RUSSELL INVESTMENTS

2013 Annual Global Outlook

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Authors:

Mike Dueker, Ph.D.
Chief Economist

Douglas Gordon
Senior Investment Strategist, North America

Shailesh Kshatriya, CFA
Senior Investment Analyst, Canadian Strategy Group

Andrew Pease
Global Head of Investment Strategy

Wouter Sturkenboom, CFA, CAIA
Investment Strategist, EMEA

Stephen Wood, Ph.D.
Chief Market Strategist

Discipline and insight are crucial in a low-return environment

In 2009 we proposed that the U.S. economy was embarking on a square root-shaped recovery—one where an initial growth rebound would be followed by a prolonged period of modest growth as the imbalances that caused the crisis were slowly worked through. The square root recovery implied that investment returns would be moderate and that fears of surging inflation from excessive monetary stimulus would be unfounded.

EXECUTIVE SUMMARY

By **Peter Gunning**
Global Chief Investment Officer,
Russell Investments

Three years on and our outlook is unchanged. The U.S. remains in a 2–2.5 percent economic growth channel, inflation remains muted and the Federal Reserve is likely to maintain remarkable levels of monetary accommodation. The other aspect of the outlook that remains unchanged is volatility. For the past three years, intermittent fears of U.S. recession and European collapse have put markets into a risk-on/risk-off yo-yo. This is likely to continue. Provided the fiscal cliff is negotiated, we think a U.S. recession is unlikely. Even so, baseline growth hovering near 2 percent means that markets will be prone to periodic bouts of recession fears, which will increase the likelihood of market volatility.

Europe remains more a glass half-empty than half-full story to us. The past year has seen remarkable policy moves from the European Central Bank (ECB) that have eased funding pressures for banks and stressed sovereigns. These moves, however, were made reactively when the alternative was full-blown crisis. The odds of proactive policymaking by European leaders seem as remote as ever. The political will to hold the eurozone together has been impressive—and should not be underestimated—but the cycle of crisis followed by policy response seems set to continue. This will continue to drive volatility across asset markets.

China is one of the more positive stories. Last year we cautioned that China was set to slow. This process appears to have bottomed, and a cyclical recovery seems underway. This should be supportive for emerging markets equities which have underperformed and have some valuation appeal. (Longer term we acknowledge that Chinese growth has now moved into a new, lower channel closer to 7–9 percent than higher historic levels.)

More broadly, 2013 is likely to bring lower returns across the major asset classes. Many share markets delivered double-digit returns in 2012 as despair about medium-term economic growth prospects gave way to a more realistic assessment of subdued growth. A further re-rating of growth prospects towards optimism seems unlikely and share market returns will be constrained by profits growth. In the U.S. high profit margins and a mature earnings cycle point to single-digit returns. Profit margins and growth cycles have moved out of sync in many markets, creating the potential for more divergence in regional returns.

The tailwind of declining sovereign yields that has boosted fixed income returns looks to have run its course. The conditions for a sudden reversal are not in place, but low-running yields are the best guide to return potential. The search for yield should continue to support risk spreads, but equities seem likely to outperform bonds for the foreseeable future.

To sum up, our outlook for 2013 is one of low but differentiated returns across asset classes and regions against a backdrop of event-generated volatility. This will be a challenging environment for achieving long-term investment goals. Traditional safe havens run the risk of locking-in negative real returns, while old-fashioned set-and-forget strategies generate significant timing risk.

How should investors react? Our belief is that actively-managed, globally-diversified, multi-asset strategies will work (and have worked) best in this environment. Investors need access to outperforming managers in every sector and the ability to enhance returns by opportunistically adding exposure to non-traditional securities. They need disciplined active management backed by a strong process that seeks to identify opportunities and avoid the trap of buying high and selling low in risk-on/risk-off markets. In short, investors need to continue paying attention to every detail about their portfolio management. In a low-return world, every basis point still counts. ■

Investment cornerstones for 2013

Russell's Global Strategist Team generally expects a continuation of moderate U.S. and Chinese growth against the backdrop of episodic European-generated volatility.

HIGHLIGHTS OF RUSSELL'S OUTLOOK INCLUDE:

1. On net, we see a modestly positive (albeit volatile) investment environment
2. U.S. economic growth of 2.1 percent for 2013, increasing to 2.5–2.75 percent by second half of the year; nominal GDP > 4.5 percent; tepid inflation for medium term at 1.9 percent
3. U.S. Treasuries 10-year yield at 2.15 percent by the end of 2013
4. Modest, single-digit corporate earnings growth with restrained multiples
5. Modest, single-digit equity market returns around a volatile, risk-on/risk-off pathway
6. Russell 1000® Index year-end 2013 target: 830
7. S&P 500® Index year-end 2013 target: 1500

YEAR-END 2013 TARGET

› 2.15% U.S. 10-YEAR TREASURY YIELD

› 830 RUSSELL 1000® INDEX

› 1500 S & P 500 INDEX

The "squeeze play"

FACTOR ONE: "Square root-shaped recovery." Long-time readers of Russell's Annual Global Outlook and market commentary will remember the call we made in 2009. At that time we forecast that the U.S. economy would grow only obstinately and in a square root-shaped recovery pattern for the "*foreseeable future*." We have reiterated this perspective in both our 2011 and 2012 Global Outlooks. Well, when you're right, you're right: We forecast the same macro outlook for 2013.

Our strategic and quantitative capital markets research again supports the expectation that the U.S., and increasingly the global, economy are still *within that timeframe of the "foreseeable future"*—and that our 2009 strategic forecast of a square root-shaped recovery remains intact for 2013. As a consequence (absent a massive policy mistake) we think that expectations of either a robust, V-shaped recovery or a dire, double-dip recession will prove inaccurate.

The unsettling aspect of our central-tendency scenario is the number of things that have to go reasonably right to thread the needle and make it happen. Lawmakers have to reach a reasonable, confidence-building compromise on fiscal policy that begins to address long-run challenges, and housing construction has to increase by about 15 percent to offset the expected degree of fiscal tightening. We believe that this environment will continue to offer return—as well as risk—opportunities that are best addressed by an active, multi-asset strategy that can proactively adapt.

We don't think it is reasonable to expect a dramatic revision to this forecast. Research suggests that the recovery from such a balance sheet recession (or systemic deleveraging) takes the better part of a decade. It is reasonable to estimate that the U.S. is a bit past the halfway point of such a decade-long process.

Even though returns will be lower during this recovery process, we do think that they are identifiable and attainable. Consequently, we don't see this as either a bullish or bearish call; rather it is the realization that, going forward, leverage can no longer masquerade as corporate earnings, economic growth, real income—or investment acumen. The ebb of leverage serves to denude. Not all corporate balance sheets are created equal, and not every firm will execute and outperform—so active management in the form of active security selection should become an increasingly important component of portfolio performance.

FACTOR TWO: "Financial repression" is another fundamental backdrop for our investment perspective. In response to the lingering effects of the Great Recession, Federal Reserve policies ("Q.E. One, Two" and now "Q.E. Perpetuity," "Operation Twist," and "zero" Fed Funds rate) constitute the other key component of an investment "squeeze play."

Fed guidance has been clear: Aggressive policies that began in 2008 will last into 2015. But even when the Fed moves away from such balance sheet actions—and since we see inflation being modest for the medium term—rates may well stay historically low for some time after that. While Fed policy is complicated and has many implications, for investors it will have the intended effect of squeezing them out of "safe haven" assets and forcing them—against their will and with great disquiet—further up the risk curve than they feel comfortable.

Beyond working to ensure funding liquidity and stability in capital markets, the Fed is also trying to avoid a Japan-style deflation in the U.S. It is using monetary easing to minimize global deleveraging and hopefully gin up economic and financial activity in the process. To this end, the Fed is clearly targeting housing and jobs, where they think they'll get more bang for their—literal—buck. The Fed can do this by creating both positive and negative incentives.

And this is global. Central banks around the world are using monetary policy to alter incentives and sentiment in response to a softening global economy. The net effect upon investors of this policy path is that monetary policy will continue to pick the pockets of savers.

This is a true investment vice because on the other side of the square root-shaped recovery that has been experienced since 2009 and Fed policy that is driving returns toward zero and real rates negative, is the reality that investors still have the concomitant competing demand of a real return on their assets. These ostensibly mutually exclusive constraints constitute the "squeeze play."

How should investors navigate this "squeeze play?"

Since only positive real returns build wealth, what is to be done in a yield-starved world? This is where professional management and strategic discipline come in: Russell believes that investors need a professionally-constructed and actively-managed multi-asset portfolio strategy—one that identifies risk-return characteristics, assesses their shorter and longer run probabilities, and uses total portfolio management techniques as well as the discipline of one's strategic asset allocation to seek to increase the odds of hanging on to most of these returns.

In sum, we think that such an adaptive approach is designed to increase the odds of investors attaining their long-term goals amid the uncertainty and inherent risks associated with investing in global capital markets. Like all investing, though, multi-asset investing does not assure a profit or protect against loss.

So, don't go with your gut—instead, run the numbers! Over-correcting is a poor practice, and sentiment-driven responses have not worked: Investors who have either fed their fear (running into cash) or tried to time risk-on/risk-off mini-cycles, have likely fared worse than being invested in this volatile market. Looking at the basic level of the pairwise comparison of equity versus fixed income, it may not be so much a matter of risk assets looking great, but more a matter of "safe haven" investments being unattractive, and far more often representing a locked-in net loss. "Peace of mind," has gotten very, very expensive in the current low-return yield environment and, while all investing options including multi-asset strategies carry some degree of risk, investors will likely need a strategy that is nimble, adaptive, responsive and has the chance of building wealth.

As this "squeeze play" constrains options and impulses people into the "risk markets," we suggest using the investment approach centered around improving the odds of attaining a reasonable long-term goal. Current and forecast investment risks are certainly not trivial, but we do not believe they are insurmountable. We continue to advise clients to proceed purposefully within a strategic discipline. We think that investors will need to rely on their long-term strategic discipline: Global, multi-asset class diversification is designed to not only assist in smoothing the near-term market volatility, but can also allow investors to increase the probability that (in a zero-cash, lower-return environment) their portfolios will generate the rates of return they'll need to reach their long-term goals. Of course, like all investing there are risks, including the risk of losing money.

Using a simple example, if core inflation continues in a 2.2–2.5 percent range, returns have to be at least that high, plus whatever growth/income is needed. Currently, the yield on cash is close to zero percent (according to LIBOR 1 Month Total return U.S. Cash Index, which showed a 0.23 percent annualized total return through November 30, 2012) while the yield on a 10-year U.S. government bond is about 1.6 percent. Since 0 percent and 1.6 percent are both less than 2.5 percent—locking in a negative yield of between 2.5 percent and 0.9 percent. Investors are prisoners of the math—perhaps they can take comfort in knowing that they face limited options.

Call to action

Whether in the individual or the institutional space, the reality is that most investors require that their assets work for them. That is where disciplined, actively and professionally managed, adaptive, globally-diversified multi-asset strategies come in.

Doing nothing or overpaying for perceived safety are not viable investment options. Investors need professional guidance to balance their need for real return within this ongoing "squeeze play." Investing is about understanding risk, how it is compensated, how to best manage it, as well as implementing a disciplined multi-asset strategy that seeks to increase the odds of attaining an investment goal.

As traditional investment models flail and fail while traditional safe haven investments promise negative real returns, investors are left with fewer "traditional" options that can meet their long-term goals. Investors with an informed understanding of their personal goals and risk tolerance need to understand and harness active management, global diversification and multi-asset strategies (including alternatives, hedging strategies, global credit, real assets, etc.), and do so within a long-term discipline of their strategic asset allocation.

To our mind, the interesting question is not so much if many investors need a multi-asset strategy approach, but rather which active, globally-diversified, multi-asset approach is appropriate.

We have said for some time that every basis point counts. This becomes ever more important in a yield-starved world. We think Russell is well equipped to help investors in this challenging, yet navigable, environment—and that we can help our clients identify and collect those precious basis points. ■

U.S. economic outlook for 2013: A time to address long-term issues at last?

Our central scenario for the U.S. economy in 2013 assumes a reasonable compromise agreement to address the fiscal cliff fairly early in 2013, such that the expected degree of fiscal tightening is about 1.5 percent of GDP. At this magnitude, the expected increase in housing construction activity can offset the anticipated fiscal tightening to some degree and result in a growth rate for real GDP of 2.1 percent on a year-on-year basis.

It might be discomfiting that the economy has to thread the needle and have several things go right in order to enjoy a modest year of growth, but such is the nature of the times. Investors have to get used to counting on policymakers to make sound choices at numerous future junctures, given that the U.S. federal government is not on a solid, long-run fiscal footing.

Our call is that the fiscal cliff will be resolved in a way that does not lead to a U.S. recession, although a compromise agreement will not necessarily be in place by January 1, 2013.

President Obama and the Republican-controlled U.S. House of Representatives face twin challenges: the immediate fiscal cliff—the draconian budget cuts and wide array of tax increases that are specified in current law—and long-term budget issues facing the federal government—principally growth in Medicare spending. It is interesting that Ben Bernanke, the current Federal Reserve chairman, and Alan Greenspan, the previous Fed chair, appear to have differing views on how vigorously to implement fiscal tightening in the near term.

> **"Fortunately, avoiding the fiscal cliff and achieving long-term fiscal sustainability are fully compatible and mutually reinforcing objectives. Preventing a sudden and severe contraction in fiscal policy will support the transition back to full employment, which should aid long-term fiscal sustainability."**
>
> —Ben Bernanke, June 7, 2012, testimony before the Joint Economic Committee
> http://www.federalreserve.gov/newsevents/testimony/bernanke20120607a.htm

> **"I think if we have to have a moderate recession to solve this huge fiscal problem that's in front of us—I think that's a very small price to pay. We're not going to get out of this thing without pain."**
>
> —Alan Greenspan, CNN, November 16, 2012
> http://money.cnn.com/2012/11/16/news/economy/greenspan-recession-debt/

Ben Bernanke espouses the view that over-exuberant, near-term budget slashing would be counterproductive in the quest toward balanced budgets if it caused a recession that would set back growth in tax collection. Alan Greenspan, on the other hand, believes that policymakers ought to signal their determination to rein in spending growth, even at the risk of a recession that would raise deficits in the near term.

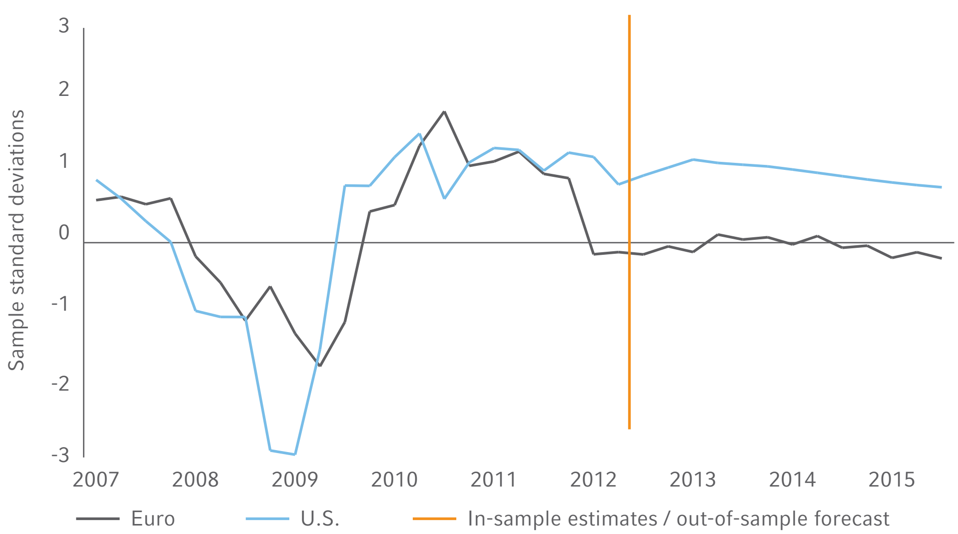
Considering the menu of possible policy choices, Russell's expectations are that the fiscal tightening in 2013 will not be severe enough to send the U.S. economy into recession. Reasons for our "no recession" call include:

1. Financial market early-warning signals are not sounding an alarm at present. Quality spreads between corporate bonds, which typically widen when recession threats emerge, have narrowed in the last two months, as has the Libor-Treasury bill spread.

These signals suggest that financial market participants are persuaded that lawmakers will avoid draconian fiscal tightening next year.

2. The fact that the 10-year Treasury yield has sunk back below 1.60 as of November 16, 2012, is likely an indicator of modest fiscal tightening from a compromise agreement, not a sign of recession from the full-bore fiscal cliff.
3. Forecasts of the Business Cycle Index (BCI) that Russell publishes every month on www.russell.com/Helping-Advisors show a continuation of the modest economic expansion as the central-tendency path. The BCI puts together these early-warning signals from financial markets in a systematic way, yet it does not foresee a recession.
4. A low-growth economy is also likely to be a less-volatile economy. Concerns that a negative shock that could drop real GDP growth by a little more than 2 percent and into recession are misplaced if they overstate the likelihood of shocks of this magnitude when the economy is in a stable, low-growth state.
5. A rise in home construction next year could partially offset modest fiscal tightening and result in a mediocre rate of real GDP growth near 2 percent in 2013.
6. The chief scenario in which the U.S. economy goes into recession in 2013 is through a lawmaker-induced policy shock, not the sort of economic imbalances that typically lead to economic downturns.
7. Lawmakers will recall that the 2001 Tax Act changed tax rates gradually across a five-year period; the same should hold when those tax cuts are partially reversed, hopefully as part of sensible, comprehensive tax reform.
8. We believe that a gradualist approach to fiscal tightening will carry the day. Increasing the already-too-large deficit in the short run through recession in the name of long-run budget consolidation will be judged counterproductive and will be avoided. Gradualism on the road to a balanced budget could lead to an intermediate target of a deficit-to-GDP ratio of 5 percent by 2017, as indicated by Ben Bernanke. A carpenter does not have to hit his thumb on purpose with the first strike of the hammer in order to demonstrate his determination to drive in the nail.

U.S. and eurozone Business Cycle Index



Source: Federal Reserve Economic Data (FRED), Russell Calculations
(Data as of September 30 2012)

Out-of-sample forecasts were calculated by simulating the time-series model into the future. The value shown is the median of the simulated value for the month. These macroeconomic forecasts do not constitute a projection of the stock market or of any specific investment. See the last page for further information regarding the Business Cycle Index.

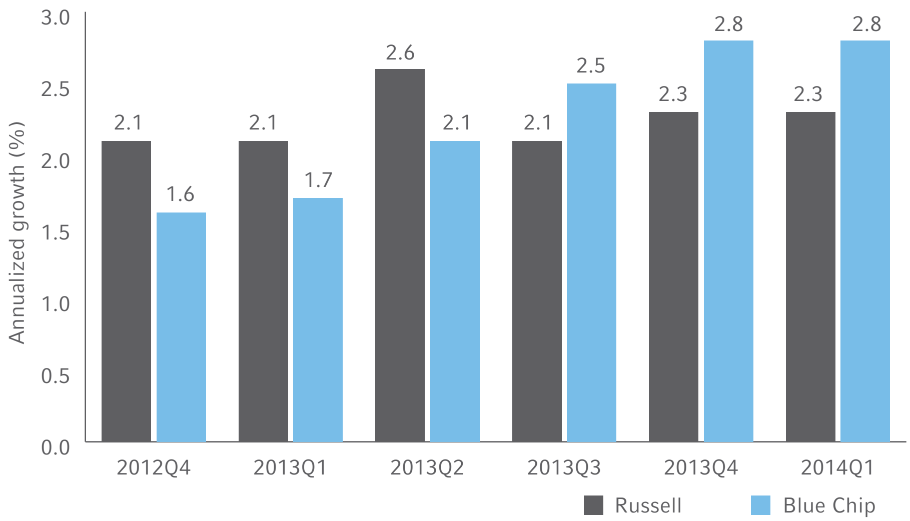
Additional highlights of our U.S. economic outlook for 2013 are:

- We expect year-on-year real GDP growth in 2013 to be 2.1 percent. This growth forecast reflects in part Ben Bernanke's view that "a credible fiscal plan to put the federal budget on a longer-run sustainable path could help keep longer-term interest rates low and improve household and business confidence, thereby supporting improved economic performance today." [http://www.federalreserve.gov/newsevents/testimony/bernanke20120607a.htm] Indeed, public perception that the federal government had attained sound long-run fiscal footing might have contributed importantly to the wave of confidence about the future and strong investment spending in the 1990s. Today, however, the best we can hope for in the immediate future is "sounder" fiscal footing, not "sound" fiscal footing.
- Perhaps the clearest illustration of our business cycle outlook for the U.S. economy is to contrast it with Europe. The Business Cycle Index that we estimate for both economies shows the divergence between modest expansion in the United States and conditions that languish on the cusp of recession in the eurozone.
- U.S. payroll employment gains will be about 160,000 jobs per month on average across 2013 in our estimation. The resulting unemployment rate at the end of 2013 will be 7.4 percent in our view.
- We expect that the 10-year Treasury yield will be 2.15 percent at the end of 2013, with slightly greater upside than downside potential from this central-tendency forecast. Market participants have scope to believe that the Federal Reserve could find itself behind the curve in raising rates, given its mid-2015 guidance for the first rate hike.
- Even if Treasury yields increase modestly, we anticipate that corporate bond yields, such as the Baa yield, will remain nearly steady in 2013.
- Based on our central-tendency scenario of 2.1 percent real GDP growth and modestly rising bond yields, we project that the S&P500 Index will end 2013 at 1500 and the Russell 1000 Index will end the year at 830, which follows from corporate profits growing a little faster than nominal GDP and having mild multiple expansion from a small drop in the equity risk premium as doomsday scenarios diminish in likelihood.
- The scenario (which we would judge to have a 20 percent probability) in which the Fed finds itself behind the curve would remind many investors of 1994. Then, rapid increases in long bond yields and the equity discount factor suppressed equity price appreciation, even in the face of stronger-than-expected economic growth. If economic growth and long bond yields were to rise at a faster-than-expected pace in 2013, we would anticipate that the equity discount factor, the risk-adjusted rate of discounting dividends, would rise less than one-to-one versus bond yields. The reason is that we would expect solid growth to lead to an accompanying diminution in long-run investor concerns—which would lower the equity risk premium and help spur equity price appreciation.
- With anticipated CPI inflation of 1.9 percent on a year-on-year basis in 2013, we expect inflation to remain contained.
- We expect the Fed to continue its Quantitative Easing purchases of mortgage-backed securities throughout 2013 and even expand it to include purchases of Treasury bonds. This policy accords with our view that the Fed has an implicit target for nominal GDP growth—the sum of real growth and inflation—of at least 4.5 percent, given the Fed's newly-announced long-run inflation target of

The Federal Reserve seeks to achieve at least 4.5 percent nominal GDP growth through its open-ended Quantitative Easing policy.

Equity risk premium is the excess return that an individual stock or the overall stock market provides over a risk-free rate. This excess return compensates investors for taking on the relatively higher risk of the equity market. The size of the premium will vary as the risk in a particular stock, or in the stock market as a whole, changes; high-risk investments are compensated with a higher premium.

U.S. GDP forecasts



Sources: Each month since 1976, **Blue Chip Economic Indicators** has polled 50 of America's top business economists, collecting their forecasts of U.S. economic growth, inflation, interest rates, and a host of other critical indicators of future business activity. This data comes from the October 2012 issue.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. it is not representative of a projection of the stock market, or of any specific investment.

2 percent. So far, nominal GDP growth has consistently fallen short of 4.5 percent in the current economic expansion on a four-quarter rolling basis—hence the adoption of open-ended Quantitative Easing by the Fed in September 2012.

› We stress that no large jump in inflation is possible when the Fed is targeting nominal GDP growth. It is not possible to have a high inflation rate if nominal GDP growth is kept in the vicinity of 5 percent.

The eurozone: Finding the right policy mix

Europe is still struggling to find the right policy mix to deal with both the symptoms and the disease of the eurocrisis. As a result, we believe 2013 will be another year in which a tug-of-war between deflationary austerity and reflationary monetary policy will keep financial markets volatile. A continuation of the crisis is guaranteed as long as the downward spiral in growth is not addressed.

A tug-of-war in 2013

By now it seems clear to everyone except European politicians that solving the eurocrisis requires a different policy mix than the one in place. Too much austerity in a world with a large fiscal multiplier combined with too little monetary easing have had a severely negative impact on growth without solving the underlying problems.

In essence, our opinion is that the eurozone needs a policy mix with a better balance between growth and austerity policies. We feel the current mix is incapable of allowing Southern European countries to escape their debt trap—when the nominal growth rate of an economy lies below the nominal interest rate, making it impossible to solve their problems. A more growth-oriented policy with less austerity, targeted fiscal transfers to boost growth, and support from the ECB to lower interest rates is the best chance the eurozone has to solve the eurocrisis.

Unfortunately, we are unlikely to see such a policy mix being implemented in 2013. Politically, it is simply the proverbial bridge too far. Instead, we expect a tug-of-war in which austerity will continue to depress economic growth while monetary policy will act as a periodic band-aid, which we expect will result in a significant liquidity injection when Spain asks for help in the first quarter of 2013. Such a liquidity injection, however, cannot meaningfully boost economic growth or counter solvency issues. The downward spiral of negative growth in Southern Europe will therefore not be broken, ensuring a worsening of the solvency problems and a continuation of the crisis.

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Projections for the eurozone

- The eurozone will hold the line in 2013: An exit by either a weak country, such as Greece, or a strong country, such as Finland, is unlikely. Together with ECB support there is enough political willingness to kick the can down the road and maintain the doctrine of extend and pretend. The amount of money to do so is relatively small, and the risk of contagion too large. The only potential game changer in this regard is civil unrest in countries such as Greece, Portugal and Spain. If such unrest gains momentum, a disorderly break-up cannot be ruled out. For now, however, that seems unlikely.
- A poor man's banking union: On the subject of implementing a banking union, the eurozone is on track to settle for less than needed. By scrapping the right for the European banking supervisor to resolve failing financial institutions and backtracking from plans to implement a European deposit insurance scheme, the proposed banking union will not be able to achieve its stated goal. That goal, breaking the link between the individual sovereign and financial institutions, is critical to staunch the

continued capital flight from Southern Europe to Northern Europe. The failure to reach that goal is likely to lead to higher Target2 imbalances and will be an important driver behind a further divergence in economic growth in 2013. In other words, it likely will continue to drive a wedge between North and South.

› No hope for a robust governance framework: The hope that a grand bargain will be struck in which sovereignty is exchanged for joint and several liability is unfounded. On the sovereignty or political union front, France is unwilling to compromise while Germany will not go for joint and several liability, or fiscal union, without the guarantees a political union brings. This is mostly problematic on a longer term horizon as it will leave the eurozone largely unable to deal with future asymmetric economic shocks. It is, however, also a negative in the context of the current crisis because a fiscal union could help regain trust and push down borrowing costs for those countries that need it most.

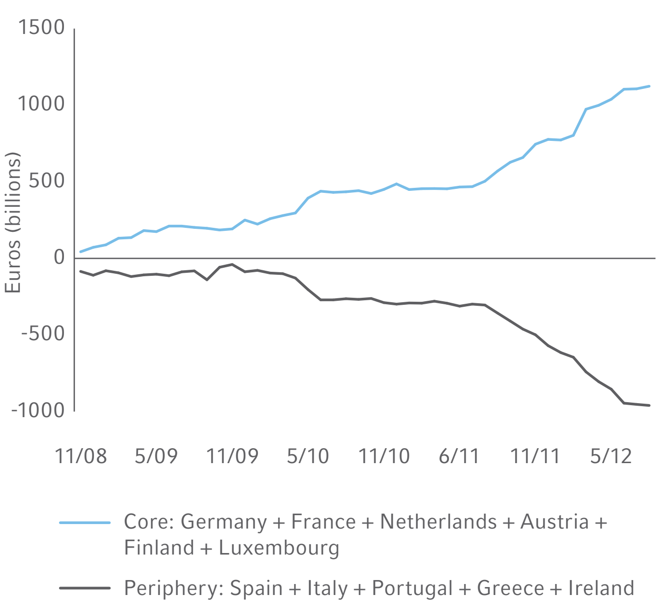
› Economic growth: After alluding to the economic wedge being driven in the eurozone, it is hard to turn around and provide a singular GDP forecast. Instead, we approach the question from its underlying parts and derive our conclusion from their sum total. Regarding growth in Northern Europe, we believe we are close to the bottom around the zero level. 2013 is likely to see a small improvement on the back of slightly better global growth, although a weak Southern Europe will prevent growth from going much above 1 percent. Southern Europe is likely to be the mirror image of that outlook and remains mired in its extended recession with growth around -1 to -1.5 percent. In total that means growth for the eurozone as a whole will stay weak at approximately -0.5 percent.

Target2: Established in 2007, TARGET2 is the Trans-European Real-time Gross Settlement Express Transfer System (variant 2), an interbank payment system for the real time processing of cross-border transfers throughout the European Union.

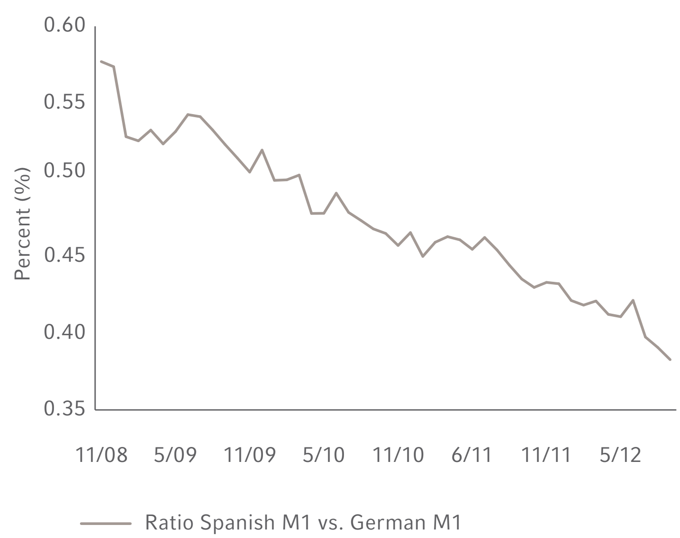
Regarding growth in Northern Europe, we believe we are close to the bottom around the zero level.

Private Capital Outflow Source of ECB Target2 Imbalances

ECB Target2 imbalances: Core vs periphery



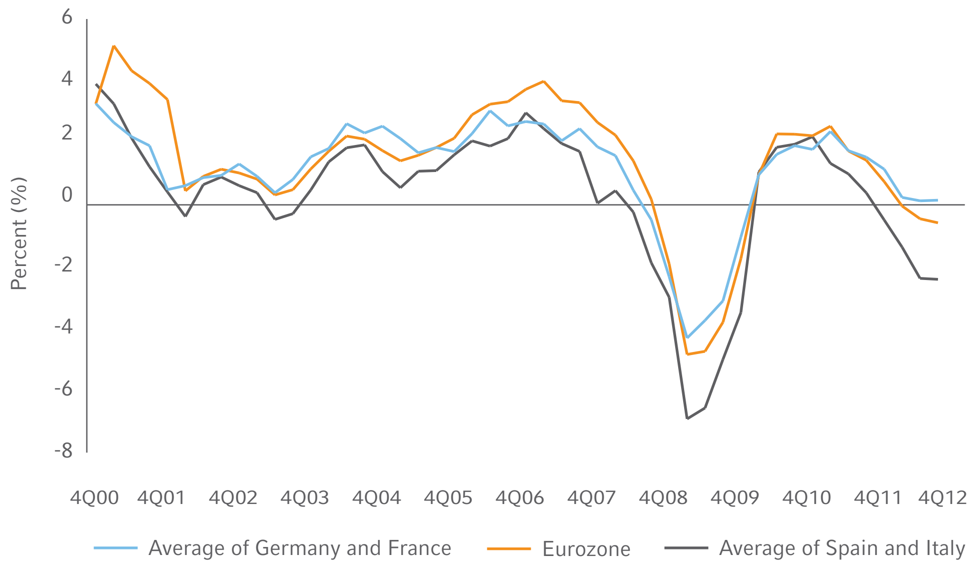
Ratio of Spain to Germany money supply



Source: Thomson Reuters (Data as of September 28, 2012)

Data shown is historical and not an indicator of future results.

GDP growth



Source: Thomson Reuters (Data as of September 30, 2012)

Data shown is historical and not an indicator of future results.

Given the expected volatility, European equities are not a buy-and-hold asset class for 2013.

› Equities: Given the expected volatility, European equities are not a buy-and-hold asset class for 2013. The uncertainty surrounding the eurocrisis means European equities need to be significantly undervalued to invest in. Current valuations are low enough to do so, and the expected support from the ECB could provide a boost to valuations. That makes Europe a higher-risk, but interesting place to invest for investors with the commensurate risk tolerance. Still, if a re-rating indeed occurs, we would become cautious, especially as growth will likely continue to disappoint during the rest of the year.

Global equities: A rising tide may not lift all boats equally

Equities are expected to outperform, although mature earnings and growth cycles make double-digit returns unlikely. The unequal risks and opportunities across regional equity markets means 2013 will be a year where active management and diversification are likely to be rewarded.

2012 has proved to be a year where headline and policy risk were the primary drivers of volatility and differential returns in global equity markets. 2013 looks to be more of the same, especially over the first half of the year. Even so, our central scenario is favorable to equities. One of the main differences to 2012 is that regional equity markets are likely to be less correlated. Markets were highly correlated in the first half of 2012 amid the relief rally following the ECB's bank refinancing in February and then the subsequent sell-off from fear ahead of the Greek elections and the outcome of the European leaders' summit mid-year.

The last time policy and headline risks forced major capital market movement was August 2011 and through the second half of 2011. At that time, the failure to achieve consensus in the U.S. surrounding the debt ceiling, combined with solvency risks and resulting pressure on peripheral European bond yields, set lows in equity markets. Globally there was both directional consistency and synchronized timing with these lows in regional equity markets set within a little over three months. Since then, returns have been anything but consistent across various regional equities. This point is made more evident when looking at returns from earlier highs in 2012 to present. During this period even the timing has become uncorrelated, with some markets reaching highs in February and March and others in September.

The key takeaway is that global equity markets have become less linked as a result of earnings and profit cycles globally falling out of sync. The rising and lowering global tide is moving all boats in a relatively consistent direction, but this tide is not moving these boats in an equitable manner. From our point of view, this makes a compelling case for diversification and active management in a multi-asset portfolio.

Provided a fiscal cliff-induced U.S. recession is avoided, low economic growth and a mature earnings cycle should yield mid-to-upper single-digit equity returns in the U.S. Emerging markets, despite downward earnings revisions through 2012 and taking into account the inherent risk premium they have, should modestly outperform developed markets. Opportunities in Europe and Japan are possible, however, volatility will be driven by policy moves. Navigating these opportunities will require proactive and nimble management to balance relative valuation advantages against sentiment surrounding policy shifts and judgments about policy effectiveness. Finally, sector differences in earnings-per-share (EPS) within equity markets may also provide opportunities with the financial services sector a candidate for better relative returns in this respect.

The rising and lowering global tide is moving all boats in a relatively consistent direction, but this tide is not moving these boats in an equitable manner.

Country/Index	2012 return	Total return from 2nd half 2011 low through December 3, 2012	Return since 2012 high through December 3, 2012
U.S. / Russell 1000® Index	12.5%	29.0% (3 OCT 11)	-3.6% (14 SEP 12)
UK / FTSE	5.4%	18.7% (4 OCT 11)	-1.6% (16 MAR 12)
GER / DAX	26.1%	46.6% (12 SEP 11)	-0.2% (21 SEP 12)
FRA / CAC	12.9%	28.2% (22 SEP 11)	-0.8% (16 MAR 12)
JPN / NIKKEI	11.5%	15.5% (25 NOV 11)	-8.1% (27 MAR 12)
AUS / ASX	7.3%	19.9% (4 OCT 11)	-1.0% (16 MAR 12)
CAN / TSX	1.8%	8.9% (4 OCT 11)	-4.5% (28 FEB 12)
EM*	10.6%	20.5% (4 OCT 11)	-6.6% (2 MAR 12)

Source: Bloomberg. Price Return data in local currencies as of December 3, 2012.

*UK/FTSE = The Financial Times Stock Exchange 100 stock index, GER/DAX = The Deutscher Aktien Index, or DAX 30, FRA/CAC = The CAC 40 index, JPN/NIKKEI = Nikkei 225 Total Return Index, AUS/ASX = The S&P/ASX 200 index, CAN/TSX = The S&P/TSX Composite Index, EM = Russell Emerging Markets Index.

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Double-digit U.S. equity market returns are possible only if investors are prepared to assign a higher multiple to EPS under a "what could go right" scenario.

Other highlights of the global equities outlook include:

Mature earnings and profit cycles amid a deleveraging global outlook

Four years following the global financial crisis (GFC) and resulting recession, global capital markets are still deleveraging. This deleveraging has helped to fuel the long square root-shaped nature of the post-GFC recovery, and its tepid pace has resulted in a protracted earnings cycle.

The earnings surge during the slow recovery has been driven by operational leverage achieved through labor shedding. Firms have grown revenues off a diminished cost base. The easy gains, however, already have been made and margins can now only grow through pricing power or declining unit labor costs. Neither are easy to achieve in a low inflation, low productivity economy. Wage pressure is likely to remain subdued, so given this environment, we feel that current margins should be sustainable. In the U.S., aggregate profits at best, are likely to grow in line with nominal GDP. Our central scenario calls for single-digit equity market returns that will outperform fixed income. Double-digit U.S. equity market returns are possible, although only if investors are prepared to assign a higher multiple to EPS under a "what could go right" scenario.

Regional valuations

The mature earnings cycle in the U.S. and high EPS relative to the 10-year average ending November 30, 2012 presents some unique valuation scenarios relative to both emerging markets and non-U.S. developed markets—most notably Europe and Japan. From a relative basis, current EPS make those equity markets appear attractive, as EPS levels appear out of sync. With more EPS upside in Europe, Japan and emerging markets, relative to the United States, we should determine if other valuation methods affirm these opportunities.

› Earnings have collapsed within continental Europe. As a result, the EPS level in Europe, when compared to the level in the U.S., looks very attractive. U.S. EPS levels are 30 percent farther from their 10-year average than those in Europe. Along with this, compelling relative valuation signals come from price-to-book value and price-to-earnings when compared over a moving 60-month window through November 30, 2012. These are over one standard deviation in favor of European equities.

Other valuations, however, are closer to neutral with long-term mean reversion and current ratio of price-to-earnings comparisons under one standard deviation in their preference for European equities. From a relative vantage, European equities appear cheap when compared to U.S. equities, though they are not overwhelmingly so. A recovery rally may follow Spanish commitment to a memorandum of understanding (MOU) with the ECB to maintain sovereign yields at a sustainable level, but this may prove short lived amid persistently weak macroeconomic data in Europe.

› Once again we find ourselves asking the question if compelling valuations represent an opportunity or "value trap" in Japan. Long-term mean reversion as well as price-to-earnings comparisons between Japan and the U.S., as well as between Japan and other developed equities markets, are favorable (most notably Australia, Canada, and the UK); relative performance and momentum, however, provide a headwind.

The central question is whether the economy can be positioned to generate sustained growth. Japan's incoming government will play a critical role in the answer. Opinion polls suggest that Shinzo Abe will be elected Prime Minister on December 16: a watch point will be the gap between future rhetoric and policy action. Mr. Abe has campaigned on reducing Bank of Japan (BOJ) independence, adopting a 3 percent inflation target and driving policy action to devalue the yen. The commitment to this will need to be sustained to be effective, perhaps akin to the line in the sand drawn by the Swiss National Bank on its sovereign currency in August of 2011. Mr. Abe and the BOJ will need to be resolute to encourage markets to "believe." It is worth keeping in mind that the potentially episodic actions by the BOJ with respect to devaluing the yen will be taking place against open-ended quantitative easing by the Federal Open Market Committee (FOMC) in the U.S. and the ECB liquidity operations. Both may make it more difficult to get the desired effect on foreign exchange rates, that could potentially help to put an end to Japan's long growth stagnation.

› Emerging markets (EM) also may be due for outperformance relative to developed markets globally. When taking currency risk out of the valuation, EM has begun to look modestly though persistently attractive from relative price-to-earnings and price-to-sales comparisons. These valuation advantages are persistent, yet more muted versus cheaper European equities. This is as a result of the reasons outlined above and in the eurozone section surrounding structural growth concerns as well as political and policy uncertainty. These concerns recognized, we still believe EM equity is aligned to outperform.

Sector opportunities

› An additional area where the mature earnings and growth cycle story may play out is within sector selection. A specific example is in U.S. equity markets in the financial services sector. With a nod to the caveat that 2013 carries with it an uncertain regulatory and tax environment as a result of the fiscal cliff and potential political deal making, the S&P 500 Financial Services Sector Index looks to have the potential to outperform the broader equity index. This sector is under its 10-year EPS average by 10.6 percent through November 30, 2012, while the EPS for the S&P 500 Index exceeds its 10-year average by over 38 percent. This trade already has been profitable, with the financial services sector outperforming the broader index by 10.6 percent since market lows on October 3, 2011 (through November 30, 2012), but the opportunity from this EPS mis-valuation may perpetuate in 2013. ■

Standard deviation:
A measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation. Standard deviation is calculated as the square root of variance. With respect to financial modeling this expresses the level of conviction within the modeling to a signal.

Emerging markets: Due for outperformance

Emerging markets equities have been a disappointing performer over the past few years. 2013 could see emerging markets outperform on the back of stronger exports, a recovering China and relatively attractive valuations.

In 2013, emerging markets (EM) equities could be one of the bright spots for investors who have the appropriate risk tolerance. They have disappointed in recent years, underperforming developed markets over the past one, three, and five years as measured by the MSCI Emerging Markets Index as of November 23, 2012. Emerging markets equities look attractive relative to developed markets, and signs of a growth turnaround in the biggest emerging market, China, should confer confidence to the EM sector.

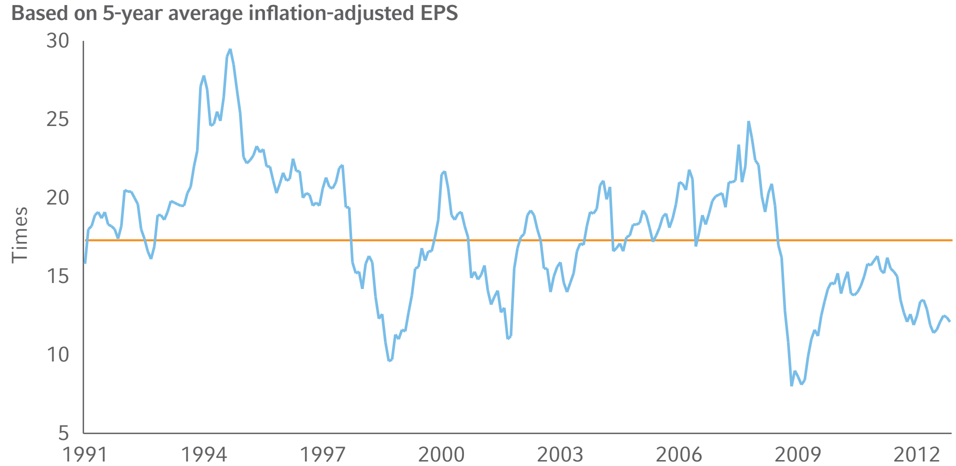
Weak export demand has been the biggest headwind for the sector over 2012, and the main risk is developed world export demand remains sluggish through 2013. Most EM economies have low inflation, are likely to maintain a stimulatory fiscal and monetary policy stance and lean against currency appreciation pressures. Moderate economic growth in the developed economies and stronger growth in China should indeed set the scene for better returns.

The highlights of the emerging markets outlook are:

› A cyclical recovery in China that delivers GDP growth of around 8 percent in 2013: China accounts for around 30 percent of emerging markets nominal GDP and nearly 20 percent of the listed market equity capitalization. There are legitimate question marks over China's medium-term growth potential, but a cyclical recovery through the first half of 2013 should provide enough comfort for investors to move back commensurately with their risk tolerance.

Emerging markets equities look attractive relative to developed markets—and signs of a growth turnaround in the biggest emerging market, China, should confer confidence to the EM sector.

Price-to-earnings ratio: MSCI Emerging Markets Index
Based on 5-year average inflation-adjusted EPS



Source: Factset, MSCI, Russell calculations (Data as of November 1, 2012)

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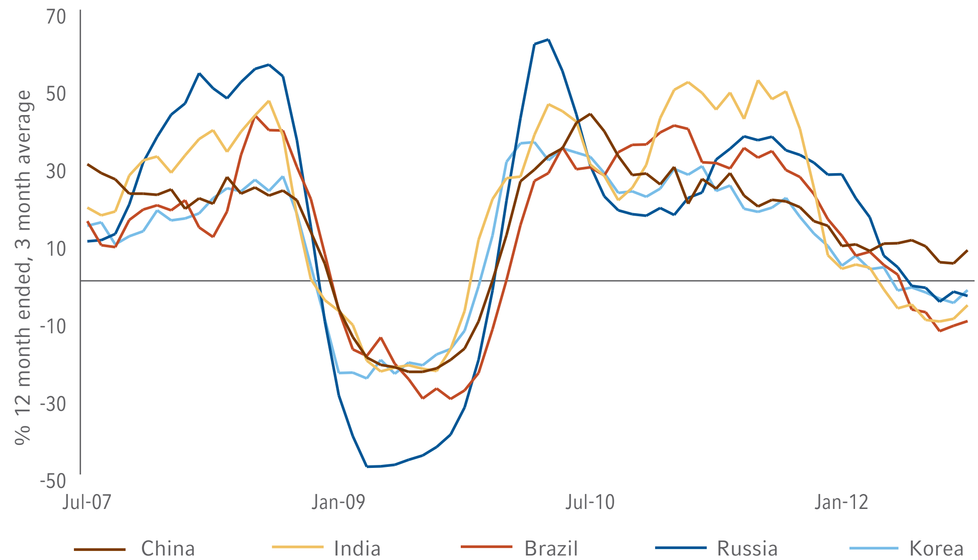
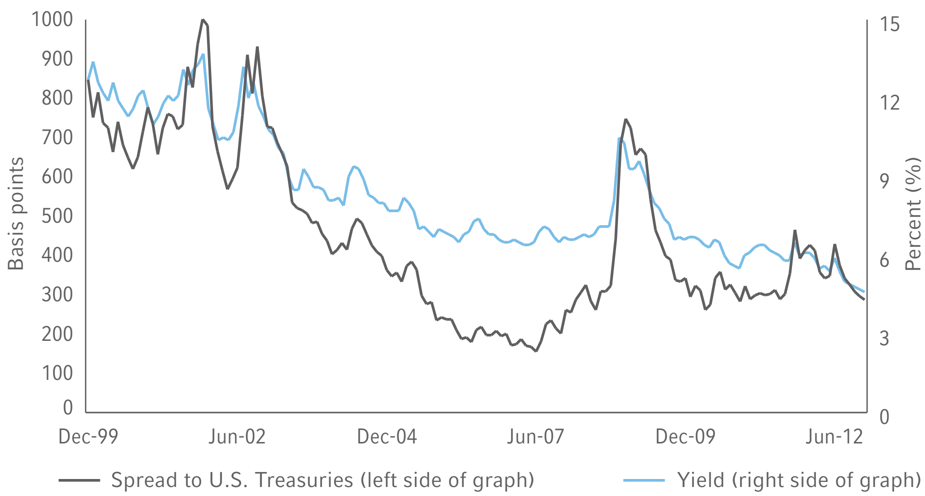
Exports by country



Source: Datastream (Data as of October 15, 2012)

Data shown is historical and not an indicator of future results.

Emerging markets debt
JPMorgan EMBI Global Index



Source: Datastream (Data as of November 1, 2012)

Data shown is historical and not an indicator of future results.

› Valuations are moderately attractive compared to history and relative to developed markets: A forward P/E of 10 times in November 2012 compared to the 10-year average of 10.5 times (from 2002 through 2012). Price-to-book value is also attractive at 1.6 times versus the 10-year average of 2 times. Emerging markets in November of 2012 as reflected by the MSCI Emerging Markets Index were trading at a 16 percent forward P/E discount to developed markets and a six percent discount in price-to-book value terms. This compares to a 15 percent price-to-book value premium to developed markets in late 2010.

› The potential for better earnings growth than in 2012: Back in April, the bottom-up consensus from IBES analysts was that earning-per-share could grow by 14 percent this year. By November this had been downgraded to barely 3 percent. The EPS disappointment was driven by the collapse in export demand and growth slowdown across EM economies. Exports look to be bottoming, and China is showing signs of a growth recovery. The bottom-up IBES consensus is for 13 percent EPS growth in 2013, which may be achievable against a backdrop of stronger economic growth. Realistic earnings projections and undemanding valuations create upside potential for EM equities.

› Returns from emerging markets debt are likely to be lower than in recent years but still okay: The JP Morgan Emerging Markets Bond Index returned 18.8 percent year-to-date in 2012 through November 30 and 12.7 percent annualized over the past three years through November 30. The spread to U.S. Treasuries is now under 300 basis points compared to over 400 basis points a year ago, and the long run average of 500 basis points from December 30, 1997 through November 30, 2012. Double digit returns are unlikely with the index yielding 4.6 percent. EM debt should remain well supported, however, against a backdrop of modestly improving economic growth and investor appetite for a yield pick-up over U.S. Treasuries. ■

Global currency outlook for 2013: More of the same, but risks aplenty

In 2013, sharp currency moves will likely appear only as the result of a substantial policy miscue. Since the Global Financial Crisis, policymakers have avoided taking any action that would precipitate a financial crisis on a wide range of issues from Greece to the U.S. debt ceiling. Our central scenario is that policymakers will make the necessary adjustments at key junctures in 2013, although not necessarily as soon as markets would hope, but before outright crisis.

Our central scenario for currencies in 2013 is that moves overall will be gradual. We expect some modest depreciation of the euro, yen, Australian dollar and Brazilian real. The Chinese renmimbi and Indian rupee are likely to achieve small gains, while the British pound and Canadian dollar will probably move sideways. However, these are scenarios under which currencies could experience bigger moves—examples would include either an escalation or a resolution of the crisis in Europe, or in Japan aggressive policy action by the BOJ characterized by easing to achieve inflation. But the central theme of our 2013 outlook—moderate U.S. growth and a modest recovery in China amid a backdrop of continuing European generated volatility—implies moderate moves in currencies on a year-end basis (although there could be significant swings during the year).

Absent any full-fledged financial crisis in 2013 (our central scenario), we expect currency movements to be modest and gradual.

Our currency modeling framework uses momentum, carry (the return or cost of an investment over time while it is held by an investor) and valuation. We use a 'threshold' approach where momentum and carry are the most important drivers the majority of the time, but valuation becomes important when a threshold, in terms of the valuation gap, has been crossed.

Scenarios matter

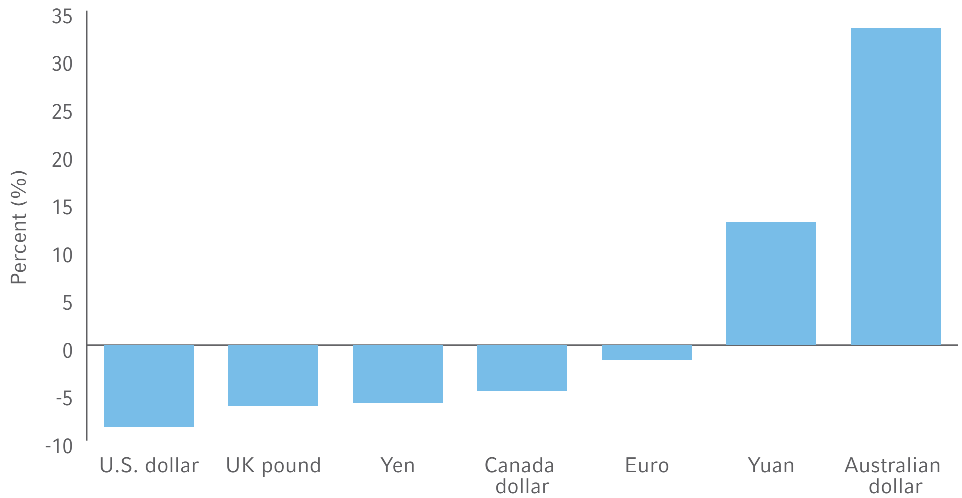
The choice of currency exposures in 2013 is highly scenario-dependent. The euro could get a boost if, for example, Spain signs up for the Outright Monetary Transaction (OMT) bond purchase program prior to an outright crisis. This could generate considerable confidence that Europe will avoid an acute financial crisis. Of course, this scenario also represents a Goldilocks case. Other currency outlooks are also scenario-dependent. For example, if China's growth rate has bottomed at about 7.5 percent and rises above 8 percent, demand from China would help sustain the values of commodity-rich currencies, such as the Australian and Canadian dollars.

The two scenarios laid out above are reduced-risk scenarios, where investor perceptions of things going wrong diminish. If less-favorable scenarios were to become more likely, currency exposures would necessarily take a turn toward risk management and a bias toward safe-haven currencies.

Here is a quick summary of our views on the major currencies vis-à-vis the U.S. dollar:

› With respect to the euro, if we include the Spanish-German bond spread as a bearish signal in our models, we find projections of mild depreciation of the euro against the U.S. dollar. If we do not include this bearish signal, the euro is projected to remain flat or even appreciate slightly. Taken together, these results lead us to discount the Goldilocks

Real trade-weighted exchange rate relative to long-run mean (percentage gap)



Source: JPMorgan, Russell calculations (Data from January 1970 through November 15, 2012)

Data shown is historical and not an indicator of future results.

scenario above, in which the euro could appreciate significantly toward 1.4 USD per euro. Our stance regarding the euro, then, is neutral with a downward bias.

› With the appointment of a highly-respected leader at the Bank of England, Mark Carney, we have a neutral outlook on the British pound, with slight upward bias. The UK economy is ahead of the eurozone and U.S. economies in that they already had a double dip led by fiscal austerity following the global downturn. Mark Carney's views on quantitative easing in the UK will be a key factor.

› The Bank of Japan (BOJ) is perhaps poised, given the expected election of Shinzo Abe as Prime Minister of Japan, to make a sharp break from past cautiousness, but we have heard strong talk from the BOJ and politicians before. Nevertheless, we expect the yen to depreciate in 2013. The scenario in which the yen would not depreciate is one in which financial turmoil elsewhere makes the yen once again a safe-haven currency.

› The "commodity currencies," the Canadian (CAD) and Australian (AUD) dollars, might be called the "parity currencies" in 2013, as we expect the AUD to depreciate toward parity and the CAD to remain near parity.

› In emerging markets, the Chinese renminbi and Indian rupee are expected to appreciate slightly against the U.S. dollar. The Brazilian real is expected to depreciate slightly, but only by about half of the inflation differential.

Commodities: It's not just about monetary policy

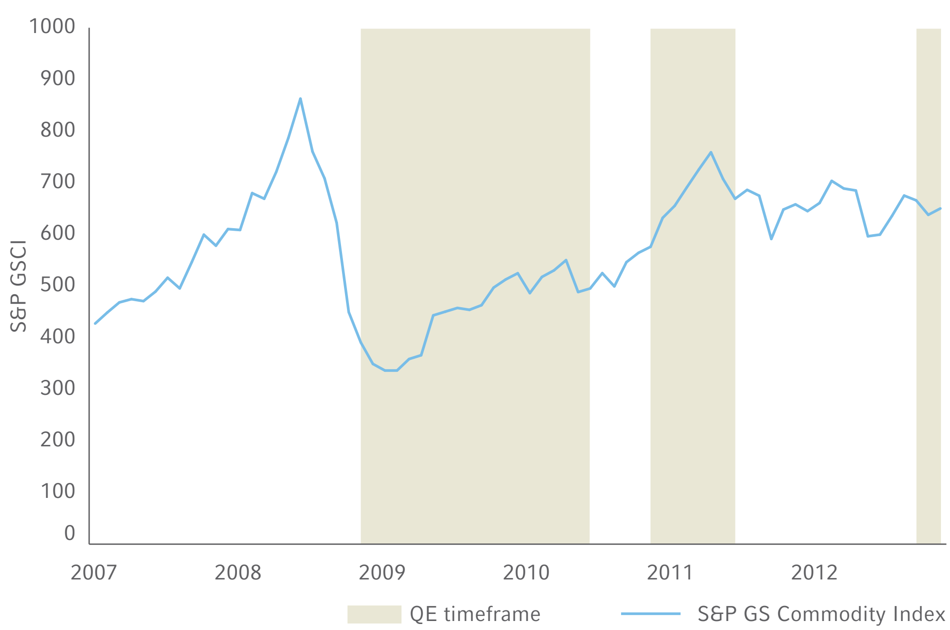
Monetary policy has often been cited as a core influence on commodities over the last several years. However, in addition to reflationary policies, supply-demand factors will be more consequential in 2013.

Quantitative easing (QE) is set to become less important for commodities, and old fashioned supply-demand fundamentals are likely to reassert themselves in 2013. Modest growth in developed economies and a cyclical recovery in China provide moderate upside potential for industrial commodities such as base metals. Oil prices are likely to move sideways under the weight of new supply. Gold remains the outlier. Ongoing QE and global uncertainty should maintain its safe-haven appeal, and the path of least resistance seems modestly higher.

› QE and U.S. dollar (USD) trends have been more important than supply-demand in driving commodity prices over the past four years. Going forward we expect commodities—specifically industrial commodities—to be influenced more by global economic fundamentals than monetary policy. Figure 1 illustrates how QE has become less potent with each successive round. QE1 was initiated at a time when the U.S. economy was recessionary but improving and monetary policy was synchronizing globally. Commodities benefited from the additional liquidity provided by QE and global reflationary efforts. QE2 was also positive, but its impact faded with time. QE3 is having minimal impact thus far.

We expect oil prices to remain range-bound in an environment where global macroeconomic conditions remain tenuous at best and the U.S. is increasing energy production and reserves.

Figure 1: Commodities and Quantitative Easing (QE)



Source: FactSet (Data as of November 30, 2012)

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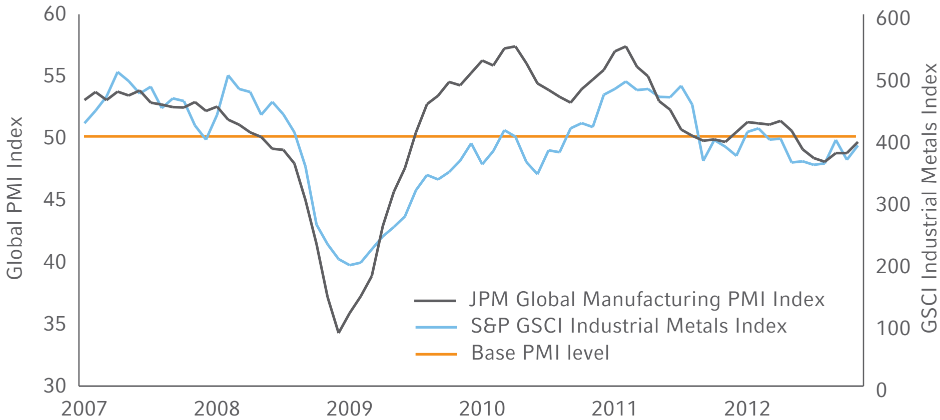
The S&P GSCI® is widely recognized as a leading measure of general price movements and inflation in the world economy. It provides investors with a reliable and publicly available benchmark for investment performance in the commodity markets, and is designed to be a "tradable" index.

Figure 2: Global PMI and Industrial Metals



Source: Russell Investments, Bloomberg, FactSet (Data as of November 30, 2012)

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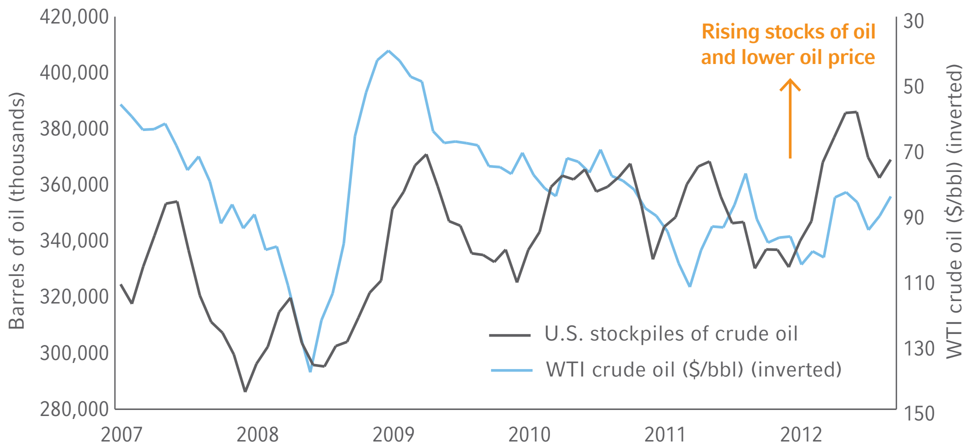
JPM Global Manufacturing PMI Index: An indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Base PMI Level: For a given period it is the starting level from which the JPM Global Manufacturing PMI Index is calculated..

Figure 3: Stocks of crude oil vs. oil price



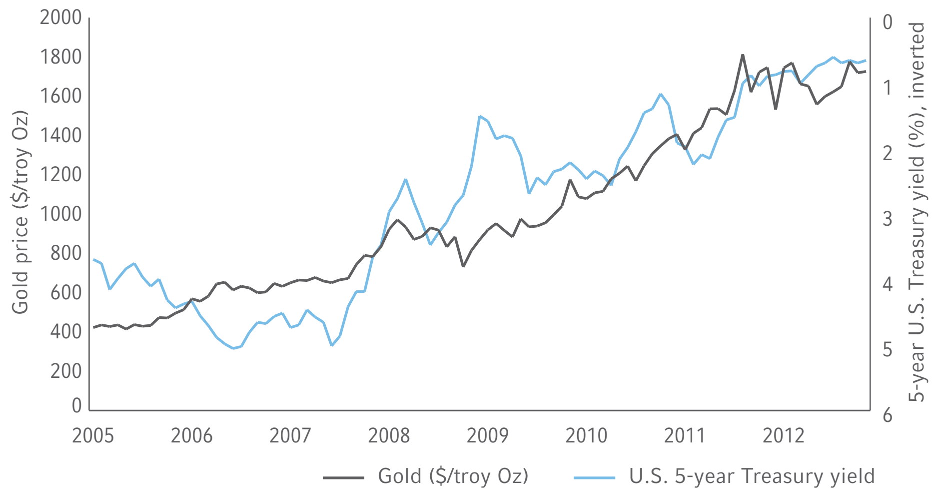
Source: Russell Investments, U.S. Energy Information Administration, FactSet.
Stockpiles of crude oil data as of September 30, 2012, crude oil price (Data as of October 31, 2012).
Note: Stocks of crude oil excludes the U.S. Strategic Petroleum Reserve (SPR).

Data shown is historical and not an indicator of future results.

- The restrained response to the latest iteration of QE is indicative of a global economy which is neither improving meaningfully nor decelerating, but simply muddling along. Figure 2 highlights how industrial metals, whose demand is positively correlated with global growth, have moved lower with the global Purchasing Manufacturers Index (PMI). The deceleration of the investment boom in China has played a crucial role. Global PMIs should stabilize as Chinese growth gradually improves and encouraging housing trends in the U.S. are sustained. We expect these trends to place a floor under base metal pricing, leaving room for modest upside.

- We expect oil prices to remain range-bound in an environment where global macroeconomic conditions remain tenuous at best and the U.S. is increasing energy

Figure 4: Gold price and interest rates



Source: Russell Investments, FactSet (Data as of November 30, 2012)

Data shown is historical and not an indicator of future results.

production and reserves. Figure 3 highlights the inverse relationship between WTI crude oil and U.S. holdings of petroleum products. Rising stockpiles of oil and petroleum in the U.S. has been a headwind for oil. Moreover, demand has been tepid. In 2011, global oil production exceeded global oil consumption for the first time since the 2008 recession. This trend is expected to play out in 2013.

› We expect the price of WTI crude oil to gyrate within the trading range established over the last two years as of November 2012—$80US and $115US per barrel, but with risks skewed towards the lower end. The wildcard is geopolitics, which is the known unknown. Longer term there is the issue of how effectively and efficiently the vast reserve of unconventional shale gas in North America can be exploited. This is the biggest structural factor facing energy markets.

› Another headwind for commodities has been the strengthening of the trade-weighted U.S. dollar since mid-2011. A sustained QE program in 2013 should restrain the USD, providing some support for commodities.

› Gold has benefited from three key trends. One, it's deemed the "safe haven" asset class benefiting from risk-averse market sentiment. Two, reflationary policies such as quantitative easing have been a boon for the precious metal. And three, exceptionally low bond yields mean idle cash earns very little and poses no material threat to a commodity providing no income stream and that has no prominent industrial use.

› Figure 4 illustrates how the price of gold has trended higher as bond yields have declined (scale for bond yields inverted to better reflect the relationship). With bond yields near historic lows in the U.S., there is no substantive opportunity cost to owning gold. However, the price of gold doubled from $400 to $800/troy oz. between 2004 and 2008, and doubled again over the subsequent four years. While we are not of the view that the price will double yet again, so long as the U.S. Federal Reserve remains committed to its zero-rate policy, it may be some time before there is a formidable headwind for the precious metal. As such, we expect the price of gold to remain firm with modest upside over the next year.

What could go right?

We expect moderate economic growth and moderate investment returns against a backdrop of event driven volatility. The downside risks to this scenario are fairly obvious—U.S. recession and European disaster. The upside risks are more intriguing and could deliver surprising investment gains in an environment where most investors are still somewhat pessimistic.

Our what-could-go right list for 2012 comprised steady but unspectacular growth in the U.S., a soft landing in China, and an effective and durable solution to the eurozone crisis. The score for 2012 was two right and partial credit for the third: Ticks for the U.S. and China but Europe is still a long way from a solution. The funding moves by the ECB through the long-term refinancing operations (LTRO) and outright monetary transactions (OMT) get us part of the way there, but the other remaining issues of debt sustainability (solvency) and a strategy for escaping recession remain unresolved in Europe.

A trifecta of eurozone solution, credible U.S. fiscal sustainability and medium-term China growth confidence could be the trigger for share-market re-rating.

Here is our list for 2013:

› At the top of the list is breaking the cycle of crisis in Europe. This will require an effective banking union and a plan to share debt burdens across the region—mutualization. It also needs a strategy to drag the region out of recession. A high wage, high consumption Germany willing to act as a demand engine for the region would significantly improve growth prospects across the eurozone.

› We think the U.S. can continue in its 2–2.5 percent GDP growth path. An upside surprise would be a credible long-term plan to reduce public debt and contain health- and age-related government spending. This would go a long way toward restoring confidence in the medium-term growth prospects for the U.S. economy.

› China is a story of the cyclical versus the structural. The cyclical slowdown of 2012 looks to have bottomed. The question now is the extent of structural limits to growth. Pessimists point to poor demographics, over-investment and the potential for rising bank non-performing loans. Optimists argue that there is a vast untapped labor supply in the rural sector, that the return on fixed investment is still high and that the growing middle class is driving the shift towards consumption and away from investment as the driver of growth. The days of 10 percent-plus annual GDP growth are over. The debate is over the new growth potential. The what-could-go-right scenario would be signs that China can sustain growth around 7–8 percent over the remainder of the decade.

› Share markets around the world are priced for modest, uncertain growth and most are trading at P/E ratios below their pre-crisis averages. A trifecta of eurozone solution, credible U.S. fiscal sustainability and medium-term China growth confidence could be the trigger for share-market re-rating. This could take the S&P 500 Index, for example, from its current trailing P/E multiple near 14 times to near its pre-crisis average of 16.5 times. Under this scenario the index could potentially reach 1750 compared to our year-end target of 1500.

Too much of a good thing?

There is a limit to how much we want things to go right, and this relates to the risks embedded in ultra-low sovereign bond yields. A potential scenario is that the U.S. housing recovery gathers pace and a successful resolution of the fiscal cliff unleashes a wave of pent-up business investment. GDP growth in the second half of the year could accelerate toward 3.5 percent with monthly payrolls gains pushing through 250,000.

The Fed could respond in two ways. The first would be to renege on its commitment to maintain near-zero short-term interest rates until 2015. It would begin unwinding quantitative easing and set the groundwork for the first rate rise. The second would be to reaffirm its commitment to ultra low rates even after the economy has begun to recover. Both responses could trigger a sharp reversal in long-term bond yields. In the first case as the market predicts rising short rates. In the second as investors increase their medium term inflation expectations towards 4 percent. The global fixed income benchmark has an average duration of around six years, so every 100 basis point lift in yields will lower returns by about 6 percent.

The impact on share markets of a sharp rise in bond yields is less clear cut. Rising discount rates could undermine share market valuation. The gap between the earnings yield on the S&P500 and the 10-year Treasury yield, however, is unusually wide and could limit the adverse impact on share markets. A U.S. growth surprise could support the share market re-rating story.

A finely balanced outlook

Our central scenario sees a continuation of moderate U.S. growth and a modest recovery in China amid a backdrop of continuing European generated volatility. This should deliver single-digit share market returns and keep government bond yields relatively low.

The main downside risks are fairly obvious—a fiscal cliff inspired U.S. recession and a eurozone implosion. The what-could-go-right scenarios are more intriguing. It's extremely unlikely that all three will come to pass but optimism that solid progress is being achieved could deliver surprising investment gains in an environment where pessimism is still the predominant investor mood. ■

These views in this Economic Outlook are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed. The information, analysis, and opinions expressed herein are for general information only and are not intended to provide specific advice or recommendations for any individual or entity.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

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

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

Investment in Global, International or Emerging markets may be significantly affected by political or economic conditions and regulatory requirements in a particular country. Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation. Such securities may be less liquid and more volatile. Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and political systems with less stability than in more developed countries.

Currency investing involves risks including fluctuations in currency values, whether the home currency or the foreign currency. They can either enhance or reduce the returns associated with foreign investments.

Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

Diversification. strategic asset allocation and multi-asset investing do not assure profit or protect against loss in declining markets.

The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

Information regarding the Business Cycle Index

Inputs to the model include non-farm payroll, core inflation (without food and energy), the slope of the yield curve, and the yield spreads between Aaa and Baa corporate bonds and between commercial paper and Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts.

The BCI is not meant to serve as a direct prediction regarding the future performance of any financial market. It is not intended to predict or guarantee future investment performance of any sort.

Historical employment data displayed in the business Cycle Index are reflective of current data as provided by the data sources including any revisions to previous data, These revisions may change historic data points and historic ranges for some or all indicators. These changes are usually due to seasonal adjustments to previously supplied data.

The **S&P 500® Index:** An index, with dividends reinvested, of 500 issues representative of leading companies in the U.S. large cap securities market (representative sample of leading companies in leading industries).

The **FTSE 100 Index** is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalization. The index is maintained by the FTSE Group, a subsidiary of the London Stock Exchange Group.

The **DAX** is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

The **CAC 40** is a benchmark French stock market index that represents a capitalization-weighted measure of the 40 most significant values among the 100 highest market caps on the Paris Bourse (now Euronext Paris).

The **NIKKEI 225** Total Return Index is an index of 225 high-quality blue chip stocks on the Tokyo Stock Exchange.

The **S&P/ASX 200 Index** is a market-capitalization weighted and float-adjusted stock market index of Australian stocks listed on the Australian Securities Exchange from Standard & Poor's.

The **S&P/TSX Composite Index** is an index of the stock prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization.

MSCI Japan: The MSCI Japan Index is a capitalization weighted index that monitors the performance of stocks from the country of Japan.

JPM Global Manufacturing PMI Index: An indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

S&P GSCI Industrial Metals Index: The S&P GSCI (formerly the Goldman Sachs Commodity Index) serves as a benchmark for investment in the commodity markets and as a measure of commodity performance over time. It is a tradable index that is readily available to market participants of the Chicago Mercantile Exchange

MSCI EM: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

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