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Fake news rally?

2017 Global Market Outlook — Q2 update

Equity markets are deeply overbought and a pullback seems likely once overinflated expectations are confronted with the more pedestrian reality. There are places where more optimism is justified, such as Europe and, to a lesser extent, Japan.

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EXECUTIVE SUMMARY

Equities have rallied on better global growth and expectations for the Trump administration's economic stimulus in the U.S. market. We worry that expectations are running ahead of reality.

Alternative facts

Donald Trump promised to "make America great again" during the presidential campaign, and equity markets have taken him at his word. The S&P 500® Index is up 12% since his election in early November through March 17, 2017. But in the same way that inauguration crowd sizes are open to dispute, the strength of market fundamentals can also be debated.

Market bulls see reflation and investor confidence. We're a bit more cautious due to very expensive U.S. equity market valuation, high profit margins and an economy unlikely to sustain the current surge. We're not bearish on the medium-term outlook; the U.S. economy shows relatively low recession risk and Europe can maintain above-trend growth, while emerging markets are showing resilience to U.S. dollar (USD) strength and U.S. Federal Reserve (the Fed) tightening. But equity markets to us look overconfident about the prospects for sustainably higher profit growth and at risk of disappointment.

Paul Eitelman questions investor optimism about the U.S. economy, preferring to label the outlook "resilient but mediocre." He thinks the Fed will tighten once more this year and that most of the rise in Treasury yields is in the rearview mirror.

Wouter Sturkenboom remains positive about the outlook for Europe. Political risk is much lower than feared, and he sees plenty of spare capacity in the economy. Inflation is being pushed higher by transitory factors, and he believes rising inflation will therefore be ignored by the European Central Bank (ECB), which likely will continue with very accommodative policy settings.

Regarding the Asia-Pacific region, **Graham Harman** reports it continues to display resilience. Japan's economy remains lackluster, China is balancing slightly better growth against rising interest rates, and both Australia and New Zealand are in reasonable shape. He expects low returns and high volatility across the region.

The U.S. dollar still has some limited upside potential, in **Van Luu's** view. Widening interest rate differentials give the USD an advantage, but this is tempered by expensive valuation. He believes the wild card is the potential for a new U.S. border tax system. However, he thinks that the tax is unlikely, and if implemented, would be less USD bullish than many analysts predict.

The business cycle index model estimated by **Kara Ng** and **Abe Robison** shows that recession risks for the U.S. have declined slightly over the past quarter. Their models for U.S. equities versus fixed income continue to show a neutral outlook.

The U.S. equity market hasn't been "made great again," and we believe investors' optimistic expectations are in danger of disappointment. Equally, investors are underplaying the genuine improvements underway in Europe. Alternative equity market facts should eventually give way to actual outcomes. ■

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Investment strategy outlook

Undue pessimism about global growth has given way to excessive optimism. Equity markets are overbought, and a correction, in our view, should create a buying opportunity. U.S. Treasuries are now fairly valued at around 2.5%, but we expect yields will be under upward pressure from rising inflation and Fed tightening.

The fake news rally

It doesn't seem long ago that investors were worried about secular stagnation — the idea that growth would remain disappointing, inflation would stay low and central banks would maintain extremely easy policy settings. Now, in early 2017, the buzzword is "reflation" as global economic growth exceeds forecasts, inflation edges higher, and the U.S. Federal Reserve warns of a faster pace of rate rises.

The earlier pessimism turned out to be unwarranted, and we believe the current optimism will prove likewise. It's true that global growth has picked up, but not by enough to justify the optimism priced into the S&P 500. We still see plenty of headwinds for the global economy, not least Fed tightening and a slowing Chinese economy.

Equity markets are deeply overbought and a pullback seems likely once overinflated expectations are confronted with the more pedestrian reality. We see places where more optimism is justified, such as Europe and, to a lesser extent, Japan. However, in our view, markets are overestimating the ability of President Trump to boost the U.S. economy and forgetting that the U.S. economy is near full capacity. This means that any Trump stimulus is likely to be offset by a more aggressive Fed to contain inflation pressures.

We're still in a "buy the dips and sell the rallies" market environment in early 2017. We want to sell the current rally and look to buy the next dip.

Key indicators update

Our 2017 annual outlook report in mid-December listed three indicators we would watch closely in 2017: U.S. wage measures, fiscal policy announcements and emerging markets exports.

- **U.S. wages** are tracking higher as the unemployment rate settles below 5%. We believe the trend in the Atlanta Fed's wage growth tracker will keep the Fed under pressure to continue lifting interest rates.
- **Fiscal policy** looks less supportive for global growth. President Trump has talked up federal tax cuts and infrastructure spending. However, his slim Senate majority means that stimulus is likely to be modest and delayed until 2018. Japan and the UK are continuing with fiscal consolidation. Fiscal trends are more positive in Europe, where elections are pushing governments to open their purse strings.
- **Emerging markets (EM)** exports continue to strengthen. The bellwether market of South Korea is experiencing its fastest export growth in five years.

The economic indicators we watch point to U.S. inflation pressures and Fed tightening, a smaller boost from fiscal policy (apart from in Europe) and a continuing recovery in global trade.

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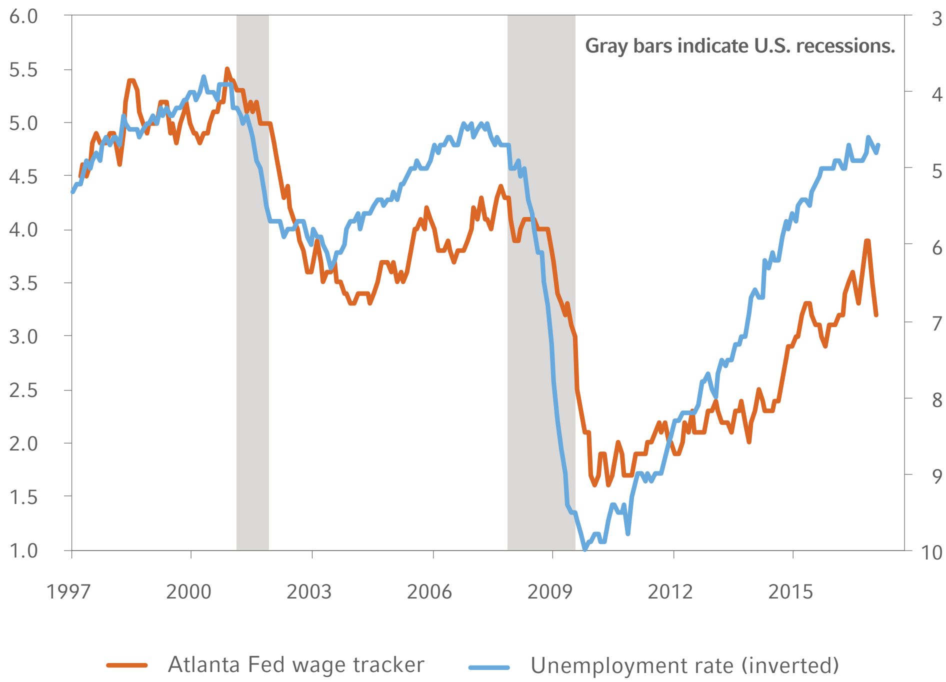
U.S. hourly earnings & unemployment rate



Source: Thomson Reuters Datastream, last observations: January 2017 (wage tracker) and February 2017 (unemployment rate).

Global equities: cycle, value, sentiment

Our investment process is based on the building blocks of business cycle, value and sentiment, and here's how we see it at the beginning of the second quarter of 2017:

› **Business cycle:** It's a mixed cycle outlook for global equities, and tailwinds for equities in our view appear strongest in Europe, followed by Japan. The U.S. cycle score is neutral. Growth might have improved, but this is offset by potential Fed tightening. The cycle has improved to neutral for emerging markets as growth indicators pick up, but EM is still vulnerable to Fed rate hikes and further USD strength.

› **Valuation:** U.S. equities are very expensive. The Shiller P/E ratio, which uses the 10-year average of inflation-adjusted earnings, is the highest it's been outside of 1929 and the late-1990s Internet bubble. European and Japan equities are around fair value, in our view, while emerging markets are still reasonably cheap.

› **Sentiment:** This combines price momentum with indicators that signal whether markets are overbought or oversold. Price momentum has picked up strongly over the past few months, but simultaneously nearly all our overbought indicators have been triggered. The U.S. appears the most overbought with a range of technical indicators pointing to a stretched market and investor-confidence survey indicators suggesting widespread overconfidence.

› **Conclusion:** We're cautious on the near-term outlook for global equities, viewing the expensive and overbought U.S. market as the most vulnerable. Looking further out, Europe has an attractive combination of reasonable value and good cycle support. Japan has reasonable value and emerging markets have good value.

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Treasuries: The cycle is turning negative

Yields on 10-year U.S. Treasuries have lifted by around 100 basis points (bps) to 2.5% over the past nine months as of March 15, 2017. This is close to fair value based on our valuation methodology. Yields have risen by much less in Japan, the U.K. and Germany, and valuation in these markets respectively remains expensive.

There is some difference in the cycle outlook across regions. The cycle is moderately negative for the U.S., where inflation pressures are picking up and the Fed is lifting short-term rates.

The big British sterling devaluation in 2016 means that inflation pressures are also a cycle headwind for U.K. gilts. By contrast, the Bank of Japan (BoJ) seems likely to maintain its policy of targeting a 10-year bond yield of 0%. And we believe the European Central Bank should continue with negative rates and asset purchases until at least the end of 2017.

Our sentiment indicators are mostly neutral, save for the U.S. being slightly oversold after the recent large rise in yields. Broadly, our process points to yields remaining in a narrow range for the next few months, although the medium-term trend is upward.

Currencies: USD has limited upside

The U.S. trade-weighted dollar has moved in a narrow range over the past few months. Rising interest-rate differentials against other regions are dollar supportive, but this is offset, in our view, by expensive valuation.

Some analysts believe there could be a large U.S. dollar rise if the Trump administration introduces a destination-based tax system that would benefit U.S. exports and penalize imports. We're a little skeptical about this. First, there is a lot of political opposition in the U.S. Congress to a border tax system, so it may not go ahead. Second, the USD impact of a border tax may be smaller than expected if there is trade retaliation from other countries.

The euro, Japanese yen (JPY) and British pound (GBP) have attractive valuations. But none seem likely to move significantly higher in the next few months. The yen is likely to remain under pressure from widening interest rate differentials with the U.S. The uncertainties surrounding Brexit will likely keep British sterling in its current range. The euro has some potential upside over the medium term, but political uncertainty over the French election likely will prevent any near-term appreciation.

Overshooting to the upside

Markets have reacted to better economic news and the hope that President Trump will deliver substantial tax cuts and fiscal stimulus.

Our process tells us that U.S. equities are very expensive, have only modest fundamental support from the business cycle and are significantly overbought across a range of indicators. Equities could push higher if President Trump announces large tax cuts and markets become outright euphoric.

The overbought signals drive our near-term caution. Beyond this, we like Europe's cycle outlook and the value in emerging markets. The USD has limited upside potential, and long-term bond yields should be under upward pressure.

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United States: Newton’s cradle in motion

Market psychology has swung dramatically over the last 12 months. In early 2016, investors were worried about the risks of secular stagnation and a U.S. recession, but the narrative has veered in recent months toward the awakening of animal spirits. We continue to argue that the truth falls in the middle of these two extremes — that the U.S. economy is resilient but mediocre. This view has underpinned our "buy the dips and sell the rallies" investment strategy. As the market pendulum swings closer to euphoria, a more cautious strategy seems warranted.

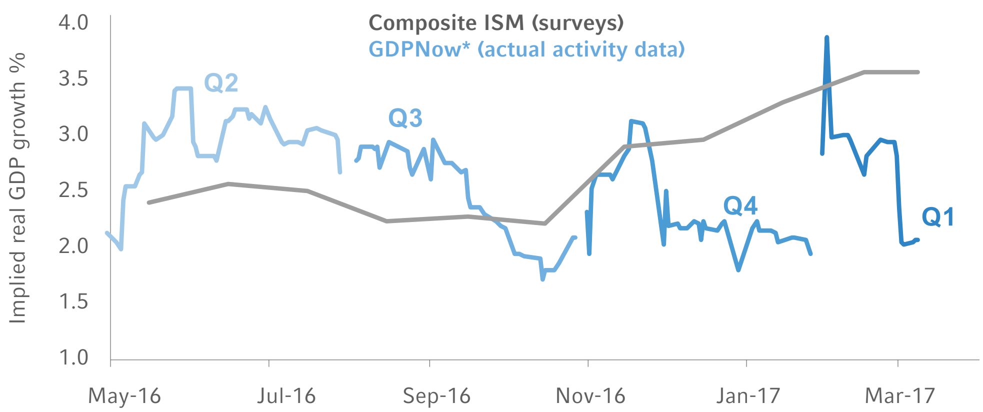
Still mediocre

Not buying into the idea of a 3% growth economy

One of the biggest puzzles that economists are grappling with in 2017 is the growing divide between strong survey-based measures of economic growth and sluggish statistics on *actual* economic activity, as illustrated in the chart below. Anecdotal evidence suggests that the strength in the surveys is being driven, in part, by anticipated pro-business policy changes from the Trump administration, specifically around corporate tax cuts and regulatory reform.

We still think market fundamentals are only strong enough to warrant a mediocre U.S. growth outlook.

Large gap opening up between surveys and actual activity data



Source: Institute for Supply Management (ISM), Federal Reserve Bank of Atlanta, Russell Investments' calculations. Data as of March 8, 2017.

*The tracking estimate for final sales is shown (GDP excluding the volatile inventories category). The Composite ISM is a weighted average of the manufacturing and non-manufacturing surveys, which has been translated into an implied rate of real GDP growth using a regression.

Normally, we focus on the business surveys of purchasing and supply executives across the nation because they provide a smoother and timelier read on economic growth. However, because the recent improvement in business confidence appears to be contingent on fiscal policy change, we need to take a step back and look at how the Trump agenda is proceeding through Congress. Thus far, the debates on Capitol Hill around healthcare and tax reform have *not* been smooth, and both issues appear very contentious and complicated. In our view, fiscal stimulus increasingly looks like a 2018 story that could ultimately prove to be watered down relative to the big promises on the campaign trail. If we're right about that, the gap in the chart above could close via a downshift in optimism as reflected in the surveys.

This is part of the reason we are stuck at a 2% GDP growth forecast. But there are also other, more fundamental forces driving our mediocre outlook. One indicator that stands out is *zero* growth in commercial and industrial loans over the last four months. This dynamic typically happens only when the economy is rolling over into recession. While that isn't our view, we still think that fundamentals are only strong enough to warrant a mediocre U.S. growth outlook.

A less cautious Fed, but still hesitant to hike quickly

The Fed's decision to hike the federal funds rate in March was ahead of schedule compared to our forecast for two hikes in 2017. Under the surface, it's clear that the Federal Open Market Committee (FOMC) has become less cautious. Much of the shift can be attributed to their belief that downside risks from the *global* economy and particularly China have diminished. Nevertheless, we still think that it will be difficult for the Fed to maintain a much faster tightening cycle. As noted above, the U.S. growth outlook is middling. And wage growth — which accelerated meaningfully in late 2016 — has taken a pause. Fundamentals continue to support a gradual process. And in a world of divergent developed markets, an aggressive path risks U.S. dollar strength and damage to the global economy and markets. For now, we stick to a two-hike baseline in 2017. Risks are now skewed to a faster Fed, but the U.S. bond market is already pricing-in three hikes for the year. In our view, this means most of the damage to U.S. Treasuries is in the rearview mirror. We are less negative on bonds than we have been in prior quarters.

Corporate earnings have recovered, but we believe it will be very difficult for growth to push sustainably above 5%. Profit margins are very high and susceptible to downgrades as the labor market tightens. We remain cautious.

Market euphoria: will earnings growth justify it?

The S&P 500 is flirting with all-time highs and the market narrative has shifted from stagnation to animal spirits in a matter of months. Trying to time when market exuberance will meet reality can be more art than science. But our investment strategy building blocks of business cycle, valuation and sentiment clearly indicate that the risks for U.S. equities are now squarely to the downside. Corporate earnings have recovered, but we believe it will be very difficult for growth to push sustainably above 5%. Profit margins are very high and susceptible to downgrades as the labor market tightens. We remain cautious.

Strategy outlook

- **Business cycle:** Corporate profits recovered to 5% growth in the fourth quarter reporting season. Most of the earnings acceleration is likely in the rearview mirror at this stage, and consensus expectations at 11% still appear too optimistic. While we don't see a recession in 2017, we also don't see enough cyclical support to sustain the U.S. market at these valuation levels.
- **Valuation:** U.S. equities are very expensive — the Shiller P/E ratio[1] for the S&P 500 is higher than ever outside of 1929 and the late 1990s. Our valuation modeling work also shows lower expected U.S. equity returns ahead.
- **Sentiment:** Our process captures a tug-of-war between strong momentum and an investor psychology that is complacent though bordering on euphoric. On net, our sentiment signals suggest caution is warranted.
- **Conclusion:** We continue to have an underweight preference for U.S. equities in global portfolios, primarily on the backs of expensive valuations and overbought sentiment signals. ■

[1] The Shiller P/E ratio for the S&P 500 is based on average inflation-adjusted earnings from the previous 10 years.

The eurozone: Reflation is winning

Eurozone economic growth has been strong and its financial markets have started to rebound. In the broader context of continued monetary stimulus, we think it is becoming ever more certain that reflation is winning. When markets see the same, we expect the rebound will accelerate and the gap with strong fundamentals will close.

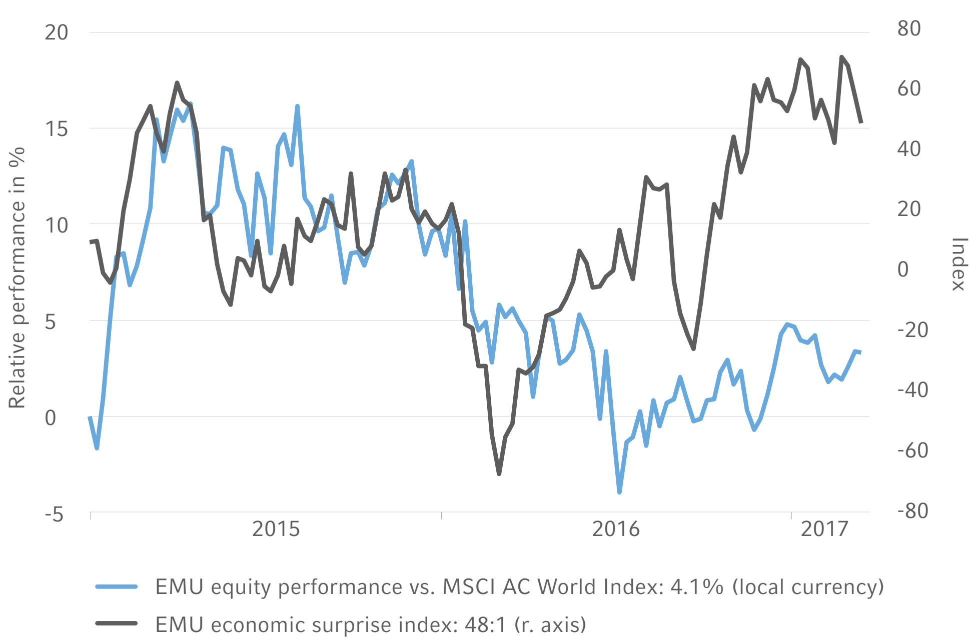
Mind the gap

Since the financial crisis of 2008, the eurozone has been in the midst of an epic struggle between deflationary and reflationary forces. As soon as ECB President Mario Draghi started to hint at an asset purchase program in 2014, we began making the case that the reflationary forces would win, supporting both economic growth and financial markets. By and large that thesis has played out and reflation is winning, although the impact on eurozone growth has been larger and more reliable than the impact on markets. However, we expect that gap will close over time and markets will catch up, keeping us positive on eurozone assets.

One worry that clients have been querying us about is whether the ECB can remain an important driver of reflation in the face of quickly rising inflation. We think it can for several reasons. First, the rise in inflation is currently driven by transitory forces, most notably a rise in energy prices. However, we believe the impact of that rise on inflation will quickly fade from Q2 2017 onward. Second, for the ECB to start worrying about inflation, it will need to see a pickup in sustainable drivers of inflation such as wage growth. With the unemployment rate still close to 1% above NAIRU[2] there is plenty of slack left in the labor market, meaning rising wage growth is some ways off.

Only when economic growth accelerates to 2% or higher and credit growth continues to rise do we see the ECB trimming back monetary stimulus.

EMU* economic surprise index vs. equity performance



Source: Thomson Reuters Datastream, 3/16/2017.
*EMU refers to the Economic and Monetary Union, which includes the 19 eurozone states as well as non-euro European Union states.

[2] NAIRU is the acronym for non-accelerating inflation rate of unemployment, and refers to a level of unemployment below which inflation rises.

Only when economic growth accelerates to 2% or higher *and* credit growth continues to rise do we see the ECB trimming back monetary stimulus. That is currently not our base-case scenario as we expect economic growth around 1.5 – 1.8% and continued, but modest, credit growth. That is enough, in our view, to push the unemployment rate toward 9% in 2017, but not enough to trigger a meaningful pickup in wage growth.

Why we continue to fade political risk

As expected, the Dutch elections turned out to be a red herring. For all the noise around the likelihood of a victory for the far-right PVV political party, the truth was it never came close to power, even at the peak of its polls. Parliamentary systems make it hard for extreme left-wing or right-wing parties to gain power because coalition governments are the norm. By the same token, we don't worry about the German elections in September. In fact, that election looks like it will become a battle between a cautious pro-European Chancellor Angela Merkel and a bold, very pro-European Martin Schultz, who formerly served as president of the European parliament. What we may lose in stability if Merkel loses we likely will gain in a more supportive pro-European stance, with some fiscal stimulus on top. Either way, it's not a bad outcome for eurozone markets in our view.

Of course, the comfort blanket of a parliamentary system is not in place for the French presidential elections in April/May. That election continues to be very important because of the enormous amount of power the French president wields. Since François Fillon is still caught in a continuing scandal, it now looks likely that former investment banker Emmanuel Macron and populist candidate Marine Le Pen will win the first round. And second round polling still shows Macron to be a heavy favorite. That, combined with the knowledge that the euro is still very popular in France, the refugee crisis is over, and rising inequality is much less of a problem. Therefore, in our view, the outlook is good and we continue to advocate fading market volatility on election worries.

> We are sticking to the reflation trade, expecting the gap between strong fundamentals and lackluster markets to close, when investors realize the eurozone is on solid footing both economically and politically.

Strategy outlook

- **Business cycle:** Expected GDP growth of 1.5%, combined with loose monetary policy and corporate earnings growth of 5 – 10%, adds up to a positive business cycle score.
- **Valuation:** Eurozone equities are considered neutral value in an absolute sense and outright cheap relative to the U.S. We remain neutral on eurozone government bonds, with yields still in our range of 0 – 0.5%. We see some value in peripheral bonds where yields have risen slightly above our range of 1 – 2%, but we will trade around the French election to mitigate risks.
- **Sentiment:** A combination of positive price momentum and overbought contrarian signals has pushed our sentiment score for eurozone equities into negative territory. Sentiment for core government bonds is still neutral, while Italian bonds remain oversold.
- **Conclusion:** We are sticking to the reflation trade, expecting the gap between strong fundamentals and lackluster markets to close when investors realize the eurozone is on solid footing both economically and politically. Of course, we will continue to monitor the political risks, but we remain optimistic that there will not be any surprises in the eurozone next year along the lines of the Brexit vote outcome or U.S. President Trump's victory. ■

Asia-Pacific: power without glory

Economies in the Asia-Pacific region are motoring on, with our expectation for full-year 2017 real GDP growth at just under 5%. That's just a slight acceleration on 2016, as trade continues to improve and as business conditions firm. In our view, Asia-Pacific equity markets are fairly priced, while interest rates are facing upward pressures as global reflation returns.

Motoring on despite concerns

The Asia-Pacific region appears in good shape, with solid recoveries apparent in many areas. We are particularly encouraged to see some growth surprises in economies that had previously been lagging, including Taiwan and Japan. Simultaneously, though, better 2016 performers such as India, Australia and New Zealand are now seeing slight downgrades to growth at the margin. It's also the case that the region continues to deliver strong growth in the face of widespread concerns about high levels of debt, growing threats of protectionism, and the challenges posed by a tightening cycle from the U.S. Federal Reserve.

In **Australia** and **New Zealand**, we are seeing the interest rate and inflation cycles bottoming out, but any moves toward tighter monetary conditions are still some way off. With commodity prices stabilizing and housing still holding up, we look for reasonable performance from those economies through the remainder of the year.

The **Japanese** economy remains one of the weaker parts of the region, despite slightly firmer GDP data this year and some improvement in exports. Demographic headwinds, a strong yen, as well as stubbornly low inflation and wage growth, leave the overall outlook there somewhat downbeat.

China is seeing a continuation of better growth numbers in 2017, and many indicators of economic activity are looking increasingly healthy. The monetary authorities there have also steadied the capital outflows that were gathering pace earlier in the year. The risk for China is that interest rates are now rising, as seen in the chart below, following a long period of quiescence in 2016. The challenge will be to manage the high levels of debt in an environment of higher rates. On the plus side, we are beginning to see a relaxation of tighter fiscal settings in recent months.

The region continues to deliver strong growth in the face of widespread concerns about high levels of debt, growing threats of protectionism, and the challenges posed by a tightening cycle from the U.S. Federal Reserve.

China's short-term interbank interest rate (3-month)

Source: The Shanghai Interbank Offered Rate (or Shibor) as of March 16, 2017. This is a daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the Shanghai wholesale (or "interbank") money market. There are eight Shibor rates, with maturities ranging from overnight to a year.

The outlook for Asia-Pacific equities over the remainder of 2017 is unexciting. We continue to take a slightly positive stance, largely motivated by the value scores.

Investment strategy

For regional equities, we assess cycle, value and sentiment considerations as follows:

› **Business cycle:** The cyclical backdrop for the Asia-Pacific region remains neutral as we move through 2017. China, together with Indonesia and India, remains an engine of growth, but Japan will be much more sluggish, and the outlook for Australia/New Zealand is mixed. The drivers of official interest rate cuts and of monetary stimulus have now faded.

› **Valuation:** As of March 10, 2017, using the MSCI Index, the Asia-Pacific region (including Japan) was trading on a forward (2017) price-to-earnings ratio of 14.0x, a price-to-book ratio of 1.4x, and a dividend yield of 2.7%. The value story is losing some of its shine following rises in prices this year, but the region is not yet in expensive territory.

› **Sentiment:** Regional markets are demonstrating reasonably positive momentum. However, recent buoyancy leaves equities "overbought." We also believe that perceptions of economic health are at a high watermark and are likely to sour over the year ahead. Consequently, we rate sentiment as a negative.

› **Conclusion:** The outlook for Asia-Pacific equities over the remainder of 2017 is unexciting. Our investment thesis of "low returns and high volatility" for Asia-Pacific equities for 2016 and into 2017 remains intact. At current prices, repeating what we said in our Annual Outlook in December, we continue to take a slightly positive stance, largely motivated by the value scores.

Currencies: U.S. dollar has limited upside

Interest rates still give the U.S. dollar (USD) an advantage over other developed-market currencies, but the 25% appreciation predicted as a result of the so-called border tax is not in the cards.

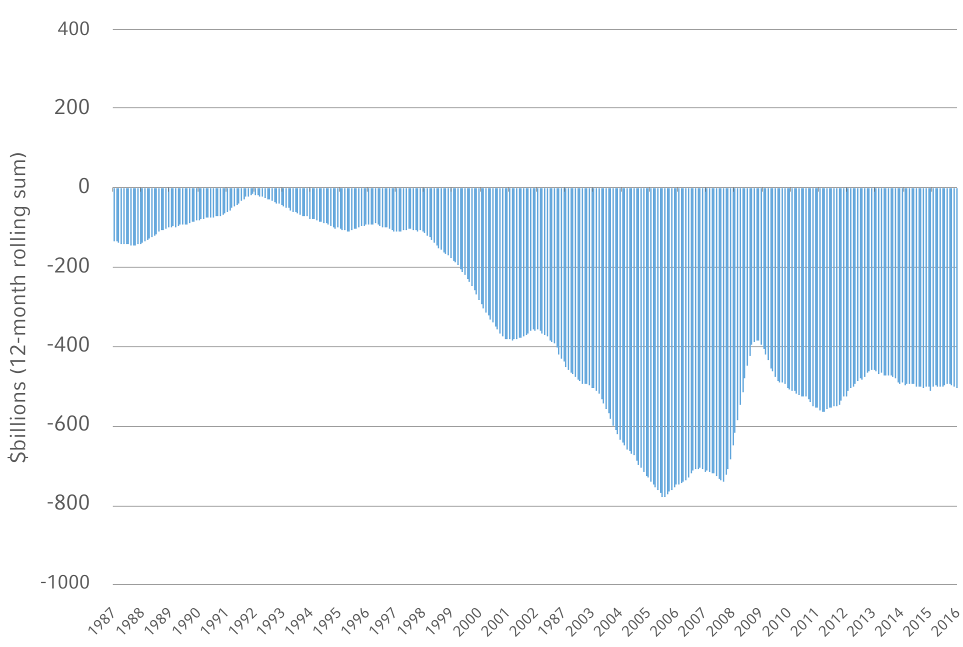
Holding breath for huge U.S. border tax boost?

Currency markets are waiting with bated breath for news on the destinations-based tax with border adjustment (the "border tax"), a policy proposed by Republicans in the U.S. House of Representatives. Under this policy, exports by U.S. firms would not be taxable and import costs could not be deducted from corporate profits. Because the U.S. has a $500 billion trade deficit, a 20% border tax could raise $100 billion per year. The policy would allow the U.S. to cut corporate taxes and potentially prevent American companies from shifting production overseas.

Proponents of the border tax, including House Speaker Paul Ryan, also say that it should lead to a super strong USD and have no effect on the nation's trade balance. The border tax effectively acts like an import tariff and export subsidy. Economic theory says that an import tax would decrease American demand for foreign goods (and decrease demand for foreign currencies to buy those goods), while the export subsidy increases demand for USD. Less demand for foreign currencies and more demand for dollars would cause the USD to appreciate enough to wipe out the competitive effect of the tax. If successfully implemented, a 20% border tax could lead to a 25% appreciation in the dollar for the net effect on trade balance to remain unchanged.

The U.S. border tax could raise $100 billion per year because the U.S. has a large trade deficit.

U.S. trade balance



Source: Thomson Reuters Datastream, as of January 2017.

That's the prediction of a simple economic model. We are somewhat skeptical that the border tax will have such a big effect on the USD for the following two reasons:

(1) It is uncertain whether it will pass through the U.S. Congress. The policy creates big winners and big losers, and companies hurt by this policy (e.g., Walmart, which depends on imports but sells domestically) are fiercely lobbying against the tax. In addition, President Trump has not endorsed it (nor ruled it out).

(2) Even if the policy passes, other countries could threaten to retaliate with their own protectionist measures, blunting the effect of a strengthening USD.

Having said that, the greenback still enjoys the benefit of higher U.S. interest rates compared to other major countries. This could push the dollar a little further against other major currencies, but given uncertainty around the U.S. border tax boost, expensive dollar valuation, and crowded long dollar position, the upside may be very limited.

Other major currencies

› **Euro (EUR)**

Eurozone economic data is improving rapidly, but uncertainty around eurozone politics still weighs on the euro. By far the most important political event is the French presidential election in April/May. A victory for populist candidate Le Pen would be a shock, potentially eclipsing the Brexit vote and Trump victory in terms of its impact on markets. While Le Pen says she intends to extract France from the eurozone, we think a victory for her in the crucial second round of elections is unlikely. According to most public opinion polls released in 2017, her support seems to peak at 40 – 45% of the vote and not high enough to win in a two-person race. Although the euro may come under some pressure in the run-up to the French election, we do not foresee severe disruption or a eurozone breakup scenario.

Eurozone economic data is improving rapidly, but uncertainty around eurozone politics still weighs on the euro.

› **Japanese yen (JPY)**

This upward pressure from higher interest rates on the USD has played out mostly against the yen. As the BoJ is keeping 10-year Japanese government bond yields anchored around 0%, the interest-rate differential between the USD and JPY has been widening sharply, putting pressure on the Japanese currency. Further depreciation could be limited by the already cheap valuation of the yen.

› **UK pound sterling (GBP)**

Britain is on the brink of evoking Article 50[3] of the Lisbon treaty to leave the EU. While Brexit has been the driver behind sterling's dive in 2016, the pound has stabilized this year in a range of 1.20 – 1.28 GBP/USD. We think it is attractively valued and much worse news is needed to push it out of the range. ■

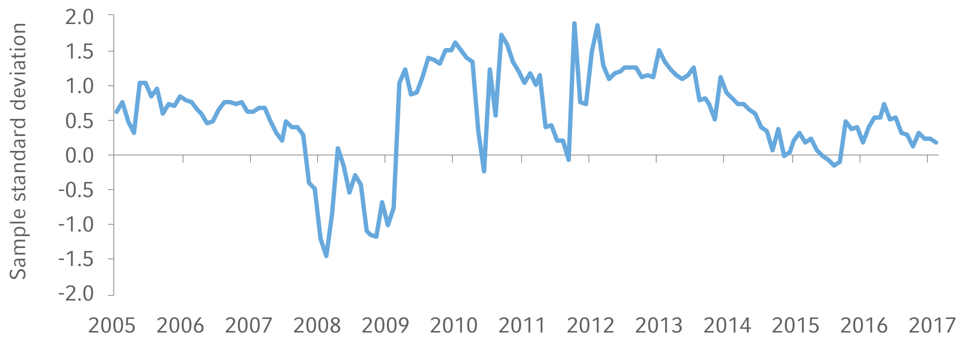
[3] Article 50 of the Treaty on European Union sets out the process by which member states may withdraw from the European Union.

Quantitative modeling insights: holding pattern

Neutral equity outlook

Our model for U.S. equities versus U.S. fixed income continues to show a neutral preference as of March 15, 2017, without much change since our annual outlook report.

EAA[4] U.S. equity vs. U.S. fixed income aggregate signal



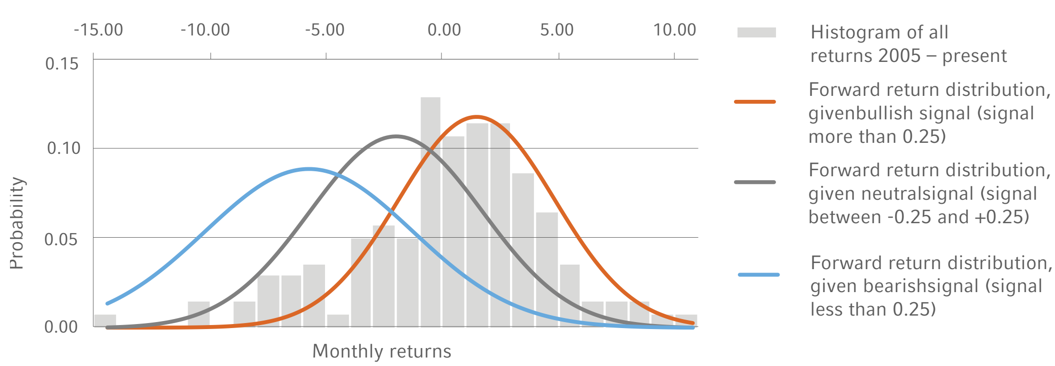
Source: Russell Investments as of March 15, 2017.
Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

- **Business cycle:** Our model that estimates the likelihood of being in a bull or bear market neutralized during the first quarter of 2017. The U.S. Business Cycle Index (BCI) still shows the economy on a path of moderate growth with low probability of recession over the next 12 months.
- **Valuation:** Our Fed model stayed positive, but became more muted as the earnings yield decreased relative to bond yields.
- **Sentiment:** Equities are hitting historic highs. As such, the 12-month declining weighted average signal of excess equity momentum stayed positive and has steadily increased over the last quarter. However, the overall sentiment signal is slightly dampened by our mean reversion model. This contrarian model says that equities are overbought.

The following graph shows the distribution of forward returns, conditional on the U.S. equity/U.S. fixed income model's signal. Given our signal is neutral, we expect a return distribution close to the dark gray line.

> The U.S. Business Cycle Index (BCI) still shows the economy on a path of moderate growth with low probability of recession over the next 12 months.

Distribution of returns, conditional on EAA U.S. equity vs. U.S. fixed income aggregate signal



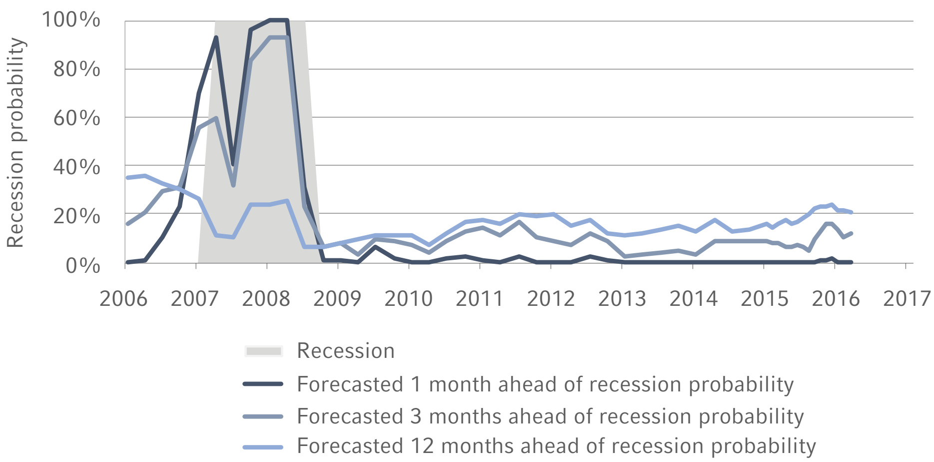
Source: Russell Investments as of March 15, 2017.
Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

[4] Enhanced Asset Allocation (EAA) is a capability that builds on Strategic Asset Allocation (SAA) by incorporating views from Russell Investments' proprietary asset class valuation models. EAA is based on the concept that sizable market movements away from long-term average valuations create opportunities for incremental returns. The EAA Equity-Fixed Income Aggregate Signal is based on the S&P 500 and Bloomberg Barclays U.S. Aggregate Bond Index.

Recession probabilities: short-term risks faded

The Business Cycle Index (BCI) model uses a range of economic and financial variables to estimate the strength of the U.S. economy and forecast the probability of recession. The index estimates that the probability of recession in the next 12 months is only 20%. Risks had been gradually building over the last few years, but declined a bit recently. We conclude that a near-term U.S. recession is unlikely, but we should monitor this aging bull market cycle.

BCI model: Historical forecasted recession probabilities



The recent decrease in recession probabilities is driven by a steepening yield curve and lower credit spreads — indicators that reflect stronger future growth expectations and lower financial risk. This optimism is echoed through a range of business, consumer and CEO surveys that show increased confidence in the U.S. economy. Although we observed a recent boost of positivity in early 2017, it may be difficult to reduce recession probabilities to the levels we saw two years ago, given we've already had such a long expansion. The pace of job growth is still steady, but we believe it is likely to moderate as we push toward full employment.

> We'd maintain a balanced risk portfolio, and look for opportunities to buy the dips and sell the rallies.

In addition, medium-term (two- to three-year) recession risks are building as the U.S. cycle continues to age. The unemployment rate has dropped below its sustainable level, suggesting that the labor market may be overheating. When unemployment is very low, employers are forced to bid up wages to attract the scarce pool of qualified workers, which gradually cuts into corporate profits. Firms often respond to weak profits by cutting investment and hiring, hurting consumer spending, which can feed into a negative spiral and start the onset of a recession. In the last nine economic cycles, it historically took an average of 2.5 years from the time the unemployment gap closed until the next recession.

Overall, we think that the U.S. economy is still on a path of moderate growth with low probability of recession over the next 12 months, but risks are building at the three-year horizon. We'd maintain a balanced risk portfolio and look for opportunities to buy the dips and sell the rallies. ■

IMPORTANT INFORMATION

The views in this 2017 Global Market Outlook — Q2 update 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 that, like all investing, multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell 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.

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

The Business Cycle Index (BCI) forecasts the strength of economic expansion or recession in the coming months, along with forecasts for other prominent economic measures. Inputs to the model include non-farm payroll, core inflation (without food and energy), the slope of the yield curve, and the yield spreads between Aaa and Baa corporate bonds and between commercial paper and Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts.

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

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

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

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

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

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

Indexes are unmanaged and cannot be invested in directly.

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

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

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

The MSCI AC Asia Pacific Index captures large and mid cap representation across Developed Markets countries and 8 Emerging Markets countries in the Asia-Pacific region. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

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