

Transcript of the January 20, 2012 Market Update for Investors

Natalie Thank you for joining us for our January 2012 economic and market outlook call. We're calling from a snowy and icy Seattle area here the afternoon of January 20th. I'm Natalie Miller, Consulting Director with Russell U.S. Private Client Services and today I'm joined by Mark Eibel, Director of Client Investment Strategies. Thanks for being here Mark.

Mark My pleasure.

Natalie It's the start of the New Year and with that comes an opportunity to answer questions of what may be in store for investors in 2012. As Mark and I spend time with advisors and investors, the primary questions we get deal with economic uncertainty around the globe. Over the next 20 to 30 minutes we'll review 2011, discuss Russell's outlook for 2012 and what investors should be doing. Before we dive in let me remind you that investing involves risk with possible loss of principal and diversification doesn't assure profit and doesn't protect against loss in declining markets.

So as we look back at 2011 the terms risk-on/risk-off were used extensively to describe market movements and behavior, where market movements were being driven more by sentiment linked to political decisions than by actual market fundamentals. So Mark, can I ask you to put a little more color around the volatile nature of global markets last year?

Mark Absolutely, and I think the terminology of risk-on/risk-off is a perfect way to describe 2011. If we all just step back and think about the events that we have to process and deal with from a market standpoint, it really started in a volatile nature with the tragedy and the earthquake in Japan and it's hard to believe sometimes that was only last March, it feels like it was longer ago, but that was just March of last year. Markets obviously sold off in that period then had a sharp rebound and we went right into heightened concern over a problem that has been brewing over the last few years in the markets, being the European crisis, and that kind of came to a head. Markets had a pretty dramatic sell-off in the May-June timeframe, a sharp bounce back. Then we enter into the summer where the European crisis not only heightens but with our debt¹ going from AAA to AA and what the ramifications of that would be, which really resulted probably in the longest slide down for the year in mid-July until the end of September. So right about this point you've had three opportunities as an investor to say that's it, I don't want to be involved in this market anymore.

¹ August 5, 2011, Standard & Poor announced their lowering of the long-term credit rating on the United States of America to 'AA+' from 'AAA'

You had rebounds after each one of those, the sharpest one being in October where October was one of the strongest months we've seen in decades...only to have talk of the Greek referendum. You have MF Global and their situation at the end of the year So risk-on/risk-off and is absolutely the perfect way to think about it.

A colleague of ours, David Crowder, sent me an email right at the turn of the New Year and I can't remember the exact number but I know it was over 3,000 where the S&P 500[®] essentially finished flat for the year and yet the S&P moved about 3,000 points throughout the entire year to get to flat by the end of the year. So if it was a year where you just kind of had your asset allocation you went away for a year and didn't follow the market then you came back you'd go – boy, looks like it was a pretty calm year – but all of us that were in the markets know that it was obviously not. That type of an environment where it is much more driven by the events that we see going on around the world, not necessarily whether I own fundamentally strong stocks or bonds in my portfolio or not, those news items drive how the markets do and again, give more opportunities for all of us as investors to act reflexively, and usually we do that in periods of stress or down markets, not necessarily when they go up.

So I think one of the best ways, and the way I've described going into 2012 when asked is – I'm just glad that it's not 2011. From a return standpoint particularly in US markets, again I mentioned it was flat. It's not as if the returns themselves, it wasn't the type of returns we saw during the recession for client portfolios; it was just that constant whipsawing in the marketplace that was just, quite frankly exhausting for all of us as investors and a turn of the calendar in many ways is certainly a welcome one in investment terms this year.

Natalie

So at the start of every year our strategists and economists put together a global forecast for the coming year. Can I get you to comment on our outlook, specifically for the US, Europe, and Asia?

Mark

Yes, and I think as a strategist this is one, and I've read other firm's as well and I kind of got the same sense. This is one of the more difficult years in order to do the outlook. You can look out on many things. I walked through many events where you go boy, that was a one-time event, that can't happen again or that won't happen again. And in that kind of cases if some of the headlines just calm down, I think there's a lot of reasons to say the outlook is pretty positive for the markets and for equities in general. However there's one very large event and to put it in statistical terms, we call it a left tail event and what that simply means is left tail events don't happen very often but when they do they're very negative. That obviously being – what happens if Europe not only doesn't get better but actually even gets worse from here? As a strategist team we have to balance that. I see a lot of things that can go one way, markets are fairly valued, I talked a little bit about Europe and how undervalued it is

now, but boy I've got this one scenario on the other side that wipes all of that out if it happens.

So, we start the outlook for 2012 in late-November in order to have it available for clients at the beginning of the year. At that point we thought our outlook for 2012 – again more from an S&P 500 Index standpoint – was going to be around 1300. Well anybody who follows the market closely realizes we just crossed over that on the upside a couple days ago. So the outlook is 1300 which again, if I'm listening to this call I'm going – that sounds like a pretty cautious outlook particularly since we already hit it but it's that weighing of boy, what happens if just one negative event happens? So when I look at our outlook I think of it as we want to be cautious in our outlook to equities yet we have an entire laundry list of things we write about in our outlook that says – but here are the things that might go our way. So it's cautious with more of a bias to it possibly moving up throughout the year. It will be very interesting I think come June when we do our updates to see what we do to our equity number. But we're rather cautious in that number and we'd rather be cautious obviously and come in above it than be too opportunistic and see something like Europe.

As it relates to Europe I think it has been interesting already this year. We're continuing to see lots of news out of Europe. S&P just came out and downgraded a number of countries in Europe including France, and the markets in Europe actually reacted flat or some of them went up that day. And while it has been widely known, that these changes were going to happen, I think if they had happened even three or four months ago, any news like this in Europe would have been enough to take their market and probably our markets down pretty dramatically in one day and yet the markets reacted kind of flat or moving up. And I think what the markets are telling us in Europe, there certainly seems to be the right people and the right focus and maybe the right amount of money being discussed by whether it's European leaders, whether it's their Central Bank, whether it's the IMF which is being talked about – the focus is there. And once markets see that the focus and an attention is being given to a matter, they have more confidence that okay, the resolutions are going to start. Now is Europe going to be messy, is it going to take years to really resolve things and to find out if we get any traction here? Absolutely. But unlike other points during this crisis over the last few years it just seemed as if they weren't giving it kind of the due that I think the marketplace thought it needed, that seems to have changed and we see that happening right now in how the markets are responding to Europe.

Natalie

What about recession possibilities, both here in the US and in Europe?

Mark

Yes, let's talk about both. First let's start here, an awful lot of talk about recession last summer. I know when I did a lot of speaking at events that would be the first question. At Russell we assign our own views of that with Mike Dueker our chief economist who spent 12 years at the St. Louis

Fed as our chief architect and voice on that. I think Mike was right on with this one, he had assigned a lower probability to a U.S. recession than most people in the industry, we were more in that 20%-25% camp that a recession would happen. I think many people were above 50%. What's interesting is that we moved forward and we're certainly not having huge growth that we would like to be seeing at this point coming off of recession but we think we'll grow at about 2.5% GDP this year, which certainly sounds a lot better than zero which is what people were starting to talk about in recession talk last summer. Many other strategists have kind of come to our view and their percentages about moving into a recession are very much in line with ours now. So I think we were ahead on that and might be able to check the box that we got that one right relative to others.

As far as jobs are concerned, we think approximately 180,000 jobs a month will be added to go along with that growth, which again isn't a great number but to put it into perspective during the recession we were losing 600,000 to 700,000 jobs a month, so it sounds a lot better than that and then some folks saying zero job growth and we certainly saw zero jobs for a few months last summer so 180,000 in that context sounds pretty good but it really only starts bringing that unemployment rate down very slowly because about 125,000 to 150,000 jobs are needed just to take into account our kids and immigration, positive numbers of both that enter the workforce. But we'll say US growing at about 2.5% so that's group number one that you had mentioned.

Let's talk about Europe. We agree with many others that Europe is probably in a recession right now, we just don't have the numbers yet to show that, if not they probably collectively will be in a recession, meaning their economic growth will be below zero. We think it'll be a rather mild recession and it'll obviously hit some of those countries harder than others but when you look at the economic engines of the world so to speak, and I like to just put it in terms of three large pies. Let's talk the US economy at \$15 trillion or so growing at about 2.5%; we'll call Europe, the 17 countries plus the 10 peripheral countries around it that kind of make up the 27 countries in the Euro Zone which collectively the economy is a little bit larger than us, we'll put them at zero or maybe slightly negative for the year. And then the third group is led by China which just reported their fourth quarter GDP came in at an annualized rate of 8.9%, we'll roll them up with the rest of the world and we're kind of in that 5% camp for that group. Again, as long as two of those three groups are at least firing on some cylinders, it's enough to keep the global economy going and I think get through it despite the fact that Europe – at least right now – won't be participating in that. If they can get some of their growth plans on board along with austerity, hopefully that'll be a short-lived recession and then we can start talking about a true global recovery with all three of those large groups participating. But right now it's going to rely on two of those engines working, not all three.

Natalie

One of the most frequent questions we get has to do with investing in markets outside of the US. Investors see the recent returns of US versus non-US equity and question the validity of continuing to invest outside the US or moving outside the US with their investment dollars. Can you spread some commentary around of why we still believe in the benefits of investing outside of the US?

Mark

Absolutely! In hindsight the US was one of the leading performing countries, our economy so to speak last year. The market certainly reflected that. If I could go back in time I would love to have all assets in US last year and not other parts of the world, but you obviously can't manage assets looking back. If you look at say over the last 40 years on US markets versus non-US, it's pretty close. The returns are quite similar between what you get being in one or the other and the benefit that you get from having not only exposure to one part of the world but having it to all is the overall risk or standard deviation, to use technical terms. It's lower if you have it broadly. So that hits on part of it.

I think the second one – and I don't think people sometimes realize it – but those swings can change rather dramatically. Just take yourself back a few years ago, particularly we were starting to go through, we kind of kicked off this global recession and at that time there was an awful lot of talk about – why would you want to have any money in the US? I want my money elsewhere, and yet two years later people are now starting to say – why do I want my money elsewhere? I'd rather have it in the US. So you can make that swing back and forth and obviously what people will do is sell one or the other at exactly the wrong time so we would much rather have exposure to all those areas.

People hear international and global and because it's in the news so much they think – well, that equals Europe. I'd just like to remind folks that also includes Canada, Australia, Japan, South America...it isn't as if it's all Europe, that's point number one. And point number two, they are companies that happened to be located in Europe but their client base isn't necessarily leveraging Europeans.

Again, US, non-US will go in and out of favor with each other, they have over my entire 25-year career, that won't change moving forward. I think when you're looking at it, looking back over many years the more consistent return pattern and being at the right places and having those right kinds of strategies is a better way to build and allocate a portfolio rather than trying to guess, well next year which one of those markets is going to win or lose?

Natalie

As investors look forward in 2012, knowing that volatility will likely be a constant companion again, what would you encourage investors to do or to be thinking about?

Mark

Yes, that's a great question because I do think there will be things that happen in 2012 that didn't happen in 2011 and vice-versa; the only consistency that we will see is I do think volatility is here to stay. My best advice and if this is what you take away from the call, this is more important I think than anything I've said from an investor standpoint is... before you make a drastic move in your portfolio, before you hear somebody from Russell or somebody else in the media in three or five minutes give a point on something and go wow, that person makes sense, I want to do what they said and then five minutes later on the same program somebody comes and gives a completely opposite view and you go well that person made sense, I want to do that... just talk to your advisor.

When markets are volatile it gives us more opportunities to act emotionally, act on things that we hear and make drastic moves sometimes in our portfolios. I just encourage you to take a step back, talk to the advisor that you're working with and say – does this make sense for me or not? Hopefully you all have a plan and if it fits into that plan and it's the right move then together make that move. Volatility will be here; just don't let it control you and stick to your plan and things will hopefully, we think, in the long run you'll look back and have made more right decisions than wrong ones and be able to fund those dreams and goals that you've set together with your advisor.

Natalie

Thanks Mark, I certainly appreciate all of your comments and commentary. So in summary Russell continues to believe that strategic discipline will lead to diversified asset allocation and active management will be primary contributors to investor's long-term portfolio returns and the expertise and guidance of their financial advisors will keep you investors on your path to meeting your long-term financial goals.

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Mark

My pleasure, thank you.

Natalie

And that ends our call.

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