



RUSSELL INVESTMENTS

Running with the bulls

2018 Global Market Outlook

Our central view is that equity markets can push higher before facing headwinds later in 2018 as markets factor in rising risks of a 2019 recession. Running with the bulls can be dangerous. It's easy to get swept up in the elation of the crowd and underestimate the risks.

DECEMBER 2017

Andrew Pease
*Global Head of Investment
Strategy*

Paul Eitelman, CFA
*Senior Investment Strategist,
North America*

Graham Harman
*Senior Investment Strategist,
Asia-Pacific*

Shailesh Kshatriya, CFA
Director, Canadian Strategies

Van Luu, Ph.D.
*Head of Currency &
Fixed Income Strategy*

Kara Ng
*Senior Quantitative Investment
Strategy Analyst*

Abraham Robison
Quantitative Investment Strategist

Wouter Sturkenboom, CFA, CAIA
Senior Investment Strategist, EMEA

Alexander Cousley
Investment Strategy Analyst

Stephen Wood, Ph.D.
Chief Market Strategist

INTRODUCTION

BY JEFF HUSSEY, GLOBAL CHIEF INVESTMENT OFFICER

Markets have turned optimistic, but it's late in the cycle and central banks are becoming hawkish. The challenge ahead is to safely navigate between euphoria and danger.

Golden Oldie

By rights, the current market cycle should be shuffling into retirement, putting its feet up and taking things easy. It is, after all, nearly nine years old, the second-longest bull market on record and positively geriatric by the standard of these things.

But this cycle belongs to the baby boomer generation, and like them, refuses to succumb to dotage. It's having a vigorous later life while frittering away the next generation's inheritance.

This raises a critical issue: how to make the most of late-cycle returns while preparing for the inevitable downswing? Late cycle can be the most challenging phase. Valuations are stretched, central banks are taking away the punch bowl and fundamentals look long in the tooth. But markets may surge as investors, buoyed by their recent success, become overconfident and start believing (again) that this time is different.

Our cycle, value, sentiment (CVS) investment decision-making process helps deal with this challenge. We step back from the current market psychology and have the discipline of breaking each decision into the three building blocks: is this asset class cheap or expensive, is the cycle a tailwind or headwind, is sentiment overbought or oversold?

Without a solid process, there is the very real risk of being drawn into euphoria at the market peak and capitulating with despondency at the cycle bottom. Investors can't afford these mistakes. Particularly given the grim outlook for longer-term returns told by high equity market valuations and low government bond yields.

We spend a lot of time talking about the low-return imperative. For most investors, the market returns available in coming years likely won't be high enough to achieve their retirement goals.

To have a chance of overcoming this, we believe investors need to respond in three ways: (1) diversify their sources of returns, (2) have effective implementation capabilities and (3) use a robust dynamic asset allocation process to guide tactical positioning.

In other words, they need to squeeze every basis point out of their portfolio using smart strategies, implemented in a cost-effective manner, backed by a dynamic process that leans into opportunities and away from risks.

We're not especially bullish or bearish about 2018. 2017 delivered better returns than most industry analysts expected, but the cycle is old and the U.S. Federal Reserve (Fed) is about to step up the pace of rate hikes. Our central view is that equity markets can push higher over the first part of the year, before facing headwinds later in 2018 as markets factor in rising risks of a 2019 recession.

Enjoy this energetic old cycle while it lasts, but remember that the Fed Reaper (or Jay Powell¹ as he is known to his friends) is getting ever closer... ■

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¹Jerome Powell, a member of the U.S. Federal Reserve Board of Governors since 2012, was nominated in November 2017 to serve as the next Chairman of the Federal Reserve.

Outlook 2018: Running with the bulls

2017 delivered better-than-expected global equity returns, but the cycle is old and the Fed is set to step up the pace of rate hikes. The current bullish momentum will face strengthening headwinds as 2018 progresses.

We expect the following in 2018:

- › The Fed to follow a December rate rise with three additional hikes
- › U.S. 10-year Treasury yield at 2.7% by the end of 2018
- › Flattening yield curve to heighten 2019 recession fears
- › U.S. GDP growth of 2.25%
- › Better returns in Europe and Japan, relative to a lackluster U.S. equity market
- › Upside for the euro, yen and pound, while the U.S. dollar remains subdued

Wall of worry & the slope of hope

2017 demonstrated the capacity for equity markets to climb the “wall of worry.” Investors began the year uncertain about the new Trump administration, the potential for trade protectionism and escalating geopolitical tensions. There was the Euroskeptic election scare in France, nervousness about the Fed’s balance sheet reduction plans and worries about North Korean aggression.

However, these uncertainties turned out to matter little and by late November the MSCI All Country World Index had returned around 18% for 2017. It also helped that 2017 saw the strongest synchronized global growth and biggest gains in corporate profits since 2010.

The 2018 outlook looks less threatening. Despite an active Twitter feed, President Trump’s first year has been less eventful than feared, the Fed’s leadership is moving to the safe hands of Jerome Powell, tax cuts are progressing through the U.S. Congress, Europe has navigated most of its political land mines, and the 2017 global growth momentum seems likely to persist into 2018.

But with seemingly clear air ahead, are markets poised to fall off the “slope of hope”? We don’t think so, although many of our sentiment indicators point to the near-term risk of a pullback.

The critical issue is the timing of the next U.S. recession, as this almost always results in an equity bear market. By next April, this will be the second-oldest U.S. economic expansion on record. The Business Cycle Index (BCI) model puts the probability of a U.S. recession in the next 12 months at around 25%, a high but not alarming percentage given the age of the expansion. This probability, however, could easily rise through the year, if, as we expect, the Fed tightens another three times in 2018.

Credit and equity markets tend to price in recessions around 6-12 months ahead of time. This means that 2018 could be a year of two halves. The first, which sees the continuation of the current market momentum, and a second half where markets begin to focus on the downside risks to U.S. and global growth.

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Scenarios

The uncertainties mean that it makes sense to look at various scenarios for 2018, rather than focus on one story. We think there are three plausible scenarios:

Central scenario

- › Equity markets face increasing headwinds later in the year. Japan, Europe and emerging markets (EM) outperform the U.S. in what could be a relatively flat year for global equities.
- › Growth and earnings are stronger in Europe, Japan and emerging markets.
- › The U.S. 10-year Treasury yield approaches its fair value of 2.7% before declining as recession odds grow. The yield curve flattens and potentially inverts by year-end.

 Our central scenario is that equity markets face increasing headwinds later in the year.

Upside scenario: blow-out rally

- › Fed is dovish and tightens by less than expected, growth is ok and inflation doesn't rise much.
- › USD is weak, emerging markets do very well.
- › Euphoria takes hold and investors leverage into the market.

Downside scenario: Fed mistake triggers a 2018 recession

- › Fed overtightens into a sluggish economy.
- › R-star (the real rate consistent with full employment/neutral real rate) turns out to be much lower than expected.
- › Markets hit turbulence in early 2018.

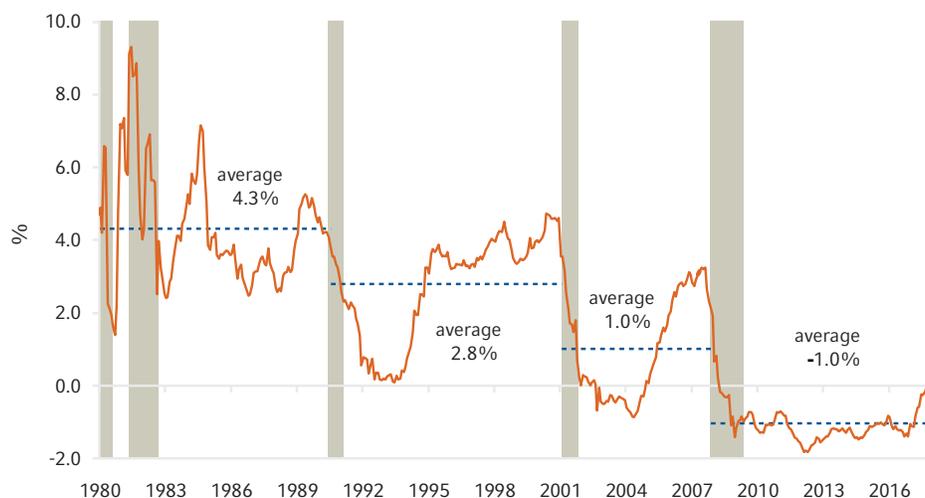
There's an old saying that bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. The phase we have yet to encounter this time is euphoria. This is when we would see the blow-out rally scenario.

Sentiment, from our CVS investment decision-making process of cycle, value and sentiment, provides the main guide to this scenario. It currently seems complacent and overbought, but not euphoric. One of the best indicators is that margin debt has yet to take off. According to the New York Stock Exchange (NYSE), margin debt grew by just 15% in the year through October 2017. Looking through this NYSE data, it often grows by more than 40% in the year before a major market peak, as overconfident investors borrow to gain market exposure.

Bull markets don't have to end in euphoria. As another market saying holds, they can be killed by the Fed. One of the key recession-risk issues is working out when Fed policy becomes restrictive. In other words, where is r-star? The chart on the next page shows the average real Fed funds rate from peak to peak in each cycle over the last 37 years. It's stepping down because of rising debt, poor productivity and weaker potential growth.

The Fed's rate hikes have so far slowly reduced the amount of stimulus from monetary policy. Given the uncertainty around r-star, it's entirely plausible that a couple rate hikes could lift the Fed funds rate above r-star and turn policy restrictive. We will be monitoring the yield curve closely. This is one of the key inputs into the BCI model. The yield curve has inverted before every recession over the last 50 years. The spread between yields on 10-year and 2-year Treasuries has narrowed from 140 basis points, when the Fed started tightening at the end of 2015, to 60 basis points in late November.

Real U.S. Fed funds rate (based on the core PCE² deflator)



Source: Datastream (Fed funds data), Russell Investments calculations; as of October 31, 2017. Gray columns represent National Bureau of Economic Records (NBER)-dated recessions.

² The personal consumption expenditure (PCE) deflator measures the price change in the basket of goods that are captured in personal consumption expenditure. The core measure, which excludes energy and food prices, is the Fed's preferred measure of inflation.

Our 2018 annual outlook overview is very U.S.-centric. The U.S. still dominates global markets and is further advanced in its cycle than other economies, which means that most scenarios are likely to be driven by the U.S. It's worth asking whether there are any global factors that could trigger a global bear market.³ The last big global negative shock was the Organization of the Petroleum Exporting Countries (OPEC) oil crisis in the early 1970s. The eurozone sovereign debt crisis in 2011 did not have much impact beyond Europe.

Keep an eye on China

The main candidate for a non-U.S. shock is China. We're not expecting a China-sparked crisis, but high debt levels are a risk and outgoing People's Bank of China governor Zhou Xiaochuan recently warned about the risk of a "Minsky moment."⁴

The recent Communist Party National Congress entrenched the power of President Xi Jinping, giving him the authority to pursue his reform agenda in his second five-year term. Near the top of his list is deflating the debt bubble. Chinese central bankers have many more levers than their counterparts in developed markets, so the likelihood is they will be able to engineer a gradual deleveraging. But tightening credit in a high debt economy is a fraught exercise. China's monthly money and credit growth statistics will bear close watching for signs of a sharper-than-expected slowdown.

Finding a path between euphoria and danger

The cycle is very old and the Fed is preparing to step up the pace of tightening. This creates plenty of uncertainty. Our central view is that equity markets can push higher over the first part of the year, before facing headwinds later in 2018 as markets factor in rising risks of a 2019 recession.

Running with the bulls can be dangerous. It's easy to get swept up in the elation of the crowd and underestimate the risks. ■

■ We're not expecting a China-sparked crisis, but high debt levels are a risk.

³ A bear market is defined as a 20% fall in equity markets. The average S&P500® Index decline in the six bear markets since 1968 was -42%.

⁴ A Minsky Moment refers to a sudden collapse of asset prices after a long period of growth, sparked by debt or currency pressures. The theory is named after economist Hyman Minsky.

United States: Too much of a good thing?

Global growth has lifted the U.S. economy and multinational earnings to their strongest position in years. But with an eight-year-old U.S. expansion, imbalances gradually building, and expensive market valuations, we believe some caution is warranted for U.S. equities. We forecast lackluster U.S. equity market returns in 2018 and view end-of-cycle risks as becoming elevated thereafter.

Strong growth, growing risks

The U.S. economy has been strong in recent months. Business surveys are indicating some of the best economic conditions for the eight-year expansion thus far. The unemployment rate is at its lowest level in 17 years; the consumer is a pillar of stable growth; both capital expenditure (capex) and housing have turned a corner; and corporate earnings results have come in ahead of schedule all year. When we look under the surface of this improvement, one key observation to note is that a lot of the positivity seems to be flowing into the U.S. from a stronger global cycle. For example, FactSet statistics show large multinational U.S. companies have been significantly out-earning their domestically focused peers. In our previous quarterly outlook report we called this “secondhand growth,” and that continues to be a theme dominating U.S. markets as we look toward 2018.

The challenge for investors as we get later in the cycle is that strong growth comes at a price: back in 1999, New York Fed President William Dudley famously said that “too much of a good thing is a bad thing.” That comment feels very relevant again. This is already the third-longest business cycle in NBER records dating back to the 1800s. And after eight years of growth, many of the signs of an aging business cycle are starting to flash amber.

The labor market is already at or beyond full employment. Continued, strong employment growth at this stage of the cycle comes at the expense of wage and cost pressures for businesses.

The Fed’s estimate of the output gap — which measures the amount of spare capacity in the economy — has closed. And this puts pressure on the Federal Open Market Committee (FOMC) to keep raising interest rates. The Fed’s policy stance isn’t that accommodative anymore, as the chart below illustrates. Most estimates of the neutral rate — the level at which Fed policy pivots to becoming restrictive and a hindrance to growth — are only one to four hikes away from current levels. If the neutral rate is much lower than expected, the Fed could inadvertently make a policy mistake in 2018. However, the more likely scenario in our view is that the Fed continues its gradual hiking process and takes the punchbowl away sometime in late 2018 or early 2019.

The Investors Intelligence bull-bear ratio⁵ shows investors are the most optimistic that they’ve been since 1987. We use this as a contrarian market risk indicator.

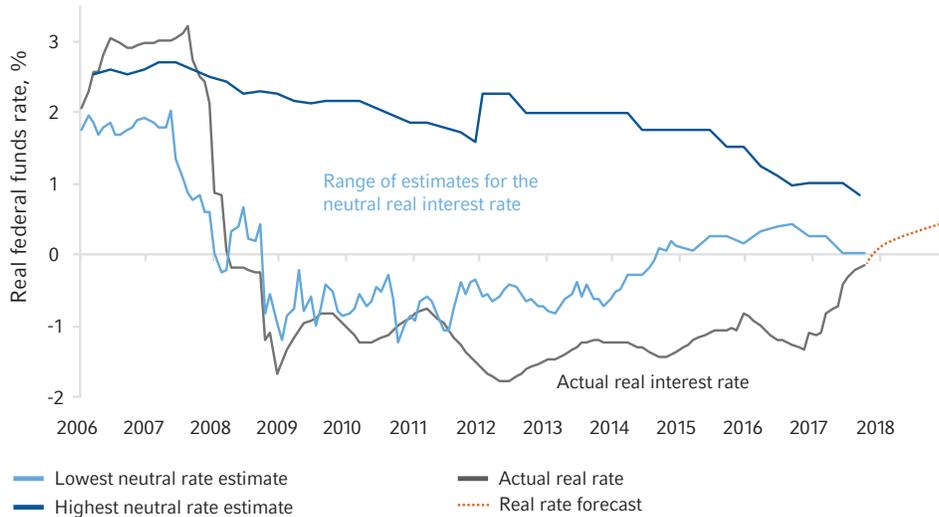
The corporate debt-to-GDP ratio is elevated and matches prior business cycle peaks.

And, perhaps the biggest warning sign is that the yield curve has flattened significantly. With a low unemployment rate and strong medium-term inflation fundamentals, we expect the Fed will be able to raise its policy rate by another 100 basis points by the end of 2018. That forecast, coupled with our forecast for a 2.7% 10-year U.S. Treasury yield, suggests the yield curve is likely to invert in late 2018.

After eight years of growth, many of the hallmarks of an aging business cycle are starting to flash amber.

⁵ The bull/bear ratio indicates overall investor sentiment in the market by comparing the number of bullish and bearish investors. This market indicator is calculated and published weekly by the Investors Intelligence Sentiment Survey.

Fed policy isn't that accommodative anymore



Forecasting recessions is a difficult and inexact science. The current run-rate of growth is strong and the BCI model suggests the risk of a recession in 2018 is still modest, at about 25%. But, as mentioned earlier, too much of a good thing can be a bad thing. Imbalances are gradually accumulating in the U.S. economy, and as we look out beyond 2018 to 2019, many of the pre-conditions for a recession are likely to be in place. An economic downturn doesn't have to happen — after all, Australia has gone 25 years without one — but recession risks are likely to become elevated.

What could go right? Arguably the biggest macro surprise of 2017 was the soft patch in U.S. core inflation. If growth stays strong and this inflation weakness persists into 2018, incoming Fed Chair Jerome Powell (once confirmed by the U.S. Senate) might be forced to slow down or halt the Fed's hiking process. That would likely be a Goldilocks environment for U.S. equities and could create a blow-off rally. The other upside scenario that we are paying attention to is the potential for a younger and stronger global cycle to continue to boost U.S. corporate earnings. Coupled with a possible cut in the corporate tax rate, earnings could surprise to the upside again next year and sustain already high valuation levels.

Strategy outlook

- › **Business cycle:** Corporate profits have come in ahead of schedule this year as a stronger global cycle helped U.S. multinationals. Nevertheless, the pace of growth has moderated from 14% in Q1 2017 to 10% in Q2 to 6% in Q3, according to FactSet. It looks like earnings growth is settling down at mid-single-digit levels, but corporate tax reform could provide a one-off boost in 2018. The combination of strong growth but growing late-cycle risks leaves us neutral on the cycle.
- › **Valuation:** U.S. equities are very expensive. The Shiller P/E ratio⁶ for the S&P 500 Index stands at 31.3x — its highest level ever outside of 1929 and the late 1990s.
- › **Sentiment:** Price momentum is firmly positive and a tailwind. But several of our contrarian measures show the U.S. market may have moved too far, too fast this year. Equities look complacent and vulnerable to bad news. The market doesn't look euphoric yet but our sentiment signals are suggesting some caution is warranted at current market levels.
- › **Conclusion:** We continue to have an underweight preference for U.S. equities in global portfolios, primarily on the back of their very expensive valuations. Our interest-rate forecasts support a modest underweight preference for U.S. 10-year Treasuries. ■

We continue to have an underweight preference for U.S. equities in global portfolios, primarily on the back of their very expensive valuations.

Sources: Federal Reserve Board, Federal Reserve Banks of New York and San Francisco, BlueChip, BEA, Thomson Reuters Datastream and Russell Investments. Data as of November 16, 2017. The long-term FOMC forecast is the Committee's longer-run fed funds forecast minus their longer-run core PCE inflation forecast. The long-term economist survey is an average of the Blue-Chip estimate (3-month T-bill yield 5-10 years into the future) and the NY Fed Primary Dealer survey (longer-run fed funds target minus 2 percent). The long-term model is an average of the r-star estimates in Laubach-Williams (2003) and Holston-Laubach-Williams (2016). The long-term market pricing is the 7-10 year ahead risk neutral yield from the New York Fed's term-structure model minus 7-10 year ahead inflation expectations from CPI swaps. The actual real rate is the federal funds rate minus a smoothed version of core PCE inflation. The forecast is Russell Investments' forecast for the same.

⁶The cyclically adjusted price-to-earnings ratio, commonly known as the Shiller P/E, is a valuation measure usually applied to the U.S. S&P 500 equity market. It is defined as price divided by the average of 10 years of earnings (moving average), adjusted for inflation. As such, it is principally used to assess likely future returns from equities over timescales of 10 to 20 years, with higher than average CAPE values implying lower than average long-term annual average returns.

The eurozone: Mid-cycle renaissance

The eurozone is in the middle of a mid-cycle renaissance, both economically and politically. Reflation combined with the refutation of populist movements in the region have laid the foundation for a self-sustaining recovery that could last for years to come. This environment should provide a strong tailwind to eurozone financial markets, which we continue to favor.

Why it can last

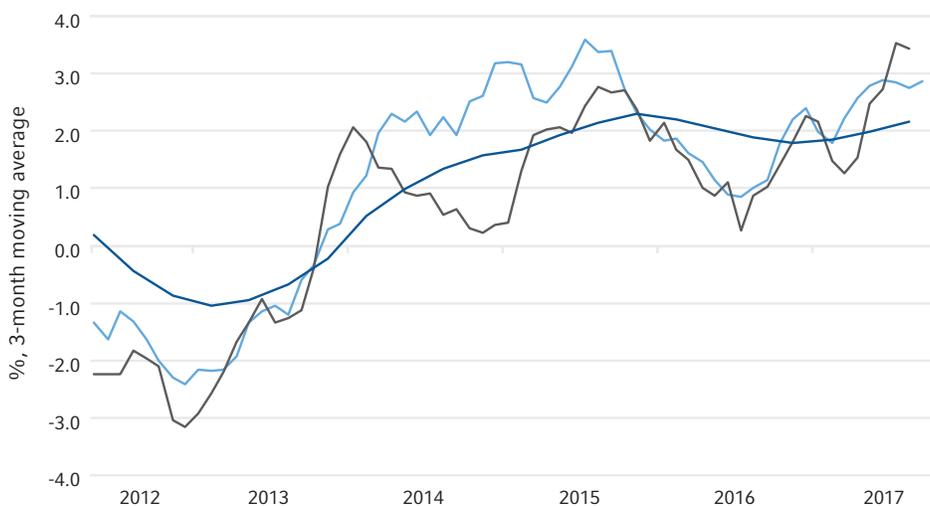
In our 2017 annual outlook we talked about being optimistic about eurozone growth, financial conditions, corporate earnings and political risk. Those strong fundamentals, which were the product of reflationary forces outweighing deflationary ones, would in turn support eurozone financial markets.

Looking back, it is interesting to see we were simultaneously not optimistic enough about how much those fundamentals would improve and too optimistic about their impact on financial markets. Growth and earnings have both come in slightly higher than expected, financial conditions improved in line, political risks turned into opportunities, and yet relative equity market performance is slightly down. In our third quarter 2017 outlook report we explained why: a rising euro has been a formidable headwind in a market environment characterized by strong absolute performance.

Looking ahead we expect eurozone financial markets can overcome that headwind, and the economic and political renaissance will once again drive both relative and absolute performance. We also expect eurozone economic growth in 2018 to stay strong at 1.8%-2.4%. Economic sentiment stands at a 17-year high in November 2017, according to the European Commission, and strong global growth is a boon for exports. Real economic activity such as industrial production and retail sales is expanding robustly and — in light of easy financial conditions and high levels of producer and consumer confidence — should continue to do so.

 We believe the region's economic and political renaissance can last for years to come.

Eurozone retail sales, industrial production & GDP growth



— Retail sales: 2.9% year-on-year (YoY)
— Industrial production: 3.4% YoY
— GDP growth: 2.2% YoY

Source: Thomson Reuters Datastream, through Q3 2017.

What could go wrong

The risks around our outlook are threefold. First, when it comes to the eurozone, political risk is always lurking around the corner. Currently, we are worried about both the troubled state of the Brexit negotiations and the Italian elections in Q1 2018. With respect to the former, we still expect an agreement will be reached to implement a two-year status-quo transition period, which should minimize the economic fallout from Brexit. However, a complete breakdown in talks cannot be dismissed as a possibility, and severe trade disruptions with the UK could wreak havoc on the region's economic growth. With respect to the Italian elections, we are mostly focused on the risk of a Euroskeptic bloc taking power. However, Euroskepticism has not been a winning strategy in recent elections and is notably in decline in Italy. Even more, the recent electoral reform makes it unlikely the populist Five Star Movement can win an outright majority on its own.

Second, there is the risk that financial conditions unexpectedly tighten materially. A combination of higher bond yields, higher credit spreads, lower equity markets and a rising euro would materially weigh on the eurozone recovery. It is hard to foresee what could trigger such an event now that the European Central Bank (ECB) has committed to continued bond purchases, but a global selloff in financial markets triggered by an inflation scare could potentially do the trick. This is not something we consider likely.

Third, a slowdown in global growth triggered by China is a risk. With the National Congress of the Chinese Communist Party behind it, China might decide to prioritize reform over growth and deflate its economy a bit. That would pose a headwind to the eurozone and, although there are no signs this is happening, it is something we are monitoring.

Strategy outlook

- › **Business cycle:** Strong GDP growth, loose monetary policy and corporate earnings growth of approximately 5-10% equates to a positive business cycle score.
- › **Valuation:** Eurozone equity valuations are neutral in late 2017 while core government bonds are long-term expensive. However, for 2018 we expect core bonds to remain rangebound at 0-0.8% due to ECB bond purchases and lack of inflation. Peripheral bonds have done very well in 2017, which has pushed their valuation levels to neutral. As such, we have neutralized our overweight position.
- › **Sentiment:** A combination of positive price momentum and overbought contrarian signals have kept our sentiment score for eurozone equities in negative territory. However, sentiment for core and peripheral government bonds is neutral.
- › **Conclusion:** We continue to favor eurozone financial markets over U.S. markets in particular. Strong fundamentals and relatively attractive valuations underpin our view while sentiment is currently not a differentiator. ■

▮ The things to watch for in eurozone financial markets are Brexit, Italy, financial conditions and China.

Asia Pacific: Low rates, solid growth

2017 was a strong year for the Asia-Pacific region, underpinned by solid global growth and Chinese demand. We expect the region's economy to post another year of high growth in 2018, with good support from Australia and Japan, though with developing economies outpacing developed.

The Asia-Pacific economy continues to move along at a brisk pace, with GDP growing by 5% in 2017 through the third quarter. The strength of the global economy, along with inter-regional trade, has been beneficial. The region's outlook for 2018 is solid, with industry consensus expectations of 10% earnings growth on the MSCI Asia Pacific Index and GDP growth expected to come in at just under 5%. A sharp slowdown in China remains a risk, although the outcome of the 19th National Congress indicates the Chinese government will not be aggressively pursuing deleveraging. Tensions with North Korea persist in the background, despite having dissipated in recent months.

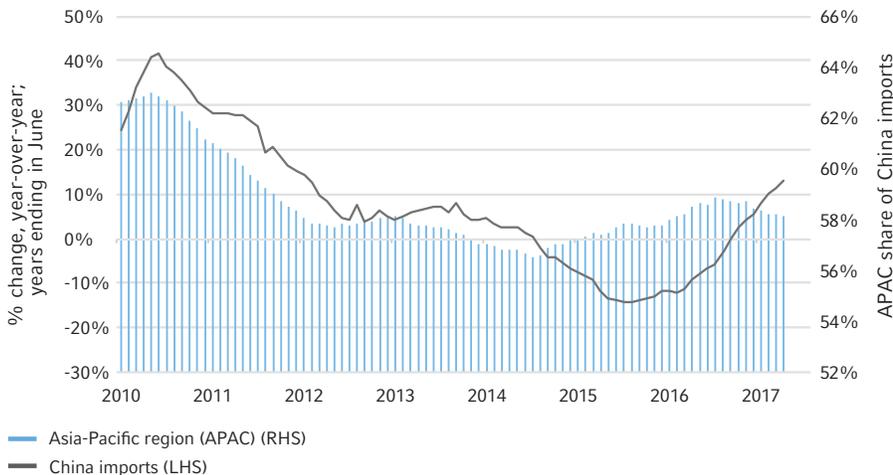
The outlook for China, in our opinion, remains positive. The National Congress revealed a Chinese government that will continue to focus on sturdy growth rates. The goal of doubling GDP per capita requires 6.5% per year in the three years to 2020, which we expect the Chinese economy will achieve. The move toward a consumption-led economy will continue at a gradual pace, which will benefit many countries in the region that produce consumer goods. In an equivalent manner, Japanese export growth has been driven higher in recent months by Chinese demand for machinery and electronic equipment. The key risk to the Chinese economy remains the elevated levels of leverage, however we think the deleveraging effort will be gradual.

We remain constructive on other developing Asia-Pacific economies. With more than 55% of Chinese imports coming from the region, according to Thomson Reuters Datastream, our positive outlook on China will result in strong external demand for Asia-Pacific developing economies. Additionally, domestic demand across most of these countries is reasonably healthy, supported by accommodative monetary policy.

Investors have been piling into Japanese equities in the second half of this year, with the Nikkei Stock Average rising by 11% (as of November 20, 2017). We expect further strength in the

The region's outlook for 2018 is solid, with industry consensus expectations of 10% earnings growth and GDP growth expected to come in at just under 5%.

China imports



Source: Thomson Reuters Datastream, as of November 25, 2017.

Japanese economy through 2018. The one cylinder of the economy that is not currently firing is the consumer (which was a detractor from Q3 GDP growth). But with a tightening labor market and a very gradual inflation pulse putting pressure on wages, we expect to see an improvement in consumption.

Our 2018 outlook for investment in Japan is also bright, with business surveys pointing to an increasingly confident business sector. Additionally, the 2020 Tokyo Olympics is expected to inject further stimulus into the economy. We also think the Bank of Japan is going to maintain an accommodative policy, even in the face of tightening policy elsewhere in the world. This will have a two-pronged benefit, in that it will continue to pump liquidity into the Japanese economy and put downward pressure on the yen, both of which we expect to be beneficial.

Further south, we continue to be constructive on the Australian economy. Strong business confidence has been translating into solid payroll gains, and we are starting to see the signs of improving capex plans. The economy may start the year in a 'Goldilocks' zone, with solid growth and a low inflation pulse. However, we expect to see signs of re-emergent wage and price inflation over 2018, which will see the Reserve Bank of Australia hike rates twice. The Australian equity market has lagged global markets in 2017. We see potential for the market to catch up through 2018, driven by improving commodity prices.

In New Zealand, we think the best economic growth has been seen for now. The economy's impressive performance over the last three years had been driven by migration and the housing market. The new Labour government has announced a reduction in migration to New Zealand and a ban on foreign purchases of new property, which should moderate these drivers of growth. On monetary policy, the government has also announced a review of the Reserve Bank of New Zealand's (RBNZ) mandate, and it is likely that full employment will be added as an objective (along with price stability). This will provide the central bank with more flexibility, which we think will lead to a more dovish approach. Our base case is that the RBNZ will raise rates once in 2018.

As highlighted in our previous quarterly outlook report, there remain a couple of risks for the region: 1. The continued demand from China. For China itself, the risk of some sort of trade altercation with the United States has not completely disappeared. 2. Tensions with North Korea still have the potential to flare up, although we are giving this a lower probability following the implementation of trade sanctions by China.

Investment strategy

For regional equities, we make an assessment of business cycle, value and sentiment considerations as follows:

- › **Business cycle:** We expect 2018 will be another strong year for the region. Developing countries will continue to set the pace, but we will be looking for further incremental improvements in Japan and Australia. Central bankers will remain highly supportive.
- › **Valuation:** The region as a whole continues to look a tad expensive, in part driven by the Chinese technology sector which is extremely expensive. Within the region, we think Japan remains fairly valued, but is moving toward expensive territory following the impressive run this year, while Australian equities remain slightly expensive.
- › **Sentiment:** Strong momentum in regional equities has triggered contrarian indicators, suggesting that some markets have become overbought. This has become particularly apparent in Japan. Despite this, we note that a late-stage cyclical upswing in the global economy would be a driver for momentum in the region.
- › **Conclusion:** The Asia-Pacific region is set to continue its impressive performance through 2018, underpinned by robust growth in China and the global economy. Valuations are looking a bit expensive, but within the region there remain pockets of fair value. Late-cycle dynamics in the global economy will further boost regional growth. ■

Our 2018 outlook for investment in Japan is also bright, with business surveys pointing to an increasingly confident business sector.

Currencies: Don't be tempted by yield

Despite offering higher interest rates than most of their developed-market counterparts, the U.S. dollar (USD) and the New Zealand dollar (NZD) were the two worst performers among Group of Ten (G10) currencies in 2017. We would not bet on a reversal of that trend. The story is different with emerging markets (EM) currencies, which are still appealing despite a tentative recovery this year.

The so-called “dollar bloc” (comprising the U.S., Canada, Australia and New Zealand) boasts higher interest rates than the remaining G10 countries.⁷ If the Fed continues to hike interest rates in 2018, the yield difference between the USD and the euro is likely to approach 3% as the ECB has all but ruled out any deposit rate increases from the current level of -0.4% in effect since March 2016. Swedish, Swiss and Japanese central bankers have also taken their deposit rates into negative territory. It may be tempting to buy high-yielding dollar-bloc currencies to benefit from their interest-rate advantage. We believe that investors should resist that urge.

In terms of valuations, the high-yielding G10 currencies are still expensive, except for the Canadian dollar (CAD). Relative to purchasing power parity, the U.S. dollar is around 10% overvalued vis-à-vis the euro. This partly explains why EUR/USD rose by 13% this year, despite the interest-rate differential widening in favor of the greenback. Currency markets were surprised by how cautiously the Fed raised interest rates and are already looking ahead to the end of the tightening cycle. The ECB, on the other hand, did not raise rates at all, but merely announced a reduction in its bond purchase program for 2018. In contrast to the U.S., the eurozone is at an early stage of its exit from very loose monetary policy.

We believe that the euro, Japanese yen and British pound will hold up well against the U.S. dollar despite being at a yield disadvantage. The antipodean currencies, (AUD and NZD), are at risk of underperforming as their rate buffer is slim relative to history. As commodity-linked currencies, they are also more vulnerable to any potential growth slowdown or downward correction in risk assets.

Diversifying and risky currencies

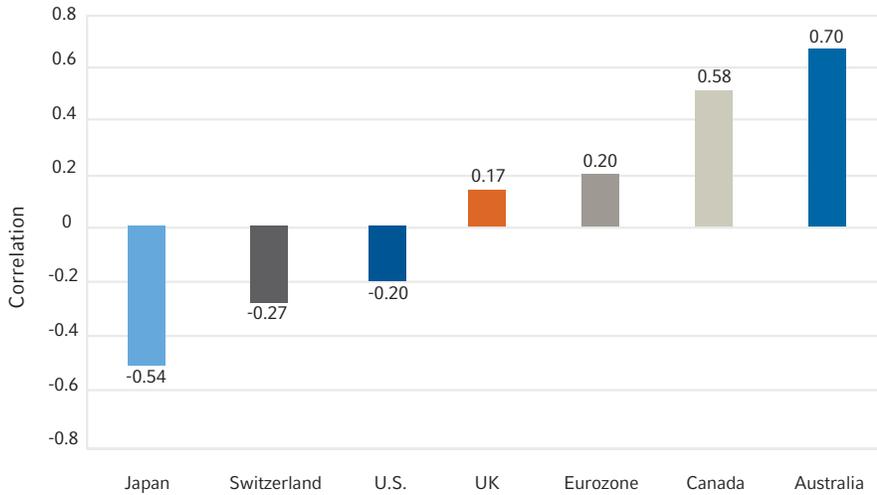
As global equity markets scale new heights going into 2018, it is worth revisiting the relationship between exchange rates and risk assets. Currencies that go up when equity markets go down can be thought of as “diversifiers” of stocks and other growth assets. It may be worth having some exposure to diversifying currencies even when their interest rates are low. On the other hand, currencies that have a stable positive correlation with equities should be considered “risky”. In the chart below, we plot the trailing 10-year correlation of seven important currencies with global equity market returns, based on weekly data.

The two currencies with the most negative correlations are the yen and the Swiss franc (CHF). Traditionally these are known as “safe haven” currencies with consistently diversifying properties. The U.S. dollar also offered diversification benefits over the last 10 years, but its correlation with equity markets over other time periods is less stable than that of JPY and CHF. Among these diversifying currencies, we prefer JPY over CHF as the yen is significantly cheaper than CHF on our preferred valuation measures, including, for example, purchasing power parity.

 High-interest rate currencies such as the Australian and New Zealand dollar are expensively valued.

⁷ The G10 are the most liquid developed-market currencies, i.e. Australian dollar, Canadian dollar, euro, Japanese yen, New Zealand dollar, Norwegian krone, Swedish krona, Swiss franc, U.K. pound and U.S. dollar

Correlations of currency returns with the global equity index



Source: Thomson Reuters Datastream, as of November 13, 2017, as measured by the MSCI World local index.

Commodity-linked currencies such as the Australian dollar and the Canadian dollar have high positive correlation with the global equity market and are likely to go up and down in unison with risk assets. That makes them undesirable from a risk perspective although they usually come with higher interest rates. Among the risky currencies, CAD is more attractive than AUD and NZD, both from valuation and cyclical perspectives.

Emerging market currencies

Regarding talk of U.S. protectionist trade policies, the Trump administration is the dog that barked, but hasn't bitten yet. The U.S. is in the process of renegotiating the rules governing the North American Free Trade Agreement (NAFTA), but it has neither withdrawn from the trade agreement nor branded China a currency manipulator. Supported by a synchronised global upswing, the economic fundamentals of EM economies are sound, as evidenced by improving current-account balances. Despite continuing the tentative recovery that EM currencies began in 2016, as shown in the chart below, we believe they are still cheaply valued and offer potential for investors who increase their exposure to these currencies. ■

■ We believe EM currencies are still cheaply valued and offer potential for investors who increase their exposure to these currencies.

Emerging market currencies continue their tentative recovery



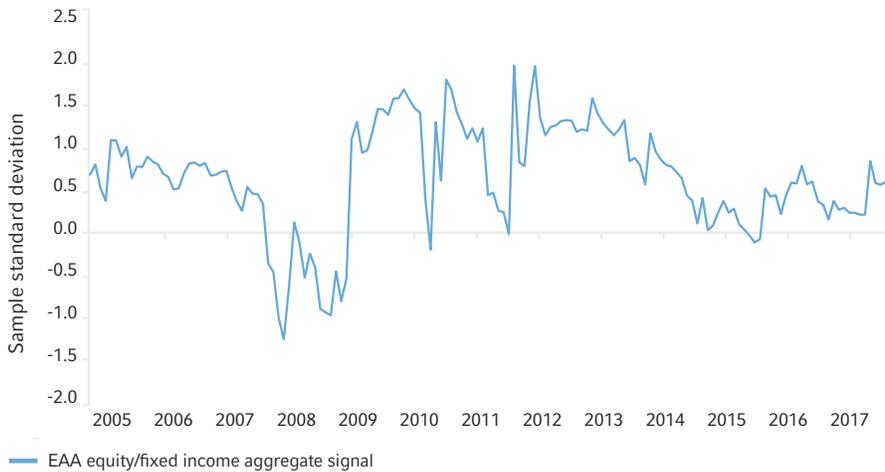
Source: Thomson Reuters Datastream, as of November 22, 2017. Emerging market currencies are proxied by the JP Morgan Emerging Market Currency Index.

Quantitative modeling insights

Keeping it positive

Our model for U.S. equities versus U.S. fixed income continued to stay in the positive range in the past few months. We still see low inflation and decent GDP growth which are good conditions for equities. While we have seen them increase in value, we'd be cautious of expensive valuations and a flattening yield curve.

EAA U.S. equity vs U.S. fixed income aggregate signal



Source: Russell Investments, as of November 15, 2017. 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. Enhanced Asset Allocation (EAA) is a capability that builds on Strategic Asset Allocation (SAA) by incorporating views from Russell Investments' 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 EAA Equity-Fixed Income Aggregate Signal is based on the S&P 500 Index and Bloomberg Barclays U.S. Aggregate Bond Index.

Within our cycle, value and sentiment (CVS) investment framework we make the following overarching assessments based on our quantitative models

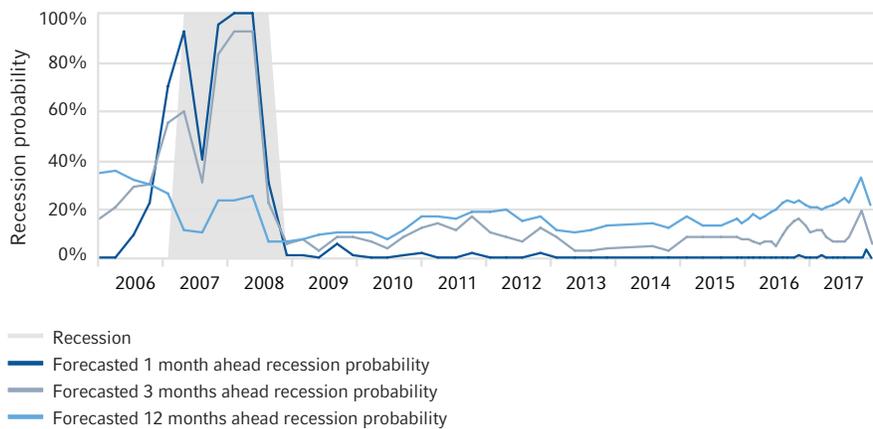
- › **Business cycle:** The BCI model uses a range of economic and financial variables to estimate the strength of the U.S. economy and forecast the probability of an upcoming recession. We conclude as unlikely the following two scenarios: a near-term U.S. recession, or accelerating economic growth in this aging cycle.
- › **Valuation:** Our Fed model declined but stays near fair value for equities and fixed income assets. Our dividend discount model continues to see equities as a worthwhile investment.
- › **Sentiment:** Equities have continued to grow in the last few months. Our momentum signal grew slightly and has been stable and positive. Our contrarian long-term mean reversion signal is stable and negative for equity versus fixed income.

This combination of positive value from the dividend discount model and positive momentum overcomes the contrarian signal to put us slightly in favor of U.S. equities.

Recession probabilities: Alert but not alarmed

The U.S. is now in the third-longest economic expansion since the 1800s. Given recessions are damaging to equity markets as well as the expensiveness of the S&P 500 index, having a clear read on recession risk is crucial for navigating investments. The BCI model uses a range of economic and financial variables to estimate the strength of the U.S. economy and to forecast the probability of recession. As of November 25, 2017, the BCI index estimates that the probability of a U.S. recession in the next 12 months is around 25%— a level which signals caution, but not an outright warning. We conclude that a near-term U.S. recession is unlikely, but we should monitor this aging cycle.

BCI historical forecasted recession probabilities



Source: Russell Investments, as of October 31, 2017.

There are two major watchpoints with regards to the BCI model. The first is the labor market. Headline unemployment in November 2017 is 4.1%, the lowest since December 2000, and well below what the Fed estimates as sustainable. We expect the pace of job growth will moderate as the labor market overheats further, which will raise the BCI model's recession probabilities. Separately, an overheated labor market puts us at risk for a potential policy mistake: in a tight labor market, companies compete for a scarce pool of workers and tend to bid up wages. In response to higher inflation, the Fed could raise interest rates too aggressively, restrict growth, and unintentionally start a recession. In the last nine economic cycles, an overheated labor market preceded a recession by two or three years on average.

The second watch point is the U.S. yield curve. The slope of the yield curve is a proxy for future growth expectations and an input to the BCI model. In the last five cycles, an inverted yield preceded a recession by 10 to 32 months. The current yield curve is far from inverted, but has uncomfortably flattened. As the Federal Reserve continues to tighten monetary policy, the short end of the yield curve will likely face upward pressure, potentially flattening the slope even more.

Yield curve: Uncomfortably flattening



Source: Thomson Reuters Datastream, as of November 11, 2017.

Overall, we think the U.S. economy is still on a path of moderate growth with low probability of recession over the next year, but risks are building at the three-year horizon. In our view, investors should maintain a balanced risk portfolio and look for opportunities to buy the dips and sell the rallies. ■

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.

IMPORTANT INFORMATION

The views in this 2018 Global Market Outlook are subject to change at any time based upon market or other conditions and are current as of the date on the cover. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

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

Keep in mind that, like all investing, multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell Investments 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 Business Cycle Index (BCI) forecasts the strength of economic expansion or recession in the coming months, along with forecasts for other prominent economic measures. Inputs to the model include non-farm payroll, core inflation (without food and energy), the slope of the yield curve, and the yield spreads between Aaa and Baa corporate bonds and between commercial paper and Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts.

Investment in global, international or emerging markets may be significantly affected by political or economic conditions and regulatory requirements in a particular country. Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation. Such securities may be less liquid and more volatile. Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and political systems with less stability than in more developed countries.

Currency investing involves risks including fluctuations in currency values, whether the home currency or the foreign currency. They can either enhance or reduce the returns associated with foreign investments.

Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

The S&P 500, or the Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

Performance quoted represents past performance and should not be viewed as a guarantee of future results.

Indexes are unmanaged and cannot be invested in directly.

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

Source for MSCI data: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

The MSCI All Country World Index is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

The JP Morgan Emerging Market Currency Index (EMCI) is a tradable benchmark for emerging markets currencies versus the U.S. Dollar.

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