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Shifting winds

2018 Global Market Outlook – Q2 update

Cycle tailwinds from synchronized global growth, strong earnings and fiscal easing currently outweigh the growing headwinds from monetary tightening and inflation pressures, but we wouldn't throw caution to the wind as 2018 progresses.

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Andrew Pease
Global Head of Investment Strategy

Paul Eitelman
Senior Investment Strategist, North America

Graham Harman
Senior Investment Strategist, Asia-Pacific

Shailesh Kshatriya, CFA
Director, Canadian Strategies

Van Luu, Ph.D.
Head of Currency & Fixed Income Strategy

Kara Ng
Senior Quantitative Investment Strategy Analyst

Abraham Robison
Quantitative Investment Strategist

Wouter Sturkenboom CFA, CAIA
Senior Investment Strategist, EMEA

Alexander Cousley
Investment Strategy Analyst

Stephen Wood, Ph.D.
Chief Market Strategist

Executive Summary

Volatility is back, the U.S. Federal Reserve (Fed) is picking up the pace of hiking and trade-war threats are increasing. But global growth is still strong and the U.S. economy is getting a jolt of fiscal stimulus. The tailwinds still outweigh the headwinds for now; however, this balance could shift as the year progresses.

Shifting winds

January's burst of equity-market euphoria has given way to fear of a trade war, a more hawkish Fed and the return of volatility. The challenge of late-cycle investing is that equity valuations are stretched, there are worries about the economy overheating and the Fed is taking away the punchbowl. But at the same time, economic growth and earnings are strong, and surveys of U.S. investors still suggest plenty of optimism, even after the late January equity-market correction.

The added complications are that the U.S. federal government has enacted substantial fiscal stimulus at a time when the economy is at full employment, and President Trump is imposing trade sanctions that could escalate into a major trade war.

Our cycle, value and sentiment investment decision-making process has us broadly neutral global equities. We're underweight U.S. equities because of expensive valuation, and because we believe much of the good news is priced in. Positive cycle views and relatively better valuation give us small overweights to Europe, Japan and emerging markets within global equities.

Paul Eitelman sees the U.S. fiscal stimulus as cycle supportive, but argues there will be a price to pay in terms of inflation and the pace of Fed tightening. He worries that a trade war could be bad for growth and inflation – inviting stagflation – but thinks the U.S. is embarking on a negotiating strategy rather than an all-out trade war.

Wouter Sturkenboom remains positive on the cycle outlook for Europe. The strength in the euro has been a significant headwind for the local currency performance of European equities. He believes this drag should start to wane in coming months, allowing the positive cycle fundamentals to be rewarded.

Graham Harman and **Alex Cousley** remain broadly positive on the Asia-Pacific region. Policy settings are still broadly accommodative across the region and corporate earnings growth is healthy. They see the main risk as U.S. trade protectionism, targeted against China.

The Japanese yen has taken over from the euro as **Van Luu's** preferred currency. The yen is relatively cheap against the backdrop of an improving economy and a current account surplus. Van expects the U.S. dollar to remain under pressure from the twin forces of large fiscal and current account deficits.

The U.S. business cycle index model estimated by **Kara Ng** and **Abe Robison** points to relatively low recession risk over the next 12 months. Though, their model for U.S. equities versus fixed income has moved to neutral following a lengthy period of favoring equities.

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Investment strategy outlook

Big U.S. tax cuts, synchronized global growth and strong earnings are battling Fed rate hikes, rising inflation and protectionist threats. For now, the cycle tailwinds are stronger than the headwinds, but this balance could shift as the Fed continues to lift rates.

Tailwinds still outpacing headwinds

It's been an eventful start to 2018 for global financial markets. The S&P 500® index rose 5.6% in the first month, which was the biggest gain for a January since 1997. This was followed by a record one-day spike in the CBOE Volatility Index® (VIX[1]), the first 10% market correction since early 2016 and a subsequent 8% rebound. The U.S. 10-year Treasury yield rose 50 basis points to 2.90%, hitting its highest point since the "taper tantrum" in late 2013.

Strong Q4 corporate earnings and a much larger than expected federal government fiscal stimulus package provided the initial boost, but this was undone when a spike in average hourly earnings, released with the January payrolls data, triggered an inflation scare.

The result is that 2018 looks different from last year along a number of significant dimensions:

› More fiscal stimulus adding to already strong global growth momentum.

› Labor market inflation pressures, centering on the United States.

› Central banks becoming more hawkish, with the U.S. Fed potentially hiking four times this year and the European Central Bank (ECB) preparing to wind-down quantitative easing.

› President Donald Trump implementing trade tariffs following a year in which he was less protectionist than feared.

› More market volatility, implying larger risk premiums across asset classes.

This adds up to a complicated late-cycle backdrop for markets. Our view is that, for now, the cycle tailwinds from synchronized global growth, strong earnings-per-share (EPS) gains, and fiscal easing, all combine to outweigh the growing headwinds from monetary tightening and inflation pressures.

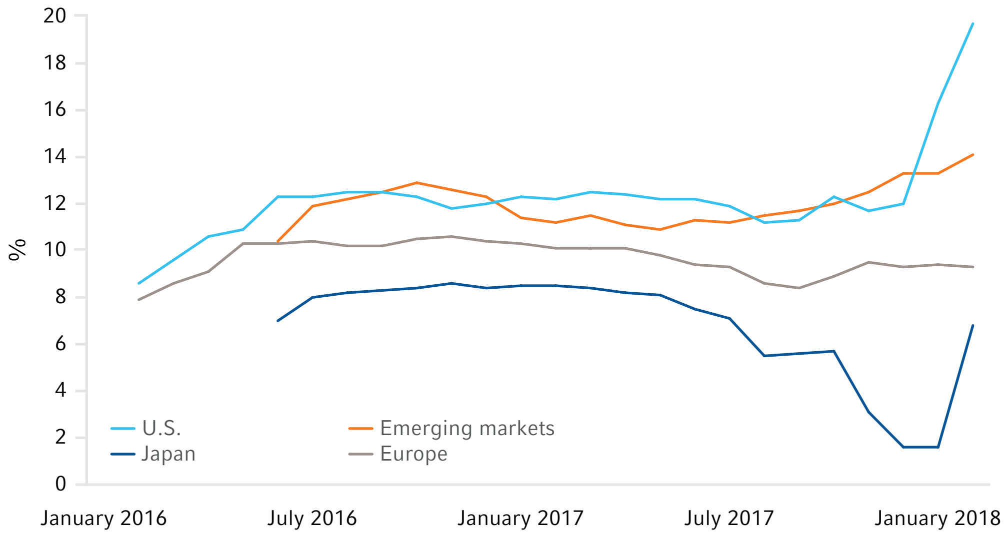
The outlook for corporate profits this year is particularly robust. The chart in this segment shows the regional industry consensus forecasts for EPS growth in 2018, which are aggregated from the individual company forecasts by brokerage house analysts.

The stand-out is the upgrade in the U.S. EPS growth forecast to nearly 20%. Four to five percentage points of this can be attributed to the impact of the corporate tax cuts, but even accounting for this, the surge in profit expectations is impressive. EPS forecasts are also robust for the rest of the world. Japan looks the laggard at 5% growth, but this follows more than 30% EPS growth in 2017.

We see business cycle tailwinds as stronger than the headwinds, but this balance could shift as the Fed continues to lift rates.

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

Forecast 2018 EPS growth



Source: MSCI and Institutional Brokers' Estimate System (IBES), as of February 2018. Markets reflected by the MSCI USA Index, MSCI Japan Index, MSCI Emerging Markets Index and MSCI EMU Index. Indexes are unmanaged and cannot be invested in directly.

Our cycle, value and sentiment investment decision-making process tells us to be cautious about U.S. equities. Very expensive valuation in the U.S. implies asymmetry in the return outlook, where the potential downside is larger than the upside. Other markets range from slightly cheap (emerging markets) to slightly expensive (Europe and Japan).

Our cycle, value and sentiment investment decision-making process tells us to be cautious about U.S. equities.

We're scoring the cycle as slightly positive for global equities, but watching closely for any signs of U.S. recession risk. Our base-case analysis is that the most likely timing for the next recession is late 2019/early 2020. This means it's probably another 12 months or so until recession risk enters the market radar.

Our sentiment indicators were signaling that equities were overbought in late January. The subsequent market recovery has taken most of our signals back to neutral.

Overall, our process still recommends a neutral allocation to global equities, with a value-driven underweight to the U.S. offset by overweights to emerging markets (EM), Japan and Europe.

We're also neutral on high-yield credit, where expensive valuation is being offset by a moderately positive cycle tailwind from low default rates and strong corporate profits.

One of the main takeaways from the start to the year is that volatility is back. The VIX index averaged just 11.1 in 2017, the lowest annual average on record. The combination of central bank tightening, rising inflation, protectionist pressure, and geopolitical risks, means that volatility is almost certain to be higher this year – as we already have experienced through the first quarter.

Our preference for the past few years has been to "buy the dip" as our broadly positive views on the cycle outlook supported equities and credit. For now, the cycle tailwinds are stronger than the headwinds, so we are still looking to add risk when the market pulls back.

We believe the headwinds will increase as the Fed becomes more aggressive, inflation picks up and profit margins come under pressure from rising labor costs. Buying dips will likely become more challenging as we move through the year and markets become more sensitive to recession risks.

Treasuries: fair value in the U.S., expensive elsewhere

One of the stories of 2018 has been the lift in government bond yields. As of mid-March, the 10-year U.S. Treasury yield has risen by 50 basis points, U.K. gilts are up 30 basis points and German bunds have risen 23 basis points. Only Japanese government bonds (JGBs) have bucked the trend, where the Bank of Japan's yield curve control policy is keeping the 10-year yield below 10 basis points.

Our fair value estimate for the 10-year U.S. Treasury yield is around 2.8%. This is based on our expected path for the Fed funds rate over the next few years plus the term premium. Our fair value includes our expectation that there is a good likelihood the U.S. will experience a recession by 2020, which means the Fed will be lowering rates. At 2.9% in mid-March, the U.S. 10-year yield is marginally on the cheap side of fair value. Bunds, gilts and JGBs, however, remain very expensive based on our methodology.

U.S. 10-year Treasury yields in our view could rise to 3.0% or slightly higher over the next few months as inflation is expected to pick up. The breakeven inflation rate – the difference between the yield on the nominal and 10-year inflation protected bond – has risen from 1.75% in September to 2.1% in mid-March. It's not uncommon for the breakeven inflation rate to reach 2.2%-2.5% late in the cycle. This means that cycle forces are still moderately negative for U.S. Treasuries, but valuation is now a constraint on how much further yields can rise.

Scenarios for 2018: update

Our 2018 annual outlook report issued in early December 2017 recommended watching the following three potential scenarios for 2018 given the uncertainties.

Central scenario

- Equity markets face increasing headwinds later in the year. Europe, Japan and emerging markets outperform the U.S. in what could be a relatively flat year for global equities.

Upside scenario: blow-out rally

- Fed is dovish and tightens by less than expected.
- Euphoria takes hold and investors leverage into the equity market.

Downside scenario: Fed mistake triggers a 2018 recession

- Fed overtightens into a sluggish economy and R-star (the real interest rate consistent with full-employment and stable inflation) turns out to be much lower than expected.

The impressive January for equity markets suggested that the blow-out rally was underway, and there was plenty of anecdotal evidence about strong demand from retail investors at discount stock-brokerages in the U.S. However, we believe both market volatility and relatively hawkish comments by new Fed chair Jay Powell mean that the blow-out rally is becoming less likely.

The "Fed mistake" scenario is still a possibility, although the magnitude of the Trump fiscal stimulus and the growth momentum so far are pushing this scenario into 2019.

This means we still favor the central scenario. This is where global equity markets push higher over the first half of the year, before facing headwinds later in 2018 as the Fed continues to raise rates and investors start to worry about a recession in late 2019/early 2020. ■

> We still favor our central scenario, where global equity markets push higher over the first half of the year before facing headwinds later in 2018.

United States: Tug of war & trade war

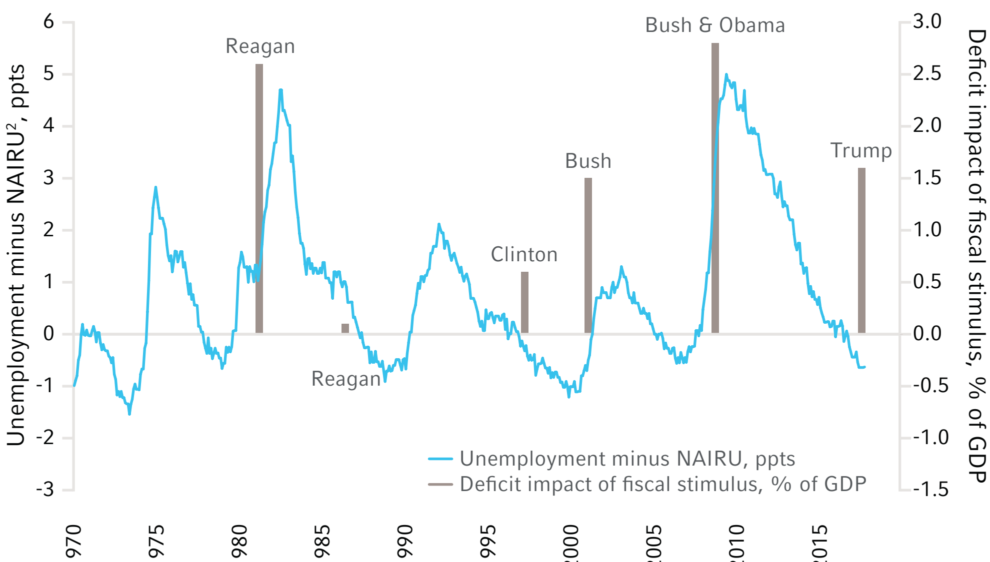
Congress is slated to inject a lot of fiscal stimulus over the next two years. The Fed's job will be to carefully take that away to prevent risks of an overheating economy. This late-cycle tug of war between fiscal policy and monetary policy is highly unusual. We believe the outlook for the U.S. economy and corporate profits in 2018 is strong, but the challenge for markets is that this optimism is already priced in. We maintain an underweight preference for U.S. equities and see better value in other regional markets.

Tug of war between fiscal and monetary policy

President Trump has signed two fiscal stimulus packages since our annual outlook report was issued in early December. The first – the Tax Cut and Jobs Act of 2017 – significantly lowers the tax burden on corporations and high-income individuals. This bill should provide a strong tailwind for U.S. corporate profits in 2018. The second – a two-year budget deal signed in February – allows for large increases in discretionary government spending in 2018 and 2019. Taken together, this stimulus is significant; and it's larger than the tax cuts that President Bush enacted to combat the recession in 2001 (see chart below). On the back of these developments, we have raised our 2018 forecasts for real GDP growth (to 2.6%) and S&P 500 earnings growth (to 12-15%).

We have raised our 2018 forecasts for real GDP growth to 2.6% and S&P 500 earnings growth to 12%-15%.

Late-cycle stimulus of this magnitude is highly unusual



Source: Bureau of Labor Statistics, Congressional Budget Office, Bridgewater Associates, Russell Investments.

[2] NAIRU (non-accelerating inflation rate of unemployment) refers to a level of unemployment below which inflation rises – in percentage points (ppts) on the chart.

However, two factors prevent us from turning more optimistic about the cyclical outlook for U.S. equities.

- Industry consensus expectations for the U.S. economy and corporate earnings have soared in recent months. This increases the hurdle for future data to satisfy markets and suggests a more subdued return environment ahead.
- Injecting more growth this late in the expansion comes at a price – namely, faster inflation and a faster pace of Fed tightening. In his first testimony as Fed Chair on Feb. 27, Jerome Powell sounded more confident about both the growth and inflation outlook and hinted that the Federal Reserve may now be on track to raise rates four times this year. Against the backdrop of what is already a full employment economy, it will be the Fed's job to take away this stimulus to prevent the risk of overheating. Longer-term Treasury yields have moved up in sympathy with these concerns to their highest level since early 2014. At 2.8%, 10-year U.S. Treasury yields are now in-line with our estimate of fair value.

> With 10-year U.S. Treasury yields hovering around our 2.8% fair value estimate, we move back toward a neutral preference on U.S. government bonds for the first time in several years.

America First

After a century of U.S. policies that have generally trended in favor of globalization, President Trump has now lived up to his America First campaign pledge, imposing tariffs on steel and aluminum products and threatening the world with a trade war. We see this as a dangerous development for global markets. Directionally, trade wars are "stagflationary" in that they simultaneously damage growth and stimulate inflation. Today, U.S. businesses source more than 40% of their revenues from overseas, and they have complex global supply chains for bringing products to market. In this context, a disruption in either the volume or price of global trade could be very damaging in the short run.

The tariffs that have been imposed thus far on aluminum and steel imports do not materially impact our outlook. But we are wary that conditions could escalate further. An investigation by the United States into Chinese intellectual property theft is a major concern in this regard. Our watch points will include the severity of any punitive measures that the United States imposes on China, the severity of China's retaliation to these steps, and whether these steps appear to be leading toward a constructive negotiation or a destructive tit-for-tat trade war. The final outcome of this is difficult to forecast. Our baseline is that the Trump Administration will leverage these tools to work towards a better deal for America. But nine years into the expansion, we recognize there is a small, but non-zero probability, that the situation could escalate into an end-of-cycle event for markets.

Strategy outlook

- **Business cycle:** Corporate profits have come in ahead of schedule as a weak dollar and stronger global cycle helped U.S. businesses deliver 15% earnings growth in Q4. We expect earnings growth to hover around this same, strong level in 2018 given the tailwinds from tax reform. The challenge: industry consensus expectations have shot up to 20%, increasing the risk that a good earnings year will still end up as a disappointment for markets.
- **Valuation:** U.S. equities remain very expensive. The Shiller P/E ratio[3] for the S&P 500 stands at 33x – its highest level outside of the late 1990s.
- **Sentiment:** Positive momentum is offset by some evidence that U.S. equities have re-entered overbought territory.
- **Conclusion:** We continue to have an underweight preference for U.S. equities in global portfolios. With 10-year U.S. Treasury yields hovering around our 2.8% fair value estimate, we move back toward a neutral preference on U.S. government bonds for the first time in several years. ■

[3] The Shiller P/E ratio is a cyclically adjusted valuation measure defined as price divided by the average of 10 years of earnings (moving average), adjusted for inflation.

The eurozone: Stuck in the middle

The eurozone is still enjoying a mid-cycle renaissance, but its financial markets continue to struggle with euro strength. It is stuck between two competing forces. As such, it is an almost perfect exemplar of the global tension we identified between cyclical headwinds and tailwinds. However, the euro headwind is waning as we move into the second quarter of 2018 and the fundamental tailwinds are as strong as ever.

Euro headwind

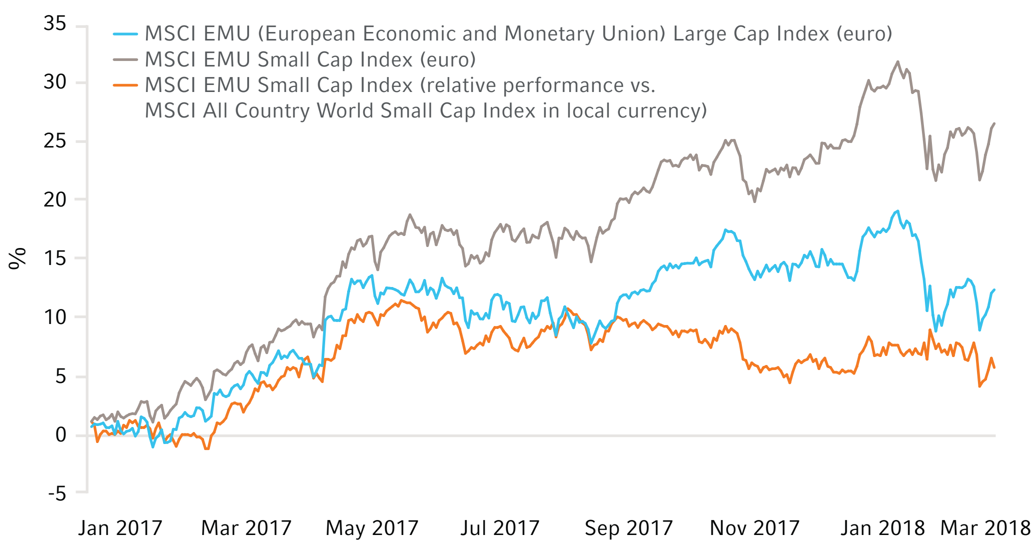
As a rule, when we write about our preferred equity regions, we focus on returns in local currency terms, while our currency views are either explicitly mentioned or covered in the currency segment of this quarterly outlook report. In the case of the eurozone and the euro, we have talked at length over the past few quarters about both the outlook for the currency as well as the impact it was having on our investment stance. In fact, we have combined long positions in both equities and the euro to reflect the positive impact the strong cycle developments were having on both.

We believe most of the damage for the eurozone equity market from a strong euro is probably in the rear-view mirror.

That stance notwithstanding, we have been surprised by how much euro strength has weighed on the equity market. This headwind is clearly revealed by the relative performance of small-cap vs. large-cap companies' shares. The former is less sensitive to currency swings because the bulk of their book of business is conducted regionally and therefore denominated in euros. By the same token, they are also more sensitive to regional economic developments.

Since the start of 2016 small-cap stocks have outperformed large caps by almost 14 percentage points in euro terms (see chart below). Additionally, eurozone small caps have outperformed global small caps by almost six percentage points in local currency terms. That means that small caps were able to outperform in the face of an 8% rise in the trade-weighted euro exchange rate (and a 17% rise vs. the U.S. dollar). Clear evidence in our view that the strong fundamentals matter, but in the case of large-cap equities were simply outgunned by the currency effect.

Eurozone small-cap stocks outperform amid competing cyclical forces



Source: Thomson Reuters Datastream, as of March 12, 2018.
Indexes are unmanaged and cannot be invested in directly. Performance quoted represents past performance and should not be viewed as a guarantee of future results.

However, large caps being outgunned was not just the result of euro strength. In relative terms, another headwind came in the form of the fiscal boost to corporate earnings expectations in the U.S. Although expected earnings growth in the eurozone is still a healthy 9%, it pales in comparison to the 20% in the U.S. However, we believe this relative cloud comes with a silver lining. As the fiscal boost starts to be felt, we expect the Fed to become more hawkish to prevent the economy from overheating and to help stave off the threat of inflation. This in turn should support the U.S. dollar, and by extension slow down or maybe even halt the euro rally. In any case, with the EUR/USD exchange rate near 1.24 as of March 13, 2018, most of the damage for the eurozone equity market from a strong euro is probably in the rear-view mirror.

Fundamental backdrop

Our optimism regarding eurozone economic growth, financial conditions, corporate earnings and political risk remains in place. Gross Domestic Product (GDP) growth is currently at the upper end of our 1.8%-2.4% band, consumer and producer confidence is strong, and credit growth is rising. Corporate earnings continue to be well-supported by both revenue growth and rising margins.

We continue to favor eurozone financial markets, particularly over U.S. markets.

Political risks are still there, but so far have not materialized. In Germany a new "grand coalition" government was formed by two mainstream political parties, while in Italy there was no outright victory for the Five Star Movement populist political party. Of course, we are closely watching how Italy will manage its coalition talks, but in the short term we see only limited market risk. Finally, the Brexit negotiations between the UK and the European Union (EU) are moving forward, albeit at a dangerously slow pace. We still expect an agreement will be reached to implement a two-year status-quo transition period, but it is clear that the Irish border is a dangerous sticking point. We hope UK Prime Minister Theresa May will reverse course and opt to pursue a new customs union with the EU to resolve that problem.

Strategy outlook:

- **Business cycle:** Strong GDP growth at the upper end of our band has allowed us to upgrade our business cycle score. We expect the ECB to stay accommodative and dovish this year. Corporate earnings growth of approximately 5%-10% is robust.
- **Valuation:** Eurozone equity valuations are neutral while core government bonds are long-term expensive. Our expected range for core bond yields at 0%-0.8% is unchanged, although we would be surprised to see the low end of that range again. Still, a significant breakout remains unlikely given ECB bond purchases and lack of inflation. We remain neutral in peripheral[4] bonds.
- **Sentiment:** A combination of positive price momentum and overbought contrarian signals have kept our sentiment score for eurozone equities in slightly negative territory. Sentiment for core and peripheral government bonds has gone from neutral to positive as negative momentum was overruled by oversold contrarian signals.
- **Conclusion:** We continue to favor eurozone financial markets, particularly over U.S. markets. Strong fundamentals and relatively attractive valuation underpin our view, while sentiment is currently not a differentiator. ■

[4] Europe's peripheral countries Portugal, Spain, Italy, Ireland and Greece are generally seen as less developed than the region's core counterparts.

Asia Pacific: And the show rolls on

We continue to expect solid growth and low inflation out of Asia Pacific in 2018. The Chinese government's economic growth target indicates another solid year, which we anticipate will be achieved with some mild attempts at reform. We expect the Japanese and Australian economies to continue to tick along. A move by the U.S. toward protectionism is a key risk to the region, although this is not our base case.

We remain constructive on the Asia-Pacific region and see no sign that this view needs to be moderated. The tailwinds of global growth and an expanding middle class in the region are outpacing concerns around high debt levels, notably in China. Earnings expectations for the Asia-Pacific region (excluding Japan) remain fairly modest and achievable in our view, and we expect to see upward revisions in coming months. As always, the risk of a China slowdown remains, however the consolidation of the government suggests to us this has mitigated at the margin. A shift towards protectionism is a growing risk, despite fairly high intra-regional trade, although our base case is that we will not see a full-blown trade war.

Earnings expectations for the region (ex-Japan) remain fairly modest and achievable, and we expect to see upward revisions in coming months.

The **Chinese** government has announced that growth will continue to roll on, reiterating its 6.5% GDP growth target for 2018, albeit with a slightly tighter fiscal stance. Our reading is that they are anticipating further pick up in private activity, which provides them with the opportunity to rein in the deficit. More broadly, activity in China has continued to be impressive, despite the environmentally driven capacity shutdown that has been in effect since the beginning of the winter heating season. Looking further ahead, significant supply-side reform is needed to allow for sustainable growth. We have yet to see many signs of this, but the consolidation of power that has been seen should provide the opportunity. We would expect this reform will include efforts to reduce the debt levels, but not to the extent that it compromises growth.

Looking at other developing economies in the region, the outlook remains positive. In **South Korea**, a tight labor market has translated into elevated consumer confidence and robust retail sales growth. Monetary policy remains accommodative, although the Bank of Korea will likely move towards tighter policy as the year progresses. A similar story is playing out in India, with solid growth in retail sales being supported by strong industrial production and manufacturing, with monetary policy expected to tighten through the year.

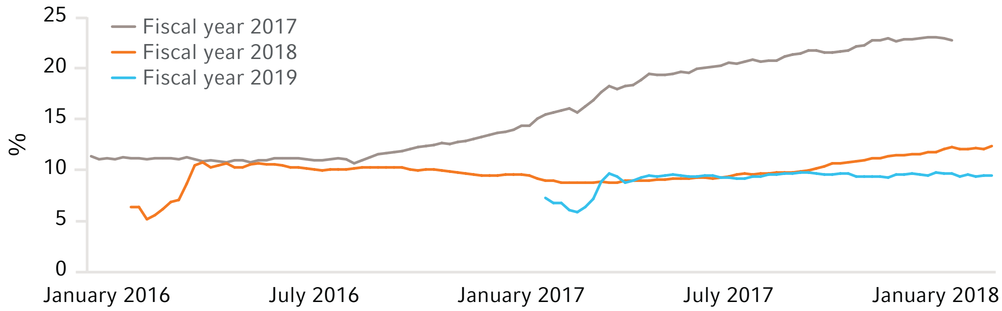
In **Australia**, our 'good, but not great' theme rolls on for the economy. In **New Zealand**, further detail on immigration, housing and foreign investment policy changes from the government will provide clarity into the outlook. This activity in our view will mildly slow as population and housing growth cools. The main recent development is the negative spread that is now in place between the U.S. and both Australia and New Zealand, which is something that we haven't seen in some time. On the short end, it is likely that this will remain through the year, given our view that the Fed will raise rates at least three times this year, while the Reserve Bank of Australia will hike twice at most and the Reserve Bank of New Zealand will leave rates unchanged. This should place some downward pressure on both currencies over the medium term.

We think earnings expectations for Asia Pacific (excluding Japan) are a bit cautious. The following chart shows I/B/E/S expectations[5] of 12% growth (following last year's stellar 23%). With the economic story expected to remain positive, and solid Chinese demand for regional imports, we think the market is being too pessimistic, and expect upward revisions as the year progresses.

In **Japan**, we believe that a slight moderation in headline Q4 GDP hid the strength of the Japanese consumer and the positive investment outlook. Buoyed by the tight labor market, and some very early signs of wage growth, we are seeing an acceleration in consumption spending. On the business side, elevated confidence and high capacity utilization should see a pick-up in investment, while 2020 Olympics-related spending should ramp up in coming quarters.

[5] IBES (also known as I/B/E/S) stands for Institutional Broker's Estimate System. It is a database that basically compiles the analysis and forecasted future earnings of publicly traded companies.

MSCI Asia-Pacific ex Japan Index: EPS growth



Source: Thomson Reuters Datastream, as of March 7, 2018.
Indexes are unmanaged and cannot be invested in directly. Performance quoted represents past performance and should not be viewed as a guarantee of future results.

The strength of the yen, in our view, will be the major headwind that Japan will face. Japanese firms have been assuming a yen at around 110 USD/JPY in their forward estimates. As of March 15 it is at 106. We think the yen's positive run can continue through the year. This will likely see some downward revisions to earnings guidance and forecasts, given roughly 40% of Japanese earnings come from abroad, although this will be offset to some extent by further strength in the domestic economy.

Valuations are looking less expensive following the February sell-off, with Japan standing out as offering fair value.

We wouldn't be able to have a theme of 'the show rolling on' without mentioning the Bank of Japan, which continues to pursue a very accommodative monetary policy. There has been speculation that the BoJ is planning an exit strategy from the current policy stance. We think these expectations are a bit ahead of themselves, and see no change in monetary policy any time soon. Inflation remains very contained, with a return to 2% not expected until 2019 (which could prove to be optimistic). If inflation does reach 2% in 2019, the BoJ will have to also deal with the lift in the consumption tax, which is likely to be implemented in October 2019. Additionally, by reiterating a commitment to loose policy in the face of tightening policy in the U.S., the BoJ may be able to ease some of the pressure on the yen.

The key risk to Asia Pacific, and the global market more generally, is the heightened possibility of the U.S. engaging in some form of a trade war. We have recently seen the Trump Administration introduce tariffs on steel and aluminum imports. While this doesn't significantly impact China, Trump has been very clear in targeting China as problematic. We also have an eye on the outcome of the U.S. government's investigation of China's intellectual property trade practices. Despite relatively high intra-regional trade (around 50% of Asia-Pacific trade is intra-regional), we believe an escalation into higher tariffs and a move toward protectionism would have negative consequences.

Investment strategy

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

- **Business cycle:** Look for developing economies to continue to lead the way, with growing support from Australia (underpinned by public investment and a pick-up in consumption) and Japan (supported by very accommodative policy and Olympics-related stimulus). We anticipate positive earnings revisions for the region, focused in the developing countries.
- **Valuation:** Valuations within the region have become slightly less expensive following the February 2018 sell-off. Within the region, we believe Japan offers the best value. Within the developing countries, we see China mainland valuations as more attractive than the H-share[6], due to the expensive tech names (Alibaba, Tencent, Baidu) being included in the H-share index.
- **Sentiment:** We have seen a deterioration in momentum, although it remains positive for the region. Equity flows remain healthy, indicating that there is still demand for Asian exposure from global investors. Signs that Asia-Pacific equity markets are overbought remain, restraining our sentiment view from being positive.
- **Conclusion:** We believe Asia-Pacific economic data and equity markets should see another solid year of performance as global growth underpins demand and monetary policy remains relatively accommodative. Valuations are looking less expensive following the February sell-off, with Japan standing out as offering fair value. A negative turn in the current U.S.-China trade discussions stands as a key risk.

[6] H-shares are shares of a company incorporated in the Chinese mainland that is listed on the Hong Kong Stock Exchange or other foreign exchange. Although H-shares are regulated by Chinese law, they are denominated in Hong Kong dollars and trade the same as other equities on the Hong Kong exchange.

Currencies: Yen rally has further to go

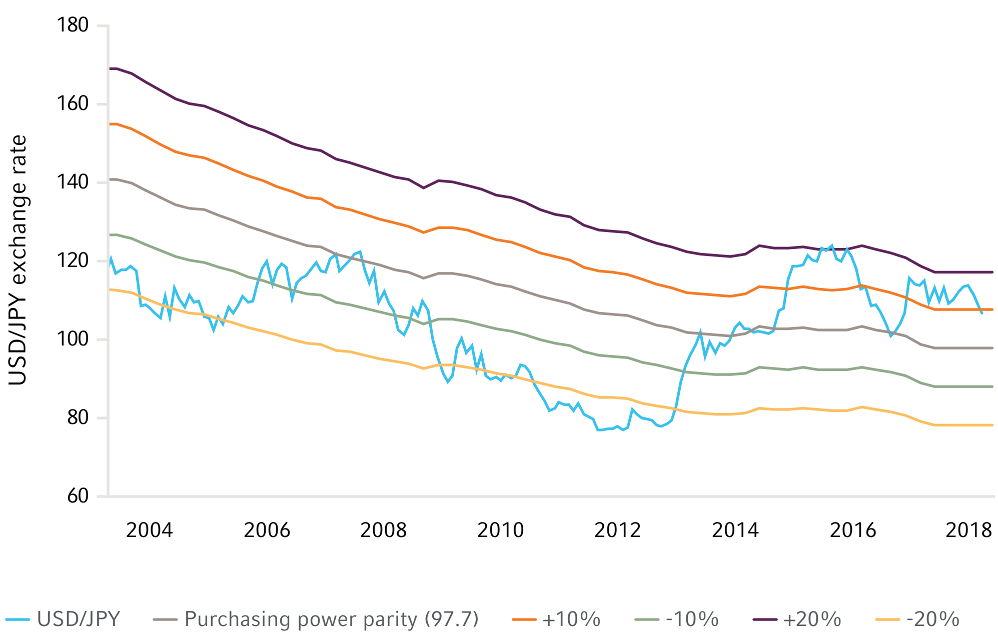
The Japanese yen (JPY) has taken over from the euro as our preferred G10[7] currency. The Bank of Japan's (BoJ) 'yield curve control' policy has kept JPY performance uninspiring until recently, despite cheap valuation and an improving economy. However, speculative yen positioning is still very short. This could render markets vulnerable to yen-positive news. Either a move by the BoJ toward less easy policy, or a big risk-off event could further fuel the yen rally.

In our view, the Japanese yen, which started 2018 on a firm footing, has taken over from the euro as the most attractive developed market currency. As of March 13, it was up 4.8% against the U.S. dollar[8], making it the second-strongest G10 currency after the Norwegian krone. We think the yen's positive run can continue.

> The Japanese yen, which started 2018 on a firm footing, has taken over from the euro in our view as the most attractive developed market currency.

Valuation is favorable. In the chart below, we plot the USD/JPY exchange rate together with its purchasing power parity (PPP), a level that equalizes the cost of living across the two currencies and can be considered one measure of fair value. With USD/JPY trading at 107 as of March 13 and the PPP exchange rate at 97.7, the yen is about 10% undervalued vis-à-vis the greenback. It is noteworthy that prior to Abenomics, the economic policies initiated by current Japanese prime minister Shinzo Abe in 2013, the yen was mostly expensive against the U.S. dollar. Abenomics has the goal of lifting Japanese inflation to 2%, and a weaker yen has been one of the ways to achieve that goal. We think that the forces pulling the yen toward fair value are becoming too strong even for the BoJ to successfully fight.

USD/JPY exchange rate and purchasing power parity



Source: Thomson Reuters Datastream, as of March 12, 2018.

[7] The Group of Ten (G10) refers to the group of countries that agreed to participate in the General Arrangements to Borrow, an agreement to provide the International Monetary Fund (IMF) with additional funds to increase its lending ability.

[8] Source: Thomson Reuters Datastream.

While the yen has been cheap for some time, cycle and sentiment indicators in our investment decision-making process are now also falling into place. The Japanese economy grew for the eighth straight quarter in Q4 2017, marking its best stretch of GDP growth since 2001. Japan also enjoys a current account surplus, while net portfolio flows have turned from deeply negative to roughly balanced. On the sentiment side, the recent improvement in yen momentum coincides with hedge funds and other speculators still holding large net short positions in the yen, according to Commitment of Traders (COT) reports in mid-March 2018. Further yen-positive news could force those market participants to close out their shorts.

Other major currencies

The euro enjoyed a tremendous 12-month period and is maybe now due for a short-term correction.

- **U.S. dollar (USD)**
  We have not been dollar bulls since March 2017, but the extent of the U.S. dollar weakness in 2017 and early 2018 has been puzzling. It runs counter to the widening interest-rate gap in favor of the greenback vis-à-vis the other G10 currencies. Two new explanations have been put forward for the dollar malaise: (1) concerns over the widening U.S. budget and current account deficit (so-called twin deficits), and (2) a decline in the U.S. dollar as an international reserve currency. Historical precedents of U.S. twin deficits do not provide conclusive evidence for a weaker dollar impact. While we would not chase the weaker dollar narrative at this stage, we do not see a lasting recovery on the horizon. Escalating trade tensions, kicked off by Trump's decision to impose tariffs on steel and aluminum imports, pose the risk of undermining the willingness of America's trade partners to hold USD assets.
- **Euro (EUR)**
  The euro enjoyed a tremendous 12-month period and is maybe now due for a short-term correction. Long EUR has been an industry consensus trade, and political uncertainty recently resurfaced after the inconclusive Italian election. The formation of a grand coalition in Germany between the two largest mainstream political parties is a positive development for the eurozone. In the medium term, we think a move to 1.30 is more likely for EUR/USD than a fall back towards 1.15 as the ECB starts its gradual exit from quantitative easing.
- **UK Pound Sterling (GBP)**
  A surprise hawkish shift by the Bank of England lifted GBP/USD to a post-Brexit high of 1.43 in late January, which is close to the PPP fair value. Sterling has since simmered down due to snags in the EU-UK Brexit negotiations. We expect a transition deal to result, which would be supportive of the pound. While the British prime minister has so far rejected calls for the UK to be part of the EU customs union (or a customs union arrangement), we think it the most likely endgame. Until then, there is still plenty of "toing and froing" to endure from the talks, keeping GBP/USD in a range between 1.35 and 1.45. ■

Quantitative modeling insights

Recession probabilities: Late cycle but still some runway

Our 2018 annual outlook offered three main takeaways regarding the next U.S. recession, which bear repeating:

1. Recessions are damaging to equity markets and the U.S. expansion is very old. Given the expensiveness of the S&P 500® index, it's crucial to get a clear read on recession risk.
2. The Business Cycle Index (BCI) model, which uses a range of economic and financial variables to estimate the strength of the U.S. economy, predicts a low probability of recession in the next 12 months.
3. Although short-term recession risks are low, we see risks building at the three-year horizon.

While 2018 had an eventful start, all three takeaways still hold true. First, we believe a timely and accurate risk on/risk off call is vital for portfolio positioning. By May 2018, the U.S. economic expansion will be the second-longest since the 1800s. Juxtaposed with expensive equity valuations, late-cycle fiscal stimulus, signs of inflation pressure, and the potential for a surprise from a more-hawkish Fed; it's especially important to get a clear read on the timing of the next U.S. recession.

Second, short-term recession risk remains low. As of March 14, 2018, the BCI model estimates that the probability of a U.S. recession in the next 12 months is 27%, which is a level where we should be alert but not alarmed. We believe this probability is more likely to rise than significantly fall in the future, but it's notable that the recession probability has mostly fluctuated around mid-20% in the last eight months. Short-term recession risk hasn't significantly increased since our 2018 annual outlook report in early December.

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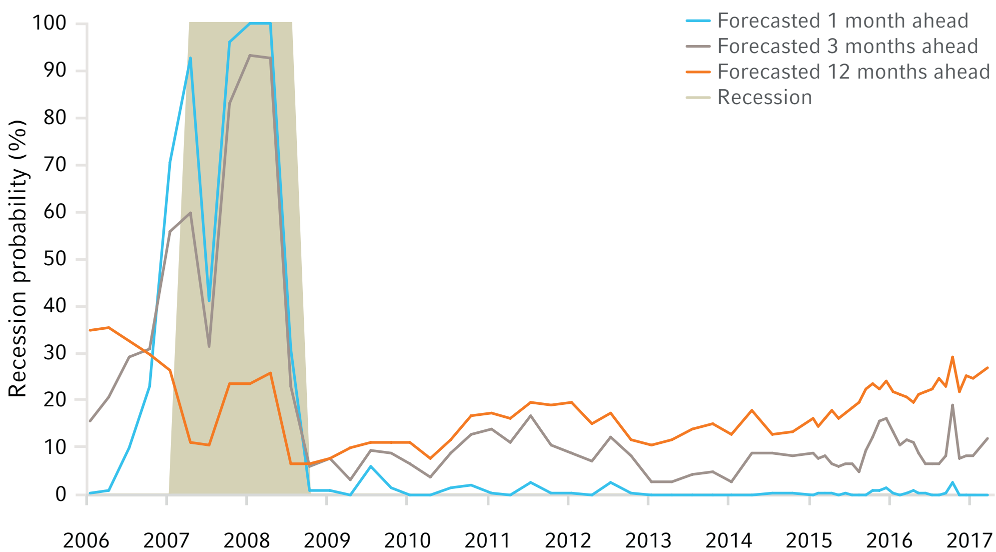
BCI historical forecasted recession probabilities



Source: Russell Investments, as of March 2018.

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.

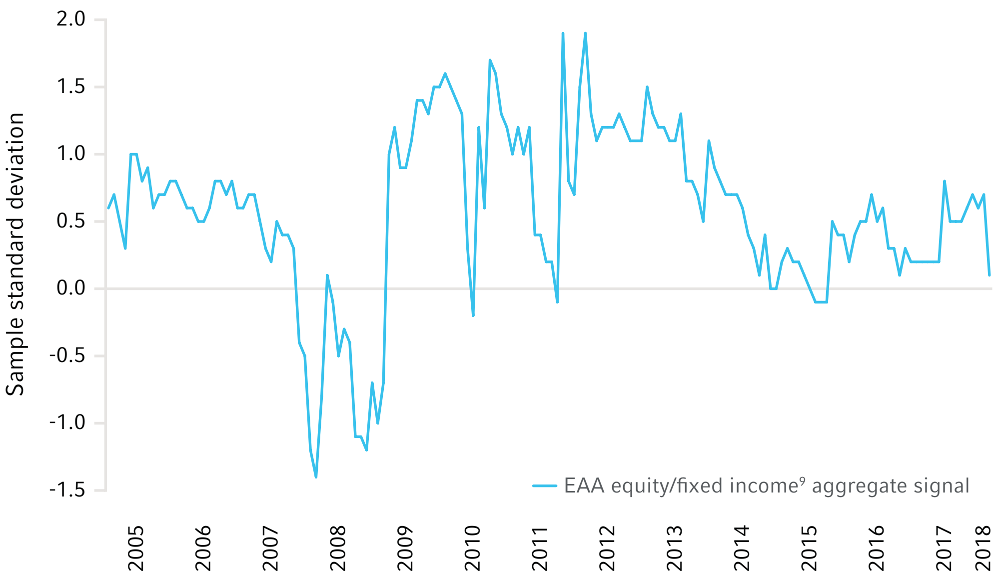
Third, medium-term recession risks are still building. Notably, the U.S. labor market is very tight with low unemployment and signs of wage inflation. Combined with late-cycle fiscal stimulus, the Fed may be forced to raise interest rates aggressively. In the medium term, a Fed policy mistake could restrict growth and unintentionally spark a recession. Overall, we conclude that a near-term U.S. recession is unlikely, but we should monitor this aging cycle.

A stumble, but not a fall

With the recent volatility in equity markets, our model for U.S. equities versus U.S. fixed income moved to neutral on risky assets. We expect inflation to pick up, but still have a decent outlook for GDP growth. This gives us mixed conditions for U.S. equities. Together with expensive valuations and a lowering yield curve, we believe a neutral score is appropriate.

The first-quarter pullback in equities has made us more cautious and puts us in a neutral position.

EAA[9] U.S. equity vs. U.S. fixed income aggregate signal



Source: Russell Investments, as of March 12, 2018.

Within our cycle, value and sentiment investment decision-making framework, we make the following overarching assessments based on our quantitative models:

› **Business cycle:** From the BCI model, we conclude that a near-term U.S. recession is unlikely. However, accelerating economic growth in this aging cycle is also unlikely.

› **Valuation:** Our Fed model improved as the equity yield increased by more than the bond yield. Our dividend discount model continues to see equities as a worthwhile investment.

› **Sentiment:** Our momentum signal declined with the first-quarter pullback in equities. Our contrarian long-term mean reversion signal became less negative, but is still negative for equity versus fixed income.

All considered, while we see some runway, the first-quarter pullback in equities has made us more cautious and puts us in a neutral position. ■

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

IMPORTANT INFORMATION

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

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

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

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial 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.

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.

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.

Performance quoted represents past performance and should not be viewed as a guarantee of future results.

Indexes are unmanaged and cannot be invested in directly.

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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 Pacific ex Japan Index captures large and mid-cap representation across four of five Developed Markets countries in the Pacific region (excluding Japan). With 149 constituents, the index covers approximately 85% of the free float-adjusted market capitalization.

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2018 Global Market Outlook – Q2 update

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