

Strapping in and holding on.

Quarterly Market Outlook: November 2011



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Do Something, just nothing stupid or risky



Welcome

Strong performance in the first half of the year, and then a rapid late-summer decline in equity markets followed by a nearly equally rapid and strong rebound in October. Since this summer, global investors have been trapped aboard what seems to be the market equivalent of the world's bumpiest roller coaster, the ups and downs seemingly orchestrated by newsflow coming out of Europe. On the macroeconomic side, we went from strong US and developed World Growth in the first half of the year to fears of a double dip in North America, a credit crunch and sovereign debt crisis in Europe and a slowdown in China. Behind all of this is a slew of policy volatility and a flood of disappointing, insufficiently bold eleventh hour stopgap measures. One can only imagine the havoc this environment is wreaking on investment portfolios.

If we could somehow put the turmoil in Europe aside, we could actually put together a convincing case for maintaining modest overweight exposure to the global risk trade. Economic growth in the US has exceeded expectations and seems likely to make fears of a double dip look like much worry about nothing. Corporate profits continue to be strong, and valuations are not prohibitive – even more so after the events of August and September.

The problem is that we, and it seems the market, cannot just forget about the mess on the continent. We suspect that in the short term, markets will be driven (or if you prefer a strong and more accurate term, how about “heaved”) to and fro by European political developments with respect to the Euromess. The situation has got too acute to ignore, unlike it had been between January 2010 and say, May of this year. There is a real chance that events could end badly and we will be dealing with messy, Lehman-like madness. Let us be clear, we are not forecasting a messy outcome, but we are cognisant that the probability of one is not trivial. Oh, and then in a few weeks we will be presented with the US Congress’s “Super Committee’s” budget cutting proposals, which in the current poisonous political climate in Washington are unlikely to come in the form of wind in the market’s sails.

Hence, we cannot in good conscience advocate much risk taking across multi-asset portfolios for the foreseeable future. Doing nothing in this sort of climate is actually doing something, just not something stupid or risky. Fasten your belts and hold on.



John Velis
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Market Background and Outlook

It was all going so well, or so it seemed. Entering the year with a slightly positive stance on risky assets, our model portfolio had an overweight relative to benchmark in favour of global equities. While our overweight position was smaller than it had been the previous year, we were expecting that in a world in which economic growth would stay positive (if muted), monetary policy somewhat loose, and corporate earnings robust, equity markets would have a decent year. Even while slightly long equities, we had always been wary of policy risks and there has been no shortage of worries from national capitals from Beijing to Washington; from Tunis, Tripoli and Cairo to Berlin, Rome and Athens; and from Tokyo to Brasilia.

Yet for the first half of the year, these national-capital-based tremors (please pardon the pun!) seemed to cause only slight and short-lived ripples to the outlook. Sure the Eurozone debt crisis remained unresolved and gridlock in Washington provided little confidence that the United States' fiscal situation would be put to rest any time soon, but inasmuch as these issues led to some short-lived dents to market confidence, their impact on corporate profits, asset class valuations, and – as a result – our view on the risk trade were negligible.



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This all changed in the summer. Greece, whose ability to implement agreed-upon fiscal consolidation, and hence its access to bailout funds, has been a worry for well over a year. But those worries intensified over the summer and they spread to Italy. On the eve of a special European Union summit in late July, we decided to pull in our risk positions, as the politically-designed solutions to the Eurozone mess that had been crafted in piecemeal fashion for the previous 14 months ultimately fell short in investors' eyes. The July 21st summit promised more of the same, and at an ever more crucial time in the arc of the crisis.

Sure enough, this move to a more cautious stance served us well. (Please see Exhibit 1.) Late summer and early autumn was a truly awful period in the markets, and we suffered through a proper "risk-off episode." The Russell Global Developed equity price index was off nearly 20% (down 18.6% in local terms). The unsatisfactory outcome to the US budget negotiations and subsequent downgrade of US sovereign debt certainly did not alleviate investor fears, but in a risk-off market regime like we saw in late summer, even treasury assets that are rated "only" AA+ were more attractive places to park funds than in equity markets. We have stayed in neutral this quarter as we move towards year-end.



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EXHIBIT 1: Russell Global Developed Price Index



SOURCE: Factset, data as at November 3, 2011.

Market Background and Outlook *continued*

So, what changed in July? The Eurozone mess has been raging with more or less intensity since January of last year and markets had managed to post solid gains right along through mid-July of this year. To answer this properly, we remind readers of the structure we think is necessary to ensure the survival of the zone and to guard against a “messy” outcome. (By “messy” we mean an unscheduled default by one of the peripheral countries or a breakup of the single currency). We have long referred to this structure as the “three legged stool.”

- › Leg one, recognising the lack of a central fiscal authority to compliment the central monetary authority in Frankfurt, we felt that the EFSF rescue facility needed to be increased in sheer size (i.e. pledges of more money by the core) and extended in its remit. This later feature would include the ability to buy bonds on secondary markets to prevent solvent sovereigns from losing market share as well as have a pool of funds dedicated to recapitalise banks that would encounter solvency problems should sovereign default.
- › Leg two, recognising the inherent insolvency of some peripheral states, even those that have accepted austerity and have been enrolled in EU bailout programmes. These debts, inherently unsustainable, would have to be restructured in an acceptable way that would not disrupt markets. This would reduce the overall debt burden on insolvent countries, and impart some justified losses on lenders, who should be on the hook for some portion of their bad lending decisions.
- › Leg three, recognising that the monetary union was structurally flawed from the beginning and needed further economic convergence between the periphery and the core if monetary union were to survive into the future. This involves pro-growth reform, some shrinking of the economic role of the state and regaining internal competitiveness in the absence of being able to devalue the exchange rate (which is fixed in a monetary union). Some surrender of economic sovereignty in peripheral countries would also probably be required.



It was our fear going into the July 21st summit that these legs were far from being fully and clearly designed, let alone built. After the summit it was clear that this fear was realised, hence the subsequent market plunge.

Something happened in October. Markets began to rally, and between October 3rd and October 28th, the global index posted a rebound of 14.1%. What happened? Surely Europe hadn't solved its problems? Indeed even as equity – and other risky asset classes – markets rose during this time, benchmark bond yields in the peripheral Eurozone countries continued to slowly rise. (Please see Exhibit 2.)

Investors were no more sanguine about the sovereign debt situation on the continent during this period than they had been before. It was as if equity investors were content to put the Euromess out of their minds, shunted off into

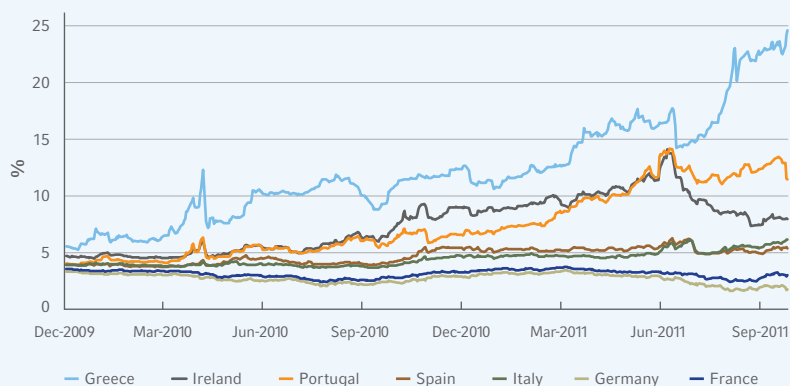
a corner, as they paid more attention to positive fundamentals that had nothing to do with the ECB, the legs of a stool, Merkel, Sarkozy, Berlusconi or the IMF.

And indeed, herein lies the irony. Our central thesis for 2011 was reasserting itself quite apart from the chaos of Europe. US growth was firming up and it became more and more clear that a recession would be avoided. Corporate earnings season presented us with the still encouraging news that World, Inc. was ever more profitable. Central banks not based in Frankfurt were keeping policy accommodative (and in some places, as seen by "Operation Twist" in the US and QE II in the UK, even more expansionary). After nearly ten weeks of being bombed out, certain sectors and individual companies were lying on the top of the bargain bin and were being picked up by investors who were concentrating on the positive news flow that didn't involve Europe.



Yet something happened in October. Markets began to rebound. Surely Europe hadn't solved its problems?

EXHIBIT 2: Ten Year benchmark Bond Yields for Selected Eurozone Countries



SOURCE: FactSet, data as at November 3, 2011.

Market Background and Outlook continued

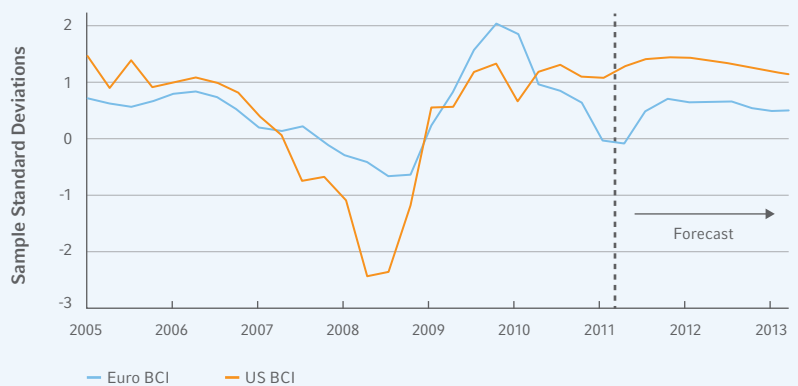
So, it seems, political risk aside, the prospects for markets had reasserted themselves and we could resume “normal” investing. Not so fast. Political risk, especially the type that the European leaders have managed to manufacture and dole out in heaps, cannot be put aside at the moment. Going into yet another summit of Eurozone leaders last week, we had faint hopes that the three legs or any other support structure would be built. Although we are heartened by the recognition of the need for these legs, and we give leaders some credit for designing a few solutions that seem sensible and relevant, the market has since concluded that the summit’s conclusions have been too little, too late, and too lacking in detail to be seen as sufficient.

The market has taken another negative turn, and bond yields continue to register fears that the peripheral countries, under current arrangements, cannot stabilise their finances any time soon. The Greek referendum bombshell rocked markets on Tuesday, angered European leaders, and advanced the deep-set notion that political will and consensus to solve the crisis is a long way off. The fact that 48 hours later the Greek referendum was cancelled only underscores the lurching, haphazard nature of Eurozone leaders’ approach. Greece is and has been an obvious problem and by itself is a significant threat.



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Exhibit 3: Eurozone and US Business Conditions Index



SOURCE: Russell Calculations. For illustrative purposes only.

Yet across the Aegean Sea, Italy represents an altogether more terrifying problem. As the discordant and so far feckless Berlusconi government proves itself unable to commit to and pass a significant plan to balance its budget in short order, Italian bond yields widen. If the third largest economy in Europe, and third largest public debtor in the world with nearly €2 trillion in public debt outstanding and €300 billion to finance in 2012 cannot reverse the trend, the Euromess gets messier and markets get wobblier.

Meanwhile, our estimates show the EU in recession already; the ECB's recent rate cut under new President Draghi was not unwelcome, but is hardly a panacea. European consumer, financial and industrial confidence ebbs as the sovereign debt crisis rolls on. (Please see Exhibit 3).

As we move deeper into November, the inaptly named US budget "super committee" will add its results to the economic landscape. Can they come up with a credible, useful plan to sort out the US's problems sufficient to allay the concerns of the ratings agencies and foreign creditors? One of those creditors, often seen as a potential white knight, China is in the throws of trying to engineer its own soft landing without causing structural imbalances to turn a deceleration towards economic sustainability into a crash. (Please see Exhibit 4.) At the same time, European leaders are licking their lips and hoping that the Middle Kingdom will deploy its excess savings for debt purchases in Europe, surely one way to balance the global balance sheet amongst savers and borrowers.



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Exhibit 4: Chinese Purchasing Manager Index



SOURCE: Factset, Data as of November 3.

Investment conclusions – Do Something, just nothing stupid or risky

So what is an investor to do? We just got through describing a seemingly schizophrenic market outlook. On the one hand, we believe that corporate and economic fundamentals were behind the handsome market recovery seen in October, but on the other hand we describe a “risk-off” world, in which investors are shunning everything but the safest of assets while they fret that a “clean” Eurozone outcome is less and less likely.


This indeed is the dilemma that we face. If we could somehow just analyse the markets on their merits, we would still be relatively positive (although more cautious than we were in the first half of the year). But we cannot do so. This is a world that is currently somewhat akin to the autumn of 2008. Will Europe descend into a Lehman-like mess of contagion, near financial collapse, and massive flights to quality, all thanks to an abrupt and disruptive event in Europe? We don’t think so, but we cannot rule it out. In some ways, we actually think that the situation in Europe has to get worse, providing European leaders with a glimpse of their own mortality before they act decisively. Indeed the hope was that October 26th would be that near-death experience that led to a comprehensive solution. The reality is that it fell short of investor requirements.

The markets continue to be in the thrall of daily developments in Europe, and we do not think that this sort of news-driven regime, with wild intra-day and day-to-day swings in performance (according to the latest out of the capitals and government meeting halls in Europe) is one in which savvy investors should be making big bets.

Who knows, one day we might wake up to find that all the problems have been solved for the time being and the markets will rally strongly. In such a case, a neutral position will see us partake in that rally, even if we are not overweight risk. Yet is also plausible, that we awake one day to the news that Greece couldn’t hold it together and must default, or Italy is so consumed by market scepticism that they need to turn to the EFSF bailout fund, only to find it is not large enough to cope with such a “too big to fail, too big to save” mess. The downside in markets could be severe indeed.

Thus, while we may be accused of being cautious, we accept that title and advise neutral risk positions across the board. We take no macro-asset class bets and no intra-asset class bets, and we stay at our benchmarks. We point out that this is the very opposite of not taking a decision. In such an environment not straying from one’s benchmark is indeed an active decision, and we go there with comfort in our position, strapped in and ready to ride out the waves of the next few months.





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286/November 2011/UK
