

# 10 for 2010

*2010 Global Market Outlook*

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# Executive summary

## 2010: A year of transition

Take a deep breath and settle in, but hold your resolve – we're in for another interesting year as the global economy transitions from recovery to an uncertain longer-term trend. After last year, we could all use some rest. Thankfully, the market produced more 'ups' than 'downs' in 2009 and the global economy appears to be on its way to recovery.

One thing we can say for sure is that 2010 will be markedly different than last year. 2009 contained plenty of challenges, but it also provided some remarkable opportunities as valuations on assets such as equities, property and credit hit extremes early in the year. Valuations have now returned to broadly normal levels, and investors should target broad diversification.

Our view is that 2010 will be dominated by a range of macro themes that cause spikes in asset return volatility against the back drop of an improving economy and generally positive market outcomes. This means it will be just as important to be patient in 2010 as it was in 2009 – perhaps even more so. It will be tempting to take action, but patience and prudent risk-taking will win in 2010.



## Guide to selected asset class views

Asset class	Valuations	View	Upside risk	Downside risk
Equity	Normal-ish	Modestly positive	Last leg of the risk trade as cash returns to market	An inflation or a growth scare
Credit	Normal-ish	Modestly positive	Last leg of the risk trade as cash returns to market	Sovereign risk erupts or a scare as above
Global sovereign debt	Expensive	Negative	Deflation and/or double-dip fears drive yields lower	Major downgrade or default (i.e. Euro PIIGS <sup>1</sup> ), inflation scare
Australian Government bonds	Normal-ish	Neutral	RBA rate hikes & strong AUD stall economy later in the year	Economy stays strong and RBA hikes by more than expected
Commodities	Expensive	Negative	Stronger than anticipated growth, inflation scare	Double dip scare or overstocking
Currency	USD cheap	USD should appreciate.		
Overall Portfolio	Diversification will 'win' in 2010			

<sup>1</sup> Portugal, Italy, Ireland, Greece and Spain

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## 1. The shape of things to come

There has been a great deal of discussion surrounding the 'shape' of this recession and subsequent recovery. Specifically the use of alphabetic symbols to describe forecast economic growth; 'V' reflecting a steep downturn and steep 'snapback' recovery; 'U' describing a more gradual entry and sub-trend exit; and the double-dip 'W'. If granted a little latitude in the list of symbols, the square root sign seems our best candidate. With this symbol we capture the steepness of the downward entry into the recession following Lehman's failure and the rapid and widespread deleveraging in global markets. Similarly it captures the steepness in the equity market recovery as financial Armageddon was avoided.

The most important factor in making the square root sign our symbol of choice, is the relative 'flatness' that seems likely to follow, as seen in forecasts of the business cycle index. There is a fairly high likelihood that both investors and the media will worry about the double dip 'W'. However, the unprecedented amount of policy stimulus should provide a bridge until the consumer returns, albeit slowly. Dysfunctional credit markets make the potential for a V-shaped recovery less likely, but there may be a silver lining here. The slower recovery and the low probability of inflation (although fears may be rampant), may make a difficult task easier: the exit from near-zero interest rates and quantitative easing in the major economies. Central banks will need to keep one eye to price stability and one eye to not stalling recovery as they withdraw liquidity. This delicate balancing act will be easier in a slower growth environment.

Our square root sign scenario suggests markets may be characterised by dynamic 'risk on/risk off' behavior in asset returns and likely volatility in commodities as markets attempt to accurately price the uncertain trajectory of future growth and earnings. This environment will suit a portfolio that favours dividend stocks while maintaining a measured exposure to more risky assets. In 2010 patience and a disciplined investment perspective will be critical to navigating the potential volatility, while we watch macroeconomic data including inventories, CEO and consumer confidence, and capacity utilisation to gain a measure of insight looking forward.

## 2. Zimbabwe or Japan: inflation or deflation?

In considering whether inflation or deflation will be seen in 2010, the most likely answer appears to be neither really. Fears of uncontrolled inflation didn't take into account the tools available to the Fed to wind back its balance sheet, and the demonstration of its resolve to avoid sustained deflation as seen in Japan.

Two years ago, when the US unemployment rate was 4.7 percent, the suggestion that it would reach double digits would have been met with disbelief. This hasn't been called the 'Great Recession' for nothing. The Federal Reserve has needed to pull out all stops – cutting the short-term interest rate nearly to zero and undertaking a massive expansion of its balance sheet as further quantitative easing emerged. The priority has been to prevent a bankruptcy-inducing deflation. We believe the Fed has succeeded, although the ongoing declines in bank lending mean the threat of deflation has not completely disappeared.

On the flip side, the USD1.3 trillion increase in the Fed's balance sheet since mid-2008 has some worried that monetary base growth will be inflationary. However, growth in broader measures of money and bank lending matter most for inflation, and this has been moderate. Nevertheless, banks will not sit on USD1 trillion in excess reserves indefinitely. As the economy recovers, banks will find opportunities to make loans. The Fed's balancing act is to keep the growth in total money supply high enough to sustain economic growth, yet have an exit strategy ready to remove reserves before inflation can take root. Fortunately, it has the tools to do this (for those with a technical inclination, a way to reduce bank reserves is through reverse repo sales of mortgage-backed securities).

Inflation anxiety should diminish as the Fed's balance sheet starts to shrink in an orderly fashion. Inflation fears already seem well contained – inflation linked security yields predict inflation below two percent for horizons up to 10 years.

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### 3. Low for really, really long

According to market pricing, the Fed will have lifted the funds rate by around 100 basis points by the end of 2010. However, we expect that the Federal Reserve will not raise the fed funds rate until 2011. What are the reasons for Russell's non-consensus view?

It's important to keep in mind that economic slack really does help hold down inflation. Any reasonable measure of how far the unemployment rate is above normal suggests that inflation is likely to be held in check. We anticipate a jobless recovery in the sense that it could take a full year between the time GDP growth turned positive (third quarter 2009) and the resumption of consistent trend employment gains of at least 150 thousand jobs per month. Unlike any previous recovery, the Fed can tighten monetary policy for a time by undoing its quantitative easing (shrinking its balance sheet) without raising the fed funds rate.

At some point, interest rate hikes will be necessary, but that moment is not imminent. Furthermore, it is not clear how soon the Fed will start to shrink its balance sheet. The announced plan is for the Fed to finish its purchases of mortgage-backed securities from Fannie Mae and Freddie Mac by the end of March 2010. However several Fed policymakers have indicated that the Fed might want to stretch out the remaining purchases or even increase the target level of purchases. The Fed's support to the mortgage market in the past year has been crucial to the market's functioning and helped prevent even greater declines in house prices. Finally, a relatively steep yield curve (i.e. low short term interest rates) should help the banking system recapitalise itself and reduce the number of bank failures. The Fed is in no hurry to see the yield curve flatten.

### 4. Look out for leverage

One of the key features distinguishing the current economic and financial landscape from that of previous cyclical turning points is that we are now in the throes of a massive deleveraging process. Individuals are consuming less and saving more, firms are focusing on balance sheet issues, and financial institutions are restricting lending while they dispose of non- or under-performing assets. Unwinding the huge amounts of financial leverage built up globally over the past several decades requires a long workout period, and suggests that the current recovery will take longer than normal to really gain traction. Moreover, when it does, we will most likely see lower overall rates of consumption, borrowing and lending that could result in comparatively mediocre rates of growth. In the meantime, the only entities in the economy that have the ability to consume and lever-up are governments, and they have spent most of 2008 and 2009 doing so in earnest. If they feel the need to continue such supportive fiscal policies in 2010, there is some question whether they will have much room to do so. (See *Let the Grandkids Pay For It*)

If growth will be lackluster in 2010, there is a risk that investors currently counting on a rapid recovery in corporate earnings, credit creation and household consumption will be disappointed. If so, this could mean a volatile year in risky assets on the heels of such a strong 2009. While the banking system has staved off outright collapse and central banks have played a crucial role in keeping balance sheets relatively healthy and providing much-needed liquidity, evidence so far suggests that lending remains severely restricted. Opinions differ as to whether or not this is due to banks' reluctance to lend or would-be borrowers' reluctance to borrow. Nevertheless, the fact remains that the credit channel is still weak. It is difficult to envision rapid economic growth in the developed world with an under-functioning credit channel and consumer restraint.

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## 5. No more easy credit

At Russell, we have been credit bulls for the last year and a half. While initially, this view came under great stress, the recovery in corporate debt markets in 2009 has been heartening. At this juncture, we feel it is prudent to reconsider this position. Looking to early 2010, we still think that cyclical momentum will work to the benefit of the asset class in the short term. Corporate earnings are continuing to show a much-welcomed recovery, risk aversion has declined to acceptable levels and demand for corporate credit is healthy. These factors should all conspire to keep credit's upward momentum on track, even if the occasional bump in the road should present itself.

However, as we move into the middle of 2010 and beyond, we think that the story in favour of credit could become less compelling. Valuations, which a year or so ago were pricing in default rates worse than those observed in the darkest days of the Great Depression, are now approaching much more 'normal' levels. Two of the underlying themes driving our 2010 outlook are that global economic growth might well be subdued and ongoing deleveraging will crimp demand for new debt. Credit spreads will probably settle down but remain at levels that provide a sufficient risk premium for holding this asset class. However we suspect that the argument for holding credit in weights above a neutral strategic asset allocation will be increasingly hard to make.

## 6. Let the grandkids pay for it

In the past year, governments' fiscal responses to collapsing demand have been impressive to say the least. We remain agnostic as to whether 2010 will present the need for additional fiscal stimulus, or if political, institutional or financial constraints would allow for such measures. We do feel that the massive spending undertaken in 2009 will prompt vigorous discussion of the long-run sustainability of governments' budget positions and fiscal solvency.

While considering this question, we advise readers to recall the difference between government deficits and debt. The former refers to the shortfall between tax revenues and government spending in any one period that need to be addressed by borrowing. The latter refers to the aggregate amount owed (including principal and interest payments) by governments, and thus represents financial obligations on which they have to eventually make good. The former is analogous to the 'income statement' while the latter is a 'balance sheet' concept.

Many western governments have seen their income statements deteriorate to the worst positions since World War II. While some of these government balance sheets are still in acceptable shape, the gaping holes in their income statements – if allowed to persist for several more years – risk turning even 'decent' balance sheet positions into potential fiscal train wrecks. Furthermore, leaving aside the current record-high deficit spending, the liabilities that will come due to many western governments in the next few decades will also severely worsen debt positions. For example, demographic challenges will mean ever larger pension obligations and healthcare spending.

There is a considerable risk of tension between the competing goals of reducing the deficits and continuing government action to counter any lingering effects of the global recession. We suspect that how this tension is resolved will come into the forefront for investors over the course of the year.

Two historical analogies from the US are relevant here. In 1937, after four years of extraordinary government spending, the economy had begun to recover. President Roosevelt was forced into raising taxes and cutting spending in response to worries about the US budget position. Many argue that this fiscal tightening created a second downturn in the economy that persisted until the US's entry into World War II in late 1941. In 1992, one of President Bill Clinton's first major policy actions was to enact a far-reaching, but not overly draconian, fiscal reform. Many suggest that this measure helped assuage concern about the US's build up of red ink and arguably set the stage for a bond market rally and equity bull market. 2010 will present a challenge: how to walk the fine line between effective deficit reduction and growth-stifling fiscal austerity.

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## 7. Year of the tiger

Not surprisingly, Asia's strong share market rebound from the global financial crisis and robust economic performance is attracting a lot of investor interest. Ask any investor where the best returns will be over the next few years and the answer is likely to be emerging markets, and in particular Asia. With the developed economies facing an extended period of lacklustre growth amid deleveraging and balance sheet repair, Asia could easily develop into the 'next big thing' on the investment horizon.

Two factors stand out as favourable for Asian markets in 2010. The first is that sharemarket valuations are not overly stretched. Asia is not cheap, but metrics such as price-to-book value and price-to-earnings are not yet pricing in an excessively optimistic outlook for corporate profit growth. The second is that monetary policy across the region is likely to remain extremely accommodative as central banks maintain US dollar currency pegs. Central banks can either control their currency or their domestic monetary policy. By pegging to the US dollar, Asia's central banks are effectively importing the ultra-easy monetary policy settings of the Fed. As a result, money and credit growth are likely to accelerate across the region. This will most likely find its way into asset price inflation before showing up later in the year as higher consumer price inflation.

Yet Asia is not without risks. There is still a question as to whether the region can maintain robust economic growth in the absence of strong export demand from the developed economies. The region could also suffer a hiccup if inflation pressures and the potential for over-heated property markets prompt a strong policy response.

It's hard not to be impressed by the longer-term growth potential of the region, especially compared to diminished prospects for the developed economies. Investors need to remember the region's potential for volatility, but Asia stands out as one of the bright spots on the investment horizon.

## 8. Commodities – mind the gap

Commodities have bounced back strongly from the lows of March 2009 (the CRB index is up around 40 percent). Investors are once again mesmerised by the long-term demand prospects from rapidly growing emerging markets, especially China and India. We worry that rising inventories and sluggish developed world demand are being ignored in the rush to buy the long-run China demand story.

Despite the rebound since March, the level of G-7 industrial output is still 15 percent lower than at the end of 2007. London Metal Exchange inventories are high and rising for all the base metals. It's a similar story for oil – rising inventories and sluggish demand. We know that oil consumption fell by three percent across the Organization for Economic Co-operation and Development (OECD) countries in 2008, when economic growth was positive. The deep recession of 2009 is likely to have triggered a much sharper contraction in demand and a subdued economic recovery in 2010 means there will probably be a fifth consecutive year of falling OECD oil consumption. China and the rest of the emerging world will need to grow oil demand rapidly to offset the OECD demand shortfall.

Of all the commodities, gold is the most perplexing. Its rise has been fuelled at different times by fear of financial Armageddon and fear of inflation from money printing. Along with other commodities, it has received a boost from the falling greenback. None of these factors seem likely to be as supportive in 2010. Sovereign risk could amplify as an issue, but we're unlikely to revisit the depths of financial panic seen last March. Deflation seems more of a threat than rampant inflation, given the excess capacity in developed economies, and the scope for further US dollar weakness seems limited. At current levels, gold looks nothing like a safe haven asset; it could surge to USD1,800, but it could also easily fall to USD600.

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## 9. Don't write off the greenback

We do not expect a significant US dollar rebound during 2010. 'Low for long' Fed rates, deleveraging and an economy that needs to transition from consumption to more export dependence, all argue for an extended period of US dollar undervaluation. However, it seems that the pessimism about the greenback is overdone. For a start, the US dollar is already extremely weak. The Fed's real trade-weighted broad US dollar index has fallen 12 percent since March, and 24 percent since the 2002 peak. It is now near the previous lows of the past 35 years.

It's worth remembering that currencies are relative. For the greenback to sink lower, other currencies have to appreciate. The poor state of the European and UK economies make it hard to argue for euro or sterling strength; the euro is already close to the 2008 peak. Yen depreciation seems the only policy option left in Japan given the re-emergence of persistent deflation and the faltering economic recovery. China seems unlikely to abandon its de-facto dollar peg anytime soon, and with domestic inflation still negative, is under no pressure to revalue. This means that the People's Bank of China will continue to be the US dollar buyer of last resort.

The US dollar could even be one of the better performing currencies next year if the US continues its gradual economic recovery, firming expectations for an early 2011 start to Fed interest rate normalisation. So although it's hard to make a strong case for the greenback, it may win the 'least-ugly' competition and confound those predicting the end of the dollar-era.

## 10. Much patience required

Without question, 2009 tested resolve and discipline as investors weighed the probability of financial market collapse against the prospects of a global recovery. But while it was difficult to stay disciplined in the depths of pessimism during March, there were distinct opportunities and forecasts that saw a patient and disciplined perspective rewarded. The narrowing of credit spreads, the performance of investment grade debt relative to treasuries and the recovery in global equity markets serve as noteworthy examples. 2010 may reward similar principles but in a different way.

As we consider our '10 for 2010', a picture of a volatile and uncertain global economy and markets emerges with respect to the following:

- Balancing the holding of dividend yielding shares with a measured exposure to more risky assets amid the 'square root sign' shaped recovery.
- Recognising the opportunities of a perception of inflation risk without the material manifestation of inflation.
- The likelihood of major central banks maintaining low interest rates and instead curtailing quantitative easing policies to intrinsically tighten money supply with less risk of stalling the recovery.
- A new environment characterised by continued deleveraging resulting in muted levels of consumption and borrowing, leading to confirmation of lacklustre consumer spending.
- The end of the opportunities amid 'easy credit' as spreads have come in.
- Concerns and uncertainty surrounding the material increase in national deficits globally and in fiscal leverage. Will this look like 1993 or 1938?
- How best to take advantage of opportunities in emerging markets.
- Uncertainty as to whether global recovery and emerging market opportunities will provide upward pressure on commodity prices through the cyclical recovery.
- The fate of the US dollar and its role as the global reserve currency.

2010 is unlikely to offer the same distinct opportunities as 2009, yet a valuable lesson can be observed in the importance of discipline and process in investment decision making. The worst outcomes were suffered by those who lost discipline, panicked out of risk exposure early in the year and missed the

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subsequent rebound. Successful investors were distinguished by their rebalancing discipline and the use of rigorous decision making processes to take advantage of opportunities.

We expect that a well-diversified portfolio should generate a reasonable, but not spectacular, return in 2010. Most asset classes appear priced for moderate economic growth, which seems the most likely outcome. As the global economy transitions from initial recovery to still uncertain longer term trend, there is plenty of scope for renewed volatility as expectations shift. Investors will be well served by heeding the lessons of 2009.



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