

GROWING PAINS



2021 Global Market Outlook – Q4 update





Growing pains

The COVID-19 delta variant, inflation and central bank tapering are unnerving investors. We expect the pandemic-recovery trade to resume as inflation subsides, infection rates decline, and tapering turns out to not equal tightening. The outlook favors equities over bonds, the value factor over the growth factor and non-U.S. over U.S. stocks.



The strong cycle delivers a preference for equities over bonds for at least the next 12 months, despite expensive valuations.

Andrew Pease, Head of Global Investment Strategy



Introduction

The post-lockdown recovery has transitioned from energetic youthfulness to awkward adolescence. It's still growing, although at a slower pace, and there are worries about what happens next – particularly about monetary policy and the outlook for inflation. The [inflation spike](#) has been larger than expected, but we still think it is [transitory](#), caused by base effects from when the U.S. consumer price index (CPI) fell during the lockdown last year and by temporary supply bottlenecks. Inflation may remain high over the remainder of 2021 but should decline in early 2022. This means that even though the U.S. Federal Reserve (Fed) is likely to begin tapering back on asset purchases before the end of the year, rate hikes are unlikely before the second half of 2023.

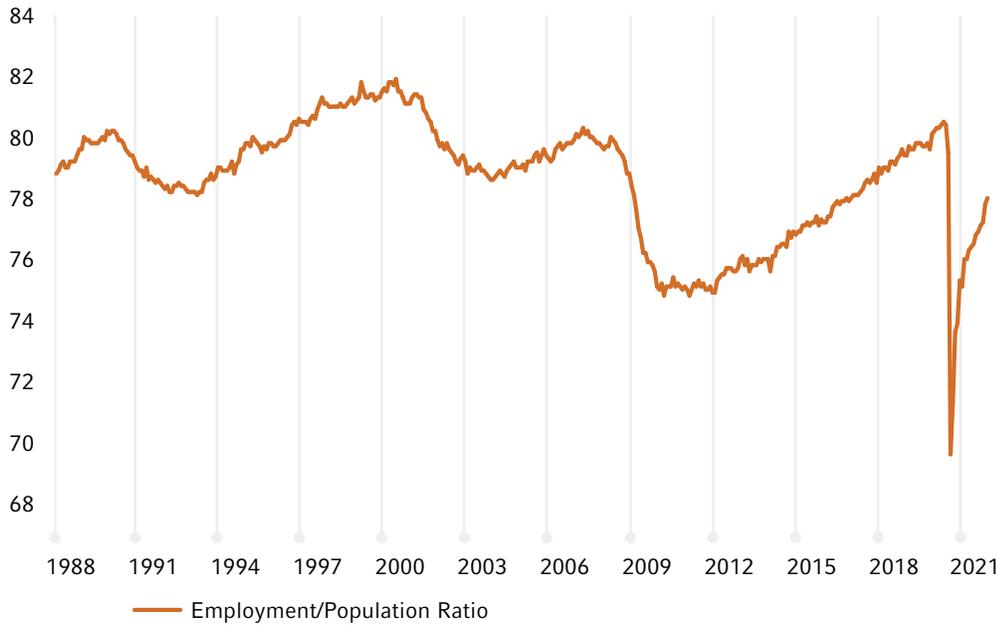
Another worry is the [highly contagious COVID-19 delta variant](#). The evidence so far is that vaccines are effective in preventing serious COVID-19 infections. Vaccination rates are accelerating globally, and emerging economies are catching up with developed markets. Infection rates appear to have peaked globally in early September. This means the reopening of economies should continue over the remainder of 2021. The onset of winter in the northern hemisphere will be a test, but the rollout of booster vaccination shots should help prevent widescale renewed lockdowns.

The conclusions from our cycle, value and sentiment (CVS) investment decision-making process are broadly unchanged from our previous quarterly report. Global equities remain expensive, with the very expensive U.S. market offsetting better value elsewhere. Sentiment is slightly overbought, but not close to dangerous levels of euphoria. The strong cycle delivers a preference for equities over bonds for at least the next 12 months, despite expensive valuations. It also reinforces our preference for the [value equity factor over the growth factor](#) and for non-U.S. equities to outperform the U.S. market.

Cycle still in recovery phase

The post-lockdown recovery has been powerful, and most developed economies have seen double-digit gross domestic product (GDP) rebounds from 2020 lows. Even so, we think the cycle is still in the recovery phase, although it is maturing. Despite strong growth, there is plenty of spare capacity. This can be seen in the employment-to-population ratio for prime-age workers in the United States. The chart below shows the ratio has recovered from the pandemic lows, but only to levels reached during the relatively mild recessions in the early 1990s and 2000s. We expect the [U.S. labor-market recovery](#) should still resemble a typical post-recession recovery over the next few quarters.

U.S. employment-population ratio for prime-age workers

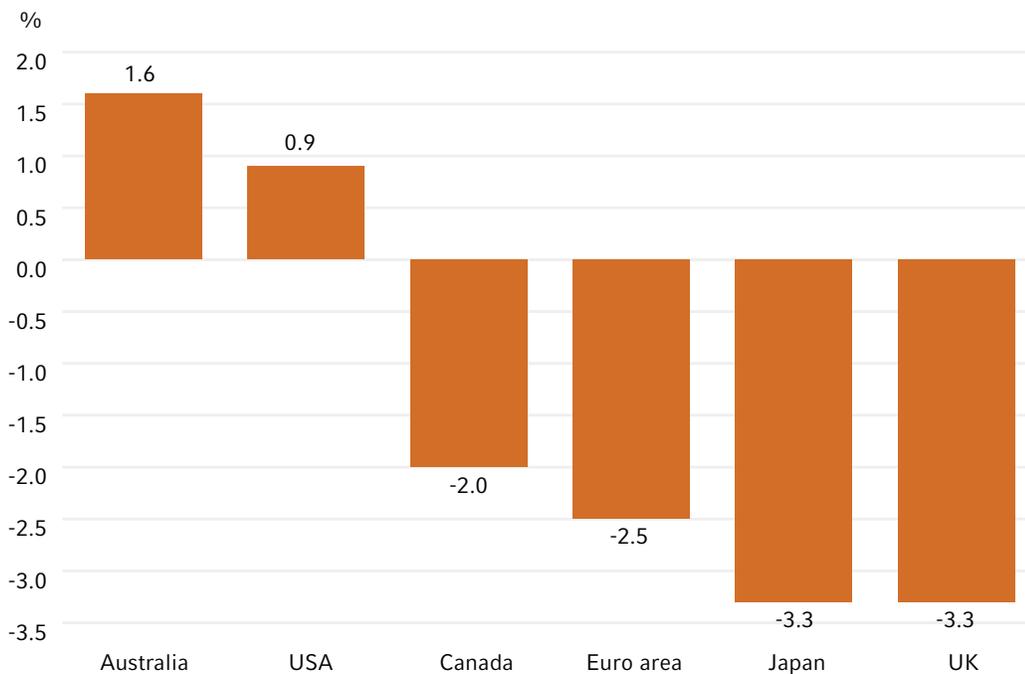


Source: U.S. Bureau of Labor Statistics, as of August 2021.

The U.S. recovery, however, is more advanced than that of other developed economies. The following chart shows how far GDP has recovered, relative to the pre-COVID-19 peak in 2019. GDP is 0.8% higher in the U.S., although this level is still short relative to the pre-COVID-19 trend.

GDP is 2.5% below 2019 levels in the euro area and 4.5% below in the United Kingdom. We expect more cyclical upside for economic growth outside the U.S., and this should allow market leadership to rotate toward the rest of the world.

GDP in Q2 2021 relative to pre-COVID-19 peak in 2019



Source: Refinitiv® Datastream®, Russell Investments' calculations.

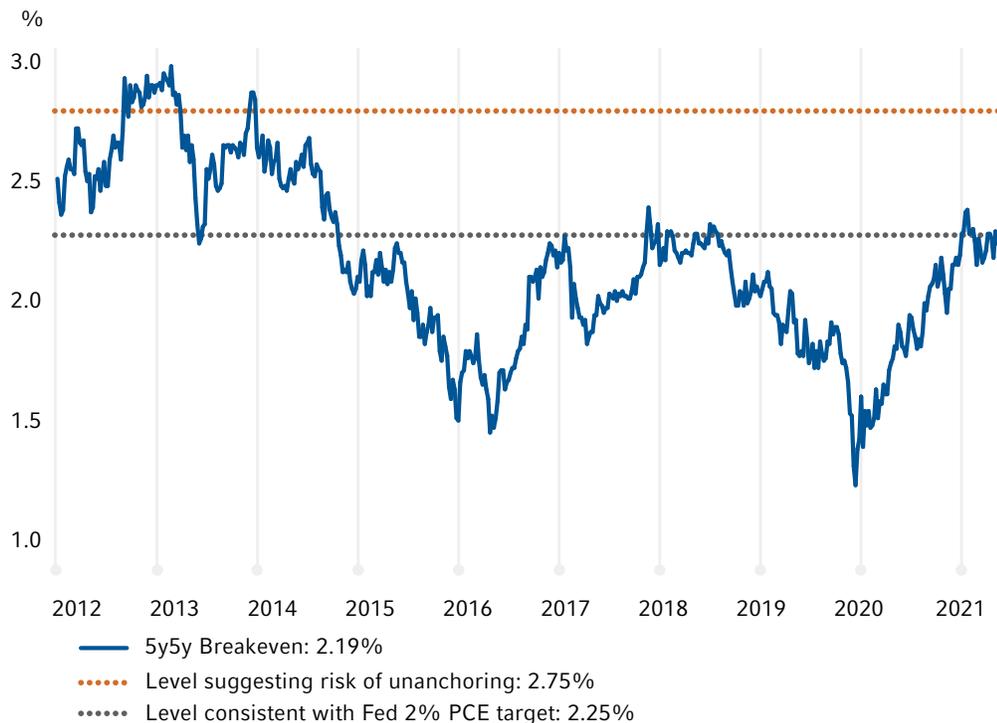
Two key indicators

Last quarter, we listed two indicators that should offer a guide to the Fed's expected reaction to the inflation spike.

The first is five-year/five-year breakeven inflation expectations, based on the pricing of Treasury Inflation Protected Securities (TIPS). This is the market's forecast for average inflation over five years in five years' time. It tells us that investors expect inflation will average 2.17% in the five years from late 2026 to late 2031. The TIPS yields are based on the CPI, while the Fed targets inflation as measured by the personal consumption

expenditure (PCE) deflator. The two move together over time, but CPI inflation is generally around 0.25% higher than PCE inflation. A breakeven rate of 2.75% would suggest the market sees PCE inflation above 2.5% in five years' time. Market inflation expectations are currently comfortably below the Fed's worry point.

Watchpoint indicator #1: U.S. 5-year/5-year breakeven inflation rate

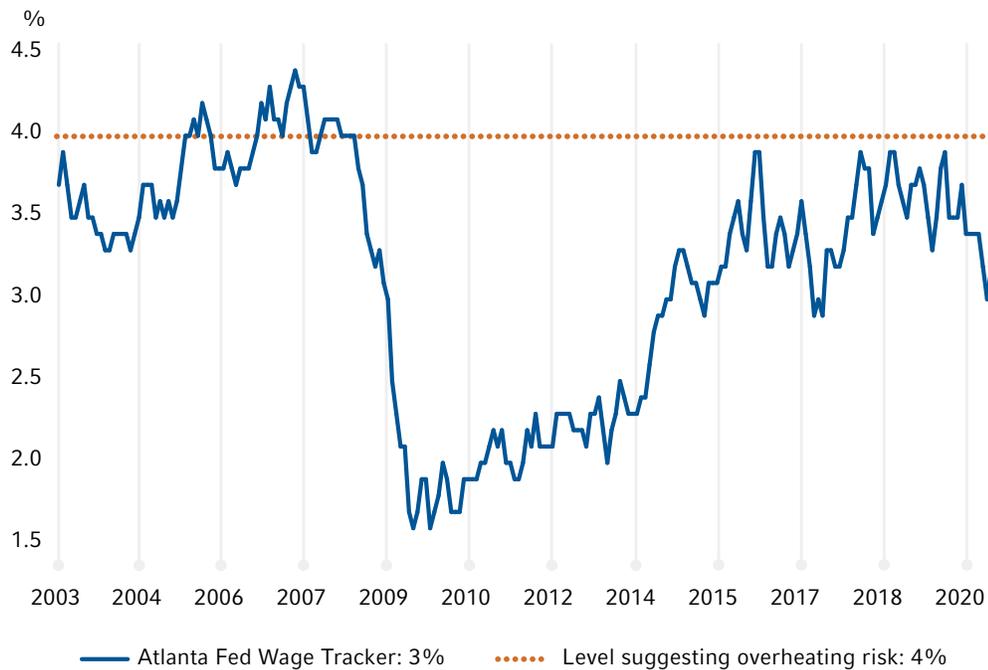


Source: Refinitiv®
Datastream® as of
September 15, 2021.

The second indicator is the Atlanta Fed's Wage Growth Tracker, and this has a less-comforting message about inflation risks. It reached 3.9% in August, which is [close to the 4% threshold](#) where we judge that the Fed will become concerned about the inflationary impact on the growth of wages. A breakdown shows that the spike has been mostly driven by wages for low-

skilled, young people in the leisure and hospitality industry. This suggests the surge has been caused by temporary labor supply shortages and that wage pressures should subside as economic activity normalises. This indicator, however, will be an important watchpoint over the next few months.

Watchpoint indicator #2: Atlanta Fed Wage Growth Tracker



Source: Refinitiv® Datastream® as of August 2021.

Market inflation expectations are currently comfortably below the Fed's worry point.

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Reopening trade still makes sense

The re-opening trade, which lifts long-term interest rates and favors cyclical and value stocks over technology and growth stocks, worked well for several months following the vaccine announcement last November. Value outperformed growth and yield curves steepened. The trade has reversed in recent months, however, amid fears that the delta variant might derail the economic recovery. The impact has been magnified by short covering in bond markets as investors, who have been short or underweight, have been forced by the rally to buy back into the market, pushing bond yields even lower.

The re-opening trade should resume in coming months. The cyclical stocks that comprise the value factor are reporting stronger earnings upgrades than technology-heavy growth stocks, and the value factor is cheap compared to the growth factor. Financial stocks comprise the largest sector in the MSCI World Value Index, and they should benefit from further yield-curve steepening, which boosts the profitability of banks. Long-term interest rates should rise as global growth remains above trend, delta-variant fears fade, the short squeeze unwinds and central banks begin tapering back on bond purchases.

The rotation in economic growth leadership away from the United States should also help the re-opening trade. The rest of the world is overweight cyclical value stocks relative to the U.S., which has a higher weight to technology stocks.

Emerging market (EM) equities have been poor performers since the vaccine announcement, but there are some encouraging signs. Initially, they were held back by the exposure to technology stocks in the MSCI Emerging Markets

Index and the slow rollout of COVID-19 vaccines. More recently, they have come under pressure from the slowdown in the Chinese economy and the [regulatory crackdown on Chinese tech companies](#). The vaccine rollout across emerging markets has accelerated and policy easing in China should soon improve the growth outlook. The path of Chinese regulation is harder to predict, but it is now largely priced in, with Chinese technology companies underperforming their global peers by nearly 50% from February 2021 through mid-September.

The resumption of the re-opening trade should also result in U.S. dollar weakness. The U.S. Dollar Index (DXY) has traded sideways since the vaccine announcement. It should weaken once investors have confidence that delta-variant risks are subsiding and realise that the Fed is likely to remain dovish as inflation risks decline. The dollar typically gains during global downturns and declines in the recovery phase. Dollar weakness should support the performance of non-U.S. markets, particularly emerging markets.

Risks: variants, inflation, China weakness

The key risk is that the delta variant or similar proves resilient to vaccination or that infection rates escalate during the Northern Hemisphere winter. The evidence so far is that vaccinations are highly effective in preventing serious illness. In Israel, booster shots appear to have slowed the rate of new cases.

Another watchpoint is inflation and the response of central banks. Our expectation is that this year's inflation spike is mostly transitory and that the major central banks, led by the Fed, are still two years from raising interest rates.

Finally, there is the risk of a sharper-than-expected slowdown

in China. [Credit growth has slowed this year](#) and the purchasing managers' indexes (PMI) have trended lower. Monetary and fiscal policy have been eased, however, and senior officials have signaled that more stimulus is on the way. China policy direction and credit trends will be an important watchpoint over coming months.

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Canada market perspective

Growth trended down as COVID-19 infections trended up over the summer months. However, an increasingly vaccinated population, stable consumer spending trends, and an improved outlook for business investment should support the economy. This ought to keep the Bank of Canada (BoC) on track to remove monetary accommodation gradually. And although the cyclical trade took a step back over the third quarter, we believe Canadian equities should benefit from a continued global economic recovery.

Shaken, not shocked

Canada has vaccinated its population at an extraordinary pace and is a leader among G7 nations. With COVID-19 unlikely to fade away completely, a close to fully vaccinated population should provide a potential shield against future variants. Nonetheless, the delta variant has shaken economic prospects. Industry consensus estimates for gross domestic product (GDP) growth have been reduced relative to what the Bank of Canada had forecasted in its July Monetary Policy Report (MPR), as shown in Chart 1. GDP growth is expected at about 5% and 4%, vs 6% and 4.6%, respectively, for 2021 and 2022. However, the broader point is that growth remains above trend. Moreover, the snap election in September led to yet another Liberal-led minority government that has plans to raise spending by roughly \$80 billion over the next five years toward social, health care and climate-related initiatives. This is enough to potentially boost GDP by up to 0.5% in 2022.

Taken together, we doubt the downshift in growth has shocked the BoC away from its tightening bias. We believe tapering of asset purchases will be completed by the end of the first quarter of 2022. BoC Governor Tiff Macklem has indicated the reinvestment phase will commence after that and will require an estimated \$1 billion in weekly bond purchases to maintain the size of the central bank's balance sheet. Moreover, the BoC will only consider shrinking its balance sheet once the process to normalize its policy interest rate has commenced, for which a closed output gap is a prerequisite. BoC projects the closure of the output gap to occur sometime over the second half of

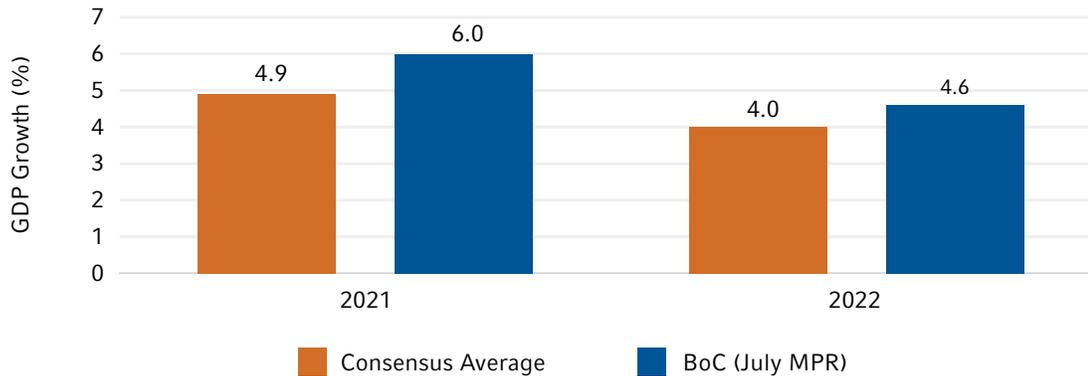
2022, with an interest rate hike possible at that time. We believe that timeline may be a tad aggressive, and a 2023 liftoff cannot be ruled out, better aligning the Canadian central bank with its American counterpart.

The market implications based on our assessment would be higher bond yields and a modestly stronger Canadian dollar.

The expected slowdown in growth has contributed to the Canadian 10-year bond yield declining from a recent high of 1.6% in May to around 1.2% as of September 21. However, we don't believe the growth downgrade means the recovery is derailed. Retail spending trackers produced by major Canadian banks suggest consumption trends remain stable, despite the delta-variant wave. Moreover, imports of machinery and equipment suggest healthy business investment, as shown in Chart 2. Therefore, a resumption of growth after the soft summer months should be enough to lift the 10-year yield back above 1.5%.

Similarly, our positive cycle outlook also aligns with our positive outlook on the Canadian dollar (CAD). The CAD should benefit from firm oil prices, and a Canadian central bank that is moderately ahead of the U.S. Federal Reserve in normalizing policy. Therefore, a purchasing power parity implied level for the CAD/USD exchange rate of around \$0.83 is possible. However, we caution optimism should be tempered considering the strong CAD rally since March 2020.

Chart 1: GDP growth forecasts



Source: Bank of Canada, Russell Investments. BoC forecast based on July MPR, consensus average based on the GDP forecasts from the following: Capital Economics, Morgan Stanley, Scotia Bank, BMO, TD, CIBC, and RBC.

Canadian equity outlook: Cyclically recharged

Rising COVID-19 cases and growth concerns have taken the enthusiasm out of the cyclical trade, and, along with it, the lead that Canadian equities had commanded over U.S. equities through the first two quarters of the year. The S&P/TSX Composite Index outperformed the S&P 500 Index (in CAD) by about 960 basis points (or 9.6%) as of June 1. This lead has all but diminished as of September 20. Despite this recent relative misfortune, we remain optimistic that the resumption of growth recharges Canadian equities. For a broader assessment, we look to our investment decision-making building blocks of cycle, valuation and sentiment:

Cycle: With the Canadian economy still 2% below the pre-COVID-19 level, above-trend economic growth is likely over the coming year. Moreover, as Canada gets closer to fully vaccinating

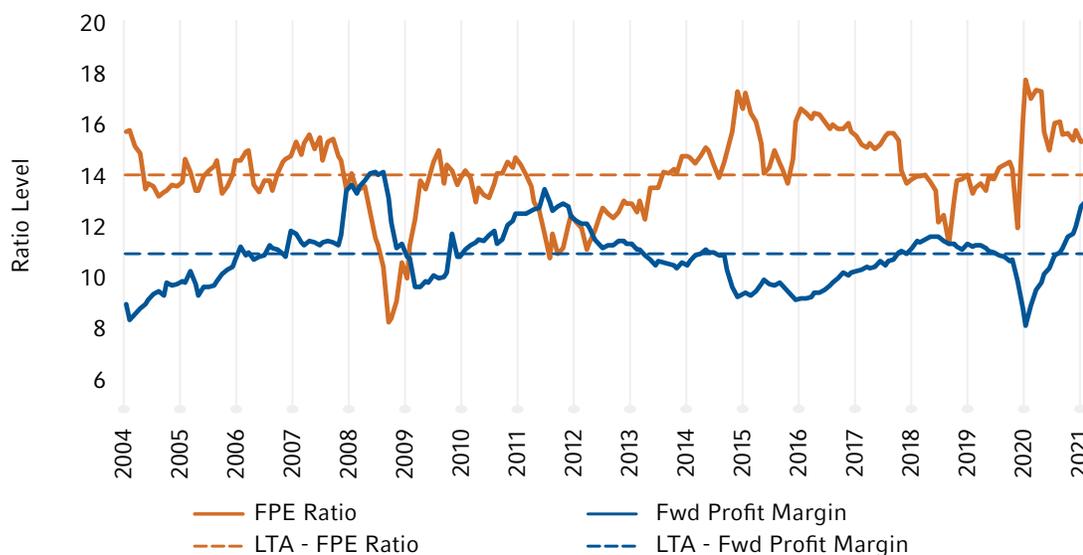
the entire population, this should help combat future COVID-19 outbreaks if vaccines remain effective toward newer strains. Overall, we are positive about the outlook for the business cycle.

Value: Profit margins, as well as traditional measures of value like the price-to-earnings (PE) ratio, are above their long-term averages (shown below), making value slightly negative.

Sentiment: Our contrarian indicators are broadly neutral; however, positive price momentum lifts sentiment to positive overall.

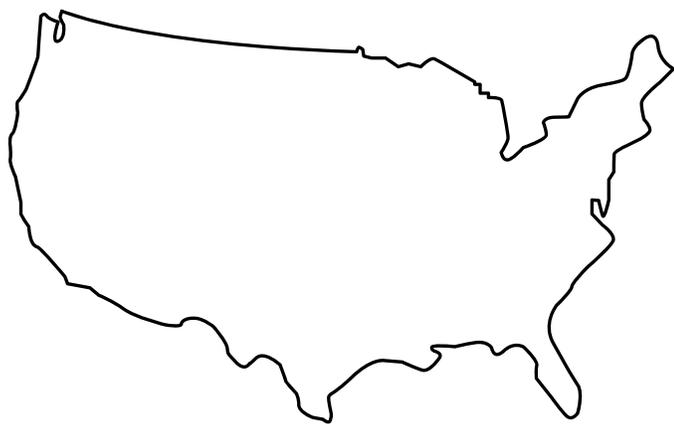
Conclusion: Value is less attractive, but a positive business cycle and price momentum have us leaning into Canadian equities, particularly relative to U.S. equities.

Figure 1: Canadian equity valuation overview



Source: Refinitiv DataStream, Russell Investments, as of August 2021. FPE = 12-month forward price to earnings ratio. LTA = Long term average, Fwd Profit Margin = 12-month forward profit margin.

Regional Snapshots



United States

The U.S. economy is likely to sustain above-trend growth into 2022. However, the easiest gains appear in the rear-view mirror at the end of the third quarter as the recovery phase of the business cycle matures. This is most visible for corporate earnings, where S&P 500® Index earnings-per-share already sit 20% above their previous cyclical high.

Strong fundamentals have helped power the stock market to new highs. Early evidence that the delta-variant wave may be fading and the potential for greater vaccine access for children are positives for a more complete recovery in the quarters ahead. The Fed [looks poised to start tapering its asset purchases](#) around the end of 2021. The timing of the first rate hike will then hinge on what happens to inflation next year. Our models suggest that inflation is likely to drop back below the Fed's 2% target in 2022. If that is correct, the Fed is likely to remain on hold into the second half of 2023.

Wage inflation is a key risk to this view. It is running unusually strong for this stage of the cycle, and record hiring intentions from businesses could exhaust spare capacity in the year ahead. We expect the 10-year U.S. Treasury yield to rise moderately from 1.37% in mid-September to 1.75% in coming months.

Fiscal stimulus negotiations continue to grab headlines in Washington, D.C. The tax provisions in these bills are likely to be the most impactful for financial markets. We estimate that higher corporate taxes could subtract about four percentage points from S&P 500 earnings growth in 2022. This could create volatility and opportunity in markets. Given our strong cyclical outlook, our bias continues to be a risk-on preference for equities over bonds for the medium-term.



Eurozone

[Euro area growth](#) slowed through the third quarter but looks on track for a return to above-trend growth over the fourth quarter and into 2022. Vaccination rates are high, and the euro area has more catch-up potential than other major economies, particularly the United States. The euro area is also set to receive more fiscal support than other regions, with the European Union's pandemic recovery fund only just starting to disburse stimulus, which will provide significant support in southern Europe. Polls in advance of Germany's federal election on 26 September suggest the electorate is moving toward the left, which means the new government is likely to support expansionary fiscal policy and support a continued dovish stance by the European Central Bank (ECB).

The MSCI EMU Index, which reflects the European Economic and Monetary Union, has performed broadly in line with the S&P 500 so far in 2021. We think it has potential to outperform in coming quarters. Europe's exposure to financials and cyclically sensitive sectors such as industrials, materials and energy, and its relatively small exposure to technology, gives it the potential to outperform as delta-variant fears subside, economic activity picks up and yield curves in Europe steepen.



United Kingdom

As of mid-year, UK GDP was still nearly 4.5% below its pre-pandemic peak. We see plenty of scope for strong catch-up growth as borders are fully re-opened and activity normalises. Supply bottlenecks and labor shortages have triggered a sharp rise in underlying inflation and created concerns that the Bank of England (BoE) may start rate hikes in the first half of 2022. We think the BoE is unlikely to be that aggressive. We expect inflation to decline in early 2022 as supply constraints ease, which should convince the BoE to delay rate hikes.

The FTSE 100 Index is the cheapest of the major developed equity markets in late 2021, and this should help it reflect higher returns than other markets over the next decade. Around 70% of UK corporate earnings come from offshore, so one near-term risk is that further strengthening of British sterling dampens earnings growth. The other risks are mostly around policy missteps, for example, early tightening by the Bank of England.



Japan

The Japanese economy is expected to get a shot in the arm as rising vaccination rates improve mobility and reduce the risk of further lockdowns, and as political leadership changes result in more fiscal stimulus: the Japanese election is due to be held before Nov. 28. Japanese equities look slightly more expensive than other regions such as the UK and Europe. We maintain our view that the Bank of Japan will significantly lag other central banks in normalizing policy.



China

We expect Chinese economic growth to be [robust over the next 12 months](#), supported by a post-lockdown jump in consumer spending and incremental fiscal and monetary easing. Despite a big improvement in vaccination rates, [COVID-19 outbreaks remain a risk](#) given the Chinese government's zero-tolerance approach. The major consumer technology companies have seen significant drops in stock prices recently due to more aggressive regulation. Some uncertainty remains around the [path of future regulation](#), especially as it relates to technology companies, and as a result we expect investors will remain cautious on Chinese equities in the coming months. The property market, particularly property developers as recently highlighted by Evergrande's debt crisis, remains a risk that we are monitoring closely.



Canada

Canada leads the G7¹ countries in terms of the vaccination rollout, which should minimise the risk of large-scale lockdowns over winter. The delta variant has taken an economic toll, however, with industry consensus projections now predicting 5% GDP growth in 2021 versus estimates of more than 6% just three months ago. Even so, growth remains above-trend and the odds of additional fiscal expenditures to support the economy have increased. This means that weaker growth due to COVID-19 is unlikely to change the Bank of Canada's (BoC) tightening bias.

[Tapering of asset purchases](#) should be complete by the end of the first quarter of 2022. BoC Governor Tiff Macklem has indicated that the reinvestment phase of the bonds held by the central bank will commence once quantitative easing has ended. This should generate an estimated C\$1 billion in weekly bond purchases, down from the current pace of C\$2 billion. The BoC will likely only consider shrinking its balance sheet after it has started lifting interest rates. The BoC projects that the output gap will close sometime over the second half of 2022, and that rate hikes will be considered after economic slack has disappeared. We believe that the timeline may be a tad aggressive, and a delay to 2023 for lift-off is more likely. This would better align the Canadian central bank with its American counterpart.

¹ The Group of Seven is an inter-governmental political forum consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States



Australia and New Zealand

The Australian economy is set to return to life, with lockdowns likely to be eased in October and November. Consumer and business balance sheets continue to look healthy, which should facilitate a strong recovery. The re-opening of the international border in 2022 will provide a further boost. Fiscal policy has supported the economy through the downturn, and there is potential for further stimulus in the lead-up to the federal election, which is due before the end of 2022. The Reserve Bank of Australia has begun the process of tapering its bond-purchase program, but we expect that a rise in the cash rate is unlikely until at least the second half of 2023.

New Zealand's most recent lockdown will drag on Q3 GDP, but similar to Australia, we expect a solid rebound as the economy reopens. The government aims to provide a vaccine to all adults by the end of 2021, after which borders will gradually re-open. This will provide a boost, particularly to tourism-exposed sectors. Despite having recently put-off hiking interest rates due to the recent lockdown, we expect the Reserve Bank of New Zealand will start raising rates this year. Even though they have significantly underperformed global equities this year, New Zealand equities still screen as relatively expensive compared to other regions.

Our models for the U.S. suggest that inflation is likely to drop back below the Fed's 2% target in 2022. If that is correct, the Fed is likely to remain on hold into the second half of 2023.

Andrew Pease

Asset-class preferences

Our cycle, value and sentiment investment decision-making process in late September 2021 has a moderately positive medium-term view on global equities. Value is expensive across most markets except for UK equities, which are near fair value. The cycle is risk-asset supportive for the medium-term. The major economies still have spare capacity and inflation

pressures appear transitory, caused by COVID-19-related supply shortages. Rate hikes by the U.S. Fed seem unlikely before the second half of 2023. Sentiment, after reaching overbought levels earlier in the year, has returned to more neutral levels.

Composite Contrarian Indicator: Sentiment shifts toward neutral



Source: Russell Investments. Last observation: September 15, 2021. Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors are through time.



We prefer **non-U.S. equities** to **U.S. equities**. Stronger economic growth and steeper yield curves after the third-quarter slowdown should favor undervalued cyclical value stocks over expensive technology and growth stocks. Relative to the U.S., the rest of the world is overweight cyclical value stocks.



Emerging markets equities have been relatively poor performers this year, but there are some encouraging signs. The vaccine rollout across EM has accelerated and policy easing in China should soon boost the economic growth outlook. China's regulatory crackdown has caused significant underperformance by Chinese technology companies, but this should be less of a headwind going forward now that it is priced in.



High yield and **investment grade credit** are expensive on a spread basis but have support from a positive cycle view that accommodates corporate profit growth and keeps default rates low. U.S. dollar-denominated **emerging markets debt** is close to fair value in spread terms and will gain support on U.S. dollar weakness.



Government bonds are expensive, and yields should come under upward pressure as output gaps close and central banks look to taper back asset purchases. We expect the 10-year U.S. Treasury yield to rise toward 1.75% in coming months.

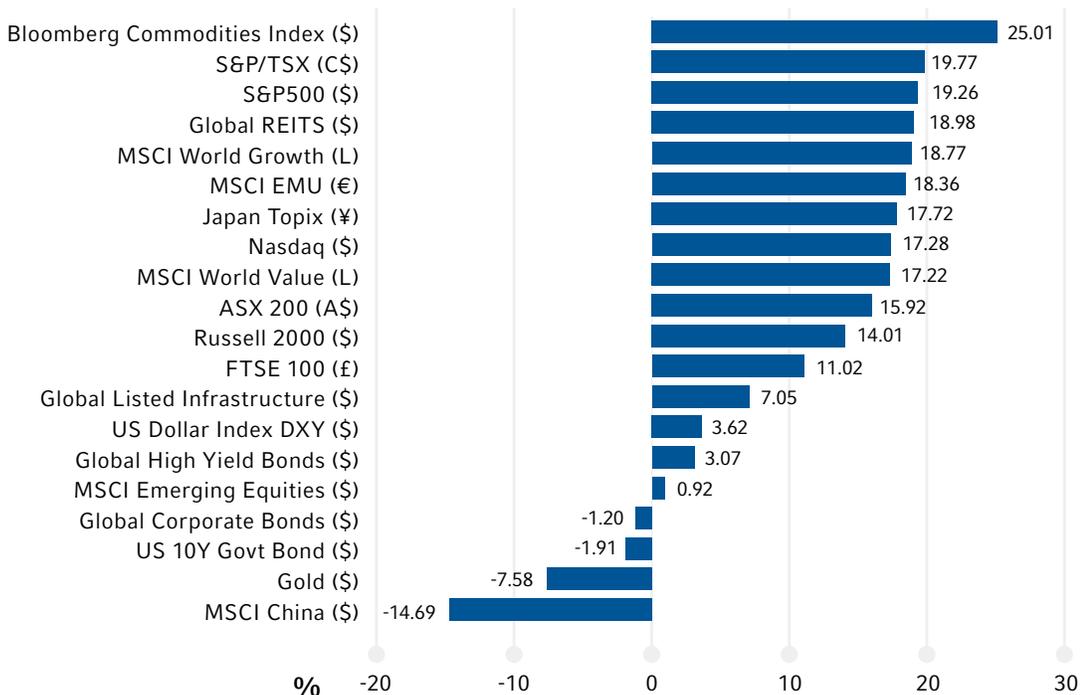


Real assets: Real Estate Investment Trusts (REITS) have significantly outperformed Global Listed Infrastructure (GLI) so far this year, to the extent that REITS are now expensive relative to GLI. Both should benefit from the pandemic recovery, but GLI has some catch-up potential. GLI should benefit from the global re-opening boosting domestic and international travel. Commodities have been the best-performing asset class this year amid strong demand and supply bottlenecks. The gains have been led by industrial metals and energy. The pace of increase should ease as supply issues are resolved, but commodities should retain support from above-trend global demand.



The U.S. dollar has been supported this year by expectations for early Fed tightening and U.S. economic growth leadership. It should weaken as global growth leadership rotates away from the U.S. and toward Europe and other developed economies. The dollar typically gains during global downturns and declines in the recovery phase. The main beneficiary is likely to be the **euro**, which is still undervalued. We also believe **British sterling** and the economically sensitive *commodity currencies*—the **Canadian dollar**, the **New Zealand dollar** and the **Australian dollar**—can make further gains, although these currencies are not undervalued from a longer-term perspective.

Asset performance since the beginning of 2021



Source: Refinitiv Datastream, as of September 17, 2021. (L) implies local currency. In USD unless otherwise indicated.

Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

Stronger economic growth and steeper yield curves after the third-quarter slowdown should favor undervalued cyclical value stocks over expensive technology and growth stocks.

Andrew Pease

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The S&P 500® Index, or the Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The MSCI EMU Index (European Economic and Monetary Union) captures large and mid cap representation across the 10 developed markets countries in the EMU. With 246 constituents, the index covers approximately 85% of the free float-adjusted market capitalization of the EMU.

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