Investment directions

Enigmas

Riddles and mysteries
Winston Churchill famously described Russia as “a riddle, wrapped in a mystery, inside an enigma.” Without getting into current relations with Russia, it does strike us that markets these days are similarly shaped by a number of conundrums.

Is historically low volatility a danger?
The current period of historically low volatility has resulted in some anxiety—many assume it’s only a matter of time before volatility spikes and a painful reversal occurs. However, a fascinating new paper by BlackRock’s Jean Boivin and Ed Fishwick notes that low-volatility regimes can last for years and a switch occurs when signs indicate a recession is nearing. But the global economy remains in a regime of steady, synchronized and above-trend growth.

Time to de-risk?
While concerns about valuations and sustained low volatility have led some to wonder if markets are too risky, we see a risk that many investors are not putting their cash to work. Indeed, BlackRock’s Investor Pulse survey found Americans hold 58% of their investable assets in cash where they earn little or no interest.

Do valuations matter?
Meanwhile, U.S. stocks are expensive by many measures. However, the economic backdrop is positive and earnings are strong—as of this writing, 77% of the S&P 500 have beat earnings forecasts. Still, we are neutral U.S. stocks, while overweight equities outside the United States, specifically Europe, Japan and emerging markets.

What rising rates?
Will interest rates ever rise? Since the Federal Reserve (Fed) began its current tightening, the path to higher rates has not been steady and smooth. Going forward, we expect the Fed will continue to be patient in raising rates with the next increase in December. Still, the market is not sufficiently pricing in what the Fed is likely to do, or the potential risks of the Fed slowing its asset purchases. All of this underscores our preference for equities over fixed income.
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 (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. Within the United States, we are positive on the momentum and value factors, the tech and financials sectors, and dividend growers. The U.S. expansion continues to chug along and the Federal Reserve hasn’t upset the apple cart. But the persistence of low inflation and the inability to pinpoint how much slack remains from the great recession mean that its path forward carries some risk. Balance sheet reduction is next on the agenda, and economic data certainly seem supportive for the Fed to proceed with a slow and predictable shedding of assets acquired during the QE era. However, the market seems to need convincing to actually price in another hike in December, as consensus forecasts—as well as our own—suggest. In such an environment of resilient economic footing and gradual expansion, the backdrop for stocks remains supportive and our research on volatility regimes suggests further support for momentum and value stocks. Earnings-per-share growth is now running at a double-digit pace year-over-year for a second consecutive quarter, and surprises on top and bottom lines are at the healthiest level in years. Still, much of this optimism is priced in, even with 72% of companies beating on earnings and only 24% missing on revenues (at time of writing). Price action in the session following a report bears this out, as double misses (earnings and revenues) have been whacked for 5.5%, while double beats only rewarded less than 0.05%. Such is life at all-time highs.

Regional equity earnings since 2006

Sources: Thomson Reuters Datastream, IBES, August 8, 2017.
Notes: The U.S. is represented by the S&P 500, eurozone by the MSCI EMU Index, emerging markets by the MSCI EM Index, and Japan by the MSCI Japan Index. Index returns are for illustrative purposes only. Index performance returns do 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.
International developed markets

We remain overweight eurozone equities. European Central Bank (ECB) President Mario Draghi took the stage in July amid heightened expectations for clarity on plans to reduce the ECB’s extraordinary stimulus. However, he continually pointed to greater detail in the autumn, stating that the timing was being kept deliberately open, which buys more time for inflation, particularly core, to pick up as low levels continue to be a thorn in the ECB’s side. We believe that the ECB will likely finish its asset purchase program by the end of 2018. Macro data have continued to perform well—in line with a view of sustained economic expansion—as PMIs and economic sentiment indicators have held up well in the face of a strengthening euro. With the euro rallying 13% against the dollar year-to-date, earnings have been a muted affair in the second quarter for the eurozone. The beats rate is subdued compared to the United States (56% vs. 76%) and downgrades have become more common as analysts have focused on the stronger euro. EPS growth is still higher than in the United States (11% vs. 10%), an important historical driver of eurozone equity outperformance, but only just. That said, even with strong performance year-to-date and slight downward revisions in still-positive earnings, eurozone equities remain good values compared to developed market counterparts such as the United States (see chart below) and we continue to see them as an attractive opportunity moving forward.

U.S. and Europe 12-month forward P/E ratio, 1992-2017

Notes: Indexes used are MSCI USA and MSCI Europe. Index returns are for illustrative purposes only. Index performance returns do 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
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 remain positive on Japanese equities. As Japan is set to equal the longest winning streak in stocks since the 1980s, it is unsurprising that the run has coincided with one of the most stable political backdrops in the post-Asia crisis era. Prime Minister Shinzo Abe’s second term is already longer than his five predecessors. As the next critical election nears in 2018, politics could begin to play an even larger role. Still, the economic bounce back and strength are arguably more important than the political backdrop for equity performance at this point, along with a global trade recovery. We therefore see several reasons for continuing to support Japanese equities, including attractive valuations, a still-improving earnings outlook, and continued Bank of Japan accommodation. Political risks appear overblown for now, in our view, and strong fundamentals are likely to prevail. Japan’s competitive export position and improving domestic fundamentals may continue to support the earnings growth at home and abroad, while the risks of yen strength appear limited.

Japan Tankan survey

Sources: Thomson Reuters Datastream, BlackRock Investment Institute, August 4, 2017.
We remain cautious on U.K. equities. Recent focus in the United Kingdom has been on the Bank of England (BoE) and the tough position it has been facing with its rates decisions, reflected by a divided Monetary Policy Committee (MPC). Rising inflationary pressure, with CPI numbers running above the bank’s target, helps support the case for a rate hike, but an uncertain economic environment with lack of clarity on the government’s vision for Brexit and a view that the recent inflationary surge is transitory argue for patience with rates. The latest uptick in retail sales data, following a large post-Brexit drop, has removed some of the near-term pressure, as has the departure of a “hawk” from the MPC. But arguably most important has been the drop in the GBP, and future GBP direction will likely remain dependent on the BoE, which will in turn depend on the trajectory of economic data, but beware ongoing Brexit developments. This GBP volatility means investors could consider a currency hedged approach to investing in U.K. equities.

A tale of two trends: GBP and U.K. inflation

Canadian stocks appear poised for a comeback during the back half of 2017 after underperforming the S&P 500 by roughly 10 percentage points during the first half of the year in local currency terms. The factors leading to the sharply weaker performance of Canadian stocks could potentially help with the turnaround: valuations, oil prices and sector exposures. Since the start of the year, 12-month forward price-to-earnings ratios for Canadian stocks have turned lower and now rest at a healthier discount relative to the U.S. market. Moreover, much of the weakness in energy prices has already been reflected in downward revisions to Canadian earnings, implying less pressure on forward-looking multiples. To the extent that oil represents less of a headwind for the energy sector—the second largest equity sector behind financials in Canada—then the prospects for Canadian stocks should brighten somewhat.
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 Brazil Capped ETF (EWZ)
• iShares MSCI Mexico Capped ETF (EWW)

Emerging markets
We remain overweight emerging market equities. July marks the sixth consecutive month of positive performance—making it the longest such streak since 2014. The synchronized global recovery and dollar weakness have been constructive. Concerns over tighter credit conditions in China leading to a broad deceleration also appear to have faded—at least for the time being—helping improve investor sentiment. Furthermore, a benign volatility environment has been supportive of risk assets. On the corporate fundamentals side, a constructive earnings backdrop and stronger revenue growth driven in part by the uptick in global growth further strengthen our view. While the culmination of these factors has led to strong inflows year-to-date, valuations remain attractive relative to developed markets, suggesting a favorable entry point. We continue to favor India, China, and select Southeast Asian markets.

A weaker dollar supports EMs

Source: Bloomberg, as of June 30, 2017. Indexes used are MSCI Emerging Markets Index and MSCI World Index. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

We maintain our overweight to Chinese equities. China is walking a tightrope where the acceleration of growth must be carefully moderated. The People’s Bank of China implementing reforms to minimize credit dependency initially caused investor concern, as data on the manufacturing side came in softer than in past quarters. But July export figures were constructive due to steady demand from growth abroad, which we believe will continue. In addition, a recent uptick in corporate profits among more levered sectors of the Chinese market should help alleviate some dependency on external credit. That said, we remain constructive on the economy despite some recent weakness in data but underscore that commitment to reforms and stable global market conditions are paramount. From an equity perspective, we continue to
see potential opportunities in what is an underowned asset class and see the future inclusion of A-shares into MSCI indexes as a positive sign for equity markets.

**China: Recent softening**

![PMI level chart for CH NBS purchasing managers index for manufacturing SADJ, CH NBS PMI manufacturing - new order index SADJ, and CH NBS PMI manufacturing - new export orders index SADJ](chart)

Source: Bloomberg, as of June 30, 2017.

**We hold a strategic overweight in Indian equities.** Commitment to government reforms and progress toward a more service-based economy underpin our long-term view. Yet the implementation of the Goods and Services Tax in July had an immediate and considerable impact on the economy. Both PMIs and services sector activity significantly deteriorated post-implementation, some of which was to be expected as companies must quickly work to align with the new tax framework. While disruptive in the interim, we see such reforms increasing government revenues and leading to a higher tax-to-GDP ratio over time. A constructive backdrop for future rate cuts and a fruitful monsoon season may also be positive tailwinds for near-term growth. We continue to believe investors should consider building a strategic position in Indian equities, finding potentially attractive entry points while markets adjust to the reform era.

**We hold a neutral view in Brazil.** While President Michel Temer’s corruption scandal is likely to weigh on sentiment, he appears to have rallied enough support to survive an impeachment trial for now. Most importantly, he can move forward with fiscal and labor reforms, which are critical to shaping the economic outlook. Fiscal reforms have helped control inflation dynamics, allowing the central bank to continue its easing cycle, which now totals 500 basis points (bps), or five percentage points, in interest rate cuts. Still, market activity has been rather sanguine, although, as recent history has shown, political disruptions can cause considerable market shifts, underscoring the importance of future stability and commitment to the reform agenda. As such, we take a more cautious view, as the lingering political uncertainties are not fully put to rest.
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
- Strategic Income Opportunities Fund (BSIIX)
- Total Return Fund (MAHQX)
- 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 (LQD)
- iShares National Muni Bond ETF (MUB)
- iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB)

Fixed income

We remain underweight U.S. Treasuries. Treasury yields continue to be range bound, with the 10-year hovering between 2.20% and 2.40%. The economic data have been decidedly mixed with job and wage growth continuing to improve, but overall inflation disappointing. Nonetheless, the Fed is likely to announce normalization measures (i.e., reducing and eventually ceasing to reinvest cash flows and maturing proceeds of securities they are holding) in September and commence with those measures as early as October. Away from balance sheet normalization, we believe that the next rate hike is not likely until 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.

The path to higher rates?

We are underweight non-U.S. developed market bonds. Developed market debt continues to trade at tight valuations while growth prospects, particularly in Europe, continue to improve, setting up the potential for a correction in the form of higher yields. That said, Brexit uncertainty continues to loom over both the United Kingdom and the continent, which could create volatility as events unfold.

We maintain a benchmark weight in high yield. Although high yield remains an excellent source of income, we remain concerned about valuations as spreads continue to grind along at multi-year tights. However, given improving economic prospects, we are not yet concerned about a turn in the credit cycle.

Source: Bloomberg, as of July 31, 2017.
We remain overweight investment grade corporates. While we are also concerned about tight spread levels in investment grade debt, valuations are still not as rich as high yield and 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 July, with the broad S&P National Municipal Bond Index returning 75 bps. More than half of the benchmark’s year-to-date return has occurred over the past three months. 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. With volatility remaining at very low levels and interest rates continuing to trade in a range, agency MBS have continued to provide modest, positive returns (nearly 50 bps over the past month and 1.80% year-to-date). However, given the low levels of volatility and interest rates, as well as the uncertainty surrounding Fed balance sheet normalization, we believe a benchmark weight is 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 could be poised for default as billions in debt come due this year.
Overview
While the political winds can affect biopharma stocks in the short term, investors may want to keep their focus on the longer-term trends underpinning the industry.

Consider
Active mutual fund
• Health Sciences Opportunities Fund (SHSSX)
ETFs
• iShares Nasdaq Biotechnology ETF (IBB)
• iShares U.S. Pharmaceuticals ETF (IHE)

Biotech: Ignore the noise
Long-term trends driving the biotechnology industry—aging demographics, the ongoing need to develop new patent-protected drugs and M&A activity to secure new drug patents that may offer significant pricing power—have long appealed to investors. But since September 2015, investors have increasingly shifted focus to political noise from Washington as the biopharma industry became a rhetorical target of politicians focused on drug pricing. Gains in biopharma stocks were punctuated by sharp, bearish reversals due to political headlines. This led many biopharma names to decouple from the broader momentum names.

Biotech’s correlation to momentum has broken down

![Graph showing 90-day rolling correlation between MSCI USA Momentum Index and Nasdaq Biotechnology Index. Correlation ranges between +1 and -1. A correlation of +1 indicates returns moved in tandem, -1 indicates returns moved in opposite directions, and 0 indicates no correlation.]

Of course, the political winds can blow both ways. Just as investors pivoted out of biopharma names due to near-term regulatory risks, they rotated back in following President Trump’s election with the expectation of deregulation. Those expectations may pay off, but investors appear to be missing the broader point: An emphasis on the near-term political hubbub has come at the expense of focusing on the secular trends.

While biopharma’s long-term growth drivers haven’t changed, its investor base may have. The momentum breakdown in 2015 and lingering political headwinds led to industrywide outflows and cheapened valuations. Relative valuations—measured here as the ratio of the Nasdaq Biotechnology Index P/E ratio to the Russell 1000 Growth Index P/E ratio—have gone down over the past year and now sit below the five-year average. More recently, valuations have stabilized as industrywide biopharma-focused ETP inflows have begun to recover.

Bottom line: Long-term investors may want to consider biopharma given current valuations, lack of crowding, and potential long-term growth prospects.
Drilling down: Equity and fixed income outlooks

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**Our View and Outlook**

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

**Contributors**

**Heather Apperson** is an Investment Strategist for the ETF Investment Strategies & Insights group.

**Grant Dechert** is an Analyst for the ETF Investment Strategies & Insights group.

**David Kurapka**, Editor, is Head of Investment Communications for the ETF Investment Strategies & Insights group.

**Stephen Laipply** is Product Strategist for BlackRock’s Model-Based Fixed Income Portfolio Management group.

**Thomas Logan** is an Investment Strategist for the ETF Investment Strategies & Insights group.

**Kurt Reiman** is BlackRock’s Chief Investment Strategist for Canada and is a member of the BlackRock Investment Institute (BII).

**Matt Tucker, CFA**, is the Head of North American Fixed Income iShares Strategy within BlackRock’s Fixed Income Portfolio Management team.

**Tushar Yadava** is an Investment Strategist for the ETF Investment Strategies & Insights group.

**Let us know...**

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Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments. There may be less information on the financial condition of municipal issuers than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. Some investors may be subject to federal or state income taxes or the Alternative Minimum Tax (AMT).

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