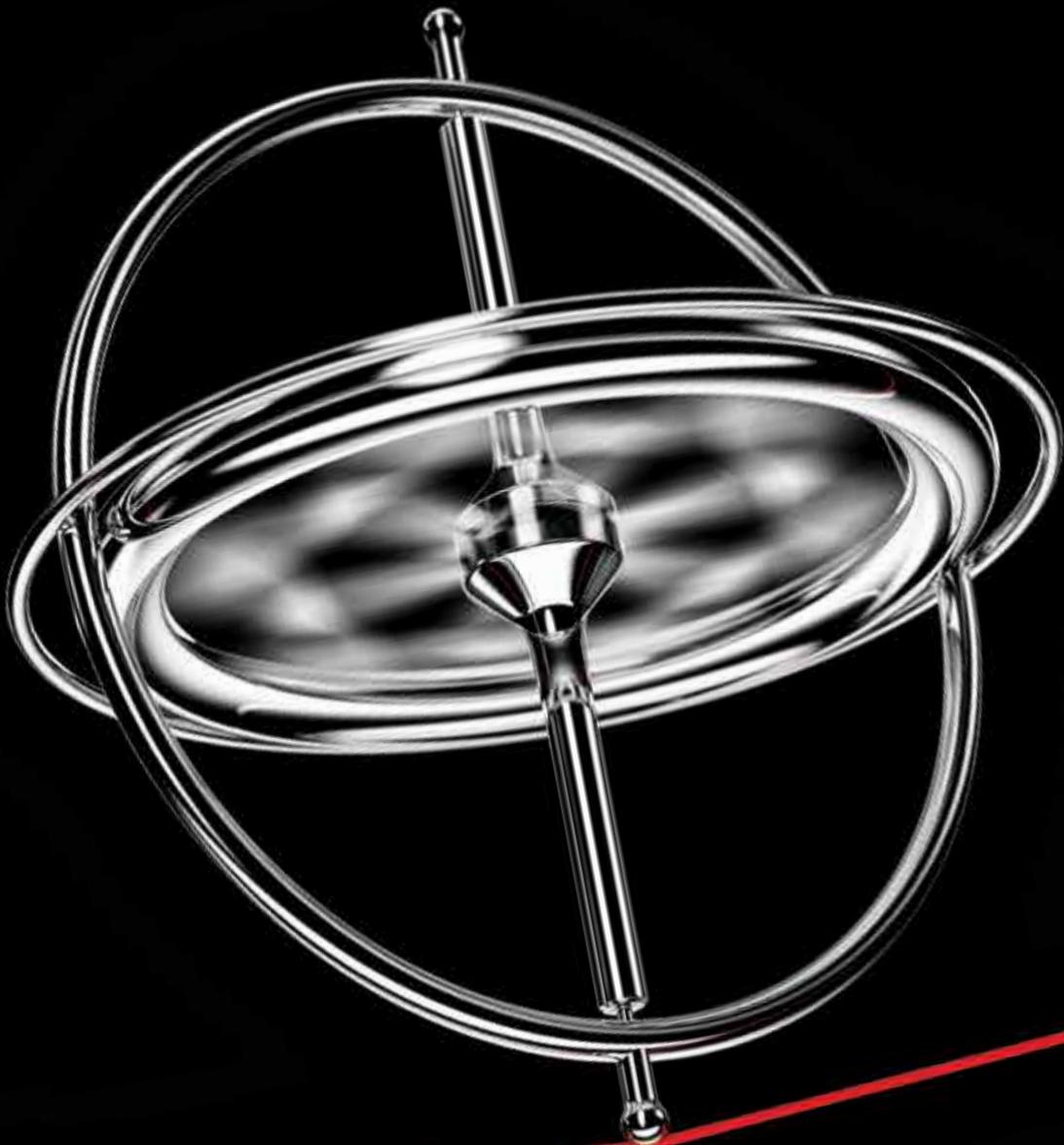


TIGHTROPE



2018 Global Market Outlook – Q3 update



Synopsis

The two key global market trends of early 2018—U.S. growth leadership and the U.S. dollar bounce—have probably run their course.

Be alert for an escalation in the trade-war issue, and keep an eye on the yield curve for a U.S. recession warning, although a recession seems unlikely before late 2019.

Key market themes

We maintain an underweight preference for U.S. equities in global portfolios, primarily on the back of their expensive valuations. The cyclically adjusted price-to-earnings ratio for the S&P 500® Index – commonly called the Shiller P/E ratio – stands at 32x in June 2018, which is its highest level outside of 1929 and the late 1990s. Our *valuation* conditional framework as of mid-year suggests the expected total return on U.S. equities over the next decade is likely to be very subdued – at only about 2% per year. Our underweight preference for U.S. government bonds and interest rate risk from prior years has shifted to neutral, as a 3% U.S. 10-year Treasury yield better reflects our macro outlook and the risks surrounding U.S. Federal Reserve (the Fed) policy and inflation.

We believe Asia-Pacific valuations are fair priced to slightly attractive across the region. We continue to like Japanese valuations and believe that part of the rise in Japanese profit margins is structural (rather than cyclical). Australia is close to fair value in our view. Developing Asia looks attractive, with the caveat that China H-shares are expensive due to the Chinese tech names. We expect to see solid performance out of the economic data and equity markets in the region, underpinned by strong Chinese activity, robust global growth and supportive policy. However, an escalation in trade tensions or further strengthening in the U.S. dollar remain key risks.

We are neutral on eurozone equity valuations, while we see core government bonds as long-term expensive. We decided to slightly alter our range for eurozone core bond yields from 0-0.8% to 0.2-1.0% to line up with the low point in yields during the Italian political flare-up. We went underweight Italian bonds in April and moved to overweight subsequently in two steps when valuations jumped from expensive to cheap. We continue to favour eurozone financial markets over U.S. markets in particular. The push from strong fundamentals, relatively attractive valuation and supportive monetary policy will likely combine to outweigh the pull from increased political risk.

While UK equity valuations have become slightly cheap on our scorecard at mid-year 2018, we continue to advocate caution given the uncertainties surrounding Brexit as well as the economic slowdown. Government bond valuations are long-term expensive, but at 1.3%, the current 10-year gilt yield is well within our expected range of 1.0%-1.8% for 2018.

Canadian valuation measures such as price-to-earnings and price-to-book continue to improve on the back of encouraging energy earnings fundamentals. We remain largely neutral in an absolute sense, but are modestly positive toward Canadian equities relative to the U.S.

Economic indicators

- The main economic data trend has been the growing gap between the economic performance of the United States and the rest of the world. The manufacturing purchasing managers' index (PMI) for the United States has trended higher this year, while Europe and Japan have reversed some of last year's gains.
- This theme of U.S. growth leadership is one reason U.S. equity-market returns have outpaced those in Europe and Japan in the first half of 2018. We expect a rotation away from the U.S. in coming months.
- Data surprise is cyclical and we believe Europe should rebound to positive surprise as industry consensus forecasts are downgraded and the region maintains its above-trend growth path.
- Our one-year to 18-month outlook favours regions with the potential for low inflationary above-trend growth, continued accommodative policy settings and corporate margin expansion. This puts Europe, Japan and emerging markets in our view ahead of the U.S. in the cycle pecking order.

Asset class views

Equities: Broadly neutral

Our cycle, value and sentiment (CVS) investment decision-making process holds us at a broadly neutral weighting on global equities. We have a small preference for Europe, Japan and emerging markets over the U.S., and expect that the U.S. 10-year Treasury yield has limited upside. We see the U.S. dollar bounce as having run its course.

Fixed income: Fair value at 2.6% in the U.S., very expensive elsewhere

3% has proven a strong resistance level for the 10-year U.S. Treasury yield. Our fair value estimate is 2.6% as of mid-year 2018. This is based on our expected path for the Fed funds rate over the next few years plus the term premium. It includes our expectation that the U.S. will possibly experience a recession by 2020, which means the Fed likely will be lowering rates by then.

German bunds, UK gilts and Japanese government bonds (JGB) are very expensive, based on our methodology. The cycle forces on JGBs and gilts are broadly neutral and unlikely to push yields higher. The Bank of Japan remains committed to *yield curve control* and is targeting the 10-year JGB yield to remain below 0.1%.

The cycle is moving against bunds as the European Central Bank (ECB) approaches tapering and inflation pressures build. This makes bunds our least preferred government bond exposure.

Currencies: Neutral on U.S. dollar

We retain an overall neutral view on the U.S. dollar. The U.S. dollar trade-weighted index has rebounded 5% since mid-April, reversing some of the downward trend since the beginning of 2017. Our cycle, value and sentiment (CVS) investment decision-making process suggests that the upside for the USD is limited from here. We estimate that the USD is around 10% overvalued in purchasing power parity terms against a basket of developed market currencies.

Cheap valuation, a healthy current account surplus and the expected gradual exit from the ECB's loose monetary policy keep us constructive on the euro. The Japanese yen is still our favourite G10 currency based on its attractive value and safe-haven characteristics.

Please visit russellinvestments.com to read the complete 2018 Global Market Outlook – Q3 Update.



IMPORTANT INFORMATION

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Keep in mind that, like all investing, multi-asset investing does not assure a profit or protect against loss.

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