



Global Investment Outlook

2017

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Richard Turnill
Global Chief
Investment Strategist
BlackRock Investment
Institute

We expect U.S.-led reflation – rising nominal growth, wages and inflation – to accelerate, and see fiscal expansion gradually replacing monetary policy as an economic growth and market driver around the world. We discussed this, as well as the impact of technological change, the risk of a China credit bubble and the dynamics of investor risk appetite, at our semi-annual Outlook Forum. Our key views:

- **Reflation implications:** We see reflation taking root and believe global bond yields have bottomed. As a result, we prefer equities over fixed income and credit over government bonds. We see higher yields and steeper curves, and favor short- over long-duration bonds and value shares over bond-like equities.
- **Low returns ahead:** Structural factors such as aging societies and weak productivity growth have led to a drop in economic growth potential. We see these factors limiting how high real yields can go and see rewards for taking risk in equities, emerging market (EM) assets and alternatives in private markets.
- **Dispersion:** We see the gap between equity winners and losers widening. A more unstable relationship between bonds and equities signals a regime change that challenges traditional diversification.
- **Risks:** Political and policy risks abound. There is uncertainty about U.S. President-elect Donald Trump's agenda, its implementation and the timing. French and German elections will test Europe's cohesion amid a forest fire of populism around the world. China's capital outflows and falling yuan are worries.
- **Markets:** We see developed market equities moving higher in 2017 and prefer dividend growers, financials and health care. We like Japanese and EM equities but see potential trade tensions as a risk. In fixed income, we favor high-quality credit and inflation-linked securities over nominal bonds.



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Jean Boivin
Head of Economic and
Markets Research
BlackRock Investment
Institute



Isabelle Mateos y Lago
Chief Multi-Asset Strategist
BlackRock Investment
Institute



Kate Moore
Chief Equity Strategist
BlackRock Investment
Institute



Jeff Rosenberg
Chief Fixed
Income Strategist
BlackRock Investment
Institute

Setting the scene

Global growth expectations appear to be picking up after an extended slide. Our *BlackRock Macro GPS* – which combines traditional economic indicators with big data signals such as Internet searches – points to a rise in consensus growth estimates in the months ahead. See the *Excessive pessimism* chart. The gap between our gauge (the green line) and G7 growth forecasts (blue) is the widest since early 2013, just before forecasts saw a string of upgrades. Solid manufacturing readings around the world reinforce the upbeat GPS message. Expectations for a large U.S. fiscal stimulus and regulatory easing under a Trump administration have strengthened the reflationary mindset. We expect China to support the economy with credit growth before President Xi Jinping consolidates power at the Communist Party's National Congress in late 2017.

Global growth appears to be at an inflection point, with economies showing resilience to 2016's two surprises: Brexit and the U.S. election.

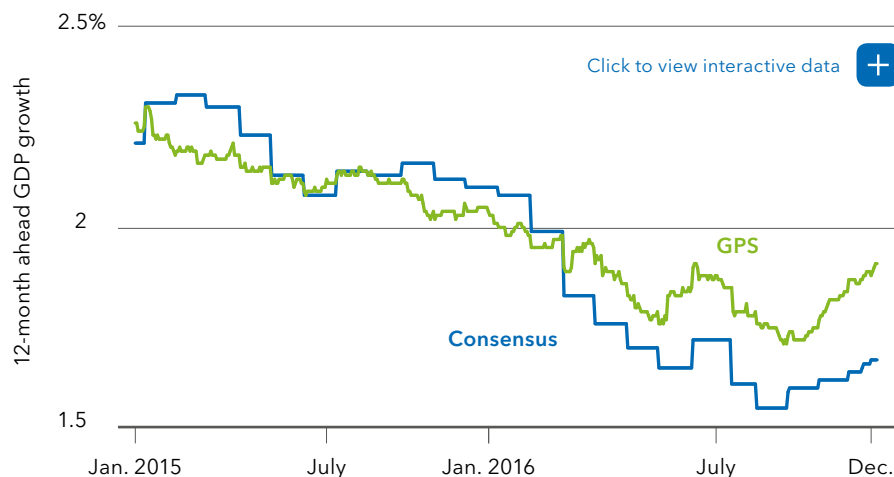
The battle with deflation in much of the world looks to be over. The rise in inflation is increasingly broad-based – particularly in the U.S. A tighter U.S. labor market is pushing up average hourly earnings at the fastest pace since 2009, and we expect core inflation to increase on the back of rising services inflation. We see this giving the U.S. Federal Reserve the confidence to raise interest rates further in 2017.

The prices of more than half the goods in the U.S. Consumer Price Index (CPI) basket are rising at an above-average historical pace for the first time since 2008. See the *Inflation broadens* chart. China's Producer Price Index has clawed out of five years of deflation. Eurozone headline inflation has hit a two-year high, yet core inflation is largely moving sideways. We see the European Central Bank (ECB) keeping policy easy after recently extending its bond-buying program. And we expect the Bank of England to stand pat and look past any inflation spike caused by a weaker British pound.

The U.S. appears to be leading a global rebound in inflation, but the roots are shallow in other developed economies.

Excessive pessimism

BlackRock Macro GPS for G7 economies, 2015–2016

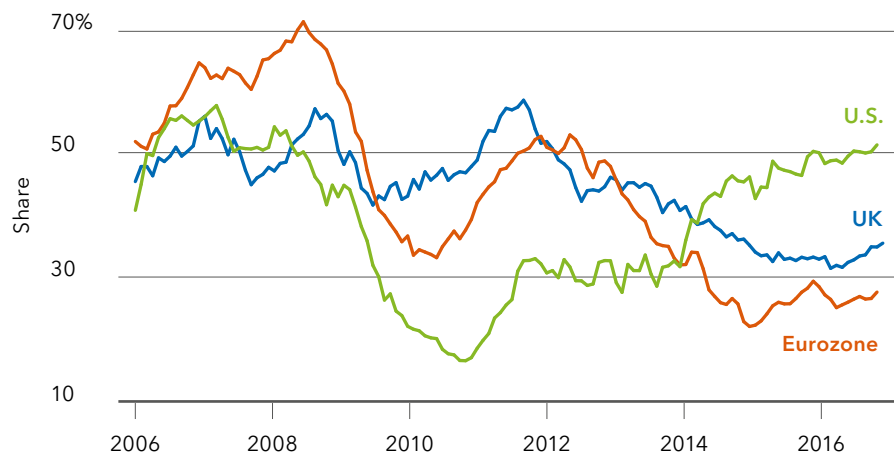


Sources: BlackRock Investment Institute and Consensus Economics, Dec. 2, 2016.

Notes: The GPS shows what the 12-month average GDP forecast of economists may be in three months. The forecasts are measured by Consensus Economics. The G7 countries are the U.S., UK, Canada, France, Germany, Italy and Japan.

Inflation broadens

Share of CPI components with above-average inflation, 2006–2016



Sources: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, UK Office for National Statistics and Eurostat, November 2016.

Notes: The lines show the percentage of CPI basket components with seasonally adjusted, month-on-month inflation above the average since 1999. The indexes capture 77 components in the U.S., 94 in the eurozone and 85 in the UK.

Setting the scene

U.S. President-elect Donald Trump has pledged to slash taxes and boost infrastructure spending. How much will this boost growth? Uncertainties over the details of the plans as well as the fiscal multiplier – how much each dollar of fiscal expansion boosts GDP – make estimates difficult. It could lift GDP by anywhere from 3% to 23% over the next decade, we estimate, mostly driven by tax cuts. See the *Trumponomics* chart. Deregulation could give an additional boost. There are big caveats. Nobody knows how Trump will govern. Will he be a pragmatist or populist? His plans could be watered down by fiscal conservatives or, conversely, could lead to a surge in debt levels and interest rates that undermine growth. Corporate tax cuts could be offset with measures such as eliminating the deductibility of paid interest. This would be a game changer for equity and credit markets, reducing the incentive for companies to issue debt and buy back shares.

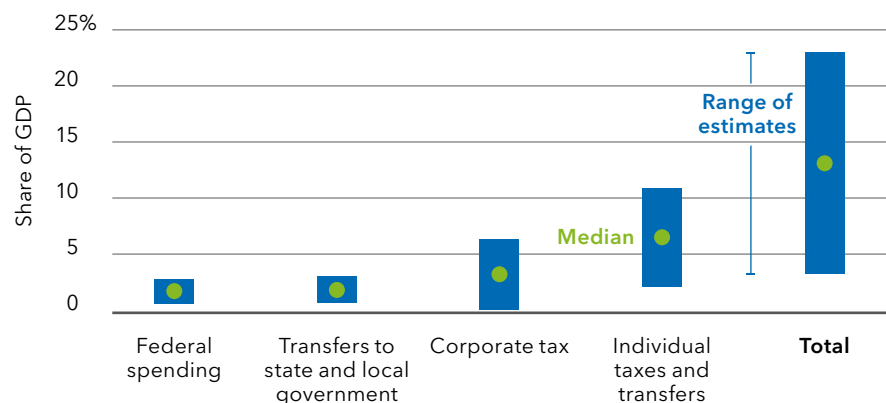
Trump's fiscal plans could deliver a boost to U.S. growth, but the magnitude and potential side effects are uncertain.

The pick-up in growth is global. EM economies are seeing a solid recovery take root, with higher factory output and signs companies are confident enough to pass higher prices on to customers. See the *Emerging reflation* chart. Some of the EM rebound is the result of fading recessions in Russia and Brazil. China's stabilizing growth and hunger for commodities help EM resources exporters. A deal by the Organization of the Petroleum Exporting Countries to cut supply has raised the floor for oil prices, at least for now. We see the prospect of higher U.S. growth outweighing any tightening of financial conditions caused by the strong U.S. dollar for now. In addition, EM growth momentum has proved resilient, and most countries with high current account deficits have adjusted via currency slides. Our bottom line: EM assets are well-positioned to contribute to portfolio returns, even given challenges such as global trade tensions or fickle investor sentiment.

The reflationary trend shows signs of taking root in EM, with a rebound in economic activity and prices.

Trumponomics

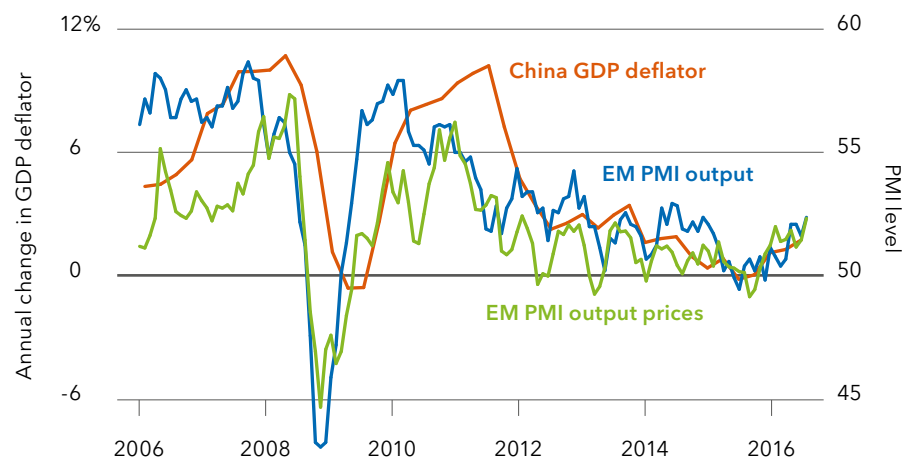
Estimated 10-year impact on U.S. GDP of Trump's potential policies



Source: BlackRock Investment Institute, Congressional Budget Office and Committee for a Responsible Federal Budget, November 2016. Notes: The chart shows estimates of the impact of President-elect Donald Trump's policies on U.S. GDP over the next 10 years, measured as a percentage of 2015 GDP. The estimates are derived by applying Congressional Budget Office estimates of fiscal multipliers of different tax and spending policies to estimates of the fiscal impact of the President-elect Donald Trump's policies produced by the Committee for a Responsible Federal Budget. The bars represent the range of estimates, which are driven by different fiscal multipliers.

Emerging reflation

Emerging market output, prices and China GDP deflator, 2006–2016



Sources: BlackRock Investment Institute, National Bureau of Statistics of China and Markit, November 2016. Notes: China's GDP deflator is a measure of economy-wide inflation. Purchasing managers' indexes (PMI) are survey-based measures of economic activity; a value above 50 indicates an increase in prices or activity, while below 50 indicates a decrease.

Theme 1: reflation

We see U.S. fiscal expansion amplifying expectations for a steepening yield curve. Tax cuts and infrastructure spending could boost growth and inflation as well as widen the fiscal deficit, we believe. This should lead to higher long-term U.S. yields, although we see the rise capped by structural factors (see page 6) and buying by investors with long-term liabilities. We also see steeper curves in the eurozone after the ECB gave itself more room to buy short-term paper as part of the extension of its bond buying program. We see the Bank of Japan (BOJ)'s aim to keep 10-year yields near zero limiting moves there. See the *Steeper and steeper* chart. We believe we have seen the low in bond yields – barring any big shock. We prefer shorter-duration bonds less sensitive to rising rates. It is also easier to get a handle on short-term yields, much as golfers tend to be better with a pitching wedge than long-distance driver.

We see yield curves steepening further in 2017 but brace for temporary reversals after a rapid move higher in long-term yields.

Expectations for global reflation are driving a rotation within equities.

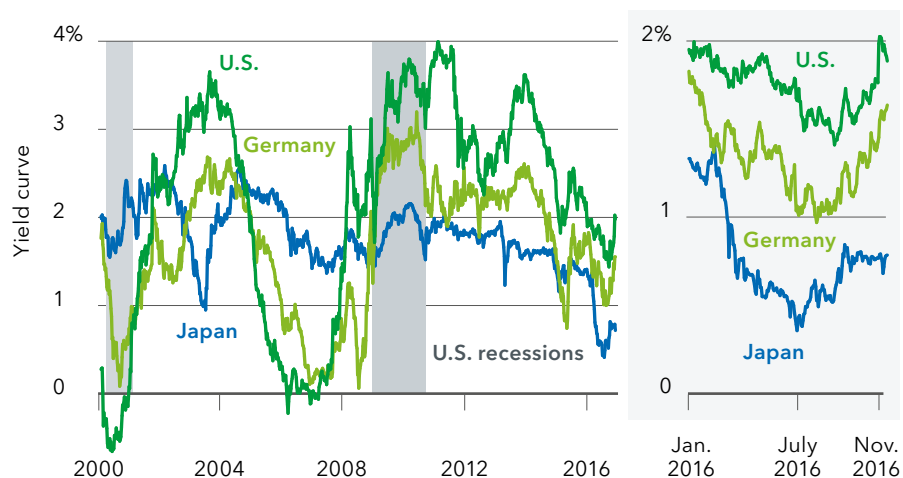
Bond-like equities such as utilities dramatically undershot the broader market in the second half of 2016. Global banks, by contrast, have outperformed along with other value equities on expectations that steeper yield curves might boost their net interest margins – the gap between lending and deposit rates. See the *In with banks, out with utilities* chart.

We see this trend running further in the medium term, albeit with the potential for short-term pullbacks. We could see beneficiaries of the post-crisis low-rate environment – bond proxies and low-volatility shares – underperforming. We see dividend growers – companies with sustainable free cash flow and the ability to raise their payouts over time – as most resilient in a rising-rate environment. Dividend growers perform well when inflation drives rates higher, our research suggests.

We see reflationary trends spelling trouble for bond-like equities, but with financials and dividend growers outperforming.

Steeper and steeper

Government bond yield curves in selected countries, 2000–2016

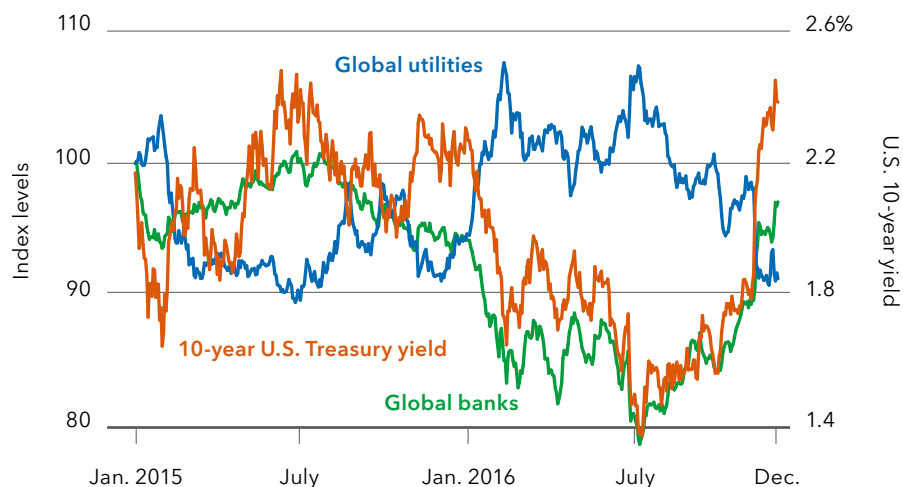


Sources: BlackRock Investment Institute and Thomson Reuters, November 2016.

Note: The lines show the difference between benchmark 30- and two-year government bond yields for each country in percentage points.

In with banks, out with utilities

Relative performance of global utilities and banks versus U.S. yields, 2015–2016



Sources: BlackRock Investment Institute, Thomson Reuters and MSCI, Dec. 5, 2016.

Note: The relative performances of global banks and utilities are represented by dividing the MSCI World Utilities and Banks indexes by the MSCI World Index and using a base value of 100 at the start of 2015.

Theme 2: low returns ahead

Still-low rates and a relatively subdued economic growth trend take a toll on prospective asset returns. Our capital market assumptions point to particularly poor five-year returns on government bonds. We see long-term U.S. Treasuries posting negative returns – with lots of volatility. See the *Risk and reward* chart. This is one reason we believe investors need to have a global mindset and consider moving further out on the risk spectrum.

U.S.-dollar-based investors should consider owning more non-U.S. equities and EM assets over a five-year time horizon while reducing exposure to government bonds, our work suggests. We see structural changes to the global economy – aging populations, weak productivity and excess savings – limiting growth and capping rate rises. Yet we see room for a cyclical upswing, even within the context of today's reflationary theme.

We believe investors are still being rewarded for moving up the risk spectrum into equities, credit and alternative asset classes.

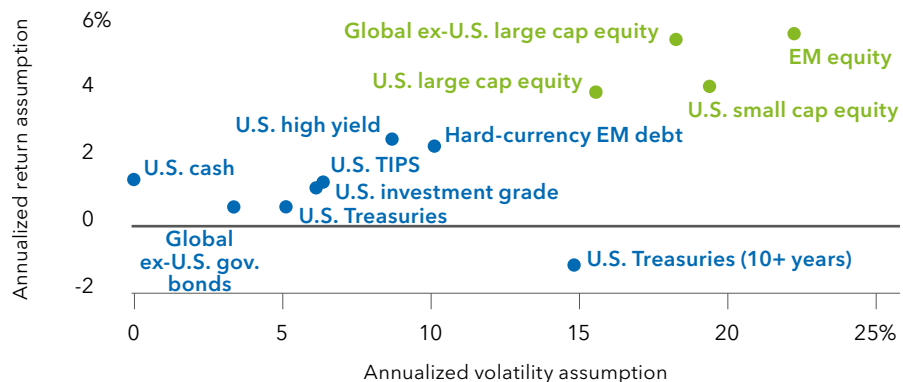
Potential economic growth rates – the natural speed limit of economies – have headed lower and lower in recent decades. Trend economic growth is made up of three factors: growth in the labor force, the total capital stock and productivity. Graying populations have stalled labor force growth, while corporate capital spending and productivity growth have been tepid. This has dragged down trend growth and, with it, the neutral interest rate – the level at which rates neither stimulate nor hinder growth. See the *Low for no longer?* chart. This is a trend mirrored across the developed world.

U.S. potential growth has declined to just below 2%, taking down estimates of neutral rates (known as r^*) to 0.5%. That points to a nominal neutral rate of 2.5%–3.0% after accounting for the Fed's 2% inflation target. This should limit how high bond yields can climb, unless structural reforms such as infrastructure spending and deregulation push trend growth higher.

We are seeing a cyclical recovery and rise in bond yields in a structurally low-rate environment.

Risk and reward

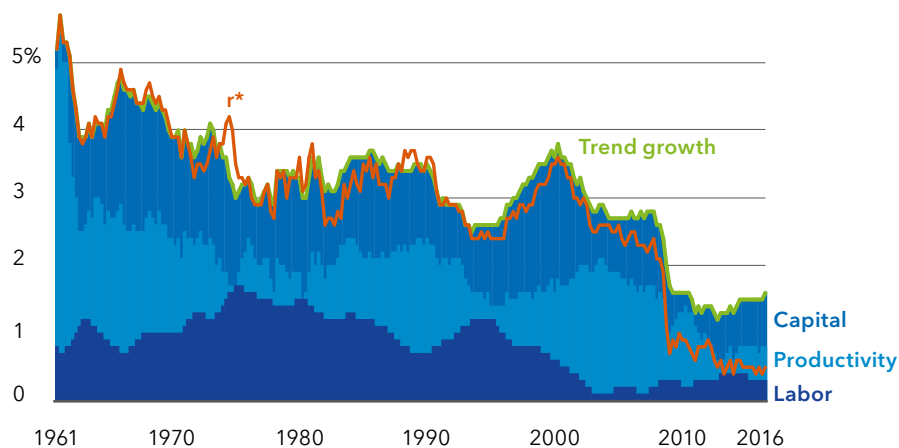
BlackRock five-year asset return and long-term volatility assumptions, October 2016



Sources: BlackRock Investment Institute and BlackRock Solutions, October 2016. Notes: This is not a recommendation to invest in any particular asset class or strategy, nor a promise of future performance. The dots show our annualized nominal return assumptions for the next five years from a U.S. dollar perspective versus our long-term annualized volatility assumptions. Indexes used are the Bloomberg Barclays U.S. Long Government, Global Treasury ex U.S., Government, U.S. Credit, U.S. Government Inflation-Linked Bond and U.S. High Yield indexes. Other indexes used are Citigroup 3-Month Treasury Bill Index, J.P. Morgan EMBI Global Diversified Index, and the MSCI USA, USA Small Cap, World ex USA and Emerging Markets indexes. It is not possible to invest directly in an index.

Low for no longer?

U.S. trend growth and neutral rate, 1961–2016



Sources: BlackRock Investment Institute and Federal Reserve, December 2016. Notes: The chart shows trend GDP growth broken down by contribution and an estimate of the real neutral rate, called r^* . We derive the r^* estimate via a similar methodology used in the August 2016 Federal Reserve study (Holston, Laubach, Williams). r^* is modeled as the sum of trend growth and other factors that have historically played a smaller role, such as global excess savings.

Theme 3: dispersion

The gap between winners and losers in the stock market is likely to widen from the depressed levels of recent years as the baton is passed from monetary to fiscal policy. The dispersion of weekly stock returns – the gap between the top and bottom quartile – recently hit its highest level since 2008. See the *Wanted: stock pickers* chart. Bottom line: Future returns may be more muted, but we should see a lot more action below the surface.

Under extraordinary monetary easing during the post-crisis years, a rising tide lifted all boats. Fiscal and regulatory changes, by contrast, are likely to favor some sectors at the expense of others now. Other markets are likely to mirror the U.S. trend as major central banks approach the limits of monetary easing. Rising asset price dispersion creates opportunities for security selection. Yet the risk of sharp and sudden momentum reversals in sector leadership highlights the need to be nimble while staying focused on long-term goals.

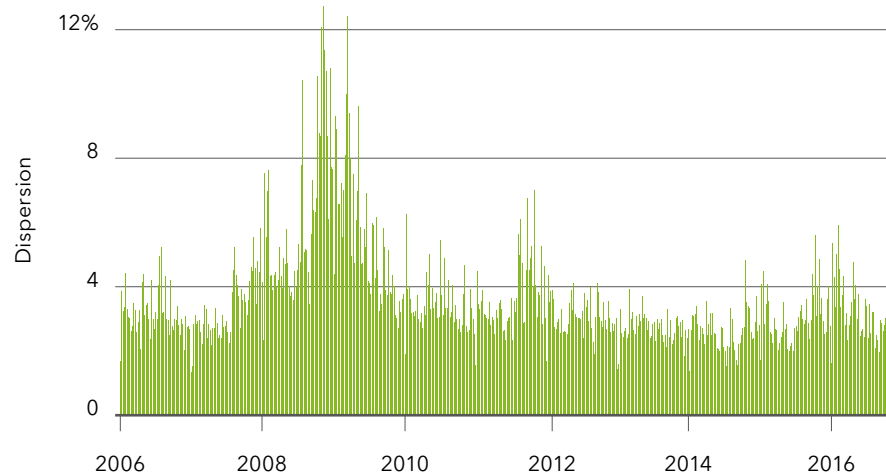
We favor an active approach to investing as rising dispersion creates opportunities to identify security and asset class winners and losers.

The old rules of diversification are no longer working. Long-held relationships between asset classes appear to be breaking down as rising yields have led to a shakeup across asset classes. Bond prices are no longer moving as reliably in the opposite direction of equity prices. Similarly, asset pairs that have historically moved in near-lockstep – U.S. equities and oil, for example – have become less correlated. See the *Correlation chaos* chart. This means traditional methods of portfolio diversification, which use historical correlations and returns to derive an optimum asset mix, may be less effective. Bonds are still useful portfolio buffers against “risk-off” market movements, we believe. Yet we see an increasing role for equities, style factors and alternatives such as private markets in portfolio diversification.

We are seeing a regime change in cross-asset correlations. Portfolios that appear diversified now may prove less diversified going forward.

Wanted: stock pickers

Dispersion of weekly U.S. equity price moves, 2006–2016

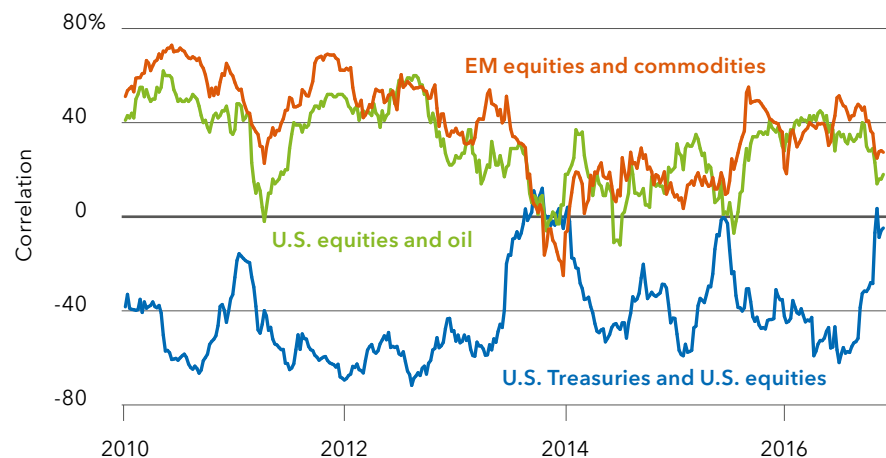


Sources: BlackRock Investment Institute and Thomson Reuters, November 2016.

Note: The chart shows the difference between the weekly price move of the top and bottom 25th percentile of movers in the S&P 500 in percentage points.

Correlation chaos

Selected cross-asset correlations, 2010–2016



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

Notes: The lines show the rolling 90-day correlations of daily returns. EM equities are represented by the MSCI Emerging Markets Index, commodities by the S&P GSCI; U.S. equities by the S&P 500 Index, oil by the Brent crude price and U.S. Treasuries by the Bloomberg Barclays U.S. Treasury Index.

Outlook Forum: risk appetite

Trump's victory has sparked a big shift into equities and out of bonds in developed markets. But the change is tiny when put into context: Bond buying in mutual funds and exchange-traded funds has far outpaced equity buying over the past five years. See the *Equity catch-up?* chart.

The trend in 2016 looks even more stark as the equity sell-off at the start of the year sent money into bonds and bond proxies, such as high-dividend shares. Expectations for a "great rotation" out of bonds and into equities after the 2013 taper tantrum fell flat as the stampede into bonds soon resumed. Today's more positive economic backdrop could serve as the catalyst for investors to embrace riskier assets, however. Even a trickle of funds out of government bonds and bond-like equities into credit or value equities can have a significant effect on asset prices.

We see a sustainable rotation into value shares from bond-like equities, but expect bumps along the road.

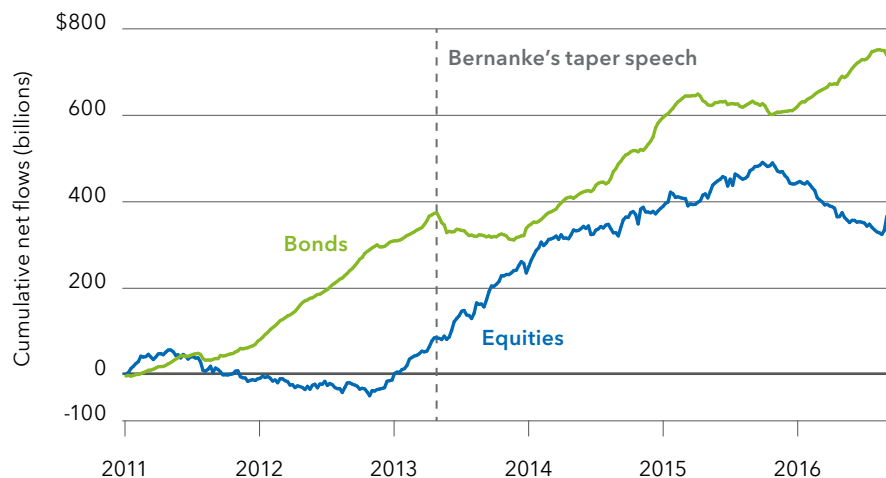
U.S. equity indexes have hit record highs since the U.S. election, yet our risk appetite gauges point to little sign of frothiness. See the *How money morphs* chart. The financial multiplier measures how financial assets move relative to money, thereby giving a sense of how quickly money is moving through the financial system. The risk ratio shows the value of risk assets relative to safe assets (money and government bonds). Both show how extreme conditions were in the run-up to the dot-com bust and 2007-2008 crisis – and how subdued things are today. This partly reflects a slowdown in the speed of money due to post-crisis regulations requiring banks to hold more capital. See our *Global Macro Outlook* of November 2016.

Yet we still see scope for increased investor optimism lifting equities and other risk assets further if a wall of money stashed in cash and low-yielding assets is put to work again, and some of the cautiousness relents.

Our gauges suggest risk appetite is relatively subdued, pointing to further upside for risk assets if investors make their cash work harder.

Equity catchup?

Fund flows into developed market bonds and equities, 2011-2016

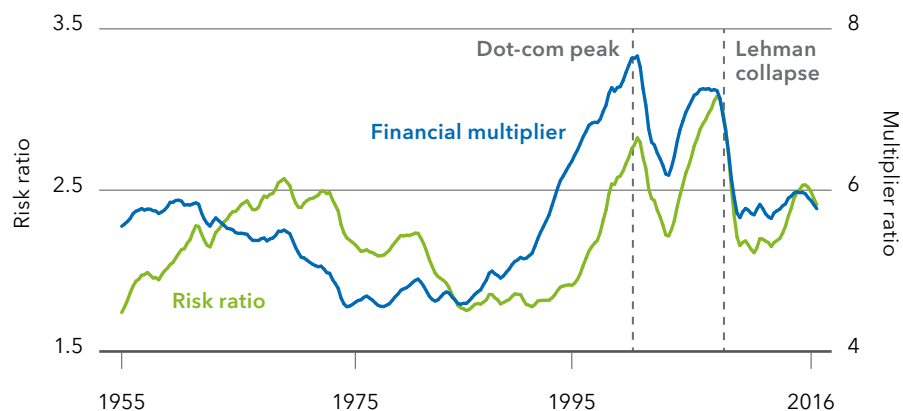


Sources: BlackRock Investment Institute and EPFR, November 2016.

Notes: The lines show cumulative fund flows since January 2011. Ben Bernanke's tapering speech is when the then Fed chairman flagged the gradual end of bond purchases by the central bank.

How money morphs

U.S. financial multiplier and risk ratio gauges, 1955-2016



Sources: BlackRock Investment Institute and Federal Reserve, November 2016.

Notes: The financial multiplier and the financial asset risk ratio are based on U.S. flow of funds data. The financial multiplier is defined as the ratio between the market value of most financial assets – excluding assets such as securitizations to avoid double counting – and cash (currency and deposits). The risk ratio is defined as the ratio between the market value of risk assets (such as equities and corporate bonds) and that of less risky assets (government and agency bonds plus cash) but excluding central bank holdings.

Outlook Forum: technological change

Technological change is sweeping through industries, overhauling business models, reducing traditional jobs and limiting inflation. The number of people employed in U.S. manufacturing has fallen by almost 30% since 2000, even as manufacturing output has increased over the same period. See the *Rise of robots* chart. Advances in artificial intelligence could have an even bigger impact on better-paying white-collar jobs in services industries such as finance. And fossil fuel companies risk being upended by renewables once energy-storage technologies improve. The implications are broad-based. We see technological innovation keeping a lid on price increases, not just in manufacturing but also in some services. Technological change – coupled with globalization – is also making many people fear for their futures. This is not new; machines and the steam engine replaced textile workers and horses during the Industrial Revolution. Yet horses don't vote; people do. Innovations today are being adopted at an increasingly rapid pace. This is feeding into a forest fire of populist politics around the world – and likely voter disappointment as technological change is unlikely to decelerate.

The rapid pace of technological change is causing disruption across industries and displacing jobs – and is arguably fueling populist politics.

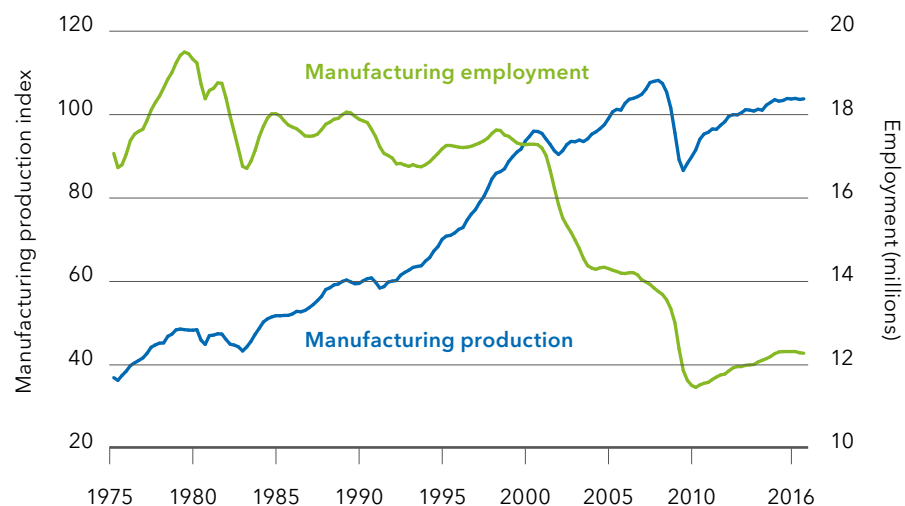


"Official data still understate productivity and don't fully account for technology's downward impact on prices."

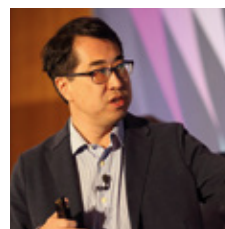
Rick Rieder – Chief Investment Officer,
BlackRock Global Fixed Income

Rise of robots

U.S. manufacturing production and employment, 1975-2016



Sources: BlackRock Investment Institute, Federal Reserve and U.S. Bureau of Labor Statistics, November 2016.
Note: The base year (100) for manufacturing production is 2012.

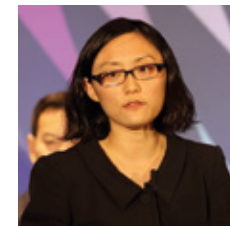


"Artificial intelligence (AI) is the new electricity. The big bang is upon us. We have all this data, but we can't do anything with it. AI is the solution."

Tony Kim – Portfolio Manager,
BlackRock's Global Opportunities Group

"Big data in China will exceed the U.S. China has 500 million smart phone users but only a 55% penetration rate. So there's a lot of upside."

Rui Zhao – Portfolio Manager,
BlackRock's Scientific Active Equity Team



Outlook Forum: China

China's stabilizing growth has eased some of the anxiety that rattled investors in early 2016. But it is partly the result of returning to an old habit: hefty lending to state-owned enterprises and local governments. China's debt-to-GDP ratio has surged to more than 200%. Never has a big economy piled up so much debt so quickly. See the *China credit conundrum* chart. Credit binges in the past often led to busts. Yet China is different in some ways. It has little external debt – the original sin that has sparked many an EM crisis. Beijing is working on fixes, such as turning short-term bank debt into long-term bonds and redirecting credit to the private sector and households. The longer China delays attacking the problem head-on, the greater the risk of accidents.

China is attempting a difficult balancing act: prioritizing near-term economic growth while tackling debt issues for the longer-term good.

Rising global rates and a stronger U.S. dollar are creating challenges for China. They are leading to capital outflows and a drain on reserves, pushing the yuan lower, while also contributing to higher local interbank rates. See the chart *Lurking yuan risks*. If China keeps running down reserves to smooth the yuan's drop, speculation may build that authorities will engineer a one-off large devaluation to stem capital outflows. This would likely have knock-on effects on other EM currencies and asset prices. We expect a further gradual decline in China's currency in 2017, but a large devaluation is not our base case. We are on the lookout for any signs of stress such as greater capital outflows, especially in case of increased trade frictions, or disruptions in China's fixed income markets.

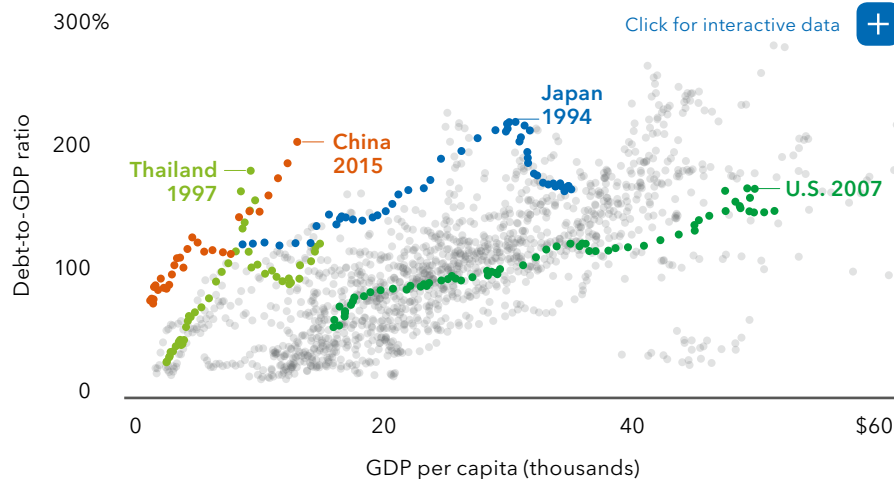


"The credit situation is a mismatch of supply and demand... It's a deeply embedded structural problem. Fixing it is not going to happen overnight, but it is starting to happen."

Helen Zhu – Head of BlackRock China Equities

China credit conundrum

Rise of non-financial private debt versus economic development, 1952-2015

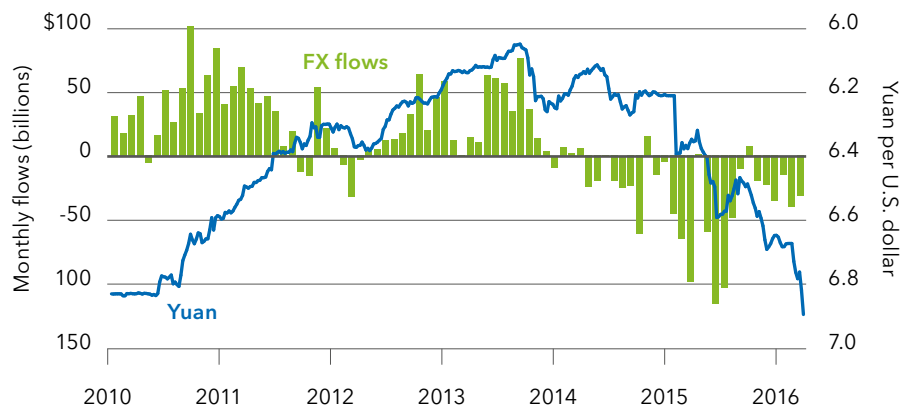


Sources: BlackRock Investment Institute, Bank for International Settlements and IMF, November 2016.

Notes: The dots plot private, non-financial debt as a share of GDP versus GDP per capita for 37 countries from 1952 to 2015. GDP per capita is shown in 2009 dollars at purchasing power parity. Some countries lack complete data.

Lurking yuan risks

China onshore foreign exchange flows and yuan, 2010-2016



Sources: BlackRock Investment Institute, Thomson Reuters, State Administration of Foreign Exchange and the People's Bank of China, November 2016.

Notes: Flows are a three-month moving average of three different gauges of net foreign exchange (FX) flows in mainland China: the People's Bank of China's FX on its monetary balance sheet, its foreign reserves and its measure of net FX settlements by commercial banks on the mainland. A negative number suggests net currency outflows, or buying of foreign exchange and selling of yuan.

Outlook Forum: risks

2017 is dotted with political risks that have the potential to shake up longstanding economic and security arrangements. The Trump administration's policies on trade and security remain question marks. Known unknowns include White House tweets that could spark an international misunderstanding or worse, and potential trade disputes. The UK has vowed to trigger its exit from the European Union by the end of March, starting two-year negotiations that will determine how much economic activity may be disrupted. See the *Dates with destiny* chart.

Elections in the Netherlands, France and Germany will show to what extent populist forces hostile to the EU and euro are gaining sway. At the same time, expectations are building for the Fed to step up the pace of rate increases after a stop-and-go-slow start. China's Communist Party will hold its 19th National Congress, at which Xi is expected to consolidate power.

2017 is shaping up to be another year of political risk. Rising populism has the potential to affect policy – with big implications for markets.

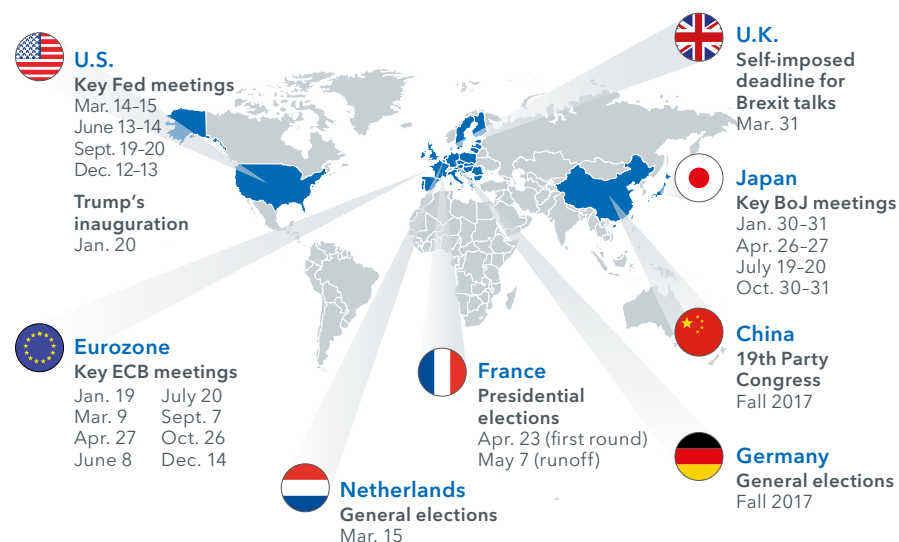
The trade-weighted U.S. dollar's surge to near-record highs raises the risk of tighter global financial conditions. Rapid dollar gains tend to cause EM currency depreciation, apply downward pressure on commodity prices and raise the risk of capital outflows from China. See the *Dollar headaches* chart. Also, about one-third of non-U.S. corporate debt is still issued in dollars, Barclays data as of November show, so a rising dollar squeezes debtors with local currency revenues. The dollar's gains have forced adjustments in EM economies and commodities (shrinking trade deficits and supply cuts), laying the groundwork for eventual recoveries.

We see the dollar modestly rising in 2017 as we expect the Fed to raise rates slowly and gradually in contrast with the still accommodative ECB and BoJ. A looming shake-up of the Fed's leadership in early 2018 is a wild card that we see markets focusing on as the year progresses.

A stronger dollar could lead to tightening global financial conditions, but so far EM assets and commodity prices have proved resilient.

Dates with destiny

Events and risks to watch in 2017

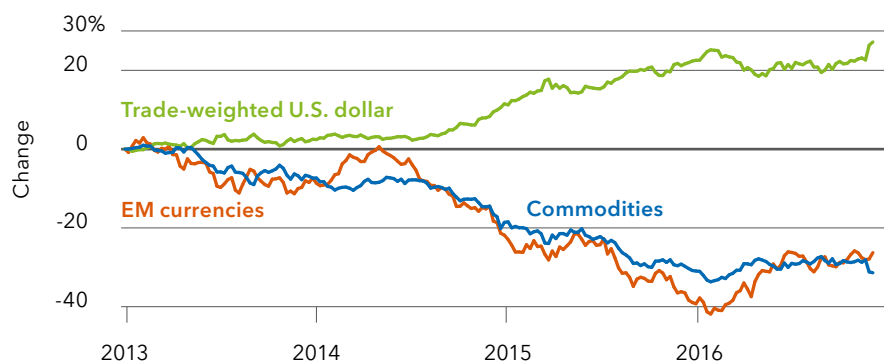


Source: BlackRock Investment Institute, November 2016.

Notes: The Fed and ECB meetings are those accompanied by press conferences. The BoJ events shown are followed by the publication of the central bank's outlook report.

Dollar headaches

Commodities, EM currencies and the U.S. dollar, 2013-2016



Sources: BlackRock Investment Institute, J.P. Morgan, Bloomberg and Thomson Reuters, November 2016.

Notes: The lines show the percentage change in each asset since the start of January 2013. Commodities are based on the Bloomberg Commodity Spot Index, EM currencies are based on the J.P. Morgan Emerging Markets FX Index and the U.S. dollar is based on the J.P. Morgan Broad Trade-Weighted Exchange Rate Index.

Government bonds

We prefer inflation-linked securities over nominal bonds as a global reflationary trend takes root. U.S. inflation expectations have bounced back from depressed levels, pointing to inflation settling at around 2.5% in the medium term. See the *Inflation protection wanted* chart. Eurozone inflation expectations have followed suit, but remain more subdued. We are cautious on inflation-linked debt in the short term after a recent spike in implied inflation rates – but see further upside in 2017. This includes UK inflation-linkers, which should benefit as weak sterling raises import prices and feeds through to higher headline inflation.

We do see some opportunities in nominal government bonds. These include selected peripheral eurozone sovereigns. We are underweighting French debt given market perception of a possible populist surprise in the country's 2017 election. We see the BoJ's target to keep 10-year Japanese government bond yields at zero helping to suppress bond yields globally.

We have a long-term preference for inflation-protected securities but see short-term risks as markets appear to have gotten ahead of themselves.

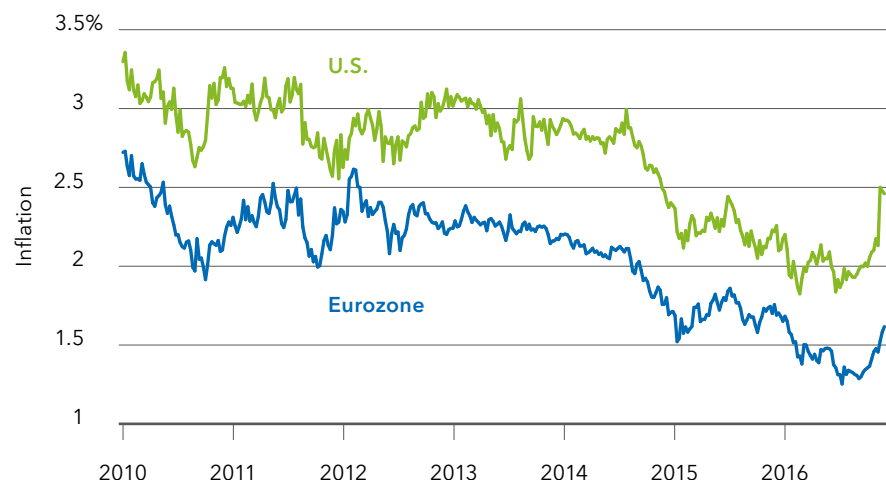
We see opportunities for income investors in the U.S. municipal bond market after a post-election sell-off. The yield premium of munis over corporate debt has risen to more than one percentage point for the first time since 2014. See the *Restoring the muni yield premium* chart.

Yet there are risks. The muni market saw large fund outflows in November, reversing course after steady inflows over the past year. Further outflows could pressure the market in the short term. Trump's planned personal income tax cuts would lower the effective value of tax-exempt interest income for investors in the highest tax brackets. This would make munis less attractive and could lead to a rise in yields. And any move to cap the amount of interest income individuals can claim as tax exempt – a feature of previous Republican proposals – would also hurt.

We see value in U.S. municipal bonds after a sharp sell-off, but potential tax reforms lowering the value of the tax exemption are challenges.

Inflation protection wanted

Medium-term inflation expectations, 2010–2016



Sources: BlackRock Investment Institute and Bloomberg, November 2016.

Notes: The lines show the market expectation for five-year forward inflation in five-years' time. Inflation expectations are based on five-year/five-year forward inflation swaps.

Restoring the muni yield premium

Yield spread between municipal and corporate bonds, 2012–2016



Sources: BlackRock Investment Institute and Bloomberg, Dec. 5, 2016.

Note: The chart shows the spread between the tax-equivalent yield (assuming a top effective marginal tax rate of 43.4%) of the Bloomberg Barclays U.S. Municipal Bond Index and the yield on the Bloomberg Barclays U.S. Aggregate Corporate Index in percentage points.

Credit

The rising U.S. dollar and prospect of greater trade protectionism have increased risks for EM debt. Yet some of this is in the price, with yields having shot up since the U.S. election. EM local and hard currency bonds still offer hefty yield premiums over U.S. Treasuries. See the *Emerging attractions* chart. We generally prefer hard-currency EM debt, and favor overweighting the higher-yielding sovereign debt of commodity exporters (beneficiaries of global reflation) – and underweighting lower-yielding EMs reliant on manufacturing exports (vulnerable to the risk of trade barriers). We are cautious on local-currency EM debt but see selected opportunities in countries that have potential for monetary easing. We also prefer corporate debt, which tends to have a shorter duration than EM sovereigns and offers greater insulation against the risk of global interest rate spikes.

We see opportunities in hard currency EM debt, but guard against the risk of global yield spikes, a further rally in the U.S. dollar or trade tensions.

We see stronger growth favoring credit over government bonds, and believe fixed income investors are being paid to take risk. Credit markets have a larger safety cushion than government bonds against the risk of further rises in interest rates. Yields are not as attractive as they were before the financial crisis, but look favorable in an otherwise low-yielding fixed income universe. See the *Credit attractions* chart. We prefer higher-quality names as credit spreads have recently tightened. Many investors have fled to floating-rate bank loans for insulation against rate rises, yet loan spreads are richly valued and floating rates already price in further Fed tightening.



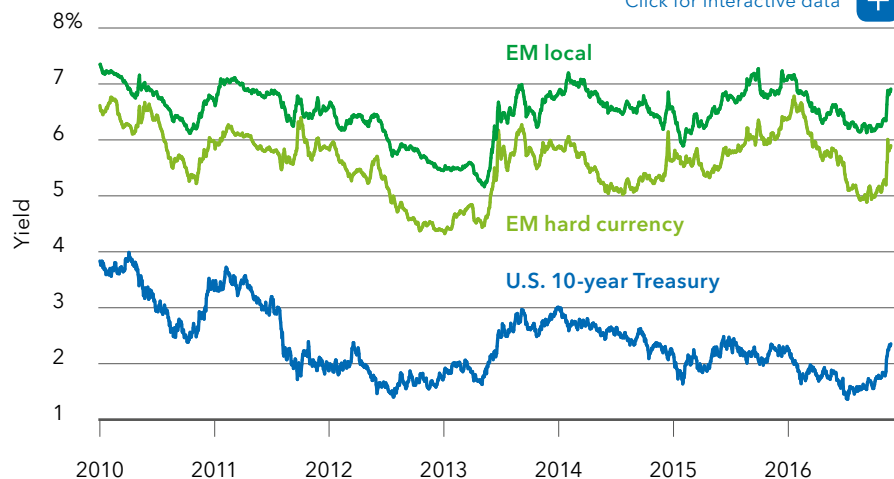
"2017 looks to be a multi-transition year. Expect some QE unwind, a shift to fiscal expansion from austerity and normalized volatility."

Sergio Trigo Paz – Head of BlackRock's Emerging Market Fixed Income

Emerging attractions

EM debt and 10-year U.S. Treasury yields, 2010-2016

[Click for interactive data](#)

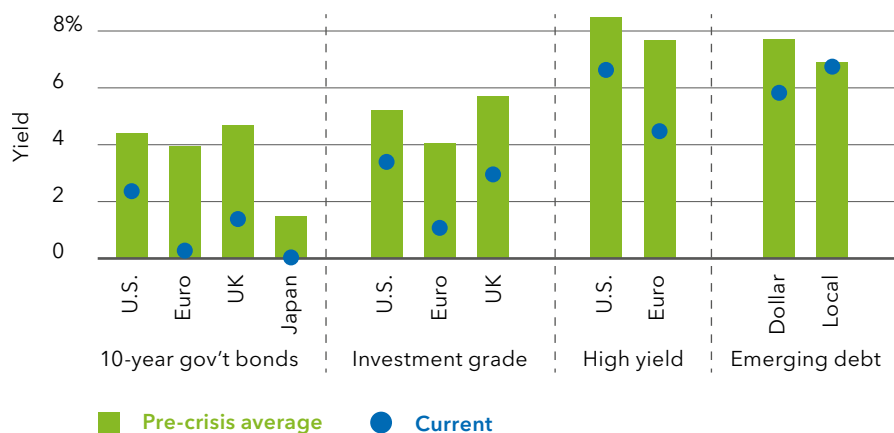


Sources: BlackRock Investment Institute, J.P. Morgan and Thomson Reuters, November 2016.

Note: EM local-currency debt is based on the J.P. Morgan GBI-EM Global Diversified Composite Index while EM hard-currency debt is based on the J.P. Morgan EMBI Global Diversified Composite Index.

Credit attractions

Selected asset yields: current vs. pre-crisis average



Sources: BlackRock Investment Institute, Thomson Reuters, Bank of America Merrill Lynch and J.P. Morgan, December 2016. Notes: The pre-crisis average is based on the five-year period before the financial crisis (2003-2008). Corporate bonds are based on Bank of America Merrill Lynch U.S. Corporate Master, Euro Corporate, UK Corporate, U.S. High Yield Master and European High Yield indexes. Emerging debt dollar is based on the J.P. Morgan EMBI Global Diversified Index; EM local is based on the J.P. Morgan GBI-EM Diversified Index.

Equities

U.S. and emerging market companies are leading a global revival in earnings expectations. See the *Earnings hopes spring eternal* chart.

We see earnings growth and further rotation into big sectors such as financials underpinning a U.S. market advance in 2017, but are cautious in the short run after inflows surged and indexes set records. We like EM equities, based on global reflation, improving domestic economies and low valuations. Risks are further dollar strength and trade disputes.

We are neutral on European stocks. We see the weaker euro and global reflation as positives for exporters and cyclical but are wary of political, policy and trade risks.

We are overweight Japanese equities for now due to the weaker yen, improving global growth and potential earnings upgrades.

We see rising earnings estimates supporting most equities in 2017.

We see a sustained big sector rotation out of bond proxies and into reflation beneficiaries such as value stocks. The second half of 2016 has been a mirror image of the first, with the rotation gathering steam since the U.S. election in November. See the *Accelerating rotation* chart.

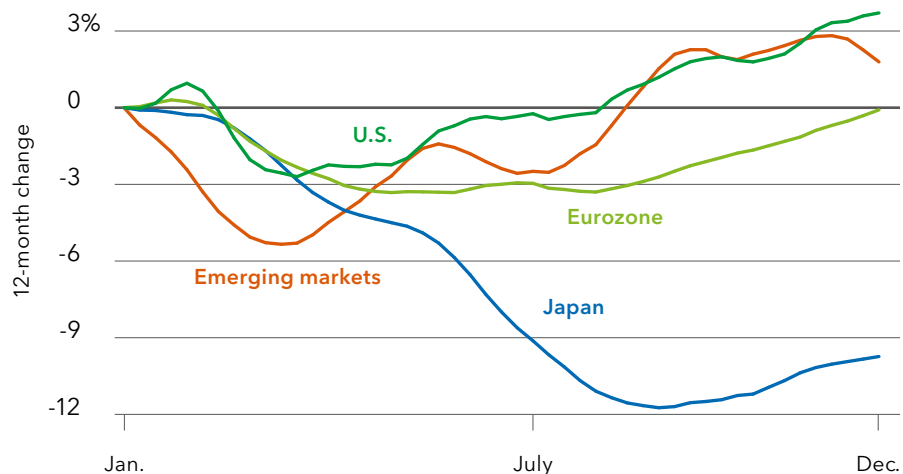
We see a steeper yield curve and the prospect of loosening regulation as positive for U.S. financials, especially regional banks. We also see opportunities in the U.S. health care sector such as selected biotechs. Health care stocks look cheap, reflecting ongoing downward pressure on drug prices and uncertainties over a potential dismantling of Obamacare, but we see long-term growth in demand.

We recognize a risk of temporary pullbacks but believe the rotation into cyclical and value stocks can push the broad U.S. market to positive returns in 2017. For income, we like dividend growers because they have historically held up better than higher-yielding dividend stocks when yields rise.

We like U.S. regional banks, selected health care stocks, as well as companies able to expand their dividend payouts over time.

Earnings hopes spring eternal

Changes in U.S., eurozone, Japan and EM earnings estimates, 2016

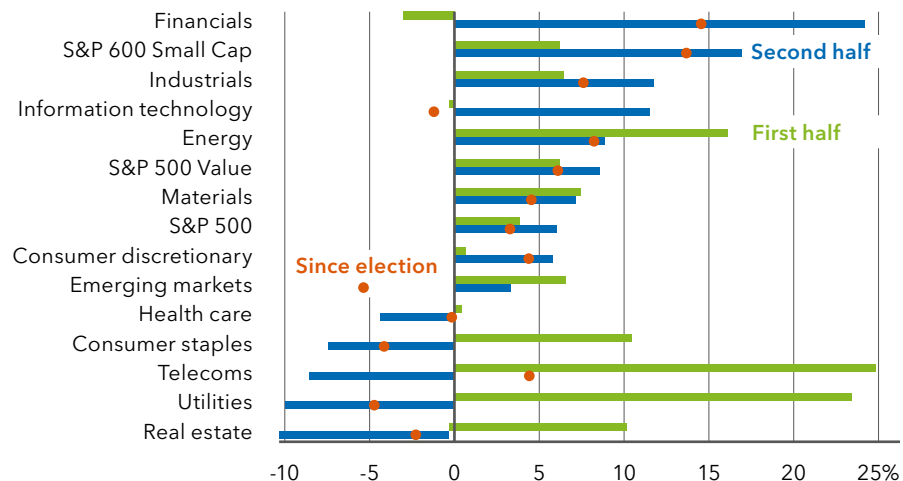


Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, Dec. 2, 2016.

Notes: The lines show the change in 12-month earnings estimates for the MSCI U.S., Emerging Markets, EMU and Japan indexes. The estimates are rebased to zero at the start of January 2016.

Accelerating rotation

U.S. equity sector and EM performance, 2016



Sources: BlackRock Investment Institute, S&P, MSCI and Thomson Reuters, Dec. 5, 2016.

Notes: The bars show total returns for a range of S&P 500 indexes and the MSCI Emerging Markets Index for the first half of 2016 (green) and the second half to date (blue). The dots show returns since the U.S. election on Nov. 8.

Assets in brief

Views on assets for Q1 from a U.S. dollar perspective

Asset class		View	Comments
Equities	U.S.	—	A shift toward fiscal expansion and deregulation are supportive, but uncertainties about the timing and implementation abound. Valuations are elevated. We like value, financials, health care and dividend growers.
	Europe	—	Euro weakness, signs of global reflation and ultra-easy ECB monetary policy support cyclical and exporters. Uncertainties abound, however, including Brexit, upcoming elections and future U.S. trade policy.
	Japan	▲	Positives are a weaker yen, improving global growth and more shareholder-friendly corporate behavior. We see the BoJ anchoring 10-year yields near zero as supportive. Risks are renewed yen strength and rising wages eating into margins.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks, we believe. Reflation and growth in the developed world are another positive. Risks include shifts in currency policies and trade conflicts.
	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 Southeast Asian markets.
Fixed income	U.S. government bonds	▼	A reflationary outlook challenges longer-term bonds. Shorter-term bonds should benefit from a slow path of Fed rate rises. We prefer TIPS over nominal debt. Agency mortgages look pricey, but duration risks are mostly reflected in higher yields.
	U.S. municipal bonds	—	Fund outflows and potential tax reforms that could reduce the attractiveness of munis' tax exemption are challenges. Yet we believe a recent cheapening of valuations mostly reflects these risks.
	U.S. credit	▲	Stronger growth favors credit over Treasuries. We generally prefer up-in-quality exposures and investment grade bonds due to elevated credit market valuations. Floating-rate bank loans appear to offer insulation from rising rates but we find them pricey.
	European sovereigns	—	We prefer selected peripheral bond markets due to higher yields and ECB support. Upcoming elections in France and Germany keep us neutral.
	European credit	—	Elevated valuations keep us neutral. Steepening yield curves and rising bank share prices should bolster the outlook for selected financials, including subordinated debt, but Italian banking sector woes pose a risk.
	EM debt	▲	Economic reflation should benefit EMs. Risks include a rising U.S. dollar and global rates, threats to free trade and China's currency policy. Yet valuations reflect much of these risks, and we see selected opportunities, mostly in hard-currency debt.
	Asia fixed income	▲	Muted net issuance and positive fundamentals such as stabilizing leverage support Asian hard-currency credit despite challenging valuations. Any U.S. policy shifts that dampen global trade would pose a risk to export-dependent EMs.
Other	Commodities and currencies	—	Supply rationalization and reflation are underpinning oil and industrial metals in the near term. We see the U.S. dollar strengthening, especially against the yen and EM currencies, on stronger growth expectations and interest rate differentials.

▲ Overweight — Neutral ▼ Underweight

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