

RUSSELL INVESTMENTS

The Fed awakens

2016 Annual Global Market Outlook

Global economic growth should be robust, but the upside for investment returns is limited.

DECEMBER 2015

Paul Eitelman
*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
Investment Strategy Analyst

Andrew Pease
*Global Head of
Investment Strategy*

Abraham Robison
*Quantitative Investment
Strategist*

Wouter Sturkenboom, CFA, CAIA
Senior Investment Strategist, EMEA

Robert Wilson
Investment Strategy Analyst

Stephen Wood, Ph.D.
Chief Market Strategist

Outlook 2016: Curb your enthusiasm

Active management was the key to investment returns in 2015, and we believe this also will prove true in 2016. Asset-class returns are likely to be modest amid stretched valuations, Fed tightening and mature business cycles.

EXECUTIVE SUMMARY

By **Jeff Hussey**
Global Chief Investment Officer,
Russell Investments

In our 2015 Annual Global Market Outlook we talked about how the bar for generating investment returns was rising as a result of stretched equity valuations, low bond yields and narrow credit spreads. This reality hit home in 2015. Global equities and fixed income barely posted positive returns for the year and anything related to emerging markets (EM) fared worse. Looking ahead to 2016, the bar keeps rising, and we believe it will likely be another year of limited upside potential for investment returns.

The good news is that the outlook for the major developed economies is still reasonably robust. The U.S., Europe and Japan should achieve trend-like growth in 2016. The economic cycle is most advanced in the U.S., and the U.S. Federal Reserve (Fed) is likely to continue a gradual tightening process. But “gradual” is the key word. Inflation is likely to remain low and the next recession is still not on the radar.

Our global team of investment strategists has a clearly defined process that is based on the building blocks of business cycle, value and sentiment. This process has helped us navigate markets in recent years. Through 2016 our strategists will need to balance concerns about valuations against positive cycle views and also help us steer a course through shifts in sentiment between the extremes of overbought and oversold.

The starting point in 2016 is a broadly neutral outlook in terms of our preference between global equities and fixed income investments. The U.S. equity market is expensive and, although Gross Domestic Product (GDP) growth should be near trend, profit margins face downward pressure from the rising U.S. dollar (USD) and a gradual lift in labour costs. Europe and Japan in our view rank ahead of the U.S. with less demanding valuations and more upside to profit growth.

The value in emerging markets is tempting. However, falling commodity prices, a rising USD, and the impact of Fed tightening on EM economies mean that the cycle is still a significant headwind. It’s not all negative: China has undertaken stimulus measures and may do more. Also, many EM currencies already have had large adjustments. There may be an opportunity to take advantage of the value in EM assets during the year, and our team will be watching out closely for this.

On the fixed income side, government bonds also are expensive with yields near historic lows. Fed tightening and falling unemployment will put upward pressure on yields. Gradual is the key word again. Corporate credit will be under pressure from rising debt levels and subdued profit growth. Returns should be positive in 2016, but the upside is limited.

The low-return environment is set to tighten its grip in 2016. There is a chance that markets will post surprisingly strong returns on the back of better-than-expected economic growth combined with low inflation and a restrained Fed. But this would be a temporary reprieve at this late stage of the cycle.

Active investment choices will therefore be critical to portfolio performance, in our view. We see two keys to success in such an investing environment: access to a wide source of investment opportunities and a robust investment process that guides active asset allocations. □

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Outlook 2016: The Fed awakens

Fed tightening, rising U.S. wages and uncertainties in emerging markets dominate the outlook. We expect moderate equity returns globally, led by Europe and Japan, and a gradual rise in long-term interest rates as bond markets respond to Fed action.

Expectations for 2016:

- › Equities to modestly outperform fixed income and cash over 2016
- › U.S. GDP growth of 2.5% for 2016
- › Monthly payroll gains averaging 190,000 through 2016
- › Fed funds rate to reach 1.25% to 1.5% in 2016
- › U.S. 10-year Treasury yield at 2.8% by year-end 2016
- › Europe and Japan to outperform U.S. equities; emerging markets to underperform other major asset classes
- › Target for the S&P 500® Index of 2,100 at year's end

Evading the dark side

2015 has been forgettable in terms of investment returns. Globally, developed equities showed slightly negative returns, while fixed income reflected a slightly positive return¹ and anything related to emerging markets (EM) lost value. The only bright spots were European and Japanese equities. U.S. bond yields remained low, and we spent most of the year wondering when the Fed would raise interest rates.

Key market indicators for 2016 have a lot in common with those for 2015. U.S. equity market valuations are elevated and interest rates are historically low. We expect that major developed economies will likely record GDP growth rates similar to those in 2015. Earnings growth in Japan and Europe will most likely outstrip the U.S. market. And EM will remain under pressure.

The two main differences for the coming year are, first, the fact that the Fed finally started raising rates on December 16, and we expect them to hike further during 2016. And, second, the economic and market cycles are now one year older, taking us closer to the next global recession and bear market. The good news is that, despite this cycle's old age, we don't see a recession on the horizon: The major developed economies have few imbalances and possess spare capacity. The less positive news is that the upside for investment returns looks fairly limited.

Our favoured scenario

Our favoured scenario is for mid-to-low single-digit returns for global equities. U.S. equities are expensive and profit margins are near record highs. Fixed income returns will be constrained by the upward pressure on yields from Fed rate hikes. Credit returns will be held in check by concerns over profitability and default rates.

The bullish scenario for 2016 involves a combination of better-than-expected economic growth, led by the U.S., and confidence that the Fed will increase rates slowly and only by a small amount. This could generate a burst of late-cycle investor euphoria similar to the latter stages of previous cycles. Equity markets could deliver double-digit returns. Valuations, however, would become even more stretched, creating the risk of a large correction once economic growth inevitably moderates on the back of Fed tightening.

The good news is that, despite this cycle's old age, we don't see a global recession on the horizon: The major developed economies have few imbalances and possess spare capacity. The less positive news is that the upside for investment returns looks fairly limited.

¹ As of Dec. 11, 2015, based on the Russell Developed Index (down 1.9% year-to-date) and the Barclays U.S. Aggregate Bond Index, which showed a 1.7% increase.

Two bearish scenarios

Two different bearish scenarios could emerge, depending on whether or not economic growth is strong enough to trigger inflation.

- › *Scenario 1:* We experience weaker profit growth due to slower-than-expected economic growth in the developed economies, possibly accompanied by declining profit margins from rising wages, a stronger U.S. dollar (USD) for U.S. companies, and rising interest costs.
- › *Scenario 2:* Higher-than-expected inflation emerges in the U.S. as strong jobs growth pushes up wages, pulls down profit margins, and triggers more Fed rate increases than currently expected.

Both of these bearish scenarios imply lower equity market valuations, either because investors will mark down their expectations for future profits growth, or because rising interest rates will make equities look less attractive.

The first bearish scenario would see fixed income investments outperform equities, as weaker growth would mean less Fed tightening and potentially lower long-term interest rates. The second bearish scenario would generate negative returns across both equities and fixed income.

Even including our favoured outcome, it's not a great selection of scenarios. But that reflects the late stage of the market cycle. The bullish scenario seems less likely than the bearish ones. An upside surprise would imply equity market gains in excess of earnings growth, which would push up price-to-earnings ratios from already high levels. This is not impossible, but a burst of investor euphoria would be a surprise in this post-financial crisis world.

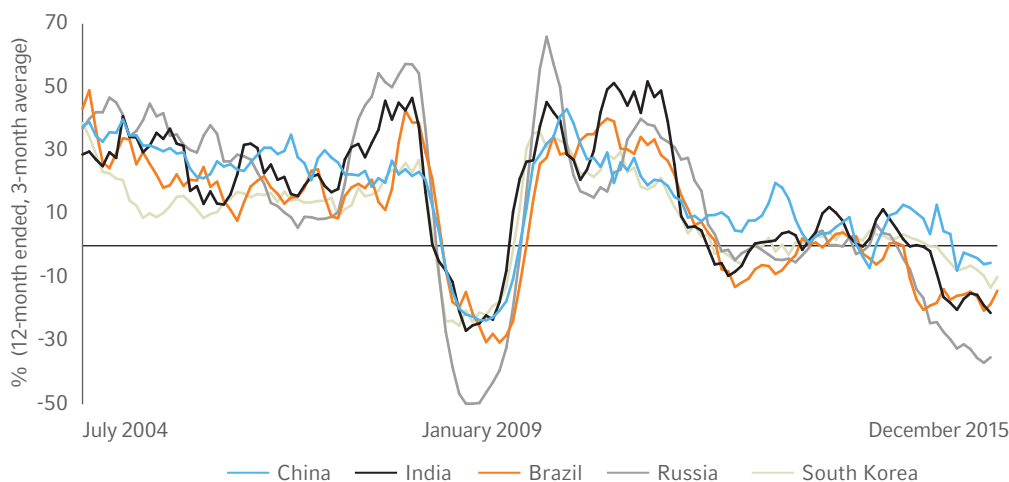
/// We're anticipating monthly gains of 150,000 to 200,000 jobs in the U.S. through 2016 and average hourly earnings growth of around 2.5%.

Key indicators

The indicators we will watch most closely are:

- › **U.S. non-farm payrolls.** We're anticipating monthly gains of 150,000 to 200,000 jobs through 2016 and average hourly earnings growth of around 2.5%. That would be consistent with our favoured scenario of moderate returns, moderate growth, and a restrained Fed.
- › **S&P 500 earnings-per-share (EPS) growth.** Expectations built into our favoured scenario call for 3% to 5% growth.
- › **Emerging markets trade.** Exports from emerging markets are contracting, as shown in the graph below. These need to recover for our favoured scenario to play out. A continued trade downturn in emerging markets could flow through to developed economies.

Exports by selected EM country



Source: Thomson Reuters Datastream: CountryData macroeconomic database as of Dec. 3, 2015

Global equities: value, cycle, sentiment

Our investment strategy process is based on the building blocks of value, business cycle and sentiment. Applying this process to global equities we see the following:

- › **Value:** The U.S. market is the most expensive among major markets. We score Japanese and European equities as fairly valued. EM equities remain moderately cheap.
- › **Cycle:** Europe and Japan look best with the potential for more quantitative easing and high single-digit EPS growth. The U.S. is less positive given the more lackluster outlook for EPS and the potential for Fed tightening. The cycle is still negative for EM amid U.S. dollar strength, falling commodity prices, and the economic slowdown in China.
- › **Sentiment:** Momentum is broadly neutral for developed markets and negative for EM. Our contrarian indicators have moved back to neutral after signaling oversold conditions following the August 2015 sell-off. Overall, sentiment is neutral.

Europe and Japan are our preferred exposures, and we are still cautious on EM, where the poor cycle outlook dominates good valuation. For the U.S., expensive valuations and a subdued cycle outlook add up to a fairly unexciting overall outlook.

Emerging markets: remain cautious

EM equities have underperformed developed markets by 70 percentage points over the last five years, and EM local debt delivered a -20% return over the past two years.² The bottom in the EM cycle is getting closer and may occur during 2016. However, for the time being, we still have a negative view on EM-related asset classes. EM trade is still declining, commodity prices remain under downward pressure, and the rising USD and Fed tightening are applying financing pressure on current-account-deficit countries like Brazil, Turkey and Indonesia.

To become more positive, we need to see signs that China's economy is bottoming, global export demand is picking up, and EM currencies and interest rates have adjusted to Fed tightening expectations.

Credit becoming less attractive

Credit was also a lackluster performer during 2015. Investment grade returns were just above zero and high yield posted a small negative return.³ The outlook for 2016 is arguably less attractive. Spreads for both credit categories are slightly above long-term averages, but this is offset by the low level of yields in absolute terms. High yield has less interest rate exposure than investment grade, meaning that it should perform better in a rising rate environment.

A positive for bond markets in 2016 is our expectation that default rates will stay low through the year—with the exception of the energy sector, which accounts for just over 10% of the high-yield index.⁴ A negative, however, is corporate balance sheet quality, which is deteriorating on the back of increased leverage from buybacks and slowing profits growth.

Currency: strong USD to continue

It's been another strong year for the greenback, up by about 10% in trade-weighted terms since the beginning of the year. The USD is no longer cheap, but central bank policy divergence and further EM weakness mean the path of least resistance should be upwards. A strong USD is the market's consensus call, so there is a risk that central bank divergence has been priced in. The USD could also fall if the U.S. economy turns out significantly weaker and prevents the Fed from tightening.

Everything in moderation

Our favoured scenario sees moderate growth, a moderate Fed and moderate asset-class returns. Europe and Japan appear to have upside, the U.S. likely will be lackluster, EM will remain under pressure, and fixed income will be challenged by rising interest rates. □

We can't be sure how markets will react to Fed tightening. There are risks that U.S. growth will weaken, or that a slowdown in EM will flow into developed economies. If growth is too strong, there is a risk of inflation pressures and more aggressive Fed action. As stated above, the indicators to focus on are U.S. payrolls and wage growth, corporate profit growth and EM exports.

² Based on the Russell Emerging Markets Index and Russell Developed Index as of Dec. 11, 2015.

³ Based on the Barclays U.S. Corporate Investment Grade Index as of Dec. 11, 2015.

⁴ Based on the Barclays U.S. Corporate High Yield Index as of Dec. 11, 2015.

United States: Life after liftoff

Fed liftoff is a sign of economic strength, not weakness. However, U.S. equity markets are already fully priced. Further upside will be determined by corporate earnings power. This will be challenged by labour costs and the rising dollar. Returns likely will remain positive but modest.

Show me the earnings

The U.S. economy has come a long way from the depths of the crisis: The unemployment rate has been slashed in half from 10% to 5% as of November 2015, the housing market has turned from a source of vulnerability to a source of growth, and the consumer is fundamentally supported by healthy employment growth and lower energy prices. The strength and cumulative progress of the economy is what prompted Janet Yellen and the Federal Open Market Committee (the Fed) to hike interest rates off of zero for the first time in seven years at their December meeting. Naturally, the market's attention is now shifting squarely from the initial timing to the future pace of hikes.

The Fed has consistently communicated an intention to hike rates gradually. But the exact meaning of "gradualism" is open to interpretation. Our favoured scenario predicts continued moderate 2.0-2.5% real GDP growth and a tighter labour market that helps drive inflation higher. In such an environment, we think the Fed would feel comfortable hiking four times in 2016 (i.e. at every other meeting). Indeed, that would be the most gradual hiking cycle in the modern era of U.S. monetary policy. However, it could be perceived as aggressive relative to current market valuation, which appears to be pricing in only two hikes in 2016.

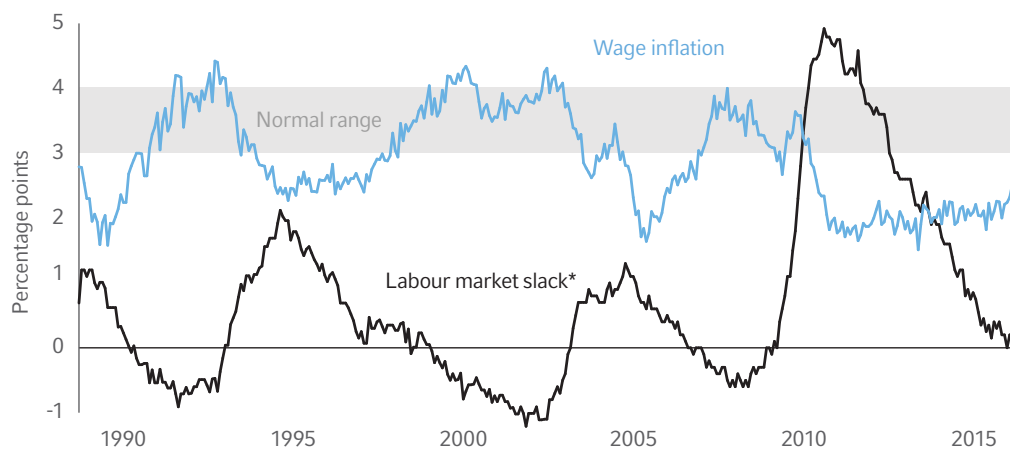
On a standalone basis, the U.S. appears resilient enough to weather higher interest rates. But the impact of further dollar strength – on both the U.S. and other global markets – could stay the Fed's hand. Fed liftoff is a signal of a more robust expansion, but that isn't to say that U.S. financial markets are without risk.

Years of asset purchases and ultra-accommodative monetary policy have pulled market returns forward. As a result the U.S. equity market is now fully priced at 17 times forward earnings, based on the S&P 500® as of Dec. 11, 2015. Expensive valuations act as a headwind to the market, and further upside in 2016 will hinge increasingly on corporate earnings power. Our baseline forecast calls for low to mid-single-digit U.S. earnings growth in 2016 as the large drags from the energy and materials sectors fade. But, in our view, the risks to earnings are still skewed modestly to the downside. In particular, we anticipate the unemployment rate will fall to 4.5% (or lower) by the end of 2016, and that could trigger upward pressure on wages, which would eat into profit margins.

The good news is that we do not see a recession on the horizon for 2016. The U.S. Business Cycle Index supports that view. And more fundamentally, we do not observe the types of economic imbalances today that would typically drive a recession. The labour market is nearly back to normal, but it isn't overheating; business investment remains below trend (and well below the worrying levels of the late 1990s); and household balance sheets are much healthier than they were in the run-up to the financial crisis. The corporate credit cycle, however, is moving into the later innings. For the time being this does not appear to be a systemic risk, as low interest rates make it easy for businesses to service their debt. But corporate credit will be a watch point for investors in the years to come.

/// We predict continued moderate 2.0-2.5% real GDP growth and a tighter labour market that helps drive inflation higher. In such an environment, we think the Fed would feel comfortable hiking four times this year (i.e. at every other meeting).

A tightening labour market poses upside to wages and downside to earnings



Percentage-point deviation of unemployment from its normal level

Sources: Bureau of Labor Statistics, Russell Investments as of Nov. 30, 2015.

Investment outlook

We maintain our underweight to the United States equity market in global portfolios as expensive valuations offset a modestly favourable macro backdrop.

- › *Monetary policy:* We expect the Fed to hike interest rates four times in 2016 and for that to drive further upside in the U.S. dollar and push the 10-year U.S. Treasury yield towards 2.8% by the end of 2016.
- › *Stronger dollar:* We expect the dollar to appreciate by another 5% to 10% in 2016 on a trade-weighted basis, driven by policy divergence between the U.S. and other major central banks. A stronger dollar is a drag on multinationals' profits, and our dollar estimates subtract roughly one to two percentage points from the corporate earnings growth outlook in 2016.
- › *Corporate earnings growth:* Excluding energy and materials, U.S. trailing earnings growth estimates remain decent, at roughly 5%. However, earnings expectations for 2016 (+8%) remain somewhat elevated relative to our forecast for mid-single-digits. A tighter labour market and peak profit margins pose a risk and we expect earnings expectations to be downgraded as the year progresses.

Volatility in U.S. equities and rates should remain somewhat elevated into March when the Fed potentially will provide investors with further clarity on the pace of its hiking cycle.

Strategy outlook

- › **Valuation:** U.S. equities remain quite expensive, which is a headwind to future market performance.
- › **Business Cycle:** We expect the U.S. economy to continue to grow at an above-trend pace in 2016. Fed policy is tightening, but still accommodative in an absolute sense. The economy should be able to chug along with little risk of recession in 2016.
- › **Sentiment:** Equity sentiment is slightly positive but fading back to neutral. Our short- and medium-term oversold signals have faded since the August selloff.
- › **Conclusion:** We continue to have a modest underweight preference for U.S. equities in global portfolios with our earnings outlook supporting a low- to mid-single-digit total return expectation in 2016. Volatility in U.S. equities and rates should remain somewhat elevated into March when the Fed potentially will provide investors with further clarity on the pace of its hiking cycle. □

The eurozone: Maintain your enthusiasm

We remain enthusiastic about eurozone risk assets, even as our appetite wanes for risk assets in general. In fact, we want to remind our readers that our preference for euro-zone assets was never a trade, but an investment. Looking ahead to 2016 we believe there is still quite a bit of gas left in the tank—even if we account for the fact that the starting point has moved up.

Gas in the tank

Euro-zone risk assets have had a good year. In local currency terms, which we continually point out as an important consideration in our investment decision, the Russell Eurozone Index returned 17.2% as of Nov 30, 2015. Government bonds have done well too, with the periphery gaining 4% to 7%⁵ versus the core gaining 2%. Obviously, these healthy returns move up the starting point for euro-zone assets, making it harder for them to continue to outperform. However, we believe there is enough gas left in the tank to keep the eurozone going for another year, albeit at a slower pace in terms of outperformance.

In order to explain why we think there are still gains to be had, it is important to start with our analysis of both the size and value of future earnings. With respect to the size of future earnings, we see a positive impact from a continued economic recovery, rising profit margins, and a weaker euro. With GDP growth expected to continue at 1.5%-2%, driven by pent-up consumer demand, positive credit growth, a cheap euro, and low oil prices, revenue growth should be supported. At the same time, profit margins are expected to keep on trending higher as the input cost of raw materials is falling and wage growth is low. Finally, the weaker euro is supporting the export sector and is boosting foreign earnings in euro terms. Combined, we expect corporate earnings to grow by 4-8% in 2016, which, given the 10% growth⁶ already achieved in 2015, is quite healthy.

With respect to the value of future earnings the focus lies on the discount rate used to calculate their present value. We expect the discount rate to remain under downward pressure from loose monetary policy. Indeed, although European Central Bank (ECB) President Mario Draghi boosted monetary policy on Dec. 3, 2015, he did not quite meet elevated market expectations.

In previous reports, we've often focussed on euro-zone tailwinds and our focus on the balance between reflationary and deflationary forces. Nothing has really changed in this respect. What has changed, however, is the fact that expectations have been steadily increasing. Not only does that make it harder to surprise on the upside, it also means more of the recovery has been priced in already.

This combination of higher expectations and higher prices has lowered the potential for future outperformance. Simply put, the threshold has gone up. In fact, for government bonds in the periphery we have trimmed our overweight back to neutral after reaching our target spread of 1% versus German bunds (see chart on page 9). In equities, however, we still strongly favour the eurozone because the supports mentioned above are combined with relatively cheap valuations versus U.S. equities.

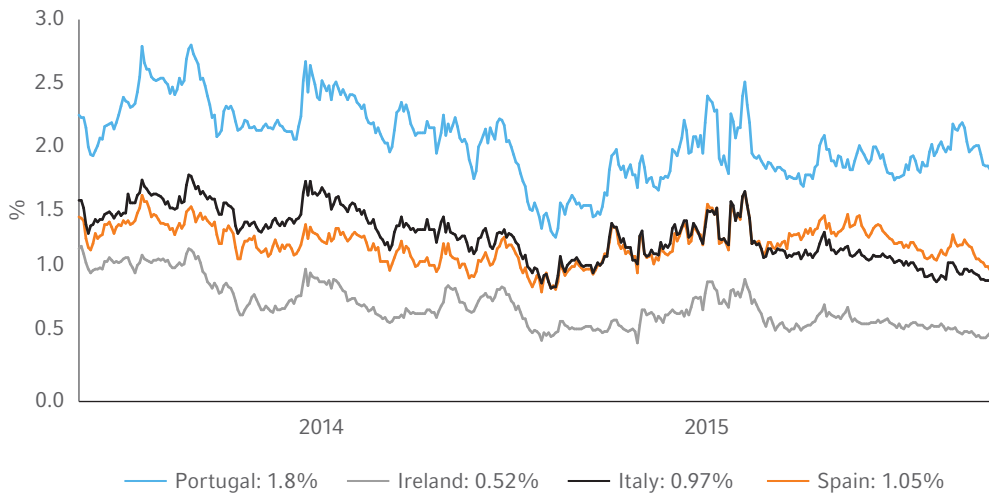
 We expect eurozone GDP to continue growing at 1.5%-2%, driven by pent-up consumer demand, positive credit growth, a cheap euro, and low oil prices.

⁵ Based on 10-year government bonds in Italy, Spain and Portugal for "periphery" and Germany, France and the Netherlands for "core".

⁶ Based on the MSCI European Monetary Union Index (in €), 12-month-trailing earnings-per-share as of Nov. 30, 2015.



10-year bond spread relative to Germany



Source: Thomson Reuters
 Datastream: Benchmark Bonds
 data as of Dec. 3, 2015

Revisiting our watchpoints

As always, we continue to monitor watchpoints for signs of trouble:

- › *The 5-year, 5-year forward inflation swap.* At approximately 1.7%, this watchpoint is still flashing amber, although only slightly. We would like to see inflation expectations pick up a bit more, and we expect the latest ECB moves to do just that.
- › *Credit impulse.* The credit impulse (the change in credit growth) has gone back from a slight shade of amber to a slight shade of green. Credit growth has picked up again after a lull in the third quarter and the ECB's Senior Loan Survey continues to improve.

Strategy outlook:

- › **Valuation:** Eurozone equities are neutrally valued in an absolute sense, but they are cheap relative to the U.S. In government bonds we have gone back to neutral in peripheral bonds after having gone back to neutral in core bonds last quarter.
- › **Business cycle:** We maintain our positive outlook for the business cycle although higher expectations have caused us to trim our score a tad. GDP growth in 2016 is expected to be 1.5% to 2%, the same as in 2015. After meeting our target for 10% corporate earnings growth in 2015 we are looking for a healthy 4% to 8% in 2016. Finally, both fiscal and monetary policies remain supportive.
- › **Sentiment:** Price momentum is still neutral, but our contrarian indicators continue to keep the overall score slightly positive.
- › **Conclusion:** We maintain our overweight position to eurozone equities, but we go to neutral in peripheral bonds alongside our existing neutral position in core government bonds. □

After meeting our target for 10% corporate earnings growth in 2015 we are looking for a healthy 4% to 8% in 2016.

Asia-Pacific: Waiting on hopes and fears

As we move into 2016 we have seen scant evidence, so far, of the hoped-for recovery in the Japanese economy and in regional trade. On the other hand, fears of recession in China and Australia are also not supported by the still-reasonable data. As the region traces out this middle path, we look for moderate growth in 2016.

2016: Stumblin' in

We expect Asia-Pacific economies to respond to monetary stimulus, to currency devaluations, and to recovery in the U.S. and Europe. Equity markets lack momentum, but offer acceptable value. Bond markets across the region remain vulnerable.

Economic and market conditions in the Asia-Pacific region are less than dynamic as we move towards 2016.

In Japan, despite the "Three Arrows" of Abenomics – fiscal stimulus, monetary stimulus and structural reform – the evidence of economic recovery is patchy and unconvincing. GDP data has skirted (and barely avoided) recording a "technical recession."

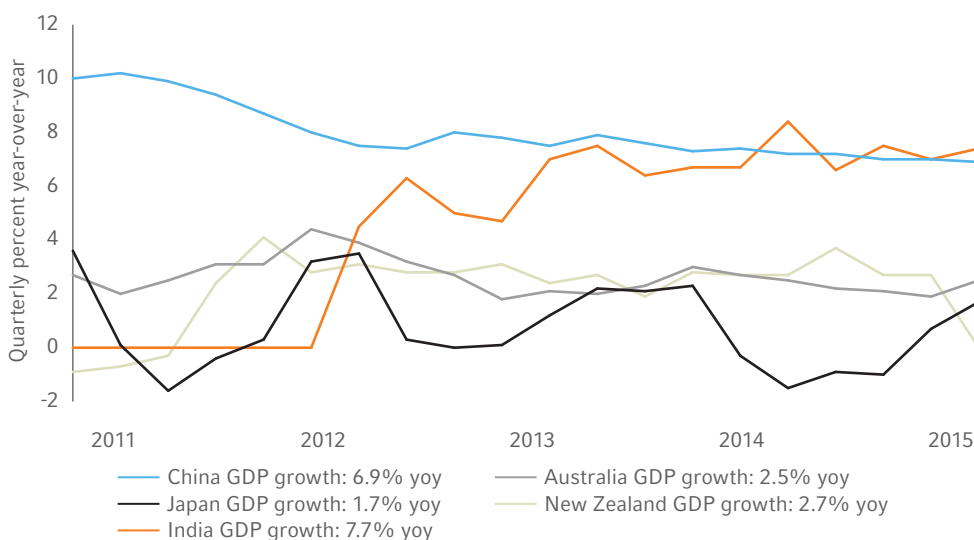
Meanwhile, in China, GDP growth has slipped from the 7% to 8% range to the 6% to 7% range. A number of Chinese indicators are very weak, notably trade and construction activity.

The Australian national income numbers are holding up, but with weak commodity prices, a softening housing sector and flat corporate profits, it's hard to get too excited. Growth in New Zealand is acceptable, but modest.

Indeed, of the major regional economies, only India is delivering some upbeat results.

The chart below shows recent GDP trends in a selection of regional economies:

Asia-Pacific real GDP growth



We expect Asia-Pacific economies to respond to monetary stimulus, to currency devaluations, and to recovery in the U.S. and Europe. Equity markets lack momentum, but offer acceptable value. Bond markets across the region remain vulnerable.

Source: Thomson Reuters Datastream as of December, 3, 2015

Growth drivers for the year ahead

Whether market “hopes” for the recovering economies or “fears” for the vulnerable nations will gain the ascendancy in 2016 depends in large part on the growth outcomes in the U.S. and Europe. We are sufficiently positive about the global outlook to expect ongoing recovery in Japan; soft landings in China and Australia; and steady growth in India—and, at lower levels, in New Zealand.

Greater or lesser currency weakness across much of the region, and broadly stimulatory monetary policies, are common themes in our optimistic diagnosis for the year ahead. In Japan in particular, fiscal stimulus and a program of corporate reform should provide the economy with added support, as will lower energy prices.

In China, we are witnessing a convincing program of market reform—recently acknowledged by the International Monetary Fund with its inclusion of the renminbi in the international Special Drawing Rights (SDRs) currency basket. The transition from an economy driven by fixed investment to one driven by consumption and services also appears to be on track.

Further south, in Australia, both fiscal and monetary policy are somewhat gridlocked, and the downside risks following a record housing boom remain a watch-point. The current data as of Dec. 11, 2015, remains mixed rather than negative, however, and we do not expect recession in 2016.

Investment strategy: value, cycle, sentiment

Applying our investment strategy process of value, business cycle and sentiment we get the following:

Equity markets in the Asia-Pacific region offer reasonable value, in our assessment. We are broadly positive about the cycle outlook, but we are not looking for more than single-digit percentage returns in 2016. Sentiment is muted, though it offers some potential for upside.

Japan is our preferred equity market in the region, benefitting as it does from good corporate profit growth, a favourable policy backdrop, lower oil and gas prices, as well as a weaker yen.

China “A” shares had a roller-coaster ride in 2015, but we believe that the valuation excesses of mid-year have now been largely unwound. Tailwinds from the market-deregulation program, in conjunction with China’s good long-term growth prospects, provide this market with support. Only uncertainties regarding debt imbalances hold us back from a more overtly positive stance, for now.

In **Australia**, the equity market is still trading down at 2006 levels, and the dividend yield is up to an eye-catching 5%, based on the S&P/ASX 200 Index as of Dec. 11, 2015. Value is less compelling than it might at first appear, however. The thin price-to-earnings discount to global valuations leaves us cautious about this materials- and financials-heavy market, however, as do the lack of earnings momentum and the stretched payout ratios. Cyclical factors are acceptable, but no better than neutral. Sentiment is downbeat. □

Equity markets in the Asia-Pacific region in our assessment are fairly priced. We are broadly positive about the outlook, but we are not looking for more than single-digit percentage returns in 2016.

FX Outlook 2016: The peak in the U.S. dollar

The U.S. dollar is entering the mature phase of its cyclical bull market which is likely to end before the second half of 2016. Sometime in 2016, we expect to see the start of a multi-year period of EM currency outperformance.

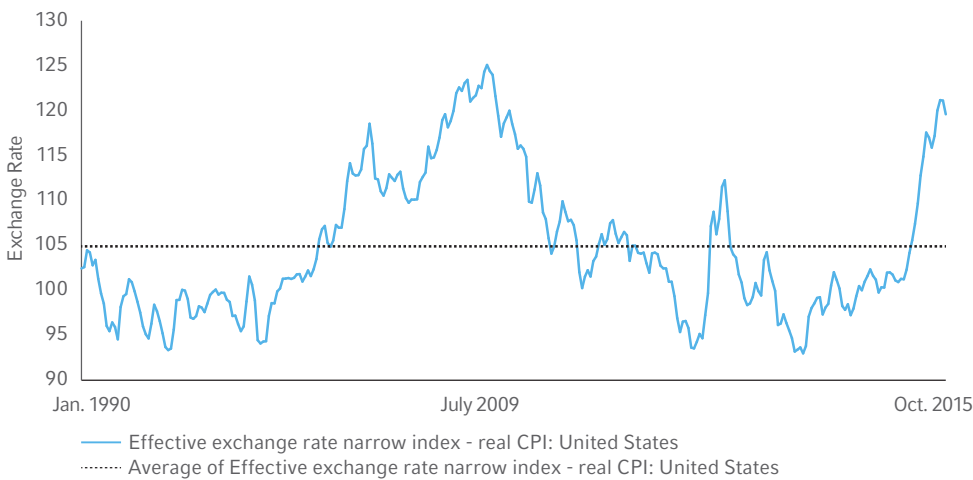
How high can the U.S. dollar go?

The dollar bull cycle is maturing. In Chart 1, we see the trade-weighted real U.S. dollar (USD) exchange rate index against 27 developed country currencies (the narrow index), as calculated by the Bank for International Settlements. A high real exchange rate may signal overvaluation and a low rate suggests undervaluation.

The trade-weighted dollar bottomed in late 2011 and has been appreciating since then. It is some 5% below the previous peak of 2002, which suggests that the dollar's ascent against the major currencies is getting long in the tooth and valuation is becoming a headwind.

For the dollar to reach its 2002 valuation peak requires good support from sentiment and cycle factors, which we think will be forthcoming in the first half of 2016 due to policy divergence.

Trade-weighted U.S. dollar exchange rate index (narrow)



Source: Thomson Reuters Datastream as of Oct. 15, 2015

USD and group of three: Euro, yen, sterling

While the greenback is fairly valued against the pound, it is 10% rich versus the euro (EUR) and 20% rich versus the Japanese yen (JPY) according to purchasing power parity as of Dec. 11, 2015. However, previous dollar cycles suggest that developed market currencies have a tendency to overshoot fair value by 20% to 30%.

For the dollar to reach its 2002 valuation peak requires good support from sentiment and cycle factors, which we think will be forthcoming in the first half of 2016 due to policy divergence. The U.S. Federal Reserve will probably continue raising interest rates while other major central banks are still easing policy or standing pat. If previous cycles are a guide, the EUR/USD exchange rate could drop to around parity and USD/JPY could reach 125 before the dollar bull cycle ends. Due to its high valuation, the pound (GBP) is most at risk and GBP/USD could fall to 1.40.

Commodity currencies

Even after two years of weakness, we think that commodity-related currencies (the Australian, New Zealand and Canadian dollars) remain vulnerable to further softness in the prices of their main exports, mostly raw materials.

The terms of trade of these economies (the ratio of export prices to import prices multiplied by 100) are important determinants of currency valuation. A fall in the terms of trade is usually associated with a fall in the exchange value of the commodity currencies. Unlike the euro and the yen, the commodity currencies are not considered significantly undervalued against the dollar yet, because their devaluation over the last two years has roughly been commensurate with the fall in their terms of trade.

Emerging market currencies

Emerging market (EM) currencies in our view could fall further against the dollar than those of the major developed countries. Much of that risk is due to weakness in the Chinese yuan. The dollar peg put in place by China after the global financial crisis led to strong real appreciation of the Chinese yuan over the last five years. We think that the Chinese currency could be around 10% overvalued. To restore competitiveness and boost its economy, we think that China is likely to embark on a gradual depreciation of the yuan in 2016.

In the short-term, weakness in the Chinese Yuan could drag down other EM currencies. However, some of the other emerging market countries have seen their currencies fall to attractive levels. Sometime in 2016, we expect to see the start of a multi-year period of EM currency outperformance.

Where could we be wrong?

We see two main risks to the central scenario outlined above:

1. The U.S. economy could be too weak in 2016 (or the European and Japanese economies too strong) for policy divergence. In this case, we could already have seen the peak in the dollar against the majors. The other safe-haven currencies like the euro and the yen could strengthen in the first half of 2016.
2. If the global economy falls into recession, China commits a major policy mistake, or the fundamental imbalances in EM are more severe than we currently realise, the turnaround in EM currency performance we expect for later in 2016 will not materialise.

Conclusion

We see 5% upside potential for the trade-weighted U.S. dollar against developed market currencies and 10% against emerging markets. However, we think that this dollar strength is mainly going to play out in the first half of 2016. Sometime later in the year we expect to see the peak in the U.S. dollar bull cycle and the start of a multi-year period of EM currency outperformance. □

 The dollar peg put in place by China after the global financial crisis led to strong real appreciation of the Chinese yuan over the last five years. To restore competitiveness and boost its economy, we think that China is likely to embark on a gradual depreciation of the yuan in 2016.

Quantitative Modeling: Moderation in all things

Russell Investments' suite of proprietary quantitative models forecasts:

- › Portfolios should include equal amounts of U.S. equity and U.S. fixed income.
- › The U.S. Business Cycle Index indicates low recession risk and forecasts 2.5% U.S. real GDP growth in 2016, year-over-year.
- › The target range for the federal funds rate will see four more hikes during the year of 25 basis points each, ending 2016 at 1.25% to 1.5%.

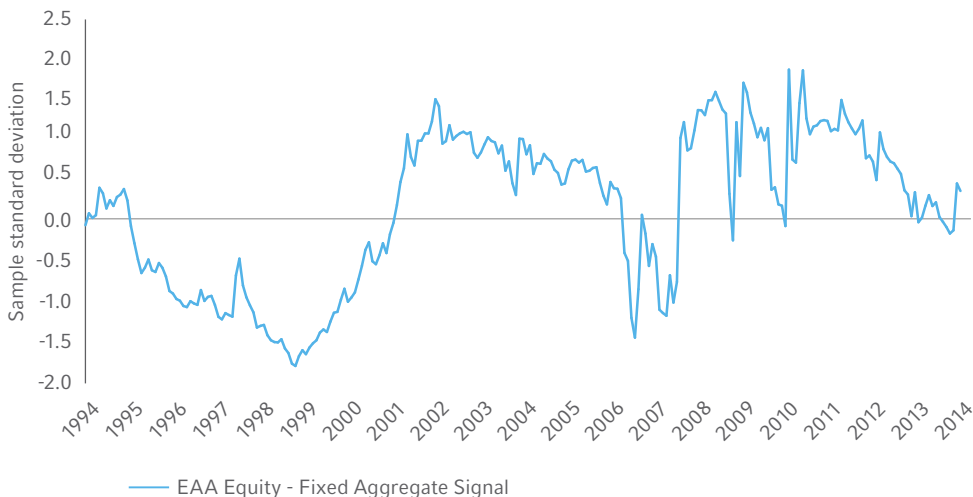
Neutral equity outlook

Our models-based outlook continues to signal neutral on equity versus fixed income. Following the U.S. stock market rally in October of 2015, the signal moved toward equity, but not enough to indicate a bull market. We see some potential headwinds for equities given that our expected pace of rate hikes is faster than the market's (as measured by 30-day Fed funds futures as of November 30). This view tempers our bullishness.

- › **Business Cycle:** The U.S. Business Cycle Index still shows low recession risk, but has softened amid global concerns. It was a negative contributor to our equity/fixed call.
- › **Sentiment:** Following recent market events, the 12-month declining weighted average of excess returns turned positive. However, we need to see more sustained momentum in order to upgrade our score.
- › **Value:** As equities have increased in price since our previous quarterly report in September (as measured by the S&P 500® Index), the earnings yield has decreased. This makes equities look less attractive to a dividend discount model and Fed model.

Our quantitative signals point to moderate growth and moderate inflation, which in turn suggest moderate positioning in multi-asset class portfolios.

EAA¹ Equity - Fixed Aggregate Signal



Source: Russell Investments as of Dec. 10, 2015

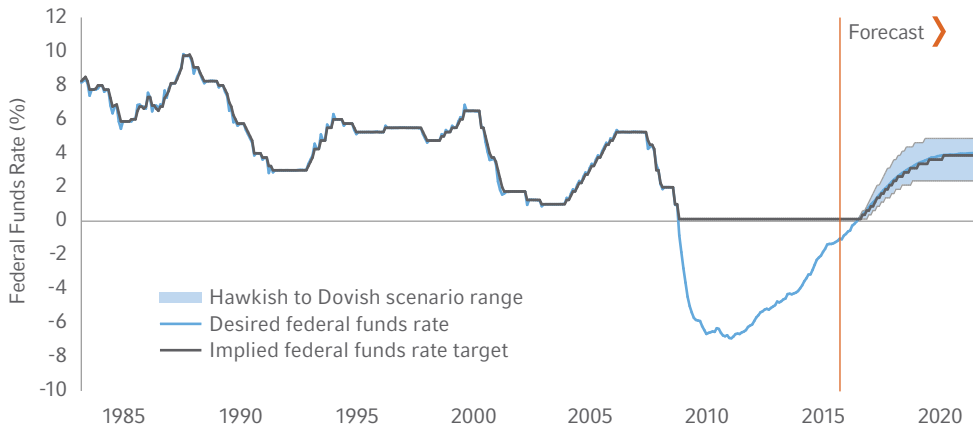
¹ Enhanced Asset Allocation (EAA): A holistic approach designed to aggressively look for return opportunities while maintaining portfolio discipline within a total portfolio management program.

Scenarios for the pace of Fed tightening

Since the first Fed tightening is over, we're moving our attention from the timing of the first rate hike to the pace of future hikes. Our Fed Funds Target Model forecasts a Fed funds target range of 1.25% to 1.5% (four more 25 basis points hikes) by the end of 2016. The model projects the Federal Reserve's desired monetary policy, given expectations of unemployment, inflation, and the U.S. Business Cycle Index.

Forecasting represents predictions of market prices and/or volume patterns utilising varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

Federal funds rate target absent zero lower bound



Source: Russell Investments as of Dec. 10, 2015

Since the pace of rate hikes is data driven, we have projected the path of interest rates under the Fed’s different scenarios for unemployment and inflation. The dovish scenario of only two hikes in 2016 (the current market pricing) requires stubbornly low inflation with stalled unemployment, or a deterioration of the U.S. Business Cycle Index.

The unlikely hawkish scenario of seven hikes in 2016 (a historical pace) requires many forces to align such as: steady payrolls driving unemployment down to the low four percent range; a robust business cycle; and above-target inflation—specifically, around 2.4% for core personal consumption expenditure (PCE) inflation.

Using the U.S. Business Cycle Index’s central scenario of low recession risk and 2.5% GDP growth, the chart below shows the number of additional 25 basis point rate hikes by the end of 2016 under the Fed’s scenarios for the economy. □

The Federal Reserve’s inflation and unemployment scenarios, as of their September 2015 projections:

		Unemployment		
		High	Central	Low
Inflation	Low	2	3	5
	Central	3	4	5
	High	5	6	7

INFLATION SCENARIOS:

Low inflation:
1.5% core PCE inflation by end of 2016

Central inflation:
1.7% core PCE inflation by end of 2016

High inflation:
2.4% core PCE inflation by end of 2016

UNEMPLOYMENT SCENARIOS:

High unemployment:
5.0% unemployment by end of 2016
(115,000 average payrolls required)

Central unemployment:
4.8% unemployment by end of 2016
(140,000 average payrolls required)

Low unemployment:
4.5% unemployment by end of 2016
(175,000 average payrolls required)

IMPORTANT INFORMATION

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

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

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

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behaviour, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behaviour. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

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 capitalisations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The Russell Eurozone Index measures the performance of the equity markets located in the Euro Zone, based on all investable equity securities in the region.

The Barclays U.S. Aggregate Bond Index is a broad based index often used to represent investment grade bonds being traded in United States. It is maintained by Barclays.

Barclays U.S. Corporate Investment Grade Index is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least \$250 million par amount outstanding.

Barclays U.S. Corporate High Yield Index is an unmanaged index that covers the US dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market.

The MSCI EMU (European Monetary Union) Index is an unmanaged index considered representative of the EMU group of countries.

The S&P/ASX 200 Index tracks the performance of 200 large companies based in Australia.

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