

Global Markets Outlook

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9 for 2009



"The message to investors; there is risk ahead and opportunities present; make sure your portfolio is well diversified and consistent with your objectives. This should be a rewarding year."

Symon Parish

Chief Investment Officer
Australasia

Given the extraordinary economic and financial pain investors experienced in 2008, we sometimes forget the big event that didn't happen. Despite myriad dire predictions to the contrary, the sky did not fall, the world did not end and the Armageddon doomsday scenario did not occur.

Of course, much of the world is in recession and sentiment is deeply pessimistic. However, we are also witnessing a global policy response by central banks and governments of unprecedented size and speed. While Australia has been more resilient than other economies to date, we have also experienced our share of economic slowdown and financial loss.

Make no mistake about it, from many perspectives this has been the worst year most of us have ever witnessed. We hope never to have another like 2008. At Russell, we are extremely aware that our investors are frustrated and fearful, and we share your pain. But at the risk of seeming to minimise the experience of 2008, which is not the intent, it is important to put what is happening globally in perspective: the global meltdown is very bad, no doubt about it, but it has not been the end of the world. Every day that we move forward in the markets is one day closer to recovery.

Here are our nine key themes for 2009 from across the globe.

1. After the pain, there will be gain

Looking forward through 2009, we expect US economic recovery to take hold in the later part of the year, perhaps in late second or early third quarter, with other developed economies following somewhat later. Key features of this recovery will be a relatively benign inflation environment, modest increases in US Treasury yields, and higher levels of unemployment than we have grown accustomed to. Our anticipated scenario for the US is more of a jobless recovery than a full expansion, with economic growth returning to trend less quickly than in past recoveries. Across the globe, the impact of the fiscal stimulus proposals remain the wild card in determining the full recovery rate and the intermediate term cost of recovery.

The Australian economy is in a relatively better position on the economic front. If we do indeed enter recession, it will be far milder than other countries are experiencing.

2. Markets will lead recovery

Market recovery during past recessions often comes before economic recovery when the market environment is still filled with negative news and uncertainty. Data confirming the actual end of an economic downturn almost always comes many months after the recovery is well underway. Currently, Russell's models indicate that economic recovery in the US will take root in the later half of the year. We also believe that the market will begin to recover before the economy. In fact, we believe the market may be starting to price in some signs of economic recovery now, and this trend will likely accelerate through the year. Thus, it is important to be invested in the markets now, as investors sitting on the sidelines in 2009 may miss significant opportunities.

3. King cash dethroned

Markets can overreact in beating down the prices of equities and bonds, especially in the early phase of a recession. Last year, market participants fled any assets with the slightest bit of perceived risk, seeking the security of cash safe havens. In fact, government bonds were the strongest performing asset class in 2008!

However, with equity prices substantially depressed, but earnings estimates falling more slowly, equity valuations look attractive relative to the significantly lower returns from cash as a result of the series of recent interest rate cuts. Cash will no longer be king as risk aversion dissipates and investor confidence in equity markets picks up over 2009.

But where? We are optimistic about opportunities in Japan, with valuations at their lowest levels for several decades and Japanese banks seeming to have weathered the financial crisis better than their western counterparts.

We also believe that the US will lead other international markets in recovery as they have experienced the financial turmoil and slowdown in productivity earlier and deeper than other countries.

4. Prudent risk-taking will be rewarded.

In times of deep uncertainty, such as the second half of 2008, all sectors of financial markets can fall under the same clouds of doubt. As uncertainties start to lift, the market rewards shares and bonds of stronger companies, and this in turn rewards investors who take prudent risks.

The crucial message for investors is this: there is risk ahead and opportunities present; make sure your portfolio is well diversified and consistent with your objectives. This should be a rewarding year.

5. Dividends are an investor's best friend

Russell's model signals show a preference for equities over bonds. In particular, the earnings of many high-quality companies have not declined as much as their share prices, leading to historically high dividend yields relative to cash and bond yields.

The dividend yield on the Australian sharemarket stood at 6.5% in mid-January – the highest in over thirty years. The yield is even higher when franking credits are added. More significantly, the dividend yield is now above the long-term government bond yield for the first time since at least the late 1960s.

6. Fund managers to find their mojo

2008 was a very difficult period for managers across a number of asset classes, although it was one of the best years in some time for Australian shares managers. The indiscriminate selling of risky and illiquid assets through the year, underperformance of small caps and emerging markets and decimation of credit markets, made active funds management challenging. Russell believes 2009 will produce more favourable conditions for managers of both equity and debt funds, with plentiful opportunities for the most skillful active managers to add value versus market benchmarks. In 2008, the markets were driven by fear and sentiment: Russell believes that we will begin to see a shift back to a fundamentals driven market.

7. Getting credit where it's due

In 2009, we expect that credit instruments will finally benefit from government market intervention through commercial paper and other asset purchase programs. The global injection of liquidity appears to have stabilised financial markets and prevented the worst-case "doomsday" scenario. Looking forward, with 10-year Treasury rates in developed markets at or near historical lows, the balance of risks is to the upside for yields. An increase in the supply of government debt may start to put upward pressure on yields and aggressive easing around the world increases future inflation risks.

On the credit side, spreads are at their widest to Treasuries at any time in recorded history. The observation that all forms of credit have been painted with the same risk-averse brush leads to the conclusion that there are solid companies whose debt prices will benefit from a reversal in the level of risk aversion. We think that any unwinding of the extreme flight to safety into short Treasury bills will benefit credit-based securities, and we anticipate a tightening of spreads globally at some point in the coming year. Overall, the outlook is for the primary fixed income beneficiaries of a global economic recovery to be corporate credits.

8. Currency off the ledge, review your hedge

There was an argument for reduced hedging on overseas investments during mid-2008, with the A\$ pushing ever further into 'overvalued' territory as it approached parity against the US. As we enter 2009, the case for maintaining lower hedge ratios is no longer clear. The move to less than 70 cents has brought the currency back into value territory, and volatility has subsided. A rally in anticipation of recovery in the economy and commodity markets cannot be ruled out at some stage. Furthermore, Australian investors should bear in mind they 'get paid to hedge', in the sense that hedging locks in the interest rate differential versus offshore markets. Those fortunate enough to have stepped aside as the A\$ swan-dived should look to reinstate their normal levels of hedging.

9. Keep your head when all others are losing theirs...

...and as Kipling said "yours is the Earth and everything that's in it"

2008 was unprecedented, with a constant flow of negative headlines, record lows for tumbling financial markets and weak economic conditions.

Although the economy may continue to look bleak for some time after markets have turned, we think 2009 will be a year of transition to better times ahead. We believe the markets will anticipate a trajectory out of the current recession that will gain momentum in the second half of the year. The important thing is to remain well diversified and disciplined in the face of the inevitable bumpy ride that accompanies a return to economic expansion. Patience and the ability to maintain a long-term perspective are key. This has been always the best strategy and we're confident it will be this year as well.

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