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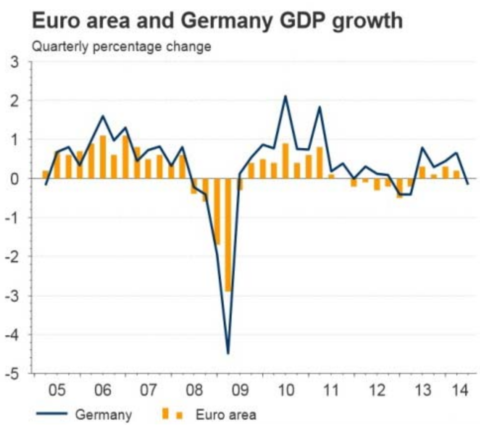
Policy Action Needed in Europe

Europe's nascent economic recovery is failing and inflation has been consistently under 1% (see chart below, left), well below both the European Central Bank's (ECB) targets and forecasts. This should prompt a policy response, and the sense of urgency has intensified with the situation in Ukraine. Last week, ECB president Mario Draghi appointed Blackrock to advise on developing a program to buy asset-backed securities, which has raised expectations of a much-needed quantitative easing program to emerge by the end of the year. Since we believe European monetary policy will become more expansionary over the next four months, we remain overweight Europe.



Source: Thomson Reuters Datastream

Russian President Vladimir Putin's actions last week suggested that he is not willing to settle for annexation of Crimea, and that he is undeterred by Western sanctions in his attempt to ensure that Kiev does not control Eastern Ukraine. The Ukrainian crisis is a relatively small economic headwind, but it is likely to act as a catalyst for European 'pro growth' policies, in our view.

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We continue to believe that Putin's military strategy will have dire long-term consequences for the Russian economy as Russia isolates itself from the West. This is already reflected by declining European exports to Russia. Russia accounts for only about 4.5% of Eurozone exports (see chart above, right), but Europe has lost a growth market that is unlikely to return. Russia accounts for about 8% of Europe's imports, most of which is crude oil and natural gas. As we noted last week, oil is a global product, and we believe that Russia will continue to supply its share. Natural gas is different; it trades on a more local basis; thus, prices vary widely across the globe because there is no quick or inexpensive way to transport surpluses from one part of the world to another.

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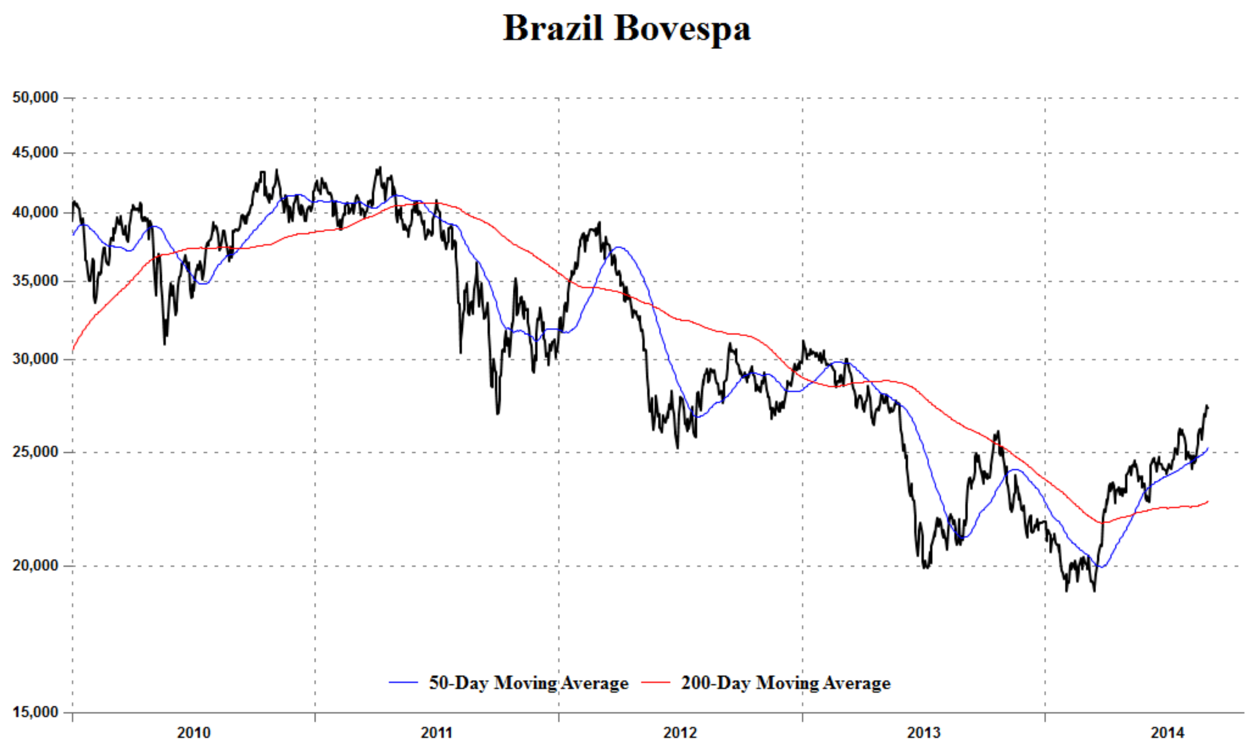
Germany imports a third of its natural gas from Russia, so Russia could potentially cause economic disruption to Germany this winter. However, Germany has accumulated gas inventories equal to about a three-month supply (approximately 33% higher than normal inventory levels). We do not expect Russia to disrupt gas supplies to Europe, but we recognize that we are trying to anticipate the thinking of a Machiavellian autocrat. Our belief is based on the impact of gas sales on Russia's economy and the risk it poses to

Putin's hold on power.

Energy provides two-thirds of Russian government revenue. Russia is engaged in an expensive incursion into Eastern Ukraine even as it makes major expenditures in recently annexed Crimea. Without natural gas revenue, we think it would be very difficult for Russia to fund these foreign policies while maintaining popular domestic spending programs. Funding would be especially problematic if, as is being discussed, the next round of sanctions eliminates Russia's access to foreign capital markets and the ability of Russian banks to tie into the global banking system.

Warming up to Brazil: Since Dilma Rousseff became Brazil's president in January 2011, Brazil's stock market, measured in US dollars, declined by 53% through March 2014 (see Weekly Chart) due to unfriendly business policies and economic mismanagement. In the last five months, stocks have rallied by more than 40% as Rousseff's reelection prospects have dimmed. Brazil's economy fell into recession in the second quarter, providing a challenging backdrop for October's elections. Rousseff has two main challengers, both with more market-friendly credentials, and in a runoff election either of them would likely beat the incumbent, based on recent polling. Until an August 13 plane crash killed presidential candidate Eduardo Campos, Rousseff's main rival was Aécio Neves, who *The Economist* has described as pro-business and competent. Following the national tragedy, however, Campos' running mate, Marina Silva, has surged in the polls after deciding to run in his stead and is now edging out Neves. Silva, although not as experienced as Neves, has adopted a business-friendly economic platform that "includes more fiscal discipline, consistent inflation targeting, free-floating exchange rate, updating of managed prices and rapprochement with agribusiness," as Forbes describes it. On August 5 we raised exposure to Latin America in our longer-term portfolios.

THE WEEKLY CHART: BRAZIL STOCKS RALLY ON ELECTION HOPES



Source: FactSet Research Systems; Past performance is no guarantee of future results.