AFTER THE PARIS TRAGEDY

BLACKROCK®

November 17, 2015

Our thoughts and sympathies are with those affected by the Paris terror attacks. The ramifications of these horrific events are likely to be significant and long-lasting. We share some insights in this note on how we think this tragedy might affect politics, policy and markets.

Key Points

- Episodes of terror tend to accentuate existing economic trends, rather than constitute turning points. We expect France to further loosen the austerity reins to boost defense spending, and we see other European Union (EU) members following suit. A security pact essentially is superseding the existing stability pact that sets debt and spending limits on EU members, we believe. A likely (but reversible) dent in European consumer confidence should cement plans by the European Central Bank (ECB) for more easing measures in December, we think.
- The Paris tragedy is a crisis on top of an existing (refugee) crisis. Outcomes are dynamic and could be profound – especially against a backdrop of potentially tightening financial conditions in 2016. First is the future of the EU. Closing borders, the rise of eurosceptic parties and a UK referendum on EU membership arguably pose threats to the European project. Yet there is a different, perhaps more likely path: tighter border controls, cooperation and, eventually, more integration. The words of one of the EU's architects, Jean Monnet, ring true today: "Europe will be forged in crises, and will be the sum of solutions adopted for these crises."
- The second major question is one of magnitude. Is the Paris attack part of (a sad) continuum of human bloodshed emanating from a protracted but hereto regional conflict? Or does this tragedy mark an evolution toward an extended, global conflict? If the latter is true, the market impact could be much greater and previous "war" episodes a better guide to the future, 14 years after the September 11 attacks.

Today's geopolitical landscape is a dangerous mixture of failed states and increasing frictions between both erstwhile friends and superpowers. Markets will have to contend with many political uncertainties in 2016: possible setbacks to the European project in the face of a refugee crisis and risk of more terror attacks; rising instability in the Middle East likely to be aggravated by the impact of low oil prices; regional "zero-sum conflicts" unlikely to be resolved by diplomacy; a Russia and China increasingly assertive abroad while grappling with economic slowdowns at home; and a US presidential election with a wide-open field of candidates and outcomes.

These risks are playing out against a backdrop of asset prices propped up by years of plentiful liquidity. Yet the gift that kept on giving – ever-loosening global financial conditions – could be less generous in 2016. The US Federal Reserve is set to raise interest rates for the first time in nearly a decade. Emerging market (EM) central banks and sovereign wealth funds have been selling reserves and risk assets to defend currencies and/or plug budget holes. This means geopolitics, and other factors such as the business cycle, should start having a greater impact on markets, in our view.

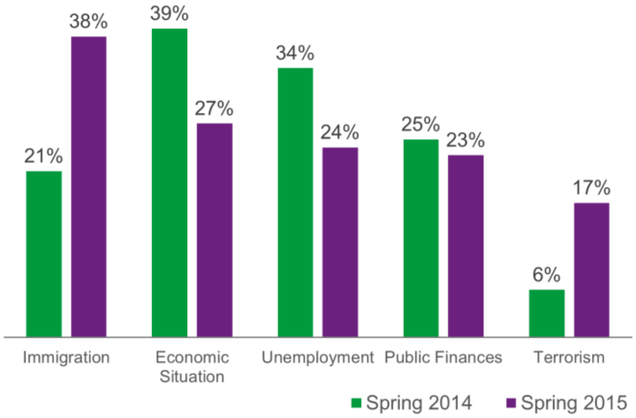
Tom Donilon
Senior Director,
BlackRock Investment Institute

Philipp Hildebrand
Vice Chairman, BlackRock

Ewen Cameron Watt
Global Chief Investment Strategist,
BlackRock Investment Institute

PRESSING CONCERNS

Polls on the Two Most Important Issues Facing EU, 2014 vs. 2015



Sources: BlackRock Investment Institute and European Commission, November 2015. Note: The polls are based on about 1,000 face-to face interviews per EU country in May of 2014 and 2015.

Populism after Paris

The Paris attacks play into a brewing political storm around the right approach to the refugee crisis. Polls this spring already showed that immigration had become the public's top concern across EU member states, replacing worries about the weak economy. See the chart above.

German Chancellor Angela Merkel and other leaders have tried to disassociate migration policy from the heightened terrorist threat, with limited effect. The refugee stream has bolstered the rise of populist parties and exposed EU rifts. New-accession countries Poland and Slovenia are refusing to take their quota of refugees. This is putting pressure on the Schengen agreement, the accord that has guaranteed free movement of people inside the EU since the 1990s. The Paris tragedy and the risk of other terrorists posing as refugees from Syria will likely intensify these rifts.

Yet there is an alternative path. This crisis could also unify Europe and halt the rise of populist eurosceptics. The events could give Merkel air cover to rethink a near open-door policy that is facing growing opposition. The issue is closer to home than the Greek debt drama: Many Germans have seen their school gyms turned into refugee centres. A reversal of the welcome policy could play well at home and remove tensions between Germany and neighbours. Our conclusion: Merkel is a proven crisis manager, and we are far from her demise.

Similarly, we think the Paris events could bolster French President François Hollande. It will be tough for the populist Front National to outflank him on national security. We expect structural reforms aimed at liberalising the economy to take a backseat. Hollande will likely use his political capital to push through security measures and forge a joint European response. Europe's focus on security and fiscal stimulus is a near-term positive for the economy, but sets it up for a future reckoning due to high debt loads and low growth.

Brexit Vote Looms

The UK is headed for a key poll on whether or not to remain in the EU. Prime Minister David Cameron hopes to renegotiate Britain's membership. His wish list includes an opt-out from further political integration, protection against a shut-out of non-eurozone members (Britain does not like to be outvoted on regulations for the key financial industry), and a tightening of welfare eligibility for migrants. The latter has the least economic impact but is likely to create the most political noise – and therefore may determine the outcome.

The EU may give Cameron some leeway for fear of losing Britain's military and security prowess, we think. If negotiations indeed yield fruit in coming months, we see a referendum by October 2016. Will Cameron's bounty be enough to sway a British public sceptical of the EU benefits? Polls point to a narrow lead for the "stay" camp, but political polls have a checkered history in the UK. At the extreme, a "leave" vote could result in England going it alone. Scotland plans another independence poll if the UK exits the EU. We do not think this is a likely scenario but brace for volatility in sterling and gilts as the referendum nears.

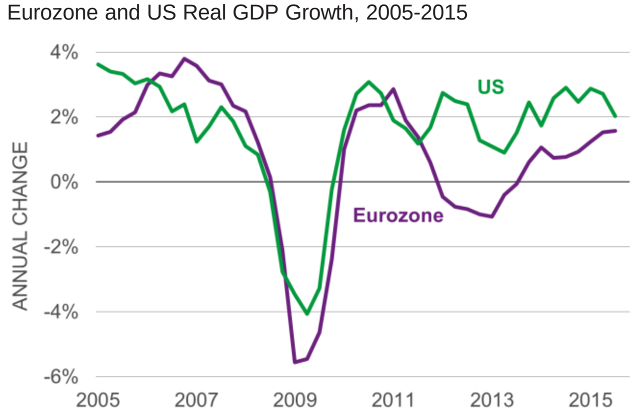
ECB Easing

Increased border scrutiny will likely hurt trade and be a drag on growth – at a time when the eurozone is finally showing signs of economic life. See the chart below. Private sector loan growth is rising (albeit sluggishly) after contracting for some three years. Eurozone manufacturing gauges have held steady in 2015 in the face of declining US and EM activity.

Yet the economic recovery is weak and core inflation stubbornly low. We expect the Paris tragedy to cement the ECB's plans to announce more and longer quantitative easing measures as well as cut its deposit rate deeper into negative territory in December. We do see a risk of market disappointment because expectations are very high, as reflected in a weak euro.

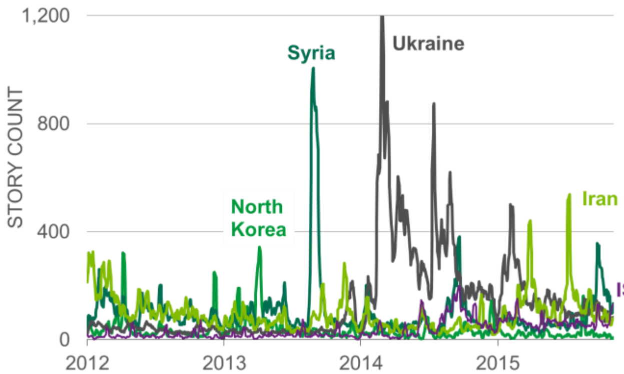
FINALLY CATCHING UP

Eurozone and US Real GDP Growth, 2005-2015



Sources: BlackRock Investment Institute, Eurostat and U.S. Bureau of Economic Analysis, November 2015.

THE CRISIS TIDE
Bloomberg Story Count of Geopolitical Events, 2012-2015



Sources: BlackRock Investment Institute and Bloomberg, November 2015.
Note: The lines represent the five-day average Bloomberg story count for each word.

Middle East Breakdown

The market impact of geopolitical crises tends to be ephemeral. They create headlines, become market talking points and then disappear. See the chart above. Past terror episodes (the 2005 London bombings and 2004 train bombing in Spain) show these events reinforce existing market trends, rather than cause turning points. The September 11 attacks magnified the 2001 US tech bubble recession, but did not cause it.

The current crisis is more fundamental. It is rooted in a systematic breakdown of state control in the Middle East. Iraq, Yemen, Syria and Libya are all essentially failed states. The region is dogged by the aftereffects of the Arab Spring, sectarian conflicts and proxy wars between Sunni Saudi Arabia and Shiite Iran. This cycle may just be getting started.

Islamic State (ISIS) and its affiliates have claimed both the recent downing of a Russian tourist charter and the Paris attacks, suggesting this indiscriminate terror franchise is bent on internationalising its reach. Its social media savvy attracts thousands of EU passport-carrying fighters and inspires “lone wolf” attacks around the world. The terrorist threat against the West is likely the highest it has been since 2001, we believe. The solutions, in our view, are to shrink ISIS’ territory and achieve visible victories such as retaking Raqqa.

Does Paris upset the status quo in Syria? It might. Russia’s entry into the war changed dynamics by throwing a lifeline to the Syrian regime with an air campaign directed mostly at moderate rebels. This pitted President Vladimir Putin against the US and its allies. The sides could come together to eradicate ISIS, especially now that Russia acknowledges a bomb blew up the Russian flight. A settlement to end the war in Syria looks far off, but the two superpowers might be aligned in their goals. This could also decrease tensions between Russia and the West over the Ukraine conflict. It is hard to see a true détente, but Putin now has an opportunity to rehabilitate Russia’s near-pariah status.

Iran, Saudi and Oil

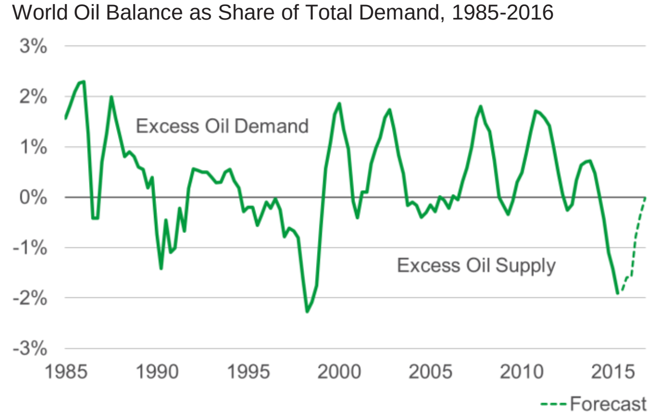
Any Syria solution would have to include archrivals Iran and Saudi Arabia. We see Iran’s nuclear deal with the West as transactional, not transformational. Relations between the US and Iran are still strained, with little desire on either side for rapprochement. The US is gearing up for presidential elections in 2016, with Republicans opposing the deal. Hardliners in Iran will likely make it hard for foreigners to do business there even after sanctions are lifted in six months.

Saudi Arabia, for its part, is facing fiscal pressures due to the oil price collapse, the costs of fighting a proxy war in Yemen, rising social outlays to quell dissent and handouts to allies Egypt and Jordan. The country’s assertive new leadership is issuing the first sovereign bonds since 2007 to shore up finances and is likely to keep oil production at record levels.

Ample supply will likely keep oil prices range bound, even as global demand is forecast to finally catch up with supply in 2016. See the chart below. Conversely, an intensification of Middle East hostilities could disrupt supply and propel prices higher. The oil plunge dragged down long-term inflation expectations, making central bank inflation targets harder to achieve and putting downward pressure on yields. A sustained oil price rise would reverse this.

We could see higher yields in such a scenario, and a rebound in beaten-down energy and EM assets. The more likely outcome: a muted oil price recovery in 2016. This would reinforce the receding global liquidity tide. The commodity price collapse has put many EM currencies under pressure, triggering selling of reserves by central banks. Further drawdowns could lead to selling of risk assets. This would mark a sea change from years of petro dollars flowing into capital markets. This calls for cautious navigating in 2016.

BALANCING ACT
World Oil Balance as Share of Total Demand, 1985-2016



Sources: BlackRock Investment Institute and Oxford Economics, November 2015.
Notes: The world oil balance is calculated by subtracting global supply from demand. 2016 is an Oxford Economics forecast.

WHY BLACKROCK

BlackRock helps people around the world, as well as the world's largest institutions and governments, pursue their investing goals. We offer:

- **A comprehensive set of innovative solutions**
- **Global market and investment insights**
- **Sophisticated risk and portfolio analytics**

BLACKROCK INVESTMENT INSTITUTE

The *BlackRock Investment Institute* leverages the firm's expertise across asset classes, client groups and regions. The Institute's goal is to produce information that makes BlackRock's portfolio managers better investors and helps deliver positive investment results for clients.

EXECUTIVE DIRECTOR
Lee Kempler

GLOBAL CHIEF INVESTMENT STRATEGISTS
Ewen Cameron Watt and Russ Koesterich

EXECUTIVE EDITOR
Jack Reerink

Want to know more?

blackrock.com

BII-0101

BLACKROCK®