RUSSELL INVESTMENTS

The Great Re-moderation

Strategists' 2014 Global Outlook: Third quarter update

High equity market valuations tell us that the longer-term return outlook is subdued, but for now our value, cycle, sentiment process and models tell us to favor equities over fixed income and maintain some credit exposure.

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Mid-year 2014: Is a lack-of-fear index needed?

Volatility is at worryingly low levels, making us nervous about a pullback. Our process and models have a pro-equity bias, and we still think it is a buy-the-dips market.

EXECUTIVE SUMMARY

By **Andrew Pease**
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Franklin Roosevelt famously said "the only thing we have to fear is fear itself." Right now, the thing to fear is, actually, the lack of fear.

This idea stems from an objective reading of volatility measures, which are unsustainably low across asset classes. The most widely used volatility indicator, the VIX index[1] (often called the fear index), has fallen to near-record lows. These levels reflect the reality that many of the issues investors were anxious about have become less worrying: China's economy appears to be stabilizing; the U.S. Federal Reserve's tapering has not caused a financial collapse; Europe is on the mend; and the first quarter U.S. GDP contraction looks an aberration. The Ukraine-Russia conflict has gone up a notch with the downing of the Malaysian Airlines flight. But this is unlikely to result in a sustained lift in volatility unless harsh sanctions are imposed on Russia.

As we explain in "The great re-moderation"on the following page, volatility at current levels has historically been a pre-condition for higher volatility. So it's reasonable to expect volatility to increase at some stage. The challenge is to identify catalysts. Geopolitics is always a risk, but the signal we are on alert for is a hawkish shift in Fed language. This could happen if the rise in U.S. core inflation over the first half of the year continues. We're not forecasting this—our models predict core inflation will stay close to 2% through 2015—but an inflation surprise could shake markets out of their current complacency.

Our investment strategy views are largely unchanged. We have a modest preference for equities over fixed income, a liking for credit, and a bias against exposure to rising long-term interest rates. The U.S. business cycle index continues to forecast a moderate, low inflation expansion that will generate job gains of around 230,000 per month over the 12 months, allowing the Fed to delay any rise in interest rates until the middle of 2015.

Doug Gordon explains that in the U.S. looking forward rather than backward makes more sense. The Q1 GDP decline looks overstated and forward-looking indicators point to a stronger economy. The Fed is on track to start tightening by mid-2015, making him wary of interest rate exposure. But solid corporate profits growth means he still favors equities, even though valuations are increasingly stretched.

In Asia-Pacific, Graham Harman sees solid economic growth with undemanding equity valuations. The main causes for investor concern have not been realized: China's economy is stabilizing, Japan is recovering from the consumption tax hike, and Australia is proving resilient to the winding down of the commodities boom.

Europe is one region where we have upgraded our outlook. Wouter Sturkenboom likes the growth potential stemming from the European Central Bank's (ECB) latest salvo of accommodative moves which at the margin, should ease some credit constraints. The recovery is still fragile, but the ECB action puts Europe marginally ahead in our regional equity rankings.

The perverse logic of markets is that the time to take on risk is when everyone else is panicked, and the time to seek safety is when most investors think risks are low. Right now, the outlook feels a little too comfortable and markets a bit complacent. We're nowhere near the levels of euphoria that precede a major correction, but volatility can move in only one direction from here. Our models and process give us a pro-equity bias and we think any pull-back should be a buying opportunity. Watch out for events that can shake the current complacency. In particular, watch inflation.

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[1] Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options

Investment strategy outlook: The great re-moderation

Low volatility makes us wary of a correction, but we believe it is still a buy-the-dips market. We score the cycle as positive in most regions, giving us a modest pro-equity bias despite increasingly stretched valuations.

The 'great moderation' was a popular phrase before the 2008 financial crisis to describe the low volatility in markets and developed economies that went hand-in-hand with strong investment returns. We're calling current market conditions "the great re-moderation" because we are in another low volatility, good return period. We think recession risks are low, so a major market reversal seems unlikely. However, volatility could easily spike higher, creating a temporary shake-out. The numbers tell the story, so let's take a closer look.

Three things surprised over the first half of 2014: the -2.9% contraction in first quarter U.S. GDP, the large rise in U.S. core inflation, and the decline in volatility across all asset classes to levels that are unsustainable in the long run.

The first quarter GDP contraction seems more statistical noise than signal. The cold weather and inventory unwind meant the first quarter was always going to be weak. The size of the contraction, however, stands at odds with almost every other economic indicator. Manufacturing and consumer confidence surveys point to an economy growing at a reasonable pace. In particular, U.S. non-farm payrolls have grown at a 2% annualized pace over the first half of 2014—hardly the sign of a stalling economy.

More worrying are the low levels of volatility. The VIX index is close to all-time lows. The combination of complacency and stretched equity market valuations means that markets are especially vulnerable to shocks. Geopolitics is one obvious risk, with events escalating in Iraq and the ongoing China-Japan dispute rumbling in the East China Sea.

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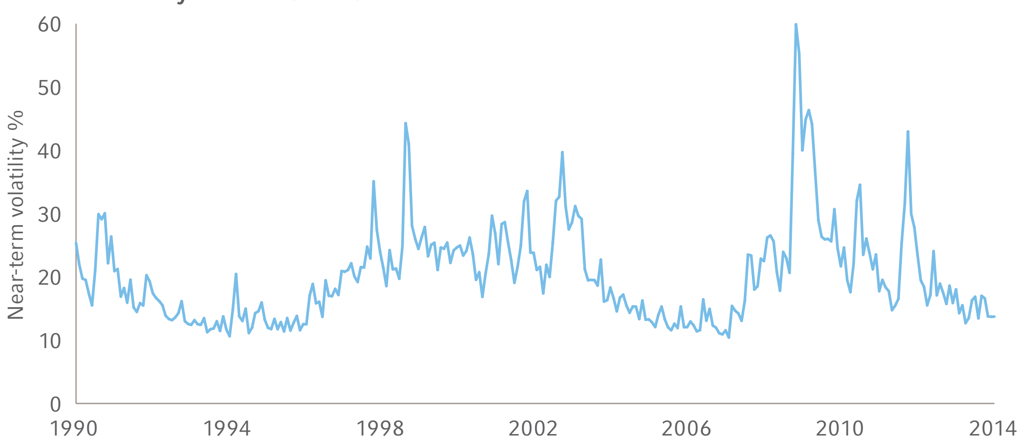
CBOE Volatility Index® (VIX®)



Source: Datastream

Data as of June 30, 2014.

Top of the list, however, is an inflation scare.

The core U.S. Consumer Price Index (CPI) increased from 1.6% in January, 2014, to 2.0% in May. Also, the U.S. Federal Reserve's (the Fed) preferred measure of inflation, the PCE deflator[2], rose from 1.1% to 1.5%. The CPI rise also looks more like noise than signal (and is at odds with the unexpectedly low first quarter 2014 GDP outcome). Our models suggest core inflation will stay close to 2% through 2015.

[2] The personal consumption expenditure (PCE) deflator is a measure of price changes of domestic personal goods and services across the U.S.

However, there is a risk that the core CPI could rise further in the near term. Shelter (which is primarily owners' equivalent rent) has a 42% weight in the core CPI and these costs increased by 2.6% over the 12 months to May 2014. Rising shelter costs could at least temporarily send the core CPI above 2%, triggering a shift to more hawkish rhetoric from the Fed—which could destabilize markets.

Unsustainably low volatility and high equity valuations make us wary of a pullback, but our overall views on the direction of markets are broadly unchanged. We still have a modest pro-equity bias and think that global growth and earnings are on track to validate last year's large gains in global developed equity markets.

In particular, our key U.S. forecasting models still see low recession risks, employment gains of around 230,000 per month over the next year, and a first Fed tightening in mid-2015. These data points support our outlook that U.S. 10-year Treasury yields are likely to rise, default rates will stay low and support credit spreads, and equities can continue to outperform fixed income.

Value, cycle, sentiment

Our investment strategy process combines qualitative views from our value, business cycle, and sentiment building blocks with quantitative inputs from our large range of forecasting models. Applying this process to global developed equities we get:

Value: Not much has changed on the value front in the last three quarters. The U.S. has become marginally more expensive as the market reaches record highs. Two key measures are at their highest levels since mid-2007: The cyclically adjusted price/earnings ratio for the U.S. large-cap Russell 1000® Index stands at more than 20 times, and the price to book value is around 2.8 times. European equities appear modestly expensive while Japan's valuation score is neutral.

Cycle: This is positive for the developed economies. Growth should strengthen across the United States and Europe over the remainder of the year. As discussed above, we're not placing too much weight on the first quarter 2014 GDP outcome for the U.S. We believe GDP growth should track between 2.5% to 3.0% for the next few quarters. Importantly, over the past couple of months, IBES (Institutional Broker Estimate Service) consensus earnings-per-share growth forecasts for the companies included in the Russell 1000 have stabilized near 8% as of July 3, 2014.

We've increased our confidence on the Europe growth outlook after the latest European Central Bank stimulus package. Credit constraints have been a brake on European economic activity since the 2008 financial crisis. Access to funds should start to improve now that banks have their balance sheets prepared for the asset quality review, and as the new €400 billion targeted long-term refinancing operation (LTRO) program gets underway.

Growth in Japan seems to be recovering from the April consumption tax rise, although it's still too early to make a firm conclusion.

Sentiment: This signal reflects price momentum and whether markets have moved into over-bought or over-sold territory and are in danger of reversing. We track a range of indicators on positioning, fund flows, investor confidence, risk appetite and technicals to judge market sentiment.

Momentum is still a strong positive driver, particularly in the U.S. and Europe. The low VIX is a signal that U.S. markets may be over-stretched, but most of the other indicators we track are not yet in the danger zone.

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Within an overall modest pro-equity bias, there's not a lot to choose between regions with the ECB stimulus package putting Europe just ahead of the other regions.

Neutral on emerging markets equities

Emerging markets (EM) equities performed pretty much in line with developed markets (DM) equities over the first half of 2014 after underperforming by 45 percentage points over the past three years through Dec. 31, 2013, as reflected by the Russell Emerging Markets Index and Russell Developed Index. We believe a fair bit of the performance in the first half of 2014 owed more to local factors than an overall EM trend. Elections played a big part, particularly with large market moves on the Narendra Modi victory as prime minister in India and hopes for positive change with elections in Brazil and Indonesia. Currency rebounds and rising energy prices also helped in markets like Brazil and Russia.

Value is strong, with EM equities 30% to 40% undervalued relative to DM equities across a variety of measures as of June 30, 2014. The cycle, however, is at best neutral.

China is starting to stabilize as a series of mini-stimulus measures take effect, but the extent of the housing downturn is the main uncertainty. In the rest of EM, there are still questions over whether or not the currency adjustments in current-account-deficit economies like Brazil have been large enough as the U.S. Fed gets closer to lifting interest rates.

Our models have become more positive on EM in recent months; we've now assigned a more neutral ranking based on the improvement in relative attractiveness from last quarter. This seems like a sensible position as the risks look evenly balanced. Good valuation means EM could rebound on confidence in the outlook for China and stronger global export demand as the developed economies pick-up. Equally, there may be another down-leg if China disappoints or concerns about Fed tightening cause another funding crisis for the current-account-deficit economies.

The equity market upswing is getting old compared to previous cycles, but shows no sign yet of ending.

Positive on credit exposure globally

The story for credit feels a lot like the one for equities. Credit is expensive, but the positive outlook for economic growth—and hence low default rates—keeps us positive on the asset class. One risk with credit exposure late in the cycle is that firms typically start levering up balance sheets through buybacks and merger and acquisition activity, thus favoring equity holders over bondholders. This process has started, but it doesn't yet look advanced enough to warrant tapering back on credit exposure in our view.

We have a slight preference for riskier high yield over investment grade bonds, mostly because of the lower interest rate (duration) risk in high yield exposure.

Complacency a risk, but the cycle still favors risk-on

The equity market upswing is getting old compared to previous cycles, but shows no sign yet of ending. Bull markets typically end for one of three reasons: restrictive Fed policy, extreme overvaluation, or excess leverage. We're a long way from tight Fed policy, valuation is stretched but not extreme, and although firms are levering up, overall leverage in the developed economies is still declining.

The risk of a market correction is rising with in our view an inflation scare or adverse geopolitical events the most likely culprits. That said, our sentiment indicators are not signaling an imminent risk of a pull-back.

High equity market valuations tell us that the longer term return outlook is subdued, but for now our value, cycle, sentiment process and models tell us to favor equities over fixed income and maintain some credit exposure. ■

United States: Looking past the rear-view mirror

U.S. GDP growth materially disappointed in the first quarter of 2014. Looking ahead, however, we remain optimistic that the recovery is on track. We expect financial markets to look past the rear-view mirror as well, grinding higher on robust earnings growth. For the Federal Open Market Committee (FOMC or Fed), there is still ample room to maintain its accommodative stance.

Validation from a lower starting point

Over the past few quarters we have characterized 2014 as the year of validation. This characterization captures what we believe to be crucial: For the second half of 2014, the U.S. economy must deliver a combination of GDP and earnings growth in order to validate the rally in risk assets. As such, the downward revision in the third release of Q1 GDP growth to -2.9% annualized was a negative surprise. It is not, however, a game changer. In fact, because of one-offs and countervailing positives we are largely looking past it—in effect looking for validation from a lower starting point.

The impact of one-offs in the Q1 GDP number is well known. A severe winter hampered economic activity, most notably in production and house building. As a result, we believe inventory destocking depressed investments and lower exports pushed the contribution of trade into negative territory. Neither provides investors with real insight into the underlying strength of the recovery. This conclusion is reinforced by the statistical noise emanating from the introduction of the Affordable Care Act (ACA). Initially, ACA pushed up personal consumption at launch early in the year only to be revised later into detracting from it. With the GDP data carrying little credibility, reliable indicators such as employment growth act as an anchor. In our opinion, continued robust employment growth is a better indicator of US economic strength than last quarter's GDP disappointment.

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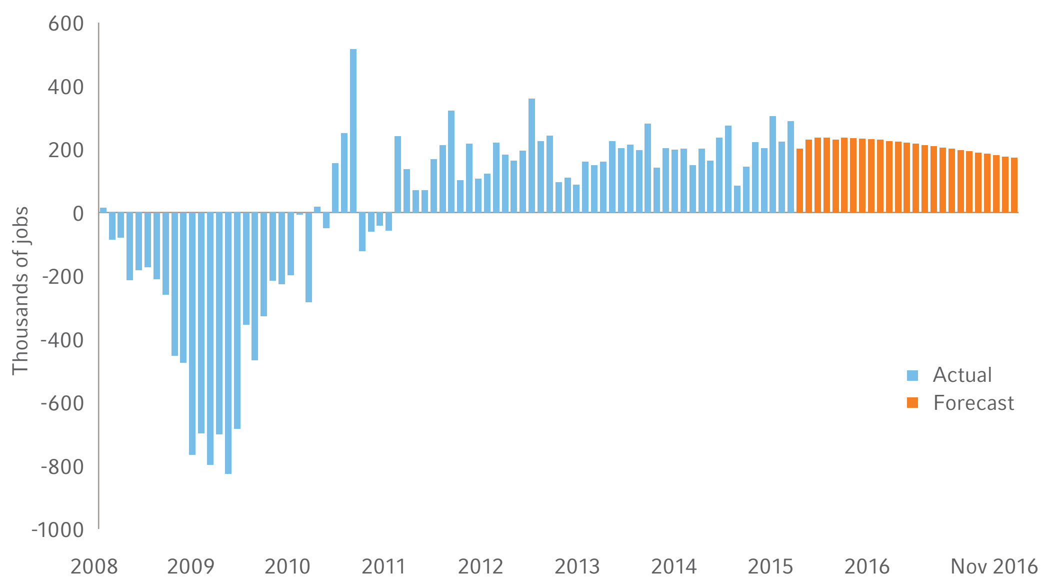
The economy's current strength notwithstanding, we still need to lower our expectations for real GDP growth in 2014. Given the weakness in Q1, our new forecast is for 1.6% growth,

Forecasts of nonfarm payroll employment changes as of June 2014



Source: Thomson Reuters Datastream

which is quite a bit lower than our previous forecast of 2.9%. That being said, our forecast for 2015 is a robust 3.1%. We expect financial markets to continue to look past the rear-view mirror of the extraordinarily weak Q1 and focus on growth going forward. The consensus forecast for earnings growth at an expected 8% for 2014 is helpful in this regard. As long as the recovery continues and earnings growth stays strong, validation should not be an issue.

FOMC action and timing

Based on our positive outlook for the business cycle and continued strong momentum, we maintain a small overweight to equity versus fixed income.

Another important entity that has chosen to look past the rearview mirror is the FOMC. Fed chair Janet Yellen has made it clear the surprising result in Q1 did not affect the Fed's policy stance. The Fed has continued to taper its quantitative easing (QE) program in $10 billion intervals, while stating that there will be a substantial time period between the end of QE in October of 2014 and the first rate hike. It is widely understood that six months is a good proxy for 'substantial time period,' meaning a first rate hike should be expected somewhere in the first half of 2015. Obviously, this is all contingent on economic developments, of which we want to highlight two.

1. **The improvement in U.S. labor markets**: With the unemployment rate at 6.1% and average monthly nonfarm payroll gains of 270,000 over the past three months, the question of how much slack is left arises. Yellen has pointed to the labor participation rate, which continues to stand at a low 62.8% and lackluster wage growth as indicators of continued slack. We agree. However, we also acknowledge the inflationary risk of letting the unemployment rate drift toward the natural rate of unemployment, especially because the labor participation rate might be depressed for secular as opposed to cyclical reasons.
2. **The increase in inflation over the past couple of months**: With the Fed's preferred Core Personal Consumption Expenditures (PCE) measure reaching 1.5% in May the question arises if this could push the Fed into hiking earlier than currently expected. We think this is unlikely. Not only has Yellen gone on record as saying that she could stomach inflation modestly above 2%, she is also focused on wage growth as a necessary condition for sustained inflation. Absent wage growth, the Fed is likely to continue to shrug off increases in inflation as being noise. As a result, we continue to expect the first rate hike to occur in Q2 2015.

Strategy outlook

- **Valuation**: The U.S. equity market is considered expensive given its low dividend yield, high price-earnings ratio, and high profit margins. That being said, earnings growth at 8% is still healthy and sustainable given the ongoing economic recovery. Nonetheless, our overall score for valuation is negative.
- **Business cycle**: We expect the recovery to continue, delivering close to 3% real GDP growth over the next four quarters. Average nonfarm payrolls for 2014 are expected to be 230,000 and Core Consumer Price Index (CPI) growth at 2.0%. Regarding monetary policy, we do not expect the FOMC to deviate much from its current trajectory, maintaining its accommodative stance. We score the business cycle as a positive.
- **Sentiment**: Positive momentum allows us to maintain a positive score for sentiment, even though we take note of some amber contrarian signals. Most notably, the low level of volatility, as measured in the VIX index, and high levels of investor sentiment are a worry. However, we believe they are not reason enough to lower our sentiment score—at present.
- **Conclusion**: Based on our positive outlook for the business cycle and continued strong momentum, we maintain a small overweight to equity versus fixed income. Within fixed income in the U.S., we still expect interest rates to rise toward 3.0% by the end of the year. ■

The eurozone: Draghi finally blinks

On June 5, European Central Bank (ECB) President Mario Draghi announced a monetary stimulus package that included interest rate cuts and €400 billion of cheap loans to banks. We had been waiting for the ECB to decisively implement a more accommodative policy. Now we finally have it. But will it be enough?

Reactive ECB fires a salvo

It took longer than we would have liked, but when the ECB finally took action in June of 2014, at least it did so decisively. Weak growth in France and Italy, combined with falling inflation and low levels of liquidity in the financial system, finally pushed the ECB into taking action. And because it had waited so long, what normally would have been a staggered policy response turned into a salvo. The mix of policy measures ranged from:

› A small interest rate cut, bringing the deposit rate to -0.1%. (Yes, that is a negative rate of return).

› An extension of the Fixed Rate Full Allotment (FRFA) period to 2016. (FRFA is a tool that ensures banks always have access to funding).

› A stop to sterilizing the Securities Market Program (SMP).

› The introduction of a new Target Long-term Refinancing Operation (TLTRO). (This is basically a Funding for Lending[3] program).

› Preparations for purchases of Asset Backed Securities (ABS). (The securities must be "simple and transparent" in order to qualify).

› The promise to implement QE if necessary. (QE refers to large-scale asset purchases, similar to the program the U.S. Federal Reserve is now winding down).

To be sure, even combined, the impact of these policy measures on the real economy is likely to be limited. At the margin they exert downward pressure on the euro, alleviate funding pressure for banks, boost credit growth, and improve the functioning of money markets by increasing liquidity in the financial system.

This is all helpful but we believe it is not enough to meaningfully change the eurozone's growth trajectory. The impact on eurozone risk assets, however, in our view is likely to be more positive. A renewed push to support previously waning reflationary forces is very supportive and exactly what we were looking for. It lowers the risk of deflation and shows the ECB is still accommodative.

It's nice to have the rate cut and the increase in excess cash in the banking system. The boost to credit growth through a new targeted LTRO program is a must have. Combined, this set of measures clears our 'decisiveness hurdle' and we once again advocate a small overweight to euro zone risk assets.

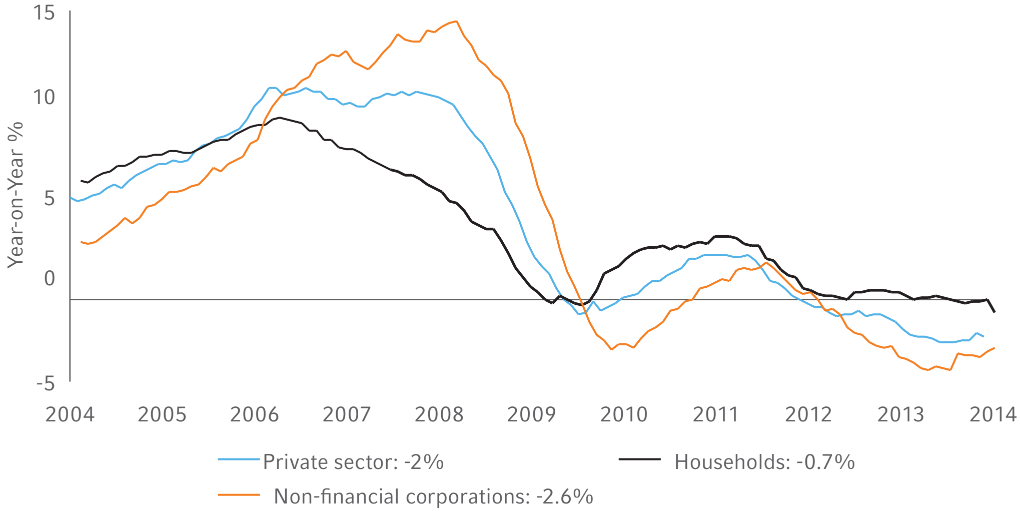
[3] Funding for lending is a Bank of England and UK Treasury program designed to incentivize banks and building societies to boost their lending to the UK real economy.

Credit growth is key

Looking forward, the success or failure of the ECB's policy actions hinges on credit growth. Lowering the interest rate, providing cheap funding, and boosting liquidity are all aimed at making credit cheaper and more readily available. On top of this, the TLTRO program tries to unclog the credit channel to households and small businesses, which we see as a crucial step in fixing the broken transmission mechanism of monetary policy to the real economy.

We are optimistic that, in the second half of 2014, credit growth at a minimum will exit negative territory; and we are hopeful it will move into moderately positive territory. The recent policy actions from the ECB are only one reason for this expected growth.

Eurozone Credit growth



Source: Thomson Reuters Datastream

Data as of May 30, 2014

We also note the improvements in the ECB's Senior Loan Officer Survey in both credit standards and loan demand. This indicates both a greater willingness to lend as well as borrow. Even more, the pressure from the Asset Quality Review on banks to clean up their balance sheets is gradually disappearing. We should also not forget that if credit merely stops shrinking, that in itself would constitute an incremental improvement for the eurozone.

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Strategy outlook at mid-year 2014

› **Valuation**: Euro-zone equities are still considered slightly expensive in an absolute sense after their 30% rally over the past 12 months through June 30, 2014, as measured by the Russell Eurozone Index. Consensus earnings expectations have declined from 14% at the start of the year to 7.5% at mid-year, exactly in the middle of our expected range of 5-10%. We think that is still a reasonable expectation given the return to GDP growth (see below) and the current level of relatively low profit margins for businesses.

› **Business cycle**: On the back of the ECB's policy action and its expected positive impact on credit growth, we have increased the business cycle score. That is not to say that we expect growth to come in above our expected range of 0.5% to 1.0%, but it does reflect a more constructive outlook for the euro-zone economy and financial markets.

› **Sentiment**: Price momentum is still leading to a positive score.

› **Conclusion**: Decisive policy action by the ECB was the key trigger mentioned earlier to buy back into euro-zone risk assets. We believe this hurdle was cleared in June and have subsequently moved back to a small overweight position. Going forward we will continue to monitor the recovery closely, paying particular attention to credit growth. This is still a fragile recovery after all. ■

Asia Pacific: Resilient growth chugs along

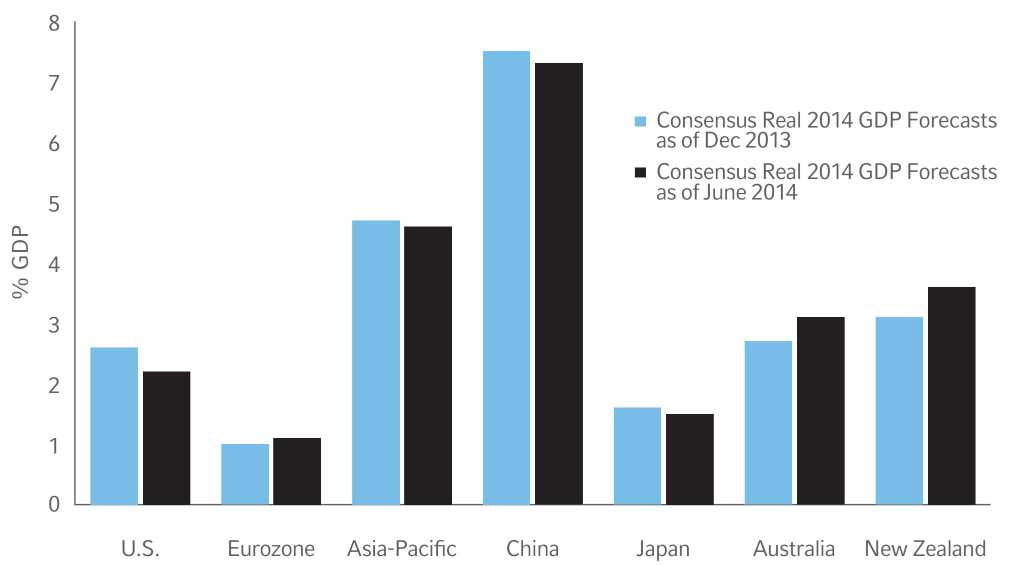
The Asia-Pacific region has delivered reasonable growth so far in 2014. Japan and Australia have delivered strong GDP numbers, but these may not be sustainable in the second half. Chinese data are firming after a sluggish start and are consistent with our "soft landing" thesis.

So far, so good

Entering the second half of 2014, the Asia-Pacific economies are travelling reasonably well. As you can see from the chart below, the region as a whole has failed to deliver convincing upgrades to full-year GDP growth estimates.

That's a little disappointing as we anticipated buoyant economic outcomes to "validate" the strong market returns of 2013 and propel the prices of risk assets meaningfully higher. But in contrast to other regions, growth in the Asia-Pacific region has been stellar.

We expect solid economic growth in the Asia-Pacific region during the second half of 2014. Equity markets are undemandingly priced, and we expect regional equities to perform in line with our modest preference for equities over bonds globally.



Source: Consensus Economics

Consensus estimates at mid-year for regional growth—at just over 4.5% real GDP for 2014—are twice that of the U.S. economy (2.2%), and four times that of the Eurozone (1.1%).

A second key point of difference with Western economies is the state of market expectations regarding the Asia-Pacific region. In the U.S. and Europe, the financial crisis is now five years in the past, and monetary policy has been running on a near-open throttle. The default expectation has been an acceleration of economic growth this year and next. Against such a backdrop, any faltering of the run-rate can readily become problematic for markets.

However, in the Asia-Pacific region expectations have been far more circumspect if not explicitly downbeat:

› In China, concerns have centered on the costs of the reform program, and the risks that stringent monetary settings pose to overstretched property and debt markets.

› In Japan, two decades of stagnation, together with daunting demographics, has fostered an entrenched skepticism about the pro-growth "Abe-nomics" program. Uncertainty surrounding the hike in the rate of the consumption tax, from 5% to 8%, has also kept expectations restrained.

› In Australia, the unraveling of the decade-long resources boom is causing uncertainty. Can Australia remain a tempting oasis of yield in a world of near-zero cash rates? And will downdrafts in capital spending and bulk commodity prices finally derail the 20-year record of unbroken growth?

In this context, the market's worst fears about risks to the region are very far from being realized.

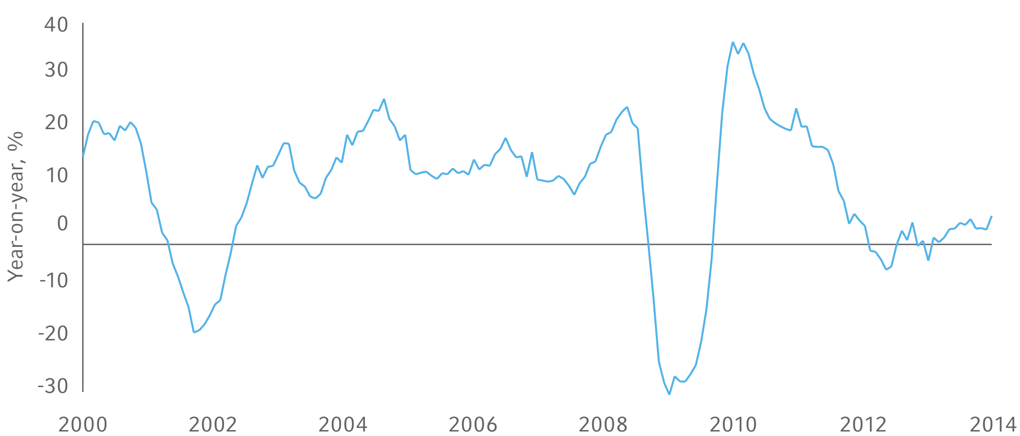
Also standing out, although for much more upbeat reasons, is small but pace-setting New Zealand. Buoyed by strong commodity prices and an economy firing on all cylinders, official cash rates have risen three times this year. We expect that the Reserve Bank of New Zealand will continue to write the playbook for monetary tightening over the coming months and into 2015.

Outlook benign

A key driver for the externally-oriented economies of the Asia-Pacific region will be the growth of world trade. The chart below shows that, following a slight setback in the early months of 2014, the typical export experience within the region is improving.

We expect Chinese growth to stabilize. After a slow start to the year, we're predicting Chinese GDP growth in the 7.0% to 7.5% range as we move toward 2015. We look for firming manufacturing in general, and exports in particular, to take up the slack from a weakening property sector. Japanese GDP growth started the 2014 year with a rush, at 6.7% annualized, and following a period of adjustment mid-year, we expect that recovery to persist, although at a steadier pace. Australia will slow from its current clip—just over 3.0%— but not dramatically.

Export Growth—Asia-Pacific



Source: Datastream

Data as of June 30, 2014.

Market prospects at mid-year 2014

Asia-Pacific markets are undemandingly priced, and we expect regional equities to perform in line with our global modest preference for equities over bonds. Chinese banks in particular are priced for a poor outcome in debt markets. Australia's bank-and-resources-skewed equity market remains a reasonable funding source for more attractive investments elsewhere. That said, Aussie equities have been a lackluster performer already and we are not strongly negative.

Bond markets across the world at are increasingly priced for complacency. In Australia, for example, the spread of 10-year Treasuries over the U.S. are trading at 7-year lows as of June 30, 2014. In other words, they're expensive in historical terms. As an investment, we would view both long bonds and credit as being vulnerable to any increase in market volatility or risk aversion, from whatever cause.

The long journey back to "normal"

For the U.S. 10-year Treasury note, getting back to the pre-crisis norms of yields around 4% could take a long time.

When secular meets cyclical

One unexpected feature of 2014 has been the decline in the U.S. 10-year bond yield. The yield on the benchmark Treasury security began the year at 3% and fell to nearly 2.4% in late May before rising back to 2.5% in mid July. We expect the yield to head towards 3.4% over the next 12 months, but as the first half of this year has shown, the outlook is far from clear-cut.

The consensus at the beginning of the year was that the yield was headed higher. In January, the Blue Chip[4] panel of forecasters predicted a 3.3% 10-year yield at the end of 2014, and our own forecast was 3.2%. The logic was that a steady improvement in the U.S. economy would see the U.S. Federal Open Market Committee (FOMC or the Fed) continue to taper its asset purchases—a process that began in December—in preparation for a mid-2015 first increase in the Fed funds rate.

Why did the yield decline instead? One interpretation is that the Treasury market experienced a classic "short-squeeze," where investors with short duration positions got caught when events escalated in Crimea and as U.S. economic data turned surprisingly weak, at least partly due to an extremely cold winter. As bond yields came under downward pressure, investors were forced to cover their loss-making short duration positions.

A gradually improving U.S. economy, non-farm payrolls gains of around 230,000 per month, and a first Fed tightening by mid-2015 should lift the 10-year note yield above 3%.

If the short-squeeze interpretation is correct, yields should soon move back towards 3%. Recent data points show that growth is recovering in the U.S., the situation in Ukraine is cooling, and the Fed is beginning to sound a bit more hawkish. Indeed, if that view is correct, then a 3% yield is simply a stop along the way toward a 10-year yield of at least 4%. That's because, over time, the long-term interest rate has historically tracked trends in nominal GDP growth. In other words, near-term cyclical trends typically eventually give way to the long-term secular trend. A reasonable assumption is that the U.S. economy can sustain annual real GDP growth of 2%. Add on the Fed's 2% unofficial inflation target and 4% looks like a reasonable long-term target for 10-year yields.

FOMC members see higher rates ahead

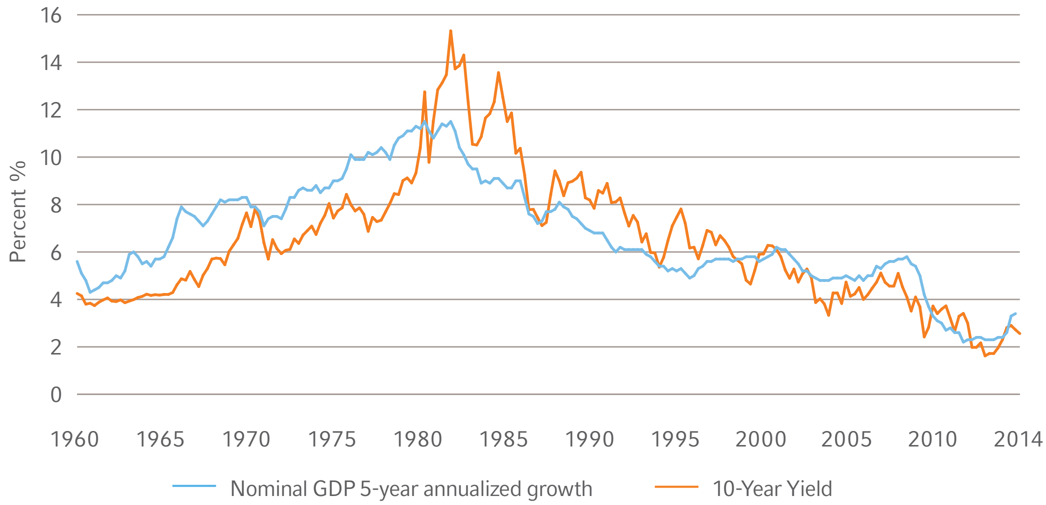
The 4% yield target aligns with the expectations of FOMC members about the long-run level of the Fed funds rate. At the June meeting, FOMC members nominated a range of 3.25% to 4.25% for the longer-run Fed funds rate, with most responses clustered around 3.75%. The 10-year yield is the average of future expected short-term rates plus a term premium, so Fed members are looking for interest rates to return to more normal levels.

Unsurprisingly, the outlook is not that straightforward. Many forecasters now argue that we are in a world of permanently lower interest rates. These prognostications often appear under the headings of "new normal" and "secular stagnation." The essential point is that the financial crisis and great recession resulted in a permanent demand shortfall that will prevent interest rates from returning to pre-crisis levels. This is due to a combination of de-leveraging and demographics; as unemployed baby boomers permanently leave the labor force.

The two charts on the following page tell that story. The first chart shows the strong positive correlation between GDP growth and 10-year Treasury yields.

[4] Blue Chip consensus forecasts as of June 30, 2014. Each month since 1976, Blue Chip Economic Indicators has polled 50 of America's top business economists, collecting their forecasts of U.S. economic growth, inflation, interest rates, and a host of other critical indicators of future business activity.

Nominal US GDP Growth & the 10-Year Yield



Source: Datastream, Russell calculations

Data as of June 30, 2014.

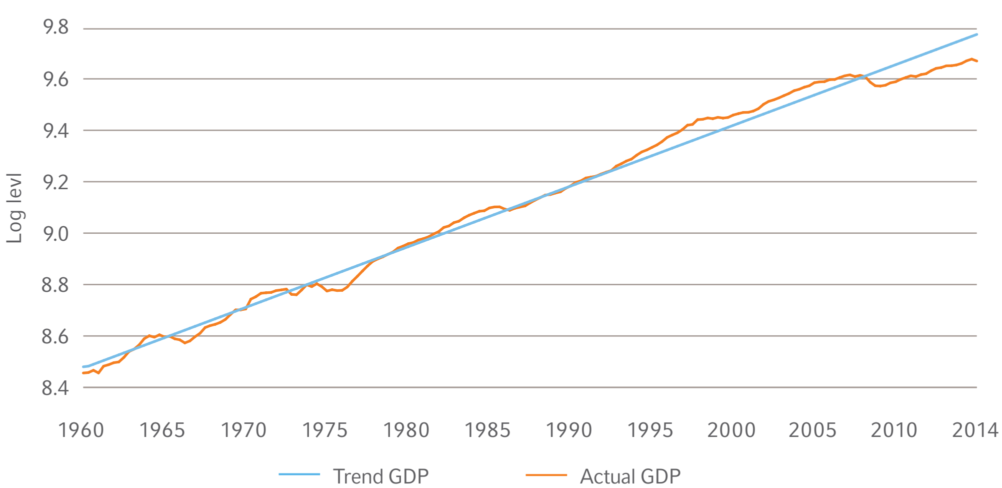
The chart below plots GDP growth versus its long-term trend. You can see that the aftermath of every recession (1973-4, 1980-2, 2008-9) including the severe recession in the early 1980s, has seen GDP return to, and exceed its previous trend. This time, something very different is happening; GDP is not returning to trend. This makes it hard to dismiss new-normal views.

We think it's really an argument about time horizon. Given enough time, growth and inflation should eventually be strong enough to see the Fed funds rate rise towards the longer-term expectation of FOMC members. But with the demand shortfall and moderate GDP growth trends, it may take a few years to get there.

Our models have the economy on a gradually improving path: We expect to see non-farm payrolls increasing by around 230,000 per month and the Fed lifting the Fed funds rate in mid-2015. That said, the models also suggest that inflation pressures are likely to remain muted, meaning the pace of Fed tightening will be gradual.

This outlook implies that the 10-year yield should rise above 3% over the next 12 months, but it could be a long time before the yield reaches 4%. The cycle will push yields higher, but like everything else in this post-crisis world, getting back to the old-normal benchmarks will be a slow journey.

United States Real GDP: actual versus trend



Trend is calculated using a log-linear time-trend from Q1 1970 to Q14 2013.

Source: Datastream, Russell calculations

Data as of June 30, 2014.

Three Key Asset-class Comparisons: U.S. Market

1. U.S. Equity vs. U.S. Fixed Income

We continue to hold a preference to equities relative to fixed income in the United States despite markets reaching all-time highs. The rally continues on the back of disparate data points; first quarter GDP at -2.9%, improving recent macroeconomic data headlined by a 6.1% unemployment rate and nonfarm payroll gains averaging 272,000 over the previous three months. Perhaps the short fixed income position is the more attractive portion of this pair comparison amid an anticipated rising rate environment. Key elements to our forecasts include:

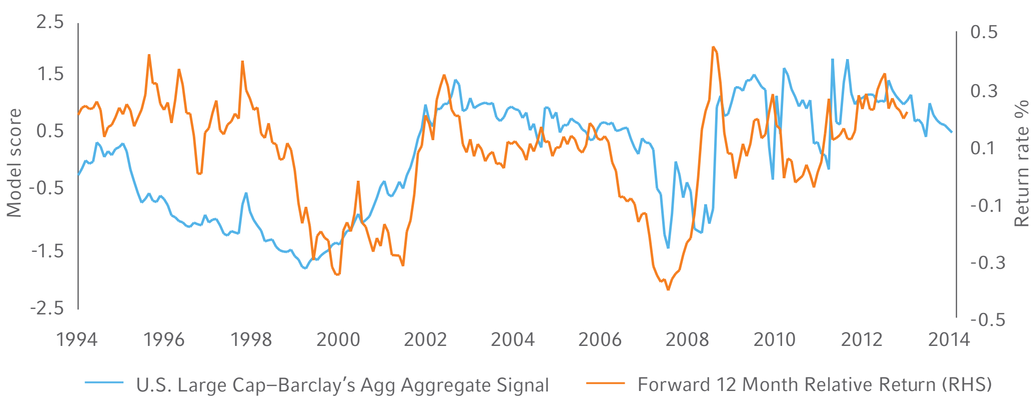
› Similar to the previous quarters, the most compelling signals are the forward earnings based model and momentum. We still see a rolling 12-month relative performance advantage of greater than 20% in favor of equities (as measured by the Russell 1000® Index and Barclay's U.S. Aggregate Bond Index through June 30, 2014), with over 2% coming from the rise in U.S. treasury yields during the month of June.

› There is a modestly contrarian signal from our long-term mean reversion model, while the signal in favor of equities from our trailing earnings based Fed model is weakening. To put context around these signals, they both fall well within our neutral tilt thresholds for each model.

› This pair at some level is a good case study around our modeling structure, which uses a diversified set of signals to arrive at a high-conviction position. Our models give some compelling signals and some neutral signals. This leaves us overall with a preference for U.S. equities relative to U.S. fixed income, but not an outsized one. U.S. equities are not cheap, but are preferred to fixed income at current yields.

Overall, we still choose U.S. equities over U.S. fixed income. However, our conviction has diminished somewhat.

U.S. Equity vs. U.S. Fixed Income



Indexes shown here and on subsequent pages 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.

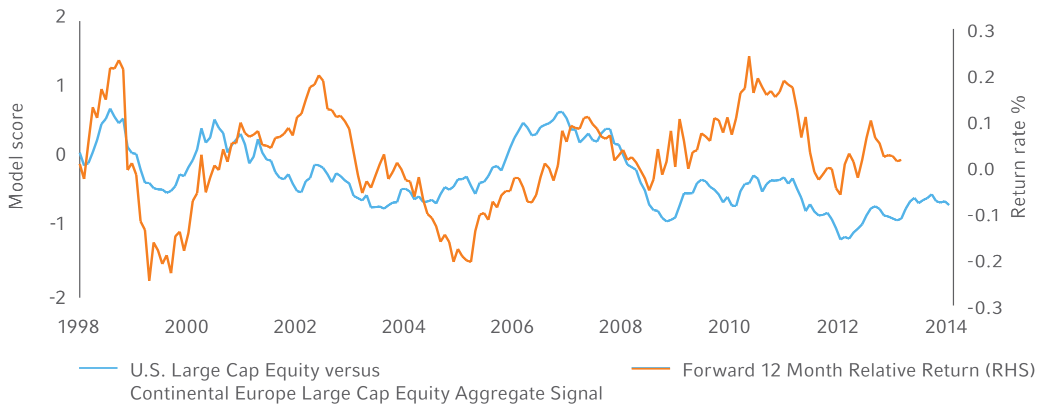
Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

2. U.S. Large Cap Equities vs. Continental Europe Equities

As outlined in the Europe Outlook section, the policy actions by the European Central Bank are supportive of European equities as an accommodative credit environment is being fostered but also evidence of growth concerns. Our modeling work leads us to a neutral position with respect to U.S. large cap equities and Continental European large cap equities from a fully hedged perspective. The modest preferences in favor of Europe across our quantitative modeling suite do not pass the threshold to generate an actionable signal.

› All of our valuation signals favor Continental Europe (although some only slightly). These slight signals fall inside a noise threshold, which means we get neutral preferences from a number of the models. The strongest valuation signals favoring Continental Europe are from a rolling window price-to-earnings comparison (60 month moving average), and price-to-book ratio comparison. ■

U.S. Large Cap Equities vs. Continental Europe Equities



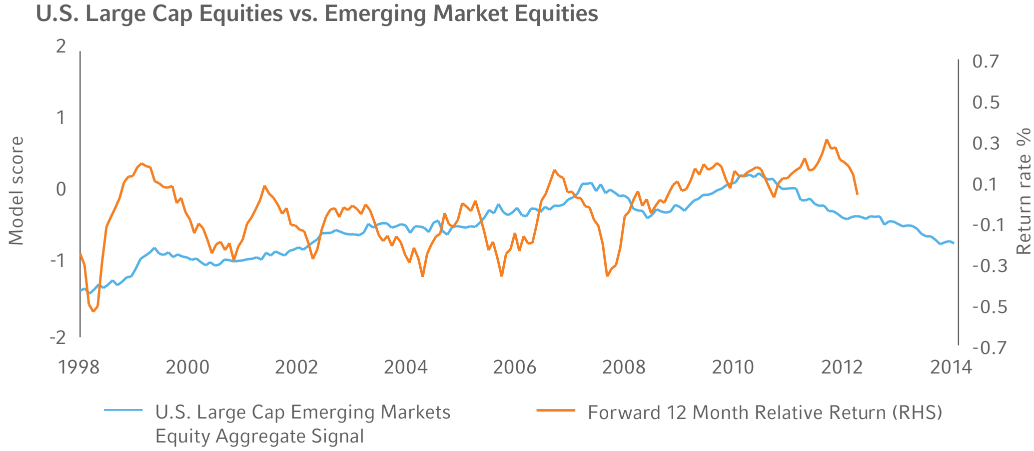
3. Caught our Eye: U.S. Large Cap Equity vs. Emerging Market Equities

Emerging markets (EM) equities have underperformed U.S. large cap equities by a wide margin despite a compelling valuation advantage. The slight tilt toward EM from our models has therefore caught our eye. Previously, there have been a number of "false dawns" with respect to an EM overweight. Thus, our conviction is only modest, but we are beginning to see potential for a more material tilt toward EM. Elements to this position include:

› Across our model suite we are either neutral or slightly in favor of merging Market Equity relative to U.S. Large Cap equities. The strongest signals come from a comparison of price-to-sales ratios and our 60 month moving average price-to-earnings comparison. Momentum is a slight contrarian signal but this is not surprising given U.S. Large Caps' near 11% relative performance advantage over the previous 12 months. based on the Russell 1000® Index versus the MSCI EM index through 6/30/14. This headwind, however, is abating.

› Some concerns include the scenario in which the U.S. dollar strengthens as monetary policy in the U.S. tightens. This could place pressure on EM economies via the impact on commodities price volatility and through funding concerns for EM countries with large current account deficits. ■

U.S. Large Cap Equities vs. Emerging Market Equities



In assessing the attractiveness of asset classes relative to one another, Russell's modeling capability uses a pair-wise construct with asset classes shared across multiple pairs, each with independent valuations. At present, the capability includes over 120 pairs leveraging signals from greater than 400 models. The signals used are based on proprietary models developed by Russell, and they generally fall into three categories:

Multi-variate, where the valuation signal is a function of various economic, characteristic and market variables.

Uni-variate, in which return differences between two asset classes are a function of a single characteristic or market variable.

Statistical, in which deviations from long-term trends in return patterns of two asset classes signal the direction and magnitude of expected returns.

All the models seek to identify factors to signal which of two asset classes in a pair has better return prospects, given historical patterns of subsequent relative returns. Married to each individual model is a model-specific tilt function to make best use of each unique signal. Having multiple models per pair provides diversification of signals to arrive at a weighted tilt.

This report is not intended to be used as the basis for a trading strategy or as an asset class trading tool.

The views in this Quarterly Outlook are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Keep in mind, like all investing that multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

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.

Investment in Global, International or Emerging markets may be significantly affected by political or economic conditions and regulatory requirements in a particular country. Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation. Such securities may be less liquid and more volatile. Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and political systems with less stability than in more developed countries.

Currency investing involves risks including fluctuations in currency values, whether the home currency or the foreign currency. They can either enhance or reduce the returns associated with foreign investments.

Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

Bond investors should carefully consider risks such as interest rate, credit, repurchase and reverse repurchase transaction risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage backed securities, especially mortgage backed securities with exposure to sub-prime mortgages.

Diversification: strategic asset allocation and multi-asset investing do not assure profit or protect against loss in declining markets.

The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The Russell Global Index measures the performance of the global equity market based on all investable equity securities. The index includes approximately 10,000 securities in 63 countries and covers 98% of the investable global market. All securities in the Russell Global Index are classified according to size, region, country, and sector, as a result the Index can be segmented into more than 300 distinct benchmarks.

The Russell Eurozone Index measures the performance of the equity markets across the Eurozone region represented in the Russell Global Index based on all investable equity securities.

The S&P 500, or the Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

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