



CYCLES OUT OF SYNC
2016 INVESTMENT OUTLOOK
DECEMBER 2015

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Summary

The monetary policy cycle has dominated financial markets for years. As the global liquidity wave crests, the business, credit and valuation cycles should gain in importance. Unusually, these cycles appear to be out of sync. This argues for careful navigating in 2016.



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- ▶ We see an extension of the business cycle as crucial for further gains in risk assets. With valuations no longer cheap and corporate profit margins under pressure in many markets, economic growth is needed to boost revenues. We expect little or no price appreciation in fixed income and only muted gains for most equity markets in 2016.
- ▶ China's economic deceleration and shift to a consumer-driven economy are putting the brakes on the global business cycle. Both are part of a natural evolution but pose structural challenges to emerging markets (EMs) and commodity producers. We expect China to muddle through. Risks, including a yuan devaluation, are rising – but we do not see them coming to a head in 2016.
- ▶ The knock-on effects of movements in oil prices and the US dollar are critical. Falling oil prices have dragged down long-term inflation expectations. This is puzzling and brings into question the credibility of central bank inflation targets. The dollar's rise has led to some tightening in financial conditions. Further gains would intensify pressure on US profits, commodity prices and EM currencies.
- ▶ EM economies are in a downturn due to their China dependency and the commodity price implosion. Cyclical factors such as an uptick in global growth and better trade balances due to currency depreciations could give a (temporary) lift to depressed EM equities.
- ▶ The US economic expansion is following the script of a grinding advance after a banking crisis and likely has room to run. A lot is riding on the recovery as other economies are struggling. We see a gradual path to higher US rates in 2016, but think the market has priced in too few rate increases given jobs, wage and inflation trends. We see rising US rates widening monetary policy divergences.
- ▶ The eurozone is in (weak) recovery mode, helped by bank credit growth and a falling euro. The monetary policy cycle has moved into high gear with a negative deposit rate and quantitative easing (QE) until March 2017. We see this supporting eurozone equities and corporate bonds. Risks include threats to European unity such as the refugee crisis and the possibility of a 'Brexit.'
- ▶ Long-term trends such as ageing populations, high debt loads and technological change are intersecting with short-term cycles. This means the high growth rates of the past may not return. The good news? We see a modest pick-up in global growth, and a renewed investor focus on fundamentals.

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Introduction

The monetary policy cycle has dominated investment outcomes in recent years. A tide of easy money has inflated valuations. Yet the gift that kept on giving – plentiful liquidity and ever-loosening global financial conditions – will be less generous in 2016. As the US Federal Reserve (Fed) draws the curtains on a seven-year period of zero interest rates, other cycles need more attention.

This is why we debated the state of play in the business, credit and valuation cycles over two days in mid-November at our ninth Investment Outlook Forum. The semi-annual event hosted 85 BlackRock portfolio managers and executives from around the world as well as a handful of external thought leaders.

Of course, we could not resist discussing the monetary policy cycle as well. It is important to understand where we are in the various cycles – and where we are headed. This can help identify future drivers of investment returns and guide asset allocation decisions.

The EM and US business cycles were at the heart of our debates (pages 4-5). The world relied on EM economies for growth after the financial crisis. Enter China's deceleration, the commodity price implosion, sluggish world trade and the EM downturn. These interrelated factors mean the US economy once again will have to play an outsized role in supporting global growth, we think. We also focused on the path of the US dollar and oil prices, and their impact on liquidity and inflation expectations (6-7).

Valuations are high, and we see risks of higher volatility and momentum reversals (8-9). Credit cycles can warn us of future asset bubbles and recessions. We think the US credit cycle is long in the tooth, while the eurozone's has legs (10). This is crucial; corporate leverage has enabled the buyback and deal frenzy that has been underpinning equity markets.

QE-saturated markets have long ignored spreading regional wars and heightened geopolitical tensions. We could see this changing (11). Last, we analyse the business cycles and detail preferred assets in the US (12-13), Europe (14-15), Japan (16), and China and EM (17-19).

CYCLES ARE TURNING

- ▶ The wave of central bank liquidity looks to have crested. Monetary policy may take a back seat to other cycles for the first time since the financial crisis.
- ▶ The key business cycle could last longer than usual because the global economic recovery has been slow. But demand growth is needed to support corporate profit margins.
- ▶ The US credit cycle appears to be nearing its end, with return dispersion and default risks rising. The eurozone's looks like it has more room to run.
- ▶ Valuations appear to have leapt ahead of the business cycle in many markets, especially in the US. We have essentially been borrowing returns from the future.

INVESTMENT CHOICES

- ▶ We prefer stocks over bonds, particularly European and Japanese equities. Many US stocks appear fully valued. The dollar looks set for more gains, but we expect a bumpy road.
- ▶ We see little or no price appreciation in fixed income. Selected high yield, investment grade and hard-currency EM debt look attractive relative to government bonds.
- ▶ We like market-neutral strategies such as long/short equity and credit. We also favour 'hard' assets such as prime US commercial property and infrastructure.
- ▶ Minority views include buying global oil majors and low-cost US shale explorers. Some of us have started to nibble at beaten-down EM stocks.

RISKS TO OUTLOOK

- ▶ An unexpected US yield spike as the Fed starts raising rates. Conversely, a US growth disappointment is also a risk: a lot is riding on the US economy because other regions are slowing or barely growing.
- ▶ Momentum reversals. Consensus positions such as underweighting EM, overweighting growth or counting on US dollar strength could unwind quickly.
- ▶ A substantial devaluation of the Chinese yuan. This is unlikely, but possible. It could trigger a damaging currency race to the bottom, particularly in EM.
- ▶ Intensifying regional conflicts and geopolitical tensions could finally start to affect markets. Refugees and the 'Brexit' referendum are stress-testing the European Union (EU).

Business cycle

The economic recovery from the financial crisis has been unusually tepid. The US advance is tracking the weakest end of the range seen since 1960 – consistent with recoveries from past major financial crises. See the chart on the right. The eurozone has fared even worse. Its economy is about the same size (in real terms) as in early 2008. See our interactive [recovery tracker](#) for details on other economies.

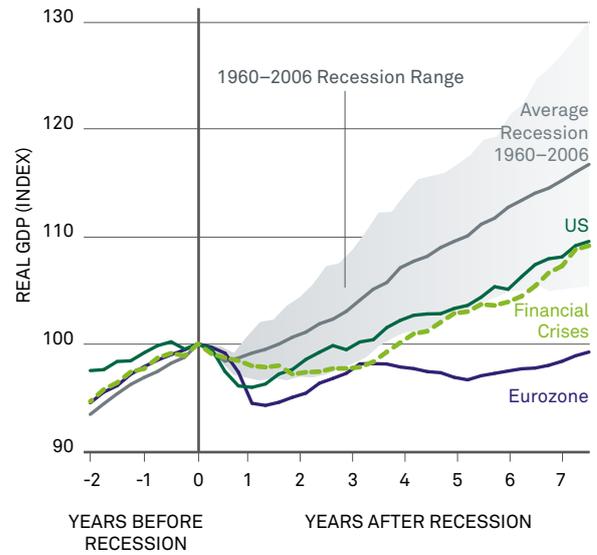
This suggests the economic recovery in the US could still have legs. A lot is riding on this expectation as other economies are struggling. Japan is back in recession, while Europe needs economic reforms to unlock its growth potential. Similarly, many EM economies face structural challenges that are hurting growth. Brazil is in a severe downturn while China is slowing significantly.

Current cyclical dynamics are hard to read, in part because structural trends such as ageing populations, high debt loads and technological change are intersecting with short-term dynamics. The result? There is no guarantee that economic growth rates, inflation or corporate profits will settle at the average levels of the past.

Example: productivity growth would have to reach 3.3% a year over the coming half century – 80% faster than its average rate during the past 50 years – just to compensate for the effect of ageing populations, McKinsey estimates. Economic output would grow 40% slower than past annual averages if productivity were to remain at the level of the past 50 years, the firm argues.

SUBPAR RECOVERY [CLICK FOR INTERACTIVE DATA](#)

Current vs. past recoveries from recession, 1960–2015

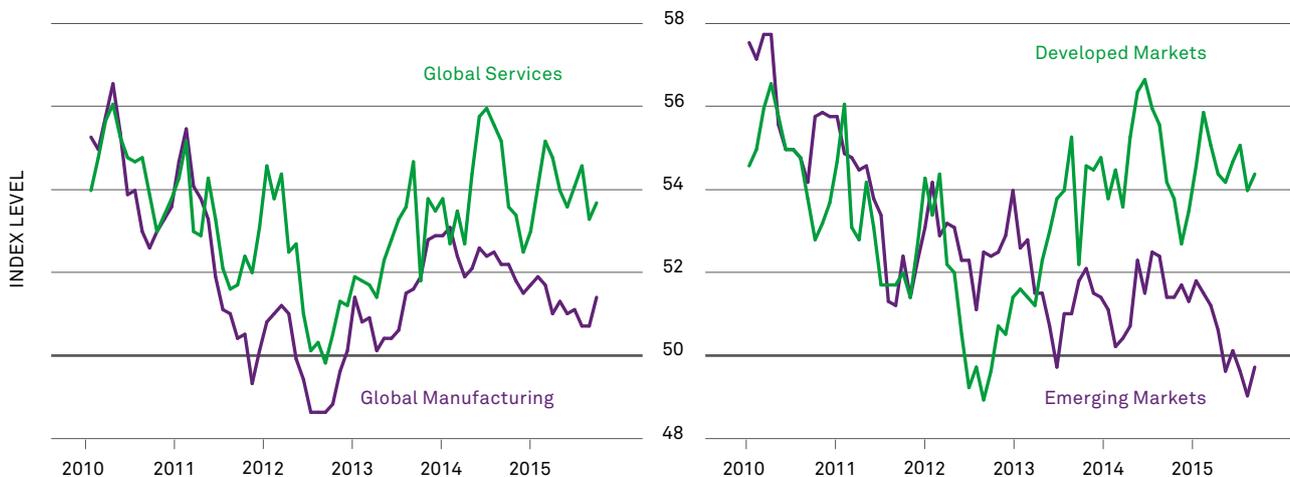


Sources: BlackRock Investment Institute, IMF, OECD and Thomson Reuters, November 2015. Notes: the financial crises are Finland (1990), Japan (1993), Norway (1988), Spain (1978) and Sweden (1990). The recession range is based on an average of the five best and worst recoveries. The average recession (two straight quarters of contraction) is based on advanced G20 countries from 1960 to 2006. The lines are rebased to 100 at the quarter before the start of each recession.

The global business cycles are diverging. Manufacturing is weak, while the services sector (which makes up more than two-thirds of economic activity in developed economies) is holding up. See the left chart below. Another divergence: EM economies are stalling due to China's slowdown and credit growth hitting the ceiling in many countries. Developed markets are still in expansion. See the right chart below.

TALES OF DIVERGENCE

Global activity surveys, 2010–2015



Sources: BlackRock Investment Institute, JPMorgan and Markit, November 2015. Note: the lines are based on global purchasing manager surveys. A value above 50 indicates expansion.

CORPORATE CONVERGENCE

Corporate profit margins, by contrast, are generally converging – downward. US margins have retreated from near-record highs. European margins have fallen back below average levels since 1995. See the chart on the right.

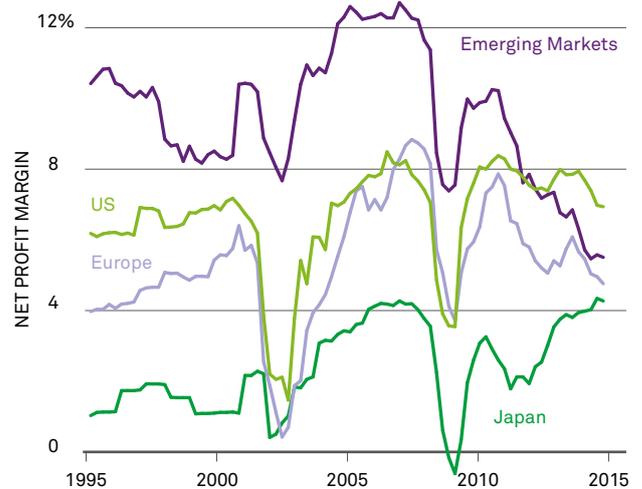
EM margins have collapsed more than 50% since 2007. This mirrors a sharp decline in productivity growth that started even before China’s slowdown. EM economies need reforms to pave the way for a shift from imitation to innovation.

Rising wages contributed to the EM margin contraction, and could start to affect corporate profits in developed markets. Strong jobs growth is leading to worker shortages in parts of the US and UK, modestly lifting wage expectations. A tide of regulations to curb carbon emissions also threatens (longer-term) profitability in the resources and other sectors, as detailed in *The Price of Climate Change* (October 2015).

Japan is an outlier with strong profit growth. This reflects a shareholder-friendly shift in corporate Japan (page 16).

MARGINS MATTER

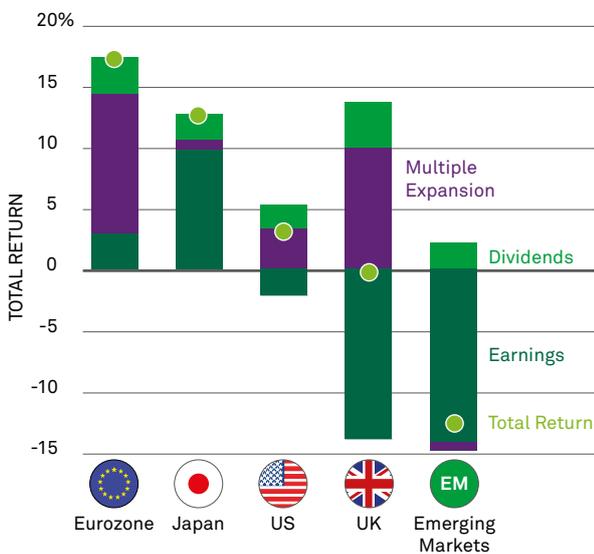
Net corporate profit margins by region, 1995–2015



Sources: BlackRock and Thomson Reuters, November 2015. Note: the lines show 12-month trailing net profit margins for Datastream Total Market Equity Indices excluding financial companies.

WANTED: EARNINGS GROWTH

Equity returns by source, 2015



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, 30 November 2015. Notes: all returns are in local currency except for emerging markets, which are in US dollars. Earnings growth is based on aggregate 12-month forward earnings forecasts. Multiple expansion is represented by the change in the 12-month forward price-to-earnings ratio.

RUNNING ON EMPTY

Companies around the world are boosting earnings per share by shrinking their share count. They have been issuing debt on the cheap, and are using the proceeds to buy back their own shares and acquire other companies. This is rational when credit is easy and growth opportunities are scarce.

Tightening financial conditions would make it less attractive for companies to tap the corporate debt markets and cannibalise their own shares. How would companies then grow earnings? A return to top-line growth (higher revenues) is key – especially for markets where valuations are high, such as the US. This is why we believe the business cycle will play a big role in 2016 investment outcomes.

Most equity markets have been running on empty in 2015, with multiple expansion (a rising price-to-earnings ratio) and dividends hiding sins such as flat or falling earnings. Multiple expansion accounted for two-thirds of the 17% gain in European equities year-to-date. Declining earnings were a big drag in the UK and emerging markets – and a modest one in the US. See the chart on the left.

It is no accident that markets with some earnings growth (think Japan) performed well in 2015. This is a welcome sign that investors are looking beyond financial engineering.



“The belief that US growth is immune from the global slowdown and deflationary forces runs through our favourite themes. It does not take an MIT degree to understand this. This means convergence is a risk.”

– Tom Parker

Chief Investment Officer,
BlackRock Model-Based Fixed Income

Policy and liquidity cycles

Monetary policy cycles appear out of sync. We expect the Fed to tighten, whereas we see the European Central Bank (ECB) and the Bank of Japan (BoJ) keeping policy very loose.

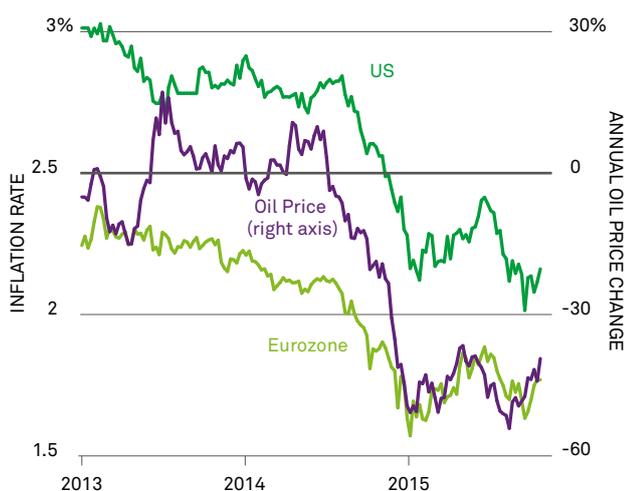
The provision of global liquidity looks to be broadly a wash in 2016, yet we expect some tightening of financial conditions. Central bank asset purchases, which lubricate the global financial system, have already dipped below zero (on a net basis) for the first time since the financial crisis, according to Citigroup. See the chart on the right. This changes dynamics for asset prices artificially pumped up by QE: a hot air balloon needs fuel to maintain altitude.

The main culprit? Shrinking EM reserves. The commodity price collapse and slowing growth have triggered reserves selling to shore up falling currencies. The Fed's holdings of five-year-plus bonds are shrinking, but we expect it to only slowly scale back its re-investments of maturing securities (8.7% of the Fed's US Treasury holdings mature in 2016).

There is more to global liquidity than central bank purchases. The liquidity tide ebbs and flows with investor risk appetite – and the willingness of capital markets to provide credit. Our bottom line: we expect tightening but still generous global financial conditions in 2016.

CRUDE EFFECT

US and eurozone inflation expectations and oil, 2013–2015

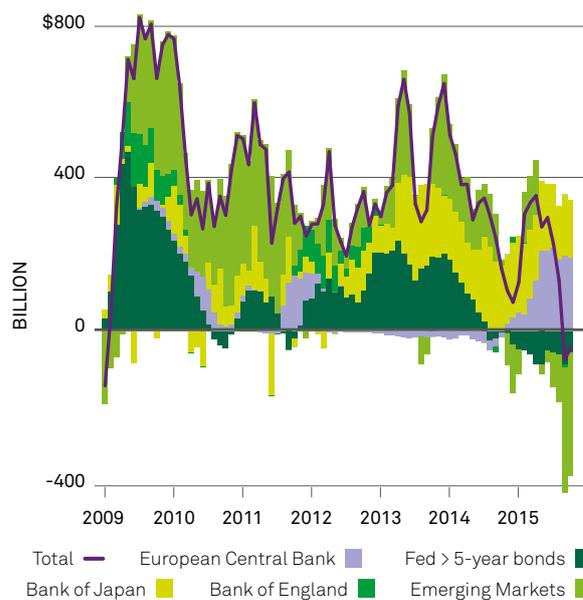


Sources: BlackRock Investment Institute, ICAP and Thomson Reuters, November 2015.

Notes: inflation expectations reflect swaps-based expected inflation rates for five years, starting five years ahead. Oil price changes are based on the average of the annual change in Brent and West Texas Intermediate oil prices.

OUT OF GAS?

Changes in central bank assets, 2009–2015



Sources: BlackRock Investment Institute and Citi Research, November 2015.
Notes: the chart displays the three-month average of net changes in assets held by central banks of developed countries. For emerging markets, the chart uses the three-month change in foreign reserves, netting out the effects of US dollar swings. The data exclude the ECB's long-term refinancing operations and only include net changes in Fed holdings of bonds with maturities of more than five years.

OIL PRICE PUZZLE

Low oil prices are playing into the monetary policy cycle. Crude's collapse has dragged down even long-term inflation expectations. See the chart to the left. This is a conundrum for central banks. Most were already struggling to meet their inflation targets. Low inflation expectations could encourage some to step harder on the monetary accelerator.

The oil price also affects global liquidity because Middle East reserve managers and sovereign wealth funds are selling assets to plug widening fiscal holes. The selling could gather pace if the oil price were to fall below \$40 per barrel, in our view. This is a sea change from years of petrodollars flowing into capital markets. Ample supply will keep the oil price mostly range-bound in 2016, we expect, with some chance of a modest recovery as demand finally catches up with supply.

A rising US dollar makes oil more expensive in other currencies, eroding the benefits of cheaper energy in oil-importing nations. It helps oil producers such as Russia (petroleum revenues look good in depreciated rubles). Dollar strength does put pressure on oil-producing countries with currency pegs, including Saudi Arabia. We do not see the kingdom devaluing the Saudi riyal in 2016 (you only mess with a peg under a blue sky), but acknowledge the risk.

DOLLAR DEBATE

The path of the US dollar is a driver of global liquidity. The burden of dollar-denominated debt rises in local currency terms when the greenback rallies. Offshore US dollar credit has risen to \$9.6 trillion, according to the Bank for International Settlements (BIS), up 50% from 2009. EM corporate borrowers accounted for much of this increase.

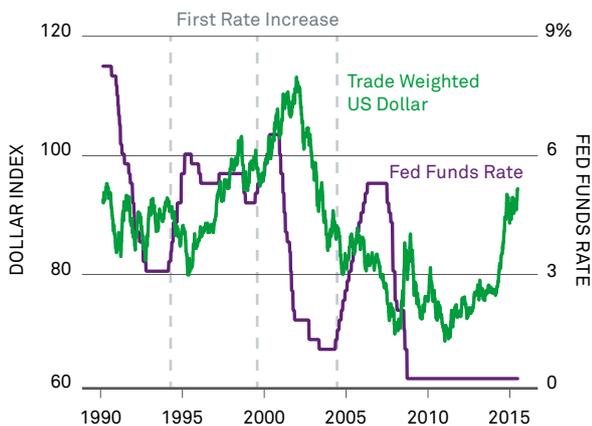
Yet EM economies are less vulnerable today than in the late 1990s. The BIS cites three reasons: larger foreign exchange reserves, longer average debt maturities (meaning less rollover risk), and the fact that many EM borrowers today are global firms with revenues in foreign currencies.

What happens to the dollar when the Fed starts raising interest rates? The history of recent rate cycles shows the dollar usually falls in the first few months after a rate increase, before recovering. See the chart below.

Yet policy divergence means this time may be different, we think. As the Fed tightens and the ECB and BoJ ease, interest rate differentials are likely to widen further in the dollar's favour against the euro and Japanese yen. The Bank of England (BoE), Bank of Canada and Reserve Bank of Australia all appear in suspended animation as they wait for the Fed to pull the trigger first. The same is true for EM central banks, some of which have room to ease.

DOLLAR DOINGS

US interest rate increases and the dollar, 1990–2015



Sources: BlackRock Investment Institute and Federal Reserve, November 2015.
Note: the dotted lines represent the first rate increase in a Fed tightening cycle.

READY FOR REVERSALS

We, therefore, expect the dollar's path in the short term to be dominated by policy action and intent – and the market's interpretation of both. Fundamental dynamics such as relative growth trajectories and an improving US trade balance look set to reassert themselves later in 2016, and should support the dollar in the medium term.

Yet we are girding for occasional snapbacks. First, markets have a way of upending ostensibly logical investment theses. Second, oversold EM currencies could stabilise or even rebound as current account balances improve and financial stresses ease. A note of caution: the dollar's upward momentum has been very strong, so the impact of potential reversals could be dramatic.

LIQUIDITY CYCLES

Monetary policy cycles these days include hefty doses of QE. What happens to asset prices as central banks move through the asset-purchase cycle? We see three phases:

- 1 Early:** central banks kick off or expand their programmes. Risk assets tend to do well. Investors hunt for yield and future growth – at the expense of return factors such as quality and value. Beta (market) returns are high, and volatility and dispersion fall. Think the eurozone and, to a lesser extent, Japan today. Active investment management (fundamental, smart beta or factor-based investing) struggles to keep up with benchmark indices.
- 2 Transition:** the end of QE and zero-interest-rate policy (ZIRP) looms. It is a tough environment for active management and beta alike. Relative value trades generally do not work because dispersion is low. Small changes in QE and liquidity expectations can lead to large swings in prices. The US market currently shows many of these characteristics. Outsized share price reactions to US earnings releases indicate the regime may be shifting.
- 3 Late:** central banks start raising rates and shrinking their balance sheets. Beta returns are low or negative for QE-inflated assets, while volatility and dispersion rise. This favours active management, we believe, especially market-neutral strategies such as long/short equity and credit. Think parts of the emerging world today, as well as US markets in 2016.



“A near-term drop in oil prices should not affect long-term inflation expectations. Yet it has – and this has created opportunities in inflation markets, especially in the very long end.”

– Gargi Chaudhuri
Portfolio Manager,

BlackRock Inflation-Linked Bond Portfolios

Valuation and credit cycles

Valuations have gotten ahead of other cycles. Safe-haven government bonds hover near record levels. Credit spreads look reasonable – on a relative basis. See the chart below. We expect little price appreciation across fixed income in 2016, and focus on income or ‘carry.’ Yield curves are flattish due to depressed term premia (compensation for the risk of unexpected spikes in rates), low inflation expectations and strong demand for yield. The main risks, therefore, are a revival of the term premium or unexpected signs of inflation.

Equities range from pricey to fairly valued. We do not expect a repeat of the double-digit annual returns enjoyed in many developed markets since the financial crisis. This is especially true for US equities. EM stocks, by contrast, look relatively cheap. We are underweight but have started to close this gap. Note that EM equities look cheap due to battered financials and energy shares dragging down the aggregate; growth and quality stocks are actually expensive.

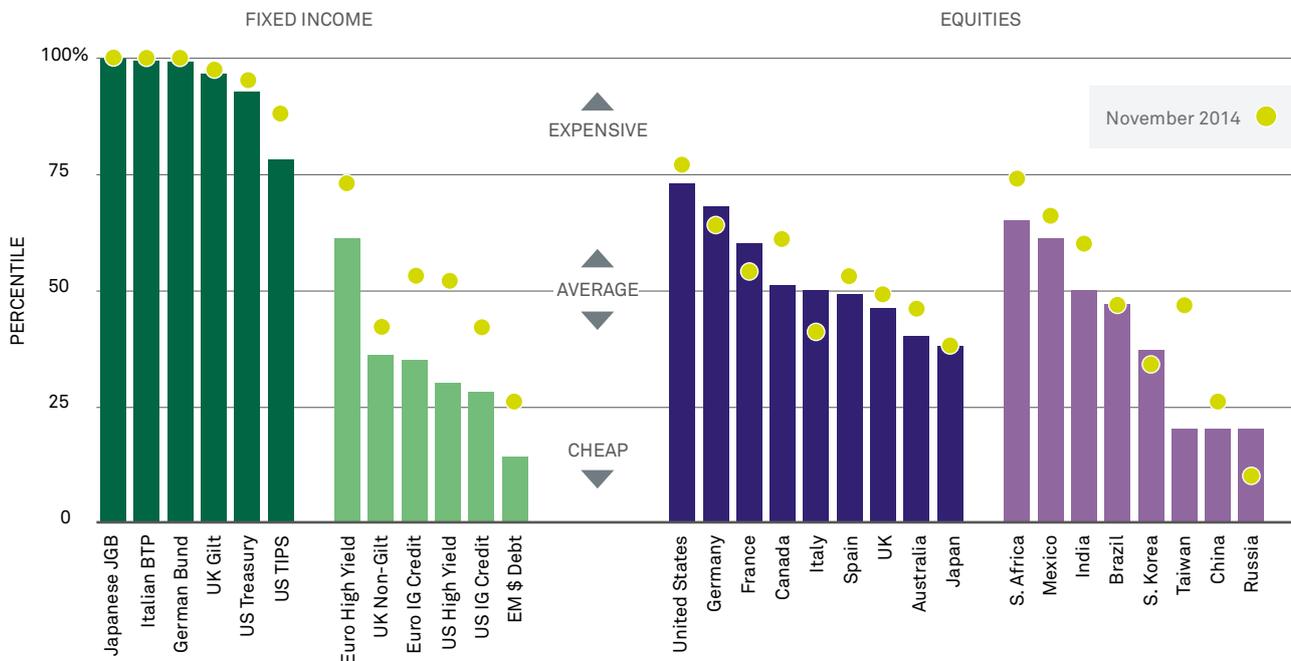
Averages are misleading. The current US high yield spread of around 6%, for example, is an average of 10%-plus spreads for energy credits and tight spreads elsewhere. The elevated energy spreads, in turn, range from companies priced for imminent bankruptcy to well-capitalised players. Other asset classes offer a similarly bipolar picture.

Credit and EM debt spreads have widened in the past year, mostly due to the commodity price implosion. See the yellow dots indicating year-ago levels in the chart below. Some value has been restored – especially if you believe economic growth and interest rates will stay low for a long time.

Among government bonds, only Treasury Inflation Protected Securities (TIPS) have gotten cheaper. Ten-year TIPS are effectively pricing in an average annual inflation rate of just 1.25% measured in personal consumption expenditures (PCE) terms, well below the Fed’s 2% target. Even 30-year inflation expectations have been dragged down by the oil price slump, pricing in annual PCE inflation of 1.45%. Can inflation really stay so low for so long? This sets a low bar for TIPS to outperform nominal bonds. We also like eurozone inflation-linked debt, which prices in annual eurozone inflation of just 1.17% (Germany) or 0.97% (Italy), until 2025.

IN SEARCH OF VALUE

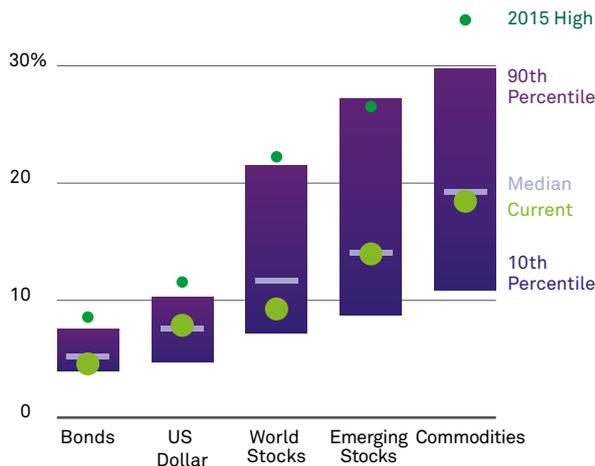
Valuations by percentile vs. historical norms, November 2015



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, 30 November 2015. Notes: the percentile bars show valuations of assets as of 30 November 2015, versus their historical ranges. For example, US equities are currently in the 73rd percentile. This means US equities trade at a valuation equal to or greater than 73% 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 indices 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 indices 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 market equities) to 2004 (EM\$ Debt).

VOLATILE NORMAL

Realised volatility by asset class, 1995–2015



Sources: BlackRock Investment Institute and Thomson Reuters, 30 November 2015. Notes: volatility is measured as the standard deviation of daily returns over a rolling 30-day window on an annualised basis. The purple bars show the 10th to 90th percentile since 1995. The lines show the median over this period and the dots the current levels. Bond volatility is based on an average of 10-year US Treasuries, German Bunds, Japanese JGBs and UK Gilts. US dollar volatility is based on the DXY Index. Stock volatilities are based on MSCI indices. Commodities are based on the S&P GSCI Commodity Index.

VOLATILITY VIBES

Volatility is normalising after years of being suppressed by QE. It has died down from highs seen during the summer's global equity sell-off, and now stands near 20-year medians in most asset classes. See the larger dots in the chart above. Could volatility spike again? We think it may. The good news: we see few pockets of true exuberance. Exceptions are unicorns, private tech outfits led by hoodie-clad millennials with \$1 billion-plus valuations. There are 12 dozen of them, according to CB Insights, up five-fold from 2012. We expect at least some damage to the horns in coming years.

Even without any shocks, volatility is likely to rise. Structural changes such as the advent of high-frequency trading and withdrawal of broker-dealers have hurt trading liquidity in outdated market structures. This can result in exaggerated price moves, as detailed in [Lessons From August 24](#) (October 2015). These trends can also lead to anomalies. Case in point: the current lack of dispersion in energy shares. When oil prices fell in the past, exploration companies with shaky balance sheets would get hit harder than well-capitalised and diversified oil majors. Now, many often trade in lockstep.



"Generally, it's good to be long momentum – but you have to worry about a reversal. You don't want to buy last year's fashion today, only to find it out of style and in a discount bin tomorrow."

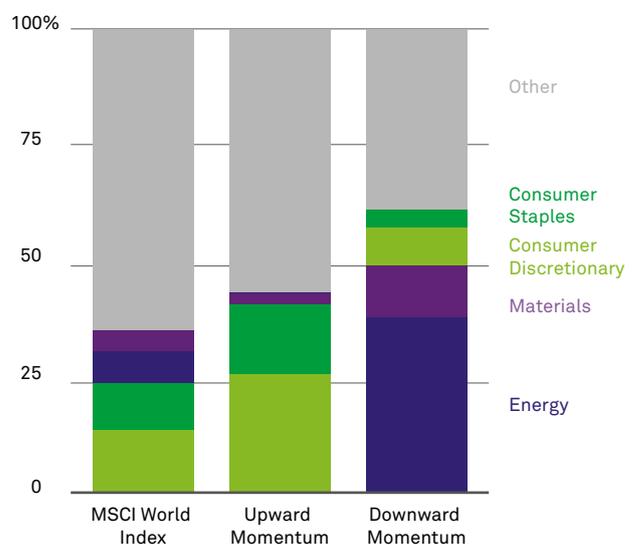
– Sergio Trigo Paz
Head of BlackRock
Emerging Markets Fixed Income

Momentum is another fixture of today's markets. It is okay to be long momentum; it simply means you own the stuff that has been winning. But beware periods when market leadership reverses abruptly. We see this as a key risk in 2016. The reason? Momentum is getting old and more concentrated. Consumer discretionary shares steadily rose in 2015 (see the middle bar in the chart below), whereas energy and materials equities (right bar) kept heading down. Momentum has been strongest (downward, in this case) in places where asset owners have been underweight. A 'melt-up' in energy and EM assets would hit investors banking on further declines in these sectors.

What really hurts is a momentum reversal in supposedly 'safe' assets (example: consumer staples). It is like taking a trusted iron instead of the driver to tee off at a challenging golf hole, only to hook the ball into the woods anyway, a Wall Street strategist told us. We feel his pain – and suggest quality as a potential club to pull out. This factor exposure (to companies such as established tech and health care) has proved an effective counterweight to momentum in periods of rising volatility.

MOMENTOUS MOMENTUM

MSCI World Index sector weights by momentum, October 2015



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, 30 October 2015. Notes: stocks in MSCI World Index are ranked by price momentum (defined as rolling 12-month minus one-month returns). The bars show the weights of sectors within the overall index (left) and the four sectors with the biggest upward (middle) and downward (right) momentum overweight.

A CANARY IN A COAL MINE

US high yield spreads are often a canary in a coal mine for asset price bubbles. Our high yield complacency gauge measures whether investors are indiscriminately snapping up high yield in a mad dash for income. Dispersion, the variation in performance of individual bonds in an index, has increased. This has brought our US gauge into reasonable territory, whereas a year ago it was in the danger zone. See *Dealing With Divergence* (December 2014). Our European gauge, however, is giving off warning signs as QE has pushed asset owners up the risk spectrum.

The reason why US high yield credit spreads have widened is obvious (stress on issuers in the resources sector). What it means is less clear. Does it signify the end of the credit cycle – and a bear market for risk assets? This would bring the moniker ‘junk bonds’ back in fashion. Or is it the result of well-known events and limited to one sector?

CREDIT DEBATE

End-of-cycle believers say trouble in a particular sector always is a precursor to a downturn (there is never just one cockroach). An industry attracts too much excitement and capital; underwriting standards slip; and buyers snap up paper for ever smaller risk premia. The inevitable bust then deflates other sectors. Look no further than tech and telecoms in the late 1990s, and housing in the mid-2000s.

The late-cycle crowd argues the downturn in energy is natural. China’s slowdown and its shifting growth mix mean a structural decrease in demand growth for resources. The rest of the world cannot make up for the shortfall due to below-trend growth rates. The market knows all this – and has priced it in. Plus, a long period of low rates allows issuers to roll over or extend the term of their debt, buying them time to fight another day.

Most of us are in the late-cycle camp, and believe the US cycle is nearing the end while Europe has a distance to go.

The credit debate has bifurcated outcomes, according to scenarios run by our Risk and Quantitative Analysis group. Our end-of-cycle scenario has credit spreads spike higher, equities sell off (with EM and value stocks underperforming) and safe-haven government bonds rise. The reverse happens in our late-cycle scenario, albeit with more modest moves.

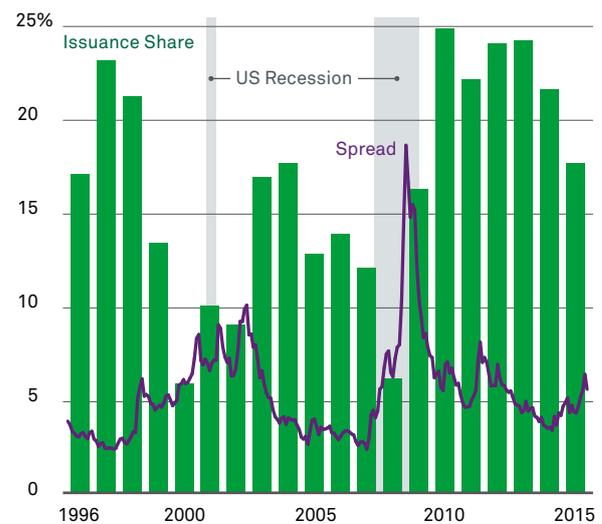


“We are somewhere between the late stages of a bull cycle and the beginning of a correction in credit, with the US further ahead than Europe.”

– Sarah Thompson
Head of BlackRock
US Liquid Credit Research

TROUBLE AHEAD?

US high yield spread and issuance share, 1996–2015



Sources: BlackRock Investment Institute, Barclays and Securities and Financial Markets Association, November 2015. Notes: the issuance share is US high yield corporate debt issuance as a share of total US corporate issuance. The 2015 value is based on extrapolation of year-to-date values. The high yield spread is based on option-adjusted spreads and shown in percentage points.

Buoyant sentiment in the US credit market (as evidenced in narrow credit spreads and a rising share of high yield issuance) often has been followed by a contraction in US economic activity two to four years later, according to a *study* by three researchers including Jeremy Stein, a Harvard professor and former Fed governor. The chart above shows this for the last 20 years. The high yield share of issuance peaked in 1997 and 2004, three to four years before recessions stoked by the dot-com bust and the financial crisis, respectively.

The effects are significant. Credit booms on average lead to a cumulative 4% decline in gross domestic product (GDP) and an unemployment rise of two percentage points, the study finds. The reason? When sentiment is unusually high today, it is likely to deteriorate in the future. This causes a contraction in the supply of credit, especially to low-quality borrowers. This, in turn, weighs on economic activity.

High yield’s issuance share peaked in 2010, but spreads only hit multi-year lows in 2014. Could that signal a recession in 2016 or 2017? Perhaps. It is a somewhat crude measure. The search for the perfect leading indicator will go on.

Political risks

QE-numbered markets have long disregarded an increasingly dangerous world. We could see risk premia returning in 2016. We expect the breakdown of state control in the Middle East to get worse rather than better. The region is dogged by the after effects of the Arab Spring and proxy wars between Sunni Saudi Arabia and Shiite Iran. Terror group Islamic State is internationalising its reach. The only way to neutralise it, in our view, is to shrink its territory and achieve visible victories such as taking its self-declared capital of Raqqa.

The Paris terror attacks may change the status quo in Syria. Russia's bombing sorties against moderate rebels pitted it against the US. The two sides are more aligned now, giving Russia an opportunity to rehabilitate its near-pariah status. The situation is combustible, however, as evidenced by Turkey's downing of a Russian fighter plane. We expect Iran's relations with the West to remain frosty. Saudi Arabia is facing rising fiscal pressures due to the oil price collapse, the cost of the war in Yemen, social outlays to quell dissent and subsidies to allies Egypt and Jordan.

EU STRESS TEST

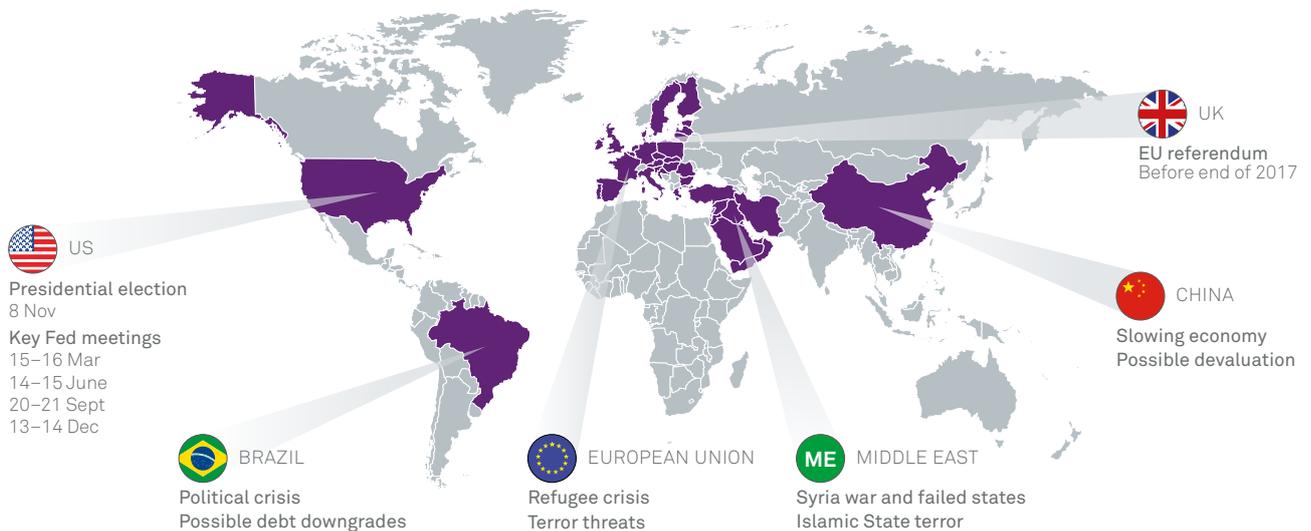
The refugee crisis has spurred border closings and the rise of eurosceptic parties, posing threats to the European project. The Paris terror attacks could strengthen frayed ties, leading to tighter security, more cooperation and, perhaps, more integration. See *After the Paris Tragedy* (November 2015). The need for action could give European leaders air cover to rethink an open-door policy and reduce intra-bloc tensions.

A UK referendum on whether to remain in the EU could come as early as June 2016. Prime Minister David Cameron is renegotiating the UK's membership, with protections for its key financial industry on his wish list. The EU may give Cameron some leeway for fear of losing Britain's military and security prowess. Could this sway a British public sceptical of the EU? Polls show the 'stay' camp has a narrow lead. We brace for volatility in sterling and gilts as the 'Brexit' referendum nears.

And then there is a US presidential election with a wide field of candidates and outcomes. We see the election's populist overtones, combined with scandals uncovering bad corporate behaviour, raising the risk of regulatory backlashes.

KNOWN UNKNOWNNS

Events and risks to watch in 2016



Source: BlackRock Investment Institute, November 2015. Notes: the key Federal Reserve meetings listed are those accompanied by a press conference. EU Referendum refers to a likely vote on whether the UK should remain a member of the EU.



“The terrorist threat against the West is likely the highest it has been since 9/11.”

– Tom Donilon
Senior Director,
BlackRock Investment Institute

United States

A lot is riding on the US business cycle in 2016 as many other parts of the world show declining or sluggish growth. We expect the grinding recovery to have legs.

The BlackRock US Employment Index (our gauge of 10 key labour market indicators) has risen to its highest level since 2007. See the chart on the right. The US unemployment rate stood at 5% in December, around the rate below which economists estimate wages usually start to take off. Inflation may soon start creeping back up.

Other bright spots include a robust housing market and pockets of strength in consumer spending. US auto sales were on track to hit a record in 2015. Falling energy prices are a boon for consumers. The average hourly paycheck today can buy 10.3 gallons of petrol – more than twice the amount in 2008, our calculations show.

Could the US business cycle be getting long in the tooth? Weak US manufacturing, in part caused by the strong dollar and lower spending in the oil sector, is setting off alarm bells. The Institute for Supply Management's manufacturing gauge fell below 50 (which means contraction) for the first time in three years in November.

This has put a damper on growth expectations. Consensus expectations for 2016 GDP growth have been gradually ratcheted down, tracking a familiar pattern of over-optimism followed by re-adjustment to reality. See the chart below. Our conclusion: this cycle has some room to run.

PERENNIAL DISAPPOINTMENT

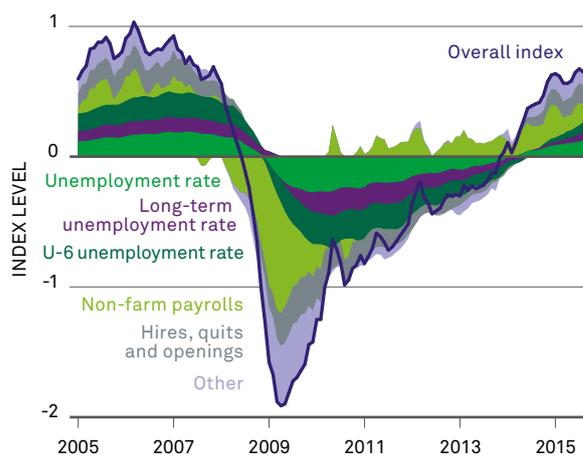
Evolution of US GDP forecasts, 2011–2015



Sources: BlackRock Investment Institute and Bloomberg, November 2015. Note: the lines show the path of median estimates of economists polled by Bloomberg for US real GDP growth for each year.

HELP WANTED

BlackRock US Employment Index, 2005–2015



Source: BlackRock Investment Institute, November 2015. Notes: other includes household employment, vacancy-to-unemployment ratio and GDP growth. The U-6 unemployment rate includes those who are seeking full-time work but have settled for a part-time job, as well as those who are not actively looking for work but have indicated they want a job.

FOLLOWING THE FED

The Fed appears finally ready to end its ZIRP. This is a good thing, in our view: the longer rates stay near zero, the greater the risks to financial stability. And it is better to start gradually raising interest rates now than to wait – and have to play catch-up later and increase rates at a faster pace.

The real question is what happens after the Fed's initial increase. It will likely raise rates at only a gradual pace, given moderate economic growth and low inflation. A strong appetite for yield should keep long-term interest rates anchored even as short-term rates rise. Long-term rates are what really matter for the housing market and capital spending. We are in uncharted territory, however. The term premium in US Treasury bonds is unusually depressed. Snapbacks appear likely, as detailed in *When the Fed Yields* (May 2015).

The Fed appears to be looking beyond the near-term drag of lower energy prices on inflation. As the unemployment rate falls, it is getting harder for employers to find qualified applicants for jobs. That, in turn, is likely to push wages higher, boost consumption and feed into inflation. Rising rents in the housing market will also help inflation edge higher in 2016, we believe.

Bottom line: the days of obsessing over every economic data point – and its implications for monetary policy – will roll on. Still, we will be living in a somewhat clearer world than in 2015. It is no longer 'whether or not' but *how* the Fed will normalise policy.

BEWARE BOND PROXIES

US companies have used low interest rates to obtain cheap financing in corporate debt markets. They have leveraged up to buy back their own stock or do acquisitions, rather than invest in their own businesses. See the chart on the right.

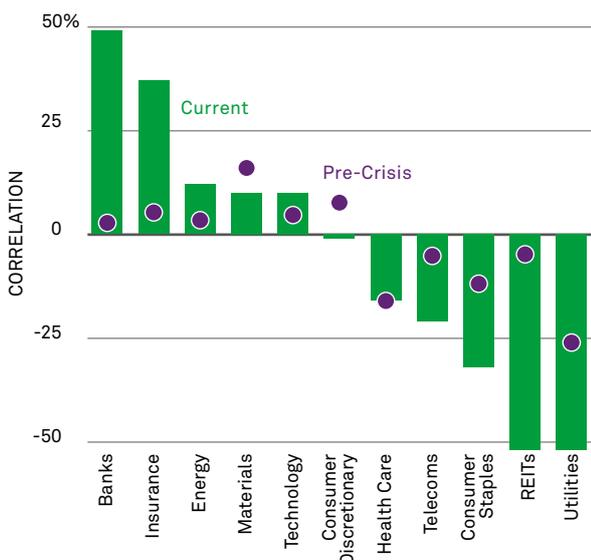
It has been a potent recipe: buybacks have delivered the highest shareholder returns of any form of capital use since 1985, our analysis shows. (This may be changing: the S&P 500 Buyback Index has lagged since mid-year.) Dead last in our study were cash acquisitions – a reason to watch deal activity. Also, M&A booms can signify stock market tops. We are not there yet: megadeals have lifted deal volume to 5% of global market cap, below peaks in 2000 (11%) and 2007 (8%).

We see the market's focus shifting toward revenue growth in 2016, and expect analysts once again to mark down rosy earnings estimates (blame the strong dollar and weaker oil).

What happens when yields rise? Dividend payers look vulnerable. Utilities, property investment trusts (REITs) and consumer staples became bond substitutes as yields hit bottom. Bond proxies today have an unusually high negative correlation to bond yields (falling in price when yields rise, and vice versa). See the chart below. Also, high-yielding US large caps trade one standard deviation (SD) above average valuations since 1976, we calculated. We prefer dividend *growers*, which are one SD cheaper.

RISING RATES LIFT DIFFERENT BOATS

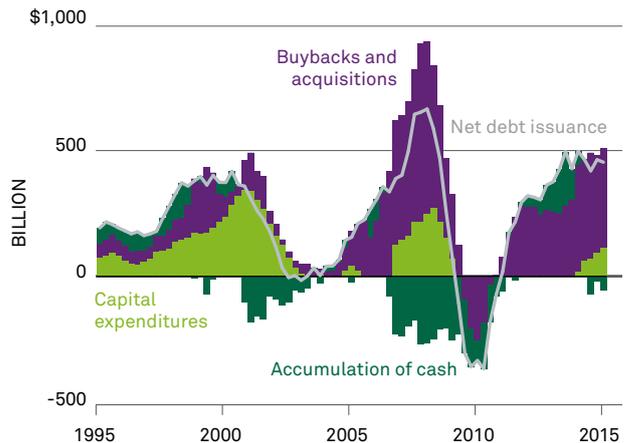
US sector correlations with US 10-year yield changes, 2015



Sources: BlackRock Investment Institute, S&P and Thomson Reuters, November 2015. Notes: the bars are correlations based on daily sector relative performance (versus the S&P 500) and changes in 10-year US Treasury yields in the past 12 months. The dots show the correlations from 2005 to 2008.

DEBT-FUELLED BUYBACKS

US non-financial firms' use of debt, 1995–2015



Sources: BlackRock Investment Institute, Federal Reserve and IMF, October 2015. Notes: capital expenditures represent the portion funded by debt only (capex minus internal funds). Buybacks and acquisitions are net of any new share issuance by companies. Cash includes other financial assets.

Banks and insurers have been positively correlated with rising yields, as the chart shows. Higher interest rates typically help boost banks' net interest margins and discount rates for insurance portfolios. The regulatory cycle (yes, we found another cycle) of legal settlements and curtailing risky but profitable activities also looks to have peaked.

Other preferences include technology (growth is at a premium in a low-growth world), oil and gas companies in prime shale areas and builders (mortgage credit is getting easier and housing starts should perk up). We also like prime US commercial property. It tends to perform well during rate-hiking cycles, the supply/demand balance looks favourable, and we see no red flags such as rising leverage or forests of construction cranes.

BOND LIKES AND DISLIKES

The search for yield in fixed income lives on. Investors who bought high-income bonds before the financial crisis are finding it hard to replace them as they mature. Yet volatility is rising – and bad credits (think energy) are being punished. Fundamentals are coming back to the fore.

In investment grade, we prefer sectors such as financials and cable over materials, manufacturing and consumer products. We see selected opportunities in high yield, but are avoiding most energy debt, where we see more pain (and defaults) to come in 2016. We favour mortgages because of their high liquidity and diversification benefits. We also like long-dated tax-exempt municipal debt. Munis offer attractive income; and we see credit quality plateauing – not peaking.

Europe

The eurozone business cycle is in the early stages of a slow-motion recovery. Manufacturing gauges have been on an upswing since 2012, and the trade surplus has risen to record highs (helped by a weak euro). Private-sector loan growth is rising again, tracking a money supply increase. Thank the ECB's asset quality review (AQR) of European banks in 2014, which helped restore confidence in the financial system and released pent-up credit demand. See the chart below.

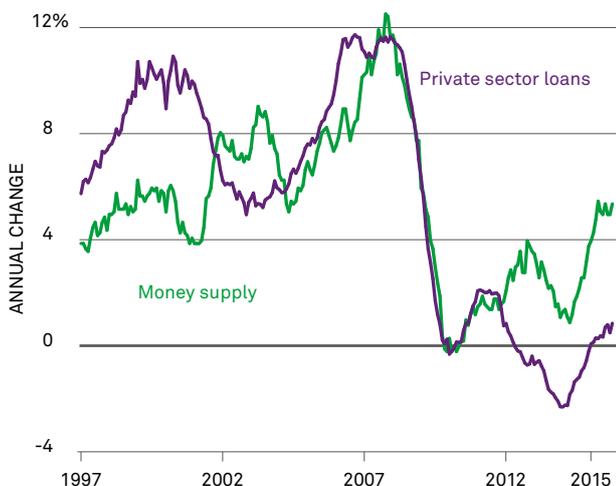
The problem: core inflation remains stubbornly low (although it has been ticking higher). And Europe's export revival is under threat from the EM slowdown. China is an important market for European luxury and consumer goods makers.

ECB President Mario Draghi appears ready to do whatever it takes to get inflation up and the euro down. The latest salvo: a deposit rate cut to -0.3% and extension of QE by six months until March 2017. This initially disappointed markets. Our view: -0.3% is very negative, and we see the ECB marching farther down its monetary policy path if needed.

Monetary policy alone cannot solve the eurozone's woes. US-style reforms to liberalise product and labour markets could boost GDP by 20% in the longer run, according to a 2014 *OECD study*. We expect reform momentum to take a back seat in 2016 to border controls and security issues. We see a modest growth boost in 2016 as governments loosen their austerity belts and spend more (not just on security).

CREATING CREDIT

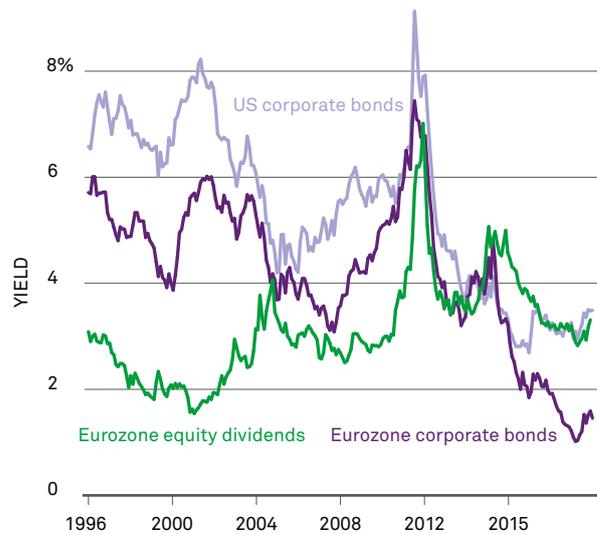
Eurozone money supply and loan growth, 1997–2015



Sources: BlackRock Investment Institute and European Central Bank, November 2015. Note: money supply is based on M3, a broad measure of money that includes currency and deposits as well as certain money market instruments and repurchase agreements.

EUROPEAN HUNT FOR YIELD

Eurozone dividend vs. corporate bond yields, 1995–2015



Sources: BlackRock Investment Institute, Bank of America Merrill Lynch and MSCI, November 2015. Note: the dividend yield is for the MSCI EMU Index; the bond yields are based on Bank of America Merrill Lynch's corporate bond indices.

FINDING FIXED INCOME

Income is hard to come by in the eurozone. Yields on European sovereigns are at historically low levels, with some 'offering' negative rates. Relative value is our mantra. We favour Spain's bonds over Italy's, for example, and prefer inflation-linked securities over nominal bonds in both markets. Some peripheral bonds are priced to perfection and vulnerable to the rise of anti-austerity parties, we believe.

QE has led asset owners to climb up the risk ladder. Yields on investment grade corporate bonds have plummeted to 1.4%, less than half the yield of their US counterparts. The corporate bond rally has widened the yield gap with eurozone equity dividend payouts to a near-record level of 1.9%. See the chart above. In this tight-spread space, we like financials because of increased capital buffers and greater clarity on financial regulations. We steer away from industrials due to increasing leverage and appetite for deals.

We think the BoE is eager to raise interest rates, given moderate jobs growth, wage gains, decent availability of credit and strong consumer spending. The problem: more ECB easing and a dovish Fed increase (a rate rise coupled with signs that further increases will be gradual) could boost the pound and weigh on UK exports. The timing of the 'Brexit' referendum (see page 11) complicates matters; we see the BoE being loath to raise rates close to the vote. This is why the current market expectation of a increase in the fourth quarter of 2016 looks right to us.

EXAMINING EQUITIES

We staged a vigorous debate on the relative merits of European and US equities. It mirrored the excitement and outcome of the Ryder Cup (Europe usually wins, these days).

European equity valuations look attractive. They offer 50% higher dividend yields than US peers (see the table below) and cheaper price-to-book ratios (the gap is near record highs). The weak euro, subdued wage growth and expanding domestic credit should support corporate earnings in 2016 – whereas the strong dollar is pressuring US profits.

Consumer staples look richly valued in both markets, while energy appears inexpensive. It is tough to come up with bullish arguments for energy beyond low valuations and rock-bottom sentiment. Yet there are nice precedents: oil equities did well in the 1980s after crude cratered. Earnings are depressed – which historically has been the time to buy. Contrarians in our midst like global integrated oil companies.

In the UK, we like domestic themes such as general retail and financials because the business cycle is running strongly. This is vulnerable to a momentum shift, however, as domestically focused small- and mid-caps have long outperformed large-cap resources and global banks.

HEALTHY PARANOIA

Our Scientific Active Equity (SAE) team takes a contrarian view, favouring US over eurozone stocks for the next three to six months. Its model crunches 100 billion Google search queries a month to gauge consumers' spending intentions. Compare this with the University of Michigan's popular consumer confidence survey, which is based on a poll of 500 people per month – by landline! SAE's model points to a pickup in US consumption and a downtrend in Europe's periphery in the near term.

Risks to European exporters and other cyclical are mostly priced in, we believe. We do not expect a hard landing in China (see page 17), and are starting to edge back into beaten-down luxury brands reliant on EM sales.

Yet we believe in healthy paranoia and constantly ask ourselves: what can go wrong in 2016?

- ▶ We worry that overweighting European equities has become a consensus view. There are good reasons for this, but markets have a way of going against the grain.
- ▶ Political disturbances could have an outsized impact given this consensus view.
- ▶ Expectations of more eurozone QE could start to inflate asset markets, with risks of sharp reversals rising.

RELATIVE VALUE

Selected European and US equity sector valuations, 2015

	Europe				United States			
	P/E ratio	Dividend yield	Valuation vs. history	Index weight	P/E ratio	Dividend yield	Valuation vs. history	Index weight
Consumer staples	20.9	2.6%	72%	15%	19.3	2.6%	58%	9%
Information technology	18.8	1.7%	57%	4%	16.6	1.5%	37%	21%
Consumer discretionary	14.6	2.5%	57%	12%	19.3	1.4%	72%	14%
Health care	17.6	2.7%	48%	14%	16.3	1.6%	53%	15%
Utilities	14.4	4.8%	36%	4%	15.3	3.8%	62%	3%
Financials	11.2	3.8%	34%	23%	14	2.2%	61%	16%
Energy	14.8	5.9%	19%	7%	28.9	3.3%	31%	7%
Overall	15.2	3.3%	48%	—	16.9	2.1%	53%	—

Sources: BlackRock Investment Institute, MSCI, Thomson Reuters, 30 October 2015. Notes: the sector and index data are based on MSCI indices. The P/E ratio shows current 12-month forward price/earnings ratio. Valuation versus history shows the average percentile rank since 1995 of earnings yield, cyclically adjusted earnings yield, trend real earnings, dividend yield, price to book, price to cash and 12-month forward earnings yield. Example: European consumer staples currently trade at a valuation equal to or greater than 72% of their history since 1995. The index weights show the sectors' market cap weights within the overall MSCI index.



“What happened to Europe? We were all terrified. Is it fixed? Or just QE'd over? Is there too much complacency here?”

– Dennis Stattman
Head of the BlackRock
Global Allocation team

Japan

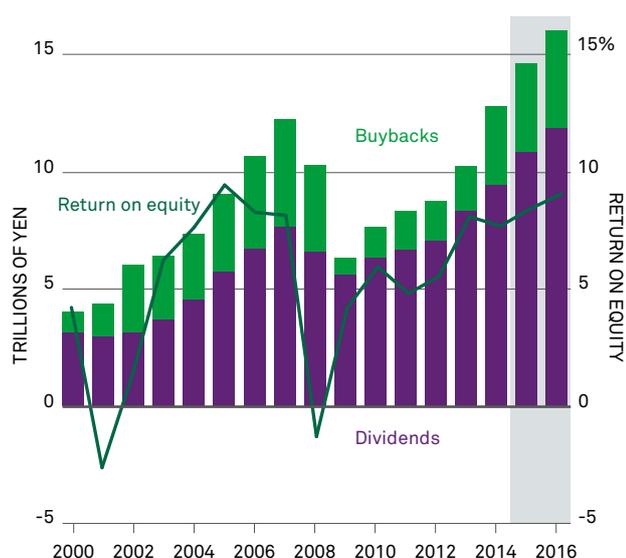
Japan's business cycle appears to be running out of steam, as evidenced by two straight quarters of contraction. This is casting doubt on the success of 'Abenomics,' Prime Minister Shinzo Abe's plan to revive the economy through structural reforms, fiscal stimulus and monetary easing. Sceptics contend the policy looks more like 'Kurodanomics' due to a heavy reliance on QE and yen weakness engineered by BoJ head Haruhiko Kuroda.

Rebuilding after the 2011 tsunami and a consumption spree ahead of a 2014 sales tax increase boosted the economy only temporarily. The BoJ is falling well short of its 2% inflation target. Real wages have been creeping higher – but not enough to set off a virtuous cycle of higher consumer confidence and consumption. Waiting for progress at wage negotiations in the spring has become an annual ritual that has inevitably ended in disappointment.

We could see the central bank expanding QE (and the government boosting spending) as the economy once again flirts with deflation. This bodes well for corporate earnings. Importantly, Japan Inc. is showing a newfound appreciation for shareholder rights. Dividend payouts are at record highs, and share buybacks are on the rise. See the chart below. And return on equity has been steadily rising since 2008. We also like Japanese equities because they are cheap (see page 8) and enthusiasm for the Japan trade has cooled.

SHARING WITH SHAREHOLDERS

Japan dividends, buybacks and return on equity, 2000–2016



Sources: BlackRock Investment Institute and Nomura, November 2015.
Notes: the 2015 and 2016 fiscal years are based on Nomura estimates.

LAND OF RISING RISKS

A near-term risk is China's slowdown. The country is Japan's second-largest trading partner after the US, accounting for about 18% of exports, according to the Japanese Ministry of Finance. The yen has depreciated about 30% against the yuan since 2010. This has increased Japan's relative trade competitiveness, but also exposes it to the effects of a possible yuan devaluation (page 18). This is a reason why we have slightly reduced our (still large) overweight to Japanese equities in the past year.

The good news? Japan's economy is pretty domestically focused, with less than 5% of corporate Japan's overall revenues coming from China, according to our analysis of MSCI data. This is roughly in line with the developed country average, and well below an 18% average for emerging markets. (The figures may understate China exposure as they do not include fast-growing luxury goods and other sales to Chinese tourists in Japan.)

ENDGAME UNKNOWN

We also see two long-term risks:

- 1 Japan needs to generate faster growth and inflation to sustain its huge debt load. The public debt stands at more than one *quadrillion* yen (\$8 trillion) – roughly 245% of GDP, according to the International Monetary Fund (IMF).
- 2 How much longer can the central bank keep buying \$650 billion of assets a year without creating big distortions in financial markets? The endgame for Japan's QE is unclear. The BoJ will own about half of outstanding Japanese government bonds (JGBs) by the end of 2016, Nomura estimates. (The central bank's balance sheet is starting to resemble the waistline of a sumo wrestler.) For now, there are plenty of willing sellers. Big Japanese pension funds are trimming JGB holdings for equities and foreign assets.

Yet eventually the BoJ will start running out of bonds to buy. It may replace some bond buying with more equity purchases. This could boost the equity market – but create greater asset price distortions down the road.

What about the yen? We think yen weakness may have mostly run its course after a sustained three-year decline. It is now *undervalued* by around 15% versus the US dollar, according to OECD estimates of long-term fair value. The BoJ appears to think the yen has fallen enough. A weak yen makes imports pricier for households and small businesses, and could raise tensions with Japan's trading partners. Plus, Japanese manufacturers have moved much of their production overseas – and, therefore, do not benefit from a weaker currency as much as they did in the past.

China and EM

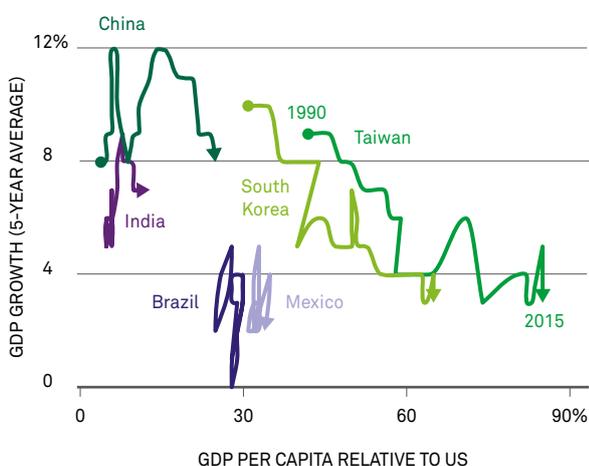
China's super-charged business cycle looks to be fizzling out. This matters because the country has accounted for one-third of global growth since 2010, according to the IMF, and probably even more through its multiplying effect on the EM world. Yet JPMorgan sees China maintaining this share in 2016 – even as its slowing economy has markets in turmoil. China consumes 40%-60% of the world's iron ore, nickel, copper and zinc production, and has sizable shares in corn (21.5%) and crude oil (13.7%), according to Goldman Sachs.

Our base case is a soft economic landing. Sure, we see China undershooting its current five-year plan's 6.5% annual real growth target. Yet even real GDP growth of 5% and nominal growth of 4% (reflecting deflation caused by rampant overcapacity) would be healthy for a roughly \$20 trillion economy (measured in purchasing power parity terms). This represents about \$800 billion of new activity and potential business next year – not bad in a low-growth world.

One colleague described China's economy as a black box, a description that gathered much sympathy. Yet when we take a step back, it becomes clear that a gradual deceleration is perfectly normal – and welcome. South Korea and Taiwan, countries that successfully avoided the 'middle income trap,' went through a similar phase as they caught up with the US in GDP per capita over the past quarter century. See the chart below. China so far is following their tracks, avoiding the volatile growth patterns of Mexico and Brazil that have resulted in little progress in closing the gap with the US.

MIDDLE INCOME TRAP

Emerging market GDP growth paths, 1990–2015



Sources: BlackRock Investment Institute and IMF, November 2015.
Notes: the lines show five-year averages of annual data from 1990 to 2015.
The relative GDP-per-capita data are based on purchasing power parity terms.

WANTING TO BE NORMAL

Discussions about China often assume a tradeoff between structural reforms and economic growth. Yet we see many reforms in motion actually stimulating GDP in the near term. They are meant to make China more like other countries, weeding out the 'abnormal' and phasing in the 'normal':

- ▶ Moving toward market pricing to better allocate resources (financial liberalisation and price deregulation in energy).
- ▶ Cutting manufacturing overcapacity by encouraging competition between state-owned enterprises (SOEs) and providing incentives for management teams to behave like owners rather than caretaker politicians. China currently is split into two halves: a vibrant consumer sector with booming e-commerce on the one hand, and thousands of lumbering enterprises producing goods that may never be sold at an economic profit on the other.
- ▶ Reducing the risk of a credit crunch by converting short-term bank loans to SOEs and local governments into long bonds. Note this extend-and-pretend policy has been tried before (in South Korea and Japan), and could stifle long-term growth by propping up zombie borrowers.
- ▶ Implementing land reforms to unlock wealth held by rural populations and reducing tariffs on imported agricultural products to bring down food prices.

We expect the government to go easy on reforms that detract from short-term growth (property tax) or are too risky (opening up the current account). Structural reform is a long process. Just as well that expectations are low.

DEBT ISSUANCE BONANZA

What surprised markets in 2015 were the magnitude of China's deceleration and deflationary pressures; the speed at which asset quality worsened and reduced the efficacy of credit growth; and the mixed policy response to the stock market crash. It became clear Beijing policymakers were not the omnipotent and omniscient beings markets saw them as (they are human). The risks now appear better understood.

On our radar screen is China's fast-accumulating debt pile. This has been mostly a domestic problem up to now: foreigners own only roughly 2% of outstanding Chinese debt, official data show. The push to convert bank debt into bonds, however, coincides with a gradual opening of capital markets. We expect a debt issuance bonanza as a result. Playing into this is the internationalisation of the yuan. The currency will become part of the IMF's special drawing rights (SDR) basket in October 2016. We see this boosting issuance of yuan-denominated government bills and bonds abroad.

YUAN WORRIES (YIKES!)

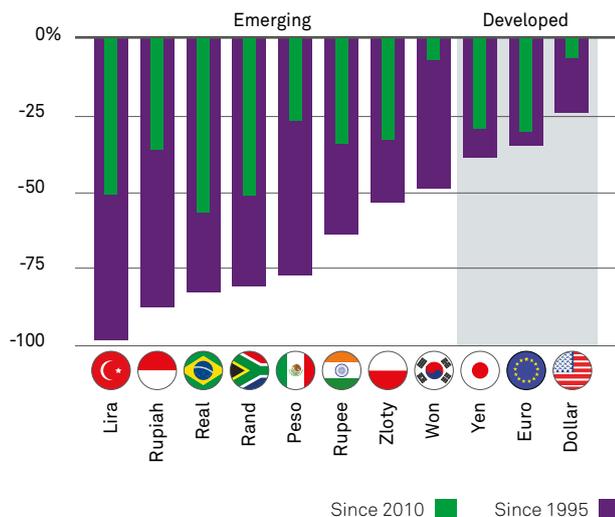
The yuan has appreciated significantly, especially against EM currencies. See the chart below. A strengthening US dollar is bringing even more upward pressure. A market worry, therefore, is the possibility of a big yuan devaluation to rev up exports. This could accelerate capital outflows and trigger a damaging round of competitive devaluations by other EM economies. Not cool. It could also exacerbate the problems caused by overcapacity in China's industrial sector. The country could export even more deflation – at a time when central bankers are trying to encourage inflation to awaken animal spirits and chip away at debt loads.

We think a sharp yuan devaluation is unlikely – but a risk nonetheless. Some of us see a gradual depreciation against the dollar. Others expect China to keep the currency stable in 2016, even if the dollar rises further. Why? Policymakers ostensibly were caught off guard by the capital outflows and market mayhem ignited by the small (but unexpected) yuan depreciation this summer. They appear concerned about an outflow of deposits from the financial system and may not want to rock the dragon boat again – at least not until markets are convinced China's slowdown is under control.

Nowhere do China's economic shifts reverberate more than in the emerging world. The EM and trade booms relied heavily on Chinese demand. China and other EM demand consumed two-thirds of EM output in 2011, Credit Suisse research shows, whereas just 10% of the developed world's output went to EM. No wonder world trade volumes are so anaemic.

WHAT CURRENCY MANIPULATION?

Performance of selected currencies vs. Chinese Yuan, 1995–2015



Sources: BlackRock Investment Institute and Thomson Reuters, November 2015. Notes: the bars show the percent change in spot rate from the start of 1995 (purple) and 2010 (green) to 2015. The euro is based on a synthetic calculation before 1999.

JOINED AT THE HIP

EM exports, earnings and commodity prices, 2000–2015



Sources: BlackRock Investment Institute, IMF and Thomson Reuters, November 2015. Notes: exports are based on the value of goods exported by emerging markets and do not include services. Earnings are based on 12-month forward estimates for companies in the MSCI Emerging Market Index. Commodity prices are based on the CRB spot commodity index.

ATTACHED TO CHINA

Swings in commodity prices, EM corporate earnings and exports have almost perfectly tracked each other since the financial crisis, as the chart above shows. Which is leading which? We are debating this chicken-and-egg problem and have yet to arrive at a firm conclusion. What is clear is that EM countries reliant on Chinese demand and commodity exporters such as Australia now face a double whammy:

- ▶ China's growth has fallen further and faster than expected.
- ▶ The composition of the growth is changing fast, from demand for natural resources to an appetite for consumer goods, services and dairy products.

These are structural changes that we see dampening commodity prices (absent any supply shocks). They also look poised to reduce future EM growth, in combination with greying populations and cyclical factors such as domestic credit growth reaching its limits in many economies.

Which countries and companies are nimble enough to retool their economies or operations to service the new China? This is especially challenging for countries that lack strong government institutions or have hollowed out their industrial base in a blaze of consumption paid for by an overvalued currency and credit (think Brazil). It is also about financial firepower: which countries and companies can afford the needed investments to engineer such a shift? And which will face more competition as China's economy moves up the value chain? The answers to these questions will likely translate into winning investments for years to come.

A CYCLICAL HELPING HAND

Even if you are bearish on EM in the long run, it is prudent to recognise cyclical swings that could propel these markets higher – at least temporarily. Consider:

- ▶ Global growth is expected to edge up to 3.6% in 2016, according to the IMF's latest forecast. (Note: forecasts have had a habit of slipping in recent years.)
- ▶ Many EM currencies have depreciated significantly, improving current account and trade balances. This is the power of free-floating currencies – and contrasts with the late 1990s, when currency pegs magnified imbalances.
- ▶ Inflation should ease in 2016 in some countries (Russia, for example), creating room for monetary easing.
- ▶ The oil price collapse is a boon for oil-importing nations and has allowed for cutting of costly energy subsidies.

Investor sentiment is near record lows, according to the latest BofA Merrill Lynch Global Fund Manager Survey, which we view as a good contrarian indicator. Assets also are generally cheap, even if valuations between EM countries, sectors and return factors differ considerably. The same is true for companies that derive a large part of their revenues from the emerging world including China. They have severely underperformed in the past year, as the chart above right shows, and now offer selected value.

We are nibbling at EM assets, but not enough to fill our overall underweights. We focus on countries and companies with improving balance sheets and few external liabilities. The External Finance component of our 50-country *BlackRock Sovereign Risk Index* is key in this respect. We also like countries with reform momentum. India and Mexico, for example, both have credible agendas for structural reforms to liberalise their economies.

We like infrastructure projects, especially essential services such as power, energy and transport. There is a great need for EM infrastructure, and insatiable demand for long-dated, stable and diversifying cash flows. We prefer to co-invest with local pension funds or government entities to mitigate regulatory and political risks. The ability to source deals is key as everybody chases after choice assets. Operational expertise also is a must. The same asset can have a different risk profile in a different location. Plus, projects never fail in PowerPoint presentations – but they do fail on the ground!



“Quantifying the impact of China’s economic shift is key. And ‘country’ is not the only unit of analysis. We need to think in terms of sectors and companies.”

– Jeff Shen

Head of BlackRock Emerging Markets
and Co-Head of Scientific Active Equity

WHEN DEVELOPED IS EMERGING

Returns of global stocks with high EM and China exposure, 2015



Sources: BlackRock Investment Institute and MSCI, November 2015.

Notes: the emerging market exposure index takes roughly 300 companies in the MSCI World Index with the highest proportion of revenues derived from emerging markets. The China index contains some 50 companies in the MSCI World with the highest revenue exposure to China.

EMERGING LESSONS

EM investors need to keep in mind five overarching trends:

- 1 Domicile does not equal exposure. Many companies based and listed in the EM world derive a majority of their sales from developed markets, and vice versa. Also, services (the EM growth sector) are underrepresented in benchmark EM indices relative to their share of GDP in most countries.
- 2 Traditional quant strategies have become challenged, our SAE team finds. The answer: use big data techniques to mine Google searches or investor blogs for insights.
- 3 There is life beyond country, industry and factor investing. There is a convincing case for health care as a thematic investment thesis, for example, due to ageing populations with widening girths.
- 4 Local debt markets have deepened, and may offer income and diversification in the low-yield world. Yet tradable debt and publicly listed equities are a sliver of the economy in most countries. As a result, we believe the best opportunities may be in private markets.
- 5 Currencies matter in EM investing. The good news? Oversold currencies have typically heralded protracted EM equity rallies, according to Credit Suisse.

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