TRADE-OFF

Russell Investments

2018 Global Market Outlook – Q4 update

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Synopsis

Trade wars, the U.S. Federal Reserve (the Fed), China stimulus and the direction of the U.S. dollar dominate our near-term outlook. At this juncture, U.S. recession risks appear low. We believe that European growth can improve over the next couple of quarters. We view emerging markets as oversold, but see a bounce as dependent on the next move in the ongoing trade wars between the U.S. and other countries.

Key market themes

The S&P 500® Index has been the best performing regional equity market this year, but U.S. equities remain very expensive, with a Shiller cyclically adjusted price-to-earnings ratio of 33 times as of mid-September. While we see momentum as continuing to favour U.S. equities, some of our contrarian over-bought indicators are beginning to trigger. In addition, a December Fed funds rate hike looks likely, as do three or four more hikes in 2019, which would take the rate to 3.3%. A shift to a more aggressive outlook would put upward pressure on the U.S. dollar and Treasury yields. It also would add to the stresses in emerging markets.

We like the idea of leaning into eurozone equity exposure after its recent underperformance. In particular, Italian risk looks to be dissipating, corporate earnings are still robust and the industry consensus has become too pessimistic about the economic outlook. Trade-war risk, however, tempers our enthusiasm for this region as a whole.

UK equities continue to look slightly cheap on our scorecard. At 1.5%, 10-year gilts are still long-term expensive. However, given the near 20 basis-point rally in yields we've seen over the third quarter, we no longer classify government bonds as very expensive — just expensive.

One of the top stories in Asia Pacific has been Australian growth, which has been impressive so far in 2018. However, we believe that this economy may have seen a peak in growth for the next couple of years, as the headwind of falling housing prices continues to grow and uncertainty around the strength of the Australian consumer remains. Meanwhile, in New Zealand, our outlook for the country is deteriorating as uncertainties around government policy are likely to slow the economy and damage business confidence.

Canadian valuations continue to improve, but we see them as more attractive on a relative basis, especially compared to U.S. equities. We are generally neutral in absolute terms, but remain modestly positive toward Canadian equities relative to the U.S.

Economic indicators

- Corporate earnings growth in the U.S. has exceeded industry analysts' expectations and, according to International Monetary Fund (IMF) estimates, fiscal stimulus is adding 0.7% to GDP growth this year and will add 0.8% in 2019.
- We believe the hurdle for U.S. earnings to surprise on the upside is now very high. The impact of corporate tax cuts on earnings will soon disappear, and both borrowing costs and wages are headed higher. A slowdown in earnings growth will take away one of the main supports for U.S. outperformance relative to other markets.
- We view China stimulus as more likely to resemble *stepping off the brake than pushing on the accelerator*, as President Xi Jinping focuses on deleveraging and structural reform while balancing the need for policy stimulus to counteract the impact of U.S. tariffs.
- We see an escalation in trade wars between the U.S. and other nations as a threat to emerging markets and global trade.

Asset class views

Equities: Broadly neutral

We're neutral global equities for now, with a small preference for non-U.S. markets. The pessimism on eurozone equities looks overdone. We're waiting for more clarity on trade wars, the Fed and China stimulus before leaning into oversold emerging markets.

Fixed income: Reasonable value at 3% in the U.S.

Ten-year U.S. Treasury yields near 3% offer reasonable value amid the current uncertainty. Over the medium term, however, the cycle forces of inflation pressures and central bank tightening look to put global government bond markets under pressure.

Currencies: Japanese yen undervalued

We like the defensive qualities of Japanese yen exposure. It's 20% undervalued relative to purchasing power parity, is getting cycle support at the margin as the Bank of Japan moves less dovish and has solid sentiment support from sizeable net short positions. The added benefit, in our view, is that it also performs well as a safe haven. We see it as a defensive diversifier on portfolio construction grounds.

We also see more upward pressure on the U.S. dollar in 2019, as we think the risks are shifting toward a slightly more aggressive Fed than the market is pricing.

Please visit russellinvestments.com to read the complete 2018 Global Market Outlook – Q4 update.

IMPORTANT INFORMATION

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