RUSSELL INVESTMENTS

# Inflection point

## 2015 Global Market Outlook: Q4 update

The outlook is dominated by uncertainties around China and the prospect of Fed tightening. Our investment strategy process tells us to lean into market pullbacks.

SEPTEMBER 30, 2015


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# Separating signal from noise

**Volatility has risen, there is uncertainty around China, and we're still waiting for U.S. Federal Reserve (Fed) lift-off. Looking through the noise, we still like European equities and the U.S. dollar (USD), and dislike long-term interest rate exposure.**

## EXECUTIVE SUMMARY

By **Andrew Pease**
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Volatility has gone up, and not just in financial markets. We're seeing it in politics where Donald Trump leads the Republican presidential primary contest and an old-school socialist Jeremy Corbyn now heads Britain's Labour Party. And in the world of sports, we've just witnessed minnow Japan beating rugby powerhouse South Africa at the world cup. Previously implausible events are starting to look more possible…

In global financial markets, investors have had their comfortable views called into question as steady U.S. gross domestic product (GDP) growth, a moderate Fed policy and a China soft landing can no longer be taken for granted. The result is that markets are struggling to find direction. It's important to separate market noise from signal. We do this through our investment strategy process that is based on cycle, value, and sentiment.

Our core views about the global economy have been broadly unchanged since the beginning of 2015. We're still looking for moderate growth in the U.S. We think the European recovery is gathering pace and that Japan is gradually improving. Emerging economies remain under pressure and the China slowdown has further to run.

Our North American strategist, Paul Eitelman, thinks caution over China and market volatility kept the Fed on hold in September. Paul expects one rate rise before year-end and another four during 2016. He's forecasting 2.5% U.S. GDP growth and a 2.8% 10-year U.S. Treasury yield over the next 12 months as of Sept. 30, 2015.

Wouter Sturkenboom reaffirms his positive view on the eurozone. He sees healthy GDP growth momentum, double-digit growth in corporate profits, supportive central bank policy, and equity market valuations that are attractive in relative terms.

By contrast, Graham Harman, our Asia-Pacific strategist, is more downbeat. He sees growing pains in China, commodity headwinds in Australasia and unconvincing momentum in Japan. He prefers buying the dips to taking an overweight position in the region at this time.

Our focus topic in this quarterly report is the outlook for China. Robert Wilson argues that China is slowing but not collapsing. More policy support is likely on the way, and he believes Chinese shares could eventually provide global investors with a buying opportunity.

This quarter we welcome our new currency strategist, Van Luu. Van outlines his approach to currency analysis which uses the currency building blocks of value, carry and trend. His conclusion is that the U.S. dollar can still move higher. It's expensive but will likely get a boost from Fed tightening while the Bank of Japan and European Central Bank contemplate more easing.

Our investment strategy process is based on both the qualitative insights of our strategists and a range of quantitative models run by Abe Robison and Kara Ng. Most of the asset class models have a neutral preference between equities and fixed income, and the August sell-off was not large enough to trigger buy signals. Our econometric models of the U.S. economy still point to moderate growth and low recession risk. ■

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We're still looking for moderate growth in the U.S. We think the European recovery is gathering pace and that Japan is gradually improving. Emerging markets economies remain under pressure and the China slowdown has further to run.

# Investment strategy outlook

**The outlook is dominated by uncertainties around China and the prospect of Fed tightening. Our investment strategy process tells us to lean into market pullbacks. Our highest conviction view is still overweight euro-area equities.**

## An inflection point, not a turning point

Volatility returned in August of 2015 with a bang. The Chicago Board Options Exchange Volatility Index (VIX)* spiked to over 40 on Aug. 24—the highest in four years—and the S&P 500® Index suffered the first pull-back of more than 10% during the month since the depths of the eurozone debt crisis** in late 2011. Other equity markets suffered more with benchmarks in the U.K., Europe, Australia and Japan down by around 15% during the month. The Russell Emerging Markets Index lost over 25% during the same period.

The main culprits were China's devaluation of the yuan in mid-August and growing market anxiety about the implications of the first Fed rate hike in nine years. The key question is whether the market turbulence is simply a retreat from overbought conditions or the beginning of a new bear market. Our view is the former. An equities bear market requires a sustained downturn in company earnings, which usually only happens in a recession. We don't expect a recession anytime soon and think U.S. GDP growth can stay in a solid but unspectacular 2.0%-2.5% range.

However, the upside for U.S. equities is limited by the lackluster outlook for corporate profits. The headwinds to U.S. profits growth are high margins, rising labour costs, and the rising dollar. We still think U.S. equities will outperform U.S. Treasuries over the next year as interest rates rise modestly, but there are likely to be better performing equity markets. Europe and Japan stand out in terms of profit performance.

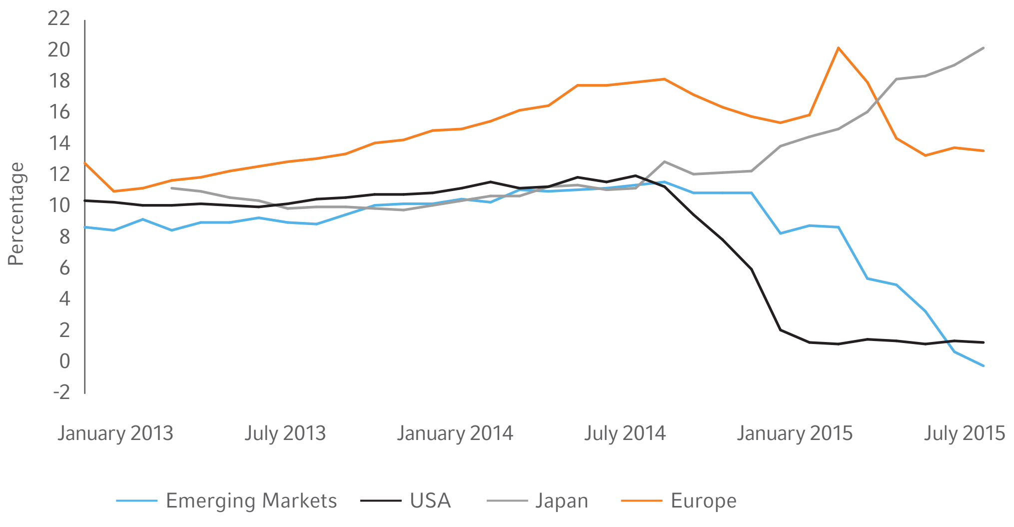
This chart shows how industry analysts' consensus forecasts for earnings per share (EPS) growth as of Sept. 18, 2015 have shifted over the past year and a half. Japan has had consistent upgrades, and the eurozone is still expected to record double-digit growth. The downgrades have been in the U.S. and emerging markets (EM). The U.S. downgrades mostly reflect the

The key question is whether the market turbulence is simply a retreat from overbought conditions or the beginning of a new bear market. Our view is the former.

* The CBOE Volatility Index measures the implied volatility of S&P 500 index options. Calculated by the Chicago Board Options Exchange (CBOE), it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

** The multi-year European debt crisis has been taking place in the European Union since the end of 2009 affecting several member states (Greece, Portugal, Ireland, Spain and Cyprus).

**Forecast 2015 EPS Growth**




Source: IBES

Emerging Markets = Russell Emerging Markets Index; USA = S&P 500; Japan = MSCI Japan Index; Europe = Euro Stoxx 50 Index, as of Sept. 18, 2015.

Indexes are unmanaged and cannot be invested in directly.

reality of declining oil prices. Energy stocks in the S&P 500 account for around 10% of market capitalisation, and the consensus now expects energy EPS to decline by nearly 60% in 2015. Excluding energy, EPS for the remaining 90% of the U.S. market is expected to grow by nearly 8% this year. The weak earnings story is more broadly based for emerging markets, and EPS is on track for the second consecutive year of contraction.

## Global equities: value, cycle, sentiment

Our investment strategy process is based on the building blocks of value, cycle, and sentiment. Applying this process to global equities we get the following:

**Value**: The U.S. market remains the most expensive. We score both Japanese and European equities as moderately expensive. Emerging market equities are still moderately cheap.

**Cycle**: We're still moderately positive on the U.S. cycle, although we have downgraded our views because of modest EPS growth prospects and the likelihood of Fed tightening. We're more positive on the cycle for Japan, where EPS growth is strong and there is the potential for more Bank of Japan (BoJ) policy support. Our strongest cycle view is for Europe, where the tailwinds of euro depreciation, credit growth, less fiscal austerity and European Central Bank (ECB) quantitative easing are supporting EPS growth. The cycle is still negative for emerging markets amid U.S. dollar strength, falling commodity prices, and the economic slowdown in China.

**Sentiment**: Momentum is now neutral across most equity markets and negative for the U.K. and emerging markets. Our contrarian indicators, however, suggest that most markets are oversold following the declines in August and early September.

Energy stocks in the S&P 500 account for around 10% of U.S. market cap, and the consensus now expects energy EPS to decline by nearly 60% this year. Excluding energy, EPS for the remaining 90% of the U.S. market is expected to grow by nearly 8% this year.

The bottom line from our value, cycle and sentiment process is that Europe is still our most preferred equity market, followed by Japan. The process has us cautious on the U.S., U.K. and emerging markets.

## China, slowing but not collapsing

China has been the source of much of the market's recent volatility. Investors have been rattled by a run of weak economic data and the ham-fisted attempts by the Chinese government to stabilise the market for locally owned A-shares. Our view is that China's economy is experiencing a meaningful slowdown, but over the next few months it will stabilise and recover to around 7% GDP growth as policy stimulus takes effect. There is already policy stimulus in the pipeline from monetary easing, the currency devaluation, and public sector infrastructure projects.

There is scope for further stimulus measures and we would not be surprised to see further monetary easing and government spending announcements. There could even be further yuan devaluation. Beijing policymakers, however, do not want to trigger a repeat of the debt-fueled investment binge that followed their 2009-2010 efforts.

The China slowdown is having a knock-on, or ripple, effect across other emerging economies. Causes include weaker export demand, falling prices for commodity exports, and a loss of competitiveness against China. EM economies are also being hit by higher financing costs as markets price-in Fed tightening expectations.

This means that, for the time being, we have a negative view on EM-related asset classes. To get more positive, we need to see signs that China's economy is bottoming, global export demand is picking up, and EM economies have adjusted to Fed tightening expectations in terms of currency and interest-rate adjustments.

## Fed taking its time

We believe there were two main factors behind the Fed's decision not to tighten at the September meeting of the Federal Open Markets Committee: market volatility and China uncertainty. This, however, is just a delay in U.S. monetary policy, and we expect the Fed to announce its first rate rise before the end of the year. The unemployment rate, at 5.1% in August, is close to most estimates of the NAIRU (non-accelerating inflation rate of unemployment), below which inflation starts to pick-up.

Our models and analysis suggest that payrolls can increase by around 195,000 per month over the next 12 months. This could take the unemployment rate to 4.5% by next August. Under this scenario, it's easy to see the Fed gradually lifting the funds rate by around 100 basis points over the course of 2016.

The combination of falling unemployment, a pick-up in inflation pressure, and the Fed taking rates gradually higher gives us a bias against exposure to long-term interest rates. We expect yields on 10-year U.S. Treasuries to move into a 2.5%-3.0% range by the middle of next year.

## USD is no longer cheap, but can strengthen further

The U.S. dollar (USD) has risen by around 20% in trade weighted terms against the major currencies since the beginning of 2014. Most of our indicators now have the USD overvalued. Cycle and sentiment are still USD supportive. Central bank divergence is the main positive with the Fed set to start tightening while the BoJ and ECB contemplate more easing. Momentum is an important part of our sentiment assessment, and longer-term momentum measures still favour the USD.

> Our medium-term outlook for the U.S. and global economy is still positive and we believe global equities should deliver moderate returns.

At this point in time, we believe that most of the USD gains have been realised, but we expect that it can still push modestly higher.

## Conclusion: volatility to create opportunities

Our cycle, value and sentiment investment process currently identifies most asset classes as expensive. The main exception is riskier emerging market equities. Our positive view on the cycle in developed economies, however, prevents us from taking an overly defensive investment stance.

The volatility created by uncertainty over the Fed and China is unlikely to subside anytime soon. Our medium-term outlook for the U.S. and global economy is still positive and we believe global equities should deliver moderate returns. We think markets are going through an inflection point rather than a turning point. Market pullbacks could be an opportunity to add more risk exposure to portfolios. ■

# United States: Economy strengthens, Fed lift-off looms

**The U.S. economy has shown signs of strength. But market volatility and global growth concerns prompted the Fed to remain cautious in September. We still expect lift-off for interest rates by the end of 2015. U.S. earnings have been respectable in our view, but a tightening labour market is likely to act as a headwind over the medium-term. Against this backdrop—and expensive valuations—we prefer a modest underweight to U.S. equities.**

## The Fed is still poised to hike rates later in 2015

After a soft start to 2015, the U.S. economy reaccelerated in line with our expectations. Domestic growth—including employment, housing and consumer spending—is back on track and chugging along at an above-trend pace. But stronger growth also carries with it a higher hurdle for future positive surprises. Over the next 12 months we expect economic momentum to fade towards a more modest 2.5% pace of real GDP growth. And new question marks have emerged, particularly surrounding the outlook for China and its implications for U.S. monetary policy.

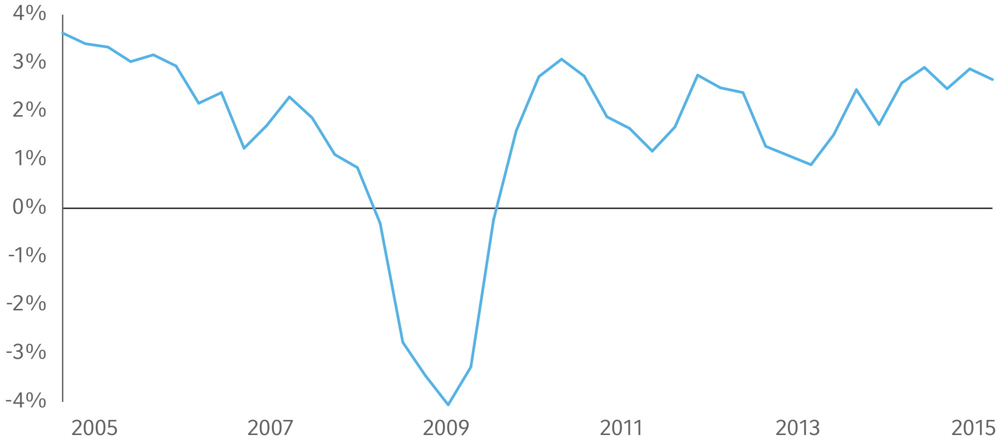
The Federal Reserve's decision not to hike interest rates in September was a surprise to many investors. After all, U.S. economic growth and the labour market had, by most measures, outperformed the Fed's own criteria for lift-off. Ultimately, however, financial market volatility and growth concerns in the emerging markets created a large enough cloud of uncertainty for the Fed to "err" on the side of caution. We continue to expect that the Fed will hike rates in December, per their comments during the Federal Open Market Committee (FOMC) Sept. 17 meeting. But, importantly, the U.S. economy is big enough, domestic enough and strong enough to shrug off downside risks from abroad.

Over the next 12 months we expect economic momentum to fade towards a more modest 2.5% pace of real GDP growth as of Sept. 30, 2015.

From a markets perspective, we are monitoring two other key developments. First, we are closely watching the extent to which asset price volatility ripples through the real economy. Consumer and business confidence were dented in early September, but so far actual activity levels have remained strong, and we expect this to continue. The second watch point is the sustainability of U.S. earnings. Excluding the energy sector, U.S. businesses generated healthy earnings growth of 5% in the first quarter of 2015 and 10% in the second quarter, as measured by the S&P 500. Going forward, however, we expect upward pressure on wages and an erosion of profit margins as the labour market tightens.

**The U.S. economy is still chugging along**

Real GDP growth, Q/Q annualised % change




Source: Bureau of Economic Analysis as of Sept. 18, 2015.

## Investment outlook

We maintain our underweight preference to the U.S. equity market in global portfolios. This is chiefly due to relatively expensive valuations, which offset a modestly favourable macro backdrop. Investors should expect more muted returns from U.S. assets going forward.

- *Monetary policy*: We expect the Fed to hike in December 2015 and for financial markets globally to remain volatile in the run-up to that decision. The pace of interest rate hikes is arguably more important than the initial timing. We expect a "gradual" profile with hikes at every other FOMC meeting. The market in our view is pricing-in an even slower trajectory, which supports our outlook that long-term interest rates will move higher.
- *Stronger U.S. dollar*: The trend of dollar appreciation took a breather in the third quarter of 2015. But we expect more upside when global monetary policies diverge at the turn of the year. The stronger dollar is currently estimated to subtract two to three percentage points from corporate earnings growth. This headwind is likely to persist for U.S. multinationals over the next 12 months.
- *Lower energy prices*: The consumer has shown signs of life after initially being slow to respond to the windfall from lower energy prices. We continue to view cheap energy as a fundamental tailwind for the U.S. economy.
- *Corporate earnings growth*: Corporate earnings held up well in the first half of 2015, according to S&P 500 data. However, in our view, earnings expectations for 2016 remain somewhat elevated. Absent a meaningful up-shift in trend growth, margins are likely to compress and challenge the earnings outlook as the cycle matures.

There are no obvious economic imbalances in our view, and the economy should be able to chug along with little risk of recession over the next few years.

## Strategy outlook

- **Valuation**: Despite the August 2015 market selloff, U.S. equities in our view remain quite expensive. However, U.S. government bonds and the dollar are also expensive, leaving few value opportunities at the asset-class level in the U.S. market.
- **Business Cycle**: With the growth reacceleration now largely behind us, the macro backdrop for U.S. equities has moved closer to neutral. Continued modest economic growth is constructive for earnings over the next 12 months, particularly in a low inflation world. While Fed policy remains extremely accommodative, the expected divergence of U.S. rates relative to the European Central Bank (ECB) and Bank of Japan (BoJ) remains a key theme for investors. There are no obvious economic imbalances, and the economy in our view should be able to chug along with little risk of recession over the next few years.
- **Sentiment**: Equity sentiment is favourable. Our short- and medium-term contrarian indicators moved into positive territory around the market declines in late August.
- **Conclusion**: We continue to have a modest underweight preference for U.S. equities in global portfolios, and our earnings outlook for U.S. equities supports a mid-single-digit total return expectation. Volatility should remain somewhat elevated as we move into the fourth quarter. And with a 2015 baseline for the Fed's lift-off of interest rates, our view is that the 10-year U.S. Treasury yield is likely to increase to 2.8% over the next 12 months.

# The eurozone: Alive and well

**Pronouncements of the eurozone's demise have once again turned out to be greatly exaggerated. The Greek crisis has come and gone and the economic recovery has barely lost momentum. The only thing keeping the eurozone back in our view is that which is keeping everyone back: a slowdown in emerging markets. For us, that is not enough to change our overweight position, and we keep our eye firmly on the tailwinds.**

## Revisiting the high conviction overweight

Over the past few quarters we have repeatedly pointed out that the eurozone looked very attractive. The lens we use to look at the world differentiates regions based on the answers to three questions:

1. Do reflationary or deflationary forces hold the upper hand?
2. Are economic and corporate earnings growth figures likely to beat expectations?
3. How attractive are valuations in financial markets?

At the beginning of 2015, we were getting the "right" answers to all three questions. The European Central Bank's (ECB) quantitative easing (QE) program decisively tipped the scales in favour of the eurozone's reflationary forces, while several tailwinds started to boost both economic and corporate earnings growth against a background of low expectations. And of course valuations were relatively attractive. Thus, at the start of the year, the eurozone was a high conviction overweight.

The core of that view still holds today. The ECB's QE program remains in full swing, and may even be expanded if global growth slips too much for comfort. Growth momentum has stayed healthy in the face of the Greek crisis. And earnings expectations are still firmly in double-digit territory. In fact, a continued recovery in credit growth and persistently low oil prices continue to provide support. Finally, valuations are also still relatively attractive, despite eurozone equities outperforming the rest of the world by almost 10 percentage points year-to-date through Sept. 17 (returns in euros, see chart on next page, as measured by the MSCI All World Country Index and Euro Stoxx 50 Index).

Growth momentum has stayed healthy in the face of the Greek crisis. And earnings expectations are still firmly in double-digit territory.

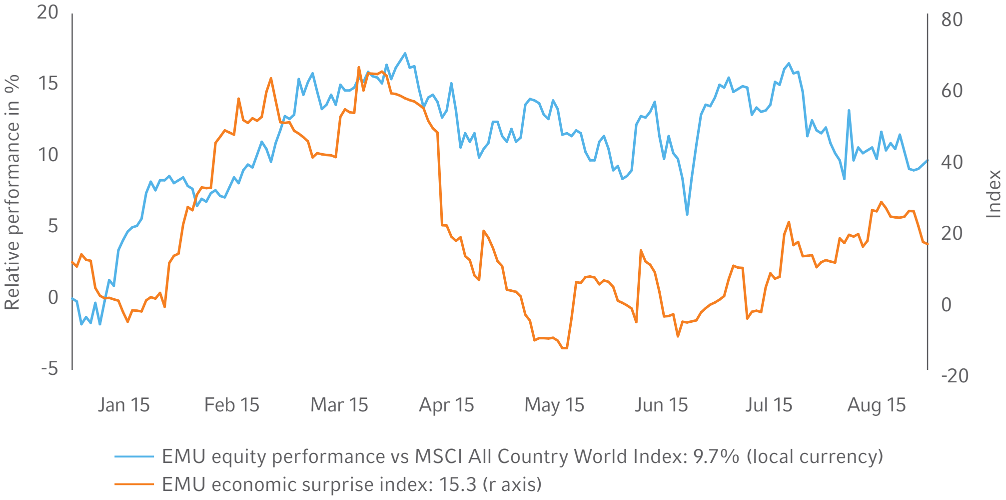
However, that does not mean the economic and financial environment is unchanged. First, it is important to note that consensus growth expectations have been revised up, making it more difficult for the eurozone to beat expectations. The Citigroup Economic Surprise Index has stayed positive, but at a much lower level than it was at the start of 2015.

Second, deflationary forces in the eurozone have been boosted by the slowdown in emerging markets and the drop in commodity prices; though, we still believe reflationary forces have the upper hand. However, inflation expectations are likely to stay low while these transitory forces play out.

Third, although credit growth is still improving, the change in credit growth, otherwise called the credit impulse, is waning a bit. We think it is too early to get overly concerned about this, but we do monitor it closely because it is a good leading indicator for economic activity.

Taking stock of what has changed and what has stayed the same, we remain comfortable with the eurozone as a high conviction overweight. As a whole, eurozone investments probably do not have the same potential they did at the start of 2015. But through our analytical lens, the eurozone still looks relatively attractive.

**EMU economic surprise index* vs Equity performance**
(European Economic and Monetary Union)




* 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.

Source: Thomson Reuters Datastream as of Sept, 15, 2015

## Revisiting our watchpoints

As always, our analysis is based on data acquired from continual monitoring of our watchpoints:

› *The 5y5y forward inflation swap*. At approximately 1.6% as of Sept. 18, 2015, this watchpoint is flashing amber. We would like to see inflation expectations pick up a bit. Obviously, we take cognisance of the fact that, at the end of the third quarter of 2015, the oil price is having an outsized impact on this swap. We are comforted by the fact that the ECB stands ready to increase QE if necessary.

› *Credit impulse*. Although the credit impulse (the change in credit growth) is still positive, it is not as strong a signal as it was at the start of 2015. However, the ECB's Senior Loan Survey is still improving. This trend points to the likelihood of a renewed pick-up in credit growth over the remainder of 2015, so we believe it is too early to be concerned.

Eurozone investments probably do not have the same potential they did at the start of 2015. But through our analytical lens, the eurozone still looks relatively attractive.

## Strategy outlook:

› **Valuation**: Eurozone equities are slightly expensive in an absolute sense, but they are still cheap relative to the U.S. In government bonds we have gone back to neutral in core bonds after the third-quarter 2015 rally. We remain overweight in the periphery in the expectation that QE will cause further spread contraction.

› **Business cycle**: We maintain our positive outlook for the business cycle. GDP growth in 2015 is still expected to be 1.5% to 2%. Our expectations on earnings growth are also unchanged at a strong 8% to 10% thanks to rising profit margins and a lower oil price and euro exchange rate. Finally, both fiscal and monetary policies remain supportive.

› **Sentiment**: Price momentum has gone to neutral due to the sell-off of equities in August of 2015. However, that same sell-off pushed our contrarian indicators into oversold territory, bringing our total score to positive.

› **Conclusion**: We maintain our overweight position to eurozone equities and peripheral bonds while going to neutral on core government bonds. ■

# Asia-Pacific: A time for torpor

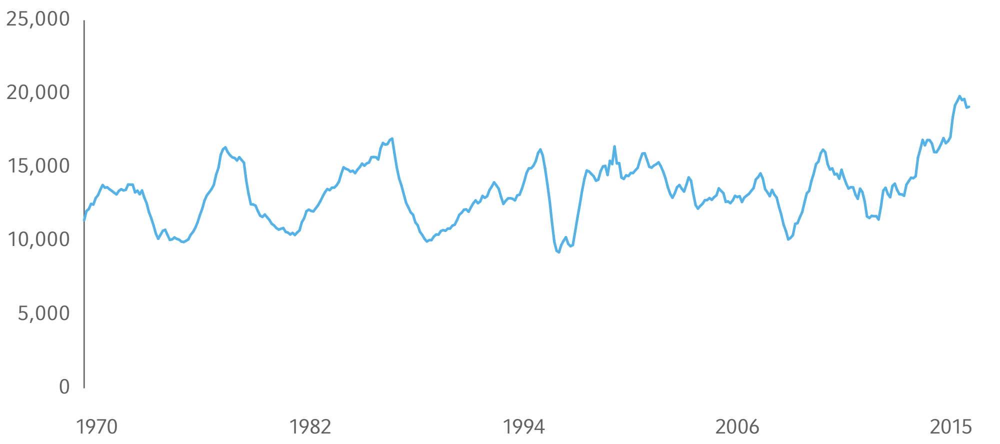
**The Asia-Pacific region continues to trace out a somewhat downbeat economic growth path. Growing pains in China, commodity headwinds in both Australasia and the emerging markets, as well as unconvincing momentum in Japan are combining into an unexciting overall picture. As a result, we are broadly "neutral" on equity markets in this region.**

## Slowdown in developed regional economies

Real growth in Australia and New Zealand is settling down to around 2%, following an extended period when 3% was the norm. Risks to the housing sector are increasing, in our view, for both economies, particularly in Australia where dwelling approvals are beginning to come down from their peak. The commodities backdrop remains dour as over-supply and weaker global demand is placing downward pressure on key export prices such as iron ore in Australia and dairy and lumber in New Zealand. However, we believe that stimulus from lower official interest rates and, more cogently, sharply lower exchange rates will cushion the downside in the Australasian region.

The Japanese recovery story is taking its time to gain strength, and our degree of conviction in the growth story is somewhat qualified.

**Australian Dwelling Approvals**
Annual rate, 3-month moving average




Source: Australian Bureau of Statistics as of July 2015.

The Japanese recovery story is taking its time to gain strength, and our degree of conviction in the growth story is somewhat qualified. Earlier signs of improvement are seeing poorer follow-through than we would have hoped, and only corporate earnings growth stands out as a meaningful positive. With a negative second-quarter GDP reading for Japan, real growth over the past 12 months now stands at just 0.8% and we would not be surprised to see an additional dose of monetary easing from the Bank of Japan before the end of 2015.

## The Pacific Rim—a mixed bag

Outside of Australasia and Japan, the Asia-Pacific nations are enjoying – or suffering, as the case may be – a diversity of economic and financial experiences. Central to the region is the dominant economy of China. In brief, we believe that Chinese officials will successfully engineer a soft landing. However the heightened risks associated with high debt and declining growth, in conjunction with the downdraft in equity prices and weak trade, render it advisable to take a "wait and see" approach to investments in this arena in the short-term.

Elsewhere in the region we are seeing solid and convincing growth in India and reasonable outcomes in the Philippines. There's a slowdown occurring in South Korea. Meanwhile, Indonesia, Thailand and particularly Malaysia are finding the going tough. Corporate profit growth, already downgraded, is likely to disappoint further. The good news is that trends in monetary policy—Malaysia aside—are increasingly supportive, and we believe these actions will lead to more positive growth in due course. As with China, however, we believe it is still too early to buy.

## Strategy outlook

- **Value**: The pullback in stock prices over recent months means that we no longer rate regional equity markets as "somewhat expensive." Value is no worse than "fair" in Japan, China and Australia—although none of those markets is particularly cheap. The backdrop of official rate cuts in many countries (or in the case of Japan, the renewed prospect of further monetary easing) should help support market ratings.
- **Business cycle**: Economic growth, as noted above, is mixed and downbeat. The earnings cycle continues to face headwinds from commodity weakness and from the trade slowdown. However, we expect that easier monetary policy will increasingly underpin cyclical recovery.
- **Sentiment**: This remains downbeat in Australia, and the effervescence which typified China at mid-year 2015 has been well and truly doused. Investor sentiment towards Japan and emerging Asian markets is unenthusiastic. Taken together, this new-found realism should help markets to find a firmer foundation.
- **Conclusion**: We are warming to regional equity markets as prices fall and then settle at lower levels. But we would not yet be overweight the region as a whole. ■

# China: A managed slow-down

**The Chinese economy is decelerating but not collapsing. Policy instruments are being activated towards the goal of a soft landing. While we remain wary of China and its bearing on emerging markets, we believe the impact on developed economies will be contained. A soft landing in our view is not enough to derail global growth.**

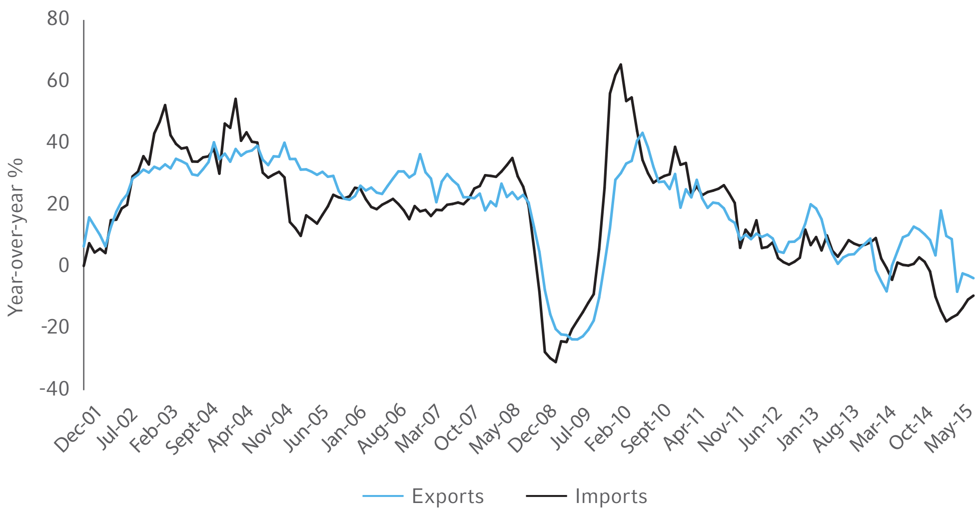
China's real GDP growth decelerated in the first half of 2015 to its slowest rate since the end of the 2008 financial crisis. The deceleration has stirred investor fears that Chinese weakness may undermine global growth. As a major participant in global trade, any weakness in China's economy reverberates throughout the world, and most particularly through to emerging markets and/or commodity exporter nations.

Three key scenarios could play out from here: 1) Chinese growth stabilises and leads a global recovery. 2) China continues to weaken unchecked and causes a global recession. 3) China continues to decelerate, but policy easing prevents the threat to overall global growth from becoming material. With policy responses already visible across the spectrum, we believe this third scenario is the most probable. That is, we believe China is experiencing a meaningful, but ultimately soft landing.

We believe China is experiencing a meaningful, but ultimately soft landing.

The Chinese economy continues to grow at a rate in excess of 6% per annum and, in that sense, remains an engine for world growth. We are seeing solid economic recoveries in the U.S., Europe, India and, less conclusively, Japan. China's central control of its economy means it has a larger toolkit than most other countries.

**China: Import and Exports**




Source: Thomson Reuters Datastream as of Aug, 15, 2015

We believe China's impact on developed markets will remain contained and that a China wobble will not derail the global recovery. Our central case is that the recovery in the developed economies will help underpin the Chinese economy, particularly as the U.S. has so far deferred monetary tightening and as Europe and Japan weigh further monetary easing. Emerging markets, however, are of more concern.

Cyclical weakness in China is a large factor in our ongoing underweight to emerging market equities. Not only does China make up a significant proportion of emerging market equities in its own right, but weak Chinese demand impacts directly upon trading partners such as South Korea, Taiwan and Brazil. More time needs to pass, in our view, before weaker emerging market currencies—and widespread cuts to official interest rates—gain traction.

## Investment outlook

- **Yuan depreciation**: In early August of 2015, China announced it will begin to focus more on market movements when setting the daily yuan reference rate. Accordingly, we expect depreciation pressure will remain on an overvalued yuan. However, with China looking to have its currency included in the International Monetary Fund's (IMF) reserve basket in late 2015 and also hoping to prevent capital outflows, it looks like any ongoing yuan depreciation will be orderly and contained for now.
- **Weaker commodity prices**: We have a negative 12-month outlook for commodities as of Sept. 30, 2015. This is due to a supply overhang across the commodity complex and weakening global demand. Weakness in China, one of the world's largest net commodity importers, is an important consideration, but is far from the sole driver of our decision to underweight commodities.
- **Monetary and fiscal policy**: We expect China to further ease interest rates and reserve requirement ratios. With fiscal and government agency deposits up at close to $US4 trillion, or over a third of GDP, there is also significant scope for fiscal stimulus should it be required.

> Our central case is that the recovery in the developed economies will help underpin the Chinese economy, particularly as the U.S. has so far deferred monetary tightening and as Europe and Japan weigh further monetary easing.

## Strategy outlook

- **Valuation**: Recent market downturns have done much to restore reasonable value to the mainland China equity market. Valuation in our view will be supported into 2016 by falling interest rates and, in due course, a stabilisation of earnings.
- **Business Cycle**: The economic growth cycle is slowing but not, so far, collapsing. We believe China's growth will enter a "soft landing." The earnings cycle is lackluster in 2015, but not negative. Margins in general are improving a touch. The monetary policy cycle is stimulative. However, it is struggling to find traction in the economy in the short term as China makes significant structural reforms from an investment-orientated economy to a consumption-driven economy.
- **Sentiment**: The market in our view is short-term oversold following a dramatic fall. Offsetting this, negative momentum from overblown levels creates a powerful downdraft. We see sentiment as a net negative for now, but expect a levelling out in the months ahead.
- **Conclusion**: We're cautious on exposure to emerging market equities and the slowdown in China is a big part of this view. Volatility could continue through the remainder of 2015. However, in the longer term (2016), the dust should begin to settle as Chinese monetary and fiscal policies begin to stabilise the economy. ■

# Currencies in the low-return world

**Applying our cycle-value-sentiment investment strategy framework to foreign exchange markets, we conclude that the U.S. dollar is still the currency to back.**

Lackluster economic growth and low expected financial market returns have become reluctantly accepted features of the post-financial crisis world. It is easy to see why. The Barclays Capital Aggregate Bond Index shows yields of a measly 1.7% as of Sept. 18, 2015. The long-term return potential for U.S. equities looks uninspiring also.

One potential additional source of portfolio return can come from currency factor strategies, which are rules-based long and short positions in foreign exchange markets. We also describe below how these factors can be used in our cycle, value and sentiment investment process.

One potential additional source of portfolio return can come from currency factor strategies...

## Currency factors

The three most commonly used factors are carry, value, and trend.

› *Carry* captures the tendency of higher interest rate currencies to appreciate relative to lower interest rate currencies.

› *Value* takes advantage of the tendency of currencies to mean revert to a level of long-term economic parity, such as purchasing power parity (PPP).

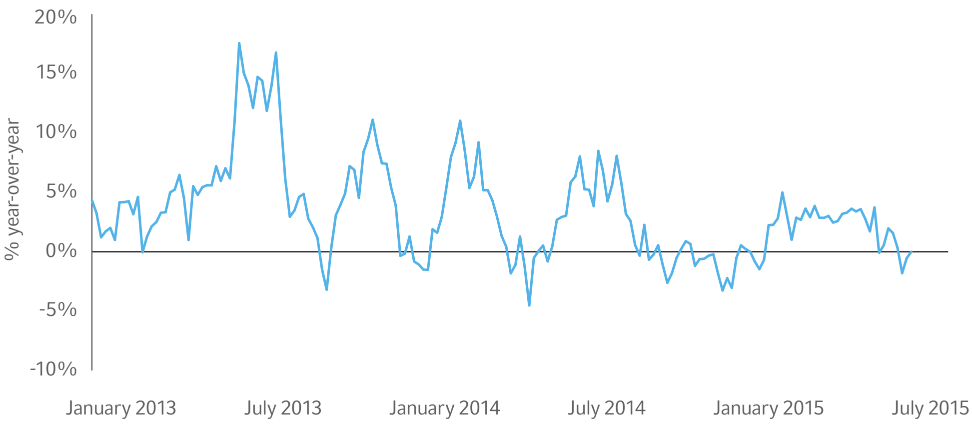
› *Trend* exploits the propensity of currency returns to persist over short- to medium-term horizons so that past returns have some predictive power for future returns.

On their own, each of these factors produces positive average excess returns. However, over shorter time periods each is also susceptible to episodes of negative returns. Fortunately, downturns in currency factor returns do not often happen concurrently, so diversification benefits can be obtained by putting them together.

An equal-weighted combination of all three factors, as represented by the FTSE Russell Conscious Currency index, has earned an annualised return of 3.6% per year between Nov. 1, 1999 and Aug. 31, 2015. Given annualised volatility of 4.5%, the reward-to-risk ratio* is an attractive 0.8.

* A ratio that compares the expected returns of an investment to the amount of risk undertaken to capture these returns. This ratio is calculated mathematically by dividing the amount an investor stands to lose if the price moves in the unexpected direction (i.e. the risk) by the amount of profit the investor expects to have made when the position is closed (i.e. the reward).

**FTSE Russell Conscious Currency Index** (returns as of July 30, 2015)




Source: Bloomberg, as of Sept. 7, 2015

## A cycle-value-sentiment framework for currencies

Currency factors are a simple way to inform currency investment and hedging decisions. They also correspond nicely with Russell Investments' well-established cycle/value/sentiment (CVS) investment strategy framework.

In fact, there is a nearly perfect analogy between the three currency factors of carry, value, and trend and the individual elements of CVS.

Carry corresponds to cycle, as interest rate differentials reflect the relative cyclical positions of the two economies. PPP in currency is analogous to value in other asset classes whereby the goal is to obtain an estimate of equilibrium to which the market price will revert to. Trend can be interpreted as an important part of the sentiment component in our CVS framework.

An increase in the QE programs in Japan and the eurozone in our view is the most likely catalyst for a renewed period of U.S. dollar strength.

But that's only the starting point. When one approaches foreign-exchange markets with a CVS mindset, it is easy to think of additions to the currency toolset.

As shown in the table below, PPP can be complemented with other fair value measures of exchange rates, including real exchange rates and fundamental equilibrium exchange rates. Cycle is not only 1-month carry, but incorporates our regional strategists' view of the policy cycle for the relevant currency area as well as longer-term interest rate differentials. Finally, in the sentiment column on the table, we supplement momentum measures with short-term and medium-term contrarian indicators to determine when trend may be stretched and more likely to reverse.

| Value | Cycle | Sentiment |
|---|---|---|
| PPP | Carry (1-month interest rate differentials) | **Momentum:** Deviation of 50-day from 200-day average |
| Relative PPP and real exchange rates | Regional strategists' cycle view (policy cycle) | **Momentum:** Currency returns over various look-back periods |
| Fundamental equilibrium exchange rate | Longer-term carry | Short-term and medium-term contrarian indicators |

## Current outlook for currencies

During the third quarter of 2015, the U.S. dollar consolidated in a range between 1.08 and 1.15 against the euro. Against the British pound and the Japanese yen, it was a very similar range-bound market while the U.S. currency continued to strengthen against the dollar-bloc currencies of Canada, Australia and New Zealand and most emerging market currencies. The big question in the fourth quarter of 2015 in our view is whether the dollar bull cycle is over or whether the summer consolidation vis-à-vis the other major currencies was merely a pause.

› **Valuation**: According to our models, the dollar is in a range of 10 to 20 percent rich against the euro and yen respectively, and around fair value against the pound sterling.

› **Cycle**: The U.S. Federal Reserve's recent inaction has cast some doubt on the theme of policy divergence, but we still believe that the impending start of a tightening cycle in the U.S. and the U.K. is supportive of the dollar and sterling, respectively, while Japan and the eurozone engage in (and could increase) quantitative easing (QE).

› **Sentiment**: The U.S. greenback seems to have run out of steam against the euro and yen towards the end of the third quarter of 2015; however, longer-term trends still buttress the U.S. dollar.

› **Conclusion**: All in all, we believe that the outlook is still favourable for the U.S. dollar and pound sterling, but less so than at the beginning of 2015. An increase in the QE programs in Japan and the eurozone in our view is the most likely catalyst for a renewed period of U.S. dollar strength.

# Quantitative Modelling: Neutral is the new exciting

**Our quantitative models are neutral and do not indicate a preference for either equity or fixed income. That is, you're unlikely to get any additional compensation from holding equities—despite the higher risk, relative to bonds.**

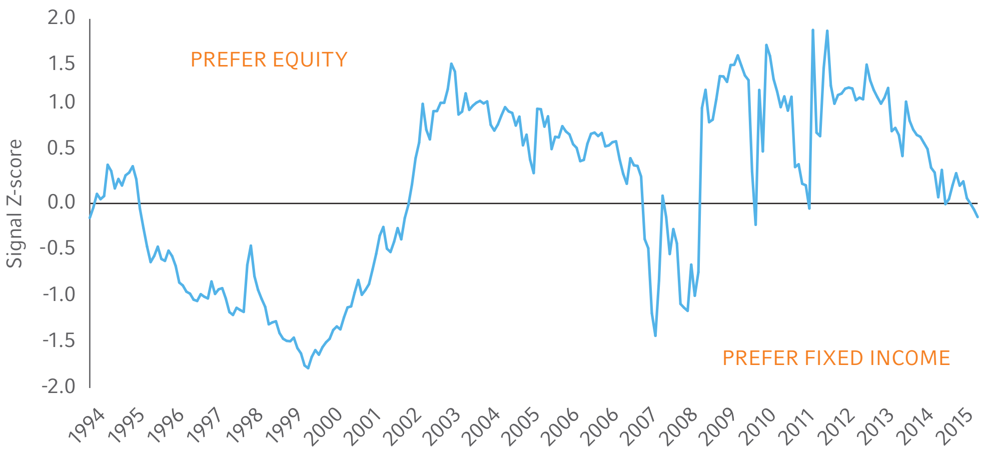
Following the market sell-off in August 2015, equities are cheaper, but still not worth overweighting in our view because of negative momentum and the lack of economic support. Since last quarter, the signal trend has moved further away from equity, but not enough to indicate a bear market.

- **Business Cycle**: The Business Cycle Index has softened slightly but steadily over the past two quarters, and it was a negative contributor to our equity/fixed call.
- **Sentiment**: Following the recent market events, the 12-month declining weighted average of excess returns turned negative.
- **Value**: Since equities dropped in price, the earnings yield increased. This makes equities look more attractive to both dividend discount models and the U. S. Federal Reserve (Fed) model.

Russell Investments' suite of proprietary quantitative models forecasts:

- Portfolios should include a balance of U.S. equity and U.S. fixed income.
- 2.4% U.S. real GDP growth in 2015.

**Equity vs Fixed income Aggregate Signal** (as of Sept. 18, 2015)




## Delayed rate rise

Our Fed Funds Target Model forecasts a January 2016 tightening, at a pace of zero 25 basis point (bp) hikes in 2015, six 25bp hikes in 2016, and two 25bp hikes in 2017. The model projects the Fed's desired monetary policy, given expectations of indicators such as unemployment, inflation and the Business Cycle Index. The U.S. labour market is strengthening, but soft inflation and mixed U.S. economic data pushed up the predicted date of the first rate hike to the beginning of next year. However, the team expects the Fed to raise interest rates in December 2015, because 13 out of 17 Fed members stated that they wish to start raising rates this year.

**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 Quarterly 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 behaviour, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behaviour. 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.

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 FTSE Russell Conscious Currency Index is designed to reflect the performance of common foreign currency market factors (Carry, Value, and Trend). These indexes are built based on transparent and objective rules and provide investors with non-discretionary benchmarks for use in investing in the foreign exchange market.

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 MSCI All Country World Index is a market capitalisation weighted index designed to provide a broad measure of equity-market performance throughout the world. Maintained by Morgan Stanley Capital International, it is comprised of stocks from both developed and emerging markets.

The Shanghai Composite Index in made up of all the A-shares and B-shares that trade on the Shanghai Stock Exchange in China.

The Russell Eurozone Index measures the performance of the equity markets located in the Eurozone, based on all investable equity securities in the region.

The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 314 constituents, the index covers approximately 85% of the free float-adjusted market capitalisation in Japan.

The Euro Stoxx 50 is a stock index of Eurozone stocks designed by STOXX, an index provider owned by Deutsche Börse Group and SIX Group. According to STOXX, its goal is "to provide a blue-chip representation of Supersector leaders in the Eurozone". It is made up of 50 of the largest and most liquid stocks.

The Barclays Capital Aggregate Bond Index is a broad based index often used to represent investment grade bonds being traded in United States. It is maintained by Barclays Capital.



2015 Strategists' Global Outlook (4Q update)

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