RUSSELL INVESTMENTS

Late-cycle volatility

2016 Global Market Outlook—Q2 update

Our view on global equities has shifted downward and we now see low single-digit returns as more likely for 2016.

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Diminishing outlook for global equities; still positive

Global divergence between the U.S. and the rest of the world remains a key theme and is driving market volatility. Weaker global business cycle conditions are making us more cautious. We still prefer Europe for equities and remain wary of long-term interest rate exposure.

EXECUTIVE SUMMARY

By **Andrew Pease**
Global Head of Investment Strategy, Russell Investments

Markets are jittery and it's not hard to see why. Investors are swinging between fear of recession, relief when it doesn't happen, and anxiety when good economic news brings U.S. Federal Reserve (Fed) tightening back onto the radar. Political uncertainty is adding to the unease as the Brexit[1] referendum draws closer and Donald Trump continues his remarkable showing in the Republican primary race. Identifying the signals amid all the noise is a challenge, and we do this using our cycle, value and sentiment investment strategy process.

The process is telling us that business-cycle support for equities is weakening as the corporate profit outlook softens, the Fed continues tightening, and the Bank of Japan and the European Central Bank reach the limits of additional policies support. It also tells us that U.S. equities are expensive and that sentiment is now less favourable with underlying price momentum flat to negative after the solid uptrend of the past four years.

Paul Eitelman in the United States sees a deteriorating outlook for corporate profits and a slightly weaker outlook for gross domestic product (GDP) growth this year. Even so, growth is likely to be robust enough to see the Fed tighten a couple of times this year. He reiterates an underweight preference to U.S. equities and sees U.S. 10-year Treasury yields rising to 2.3% over the next 12 months.

By contrast, Wouter Sturkenboom thinks eurozone equities are being unfairly penalised in the market pull-backs. He sees reasonable value and a business cycle that is equity-market supportive, although less so than a few months ago. Eurozone equities should be solid outperformers during market rebounds.

Graham Harman expects the Asia-Pacific region to remain a modest performer. Economic growth performance is patchy across the region. His assessment of Japan's cycle has been downgraded, but he sees brighter signs for India, Australia, and New Zealand. Graham is still in the "soft landing" camp for China. Overall, Graham scores the cycle as neutral across the region and sees modestly positive value. He expects low returns and high volatility.

Van Luu applies cycle, value and sentiment to currencies and sees the end of the U.S. dollar bull run. The Japanese yen is bottoming in his view and may have upside potential. The euro should stay weak while the Chinese yuan and the commodity currencies could have one further leg-down.

Our investment strategy process is based on both the qualitative insights of our strategists and a range of quantitative models run by Abe Robison and Kara Ng. Their models point to a neutral outlook for equity versus fixed income. (The macro models continue to suggest low recession probabilities and a more hawkish outlook for the Fed than Paul's qualitative assessment). ■

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[1] Brexit refers to the possible British exit from the European Union.

Investment Strategy Outlook

The business cycle outlook is weakening across the globe, while U.S. inflation pressures mean the Fed is likely to lift rates a couple of times in 2016. Volatility should persist; Treasury yields will be under upward pressure; and our view on global equities has shifted from mid-to-low single digits to low single digits as more likely for 2016.

Late-cycle volatility

It's been a rough start to the year. Global developed equities, as measured by the FTSE Developed Index, lost nearly 20% from their 2015 peak by mid-February of 2016, before rebounding by around 10% by mid-March. The volatility has been driven by a combination of China fears, Fed tightening, U.S. recession concerns, bank balance sheet worries and soft corporate profits. The move to negative interest rates in Europe and Japan has triggered fears that central banks have run out of easing options. Negative rates also tend to squeeze the margin between banks' borrowing and lending rates; this in turn could hurt bank profitability, and could end up making things worse.

A sustained bear market seems unlikely as long as the U.S. does not fall into recession. Our U.S. business cycle model places a low probability on a recession over the next couple of years.

Our favoured scenario in the 2016 Annual Outlook report was for mid-to-low single digit returns for global equities and a gradual rise in long-term interest rates. This is still the case, although low-single digit returns now look more likely. The outlook for corporate profits has weakened, global trade and manufacturing are softer, and the risks around emerging markets (EM) have slightly increased. The cyclical backdrop for equities is becoming less supportive.

A sustained bear market seems unlikely, however, as long as the U.S. does not fall into recession. And, as of March 15, 2016, our U.S. business cycle model places a low probability on a recession over the next couple of years.

Global divergence remains a key theme and this is likely to drive ongoing market volatility. The European Central Bank and the Bank of Japan are expanding quantitative easing and moving interest rates further negative. The Fed, by contrast, faces inflation pressures from an unemployment rate below 5% as of Feb. 29, 2016, and the waning of the deflationary impacts of falling commodity prices and the rising USD. The weakness in the rest of the world is a headwind for the U.S. economy, but domestic inflation pressures mean that the Fed is likely to raise rates a couple of times this year. The net result is that periods of market stability are likely to be punctuated by episodes of Fed tightening speculation and fears of global slowdown.

Key indicators

We identified three key indicators in our 2016 Annual Outlook report to watch closely this year: U.S. non-farm payrolls, earnings-per-share growth for the S&P500® Index and exports from emerging markets. Only non-farm payrolls support our preferred scenario of mid-to-low single digit equity returns. The other two indicators have us a little worried about weaker business cycle conditions this year.

› **U.S non-farm payrolls**. These averaged 207,000 for the first two months of 2016, according to the U.S. Bureau of Labour Statistics, while the annual growth in average hourly earnings has decelerated from 2.6% in December to 2.2% in February. This combination of robust jobs growth and moderate growth in wages we believe supports equities and reduces pressure for the Fed to tighten aggressively.

- **S&P500 earnings-per-share (EPS) growth**. We were looking for 3% to 5% growth this year. The fourth quarter 2015 company reporting season was poor, and profits are under pressure from weak productivity growth (which pushes up unit labour costs), the strong U.S. dollar (USD), and sluggish growth in revenue. The consensus forecast of bottom-up industry analysts for 2016 EPS growth, according to the Institutional Broker Estimate Service, was downgraded from 7.0% in December to 1.6% in March. This was a weak start to the year and highlights the downside risk to our EPS growth expectation.
- **Emerging markets exports**. The trade slump in emerging markets has deepened. The bellwether markets of South Korea and China are both experiencing double-digit export declines.

Global equities: favour Europe, cautious U.S. and EM

Our investment strategy process is based on the building blocks of value, cycle, and sentiment. Applying this process to global equities we get the following as of March 15, 2016:

- **Valuation**: The recent pullback in equity markets has improved value across developed markets. We still rate the U.S. as the most expensive. Japanese and European equities are now slightly cheap and EM equities are moderately cheap.
- **Cycle**: The cycle is becoming less supportive for equities. Europe and Japan still have the most favourable cycle backdrop, with supportive monetary policies, weak exchange rates, and the potential for rising profit margins. We now think the cycle is neutral for U.S. equities given the risks around EPS growth and the potential for further Fed tightening. The cycle is negative for EM amid slowing growth, export weakness, and a deteriorating outlook for EPS growth.
- **Sentiment**: Price momentum is negative in every region, which is a negative sentiment indicator. Our contrarian indicators still point to modestly oversold conditions, which offsets negative price momentum. Overall, sentiment is neutral across the major regions.

The cycle is becoming less supportive for equities. Europe and Japan still have the most favourable cycle backdrop, while the cycle is neutral for U.S. equities and negative for EM.

Europe continues to be our preferred exposure, and we have become more cautious on the U.S. alongside EM. The valuation of U.S. equities is expensive, and its business cycle score struggles under downward pressure. The chart on page five shows the S&P500 against its underlying trend—as measured by the 200-day moving average.

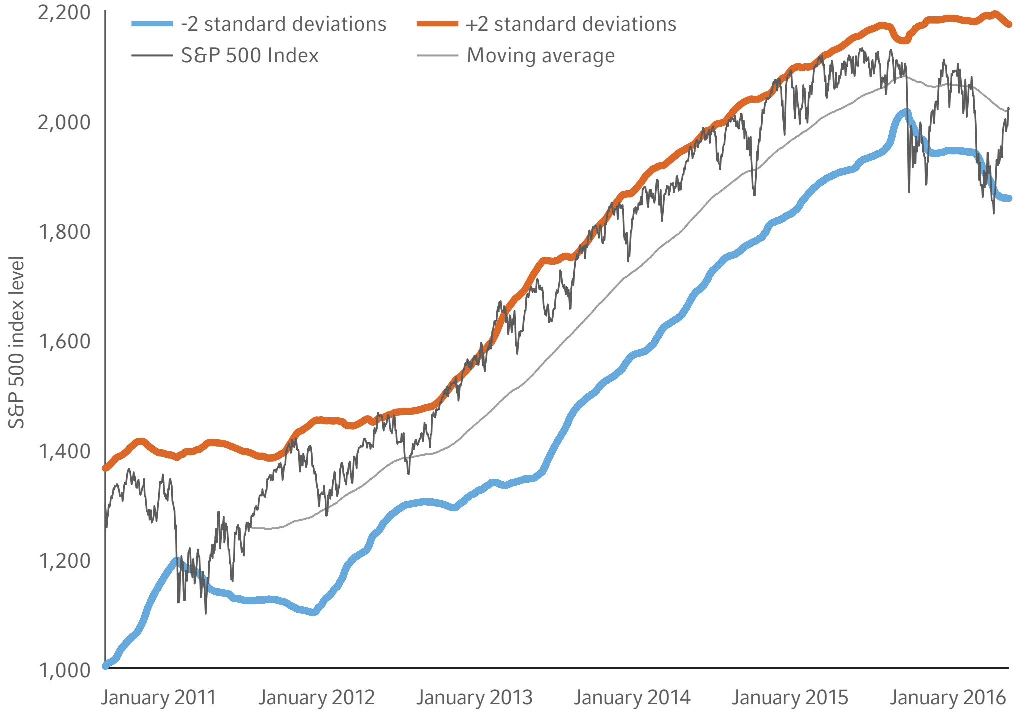
There is an old saying in markets that "the trend is your friend." For example, the S&P500 had a strong upward trend from 2012 to 2015. This made it relatively easy to "buy the dips", particularly when combined with a positive business cycle outlook. Now, however, price momentum has turned negative and the U.S. business cycle is at best neutral for the equity market. Under these circumstances, we think it's better to "sell the rallies" than chase the market higher.

Government bonds: poor value, but more cycle support

Our process, not surprisingly, scores government bonds poorly on value. Ten-year yields are negative in Japan and not far from record lows in the U.S. and Europe. But, as the cycle is becoming less favourable for equities, it is becoming a bit less unfavourable for government bonds.

We see the divergence referred to earlier as central banks in Europe and Japan continue quantitative easing (QE) programs. This contrasts with the likelihood of a couple of Fed rate hikes in the U.S. this year. And our sentiment indicators score government bonds as overbought after the recent rally. The combination of cycle, value and sentiment considerations keeps us negative on U.S. government bonds. The softer business cycle outlook, however, is making us less negative.

S&P 500 versus 200-day moving average



Source: Datastream, as of March, 18, 2016

Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation. In finance, standard deviation is applied to the annual rate of return of an investment to measure the investment's volatility.

End of the dollar bull run

The three-year bull run for the greenback (U.S. dollar) looks to be running out of steam. In part, this is because it now seems that the Fed will raise rates only a couple of times this year, rather than the four times that seemed likely at the beginning of the year. It is also because further QE announcements and negative policies interest rates aren't having a big impact on the Japanese yen or euro. The USD could have a final move higher against emerging currencies (particularly China's yuan) and commodity currencies such as the Australian and Canadian dollars. But it is likely to move in a more narrow horizontal range against the other major currencies.

Equity markets have limited upside

Our investment process is effectively telling us that the downside risk from a waning business cycle and negative price momentum outweighs the upside potential of a continued snapback rally from oversold conditions and slightly more attractive valuations. We are becoming more cautious and, unless the business cycle improves, likely to stay cautious. ■

United States: A more clouded outlook

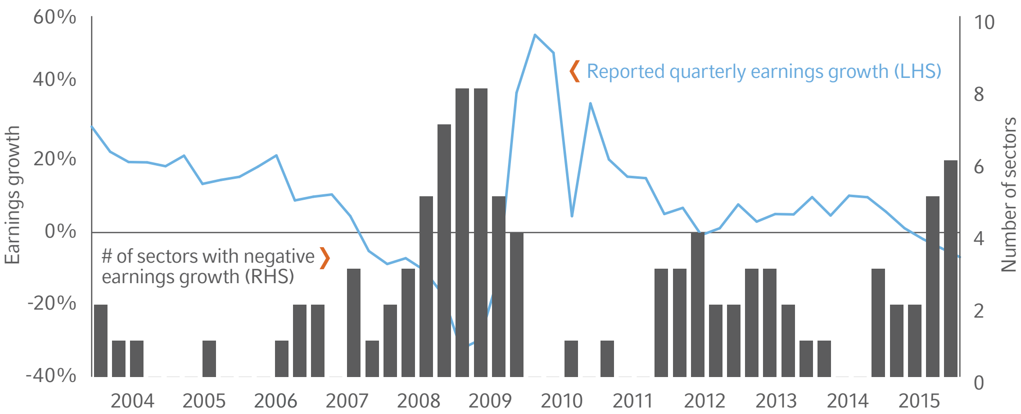
The fourth-quarter 2015 U.S. earnings season was disappointing. Negative profit growth spread beyond the commodity-linked sectors, while downside risks to the economy intensified. However, we still do not foresee a recession in 2016. With domestic inflation firming, the Fed is likely to hike twice by the end of the year.

Lacklustre earnings

In our 2016 Annual Outlook report we wrote that "expensive valuations act as a headwind to the market and further upside in 2016 will hinge increasingly on corporate earnings power." As such, earnings were a key risk factor to our outlook. In fact, the recently concluded fourth-quarter reporting season proved quite disappointing. Headline S&P 500 profits contracted 6.8% relative to the fourth quarter of 2014. But the more troubling feature of the reporting season was that negative earnings growth has become more pervasive. Whereas in late 2014 and early 2015, profit weakness was concentrated in the energy and materials sectors (a natural byproduct of the sharp fall in commodity prices), today six out of 10 S&P 500 sectors show contracting earnings growth. If sustained, this could engender further erosion of business confidence, leading to more conservative hiring and capital expenditure decisions, which could ultimately slow the run-rate of the U.S. economy.

A tentative topping out of the U.S. dollar and a compression of corporate bond spreads have now brought financial conditions back to roughly the same levels that were prevailing at the time of the Fed's December 2015 liftoff announcement. If sustained, market conditions are likely to be supportive of a next hike by the June FOMC meeting.

Weak S&P 500 earnings extend beyond energy and materials sectors



Source: Bloomberg. Data as of March 14, 2016

While downside risks are more prevalent than late last year, it's not all bad news from an economic perspective. We note a lack of major imbalances in the U.S. economy. For example, the labour market is operating at near-normal levels and business investment is still below trend. Thus, we continue to believe that a recession is unlikely.

But on net, our U.S. outlook is certainly more nuanced and clouded than late last year. Our central scenario now calls for 2.0% real GDP growth in 2016—down from a range of 2.0% to 2.5% at the end of 2015. Robust real income growth, a healthy housing market and fading drags from fiscal policies continue to be the primary drivers of this view. A more pessimistic scenario results in an economy that could slip into a mid-cycle soft patch (i.e., positive but sub-2% growth) if the transmission channel from weak corporate earnings into the real economy gets activated. The asymmetry around earnings and economic prospects has led us to downgrade our assessment of the U.S. business cycle to neutral.

The Federal Open Market Committee's (FOMC) calculus has become quite complicated, too. Ongoing concerns about the health of the emerging markets (EM) and wild swings in financial markets left the FOMC in a holding pattern at its March meeting. The timing of the next rate hike will ultimately be predicated on three fundamental building blocks, or what we call the "three-legged stool" of Fed policies: labour, inflation and financial conditions.

The labour market remains healthy. Non-farm payrolls have averaged a stronger than expected 207,000 in the first two months of 2016. And with the unemployment rate below 5.0%, the labour market "leg" is ready for further rate hikes.

The inflation "leg" has also strengthened. Core personal consumption expenditures (PCE) inflation accelerated in January to 1.7% on a year-over-year basis. Notably, this measure now already exceeds the Fed's year-end forecast of 1.6% for 2016. Market-based measures of inflation expectations have also improved in line with the recent stabilisation in commodity prices.

The wildcard is the third "leg"—financial conditions. The Fed keeps its eye on the feedback channel from the dollar exchange rate, corporate bond spreads and other financial variables to determine the balance of risks for the growth outlook. A tentative topping out of the U.S. dollar and a compression of corporate bond spreads have now brought financial conditions back to roughly the same levels that were prevailing at the time of the Fed's December 2015 liftoff announcement for interest rates. If sustained, market conditions are likely to be supportive of a next hike by the June FOMC meeting.

We now look for the Fed to hike two times in total in 2016. Our Fed view remains somewhat more aggressive than what is currently priced into the U.S. bond market, and – coupled with our assessment of global risk factors – we forecast a gradual increase in the 10-year U.S. Treasury yield to roughly 2.3% over the next 12 months.

We have an underweight preference for U.S. equities in global portfolios as Lacklustre earnings and rich valuations suppress total return expectations to near-zero over the next 12 months.

Strategy outlook

We reiterate an underweight preference to the U.S. equity market in global portfolios on the back of expensive valuations, a softening business cycle and fading price momentum.

- **Valuation**: U.S. equities remain quite expensive and we see valuation as a headwind to future market performance.
- **Business Cycle**: Downside risks to corporate earnings and the economy have led us to reduce our cycle assessment to neutral (from slightly positive). We now expect 2.0% real GDP growth in 2016, but also cannot rule out a slower growth scenario. We continue to see little risk of recession in 2016.
- **Sentiment**: Price momentum is fading. Our sentiment signals showed the U.S. market as oversold in February of 2016 but these signals have largely faded with the subsequent rally into mid-March.
- **Conclusion**: We have an underweight preference for U.S. equities in global portfolios as Lacklustre earnings and rich valuations suppress total return expectations to near-zero over the next 12 months. Risks to this view are asymmetrically skewed to the downside.

The eurozone: Bad start, better outlook

Eurozone equities have had a bad start to 2016, underperforming their global peers. In our view, the combination of a steep selloff in global risk assets and a strong euro were to blame.

The fundamentals still look good

We've observed a tendency for Eurozone equities to underperform in global selloffs. This unfortunate characteristic is likely the result of eurozone companies generally having a global presence with relatively large exposures to growth-sensitive sectors. When financial markets worry about global growth slowing, eurozone equities can get beaten down regardless of their fundamental outlook.

Lately, this dynamic has been exacerbated by the behaviour of the euro. As the European Central Bank (ECB) cut interest rates deeper and deeper into negative territory, it turned the euro into a funding currency. This means that it is now very attractive for investors to borrow euros and use that money to fund purchases in other currencies, such as the U.S. dollar or the British pound. However, when markets get spooked, investors scramble to unwind those positions, causing demand for the euro to surge and the exchange rate to rise. For eurozone companies, that adds to their pain because they source so much of their earnings from abroad.

We expect cheap oil, positive credit growth and pent-up consumer demand will keep Eurozone growth positive, even if we account for the headwinds from weaker trade and industrial production.

Of course, the reverse of the dynamic mentioned earlier also holds. That is, when investors realise their fears were overdone, eurozone equities tend to outperform, helped by the euro weakening. However, our investment case for eurozone equities aims to look through these sorts of short-term, transitory dynamics. Instead it is predicated on the fundamentals, which in turn are analysed through our value, cycle and sentiment lens. Those are the drivers of investment returns when markets calm down, and we believe markets are calm more often than not.

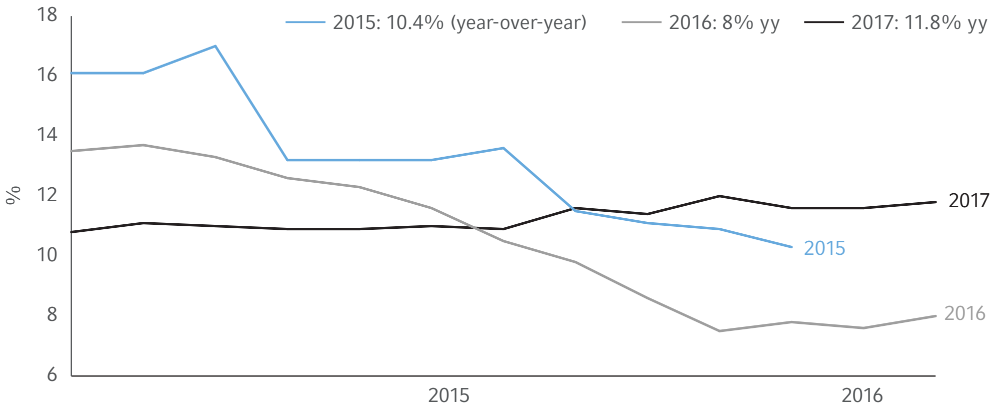
On the value side, we have recently upgraded eurozone equities after the selloff[2]. At that point the dividend yield had increased to 3.3%, the 12-month forward price-to-earnings ratio had declined to 12.2, and the price-to-book ratio had declined to 1.5. Combined, those changes pushed our value score to +0.5 from 0.

Our business-cycle score remains positive at +1.0. Although we acknowledge that the global growth slowdown is hampering the eurozone recovery, we still see growth coming in close to 1.5%. Admittedly, that is a small downgrade from our previous expected range of 1.5% to 2%. However, we expect cheap oil, positive credit growth and pent-up consumer demand will keep growth positive even if we account for the headwinds from weaker trade and industrial production. Also, monetary policies continues to be very loose, providing the eurozone business cycle with incremental support. Our big worry with respect to the business cycle is corporate earnings. Although expected earnings growth is still positive at 8% as of March 15, 2016, it is clear that the trend is down this year. We will monitor this closely.

Regarding sentiment, we still have a positive score of +1.0. Even though momentum has turned negative, our contrarian indicators turned positive in the selloff, indicating oversold conditions. When markets calm down, we expect the contrarian indicators to neutralise and our overall sentiment signal to come down.

[2] Figures in this paragraph are as of March 15, 2016 and based on the MSCI EMU Index, which is a market capitalisation weighted index maintained by Morgan Stanley Capital International (MSCI) that measures the performance of stocks based in the European Economic and Monetary Union (EMU). Indexes are unmanaged and cannot be invested in directly.

MSCI EMU I/B/E/S EPS growth forecast



Source: Thomson Reuters Datastream, as of March 3, 2016

The ECB shoots its last big bullet

In its March 2016 policies meeting the ECB took decisive action to loosen monetary policies. Although expectations were high, ECB President Mario Draghi managed to exceed them by announcing TLTRO II[3] and the inclusion of non-financial investment grade corporate bonds in the list of eligible assets for quantitative easing purchases. The cut in the deposit rate and the increase in the amount of monthly purchases were largely expected.

The new four-year TLTRO II program is very interesting. We believe it will help banks with their long-term financing; and with incentives to lend embedded in the program, TLTRO II directly targets credit growth. Therefore it should help keep the recovery on track. The inclusion of investment grade credit in the list of eligible assets is also a positive. It expands the scope of eligible assets and has the potential to directly lower companies' funding costs.

Taking everything together, the program is really as much as we could expect and hope for. At the margin, it will help support growth and inflation and boost eurozone financial markets. Looking ahead, we think the ECB probably can't meaningfully change its policies mix from here. For all intents and purposes, it has shot its last big bullet.

We maintain our overweight position to eurozone equities. The slowdown in both global growth and global earnings expectations are a worry but for now the strong eurozone fundamentals carry the day.

Strategy outlook

- **Valuation**: Eurozone equities have received a value upgrade after the selloff in the first quarter. We now consider them to be slightly cheap in an absolute sense and outright cheap relative to the U.S. In government bonds we have reopened a long position in peripheral bonds when spreads widened to 150 basis points (bps) with a target of 100 bps. We have maintained our neutral position in core bonds and have slightly lowered our expectation for core bond yields.
- **Business cycle**: We maintain our positive outlook for the business cycle and have kept our score unchanged. GDP growth in 2016 is still expected to be 1.5% to 2.0%, although the lower end of the range looks more likely than the upper end given the continued slowdown in global growth. Expectations for earnings growth have declined rapidly and currently stand at 8%. That is still at the upper end of our expected range of 4% to 8% for 2016, but we are concerned about the pace of earnings downgrades. This is something we are closely monitoring. Finally, monetary policies has become even more supportive with the latest actions by the ECB.
- **Sentiment**: Price momentum has become slightly negative, but oversold contrarian indicators keep the overall neutral score.
- **Conclusion**: We maintain our overweight position to eurozone equities. The slowdown in both global growth and global earnings expectations are a worry, but for now the strong eurozone fundamentals carry the day.

[3] TLTRO stands for Targeted Longer-Term Refinancing Operation. In mid- 2014, the ECB's governing council decided to support bank lending to the euro-area non-financial sector through a series of eight targeted longer-term refinancing operations with a maturity of up to four years and an early repayment option.

Asia-Pacific: All eyes on China

The Asia-Pacific region continues to lumber along. Reported real GDP growth is running at over 5%, and policies settings are broadly supportive. Equity markets lack either positive momentum or convincing cyclical support, but do offer acceptable value. Bond markets remain expensive.

Modest growth continues

"More of the same" remains the outlook for Asia-Pacific economies in 2016. Among the bright spots in the region are India, which is growing strongly, and Australia and New Zealand, where the property markets remain surprisingly well-behaved. Japan is more downbeat, but is still growing a little ahead of stall speed. China is the big unknown, but in the light of resolute monetary and fiscal stimulus, a soft landing remains our central case. All told, economic growth is travelling as well as could be expected, and policies settings are broadly supportive in underwriting a continuation of modest growth.

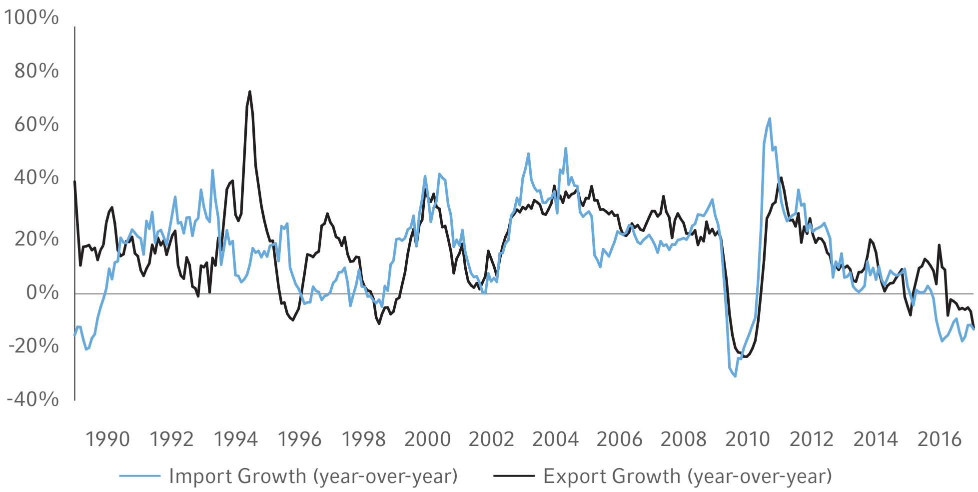
"More of the same" in 2016 is a somewhat surprising outcome in a number of Asia-Pacific economies. In areas of good-to-strong growth, we have been on the watch for any signs of slowing. In Australia and New Zealand, for example, there is a risk that recession in the commodity sectors could broaden to the still-booming housing sectors. And in India, there have been questions raised over the effectiveness of Prime Minister Modi's reforms.

So far, however, these countries continue to track well. Conversely, in areas where growth is very weak—Japan, most noticeably—we hoped that real growth would have lifted to the 1% to 2% range by now in response to the resolute stimulus packages that constitute "Abenomics.[4]" However, with counter-trend strength in the yen materialising in early 2016, oxygen has been sucked from that economy. "More of the same" for Japan means growth little earlier stall speed at about 0.5%. As a result, we have downgraded our assessment of the Japanese cycle this quarter.

China is the big unknown, but in the light of resolute monetary and fiscal stimulus, a soft landing remains our central case.

[4] Abenomics refers to the aggressive set of monetary and fiscal policies and structural reforms introduced by Prime Minister Shinzo Abe in 2012. His three-arrow strategy was designed to lift the Japanese economy out of prolonged economic stagnation.

China: imports and exports



Source: The World Bank, as of March 15, 2016.

China: the swing factor

The big swing factor in the region for 2016 is China. We have long been in the "soft landing" camp regarding the slowdown currently underway, and we adhere to that view.

However, if there's a time when the China skeptics are going to be proved correct, this is the year. The pressure on China's debt-ridden economy at present is intense, with actual growth over the past 12 months likely well below the headline claim of 6.8%. Rail freight volumes in China have dropped 13% over the past year, for example. The chart on the previous page shows that the value of Chinese imports is contracting at a rate not seen since the global financial crisis. Languishing exports, in turn, are proving a major drag on the world's second-largest economy. The commitment to a 6.5% to 7.0% GDP target at the National People's Conference in March looks "brave" given that very negative trade environment.

Despite the obvious risks, we remain sanguine about the year ahead for China. Reasons for a degree of optimism include:

› Strongly stimulatory monetary and fiscal policies working together

› A softer Chinese currency in 2015 (although not, so far, in 2016)

› Reasonable import volumes (Much of the apparent import weakness illustrated earlier reflects the collapse in commodity prices.)

› Mixed signals from the property market, which we view as a respectable outcome following a long period of boom. (House prices, in particular, have been resilient.)

› Recent indications that the central government may be prepared to play a role in managing the private sector's toxic debt issues

The business cycle in the Asia-Pacific region is a mixed bag. India is growing at a rapid pace, while Japan is barely growing at all.

Strategy outlook

Bonds in the Asia-Pacific region are at extremes of expensive valuation. Japan in particular, with the 10-year Treasury Bond rate trading in negative territory over much of the first half of March, is hard to like, no matter how supportive the central bank.

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

› **Valuation:** Following downbeat equity performance over the past few quarters, we rate "value" as "slightly positive." Asia-Pacific's price-to-book ratio of 1.2x is significantly cheaper than the world average (1.9x) and the U.S. (2.6x), in particular.[5] PE and yield metrics are also supportive, although less compelling.

› **Cycle:** The business cycle in the Asia-Pacific region is a mixed bag. India is growing at a rapid pace, while Japan is barely growing at all. Stimulatory policies settings are a cyclical tailwind, but negative earnings developments are a headwind. In China and Australia, the outlook is for cyclical upswings in some sectors, but cyclical downturns in others. On balance we score the "cycle" as "neutral," partly because these competing forces cancel out, and partly because we are waiting for greater clarity on the bad debt cycle in China.

› **Sentiment:** Asia-Pacific markets are out of favour and displaying poor medium-term momentum. We view short-term rallies in late February and in March with suspicion.

› **Conclusion:** On an absolute basis, we expect low returns and high volatility from regional equities. In relative terms, we believe Asia-Pacific equities offer better value and have a more favourable policy backdrop than U.S. equities. ■

[5] Footnote: Indexes cited are the Russell Asia-Pacific Index, Russell Global Index and S&P 500 of U.S. stocks, as of March 18, 2016.

Currencies: The end of the dollar bull run

We think the U.S. dollar is peaking after three years of strong gains. In particular, it has already turned weaker against the Japanese yen, and we don't expect too much upside against the euro. Vis-à-vis the emerging market currencies and the Chinese yuan, there could be one last hurrah. Another significant leg down in emerging market currencies should be treated as a buying opportunity.

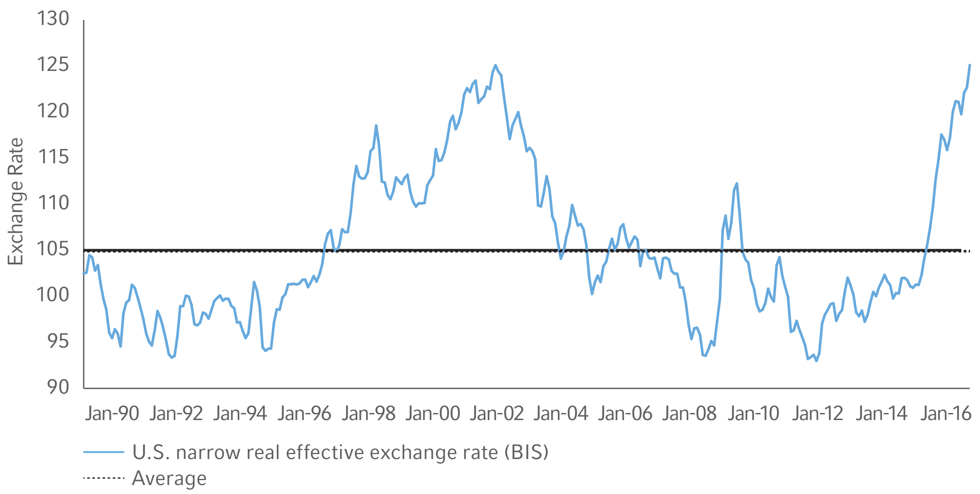
Fed's timidity halts dollar run

The three-year bull market of the U.S. dollar (USD) is coming to an end, and the greenback is now entering into a range-bound[6] environment against the major developed-market currencies. Going into 2016, we expected the Fed to raise interest rates on four more occasions—after having done so for the first time in December 2015. However, market turbulence in January and February appeared to significantly weaken the Fed policiesmakers' resolve to continue with the normalisation cycle.

We now only anticipate two further increases in the federal funds rate. While the Fed is currently the only systemically important central bank to tighten monetary policies, its relative timidity and the USD's high valuation will limit further upside potential for the greenback.

The end of the dollar bull cycle has implications for asset markets. A plateau in the dollar exchange rate could bring some much-needed relief to U.S. corporate earnings.

USD trade-weighted real exchange rate against major currencies



Source: Datastream, as of March 15, 2016.

Outlook for major currencies

We believe that the yen has started a period of relative strength and will not revisit its lows against the U.S. dollar. In January, the Bank of Japan surprised markets with a foray into negative interest rate policies, but the ensuing weakness of the yen only lasted for a few days. The Japanese currency's attractive valuation and defensive characteristics make it our top currency pick at the moment.

[6] Footnote: Range-bound means more likely to move in a more narrow horizontal range against the other major currencies.

By our valuation measures, the euro is also cheap, relative to the U.S. dollar. However, the eurozone's large negative output gap and the European Central Bank's loose monetary policies provide a counterweight and should keep the euro/USD relationship range-bound.

Despite the sharp fall since late 2015, the pound sterling is still overvalued against the USD by the Organization for Economic Cooperation and Development's (OECD) purchasing-power-parity measure. A large current account deficit, the risk of Britain leaving the European Union as well as a more dovish Bank of England could see the pound sterling/U.S. dollar exchange rate drop towards the lows of its recent range.

Commodity currencies—such as those of countries like Australia and Canada that are economically driven by the strength of their raw material exports—weakened in the first six weeks of 2016, but staged a sharp recovery since then. At current levels, the Australian dollar is rich relative to a fair value measure that takes into account the deterioration in Australia's terms of trade. However, we remain on the sidelines as a robust domestic economy and price momentum currently support the Australian currency. The Canadian dollar is not overvalued, but heavily overbought after an oil-driven surge in March and could weaken in the months ahead.

Prospects for emerging market currencies

The prospects for emerging market currencies hinge on commodity prices and the Chinese economy. China is showing tentative signs of stabilisation after slowing down around the turn of the year. The decline in foreign exchange reserves has decelerated and the USD/Chinese yuan relationship is steady. However, the underlying devaluation pressure is still present. After five years of real currency appreciation, China's currency is overvalued against the USD. While other emerging market currencies are now cheap, they may be dragged down by another leg of Chinese currency weakness. A significant selloff in developing country currencies should be considered a buying opportunity.

After five years of real currency appreciation, China's currency is overvalued against the USD. While other emerging market currencies are now cheap, they may be dragged down by another leg of Chinese currency weakness.

Strategy implications

In our view, we are in the process of forming a plateau for the trade-weighted U.S. dollar. The end of the dollar bull cycle could have significant implications for asset markets:

› The strong dollar had been a negative factor for U.S. corporate earnings. A plateau in the dollar exchange rate could bring some relief to U.S. equities. Conversely, Japanese and European equities will no longer benefit from depreciation versus the USD.

› A peaking dollar is supportive of commodities, although a significant slowdown in the Chinese economy remains a key risk to raw material prices.

› Another leg down in emerging market currencies could be followed by a multi-year period of emerging market currency outperformance. ■

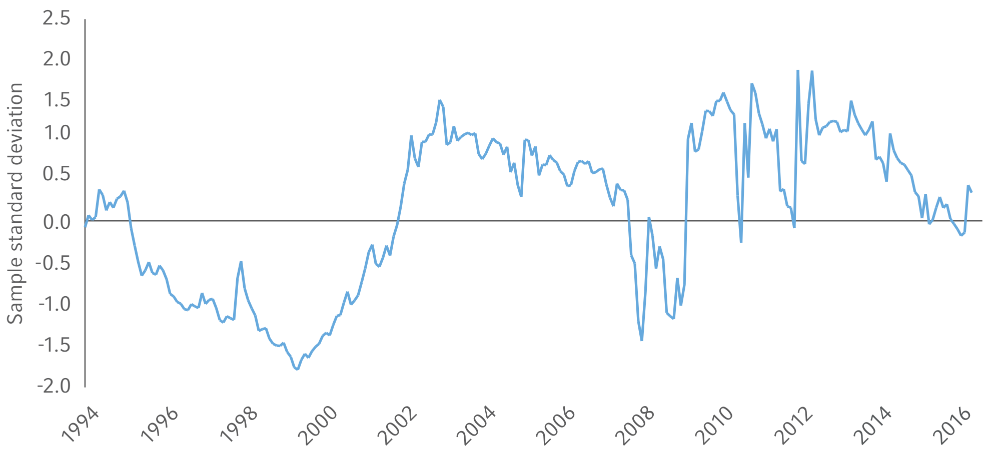
Quantitative modeling: Signals trending sideways

During the first quarter of 2016 our U.S.-equity-versus-fixed-income signal has fluctuated between neutral and slightly positive. Due to recent market volatility and slower momentum as of Feb. 29, 2016, we will maintain our neutral view. Valuations now look more attractive as corporate earnings have improved and bond yields have fallen.

- **Valuation**: Since U.S. equities decreased in price in early 2016, the earnings yield increased. This makes equities look more attractive to our Fed model. Bond yields also fell, making equities look more attractive since we wrote our 2016 Annual Outlook report in late December.
- **Business Cycle**: Our model that estimates the likelihood of a bull or bear market occurring currently barely supports equities, which is unchanged from the fourth quarter of 2015. The U.S. Business Cycle Index still shows low recession risk, but forward expectations of S&P 500 earnings look less optimistic than last quarter.
- **Sentiment**: Following the recent market events in the first quarter of 2016, the 12-month declining weighted average[7] of excess returns turned negative from the beginning of the year. We would need to see this turn positive to upgrade our score.

Our model that estimates the likelihood of a bull or bear market occurring barely supports U.S. equities—unchanged from the fourth quarter of 2015. However, our valuation score recently turned more positive.

EAA[8] Equity - Fixed Aggregate Signal



Source: Russell Investments as of March 18, 2016

[7] Declining weighted average means that the returns from the most recent months are more heavily weighted than the older months.

[8] 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 Aggregate Signal is based on the S&P 500 and Barclays U.S. Aggregate Bond indexes.

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.

Scenarios for the pace of Fed tightening

Our Fed Funds Target Model forecasts the Fed's desired monetary policies, given its expectations of economic growth, unemployment, and inflation. The model forecasts four more hikes of 25 basis points by the end of 2016—if based on economic expectations alone. It predicts three more hikes of 25 basis points if we include financial conditions. Given the Fed's dovish and hawkish economic projections, and with current financial conditions considered, we could make a case for as few as one hike and as many as five hikes in 2016. You've probably noticed that earlier segments in this quarterly report mention two more rate hikes this year as our team's central scenario, and how we came to that conclusion is explained overleaf.

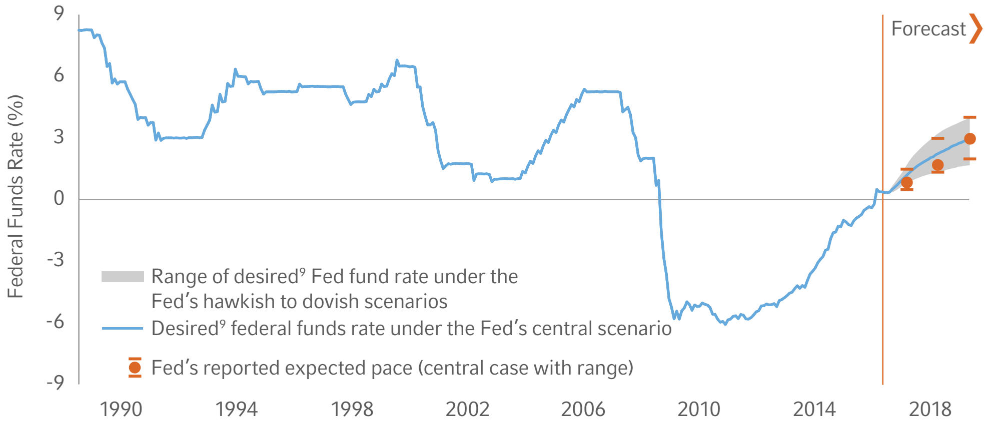
A useful feature of our Fed model is its ability to map different Fed expectations to past Fed actions, then compare the mapped pace to the Fed's reported expected hikes. We noted:

- **Financial concerns will postpone some hikes in 2016**. When the model includes credit spreads as an indicator for financial risk, the number of hikes in 2016 decreases.
- **The Fed seems extra cautious of financial conditions**. In the central and hawkish scenarios, the cumulative number of rate hikes for 2016, 2017 and 2018 is the same for

the Fed (10 and 14 in total respectively) and the scenario that also considers financial conditions. However, in order to be cautious, the Fed could postpone one of the 2016 hikes. This is subject to change if the recent improvement in markets continues.

› **If the dovish scenario occurs, the Fed may move slower than it is currently communicating**. If the labour market stalls and inflation remains persistently below target through 2018, the Fed historically would not move as fast as it is currently communicating.

Federal Funds Rate—absent zero lower bound



Source: Russell Investments as of March 18, 2016

[9] By "desired", we mean as determined by Russell Investments' proprietary Fed Funds Target Model, which forecasts the Fed's desired monetary policies given its expectations of economic growth, unemployment and inflation.

The final team view of two hikes in 2016 is less aggressive than our quantitative model for two reasons:

1. The team sees global growth concerns and financial conditions as wild cards with much more downside risk than domestic growth and inflation.
2. Federal Open Market Committee communications show that members are increasingly cautious. However, in our view, scenario analysis is still a useful exercise to model how the Fed would have reacted historically.

SCENARIOS:[10]	DOVE	CENTRAL	HAWK
	Model, conditional on economic outlook only		
2016	3	4	6
2017	1	4	6
2018	1	3	3
	Model, accounting for financial conditions		
2016	1	3	5
2017	3	4	6
2018	1	3	3
	Fed reported expected pace		
2016	1	2	4
2017	4	4	6
2018	2	4	4

The numbers earlier indicate how many Fed rate hikes are expected per scenario in each year shown.

[10] The Federal Reserve's economic scenarios, as of their March 2016 projections:

- **Central Scenario**: 2.2% real GDP, 1.6% core Personal Consumption Expenditure (PCE) inflation, 4.7% unemployment (145,000 average payrolls) by the end of 2016.
- **Dovish Scenario**: 1.9% real GDP, 1.4% core PCE inflation, 4.9% unemployment (115,000 average payrolls) by the end of 2016.
- **Hawkish Scenario**: 2.2% real GDP, 1.6% core PCE inflation, 4.7% unemployment (175,000 average payrolls) by the end of 2016.

IMPORTANT INFORMATION

The views in this quarterly outlook are subject to change at any time based upon market or other conditions and are current as of the date at the bottom 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.

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.

The FTSE Developed Index is a market-capitalisation weighted index representing the performance of large and mid cap companies in Developed markets. The index is derived from the FTSE Global Equity Index Series (GEIS), which covers 98% of the world's investable market capitalisation.

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

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