Multi-asset review Q2 2018

RUSSELL INVESTMENTS' DYNAMIC APPROACH HELPS TO NAVIGATE VOLATILITY FOR INVESTORS

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Andrew Sneddon, Managing Director – Multi-Asset Solutions, discusses Russell Investments' performance in the June quarter and the outlook for 2018.

1. What drove markets during the second quarter of 2018?

The June quarter was a better one for financial markets, with growth assets significantly outperforming their defensive counterparts amid further evidence the global recovery is gathering momentum. However, ongoing geopolitical risks, including an escalation in US-China trade tensions through the second half of the period, did spark periodic bouts of uncertainty.

Two key events helped shape market movements over the quarter:

1. **The US Federal Reserve raises interest rates yet again.** The US Federal Reserve (Fed) raised interest rates again in the second quarter, lifting the benchmark federal funds rate a further 0.25% to between 1.75% and 2.00%. It was the Bank's second rate hike this year and came on the back of continued economic expansion, a strengthening labour market and expectations inflation will rise faster than previously forecast. The Fed also signalled that the pace of rate hikes this year will accelerate from three to four, with officials confident the US economy is strong enough to withstand higher borrowing costs without it impacting growth. Moving forward, the challenge for the Fed will be to balance its need to encourage further economic growth without allowing inflation to get out of hand. Raising interest rates too quickly could end up stifling the economy's recovery, while moving too slowly could cause inflation to spike, pushing prices higher and potentially sending the economy into recession.

2. **Chinese stocks enter bear market.** Chinese stocks fell into a bear market late in the June quarter, with the Shanghai Shenzhen CSI 300 Index falling as much as 22.4% from its recent January peak. A bear market is generally considered a decline of 20% or more. Part of the decline can be attributed to deleveraging, a fresh, widespread crackdown on financial market irregularities and profit taking following the strong gains we saw ahead of the long Lunar New Year holiday. Exacerbating the decline was a weakening yuan and an escalation in trade tensions between Beijing and Washington that began with Donald Trump's decision in March to slap around USD50 billion in tariffs on Chinese imports. This sparked a tit-for-tat battle between Trump and Chinese counterpart Xi Jinping over tariffs, with both leaders waiting for the other to blink first. China's share market closed the quarter 9.9% lower; its worst quarterly performance since the first quarter of 2016.

Global shares rose 3.4%[1] in the June quarter with UK, Japanese and US names posting some of the biggest gains. Australian shares tracked their global counterparts higher over the period; the local market returning 8.4%[2] amid some positive earnings updates, stronger commodity prices and further domestic M&A activity. In contrast, emerging markets equities were sharply lower for the quarter, driven by rising US interest rates, heightened US-China trade tensions and a stronger US dollar (USD).

The Reserve Bank of Australia (RBA) left the official cash rate unchanged at a record low 1.50% throughout the period. In its latest post-meeting statement, the central bank said it expects growth to average a bit above 3.0% this year and next, employment growth to continue to improve and inflation, which remains below the RBA's 2-3% target range, to stay low for some time; though a gradual pick-up in inflation is expected as the economy strengthens. Meanwhile, officials acknowledged wage growth remains low and that a stronger Australian dollar (AUD) would be expected to result in a slower pick-up in economic activity and inflation than is currently forecast. Household consumption is also a concern, with household incomes growing slowly while debt levels remain high.

The AUD made modest gains in the June quarter with the Australian Trade-Weighted Index up 0.5%[3] for the period. The local currency benefited from another round of positive earnings results, further encouraging Chinese growth figures and higher commodity prices.

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. 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.

Interest rate sensitive assets such as bonds, listed infrastructure and global listed property were all positive for the quarter. Australian listed property was also stronger for the period amid relatively flat bond yields and a number of large acquisitions within the sector.

Periodic bouts of volatility weighed on corporate bonds over the period, though stronger oil prices and expectations global growth remains relatively robust did help to limit the decline. Meanwhile, rising US interest rates, a stronger USD and the threat of a full-blown US-China trade war negatively impacted demand for emerging markets debt.

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

Absolute returns. The Russell Investments Balanced Fund returned 2.9% for the quarter on a net of fees and tax basis. Performance was driven largely by positive absolute returns from the Fund's domestic equity exposure, and unhedged international equity exposures.

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 include:

› Positive absolute and excess returns from the Russell Investments Australian Shares Tracker Fund.

› An overweight to international equities.

› Dynamic currency management; lowering the AUD hedge ratio for portfolios.

Negative contributors included:

› Negative absolute returns from local currency emerging markets debt.

› Negative excess returns from our international equity and fixed income sector funds, including the Russell Investments Global Opportunities Fund and the Russell Investments International Bond 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.

3. What is Russell Investments' outlook for 2018? How is it impacting your active multi-asset positioning?

We expect volatility to continue through 2018 as investors contend with US policy agenda, potential further US rate hikes, potential normalisation of monetary policy outside the US and ever-present geopolitical risks.

Relative to the US, we still believe other developed markets represent better value. Despite the slowdown in early 2018, we remain upbeat on the health of European economies; though caution is warranted given rising near-term political risks. Emerging markets assets have weakened recently from a stronger USD, but corporate earnings and economic growth are still resilient. In saying that, geopolitical risks remain along with the threat of tighter US monetary policy and a potential trade war between the US and China. We still believe emerging markets represent superior value relative to their developed peers on a longer time horizon.

Our base case is for the Fed to raise interest rates a total of three to four times in 2018. We feel bonds remain expensive and may face headwinds in the form of potential rising inflation and higher US yields, especially given that the US labour market is tight. Any selloff in bonds could be amplified if the Fed decides to raise rates at a faster pace than expected, and if global central banks shift away from their accommodative monetary policy stances. We hold an unfavourable view on high-yield debt, as valuations have become stretched given the compression in credit spreads to near-historical lows. Conversely, we favour local currency emerging markets debt, with fundamentals remaining strong.

In terms of currencies, the USD has staged a recovery, driven by interest rate differentials between the US and the rest of the G10. We hold a neutral view on the USD, and believe its recent rebound is technical rather than structural in nature. We continue to hold a preference for the Japanese yen, given the solid economic data flow from Japan, including strong external demand and a tightening labour market. The yen is also attractive from a 'safe haven' perspective, as it is the currency most negatively correlated with global equity returns. Meanwhile, the future direction of the AUD is likely to continue to be influenced by movements in commodity prices together with any potential shift in the RBA's stance on monetary policy.

Overall, we expect global growth to remain modestly positive through 2018, 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.

For more information, please contact your Russell Investments regional manager:

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