Russell Investments

Multi-asset review Q3 2017

INVESTORS CONTINUE TO BENEFIT FROM RUSSELL INVESTMENTS' DYNAMIC APPROACH

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Andrew Sneddon, Managing Director – Multi-Asset Solutions, discusses Russell Investments' performance in the September quarter and the outlook for the remainder of 2017

1. What drove markets during the third quarter 2017?

Financial markets made further gains in the September quarter, with growth assets once again outperforming their defensive counterparts amid expectations the global recovery is gathering momentum. Meanwhile, volatility remained relatively subdued throughout the period, though escalating tensions between the US and North Korea did cause periodic bouts of uncertainty.

Two key themes emerged over the quarter which influenced market movements:

1. **The US Federal Reserve calls time on quantitative easing.** In September, the US Federal Reserve (Fed) announced that it would soon begin the process of unwinding the massive quantitative easing program it implemented in the wake of the global financial crisis. The central bank will from October start to pare back its multi-trillion-dollar balance sheet – made up largely of US Treasuries and mortgage-backed securities – amid signs growth in the world's biggest economy continues to strengthen. Expectations are the Fed will start small, offloading around USD6 billion of Treasury debt and USD4 billion of mortgage-backed securities each month, rising over time to USD30 billion and USD20 billion, respectively, by 2019.
2. **Commodity prices rebound.** Commodity prices staged a strong rebound in the third quarter. Oil led the way; the price for West Texas Intermediate crude rising on expectations of stronger US demand, hurricane-related shutdowns and a weaker US dollar (USD). Gold and base metal prices were also stronger for the quarter. Gold gained as investors favoured the precious metal's safe haven characteristics in the face of heightened geopolitical risks, while base metals benefited in part from supply disruptions and an element of speculative buying. In saying that, iron ore was a notable exception; the commodity falling into a bear market in September amid tougher environmental controls in China and concerns supply is again set to outpace demand.

Global shares rose 2.8%[1] in the September quarter with US, German and Japanese stocks all hitting record highs. Emerging markets also extended their impressive run, once again outperforming their more developed peers. Meanwhile, Australian shares made reasonable gains over the period. The local market rose 0.8%[2] following strong performances from our major miners and three of the 'Big Four' banks; CBA being the notable exception after it emerged Australia's largest lender may have breached rules designed to prevent money laundering.

The Reserve Bank of Australia (RBA) left the official cash rate unchanged at a record low 1.5% throughout the quarter and, in doing so, maintained a relatively upbeat assessment of the local economy. The RBA said it expects employment growth to continue to improve while inflation, which remains below the Bank's 2-3% target range, is expected to pick up gradually as the economy strengthens. However, a stronger Australian dollar (AUD) remains a concern for officials, as a higher exchange rate would likely result in a slower pick-up in economic activity and inflation than is currently forecast.

The AUD rose in the September quarter with the Australian Trade-Weighted Index up 1.1%[3] for the period. Much of the currency's strength was driven by improving domestic economic activity, stronger commodity prices and general USD weakness.

Interest rate sensitive assets such as bonds, listed infrastructure and global listed property all made reasonable gains over the quarter despite rising long-term bond yields; investors choosing to focus instead on their traditionally defensive characteristics in the face of heightened geopolitical uncertainty. Australian listed property tracked its global counterparts higher amid an uptick in domestic corporate activity and some encouraging forward-looking earnings guidance.

[1] Global shares measured by the Russell Global Large Cap Index (in unhedged AUD)
[2] Australian shares measured by the S&P/ASX 300 Accumulation Index
[3] 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.

Still-strong risk appetites, rising oil prices and general optimism surrounding the global growth outlook contributed to further, albeit modest, gains in corporate bonds. Meanwhile, demand for emerging markets debt remained robust due to stable Chinese growth, higher commodity prices and ongoing USD weakness.

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

Absolute returns. The Russell Investments Balanced Opportunities Fund returned 2.0% for the quarter on a gross of fees and tax basis. Performance was driven by positive absolute returns from the Fund's global equities and alternative assets portfolios, as well as our AUD positioning.

Returns relative to fund benchmark. Relative to its strategic benchmark, the Russell Investments Balanced Opportunities Fund outperformed by 0.5% on a gross of fees and tax basis.

Returns relative to peers. Relative to the median manager in our peer universe, on a net of fees and tax basis, the Russell Investments Balanced Opportunities Fund outperformed the peer median by 0.1%[4].

Positive contributors included:

- Strong benchmark-relative performance from the Russell Investments Global Opportunities Fund and Russell Investments Tax-Effective Global Shares Fund.
- Positive absolute returns from our global high-yield debt, global listed infrastructure, global listed property and local currency emerging markets debt portfolios.
- Active currency positioning, including a long euro position relative to the USD.

These were partially offset by:

- Underweight exposures to US equities, commodities and Australian listed property.
- Overweight exposure to cash.
- Underweight exposures to interest rate sensitive assets such as bonds and global 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.

3. What is Russell Investments' outlook for the remainder of 2017? How is it impacting your active multi-asset positioning?

We expect volatility to continue through the final quarter of 2017 as investors contend with Donald Trump's aggressive policy agenda, potential further Fed rate hikes, and potential normalisation of monetary policy outside the US.

Europe has benefited from improving earnings and receding political risks involving the spread of populism. Relative to the US, we still believe other developed markets represent better value, though we would like to see further signs of earnings growth and more confidence in the economic growth outlook. Emerging markets were thrown a curve ball by Trump's election victory in November, as the possible rejection of international trade deals and the threat of higher global yields were both expected to have negative impacts. However, emerging economies have shown resilience, even in the face of recent Fed tightening. Whilst we believe emerging markets represent superior value relative to their developed peers on a longer time horizon, we nonetheless remain cautious about buying any dips.

Though bond markets have retraced some of their losses following the US election, we nonetheless maintain our neutral outlook for both government and investment-grade bonds. With interest rates still at historically low levels, we feel bonds are expensive and may face headwinds in the form of potential rising inflation and higher US yields; which could be amplified if the Fed decides to raise rates at a faster pace than expected over the remainder of this year and next, and if global central banks shift away from their accommodative monetary policy stances.

In terms of currencies, the prospect for US tax cuts, deregulation and increased fiscal spending, together with potentially higher US interest rates, could still lead to a rebound in the USD, however the timing and implementation of reforms is uncertain. Meanwhile, the future direction of the AUD is likely to continue to be influenced by movements in commodity prices, especially with the RBA expected to keep interest rates on hold in the foreseeable future.

Overall, we expect global growth to remain modestly positive through the end of the year, with downside risks of further market selloffs as markets continue to adjust to potentially higher levels of interest rates and changes to monetary and fiscal policy, especially in the US. Importantly, though, we believe financial markets will continue to provide further investment opportunities for our active management approach.

[4] The peer benchmark on a net of fees basis for the Russell Investments Balanced Opportunities PST became the Chant West Implemented Consulting – Custom Growth survey effective 1 October 2015 and includes MySuper competitors (including retail and industry super funds). The peer median returned 1.4% for the September quarter 2017.

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