

# WELCOME BACK VOLATILITY

Investment Directions

**BLACKROCK®**

FEBRUARY 2014

## MARKET OUTLOOK

### ► Volatility Is Back

After a relatively tame 2013, market volatility returned in January and early February amid emerging market (EM) turmoil and disappointing U.S. economic reports. Though we foresee modestly higher U.S. and global growth in 2014, the combination of further soft economic data, Federal Reserve (Fed) tapering, and turbulence in emerging markets means more volatility in the weeks ahead.

### ► Rates Likely to Modestly Rebound

Yields have plunged recently amid market volatility, but we still expect the 10-year Treasury to rise in 2014 to around 3.25% to 3.5% by year's end. Although the Fed has begun its long-awaited taper, it's likely to keep interest rates low until inflation is close to its long-term goal of 2%. With labor market conditions remaining soft and inflation well below the Fed's target, we expect short-term interest rates to remain low for an extended period of time.

### ► Stocks Still Look Attractive

We continue to advocate overweighting stocks. While we expect a rockier ride and more muted gains in 2014, we believe stocks can still offer better value than bonds. In fact, the recent drop in interest rates has made bonds look even more expensive in comparison to equities.

### ► Especially International Ones

While U.S. equity market gains will likely be more modest this year than in 2013, international stocks have more room for multiple expansion, and we continue to advocate exposure to select developed and emerging markets. Within fixed income, there still are few bargains, although high yield looks interesting on a relative basis. Finally, we see low inflation, higher real rates and a recovering global economy further dampening demand for gold.



**Russ Koesterich, CFA**  
Managing Director  
Chief Investment Strategist

## WHAT'S NEW

- 3 Truths About EM Investing – pg. 4
- Upgrade of High Yield Bonds to Overweight

## SO WHAT DO I DO WITH MY MONEY?™

### ▲ OVERWEIGHT

Equities  
U.S. Mega Caps  
Fixed Income Credit Sectors

### ▼ UNDERWEIGHT

Bonds  
U.S. Small Caps  
Treasuries

### ADDITIONALLY, FOCUS ON

- Potential downside protection through minimum volatility funds and high quality global dividend stocks.
- Maintaining a strategic allocation to commodities – but consider trimming exposure to gold, which is likely to come under pressure from rising rates, a benign inflation outlook, and poor supply and demand dynamics.

## UNITED STATES

- ▶ **We remain neutral U.S. stocks**, which we expect to push ahead this year, albeit more modestly than last year given high valuations, increasing rates and soft earnings reports so far in 2014. We foresee U.S. economic growth of 2.5% to 2.75%, up from the around 2% of the past couple of years. But the U.S. labor market remains bedeviled by structural problems as evident in January's disappointing jobs report (see the chart to the right) and recent weak manufacturing data suggests that first quarter growth may disappoint. As such, we expect that the market will remain volatile in coming weeks. Still, we expect that the Fed will continue tapering at the current pace of \$10 billion per meeting, though it's likely to focus on keeping interest rates low until inflation is at, or even above, the Fed's long-term goal of 2%.

## U.S. JOB GROWTH REMAINS STALLED



U.S. job growth remained stalled in January. While weather-related issues may still be impacting the numbers, the recent slowdown provides evidence that structural issues still bedevil the U.S. labor market.

Source: Bloomberg as of 31 January 2014.

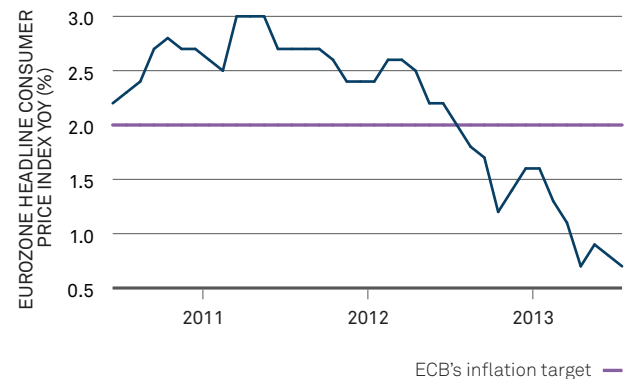
## INTERNATIONAL DEVELOPED MARKETS

- ▶ **We maintain our overweight view of the eurozone.**

From a valuation perspective, eurozone equities remain attractively priced relative to U.S. stocks, and the region's growth recovery will likely continue on the back of improving confidence, reduced fiscal drag and easier financing conditions. Despite the European Central Bank (ECB)'s decision to leave its policies unchanged in February, ongoing disinflationary pressure (see the chart to the right) raises the likelihood for possible ECB actions in the near term, including a reduction in the ECB's benchmark rate, a move to a negative interest rate on bank deposits with the ECB, and the initiation of an asset purchase program. Should the ECB adopt the latter policy, it would arguably be a net positive for European equities.

- ▶ **We remain neutral the United Kingdom**, where valuations and an improving growth outlook continue to lend support to U.K. large cap stocks. Still, local economic data is looking strong, which is sparking fears over further central bank tightening and denting local sentiment.
- ▶ **We maintain our overweight view of Japan** given Japanese stocks, attractive valuation relative to U.S. equities. In the past few weeks, Japanese stocks have come under pressure as investors fleeing emerging markets have pushed up the yen. While global risk sentiment remains a major source of risk for the yen and for Japanese stocks, diverging monetary policy paths in the United States and Japan will, in our view, continue to keep the downward pressure on the yen, supporting Japanese corporate earnings. Still, as inflation starts to rise thanks to Prime Minister Abe's reflationary effort, wages are not yet keeping up, weakening consumer sentiment. If the local recovery is going to continue, wages will need to rise to compensate for rising Japanese inflation.

## THE DISINFLATIONARY EUROZONE



Headline inflation in the eurozone is currently at 0.7%, which is well below the ECB's inflation target of 2% or less.

Source: Bloomberg as of 31 January 2014.

## EMERGING MARKETS

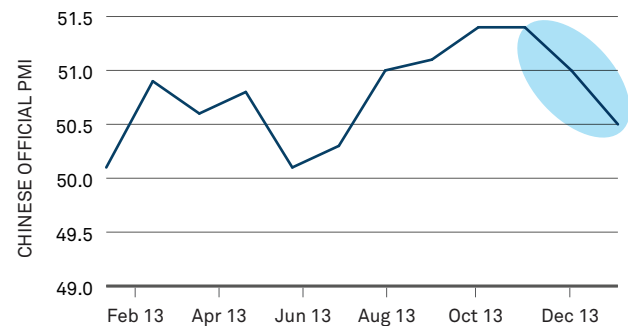
### ► We maintain our neutral view of emerging markets.

The catalyst for the recent turmoil in EMs was weakening sentiment rather than any new deterioration in fundamentals. Still, we see few economic catalysts on the horizon for EM outperformance in the near term given the challenging backdrop of reduced monetary stimulus from the United States and tighter EM local rates. In addition, political risk is rising, and volatility is likely to persist, given the heavy election calendar this year. While we still view EMs as a strategic asset class, we continue to advocate taking a more discerning single-country approach and expanding the definition of EMs to include frontier markets.

### ► We remain overweight Chinese and Korean equities.

Both markets look cheap considering their growth and profitability prospects. Still, investors need to lower their expectations for Chinese growth for the year (see the chart to the right). This is because the process of evolving the economy and deleveraging shadow banking will require policymakers to exercise discipline in stimulus and to slow credit growth. However, over the long term, a deleveraged and more transparent Chinese banking sector could lead to higher Chinese valuations. Meanwhile, Korea's heavy exposure to global cyclical demand makes it an attractive play on developed market growth, while its strong current account and foreign exchange market ('forex') reserve may help insulate it from U.S. tapering effects.

## INVESTORS NEED TO ADJUST THEIR EXPECTATIONS FOR CHINESE GROWTH



China's Purchasing Managers' Index ('PMI'), a key manufacturing survey, fell to a six-month low in January amid the government's effort to clamp down on the shadow banking system. Slowing Chinese manufacturing added to investors' growing frustration over China. While we do not see a hard landing, investors need to adjust their expectations for slower growth.

Source: Bloomberg as of 31 January 2014.

### ► We maintain our underweights to Mexico and South Africa.

In South Africa, any escalation of ongoing platinum mine labor strikes could hurt profit margins and worsen the country's current account deficit. In Mexico, while the economy has started to improve and the country's reform progress was recently rewarded with a credit rating upgrade, Mexican stocks trade at a significant premium to broader EM stocks and the impact of new regulations remains uncertain.

## GLOBAL SECTORS

### ► We remain overweight the technology and energy sectors.

A number of factors – including stronger economic growth and normalizing real interest rates – suggest a modest pickup in capital spending in 2014, and technology companies are likely to be a beneficiary of this (see the chart to the right). Energy stocks, meanwhile, remain attractive to us from a valuation perspective.

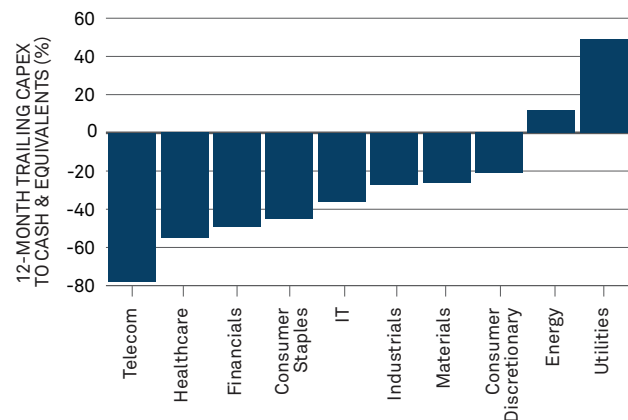
### ► We are still underweight the consumer discretionary and consumer staples sectors.

While personal consumption figures have been strong recently, the gains have come from lower savings and U.S. disposable income growth remains elusive. As consumption growth can only be sustained in the long term by organic income growth, consumption sectors' stretched valuations will likely face additional downward pressure.

### ► We continue to advocate a benchmark weight to the utilities sector.

Utilities stocks are no longer as overvalued as they have been for most of the past two years, and we expect only a modest increase in rates this year. Still, we believe that there are other defensive areas of the market that offer more value (notably healthcare).

## THE UNDERINVESTED INDUSTRIES



Many of the industries that appear the most under-invested compared to their historical average level of capital spending – telecom, healthcare and financials – are services industries for which technology accounts for the bulk of capital spending. Hence, technology companies may be beneficiaries if service companies' capital spending begins to accelerate.

Source: Bloomberg as of 31 January 2014.

## FIXED INCOME

- ▶ **We remain underweight Treasuries and TIPS, particularly short to intermediate exposures.** Though yields have plunged recently amid market volatility, we still expect the 10-year Treasury to rise modestly in 2014 to around 3.25% to 3.5% by year end. We also expect to see greater volatility in short – to intermediate-duration sectors, as the market turns its attention from tapering to the potential trajectory of future monetary tightening.
- ▶ **We continue to prefer credit sectors – like high yield bonds – to Treasuries, and we have upgraded our view of high yield to overweight.** Such bonds are reasonably priced given strong corporate balance sheets and ample liquidity, offer higher relative yields and generally lower sensitivity to interest rate volatility.
- ▶ **We continue to advocate an overweight to mortgage-backed securities (MBS) and a neutral to emerging market bonds.** As we expect EM equity market volatility to continue in the near term, USD EM bonds potentially are a lower volatility solution for EM exposure and offer attractive valuations. In addition, given the performance of USD EM bonds during the late 1990s Asian financial crisis (see chart above), we expect that USD EM bonds are likely to continue to outperform their local currency counterparts amid today's EM currency sell-off and EM central bank tightening.

## HOT TOPIC: 3 TRUTHS ABOUT EMERGING MARKET INVESTING

Amid headlines about EM currency crises and political turmoil, investors continue to abandon the asset class as part of a generalized flight to quality. However, while the current sell-off is somewhat different from last spring's variety, it is a good reminder of three truths about EM investing.

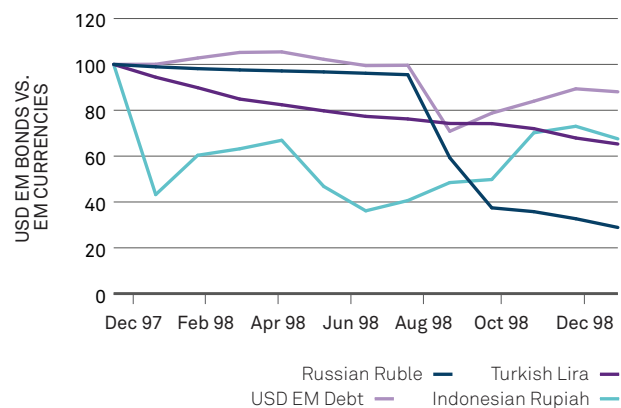
**Volatility in these markets can't be avoided.** EMs tend to be volatile, and are likely to remain so in the near term. In particular, EM currencies are likely to remain under pressure as the Federal Reserve tapers and several countries deal with lingering structural issues.

**Not all EMs are created equal.** The issues facing countries like Turkey and Indonesia are not the same ones facing other EMs. Despite the dour EM headlines, some of the markets, particularly in Northern Asia, appear sound.

**EMs offer deep value.** EMs look cheap by most metrics, particularly if you assume that these countries will still grow faster than developed markets over the long term (see the chart to the right).

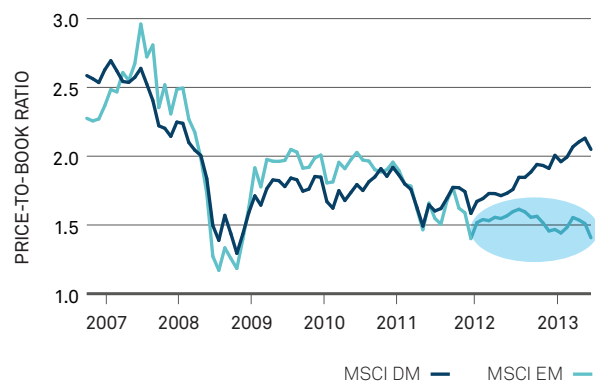
As such, we still view EMs as a strategic asset class and wouldn't abandon them. But given that not all EMs look equally attractive, we continue to advocate taking a more discerning approach and expanding the definition of EMs to include frontier markets.

### USD EM BONDS & THE ASIAN FINANCIAL CRISIS



As the chart above shows, USD EM bonds sold off initially during the 1997 to 1998 Asian financial crisis but then rebounded. Source: Bloomberg monthly data December 1997 to December 1998.

### EM EQUITIES OFFER DEEP VALUE



EM valuations currently look cheap by price-to-book measurements, particularly if you consider that EM countries will still grow faster than developed markets over the long term. Source: Bloomberg as of 31 January 2014.

The bottom line: In order to potentially reap the benefits of economic growth and financial deepening in these markets, you need to invest over the medium and long term, selectively finding value and waiting out the storm.

## DRILLING DOWN: EQUITY AND FIXED INCOME OUTLOOKS

Global Region	Valuations	Growth	Profit-ability	Risk/ Sentiment	Momentum	Our View underweight ◀ neutral ▶ overweight
DEVELOPED MARKETS						
North America						
United States	–		+		+	●
Canada			–			●
Europe						
Eurozone		+		+	+	●
Switzerland	–				+	●
United Kingdom		+	+	–		●
Asia Pacific						
Japan	+	+	+	+	+	●
Australia	–	–	–			●
EMERGING MARKETS						
Asia Pacific						
China	+				–	●
India	–					●
South Korea	+	+				●
Latin America						
Brazil	+	–		–	–	●
Mexico	–	+	–			●
Emerging EMEA						
Russia	+			–	–	●
South Africa	–	–	–	–	–	●
Global Sector & Style	Valuations	Growth	Profit-ability	Risk/ Sentiment	Momentum	Our View underweight ◀ neutral ▶ overweight
CYCLICAL SECTORS						
Consumer Discretionary	–		+			●
Energy	+		+			●
Financials	+		–			●
Industrials		+			+	●
Information Technology		+	+		+	●
Materials				–		●
DEFENSIVE SECTORS						
Consumer Staples	–	–	+		–	●
Healthcare	–	+	+			●
Telecommunications		+	–			●
Utilities		–	–		–	●
STYLES						
U.S. Small/Mid Caps	–		–			●
U.S. Mega/Large Caps	+		+			●
Fixed Income Sector	Valuations	Economics		Risk/ Sentiment	Momentum	Our View underweight ◀ neutral ▶ overweight
Emerging Markets	+	–		–		●
U.S. High Yield Credit		+			+	●
U.S. Investment Grade Credit	–	+		+		●
U.S. Mortgage-Backed Securities		+				●
U.S. Municipals	+			–		●
Non-U.S. Developed Markets	–	–		+		●
U.S. TIPS	–	–			–	●
U.S. Treasuries	–	–			–	●
	Supply & Demand	Opportunity Holding Cost	Safe Haven Demand	Inflation Hedge Demand	Momentum	Our View underweight ◀ neutral ▶ overweight
Gold*		–	–	–	–	●

## GLOSSARY

- unattractive    + attractive    □ neutral  
 ● current underweight outlook    ● current overweight outlook    ● current neutral outlook

**Underweight:** Potentially decrease allocation

**Overweight:** Potentially increase allocation

**Neutral:** Consider benchmark allocation

\* See the appendix for an explanation of the methodology for our gold views and other outlooks.

Please note that the views expressed above in the factor table are for timeframes of at least three months. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding the iShares Funds or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future holdings or portfolio of any BlackRock client.

## APPENDIX

### The analysis behind our equity views:

Our country and sector views are based on an analysis of the extent to which macroeconomic factors have been priced in at the country and sector level. We are overweight (underweight) countries and sectors where market valuations are low (high) relative to the underlying fundamentals, with the expectation that the economic factors will be fully incorporated into prices in the future. To determine our country views, we look at these macroeconomic factors:

**Valuations:** If a country has a low price-to-book ratio (P/B) relative to both its own trading history and to other emerging or developed countries, we assign it a '+'; if high, a '-'.

**Growth prospects:** We assign a '+' to countries that are growing faster (as measured by leading indicators and earnings growth prospects) than their past trends and a '-' to countries growing slower.

**Corporate sector profitability:** A country with a relatively profitable corporate sector (as measured by ROA) is assigned a '+' and we give a '-' to countries growing more slowly.

**Risk / sentiment:** A country that is perceived as relatively safe (according to historical volatilities and credit default swap (CDS) spreads) is assigned a '+'; a risky country is assigned a '-'.

**Momentum:** An asset with a relatively good return performance within the previous year is assigned a '+'; an asset with relatively poor returns is assigned a '-'.

The factors are not equally important in driving returns at a given point in time. As a result, when it comes to formulating our final views, the various factor readings are not additive. For example, a '+' value factor may overshadow negative readings in other factors, leading us to still like the country.

We use a similar methodology for coming up with our sector and style views, focusing on valuations (P/B and P/E), profitability (ROA) and risk / sentiment (historical volatilities and sector spreads) and momentum. In addition, we consider the global growth outlook for cyclical and defensive sectors.

In addition, our view on gold is similarly based on the macroeconomic factors that historically impact gold returns. These include the opportunity cost of holding gold (real interest rates); supply and demand; inflation (gold as a real asset tends to act as an inflation hedge); safe haven demand (during periods of high financial stress, demand for gold tends to increase); and momentum.

### The analysis behind our fixed income views:

In general, when formulating our fixed income views, we put more weight on the Valuations bucket than on either the Economics or Risk/sentiment buckets.

**Valuations:** We focus on discounted risk-adjusted cash flows relative to market prices. When a sector exhibits market prices well above what our model sees as fair, we assign the sector a '-'; we assign a '+' when the opposite is true.

**Economics:** In general, when the overall economic environment (as measured by basic economic and/or aggregate balance-sheet fundamentals) is particularly favorable for a given fixed income sector, we assign a '+'; we assign a '-' when the opposite is true.

**Risk / sentiment:** When a sector has exhibited strong positive returns/risk appetite (as measured by trailing returns) over the previous several months, we score it a '+'; we assign a '-' when the opposite is true.

**Momentum:** An asset with a relatively good return performance within the previous year is assigned a '+'; an asset with relatively poor returns is assigned a '-'.

### Contributors

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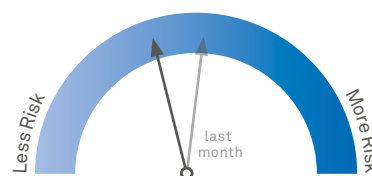
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### RISK APPETITE DIAL



### RISK APPETITE INDEX:

Investors have turned more risk averse since the last *Investment Directions* update on the back of worsening sentiment triggered by renewed concerns about global economic growth. In signs of growth moderation, China's official manufacturing PMI dipped to a six-month low in January, though it remained above the 50 mark that indicates expansion. Meanwhile, the U.S. ISM manufacturing survey fell to 51.3 (well below expectations of 56) in January, sending volatility to a 13-month high. Despite these jitters, credit spreads between low-quality and high-quality U.S. corporate debt contracted for the seventh consecutive month since July.



## Data source is Bloomberg unless otherwise stated.

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