NEARING NORMAL

2015 MID-YEAR OUTLOOK

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Jean Boivin (TOP LEFT)
Deputy Chief Investment Strategist, BlackRock Investment Institute

Nigel Bolton (TOP RIGHT)
Chief Investment Officer, BlackRock International Fundamental Equity

Russ Koesterich (MID LEFT)
Global Chief Investment Strategist, BlackRock Investment Institute

Neeraj Seth (MID RIGHT)
Head of Asia Credit, BlackRock Alpha Strategies

Sarah Thompson (BOTTOM LEFT)
Head of BlackRock's US Liquid Credit Research

Ewen Cameron Watt (BOTTOM RIGHT)
Global Chief Investment Strategist, BlackRock Investment Institute

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Summary

The US Federal Reserve is (reluctantly) ending a long period of abnormally low rates. The world's premier central bank and its peers have quashed volatility, helped lift asset prices to great heights and had us obsess about monetary policy.

As we near a US exit from zero interest rates, traditional drivers of portfolio returns such as productivity and earnings growth are set to reassert themselves. We started debating this in a series of global videoconferences and webcasts in mid-June, and updated our 2015 outlook ***Dealing With Divergence****. Our main conclusions were:*

- Our base case – global divergence in monetary policy and asset prices – looks to be playing out. We see the Fed leading the tighteners' camp by raising short-term rates in the autumn on an expected US economic acceleration and rising wages. We expect the Bank of England (BoE) to follow in November or February.
- On the other end of the spectrum, we see the European Central Bank (ECB) keeping up asset purchases until September 2016. The Bank of Japan (BoJ) looks to press on with quantitative easing (QE), and we expect more domestic stimulus from the People's Bank of China (PBoC). It is therefore premature to call an end to global QE – but worth thinking about because markets tend to front-run events.
- As we shift our focus to fundamentals, we see some key indicators flashing red. Productivity growth appears to be flagging. This affects growth rates, monetary policy and, ultimately, corporate margins. We are split on the reasons, but note the possibility of a cyclical rebound in productivity. This would enable central banks to raise rates at a slow pace but end at a higher-than-expected destination.
- Most assets are priced for a prolonged period of low growth, rates and volatility. The pullback of the appreciating US dollar (temporary, we think) and juggernaut rise in German yields from ultra-low levels (stickier, in our view) illustrate how this paradigm is changing. Things only have to go a little awry to become dodgy.
- Heady valuations in many markets, uncertainty over the pace of Fed tightening and intermittent fears of a Greek eurozone exit argue for caution – and selectivity in countries, sectors and securities. We balance this with the knowledge that bull markets often last much longer than expected – and the risk of missing out on gains. We favour lower-risk portfolios with upside hedges in the form of call options.
- Fixed income is looking less expensive after recent yield rises. Yet we brace for volatility. The US term premium – or compensation for interest rate risk – is well below its long-term average. We expect the US yield curve to eventually flatten as the Fed normalises rates. Short-maturity bonds look vulnerable, whereas long-term bonds are supported by a global craving for yield.
- We favour US credit over government debt. In the eurozone, we like QE-supported subordinated bank debt and selected long-maturity peripheral bonds. We see the higher yields of emerging market (EM) hard-currency bonds cushioning price falls caused by Fed rate rises.
- US stocks look pricey and corporate margins high. We prefer cyclical sectors such as consumer discretionary, tech and financials over bond proxies (utilities and consumer staples). We like equities in Europe (banks) and Japan (financials and exporters) on weak currencies and monetary stimulus. We favour EM equities in countries with reform momentum or monetary easing.

Economics

Market trepidation about the first Fed interest rate increase in nine years is awakening global fixed income markets lulled into complacency by years of near-zero rates and regular doses of quantitative easing (QE). This is just the beginning. Fundamentals such as productivity and corporate earnings growth should gradually regain their prominence as drivers of portfolio returns, we believe.

Yet divergent monetary policies and resulting currency moves are dominating global markets for now. The prime focus in the second half is the Fed. We expect the US central bank to raise short-term interest rates on signs of strength in the labour market, an uptick in wages and a bottoming in inflation. The BoE looks set to follow the Fed's lead either in November or February as construction spending is helping power the UK's recovery.

The rest of the world remains in monetary easing mode, due to lacklustre growth and limp inflation expectations. Some 20 central banks – including those of China, Australia and Canada – have cut official interest rates so far this year. See the countries in light green below. The eurozone and Japan (dark green) have extraordinary monetary policies in place in the form of QE.

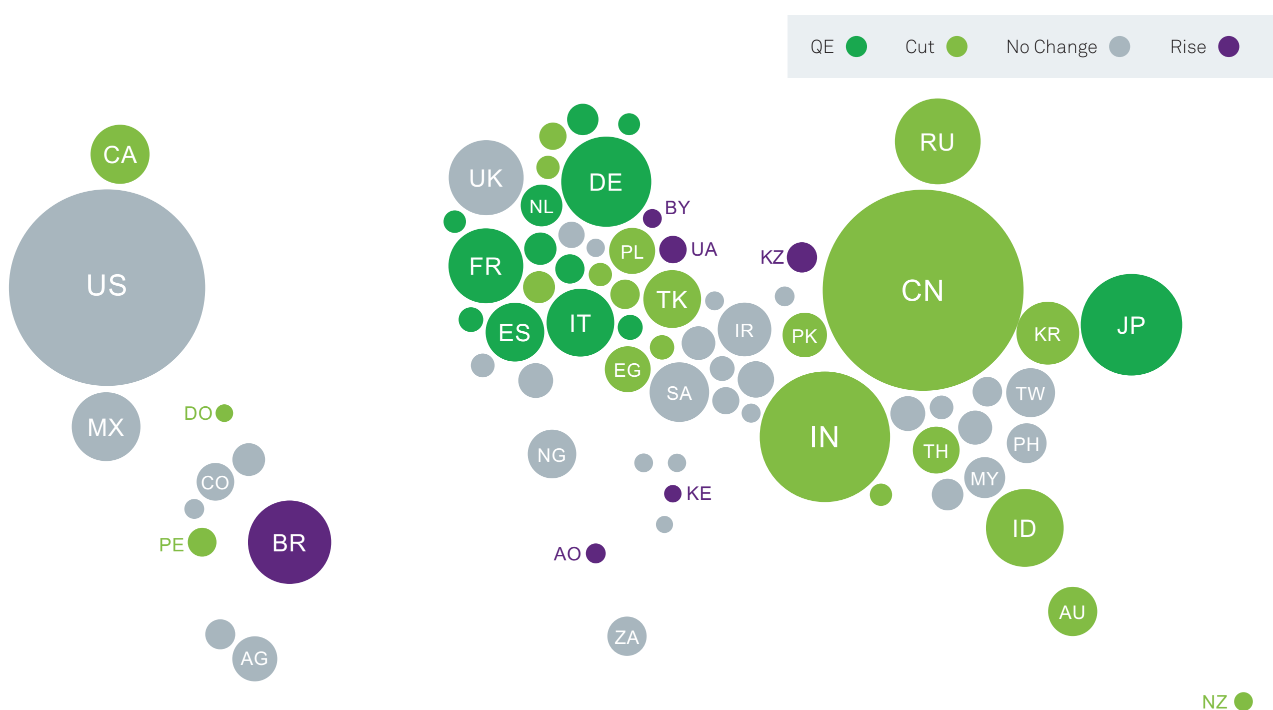
We expect the ECB to run its asset-purchase programme until September 2016 as planned. We currently are not counting on additional doses of QE beyond that; inflation appears to have bottomed. We see the BoJ keeping up QE in a bid to hit a 2% inflation target. More yen weakness, however, appears unlikely to us (unless portfolio outflows accelerate). Japan's real effective exchange rate has fallen 30% in three years. This is raising import prices – and further depreciation could undermine policymaker plans to revive consumer spending.

Most emerging markets are cutting rates to cushion slowing export growth. We expect the PBoC to further cut interest rates and bank reserve ratios as China's policymakers try to rebalance an economy dependent on credit, investment and exports toward sustainable consumption. See ***Climbing China's Great Wall of Worry*** of June 2015 for details. Many others (including India) have the room for monetary stimulus with inflation at historically low levels. Some may have delayed easing to await the impact of the Fed's rate rise.

Falling commodity prices have pressured the current account balances of commodity-exporting economies. This is hitting the currencies and depleting the foreign reserves of those dependent on external financing. Some (including Brazil) have raised interest rates in 2015 to suppress inflation and/or to defend their currencies (the countries in purple).

DIVERGING WORLD

Latest central bank move by country, June 2015



Sources: BlackRock Investment Institute and central bank websites, June 2015. Notes: the map shows the latest central bank policy move in 2015 in the 75 largest economies by GDP (calculated on a purchasing power parity basis). Countries are scaled according to the size of their GDP.

REGIME CHANGE

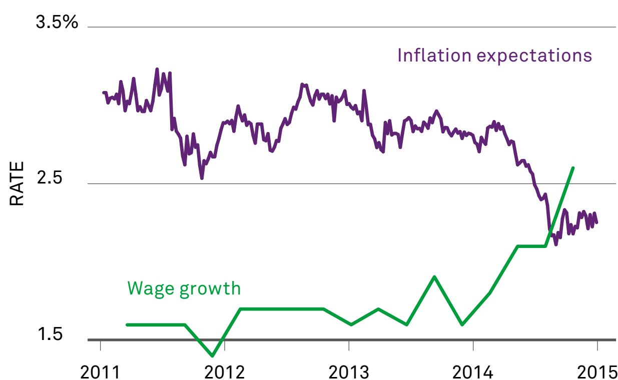
The era of zero interest rate policy (ZIRP) is finally drawing to an end. Signs of a healthier economy and frothiness in financial markets are paving the way for a Fed rate rise. Three key signposts: 1) Jobs: the US economy created more jobs in the past 24 months (through May 2015) than in the previous 13 years, government data show. See our interactive ***Jobs Barometer*** for global trends; 2) Inflation: we think US inflation expectations bottomed in early 2015 due to the collapse in oil prices. See the chart below; 3) Wages: US wages are rising after flatlining for years.

The emergency that brought about ZIRP is gone. Yet the Fed appears to react more strongly to growth disappointments than upside risks. We expect it to tighten with one hand while easing with the other (lots of soothing words like 'gradual'), as detailed in ***When the Fed Yields*** of May 2015. Base case: an initial 0.25% rate rise in September or December.

What happens next? We see the yield curve flattening eventually as the Fed gently tightens policy (see page 6). Yet there are risks. If the US economy weathers the first few rate rises and financial conditions do not tighten, the Fed may act more boldly. Two scenarios: 1) The Fed increases faster, and ends up inverting the yield curve. 2) The Fed starts selling down the $4.2 trillion of bonds on its balance sheet. This would lead to a steepening of the yield curve, we think.

THE CASE FOR A US RATE RISE

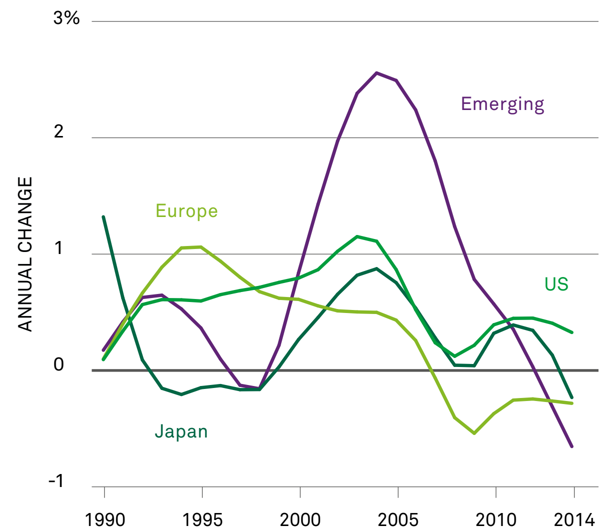
US inflation expectations and wage growth, 2011-2015



Sources: BlackRock Investment Institute, Thomson Reuters and US Bureau of Labor Statistics, June 2015. Notes: inflation expectations reflect the average expected inflation rate over the next five years, starting five years ahead. Wage growth is based on the 12-month change in the US Employment Cost Index.

PRODUCTIVITY PUZZLE

Productivity growth in selected economies, 1990-2014

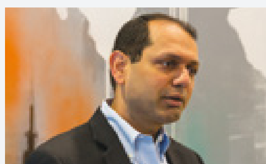


Sources: BlackRock Investment Institute and The Conference Board, June 2015. Notes: productivity is measured as annual growth in total factor productivity. The growth rate is smoothed using a Hodrick-Prescott filter to remove short-term fluctuations caused by business cycles. The Europe category consists of European Union members plus Iceland, Norway and Switzerland.

As the Fed starts to normalise, fundamentals will take centre stage. The problem: productivity growth appears to have imploded. See the chart above. What is causing this? Three possibilities: 1) The full productivity bounty from innovations such as 'big data' is just around the corner; 2) The benefits of the digital economy are not captured in official statistics (we are underestimating productivity); 3) Today's innovations will not have the same impact as past ones (electricity).

There is another dimension to this debate: productivity may be at a *cyclical* trough in the current unusually weak economic recovery. Companies have been ploughing money into share buybacks and dividends – whereas capital expenditures have been growing at a slower clip than might be expected after a recession. And the capital stock is ageing (at least in the US).

A cyclical productivity rebound would help wages and profit margins. It would keep inflation subdued, allowing central banks to tighten at a slower pace – but end at a higher rate than markets expect. A structural productivity slump, by contrast, could crimp corporate profits and lower the economy's speed limit. Central banks would be forced to raise rates rapidly due to inflationary pressures – but end at a lower peak rate. This could hurt both stocks and bonds.



"Hope is triumphing over data. The Fed hopes to expand the labour market by leaving rates very low. The risk is that inflation creeps up and the Fed finds itself behind the curve."

– **Pavan Wadhwa**
Head of BlackRock's Interest Rate Strategy Team

Markets

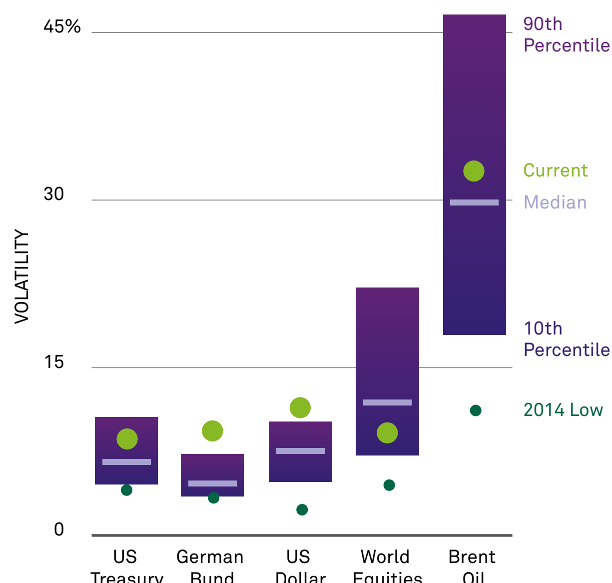
Investors could have snored through the first half – and woken up to find little had changed. Yet they would have missed some heady stuff in between. Ten-year German Bund yields jumped 13-fold in seven weeks (from extraordinarily low levels) when the eurozone showed a faint pulse, with growth and inflation ticking up. This ended a greater fool theory that said: it is fine to buy very expensive bonds because you can always sell them at an even higher price.

The term premium of US Treasuries (compensation for the risk real rates will rise by more than expected) also bounced back. The resulting tempest was magnified by poor market liquidity. Trading volumes have not kept up with the explosion of debt since the 2008–2009 financial crisis, as detailed in ***The Liquidity Challenge*** of September 2014. Even central bankers have started to voice unease – and not out of sympathy for the plight of hard-working bond traders, we think.

Overhanging these concerns: valuations that are pretty rich. See the chart below. Government bonds are hovering near record prices – even after the tempest. Credit markets offer better relative value than a year ago. Valuations of developed equities are average, with the US market the outlier. EM stocks look reasonable but are not screaming buys. Where they look cheap, it is often for good reasons.

CAUTION: EQUITY VOLATILITY AHEAD

Realised volatility by asset class, 1995-2015

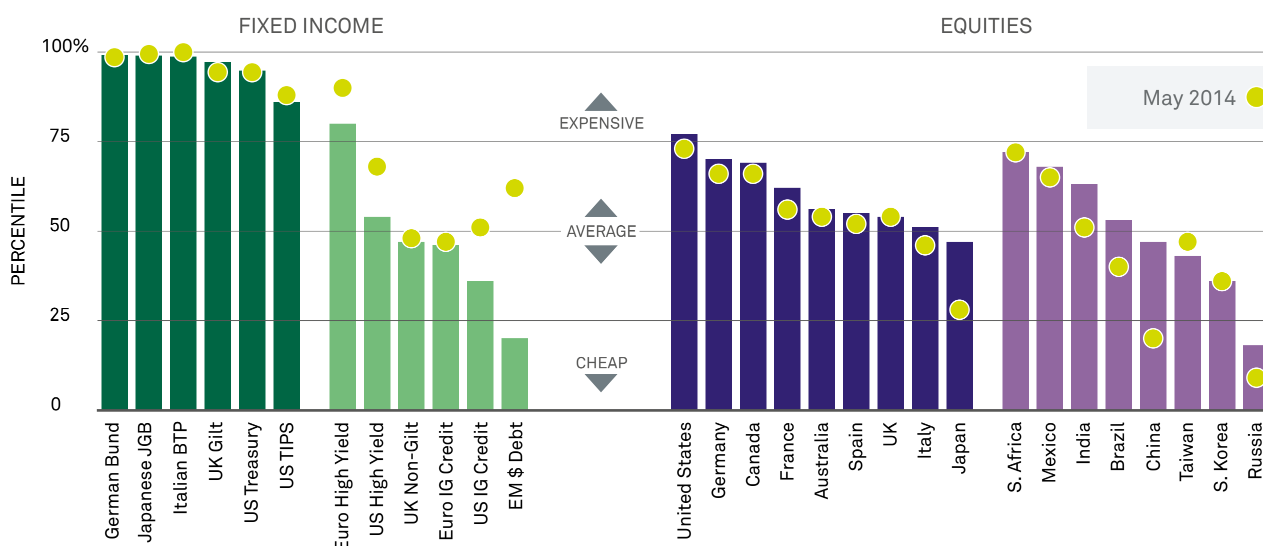


Sources: BlackRock Investment Institute and Thomson Reuters, June 2015. Notes: volatility is measured as the standard deviation of daily returns over a rolling 30-day window on an annualised basis. The bars show the 10th to 90th percentile over the past 20 years. The lines show the median and the dots the current levels. Bond volatilities are based on 10-year US Treasuries and German Bunds. Stock volatility is based on the MSCI World Index. Dollar volatility is based on the DXY Index.

Bond and currency volatilities have already spiked, as the chart above shows. We expect equity volatility to follow. This would challenge traditional bond-equity diversification.

IN SEARCH OF VALUE

Valuations by percentile vs. historical norms, May 2015



Sources: BlackRock Investment Institute and Thomson Reuters, 29 May 2015. Notes: the percentile bars show valuations of assets as of 29 May 2015, versus their historical ranges. For example, US equities are currently in the 77th percentile. This means US equities trade at a valuation equal to or greater than 77% of their history. The dots show where valuations were a year ago. Government bonds are 10-year benchmark issues. Credit series are based on Barclays indexes and the spread over government bonds. Treasury Inflation Protected Securities (TIPS) are represented by nominal 10-year US Treasuries minus inflation expectations. Equity valuations are based on MSCI indexes and are an average of percentile ranks versus available history of earnings yield, cyclically adjusted earnings yield, trend real earnings, dividend yield, price to book, price to cash flow and forward 12-month earnings yield. Historical ranges vary from 1969 (developed equities) to 2004 (EM$ Debt).

PERFORMANCE IN PERSPECTIVE

Actual performance and option-implied ranges for selected assets, 2012-2015

Market	Current level	Three-year actual range			Option-implied range for second half	
10-Year US Treasury	2.32%	1.39%	Average ● ● Current	3.03%	1.81%	2.82%
10-Year German Bund	0.81%	0.08%		2.05%	0.36%	1.26%
Emerging Market Debt (ETF Price)	$109.37	$103.69		$123.16	$101.42	$117.32
US Investment Grade (Spread)	0.70%	0.55%		1.19%	0.46%	0.94%
US High Yield (Price)	$105.75	$94.47		$110.5	$101.10	$110.40
US Dollar Index	94.3	78.85		100.33	89.47	99.13

Sources: BlackRock Investment Institute and Bloomberg, June 2015. Notes: the data are as of 17 June 2015. The purple dots indicate the average levels of the past three years. Emerging market debt is based on the iShares JPMorgan Emerging Markets Bond ETF. The credit sectors are based on Markit credit indexes. The option-implied ranges are based on six-month, at-the-money forward straddles, referenced to 17 June spot rates. Performance is shown for illustrative purposes only. It is not possible to invest directly in an index.

BONDS: FOLLOW THE FED

What happens to bond markets when the Fed normalises? A September rate increase would likely hit short-maturity bonds. Yet any rise in long-term rates should be subdued by yield-hungry buyers. There is a $5.8 trillion global shortage of high-quality bonds in 2015 and 2016, we estimate. Demand from regulated asset owners such as insurers exceeds net supply.

Global bond yields shot up in the second quarter but still look low to us (particularly in Germany), even when viewed against relatively short three-year histories. See the third column in the table above. Where to in the second half? Options markets point to wide ranges. We see risks for the US dollar and government bond yields skewing to the upside and expect a tighter range for US credit spreads.

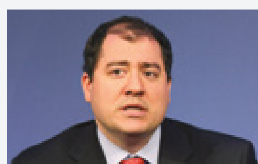
Corporate bonds look like better value after a rise in absolute yields and credit spreads. In investment grade (IG), we like financials, energy (pipelines), REITs and tobacco issues. The key risk for the IG market: a takeover boom is threatening credit quality. High yield bonds are less exposed to this risk (they are often the targets rather than the acquirers). Earnings growth and low default rates (just 1.9% in the first quarter, versus a long-term average of 4.4%, according to Moody's) help, too. Markets are pricing in little or no inflation risk, so we prefer inflation-linked over nominal bonds.

The biggest risk: an expansion of the US term premium. The current premium (0.4%) sits far below a long-term average of 1.6% . Past rebounds from low levels have been fast and furious. See *When the Fed Yields* for details.

The ECB's largesse has driven a collapse in bond yields across the eurozone and pushed down the euro. Yet it is hard to see the ECB extend QE beyond the September 2016 termination date if core inflation stabilises around 1%. Formerly high-yielding nations such as Spain no longer offer much absolute value. We prefer long-dated sovereign debt of Portugal and subordinated bank debt. We see the euro heading to parity with the dollar over time – but expect bumps along the way. Fears of a Greek exit from the eurozone and/or the impact thereof are likely to come and go, we expect. Markets are like goldfish: only able to focus on one thing at a time and finding each trip around the bowl a brand-new experience.

EM DEBT DECISIONS

Fed tightening cycles have sparked EM debt crises in the past. Yet emerging markets are in better shape these days, with less external debt, deeper financial markets and more dry powder for stimulus. The bigger risk today: anaemic growth. Global trade (the engine of EM growth) is slowing. And EM productivity has fallen more sharply than elsewhere. Yet EM hard-currency debt yields of almost 6% offer a buffer against price declines caused by Fed tightening. We prefer hard-currency over most local bonds, as we see the US dollar rising against many EM currencies. We like countries with reform momentum and falling inflation (India, China and Mexico), and avoid those with high inflation, trade deficits and piles of foreign currency debt. Years of easy money suppressed divergences in the EM world. Dispersion is set to rise as fundamentals return to the fore. View our interactive *Emerging Market Marker* to compare countries.

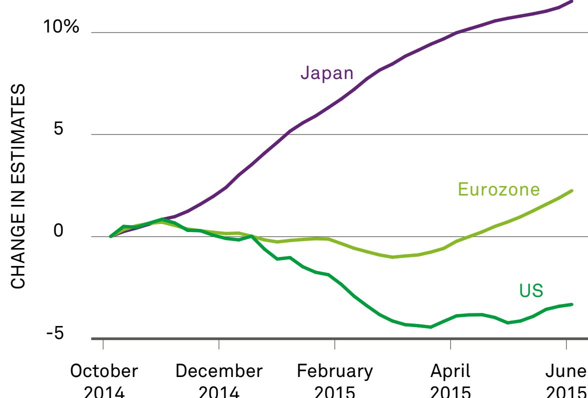


"Europe has benefited from a cyclical recovery – a manifestation of currency depreciation, an energy dividend and depressed year-ago levels. We like subordinated bank debt as a reflection of our view growth will persist."

– **Joe Di Censo**
Portfolio Manager, BlackRock Global Rates Investment Team

FX FALLOUT

Change in 12-month forward earnings estimates, 2014-2015



Sources: BlackRock Investment Institute and Thomson Reuters, June 2015. Notes: the lines show the change in 12-month earnings estimates for the MSCI US EMU and Japan indexes. The estimates are rebased to zero on 30 Sept. 2014.

EQUITIES: LEAST DIRTY SHIRT

Equities look reasonably valued – *relative* to bonds. This explains the angst about the Fed rate rise, especially for richly valued US equities. We offer three observations here:

1. Rising rates threaten US dividend-paying, low-volatility sectors such as utilities, property investment trusts and consumer staples. These so-called 'bond proxies' have racked up average annual returns of 9% in periods of falling rates but lost ground otherwise, our analysis of monthly S&P 500 returns between 1953 and 2012 shows. US bond proxies fell in the first half, but we do not think current valuations reflect the risk of further yield rises.
2. Rising rates benefit banks as loan growth tends to rise in tandem. We favour large US banks on modest valuations, strong balance sheets, potential for dividend growth and rising trading revenues. Regulatory risks abound, but we think legal bills and compliance costs have peaked.
3. US profit margins look unsustainably high given a productivity slowdown. Productivity trends often lead margins, as the chart on the right shows. Have margins moved to a higher plateau thanks to 'asset-lite' companies with few physical assets? Maybe. Yet workers demand more pay when labour markets tighten. Rising labour costs are fine – for companies with accelerating revenues (there are few) or pricing power (ditto). A potential double whammy: rising wages cause a margin slide *and* faster rate increases.

DOLLAR MAGIC

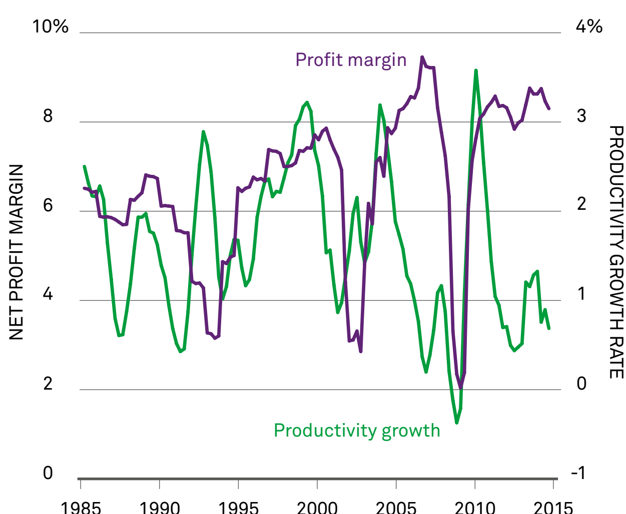
European equities are no longer cheap, but earnings forecasts are finally on the rise (see the light-green line in the left chart). Thank the weak euro, loose credit conditions engineered by the ECB's bond purchases and signs of loan growth. We like value equities, particularly banks. Bad loans look to have peaked. We are avoiding banks with weak balance sheets in countries such as Italy, France and Spain. We also like selected telecoms and construction companies.

We still like Japanese equities. The weak yen has boosted earnings estimates (see the purple line in the left chart) while increasing dividends and buybacks provide extra support. We favour beneficiaries of capital investment (exporters) and domestic reflation (financials). We also like selected utilities on nuclear reactor restarts, low fuel prices and deregulation.

We believe Asian equities are at the cusp of a long run higher. Why? Reasons include good value, easing financial conditions and reform momentum to liberalise economies such as India. Chinese domestic small- and mid-cap shares are in bubble territory, we think. We prefer Hong Kong-listed Chinese equities, as detailed in *Climbing China's Great Wall of Worry*.

DEFYING GRAVITY

US profit margins and productivity growth, 1985-2015



Sources: BlackRock Investment Institute, Oxford Economics and Thomson Reuters, June 2015. Notes: the US profit margins are based on Thomson Reuters Datastream's US Total Market Equity Index. Productivity growth is a one-year moving average of the annual growth rate.

"When growth is scarce, investors flock to the few companies that generate growth. Now it's time for value to outperform as the economy finds a more solid footing."

– **Carrie King**
Portfolio Manager, BlackRock's Basic Value Team

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