RUSSELL INVESTMENTS

Waiting for the Fed

2015 Global Market Outlook: Q3 update

The advent of Fed tightening is likely to cause volatility, but global equity markets should remain supported over the medium term if the U.S. economy continues to post moderate growth as we expect.

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Beware of Greeks near Fed rate hikes

Volatility is edging up as the decisions on the first Fed rate hike and Greek debt get closer. We're cautious heading into these events, but will be looking for opportunities if markets pull back. Going forward, we still have a preference for European equities and dislike long-term interest rate exposure.

EXECUTIVE SUMMARY

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

Financial markets are transfixed by two upcoming events: the negotiations around the Greek bailout and the timing of the first interest rate increase by the U.S. Federal Reserve (the Fed). Will Greece stay in the euro? And will Chairperson Yellen announce the first Fed rate rise in nine years?

We expect a September rate hike and that Greece will stay in the eurozone—but there is a large amount of uncertainty around both events. Markets hate uncertainty, which points to rising volatility.

Our core views about the global economy are unchanged from those in the previous update to our global outlook, published at the end of March. We're still looking for moderate growth in the U.S. We also think the European recovery is becoming more entrenched and that Japan is improving. Emerging markets economies remain under pressure and in our view the China slowdown has further to run.

With this quarter's update, we welcome our new North American strategist, Paul Eitelman. Noting that U.S. economic data points were soft over the early part of the year, Paul expects a turnaround driven by robust mid-single-digit growth in corporate profits. He expects the economy to produce 2.5% to 3% gross domestic product (GDP) growth over the second half of 2015. However, expensive U.S. equities and low bond yields mean he is cautious on both asset classes heading into the Fed policy shift.

European equities have given up some of their gains over the past quarter, but Wouter Sturkenboom sees rationale for staying the course on European exposure. Wouter thinks that any further Greek-related unrest is a buying opportunity.

Wouter also looks at the big recent moves in long-term European bond yields and concludes it is a case of "flows versus fundamentals." Central-bank-driven flows in his view should win out in Europe and keep German Bund yields low, but fundamentals should put upward pressure on U.S. and UK yields.

Asia-Pacific is a mixed story. Graham Harman sees more signs of improvement in Japan, especially through Abenomics' "third arrow" of corporate reform and rising female workforce participation. China, Australia and New Zealand continue to slow, but this is being offset by more policy accommodation. Significantly deeper downturns seem unlikely in his view, while Japan remains the pick of the regional equity markets.

Our investment strategy process is based on both qualitative insights from our team of strategists and a range of quantitative models run by Abe Robison and Kara Ng. Most of the quantitative models have moved toward neutral over the past quarter. These confirm our qualitative assessment that neither the Fed decision nor the outcome of the negotiations over Greece will contain any nasty surprises. Thus, our strong conviction in moving to a neutral asset allocation stance for global equities versus fixed income. ■

CONTENTS

Markets hate uncertainty, which points to rising volatility.

Investment strategy outlook

The first Fed rate rise in our view is imminent, and this dominates the outlook. Our investment strategy process has moved to a neutral weighting for global equities versus fixed income. We still favor Europe within global equities.

Serenity now, volatility later

Equity markets have been eerily calm in recent times. The S&P 500® index has moved in a narrow range of 2050 to 2130 over the past three months. In fact, as of June 24, 2015 it has been 43 months since the S&P 500 suffered a decline of 10% or more. There has been more volatility in global bond markets with the 10-year German Bund yield rising 90 basis points between late April and mid-June[1]. The U.S. 10-year Treasury yield rose 60 basis points over the same period to 2.4%. This sell-off, however, seemed to be technical in nature, rather than a significant reassessment by investors of the fundamentals driving economic growth, inflation, or the monetary policy outlook.

It makes sense to expect volatility around the Fed policy shift, but a key question is whether any resulting market setback would represent a turning point or an inflection point

U.S. economic data trends have been inconsistent, but on balance strong enough for the Fed to announce a first rate rise in September. The start of Fed tightening is a rare event. It's been 11 years since the Fed last kicked off a series of rate rises. Before that, it started a tightening phase in June 1999, although this was really a continuation of the rate rises that started in February 1994. And remember that tightening was interrupted by the Asian economic crisis and Russian bond default in 1997 and 1998. Effectively, this means there are only two initial Fed rate rises over the past 20 years from which to draw lessons.

The February 1994 episode was a significant event for markets. The S&P 500 fell 9% over the following two months; U.S. 10-year Treasury yields ended the year more than 200 basis points higher; and the U.S. trade-weighted dollar fell by around 5% against the major currencies.

The response in June 2004 was more muted but still significant. The S&P 500 fell 7% over the following two months, but U.S. 10-year Treasury yields fell around 60 basis points over the next year. The trade-weighted dollar also fell after the Fed move, losing 10% against major currencies over the next six months.

U.S. asset market conditions heading into 1st Fed rate hike

	Equity Market	Treasury Market	U.S. Dollar
February 1994	**Slightly expensive**: Shiller[2] PE[3] 20X, P/BV[4] 2.7X	**Cheap**: 10-year yield 6.2% before rate hike	**Undervalued**: Real TWI[5] 7% below long-term average
June 2004	**Very expensive**: Shiller PE 26X, P/BV 3.0X	**Fair value**: 10-year yield 4.7%	**Fair value**: Real TWI near long-term average
June 2015	**Very expensive**: Shiller PE 27X, P/BV 2.9X	**Very expensive**: 10-year yield 2.2%	**Expensive**: Real TWI 11% above long-term average

[1] Period: April 17, 2015 through June 10, 2015.

[2] Shiller PE defined: This cyclically adjusted price/earnings ratio, otherwise known as the CAPE, measures the price of a company's stock relative to average earnings over the past 10 years.

[3] Price-earnings ratio or PE: The valuation ratio of a company's current share price compared to its per-share earnings.

[4] Price-to-book ratio or P/BV: A ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.

[5] The trade-weighted U.S. dollar index is a measure of the value of the U.S. dollar relative to other world currencies. It is similar to the U.S. Dollar Index in that its numerical value is determined as a weighted average of the price of various currencies relative to the dollar, but different currencies are used and relative values are weighted differently.

The stand-out feature this time is that equities, bonds and the U.S. dollar are all expensive compared with the start of last two tightening phases. Another important difference is the stage of profit cycle. After the first rate hikes in 1994 and 2004, S&P 500 earnings per share increased by around 17% in the following 12 months. The profit cycle is far more advanced this time. Profit margins are at record highs and the outlook at best is for single-digit earnings-per-share (EPS) growth.

On the other hand, this is one of the most anticipated policy shifts on record, so arguably most of the impact on the U.S. equity market should already be priced in. Even so, the "taper-tantrum" of May 2013 is a lesson in how even a well-signaled policy shift can shake up markets. Former Fed Chairman Ben Bernanke's warning that Fed bond purchases might soon be wound down triggered a 100 basis point rise in the U.S. 10-year bond yield and a 6% decline in the S&P 500.

It makes sense to expect volatility around the Fed policy shift, but a key question is whether any resulting market setback would represent a turning point or an inflection point. In our view, the latter seems more likely. Our favored scenario for the U.S. economy is moderate jobs growth, moderate inflation, and single-digit profit gains. The Business Cycle Index model indicates low recession probabilities and the economy does not seem to have yet reached inflation-generating capacity constraints. The advent of Fed tightening is likely to cause volatility, but equity markets should remain supported over the medium term if the U.S. economy continues to post moderate growth as we expect.

Global equities: Value, cycle, sentiment

Our investment strategy process is based on the building blocks of value, cycle, and sentiment. Applying this process to global developed equities we get the following as of June 24, 2015:

Value: The U.S. market, as measured by the Russell 1000® Index, is the most expensive major equity market with price-to-book value at 2.9 times and the Shiller PE ratio at 27 times. We score both Japanese and European equities as moderately expensive. Relatively riskier emerging markets equities are still moderately cheap.

Business Cycle: This is moderately positive for the U.S. and Japan. U.S. economic growth is robust, and profits are growing at a moderate pace. Profits are picking up in Japan, but economic indicators are fairly lackluster. There is, however, the likelihood of extra stimulus from the Bank of Japan (BoJ). We score the cycle as very positive for Europe. Economic indicators are improving and there is the potential for strong gains in corporate profitability after four years of sluggish growth. The cycle is still negative for emerging markets amid U.S. dollar strength, falling commodity prices and the economic slowdown in China.

Sentiment: Momentum is a positive driver of most equity markets. Relatively stable markets mean that many of our overbought contrarian signals have now moved into neutral territory. The exception is Japan, where the strong run has moved that market into solidly overbought territory.

Conclusion: The combination of expensive value in most markets, a positive cycle and neutral/slightly positive sentiment gets us to an overall neutral view on global equities. Within equities, the strong cycle view gives us a preference for Europe among major geographic regions globally. Expensive value makes the U.S. our least-preferred major market, while the overbought sentiment signals have trimmed our view on Japan back to neutral. We're also neutral emerging markets, where the negative cycle score offsets good valuation and moderately positive momentum.

The advent of Fed tightening is likely to cause volatility, but equity markets should remain supported over the medium term if the U.S. economy continues to post moderate growth as we expect.

Greek drama to intensify

The Greek debt saga has been going on for five years now, and investors are naturally growing tired of the seemingly never-ending drama. It is, however, likely to reach another climax soon with the June 30 deadline for the extension of the current bailout program. The nature of the negotiation process means that an agreement is unlikely to be reached until the last moment and possibly after markets have begun to riot and create pressure for a solution. The most likely outcome seems another round of "extend and pretend" where European Union funding is provided, Greece's debt repayment terms are relaxed, and difficult issues are pushed into the future.

Greece in our view still has the potential to upset markets but it no longer represents a systemic risk to the global economy. While we remain wary heading into the June 30 deadline, our approach will be to look for opportunities from any market shake out.

USD outlook is mixed

The U.S. dollar (USD) has taken a breather over the past three months after rising by around 20% in trade-weighted terms against the major currencies from the beginning of 2014. Valuation is no longer a support and most of our indicators have the USD overvalued against the major currencies. The positive and potentially widening interest rate differential between the U.S. and other economies means that carry is moderately supportive. Momentum is slowing but still USD supportive.

The USD could get another leg-up if the BoJ announces further easing, Greek concerns derail the euro, or Europe's growth momentum stalls. But as noted previously, the USD declined following the last two Fed tightening cycles, which commenced at cheaper valuation levels.

Within global equities, our favored exposure is Europe, while we are neutral on Japan and emerging markets as well as underweight the United States.

Conclusion: caution warranted ahead of Fed move

Our qualitative cycle, value, sentiment process and our quantitative asset class models both recommend a neutral stance for global equities and global fixed income. This seems a sensible position heading into the next showdown on Greece and the beginning of a Fed tightening phase. The U.S. dollar, U.S. Treasuries and U.S. equities are all expensive ahead of this Fed shift, and the outlook for corporate profits is far more subdued.

It's reasonable to expect a lift in volatility around these two events, especially after an extended period of relative market calm. We don't expect either event to represent a turning point for markets and a shakeout could be an opportunity to add more risk exposure to portfolios.

Our medium-term outlook for the U.S. and global economy is still positive and global equities should still deliver moderate returns. Within global equities, our favored exposure is Europe, while we are neutral on Japan and emerging markets as well as underweight the United States. ■

U.S. outlook: Back on track, Fed Watch

The U.S. economy is rebounding after a soft start to 2015. Stronger growth should support corporate earnings, but in our view it also increases the odds that the Fed will hike interest rates in September. Fed hikes likely will usher in a period of heightened volatility in markets globally. Against this backdrop and expensive valuations, our models show a modest underweight to U.S. equities.

The U.S. economy bounces back from its winter jitters

Severe winter weather and labor disruptions at major ports drove a contraction in U.S. output in the first quarter of 2015. However the economy as of mid-June has reaccelerated over the last several weeks, and we expect healthy 2.5% to 3% real gross domestic product (GDP) growth over the remainder of the year. It's a script many investors will remember from 2014, though with a difference: the cycle is one year older, and we are now on the cusp of a potential rate hike from the Fed.

The Fed has clearly communicated its expectation to hike interest rates this year and that the decision around exactly when to do so will be data-driven. Fed officials were forecasting a rebound in GDP and, if the trend of improving growth momentum continues, we anticipate the Fed should feel comfortable hiking interest rates in September.

It's important to recognize that a "data-dependent" approach also means the market is going to closely scrutinize every release of economic data. The transition from absolute certainty around the future path of monetary policy (i.e. forward guidance) to one that is data-driven and by definition uncertain is likely to usher in a period of heightened volatility in rates and broader financial markets.

One of the key watch points is wage inflation. Over the last few years, low wages supported the equity market for two reasons: They allowed the Fed to remain accommodative and facilitated record corporate profit margins in the face of a protracted economic recovery. Above-trend GDP growth should gradually close the slack in the labor market. But discouraged workers are also re-entering the labor force which slows down this process. On net, we expect cost pressures to build gradually. Coupled with a meaningful rebound in GDP, we think businesses

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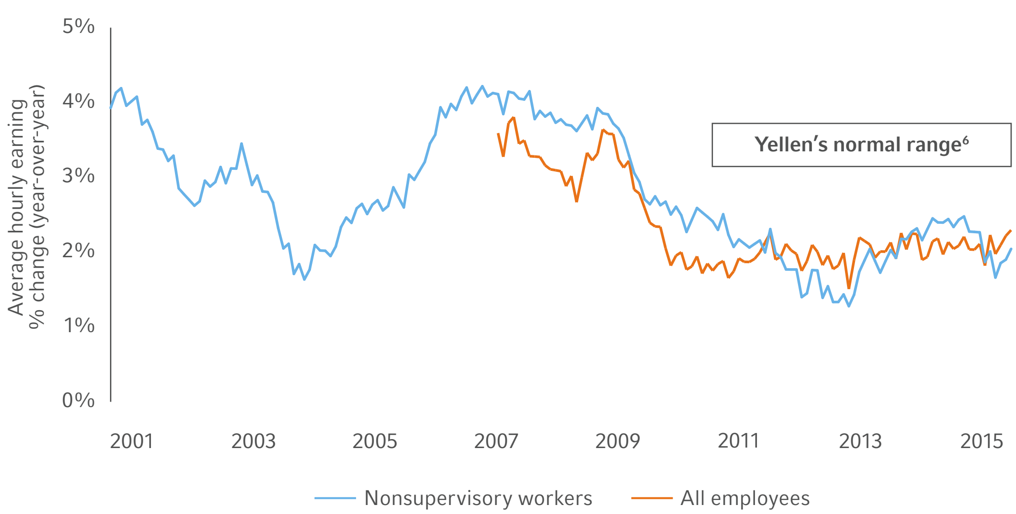
U.S. wage growth: Early signs of a gradual normalization



[6] Yellen's normal range: Federal Reserve Chair Janet Yellen has said she considers 3 percent to 4 percent increases as "normal" with 2 percent inflation.

Source: U.S. Bureau of Labor Statistics

can deliver decent mid-single-digit earnings growth over the next 12 months. A more rapid acceleration in wages would be a key downside risk in the near-term, as it could erode profitability and provoke a more aggressive Fed tightening cycle. In our view, the longer-term earnings outlook is challenging as profit margins are already at record levels.

Investment outlook

We maintain our underweight preference to the United States as expensive valuations offset a favorable macro backdrop. Investors, in our view, should expect more muted returns from U.S. assets going forward.

- *Stronger dollar*: The dollar continued to appreciate in the first half of 2015. It's a trend we expect to continue as monetary policies finally diverge in September. The pace of appreciation, however, is likely to be more muted given the moves seen already. A stronger dollar will continue to hurt earnings of U.S. businesses that are sourced from abroad.
- *Lower energy prices*: Consumers were slow to respond to the windfall from lower energy prices. However, we view this income windfall as a strong fundamental, and signs of a pickup in spending growth in May bode well for the economic and earnings outlook over the remainder of the year.
- *Corporate earnings growth*: Corporate earnings held up well in the first quarter of 2015. Excluding the energy sector, EPS growth for the S&P 500 was up 10% on a yearly basis. Expectations for 2015 have stabilized and remain in positive territory. Going forward, we think improving economic growth can drive mid-single-digit profit growth. But longer term, the outlook is more challenged. Absent a meaningful up-shift in trend GDP, earnings and margins are likely to compress gradually as the cycle matures and cost pressures build.
- *Monetary policy*: We expect the Fed to tighten in September 2015 and for that to bring higher volatility in markets. The pace of rate hikes is also important. We expect a "gradual" profile with hikes at every other meeting. As of mid-June 2015, the U.S. equity market seems to be pricing in an even slower trajectory than that.

There are no obvious economic imbalances in our view, and the economy should be able to chug along with little risk of recession over the next few years.

U.S. equities: Value, cycle, sentiment

- **Valuation**: U.S. equities had a strong run in recent years. The broad market as of late June 2015 is clearly quite expensive. However, government bonds are also expensive, leaving few value opportunities at the asset class level in the U.S.
- **Business Cycle**: The macro backdrop for U.S. equities remains supportive. A robust and accelerating economy is constructive for earnings, in our view, over the next 12 months. Monetary policy remains accommodative but, on a relative basis, Fed policy is tightening. A rising rate environment presents headwinds, but historically investment-grade and high-yield spreads typically don't widen until the end of the hiking cycle when the economy slows and default rates rise. There are no obvious economic imbalances in our view, and the economy should be able to chug along with little risk of recession.
- **Sentiment**: Equity momentum remains positive. But, with prices moving sideways more recently, our overbought signals have neutralized. On net, overall equity market sentiment is now slightly constructive. U.S. Treasury market sentiment has changed more materially. With the sharp increase in yields, short-term contrarian measures as of late June 2015 signal that the market is oversold.
- **Conclusion**: We have a modest underweight preference for U.S. equities in global portfolios as expensive valuations offset a favorable business cycle. We expect the 10-year U.S. Treasury yield to increase to 3.1% over the next 12 months. With the large selloff seen already in government bonds, our preferred underweight position has moved toward a more neutral stance.

Eurozone outlook: Staying the course

Although the second quarter of 2015 has not been great for eurozone equities, we are staying the course on our overweight position. Growth is still improving, corporate earnings are rising, and the drag from Greece is expected to be transitory. Even more, ECB President Mario Draghi has made it clear he will be sticking to a monetary stimulus policy.

Toward a stable recovery

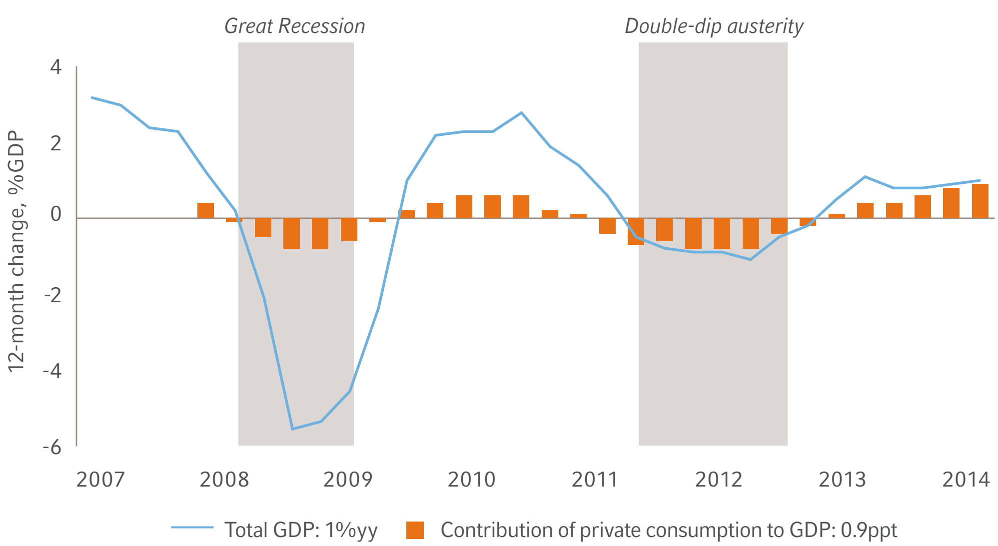
After outperforming expectations for six months, the eurozone has gradually transitioned toward a stable recovery driven by private consumption (see chart below). This is in line with our outlook, and it is important to note there is more to this story than German economic vigor. All four of the big eurozone economies have participated as well as many of the smaller countries. To us, this exemplifies the power behind the tailwinds that are pushing the eurozone forward.

Our position on eurozone equities is not a short-term trade but a medium-term investment.

When reflationary forces hold sway over deflationary forces, a broad-based improvement likely can be expected. In this case, the combination of monetary and fiscal policy stimulus, a sharply lower oil price, and strong financial markets have boosted consumer confidence across the eurozone. As a result, we are witnessing a synchronized upswing that we believe has at least another 18 months to go.

Of course, because it is the eurozone, "recovery" means GDP growth of "only" 1.5% to 2.0% in 2015 and 2.0% to 2.5% in 2016, according to our models. However, because potential GDP growth is estimated to be about 0.5% to 1.5%, those growth rates are high enough to gradually lower unemployment rates, stabilize government debt ratios, boost corporate profitability, and increase inflation. In our view, this is really all we can ask for at this point, especially since we believe there is more upside potential than downside risk when you are in a virtuous cycle.

Eurozone GDP growth & private consumption



Source: Thomson Reuters Datastream: Q1 2015

Greece is obviously a source of downside risk that has received a lot of attention lately. A potential default and/or exit from the eurozone has caused financial market volatility. We continue to believe this will be transitory. First, in our judgment, both Greece and its creditors still prefer the status quo over an uncertain exit. Therefore, a deal is still likely. Second, we note that Greece is too small to matter economically and its debt is largely in public hands. This means the eurozone economic recovery likely will continue because contagion risk is limited and any losses can be dealt with in a structured manner. Finally, the ECB has created the equivalent of a safety net in the form of its quantitative easing program. That net won't go away and might even be strengthened.

The Bund riddle

As of late June 2015, we have recently witnessed two rounds of what can only be described as a selloff in the German government bond known as the Bund. From its low of 0.05% the 10-year Bund yield has risen to as high as 1.06%[7]. We did not foresee this sudden spike and fail to see a clear catalyst. As such, we think the selloff was more a "market event" than a fundamental repricing. The fact that the increase in yield was concentrated in the long end of the curve—and mostly driven by the real yield—indicates that eurozone markets did not significantly change their outlook for inflation or monetary policy. Indeed, at 0.05% yield, the Bund had become very expensive and overbought, and a technical flow-driven correction was overdue. This was one of the reasons we were neutral.

Any further Greece-related unrest is still considered a buying opportunity because we do not believe Greece is capable of derailing the eurozone recovery.

Looking ahead, we don't think the selloff represents a trend reversal and we expect downward pressure on yields to resume once the technical and flow-driven forces have run their course. In our investment process based on valuation, business cycle and sentiment we have a small positive score on the Bund, meaning we are moving to a small long position by incrementally adding to our portfolios.

Eurozone equities: Value, cycle, sentiment

› **Valuation**: Eurozone equities are slightly expensive in an absolute sense but they are still cheap relative to the U.S. Regarding government bonds in the eurozone, we have gone from neutral to overweight in response to the sudden selloff.

› **Business cycle**: We maintain our positive outlook for the eurozone business cycle. GDP growth in 2015 is expected to be 1.5% to 2%, with upside potential. Earnings growth is strong and likely to reach 8% to 10% thanks to rising profit margins as well as a lower oil price and euro exchange rate. Finally, both fiscal and monetary policies remain supportive.

› **Sentiment**: Price momentum is still strong and our contrarian indicators have gone from overbought to neutral, giving us a positive score overall.

› **Conclusion**: We maintain our overweight position to eurozone assets, expanding from equities and peripheral government bonds into core government bonds. Any further Greece-related unrest is still considered a buying opportunity because we do not believe Greece is capable of derailing the eurozone recovery. However, we're on watch for any such unforeseen geopolitical or economic risks such as a surprise shift in monetary policy. ■

[7] Period: April 17, 2015 through June 10, 2015.

Asia-Pacific outlook: Lurching along

The Asia-Pacific region is traveling in line with our previous expectations. There are plenty of "worry factors," but the underlying growth rates remain reasonable.

Visibility on Abenomics is improving

Getting Japan back onto a convincing growth path, after two lost decades, has been a long journey. The evidence is now starting to build around a real reacceleration. Improvements are being driven by short-term stimulus effects such as lower energy prices, a weaker yen, and resolute Bank of Japan (BoJ) action. Also important are structural drivers, such as a corporate reform process and a lift in the female workforce participation rate.

We are now starting to see visible signs of improvement in business surveys, where confidence indicators are making new highs. The Japanese economy is also enjoying accelerating GDP growth—including upward revisions to the first quarter numbers—and a reacceleration in the monetary aggregates following a dip at the start of 2015.

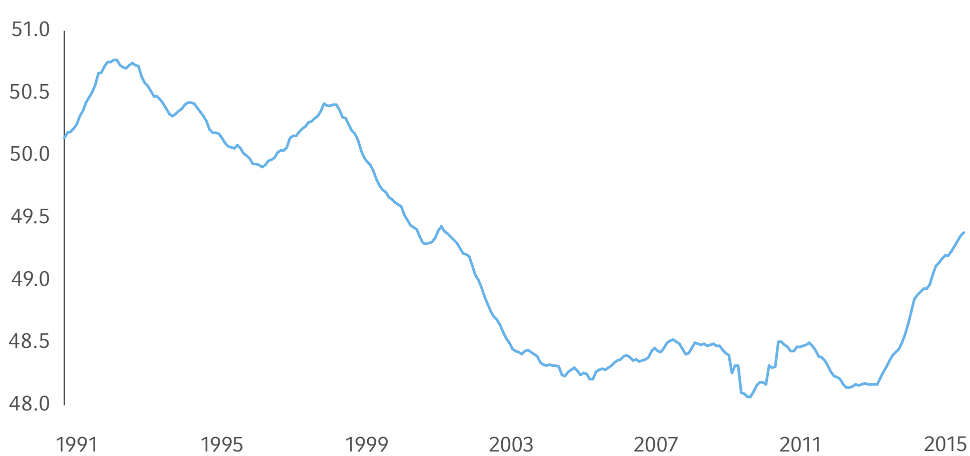
Moderate recoveries in Japan and India, and equally moderate slowdowns in China, Australia and New Zealand, are continuing to lurch along. Many regional equity markets have performed well this year, however we sound a slight note of caution for coming quarters.

China: a well-managed slowdown

China, like Japan, is also performing well in the face of some challenging headwinds. Exports have been struggling; partial economic indicators such as electricity production have been extremely weak; and the China "A" share market is trading in an increasingly frothy manner. The Shanghai Composite Index has suffered three sharp corrections from 5% to 10% over the course of the past three months.

Nonetheless, the Chinese are doing a good job of managing the slowdown so far, with cuts to official rates announced in the first half of 2015 and an expectation of more to come. Inflation remains well under control, and this lack of pressure allows plenty of scope for policy flexibility. Housing in particular is responding well to targeted stimulus measures and there are no signs, so far, that the slowdown may turn into a collapse.

Female Workforce Participation Rate—Japan



Source: Ministry of Internal Affairs and Communications, Japan as of April 15, 2015.

Among efforts to improve Japan's economy, Prime Minister Shinzo Abe's strategy to increase the number of mothers who return to work after giving birth to 55% by 2020 is reversing the trend of low female workforce participation.

Australia and New Zealand face commodity headwinds

Our central case for Australia and New Zealand this year has been that those economies are slowing, but not collapsing. Looking ahead, the 3% real GDP growth rates in recent years will be giving way to annual growth of around 2%, which we believe to be a reasonable outcome.

However the risks are increasingly to the downside. For example, Australian bulk commodity export volumes are vulnerable—with coal exports already stalled at around 100 million tonnes—primarily due to inventory swings in China. Even though the Chinese economy overall remains relatively well-behaved, these dislocations in demand for imported raw materials have a serious impact on Australian commodities exporters.

A second important swing factor in Australia is residential housing. The market remains strong for now, but we expect it to shift from "upcycle" to "downcycle" over the coming 12 months. Meanwhile in New Zealand, downdrafts within the dairy and forestry sectors have already resulted in a meaningful setback to the national income statistics.

Asia-Pacific equities: Value, cycle, sentiment

- **Valuation**: Regional equity markets have been good performers overall and we now rate the region as somewhat expensive. Scope for further cuts in interest rates—particularly in China, India, Australia and New Zealand—will likely provide ongoing valuation support. In the bond market, the recent selloff has seen rates in Australian and New Zealand 10-year bonds jump to levels not seen since late 2014; and "overvaluation" fears have been somewhat ameliorated in consequence.
- **Business cycle**: For the year ahead we expect the Japanese and Indian economies to accelerate slightly, while China, Australia, and New Zealand all drop the pace a notch. However, the monetary policy cycle is positive across much of the region. Hopes of additional stimulus in Japan are fading a little, in light of the better news flow in recent months.
- **Sentiment**: While downbeat in Australia, sentiment is effervescent in China, and we see Japan as being slightly overbought.
- **Conclusion**: We sound a slight note of caution for regional equity markets in coming quarters, but still like Japan as a recovery play, and Australia for yield. ■

We sound a slight note of caution for regional equity markets in coming quarters, but still like Japan as a recovery play, and Australia for yield.

Fixed income: Flows versus fundamentals

Global fixed income markets have been volatile lately. European bonds in particular have made big moves, dragging global fixed income markets along in their wake. In our view, this volatility is a precursor of things to come.

Volatility is back

Remember the 'taper tantrum' in 2013, when government bond yields spiked higher on then-Fed Chairman Ben Bernanke's indication that the Fed would start reducing its bond buying program? After that, fixed income markets entered a period of relative calm. Volatility declined alongside yields, with the U.S. 10-year Treasury yield reaching 1.7% in January and the German 10-year Bund yield reaching 0.05% in April.

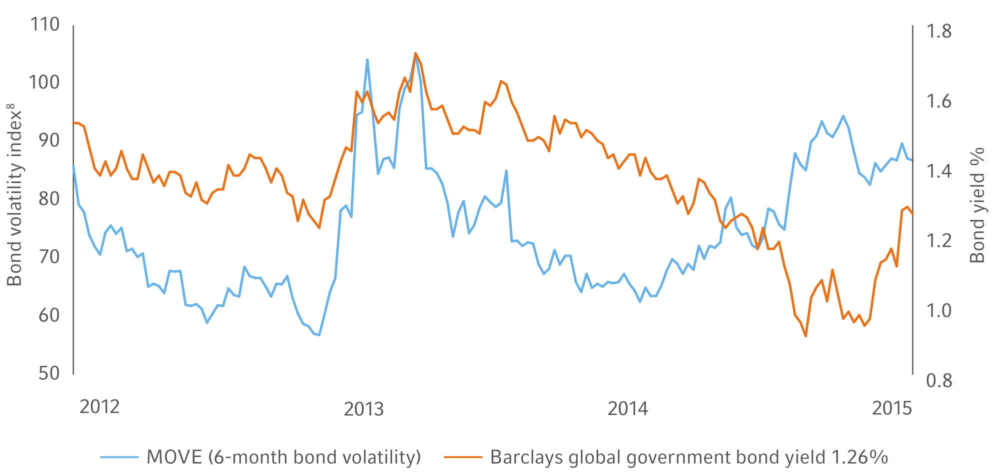
Since then, however, volatility is back with a vengeance (see chart below). The current environment can best be characterized as expensive, technically overbought, and not very liquid. Recently, legendary bond manager Bill Gross sparked the markets when he called the Bund "the short of a lifetime"—causing something akin to a wildfire. Better-than-expected eurozone growth and inflation data only added to the flames. As the German 10-year Bund yield spiked higher in two waves, yields in the U.S. and UK rose too, causing a widespread pullback in financial markets.

'Flows versus fundamentals' means that, when formulating expectations on future rates, one has to weigh the (potentially competing) influences of trends in growth and inflation and central bank policy.

Interestingly, the breakdown of the activity revealed that the majority of the move happened on the long end of the real yield curve. In other words, short-term interest rates barely moved, and neither did inflation expectations. Instead, markets priced in a slightly higher growth rate and, crucially, a much higher term premium. The term premium is the return that investors require for bearing the risk that short-term bond yields do not evolve as expected. This premium had been compressed as a result of loose monetary policy.

Looking ahead, we expect the term premium to come under renewed downward pressure in the eurozone, where the flow from the European Central Bank's (ECB) quantitative easing (QE) program will continue to exert downward pressure. In the U.S. and UK,

Bond Yield and Volatility



Source: Thomson Reuters Datastream, June 18, 2015

[8] The Merrill lynch Option Volatility Estimate (MOVE) Index is a yield curve weighted index of the normalized implied volatility on 6-month Treasury options which are weighted on the 2, 5, 10, and 30 year contracts.

however, where central banks are gearing up to hike interest rates, we expect the fundamentals from improving growth and inflation to keep the term premium positive and push yields higher.

Flows versus fundamentals

The concept of flows versus fundamentals refers to a phenomenon that has emerged since the financial crisis. "Fundamentals" of course is a familiar concept. "Flows" refers to the extraordinary actions of central banks in reaction to the crisis and its subsequent economic fallout—specifically, the impact of central banks buying enormous quantities of bonds. QE and related programs exert new kinds of pressures on government bond yields and have created a whole new dynamic between flows and fundamentals. No longer can we rely on government bond markets giving us reliable estimates of expected growth and inflation without taking into consideration the impact of central bank buying.

As stated before, this impact was most noticeable in the term premium. For example, yields on Treasury inflation-protected securities (TIPs) went into negative territory in the U.S.—and also in the UK—first, and in the eurozone later. This is something that historically only happens in times of severe stress, when safe-haven demand dominates.

Of course, this means that, when formulating expectations on future rates, one has to weigh the (potentially competing) influences of trends in growth and inflation and central bank policy. In the eurozone, we observe improving fundamentals on growth and inflation pushing yields higher, while the flow from ECB bond buying is pulling yields lower. Given the size of its bond buying program, we expect flows to dominate over a six- to 12-month horizon.

> In the eurozone, the combination of positive business cycle and sentiment scores outweighs the negative valuation score, giving us a small positive score overall.

At the moment, there are no central bank flows to contend with in the U.S. and UK, although there is the prospect of future rate hikes. The fundamentals of improving growth and inflation are pushing yields higher alongside the prospect of the first rate hike. That means we feel comfortable in expecting yields to gradually rise to 2.5% and possibly 3.0%.

Fixed Income: Valuation, cycle and sentiment

- **Valuation**: Even after the recent spike in yields, we consider government bonds to be expensive. This assessment derives from the fact that, across markets, we observe yields that are far below what we consider to be fair value. For instance, at 0.8% the 10-year German Bund yield is lower than the ±2.5% we estimate as its fair value. Similarly, at 2.3% the yield on the 10-year U.S. Treasury is below its fair value estimate of ±3.5%.
- **Business cycle**: Because we expect the flows to dominate in the eurozone and the fundamentals in the U.S. and the UK, we score the business cycle as a small positive in the eurozone and a small negative in the U.S. and UK.
- **Sentiment**: The selloff in government bonds has been most pronounced in eurozone bonds, giving us an oversold buy signal on sentiment. In the U.S. and the UK we did not quite reach the oversold level, but underlying momentum still gives a small positive score.
- **Conclusion**: In the eurozone, the combination of positive business cycle and sentiment scores outweighs the negative valuation score, giving us a small positive score overall. This means we are slightly long this market. In the U.S. and the UK this is not the case, and we end up with a small negative score, pushing us into an underweight position. Overall, we maintain a small underweight duration position. ■

Quantitative Modeling: Just say no to more risk

Our appetite for additional risk has shrunk after a diet of slowing momentum, expensive valuations, and a softening U.S. business cycle.

Model-based outlook:

Russell Investments' suite of proprietary quantitative models forecast:

- Investment portfolios could be better positioned with a balance of U.S. equity and U.S. fixed income.
- The business cycle, based on the Business Cycle Index (BCI), will rebound following the setback in the first quarter of 2015.
- 2.0% U.S. real GDP year-over-year growth in 2015.

Risk-on/risk-off signals go to neutral

Our quantitative models no longer show a preference for U.S. equity over U.S. fixed income. That is, it's unlikely one would see any additional benefits from holding equities over fixed income. Since our previous quarterly report, equity and fixed income have become equally expensive. Furthermore, momentum signals for equity-fixed have slowed, and the U.S. business cycle outlook has softened.

- **Value**: The equity indifference is supported by a Fed model that compares relative yield, a dividend discount model that finds fair value, and a long-term mean reversion model. Over the last quarter, the aggregate valuation signal went from favoring equities over fixed income to a neutral signal between the two.
- **Sentiment**: The 12-month declining weighted average excess return is slowing, suggesting that equity is losing momentum versus fixed income.
- **Business Cycle**: The U.S. BCI was hurt by tepid Q1 2015 growth, but still signals a low risk of recession and is consistent with 2.5% average real GDP growth for the remainder of 2015. The BCI incorporates inflation, consumption growth, employment growth, the U.S. corporate credit spread and U.S. yield curve to diagnose the overall economy's health.

Our signals are flattening to neutral. In essence, we're looking for a balanced, risk-adjusted portfolio, since there are no 'table thumpers' with regard to risk exposures. ■

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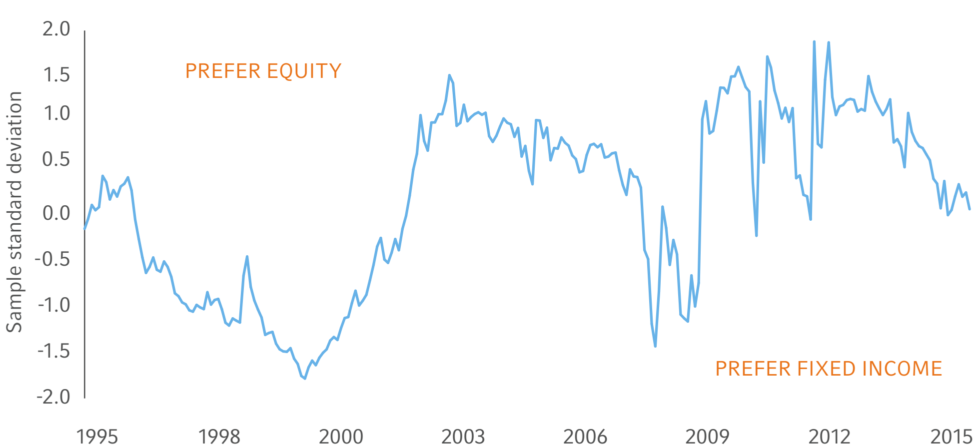
U.S. Equity-Fixed Income Aggregate Signal



Source: Russell Investments

In assessing the attractiveness of asset classes relative to one another, Russell's modeling capability uses a pair-wise construct with asset classes shared across multiple pairs, each with independent valuations. At present, the capability includes over 120 pairs leveraging signals from greater than 400 models. The signals used are based on proprietary models developed by Russell Investments.

This report is not intended to be used as the basis for a trading strategy or as an asset class trading tool.

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 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, like all investing, that 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.

Diversification: strategic asset allocation and multi-asset investing do not assure profit or protect against loss in declining markets.

The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

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 Shanghai Composite Index in made up of all the A-shares and B-shares that trade on the Shanghai Stock Exchange in China.

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