

FISHER INVESTMENTS™

Stock Market Outlook

Independent Research & Market Analysis

Published Quarterly by the Investment Policy Committee

2011: Part 3



2011 STOCK MARKET OUTLOOK, PART III

Executive Summary

In Q2, concerns regarding peripheral eurozone debt and a possible economic slowdown resurfaced. A correction-like pull back then late-quarter rebound left stocks essentially flat for the quarter—world stocks rose a mere 0.5%.ⁱ Year to date, world stocks are up 5.3%.ⁱⁱ No one quarter is ever indicative of full-year returns, but this quarter was very illustrative of what we expect for the full year—muted broad market returns with considerable choppiness.

2011 continues to look like a year of transition with increasing return dispersion among narrower equity categories, setting the stage for the bull market to resume with gusto in 2012. (See Appendix 1.)

Some economic metrics slowed in Q2. However, growth rate volatility is normal, and overall, the economic expansion remains on track in our view. Further, a material portion of the slowdown can be tied to earthquake-related supply chain disruptions from Japan. Those effects should be fleeting and are already showing signs of rebounding. Our expectation is global growth and corporate earnings should be fine in 2011—better than most expect—with the US among the developed world's leaders. (Appendix 2.)

With very little fanfare, QE2 (the second round of the Fed's quantitative easing following the 2008 debt crisis) ended as Q2 did. Camps were very divided on QE2—some hopeful it would spur lending and investment, others fearing it would cause an inflationary death cycle. Neither happened. In our view, QE2 was largely unnecessary since both the economy and markets were already recovering on their own. It did seemingly provide a nice sentiment boost in Q4 2010. Beyond that, QE2 didn't do as much as the critics feared or the proponents hoped. While we believe QE2 heightens the risk of inflation down the road, for now there are ample forces keeping prices in check.

Headlines and pundit commentary took on tones that sounded amazingly like a year earlier—almost as if they were ghosts returning to haunt us—the overriding themes being debt and fears of a “double-dip” recession. (See Appendix 2.) It is always possible that there is a recession ahead. But it is technically impossible for that to be a “double-dip” recession at this time. You can't have a double dip two years into an expansion with US and global GDP at all-time highs, a story the media somehow misses. If we were to have a recession ahead, it would technically be a new recession—not a double dip. But that didn't stop the double-dip chatter, which rose to a din into mid-June—until economic numbers suddenly came in stronger than most expected, ending those headlines almost overnight.

On the debt side, the old-ghost fears refocused on PIIGS and new fears focused on US government debt and the debt ceiling. All this contributed to a market pullback—though of much smaller magnitude so far than in 2010. Our view is the other eurozone members have significant incentive to take whatever steps necessary to maintain their monetary union—at least for the near term.

By mid-year 2011, the fear there would be a huge crisis leading to economic implosion from US municipal bond defaults causing a new debt contagion was dead in the water (as we foreshadowed in our Q1 2011 Stock Market Outlook). Instead, muni prices are up and defaults are down over last year. There will surely be more defaults this year, but nothing approaching a catastrophe as was widely expected as 2011 began. In the same vein, state tax receipts are up and budget gaps narrowing—as is normal in an expansion. That said, Minnesota’s state government shut down and capital markets simply yawned—actually rising as the shutdown occurred.

As for the US federal debt ceiling, we anticipate debate will be heated, but this arbitrary marker will be raised again, as it has over 90 times since 1940 (10 times since 2001). But if we’re wrong and the US government shuts down, don’t forget this wouldn’t be the first time, and when it happened before, capital markets, again, yawned.

Despite none of these fears having real validity—or legs that should hamper markets or the economy in a material way—in our view, the fears won’t go away either. Instead, they likely continue morphing and contributing to short-term volatility both ways—being the proverbial “wall of worry” bull markets legendarily love to climb.

Nor can we identify material, negative fundamental issues not already well known and hence digested into market pricing—which argues against stocks being down a lot. The pullback that began in April knocked a lot of optimism out of folks, reducing risk. We still see two very divided sentiment camps—newly bullish and dug-in bearish—contributing to ongoing back-and-forth market action in 2011.

The Investment Policy Committee

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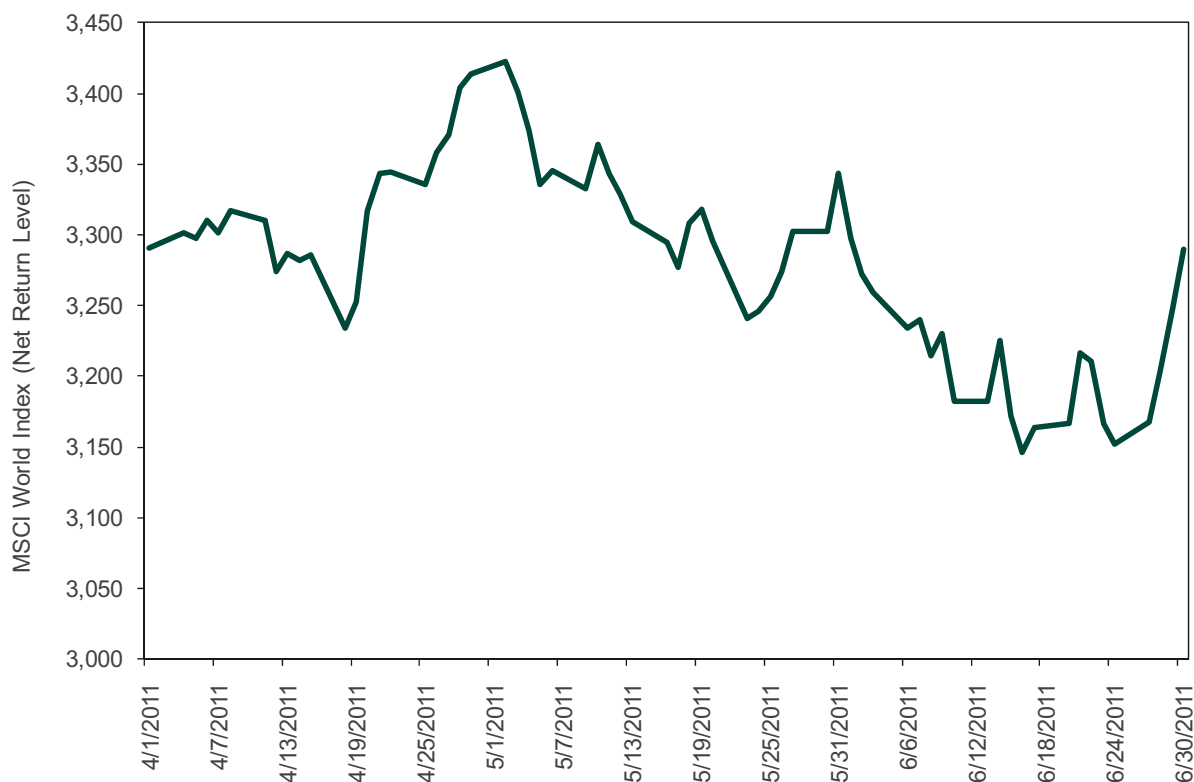
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Appendix 1: A Look Back at Q2

Broad stock indexes ended Q2 2011 about where they began with a fair amount of volatility including a decent-sized pullback along the way. As we write, it's not clear if the pullback is over, though stocks staged a late-quarter comeback (see Exhibit 1). Overall, the year seems to be playing out largely as we expected—a transition year with modest overall returns and greater dispersion among categories.

Exhibit 1: MSCI World Index Performance, Q2 2011



Source: Thomson Reuters, MSCI World Index net return, from 03/31/2011 to 06/30/2011.

The Q2 market pullback felt much like a correction—it certainly qualified in duration, but not magnitude. (Recall, a correction is a market drop of between -10% and -20%.) From this year's early May market peak to the Q2 low, the MSCI World Index fell about 8%—but the drop lasted nearly two months. We cannot say if the pullback is definitively over—markets could yet move sideways or fall further. But even a full-fledged correction wouldn't be out of line with our expectation for 2011 to be overall choppy and sideways.

The pullback was predicated on a number of fears—some new, some old. We'll discuss these in detail in Appendix 2. But in short, our view is many much-talked about fears now are overstated or misunderstood, and true material negatives are already well known and largely reflected in current market prices. Further, existing positive fundamentals remain mostly overlooked and outweigh current negatives.

Our overall 2011 outlook remains intact, with single-digit returns (up a little) most likely. We continue to believe a down-a-lot scenario for stocks is least likely by a wide margin. And we expect to see increased dispersion among narrower equity categories and individual securities as fundamentals continue to regain primacy in driving returns.

At the start of this year, we expected to see an ongoing sentiment tug-of-war with newly bullish forces fighting dug-in and converted bears, contributing to sideways broad market action. Positively, the Q2 pullback did serve to knock some resurgent optimism out of the market, a force that should help buoy stocks as reality surpasses lowered expectations. However, though the bulls' ranks have seemingly thinned for the moment, that doesn't prevent reinforcements from joining their camp as the year proceeds, balancing our sentiment see-saw.

For the rest of the year, we believe this market lull continues—a pause that refreshes, allowing the bull market to resume with gusto in 2012.

Appendix 2: Market Risks and See-Saw Sentiment

Q2's pullback knocked some optimism out of the market, helped by a handful of widely held fears. However, in our view, none were materially new concerns. Rather, they seemed more like morphed versions of past concerns:

As Ken said in his July 18, 2011 *Forbes* column:

As bull markets pick up steam, many investors fall prey to what I call the “morphing fear phenomenon.” It’s a subset of the legendary “wall of worry” that bull markets love to climb. In any bear market something frightens us—whether justified or not—and recessions always do. Early in the subsequent bull market and expansion we keep expecting these worries to appear. If they don’t, we morph fresh scary fantasies that seem like new problems but are simply manifestations of old fears.

In Q2, investors rehashed last year's PIIGS and economic double-dip worries in addition to trotting out morphed versions of some longstanding fears. These persistent concerns likely continue contributing to dour sentiment for the balance of the year, but none in our view are new or material enough to be a significant fundamental stumbling block for stocks this year.

Debt Fears of Many Flavors—European Sovereign Debt

Last year's PIIGS concerns resurfaced in Q2 as it became clear Greece, the fiscally weakest eurozone member, had missed austerity benchmarks, putting future aid payments from the troika (European Union, European Central Bank and International Monetary Fund) in jeopardy. By early July, a deal had been worked out—again pushing off a potential Greek default.

Greece and to varying degrees other peripheral European countries face very real fiscal issues. However, it's not terribly surprising Greece struggled to meet austerity targets. Core aspects of their austerity plan include increasing competitiveness and privatization—the nation has had an uncompetitive economy for years and is currently led by a Socialist government. But scaling the situation is important. In past reviews, we've noted Greece is an economically tiny member of the much larger eurozone. The same can be said for troubled PIIGS Portugal and Ireland.

Of greater potential concern are the larger peripheral countries, namely Spain and Italy. Shortly after the quarter ended, Spanish and Italian interest rates jumped on renewed concerns about the fiscal situations there. Serious trouble for Spain and Italy would be harder for the eurozone to bear and could pose a greater threat to the viability of the euro. However, in our view, while Spain and Italy face challenges, they're in far better fiscal shape than their smaller counterparts. For instance, Italy carries a large debt load (roughly 120% of GDP) but has already implemented austerity measures and made significant headway toward balancing its budget. Spain has further to go with its budget deficit and may have to recapitalize a number of its regional banks (*cajas*) but carries much less debt relative to its economic size than the rest of the PIIGS.

With that said, all aspects of the European debt scenario are in flux. It is a slow, ongoing process and negotiations have been characterized by frequent political machinations. But importantly, eurozone members have repeatedly displayed a willingness to maintain the currency union. And a slow process is not altogether bad—in fact, a gradual resolution is vastly preferable to a sudden, disorderly one (which we see as unlikely for the foreseeable future). For now, the approximately \$1 trillion European Financial Stability Facility (EFSF) and other bailouts provide ample backstop for these nations through 2013, pushing any real risk of legitimate default beyond then while buying time for the eurozone to find a way forward.

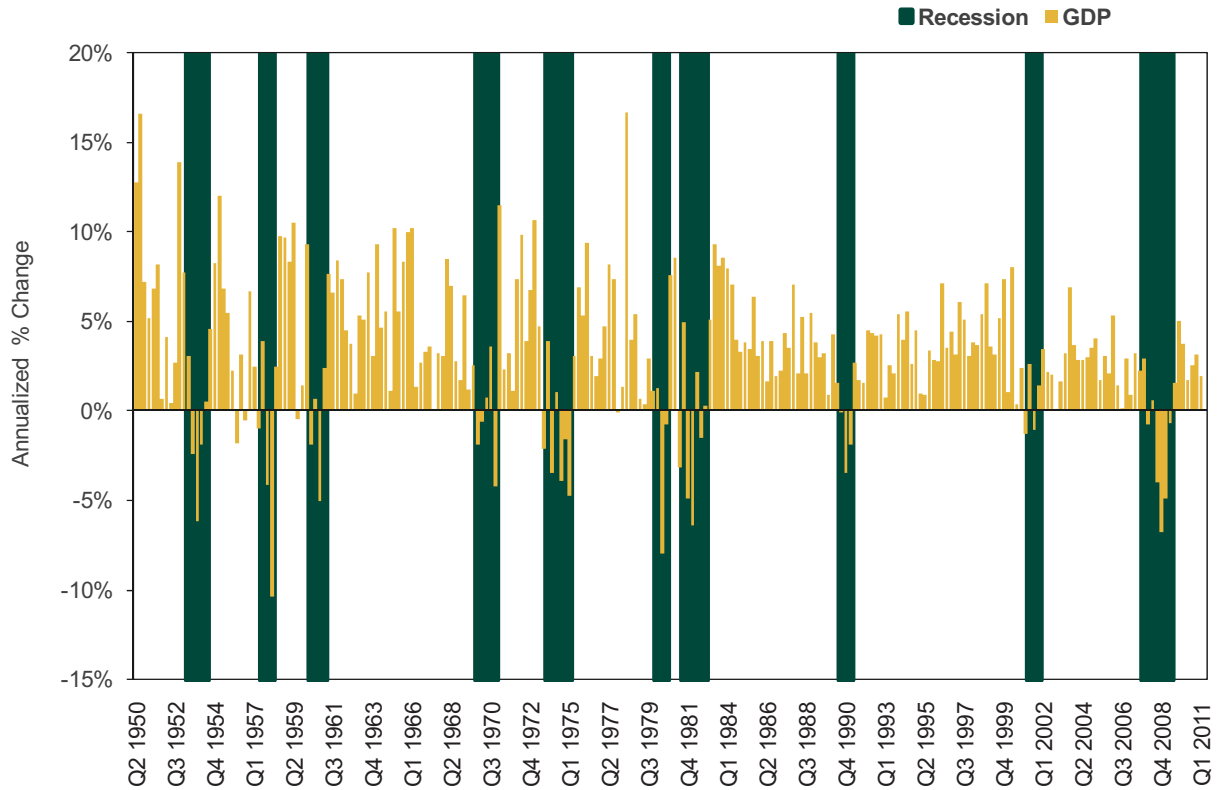
Double-Dip Recession Fears

Double-dip recession fears resurfaced as growth rates in some economic metrics slowed. Economic measures never move in a straight line—every expansion has some variability. Nearly identical double-dip fears surfaced during an economic soft patch in 2010, only to have economic growth reaccelerate through the end of last year. We view this period similarly—normal volatility in midst a continuing expansion. In the unlikely event a new recession occurs in 2011 or 2012, it wouldn't technically be a double dip but a new recession—the US economy has grown for two years and GDP is at an all-time high. Technicalities aside, current consensus forecasts are for continued growth ahead, and we agree.

What many headlines mistook for a looming double dip was actually a temporary slowing in growth *rates*. Supply chain disruptions stemming from March's disasters in Japan were behind much of the slowdown. Fortunately, the quake's economic impact—even within Japan—already appears to be abating. For example, the automotive industry was heavily impacted by parts and vehicles shortages from Japanese producers. This led to US automakers deciding to bring forward scheduled plant maintenance into Q2, dampening production and output. Further downstream, the lack of available parts and inventory led some dealers to slash incentives—and some consumers opted to wait to purchase.

While problems related to Japan may have been a proximate cause for slower Q2 growth, it's also important to recall economic statistics frequently gyrate in even the best expansions. Exhibit 2 shows quarterly annualized GDP growth over the last 60 years, with growth accelerating and decelerating during every expansion.

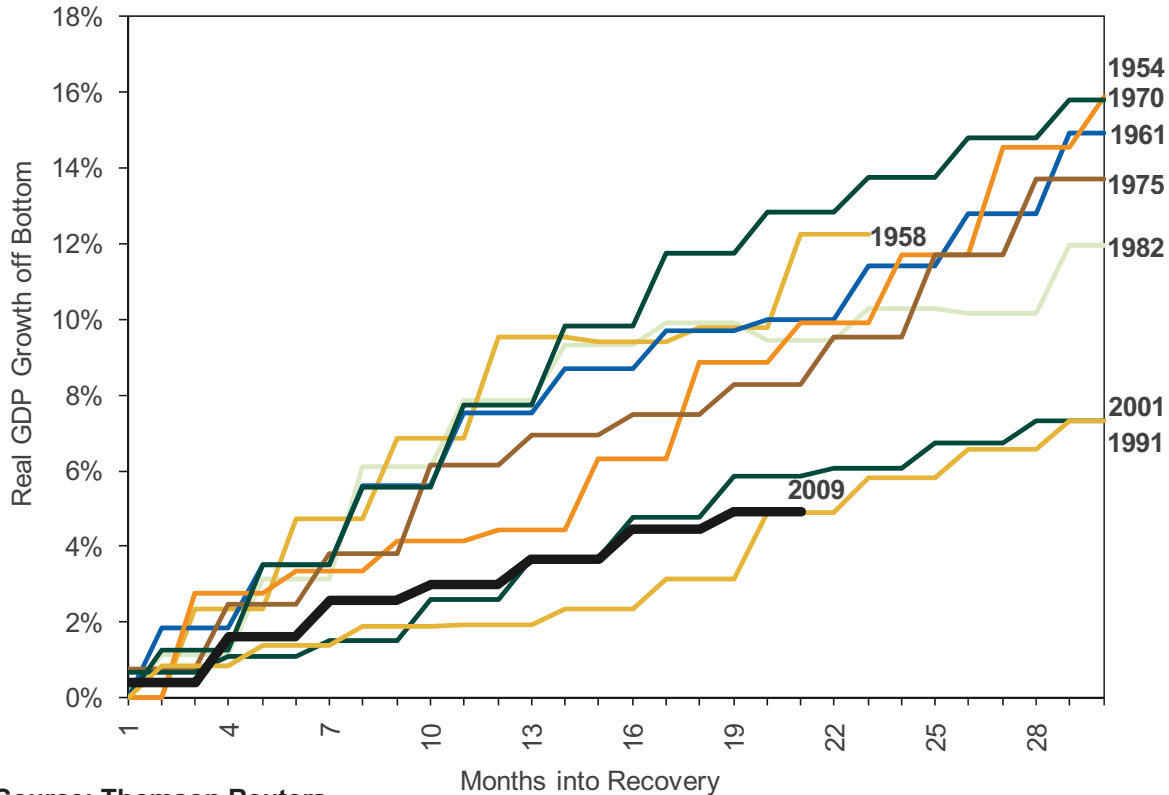
Exhibit 2: Economic Growth Is Volatile, Even During Expansions



Source: Thomson Reuters.

While some opine this expansion is unusually weak, the current expansion is not very different from those following the last two recessions (beginning in 1991 and 2001). In retrospect, few cite the 1991-2001 or 2001-2007 economic expansions as problematic. (See Exhibit 3.)

Exhibit 3: GDP Growth Rates in Recovery

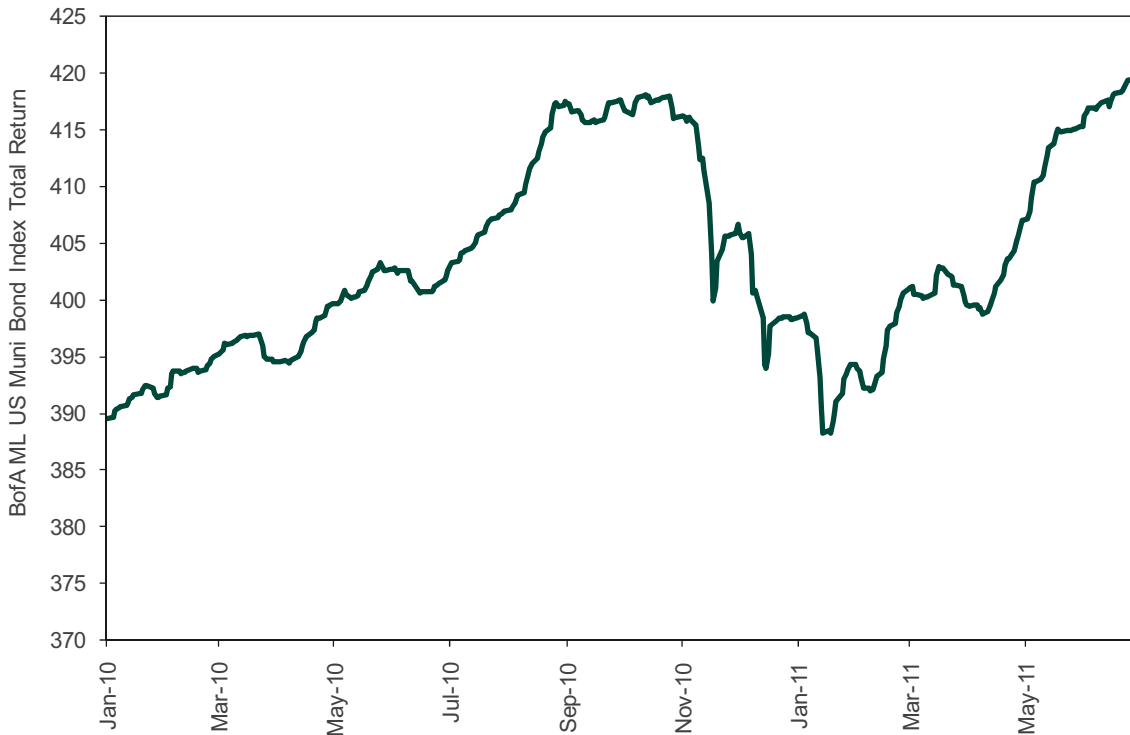


Source: Thomson Reuters.

US Municipal Debt Fears

In late 2010, fears surfaced over a potential wave of US municipal bond defaults—possibly totaling tens if not hundreds of billions of dollars. In our Q1 2011 Stock Market Outlook, we detailed why we felt these fears were disconnected from facts and unlikely to materialize. In fact, as 2011 has progressed, municipal bond prices have risen, yields have fallen and defaults are down relative to 2010. Exhibit 4 shows the Bank of America Merrill Lynch Municipal Bond Index—a widely followed measure of municipal bond returns—has rebounded significantly this year.

Exhibit 4: Municipal Bond Total Return Since 2010



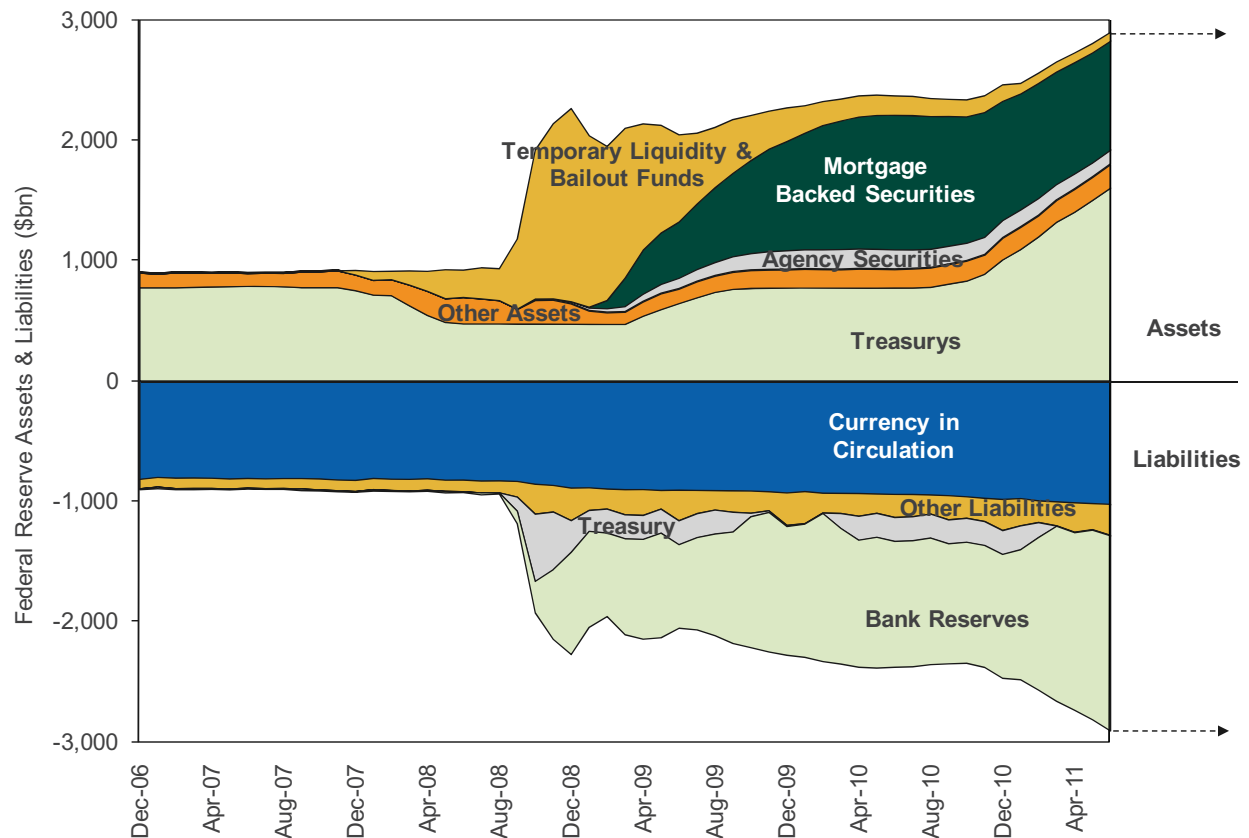
Source: Thomson Reuters, as of 06/30/2011.

In 2011’s first six months, only 26 municipal issues defaulted, down from 60 in the same period in 2010. 2011’s defaults total \$818.2 million thus far—about 29% of 2010’s \$2.8 billion.ⁱⁱⁱ As is normal in this stage of economic expansion, state income tax receipts are rising, closing funding gaps. At a local level, some communities continue to experience lagging property tax receipts, but cost-cutting measures have alleviated much of the pressure.

QE2 Sets Sail

QE2, the second round of US quantitative easing, ceased June 30, 2011. QE2 proponents posited QE2 was necessary to prop up the economy. In our view, QE2 wasn’t necessary—both the market and economy were growing before its implementation and have continued to do so since. QE2 likely did have some positive sentiment effects early on, but since much of the money pumped into the system is sitting as reserves parked at the Fed (see Exhibit 5), it didn’t have any hugely positive effects, and the removal of the program doesn’t present an economic hurdle.

Exhibit 5: The Federal Reserve's Balance Sheet



Source: Federal Reserve.

Nor did it have the inflationary impact critics feared—again because that money was largely parked, not accelerating through the economy. For now, the Fed plans to maintain its balance sheet—using principal payments on its existing holdings to purchase Treasuries. The Fed’s bloated balance sheet does heighten inflation risk down the road. But the slow velocity of money combined with other factors like elevated unemployment and still-low capacity utilization put sufficient downward pressures on prices for now to prevent them from soaring unexpectedly.

The US Debt Ceiling Debate

On May 16, 2011, the US federal government hit the roughly \$14.3 trillion debt ceiling. (Note: This is gross debt, which includes intra-governmental holdings.) The debt ceiling is a legislative limit imposed on the aggregate amount of federal government debt first established in 1917. This arbitrary marker was originally created by Congress to facilitate the debt issuance process, most notably for WWI-related expenditures. Prior to it, a congressional vote was required on every debt issuance related to legislation or appropriations. Since 1940, the debt ceiling has been raised 90 times, with the 91st pending as we write.

In our view, the heated debate is almost entirely political. The government is currently using what the Treasury calls “extraordinary measures” to avoid curtailing some expenditures, and it anticipates reaching the limit of these extraordinary measures by August 2, 2011. It’s likely the

debt ceiling is raised prior to August 2—following a similar process as debt limit debates in 2002, 2003, and 2004. In those years, heated debate required the Treasury to use similar “extraordinary funding measures” until a new debt limit was passed just days before the Treasury’s stated deadline. But even if it isn’t raised this time around, a default need not result.

The debt ceiling is an aggregate number—new debt can be issued to replace maturing bonds up to the limit, so principal payments on maturing debt are not at risk. If the limit isn’t raised, the government theoretically can’t spend in excess of tax receipts, which many fear puts debt interest payments at risk and raises the possibility of a US default. However, US government tax revenue is more than sufficient to cover debt interest payments—by prioritizing debt interest first, a default can be avoided. Some speculate the Treasury cannot prioritize its payments, but in an official letter dated October 9, 1985, the Government Accountability Office clearly stated, “...the Secretary of the Treasury does have the authority to choose the order in which to pay obligations of the United States.”

Additionally, according to the Congressional Budget Office, current tax revenue is sufficient to not only cover interest payments, but also Social Security, Medicare and Medicaid (which we note aren’t debt, but legislated entitlements subject to change at congressional whim). So the debate largely hinges on a potential government shutdown, like Minnesota’s state government shutdown in June (which didn’t bother markets) or the 1995 federal government shutdown. Republicans suffered politically, but 1995 was a perfectly fine year for the economy and a terrific one for US and world stocks (up 37.6% and 20.7% respectively).^{iv} Ultimately, the debt ceiling debate will likely be resolved, and the current debt ceiling will be replaced with a new arbitrary marker—to eventually be usurped by yet another arbitrary marker.

Chinese Regional Debt

In Q2, rumors surfaced that bad Chinese regional government debt would send banks into a tailspin, with some default estimates reaching north of \$300 billion. The government did confirm the existence of some bad debt, but we’ve long taken China’s loan statistics (and all their economic data for that matter) with many grains of salt.

China’s banks are the country’s primary source of credit—bond markets are small and immature. In fact, municipal bonds weren’t authorized until June 2011, so the banking system is heavily exposed when loans go bad and could require a recapitalization.

But a recapitalization wouldn’t be a tremendous global-market-roiling surprise. China has recapitalized its banks numerous times via several different mechanisms since 1998—and they have over \$3 trillion in foreign currency reserves to do it now, should they wish. If another bank recapitalization happens, it shouldn’t be a tremendously negative event for global stocks.

Emerging Markets Hard Landing?

Fast growth in Emerging Markets (EM) economies continued as Q2 came to a close, a key source of surging demand for the global economy. However, faster overall growth and rapidly increasing wages combined with rising oil and food prices mean EM countries face greater

inflationary pressures than the developed world. As such, a number of EM central banks have been tightening more aggressively than their developed-economy counterparts—this includes Brazil, China, India and others.

Some fear this tighter monetary policy could trigger a hard landing. While EM central banks do face a challenge reining in inflation, we doubt they will sacrifice too much economic growth to do so. In our view, the greater risk is the use of unconventional and untested monetary measures to achieve their goals. But here again, we think EM central banks will continue proceeding with caution.

China utilizes a number of monetary measures beyond just interest rates. In economics, controlled monetary policy and exchange rates simply cannot be combined with free capital flows—it's a combination often called the “impossible trinity.” China attempts to overcome this by restricting capital flows. Still, capital flows through trade, direct investments and other means do occur. Therefore, China has only partial control over its monetary policy.

Thus, China employs other, cruder monetary policy tools including loan quotas, bank reserve ratios and currency peg adjustments. But China is unlikely to risk a dramatic tightening as it could risk civil unrest associated with a downturn—especially not with an election in 2012 (see Appendix 3). Therefore, China's measures have been incremental and gradual—and economic metrics continue to show growth (i.e., no hard landing).

Brazil has similarly taken a gradual approach to tightening and controlling inflows of foreign capital, placing loose restrictions on investors seeking to place capital in the country. However, tightening measures have again been baby steps and economic metrics are mostly expansionary.

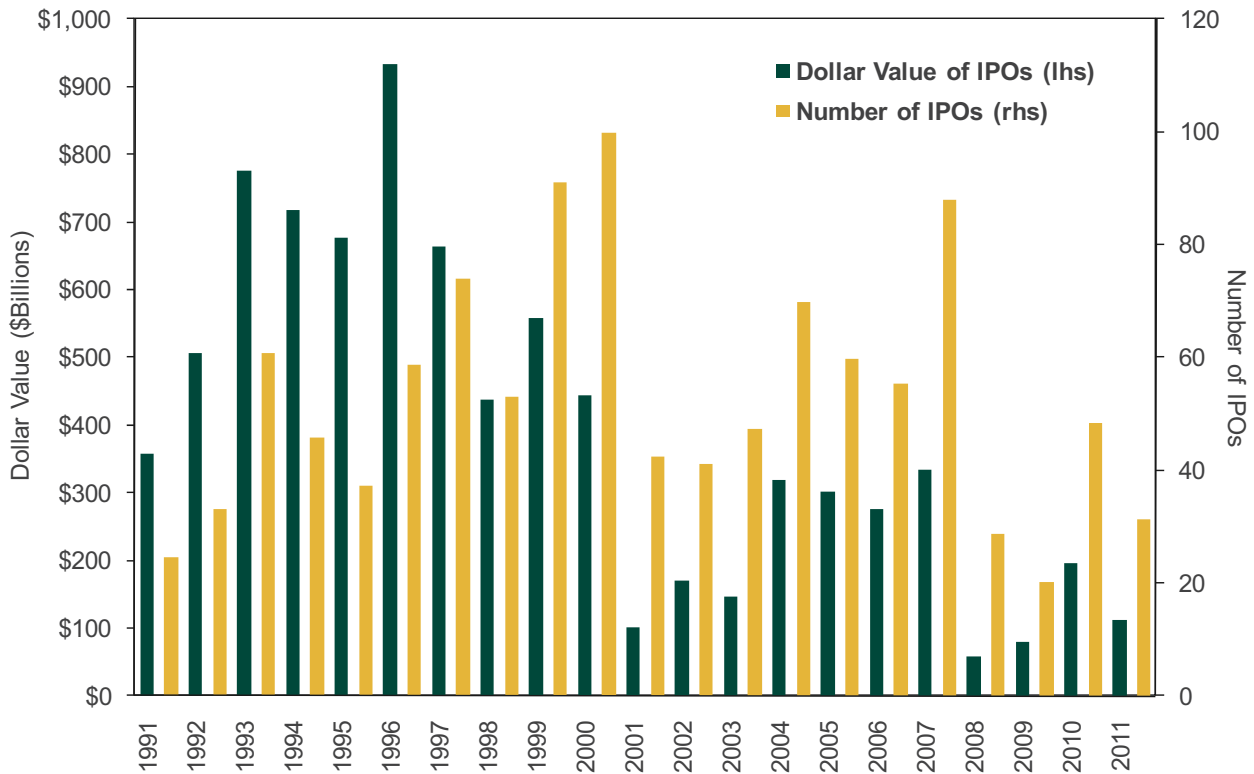
India is leaning on more conventional interest rate increases to fight inflation. And they're doing so aggressively—flattening and, by some measures, inverting India's yield curve (i.e., raising short-term interest rates above long-term interest rates).

A New Technology Bubble

Recently, a few high-profile technology IPOs—most notably social media firms—have prompted comparisons to the late-1990s tech bubble. What's more, a July 25, 2011 *Fortune* cover story titled “Tech Bubble 2.0” warned of parallels to 2000. It is true an influx of IPOs can spike stock supply—a negative as increased stock supply puts downward pressure on prices, all else being equal. However, though some recent IPOs have made a media splash, the magnitude of IPO issuance thus far in 2011 is well below levels seen in the late 1990s. (See Exhibit 6.) In total dollar value, 2011 IPOs are also far below 1999 and 2000 and even below levels seen in 2004, 2005 and 2006—well after the Tech bubble burst.

Though we think none of the market fears covered here are sufficient to derail markets, we anticipate they will continue to garner headlines for the balance of the year, contributing to the dour side of the sentiment see-saw.

Exhibit 6: US IPO Activity: Overall New Supply Is Limited



Source: Bloomberg Finance, L.P., as of 07/11/2011.

Appendix 3: A Look Ahead—2012 Politics

The 2012 political race is already taking shape. As always, our political commentary is non-ideological by design. We prefer neither party and find plenty to criticize (and even occasionally like) about politicians in both camps. Rather, understanding political drivers (along with economic and sentiment drivers) is key to shaping forward-looking expectations. Our aim is to understand the range of likely outcomes, what most people expect to happen, and whether those expectations reflect reality.

It's far too early to handicap a likely outcome—either in the Republican primary or in the general election. However, either way, election years are typically (though not uniformly) good for stocks. In our view, this contributes to the likelihood of the bull market resurging in 2012.

Third Year/Fourth Year

We've written in past Outlooks that, tied to lessening political risk aversion, both the third and fourth years (i.e., 2011 and 2012) of presidential terms are overwhelmingly positive for stocks. (See Exhibit 7.) In the past, this cycle has been dismissed or even ridiculed. But as 2010 came to a close, a number of market observers cited it as one reason to be optimistic about 2011. In our view, wider acceptance lessened its power—contributing to our view stocks are likeliest to be up a little in 2011 despite the historic precedent for a stronger year. However, lessened political risk aversion is a powerful enough driver to make down a lot even more unlikely.

Positively, if 2011 has middling returns, that likely turns recent converts into skeptics again, giving this forecasting tool heft again—in time for the year four effect. Though averages are not as high in year four, the same reduced risk of legislation applies, making year four returns overwhelmingly positive.

Exhibit 7: Presidential Terms—Third & Fourth Years Good for Stocks

| Party | President | First Year | | Second Year | | Third Year | | Fourth Year | |
|----------------|-------------------|------------|-------------|-------------|-------------|------------|--------------|-------------|--------------|
| R | Coolidge | 1925 | N/A | 1926 | 11.7% | 1927 | 37.7% | 1928 | 43.8% |
| R | Hoover | 1929 | -8.5% | 1930 | -25.0% | 1931 | -43.5% | 1932 | -8.4% |
| D | FDR - 1st | 1933 | 54.4% | 1934 | -1.5% | 1935 | 47.7% | 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 | 31.5% | 1956 | 6.6% |
| R | Ike - 2nd | 1957 | -10.8% | 1958 | 43.4% | 1959 | 11.9% | 1960 | 0.5% |
| D | Kennedy / Johnson | 1961 | 26.8% | 1962 | -8.8% | 1963 | 22.7% | 1964 | 16.4% |
| D | Johnson | 1965 | 12.4% | 1966 | -10.1% | 1967 | 23.9% | 1968 | 11.0% |
| R | Nixon | 1969 | -8.5% | 1970 | 4.0% | 1971 | 14.3% | 1972 | 18.9% |
| R | Nixon / Ford | 1973 | -14.8% | 1974 | -26.5% | 1975 | 37.3% | 1976 | 23.7% |
| D | Carter | 1977 | -7.4% | 1978 | 6.4% | 1979 | 18.4% | 1980 | 32.3% |
| R | Reagan - 1st | 1981 | -5.1% | 1982 | 21.5% | 1983 | 22.5% | 1984 | 6.2% |
| R | Reagan - 2nd | 1985 | 31.7% | 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, GW - 1st | 2001 | -11.9% | 2002 | -22.1% | 2003 | 28.7% | 2004 | 10.9% |
| R | Bush, GW - 2nd | 2005 | 4.9% | 2006 | 15.8% | 2007 | 5.5% | 2008 | -37.0% |
| D | Obama | 2009 | 26.5% | 2010 | 15.06% | 2011 | --- | 2012 | --- |
| Average | | | 8.1% | | 9.0% | | 19.4% | | 10.9% |

Source: Global Financial Data, Inc. S&P 500 total return as of 12/31/2010.

Two Possible Outcomes

There are just two possible outcomes in the 2012 election: We either re-elect a Democrat or newly elect a Republican. Tautological though it may be, historically this is a sweet spot for stocks.

As we've written in the past, stocks tend to fare better in election years (i.e., year four of the cycle) when a Republican wins, averaging 18.8%, but worse when a Democrat wins, falling - 2.7% on average. This is tied to the market's expectation Republican candidates will be pro-business and the Democrat candidate less so. However, that effect reverses inauguration year (year one) when markets discover the newly elected president is just a politician, neither as good nor bad as perceived. Markets are disappointed by not-as-business-friendly-as-hoped Republican but relieved by the less-anti-business-than-feared Democrat, so stocks fare worse on average year one under Republicans, better under Democrats.

There's a further distinction. (See Exhibit 8.) Stocks tend to fall election years when we *initially*

elect a Democrat, but stocks average 14.5% years we re-elect a Democrat. Stocks still average 10.6% when we re-elect a Republican, but it seems markets no longer fear a Democrat they already know. This is another strong precedent for 2012 being fine for stocks, no matter the election outcome.

Exhibit 8: Election Versus Re-Election—S&P 500 Returns

| | Democrat | Republican |
|------------------|----------|------------|
| Initial Election | -2.7% | 18.8% |
| Re-Election | 14.5% | 10.6% |

Source: Global Financial Data, Inc. S&P 500 total return as of 12/31/2010.

A Senate Power Shift

It's too early to know if Republicans can win a Senate majority, but the 2012 race is structurally in their favor—it's very likely they gain relative power. Exhibit 9 (from the Cook Political Report) shows Senate races in 2012, and which seats are solid Democrat, likely Democrat, all the way through solid Republican. Again, it's very early and things can change fast during a campaign—but this is how 2012's races currently look.

Thirty-three seats are up for election. Ten currently Republican seats are up, compared to 21 Democrat and two now-Independent seats that caucus with the Democrats (23 total). Democrats must defend 23 seats, whereas Republicans just 10—already leaning the race in their favor.

Open seats—those where the incumbent isn't running—are particularly vulnerable to party changes, as are “toss-up” races. As of now, eight retiring senators are leaving open seats. However, six retirees are Democrats and one retiring Democrat's seat, North Dakota's Kent Conrad, already leans Republican. Of the two open Republican seats, one is Kay Bailey Hutchinson's reliably Republican seat, and Jon Kyl's seat leans Republican. Again, favoring Republicans.

Of nine toss-up races—just two are Republican seats compared to seven Democrat. Republicans get added juice here because three Democrat toss-ups are also open seats. Leaning seats are another source for easier opposition pick-ups. Republicans have none (besides their two toss-ups, the rest are all likely or solid Republican now), whereas the Democrats have two leaning. In all, Republicans can play much less defense and instead focus on going after seven toss-ups and two leaning Democrat seats.

Exhibit 9: The 2012 Senate Race

| Senator | Party | Democrat | | | | Republican | | | | |
|--|-------|---------------|-------|--------|------|------------|------|--------|-------|---------------|
| | | No race 30 | Solid | Likely | Lean | Toss-up | Lean | Likely | Solid | No race 37 |
| CA, Diane Feinstein | D | | X | | | | | | | |
| DE, Tom Carper-D | D | | X | | | | | | | |
| HI, Daniel Akaka RETIRING | D | | X | | | | | | | |
| MD, Ben Cardin | D | | X | | | | | | | |
| MN, Amy Klobuchar | D | | X | | | | | | | |
| NJ, Robert Menendez | D | | X | | | | | | | |
| NY, Kirsten Gillibrand | D | | X | | | | | | | |
| RI, Sheldon Whitehouse | D | | X | | | | | | | |
| VT, Bernie Sanders* | I | | X | | | | | | | |
| MI, Debbie Stabenow | D | | | X | | | | | | |
| PA, Bob Casey | D | | | X | | | | | | |
| WA, Maria Cantwell | D | | | X | | | | | | |
| CT, Joe Lieberman* RETIRING | I | | | X | | | | | | |
| FL, Bill Nelson | D | | | | X | | | | | |
| OH, Sherrod Brown | D | | | | X | | | | | |
| MO, Claire McCaskill | D | | | | | X | | | | |
| MT, Jon Tester | D | | | | | X | | | | |
| NE, Ben Nelson | D | | | | | X | | | | |
| NM, Jeff Bingaman RETIRING | D | | | | | X | | | | |
| VA, Jim Webb RETIRING | D | | | | | X | | | | |
| WV, Joe Manchin | D | | | | | X | | | | |
| WI, Herb Kohl RETIRING | D | | | | | X | | | | |
| MA, Scott Brown | R | | | | | X | | | | |
| NV, John Ensign | R | | | | | X | | | | |
| ND, Kent Conrad RETIRING | D | | | | | | | X | | |
| AZ, Jon Kyl RETIRING | R | | | | | | | X | | |
| IN, Richard Lugar | R | | | | | | | X | | |
| ME, Olympia Snowe | R | | | | | | | X | | |
| TX, Kay Bailey Hutchison RETIRING | R | | | | | | | X | | |
| MS, Roger Wicker | R | | | | | | | | X | |
| TN, Bob Corker | R | | | | | | | | X | |
| UT, Orrin Hatch | R | | | | | | | | X | |
| WY, John Barrasso | R | | | | | | | | X | |

*Senators Sanders and Lieberman caucus with the Democrats

Source: The Cook Political Report, as of 07/11/2011.

Incumbents Are Tough to Beat

Regardless of ideological bent, there's something to like and something to hate in 2012. The Senate race favors Republicans, but incumbent President Obama will be hard to beat, as any incumbent president is. During the history of the S&P 500, 14 incumbents have tried for reelection and only 3 failed—Gerald Ford, Jimmy Carter and George H.W. Bush. Gerald Ford was a weak candidate—the only major race he previously won on his own was for the House. Jimmy Carter was running against the misery index and a very strong candidate in Ronald Reagan—among the best Republican campaigners ever. Similarly, George H.W. Bush oversaw the start of a recession (and the end of it, but he was ridiculed for saying the economy was improving when in fact it was) and was running against one of the Democratic Party's best ever campaigners, Bill Clinton.

People will say the economy is lousy and unemployment high—giving Obama an uphill climb. We don't think Obama will cruise into office, but these may not be the high hurdles many presume. Unemployment is indeed high, but it remained high after the 2001 recession and was still elevated when George W. Bush won re-election. Further, as discussed in Appendix 2, the economy isn't lousy, it's in line with the post-1991 and -2001 expansions. Saying, "The economy is lousy," is a common campaigning tactic. Recall Clinton's rallying cry, "It's the economy stupid," though the recession was, in fact, over. Today, Republicans have every reason to say the economy is lousy. And Obama likely remembers Bush (41) and doesn't want to counter that too hard and seem out of touch.

Some observers will say Obama's approval rating is too low. As we write, Obama's approval rating is 44%.^v Much has been made about a president never having been re-elected with an approval rating that low. However, the election isn't tomorrow. Reagan's approval rating was 43% at this time in his first term.^{vi} President Bush was re-elected on a 48% approval rating^{vii}—current approval ratings aren't reliable predictors for an election still 17 months away.

Ultimately, at election time, independent voters may decide the guy they know now—even if they don't like him much—is still better than the devil they don't know. This is part of why, historically, incumbents have been hard to beat.

And the Nominee Is . . .

With the Republican field still wide open, we can make a few observations. Since the Dewey/Taft primary fights resulted in a two-term Eisenhower, there have been no Republican nominees who weren't perceived as bona fide Westerners. The one exception was Ford, but he lost. Even if a Republican is in fact an Eastern urbanite, he'll still run as a Western Republican (e.g., Nixon, George H.W. Bush).

Meanwhile the Democrats haven't had a nominee win from west of Illinois (if you think of Obama as being from Chicago, not Hawaii, which most people do), other than Lyndon Johnson—who had tremendous goodwill following JFK's assassination and was from Texas at a time when Texas was as blue as California is now. Humphrey and Mondale were from Minnesota and they lost. McGovern from South Dakota also lost.

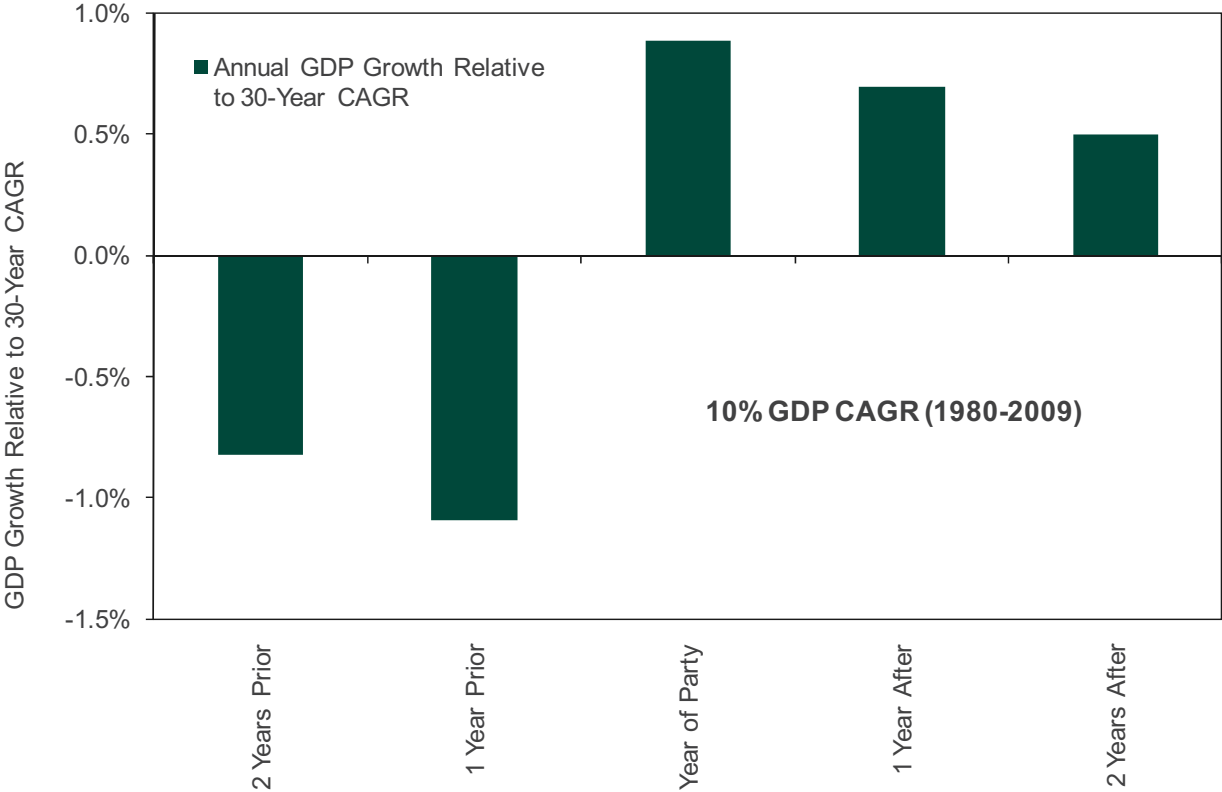
Mitt Romney is an Eastern businessman and former governor of Massachusetts. Still, Republicans tend to nominate candidates who've "been around the block"—2012 may be Romney's turn. Conversely, Rick Perry is a classic Western Republican. He's the very popular, three-term governor of Texas, and was lieutenant governor before that. He also has the benefit of saying 45% of the jobs added in this economic expansion have been in Texas.^{viii}

Given Romney's previous run and Perry's Western profile, at this (still early) point, the odds are roughly one-third for Romney, one-third for Perry and one-third something unforeseen. Fortunately, whatever the outcome—re-elected Democrat or newly elected Republican—there's strong historical precedence for a fine 2012 for stocks.

Global Political Forces

There are other positive global political drivers coinciding with 2012. China has a regular five-year congressional election cycle—2012 is the next election year. Though China has increasingly adopted free-market reforms, it largely remains a command economy. As such, the government actively boosts economic growth during election years to increase popularity of the Communist party (the only party allowed). Exhibit 10 shows China's average GDP growth (relative to the long-term average) in each year of the cycle. Election years do routinely show above-average growth, while the prior year has the worst average. This is because the government has traditionally aimed to pull down growth and inflation prior to election year to ensure it can add stimulus election year without spurring excessive inflation. In 2011, we are indeed seeing China aiming to draw down inflation, laying the groundwork for continuation of this cycle.

Exhibit 10: Relative Chinese GDP Growth—1980-2009



Source: Thomson Reuters.

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- i Thomson Reuters, MSCI World Index total return with net dividends, from 03/31/2011 to 06/30/2011.
 - ii Thomson Reuters, MSCI World Index total return with net dividends, from 12/31/2010 to 06/30/2011.
 - iii Source: Thomson Reuters.
 - iv Thomson Reuters, S&P 500 total return and MSCI net return from 12/31/1994 to 12/31/1995.
 - v *Gallup Daily: Obama Job Approval*, <http://www.gallup.com/poll/113980/gallup-daily-obama-job-approval.aspx> (accessed July 15, 2011).
 - vi *Reflections on Presidential Job Approval and Re-election Odds*, <http://www.gallup.com/poll/8608/reflections-presidential-job-approval-reelection-odds.aspx> (accessed July 15, 2011).
 - vii *Presidential Approval Ratings – George W. Bush*, <http://www.gallup.com/poll/116500/presidential-approval-ratings-george-bush.aspx> (accessed July 15, 2011).
 - viii *The Lone Star Jobs Surge*, http://online.wsj.com/article/SB10001424052702304259304576375480710070472.html?mod=WSJ_newsreel_opinion (accessed July 15, 2011).

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M.01.034-Q3110715