Global Investment Outlook

MIDYEAR 2017

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The global expansion is chugging along, with an improved eurozone outlook in particular; deflation fears and near-term political risks look to have faded; and financial market volatility is subdued. We believe this provides fertile ground for modest gains in risk assets such as equities. Our key views:

- **Outlook debate:** a mid-June gathering of some 90 BlackRock portfolio managers and executives featured vigorous debates on the drivers of low volatility, how to think about valuations and the outlook for monetary policy and markets. We dissected key risks such as a snapback in government bond yields, discussed how poor trading liquidity could aggravate any sell-offs in frothy pockets of credit markets, and concluded that worries over a China slowdown are overstated in the near term.
- **Themes:** we see the world in a synchronised and sustained economic expansion that is slower than previous cycles. We believe structurally lower growth and interest rates mean that comparing valuation metrics to past levels may not be a good guide to the future. We see low volatility as a normal feature of the benign economic and financial backdrop – and not as a warning sign in itself. Taken together, this could mean equities are cheaper than they look – and investors may run the risk of being under-risked.
- **Market views:** we prefer equities over fixed income, and credit over government bonds. In equities we generally prefer European, Japanese and emerging market (EM) stocks over their more expensive US counterparts. We see room for the momentum style factor and the technology sector to outperform further, albeit with potential for swift reversals. We also like the value style factor and selected financials. In fixed income, we like higher-quality credit and generally prefer inflation-linked bonds over nominal ones. We also see opportunities in selected EM debt.

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Setting the scene

Growth in the world's major developed economies is cruising at a rate that is slightly above the trend in place since the financial crisis. *The BlackRock GPS* – which combines traditional economic indicators with big data signals such as web searches and text mining of corporate conference calls – suggests a higher growth rate over the coming 12 months than currently reflected in consensus estimates. See the *Firing on more cylinders* chart. Unusually stable economic growth paths are a key contributor to low volatility across asset classes, we believe.

Germany tops the year-to-date improvers in our GPS as the European recovery is gathering speed. See *page 9*. Italy has slipped – and its fractious politics and fragile banking system pose ongoing risks. EM growth is holding up even in the face of falling oil prices. We believe the risk of a near-term China slowdown is overstated, as detailed on *page 8*.

We see upside to growth forecasts for key developed economies.

Deflation fears have dissipated. We look at a more granular gauge of core inflation – one that strips out noisy items beyond volatile food and energy components.

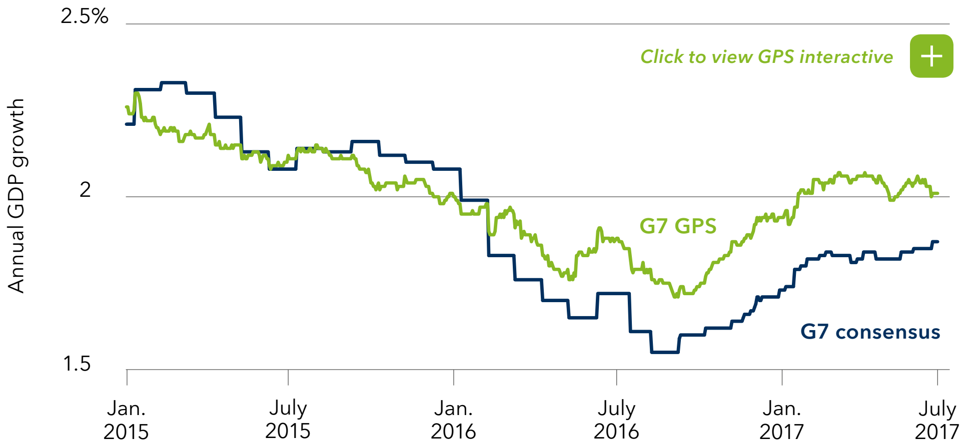
Such sticky core inflation remains stubbornly low in Europe and Japan but more resilient in the US despite a recent pullback. See the *Inflation dip* chart.

Further employment gains should stir wage growth and higher inflation, in our view. The US is further into its long expansion and erosion of spare capacity than Europe, helping explain the inflation divergences. Japan isn't showing any signs of reviving inflation. We see inflation as crucial to the policy outlook. We believe the Fed would be more worried about a further inflation slowdown than brief growth hiccups. The European Central Bank (ECB) faces constraints on asset purchases as it approaches self-imposed limits. Its plans for winding down purchases could be complicated if a resurgent euro helps core inflation stay subdued. See *page 8*.

Deflation fears have ebbed. We see core inflation rising slowly as employment gains feed into wage growth.

Firing on more cylinders

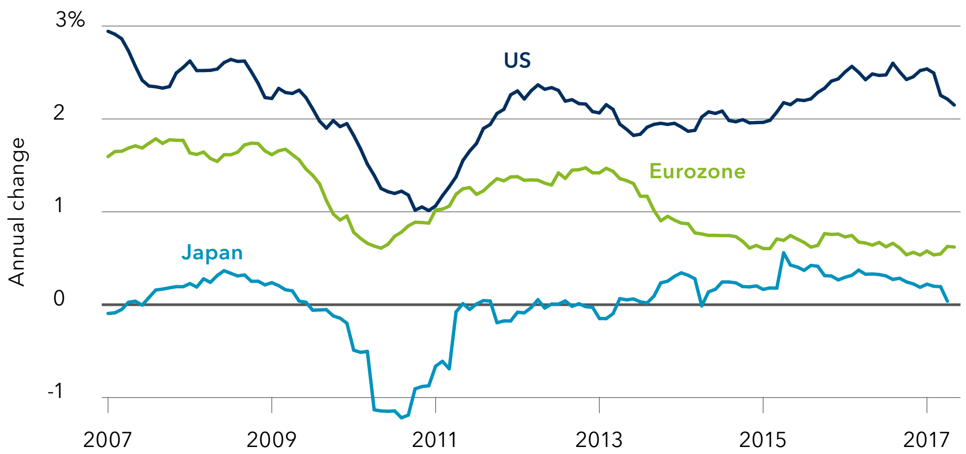
BlackRock GPS vs G7 consensus, 2015–2017



Sources: BlackRock Investment Institute, with data from Consensus Economics, July 2017.
Notes: the GPS shows where the 12-month consensus GDP forecast may stand in three months' time for G7 economies. The blue line shows the current 12-month economic consensus forecast as measured by Consensus Economics.

Inflation dip

Sticky core inflation in the US, eurozone and Japan, 2007–2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters, May 2017. Notes: we take all components in a CPI basket (excluding food and energy) to see which make statistically significant price moves relative to the median on a monthly basis. We then exclude those volatile components to gauge underlying inflationary pressures.

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Theme 1: sustained expansion

The current US economic cycle has been unusually long, sparking market fears that it is ready to die of old age. We have a different take. We compared this cycle with previous ones not in time but in quantity, or how close the economy is to eroding the slack created in the last recession. See the *Room to run* chart and our ***Global macro outlook*** of May 2017.

The slower the pace of a recovery, the longer it takes to absorb economic slack – and the longer it takes to reach full capacity and ultimately the peak that signals the cycle's end. The current cycle (the orange line) looks normal. It is tracking the 1990–2001 and 2001–2007 cycles (blue and green). Estimates of economic slack are imprecise. Yet even if there is no slack left, as some labour market indicators suggest, we believe the economy's sluggish growth means that the current cycle has a long way to run.

We believe this US economic expansion's remaining lifespan can be measured in years, not quarters.

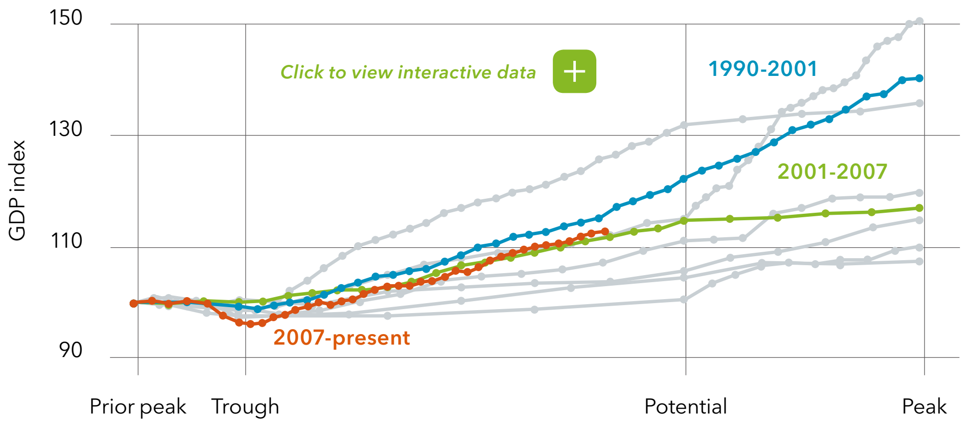
The reflation trade has waned as growth has shifted from acceleration to steady expansion. The 10-year US Treasury yield has faltered in recent months – even as the Federal Reserve has pressed on with normalising policy. Global bank shares have underperformed in tandem. See the *Hooked on yields* chart. A softening of US inflation and scaled-down expectations for stimulative tax reform under President Donald Trump's administration are part of the story.

We see the economic expansion over time feeding into upward pressure on wages and inflation. A gradual approach to monetary policy normalisation should eventually result in higher yields and a steeper yield curve as markets price in more inflation risk, in our view. This helps banks by boosting their net interest margins, the gap between deposit and lending rates. We also favour the momentum style factor in today's expansionary, low-volatility environment. See ***page 15*** for details.

Global economic expansion and monetary policy normalisation point to a rebounding of bond yields.

Room to run

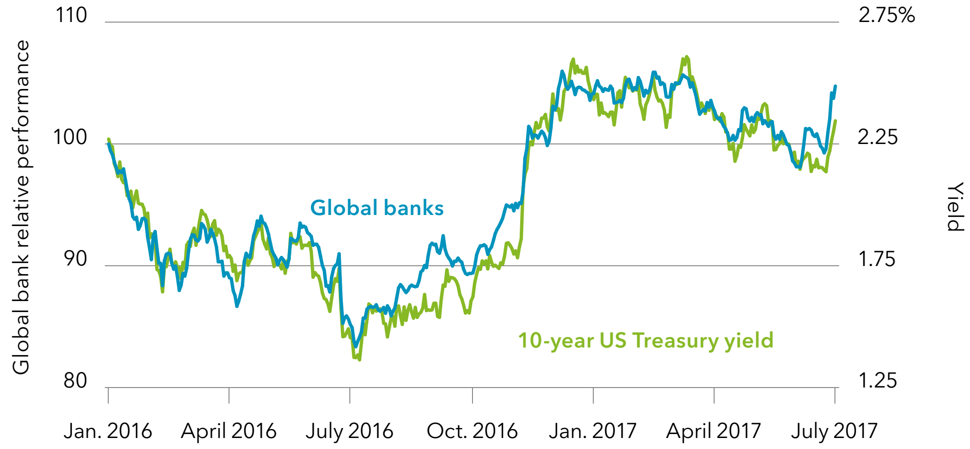
Comparison of US economic cycles from peaks to troughs, 1953–2017



Sources: BlackRock Investment Institute, with data from US BEA, Congressional Budget Office, National Bureau of Economic Research (NBER), July 2017. Notes: this chart compares real US GDP with other cycles. Each line begins with the previous cycle's peak, as determined by the NBER. We align the cycles based on their peaks, troughs and the point when potential output is reached. For details, see our interactive graphic at blackrockblog.com/cycles-in-context.

Hooked on yields

Relative performance of global bank stocks and US yields, 2016–2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters and MSCI, July 2017.
Notes: the relative performance of global banks is represented by dividing the MSCI World Banks Index by the MSCI World Index and using a base value of 100 at the start of 2016.

Theme 2: rethinking risk

Financial market volatility is low. Popular 'fear' gauges such as the VIX for the S&P 500 or the MOVE for US Treasuries are stuck at the bottom of their long-term ranges. Some argue that the lack of fear is so striking that we should be feeling… fearful. Low volatility breeds complacency, the story goes. Sooner or later, volatility reverts to more 'normal' levels – with spikes blowing up trades predicated on ever-low volatility.

Yet volatility does not follow a normal distribution, our analysis of US market data since 1872 shows. This implies we should not necessarily expect volatility to revert to a historical mean. Today's monthly realised volatility of around 5% is low but not abnormal. See the *Low… with a long tail* chart. There is a long tail of infrequent, but ugly, bouts of volatility.

Low volatility does not necessarily mean markets are complacent. It is simply what we should expect – most of the time.

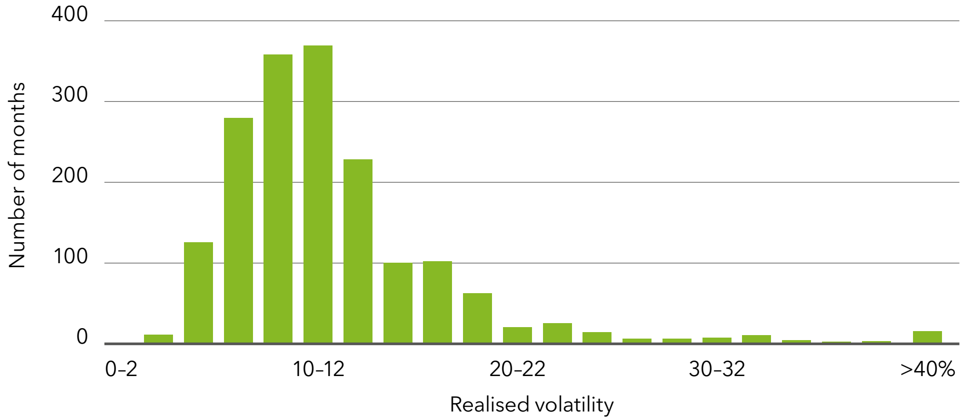
The history of volatility is one of long stretches of calm punctuated by brief moments of crisis. Markets are typically either in a low- or high-volatility state, our research shows. See the *Volatility switch* chart. The question is what flips the switch. Our research suggests that breaks to a high-volatility regime rarely occur without the economic expansion coming to an end. We see the probability of a volatility regime shift as low – as long as the economy remains stable and systemic financial vulnerabilities are kept in check. Result: we see a risk that many investors are under-risked.

Low volatility does mask risks unique to fixed income markets, in our view. Volatility spikes can be led by financial, rather than economic, events. We see evidence of these financial risks in pockets of credit but not in the broader market. Poor liquidity in credit markets makes it tough to exit positions quickly and could worsen any sell-off. Rising corporate leverage could exacerbate these risks. Risk management is key as long-run investment success depends on avoiding catastrophic drawdowns. Yet we believe our basic conclusion holds: low volatility is surprisingly persistent.

Today's low-volatility regime may persist for longer than many expect.

Low… with a long tail

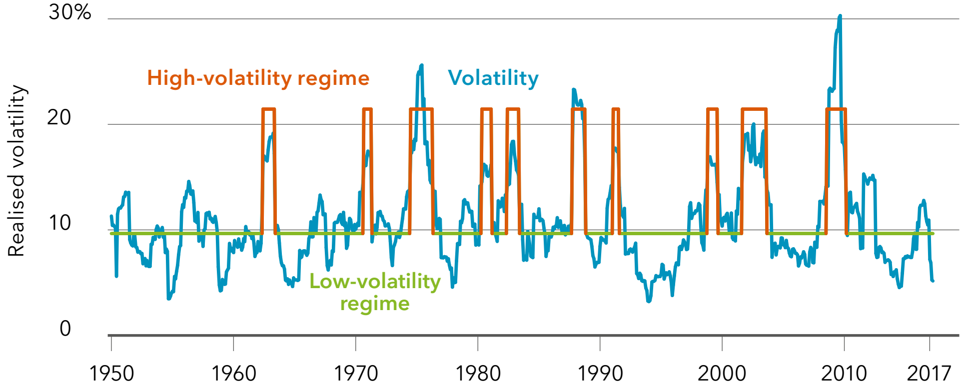
Distribution of realised monthly US equity volatility, 1872–2017



Sources: BlackRock Investment Institute, with data from Robert Shiller, June 2017. Notes: realised volatility is calculated as the annualised standard deviation of monthly changes in US equities over a rolling 12-month period. Bars show the number of months at each level of volatility. Each bar represents a bucket of two percentage points in realised volatility. For example, the bar marked 10–12 shows that volatility was between 10% and 12% for 369 months.

Volatility switch

Realised monthly US equity volatility, 1950–2017



Sources: BlackRock Investment Institute, with data from Robert Shiller, June 2017. Notes: realised volatility is calculated as the annualised standard deviation of monthly changes in US equities over a rolling 12-month period. Using a Markov-Switching regression model, we calculate two volatility regimes: a high-volatility regime (orange) and a low-volatility regime (green). The orange and green lines plot the average level of volatility during each regime based on data from 1872 to 2017.

Theme 3: rethinking returns

Historically low government bond yields are likely here to stay. Structural factors such as aging populations, poor productivity growth and high debt levels are reasons why. Real neutral short-term rates – those that neither stimulate nor hold back growth (known by academics as r*) – are much lower than in the past. See the *Low yields matter* chart. That is an important reason why the Fed is treading cautiously in raising rates and other central banks appear slow to follow that path.

We expect long-term bond yields to rise gradually over the next five years but to stay well below historical averages. Such a view feeds directly into how we think about valuations in this post-crisis world. If discount rates for judging asset prices are not poised to revert to their historical mean, then perhaps we need to look at valuations through a different lens.

We see structurally lower growth and interest rates forcing a rethink of asset valuations.

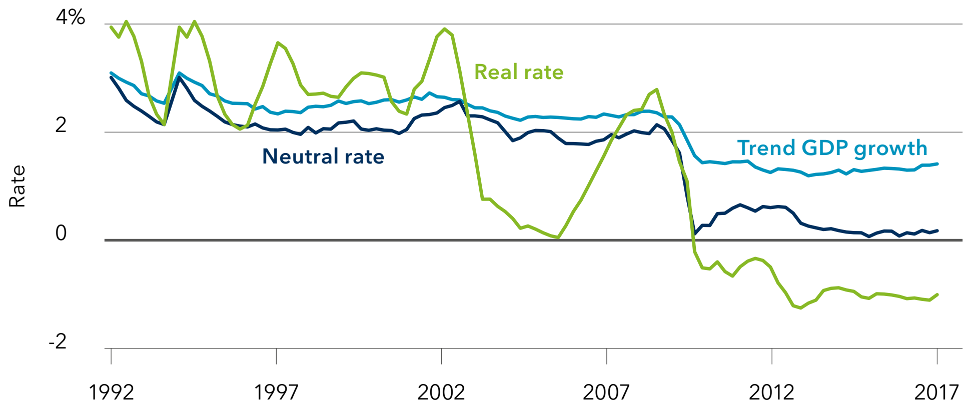
Worrying about equity valuations – particularly in the US – has become a favourite pastime. The earnings yield (earnings per share divided by the share price, or the inverse of the price-to-earnings ratio) gauges the attractiveness of equities versus bond yields. This measure puts US equity valuations in the richest quartile of their history. Yet the earnings yield still looks attractive versus bond yields. See the *Eye of the beholder* chart. Earnings are staging a recovery, and long-term rates are held down by structural factors and plentiful global savings. We see less reason to expect equity valuation metrics to fall back to historical means in such a world.

There are risks. The share of income going to labour (wages) is historically low, and corporate margins are elevated. Any policies that reverse this trend – or labour shortages causing wages to spike – could erode margins and equity valuations. In the final analysis, however, we believe investors are being paid to take equity risk against the backdrop of low rates. This is especially the case for non-US equities, in our view. See *page 13*.

We believe equities may be cheaper than they look in a low-rate world.

Low yields matter

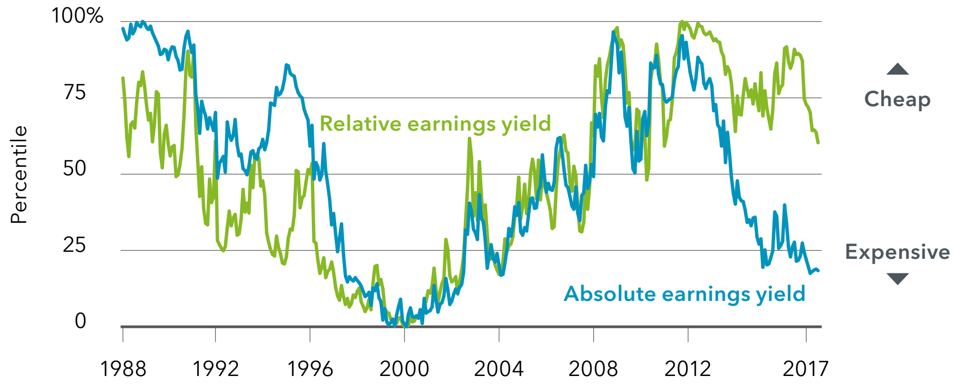
Developed market real rates, neutral rates and trend growth, 1992–2017



Sources: BlackRock Investment Institute, with data from the Federal Reserve, US BEA, Eurostat, Statistics Canada and Japan Cabinet Office, July 2017. Notes: this chart shows the GDP-weighted averages of **1** estimates of the neutral rate, called r*; **2** estimates of trend GDP growth rates, and; **3** the real short-term rate for the US, Japan, eurozone, UK and Canada. Data are through February 2017. For more details, see our **Global macro outlook** of November 2016 at blackrock.com/corporate/en-us/literature/whitepaper/bii-global-macro-outlook-november-2016.pdf.

Eye of the beholder

US equity market valuation, 1988–2017



Sources: BlackRock Investment Institute, with data from MSCI and Thomson Reuters, June 2017. Notes: US equities are represented by the MSCI US Equity Index. Absolute valuation is based on earnings yield (the inverse of 12-month forward price/earnings ratio. Valuation relative to bonds is based on earnings yield minus US real bond yield (10-year US Treasury yield minus US core CPI inflation). Valuations are shown in percentiles. For example, the current US absolute earnings yield is in the 18th percentile. This means the earnings yield has been equal to or lower than that level 18% of the time since 1988.

Outlook forum: term premium revival

We see the term premium – the extra yield that compensates investors for holding long-term bonds – rising gradually. The reason? Central banks are slowing or unwinding quantitative easing (QE). We see G3 net sovereign bond issuance flipping positive in 2018 for the first time in three years. See the *Bond supply is back* chart. That raises the risk of indigestion. Compressed term premiums in recent years helped push investors into riskier fixed income sectors such as credit and EM debt. This process is about to go into reverse, we believe.

Our base case: G3 term premiums gradually rise in the years ahead but stay at low levels due to the same structural factors holding down yields. This anchors our views across asset classes. The risk is a yield overshoot as central banks are in uncharted territory in winding down QE. And there is a risk yields will rise faster if fiscal expansion results in greater bond issuance.

As central banks start to wind back asset purchases, we see the long-suppressed term premium rising – albeit gently.

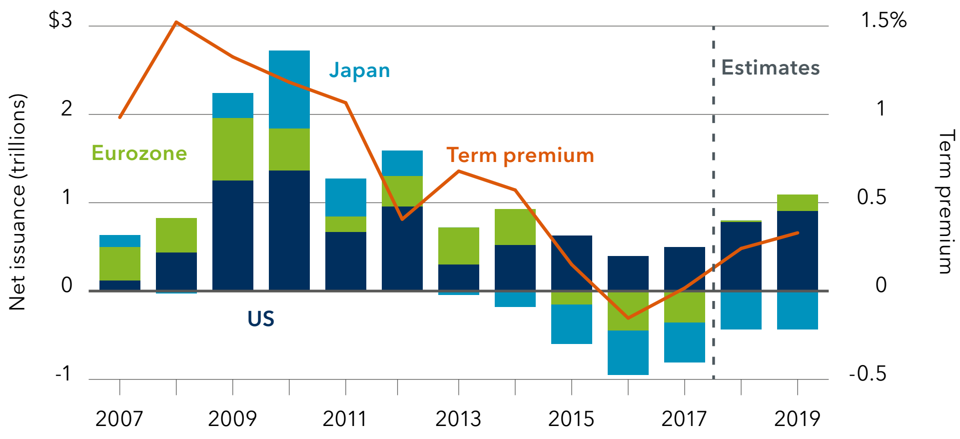
The Fed is paving the way for a post-QE world, laying out a roadmap for shrinking its balance sheet. The unprecedented QE reversal creates the risk of a misstep that sends yields spiking, hurting risk assets and the economy's steady expansion. As such, we see the central bank unwinding cautiously – akin to ***crossing the river by feeling the stones***. The benign market reaction to the detailing of its balance sheet plans in June suggests that, for now, it has avoided another 'taper tantrum.' See ***page 11*** for our views on the likely impact on fixed income markets.

We see the Fed running off about $400 billion of Treasuries and mortgage-backed securities each year in 2018–20. See *Shrinking the balance sheet*. The downsized balance sheet should still be about four times bigger than pre-crisis levels. This is tied to more currency in circulation and the need for assets to guide short-term rates via repurchase agreements.

The Fed is leading the way in backing away from mega monetary stimulus and normalising rates. Other central banks appear far behind.

Bond supply is back

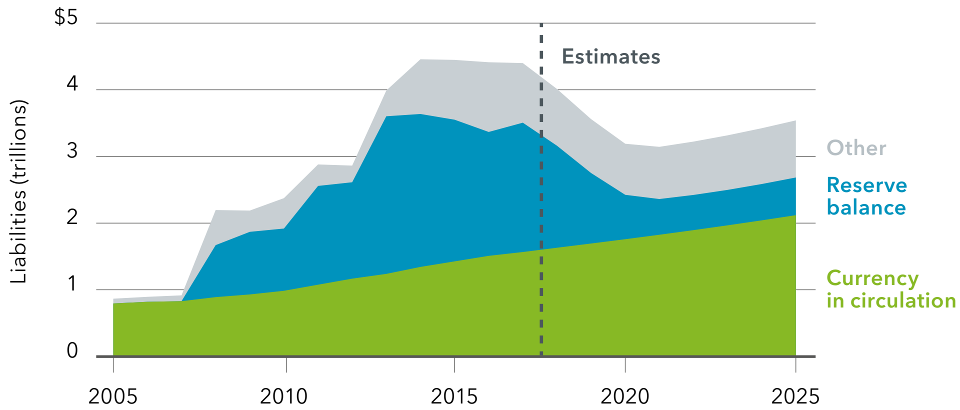
G3 net debt issuance ex central bank purchases, 2007–2019



Sources: BlackRock Investment Institute, with data from IMF, Morgan Stanley and Thomson Reuters, June 2017. Notes: the bars show net government bond issuance for the US, eurozone and Japan, net of central bank purchases via quantitative easing programs. Estimates are from Morgan Stanley. The term premium is based on BlackRock calculations, with 2018–19 estimates factoring in the global savings glut and IMF projections of current account balances.

Shrinking the balance sheet

Federal Reserve balance sheet breakdown, 2005–2025



Sources: BlackRock Investment Institute, with data from Federal Reserve and New York Fed, June 2017. Notes: our estimates follow the New York Fed's liability-related assumptions: a minimum size of $500 billion reserve balance and currency in circulation growing in line with nominal GDP forecasts. The reserve balance is estimated to fall from $1.86 trillion now to $500 billion in 2020, and then grow in line with nominal GDP. The 'other' category includes the Treasury general account and repurchase agreements.

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Outlook forum: ECB and China risks

We see the ECB at risk of reducing stimulus too soon as its bond-buying program runs into self-imposed limits. It is not our base case – but a risk all the same. The ECB's purchases have been on a strict schedule since 2015, with the central bank buying up debt of each eurozone member state in proportion to its size. But the ECB now faces a balancing act. It has had to start varying its purchases to avoid hitting limits that bar it from holding more than a third of any country's outstanding debt. See the green bars in the *Juggling act* chart. Any premature tightening could deal a blow to inflation expectations. Reduced bond purchases may see weaker peripheral countries come under pressure. We could see the ECB announcing a reduction in monthly asset purchases, to start in 2018, as early as September. But we expect the ECB to reiterate patience in such a delicate policy transition.

We see some risk of the ECB starting to wind back its bond-buying program too soon.

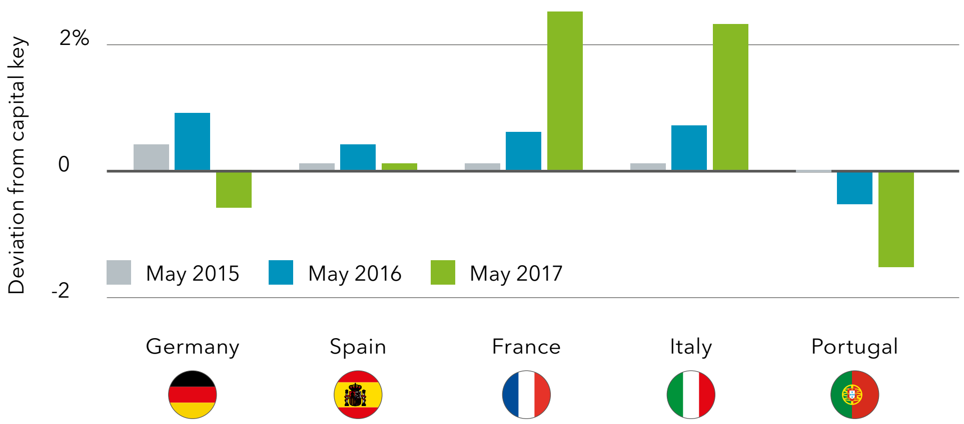
We believe China is managing its monetary tightening in a way that will allow for a gradual slowdown. A crackdown on leverage in the 'shadow' financial system is putting the brakes on non-bank lending. Yet overall credit is still growing at an annual pace that is equivalent to more than a quarter of GDP. This means China is still far from deleveraging. See the *Risky lending* chart and ***China's tricky transition*** of February 2017 for details.

We believe the targeted tightening should take GDP growth to a 6%–6.5% pace. China is likely to slow further in coming years, but its growth comes off a much bigger base. Will the glide path be smooth? It depends on how well China rebalances its economy toward services and manages its debt pile. Much-needed attempts to clamp down on financial leverage raise the risk of debt accidents. For now, supply-side reforms are boosting profits at state-owned companies. And we see China keeping growth steady ahead of the Communist Party's National Congress later this year.

We believe the near-term risks to China's growth are overstated.

Juggling act

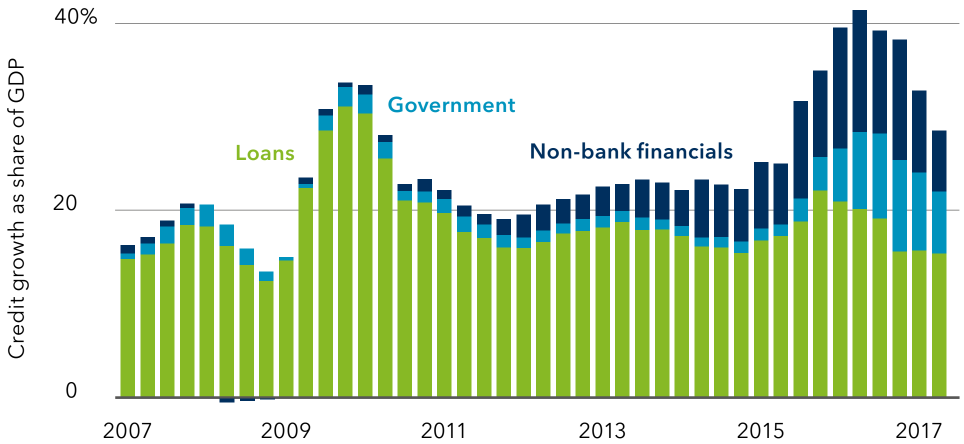
Monthly deviations from countries' capital key in ECB bond purchases, 2015–2017



Sources: BlackRock Investment Institute, with data from the ECB, June 2017.
Notes: the ECB uses the capital key, or share of national central bank capital in the ECB based on population and GDP, as a means of determining how much of each country's bonds it buys in its asset purchase program. The chart shows monthly divergences in the ECB's bond purchases from each country's capital key. A positive number indicates bond purchases larger than the capital key and vice versa.

Risky lending

Annual growth in China bank claims as a share of GDP, 2007–2017



Sources: BlackRock Investment Institute, with data from the People's Bank of China, June 2017.
Notes: the chart shows the annual growth in various China bank claims as a share of GDP. Bank claims include loans as well as claims on the government and non-bank financial institutions.

Outlook forum: debating Europe

Years of investor pessimism on Europe are morphing into cautious optimism. Europe's economy is enjoying a cyclical upswing, supported by a still accommodative ECB. And the two largest countries and long-time drivers of integration, Germany and France, are poised to have pro-European, newly legitimised governments. Emmanuel Macron's party has won a large majority in parliament, giving the French president leeway to pass labour and tax reforms needed to revive growth. Polls suggest German Chancellor Angela Merkel is poised to win a fourth term in September, with an eye to preserving her legacy as a defender of European integration.

Our once-contrarian overweight on European equities has now become consensus – yet we see further upside as investors warm to the European story. European equities have traded at a valuation discount to US peers. See the *Cheap for a reason?* chart. Some of us argue this persistent discount is justified – partly reflecting a weak banking sector and a lack of globally competitive companies. Structural reforms such as greater labour market flexibility could unlock Europe's growth potential and raise return on equity. This could narrow Europe's valuation discount a bit over time. This means politicians need to deliver. Other risks include the ECB winding back stimulus too soon (see *page 8*) or renewed political instability in Italy.

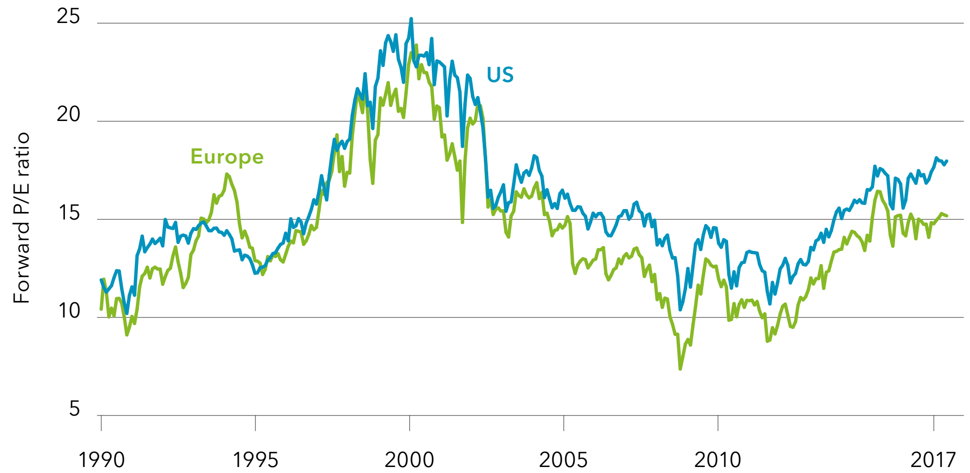
Europe may have its best opportunity in decades to push through reforms that make the EU more durable and effective.

"It's very rare for me to feel excited about politicians in my home country of France. That has changed with Macron. If this has legs, it could be a turning point for Europe."

Pierre Sarrau – BlackRock's Global Chief Investment Officer of Multi-Asset Strategies

Cheap for a reason?

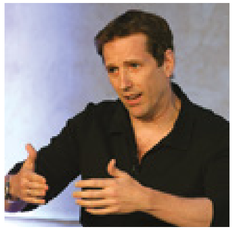
US and European P/E ratios, 1990–2017



Sources: BlackRock Investment Institute, with data from MSCI and Thomson Reuters, July 2017.
Note: the lines show the 12-month forward P/E ratio for the MSCI US and Europe indexes.

"Europe is showing some compelling growth. While the US is distracted politically, Europe can do well."

Rick Rieder – BlackRock's Global Chief Investment Officer of Fixed Income



"The idea that people can look at European equities and make a bull case is somewhat startling. Europe is being structurally beaten in many industries."

Alister Hibbert – Portfolio manager, BlackRock's European Equity team

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Outlook forum: politics not quite as usual

The coming year brings a mosaic of elections, monetary policy decisions and geopolitical hot spots. See the map to the right. Washington lawmakers face a shrinking window of opportunity to implement tax reform, as detailed in ***Politics not quite as usual*** of June 2017. Mexican elections loom large on the EM political calendar. And geopolitical hot spots abound, with North Korea representing the most immediate threat, in our view.

How do we navigate these events? 'Unknown unknowns' can hit at any time and are tough to anticipate – think of the 2011 earthquake and tsunami that struck Japan. Yet it pays to prepare in advance for the 'known unknowns,' especially ones that could have very different outcomes. We find that markets typically don't wake up to such event risk until about two months ahead. Volatility tends to peak near the event – and then quickly subsides.

It pays to do your homework ahead of binary political events. Markets are often slow to appreciate the risks.

Broadly speaking, political events don't tend to be game changers for markets. Sell-offs after recent surprises like last year's UK Brexit vote have been seen as buying opportunities. Even still, such events may generate more volatility than desired. Hedging is seldom cheap, but it can help smooth the ride. For example, our global fixed income team performed scenario analysis ahead of the recent French elections. They used liquid instruments such as the euro and government bonds to fortify portfolios against the 'tail risk' of a game-changing event, and left intact core illiquid holdings such as bank debt to avoid getting whipsawed.

"The Gulf is no longer an island of stability in the Middle East because of low oil prices, changes in leadership and intensified competition between Saudi Arabia and Iran."

Tom Donilon – Chairman, BlackRock Investment Institute

On the agenda

Events and geopolitical risks to watch in 2017 and beyond

Source: BlackRock Investment Institute, July 2017.

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Markets: government bonds

What happens to the bond markets as the Fed starts shrinking its balance sheet? Our base case is a relatively gentle climb in yields from current levels. We see a shortage of perceived safe assets globally, with strong demand for income likely to moderate any spikes in yields. Yet within this context, we believe yields may rise more than markets currently expect.

The Fed's reduction of US Treasury purchases will play out just as net issuance is set to start steadily rising – partly a result of mounting health care and Social Security obligations. See the *Bond appetite test* chart. Fears of increased supply may result in steeper yield curves over time. Any steps toward normalisation by the ECB or Bank of Japan could accelerate this trend, as ultra-loose monetary policy elsewhere has helped hold down US Treasury yields. Another key risk we see is deficit-financed tax cuts. This could lead to increased issuance and rising inflation expectations. It may even cause the Fed to sharply raise its pace of rate hikes.

We see a deliberate Fed and strong demand for income keeping yield rises in check, but increasing issuance poses a risk to bond prices.

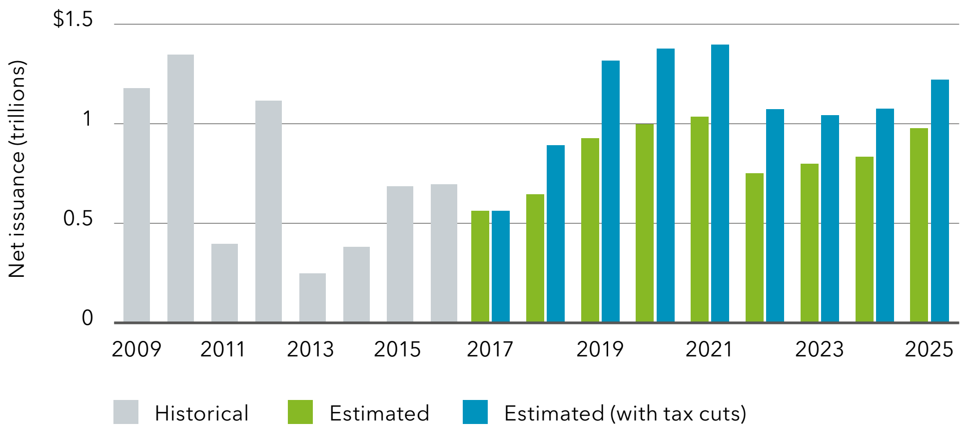
Inflation expectations have taken a hit this year as price pressures turned south. See the *Elusive inflation* chart. We think much of the slowdown is due to a renewed oil price slide and one-off factors such as a decline in US wireless charges. The latter should eventually wash out of the data, we believe. Yet it does illustrate technology's disinflationary impact.

We see scope for US core inflation to climb from here, though sluggishly. We favour Treasury inflation-protected securities over nominal bonds, particularly beaten-down short-term paper. We could see core inflation in the eurozone ticking up and believe there is some value in medium-term inflation-linked bonds. We see long-term inflation-linked UK gilts as pricey but believe limited supply offers some value versus short-term securities.

We see recent weakness in US and eurozone inflation-linked bonds as a buying opportunity as inflation normalises over the medium term.

Bond appetite test

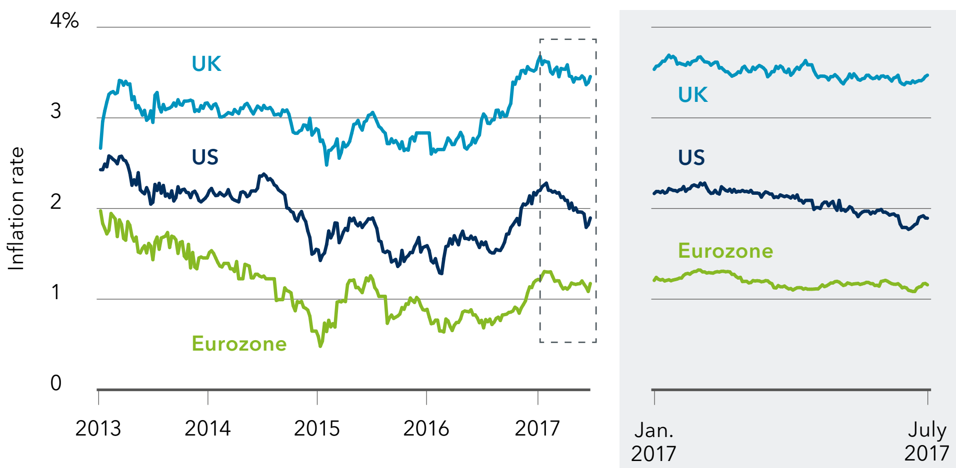
US Treasury net issuance ex Fed purchases, 2009–2025



Sources: BlackRock Investment Institute, with data from Bloomberg, June 2017.
Notes: the estimated debt issuance figures are based on the Congressional Budget Office (CBO) **baseline projections**.
The tax cut scenario is based on the same CBO figures and analysis by the **Tax Policy Center** (September 2016) on the budgetary impact of the House Republican tax plan blueprint released in June 2016.

Elusive inflation

Five-year inflation expectations, 2013–2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters, July 2017.
Note: inflation expectations are represented by five-year zero-coupon inflation swaps.

Markets: credit

Credit markets today appear to be pricing in steady economic expansion, based on their historical relationship with global growth levels. See the *Pricing in growth* chart. Investment grade and emerging market debt spreads have been right in line with the historical trend since 2006. High yield bond spreads have been a little tighter than normal, according to our analysis, making them less attractive than other credit sectors.

We could see spreads tightening a bit more if global PMI levels stay robust and liquidity plentiful but expect future returns in credit to be more muted than in the recent past. We see returns coming mostly from income or 'carry,' not from further spread tightening. Any moderation in global growth from today's levels could lead to spread widening, however, eroding returns in the credit sector. Credit markets currently do not compensate investors well for the risk, we believe, in contrast to equities.

We see future credit market returns as more muted than in the recent past. Tight spreads leave little room for error.

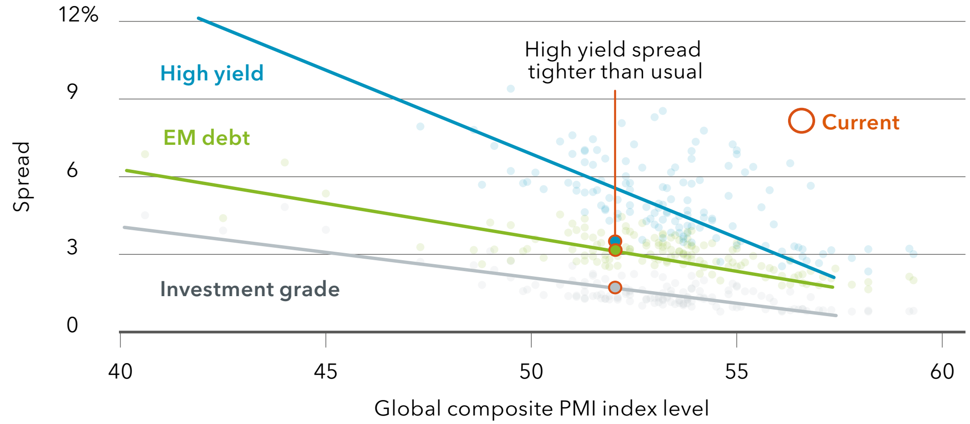
We still like credit within a fixed income context but see more reason to be selective. Investors have been hunting for yield in global credit and EM debt markets due to ongoing central bank QE and negative rates in much of the developed world. Spreads have declined across the board from early 2016 peaks, especially in higher-yielding credit markets. This has reduced dispersion across global bond sectors. See the *Little juice left* chart.

We prefer US investment grade bonds against this backdrop of reduced compensation for credit risk. We are neutral on US high yield and prefer up-in-quality names. We are underweight European credit, as ECB purchases and negative rates have helped lead to steep valuations. We like selected EM debt. Global growth favours the asset class, even if the Fed is raising rates. We see further capital gains as limited after a big run-up, and focus on income as the main source of returns.

Quality credit with a decent yield is tough to find. We prefer investment grade and selected EM debt.

Pricing in growth

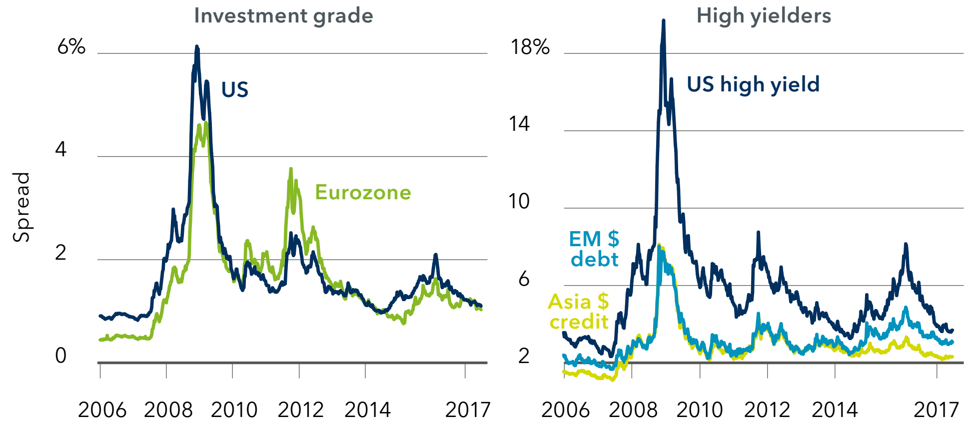
Global PMIs versus credit spreads, 2006–2017



Sources: BlackRock Investment Institute, with data from IHS Markit, Bloomberg Barclays, JP Morgan and Thomson Reuters, June 2017. Notes: a PMI above 50 indicates economic expansion. Indexes used are the Bloomberg Barclays US Corporate Bond and US Corporate High Yield Indexes, and the JP Morgan Diversified Emerging Market Bond Index. Each dot is a monthly observation. The lines are linear regressions for each sector over the 2006–2017 period.

Little juice left

Credit spreads, 2013–2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters, July 2017. Notes: the lines are based on option-adjusted spreads for the following indexes: Bloomberg Barclays US Corporate Index, US Corporate High Yield Index, Euro Aggregate Corporate Index, Euro High Yield Index, JP Morgan EMBI Global Diversified Index and Asia Credit Index. Past performance is no guarantee of future results.

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Markets: equities

The global corporate earnings picture has brightened. The ratio of upward to downward estimate revisions by analysts has surged to the highest levels in over five years. See the *Earnings comeback* chart. It is a broad-based increase. Earnings momentum is on the rise in the US, Europe and particularly emerging markets. This is another piece of evidence supporting our belief that the global economy is in a period of sustained, above-trend growth.

This is more than just a one-time rebound. Share buybacks and cost-cutting have propelled bottom-line growth in recent years, but sales growth in the US is tracking at the strongest level in six years. The risk is that prices largely reflect lofty earnings estimates, leaving room for reality to disappoint. We prefer European, Japanese and EM shares. In the US, we like financials, technology and dividend growers.

A sharp and synchronised recovery in global earnings supports global equity markets.

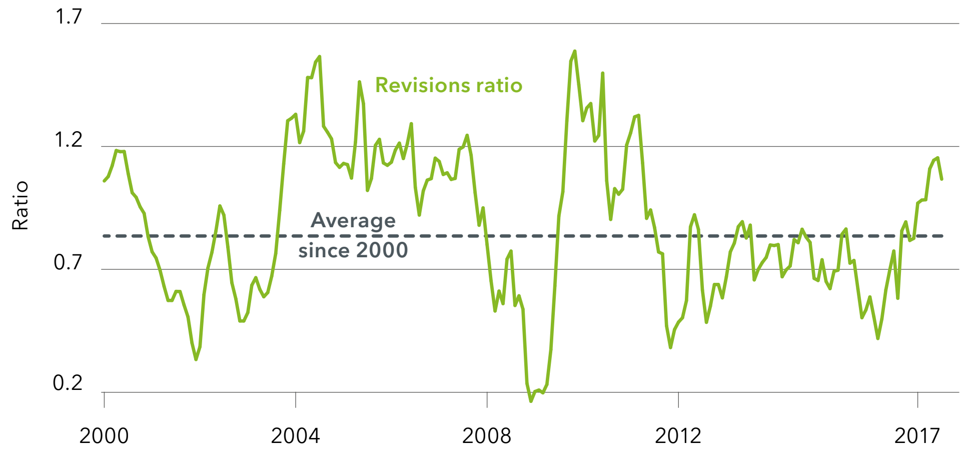
The technology sector has been a stand-out performer in 2017. The global tech index is again approaching the peak levels seen in the early-2000s dot-com bubble. The big difference today? Gains are being supported by corporate profits. See the *Tech renaissance* chart. The tech sector has the highest forecast earnings growth in 2017 outside energy and materials.

The development and adoption of new technologies is changing the business model for nearly every industry, from retail to energy production. We believe we are still in the early stages of this transformation. The pie is not getting bigger in many sectors, but tech is stealing a larger slice. Many leading tech firms are found in other sectors (think online retailers). This means the sector's influence goes beyond its 17% weight in the MSCI ACWI Index. Overall, tech valuations are not cheap, but we see stable and sustained earnings growth offering better support than in other sectors.

We see tech as a long-term growth opportunity but brace for the risk of sudden reversals after sharp price gains.

Earnings comeback

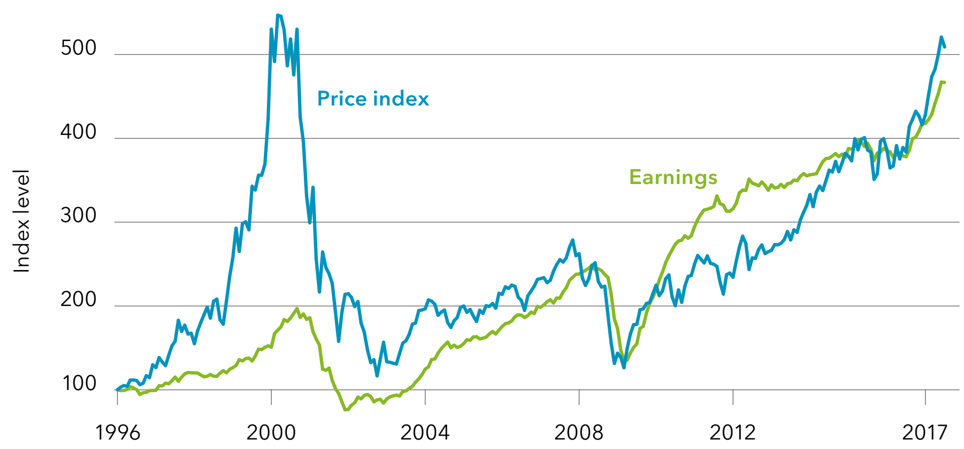
Global equities earnings revisions ratio, 2000–2017



Sources: BlackRock Investment Institute, with data from MSCI and Thomson Reuters, July 2017. Notes: the lines show the number of companies in the MSCI ACWI Index with 12-month forward earnings-per-share (EPS) estimates revised up from the previous month divided by the number of companies with downward EPS estimate revisions.

Tech renaissance

World technology stocks price and earnings, 1996–2017



Sources: BlackRock Investment Institute, with data from MSCI and Thomson Reuters, July 2017.
Notes: the price index is based on the MSCI All-Country World Technology Index. Earnings are represented by the aggregate 12-month forward earnings estimate. Both series are rebased to 100 at the start of 1996.

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Markets: style factors

Today's economic regime favours risk-seeking style factors over defensive ones, we believe. The momentum factor – securities with strong recent price gains – has outperformed in economic expansions, our ***Factor-based Strategies Group***'s analysis of US factor performance since 1990 suggests. See the *In and out of style* chart. We see the backdrop of stable growth also offering potential for the value style factor to outperform in the long run. Yet any soft growth patches could hurt its short-term performance.

Investors can enhance returns by tilting, or adjusting, factor exposures through the economic cycle, we believe. Yet exposure to all style factors has diversification benefits. For example, the quality and minimum volatility factors have historically tended to outperform in economic decelerations, but can provide some diversification throughout the cycle to cushion against volatility. See ***Focusing on factors*** of June 2017.

We advocate tilting style factors throughout the economic cycle, but believe exposure to multiple factors may help provide diversification.

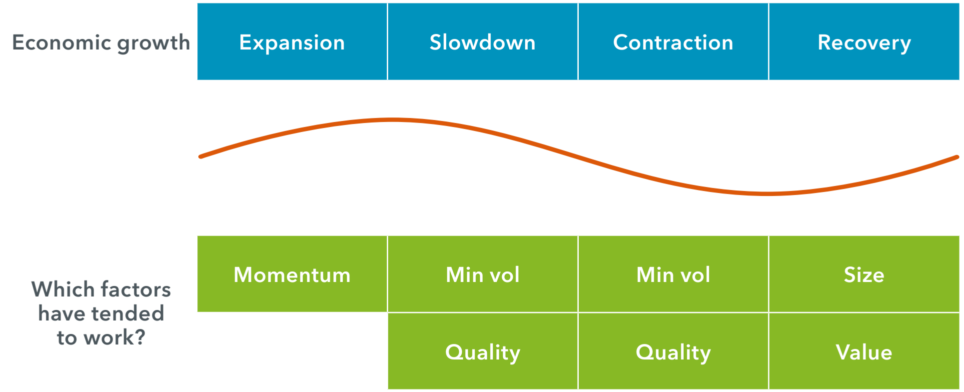
The momentum style factor has been on a winning streak in 2017. Momentum has historically outrun the broader market, but with periodic sharp drops. See the *Riding the momentum train* chart. The biggest dips have coincided with recessions and financial crises. Today's low-volatility environment coupled with a sustained economic expansion bode well for momentum, we believe.

A sharp drop in tech stocks in mid-June illustrated the risks of momentum breaks. Momentum drawdowns typically last two months or less, our analysis shows. And they are typically buying opportunities, provided there are no economic or financial shocks to the volatility regime. The momentum factor today is dominated by technology but exposure to financials should cushion the downside in any tech sell-off. We do not see the momentum factor today as expensive or crowded. The risks: a sudden shift in stock leadership as a result of a growth or profits slowdown, or a yield spike.

We like the momentum factor in today's economic expansion, even if its performance could be prone to short-lived reversals.

In and out of style

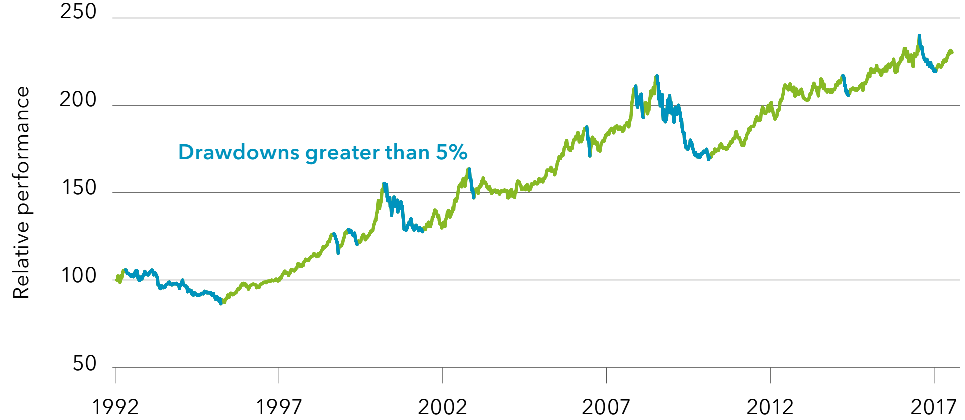
Economic regimes and equity style factor performance



Sources: BlackRock Investment Institute and BlackRock's Factor-based Strategies Group, June 2017.
Notes: this is for illustrative purposes only and does not represent any actual fund or strategy performance. We define each factor above and throughout this piece using the relevant MSCI indexes: the MSCI USA Momentum Index (momentum), MSCI USA Minimum Volatility Index (min vol), MSCI USA Risk Weighted Index (size), MSCI USA Sector Neutral Quality Index (quality) and MSCI Enhanced Value Index (value).

Riding the momentum train

Relative performance of momentum stocks, 1992–2017



Sources: BlackRock Investment Institute, with data from MSCI, July 2017.
Notes: the line shows the performance of the MSCI ACWI Momentum Index relative to the MSCI ACWI Index, by dividing the former by the latter and rebasing to 100 at the start of 1992. Areas in blue show periods of drawdowns, or peak-to-trough declines, of more than 5%, based on weekly data. Past performance is no guarantee of future results.

Assets in brief

Views on assets from a US dollar perspective

Asset class		View	Comments
Equities	US	—	2017 earnings momentum is strong. Fading prospects for tax reform have been largely discounted, leaving room for positive surprises. We like value, momentum, financials, technology and dividend growers.
	Europe	▲	We see global reflation and an improving earnings outlook supporting cyclicals and exporters, particularly industrials and multinationals with EM exposures.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behaviour and earnings upgrades amid a stable yen outlook. We see BoJ policy and domestic investor buying as supportive. Risks are yen strength and rising wages.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks. Reflation and growth in the developed world are other positives. Risks include sharp changes in currency, trade or other policies.
	Asia ex-Japan	▲	The region's economic backdrop is encouraging. China's economic growth and corporate earnings outlook look solid in the near term. We like India, China and selected Southeast Asian markets.
Fixed income	US government bonds	▼	Reflation challenges nominal bonds. We favour TIPS for the long run after valuations cheapened amid falling oil prices and weaker inflation readings. We are neutral on agency mortgages due to current valuations and potential future impacts of the Fed's balance sheet run-off.
	US municipal bonds	—	Demand for income and diversification are likely to drive further demand for munis despite tightening valuations. We see seasonally weak supply supporting the sector in coming months and favour intermediate to 20+ year securities.
	US credit	▲	Stronger growth favours credit over Treasuries. We generally prefer up-in-quality exposures and investment grade bonds due to elevated credit market valuations. Floating-rate bank loans appear to offer insulation from rising rates, but we find them pricey.
	European sovereigns	▼	High valuations and the market's focus on improving economic data make us cautious. Waning political risks should cause core eurozone yields to rise and spreads of semi-core and selected peripheral government bonds to narrow.
	European credit	▼	Risks are tilted to the downside amid heady valuations and the possibility of shifting market expectations for central bank support. We are defensive and prefer selected subordinated financial debt.
	EM debt	—	We see sustained global growth benefiting EM debt. The asset class has historically performed well in such an environment, even if the Fed is raising rates. We focus on income as high valuations make further capital gains less likely.
	Asia fixed income	—	We like markets with positive fundamentals and reform momentum, such as India. The upside is limited as spreads have compressed. A positive cyclical outlook for China is supportive, but US trade protectionism is a risk.
Other	Commodities and currencies	NA	We expect oil prices to trade in a range around current levels as we see any supply-and-demand rebalancing late in the second half. We see gradual US dollar strength in the medium term on interest rate differentials with many other advanced economies.

▲ Overweight — Neutral ▼ Underweight

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BlackRock Investment Institute

The *BlackRock Investment Institute* (BII) provides connectivity between BlackRock's portfolio managers, originates market research and publishes insights. Our goals are to help our fund managers become better investors and to produce thought-provoking content for clients and policymakers.

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