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Stategists' outlook and barometer

Heading into the second half of 2013, we believe equities can continue to outperform bonds, although by a smaller margin. The investing world looks less like 1994 and more like 1984 to us.

2013 // 3RD QUARTER

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Executive summary

The second half of 2013 should be less exciting than the first now that bond and equity markets have re-rated. We still like equities more than bonds, but the performance gap should be smaller going forward. Europe and Japan have valuation appeal and high yield bonds may offer an attractive yield pick-up.

More '84 than '94

Mark Twain famously said that history doesn't repeat but does rhyme. Right now, some investors worry that today's markets rhyme with 1994. Back then, Fed tightening drove losses in both equity and bond portfolios. Now, "taper talk" and spiking bond yields have many seeing parallels. However, as our chief economist Mike Dueker argues, the current period may have more in common with 1984. This was a time when the U.S. economy embarked on a period of more stable growth. Coming out of a large recession, the economy had plenty of spare capacity and was able to grow without generating inflation pressures.

Of course, the parallels aren't perfect; equity markets were much cheaper in 1984 than now, and bond yields today are much lower than the 11% yield on 10-year U.S. Treasuries back then. Even so, the steady-growth, moderating-inflation, low-recession risk economy of 1984 may rhyme better with current circumstances.

Our models still favor equities over bonds and cash. However, compared to the first half of 2013, the valuation signals are not as strong and in some cases more reliant on momentum. Within equities, we have a preference for Europe and Japan over the U.S. market. Wouter Sturkenboom, our European strategist, sees Europe emerging from recession in the second half of the year. Our Asia-Pacific strategist, Graham Harman, thinks 'Abe-nomics'[1] is paying off in terms of Japanese confidence, growth and corporate earnings.

Everything that could go wrong has gone wrong for emerging markets (EM) equities. The U.S. dollar (USD) has strengthened, commodity prices have fallen, China has had a credit squeeze, and the plunging yen has hurt the export competitiveness of many EM economies. We think a lot of the bad news is now priced in and emerging markets offer good medium term value. It's hard to see catalysts for a sustained rebound, however, until the uncertainties around China clear up.

The first half of 2013 saw the re-rating of both equity and bond markets. It began with equity markets reacting to European Central Bank President Mario Draghi's "whatever it takes" comments on Europe late last year and continued with markets rising on confidence that the U.S. economy was on a sustainable footing. U.S. bond yields re-rated from unrealistically low yields near 1.6% to more sensible levels around 2.5%. The net result is that we head into the second half of the year with equity markets offering what we think are reasonable, but not outstanding value, and with bond markets less dangerously overvalued than before.

Less re-rating and smaller valuation gaps should make the second half of the year less exciting than the first. We think that equities can continue to outperform bonds, although by a smaller margin. The world looks less '94 and more '84 to us. ■

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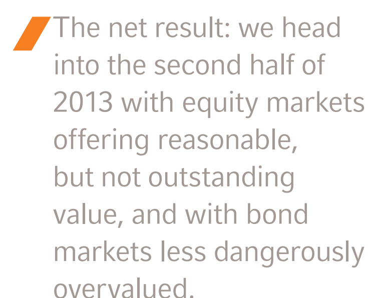


[1] Abenomics refers to the economic policies advocated by Shinzō Abe, the current Prime Minister of Japan.

Investment strategy outlook

The U.S. economy is improving and Europe is becoming, if not better, at least "less bad." Global equity markets have hit a consolidation phase ahead of the next stage of the potential upswing. Bond yields are in a long-term process of returning to more normal levels.

Fed up with taper talk

The global equity market volatility in June was not surprising after such a strong upward run, which saw, for example, the Russell Global Index advancing 28% for the one-year period through May 30, 2013. Now, investors appear to be taking time to assess the direction of U.S. monetary policy, Japan's reflationary efforts, the slowdown in China, and the outlook for corporate earnings.

We still like global equities over fixed income for most time frames. The U.S. market is no longer cheap but other regions still appear to offer reasonable value. We're warming up to Europe and think that Japan can achieve a second, more moderate, upswing. Credit, especially high yield, still likely offers reasonable compensation for default risk and a respectable yield pick-up. Our emerging markets (EM) equities preference has not worked, but valuations are becoming more appealing. The short-term tactical outlook for EM is challenging but we still like it as a medium-term value play.

The U.S. Federal Reserve (the Fed) has done a poor job in our view at communicating its intentions—most notably in Chairman Bernanke's "taper" remarks before Congress (see the sidebar to the right). In our view, there are few significant downside risks to U.S. growth, but the upside also seems limited. As a result, we don't think a Fed tightening is imminent. Specifically, we still see Gross Domestic Product (GDP) growth stuck in a 2.5% to 3% range with moderate inflation and monthly jobs gains averaging around 200,000 in 2014. Unemployment is unlikely to decline to 6.5% until late 2015. That's why we think bond investors have gotten ahead of themselves by pricing in 2014 Fed rate rises; late 2015 seems more likely for the first Fed funds rate hike. The 100 basis-point surge in the 10-year yield to 2.7% as of June 30, 2013 could be at least partly unwound in coming months as the market's expectations readjust. Even so, we see the 10-year Treasury yield heading towards 3% by the end of 2014.

On May 22, U.S. Federal Reserve Chairman Ben Bernanke told Congress that the Federal Open Market Committee might reduce or taper its bond purchases, known as quantitative easing. In response, equity markets took a dive and bond yields spiked.

Europe should finally escape recession before the end of 2013 as austerity eases and credit creation slowly unfreezes. The event risks are still there (Greek debt restructuring, Spanish banks' weakness, Italian government uncertainty, etc.) but these should not be insurmountable. Equity valuations are attractive relative to the rest of the world, and Europe has more profit upside than the U.S. market. Margins in Europe are low, which means that there is scope for operating leverage (profits that grow faster than revenues).

China is the main uncertainty. Growth forecasts are being downgraded following the surprise recent credit tightening, export weakness and unclear messages from the new leadership about policy direction. China is transitioning from the 10%-plus growth rates of the past decade to a 6% to 8% growth range. Economic indicators could weaken further over the remainder of 2013, but a "hard landing" seems unlikely and medium-term growth prospects are still solid.

Our main asset class views:

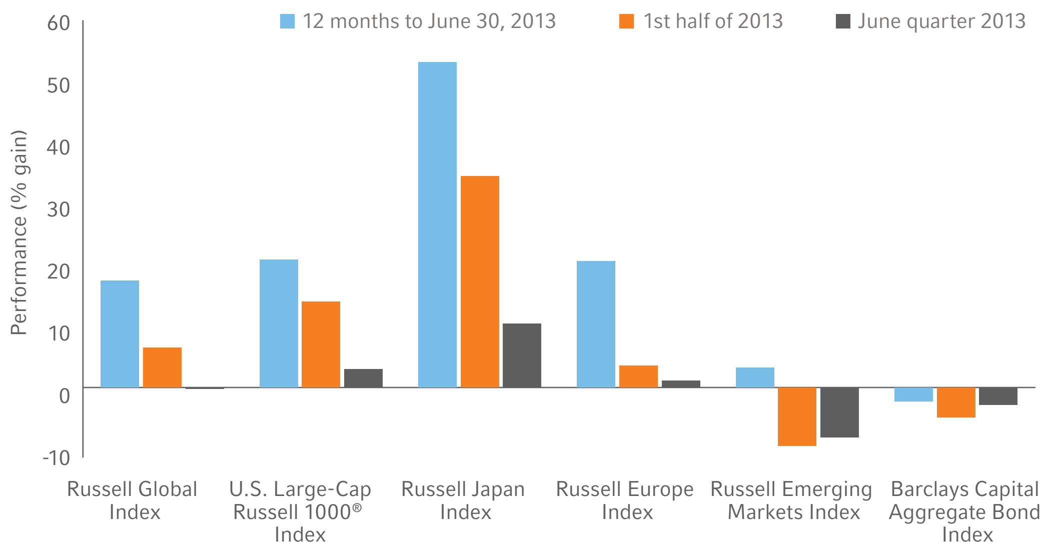
› A correction, not a turning point. The June volatility in equity markets globally does

not signal the end of the equity market upturn. Equity valuations are no longer compelling but still acceptable, especially relative to bond yields. High U.S. profit margins—with little room for improvement—are the main upside constraint. The bottom-up consensus expects nearly 10% growth in U.S. large cap earnings per share (EPS) over the next 12 months through June 30, 2014. This is too optimistic and growth around 5% seems more likely. The market should move broadly higher in line with EPS, making 1740 a realistic S&P 500® Index target for mid-year 2014 (and 965 for the Russell 1000® Index). This would leave the U.S. large-cap market with a trailing price-earnings ratio (PE ratio) of 15.5.

- Europe and Japan have more near-term equity market upside than the U.S. market. The Japanese economy is responding to policy stimulus, and business confidence surveys are signaling optimism. Japanese equities are trading at just 1.3X book value. Reflation and yen devaluation are positive catalysts for EPS growth. Bottom-up consensus forecasts for over 40% EPS growth could be achievable.
- Europe is now providing an appropriate margin of valuation safety to compensate for the still-present event risks. Euro-area EPS has fallen 14% over the past two years. Profits should recover faster than growth as the region exits from recession.
- Globally, government bond yields are in a process of returning to more historic levels. This process is likely to take place gradually (but with volatility) given the large amount of spare capacity in the U.S. economy and lack of inflation pressure.
- Credit spreads still provide a reasonable yield pick-up. The option-adjusted U.S. high yield spread stood at 492 basis points at the end of June. Although this is slightly below the long-term average, our modeling suggests that the conditions are in place for spread narrowing (stable growth, low inflation, moderate equity market volatility).

Our investment strategy process looks at valuation, the business cycle, and sentiment indicators. Valuation is a moderate positive for U.S. equities, stronger for Europe and Japan, and strongest for emerging markets. The business cycle is positive for developed market equities, particularly in Japan, but mixed for emerging markets (chiefly the slowdown in China). Sentiment is more mixed. Momentum favors developed markets but is against emerging markets. For U.S. Treasuries, valuation and the business cycle are negatives, but 10-year bonds are likely oversold and may rebound in the short term.

Returns over the past three, six & 12 months



Definitions:

Reflation: The act of stimulating the economy by increasing the money supply or by reducing taxes, seeking to bring the economy (specifically price level) back up to the long-term trend, following a dip in the business cycle.

Indexes shown here and on subsequent pages 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.

Emerging markets equities

It's been a tough first half of the year for EM equities. The near-term outlook remains challenging, but prospects for the medium term look better. Attractive valuations, an export recovery and stronger global growth should eventually deliver better returns.

Ready to re-emerge

Emerging markets (EM) have taken a pounding over the first half of 2013. The Russell Emerging Markets Index posted a return of -7.9% in the first six months of 2013 through June 30 compared to +9.1% for the Russell Developed Index. Everything that could go wrong in this asset class has gone wrong – commodity prices have fallen, the U.S. dollar (USD) has strengthened, and China has experienced surprise monetary tightening. Plus, political turmoil in Brazil and Egypt hasn't helped investor confidence. Adding to these woes has been the sharp devaluation of the yen that has undermined the export competitiveness of economies across Asia.

Aside from a rebound from oversold levels, there are few near-term catalysts for better returns. Longer term, the picture looks better. Attractive valuations, good earnings prospects, the impacts of stimulus measures, and stronger exports should eventually deliver EM outperformance.

Valuation is the strongest factor in favor of an EM rebound. The business cycle is broadly positive with the pick-up in growth across the developed economies offsetting the slowdowns in China and Brazil.

The bear case

The bear market case for EM equities continues to unwind. These markets tend to underperform developed markets when the USD is rising. Many EM countries have soft or hard currency pegs against the USD and a rising USD forces domestic credit tightening, as central banks sell foreign reserves to maintain currency pegs. In terms of other significant currency effects, the fall in the Japanese yen has hurt the export competitiveness of many economies across Asia.

The pain felt by EM commodity producers also continues to be a bearish factor in this period of falling commodity prices. And, as mentioned above, monetary tightening in China is affecting this economy's ability to produce the kind of blockbuster growth it experienced in the first decade of the century. China's reform-minded attempts to slow the growth in its shadow banking system and warn banks against excessive lending to unproductive infrastructure projects are also constricting growth—at least for the short term.

Investor sentiment continues to exert a powerful influence on these markets. Many investors remain cautious about EM investing due to recent geopolitical tremors, most recently, political upheaval in Egypt and Brazil. In addition, Brazil's policy tightening to contain inflation pressures is also dampening sentiment.

The bull case

Here's why we think we won't have to wait too long to see more upside momentum for EM equities:

› Attractive valuations exist in the "here and now", both relative to developed markets and in absolute terms. EM equities in the Russell Emerging Markets Index were trading on a forward PE ratio of 9.7x at the end of June. Price-to-book value was just 1.5x at the end of June. This is a 20% discount to developed markets and below the average 5% discount

over the past 10 years.

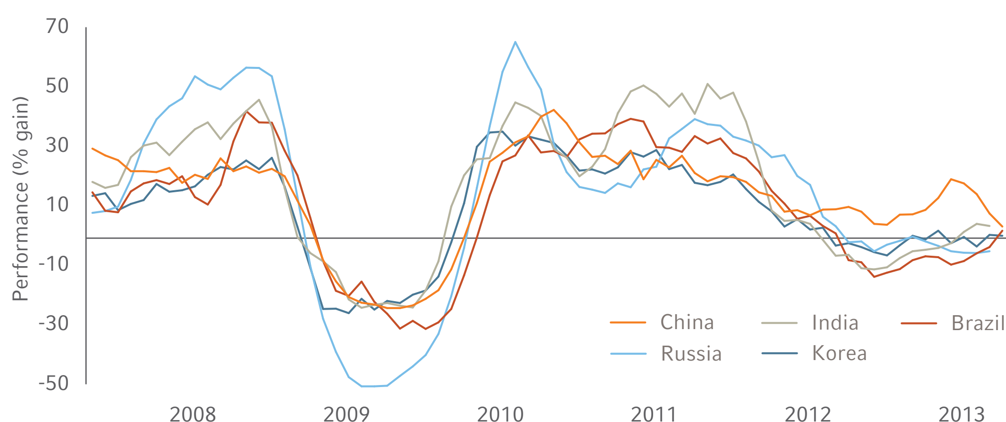
- EM exports are strengthening. Exports are beginning to recover across the main EM economies (aside from China, where we question earlier data showing remarkable export strength). Stronger economic growth across the developed economies in 2014 should support EM export growth.
- China should stay resilient. China growth forecasts are being downgraded following the surprise recent credit tightening and unclear messages from the new leadership about policy direction. China is transitioning from its 10%-plus growth rates of the past decade to a 6-8% growth range. Economic indicators could weaken further over 2013, but a 'hard landing' seems unlikely—and medium-term growth prospects are still solid.
- Commodity prices are not such a negative. The historic link between EM performance and commodity prices reflected the importance of commodity producers (Latin America, Russia, Indonesia) in the Russell Emerging Markets Index and the fact that commodity prices generally move in line with the strength of the global economy. China, the largest EM market, is a commodity consumer—and lower commodity prices are in large part due to rising supply. Commodity export volumes should stay strong.
- USD strength is less important now. Very few EM economies now run hard USD pegs[2] and soft pegs are more relaxed. One reason is the growth of local-currency EM debt. In the past, USD-denominated foreign debt limited the amount of currency weakness that EM economies could sustain. Local currency debt allows EM central banks to resist USD gains. EM countries now have more ability to depreciate against the USD and avoid policy tightening.

A favorable medium-term outlook

Our investment strategy process looks at valuation, the business cycle and sentiment indicators. Valuation is the strongest factor in favor of an EM rebound. The business cycle is broadly positive with the pick-up in growth across the developed economies offsetting the slowdowns in China and Brazil. Sentiment, on the other hand, still holding back EM equities. Price momentum is negative for these markets and earnings are being revised lower.

Our takes on valuations and the business cycle give us a favorable medium-term view on EM equities, but sentiment suggests near-term challenges. We think EM equities are valued attractively, but these markets may be more suited for medium-term positioning than short-term tactical gains. ■

Exports by country



[2] Hard currency/soft currency: USD peg refers to a currency that is held at a fixed value against the USD.

USD peg refers to a currency that is usually held to a fixed value against the USD, but which can deviate from the USD if the central bank of that country allows it to.

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

Source: Datastream, as of June 30, 2013

It’s 2013: Do you know where global growth prospects lie? With “old reliable”, the U.S. consumer

Current conditions resemble 1984, when the world relied on a profligate but bullish U.S. economy to serve as the locomotive for global growth.

Today’s market outlook parallels to 1984 include: Europe in the doldrums as the United States leads global growth; falling inflation expectations and rising expected real yields; a bullish environment for the U.S. dollar; a significant upswing in home construction; and a recognition that the U.S. economic expansion is sturdy, not fragile.

This last point may be the most important of all. First, we note that the Great Moderation—a period of less frequent recessions and less stop-go monetary policy—is believed to have started in 1984. Now it appears that the U.S. economy has put behind it both the recession scares of recent years and perceptions of an oscillating risk-on/risk-off investment climate. Together these mark the key parallels to 1984.

Moving to specifics: On the positive side of our current outlook, we have a constructive view of U.S. economic performance for the next 24 months. The best measure of our sanguine outlook is that we expect U.S. payroll jobs gains to average 200,000 per month for the next 24 months. The bad news is that the U.S. economy is entering the second half of 2013 with less short-term momentum than previously thought—momentum that the economy sorely needs to confront the most contractionary effects of federal spending sequestration, which are likely to appear in the third quarter of 2013. Consequently, we expect jobs gains in the second half of 2013 will average slightly lower than our longer-term estimate at 175,000 per month, which could disappoint those who expect 200,000 jobs per month right away.

With the June revisions, a 2.9% annualized consumption growth rate year-to-date became only 1.8% growth.

Negative data revisions imply less momentum

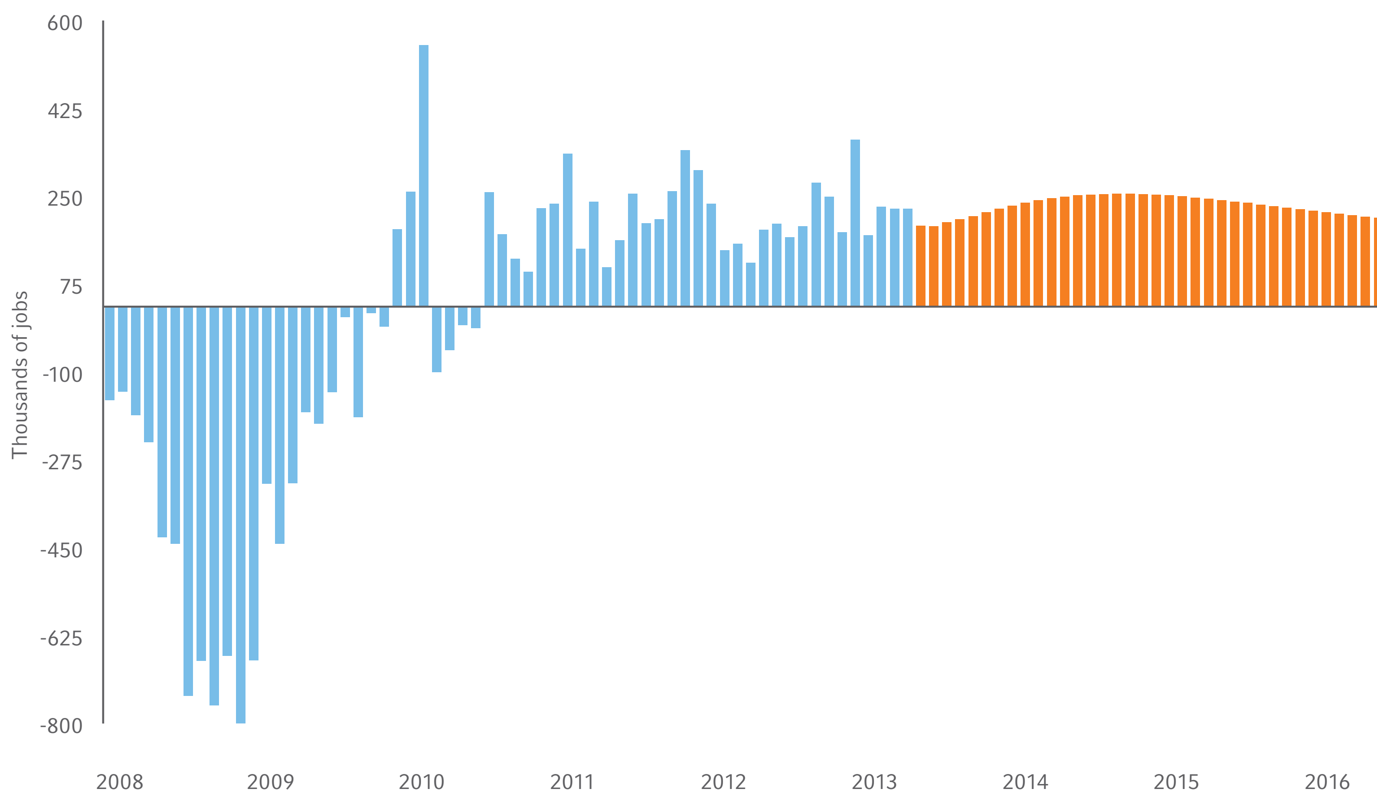
Based on the personal consumption data released through late May, it looked like real consumption spending was growing at a 2.9% annual rate during the first four months of 2013. This rate seemed almost too good to be true, given the expiration of the 2% payroll tax holiday on January 1, 2013 and looming spending sequestration. Then, the revised consumption data were released in late June. And they showed that the numbers were indeed too good to be true; in fact, real consumption had grown at only a 1.8% annual rate in the first five months of 2013. These revisions imply less momentum entering the second half of the year. Accordingly, we revised some of our short-term asset-class forecasts. For example we’re now less bullish on dynamic equities versus defensive equities than we were last quarter. We’re not bearish, however.

It’s not 1994 for bonds or equities

Just as 1984 was an historic moment for U.S. equities, so was 1994 for bonds. The mere mention of 1994 sends shudders through bond investors and, to some extent, equity investors. That year, Federal Reserve policy tightened dramatically, yet the Fed was still perceived to be “behind the curve.” As a result, the benchmark 10-year Treasury yield reached 8% by November 1994, an increase of 285 basis points from Oct. 15, 1993. This rise in bond yields raised the discount factor on future earnings sufficiently to choke off any rally in equity prices in 1994, even as the economy started to perform well.

Today, as noted above, we are in an environment of rising real yield expectations. But will the rise go too far as in 1994? Could there be a period of disconnect, as in 1994, between the performance of the economy and asset-market returns?

Forecasts of nonfarm payroll employment changes as of June 2013



Figures through June 30, 2013

Source: Actual employment data from St. Louis Fed's FRED database and Russell forecasts.

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.

The recent 100 basis-point rise in the 10-year Treasury yield between early May and early July (from 1.66 on May 2, 2013, to 2.73 on July 5, 2013) raised some concerns about a 1994 scenario. One point about this 100 basis-point rise is that it was not clear why the 10-year yield had fallen from 2.01% on March 15, 2013, to 1.66% on May 2, 2013. Perhaps this seemingly inexplicably low level in early May helped prompt Federal Reserve Chair Ben Bernanke to "talk up" the yield by initiating discussion of Fed tapering of its asset-purchase program in Congressional testimony on May 22, 2013. Was this talk from the Fed Chair necessary? As noted in the introductory essay, we have our doubts. It's our view that Federal Reserve policymakers were not intending to add more than about one trillion dollars to the Fed's balance sheet through asset purchases in the current round of Quantitative Easing—unless the economy worsened unexpectedly. To keep within this one-trillion-dollar limit, policymakers would need to wind down (taper is the current buzzword) the asset purchase program late this year and early next year.

Doing so in a mediocre economic backdrop is a little awkward, though. We would call this situation "Three strikes and Fed tapering is out." The first strike against Fed tapering is that nominal GDP growth (the sum of real economic growth and inflation) is poised to fall short of a reasonable target level in the range of 4.5-5% for this year and next year. The Blue Chip[3] consensus forecast for year-on-year nominal GDP growth is 3.3% for 2013 and only 4.5% in 2014. The second strike against Fed tapering is that inflation is expected to fall short of the Fed's 2.0% inflation target in 2013 and 2014 according to Blue Chip forecasts of the GDP price index as of June 30, 2013.

The potential third strike against Fed tapering, in our view, would have been a 10-year Treasury yield below 2.25% because of the economic stagnation scenarios built into such a low yield. This third strike was looming against Ben Bernanke in May of this year, so, again

[3] The Blue Chip consensus forecast is the average of about 50 private-sector economic forecasts compiled and published monthly by Aspen Publishers.

in our view, he chose to talk up yields by speaking in a matter-of-fact manner that tapering was a done deal. And it seems to have worked to too much effect, with the 100 basis-point rise in the 10-year Treasury yield mentioned above.

Some of that increase has already receded, however, as the 10-year Treasury yield went from 2.73 on July 5, 2013, to 2.58 on July 11, 2013. In a speech on July 10, 2013, Ben Bernanke clarified that the timetable for the first fed funds rate hike remained unchanged. He added that the economy would have to be firmly embedded in a sub-6.5% unemployment rate regime, not just barely touch 6.5%, before the Fed would take action. For this reason, our projection is that the first fed funds rate hike is likely to take place in the fourth quarter of 2015—an unchanged forecast since the beginning of the year. ■

The Eurozone: Getting ~~better~~ "less bad"

The Eurozone has travelled a bumpy road this year, especially in financial markets. Economically, the slow grind out of recession has continued while the tug-of-war between deflationary austerity and reflationary monetary policy played out. Looking ahead, the road is expected to be less bumpy, both economically and in financial markets. As a result, we have upgraded Eurozone equities from underweight to neutral.

A shift toward reflation

Our central theme for 2013 has been, and remains, the tug-of-war between reflationary monetary policy and deflationary austerity. Lacking a political consensus for pro-growth policies, the Eurozone attempted to boost solvency through austerity and reform. Because of high fiscal multipliers, the result was the longest recession on record, with peripheral countries sliding further into their debt traps.

Now, the Eurozone is changing direction. Budget deficit targets have been postponed, and the European Central Bank (ECB) has provided forward guidance of continued loose monetary policy. This is positive for the near-term outlook on both economic growth and Eurozone financial markets. It is also providing a much-needed boost to both consumer and industrial confidence (see graph following).

Of course, the shift toward more reflation does not mean the eurocrisis is over. Growth will continue to be weak due to negative credit growth and high unemployment. That is why a real banking union, and not the proposed half-baked version, is so important. Also, political risk will remain a factor, especially after the German elections. That is why investors should demand a margin of safety to commit assets in the Eurozone. Should that margin disappear we will become cautious again.

Eurozone breakup unlikely: Despite record-high youth unemployment and very significant economic pain, the Eurozone continues to stick together. We maintain the view that this will remain the case. Even though political tensions could rise after the German elections, we do not expect policymakers will want to go down the uncertain route of a breakup. The biggest risk remains social unrest, but this is still an unlikely prospect.

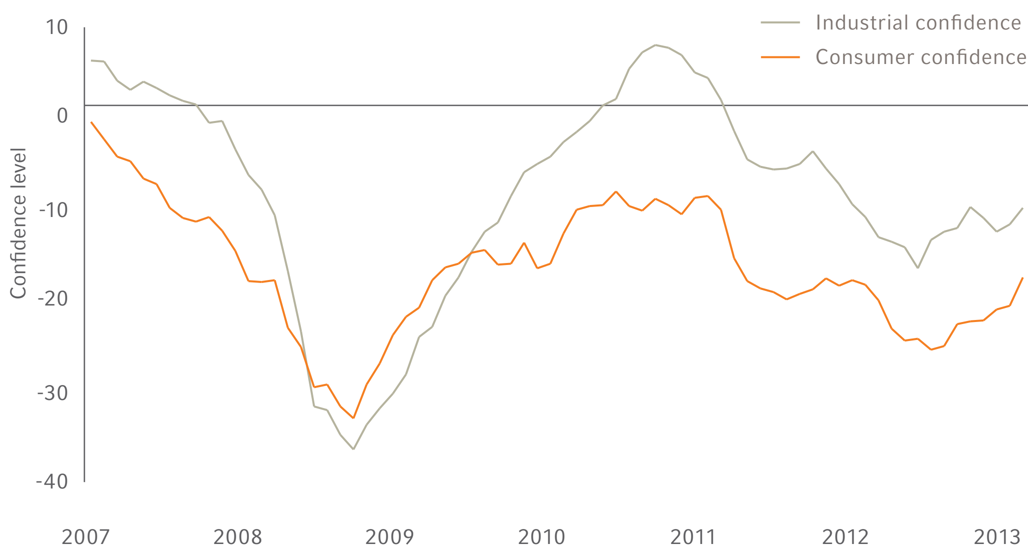
Political reform—also unlikely: The best way to describe the prospect for European political reform is "much too slowly and much too cautiously." The Eurozone desperately needs shock absorption capacity in the form of a banking union, a fiscal union, and a political union. For now, a credible road map would suffice for the latter two, although the banking union needs to be implemented as soon as possible to break the sovereign links. None, however, are likely to happen. This will ensure a flare-up of the eurocrisis somewhere down the road.

Economic growth plodding: Although we are more positive on the outlook for growth we have not changed our forecast of -0.5% for the region as a whole. That forecast was always predicated on a better second half of the year, which is now starting to materialize. Unfortunately, the dispersion in growth between North and South will continue. However, given the peripheral nations' low base, some catch-up should be possible. Our greatest worries remain French weakness and negative credit growth.

Modest earnings growth expected: The outlook for corporate earnings has not changed.

Corporate earnings growth has been rising slowly but is still slightly negative over the past 12 months. Going forward, modest single-digit growth remains our outlook, which is less than the 8-9% (revised downward from 11-12%) consensus earnings growth expectation. Given relatively low profit margins, a potential positive surprise in earnings could come from operational leverage when growth picks up.

Equities outlook improving slightly: A central theme this year has been the need for European equities to be undervalued to justify investment. At the start of Q2 equities did not provide such a margin of safety and thus we took a cautious stance, waiting for more attractive valuations to add exposure. After the correction in Q2, those valuations materialized and, combined with the better outlook for growth, we therefore advise moving from a cautious to neutral stance. ■



Data as of June 30, 2013

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

Source: Thomson Reuters Datastream

Asia Pacific – Transitions Abound

Asia-Pacific economies face a number of challenges through the remainder of 2013. As a consequence, short-term momentum in the region's securities markets is stalled, but we see value emerging in selected regional sectors.

Near-term challenges

In recent years, the Asia-Pacific region has been affected by the financial crises of the North Atlantic but has not itself been a driver. China and Australia have grown robustly, in tandem, sharing the themes of Chinese urbanization, development, and resource consumption. Japan has remained mired in its one—if not two—lost decades, and has not been a meaningful swing factor within the global economy.

These trends are now in the throes of transition

For Japan, the likely variation is to the upside, as the Bank of Japan pulls out all stops to pump liquidity into the economy and to stimulate growth. Real GDP growth has begun strongly in 2013, at an annual rate of just over 4%. Meanwhile, business conditions and industrial production are showing tentative signs of improvement. Inflation targets have not yet been achieved in Japan, but disinflationary forces are at least abating, against the backdrop of a weakened yen. If the rise in the yield structure, (currently sub-2% for 10-year government bonds) can be engineered in an orderly fashion, the outlook for the Japanese economy is positive.

As China addresses structural imbalances, Japan embraces a newfound enthusiasm for monetary stimulus, and Australia comes to terms with a downdraft in the commodity boom.

In China, real GDP growth expectations for 2013 are slipping—from over 8% at the outset of the year to barely more than 7% now. Even more disconcertingly, mid-year perturbations in credit availability have hit investor sentiment and stock prices. Our view is that these developments are positive, although risky. The authorities are prioritizing reform over short-term growth; this "tough love" includes Chinese government and central bank intervention to address corruption. Additional maneuvers are reallocating credit between state-owned enterprises, the shadow banking[4] sector, housing, and private sector businesses; and tweaking China's investment/consumption ratio. As is the case in Japan, we will be unlikely to find out until too late whether constructive restructuring can be achieved without undue damage to the significant, indebted segments of the economy. Either way, China is likely to continue to slow.

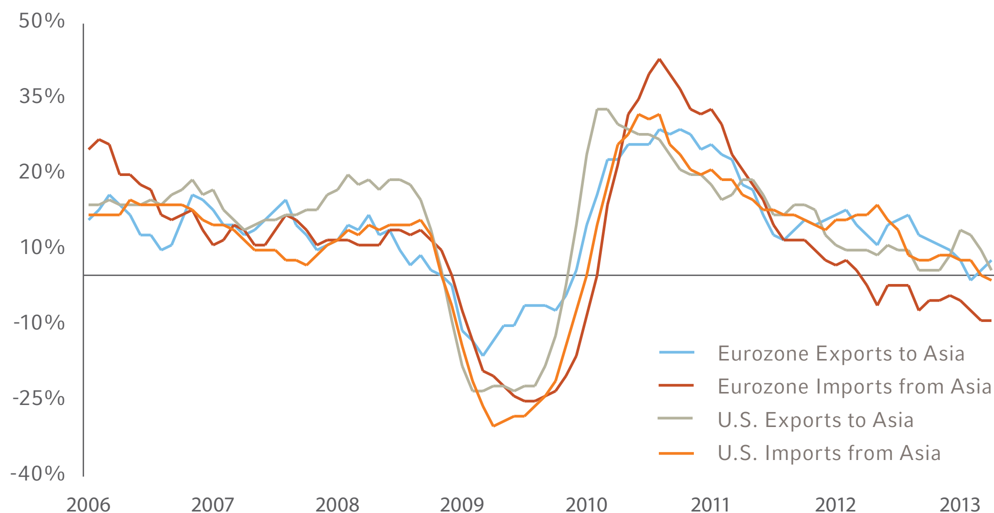
Australia is also facing a slowdown. The overwhelming challenge "Down Under" is to absorb the impact of a precipitous decline in resource sector-related capital spending (currently peaking out at an anomalous 7% of GDP), and to take up the slack in export growth, in housing, and in domestically oriented industries. Despite some encouraging signs, such as in housing finance—and the oxygen provided by a sharp 15% drop in the Australian dollar from April 11 to July 3, 2013—this adjustment process is likely to be a big ask. Unemployment numbers are already back to the highs of the financial crisis, and we remain cautious about the outlook.

Global Implications

With official cash rates still at minimal levels globally, and with still-subdued enthusiasm for borrowing, trade flows remain more critical to world growth than international capital flows at the margin. Bilateral trade flows between Asia and the United States, and Asia and the Eurozone, are shown on the next page. In both cases, but particularly in its trade with

[4] In China, where traditional banks are government-owned, an increasing percentage of financing and short-term investing is carried out through "shadow banks," which include trust companies, insurers, leasing companies, and even pawnbrokers.

Bilateral trade flows: Asia, U.S., Eurozone



Data as of June 30, 2013

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

Europe, Asia has thus far been a supportive influence—Asian demand growth is running ahead of that of its northern hemisphere trading partners. That said, trade growth in the Asian region is pedestrian at best, with only Japan recording rapid growth, and that merely an artifact of the price effects of the weaker yen. For the remainder of 2013, we don't expect Asia-Pac demand to provide a miracle stimulus to the rest of the world economy.

Market Perspectives

In contrast to the current challenges faced by Asia-Pacific nations, signs are emerging that both the U.S. and Eurozone economies may post accelerating growth in the second half of 2013. Moreover, the long downtrend in the global yield structure appears to have ended. These developments are bad news for capital flows into the Asian region. In the first place, "safe havens" such as gold, with their idiosyncratic drivers, are no longer in demand. The recent plunge in the Australian dollar is emblematic of this effect, but regional equity weakness also constitutes a related phenomenon. Secondly, in fixed income markets, spread narrowing has also run its course. Price momentum in Asia-Pacific securities markets, not surprisingly, is poor at present.

On the positive side, we see reasonable-to-good value emerging in the region. The Russell Asia-Pacific ex-Japan Index equities are trading at about 1.5x book value, and on a PE ratio of around 11; China's PE ratio has been trading in the high single digits in 2013. Value in Australian equities is also reasonable currently, although Australia remains a market dominated by low-multiple cyclicals (financials, resources) and we see market projections for 2013 and 2014 earnings growth as being vulnerable to a downgrade. Sovereign bond yields in Japan, at less than 1% as of June 30, 2013, are a poor investment; but recent sell-offs in Australian and New Zealand sovereign debt present opportunities for yield investors. ■

Russell strategists' relative-return barometer compares 16 key asset class pairings

The models shown in this section inform Russell's short-medium term asset allocation strategies. At the core of these strategies is the recognition that over time asset classes, relative to one another, present misvaluations. The identification of these misvaluations of asset classes is the goal of Russell's Enhanced Asset Allocation (EAA) capability.[5]

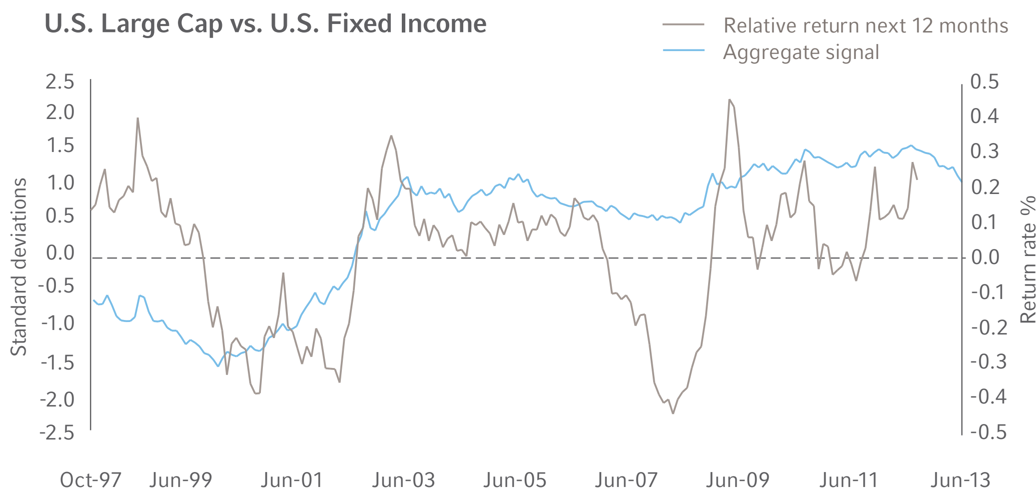
Three noteworthy observations

1. Significant Signal: US Large Cap Equity vs. Fixed Income

As we wrote our asset-class-pairing comparisons one quarter ago, we recommended a scaled overweight position to equities relative to fixed income in the United States at levels near 1593 on the S&P 500 Index. Subsequent to that, we saw the index climb to as high as 1687 and back down to 1560 , and presently we are once again resetting year-to-date market highs. The volatility in U.S. equity markets can be directly attributed to market uncertainty related to policy actions by the Federal Open Market Committee (FOMC). There have been fits and starts caused by the perceived coupling of near-term policy choices surrounding tapering and the future Fed funds rate. For its part, the Fed has gone out of its way to convey that these two decisions are not implicitly linked, and U.S. markets, seemingly, are becoming more convinced. It is with this perspective that we viewed the market pullback that occurred concurrent with the FOMC meeting in June as an inflection point rather than a turning point.

Consistent with this, we have maintained an equity overweight position relative to fixed income. With yields on the U.S. 10-year bond climbing beyond 2.6%, we have been rewarded by both sides of this pair: long equity and short fixed income. Support for this position has come from our fundamental valuation modeling using forward equity earnings expectations; these remain materially optimistic (7.95 earnings growth on a rolling 12-month basis). However, we feel that this consensus may be overly optimistic, with third and fourth quarter earnings in the United States likely to reflect the greatest impact from sequestration. Yet even when discounting forward earnings, we still have a signal in favor of equities of near 2.0 standard deviations. Aligning with this, signals from both our momentum and trailing

U.S. Large Cap vs. U.S. Fixed Income



In assessing the attractiveness of asset classes relative to one another Russell's EAA capability uses a pair-wise modeling construct with asset classes shared across multiple pairs each with independent valuations. At present the capability includes over 120 pairs leveraging signals from greater than 400 models. The signals used are based on proprietary models developed by Russell, and they generally fall into three categories:

- Multi-variate, where the valuation signal is a function of various economic, characteristic and market variables.
- Uni-variate, in which return differences between two asset classes are a function of a single characteristic or market variable.
- Statistical, in which deviations from long-term trends in return patterns of two asset classes signal the direction and magnitude of expected returns.

All the models seek to identify factors which can signal which of two asset classes in a pair has better return prospects, given historical patterns of subsequent relative returns. Married to each individual model is a model-specific tilt function to make best use of each unique signal. Having multiple models per pair provides diversification of signals to arrive at a weighted tilt.

[5] Enhanced Asset Allocation (EAA) is a capability that builds on Strategic Asset Allocation (SAA) by incorporating views from Russell's proprietary asset class valuation models. EAA is based on the concept that sizable market movements away from long-term average valuations create opportunities for incremental returns.

earnings based Fed models (though modestly less than last quarter) also prefer equities. Also consistent with last quarter, our long-term mean reversion valuation has a neutral position in its usual contrarian position relative to momentum in a rallying market.

Our recommended positioning still has us overweight in equities; however, we would consider trimming some of that and booking gains as we again approach highs for the year. We may find a modest soft patch in employment gains when compared to the previous six-month average of nearly 200,000. Should equity markets dip, based on this macroeconomic data, we would opportunistically redeploy equity positions. With few quality options, however, at these yield levels in fixed income, we would continue with a measured equity overweight.

2. Biggest Change: U.S. Large Cap Equity vs. Continental European Equity

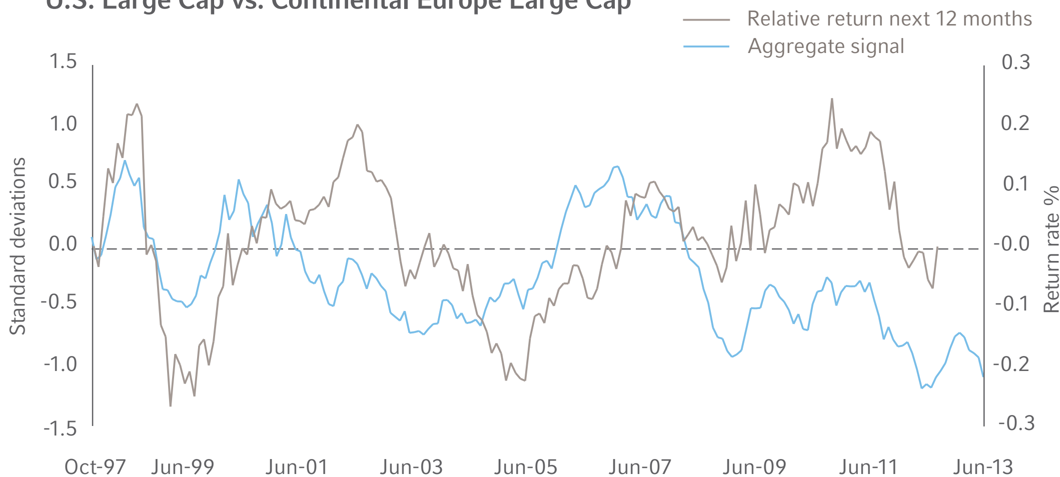
When compared to the quarter in U.S. equity markets, Europe's quarter would be one of higher highs and lower lows. In this volatile scenario, European equity markets (MSCI Europe Index) underperformed U.S. equity markets (S&P500) by 4.6% in total return from a local currency perspective. The underperformance decreases to 2.9% from a U.S. dollar investor's perspective.

In terms of valuations, Europe continues to look modestly cheap relative to U.S. equities. The most compelling comparison appears when looking at the moving average P/E ratios using a 60-month rolling window. Long-term mean reversion as well as price-to-sales and price-to-book comparisons also support a slight Europe overweight. Only a modest momentum headwind sits against this call.

In previous months, we have characterized our preference for Continental European equities relative to U.S. equities as a modest tilt. However, when we factored in policy risk, political uncertainty, and a challenged structural growth environment, we scaled this back to a neutral position. While our qualitative concerns have certainly not been removed, they are somewhat mitigated as German elections appear to be tracking toward a more predictable outcome, political concerns are modestly abating in Spain and Italy, and a very dovish-sounding Mario Draghi is again using his speeches to keep peripheral European sovereign debt yields within reasonable ranges.

It is with this backdrop that we would consider a modest tilt to European equity relative to U.S. large-cap equities, likely scaling back an already small valuation-implied tilt. This may not be the biggest change numerically this quarter, but it is a noteworthy one none the less.

U.S. Large Cap vs. Continental Europe Large Cap

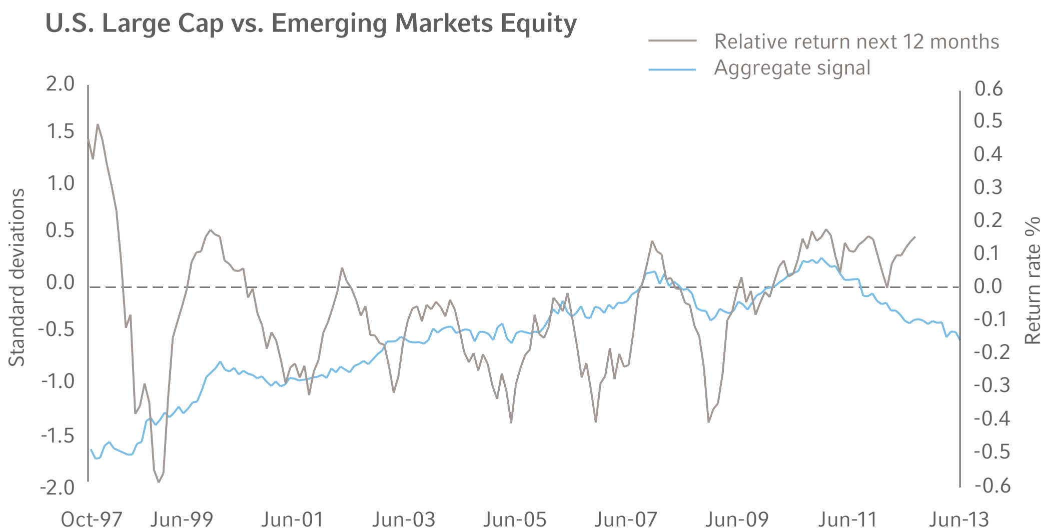


This report is not intended to be used as the basis for a trading strategy or as an asset class timing tool.

3. Caught Our Eye: U.S. Large Cap Equity vs. Emerging Market Equity

Emerging Markets (EM) have certainly been both a point of focus and interest, evident by our deeper dive into the asset class earlier in this publication, as well as a pain point for those carrying an overweight to this asset class through the first half of 2013. Having underperformed U.S. large-cap equities (S&P 500) by over 14% on a rolling 12-month basis – with 3.7% of this coming in June alone, EM (MSCI Emerging Markets Index) have been a not insignificant drag on any portfolio—particularly one with any overweight to the asset class.

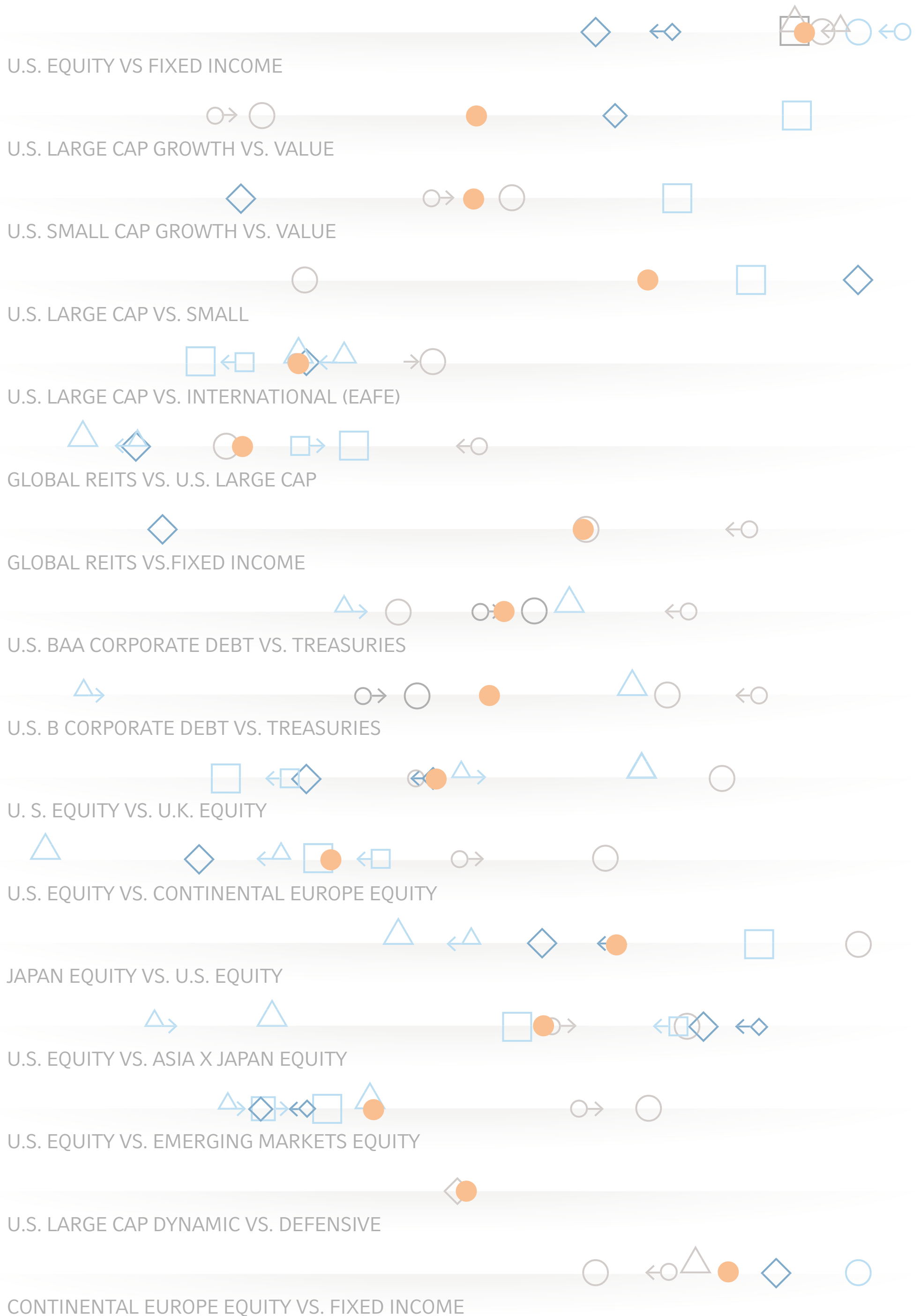
Our perspective on the relative attractiveness of EM has consistently been that there is only a modest valuation advantage, primarily from a price-to-earnings and price-to-sales comparison, but that this signal has been consistent and persistent. Given the paradigm from which we look at asset classes, specifically a diversified model perspective, and the consistent underperformance of EM, our momentum signal has started to pull back our tilt to EM. Wholesale, we welcome this effect as the previously mentioned valuation opportunity in EM is likely one that we would anticipate benefiting in a medium time horizon; in the very near term we agree with the reduction in the already small tilt to EM relative to U.S. large-cap equities from a fully hedged perspective. ■



Russell strategists' relative-return barometer

The relative return barometer represents pair-wise comparisons of the relative attractiveness of forecast valuations of asset classes of regional interest. The symbols on the "slider" represent each of multiple forecast valuation models we use in the enhanced asset allocation capability to gain a diversified perspective of the relative attractiveness of each asset class relative to its paired asset classes.

UNDERPERFORM ← → OUTPERFORM



How to read the slider

Symbol on the RIGHT SIDE of the band = strong preference for the FIRST asset class listed in the pair.

Symbol on the LEFT SIDE of the band = strong preference for the SECOND asset class listed in the pair.

Symbol in the center = neutral (i.e. if the pair is U.S. Equity vs. Fixed Income a symbol on the right would indicate a preference for U.S. Equity, on the left for U.S. Fixed Income.)

The range along the band is a normalized distribution of the different signals to make them comparable (mean of 0 and standard deviation of 1).

The previous month's signal is shown as a hollow shape when there is a greater than five-point change to the current month's signal.

For a given signal, we scale from 1% to 100% using a Standard Normal Density Function (mean of 0 and standard deviation of 1).

LEGEND

Please see next page for important disclosures.

	Q2	Q3
Momentum (12 month)		
Fundamental model		
OAS comparisons		
Long-term mean reversion		
P/E comparisons		
Probit model		
Yield comparisons		
Statistical valuation		
Federal model		
AVERAGE SIGNAL		

This report is not intended to be used as the basis for a trading strategy or as an asset class timing tool.

Russell Investments

IMPORTANT INFORMATION FOR LEGEND ON PREVIOUS PAGE:

Enhanced Asset Allocation (EAA) is a capability that builds on Strategic Asset Allocation (SAA) by incorporating views from Russell's proprietary asset class valuation models. EAA is based on the concept that sizable market movements away from long-term average valuations create opportunities for incremental returns.

The idea behind EAA is simple. On occasion markets can move to extremes of pessimism or optimism. EAA aims to take advantage of extreme asset class movements to provide investors with a unique source of potential incremental return. This information can be used to temporarily adjust or "tilt" a portfolio from its long-term SAA. It's based on the belief that markets are not fully efficient and may be occasionally mispriced. Tilts are expressed as over- or under weights of the asset classes available, relative to their SAA weights.

IMPORTANT INFORMATION FOR GRAPHIC ON PREVIOUS PAGE:

Asset class valuation models aim to identify relative mispricing of asset classes. These models are based on the assumption that the long-term historical relationships between asset classes will continue. If those relationships change, the model may identify a mispricing opportunity when in fact there is a structural shift in the long-term relationship.

The Strategists' Barometer aims to forecast shorter-term asset class returns. It is a theoretical model, not a fund or a strategy, and its allocations vary around a broader spectrum than might be practical to routinely implement once frictional costs (such as trading commissions, taxes, expenses associated with hiring and firing money managers, etc.) come into consideration. The Barometer is a viewpoint on the relative value of each asset class in comparison to its long-term historical (or "normal") valuation. It is not intended to be a trading strategy. When the model indicates that the value of an asset class has deviated unusually from its norm, it seeks to increase, or decrease, exposure to it.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

The views in this barometer 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.

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.

Bond investors should carefully consider risks such as interest rate, credit, repurchase and reverse repurchase transaction risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage backed securities, especially mortgage backed securities with exposure to sub-prime mortgages.

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 and includes approximately 1,000 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.

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 Russell Global Index measures the performance of the global equity market based on all investable equity securities. The index includes approximately 10,000 securities in 63 countries and covers 98% of the investable global market. All securities in the Russell Global Index are classified according to size, region, country, and sector, as a result the Index can be segmented into more than 300 distinct benchmarks.

The Russell Japan Index measures the performance of the Japanese equity market represented in the Russell Global Index based on all investable equity securities.

The Russell Europe index measures the performance of the equity markets across Europe represented in the Russell Global Index based on all investable equity securities.

The Russell Emerging Markets Index measures the performance of the Emerging Markets segment of the Russell Global Index based on all investable equity securities.

The Barclays Capital Aggregate Bond Index is a broad base index, maintained by Barclays Capital, which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States. Index funds and exchange-traded funds are available that track this bond index.

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3rd Quarter 2013 Strategists' Outlook and Barometer
CORP–8749