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Event Horizon

2016 Global Market Outlook—Q4 update

The backdrop of lackluster global economic growth trends and expensive U.S. equity valuation keeps us concerned that risk assets, such as equities and corporate credit, are vulnerable to bad news.

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Serenity now…

A number of upcoming events could generate market volatility. Although our process still sees U.S. equities and global government bonds as expensive, market setbacks could provide opportunities to take on more risk.

EXECUTIVE SUMMARY

By **Andrew Pease**
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Well, maybe not quite Seinfeld's "insanity later"[1], but things might soon start to get more interesting. The U.S. election, an expected Italian referendum and the re-starting of the U.S. Federal Reserve's (Fed) tightening phase could knock markets out of their summer languor.

The U.S. equity market is still worryingly expensive, profit growth is lackluster and long-term interest rates are still extraordinarily low. Asset markets are precariously priced and vulnerable to shocks. It's a low-return world where the ability to dynamically allocate between asset classes is becoming increasingly important.

Paul Eitelman expects the Fed to re-start its tightening program in December and follow up with two further hikes in 2017. He thinks U.S. corporate earnings have bottomed but growth is going to be tepid. Paul is sticking with his "underweight U.S. equities" view.

The UK's Brexit referendum has been a smaller shock than initially feared, and Wouter Sturkenboom is revisiting his case for European outperformance. The upcoming Italian referendum argues for caution, but a "yes" vote could kick-start a more positive European outlook.

Asia-Pacific remains an unexciting investment region full of crosscurrents, according to Graham Harman. China is rebalancing, Japan has unconvincing growth and Australia is coping with the commodities downturn. On the plus side, equity market valuation is moderately attractive across the region.

Increasing divergence between the Fed and other central banks is driving Van Luu's views on currencies. He thinks the U.S. dollar (USD) can rally to its previous recent highs. British sterling has the most downside as investors focus on the longer-term implications of Brexit.

Kara Ng and Abe Robison take a closer look at the recession probability for the next 12 months predicted by our U.S. business cycle index model. This has risen to 20-25% at the end of the third quarter from 10-15% a year ago. The rise is not surprising given the age of the economic expansion since the financial crisis of 2008, but the probability is still relatively low and not alarming.

Overall, our process is advocating a relatively cautious investment stance. The economic expansion is advanced, corporate earnings are subdued and the Fed seems set to resume raising rates. Low U.S. recession risks, however, mean that event-related market pullbacks may provide investors with opportunities. ■

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Asset markets are precariously priced and vulnerable to shocks. It's a low-return world where the ability to dynamically allocate between asset classes is becoming increasingly important.

[1] Seinfeld is an American television series that aired for nine seasons in the 1990s. The phrase "serenity now, insanity later" was coined by a character in reference to a self-help technique to suppress explosive urges.

Investment Strategy Outlook

Event risk is returning as the U.S. presidential election tightens, the Italian referendum approaches, and the likelihood of a December U.S. federal funds rate hike increases. We continue with our buy-the-dips, sell-the-rallies investment strategy.

Event horizon

It's been an uneventful northern hemisphere summer; the United Kingdom's Brexit vote was a smaller blow than feared and global markets have drifted toward risk asset exposure. As the weather cools, however, markets could start to heat up. The U.S. presidential election has the potential to deliver a market shock. We believe investors have yet to fully focus on the policy unpredictability that might accompany a Donald Trump victory, particularly the implications for geopolitical stability. Rising odds of a Trump victory as the election nears could trigger some flight to safe-haven assets.

The Italian referendum on constitutional reform will be held in late November or early December. Prime Minister Matteo Renzi faces a populist, anti-austerity backlash and the populist Five Star Movement is pushing for a vote on the euro. A "no" vote in the referendum could force Renzi to resign, causing a spike in fears about Italian stability and the fate of the euro.

And investors are likely to become more nervous as the Fed's mid-December Federal Open Market Committee meeting approaches. We think the Fed is on track to deliver a 25 basis point rate rise. Markets usually respond more calmly to the second and subsequent Fed hikes. However, the 12-month gap from the initial rate increase makes this similar to a new tightening phase. January and February of 2016 were volatile months, as reflected by the S&P 500® Index, as last December's rate hike was absorbed. There could be a similar reaction this time.

Our investment strategy outlook at the end of the third quarter is broadly unchanged. The outlook for economic growth is lackluster globally and inflation pressures are muted. However, recession risks for the U.S. economy are still low. Global central bank divergence remains a key theme. The Fed might be contemplating a rate hike, but the European Central Bank (ECB), Bank of Japan (BOJ), and Bank of England (BoE) are all considering further easing measures.

Our process has a neutral overall allocation to global equities. We prefer European and Japanese equity exposure to the U.S., mostly on valuation grounds. We're wary of government bonds globally on a 12-month outlook, although these may benefit from event-driven risk aversion.

We think the U.S. dollar can move to the top of its recent range and see the most downside for the British pound as the full implications of Brexit are slowly absorbed.

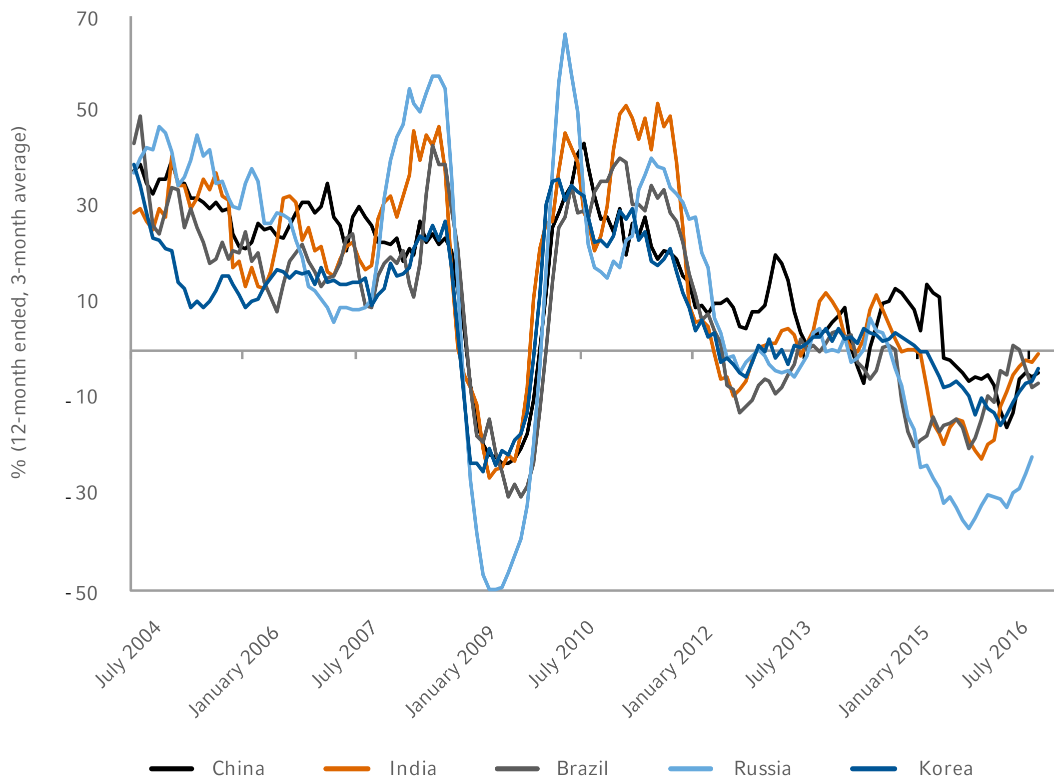
We still want to buy equity market dips and sell rallies, but for now our process has us at broadly neutral asset allocations with a slightly higher cash position.

Key indicators update

The three key indicators we identified in our 2016 Global Market Outlook at the end of 2015 continue to provide a good guide to market conditions. U.S. non-farm payrolls growth has rebounded from some overstated weakness, and earnings-per-share (EPS) growth for the S&P 500® Index has marginally improved. Exports from emerging markets economies are still mostly lower than a year ago, but they are gradually improving.

- **U.S. non-farm payrolls**. Payrolls have been volatile on a month-to-month basis, but have averaged 180,000 over the first eight months of 2016. We expect monthly gains of 150,000 over the next 12 months. In our assessment, it takes job gains of around 120,000 to keep the unemployment rate steady, so this will maintain pressure on the Fed to consider more tightening.
- **S&P500 EPS growth**. Operating earnings picked up a little in the second quarter of 2016, although they were still 3% lower than a year earlier. This, however, was an improvement on the 8% annual decline in Q1. The outlook is at best tepid. The drag from energy prices has passed, but we see rising labor costs and renewed U.S. dollar strength as headwinds.
- **Emerging markets (EM) exports**. EM exports are showing signs of recovery. As with most EM indicators currently, it is more a case of "less bad" that outright positive.

Exports by Selected EM Country



Source: Thomson Reuters Datastream export data, as of Sept. 16, 2016

Global equities: cycle, value, sentiment

Our cycle, value, and sentiment investment process offers the following assessment of global equities at the end of Q3 2016.

- **Business Cycle**: We rate the cycle as neutral for developed markets, with the exception of the UK where the ongoing fallout from the Brexit vote will be a drag on equity market performance. We also see potential upside for Europe and Japan cycle scores from further monetary policy support, but this is offset by lackluster outlooks for economic growth in both markets. The U.S. cycle score appears firmly stuck at zero. Fed policy will get tighter and profit growth is tepid, but low recession probabilities keep the overall cycle score

stable. The cycle is negative for EM due to the risks from high private-sector debt levels. Improving growth indicators mean this score has the potential for an upgrade.

- **Valuation**: Our assessment of value is unchanged. We rate U.S. equities as expensive; Japanese and European equities as slightly cheap; and emerging markets equities as moderately cheap.
- **Sentiment:** Sentiment combines price momentum with indicators that signal if markets are overbought or oversold. The post-Brexit global equity market rally triggered a few of our overbought signals, but not enough to justify a risk-off position. Price momentum is slightly positive in the U.S. and emerging markets, and flat elsewhere.

Our investment process is keeping us cautious, but it is also keeping us watchful for any opportunities that volatility might present.

Bonds: post-Brexit

The Treasury rally globally following the Brexit vote on June 23 could mark the low point for government bond yields in this cycle. Anecdotally, it seemed many investors finally gave up on their bets that long-term interest rates would inevitably rise. This type of capitulation can be one of the hallmarks of a significant turning point.

Our process, not surprisingly, scores government bonds poorly on value. Cycle pressures are moderately negative in the U.S., where wages are gradually picking up and putting pressure on the Fed to raise rates. But the cycle is more supportive of bond markets in the rest of the developed world, where growth trends are uncertain and central banks are still undertaking quantitative easing.

The net result is that the upward pressure on global bond yields from inflation pressures in the U.S. will be muted by deflation pressures in the rest of the world. We expect to see bond yields rise, but only modestly.

Upper range for USD

The U.S. dollar looks set to test its previous highs as central bank policy divergence intensifies. The Fed feedback loop, where dollar strength limits the extent of Fed tightening, puts a limit on how far the greenback can rise.

The British pound looks most at risk relative to other major currencies, based on a large current account deficit, more Brexit fall-out and the likelihood of additional BOE easing. The GBP/USD exchange rate could fall back below 1.30.

Interesting times ahead

The fourth quarter of 2016 could be challenging as markets navigate the U.S. election, Italian referendum, and likely December Fed rate rise. The backdrop of expensive U.S. equity valuation and lackluster economic growth trends keeps us concerned that risk assets, like equities and corporate credit, are vulnerable to bad news.

Our investment process is keeping us cautious, but it is also keeping us watchful for any opportunities that volatility might present. ■

United States: stirred, not shaken

The labor market is healthy, gross domestic product (GDP) growth is mediocre, and corporate profits are weak. The Fed cares most about the labor market and, based on encouraging data, moving toward the next federal funds rate hike. Normally, this would be good news for stocks because Fed hikes signal economic strength. In a slow-growth world, however, even a gradual Fed tightening can dent expensive areas of the market.

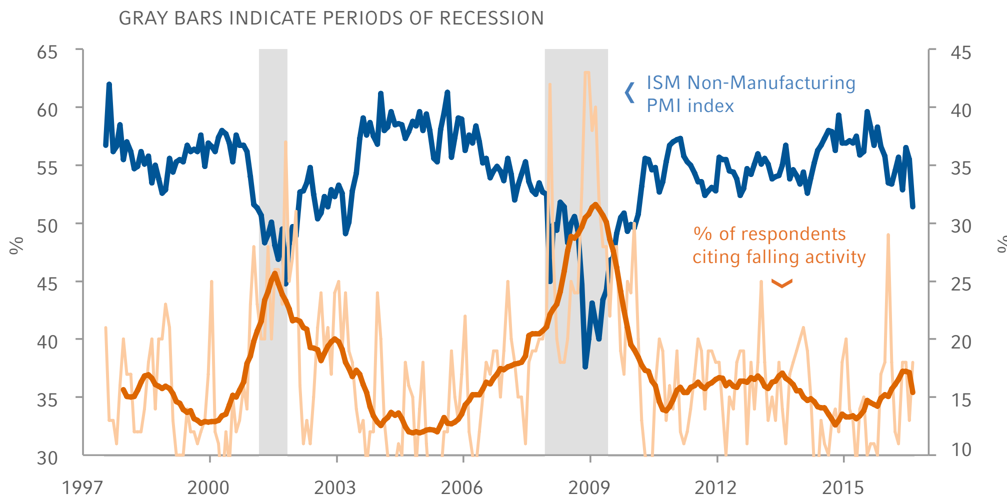
Three big questions

1/ Are we at risk of dipping into recession?

Near-term recession risks have started to edge up but remain modest by historical standards. Kara Ng discusses how we arrive at that view from a modeling perspective in the "modeling insights" segment of this report. These inputs are very important to our overall view, but we also look at the recession question through two additional lenses. First, because models focus on a subset of indicators, we also look at what the entire mosaic of data says about the trajectory for growth. Second, we take a step back to gauge if there are sufficient imbalances to justify a recession. Regarding the first lens, high frequency indicators of economic activity softened in August. Among these, the Institute for Supply Management's (ISM) non-manufacturing survey fell at the sharpest rate since late 2008. However, when we look under the surface of that survey, only 18% of respondents actually reported a drop in activity in August. Instead, the slowing in the ISM survey is much more consistent with a continuation of mediocrity than an economy that is falling apart.

The labor market continues to backstop the U.S. economy with the combination of healthy employment growth and a gradual pickup in wages supporting household income.

The business surveys have slowed but aren't signaling recession



Source: ISM Non-Manufacturing PMI index as of September 15, 2016. This index is based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives, within 60 sectors across the United States, by the Institute of Supply Management (ISM). The ISM Non-Manufacturing Index tracks economic data, like the ISM Non-Manufacturing Business Activity Index.

Indexes are unmanaged and cannot be invested in directly.

Past performance is no guarantee of future results.

The labor market continues to backstop the U.S. economy with the combination of healthy employment growth and a gradual pickup in wages supporting household income. Our forecast for 150,000 monthly nonfarm payrolls should be sufficient to sustain these trends.

Zooming out, this has been an unusual cycle in terms of both the severity of the 2008 financial crisis and the mediocrity of the recovery. We still aren't seeing worrying signs of imbalances in either the labor market or business investment. One area of risk, however, is the corporate

sector, which is showing warning signs. We are monitoring a troubling rise in corporate leverage and bank lending standards on commercial loans, which have now tightened for four consecutive quarters through the second quarter of 2016. So far, the tightening has been modest, but this is one of the so-called "accelerators" that is capable of spiraling a small macro problem into a larger one.

Taking stock of the evidence, we see the chance of a U.S. recession over the next 12 months at roughly 25%. This is about 10 percentage points higher than our estimates from a year ago but still modest by historical standards.

2/ Will earnings recover?

In our previous quarterly report, we presented a detailed analysis on U.S. earnings that led us to three main conclusions: 1) most of the drawdown in corporate profits at the start of the year was driven by prior moves in energy prices and the U.S. dollar; 2) as these headwinds faded, profits were set to improve; and 3) the underlying rate of earnings growth that profits were likely to revert to had fallen to low-single-digit levels. This remains our central view. Indeed, the S&P 500® Index saw a marked improvement in earnings growth from -8% in the first quarter of 2016 to -3% in Q2. This was welcome news, but the bigger question is what corporate profits will look like heading into 2017. S&P consensus analyst expectations for 13% growth[2] in 2017 appear overly optimistic. Medium-term headwinds from rising labor costs are a key risk to profitability. The extent of the earnings recovery is likely to be a key driver of U.S. equities over the coming year, and our lackluster earnings outlook is a central source for our caution on the U.S. business cycle.

We expect 2% real GDP growth in 2017, but risks to this view are skewed to the downside. Our 12-month-ahead recession probabilities have moved up modestly to 25%.

3/ After a long pause, what is the path forward for the Fed?

We still expect the next Fed hike in December. Global risks and a few domestic disappointments have slowed Fed Chair Janet Yellen down this year. The Fed has failed to establish its usual rhythm to normalization, which has left markets guessing as to the likely path of rates. This is driving volatility in asset prices, and the "long pause" means the next rate hike will be like liftoff all over again. The future path is uncertain, but modest economic growth and a gradual firming in inflation should be sufficient to bring two additional hikes in 2017. Debates within the Fed are centering on the asymmetric risks to policy in a slow-growth world. The fear of hiking too soon appears greater than the fear of hiking too late. The European and Japanese experience shows the Fed the difficulty of tackling low inflation close to the zero bound[3]. Yellen is likely to remain cautious and pick her spots carefully until inflation moves decisively higher.

Strategy outlook

Our cycle, value, and sentiment investment process offers the following assessment of global equities at the end of Q3 2016.

- **Business Cycle**: Corporate earnings improved in the second quarter of 2016, but are likely to remain lackluster. We expect 2% real GDP growth in 2017, but risks to this view are skewed to the downside. Our 12-month-ahead recession probabilities have moved up modestly to 25%.
- **Valuation**: U.S. equities are outright expensive and valuations are likely to act as a restraint on future market performance.
- **Sentiment**: Sentiment as of the end of the third quarter is now a slight tailwind in our view, while price momentum has improved, and our overbought signals from June have since faded.
- **Conclusion**: We continue to have an underweight preference for U.S. equities in global portfolios primarily due to their expensive valuations. ■

[2] Source: Thomson Reuters I/B/E/S Datastream, as of Sept. 20, 2016.

[3] Zero bound: A situation that occurs when the Federal Reserve has lowered short-term interest rates to zero or nearly zero.

The eurozone: looking for stage 2 liftoff

Eurozone financial markets were able to find their way up in Q3, leaving their downward skew from the first half of 2016 behind. We credit the "Brexit bounce" for this upward thrust and describe it as equivalent to stage 1 liftoff in a market rally. Now markets are at the point where stage 2 liftoff needs to start for the rally to continue. The preconditions for stage 2 are in place, but event risk looms.

Deconstructing a rally

Comparing a market rally to a rocket launch may seem a bit presumptuous, but we think it is a good way to deconstruct a rally. In the eurozone, we have seen a sequence of events this year in which financial markets experienced sell-off pressure followed by a subsequent recovery, which fizzled out after a month or two. Using the analogy of a rocket launch: after the initial selloff, eurozone financial markets entered stage 1 liftoff, which is a rally fueled by cheap absolute valuations and oversold sentiment. However, at the point where stage 2 liftoff seemed likely to start, the rally stopped.

Stage 2 liftoff is a rally fueled by relative valuations and cyclical tailwinds in economic growth, corporate earnings, as well as fiscal and monetary policy. The inability of eurozone financial markets to transition from stage 1 to stage 2 has been a recurring disappointment this year. We believe this inability was due to several factors. First, there have been worries around the sustainability of the eurozone's economic recovery in the face of global headwinds. This was a real concern, for example, after the devaluation of the Chinese yuan. Second was the

The economic recovery has shown itself to be resilient, even in the face of the Brexit vote. Corporate earnings expectations have stabilized, and rising non-financial profit margins bode well for future earnings growth.

European Economic and Monetary Union (EMU) & EMU banks: relative return

Source: Thomson Reuters Datastream, 9/19/2016
Indexes are unmanaged and cannot be invested in directly.
Past performance is no guarantee of future results.

dissatisfaction about the fall in expectations for corporate earnings growth in 2016. And third were repeated bouts of volatility in the financial sector, with distressed banks in Italy, in particular, grabbing headlines.

Looking ahead, we believe the factors preventing stage 2 liftoff are fading as reasons for the holdup. The economic recovery has shown itself to be resilient, even in the face of the Brexit vote. Corporate earnings expectations have stabilized, and rising non-financial profit margins bode well for future earnings growth. And finally, improving credit growth shows that the financial sector is boosting revenues. Of course, the financial sector still has a profitability challenge because of negative short rates and a flat yield curve. But those issues look to be priced in, and we believe for stage 2 to occur, we just need the financial sector to stop underperforming. If Italian policymakers, in particular, are able to deal with the idiosyncratic issues in the banking sector, that should not be too much to ask.

Event risk

Unfortunately, when talking about the Eurozone, almost inevitably we have to discuss potential disruptions to the recovery. As we move into the fourth quarter, there is one big event in particular that is cause for concern: the Italian referendum on constitutional reform, which appears likely to occur in late November or early December. Should Renzi lose the referendum, which allows him to streamline how the country is governed, he has promised to resign. This would create a lot of political uncertainty as to who would replace him and whether or not new elections would be called. That is not something we want to see happen, particularly at a time when the recovery in Italy is fragile at best and the financial sector is burdened by large amounts of non-performing loans. The polls are not yet giving us much indication, though it appears the rising popularity of the Five Star Movement could produce a close race. For now, we simply acknowledge the risk and keep our business cycle score at zero to reflect it in our investment process.

Strategy outlook

Our cycle, value, and sentiment investment process offers the following assessment of global equities at the end of Q3 2016.

› **Business Cycle**: We have maintained our neutral business cycle score, but the reasons behind that score have changed. Whereas we previously scaled our positive outlook down because of the weakness in corporate earnings and the Brexit referendum, we now keep the score neutral because of looming event risk. GDP growth in 2016 is still expected to be about 1.5%. Monetary policy appears set to remain ultra-supportive.

› **Valuation**: Eurozone equities are still considered to be slightly cheap in an absolute sense and outright cheap relative to the U.S. However, the "Brexit bounce" did trigger a downgrade in our value score. In eurozone government bonds we have maintained our long position in peripheral bonds and moved to an underweight position in core bonds. In addition, our view on the core bond yield remains unchanged at 0.2%.

› **Sentiment**: Price momentum has reverted back to neutral. Overbought short-term contrarian indicators from the "Brexit bounce" are balancing out oversold medium-term contrarian indicators from the "Brexit selloff." This means the overall score is neutral.

› **Conclusion**: We maintain our overweight position to eurozone equities and peripheral bonds. Stage 2 liftoff in the current rally in our view should occur when markets realize growth is robust, corporate earnings are rising, and financial sector worries overdone. Meanwhile, we acknowledge that event risk looms and vigilance is required. ■

Asia-Pacific: Stayin' alive

Economic conditions in the Asia-Pacific region are benign as we draw toward the close of 2016. China is successfully juggling the competing demands of economic rebalancing and a growth slowdown. Japan has delivered a GDP upgrade despite the headwind of a strong yen. Australia and New Zealand continue to grow steadily through cyclical gyrations in the commodity and housing sectors. Broadly, regional equity markets continue to offer moderate value.

Moving forward, and avoiding the risks

Asia-Pacific economies and markets are on track to achieve creditable performances for 2016. The risks associated with regional debt, property market excesses and currency headwinds have not completely gone away, but they are in abeyance. The potential threat to global trade from the mid-year Brexit referendum in the UK also appears to be manageable.

The risks associated with regional debt, property market excesses and currency headwinds have not completely gone away, but they are in abeyance.

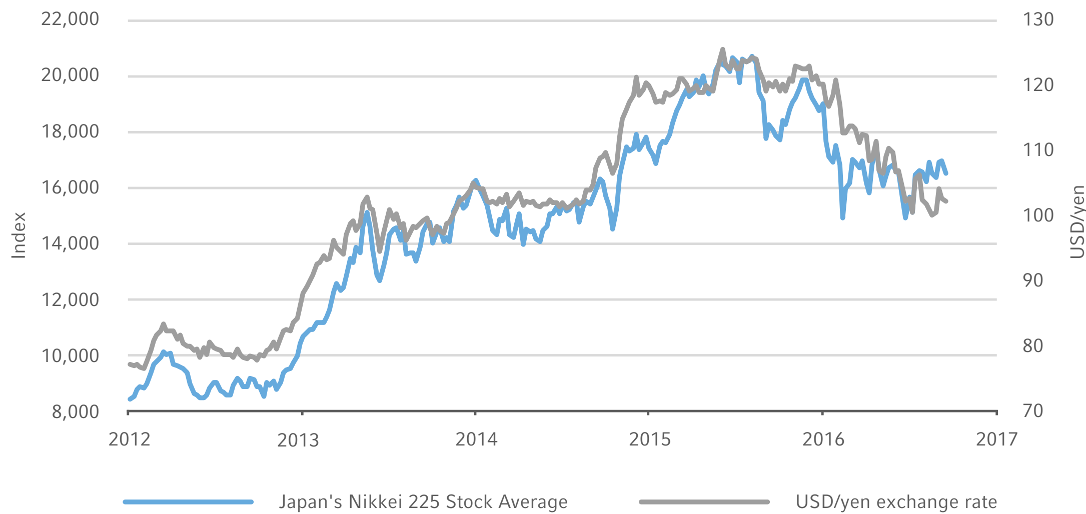
In China, GDP growth continues to trace out an orderly slowdown. Industrial production and retail sales growth have stabilized, and so have capital outflows. We are also seeing solid increases in real estate prices. Simultaneously, falls in the headline consumer price index (CPI) allow for interest-rate flexibility and accommodative monetary policy. Other major economies in the region are also travelling well. The political leadership in both India and Indonesia are belying their "populist" appearance and are delivering strong GDP growth. The successful introduction of a Goods and Services Tax (GST) in India has been a significant reform in the third quarter.

Turning to Australia and New Zealand, we're seeing a similar theme of controlled inflation and solid growth. The downdraft from the end of the commodity boom is now losing some of its bite; and, indeed, recent bounces in the coal price in Australia and milk price in New Zealand are putting some wind in the sails of those two economies. Extremely low inflation is allowing official interest rates to remain accommodative, and the housing markets in both countries remain buoyant for now.

Japan

Japan remains the least exciting major economy in the region, as it has been all year. The demographic drag of an aging and shrinking population is acting as a steady, secular brake on growth: while in the shorter term a persistently strong yen is also making growth difficult to achieve. The chart below shows the Japanese equity market, which has been downbeat for most of this year, overlaid with the U.S. dollar/yen exchange rate. The downtrend shown in the yen for 2016 denotes strength against the dollar – a deflationary development, from the viewpoint of Japanese trade and inflation.

Yen and Japanese equities



Source: Thomson Reuters Datastream exchange rates, as of Sept. 16, 2016
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Investment Strategy

For Asia-Pacific regional equities, we make an assessment of cycle, value and sentiment considerations as follows:

- **Business cycle**: The cyclical backdrop for the Asia-Pacific region remains reasonable. Underlying growth is travelling a little better than we might have feared earlier in 2016, and monetary policy settings are broadly accommodative. Set against that is an earnings growth story that is patchy at best. The challenges of structural adjustment (China): of a persistently strong currency (Japan): and of high levels of debt (across the region) also hold us back to a "neutral" score.
- **Valuation**: The lackluster performances of the Australian and Japanese markets have left them at fair to reasonable value. China and South Korea remain relatively cheap, while India and New Zealand are more fully priced. Overall, on a price/book ratio of 1.4x and a prospective price/earnings ratio of 14x, based on the MSCI Emerging Markets Index as of August 31, 2016, we do not regard Asia-Pacific equities as expensive.
- **Sentiment**: In line with the benign economic backdrop, we view the "sentiment" surrounding regional equities as reasonable. Japan has lost its negative momentum from earlier in 2016; and emerging Asia is trading more firmly in recent months. Australia looks slightly oversold.
- **Conclusion**: Our prior expectations of "low returns and high volatility" from Asia-Pacific equities through 2016 continue to play out. At current prices as of September 19, we take a slightly positive stance. ■

Overall, we do not regard Asia-Pacific equities as expensive.

Currencies: a lighter shade of divergence

The U.S. dollar is our preferred currency on the eve of the Fed's second rate hike, while central banks in the eurozone, Japan and the UK are still in easing mode. After the initial Brexit shock, the UK economy seems to have stabilized, but we believe it's too early to relax, and we remain cautious on the pound sterling (GBP).

Policy divergence – the expectation for the Fed to move interest rates in the opposite direction from the Bank of Japan and the European Central Bank – pushed the U.S. dollar (USD) drastically higher in 2014 and the first quarter of 2015. But policy divergence was too successful for its own good. The stronger dollar caused stresses in the global financial system, especially in emerging markets. Financial market weakness in turn prevented the Fed from following through on further tightening after its first rate hike in December 2015. Policy divergence could only go so far without tripping itself up via the U.S. dollar's strength.

This feedback loop between policy divergence and the exchange rate has kept the narrow trade-weighted U.S. dollar index within a range of 93 to 100 during the 18 months ending August 2016 (see Chart below). As we believe a second rate hike is now likely at the December Fed meeting, policy divergence could make a comeback in a "lighter" version. Importantly, we think the dollar is now too weak relative to interest-rate differentials with other developed-market currencies. We therefore expect the dollar to strengthen during the remainder of 2016, but we don't anticipate new sustained highs for the trade-weighted index[4].

US Dollar Index

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Past performance is no guarantee of future results.

Source: Russell Investments as of Sept. 16, 2016.

[4] The trade-weighted U.S dollar index is a measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners.

Outlook for major currencies

- **USD**
  The dollar is our preferred developed-market currency. While it is slightly rich by our valuation metrics, including purchasing-power parity, we believe it could be supported by a widening interest-rate advantage over other currencies. The greenback may also benefit from safe-haven flows should global risk assets sell off from elevated levels.
- **EUR**
  The euro (EUR) still boasts attractive valuation, but easy monetary policy and political risks are offsetting negative factors. If the Italian electorate rejects proposed constitutional reform, Renzi is expected to resign and call for early elections. It is a real possibility the euro-skeptic Five Star Movement wins that election and eventually holds a Brexit-style referendum to exit the eurozone. If this happens, or if the perceived risk of this happening rises, the euro could come under pressure against the dollar. We expect the EUR to USD exchange rate (EURUSD) in a range between 1.08 and 1.15 in Q4, with a weaker tilt to the EUR.
- **Japanese Yen (JPY)**
  As speculation of additional policy stimulus in Japan built up over the third quarter, the yen weakened significantly, with the USD to JPY exchange rate (USDJPY) reaching almost 107. When the expectations were disappointed by relatively meek policy action, USDJPY retraced back to the bottom of the 99 to 110 range. The Bank of Japan announced a comprehensive review of monetary policy for the September meeting, which could presage more easing. We expect the yen to weaken slightly against the dollar and USDJPY to drift towards the upper end of the above-mentioned range.
- **GBP**
  The pound sterling is our least preferred developed-market currency. Selling the pound is admittedly a popular trade among investors. It draws its justification from ongoing uncertainty over the fallout from Britain's decision to leave the EU. The UK currency also has to contend with a large current account deficit of nearly 7% of GDP. A mitigating factor is that most of the deterioration of the UK current account in recent years is from a drop in income from Britain's foreign direct investment (FDI), not a worsening in the trade balance. The deterioration in FDI income is somewhat more likely to reverse, in our view, than the trade deficit.

  In addition, the Bank of England responded decisively to Brexit by cutting interest rates and increasing asset purchases, moves that initially weighed on the currency. Since that policy action, UK economic data has started to surprise positively and indicates stabilization after the initial Brexit shock to currency markets. We think it's too early to sound the all-clear on the economy because the ambiguity over the contours of Britain's relationship with the EU will linger well into 2017 and hold back investment activity. We expect GBPUSD to drop back below 1.30 before the end of 2016. ■

While USD is slightly rich by our valuation metrics, including purchasing-power parity, we believe it could be supported by a widening interest rate advantage over other currencies.

Modeling insights: U.S. cycle sports a touch of gray

The U.S. business cycle is getting older, with recession probabilities slowly creeping up, but our quantitative models indicate it still has life left. We maintain a small positive preference for U.S. equity over U.S. fixed income.

Slightly positive equity outlook

Our model for U.S. equities versus U.S. fixed income maintains its positive signal in favor of equities.

Enhanced Asset Allocation (EAA)[5] U.S. equity vs. U.S. fixed income aggregate signal

Standard deviation is a measure of the dispersion of a set of data from its mean.
The more spread apart the data, the higher the deviation.

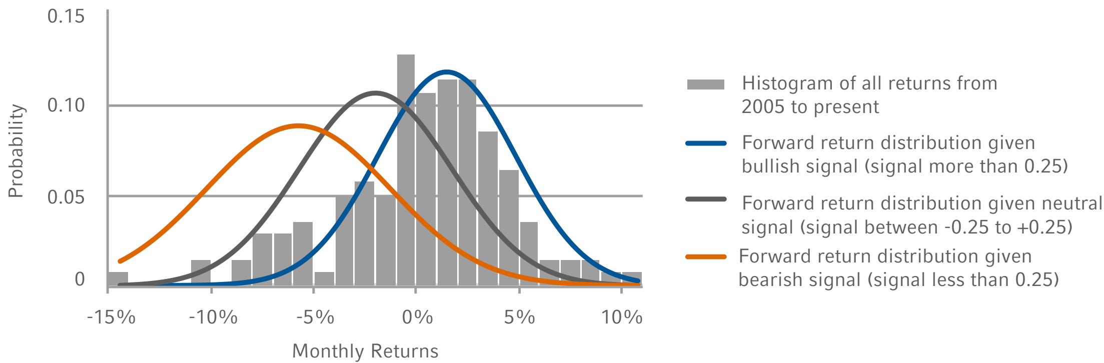
Source: Russell Investments as of Sept. 16, 2016.

- **Business cycle**: Our model that estimates the likelihood of being in a bull or bear market still supports equities, but has moderated since mid-year 2016. The U.S. Business Cycle Index (BCI) shows low recession risk and a path of modest economic growth.
- **Valuation**: Our Fed model stayed positive as the earnings yield and bond yields barely changed.
- **Sentiment**: Our 12-month declining weighted average signal of excess equity momentum remains slightly positive.

The following graph shows the distribution of forward returns, conditional on the U.S. equities/U.S. fixed income model's signal. Since this signal is in the lower range of bullish, we expect a return distribution somewhere between the gray and blue lines. Given our signal and these ranges of outcomes we remain positive on equity versus fixed income.

[5] Enhanced Asset Allocation (EAA) is a capability that builds on Strategic Asset Allocation (SAA) by incorporating views from Russell Investments' proprietary asset class valuation models. EAA is based on the concept that sizable market movements away from long-term average valuations create opportunities for incremental returns. The EAA Equity-Fixed Aggregate Signal is based on the S&P 500® and Barclays U.S. Aggregate Bond indexes.

Distribution of returns, conditional on EAA U.S. equity vs. U.S. fixed income aggregate signal



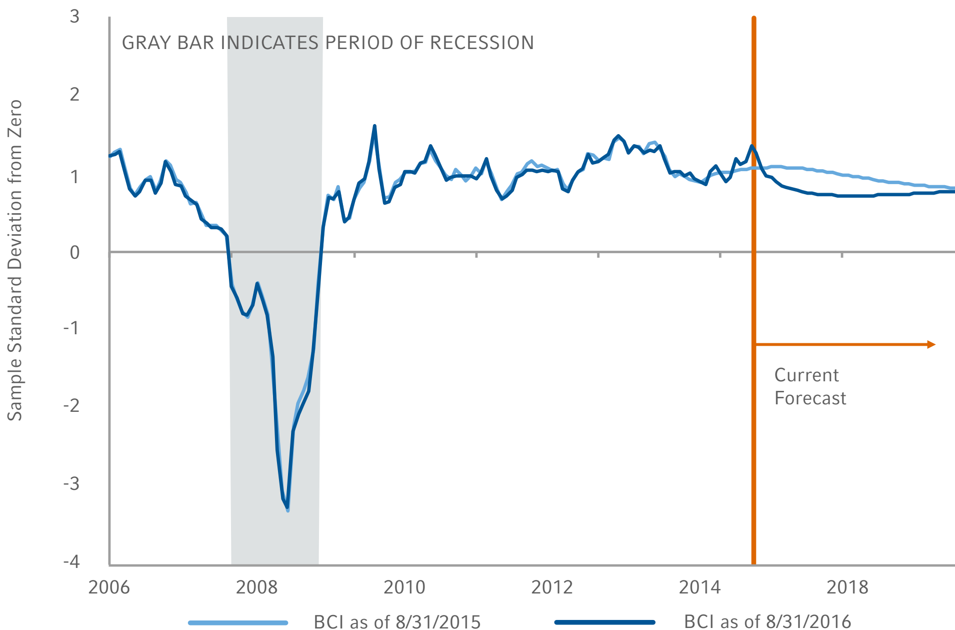
Source: Russell Investments as of Sept. 16, 2016.

U.S. recession probabilities: rising?

The U.S. economy is tracking below the stated expectations from our 2016 Global Market Outlook issued at the end of 2015. Real GDP grew only at an annualized 0.8% and 1.1%, respectively, during the first two quarters of 2016, with recent business surveys from IHS Markit and Institute for Supply Management (ISM) implying that growth will slow to an approximate 1% pace in the third quarter, well below historical average levels. Corporate earnings have been negative for several quarters, and stubbornly low global bond yields reflect global growth concerns. Given this backdrop, it's time to revisit the recession question. Our proprietary BCI model shows that the chances for a U.S. recession have risen, but are still low by historical standards.

The BCI model considers a range of economic indicators (consumer spending, job growth, inflation, interest rates) and financial stress variables (slope of yield curve, credit spreads, TED spreads[6]) to estimate the strength of the U.S. economy and probability of recession. The BCI forecast path is lower at the end of the third quarter than a year earlier, mapping to a 20 -25% 12-month recession probability as of August 31, 2016 (up from 10-15% from this point in 2015).

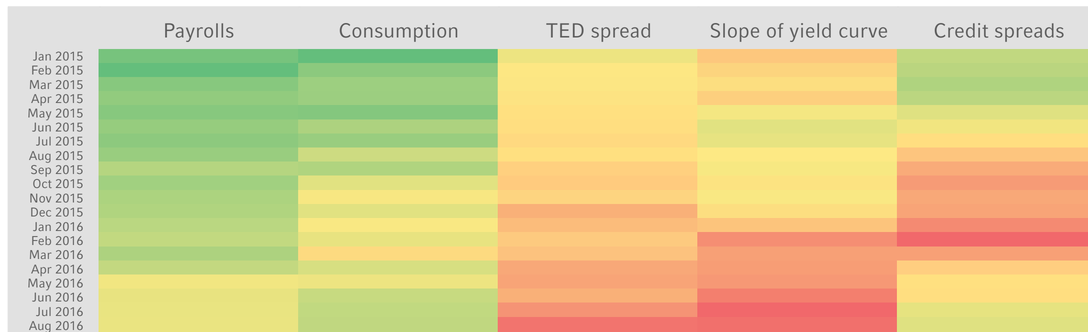
U.S. Business Cycle (BCI) Index



Source: Russell Investments as of Sept. 16, 2016.

[6] The TED spread is the difference between the interest rates on interbank loans and on short-term U.S. government debt ("T-bills").

Our BCI-based heat map shows aging U.S. business cycle



Heat map colors of green/yellow/red denote the economic variable's positive (green)/ neutral (yellow)/negative (red) impact on business cycle strength relative to recent history.

Source: Russell Investments as of Sept. 16, 2016.

Higher payrolls, higher consumption, a steeper yield curve, narrower TED spread, and narrower credit spreads contribute to a stronger BCI model signal and lower recession probability. Payrolls and consumption are still robust, but have moderated since 2014-2015. The yield curve has flattened, which could foreshadow slower economic growth. The TED spread has widened, partially reflecting increased financial stress (relevant to our team when modeling recession risk) and partially reflecting a change in money market mutual fund regulation (less relevant to our team). Removing the regulation component raises the BCI marginally and lowers the recession probability by a couple of percentage points. Credit spreads, which have stabilized since early 2016, are no longer a headwind.

In aggregate, the indicators reflect an aging business cycle that warrants monitoring, but a U.S. recession in the next 12 months is still unlikely.

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

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IMPORTANT INFORMATION

The views in this 2016 Global Market Outlook—Q4 update are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Keep in mind, that like all investing, that multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

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

Investment in Global, International or Emerging markets may be significantly affected by political or economic conditions and regulatory requirements in a particular country. Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation. Such securities may be less liquid and more volatile. Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and political systems with less stability than in more developed countries.

Currency investing involves risks including fluctuations in currency values, whether the home currency or the foreign currency. They can either enhance or reduce the returns associated with foreign investments.

Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

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

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

The MSCI Emerging Markets Index, created by Morgan Stanley Capital International, is designed to measure equity market performance in global emerging markets.

The MSCI EMU Index (European Economic and Monetary Union) captures large and mid cap representation across the 10 Developed Markets countries in the EMU. With 236 constituents, the index covers approximately 85% of the free float-adjusted market capitalization of the EMU.

The MSCI World ex EMU Index (European Economic and Monetary Union) captures large and mid cap representation across 13 of 23 Developed Markets countries (excluding those in the EMU). With 1,403 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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