

Economic outlook and market expectations | Second quarter 2012

Perspective on the prospects for the U.S. economy

MAY 2012

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The Business Cycle Index presented here is a key component of Russell's preparation of forecasts in contribution to the Blue Chip forecasting panel. The Blue Chip is a group of 50 top economic forecasters who produce two monthly publications: Blue Chip Financial Forecasts and Blue Chip Economic Indicators.

ECONOMIC ENVIRONMENT:

Pros:

- Decent U.S. growth remains our projection
- U.S. economy expected to withstand Eurozone recession in 2012
- Fed announces plan to hold interest rates low until 2014

Cons:

- Europe could still have financial conflagration
- 'Fiscal cliff' still on 2013 horizon
- Federal government not on sound fiscal footing for the long run

Third time is the charm?

After two consecutive second-quarter stumbles in the U.S. economy in 2010 and 2011 that led to recession scares, equity and bond markets have entered the second quarter of 2012 almost on a hair trigger. Based on data through April, our models suggest that the third time will be one of a mini-stumble in 2012Q2. At the same time, the cycle in earnings growth is likely nearing a peak; after all, profits cannot grow indefinitely as a share of gross domestic product (GDP). Thus, further equity market appreciation after a gangbuster relief rally in the first quarter of 2012 is likely to rest, to an increasing extent, on expansion of price-earnings ratios due to diminution of perceived long-run risks among investors.

Nevertheless, when we lay out a list of long-run risks that investors would like to see diminish, the prospects for significant improvement this year seem limited.

These include:

- the lack of sound long-run fiscal footing of the U.S. federal government
- the lack of a roadmap back to competitiveness for peripheral European countries, given the fixed exchange rate within the Eurozone
- the overreliance in China on increases in the investment-to-GDP ratio to sustain growth in the neighborhood of 7 to 8 percent.

Stay the course on the U.S. growth story: 2.4 percent 2012 expected growth

At the height of the recession scare last autumn, the Blue Chip consensus forecast for real year-on-year GDP growth in 2012 was as low as 2.0 percent when the consensus probability of a recession in 2012 reached 34 percent, whereas Russell did not raise its recession probability above 20 percent and maintained a growth forecast of 2.5 percent for 2012 until it lowered the projection slightly to 2.4 percent at the end of April. Since then, the Blue Chip consensus has moved in Russell's direction and is now up to 2.3 percent as of the April 2012 survey.

On the employment front, we expect employment gains of about 150,000 jobs per month, on average, across the remainder of 2012. The gain of only 115,000 payroll jobs in April 2012 had less effect on Russell's projections than did the precipitous decline in the 10-year Treasury yield from 2.39 on March 19, 2012, to 1.88 on May 4, 2012. The Business Cycle

Index model includes the 10-year Treasury yield as a reference point to measure the slope of the yield curve and also in measures of quality spreads on corporate bonds.

As one source of strength for the economy in 2012, we expected to see well-anchored inflation expectations. In March 2012, however, the breakeven inflation rate between conventional and inflation-indexed 10-year bonds briefly reached 2.44 percent on March 20. As of May 4, 2012, the breakeven inflation rate had receded to about 2.21 percent. The bad news is that 10-year real returns expectations on Treasury bonds remain below zero. One of our projections for 2012 was that long-run expectations of real rates of return on Treasury bonds would rise above zero. So far, this has not happened, but our forecast is that the 10-year Treasury yield will end the year at about 2.4 percent, which, if inflation expectations remain in check, will finally connote positive real return expectations.

Another development in the markets to-date in 2012 is a shift in focus from near-term concerns to longer-term challenges. In Europe, the two Long-Term Refinancing Operations (LTRO) by the European Central Bank appear to have forestalled a banking crisis for the time being, barring something like a sudden, unanticipated withdrawal by Greece from the monetary union. In two installments, the European Central Bank opened its spigots and allowed banks to borrow as much as they wanted for a three-year term at 1 percent interest. This source of financing helped offset the reduced willingness of private investors to roll over short-term funding to European banks.

Now that fears of a liquidity squeeze have been addressed, investors are becoming increasingly aware that Europe has a long-term growth problem. Even as the Eurozone exits recession, expectations are for early next year, the recovery looks like it will be a Japan-style period of extremely low growth and stagnation. Most importantly, it looks unlikely that income growth will keep pace with the interest rate on the public debt in many of the peripheral Eurozone economies. For this reason, it is hard to see how the peripheral countries will be able to stabilize their debt-to-GDP ratios. At this point, we do not even have the outline of a long-term solution to Europe's growth problem, especially among the peripheral countries.

On the fiscal front in the United States, the 'fiscal cliff' that last summer's debt-ceiling agreement put in place for January 2013 represents both a near-term and long-term concern. The near-term concern about the tax increases and spending cuts is actually secondary, in my view, because I expect a budget agreement in the first part of 2013 that is retroactive in dealing with the full bite of the tax increases and that prevents gutting the Defense Department budget. The longer-term issue is that major, positive steps toward putting the U.S. federal government on more sound, long-run fiscal footing are as remote as ever. In my view, if such steps are taken, they could contribute to a wave of optimism regarding the future and act as a stimulus program by themselves.

One key observation in our interest-rate outlook is that additional Quantitative Easing by the Federal Reserve will likely remain on the table as long as the 10-year Treasury yield lingers below 2 ¼ percent. For a short time in late March and early April, the 10-year Treasury yield rose above 2 ¼ percent, but then fell back. Long-term interest rates can be too low for an economy's well-being, with low long-term interest rates reflecting expectations of low growth, low rates of return and low inflation. One of the chief purposes behind the Fed's two rounds of Quantitative Easing and Operation Twist, which is scheduled to end in June 2012, has been to reverse expectations of economic stagnation that lead to low long-term bond yields

The details of our U.S. economic outlook for the remainder of 2012:

- Real GDP growth is expected to be 2 ½ percent on a year-on-year basis in 2012. Our central-tendency forecasts are predicated on not having a full-bore financial meltdown in Europe.
- Our baseline forecast is that Europe will have a recession in late 2011 and in 2012, but the United States will not likely be dragged into it. This scenario is the reverse of 1990 and 2001, when the United States entered recession and Europe did not. Nevertheless,

the U.S. economy would not be able to hum through a European financial meltdown in the way it did through the East Asian crisis of 1997-98. The financial and economic linkages between these two economies are too great to make the U.S. impervious to a European meltdown.

- Non-farm payroll employment gains are projected to average 150,000 jobs per month in the remaining seven months of 2012. Even with this level of job creation, the unemployment rate is expected to fall very slowly in 2012, with a small gap between the year's jobs gains and the trend rate of increase in the labor force of about 110,000 entrants per month. Moreover, stronger labor market conditions might induce more people to return to the labor force.
- Russell projects that the benchmark 10-year Treasury yield will end the year at about 2.4 percent. If this scenario unfolds, the U.S. economy will exit Japan-style stagnation expectations in 2012.
- Inflation outlook: Russell projects that the all-items CPI will increase at an average rate of 2.4 percent in 2012 and by 2.2 percent in 2013. Decent economic growth globally (with the exception of the Eurozone) will support energy prices that should keep the all-items CPI increase above core inflation, which is expected to remain near the target level of 2 percent.

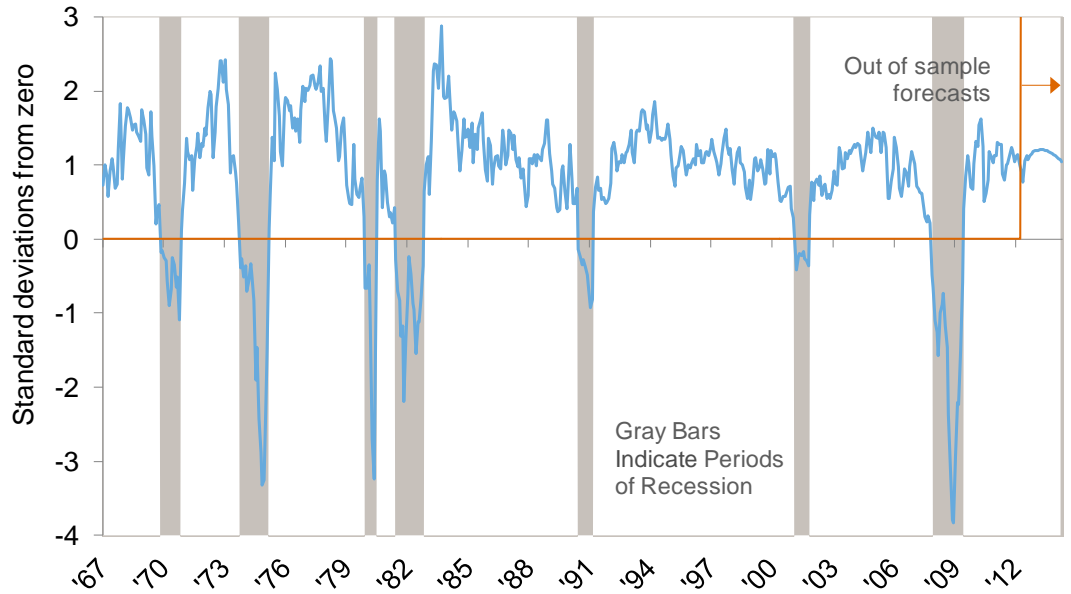
Focus on the Fed

Even though the last two Fed policy statements have specified that the first Fed rate hike is not likely to take place until the second half of 2014, 57 percent of the respondents in a mid-March 2012 CNBC survey on Fed policy (in which Russell participated) believe that the Fed will raise the target federal funds rate prior to that date. Clearly there are Fed policymakers who were and are opposed to the late 2014 timeline.

In my view, however, two factors make it likely that the Fed will wait until 2014 (the year in which Ben Bernanke's term as Fed chair is scheduled to end). First, it seems very likely that the unemployment rate will remain at levels that would be associated with a high-unemployment economy until at least the middle of 2014. Second, Ben Bernanke is likely to argue for a symmetric interpretation of the Fed's 2 percent inflation target and the Fed's dual mandate.

The argument for symmetric treatment is that if the economy were in a boom with an inflation rate of only 1 percent, the Fed may look at the state of the economy and choose not to loosen policy in order to raise the inflation rate. Instead, they may believe that, in time, economic conditions would push the inflation rate back toward the 2 percent target on their own. By symmetry, then, in a high-unemployment economy, the Fed may not immediately tighten monetary policy in response to an inflation rate a little below 3 percent either. For this reason, we believe the Federal Reserve is likely to wait until 2014 to raise the target federal funds rate. Moreover, before that date the Fed is free to let its balance sheet shrink organically through repayment of bonds (prepayments also in the case of mortgage-backed securities) and coupon payments. Nor would we think that the Fed would want to have its first published forecasts of the federal funds rate not be fulfilled.

Figure 1: U.S. Business Cycle Index



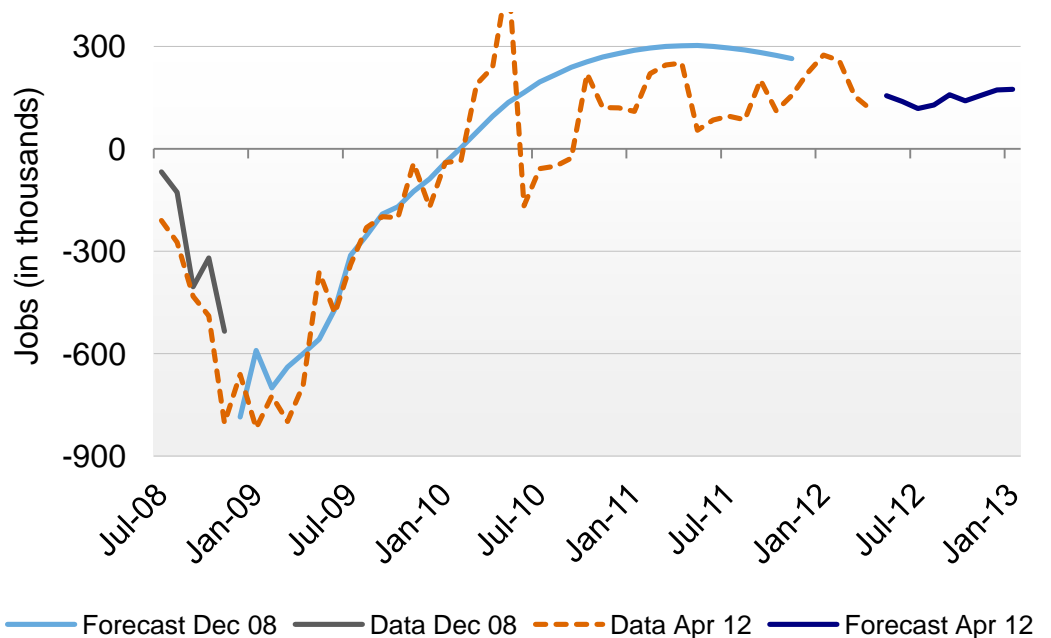
Data as of April 2012

Out of sample forecasts were calculated by simulating the time-series model into the future.

The value shown is the median of the simulated value for the month.

Source: Recession data from National Bureau of Economic Research

Figure 2: Non-farm payroll employment changes



Data and forecasts as of December 2008 and actual data through April 2012

Source: Actual employment data from St. Louis Fed's FRED database

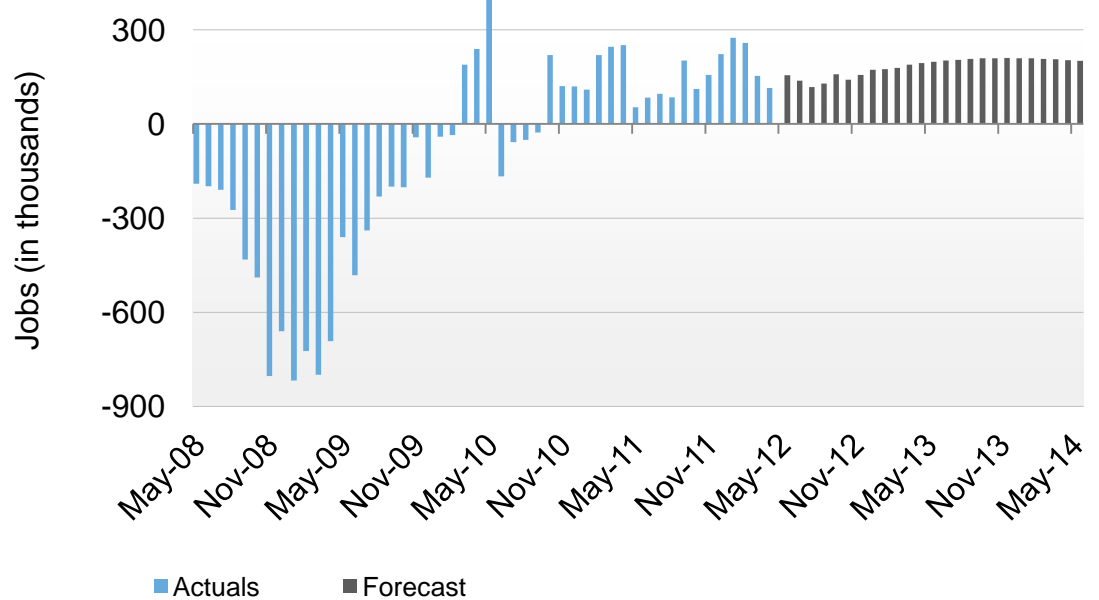
Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data.

There is no guarantee that the stated results will occur.

Indexes are unmanaged and cannot be invested in directly.

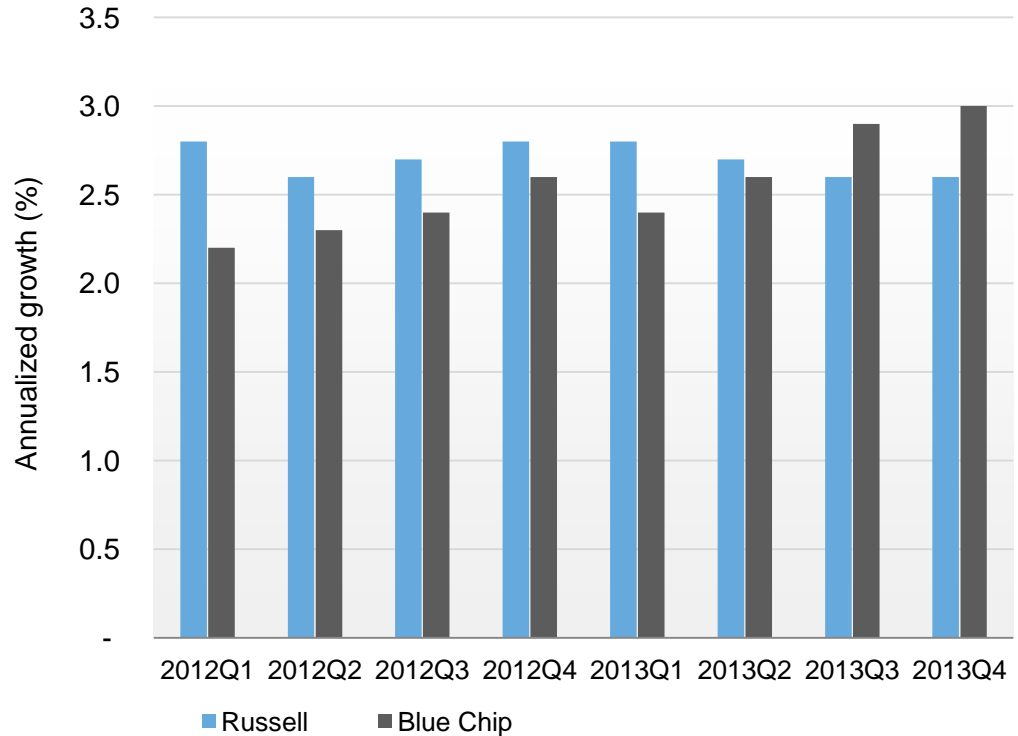
Historical data is not indicative of future results.

Figure 3: Forecasts for nonfarm payroll employment changes



Data as of April 2012
 Source: Actual employment data from St. Louis Fed's FRED database

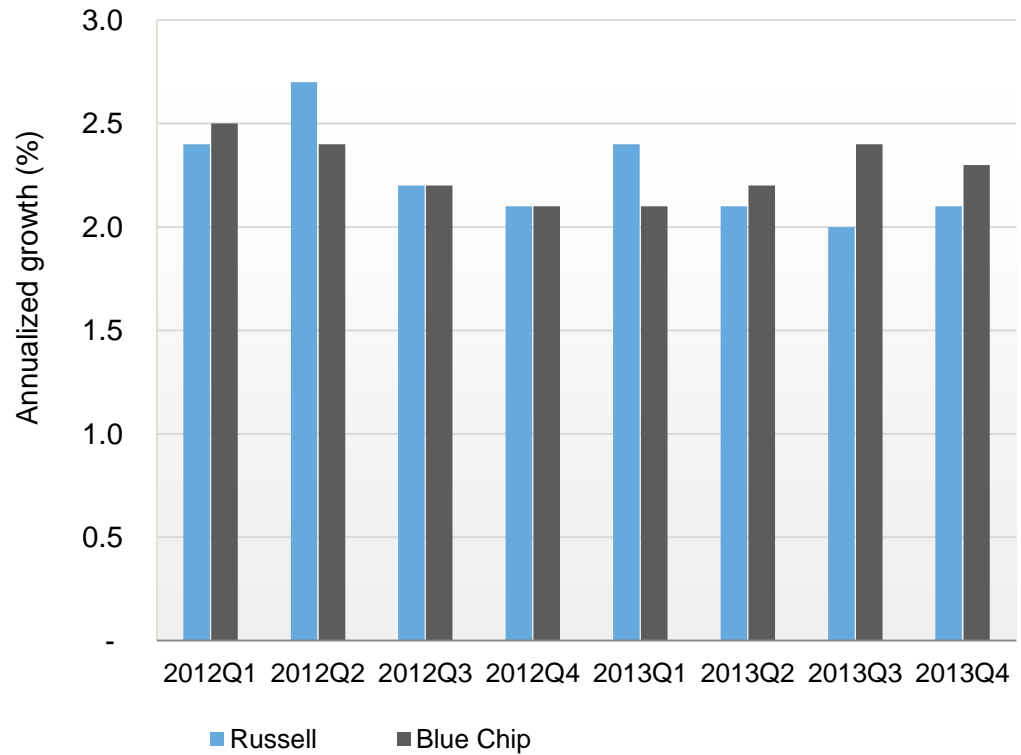
Figure 4: Forecasts for GDP growth: Blue Chip consensus and Russell's forecast



Source: Blue Chip Financial Forecasts, April 2012 issue

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Figure 5: Forecasts for CPI Inflation: Blue Chip consensus and Russell's forecast



Source: Blue Chip Financial Forecasts, April 2012 issue

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Perspectives on the prospects for the global economy

The Eurozone, as a whole, is probably in recession in early 2012 and, even if the recession is not a long one, the limited growth prospects after the recession are the real problem.

GLOBAL ECONOMIC ENVIRONMENT:

Pros:

- Can policymakers be counted on to avoid the worst outcomes?
- Emerging markets look young and stable comparatively
- Soft landing in China?

Cons:

- RE: Europe, can anyone give an example of reducing an overvalued real exchange rate through deflation with a fixed exchange rate?
- Asian economies must adapt to higher real exchange rates in future
- Is robust global growth compatible with moderate oil prices?

Europe, you have a growth problem

In peripheral European countries, wages rose too much in the early days of the euro, currency and businesses, consumers and/or governments in those countries borrowed too much. This mix did not prove to be a recipe for lasting growth or competitive economies. The real exchange rates for these peripheral countries became overvalued, with no possibility of correction through exchange-rate depreciation within the Eurozone. The upshot is that even one-time debt write-downs, such as the one Greece did this winter, leave an economy that is not competitive. In addition, Greece's economy is not likely to grow fast enough under the common monetary policy to keep nominal GDP growth equal to the interest rate on its debt; for this reason, even without running primary (non-interest-expense) government deficits, these countries will likely experience rising debt-to-GDP ratios from whatever level they started. (For example, Spain entered the Global Financial Crisis with a comparatively low debt-to-GDP ratio, but its solvency is in question because there is no foreseeable way to arrest the upward climb of its debt-to-GDP ratio.) Thus, fiscal solvency becomes a question mark, even as austerity programs keep primary deficits in check.

The situation is severe enough to cast a pall over the growth outlook for the entire Eurozone. The first graph in this section is intended to have some shock value. It shows the results of comparing a Business Cycle Index for the Eurozone with the Business Cycle Index discussed earlier for the United States. Whereas the projected path of business cycle conditions in the United States looks relatively mediocre, the projected path for Europe is dismal. While the current recession is not expected to last long, the lack of a recovery suggests that the Eurozone economy is poised to have a Japan-style lost decade of economic stagnation.

Groucho Marx redux?

We can posit the following question: Where can we find examples of countries with twin problems of high debts and overvalued real exchange rates that were able to rectify both of these problems while maintaining a fixed nominal exchange rate with major trading partners? It is hard to think of any success stories, in large part because the measures one would take to address one problem are deleterious to the other. For example, to address the debt burden, a country would like to have a relatively high nominal GDP growth rate, one higher than the interest rate on the debt. This would imply some inflation, however, and, by itself, imply further increases in the country's real exchange rate.

On the other hand, to lower the real exchange rate given a fixed nominal exchange rate, the recipe would call for deflation. But, given that no peripheral country is going to enjoy lower borrowing costs than Germany, every percentage point of deflation adds one percentage point to a country's real rate of interest expense, which harms their ability to service their debts.

One European plan out of this Catch-22 would be if peripheral countries had wide scope to institute reforms to their economies in terms of adding flexibility through labor-market liberalization, for example. The aim would not be to change the real exchange rate per se, but to create positive changes in the economy that would enable the country to live better with the real exchange rate it has, i.e., keep it the same but remove the overvalued label. In many cases among peripheral European countries, it would appear that they fired their best

bullets on this dimension in the 1990s in order to qualify for membership in the monetary union.

The decision whether to continue in the European Monetary Union (EMU) rests not only on economic considerations, however; it also involves national pride and sense of standing in the world. It harkens back to the old Groucho Marx quote: "I would not want to belong to a club that would have me as a member." The peripheral EMU members might not feel entirely welcome in the club at this point, but that could be a reason why they are eager to stay.

A shot across the bow

Many commentators have been asking where the bond market vigilantes are vis-à-vis the United States, given that bond yields remain relatively low, even following the downgrade of U.S. government debt. The answer might be that they have already begun to attack unsustainable social welfare states by concentrating their initial salvos on the peripheral European Economic and Monetary Union (EMU) countries. It is the common currency that has made these economies the most vulnerable to bond market vigilantes.

United Kingdom (UK) struggles but might avoid following Eurozone into recession

We also estimated (with forecasts) a UK Business Cycle Index, using data through Q4 2011. The projected path suggests the UK is likely to avoid following the Eurozone into recession in 2012. One caveat about the model, however, is whether it fully captures the nearly unprecedented fiscal tightening taking place in Britain by the Cameron government.

China's soft landing

China's 8.1 percent real GDP growth rate in the first quarter of 2012 (versus one year earlier) was released on April 13, 2012. This figure was slightly below consensus expectations of about 8.4 percent. Thus, for the Chinese central bank, concerns about growth below target are likely to become almost as important as concerns about inflation above target. Current Blue Chip consensus forecasts indicate that China's myriad measures to contain inflation have worked in the short run, with inflation projected to be 3.5 percent in 2011 and 3.6 percent in 2012.

Figure 6: Eurozone and U.S. business cycle indices (1970-2012)

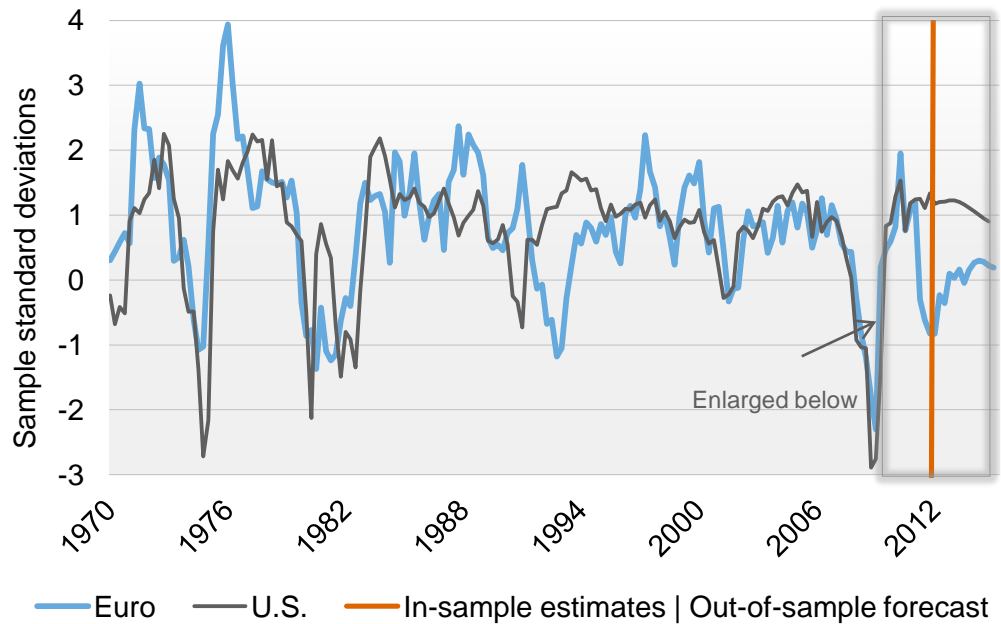
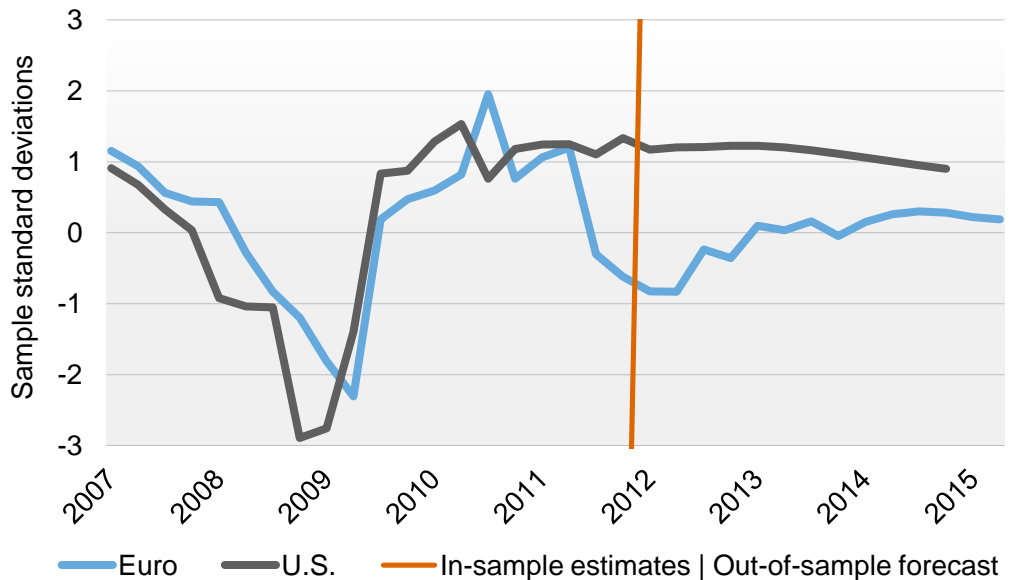


Figure 7: Eurozone and U.S. business cycle indices (2007-2012)



Values shown for the in-sample estimates and out-of-sample forecasts are the median of the simulated values for the quarter. Out-of-sample forecasts were calculated by simulating the time-series model into the future.

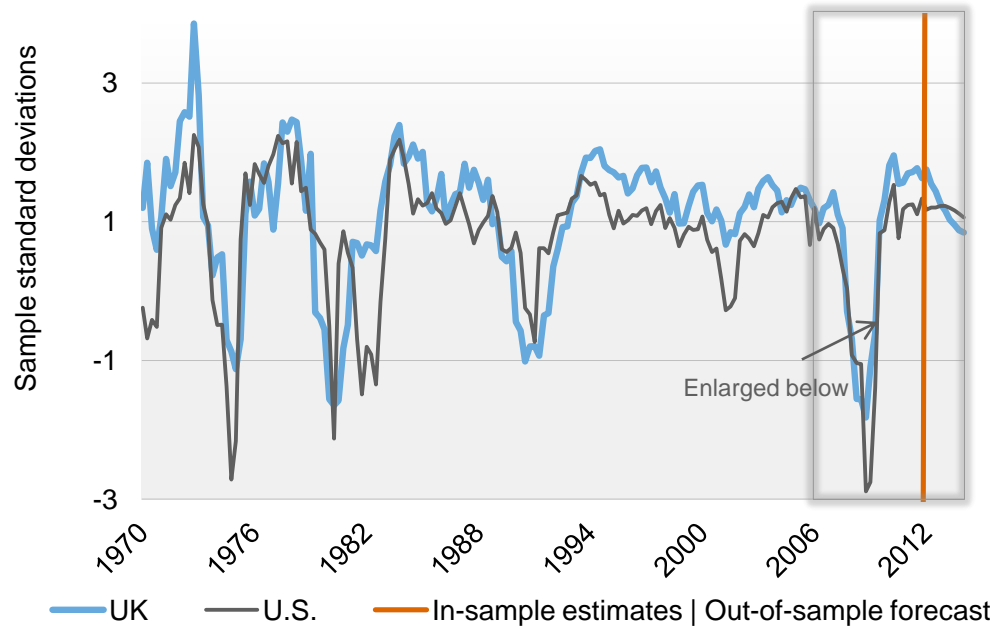
Source: U.S. recession data from National Bureau of Economic Research. Europe recession data from the Centre for Economic Policy Research. Recession for Europe in 2002 is based on research completed by Mike Dueker, Ph.D., Russell Investments: <http://research.stlouisfed.org/wp/more/2008-001>

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. There is no guarantee that the stated results will occur.

Index performance is not indicative of the performance of any specific investment.

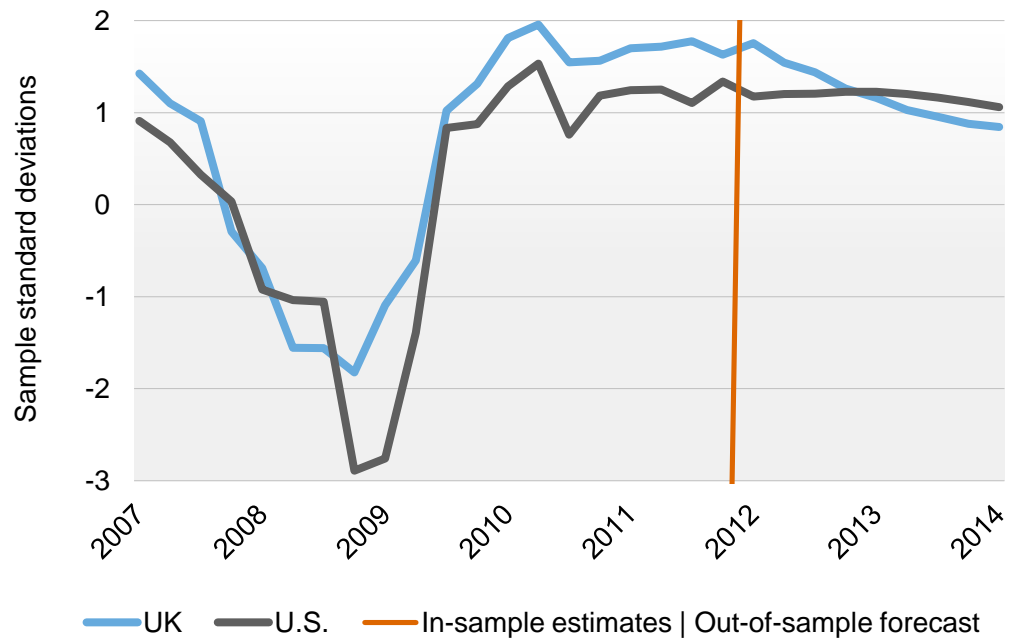
Indexes are not managed and may not be invested in directly.

Figure 8: UK and U.S. business cycle indices (1970-2012)



Source: Factset: European data as of March 31, 2012, Russell calculations: forecasts through March 31, 2014

Figure 9: UK and U.S. business cycle indices (2007-2012)



Source: Factset: European data as of March 31, 2012, Russell calculations: forecasts through March 31, 2014

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. There is no guarantee that the stated results will occur. Historical data is not indicative of future results.

Russell's Market Expectations for Q2 2012

Signal date: April 1, 2012

WHERE ARE THE MARKETS GOING?

So far, the European Central Bank's long-term refinancing operation (LTRO) for European banks has been perceived as partially successful in reducing the spread of European risks globally. Although many U.S. banks have modest exposure to European sovereign debt, they may have material exposure to European banks – thus the importance of the liquidity provided by the LTRO funding access. Nevertheless, structural concerns, as well as questions surrounding the mechanism for addressing sovereign troubles in Europe, are still unresolved. Against this backdrop, we believe that reduced risk in Europe may benefit U.S. equities more than European equities and we anticipate continuing market volatility. With the United States likely providing a material portion of risk asset opportunities, we will continue to monitor U.S. macro economic data as we move into the more mature portion of the earnings cycle.

Please remember that even in more normal market environments, the high level, simplified overview of our market forecasts presented in this document is not intended to be used as the basis for a trading strategy or asset class timing. Among other things, a client's individual risk tolerance and objectives, and more extensive details about the power and alignment of the various model signals, would need to be taken into account to form a robust trading strategy.

COMPARISON ¹	EXPECTATION	WHY WE CHOSE IT	+ Outperform ++ Strongly outperform	How do we expect the U.S. dollar (USD) to compare to other currencies? ²
U.S. Equities vs. U.S. Fixed Income	U.S. Equities +	Momentum, long-term mean reversion, trailing earnings and fundamental valuation comparisons using forward earnings favor U.S. Equity. Note, however, that we believe that consensus forward earnings estimates may be too optimistic.		UNDERVALUED relative to USD
U.S. EQUITY STYLES				
Large Cap vs. Small Cap	Neutral	We remain slightly more positive for Large Cap but not enough to move away from neutral for the pair. Although Large Cap benefits from a mean reversion and modest price-to-earnings advantage, momentum, price-to-book and price-to-sales signals are neutral.		Chinese yuan/RMB British pound
Growth vs. Value	Neutral	With the exception of price-to-sales and price-to-earnings comparisons, all of our signals are neutral. We do have a slight preference for growth over value, but only among Large Cap stocks.		OVERVALUED relative to USD Yen Euro
EQUITY REGIONS				
U.S. vs. Non-U.S. Developed	Neutral	While we see compelling valuations for non-U.S. Developed Equities from a moving average price-to-earnings basis, a momentum headwind as well as neutral signals in all our other valuation models lead us to a neutral position.		NEUTRAL relative to USD
Global REITs vs. U.S. Equities	Neutral	We have a neutral position in this pair. U.S. Equities are favored very slightly from a long-term mean reversion perspective. However, virtually all other indicators are neutral.		Australian dollar Canadian dollar
U.S. vs. Emerging Markets	Neutral	U.S. Equities benefit from a recent relative performance advantage. But concerns about Chinese domestic politics and growth forecasts, and neutral signals from our valuation models keep us in a neutral position in this pair.		
Non-U.S. Developed vs. Emerging Markets	Neutral	We have a neutral position based on neutral signals from a long-term mean reversion, price-to-sales, price-to-book, and price-to-earnings basis. Fundamental valuation using trailing earnings favors Emerging Markets slightly.		
U.S. FIXED INCOME				
Corporate Bonds vs. Treasuries	Neutral	We hold a neutral to very slight preference for Corporate Bonds in this pair as a result of favorable option-adjusted spreads and positive momentum amid otherwise neutral signals.		
U.S. Fixed Income vs. Global REITs	Global REITs +	We continue to hold a slight preference to Global REITs in this pair based on relative yield comparisons. The long-term mean reversion signal remains neutral while momentum shows a slight recent preference for Global REITs.		

¹All asset class comparison are Large Cap unless otherwise noted.

²Currency rates may fluctuate significantly due to many factors including political developments in the U.S. or abroad. As a result, investments in non-U.S. dollar-denominated currencies may result in reduced returns.

Frequently Asked Questions

What is *Russell's Market Expectations*?

- This quarterly report provides **Russell's viewpoint on the direction of the market** based on which asset classes and currencies we think are undervalued as indicated by our proprietary models.
- The information is used to **estimate the relative performance of the two asset classes shown in the pair**. It does not provide insight into the absolute returns that an investor could expect. A model may suggest that asset A will offer a higher return than asset B if the relative valuation between the two returns to a historical level. However, the models do not suggest that asset A will provide a high return, simply a return that may surpass that provided by asset B. The returns of both asset A and B could be negative.
- The asset class and currency views are **pair-wise comparisons, based on the relative value of each asset class or currency**, and reflect the valuation of asset classes or currencies that may be most attractive compared to one another.
- Russell's proprietary models use financial theory, historical data and forecasts to measure relative valuation.
- Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Why is it important?

- *Russell's Market Expectations* can be used as **a reference point for providing context and perspective on the direction of the market** and as a viewpoint on the attractiveness of different asset classes and currencies.

Can I use *Russell's Market Expectations* as an asset class-timing tool?

- **No. This report is not intended to be used as the basis for a trading strategy or as an asset class-timing tool.**
- The signals displayed in *Russell's Market Expectations* are a high level overview of a limited subset of the insights from Russell's Enhanced Asset Allocation (EAA) Strategies and do not reflect the risk and conviction controls that are part of the EAA portfolio customization.

How should I interpret it?

- In simple terms, **the chart shows you the relative valuation of asset classes for this quarter**.
- Each pair-wise expectation contains two important data points: the asset class we believe will outperform – or a neutral expectation if we believe they will have similar performance – and, if applicable, the strength of the outperformance. **Moderate outperformance potential is indicated by a single plus sign (+), while strong outperformance potential is indicated by two plus signs (++)**.
- The boxes shown to the right gives you a view on which major currencies we believe will be stronger, or weaker, than the U.S. dollar.
- 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.

How often is it updated?

- *Russell's Market Expectations* is updated during the first month of each quarter.

FOR MORE INFORMATION, CONTACT YOUR RUSSELL REPRESENTATIVE.

Important information

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Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

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.

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