/09/1975 – 25/01/2020.

MANAGING GOVERNMENT DEBT

Parallel to the downgrade debacle, a CBO forecast alleged America's deficit would double in fiscal 2023, widening by $1 trillion versus 2022.[xii] This figure isn't real. It relied on excluding changes to Federal student loan repayment. But it dominated far more headlines than the actual $300 billion projected increase.[xiii] They painted an America careening toward insolvency and a "debt bomb," where the government borrows to pay interest, driving rates higher, forcing more borrowing—eventually collapsing the economy.

This is concerning, but far off reality. As we have explained in the past, the critical factor is a government's ability to pay its debt—which you can assess by comparing tax revenue with interest payments. Today, US interest payments' share of tax receipts is lower than all of the 1980s and 1990s, which were boom times for the economy—and equities.[xiv]

Rising rates won't change this immediately. Most interest payments are locked in at bond issuance. Furthermore, today's yields are far removed from the double-digit 1980s (which also didn't sink the US economy). To render costs prohibitive, rates must keep climbing and stay high for several years. This looks unlikely, given current bond market fundamentals. Not that we endorse running larger and larger deficits from here. But calamity looks distant.

xii Source: Congressional Budget Office, as of 11/10/2023.

xiii Ibid.

xiv Source: Federal Reserve Bank of St. Louis, as of 15/09/2023. Federal outlays (interest) as a percentage of federal receipts, annual, fiscal years 1977 – 2022.

CONSUMER DEBT WORRIES

Consumer debt fears surged on the news credit card debt hit $1 trillion as pandemic savings dwindled and student loan payments' restart loomed.[xv] All will supposedly conspire to derail consumers, supposedly the one resilient part of America's economy.

But things aren't so dire. US bank deposits were $17.3 trillion through 20 September, dwarfing credit card debt.[xvi] Large accounts skew this figure, but consumers are in solid shape. Just 8% of credit card balances were 90+ days delinquent, better than Q4 2019's pre-COVID 8.4% rate.[xvii] Total consumer debt's 90+ day delinquency rate is 1.5%, below the 3.9% average since 2003.[xviii] Note, too, households' liquid net worth neared all-time highs in Q2, with assets exceeding liabilities by near- record amounts.[xix] Combined with rising incomes and wages—now outpacing inflation—this suggests American households are faring better than appreciated.

Headwinds exist. Inflation remains elevated. Resumed student loan repayments will present challenges for some. But the latest data suggest Americans, overall and on average, aren't making major spending cuts. Spending is also generally more stable than other GDP components (*e.g.*, business investment or exports) since most goes to essential goods and services, so discretionary cuts usually aren't an economic swing factor.

INFLATION, INTEREST RATES AND SENTIMENT

Inflation has eased significantly. Fed rate hikes haven't induced a recession. Now economists project a "soft landing" of slower inflation and continued, if tepid, growth. In many ways, investors got what they wanted, though pessimism remains. For one, while inflation rates have cooled, prices haven't retreated, making inflation's improvement hard to feel. Two, Fed forecasts pointed to higher-for-longer interest rates, hurting sentiment toward bonds and the economy. It all creates ample room for uncertainty to fall, boosting returns.

INFLATION'S OVERLOOKED IMPROVEMENT

Mercifully, inflation has slowed. The Consumer Price Index (CPI) inflation rate, which peaked at 9.1% y/y in June 2022, sank to 3.0% a year later—matching the long-term average.[xx] While it ticked up to 3.7% y/y in August and September, this stemmed primarily from rising gas prices, not broad reacceleration.[xxi] Pricier gas is unpleasant but unlikely to last given rising oil production should tame prices at the pump. The other major component propping up CPI, shelter, should also ease. Both actual rent and Owners' Equivalent Rent—an estimate of what homeowners would pay to rent their house, which accounts for ~25% of the CPI basket—continue stabilizing.

---

xv Source: New York Fed, as of 06/10/2023.

xvi Source: Federal Reserve Bank of St. Louis, as of 10/06/2023. Deposits, all commercial banks, weekly, in week ending 20/09/2023.

xvii "Quarterly Report on Household Debt and Credit 2023: Q2," Federal Reserve Bank of New York, as of 06/10/2023.

xviii Ibid.

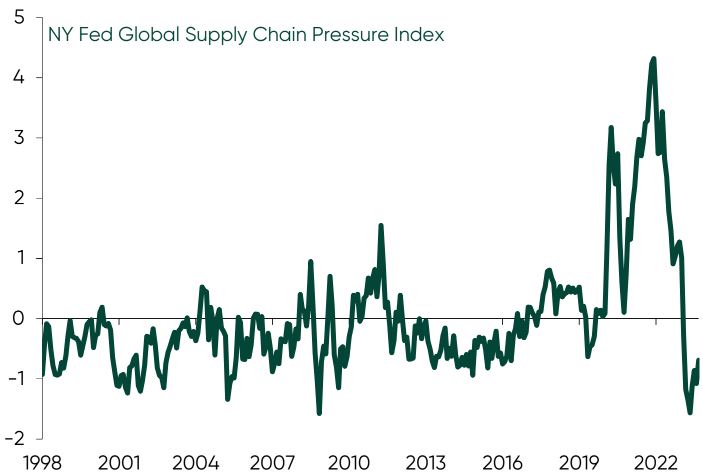
xix Source: Federal Reserve, as of 10/10/2023. "Financial Accounts of the United States – Z.1: 2023 Q2 Release." Liquid net worth here defines assets as foreign deposits, checkable deposits and currency, time and savings deposits, money market fund shares, debt securities (*e.g.*, Treasurys), corporate equities, miscellaneous other equity and mutual fund shares. Liabilities are outstanding loans.

xx Source: FactSet, as of 05/10/2023.

xxi Ibid.

While the inflation rate may bounce around, material reacceleration is unlikely. The factors fuelling 2022's spike are gone. As Nobel laureate Milton Friedman preached, inflation is always and everywhere a monetary phenomenon of too much money chasing too few goods and services. Both parts of this have improved. Supply chain conditions have eased significantly, reducing last year's shortages. Meanwhile, the pandemic-era money supply surge flipped to a shallow decline. Without surplus money in the system, there is no fuel to reignite prices. (Exhibit 6)

EXHIBIT 6: NY FED GLOBAL SUPPLY CHAIN PRESSURE INDEX AND M4 MONEY SUPPLY



Source: Federal Reserve Bank of New York and Center for Financial Stability, as of 09/10/2023.

For many Americans, though, sticker prices remain elevated, and—while slower—a lower inflation rate means they are still rising. But the case for "normal" or "improved" inflation never involved a return to 2021's prices. Getting there would require deep deflation, which is rare and, historically, devastating.

Deflation sounds appealing, conjuring images of cheaper living costs and improved living standards. But true, economy-wide deflation is quite rare, and its few appearances usually came alongside wicked recessions and severe credit crunches that destroyed money supply, businesses, jobs and incomes. One major example: the Great Depression's deflation. Between 1929 and 1933, Friedman estimates money supply fell -33% and money velocity (the rate at which money changes hands) plunged -29%.[xxii] Prices fell accordingly, and hardship ran rampant.

Deflation was a normal effect of bank panics throughout the late 19th and early 20th centuries, as Friedman's opus *A Monetary History of the United States*, 1867 – 1960, explored. The recession stemming from the slow unwinding of WWII-era economic policies in 1949 brought over a year of deflation—again a side effect of tough times. It returned intermittently in the mid-1950s, again accompanying recession, then stayed away until December 2008, in the wake of the global financial crisis. Prices sank throughout early 2009, with the deflation rate bottoming at -2.0% y/y that July, and didn't turn positive until November.[xxiii] Then, as in the Depression, deflation followed severe banking problems that brought a deep recession and brutal bear markets.

xxii Milton Friedman & Anna Jacobson Schwartz, *A Monetary History of the United States, 1867 – 1960*, Princeton University Press, 1963. P 352.

xxiii Source: US Bureau of Labor Statistics, as of 22/09/2023.

Today, returning the Consumer Price Index's level to December 2020's—before inflation spiked—would require a cumulative deflation of -15.2%.[xxiv] On a year-over-year basis, the only period meeting or exceeding that rate is 1921's intense deflation, which accompanied a deep recession.[xxv] Even if you adjust the needed cumulative deflation to an annualised rate (to account for the fact this inflation occurred over 32 months), it would take a -6.0% annualised deflation rate. The only two times the US experienced this since CPI data start in 1914 were the aforementioned 1921 and 1929 – 1933. It is hugely unlikely anything close to this develops.

2022's inflation is painful for consumers but beneficial for equities, which see the bulge filtering through the system even if people don't feel it. We are very near the end of the process, which lately includes faster wage growth—helping households restore lost purchasing power. As wages keep growing and living standards improve, the pain should recede further into the rearview, gradually lifting sentiment.

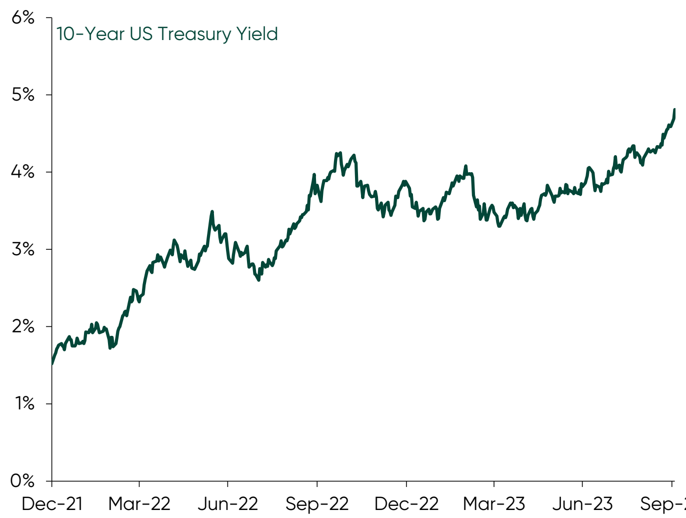
THE GREAT INFLATION AND INTEREST RATE DIVIDE

Long-term bond yields typically move with inflation, rising and falling as investors anticipate needing more or less compensation for rising prices over a bond's lifetime. Yet for the past six months, long rates rose as inflation slowed, flummoxing many. Now bonds are down slightly on the year, a frustrating sequel to last year's decline. Exhibit 7 shows the recent history.

We didn't share the general expectation for falling long rates this year, as we will discuss momentarily. But we do think rates' recent rise is likely a sentiment-fueled selloff tied to uncertainty over Fed moves and US deficit worries. On the Fed front, policymakers' September dot-plot of rate expectations projected rates staying "higher for longer" than prior forecasts, upending expectations for several rate cuts next year. On the deficit side, there is abundant chatter about rapidly rising bond issuance overwhelming demand.

Both seem overwrought. As previously outlined, public finances remain quite manageable. Treasury bond auctions are routinely oversubscribed. Data on international holdings lag a few months, but as of July foreign demand was up nicely. As for Fed policy, their decisions have less influence over long rates than you might think. If there were an air-tight relationship, long rates probably wouldn't have spent the better part of a year below short rates. Bond prices (and therefore yields) move on supply and demand, and the Fed is just one variable affecting the latter. Other factors usually matter more.

EXHIBIT 7: BOND YIELDS GRIND HIGHER



Source: FactSet, as of 04/10/2023. 31/12/2021 – 03/10/2023.

REVISITING OUR RATE OUTLOOK

To better understand bond market developments, let us return to 2023's start. Then, rates were falling from October 2022's relative highs and pre-pricing inflation's eventual return to normal. Alongside slow economic growth and dim sentiment, we thought this pointed to a continued, albeit modest, fall in long rates—and rising bond prices.

xxiv Source: US Bureau of Labor Statistics, as of 22/09/2023.

xxv Ibid.

Midway through Q1, our views—and conditions—changed. Inflation's improvement became much more well-documented, appreciated and factored into analysts' forecasts, bringing a high likelihood markets pre-priced it. Surprise power was gone. Meanwhile, economic fundamentals and sentiment were improving, giving yields even less reason to continue falling. This also made the yield curve unlikely to stay deeply inverted. A re-steepening yield curve entails falling short rates, rising long rates or some combination of the two. Continued rate hikes made falling short rates unlikely, rendering higher long rates the most probable outcome.

Long-term US Treasury yields' gradual rise from early April onward matched our expectations. After pre-pricing improving inflation, markets began discounting economic improvement. The risk aversion accompanying March's regional banking issues gradually faded as banks kept lending. Business investment reaccelerated. The Atlanta Fed's nowcast of Q3 GDP growth signalled a big acceleration. Even the beleaguered housing sector showed signs of life as low supply lifted home prices, encouraging new construction. Alongside modest bond supply increases and the Fed's continued balance sheet unwinding—and widespread expectations for lower rates—long rates' upward drift looked reasonable to us.

Yet we don't think rates are likely to keep soaring. Many tied the latest volatility to the surprise ouster of House Speaker Kevin McCarthy and the prospect of a protracted contest to replace him. But we don't see a fundamental connection to bond yields. House gridlock isn't new, and contrary to what credit raters like Moody's argue, shutdowns have little bearing on the government's creditworthiness. The Treasury keeps paying its bills during a shutdown, and as we showed earlier, no shutdown ever caused a bear market or recession. Yields' jump therefore seems like a classic overreaction. Typically, such selloffs reverse quickly.

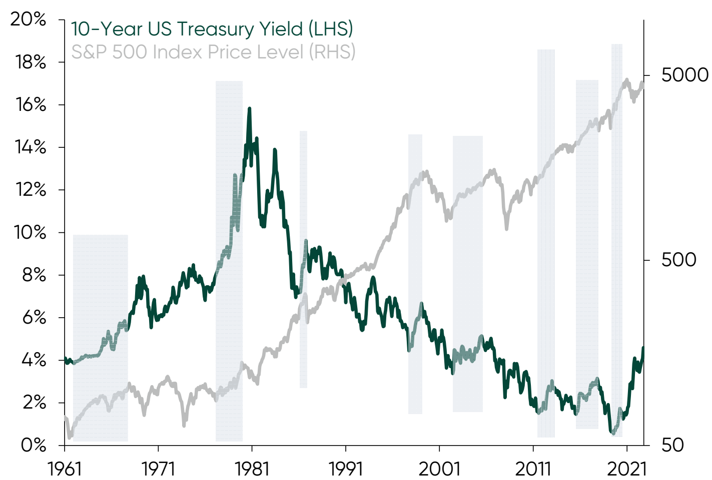
AS FOR INTEREST RATES AND EQUITIES

Bonds aren't rate fears' only target. Equities are also impacted, with many tying the pullback to talk of higher-for-longer rates. Bears generally make two points. One, higher rates mean business investment will shrivel, sapping earnings and growth. Two, with rates up, people won't see a need to take risk in equities—the end of the *there is no alternative* stance that allegedly propped equities in the 2010s.

In our view, neither claim is valid. Business investment has been fine thus far, rising seven straight quarters prior to Q3 2023's minor, -0.1% annualised decline despite rising rates. Business loan growth slowed substantially but remains positive, and corporate bond issuance is having a banner year. Businesses still have plenty of access to capital to fund future growth.

As for equities' and bonds' allegedly fraught relationship, the data don't support it. Since 1962, the correlation between US 10-year yields and S&P 500 price returns is -0.05—functionally meaningless.[xxvi] As Exhibit 8 shows, there are plenty of times where equities and yields marched higher together (albeit with wiggles along the way). While yields don't look likely to soar, it wouldn't automatically sink markets if they did.

EXHIBIT 8: EQUITIES AND BOND YIELDS CAN RISE TOGETHER



Source: FactSet, as of 09/10/2023. 10-Year US Treasury Yield (Constant Maturity) and S&P 500 Price Index (logarithmic scale), monthly, 31/12/1961 – 30/09/2023. Shaded regions indicate periods when both equities and yields rose.

xxvi Source: FactSet, as of 06/10/2023.

Some argue Tech is extra-vulnerable to higher long rates. Tech is a growth-heavy category, which means investors typically pay a premium now for longer-term earnings growth. Higher long-term interest rates, some claim, discount the present value of those future earnings, making Tech a bad investment. For proof, just look to Tech's lag since mid-July's year-to-date high.

But as we noted, Tech is outperforming on up days and lagging on down, so its Q3 lag is mostly about broad market volatility, in our view. Tech had plenty of good stretches alongside rising rates earlier in this bull market, like its big run from the date 10-year yields bottomed, 6 April, through the next three months. We rather doubt Tech suddenly realised in mid-July that yields were up and making future earnings relatively less attractive. Liquid markets are too efficient for that. Furthermore, big Tech has among the world's cleanest balance sheets—they don't need material debt financing now. That reduces rates' relevancy even more.

There are plenty other examples of rising rates accompanying positive Tech returns.

- In 2003, 10-year yields jumped from 3.13% to 4.60% between June and September—yet Tech rose 16.6%, beating global equities' 4.8%.[xxvii]
- Treasury yields climbed from 1.39% to 3.00% from July 2012 – January 2014. Tech equities rose 34.4%—trailing global markets' 37.1% but still nicely positive.[xxviii]
- From July 2016 – November 2018, Tech returned 65.6%—more than doubling global equities' 30.2% despite Treasury yields' also more than doubling (1.37% to 3.23%).[xxix]

The theoretical argument isn't valid, either. One, Tech's earnings aren't entirely distant. They are here and now: S&P 500 Tech firms delivered 4.0% y/y earnings growth in Q2, rebounding from the prior two quarters' decline.[xxx] The near future looks bright, too, with robust demand for high-powered chips, cloud-based services and other growing fields. Add in Tech's history of growing in a slow world—and Tech firms' low sensitivity to higher borrowing costs—and today's high rates seem unlikely to hurt future margins.

Sometimes Tech lags the market when Treasury yields rise, and sometimes it leads—but it doesn't fall automatically. Here, too, correlations shed more light. Over the past 20 years, the weekly correlation between Tech returns and Treasury yield moves is 0.23.[xxxi] This means they tend to rise and fall together modestly more often than not, albeit not enough to be statistically significant. If rising rates were truly bad for Tech, the correlation would be deeply negative.

xxvii Source: FactSet, as of 28/09/2023. US 10-Year Treasury Yield, MSCI ACWI Information Technology sector and MSCI ACWI Index returns with net dividends, in USD, 13/06/2003 – 03/09/2003.

xxviii Ibid. US 10-Year Treasury Yield, MSCI ACWI Information Technology sector and MSCI ACWI Index returns with net dividends, in USD, 24/07/2012 – 03/01/2014.

xxix Ibid. US 10-Year Treasury Yield, MSCI ACWI Information Technology sector and MSCI ACWI Index returns with net dividends, in USD, 08/07/2016 – 08/11/2018.

xxx Ibid.

xxxi Ibid. Correlation coefficient between MSCI World Information Technology price returns and the change in 10-year Treasury constant maturity yields, calculated weekly from 26/09/2003 – 22/09/2023.

POLITICS—A CONTINUED TAILWIND

With the GOP debates underway, 2024's US Presidential election is taking centre stage. Yet it remains too early to assess the outcome or market impact. The field is full, the votes relatively distant, and whether early frontrunners will go the distance is highly unclear. Usually, with an incumbent Democratic president, we could know there would be a re-elected Democrat or newly elected Republican. Even that is uncertain this year—it could be a new or re-elected Democrat. Or a new or re-elected Republican. Hence, we will reserve our views of how the contest is shaping up and the likely impact on markets until early 2024. But there are interesting items worth noting in the meantime, particularly equities' strong history of positive election years.

SET PARTISANSHIP ASIDE

First, though, as always when it comes to politics, we are nonpartisan, favouring no party nor any politician. Of course, each individual Investment Policy Committee member has their own ideology, beliefs and views of the candidates. But we set those beliefs aside in formulating a forecast, and the firm itself has no view on politics as they pertain to capital markets.

Political bias can blind and drive investing mistakes. This is particularly important to recall in election years when emotions run high. But basing investment decisions on them often hurts. In our experience, many investors—particularly during campaign season—fall into the trap of believing equities have a better chance if their preferred party or candidate wins. If they don't, supposedly, markets will tank. But market history argues otherwise.

As Exhibit 9 shows, there are good and bad years under Democratic presidents. And good and bad years under Republicans. Bear and bull markets began and ended under each. Consider recent history: 2008's financial crisis began under Republican President George W. Bush but continued into 2009 after the election of Democratic President Barack Obama. It then bottomed under Obama and the ensuing bull market lasted the entirety of his term and most of Republican President Donald Trump's. Neither party is inherently bullish or bearish.

EXHIBIT 9: RETURNS BY PRESIDENTIAL YEAR

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 / Johnso	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., as of 10/10/2023. S&P 500 annual total returns, 1925 – 2022.

THE PATTERNS WITHIN THE PRESIDENTIAL PATTERN

While we haven't yet finalised our 2024 outlook, political drivers give us several reasons for optimism. One, the midterm miracle played out near perfectly, with the bull market starting in Q4 2022 and extending gains in the following two quarters—in keeping with history. Q3 was down, but that happened in almost half the third years since 1925. However, Q4 has been positive in 79.2% of third years, and no negative third-year Q4 has followed a down Q3 since 1943. It all speaks to gridlock's power extending through year three—and likely into year four.

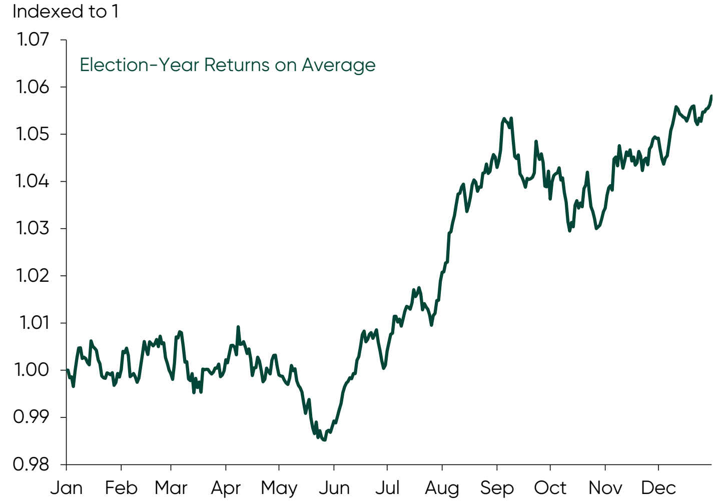
EARLY ELECTION YEAR UNCERTAINTY TYPICALLY FADES—BOOSTING EQUITIES

Many investors fear elections are bad for equities. But history doesn't support this. In the 24 election years since 1926, equities rose 20 times, an 83.3% frequency of positivity, with 11.4% average returns. This isn't as good as year three's 91.7% and 18.4%, but it is well above average. Furthermore, when second years were down—as 2022 was—the presidents' fourth year has been positive every time since 1932.

Regardless of who eventually wins, trends in political uncertainty are worth noting. Before the vote, the uncertain outcome—often fanned by campaigning—stokes fears of huge change, dampening investor sentiment. However, this enables falling uncertainty to boost equities later. Already, 2024 uncertainty is stirring. It is too early to assess the market impact, and politics is just one market driver, but the potential is worth weighing.

US House and Senate races will also crystalise, providing further clarity on the next government's configuration—and the parties' likelihood of enacting their legislative agendas. Then the general election clears remaining doubts. When markets know the likely outcomes they will be dealing with—whoever eventually prevails—they can move on. This typically happens late in the contest—one reason why election years are often back-end loaded, as Exhibit 10 shows.

EXHIBIT 10: AVERAGE RETURNS IN THE PRESIDENTIAL CYCLE'S FOURTH YEAR



Source: Global Financial Data, Inc., as of 10/10/2023. S&P 500 Price Index, 31/12/1930 – 31/12/2020.

Presently, it looks likely the presidential contest will feature President Joe Biden and former President Donald Trump. That isn't a foregone conclusion. But they have pole position despite surveys showing most people in both parties want someone different and in their view "better." Two-thirds of Democratic-leaning voters don't want President Biden as their nominee, while 52% of Republican voters prefer a candidate other than former President Trump.[xxxii]

But the longer the status quo drags on, the likelier it is to cement. The clock is ticking for challengers to gain serious momentum. "None of the above" may poll well, but actual names struggle. But given Biden vs. Trump is a broadly unwanted matchup—as the primary process frustratingly yields nobody "better" (which is always an opinion anyway)—if they seem set to cruise to the main event, it probably contributes to negative sentiment.

Yet this paves the way for political uncertainty to fall as the election year unfolds. Candidate dissatisfaction won't be permanent. Positive sentiment usually coalesces around primaries' winners as challengers fall away and support for the nominees swells. Eventually we will have a general election winner, along with the general sentiment that the winner isn't quite as bad as everyone thought, which can bring big late-year rallies.

xxxii "Poll: Two-Thirds of Democrat-Leaning Voters Don't Want Biden as 2024 Nominee," Shauneen Miranda, Axios, 07/09/2023. "Trump Stays Dominant in GOP Race," Patrick Murray, Monmouth University Polling Institute, 26/09/2023.

THE FIELD WILL EVENTUALLY NARROW

Anything can still happen, but the odds of fresh challengers next November are narrowing as Republican hopefuls fail to make headway against Trump. Meanwhile, Democrats whisper about President Biden not running, but the remaining formal challenger (Marianne Williamson) is irrelevant in polls. The rest of the party, to the extent they harbour reservations about a second Biden term, has been good at keeping them bottled up.

What could change to shake things up? On the Democratic side, the whisper campaign about President Biden's mental fitness could grow louder, spurring more viable challengers. Or party luminaries, perhaps former President Barack Obama, could usher him to the exit. Or his son Hunter's mounting legal woes could prompt President Biden to decide to pardon him then step aside. This could happen early enough for a primary race, or it could happen later with horse-trading and a coronation at or after the convention. But the ramifications of the latter are potentially vast.

On the Republican side, perhaps former President Trump's legal woes become too time-consuming for him to campaign—particularly the ongoing civil case threatening to unwind his business. Or, what if one of his criminal cases lands him in jail? Nothing says a president can't run and win from a cell, but will GOP delegates bless this? There are no answers to any of the above. But everything should gradually come into focus, reducing uncertainty.

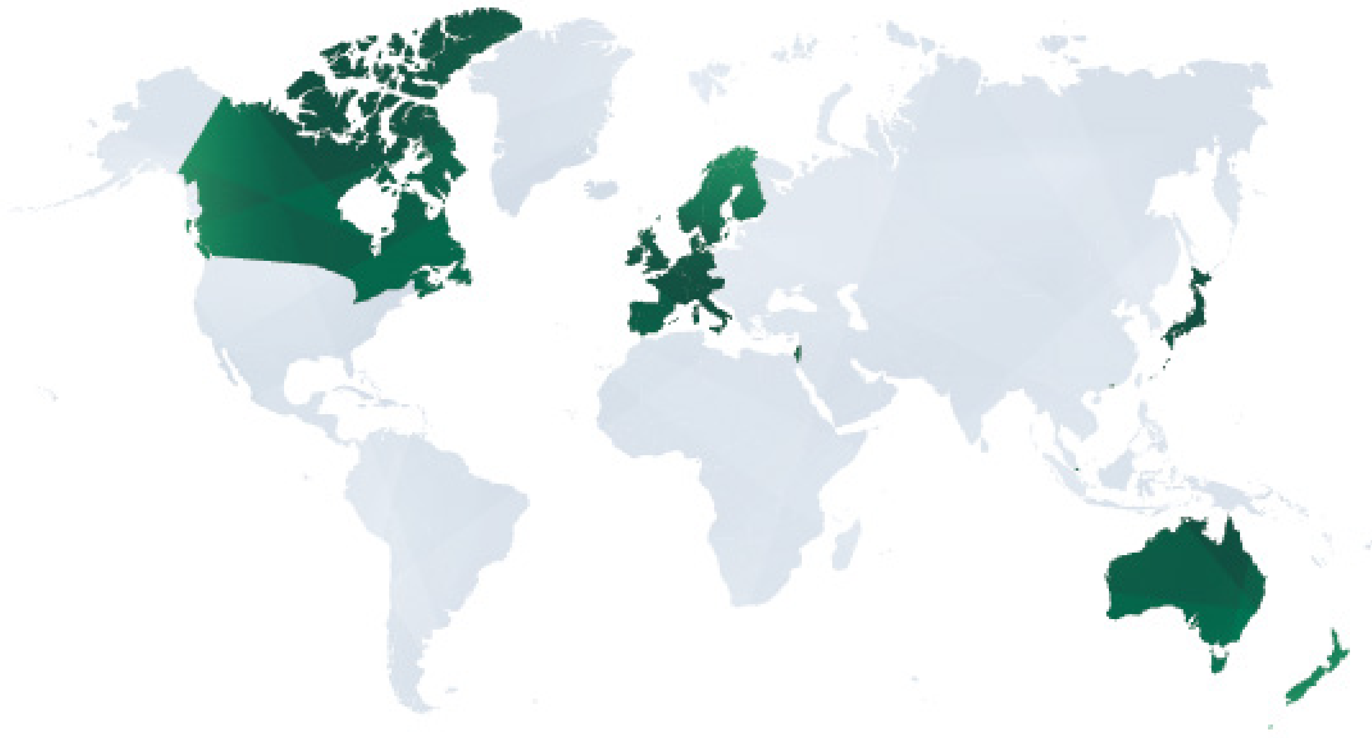
This probably won't happen in Q4. But election odds should firm in Q1 as primaries (especially South Carolina's in February) clear the fields. While primaries and caucuses will run through June ahead of the Republican National Convention in July and Democrats' in August, much of the dust should settle well before then.

South Carolina will be a key state because it is generally more indicative of national trends—one reason Democrats moved up its primary to kick of their nomination process on 3 February. South Carolina's Republican primary takes place on 24 February. Michigan comes three days later, with Super Tuesday a week after that. By 5 March, 49% of Democratic delegates and 43% of Republican will be decided. The main contests should be settled around then unless something changes drastically. This should allow both parties to pivot to the general election, helping steer rhetoric from rallying the base to courting independents (whom now-Independent candidate Robert F. Kennedy, Jr. will also be vying for).

Parallel to this, party infighting probably settles down as all focus on the ultimate prize, further reducing negativity. Democrats so far look pretty good at keeping internal discontent quiet while supporting President Biden publicly, but the anonymous briefing against him is nonetheless weighing. Republicans are louder, staking out more extreme positions to draw attention—shining a spotlight on discord and contributing to voters' angst. But if former President Trump remains the GOP's dominant force by Q1's end, expect them to close ranks and toe the party line.

Political uncertainty likely weighs in Q4 and into 2024, perhaps unsettling markets a bit. But investors who know what to expect—when they are expecting election outcomes—are better prepared to navigate political cycles, even when they throw curveballs.

GLOBAL DEVELOPED EX-US COMMENTARY



INTO PERSPECTIVE: MARKETS AND HAMAS' ATTACK ON ISRAEL

Over the 7 – 8 October weekend, terrorist group Hamas launched a major, brutal surprise attack on Israel and Israeli civilians, claiming many hundreds of lives—a tragedy of epic proportions. Hezbollah, the southern Lebanon-based terror group long affiliated with Hamas, also fired rockets, and there are fears of Israel's northern border becoming a second front. Intelligence since the attack implicates Iran supported the operation. In response, Israel has begun a counteroffensive against Hamas positions in Palestine and Hezbollah.

Many fear the market implications of conflict in the Middle East, one of the world's most volatile regions—fretting the impact on markets and oil prices. But in our view, this is much more a humanitarian crisis than a market one at this point. The situation is worth monitoring, but does little to change our view that global equities should continue to rise in a year of recovery.

SCALING THE ECONOMIC EFFECTS

Fundamentally, Israel, Lebanon and Palestine are minor contributors to the global economy. The three totaled just over half a percentage point of global GDP in 2021 (the latest data available for Lebanon and Palestine).[xxxiii] Israel is the largest share of this, at 0.5% of world output. There will likely be an effect on growth tied to the conflict, especially as people leave normal life and the Israeli Defense Force mobilises. Lebanon and Palestine will likely also see effects, but the two are 0.02% of global GDP apiece and the former has dealt with self-created economic crises tied to government instability, corruption and central bank mismanagement for years.

THE ENERGY EFFECTS

Beyond the direct impacts, the Middle East always conjures images of oil and harkens back to disruptions in the 1970s, perhaps even last year's Russian invasion of Ukraine, given the heavy oil and gas industry exposure. But even here the effects don't look huge presently. While Israel instructed western oil firms to temporarily shutter natural gas production from a field near Gaza tied to security concerns, there is little other oil infrastructure involved. That field mostly serves Europe, and European gas storage filled much faster than normal this year as LNG imports from the US, Norway and elsewhere fill the gap left by Russia. In early October, S&P Global estimated European storage was 96% full—above last winter's peak.[xxxiv] The outage of fields in Israel isn't great, but this significantly mutes the impact.

On oil, Brent crude initially jumped 4% on Monday, 9 October—the first trading session after Hamas' attack—hitting $91.37 per barrel.[xxxv] But since then, it sold off, retracing the entire post-attack gain. This makes sense when you consider the *fear of disruption* drove the initial jump, but the reality is oil supplies haven't been disrupted—at least thus far.

ON MARKETS

Many feared the conflict would stoke risk aversion and drive a large-scale equity market decline. Israeli equities have, understandably, fallen -6.1% in shekels and -7.4% in USD in the three days since the attack.[xxxvi] But global response has been entirely different: Global equities rose in each of the first three days after the attack, climbing 1.9% in price terms.[xxxvii]

This doesn't surprise us: While sentiment can sway markets short term for any or no reason, there is a long history of regional conflicts. They rarely cause material negativity because the impacts tend to be too localised to affect the profit outlook for major companies over the next 3 – 30 months, the window we think markets focus on most. Yes, last year's Russian invasion of Ukraine did contribute to the sentiment-driven bear market, but it was one of many factors that roiled sentiment, including Chinese economic and regulatory uncertainty, global inflation, supply chain issues, global central banks' surprising policy reversal and more. Then, too, fears of NATO involvement had people fearing the worst sort of escalation. So it looks like an outlier, in our view.

Even in the Middle East, regional conflict doesn't have a lasting spillover into global returns. Investors associate Middle Eastern conflict with sky-high oil prices—and therefore big inflation and equity market declines—because of 1973, when the Yom Kippur War led directly to the Arab oil embargo, contributing to the early 1970s' bear market. But this was the exception, not the rule. Other conflicts involving Israel didn't trigger similar backlash, and in the wake of the Abraham Accords, other improvements in Arab-Israeli relations and the lack of unity among Arab nations today, an embargo is highly unlikely now. Hence, we think the other examples in Exhibit 11 are better parallels for the present.

---

xxxiii Source: World Bank, as of 12/10/2023. Databank for Israel, World and Lebanon; "Palestinian Territories Macro Poverty Outlook" for Palestine.

xxxiv "EU Gas Storage Fullness Surpasses 2022/23 Peak: GIE," Stuart Elliott, S&P Global, 03/10/2023.

xxxv Source: FactSet, as of 12/10/2023.

xxxvi Source: FactSet, as of 12/10/2023. MSCI Israel Index price returns in local and USD, 06/10/2023 – 11/10/2023.

xxxvii Ibid. MSCI ACWI Index price return in USD, 06/10/2023 – 11/10/2023.

EXHIBIT 11: SELECTED REGIONAL CONFLICTS AND EQUITIES

Global Events	Full Conflict	Months After Start		
		1	6	12
Suez Crisis (1956)	1.6%	-3.9%	0.5%	-8.1%
Six-Day War (1967)	3.6%	3.6%	9.4%	16.6%
Yom Kippur War (1973)	0.8%	-3.7%	-13.8%	-38.4%
Iran–Iraq War (1980)	180.0%	1.6%	5.7%	-6.9%
Iraq-Kuwait Invasion (1990)	6.8%	-7.8%	-0.6%	14.1%
Desert Storm (Gulf War) (1991)	12.5%	13.0%	19.1%	31.9%
Iraq Invasion (2003)	65.4%	2.2%	19.4%	29.0%
Israel–Hezbollah War (2006)	0.9%	0.8%	14.2%	25.7%
NATO-Libya Conflict (2011)	-0.8%	2.2%	-4.0%	12.6%
Crimea Annexation (2014)	0.9%	1.6%	9.2%	17.1%
Russia-Ukraine War (2022)	?	6.1%	-4.6%	-5.9%
Average	-	**1.4%**	**5.0%**	**8.0%**
Median	-	**1.6%**	**5.7%**	**14.1%**
Percent Positive	**90.0%**	**72.7%**	**63.6%**	**63.6%**

Source: Global Financial Data, Inc., as of 12/10/2023.

And these aren't the only examples: Conflicts in Bosnia and Kosovo came during the 1990s' bull market. So did the Korean War in the early 1950s. And the Syrian Civil war in the last bull market, which many feared would prove a proxy war between the US and Russia—a tinderbox.

ON ESCALATION

As ever, the main fear is escalation. Some analysts warn Iran's reported complicity in the attacks mean it could see impacts. They warn it could disrupt regional oil supply—likely through escalated Western sanctions—but Iran hasn't been a major player in global markets for years. Yes, some estimate Iranian production has climbed 600,000 barrels per day this year. If sanctions hit this, that wouldn't be great for supply. But it isn't insurmountable. Saudi Arabia and Russia ending this summer's output cuts would more than do it, if they chose to go that route, and long-running geopolitical tension between the Saudis and Iran suggest that possibility isn't far-fetched at all. Furthermore, if prices are high, producers in the US, Brazil and elsewhere could ramp output up more. And that is if sanctions hit Iranian production. Much of its exports go to China, which may or may not participate in Western sanctions on Iran.

Further escalations across the Middle East and disrupting oil traffic in the Red Sea and shipping through the Suez Canal are theoretically possible, but this seems distant today. Weighing probabilities of those events occurring is mere speculation. In our view, the conflict between Hamas and Israel doesn't appear likely to derail the young bull market, although we are closely monitoring developments.

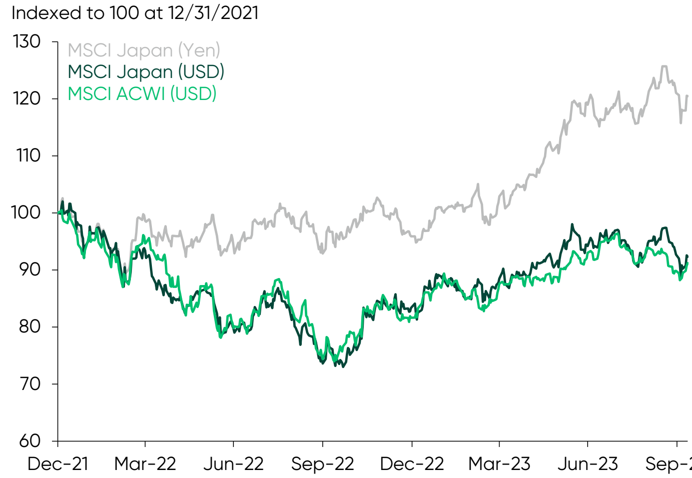
WILL JAPAN MEET LOFTY EXPECTATIONS?

While skepticism lingers toward the vast majority of developed markets, there is one noteworthy pocket of cheer: Japan. Globally, headlines noted Japanese equities' outperformance during last year's bear market and big year-to-date returns. Endorsements from major players like Warren Buffett, plus enthusiasm over the prospect of rebounding economic growth and shareholder-friendly policies at large Japanese firms, has set high expectations for the country. However, there is a catch, and while we think some Japanese exposure is beneficial, we think high hopes are likely to be disappointed.

It is true that Japanese equities skipped last year's bear market and soared to multi-decade highs this year—though only when measured in yen. That makes these returns imaginary for anyone not investing in yen. In US dollars, returns hardly look special and have largely tracked global markets. (Exhibit 12)

EXHIBIT 12: IN DOLLARS, JAPAN ISN'T SO HOT

Indexed to 100 at 12/31/2021



Source: FactSet, as of 12/10/2023. MSCI Japan total returns in yen and MSCI ACWI and MSCI Japan returns with net dividends in USD, 31/12/2021 – 11/10/2023.

Perversely, the weak yen is a big reason why there is so much enthusiasm for Japan. Conventional wisdom holds that a weak currency boosts exports, which is a big plus for an export-heavy nation like Japan. And in Q2, that perhaps appeared to hold: Exports' 12.9% annualised growth was primarily responsible for GDP's 4.8% rise.[xxxviii] However, there isn't much indication this is boosting broad domestic activity. Consumer spending and business investment each fell in the quarter, and industrial production has been weak all year. None of these are a surprise when you consider that a weak yen raises import prices, adding headwinds in an economy reliant on imported energy—as well as businesses that import components, raw materials and labour. Any weak yen positives from the export side of things could well be a wash once the associated costs are factored in.

Even exports' rise isn't what it seems. When the yen is weak, Japanese firms have two options for taking advantage. Following conventional wisdom, they can cut prices overseas to steal market share, boosting export volumes—and domestic production and investment as a result. Or, they can hold prices constant and reap larger returns from converting overseas revenue back into yen. Monthly trade data indicate many firms have opted for the second option, as export volumes have been negative on a year-over-year basis for the past 12 months. This echoes Japan's experience when the yen weakened sharply a decade ago at the start of late Prime Minister Shinzo Abe's long tenure. That didn't foster a domestic boom, and we doubt this time is different.

Equities move most on the gap between reality and expectations, and this doesn't look favourable for Japan right now. Sentiment seems too enthusiastic for there to be a big wall of worry, and positive fundamentals look too widely known to provide much of a lift from here. Shareholder-friendly reforms grab headlines, but the plans announced thus far are incremental and discussed globally—and likely priced in as a result. Moreover, these are all the result of measures passed during Prime Minister Abe's administration, which were widely discussed at the time. To the extent they were tailwinds, they are probably long since spent. Positive as they may be over the long run, they are likely part of the structural backdrop at this point.

Note, we aren't at all bearish on Japan. We think Japanese equities will participate in this global bull market. However, we think it is important to be selective and not get carried away. Large, export-focused multinationals likely have more potential than companies that depend on domestic demand, and they happen to be the prime beneficiaries of currency conversion. Domestically focused companies, however, likely face greater headwinds.

RENEWED EUROPEAN ENERGY FEARS

An old fear recently reemerged: wintertime energy shortages in Europe. Natural gas prices climbed starting in July on concerns about global supply, with fretting persisting into October after Hamas attacked Israel and Finland discovered a gas pipeline leak due to suspected sabotage. While these stories weighed on sentiment, supply fundamentals are in better shape than appreciated, in our view—which should help Europe once again weather winter better than feared.

European energy supply concerns aren't new. They were widespread last year after Russia's invasion of Ukraine sent natural gas prices soaring. Given Europe's dependence on Russian gas, many observers worried Western sanctions (and Moscow's retaliation) would leave the Continent with an energy shortfall, leading to rationing and blackouts—hitting economic activity hard.

That worst-case scenario didn't happen, but fear has lingered anyway. And now, new pressures rekindled worries. Q3 labour strikes at Australian platforms threatened Asia-bound liquefied natural gas (LNG) exports, which many feared would tighten global supply. In the Middle East, the Israel – Hamas conflict led to a shutdown of the Tamar gas field, straining Egypt's gas supply, which impacts European exports—and some worry a broadening regional conflict will have spillover effects. In northern Europe, Finland closed a gas pipeline

xxxviii Source: FactSet, as of 12/10/2023.

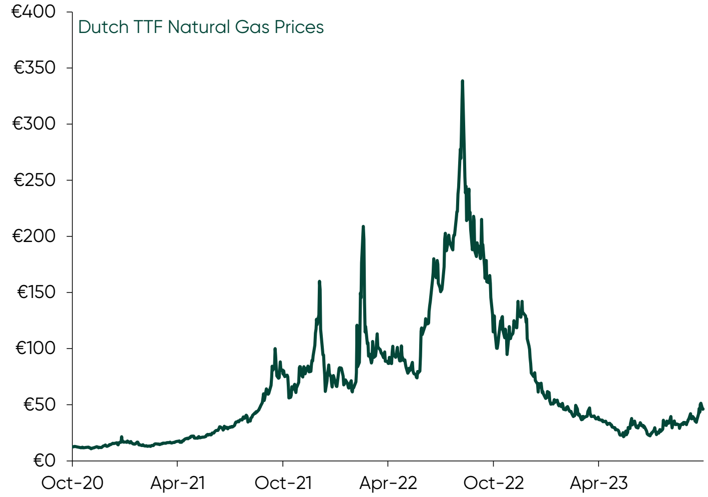
in the Baltic Sea over suspected sabotage, and some think instability in the region could affect production in Norway, Europe's largest gas exporter.

While each of these developments isn't sufficient to derail global supply on their own, they seemingly add up when taken in tandem. Yet there are many mitigating factors. For one, strikes like those in Australia are by definition temporary, and it seems as though Chevron, which owns the facilities, reached a deal with workers in mid-October. Beyond this, focusing on possible future supply concerns overlooks today's solid fundamentals. EU gas-storage levels hit pre-winter targets two months early, and German underground gas storage caverns are over 97% full. Some industry groups estimate the Continent's gas storage facilities already exceed last winter's peak, and research outfit Bruegel projects current levels would allow Europe to withstand a particularly cold winter—without any Russian gas.[xxxix]

Beyond this, France has more nuclear plants operational now compared to this point last year, when many were offline due to needed repairs. In Germany, officials have approved bringing coal plants online through next March, if needed to avoid shortages.[xl] Looking ahead, producers appear ready to add to supply, too. America exported a record-high volume of natural gas in the first half of 2023, and the Energy Information Administration projects continued increases over the next 12 months. African nations like Algeria are also boosting production to satisfy continental demand.

Note, too, that despite this summer's rise, European natural gas prices remain far off from last year's all-time highs. (Exhibit 13) Those record highs didn't lead to rationing or blackouts, so we think it is a stretch to argue today is automatically different. Considering Europe has been contending with elevated energy prices and supply worries for over 18 months, these developments also aren't surprising. While challenging for businesses and households, we think markets have likely pre-priced the impact already—and moved on.

EXHIBIT 13: EUROPEAN NATURAL GAS PRICES, OCTOBER 2020 – OCTOBER 2023



Source: FactSet, as of 17/10/2023. Dutch TTF natural gas prices, 17/10/2020 – 16/10/2023.

UK ECONOMIC AND POLITICAL TURMOIL

The UK grappled with many of the issues that hammered sentiment globally throughout Q3, including rising rates, shaky economic data and political uncertainty. The associated fears weighed on equities, sending the MSCI UK IMI into correction territory in price terms (and when measured in pounds) in early July and again in late August, contributing to a sideways bounce this year that has it lagging global markets. While we don't expect the UK to lead in a market where Tech and Tech-like companies lead, we still see plenty of room for improving sentiment to boost returns as uncertainty gradually falls.

xxxix "The European Union Is Ready for the 2023-24 Winter Gas Season," Ben McWilliams, Giovanni Sgaravatti, Simone Tagliapietra and Georg Zachmann, Bruegel, 10/10/2023.

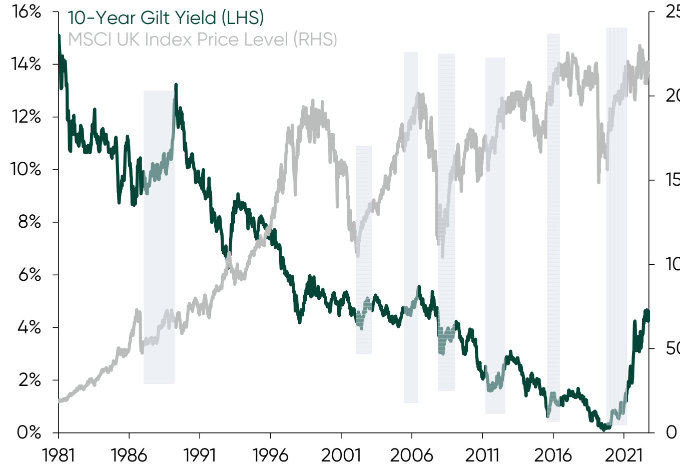
xl "Germany Approves Bringing Coal-Fired Power Plants Back Online This Winter," Staff, Reuters, 04/10/2023.

HIGHER LONG RATES AREN'T ALWAYS A NEGATIVE FOR EQUITIES

The counterintuitive combo of higher rates and falling inflation wasn't unique to the US. It also reigns in Britain, where 10-year Gilt yields hit their highest levels since 2008. Analysts tied this partly to the BoE's rate hikes—and forward guidance signalling higher-for-longer rates—as well as the stubborn budget deficit and the allegedly waning "kindness of strangers," which is a euphemism for foreign demand. In our view, all ignore that rates' move is global, making it hard to argue convincingly that negative UK-specific factors explain the increase. Like US bond markets, Gilt markets have gradually priced in better-than-expected economic conditions and modestly re-steepened the yield curve. And like US bond markets, they sold off sharply toward Q3's end—a sentiment-fueled move that appears detached from fundamentals. We doubt Gilt yields retrace their early-year lows, but they don't look likely to soar.

Nor are higher UK Gilt yields likely to be any more of a headwind than higher US Treasury yields. Since 1982, the correlation between 10-year gilt yields and MSCI UK Index price returns is -0.07, meaning they move in opposite directions ever so slightly more often than not.[xli] Statistically, it is a meaningless relationship. If higher Gilt yields were consistently bad for equities, we would expect a much deeper negative correlation. Instead, as Exhibit 14 shows, there are plenty of times historically where Gilt yields and equities have moved together. Note, too, that UK equities had many great bull market years throughout the 1980s, 1990s and 2000s when rates were as high as—or higher than—they are now.

EXHIBIT 14: EQUITIES CAN RISE WITH GILT YIELDS



Source: FactSet, as of 10/10/2023. 10-year benchmark UK Gilt yield and MSCI UK Index price level, weekly, 31/12/1981 – 06/10/2023. Shaded regions indicate periods when both equities and yields rose.

Some argue rising rates signal brewing debt problems that will take years of painful austerity to get under control. Chancellor of the Exchequer Jeremy Hunt seemingly underscored this when he opposed the prospect of pre-election tax cuts at the Conservatives' party conference. Others say it gives the country little wiggle room to deal with budget shortfalls in Birmingham and other local councils, potentially requiring the central government to borrow heavily to fund local bailouts. We think both are false fears.

On the austerity front, as Ken Fisher noted in his recent column for *The Telegraph*, the UK's debt service costs are quite manageable by historical comparison. Relative to tax revenues, debt interest payments are elevated compared to recent years but on par with levels seen throughout the 1980s and 1950s. While the latter was a difficult time of post-War austerity and rebuilding, the economy nevertheless demonstrated remarkable growth and resilience. The 1980s were also a period of strength for the UK economy and equities, which participated in a global boom. On both occasions, economic growth lifted tax revenues, helping keep debt interest manageable. It is already doing so now, with total current receipts up quite nicely.

xli Source: FactSet, as of 12/10/2023.

As for Birmingham and other councils' budget issues, we have seen several headlines (predominantly outside the UK) wrongly portray these as local government bankruptcies. In reality, the affected councils have issued Section 114 notices, which are formal announcements that the council's income will fall short of the next year's projected expenses. A House of Commons Library primer on this subject makes clear these *are not* bankruptcy notices and states, plainly, "UK local authorities cannot go bankrupt." The typical solution, according to the Commons, is local spending cuts that spare essential services. Occasionally, councils will seek government permission to sell assets to meet the shortfall, or the central government will "intervene in how council services are run," which the publication explains generally amounts to cutting non-essential services. Outside a handful of small grants to support essential social services, central government funds aren't involved.[xlii] So we think the image of HM Treasury borrowing significantly to bail out councils and creating a sovereign debt crisis seems far-fetched.

THE SURPRISINGLY STRONG POST-PANDEMIC RECOVERY

For well over a year now, pundits and policymakers alike bemoaned the UK economy's recovery from the lockdown-induced recession. Data showed GDP remained well short of its prior high, and its growth rate was the worst in the G-7—all seemingly incongruous with UK equities, which were some of the world's top performers in 2022 and hit all-time highs earlier this year.

Now, thanks to revised data from the Office for National Statistics, we know this was a statistical error. The latest figures show that instead of finishing Q2 0.2% below its prepandemic high, UK GDP ended June 1.8% above its year-end 2019 level.[xliii] Where the Bank of England and many other outlets forecasted a recession beginning in late 2022, UK GDP contracted just once, in Q3 2022, due primarily to the extra bank holidays associated with the late Queen's death and funeral. Modest growth of 0.5% annualised, 1.3% and 0.8% followed in the next three quarters, with business investment jumping in 2023's first half.[xliv]

Monthly data have been mixed in Q3, with rainy weather and industrial actions weighing at times. But they haven't been uniformly negative, and it remains to be seen whether contractionary purchasing managers' indexes translate to falling output. Last year, PMIs' signals proved false, with growth continuing despite contractionary readings. There is some evidence this is the case now. Monthly GDP's -0.6% m/m drop in July stemmed primarily from strikes hitting the transit, healthcare and education sectors.[xlv] Improvement on that front lifted GDP 0.2% m/m in August, driven by services' 0.4% rise.[xlvi] Manufacturing fell in both months, and the split between manufacturing and services output more or less echoes the divide between their respective PMIs. Manufacturing PMIs spent Q3 in the mid-40s, well under the 50 marker dividing growth and contraction, while services PMIs were in the high 40s. PMI readings on the bubble could usually go either way, as PMIs measure growth's breadth, not its magnitude. If the minority of growing businesses expand more than the shrinking businesses contract, output can still grow. This seemed to be the case for services in August, as it was throughout 2022's second half.

---

xlii "What Happens If a Council Goes Bankrupt?" Mark Sandford, House of Commons Library, 13/09/2023.

xliii Source: Office for National Statistics, as of 10/10/2023.

xliv Source: FactSet, as of 10/10/2023.

xlv Source: FactSet, as of 12/10/2023.

xlvi Ibid.

None of these indicators point to exceptional growth, but mixed results are better than the recession so widely expected at this year's outset. With many outlets now arguing higher interest rates' economic impact was merely delayed, expectations are low enough that mixed results likely qualify as positive surprise—generally all equities need for economic fundamentals to point positively. Reality needn't be great in a vacuum. Better than expected usually suffices.

POLITICAL GRIDLOCK REIGNS, BUT UNCERTAINTY COULD TEMPER THE BENEFITS AT TIMES

With the next general election now little more than a year away (it is due by January 2025), political gridlock is running hot. With Labour polling well, the Conservative government has little incentive to rock the boat with major, contentious legislation. Even if they did, intraparty divisions run deep—as highlighted by the strong grassroots support for former Prime Minister Liz Truss's speech on the fringes of the party conference. With long rates now above their levels at the apex of the mini-budget panic last autumn, people are broadly starting to rethink prior claims that her pro-growth agenda was uniquely bad for markets, hardening divisions among the party's various factions.

Typically, gridlock lowers equities' legislative risk aversion, providing a calm backdrop for investment, risk-taking and equity returns. Major bills, however well-intended, create winners and losers, and prospect theory dictates the losers' gloom outweighs the winner's joy, creating a net negative sentiment that weighs on equities. Politics is just one market driver, so higher legislative risk doesn't always show in negative returns—and gridlock's benefits don't always mean positive returns—but we have found this to be a consistent force.

Yet rising uncertainty can counteract gridlock in the short term, adding sentiment headwinds. Looking to 2024, it won't surprise us if rising uncertainty weighs at times, especially with Labour leader Keir Starmer signalling his intent to renegotiate the Brexit deal if Labour wins the next election. Prime Minister Rishi Sunak says he doesn't intend to reopen the agreement if he wins re-election, but it is up for its first quintennial review in 2025, and EU officials may find items they wish to revise. Therefore, it won't surprise us if this becomes a campaign issue, spiking uncertainty if the rhetoric runs hot. Other major economic policies from both parties could also stoke uncertainty as both continue trying to court businesses and everyday people alike. Brace now for big talk on taxes and regulations. We still think UK political drivers point positively, but short sentiment-fueled swings are possible.

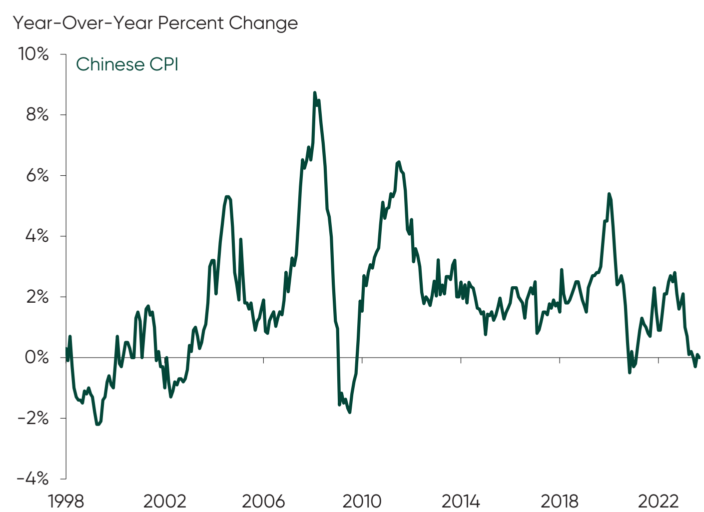
EMERGING MARKETS **COMMENTARY**

WHAT CHINA'S "DEFLATION" FEAR SAYS ABOUT SENTIMENT

To a growing number of bearish pundits, the fear of deflation haunts China. After its CPI briefly dipped negative year over year in Q3—and producer prices fell even more—pundits drew myriad parallels to Japan's "lost decade(s)" of economic malaise. But in our view, reality is likely to exceed expectations weighed down by depressed sentiment.

For many months, a steady drumbeat of headline coverage has suggested China's ongoing real estate implosion is a prelude to an economic hard landing. The National Bureau of Statistic's August release of July CPI, which showed it falling -0.3% y/y, seemed to cement concerns the country's property woes and debt troubles are set to broaden and escalate, crippling growth. (Exhibit 15)

EXHIBIT 15: CHINESE CPI DIPS NEGATIVE

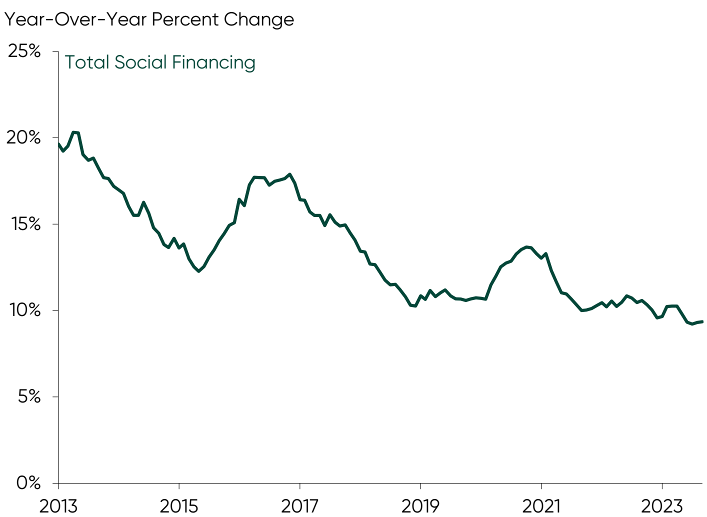


Source: FactSet, as of 12/10/2023.

This was China's first deflationary reading since the immediate reaction to COVID caused sharp economic contraction. Many fear deflation making debt harder to pay back, which would lead to mounting insolvencies, constricting credit and spurring a vicious cycle of further price and debt deflation. Or it could simply encourage consumers to cool spending, in hopes of getting cheaper prices later. Both, the theory goes, could hurt output badly.

Other July data seemingly confirmed the dire view. Exports plunged -14.5% y/y, accelerating downward from June's -12.4%, while industrial output and retail sales both slowed more than expected, to 3.7% y/y and 2.5%, respectively.[xlvii] Meanwhile, as Exhibit 16 shows, total social financing (TSF)—a broad measure of aggregate credit creation—decelerated to its slowest pace on record in July (9.2% y/y).

EXHIBIT 16: CHINESE CREDIT GROWTH SLOWED TO LOWEST ON RECORD



Source: FactSet, as of 13/10/2023.

But there are big holes in this thesis, in our view. For one, July's deflation was heavily influenced by one-off factors. The main driver was meat—specifically pork. Pork prices plummeted -26.0% y/y in July, August (-17.9%) and September (-22.0%).[xlviii] But these outsized drops are due to base effects from last year's shortages, as a years-long fight with African swine fever hit China's pig herds. Those shortages drove prices up massively last year, which is now the comparison in Q3 CPI data. An energy price snap-back dented headline CPI, too—the index's Transportation/Communication segment fell -4.7% y/y in July and another -2.1% in August.[xlix] Hence, excluding food and energy, core CPI accelerated from 0.4% y/y in June to 0.8% in July and has remained at that rate through September.[l]

Beyond CPI, some suggest the even-weaker producer price index (PPI) foretells more deflationary pressures for consumers to come, on the theory these factory gate prices precede final products in stores. But the data don't support this. Over the last two decades, China's CPI and PPI have a correlation of 0.44, showing a modest tendency to rise and fall simultaneously.[li] This is *higher* than PPI's correlation to CPI 3 months, 6 months or 12 months ahead. Even acceleration and deceleration are more coincident than forward looking.

Moreover, while TSF slowed to a record low 9.2% y/y in July—ticking up to a still relatively slow 9.3% and 9.4% in August and September, respectively—that is hardly a contraction, much less one akin to "textbook" debt deflations like the Great Depression, following Japan's 1990 crash and 2008 – 2009's global financial crisis. And in all three of those episodes, falling prices resulted *from* economic and monetary conditions, not the reverse.

xlvii Source: FactSet, as of 15/08/2023.

xlviii "China's Deflation Pressures Ease, More Steps Expected to Spur Demand," Kevin Yao and Joe Cash, Reuters, 10/09/2023. "China's Consumer Prices Stall, Factory Deflation Persists," Staff, Reuters, 12/10/2023.

xlix Source: FactSet, as of 18/10/2023.

l Source: FactSet, as of 12/10/2023.

li Source: FactSet, as of 11/10/2023.

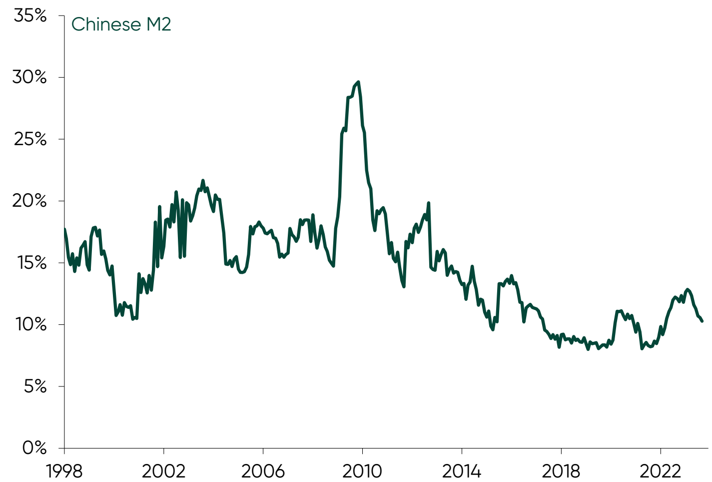
Inflation—and deflation—are always and everywhere monetary phenomena of too much (or little) money chasing too few (or many) goods and services. The Great Depression was chiefly about the US Fed errantly shrinking money supply by nearly a third during the 1929 – 1933 span, with the attendant bank failures compounding the effect. Japanese weakness as a result of 1980's bubble economy was much more about a lack of corporate and regulatory reforms to encourage competition, business failure and dynamism, as well as monetary policy errors that dissuaded lending. And, of course, 2008 – 2009's deflation was the byproduct of the financial crisis wrought by accounting rule changes that caused a cycle of bank write downs that destroyed capital and governments' haphazard policy responses.

Deflation by itself isn't necessarily problematic. For example, we don't think most would consider past technological deflations—when technology improvements cause prices to decline, like with mass production during the Industrial Revolution, illumination costs following electrification or personal computer and electronics prices in the last couple of decades—as particularly troublesome. While supply-driven abundance isn't cause for worry, persistent demand destruction may be—especially if accompanied by protracted money supply contraction.

Exhibit 17 shows this isn't evident in China. Like overall credit growth, Chinese M2 is decelerating, but it rose 10.3% y/y in September. Prolonged deflation is unlikely to take hold when both credit and money supply are growing.

EXHIBIT 17: CHINESE MONEY SUPPLY SLOWING, BUT STILL EXPANSIONARY

Year-Over-Year Percent Change



Source: FactSet, as of 13/10/2023.

Indeed, August CPI ticked back above zero to 0.1% y/y, although September's reading was flat. This hasn't completely silenced deflation alarm, but underlying inflation trends suggest China's economy is more resilient than feared, as other economic indicators show ongoing growth. While Q3 GDP eased from Q2's 6.3% y/y pace, it still rose 4.9%—pretty much at the government's long-running target of "around 5%."[lii] Industrial production increased 4.5% y/y in September, matching August's rate, and retail sales accelerated to 5.5% from 4.6%.[liii] Also in September, China's official manufacturing purchasing managers' index (PMI) hit 50.2, indicating expansion for the first time since March.[liv] The non-manufacturing PMI rose slightly to 51.7 and has been above 50 all year.[lv] We don't know if inflation will remain north of zero or economic data will continue improving, but the fear of deflationary doom in China—with global effects—seems a stretch to us.

It is no question China faces real problems. However, they are well known—not new or surprising. That headlines continually rehash them speaks to how dour sentiment is more than where the economy and markets are headed.

lii Source: FactSet, as of 18/10/2023.

liii Ibid.

liv Source: FactSet, as of 29/09/2023.

lv Ibid

A NEW THAI PREMIER

Thailand has its first new leader since 2014: former property tycoon Srettha Thavisin. The Pheu Thai party leader became prime minister after taking almost two-thirds of the votes across the House of Representatives and military-controlled Senate. PM Srettha's win resolves some uncertainty following May's general election, in which pro-democracy parties did well. In particular, the grassroots Move Forward party, led by Pita Limjaroenrat, won the most seats in the House, spurring optimism for major change. But Pita failed to win enough support in parliament. Hence, Pheu Thai maneuvered with the military establishment to consolidate power, winning Congressional support on 22 August.

While this closes a chapter in Thai politics and grants clarity with an establishment, military-approved figure in power, we don't expect major legislative changes to come down the pike. The government's priority now appears to be currying favour with the people via economic stimulus. Among his first moves, PM Srettha announced his "Digital Wallet" plan to stimulate growth, under which the government will hand out 10,000 baht (~$286) to every citizen above age 16. In total, the plan amounts to a $16 billion cash handout to spur domestic demand on selected goods. He has additionally promised to help with energy prices and enact a debt moratorium on select farmers and small businesses. Beyond these measures, PM Srettha has announced intentions to engage in free-trade talks with the EU, India and others and enact special economic zones to foster development. There is good and bad in these ideas, but none look very near term to us. Negotiating FTAs could take years, especially since they can upset voters.

From a market perspective, equities are well-acquainted with Thailand's turbulent politics and the legislature's long-running military ties. PM Srettha's ascension also speaks to a basic political reality: Don't overrate election outcomes without assessing the likelihood the hopes become reality. Though pro-democracy groups won over half of the House of Representatives' seats in May's general vote, enthusiasm about major changes wasn't realistic, in our view, due to a key obstacle: the military's firmly entrenched influence. All 250 Senators are unelected military appointees, and to become prime minister, a candidate needs to win a majority in a bicameral legislative session (the House *plus* the Senate) to become prime minister. For all the hype around the civilian coalition, it was never clear they could form the alliances necessary to overcome the military's opposition—and they didn't. Thailand's election is a reminder that political hope isn't a solid investment thesis. It is critical to assess the existing fundamentals and compare how they align with expectations.

INDIA GEOPOLITICS

India featured prominently on the global stage in Q3 as a first-time host of the G20 summit. However, at the meeting of world powers, Indian Prime Minister Narendra Modi and Canadian Prime Minister Justin Trudeau engaged in tense talks after the latter accused the Indian government of involvement in the June killing of a Sikh activist in Vancouver. The accusation roiled relations between the two countries, leading to the expulsion of top diplomats and issuance of travel warnings to each other's countries.

The heated, sharp rhetoric seems like a threat to talks over the Comprehensive Economic Partnership Agreement (CEPA), which the two countries had hoped to seal by yearend. Talks are now on hold and could drag out. While this spat appears to be delaying the deal's approval, and we can't predict exactly how this controversy will play out, it is worth keeping in mind that past heated diplomatic episodes haven't permanently damaged relations between other nations. Consider a 2019 row between Japan and South Korea tied to World War II-era atrocities and compensation. Japan imposed export restrictions on materials used in semiconductor production—a major South Korean industry. But the rhetoric surrounding this looks harsher than the actual economic impact. Japan removed fast-track approval in trade, but it didn't cease commerce with South Korea. Moreover, relations have improved since then. Japan removed those export controls in July, and both sides reinstated "preferred trade nation" status to the other.

We will monitor how Indian-Canadian relations develop, but it is worth noting shrill rhetoric won't automatically roil economic activity. Besides, CEPA wasn't assured to materially boost commerce any time soon—a factor outside the 3 – 30 month window markets usually weigh. Given India's history of protectionism, it wasn't even assured the two would strike a meaningful deal even if the diplomatic spat hasn't erupted. If CEPA doesn't come to pass, it would be the absence of a long-term potential plus, not a swing factor today.

CHILE'S SCANDAL

In Chile, leftist President Gabriel Boric is struggling to make good on his campaign pledges. He entered office in 2021 on the promise of sweeping changes, including scrapping the private pension system and raising taxes to fund social programs. However, 18 months in, his government hasn't reshaped the country's political landscape. Instead, President Boric has floundered. He has reshuffled his cabinet three times—the latest bringing in established politicians over those from his youth-led leftist coalition. His government also became embroiled in a corruption scandal, in which regional officials allegedly awarded big contracts to politically-friendly foundations lacking the relevant field expertise.

President Boric's approach now seems more pragmatic as he looks to compromise and pass what he can over the second half of his term. It won't be easy to pass even watered-down measures, though, since his coalition spans from centrists to those on the far-left. But for equities, President Boric's struggles to pass his legislative agenda are likely a positive. Markets seemingly feared the major change he touted while campaigning. Consider, in the month after President Boric's election, Chilean equities plunged -22.7% to the MSCI Emerging Markets' -5.5%—likely reflecting some fear of "anti-business" policies to come (*e.g.*, higher taxes).[lvi] But after gridlock reared over the past year, Chilean equities are vastly outperforming EM, falling just -3.2% to EM's -24.3%. That gridlock watered down a widely feared copper tax hike that targeted one of the nation's chief industries. In sum, nearly two years after the election, the MSCI Chile is ahead of the broader index: -9.1% to -20.9%.[lvii]

The lesson here, in our view: President Boric's victory weighed on sentiment for a short spell, but over the longer term, markets priced in the reality he wasn't likely to make good on all his extreme-sounding campaign pledges. Politics seem to be proving better than feared in Chile.

lvi Source: FactSet, as of 17/10/2023. MSCI Chile Index and MSCI Emerging Markets Index returns with net dividends, in USD, 22/11/2021 – 20/12/2021.

lvii Ibid. MSCI Chile Index and MSCI Emerging Markets Index returns with net dividends, in USD, 22/11/2021 – 22/11/2022 and 22/11/2021 – 16/10/2023.

AUGUST'S BRICS SUMMIT: A THEATRE OF NOTHINGNESS

During Q3, a geopolitical summit stole headlines globally as the BRICS countries—Brazil, Russia, India, China and South Africa—held talks in Johannesburg, South Africa from 22 – 24 August. The meeting brought together these countries' leaders, with the exception of Russian President Vladimir Putin, who joined digitally to avoid arrest on war crimes charges over his invasion of Ukraine. This meeting, the 15th annual get-together, centred on twin topics: One, expansion of the group beyond the core five. And two, the potential creation of a shared currency to rival the US dollar and put the world's economic system on—in their eyes—fairer ground. The summit fueled an ocean of op-eds and papers arguing things like it signalled the era of one or two superpowers dominating the geopolitical stage was giving way to a "multipolar" world and the threat of de-dollarization. But in reality, we think the summit amounted to extremely little and demonstrates the group's fecklessness.

BRICS isn't a treaty organization, supranational outfit or even a trade bloc. It isn't like Mercosur, the EU or anything to that effect. Actually, the term was coined by an economist—Goldman Sachs' Jim O'Neill, who did so largely for marketing purposes. The countries didn't begin meeting until years thereafter, and South Africa didn't join the other BRIC nations until 2010. After this August's summit, the BRICS nations extended invitations to six other countries—Iran, Saudi Arabia, the United Arab Emirates, Egypt, Argentina and Ethiopia. All had previously expressed interest in joining (along with several other nations).

That said, it isn't clear membership means much. While many commentators argue this is tremendously meaningful to the world's geopolitical and economic structure, the evidence for this is lacking, in our view. There are no binding treaties, and membership doesn't afford special trade status.

Beyond this, these nations have many divides that prevent them from presenting a united front for geopolitical purposes. India and China have long had border disputes in the Himalayas and vie for power in South Asia with regularity. Saudi Arabia and Iran are on opposing sides of a geopolitical divide in the Middle East, with Saudi an American ally that is normalizing relations with Israel of late while Iran is sanctioned by the US and supported Hamas' October attack on Israel. Similarly, Egypt long ago normalised relations with Israel, although its government under President Abdel Fattah el-Sisi has a standoffish relationship with America.

On a political structure level, consider the huge differences: India and Brazil are both functional democracies, while China is a single-party state. Russia is a kleptocracy. In many cases, Argentina to Saudi Arabia, Iran to South Africa, the divides are stark.

Economically, the same holds. China is nominally communist, although it has gradually opened to market-oriented reforms since Deng Xiaoping's rule, triggering a long-lasting economic boom in the process. Russia, which ditched communism around that same timeframe, is an oil-dependent economy stung by sanctions and cronyism. Six of these nations are heavily commodity-reliant (Brazil, Iran, Russia, Saudi Arabia, South Africa and the UAE). Meanwhile, Argentina, China, Egypt and India are heavy commodity importers. There could be big policy divides as a result. We don't see this outfit as anything approaching a cohesive treaty organization capable of wielding collective clout.

ON 'DE-DOLLARIZATION'

The central point of overlap appears to be dissatisfaction with the dollar's central reserve currency role and international organizations like the IMF and World Bank. These western-dominated outfits have been involved in bailing out many of this group of 11 in the past, and they often impose terms like austerity and reforms that the leaders see as imposing on their independence. This, plus America's ability to use dollar access in sanctions, seems to be a primary sticking point.

For his part, Brazilian President Luiz Inácio Lula da Silva has long decried the dollar's role in international trade and finance as unfair, arguing nations should trade with one another on their own terms—far from a reality today. This, plus the obvious desire of Russia and Iran for an alternative, led to significant speculation that the August BRICS summit would see steps toward creation of a common currency for use in trade. But that didn't happen, and the concept is far-fetched.

Creating the euro—a shared currency—required member nations to give up significant autonomy over fiscal and monetary policy, to say nothing of trade. This project has proven quite difficult, despite a shared culture, similar political and economic systems and a free-trade zone spanning much of the continent.

With all the aforementioned political and economic divides among the BRICS, it is difficult to imagine the members and invitees surrendering autonomy over those matters in any meaningful sense. China doesn't even allow currency to flow freely across its borders. Russia and Iran can't. Argentina's newly elected president is flirting with dollarizing the economy to quell endemic currency crises, defaults and inflation. The oil-rich UAE and Saudi Arabia peg their currencies to the US dollar. It is hard to see how or why these nations would enter into a currency arrangement, even if it is only for trade purposes.

For all the attention paid to the BRICS, we think it is hard to see it as much more than geopolitical theater that amounts to little of consequence.

Should you have any questions about any of the information provided above, please contact FIE by mail at Level 18, One Canada Square, Canary Wharf, London, E14 5AX or by telephone at +44 (0)207 299 6848.

For professional client use only.

Fisher Investments Europe Limited, which also trades as Fisher Investments Europe, is authorised and regulated by the Financial Conduct Authority (FCA Number 191609) and is registered in England (Company Number 3850593). Fisher Investments Europe has its registered address at: Level 18, One Canada Square, Canary Wharf, London, E14 5AX. Fisher Investment Europe's parent company is Fisher Investments (FI), a U.S. investment adviser registered with the Securities and Exchange Commission. FI and its subsidiaries maintain four principal business units - Fisher Investments Institutional Group (FIIG), Fisher Investments Private Client Group (FIPCG), Fisher Investments International (PCGI), and Fisher Investments 401(k) Solutions Group (401(k) Solutions). These groups serve a global client base of diverse investors including corporations, public and multi-employer pension funds, foundations and endowments, insurance companies, healthcare organisations, governments and high-net-worth individuals. FI's Investment Policy Committee (IPC) is responsible for investment decisions for all investment strategies.

Since Inception, Fisher Investments and its subsidiaries have been 100% Fisher-family and employee owned.

Unless otherwise specified, references to investment professionals, operations personnel, and middle and back office personnel are references to FI employees. "We", "our," "us" and "the firm" generally refer to the combined capabilities of FIE and FI.

The foregoing information constitutes the general views of FI and should not be regarded as personalised investment advice or a reflection of the performance of FI or its clients. This analysis is for informational purposes only. It has been formulated with data provided to FI and is assumed to be reliable. FI makes no claim to its accuracy. Investing in securities involves the risk of loss. FI has provided its general comments to you based on information they believe to be reliable. There can be no assurances that they will continue to hold this view; FI may change its views at any time based on new information, analysis, or reconsideration.

This material may also be found posted on the Fisher Investments Europe website at FisherInvestmentsEurope.com. If your firm wishes to be removed from receiving these materials in the future or wishes to pay for this material, please contact Fisher Investments Europe.

This document may be considered advertising within the meaning of article 68(1) of the Swiss Financial Services Act dated June 15, 2018 (status as of January 1, 2020).