

# Enhanced Asset Allocation

## Investable Market Insights

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Market review and outlook // January 2010

Steady as she goes...

## Table of contents

Executive Summary	1
Market review and outlook	2
U.K. market review and outlook	5

## Executive summary

There is no doubt the global economy is improving. Both economic data and investor sentiment are improving across the board, even in heretofore beleaguered countries such as Great Britain and Japan. This positive development has been reflected across nearly all manner of risky assets and—recently—in rising bond yields. We are heartened that our bullish views on equity and credit, first put forth in the late autumn of 2008, have paid off, with global equity markets up 33% over 2009. Since the March 9th rally kicked off, markets have fared even better, up 77% through 31 December. In retrospect, it seems that in late 2008 ours was an easy call to make; valuations were at rock-bottom levels, and the amount of fiscal and economic stimulus that had been thrown at the global economy and financial markets was massive. Nevertheless, an investor would have required considerable nerve to plunge into asset markets during what appeared to be their darkest hour.<sup>1</sup>

Surveying the global economy and financial landscape in January 2010, the story looks much more complicated, even if the tone is

markedly less bleak. As set out in our annual outlook (“Ten for 2010”), this will be a year of transition, and the variety of themes we identified as key issues for the year reflect the substantial uncertainty and continued risk ahead. Thus today we find ourselves in the seemingly ironic position of standing on firmer economic and fundamental ground than a year ago, but with somewhat less clarity regarding investment decisions.

The general conclusion is “steady as she goes,” but beware of any buffeting forces that might arise in 2010. If last year was all about confirming and profiting from the belief that the end was not nigh, this year will be about finding our way through a new landscape that has emerged after a significant change in markets, economies and political and regulatory arrangements. Our advice is to continue to ride the present upswing in the cycle, albeit cautiously and with realistic expectations. Be prepared to spread your bets, build a few defensive positions just in case, and assume a stance of both patience and alacrity.

<sup>1</sup> Russell Global Developed Index, total return, in USD.

## Market review and outlook

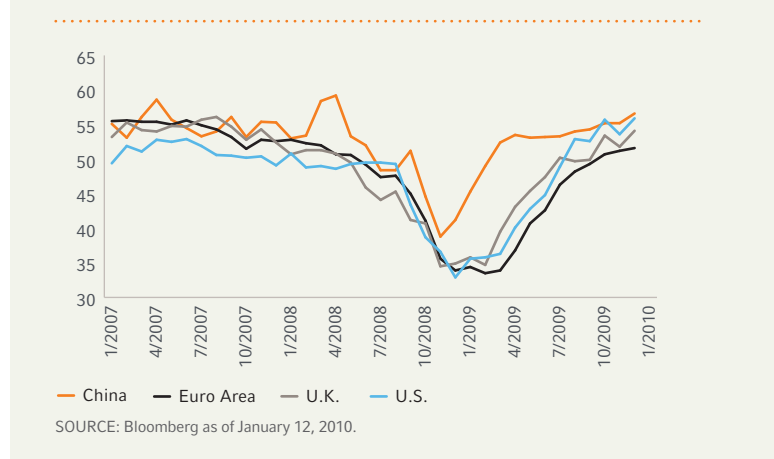
- › Investment outlook still broadly positive
- › Growth trajectory to be moderate
- › Inflation environment expected to remain benign
- › However, watch out for an “inflation scare”
- › Small risk of a “double-dip scare”

### Economic backdrop

The stronger economic backdrop against which market events play out today is indeed heartening, and the implication this has for the near-term market outlook is similarly positive. In many ways, our view on asset markets reflects the one we set forth in our October Market Outlook document, “Cycling Higher.” The cyclical case remains intact. We continue to maintain that improving earnings, receding investor risk aversion and improving macroeconomic momentum will

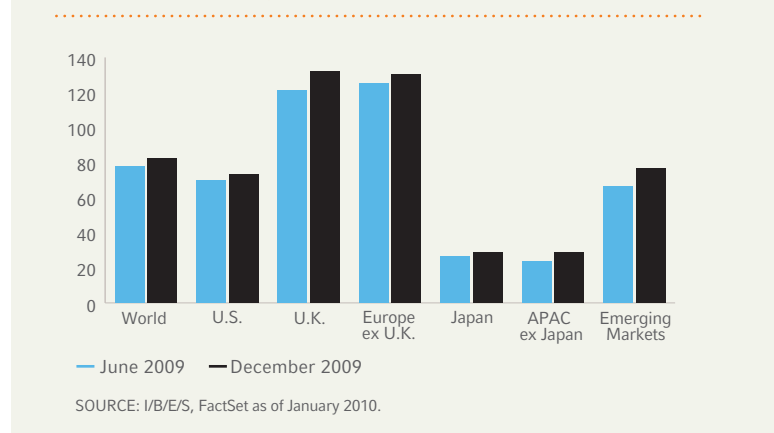
support the investment outlook. Nevertheless, given valuations and the likely trajectory of economic growth for the second half of 2010, we are of the view that positive returns will be muted in comparison to those realized in 2009. Last year we were recovering from a near-death illness, as it were—coming from the bottom of a nearly bombed-out economic and financial landscape. This year we will be entering a more mature part of the cycle, most of which has been already priced into markets, and the upside is more likely limited.

EXHIBIT A: Purchasing Manager Indexes (PMI), selected countries



NOTES: Manufacturing Purchasing Manager Survey (PMI).

EXHIBIT B: Forecast Earnings Per Share (EPS) levels Dec. 2010, selected countries



NOTES: Chart shows analysts' forward EPS level estimates as of June and December 2009 for the twelve months to December 2010.

# Market review and outlook

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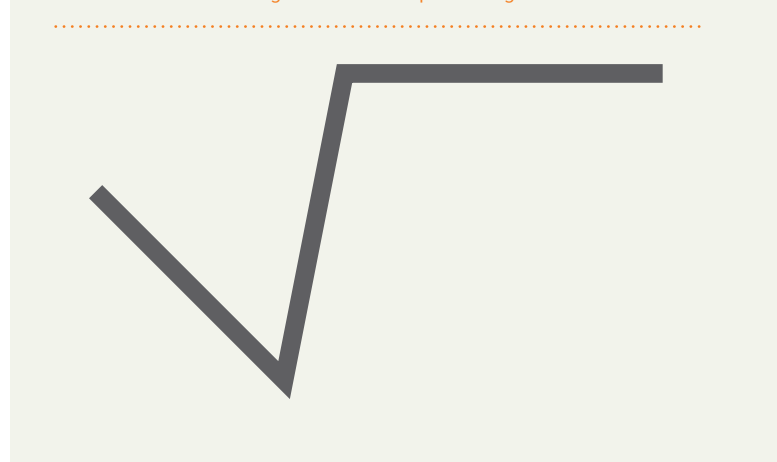
Our position in this economic cycle poses its own set of questions and risks. Take the current parlour game of assigning letters or shapes to the likely path of recovery: Will it follow a “U,” a “V,” a “W” or some other pattern? Perhaps letters which might not even exist in the Latin alphabet? Our best thinking at Russell, set out in our annual outlook, is that the global economy will trace something akin to a “square root” sign. That is to say, after the plummeting in early 2009, the subsequent reacceleration has been strong, tracing a steep upward-sloping line segment. But we expect growth to level off and trace a near-horizontal path, probably around second-half 2010. This is partially due to the eventual expiration (or

even withdrawal) of economic stimuli around the world. We also expect that the consumer segment, especially in the United States, will remain constrained in comparison to previous cycles, as the long period of deleveraging continues and the labour market takes time to recover.

Will markets be disappointed with this less than spectacular rate of economic growth? Have they priced in something more aggressive? At the moment, both equity and credit market valuations, as well as earnings assumptions, leave us confident that some upside remains in markets, even if most of the easy money has probably already been

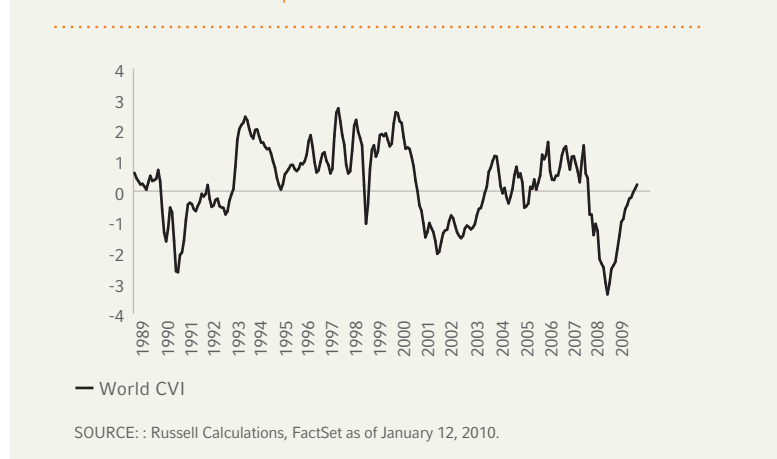
earned. That said, we wouldn't be surprised if this cyclical trajectory encounters a bump or two down the road. Market valuations, while not overstretched, are no longer at the unforgiving low levels of a year ago. Note that valuation multiples reflect, among other things, the price investors are willing to pay for assuming risk. Should 2010 present us with any unforeseen and unwelcome developments, there may very well not be much room for multiples to expand.

EXHIBIT C: Economic growth—the shape of things to come



NOTES: For illustration only.

EXHIBIT D: Global Composite Valuation Indicator



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. The indicator 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.

## Market review and outlook

(continued)

### Risk

Interestingly, one of the primary risks to our rather benign central economic and market scenario would result from the very same cyclical momentum story we just conveyed. We have been (and remain) of the view that central banks (the Fed and the Bank of England, in particular) will maintain a near-zero interest rate policy throughout 2010 (please see our annual outlook, “Ten for 2010”, for more detail). Yet we acknowledge that as the global economy continues to accelerate, investors might become “spooked” into worrying that growth is too fast. This could lead either to fears that central banks will fall “behind the curve”, resulting in rising inflation, or that they will be compelled to raise rates sooner (and possibly faster) than has been expected. Given such worries, and the probable rise in bond yields subsequently, this could take the wind out of the market’s sails. Here we stress that this so-called “inflation scare” scenario will indeed just be a scare; we do not see evidence of the underlying conditions that would likely lead to inflation taking off. Yet what markets fear and what actually lies beneath can be different things, and we acknowledge this risk.

Of course, for every yin there is a yang, and an equal and opposite risk exists: the infamous “double-dip.” Under this hypothesis, the current “snap back” in growth which we are enjoying would be transitory. First, the government stimulus programmes around the world will eventually end. This scenario is especially true in the U.S. and U.K., given their precarious and deteriorating fiscal positions, but also applies in some emerging markets. The Chinese government has

provided the largest stimulus packages (in terms of the size of its economy) and is already beginning to tighten policy. Secondly, there is some evidence that the snap back in corporate activity currently under way might be overdone. The thinking here is that as economic and financial conditions deteriorated in the autumn of 2008 and into 2009, firms cut back activities very quickly in response. Now that it is evident that global calamity has been avoided, they may be similarly over-reacting to catch up. There are signs that final demand in the West will remain lacklustre, and if this is so, the re-ramping up of activity may prove to be overdone. In this scenario, once this “sugar rush” has exhausted itself, the economy will still find its underlying pillars somewhat weaker than anticipated. We would be in a situation wherein credit is still constrained and consumers are still cautious; and economic stimulus from the top cannot persist forever. (Paradoxically, this second-round weakening could also come about or be exacerbated by the inflation scare; if central banks are cowed into unnecessarily raising rates, they could in fact potentially choke off a nascent recovery.)

At present, if we were forced to specify which risk we believed to be more likely—a fall in growth, or unanticipated inflation—it would be the (unfounded) inflation scare. The good news is that if this were to occur, we could eventually be staring at a buying opportunity in late 2010. The inflation risk, while more remote, is more worrying. But for now, let’s not concern ourselves too much with either scenario. Having identified those risks will enable to us to monitor events and adjust our thinking accordingly, if necessary.

## U.K. market review and outlook

As we enter 2010, the U.K. economy seems to be finally emerging from its nearly two years of discomfort. Certain indicators, such as business and consumer sentiment, as well as house prices, seem to be turning up, and most forecasts for GDP in 2010 are anticipating some growth. Nevertheless, we expect our “square root” shaped recovery scenario (see “economic outlook” section above) to be the order of the day in the U.K. It has probably been one of the hardest-hit economies in the globe at this point, and its path to full recovery has been one of the most difficult.

We know that consumption fell markedly over 2008 and 2009 as labour markets and house prices weakened, and the indebted U.K. consumer faced a difficult balance-sheet adjustment. However, the falloff in business activity—both manufacturing output and capital spending—has been even more pronounced. It is common knowledge that the banking system is in difficult shape after the credit crunch. It is bad enough that the economy depended so heavily on this sector in the past. Looking forward, the reliance cannot ease and the effects of a constrained lending channel will affect the business sector. Firms, especially small and medium-sized enterprises, cannot get access to financing in this economy, so their activities remained constrained.

Furthermore, and possibly more worrying for the U.K., is the domestic budget situation. The Chancellor’s pre-budgetary announcement grabbed headlines by imposing putative taxes on City of London bonuses, but a further examination reveals that, in aggregate, the Government’s plan will do little of the work needed to close a gaping hole in public finances. While we hesitate to speak to

political issues, it seems clear that the bond market, the ratings agencies and taxpayers will be looking to the upcoming election winner to present a credible fiscal consolidation plan—without tightening spending and/or raising taxes, which could spark a recession. Just when the U.K. economy is slowly recovering, a draconian fiscal policy might be seen as recessionary. We suspect the outcome of this drama will be vital to the medium-term view on the U.K. economy.

So, where does this leave investors? Again, we note that the U.K. shares market tends to be more globally than locally exposed, so domestic macro events should not play too heavily on the market. However, the shares market does also tend to be a “low-beta” play on global markets. In other words, it goes up (or down) less than the world market. Given this characteristic, we expect it to underperform the broader global equity market. In addition, its valuations are not terribly attractive. Finally, the negative macro situation elaborated above, while not determinative, will certainly not be supportive.

We get a lot of questions from investors regarding the U.K. bond market. Given the fiscal situation, the eventual ending of quantitative easing and positive economic growth, shouldn’t yields be rising? Our valuation work suggests some moderate upside to long yields, but not a lot. Appetite for gilts continues to be strong, and for bond yields the impact of quantitative easing probably hasn’t been as great as it has been for risky assets and the stability of the banking system. Our inflation outlook remains benign, so while we have a slightly negative view on long bonds, we don’t foresee calamity.

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