DYNAMIC

Multi-asset review Q4 2018

Russell Investments' dynamic approach helps navigate a challenging quarter for investors

Andrew Sneddon, Managing Director – Multi-Asset Solutions, discusses Russell Investments' performance in the December quarter and the outlook for 2019.

What drove markets during the fourth quarter of 2018?

The December quarter was a challenging one for financial markets, with growth assets significantly underperforming their defensive counterparts amid heightened geopolitical risks, some softer European and Chinese economic data, and renewed fears of a global slowdown.

Two key events helped shape market movements over the quarter:

1. **US Federal Reserve raises interest rates**. The US Federal Reserve (Fed) raised interest rates again in the December quarter, lifting the benchmark federal funds rate a further 0.25% to between 2.25% and 2.50%. It was the bank's fourth rate hike this year and its ninth since 2015. However, in its post-meeting statement the bank flagged a slower pace of rate hikes in 2019, with officials saying they now expect two rather than three rate increases in the next 12 months. Moving forward, the challenge for the Fed will be establishing a 'neutral' rate; one which is neither restrictive nor accommodative for economic growth. According to the bank's latest projections, this neutral rate is somewhere between 2.50% and 3.00% in nominal terms, putting it just above the current federal funds rate of between 2.25% and 2.50%. In saying that, the market's expectation of Fed tightening eased considerably toward the end of December amid renewed concerns about slowing US and global growth, and recent, tighter financial conditions. We currently still expect the Fed to raise interest rates once in 2019, though we think the decisions from there will get a lot more interesting.

2. **Oil prices tumble**. Oil prices fell sharply in the fourth quarter, with West Texas Intermediate crude closing the period 38% lower at USD45/barrel. Much of the decline can be attributed to a combination of rising supply and falling demand. Output across major OPEC and non-OPEC producers has risen significantly, with surging US shale production seeing the country overtake Saudi Arabia as the world's biggest oil producer and Russian output hitting a post-Soviet record. At the same time, global economic growth is showing signs of slowing, with multiple purchasing manager indexes – particularly in key Asian growth markets – pointing to a slowdown in manufacturing activity. For the year, oil was 24.8% lower; the commodity's first annual decline in three years.

Global shares fell 13.3%[1] in the December quarter with Japanese, US and European names posting some of the largest losses. Australian shares were also sharply lower for the period; the local market returning -8.4%[2] amid a series of mixed shareholder updates, some disappointing third-quarter growth data and further evidence China's economy is slowing. Emerging markets equities closed the quarter 7.8%[3] lower; though they did outperform their developed counterparts over the period.

The Reserve Bank of Australia (RBA) left the official cash rate on hold at a record low 1.50% throughout the period. In its latest post-meeting statement, the bank said it still expects domestic growth to average around 3.5% this year and next, before slowing in 2020. Officials also noted that the labour market remains positive and that inflation is expected to pick up over the next couple of years, with the pick-up likely to be gradual. Meanwhile, the outlook for household consumption remains a concern, with growth in household income low and debt levels high. The RBA concluded its latest meeting by saying that *"taking account of the available information, the Board judged that holding the stance of monetary policy unchanged… would be consistent with sustainable growth in the economy and achieving the inflation target over time."*

The Australian dollar (AUD) weakened in the fourth quarter with the Australian Trade-Weighted Index down 2.4%[4] for

[1] Global shares measured by the MSCI World ex Australia Net Accumulation Index (in local currencies)

[2] Australian shares measured by the S&P/ASX 300 Accumulation Index

[3] Emerging markets measured by the MSCI Emerging Markets Index (in USD)

[4] The trade-weighted index for the AUD is an indicator of movements in the average value of the AUD against the currencies of our trading partners. Source: RBA.

the period. The AUD fell amid ongoing trade and political uncertainties, some disappointing third-quarter growth data and further evidence Chinese growth is slowing. The currency was also impacted by weaker commodity prices and general US dollar (USD) strength.

Interest rate sensitive assets were mixed for the quarter. Global and domestic bonds posted good gains over the period, while global listed property, global listed infrastructure and Australian listed property all underperformed.

In credit markets, spreads widened as investors remained largely risk averse against a backdrop of heightened market volatility. Meanwhile, strength in several emerging markets currencies contributed to reasonable gains for local currency emerging markets debt. In contrast, hard currency emerging markets debt weakened while corporate emerging markets debt was flat for the period.

How did Russell Investments' active multi-asset portfolios perform in the December quarter? What was rewarded by the market and what wasn't?

Absolute returns. The Russell Investments Balanced Fund returned -6.5% for the quarter on a net of fees and tax basis. Performance driven primarily by negative absolute returns from the Fund's equity exposures, both domestic and international.

Returns relative to fund benchmark. Relative to its strategic benchmark, the Russell Investments Balanced Fund underperformed by 1.1% on a net of fees and tax basis.

Positive contributors included:

›› An overweight to local currency emerging markets debt and our exposure to Amundi's long volatility strategy.

›› Positive excess returns from our global equity sector funds, including the Russell Investments Tax Effective Global Shares Fund and the Russell Investments Global Opportunities Fund.

›› Dynamic currency management; adding Japanese yen exposure to the portfolio.

Negative contributors included:

›› Negative excess returns from the Russell Investments Australian Shares Fund and the Russell Investments International Bond Fund (AUD hedged).

›› Negative absolute returns from growth alternatives, including high-yield debt, listed property and listed infrastructure.

Historically, Russell Investments' multi-asset funds tend to outperform peers in volatile market environments due to our diversified and dynamic investment approach, which seeks to anticipate emerging risks and position our funds accordingly.

What is Russell Investments' outlook for 2019? How is it impacting your active multi-asset positioning?

Volatility returned in 2018 and will likely continue in 2019. As late-cycle risks rise, there are several issues which remain on investors' minds, including tightening US monetary policy, global trade war escalation, budget conflict between Italy and the European Union, and uncertainty over Brexit. To add further complexity, it's likely both economic and corporate earnings growth will slow in the US.

In a volatile equity market environment, we have a neutral view on global equities overall. We believe that Europe and Japan still represent better relative value compared to the US. For Europe, we believe consensus expectations have become too pessimistic. Our base case is for the negative risks associated with Italy's budget, Brexit and global trade uncertainty to fade in 2019, and for European corporate earnings and economic growth to improve. We continue to like valuations for emerging markets equities, particularly given their attractiveness relative to developed markets. However, the threat of trade wars, slowing economic growth in China and a stronger USD temper our view.

For fixed income assets, we see the cycle as a headwind for bond markets, given the risk of rising inflation pressures and tighter monetary policy from major global central banks. We feel bonds remain expensive, especially given the US labour market is tight. Any selloff in bonds could be amplified if the Fed decides to raise interest rates at a faster pace than expected, and if global central banks shift further away from accommodative monetary policy stances. We believe high-yield credit remains expensive, which is typical late in the cycle when profit growth slows and concerns over defaults rise.

In terms of currencies, the Japanese yen remains our preferred currency. We believe the yen is undervalued, has attractive 'safe haven' properties due to its strong negative correlations with global equity returns, and is under owned from a market positioning standpoint. We also think the USD has modest upside potential, driven by interest rate differentials between the US and the rest of the G10. The strength of US growth relative to the rest of the world will continue to have implications on USD movements. With the RBA unlikely to shift monetary policy, we think the AUD will continue to be impacted by the US-Australian bond yield differential, geopolitical risks involving China and other emerging markets, and commodity price movements.

Although we expect late-cycle risks to rise further, we nonetheless expect the current US expansion to continue through 2019. In saying that, we see increasing risks for a US recession in 2020. Overall, we expect global growth to remain modestly positive, with volatile equity markets to deliver mid-single-digit returns. Downside risks of further selloffs remain, given uncertainty over US monetary policy and changes to global trade policies. Importantly, we believe this is an environment that will favour our active management approach.

For more information, please contact your Russell Investments representative:

Sydney 02 9229 5111
Melbourne 03 9270 8111

Important Information: