



Russell Research

Market Outlook

Green Shoots vs. Dead Cats

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Europe, Middle East and Africa

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Executive summary

- We maintain our positive view on global equities versus bonds. The current Outlook discusses whether or not the rally that equity markets have posted since March 9 is indeed *the* rally that will bring us unequivocally out of the bear market and towards a generally strong year-over-year equity performance by year end. We contrast this hypothesis against the alternative view that the current rally will reverse and ultimately be seen as a “dead cat bounce” or a false dawn. We conclude that whatever happens over the next few months, our view remains that global stocks will end the year with higher valuations than when they started it. Those valuations could rise inexorably from here or there could be another brief set-back or two. Nonetheless, no matter how smooth the journey, we believe the year will end in positive territory.
- Since November 2008, we have been telling our readers that our baseline scenario is a series of steps forward followed by some reversals. Market activity since then has confirmed this belief. The next few months may very well replicate this behaviour. Yet the massive policy stimulus, cheap markets and eventual bottoming of the global economy sometime around Q4 of this year or Q1 of next will conspire to eventually bring markets higher.
- We acknowledge that both interpretations of the current rally– the beginning of the end of the bear market or merely just one of several “dead cat bounces”– have merit. However we assert that it is not important which, if either, of the two alternatives is more likely. In either case, our longer term view remains that at some point in 2009 we will see the end of the bear market.
- Regionally, we think the US will lead this trend and thus our strongest preference is for this market. On the other hand, Europe is lagging in both the assertiveness of its policy response and the cyclical adjustment that corresponds to a deep global recession. We reverse course on Japan; while it had been relatively exceptionally cheap, its solid performance over the last six months has closed the valuation gap.
- While the arguments in favour of global government bonds is underscored by the quantitative easing undertaken by the US Federal Reserve, the Bank of England and other central banks around the world, we feel that this action will be more than offset by the massive amounts of supply that will come on line during 2009 as a result of the massive fiscal stimulus committed to by governments. Instead we prefer to focus on fixed income opportunities in credit, both high yield, and most emphatically in investment grade corporates.

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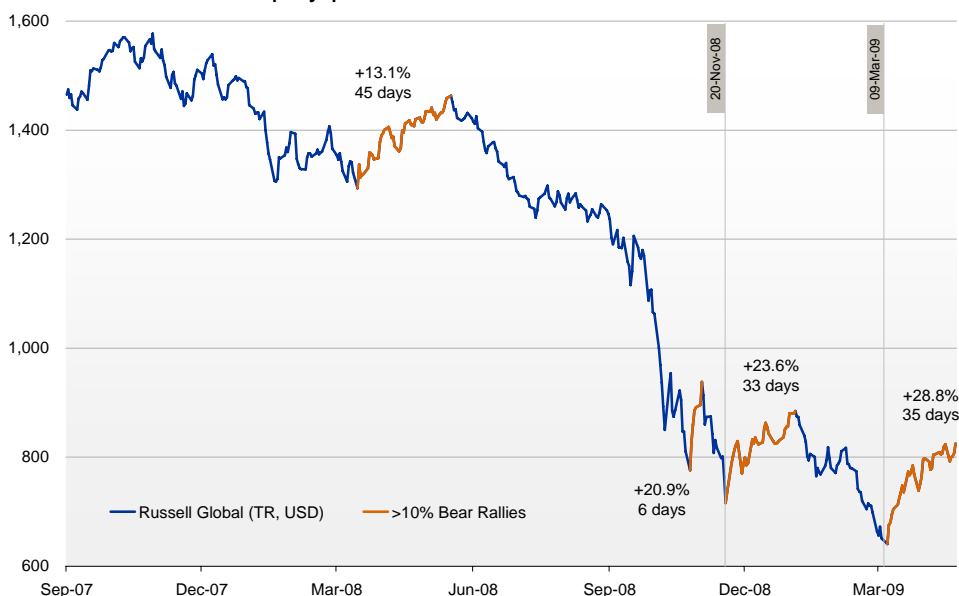
Market review and outlook

Back in November of last year, the Outlook first advanced a “positive” view on global equities versus bonds. We reiterated this view in our January Outlook. Since late last year – looking back this was probably the moment when sentiment was at a nadir and news flow was uniformly negative – we have felt that by the end of 2009, the market would be higher. Despite our positive rating on global equities, we consistently pointed out that we expected the path to a positive 2009 by year-end would be fraught with set-backs, pauses and false dawns, especially in the first half of the year. Hardly a steady ascent at first, but sometime around mid-year, a clear trend will emerge.

Sure enough, the period from early November through early January saw some stability in risky assets, even creating the impression that perhaps markets were already out of the woods. Yet from around mid-January through early March, our confidence was tested and our view challenged. Nevertheless, painful and gloomy as that period was, it was not a surprise to us. This was precisely the sort of several-steps-forward-several-steps-backward action we expected.

So now, at the end of April, we find ourselves looking at an equity market rally that has seen markets rise more than 25% since March 9. Today we find ourselves asking if this 7 week trend is the start of *the* rally that removes us permanently from the clutches of the bear and drives us headlong into the next great bull run, or if this period merely reflects another one of the several bear market rallies that we have already seen in the past 18 months. Put into the clichéd jargon of the times, are we seeing “green shoots” of recovery or merely a “dead cat bounce”?

FIGURE 1: Global equity performance



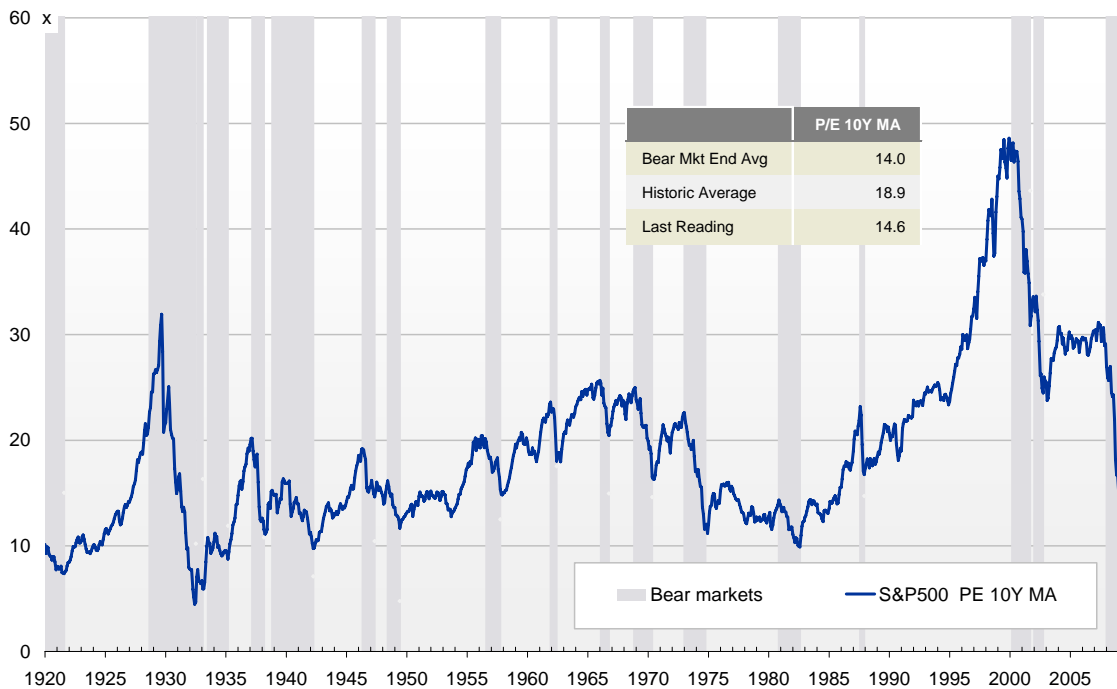
SOURCE: Russell Global Developed Large Cap Index as of 24-Apr-09

Valid arguments for both views exist, but the answer is probably “neither.” We would not be surprised to see a reversal in the weeks or months to come and yet another brief period of negative performance. That would be entirely in line with our (now six month old) view that the short term outlook remains murky and will be challenging. We will (and have) see(n) periods of strong equity market performance leading to reversals. Looking at the fundamentals we reiterate our view that for those with the stomach to ride out these expected ups and downs, there will be a rally that kicks off in 2009. So to the debate of “green shoots” versus “dead cats” we add a third scenario – “either, neither, both.”

Let us first consider the arguments of the bulls, or the “green shooters,” if you will.

- Valuations are low. We don't like using simple price earnings (PE) ratios, with either trailing earnings or forecasted consensus earnings in the denominator of the ratio. The former do not reflect broader cyclical considerations nor are we sure what the accountants and CFOs of the reporting companies consider to be earnings. The latter is subject to slow-moving analyst forecasts and their persistent upward bias. We prefer to use a ten-year trailing average of earnings on the bottom of the fraction. This method, simple as it is, has the advantage of smoothing cyclical fluctuations, washing out accounting trends and gives us a better idea relative to history where we are in valuations. By this measure, the current US PE is between 14x and 15x. (We use the US because we have the benefit of a nearly 150 year history of data, allowing us to be rigorous and robust in our historical comparisons). The average bear market of the twentieth century ended when PEs were 14x. Granted, compared to the four worst bear markets since the Great Depression, markets are still a touch more expensive, but we are clearly in the range that suggests equity prices have nearly fully adjusted and the next major move will be up.

Figure 2: S&P500 long term P/E measures



NOTES: S&P 500 P/E, monthly, last reading as of 31-Mar-09. Chart shows PE based on a 120-month average of trailing EPS.
SOURCE: Russell Calculations, Shiller Database until Jan-08, Bloomberg subsequent as of 31-Mar-09

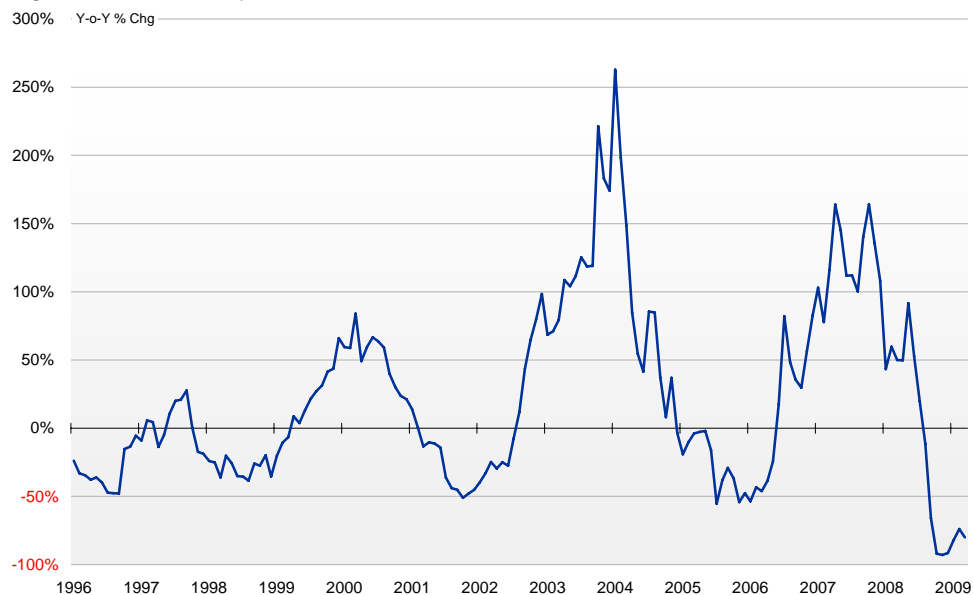
- Sector leadership is favourable. During the bear market, the sectors that were the best (or least bad) performers were classical defensives: health care, consumer staples and utilities. These are sectors that have much steadier earnings streams and can still generate profits even in the throes of a deep recession. In the current rally, sector leadership was provided by those sectors that tend to lead markets into eventual economic strength: consumer discretionary sectors, certain industrials, even materials and energy. This is the pattern we like to see – indeed need to see – when coming out of market and economic downturns.
- Policy measures are massive. Government spending, quantitative easing, banking rescue plans, homeowner and jobless assistance, infrastructure investment. On a number of fronts, the leaders of the major economies have responded to the crisis, and in a significant fashion. We will not go into numbing detail here to describe the myriad policy actions and their sizes. Suffice to say, government response has been quick, massive and broad. Some measures have

been accompanied by poor communication and/or risk potential long term negative side affects. Some may not even work as intended. But however haphazard these initiatives have been, they are undeniably significant in their scale and scope, and will have an effect.

On the other hand, the “dead catters,” if you will (this metaphor, common for years in market chatter comes from the gruesome truth that when dropped from an appreciable height, even a dead cat will bounce once or twice before it eventually settles into its final resting position) have some strong arguments on their side.

- The global economy is undeniably weak. The IMF reports that 2009 will be the first year in the past 60 in which global economic growth is negative. The credit crunch has propagated a massive global recession which shows no signs of abating anytime soon. There is a discussion that the rate of decline in economic statistics around the world has slowed somewhat but that the necessary reacceleration is still far off. In figure 3 below we plot the year-over-year change in the Baltic Dry Index, a measure of the demand for international shipping. It is a widely-accepted proxy for international trade and as can be seen, it has been hovering near its fastest rate of decline in over a decade.

Figure 3: Baltic Dry Index

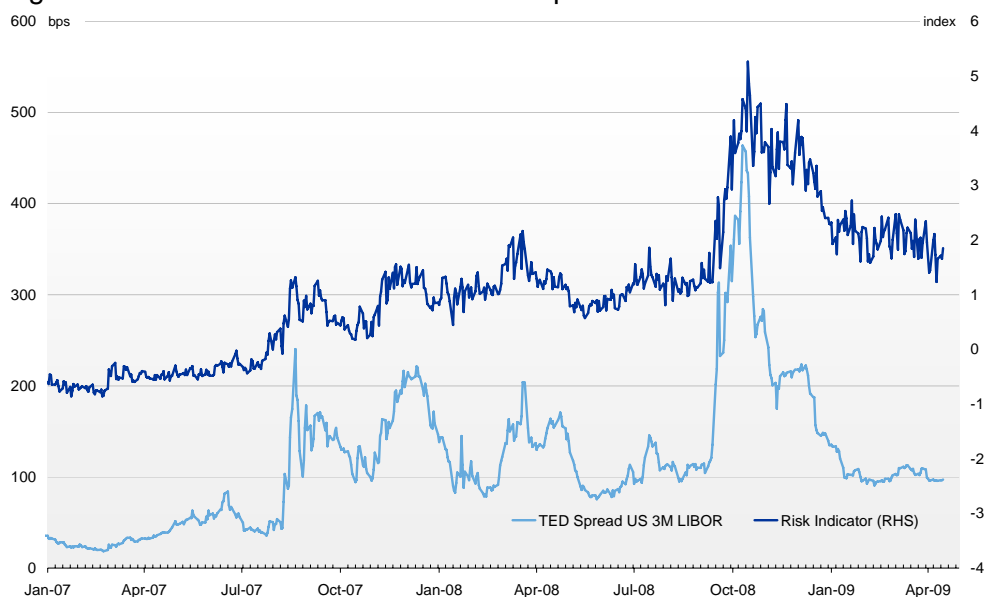


NOTES: The Baltic Dry Index measures the price of transport for major raw materials by sea. Taking in 26 shipping routes measured on a timecharter and voyage basis, the index covers Handymax, Panamax, and Capesize dry bulk carriers carrying a range of commodities including coal, iron ore and grain. Y-o-Y percentage change in index shown.

SOURCE: Russell Calculations, Bloomberg as of 14-Apr-09

- Earnings will be depressed for a long time. The bears contend that in such an economic environment, corporate earnings will be exceptionally weak for the balance of 2009 and the market has not got its head around that fact. Indeed, analysts still forecast rates of growth (or in some cases rates of decline) that baffle logic in their optimism.
- Risk aversion and volatility are still high. The prerequisite for a sustainable upturn in markets is the willingness of investors to buy risk again. Banks making loans, investors buying shares, corporations investing in their business. All of these actions, necessary to get the economy and markets going again, are constrained by investors' timidity and the presence of high volatility in markets. Indicators suggest that while lower, risk aversion is not nearly at the levels we have seen in the past when markets were strong. This is confirmed by other forward-looking market volatility indicators. It is hard to be unconditionally bullish when these sorts of measures of risk are still quite high.

Figure 4: Russell Risk Indicator and Ted Spread



NOTES: Russell Risk index is a combination of: US two year SWAP spreads over generic US govt 2-year yields, BarCap HY versus IG spreads, Def vs Cyc (Mcap weighted average of MSCI-W Cons. Staples, Health Care and Utilities versus MCap weighted average of MSCI-W Consumer, Discretionary and Finance), rolling 3 month forward federal funds futures contracts, Moody's BBB - US Gov 10 year spreads, Ted Spread USD 3M LIBOR, VDAX, VIX. SOURCE: Russell Calculations, Bloomberg as of 15-Apr-2009

- Banks aren't lending While no more Lehmans seem to be lurking, the sad fact is that credit growth is still anaemic, despite multiple nudges from the central banks in the form of lower rates, support lines, asset guarantees and now the “printing” of money via quantitative easing. A look at bank balance sheets shows that a huge percentage of their assets are tied up in home loans, consumer credit and other agency-backed securities, all of which are still seen as being of dubious quality.

We acknowledge that the arguments on both sides of the Green Shoots versus Dead Cats debate are valid, statistically verifiable and founded upon solid understanding of economics and markets. So, we refrain from making an unequivocal call on whether March 9 represented the bottom of the slump. Nor will we conclude that we may visit market lows that are lower than those of March 9. While it is an interesting question, we tip our cap to our US-based colleagues and unashamedly steal from them one of their recent quotes: “While this is an interesting question, it is not really an important one.” We continue to argue – and the events of the past six months confirm that we have been right to do so – that the market is now in the process of wrestling with the issues enumerated above. The green shooters and the dead catters have joined one another in battle, if you will.

It is entirely possible that over the next few months the bears' arguments will win the day temporarily and the market will once again decline. Yet we still believe that these negative arguments, while valid, will eventually become less important and that some of the issues inherent in such a negative view may be resolved favourably. In a year's time, we firmly believe that we will be able to point to a date earlier in the year and say that that was the day *the* rally kicked off. It may be March 9, it may be some day after that. It is indeed interesting, but not important, and we will see the markets higher at the end of the year.

Investment conclusions

GLOBAL EQUITIES/BONDS

Global equities have been on a roll since March 9, up over 25% in the period. In fact, you could argue that with the exception of a really brutal January-February this year, equities have shown impressive strength since November, posting 12 positive weeks and 10 negative weeks (six of which occurred during that ugly January-February period). Questions abound as to whether or not the current rally is *the* rally that heralds the end of the bear market or just another “dead cat bounce”, only to be reversed sometime in the next few months. In our opinion the answer to that question, while interesting, is not as important as our belief (held since November of 2008) that by the end of 2009 we will look back on a year in which global stocks’ performance was positive. We acknowledge the risk of a set-back. (See the argument of the “dead cats” above.) Yet the “green shoot” case has some strong arguments on its side as well. At this point we come down to an assessment of investment risk. We feel that over the course of the rest of the year, there is a higher probability of the market being higher by year-end than when it started. Whether or not it will ascend inexorably so from this point onward, we cannot say – although we would be surprised if this were the case. Still the risk of being out of the market runs the risk of missing that eventually sustainable upturn.

REGIONAL EQUITY

The US represents nearly 45% of global market capitalization and is doing the heaviest lifting on the policy front. It was the first region to enter the morass nearly two years ago and we believe it will be the first to exit it. Elsewhere, we admit that our view on Emerging Markets (negative last quarter) hurt us, as this region has posted great gains so far this year. We move to “neutral” from “negative” here, and also begin to favour the Asia Pacific region. Japan, where we have been positive since May of last year, had a good last six months and we feel that the valuation argument that had been so strongly in its favour has diminished and we now favour other regions more.

FIXED INCOME

We remain neutral on duration, which reflects a healthy appetite for investment grade and high yield credit offset by a negative view on US Treasuries. While the quantitative easing package announced by the Fed should be a positive force, in magnitude, the central bank’s commitment to purchase \$300 billion in US Treasuries will be more than offset by the issuance required to fund an ever ever-widening deficit.

Market ratings summary

GLOBAL ASSET ALLOCATION ¹ (N.B.: ** indicates a change in recommendation from previous quarter)		
Stocks versus Bonds	<ul style="list-style-type: none"> While still behind, equities are catching up with global bond performance. Current rally may be the rally, but we acknowledge that one or two down legs might still be in the offing. Valuations are low, appetite for risk is slowly increasing and consensus is that economic growth will return by the end of this year or beginning of next. The case for global fixed income is offset by the likely wave of new supply for the rest of the year. 	Positive (Positive)
EQUITY ²		
US	<ul style="list-style-type: none"> US should lead the global market recovery. Policy stimulus is huge and cyclical adjustment is more advanced. 	Strong Positive* (Positive)
UK	<ul style="list-style-type: none"> Low-beta play, defensive market. Should perform in line with global equities as it usually does. 	Neutral (Neutral)
Euro(Ex-UK)	<ul style="list-style-type: none"> Lack of policy cohesion, severe recessionary strain in absence of strong government response and gearing to global growth will likely continue to hurt Europe. 	Negative (Negative)
Japan	<ul style="list-style-type: none"> Valuation gap with the rest of the world has closed. Very strong last six months justified positive stance at the time, but it is now time to close this position. 	Negative* (Positive)
APAC (Ex Japan)	<ul style="list-style-type: none"> Low valuations and global reflation will benefit the region. 	Positive* (Neutral)
Emerging Markets	<ul style="list-style-type: none"> A big miss on our part last quarter as emerging markets raced ahead. Balance of positive and negative arguments lead us to close our losses and stay neutral. 	Neutral* (Negative)
BONDS ³		
Cash	<ul style="list-style-type: none"> The slump in global economic growth and steeper yield curves have made bonds more attractive. That should be balanced against the wave of bond supply that is on the horizon. We stay neutral. 	Neutral (Neutral)
US	<ul style="list-style-type: none"> The greatest fiscal impulse among the G4 economies and quantitative easing – although supportive in the short run – set the Treasury market up for higher yields sometime over the next twelve months. 	Negative (Negative)
UK	<ul style="list-style-type: none"> The asset purchase programme of the Bank of England allows for gilt purchases of at least £100bn. In relative terms and compared to a borrowing requirement of £175bn, UK quantitative easing is bigger than in the US, which could support the gilt market in the short term. 	Positive* (Neutral)
Euro	<ul style="list-style-type: none"> Reluctance on the part of the German government to engage in further fiscal stimulus should be beneficial to Euro government bonds. Sovereign spreads to German Bunds are also high and could decline if markets abandon the idea of a European Monetary Union break-up. 	Positive (Positive)
Japan	<ul style="list-style-type: none"> Still the lowest nominal yields in the G4. The Japanese curve is steep but so are the others now. New fiscal stimulus will swell already bloated public debt further. 	Negative* (Neutral)
CREDIT ⁴		
Inv Grade Corporate	<ul style="list-style-type: none"> Spreads have declined less than in high yield and emerging market debt since the last Market Outlook. Doubts over financial bonds are still weighing on the investment grade sector. With continued government commitment to bank debt, we remain strongly positive. 	Strong Positive (Strong Positive)
High Yield	<ul style="list-style-type: none"> A decent rally has pushed excess returns of the high yield sector vs. government bonds close to double digits for the calendar year. We retain our positive view based on easing financial conditions, although valuations are not as favourable as for investment grade. 	Positive (Positive)
Emerging Market Debt	<ul style="list-style-type: none"> Emerging market debt has strongly outperformed government bonds and other credit sectors since last October. Although we see less downside risk due to policy actions in the Emerging Markets and International Monetary Fund support, we also are reluctant to jump in after such a strong run. 	Neutral (Neutral)
CURRENCIES ⁵		
EUR	<ul style="list-style-type: none"> The Euro was basically flat against the US dollar over the period under review. Being slightly less expansionary with regard to monetary policy could work in favour of the Euro but risks from exposure to Central and Eastern Europe are likely to weigh on the single currency. 	No View
GBP	<ul style="list-style-type: none"> Also nearly unchanged against the US dollar compared to last Market Outlook. Housing market shows some signs of stabilization and valuations have moved closer to purchasing power parity values. 	No View
JPY	<ul style="list-style-type: none"> The Yen reversed some of the outperformance recorded in H2 2008 as risk aversion abated and the Japanese economy appeared to be hit harder by the slowdown than the US or Europe. 	No View

Ratings sheet explanations

EXPLANATIONS

Russell EMEA's Market Attractiveness Ratings are indicative of each asset class's relative attractiveness (and hence recommended weight in a representative portfolio) over a twelve-month investment horizon.

Market Attractiveness Ratings are decided upon by the Russell EMEA Market Outlook Committee, which is composed of senior Russell investment professionals in the EMEA region and globally. Inputs used by the Market Outlook Committee consist of a combination of quantitative and qualitative inputs provided by Russell's Global Investment team.

For more information on methodology, definitions and investment implications, please contact your relationship manager.

Notes

General: The Market Attractiveness Ratings on the previous page do not refer to a pre-specified model portfolio or specific investor portfolio, risk budget or investment guidelines.

(1) Global Asset Allocation refers to the recommended relative attractiveness of global equities and bonds.

(2) Equity relative ratings reflect relative attractiveness of each region's equity market within a global equity benchmark. All regional equity weightings are in local currency (i.e. USA in USD, Europe ex-UK in EUR, UK in GBP, Japan in JPY, APAC ex Japan in USD and Emerging Markets in USD) relative to a hedged global equity index.

(3) Bond relative ratings refer to relative regional duration weighting in a global bond portfolio.

(4) Market Attractiveness ratings for Investment Grade, High Yield, and Emerging Market Debt are relative to developed market long duration treasuries.

(5) At present Russell has no formal currency views, although we do maintain and monitor a range of models and indicators. Contact your client services representative to discuss currency hedging policies.

(6) Cash is considered a portion of a global fixed income benchmark, and its Market Attractiveness Rating reflects the Market Outlook Committee's overall duration view. For example, a positive (negative) Rating for cash implies an overall short (long) duration preference within fixed income, independent of currency considerations.

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