Tread carefully

Outlook Q4 2016

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We continue to see upside to global economic growth prospects but also greater market volatility in the fourth quarter of 2016. This comes after a summer lull, record highs for US equity markets and a rebound in emerging market (EM) assets. We expect the US Federal Reserve to press on with the slow interest rate increase process that began in December 2015 while other major central banks start to approach the limits of their easy policies. Our key views:

**Policy limits**
Central banks appear to be nearing the limits of extraordinary monetary easing. Their bond purchases are exacerbating a shortage in ‘safe’ assets. As monetary policy reaches its limits, some major economies appear on the verge of turning more to fiscal policy, such as infrastructure spending, to boost growth. See the BlackRock Global Macro Outlook from September 2016 for more on this material change in tone.

**Low returns**
Our return expectations across asset classes are at post-crisis lows. Asset class valuations look high versus long-term history and point to more muted returns in the future. Most investors are being forced to take on more risk to meet their targeted rates of return. Despite the low return outlook, we believe there is still potential for investors who willingly take on certain risks to be rewarded appropriately.

**Volatility**
Central bank asset purchases have generally smothered volatility, but we could see short bursts ahead amid looming political risks in developed markets and the ongoing debate around monetary policy effectiveness.

See the BlackRock Q4 2016 Global Investment Outlook for more on our central themes.
Flows and trends

Fund flows can provide a measure of investor sentiment; Exchange-Traded Product (ETP) flows can be especially sensitive to sentiment changes due to the ease with which they can be traded. Our analysis of ETP flows year-to-date indicates:

ETP flows: Risk on...and on

A Brexit vote in the UK’s EU referendum was expected to be negative for market sentiment, yet markets rallied and global ETP flows followed suit throughout Q3.

In fact, as at 23 September, 50% of all ETP inflows this year have come after 23 June. These were not purely safe-haven seeking flows either. Flows into EM assets – both equities and bonds – picked up significantly in Q3, slowing only momentarily in early September when volatility spiked.

As well as generally dampening volatility across financial markets, the presence of central banks is evident in ETP flows. 83% of inflows into Japanese equities this year came in Q3, coinciding with the Bank of Japan doubling its ETF purchase programme in July.

In Europe, the European Central Bank (ECB) Corporate Sector Purchase Programme (CSPP) has driven interest in investment grade corporate bonds since it was announced in March 2016.

BREXIT BOUNCE

ETP flows across key asset classes since Brexit (blue) and year-to-date (green)

Source: BlackRock ETP Landscape, data as at 15 September 2016.

All data in this section is sourced from the BlackRock ETP Landscape, as at 15 September 2016 unless otherwise specified.
Volatility: It’s been quiet, too quiet

If Q3 flows were mainly characterised by risk-on sentiment, then equity markets’ most prominent feature was low volatility – especially in the US.

At the end of August, US equities had recorded their least volatile 30-day period in more than two decades. Such tranquility seemed at odds with political and policy uncertainty.

Outside of US equity markets, there is some evidence that markets are pricing in volatility in Q4: the price of EURO STOXX 50 Index options contracts expiring in November 2016 suggests that some believe European equity volatility could move higher around the US presidential election and the Italian senate referendum.

A mid-September spike in the VIX, triggered by a sell-off in government bonds, shook markets from their slumber. As volatility spiked, correlation between equity and bond prices turned positive (see the In unison chart) potentially making diversification, which can offer some protection against such volatility, harder to find. BlackRock Investment Institute analysis of implied volatility in US election years shows that, prior to the September spike, volatility had looked too low for what is an unusual election season (see the It’s oh so quiet chart). We expect volatility to move higher as the election nears and markets begin to price in political uncertainty.

IN UNISON

US equity-bond 30-day rolling correlation, 2011-2016

Source: Bloomberg, 19 September 2016. Equity prices represented by the S&P 500 Price Index. Bond yields represented by the US Generic Government 10 Year Yield. As bond yields move in the opposite direction to bond prices, when the equity price-bond yield correlation moves below zero it means bond and equity prices are exhibiting a positive correlation. The closer the number gets to -1.0, the stronger the positive correlation.
Indicator reactions: Uncertain terms

Volatility may have not been particularly evident in Q3 but uncertainty in markets was – if you knew where to look.

Equity market reaction to economic data seems to be increasingly harder to predict. The building debate around the effectiveness of central bank policy seems to have led to a situation where bad news does not always equal good news (weak data builds expectation of central bank intervention) for markets, but neither does bad news always equal bad news (weak data interpreted as economic recovery is slowing). Market reaction to positive economic surprises (good news) has been similarly inconsistent.

In Q3, one determinant of whether market reaction correlated with economic data appears to have been the market’s pricing of a US rate rise.

Our analysis of equity correlation with the Citi US Economic Surprise Index suggests that earlier in the quarter, when the probability of a US rate rise in December 2016 was low, the S&P 500 was more negatively correlated with economic data – good news was seen as bad news as it increased the possibility that the Fed might surprise markets.

Later in the quarter, as rate rise expectations moved towards a 50–50 probability of a December hike, that correlation swung back and forth between weak negative and positive relationships. It seems that the more certain the path for policy looks, the more the debate around its effectiveness intensifies – in turn, creating more confusion about how to react to data.

IT’S OH SO QUIET


Source: BlackRock Investment Institute and Thomson Reuters, Notes: The blue line shows average VIX levels around US presidential elections from 1992 to 2012. The VIX represents expectations of 30-day volatility calculated from S&P options. The shaded area shows the VIX’s trading range in the periods, while the green line shows the actual VIX this year. This analysis excludes the 2008 election due to the impact of the financial crisis.
Diversification in a highly-correlated world

A busy developed market political calendar, mounting questions around the efficacy of monetary policy and a build-up in popular positions lead us to believe that investors should take steps to diversify portfolios to protect against volatility spikes.

Infrastructure

As monetary easing reaches its limits, major economies appear to be moving away from austerity. Infrastructure spending, for instance, features in the US presidential campaign. Japan and Canada have pushed ahead with public investment. The UK appears set to combine fiscal and monetary easing to fight a potential economic slowdown following the Brexit vote. A multi-asset approach to infrastructure investing – gaining exposure to both equities and bonds issued by infrastructure companies – could have diversification benefits. Multi-asset infrastructure ETFs may represent a way for investors concerned about liquidity to access what is an otherwise illiquid, private market. See our The only way is the highway piece of September 2016 for more detail.

Gold

Gold has regained the qualities that made it a powerful portfolio diversifier before the global financial crisis. In 2016, the correlation between the spot gold price and global equities has been negative. If (as the Federal Reserve has indicated) US inflation is allowed to ‘run hot’, then gold’s usefulness as a hedge against inflation could also be reinstated.

Inflation-linked bonds

Market expectations of US inflation look too low, in our view. US treasury inflation-linked bonds – the yields of which rise and fall in line with changes in the US inflation rate – have outperformed equivalent US treasuries by around 2% on a total return basis this year (as at 23 September). We believe there is room for further outperformance as we head towards the end of 2016. A similar dynamic is present in Europe, where inflation expectations also look depressed.

Cash equivalents

Investors holding significant amounts of cash as a way to diversify their portfolio may be concerned about the impact of negative, flat or very low interest rates. Cash equivalents, such as corporate bonds with very short maturities, could offer a way to generate additional yield from cash holdings for those willing to tolerate the resultant pick up in interest rate risk.
Growth in a low return world

Global growth expectations, on a steady decline since 2015, have shifted lower this year – particularly post-Brexit. We see room for upside surprises over the coming quarter. See the BlackRock Macro GPS for more on our assessment of the global economic outlook. With equity valuations at their highest absolute levels since the financial crisis, selectivity will be key to realise any opportunities that emerge.

EM equities

EM equities have outperformed their developed market counterparts by 11% this year on a net total return basis (as at 23 September) and ETP inflows have been strong as a result. However, not quite strong enough to reverse a net outflow from EM equity ETPs since 2013’s ‘taper tantrum’. On that basis, we do not believe it is ‘too late’ to join the EM rally. Range-bound oil prices, improving EM economic fundamentals and a gentler Fed rate hiking path may also be supportive for EM equities. Reform momentum, consumer strength and stabilisation in China draw us to EM Asia, in particular. See our EMotions running high piece from September 2016 for additional colour on EM.

US tech

Technology companies in the US generally have lower levels of debt than other sectors. If rates rise and servicing debt gets more expensive, US tech could benefit on a relative basis. High levels of cash on balance sheets also give US tech firms the capacity to sustain share buyback programmes – a critical driver of US equity prices over the last few years that appears to be peaking (see our Buybacks piece from April 2016) – for longer than other sectors.

Minimum volatility

Despite historically-low levels of volatility, minimum volatility strategies – designed to offer investors exposure to broad equity markets with potentially less volatility – have outperformed more traditional equity indices year-to-date. On a net total return basis, the S&P 500 Minimum Volatility Index has outperformed the S&P 500 Index by more than 5% at the time of writing. That said, it is important to remember that minimum volatility strategies are designed to reward investors for bearing a specific risk (lower volatility) over long periods rather than necessarily protecting against short, rate-driven spikes in volatility of the type we saw in September.
Income in a low yield world

Monetary policy may be at its limits, but the ECB, Bank of Japan and Bank of England are still buying bonds in significant quantities. Bond yields remain at low levels relative to long-term history.

Dividend equities

Investors searching for yield may be naturally drawn to dividend-paying equities. Dividend exposures that employ a quality screen to select companies that are capable of sustaining dividend payments tend to target companies with healthy balance sheets and robust business models – qualities that could be in demand should volatility tick up.

Credit

With bond yields so low versus history, investors may be better served thinking about yield in relative, rather than absolute, terms. On that basis, corporate bonds in Europe and the US may be opportunities to consider for income investors. European corporates across the credit spectrum could be supported by the ECB’s purchase programme – even into areas not actually on the ECB’s buy list thanks to a ‘trickle down’ effect. In US credit, the higher yields on offer relative to global counterparts and the potential for dollar appreciation may be attractive for yield-hunters.

EMD

The global hunt for yield has driven flows into emerging market debt (EMD) this year, reversing a sustained period of outflows that began with 2013’s ‘taper tantrum’. On a selective basis, we believe there could be upside in local currency EMD due to stabilising currencies, improving economic fundamentals such as current account balances and the scope for lower policy rates. On a risk-adjusted basis, we believe hard currency (dollar-denominated) EMD could offer a relatively stable source of income.
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