DYNAMIC

Russell Investments

Multi-asset review Q4 2019

RUSSELL INVESTMENTS' DYNAMIC APPROACH CONTINUES TO DELIVER POSITIVE ABSOLUTE RETURNS FOR INVESTORS

Here our Multi-Asset Solutions team discusses Russell Investments' performance in the December quarter and their outlook for 2020.

What drove markets during the fourth quarter of 2019?

The final quarter of 2019 saw growth assets significantly outperform their defensive counterparts as investors, buoyed largely by encouraging US-China trade developments, adopted a more 'risk on' mentality.

Two key events helped shape market movements over the quarter:

1. **Reserve Bank of Australia cuts interest rates**. The Reserve Bank of Australia (RBA) cut interest rates again in October; taking the official cash rate to a new low of just 0.75% as it looks to support employment and income growth and provide greater confidence that inflation will be consistent with its medium-term target. The cut was the Bank's third for 2019; the most in a calendar year since the four cuts we saw in 2012. At the time of the decision, officials noted that domestic growth for the year to 30 June was weaker than expected, that employment was likely to slow from its recent fast pace and that inflation pressures would likely remain subdued. Officials also reiterated their concerns over the outlook for consumption, with a sustained period of only modest increases in household disposable income continuing to weigh on consumer spending. However, there were reasons to be optimistic; notably the RBA's comment that a 'gentle turning point' appeared to have been reached, with economic growth a little higher over the first half of 2019 than over the second half of 2018. The Bank also pointed to the low level of interest rates, recent tax cuts, ongoing spending on infrastructure, signs of stabilisation in some established housing markets and a brighter outlook for the resources sector as factors that should support growth moving forward.

We've been of the view that the RBA would likely cut interest rates twice from their 1.00% level. We saw the first of these rate cuts in October and we continue to believe another cut is coming; most likely in the first half of 2020. The risk of the cut coming earlier has abated given the more positive direction of trade negotiations and reduced expectations of easier monetary policy globally.

2. **US and China agree limited trade deal**. In December, US and Chinese officials announced that they had finally agreed on a limited, 'phase one' trade deal that will, for now at least, halt the trade war between the two countries. The agreement comes after months of often tense discussions and will see China increase its purchases of US energy, farm and manufactured goods and the US reduce some tariffs on Chinese products. The deal also addresses US concerns over its trade and technology secrets, with China agreeing to better protect American intellectual property rights. We view the deal as a bit of a short-term panacea, with the broader structural issues around the US-China relationship still to be properly worked out. However, the deal, along with accommodative monetary policy, should help to push out the risk of recession. News of the agreement contributed to the good gains we saw in global share markets over the period, with US stocks in particular hitting fresh record highs in the wake of the announcement. Share markets were also higher in China, Japan, Europe and the UK.

Global shares rose 4.3%[1] in the December quarter. Australian shares were also positive, returning 0.7%[2] on the back of encouraging US-China trade developments, the RBA's decision to lower interest rates and strong performances from the major miners. Limiting the advance was weakness across the banking sector, a series of mixed domestic earnings results and softer third-quarter growth data. Emerging markets equities

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

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

outperformed their developed counterparts over the period, closing the quarter 7.3%[3] higher.

The Australian dollar (AUD) was stronger in the fourth quarter with the Australian Trade-Weighted Index up 1.9%[4]. The local currency rose on the back of positive US-China trade news, stronger commodity prices and general US dollar (USD) weakness. Limiting the gains were the RBA's rate cut decision and disappointing domestic growth.

Interest rate sensitive assets were mixed for the quarter. Rising yields contributed to negative absolute returns for Australian listed property and global and Australian bonds, while global listed infrastructure and global listed property both benefited from improving risk appetites.

In credit markets, spreads on US and European investment-grade and high-yield debt narrowed over the period amid encouraging US-China trade and Brexit developments. Meanwhile, local, hard currency and corporate emerging markets debt all posted good gains for the quarter.

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 2.1% for the quarter on a net of fees and tax basis. Performance was driven primarily by positive absolute returns from the Fund's global equity exposures.

Returns relative to fund benchmark. Relative to its strategic benchmark, the Russell Investments Balanced Fund outperformed by 0.3% on a net of fees and tax basis.

Positive contributors included:

›› Positive excess returns from Australian and global equity sector funds.

›› Overweights to global equities, global listed property trusts and local currency emerging market debt.

Negative contributors included:

›› Defensive exposures, including Australian and international bonds and (overweights) to the Japanese yen and Amundi Absolute Volatility World Equities Fund (AUD Hedged).

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 2020? How is it impacting your active multi-asset positioning?

Global markets finished 2019 strongly, with US equities notching their best calendar year return since 2013. We believe central bank easing and US-China trade war de-escalation pushes recession risks out to late 2021. With global manufacturing showing tentative signs of 'green shoots', equity markets may have modest upside potential for 2020. However, any setback in US-China trade relations and uncertainty over the US presidential election outcome could accelerate the timing of the next recession.

Our view on global equities has become more optimistic. We maintain an underweight preference for US equities, driven primarily by relatively expensive valuations. Additionally, cycle conditions appear firmer outside the US, which has us favouring non-US developed equities. Both Japan and Europe should benefit from fading trade war concerns and China policy stimulus, which would help bolster export demand. We think emerging markets remain attractive from a value standpoint. Regional central banks are easing policy and Chinese stimulus will likely be beneficial, however the smaller scale of stimulus may limit the upside for emerging markets.

For fixed income assets, we continue to see government bonds as universally expensive. US Treasuries offer the most attractive relative value. However, the concern is that central banks have limited ammunition to fight a downturn. Interest rates remain at zero or negative in Japan and Europe. The US Federal Reserve (Fed) has more scope to ease, but it also faces the zero-lower bound constraint. A Fed 'on hold' and improving US economy should lead to higher Treasury yields and a steeper yield curve. In credit markets, we still view high-yield bonds as slightly expensive given the risks from slowing corporate profit growth. This is typical late in the cycle when profit growth slows and concerns over defaults rise. We believe investment-grade credit is expensive, given the spread compression versus government bonds and a decline in average rating quality.

In terms of currencies, we maintain our preference for the Japanese yen. It remains undervalued despite the 2019 rally and has attractive 'safe haven' properties should the US-China trade war re-escalate. A mini-cycle recovery as the trade war is resolved, at least temporarily, could see the USD weaken, given its counter-cyclical tendency. In Australia, the RBA has hinted at further rate cuts to support the economy, which is being dragged down from falling housing construction and heavily-indebted households. We expect another rate cut by the middle of 2020. The AUD is likely to continue to be impacted by monetary policy, geopolitical risks involving China and other emerging markets and commodity price movements.

Short-term recession risks have been staved off, however late-cycle risks remain. The current economic expansion could extend further thanks to additional

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

[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.

policy stimulus from central banks and a trade truce between the US and China, even if only temporarily. However, major risks to our 2020 outlook include a re-escalation in US-China tensions, central bank policy turning hawkish if inflation pressures build, and the Democrats winning the US presidential election and triggering a policy shift which is negative for corporate profits. We remain alert to downside risks of further selloffs given uncertainty over central bank policy and changes to global trade policies. Importantly, we believe this is an environment that will favour our active management approach.

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