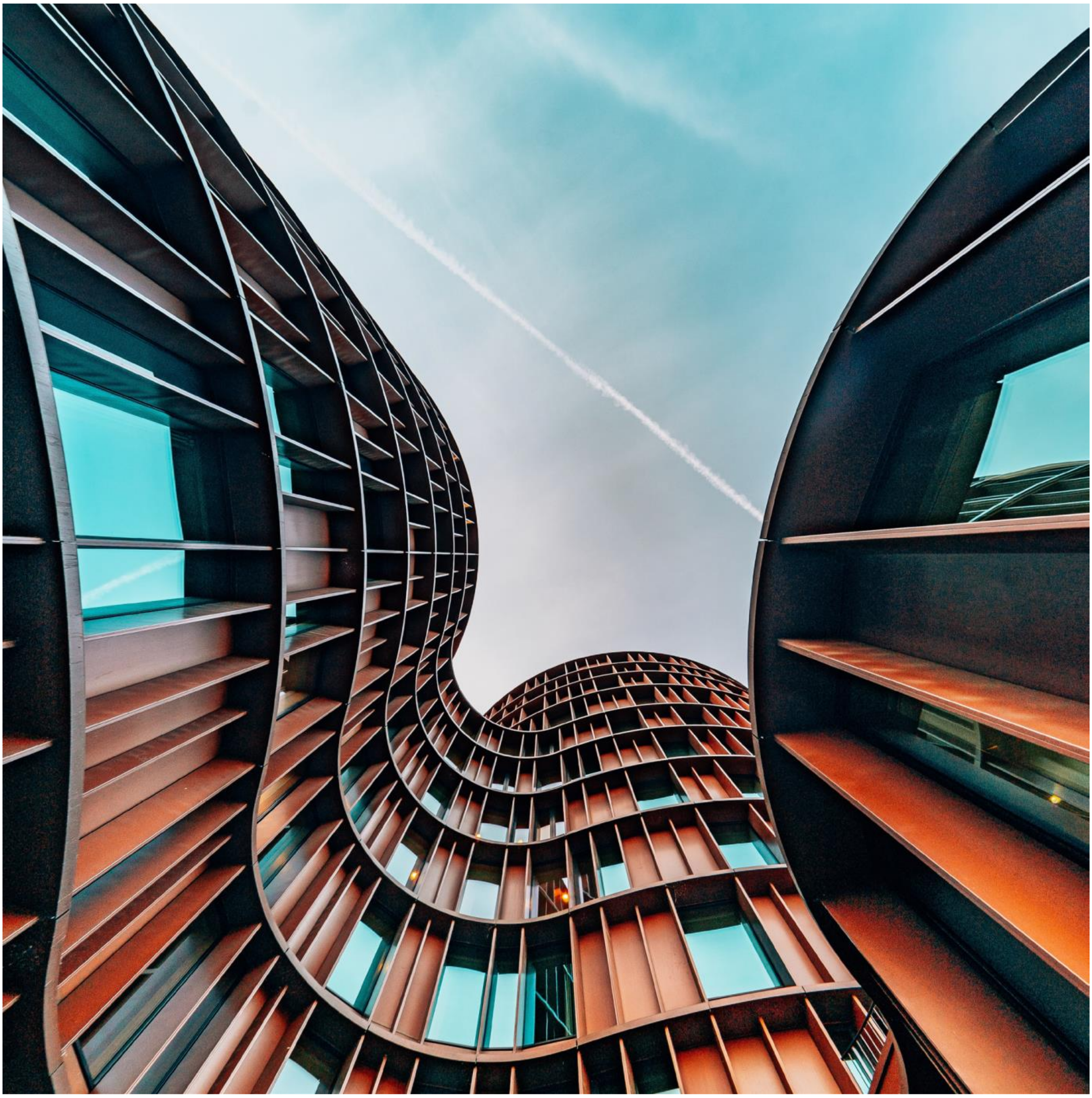
EQUITY MANAGER REPORT Q3 2022

REPORT ANALYSIS



EMBRACE THE POSSIBLE™

October 2022 Equity Market Outlook: Market volatility expected to persist

Could this year's topsy-turvy ride in markets calm down during the final months?

The answer: Probably not, according to the results from our third-quarter equity market outlook. Amid concerns over persistently high inflation, hawkish central banks and geopolitical instability in Europe, most equity managers expect market volatility to persist through year-end.

The outlook also shows that with inflation still high, managers are continuing to favour sectors of the market that offer a natural hedge and downside protection - and will likely keep doing so until signs emerge that inflation is coming under control. Broadly speaking, managers also see non-U.S. equities as more attractive than U.S. equities, due to cheaper valuations and an expectation that the U.S. dollar will begin weakening once the U.S. Federal Reserve (Fed) pivots.

One of the key risks cited by equity managers in our third-quarter report is the possibility of inflation remaining stuck at high levels. This could lead to a more aggressive slowdown in global growth as central banks continue aggressively hiking rates, which in turn could trigger a deeper-than-expected recession. At the moment, however, most managers still believe that a mild recession is the most likely outcome, particularly for the U.S.

Overall, the third quarter proved to be yet another challenging one for equity markets, with almost all markets ending with negative returns in U.S. dollars and local currencies. The exceptions were some emerging markets countries - such as Brazil - that aggressively hiked rates earlier in 2021 and is already seeing inflation correcting while also benefiting from the reopening trade. Other commodity exporters - such as Australia - also benefitted from the current environment posting positive returns in local currency.

The third quarter did prove to be a more favourable environment for active managers in Emerging Markets, Japan, Australia, Canada and Global Real Estate/Infrastructure, while being significantly more challenging for Global, Global ex-U.S., U.S. large cap, U.S. small cap, Europe and UK managers. The UK government's announcement of planned fiscal policies added to market volatility toward the end of the quarter, ultimately costing Prime Minister Liz Truss her job in October.

Notably, the growth and quality factors generally fared better during the third quarter, while the value factor underperformed across all regions. The exception to this was in emerging markets, where growth and value both underperformed while the low-volatility, momentum and small cap factors outperformed. Overall, outside of emerging markets, style remained a driver of performance dispersion.

Drawing on our unique relationship with underlying managers, we've compiled these and other insights from specialists across the manager universe into an easy-to-read report. Listed below are the chief tactical observations from key equity and geographic regions around the globe during the third quarter of 2022.

Australian equities

Concerns for company earnings in first half of 2023

- Managers have described the August company results reporting season as *benign* and *a sideshow*, noting that macroeconomic news drove share prices in the volatile quarter. As a result, portfolios remain largely unchanged.
- Expectations are that increased interest rates and higher inflation will cut into profits in the first half of the 2023 calendar year, where managers expect consumer demand and company margins to fall.
- Managers are preferring companies which can protect margins in inflationary environments and/or are exposed to structural growth. Balance-sheet strength is a key requirement for selected names. They are wary of consumer discretionary names, with the exception being those in the gaming and alcohol sectors, which are considered more defensive.

Turning positive on China

- Managers are cautiously positive regarding the outlook for the Chinese economy, believing that there will be less COVID-19 lockdowns in the future and more fiscal stimulus, which would improve consumer and industrial activity. This supports positioning in the resources sector, which they expect to outperform other sectors.

Future-facing metals theme strengthens

- Resource companies that are mining materials used in electric vehicles (EVs) and renewable energy production continue to be a favoured pick by managers. Managers have increasingly been adding to this theme, while others are maintaining existing exposures and looking to add based on further volatility.
- Managers note that stock selection is paramount, and continue to select low-cost producers, with quality assets and strong balance sheets. Lithium miners were called out as being overpriced, as managers believe the market is ignoring production risks.

> *Resource companies that are mining materials used in electric vehicles (EVs) and renewable energy production continue to be a favoured pick by managers.*

Canadian equities

Recession fears continue to drive manager positioning

- Managers are mindful that the Bank of Canada, like other central banks, is committed to a path of raising rates in order to control inflation. This monetary policy is likely to cause a recession, and as such, managers have been cautious about increasing exposure to economically sensitive companies.
- Investors have been reducing risk and are very selective in financials, given the high leverage of the Canadian consumer and the mortgage-heavy loan books of the banking segment.

Barbelled approach to consumer discretionary

- Within the consumer discretionary sector, managers are positioning toward companies that serve either the higher-end consumer or the lower-end consumer, while avoiding the mass-market consumer.
- Consumer companies catering to the higher-end consumer are preferred, since that segment is less likely to have a decline in spending during periods of economic weakness.
- Companies selling into the lower-income consumer segments also benefit from the *trade-down* of mid-income consumers who become more cost conscious. As a result, managers see mass-market consumer discretionary companies as the most at risk.

Continuing opportunity in energy

- While energy stocks lagged in the third quarter during commodity price retrenchment, managers continue to be favourably disposed to the sector.
- This is because valuations are compelling, balance sheets are generally healthy for Canadian energy companies and businesses should benefit from continuing momentum, given the global commodity supply/demand imbalance.

Emerging markets equities

Positioning for China recovery while timing remains uncertain

- With the Communist Party leadership's confirmation in October, as well as advancing vaccine tests, investors anticipate lockdowns to further ease, as signalled in Hong Kong. There nonetheless remains uncertainty with regard to the timing of this and broader impacts following the conclusion of the Party Congress and future policies. Travel and consumer-related names are expected to benefit from economic normalisation.
- Managers see attractive opportunities among internet names, with growth managers looking to top-up positive earnings revisions. Value managers are also increasingly constructive due to cost cuts and margin effects.
- Value managers are also picking up dislocated property service businesses impacted by the broad sector-related selloff.

The cusp of a new commodity cycle

- Managers remain positive on commodity producers such as Indonesia, Mexico and Chile, as they benefit from *green metals* demand and strong earnings upgrades.

Softer technology industry dynamics

- Across investment styles, managers are increasingly cautious on Taiwan and South Korea, given cyclical recession risks and slowing hardware demand, particularly in consumer technology. Value-sensitive managers see attractive opportunities in memory names, given cheap valuations and consolidated pricing power.

Brazil emerging from inflationary pressures

- With inflation coming under control, market sentiment is increasingly positive in Brazil, with expectations of future rate reductions. Former President Luiz Inácio Lula da Silva is expected to win the presidential election on 30 October, with markets reacting positively.

With inflation coming under control, market sentiment is increasingly positive in Brazil, with expectations of future rate reductions.

Middle East: Rapidly growing financial hub

- Investors increasingly see opportunities in Saudi Arabia banking on the back of elevated oil prices, which are providing strong macroeconomic tailwinds for stronger spending and credit penetration.
- In conjunction with policy support, United Arab Emirates commercial property is becoming an attractive growth opportunity, with urbanisation projects and infrastructure investments.

Europe and UK equities

High inflation is squeezing both UK consumers & businesses

- Fears around the impact of rising inflation on consumer discretionary spend are weighing heavily on retailers, travel and leisure, home construction and other domestically focused companies. Companies that are unlikely to be immune from these pressures are being sold off.

UK volatility is presenting medium-term opportunities

- Volatility is occurring not only in cyclicals with earnings risk. There are many relatively defensive, low-beta companies that have also been significantly derated that managers are taking advantage of, such as defence companies and consumer credit-rating agencies.

Sterling weakness

- Large UK multinational consumer staples and energy companies are benefiting from the strong dollar and are also seen as better able to cope with a *stagflationary* environment.
- We have already seen several news bids for UK companies, and take-over activity is expected to accelerate, given the increasingly attractive exchange rates.

More pain to come for quality

- While the more cyclical and value areas of the European market remain attractively valued, the higher quality segment remains expensive despite degrading long-term visibility and shifting consumer demand.

Green capital expenditures remain a priority

- Recent market volatility is unlikely to disrupt the European focus on building out green infrastructure and increasing sustainable energy production. Managers believe fiscal policy will remain supportive of these industries.

> *We have already seen several news bids for UK companies, and take-over activity is expected to accelerate, given the increasingly attractive exchange rates.*

Global equities

Market volatility expected to persist

- Managers expect that global markets will remain volatile in the near-term, given ongoing geopolitical instability in Europe, inflationary concerns in the U.S. and slowing growth in China.

Increasing opportunities outside of the U.S. market

- Global managers see European equities as interesting, given low valuations from economic concerns and currency effects.
- Japanese equities continue to attract interest as corporate Japan remains awash in cash and these balances continue to build. Weakness in the Japanese yen and an ongoing focus on shareholder interests and corporate governance policies are creating additional reasons for support.
- Hesitation to invest in China persists, but significant declines in Chinese stocks are making way for a returned interest, particularly from value managers.

Negative earnings revisions are ahead

- Current estimates still reflect growth in 2023, but managers expect negative revisions, noting signs that cash flows have already slowed (working capital, accruals) ahead of expected earnings revisions. Rising rates and a slowing global economic backdrop are the primary drivers for this.

Investors seeking safety and downside protection

- As recessionary concerns persist, managers continue to look for returns in areas that can offer a hedge against inflation, along with downside protection. Many are expressing a preference for companies with pricing power, strong market share and little or no leverage.

Dollar strength has winners and losers

- Managers overweighting Europe have felt the performance headwinds of a weak euro but are expecting a reversal to become a tailwind for non-U.S. stocks in the future.

Japan equities

Mixed market views despite common recession fears

- Most managers have raised the probability of a recession scenario, due to ongoing Fed tightening as a result of persistent inflationary pressures. Some managers remain defensive, while others have started to accumulate higher beta stocks which underperformed significantly. The latter group expects a possible recession to lead to rates peaking out, and even a bear-market rally. There are differences in expectations regarding the timing of the Fed's pivot toward a less-hawkish monetary policy.

> *While the Bank of Japan maintained its monetary easing policy, an increasing number of investors are beginning to believe the current policy is not sustainable.*

Reopening names continue to attract investors

- Many managers maintained or further increased positions in reopening beneficiaries due to the continued normalisation of economic activities in Japan. A recovery in inbound tourism is also expected, due to the significant relaxations of entry restrictions.
- The relative attractiveness of domestic demand-driven stocks has increased, along with a concern over global economic weakness.

Growing interest in regional banks among value investors

- While the Bank of Japan maintained its monetary easing policy, an increasing number of investors are beginning to believe the current policy is not sustainable.
- Many managers believe governance of some regional banks has improved significantly, and that this could become a catalyst for valuation corrections in addition to a possible policy change.

Near-term concern over tech remains

- Some managers have shown interest in accumulating tech companies where valuations have become more attractive, given their underperformance.
- However, there is uncertainty on timing, given earnings deterioration could be worse than consensus expectations.

Long/short equity

Hedge funds increase trading activity, but maintain risk-off

- Hedge funds have been adding both alpha longs and shorts, while also increasing their use of macro products (exchange-traded funds and indexes) to protect against a broader market decline.
- Many managers remain in risk-off positioning. The average net leverage has dipped to two-plus year lows (the lowest since May 2020, according to Morgan Stanley Prime Brokerage).

Hedge funds continue to sell China and remain highly underweighted

- Hedge funds flipped to being net sellers of global equities in the third quarter, following two consecutive months of net buying, with short additions being the largest seen year-to-date.
- The selling was driven by Asia ex-Japan - mostly China – with small net selling activity taking place in Japan and Latin America.

Continued rotation into defensive longs

- Managers have continued to build long positions in more defensive sectors, such as consumer staples, healthcare and utilities, in order to further add downside protection.

Real assets equities

Global property

- Global property's continued underperformance versus global equity has moved to over 10%, annualised, for trailing three years. For the same period, U.S. listed real estate has underperformed both U.S. equities (the S&P500 Index) by 9.3%, and unlisted real estate (National Council of Real Estate Investment Fiduciaries (NCREIF) Fund Index – Open End Diversified Core Equity) by 13.5%. Those are significant differentials.
- On a forward earnings-multiples basis, global real estate is trading below global equity, and is also trading at a discount to private market values. The private market values are based on estimates of appraised value, which tend to utilise discounted case flows, which are typically conservative. Conversely, the listed market tends to value future earnings growth, and is pricing in a slowing economy or recession.
- Despite decent fundamentals in underlying property markets, private market values are expected to decline as higher borrowing costs are slowing transaction markets. Case-in-point: Green Street recently lowered its estimates of private real estate values in the U.S. - but even with those changes, the sector remains highly discounted.

On a forward earnings-multiples basis, global real estate is trading below global equity, and is also trading at a discount to private market values.

Infrastructure

- Listed infrastructure is defensive in nature due to its contractual-based concessions but wasn't immune to the turbulence in financial markets caused by higher interest rates and worrisome geopolitical issues. Towers and data centres – which are especially sensitive to changes in interest rates – underperformed, mainly due to long-term lease structures and slowing growth. However, they were strong performers earlier in the cycle, so this is partially a give back of prior performance.
- The U.S. utilities/renewables sector benefited from the recently passed Inflation Reduction Act, which includes positive measures for renewables development. Utilities benefit from wind, solar and storage tax credits that are expected to accelerate growth. This is because utilities are essentially able to earn a return on

their capital expenditures to pay for improved efficiencies, which can be accomplished faster than relying on customers to pay higher utility bills.

U.S. large cap equities

Earnings

- Investors remain relatively cautious heading into third-quarter earnings season, as the continued increase in interest rates and a stronger dollar are expected to start impacting corporate profitability. Some managers are beginning to see opportunities within consumer names, as they feel that those stocks are already discounting a recessionary scenario.

Fed response to inflation

- Opinions on the outlook for inflation are mixed, although many managers admit that the current inflation rate is higher than they would have anticipated earlier this year.
- There is broad agreement, however, that investors should take the Fed at its word and that the central bank will continue raising rates aggressively to stamp out inflation. Managers are overweight industries that benefit from higher rates (e.g., insurance) or can pass through increases (e.g., travel platforms).

Deglobalisation and reshoring

- While previously, efficiency and cost dominated all other considerations, there is now a heightened awareness of the inherent fragility of just-in-time delivery and the single-point-of-failure nature of some supply chains, notably within energy and semiconductors.
- Managers are seeing evidence of corporate capital spending decisions that are increasingly based on security of supply, with domestic investments favoured over those abroad and U.S.-based industrial and technology suppliers standing to benefit.

Quality within growth

- Growth managers are using the indiscriminate selloff within their investment universes to high-grade their portfolios, increasing positions in high-conviction companies with significant recurring revenue streams and durable competitive advantages.

> *After shifting toward more defensive areas in prior quarters, small cap equity managers are beginning to consider more cyclical opportunities.*

U.S. small cap equities

Small cap managers across the style spectrum becoming more constructive

- After shifting toward more defensive areas in prior quarters, small cap equity managers are beginning to consider more cyclical opportunities. Although most are still cautious, with a view of recessionary risks into 2023, managers acknowledge that valuations already reflect considerable downside risk - and that stock prices often move in advance of economic improvement.

Shift toward companies that cater to the high-end consumer

- As budgets for low-end and mass-market consumers become more constrained by inflation, spending by higher income consumers continues to be strong. Managers are emphasising travel and leisure stocks, retail and consumer durables companies that cater to the higher-end consumer.

Market-oriented managers are keeping a low-beta stance

- Market-orientated managers are adding to consumer staples and healthcare as they are expecting a challenging third-quarter earnings season. They believe most earnings estimates do not yet reflect interest-rate-driven slowdowns, foreign exchange and higher rates risks.

Increasing interest in healthcare and biotech

- Many managers are increasing exposure to the healthcare segment since it's less correlated to the economic cycle. However, most small cap investors are underweight biotech due to the complexity and speculative nature of investing in pre-revenue companies.

Growth managers see attractive valuations in high-growth software names

- Investors are becoming more constructive on the software space as valuations have compressed meaningfully since the third quarter of 2021.
- Managers are looking to emphasise software companies with more transparent revenue streams.

The bottom line

With inflationary pressures and recessionary fears remaining top-of-mind, equity managers see no short-term end to the bumpy ride in markets. Amid this anticipated backdrop of ongoing market turbulence, we believe the views of specialist managers will be critical to exploiting both volatility and opportunity. We look forward to continuing to share these insights with you as the year winds down.

QUESTIONS?

Call Russell Investments at +44 (0) 20 7024 6000

or visit russellinvestments.com.

ABOUT RUSSELL INVESTMENTS

Russell Investments is a global asset manager with a unique set of capabilities that we believe is essential to managing your total portfolio and to meeting your desired outcome. At Russell Investments, we stand with you, whether you're an institutional investor, a financial adviser, or an individual guided by an adviser's personalised advice. We believe the best way to reach your desired outcomes is with a multi-asset approach that combines: asset allocation, capital markets insights, factor exposures, manager research and portfolio implementation.