Global Investment Outlook

Q2 2016

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Fears of global recession hit markets hard at the start of the year. Yet the anxiety has waned. Stabilising growth, a slower pace of rate increases by the US Federal Reserve (Fed) and a pause in the US dollar's rise bode well for markets in the near term, we believe. Our key views:

- **Theme 1:** we are living in a low-return world. Quantitative easing (QE) and negative interest rate policies have inflated financial markets. Many assets have had a great run since the financial crisis. This means future returns are likely to be more muted. We have been borrowing from the future.
- **Theme 2:** monetary policy divergence – a key driver of the US dollar's gains – looks to be slowing. The eurozone and Japan are reaching the limits of negative interest rates, and we see future easing coming through QE. The Fed has signalled a slower pace of rate increases. This bodes well for markets.
- **Theme 3:** we expect more volatility as the Fed normalises policy, the business and credit cycles mature, and risks come to the fore. We see sharp momentum reversals as many investors have piled into similar, correlated trades. This means diversification and security selection are key.
- **Risks:** key downside risks are a Chinese yuan devaluation and a UK exit from the EU. Upside risks are an emerging market (EM) rebound and a rise in inflation expectations on improving growth prospects.
- **Assets:** income is king in a low-return environment. We like value equities and dividend growers. We are neutral on credit but favour it over government bonds. And we are warming up to selected EM assets.

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Setting the scene

Global markets appear ready to leave recession fears behind. US manufacturing activity has been slowing since mid-2014, yet there are signs of a bottoming out. US corporate executives show little concern about recession risk, our analysis of earnings call transcripts shows. China's manufacturing sector looks to be stabilising. And eurozone activity is rising – albeit at a moderating pace. **See the *Mixed Signals* chart.**

Manufacturing weakness is concentrated mostly in sectors exposed to energy and exports. Yet there are signs the two key headwinds of falling oil prices and weak EM economies are easing. Also, the services sector is in much better shape, and financial systems in the US and Europe are healing. In the longer term, however, we see sluggish growth due to structural reasons such as ageing populations and high debt levels.

We are in the midst of a long, shallow economic recovery – and we do not see a recession on the near-term horizon.

The collapse in energy prices has dragged down inflation expectations globally. Markets recently were pricing in US consumer price index (CPI) inflation of as low as 1% annually over the coming five years. This is puzzling: core CPI inflation in February surged to the highest level in almost four years. Core personal consumption expenditures (PCE) inflation – the Fed's preferred inflation gauge – hit 1.7%, but remains below the central bank's target level of 2%. **See the *Inflation Puzzle* chart.** Note, however, that eurozone core inflation is still falling.

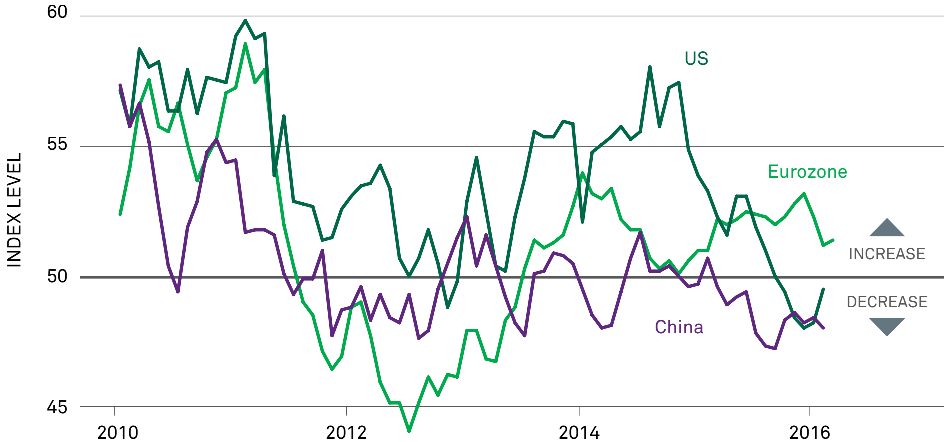
The Fed appears willing to run the risk that inflation overshoots its target – at least in the short term. It looks more concerned about market-based inflation expectations catching up with actual inflation.

A stabilisation in energy prices could cause such a rebound. This would be a positive for risk assets – unless the rise in inflation expectations was so sharp that it led investors to price in a more rapid pace of Fed tightening.

A modest rebound in inflation expectations would ease fears of a deflationary spiral – and could boost investor sentiment. This would likely bode well for cyclicals and beaten-down EM assets.

MIXED SIGNALS

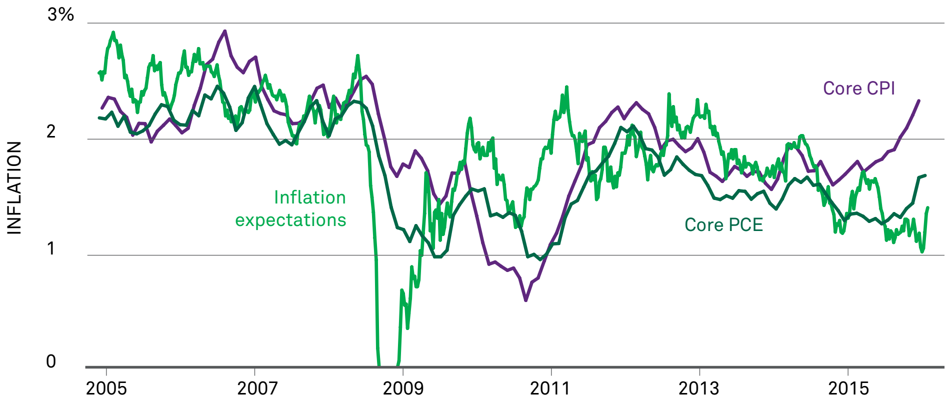
Global manufacturing activity, 2010–2016



Sources: BlackRock Investment Institute, Institute for Supply Management and Markit, March 2016.
Notes: the lines show purchasing managers' index levels. A value above 50 indicates an increase in activity, while below 50 indicates a decrease.

INFLATION PUZZLE

US core inflation and inflation expectations, 2005–2016



Sources: BlackRock Investment Institute, US Federal Reserve and US Bureau of Labor Statistics, March 2016.
Notes: core consumer price index (CPI) and core personal consumption expenditures (PCE) inflation exclude food and energy prices. Inflation expectations are represented by the five-year breakeven inflation rate. This is the difference between the nominal yield on five-year US Treasuries and that on five-year Treasury Inflation Protected Securities. Breakeven inflation rates briefly fell below zero during the financial crisis; this has been excluded from the chart.

Theme 1: low returns ahead

The hunt for yield is getting even harder. Negative short-term interest rate policies in Europe and Japan have pushed yields on many bonds below zero – and have made safety deposit boxes popular items.

Almost $7 trillion in government bonds carried negative yields as of March 2016. **See the *Going Negative* chart.** This is the equivalent of 27% of the J.P. Morgan Global Government Bond Index.

A long period of low rates has encouraged investors to assume greater risk in the stretch for yield. This has inflated asset prices. Higher valuations today typically mean lower returns in the future. Our five-year *Capital Market Assumptions*, for example, are near post-crisis lows. We are in a low-return, but not no-return, environment. This poses a dilemma for investors: accept lower returns or dial up risk by taking equity, credit and interest rate exposure.

Income is golden in a low-return, low-rate world. Yet it is getting harder to come by.

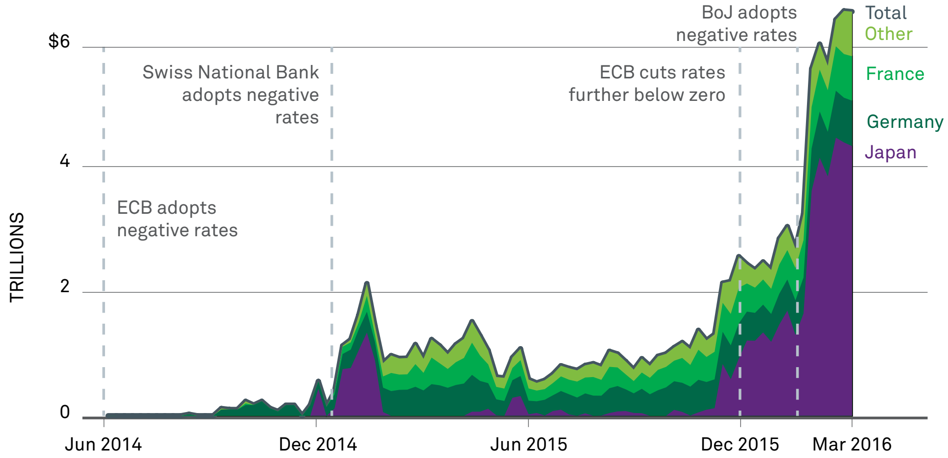
Global equities have been powered by rising price-to-earnings multiples in recent years. The multiple expansion includes the impact of share buybacks, which are hovering near post-recession highs by dollar value in the US, according to FactSet. Companies have been using cash flow or borrowing to fund share repurchases, rather than investing in future growth. Earnings growth has been paltry since 2011, and revenue growth is weak. **See the *Running on Empty* chart.** Equity valuations still look reasonable in a low-rate world. Yet revenue and earnings growth are needed to sustain the post-crisis recovery, we believe.

"Negative rates are moving the financial transmission mechanism aggressively back to the Stone Age."

Rick Rieder – Chief Investment Officer of BlackRock Global Fixed Income

GOING NEGATIVE

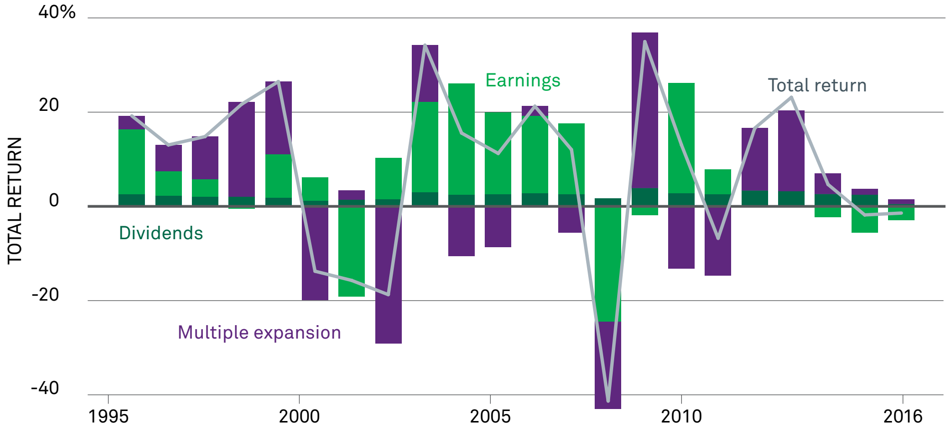
Government bonds with negative yields, 2014–2016



Sources: BlackRock Investment Institute, J.P. Morgan and Thomson Reuters, March 2016.
Notes: the chart is based on the J.P. Morgan Global Government Bond Index.

RUNNING ON EMPTY

Global equity returns by source, 1995–2016



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, March 2016.
Notes: global equities are based on the MSCI All-Country World Index. Earnings growth is based on aggregate 12-month forward earnings forecasts. Multiple expansion in represented by the share of return not explained by earnings growth or dividends. The 2016 returns are for the first quarter only.

Theme 2: divergence is slowing

Monetary policy divergence has been a clear market theme since 2014, sparking a persistent appreciation in the US dollar. Expectations of a Fed liftoff contrasted with further easing measures from the European Central Bank (ECB) and the Bank of Japan. The path of two-year bond yields illustrates this divergence. Yields have steadily climbed in the US and declined in the eurozone and (to a lesser extent) Japan. **See the *Dealing With Divergence* chart.**

Bond futures point to a further divergence in yields across countries. Yet we believe this is mostly priced in. The era of ever-widening policy divergence through interest rates is likely behind us. We believe future divergence will be more subtle, driven by incremental QE in Europe and Japan as well the trajectories of US growth and rate increases.

Policy divergence is slowing – and appears mostly priced in. Surprises at the margin are what matters now.

The dollar's rise has led to a de-facto tightening of global financial conditions as it is the world's premier funding currency. It pressured commodity prices, pulling down US inflation expectations. It hit EM assets hard. And it weighed on the earnings of US companies with overseas revenues. Conclusion: the US dollar has become a key driver of investment returns.

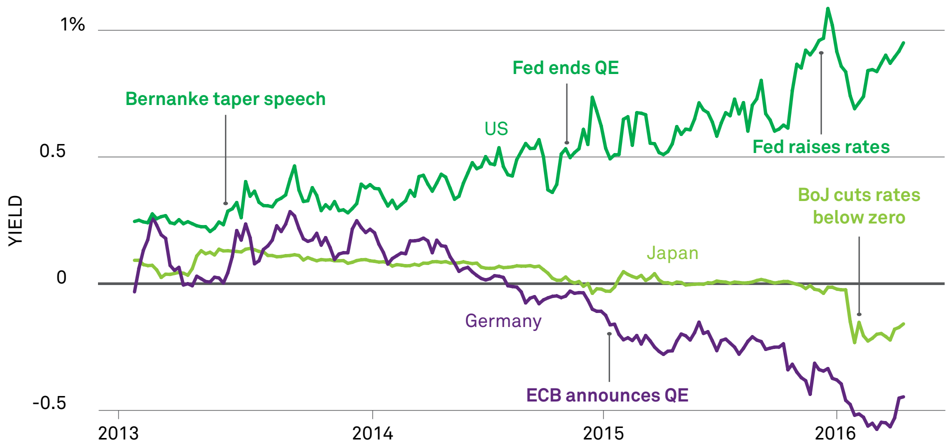
Yet further significant dollar appreciation appears less certain from here. This is partly because central banks have expressed concerns about the global impact of a stronger dollar, and agreed at a recent G-20 meeting to consult closely on exchange rate markets.

The dollar's rise petered out against other G3 currencies (70% of the DXY Index) in early 2015, but remains on an uptrend versus a broader set of currencies. **See the *Dollar Pause* chart.** A halt in this trend could light a fire under oversold commodity and EM assets.

We see dollar appreciation slowing in the near term. This bodes well for markets, we believe. The dollar will likely only resume its uptrend once markets start pricing in faster Fed rate increases.

DEALING WITH DIVERGENCE

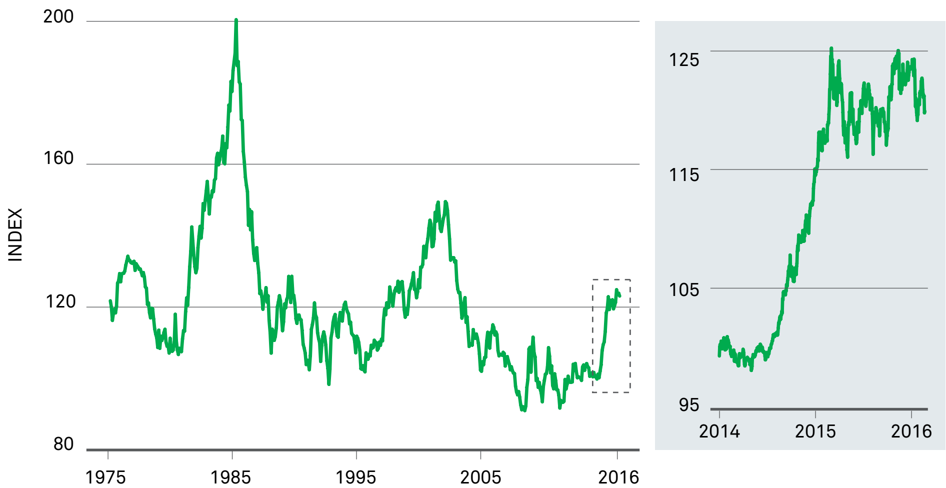
Two-year government bond yields, 2013–2016



Sources: BlackRock Investment Institute and Thomson Reuters, March 2016.
Notes: QE stands for quantitative easing. BoJ stands for Bank of Japan. ECB stands for European Central Bank.

DOLLAR PAUSE

US dollar index, 1975–2016



Sources: BlackRock Investment Institute and Thomson Reuters, March 2016.
Notes: the chart shows the DXY Dollar Index. The lines have been rebased to 100 at 1 January 2014.

Theme 3: volatility and dispersion

Markets today are characterised by a lot of 'me-too' trades. Many investors have piled into similar strategies. Trends have been persistent – and counting on yesterday's winners rising (or falling) further has often paid off. Popular trades have included overweighting the US dollar and underweighting EM and commodity assets. **See the *Copycats* chart.**

We see two problems with this picture. First, many of these trades are highly correlated. This means portfolios may be riskier than they appear. Second, monetary policy normalisation is likely to increase volatility, we believe. This raises the risk of rapid momentum reversals and shifts in market leadership. Positioning in popular trades has moderated from recent peaks. This has coincided with a slowing of the US dollar's rise and signs of stabilisation in EM economies.

Gold, inflation-linked bonds, government debt and currency exposures can be useful portfolio hedges for volatility spikes.

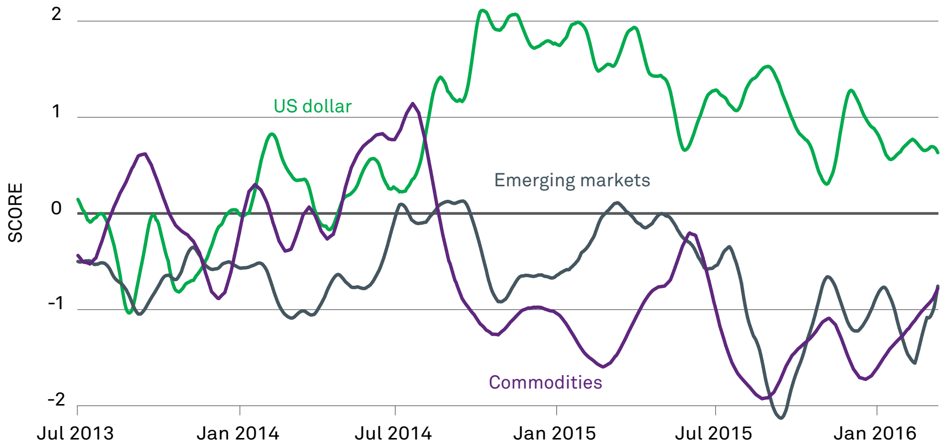
Extraordinary monetary policies have suppressed volatility. This has made it harder for fundamental investors to exploit expert knowledge of individual securities. Yet we are starting to see the gap between winners and losers widen again. Cross-sectional dispersion in global equities – a measure of the variation in returns across individual securities – recently reached its highest level in four years. **See the *Rising Opportunity* chart.** We see similar trends in other asset classes such as credit.

Volatility and dispersion tend to rise late in monetary policy cycles when central banks start raising rates and shrinking their balance sheets, our research suggests. This favours an active approach to investing, we believe. Market-neutral strategies may benefit. We see volatility and dispersion rising to normalised levels as the Fed lifts rates and markets pay more attention to lurking tail risks (see page 7). This creates opportunities for security selection, but also a need to diversify.

Investors can no longer rely on a rising tide lifting all boats. Security selection is crucial as dispersion re-emerges in asset markets.

COPYCATS

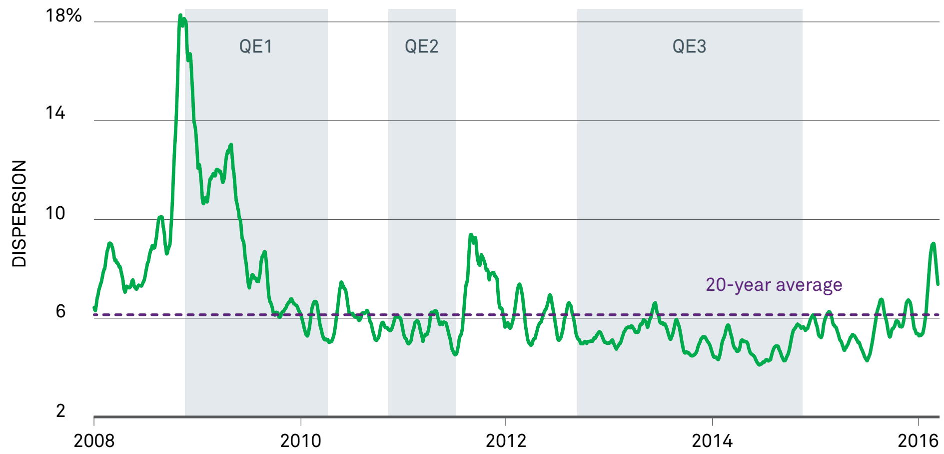
Crowded positions, 2013–2016



Source: BlackRock Investment Institute, March 2016. Notes: data are based on BlackRock analysis of portfolio flows, reported positions by fund managers and price momentum. A positive score means investors are overweight the asset class; a negative score indicates the reverse. The emerging markets line is based on an average of emerging market currency and equities positioning. Commodities are based on an average of energy and industrial metals.

RISING OPPORTUNITY

Cross-sectional global equity return dispersion, 2008–2016



Sources: BlackRock Investment Institute and MSCI, March 2016.
Notes: cross-sectional return dispersion is the standard deviation of monthly returns of individual securities within the MSCI World Index. QE refers to the US Federal Reserve's quantitative easing programmes.

Downside and upside risks

A possible devaluation of the Chinese yuan has kept markets on edge. Capital outflows are draining China's foreign reserves, pressuring the currency. **See the *Reserves Drain* chart.** A large, sudden devaluation could trigger competitive devaluations. It could suggest policy makers had lost control and hit risk assets globally, in our view. We place a low probability on this scenario for now. Chinese policy makers have tightened capital account rules to prevent seepage and are targeting the yuan rate against a basket of currencies. Yet fears of a major devaluation could return in the long run due to economic imbalances. We watch for signs of capital flight.

Other risks include a 'Brexit,' or British exit from the European Union after a June referendum; a chaotic US presidential election campaign; further disintegration in the Middle East; and another leg down in oil prices.

Markets have become more susceptible to geopolitical risks as the Fed slowly undoes its volatility-suppressing monetary policy.

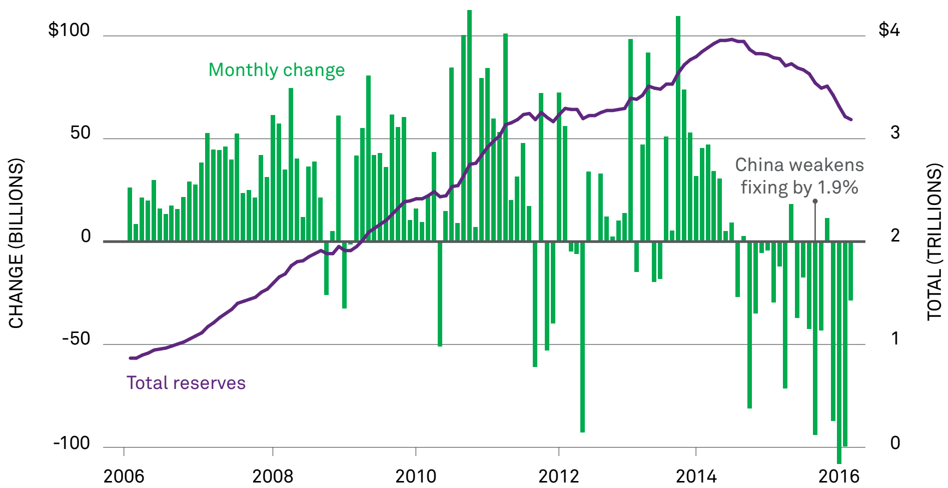
An EM recovery is a key upside risk. EM currencies have lost a third of their value since 2013 on a trade-weighted basis. Those of commodity exporters Brazil and South Africa have fallen almost as much as during the Asian financial crisis. **See the *Currency Collapse* chart.** A lot of EM adjustment is now behind us, and trade balances are improving. EM equity exchange-traded funds were on track to attract about $9 billion in inflows in March, the highest monthly total in three years, BlackRock research shows. Another upside risk is a stabilisation in oil boosting inflation expectations. It would be a positive – provided the rise was not fast enough to prompt a more rapid pace of Fed tightening.

"EM FX and equities have been stuck in a vicious cycle of yuan depreciation fears begetting outflows and growth worries. Breaking this loop is key not only for EM, but for global stabilisation."

Helen Zhu – Head of China Equities, BlackRock Fundamental Active Equity

RESERVES DRAIN

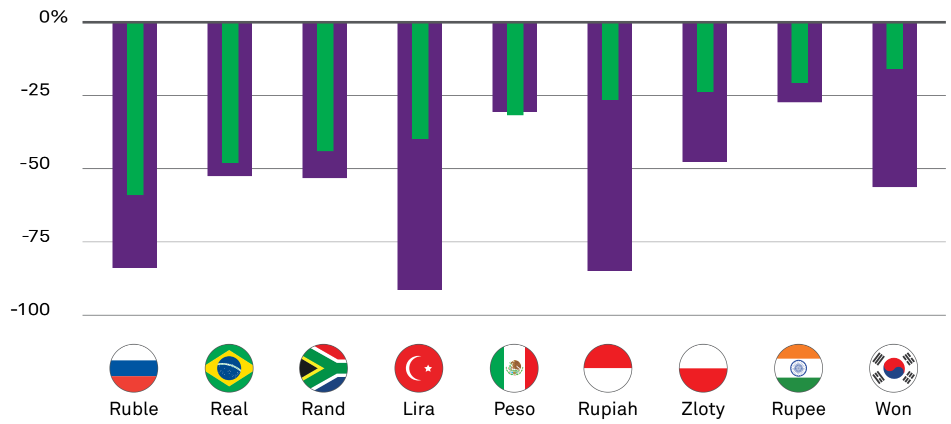
Chinese foreign exchange reserves, 2006–2016



Sources: BlackRock Investment Institute, People's Bank of China and Thomson Reuters, March 2016.

CURRENCY COLLAPSE

Emerging market currency declines: current vs. Asia crisis



Sources: BlackRock Investment Institute and Thomson Reuters, March 2016.
Notes: the chart shows the peak-to-trough decline in currency value versus the US dollar during the Asia crisis (1996-2000), compared with the decline from the peak value since the start of 2013 to today.

Sovereigns: expensive but useful

Government bond yields around the world are exceptionally low. This leaves little cushion against the risk of rising growth or inflation. Yet low yields arguably make sense in a world where interest rates are falling in many countries, central banks are gobbling up a big share of issuance and investors are more worried about return *of* capital than return *on* capital.

We do see sovereigns such as US Treasuries (including inflation-linked bonds) playing their traditional role as portfolio diversifiers. Long-duration bonds have historically outperformed in risk-off scenarios. They also have a steady bid in a low-growth, low-rate world. For income investors, we favour longer-dated peripheral European sovereigns such as Spain and Portugal, which offer a yield advantage over Germany. **See the *Compression Coming* chart.** We see ECB asset buying narrowing the gap.

We see government bonds as useful portfolio diversifiers, yet this benefit comes at the cost of very low yields.

Asset purchases by the ECB underpin European sovereign debt. Net bond issuance in the eurozone turned negative in 2015 after accounting for ECB purchases – and the bond market is set to shrink even further this year (along with Japan). **See the *Big Buyers* chart.**

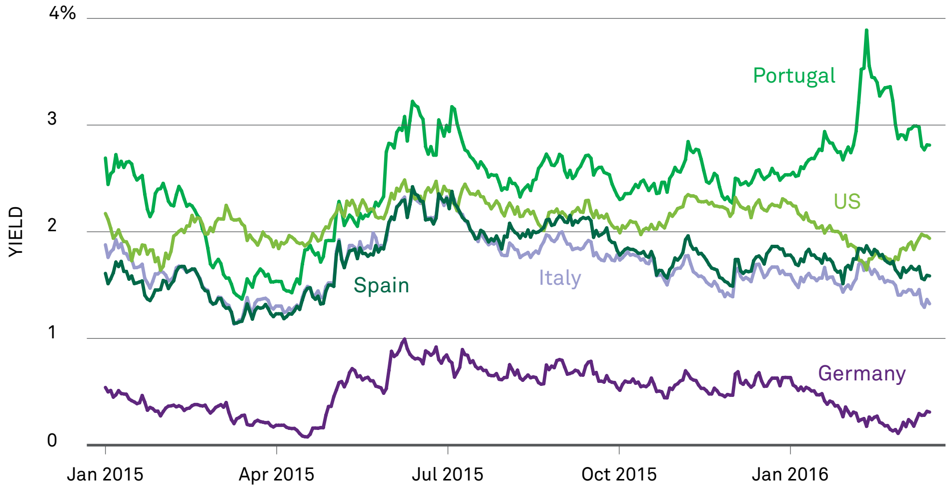
European peripherals offer the greatest scope for spread compression, we believe. Yet they do not come without risks. A potential downgrade by rating agency DBRS may rob Portugal of its last remaining investment grade rating, and could threaten its eligibility for ECB asset purchases. Spain's inconclusive election result poses the risk that the country may go to the polls again in June.

"We like longer-dated inflation-linked bonds, both in Europe and the US. Meagre breakevens are pricing in very low inflation – especially in light of central bank inflation targets."

Scott Thiel – Deputy Chief Investment Officer
BlackRock Fundamental Fixed Income

COMPRESSION COMING

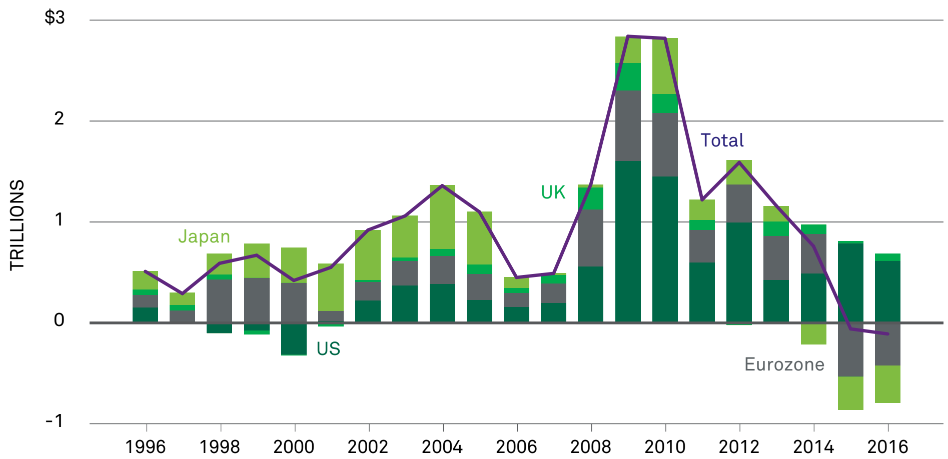
10-Year government bond yields, 2015–2016



Sources: BlackRock Investment Institute and Thomson Reuters, March 2016.

BIG BUYERS

Developed market net government bond issuance after central bank purchases, 1996-2016



Sources: BlackRock Investment Institute and Morgan Stanley, March 2016.
Notes: the chart shows gross issuance of government bonds, minus central bank purchases and redemptions. 2016 is a Morgan Stanley forecast.

Credit: short-term gain, long-term pain

Credit fundamentals look decent in the short term. Investment flows into the asset class are positive, and income is king in a low-rate environment. Most yields are far below pre-crisis levels, helped by the sell-off earlier this year. Yet they are well above those on government debt. **See the *Attractive Credit* chart.**

We generally prefer high yield over investment grade in corporate debt. The former offers greater compensation for the risks entailed, we believe. Yet security selection is crucial in high yield as the market is bifurcated. It is a mix of distressed energy companies (often cheap for a reason) and stronger players offering much lower yields, but less risk. In the medium term, we see rising risks to corporate credit. These include increasing defaults and ratings downgrades of investment-grade energy issuers.

Credit markets look attractive for now in a low-return world, yet we are wary of rising medium-term risks. This leaves us neutral overall.

Credit fundamentals look pretty solid in the eurozone. Investment-grade corporate bond issuance has surged as many companies – including US multinationals – take advantage of low yields. Yet corporate leverage still looks subdued in the eurozone compared with the crisis peak – contrasting with a steady rise seen in the US. **See the *Leverage Rising* chart.**

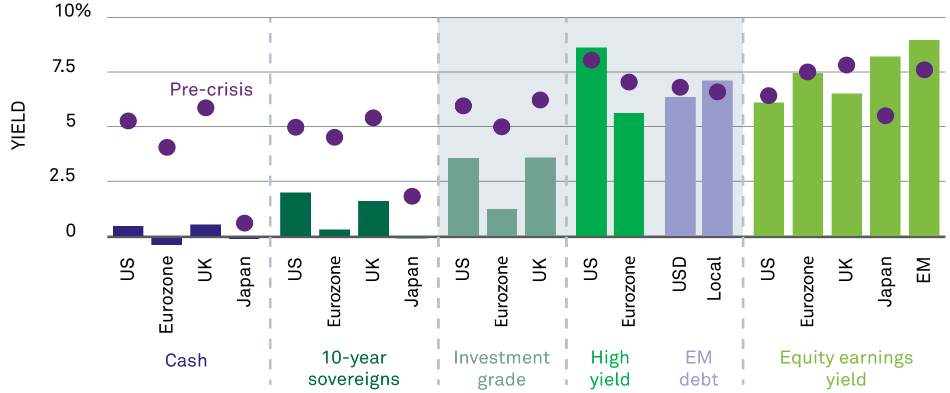
Signs of green shoots in the economy should help keep default risk low. Credit spreads look reasonably attractive again after ballooning to their widest levels since 2013. And the addition of corporate debt to the ECB's asset purchase programme underpins demand.

Sector and security selection are key. We like hybrid debt in the industrial sector, which offers yields of 5-6% and appears oversold on worries about exposure to China's slowdown. We also see selected opportunities in subordinated insurance debt and lower Tier 2 bank debt ranked just below senior in the capital structure.

Eurozone corporate debt looks attractive after the recent sell-off. ECB buying provides a strong backstop for the sector.

ATTRACTIVE CREDIT

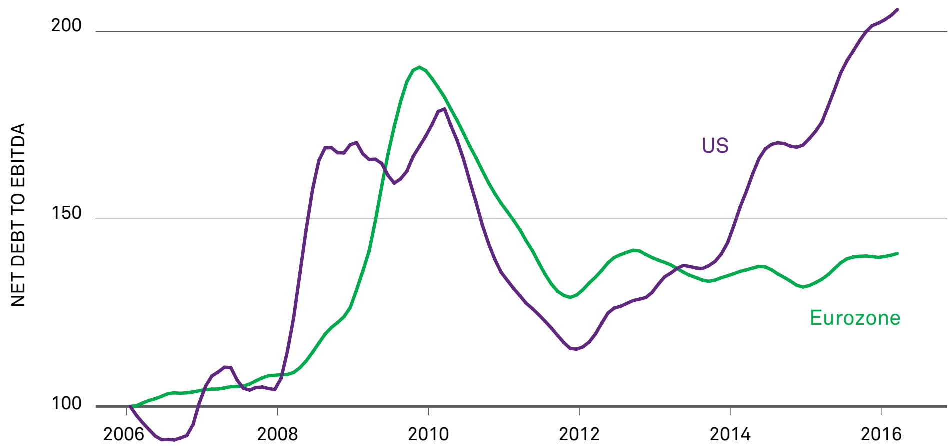
Selected asset yields: current vs. pre-crisis



Sources: BlackRock Investment Institute, Thomson Reuters, Bank of America Merrill Lynch, J.P. Morgan and MSCI, March 2016. Notes: pre-crisis refers to June 2007 levels. Cash is based on one-month interbank rates. Corporate bonds are based on Bank of America Merrill Lynch index yields; US dollar emerging debt is based on the J.P. Morgan EMBI; local emerging market debt is based on the J.P. Morgan GBI-EM. The equity earnings yield is based on the inverse of the 12-month forward P/E ratio for MSCI indexes.

LEVERAGE RISING

Net debt to EBITDA for US and eurozone equities, 2006–2016



Sources: BlackRock Investment Institute and Thomson Reuters, March 2016.
Notes: the chart shows the ratios of net debt to 12-month forward EBITDA for US and Eurozone Datastream Total Market Index excluding financials. The ratios are rebased to 100 at the start of 2006.

Equities: there is some value here

Equities look attractive versus government debt, offering dividend yields above the yield on 10-year government bonds in all major markets. The gap is widest in negative-rate countries such as Japan and Switzerland. **See the *The Case for Equities* chart.** The US is the only major region where bond yields rival equity dividends. We like dividend *growers* here, and see strength in consumption and housing supporting equities overall.

We also favour European equities due to a supportive ECB. We have long liked Japanese stocks, but now are neutral because of the strengthening yen and mounting doubts over the progress of structural reforms. We are warming up to EM equities after a long underweight. Valuations are cheap. Signs the Fed will go easy on raising rates bode well for the asset class. And we see progress on structural reforms in countries such as Argentina.

We do not see any major equity markets as materially overvalued (even the US) – and we consider EM equities to be cheap.

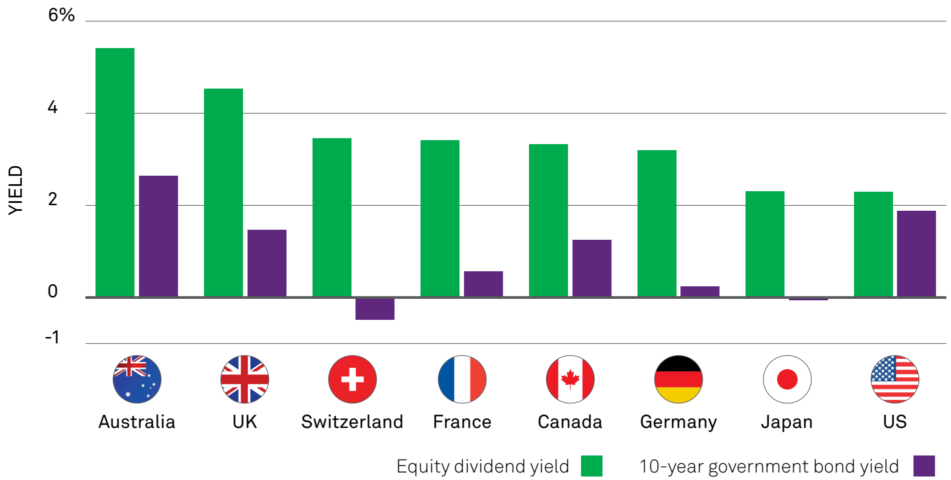
Value stocks have underperformed since the financial crisis. We are seeing signs of a rebound. **See the *Rediscovering Value* chart.** A value renaissance may just be getting started. First, value equities still traded at a 35% discount to the broader market globally as of March 2016, compared with an average 20% discount over the last decade, our analysis based on forward earnings shows. Second, economic fundamentals are improving. Third, there is room for flows to come into the asset class as underweight investors raise allocations. We favour sectors with attractive yields such as telecoms, but avoid European financials due to the challenges of low rates, more regulation and a need to raise capital.

"A dovish Fed and central bank coordination to reduce currency stresses are positive for EM equities and should allow value stocks to do well."

Nigel Bolton – Chief Investment Officer of BlackRock International Fundamental Equity

THE CASE FOR EQUITIES

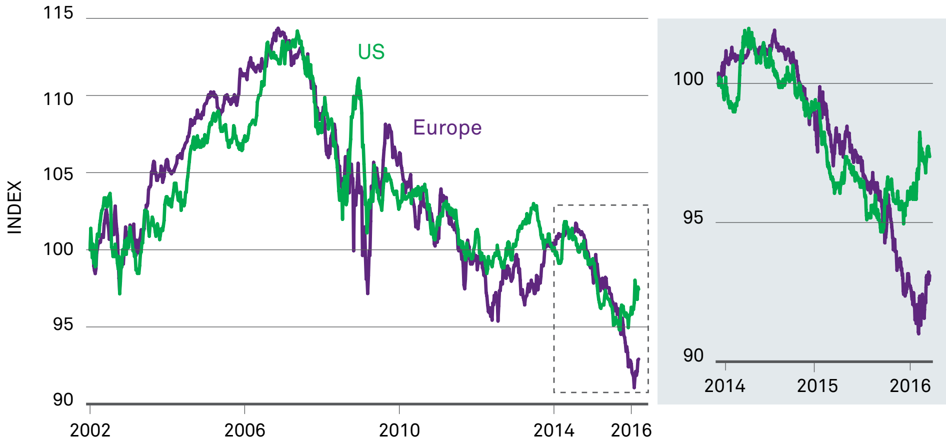
Equity dividend yields vs. government bond yields, 2016



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, March 2016.
Note: the chart shows the eight largest developed equity markets based on MSCI market capitalisation.

REDISCOVERING VALUE

Value equities relative to overall market, 2014–2016



Sources: BlackRock Investment Institute and MSCI, March 2016.
Notes: the lines show the MSCI value indexes divided by their respective total market indexes, rebased to 100 as of January 2002. For example, the purple line shows the MSCI Europe Value Index relative to the MSCI Europe Index.

Assets in brief

Views on assets for Q2 on an unhedged currency basis

Asset Class		View	Notes
EQUITIES OVERWEIGHT	United States	▲	The US consumer and housing sectors are strong, and growth appears to be stabilising. We see peak margins and payout ratios limiting returns, however.
	Europe	▲	Reasonable valuations and ECB policy are supportive, but weak growth and a challenged banking system are risks. Domestic UK equities look vulnerable to Brexit fears.
	Japan	—	Attractive relative value and improving corporate governance are positives. Yet much is priced in, and the Bank of Japan may have reached its limits in weakening the yen.
	EM	—	Structural challenges such as excess debt persist. Yet we see value for long-term investors. An expected slower pace of Fed rate increases is a positive.
	Asia ex-Japan	—	China's rebalancing weighs on growth, and a yuan devaluation is a risk. We like India on reform momentum.
FIXED INCOME UNDERWEIGHT	US Treasuries	▼	Improving data are a short-term risk. Long bonds have a structural bid amid low rates and are portfolio diversifiers, yet they are vulnerable to upticks in inflation in the short run.
	Eurozone sovereigns	—	We are avoiding core eurozone sovereigns except as portfolio diversifiers. We like European peripherals on the back of ECB purchases and strong demand for income, but an actual Brexit is a risk.
	UK gilts	▼	Gilts look vulnerable to Brexit fears in the near term, but we see value in the very long end.
	US credit	—	We generally prefer US high yield over investment grade. Higher yields offer better compensation for risks such as rising corporate leverage.
	European credit	▲	ECB asset purchases underpin demand. We see value in subordinated financials and high yield. Yet we are becoming more cautious overall due to rising valuations and increasing investment-grade issuance.
	EM debt	—	We lean toward local-currency EM debt. Currencies have adjusted, yields have risen to attractive levels, and the US dollar has slowed its appreciation trend.
	Asia fixed income	—	We like local-currency debt in countries such as Indonesia, Malaysia and India, where we see potential for easier monetary policy. We are cautious on high yield in the region due to rising valuations.
COMMODITIES NEUTRAL	Commodities	—	Commodity markets are oversupplied and sensitive to downward global growth revisions. A strategic allocation to gold may make sense for diversification.

▲ OVERWEIGHT — NEUTRAL ▼ UNDERWEIGHT

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