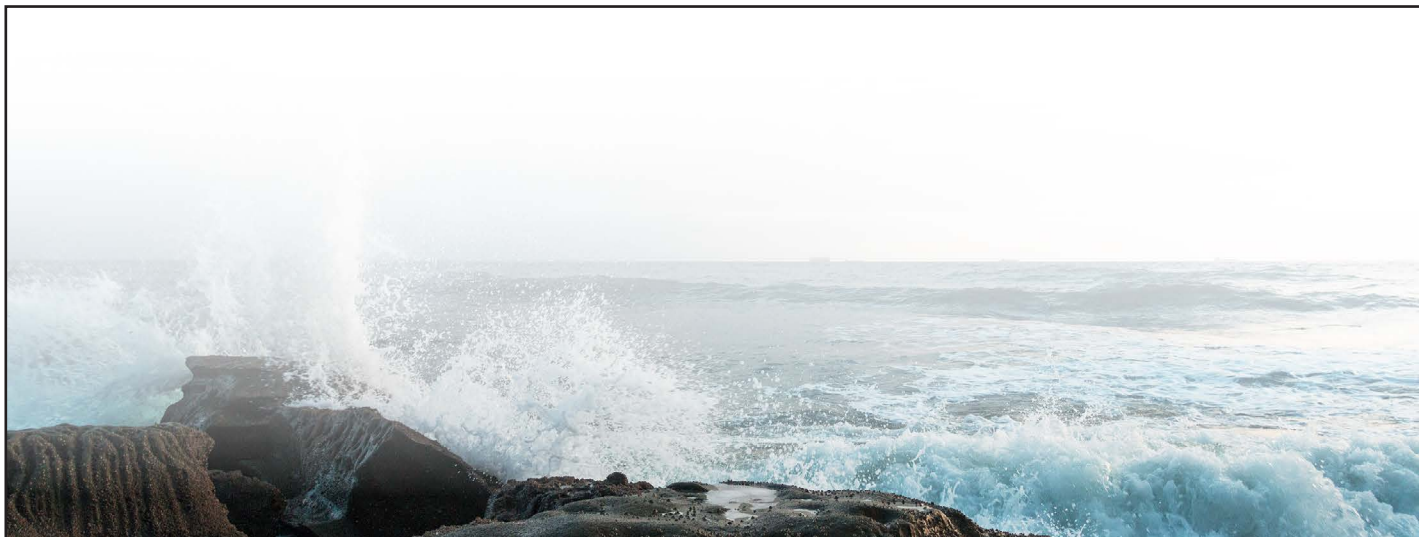


CYCLE, FURTHER
INTERRUPTED

Global Market Outlook – Q2 update





Cycle, further interrupted

The COVID-19 virus has stalled the mini-cycle rebound and made a global recession likely. The duration of the virus pandemic is unpredictable, but policy stimulus, pent-up demand and a lack of major imbalances argue for a solid upswing when the virus threat clears.



Our central case is that global growth begins to recover in the second half of the year as the virus outbreak fades.

Andrew Pease, Head of Global Investment Strategy



Introduction

"Events, dear boy, events" was how former British prime minister Harold Macmillan described the unpredictability of politics, and the same can be said of investment strategy. As of mid-February, our expectation for a global mini-cycle recovery was on track. Green shoots were apparent in manufacturing indicators and a *phase 1* trade deal had been agreed between the U.S. and China.

By mid-March, however, events had taken over. The virus outbreak has quickly progressed to an economic shock as governments across the globe enact strict containment policies. Borders have been closed, and schools and universities shut down. Markets are panicked by uncertainty over the duration of the virus threat and the extent of further containment measures. This has been compounded by fears that monetary policy has reached its limits with almost all central banks at the zero-lower bound¹. We expect that more aggressive fiscal stimulus measures will offset any shortfall in monetary firepower. The main uncertainty is the duration and depth of the virus-induced recession. Our central case is that global growth begins to recover in the second half of the year as the virus outbreak fades, but expert medical opinions on the longevity of the virus threat vary.

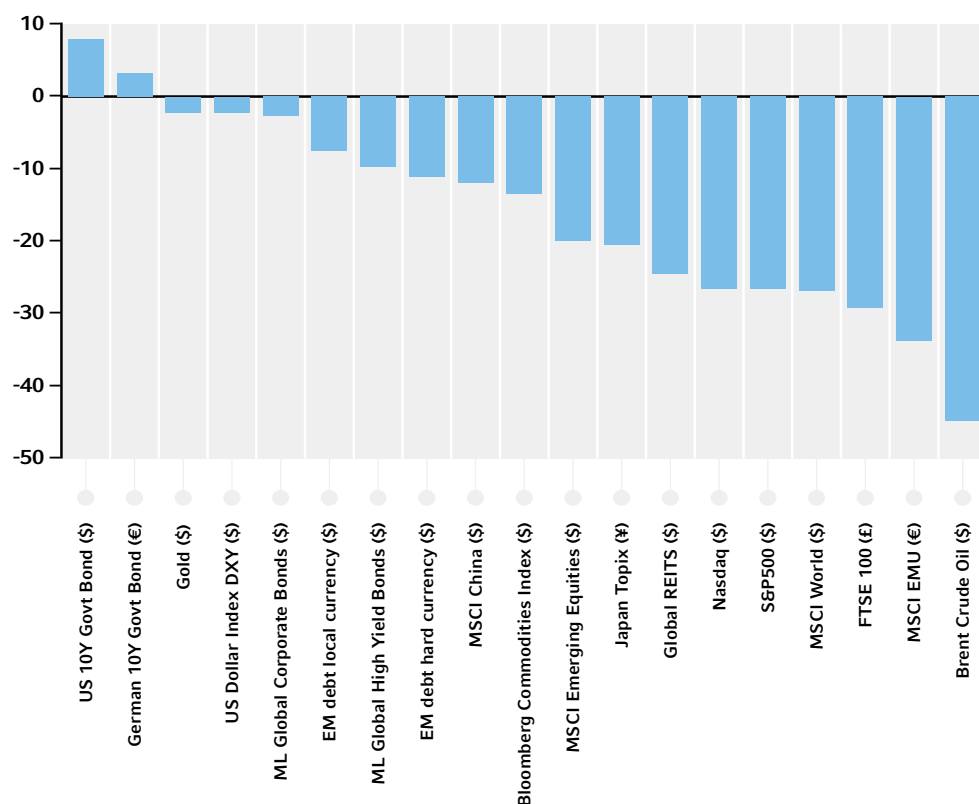
Confidence should recover on the back of substantial stimulus once the virus 'all clear' is given.

Andrew Pease

The chart below shows that the result has been a severe risk-off event since the U.S. equity market peak on February 19.

¹ Zero-bound is an expansionary monetary policy tool where a central bank lowers short-term interest rates to zero, if needed, to stimulate the economy. A central bank that is forced to enact this policy must also pursue other, often unconventional, methods of stimulus to resuscitate the economy.

Coronavirus impact on asset performance / From S&P 500® peak on February 19, 2020 through March 12, 2020



In USD unless otherwise indicated.
Source: Refinitiv Datastream, last observation March 12, 2020.

2020 recession now likely

Containment measures around the world are having a large economic impact.

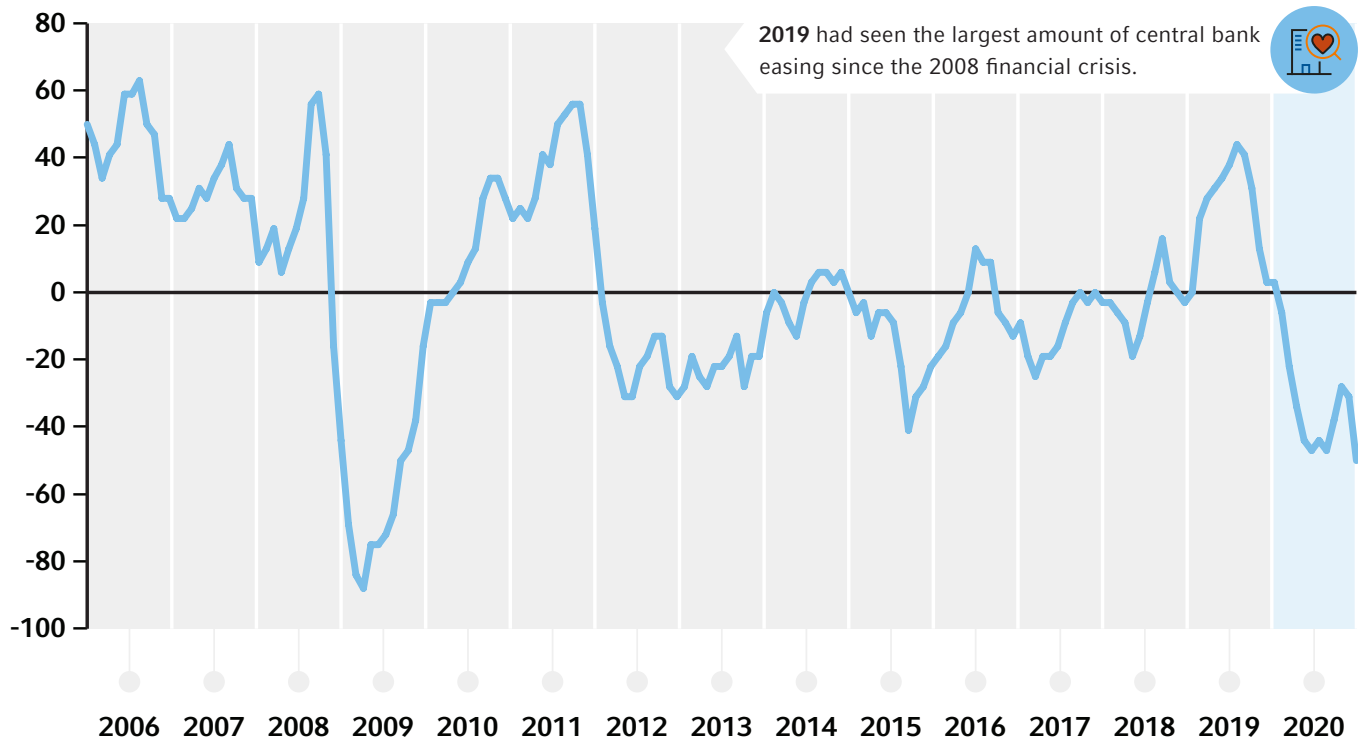
Global gross domestic product (GDP) growth will probably be negative for the first quarter, and the shutdown in economic activity from the virus containment measures virtually assures negative growth in the second quarter. The number of virus cases is likely to increase, which means more drastic containment measures may continue to be implemented. It is also possible that stresses in credit markets create a wave of defaults and liquidity issues that cascade across investment markets.

China's experience shows it is possible to contain the virus. Outside the stricken Hubei province, there have been an average of only 10 new cases per day in China during the first 18 days of March. South Korea is likewise having success in containing the outbreak. The fatality rate from the virus also

seems lower than originally feared, with many estimates now placing it below 1%. Most deaths so far have been confined to the elderly and those with pre-existing respiratory conditions.

Provided the virus is transitory, perhaps contained in the second quarter, the global economy should be poised to recover in the second half of 2020. There were signs of recovery in global economic indicators before the virus escalated in China during February. In addition, 2019 had seen the largest easing in monetary policy by global central banks since the 2008 financial crisis.

Central banks tightening globally / net %



Source: Refinitiv Datastream, Russell Investments calculations. Diffusion index that calculates the percentage of central banks that have raised rates over the last three months minus the percentage of central banks that have lowered rates. Coverage includes Argentina, Australia, Brazil, Canada, Chile, China, Colombia, Denmark, the ECB, Hong Kong, Indonesia, India, Israel, Japan, South Korea, Malaysia, Mexico, New Zealand, Norway, Peru, Philippines, Poland, Russia, South Africa, Singapore, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom, and the United States. Last observation March 2020

Since the virus outbreak, major central banks have eased even further, in some cases significantly, and governments are starting to issue substantial fiscal stimulus measures. U.S. Treasury Secretary Steven Mnuchin has proposed a US\$1.2 trillion stimulus package, which equates to 5.5% of U.S. GDP. Finance ministers and central bankers around the world are making “whatever it takes” statements. China is enacting large monetary and fiscal stimulus.

The combination of monetary and fiscal stimulus on top of last year’s easing, combined with the reduction in China-U.S. trade tensions, argue for a solid recovery when the virus threat recedes.

However, there are risks to this view of an economic recovery in Q3, including:

- The progress of the virus can't be forecast. The number of cases in the U.S. may be under-reported, and there could be a dramatic escalation in confirmed cases. The containment measures may be more drastic, and the recession could continue into Q3.
- The economic impact of the virus may turn out larger than expected. There is evidence that labor markets have already been damaged, and the shock to consumer and business confidence could generate a self-sustaining economic downturn. There also could be a credit-market event that leads to rising defaults and liquidity issues, which in turn creates fears of a 2008-style downturn.
- Global supply chain disruptions may have a larger and more sustained negative impact on global growth.
- Central banks have limited firepower compared to previous recessions. The U.S Federal Reserve, Bank of England, Bank of Japan and European Central Bank (ECB) are already at the zero-lower bound.



A Biden-versus-Trump contest likely will be largely neutral for markets

Andrew Pease

The most material risks in our view are that the number of virus cases increase exponentially, and virus containment measures continue through Q3. The others seem less likely. Confidence should recover on the back of substantial stimulus once the virus ‘all clear’ signal is given. The issues around supply chains are longer-term. These have been under pressure since the China-U.S. trade war started. The virus outbreak adds to this but shouldn’t hamper the economic rebound.

A re-run of the 2008 financial crisis seems unlikely. Tier 1 capital ratios² for large U.S. banks are significantly improved from 2007 and should cushion against the risk of a severe drawdown. Bank mortgage lending has been prudent. Consumer balance sheets are reasonably healthy. It’s true that central banks have less scope to cut interest rates, but if needed they can turn to quantitative easing and other unorthodox policies. There also will be substantial political pressure on governments to provide fiscal stimulus.

² Tier 1 capital is the core measure of a bank’s financial strength from a regulator’s point of view. It is composed of core capital, which consists primarily of common stock and disclosed reserves, but may also include non-redeemable non-cumulative preferred stock.

Not feeling the Bern

It’s been easy to overlook amid the COVID-19 and oil market shocks, but the other important recent event for markets has been the shift in favoritism for the Democratic presidential nomination away from the self-described socialist Bernie Sanders and towards the party’s status-quo, centrist candidate, Joe Biden.

A Sanders presidency would represent a structural shift for the U.S. equity market. He favors the regulation and breaking up of the tech giants, the abolition of private health insurance and the repeal of Donald Trump’s large corporate tax cuts. But such change isn’t likely now with Biden heavily favored in betting markets to win the Democratic nomination. The economic turmoil caused by COVID-19 means he also may have a better chance of beating Trump in the November election. A Biden-versus-Trump contest likely will be largely neutral for markets. A Sanders-versus-Trump election would have been an additional worry-point, creating uncertainty about the strength of the eventual market rebound.



Twin shocks

Canada grappling with impact of virus outbreak and oil price decline.

The twin shocks of the COVID-19 outbreak and the collapse in the price of oil has complicated what was already a lackluster outlook for the Canadian economy. Canadian equities, as of March 18, have declined 29% from peak levels on February 19, 2020 and have all but priced in a highly probable technical recession.

However, all may not be lost. Policy makers have been actively responding to the escalating risks emanating from the virus and oil price shock. The Bank of Canada (BoC) has responded by reducing interest rates 100 basis points (bps), bringing its target rate to 0.75%. We believe there will be additional easing this year, with the target rate eventually reverting to the global financial crisis low of 0.25%. The central bank has also announced various other measures aimed at improving the functioning of funding and credit markets. The federal government, importantly, has announced a CAD \$82 billion stimulus package³, or roughly 4% of gross domestic product (GDP), aimed at supporting businesses and households. This should be welcome news, particularly for the ailing energy sector and indebted households.

The energy sector was still recovering from the 2014/15 bear market in oil prices and now finds itself in an eerily similar predicament. The escalating price war between Russia and Saudi Arabia could not have occurred at a worse time.

The other major source of concern is the vulnerability of highly indebted households. Canadian households have been binging on cheap money over the entirety of this business cycle. Prior to the 2008/09 Global Financial Crisis, Canadian household debt to GDP stood at 83.0%; as of the third quarter of 2019, it had soared to 101.7%⁴. With the economy humming along and interest rates low and stable, this debt has been manageable. That math will be tested going forward. Yes, financing conditions will ease as the BoC brings the target rate towards the zero-lower bound. But this factor is offset by potentially rising unemployment and/or a weakened consumer.

A technical recession, commonly defined as two consecutive quarters of negative GDP growth, is likely, and risks pushing 2020 GDP growth to something significantly below our conservative estimate of 1.0%.

While the impairment to growth due to the coronavirus and the collapse in the price of oil will be meaningful, there is a clear sense of urgency, not just from Canadian, but global fiscal and monetary authorities, to present a strong coordinated response as was done in the Global Financial Crisis.

³ <https://pm.gc.ca/en/news/news-releases/2020/03/18/prime-minister-announces-more-support-workers-and-businesses-through>

⁴ Statistics Canada

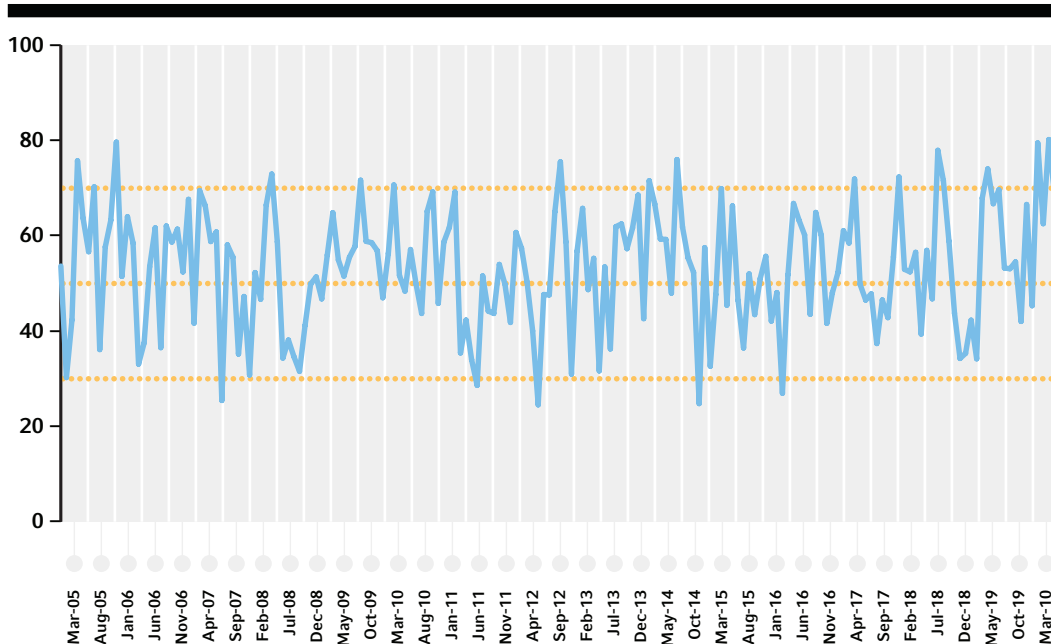
Canadian Market Observations

Canadian Equity

Canadian equities have underperformed global equities by roughly 500bps since the start of the market rout on February 20, 2020. The dual shock from the virus and the collapse in the price of oil hit the domestic bourse particularly hard. Our cycle-value-sentiment process now has us gradually leaning into riskier assets.

The business cycle is challenged as discussed above, however the coordinated initial response from Canada's fiscal and monetary authorities has been encouraging. Moreover, the domestic stimulus will be complemented by global efforts. Valuations have also improved, though further downside to already reduced earnings expectations is likely. Finally, we believe sentiment has started to reflect investor panic. For instance, the relative strength index, which measures short-term momentum of equity prices, signals temporarily oversold conditions. While we are acutely aware of the potential for further downside risks, we also realize that none of us can perfectly time the markets. Our process is designed to lean in and out, not swing for the fences. Our process has us leaning in.

Relative Strength Index – S&P/TSX Composite Index

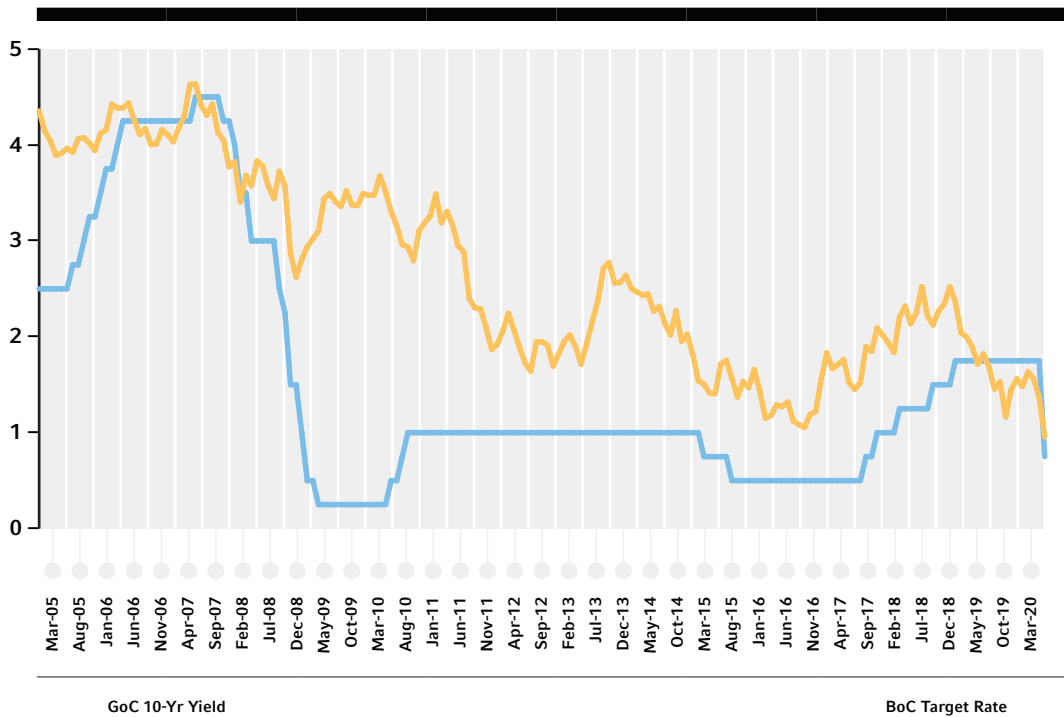


Source: Refinitiv DataStream, Russell Investments. As of March 16, 2020.

Bond Yields

Concerns around negative yields in North America have been percolating with rapidly declining bond yields and central banks rushing towards the zero-lower bound (ZLB). While the anxiety is understandable, we place very low odds on that outcome. Central bank governors from both the Bank of Canada and US Federal Reserve have expressed a certain degree of skepticism toward negative policy rates. Frankly the experience from Europe does not instill confidence. A negative policy rate stresses the financial sector and can hinder the pace at which the economy eventually recovers. There is the possibility than in an extreme risk-off environment where indiscriminate bond buying ensues, yields could be driven below zero, even with a positive policy rate. That said, we assign a low probability to that scenario.

Bond yields & Target Rate / %

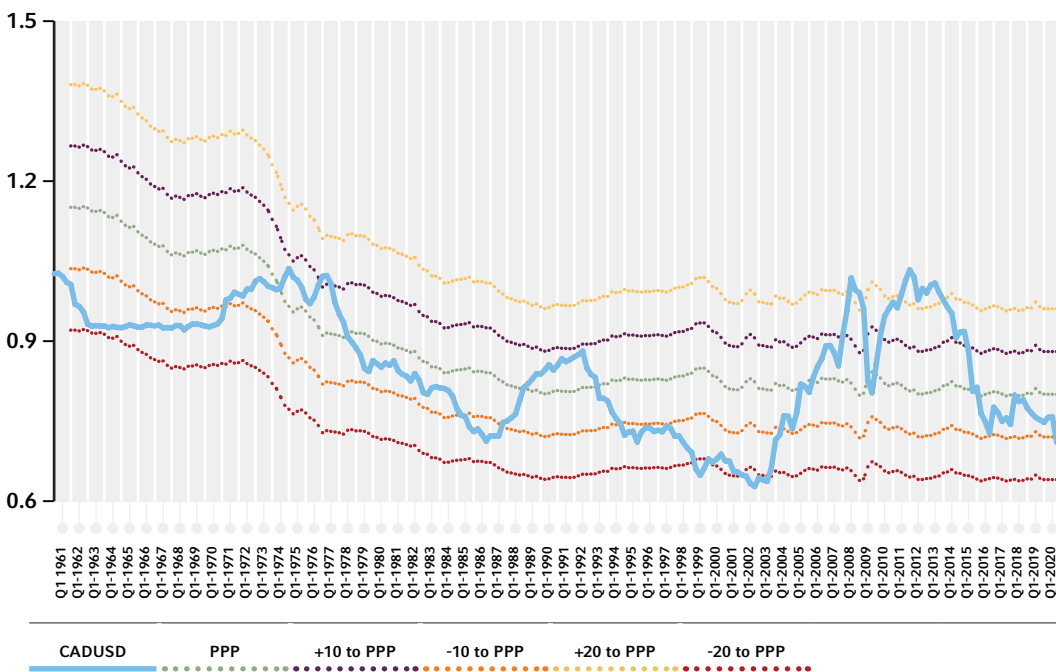


Source: Refinitiv DataStream, Russell Investments. As of March 17, 2020.

Canadian Dollar

In our annual outlook we set our fair-value range for the CAD/USD exchange rate at 0.71-0.77. Our fair value range has intentionally been more conservative relative to the fair-value (FV) derived from purchasing power parity (PPP⁵). Based on this measure, the implied level is closer to 0.80: a far cry from current levels and well below the mid-point of fair value range. Nonetheless, PPP does have merit as a valuation gauge and can be useful during times of heightened currency volatility to determine the bands within which a currency can move. The chart below illustrates this. It highlights how PPP levels will change over time but are generally stable relative to the actual change in the CAD/USD FX (foreign exchange) rate. This stability makes it a guidepost for longer-term fair value and can also operate as a proxy from which to determine price-bands. The chart illustrates that most of the time, the CAD/USD exchange rate fluctuates around +/-10% of the PPP implied levels, however in extreme scenarios, it has drifted toward +/-20%. Bottom line is that given the uncertainty around the Canadian economy, it is not a surprise that the CAD/USD exchange rate has not only dipped below the low end of our FV range but also below the -10% PPP levels as of March 17, 2020. A move to -20% would imply an exchange rate of roughly 0.64. While not our expectation it does serve as a guide to the potential.

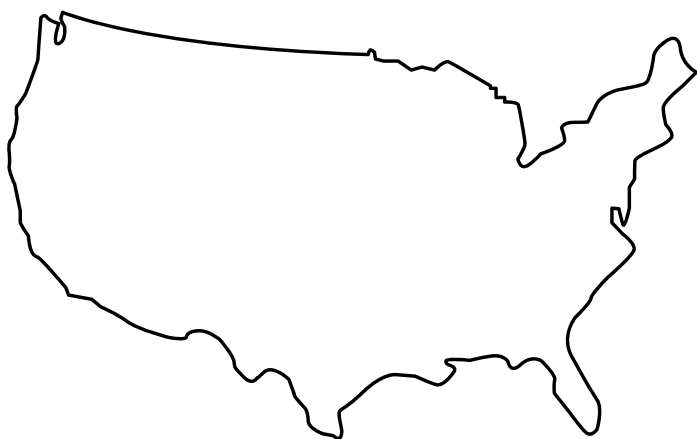
CADUSD Exchange Rate vs. Purchasing Power Parity (PPP) suggested levels / CADUSD



Source: Refinitiv DataStream, Russell Investments. As of March 16, 2020. PPP approximates long term equilibrium exchange rates based on relative prices between two nations.

⁵ Purchasing power parity states that exchange rates between currencies are in equilibrium when their **purchasing power** is the same in different regions by comparing the prices of a specific good/goods in those regions.

Regional Snapshots



United States

The government's virus containment measures mean a technical recession – negative GDP growth in Q1 and Q2 – is probable. As of March 19, the S&P 500® Index has declined 29% from its 2020 peak, which is on par with a moderate economic recession. A reasonable amount of economic pain is already in the price.

A risk is that the sharp plunge in cash flows causes highly indebted companies to default, triggering a credit-crunch in the broader economy. This threat should be lessened by the Fed's 150 basis points (bps) of emergency easing, asset purchases, and the resumption of an alphabet soup of crisis-era liquidity management facilities.

Fiscal policy will be important in offsetting the recession. The nature of the COVID-19 shock should force bipartisan agreement on large stimulus measures. More immediately, though, Congress and the U.S. Treasury can put emergency funding channels in place for stressed industries facing liquidity pressures.

Tailwinds from monetary and fiscal policy should eventually promote stronger economic conditions when the virus disruption has cleared. The upside risk is that should the number of new virus cases begin to decline in Q2, the subsequent recovery will be boosted by the strongest stimulus measures in more than a decade.



Eurozone

Europe is the worst-affected region outside of China by COVID-19. It has high exposure to global trade, particularly China, the ECB has little monetary policy firepower and the rules around fiscal policy in the Eurozone make stimulus measures difficult to implement. Italy is in quarantine and strict containment measures have been put in place in France and Spain. These seem likely to be adopted by other European countries.

The combination of these factors means that the Eurozone stock index has been the hardest hit of the major bourses, down more than 35% as of mid-March.

The Eurozone is likely to experience a deeper recession than the U.S. but should also experience a bigger economic bounce when the virus subsides. It will be one of the main beneficiaries of the rebound in global trade. Eurozone equities are now very attractively valued, and we would look for the European stock market to be one of the best performers in the recovery.



United Kingdom

The UK economy has two main advantages over Europe:

1. The Bank of England, unlike the ECB, has been able to cut interest rates by 65bps, taking its policy rate to the effective zero-lower-bound.
2. The ability to quickly implement fiscal easing. The UK government has announced over 1% of GDP in stimulus measures.

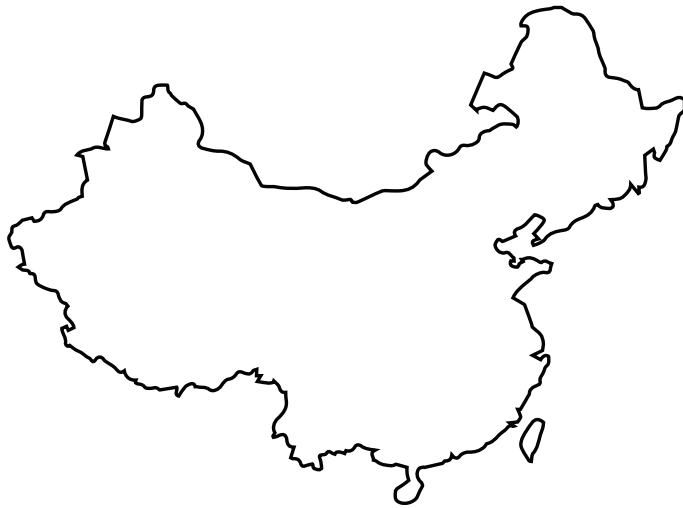
The FTSE 100 Index has been hit by a trifecta of challenges: Brexit uncertainty from the end-2020 deadline for an agreement, the large exposure to multinational firms with profits based overseas, and the high weighting to energy companies that have been hurt by the oil price collapse. The UK equity market has already been a poor performer, hit by three years of Brexit wrangling following the 2016 referendum. The COVID-19 declines take the FTSE 100 into exceptional value territory. It has a trailing price-to-earnings ratio of less than 10-times and a dividend yield pushing towards 7%.



Japan

Japan's economy was weak at the end of 2019, weighed down by the October value-added tax (VAT) increase and a natural disaster caused by the largest typhoon in half a century. The COVID-19 disruption has almost certainly pushed the economy into recession.

Stimulus measures are underway. The Bank of Japan has limited firepower, but has increased its purchases of government bonds, corporate bonds, and equities via exchange-traded funds (ETFs). The government is likely to announce emergency fiscal measures. Japan's structural weaknesses in terms of weak monetary policy and persistent deflation mean it will likely remain an economic laggard relative to other developed economies.



China

China was the first country to enter the COVID-19 crisis and see a downward trend in the number of new cases. High frequency trackers of daily economic activity show that economic activity is resuming. Traffic congestion in Shenzhen and Shanghai has returned to normal levels and coal consumption by power generators is trending higher.

Government stimulus is coming. Local provinces have announced infrastructure projects, and the People's Bank of China has cut interest rates and the reserve ratio requirement several times. Banks have been encouraged not to call in loans while there is pressure on cash flows. The main uncertainty is whether the combined monetary and fiscal stimulus will be as large as in 2015/16, which created a V-shaped recovery in 2016. We don't think it will be nearly as large, as China's leadership is still worried about excessive debt levels. But it will be substantial and position China for a strong rebound when the threat from the virus starts to subside.



Australia/New Zealand

The Australian economy was already soft—under the weight of a cautious consumer and slowing housing market—and the COVID-19 threat will accelerate this trend. The Reserve Bank of Australia has made two emergency rate cuts totaling 50bps that take the cash rate to 0.25%. It has implemented its first steps into unconventional policy by setting a target of 0.25% for the three-year government bond yield. Quantitative easing through government bond purchases is not far away.

The government has announced a fiscal stimulus package worth 1.2% of GDP, and the Australian dollar is fulfilling its traditional shock absorber role by depreciating and softening the blow on export-exposed industries. Australia's outlook appeared promising heading into 2020 with its biggest trade partner, China, about to be boosted by a phase-1 trade deal with the U.S. The virus outbreak has substantially delayed this outlook.

Adding risk

Our cycle, value and sentiment (CVS) investment process for tactical decisions looks for times when fear or euphoria cause markets to overshoot. Most of the time, the market consensus embodies the "wisdom of crowds", and there are no strong tactical opportunities. But markets sometimes descend into the "madness of crowds" where herding creates tactical opportunity.

Our composite sentiment indicator combines a range of indicators, such as technical market measures, positioning signals and surveys of investors.

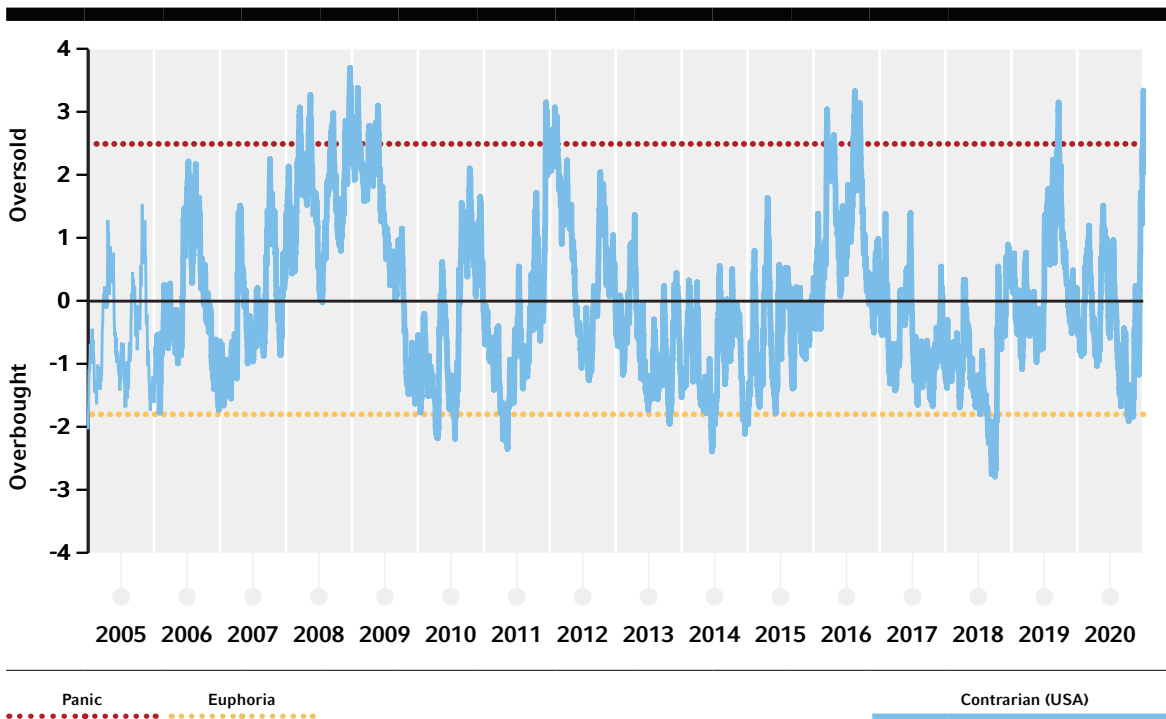
The market action on March 12, when global equities fell by 10% in a single day saw this indicator provide one of its most extreme "buy" signals.

The signal from our CVS investment process is to cautiously lean into riskier assets. Equity value has improved after the large market decline. The cycle outlook is supported by the substantial amount of stimulus being implemented, even though the near-term outlook is for recession. The message from our

composite sentiment indicator is that investors have panicked and herded into a pessimistic outlook, which supports taking a contrarian view.

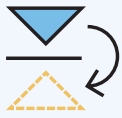
The main uncertainties are around the duration of the virus threat and whether it will re-escalate when the extreme containment measures in many countries are relaxed. It's likely that markets will find a bottom when the daily number of new virus cases in Europe and the U.S. begins to decline.

Composite Contrarian Indicator



Source: Russell Investments. Last observation: March 12, 2020. Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors at large are.

Asset class preferences



The equity markets that have been hardest hit by the COVID-19 crisis should be those that benefit the most from the eventual rebound. U.K. and Eurozone equities are attractively valued. Europe's high weighting to cyclical stocks should help it outperform in the recovery.



Emerging markets equities should also benefit from the eventual recovery. They are attractively valued and will gain the additional benefit of reduced trade-war tensions.



High-yield credit is now very attractively priced after selling off as a result of the COVID-19 shock and oil price collapse. Energy companies make up a large share of the high-yield bond market. The spread to U.S. Treasuries on March 19 was close to 900 basis points. The spread could widen further if the virus news deteriorates, but this historically has been a good entry point into high-yield exposure, although there is obviously considerable uncertainty in the market and liquidity risk that investors will need to consider in deciding whether to take advantage.



Our main expectation around currencies is that the safe-haven rally in the U.S. dollar should unwind once we are in the post-virus recovery phase. This will favor currencies such as the Canadian dollar, Australian dollar, New Zealand dollar and British pound, which after significant depreciation are substantially undervalued at the end of the first quarter relative to long-term purchasing power parity comparisons.

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2020 Global Market Outlook – Q2 update

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