Investment directions
The good, the bad and the ugly

The good
We enter the last few months of 2017 in a relatively decent position. As BlackRock’s Chief Equity Strategist Kate Moore noted recently, the global economy is in a “Goldilocks” moment, with strong enough growth to bolster markets, but not too hot to trigger greater monetary tightening by central banks. Equities have performed well this year, including outside the United States, and surprisingly, so have many bonds, which have avoided another “taper tantrum.”

The bad
However, many investors seem nervous. Some question valuations in the United States after an eight-year rally. (We believe valuations are not as stretched as they appear, and stocks still look attractive relative to bonds.) Others may believe that spikes in volatility like we saw earlier in August will be more commonplace, given the unusually long period of low volatility we’ve enjoyed. (We believe a more sustained correction will occur when we detect signs of a recession coming, which we are yet to see.)

The ugly
Still, there is no shortage of potential black swan events that could rattle markets. Escalating tensions with North Korea are obviously a major concern. In Washington, meanwhile, it appears that an increase to the debt ceiling and funding for the government will go through, but on a short-term basis, setting the stage for another showdown in a few months. With the additional fight over immigration legislation to address the Deferred Action for Childhood Arrivals (DACA) program, this may potentially create headwinds for tax reform, passage of which the markets have been eager for.

For a few dollars more
Nonetheless, none of this backdrop leads us to change our positioning. We prefer stocks over bonds, but are neutral U.S. stocks, while overweight equities outside the United States, specifically Europe, Japan and emerging markets. However, we still favor a strategic position in bonds, which can help provide ballast and act as a vital diversifier in times of turmoil.

What’s new
• Budget and debt: Delaying until December - p. 10
Overview
Earnings momentum has been strong against a positive economic backdrop. Still, valuations are expensive and selectivity is important in the U.S. market, where value will vary by sector and individual company.

Consider
Active mutual funds
- Equity Dividend Fund (MADVX)
- Mid-Cap Growth Equity Fund (CMGIX)
- Science & Technology Opportunities Fund (BGSIX)

ETFs
- iShares Core Dividend Growth ETF (DGRO)
- iShares Edge MSCI USA Value Factor ETF (VLUE)
- iShares Edge MSCI USA Momentum Factor ETF (MTUM)

United States
We are neutral on U.S. stocks. We maintain a preference for technology and financial stocks as well as the value and momentum factors. We prefer stocks offering dividend growth over those with high payout ratios, debt burdens or both. Before earnings season arrives, analysts remain fairly constructive on U.S. stocks. Estimates for full-year earnings are little changed, and earnings growth expectations into 2018 do not seem under threat either. Stocks enter the final quarter of the year with solid returns, which few expected to come so fast, and a resilience that many doubted would last in the face of much macro disquiet. Late summer is a period normally quiet for stock-specific drivers, but a variety of difficult “one-off” scenarios have emerged for the market to discount. Among them: a devastating flood in the nation’s fourth largest city, the potential for a government shutdown and debt default, conflict with North Korea, and the Federal Reserve (Fed) unwinding its historic program of quantitative easing.

Still, the economy has remained resilient, if not stubbornly devoid of new developments, especially with regard to inflationary pressures. Rising wages will be this Fed’s white whale as the economy is lurching past its estimates of full employment. September’s Summary of Economic Projections will also bear close watching as the Fed embraces forecast dependency over the incoming data. The dots for 2018 and 2019 will have to reconcile with a market that isn't convinced that a December rate hike will occur. And while many characterize much of the current market backdrop as difficult, we continue to find the economy less vulnerable than many would state. This drives our view that the current low volatility regime is likely to persist and not revert to some long-run average as long as the economy remains resilient.

U.S. private payrolls and unemployment

![Chart showing U.S. private payrolls and unemployment](chart.png)

Sources: Thomson Reuters Datastream, BLS, BlackRock Investment Institute, September 5, 2017.
International developed markets

We remain overweight eurozone equities. In the upcoming months, focus will be on the European Central Bank (ECB), which may announce tapering of its quantitative easing program. Although inflation is still below the ECB’s 2% target (July’s final reading came in at 1.3% year-over-year), eurozone growth has remained resilient and the bond scarcity issue is becoming increasingly pressing. The euro has been strengthening on expectation of the announcement, particularly after ECB President Draghi did not comment on the euro direction at the Jackson Hole symposium. Nevertheless, we remain positive on eurozone equities. We expect any ECB tapering announcement to have a dovish tone in order to prevent tightening of financial conditions. The euro strength has overshot in the near term, in our view, and could be further countered by potentially hawkish Fed repricing later in the year, which could lead to the euro stabilizing in the near term. The political environment remains supportive as well: Although Italian elections next year could drive volatility, the key eurozone event of 2016—German elections—represents little risk for markets, with Merkel’s party firmly leading in polls.

Despite some reversal from the elevated levels at the start of the year, eurozone PMIs remain firmly in expansion territory
Overview
We favor broad European and Japanese equities, but selectivity is key.

Consider
Active mutual funds
• Global Allocation Fund (MALOX)
• Global Dividend Fund (BIBDX)
• International Fund (MAILX)

ETFs
• iShares MSCI Eurozone ETF (EZU)
• iShares Currency Hedged MSCI Japan ETF (HEWJ)
• iShares MSCI Canada ETF (EWC)

We are overweight on Japanese stocks. The macro conditions are favorable for investors in Japanese equities, with strong growth, low inflation, supportive monetary policy, and a favorable earnings backdrop (as confirmed by the recent quarterly corporate survey conducted by Japan’s Ministry of Finance). Yet Japan is always a globally susceptible investment, and the global headwinds are building. This is manifested in the form of yen strength, a result of it continuing to act as a perceived safe haven investment. With tensions building with North Korea, there is a near-term anchor on risk sentiment. Despite this, data remains strong as the manufacturing and consumer sectors are expanding and the labor market continues to tighten. Wage growth is expected to follow, but is considered a necessary ingredient to help augur the ever-elusive inflationary gains that Abenomics have long touted.

Japan wage growth

Sources: Thomson Reuters Datastream, BlackRock Investment Institute, September 5, 2017
We remain cautious on U.K. equities. Summer offered little respite from the ongoing Brexit saga as often contradictory headlines continued throughout August. However, we learned one important lesson last month: Be wary whenever Theresa May goes hiking. Last time, she came back with a grand plan to call an election in order to secure a stronger parliamentary majority, which drove volatility in GBP markets. This time, pro-leave and pro-remain cabinet ministers launched a campaign to secure a robust transition period in order to prevent a “cliff-edge” scenario. Still, the details of any transition period remain sparse and negotiations with the EU appear to be making little progress. Watch out for FX volatility, with GBP being a barometer of Brexit sentiment, which advocates for currency hedging any exposure to GBP. Meanwhile, the fundamentals offer a slightly better picture with stronger-than-expected retail sales and average earnings. Still, business investment has dropped, house prices have faltered and inflation remains at such a level that real incomes have continued to shrink.

Real wage compression

![Graph showing real wage compression](source: Bloomberg, as of September 1, 2017)

Canada's leading position among developed economies during 2017 stands in stark contrast to its lagging equity markets. Real GDP growth raced ahead at a 4.5% pace during the second quarter, following its 3.7% increase during the first quarter. Consumer spending remained resilient, despite high household debt loads and efforts to cool overheated housing markets in Toronto and Vancouver. Although inflation is currently well contained, the strong pace of economic activity reinforces the Bank of Canada's decision to raise rates in July and again in early September. Second-quarter earnings were likewise resilient, especially among the country's largest banks. Although economic activity is likely to moderate somewhat, Canada's equity market underperformance is increasingly disconnected from fundamentals. In our view, cheaper valuations for Canadian stocks suggest some catch up is warranted alongside decent economic activity, stable oil prices and solid earnings growth.
Overview
The broad outlook remains positive for emerging markets, but investors should be aware of the risks and remain very selective.

Consider
Active mutual fund
- Total Emerging Markets Fund (BEEIX)

Emerging market equity ETFs
- iShares Core MSCI Emerging Markets ETF (IEMG)
- iShares Edge MSCI Min Vol Emerging Markets ETF (EEMV)

Country equity ETFs
- iShares MSCI China ETF (MCHI)
- iShares MSCI India ETF (INDA)
- iShares MSCI Mexico Capped ETF (EWW)

Emerging markets
We remain overweight emerging market equities. Emerging markets have remained resilient against heightened geopolitical risk and the tensions with North Korea. Macroeconomic volatility remains low as global growth remains broad-based and steadily above trend. A rebound in global trade has also helped support emerging markets growth. Shorter-term drivers have also been supportive, including a weaker U.S. dollar and strong inflows. While the ECB and Federal Reserve are each reaching an important inflection point, emerging market current account balances have improved over the past few years and are now less exposed to tighter global monetary conditions. Valuations are still the lowest among the global equities, and many investors remain largely underweight relative to developed markets. That said, we see this as a potentially attractive entry point for investors. From a regional perspective, we favor Asian countries committed to longer-term reform agendas.

Global GDP growth: EM and DM divergence

Sources: Thomson Reuters and International Monetary Fund, as of September 1, 2017. Developed and emerging markets are represented by IMF classifications.

We maintain an overweight to China. The 19th National Congress of the Communist Party of China will convene this fall, at which President Xi Jinping is widely expected to consolidate his power. The leadership change is expected to bring a greater focus on economic stability by rebalancing the economy away from the credit-fueled, rapid pace of growth toward a more sustainable growth path. Supply-side capacity cuts and structural reforms to state-owned enterprises (SOEs) illustrate the government’s commitment to stable, long-term growth. Some supply-side reforms have actually been supportive of near-term growth, including capacity cuts that have helped lift producer prices from a multi-year downturn and increased industrial corporate profits. The need to rebalance China’s economy warrants close monitoring of longer-term reform efforts, including restructuring and deleveraging of the SOEs.
We hold a strategic overweight in Indian equities. The immediate impact of Prime Minister Narendra Modi’s reform agenda has been mixed. Demonetization is proving to be particularly challenging as recent figures show business conditions weakening and consumption softening. While the Goods and Services Tax implemented in July will increase the overall tax base, helping to support fiscal dynamics in the long run, its immediate impact on consumption presents some near-term challenges. The deceleration in second-quarter GDP to 5.7% from 6.1% the prior quarter highlights the near-term reform drag on growth. However, equity markets have remained resilient and focused on long-term growth prospects. Whether the public remains committed to Modi’s vision during this period is another concern and a risk to keep in mind. Nevertheless, the post-reform era may lead to equity volatility, potentially providing an attractive entry point for strategic positions.

We maintain a neutral position in Mexico. Since the post-U.S. election selloff, Mexican assets have sharply recovered, particularly the peso, which is up 17% year-to-date against the U.S. dollar. The FX selloff raised inflation, yet after a series of rate hikes, inflation appears to have plateaued, leaving room for the central bank to potentially relax policy in the coming months. GDP has also surprised to the upside for two straight quarters and 2018 expectations were recently raised. On the equity side, 15% year-over-year forward-looking earnings estimates paint a potentially favorable picture, yet much of this positive news appears to be priced in at the moment. Ongoing NAFTA negotiations and Mexican elections may increase volatility, potentially opening a more favorable entry point. The key NAFTA issues to watch include modifications to the “rules of origin” of goods, the scope of industries included and labor regulations.

Mexico rebounding

Source: Thomson Reuters, September 1, 2017. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.
Overview
With interest rates still at historic lows in the United States, fixed income investors continue to face challenges in their bond portfolios in managing interest rate duration and interest rate risk, as well as in seeking income or building a diversified core.

Consider
Active mutual funds
- Total Return Fund (MAHQX)
- Strategic Income Opportunities Fund (BSIIX)
- Multi-Asset Income Fund (BIICX)
- Strategic Municipal Opportunities Fund (MAMTX)

ETFs
- iShares Core U.S. Aggregate Bond ETF (AGG)
- iShares Core Total USD Bond Market ETF (IUSB)
- iShares iBoxx $ Investment Grade Corporate Bond ETF (LQQK)
- iShares National Muni Bond ETF (MUB)
- iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB)

Fixed income
We remain underweight U.S. Treasuries, but are mindful of the purpose that they serve as diversification against risk assets. To that end, Treasury yields fell over the past month (with the 10-year finishing at 2.11% versus 2.25% at the beginning of August) due to a combination of geopolitical fears and subdued inflation. This month, the Fed is likely to announce that it will begin to reduce reinvestment of cash flows and maturity proceeds from securities that it is holding in October. Should this occur, there could be some upward pressure on interest rates in anticipation of the increase in bond supply. That said, we continue to believe that the Fed will increase short-term interest rates in December. Despite stubbornly anemic CPI growth, we continue to favor TIPS over Treasuries with a view that a tightening labor market will ultimately manifest in broader-based, albeit relatively contained, inflation.

10-year Treasury yields (5/31 - 8/31)

Source: Bloomberg, as of August 31, 2017. Past performance does not guarantee future results.

We are underweight non-U.S. developed market bonds, but believe that some allocation is necessary given the potential for increasing volatility in risk assets. Longer term, developed market debt has continued to trade at tight valuations while growth prospects have continued to improve, setting up the potential for a correction in the form of higher yields. However, geopolitical risk is on the rise, which could keep rates contained over the near term.
We maintain a benchmark weight in high yield. Although high yield has been an excellent source of income, we remain concerned about valuations as spreads have remained near multi-year tights and volatility in risk assets is now increasing. Longer term, improving economic prospects leave us less concerned about a potential turn in the credit cycle.

We remain overweight investment grade corporates. Despite spread widening in August, we believe that the economic backdrop should continue to be supportive. Within investment grade, we also highlight floating rate debt, which allows investors to directly benefit from Fed tightening.

We remain neutral on municipal bonds. Municipals continued to perform well in August, with the broad S&P National Municipal Bond Index returning 85 bps. Supply technicals continue to be favorable and, although tax reform is still possible this year, prospects for radical change seem low. Accordingly, valuations remain high in our view.

We maintain a benchmark weight in U.S. agency mortgages. Agency MBS had their best month of the year in August with returns of 73 bps bringing year-to-date performance to 2.55%, as of August 31, 2017. However, given the recent decline in longer-term interest rates, as well as the uncertainty surrounding Fed balance sheet normalization, we believe a benchmark weight continues to be warranted.

We maintain a neutral position on emerging market bonds. Global growth should benefit EM debt generally, even in light of central bank policy tightening. However, there are some areas for concern, particularly Venezuela, which is facing sanctions on newly issued debt.
Budget and debt: Delaying until December

As of this writing, it appears that the Trump administration and U.S. legislators have reached agreement on a bill that would pay for hurricane relief, along with a continuing resolution to fund the government and increase the debt ceiling until December 15. Even before that announcement, the odds of a government shutdown and/or a default had been diminishing, especially given the need for disaster relief providing an impetus for quick action.

However, merely delaying until December is not a resolution of the matter. Although we continue to believe a government shutdown or default is unlikely, it is important to note a number of points regarding the ongoing negotiations over the budget and debt ceiling that will continue to simmer, which could potentially have market implications.

First, President Trump has not changed his insistence that a spending bill include funding for a U.S./Mexico border wall. The additional priority of the immigration issue addressing the Deferred Action for Childhood Arrivals (DACA) program, which some legislators could tie to budget negotiations, adds another wrinkle. There is a possibility that the Affordable Care Act (ACA) might still disrupt negotiations on both sides of the aisle. One consequence of all this is that, although these issues are not tied directly to tax reform, the backlog of legislation creates a headwind to addressing tax reform.

Even before the agreement, equity markets had shown little concern about the budget or debt ceiling. However, there was a notable impact on short-term Treasury bills. The chart below shows the yield curve for Treasury notes with durations from one month to one year. One day before the agreement (September 5) the yield for the one-month bill was higher than that of the one-year bill, indicating significant nervousness about the very short term. After the announcement on September 6, short-term yields dropped, while the one-year rose.

Nonetheless, although we don’t believe a government shutdown or a debt ceiling fiasco in December is likely, should one occur, it could cause short-term volatility, but also could present opportunities for long-term investors.

What a difference a day makes

Short-term Treasury bill yields before and after agreement to fund government and lift debt ceiling until December

Source: Bloomberg, as of September 6, 2017 Past performance does not guarantee future results.
Drilling down: Equity and fixed income outlooks

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- **Underweight:** Potentially decrease allocation
- **Neutral:** Consider benchmark allocation
- **Overweight:** Potentially increase allocation

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