THE GREAT

REOPENING

Russell Investments

Global Market Outlook – Q3 update

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The great reopening

Markets have rallied on hopes for a recovery as lockdowns are eased. The rebound has been helped by oversold investor sentiment, but with sentiment back to neutral, so is the market outlook.

> *Record levels of fiscal stimulus, sustained low interest rates and ongoing low inflation create a supportive environment for risk-asset outperformance."*
>
> **Andrew Pease, Head of Global Investment Strategy**

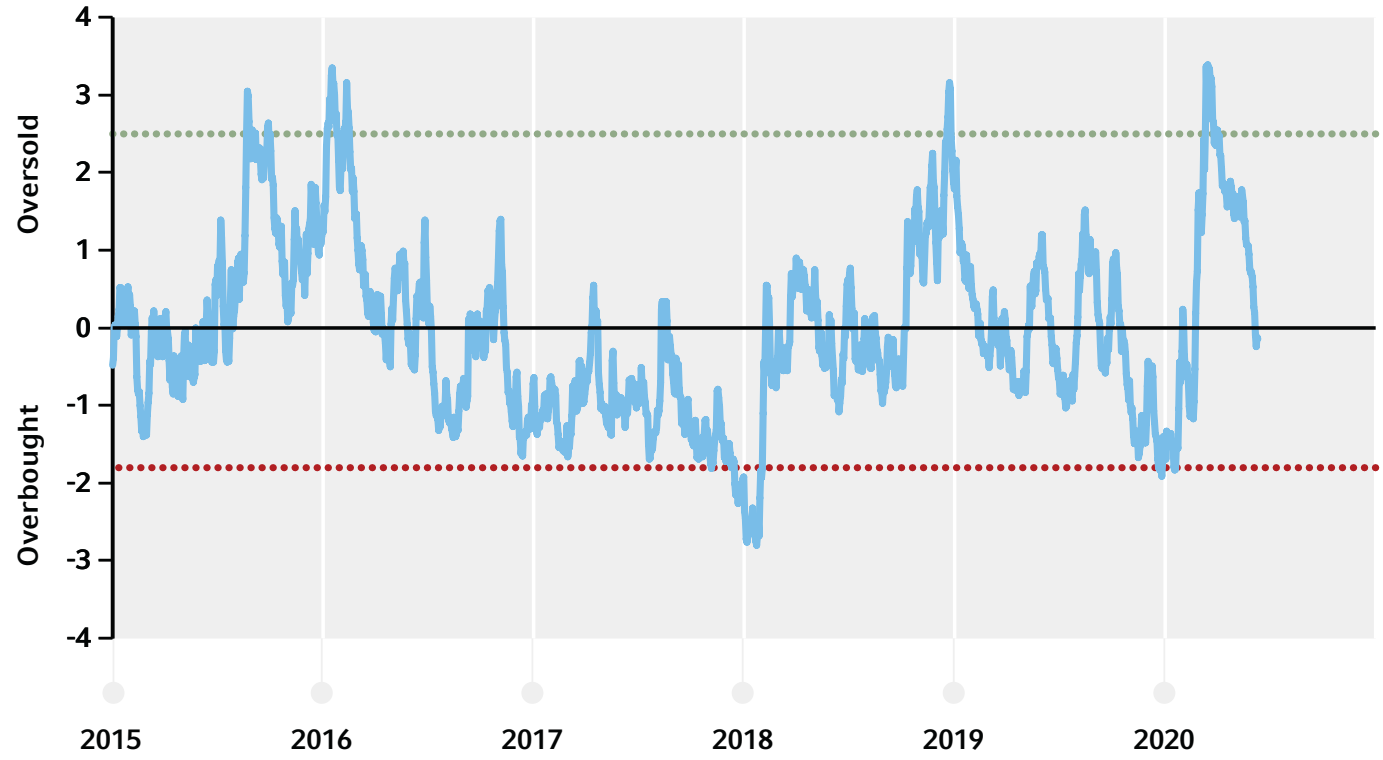
Introduction

Well, that was historic. The fastest 30% drawdown in the history of global equities in the first quarter followed by the largest 50-day advance in market history in the second quarter. The S&P 500® was back above 3,100 on June 3 and the Nasdaq hit a record high on June 10. Meanwhile, commentators have been lining up to claim that markets are detached from fundamentals.

We're not so certain that investors have it wrong. For sure, markets seem to be priced for an optimistic outcome of no meaningful second wave of infections as lockdowns are lifted. But record levels of fiscal stimulus, sustained low interest rates and ongoing low inflation create a supportive environment for risk-asset outperformance.

Our previous quarterly report in late March laid out a cautiously optimistic case for riskier assets, such as equities and credit, to outperform defensive assets like cash and bonds. This was based on our cycle, value and sentiment (CVS) investment decision-making process. Value had improved following the market crash, the cycle outlook was turning positive with central banks and governments in "whatever it takes" mode and, most importantly, our composite contrarian indicator of market sentiment was providing one of its most extreme buy signals. Oversold conditions imply that investors are cautious and worried about downside risks. These conditions provided a springboard for risk assets to rebound as the economic impact of the lockdowns turned out less bad than feared and as a possible second wave of infections failed to materialize by mid-June.

Chart 1: Composite contrarian indicator



Source: Russell Investments. Last observation: 12 June 2020. Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors at large are.

The market rebound means that value is no longer compelling for global equities or credit. On the other hand, the cycle outlook has improved as fiscal and monetary stimulus announcements continue and economies start to emerge from lockdown. The bottom of a major recession when stimulus is flowing is one of the few times it is possible to have a relatively confident view on the cycle. Sentiment, unsurprisingly, is no longer as supportive. Our composite contrarian indicator, as of mid-June, is providing a neutral signal. This means that the support from oversold conditions is waning and markets are at greater risk of pulling back on negative news.

Neutral value, neutral sentiment and a supportive cycle give us a more balanced view on the investment outlook. Looking near-term, markets are vulnerable to negative news after a 40% rebound and with sentiment on the verge of triggering our overbought signal. Over the medium-term, the supportive cycle outlook should allow equities to outperform bonds.

Main risks

The main risks come from a second wave of virus infections and the approaching U.S. federal elections in November.

- There is little evidence so far in mid-June of a meaningful second wave of virus infections following the easing of lockdowns across Asia and Europe. COVID-19, however, is highly contagious and has only been contained through the imposition of severe lockdowns. We should know in the next couple of months whether a second wave is underway. On the plus side, most countries are now better placed to manage a second wave in terms of healthcare capacity and treatment. Also, the news on vaccine development is promising, although 2021 is the most optimistic timeline.
- The U.S. federal elections are too close to call. They will become a bigger focus for markets if the Democrat nominee, Joe Biden, takes a decisive lead. Biden plans to at least partially reverse President Donald Trump's 2017 corporate tax cuts. This could deliver a hit to earnings per share in 2021. One of the key watchpoints will be the election outcome of the Republican-led U.S. Senate. Democrat control of the White House, Senate and House of Representatives would make a corporate tax hike more likely. It would also create the risk of more corporate regulation.
- The other election risk is a re-escalation of the U.S./China trade war. A recovery in the stock market and the economy provide President Trump with his best chance of re-election. We expect he will not endanger this by re-starting trade hostilities. This calculus could change if Trump's poll ratings show him in a losing position a couple of months from the election. He may conclude that nationalism and China-bashing increase his chance for victory.

Longer-term COVID-19 implications

Here are five likely longer-term impacts of the pandemic.

1. **Low interest rates for longer.** The global economy has taken a huge hit from the pandemic and interest rates are zero or lower at all the major central banks. There is a lot of economic spare capacity which will keep inflation low for the next couple of years at least. This means central banks will keep rates low, which will keep bond yields low. Furthermore, after experiencing zero rates, central banks are likely to keep rates low once inflation rises. They will be reluctant to tighten too quickly.
2. **Less globalization.** Globalization was already in reverse before COVID-19. The 2008 financial crisis undermined the trust of western voters in the free market capitalist model. The backlash continued with Brexit, the rise of Trump and the U.S./China trade war. The virus is accelerating the anti-globalization trend. Global supply chains are being unwound and the pandemic has created fears about food security and pressure for domestic production of medical supplies.
3. **More government debt and a bigger share of government in the economy.** The lockdowns are leading to the largest rise in government debt levels since World War II and higher levels of government support for industries. Eventually, the political debate will turn to how to pay for the lockdown support measures and how to address the inequalities that have been worsened by the pandemic. Well-paid white-collar workers have been able to isolate at home while lower paid workers have been laid off or had to work in less-safe conditions.
4. **Higher inflation, eventually.** Inflation shouldn't be a problem for the next couple of years due to economic spare capacity caused by the recession. Longer-term, inflation could rise by more than expected. Globalization was deflationary and its reversal will be inflationary. On the supply side, it would be inflationary from higher input costs, less cheap foreign labor and rising tariffs and protectionism. On the demand side, central banks likely would take a lax approach to rising inflation and governments would see higher inflation as a way of reducing debt burdens.

> *Ongoing low interest rates favor higher yielding assets such as stocks, property and infrastructure over government bonds and cash.*
>
> **Andrew Pease**

5. **Pressure on profit margins.** Slower trend economic growth, less efficient capital allocation, just-in-case instead of just-in-time inventory management, higher taxes and higher labor costs will place profit margins under pressure. One potential offset is that the increased use of technology encouraged by the lockdowns will generate cost savings and productivity improvements.

These trends should favor domestic stocks over those exposed to global revenues and supply chains. Mid- and small-cap stocks should do better than large-cap stocks, in a reversal of the trend of the last decade. Developed markets should benefit relative to emerging markets as there will be less technology transfer and less export-led growth. The unwinding of globalization is a headwind for emerging markets. Ongoing low interest rates favor higher yielding assets such as stocks, property and infrastructure over government bonds and cash.

Canada Market Perspective

Recovery is just the start

The federal government's efforts to contain the humanitarian toll brought on by the COVID-19 pandemic is expected to contribute to an economic contraction that is rivaled only by the Great Depression. Based on consensus estimates, the expected decline in output, as measured by Gross Domestic Product (GDP), is projected to be up to 15% compared to the peak at the end of 2019 (as illustrated in Chart 2). The chart compares the current estimated path of the economy (black line) relative to other Canadian recessions since the 1960s (light blue line), as well as provides a comparison to the median historical recession (red line). Nothing in recent history comes close to the expected contraction from the "great shutdown". Moreover, it is likely to take the economy up to two years to return to a pre-pandemic level.

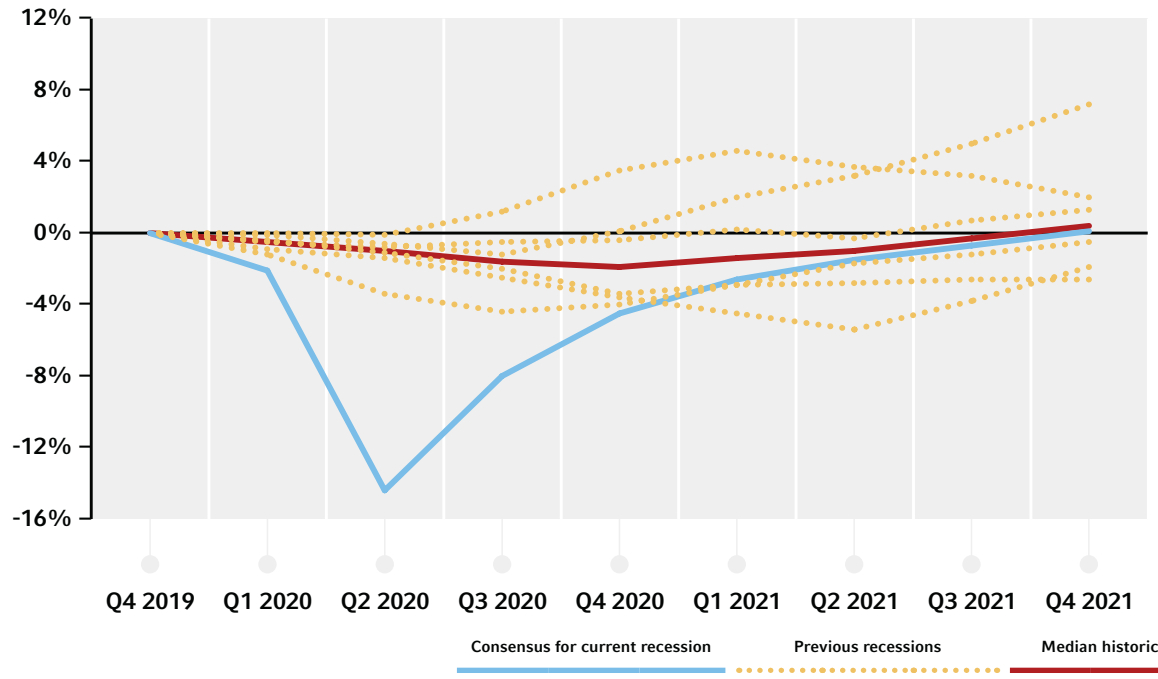
What Chart 2 makes clear is the downturn will be swift and deep; however, the recovery, at least initially, is likely to be sharp but also tenuous. The consequences to this outcome are twofold:

1. On inflation: As the output gap (which measures the difference between actual and potential rate of growth), widens, disinflation is the immediate concern. Inflationary pressures will be dampened by higher rate of unemployment and heavy debt burdens restricting domestic demand.
2. On monetary policy: Monetary conditions are expected to remain accommodative. While it's reasonable to expect some withdrawal of monetary (and fiscal) support over time, we don't anticipate the Bank of Canada (BoC) to be in a rush to raise its policy rate. The "effective lower bound" (ELB) policy rate of 0.25% will stay for some time to come.

To be clear, while we expect growth to resume over the second half of 2020, there are obvious uncertainties over the projection horizon. Fully restoring confidence (business and household) will likely require either a viable treatment against the COVID-19 virus, or ideally, a vaccine. We know this will take time to develop. Therefore, while the recovery may be getting started, the macroeconomic backdrop demands that both monetary and fiscal conditions remain accommodative during this transitory period.

Chart 2: Sharpest, shortest? A natural disaster recession

Canada real GDP, % change from business cycle peak



Source: Refinitiv DataStream, Russell Investments. Recession periods guided by CD Howe Institute data.

Canadian Market Observations:

Canadian Equity

To say the profit outlook for cyclically oriented domestic equities has been challenged would be an understatement. Two critical sectors of the economy -- financial and energy -- have struggled as the combination of lower bond yields and weak commodity prices dimmed the outlook for profit margins. That said, there is reason for hope.

Chart 3 illustrates the relationship between commodity prices and profit margin expectations based on consensus estimates. The chart shows a close link between commodity prices and the outlook for profits. Despite the resource sector's diminished role within the broad market S&P/TSX Composite Index, what's clear is that commodity prices do matter for profits. To that end, the recent rebound in commodity prices, oil in particular, is encouraging. Therefore, if higher to stable commodity prices can be sustained, it signals a potentially brighter outlook for corporate profits ahead.

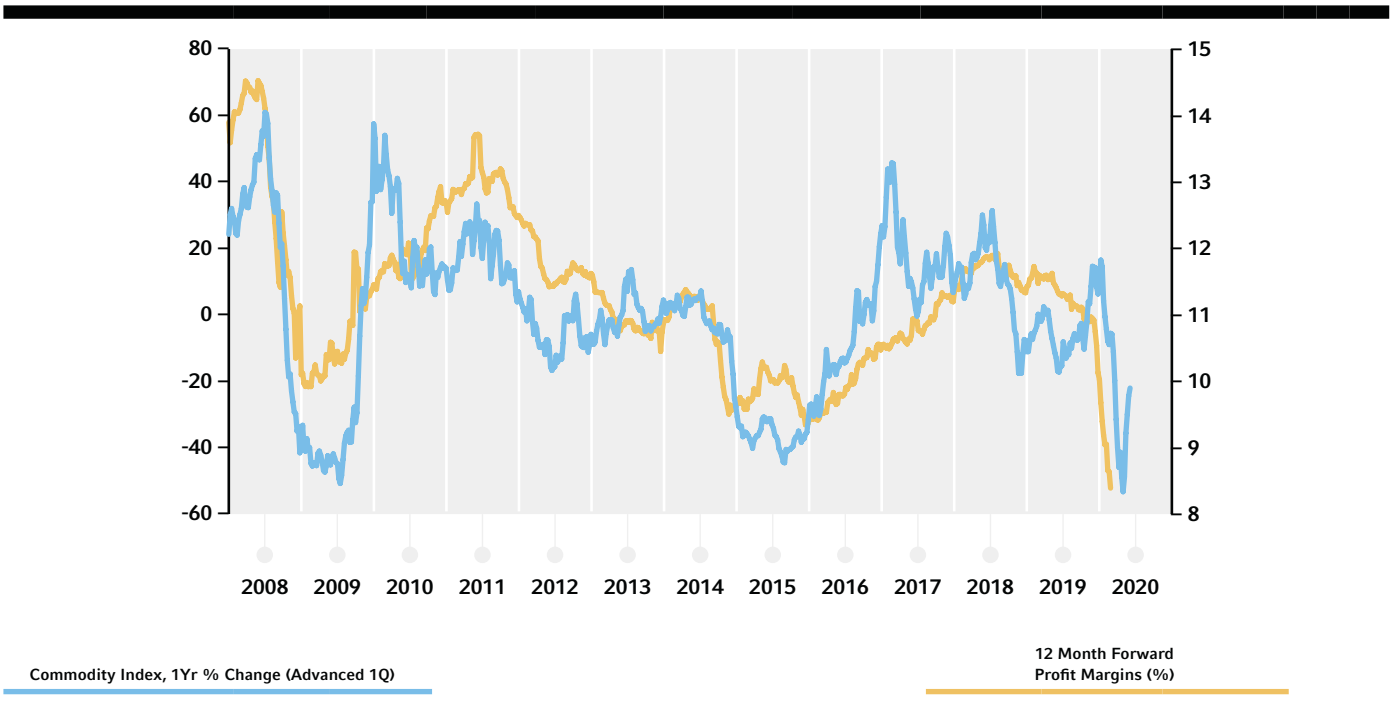
For a broader perspective, we turn to our cycle-value-sentiment framework:

The business *cycle* has its challenges currently; however, April might have marked the cycle trough as businesses began to gradually reopen in May. Further, as noted above, higher commodity prices improve the outlook for earnings, and importantly, fiscal/monetary stimulus will remain a pillar of support for some time. *Valuations* are closer to neutral considering the pace at which equity prices have recovered. Finally, *sentiment* no longer reflects investor panic nor market conditions as oversold.

In our second quarter update, our process had us leaning into risk assets. While we remain constructive on the macro outlook over the next 12 months, a reflective pause would be a healthy development considering the S&P/TSX Composite Index has rallied more than 40% from the March 23rd low to June 8th.

Chart 3: Improving commodity prices a precursor to recovering profit margins

Commodity Prices and Profit Margins



Source: Refinitiv DataStream, Russell Investments. Commodity Index based on Bank of Canada Commodity Price Index, profit margins based on IBES estimates for MSCI Canada Index. Indexes are unmanaged and cannot be invested in directly.

Canadian Fixed Income

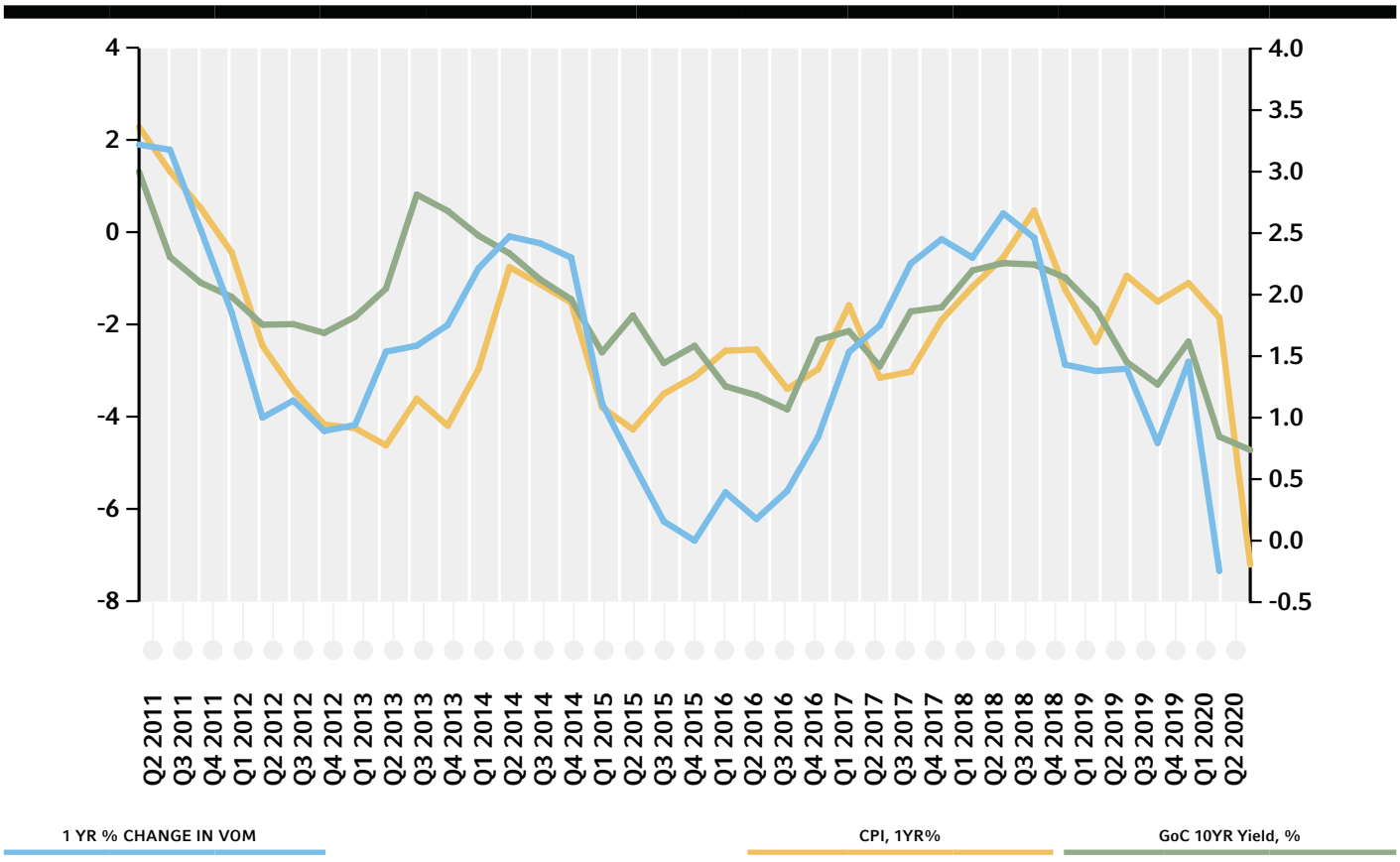
The Government of Canada (GoC) 10-year bond yield at less than 1% is yet another example of the extraordinary impact this recession is having on financial market variables. In our second quarter outlook we discussed — and continue to maintain the view — that except for shorter-term technical reasons, we do not expect negative sovereign bond yields. This implies asymmetry: further downside to yields is limited by the effective lower bound[1], while the upside is theoretically unlimited. Though true, we believe materially higher bond yields are not an immediate concern for several reasons:

1. As discussed above, the BoC will be in no rush to tighten financial conditions until a recovery is "well under way".
2. The capacity utilization rate has collapsed to around 50% based on the May 2020 CFIB Small Business Barometer[2]. This suggests significant slack in the economy which will take time to restore.
3. While stimulus measures have boosted liquidity, they are unlikely to be inflationary. The velocity of money (VOM) measures the rate at which money is circulating in an economy. When the growth rate at which money is circulating breaks down, as it has currently, it suggests demand is lacking. This in turn dampens inflation pressures which ultimately limits the upside to bond yields. Chart 4 illustrates this relationship.

We understand low yields are a concern for conservative investors. Frankly these concerns have been part of the market narrative for several years running. Importantly, financial market volatility this year serves as yet another reminder that core fixed income remains a crucial ballast to equity market risk.

Chart 4: Breakdown in the velocity of money signals lack of inflationary pressure

Velocity of Money (VOM) vs. 10Yr Yield & Inflation

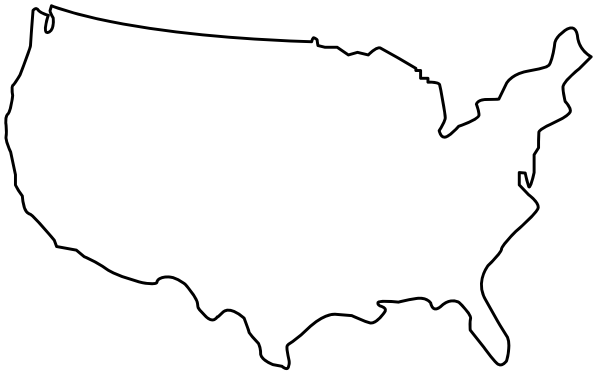


Source: Refinitiv DataStream, Russell Investments. Velocity of Money (VOM) defined as GDP/M2. VOM as of 1Q2020, 10 Yr Yield as of June 5, 2020. Inflation, as measured by the Consumer Price Index (CPI) as of May 2020. M2 is a broad measure of money supply.

[1] Effective lower bound is the theoretical floor in the policy rate. The Bank of Canada has communicated the effective lower bound to be 0.25%. https://www.bankofcanada.ca/2020/06/fad-press-release-2020-06-03/

[2] Source: https://www.cfib-fcei.ca/en/research-economic-analysis/business-barometer

Regional Snapshots



United States

The U.S. economy experienced a historic slowdown through April with, at one point, 95% of Americans under stay-at-home orders. The fiscal and monetary response, however, has been equally extraordinary. The U.S. Federal Reserve cut interest rates to zero, announced unlimited quantitative easing, and committed to buy investment grade and high yield corporate bonds. The fiscal stimulus packages include forgivable loans to small businesses and unemployment benefits equal to wage income for the median worker who loses their job. This is the most significant fiscal thrust since World War II, and more stimulus appears to be on the way. We are positive on the economic outlook.

Unprecedented stimulus and the potential for a few years of non-inflationary growth suggest investors may earn a larger than normal equity risk premium going forward. The U.S. still has relatively high infection rates, so a second wave is an obvious downside risk to monitor. A further deterioration in U.S./China relations would also be a concern. Conversely, news of an effective vaccine, with results expected in June or July, could drive markets significantly higher well in advance of doses becoming widely available. The risks to markets from here are two-sided, not purely to the downside as many commentators are suggesting.

Eurozone

European economies are emerging from lockdown and, so far, there has been no evidence of a significant second wave of infections. The economic cost, however, has been large with the Organization for Economic Co-operation and Development (OECD) forecasting a Eurozone gross domestic product (GDP) decline of 9.1% in 2020 followed by a 6.5% rebound in 2021.

Europe's disadvantage heading into the COVID-19 crisis was its lack of policy ammunition. The European Central Bank (ECB) policy rate was already negative, there were strict rules around increasing fiscal deficits, and high-debt countries like Italy were at risk of a re-run of the 2012 debt crisis. The policy response has surprised to the upside. The ECB has increased its asset-purchase program by more than 12% of GDP. Rules on fiscal deficits have been temporarily relaxed, resulting in fiscal stimulus of around 3.5% of GDP across the region. The work subsidy schemes implemented in most countries have kept the Euro area's unemployment rate near record lows. The most far-reaching policy response is the proposal by Germany and France for a €750 billion (6% of GDP) recovery fund that would be financed by the first-ever issuance of bonds jointly guaranteed by all 27 members of the European Union. This is still to be agreed upon but represents an historic step forward in European unity and stability.

The MSCI EMU Index rebounded by 33.3% from its March lows through June 10 but lagged the 43.2% rebound in the S&P 500. Europe's exposure to financials and cyclically sensitive sectors such as industrials, materials and energy give it the potential to outperform in the second phase of the recovery, when economic activity picks up and yield curves steepen.

United Kingdom

The U.K. has been hit hard by the COVID-19 crisis. It has suffered high infection and death rates, which are delaying the easing of lockdowns. The OECD is forecasting an 11.5% GDP decline in 2020 followed by a 9% rebound in 2021.

Economic uncertainty is compounded by the Brexit negotiations. There is a year-end deadline for a European Union/U.K. trade deal, but negotiations seem to be at a stalemate. Our assumption is that a deal will be reached, but the risk of a no-deal exit, with negative consequences for trade and the economy, cannot be ignored.

This has been reflected in the FTSE 100 Index, which has been the worst performer of the major developed stock indices. We like the value in the U.K. market on a longer-term basis. It offers a dividend yield at mid-year of 4.5% with a trailing P/E ratio[3] of 14.5 times. Brexit uncertainty and the slow decline in virus cases could continue to hold the U.K. market back.

Japan

The Japanese economy was struggling before the COVID-19-led downturn. Fiscal policy has become supportive, with the Japanese government recently approving a second stimulus package worth close to 117 trillion yen ($1 trillion U.S. dollars). The Bank of Japan has expanded its toolkit and is providing commercial banks with the funds to make loans. The boost to the economy from the postponed Olympics has been delayed to 2021.

Japan's structural weaknesses in terms of weak monetary policy and persistent deflation mean it will likely remain an economic laggard relative to other developed economies.

[3] Trailing price-to-earnings (P/E) is a relative valuation multiple that is based on the last 12 months of actual earnings. It is calculated by taking the current stock price and dividing it by the trailing earnings per share (EPS) for the past 12 months.

China

After being the first country to enter the COVID-19 crisis, China has emerged from the shutdown. The recovery in China has continued through the second quarter of 2020, with the services sector starting to catch up to the manufacturing sector. Construction activity has seen significant improvement in the last month, and there remains a large pipeline of infrastructure projects to be started.

The Chinese government has announced further stimulus measures, including coupons to households to encourage spending, and the People's Bank of China is making monetary policy more accommodative. However, the stimulus does not match 2015/16 or the financial crisis of 2007-08, and the government appears worried about excessive debt levels. While geopolitical risks are rising, we think the rhetoric between the U.S. and China is at this stage unlikely to see the Phase One trade deal dissolved in the short term. China seems well positioned for a strong rebound through the second half of 2020 and into 2021 as stimulus kicks in and the global economy recovers.

Canada

The Canadian economy is expected to contract by around 9% in 2020 based on industry consensus estimates. The path forward looks more optimistic. The phased reopening of the economy, recovery in the price of oil, and historic fiscal and monetary stimulus are laying the foundation for the upturn. A risk to the outlook is consumption. The Canadian consumer had underpinned the most recent expansion. Rising home values elevated household net worth but also indebtedness. Coupled with a high level of unemployment at mid-year, the cracks may be forming in this foundation.

High frequency data such as credit card transactions suggest April marked the cycle trough. Although a full jobs recovery will take time, 290,000 jobs were added in May. While this recaptures just 10% of the jobs lost in the prior months, it suggests a gradual recovery is unfolding.

Australia/New Zealand

Australia and New Zealand have been successful in containing the coronavirus through a combination of stringent border control and lockdowns. The focus now turns to the economic recovery, where some caution is warranted.

High household debt levels and slow growth in wages mean a cautious consumer will be a headwind to the recovery in Australia. A similar situation is likely in New Zealand, where household debt is also elevated. The downturn in tourism will also be a challenge for both economies in the shorter term.

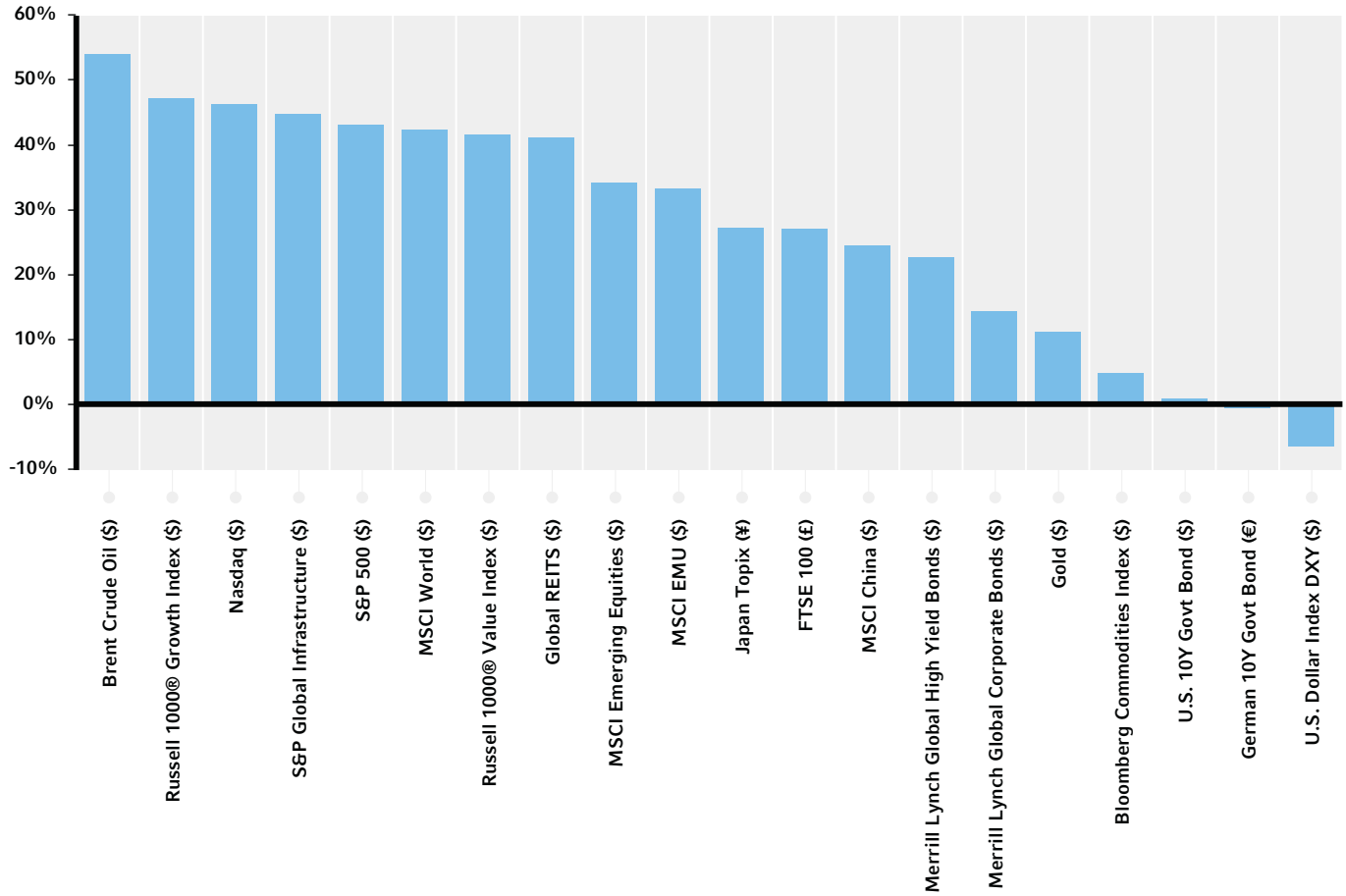
Asset class preferences

> *The recovery from the recession means a long period of low-inflationary growth supported by monetary and fiscal stimulus.*
>
> **Andrew Pease**

Our cycle, value and sentiment investment decision-making process has a moderately positive medium-term view on global equities. Value is neutral, with the expensive U.S. offset by reasonable value in the rest of the world. Sentiment is also neutral as of mid-June after being strongly oversold in late March. We see the cycle as supportive of risk assets for the medium-term. The recovery from the recession in our view means a long period of low-inflationary growth supported by monetary and fiscal stimulus.

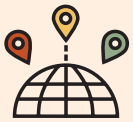
Sentiment is no longer overbought, and supportive following the market rebound. Our near-term view on equities is more cautious with the risks around a second wave of infections and U.S. politics heading into the federal elections in November.

Chart 5: Asset performance since the coronavirus-driven market bottom
From the S&P 500® Index through on 23 March 2020 through 10 June 2020



Source: Refinitiv Datastream, last observation 10 June 2020.

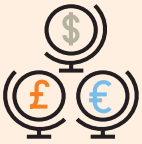
We prefer **non-U.S. equities to U.S. equities.** This is partly driven by expensive relative valuation. It also reflects that the second stage of the post-coronavirus economic recovery will see corporate profits recover. This should favor cyclical and value stocks over defensive and growth stocks. The rest of the world is overweight these stocks relative to the U.S.



We like the value in **emerging markets (EM) equities**. China's early exit from the lockdown and stimulus measures should benefit EM more broadly

High yield and **investment grade credit** were very attractive in late March when spreads were wide. Spreads have since narrowed and as of mid-June only adequately compensate for the likely rise in default rates following the recession. We have a neutral view.

Government bonds are universally expensive. Low inflation and dovish central banks should limit the rise in bond yields during the recovery from lockdowns.



Real assets: Real Estate Investment Trusts (REITs) sold off heavily in March, with investors concerned about the implications of social distancing and online shopping for shopping malls and office buildings. Sentiment appears overly bearish, while value is very positive. By contrast, Global Listed Infrastructure (GLI) is expensive, which leads us to prefer REITs to GLI.

The **U.S. dollar** should weaken into the global economic recovery given its counter-cyclical behavior. The dollar typically gains during global downturns and declines in the recovery phase. The main beneficiaries should be the economically sensitive "commodity currencies", such as the **Australian, New Zealand and Canadian dollars.** The **euro** and **British sterling** are undervalued at mid-year 2020. The euro should gain if a second wave of the virus is avoided and a recovery is sustained. Sterling, however, is likely to be volatile around uncertain Brexit negotiations.

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