Multi-asset review Q1 2017

RUSSELL INVESTMENTS' DYNAMIC APPROACH DELIVERS A SUCCESSFUL QUARTER

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

1. What drove markets during the first quarter 2017?

Financial markets extended their gains in the March quarter, with growth assets in particular continuing to perform well as investors remained optimistic about the global recovery. Meanwhile, volatility remained relatively subdued throughout the period as global and domestic equities rallied and bond yields traded within fairly narrow ranges.

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

1. **The US Federal Reserve raised interest rates.** In March, the US Federal Reserve (Fed) raised its benchmark interest rate a further 0.25%, to between 0.75% and 1.00%. The decision – which came on the back of a similar move in December – had been widely anticipated and came against a backdrop of steady growth, a strengthening labour market and inflation expectations moving toward the bank's 2% target. In her post-meeting statement, Fed chair Janet Yellen reaffirmed the bank's pledge to raise interest rates only 'gradually'. Importantly, investors interpreted the Fed's move as further evidence growth in the world's biggest economy is gathering momentum.
2. **Heightened geopolitical risks.** Politics took centre stage throughout the quarter, led by President Donald Trump's proposed travel ban on citizens of seven, mostly Muslim, nations, his missile attack on Syria – a move which drew a sharp rebuke from Russia – and his decision to send warships to the Korean peninsula in a bid to rein in North Korea's Kim Jong-un. We also saw British prime minister Theresa May officially began the process of Britain's exit from the European Union, and uncertainty in the lead up to elections in the Netherlands and France.

Global shares rose 1.4%[1] in the March quarter with US and UK stocks both hitting fresh record highs. Emerging markets were also positive for the period, significantly outperforming their developed peers. Australian shares posted further gains despite a slow start; the local market rising 4.7%[2] amid strong returns across the 'Big Four' banks, a better-than-expected December-half earnings season and a series of improving domestic and Chinese economic data.

The Reserve Bank of Australia (RBA) left the official cash rate unchanged at a record low 1.50% throughout the quarter; the bank noting that the economy is continuing its transition following the end of the mining boom. However, the bank did note that labour market indicators continue to be mixed and inflation remains quite low, while a stronger Australian dollar (AUD) still has the potential to complicate the transition.

During the quarter, the AUD rose from 72.1c to 76.3c. Much of the currency's gains came in the early part of the period as the US dollar (USD) weakened, commodity prices jumped and investors bet the RBA had reached the bottom of its current easing cycle.

Interest rate sensitive assets such as bonds, listed infrastructure and global listed property all posted positive returns for the quarter as yields traded in a fairly narrow range and as investors favoured their traditionally defensive characteristics amid heightened geopolitical uncertainty. In contrast, Australian listed property weakened slightly despite a strong finish to the quarter; due in part to expectations the RBA's next rate move will be up.

Still-strong risk appetites and expectations of better company earnings helped drive further gains in corporate bonds, while emerging markets bonds recovered as emerging markets currencies rebounded and global yields remained range bound.

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

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

Absolute returns. The Russell Investments Balanced Fund returned 2.2% for the quarter on a net of fees and tax basis. Performance was driven by positive absolute returns from the Fund's global and domestic equities portfolios, as well as its exposure to global high-yield and local currency emerging markets debt.

Returns relative to fund benchmark. Relative to its strategic benchmark, the Russell Investments Balanced Fund underperformed by 0.4% on a net of fees and tax basis. Key drivers of this underperformance were our underweight exposures to global and domestic equities, and an overweight exposure to cash. Underweight exposures to bonds and listed infrastructure also weighed on benchmark-relative returns.

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 Fund underperformed the peer median by 0.2%[3].

Negative contributors include:

- Underweight exposures to global and domestic equities, particularly toward the end of the period.
- Overweight exposure to cash in March.
- Underweight exposure to interest rate sensitive assets such as bonds and listed infrastructure.

These were partially offset by:

- 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, global listed property and local currency emerging markets debt portfolios.
- Active currency positioning, including long AUD positions relative to the Euro, the British Pound and the Japanese Yen.

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 2017? How is it impacting your active multi-asset positioning?

We expect volatility to continue in 2017 as investors grapple with President Donald Trump's policy agenda, Fed rate hikes, European elections and the longer-term impact of Brexit.

Relative to the US, we currently 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 when faced with recent Fed tightening. Whilst we believe emerging markets represent superior value relative to developed regions on a longer time horizon, we still remain cautious about buying any dips.

Though bond markets have retraced some of their losses following the US election, we continue to have a 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.

In terms of currencies, broad anticipation for US tax cuts, regulatory reform and increased fiscal spending, together with the prospect of higher US interest rates, could drive the USD higher this year. For the AUD, the recent surge in commodity prices has led to an appreciation against other major currencies. The future direction of the AUD is likely to be influenced by the sustainability of commodity prices at current levels, especially with the RBA expected to keep interest rates on hold this year.

Overall, we expect global growth to remain positive this year, with downside risks of further market selloffs. The first half of the year is likely to be a modest growth environment as markets adjust to potentially higher levels of interest rates and changes to monetary and fiscal policy, especially in the US.

Importantly, we believe 2017 will provide some real opportunities for active management compared to the prior 12-18 months. With this in mind, we will maintain a dynamic and diverse investment approach to help investors achieve their goals.

3 The peer median on a net of fees basis for the Russell Investments Balanced Fund is the Chant West Multi-Manager Investment Survey. The peer median returned 2.4% for the March quarter 2017.

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

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