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Fed watch.

2015 Global Outlook: Q2 update

The main threat to our moderately positive outlook is that US wage and inflation pressures will emerge.

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Oil prices magnify divergent monetary policies

The first US Federal Reserve (the Fed) rate rise is getting closer, US profits are slowing, the European Central Bank (ECB) has commenced Quantitative Easing (QE), and oil prices have fallen 50%. Amidst these cross-currents, we still like European equities, are cautious on US Treasuries, and remain on alert for rising volatility.

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EXECUTIVE SUMMARY

By **Andrew Pease**

Global Head of Investment Strategy, Russell Investments

A seminal event is approaching as the Fed painstakingly prepares the ground for its first rate increase. It has been six-and-a-half years since the federal funds rate was cut to effectively zero and nearly nine years since the Fed last increased interest rates. The taper tantrum in 2013, when then Chairman Ben Bernanke warned that the Fed might start slowing the pace of asset purchases, reminds us of the risks around monetary policy shifts.

Making the outlook more complex are two factors: the divergent policy direction between the Fed and most other central banks, and the implications of the sharp drop in oil prices. On the one hand, lower energy costs are adding to deflationary pressures, but on the other they are providing a much-needed boost to household spending power across the developed economies.

Our views are largely unchanged from those published last December in the 2015 Annual Global Outlook. Equity markets should rise modestly over the remainder of the year with low oil prices fueling increased consumer spending, and US Treasury yields will likely rise once the Fed starts moving rates up.

Wouter Sturkenboom takes over the reins on the US outlook this quarter. He highlights the financial headwinds from the rising dollar and declining corporate profit margins. Add on lofty equity valuations, and the US starts moving downward on our list of preferred equity market exposures. Wouter is still positive on the US economy, but at this late stage of the cycle, good economic news comes at the cost of an earlier start to Fed tightening.

Europe, by contrast, is experiencing only tailwinds. Growth is picking up, profits are improving, the exchange rate has declined, and monetary policy has been eased decisively. There are still concerns around Greece, but Wouter thinks that these are exaggerated. The European re-rating story looks like it has further to run.

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Asia-Pacific, as usual, is a more diverse story. China, Australia and New Zealand are coming off the boil, but the recovery in Japan is gaining strength. Graham Harman picks Japan as his preferred market and thinks that Abe-nomics is gaining traction. Profits are picking up and the labour market is improving. Inflation remains close to zero, but the upside is that this should encourage an extra dose of quantitative easing from the Bank of Japan. Graham remains relatively relaxed about the China outlook. Growth is slowing, but policy support is already in place and more is likely on the way.

Our investment strategy process relies heavily on the insights from a range of quantitative models. This quarter, Abe Robison and Kara Ng highlight the signals from our key macro-US forecasting models. Our fed-funds model predicts September as the most likely start date for Fed tightening, while our US-business-cycle model predicts that monthly employment gains will average a healthy 230,000 per month for the rest of 2015. The aggregate US equity versus fixed income signal is still in favour of equity, but is moving closer and closer to neutral. ■

Investment strategy outlook

Oil prices, ECB quantitative easing, and the Fed-tightening speculation all dominated the first quarter of 2015. Our highest conviction view remains overweight Europe as we move into the second quarter and our biggest watch point is US wage growth.

Disinflation now, inflation later

Our 2015 Annual Global Outlook published in December 2014 argued that there are two key issues facing investors this year:

1. The implications of divergence in central bank policy direction between the Fed, the Bank of England (BoE), and the rest of the world—and resulting impact on market volatility.
2. The amount of spare capacity in the US economy and how it may influence the Federal Reserve's monetary policy.

These two issues already have come to the fore. With regards to divergent central bank policy, the ECB has launched a 19-month commitment to buy over €1.1 trillion in eurozone bonds, and there is speculation that the Bank of Japan (BoJ) will increase the magnitude of its Quantitative Easing (QE) programme in coming months. Central banks across emerging markets have eased monetary policy so far this year. Simultaneously, the Fed is moving closer to ending six years of zero percent interest rates. Based on observed price movements, the overnight interest-rate swap market predicts three 25 basis point (0.25%) rate hikes over the next 12 months. Regarding the issue of spare capacity, previously, when the unemployment rate has fallen to 5.5%, as the chart on the next page shows, it has usually been associated with faster wages growth.

The 50% drop in the crude oil price since last June magnifies these two key issues. For the ECB and BoJ, the oil-price decrease has added to fears of outright deflation and supported their determination to make monetary policy even more accommodative. The Fed, by contrast, seems more focused on the growth stimulus provided by lower energy costs at a time when the US unemployment rate is falling rapidly.

Meanwhile, European and Japanese equities have outperformed US equities so far this year[1] in local currency terms. Also, the US dollar (USD) has continued to rise, and the spread between yields on US 10-year Treasuries and German government bonds (Bunds) has widened to a 25-year high as at 13 March 2015.

Our central scenario is that equity markets will push modestly higher over the remainder of 2015, and we believe Europe has the most upside potential. We think the US can deliver single-digit gains in earnings per share (EPS) and there will be double-digit EPS gains in Europe and Japan.

A key issue will be the reaction of long-term bond yields to different monetary policy environments in the US and Europe. We expect the Fed to begin a gradual rate rise sequence later in the year that will take the 10-year Treasury yield above 2.5%. At the same time, we expect the magnitude of the ECB's QE programme will keep Bund yields near current levels. Credit should perform well in our view, amid low default rates and an ongoing search for yield by investors.

The main threat to our moderately positive outlook is that US wage and inflation pressures will emerge. This would squeeze profit margins and generate fears of more aggressive Fed tightening. Bond yields under this scenario could spike higher and volatility would increase.

[1] As measured by the Russell Developed Europe Index, Russell Japan Index and US large-cap Russell 1000® Index.

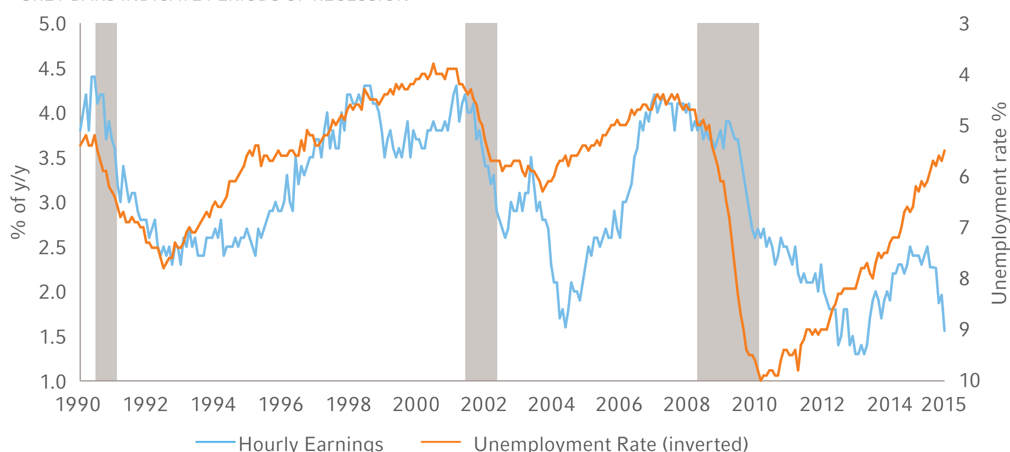
Equities, bonds and credit could all post negative returns. This could be aggravated by the fact that the equity bull market is now six years old, and markets generally get riskier as they get older.

So far, strong US employment gains have not triggered wage gains, and our favoured scenario of moderate jobs growth, moderate inflation, and single-digit profit gains is still on track. The Business Cycle Index (BCI) model that we use predicts—as at 13 March 2015—that 230,000 jobs per month will be created through 2015 on average. At an unchanged labour participation rate, this would take the unemployment rate to near 5% by the end of 2015—below the threshold at which we might expect low unemployment to push up wages.

The most important indicator to watch is hourly earnings in the monthly employment report. This will provide the first evidence that labour market conditions are tightening enough to hurt margins, push up inflation and make the Fed more hawkish. As at February, the monthly employment report showed a surprising lack of wage pressure.

US wage growth & unemployment rate

GREY BARS INDICATE PERIODS OF RECESSION



Sources: Thomson Reuters Datastream and National Bureau of Economic Research

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 developed equities we get the following as at 20 March 2015:

Valuation: The US market is the most expensive equity market with a price-to-book value at 2.9 times and the cyclically adjusted price-earnings (PE) ratio at 22 times. We score both Japanese and European equities as moderately expensive after the strong runs in both markets so far this year.

Business Cycle: This is moderately positive for the US market and Japan. US economic growth is robust and profits are growing at a moderate pace. Profits are picking up in Japan, but economic indicators are fairly lackluster. Japan, however, is a big beneficiary of lower energy prices: the weak yen is boosting exports and there is the likelihood of extra stimulus from the BoJ. Regarding Europe, we score the cycle as very positive. Economic indicators are improving, the ECB's QE programme is kicking off, and there is the potential for strong gains in corporate profitability after four years of sluggish growth.

Sentiment: Momentum is currently a positive driver of most equity markets, although this has weakened in the US and strengthened in Japan and Europe. Many of our contrarian signals, such as investor-sentiment surveys, are in overbought territory. However, these point to a modest pull-back rather than a large correction. One important indicator, the level of margin debt at the New York Stock Exchange, has declined over the past four months[2], suggesting that the US market is not yet over-exuberant or at risk of a major sentiment shift.

[2] The New York Stock Exchange posts monthly margin debt figures on its website: NYXdata.com.

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

US Treasuries versus Bunds

The yield on 10-year Bunds has fallen more than 30 basis points (0.30%) to a record low around 0.2% as at early March. That puts the spread between the yield on 10-year Treasuries and Bunds at its widest in 25 years.

Our outlook for treasuries is driven by flows versus fundamentals. The flows reflect the increased demand for Treasuries, which are yielding more than European bonds being bought in huge amounts as part of the ECB's QE programme. In contrast, the fundamentals include the tightening US labour market and prospects for rising wages, inflation, and Fed tightening. In the short term, flows could dominate as ECB buying of European bonds creates demand for higher yielding Treasuries from investors who sold to the ECB. But fundamentals could take over later in the year once the Fed starts raising interest rates. We think 10-year US Treasury yields can rise above 2.5% over the next 12 months and the spread to Bunds may widen even further.

Still hard to be bearish USD

The USD has been the star performer relative to all other major currencies so far in 2015, rising over 5% in trade-weighted terms as at 13 March 2015. It is close to parity against the euro and near an eight-year high against the yen. The arguments against a continued rise in the USD are that it has already had a big run and is now 7.5% above its long-term average[3]; and events like ECB QE, BoJ easing and anticipated Fed tightening are already largely priced into the price of the USD. Currencies, however, are prone to overshooting, and, in our view, it would be unwise to bet against the current momentum, especially when the Fed is headed in the opposite direction of the ECB and BoJ.

We think 10-year US Treasury yields can rise above 2.5% over the next 12 months and the spread to Bunds may widen even further.

Emerging markets: cheap but exercise caution

Our value, cycle, sentiment process rates emerging markets (EM) exposure as cheap for both equities and debt, suggesting there are good long-term return opportunities. Tactically we're cautious because of cycle concerns. The rising USD, falling commodity prices, and political instability in many regions feed into our negative cycle score. This could change if policy easing by many EM central banks starts to take effect, China eases fiscal policy significantly, and the USD continues to stabilise.

Still waiting for the Fed

The key question for 2015 in our view remains the amount of spare capacity in the US economy. This will determine the amount of inflation pressure, the extent of Fed tightening, and the readings on profit margins and long-term interest rates. We expect moderate inflation pressures and a moderate Fed, but there is a risk that markets get a fright when the Fed starts raising rates. Europe and Japan offer potentially more equity upside, and we are wary of the potential for long-term interest rates to rise later in the year. A continued strong USD is the consensus view, and the divergence in monetary policy between the Fed, ECB and BoJ means it is too early to expect a reversal. ■

[3] Source: US Federal Reserve. Real trade weighted exchange rate against the major currencies, average since 1973.

United States: Two steps forward, one step back

The US economy continues to move forward, but some investors are taking a step back. And we can't blame them since the headwinds to US financial markets are gathering strength. High valuations, the strong dollar and lower profit margins are making it a challenging environment. Paradoxically, even strong jobs reports are no longer unequivocal good news because they bring forward the likely date of the first Fed rate hike.

A robust economy leads to normalised monetary policy

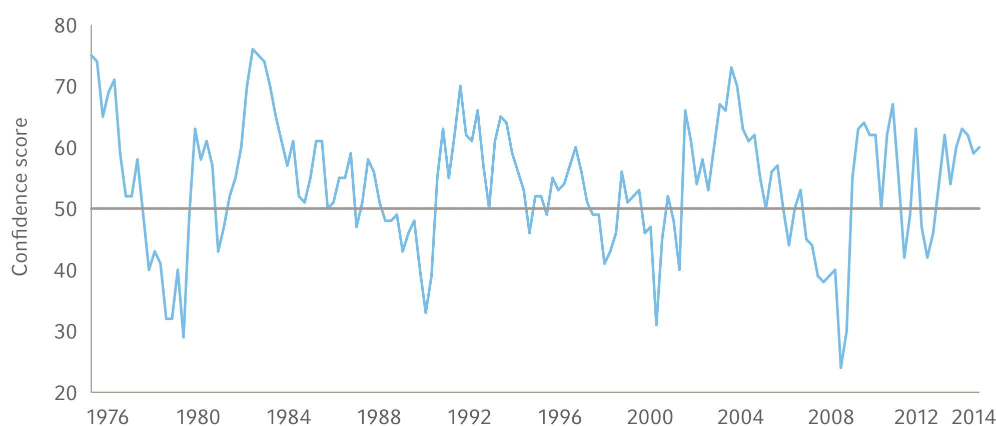
Although the US economy is currently going through a bit of a soft patch, we remain optimistic that growth will recover its vigour over 2015 as a whole. A strong consumer, supported by a large fall in energy prices and an improving labour market, is going to be an important growth driver through mid-2015. Consumption strength even has the opportunity to become a sustainable driver over the longer term.

This requires wage growth to finally pick up, which we expect to materialise in the coming quarters. Business investment should also stay healthy, as revenue growth beckons and because CEO optimism is high. On the downside, the strong dollar will hurt exports and multi-national profits, while monetary-policy tightening will act as a brake on growth. But since lower oil prices depress energy imports, net trade is unlikely to be very negative.

As the US economy advances, it slowly runs out of non-inflationary growth potential. With every strong jobs report, the labour market tightens, which in due time will cause wage growth to rise and prices for goods and services to be bid up. The Fed recognises this, which is why it ended its Quantitative Easing programme, removed the 'extended period' language from its policy statement in 2010, and started communicating to markets that it is getting ready to hike rates. Interestingly, it is doing so while inflation is falling rapidly—the 12-month-based figure dropped from 2% last July to -0.2% this January—and the strong dollar is effectively tightening monetary conditions. However, the Fed is currently choosing to look through what it views as the transitory nature of the oil price decline while downplaying the negative impact of the strong dollar on a relatively closed economy such as the US.

Expectations for 2015 earnings growth have collapsed from 12% to 2% over the past six months through the end of February. About half of that reduction is due to the downgrades in earnings for the energy sector and the rest can be attributed to the strong dollar and falling profit margins.

CEO Confidence Index



Source: The Conference Board as at December 2014

From our point of view, the Fed is on the right track. It is moving away from calendar-based forward guidance and towards data-dependent monetary policy. This will give it the flexibility to respond to the economy as it evolves. If we are correct in thinking that wage growth will accelerate, reflecting the fall in unemployment, then a rate hike in September is most likely. Of course, it's possible that the Fed may choose not to wait for wage growth to rise before it hikes rates – in which case we would see the first rate hike in June. However, given the Fed's cautious attitude, mixed with the current run of softer data, we do not think the first rate increase will come until the end of summer.

Investment outlook

Although we have a positive outlook for economic growth, we are worried about the obstacles to a sustainable rally in US financial markets. Incidentally, the headwinds that US markets face are almost the exact opposite of the tailwinds to eurozone assets:

› *Valuation*: US equities are outright expensive. The Shiller P/E[4] ratio is above 27 versus a long-term average of 16, and the price-to-book ratio is a lofty 2.9 as at 15 March 2015.

› Stronger dollar: The continued rise is hurting exports and depressing foreign earnings.

› *Falling profit margins*: The pressure on profit margins is already tentatively visible and is likely to rise as wage growth picks up.

› *Corporate earnings growth*: Expectations for 2015 earnings growth have collapsed from 12% to 2% over the past six months through the end of February (as measured by the Institutional Broker Estimate Service survey of earnings forecasts by sell-side analysts for the S&P 500® Index.) About half of that reduction is due to the downgrades in earnings for the energy sector and the rest can be attributed to the above-mentioned strong dollar and falling profit margins. Combined, the outlook has deteriorated below our previous expectation of mid-single digit earnings growth in 2015.

› *Monetary policy*: As the Fed slowly moves toward its first rate hike, equity markets start to use a higher discount rate to value future profits.

The outlook has deteriorated below our previous expectation of mid-single digit earnings growth in 2015.

Of course, positive revenue growth and a lower oil price are tailwinds, but they fall short as a full counterweight. In sum, although we are not overly negative on US financial markets, we also don't see them pushing higher in a sustainable manner.

Strategy outlook

Applying our investment strategy process to US equities we see as at 20 March 2015:

› **Valuation**: Both US equities and US government bonds are considered expensive, and this acts as a substantial headwind.

› **Business cycle**: The US economy is robust and GDP growth is likely to reach 2.5% to 3.0% in 2015, which keeps our score moderately positive. This does not mean, however, that we fully discount the negative impact on equity markets from potentially disappointing earnings growth and falling profit margins. For US Treasuries, it will be important when the Fed hikes rates and how it proceeds thereafter. Fed policy—combined with GDP growth and inflation picking up in the second half of the year—is expected to push 10-year Treasury yields higher.

› **Sentiment**: Equity momentum has stayed positive but several of our other sentiment indicators have continued to flash red. As a result, overall equity sentiment is neutral. In terms of sentiment for fixed income, US Treasuries became very overbought in January 2015, and we have maintained a negative score since then.

› **Conclusion**: We have moved from a recommended small overweight in US equities relative to global equities to a small underweight because of expensive valuations and disappointing corporate earnings growth. We still expect 10-year Treasury yields to reach 2.5% to 3.0% by the end of 2015. ■

[4] Shiller PE defined: This cyclically-adjusted price/earnings ratio, otherwise known as the CAPE, measures the price of a company's stock relative to average earnings over the past 10 years.

The eurozone: The pieces are falling in place

The puzzle of eurozone economic growth, corporate earnings and policy action is being solved. Growth is back and earnings are rising, while monetary and fiscal policies are decisively reflationary. In other words, the tailwinds are working their magic. Eurozone assets are reflecting this new reality and our high conviction overweight is paying dividends.

When a plan comes together

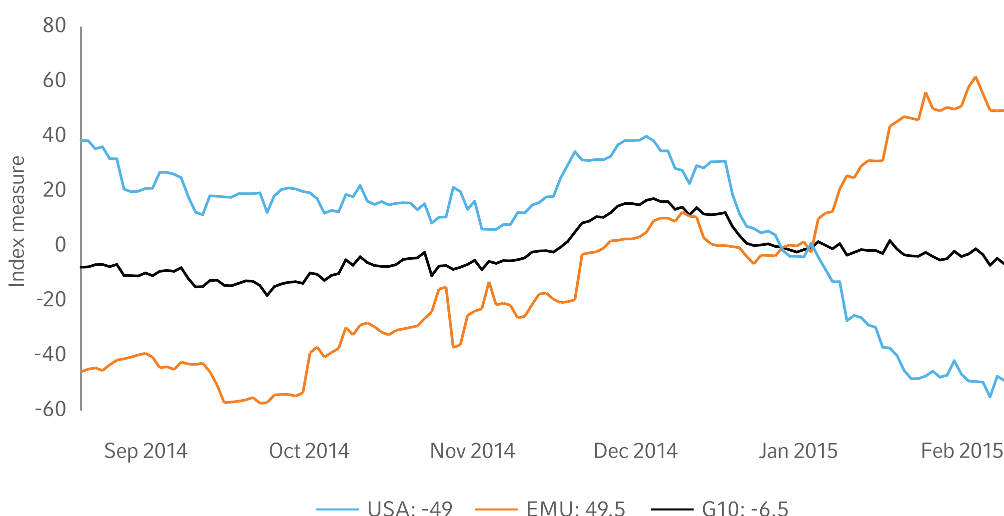
European Central Bank president Mario Draghi is sounding a lot like Hannibal from the A-Team* these days. His bold interventions to stop falling inflation expectations from tightening monetary conditions is working—and growth is receiving a nice boost, to boot. The smile on his face is already there; all he needs to complete the picture is a cigar.

Despite the strong rally, eurozone financial assets are still relatively cheap, especially versus US assets.

Obviously, Draghi is taking credit for something that is only partly of his making. Sure, his interventions have pushed down the euro exchange rate and shored up credit growth. These outcomes, in turn, have supported corporate earnings and exports. What he did not do, however, is push down the oil price or boost domestic consumption. Even more, from an investor's perspective, he did not make eurozone assets cheap relative to their international counterparts.

Still, his plan is coming together. Inflation expectations are rising and growth momentum is picking up. And the side effects are nice too: strong corporate earnings growth, rising asset prices, and increased fiscal leeway. This positive feedback loop proves how quickly a situation can advance when you combine strong reflationary forces with low expectations.

In the chart below, we see that the eurozone economy has surprised to the upside for six months straight and its financial markets have outperformed significantly as a result.



Source: Thomson Reuters Datastream as at 9 March 2015

Index measures the actual outcome of economic data releases relative to consensus estimates.

G-10: Eleven industrialised nations that meet on an annual basis to consult each other, debate and cooperate on international financial matters. The member countries are: France, Germany, Belgium, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States and Canada, with Switzerland playing a minor role.

EMU: Euro-area Economic and Monetary Union

*The A-Team is an American action-adventure television series from the 1980s about a fictional group of ex–US Army Special Forces personnel who work as soldiers of fortune. The cigar-smoking team leader's catchphrase was "I love it when a plan comes together."

Looking ahead, we maintain our overweight to the eurozone because we think the positive effects of the tailwinds mentioned below will continue. Our eurozone overweight is not a short-term trade:

› Valuation: Despite the strong rally, eurozone financial assets are still relatively cheap, especially versus US assets.
› Corporate earnings growth: Expectations have held up well despite the large downgrades in the energy and materials sectors. At 15.4%, observed industry consensus expectations for 2015 earnings per share (EPS) growth are a bit high relative to our estimate of 8% to 12%, but far from impossible.
› Lower euro: The euro continues to fall, supporting both corporate earnings and inflation.
› Lower oil price: The oil price has bounced a bit in euro terms but is still down about 30% relative to a year ago.
› Fiscal & monetary policy: Quantitative easing has arrived, pushing down bond yields and supporting equity prices. Incidentally, lower bond yields are giving cash-strapped eurozone governments much needed fiscal relief.
› Credit growth: Eurozone credit growth continues to improve and has turned positive for the first time since mid-2012. Money growth is also accelerating and we expect this trend to continue, supporting overall economic growth.

Of course, all of this optimism does not mean we can stop being vigilant, which is why we continue to monitor our watch points:

› The 5y5y forward inflation swap. We don't want to see inflation expectations, as discounted by this measure, decisively fall below 1.8%. (It stands at 1.76% as at 20 March 2015.)
› The spread of 10-year Portuguese government bond yields over their German counterparts. We used to look at the Bund yields as well as Italian and Spanish spreads, but the impact of QE on the former and the lack of contagion risk from Greece on the latter have made us shift our focus to Portugal. We don't want to see the spread rise above 2.5%. (It stands at 1.36% as at 10 March 2015.)
› Credit growth. The improvement has to continue.

We maintain our overweight position to eurozone assets. For international investors, we reiterate that the worries around Greece need to be heavily discounted. In the end, we believe it is too small to matter.

Strategy outlook:

› **Valuation**: Eurozone equities are neutrally valued in an absolute sense, but they are still cheap relative to the US market.
› **Business cycle**: We maintain our positive outlook for the business cycle. On the back of better-than-expected growth momentum, we have upgraded our expectation for GDP growth in 2015 from a range of 1% to 1.5% to a range of 1.5% to 2%.
› **Sentiment**: Price momentum is improving but our contrarian indicators are now stretched, giving us a small negative score overall.
› **Conclusion**: We maintain our overweight position for eurozone assets. As for international investors, we reiterate that the worries around Greece need to be heavily discounted. In the end, we believe it is too small to matter. The situation in Ukraine is more serious, but unless it escalates into a trade war, we don't expect markets to be heavily impacted. We also believe the stories around the feasibility of QE are overdone. At €8 trillion—over half of which is in foreign hands—there are plenty of bonds to buy, although doing so will of course drive yields and spreads further down. In fact, the real surprise may be that the ECB can stop QE earlier than expected because growth and inflation outperform. ■

Asia-Pacific: Getting back to normal

Economic growth in the Asia-Pacific region looks to be well-behaved as we enter the second quarter of 2015. The strong numbers delivered by China, Australia and New Zealand in 2014 are coming off the boil, but their slowdowns are orderly. Recovery in Japan is gathering strength, and a convincing reform programme is underway in India. Regional equity markets are performing well. They remain reasonably valued, but we see lower rates of return in the year ahead.

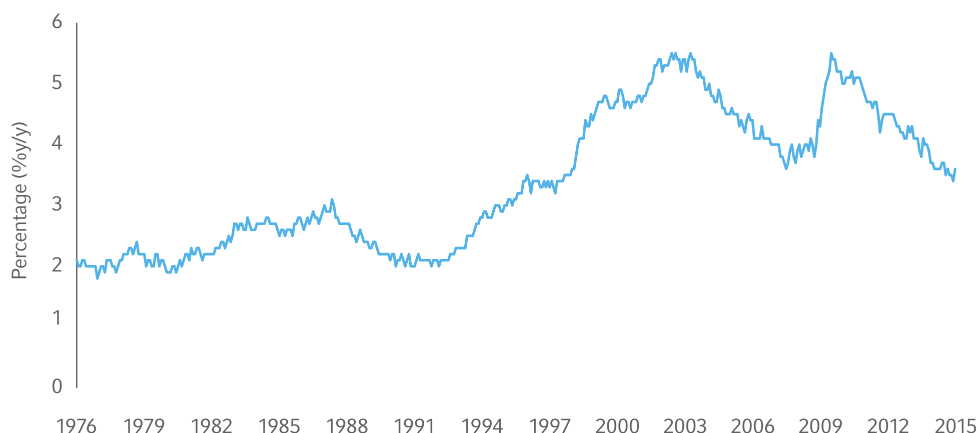
China and Japan—the lynchpins

China and Japan are the two major players in the Asia-Pacific region, and we expect respectable growth from both countries through the remainder of 2015. In China, 'normalisation' implies a gradual slowdown, following the heady growth of recent years. We look for GDP to grow at 6.5% to 7% in 2015, down from 7.3% last year. Headwinds include a pull-back in residential property prices, concentrations of debt, and the costs of governance; as well as environmental-reform programmes. However policy-makers have at their disposal a formidable array of tools, including monetary, fiscal, and exchange-rate policy—and all of the dials are set to 'supportive.' A range of more 'micro' levers, such as debt-swaps and adjustments to reserve requirements are also being actively managed. With Chinese inflation not-too-hot and not-too-cold, flexibility exists to manage the slowdown in a constructive manner.

Expectations of 8% EPS growth for Asia-Pacific ex-Japan and growth in the low teens for Japan, in our view, leaves the region well ahead of the world as a whole.

To the east of the Yellow Sea, 'normalisation' takes on a different perspective as growth re-emerges in Japan following long decades of stagnation. We believe that Prime Minister Shinzo Abe's 'Abenomics' is gradually gaining traction—with the labour market strong—and resolute monetary stimulus delivering the desired result of a sharply weaker yen. In the context of these developments, corporate earnings growth in Japan is now amongst the most buoyant in the world. Nonetheless, significant areas at weakness remain; in particular, core inflation is running at levels not noticeably different from zero. A further dose of Quantitative Easing (QE) remains a possibility, perhaps mid-year.

Unemployment rate, Japan



Source: Statistics Bureau, Ministry of Internal Affairs & Communication, Japan (as at February 2015).

Australia and New Zealand are holding up

Moving south to Australasia, the two miracle economies of the 2008 financial crisis are settling down from economic performances which, by western developed-nation standards, have been eye-catching for some time. Broadly speaking, both Australia and New Zealand are decelerating from growth rates around 3% and are looking for growth of about 2% or so for the year ahead. Both countries are beset by plummeting commodity prices—iron ore and energy in Australia, milk in New Zealand—and both are using currency weakness to cushion the downdraft. Of the two, the economic outlook is reasonably well balanced in New Zealand, and we expect ongoing steady growth with official cash rates steady. Australia, in contrast, is being wrenched in a number of directions simultaneously. Housing is booming, but could cool dramatically on a 12-month view; the mining sector continues to plummet; and overall economic health is mixed, but not bad.

Investment outlook

In line with this acceptable, but mixed and unexciting economic growth outlook, we see risk assets—both stocks and bonds—as reasonable, but not compelling, investments. Major drivers include:

- Supportive monetary policies: Particularly notable in China, Japan, India and Australia.
- Currency weakness: Across the region.
- Corporate earnings growth: Observed industry consensus expectations of 8% EPS growth for Asia-Pacific ex-Japan and growth in the low teens for Japan leaves the region well ahead of the world as a whole.
- Weaker energy prices: A headwind for Australia, but a significant tailwind for major economies such as Japan and China.
- Competitive bond yields: Particularly in Australia and New Zealand, even following the significant spread-narrowing that has already occurred.

Bond spreads (over the US) in Australia and New Zealand are thin by historical standards, but in our view still offer some of the last pockets of yield across the globe.

Strategy outlook:

- **Valuation**: Asia-Pacific equity markets have run hard in recent years, and we rate the region as somewhat expensive; however, we believe yield support in Australia and New Zealand and low price-to-book ratios in Japan and China will provide some support. Bond spreads (over the US) in Australia and New Zealand are thin by historical standards, but in our view still offer some of the last pockets of yield across the globe.
- **Business cycle:** Steady growth in the region should be sufficient to put a floor under equity markets, although in China and Australia in particular, a deceleration flavour may cast a shadow over equity performance. On the plus side, the policy cycle remains very supportive in both the slowing economies (China, Australia) and also those where growth is on the up, but inflation is not an impediment to QE and/or rate cuts (such as India and Japan). Local cyclical forces, likewise, do not pose any particular risks for bond markets.
- **Sentiment**: Sentiment has remained reasonably upbeat, albeit with some concerns about the downside risks in Australia and China.
- **Conclusion**: Japan is our preferred Asia-Pacific equity market. We expect lower returns for the region in the year ahead, compared to the year behind us. Australian and New Zealand bonds offer reasonable yields, but the strength in those markets is now mature. Both are at risk in the event of any sell-off in the US Treasury market.

Quantitative Modeling Insights: Equities aren't cheap, but have you looked at bonds?

The US economy is strong and heading toward a rising interest rate environment. This makes equity more attractive than fixed income, despite both being expensive.

Model-based outlook:

Russell's suite of proprietary quantitative models forecast that:

- Globally, equity will outperform fixed income.
- The business cycle, as measured by the Business Cycle Index (BCI), will be relatively robust in the coming year.
- US real GDP growth will accelerate toward 3.0% in 2015.
- The US Federal Reserve will first raise interest rates in September 2015.

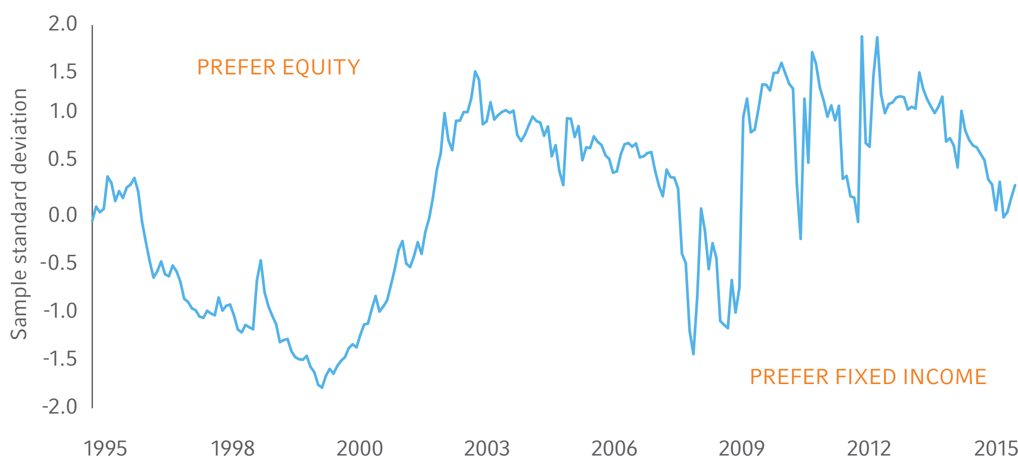
Since 2010, our Fed Funds Target model has consistently predicted a first tightening in 2015. By contrast, the Blue Chip Consensus was expecting rate increases as early as 2011, and has gradually moved toward our view.

Equity looks more attractive than fixed income…

Our quantitative models show a moderate preference for equity over fixed income. The models suggest that equity is absolutely expensive and overbought, but relatively cheap when compared to fixed income. This equity preference is supported by a Fed model that compares relative yield and a dividend discount model that finds fair value. Furthermore, our dynamic probit model, which incorporates economic and financial indicators, foresees mid- to high-single-digit growth in equities, but with higher volatility than in 2014. This is driven by both price momentum and the economic cycle.

When we aggregate the signals, we get a moderate preference for equity— although this signal has weakened over the last couple of years. A strong US economy helps equity, but a rising interest rate environment disproportionally hurts fixed income.

Equity-Fixed Income Aggregate Signal



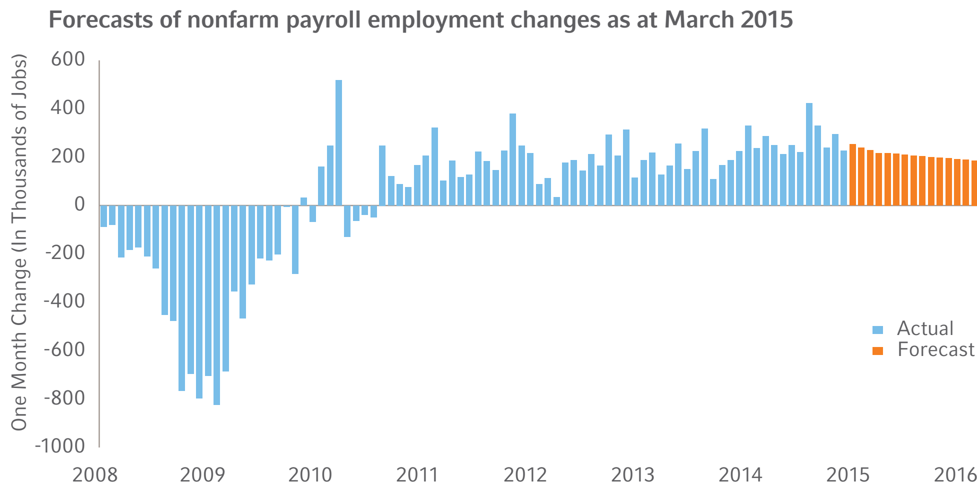
Source: Russell Investments

In statistics, the standard deviation is a measure used to quantify the amount of variation or dispersion of a set of data values. A standard deviation close to 0 indicates that the data points tend to be very close to the mean of the set, while a high standard deviation indicates that the data points are spread out over a wider range of values. When only a sample of data from a population is available, the term sample standard deviation is used.

… given the robust economic backdrop…

Turning to the business cycle, the US BCI signals a low risk of recession and is consistent with 3% GDP growth and 230,000 average monthly job gains in 2015. The BCI incorporates inflation, consumption growth, employment growth, the US corporate credit spread, and the 10-year US Treasury yield curve to diagnose the overall health of the economy.

Forecasts of nonfarm payroll employment changes as at March 2015

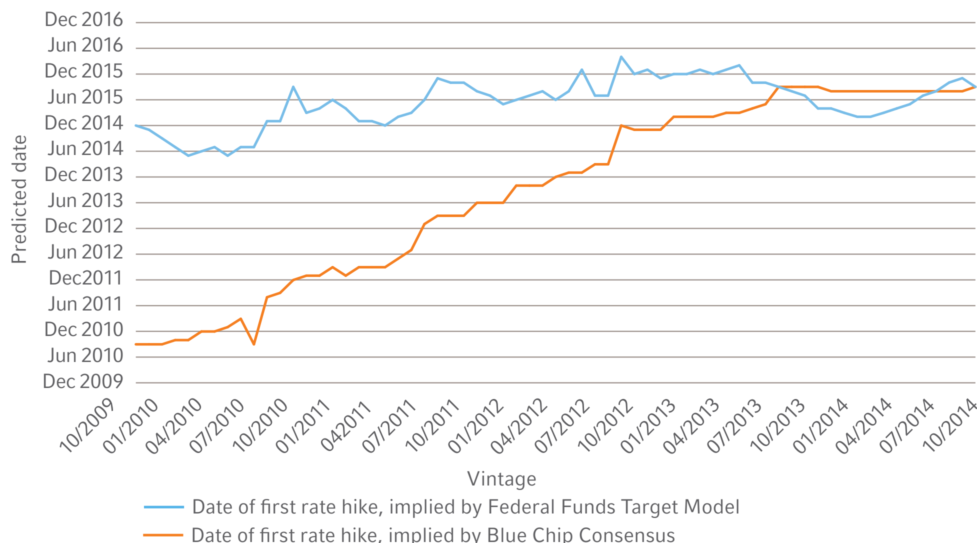


… and rising interest rate environment.

Our Fed Funds Target model forecasts a September 2015 rate hike. The model projects the Fed's desired monetary policy given our analysis of indicators such as unemployment, inflation, and the BCI. The US economy is robust and the labour market is strengthening but soft inflation, exacerbated by transitory energy price drops, pushed the predicted date of a rate hike to the second half of the year.

The graph below compares Russell's model and Blue Chip Consensus' historical predictions of when the Fed will first raise the Fed funds target rate. Since 2010, our model has consistently predicted a first tightening in 2015, and the consensus has moved toward our view. ■

Vintage predictions for date of first Fed funds rate hike



Source: Russell Investments

Date of first rate hike implied by Blue Chip: The date of the first Federal Reserve rate hike, as implied by Blue Chip Consensus' forecasted effective federal funds rate. Blue Chip is a monthly publication that polls top economists in industry.

Date of first rate hike implied by Federal Funds Target Model: The forecasted date of the first Federal Reserve rate hike, as implied by a model that looks at inflation, labour conditions, and economic health.

In assessing the attractiveness of asset classes relative to one another, Russell's modeling capability uses a pair-wise construct with asset classes shared across multiple pairs, each with independent valuations. At present, the capability includes over 120 pairs leveraging signals from greater than 400 models. The signals used are based on proprietary models developed by Russell, and they generally fall into three categories:

Multi-variate, where the valuation signal is a function of various economic, characteristic and market variables.

Uni-variate, in which return differences between two asset classes are a function of a single characteristic or market variable.

Statistical, in which deviations from long-term trends in return patterns of two asset classes signal the direction and magnitude of expected returns.

All the models seek to identify factors to signal which of two asset classes in a pair has better return prospects, given historical patterns of subsequent relative returns. Married to each individual model is a model-specific tilt function to make best use of each unique signal. Having multiple models per pair provides diversification of signals to arrive at a weighted tilt.

This report is not intended to be used as the basis for a trading strategy or as an asset class trading tool.

Russell Investments

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 at 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.

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

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

Investment in Global, International or Emerging markets may be significantly affected by political or economic conditions and regulatory requirements in a particular country. Investments in non-US 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-US 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-US and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

Diversification: strategic asset allocation and multi-asset investing do not assure profit or protect against loss in declining markets.

The Russell 1000® Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000 and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the US market.

The Russell Japan Index, a country-specific subcomponent of the Russell Global Index, measures the performance of investable Japanese securities, based on market capitalisation.

The Russell Europe Index, a subcomponent of the Russell Global Index, measures the performance of investable European securities, based on market capitalisation.

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.

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2015 Strategists' Global Outlook (2Q update).

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