RUSSELL INVESTMENTS

Global squeeze play.

2015 Annual Global Outlook

Investors face divergent central bank policies and differential growth rates across the globe through 2015, all but guaranteeing the need for another year of living actively.

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Outlook 2015: Another year of living actively

Central banks are moving in different directions, equity market valuations vary by region and there are different scenarios for the macro outlook. We believe good returns can still be achieved, but investors will need to be alert to changes in the outlook.

CONTENTS

INTRODUCTION

By **Jeff Hussey**
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We talked about 2014 as being a year of validation for the big equity market returns of 2013. We got that and more as robust growth in global corporate profits generated healthy returns for equities (in local currency terms) in most regions and across credit markets. Strong returns from government bonds were the main surprise as long-term yields across developed markets declined from already low levels.

It feels, however, that 2014 was a year of reprieve from our inevitable low-return future. Bond yields are likely unsustainably low, credit spreads are unlikely to narrow further and equity market valuations, at least in the United States, are stretched. The bar for generating returns is rising each year.

We're not pessimistic, but at this late stage in the cycle it's important to be realistic about return potential. In fact, we're relatively optimistic about economic growth in 2015. Our global team of investment strategists has been talking about the square-root shaped recovery for the global economy since 2009; one in which the initial growth rebound is followed by a prolonged period of modest growth as the imbalances are slowly worked through. This insight has guided us well and we expect this process to continue in 2015, with stronger growth in all the major developed economies.

The United States is further down the road in this recovery process than other economies and this is where the main tensions over the 2015 outlook lie. How much will the U.S. Federal Reserve (the Fed) need to tighten and what will be the impact on central banks in Japan and Europe moving in the opposite direction? We expect it to turn out smoothly, with the Fed moving gradually and with clear communication. However, markets could be spooked if inflation pressures emerge and force more aggressive Fed action, or if Europe and Japan fail to respond to more stimulus.

Russell's investment strategists have a clearly defined process that is based on the building blocks of cycle, value and sentiment. This process has helped us maintain a positive outlook for risk assets (such as equities and credit) even as valuations have become less attractive. Our starting point for 2015 is a modest preference for equities and credit over government bonds. Within equities, Europe ranks ahead of Japan and the United States. We like the value in emerging markets but the uncertainty over their growth outlook keep us on the sidelines. Even though we were wary of rising long-term interest rates, one of the important lessons of 2014 was in maintaining diversification across a full range of asset classes.

Similarly, 2015 looks to be a year when active investment choices will matter, especially given divergent central bank policies and differential growth rates across the globe. In particular, it should be a year that suits the use of actively managed globally diversified, multi-asset strategies. In this low-return world, a wide source of opportunities and a nimble process will be crucial when navigating the investment landscape in the year ahead.

Investment Outlook: It's still a central banker's world

Fed and Bank of England (BoE) tightening – contrasted to more easing from the European Central Bank (ECB) and Bank of Japan (BoJ) – define the outlook. We expect moderate equity returns and small rises in long-term fixed income interest rates.

Expectations for 2015:

- Global equities to modestly outperform fixed income and cash through 2015.
- Europe to outperform other major regional equity markets. Japan and the U.S. in line with global equities. Emerging markets (EM) to underperform.
- U.S. Gross Domestic Product (GDP) growth of 3.0% over 2015.
- U.S. payroll gains that average 200,000 per month.
- U.S. core inflation of just 2.0%.
- U.S. Federal Reserve to commence gradual tightening process in mid- 2015.
- U.S. 10-year Treasury yield at 3.0% by the end of 2015.
- Year-end 2015 target for the U.S. large-cap Russell 1000® Index is 1,200 (and 2,150 for the S&P 500®).

Key question: How much economic slack is in the U.S.?

Investors have spent the past five years obsessed with the central bankers, as they have lowered interest rates to zero and implemented historically unorthodox policies like quantitative easing (QE) and forward guidance. The 2015 outlook is again dominated by central banks. The difference, however, is that in 2015 we are likely to see the major central banks head in different directions. The Fed and the Bank of England (BoE) are expected to take the first steps towards interest rate normalisation. Simultaneously, we anticipate the European Central Bank (ECB) and the Bank of Japan (BoJ) will move deeper into unorthodox territory.

The pivotal question about our investment outlook centers on the United States: How much spare capacity in the economy remains now that the unemployment rate is below 6%? This will determine the amount of wage and inflation pressure and it also likely will drive the timing and amount of Fed tightening. In addition, it will play a large role in the outlook for corporate profits as subdued wage growth has, until now (as of mid-December 2014), allowed profit margins to expand and profits to grow at a much faster pace than the overall economy.

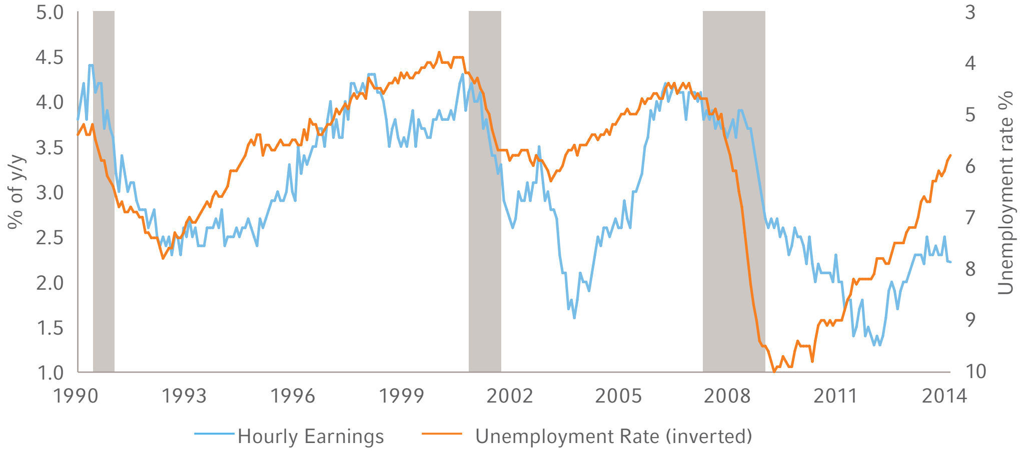
The chart on page 4 shows that, over the past 12 months, U.S. wage growth has tracked sideways at around 2.25% per annum. Over the same period, the unemployment rate has fallen from over 7% to under 6%. The unusual feature we note here is the downward trend in the labour market participation rate. The 62.7% reading in September 2014 marked this indicator's lowest level since 1978.

The key indicator to watch will be hourly earnings in the monthly U.S. employment report. This may provide the first evidence that labour market conditions are tightening enough to hurt margins, push up inflation and make the Fed more hawkish. Conversely, subdued wage growth will be evidence that our favoured scenario is on track.

Normally, strong jobs growth encourages previously discouraged job seekers back into the labour market, which slows the decline in the unemployment rate. This time, it seems that a lot of baby boomers have given up looking for work and have taken early retirement. This puts a different perspective on the unemployment numbers. We know that the unemployment rate peaked at 10% in late 2009 and it has since declined by 4.2 percentage points. Of this, however, 3.1 percentage points are due to the decline in the participation rate. Only 1.1 percentage points are due to employment gains.

US: Private hourly earnings & unemployment rate

GRAY BARS INDICATE PERIODS OF RECESSION



Source: Datastream, NBER

The Business Cycle Index model predicts, as of November 30, 2014, that 200,000 jobs per month will be created over the next year. At an unchanged participation rate, this will take the unemployment rate to 5.1% by the end of 2015. The participation rate has declined by 0.2 percentage points over the past 12 months. A similar fall in 2015 would take the unemployment rate to 4.8%. It's hard to imagine that wages won't be rising strongly if this happens.

Our favoured outlook scenario is a continuation of the theme that we saw during 2014: single-digit profit growth, further gradual declines in unemployment (with the participation rate starting to rise) and a Fed that acts gradually and with clear communication. In other words, there are still enough spare workers to stop wages from rising quickly, allowing firms to maintain profit margins. In this scenario, equities increase in line with profit growth, 10-year Treasury bond yields rise toward 3.0% and credit performs well amid a backdrop of low default rates and subdued volatility.

The bearish scenario is that labour participation continues to fall and wage pressures build as employers compete for increasingly scarce workers. Profit margins get squeezed by rising labour costs, which puts downward pressure on equity prices. The Fed becomes more aggressive – or investors worry that it will – and 10-year Treasury yields rise beyond 3.5%. In the bearish scenario, volatility spikes higher and credit underperforms.

The key indicator to watch will be hourly earnings in the monthly employment report. This will provide us with the first evidence that labour market conditions are tightening enough to hurt margins, push up inflation and make the Fed more hawkish. Conversely, subdued wage growth will be evidence that our favoured scenario is on track.

Within an overall modest pro-equity bias, there's not a lot to choose from between regions and the ECB stimulus package puts Europe just ahead of the other regions.

Value, cycle, sentiment

Our investment strategy process focuses on three building blocks: Valuation, the business cycle and investor sentiment. Applying this to global developed equities, we see:

Valuation: The U.S. is the most expensive major equity market with a price-to-book value at 2.8 times and a cyclically adjusted price-to-earnings (P/E) ratio at 21 times.[1] We score Japanese equities as slightly expensive and European equities as neutral value.

Business Cycle: This is moderately positive. U.S. economic growth is robust and profits are growing at a moderate pace. Japan is showing tentative signs of recovery from the consumption-tax induced downturn and likely will benefit from more quantitative easing (QE) as well as the delay of next year's consumption tax increase. Europe's growth indicators are mixed, but the ECB is promising aggressive stimulus and corporate profits are recovering.

Sentiment: Momentum is still a positive driver of equity markets, however some of our signals are in overbought territory following the strong rebound from the October 2014 pull-back. The U.S. in particular looks overbought on a range of short and medium-term indicators. These include some technical indicators, measures of investor sentiment and positioning indicators that suggest investors are crowded into bullish trades.

Conclusion: The cycle and sentiment scores matter the most in the near-term tactical time frame and these broadly cancel each other out. This means we have a near-term neutral tactical view. Our dynamic (one-year) view is more positive. Sentiment matters less in the dynamic time frame in which the cycle and value considerations have larger weights. Overall, our positive view on the cycle makes us moderately positive on the medium-term outlook. However, the different views on valuation give us a preference for Europe over the United States and Japan.

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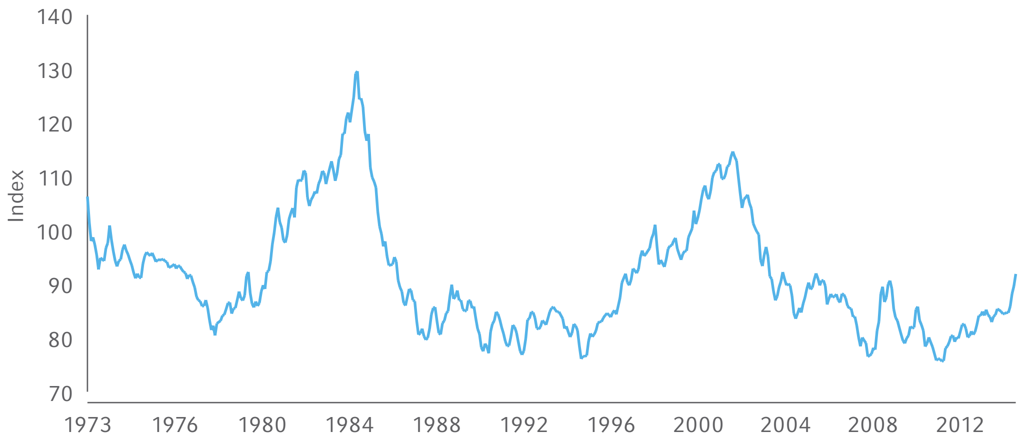
Cautious on emerging market equities

Value is attractive for emerging markets. As of November 30, 2014, the forward P/E ratio was just 11 times and the sector was at its biggest price-to-book value discount relative to developed markets in 10 years.[2] It's the cycle that keeps us cautious. China is slowing, commodity prices are falling and the rising U.S. dollar (USD) is putting financing pressure on current-account-deficit countries like Brazil and Turkey. A larger monetary and fiscal stimulus program in China and evidence that the EM currency adjustment is complete would make us more positive. Until then, we will remain cautious on EM equities, but with an eye on the longer-term value opportunity.

Real trade-weighted USD against the major currencies



Source: U.S. Federal Reserve

[1] As measured by the Russell 1000 Index.

[2] As measured by the Russell Emerging Markets Index and Russell Developed Index.

Currency: It's hard to be bearish USD

Strong USD in 2015 is a widely held view by industry analysts. It's hard not to see the logic with the Fed preparing the ground for rate hikes next year and the ECB and BoJ looking at ways to extend QE. This view (as of November 30, 2014) already has driven the USD up by 8% since July in real trade weighted terms against the major currencies.

However, we believe it's important not to get too carried away with the bullish dollar theme. Aside from it being a consensus call among industry analysts (remember that 2014's big consensus call was rising long-term interest rates), the yen is already at 45-year lows in real trade-weighted terms and the eurozone has a large and growing current account surplus. More USD strength is possible against the major currencies, but it's likely that the major gains have already been made.

Real Assets: A mixed outlook

In our view listed infrastructure looks best as its value is neutral and demand for infrastructure is growing. Value is a little less attractive for real estate investment trusts and they are more exposed to rising interest rates than listed infrastructure. Commodities in general still look expensive after the bull market super-cycle. New supply is coming onboard in many sectors and the weakness in China diminishes the main source of commodity demand. It's still too early to get positive on commodities.

A year of Fed watching ahead

The key question for 2015 is the amount of spare capacity in the U.S. economy. This will determine the amount of inflation pressure, the extent of Fed tightening, profit margins and long-term interest rates. Our models tell us to expect only moderate inflation pressures and moderate Fed tightening, which is consistent with expectations for moderate equity returns and a small rise in long-term interest rates. Europe offers potentially more upside, while the outlook for real assets is mixed. The USD has more upside, but we believe most of the gains have already been made. ■

United States: Will the dog wag the global economic tail in 2015?

The U.S. economy is transitioning from one backstopped by accommodative monetary policy to one supported by steady economic growth. With markets attempting to address this change, we anticipate some volatility amid mid- to upper-single-digit equity market gains amid rising Treasury yields.

As the United States goes, so goes the globe?

It seemed anything but data from the United States was driving global capital markets as we moved through the start of the fourth quarter of 2014. A seemingly technically driven pullback occurred early in the quarter as the U.S. large-cap Russell 1000® Index lost 7.1% from September 18 through October 15. Observers pointed to, weaker than forecast, macro-economic data outside the U.S. as the rationale for the pullback.

The quick rebound, however, demonstrated that what is happening in late 2014 in the United States is driving global capital markets. The Russell 1000 regained its previous highs by the end of October and then reset to higher levels. The health of the U.S. economy has proven to be the buffer for global capital markets as we await the impact of expansionary monetary policy from the ECB, BOJ and other central banks.

The success and robustness of the U.S. economy will likely set the tone for global capital markets in 2015.

The U.S. economy's role as the dog wagging the global economic tail likely will continue, with the robustness of the U.S. economy allowing it to buffer any global economic shocks. Russell's global strategy team laid out our two main scenarios for the U.S. market in 2015, and our central scenario has moderate growth married with a benign inflation environment as the Federal Open Market Committee (FOMC) transitions from quantitative easing to actual rate rises.

FOMC's path forward will be navigated by data

As we mentioned a quarter ago, the FOMC has communicated that its course of action will be data driven. This has the benefit of the Fed being able to tailor its policy in line with the pace of economic recovery. It also causes potential volatility from the lack of certainty around the pace, timing and amounts of its actions. This continues to leave Fed chair Janet Yellen's labour dashboard as one of the most important watch points.

Yellen's labour market dashboard

DASHBOARD METRIC	CURRENT	2004-2007 PRE-RECESSION AVG.
Unemployment	5.8%	5.0%
Nonfarm payrolls	321,000 (258,000 6 month average)	162,000
Labour participation rate	62.7%	66.1%
U-6 Underemployment	11.4%	8.8%
Long-term unemployment	30.7%	19.1%
Layoffs rate	1.2%	1.4%
Job openings rate	3.3%	3.0%
Quits rate	2.0%	2.1%

Source: Bureau of Labour Statistics as of 5 December 2014

Our expectations for 2015 include:

- An initial movement of the targeted Fed funds rate at the end of the second quarter of 2015.
- The market is anticipating a more dovish and therefore slower pace, than the FOMC may eventually pursue.
- In its November 19, 2014, meeting minutes, the FOMC discussed potentially moving away from the current disaggregated "dot plot"[3] forecasts to a single aggregated forecast. If adopted, this would improve transparency, aid the market to correctly handicap FOMC policy action and potentially mitigate some volatility.

Watch points for the central scenario

A few of the key areas to monitor through 2015 include:

- Consumer Price Index (CPI) and wage inflation: These will either afford the Fed the latitude to err on the side of conservatism or force their hand with respect to pace, timing and size of the coming targeted funds rate moves.
- Impact of a strengthening U.S. dollar (USD) on earnings: This seemed to have only a small impact and was well-navigated in the most recent quarter, but the costs of a strong dollar will likely linger as a concern through the first few quarters of 2015.
- Oil and energy prices: Should they remain low, this will continue to be a tailwind for the U.S. consumer.

Conclusion

Placing our forecasts in the now familiar cycle, valuation and sentiment building blocks of our investment process, we continue to favour a modest overweight to equities relative to fixed income. The underweight position in fixed income is our highest conviction position in the United States. We look to diversify our equity positioning globally with continental European equities near the top of our non-U.S developed alternatives, though this positioning would be at a lower preference for anything other than a fully hedged exposure.

The underweight position in fixed income is our highest conviction position in the United States.

Business Cycle: Stemming from the Business Cycle Index (BCI) forecasts we continue to see a U.S. economy that is robust relative to recession risks and likely to continue to produce healthy non-farm payroll gains amid a slowly increasing inflationary environment in 2015.

Our modelling for 2015 forecasts the following:

- Average Real GDP: 3.0%
- Core CPI: 2.0%
- Average nonfarm payrolls: 200,000 monthly

Valuation: The U.S. equity market is expensive with a price-to-book value of 2.8 times and a cyclically adjusted P/E ratio of 21 times.[4] It only shows value in comparison to 10-year Treasury bond yields that in our opinion are unsustainably low.

Sentiment: Many of our indicators moved into overbought territory in mid-November 2014, following the market rebound. These include technical indicators, measures of investor sentiment and positioning indicators that suggest investors are crowded into bullish trades.

Conclusion: We have a preference for equity relative to fixed income, while maintaining modest equity preferences in a well diversified multi-asset portfolio. Our highest conviction position is an underweight to U.S. Aggregate Fixed Income in the rising rate environment that never materialised in 2014. For those investors that can be nimble, we believe there will be opportunities created by the volatility induced from the market's attempts to anticipate monetary policy action. ■

[3] Dot plots are the summary forecasts of target rate levels by each of the FOMC members, accompanied by GDP and inflation forecasts. They are anonymous.

[4] As measured by the Russell 1000 Index as of November 30, 2014.

The eurozone: Focus on the tailwinds

Reflationary forces are gathering strength and operational leverage is propelling corporate earnings higher. That means investors have the opportunity to buy into a relatively cheap market with positive earnings momentum – plus a powerful tailwind from monetary policy. As such, eurozone assets are a high conviction overweight.

Tailwinds

All through 2014 we have talked about the importance of the battle between deflationary and reflationary forces in the eurozone. Only when reflationary forces decisively had the upper hand in the third quarter did we feel comfortable suggesting a preference to clients to buy into eurozone financial markets. Looking ahead to 2015, we are so positive that the combination of growth factors and policy prescriptions will work to strengthen reflation that we are increasing our recommended overweight.

This might seem like an odd stance given the fact that inflation is currently very low and growth momentum has been very weak lately. That, however, is the view through the rear-view mirror. Looking ahead, there are several tailwinds we want to highlight:

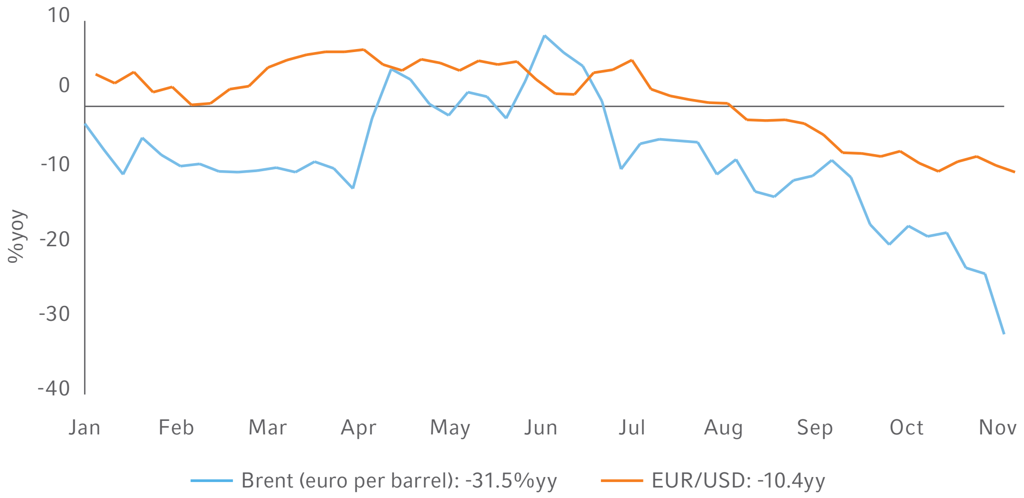
- **Valuation**: Euro-zone financial assets are relatively cheap, especially versus U.S. assets. With a dividend yield of 3.5%, a forward price-to-earnings ratio of 13.8 and a price-to-book ratio of 1.5 it compares well to the U.S. where indicators are, respectively 2%, 16.5 and 2.8.[5]
- **Corporate earnings growth**: Euro-zone corporate earnings-per-share (EPS) growth is already healthy at 6.5% in 2014.[4] We expect that, through the power of operational leverage, 8% to 12% EPS growth in 2015 is likely. The key here is the fact that euro-zone profit margins are still far below their historical average. A small increase in profit margins and revenues likely will boost earnings significantly, something that is almost impossible in the U.S. where margins stand at all-time highs.
- **Lower euro**: Euro-zone growth and corporate earnings are positively impacted by the fall in the euro versus the U.S. dollar. This supports exports and foreign earnings, which constitute about half of total earnings. Incidentally, a weaker euro will also push up inflation.
- **Lower oil price**: Euro-zone growth and disposable income is supported by a fall in the price of oil. As a net importer of energy, the fall in the oil price acts as a tax cut. Of course it will also push down inflation, but for the right reason.
- **Fiscal & monetary policy**: Euro-zone monetary and fiscal policy in our view will remain favourable and are likely to be ramped up. On the fiscal side the stimulus will arguably be modest, but the direction is clear and investors are planning accordingly. With respect to monetary policy there is more in store. European Central Bank President Mario Draghi is very dovish and looks committed to preventing an unwanted tightening, which he describes as a rise in the real interest rate as a result of falling inflation expectations. At worst, Draghi will provide downside protection for financial markets, at best he implements a new round of quantitative easing.

Euro-zone profit margins are still far below the historical average. A small increase in profit margins and revenues will boost earnings significantly, something that is almost impossible in the U.S., where margins stand at all-time highs.

[5] Euro-zone market as measured by the Russell Eurozone Index U.S. market as measured by the Russell 1000 Index. Both as of November 30, 2014.

› **Credit growth**: Eurozone credit growth is showing tentative signs of life. With the asset quality review (AQR) and stress tests out of the way, banks are unburdened and can get back to business. The ECB's Senior Loan Survey continues to show improved supply and demand for credit and money growth is picking up.

Brent oil price in euro & EUR/USD exchange rate



Source: Thomson Reuters Datastream, 05/12/2014

Of course, all of these tailwinds do not mean that the eurozone is out of the woods. There is still a real risk that the mediocre recovery falters or political developments cause an upheaval. However, we feel that those risks will be amply rewarded, which is not to say that we won't continue to monitor our watchpoints:

› **The 5y5y forward inflation swap**.[6] We don't want to see inflation expectations as discounted by this measure decisively fall below 1.8%;

› **The 10-year German Bund yield combined with the average spread of Italian and Spanish government bund yields over their German counterparts**. We don't want to see the Bond yield fall much below 0.8% if at the same time the Italian and Spanish spreads rise above 1.75%.

› **Credit growth**. To keep the recovery on track, we need credit growth to turn positive over the next six months.

Euro-zone growth and disposable income are supported by a fall in the price of oil. As a net importer of energy, the fall in the oil price acts as a tax cut.

Strategy outlook:

› **Valuation**: Euro-zone equities are neutrally valued in an absolute sense. But they are cheap relative to the U.S. market consensus earnings expectations for 2015 are currently 16%.[7] Though not impossible, this target still looks a tad high. We expect 8% to 12% growth.

› **Business cycle**: We maintain our positive outlook for the Euro-zone business cycle, given the tailwinds mentioned above. We expect GDP growth of 1% to 1.5% in 2015.

› **Sentiment**: Price momentum is positive and, although short-term sentiment has run up quite a bit, we maintain a positive score.

› **Conclusion**: We will increase our overweight position for the eurozone from small to average.

[6] 5y5y is an inflation swap beginning in five years for a duration of five years.

[7] Euro-zone market as measured by the Russell Eurozone Index U.S. market as measured by the Russell 1000 Index. Both as of November 30, 2014.

Asia-Pacific: Thumbs up from equity markets

For 2015 we expect "more of the same" from the Asia-Pacific region. That is, we see economic growth that is just good enough to underpin financial markets over the year ahead, against a backdrop of accommodative monetary policy.

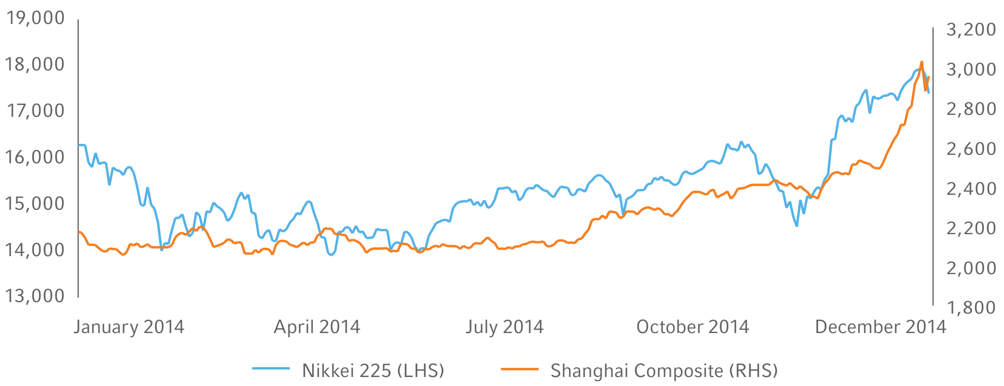
Economic developments in the Asia-Pacific region in 2014 have been somewhat idiosyncratic. Major countries in the region have been running their own race with relatively little correlation with each other or the U.S. and euro-zone economies. We expect this experience to continue through 2015. Our view is that the Chinese, Australian and New Zealand economies will slow, but in a controlled fashion and that recovery will strengthen somewhat in Japan. India is performing well, although market expectations are demanding. Inflation is not a constraint to policy-makers in the region and monetary policy in our view will remain stimulatory or at least supportive.

Overall, at the end of 2014, equity markets are reacting positively to this state of affairs and are exhibiting a willingness to treat any "bad news" as "good news" in the sense that negatives should encourage central bankers to provide further stimulus.

While our own central case is similarly positive, we would be cautious about uncritically chasing markets higher. There remains a risk that growth concerns re-emerge as a brake on equity market performance in 2015.

Our view is that the Chinese, Australian and New Zealand economies will slow, but in a controlled fashion and that recovery will strengthen somewhat in Japan.

Index returns for China and Japan in 2014



Japan's Nikkei 225 Stock Average is a price-weighted index comprised of Japan's top 225 companies on the Tokyo Stock Exchange.

The Shanghai Composite Index tracks the biggest and most important public companies in China.

Japan

We are optimistic that the insipid and patchy improvements to the Japanese economy that characterised 2014 will gradually broaden and strengthen through 2015.

Our positive view is based on:

- Extremely stimulatory monetary policy
- Support from a weaker yen and weaker oil prices
- Commitment to reform under the umbrella of "Abenomics"

We would also note, however, that the actual growth in Japanese real GDP is still languishing, on the basis of the reported data as of November 30, 2014, at around -1.0% year-on-year. The hard work of recovery still lies in the future and we see ongoing structural imbalances related to demographics and debt as potential threats to our optimistic view.

China

The Chinese economy continues to deliver convincing GDP growth in the 7.0% to 7.5% range. At the same time, policymakers are looking to execute a structural reform agenda and to manage excesses in some sectors of the economy. This balancing act has held together over the past 12 months and we believe that further GDP slowing in 2015 will take the growth rate to about 7.0%.

In the wake of an extended period of rising housing prices and of debt expansion, the risks for China are now elevated as the trend in housing prices turns down. However, with scope for constructive contributions from monetary and exchange rate policy, together with reasonable although volatile export growth, we believe the Chinese economy should be able to negotiate these headwinds.

Australasia

Australia and New Zealand delivered impressive economic outcomes through the years of northern hemisphere crisis, but are now facing their own challenges, in turn, as a range of relevant commodity prices turn decisively down.

For Australia in particular, our fear is that the housing cycle will swing from "up" in 2014 to "down" as 2015 unfolds, and will reinforce the contractionary effects of a resources boom turned to bust. However, given support from a sharply weaker Australian dollar, and with the corporate sector in good shape, we foresee a slowdown from real growth of around 3% in 2014, to about 2% or thereabouts in 2015. The risk of full-blown recession is in our view low.

New Zealand is tracing out a more even course and, whilst we believe that the economy will slow a little in 2015, real GDP growth is unlikely to drop much below 3%. Further official rate rises are in our view on hold for the time being, and New Zealand bond yields offer attractive premiums over both US and Australian bonds. Despite this relatively benign outlook, downward pressure on prices right across the commodity spectrum is likely to persist in 2015. We expect the New Zealand dollar to trend lower in the year ahead, partly as a result of that commodity weakness. Other factors supporting this currency view are the fact that US growth will likely overtake NZ growth; the overvaluation currently priced into the New Zealand dollar; and a persistent backdrop of US Dollar strength.

For 2015 as a whole, we see Asia-Pacific equities performing in line with global peers and modestly outperforming both bonds and cash, albeit with heightened volatility.

Markets

Applying our investment strategy process – based on the building blocks of valuation, business cycle and sentiment – to Asia-Pacific regional equities, we diagnose the outlook for 2015 as follows:

› **Valuation**: The strength in regional markets is causing valuations to become more elevated, particularly as equity market enthusiasm runs ahead of the fundamentals in markets such as Japan and India and, to a lesser extent, China. Australian equities have shed their premium to the rest of the world and are starting to find yield support.

› **Business cycle**: We rate the business cycle, ex-Australia, as positive. However, the composition of that positive rating, particularly in Japan, is skewed very heavily towards stimulatory monetary conditions. Hard evidence of recovery can be found, but is quite sketchy in nature. Cyclical conditions in Australia in 2015 likely will be downbeat.

› **Sentiment**: Sentiment in the major regional markets, perhaps with the exception of Australia, is upbeat, but prone to disappointment in the short term.

› **Conclusion**: Our view is that regional equities have run ahead of the fundamentals and may struggle to hold their gains over the next few months. For 2015 as a whole, we see Asia-Pacific equities performing in line with global peers and modestly outperforming both bonds and cash, albeit with heightened volatility.

Quantitative Modelling Insights: Valuations and interest rates are key watch points in 2015

In 2015, we expect the risk-return trade-off globally to moderately favour equities over fixed income. Our model suggests a U.S. Federal Reserve rate hike earlier than the widely held industry view of a September move.

Risk-return trade-off and valuation predictions

Russell's suite of proprietary quantitative models forecast that:

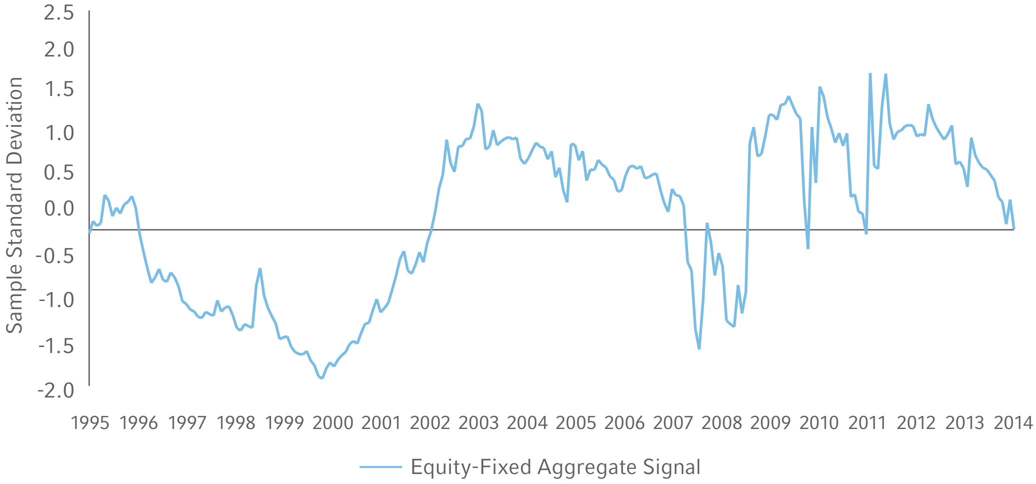
- Equity globally will moderately outperform fixed income.
- The business cycle, using the Business Cycle Index (BCI), will be relatively robust in the coming year.
- U.S. GDP growth will accelerate to 3% in 2015.

Globally, our equity over fixed income signal shows that, in 2015, we can expect mid to high single-digit growth in equities. In 2014, we saw moderately higher volatility and lower returns than in 2013 and the stage looks set for a similar story in 2015. This signal is mainly driven by momentum, which favours U.S. equities on a 12-month horizon. Also, the signal is modestly positive from our dividend discount model which looks at discounted future cash flows.

Our financial and economic signals favour equities over fixed income in 2015

Our macro forecasting model and our mean reversion signal however, are neutral to slightly in favour of fixed income over equity. A key input into our models involves valuation measures. If these become too stretched, our models will move from neutral to negative.

Equity-fixed aggregate signal

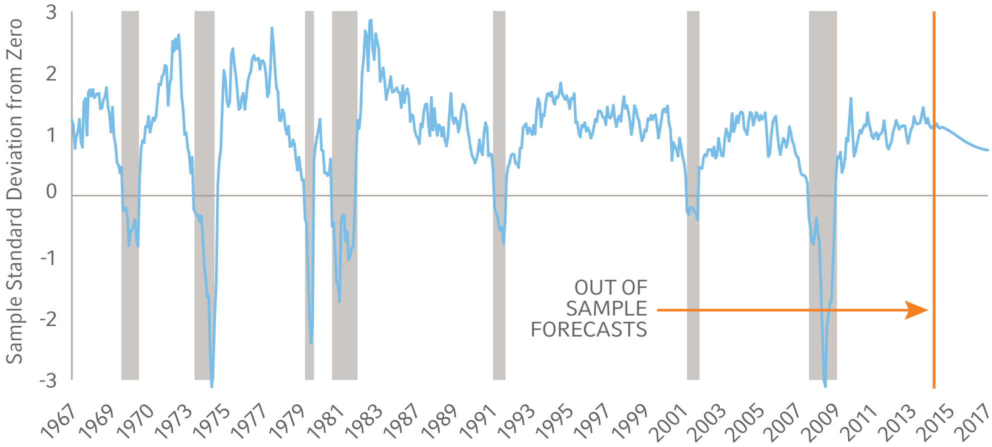


Source: Russell Investments

The U.S. Business Cycle Index (BCI) signals a low risk of recession and is consistent with a 3.0% GDP growth forecast for 2015. The BCI incorporates inflation, consumption growth, employment growth, the U.S. corporate credit spread and the U.S. Treasury yield curve to diagnose the overall health of the U.S. economy.

U.S. business cycle index

GRAY BARS INDICATE PERIODS OF RECESSION



Source: Recession dates from National Bureau of Economic Research.

Out of sample forecasts were calculated by simulating the timeseries model into the future. The value shown is the median of the simulated value for the month.

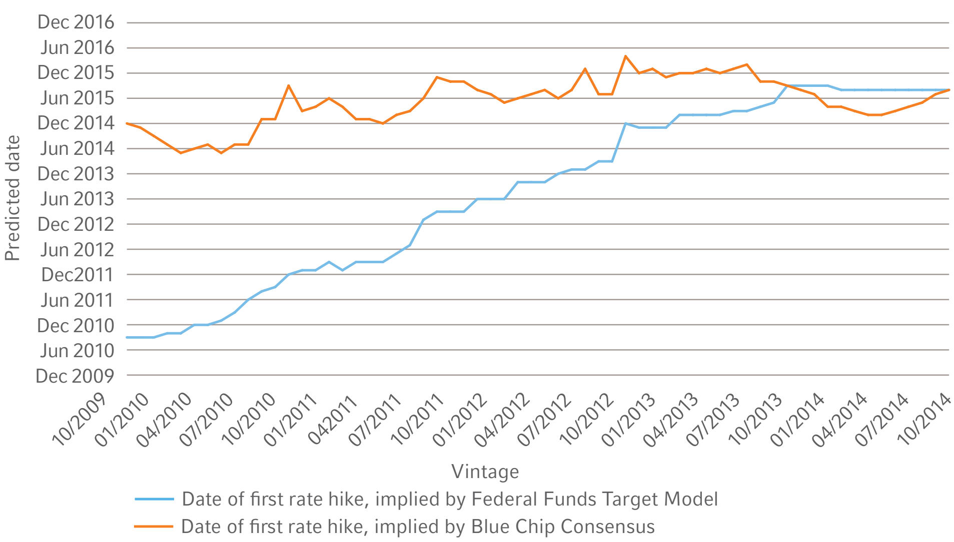
Source: Russell Investments

Rate hike predictions and rate sensitive assets

Our Fed funds target rate model predicts a rate hike in mid-2015. This is a probabilistic ("Dynamic Probit") model that incorporates factors such as inflation, unemployment, and the BCI. The chart compares Russell's model and Blue Chip[8] Consensus' historical predictions of when the Fed will first raise the Federal Funds Target Rate. Since 2010, our model has consistently predicted a first tightening in 2015 and the consensus has moved toward our view.

> We expect a likely Fed Funds target rate rise in mid-2015. Both the timing and the pace will be important factors to keep an eye on.

Vintage predictions for date of first Fed funds rate hike



Source: Russell Investments

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

Quantitative Model Summary

While our models favour equities over fixed income in 2015, key watch points that we are monitoring include valuations and interest rates. Any loss of momentum on either front would constitute a potential red flag. ■

IMPORTANT INFORMATION

The views in this Annual Outlook are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

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.

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.

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

The Business Cycle Index (BCI) forecasts the strength of economic expansion or recession in the coming months, along with forecasts for other prominent economic measures. Inputs to the model include non-farm payroll, core inflation (without food and energy), the slope of the yield curve and the yield spreads between Aaa and Baa corporate bonds and between commercial paper and Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts.

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 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 Emerging Markets Index measures the performance of the world’s largest investable emerging markets securities, based on market capitalisation.

The Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure.

The Barclays U.S. Aggregate Bond Index is an index, with income reinvested, generally representative of intermediate-term government bonds, investment-grade corporate debt securities and mortgage-backed securities.

The S&P 500, or the Standard & Poor’s 500, is a stock market index based on the market capitalisations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The trademarks, service marks and copyrights related to the Russell Indexes and other materials as noted are the property of their respective owners. The Russell logo is a trademark and service mark of Russell Investments.

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