RUSSELL INVESTMENTS

# Late-cycle lean out

## 2017 Global Market Outlook — Q3 update

We're in a late-cycle, momentum-driven market, where valuation is at an extreme. Momentum can drive markets beyond fundamentals for an extended period. No investment process is going to pick the peak in the cycle, but we'd lean out as the risks increase.

JUNE 2017


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# EXECUTIVE SUMMARY

**U.S. equities continue to post record highs as the economy disappoints and bond yields decline. We're cautious about the rally, and we maintain our "buy the dips and sell the rallies" mindset.**

## Venus & Mars

Bond investors are from Mars and equity investors are from Venus, or at least that's what their current behavior suggests. The unbridled optimism of record highs in the U.S. equity markets is in stark contrast to the somber mood depicted by low and declining Treasury yields.

The two will eventually reconcile, but it's possible that these contradictory views will persist for a while longer. Our cycle, value and sentiment investment process has us skeptical about U.S. equity market optimism, but it also acknowledges that momentum can push markets beyond fundamentals for an uncomfortably long time.

We're still seeing a resilient but mediocre U.S. economy and better growth prospects in the rest of the world, most notably Europe.

**Paul Eitelman** warned last quarter that U.S. growth was likely to disappoint, and the data flow has supported his judgment. He expects inflation to stay low and prevent the U.S. Federal Reserve from raising the Fed funds rate again this year. Expensive valuation and a lackluster economy underpin Paul's recommendation for remaining underweight U.S. equities.

By contrast, **Wouter Sturkenboom** thinks the good news in Europe can continue. Europe is in a sweet spot of robust growth, low inflation and strong corporate earnings. Political risk is also easing, following the election of Emmanuel Macron in France. Next year's Italian election is the main cloud on the horizon. A win by the centrist Matteo Renzi would cement Europe's political renaissance.

**Graham Harman** and **Alex Cousley** see a mixed, but mainly positive, outlook across the Asia-Pacific region. Japan is benefiting from strong exports, and there are the first signs of an inflation uptick. China's economy remains robust ahead of the five-yearly meeting of the National Congress later this year. Australia and New Zealand remain lackluster.

The lifting of political risk has made **Van Luu** more constructive on the outlook for the euro. Van thinks the U.S. dollar has peaked in this cycle and that there is some upside for the undervalued Japanese yen. Brexit uncertainty and the political instability caused by the minority government in the UK should keep the British pound in a 1.20-1.30 range.

The models estimated by **Kara Ng** and **Abe Robison** are largely unchanged from the previous quarter. The U.S. business cycle index model continues to show low recession probabilities. Their models for U.S. equities versus fixed income remain firmly in the neutral zone.

We're more inclined to side with the bond market than the equity market at this late stage of the cycle. As we look ahead to the second half of 2017, like Paul McCartney's lyrics, we're sitting in the stand waiting for the show to begin when Venus and Mars align again. ▯

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# Investment strategy outlook

**We still want to buy dips and sell rallies against the backdrop of an expensive U.S. equity market, a broadly neutral earnings outlook, and sentiment indicators that point to complacency. Europe and, to a lesser extent, Japan and emerging markets (EM) have better cycle support. Government bonds are expensive, but a lack of global inflation pressure should keep yields in a range.**

## Late-cycle lean out

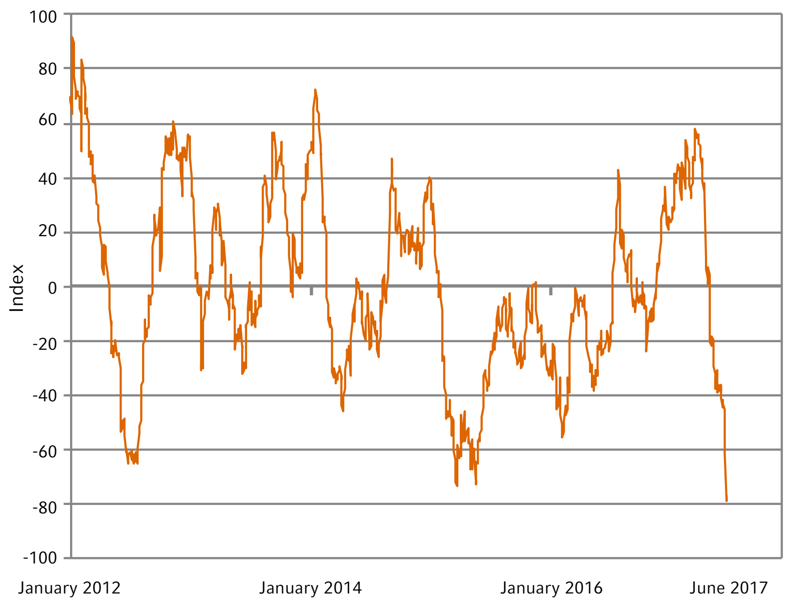
In our previous quarterly report, we cautioned that investors were becoming overoptimistic about near-term U.S. economic growth prospects. Disappointment seemed likely, creating the potential for market volatility. Sure enough, U.S. economic data subsequently began to disappoint. The Citigroup Economic Surprise Index, which tracks U.S. economic data releases against consensus forecasts from economists, plunged from +60 in mid-March to -80 in late June.

Our cycle, value and sentiment investment analysis process tells us to be cautious about U.S. equities.

The shift from positive to negative economic surprise triggered a 45-basis-point decline in the U.S. 10-year Treasury yield and a 5% fall in the U.S. Dollar Index. It hasn't, however, generated a meaningful pullback in equities.

This points to the role of declining interest rates in supporting U.S. equity market valuation. Investors have embraced a type of cognitive dissonance; sky-high U.S. equity valuations say the outlook is fantastic, but low Treasury yields warn that the growth outlook is lackluster. The U.S. equity market is being supported by a view that growth will remain reasonable and interest rates will stay low. This means the market is vulnerable to either of those assumptions being questioned: either a recession scare or a rising interest rate scare. We believe both scenarios seem unlikely in the near term.

**U.S. economic surprise index**




Source: Citigroup, last observation June 21, 2017.

Performance quoted represents past performance and should not be viewed as a guarantee of future results. Indexes are unmanaged and cannot be invested in directly.

The challenge of 2017 is that we are in a late-cycle, momentum-driven market where valuation is at an extreme. Momentum can drive markets beyond fundamentals for an extended period. No investment process is going to pick the peak in the cycle, but it should lean out as the risks increase.

Our cycle, value and sentiment investment analysis process tells us to be cautious about U.S. equities. Expensive valuation implies asymmetry in the return outlook, where the potential downside is larger than the upside. But the absence of significant U.S. recession risk means the cycle is broadly neutral for equities. This stops us from being too bearish. Overbought sentiment stops us from chasing the current momentum-driven rally. We're still in a "buy the dips and sell the rallies" market environment. We want to lighten up in the current rally and look to buy the next dip.

## Key indicators update

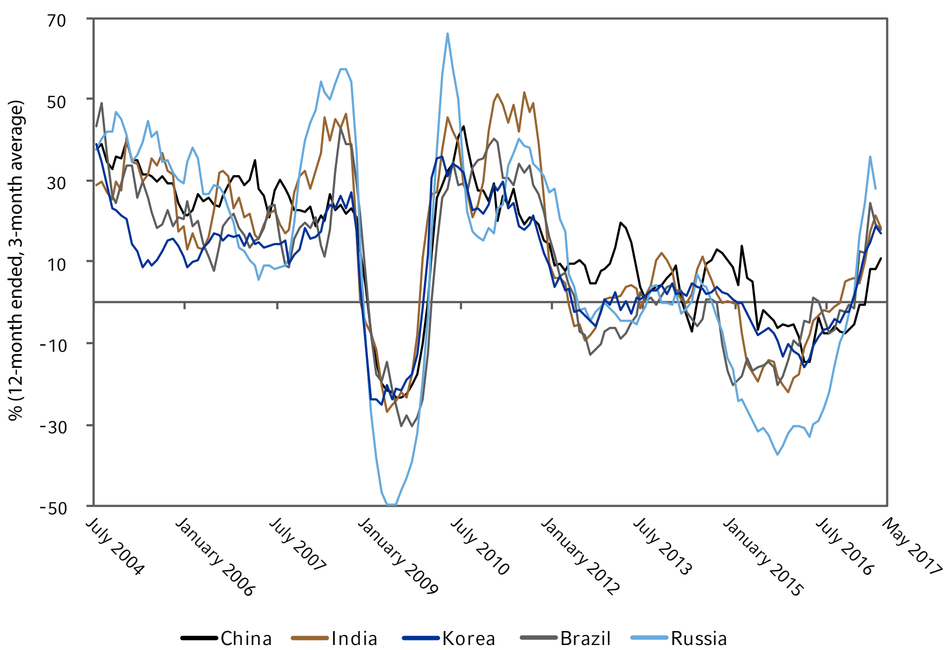
Our 2017 annual outlook report listed three indicators we would watch closely in 2017: U.S. wage measures, fiscal policy announcements and emerging markets exports.

- **U.S. wage growth** has moved sideways this year, despite the unemployment rate declining to 4.3% in May. This is reducing the pressure on the U.S. Federal Reserve (the Fed), which is under pressure to lift interest rates further. We expect that the Fed funds rate will be held steady for the rest of 2017.
- **Fiscal policy** is providing a modest boost to growth this year, but the recent news is mixed. President Trump's plan for tax cuts and infrastructure spending looks delayed until 2018. His slim Senate majority means that stimulus is likely to be modest. Newly elected President Macron in France is promising fiscal restraint. By contrast, the UK's conservative government is planning to ease back on fiscal austerity after nearly losing the recent general election.
- **Emerging markets** exports remain robust, but there are tentative signs of a peak.

The indicators point to an easing of U.S. inflation pressures, a still modest boost from fiscal policy, and continuing strength in global trade.

We're still in a "buy the dips and sell the rallies" market environment. We want to lighten up in the current rally and look to buy the next dip.

**Exports by selected EM countries**




Source: Thomson Reuters Datastream, as of May 15, 2017.

## Global equities: cycle, value, sentiment

Our investment process is based on the building blocks of cycle, value and sentiment.

- **Business cycle:** It's a mixed-cycle outlook for global equities. Cycle tailwinds for equities appear strongest in Europe, followed by emerging markets, and Japan. The U.S. cycle score is neutral. Economic growth is near trend and corporate earnings growth is limited by high margins and a lack of pricing power. Tax cuts and infrastructure spending could provide a fiscal policy boost, but if enacted, are likely to be offset by further Fed tightening.
- **Valuation:** U.S. equities are very expensive. The Shiller P/E ratio, which uses the 10-year average of inflation-adjusted earnings, is the highest it's been outside of 1929 and the late-1990s Internet bubble. European equities have moved to slightly expensive after their recent run. Japanese equities are around fair value, while emerging markets are still reasonably cheap.
- **Sentiment:** Price momentum is positive across all regional markets, but a range of indicators still suggest markets are overbought and complacent. The most prominent contrarian indicator is the CBOE Volatility Index® (VIX®) otherwise known as the "fear index." It has fallen to levels last seen in 2006.
- **Conclusion:** We're still cautious on the near-term outlook for global equities, with the expensive U.S. market the most vulnerable. Europe is slightly expensive after its recent run, but has good cycle support. Japan and emerging markets have some modest cyclical tailwinds, with EM having some valuation support as well.

## Treasuries: The cycle has become more neutral

Government bonds are still expensive in all regions. They are closest to our fair value estimate in the U.S. and furthest from fair value in Germany and the UK.

Cycle tailwinds for equities appear strongest in Europe, followed by emerging markets and Japan.

The main change is that the cycle view for U.S. Treasuries has moved from negative to broadly neutral. Economic disappointment, the stalling in wage acceleration, and the lack of pricing power have generated some disinflationary forces in the U.S. economy that look likely to persist for the next few quarters.

Cyclical forces look broadly neutral in Japan and the eurozone. The Bank of Japan has recently reaffirmed its policy of targeting zero percent for the 10-year bond yield. The European Central Bank has signaled that it will continue with negative rates and asset purchases until at least the end of 2017.

The cycle is slightly negative for UK gilts, where the large post-Brexit referendum British pound sterling devaluation is pushing up inflation.

Our sentiment indicators are mostly neutral, save for the U.S. being slightly overbought after the recent rally. Broadly, our process points to yields remaining in a range for the next few months, but expensive valuation means the medium-term trend is upward.

# United Kingdom: May's shambles

**Another prime minister, another lost gamble. That's how we summarise the outcome of the snap election. Now the UK must deal with May's shambles, which consist of renewed political uncertainty and an unknown Brexit stance. This, against the backdrop of an economic slowdown, means we continue to be cautious on domestically exposed UK markets.**

## A worrying set of circumstances

When prime minister Theresa May surprised the world by calling a snap election, everyone expected her to win. After all, she was miles ahead in the polls and the opposition was in disarray. But it was not meant to be. After a disastrous campaign, her cynical ploy backfired and the election result meant the Conservatives had lost their majority in the House of Commons. They now have to rely on the Northern-Irish Democractic Unionist Party (DUP) for a working majority.

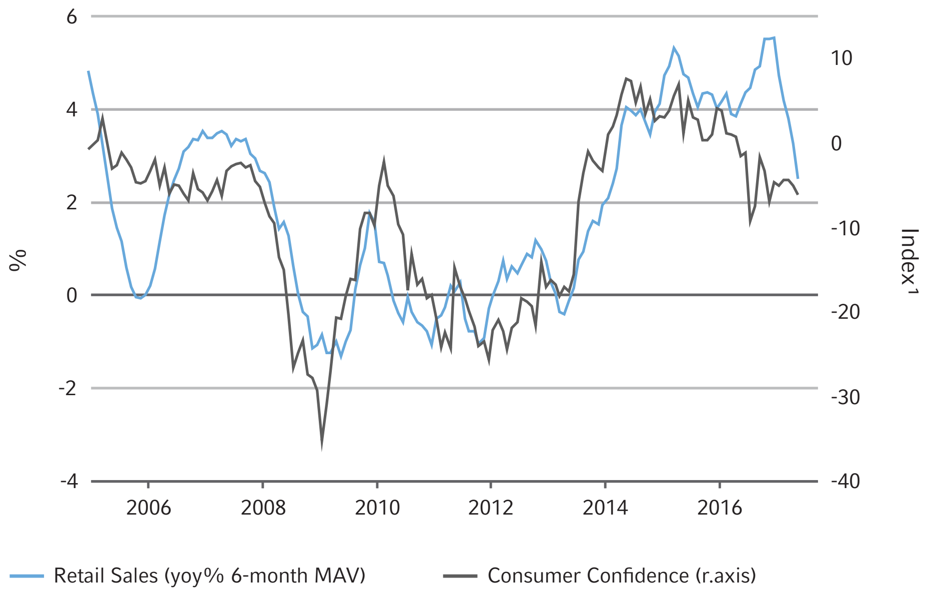
The most direct impact of this event is the utter destruction of May's authority and credibility. She is still prime Minister, but only remains so at the behest of a few senior ministers. How long she will survive is anybody's guess, but more importantly, we can no longer rely on her vision for Brexit to prevail. And what vision would come in its place is also unclear. That means the Brexit negotiations are even more uncertain than before. We don't know what sort of Brexit the UK will aim for, and we don't know who will be able to get the negotiated outcome through parliament. In the face of a unified EU front and a reinvigorated Franco-German tandem, that means the UK is in a very weak position. And that means it is more likely something will go wrong. Brexit risk has notably gone up.

The UK is in a very weak position in the Brexit negotiations, which means Brexit risk has gone up.

However, that is not the worst of it. Increased Brexit risk is only part of a bigger set of worrying circumstances. We have highlighted previously that the UK consumer is under pressure. Consumer price inflation has risen rapidly towards 2.9%, pushing real wage growth into deeply negative territory. That means living standards are in outright decline, which in turn is weighing on both consumer confidence and retail sales (see chart). Given how important the UK consumer has been as a driver for the overall economy, this underlines that the economic slowdown already underway will continue going forward. Rumblings in the housing market only add to this trend.

Finally, another worrying circumstance is the more hawkish tone from the Bank of England (BoE). Because the UK economy has so far been able to weather the Brexit storm better than expected, the BoE is focused more on the rise in inflation than on the economic slowdown. To them, the former is clear and present, whereas the latter is still uncertain. And that has pushed them closer to tightening monetary policy than we expected, voting only narrowly 5-3 in June to maintain rates at current levels. We expect the BoE to stay put for the rest of the year when the slowdown deepens and the import price inflation rolls over, but having to even worry about this is not helpful.

### UK retail sales and consumer confidence




[1] Consumer Confidence Index of the Directorate General for Economic and Financial Affairs, European Commission.

Source: Thomson Reuters Datastream, May 2017.

## Strategy outlook

- **Business cycle:** Our growth expectation for 2017 is unchanged at 1.2-1.8%, which remains below industry analysts' consensus. Our worries on consumer spending and housing are behind the more cautious outlook. Corporate earnings are still doing well but there is a notable divergence between internationally and domestically exposed companies, given the impact of the devaluation of the pound.
- **Valuation:** UK equity valuations remain slightly cheap at +0.5 on our scorecard scale of -2 to +2. Government bond valuations are long-term expensive but at 1.04% the current 10-year gilt yield is well within our (lowered) range of 0.7-1.5%. Bond yields are still in a tug-of-war between lower growth and higher inflation, but renewed political uncertainty means a lower range is more appropriate.
- **Sentiment:** Within UK equities, price momentum has remained positive, but this is neutralised by overbought short-term contrarian indicators. Government bond sentiment is modestly positive on momentum.
- **Conclusion:** We continue to be cautious on UK equities, favouring internationally exposed companies over domestically exposed companies. Within fixed income we maintain a neutral stance as we expect lower growth and political uncertainty will prevent yields from rising much while higher inflation should cap the downside. The Brexit negotiations have started and the agreed sequence means the exit agreement is handled first before a trade agreement. That, combined with the uncertainty of what the UK government really wants, means risk around the final outcome has increased. This will likely be a source of future volatility.

# United States: Strike three on inflation?

**The U.S. economy still looks resilient but mediocre. Incoming data during the second quarter proved consistent with our below-consensus growth forecast for 2017. The bigger surprise has come from the sharp slowdown in core inflation. We think this should put a halt to further Fed funds rate hikes this year. The lack of pricing power also poses a medium-term threat to corporate profitability.**

## U.S. mediocrity saved by global strength

In mid-March, we shifted to a below-consensus real GDP growth outlook for 2017. That timing proved prescient, as cited earlier in this report, when the Citi U.S. Economic Surprise Index subsequently fell a staggering amount during the second quarter.

Our central thesis for the U.S. economy is unchanged: The economy is resilient. The business cycle index model suggests that recession risks are contained. But the economy remains mediocre with fiscal stimulus increasingly looking like a 2018 story and businesses being incentivised to sit on the sidelines until these favourable policy initiatives take effect. We continue to look for an "air pocket" scenario of weaker growth this year. Stronger economic conditions in 2018 will require that Republicans deliver on their promised growth agenda in Congress.

Economic mediocrity has not translated into earnings mediocrity. Earnings growth for S&P 500® Index companies accelerated to +14% in the first quarter. There were two catalysts for this strength. First, the stabilisation in commodity prices relative to early 2016 provided a large boost to earnings in the energy and materials sectors. This tailwind is likely to prove transitory. But the second force boosting profitability was more fundamental. S&P 500 companies source almost half of their revenue from abroad, and the cycle in Europe and the emerging markets has strengthened notably over the past year.

The Business Cycle Index model suggests that recession risks are contained. But the U.S. economy remains mediocre.

Indeed, the earnings growth of more globally oriented U.S. businesses was double that of their domestic counterparts in the first quarter. However, we believe it will be very difficult to sustain this strength over the course of 2017. The J.P. Morgan Global Purchasing Managers' Index has already started to moderate from a very high level, and risks are skewed towards "still healthy, but slower growth" in the months ahead. Translation: The first quarter is likely to be as good as it gets for U.S. earnings growth in 2017.

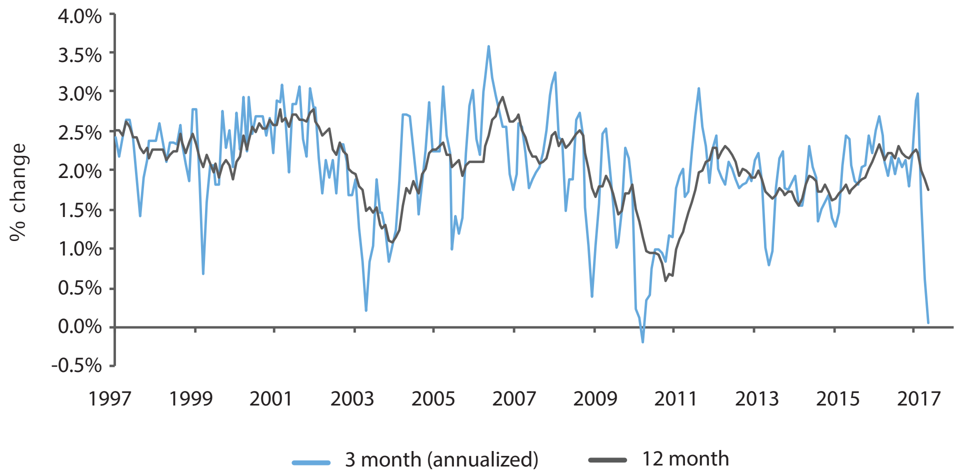
## Inflation: a sharp turn in the wrong direction

In her June press conference, Fed chair Janet Yellen noted that "core inflation…edged lower" and that "recent lower readings on inflation have been driven significantly by… one-off reductions in certain categories." In our view this belies a much more significant inflation problem. Core consumer price index (CPI) inflation was effectively flat over the three months through May (as indicated by the blue line in the chart on the next page), which is the worst sequential run rate since the 2008 financial crisis. And relative to consensus expectations, this was the worst three-month period for core CPI ever in records dating back to 1997.

The Fed's preferred measure, core personal consumption expenditure (PCE) inflation, is likely to dip to 1.4% in May, moving away from the Fed's 2% inflation target. A key question for our mid-year outlook is whether this recent disappointment simply represents noise in the data (as Yellen is suggesting). We think the downside to inflation could prove more persistent for several reasons: A price war in the telecom industry has had an outsized impact on the official inflation statistics, but shows no signs of abating in June; oversupply problems in the automobile industry are dampening pricing power and likely to persist; a significant build-out in multifamily homes is dampening rental price inflation; and technological change is exerting a disruptive, disinflationary force on the retail sector.

Given our caution around the near-term outlook for both growth and inflation, we think the Fed will be forced to stop its hiking process for the remainder of the year. The Fed does seem very committed to winding down its balance sheet, and we expect them to start that process later this year. The key for fixed income markets is that the Fed wants to do this in a gradual and predictable way. Our analysis suggests that balance sheet normalisation should add only one- or two-tenths of a percentage point to U.S. 10-year Treasury yields each year. As such, we continue to look for the yield to slowly shift up to 2.5% over the next 12 months.

**Core inflation is headed in the wrong direction**




Source: Bureau of Labor Statistics, Russell Investments calculations. Based on core CPI data through May 2017.

Given our caution around the near-term outlook for both growth and inflation, we think the Fed will be forced to stop its hiking process for the remainder of the year.

## Strategy outlook

› **Business cycle:** Corporate profits recovered to +14% growth in the first quarter reporting season. But this is likely as good as it gets for the remainder of 2017. The U.S. economy is resilient but mediocre. We don't see enough cyclical support to extend the U.S. market rally at these valuation levels.

› **Valuation:** U.S. equities are very expensive. The Shiller P/E ratio for the S&P 500 stands at 30x as of mid-June — its highest level ever outside of 1929 and the late 1990s.

› **Sentiment:** Price momentum is strong, but partially offset by our contrarian indicators that show signs of complacency in the market.

› **Conclusion:** We continue to have an underweight preference for U.S. equities in global portfolios primarily on the back of their expensive valuations.

# The eurozone: Markets are closing the gap

**In the past quarter, eurozone markets started to close the gap between strong fundamentals and weak relative performance. A "good news" show coming from the economy, political developments, earnings growth and monetary policy pushed markets higher. Although this rally has stretched near-term sentiment, we expect the eurozone to continue to do well in the medium term.**

## The good news show

From a eurozone perspective, the past few months have resembled a good news show. Virtually nothing went wrong and all the important stuff went right. Of course, the most important piece of good news came out of France, where Emmanuel Macron won the presidency and his party En Marche won an absolute majority in the Assembly. Not only did this eliminate the tail risk of a win for the euro-skeptic Marine Le Pen, but it also highlighted the potential of a political renaissance in the eurozone.

> In the face of such a good news show, it was nice to see eurozone markets finally pushing hard to close the gap between weak relative performance and strong fundamentals.

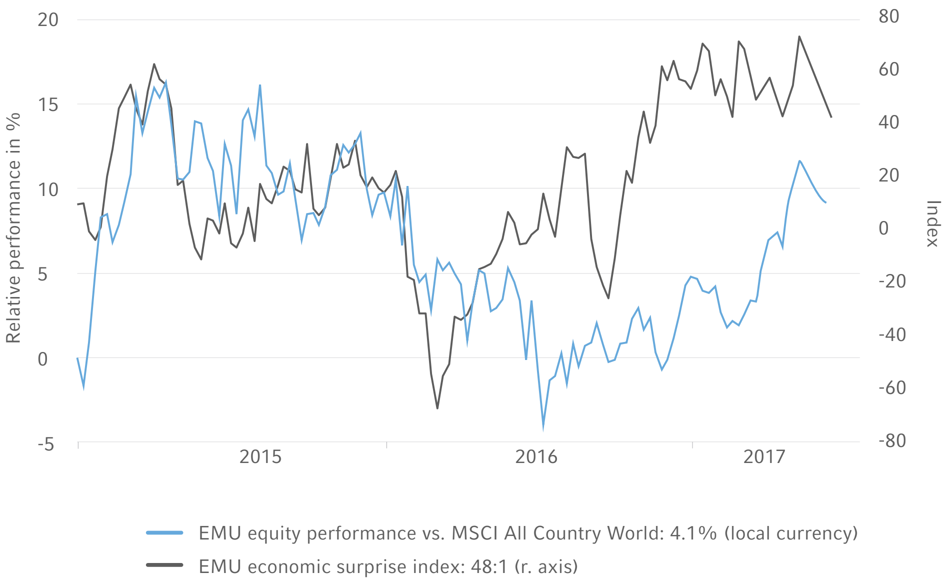
A refurbished Franco-German engine can revive important reforms on the banking union and permanent stability mechanism, for instance. And in the face of Brexit, unity between France and Germany is important to safeguard the future of the monetary union. Obviously, Brexit itself is still somewhat of an economic risk, especially after the Tories lost their majority in the House of Commons. However, that risk lies more with the UK, and the political unity that Brexit is fostering amongst EU members is probably more valuable than any economic disruption Brexit may cause. Finally, if Matteo Renzi can win the Italian elections in 2018, it is very likely that eurozone political developments will become a source of upside potential, which is a big positive change from representing downside risk.

On the monetary policy front, the news was also good. ECB President Mario Draghi made it clear he will be slow to remove the amount of stimulus, eliminating fears of an abrupt end to quantitative easing at the end of 2017. In line with our expectations, a quick decline in inflation helped underline his position that inflation was still being driven by transitory forces as opposed to sustainable drivers. There is simply still too much slack in the eurozone economy to worry about inflation.

On the economic growth front the news was also good. GDP growth continues to accelerate and is close to 2%. Consumer and business confidence are riding high and credit growth is positive. As a result, consumer spending, corporate investment, and housing are all doing well. On top of this, companies are reporting strong earnings growth driven by both margin and revenue expansion.

In the face of such a good news show, it was nice to see eurozone markets finally pushing hard to close the gap between weak relative performance and strong fundamentals. In the very near term such a rally is risky because a sentiment reversal is possible, but in the medium term we expect the fundamental tailwind to continue to support eurozone markets.

**EMU* economic surprise index vs. equity performance**




Source: Thomson Reuters Datastream, 6/19/2017.
*EMU refers to the Economic and Monetary Union, which includes the 19 eurozone states as well as non-euro European Union states.

Performance quoted represents past performance and should not be viewed as a guarantee of future results.
Indexes are unmanaged and cannot be invested in directly.

## Strategy outlook

- **Business cycle:** Strong GDP growth, loose monetary policy, and corporate earnings growth of approximately 15% adds up to a positive business cycle score.
- **Valuation:** Eurozone equities have pushed into slightly expensive territory, but are still cheap relative to the U.S. In eurozone core government bonds we remain neutral with yields still in our range of 0-0.5%. Peripheral bonds have done well lately and yields have returned to our range of 1-2%. However, in our view, there is still a smidgen of value left with spreads slightly above fair value.
- **Sentiment:** A combination of positive price momentum and overbought contrarian signals have kept our sentiment score for eurozone equities in negative territory. Sentiment for core government bonds is still neutral. The rally in peripheral bonds means they are no longer oversold but they are not yet overbought either.
- **Conclusion:** The strong rally in Q2 has pushed eurozone equity valuation and sentiment down, which means we need to be careful in the very near term. In fact, over the past few weeks eurozone equity outperformance has already paused. However, beyond that near-term pause we continue to believe in the reflation trade where strong fundamentals and attractive relative valuation drives markets higher. The eurozone is on solid footing both economically and politically. Of course, with respect to the latter, we continue to monitor developments in Italy. The next, yet unscheduled, election is still most likely a 2018 story, and in the meantime we were happy for the sake of the eurozone to see that the euro-skeptic Five Star Movement lost the local elections in April. But because of Italy's importance to the eurozone, we must be vigilant.

Although we are careful in the very near term, we continue to believe in the medium-term reflation trade.

# Asia-Pacific: tortoise and the hare?

**The developing Asia-Pacific economies are powering ahead like the speedy hare in the classic fable, although we are less optimistic on the outlook for some of the more developed regional countries that plod along like the fable's tortoise. Resilient global trade continues to be a tailwind, and Asia-Pacific equities currently appear slightly expensive after a strong second-quarter performance.**

The Asia-Pacific region remains resilient, and we continue to expect GDP growth of around 5%. Along with strong domestic demand in some countries, global demand (particularly inter-region demand) is proving a significant boost for export-oriented companies. The forward 12-month earnings growth expectation for the MSCI AC Asia Pacific Index is 12% as of June 16, 2017. We expect the developing countries within the region to outperform through 2017, while the outlook for the developed countries is far more mixed. The three key threats to our outlook are a global slowdown, a follow-through on some of the recent protectionist trade threats coming out of the United States, and high levels of debt in a rising interest rate environment.

We expect developing countries within the region to outperform through 2017, while the outlook for the developed countries is far more mixed.

Looking first at developed Asia-Pacific countries, the **Japanese** economy is benefiting from strong demand for exports, but remains lackluster as personal consumption lags. Inflation continues to be sluggish; however, we see anecdotal signs of inflation beginning to come through. Some very visible prices are rising for the first time in years (for example, postage stamps and beer). Monetary policy has been accommodative, and we expect the Bank of Japan to maintain this through the remainder of the year.

The **Australian** economy has been stumbling along recently, while **New Zealand** finds itself in a better state. New Zealand's exposure to soft commodities (which have been performing well) is beneficial, as compared to Australia's exposure to hard commodities (which have struggled). Both countries are facing a slowing housing market, while slow wage growth has meant the Australian consumer is becoming cautious. We look for an outperformance by New Zealand versus Australia through the remainder of the year.

In **Singapore**, consumption and investment have been declining, despite strong regional demand for exports. We expect to see domestic demand remain weak, as consumers face weak wage growth. The one fully positive story among developed Asia-Pacific economies is **Hong Kong**, where growth has been accelerating off the back of strong external demand and robust investment. We expect decent growth for the rest of the year, with an overheated property market becoming the key threat to the economy.

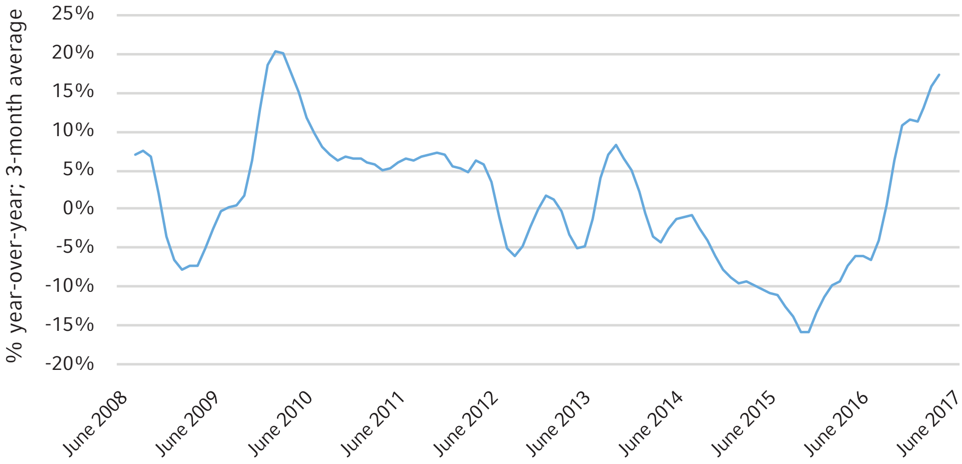
In comparison, the developing economies in the region continue to show strength. Growth in **China** remains robust, and we maintain our constructive outlook on the Chinese economy. Despite concerns around heightened debt levels, industry surveys of business activity and indicators of growth (such as rail freight volumes) point to further expansion. The government will be focused on stable growth in the lead-up to the 19th National Congress of the Communist Party of China later this year, an important planning session for the Chinese government every five years.

Growth in **India** has been hampered recently by the effects of the demonetization[1] policy. We expect this to filter out over coming months, and an acceleration in economic activity in the second half of 2017. Business and consumer sentiment have been rising in **South Korea**, which is driving a pickup in economic activity, while monetary policy remains

[1] Demonetisation is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency: The current form or forms of money are pulled from circulation and retired, often to be replaced with new notes or coins. On Nov. 8, 2016, the government of India announced the demonetisation of two widely used banknotes of the Mahatma Gandhi Series.

accommodative. Growth in the **Philippines** and **Malaysia** is accelerating, while economic activity in **Indonesia** continues to expand at around 5% per year.

**China's rail freight volumes**




Source: China's National Bureau of Statistics, as of April 15, 2017.

## Investment strategy

For regional equities, we assess business cycle, value, and sentiment considerations as follows:

› **Business cycle:** We have a positive outlook on the developing countries within Asia-Pacific; however, our view on the developed economies is less optimistic, dragging our aggregate view to neutral. China, India and South Korea, in our view, will be drivers of growth. On the developed side, Japan is expected to muddle along, while Australia and New Zealand remain lackluster.

› **Valuation:** Asia-Pacific equity markets have performed strongly in the second quarter, adding just over 4% through June 9, according to the MSCI AC Asia Pacific Index, pushing the region into slightly expensive territory. The index currently shows stocks in the region trading on a forward price-to-earnings ratio of 16.2X, a price-to-book multiple of 1.6X and a dividend yield of 2.4%.

› **Sentiment:** Asia-Pacific markets have been riding on a wave of positive momentum since the start of the year, while the market remains in overbought territory. The perception of the Asia-Pacific economy's health has fallen since our previous quarterly report, which is a positive for our assessment of sentiment, but overall we have a slightly negative rating on sentiment.

› **Conclusion:** Overall, we are neutral on the Asia-Pacific region. There are pockets of strength in the region, namely the developing countries, although we are cautious to chase the hares. While the tortoise came out ahead in the fable, we expect the slower-moving developed economies to underwhelm. The strong year-to-date performance in 2017 has made valuations less attractive and, in our view, pushed the region into overbought territory.

Strong equity performance in 2017 has made valuations less attractive and in our view pushed the region into overbought territory.

# Currencies: European renaissance

**The political risks to the eurozone project are fading after elections in France, Austria and the Netherlands put centrists into power. A pro-euro, pro-globalisation reform agenda could make the single European currency more appealing in the longer term.**

Political risks are fading in Europe. After the win of Emmanuel Macron in France's presidential election, one big threat hanging over the euro (EUR) exchange rate is now removed. Macron's rival Marine Le Pen of the National Front had threatened to take France out of the eurozone. Earlier elections in the Netherlands and Austria did not end with populist victories either, while we believe the upcoming German election in September is likely to see the prolongation of Chancellor Angela Merkel's time in office. Political headwinds for the euro are not completely gone as elections in Italy are expected in the spring of 2018, with the euro-skeptic Five Star Movement currently polling strongly. However, pro-euro and pro-globalisation parties and politicians are on the rise in the countries of the single currency area, contrasting with the rise of populist movements looking to restrict free trade and migration in the U.S. and the UK.

In this edition of our quarterly outlook report, we look in detail at the prospects of the euro through the lens of our cycle, valuation and sentiment framework for market analysis:

› **Business cycle:** Negative interest rates and quantitative easing (QE) continue to weigh on the EUR, although we believe the European Central Bank's next move will probably be to extend, but reduce its bond purchases in 2018. On the fiscal and structural policy front, President Macron may be joined by a reelected Chancellor Merkel to push for a reform of the eurozone institutions. As we wait for further positive signals, our cycle view on the euro remains neutral.

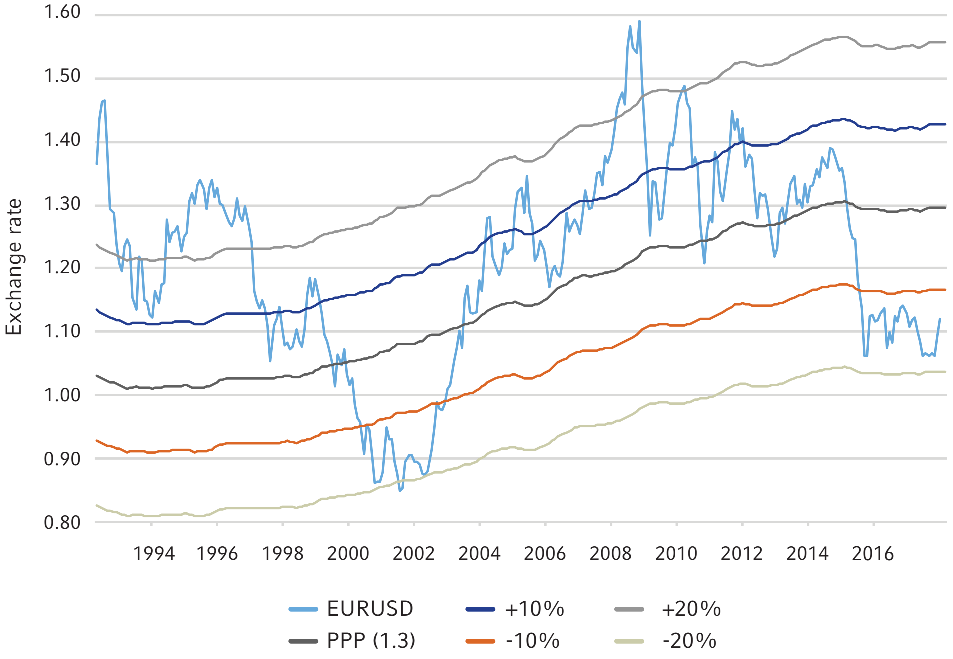
› **Valuation:** The European single currency is supported by attractive valuations, and the euro trade-weighted exchange rate is low compared to history. The euro is also cheap vis-à-vis the U.S. dollar (USD) from a purchasing power parity perspective, as shown in the chart on the next page.

› **Sentiment:** For the euro, it is positive. The currency has enjoyed a solid recovery since the beginning of the year, particularly after the French elections, without the rally becoming overheated.

› **Conclusion:** We are becoming more constructive on the euro. Already attractively valued and buoyed by fading political risks, more pieces of the jigsaw puzzle could fall into place in the second half of the year to create a sustained rally. Other European currencies that usually correlate closely with the euro, such as the Swiss franc and the Swedish krona, could also benefit.

The U.S. dollar index is unlikely to revisit or exceed its previous highs through the second half of 2017.

**EUR/USD: purchasing power parity (PPP)**




Source: Thomson Reuters Datastream, as of June 12, 2017.

## Other major currencies

› **U.S. dollar (USD)**

Long USD was a winning consensus position after the 2016 U.S. presidential election, but the greenback has reversed course since the beginning of the year. Optimism around U.S. federal tax reform (including the border tax adjustment, and corporate and personal tax cuts) proved premature and faster Fed rate hikes did not come through in early 2017. While interest rate differentials between the U.S. and the rest of the G10 countries are still supportive of the U.S. dollar, the greenback is also still expensively valued. All in all, we believe that the greenback is unlikely to revisit or exceed its previous highs in the second half of 2017.

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› **Japanese yen (JPY)**

From a monetary policy perspective, the JPY is subject to similar forces as the EUR. The Bank of Japan is very stimulative, having promised to keep Japanese government bond yields at zero. While this is a drag on the yen, the latter enjoys the tailwind of appealing valuation. We are also wary of the potential for a downward correction in risk markets, which could drive demand for safe-haven currencies such as JPY.

› **UK pound sterling (GBP)**

After the UK general election in early June delivered a hung parliament, the ruling Conservatives managed to form a minority government propped up by the Democratic Unionist Party (DUP) in Northern Ireland. In our main scenario, a diminished Conservative seat share may actually deliver a "softer" Brexit, which would be a positive for the pound and keep it within the 1.20 to 1.30 range to the U.S. dollar. Sterling also enjoys favourable valuation vis-à-vis the U.S. currency, which could eventually push it beyond 1.30. Due to the slim margin of safety for the government and the possibility of inconclusive new elections, there is an outside risk that Britain leaves the EU without a deal. This prospect could push the pound below 1.20, but it is a less likely scenario.

# Quantitative modeling insights: repeat performance

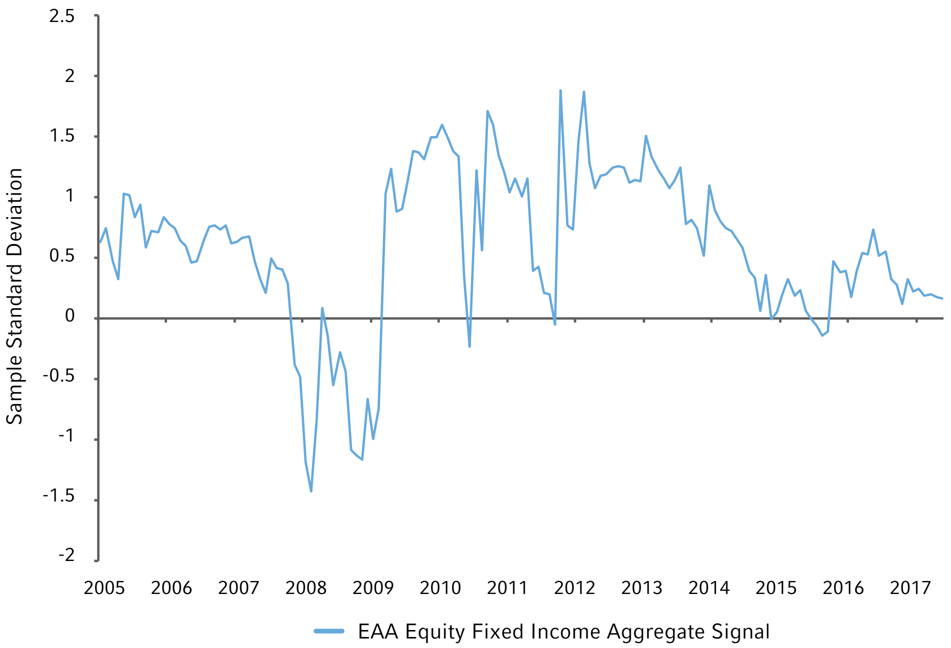
**Our modeling inputs appear stuck in neutral for 2017, offering no reason to change our outlook on equities or recession risk.**

## Neutral equity outlook

Our model for U.S. equities versus U.S. fixed income remains neutral, similar to what we reported in our annual outlook report in December and the subsequent quarterly update in March.

> Our momentum signal is stable and positive, but our long-term mean reversion signal is stable and negative for equity versus fixed income.

**EAA[2] U.S. equity vs U.S. fixed income aggregate signal**




Source: Russell Investments, as of June 15, 2017.
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.

Within our cycle, value and sentiment investment framework we make the following overarching assessments based on our quantitative models.

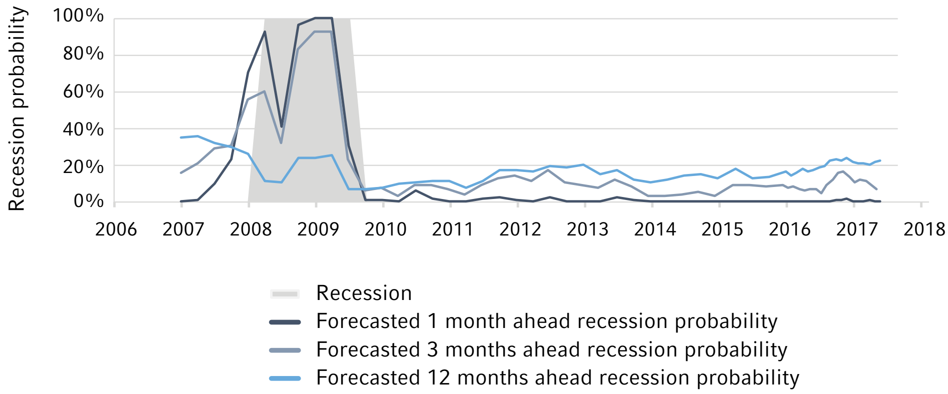
- **Business cycle:** Our proprietary Business Cycle Index (BCI) model uses a range of economic and financial variables to estimate the strength of the U.S. economy and forecast the probability of an upcoming recession. We conclude:
  1. A near-term U.S. recession is unlikely.
  2. We're also unlikely to see accelerating economic growth in this aging cycle. Our probit model, which incorporates the BCI's "mediocre but non-recessionary" view, gives a neutral preference to U.S. equity versus U.S. fixed income.
- **Valuation:** Our Fed model stayed positive and increased slightly because the 10-year U.S. Treasury yield dropped while the earnings yield held constant.
- **Sentiment**: Equities have continued to hit historic highs in the first half of 2017, but the pace of the rally has slowed. Our momentum signal as of June 15, 2017, is stable and positive, but our long-term mean reversion signal is stable and negative for equity versus fixed income.

[2] Enhanced Asset Allocation (EAA) is a capability that builds on Strategic Asset Allocation (SAA) by incorporating views from Russell Investments' 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 EAA Equity-Fixed Income Aggregate Signal is based on the S&P 500 Index and Bloomberg Barclays U.S. Aggregate Bond Index.

## BCI model: historical forecasted recession probabilities

Similar to last quarter's report, the BCI model shows near-zero risk of a recession in the near term, while probabilities for the next 12 months fluctuate between 20% and 25%.

**BCI historical forecasted recession probabilities**




Russell Investments as of June 15, 2017.

## BCI-based heat map: ups and downs, but still neutral

The heatmap below shows payrolls and consumption have moderated in the past year, compared to 2015, while more favourable credit spreads help to offset those trends. The yield curve remains flat, which could foreshadow slower economic growth.

**Impact on BCI, relative to recent history**


Heat map colors of green/yellow/red denote the economic variable's positive (green)/neutral (yellow)/negative (red) impact on business cycle strength relative to recent history.

Source: Russell Investments as of June 15, 2017.

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**IMPORTANT INFORMATION**



2017 Global Market Outlook — Q3 Update

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