

RUSSELL INVESTMENTS

# Strategists' outlook and barometer

A strengthening low-inflation recovery across the major economies should favor equities over bonds despite relatively full equity market valuations. The main thing to fear is not fear itself, but short-sighted politicians.

2013 // 4th QUARTER

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NOT FDIC INSURED -  
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NO BANK GUARANTEE

# Executive summary

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Synchronized growth in the major economies next year should help equity markets post further modest gains and also put bond yields under upward pressure. We still prefer equities in Europe and Japan over the U.S. and have become more positive on emerging markets equities.

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## Self-inflicted dangers

It's over five years since Lehman Brothers collapsed and four years since the U.S. economy exited the great recession. In other words, the cycle is fairly well advanced. Based on historical trends, we'd be facing inflation pressures and tighter monetary policy by now, but this isn't a normal cycle. The defining feature of the post-Lehman world is de-leveraging and sluggish growth that has left the major economies with plenty of spare capacity and minimal inflation pressure. This means that it should still be a while before we hit capacity pressures that would justify tighter policy settings.

We believe policy mistakes represent the biggest risk. As we write, the U.S. Congress has just extended the debt ceiling limit, albeit temporarily until early next year. Failure to reach a deal would have triggered an outcome so calamitous (default, recession) that it was inconceivable a deal wouldn't be reached. However, as Doug Gordon, our North American strategist argues, "kicking the can" was the most likely outcome—a short-term agreement that will see the sorry debate revisited before the November 2014 elections.

Our Chief Economist, Mike Dueker, points out that the U.S. economy has few imbalances and is in the middle of a fairly sturdy expansion. His concern is that the political stand-off will deliver more fiscal cutbacks that will halt the momentum of the economy. Without this, he thinks the U.S. can achieve nearly 3% growth next year and job gains of 200,000 per month.

It's a similar story in Europe where long-anticipated signs of economic recovery could soon be challenged by the failure to create a proper banking union. Our European strategist, Wouter Sturkenboom, still likes European equities on valuation grounds, but worries that failure to deal with the banking issues could derail the current optimism.

Even in Japan, policy mistakes are the main risk. Prime Minister Shinzo Abe has turned Japan's economy around. His gamble is to introduce a hefty consumption tax increase while the recovery is gathering momentum. Here, the risks look less acute and our Asia Pacific strategist, Graham Harman, sees that deflation is becoming entrenched.

Developed equity markets have run hard so far this year and most of our metrics suggest that they are fully valued. Most of the gains from here are likely to come from growth in earnings per share, which in the U.S. we expect to grow broadly in line with nominal Gross Domestic Product (GDP) growth—around 5% to 6%. A lot of the adjustment in government bond yields has now taken place and we expect U.S. 10-year Treasury yields to drift towards 3% by the end of 2013 and 3.2% in 2014.

A strengthening low-inflation recovery across the major economies should favor equities over bonds despite relatively full equity market valuations. The main thing to fear is not fear itself, but short-sighted politicians. ■

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# Investment strategy outlook

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Last quarter, we thought that equity markets would be volatile, but still in an upward trend, that the rise in bond yields was overdone, and that the Fed had made a mess of communicating its monetary policy intentions. These are still broadly our views—except that we now think that the fall in bond yields is overdone.

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## The Fed's long goodbye

Our guiding principle over the past few months has been to “buy the dips and sell the rallies.” Although markets have been volatile, the equity market dips in our opinion have not been large enough to buy and the rallies have not been high enough to sell. Our models still have the U.S. equity market near fair value, although the potential upside from here is limited by the modest outlook for earnings per share (EPS) growth.

In this segment, we'll focus on U.S. monetary policy and political pressures worldwide as the backdrop for our expectations from individual asset classes.

The U.S. Federal Reserve System's (the Fed's) non-taper decision on September 18, 2013, left the controversial Quantitative Easing (QE) bond-buying program in place. This shows just how determined Fed Chairman Ben Bernanke is to maintain supportive monetary policy settings. As the next article in this issue on quantitative easing argues, we're skeptical about the size of the impact of QE3 on markets. The eventual ending of QE likely will cause market volatility, mostly because of the Fed's confused messages about the link between QE tapering and the timing of the first rate rise. Our take-away from the Fed's decision is that short-term rates will stay low for a long time: we don't expect the first rate rise until the second half of 2015. Even then, the pace of tightening is likely to be gradual. Our U.S. macro model shows inflation barely touching 2% by the end of 2015. The exit from accommodative monetary policy settings is likely to be a slow, drawn-out process.

In our view, the overall environment is one that favors equities over fixed income. The developed world is likely to experience synchronized growth across the U.S., Japan, and Europe in 2014 for the first time since 2010. Economic indicators in China are starting to improve and exports are picking up across the developing economies.

## Politics provides the fear factor

Politicians and policymakers are generating most of the worry factors. Top of the list is the Fed's communication challenge. Taper talk will return some time in the next few months. The Fed will need to convince investors that the ending of QE does not necessarily signal that the first rate rise is imminent. The lack of inflation pressures should help confirm this message, but bond market nervousness is likely to continue to be a significant source of volatility. It isn't helpful that the Fed will be transitioning to a new chairperson over this period. It is helpful, however, that the likely new chair, Janet Yellen, has a solidly dovish reputation as someone likely to favor keeping rates low.

As we write, markets have responded positively to the re-opening of the U.S. government as politicians reached a temporary compromise. Failure to lift the debt ceiling would have forced the U.S. government to run a balanced budget and triggered a fiscal tightening of around 4% of GDP. This would have almost certainly sent the U.S. economy into recession. Like most observers, we expected sanity to ultimately prevail, but the eleventh hour

Our take-away from the Fed's September 18 decision is that short-term rates will stay low for a long time: We don't expect the first rate rise until the second half of 2015.

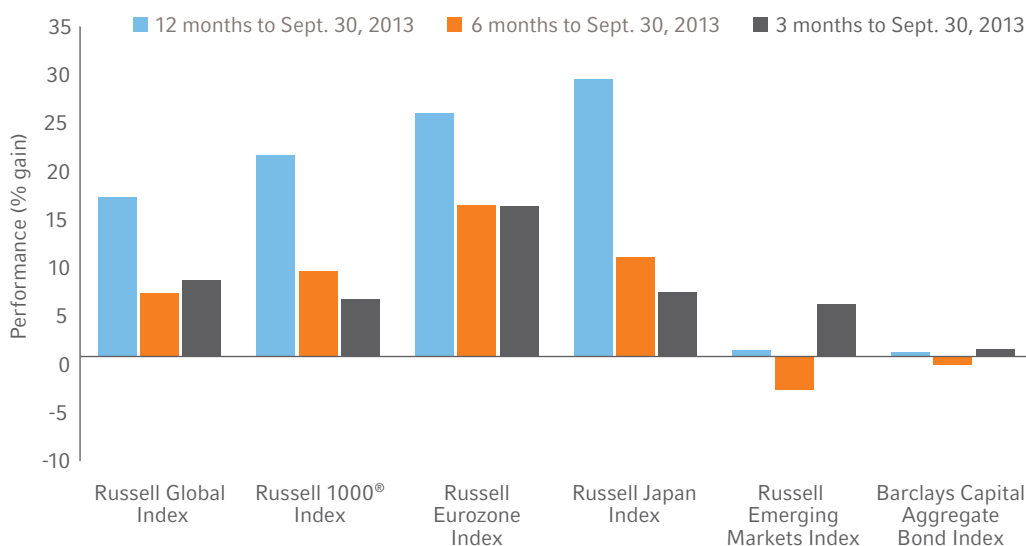
compromise took pressure from financial markets in the form of a sell-off to force a deal.

In Europe, Italy’s government continues to defy expectations by surviving, and the recent German election was a vote for the status quo. However, things are likely to heat up around the time of the banking sector’s Asset Quality Review (AQR) in early 2014. A rigorously conducted review and stress test could uncover some significant capital shortfalls. This would bring to a head once more the issue of a banking union—and how cash-strapped peripheral countries could possibly recapitalize their banks without help from the German taxpayer. After a long period of relative calm, this could trigger at least a mini-eruption of euro-zone nerves.

**Our main asset class views:**

- › A moderately positive view on global equity markets. The Russell Global Index has returned 13.4% over the first nine months of the year through September 30, 2013. This unexpectedly generous return makes us nervous, and valuation measures are towards the upper end of what we consider to be acceptable. However, synchronized global growth and solid single-digit earnings growth mean the path of least resistance should be upwards.
- › European equities are still favored over U.S. equities. Europe’s outperformance over the third quarter of 2013 has seen the valuation gap narrow, but earnings should recover as revenues improve alongside the economy and as labor costs remain subdued.
- › We’re still positive on Japan even after the 41% rise in the Russell Nomura Index in local currency terms in the first nine months of the year through September 30, 2013. Valuations appear less attractive than at the beginning of the year, but the impact of Japanese Prime Minister Shinzo Abe’s economic program (known as Abe-nomics) is becoming evident in economic indicators and corporate earnings. According to our analysis, corporate profits appear on track to rise by around 60% in the financial year ending March 31, 2014. Business surveys are optimistic and the economy seems likely to exit deflation for the first time since 2008. The consumption tax in Japan is scheduled to rise by 3 percentage points next April but the momentum in the economy seems strong enough to offset this.
- › Emerging markets equities are looking more positive. Valuation is a strong positive and, according to our metrics, emerging markets were trading at a 25% discount to

**Index returns (in US\$) over the past three, six & 12 months**



Please see “The Eurozone: Don’t be complacent” (page 13) for more details on the AQR.

Indexes shown here and on subsequent pages are unmanaged and cannot be invested in directly. Returns represent past performance, and are not a guarantee of future performance, and are not indicative of any specific investment.



developed markets at the end of September. Emerging markets could get a renewed shakeout when talk of Fed tapering resumes, but we believe much of the currency adjustment has already occurred across the vulnerable economies. China's economic indicators have bottomed and stronger export growth is expected as demand from the developed economies picks up. This suggests to us that low double-digit earnings growth is possible across emerging markets in 2014.

- › In the opening paragraph, we said that the fall in bond yields has been overdone. We think that bond markets have overreacted to the non-taper decision and the U.S. government shutdown. The rally in the U.S. 10-year Treasury bond to 2.6% in early October, 2013 is counter to the longer-term trend for the yield to rise to more normal levels above 3%. Our models have the U.S. 10-year bond yield reaching 2.8% in the first quarter of 2014 and 3.2% by the end of 2014.
- › Credit spreads still provide a reasonable yield pick-up. The option-adjusted U.S. high yield spread stood at 460 basis points at the end of September 2013 while the investment grade spread was 143 basis points. Both are slightly below their long-term historical averages but should be sustainable with growth picking up and default rates remaining low. ■

Credit spread: The spread between Treasury securities and non-Treasury securities that are identical in all respects except for quality rating.

Option-adjusted spread (OAS): This is a measurement tool for evaluating price differences between similar products with different embedded options. A larger OAS implies a greater return for greater risks.



# Special focus: Quantitative easing in proper perspective for portfolios

The Fed is likely to begin tapering back its asset purchases in coming months. This will create market volatility, but quantitative easing (QE) has not lifted asset prices to unsustainable levels.

## Pushing on a string

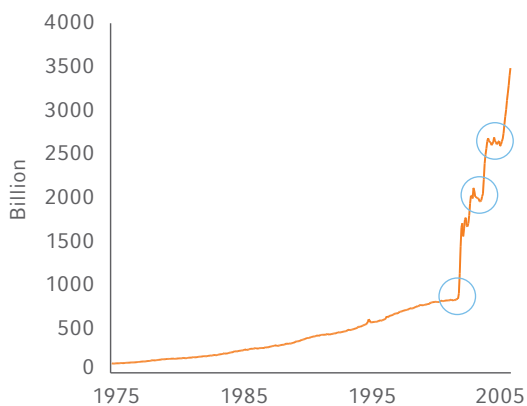
A common criticism of quantitative easing is that money printing by the Fed has lifted the prices of financial assets beyond levels that can be sustained by fundamentals, creating the risk of a market crash when the stimulus is withdrawn. These fears seem overdone. QE has more closely resembled pushing on a string<sup>1</sup> than an irresponsible act of market distortion. The eventual winding down of QE will generate volatility, but there is little evidence that the Fed has significantly distorted asset prices.

## Remarkable size of QE

What can't be argued is the extraordinary size of the Fed's monetary expansion. Economists classify different types of money in a series of "M"s, ranging from M0 to M3. M0 (currency plus bank reserves held at the Fed) is the money measure that the Fed most directly controls. Up to the end of 2007 it grew by 5.5% to 6.0% per annum—roughly in line with nominal GDP growth. Since late 2008 the size of the money base has nearly quadrupled. The three episodes of QE can be readily identified on the chart on the left below.

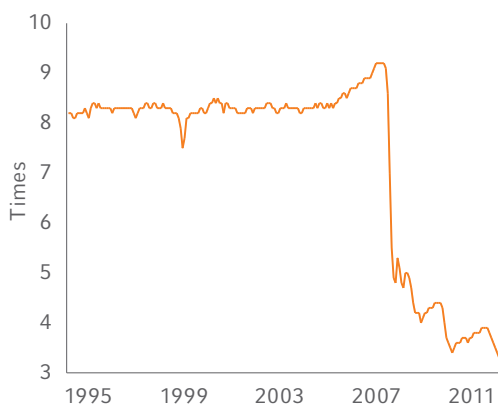
This is why Fed money creation has failed to trigger consumer price inflation—it hasn't flowed into the money supply measures that matter for actual spending in the economy.

US Money Base, M0



Source: U.S. Federal Reserve

US: M2 Money Multiplier



Source: U.S. Federal Reserve, Russell calculations

The huge expansion in the money base has not flowed onto broader measures of money supply. M2 comprises M0 plus deposits with banks and money market funds. M2 expands when banks use the money created by the Fed to make loans and these generate more deposits. The money multiplier is the ratio of M2 to M0. It collapsed when the Fed embarked on the first round of QE and continues to slide. Because of deleveraging, banks have been unable to lend the funds created by QE and the money has remained in reserves. This is why Fed money creation has failed to trigger consumer price inflation—it hasn't flowed into the money supply measures that matter for actual spending in the economy.

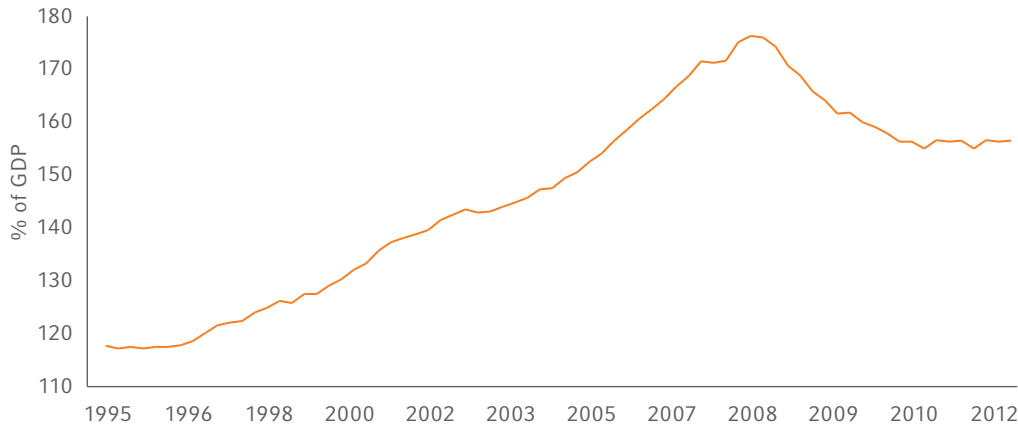
<sup>1</sup> Pushing on the string is a figure of speech used to describe a futile effort to stimulate the economy by increasing the supply of money.

Data shown is historical and not an indicator of future results.

Data as of September 30, 2013

QE has not triggered a credit boom that has pushed up asset values in an unsustainable manner. The deleveraging efforts of firms and households have greatly counteracted the Fed's desire to pump liquidity into the economy.

### Household & Business Debt as a % of GDP



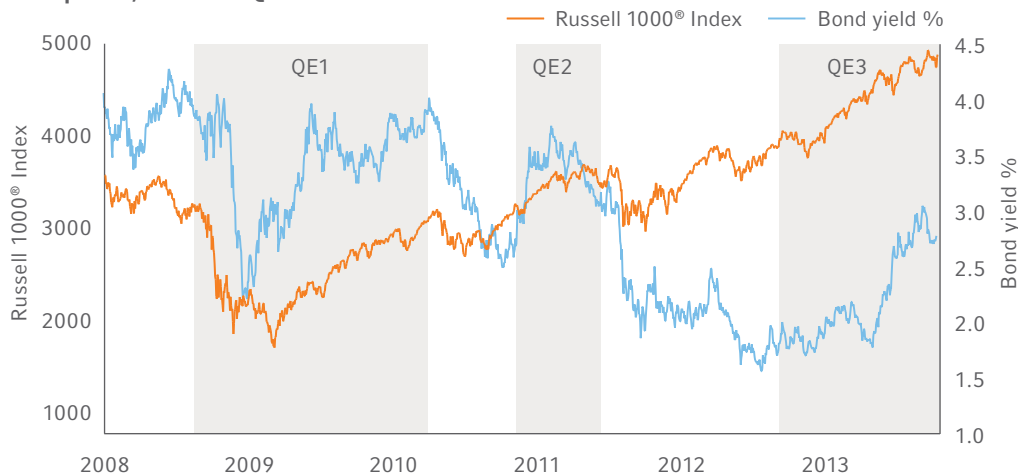
Source: U.S. Federal Reserve flow of funds, last observation June quarter 2013

### Portfolio balance effect is real but hard to quantify

One of the Fed's stated aims through quantitative easing is to reduce the cost of corporate finance by forcing investors to take more risk—the so-called portfolio balance effect. Simply put, the Fed purchases \$85 billion of U.S. Treasuries and mortgage-backed securities each month. Those pension funds and other investors who purchased them now have \$85 billion to invest in similar but slightly more risky securities. Eventually, the monthly Fed purchases flow through to asset classes such as equities and property.

The portfolio balance effect makes logical sense, but is hard to identify in the data. The chart shows the Russell 1000® Index and the 10-year U.S. government bond yield during the periods that QE has been underway. The 10-year yield has mostly risen during QE and fallen when QE has stopped. Equity prices experienced brief corrections at the end of QE1 and QE2 but have generally been in an upward trend.

### Equities, Bonds & QE



Source: Datastream

Data shown is historical and not an indicator of future results.

Data as of September 30, 2013

## QE helps forward guidance, but this is also the biggest problem

One motive for QE, particularly QE3, is for the Fed to demonstrate its commitment to keep the funds rate near zero for an extended period. At the zero lower bound, one of the few ways the Fed can keep real borrowing rates low is to credibly promise to keep official rates low for an extended period after the economy starts to recover. This helps anchor long-term rates since these are the average of expected future short-term rates over time (although as noted above, there is little evidence that long term rates are lower as a result of QE).

QE3 also helps maintain expectations for positive inflation (something that the Bank of Japan failed to do in the 1990s and 2000s), keeping real interest rates low or even negative. The problem is that by linking forward guidance to QE, the Fed causes investors to expect earlier rate rises when it hints at winding back asset purchases. Although the Fed may formally protest that there is no link between tapering and monetary tightening, the confused messaging creates market volatility.

## Overall impact of QE has not been large

The first episode of QE in 2009 helped restore credit markets but effects of the second and third installments have been less clear-cut. QE has most likely had a mild positive impact on the economy by preventing deflation and keeping real interest rates low. It also has boosted asset prices through the portfolio-balance effect and by creating confidence that borrowing costs will stay low and the United States will avoid a double-dip recession. Investors may have taken on extra risk through believing that the Fed will offset large market declines with more QE. However, it is hard to see a large impact on asset prices given that the private sector has continued to de-leverage, the money multiplier has declined and U.S. bond yields have risen during QE.

The eventual winding down of QE will no doubt trigger market volatility. In part, this will be due to the Fed's confused messages about the link between QE tapering and future interest rate moves. There will also be volatility caused by the fact that some investors who believe that QE has boosted asset prices will likely to become nervous as the program ends. However, we see little evidence that QE has pushed asset prices beyond levels that can be justified by the current combination of stable economic growth, low inflation and moderate corporate earnings growth.

As such, QE itself has little influence on our portfolio-weighting decisions. Up against the zero and lower bound for short-term interest rates, the only option for the Fed has been to expand the money base. The future direction of Fed policy will, of course, be a decisive factor for markets, but in our view, the overall impact of QE has been smaller than the headlines would suggest. ■

Forward Guidance is a tool used by central banks to influence market expectations of future interest rates.





# Economic outlook: More fiscal tightening in 2014?

## The third time would not likely be a charm for equity markets

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Economic growth in the United States at the end of 2013 will have been below 2 percent for two out of the last three years, as this year is likely to finish with 1.6 percent growth on a year-on-year basis. Fiscal-policy tightening, actual and prospective, contributed significantly to these sub-par outcomes. If fiscal tightening continues in 2014 at the same pace, it is unlikely that equity markets will find a silver lining, as they did in 2011 and so far in 2013.

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### Recession fears came and went

Let's start with some recent history. At the end of July 2011, the first U.S. debt-ceiling debacle and the initial codification of federal spending sequestration helped set off a recession scare and contributed to lower growth that year. Despite low overall growth during 2011 of only 1.7 percent, when the markets realized that a recession was not imminent, the U.S. large-cap Russell 1000® Index enjoyed a significant relief rally of 17.4 percent between October 3, 2011, and October 28, 2011.

As for 2013, by the end of the first quarter, federal spending sequestration in the United States arrived to hit the economy full force. Given this dreaded degree of across-the-board fiscal tightening, it is not surprising that real GDP growth is likely to be only 1.6 percent this year. Once again, however, despite sub-par growth, the Russell 1000® rose at one point by 21.7 percent from the beginning of the year, between December 31, 2012, and September 18, 2013.

This year, we have not seen a recession scare in the markets. Thus, the rally in equity prices appears to have been a result of re-pricing of recession risks in general, rather than the avoidance of a specific and immediate recession scenario. Essentially, markets have come to the conclusion that the U.S. economy is in the midst of a fairly sturdy economic expansion, not populated by cycle-ending economic imbalances.

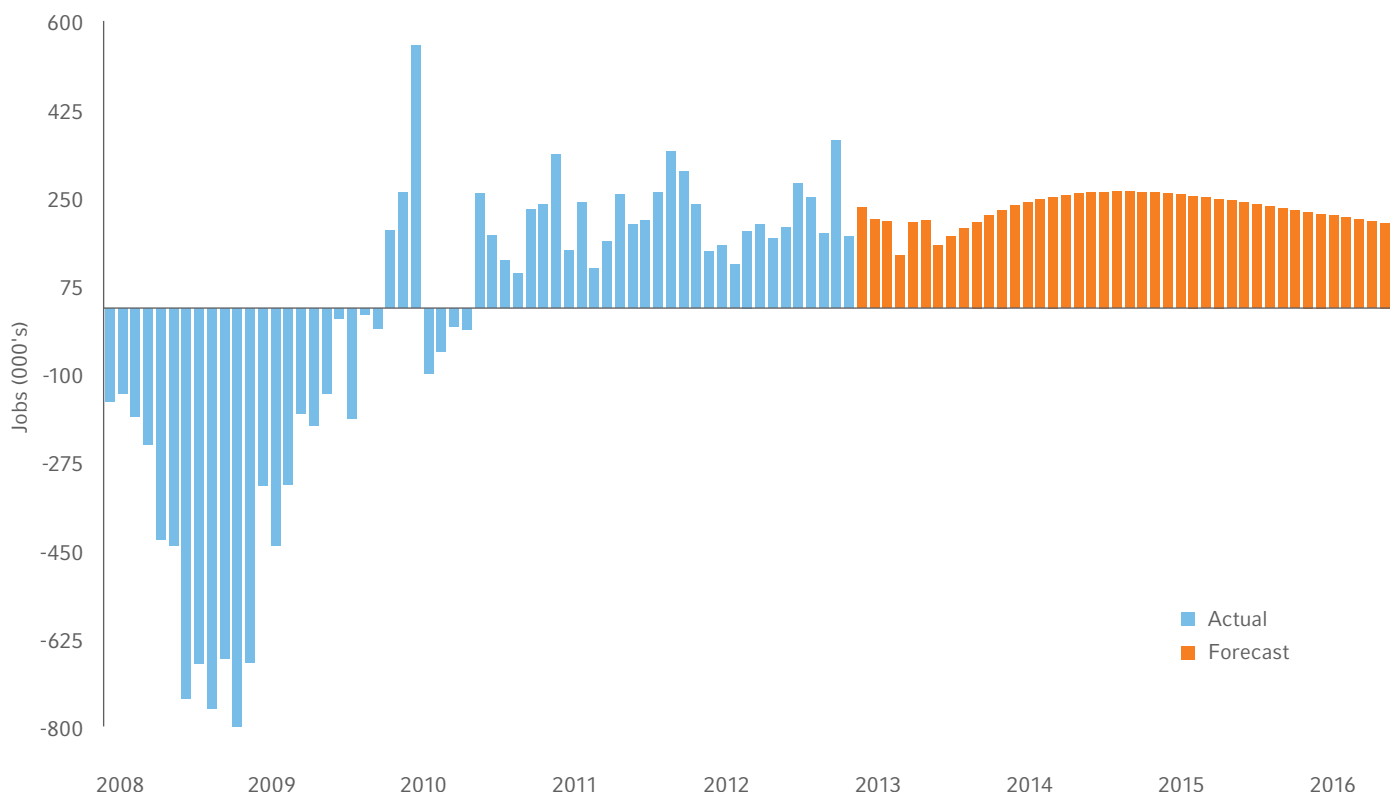
If the fiscal-policy tightening in 2014 that is currently scheduled in January as federal spending sequestration (part II) proves to be milder than the fiscal tightening in 2013, we have a constructive view of U.S. economic performance in the next 24 months. The best measure of our sanguine outlook is that we expect U.S. payroll gains to average 200,000 per month in the next 24 months. The bad news is that the U.S. economy is ending 2013 with less short-term momentum than this point last year and with only about 150,000 jobs per month expected during the fourth quarter of 2013 (whenever we get government data on the fourth quarter, that is).

Economic expansions get into trouble when firms invest too much in the wrong areas and begin to experience disappointing rates of return on those investments, which leads to retrenchment in investment spending. In the current economic expansion, in contrast, firms likely have held too much cash relative to what they have invested in new capital. Their most disappointing rate of return is likely to be on their cash holdings. The remedy for this will not be a retrenchment in investment spending but an acceleration. Moreover, given our view of only very gradual normalization of bond yields, profits are unlikely to face headwinds from mark-to-market pricing of firms' existing capital bases.

Following what is likely to be only 1.6 percent real GDP growth in 2013, the U.S. economy needs a solid 2014 to ratify this year's equity market gains.

Sequestration refers to the imposition of automatic spending cuts to the U.S. Federal government budget to manage the deficit.

## Forecasts of nonfarm payroll employment changes as of September 2013



### A fiscal tailwind would be appreciated

As of this writing, the U.S. federal government has reopened, postponing the debt ceiling debate until early in 2014. At that time, if the outcome of negotiations involves additional significant fiscal tightening in 2014, such as the mindless federal spending sequestration part II, it is hard to see how equity markets would treat unexpectedly slow growth in 2014 as good news. The fact that the U.S. federal budget is already (per the Congressional Budget Office) on course to attain deficits below 3 percent of GDP within a few years greatly weakens the case that additional fiscal tightening is needed in 2014. Equity markets would be challenged next year to see any charm in yet another round of fiscal tightening when the U.S. economy needs a solid year of growth to ratify this year's equity market gains.

Other highlights of our U.S. outlook include:

- › A 10-year U.S. treasury yield just over 3 percent by the end of Q3 2014. We project lengthy pauses and gradualism on the path of interest rate normalization, even as monthly jobs gains cross 200,000 per month.
- › Year-on-year real GDP growth of 2.9 percent in 2014, barring significant additional fiscal tightening ■

Figures through September 30, 2013

Source: Actual employment data from St. Louis Fed's FRED database and Russell forecasts.

Out of sample forecasts were calculated by simulating the time-series model into the future. The value shown is the median of the simulated value for the month.

# Asia-Pacific: Land of the rising markets?

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Asia-Pacific economies are delivering steady growth in 2013 and we are optimistic about the outlook for the year ahead. The Japanese economy in particular is undergoing meaningful growth resurgence. Japan, along with China, are our preferred equity markets in the region. We also like the prospects for Emerging Asian equity markets, which are attractive on a 12-month view. However, we believe Japanese bonds offer poor value and are at risk in the medium-term.

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## Japan resurgent

Over the past 20 years, Japan's share of world economic activity has fallen from over 10% to just over 5%. Put another way, the world economy would be 5% larger today, if Japan had grown in line with the global average over two lost decades, rather than the minimal growth that was actually delivered. So, Japan matters to the world, as well as being an important financial market in its own right. More importantly, things are now changing.

Japan's new leadership of Prime Minister Shinzo Abe (elected, in his current tenure, in December 2012), and Bank of Japan Governor Haruhiko Kuroda (appointed in March 2013), have shown resolve in rejuvenating economic activity. Key drivers, actual and planned, in this galvanization of the economy have included:

- › A significant devaluation of the yen (down 20% versus the U.S. dollar over the past 12 months through September 30, 2013)
- › Fiscal stimulus, in the order of an incremental 2% of GDP, focusing on public works
- › Monetary stimulus, with a lift in base money in 2013 of over 40%
- › Structural reform (e.g. of trade, agriculture, the power industry, healthcare and labor markets) commenced in June, but with more still needed
- › Planned increases in the consumption tax (from 5% to 8%, in 2014), with offsetting proposed stimulus measures for the corporate sector

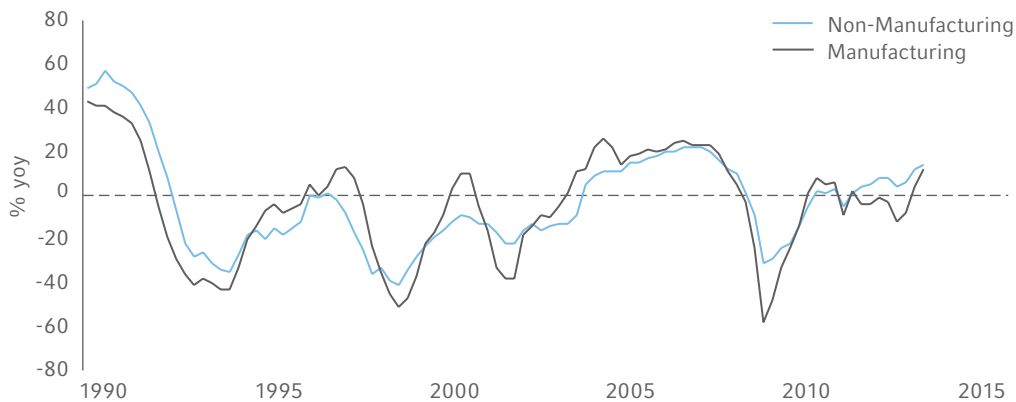
Our view in the Q2 edition of the Strategists' Outlook & Barometer was that "policy settings were full-steam ahead" in Japan and, in our Q3 commentary, that "likely variation was to the upside". We now see evidence coming in that:

- › Real GDP growth has been sustained in the order of 4%.
- › Money growth, which was languishing close to zero at the beginning of 2013, is now printing a healthy 3% year-on-year as of September 30, 2013.
- › The "Tankan" survey of Japanese business conditions (issued by the Central Bank of Japan) is moving steadily into positive territory (see following chart).
- › Consumer Price Index (CPI) inflation over the last six months, at an annual rate, is now running above the 2% official target.

Challenges remain for Japan, although we do not believe them to be insuperable. Interpreting the data will also be difficult, with distortions arising from the 2011 Great East Japan Earthquake reconstruction spend, and from the impact of a looming consumer tax rise, in particular. Most notably, it will be hard to maintain current levels of fiscal discretionary stimulus to support consumer spending. Japan's welfare budget is constrained by the persistent demands of a markedly aging population, in conjunction with a debt/GDP ratio already

High expectations for a Japanese recovery over 2013 are now evidenced by economic data.

## Japanese Tankan survey of business conditions—large enterprises



approaching 250%. Secondly, it will be important for wage inflation to join CPI inflation on an upward trajectory, if a sustained lift in private consumption spending is to be achieved.

## Regional developments

Elsewhere in the region, growth is steady, but not so robust as to be a vibrant source of demand for northern hemisphere exporters. In China, the difficult task of engineering a rebalancing of the economy while maintaining real GDP growth rates above 7% is on track, in our view. However, the dampening lagged effects of monetary tightening likely will keep a lid on any upside. Indicators such as steel and electricity production are strong.

In the smaller economies, we see growth disruptions in countries such as India and Indonesia as idiosyncratic, rather than as indications of a regional malaise. Indeed, many countries are in good shape from both a balance sheet and current account perspective. The region as a whole (both economies and markets) would, in our view, respond well to any acceleration in U.S. and/or European growth in 2014.

In Australia, low interest rates are fuelling a house-price boom, but the economy overall is decelerating in the wake of a resource-sector boom. Our central case is for more of the same over the next 12 months, i.e., lackluster conditions, but no outright recession.

## Markets

Financial markets in the region offer reasonable opportunities. In U.S. dollar terms, Asia ex-Japan has lagged global equities by around 5% in 2013 through September 30, with Japanese equities outperforming by a similar magnitude, according to Russell Indexes. In equities, our preferences are for:

- › Japan, where positive underlying economic and earnings momentum, together with a prospect of meaningful structural reform, more than compensate for slight overvaluation. However, we believe that the next phase of Japan's bull market could be more volatile, and offer lower returns, than the first phase delivered.
- › Emerging Asia, particularly China, where good value and good growth prospects combine.

In the bond market, we see value in Australian and in New Zealand long government bonds. We believe currencies of both those markets remain expensive. In Japan, we are concerned that accelerating growth and accelerating inflation may combine to destabilize the bond market and shift interest rates higher on a 12-month view. For the remainder of 2013, however, with liquidity available effectively without limit, it is difficult to identify any short-term catalyst for a Japanese bond market sell-off. ■

# The Eurozone: Don't be complacent

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The Eurozone has clawed itself out of recession. Its equity markets are outperforming other regions, capital is flowing in, and the European Central Bank (ECB) is sounding very dovish. Austerity is lessening, and socio-political risks seem contained. In our opinion, these positives outweigh the negatives and therefore we maintain our tilt toward euro-zone equities. That does not mean, however, that all is well. In fact, we warn against being complacent, as none of the region's key long-term problems have been solved: The periphery is still stuck in its debt trap, the banking sector is weak and not lending, growth is insufficient to lower debt burdens and/or unemployment rates, and structural reforms are largely nonexistent.

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## The positives outweigh the negatives—just

Balancing short-term positive developments against medium-to-long-term negatives is difficult, especially when facing a problem like the eurocrisis that is as much political as economic in nature. We don't want to ignore cyclical improvements—especially not against a background of attractive valuations—but at the same time we never feel comfortable because we know what structural challenges lay ahead.

To navigate these treacherous waters, we have followed a few simple guidelines. We:

- › Don't currently view European financial markets as a buy-and-hold investment
- › Look for a margin of safety in valuations against socio-political risks
- › Closely monitor the policy mix in terms of its reflationary and deflationary content
- › Follow the progress made in institutional reform (and keep expectations low)

At the end of the second quarter of 2013, these guidelines made it relatively easy to hold a more positive outlook on the Eurozone and its financial markets. The positives—an improvement in the policy mix toward more reflation, combined with attractive valuations—clearly outweighed the negatives, which were chiefly the socio-political risks.

We still hold that view today, even though the positives have diminished somewhat relative to the negatives. First, the rally in the third quarter of 2013 has clearly lowered the margin of safety in financial markets. Second, we are once again approaching political hurdles with the renegotiation of the Greek and Portuguese bailouts, as well as a major institutional dilemma with regard to the implementation of a European banking union. More on that in a minute.

Looking forward to the remainder of 2013, in our opinion the positives continue to outweigh the negatives—albeit just barely. Growth may be lackluster, but the recession is over and austerity is in decline. The ECB may be slow, but it is dovish—which is to say, relatively easy in its monetary policy—and gearing up to provide more support soon. Valuations may have gone up, but euro-zone equities are by no means expensive; they look outright cheap, relative to U.S. equities. That's why we believe the overall outlook for the Eurozone is positive enough to maintain current exposures.

## Stress tests and the Greek-and-Portuguese mess

The risks to this outlook are twofold. The first is political in nature. German Chancellor Angela Merkel's decisive victory in the recent elections implies there is little chance of a

Valuations may have gone up, but euro-zone equities are by no means expensive; they look outright cheap relative to U.S. equities. That's why we believe the overall outlook for the Eurozone is positive enough to maintain current exposures.

Reflation: The act of stimulating the economy by increasing the money supply or by reducing taxes, seeking to bring the economy (specifically price level) back up to the long-term trend, following a dip in the business cycle.

more lenient German stance regarding current and future bailout programs. That is bad news for Greece and Portugal, the peripheral economies that are most in need of more support (and debt forgiveness). Over the past few years, we've noted the ability of European politicians to kick this can down the road without long-term consequences. We see no reason why this pattern will not continue.

More worrying is the risk regarding the first step to implement a European banking union, namely the installation of the ECB as a single supervisor. In the run-up to assuming this role in the first quarter of 2014, the ECB will conduct a so-called Asset Quality Review (AQR), with the goal of harmonizing the methodology that European banks use to calculate the amount of assets and capital they hold. Afterwards, in coordination with the ECB, the European Banking Authority (EBA) will carry out a bank stress test in the second quarter of 2014.

The worry is that there is reluctance to conduct a truly thorough review and stress test, which would include hair-cutting, such as marking down questionably valued assets to their current market price. This is especially of concern because this issue may apply to government bonds, which would place considerable stress on peripheral banks that hold these bonds as capital and possibly create a huge hole in their balance sheets: estimates range from €50bn to €100bn.

In the absence of a European resolution mechanism, plugging that hole would be up to each respective sovereign government, which could restart the negative feedback loop from weak banks to weak governments. This issue is the source of much tension and concern. For now we assume it will be handled cautiously. It is in no one's interest to plunge the Eurozone back into a financial crisis. However, because the tension is there, the risk is there, and negative credit growth is a big problem already (see following graph).

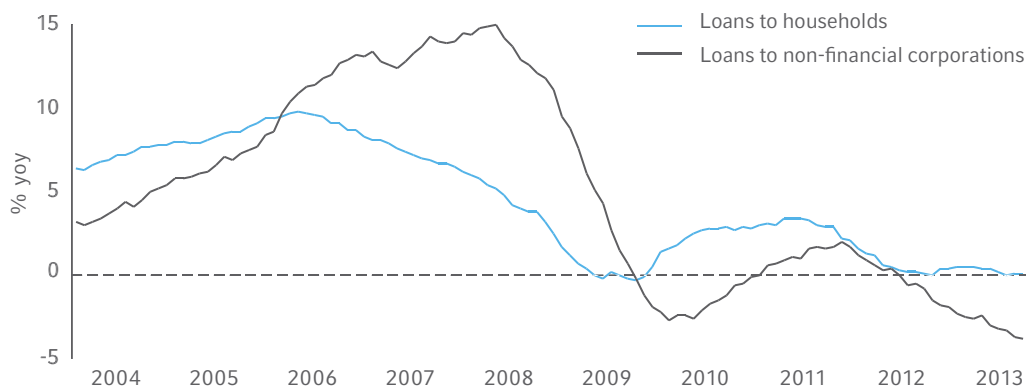
Key euro-zone metrics:

**Economic growth:** The eurozone left recession in Q3 and we expect economic growth to remain positive, but lackluster, in 2014 at between 0.5 to 1.0%. Our greatest worries remain French weakness and negative credit growth.

**Corporate earnings:** The outlook for earnings has not been changed, with earnings growth still in negative territory over the past 12 months through September 30, 2013. Going forward, modest single-digit growth remains our outlook, driven by a gradual rise in profit margins on the back of low labor costs and increased revenue due to a small uptick in growth in 2014.

**Equities:** Euro-zone equities are still attractively valued, even though their margin of safety has clearly decreased. Given our outlook for modest but positive growth and more monetary stimulus, we maintain our positions after last quarter's upgrade. ■

### Eurozone lending



Source: Thomson Reuters Datastream

Data shown is historical and not an indicator of future results.

Data as of September 30, 2013

## United States: Done deal, for now

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Capital markets appear to have sounded the all clear around the debt ceiling but are underestimating the difficulty in hammering out the specifics of a compromise. There could be more market volatility; however, this would likely represent a buying opportunity.

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### The ice may have cracked, but politicians won't be sharing cocktails yet

As investment strategists, we find forecasting capital markets difficult enough, but this seems far easier than the near-impossible challenge of forecasting politicians. We thought there would be a last-minute deal to avoid a U.S. government default and forced fiscal tightening. However, any deal seemed likely to be a can-kicking exercise, and this debate would come back again. The good news is that the U.S. is having a serious debate about its fiscal future. The bad news is each debt-ceiling deadline involves holding the global economy and capital markets to ransom.

As of mid-October, the market response has been surprisingly muted. Equity markets did sell off, with the Russell 1000® Index declining 2.6% as of October 9 from the high up to that point for 2013 on September 18. But given that the Russell 1000® reflected a gain of 23.6% year-to-date through September 18, this wasn't too shocking. Similarly, fixed income markets have seemed to apply almost no risk premium as a result of default concerns thus far.

Our overall view is that the U.S. equity market still has some modest upside potential. On our calculations, the U.S. equity market at the end of September was trading on a trailing Price/Earnings (PE) ratio of just under 16 times and a cyclically adjusted PE ratio (CAPE) of 20 times. The CAPE, which uses the average of inflation-adjusted earnings for the last 10 years, is in our view approaching the upper end of acceptable valuation. The overall equity market gains going forward are most likely to be generated by earnings per share (EPS) gains. But with profit margins close to all time highs, we believe EPS at best will grow in line with nominal GDP, around 5% to 6%.

### The path forward and what to do about it

A near-term deal has been achieved on both the shutdown and debt ceiling. However, the political path forward may be more difficult than markets currently assume. Given our view on valuations, however, we would treat a correction on "political impasse" fears as an opportunity to increase equity positions.

Some key elements to keep in mind going forward include:

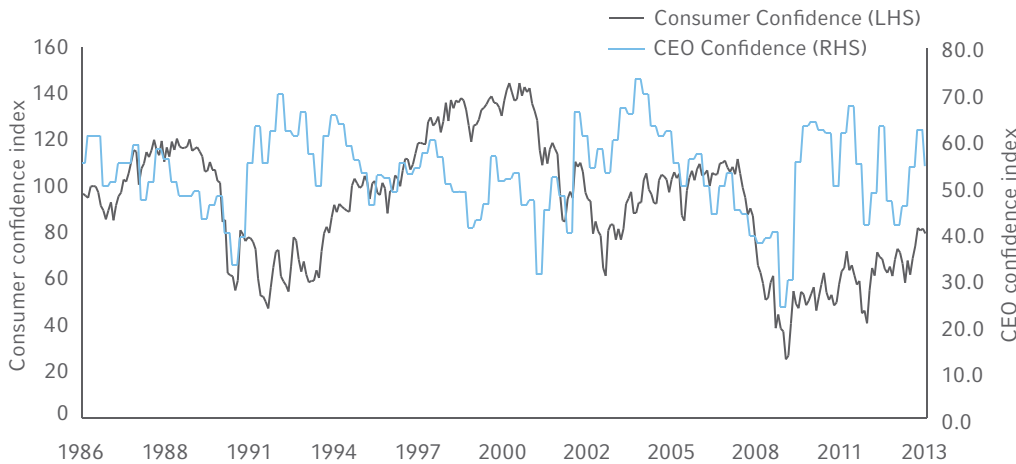
- › One of the likely sticking points in political negotiations will be the time horizon for funding the government and raising the debt ceiling. We expect to see Republicans aiming to negotiate a solution that keeps or reintroduces these issues prior to the 2014 midterm elections, while Democrats try to push solutions beyond these elections.
- › The shutdown will of course have some impact from a fiscal tightening perspective, but furloughed government employees will receive all of their pay retroactively and funding for shutdown government agencies will catch up in part. This will likely push forward growth into the first or second quarter of 2014.

▮ A near-term deal has been achieved on both the shutdown and debt ceiling. However, there may be continued volatility primarily in equity markets and, should this ensue, it would represent an opportunity to increase equity positions.

- › The Federal Open Market Committee (FOMC) may take a more cautious approach following the 16 day U.S. government shutdown, delaying or decreasing the size of taper plans. We thought the FOMC would likely backstop liquidity concerns, in a disaster scenario of default, on the short end of credit markets—as they did during the global financial crisis in money market funds. If the precedent held, they would simply act as the purchaser of last resort for short-term instruments, holding these in exchange for a modest interest payment from the U.S. Treasury when reconciled.
- › Another potential negative impact—and one of our current watch points—would be a decline in confidence in the U.S. economy. As shown in the chart below, business confidence as measured by a survey of CEOs remains relatively strong. However, we believe a decline in CEO confidence could lead to a decrease in capital expenditures or hiring. Similarly, a decline in consumer confidence could reduce spending during the pre-holiday season. In both cases, we would encourage more cautious positioning.

Markets are likely to be on a bumpy path through the end of 2013, but we think solutions to both the U.S. government shutdown and debt ceiling debate likely will postpone crisis. We look forward to the days when financial markets look for their news from Bloomberg and CNBC rather than CSPAN<sup>‡</sup>. ■

### Consumer vs. CEO Confidence



<sup>‡</sup> CSPAN: A U.S. cable news television channel that televises Federal Government proceedings.

The U.S. Consumer Confidence Index (CCI) in the United States is issued monthly by The Conference Board, an independent economic research organization. It is an indicator designed to measure consumer confidence, which is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending. Global consumer confidence is not measured. Country by country analysis indicates huge variance around the globe. In an interconnected global economy, tracking international consumer confidence is a lead indicator of economic trends.

CEO Confidence Index: A monthly survey of 100 CEOs from a variety of industries in the U.S. economy. The survey is conducted, analyzed and reported by the Conference Board, and it seeks to gauge the economic outlook of CEOs, determining their concerns for their businesses, and their view on where the economy is headed. A reading above 50 indicates that the CEOs surveyed are more bullish than bearish on their economic outlook.



# Russell strategists' relative-return barometer compares 16 key asset class pairings

The models shown in this section inform Russell's short to medium term asset allocation strategies. At the core of these strategies is the recognition that over time asset classes, relative to one another, present misvaluations. The identification of these misvaluations of asset classes is the goal of Russell's Enhanced Asset Allocation (EAA) capability.<sup>5</sup>

## Three noteworthy observations

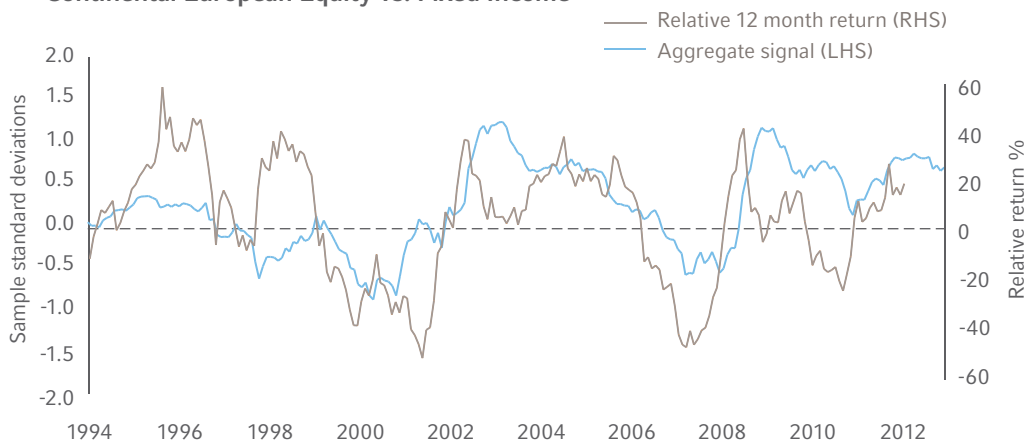
### 1. Significant Signal: Continental European Equity vs. Fixed Income

While there have been political fireworks in the United States, the policy and political risks that have kept us modestly concerned in Europe have mitigated. Whether it is the anticipated outcome of German elections, a successful navigation of potentially destabilizing friction in Italian government, or diminishing risks in regional banks, the aggregate threat from these potential sources of volatility has declined.

While we continue to have some concerns surrounding longer-term structural issues, and the political minefield is only partially crossed, some of the near-term issues have diminished. This leaves us with higher confidence in our valuation signals that are compelling for equities relative to fixed income alternatives. Some key points and drivers are:

- › Our strongest valuation signal comes from our fundamental fair value assessment based on forward earnings: The signal shows more than 1.25 standard deviations in favor of equities.
- › Sentiment and momentum have increased in favor of European equities according to our models.
- › Both our Fed modeling, which uses trailing earnings, and our long-term mean reversion modeling are inside their neutral ranges. Yet they are both on the equity side of the ledger in this pair adding quantitative confirmation of our preference amid decreasing qualitative concerns.

### Continental European Equity vs. Fixed Income



<sup>5</sup> Enhanced Asset Allocation (EAA) is a capability that builds on Strategic Asset Allocation (SAA) by incorporating views from Russell's 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.

In assessing the attractiveness of asset classes relative to one another, Russell's EAA capability uses a pair-wise modeling 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, and they generally fall into three categories:

- › Multi-variate, where the valuation signal is a function of various economic, characteristic and market variables.
- › Uni-variate, in which return differences between two asset classes are a function of a single characteristic or market variable.
- › Statistical, in which deviations from long-term trends in return patterns of two asset classes signal the direction and magnitude of expected returns.

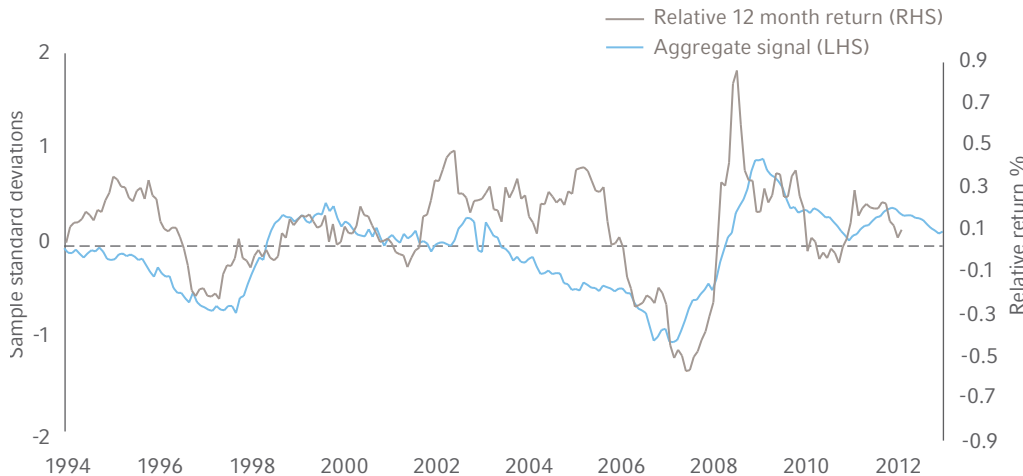
All the models seek to identify factors to signal which of two asset classes in a pair has better return prospects, given historical patterns of subsequent relative returns. Married to each individual model is a model-specific tilt function to make best use of each unique signal. Having multiple models per pair provides diversification of signals to arrive at a weighted tilt.

## 2. Biggest Change: Global REITs vs. U.S. Fixed Income

It is worth pointing out that we have not seen significant change in any of the valuation suite's signals relative to last quarter. However, we did notice a modest decline in our preference for Global Real Estate Investment Trusts (REITs) relative to U.S. Fixed Income. This is a case of divergent valuations with slight influence from a waning momentum signal. In the aggregate, this has pushed our preference in the previous quarter from a stronger bias for Global REITs toward a more neutral stance. Most notably:

- › We have competing signals. Global REITs look attractive from a relative yield comparison. But from a long-term mean reversion perspective, U.S. Fixed Income appears relatively undervalued.
- › Momentum is trending toward a fair-valued position, thus the aggregate signals bring us to a near neutral weighting.
- › We've noted the volatility on the short end of the U.S. treasury yield curve that was tied to the debate in the U. S. surrounding the government shutdown and debt ceiling. However, the longer end of the curve has been stable and increases our conviction surrounding the valuation work in this pair.

### Global REITs vs. U.S. Fixed Income



## 3. Caught our Eye: U.S. Large Cap Equity vs. U.S. Fixed Income

Third-quarter volatility presented challenges to our preference for U.S. Large Cap Equity over Fixed Income. Negatives impacting the equity market included geopolitical risk from potential military involvement in Syria, softer macroeconomic data, and of course, most recently, concerns surrounding the U.S. government shutdown and debt ceiling debate. Upside pressure resulted from the continuation of quantitative easing in September, and a snap back whenever fears receded about the economic impact from the shutdown.

In conversations with clients, we have supported an opportunistically nimble course, leveraging volatility as buying opportunities. However, when investors are not as agile (or more risk averse), then we have suggested holding the course with an equity overweight. Although we do not have as strong an equity preference as we did at the start of 2013, or even in April through June, we still observe compelling valuations that lead us to prefer Equities over Fixed income in the United States.

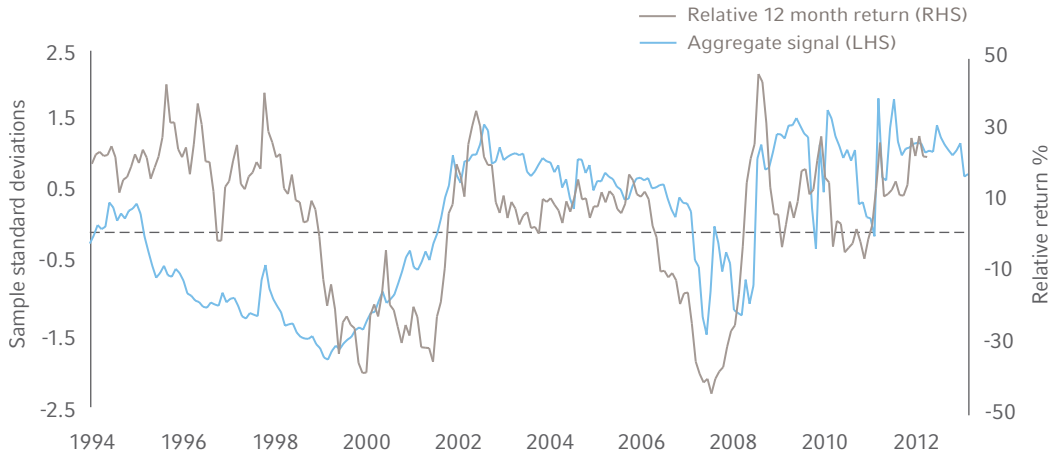
- › Our most significant valuation preference comes from our fundamental modeling using forward earnings, which notably, currently are at their highest level. This

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

measure presently sits at its highest level in 2013, with consensus U.S. equity earnings expectations for 2014 at 116.

- › Our long-term mean reversion signal is now less bullish; in fact, it now sits in its neutral range. This is not surprising, given the recent politically induced volatility and the current rebound rally that has re-approached U.S. equity index highs for the year.
- › The balance of our valuation suite favors Equities relative to Fixed Income in the United States. Measures include the trailing-earnings-based Fed model, momentum signal, and dynamic ordered probit model. Though the signals are not as strong as earlier in 2013, this quantitative support—primarily tied to improving growth prospects in 2014—reinforces our strategy to use pull backs as buying opportunities.

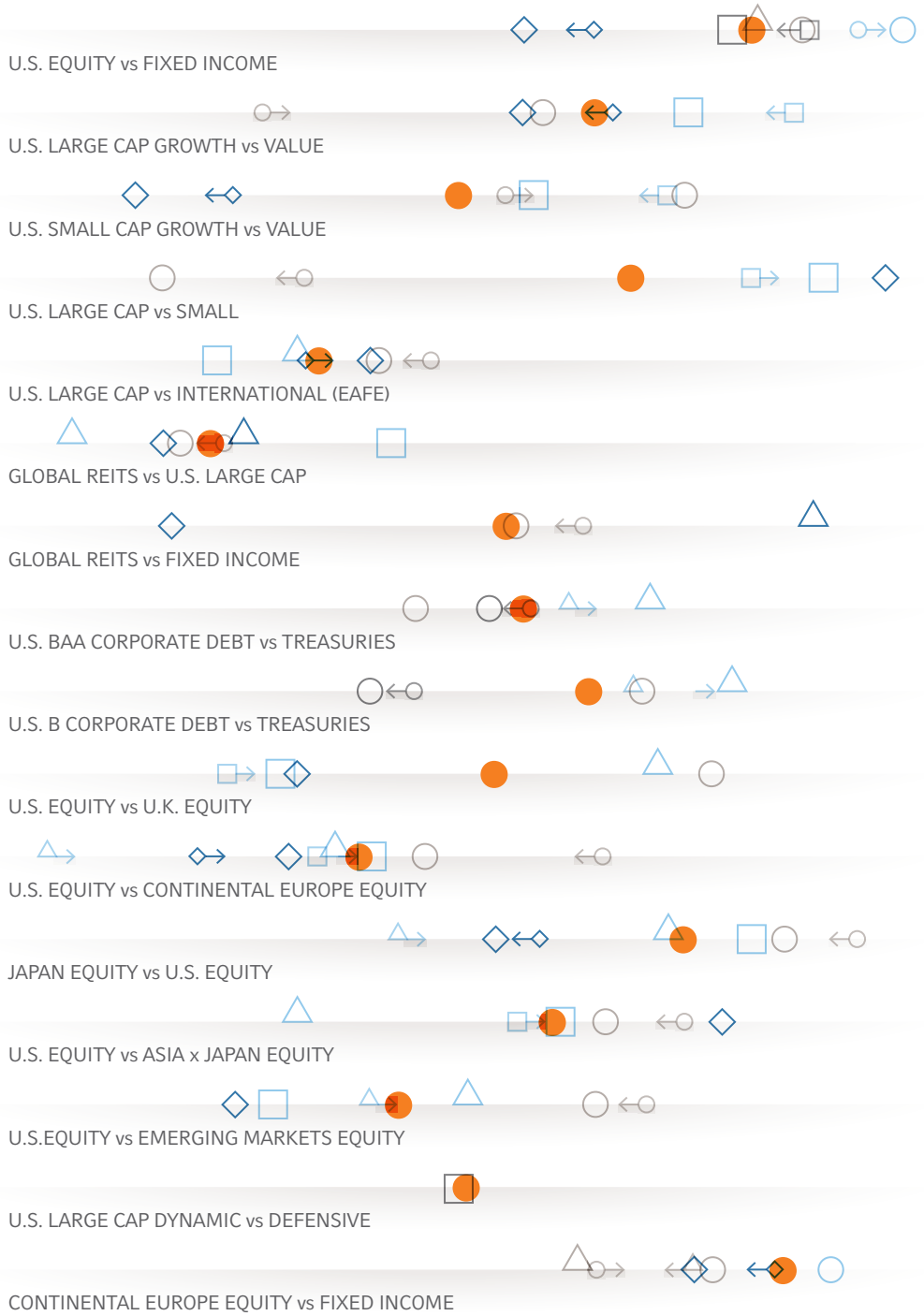
### U.S. Large Cap Equity vs. U.S. Fixed Income



# Russell strategists' relative-return barometer

The relative return barometer represents pair-wise comparisons of the relative attractiveness of forecast valuations of asset classes of regional interest. The symbols on the "slider" represent each of multiple forecast valuation models we use in the enhanced asset allocation capability to gain a diversified perspective of the relative attractiveness of each asset class relative to its paired asset classes.

UNDERPERFORM ← ————— → OUTPERFORM



## How to read the slider

Symbol on the RIGHT SIDE of the band = strong preference for the FIRST asset class listed in the pair.

Symbol on the LEFT SIDE of the band = strong preference for the SECOND asset class listed in the pair.

Symbol in the center = neutral (i.e. if the pair is U.S. Equity vs. Fixed Income a symbol on the right would indicate a preference for U.S. Equity, on the left for U.S. Fixed Income.)

The range along the band is a normalized distribution of the different signals to make them comparable (mean of 0 and standard deviation of 1).

The previous month's signal is shown as a hollow shape when there is a greater than five-point change to the current month's signal.

For a given signal, we scale from 1% to 100% using a Standard Normal Density Function (mean of 0 and standard deviation of 1).

## LEGEND

Please see next page for important disclosures.

	Q2	Q3
Momentum (12 month)	○→	○
Fundamental model	○→	○
OAS comparisons	○→	○
Long-term mean reversion	◇→	◇
P/E comparisons	□→	□
Probit model	□→	□
Yield comparisons	△→	△
Statistical valuation	△→	△
FED model	△→	△
<b>AVERAGE SIGNAL</b>		●

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

#### IMPORTANT INFORMATION FOR LEGEND ON PREVIOUS PAGE:

Enhanced Asset Allocation (EAA) is a capability that builds on Strategic Asset Allocation (SAA) by incorporating views from Russell's 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 idea behind EAA is simple. On occasion markets can move to extremes of pessimism or optimism. EAA aims to take advantage of extreme asset class movements to provide investors with a unique source of potential incremental return. This information can be used to temporarily adjust or "tilt" a portfolio from its long-term SAA. It's based on the belief that markets are not fully efficient and may be occasionally mispriced. Tilts are expressed as over- or under weights of the asset classes available, relative to their SAA weights.

#### IMPORTANT INFORMATION FOR GRAPHIC ON PREVIOUS PAGE:

Asset class valuation models aim to identify relative mispricing of asset classes. These models are based on the assumption that the long-term historical relationships between asset classes will continue. If those relationships change, the model may identify a mispricing opportunity when in fact there is a structural shift in the long-term relationship.

The Strategists' Barometer aims to forecast shorter-term asset class returns. It is a theoretical model, not a fund or a strategy, and its allocations vary around a broader spectrum than might be practical to routinely implement once frictional costs (such as trading commissions, taxes, expenses associated with hiring and firing money managers, etc.) come into consideration. The Barometer is a viewpoint on the relative value of each asset class in comparison to its long-term historical (or "normal") valuation. It is not intended to be a trading strategy. When the model indicates that the value of an asset class has deviated unusually from its norm, it seeks to increase, or decrease, exposure to it.

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.

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The views in this barometer 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.

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-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, repurchase and reverse repurchase transaction 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.

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 Russell Global Index measures the performance of the global equity market based on all investable equity securities. The index includes approximately 10,000 securities in 63 countries and covers 98% of the investable global market. All securities in the Russell Global Index are classified according to size, region, country, and sector, as a result the Index can be segmented into more than 300 distinct benchmarks.

The Russell Japan Index measures the performance of the Japanese equity market represented in the Russell Global Index based on all investable equity securities.

The Russell Europe Index measures the performance of the equity markets across Europe represented in the Russell Global Index based on all investable equity securities.

The Russell Emerging Markets Index measures the performance of the Emerging Markets segment of the Russell Global Index based on all investable equity securities.

The Barclays Capital Aggregate Bond Index is a broad base index, maintained by Barclays Capital, which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States. Index funds and exchange-traded funds are available that track this bond index.

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