

# Key investment issues in 2019



How we're managing our clients' portfolios



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As the markets move into a late-cycle phase and risks build, a potent cocktail of geopolitical unrest, market volatility, and economic uncertainty continues to weigh on investors. With central banks beginning to remove the punch bowl, trade wars brewing between the United States and China, recession risks rising, and Brexit unravelling—2018's volatility should continue well into 2019. And, with U.S. equities overvalued and government bond yields under threat from late-cycle inflationary pressures, it's hard not to feel that every last drop of return is being extracted.

We still see return opportunities on the horizon, but taking advantage of them in a volatile market environment will require strong investment discipline and a robust decision-making process. At Russell Investments, we believe it is critical to set aside the noise and focus on market fundamentals: business **cycles**, security **valuations**, and investor **sentiment** (CVS). These factors, not geopolitical headlines, are the key drivers of investment performance and market behavior.

Are you wondering how we're using our CVS framework to manage volatility in our clients' portfolios in 2019?

## Strengthening regional markets

We believe 2019 will feature volatile global equity markets that deliver mid-single-digit returns, with better potential in Europe and Japan than in the United States. Therefore, we have slight overweights in our multi-asset portfolios to non-U.S. developed equities, and we are underweight U.S. equities due to expensive valuations. While we like the value provided by emerging market equities, we maintain neutral allocations due to simmering trade disputes, the strengthening U.S. dollar, and sputtering economic growth in China. A stronger contrarian signal, indicating that investor sentiment is souring on emerging markets, would be a reason for us to increase allocations—as we believe going against the grain has upside potential.

## Interest rate volatility

Recent remarks by the Fed indicate that it is likely to pause its quarterly rate-hiking cycle and is willing to adopt a “wait-and-see” approach to assess the latest economic data before making a decision on future rate increases. On the global fixed income front, we like the value offered by U.S. Treasuries, versus fair value at 2.7%, but we see German, Japanese, and U.K. bonds as very expensive, with yields well below fair value. The cycle is a headwind for all bond markets as inflation pressures build and central banks either tighten further (e.g., the U.S. Fed and Bank of England) or move away from extreme stimulus (e.g., the European Central Bank and Bank of Japan). Beyond the fixed income allocation, we are managing interest rate volatility across the total portfolio—which has served us well.

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For example, we were rewarded for maintaining underweight positions to interest-sensitive asset classes such as listed infrastructure, which also suffered from weak energy pipeline returns. At the same time, we continue to maintain overweight positions to the financial sector, which has tended to benefit from higher interest rates.

## Increasing recession risks in the United States

The current U.S. economic expansion will become the longest on record if it continues through July 2019, which seems likely. Our Business Cycle Index (BCI) model estimates that the probability of recession in the next 12 months is around 29%, a level that signals caution, but not alarm. That said, we are hedging against recession risks in our portfolios by implementing downside protection strategies that are

designed to enable us to participate in the upside and also to protect us from the downside of market movements. Additionally, we maintain underweights to high yield bonds, which are not only expensive and losing cycle support (as is typical late in the cycle, when profit growth slows and concerns about defaults rise); they also tend to exhibit more sensitivity to the impact of a recession than other types of fixed income securities.

Some of the ways we are helping our clients weather the coming storm include: Adjusting our portfolios to diversify return sources, using effective implementation to save basis points, and applying a robust dynamic process that leans out as late-cycle risks accumulate. We believe this allows our clients to benefit from the best opportunities in the marketplace and feel comfortable, knowing that portfolio risks are being managed below long-term strategic levels. At the end of the day, our focus is empowering our clients, and making sure we're putting your money in the right place.

## Related reading

See Russell Investments' 2019 Global Market outlook: [Russellinvestments.com/us/global-market-outlook](https://Russellinvestments.com/us/global-market-outlook)

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## For more information

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