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Transcript of the April 14, 2011 Market Update for Investors

NATALIE Thanks for joining us for our April 2011 economic and market outlook call. I'm Natalie Miller, Consulting Director for Private Client Services at Russell and I'm joined today by Erik Ristuben, Chief Investment Officer Client Strategies. Thanks for being here Erik.

ERIK Thanks Natalie.

NATALIE So the backdrop during the first quarter of 2011 was anything but dull. We had oil prices rising, political unrest in North Africa and the Middle East, earthquakes, tsunamis, and nuclear accidents. So over the next 30 minutes I'd like to go over a review of the first quarter, have a discussion of some of the headline-grabbing events and their effects on the markets and the economic recovery and then end with a discussion about Russell's economic outlook for the remainder of the year. So before we dive in I'd like to take a moment to remind you that investing involves risk and that a principal loss is possible and that diversification doesn't assure a profit and doesn't protect against loss in declining markets. Erik, let's start with a review of first quarter. I think that there were surprisingly positive returns that investors experienced during the first quarter, especially given the events that took place.

ERIK The US equity market as measured by our Russell 3000® Index was up 6.4% for the quarter. You can do this and everybody knows this, but if you were multiply that by four, that's a very healthy return on an annual basis and much more than we expect of the year. We're not expecting a return in the 20's on the stock market; we're expecting something in the very low double digits or high single digits. So a very good quarter, yes, which is interesting, I think you're right. On a backdrop where a lot of people were worried about the Middle East, obviously were worried about Japan and I think all of us still remain worried about the people in Japan and then a fair amount of headlines coming out of Europe, I don't know how much worry but there's a fair amount of headlines coming out of Europe, particularly recently about Portugal. Yes, so for a lot of people you're looking at what looked to be from a macroeconomic big picture viewpoint, a very chaotic quarter and you're seeing a very solid rate of return. I think that that's a reflection of the fact that I think people are beginning to understand that what happens in exogenous things, political things and natural disasters…natural disasters very rarely have a major impact on the market in any major long-term way. If you think about the percentage of the overall world's economy in Japan and then you think about the fact that their economy is still functioning – just not at complete capacity – you see well maybe it's not that big of a deal because Japan's 8% or 9% of the global economy but it's that fear factor that initially gets priced in and I think people generally move back from that. So we really don't see a lot of the events actually have major impacts, and I think people were looking at the economic data and they were realizing that the US economy is in fact probably in the process of moving from recovery into expansion, albeit a very mediocre recovery and probably a mediocre expansion.

NATALIE Did we have economic data come out this quarter that was surprising at all, or within our expectations?

ERIK Interesting. Let's take a step back and we'll remind the people in the audience that listened to our last quarter call, because we did talk about our expectations for 2011. And our Chief Economist Mike Dueker, who has been very accurate frankly over the last three years in terms of his expectations and what's actually coming in the market, Mike's expectation is and effectively was for the gross domestic product, so the US economy to grow at 3%-3.5% in real terms, so real growth at 3%-3.5%. I think what we saw at the beginning of the quarter, we talked a lot about this internally about the fact that one of the concerns we were beginning to have at the beginning of the year was…and it was kind of comparing where we were last year…last year we spent a lot of time talking to our investors and our clients about trying to encourage them to be more optimistic about the economy than they wanted to be because there were a lot of things on the run last year. In July it looked like it was going to be a very bad year for equities and then you saw a massive surge starting in late-August because people were worried about a double-dip recession. We just didn't think that was going to happen and we tried to get people more optimistic about the economy. When I say more optimistic I don't mean wild-eyed optimism; we were saying that our view was that the US economy last year was going to experience mediocre growth, and we thought the market was pricing in negative growth. So we were much more optimistic than a lot of people in the market; we were just not wild-eyed optimists. We were very much in the mediocre stage. So we spent a lot of time trying to get people more optimistic last year. At the beginning of this year we talked with them in a group that we probably felt we would be spending a fair amount of time getting people to be a little less optimistic than they wanted to be. What kind of took me by surprise in the first quarter is that we kind of went through that cycle a lot faster than I thought we were going to. When we saw the flush of data from the fourth quarter in January and February, it was clear that the fourth quarter was strong, consumer spending was good, good holiday season, you kind of had economic numbers across the board were positive, robust, and strong and our fear at the beginning of the year was that people were going to say – well that's how it's going to be the whole year. And we frankly felt that what we saw in fourth quarter was probably kind of a makeup quarter for the soft patch we experienced last summer and we were concerned people were going to misinterpret it and say – well the economy's even growing more than 3%, it's growing north of 4%, it's going to be a robust recovery. And you saw that kind of happening in the first couple of months and the data supported it. I think in March what you began to see was data that began to soften relative to the increase that you'd see in January and February. Still good data but it wasn't quite as good and it certainly wasn't so good that you could really think 4% and 5% were possible and so we actually were watching some of the peers in our industry and in their forecasts, we saw them much more negative than we were last summer; by the end of the year they became much more positive about 2011 than we were, they were at 4%+. And now a lot of them are back to being more pessimistic than we are, kind of like 2.5%. It's an interesting phenomenon. So to answer your question we saw stronger economic data in January and February than we saw in March. March was still pretty good, but for us that just supports the notion that we're in a 3% very mediocre growth pattern – mediocre but positive.

NATALIE So as we think about the headline-grabbing events that happened during the first quarter, certainly the March 11th earthquake in Japan is top of mind with a horrific human toll. Do we have any thoughts…you had mentioned perhaps a long-term impact of that situation…on that markets, on the economy?

ERIK It's hard to actually be able to be real confident in your ability to actually understand that because there are a lot of unknowns. But there are a lot of knowns, too. What's known is that Japan is 8% to 9% of the world's economy. What's known is that they are going to experience a negative impact by this disaster. And that negative impact has to do with the nuclear nightmare that they're dealing with but it also has to do with the fact that they've had rolling blackouts, they've got 10% of their electric grid down and that's an issue for them. That has real meaning. Plus other infrastructure has been damaged so you have this feeling that you're going to see some pretty profound negative impacts on the Japanese economy, probably in the 3%-5% maybe range. But again that's 3% -5% of 8%-9% of the world's growth. So the global growth forecast, GDP growth forecast for the globe is close to 5%. It's

not non-existent but it's probably pretty small, like .2-.3 tenths of a point on global growth. But the flipside of that is they're going to rebuild and that rebuilding is going to be quite stimulative economically, they're going to put people to work and they're going to rebuild train systems, electric grids, their factories are going to get back up and running and a lot of them are already back up and running. So you're probably going to see a duck-down for a quarter or two then you'll probably see an acceleration in Japanese growth based on the building. I think one of the things that people are most concerned about is the dependency the rest of the world has in certain industries – cars and electronics are two of them – where Japan is a big parts producer. And you're beginning to see stories in the US that some American manufacturers and non-American manufacturers are beginning to have some supply side difficulties with parts and that's preventing them from finishing goods. I think Japan knew that was probably the biggest impact and I don't think it's coincidental say for the car companies, they have multiple factories down; the first factories they brought online were the parts factories. Those were the first and they did that intentionally because they have a competitive advantage in a lot of those part manufacturing and they know that if they're down for a long time, people are going to find new suppliers in Malaysia, Vietnam, Cambodia; they're going to go someplace else. So Japan made sure to try to get that up and running as quickly as possible. So in the long run negative economically for Japan in the short run but in the long run I think you're going to see some growth as a result of the rebuilding and maybe it will be kind of the rallying cry that gets Japan out of (to quote Jimmy Carter) the malaise to a large degree that they've had. They've really been in a recession and a very low growth environment for the last two decades. Maybe this is kind of a call to arms nationally and certainly the prime minister is trying to make it that.

NATALIE And the uprisings in the Middle East and North Africa contributed to significantly higher oil prices. At what point do you start to worry about oil getting too high? When does that start to derail the global economic recovery?

ERIK Yes, at some point it does. Now what we saw the last time we saw oil go up – and particularly when we saw gasoline go up – in the United States what we saw was when gas gets north of $4 a gallon people change their behaviors. They buy different cars, they drive less, they carpool more; they change their behaviors. So I think $4 is a meaningful number. Going over $4 and coming back is not a big deal; isolated pockets – California in many cases is already over $4 a gallon but that's taxation, that's tax policy, we in Washington are awfully close to $4 a gallon with the fairly high gas taxes as well – oil, I would say a sustained period of over $125/barrel is probably the thing you're going to want to watch. It's not what the Fed thinks is going to happen, it's not what a lot of experts think is going to happen, but at north of $125/barrel you're probably in for an extended period, spike's over, not a big deal, but extended periods over…you're going to see a substitution effect, not just with consumers but kind of a change in behavior of manufacturing and a lot of other industries and that change in behavior is going to reduce the growth rate. That's kind of what I would watch. It's not expected to happen at this point but another couple of shocks and a major oil company actually going down in production, where their production actually goes offline maybe enough to push it over…

NATALIE So as we move into the Euro zone area, it was surprising to see that Portugal, Ireland, Italy, Greece, and Spain all had positive equity returns for this quarter. Countries that have been in the news –

ERIK And more or less strong rebounding…

NATALIE Yes. So while that was surprising there are still wash points in that area. Can you talk a little bit about that?

ERIK Yes, I think the one thing all of us have learned in the last few years is that it is enough actually that the worst-case scenario doesn't come true for assets to actually benefit. I think what the market is saying is that it isn't exactly great in those countries right now, but they did fall off the end of the earth so they're more valuable than we thought they were going to be. It's similar to some of the stocks that you saw rally really hard in 2009 – where the best thing you could say about them was well, they're not going to go out of business tomorrow, same kind of thing. So you have that rally. But they're not out of the woods. We've talked since this started that our biggest concern was this is a political issue. It is the financial issue, the economic issues, the economic strategies to deal with these issue are pretty straightforward. The people who make the decisions know what they need to do, they know it. And they know they need to do them. The problem is that with the political environment to which they face, they may not be the people who actually make the final decision because they may no longer be in power. You're seeing that play out in Portugal, right? In Portugal they're trying to live within their means, they're trying to find a budget that they can actually kind of meet the requirements of the core European countries (Germany for instance); the Germans think that you've done enough pain, you've kind of experienced enough pain for us to give you your money, give you our hard-earned money. They're trying to reach that; they couldn't do it. They're having an election because they couldn't actually reach a budget deal and now actually in the election cycle the European Union is now trying to broker directly a political deal with the opposition party and the party in power, during an election cycle which…that's big stuff. I'm not sure they can do it. You've got this political issue, we've talked about it right? At the end of the day the solution that probably will be implemented is a three-prong solution and it's one of those King Solomon kind of solutions – everybody experiences the pain. The way it works is that healthy core Europe writes a check, they basically make good the bad debts to some degree. The next thing is the countries like Portugal and Spain and Ireland actually live within their means, Greece…live within their means. They were living on borrowed money; they can't do that anymore. They've got to live within their means and they've got to prove that they can do that that's going to be painful. And then the last thing is the creditors. So some of the bond holders, there's going to be restructuring of that debt in some form, so they'll take a haircut too. So everybody experiences the pain. What's we're seeing now in Portugal, Greece, the political turmoil is they actually have to take their pain first. They have to show that they can live within their means and that's going to be a messy process. It's going to be a messy and painful process but at the end of the day there's every reason economically to do it and the leaders know it.

NATALIE We anticipate it will – should happen.

ERIK That's the problem. The folks I work with are all economists and they believe in the rational man. I don't think politics is completely rational, that's a problem.

NATALIE You had mentioned earlier Russell's outlook coming into 2011. Given the events of the first quarter I wonder if we could hit on a few of those outlooks and discuss whether we've made an adjustments or changes to them. So – inflation. Inflation's in the news a lot, we were thinking mediocre, moderate-low, inflation coming into the year. Has that changed at all?

ERIK Not really, no. Now inflation is something you have to be – now we're getting to the point where when we talk about inflation we have to be very specific about where we're talking about inflation. If we're talking about inflation in the US, we're not that worried about inflation. In fact, when you look at the implied expectations of inflation in the Treasury inflation-protected securities market, if you kind of back it out and say – what's the implied inflation rate the market thinks is going to happen over the next five years, we're at 2.36% at the end of last month. So the market's not thinking inflation's going to be a big deal in the coming few years. That's in the US. And there's a reason for that. One is in order for inflation to really become an issue, you got to have a combination of three things. One of them has to be unbelievably strong or all three need to be present and usually at least two out of three need to be present

for inflation to happen. Number one is you need to see upward wage pressure. Well, in order to have that you generally need a tight labor market. We have unemployment just south of 9%; we don't have a tight labor market. Wage inflation is awfully hard to see. It's not very good for a lot of workers but it's hard to see. The other thing is capacity utilization – how much of your overall capacity economically are you using? Think of it as a factory – are you using 70% of the factory's capability or are you using 90%? Because if you're north of 90% and you see demand increase, you got to build a new factory (laughter). And then you got to hire a bunch of people and that's going to be inflationary eventually if enough people do it and they do for a longer period of time, they'll create their own wage inflation, they'll create inflation in every other thing in the marketplace. Plus they'll probably like to have pricing power so they'll be able to price things, so you got that; we're not there, we're in the mid-70s so we got a long way to go there. And the last thing is you need credit creation to be liberal. I don't know if you've tried to get a loan in the last six months or the last three years but I know people who have, some of my friends are developers and business people and what they'll tell me is – it isn't easy to get a loan, it's just possible now (laughter). Which I don't think means we have credit creation happening at an unbelievable rate, we don't have that. And without that it's hard to see inflation, and that's why I think the market's pretty benign in its inflation expectations. It's a little different in Germany. Their capacity utilization numbers are up and they're getting some wage pressure in Germany. So they've got a different issue which is probably why Trichet – the head of the European Central Bank – actually raised rates. It was because they've got to keep the German engine running because Germany's got to write a check and it's in everybody in Europe's best interest to make sure Germany's healthy enough to write the check. That's my kind of massive over-simplification of what's going on there. And then emerging markets, inflation's an issue in emerging markets. Because commodity prices are up, commodity prices are up and if you think about the percentage of your overall discretionary budget and the people on the phone that you spend on energy and food, it's significant, but it's not anywhere near as large a portion of our daily expenditures as it is in the emerging markets where food and energy costs dominate, in many cases, their budget. When those prices go up, that's an inflation issue for them.

NATALIE Because they're a lower percentage of our budget within the US…?

ERIK Yes, that's the thing and a lot of people look at price rises in commodities and they say it axiomatically has to be that you will see inflation. If you think about it from 1999 to 2007 or July of 2008 actually, we went from oil at $9 a barrel to $147 a barrel. The CPI showed none of that; that was the core CPI. It showed really almost none of that. What that meant was either companies took margin hits or they became more productive.

NATALIE And core CPI is CPI without food and energy? Because those two are pretty volatile…

ERIK Yes! Not for great reasons but they came down, yes. If you listen to us talk we have basically said it's going to take an interminably long time for unemployment to come down; it's certainly taking a while but it's actually happening quicker than we thought it was going to. Unfortunately I think probably for the wrong reasons. It's not happening because we're creating lots of jobs; it's happening because a lot of people…normally what happens in an economic cycle is in a recession there's a point at which people who are out of work just give up looking for a job. And they don't actually show up anymore on the unemployed charts. When the economy picks up and job creation begins to happen people go – oh well, now I can try because there's actually…like the loan, right, it may not be easy to get a job but it's possible. We don't seem to be seeing the numbers of people coming back into the job market that you would expect. And therefore what you're finding is that number's a lot healthier (the unemployment number)…I don't think that means fewer people in the country are unemployed, I just think it means that we've got more people employed and a lot of people just gave up. At some point they probably will return.

NATALIE And so we had envisioned a pretty slow, steady slog to get unemployment down considerably, a couple of years?

ERIK Yes, yes, 2012 and we're in the high-8's now, we're still probably very likely to be north of 7% in 2010. Two things on that. One, we're expecting about 200,000 jobs a month to be – on average, there's a lot of volatility in those numbers but 200,000 jobs in average for the remainder of this year and into next year to be created. You need about 150,000 jobs just to actually meet the new college and high school grads and new immigrants that come into the country, just the expanding labor force. So that's not a lot of jobs being created net on a monthly basis and that's why it's going to take a while to come down. But I think one thing I want to caution people against because we're human and tend to anchor on recent experience…and so I think there's a lot of people out there saying – when are we getting back to 4.5% unemployment? And what I would say to them, it seems pretty clear to me that the only way you get to 4.5% unemployment is that you pay a lot of people to swing a lot of hammers to build a lot of houses that nobody wants to buy. I don't think we're going to repeat that move. I don't think we need to see that movie again, I don't think it's going to happen so you really should be thinking about…you know it's funny…we talk about full employment as expressed by unemployment. So full employment should probably mean 6.5% to 7% unemployment. Ironically when I went to school that's what the numbers were. We've just kind of recalibrated because the number got so low. Normal isn't 4.5%; normal's probably 6.5% to 7%.

NATALIE So what's an investor to do with all of the market and economic news that they hear in the media? What does all of that mean to investors?

ERIK It's interesting if you think about it right? Let's think about the things we've talked about. We've talked about North Africa to some extent, right? We've talked about Asia. We've talked about the US. We've talked about Europe – and by the way we didn't even hit the US fiscal issues which I can assure you are on the minds of the marketplace. The deficit conversation and the brinksmanship to potential government shutdown was certainly – I don't know if I'd call it entertaining – but it was good theater. It was meaningless. The Republicans at the high end wanted to cut 4.5% of the deficit – not of our budget, of the deficit – the Democrats wanted to cut 2.5% of the deficit. I don't think there's a huge difference between those two numbers. If we're going to solve that problem we're going to solve it probably by controlling spending, cutting spending on the margin and increasing tax receipts. The best way to increase tax receipts is to have the economy grow. That's interesting, right? So the US, Europe, North America – what it kind of tells you is a really well diversified portfolio might make a lot of sense and not just diversified across equities and bonds but diversified across regions, across instruments, across real assets and publicly traded assets. Which of these risks is going to kill us? I don't know. I doubt any of them are going to – they may hurt a lot but I don't know which ones and when. All I know is that my best bet of remaining kind of whole is if I own a lot of different things and the likelihood of everything getting hit at once is there, it's just probably not real likely. And if that does happen I'm not sure what you do about it.

NATALIE Well you certainly don't make rash decisions based on headlines in the news today.

ERIK No, absolutely not. All that political risk, all that headline risk, all that CNN coverage, all that CNBC coverage, the US equity market was up 6.5% last quarter. It is oftentimes not what people think is going to drive…Portugal, right? Almost universally bad coverage about Europe, unfortunately nicknamed PIIGS…and they were some of the strongest performing equity markets in the world last quarter. It's not always the headlines that drive performance.

NATALIE Great, thank you Erik.

ERIK Thank you very much.

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First used April 2011. RFS 11-5722