

FOR PROFESSIONAL CLIENTS AND QUALIFIED INVESTORS ONLY

Global Investment Outlook

Q4 2016

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INSTITUTE



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We see upside to global economic growth prospects but also greater market volatility in the fourth quarter. This comes after a summer lull in volatility, record highs for US equity markets and a rebound in emerging market (EM) assets. We see early signs of a regime change for market returns due to US reflation and a global pivot from monetary stimulus to fiscal support, even if the immediate economic impact is limited. Our key views:

- **Policy limits:** we expect the US Federal Reserve to press on with slow interest rate increases while other major central banks start to approach limits of their easy policies.
- **Low returns:** our return expectations are at post-crisis lows across asset classes, but we believe investors will be compensated for taking on risk in equities, selected credit, EM and alternative assets.
- **Volatility:** central bank asset purchases have smothered volatility and pushed investors to take greater risks, but we could see short bursts of heightened volatility as the limits of monetary policy become clearer.
- **Risks:** equity and bond returns are becoming more correlated and could fall in tandem, while rising long-term yields are a tail risk that could cause an unwanted tightening of financial conditions. A divisive US presidential election is the top political risk. Near-term China risks have receded amid a gradual currency depreciation and a pick-up in Asia's export machine. China's yuan stability and debt build-up remain medium-term risks, however.
- **Markets:** we prefer shorter-duration US government bonds and favour selected eurozone peripheral debt over other sovereigns. We generally like investment grade corporate bonds in the eurozone, UK and US. We find EM debt attractive but have become more selective, and we see further upside in EM equities. Dividend stocks may come under pressure from higher bond yields, so we prefer companies that can sustainably grow dividends.

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Setting the scene

Global growth expectations have been on a steady decline since 2015. Yet our proprietary economic indicator, the *BlackRock Macro GPS*, indicates the global recovery is grinding on, with little sign of Brexit contagion. The GPS incorporates big data signals, such as Internet searches and corporate conference call transcripts, to gauge how growth expectations could evolve over the next three months. Consensus GDP forecasts for the G7 appear too low, our GPS suggests. See the *Excess pessimism* chart. This masks a lot of variation: we see large upside in Japan, for example, but little in the UK.

A pick-up in economic growth forecasts could spur risk appetite toward the end of the year. EM growth is set to rebound next year, outperforming growth in developed markets by the most since 2013, the International Monetary Fund forecasts. China's stabilizing economy is a positive. The country has effectively managed a transition to slower, consumer-led growth, in our view – albeit at a cost of limited reforms to state-owned enterprises.

Global growth expectations have shifted lower in 2016, yet we see room for upside surprises this quarter.

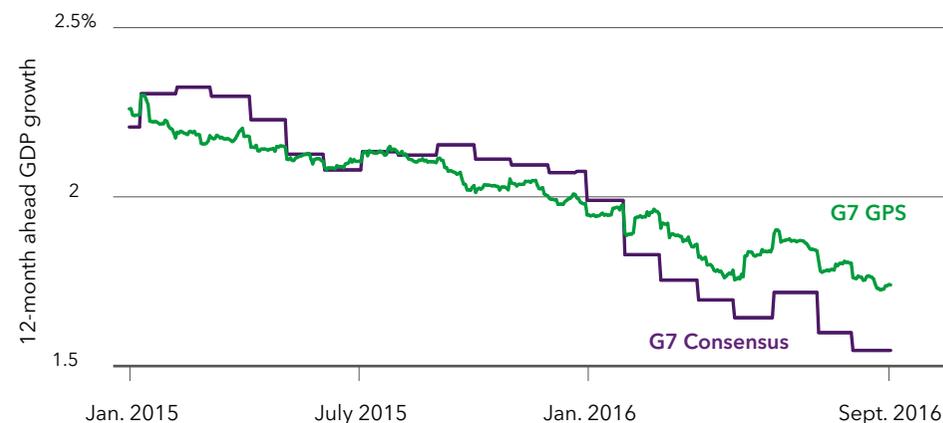
The Fed has been very patient with lifting interest rates in the hope of strengthening the labour market and stoking higher wages. US wage growth is showing signs of accelerating, greasing the wheels of a broad pick-up in household spending. The Fed's favoured measure of core inflation – core personal consumption expenditures (PCE) – remains steady below its 2% target, even as other measures of inflation are ticking higher. See the *Letting reflation take root* chart.

We expect the second US rate increase of this cycle in December, but believe the Fed will move gradually thereafter and allow employment gains and inflation to run hot. The Fed has been very slow to lift rates compared with its pre-crisis stance, and we expect it to stay the course. The Fed's Summary of Economic Projections in September showed committee members have reduced their long-term interest rate projections but still expect a median of 2.25 percentage points of rate rises by the end of 2019. Markets are pricing in a total rate increase of only around 0.5 percentage points over the same period. We think this is too low – and see risks to fixed income if market expectations inch closer to the Fed.

Inflationary pressures are bubbling below the surface, yet the Fed's favourite measure of inflation remains low. This allows the Fed to be patient in raising rates.

Excess pessimism

BlackRock Macro GPS, 2015-2016

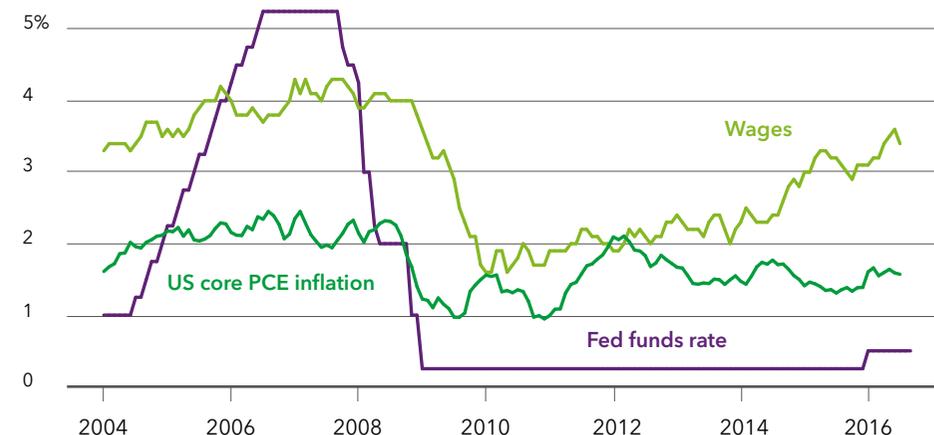


Sources: BlackRock Investment Institute and Consensus Economics, September 2016.

Notes: the GPS shows where the 12-month consensus GDP forecast may stand in three months' time. Consensus forecasts are measured by Consensus Economics. GDP stands for gross domestic product. The G7 countries are the US, UK, Canada, France, Germany, Italy and Japan.

Letting reflation take root

US wages, inflation and interest rates, 2004-2016



Sources: Thomson Reuters Datastream and BlackRock Investment Institute, September 2016.

Note: wages are represented by the Atlanta Fed Wage Tracker, which measures the median change in US hourly earnings. Inflation is measured using the core personal consumption expenditure (PCE) price index.

Theme 1: policy limits

Central banks are nearing the limits of monetary easing. The Bank of Japan (BoJ) is at the forefront, owning some 40% of Japanese government bonds (JGBs). At its current pace of buying, the BoJ would hold two-thirds of the JGB market by 2020, we estimate. The BoJ appears to have recognised these limits by starting to target 10-year yields, possibly allowing it to reduce JGB purchases over time. The European Central Bank (ECB) also faces a looming shortage of eligible bonds. See the *Pushing the limits* chart.

Central banks are not entirely out of bullets. Options include expanding purchases to riskier assets, engineering steeper yield curves to offset pressures on banks and even targeting the level of long-term yields. We see cutting short-term rates more negative as possible but less likely. Additional measures may have diminishing returns – and unintended consequences. Steeper yield curves could result in an unwanted tightening of financial conditions. And negative rates have been blamed for hurting the banking sector and encouraging cash hoarding. We see the ECB extending its asset purchase program beyond March 2017 and relaxing self-imposed limits on the types of bonds it can buy.

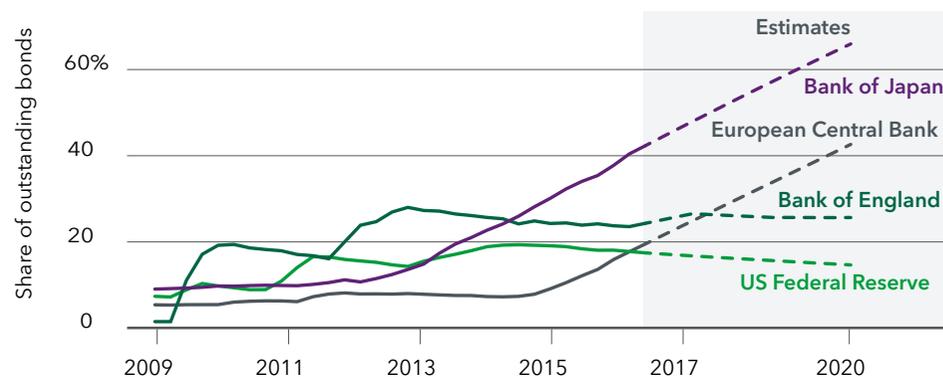
Monetary policy is becoming less effective in boosting growth.

As monetary policy reaches its limits, some major economies appear on the verge of relying more on fiscal policy to boost growth. Infrastructure spending proposals feature in the US presidential campaign. Japan and Canada have pushed ahead with public investment. And the UK looks set to temper its fiscal consolidation. The result: fiscal expansion in the developed world should modestly support growth in the medium term, a sea change from years of fiscal contraction. See the *Bye bye austerity* chart. Reckless fiscal expansion is never a good idea, we believe. Yet we see productivity-enhancing measures such as infrastructure investment as more effective than usual amid near-zero rates. See our *Global Macro Outlook* of September 2016. The shift to fiscal policy could mark a regime change for markets. It may spark a rise in long-term yields, but we see a muted impact. Central banks still have the ability to limit any unwanted yield rises – and income-hungry investors are eager to pounce on yield spikes.

Polymakers are guiding fiscal policy away from austerity. It is too soon to expect a big growth boost, but the change in tone could support risk sentiment.

Pushing the limits

Central bank share of outstanding bonds, 2009-2020

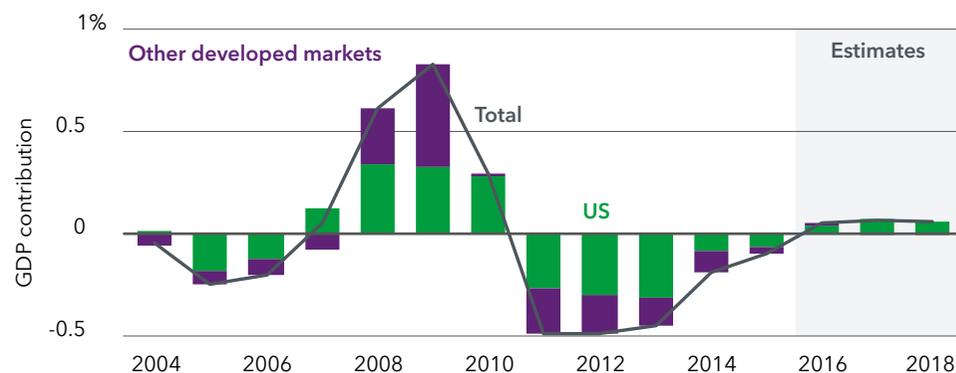


Sources: BlackRock Investment Institute, Central Banks and IMF, September 2016.

Notes: the chart shows total central bank holdings of government debt securities as a percentage of outstanding issuance (including bonds ineligible for purchase). The estimates are illustrative in nature and do not express a forecast; they are constructed using IMF fiscal balances forecasts and with the following assumptions: the Fed maintains re-investment; the ECB and BoJ maintain their current pace of buying; the Bank of England does not expand asset purchases beyond the £60 billion announced in August 2016.

Bye bye austerity

Developed markets' fiscal contributions to world GDP, 2004-2018



Sources: BlackRock Investment Institute and IMF, September 2016.

Notes: the GDP contribution is in percentage points and based on the change in primary structural fiscal deficits of selected economies as a share of world GDP. Other developed markets are the eurozone, Japan, UK and Canada. Data from 2016 onward are adjustments to IMF forecasts based on BlackRock's estimates of additional stimulus. These estimates are illustrative in nature and do not represent forecasts. They are based on recently announced spending plans, election campaign materials and BlackRock's analysis.

Theme 2: low returns ahead

Equity valuations have risen to their highest absolute levels since the financial crisis. This would normally be cause for concern. Yet we believe elevated equity valuations may make sense in a low-return world where risk-free rates are expected to stay low for longer. Equities still look cheap on a relative basis due to the precipitous drop in bond yields. Our measure of the gap between expected returns on global equities and real government bond yields – a proxy for the equity risk premium (ERP) – still sits well above its long-term average. See the *Rewarded for risk* chart.

In short, investors are still compensated for taking on equity risk in an environment where we expect very low returns across asset classes in the next five years. What could undermine this thesis? A spike in bond yields – perhaps due to a rise in inflation and a steepening of the expected path of Fed rate hikes – would erode the ERP and diminish the relative attractiveness of equities.

It is tempting to sit on the sidelines in a market environment with so much uncertainty, yet investors today are still compensated for taking on equity risk.

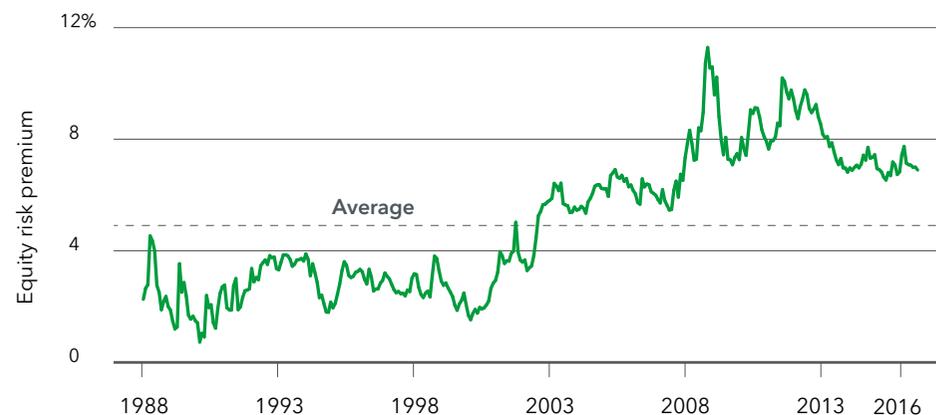
Talk of Fed ‘normalisation’ is intensifying, yet financial markets are looking less and less normal. Yields on cash have been driven below zero in the eurozone and Japan – and are paltry to negative on government debt. See the *Desperate for yield* chart. Credit markets offer comparatively attractive returns, albeit below pre-crisis levels. This poses a challenge for pension funds and other institutional investors aiming to meet long-term liabilities.

Investors are being forced to take on more risk to meet their targeted rates of return. This is pushing them into smaller asset classes, such as high yield and EM debt, that may be more prone to bouts of severe volatility. High valuations versus history point to more muted returns across asset classes in the long run. Yet slowing nominal GDP growth and aging populations argue for lower bond yields than in the past – and sustained demand for high-quality bonds. This structural shift changes the prism of assessing today’s valuations. It makes risk assets such as equities, credit, local EM bonds and selected alternatives look attractive on a relative basis.

We see relative valuations mattering more in a low-growth, low-yield world and focus on uncovering value within and across asset classes.

Rewarded for risk

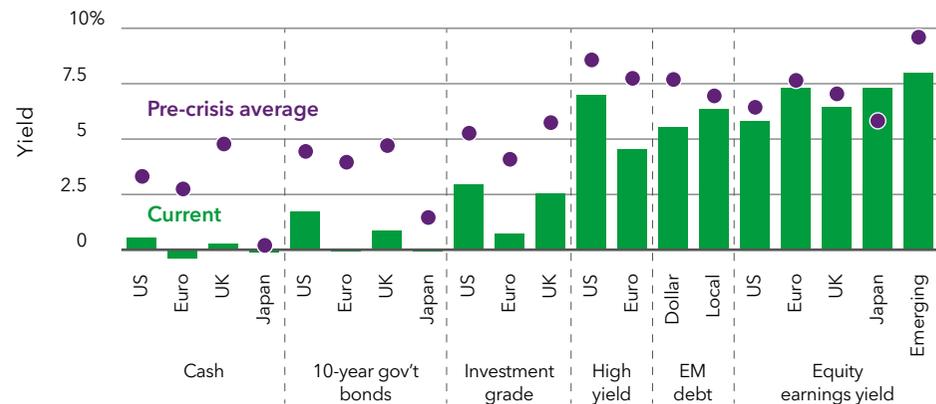
Proxy for global equity risk premium, 1988–2016



Sources: BlackRock Investment Institute, Thomson Reuters Datastream, Barclays and MSCI, September 2016. Notes: our equity risk premium proxy is calculated by subtracting the real bond yield from the earnings yield. The real bond yield is the yield on the Barclays Global Treasury Index minus the five-year average US consumer price inflation. The earnings yield is the inverse of the 12-month forward price-to-earnings ratio for the MSCI World Equity Index.

Desperate for yield

Yields of selected assets: current vs. pre-crisis average



Sources: BlackRock Investment Institute, Thomson Reuters, Bank of America Merrill Lynch, J.P. Morgan and MSCI, September 2016. Notes: the pre-crisis average is based on the five-year period before the financial crisis (2003-2008). Cash is based on one-month interbank rates. Corporate bonds are based on Bank of America Merrill Lynch index data; EM dollar debt is based on the J.P. Morgan EMBI; local EM is based on the J.P. Morgan GBI-EM Global Diversified Index. The equity earnings yield is based on the inverse of 12-month forward price-to-earnings ratios for MSCI indexes.

Theme 3: volatility

Years of muted volatility and the success of momentum strategies – betting on yesterday's biggest gainers rising even further – have led many investors to pile into similar investments.

Popular positions today include overweights in EM debt, US credit and US equities, according to our Risk and Quantitative Analysis (RQA) group. This is mirrored by consensus underweights in European equities and the British pound, according to RQA's analysis of portfolio flows, fund manager positions and price momentum. *See the Navigating the crowds chart.*

Positioning in these asset classes has moderated from summer peaks. Yet some popular investments are still hovering near extreme levels (scores above 2 and below -2), which we see as an important signal of short-term risk. These positions may be vulnerable to a market shock or rising volatility, especially when combined with high valuations. It is important to manage this risk by being selective.

Be mindful of the short-term risks in consensus trades, and look for potential opportunities away from the crowds.

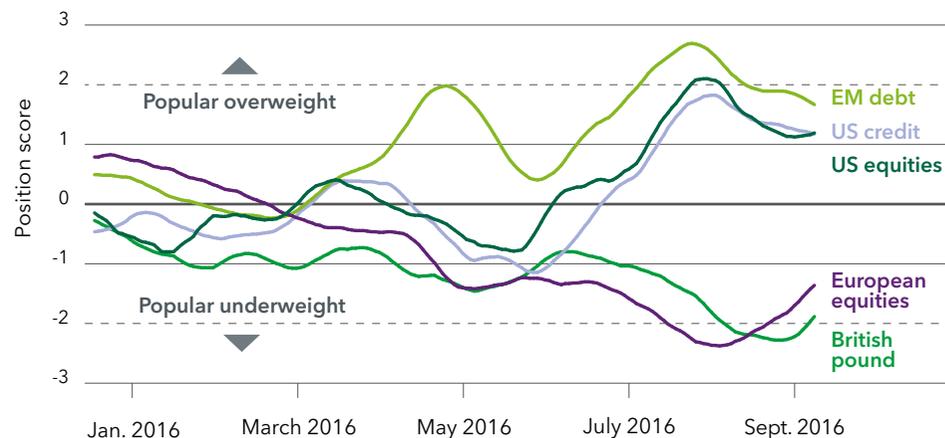
Extraordinary monetary easing by central banks has dampened volatility across financial markets. Yet expectations of Fed rate normalisation are leading to greater asset price swings. Commodity and currency markets have led the march higher, with volatility now above the long-term median. *See the Volatility ahoy chart.*

The US equity market has been an outlier. US equities recently posted their least volatile 30-day period in more than two decades. This calm is unlikely to last. We expect volatility to pick up ahead of the US presidential election in November, similar to previous elections. We also see bond market volatility heading higher. Rock-bottom rates suggest price volatility will be even greater due to much smaller safety cushions against higher yields. Any further inflation rise may serve as the spark. We see higher volatility across asset classes as the Fed presses ahead with rate rises. We favour credit over government bonds in such an environment. Higher volatility creates risks but also offers opportunities to capture relative value as asset prices disperse.

We see potential for higher equity and bond volatility amid looming political risks and the Fed's normalisation of interest rates.

Navigating the crowds

Positioning across asset classes, September 2016



Sources: BlackRock Investment Institute, Bloomberg, CFTC, EPFR and State Street, September 2016.

Note: data are based on BlackRock's analysis of portfolio flows, fund manager positions as reported by State Street and price momentum. A positive score means investors are overweight the asset class; a negative score indicates the reverse.

Volatility ahoy

Realised volatility by asset class, 1996-2016



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

Notes: volatility is measured as the standard deviation of daily returns over a rolling six-month window on an annualised basis. The green bars show the 10th to 90th percentile since 1996. The grey lines show the median over this period and the purple dots show the current level. Bond volatility is based on an average of 10-year US Treasuries, German bunds, Japanese JGBs and UK gilts. FX volatilities are based on an average of US, euro and yen trade-weighted indexes. Stock volatilities are based on MSCI indexes. Commodities are based on the S&P GSCI Commodity Index.

Risks

Stocks and bonds are trading in greater synchronicity, breaking from their usual inverse relationship: rising stocks coupled with falling bond prices, and vice versa. Risks are building that long-term yields could rise and lead to steepening yield curves. Typically that should be positive for equities: a sign of confidence in stronger economic growth, with the bonus that steeper yield curves provide to banks' net interest income.

Yet a jump in long-term yields can hurt stocks – especially low-volatility, dividend-paying 'bond proxies' that have become popular defensive plays. The usual negative relationship between bonds and stocks has flipped based on one-month correlations, our analysis suggests. This creates challenges for investors trying to diversify portfolios. Longer-term correlations between the two asset classes are still negative but also show some signs of turning. **See the *Correlation frustration* chart.** Correlations between stocks and bonds have recently tended to rise in line with expectations of Fed tightening. Cash may become a useful portfolio buffer. We also see a role for diversifiers such as gold.

Equity and bond prices are becoming increasingly correlated, posing challenges to traditional portfolio diversification.

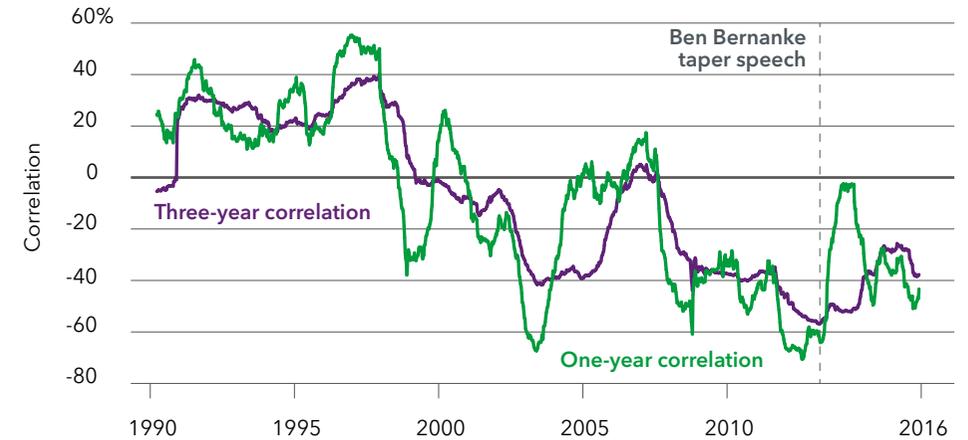
China has managed a Goldilocks depreciation by taking advantage of the yuan's losses on a trade-weighted basis. **See the *Stealthy depreciation* chart.** The weaker yuan is helping China's battered industrial sector claw its way out of deflation, we believe. Investor sentiment toward Asia in general is improving: the region's export engine shows signs of gaining momentum, and growth-enhancing reforms are taking place. As a result, we have become more bullish on Asian equities, in particular selected Indian, Indonesian and Hong Kong-listed Chinese shares. Medium-term China risks remain, however, including the potential for a credit bust as well as renewed downward pressure on the yuan causing a resumption of large capital outflows and spillovers in other markets.

The US presidential election may result in market volatility as well as policy uncertainty, particularly in the case of a Donald Trump victory. Other political risks are Italy's December referendum on constitutional reforms and a potential unravelling of the EU-Turkey refugee deal.

China risks have receded in the short term. A contentious US presidential election campaign highlights looming political risks.

Correlation frustration

Global equity and US Treasury return correlations, 1990-2016



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

Notes: the lines show the one-year and three-year rolling correlation of daily returns for the MSCI World Equity Index and the Datastream US 10-year Benchmark Government Bond Index.

Stealthy depreciation

Trade-weighted Chinese yuan and US dollar, 2013-2016



Sources: BlackRock Investment Institute and JP Morgan, September 2016.

Notes: lines show JP Morgan nominal effective exchange rate indexes for China and US rebased to 100 at the start of 2013.

Government bonds

Long-term government bond yields are starting to rise. The Fed's go-slow approach to raising policy rates and the BoJ's encouragement of a steeper yield curve have lifted yields across major bond markets. Quantitative easing (QE) is showing signs of reaching its limits in Japan and Europe. We see the potential for yields to rise more and for curves to steepen further.

The recent yield curve steepening has largely been driven by JGBs, showing the interconnectedness of global fixed income markets. German bunds and US Treasuries followed Japan – with a lag. See the *Made in Japan* chart. We see selected opportunities in inflation-linked bonds in the US, eurozone and Japan. Headline inflation appears set to creep higher as a rebound in oil prices makes the year-on-year change in consumer prices look increasingly favourable. We like 10-year UK gilts as renewed QE by the Bank of England (BoE) could push yields lower.

We see yield curves steepening further as the Fed takes its time raising rates and other central banks exhaust their policy options.

Foreign investor buying, spurred by negative interest rates in much of Europe and Japan, has helped drag down long-term US Treasury yields in the past few years. Many foreign investors hedge those purchases against currency swings. But the sheer hunger for US bonds and a rise in short-term US dollar rates has made that hedging more expensive, and those hedging costs now erode the entire extra yield offered by Treasuries. See the *Fading attraction* chart. The upshot: US bonds are less attractive to foreign investors. This removes some support that has helped keep long-end yields low.



"The effectiveness of extraordinarily low rates to stimulate growth is minimal today. The baton must now be passed to the fiscal channel."

Rick Rieder – Chief Investment Officer,
BlackRock Global Fixed Income

Made in Japan

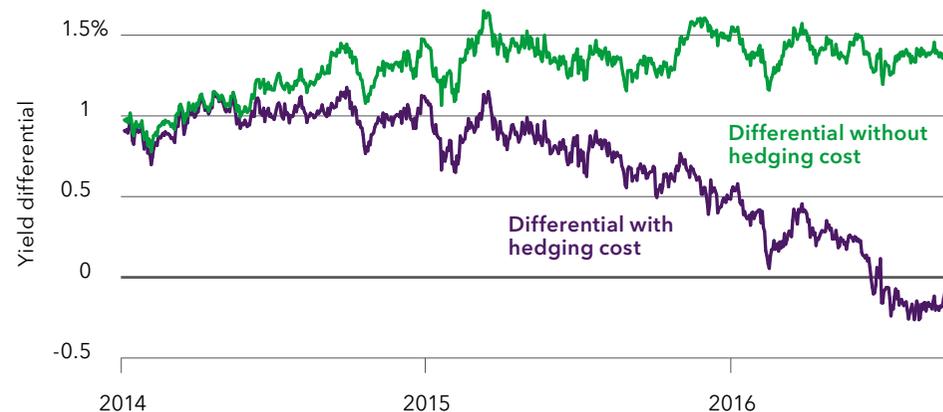
Change in yield curves in selected countries, 2016



Sources: BlackRock Investment Institute and Bloomberg, September 2016. Notes: the yield curves are the difference between 30- and five-year benchmark government bond yields in the countries displayed. The lines show how the yield curves have evolved in 2016 by rebasing them to 100 at the beginning of the year.

Fading attraction

Yield differential between US and global sovereign bonds, 2014-2016



Sources: BlackRock Investment Institute and Bloomberg, September 2016. Notes: the yield differential is the difference in percentage points between the US 10-year Treasury yield and a GDP-weighted average of Japanese, Swiss, German, French, Italian and Spanish 10-year government bond yields. Hedging costs are estimated based on three-month foreign exchange forward points.

Credit

We see opportunities in short-term US credit. Money market reforms due in mid-October have pushed up yields of short-end corporate and municipal bonds, and we see short-term paper offering some protection from any jump in long-term rates. US investment grade corporate debt remains attractive in a yield-hungry world, in our view.

We favour cable/wireless tower operators, software companies, banks and property and casualty insurers. We expect US high yield returns to be more modest going forward, and like the cable/satellite, technology and building materials sectors.

We also like European and UK investment grade credit. The ECB's new corporate bond purchase program should provide support, even for areas not directly part of the program such as hybrids and subordinated financials. We like UK credit due to the BoE's corporate bond purchases, with spreads slightly wider from their recent lows after the program's announcement. See the *A helping hand* chart.

Credit markets look attractive in a low-yield world, with additional support from central bank asset purchases in the eurozone and UK.

EM debt has seen a new wave of investor demand after three years of heavy outflows. See the *Turning the ship* chart. We are growing more selective amid rising valuations. We see the greatest upside in local-currency EM debt due to stabilising currencies, improving economic fundamentals such as current account balances, and scope for lower policy rates. Local currency bonds generally have lower duration than hard-currency EM debt. That should make them more resilient to any spike in global long-term bond yields. In short, local EM debt is more than just an income-producing 'carry trade.' Risks include a renewed surge in the US dollar.

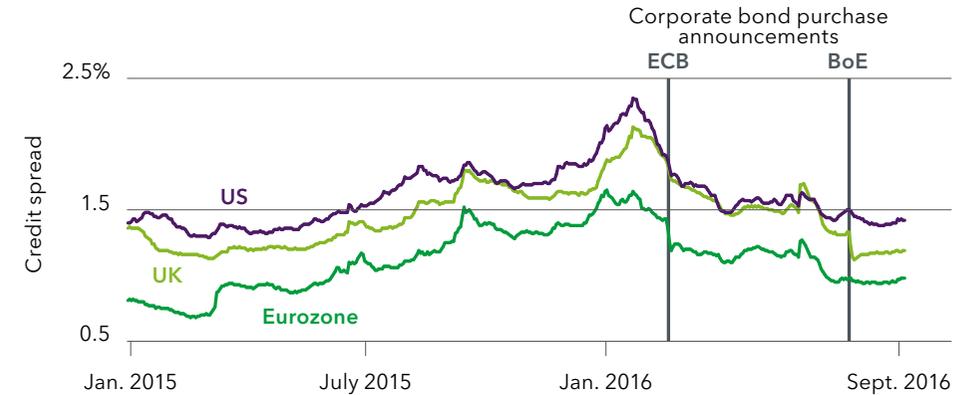
"If the policy focus is shifting to fiscal and infrastructure is being upgraded, it will be very positive for EM and commodities."

Sergio Trigo Paz – Head of BlackRock Emerging Markets Fixed Income



A helping hand

Non-financial corporate credit spreads, 2015-2016



Sources: BlackRock Investment Institute and Barclays index data, September 2016.
Notes: the lines show the option-adjusted spread in percentage points for each region and country's Barclays corporate industrials index versus the corresponding government bond index. Bonds on these indices are investment grade. Option-adjusted spreads represent the difference in yields offered between corporate bonds and equivalent government bonds. ECB stands for the European Central Bank, BoE for the Bank of England.

Turning the ship

Emerging market funds flows, 2013-2016



Sources: BlackRock Investment Institute and EPFR, September 2016.
Notes: the chart shows cumulative fund flows since January 2013, expressed as a percentage of assets at that point.

Equities

Dividend equities have reached their most expensive levels in more than a decade as the search for yield extended to the stock market. The price-to-earnings ratio of global dividend stocks has risen to two standard deviations above its long-term mean. Still, dividend equities look inexpensive versus bonds. See the *Relative value* chart.

We see the potential for valuations to rise further if yields stay low. The highest-yielding stocks may follow the bond market lower when rates rise. Yet not all dividend stocks are created equal. We prefer dividend *growers* – quality companies with enough free cash flow to sustainably increase their dividends over time.

We see opportunities globally in technology and non-eurozone financials, and generally avoid utilities.

We see dividend equities attracting more inflows in a world starved of yield. Dividend growers are likely to prove resilient amid rising rates.

EM equities have outperformed their developed counterparts in 2016, reversing a five-year run of dramatic underperformance. The EM rebound has coincided with a recovery in corporate profitability relative to the developed world. See the *Emerging profit rebound* chart. We see potential for a virtuous cycle of capital inflows into the EM world boosting domestic liquidity and reinforcing the recovery in the economy and corporate earnings.

Valuations are still cheap, with the EM world's price-to-book ratio one standard deviation below its long-term average. We are focused on countries that are still early in the recovery cycle, have strong current account positions and are pushing ahead with structural reforms. We see opportunities in India, Indonesia and China in particular.

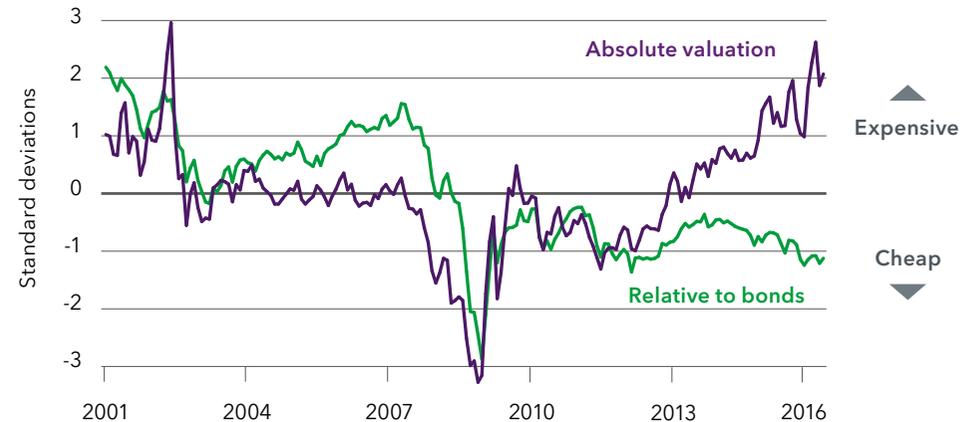


"We want to own quality companies that have a solid dividend today – and that we expect can grow that dividend over time."

Tony Despirito – Co-head of BlackRock Equity Dividend team

Relative value

Valuation of global high-yielding equities, 2001-2016

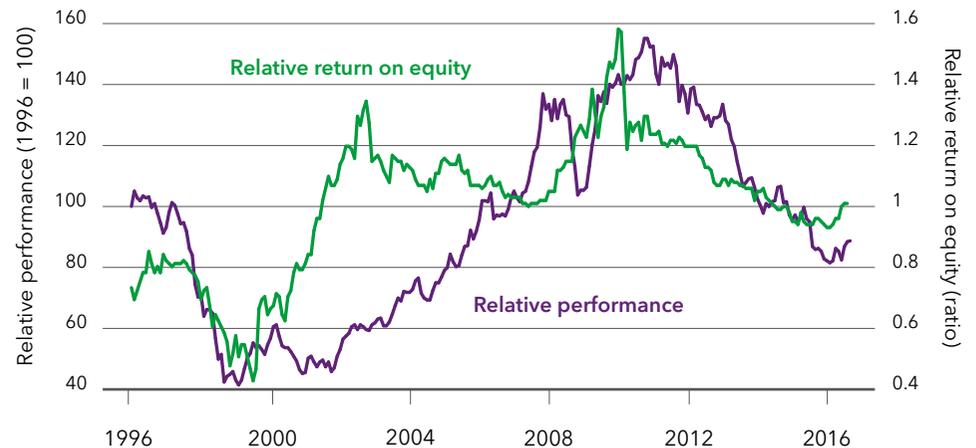


Sources: BlackRock Investment Institute, MSCI and Barclays, September 2016.

Notes: high yield equities represented by the MSCI Global High Dividend Index. Absolute valuation based on trailing price to earnings ratio. Relative to bonds based on dividend yield minus yield on Barclays Global Sovereign Index. Valuations show the difference from the average of the period of the chart measured in standard deviations.

Emerging profit rebound

EM equities relative performance and profitability, 1996-2016



Sources: BlackRock Investment Institute and MSCI, September 2016.

Notes: relative performance is the MSCI Emerging Markets Index (total return) minus the MSCI World Index (total return), rebased to 100 at the start of the chart. Relative ROE measures the ratio of the return on equity (ROE) on these two indexes.

Assets in brief

Views on assets for Q4 from a US dollar perspective

Asset Class	View	Notes
EQUITIES	United States	— Monetary and fiscal policy should support economic expansion, but political uncertainty may dampen capex. Valuations remain elevated. We like structural growth stories, dividend growers and quality stocks.
	Europe	▼ Post-Brexit uncertainties challenge already poor profits. We see only modest prospects for an earnings acceleration despite a supportive ECB. Multinationals should benefit from EM demand. We avoid banks.
	Japan	— Attractive valuations and improved corporate governance are not enough to offset a soft economy and strong yen, we believe. The BoJ is nearing the limits of monetary policy.
	EM	▲ A stable US dollar, economic reform momentum, improving corporate fundamentals and reasonable valuations support the asset class, we believe. We also see more room for inflows given light investor positioning.
	Asia ex-Japan	▲ Financial sector reform and rising current account surpluses are encouraging. China's economic transition is ongoing, but we believe lower growth rates are priced in. We like India and selected ASEAN markets.
FIXED INCOME	US Treasuries	— Fed normalisation is likely to be very gradual and easy global monetary policy is supportive. Policy shifts that steepen global yield curves make us cautious of longer-duration bonds.
	Municipal bonds	— Richer valuations and higher US Treasury yields challenge the near-term outlook. Yet we see munis' tax-exempt income making them a core holding longer term.
	US credit	▲ We generally prefer investment grade bonds. Yields offer compensation for the risks entailed, such as rising corporate leverage.
	European sovereigns	— We prefer selected peripheral bond markets due to higher yields and ECB support. An eventual relaxation in the ECB's self-imposed limits on bond buying should result in steeper yield curves in the eurozone core.
	European credit	▲ The ECB's corporate bond purchases and a modest BoE purchase program support investment grade credit in Europe. Bonds not eligible for the ECB programme also look attractive to us in selected countries.
	EM debt	▲ We have become more selective given rising valuations. We prefer the front end of local markets with room to cut rates further, such as Brazil, and also see opportunities in hard currency corporates.
	Asia fixed income	— We see local currency debt as attractive in Asian economies with a monetary easing bias, including India. In China, we are focused on higher-quality issuers.
OTHER	Commodities and currencies	— Supply rationalisation is improving our outlook for oil and industrial metals. We like gold as a portfolio diversifier. We see major currencies mostly stable, even as a Fed rate rise could nudge up the US dollar.

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