Momentum vs asymmetry: Why downside management strategies are even more important now

Momentum: Benign Economics

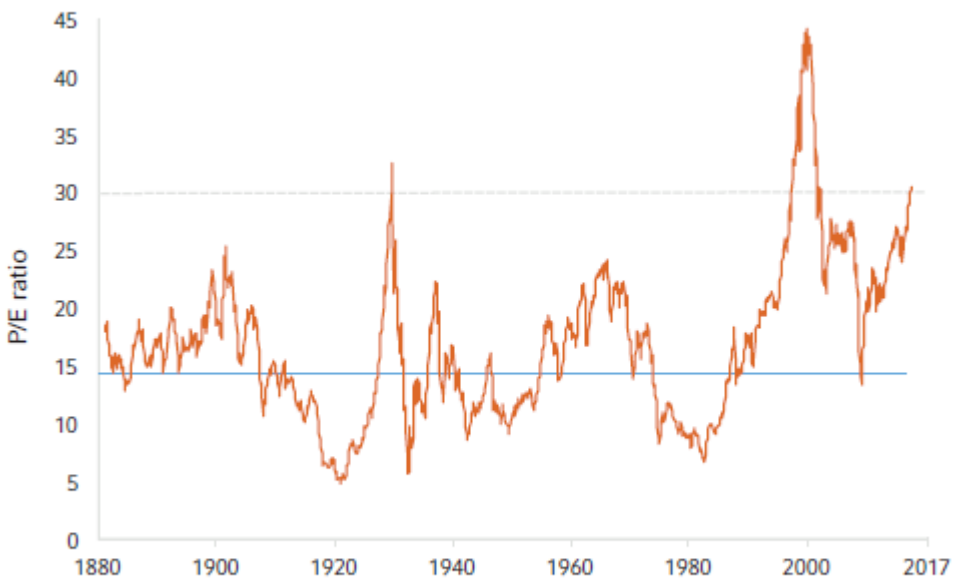
Developed economies are in the "sweet spot" of moderately above-trend growth, continuing low inflation and low interest rates (easy monetary policy—or in the case of the U.S. Federal Reserve (the Fed), very gradual tightening). It's a supportive environment for just about every part of a portfolio. A benign economic environment can see markets trend higher thanks to positive market sentiment.

Asymmetry: Extremely expensive U.S. equity markets

On the other hand, however, we believe U.S. equity markets are extremely expensive relative to historical levels, which makes the market vulnerable to any unwelcome news.

Prices for U.S. equities, as measured by the S&P 500® Index as of September 2017, are trading at 30 times cyclically adjusted earnings[1], which is the most expensive level ever outside of 1929 and the late 1990s. This creates asymmetry in the expected returns going forward.

Shiller P/E ratio: rolling 10-year trends since 1880



Source: Economist Robert J. Shiller, last observation September 8, 2017
Blue line shows average P/E of 14.3 for the entire time frame.

[1] It's the elevated level of the cyclically adjusted price earnings ratio (CAPE) that makes us nervous about asymmetry—that the downside for S&P 500® Index returns is larger than the upside. A high CAPE means that future returns are likely to be disappointing. The average annualized return over the following three years when the CAPE has been above 22-times earnings trends is less than 5%. It also increases drawdown risk dramatically. The average drawdown over the following three years when the CAPE has been above 22-times is around -21%.

Downside risks could be significant

Equities can keep grinding higher with positive momentum. *But at current valuations, our analysis suggests the upside potential is limited, and the drawdown potential could be significant.*

The two big risks in our view are either a recession scare or an inflation scare that sends interest rate expectations significantly higher. Both seem unlikely in the near term, although we believe fixed income markets seem to be underestimating the potential for U.S. inflation pressures and Fed rate hikes in 2018.

Further, the U.S. business cycle index model points to rising recession probabilities (25% as of Sept. 15, 2017). Overall, we think the U.S. economy is still on a path of moderate growth with low probability of recession over the next year, but risks are building at the three-year horizon.

Another worry is the potential for a sharp spike in volatility. The low level of the CBOE Volatility Index® (VIX Index) underlines the degree of investor complacency. The issues that could cause a volatility spike are hard to predict, but an obvious current candidate is the tension around North Korea.

Downside management strategies becoming increasingly important

At Russell Investments, we have been advising caution about the outlook for markets over the past 2 to 3 years as valuations became increasingly expensive and vulnerable to pull-backs. Our portfolio managers have been dynamically managing our client portfolios by including a variety of downside management strategies to achieve long-term goals, while managing the progressively larger risks of a drawdown.

We have also prepared a comprehensive toolkit of resources to help our clients stay calm and make informed decisions if anticipated market fluctuations occur.

For further information, please see:

- Russell Investments Global Market Outlook Q4 2017 update.

DISCLOSURES

The views in our 2017 Global Market Outlook — Q4 update are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

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

Keep in mind that, like all investing, 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.

Citi tracks a measure known as the “economic surprise index” for various locales, which shows how economic data are progressing relative to the consensus forecasts of market economists.

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

The U.S. Dollar Index (USDX, DXY) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies. The index is currently designed, maintained, and published by the commodity exchange ICE Futures U.S., Inc., with the name "U.S. Dollar Index" a registered trademark. USDX goes up when the U.S. dollar gains "strength" (value) when compared to other currencies

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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 AC Asia Pacific Index captures large and mid cap representation across Developed Markets countries and 8 Emerging Markets countries in the Asia-Pacific region. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

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UNI-11142