

Transcript of the October 13, 2011 Market Update for Investors

Natalie Hi and thank you for joining us for our October 2011 economic and market outlook call. I'm Natalie Miller, a Consulting Director at Russell within the US Private Client Services Group here in Seattle. Today I'm joined by Erik Ristuben, our Chief Investment Officer of Client Strategies. Erik is often a spokesperson for us on the media and through other various industry events. Thanks for being here Erik.

Erik Very happy to be here, thanks Natalie.

Natalie So the dialog over the next 20-30 minutes should be about issues that you are concerned about, that you've been talking to your advisor about and hopefully we'll be able to provide our insight and help put some things into perspective. You know as Erik and I spend time with advisors and investors, the questions that we've been hearing most often deal with the current market volatility, the recovery of the US economy and the possibility of a double dip recession, and the continued uncertainty around events in Europe. Before we dive in I'd like to take a moment to remind you that investing involves risk and principal loss is possible. Diversification doesn't ensure a profit and doesn't protect against loss in declining markets. So let's start with the markets, especially market volatility. Third quarter of this year was a disappointing period for investors. The quarter started off slowly after a flat second quarter and then the quarter soon got worse. Although now the markets seem to be on a bit more of a positive bent – Erik, can you talk a little bit about what's driving some of that volatility?

Erik Yes, I think it's pretty simple – it's Europe. We can strip away all the other issues but at the end of the day it's pretty clear that the market has been overwhelmingly concerned about Europe. And really since the US debt downgrade, the response to which ironically was our debt got incredibly more expensive, we'll talk about that a little bit later which is a little bit counterintuitive...but basically since early August when we hit a low of 1100 on the S&P 500® we've been trading between 1100 and 1230 pretty much the entire time and we've hit both the top and the bottom of that range more than once. Right now, at the beginning of the day we were actually a little bit closer to the top of that range; now we're kind of more back in the middle of that range but we're bouncing around in that range, and all the volatility that we're experiencing, those swings up and down, are really about Europe.

Natalie So what about the underlying strength of balance sheets within US companies?

Erik Yes, I think that's the interesting thing because fundamentally US stocks – and stocks globally – look like they're good value, right? If you look at technology generally as a sector, and everybody knows the big names – Apple, Google, and Microsoft – you look at those three companies and one of the things when you look at their balance sheets in terms of what assets they have on their balance sheets, they have mountains of cash, oceans of cash, they're more cash-rich than other companies but companies in general have a tremendous amount of cash on hand, meaning they're really not over-levered, they're not hugely exposed. If there's a downturn or some kind of credit event in the marketplace they really don't have as much exposure as they did in 2008 and frankly not nearly as much exposure as in past history. Kind of that fundamental value of stocks is really why I think there's a floor of 1100 on this trading range, it's that

the market without a major crisis in Europe that actually happens rather than worry about happening, there's too much valuation, good valuation in equities for stocks to get super cheap before somebody comes in and buys it, and that's kind of what we've seen.

Natalie So spending a little bit more time on the Europe debt issue, investors are tiring of and demanding more decisive action by the European policymakers. It seems to be that we've been seeing better movement towards a resolution – true?

Erik Yes, but a lot of wood to chop before we're done. But yes, they've actually made progress. But there's a lot more to go.

Natalie So what can we expect from that over the next couple months?

Erik Yes...well if you believe Angela Merkel and Nicolas Sarkozy, who had a weekend meeting, you can kind of tell that the crisis in Europe has been escalating in terms of the overall crisis. You can kind of actually use the frequency of the meetings of those two as an indication. The gap between their meetings is getting smaller and smaller and smaller. They're really the lead dogs in core Europe that are going to have to address this issue with Germany being the lead sled dog in this thing. They actually said at the beginning of the week that they have an expectation that they will be submitting a joint European plan, driven principally by Germany and France, for the European Union to consider it, they're meeting at the end of the month, and for the G-20 to evaluate at the end of this month, the European Union meeting at the end of October. And the beginning of next month will be the G-20 meeting where that plan will be discussed. So the good news is over the last two weeks particularly Merkel has actually recognized that there's a serious problem from which they need to protect their system against. Before two and a half weeks ago, the weekend of the 30th of September she wasn't even saying that.

Natalie That was driving a lot of the volatility in global markets.

Erik Oh that was driving a lot of the volatility. But again what they've said is, what they've admitted is there is a fire, and they have to contain that fire so it doesn't burn down the whole European house. They have to contain that fire, they have to eventually put the fire out. They said all that...but they actually haven't said how they're going to do it, and they haven't yet even started putting it out so a lot of wood to chop. What we're talking about, what to expect over the next couple of months is a plan to address the issues and then the actual starting of the implementation of that plan. But market expectations are very high for the end of this month.

Natalie So do we at Russell have some expectation about what we think that plan or approach should entail or would look like?

Erik Yes, we're like broken records, so the 20 months we've been talking about the sovereign debt issue, if you look back and look at our forecast for 2010 that we shared with our clients in December of 2009, one of the very first issues we talked about was the sovereign debt issue and the pressure it was going to put on the Euro. So we're not 20 months into that little festival, actually a little bit longer than that, and they really haven't solved it yet. The solution that we identified over a year ago was what we called a three-legged stool. There are three things that basically need to happen. One has already begun to happen, that these countries like Greece and Spain and Italy and Portugal and Ireland that have lived beyond their means – they have – actually practice some austerity, some fiscal discipline, learn to live within their means, basically economically what they need to do is become more productive and more competitive. They're doing that. The problem is – Greece in particular – they

can't do enough of it to matter, to really fix the problem. Because think of it as – they have a growth rate, a nominal GDP economic growth rate of something on the order of negative five right now, roughly. The market is charging them a 20% interest rate. If you're running a business out there, anybody who's running a business out there could tell you how long you'd survive doing that.

Natalie Not long.

Erik You need help, right? Somebody's got to help you and that's one of the other legs of the stool. Germany's got to come in and actually help these peripheral countries by effectively underwriting their interest costs, right? So subsidizing the interest rates these five countries are getting from the marketplace so that they have the time to get competitive. The last thing that has to be done, and that's really a form of Germany has to write a check, right? That means money. That means real money put aside to actually finance these countries over the interim. The other thing they need to do is they actually need to put stability in their banking system, so they have to recapitalize their banking system and one of the key components they need to do there is right now everybody knows that Greek debt's not worth...you know if it's \$100 on the par value, everybody knows it's not worth \$100. What they don't know is what it is worth – is it worth \$20? Is it worth \$40? Is it worth \$60? What core Europe has to do is basically say how much of a haircut are bondholders going to have to take? Because they're going to have to take a haircut, that's the third leg of the stool. Is it going to be 60-cents on the dollar? What Germany would effectively be doing is saying – it doesn't matter what the market says these things are worth, we will buy them at 60. Therefore they are worth 60-cents on the dollar. And therefore people who are worried about kind of the value of assets on banks in Europe can look at 60 and say – do I still think the banks are solvent at 60-cents on the dollar? They're going to have to add some more money to the banking system in addition to just putting a floor on these bonds, but the one thing that shouldn't be lost on investors is bondholders are taking a haircut. But that's already priced into most of these bonds.

Natalie So when we say bondholders are taking a haircut, that's a nice way of saying default?

Erik Yes...

Natalie We hear that a lot.

Erik I'll take the suspense out of it, in our opinion there is no way that Greece is going to do anything other than default. That's not the question. The question is whether or not it's going to be an orderly default, Germany coming in and saying – the number's 60. It's certain, it's precise, it's final, it's painful, but sometimes pain is a lot better than uncertainty and this is one of those cases where...if you thought the number you might get is 20-cents on the dollar, you're going to love 60-cents on the dollar. If you think you were going to get 100, then you're just basically irrational and haven't been paying attention...you're not going to like 60. So basically the 60-cents – although it's incredibly painful – will be viewed by most market participants as good news, because it's a certain number, and uncertainty kills the markets. And uncertainty causes volatility and there's a ton of uncertainty around that stuff right now that has to be taken out of the system.

Natalie And that seems to be affecting markets around the globe and here in the US and otherwise. So we also have a lot of questions about the possibility of a double dip recession here in the US. What are Russell's views on the US economic recovery?

Erik

And again we'll kind of go back a little bit because it's always helpful to remind folks what we were telling people at the beginning of the year. Our basic economic forecast, which is really spearheaded by Mike Dueker our Chief Economist, and Mike has gotten a lot of things right in the last four years, and what he basically has been saying all year and what we've been saying all year is we think that the US will continue the spectacularly mediocre recovery that we've been engaged in. Now we thought mediocre at the beginning of the year was going to be 3% and we've put up basically growth numbers in the first half of the year that are half of that – positive. But spectacularly mediocre. But positive – that's not a recession. Our expectation is we will skirt recession in the United States. Six weeks ago it was a little harder to say that. I said six weeks ago with end investors that were on the call and a lot of them thought I was just unrealistic, there's no way that's going to happen. The economic data has actually solidified in the US a little bit more. You're actually seeing stories now in the Wall Street Journal, CNBC, Bloomberg...that maybe we aren't going into recession. Those are kind of new, that's kind of this week. And I think it's a little bit of what's behind this market move too, that the market I think is beginning to realize that there is a possibility, we think a likelihood, that if the European situation doesn't implode, that they actually do what they need to do even if it's painful and too late, much later than you wanted...then it doesn't automatically follow that the US is going to go into a recession. Actually there's a chance that the US can avoid recession which is what we've always believed, and the data is pretty much supporting that position now. The problem is is that growth is so weak, that it just doesn't feel anywhere near good. And the other problem is it's not doing anything for employment, it's not doing anything...there's a whole bunch of things it's not improving at that level of growth. But I think that's kind of the lot we're left with right now.

Natalie

So on the flipside, while we certainly think that the highest probability is not to have a recession, there is a slight possibility of a recession. What would be a trigger point for that?

Erik

Well, let's talk about what kind of recession we're likely to experience. Let's say we have one, what kind of recession are we likely to experience? If in fact what you have is a complete mess in terms of the policy implementation in Europe, where they basically make tragic mistakes and cause an implosion and set off a global financial crisis, we're going to have a pretty serious recession. I don't think that's likely because frankly I think everybody involved knows what the stakes are in this thing and the beautiful thing about our view on the politicians of Europe doing the right thing isn't based on some kind of Pollyanna or naïve view of – people do the right thing when pushed – it actually is we're expecting the politicians, politicians act in their own best self-interest. And you know what? If you can bet on politicians working in their own best self-interest, that's usually a pretty good bet. So if that doesn't happen, right, we don't have implosion and a recession...even if we have a recession in the US, normally a recession is really severe if there's a lot of excess in the system, and right now we talked about there's not a lot of leverage in corporate balance sheets, banks generally in the US are actually well capitalized...certainly much better capitalized than they were in 2008. And much, much less leveraged than they were in 2008. We don't have really tight unemployment, we don't really have tight capacity utilization. Think of what percentage of our overall factory output we're using; it's not high. So normally what recessions are is there were a lot of excesses built up and then you kind of have to have a down period to work out those excesses in inventories and a whole bunch of other things. We just haven't built up those excesses so if we had a recession, it's very likely going to be a fairly mild one. Because it's kind

of like – how far you fall is directly related to how high you got, and we just didn't get that high.

Natalie Yes. So though we are still anticipating no recession...it'll just be that slow mediocre growth.

Erik Yes, and that is the challenge. No one is enjoying this particular economic cycle. We always talked about what we talked about the square root recovery. We always talked about the fact that relative to people's expectations, the actual economic performance in the US was going to disappoint. All those reasons, it was interesting because I talked to audiences a lot in the fourth quarter of 2008/first quarter of 2009. And everybody talked about all the things that were wrong, said that those things were going to prevent a recovery from ever happening. I said – I don't think so. But what they are going to effect is the strength of that recovery, and that's exactly what we're seeing. If you ever thought you had to have a cost for the excess of leverage and the excess of consumerism of the first decade of the 21st century, the cost is – a 2%-3% growth rate instead of 3%-4% growth rate; that's the cost.

And a lot of it has to do with housing. A lot of the unemployment that we're feeling, this persistent high unemployment, is about housing. And it's also about people's expectations for what full employment is. We all as human beings tend to anchor on recent experiences, and we all tend to remember back fondly in 2007 when the unemployment rate in the United States was 4.5%. It didn't seem clear to me then, but it seems very clear to me now the only way you get to 4.5% is if you pay a lot of people to swing a lot of hammers to build a lot of houses that nobody wants to buy. We have too many houses in the United States; that's our housing problem; it's an inventory problem. There's only three ways of getting rid of that inventory. Number one, nobody likes this and property owners particularly don't like this – you blow up the houses. You do a lot of overpasses or freeway off-ramps or whatever, just blow up the houses and get rid of them. That's usually not the selection anybody takes. Number two you start easing credit and you make it possible for people – who probably shouldn't qualify for a mortgage to qualify for a mortgage and take the excess inventory out. We kind of know how that movie ends. And then number three – and that's the course that we've taken – is that you actually use our demographic trends, that we have population growth in the United States, we have a higher birth rate than most developed nations and we have an immigration policy that's very supportive of a positive demographic economic growth rate. Not as big as we'd like probably but it's positive. That means 23-year-olds, 24-year-olds, my son will work for six years, decide to save money then qualify, really qualify for a mortgage, save for the down payment...that's how we're going to get rid of the housing. So you think about this recovery – we're not building new houses. Building new houses is one of the most stimulative economic, it is the most stimulative economic event you can have. You pay for all the materials that go into the house, you pay for all the people that are building the house, you pay all those people that manufacture appliances, rugs, flooring, furniture...it is wildly stimulative. And so the reason we're at 2%-3% and not 3%-4%, a lot of that has to do with the fact that we're not building any houses. The other thing is that again, we're underemployed in the housing sector. If full employment is not 4.5% unemployment but more like 6.5% or 7%, which is what I learned when I went to school, that full employment was 6.5% or 7%. Now we're about 2% or 2.5% above that number. A good chunk of that is likely the fact that we're not building houses, and we're not paying people to swing those hammers and we're not paying people at the levels we normally would for carpeting and lumber and furniture and all that. And that's the reality, and that's not changing until we work the excess of houses out of the system. As

we've said from the start of this, that's going to take a long time. We're still three, four, maybe five years away from that.

Natalie So in times like this and uncertainty, investors are often inclined to move to safe assets like cash, US Treasuries, gold...what would you say to investors in those kinds of situations?

Erik I think that particularly when you're in the middle of a storm, safety is generally very expensive. And if you look at Treasuries...again I talked about the fact that the answer to the question of what happens when you downgrade US Treasuries is the price goes through the roof is – interesting. The way you think about the prices of bonds is it's a little inverted logic here, you talk about their yields. And when yields go down, prices go up; that's how it works. And the yields on 10-year Treasury notes went to 1.7% at one point; that's really low. I think that's 1951 low. Think about it this way – the average instrument was yielding about 1%. The inflation rate is 1.6%. So you are locking in a negative real return, real yield, in terms of your Treasury positions – so when we say those are expensive, that's what we mean. You're actually paying the government 6/10th of a percent a year for the safety of the fact if the world does fall apart, the Treasuries will probably maintain value better than any other asset. As soon as that fear comes out you start seeing those yields begin to move up and those prices drop, we've seen it. Earlier this week that yield is again at about 2.16%, so it did move .45 (almost half a percentage)...and that's a big move.

The other thing is gold...gold has been this interesting thing. The week the Fed announced they were not going to do QE3¹, that they were going to do Operation Twist, and I don't actually think it's worth talking about, what Operation Twist is, because we didn't think it was going to have an effect and it doesn't look like it's going to have an effect, when they weren't going to do QE3 you saw gold actually sell off dramatically. Gold went from \$1,900 to \$1,600. I think a lot of that was – there's a lot of speculation in gold. People buy gold for sentiment reasons and for speculation reasons and well, because they like it, there's a lot of potential expensive both deferred returns in buying gold and maybe even some reverses, like \$1,900 to \$1,600.

Natalie And deciding to get out of the market requires a decision also, of deciding when to get back in, when to move back into a diversified portfolio and that's hard to do.

Erik Yes...every study ever done of every investor population, individual investors, has shown that we as human beings, our natural behavior actually allows us to have a remarkable capacity to buy high and sell low continually. Because it's that sense of when the market is very negative, I'm fearful, I sell. You're down 20%, at one point the market was down 20% you sell...and the world doesn't end, the market rallies, very much what we saw in March of '09. We saw in that first week of March massive flows out of mutual funds, massive flows out of the equity asset class and lots of people – millions of people probably – unfortunately sold at the bottom, only to miss the rally. And they didn't feel strongly enough about it, didn't feel good enough to go back in. Some people didn't start moving back in until earlier this year so yes, you need to know what's going to cause you to go back in and if what's going to cause you to go back in is that the market goes up, what that means is you're buying high or certainly higher than it was, and you're selling low. Buy low/sell high is something everybody talks about, it is extraordinarily difficult to do and frankly at the end of the day is why Warren

¹ QE is an abbreviation for Quantitative Easing; the practice of spurring economic growth by making money more readily available.

Buffett is one of the richest men in the world. He has an unbelievable stomach and can buy low and hold it long enough to sell high.

Natalie I think that's why we hit diversification so hard.

Erik Yes, what diversification does is it makes sure you're not exposed entirely to the worst performing asset class. The flipside is you're never exposed fully to the best performing asset class but most people are more than willing to make that trade. And I think it's a very good trade to make. And that whole notion of – something's working – so the equity portfolio's up, the bond portfolios are positive, in the mid-single digits, that's good bond performance. Well, when your yield is 1.7% that's good performance and that's an absolute return, so that's what diversification does. It helps you know that some of your portfolio is doing well when some other parts aren't, and it smoothes out the ride and allows frankly a greater opportunity for discipline, that's really at the end of the day, the ability to maintain discipline in very difficult times, it is the most important key to building wealth. It's why institutions generally do better and it's not because they're smarter, it's because they put so much bureaucracy between the emotional event of the market and their actual ability to do something in their portfolio...by the time they actually get it through all the committees and the compliance and the due diligence, they don't want to do it anymore. I've worked with institutional clients my entire career and I will tell you, that's the main reason they outperform. And it's that discipline and in my mind, diversification is absolutely essential to make it a little easier to be disciplined...it's never going to be easy.

Natalie So for those on the phone, in summary it's hard to predict economics, it's hard to predict markets, we certainly have some insights, some of which we shared with you today. Forecasting isn't an exact science, it can be wrong and that's why we hit the idea of diversification and the importance of having an investment plan, that's why we stress that so much.

Erik I was going to mention that. This is the interesting thing, I'm a human being like everybody else, this is why you have a plan. When things are really good, the value of the plan really isn't all that...it's not really that important. I always kind of refer to your plan as – break glass in case of emergency plan – and that's why you have the plan, because you don't want to run into the fire, you actually want to run out of the house. It's unbelievably difficult to stay disciplined in periods like this. All I can say is it's generally very costly to make abrupt moves in markets like this.

Natalie The views we've shared today could change at any time based on market and other conditions, and are current as of today. Opinions we expressed are not necessarily those held by Russell Investment Group, its affiliates or subsidiaries, and accuracy and completeness cannot be guaranteed. The information, analysis, and opinions expressed on this call are for general information only and not intended to provide specific advice or recommendations and you should definitely follow-up and continue in those dialogs with your advisors who are best able to direct your actions in that regard. Securities, products, and services are offered through Russell Financial Services, Inc., member FINRA and part of Russell Investments. Erik thank you for being here today.

Erik Oh, thank you and thank you everyone on the phone. This is tough times. We'll be as communicative and try to explain as much as we possibly can for you.

Natalie Great. And thank you for joining us today. That ends our call.

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First used October 2011. RFS 11-6952