FOR PROFESSIONAL INVESTORS ONLY

2014 MIDYEAR OUTLOOK
SUMMER 2014

iShares by BlackRock

EMEA INVESTMENT STRATEGY AND INSIGHTS

# LOOKING GLASS

# Half-time recap

Half-time in 2014 and a look at the scores shows a remarkable level of consistency across asset classes YTD. Mid-single digit returns nearly everywhere and it's not surprising that volatility across asset classes has reached a seven year low. Yet the numbers belie some notable trends.

Fixed income has defied market expectations to stage a headline comeback after its disastrous 2013 while commodities YTD have quietly benefited from the growing geopolitical tensions to put in their best performance since summer 2012. Developed equities struggled in Q1 but have found renewed momentum to post new highs in many markets and the equity rally this time looks set to be joined by emerging markets which have shown signs of turnaround and are now up over 5% YTD. Only Japan amongst major markets remains in negative territory, something that could change in the coming months if the May-June rebound continues. Overall, two themes permeate through markets: the search for value which is driving increased rotation across regions and sectors, and the search for yield which has driven returns in peripheral and emerging market debt.

**TABLE 1: 2014 YTD ASSET CLASS PERFORMANCE**

| Exposure | Returns |
|---|---|
| EM Equity | 5.3% |
| European Equity | 6.1% |
| US Equity | 5.2% |
| UK Equity | 1.4% |
| Japan Equity | -5.4% |
| EUR IG | 4.5% |
| US IG | 4.1% |
| EUR HY | 5.4% |
| US HY | 5.3% |
| EM Local Debt | 5.5% |
| EM Bond USD | 8.7% |
| Gold | 5.0% |
| Oil | 7.6% |
| Broad Commodity | 9.0% |
| UST 10y | 5.8% |
| Spain gov bonds | 9.3% |
| Italy gov bonds | 8.4% |

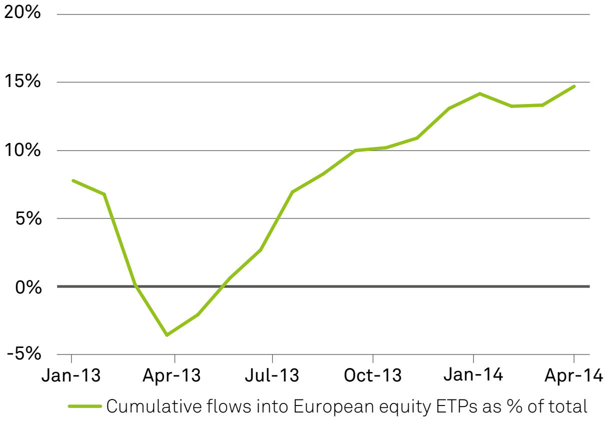
Source: Bloomberg, data as at end of June 2014.

## ETPs IN 2014

In ETPs, 2014 has seen investors focus on Developed Market (DM) equities for a second year. Within that, European equities have garnered a growing share of the inflows as global investors re-allocate to Europe. In contrast, US equities, which dominated the inflows in 2013, have been much less popular. Emerging Market (EM) equities – which saw investor capitulation last year – are starting to capture investor interest again but, as we'll discuss later, remain the major underweight in investor portfolios.

Reflecting the performance of fixed income and the search for yield, both investment grade and high yield continue to gather inflows, especially in Europe. As the search for yield has intensified, Emerging Market Debt (EMD) has seen increasing flows since Q1. Here, European investors have led the way, with inflows broadening out to local EMD while US investors have only just started to increase their exposure to external EMD.

### FIGURE 1: DM EQUITIES STILL STRONG BUT EUROPE MAKING UP FOR STALLING US FLOWS

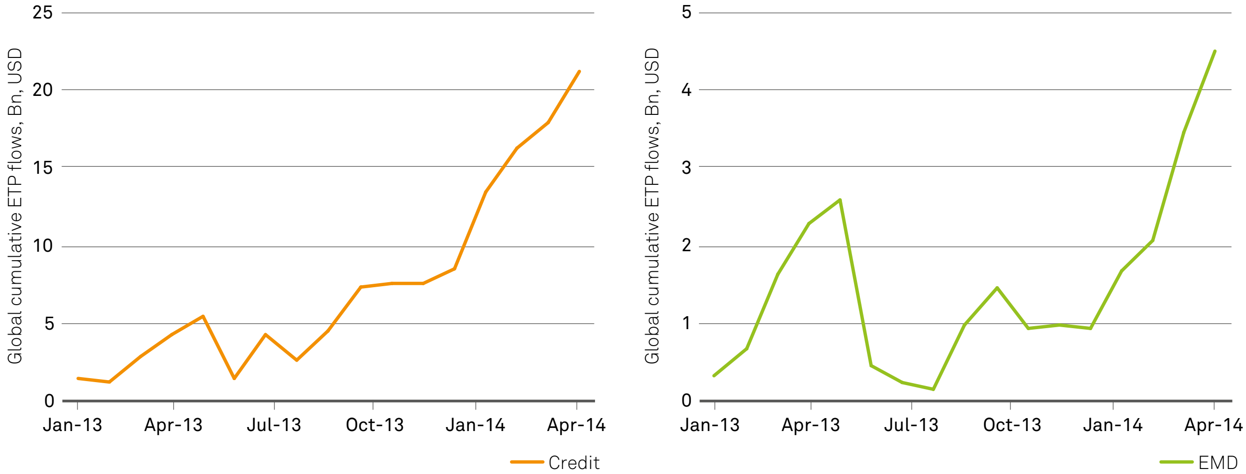



Source: BlackRock ETP Landscape, data as at end of May 2014.

### FIGURE 2: EM EQUITIES BOTTOMING OUT?


Source: BlackRock ETP Landscape, data as at end of May 2014.

### FIGURE 3: SEARCH FOR YIELD CONTINUES, ESPECIALLY IN EUROPE




Source: BlackRock ETP Landscape, data as at end of May 2014.

# H2 through the Looking Glass

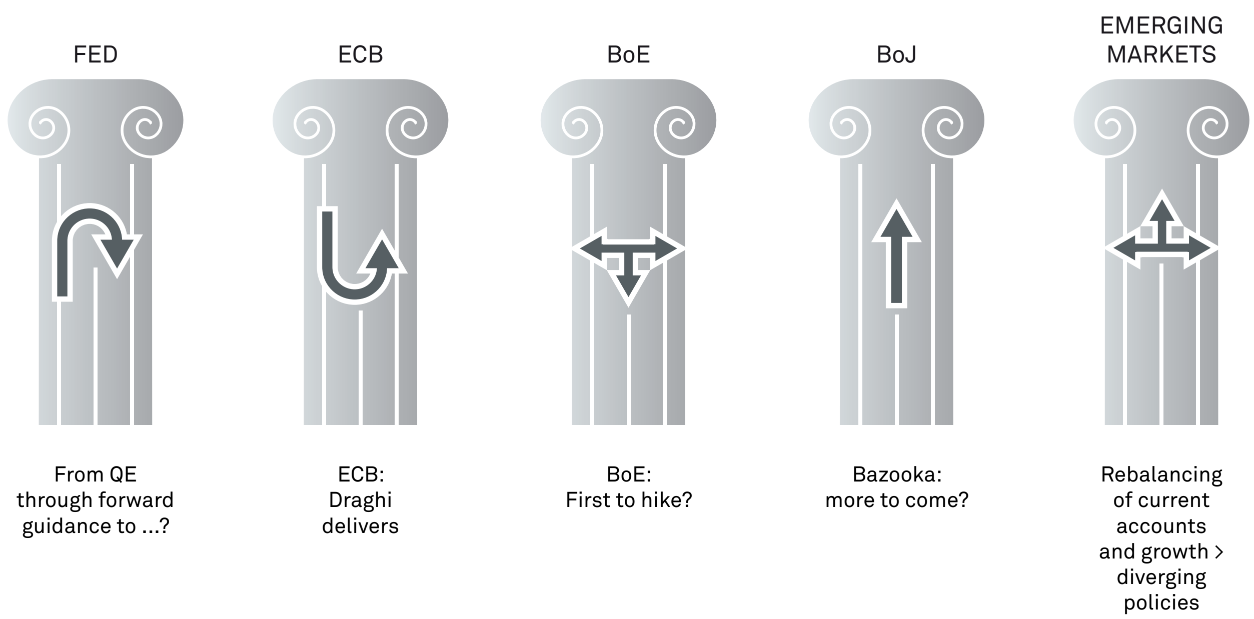
## 'SAME SAME BUT DIFFERENT'

Looking forward to the rest of 2014 and the environment looks remarkably similar to when we wrote our year-ahead outlook. The global recovery is intact led by the US, the UK continues to beat expectations, and the Eurozone is improving but remains fragile. The lack of inflation is still a concern, particularly in Europe where it is disappointing expectations, although there are signs of stabilisation in the US. The emerging world continues to lag but here again there are signs of a better second half for growth.

For asset markets, the de-synchronisation of central bank policies has driven returns in recent months and will be key for H2. The European Central Bank (ECB) took centre stage in H1 culminating in the package of easing measures Mario Draghi announced in June. Focus will remain on the lack of inflation in the Eurozone, especially the core, but we expect little further from the ECB for the rest of 2014. Instead focus now shifts back to the Fed and the Bank of England (BoE) where on the face of it their accommodative stance remains supportive for further equity and credit market gains in coming months. Both have been remarkably dovish in the first half of 2014, helping government bond markets record greater-than-expected recoveries from their 2013 *annus horribilis*.

However, as we move through H2, pressure may build in the opposite direction. As Mark Carney indicated in his Mansion House speech, rate hike expectations could grow earlier than currently expected if the data continues to improve following the weather-induced slowdown in Q1. As the labour market heals, the key question for both the Fed and the BoE is how much of the current labour market slack is structural versus cyclical. Wage growth remains the key signpost for this: if trends such as automation are driving a shift away from labour-intensive services then we could start to see a pickup in wages without a drop in long-term unemployment.

**FIGURE 4: CENTRAL BANKS IN 2014 – CHANGING GLOBAL LIQUIDITY CONDITIONS AND SHIFTING MONETARY POLICY**



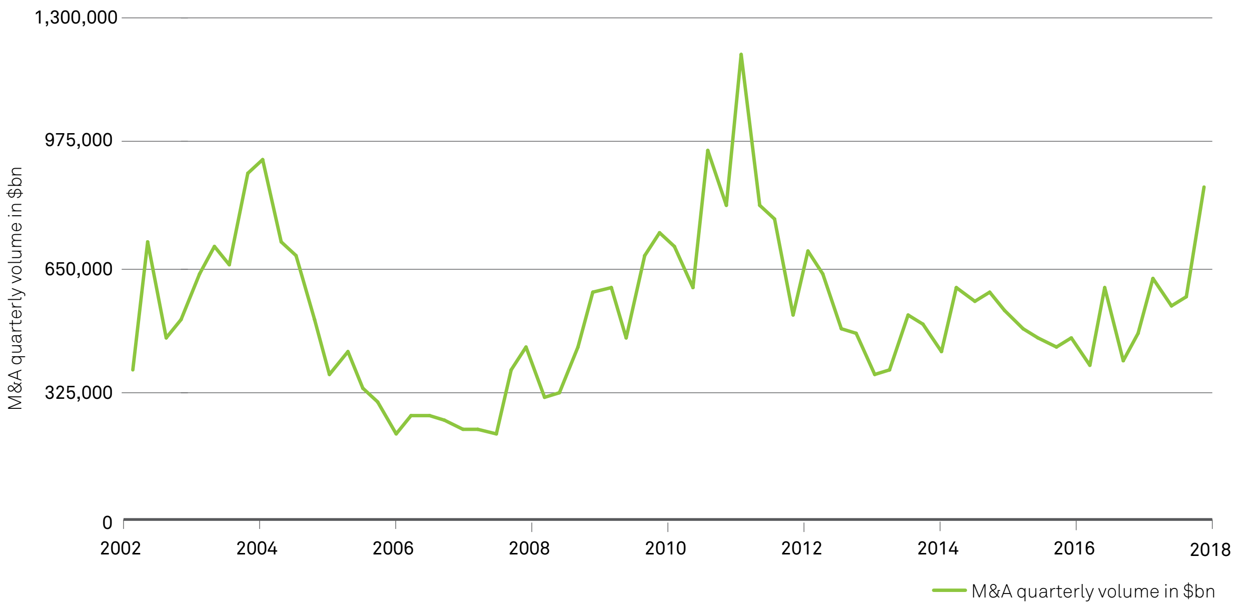

Source: BlackRock as at end of June 2014.

Beyond central banks, the changing behaviour of corporates is also becoming more influential for asset markets. Beneficiaries of the post-crisis easy monetary policy, companies globally have built up large cash-piles in recent years. Over the past year they have become more open to rewarding shareholders through dividends and share buybacks, and in 2014 that has extended to M&A (Figure 5). Alongside wages, capex has been a missing link in the global recovery – and a long-term concern for its sustainability – but for now the shift in corporate focus continues to be supportive of equity markets.

What are the risks beyond accelerated rate hike expectations? As usual it is politics. Geopolitical risks around Ukraine and now Iraq have pushed oil prices up to recent-year highs, but so far with little lasting impact on equity markets. Expect the oil price to stay supported but pose only a tail risk to the global recovery.

> *"There's already great speculation about the exact timing of the first rate hike... It could happen sooner than markets currently expect."*
>
> Mark Carney,
> Governor of the Bank of England,
> 12 June 2014

**FIGURE 5: PICK-UP IN GLOBAL M&A DEALS IN 2014**




Source: Citigroup, data as at end of June 2014.

# Investment themes

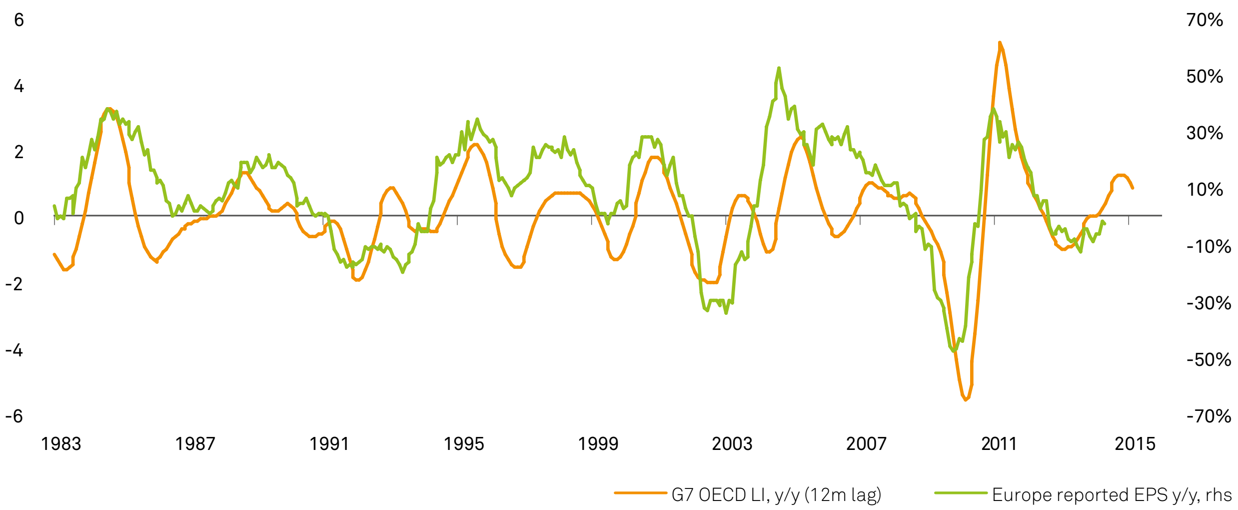
Overall, the Low for Longer scenario leaves our core themes broadly unchanged from those we set out back in January. Our preference for equities remains, with the challenge of where to find value in an increasingly fully-valued world. That keeps us focused on Europe, pinned to our Japan call where its relative value will surprise many, and incrementally positive on emerging markets. As we saw several times in H1, crowded positioning will drive an increased level of rotation. In fixed income, low default rates and global liquidity support the grind tighter in credit spreads. But the ageing cycle and likelihood of core government yields rising from here makes us increasingly cautious. Opportunities in EMD still offer relative value, and yielding assets outside fixed income look increasingly interesting. Watch for tail risks, led by oil and markets challenging the Fed. As the low for longer theme rolls on, volatility is back down to pre-crisis lows and complacency is rising.

## 1. EUROPEAN EQUITIES: EASY DOES IT!

After their resurgence last year, European equities have continued to perform in 2014 with momentum picking up again in Q2, supported by ECB easing. As we highlighted in our year-ahead outlook in January, earnings are key. A lacklustre Q1 reporting season saw some signs of bottoming out – now we need to see a further improvement to justify the multiple expansion of the past 18 months. While the Eurozone economic recovery remains fragile, the pickup in lead-lag indicators points to a positive earnings outlook ahead. Other signs of corporate confidence would be capital spending which has hardly recovered at all in Europe and the recent pickup in M&A activity.

Within Europe, on a sector basis, we have a preference for cyclicals over defensives given the recovery momentum. Banks are key beneficiaries of the recent ECB action, and have lagged broader Europe. European energy producers – which offer attractive valuations – should benefit from the surging oil price supported by supply disruptions in Iraq, Libya and Nigeria. On a country level, the UK and Germany are still leading in the Europe recovery.

**FIGURE 6: EUROPEAN EARNINGS PER SHARE GROWTH STILL TRAIL LEADING INDICATORS**



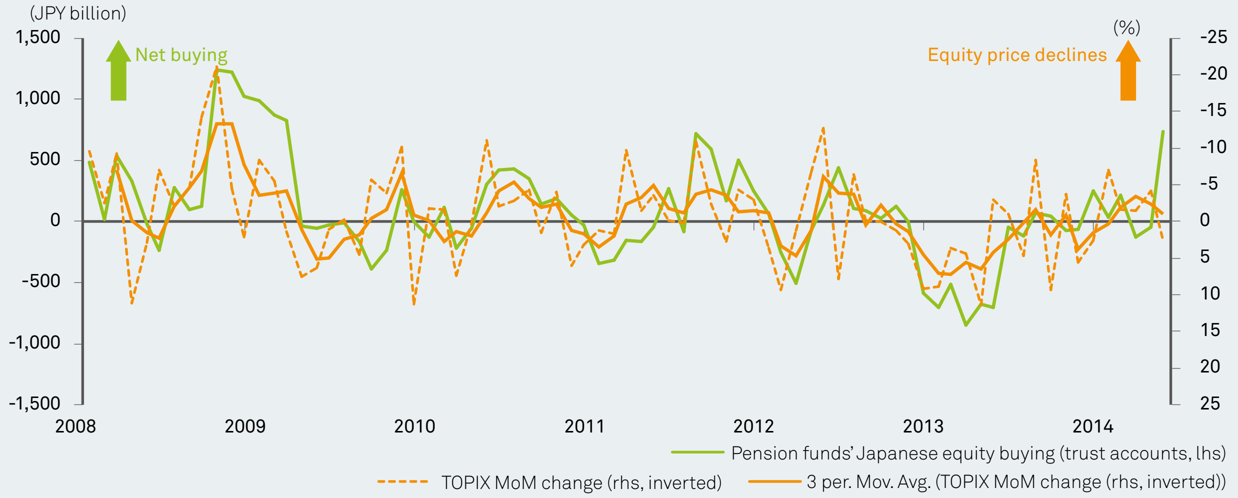

Source: BofAML, data as at end of April 2014.

## 2. JAPANESE EQUITIES: BEYOND THE CORRECTION

Japanese equities have underwhelmed in 2014 after a stellar performance last year. Recently, momentum has turned around as focus has shifted from further BoJ action to PM Abe's 'Third Arrow': a potential change in Government Pension Investment Fund (GPIF) asset allocation, measures to enhance companies' return on equity, and a commitment from PM Abe to cut corporate tax in the next few years. Expectations are for an announcement of GPIF re-allocation towards equities and overseas investments. The broader US$3.7trn Japanese pension market will likely follow GPIF, and this speculation has been supported by local pension fund buying of equities in June (Figure 7).

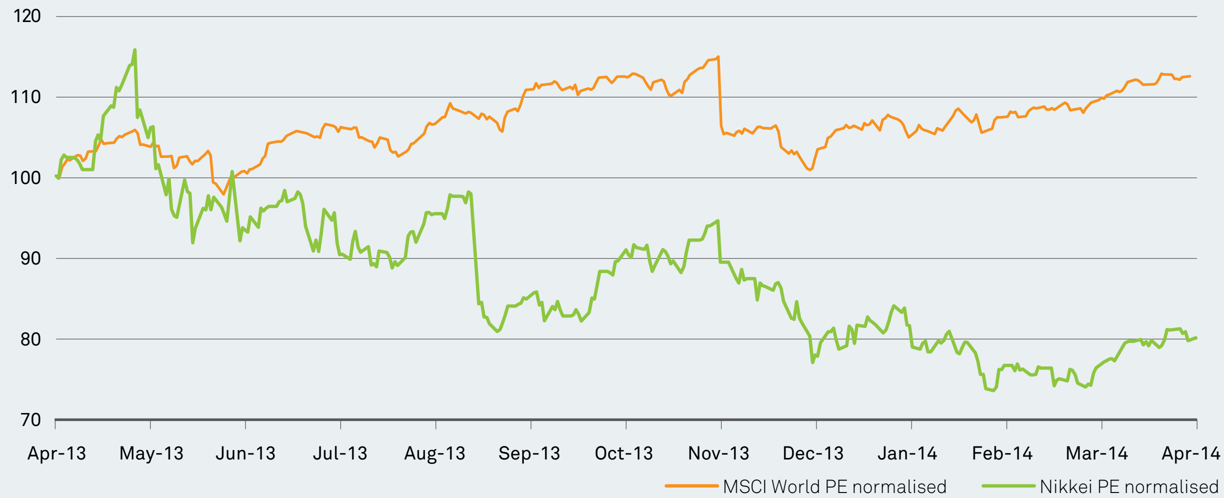
YTD underperformance of the equity market means valuations have become more attractive and are significantly less stretched than broad developed market equities (Figure 8). While we do not think equity upside is contingent on a weaker Yen, given the ongoing negative correlation between the currency and the equity market, a currency hedged strategy is still opportune.

### FIGURE 7: STOCK EXCHANGE DATA POINT TO PENSION FUND BUYING OF JAPANESE STOCKS




Source: Nomura, TSE, data as at end of May 2014.

### FIGURE 8: JAPAN STILL A VALUE CALL RELATIVE TO BROAD DM STOCKS




Source: Bloomerg, data as at end of June 2014.

## 3. EMERGING MARKETS: CONSTRUCTIVE ON THE MARGIN

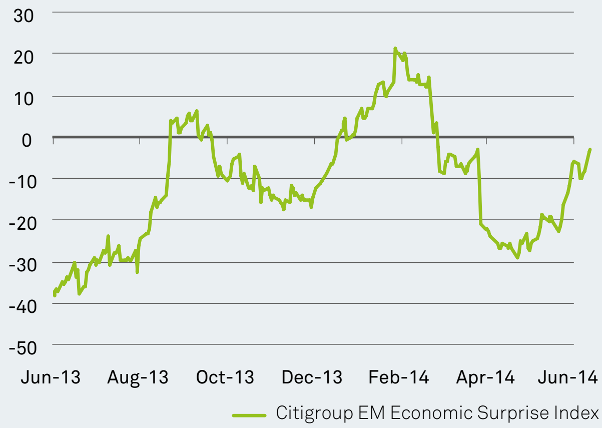
We highlighted in January that 'what to do about emerging market equities' would be one of the big asset allocation questions of 2014. Six months in and the importance of that question has grown as the recent turnaround in performance has yet to be accompanied by material inflows. Globally, most investors remain underweight. Two trends are notable:

- Firstly, while the broad growth picture in EM is still lagging (Figure 9), there are signs of stability. Most importantly, in China the economy has clearly bottomed out from the sharper-than-expected slowdown of Q1, helped by the government's stimulus measures and supported by the People's Bank of China through a weaker currency and Required Reserve Ratio cuts that have broadened out and helped keep interbank lending rates low.
- Secondly, sentiment over EM has improved as the group previously known as the 'Fragile 5' diverges. The driver has been the experience of India where PM Modi's election victory and the improved current account situation has pushed Indian equities to new highs, just 12 months after its near currency crisis.

We entered 2014 favouring external emerging market debt as the way to ease back into EM exposure after the sell-off in 2013. After its strong performance, and given the above trends, we now believe that EM equities and local EMD may offer attractive risk-reward. We became more constructive on emerging market equities in Q2 and now have a slightly more favourable view of emerging market equities over developed equities: mainly on cheaper valuations and relative ownership. Investor re-allocation similar to that witnessed in European equities over the past 18 months has the potential to re-rate many emerging markets if the current stability continues.

Over the long term we continue to differentiate among emerging market countries. Focus on countries that have improved on current account fundamentals and reforms but still offer pockets of value. For others, e.g. Brazil, Indonesia, upcoming elections will be key.

### FIGURE 9: EM GROWTH STILL LAGGING DM ... BUT THERE ARE SIGNS OF STABILISATION




Source: Bloomberg, data as at end of June 2014.

### TABLE 2: SINGLE COUNTRY EM–HOW TO DIFFERENTIATE?

| Country | Current account | Geopol. risk | Monetary policy | Inflation | Valuations | Growth | Reform |
|---|---|---|---|---|---|---|---|
| China | Positive/Worsening | Medium | Easing near-term | Low | Positive | Improving | Positive |
| Korea | Positive/Improving | Medium | Steady, potential to loosen | Low | Negative | Stable | Neutral |
| Taiwan | Positive/Improving | Low | Steady | Low | Negative | Stable | Neutral |
| Turkey | Negative/Worsening | High | Rate cut following tightening cycle | High | Positive | Worsening | Neutral |
| South Africa | Negative/Improving | High | Tightening | High | Negative | Worsening | Negative |
| India | Negative/Improving | Low | Steady | High | Negative | Stable | Positive |
| Indonesia | Negative/Improving | High | Tightening | High | Negative | Improving | Neutral |
| Brazil | Negative/Unchanged | Medium | Tightening/on pause | High | Positive | Worsening | Neutral |
| Russia | Positive/Worsening | High | Tightening | High | Positive | Worsening | Negative |
| Poland | Negative/Improving | Medium | Easing | Low | Positive | Improving | Positive |

Source: BlackRock as at end of June 2014.

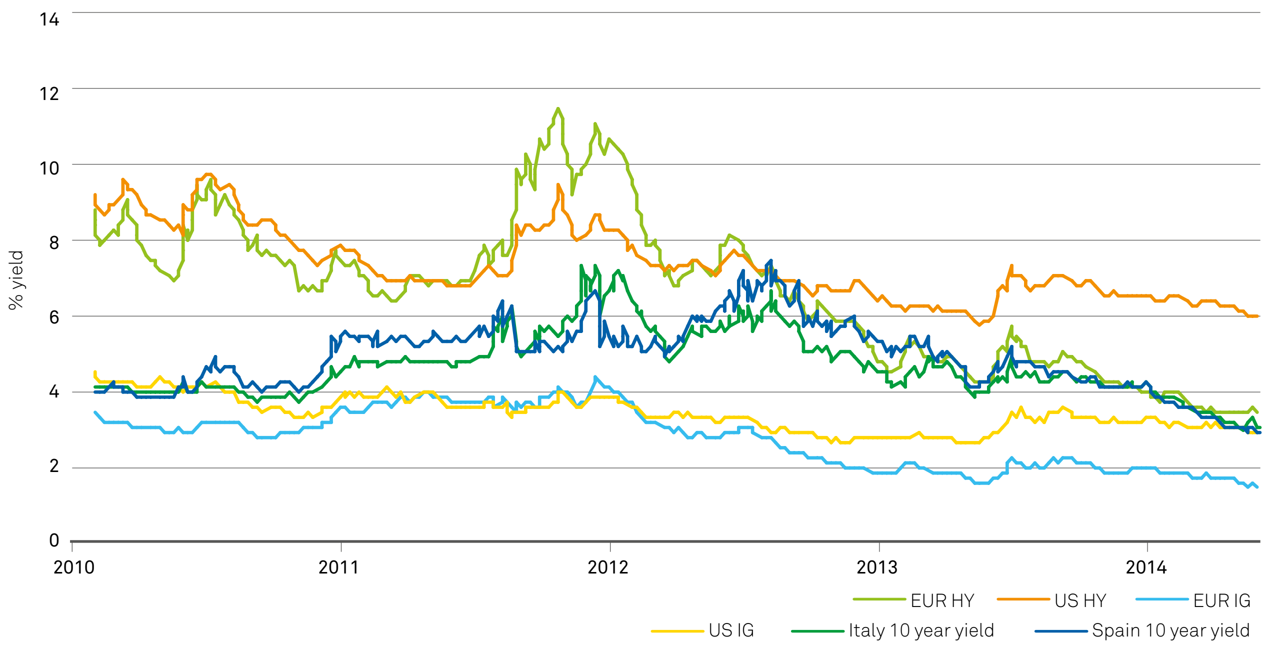
## 4. 'SEARCH FOR YIELD': WHERE NEXT?

When investors look back at asset class returns of H1 2014, two aspects dominate. One is the breadth of positive performance across fixed income, especially in Europe helped by the ECB. The second is how low yields on nearly all European fixed income assets are now including peripheral bonds and credit. For investors looking for income, this presents a major challenge as we move into H2. Low default rates and easy money are the foundation for tight credit spreads but the gap between actual default levels and those implied by spreads is closing fast. In Europe, rates remain firmly anchored by the ECB while the corporate re-leveraging cycle is behind that of the US. This should support European credit spreads relative to the US, but after the recent rally there is little outright value outside financials where banks continue to deleverage into the AQR and stress tests. For the great portfolio enhancer of 2014, peripheral sovereigns, we see limited room for further gains with the lack of any further catalyst from the ECB.

EMD should continue to attract focus and flows as investors diversify beyond developed fixed income. Hard currency external EMD still offers attractive value to developed credit, but as noted above we have started to see interesting risk reward in local debt.

Beyond that, we believe the reality of current fixed income yields will again lead many investors into yielding sectors in other asset classes. Dividend payers outside the US should benefit, notably in Europe and the UK. Additionally emerging market dividends should develop as another source of income as their growth outlook matures. Lastly, as the search for yield theme runs through its fourth year, consider alternative asset classes with higher yield characteristics: property and infrastructure.

### FIGURE 10: WHERE NEXT FOR YIELD?




Source: Bloomberg, data as at end of June 2014.

## TABLE 3: iSHARES IMPLEMENTATION

| Thematic exposure | iShares solution |
|---|---|
| Europe post ECB | **Outright exposure to European equities**<br>iShares EURO STOXX 50 UCITS ETF (Inc) (EUE)<br>iShares Core DAX® UCITS ETF (DE) (EXS1)<br>iShares FTSE 100 UCITS ETF (Inc) (ISF) |
| | **Sectors: financials post ECB, energy stocks**<br>iShares Euro Corporate Bond Financials UCITS ETF (EUCF)<br>iShares EURO STOXX Banks 30-15 UCITS ETF (DE) (EXX1)<br>iShares STOXX Europe 600 Oil & Gas UCITS ETF (DE) (EXH1) |
| Japanese equities: value beyond the correction | iShares MSCI Japan EUR Hedged UCITS ETF (IJPE)<br>iShares MSCI Japan USD Hedged UCITS ETF (IJPD) |
| Emerging resurgence... and differentiation | iShares MSCI Emerging Markets UCITS ETF (Inc) (IEEM)<br>iShares MSCI EM Asia UCITS ETF (CEMA)<br>iShares MSCI Taiwan UCITS ETF (ITWN)<br>iShares MSCI Poland UCITS ETF (SPOL) |
| Search for yield | **Emerging FI**<br>iShares J.P. Morgan $ Emerging Markets Bond UCITS ETF (IEMB)<br>iShares Emerging Markets Local Government Bond UCITS ETF (IEML) |
| | **Beyond credit**<br>iShares EURO Dividend UCITS ETF (IDVY)<br>iShares Emerging Markets Dividend UCITS ETF (SEDY)<br>iShares UK Dividend UCITS ETF (IUKD)<br>iShares Global Infrastructure UCITS ETF (INFR)<br>iShares European Property Yield UCITS ETF (IPRP) |

# Contacts

The EMEA Investment Strategy and Insights (ISI) team provides investors with market analysis and ETP specialist knowledge. As part of BlackRock's global investment strategy and research team, ISI is responsible for insights into global markets and EMEA implementation strategies, branded under the 'Looking Glass'.

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