

2011 Global Capital Markets Outlook

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Executive Summary

2011: a new year, but a continuation of the 2010 story

By Peter Gunning, Global Chief Investment Officer, Russell Investments

In June 2009, Russell proposed that in 2010 the global markets would likely avoid the *fat-tail* financial Armageddon scenario, but that investors should expect a global, structural shift in capital allocation, output, consumption and market returns. Throughout 2010, and as we move into 2011, the data we're seeing continues to reinforce this forecast.

The dominant characteristic of capital markets in 2010 was the tug-of-war between headline-grabbing risks and the less sensational—but far from trivial—global economic expansion and corporate earnings growth story. At Russell, we think it's reasonable to expect a similar pattern in 2011. Our forecasts continue to suggest a slow, grinding economic recovery that will be the backdrop for strength in global corporate profits and strong corporate balance sheets. But we also expect periodic headline risks to cause volatility spikes, and that these will likely punctuate capital market moves.

For 2011, we've identified a central (highest probability) scenario—the *square root sign-shaped recovery* will likely continue. We expect equity valuations to support some modest upside, with risky assets having a moderate year. We expect the risk of inflation in the United States to remain relatively benign, and that quantitative easing in late 2010 will succeed in avoiding deflation. And with deflation mostly off the table, we also expect that bond markets in the core will experience a mild sell-off.

There's little evidence in the last year to support a shift away from the forecasts we made in June 2009: the shape of the global economic recovery will be a square root sign, the risk of inflation would be low for the medium term, the Fed's exit strategy and sovereign risk would be key risk themes for 2010 and 2011, and investors should structure their portfolios around a lower-return environment. In fact, our expectation is that 2011 will be more of a continuation of the 2010 story than a departure from it. Please keep in mind that forecasting is a prediction of market prices using varying analytical data. It does not represent a projection of the stock market, or of any specific investment.

We've focused this outlook on **eight key issues and themes** we believe will have the greatest impact on markets and asset returns in 2011:

1. **The U.S. macroeconomic outlook: 3% in 2011?**
2. **Fixed income: a reflection of a mediocre economy**
3. **Global equity outlook: a bumpy but positive track**
4. **The Euro-mess: the only thing certain is uncertainty**
5. **Emerging markets: above-average expectations, with near-term risks**
6. **Currency: the good, the bad and the least ugly**
7. **Commodities: the old story of supply and demand**
8. **Real assets: credit-dependent diversification**

In the pages that follow, we'll provide our perspective on the full impact and investment implications of these themes. But as we enter into this lower-return and higher-volatility environment, we continue to believe that strategic discipline, asset allocation and active management will be primary contributors to long-term portfolio returns. 2010 was certainly a volatile environment; we expect further volatility in 2011, and investors should be prepared to maintain a long-term perspective while seeking out strategic opportunities to capitalize on shorter-term movements.

With opportunity comes a certain element of risk. We also caution investors that the marginal cost of mistakes going forward will be magnified by the difficulty in recovery, and that the relative value of discipline and smaller, incremental sources of alpha also increase. We believe seeking out diversification from a global and asset class perspective will be more important than ever.

2010 was dominated by the "risk on" and "risk off" trade. For 2011, it's risk on. Just be careful of what risk you assume.

The U.S. macroeconomic outlook: 3% in 2011?

We project U.S. real GDP will grow 3 percent on a year-on-year basis, despite little change in unemployment numbers.

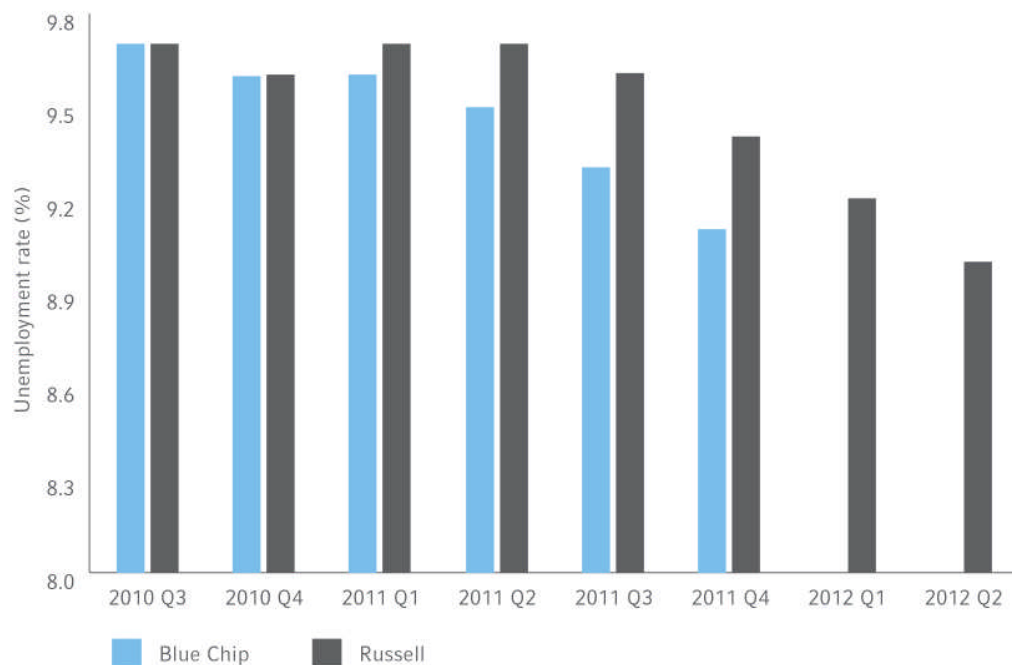
2011 is poised to be the second half of a long, flat spot in the U.S. unemployment rate. It will likely take the economy two years—January 2010 to January 2012—to reduce the unemployment rate a little more than half a percentage point.

In January 2010, the unemployment rate stood at 9.7 percent. According to November 2010 data, no progress has taken place on the jobs front in 2010. By the end of 2011, the unemployment rate is projected to still be at or above 9 percent.

A previous long, flat spot in the unemployment rate took place between May 1984 and November 1986, when it took 2 ½ years for the unemployment rate to decline from about 7.5 percent to about 7 percent. So the reduction period was similar, but the current situation is more painful because the unemployment rate hovers near double digits.

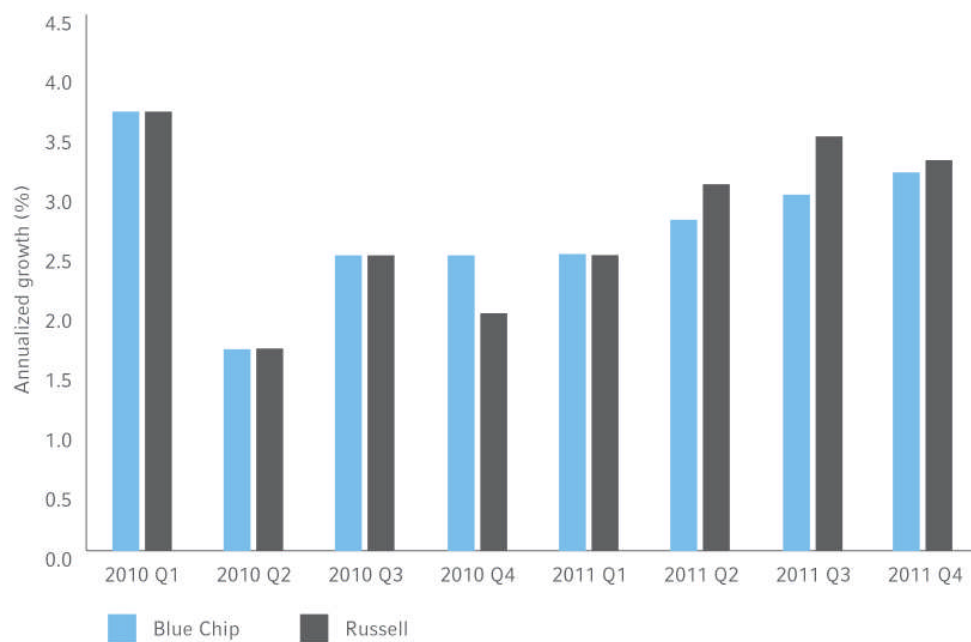
The only silver lining we can take away from the 1980s cloud is that despite dour job numbers, the economy still grew near the trend rate: real gross domestic product (GDP) growth averaged 3 percent during the flat spot in the 1980s. So in 2011, the unemployment picture does not doom the economy to dismal growth as some observers have claimed based on historical observations. In fact, Russell's forecast for 2011 is that real GDP will grow 3 percent on a year-on-year basis, despite high unemployment.

Forecasts of unemployment: Blue Chip consensus and Russell's forecast



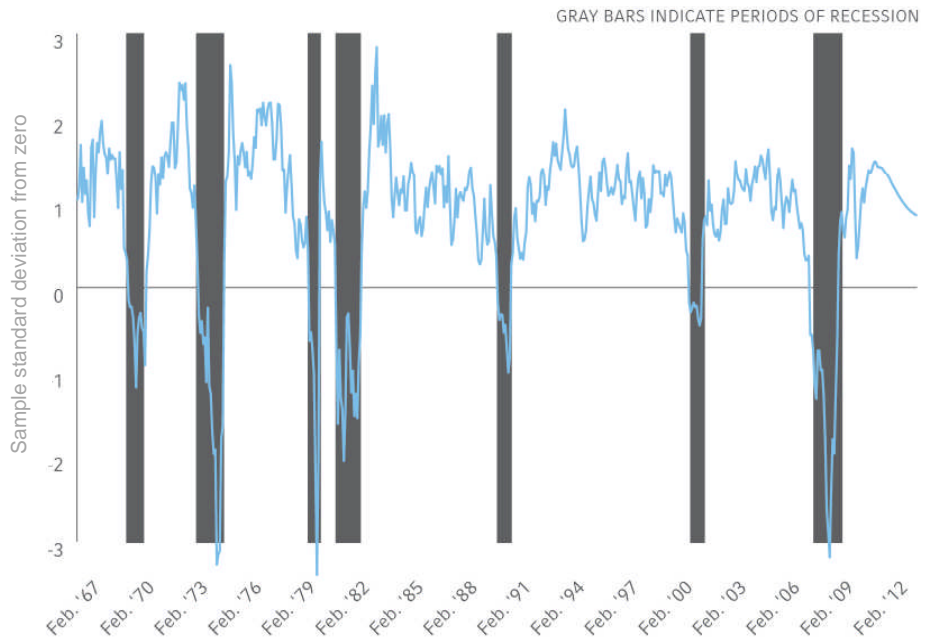
The Blue Chip is a panel of approximately 50 top economic forecasters.

Forecasts of GDP growth: Blue Chip consensus and Russell's forecast



Business Cycle Index as of Nov. 2010 data

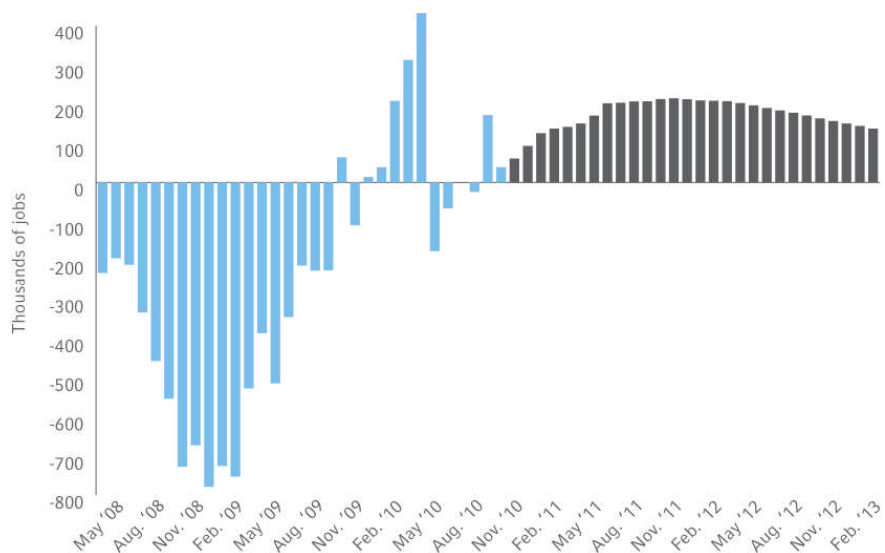
Our sample forecasts were calculated by simulating the time series model into the future. The value shown is the median of the simulated value of the month.



Source: Recession data from National Bureau of Economic Research

Created by Russell's Head economist for North America, Mike Dueker, 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. It is updated monthly after payroll employment numbers are released. Its inputs 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 Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts. The BCI is not meant to serve as a direct prediction regarding the future performance of any financial market. It is not intended to predict or guarantee future investment performance of any sort.

Forecasts of non-farm payroll employment changes as of Nov. 2010 data



Source: Actual employment data from St. Louis Fed's FRED database
Forecast data from Russell Investments

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.

Keeping calm and carrying on

In terms of setting the tone for the world economy, business cycle conditions in the United States are making the world safe for mediocrity.

With a modest square root shape in the Business Cycle Index, a plateau in jobs gains—at a little more than 200,000 per month—and a long flat spot in the unemployment rate, the U.S. economy is poised to carry on. But it will likely do so without undoing much of the damage wrought by the 2008-2009 recession.

Focus on the deficit

In December 2010, the Obama tax-cut proposal was a factor in lifting the five-year TIPS (Treasury Inflation Protected Securities) yield back into positive territory. The Obama administration decided that the economy still needed stimulus and that, following the mid-term elections, the only available stimulus was tax relief.

In particular, the lame-duck Congress extended the Bush income tax cuts for an additional two years and temporarily reduced the payroll tax by two percentage points—which means that workers will pay about 30 percent less in Social Security taxes in 2011-2012. If the president's administration wants to ensure that a high current deficit will not translate into a high permanent deficit, this short-term tax holiday may make that a tricky sell.

Thus, we can expect the Obama administration to trot out the deficit commission throughout 2011 to demonstrate how sober fiscal policy will be—after 2012. Despite all the clamor in 2009-2010 about the specter of “death panels,” the debt panel (the presidential commission on deficit reduction) is the one poised to affect our lives.

Grounds for agreement

In 1995, the U.S. entered a period of divided government on a reasonably sound, long-run fiscal footing, provided that future spending growth remained modest. Obviously today, the circumstances are much less favorable. For this reason, the recent announcement by the deficit commission that proposes an upper target for federal tax revenue at 21 percent of GDP could be the basis for much-needed cooperation between the political parties. The 21 percent figure is significant because that was the approximate level of federal spending and revenue when the U.S. last closed the budget deficit in the late 1990s.

It is instructive to note that when the Reagan-era deficits were at their peak circa-1986, federal tax revenue was about 19 percent of GDP and federal spending was about 24 percent of GDP. The deficit was finally closed in 1998 with revenue and spending meeting, not surprisingly, roughly in the middle—at 21 percent.

In the present circumstances, a key fact is that the only way to cap federal spending at 21 percent of GDP is to scale back entitlement spending significantly from its present course. At the same time, the 21 percent figure would give Republicans political cover for a gradual return to the higher tax rates of the 1990s. At some point, both political parties might be willing to venture that putting the federal government on sound fiscal footing would help unleash a wave of confidence about the future that would do more to encourage private investment than any measure that either side could enact alone.

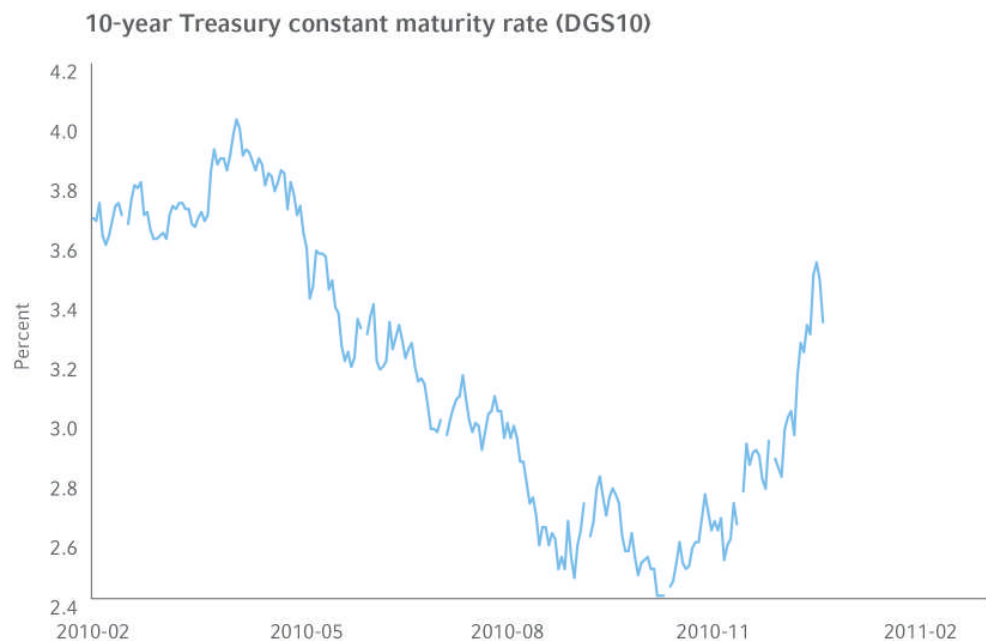
Fixed income: a reflection of a mediocre economy

We project a 3.8 percent yield on 10-year Treasuries, with both the nominal and real yield curves ripe to rise. And the Fed is likely to hold interest rates steady through most of 2011, if not longer.

A clear sign of stronger growth expectations is the five-year real TIPS yield. In October and November 2010, the five-year TIPS yield went below zero for the first time since TIPS were issued in 1997. Before TIPS were first issued, many market watchers would have anticipated that real yields at the one- or two-year maturity could go below zero during recessions, but few would have expected a negative real yield at the five-year horizon. As

scenarios involving a double-dip recession—or only 1 to 2 percent real growth—have become less likely in the market’s eyes, real bond yields rose from their recent lows in the latter part of 2010.

The five-year real TIPS yield crossed zero and returned to positive territory in early December 2010. The upward trend in long-term bond yields is expected to continue in 2011, although recent increases have reduced the extent to which long-term Treasury bonds can be considered richly priced. As of the December 22, 2010 submission to Blue Chip Financial Forecasts, Russell’s view was that the 10y-year Treasury yield would average 3.8 percent in the fourth quarter of 2011.



Source: Board of Governors of the Federal Reserve System.
2010 research.stlouisfed.org

How does quantitative easing come into play?

Regarding quantitative easing (QE), let’s agree on a basic definition: quantitative easing is a monetary policy in which the central bank injects considerably more than the minimum reserves needed in order to enforce a near-zero level of short-term interest rates. It’s also supposed to shift the market’s economic outlook away from stagnation and deflation. In the U.S., the policy is working—enough to improve our outlook for fixed income investments.

First, the policy convinced bond investors to believe in 2 percent inflation—in part through market anticipation of the second round of quantitative easing (QE2) announced at the November 2010 policy meeting—and then real rates began to rise in early December 2010. This development represents a thawing of frozen investor confidence in economic growth. And we believe that growth near 3 percent next year could lead to a substantial revision in expected real yields. Call it the end-of-the-bond rally, call it an inflation scare or call it a return to normalcy. No matter what you call it, both the nominal and real yield curves¹ are ripe to rise, as excessive bond market pessimism fails to find validation.

¹Graphs of current yields across the maturity spectrum of both nominal and real Treasury bonds.

Outlook on the Fed

With the unemployment rate among those with less than a high-school education at an alarming 15 percent, we are seeing the opposite of the “virtuous cycle” in the late 1990s. At that time, low unemployment permitted less-educated workers to gain valuable work experience and access a myriad of opportunities. For this reason, we are likely to see a continuation of supportive monetary policy from the Fed throughout 2011.

In the last two jobless recoveries, following the 1990-1991 and 2001 recessions, the Fed kept cutting the short-term interest rate well after the end of the formal recession. In other words, the Fed took a chop at the tree with an axe—a rate cut. Then, when the tree failed to fall, they took another whack—a reigniting of job growth. QE2 represents a chop—in the form of \$600 billion in Treasury bond purchases. We believe, they’ll take another whack later if the job market remains inert. Thus, the Fed will have transferred its tree-chopping approach from the interest-rate sphere to the quantitative-easing sphere.

A cynical view of QE2 is that, with 9 percent unemployment, the Fed wants to be seen chopping at the tree even if it does not materially speed up improvement in the labor market. A positive view of QE2 is that the program will prevent a deflationary mentality from taking hold and reduce expected real borrowing costs, thus boosting investment spending. The truth is probably somewhere between these poles, but the Fed clearly wants to be seen as an active participant in the economy’s recovery.

In our view, it’s unlikely that the incoming data in the first half of 2011 will warrant a cessation of data-dependent asset purchases by the Fed before mid-year 2011. If this is the case, we do not expect an old-fashioned interest-rate hike—the end of the Fed’s zero interest-rate policy (ZIRP)—until the very end of 2011 at the earliest, if not well into 2012.

One misconception about QE2 is that to be effective, the Fed must drive down long-term interest rates. For this reason, some observers claim that the market has defied the Fed, because the 10-year Treasury yield rose in the first few weeks after the Fed announced QE2. In reality, the aim of QE2 is to keep inflation expectations from dipping too low and to bolster growth expectations. Thus, the true objective of QE2 is to raise long-term interest rates toward 4 percent within a reasonable time frame.

Global equity outlook: a bumpy but positive track

Double-digit returns are not part of the most probable scenario, but equities are still expected to have an upside. The impacts of risks are not equally distributed across the globe, making a strong case for both diversification and active management.

As we assess our outlook for global equity markets for 2011, it’s worth looking back to where we’ve come from, not just to last year and 2009 but also since the lows of the global financial crisis. It’s also worthwhile to look at index performance since the previous highs at the start of the second quarter of 2010—before the mid-year stumble amid concerns of a double-dip scenario. One thing that jumps out in this review is the relative consistency—both in direction as well as relative magnitude—in 2009. Compare this with the very different experience in 2010.

2011 is likely to feel more like the bumpy, uncorrelated ride of 2010 rather than that of 2009. This is consistent with experiences in jobless recoveries, where lackluster near-trend growth becomes the norm against a backdrop of persistent slack in global economies. The length of the recession during the global financial crisis accentuated this situation as time only added to the amount of slack.

Riding the flat section of the square root sign

The recovery forecast looks a great deal like our symbol of choice from last year's forecast: a square root sign. We're now riding along the flat portion. However, when you zoom in closely on this flat portion, it's less flat than it first appears. This is where you see the volatile and bumpy ride.

We feel that 2011 will likely reward active management. Here's why: similar to the experience in 2010, the bumpy ride from headline risk will be married with lower correlations between global equity markets. This creates an environment where identification of relative attractiveness between markets will likely prove fertile ground for active management.

Below, we take a deeper look into some of the regions and national equity markets—both against their local fixed-income alternatives as well as relative to other global equity markets.

Source: Bloomberg. Performance data as of Dec. 7, 2010.

Country / Index	Annualized		Since 2009 low (date)	Since 2010 Previous high (date)
	2009	2010		
US / S&P500	26.5%	12.72%	87.8% (9 MAR 09)	1.9% (23 APR 10)
UK / FTSE	27.9%	12.07%	76.0% (3 MAR 09)	1.0% (15 APR 10)
GER / DAX	23.8%	18.82%	89.5% (6 MAR 09)	9.7% (26 APR 10)
FRA / CAC	27.7%	0.55%	61.3% (9 MAR 09)	-4.2% (15 APR 10)
JPN / NIKKEI	21.1%	-2.55%	48.7% (10 MAR 09)	-9.6% (5 APR 10)
AUS / ASX	37.0%	1.09%	59.9% (6 MAR 09)	-3.7% (15 APR 10)
CAN / TSX	35.1%	16.81%	83.2% (9 MAR 09)	9.1% (26 APR 10)

Indexes 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.

U.S. equities may surprise to the upside

Looking at U.S. equity markets, we maintain a forecast that is positive for equities relative to fixed income. In our central (highest probability) scenario, benign inflation in the U.S. and near-trend GDP growth result in a modest upside for equities. This is confirmed by long-term price reversion valuation, fundamental valuation and classic Fed valuation modeling². Additionally, given the positive performance of U.S. equities at the end of 2010, there is also a material momentum tailwind. In other words, stocks look relatively cheap and the market seems to believe it.

Relative to the rest of the world, U.S. equities don't appear cheap from a price-to-earnings basis, but given policy risk that may be more impactful overseas we could see a flight to quality that manifests as a flight from risk towards U.S. markets. The post-QE2 weakness in the U.S. dollar, with potential strengthening coming in 2011, may spur this move toward U.S. equities in the early portion of 2011. We have assigned a slightly higher probability to an upside growth surprise within the United States, relative to a deflation scare scenario. Provided that this does not create material inflation, this could be a catalyst for a modest global equity rally.

²Long-term price revision: A statistical model used to determine equilibrium price relationships between two asset classes. Fundamental Valuation: A statistical model used to determine US equity index values using index characteristics and current market conditions. Fed valuation modeling: A statistical model comparing the yields of US equities to Treasuries in an effort to determine when equities are cheap (expensive) relative to treasuries.

Disparity in European markets

Europe does appear moderately attractive from a ratio valuation of price-to-earnings, as well as with respect to long-term trends relative to the United States. But Europe is neutral when looking at a price-to-book comparison. Given the uncertainty surrounding monetary and fiscal policy action, sovereign debt risk and potential predatory market action directed toward the PIIGS (Portugal, Italy, Ireland, Greece and Spain), we do not see an opportunity to overweight European equities relative to those in the United States.

Internally, the opportunities in Europe—and independently in the U.K.—warrant a modest overweighting toward equities relative to fixed income, which aligns with our valuation modeling. It may, however, be a case where performance is not highly correlated between European equity markets, similar to what we saw in 2010. An example would be Germany's relative performance advantage which comes with little surprise, given the equity market's high global gearing and beta from their export-led economy. As a result, potential performance disparity between European markets is noteworthy and presents an opportunity for active asset class selection.

Japan: value trap or opportunity?

Japan is a very interesting case presently, and appears attractive relative to domestic fixed income markets when looking at long-term trend reversion, as well as from fundamental- and Fed-model valuations. The question is whether Japan is again a *value trap*.

Japan could be a surprise performer to the upside, but given the current exchange rate for the Yen relative to the euro and the U.S. dollar, a material portion of this upside could be eaten up by currency. A good watch-point for Japan will be the sources of fund flows in Japanese equity markets. In other words, watch where the investment comes from. If Japanese pension funds and households are the source, this is a far more bullish signal than if fund flows are coming from hedge funds and foreign sources.

Summary outlook for global equities

We have seen peer GDP forecasts migrate in a more optimistic direction toward our earlier forecasts of near or slightly better-than-trend growth in the United States. If these forecasts prove to foreshadow upward earnings estimate revisions and a rally in U.S. equity markets, this could be a catalyst for a virtuous feedback loop in the U.S. economy and could spur job creation.

In our highest probability scenario, returns in the upper single digits are more likely than double digits. With the disproportionate impact of potential risks across global markets, diversification and active management strategies that can identify potential short-term opportunities should be rewarded.

The euro-mess: The only thing certain is uncertainty

Europe provides a cautionary tale for ignoring fiscal concerns. For investors, Europe is too big a region to ignore, but its 2011 prospects don't look good because politics are likely to carry the day.

If you think that 2010 was a wild year in European sovereign debt markets, strap yourself in. We think that 2011 will be even more jarring. With the focus of much of this past year on liquidity concerns in small peripheral states like Greece and Ireland, we suspect that the next phase of the eurozone crisis will present even greater difficulties.

This year will probably see the focus shift to large countries like Spain, and possibly Italy. And instead of dealing solely with liquidity issues, concerns about solvency will become more urgent. Discussions and calculations regarding potential end-game scenarios will likely rise higher on the agenda. Looking over the choices, none of the realistic outcomes seems very palatable in our opinion.

In last year's annual global markets outlook, Russell warned that sovereign debt issues would weigh on investors' minds at some point in the upcoming year, especially given the muted growth, reduced tax revenues and extensive financial commitments that many national governments had taken on as a result of the post-credit crunch environment. We didn't expect, however, that they would have materialized so quickly.

Nevertheless, right from the beginning of 2010, the monetary union has seen the political and economic policy-making bureaucracy in Brussels and other national capitals engaged in a seemingly year-long firefighting exercise. The stakes have been high; crunching austerity programs have been hurriedly crafted, in many cases against stiff popular resistance. The looming specter of sovereign default and even the break-up of the eurozone has cast a long shadow from Athens to Dublin.

The "Euro-TARP" crafted in May 2010 was an attempt to backstop the liquidity needs of countries that had seen their borrowing costs soar as the result of a *buyers strike* in the European government bond markets. Greece, and more recently, Ireland have been forced to tap this facility. But putting a floor under Greece and Ireland, two very small countries in the European context, is a different matter than supporting large, highly indebted countries like Spain and Italy. If the markets place a target on the backs of these two giants, it is quite likely that the funds currently committed will fall well short of what is needed.

Furthermore, even if the liquidity needs can be addressed, the long-term solvency of these governments is by no means assured. The contractionary effects of raising taxes, cutting spending and being forced to borrow at ever-increasing rates of interest conspire to make solvency even more difficult to achieve. In addition, by being locked into the euro, these countries have surrendered control of their monetary policy and exchange rate. Otherwise, policy could be kept loose (granted, the European Central Bank is reluctantly doing what it can) and the exchange rate could fall, helping to restore some international competitiveness and providing stimulus.

Looking clinically at the arithmetic, a case can be made that under current arrangements some of these countries might very well not make it. Furthermore, with apologies to Shakespeare, hell hath no fury like the bond market. If Spain and Italy lose their allure to the markets, there might not be very much that could be done to prevent a full-blown and possibly insurmountable crisis. The "Euro-TARP" in part was designed to buy the European Union a few years to sort out legal and political arrangements if the worst case could not be avoided. However, they might not get three years.

Potential end-game scenarios are difficult to detail with any certainty, given that the outcome is highly dependent on political compromise amongst multiple parties. These scenarios range from an even bigger multi-national support package at the EU-level (in effect socializing these countries' problems across all 27 members of the Union) to outright sovereign defaults.

We think that a unilateral withdrawal from the single currency is nearly impossible to achieve given the practical, legal and financial consequences. Such an event would probably be seen as far too costly to contemplate. Our analysis suggests that some sort of "golden parachute" is more likely. A large pot of money could be offered to an endangered country – perhaps financed by some sort of yet-to-be-created Eurobond. These monies would be used to guarantee deposits while the government negotiated an orderly debt restructuring. It would not be necessary that the country withdraw from the eurozone.

In this way, such an approach is reminiscent of the "Brady bond" solution to the Latin American debt crisis more than 20 years ago. However, we think that if a country could withdraw from the euro, the required real exchange rate adjustment would be facilitated if it had its own monetary and exchange rate policy. The new currency would undoubtedly fall and reach an internationally competitive equilibrium.

The worst outcome—but sadly not beyond the realms of possibility—would be an outright default. This would be potentially catastrophic. Contagion across the region would mean that no country would be safe from the outward rush of money, even countries not normally associated with the peripheral countries (say Belgium or even France). And the resulting credit contraction and severe recession would almost assuredly spell the end of the eurozone.

We suspect that going into 2011, these issues will continue to percolate, from time to time reaching boiling points. But Europe cannot continue to muddle through this crisis indefinitely, even if it is only simmering at times. This means the world will have to factor significant European volatility into its risk calculations across the spectrum of investment assets.

While in many ways this is no longer *news* and we do expect Europe to be mostly a sideshow against the backdrop of other global economic issues, it means that within Europe investors will have to ride a roller coaster. National bond and equity markets will continue to show falling correlations, and the opportunity for good, top-down investing and stock picking will be both enticing and treacherous. We also suggest that other nations in the developed West not watch the European drama with smug *schadenfreude*; today's Greece could become tomorrow's U.S. or Japan. The failure to address fiscal concerns will no longer be tolerated indefinitely.

Emerging markets: above-average expectations, with near-term risks

The broad, positive consensus about the medium-term prospects for emerging markets appears to hold true for 2011. But there are some near-term risks around a China slowdown and rising inflation that should caution overweighting.

We can all agree there is a lot of hype surrounding the outlook for emerging markets. Investors are reminded that emerging economies generally have positive demographics, strong public- and private-sector balance sheets, and a declining reliance on an export-led growth model. This contrasts with the major developed economies that face an extended period of lackluster growth amid deleveraging, balance sheet repair and fiscal constraints. While emerging markets may be an appropriate part of your investment portfolio, please remember that investing in emerging markets may come with additional risks.

The optimism for emerging markets is being matched by investment flows. According to the Institute of International Finance, inward portfolio equity investment to emerging markets is on track to reach \$186 billion in 2010, more than double the level in 2007 when emerging markets investments last boomed.

Still above average

While uncomfortable with the “hype,” we mostly agree with the positive medium-term outlook for emerging markets. In particular, we think that valuations for emerging markets shares are still broadly acceptable and that the sector is potentially in the early stages of a long-term process of being re-rated. The sector is trading on a one-year-ahead price-to-earnings ratio of 11.5 times, based on the MSCI Emerging Markets Index. This is above the 10-year average of 10.5 times. It is, however, well below the average multiple of around 20 times that prevailed for most of the 1990s before the sector was downgraded following a succession of crises in Mexico, Asia and Russia.

Emerging markets appear expensive, however, when compared to global developed markets, using the MSCI World Index. Emerging markets are currently trading close to parity with developed markets in price-to-earnings ratio terms, compared to the near 30 percent average valuation discount over the past 10 years. This, however, seems more to do with the low multiple for developed equities (because of uncertainties about the

medium-term growth outlook) than an indication that emerging markets are expensive. The 11.5 times multiple for emerging markets looks relatively undemanding given the medium-term growth outlook.

Emerging markets, emerging risks

Although the medium-term outlook is favorable, there may be a number of risks that could influence emerging market investments in 2011. Foremost is the potential for a sudden slowdown in China. The December 2010 Consensus Economics survey shows most forecasters expect China's GDP growth to slow from 10 percent in 2010 to 9 percent in 2011. Inflation is accelerating despite a series of tightening measures. One risk is that further policy tightening results in weaker-than-expected GDP growth next year. Another is that inflation continues to accelerate during 2011, forcing policymakers to adopt even more aggressive tightening measures, thus creating the risk of a "hard landing" in 2012. The most likely scenario is that China's economy slows modestly in 2011 and inflation pressures moderate. However, market sentiment has the potential to swing between fear of a hard landing and worries about surging inflation.

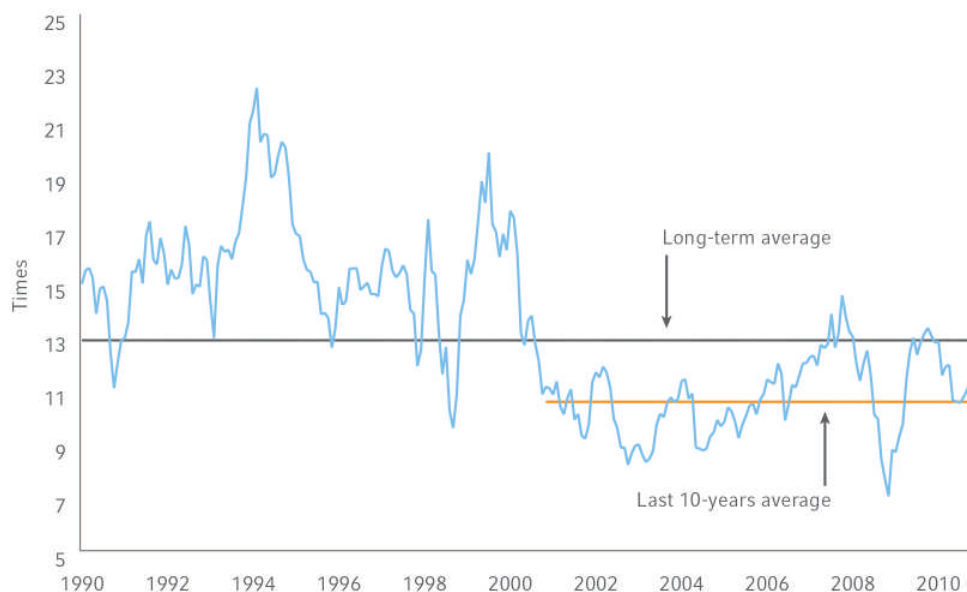
Rising inflation is likely to be a theme more broadly across emerging markets next year. Inflation is picking up in most countries and policy interest rates are low compared to the levels that prevailed three years ago. Only a few countries (Chile, India, Peru, Brazil) have raised interest rates by 100 basis points or more. Capital inflows are placing emerging market currencies under upward pressure. At the same time, export growth is slowing following the rebound from depressed levels during the global recession and as the demand boost from the global rebuild in manufacturing inventories winds down. For most emerging market countries, the level of exports has been reasonably flat in U.S. dollar terms since early 2010.

Complicated times for policymakers

The combination of rising inflation, upward currency pressure and slowing exports puts emerging market policymakers in a bind. They can lift interest rates to offset inflation pressures, but this risks putting more upward pressure on currencies. Alternatively, they can prevent currency appreciation by increasing foreign currency reserves, but unless fully sterilized (which is expensive when local interest rates are higher than in the U.S.) this can flow back into domestic money supply growth, putting more upward pressure on inflation and property prices. Another option is to impose capital controls in some form. For example, in October 2010, Brazil tripled its tax on purchases of bonds by foreign investors. We expect that there will be a combination of all of the above next year across emerging markets—rising inflation, currency appreciation, currency intervention and capital controls.

In summary, we agree with the consensus about the medium-term prospects for emerging markets and think that valuations are acceptable within the context of a longer-term re-rating. There are, however, near-term risks. These are mostly centered on the potential for a deeper-than-expected slowdown in China and the potential for volatility around the themes of rising inflation, currency appreciation and capital controls.

Emerging markets forward P/E ratio



Source: I/B/E/S, MSCI, end date is November 2010.

Performance quoted represents past performance and does not guarantee future results.

Currency: the good, the bad and the least ugly

It's hard to support a strong currency approach in 2011. Wise investors will focus on which currencies have the least negatives.

The challenge in predicting currency trends for 2011 is that the U.S., Europe, U.K. and Japan all need weaker currencies, while the one country that can withstand appreciation, China, is likely to resist revaluation. At the beginning of 2010, Russell called the search for the best-performing currency a *least-ugly contest*. Not much has changed in 12 months and picking currency winners is still about seeing which has the fewest negatives. Currency-supportive fundamentals are in short supply for any of the major currencies.

U.S. dollar may win the least-ugly contest

This approach leads us to favor the U.S. dollar. The greenback is already weak, having fallen around 10 percent in trade-weighted terms since the beginning of 2009. In inflation-adjusted terms, the trade-weighted U.S. dollar is the lowest since Fed calculations began in 1973. The U.S. economy appears on the strongest footing of the G-3 (U.S., Europe and Japan) and the currency could receive a boost late in the year if markets begin to speculate about a possible Fed rate hike in early 2012.

The main risk to this view occurs if the U.S. economic recovery again falters, causing the Fed to increase its quantitative easing program and extend it beyond May 2011. Speculation about QE2 in 2010 caused the U.S. dollar to more than reverse the gains made in the first half of the year. But, as we argue elsewhere in this report, we think the likelihood of a U.S. growth surprise next year is larger than the risk of a renewed downturn.

Expect moderate euro growth

The euro fell 9 percent against the U.S. dollar over the first 11 months of 2010. It fell 13 percent since mid-2008 against J.P. Morgan's real trade-weighted index. The euro is not especially weak—it is close to its average in trade-weighted terms since commencing in January 1999. The arguments for euro weakness are that Europe needs a weaker currency to offset the economic drag from fiscal tightening, and that worries about sovereign debt and the future of the euro will continue to weigh on the currency. The scenario for euro strength in 2011 involves stronger-than-expected economic growth that eases sovereign debt fears and turns the normally hawkish European Central Bank's focus back onto inflation risks. This is possible, but the greater likelihood is moderate growth and ongoing debt concerns keep downward pressure on a euro that is not yet weak.

Japanese yen outlook deteriorating

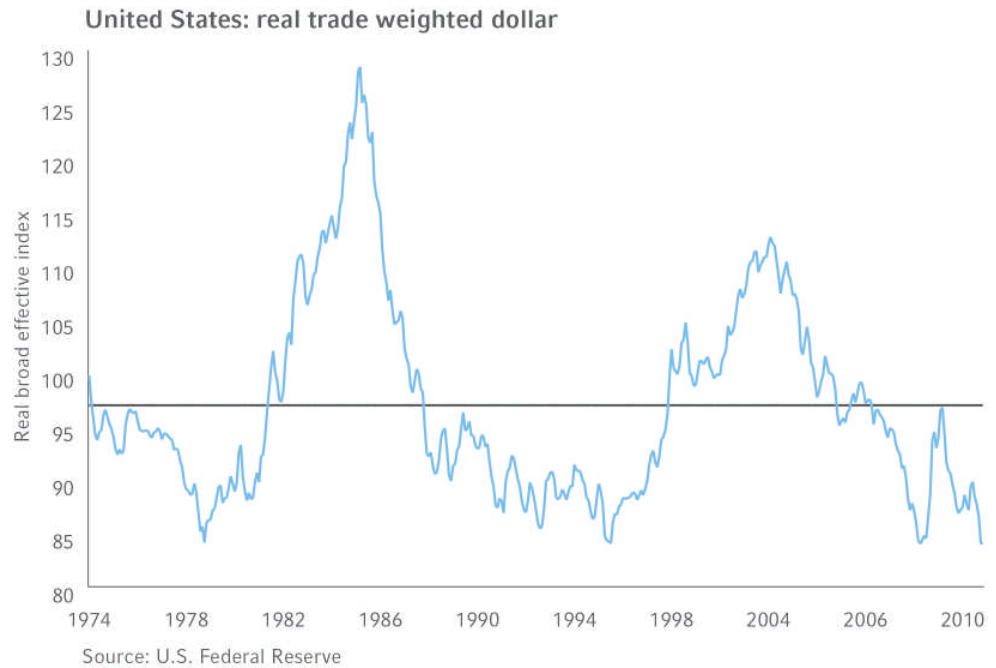
The yen has been the main surprise in 2010, rising by 9 percent against the U.S. dollar to November 2010. Deflation is becoming entrenched and the economic outlook has deteriorated to the extent that the government is considering further fiscal stimulus. There was a short-lived attempt at currency intervention in September 2010. With the yen close to a 15-year high, another attempt at currency intervention may be on the horizon given that devaluation appears the only effective policy option remaining.

Chinese yuan expects controlled appreciation

China loosened its currency peg in late June 2010, but the yuan has appreciated by just 2.5 percent against the U.S. dollar in the ensuing five months. China's challenge is that it would like currency appreciation to be smooth and gradual, but it is facing strong international pressure to allow more rapid revaluation. It needs tighter domestic monetary policy settings to combat rising inflation, but it is reluctant to allow the currency to rise when exports have only just recovered to pre-crisis levels. The net result is likely to be further modest yuan appreciation of around 5-8 percent, continued growth in foreign currency reserves (now \$2.6 trillion), and more claims of currency manipulation, unfair trade and the risk of protectionist pressures in the G-20.

Our cautious view on commodities translates to a cautious view on the commodity currencies. The Australian dollar is the most overvalued, trading near parity with the U.S. dollar compared to a 72-cent average since being floated in late 1983. Australia's wide interest rate differential is currency supportive, but it is vulnerable to a commodity reversal and episodes of investor risk aversion.

In summary, we expect the U.S. dollar to continue to be the best of an ugly bunch in 2011.



Performance quoted represents past performance and does not guarantee future results.

Commodities: the old story of supply and demand

With continuing high demand from the industry and investors, the 2011 forecast for commodities appears strong. But with high inventories, unguaranteed growth rates and a positive outlook for the U.S. dollar, don't get caught up in the commodity price outlook hype.

Commodity investors needed patience in 2010. The sector started out badly with the Dow Jones UBS Commodity Index losing 9.6 percent over the first six months of the year. But by the end of November, this had turned around to a 5.5 percent gain. The gains were led by precious metals, up 36 percent in 2010, and agriculture, up 20 percent. These were offset by a 17 percent negative return for energy while industrial metals returned 3 percent.

Proceed, but with caution

The consensus on commodities for 2011 seems strongly bullish. Optimistic commentaries typically point to China's unquenchable commodity demand, the potential for further U.S. dollar weakness, the trend growth in investment demand (with physically-backed ETFs as the latest development), a view that quantitative easing is supportive for commodity prices, and the view that commodities will protect against rising global inflation.

Our view is somewhat more cautious, especially for industrial commodities. Inflation pressures are forcing more aggressive policy tightening measures in China, creating the risk that commodity demand will disappoint. China's imports of commodities grew strongly in the global recession year of 2009 (e.g., iron imports increased by more than 40 percent, copper imports rose more than 60 percent), and there is the possibility that excess inventories are still to be unwound.

Furthermore, much of the strength in commodity demand has been due to the rebuilding of manufacturing inventories. That process is now complete and the Organisation for Economic Co-operation and Development's leading index for the G-7 countries points to a

slowdown. There is also the issue of commodity stockpiles. Inventories recorded by the London Metal Exchange are at high levels across the base metals. Aluminum inventories reached record levels in 2010, while nickel and lead inventories were at 15-year highs.

The focus on U.S. quantitative easing as a source of commodity price support also seems questionable. QE has supported commodities through a weaker U.S. dollar and declines in long-term interest rates. We believe this, however, has mostly been priced in. The Fed recommenced QE because it was worried about the downside risks to the economy. This was not a bullish signal. At best, QE helped mitigate some of the downside risks to the U.S. outlook, but given the limited transmission channels, it is not a reason to anticipate significantly stronger demand.

This also means that we are less convinced about the merits of commodities as an inflation hedge, at least for the next few years. While it may be a remote risk, deflation seems more of a threat than inflation in the major economies, given high unemployment and excess capacity. There is an incentive for governments to use inflation to reduce debt burdens, but this may be an issue for the 2020s rather than the 2010s.

As we point out elsewhere in this report, the arguments for further U.S. dollar declines are debatable. With the dollar already near its lows of the past 30 years in real trade-weighted terms, there is a good possibility that it may end the year stronger against the euro and yen.

Predictions that investment demand will continue to support commodity prices also make us a little nervous. There have been strong inflows into commodity futures funds and commodity ETFs. In the absence of growing physical demand, investment demand can only lift prices if it continues to increase (i.e., futures demand must be larger each period for prices to rise). This is certainly possible in 2011, given the amount of new investment vehicles being launched, but it also means that prices can reverse sharply if negative news causes investors to take flight.

Gold follows its own rules

Gold, as always, is a special case. Its rise over the past two years has been fueled at different times by fear of financial Armageddon and fear of inflation from money printing. Along with other commodities, gold has received a boost from the falling U.S. dollar. Gold could remain supported by episodes of eurozone sovereign risk. And gold-bugs will no doubt continue to worry about the longer-term inflation consequences of Fed balance-sheet expansion and competitive devaluation. They will also point to growing central bank demand, especially from Asia, and the potential for China to diversify its reserves further into gold.

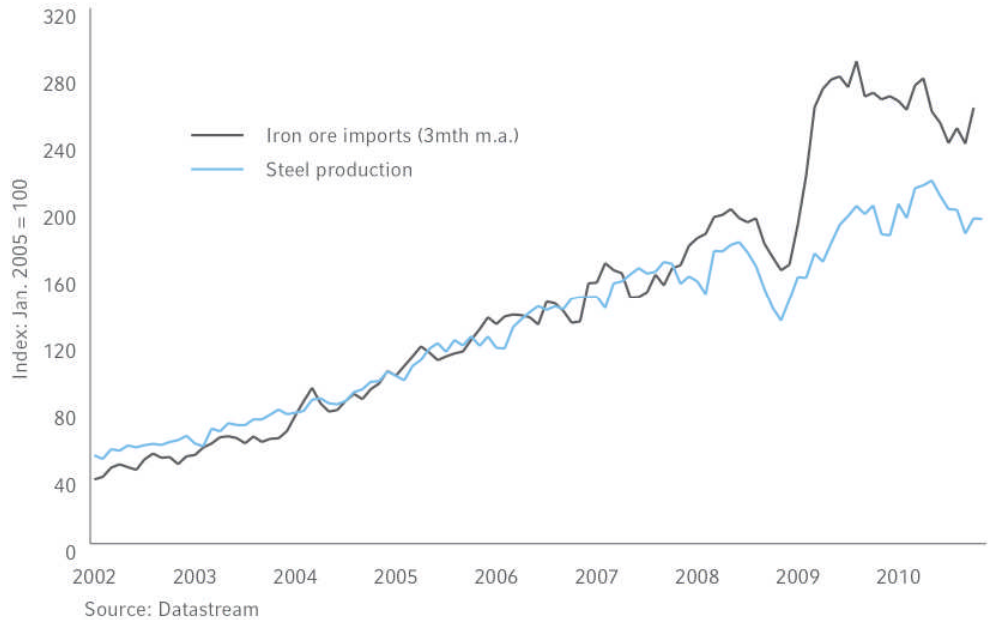
We suspect that gold will come under pressure once investors begin to anticipate Fed interest-rate increases. This may not show up on the radar until late in 2011, but rising real interest rates will increase the opportunity cost of holding gold and be the signal to move into investments that generate an income stream.

Finally, oil markets have been almost boring in 2010 with the West Texas Intermediate (WTI) price trading in a \$70-\$85 range for most of the year. OPEC seems to have gained a degree of control over supply and barring a surge in demand in 2011—which is unlikely, in our view—prices seem set to remain in this range.

Our focus for 2011 is on the risks surrounding the demand outlook. We agree that China and other emerging markets are likely to be significant sources of demand over the medium term. New supply, however, is also on the way from investment in capacity

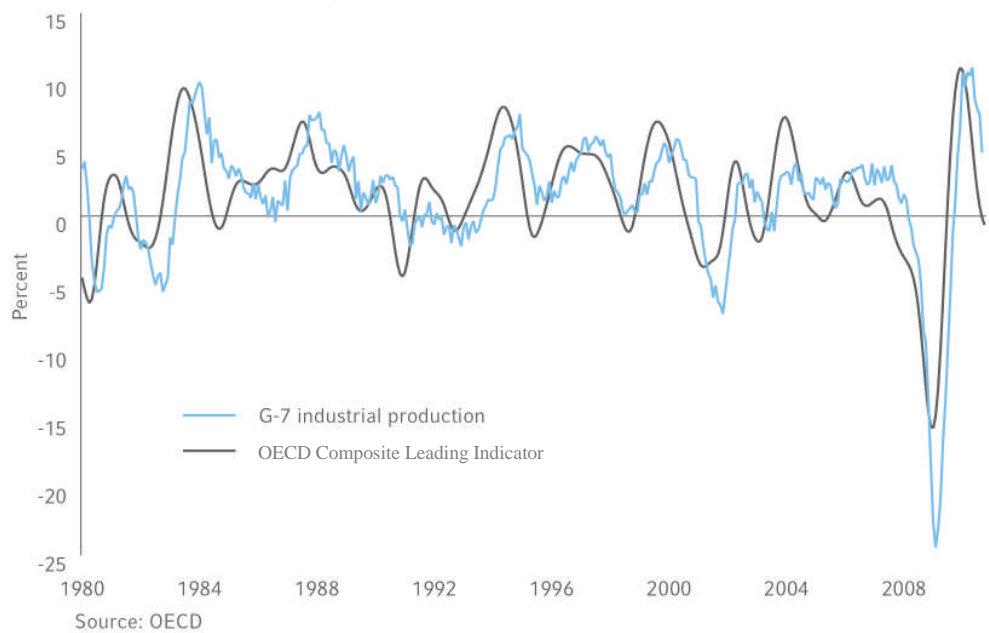
expansion. Commodities have solid medium-term investment credentials, but our main message is to be wary of the hype surrounding the commodity price outlook.

China: steel production and iron ore imports



Performance quoted represents past performance and does not guarantee future results.

G-7 industrial production and leading index
6 month annualized % change



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Real assets: credit-dependent diversification

Market uncertainty will continue to affect global infrastructure and real estate securities. Yet real assets will likely continue to make sense as a strategic holding over the longer term. In the years following 2011, inflation could become a significant tailwind for this sector.

After a turbulent 2008, both listed real estate and infrastructure assets posted very strong returns in 2009 and 2010. Cumulative returns from those two years have been north of 55 percent for global listed real estate, as measured by the FTSE EPRA/NAREIT Developed Index, and up over 25 percent for listed infrastructure, as measured by S&P Global Infrastructure Index.

Looking at the past five years from 2006 to 2010, global infrastructure has outpaced both global real estate as well as broad market equities, up 5.7 percent annualized versus 1.7 percent for FTSE EPRA/NAREIT Developed Index and 3.0 percent for the Russell Global Index⁴.

The appeal of real assets usually comes down to three core attributes, namely:

1. Steady income generation prospects
2. Diversification
3. Potential inflation protection

Over the next year, we would expect the first two of these characteristics—steady income generation and diversification—to persist as strong arguments in favor of holding a strategic position to this asset class. The exception from the list above is inflation. Broadly speaking, our forecasts for inflation for the developed region in 2011 remain fairly benign. Sustained high rates of unemployment in the U.S., coupled with the ongoing European sovereign issues, will be a major headwind to meaningful inflationary pressures. That being said, investors looking for diversification and steady income generation will still find opportunities within the asset class, but the returns will be more modest.

Real assets still appear more valuable

Breaking down real assets into the core components of listed infrastructure and real estate, we find valuations more attractive in the infrastructure space, in spite of sound returns over the last five years. Based on forward earnings forecasts, price-to-earnings valuations for 2010-2012 seem attractive relative to the average price-to-earnings ratios of 15 times for the last five years. Pure play infrastructure assets such as toll roads, airports and certain areas within utilities continue to trade at compelling valuations.

Listed real estate has seen spectacular returns since 2009 as bottom-pickers and opportunistic investors poured money into the asset class, driving up valuations. The result is now an asset class that is highly fragmented in terms of valuations, and discretion will be key. We find there are limited opportunities within the developed regions, with a few notable exceptions such as Australia.

However, there are pockets of opportunity within the emerging regions, such as developing Asia and Latin America, where demographics is a strong force in keeping REITs (Real Estate Investment Trusts) attractive. The wildcard within emerging markets in 2011 is likely to be China, where there are concerns of an overheating real estate sector and the added complications of a government-orchestrated “cooling.”

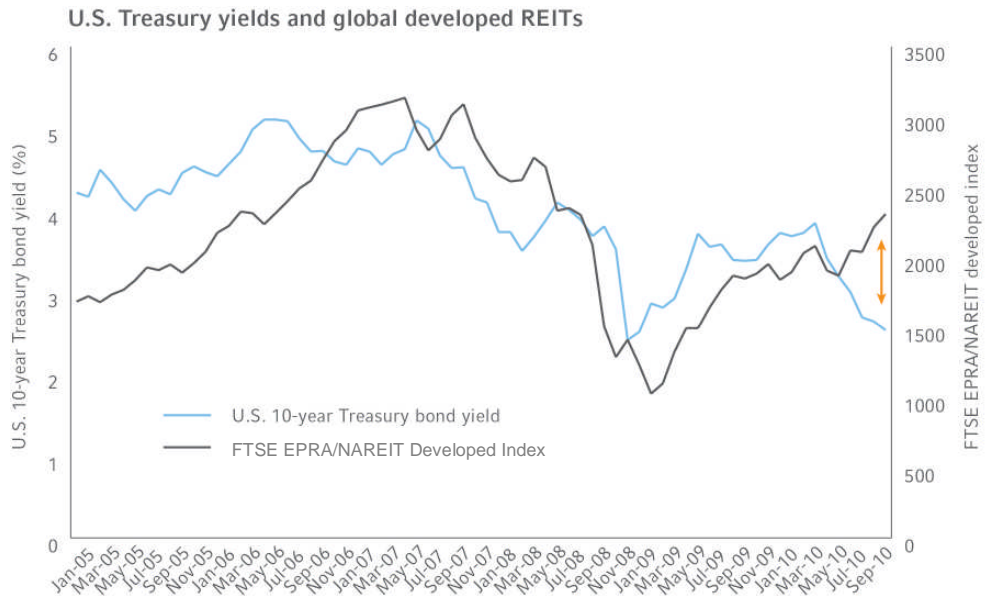
⁴All returns are in USD as of November 30, 2010.

Credit concerns

Two remaining concerns in the global economy are ongoing global macro-uncertainty and the ease of access to credit. For real assets, this could pose a risk, as the asset class generally is associated with higher leverage. (Note that this is more relevant for infrastructure than it is for listed properties.)

However, in the period after the global financial crisis, listed-property companies in particular have made significant strides in reducing the amount of leverage via recapitalization efforts. Infrastructure companies, on the other hand, typically support higher leverage as a result of their business model, but have also improved efficiencies.

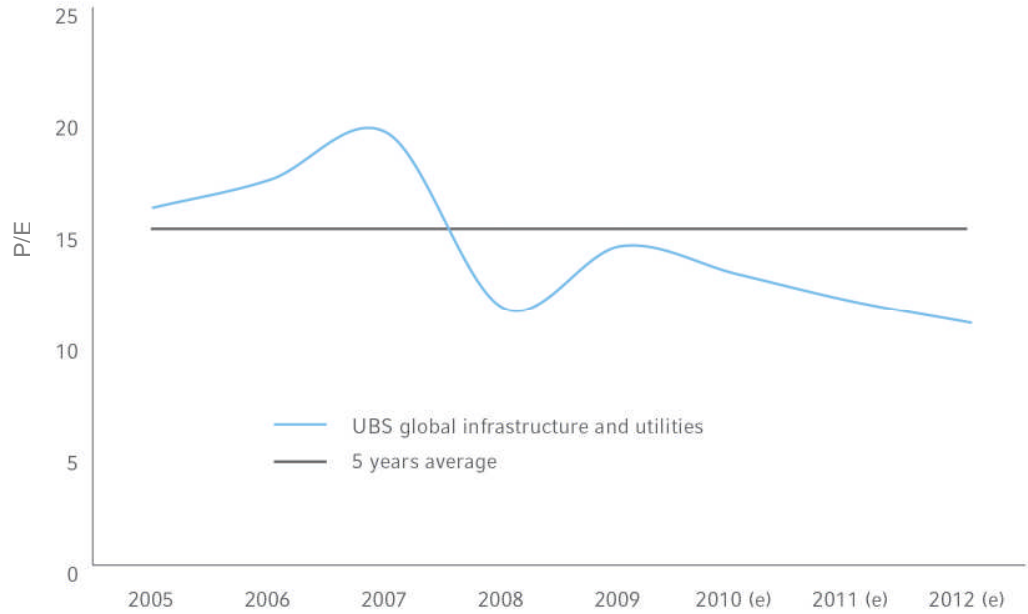
While the ongoing economic and financial market uncertainty will continue to affect global infrastructure and real estate securities, real assets continue to make sense as a strategic holding over the longer term. In addition, while we dismiss the risk of inflation as an outlying scenario for the short term, we acknowledge that it could indeed become a more pressing concern at some point over the next several years, at which time all three of the “core” attributes will be in play.



Source: Russell Investments, Bloomberg, FactSet. Data as of 1/1/05–10/31/10.

Returns represent past performance and are not a guarantee of future performance.

UBS Global Infrastructure and Utilities P/E Valuation



Source: UBS, Russell Investments
Actual returns as of November 2010

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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.

Standard Deviation is a statistical measure of the degree to which an individual value in a probability distribution tends to vary from the mean of the distribution. The greater the degree of dispersion, the greater the risk.

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.

Commodity futures and forward contract prices are highly volatile. Trading is conducted with low margin deposits which creates the potential for high leverage. Commodity strategies contain certain risks that prospective investors should evaluate and understand prior to making a decision to invest. Investments in commodities may be affected by overall market movements, and other factors such as weather, exchange rates, and international economic and political developments. Other risks may include, but are not limited to; interest rate risk, counter party risk, liquidity risk and leverage risk. Potential investors should have a thorough understanding of these risks prior to making a decision to invest in these strategies.

Specific sector investing such as real estate can be subject to different and greater risks than more diversified investments. Declines in the value of real estate, economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments. Fund investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

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

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.

The S&P 500 Index is an index, with dividends reinvested, of 500 issues representative of leading companies in the U.S. large cap securities market (representative sample of leading companies in leading industries).

The FTSE UK Index Series is designed to represent the performance of UK companies, providing investors with a comprehensive and complementary set of indices that measure the performance of all capital and industry segments of the UK equity market.

DAX - The German Stock Index is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange.

CAC - A market-capitalization-weighted index of the 40 most actively traded stocks on the Paris Bourse.

Nikkei 225 is a stock market index for the Tokyo Stock Exchange (TSE). It has been calculated daily by the Nihon Keizai Shimbun (Nikkei) newspaper since 1950. It is a price-weighted average (the unit is yen), and the components are reviewed once a year.

ASX - The largest securities exchange in Australia, established in 2006 as the result of a merger between the Australian Stock Exchange and the Sydney Futures Exchange. The exchange is fully electronic and trades both stocks and derivatives.

TSX - The largest stock exchange in Canada. The Toronto Stock Exchange (TSX) was established in 1852 and formally incorporated in 1878. The exchange is located on Bay Street in Toronto and is owned and operated by the TMX Group.

The MSCI EAFE Index, with dividends reinvested, is representative of the securities markets of twenty developed market countries in Europe, Australasia, and the Far East.

NAREIT Equity REIT Index, with dividends reinvested, is representative of tax qualified REITs listed on the New York Stock Exchange, American Stock Exchange, and the NASDAQ National Market System.

Dow Jones UBS Commodities IndexSM is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The index is composed of futures contracts on physical commodities. As the index has grown in popularity since its introduction in 1998, additional versions and a full complement of subindexes have been introduced. Together, the family offers investors a comprehensive set of tools for measuring the commodity markets.

The Organization for Economic Co-operation and Development (OECD) composite leading indicator index is designed to provide early signals of turning points (peaks and troughs) between expansions and slowdowns of economic activity. This series covers a wide range of short-term indicators such as observations or opinions about economic activity, housing permits, financial and monetary data.

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