May 26, 2015

# WEEKLY INVESTMENT COMMENTARY

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## Tantrum Potential at Home, Opportunity Overseas

### Stocks Eke Out Slight Gains

U.S. stocks ended last week essentially flat, although the S&P 500 Index did post another record close on Thursday. For the week, the S&P inched up 0.14% to 2,126, the Nasdaq Composite Index advanced 0.81% to 5,089, while the Dow Jones Industrial Average slipped 0.22% to 18,232. Meanwhile, the yield on the 10-year Treasury rose from 2.15% to 2.21%, as its price correspondingly fell.

We believe U.S. equities can continue to climb and post further gains before the end of the year. However, we also believe the best opportunities may reside *outside the United States*, which, in fact, has been the case so far this year.

### Taper Tantrum II Ahead?

Mergers-and-acquisitions (M&A) activity continues to support the U.S. stock market. Last week brought the announcement of deals in retail (Ascena Retail Group to acquire Ann Inc., owner of Ann Taylor, among other brands), pharmaceuticals (Endo International to acquire Par Pharmaceutical) and health care (CVS to buy Omnicare).

Paradoxically, another factor boosting stocks has been mixed economic data, which has alleviated concerns over an aggressive Federal Reserve (Fed) rate-hiking regime.

Although stocks have clearly benefited from the Fed's languid path to an initial rate hike, the market's luck may not last. A fall rate hike is likely, particularly after April's consumer inflation report released last week. Core inflation (which excludes food and energy) accelerated on the back of higher medical and rent costs, although the year-over-year drop in energy prices pushed headline inflation further into negative territory. As a result, two-year Treasury yields, the most sensitive to future Fed policy, reversed their recent downtrend and ended Friday at 0.61%, up nearly 10 basis points (0.10%) for the week.

An autumn rate hike by the Fed and the resultant modestly higher rates are a *unlikely to be a catastrophe* for markets. Rates will be rising from a historically low level, the pace of future hikes will be measured and bull markets rarely end with a first rate hike.

Still, liftoff by the Fed would mean that the safety blanket of ultra-accommodative monetary policy starts to be removed. And as the market demonstrated in the spring of 2013, investors' reaction to losing their safety blanket is roughly the same as most toddlers: A tantrum may, at least temporarily, ensue.

**Russ Koesterich**
Managing Director and BlackRock's Global Chief Investment Strategist, as well as Global Chief Investment Strategist for BlackRock's iShares business. Mr. Koesterich was previously Global Head of Investment Strategy for active equities and a senior portfolio manager in the U.S. Market Neutral Group. Prior to joining the firm in 2005, he was Chief North American Strategist for State Street Bank.

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**Eyes Open for Opportunities Overseas**

In contrast, most other countries can look forward to at least another year, maybe longer, of monetary accommodation. In Europe, recent comments suggest the European Central Bank (ECB) may front load its program of bond buying. This news helped to weaken the euro, which traded down to 1.10 from nearly 1.15 earlier in the week. A softer euro, a dovish central bank and lower German Bund yields helped push European equities up by nearly 3% (in euros) last week.

Japan offers a similar story, with the Bank of Japan committed to 80 trillion yen/year of asset purchases. This massive program has helped to push the yen down relative to the dollar. A weaker currency, paired with a significant surge in share buybacks, has allowed for strong earnings growth. Indeed, 30% of companies listed on the first section of the Tokyo Exchange reported record profits for the year, the largest percentage since 2006. Strong earnings growth, not multiple expansion, has been the key driver of the Japanese stock market, which last week rose to its highest level since 2007. The TOPIX Index is now up roughly 16% (in yen) year-to-date.

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Even emerging markets (EMs), long the laggards of the global equity market, are turning. China has dominated the headlines and investor focus, but Korea, Poland, Hungary and Russia have also posted double-digit gains. The turnaround in EM performance has been accompanied by a reversal of fund flows. Last week, EM equity exchange traded funds garnered $1.2 billion in investor assets.

To be sure, lingering issues remain in international markets. Chinese equities have skyrocketed on the back of speculative buying locally and easy money policies. In Europe, Greece is a lingering problem and time is running out. A leaked International Monetary Fund (IMF) memo suggests that, without additional funds, the Greek government will not be able to make its June 5 IMF payment.

Still, lower valuations and monetary accommodation suggest investors should consider ***raising their allocation*** to non-U.S. equities. And as they do, U.S. investors should preferably gain that exposure via instruments that seek to hedge the foreign currency impact, as dollar strength means equity gains in local currency terms will be muted when translated back into U.S. dollars.

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