Russell Investments

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The new mediocre

2016 Global Market Outlook—Q3 update

Our investment process at mid-year 2016 sees expensive U.S. equities, weakening business cycle fundamentals in developed markets and extended fading of oversold tailwinds.

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Something's gotta give

Our process sees expensive U.S. equities, weakening cycle fundamentals in developed markets, and flat-to-negative equity market momentum. U.S. recession risks remain low. We still want to buy significant equity market dips and sell rallies.

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EXECUTIVE SUMMARY

By **Andrew Pease**
Global Head of Investment Strategy, Russell Investments

Brexit[1] has happened and markets are still digesting the news. The investor rollercoaster of fear and relief has turned again towards fear. Britain's rejection of the European Union (EU) matters a lot for those economies, but its impact on the rest of the world should be more limited.

Volatility often creates opportunity, but the shakeout so far has not been large enough for our process to recommend taking on more risk. Even after the post-Brexit vote volatility, the U.S. market is not far from near record highs and long-term yields have trended lower. This mix of equity market optimism and bond market pessimism looks unsustainable, and our investment strategy process is warning us to be cautious.

Paul Eitelman thinks that Brexit will have only a limited impact on the U.S. The stronger U.S. dollar (USD) will be a headwind. However, this will be offset by a more cautious U.S. Federal Reserve (Fed) that may delay tightening until closer to the end of the year. Paul thinks that the worst of the corporate profits downturn may now have passed. But he continues to prefer an underweight to U.S. equities in global portfolios, mainly because of poor value.

Brexit, however, is clearly a big deal for Europe and the UK. Wouter Sturkenboom has downgraded his business cycle outlooks. It's not all bad news: Europe's economy had been improving, the currency declines will provide support, and equity market valuations are reasonable in both regions. The implications of Brexit will take months to work through, so more volatility seems likely.

Graham Harman sees Japan's "safe haven" status as putting upward pressure on the yen and downward pressure on the business cycle outlook. These trends are offset, however, by improving valuations. He also remains cautious on the cyclical outlook for emerging markets (EM) with Brexit putting some upward pressure on the USD and downward pressure on commodity prices.

Even with Brexit, Van Luu thinks the major currencies will stay in the ranges they have traded in since the beginning of the year—albeit with the USD pushing towards the top of that range. Van likes the value in EM currencies, but the downside risks to the Chinese renminbi (RMB) keep him concerned about the risks of further depreciation for EM currencies in general.

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. One of our most important models is the U.S. business cycle index model that predicts the likelihood of recession. This model continues to provide low recession probabilities despite the economic expansion being in its eighth year. This forecast is an important reason why we have been able to maintain the "buy the dips" part of our strategy recommendation to buy dips and sell rallies. ■

[1] Brexit refers to the British vote to exit from the European Union.

Investment strategy outlook

Global equity markets are in a range constrained by lackluster profits and low recession risks. U.S. inflation pressures are gradually building—and the Fed is likely to tighten once more this year. We expect global markets to remain volatile and bond yields to eventually rise. Our response: maintain our buy-the-dips, sell-the-rallies investment strategy.

The new mediocre

One word keeps recurring in our discussions of markets and economies: lackluster. The economic growth outlook is uninspiring. Corporate profit growth has weakened and record-low government bond yields point to poor medium-term investment returns. Our investment process sees expensive U.S. equities, weakening developed market cycle fundamentals, and the fading of oversold tailwinds since February.

We still want to buy equity market dips and sell rallies, but we need to see substantial moves in either direction before gaining conviction. This happened in mid-February when global equities had fallen nearly 20% from their 2015 highs, as measured by the MSCI All Country World Index, triggering our contrarian "buy" signals. There has been plenty of volatility subsequently, but even after the Brexit vote, it has not been of a magnitude to trigger another signal. Our process has kept a broadly neutral allocation between equities and bonds since the equity rebound.

Global divergence continues to be a dominant theme. The European Central Bank (ECB) is purchasing corporate bonds, and there is speculation that the Bank of Japan (BoJ) is moving towards money-financed government spending (helicopter money[2]). The Fed may be moving a bit more slowly than we had anticipated at the beginning of 2016. However, in our view, the steady tightening of the labor market will put enough upward pressure on inflation to trigger one Fed rate hike in the second half of the year.

The good news is that the worst of the profit slump is now behind us, thanks to the rebound in oil prices and the pullback in the U.S. dollar. However, this rebound is likely to be tepid, given that rising labor costs will weigh on margins.

Key indicators update

The three key indicators we identified in our 2016 Annual Outlook report highlight the challenging conditions that markets face this year. U.S. non-farm payrolls growth and earnings-per-share growth for the S&P 500® Index have slowed, and exports from emerging markets provide investors with mixed signals. Overall, the indicators signify weak business cycle conditions this year.

- **U.S. non-farm payrolls**. There has been a marked slowdown in the labor market. Monthly payroll gains have averaged 150,000 over the first five months of the year, a significant step down from gains of nearly 240,000 in the second half of 2015. Even so, this pace of job growth is still enough to put some upward pressure on wage growth; since it takes job gains of just under 120,000 to keep the unemployment rate steady. We expect job growth of around 150,000 per month over the next 12 months. This will keep pressure on the Fed to consider more tightening.
- **S&P500 earnings-per-share (EPS) growth**. S&P500 Index profits declined 8% in the 12 months ending March 2016. The good news is that the worst of the profit slump is now behind us, thanks to the rebound in oil prices and the pullback in the U.S. dollar. However, this rebound is likely to be tepid given that rising labor costs will weigh on margins. We were looking for 3%-5% EPS growth this year. Given the poor start, a recovery to zero profit growth would be a good outcome.

[2] A hypothetical, unconventional tool of monetary policy that involves printing large sums of money and distributing it to the public in order to stimulate the economy.

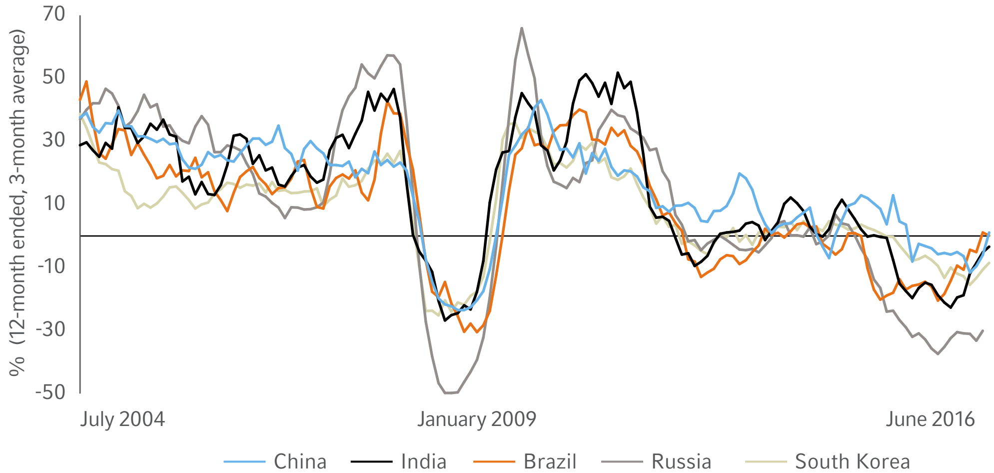
- **Emerging markets (EM) exports**. This is the most mixed of the three indicators. With the exception of Russia, exports have recovered from their lows. The recovery, however, has been weak in the bellwether market of South Korea, where exports in the three months to May were still 8.5% lower than the same period one year ago.

The cycle continues to weaken for global equities, with the slowdown in profit growth a theme across all regions.

Global equities: value, cycle, sentiment

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

Exports by selected EM country



Source: Thomson Reuters Datastream. Imports/Exports as of June 17, 2016.

- **Business cycle**: The cycle continues to weaken for global equities, with the slowdown in profit growth a theme across all regions. The cycle is neutral for U.S. equities given the poor outlook for EPS growth and the potential for further Fed tightening. The consequences of the UK exit vote mean that the Europe cycle score is downgraded to neutral. Japan's cycle is slightly positive, but this is mainly due to our expectation for further BoJ easing measures to counter yen strength. The cycle is negative for EM due to the risks from high and rising private sector debt levels, and a deteriorating outlook for EPS growth.
- **Valuation**: Our assessment of value is unchanged. We rate U.S. equities as expensive, Japanese and European equities are slightly cheap, and EM equities are moderately cheap.
- **Sentiment**: Sentiment combines price momentum with indicators that signal if markets are overbought or oversold. Price momentum is flat in the U.S. and negative in every other region. Our oversold indicators from February have now expired, with the exception of Europe where Brexit-related underperformance keeps it oversold.

Our regional equity positioning is close to neutral. We are underweight the U.S. relative to other major developed regions mostly because of valuation. This underweight is fairly evenly distributed as small overweights to the other regions. We're neutral emerging markets, where attractive valuations are offset by business cycle headwinds from deleveraging risks, along with the potential for further Fed tightening.

Bonds: don't fight the Fed—or the BoJ or the ECB

Our process scores government bonds poorly on value. This is not surprising given that 10-year yields in all the major developed markets, including U.S. 10-year Treasury bond yields, are near record lows at the end of the second quarter of 2016.

On balance, however, the cycle is neutral. 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. Both the ECB and BoJ are contemplating further unconventional easing to bolster inflation expectations.

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

Range-bound USD

The U.S. dollar (USD) has moved in a sideways range against the major currencies this year, and this seems likely to continue even following Brexit. The dollar is already high in trade-weighted terms, and the scaling back of Fed tightening expectations means it is unlikely to push past recent peaks. There is some downside risk for the euro and Japanese yen if central banks adopt more unconventional easing. But this is likely to be limited, since both currencies are relatively cheap and have already priced in significant monetary policy accommodation.

The USD could continue to move higher against the Chinese yuan and commodity currencies such as the Australian and Canadian dollars. But it is likely to be range-bound against the other major currencies.

Fading cycle fundamentals and flat equity market momentum suggest that markets are being driven more by noise than fundamentals.

Noise outweighing signals

Fading cycle fundamentals and flat equity market momentum suggest that markets are being driven more by noise than fundamentals. We worry that risk assets, like equities and corporate credit, are vulnerable to bad news given the backdrop of very expensive U.S. equity valuations, a potentially more hawkish Fed, poor corporate profit performance, and uncertain global growth trends.

Our investment process is keeping us cautious. We will stay cautious until we can see evidence of improving business cycle conditions. ■

United States: more questions, elevated valuations

Weak earnings and a surprisingly soft May employment report raised new questions about the resilience of the U.S. economy. While we expect the expansion to grind forward, expensive valuations limit the amount of upside in U.S. assets.

Decelerating, not imploding labor market

Last quarter we flagged the risk that sustained negative earnings growth could spill over into the real economy. Specifically, the economy could take a hit via a dampening in CEO confidence, leading to more conservative hiring and capital expenditure (capex) plans from businesses. In May the economy added only 38,000 jobs, compared to 162,000 expected. This weak employment report amplifies the risk that this transmission mechanism has been activated.

That being said, we still do not see a near-term recession in the U.S. economy for the following three reasons:

- First, the standard precursors of a downturn are not flashing in the danger zone. Imbalances in both the labor market and business investment are small.
- Second, our business cycle models continue to signal that the probability of a recession remains modest over the next 12 months.
- Third, and perhaps most importantly, our analysis suggests that earnings growth should quickly normalize from -8%[3] to near-zero as the residual headwinds from low oil prices and U.S. dollar strength fade over the next few quarters. A critical assumption underlying this forecast is that economic growth and top-line sales growth can continue chugging along at a 2% pace until earnings recover.

This outlook for improvement is far from guaranteed. However, a mosaic of incoming economic indicators supports this baseline forecast. We see signs that real GDP growth bounced back to a healthy 2.5% pace in the second quarter. The consumer was a major driver of this re-acceleration. For example, retail sales[4] in April and May grew at the fastest clip since early 2014.

There are also tentative signs that the manufacturing sector is turning around after detracting from growth in 2015. And the housing market is fundamentally supported by improving demand and limited supply.

That being said, the slowdown in hiring in May raises important questions about the resilience of domestic demand. Our baseline forecast calls for 150,000 net new jobs per month over the next 12 months. But we are mindful and vigilant of downside risks, particularly with U.S. equities trading at elevated valuations. As such, we continue to have an underweight preference for the U.S. equity market in global portfolios.

We continue to have an underweight preference for U.S. equities in global portfolios, as lackluster earnings and rich valuations suppress total return expectations to near-zero over the next 12 months.

The patient Fed

The U.S. Federal Reserve (the Fed) still intends to raise interest rates this year, but after the setback in the May employment report and the Brexit vote, there is much less urgency to do so. Central bankers aren't in the business of taking big risks with monetary policy. Patience is justified, and the Fed will wait for more evidence that employment growth and the broader economy are on solid footing. Against this backdrop, we now view the December meeting as the earliest timing of the next Fed move.

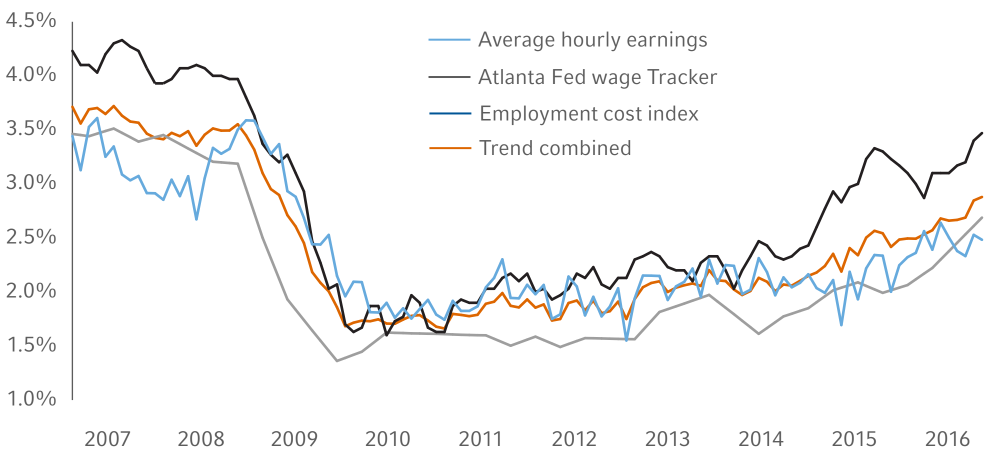
[3] Source: Bloomberg earnings estimates data as of June 17, 2016.

[4] Source: Census Bureau, Russell Investments calculation. Data as of May 2016.

Economic fundamentals support this forecast for a very gradual increase in policy rates. The unemployment rate has fallen all the way to 4.7%[5], which is right on top of the Fed's assessment of "full employment." Consistent with this tightening of the labor market, we are finally seeing more compelling signs of a broad-based pickup in wage inflation.

We continue to expect 2% real GDP growth in 2016, but cannot rule out a slower growth scenario. We continue to see little risk of recession in 2016.

Several measures of wage inflation are pointing higher
YoY % change in wage inflation



Source: BLS, Federal Reserve Bank of Atlanta, Russell Investments calculations. Data as of May 2016.

Other measures of consumer price inflation have also moved meaningfully higher this year. For example, the Fed's preferred measure of inflation—the core personal consumption expenditures (PCE) price index—has accelerated from 1.3% in May 2015 to an estimated 1.7%[6] in May 2016.

That being said, we expect a cautious and gradual path for the federal funds rate. Global growth continues to be sluggish, and the Fed pays a tax for each rate hike (via the exchange rate), in a world where they are effectively going it alone. We now expect the so-called "terminal" rate of interest to be lower than we thought coming into 2016. The path for rates is still up, but we have lowered our 12-month-ahead forecast for the 10-year Treasury yield to 2% accordingly.

Strategy outlook

We reiterate an underweight preference to the U.S. equity market in global portfolios on the back of expensive valuations, a softening business cycle, and fading price momentum.

› **Business Cycle**: Downside risks to corporate earnings and the economy have led us to reduce our cycle assessment to neutral last quarter. That assessment still looks appropriate although we are mindful of downside risks rippling out of the weak corporate earnings backdrop. We continue to expect 2% real GDP growth in 2016, but cannot rule out a slower growth scenario. We continue to see little risk of recession in 2016.

› **Valuation**: U.S. equities are outright expensive and valuations act as a headwind to future market performance.

› **Sentiment**: Price momentum has faded to neutral. Our sentiment signals which showed the market as oversold at the lows in February 2016, have reversed course and now show the market as overbought in June.

› **Conclusion:** We continue to have an underweight preference for U.S. equities in global portfolios as lackluster earnings and rich valuations suppress total return expectations to near-zero over the next 12 months. Risks to this view are skewed to the downside.

[5] Source: Bureau of Labor Statistics data as of May 2016.

[6] Source: Russell Investments forecast based on underlying data from the Bureau of Economic Analysis.

The eurozone: a bumpy ride

It has been a bumpy ride for eurozone financial markets so far this year. And we expect it will remain that way. Uncertainty around growth, inflation, policymaking, and geopolitical developments keeps markets on edge. However, while the volatility had a clear downward skew in the first half of 2016, we expect a turnaround in the second half.

Why markets worry

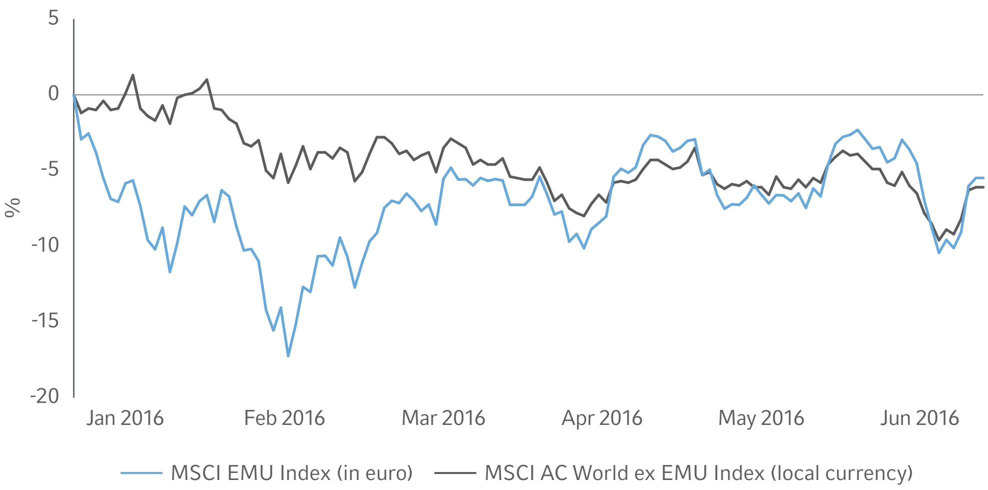
A combination of headwinds has been keeping eurozone equities on the back foot this year. In the first quarter, concerns around a slowdown in global growth hurt the globally exposed eurozone equity market. In the second quarter, worries in the lead up to the referendum on a British exit from the EU (Brexit) and then the actual Brexit vote triggered a second leg down. In both cases, volatility spiked and downward skew dominated.

In the background, it did not help that earnings expectations for 2016 continued to decline. The fall in earnings expectations—from 12% a year ago, to 8% last quarter, and 2% today*—constitutes a big downgrade. Looking at the drivers behind this move, it is clear that both expected revenue growth and profit margins have been lowered. On the revenue side, this is because of the previously mentioned worries around global growth and Brexit risk. On the profit-margin side, the pressure emanates from higher commodity prices and a stronger euro.

Although we understand that markets worry about global growth, Brexit risk, and lower expected earnings, their combined impact on eurozone financial assets has been too large in our opinion. At their low point, eurozone equities underperformed global equities by almost 10% in 2016 (see chart below). That sort of underperformance is close to what we would expect to see if the overall eurozone recovery is seriously threatened—as opposed to facing headwinds and event risk. It seems to us that markets are once again ignoring the supportive fundamentals for eurozone equities.

Although we understand that markets worry about global growth, Brexit risk, and lower expected earnings, their combined impact on eurozone financial assets has been too large.

European Economic and Monetary Union (EMU)
EMU equities absolute and relative return in local currency



Source: Thomson Reuters Datastream index returns data as of June 21, 2016.

* The MSCI EMU Index as of June 21, 2016.

What markets ignore

At the top of the list is robust economic growth. In the first quarter of 2016, eurozone GDP growth came in at a strong 0.6% quarter over quarter (and 1.7% year-over-year through the end of the first quarter). Interestingly, not only did the eurozone outperform the U.S. and UK, but the comparison also revealed how strong its domestic growth actually is. Had the eurozone not suffered from the drag on global trade, its year-over-year growth rate would be close to 3%. The consumer, in particular, is proving stronger than expected.

It seems to us that markets are once again ignoring the supportive fundamentals for eurozone equities. At the top of the list is robust economic growth.

Now, we don't think this growth rate can be maintained, especially not with the uncertainty of Brexit depressing consumer and producer confidence. We are looking for a growth rate of 1.5% over the year as a whole. But at the same time, we believe it is clear that the market's worries around revenue growth are overdone—not to mention its worries about an end to the recovery.

This becomes even clearer when we take the continued improvement in credit growth into account. Credit growth is not only positive in our view, it continues to accelerate. And that should not be a huge surprise either. After all, the support provided by the European Central Bank (ECB) is substantive and unlikely to go away anytime soon. That support is also trickling into government finances by pushing down borrowing costs, in turn helping support fiscal policy. Over the next couple of years, we believe that the budget deficits in Spain and Italy will decline by more than 1% of GDP just because of their declining interest expense.

The combination of continued growth and very supportive monetary policy is strong enough to maintain our positive outlook for eurozone equities despite the overhang of Brexit.

Strategy outlook:

- **Business cycle:** We have scaled our positive outlook for the business cycle down because of the weakness in corporate earnings and the Brexit referendum. Our expected range for corporate earnings of 4% to 8% now looks too high, but we still think earnings will remain in positive territory as some of the recent headwinds dissipate. GDP growth in 2016 is still expected to be about 1.5%. Monetary policy is and will remain ultra-supportive.
- **Valuation:** Eurozone equities are still considered to be cheap in an absolute sense and outright cheap relative to the U.S. In fact, the Brexit-related sell-off triggered an upgrade in our value score. In government bonds we have maintained our long position in peripheral bonds and stayed neutral in core bonds. In line with our lower expectations for U.S. and UK government bond yields, we have trimmed our expected core bond yield to 0.2%.
- **Sentiment:** Price momentum has become slightly negative, but oversold contrarian indicators continue to keep the overall score positive.
- **Conclusion:** We maintain our overweight position to eurozone equities and peripheral bonds keeping in mind that the driver behind this preference has shifted somewhat from a more positive business cycle outlook to more attractive valuations. The headwinds from event risk will dissipate and strong domestic growth will support earnings. We expect that will be enough to turn eurozone performance around in the second half of the year. ■

† Source: Trading Economics as of June 17, 2016.

Asia-Pacific: celebrating mediocrity

Economic growth is mediocre in the Asia-Pacific region, in line with our global theme at mid-year 2016. But "mediocre" in the region means growth in the 3.5% to 4.0% range for 2016, a rate which still compares very favorably to the U.S. and Europe.

Slow and steady for now

Asia-Pacific's ongoing growth is also confounding the skeptics, with our central case of an orderly slowdown continuing to play out. Nonetheless, risks relating to housing, debt, and economic imbalances are rising. We like the value proposition of regional equity markets, but are cautious on cyclical vulnerabilities.

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At the headline level, Asia-Pacific economies are providing few surprises as we move into the second half of 2016. The latest Chinese GDP number, at 6.7%, may reflect the slowest growth rate since the financial crisis. It's "mediocre" in that sense but still a creditable pace of expansion.

In Australia and New Zealand, terms of trade weakness—where import prices outstrip export prices—puts a damper on national income growth. However, export volumes are strong enough to support real GDP readings at close to 3% growth, a little ahead of our prior expectations.

India is belying the "mediocre" appellation altogether, with our expected GDP growth of 7.7% for this year.

At the other end of the scale, Japan is struggling to find traction. We have downgraded our estimation of the Japanese business cycle to "neutral", following the Brexit outcome and attendant global uncertainties.

Looking ahead, it's hard to envisage meaningful upside to the slow-and-steady paths that are currently being traced out. Australia and New Zealand are both buoyed by effervescent housing cycles at present and, while we are not forecasting crashes, we do see headwinds ahead in that sector.

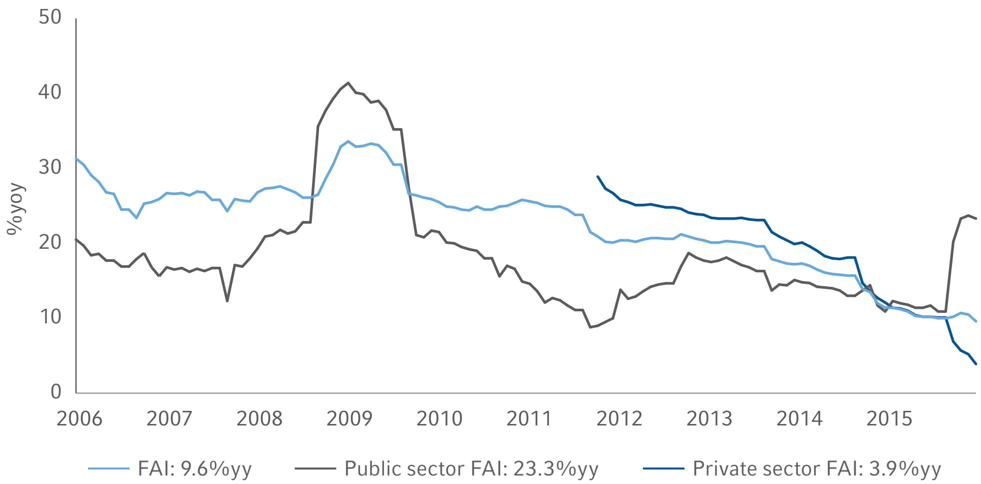
In Japan, a relentlessly strong yen is one of the major challenges, as global investors seek safe havens in an uncertain world. That's continuing to suck oxygen away from the corporate sector and from equity market performance—and our firm's currency strategists see little respite ahead.

Elsewhere in the region, we've seen official rate cuts from Indonesia and South Korea in recent weeks, and policy settings are broadly helpful. However, we expect any resilience in the U.S. dollar post-Brexit, and any disruptions to world trade, to pose further difficulties for the Pacific Rim.

China wrestles with imbalances

The above themes are all writ large in the region's largest economy—China. We retain our "soft landing" central case—and we can point to respectable growth in total business fixed capital investment, as shown in the chart on the next page. A mild slackening from just over 10% growth to just under 10% growth this year is not, in our view, a worrisome development.

China: Fixed assets investments (FAI)



Source: Thomson Reuters Datastream macro-economic data, as of May 2016.

When we look closer at some of the compositional tensions in China, however, our confidence drops somewhat, because:

- The decent macro data we see in the aggregate number are increasingly reliant on policy support. Public sector investment, for example, has spiked sharply upwards this year (gray line in chart) even as the private sector dramatically slows (dark blue line in chart).
- Regionally, within China, the differential experience of heavy manufacturing provinces versus service-sector centers is large. That's putting pressure on the labor market (unemployment) and on the incidence of bad debts.
- The currency needs to be carefully managed, to avoid precipitating capital outflows and spooking global investors.
- The residential property market has rebounded spectacularly, but looks frothy in many areas.

As with Japan, we are more confident in the value proposition in China, than we are in the cyclical outlook.

Investment strategy

For regional equities, we make an assessment based on cycle, value and sentiment considerations as follows:

- **Business cycle**: Our major concern about the "cycle" in Asia-Pacific is not so much the overall growth rates—which are "mediocre" in a positive sense—but the fact that imbalances are quite widespread and the that risks of dislocations are rising. Add to those fears the torrid headwinds of resilient currencies in Japan, Australia, and New Zealand, and we're no better than "neutral" on our cycle score.
- **Valuation:** Bouts of market nervousness and equity price weakness in the aftermath of "Brexit" leave us somewhat positive on "value." On a price-to-book ratio of 1.3x, Asia-Pacific offers an attractive combination of acceptable price-to-earnings ratios and credible levels of profitability.
- **Sentiment:** Asia-Pacific markets have been downbeat and lackluster in 2016. There's not much to like about momentum. We believe that Japan is becoming a little oversold.
- **Conclusion:** Our prior expectations of "low returns and high volatility" from Asia-Pacific equities through 2016 continue to play out. We are unenthusiastic about the immediate cyclical outlook, but we do see pockets of value.

U.S. earnings: a closer look

U.S. businesses are in an earnings recession. However, a significant portion of this weakness can be explained by earlier moves in the U.S. dollar and energy prices. We expect earnings growth to quickly return to zero over the next few quarters as these headwinds fade.

Negative today, lackluster tomorrow

S&P 500 Index constituent profits fell by 8% in the first quarter of 2016 relative to a year ago. Perhaps the most disconcerting feature of the earnings season was that this weakness had become pervasive, with six of the 10 major sectors reporting negative growth. The depth and breadth of the current earnings slump is quite rare outside of an economic recession. This special topic in our quarterly report explores important questions surrounding the resiliency of the U.S. corporate sector and the broader economy.

Over the next three years, we continue to see a lackluster outlook for U.S. earnings, with growth rates tracking in the low single digits.

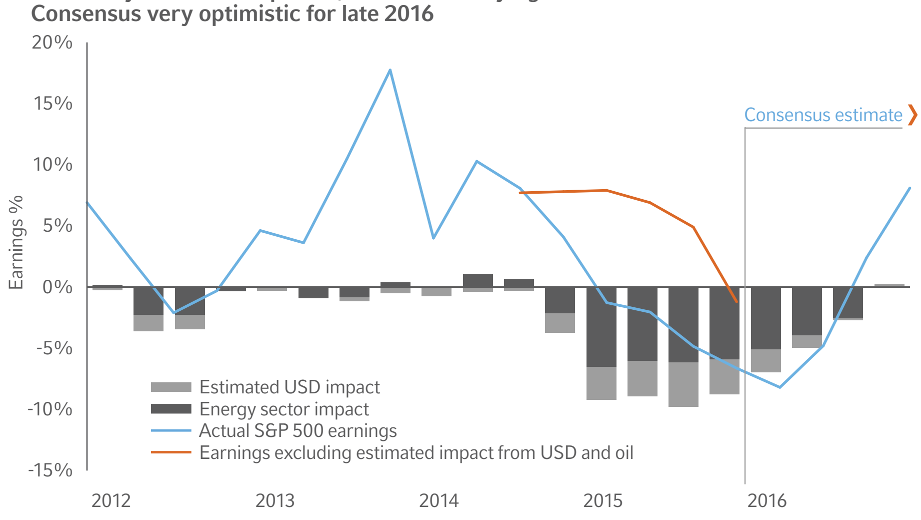
Why are earnings so weak? Part I: transitory forces

The collapse in oil prices since late 2014 acted as a meaningful headwind for energy revenues. We estimate that low energy prices subtracted about five percentage points from headline S&P 500 earnings per share (EPS) growth in the first quarter. Importantly, the recent stabilization in commodity prices suggests this headwind should fade by the end of 2016.

Similarly, U.S. dollar strength has also hurt U.S. profits. We estimate that dollar strength subtracted roughly two percentage points from EPS growth in the first quarter. Van Luu's forecast, as stated in the following segment, of a range-bound dollar implies that this headwind should also fade to zero by year-end.

The glass-is-half-full conclusion would be that, taken together, these transitory forces subtracted roughly seven percentage points from EPS growth in the first quarter and should quickly fade. While this is a significant share of the current earnings weakness, the "underlying" pace of earnings growth has deteriorated meaningfully since late 2014 (orange line, chart below). And, as argued on the next page, the fundamental outlook for U.S. earnings is rather, well, lackluster.

Transitory factors hurt profits, but the underlying trend has also weakened. Consensus very optimistic for late 2016



Source: Russell Investments, Bloomberg. Bloomberg consensus estimates from Q1 2016 onwards are as of May 2, 2016.

The consensus forecast is the average or median of all the estimates from individual analysts.

The dark gray bars reflect the consensus view on energy sector earnings. The light gray bars assume the broad USD remains unchanged at current levels.

Why are earnings so weak? Part II: fundamental headwinds

We estimate that U.S. employment growth will average 150,000 per month over the next 12 months. That's a healthy pace for jobs, but it also implies that the unemployment rate should push even lower into the 4% range. And as the labor market tightens, wage inflation should continue to push higher. Rising labor costs are likely to exert downward pressure on profit margins over the next three years—particularly given the tepid pace of top-line sales and GDP growth in the current expansion.

Lackluster growth extends beyond U.S. borders. Following a period of significant globalization in the mid-2000s, U.S. businesses now increasingly count on their global operations to generate growth. However, a slowing Chinese economy and its ripple effects drove a recoupling of developed and emerging market growth over the last few years. As a result, foreign-sourced earnings have not contributed much to the bottom line since late 2012. Also, our negative business cycle score for the emerging markets suggests that foreign earnings of U.S. businesses are likely to remain sluggish.

> Given a strong U.S. consumer and the lack of major economic imbalances in both the labor market and business investment, we see the chances of a severe downturn as low.

Can weak earnings kill the U.S. expansion?

History suggests that prolonged periods of negative earnings growth can slow the pace of economic activity. For example, our empirical analysis of S&P 500 Index earnings data stretching back to World War II identified six multi-quarter episodes—comparable to the current situation—during which the U.S. suffered an earnings recession without a broader economic downturn. During these periods, non-farm payrolls, on average, slowed by 60,000 per month and capital expenditure growth was effectively cut in half.

These are material economic impacts. Our forecasts for 2% real GDP growth and 150,000 net new jobs per month incorporate some of these headwinds. But in our view, corporate sector weakness still poses risk. The question is: How large a risk does it represent? Given a strong U.S. consumer and the lack of major economic imbalances in both the labor market and business investment, we see the chance of a severe downturn as low. Instead, a prolonged period of negative earnings growth would more likely result in a slowdown than a full-on recession.

Investment strategy implications

As the transitory headwinds from low energy prices and U.S. dollar strength fade over the next few quarters, we expect S&P 500 earnings growth to quickly normalize from -8% to roughly zero. Directionally, that is a positive development—and should remove one of the acute sources of downside risk from global markets. But looking out over the next three years, we continue to see a lackluster outlook for U.S. earnings, with growth rates tracking in the low single digits.

The combination of expensive valuations and lackluster earnings leads us to have an underweight preference toward the U.S. equity market in global portfolios. Within U.S. equities, we see "quality" stocks as offering good value. And the consistent earnings power of these businesses is likely to be advantageous in the current economic environment. ■

Currencies: range-bound[7]

After forecasting the end of the U.S. dollar bull cycle in our previous quarterly outlook report, we think major currencies will remain within the ranges we have seen since the beginning of 2016. Policy divergence is fading as a driver of G-10[8] foreign exchange markets. In emerging markets, cheap valuations should start to underpin the currencies of developing nations, but China looms as a risk factor.

Central bank impotence

Currency markets seem to have lost confidence in central banks' ability to affect exchange rates to achieve their objectives. On one side of the divide, the BoJ and ECB's negative interest rate policies and asset purchase programs failed to further weaken the Japanese yen and the euro. On the other side, the U.S. Fed has not been able to proceed as swiftly as we had expected in raising interest rates and normalizing what has been an extraordinarily loose policy.

Policy divergence turns to policy impotence.

Weaker labor market data and the then-impending Brexit vote forced the Fed in mid-June to abandon its preference for a mid-year rate hike. The U.S. central bank may end up hiking interest rates only once this year, most likely in December. Policy divergence is less pronounced and less influential on G3 currencies (the U.S. dollar, yen, and euro) than in the last three years. In this environment, we expect the major currencies to move within the ranges we have seen since the beginning of 2016 rather than establishing new trends.

Outlook for major currencies: sideways

After benefitting from the policy divergence theme for the last three years, as of June 20, 2016, the trade-weighted U.S. dollar index[9] is nearly 10% off the cyclical peak reached in January of this year. However, we do not think that the greenback has shifted to a new era of persistent weakness, but is rather more likely to stay within its recent range.

In our previous quarterly outlook report, we expected the yen to strengthen due to the currency's attractive valuation and safe-haven status. Having rallied by 9% in trade-weighted terms within the last three months, policymakers in Japan are now distinctly uncomfortable with the yen's valuation as well as the pace of its appreciation. We think the yen will consolidate around current levels rather than strengthen further.

On the eve of Britain's EU referendum, the pound rose towards 1.50 to the U.S. dollar amid some unwinding of trades intended to hedge against a Brexit scenario. After the UK surprisingly voted to leave the EU, sterling fell sharply against the dollar. We think the uncertainty around the terms of Britain's relationship with the EU will continue to weigh on the pound. The UK has relied on large capital inflows which may now be drying up.

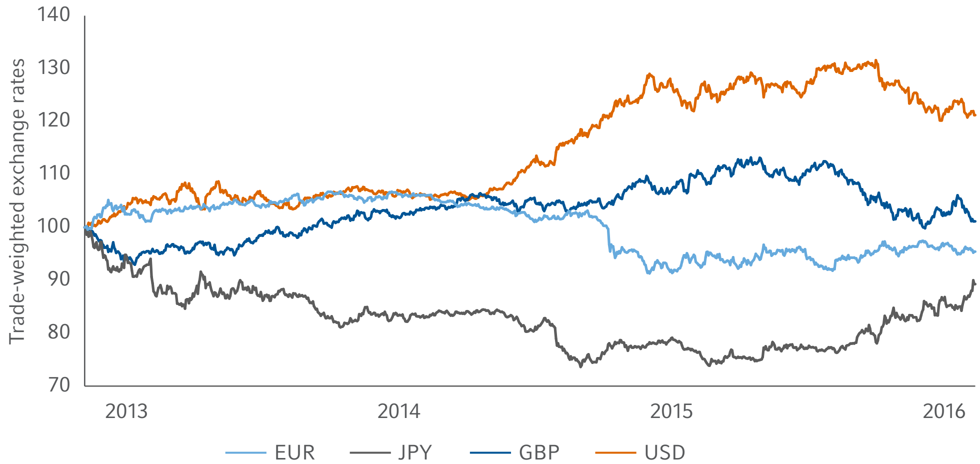
The euro has been trending sideways against the U.S. dollar over the last 18 months. More recently, it was buoyed by expectations of Britain voting to remain in the EU. Now that the Brexit risk has materialized, the euro could come under pressure against the dollar in the months ahead. However, the common European currency is supported by cheap valuation and we do not expect it to break out of its 2016 range vis-à-vis the U.S. dollar.

[7] Range-bound means more likely to move in a more narrow horizontal range against the other major currencies.

[8] The G-10 refers to Australia, Canada, the eurozone, Japan, Norway, New Zealand, Sweden, Switzerland, United Kingdom and the United States.

[9] The trade-weighted U.S. dollar index, also known as the broad index, is a measure of the value of the U.S. dollar relative to other world currencies.

Trade-weighted exchange rates



Source: Thomson Reuters Datastream trade-weighted values as of June 17, 2016. Rebase Dec. 31, 2013: 100

EM currencies attractively valued, but China looms

Many emerging markets (EM) currencies are now at attractive valuations according to our valuation metrics. For example, real trade-weighted exchange rates of many developing nations are about one standard deviation[10] below their long-term averages. Some cyclical factors are also becoming more supportive for EM currencies. Most commodity prices have stopped falling or are rebounding, shoring up commodity-exporting emerging markets. The downward revision in Fed rate-hike expectations and the recent reversal in the U.S. dollar also ease pressure on emerging markets debtors.

However, China's exchange rate policy still looms large as a risk factor. After abrupt devaluations of the Chinese yuan in August and December 2015 triggered major turbulence in world financial markets, the Chinese central bank has now moved to a more gradual depreciation of the trade-weighted yuan. In contrast to the previous two episodes, forward currency markets have remained calm. This failure to take into account a potentially large depreciation—the 12-month forward at 6.74[11] discounts less than 3% weakness—appears somewhat complacent to us. A larger-than-expected yuan devaluation remains a downside risk for other EM currencies. ■

[10] 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.

[11] Source: Bloomberg, as of June 17, 2016.

Quantitative modeling: hope springs eternal

Positive equity outlook relative to bonds

Since the end of the first quarter of 2016 our model for U.S. equities versus U.S. fixed income shifted to be in favor of equities. The model has maintained this positive position for equities for the past few months, helping us feel more confident in this view at mid-year.

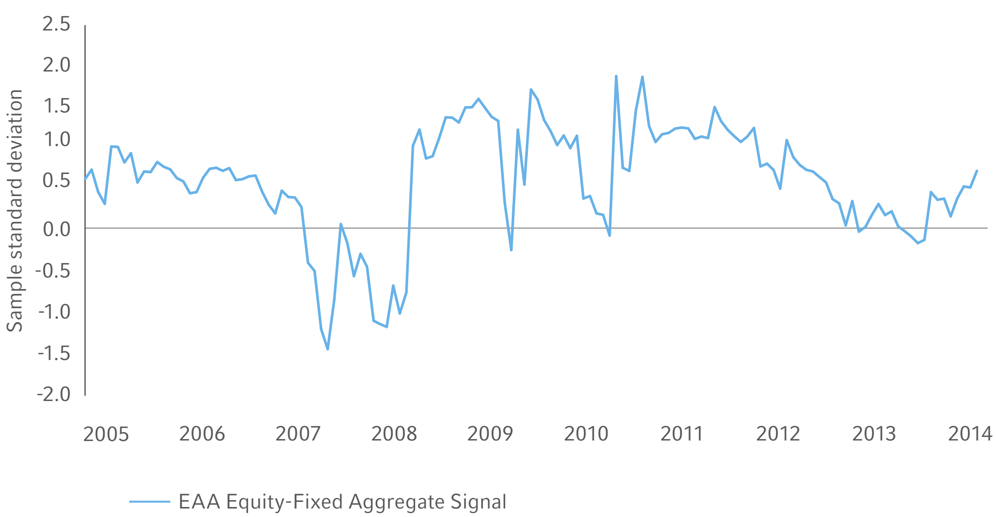
› **Business cycle:** Our model that estimates the likelihood of being in a bull or bear market has increased to support equities from last quarter. The U.S. Business Cycle Index (BCI) shows low recession risk and a path of moderate economic growth, but at mid-year 2016 we expect forward earnings to fall a bit more.

› **Valuation:** Since equities increased in price, the earnings yield decreased. Bond yields are also lower. But on net, equities look less attractive to our Fed model.

› **Sentiment:** The 12-month declining weighted average signal of excess equity momentum turned positive as markets improved over the second quarter. This would be one of the largest drivers of our change in view.

Our model that estimates the likelihood of being in a bull or bear market has increased to support equities from last quarter.

EAA[12] Equity-Fixed Aggregate Signal



Source: Russell Investments as of June 17, 2016

[12] 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.

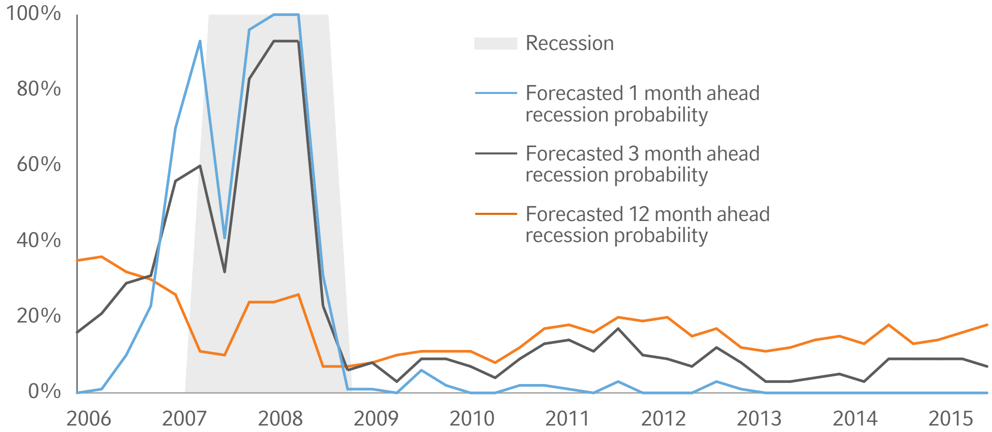
The EAA Equity-Fixed Aggregate Signal is based on the S&P 500 and Barclays U.S. Aggregate Bond indexes.

Slower U.S. growth, but recession probabilities still historically low

Equity market anxiety and low global bond yields reflect concerns about a slowing U.S. and global economy. While the U.S. economy may be tracking below our stated expectations from the end of 2015, our proprietary BCI model shows that the chances for a U.S. recession are still unlikely over the next year.

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.

BCI model: historical forecasted recession probabilities



Source: Russell Investments as of June 17, 2016

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[11]) to estimate the strength of the U.S. economy and recession risks. The 12-month recession probability has risen from the 10%-15% range to the 15%-20% range over the last year, but this is still low by the model's historical standards.

For context, a year before the 2008 recession, the model estimated a roughly 35% probability of U.S. recession in the next year; three months before the 2008 recession, the model estimated a roughly 45% probability of recession in the next three months; a month before the 2008 recession, the model estimated a roughly 70% probability of recession in the next month. The financial crisis was especially severe, but today's recession probabilities show a much more muted recession outlook.

The model doesn't explicitly cover corporate earnings, a major watch point for our team, but an earnings headwind would eventually be picked up by the model. The transmission mechanism would likely be that low earnings feed into depressed capital expenditures and hiring, which would eventually enter our model with steadily lower payrolls. Or, the market may perceive these low earning companies to be less credit-worthy, and credit spreads may increase to reflect this risk. Credit spreads were elevated earlier in 2016, but have since come down. The most recent May employment report was dismal, and if this trend continues, our BCI model may show higher concern. Until then, the quantitative outlook is that a U.S. recession in the next 12 months is unlikely. ■

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

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 bottom of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

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.

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.

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.

The Barclays U.S. 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.

Barclays U.S. Corporate Investment Grade Index is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least $250 million par amount outstanding.

The FTSE Developed Index is a market-capitalization weighted index representing the performance of large and mid cap companies in Developed markets. The index is derived from the FTSE Global Equity Index Series (GEIS), which covers 98% of the world's investable market capitalization.

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.

Source for MSCI data: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI

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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