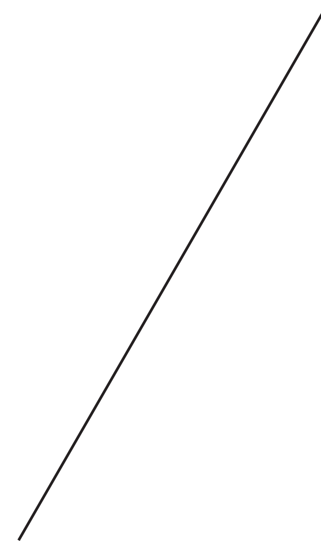
Q3 2023

SLOWLY SLOWING



GLOBAL MARKET OUTLOOK

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SYNOPSIS

The U.S. economy is defying predictions of a 2023 recession. We think a recession is likely, but it may be delayed until 2024. Inflation is receding only slowly, and central banks have still not finished tightening. We are positive on government bonds. Enthusiasm for artificial intelligence (AI) and resilient economic growth can support stocks in the near term, but longer-term headwinds are building.

KEY MARKET THEMES

A character in Ernest Hemingway's novel *The Sun Also Rises*, when asked how he went bankrupt, answers "gradually, then suddenly." This is a good description of the U.S. economic outlook. Forward-looking recession indicators such as the inverted Treasury yield curve, tighter bank lending standards, weak manufacturing activity and depressed consumer confidence readings are all flashing warning signs. Meanwhile, measures of real economic activity, such as jobs growth and household spending, are only gradually moderating.

Mega cap stocks are once again dominating the performance of the U.S. equity market, but this time their strength is due to excitement around generative AI technologies such as ChatGPT. Case-in-point: Almost all the S&P 500® Index gains so far this year have been delivered by stocks linked to AI. For now, though, we believe that aggressive U.S. Federal Reserve (Fed) tightening and the risk of a recession will likely keep a lid on AI euphoria.

We believe that the creeping economic slowdown in the United States will probably persist for a few more months, with a recession possible over the next 12-18 months. In our opinion, the tipping point will likely come when corporate profit pressures force firms into austerity measures such as layoffs and capital expenditure delays, and households—having exhausted pandemic savings from extra government payments and staying at home—respond by cutting back on discretionary spending.

In Europe, we think the region's economy is already starting to buckle under the strain of monetary tightening. For instance, lending growth has collapsed, and the credit impulse is the most negative since the 2007-08 financial crisis. While eurozone equities have performed broadly in line with U.S. equities so far this year, we expect they'll soon face the cycle challenges of tight monetary policy and recession risks.

Malaise is the best description of the UK economy. GDP (gross domestic product) has barely grown over the past year and is still lower than before the pandemic in 2019. Meanwhile, core inflation continues to move higher, hitting 6.8% in April. The persistence of inflation has forced the Bank of England (BoE) back to a hawkish stance.

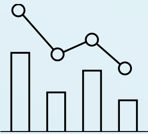
China's economy is decelerating after a strong first quarter. Consumption remains the key focus this year, and data continues to indicate that the Chinese consumer is cautious. The property-market recovery is also progressing slowly, and Chinese property developers continue to see elevated credit spreads. We maintain our view that 2023 GDP growth in China is likely to be around 5%.

In Japan, domestic spending is starting to pick up, with the country's reopening gathering some steam and inbound tourism returning. Wage growth continues to edge higher, and the stickier parts of inflation (i.e., services inflation) are approaching the Bank of Japan (BOJ)'s 2% inflation target.

In Australia, the country's economy continues to slow, but we think the probability of a recession remains lower than in the Northern Hemisphere. This is due in part to high immigration levels, which should support economic activity. However, the increase in interest rates and the expiration of many fixed-rate mortgages over the last three months will likely further slow household spending.

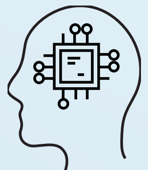
In Canada, the labor market is loosening, with the country shedding jobs in May for the first time since August 2022. Job vacancies have also declined. Weakening employment trends will eventually weigh on housing and consumer behavior and put downward pressure on inflation. We think a recession is the likely outcome over the next 12 months.

ECONOMIC VIEWS



U.S. RECESSION CHANCES

While a U.S. recession in the final quarter of 2023 is possible, we suspect that the gradual and uneven pace of the downturn could delay the recession until sometime in 2024. Markets, however, could melt upward over the next few months if investors begin to speculate (wrongly, in our view) that the resilience in the economic data suggests a recession might be avoided.

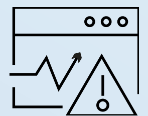


AI IMPACTS

As the use of artificial intelligence continues to increase, we believe its effects on growth and productivity may occur in a matter of years, rather than decades.

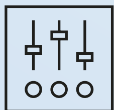
CHINA MONETARY POLICY

We anticipate that monetary policy in China is likely to remain very accommodative, given inflation is currently running below 1%, year-on-year.



EUROZONE INFLATION

We believe both headline and core inflation in the eurozone are set to decline rapidly in the coming months, due to falling energy prices.



BANK OF ENGLAND RATE HIKES

While market expectations call for the BoE's base rate to peak at over 6% in early 2024, we doubt policy can be tightened that much without the UK economy buckling, and we expect the base rate to peak at a lower level.

ASSET CLASS VIEWS

Equities: Limited upside

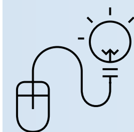
We believe equities have limited upside with recession risks on the horizon. Although non-U.S. developed equities are cheaper than U.S. equities, we have a neutral preference until the Fed become less hawkish and the U.S. dollar weakens. Within equities, we prefer the quality factor, which tracks stocks that have low debt and stable earnings growth.

Fixed income: Government bond valuations look increasingly attractive

We see U.S., UK and German bonds as offering reasonable value. Japanese bonds, however, still look expensive, with the BOJ holding the 50-basis-point yield limit. In the U.S., the spread between 2-year and 10-year government bond yields is close to an extreme. We think it's likely the yield curve will steepen in the coming months, as it tends to do after the Fed has completed hiking rates and markets start looking toward monetary easing.

Currencies: U.S. dollar could weaken further

The U.S. dollar has trended lower over the past month as investors speculate that the Fed is nearing the end of its rate-hiking cycle. We think it could weaken further if markets become confident that a recession can be avoided, given the counter-cyclical nature of the dollar. We also believe the Japanese yen is attractive from a cycle, value and sentiment perspective.



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IMPORTANT INFORMATION

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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 Investments 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.

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-domestic 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.

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.

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

The S&P 500® Index, 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 FTSE 100 Index is a market-capitalization weighted index of UK-listed blue chip companies.

The Bloomberg Global Treasury Index tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets. The index represents the treasury sector of the Global Aggregate Index. The index was created in 1992, with history available from January 1, 1987.

Indexes are unmanaged and cannot be invested in directly.

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2023 Global Market Outlook – Q3 update

First used: June 2023

RIFIS-25613 QSR-01112025-5802241.1.1