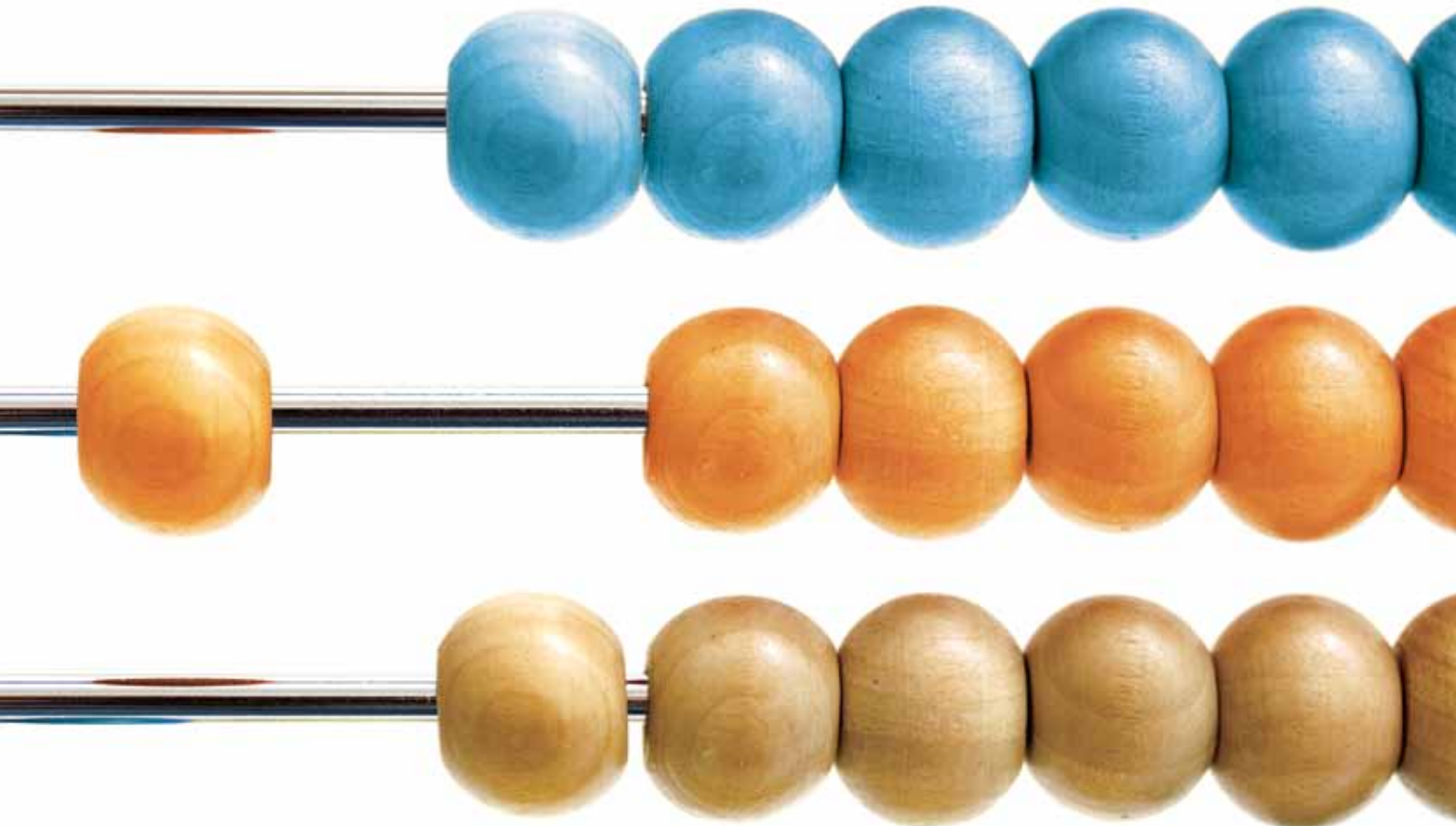


2012

Annual Market Outlook

In a low-return environment,
every basis point counts



2012 Annual Market Outlook

In a low-return environment, every basis point counts

A year ago, we proposed that 2011 would grind along on the relatively flat tail of a square-root-sign-shaped recovery. We expected there to be a continued tug-of-war between headline-grabbing downside risks and the upside news of corporate earnings. The events that played out consistently confirmed our expectations.

In 2012, we anticipate this environment continuing. Volatility, due in many cases to sensational risk stories, will likely remain elevated through most of the year. Corporate earnings, particularly by U.S. companies, are set to slow after two years of outsized gains. Even so, modest profit growth will likely balance the scales on the positive side. The sum of these two factors should result in positive, albeit modest, global share market returns in 2012.

EXECUTIVE SUMMARY

By **Peter Gunning**

Global Chief Investment Officer,
Russell Investments

While this is the summary outlook globally, specific stories will certainly vary by region. Europe will continue to dominate negative financial headlines – and rightly so. A European recession seems inevitable but Europe’s leaders can still act to prevent financial collapse and a deeper downturn. We believe they will. In Asia, and particularly China, we expect the juggernaut of economic growth to slow noticeably, but to still deliver substantial total gross domestic product (GDP) numbers. And the U.S. strikes us as an undervalued field, both in terms of the equity pricing and overly pessimistic economic growth expectations. We will be surprised if the equity market does not cash in that value by the end of the year.

Economic indicators will also tell varied tales. We expect inflation – at least in the developed world – to remain low. Interest rates will likely remain low as well, with only slight upticks at longer durations. Volatility, on the other hand, will continue to present noisy and notable spikes. And the equity risk premium combined with the current interest rate levels appears to be signposting a low return environment.

What does all this mean for investors? It means attention to every detail about their portfolio management will matter. Every basis point earned will be hard fought. We believe regional diversification will need to be firmly in place, as the economic center of gravity will continue to shift eastward because of China and emerging markets. As traditional investments remain flat, alternatives will matter more than ever. And volatility, while it certainly brings market stress, will also bring market opportunity for dynamically-managed portfolios.

We believe that making gains this year will require an active, global, multi-strategy approach and identifying outperforming managers in every sector and region will count more than ever. Gaining access to non-traditional securities through alternatives will also be a key potential return enhancement strategy. In a world of increased volatility and lower returns, a dynamic approach to investing to take advantage of opportunities as they present themselves will increasingly become the norm for successful investors.

Every basis point earned in a 2012 portfolio will need to be well-protected through rigorous, efficient trading and implementation actions. Because while growth is possible this year – and it could happen for certain dynamic, well-positioned investors – it won’t come easy. 2012 is a year to pay attention to every penny. □

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Core themes for the 2012 Outlook

2011 brought global policy risks to the forefront of attention for capital markets. 2012 will continue to see volatility and risk-on/risk-off trading, but will start the path toward clarity surrounding how successful the policy solutions will be.

1. Russell's long-term outlook: Ongoing global deleveraging will continue to be the backdrop for economics, finance and politics for 2012 – and for some years to come.

It took three decades for the developed economies to borrow too much money and it will take years to pay it back. Balance sheet recessions are typically followed by elongated, grinding and below-trend recoveries, so lowered standards of living and stubbornly high unemployment should be expected. So should lower returns and higher volatility. As "risk-less" assets take their place in the museum, discipline will be required as markets adjust to new risk realities. This will all take place against a backdrop of clashing priorities for Western democracies between the need for austerity, the need to support economic growth and the need to provide for rising outlays on entitlements. At its heart will be an intergenerational battle between the electorally numerous baby boomers and the younger generations that will be footing the bill.

2. The key risk: The second sub-prime crisis is called the Euro.

Given the fragility of the European banking system, we continue to see potential European policy errors and inaction as the single largest source of systemic risk and threat to global market sentiment, much as we noted in our 2011 outlook.

3. A modest positive: A square-root-sign-shaped U.S. economic recovery

The square-root-shaped economic recovery has been our team's highly-accurate U.S. economic forecast since 2009. With gradually improving news on the U.S. economy, continued strength in U.S. corporate earnings, and expanding pockets of private investment strength, we think this forecast persists into 2012. We expect slow stabilization in the housing market and glacial improvement in employment. While the fiscal situation in the U.S. is similar to Europe, the U.S. has the luxury of more time as a result of a more robust macroeconomic environment relative to Europe. We expect to see Europe as an accelerated time-lapse movie of the U.S.

4. A modest positive: The Chinese/Asian engine of growth

Chinese authorities have just embarked on an easing cycle and we think that China will likely achieve a reasonably soft landing. Combined with other emerging-market easing, China and these emerging markets will – along with the U.S. – once again contribute as engines of growth for global GDP.

In our outlook a year ago, we accurately forecasted that capital markets would be dominated by risk on/risk off trading, driven by punctuated spasms of volatility. In 2011, markets were indeed volatile due in large part to a continuing, violent tug-of-war between the "knowable and the feared." On the knowable – or at least measurable side has been a modestly-growing U.S. economy – growing neither briskly nor robustly to be sure, but in a square-root-sign-shaped fashion. Additionally, data continue to show that

YEAR-END 2012 TARGET

› **2.6%**
U.S. 10-YEAR
TREASURY YIELD

› **1300**
S & P 500 INDEX

› **720**
RUSSELL 1000®
INDEX

U.S. housing and unemployment appear to be stabilizing and perhaps most importantly, a material segment of U.S. corporations continue to achieve record profitability.

Also on the “knowable” side is the China wild card. The Chinese central bank began a tightening cycle almost two years ago and their equity markets and economic data have been declining since 2009. China has just started to ease policy settings and it is our expectation that the China wild card will turn positive in 2012. We think that China will engineer a soft landing and contribute to a modest global growth acceleration by the latter half of 2012.

The Euro debt crisis continues to be on the feared side of the ledger, where markets suffer spasms of the unknowable. Europe is struggling from a political problem and the solution must be political as well, even if the consequences are economic, financial and human. Political leaders and the European Central Bank need to implement swift and decisive policy action to comfort global investors that they won’t allow the crisis to “go Lehman.” Recent 2011 market rallies on moves by the International Monetary Fund and a U.S. Fed-led coordinated action by global central banks further underscore the dearth of policy leadership in Europe, which means there is an uncomfortably high probability for political conflict and policy errors.

While we do expect volatility to remain elevated in 2012 relative to historical averages similar to 2011, we also know that, ultimately, economic fundamentals and corporate earnings matter. Although we cannot predict performance, eventually we expect markets to trend away from headline-driven panic/relief return patterns and toward a more historically typical return patterns where disciplined investing and active management – including rigorous research, dynamic asset allocation and intelligent security selection – may begin to pay off for investors.

A tentative balance of risks for 2012

Our base scenario is that the two engines of the Chinese and U.S. economies will ignite and drive global growth. Should these engines not flame out, and if Europe can stabilize the deepening sovereign debt crisis, we think this scenario could be a notable positive for risk assets. While we are more confident on the U.S. and China forecast with each data release, we are acutely aware that politics are volatile and that forecasting political outcomes is very difficult. Europe will remain a source of systemic risks, reinforcing again the tug-of-war between what is measurable and what is feared.

Call to action or inaction

Since we expect volatility to remain elevated, we realize that the decision to do nothing is a big decision. But, given the balance of risks, staying close to current strategies is likely to be a reasonable and prudent starting point, understanding that there could well be additional policy-risk flare-ups out of Europe.

For disciplined long-term investors, we support them in standing pat – knowing that they could see a decline on fixed income with a modest upside to equities. For investors who are more high-frequency viewers of the markets, higher volatility is likely to lead to sell-offs, and investors will be given opportunities to add to risk in their portfolios and trim fixed assets. ■

The United Kingdom: A small open economy in a volatile world*

Make no mistake; the UK economy is indeed in the doldrums. Household demand is weak, corporate investment and optimism is waning and the government's fiscal austerity measures are not keeping pace with worsening fiscal accounts.

No wonder that the Bank of England is pushing additional Quantitative Easing (QE) even as it confronts above-trend inflation. No wonder sterling stays weak – an economy that grows slowly, spends more abroad than it takes in and cannot balance its books shouldn't expect a strong currency. Yet in many ways the UK economy is at the mercy of forces well beyond its own control. As a small open economy, it is being buffeted by forces across the Channel as well as across the Atlantic and even into Asia.

The Euromess is weakening foreign demand for UK exports (the UK conducts nearly 60 percent of its external trade with its continental neighbours) and hurting the banking sector which does not maintain significant exposure to the European debt – sovereign and corporate. Doubts around the U.S. economy, at least this past summer, also have sapped confidence. The Chinese and emerging market slowdown has weighed on large members of the UK equity market, whose materials, energy and industrial firms' performance is to some degree at the whim of developing markets. True, a domestic economy that depended for the majority of its growth from ebullient financial and housing markets during the last decade will anyway have difficulty gaining traction as long as those two sectors remain subdued. It is hard to be overly bullish on the economic outlook, yet we do think the eventual return to normal economic fundamentals sometime in 2012 will be reflected in markets and economic conditions.

It is hard to be overly bullish on the economic outlook, yet we do think the eventual return to normal economic fundamentals sometime in 2012 will be reflected in markets and economic conditions.

Our predications for the UK:

- › Bond yields seem to defy inflation and fiscal numbers, yet they are ironically seen globally as safe havens in the current risk-averse climate, and more QE from the European Central Bank (ECB) continues to provide a strong source of demand for long-dated government securities. In addition, domestic institutional demand for gilts and linkers provide reliable support.
- › Despite the headline inflation numbers, we do not see inflation as a long-term problem. Demand and wage growth remain so weak that it is hard to see the elements of inflationary spiral push headline rates higher. We agree with the Bank of England (BOE) that the effects of a weak currency and higher food and oil prices earlier in 2011 made price levels temporarily worse, but that these effects should ebb as we move into 2012. Indeed, recent data indicate that high street shops have been engaged in significant price discounting in the face of reluctant consumer demand, driving retail prices lower. We suspect this to continue into the year.
- › Based on the above, we suspect that the Bank's policy will remain extraordinarily accommodative in 2012. That being said, an eventual resolution to the Eurocrisis should see some normalisation in long yields, but only up to a point. A long yield of something between 2 and 3 percent would be the rage that we would call equilibrium.

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- › In many ways, the UK equity market is as dependant on the broader global outlook as the domestic economy. The UK market has always been dominated by international exposed firms and has also had a good number of high dividend players. As a result, the UK rarely performs much better or worse than global equities. Given that we see global equities remaining weak -- and even possibly getting weaker on the back of the lingering Eurocrisis -- but then rallying to catch up with broader fundamentals, we would suspect to see a similar dynamic in the UK. ■

*This section is for distribution in EMEA only.

The economy that could not catch a break in 2011: U.S. growth should rebound in 2012

We project U.S. real GDP will grow 2.5 percent on a year-on-year basis, despite a predicted recession for Europe. The 10-year Treasury yield to end the year between 2.5 and 2.75 percent.

With U.S. Gross Domestic Product (GDP) growth poised to finish 2011 at an anemic 1.7 percent on a year-on-year basis, it was a year in which little went right in an economy that still badly needs to recover from the Great Recession of 2007–09. We think 2012 will bring some improvement in economic growth.

On the affirmative side, many of the setbacks in 2011 need not repeat themselves in 2012:

1. Inflation expectations appear to be more firmly anchored near 2 percent than they were in early 2011. At that time, speculative bidding drove up commodity prices and fueled a temporary rise in inflation that is now falling out of the 12-month inflation numbers.
2. We can safely assume that the Japanese earthquake and the attendant supply-chain problems will not recur in 2012.
3. Libyan oil exports can only go up in 2012 after civil war took the country's oil production off-line.
4. The debt-ceiling debacle from August 2011 will not be revisited until 2013.
5. We can only hope for policy clarity on resolution of the European debt crisis and long-term budget consolidation in the U.S.

Unfortunately, the fifth problem of policy uncertainty was the most serious impediment to a strong 2011, yet it is the most likely to continue in 2012. Call this a continuous policymaker injection of uncertainty. In fact, one could argue that policymakers never missed an opportunity to inject uncertainty in 2011, as they raised expectations for definitive measures and then continually fell short. Examples included the August 2011 debt-ceiling debacle, followed by the do-nothing budget Super Committee in the U.S. Congress. More importantly, the European "big bazooka" policy proposals in November 2011 clearly failed to contain Italian bond yields to a solvency level.

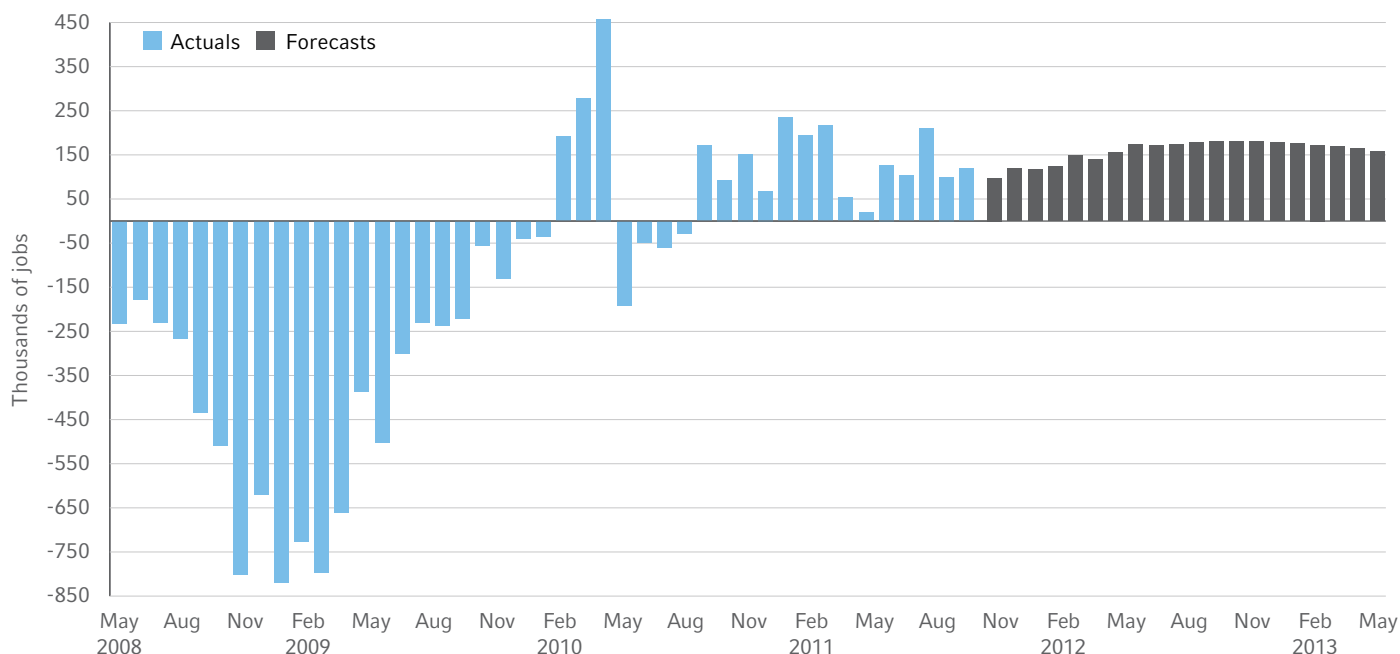
Nevertheless, economic forecasts are brighter for 2012 U.S. economic growth, even as the Eurozone experiences a shallow recession – barring a full financial meltdown in Europe. To bolster U.S. growth and to counteract the linkages that transmit economic and financial weakness from Europe to the U.S., we could see an additional round of Quantitative Easing (QE) by the U.S. Federal Reserve in 2012.

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

- › Real GDP growth of 2.5 percent on a year-on-year basis in 2012. Our central-tendency forecasts are predicated on not having a full-blown financial meltdown in Europe.
- › Our baseline forecast is that Europe will have a recession in late 2011 and in 2012, but the U.S. will not be dragged into it. This scenario is the reverse of 1990 and 2001, when the U.S. entered into a recession and Europe did not. Nevertheless, the U.S. economy would not be able to hum through a European financial meltdown in the

We think 2012 will bring some improvement in economic growth.

Forecasts of non-farm payroll employment changes



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.

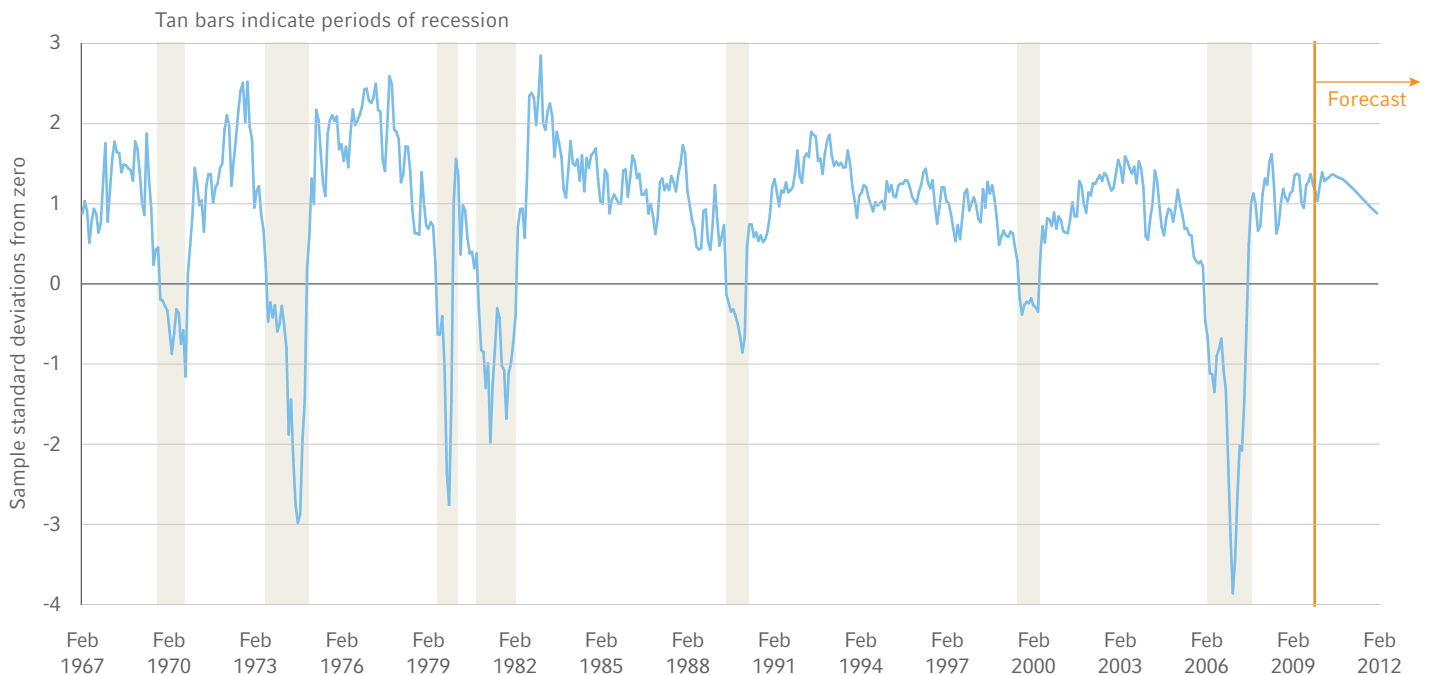
- › Non-farm payroll employment gains are projected to reach a plateau level between 180,000 and 190,000 jobs per month in mid-2012. Even with this improved level of job creation, the unemployment rate is expected to fall very slowly during the year with such a small gap between the year's jobs gains and the trend rate of increase in the labor force of about 150,000 entrants per month.
- › Russell projects that the benchmark 10-year Treasury yield will climb gradually above 2.5 percent by the third quarter of 2012, and it will end the year between 2.5 and 2.75 percent. If this scenario unfolds, the U.S. economy will exit Japan-style stagnation expectations in 2012. 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 QE and "Operation Twist," the new stimulus measure which is scheduled to end in June 2012, has been to reverse expectations of economic stagnation that lead to low long-term bond yields.
- › Our outlook for inflation is that we project the all-items Consumer Price Index (CPI) will increase at an average rate of 2.4 percent in 2012. 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. We do not expect a repeat of speculative increases in energy prices of the magnitude that we saw in the first half of 2011.
- › Equities: Russell gauges that target fair value for U.S. equities will be at 1300 for the S&P 500 Index and 720 for the Russell 1000® Index by the end of 2012. This represents about a 10 percent increase from where the U.S. market stood in late November 2011.

As of November 30, 2011.

Non-farm payroll employment forecasts are posted monthly on www.russell.com/Helping-Advisors. Monthly jobs gains are projected to average 155,000 jobs per month in 2012, with a plateau level at about 190,000 jobs per month.

Source: FactSet, Federal Reserve Economic Data (FRED), Russell Calculations

Business cycle index



As of November 30, 2011.

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. 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: FactSet, Federal Reserve Economic Data (FRED), Russell Calculations

Forecasting represents predictions of market prices and/or volume.

Accompanying charts:

The U.S. business cycle index (BCI) is posted monthly on www.russell.com/Helping-Advisors; its forecasted values illustrate our central-tendency forecast of moderate economic growth. The BCI is above zero during economic expansions, below zero during recessions and the distance from zero indicates either the strength of an expansion or the depth of a recession. The projected peak in the BCI in coming months is expected to be below 1.5 standard deviations above zero, a shockingly small rebound from such a severe recession. It appears that the economy faces too many financial headwinds, in no small part due to the European debt crisis, to have a robust recovery. That being said, we still do not expect the U.S. to go into recession in 2012. We also estimate a similar BCI for the Eurozone economy. The BCI forecast is that the Eurozone will have a recession in 2012, whereas the U.S. economy will not. This scenario is the opposite of 1990 and 2001, (as shown in the chart on the following page) when the U.S. economy went into recession and the Eurozone did not. ■

The Eurozone. The single currency: can't live with it, can't live without it

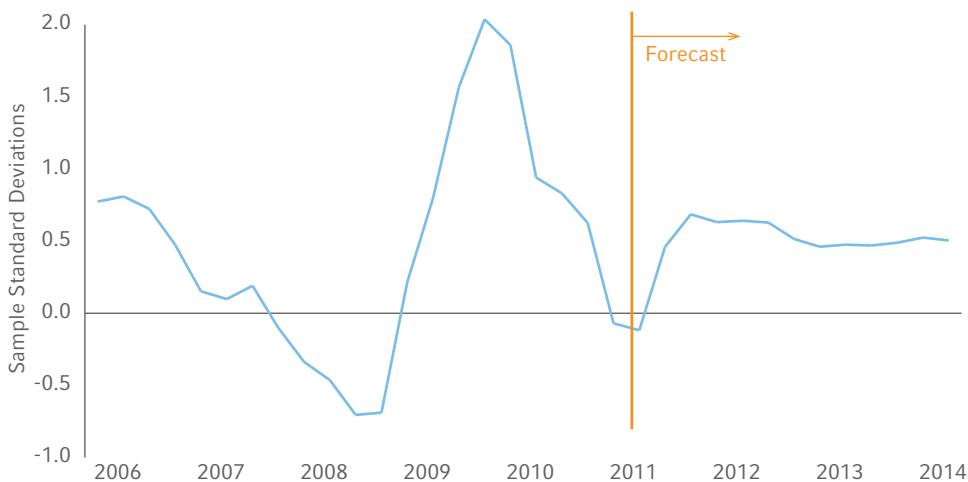
One way or another, the European Central Bank (ECB) is going to have to dig deep to bring resolution to the Eurocrisis. But the situation may have to get worse before it gets better.

As we wind down 2011 and hope to survive to the end of the year without a "Lehman-like" outcome in Europe, it is common to hear leaders in Europe warn that the continent faces its gravest moment since World War II. This, sadly, is not hyperbole. The fate of the single currency, and quite probably the European Union, is poised on a knife's edge. It is difficult to make predictions about an issue that could be resolved – either happily or tragically – at any time or could linger for quite a while longer.

We have long explained the three-legged stool when discussing what is needed to resolve the Eurocrisis. For leg one, a central fiscal authority with much more financial "firepower" than the European Financial Stability Facility (EFSF) needs to be created. Leg two takes into account that some borrowers are effectively insolvent under current arrangements; therefore some debt restructuring will be required. The third leg recognizes that peripheral states, if they wish to remain in the Eurozone, need to reform their economies to become fiscally sustainable as well as competitive with core countries. This is a longer-term issue of economic governance in the bloc.

Supporting the three legs, the European Central Bank (ECB) will need to support illiquid, but inherently solvent entities, whether they are countries or banks. This is the pivotal issue confronting financial markets in 2012, and it will have to be resolved quite soon. Spain, France and Italy alone require close to €650 billion in new funding in 2012, much of it early in the year. Dealogic, an analytics firm in the UK, estimates that European banks require a further €144 billion in short-term funding in 2012 as of December 1, 2011. The current state of half measures cannot linger deep into the coming year.

Euro Business Cycle Index



The pivotal issue confronting financial markets in 2012 is that the ECB will need to support illiquid, but inherently solvent, entities.

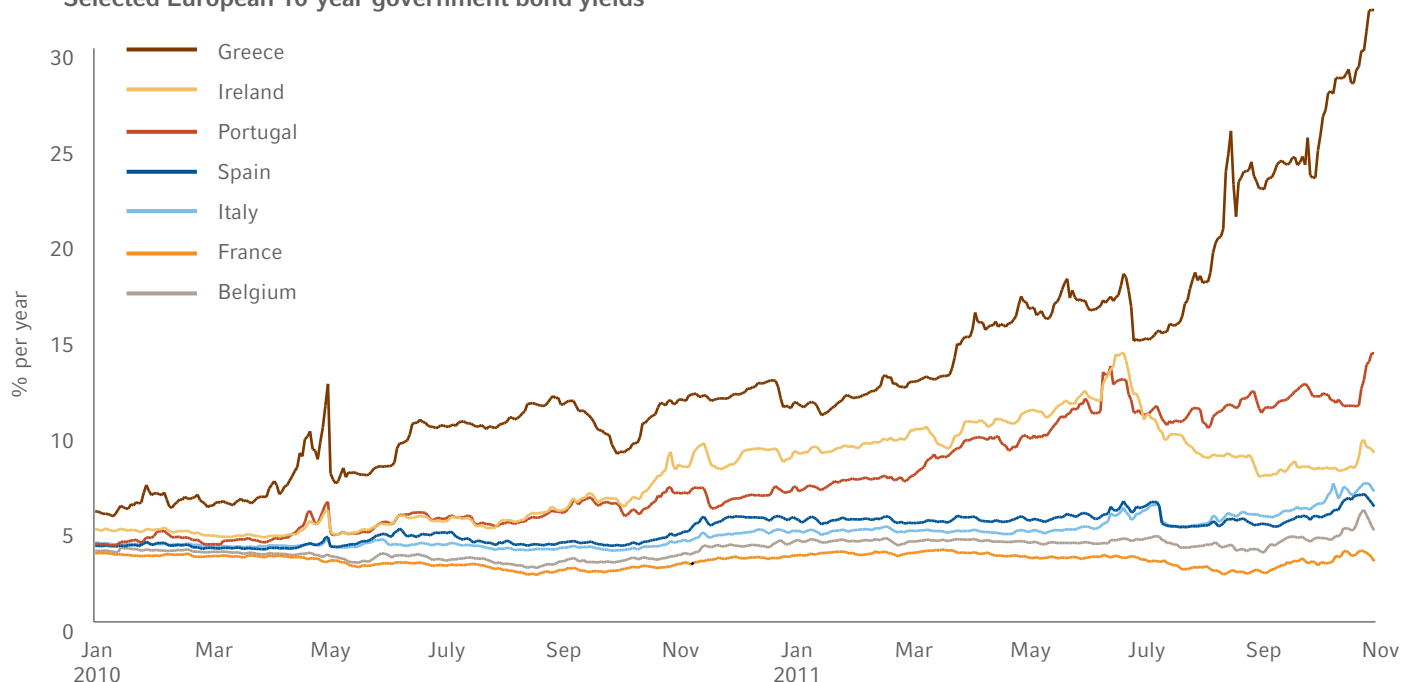
As of October 15, 2011.

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. 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.

The BCI forecast is that the Eurozone will have a recession in 2012, whereas the U.S. economy will not. This scenario is the opposite of 1990 and 2001, when the U.S. economy went into recession and the Eurozone did not.

Source: FactSet, Federal Reserve Economic Data (FRED), Russell Calculations

Selected European 10-year government bond yields



Projections for the Eurozone:

- › We believe the exit of a country from the Eurozone – be it a unilateral withdrawal or ejection by the others – would be catastrophic and ruinous for Europe and the global economy. This would cost far more in lost output and wealth destruction than even the most far-reaching and ambitious rescue program. Rational analysis therefore suggests the euro will hold together. However it cannot be entirely ruled out that the currency union could collapse.
- › European leaders may need to come close to a near-death experience before they begin to implement the three legs discussed above. It may very well have to get worse before it gets better.
- › The above also applies to the ECB’s approach to liquidity provision. Until now, it has been buying peripheral debt at the margins and openly resisting calls to do more. It is feeling the pressure of Germany and other core policymakers not to act as a lender of last resort and is unwilling to compromise its credibility by bailing out profligate members. This will have to change, and again, may come down to the eleventh hour.
- › Economic growth: To discuss GDP forecasts for a multi-national economic bloc that consists of such heterogeneous conditions across the region is quite difficult. There is a strong consensus that Europe is or will soon be in recession. In those countries implementing severe austerity, “depression” is not too exaggerated a term to apply. In the result of a resolution to the crisis, core Europe at least should return to positive – albeit very weak – growth by the end of the year.
- › Equities: Until a sustainable and credible solution to the crisis is crafted, we cannot see arguments in favor of anything but the most defensive positioning in European equities. If and when a solution is crafted that looks like it has holding power, the relief rally could be stunning; European equities have justifiably borne the brunt of investor risk aversion and valuations will be compelling in such an event.

As of December 1, 2011.

Source: Bloomberg

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- › Fixed Income: As long as the current demoralizing state of affairs persists, we expect investors to continue to find haven in German bunds and those bonds of other strong European sovereigns (including those of non-Euro members). If and when we are out of the woods, spreads should narrow between the highly-rated sovereigns and those currently under threat. The former should see prices decline as a result of normalization of investors' risk attitudes as well as a probable increase in their own riskiness as risk across the Eurozone is in some way pooled. The latter should rally if default and/or Eurozone exit leaves the radar screen.
 - › Inflation and ECB policy: Undoubtedly, the longer the crisis persists and the worse it gets, the stronger deflationary forces will become throughout the Eurozone. Wage and asset price deflation has already begun in the periphery. As the core of the European Union begins to register decelerating inflationary pressures, we would bet on falling and low ECB rates well into 2012. We might even expect to see the ECB undertake some form of quantitative easing if the growth outlook for Europe deteriorates markedly. For the time being, while they are buying sovereign bonds on secondary markets, they are sterilizing these purchases such that the money supply in Europe is not actually increasing. If they wish to be more aggressive, it is not off the table that we may see rising expectations of QE in the Eurozone. ■

Asia: year of the restrained dragon

The greatest threat to the Asian economy may come from outside the region, in the form of a European recession. But the region has strong potential for outperformance.

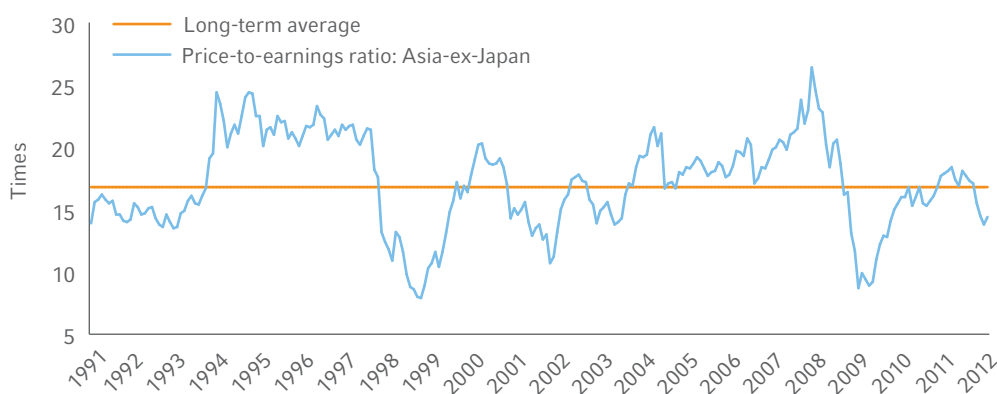
For Asia-ex-Japan, Russell believes 2012 will be a year of dealing with external threats after facing the internally-generated threats of inflation and overheating in 2011. The main danger for 2012 is a significant slowdown in export demand as Europe slides into a recession. This could be exacerbated by tighter credit conditions as European banks restrict lending to maintain capital ratios. The importance of trade finance was dramatically demonstrated in 2009 when the global credit crunch magnified the export slowdown in Asia.

The positive news is that inflation appears to have peaked across the region. China in particular has scope to significantly ease monetary conditions. Share market valuations are attractive across the region with price-to-earnings ratios below 10-year averages and price-to-book value for the region is 1.6 times. Asia-ex-Japan is likely to remain hostage to events in Europe over the first part of the year. The region, however, has potential for strong outperformance once the crisis in Europe is resolved and a global recession is avoided.

Highlights include:

- › China is slowing and there is downside risk to the consensus economic forecast for 8.5 percent GDP growth in 2012. Private property development activity in China is turning down as tighter monetary conditions reduce property demand and create financial difficulties for property development firms.
- › Weaker private sector construction activity will be at least partly offset by the government's "social housing" program to build 35 million affordable homes by 2015.
- › China's central bank has just begun to ease monetary policy and this will likely continue in early 2012. This may also limit the extent of the Renminbi (RMB) appreciation during the coming year. There is a risk that the central bank will force the RMB lower if exports weaken significantly.
- › China's forward and trailing P/E ratios are now below 10 times compared to peaks of over 20 times in 2007.

Price-to-earnings ratio: Asia-ex-Japan



The region has potential for strong outperformance once the crisis in Europe is resolved and a global recession is avoided.

As of November 1, 2011.
Based on 5-year average inflation adjusted EPS.

Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

Source: FactSet, MSCI All Country (AC) Asia-ex-Japan Index, Russell calculations

Every year we ask whether Japan is genuinely cheap or a value-trap. And every year our answer is that yes, it looks cheap and could be ready to outperform, but we have little confidence in the ability of the economy to generate sustained growth. For 2012 our view is broadly unchanged with the caveats that Japan looks even cheaper now and that rebuilding after the March 2011 earthquake will lead to some confidence-generating growth.

Our projections for Japan:

- › The rebuilding process from the March 2011 earthquake and tsunami disaster will provide a significant boost to economic activity and Japan is likely to be the only major economy to post above-trend growth in 2012.
- › Price-to-book value for the overall Japanese market is below 1 as of November 2011 and a material portion of Japanese companies are carrying a lot of cash. This creates potential for corporate activity in the form of buybacks and mergers and acquisitions.
- › The P/E ratio based on average earnings over the past 10 years is the lowest since the asset bubble burst in the late 1980s.
- › Yen strength is a significant problem for the Japanese economy. Attempts so far at currency intervention have been feeble and the Yen continues to be perceived as a safe-haven currency. Yen strength reinforces the deflationary bias of the economy.

Price-to-earnings ratio: Japan



As of November 1, 2011.
Based on 10-year average inflation adjusted EPS.

Source: FactSet, Russell calculations, MSCI Japan Index

Japan equities: price-to-book value



As of November 1, 2011.

Source: FactSet, MSCI Japan Index

Emerging markets: globally geared, locally strong

The threat – and potential reality – of European recession may temporarily limit the strength of this sector, but strong fundamentals mean EM may benefit from a return to risk.

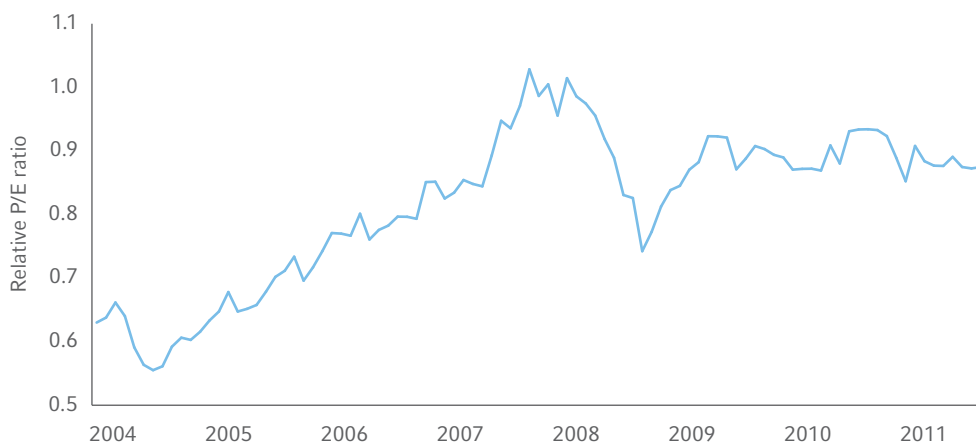
Our view on emerging market (EM) equities at the beginning of 2011 was cautious. Inflation was a significant concern for policymakers in the emerging world. Emerging market equities had moved from a significant P/E ratio discount to developed markets in the mid-2000s to near parity by late 2010. The need for policy tightening to combat inflation combined with equity market valuation that was no longer compelling suggested that emerging markets could underperform the rest of the world.

Indeed, EM equities lagged those of the developed world for the first part of 2011 when global risk markets generally fared well. EM equities have continued to stay volatile in the second part of 2011 as investors, spooked about the Eurocrisis, have retreated into risk-off mode. We don't deny that over the long term, EM economies could perform better than developed economies. This should deliver further re-rating of EM equities. Already they are trading at nearly equal forward multiples to the developed world, and this should increase over time. The short-term questions are: how will China – the 800-pound gorilla of the asset class – fare next year, and what is the impact of the global economy on the developing world?

Our answer to the first question is relatively constructive. We acknowledge the structural imbalances building up in China, but believe that cyclical forces in 2012 will probably prevent a severe and swift (and painful) adjustment. Regarding EM's gearing to broader global events, our view is that as long as the Euromess persists, growth headwinds and investment sentiment will restrain the asset class. If and when this cloud dissipates, the asset class – always a high beta play on the rest of the world given the higher risk premiums assigned to equity markets in emerging economies – should share fully in the relief rally and return to the normality that will result.

Although emerging market valuations are less attractive than elsewhere, strong fundamentals mean that the asset class can benefit from a return-to-risk appetite.

Emerging markets versus world-relative forward price-to-earnings ratios



As of September 20, 2011.

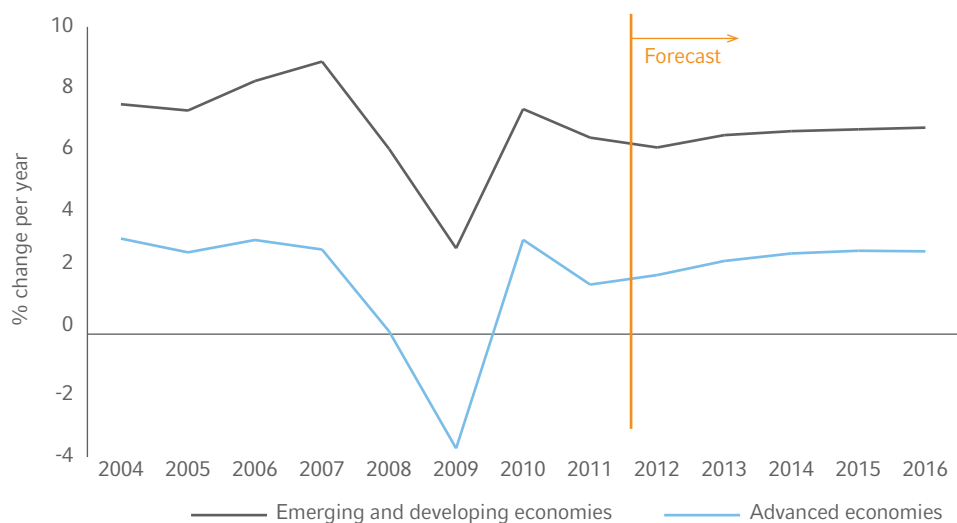
Source: FactSet, MSCI Emerging Market Index

Our projections for emerging markets:

- › The global economic consensus view is that the ongoing crisis in Europe will sap the strength of the EM asset class. We share this view: the tightening of credit globally, the knock-on effects to growth and liquidity, and sustained risk aversion will all weigh on EM.
- › We do not believe that the likely outcome for Europe is a break-up of the single currency. Once European leaders and the European Central Bank (ECB) make this clear, the rising tide of a potential relief rally globally should raise all boats, especially EM. Things may well have to get worse before they get better, and EM may suffer during the “getting worse” phase.
- › Although EM valuations are less attractive than elsewhere, strong fundamentals mean that the asset class may benefit from a return-to-risk appetite (providing that the European doomsday scenario does not play out). Assuming the year ends with positive momentum in the global outlook, EM will be leveraged to that view and should rise accordingly.
- › EM credit, which has suffered in the recent flight-to-safety climate will materialize as an attractive asset class – both fundamentally and from a valuation perspective – and could challenge battered Western sovereigns for risk-free status.
- › Central banks will join in the global policy easing, and this could also fuel a solid post-Euromess recovery. The war against inflation is almost won in most developing economies, and the room for easing is larger than in the developed world.
- › Currency strength will still be a feature of EM currencies (and China may even target a lower RMB should exports disappoint), but lower interest rates and rising yields in the West – a byproduct of normalization – will cap rises to more agreeable levels in EM policymakers’ eyes.

We can all agree there is a lot of hype surrounding the outlook for emerging markets. Investors are reminded that emerging economies generally have positive demographics, strong public- and private-sector balance sheets and a declining reliance on an export-led growth model. This contrasts with the major developed economies that face an extended period of lackluster growth amid deleveraging, balance sheet repair and fiscal constraints. ■

Gross Domestic Product (GDP) growth in advanced and developing economies



As of October 2011.

Source: FactSet, International Monetary Fund (IMF) for country classifications

Quantitative easing: what is it and which economies might see it in 2012?

While three of the central banks have undertaken QE in 2011, we project further rounds in the next year.

Among the big four central banks, three – the Federal Reserve, the Bank of England and the Bank of Japan – have undertaken Quantitative Easing (QE) since the 2008 global financial crisis. Only the European Central Bank has maintained its short-term interest rate far enough above zero to continue to implement monetary policy through interest-rate decisions rather than balance-sheet adjustments. Quantitative Easing becomes relevant once a central bank has driven the short-term interest rate close to zero. At that point, the central bank can choose to inject the minimum amount of reserves into the banking system to enforce the near-zero short-term interest rate, or it can inject some amount beyond the minimum. This extra amount can itself be a policy choice by the central bank, and this policy step is called Quantitative Easing.

In well-functioning financial markets, it does not matter much what assets the central bank buys to implement the liquidity injections behind QE. The well-known monetary economist Allan Meltzer's advice to the Bank of Japan in the late 1990s was that it buy stuff, any stuff, until long-term inflation expectations rose to two percent. The important point is that the central bank is acquiring from the private sector valuable, interest-bearing assets in exchange for zero-interest bank reserves that it is creating for free – out of thin air. The central bank aims to make a credible promise to keep exercising this advantageous exchange until the private market finally acquiesces to the central bank's desired level of inflation expectations.

In practice, however, QE is sometimes in use during periods of great stress in financial markets, when risk-averse investors are eschewing certain assets. Two examples in the recent financial crisis in the U.S. were the acquisition of commercial paper by the Federal Reserve in late 2008 and early 2009 and the Fed's purchases of mortgage-backed securities between March 2009 and March 2010. In both cases, the central bank bought assets that were having trouble finding a market among private investors at the time. In 2012, it is entirely possible that we could see targeted purchases of Italian and Spanish bonds as part of a QE program by the European Central Bank.

Below is a rundown of what we believe are the prospects for QE among the big four central banks in 2012:

- › If the U.S. labor market fails to produce at least 150,000 jobs per month by the end of the first quarter 2012 and if the 10-year Treasury yield lingers below 2.25 percent, the Federal Reserve could well opt to convert "Operation Twist" into another round of QE by canceling the asset sale side of the equation.
- › The Bank of England is ending 2011 under a program of QE, as it tries to weather the recession among its trading partners in the Eurozone. The minutes to the November 2011 policy meeting indicate that further QE could be necessary in 2012.
- › The Bank of Japan faces near-record-high levels of the exchange value of the Yen, with the Yen/dollar exchange rate at 77.6 as of December 4, 2011. In a world of near-zero short-term interest rates, we think the only way for the Bank of Japan to engineer a lasting depreciation of the Yen is with additional QE.

In 2012, it is entirely possible that we could see targeted purchases of Italian and Spanish bonds as part of a QE program by the European Central Bank.

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- › The European Central Bank still has its short-term interest rate at 1.25 percent as of November 2011, so it needs to cut the rate closer to zero before it can initiate QE. Between the Eurozone recession and the trouble that member countries, such as Italy and Spain, will likely face in placing their bonds in private hands in 2012, QE might be an essential policy step more than a choice for the ECB in the months to come. ■

What could go right?

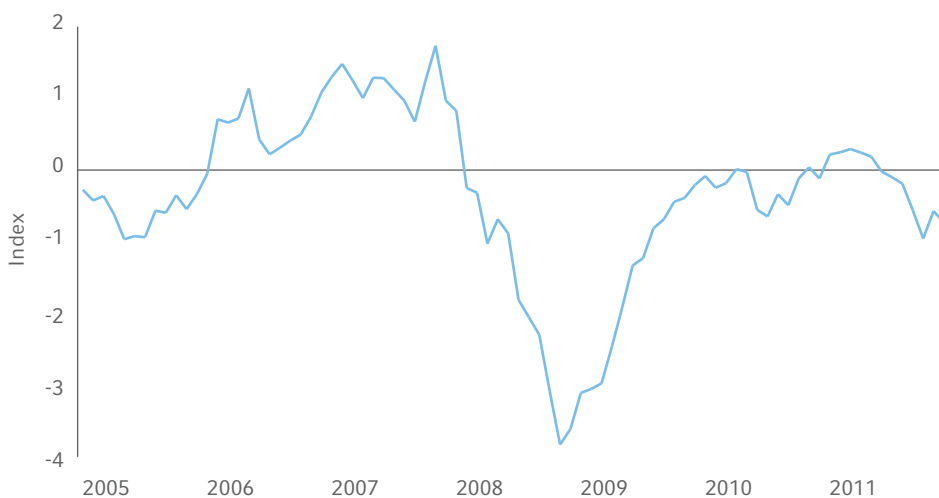
Gloom and doom. The possible break-up of the largest single aggregate economy in the world. A deadlocked U.S. government facing mounting fiscal problems. Slow-down in the Chinese economy. Expensive bond yields, shunned equity markets. Banks on the ropes. Not an appetizing cocktail, to say the least.

Our central scenario, which assumes the worst outcome in Europe is avoided, is for a moderate recovery in the global economy and a volatile, yet ultimately slightly positive, equity market outcome. This is not just our view, but an emerging consensus around the world. Indeed, this mediocre-at-best and potentially very-bad-at-worst scenario has solid groundings in any serious global analysis. Yet it is often good practice, when facts and their interpretations all seem to line up on the same side of a market issue, to look at the contrarian possibilities. What could surprise us on the upside? Almost everyone is pricing in less than extravagant risk-asset conditions for 2012, could things actually surprise us positively?

- › Any serious considerations of the positives must necessarily start with the presumption of an effective, durable European resolution. Preferably sooner rather than later, as we do not think lingering much longer will bring about best outcomes. A case can be made that Europe's problems in the short-term – namely access to funds for solvent but illiquid entities, to buy time for effective structural solutions to be developed – isn't that far away. This would set the stage for global investors to return to corporate and economic fundamentals.
- › Next on the list is a steady – even if unspectacular – U.S. economic recovery in 2012. The election cycle could induce both U.S. parties to worry about their electoral chances and prompt some meaningful compromise on fiscal policy and maybe even introduce a jobs program. Our central forecast for the U.S. labor market (barring a European convulsion) is for job growth of nearly 200,000 per month by June 2012. Move that up a few months, and add a few thousand more jobs to the central forecast, and you have

Our central scenario assumes the worst outcome in Europe is avoided, for a moderate recovery in the global economy and a volatile, yet ultimately slightly positive equity market outcome.

World Composite Valuation Indicator (CVI)



As of December 1, 2011.

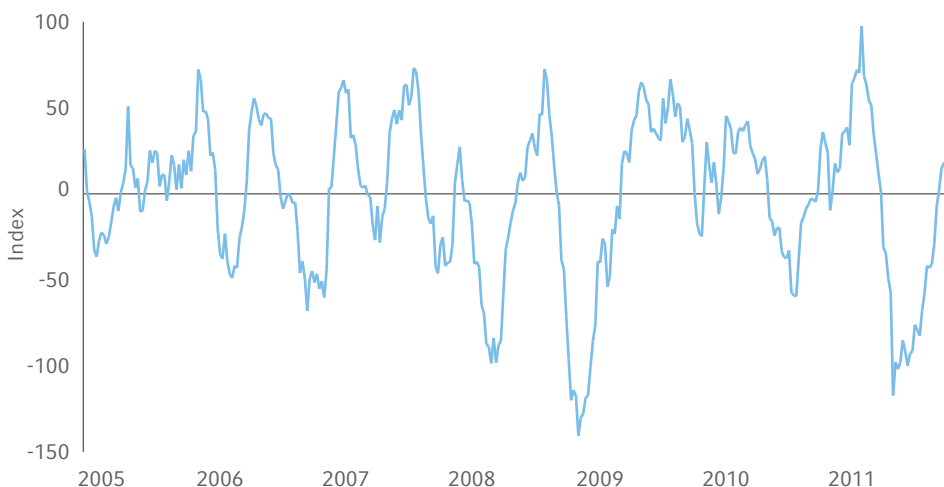
Source: Bloomberg

CVI: A proprietary index that measures the valuation of equity (at the index level, relative to its own history). High readings are considered expensive, low readings cheap.

the ingredients for much improved sentiment regarding the world's biggest economy. Monetary policy tailwinds and the possibility of a bottom in the housing market would be a powerful tonic.

- › China, clearly in slowdown mode, could pull off a smooth landing and manage to avoid an abrupt deleveraging and credit crash.
- › With the Chinese and U.S. engines running smoothly, the European scenario could quickly go from flame-out to full blast again, as the export machines in the core draw upon the fuel of U.S. and Chinese demand.
- › One can see this supporting the fourth engine of global growth: the rest of the emerging market world. Commodity exports, the resumption of ready trade financing and improved investor sentiment would find its way into this segment of the market. A positive feedback loop would ensue.
- › If stock market valuations are beaten down in early 2012, the scope for a rally will be huge. In 2009 global equities, realizing that Armageddon had been well and truly avoided, rallied nearly 25 percent through the end of the year (as measured by the MSCI AC (All Country) World Index). Active managers in all asset classes would have the chance to fill their boots with cheap, but attractive securities.
- › This does not mean that we need to worry about bond yields soaring. Central banks will continue to take out insurance policies against deflation and make sure that the bursting to life of the four engines of global demand are not mere hiccups. Even if inflation pressures mounted, this would probably be greeted with a sigh of relief, evidence the global deflation has been avoided.
- › Nevertheless, some normalization of yields would be expected, meaning equities-versus-government bonds would become a winning play, with credit and other assets leveraged to corporate fundamentals strengthening. This would generate returns from both spread-narrowing and attractive initial yields. The challenge in predicting currency trends for 2012 is that the U.S., Europe, U.K. and Japan all need weaker currencies, while the one country that can withstand appreciation, China, is likely to resist revaluation. At the beginning of 2011, Russell called the search for the best-performing currency a *least-ugly contest*. Not much has changed in 12 months and picking currency winners is still about seeing which has the fewest negatives. Currency-supportive fundamentals are in short supply for any of the major currencies. ■

U.S. Economic Surprise Index



As of December 1, 2011.

Source: Bloomberg, Citigroup
U.S. Economic Surprise Index

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MSCI EM: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

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