FIS GROUP

MARKET OUTLOOK

Q2 2016

April 2016

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Q1 2016 – EQUITIES ELUDE THE FOUR HORSEMEN…AGAIN!

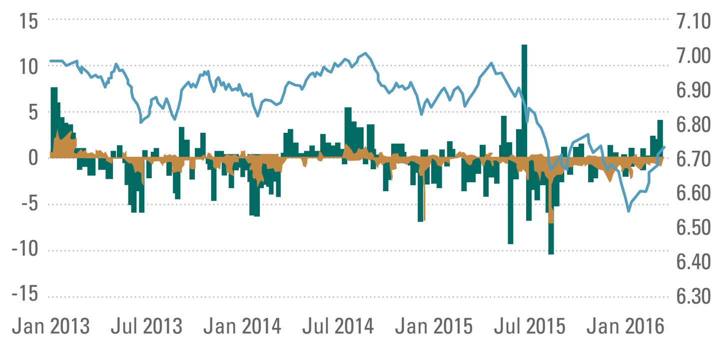
The upsurge in equity prices that started on March 10, 2009 has been among the most despised and distrusted bull-markets of all time. For each of its seven years, newfound horror stories materialized to interrupt the bull trend with corrections roughly as large and as scary as the one which began this year. In 2009 the S&P 500, still reeling from the aftermath of the GFC, declined by 25% through March 9, 2009. In 2010, fear over the U.S. deficit set off a -15 % correction. In 2011, panic over a U.S. Treasury default sent the S&P down -19.5%. In 2012, the euro crisis caused two corrections, -10% in the spring and then -8% in the autumn. In 2013, the panic was about Federal Reserve tapering and a U.S. government shutdown, although these only hit the S&P by -6%. In 2014, carnage in the Middle East and Ukraine catalyzed an -8% setback. And last summer, policy blunders in China caused a correction of -12%. Importantly, each of these corrections turned out to be a buying opportunity.

Following the Fed's first rate hike in over a decade, Q1 2016 saw another such interruption, with the S&P 500 Index gapping down by -11% through February 11 (global equities had an even steeper fall of -12%) as a result of weakening economic data and a disorderly meltdown in commodity prices. However, once again, the U.S. equity market eluded the four horsemen and sprinted to finish the quarter in barely positive territory (up 1 %). Global equities were still down 2% for the quarter; whilst Emerging Markets (EM) equities, which gapped down -9% through February 11th finished the quarter up 2%. Previously washed EM currencies, particularly those of commodity producer countries, staged an impressive short covering rally as the U.S. dollar lost its bid, while commodities rebounded and high yield spreads narrowed. Only China, India, and Greece failed to benefit from the rising tide of EM in Q1.

Four forces lie behind the post February 12th resurgence in risk assets:

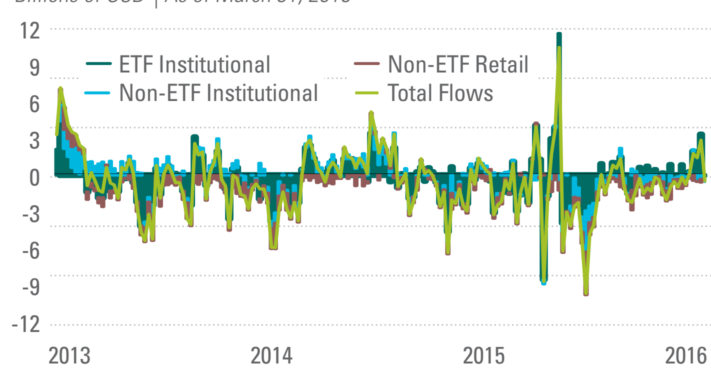
1. Intense policy support from G3 central banks: the BoJ and the ECB via NIRP and the Fed via Janet Yellen's dovish speech this week that completely priced out an April Fed hike and weakened the dollar.
2. Receding fears of a global recession and more specifically, a China hard landing as supportive fiscal and monetary policy began to bear fruit.
3. Commodity prices rebounding from oversold levels which helped to boost EM assets (particularly for commodity producers) and further ignite a rally in high yield.
4. Rebalancing flows and technical short covering from oversold levels into EM assets. According to EPFR flow data, most of the surge in EM occurred in the month of March and those flows were dominated by passive managers and institutional users of ETFs. Active managers actually continued to cause EM outflows. (See CHART 1 and CHART 2). According to Blackrock, shares on-loan (which gauges short covering) for the EM ETF (EEM) decreased by $1bn in the month of March and short interest fell to the lowest level since late 2013. Options positioning going into the March expiry and the richness of the MSCI EM Index futures roll also contributed to tactical inflows to EEM.

CHART 1 Weekly Flows by Active and Passive Investors
As of March 31, 2016



Source: EPFR Global Equity Fund Flows Database, Morgan Stanley Research

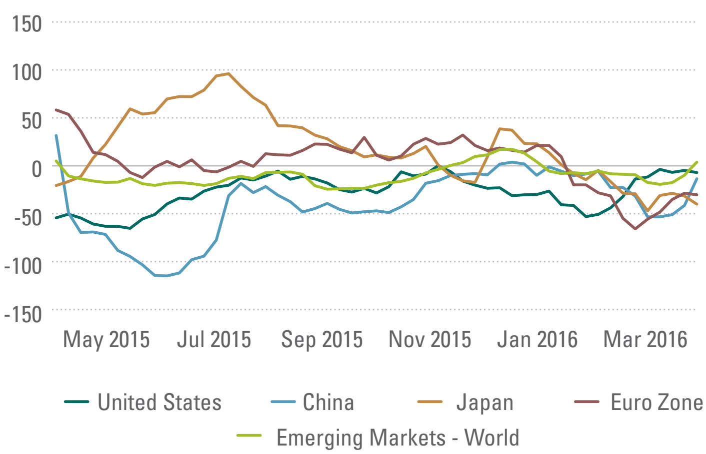
CHART 2 Dedicated EM Flows by Investor Type
Billions of USD | As of March 31, 2016



Source: EPFR Global Equity Fund Flows Database, Morgan Stanley Research

The sustainability of the Q1 rally will depend on whether these forces persist. It is therefore encouraging that several key economic indicators improved since the markets rioted earlier this year. Economic surprise data have on balance surprised to the upside, except for Japan. (See CHART 3). While not stellar, compared to the torrent of bad news early this year, even modest improvements may be enough to boost investor sentiment. Additionally, our equity beta risk indicator continues to show a positive reading. From a macro perspective, the link between the Fed, the dollar, and corporate earnings upgrades is crucial for regional performance, both in absolute and relative terms. Accordingly, we have incorporated a special section to discuss key currency trends on PAGES 6-8 of this Outlook.

CHART 3 Economic Data Suggest Marginal Improvement
Citi Economic Surprise Index | As of April 8, 2016



Source: FactSet & FIS Group professional estimates

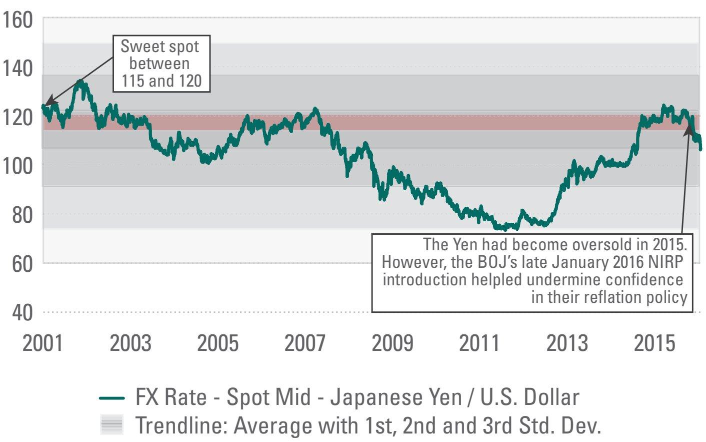
In the second half of the year, improving U.S. growth should push up Fed rate expectations, meaning current dollar weakness will prove temporary. Recent inflation numbers have surprised to the upside, with the annualized three month rate of change in core CPI reaching nearly 3% and core PCE inflation edging closer to the 2% target. While this undoubtedly overstates underlying price pressures, it does suggest that the combination of a tighter labor market and the stabilization of the dollar and oil prices may finally be pushing up inflation. Based solely on U.S. data, the risk is that the Fed dials up the hawkish rhetoric in order to prep the market for one or maybe two rate hikes in the second half of this year. However, the key factor that led to a scaling back of expected rate hikes was the prospect of China's currency falling sharply against the dollar as a significant RMB depreciation would have resulted in a meaningful negative shock, particularly in EM. This fear was stoked by the conflation of the Fed's 100 bps projected hike in the Federal Funds rate at the end of 2015 with the PBOC's opaque announcement in early January that it was no longer committed to keeping the RMB broadly stable against the dollar. In short, the market concluded (and the Fed listened) that hawkish Fed policy and a Chinese currency peg were incompatible; and thus they became less hawkish.

Market pressure on the RMB and the relentless reduction in FX Reserves have clearly eased; not because the PBOC has become appreciably more transparent, but because the market is less worried about an aggressive Fed. The implication is that a modest pace of U.S. rate hikes may now be the only path that is consistent with decent global growth and financial market stability.

For almost two years, earnings have been declining and analysts' forecasts continue to be revised down. In Fiscal year 2015, S&P 500 operating earnings declined by 11% year on year and globally, net margins have, at best, been peaking. For Q2, the weaker dollar should support U.S. corporate profits as last year's drag from overseas earnings fades. Additionally, the gradual rebalancing of oil prices towards the $45 to $50/bbl level should reduce the energy sector's drag on earnings. **Globally, for the balance of the year, relative equity market performance will remain closely correlated with currency swings and Fed policy until corporate earnings regain positive momentum. Continued U.S. equity out performance relative to the Euro Area and Japan will likely depend on whether earnings upgrades precede a rebound in Fed rate expectations or follow.** An increasingly aggressive ECB should be very positive for earnings growth in the European region, as money supply growth. **With U.S. profit margins close to a historically high level and at risk of further contraction, the low and rising margin in the euro area bodes well for further improvement in profitability given a very accommodative ECB.**

Recent macro data on the **Japanese economy** has underperformed our expectations. Specifically, Q4 GDP came in at -0.275% (1.1% y/y) vs. +0.3% in Q3; driven primarily by the slowdown in exports and private consumption. Additionally, CPI swap rates have dropped close to zero. Japanese equity prices depreciated sharply after the BoJ moved to adopt a Negative Interest Rate Policy (NIRP) in late January, which undermined confidence in Japanese monetary policy. On a more specific level, Japanese banks are most impaired by NIRP because they will have to shoulder the cost of negative interest rates, which decreases their net interest margins (since they can't very well charge customers to deposit their money with them). The timing of the NIRP announcement on the heels of the Japan Post IPO, which is estimated to have been bought by over a million individual investors, was especially and absolutely awful. This was another confidence downer; particularly when one of the centerpieces of the government's attack on deflation was to lure Japanese households deeper into stocks through the supposed solidity of the Japan Post brand. Even though the BoJ has been buying equity ETFs, TSE margin trading net buying, a proxy for domestic institutional investor activities, has been declining. So far this year, foreigners have also been net sellers of Japanese equities. Thus, in March, Japanese equities were victim to a perfect storm of negative sentiment – relentless selling by foreign long-only investors; a run on Japanese bank stocks (precipitated by NIRP) by Japanese institutions; hedge fund shorts, and retail investors forced to sell as a result of margin calls. We believe that the worst of that wave is over. On the earnings front, Japanese corporate earnings disappointed in the sectors/stocks most followed by foreigners (heavy electrical, industrial machinery; Fanuc, Toshiba, IHI, NEC, KHI). However, those sectors/stocks, as well as their global peers are of course exposed to a global industrial slowdown. Earnings were robust in less followed Japanese sectors such as pharma, software, telecom and most especially, property/construction. **On balance, the EPS for Japanese equities still compares favorably with their global peers.** However, ongoing yen strength, is worrying. Our comfort level for the Yen/Dollar cross is between 115 and 120. Trading below the bottom of that range for a sustained period would likely lead to sharply lower earnings revisions; a loss of confidence in Japanese stocks and a recoupling of the long Japanese equity thesis to one of purely a forex trade. The yen crossed the lower end of that band in mid-February and has remained below it since. (See CHART 4). This is one of the reasons why, while we are still overweight Japan, we substantially reduced the overweight during Q1.

CHART 4 Ongoing Yen Strength Is Very Concerning
As of April 8, 2016

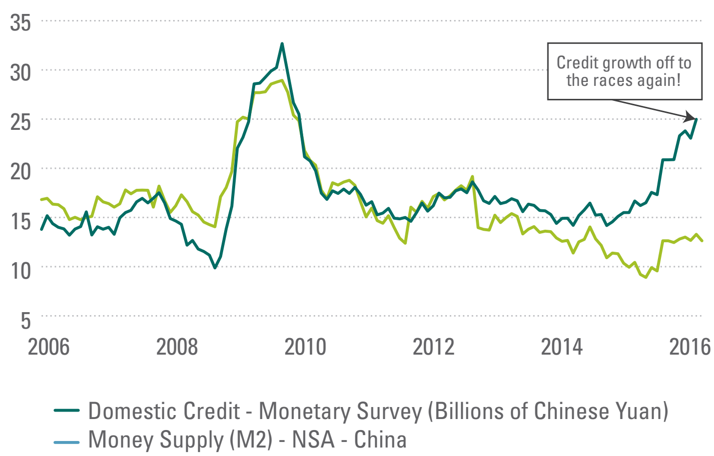


Source: FactSet & FIS Group professional estimates

The rally in **EM risk assets** may continue to have short-term legs on the back of more encouraging data out of China and a soft dollar (as a result of a more cautious Fed). Oil prices appear to be finding a bottom. In our Q1 Outlook, we posited that oil will likely equilibrate at around $45 to $50/bbl towards the end of the year as non-OPEC production cuts gather steam, primarily driven by U.S. shale and North Sea producers. Additionally, the much forecasted increase in Iranian output of 1mm b/d will be difficult to deliver without considerable expansion in foreign investment into the country. However, the rapid rise in Q1 suggests that further volatility may be in the cards before the oil price fully stabilizes. **Insofar as the markets are pricing EM risk assets on par with oil, this portends at least a net positive year in EM. However, as the technical short covering and portfolio rebalancing flows that helped to propel EM assets in March are completed, impending rate hikes in the U.S. and probable dollar strength amid mediocre to weak earnings across most of EM could easily counter these tailwinds. Moreover, while aggressive fiscal and monetary support have buoyed Chinese construction and PMI data recently, the deleveraging process there is still in its early innings (as such, we are monitoring developments in non-performing loans).**

China has shifted from reform to stimulus in order to avoid a sharp slowdown and put a temporary floor under growth. Consequently, new capital projects initiated have increased, the property market is heating up, PMI data has perked up, and industrial profits are recovering. Liquidity has also soared, with new bank lending hitting a record in January. (See CHART 5). With debt approaching 250% of GDP, the authorities will have to balance this policy with the risk of inflating the credit bubble even further, and have recently moved to cap house prices in Shanghai and Shenzhen, and find ways to deal with banks' bad debts.

CHART 5 From Reform to Stimulus
1% Yr | As of March 31, 2016



Source: FactSet & FIS Group professional estimates

Finally, several new political events appear more likely to roil EM markets over the coming three quarters, including the fallout from the "Panama Papers"; elections in Korea on April 13; the Brazilian political/corruption scandal(s); the August constitutional referendum in Thailand; and growing security and political uncertainties in Turkey. We expect India will rebound and finish the year strong as recent rate cuts and economic recovery drive sentiment ahead. Russia will continue to rebound on the back of improved prospects for oil and Brazilian equities will sell-off again or at least plateau. The second of two special sections. (See PAGE 9), provides a brief follow-on of our earlier report on Brazil, *A Short Note On Brazil's House of Cards*. **With a Q1 2016 return of 28%, Brazilian equities outperformed both their developed and EM peers and are now trading at levels last seen in 2000. At FIS we believe that the market is succumbing to overly irrational exuberance in rallying to Brazilian equities on the expectation or hope that the days of the current government led by Dilma Rousseff ("Dilma") of the Workers Party (known by its Brazilian acronym of PT) are numbered.** Readers of our Q1 2016 Outlook may recall that our tactical models correctly forecasted the relief rally in Brazilian equities; but we (incorrectly) over-rode our models and stayed away because of diminishing macro fundamentals and growing political uncertainty. For Q2, our tactical models are forecasting underperformance with high conviction. **Finally, it is noteworthy that our fractal trading model, which in Q1 2015 flagged the Chinese A share market's instability, is suggesting caution for EM equities and Brazil in particular.** (See light green boxes on CHART 6).

Please see TABLE 1 on PAGE 5 for our global country and sector positioning for Q2.

CHART 6 Fractal Score

Q1 2015 - Q1 2016

Note: In the chart above, the fractal structure of a market evaluates price momentum dispersion among investors with different time horizons. The theory is that balanced market participation by investors with different time horizons (e.g. a momentum based high frequency trader vs. a long-term value investor) inures to both greater stability and liquidity. The more one group dominates market activity, the greater the risk of instability.

Source: FactSet & FIS Group professional estimates

TABLE 1 Global Country and Sector Positioning

Risk / Environment	-		N		+	
Global Equity Risk Environment			→	● (S)		Our systemic risk indicator entered risk on in late December and has stayed there.
U.S. Dollar				● (S)		Dovish Fed policy which has stemmed the dollar rally will become more hawkish in June; resuming its rally. We expect however that this rally will be self-limiting because of the negative feed back loop between the dollar, growth and inflation.

Regions / Countries	-		N		+	
United States		● (S)				For the first half of the year, the weaker dollar should support U.S. corporate profits as last year's drag from overseas earnings fades. Additionally, the gradual rebalancing of oil prices towards the $40/bbl level should reduce the extreme energy sector drag on earnings. Our tactical models are forecasting underperformance with low conviction. We are slightly underweight to the U.S.
United Kingdom		● (S)				Energy and Materials should benefit from US dollar softness and China stabilization. However, the political machinations related to the "Brexit" vote is likely to put pressure on the pound.
EU (core)				● (S)		The ECB's aggressive monetary easing should be a positive for earnings growth in the region and Eurozone equities are trading at a discount of 18% to its U.S. counterpart. Additionally, our tactical models are forecasting low conviction outperformance for most core European bourses. Here we continue to focus on more consumer-oriented (non-bank) sectors.
EU (periphery)				● (S)		Spanish and Italian equities provide decent valuations and improving earnings. Our tactical models are forecasting outperformance with low conviction.
Japan				● (S)	←	Although our tactical models forecast outperformance with moderate conviction, during Q1 we lowered our allocation to Japanese equities to a modest overweight because of deteriorating macro fundamentals. A strong yen is causing Japanese inflation expectations to fall relative to the U.S., pushing up real rate differentials in favor of the yen; fomenting further strength. Our comfort level for the Yen/Dollar cross is between 115 to 120. Trading below the bottom of that range for a sustained period would likely lead to sharply lower earnings revisions; a loss of confidence in Japanese stocks; and a recoupling of the long Japanese equity thesis to one of purely a forex trade.
Australia		● (S)				Although early positive signs from China's policy reflation should provide tactical support of this market, out tactical models forecast underperformance with high conviction.
Canada		● (S)				Expected increase in oil prices towards the end of the year should be supportive. Substantial Financials weight may drag because of weakening credit growth. Our tactical models forecast underperformance with high conviction.
Emerging Markets (Pacific Rim)				● (S)		China has shifted from reform to stimulus in order to avoid a sharp slowdown and has put a temporary floor under growth. Consequently, new capital projects initiated have increased, the property market is heating up, PMI data has perked up, and industrial profits are recovering. The authorities must balance this policy with the risk of inflating the credit bubble even further, and have recently moved to cap house prices in Shanghai and Shenzhen, and find ways to deal with banks' bad debts. Chinese stocks, though, could still benefit given their cheap valuations. Our tactical models forecast outperformance with moderate conviction. Best sectors remain: Services, Health and IT.
Emerging Markets (South Asia)				● (S)		Indian equities' relative underperformance provide a more reasonable entry point. India's current and fiscal health render it less vulnerable to Fed normalization. We expect a rebound in Indian assets towards year-end as recent rate cuts and economic recovery drive sentiment ahead, Our tactical models forecast low conviction outperformance.
Emerging Markets (Europe)		● (S)				The marked pickup in intra-European trade and relative fiscal health of Eastern Europe equities on our radar. Russia will continue to rebound on the back of improved prospects for oil.
Emerging Markets (Africa)		● (S)				For U.S. investors, significant negative basic balances and the rand's commodity sensitivity lead to a slight underweight.
Emerging Markets (LatAm)	● (S)					Although our tactical models in Q1 correctly forecast a relief rally but we chose to stay away because of deteriorating macro fundamentals. This quarter, our models have turned bearish and predict high conviction underperformance.

Sector / Style / Capitalization	-		N		+	
Consumer Discretionary		● (S)		● (V)		Extended valuations, increasing oil prices and Fed tightening are generally bearish for this sector, even though our tactical models forecast outperformance. In Europe, Japan and China, where reflationary policies are robust, we are bullish on this sector.
Consumer Staples		● (T) ←	● (S)			Our tactical models support an overweight. Our tactical models correctly over weighted this defensive sector and shifted to a high conviction underperform forecast. This sector will begin to struggle with higher energy input costs.
Energy		→	● (T) →	● (S)		Moderate conviction overweight. Oil prices should increase towards the end of the year as non-Opec supply reduction gathers steam. However, expect continued near term volatility. We expect to gradually leg into an overweight position.
Financials		● (V)		● (S)		Our tactical models project low conviction outperformance in selective industries such as REITS. Avoid outside of US particularly in EM where banks are under-provisioned.
Health Care				● (S)		Our tactical models correctly projected some retracement in this sector's outperformance in Q1. For Q2, our models warrant a high conviction overweight.
Industrials		● (S)				This sector's limited pricing power and dollar exposure warrants an underweight, a view supported by our tactical models.
Information Technology				● (S)		Our tactical models correctly projected some retracement in this sector's outperformance in Q1. For Q2, our models warrant a high conviction overweight.
Materials	● (S) →	● (T)				Although the bear market in base metals is still in its early innings, Chinese reflation could provide temporary support for this sector. Our tactical models are signaling outperformance.
Telecommunications			● (S)			Cheap and provides defensive haven while disinflationary undercurrent still a risk. Could also be boosted by M&A activity. However, our tactical model's underweight forecast leads to a neutral weight.
Utilities		● (S)	● (V)			Utilities will typically struggle with rate normalization in US, but our tactical models support an upgrade in Q1. This recommendation was reversed for Q2.
Style (Value at Left / Growth at Right)			● (S)			On balance, we are maintaining a neutral style allocation.
Capitalization (Small at Left / Large at Right)		● (V)	● (S)			In the U.S., neutral cap allocation. Improvement in credit availability will disproportionately help non-US small caps.

→ ← Change from Q1 2016 ● Strategic (6-12 months+) ● Tactical (3 months) ● Variance for Non-U.S. Portfolios

SPECIAL ANALYSIS

THE RISING IMPORTANCE OF CURRENCIES ON EQUITY PRICES

Midway through the recovery from the GFC – i.e., in late 2012/ early 2013 – relative currency movements appeared to have a disproportionate impact on the performance of risk assets. This period marks the beginning of aggressive monetary action by first the BoJ and subsequently the ECB, which led to substantial depreciation of their respective currencies against the U.S. dollar. (See CHART 7). We believe that this is because, in an era of zero and negative real interest rates and limited fiscal policy support, currencies (and the underlying monetary policy behind them), become significantly more important for relative growth and asset price performance.

Additionally, in 2015, escalating uncertainty over Chinese growth and its impact on commodity prices and producers as well as the fate of the RMB appeared to further impact equity prices, particularly EM equities. CHART 7 shows that the correlation between both the Brazilian Real and the Chinese RMB relative to key EM Equity benchmark returns increased significantly as uncertainty over China's currency policy flared up in the second half of 2015. CHART 8 contrasts the Equity Risk Premia of the S&P 500 Index, the MSCI ACWI Index and the Economic Policy Uncertainty indices for the U.S., Europe and China. Since 2011, policy uncertainty out of Europe and China dominated spikes in the ERP. However in 2015, the primary driver of equity risk was China.

Long-term variables that determine relative currency movements include purchasing power parity, relative productivity, macroeconomic balance (i.e., the equilibration between the savings and investments and the current account balance), terms of trade shocks and net international investment position. However, in the short to intermediate term, predicting currency movements is a complex exercise. For one, FX market participants have diverse objectives. Some participants have long term hedging objectives while others trade currencies for short term financial gain. Second, since they do not have cash flows, currencies are harder to value. Third and most importantly, they have a rather unstable relationship with their fundamentals.

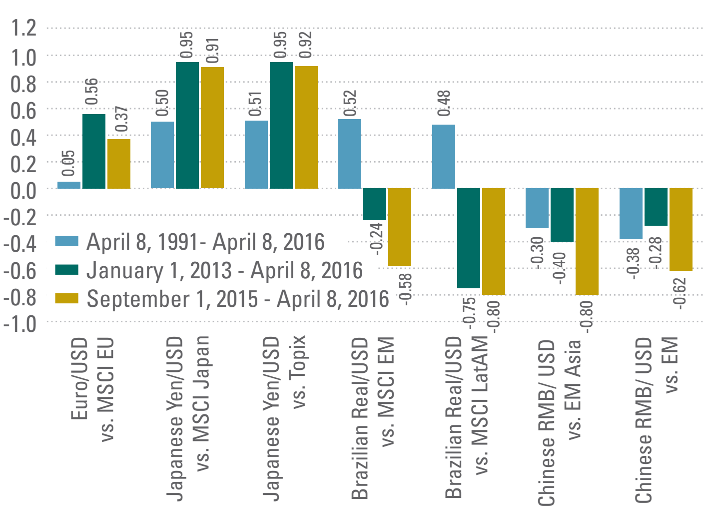
THE DOLLAR THAT BARKED BUT DIDN'T BITE

The recent weakness of the U.S. dollar against the euro and especially the yen has already led many to tear up their currency forecasts for the year. We at FIS Group were in the camp that the US dollar would be range-bound relative to the yen and euro but would appreciate against commodity currencies. (Based on Q1 results, we were half right/wrong!) That said, expectations for US monetary policy still seem to be the key driver of the euro exchange rate. **We expect renewed euro weakness as the Fed hikes rates this year. The rebound in the yen is the last thing that Japan's economy needs and therefore is also unlikely to be sustained.**

The FOMC's 25bp increase in the discount rate in December 2015 helped prolong the rally in the greenback until it halted, when the FOMC seemed to throw cold water on its own rate hike projections, citing global growth conditions in mid-January and again in March. Following an appreciation over the past three years, the U.S. dollar therefore weakened on a trade-weighted basis since the start of the year partly because the yen and euro were technically oversold and undervalued, and partly because the BoJ and ECB turned more dovish. For the next six to nine months, we expect at best, a sideways trading range for the greenback. Over the long term, our view is that the dollar

CHART 7 Currency & Equity Price Return Correlations

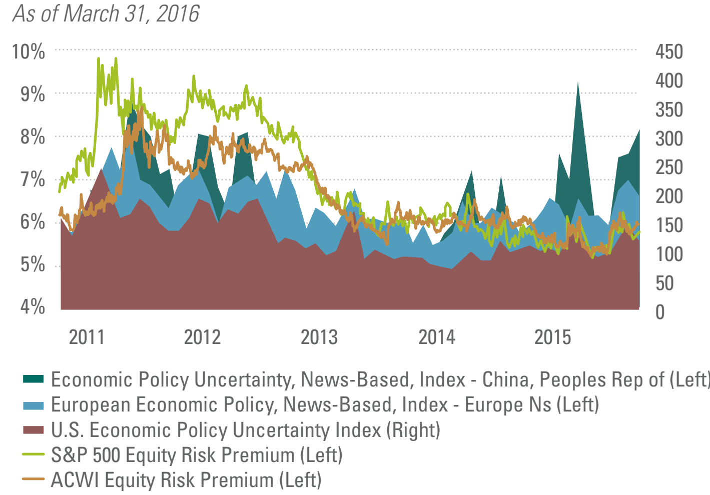
As of April 8, 2016



Source: FactSet & FIS Group professional estimates

CHART 8 Increasing Policy Uncertainty Lifted Equity Risk Premiums in Early 2016

As of March 31, 2016



Source: FactSet & FIS Group professional estimates

remains in an up-trend due to stronger structural growth in the U.S. and, therefore, continuing divergence in monetary policy.

CHART 9, which evaluates the relationship between the CPI and the inverse of the U.S. dollar basically encapsulates the negative feedback loop from which the Fed has been trying to extricate itself. As we have written about in the past, as tightening monetary conditions catalyze the dollar's appreciation, the resultant downward pressure on prices (as well as credit spreads and commodities) eventually dampens the U.S. economic outlook. These factors in turn weaken the underlying cause for a stronger dollar; higher interest rates emanating from Fed tightening. **In effect, monetary conditions will primarily be tightened through a stronger dollar, rather than higher bond yields. With zero and in some cases, negative, rates outside of the U.S. for many years to come, even minor increases in U.S. rate expectations could translate into significant dollar appreciation.**

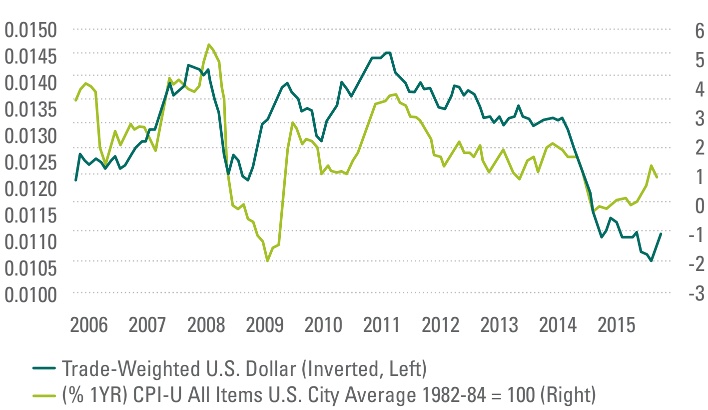
Recent inflation numbers have surprised to the upside, with the annualized three month rate of change in core CPI reaching nearly 3%. Core PCE inflation is also edging closer to the 2% target. (See CHART 10). While this undoubtedly overstates underlying price pressures, it does suggest that the combination of a tighter labor market and the stabilization of the dollar and oil prices may finally be pushing up inflation. **Based solely on U.S. data, the risk is that the Fed dials up the hawkish rhetoric in order to prep the market for a one or maybe two rate hikes in the second half of this year. In that event, we expect that the U.S. dollar will undergo yet another round of this loop in June; whereby increasing inflation expectations and robust employment trends as well as stabilization in China may support another rate hike. However, unless there is a significant pick up in global growth, this too will be self-limited.**

The key factor that led to a scaling back of expected rate hikes was the prospect of China's currency falling sharply against the dollar. A sharp depreciation of the RMB would have resulted in a significant negative shock, particularly in the EM. This fear was stoked by the conflation of the Fed's 100 bps projected hike in the Federal Funds rate at the end of 2015 with the PBOC's opaque announcement that it was no longer committed to keeping the RMB broadly stable against the dollar in early January. In short, the Fed concluded that a hawkish policy and Chinese currency peg was incompatible; and thus became less hawkish. Market pressure on the RMB has clearly eased not because the PBOC has become appreciably more transparent, but because the market is less worried about an aggressive Fed.

THE NOTORIOUS JPY

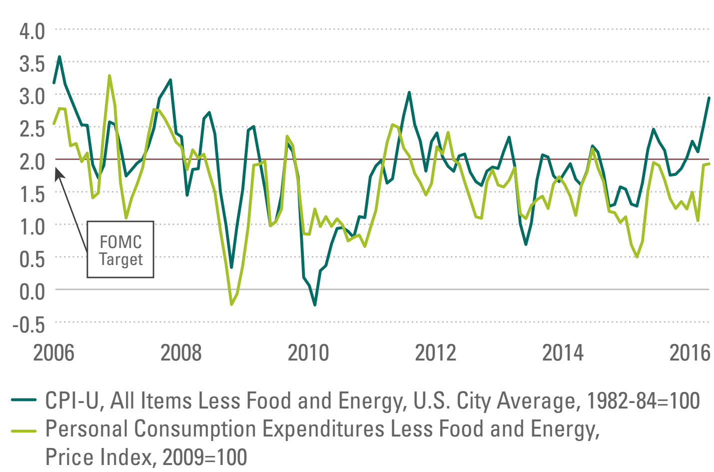
The Yen/Dollar relationship has also been a considerable source of volatility for global equity prices, not to mention frustration for investors! As a result of aggressive monetary policy, since December 31, 2012, the Japanese Yen depreciated 46% relative to the greenback. Many investors (not this one) predicted continued depreciation of the JPY based on the disparate policy trajectories of the Fed and the BoJ. However, year to date through April 8th, the JPY has since retraced its path against the greenback by 7%. (See CHART 4 on PAGE 3). Furthermore, the BoJ's surprise decision to adopt a negative interest rate policy (NIRP) undermined confidence in the BOJ and the Abe administration more broadly because it smacked of desperation and implied policy impotence. Worse, the NIRP backfired, and the yen appreciated as a result of a yen boosting flight to safety prompted by non-Japanese issues (fears of a sovereign debt crisis; fears of European bank bail-ins as well as NPLs in Spain and Italy). **With a strong foreign asset position and current account surplus, there is room for further appreciation of the JPY from the current level, especially since the currency is more of a safe-haven play than the Euro. Moreover, with the fallout in Japanese banks following the announcement of negative rates, the BoJ will be cautious about cutting rates much further. Furthermore, a strong yen is causing Japanese inflation expectations to fall relative to the U.S., pushing up real rate differentials in favor of the yen and fomenting further strength. Our comfort level for the Yen/Dollar cross is 115 to 120. Trading below the bottom of that range for a sustained period would likely lead**

CHART 9 Feedback Loop Between U.S. Dollar and Inflation
As of March 31, 2016



Source: FactSet & FIS Group professional estimates

CHART 10 Inflation Finally in Sight?
As of March 31, 2016



Source: FactSet & FIS Group professional estimates

to sharply lower earnings revisions, a loss of confidence in Japanese stocks and a recoupling of the long Japanese equity thesis to one of purely a forex trade.

WILL THE SNAP-BACK IN EM CURRENCIES CONTINUE?

During the second half of 2015 and the early weeks of 2016, EM currencies suffered their worst bout of selling pressure since 2013's "taper tantrum", leaving them deeply oversold. In the first quarter of 2016, EM currencies snapped back significantly whereby EM Commodity producers appreciated by 7.5% whilst Commodity importers saw their currencies increase by 2.1%. (See TABLE 2).

TABLE 2 Low-Beta Currencies Have Plenty of Upside

Currency Returns vs. USD (including carry) | As of March 31, 2016

	YTD Returns	H1 2015 Avg (Jan.1, 2016 = 100)	Upside to H1 2015 Levels
EM Commodity Exporters	+7.5%	113.6	6.1%
EM Commodity Importers	+2.1%	105.1	3.0%
EM Commodity Importers Ex-China	+2.3%	105.6	3.3%

Source: MRB Partners Inc.

When compared with their average levels for the first half of the year, commodity-exporter currencies have clawed back half of the previous decline so far this year, whereas commodity-importer currencies have only retraced a quarter of the way. **However, we do not believe that this rally is sustainable, as disinvestment in the commodity sector to adjust for the overhang in global capacity will add downside pressure to the commodity producer currencies. Currencies plagued with idiosyncratic risks (such as political and labor market concerns), along those with large current account deficits, have the largest downside.**

Finally, since the 2012 downturn in the Commodity Supercycle, investors have repeatedly shown that they are unwilling to sustain rallies in risky assets without hard evidence of macro-economic improvement. Unfortunately, the current evidence is sparse. While some signs of stabilization are coming from China, global trade volume growth is effectively zero, coincident indicators of U.S. growth momentum such as the PMI and Citi Surprise Index (CESI) are showing tentative signs of improvement, and euro area indicators such as private consumption and credit growth, while still positive, have gone through a soft patch recently. At a minimum, until growth drivers take over, policy conditions offer a mixed bag for the EM currency investor.

SPECIAL SECTION

BRAZIL: NUANCED POLITICAL MACHINATIONS AND ECONOMIC BACKDROP DON'T SUPPORT THE BOVESPA'S RUN-UP

As discussed in our recent market note on *Brazil's House of Cards*, at FIS we believe that the market is succumbing to overly irrational exuberance in rallying to Brazilian equities on the hope that the days of the current government led by Dilma Rousseff ("Dilma") of the Workers Party (known by its Brazilian acronym of PT) are numbered. As with most sitting presidents in a democratic country, there are three paths out of power for Dilma and the PT: elections, impeachment, and resignation. Having just narrowly won reelection in 2014, the next presidential election will not happen in Brazil until 2018…still too distant in our view for a durable market signal. Impeachment remains a real possibility in Brazil, moreso than a resignation, but neither is swift nor the outcome clear. As we pointed out in *Brazil's House of Cards* the fastest timeline to removal from office would not materialize until August, despite the recent defection of the previous coalition party (PMDB) to the opposition (see TABLE 3). On April 5, a Supreme Court judge in Brazil ordered the initiation of impeachment proceedings against former PMDB leader and Vice President Michel Temer, further impeding the political strength the opposition would need to impeach Dilma. If Dilma were impeached, Temer would succeed her. So now, it gets really complicated. If both Dilma and Temer were impeached this year, the presidency would pass to Eduardo Cunha (PMDB) as speaker of the house, who would take over as president for a period of 90 days, after which elections would be held. But Cunha is also being investigated as a part of the Lava-Jato ("carwash") probe into corruption and kickbacks from Petrobras. If Dilma were impeached next year, then Cunha (or the House Speaker) would take office for 30 days, after which congress would select an interim president until the next elections in 2018. This is a Congress, it should be noted, where 351 out of 591 (59.4%) of congresspersons in office are facing civil or criminal charges ranging from corruption to murder. The third in line behind Dilma is the head of the senate, currently Renan Calheiros, who resigned the same position in December 2007 amid charges of corruption which were never investigated by Congress. So while the removal of Dilma via impeachment certainly remains an option, politically, it is an extremely fraught process especially since the evidence against Dilma,

TABLE 3 Impeachment Timeline
As of March 16, 2016

House

- March 17-31: Special House Committee on impeachment to be set up. Said committee will have 65 members, and pro-Rousseff forces at the moment seem to have a slight majority (some 36 members), although the situation is fluid.
- April: Special Committee report presented to the committee.
- May 1-7: Committee votes on the (non-binding) report.
- May 8-15: House floor votes on impeachment. The proposal is approved if 342 representatives vote for it.

Senate

- June 1-15: Special Senate committee votes on whether to impeach the president. Then the Senate floor votes on this issue. The proposal is approved if a simple majority (41) senators vote for it. The president would immediately step down and be replaced by the VP.
- June 16-July 15: The president presents her defense.
- July 15-31: Special committee issues report on whether to ultimately remove the president or not (assuming no congressional winter break).
- August 1-15: Senate floor tries the president.

Dilma Rousseff's police file from the military dictatorship period.

The "palmatoria", an object of torture and reminder of Dilma's political resolve.

accused of falsifying budget documents, remains murky.

As discussed on PAGE 1, the run-up in Brazilian and EM equities in February and March were led principally by U.S. institutional ETF buyers. The Bovespa's 28% run up in Q1 2016 results in a P/E multiple of 20 times trailing earnings, the highest level since 2000. Because we see no room for aggregate earnings to improve, a re-rating would only be justified if aggregate earnings stop falling, the political climate stabilizes and the energy and materials sectors re-rate sustainability. However, if the P/E ratio falls back to 16 (its level before the market rallied), the resulting loss would be 36%. This outcome appears pessimistic, but is well within the range of losses over the past four years.

While we think that there is a fair amount of nuance in the above summary of Brazil's political lunacy that may not be fully understood by those buyers, some commentary in the American media seems to be banking on the expectation of our third option, resignation, to drive Dilma and the PT out of office. On this score, we believe that the market (and the US media) truly don't understand the mindset of the PT and Dilma in particular. Many PT leaders, none more than Dilma see their path to power as having been paid for with their own blood and the lives and livelihoods of their comrades. Dilma herself (pictured on PAGE 9 in her police file from the military dictatorship in the late 1960s and early 1970s) was imprisoned and tortured for her alleged acts of "terrorism." Dilma described her own torture as progressing from the "palmatória," an inquisition-like paddle instrument (see photo) used to strike the knuckles and palms of the hand, to the next, when she was stripped naked, bound upside down and submitted to electric shocks on different parts of her body.

We offer this graphic reminder of Dilma's suffering to attempt to illuminate the mindset of Dilma and her colleagues. In tapes recently released as part of the Lava-Jato investigations, which were leaked to hasten impeachment, Lula referred to the judge behind the investigation as hailing from the "Republic of Curitiba" a verbal play on the "Military Republic" that Dilma and Lula both struggled against during their formative years. We do not believe that Dilma, Lula, and the PT are authoritarians and we remain confident that they would respect the legal or democratic process to remove them from power. However, they are also not likely to succumb to political pressure which they view as emanating from the same bastions of power against which their lives' struggles have been fought. They may be defeated, but there is no surrender for these guerrillas cum democrats. As such, we do not view resignation as a likely outcome in the present environment.

Finally, even if there is a change at the top of the government by any means, we do not foresee the emergence of the necessary political consensus that will produce a budget that will reduce the fiscal drag and permit lower interest rates and reignite the economy. The political crisis in Brazil is largely the outgrowth of the economic downturn, and not vice versa (the Lava-Jato investigation only really gained traction when Petrobras' largesse dried up with the collapse in oil prices and the impeachment charges stem from Dilma's attempts to use accounting tricks to hide the true size of the budget deficit). Thus, even the most market friendly political outcome to the present crisis would at best cure only the effects and not the cause of the present economic slump. To cure the cause, Brazil will need either a substantial amelioration in oil and iron ore prices (about a doubling in both from present values) or a material change in their fiscal position to settle the economy and permit earnings to improve sustainably across the market.