



Russell Research

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# Market Outlook

## Widening Risks

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John Velis, Head of Capital Markets Research

Europe, Middle East and Africa

August 2009

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# Executive summary

- For the first time since November of last year, we are no longer positive on global equities versus bonds. We have downgraded to neutral. This is not because we think that the outlook has deteriorated. Instead, we question whether after such a remarkable run of performance, there remain catalysts as yet not priced into markets that can bring the market higher still. We conclude that while there are a number of factors to consider, the defining characteristic of the current market is uncertainty.
- We note that on a host of important topics, the range of conceivable outcomes is unusually large, from very good to very bad. The opinions and forecasts of credible and insightful commentators are notably dispersed at the moment. This lack of consensus means markets must factor in higher than normal risk premia, which translates into prices that do not necessarily rise rapidly. Under such conditions, we feel it is not responsible to take a strong directional view on the markets, and advise investors to stick to their benchmarks.
- Regionally, we still think the US offers the least uncertain outlook. The recovery, while halting and likely somewhat muted, is underway and valuations are still relatively attractive. Given this uncertainty, we reduce our recommendation from “Strong Positive” to “Positive”. The UK and Europe do not offer the same inducements, either from the macroeconomic or valuation perspectives. We think that Asia (ex Japan) is cheap and well-gearred to a global recovery, while emerging market prices probably already reflect their own improving fundamentals. Japan is under severe macroeconomic stress and no longer cheap.
- Credit is still a place where we like the combination of value, improving fundamentals and cyclical gearing. We scale back our recommendation on investment grade credit from “Strong Positive” to “Positive” and we go “Positive” on emerging market debt. This latter advice is driven by a combination of global monetary liquidity and cyclical considerations. With these economies leading the recovery, improving local fundamentals combined with increased money supply everywhere should propel valuations higher.

July 2009



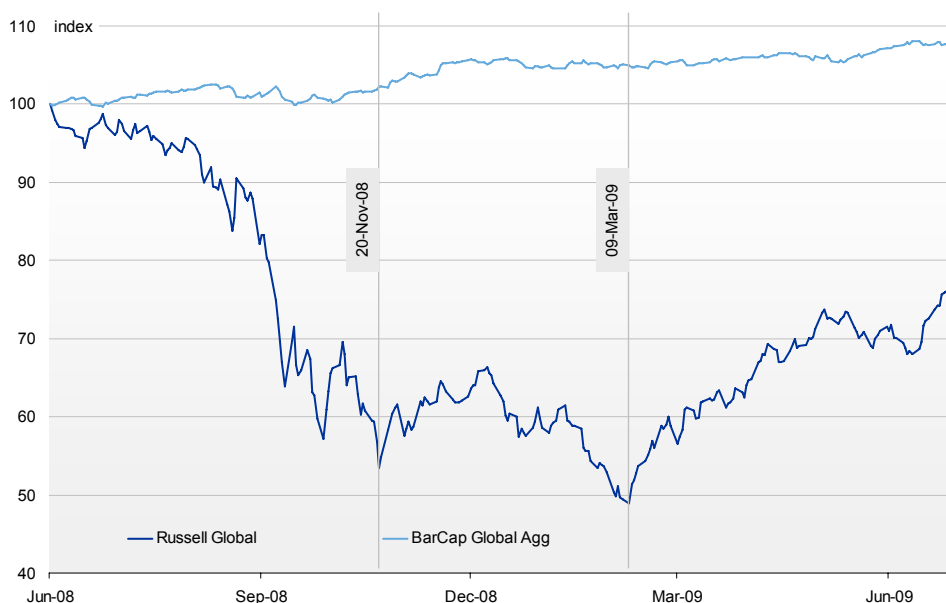
**John Velis**  
Head of Capital  
Markets Research,  
EMEA

# Market review and outlook

It has now been three quarters since we have formally held a “Positive” view on global equities versus fixed income. Since November 2008, when this position was advanced, we have seen global equities up over 15%<sup>1</sup> while the BarCap Global Aggregate Bond index has returned just over 7%<sup>2</sup>. Since the March 9th low, the two indices have posted returns of over 50% and just under 8% respectively. Nevertheless, the ride up has not been smooth or one way. January, February and more recently June of this year were difficult months for stock market bulls. We have also been warning about this saw-toothed nature of the rally the whole time we were positive on equities.

*An investor who timed the market rally correctly would have posted a career-defining performance since March 9th. We ask: what could drive markets higher still?*

Figure 1: 12 month global equity and bond performance



NOTES: Russell Global, TR, USD & BarCap GlobalAgg, TR, USD, Hgd, 30-Jun-08=100  
SOURCE: Bloomberg, FactSet

Any investor who timed entry in the markets perfectly would have posted a career-defining stretch of performance. If we consider March 9<sup>th</sup> as the beginning of the equity market rally, we witnessed what would be an excellent year's worth of performance in a mere four months.

We now ask whether a period of selective retrenchment is prudent. We question what could drive valuations higher still? Certainly, the realisation that the recession will end some time this year (or early next year at the latest) is now fully taken on board by the consensus. We have seen global and individual country economic indicators all over the world off their lows, so there is little chance for a positive surprise on the macroeconomic front. For the moment, and perhaps for good, governments and central banks have no more policy bullets to shoot at their economies, and valuations are plain for all to see. Indeed, the lacklustre performance of markets in the month of June could

<sup>1</sup> Russell Global, Index Total Return, USD. Source: Russell, FactSet

<sup>2</sup> Total Return, Hedged in USD. Source: Bloomberg

be chalked up to the fact that there seemed to be no more promising new news coming through to take markets ever higher.

What about corporate earnings? The Q2 earnings season in the United States is providing us with some cheer – at least on the surface. Although earnings are still sharply down over the same period last year, they are less depressed than we had anticipated. At this writing (nearly halfway through the season), more firms are outpacing predictions than registering disappointments by a ratio of over 3:1. We suspect that this is largely the reason behind the strong July performance in markets we have seen so far. However, we highlight that the majority of positive earnings surprises have been driven by heavy cost cutting: shedding labour and curtailing capital investment. While this helps boost quarterly earnings, the fact that total sales figures are not providing us with the same positive surprises that earnings are is potentially worrying. We would expect that unless this trend is reversed in the subsequent few quarters, equity market momentum derived from better-than-expected (or less worse than feared) earnings growth primarily driven by shedding costs, will be hard to sustain.

*Quarter two earnings season in the US has filled investors with cheer so far, but earning growth driven primarily by cost shedding is hard to sustain going forward.*

Figure 2: S&P500 EPS and sales, actual and deviation from consensus

	S&P500	Growth (% Chg YoY)	Number of surprises		Size of surprise
			Pos	Neg	
<b>Q2 2009</b>	<b>Earnings</b>	-31.2%	334	159	7.1%
	<b>Sales</b>	-11.5%	191	300	0.4%
<b>Current</b>	<b>Earnings</b>	-29.5%	184	59	10.7%
	<b>Sales</b>	-11.4%	123	122	0.3%

NOTES: Growth indicates YoY % change in earnings and sales; number of surprises indicates number of companies reporting above (Pos) and below (Neg) analysts' expectations/consensus; size of surprise indicates by what margin reported figures differed from the consensus; Q209: 07-Apr-09 to 07-Jul-09, Current: 08-Jul-09 to 06-Oct-09

SOURCE: Bloomberg Earnings Season Analysis

So where does this leave us? To answer this question, we find ourselves resisting the urge to delve into the arcane and slightly scary world of statistics and probability. We nonetheless ask the readers' indulgence in following our thinking. What we have witnessed in the last 24 months has been truly unprecedented. While some commentators justly deserve praise for foreseeing the crisis, nearly no one was able to comprehensively and precisely describe the nature and extent of the fallout, policy response or market reaction. How then, can we expect anyone to forecast the same and similar factors over the next two years with any precision?

Questions about the range of forecasts around important market and economic variables are huge. We acknowledge that credible arguments can be made for a variety of extreme – and opposite – outcomes over the next few years. Additionally the variables around which these wider-than-normal forecast ranges are present are those factors which are important for determining market direction. A (non-exhaustive) listing of these variables includes questions around inflation versus deflation, the strength and timing of the recovery in corporate earnings, the strength of economic recovery that eventually does ensue, the future of the banks, how onerous regulation will become in light of market failures in the last two years, the fate of fiat currencies, the strength of commodity prices, how long the global property bust will last, etc. These questions throw up uncertainty which is translated into risk. When risk is pervasive, risk premia must rise which in turn means valuations cannot expand rapidly.

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Jokes about economists are legion. It is probably the only profession that can rival lawyers in terms of the number of – and quality of – zingers that have been launched its way. One classic chestnut suggests that Economics is the only discipline in which a Nobel prize can be awarded to two people who say precisely the opposite things on the same topic. Well, never has this joke rung truer than now. Highly regarded economists can present theoretically sound and empirically persuasive arguments on any number of important questions today with wildly different conclusions.

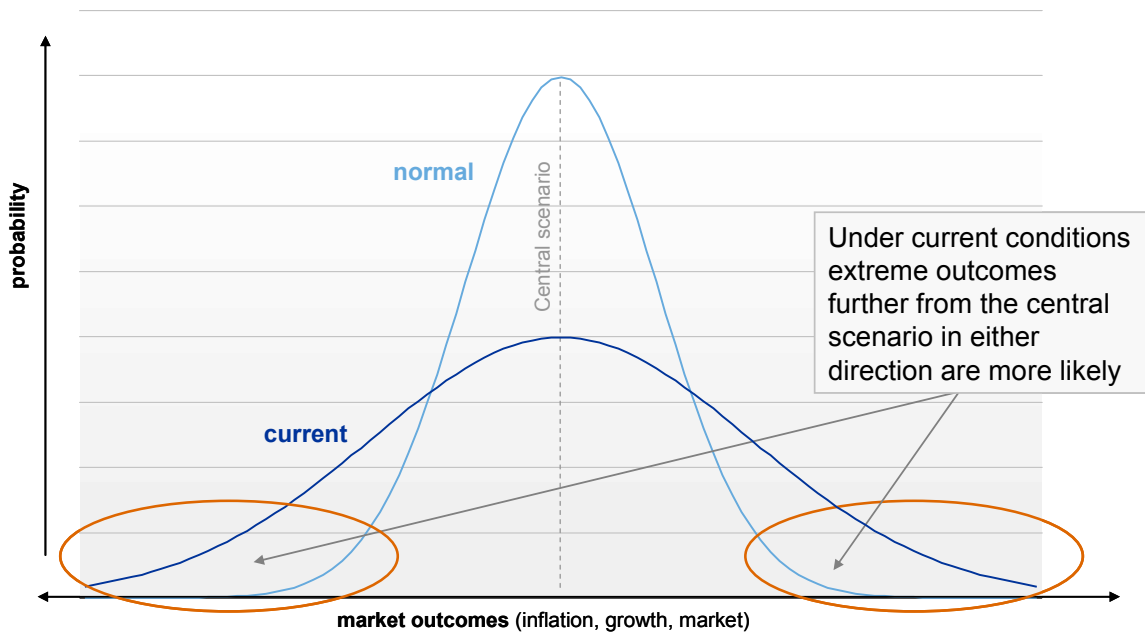
To develop a timely and topical example, take the inflation outlook. This is understandably an important question at present. Are we in the throes of global deflation, brought about by collapsing aggregate demand and balance sheet repair post-credit bubble? Or will the aggressive policy response, massive expansion of central bank liabilities combined with political pressure to inflate away government debt lead, not to mention an insatiable Chinese demand for commodities lead to a period of higher than normal inflation? The Russell view is that the second half of 2009 will remain a battle against deflation, and while 2010 and beyond presents some risks on the inflation front, we feel that central banks can manage a wind-down of balance sheets and shrinkage of the money supply without provoking inflation or creating an economic downdraft. Nevertheless, amongst commentators, there has been significant discussion around this and we acknowledge that one does not have to be a fringe economist to advance a contrary view. In short, put 100 economists in a room, ask them this question and instead of a black or white answer, one would probably get 300 different shades of grey, with most of them not implausible.

And that is just inflation. Take any of a half dozen or more critical questions, ones which are crucial to forming a high-conviction economic and market view over the next 12 months, and the number and permutations of outcomes expands. It is not just the disparate views themselves, but also the sheer scale of the difference in the outcomes on either extreme. Again, let us consider the example of inflation. Not too many years ago, differences in inflation forecasts were minor. A central scenario of 2% or 2.5% per year might be bracketed by a “high” scenario of say 3%. On the downside, perhaps 1.0% represented the lower bound of reasonable forecasts. In 2009-2010, it is not crazy to see forecasts by reputable economists between 3.5% and -1.5%. The view of other credible commentators are more extreme than that!

Markets valuations price in forecasts of the future. Huge variation exists between the best and worst case scenarios, and neither the good nor bad outcomes are outlandishly unlikely. It's not surprising then that the market cannot currently settle upon one central scenario and an identifiable equilibrium trajectory be realised. This being the case it seems sensible for investors to take a breather for a while, let some of the fuzziness on the horizon dissipate and wait for a plausible baseline scenario to assert itself.

*Under the current climate in which forecasts show such a wide range of outcomes, it strikes us as ambitious to expect the market to be able to settle upon one central scenario and for an identifiable trajectory to be realised.*

Figure 3: Widening Risks

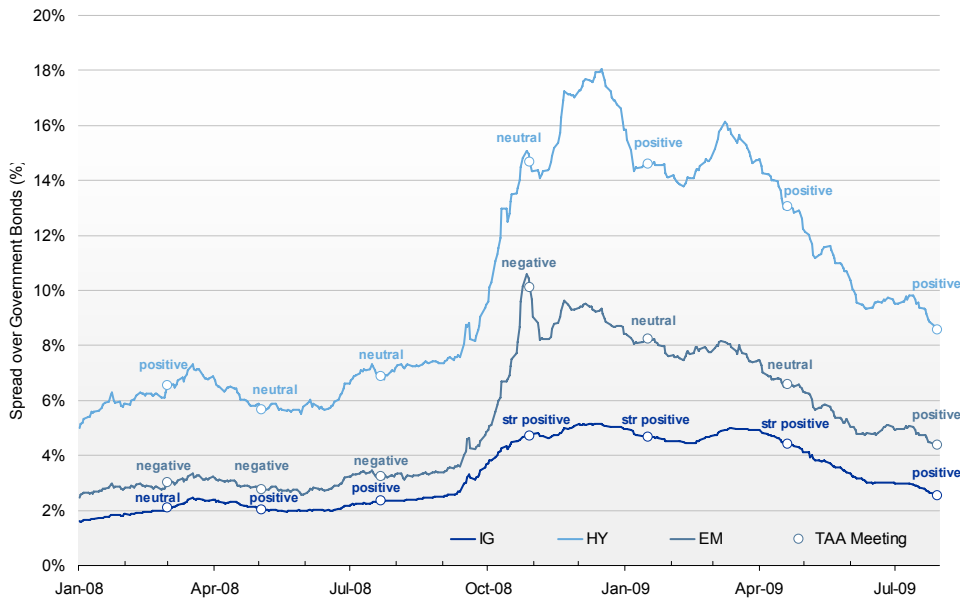


NOTES: For illustrative purposes only

In fixed income, the 1.7%<sup>3</sup> total return of the Barcap Global Aggregate Index since our April 2009 Market Outlook masks a number of noteworthy and disparate market developments. Credit outperformed government debt by a massive margin. Both our “Strong Positive” recommendation on Investment Grade Corporates and our “Positive” on High Yield paid off, with the asset classes delivering excess returns against duration-matched government bonds of around 10% and 20% respectively. In hindsight, we should have been more bullish on Emerging Market Debt as well as it continued its strong run and outpaced developed market government bonds by 12% over the quarter. A normalisation of bank funding markets, a return of risk appetite and a stabilisation in economic data drove the extraordinary returns. It is hard to believe that the pace of credit outperformance will continue as the illiquidity premiums of higher-risk asset classes have been largely priced out and valuations have moved a long way towards fair value. Cyclical factors, however, still favour a continuation of the upbeat tone to credit markets. The return of the TED spread to pre-Lehman levels points to much reduced funding market strains, lending standards on both sides of the Atlantic are becoming less restrictive and the steep government yield curves point to stimulative monetary policy and a pick-up in economic growth over the next year. Taking into account the strong rally we enjoyed, we rein in our recommendation on Investment Grade Corporates to “Positive” from “Strong Positive”, but leave High Yield on “Positive”. With emerging market economies seemingly leading rather than following advanced nations during the current recovery, we lift Emerging Market Debt from Neutral to Positive, but wish we had done so sooner.

<sup>3</sup> Total return, hedged in USD. Source: Bloomberg

Figure 4: IG, HY and EMD spreads



NOTES: Chart shows BarCap Global Agg Corporate (IG), global high yield (HY) and global emerging markets (EM) average option adjusted spreads (OAS) over government bonds.  
SOURCE: Bloomberg

Returns on government debt were less exciting and highly divergent. While US Treasuries and UK Gilts sold off over the quarter, Japanese government bonds (JGBs) advanced and spreads between different countries' debt tightened significantly in Continental Europe, providing a boost to the lower-rated issuers. Our models have recently pointed to better expected returns on government debt on the back of a continued steepening in yield curves and a high real yield premium. Against that, the threat of new supply is still looming large and we therefore maintain our overall "Neutral" stance on cash versus bonds. Within the regions, we remain "Negative" on US government debt, a stance which was well rewarded last quarter. We also remain "Negative" on Japanese bonds and "Positive" on UK Gilts, two calls that did not go in our favour recently. While the UK curve has steepened further, the rally in JGBs has led to a flattening of the term structure there and rendered Japanese debt even less attractive.

*The threat of new supply of government debt is still looming large and we therefore maintain our overall "Neutral" stance on cash versus bonds.*

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# Investment conclusions

## Global equities/bonds

Superior performance in global equities relative to bonds in the last four months has made us wonder if we saw a year's worth of performance in one third of the time. Certainly an increase of over 50% since March 9th in global markets<sup>4</sup> would suggest a reassessment is in order. To that end, we have taken an inventory of indicators and asked ourselves: what new stories can we confidently cite as evidence of why we remain bullish? While there are some good things that can indeed happen, we also feel that the range of risks around those positive stories is as wide as it has ever been. In short, pick a variable point of interest about which you would like to have some clarity over the short- to medium-term, and you can come up with credible forecasts well to the right or to the left of the central scenario. Furthermore, this uncertainty is likely to take a while to dissipate before markets and investors settle on a more narrow set of probable outcomes. Hence, given the fact that (1) we have come very far, very fast in markets, (2) there is not much new good news at the moment to bring us further, and (3) the range of conceivable outcomes is so broad, we counsel some caution and express no preference between fixed income and equities. Note: this does not mean that we recommend investors stay out of the market, just to be neutral. If the market does power further on from here, investors will still benefit. If on the other hand the market retreats for a while, they will not be unduly penalised.

## Regional equity

We still favour the US and Asia-Pacific (ex-Japan) at the expense of the UK and Europe. In the latter regions, we feel the domestic macro recovery, while still in process, will lag the US and APAC in both timing and strength. Given that valuations in these two regions are not terribly attractive, we do not think that it is worth buying sub-par growth prospects for little or no discount. The US is still cheap on a relative basis, the cyclical bounce here should be stronger and firms have more room to cut costs. Asia (ex-Japan) offers the most upside for valuations we feel are not extreme.

## Fixed income

We remain neutral on overall fixed income duration. Despite quantitative easing, oncoming supply – particularly in the US – will continue to put pressure on yields. We remain positive on both investment grade credit (less bullish than our previously “Strong Positive” outlook) as well as high yield. Although valuations in the latter asset class are probably fair, quantitative indicators which are based upon variables like the yield curve slope and the corporate financing gap still attract us to this sector. We have also become positive on Emerging Market debt.

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<sup>4</sup> Russell Global Index, Total Returns, USD

# Market ratings summary

GLOBAL ASSET ALLOCATION <sup>1</sup> ( <sup>1-3*</sup> indicates a change in recommendation from previous quarter)		
<b>Stocks versus Bonds</b>	<ul style="list-style-type: none"> <li>A historically strong rally in global equity since March 9<sup>th</sup> has justified our positive view on global equities, held since November of last year.</li> <li>However, we see a very wide range of outcomes for a number of important economic variables and scenarios over the next six to nine months.</li> <li>Given that extreme scenarios – positive or negative – are not entirely unlikely and equally plausible, we feel it is sensible not to make a strong direction bet. Hence we downshift our view to be more cautious.</li> </ul>	<b>Neutral*</b> (Positive)
EQUITY <sup>2</sup>		
<b>US</b>	<ul style="list-style-type: none"> <li>Our “strong positive” on the US from last quarter has been pulled in to a more cautious “positive”.</li> <li>Quantitative indicators as well as valuations, the ability of firms to cut costs to maintain margins and the ever strengthening scent of a cyclical bottom keep us favourable here, just less willing to be too risky.</li> </ul>	<b>Positive*</b> (Str Positive)
<b>UK</b>	<ul style="list-style-type: none"> <li>The UK consumer is undeniably weak, and deflation is threatening to take root. Valuations in the UK are not relatively compelling, nor are corporate fundamentals.</li> </ul>	<b>Negative*</b> (Neutral)
<b>Euro (Ex-UK)</b>	<ul style="list-style-type: none"> <li>While Europe is geared to global growth, and we see a clear bottom forming in global macroeconomic indicators, domestic economic indicators look to remain relatively weak for a while.</li> <li>We also do not see great value in this market.</li> </ul>	<b>Negative</b> (Negative)
<b>Japan</b>	<ul style="list-style-type: none"> <li>Our negative view on Japan, again chalked up to very weak macro data, and the fact that valuations have not gotten materially better lead us to keep our negative bet on Japan in place.</li> </ul>	<b>Negative</b> (Negative)
<b>Asia Pacific (Ex Japan)</b>	<ul style="list-style-type: none"> <li>Best gearing to global growth, and renewed demand in commodities for materials-hungry China and India should benefit this region.</li> </ul>	<b>Positive</b> (Positive)
<b>Emerging Markets</b>	<ul style="list-style-type: none"> <li>While pockets of risk abound, the lion’s share of the global recovery will be seen in place like China as well as materials exporters like Brazil and South Africa.</li> <li>Markets have run far, so not cheap, but we wouldn’t stay out all together, hence recommend neutrality here.</li> </ul>	<b>Neutral</b> (Neutral)
BONDS <sup>3,6</sup>		
<b>Cash</b>	<ul style="list-style-type: none"> <li>Steep yield curves and declining inflation (at least in the short term) are positives for bonds, but issuance and longer-term inflation worries reduce the allure of higher duration. We stay neutral.</li> </ul>	<b>Neutral</b> (Neutral)
<b>US</b>	<ul style="list-style-type: none"> <li>Although yields have backed up substantially (as expected) last quarter and the curve is exceptionally steep, the US Treasury market still represents the greatest relative risk in terms of supply and expansionary fiscal and monetary policy.</li> </ul>	<b>Negative</b> (Negative)
<b>UK</b>	<ul style="list-style-type: none"> <li>We did not anticipate the underperformance of Gilts last quarter, partly caused by confusing statements of officials with regard to the BoE’s asset purchase. Short to medium term Gilts are particularly attractive given the steep curve.</li> </ul>	<b>Positive</b> (Positive)
<b>Euro</b>	<ul style="list-style-type: none"> <li>The ECB has watered down its resistance to quantitative easing by conducting long-term fixed rate refinancing operations and effectively injecting more liquidity into the system. We move from Positive to Neutral.</li> </ul>	<b>Neutral*</b> (Positive)
<b>Japan</b>	<ul style="list-style-type: none"> <li>Japan’s government bond market seems almost to have decoupled from global yield trends. The curve has become less steep compared to other markets and we remain Negative although we were wrong last quarter.</li> </ul>	<b>Negative</b> (Negative)
CREDIT <sup>4</sup>		
<b>Inv Grade Corporate</b>	<ul style="list-style-type: none"> <li>Valuations as measured by spread-implied default rates are still favourable, but we think the rally could slow down and we downgrade the asset class from Strong Positive to Positive. Risks for financial issuers are still high and have recently been ignored.</li> </ul>	<b>Positive*</b> (Strong Positive)
<b>High Yield</b>	<ul style="list-style-type: none"> <li>Our Positive view on HY paid off last quarter and despite value being squeezed somewhat we remain Positive on improving cyclical variables, e.g. lower TED spreads, a steeper curve, lending standards tightening less and the financing gap closing.</li> </ul>	<b>Positive</b> (Positive)
<b>Emg Market Debt</b>	<ul style="list-style-type: none"> <li>EMD has been unexpectedly robust. Valuation is not cheap, but as with HY, cyclical factors and expansionary policy are tailwinds. We upgrade EMD from Neutral to Positive based on EM leading the world economy out of recession.</li> </ul>	<b>Positive*</b> (Neutral)
CURRENCIES <sup>5</sup>		
<b>EUR</b>	<ul style="list-style-type: none"> <li>The euro gained ground on the US-dollar, but lagged sterling. Doubts over dormant risks in Europe’s financial system currently prevent a break on the upside.</li> </ul>	<b>No View</b>
<b>GBP</b>	<ul style="list-style-type: none"> <li>A nascent recovery in the housing market is shoring up the pound. In the long-term, the UK economy’s status is challenged by its dependence on the financial sector.</li> </ul>	<b>No View</b>
<b>JPY</b>	<ul style="list-style-type: none"> <li>The yen is benefiting the least from the global recovery trade over the last quarter. However, it remains near decade highs against the dollar.</li> </ul>	<b>No View</b>

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# 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 comprised 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 official 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.

## Disclaimers

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