

RUSSELL INVESTMENTS

Momentum versus asymmetry

2017 Global Market Outlook — Q4 update

A benign economic environment can see markets trend higher. We capture this momentum in the “sentiment” part of our cycle, value and sentiment (CVS) investment decision-making process. Our equity cycle scores are mostly neutral to slightly positive. It’s the “value” part of our process that creates asymmetry concerns.

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EXECUTIVE SUMMARY

BY ANDREW PEASE

The monetary policy tide is heading out, putting upward pressure on government bond yields. Momentum can drive equity markets higher, but we believe extremely stretched U.S. equity valuation makes the market vulnerable to any unwelcome news.

Turning tides

The great tide of global monetary policy support that started nearly a decade ago is now receding. The Federal Reserve (Fed) is starting the slow process of balance sheet reduction and is on a gradual path to raise the federal funds rate, the European Central Bank is poised to start tapering its asset purchases in 2018 and the Bank of England has hinted at a rate rise in November. Only the Bank of Japan stands resolute in its commitment to ultra-expansionary monetary policy.

The implication is that the period of declining long-term interest rates is over. Yields, of course, can rally on softer economic news, but the lows have been seen for this cycle and the slow path to normalisation is underway.

Our cycle, value and sentiment (CVS) investment decision-making process has us broadly neutral global equities. We're underweight U.S. equities because of expensive valuation. Positive cycle views and relatively better valuation give us small overweight positions to Europe, Japan and emerging markets within global equities.

Paul Eitelman sees a mediocre U.S. economy and corporate earnings supported by strength in the rest of the world. Contrary to the industry consensus, he thinks the Fed will remain on hold in December, but he also expects a more aggressive Fed in 2018.

In Europe, **Wouter Sturkenboom** sees the tailwinds of robust growth and favourable politics outweighing the headwinds from the rising euro. Equity market valuation is reasonable, in contrast to the U.S. This underpins our relative preference for Europe.

Graham Harman and **Alex Cousley** are becoming more constructive on the Asia-Pacific region. China's National Congress in October should provide further progress on the tricky task of combining structural reform and deleveraging with ongoing economic growth. The outlook for Japan is firming with gross domestic product (GDP) surprising to the upside, and Australia's economy is improving. The main note of caution comes from the tensions around North Korea.

Van Luu thinks euro bullishness is a crowded trade and could stall the rally near-term. He sees more euro upside in 2018 but is skeptical that the British pound's strength can be maintained and thinks the Japanese yen will stay under downward pressure.

The U.S. business cycle index model estimated by **Kara Ng** and **Abe Robison** points to rising recession probabilities. We'd expect such after a long economic expansion, though in our view the model's predicted probabilities are not yet at alarming levels. It is, however, a note of caution, and we will monitor this model closely over coming quarters. ■

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Investment strategy outlook

Moderate growth, low inflation and easy monetary policy appear to provide a positive backdrop for investment portfolios as we look toward the fourth quarter of 2017. We still want to buy dips and sell rallies. Expensive U.S. equity valuation remains our main concern. Cyclical forces are moving in favour of higher government bond yields. We believe the euro has upside and that the U.S. dollar's (USD) downtrend should be arrested by early 2018.

Momentum versus asymmetry

Developed economies are in the “sweet spot” of moderately above-trend growth, continuing low inflation and easy monetary policy — or in the case of the U.S. Federal Reserve (the Fed), very gradual tightening. It's a supportive environment for just about every part of a portfolio. Over the third quarter of 2017, equity markets have drifted higher globally, corporate credit and real assets have gained and government bonds have rallied.

Two words that keep recurring in our strategist team discussions are “momentum” and “asymmetry.” A benign economic environment can see markets trend higher. We capture this in the “sentiment” part of our cycle, value and sentiment (CVS) investment decision-making process. Our equity cycle scores are mostly neutral to slightly positive.

It's the “value” part of our process that creates asymmetry concerns. U.S. equities are extremely expensive, making the market vulnerable to any news that upsets the industry consensus on moderate growth, low inflation and low interest rates.

The two big risks in our view are either a recession scare or an inflation scare that sends interest rate expectations significantly higher. Both seem unlikely in the near term, although we believe fixed income markets seem to be underestimating the potential for U.S. inflation pressures and Fed rate hikes in 2018.

Another worry is the potential for a sharp spike in volatility. The low level of the CBOE Volatility Index® (VIX Index) underlines the degree of investor complacency. The issues that could cause a volatility spike are hard to predict, but an obvious current candidate is the tension around North Korea.

Our CVS process has us broadly neutral global equities. We're underweight U.S. equities because of expensive valuation. Positive cycle views and relatively better valuation give us small overweight positions to Europe, Japan and emerging markets within global equities.

Within fixed income, we like local currency emerging markets debt from both a value and cycle perspective. We're slightly underweight high-yield credit because of expensive valuation against a broadly neutral cycle outlook. We're also slightly underweight global government bonds. Fed tightening and likely European Central Bank (ECB) tapering are negatives for the cycle view, while regional bond market valuation in late September 2017 ranges from slightly expensive in the U.S. to very expensive in Germany.

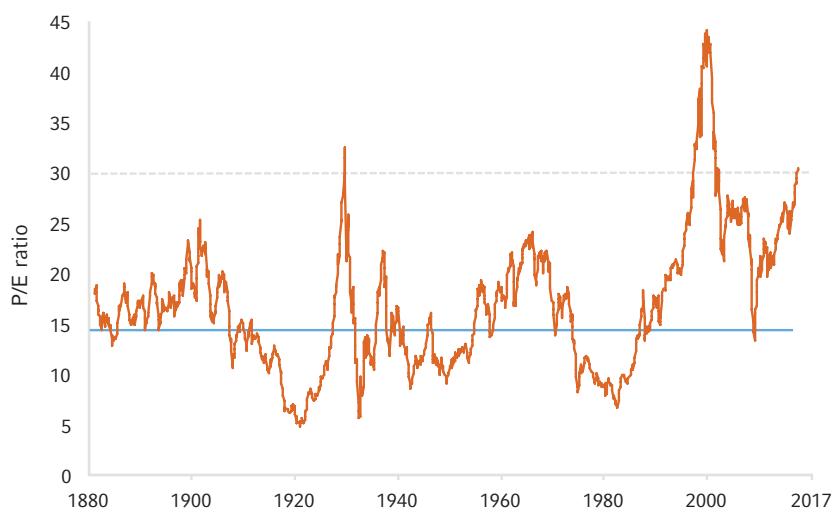
We're still in a “buy the dips and sell the rallies” market environment. This will continue while our equity cycle scores remain neutral to positive. We will look to the overbought/oversold indicators from our sentiment process to help guide us in buying dips and selling rallies. ■

■ The two big risks in our outlook are either a recession or inflation scare that sends interest rate expectations significantly higher. As of late September 2017, though, both seem unlikely in the near term.

CAPE fear

It's the elevated level of the cyclically adjusted price earnings ratio (CAPE) that makes us nervous about asymmetry – that the downside for S&P 500® Index returns is larger than the upside. The CAPE divides the current level of the S&P 500 by the 10-year average of inflation-adjusted earnings per share. In other words, it compares the current level of the equity market with the “normal” level of earnings. Traditional price/earnings (P/E) ratios can be misleading, showing the market as artificially cheap when earnings are cyclically high (as they are at the end of the third quarter of 2017) and expensive when earnings are temporarily depressed.

Shiller P/E ratio: rolling 10-year trends since 1880



Source: Economist Robert J. Shiller, last observation September 8, 2017
Blue line shows average P/E of 14.3 for the entire time frame.

The average drawdown over the following three years when the CAPE has been above 22-times is around -21%.

Thanks to economist Robert Shiller, we have a history of the S&P 500 CAPE back to 1880. It currently stands at just over 30-times trend earnings, a level reached only twice before; during the tech bubble of the late 1990s and in the 1929 market boom.

A high CAPE means that future returns are likely to be disappointing. The average annualised return over the following three years when the CAPE has been above 22-times earnings trends is less than 5%.

It also increases drawdown risk dramatically. The average drawdown over the following three years when the CAPE has been above 22-times is around -21%. We passed the 22-times mark four years ago, so this episode is already an outlier. Asymmetry will remain a significant concern.

Government bonds: Cycle & value point to rising yields

Government bonds are expensive in all regions as the third quarter ends. U.S. 10-year Treasuries at around 2.2% are closest to our fair value estimate of 2.7%. German 10-year Bunds at 0.4% are some way from fair value of 1.5%, as are UK 10-year Gilts at a yield of 1.4% and fair value of 2.4%.

The cycle is moving in favour of higher yields. ECB tapering of bond purchases in 2018 will put upward pressure on the term premium, as will the Fed's plans to slowly reduce its holdings of Treasuries.

The surprise has been low inflation in the U.S., where core inflation was just 1.7% in July 2017. We believe this should start to pick up in coming months. The U.S. unemployment rate has been below 4.5% since March and many indicators show that the economy is near full capacity. The 10% decline in the U.S. Dollar Index (DXY) this year should also start to show up in import price inflation.

Interest rate markets are pricing in less than one Fed rate hike until the end of 2018, but we think two to three rate rises are likely given the inflation backdrop.

Sentiment is turning negative for government bond markets with the recent rally triggering overbought signals.

Expensive valuation plus a more negative cycle outlook has our process pointing to a modest upward trend in global yields over the next 12 months.

Currency: Euro still has upside

The story of 2017 so far has been the weakness in the U.S. dollar (USD) and strength in the euro. We expect euro strength to continue. Our CVS process marks the euro as around 10% undervalued at the end of the third quarter. The cycle is turning more favourable as the economy picks up, the ECB winds down quantitative easing (QE) and political risks subside. The next Italian general election due in early 2018 is looking less ominous with toned-down anti-euro political rhetoric following the failure of populist political messages in the recent Dutch, French and German elections.

Sentiment is a tailwind for the euro as it has solid upward momentum, but it remains tempered by some overbought signs. The ECB is the main factor standing in the way of further euro strength. It could start warning about the disinflationary impact of euro appreciation and potentially delay the tapering of QE should the euro rise too quickly. Even so, we think the euro still has some upside.

The USD, in contrast, is expensive even after falling 10% in trade-weighted terms this year. The USD is in a downward trend, and this could continue for a few more months if weak inflation keeps Fed policy unchanged through December.

The cycle is likely to turn more dollar positive in 2018 if, as we expect, the Fed signals more aggressive tightening intentions than investors currently expect. A potential USD turning point in early 2018 is one of our key watch-points. ■

/// The USD is in a downward trend as the third quarter ends, and this could continue for a few more months if weak inflation keeps Fed policy unchanged through December.

United States: Secondhand growth

Cyclical strength in Europe and the emerging markets has rippled back into the U.S. market, helping large-cap businesses beat earnings expectations for two consecutive quarters. However, domestic fundamentals still look mediocre.

Global strength and the asymmetry problem

The global business cycle has strengthened considerably since the middle of 2016. By most measures, continental Europe and the emerging markets were the engines of this growth acceleration, and the U.S. was a passive beneficiary, at best. For example, the Citi U.S. Economic Surprise Index — which tracks incoming economic data relative to expectations — has been in negative territory for five consecutive months through September 2017. Meanwhile, the Trump Administration's original timetable for comprehensive tax reform by August has come and gone, and details are still lacking. Policy uncertainty is driving a wedge between plans for elevated business capital expenditure (capex) and actual capex, which is currently subdued. Our broader assessment of domestic economic trends remains mediocre. Nevertheless, we are cautiously optimistic that Congressional Republicans will want to demonstrate a significant legislative accomplishment (taxes) before the 2018 mid-term elections. But progress has been frustratingly slow, and market expectations have been ratcheted lower.

So why is the S&P 500 Index up 11.4% year-to-date through September 15, 2017? The one fundamental factor that we can point to, convincingly, is that the global cycle has rippled back into the U.S. in a positive way. This “secondhand growth” was a big tailwind for U.S. earnings, given large-cap businesses source almost half of their revenues from overseas. Indeed, the S&P 500 Index delivered double-digit earnings growth in the first half of 2017 — a result that was ahead of our forecasts. While the U.S. has been a beneficiary of these developments, fundamentals support tilting equity allocations towards international markets, which have been the engine of growth and trade at more attractive valuations.

Prices for U.S. equities, as measured by the S&P 500 as of September 2017, are trading at 30 times cyclically adjusted earnings, which is the most expensive level ever outside of 1929 and the late 1990s. This creates asymmetry in the expected return profile. Equities can keep grinding higher with positive momentum. But at current valuations, our analysis suggests the upside potential is limited, and the drawdown potential could be significant.

Disinflated Fed plans, deflated bond market expectations

In our mid-year report, we titled our U.S. outlook “strike three on inflation” and warned there could be some persistence to the softness in pricing. That forecast proved accurate through the July consumer price index (CPI) report which delivered the fifth consecutive month of disappointment. Recent inflation data has been a bit firmer, but the Fed is still not following through on its price-stability mandate and has understandably become much more conflicted about the need for a third hike in 2017. We expect the Fed to remain on hold for the remainder of 2017.

Our forecast does not mean that U.S. Treasury yields are likely to fall. Fixed income markets have priced-in a much slower path for the Fed (only one more hike through the end of 2018) than we think is warranted by fundamentals. There are four key reasons to expect a faster pace on rates in 2018:

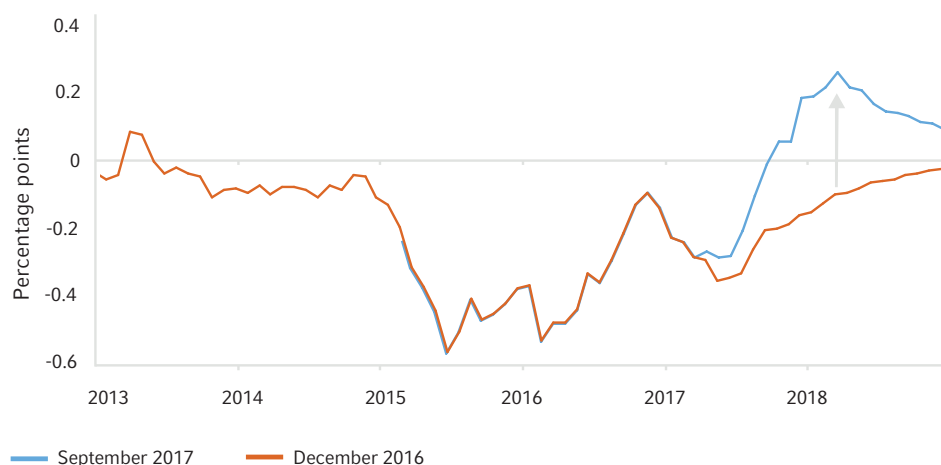
Equities can keep grinding higher with positive momentum, but at current valuations the upside potential may be limited, and the drawdown potential could be significant.

1. Even though the Fed has already hiked the overnight interest rate four times in this expansion, they haven't engendered any real tightening from an economic perspective. The 10-year U.S. Treasury yield is lower today than it was in December 2015, the U.S. dollar is weaker, credit spreads are tighter and the U.S. equity market is stronger.
2. Medium-term inflation risks are slowly building, and we believe the unemployment rate is likely to fall to 4% or lower in 2018.
3. The U.S. dollar, which had been a big disinflationary force on the U.S. economy in 2015 and 2016, has fallen off a cliff this year and we believe this is likely to start boosting import prices and the inflation numbers in early 2018 (see chart below).
4. A prolonged period of low rates is a risk to financial stability. As such, we think the Fed is on track for two or three federal funds rate increases in 2018, which is more aggressive than current pricing, and this should exert upward pressure on yields. In its most recent meeting, the Fed committed to starting balance sheet normalisation in October 2017. This is basically a form of quantitative tightening. Given the predictability of the program, we don't expect a large market impact, but directionally it should also exert upward pressure on long-term interest rates (in the same way that quantitative easing lowered them). Taken together, we look for the U.S. 10-year Treasury yield to increase to 2.5% over the next 12 months.

Fixed income markets have priced-in a much slower path for the Fed (only one more hike through the end of 2018) than we think is warranted by fundamentals.

USD appears more likely to boost inflation in 2018

Estimated impact of the broad USD on U.S. core personal consumption expenditure (PCE) inflation.



Source: Russell Investments as of September 15, 2017.

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.

Strategy outlook

- › **Business cycle:** Corporate profits have come in ahead of schedule as a stronger global cycle helped U.S. businesses deliver 14% earnings growth in Q1 and 10% in Q2. We expect a moderation in the quarters ahead and forecast earnings growth of roughly 8% in 2017. We don't see enough cyclical support to generate strong returns at current valuation levels.
- › **Valuation:** U.S. equities are very expensive. The Shiller P/E ratio for the S&P 500 stands at 30 times — its highest level ever outside of 1929 and the late 1990s.
- › **Sentiment:** Price momentum is firmly positive and a tailwind for the U.S. market. We continue to have an underweight preference for U.S. equities in global portfolios primarily on the back of their expensive valuations.
- › **Conclusion:** We continue to have an underweight preference for U.S. equities in global portfolios. ■

The eurozone: The euro versus everything else

From the perspective of financial markets, the third quarter of 2017 is best described as "the euro versus everything else." Tailwinds in the form of continued strong economic growth, favourable politics and robust earnings were neutralised by a single headwind: a rising euro exchange rate. Looking ahead, we expect the balance between these two forces to tilt back in favour of the fundamentals, supporting eurozone assets.

Headwinds and tailwinds

The "good news show" that we reported in our mid-year report has continued over the past few months. Economic growth remains strong and forward-looking indicators such as producer and consumer confidence remain at elevated levels. Our expectation for eurozone gross domestic product (GDP) growth is unchanged at 2% and we would not be surprised to see it reach slightly higher than that for 2017. On the earnings front, eurozone companies remain on track to deliver 10-15% growth for the year. Margin expansion in particular is a boon.

In our mid-year report, we also talked about a change in how political developments were impacting financial markets. With President Emmanuel Macron's victory in France and the associated advent of a renewed Franco-German engine at the heart of the eurozone, political developments shifted from a source of risk to a source of upside potential. Despite a lacklustre performance relative to expectations, Chancellor Angela Merkel is in a position to form a majority government with either the Social Democratic Party (SPD) or the 'Jamaican' coalition consisting of the CDU/CSU, the Greens and the Free Democratic Party (FDP). Meanwhile, in Italy, we have observed a noticeable turn away from euroskepticism. Macron's defeat of Marine Le Pen sent a loud and clear message: in the eurozone it does not pay to be a euroskeptic. In summary, the fundamentals were and are expected to continue to be clear tailwinds for eurozone markets.

Even though the tailwinds remained in place, their impact on financial markets shifted meaningfully from Q2 to Q3. Whereas equity markets were pushed higher in Q2, in Q3 the euro exchange rate was the main beneficiary. Strong economic growth against a backdrop of low inflation propelled the euro higher while a long spell of weak inflation simultaneously pushed the U.S. dollar down. In doing so, a headwind was created for eurozone markets. After all, eurozone companies derive 50-60% of their profits from abroad and a stronger currency diminishes their value. This dynamic is shown in the chart on the next page.

Expectations around future monetary policy played an important part too. Statements by ECB President Mario Draghi were perceived to be slightly hawkish and markets worried he might taper the amount of bond purchases more aggressively than previously anticipated. Looking ahead, we expect those worries to abate. Although bond purchases will likely be tapered towards euro 30-40 billion per month in 2018, this still constitutes a very easy monetary policy. Draghi has stated he will be patient and prudent in removing monetary accommodation. He understands that both the economic recovery and a return to 2% inflation are contingent on it, particularly given how much slack there still is in the eurozone economy.

 Our expectation for eurozone GDP growth is unchanged at 2%, though we would not be surprised to see it end up slightly higher than that for 2017.

Eurozone equities & euro exchange rate



Source: Thomson Reuters Datastream, as of September 13, 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 10-15% add up to a positive business cycle score.
- › **Valuation:** Eurozone equity valuations have gone back to neutral from slightly expensive as earnings outpaced prices over the third quarter of 2017. In eurozone core government bonds we remain neutral with yields still in our 'old' range of 0-0.5%. Looking ahead, we decided to widen our range to 0-0.8% due to ECB tapering of bond purchases. Peripheral bonds continued to do well over the third quarter and we neutralised our positions in French and Spanish bonds when spreads tightened to our target levels. We still see a bit of value in Italian and Portuguese bonds so we maintain slightly overweight positions there.
- › **Sentiment:** A combination of positive price momentum and overbought contrarian signals have kept our sentiment score for eurozone equities in negative territory. We see sentiment for core and peripheral government bonds as neutral.
- › **Conclusion:** In our mid-year report, we highlighted that near-term caution was warranted given overbought sentiment and slightly expensive valuations. This turned out to be good advice as the subsequent rally in the euro exchange rate turned into a formidable headwind for equities and relative performance waned. However, looking ahead we expect the balance to tip in favour of tailwinds from strong fundamentals and attractive relative valuation. And, similar to what we saw in Q2, that should drive markets higher. Watchpoints for this region continue to be ECB policy and political developments in Italy. Regarding the latter it is noteworthy that previously euroskeptic parties are toning down their rhetoric, learning the lessons from Macron's victory over Le Pen in France. ■

■ We believe the headwind from a stronger euro will fade somewhat while the tailwind from strong eurozone fundamentals will continue to support eurozone markets.

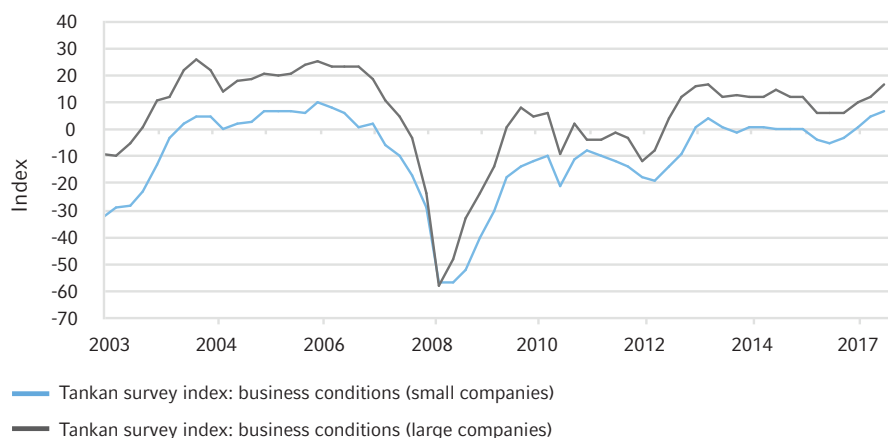
Asia-Pacific: Riding the wave of momentum?

The developed Asia-Pacific economies have been firming, while the developing economies continue to ride the wave of positive momentum. China's 19th National Congress (due to begin in late October) will be the focus for the region, while geopolitical risks with North Korea will likely remain. Valuations remain slightly expensive, although we note that Japan is looking more attractive than the rest of the region.

The Asia-Pacific region has seen greater breadth in growth, with some of the developed countries (namely, Japan and Australia) seeing improvements. The momentum in global demand has continued, which has flowed through to robust global trade, benefiting exporters in the region. Twelve-month forward earnings growth in the region is expected to come in at 10.45%, according to the MSCI All Country Asia Pacific Index as of September 12, 2017. We maintain our expectation that the developing markets in the region will outperform developed markets for 2017; however, our view on the gap between the two has narrowed. Concerns around trade threats coming out of the U.S. have dissipated, but elevated levels of debt and the tensions surrounding North Korea remain.

Starting with the developed Asia-Pacific countries, the outlook for **Japan** has firmed. Japanese earnings have been robust, while GDP has surprised on the upside. On the policy front, the Bank of Japan continues to be very accommodative, and unlike other central banks, has shown no indication of considering a shift in stance.

Japan business conditions



Source: Bank of Japan, as of May 15, 2017.

Tankan, a Japanese shorthand term for Business Short-Term Economic Sentiment Survey, is a quarterly poll of business confidence reported by the Bank of Japan showing the status of the Japanese economy. Component surveys of the Tankan are considered as leading gauges of Japan's economic growth.

 We maintain our expectation that the developing markets in the Asia-Pacific region will outperform developed markets; however, our view on the gap between the two has narrowed.

Australian economic activity has been solid, despite a cautious consumer. Australian businesses have been reporting elevated levels of confidence for much of the year, and this has been translating into robust hiring levels and increasing capex plans. The strength in the currency (up 9% against the USD, as of September 15, and 2.5% on a trade-weighted basis), if sustained, will prove a slight drag on trade.

The **New Zealand** economy has held on to its growth momentum through the year, supported by strong levels of population (although this is likely to wane over coming quarters). On the monetary side, we see the RBNZ staying on hold for some time, with inflation remaining muted.

Singapore is in reasonable shape, with the manufacturing sector expanding, retail sales solid and inflation contained. Growth remains solid in **Hong Kong**, boosted by strong export demand from China, which accounts for around 40% of total exports.

Developing Asia-Pacific has maintained momentum through much of the year. Economic activity gauges in **China** have been solid, with the purchasing managers' indexes (PMI) showing continued expansion in the manufacturing sector. **South Korea** has continued to benefit from strong external demand, while consumption has been reasonable. **Malaysia** and **Taiwan** are both benefiting from accommodative monetary policy, while the **Indian** central bank recently cut rates.

The big event in the Asia-Pacific region through the quarter will be **China's** 19th National People's Congress. We have remained cautiously optimistic about the Chinese economy all year, with concerns around debt overridden by strong levels of activity. We expect to see further attempts at supply-side reform coming out of the Congress, as President Xi Jinping consolidates power with more like-minded members.

The key risk for the region in our opinion is the ongoing tension with North Korea. We expect to eventually see a de-escalation; however, the ride there is likely to be volatile. The South Korean equity market, particularly, will likely experience some bouts of volatility and difficulty.

Investment strategy

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

- › **Business cycle:** We maintain our positive outlook for the developing countries within the Asia-Pacific region. Our views on developed economies, particularly Japan and Australia, have improved at the margin. This leaves our aggregate view slightly positive. We continue to expect to see China, India and South Korea pushing forward, while Japan also likely will post reasonable growth.
- › **Valuation:** Asia-Pacific equity markets have outperformed the global index since the end of the second quarter of 2017, with the MSCI Asia Pacific Index up 1.9% quarter-to-date through September 15 (compared to 0.9% in the MSCI World All Country Index), all of which holds steady our assessment that the region is slightly expensive. Not all markets within the region are expensive, though, particularly Japan, which we see as valued fairly.
- › **Sentiment:** Equity markets in Asia-Pacific have stayed on a wave of positive price momentum for most of 2017, although it has faded at the margin this quarter. This positive momentum has pushed the market towards an overbought environment; however, our indicators are not yet triggered.
- › **Conclusion:** Overall, we have become more positive on the Asia-Pacific region as the developed economies have been firming. We maintain our view that the developing economies will outperform the developed for 2017. However, since the Asia-Pacific equity market has stayed on the wave of positive momentum in 2017, valuations remain slightly expensive as we move into the fourth quarter. ■

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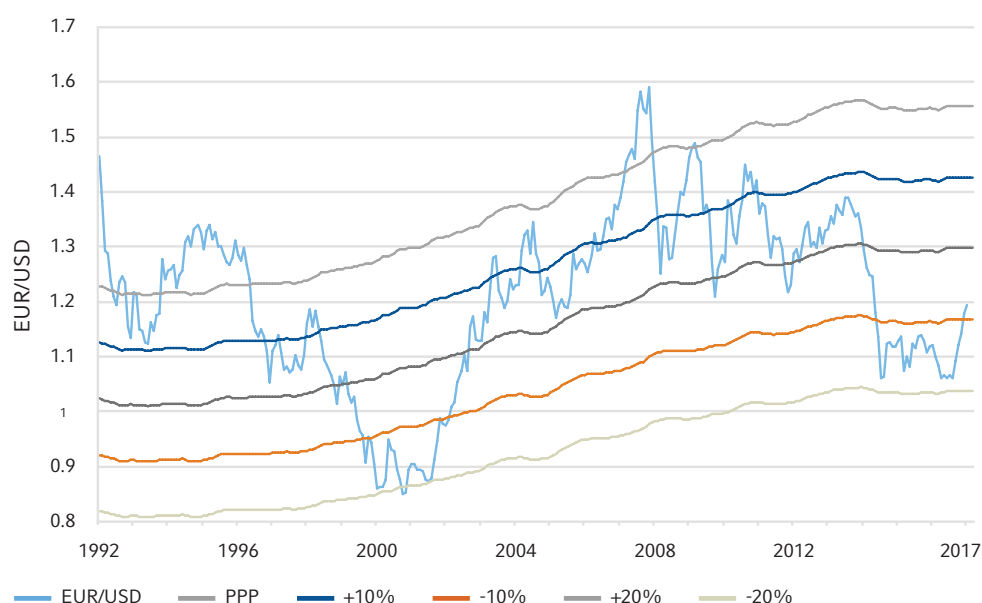
Currencies: Euro rally pauses but has legs

Everyone seems to love the euro, so much so that it may have become a crowded trade. In the near term, too much optimism could dampen the rally. However, the likely tapering of bond purchases by the European Central Bank in 2018 and the revival of centrist governments will support the euro in the medium term.

After trading within a range between 1.04 to 1.15 over the last 30 months, EUR/USD broke out higher after the July ECB meeting. While ECB President Mario Draghi reiterated the determination to provide the monetary accommodation necessary to get to 2% inflation, he also expressed more confidence in the economic outlook. This suggests that the ECB is thinking about tapering its quantitative easing program next year. Valuation is favourable for the euro, and in our view, does not stand in the way of a continued strengthening. The euro is still around 10%, which is cheap relative to its purchasing-power-parity level versus the U.S. dollar, as the chart below shows.

Valuation is favourable for the euro, and in our view, does not stand in the way of a continued strengthening as we look ahead to the fourth quarter.

EUR/USD purchasing power parity (PPP)



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

The single European currency is also cyclically attractive. Economic growth in the eurozone is very strong, as purchasing manager indices around the region linger near record highs and decouple from the rest of the world. Political risk has faded with euro-friendly outcomes in the Dutch and French elections earlier this year. Uncertainty around the next Italian general election in 2018 still looms, but probably won't heavily influence the euro until early 2018. While the euro has been the big winner in currency markets this year, the U.S. dollar is the mirror image of that strength. After enjoying a buoyant three-year period through the end of 2016, the U.S. Dollar Index has now dropped to the lowest level since January 2015. We can blame tensions between

North Korea and the United States for the most recent bout of weakness, as well as the delayed delivery on President Trump's campaign promises on tax cuts so far. Coupled with the expensive valuation of the greenback, which is still above its historical average in inflation-adjusted terms, investors were all too happy to reduce their dollar holdings this year.

From a cycle perspective, within our cycle, value and sentiment (CVS) investment decision-making process, the U.S. dollar maintains a significant interest rate advantage over most other developed nations, which should be a tailwind. However, U.S. economic data has been less uniformly robust, particularly compared to the eurozone. As for sentiment, the U.S. dollar looks oversold so we believe a short-term technical recovery is possible. Reported speculative positions in currency futures suggest that short U.S. dollar may have become a crowded trade. However, the longer-term trends and fundamental forces are now in the euro's favour.

Other major currencies

› UK pound sterling (GBP)

The pound was stronger against the U.S. dollar last quarter as GBP/USD reached a year-to-date 2017 high of 1.33 after higher-than-expected inflation figures. We are skeptical as to whether the upward price pressures will be sustained. In our view, the post-Brexit economic growth slowdown is already becoming apparent, which, together with the fading impact of sterling weakness, should lead to softer inflation numbers towards the end of this year. As uncertainty surrounding the Brexit negotiations lingers and the Bank of England probably holds steady on interest rates, we think the upside for sterling is now limited.

› Japanese yen (JPY)

The Bank of Japan (BoJ) arguably runs the loosest policy among the world's major central banks. It has adopted a yield curve control framework whereby the BoJ buys as many bonds as is necessary to keep the yield on 10-year Japanese government securities at 0%. Changes in U.S. bond yields disproportionately impact the yen because Japanese yields are pegged this way. We expect U.S. yields to rise modestly, which is a headwind for the yen. ■

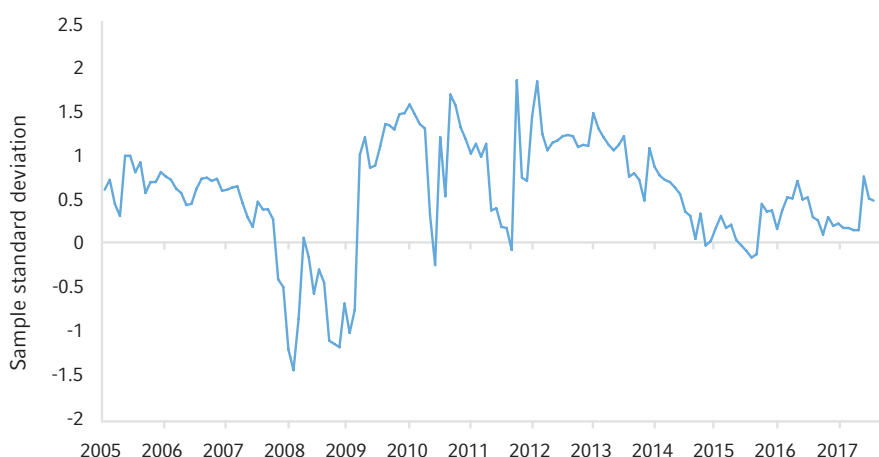
From a business cycle perspective — within our cycle, value and sentiment (CVS) investment decision-making process — the U.S. dollar maintains a significant interest rate advantage over most other developed nations.

Quantitative modelling insights

Improvement for U.S. equities

The model for U.S. equities versus U.S. fixed income has moved into the positive range, up from neutral in our mid-year report. With low inflation and steady U.S. GDP growth, equities have increased in value. This stronger momentum translated into a greater signal in favour of risk assets, though we remain cautious.

EAA U.S. equity vs U.S. fixed income aggregate signal



— EAA equity/fixed income aggregate signal

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

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.

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

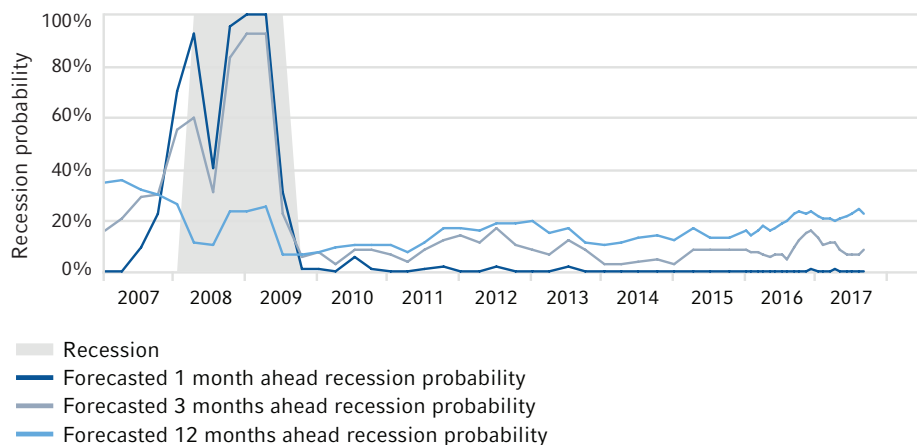
- › **Business cycle:** The Business Cycle Index (BCI) model uses a range of economic and financial variables to estimate the strength of the U.S. economy and forecast the probability of an upcoming recession. We conclude a near-term U.S. recession is unlikely and we're also unlikely to see accelerating economic growth in this aging cycle.
- › **Valuation:** Our Fed model stayed flat and suggests the relative valuation between equities and fixed income assets is fair. Our dividend discount model continues to favour equities over fixed income.
- › **Sentiment:** Equities continued to rise in the third quarter of 2017. Our momentum signal as of September 15, 2017, is stable and positive, but our contrarian long-term mean reversion signal is stable and negative for equity versus fixed income.
- › **Conclusion:** This combination of positive value from the dividend discount model and positive momentum overcomes the contrarian signal to put us slightly in favour of U.S. equities.

/// The combination of positive value from the dividend-discount model and positive momentum overcomes the contrarian signal, which puts us slightly in favour of U.S. equities versus U.S. fixed income.

Recession probabilities: Short-term risks building?

The BCI index, which estimates the probability of recession in the next 12 months, is almost 25% as of September 15, 2017. Though historically low, this marks a new high for this expansion since the 2008 recession. We conclude that a near-term U.S. recession is unlikely, but we should monitor this aging cycle.

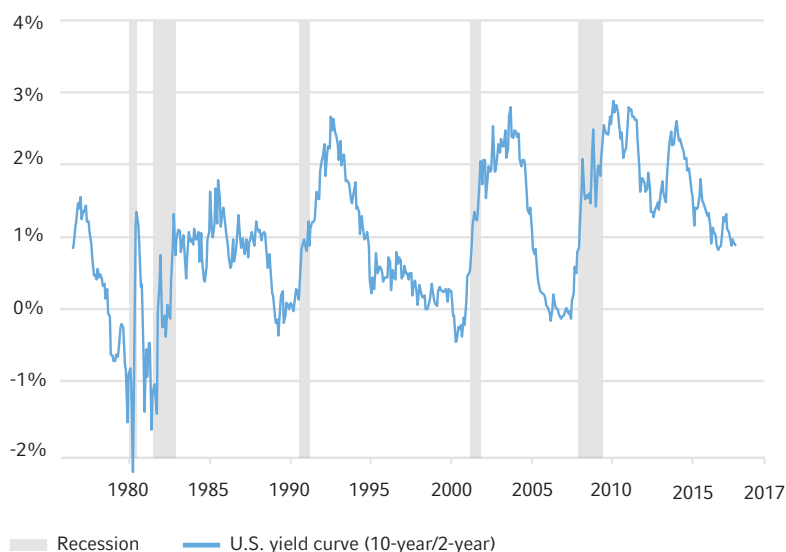
BCI historical forecasted recession probabilities



Significantly reducing recession probabilities to what we observed two years ago would be difficult for the U.S. economy, in our view, given we've already had such a long expansion. The pace of job growth is still steady, but it is likely to moderate as we push towards full employment. There was a period of decreasing recession probabilities after the 2016 U.S. presidential election, where indicators reflected increased confidence in the U.S. economy. Some of that optimism has since dampened.

The slope of the yield curve is a proxy for future growth expectations and an inverted yield curve would be a recession warning. While the yield curve flattened over the last two quarters, it is still far from inverting. Overall, we think the U.S. economy is still on a path of moderate growth with low probability of recession over the next year, but risks are building at the three-year horizon. As a result, we would maintain a balanced risk portfolio and look for opportunities to buy market dips and sell the rallies. ■

Yield curve: Flattening, but hasn't inverted yet



Source: Thomson Reuters Datastream, as of September 1, 2017.

Overall, we think the U.S. economy is still on a path of moderate growth with low probability of recession over the next year, but risks are building at the three-year horizon.

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.

Important Information

The views in this 2017 Global Market Outlook — Q4 update 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 that, like all investing, 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 behaviour, 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.

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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, default and duration 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. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates

in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

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.

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.

Citi tracks a measure known as the "economic surprise index" for various locales, which shows how economic data are progressing relative to the consensus forecasts of market economists.

The CBOE Volatility Index® (VIX® Index®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

The U.S. Dollar Index (USD, DXY) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies. The index is currently designed, maintained, and published by the commodity exchange ICE Futures U.S., Inc., with the name "U.S. Dollar Index" a registered trademark. USD goes up when the U.S. dollar gains "strength" (value) when compared to other currencies.

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The MSCI AC Asia Pacific Index captures large and mid cap representation across Developed Markets countries and 8 Emerging Markets countries in the Asia-Pacific region. The index covers approximately 85% of the free float-adjusted market capitalisation in each country.

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