



Russell Research

Market Outlook

Cycling Higher

John Velis, Head of Capital Markets Research

Europe, Middle East and Africa

October 2009

Contents

1. Executive summary
2. Market review and outlook
3. Investment conclusions
4. Market ratings summary
5. Ratings sheet explanations

Executive summary

- Global equities and credit enjoyed another strong quarter since the publication of our last Market Outlook. We expect that the next few months will be positive again, and that early 2010 will present us with the need for a reassessment. Until then, however, we think the cyclical uptrend is intact and will lend support to both stocks and corporate bonds.
- This quarter's earnings season lends some support to a market willing to take another grain of positive news and move higher. Valuations, while not at the rock-bottom levels of early 2009, are not prohibitive yet, and at this point in the cycle, the uptrend in earnings growth and the continued improvement in the risk climate will set the stage for continued multiple expansion. The story, then, for both equities and credit rests on similar considerations.
- Hence, we are positive across the board globally, while regionally we stay long the US market at the expense of its counterparts on this side of the Atlantic. We don't think the regional choice is too important, and expect the differences to be minor. Yet the US is probably better geared to the factors that we have cited which will drive markets further.
- We do expect this to be the last quarter in which a positive view on equities and credit is based on cyclical factors. We are already setting ourselves to work examining the longer term structural features which we think will emerge in 2010, including the inflation and policy outlook, trends in developed world consumption and the effects of a broad global rebalancing. This is no way intended to mean that we will start 2010 with a negative view on the markets, just that whatever our view is, it will be based in much larger part on longer-term considerations of trends, rather than current views on the economic cycle.

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Market review and outlook

The rally in markets that we have witnessed since this spring has been impressive indeed. The Russell Global index (TR, USD) gained 11.6% since the end of July. Other risky assets have done similarly well over this period. The pace and magnitude of the market recovery, as well as its nearly V-shaped pattern, have been both accompanied and in part driven by an improving risk climate. Investors have become more and more sanguine about risks, which, as shown by our in-house measure of the current risk climate, currently stands at levels which starkly contrast with those of one year ago.

Figure 1: Performance table

Equity		09-Mar to 23-Oct	31-Jul to 23-Oct
Russell Global	USD	73.7%	11.6%
Russell 1000	USD	63.1%	10.1%
Russell 2500	USD	77.2%	10.7%
Russell UK	GBP	54.1%	15.2%
Russell Europe x UK	EUR	65.2%	11.4%
TOPIX	JPY	29.3%	-4.4%
Russell Asia Pacific x Japan	USD	109.6%	14.6%
Russell Emerging Markets	USD	105.9%	15.9%
Fixed Income		09-Mar to 23-Oct	31-Jul to 23-Oct
IG Corporate	USD Hgd	17.9%	3.7%
High Yield	USD Hgd	54.0%	10.9%
EMG Debt	USD Hgd	33.4%	9.3%

NOTES: All equity indexes are total returns, in indicated currency.

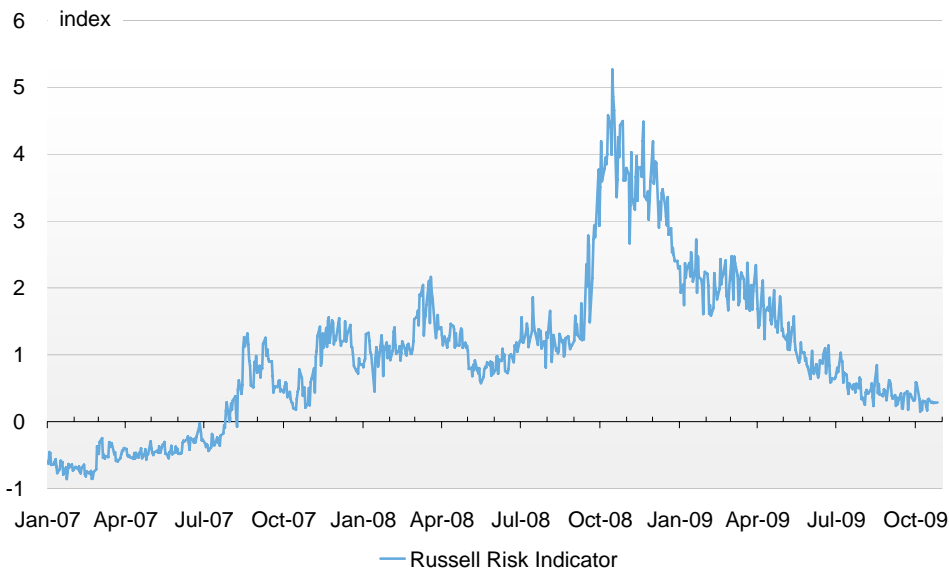
Fixed Indexes are Barclays Capital Global Emerging Markets (USD), Barclays Capital Global Aggregate Credit - Corporate, Barclays Capital Global High Yield, TR, USD, Hedged.

SOURCE: Bloomberg, FactSet as of 23-Oct-09

Along with improving data in almost every (the UK is a noticeable exception) economic region, an optimist would be tempted to declare the crisis over, and marvel at the resilience of the global financial system. Even the still weak labour force numbers wouldn't invalidate a sunny interpretation. Employment is, of course, a lagging indicator; it takes a few quarters of growth for firms to become willing to add to their payrolls. In fact, lacklustre employment growth can actually be interpreted as a positive factor, since firms can start to increase margins more rapidly by keeping their labour costs low. To add to the sanguine outlook, policy is stimulative, meaning that this supportive scenario can persist for as long as policy makers can hold their nerve. And anyway, once they begin to remove the life support measures they put in place last year, it will actually be due to the fact that the patient has recovered and is ready to venture forth on its own two feet. For example, the recent interest rate increase by the Australian Reserve Bank is a sign that the Lucky Country has weathered the worst and the supports upon which it was leaning can be gradually taken away.

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Figure 2: Risk Climate



NOTES: Russell Risk Indicator is a combination of: US two year swap spreads over generic US govt 2-year yields, BarCap HY versus IG spreads, Def vs Cyc (Mcap weighted average of MSCI-W Cons. Staples, Health Care and Utilities versus MCap weighted average of MSCI-W Consumer Discretionary and Finance), 3 Months forward federal funds futures contracts, Moodys BBB - US Gov 10 year spreads, TED Spread USD 3M LIBOR, VDAX, VIX. Daily.
SOURCE: Russell Calculations, Bloomberg, 23-Oct-09

A pessimist would look at the landscape and counter that, while output growth has stabilised and is even bouncing back, this is merely the effect of artificial and unsustainable fiscal and monetary largesse by authorities and a mere statistical blip in the inventory restocking cycle. While corporate profits are better than expected, they are still falling based on year-over-year calculations; they are just not as bad as analysts had been forecasting. And who trusts the analysts anyway? Consumers are still in debt, and their wealth has been substantially reduced by the large fall in asset and home values, leading to weak balance sheets. Their income statements don't look much better, what with employment prospects still bleak and wage growth anaemic. Banks still have plenty of toxic assets on their balance sheets and aren't lending in any case. Moreover, bears will grouse that for whatever reason, the last eight months might have seen a cyclical recovery, but the new long term trend that will reveal itself as we move into 2010 will mean that the second decade of this century will be characterised by mediocre growth everywhere, the long term consequences of an unsustainable financial and consumption binge in the west; years (or even decades) of profligacy will leave long lasting scars.

As for ourselves, we survey the landscape and follow the data and digest the arguments. We also do our own analysis and talk to our clients and the money managers we research, and we concede that both bullish and bearish arguments can be made with equal persuasiveness. Indeed, the credibility of both views led us in the last edition of the Outlook to advocate taking some risk off the table. Noting that the range of outcomes on either side of this debate was wide, we felt we were looking at a choice that was too difficult to make with a high degree of confidence. So we put forth a neutral view on global equities. Our thinking, as we explained it, was that even if the worst-case outcomes did not materialise, a neutral stance on the asset class would cost you nothing in terms of missed opportunity, but we could not with good consciousness advocate a large negative position (with respect to strategic benchmarks). We said we wished for more information and greater clarity regarding some of the more important

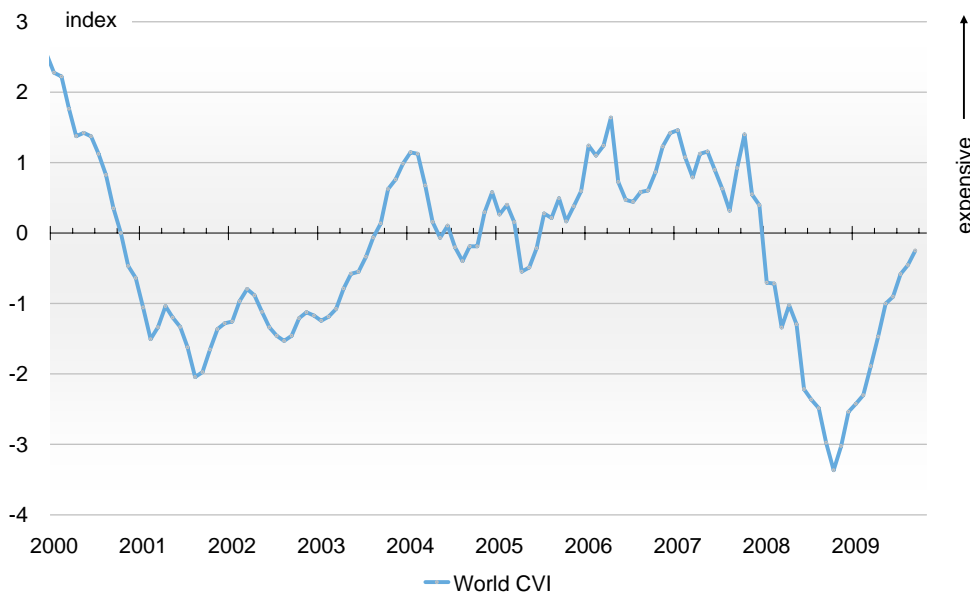
issues facing the economy and the markets. The uncertainty present at the time was too great to inspire confidence in a strong directional bet, either positive or negative.

This time around, we are persuaded to cautiously, but unambiguously, declare that the remainder of 2009 will see positive returns in the markets. We say “cautiously” because we do indeed believe that we are transitioning towards a new global economic and market paradigm and when this has happened in previous points in history, the nature of the new equilibrium takes a long time to fully realise itself. Yet while the markets wind their way towards their new “normal”, we think the current short-term dynamics and normal cyclical considerations are on balance still positive, at least for a while more.

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At the end of last year, when we became unabashedly positive on the markets, one of the main reasons was the level of most global market valuations. A long view of financial market history suggested that at the beginning of 2009, markets were showing the kind of valuations that had been traditionally associated with bear market bottoms. Presently, after an approximately 70% rally in shares, there is no such argument to make. Normally, after a correction, it is normal for markets to display multiple expansion, meaning price-earnings and other valuation ratios grow larger. The “P” rises faster than the “E”, as investors put money to work in cheap assets well ahead of the recovery of firms’ profits. At the moment, while not as cheap as they had been, markets are reflecting valuations that are not prohibitive, and still display room for multiple expansion.

Figure 3: Global Equity Composite Valuation Indicator (CVI)

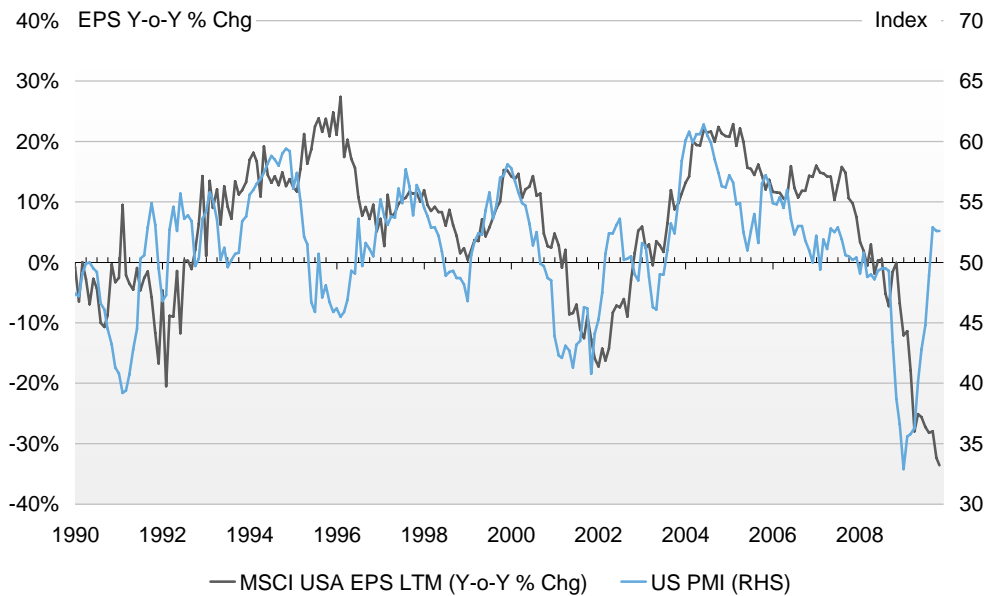


NOTES: A proprietary index that measures the valuation of equity (at the index level, relative to its own history). High readings are considered expensive, low readings cheap
 Contains: Price/Sales, Price/Book, Price/CF, EV/EBITDA, DivYield, G-D P/E (trailing). Month-end observations of an expanding daily Z-score of the above since Nov-88
 SOURCE: Russell Calculations, FactSet as of 26-Oct-09

One of the ingredients required for the above mentioned multiple expansion is investor willingness to take on risky assets. In fair value accounting, higher multiples mean lower risk premia. Markets featuring rising valuations are in effect demonstrating that investors are satisfied that the implied returns of those markets are attractive enough to warrant buying. This can only happen if investors are keen to take on risk. For whatever reason, this is indeed happening and has been almost all year.

At the time of writing, the third quarter earnings season has been underway for a few weeks. The pace of announcements picks up in earnest this week and into late-November. Consensus forecasts are weak, to be sure. Firms in most major markets are still expected to see significant negative EPS growth. But as in this past August, when the Q2 numbers were published, the actual outcomes, while poor, were not as bad as feared and the market rallied heartily. We suspect that something akin to this will happen again this time around. Looking at previous patterns of earnings recessions and recoveries, history suggests that even modest upside surprises will be treated as positive outcomes and thus help kick the markets higher. Furthermore, any evidence that the trough in earnings has passed would lend confidence to the belief that – following normal cyclical patterns – the first few quarters of 2010 will see a strong recovery in corporate profits.

Figure 4: Earnings vs Purchasing Manager Index (PMI)



NOTES: Y-o-Y percentage change in US EPS, Manufacturing Purchasing Manager Survey (PMI)
 SOURCE: I/B/E/S, FactSet, Bloomberg as of 26-Oct-09

As we approach the beginning of 2010, however, we suspect that attention will turn away from the ongoing cyclical upswing and focus more on developments further out. We would suspect two concerns to come to the fore, making calling markets a very delicate affair indeed.

The first will be fears of a “double dip” in economic activity:

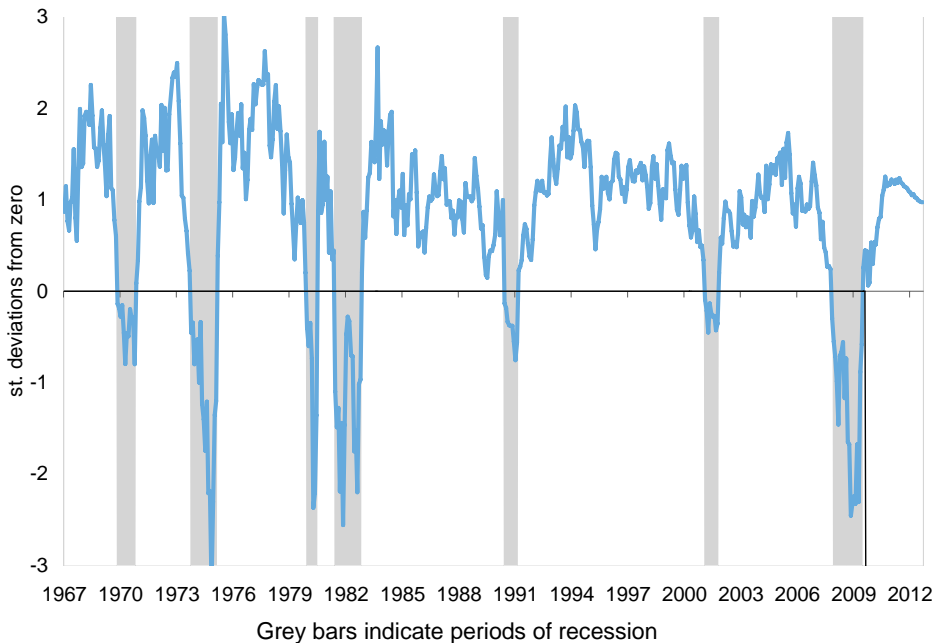
1. First, there is strong evidence to support the notion that the current upswing is more an artefact of flattering statistical comparisons between the current, stabilised situation, and the “batten down the hatches” mentality of a year ago which had led to the suspension or curtailing of great swaths of activity.
2. Second, the sluggish labour market combined with weak household balances and general decline in credit market activity could crimp demand in 2010. If what we are witnessing now is merely re-stocking activity, and firms are just replenishing depleted inventory, then in the absence of healthy demand, this episode could run its course relatively quickly.
3. Third, the policy outlook in 2010 is opaque at best. We do not think that governments will have the appetite or the fiscal space necessary to enact additional

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large stimulus measures. Central banks might even begin talking about “exit strategies” from their currently very loose policies.

4. Russell’s own model of the US business cycle suggests that there will be some “wobble” by early 2010 in the outlook. Whether or not this wobble would reflect real concerns of a second leg down or merely some softening of the data, we would expect markets to treat such signals with trepidation.

Figure 5: Business cycle index as of September 2009



NOTES: 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, Russell Calculations

The second concern regards the longer term structural picture. The move toward a new global equilibrium in the real and financial economies will mean that the west will have to consume less, and the “steroid” like effects of financial leverage and the financial innovations of the past decade will be much less pervasive in the years ahead. New financial regulations will likely crimp some of the riskier – and more rewarding – banking and lending activity that also spread during the past boom years. Weakening fiat currencies will suppress demand in the west. Thus as we settle into a world of moderating consumption, higher saving, and greater government participation in the economy, the trajectory implied by this new equilibrium will probably constrain the enthusiasm of investors.

We could be wrong, of course, and find ourselves in January peering out over much more promising terrain. Nevertheless, we feel that for the moment, the story pushing equities higher in 2009 will not be the most relevant story in early 2010. Our view, then, is to enjoy the good times while they last and come January some hard thinking will be required, and new themes will become the order of the day.

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Investment conclusions

Global Equities/Bonds

Our investment views for the rest of the year and into the earliest part of the next reflect our belief that, cyclically, we are in a propitious moment. Equities and credit will likely continue to perform well, although for investors aiming to put new money to work it may be a bit late, as we suspect that early 2010 will present a more difficult environment. Rather, after strong runs in both major risky asset markets, we feel that there is some scope left for further gains, primarily driven by positive earnings developments and receding risk aversion, as well as a bit more room in valuations.

Regional Equity

Regionally, we maintain our preference for the US relative to most other developed markets, as we think it should receive the biggest kick from the earnings reports that will be released over the next few weeks. The Asia-Pacific region includes Australia, which is probably the most attractive market at the moment (due to its global gearing and relatively benign macro outlook), but developments across the region are positive as well. While we like the emerging market story, we are dissuaded from going outright "long" in this region, due to the powerful run it has already registered in 2009 and valuations which are not as cheap as they once were. Nevertheless, a neutral view still allows a well-diversified investor to reap decent rewards in the event of continued strong performance. Japan remains a laggard, despite cheap valuations.

Government Bonds

In the government bond markets, we note that while yields are generally low at the long end of the curve, the even lower level of short rates makes the curve quite steep, which is generally a positive factor for Government bonds. We take a neutral view on duration. While there is little value in the long end, there is also no reason to think that yields will rise significantly as long as most global central banks are committed to keep easing policies in place well into 2010. Issuance in many markets (the US, UK) will be a headwind for long bonds, but lack of inflation and a muted recovery into 2010 will support them; the two factors roughly offset one another. The weak macro situation in the UK and the Bank of England's commitment to Quantitative Easing should make it an attractive market, while the relative strength of the US recovery and the end of QE there should make this market less attractive.

Credit

Credit markets have come a long way since the near Armageddon of a year ago. So much so that valuations are no longer so enticing. Nevertheless, there still is some positive carry in all three main sectors (Investment Grade, High Yield, and Emerging Markets), and the continued improvement in the investor risk climate will be supportive for a while longer, as will the cyclical strength of the corporate profits picture.

Market ratings summary

GLOBAL ASSET ALLOCATION ¹ <small>(¹ indicates a change in recommendation from previous quarter)</small>		
Stocks versus Bonds	<ul style="list-style-type: none"> After last quarter's neutral rating between the two broad asset classes, we shift back into a positive rating for the time being. A combination of earnings announcements, receding risk aversion and acceptable valuations will conspire to bring equities higher through the end of the year. In early 2010, strategists will have to carefully consider their views, and weigh cyclical forces against emerging structural themes. 	Positive* (Neutral)
EQUITY ²		
US	<ul style="list-style-type: none"> We maintain our positive stance on US equities relative to the rest of the world. The Q3 earnings season should benefit the US market. 	Positive (Positive)
UK	<ul style="list-style-type: none"> Our negative view on the UK does not reflect the poor macro conditions in the region, but rather results from a preference for the US among the developed western markets. 	Negative (Negative)
Europe (Ex-UK)	<ul style="list-style-type: none"> As with the UK, our view here should not be interpreted as bearish, but rather a reflection of our preference for the US. 	Negative (Negative)
Japan	<ul style="list-style-type: none"> Our negative view on Japan, again chalked up to very weak macro data and the fact that valuations have not gotten materially better, leads us to keep our negative bet on Japan in place. 	Negative (Negative)
APAC (Ex Japan)	<ul style="list-style-type: none"> Best gearing to global growth and renewed demand in commodities for materials-hungry China and India should benefit this region. 	Positive (Positive)
Emerging Markets	<ul style="list-style-type: none"> GEM's continue to outpace the rest of the world, but we refrain from an outright positive stance due to the riskiness of the asset class and the evaporation of the valuation discount. We still think investors should have at least a global market cap weight in this asset class, hence they will benefit from its continued strength. 	Neutral (Neutral)
BONDS ^{3,6}		
Cash	<ul style="list-style-type: none"> The tug-of-war between the positives for bonds (steep curves, low short-term inflation risk) and the negatives (massive supply, longer-term inflation concerns) has not been won by either side. For now, we stay Neutral. 	Neutral (Neutral)
US	<ul style="list-style-type: none"> The Treasury market confounded our negative expectations since the last Market Outlook by outperforming global government bonds. Despite very steep curves, we retain our Negative bias due to high deficits and quantitative easing. 	Negative (Negative)
UK	<ul style="list-style-type: none"> The Bank of England nearly funded all of this year's issuance with its gilt purchase programme. Our relative bullishness on UK Government bonds thus proved correct in the period under review. Although the longer-term debt outlook is frightening, the relative out-performance could run a little longer. 	Positive (Positive)
Euro	<ul style="list-style-type: none"> To the surprise of many observers, the Eurozone economy appears to be pulling out of recession at the same time as the US. That should be a negative for government bonds, but the stronger inflation-fighting focus of the ECB is a counterweight, adding up to our continued Neutral stance. 	Neutral (Neutral)
Japan	<ul style="list-style-type: none"> Japanese government bonds performed least well since the last Market Outlook, consistent with the Negative call we made. With a flatter curve than its counterparts, the Japanese market has lost the advantage it had last year. We stay Negative. 	Negative (Negative)
CREDIT ⁴		
Inv Grade Corporate	<ul style="list-style-type: none"> Valuations as measured by spread-implied default rates are not as favourable as they have been, but cyclical positioning and positive earnings results should conspire with an improving risk climate to support the asset class a bit longer. 	Positive (Positive)
High Yield	<ul style="list-style-type: none"> Our Positive view on HY continues to pay off despite value being squeezed. We remain positive here for the same reason we like Investment Grade credit. 	Positive (Positive)
Emerging Market Debt	<ul style="list-style-type: none"> EMD has been unexpectedly robust. Valuation is not cheap but, as with HY, cyclical factors and expansionary policy are tailwinds. 	Positive (Positive)
CURRENCIES ⁵		
EUR	<ul style="list-style-type: none"> The euro will probably remain the main beneficiary of the weakening USD and GBP, despite the pain that it imparts locally. The ECB will probably be the first bank to pull the rate tightening trigger, although is this still a concern for sometime in 2010. 	No View
GBP	<ul style="list-style-type: none"> The UK macro situation and the Bank of England's QE policies will continue to hurt the pound. 	No View
JPY	<ul style="list-style-type: none"> The yen is benefiting the least from the global recovery trade over the last quarter. However, it remains near decade highs against the dollar. 	No View

Ratings sheet explanations

EXPLANATIONS

Russell EMEA's Market Attractiveness Ratings are indicative of each asset class's relative attractiveness (and hence recommended weight in a representative portfolio) over a twelve-month investment horizon.

Market Attractiveness Ratings are decided upon by the Russell EMEA Market Outlook Committee, which is comprised of senior Russell investment professionals in the EMEA region and globally. Inputs used by the Market Outlook Committee consist of a combination of quantitative and qualitative inputs provided by Russell's Global Investment team.

For more information on methodology, definitions and investment implications, please contact your relationship manager.

Notes

General: The Market Attractiveness Ratings on the previous page do not refer to a pre-specified model portfolio or specific investor portfolio, risk budget or investment guidelines.

(1) Global Asset Allocation refers to the recommended relative attractiveness of global equities and bonds.

(2) Equity relative ratings reflect relative attractiveness of each region's equity market within a global equity benchmark. All regional equity weightings are in local currency (i.e. USA in USD, Europe ex-UK in EUR, UK in GBP, Japan in JPY, APAC ex Japan in USD and Emerging Markets in USD) relative to a hedged global equity index.

(3) Bond relative ratings refer to relative regional duration weighting in a global bond portfolio.

(4) Market Attractiveness ratings for Investment Grade, High Yield, and Emerging Market Debt are relative to developed market long duration treasuries.

(5) At present Russell has no official currency views, although we do maintain and monitor a range of models and indicators. Contact your client services representative to discuss currency hedging policies.

(6) Cash is considered a portion of a global fixed income benchmark, and its Market Attractiveness Rating reflects the Market Outlook Committee's overall duration view. For example, a positive (negative) Rating for cash implies an overall short (long) duration preference within fixed income, independent of currency considerations.

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