



# Global Investment Outlook

**MIDYEAR** 2016

**BLACKROCK®**

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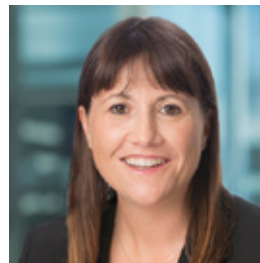


## MARKETS ..... 12

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Assets in Brief

Markets are torn between anxiety over the fallout from the UK's vote to exit the European Union and the prospect of a strengthening U.S. economy. Downside risks to global growth point to a U.S. Federal Reserve on hold — and reinforce our view of low global interest rates for long. Our key views:

- **Outlook Forum:** At a mid-June gathering of some 90 BlackRock portfolio managers and executives, we had vigorous debates on the outlook for a rebound in U.S. inflation, the prospect of a turnaround in beaten-down emerging markets (EMs) and the woes afflicting the global financial sector.
- **Themes:** We updated our three themes for this year: 1) We are living in a low-return world; 2) Monetary policy has been a key driver of asset prices — but its effectiveness looks to be waning; 3) We see more volatility ahead as Brexit-related anxiety weighs on Europe's economy and the business cycle matures.
- **Risks:** We see geopolitical uncertainties and a renewed rise in the U.S. dollar as near-term risks, and populism as a medium-term challenge for trade, growth and markets. A potential surprise: a rally in risk assets prompted by investors shifting out of cash and low-yielding assets in search of higher returns.
- **Markets:** We have turned more positive on most fixed income due to elevated geopolitical risks and easy monetary policy in a low-growth world. We like income, including investment-grade credit and EM debt. We are cautious on equities, particularly in Europe, given the turn in risk sentiment and poor profit growth. We prefer dividend growers and quality companies. We like gold as a portfolio diversifier.



**Belinda Boa**

Chief Investment Officer  
*BlackRock's Active  
Investments for  
Asia Pacific*



**Jean Boivin**

Head of Economic and  
Markets Research  
*BlackRock Investment  
Institute*



**Isabelle Mateos y Lago**

Global Macro  
Investment Strategist  
*BlackRock Investment  
Institute*



**Richard Turnill**

Global Chief  
Investment Strategist  
*BlackRock Investment  
Institute*

## Setting the Scene

We have trimmed our expectations for global growth. We see a risk of a UK recession and expect downgrades to an already poor growth outlook in the eurozone as the Brexit vote weighs on sentiment. Even in the relatively shielded U.S. economy, measures of policy uncertainty have spiked. See the *Uncertainty Is Certain* chart. It does not take much to knock the economy off its trajectory.

Consensus GDP forecasts still understate U.S. growth, according to our BlackRock Macro GPS “nowcasting” indicator, but not by as much as before the Brexit vote. We see EM economies stabilizing as the Fed keeps rates on hold. Renewed credit growth in China supports economic growth — but has less impact than in the past and could lead to a bust in the long run.

*The global economy is limping along, with the U.S. holding up, and Chinese growth, commodities and EM currencies stabilizing.*

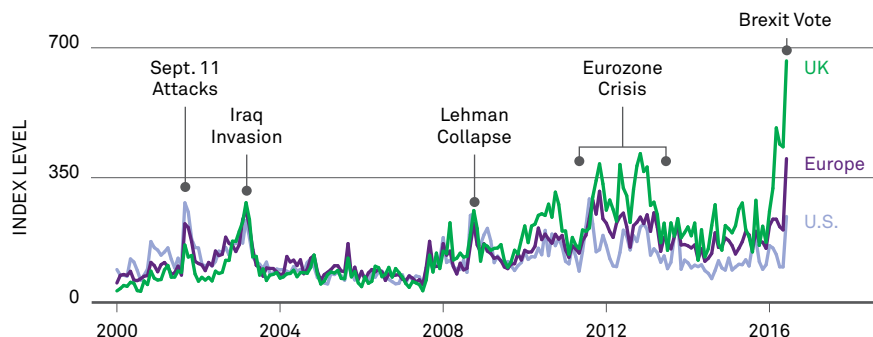
Bargains are hard to come by in the capital markets today. Government bonds are very expensive compared with their history as an ever larger part of that universe offers negative yields. See the *Few Bargains* chart. Valuations in equity and credit markets appear more reasonable on a relative basis, but corporate profits look challenged.

Those seeking to buy into market weakness should beware of notionally cheap assets facing structural challenges. Examples are UK real estate in the wake of the Brexit vote and European bank shares. We like value, but it has to have a pulse. We focus on assets with relatively attractive valuations and positive drivers, such as dividend-growth stocks, investment-grade credit and selected EM debt. “Carry,” or income, is crucial in a world where we expect low rates for even longer. Holding quality sovereigns such as U.S. Treasuries makes sense as a portfolio hedge against “risk-off” episodes — and for investors seeking to match liabilities. Negative yielding sovereigns such as German government bonds come with a hefty price tag.

*Valuations across the capital markets range from fair to very expensive. The right entry points and security selection are key.*

## UNCERTAINTY IS CERTAIN

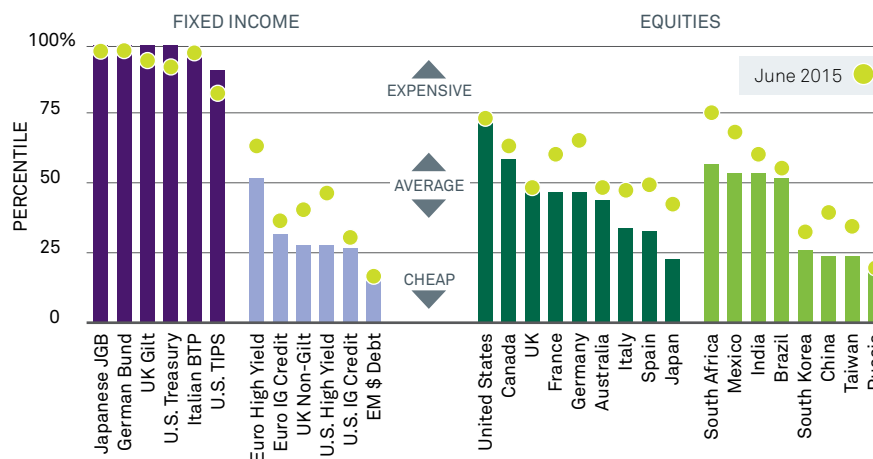
Economic Policy Uncertainty, 2000–2016



Sources: BlackRock Investment Institute and Baker Bloom and Davis – Economic Policy Uncertainty, July 2016.  
Notes: The Economic Policy Uncertainty Indexes measure policy-related economic uncertainty based on newspaper coverage of policy uncertainty. Europe is represented by Germany, France, UK, Italy and Spain.

## FEW BARGAINS

Valuations by Percentile vs. Historical Norms, June 2016



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, June 2016.  
Notes: The percentile bars show valuations of assets as of June 28, 2016, versus their historical ranges. For example, U.S. equities are currently in the 72nd percentile. This means U.S. equities trade at a valuation equal to or greater than 72% 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 U.S. 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).

## Reflation Debate

Central banks in the developed world have been trying to lift inflation from depressed levels and nudge up economic growth. Can they succeed in their reflation objective? Many of us see the U.S. as the only reflationary game in town. Services-based components of the consumer price index (CPI) such as housing rents are rising at a 2%-plus annual clip. Also, the U.S. unemployment rate fell to 4.7% in May, the lowest since late 2007, according to the U.S. Labor Department. Tighter labor markets typically lead to rising wages. This all points to rising inflationary pressures.

We had a spirited debate on reflation, with some of us seeing little chance of it due to low nominal economic growth and a world marked by oversupply. This crowd expected a slowdown driven by tightening financial conditions and renewed EM stresses such as currency weakness.

*We see the U.S. leading any reflationary trend, driven by price increases in the services sector and moderate wage growth.*

We see the hurdles for generating headline inflation moving progressively lower in the second half. Thanks to the oil price rebound, year-on-year comparisons of headline consumer prices should start to look increasingly favorable in coming months. This “base effect” alone would propel headline U.S. inflation to near 2.5% by early 2017 if core inflation and energy prices just stayed at current levels, we estimate.

This simple extrapolation tells a similar story for the UK, eurozone and Japan, albeit starting from much lower bases. See the **Coming to You Soon** chart. The prospect of higher inflation prints should not come as a surprise to markets. Yet there could still be a sticker shock, which could help nudge depressed inflation expectations higher (see page 5).

A sharp fall in the British pound may exacerbate inflationary pressures in the UK. Yet slower growth fueled by Brexit uncertainty could depress inflation expectations even more in the eurozone.

*Headline inflation is set to rise from depressed levels globally if oil prices stabilize at current levels.*



*“The case for U.S. reflation is twofold: the simple arithmetic of base effects kicking in and rising labor costs.”*

**Rupert Harrison** — Chief Macro Strategist,  
BlackRock Multi-Asset Strategies

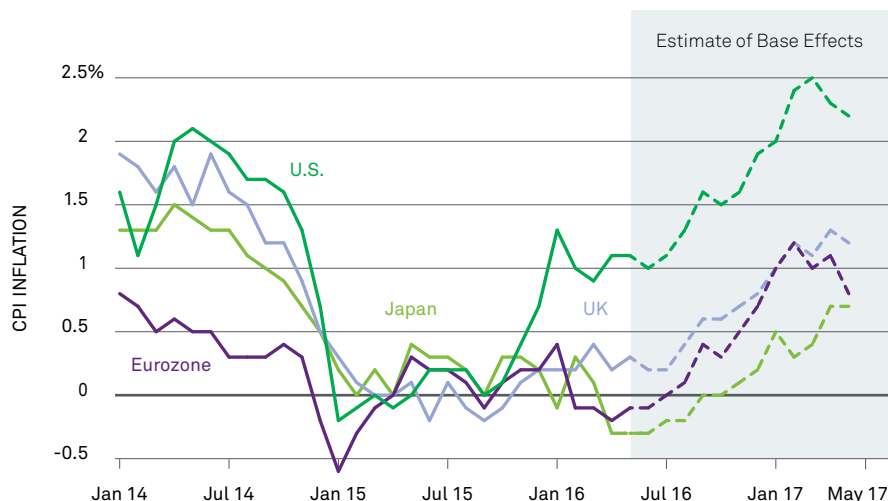
*“There are lots of factors that argue against reflation: low nominal growth, excess supply globally and the fact that services inflation is a lagging indicator.”*

**Tom Parker** — Chief Investment Officer,  
BlackRock Model-Based Fixed Income



## COMING TO YOU SOON

Consumer Price Inflation and Base Effects, 2014–2017



Sources: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, Eurostat, UK Office for National Statistics and Bank of Japan, June 2016. Note: The estimates of base effects are a BlackRock extrapolation of current energy and food prices and the rate of monthly core CPI into the future.

## Reflation Scenarios

**Actual inflation is one thing, but inflation *expectations* are another.**

This is because expectations can become self-fulfilling, dragging down actual inflation. Falling inflation expectations have put the brakes on wage growth and strengthened the perception central banks are pushing on a string. U.S. inflation expectations initially rose this year as oil prices recovered but have since fallen back to multi-year lows amid rising risk aversion. **See the *Reflation Expectations* chart.**

What does this mean for portfolios? For now, the monetary policy divergence trade looks dead. Signs of U.S. reflation would bring it back to life. This should translate into a stronger U.S. dollar — which optimists see helping limit any U.S. goods inflation. This would slow any further dollar gains, and buffer emerging economies against more currency falls. Result: a sort of Goldilocks scenario for both the global economy and risk assets.

***Signs of U.S. reflation could boost risk sentiment.***

**Not all reflationary scenarios are good for risk assets.** If the U.S. Federal Reserve appeared willing to tolerate a temporary overshoot of its inflation target, short-term nominal bond yields could spike. Investors would worry a behind-the-curve Fed may have to raise rates more quickly in the future. Similarly, a sustained rise in inflation that prompted a series of Fed rate increases would rattle most portfolios. Sovereign yields could spiral upward, and bond proxies such as real estate investment trusts and utilities would likely plunge. Value equities and commodities could rally.

Will U.S. reflation lead to a sustained rise in inflation for the rest of the world? We see this as unlikely for now. Low nominal growth and global disinflationary pressures caused by China's export machine spitting out goods with stable or lower price tags have kept a lid on global inflation. And inflation may peak at lower levels than in the past. Rapid technological change, such as automation and "asset-lite" business models that use spare capacity, is suppressing wage and price growth, we believe.

***Reflation also carries risks: Most asset prices would suffer if the Fed were seen to fall behind the curve on inflation, we believe.***



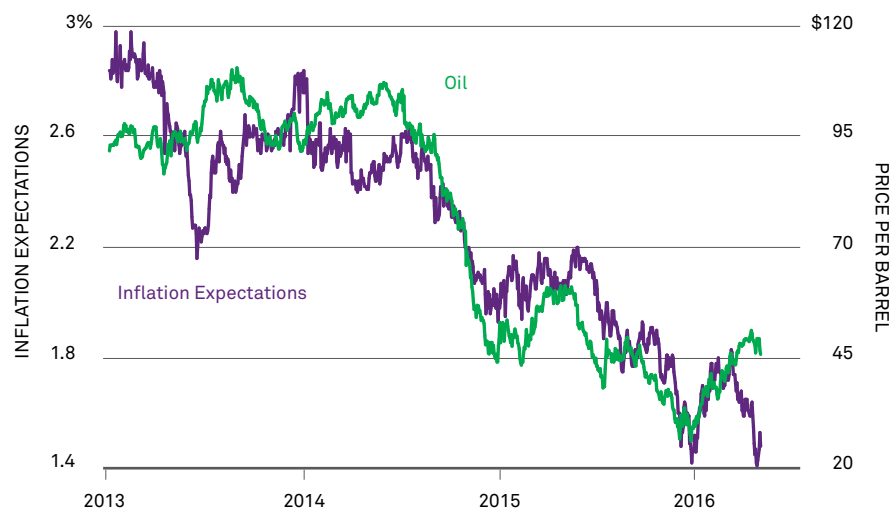
*"The key driver of U.S. inflation heading into 2017 is the service sector. The headwind of a stronger dollar also appears to be abating. The Fed's recent dovish rhetoric suggests real rates will stay low for longer than anticipated — and that the Fed is willing to allow inflation to run a little hot."*

*We also like inflation breakevens in the eurozone and Japan, given a potential mix of actual inflation and accommodative central bank policies. The British pound's fall has made UK inflation-linked assets interesting."*

**Martin Hegarty** — Head of BlackRock's Inflation-Linked Bond Portfolios in the Americas

### REFLATION EXPECTATIONS

U.S. Inflation Expectations and Oil Prices, 2013–2016



Sources: BlackRock Investment Institute, Federal Reserve Bank of St. Louis and Thomson Reuters, June 2016.

Notes: Inflation expectations are based on U.S. five-year/five-year forward inflation swaps. The oil price is based on the West Texas Intermediate crude spot price.

## Emerging Markets

**An expected hiatus in Fed rate rises bodes well for beaten-down EM assets.** The U.S. dollar paused its ascent in 2016, reversing the pressures that plagued EM currencies last year. A weaker U.S. dollar in the past has often coincided with strong performance in EM equities. **See the *Mirror Image* chart.** Brexit uncertainty has led to a resumption in dollar strength, but we see this as contained and posing little threat to the EM world.

The cyclical challenges that led to poor EM returns in recent years are now reversing. Weaker currencies have — with a lag — led to improving trade balances. The oil price and China's slowing economy have stabilized. Market-unfriendly governments have been ousted in key economies such as Brazil. And portfolio flows into EM debt have resumed — with room for upside because most investors are still underweight the asset class.

*We are warming up to EM assets, thanks to reforms in some countries and strong demand from investors fleeing negative rates.*

**Many EM stocks are cheap for a reason.** Companies tend to respect minority shareholder rights only when they need investment. The most exciting sectors (domestically oriented stocks, tech and fast-growing services) are pricey or underrepresented in indexes dominated by banks, manufacturers and government-controlled firms. Technological progress is shedding jobs in agriculture and manufacturing, potentially turning the EM world's "demographic dividend" into a liability. It is critical to be selective.

In equities, we like India on improving economic and reform momentum, and Southeast Asian countries with domestically led growth. In fixed income, we see opportunities in local-currency debt of Brazil, India, Indonesia and Poland for those who can stomach volatility. We believe markets are pricing in further EM currency declines that are excessive due to stabilizing fundamentals and a 50% depreciation since 2011. EM assets often do well from low currency values. We like hard-currency EM debt for income in a yield-hungry world.

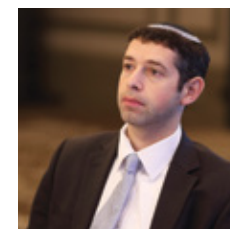
*We like EM debt for income in a world desperate for yield.*



*"The Great Migration to EM debt has kicked off. People are flocking to the asset class when yields are zero or less elsewhere."*

**Sergio Trigo Paz** — Head of BlackRock Emerging Markets Fixed Income

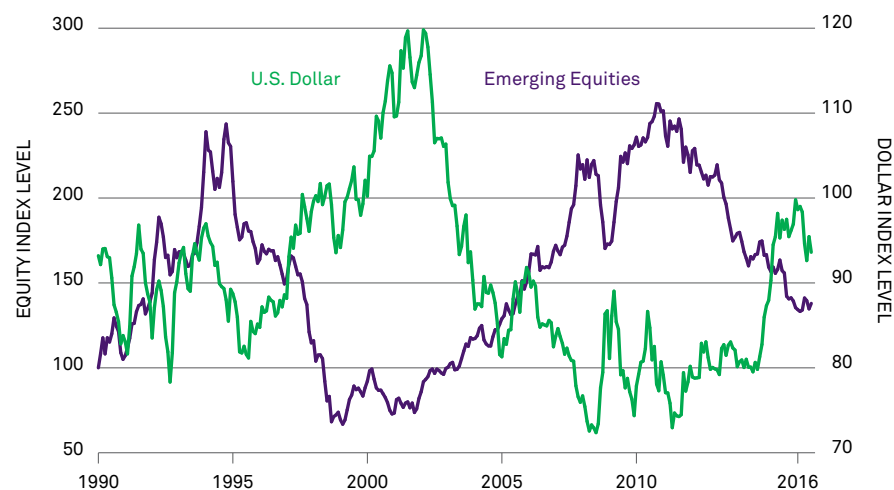
*"We like the countries that respect minority shareholder rights as a matter of course, not just when they need you."*



**Sam Vecht** — Member of BlackRock's Global Emerging Markets Equity Team

### MIRROR IMAGE

Emerging Equities and U.S. Dollar Performance, 1990–2016



Sources: BlackRock Investment Institute, Thomson Reuters and MSCI, June 2016.

Notes: The equities line represents the performance of the MSCI Emerging Markets Index relative to the MSCI World (Developed) Index, rebased to 100 in 1990. The U.S. dollar line shows the DXY trade-weighted dollar index.



## Financials

**Today's environment is depressing for banks.** Challenges include low or negative interest rates, regulatory pressures including more stringent capital requirements, a bad loan hangover from the crisis era in Europe and new competition from “fintech” disruptors.

This is reflected in bank equities globally. Valuations have dropped sharply from pre-crisis levels. Banks trade roughly at book value in the U.S., and well below book in Europe and Japan — suggesting they are actually destroying shareholder value. **See the *Fleeing Financials* chart.**

Yet we like U.S. bank credits due to improved balance sheets and see opportunities in the equities of selected U.S. universal banks. They have stronger capital positions than their European peers; the worst of the regulatory fines and penalties appears to be behind them; they have fee income; and they have room for cost cutting and returning capital to shareholders.

***U.S. universal banks are stronger than their global peers — and offer some refuge in a sector under siege globally.***

**European banks are on the front lines of financial sector mayhem.**

Restructuring, litigation and bad debt writedowns are making it hard to meet the rising bar of capital requirements. Negative rates and Brexit-related uncertainty are exacerbating these challenges. Passing negative rates on to customers could lead to deposit flight. So some banks are instead lifting rates on other activities, such as mortgage lending.

Net interest margins are depressed by low rates and flat yield curves. This makes cost cutting critical. Banks need to simplify their businesses and use technology to automate processes and reduce overhead. We see Italy's fragile banking system as Europe's Achilles' heel. An influx of capital is needed to recapitalize the banking system and restore confidence.

***We are underweight European banks. We expect well-capitalized banks with a focus on cutting costs and the ability to return capital to shareholders to be among the few equity winners.***



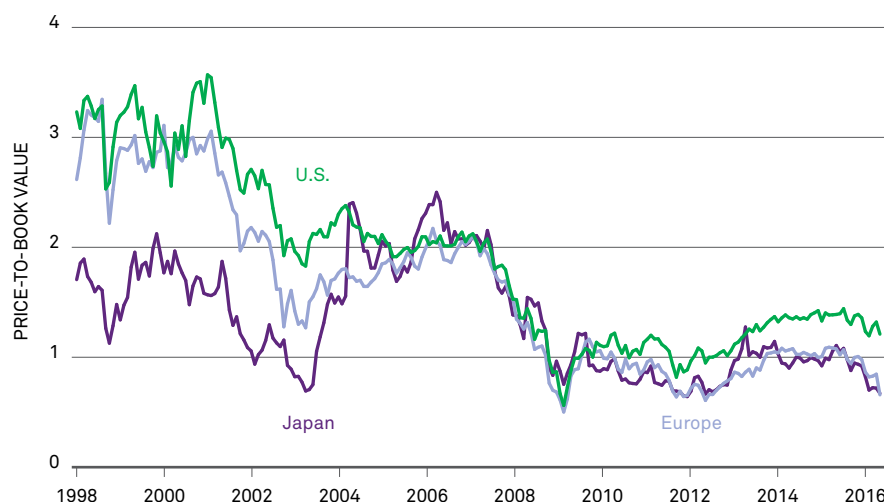
*“Banks are ultimately a leveraged play on the economy. The earnings pool has shrunk. The economic slowdown and credit saturation in many countries has led to less demand; low to negative interest rates are shrinking interest margins; and fees are being pressured as competition increases.*

*Consolidation is key, to remove excess capacity and bring about more rational competitive pricing. The good news is that values are depressed. In this low-rate and overleveraged world, we prefer high-quality banks with yield, decent return on equity and fee income from non-market related businesses like mortgage origination fees.”*

**Lisa Walker** — Member of the Global Allocation Team, BlackRock Multi-Asset Strategies

### FLEEING FINANCIALS

Financial Equities Price-to-Book Value, 1998–2016



Sources: BlackRock Investment Institute and MSCI, June 2016.

Note: The charts show the trailing price-to-book value for MSCI U.S., Europe and Japan Financials Indexes.

## Theme 1: Low Returns

**The hunt for yield is getting more challenging.** More than 70% of the bonds in developed-market government bond indexes today have yields of 1% or lower, with roughly a third below zero. **See the *Yielding Little* chart.** Bonds yielding 3% or more are going the way of the dodo. Slow global growth, negative interest rate policies, quantitative easing, and a flight to quality amid elevated global risks have pushed yields even lower. Falling yields are dragging down expected returns across the capital markets. Our five-year return assumptions are near post-crisis lows.

This means investors who want higher returns must take on greater risk — by increasing leverage or moving into riskier asset classes. This, in turn, propels valuations of risk assets higher, at the expense of lower expected returns in the future.

*Future market returns will likely be lower than in recent history. This argues for a more active approach to investing.*

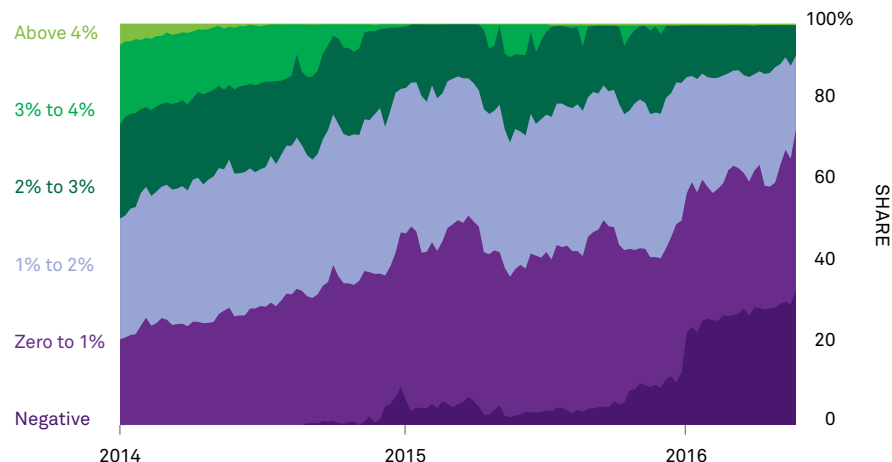
Equity market returns have leapt ahead of economic fundamentals since **the financial crisis**. The S&P 500 has generated a 60% return (including dividends) from its 2007 peak. That is roughly three times the increases in U.S. nominal GDP and corporate earnings over the same period. **See the *Borrowing From the Future* chart.** Returns have effectively been driven by multiple expansion (rising price-to-earnings ratios) and share buybacks, rather than earnings growth. Many non-U.S. equity markets have been running on fumes as well. This is not sustainable, in our view.

Global equity market returns have been muted in the past two years. Stocks staged a recovery from February lows this year, shaking off fears of a global recession, an oil-price collapse, and a Chinese currency devaluation. Yet stock markets have stumbled again in the wake of the UK's Brexit vote. Future returns will depend on a resumption of earnings growth.

*We have been borrowing from the future. We expect lower equity returns than in the recent past.*

### YIELDING LITTLE

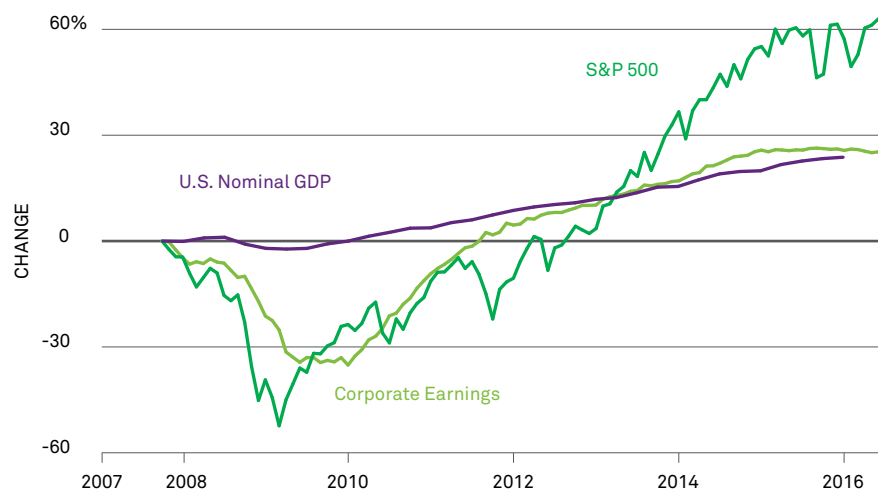
Global Government Bonds by Yield, 2014–2016



Sources: BlackRock Investment Institute, J.P. Morgan and Thomson Reuters, June 2016.  
Notes: The chart is based on the J.P. Morgan Global Developed Government Bond Index. Areas show the proportion of bonds in the index with yields in each range.

### BORROWING FROM THE FUTURE

U.S. Equity Total Returns, Earnings and GDP, 2007–2016



Sources: BlackRock Investment Institute, S&P and U.S. Bureau of Economic Analysis, June 2016.  
Notes: The chart shows the percentage change since the peak of the last equity cycle in October 2007 for S&P 500 total returns, trailing earnings per share and U.S. nominal gross domestic product (GDP) growth.



## Theme 2: Policy Limits

The impact of policy divergence on asset prices appeared to be waning in the first half. The U.S. dollar peaked in December — just before the Fed raised rates — and then stumbled as markets priced in a slower pace of tightening. This overshadowed ever-looser monetary policies by the European Central Bank (ECB) and Bank of Japan (BoJ). Yet these policies have become less effective in pushing down exchange rates, especially in Japan. The yen has shot up this year even as the BoJ's asset purchases are on track to equal last year's. See the *Diminishing Returns* chart.

The dollar appreciated after the Brexit vote. We see little room for further gains unless inflation picks up, geopolitical risks start to fade and markets again start pricing in Fed rate increases.

*We see the Fed on hold for now. Policy divergence can only reassert itself on asset prices if geopolitical anxiety recedes and markets again start pricing in U.S. rate rises.*

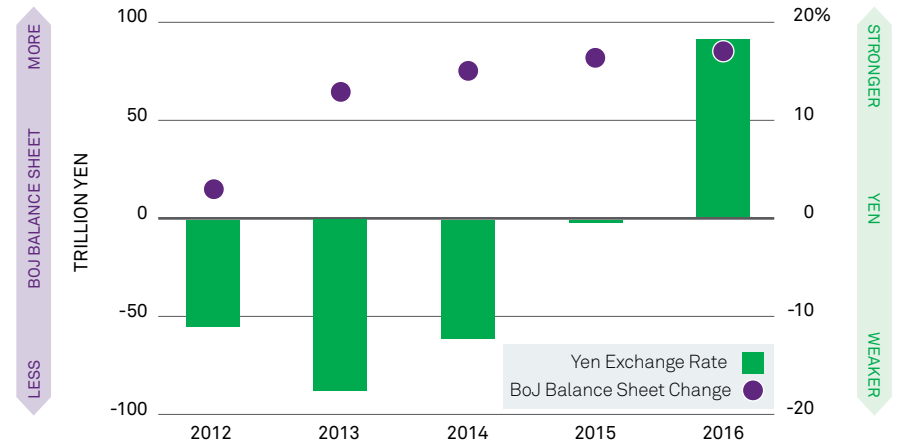
Countries have limited firepower left in their monetary arsenals. Policy rates are low, many balance sheets are bloated and some countries are near full employment. See the *Maneuvering Room* table. We see the Fed on hold for now amid lackluster growth and economic uncertainty. The ECB looks to be running into diminishing returns from negative rates. We see the Bank of England cutting rates and perhaps resuming quantitative easing. China has room for monetary easing but has to control rapid credit growth.

Fiscal stimulus and structural reforms need to take over from monetary policy to foster growth, we believe. There has arguably never been a better time for governments to finance infrastructure spending. Interest expense is low despite high debt levels. Yet this is not a quick fix. High-quality fiscal spending takes time to scale up. And fractious politics complicate things. Political dysfunction runs high in the U.S. In the eurozone, Germany does not want to boost spending while it perceives others as unwilling to reform.

*A passing of the baton from monetary policy to fiscal stimulus and structural reforms is needed, but we are not holding our breath.*

## DIMINISHING RETURNS

Annual Change in BoJ Balance Sheet and the Yen, 2012–2016



Sources: BlackRock Investment Institute, Bank of Japan and Thomson Reuters, June 2016.

Notes: The dots show the annual change in the size of the Bank of Japan (BoJ) balance sheet each year. The 2016 figure is annualized based on growth in the first half of this year. The bars show the percentage change in the yen-to-dollar exchange rate. The 2016 figure is year-to-date.

## MANEUVERING ROOM

Key Monetary and Fiscal Metrics for Selected Economies

	Measure	U.S.	EZ	UK	JP	CN
Monetary Policy	Policy Rate	0.5%	0%	0.5%	-0.1%	4.4%
	M2 Money Supply	69%	102%	113%	204%	214%
	Central Bank Balance Sheet	25%	29%	21%	93%	49%
	Proximity to Full Employment	0.9%	2.8%	0.2%	0.1%	1.2%
	Inflation	1.1%	-0.1%	0.3%	-0.3%	2.0%
Fiscal Policy	Net Government Debt	82%	70%	81%	130%	36%
	Total Debt	248%	253%	250%	379%	255%
	Government Interest Expense	3.5%	1.6%	2.3%	1.9%	0.5%
	Old Age Dependency 2050	37%	60%	42%	71%	47%
	Budget Deficit	-4.2%	-3.2%	-5.9%	-8.5%	-1.8%
	Current Account	-2.7%	2.0%	-4.3%	1.0%	2.1%
	Nominal Growth	3.7%	1.9%	3.6%	1.6%	8.2%

Sources: BlackRock Investment Institute, IMF, Bloomberg and BIS, June 2016.

Notes: Money supply, central bank balance sheets, government debt, total debt, interest expense, budget deficits and current account measures are shown as a percentage of gross domestic product (GDP). Budget deficits and current accounts show a five-year median. Nominal growth shows a three-year compound growth rate. Proximity to full employment shows the difference between the current unemployment rate and the minimum of the last 28 years.

## Theme 3: Volatility

**Easy monetary policies suppressed volatility, prompting many investors to flock to similar assets.** Popular strategies in June included overweighting Japanese government bonds and the yen, U.S. equities and precious metals, and underweighting emerging equities and industrial commodities, our analysis shows. **See the *Consensus Trades* chart.** “Me-too” trades have decreased overall this year, according to our analysis, but we have seen big shifts between asset classes. Bearish positions on precious metals, the euro and U.S. equities reversed, while many investors have thrown in the towel on European equities. The one constant: Investors remain bearish on EM equities. This gives that asset class upside potential.

Betting on yesterday’s winners rising (or losers falling) further — the momentum trade — has gotten a lease on life amid low growth and easy monetary policies. We see volatility driving more investment flows into our favorite assets: high-grade credit, quality equities and dividend growers.

*We see increased volatility risk. This raises the importance of diversification.*

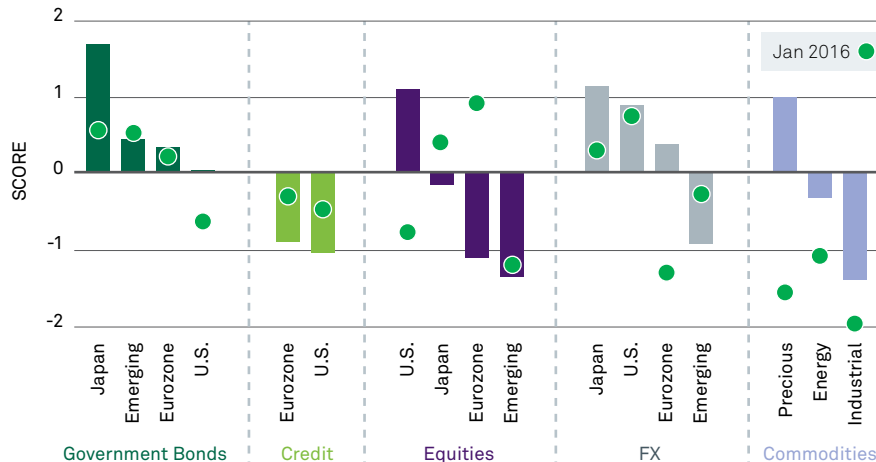
**Volatility soared when the UK voted to exit the EU, with the VIX index of U.S. equity market volatility spiking to near 2016 highs.** Yet realized equity volatility outside the U.S. has been bubbling below the surface. The frequency of 2%-plus daily moves in major equity markets has steadily increased since 2014. **See the *All Volatility Is Local* chart.** Currency volatility has spiked to near five-year highs, as reflected in J.P. Morgan’s VXY index of G7 currency volatility.

At the same time, long-held relationships appear to be breaking down. For example, the dollar has started to correlate positively with global equities on a two-year rolling basis, reversing a long-standing negative correlation. This means it no longer consistently rallies in equity market sell-offs — notwithstanding the recent risk-off period. This argues for greater diversification in portfolio hedges.

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

## CONSENSUS TRADES

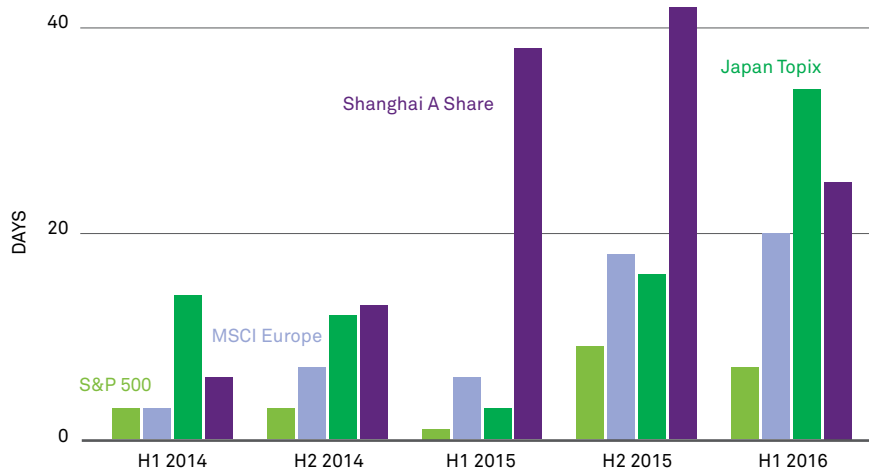
Positioning Across Asset Classes, June 2016



Source: BlackRock Investment Institute, Bloomberg, CFTC, EPFR and State Street, June 2016. Notes: Data are based on BlackRock’s analysis of portfolio flows, fund managers positions as reported by State Street and price momentum. A positive score means investors are overweight the asset class; a negative score indicates the reverse.

## ALL VOLATILITY IS LOCAL

Number of Daily Moves Greater than 2% in Selected Equity Markets, 2014–2016



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

Note: The bars show the number of days in each period with a daily move of more than 2% in either direction. H1 refers to the first half of the year; H2 is the second half.

## Risks

2016 is turning into a spectacular anti-establishment year, with a backlash against political elites that stems from rapid societal and technological changes. We believe the UK's divorce from the EU will be a long and messy process, as detailed in *Brexit: Big Risk, Little Reward* of February 2016. We also see it increase market anxiety over the EU's future. This could dampen European investment and slow activity. Attitudes toward the EU have deteriorated and now stand at lows in core nations such as France and Germany. See the *Little Love Left* chart. Yet we see little chance of more referenda on EU membership, and expect the EU to muddle through in the next year. Key votes include a referendum on Italy's reforms, and the 2017 French and German elections.

Other risks are a renewed rise in the U.S. dollar or another bout of global economic weakness. These could undo the stabilization of EM assets and commodities, and reignite market fears of a Chinese yuan devaluation.

*Brexit has put the spotlight on political risk. Next up: a referendum on Italy's reforms in October and U.S. elections in November.*

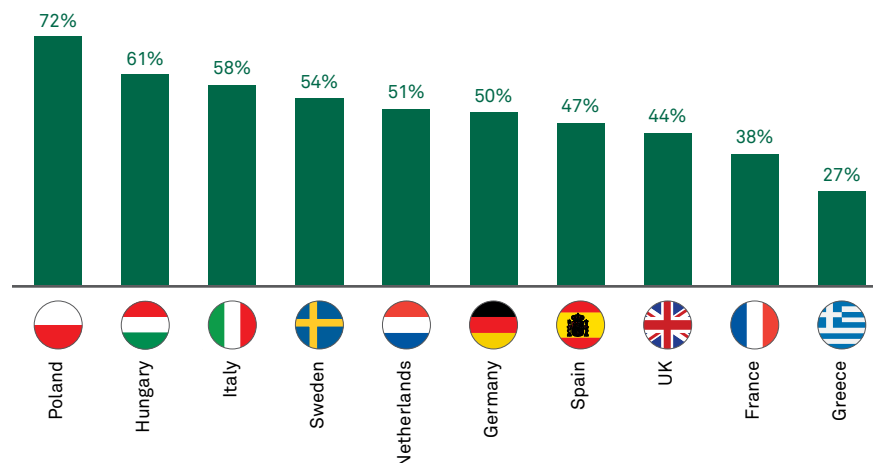
Yet we also see potential upside for risk assets. Companies, asset owners and fund managers are drowning in cash and low-yielding assets. They may shift funds into riskier assets, sparking a "risk-on" rally. The cash holdings of global fund managers stood at 5.7% of assets as of June, according to Bank of America Merrill Lynch. This matches crisis-era peaks.

Institutions face ever-lower yields when they roll over maturing bonds. Cash makes up more than half of household savings and investments in most countries, a BlackRock survey shows. See the *Cashed Up* chart. Negative real rates in many countries increase the incentive for savers to move out of cash and take more risk. Yet a catalyst is needed. A dissipation of geopolitical risks would help boost risk sentiment.

*Paltry yields on cash and bonds make it difficult for investors to meet return targets. Rising inflation and a fading of geopolitical risks may be the impetus for a shift into risk assets.*

## LITTLE LOVE LEFT

Favorable Attitudes Toward the EU, 2016

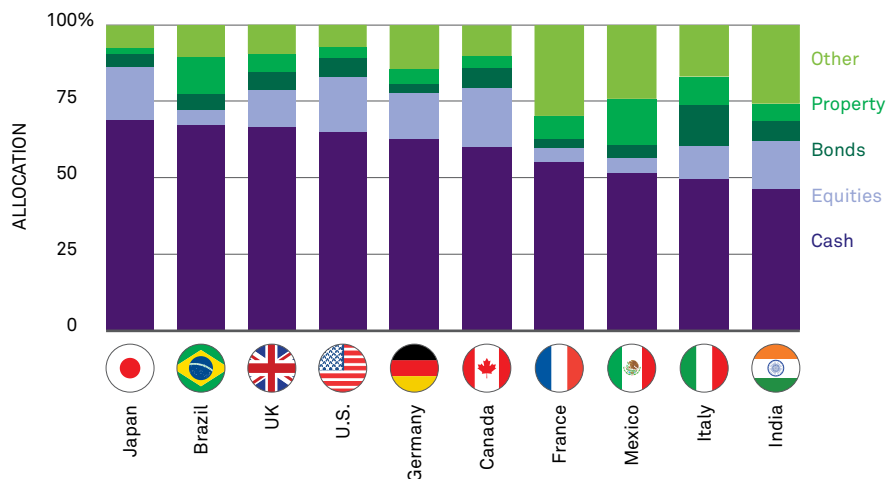


Source: Pew Research Center, June 2016.

Note: Based on the results from Pew's Spring 2016 Global Attitudes Survey.

## CASHED UP

Household Asset Allocation as Share of Overall Portfolio, 2015



Source: BlackRock Investor Pulse Survey 2015.

Notes: The BlackRock Global Investor Pulse Survey is based on a research study of more than 31,000 interviews in 20 countries, carried out by Cicero Group.

## Sovereigns

Investor demand for high-quality bonds is stronger than ever — but is met by only a trickle of supply. Net sovereign issuance across major economies has been declining, after accounting for central bank asset purchases. See the **Bond Shortage** chart. At the same time, regulated asset owners such as insurers, pension funds and sovereign wealth funds have been adding to their holdings to cover growing liabilities.

The result? Ever-falling yields. We see little let-up in such demand for now. We like U.S. Treasuries as a hedge against “risk-off” episodes and selected eurozone peripheral sovereigns for their relatively attractive yields and the potential for increased buying under any expansion of the ECB’s asset purchase program. EM sovereigns also could be prime beneficiaries from the search for yield over the medium term. Bottom line: We see potential for bonds to get even more expensive.

*U.S. Treasuries look attractive as a hedge against global risks, despite historically low yields.*

Inflation expectations around the world are struggling to bounce off multi-year lows. Expectations for consumer price inflation — as reflected in the pricing of inflation-linked bonds — rebounded earlier in the year but have since stumbled again. See the **Inflation Protection** chart. Depressed expectations today mean it is very cheap to buy protection against the risk of higher inflation in the future, we believe. We see inflation-linked bonds such as U.S. Treasury Inflation-Protected Securities (TIPS) as a valuable hedge against inflation. We also like inflation-linked debt in the eurozone and Japan as a potential substitute for nominal bonds.

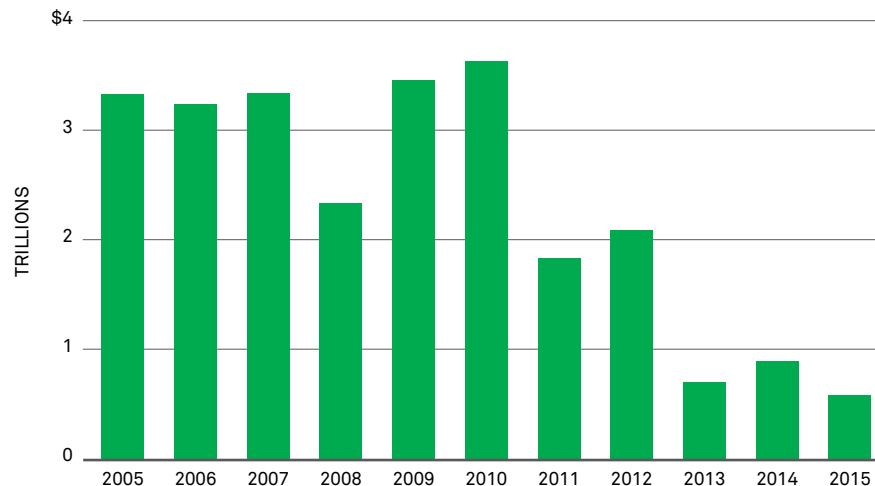


*“The huge expansion of central bank balance sheets around the globe introduced unprecedented liquidity — but dramatically reduced the availability of ‘safe’ assets.”*

**Rick Rieder** — Chief Investment Officer,  
BlackRock Global Fixed Income

## WANTED: HIGH-QUALITY BONDS

Net Sovereign Issuance, 2005–2015

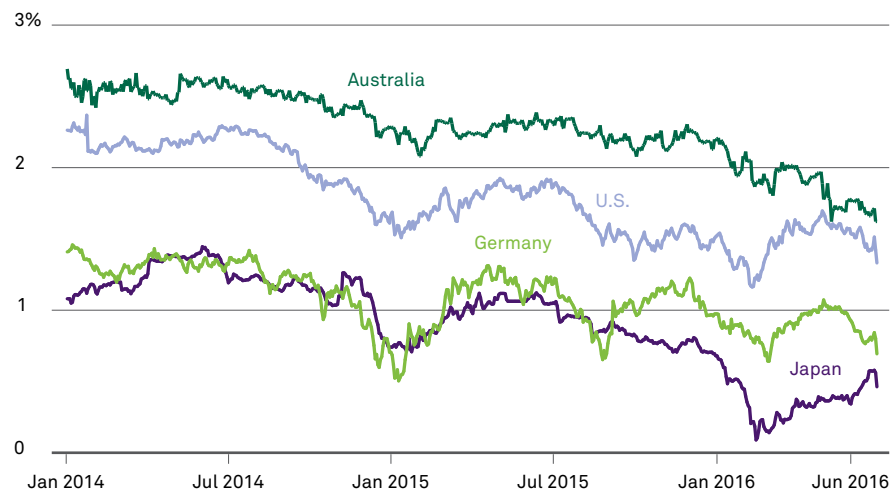


Sources: BlackRock Investment Institute and Morgan Stanley, June 2016.

Note: Net sovereign bond issuance is based on the U.S., eurozone, Japan and UK.

## INFLATION PROTECTION

Global Breakeven Inflation Rates, 2014–2016



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

Note: The lines show the differences between the yields on conventional and inflation-linked 10-year benchmark government bonds.

## Credit

We see investment-grade corporate debt as attractive in a world hungry for yield. U.S. investment-grade issuance is booming as companies rush to lock in low yields against a backdrop of strong investor demand. We like regulated utilities (predictable cash flows), global banks (strong balance sheets) and selected pharmaceuticals. Underweights include integrated energy (high costs and dividends) and metals (high leverage).

We could see U.S. high yield spreads widen as risk and illiquidity premia rise with the post-Brexit economic uncertainty. Any sell-offs could create buying opportunities. We see high yield as a good income strategy. Spreads are above typical levels associated with an economic expansion and default rates have risen. See the *Rising Distress* chart. Yet we see the risk of a recession over the next year as low. Many high yield companies have shored up balance sheets by cutting capex, dividends and selling assets. Yet interest coverage ratios have fallen. The high-risk market segment is vulnerable to a renewed fall in oil prices and bouts of risk-off sentiment.

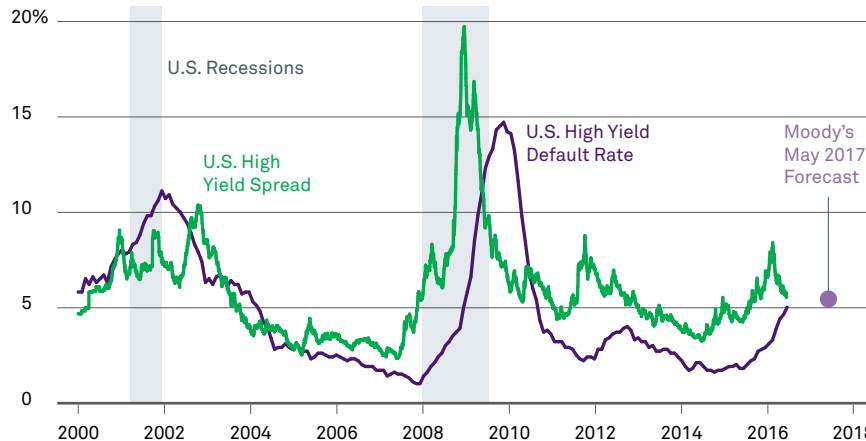
*Healthy fundamentals in the credit sector are predicated on interest rates staying very low.*

**Corporate bond purchases by the ECB are boosting European credit markets.** We expect the ECB to buy €4–5 billion of corporate debt per month in the primary market this year, roughly 15% of estimated monthly issuance. We see it purchasing an additional €1 billion per month in secondary markets. This is especially supportive of high-quality investment-grade debt — the target of the ECB's buying. For now, ECB buying trumps the risk of recession in Europe, we believe.

We are neutral on industrials, and prefer non-cyclicals such as beverages and defense. Some corporate yields have fallen below their sovereign equivalents. Is there value left amid heightened uncertainty? We see the Brexit fallout as an earnings issue for banks, not a solvency problem. This reinforces our preference for European bank credit over equities at this time. Last, we like private credit in both Europe and the U.S., including loans to midsize companies and infrastructure debt.

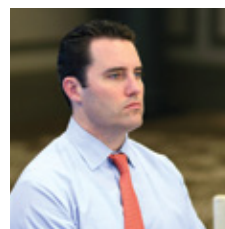
## RIISING DISTRESS

U.S. High Yield Spread and Default Rate, 2000–2016



Sources: BlackRock Investment Institute, Moody's and Barclays, June 2016.

Notes: The high yield spread is in percentage points over U.S. Treasuries and is based on the Barclays U.S. Corporate High Yield index. The high yield default rate is based on Moody's 12-month trailing default rate. The Moody's default rate forecast is for May 2017.



*"We could see high yield spreads widen in the wake of Brexit, but a prolonged period of low economic growth provides a solid backdrop for the majority of the market's credits."*

**James Keenan** — BlackRock's Head of Global Credit

*"With heightened global risks and the vulnerability of oil prices to a reversal of supply disruptions, we are cautious on higher-risk credit."*

**Jeff Rosenberg** — BlackRock's Chief Fixed Income Strategist



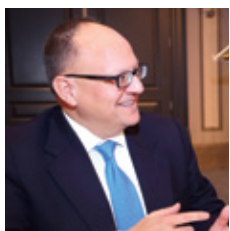
## Equities

We are cautious on global equities amid heightened economic and political uncertainty. We worry this could exacerbate already poor corporate earnings trends. U.S. earnings have been flat for a year now, Japanese earnings growth has turned negative, and EM earnings are showing only tentative signs of recovery. See the *Earnings Hopes Spring Eternal* chart. European profits have been on a road to nowhere for five years — and have yet to return to precrisis levels. Uncertainty around the shape of the UK's relations with the EU could further crimp European earnings. We do see opportunities in UK large caps that derive the bulk of their earnings overseas and benefit from a weaker British pound.

What would make us more bullish? A pick-up in earnings growth, or a shift toward fiscal expansion and structural reform.

*We are cautious on equities due to negative risk sentiment, elevated valuations and poor earnings growth.*

We prefer quality equities and dividend growers in the current low-rate environment. We focus on companies with rising dividends, strong cash flows and low payout ratios. An added bonus for dividend growers: We see them outperforming when the Fed eventually raises rates. They produced average annualized returns of 25% in periods of rising rates, versus just under 20% for the market average, our analysis of S&P 500 data since 1990 shows. See the *Go for Growth, Not Yield* chart. The highest-yielders, by contrast, underperformed. The thirst for yield has pushed up the price-to-earnings ratios of these “bond proxies.” Yet a high-yielding stock with no dividend growth is a risky bond, in our view.

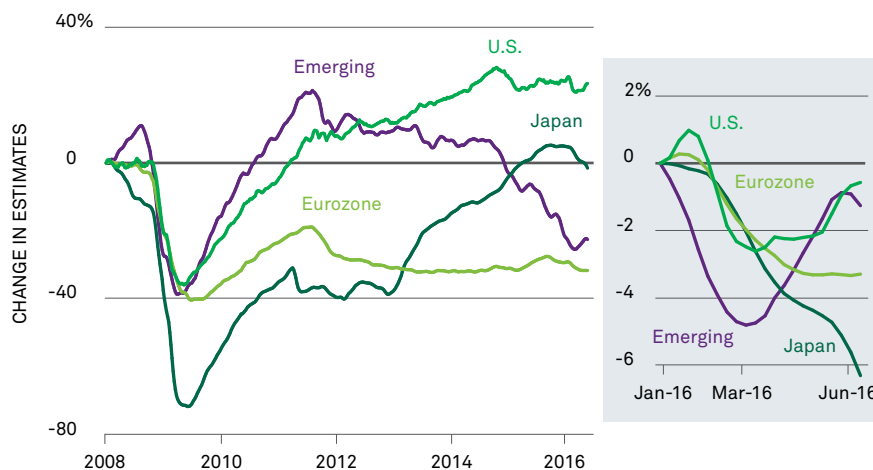


*“European equities are now very dependent on economic and earnings growth — which we have yet to see.”*

**Nigel Bolton** — Chief Investment Officer,  
BlackRock International Equities

## EARNINGS HOPES SPRING ETERNAL

Change in 12-Month Forward Earnings Estimates, 2008–2016

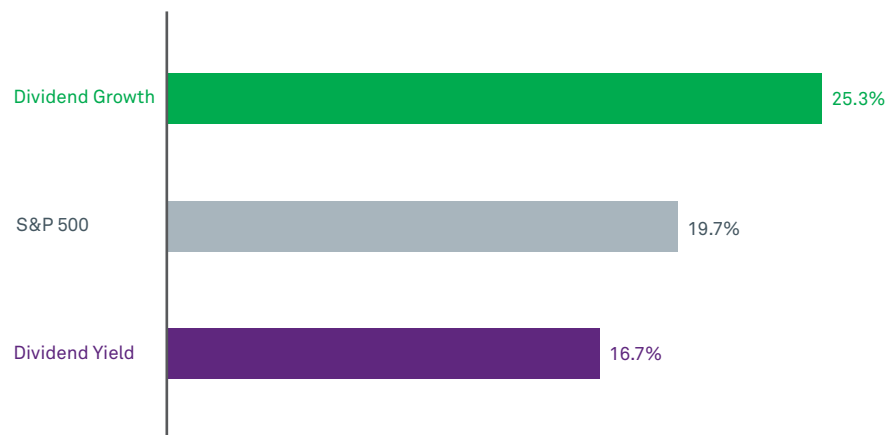


Sources: BlackRock Investment Institute and Thomson Reuters, June 2016.

Notes: The lines show the change in 12-month earnings estimates for the MSCI U.S., EMU, Japan and Emerging indexes. The estimates are rebased to zero at the start of 2008 and 2016 (inset).

## GO FOR GROWTH, NOT YIELD

Performance of U.S. Dividend Stocks in Periods of Rising Rates, 1990–2015



Source: BlackRock Investment Institute, June 2016.

Notes: The chart shows the average annualized performance of dividend stocks during six periods of rising interest rates from 1990 through 2015 as measured by the 10-year U.S. Treasury bond. Dividend yield is represented by the 50 highest yielding stocks in the S&P 500 on a monthly basis. Dividend growth is represented by the top 50 S&P 500 stocks we rank monthly by free cash flow to market value, 12-month dividend growth and low dividend payout ratio.



# Assets in Brief

Views on Assets for Q3 on an Unhedged Currency Basis

Asset Class		View	Notes
EQUITIES	United States	—	Consumption and labor markets are strong, but rising wages could pressure profit margins and valuations are elevated. We like dividend growers and quality stocks.
	Europe	▼	ECB stimulus is supportive, but post-Brexit uncertainty challenges already poor profits. A weak pound helps UK exporters; we are cautious on UK domestic stocks and European banks.
	Japan	—	Attractive valuations and better corporate governance are not enough to offset a soft economy and rising yen. The BoJ is nearing the limits of monetary policy; structural reforms are needed.
	EM	—	Our conviction is growing. Currencies and trade balances have adjusted, and we see less risk of a sharp U.S. dollar rise. We like domestically oriented stocks and EMs with reform momentum.
	Asia ex-Japan	—	China's transition to a service economy is slowing growth, yet much of this is priced in. A China credit bust and currency devaluation are tail risks. We like India and ASEAN economies.
FIXED INCOME	U.S. Treasuries	—	A Fed on hold, risk-off sentiment and easy global monetary policy offer support in the near term. Long-maturity bonds have a structural bid amid low rates and are diversifiers.
	Municipal Bonds	▲	We favor munis for their tax-exempt income, low volatility, and strong demand from investors seeking stability and yield. We prefer bonds tied to specific revenue streams.
	U.S. Credit	▲	We generally prefer investment-grade bonds. Yields offer compensation for the risks entailed, such as rising corporate leverage.
	European Sovereigns	—	The flight to perceived safety has pushed core European bond yields to unattractive levels. We prefer selected peripheral bond markets due to higher yields and ECB bond purchases.
	European Credit	▲	The ECB's corporate bond purchases and muted UK issuance support investment-grade bonds. We like the iTraxx Main credit default swap index for hedging risk-off moves.
	EM Debt	▲	We prefer high yield hard-currency debt, but are cautious on commodity exporters. We like local-currency debt in Brazil, India, Indonesia and Poland for those who can stomach volatility.
	Asia Fixed Income	—	Solid fundamentals, an issuance slowdown and strong domestic demand support hard currency debt. We are overweight local rates and underweight currencies on expected easing.
COMMODITIES	Commodities	—	Commodity markets are oversupplied. Oil fundamentals have improved, but we see much of this as priced in. We like gold as a portfolio diversifier.

▲ OVERWEIGHT    — NEUTRAL    ▼ UNDERWEIGHT

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