

Enhanced Asset Allocation

Investable Market Insights

Market review and outlook // July 2010
Picking up where we left off...

Table of contents

Executive summary	1
Market review and outlook	2
Continental drift	5
U.K.—The Blue-Yellow Coalition shows true colours	7

Executive summary

Last quarter was a tough one for equity investors; the market was first rocked by a trio of concerns relating to Chinese policy tightening, Eurozone sovereign debt worries and banking reform discussions. More recently, increasing fears of a double-dip recession in developed economies has weighed on investors' minds. We view the policy-related worries as mostly accounted for by investors at this point, and we think that fears of a double dip, while probably lingering for a few more months, will eventually prove to be unfounded. So after careful review and consideration, we maintain our positive view on equities versus bonds, yet we acknowledge that the road ahead will be rocky.

The Eurozone debt crisis looks to be fading from the minds of investors at present, the rescue package approved in early May having solved short-term liquidity pressures for the time

being. The next short-term hurdle will be the publication of the results of ninety-one banks' stress tests on the continent. Should no negative surprises surface, we expect the Eurozone to rally and this source of risk to be removed from the global market backdrop. The longer run view, however, suggests that the next few years will require lots of hard work on behalf of European Union officials, national governments and citizens. Institutional design flaws in the euro must be addressed, governments must press ahead with their fiscal reform measures, and the whole Eurozone economy must rebalance itself.

Globally, we prefer equities to bonds and think that credit has been oversold. Within equities, we still favour the Eurozone at the expense of developed Asia.

Market review and outlook

- › We have gone back to the drawing board, and questioned our assumptions...and have concluded that we should stay the course, even as we acknowledge that the course will probably be rocky and uneven.
- › We would be naive to be entirely optimistic about the second half of 2010; many of the same risks that rocked us over the last few months are still evident and we reiterate that we maintain hold of our positive outlook with more than a few white knuckles.

No doubt, as investors look back at the past quarter, they will wonder if the great bull-run in markets since March of 2009 has finally expired. Since it reached its high on the 15th of April this year, the Russell Global Index of stocks fell 17 percent through 5th July (Price Index, USD). The phrase “double dip,” referring to the possibility that some (or even many) large economies could endure an additional round of weakness, has been mentioned with increasing frequency. In addition, the adversarial tango between investors and European governments intensified during second quarter, with the background music provided by a combo composed of the ratings agencies, Brussels-based politicians and protesting mobs on the streets of national capitals. Efforts of authorities in Beijing to reign in growth in China also grabbed investor attention. The net effect of these concerns has driven substantial volatility in markets and seen a reprise of the “flight to quality” trade. Almost every asset class that smacked of riskiness was penalised as investor confidence was tested.

We look back at the past three months and lick our wounds. Our positive view on global equities relative to bonds, moderate and cautious as it was, did not pay off last time. The Russell Global Index of stocks fell approximately 11 percent in the three months, beginning the 12th April, leading up to 12th July (Price Index, USD). As we write this Insight, one might ask if we are ready to throw in the towel and succumb

to fears of double-dips, policy shocks and the rediscovery of risk aversion? Rest assured that these are questions which have preoccupied us over the last few weeks as we watched the volatility in the market. We have gone back to the drawing board, looked over our quantitative models, done our scenario analysis, and questioned our assumptions. At the end of this exercise we have concluded that we should stay the course, even as we acknowledge that the course will probably be rocky and uneven. We retain a positive view on equities going into the second half of 2010, but—as we have all year—we temper our enthusiasm. The rest of 2010 will be hard work indeed.

A bit of review is in order. Entering 2010, we were never as bullish on the markets as we were at the beginning of 2009; we expected this year to test the patience and resolve of investors and predicted that 2010 would see equity values marginally higher at the end of the year than at the beginning. It would be an “okay” year, but not a great one, and it would be heavy lifting all the way. We reaffirm this view in the current Insight.

In our “Ten for 2010” we laid out the issues we thought would occupy the markets this year. Halfway on, many of the blows that have been absorbed by the markets were foreshadowed in that document. It would be useful to identify two types of shocks, the policy-based, and the growth-related. On the former score,

EXHIBIT A: Global Macroeconomic Surprise Index



NOTE: The Citigroup Economic Surprise index measures whether economic data are better or worse than expectations.

SOURCE: Bloomberg, July 2010

The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news, covering all G10 economies. They are defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beating consensus, according to Bloomberg.

Market review and outlook

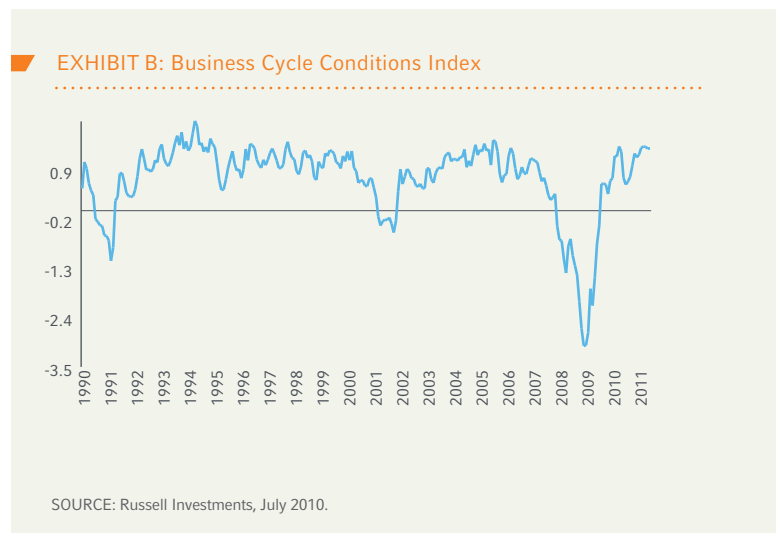
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policy tightening in China and other emerging markets, fiscal (and the related institutional and political) trauma in Europe and the drawn-out global discussions on financial sector reform have all contributed to the volatile environment. On the latter score, fears of a double-dip recession in the United States and elsewhere have—particularly recently—overshadowed the good news on the corporate earnings front as well as the modestly positive macroeconomic backdrop. (To be sure, we would caution readers against trying to disentangle policy-based and growth-based factors too cleanly; certainly the shocks emanating from national capitals will have influenced views on the course of the broader economy.)

As the policy-based factors begin to be fully digested by investors and attention has more recently turned to the growth outlook, our square-root recovery scenario, first broached

in late 2009, seems to be playing out. Although our latest Business Cycle Conditions Index¹ for the U.S. economy shows that we are currently in the throes of a weak patch. Based on current data, our models do not predict that this slowdown will take us into outright negative territory, but the summer will be clearly lacklustre. Nevertheless, going into the autumn, our best estimate is that this will be seen merely as a stumble along the way to continued modest growth. The slow recovery in labour markets and ongoing household deleveraging will still conspire to keep this recovery less ebullient than previous ones, but this will have the salubrious consequence of keeping interest rates low as we head into 2011.

The risk-averse investor behaviour of the last few months has seen spreads for credit and some of the more vulnerable sovereign bonds widen. Correlations across markets have,



¹ The Business Cycle Index (BCI) forecasts the strength of economic expansion or recession in the coming months, along with forecasts for other prominent economic measures. Inputs to the model include non-farm payroll, core inflation (without food and energy), the slope of the yield curve, and the yield spreads between Aaa and Baa corporate bonds and between commercial paper and U.S. Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts. 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.

Market review and outlook

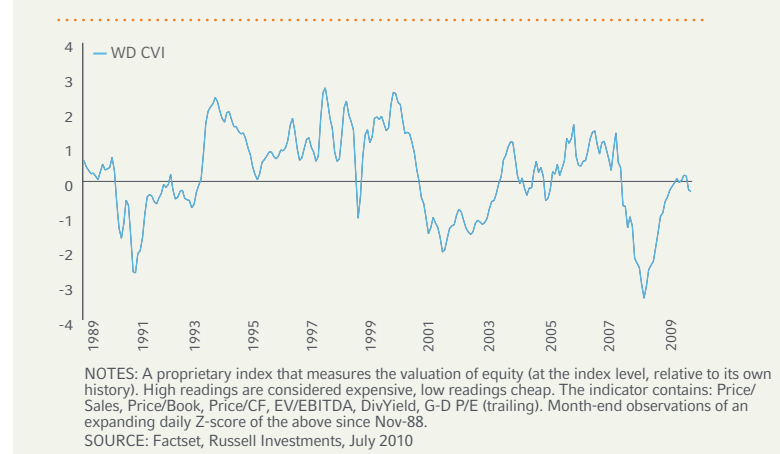
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therefore, not unexpectedly risen and investors' holdings of cash balances have increased. We feel that these market movements have actually created some valuable opportunities in asset classes and that stock markets, having fallen, will soon resume their climb, albeit up the time-hewn "wall of worry." Corporate earnings growth was very strong last quarter, as expected, and should be equally impressive in the upcoming season. Investment grade credit, an asset class on which we had been neutral last quarter, is also attractive now; having suffered the jitters of the last quarter, spreads now offer some value.

We would be naive to be entirely optimistic about the second half of 2010. Many of the same risks that rocked us over the last few months are still evident, and we reiterate that

we maintain hold of our positive outlook with more than a few white knuckles. We fully expect a few setbacks along the way and we concede that the rest of the year will be one tough slog. If we were forced to spit out a number, we would assign a probability of about 30 percent that fears of a double-dip will linger for a few more months and weigh on investors' minds but we would add that these would be just that: fears. As we have been saying all along, the recovery will press on but likely at moderate speed. If pressed further, we would concede that those double-dip fears could actually be realised with a probability akin to 10 percent or 15 percent. Not enough to make us dial down our exposure to risky assets, but enough to keep us on the watch for any further unexpected deterioration in the underlying drivers.

EXHIBIT C: Russell composite valuation indicator, global equities



Continental drift

- › If the number and size of those banks which look under-capitalised is low and the amount of support needed is not excessive, then another crisis could be averted.
- › In the longer run, however, the two-to-three years of support gained by the Euro-TARP will take on major importance.

As the spreads on bonds issued by Southern European governments rocketed ever higher during this past spring, fears that the common currency and the Eurozone economy would be mortally wounded by a three-headed dragon of institutional/political collapse, banking sector turmoil and sovereign default forced authorities in Brussels and Frankfurt into action. In a few hours on 9th May, they managed to do what officials in Athens, Madrid and Lisbon weren't able to do. Literally at the eleventh hour, officials unveiled a massive and unprecedented rescue package aimed at stemming the rising tide of investor doubt. The "Euro-TARP", a combination of guarantees and assistance from the European Commission and national governments as well as the International Monetary Fund (IMF) amounts to an arsenal of nearly \$1 trillion. For perspective, we remind readers that the original Troubled Asset Relief Program (TARP) set up in 2008 in the United States to backstop the financial sector amounted to \$700 billion, of which about \$500 billion was actually tapped. The European package is therefore twice the size of the then-unprecedented U.S. package.

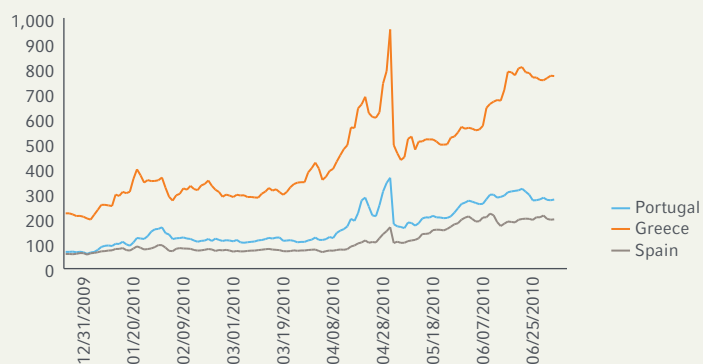
For a while the sheer enormity of the package and the show of resolve by national leaders in the Union managed to quell immediate fears. The near-crippling liquidity problems governments on the southern arc of the continent—particularly Spain, Greece and Portugal—had endured were resolved. For two or three years, if needed, they could

refinance their debts without depending on private investors' forbearance. In fact, in the few days after 9th May, spreads narrowed. Subsequently, some of these nations have actually managed to place a few bond offerings successfully in the public markets.

However, although liquidity concerns had receded, solvency concerns eventually re-emerged. It was one thing for these countries to gain a few years' worth of breathing room, but another for them to address significant structural flaws and display the political will and national cohesiveness required to set their fiscal paths straight for the longer term. Furthermore, new concerns about the solvency of the domestic banking sectors in some of the peripheral European countries—notably Spain—emerged and June once again became a difficult month in European markets.

By July, however, European Central Bank (ECB) officials faced the markets with a reassuring display of confidence. In addition, economic data are still holding strong in major countries such as Germany and some of the deficit reduction programs enacted in the UK, Spain, Greece and Portugal look significant and sincere. Perhaps these governments will be able to bite the bullet and endure the short-term pain required to put their accounts in order. Spreads have retreated once again, so much so that the ECB felt that the situation was well enough under control that it could end its extraordinary liquidity support measures on schedule.

EXHIBIT D: 10 year government bonds spreads over German Bunds



SOURCE: Factset, July 2010

Continental drift (continued)

The next big test in the short term will be the publication of the results of a series of “stress tests” on a number of European banks. These tests, undertaken by the ECB and national central banks, are risk management exercises similar to those performed over a year ago in the United States. Under varying sets of economic and financial assumptions, the stress tests will see if the banks have sufficient capital cushions to remain solvent. At the time of this writing, just prior to the publishing of the results, it was expected that some of the subjects will be named and shamed—identified as needing significant capital boosts, most likely from public coffers. However, if the number and size of those banks that look under-capitalised is low and the amount of support needed is not excessive, then another crisis could be averted. Indeed, the very act of publicly producing the results suggests that the authorities are sufficiently confident that enough of the banks will show acceptable balance-sheet strength. Whether or not the market renders a similar judgment and accepts that the tests were strenuous enough and honestly conducted remains to be seen. Negotiating this obstacle successfully will serve to further shore up confidence in the markets—not just in Europe, but globally. Fears that the Eurozone would engulf the rest of the world in yet another financial firestorm would be assuaged and the double-dip concerns could further recede.

In the longer run, however, the two-to-three years of support gained by the Euro-TARP will

take on major importance. Will the countries at risk take the opportunity to do the hard work required to get their fiscal arithmetic in order? The size of the fiscal consolidation required is enormous and the challenge is daunting. The downside risks to growth as a result of needed tax increases, spending cuts and structural reform are great. Some countries will be more successful at meeting these challenges than others and investors will be unsentimental when it comes to picking winners and losers.

At the European Union level, the fact that the single currency project was flawed from its outset will need to be acknowledged and dealt with. Formal institutional and legal mechanisms for some sort of central fiscal authority will have to be created as will contingencies for some countries to default, restructure their debt, and/or exit the zone if necessary. At the micro level, the imbalances that characterise the Eurozone will have to be addressed. Just as the global equilibrium in which China produces and saves and the United States consumes and borrows cannot endure indefinitely, a system in which Germany produces and saves and the periphery consumes and borrows and remains internationally uncompetitive cannot be maintained at the same time a single currency is in place.

The next few years in Europe will be as important to markets and the future of the European economy as the next few months will be.

U.K.— The Blue-Yellow Coalition shows true colours

Austerity versus growth: This is the prevalent debate in the U.K. at the moment. After the general election in May produced no clear majority, the nation was briefly gripped by the drama of power-sharing discussions. Now that the Conservatives and the Liberal Democrats have carved up the spoils the nation is gripped by far more serious issues. How much to cut from the deficit, when to do so and how fast? In the emergency budget presented a few weeks ago the initial answers to these questions came clear: a lot, now, and very. In one of the most aggressive fiscal consolidation measures proposed in recent history the new U.K. government has pledged to trim the budget deficit by over £30 billion this year with even more painful cuts ahead. The chattering and investing classes—not to mention the general citizenry—will be participating in a great experiment. With the recovery in the U.K. nascent and rather feeble, will such a massive fiscal shock actually plunge the U.K. back into the dark days of 2008 (or worse the 1970s)?

The intention of the government's program is to achieve a budget deficit of only 1.1 percent of GDP by 2015/2016, which would be down from 10.1 percent of GDP in 2010. Consistent with previous fiscal consolidations in, for example, Canada and Scandinavia, the majority of the deficit reduction is seen to be coming from spending cuts and only a little from new taxes. In addition to the loud and contentious debate over whether or not the economy is healthy enough to support such a draconian budget, it seems clear that the Tories (with the unenthusiastic acquiescence of their junior Lib-Dem partners) are using this moment to try to redress the social contract between the state and the private sector. To some degree, the rebalancing of the U.K. economy away

from its reliance on the financial services sector—primarily in the Southeast—and government job creation elsewhere would be a welcome development. However, whether or not the politics of this endeavour will permit the implication of such a radical plan is almost as fraught a question as whether or not the economy can shoulder the burden.

It is clear that both Labour and the Lib-Dems would have wanted to wait before undertaking such big fiscal measures, preferring to wait until signs of a deeper and more robust recovery was underway. However, it is not clear that the ratings agencies would have given them that luxury. Even for a neutral, there is a valid argument that suggests that since over two-thirds of the U.K. Gilt supply is held inside the U.K. by institutional investors and the average maturity of U.K. debt is much longer than that of the Southern European countries, the markets would have given the British government more time than they were willing to give to Greece. Nevertheless, this is a speculative discussion; what is clear is that the current government intends to press ahead.

Investors seemed to welcome the move, with Gilts rallying across the board, although it is not clear how much of this rally can be attributed to the general global flight to quality that also drove yields in Bunds and T-Bills lower. Most likely, and just as importantly, the Bank of England will probably like the move. This is key because having seen elected officials confront the budget deficit head-on, the bank might be more willing to keep rates lower for longer and be more inclined to extend quantitative easing should the economy weaken later in 2010 or 2011.

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