EXIT, ENTRY AND OVERSHOOT

2013 OUTLOOK MIDYEAR UPDATE

JUNE 2013

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What Is Inside

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BLACKROCK INVESTMENT INSTITUTE

The BlackRock Investment Institute leverages the firm's expertise across asset classes, client groups and regions. The Institute's goal is to produce information that makes BlackRock's portfolio managers better investors and helps deliver positive investment results for clients.

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SO WHAT DO I DO WITH MY MONEY?™

- **Big Picture:** Favour equities over bonds but brace for more volatility. Many bonds look expensive and risky.
- **Up and Down:** Expect more market gyrations as policies, economies and currencies diverge.
- **Hidden Risks:** Correlations rise in periods of market stress, making portfolios riskier than they appear.
- **Chemical Reaction:** Beware of liquid assets suddenly turning into solid mass.
- **On the Offensive:** Slowly move to cyclical stocks from crowded income plays and defensives. Valuations between high- and low-quality stocks are near record levels.
- **Structural Bond Bid:** Rising rates will probably be capped by limited supply and institutional demand for yield. We favour the short end of the curve for now.
- **Emerging Bargains:** EM stocks look good on most measures except free cash flow – which matters if financial conditions tighten. Wait for currencies to stabilise before sorting through the bargain bin.
- **Awaiting Further Sales:** Most emerging debt looks fully priced after an issuance boom brought to market risky bonds at high prices. Relative value is key.
- **Red Flags:** Watch currencies for funding strains in emerging markets and the drivers of real rates for signs of deflation in the developed world.
- **Flow Flux:** Bumper inflows into fixed income funds now look at risk of reversing. Investors who (mistakenly) saw bonds as money market substitutes may bail.
- **Dawn in Japan:** Our Japan trade (buy equities and sell the yen) is still on for now. Structural reform is needed to propel Tokyo stocks much higher.

The opinions expressed are as of June 2013 and may change as subsequent conditions vary.

First Words and Summary

Ever-larger doses of monetary stimulus – spiced with a touch of complacency about risk – have driven up asset values around the world. June's market volatility provided a reality check.

What changed? Diminished expectations about the size and staying power of monetary stimulus, a rise in real yields and fears about an emerging market funding crunch.

The US Federal Reserve has set a (data-dependent) timetable for ending its bond buying programme by next year. Markets have started to prepare for such a blow but could easily overshoot – the anticipation somebody will hit you on the head can be worse than the real thing.

We debated this fork in the road for both global policy and markets in mid-June, and updated our 2013 investment outlook *Slow Turn Ahead?*

- The Fed has sketched out a plan for gradual QE withdrawal but made clear the pace depends on economic data. Other signposts include Europe making progress on cleaning up and recapitalising its banks, and Japan not just talking about labour market reforms and deregulation but implementing them.
- Once-juicy risk premia shrivelled up after monetary policy distorted values in (often illiquid) markets that were mistakenly seen as safe income plays. We see markets resetting to levels where expectations and realities are better aligned. The global thirst for yield and high cash levels are buffers against bond yields shooting up and risk assets spiralling down, we believe. Prices may overshoot in the near term.
- Investors will face increased and more diverse risks, making for higher volatility. New risks are an emerging market funding crunch, a spike in real yields for the wrong reason (deflation) and an unhappy ending to Japan's reflation experiment (volatile and rising bond yields). Chances of a financial meltdown remain low, but we are raising the odds of our bearish *Nemesis* scenario to 15% (up 5%) as markets will recognise the new risks.

3 FOR 2ND HALF

1 POLICY

Global monetary policy is diverging and the era of easy money is slowly ending. Distorted markets are resetting but could overshoot.

2 DATA

The Fed is ready to wind down bond purchases if US economic momentum holds. Economic data and jobs numbers take centre stage.

3 RISKS

Risks are increasing, including a potential emerging market funding crunch and spike in real interest rates. Market volatility is back.

- Monetary policy will drive returns in the second half – but policies are starting to diverge. The Fed is the first major central bank to start winding down its massive stimulus, trying to pave the way for a gentle exit from quantitative easing (QE) in 2014 (if its sunny economic forecast pans out).
- The Bank of Japan (BoJ), by contrast, is making a new entry in the QE game. It is "all in" with a planned $1 trillion-plus monetary booster – but the effect on global liquidity looks slight. The European Central Bank (ECB) is standing pat for now. Its balance sheet is shrinking as solvent banks pay back long-term refinancing operations (LTRO).
- China's economy is slowing – but those expecting a monster stimulus are probably day dreaming. If anything, China is reining in alarming credit growth. This is a good thing in the long run, but can cause market disruptions in the short term.
- Funding strains in some emerging economies are real and could get worse, but an exact repeat of the 1997–1998 Asia crisis looks unlikely. The most vulnerable countries are those dependent on external funding. This shows up in current account deficits and plummeting currencies. Disparities among emerging markets are growing fast – and so are disparities among returns. Picking the right exposure is more crucial than ever.
- We are upgrading our *Age of Separatism* scenario to 40% (up 5%) because global policies, economies and market returns are increasingly diverging. This is good news for stock and bond pickers. We are downgrading our risk-on/risk-off *Stop 'N Go* scenario to 25% (down 5%) and bullish *Go Growth* scenario to 15% (down 5%). Our *Inflate Away* scenario of inflation driving asset prices again has very low odds of 5% in the second half.

Scenarios Reset

SCENARIO	DESCRIPTION	ODDS	ASSETS	SIGNPOSTS
Age of Separatism 40% (Up 5%)	Increasing divergence between economic growth, policy moves and financial market returns (between and within asset classes, countries, industry sectors and individual securities).	We have updated this scenario to capture growing global policy divergence (the US Federal Reserve's reining in bond purchases versus the Bank of Japan's starting a $1 trillion-plus asset buying programme).	▸ Equities look better and less risky than fixed income assets. ▸ Relative value investing and security selection. ▸ Shift gradually from income investing to assets geared toward growth (cyclicals).	▸ Correlations between asset classes further decline. ▸ Effectiveness of monetary and fiscal policies of individual countries. ▸ Policymakers keep *Nemesis* events (see below) at bay.
Stop 'N Go 25% (Down 5%)	On-and-off growth spurts in the United States and emerging world. Europe veers in and out of recession and Japan proves another false dawn. Bank delevering dampens growth and risk taking.	Investors mostly forgot about this risk-on/risk-off scenario in 2013 – until June brought back bad memories of the summers of 2011 and 2012. Thanks for the reality check!	▸ Correlated and volatile rallies dominate trading. ▸ Super short– and super long-term strategies. ▸ The hunt for yield favours dividend stocks, high yield and other credit. ▸ Defensives trump cyclicals.	▸ Scattershot growth. ▸ Money multipliers that show no sign of responding to monetary stimulus. ▸ Haphazard and reactive policies that fail to stimulate real growth and achieve sustainable debt levels. ▸ Correlations rise and returns on risk fall.
Nemesis Redux 15% (Up 5%)	The prospect of a global recession, deflation or credit crunch (or all of the above) triggers steep losses across asset classes. Named after the Greek goddess who punishes the proud.	Risks have increased and broadened: ▸ A panic on fears the Fed is taking its foot off the gas too quickly. ▸ A rapid rise in real yields that kills the economic recovery. ▸ A funding crunch in emerging markets.	▸ The usual suspects of cash, US Treasuries, German bunds, the Japanese yen, US dollar and gold. ▸ Investment grade credit should do relatively well. ▸ Volatility is still low, so protection is pretty cheap.	▸ Real interest rates rise quickly – for the wrong reasons (the prospect of deflation or emerging market selling to prop up local currencies). ▸ China's economy implodes. ▸ The ECB's pledge to preserve the Eurozone is tested. ▸ Correlations, volatility and investor blood pressure soar.
Go Growth 15% (Down 5%)	Key economies grow faster than expected. The global economy and markets start weaning themselves off ultra-loose monetary policy around the developed world.	The bar remains pretty low for upside economic surprises. June, however, showed markets remain dependent on a daily diet of monetary stimulus.	▸ A massive risk-on rally, with funds parked in cash, fixed income and quality stocks flowing to risk assets. ▸ Commodities and oil should do well.	▸ Signs monetary stimulus is working in bank lending. ▸ Sell-off in short bonds for the right reason (growth). ▸ Europe and Japan enact labour reforms and industry deregulation. ▸ Low correlations but a mild rise in volatility.
Inflate Away 5% (Unchanged)	Monetary easing triggers inflation, effectively cutting the developed world's debt load. Alternatively, a Middle East conflict and/or disastrous harvest season drive up energy and commodities prices.	Inflation looks unlikely in the second half. If anything, we worry more about deflation. Watch out, though: Some central banks want inflation. It does not pay to fight policy in the long run.	▸ Commodities, gold and hard assets such as property tend to offer some protection. ▸ Sell low-yielding government bonds and other fixed income. ▸ Cash is a (not so silent) savings killer.	▸ The Fed inflates asset prices to bubbly proportions. ▸ The ECB joins the global QE party. ▸ The developed world runs up huge deficits – but fails in structural reforms to spur growth and create sustainable budgets.

Policy Time

Policy dominates financial markets. Major central banks have bought assets on a scale never seen before. The banks' balance sheets now total between 20% to 40% of gross domestic product (GDP). Given the size of the US economy, the Fed is the biggest player. The BoJ's holdings are striking relative to Japan's GDP – and it has just started! See the chart on the right.

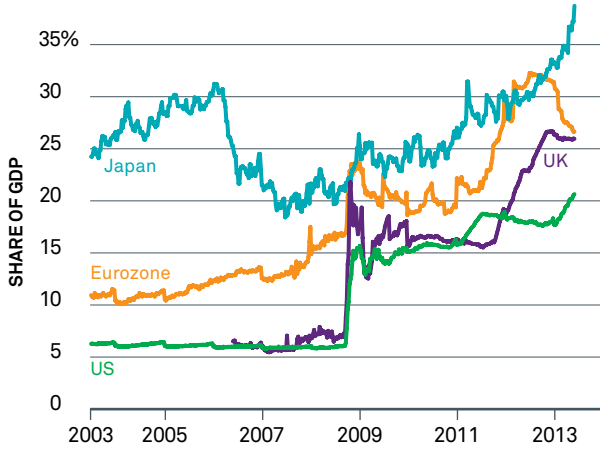
These actions have helped avert disaster. The ECB has eased worries about a banking collapse and possible Eurozone breakup. The Fed has added fuel to a housing recovery and boosted other asset prices. And the BoJ's radical agenda has created hope Japan might finally escape the clutches of deflation.

Central bankers have expended too much capital – the monetary, intellectual and reputational kind – to reverse their stimulative policies prematurely and risk killing a nascent economic recovery. Credit multipliers remain depressed. How is this different from the start of the year? Monetary policy is starting to diverge.

The Fed is likely to "taper" bond purchases in the second half. Provided the US economy remains on a solid footing, it could wind down its bond buying programme by mid-2014. The ECB is keeping the key credit channel (banks) open for business but has yet to buy actual assets.

FEELING BLOATED?

Central Bank Balance Sheets as Share of GDP, 2003–2013



Sources: Thomson Reuters, IMF and central banks, June 2013.
Note: Data for 2013 are based on IMF GDP forecasts.

The BoJ is playing a high-stakes QE game with an "all-in" $1 trillion-plus stimulus bet. The Bank of England (BoE) under new management likely will offer more explicit guidance (and fewer instances of its governor being outvoted by his own committee, at least initially).

Central banks cannot enact structural reforms; politicians can. The problem is politicians tend to act only when they have no other options left. They also have a much higher threshold for market pain than investors. The table below shows the current state of policy play, and how we see it developing.

POLICY MATTERS

Expected Global Policy by Region in 2013

	UNITED STATES		EUROZONE		JAPAN		UK	
	Mid-2013	End 2013	Mid-2013	End 2013	Mid-2013	End 2013	Mid-2013	End 2013
MONETARY POLICY	Super loose, with talk of tightening.	Fed "tapers" bond buys – slowly and modestly.	Loose, but not loose enough.	One more rate cut; little else.	First arrow launched (massive QE).	First arrow in flight (BoJ is "all-in" on QE).	Super loose.	Still super loose; forward guidance launched.
FISCAL POLICY	Tightening.	Tightening slows; medium-term budget challenges.	Periphery tightening, but more slowly.	Much austerity postponed.	Second arrow taken out of quiver (fiscal stimulus).	Second arrow in flight (stimulus kicks in).	Tightening, with a long way to go.	Still a long way to go.
FINANCIAL REGULATION	Lots of regulation talk ... but limited action.	More of the same.	Banks are delevering; credit is tight.	Still waiting for bank clean-up?	Loosening; banks are encouraged to lend.	More of the same.	Regulatory changes under way.	Changes grind on.
GDP GROWTH	Post-crisis trend.	Strengthening ... maybe.	Stagnant – but is the worst over?	Whither France & Germany?	Waking up; domestic confidence rises.	Strongest in G7...but is this a higher trend?	Growing but fragile.	Crawling toward trend.

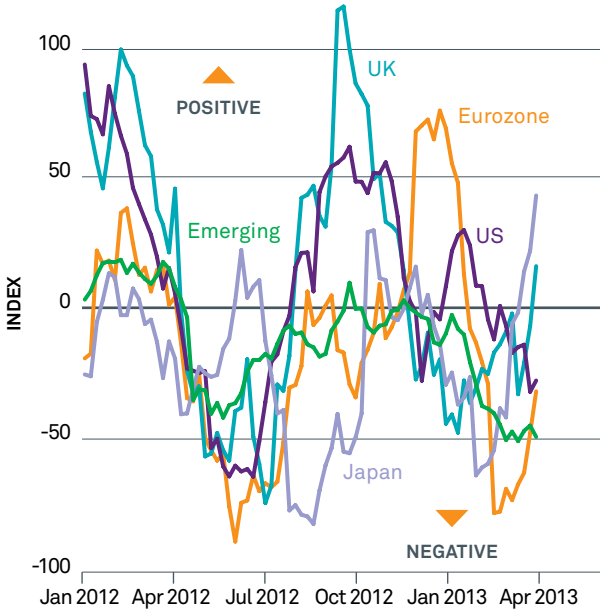
The growth backdrop is key for divining future policy. Analysts' forecasts for economic growth in the developed world have not changed much since the start of 2012, with the exception of a growing expectation Japan will engineer a turnaround. The US economy is expected to lead the developed world with GDP growth of around 2.25% in the next twelve months, according to consensus estimates, followed by Japan and the UK. The Eurozone is stuck near recession levels. Forecasts for growth in key emerging markets have steadily dropped.

Economic growth often does not move markets (some studies even show stocks are inversely correlated with GDP growth) – but expectations do.

This is why we like surprise indicators. Most economic data from developed economies have started to surprise on the upside – albeit from a low base. The exception again is the emerging world, where economic data have tended to disappoint this year. See the chart on the right. This is bad news: Emerging markets have powered world economic growth since the crisis. Are developed markets ready to take over as growth locomotives? Tough to see.

BEATING (LOW) EXPECTATIONS

Economic Surprises, 2012–2013



Sources: Thomson Reuters and Citigroup, 14 June 2013.
Note: A positive reading of the Economic Surprise Index suggests economic releases have been beating consensus forecasts.

FORKS IN THE ROAD

Asset Prices and Policy in 2013

	ASSET	POLICY PRICED IN	ALTERNATIVE POLICY PATH	PATH'S IMPACT
DEVELOPED STOCKS	Eurozone	ECB muddles through; cuts discount rate.	Eurozone resolution through banking union, some debt mutualisation.	Big upside ▲
			ECB's programme of Outright Monetary Transactions (OMT) is tested – and fails.	Big downside ▼
	United States	Fed starts reducing bond purchases by year end.	Fed "tapering" is sooner or bigger.	Downside ▼
	Japan	BoJ is "all-in" on QE; government provides some fiscal stimulus.	Less fiscal stimulus than expected.	Downside ▼
			More fiscal stimulus; labour reforms and deregulation.	Big upside ▲
EM STOCKS	Emerging Markets	Imminent Fed tapering; no China stimulus.	Fed tapering is slower and smaller; China launches stimulus.	Big upside ▲
			Fed tapering triggers full-blown funding crisis.	Big downside ▼
SELECT BONDS	Eurozone Peripherals	ECB muddles through.	Eurozone resolution.	Big upside ▲
	US Short-Term Rates	Fed tapering and rate rises.	Fed tapering is slower and smaller; rate rises are further away.	Upside ▲
	Emerging Market Debt	Imminent Fed tapering; no China stimulus.	Tapering slower and smaller.	Upside ▲
			China launches stimulus.	Upside ▲
COMMODITIES AND CURRENCIES	Industrial Metals	China slows; no stimulus.	China launches stimulus.	Upside ▲
	Euro	ECB muddles through.	ECB goes all-in.	Bon voyage, euro ▼
			OMT fails.	Farewell, euro! ▼
	US Dollar	Fed tapers this year.	Policy uncertainty intensifies.	Upside ▲
	UK Sterling	UK needs more stimulus.	More stimulus unnecessary.	Upside ▲

Sketching out policy paths and growth trajectories matters only if we can relate them to asset prices. (We are investors, not fortune tellers.) In other words, what policies do markets currently price in? And, importantly, how would markets likely react to alternative scenarios? Policies are ever changing, not static. The table at the bottom of the previous page outlines our thinking.

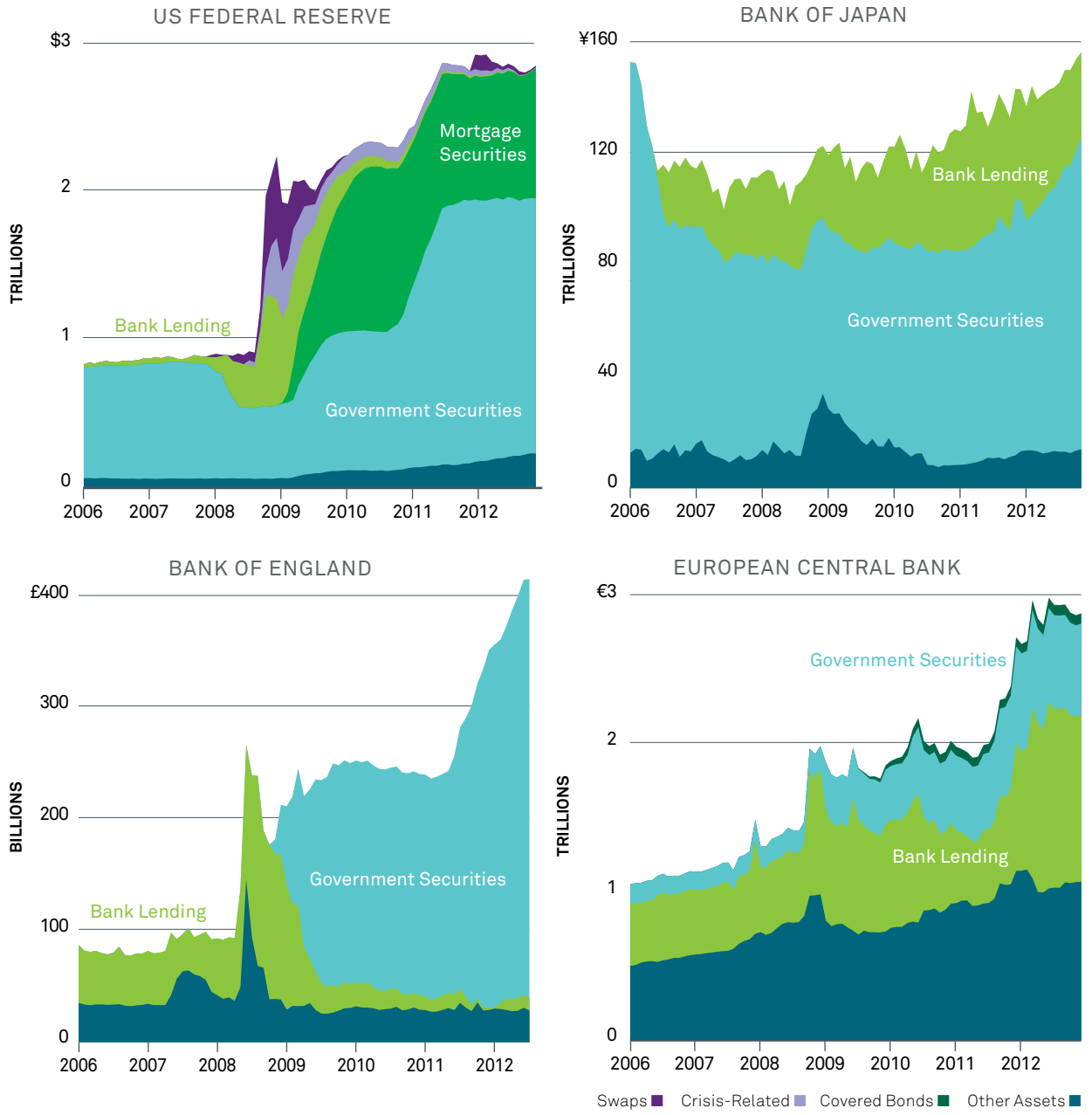
As each central bank takes its own path, it is worth considering what they have accumulated along the way.

Why? What goes in, eventually runs off (matures) or comes out. For example, the Fed is bursting with mortgage securities in addition to a $1.7 trillion pile of government bonds (11% of US GDP). See the top left chart below.

The BoJ and ECB both carry sizable bank loans on their balance sheets, but the Japanese central bank also holds $1.1 trillion in government bonds (23% of Japan's GDP) – and is determined to buy more. See the right-hand charts below.

BULKING UP

Composition of Central Bank Balance Sheets, 2006–2012



Source: IMF Global Financial Stability Report, April 2013.
Notes: Government securities include agency securities. Crisis related includes special purpose vehicles, commercial paper and money-market-related assets.

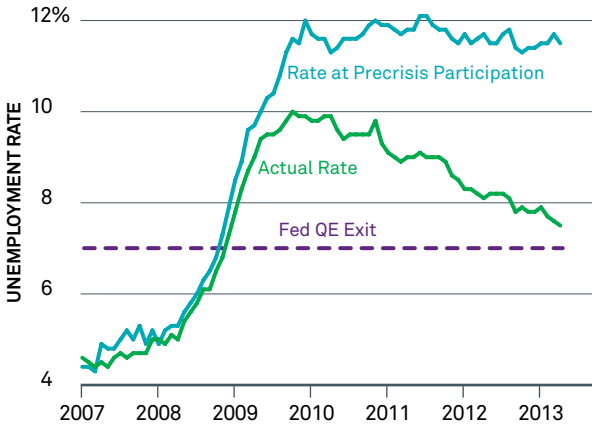
Taper Time

The Fed has signaled it will start to "taper" its $85 billion-a-month asset purchases later this year and may halt them altogether by mid-2014. This is tricky: Try putting toothpaste back into the tube. At the same time, tapering needs to be put into perspective. Less than a year ago, most market pundits felt $40 billion a month of bond buying was huge.

A reduction in the Fed's asset purchases is not Armageddon – it is actually healthy. Critics have long argued QE is not the be all and end all. Trillions of dollars of stimulus have failed to spur much credit growth and economic activity. Money market multipliers across the world have essentially collapsed.

PARTICIPATE!

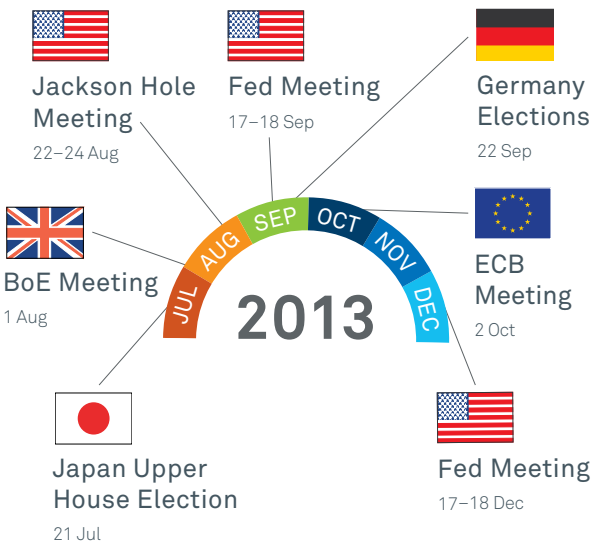
US Unemployment Rate, 2007–2013



Sources: BlackRock and Thomson Reuters, June 2013.
Notes: The blue line represents what the jobless rate would have been if the labour force participation rate had held steady at the January 2008 level of 66.2%, versus an actual rate of 63.3% in April 2013.

MARK YOUR CALENDAR

When will central banks start to slow down their purchases, and lay the groundwork for an eventual reversal? All major central banks (with the possible exception of the ECB) have implicit dual mandates – and today they are more concerned about generating growth than keeping inflation at bay. This means economic data (and central bankers' reading of these tea leaves) will be key drivers of financial markets. See the calendar below for key policy events in the second half.



Notes: Calendar only shows US Fed meetings with economic projections and press conferences. ECB meeting is the first after the German elections. BoE meeting is the first with forward guidance under new Governor Mark Carney.

A vocal minority within the Fed has been arguing for an end to QE for some time. Could the hawks finally get their way? The Roman calendar will not dictate this shift; economic conditions will. The economy is ever-changing – and not in great shape (this differs greatly by state, however). The current landscape:

- The US unemployment rate has fallen to 7.5%, down from almost 10% in 2009 – and in sight of the 7% range at which Fed Chairmen Ben Bernanke says the central bank may stop buying bonds. The complication: The jobs market *looks* a lot better than it actually is. Many workers have given up looking for work. Had the labour participation rate stayed at precrisis levels, current unemployment would have been 11.5%, as the chart above shows. The total US labour force currently totals 135.6 million, short of the 138 million peak in early 2008, when the unemployment rate was 5%, Bureau of Labor Statistics data show.
- The US housing market has bottomed out, with nationwide prices up almost 10% from the trough, according to the Case-Shiller 20 Index. Dig beneath the surface, and the recovery looks a bit more fragile. First, all property is local and regional differences abound, as detailed in *In the Home Stretch? The US Housing Market Recovery* of June 2012. Second, investors are snapping up bargains at the bottom end while wealthy (often foreign) cash buyers are targeting high-end properties. The market's middle (and biggest) slice looks decidedly less healthy. First-time homebuyers are gun-shy and many consumers have a tough time getting credit.

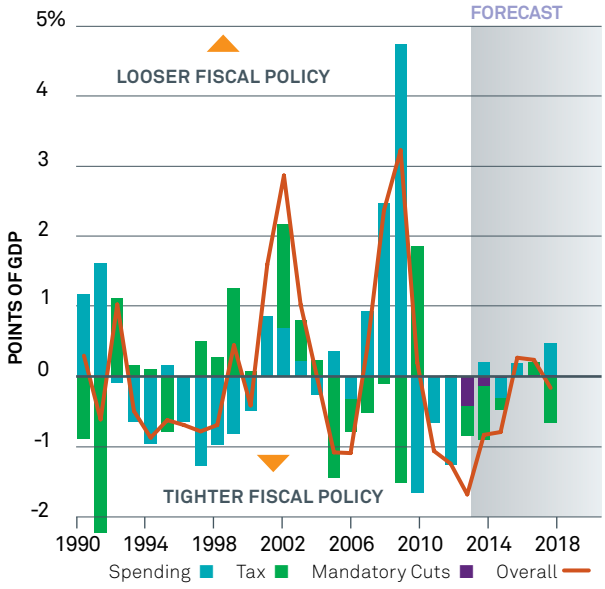
- One of our pet indicators, the Chicago Fed National Activity Index, has weakened in recent months. This index, which measures US economic activity based on 85 monthly economic indicators, has a good record of forecasting near-term GDP. Current readings point to annualised growth of 2% or less over the next quarter.
- One big positive: This year will mark the peak of US fiscal austerity, as the chart below shows. The drag of tax hikes and spending cuts will have declined to just 0.5 percentage points of GDP by the end of 2014. This will make it easier for the economy to stand on its own feet – without the Fed's help.

The reality: The US economy is pretty fragile and the Fed appears ready to give it a helping hand when needed. The other reality: The Fed had to start reining in bond purchases anyway. Simple math says the Fed is running out of stuff to buy. The reason: The US government is issuing less debt. See the chart on the right. Thank economic growth as well as Washington's increased tax revenues and slightly lower spending.

An eventual halt in Fed bond buying does not necessarily equal a 1994-style bond market rout. Then, the Fed intentionally tried to prevent the economy from overheating – a situation that appears far off for now. See our *interactive graphic* detailing the impact of previous Fed tightenings on assets and the economy.

DRAG-FREE

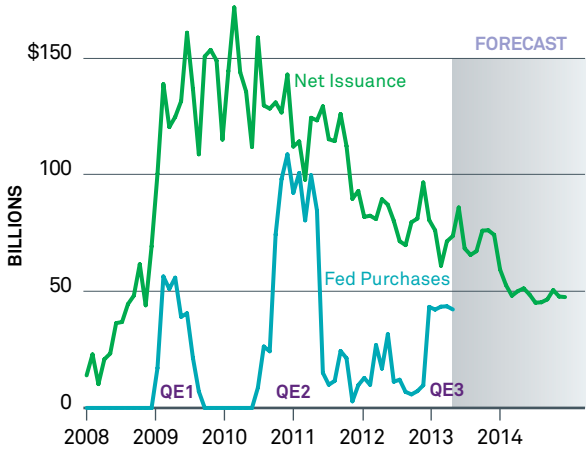
US Fiscal Policy Impact on GDP, 1990–2018



Source: Absolute Strategy Research, June 2013.
Notes: The chart shows the impact of US fiscal policy on real GDP growth. Spending excludes mandatory budget cuts or sequester. 2013 and beyond are based on IMF forecasts.

EMPTY SHELVES

Net US Treasury Issuance and Fed Purchases, 2008–2014



Source: Credit Suisse, June 2013.
Notes: Net US Treasury issuance is a three-month moving average. Shaded area represents Credit Suisse's forecast based on US public deficit projections.

Given a mild outlook for inflation, the Fed will likely err on the side of tapering slowly. In fact, signs abound of inflation falling so rapidly, some pundits have started to pull out the dreaded D-word, deflation. See page 16 for details.

Forecasting inflation is more art than science. The Fed sees inflation taking off only if unemployment falls below 6%. Some economists disagree. Years of high unemployment, and the lack of technological breakthroughs since the internet boom, have reduced potential GDP growth, they say. This means inflation could start to rise more quickly than the Fed expects.

A tapering Fed, plus two other important trends, are good news for the US dollar:

- The Fed will be first to exit QE. The BoJ and ECB are likely well behind (whither the yen and the euro).
- A glut of cheap oil and gas from shale rock could reduce the US bill for energy imports, as detailed in *US Shale Boom: A Case of (Temporary) Indigestion* in July 2012. This will ease pressure on the trade balance and support the greenback, we expect.
- The US budget deficit is falling thanks to spending cuts and rising tax revenues. This is a medium-term trend. The deficit will shrink to 2.1% of GDP in 2015 (versus 10.1% in 2009), the Congressional Budget Office projects. It then is expected to climb back above 3% by the 2020s due to rising interest payments and healthcare costs. A comprehensive budget deal is needed to arrest this long-term rise.

European Time

An eerie calm has descended on Europe ahead of the German elections in September. Chancellor Angela Merkel is unlikely to stick her neck out to foster more European integration. And we do not expect ECB President Mario Draghi to make any big moves to spur lending. Progress on a fiscal or banking union will be incomplete at best. In the meantime, markets want to see bank recapitalisations and comprehensive asset quality reviews.

The monetary transmission mechanism is still broken. Credit is most expensive and hardest to get in countries that need it most. Growth remains sluggish, but Europe looks poised to emerge from recession as it moderates austerity measures. See the chart on the right. This does not mean the debt crisis is over; governments are just postponing the inevitable. Europe needs growth (preferably triggered by labour market reforms) to truly turn the corner.

Could the Eurozone come up with a blueprint for a permanent solution – a banking union, a regional bank deposit guarantee or Eurobonds – after the German elections? We do not hold our breath.

Germany is unlikely to roll over and agree to subsidise Europe's southern tier. The country knows what wealth transfers look like after two decades of subsidies to the former communist East. It also knows the likely result: A dependent economy that is still struggling to generate growth and suffers comparatively high unemployment.

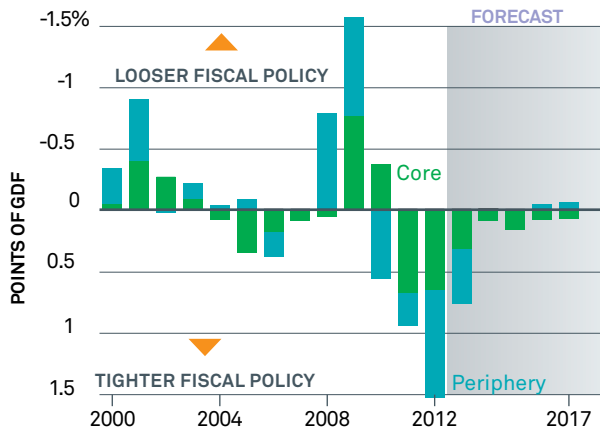
Those transfers were driven by German unification and took place within the same country. Current subsidies would have to rely on a pan-European solidarity that, if it ever existed, is fading now. (An *April 2013 ECB report* showing household wealth in Cyprus, Italy and other nations far exceeded Germany's did not help.) Bottom line: Even after the elections, Germany is unlikely to agree to debt mutualisation without significant EU reforms.

Germany's relationship with France is becoming even more crucial now that the latter's economy is slipping and starting to show "peripheral" ailments such as declining competitiveness and oversized government spending. Germany needs France to remain in the Eurozone's core – it is simply too big to fail – and will likely press for structural reforms and spending cuts after the election.

August is a good time for vacationing Europeans but often a bad time for financial markets.

TEMPORARY REPRIEVE

Impact of Eurozone Fiscal Policy on Balances, 2000–2017



Source: Absolute Strategy Research, June 2013.
Notes: Chart shows fiscal policy impact on structural fiscal balances. 2013 and beyond are based on IMF forecasts.

Trading volumes tend to drop, magnifying price moves. Policymakers are on holiday and late in soothing markets.

The first test? A possible ratings downgrade of Spain (both Moody's and Standard & Poor's rated Spanish debt one notch above junk with a negative outlook at midyear).

This could prompt the ECB to throw Spain a lifeline through the Outright Monetary Transactions (OMT) programme – a facility launched in September 2012 that offers to buy short-term debt of troubled sovereigns.

The prospect of such purchases has helped stabilise European bond yields. Draghi, however, has yet to fire his big bazooka.

One scary scenario: A Spanish debt downgrade propels Spanish and Italian bond yields higher. It turns out OMT does not work as well in practice as on paper – either because of legal challenges or because markets push the ECB beyond its OMT capacity. This would raise the spectre of another credit crunch and severe recession. Suppose the ECB were to then launch open-ended QE, what would happen next?

1. Long-term stabilisation of the Eurozone; or
2. Germany leaves the Eurozone and the European "project" (more unification) is shattered.

Very different outcomes, for both Europe and financial markets. The common thread: Lots of volatility. Will this actually happen? It appears unlikely, but investors should contemplate these types of scenarios.

Tokyo Time

Japan is in uncharted territory. Prime Minister Shinzo Abe has bet on a "three arrow" plan to reverse two decades of sluggish growth and deflation. This moniker comes from an ancient Japanese proverb that says one arrow can be easily broken, but three bound together cannot. Abe's three arrows are:

1. **Monetary Stimulus:** The BoJ has vowed to do whatever it takes to get Japan headed toward a 2% inflation target. This means massive purchases of Japanese government bonds (JGBs) – and potentially private sector assets (watch this space). The BoJ's actions are pushing Japanese investors to substitute government bonds for private (and maybe foreign) assets. This boosts asset values and weakens the yen, helping Japan's exporters at the expense of neighbouring South Korea and China.
2. **Fiscal Stimulus:** Abe announced a 10.3 trillion yen spending programme in January. Fiscal stimulus alone cannot save Japan, but it can act as life support while the patient is still in the operating room. Japan already has the highest debt level of G7 economies (a net debt-to-GDP ratio of 143%, according to International Monetary Fund data). It cannot afford to build any more bridges to nowhere (previous fiscal boosters have a checkered record).
3. **Structural Reforms:** Domestic sectors such as retail, distribution and agriculture have been shielded from competition. Deregulation is essential. Japan currently under-uses a large, highly educated group of people: women. More working women would boost output and productivity. Pension reform is also key. Japan has a fast-ageing population. The country may have to fix its budget by stealing money from pensioners (cutting benefits).

The 64 trillion yen question is whether "Abenomics" will work. The BoJ's open-ended asset purchases are meant to change expectations for good. If Abe's plan works (and it is a big "if"), we could see a revival of animal spirits not witnessed since the go-go years of the 1980s: Consumers could reopen their wallets, businesses start investing and investors buy assets abroad.

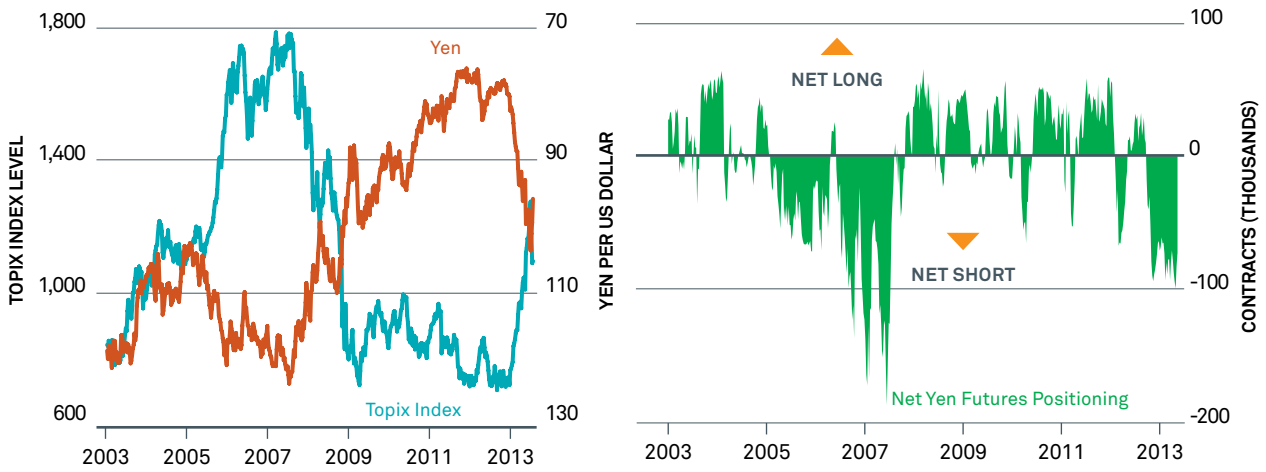
A potential catalyst: higher wages. Around two-fifths of Japan's workforce has its wages set by organised bargaining, according to the Peterson Institute. Some Japanese employers have already started hiking wages and bonuses. Stronger corporate profits would support wage increases when the next annual negotiations kick off in February of 2014. This is a key signpost to watch.

So far, foreign investors have been the most enthused by the BoJ's actions. They have helped spark a huge rally in Japanese equities and a selloff in the yen. See the left chart below. Investors got their presents all at once!

June's partial reversal was a response to extreme positioning – speculators had huge short positions on the yen at midyear, as the right chart shows. In the space of just six months, buying Japanese stocks and shorting the yen went from being the most unloved to the most crowded trade. We see this as a temporary reset, and remain fans of (hedged) Japanese stocks in the long run – if Abe manages to bundle his third arrow with the first two.

TRADE OF THE YEAR?

Japanese Equities, the Yen and Positioning, 2003–2013

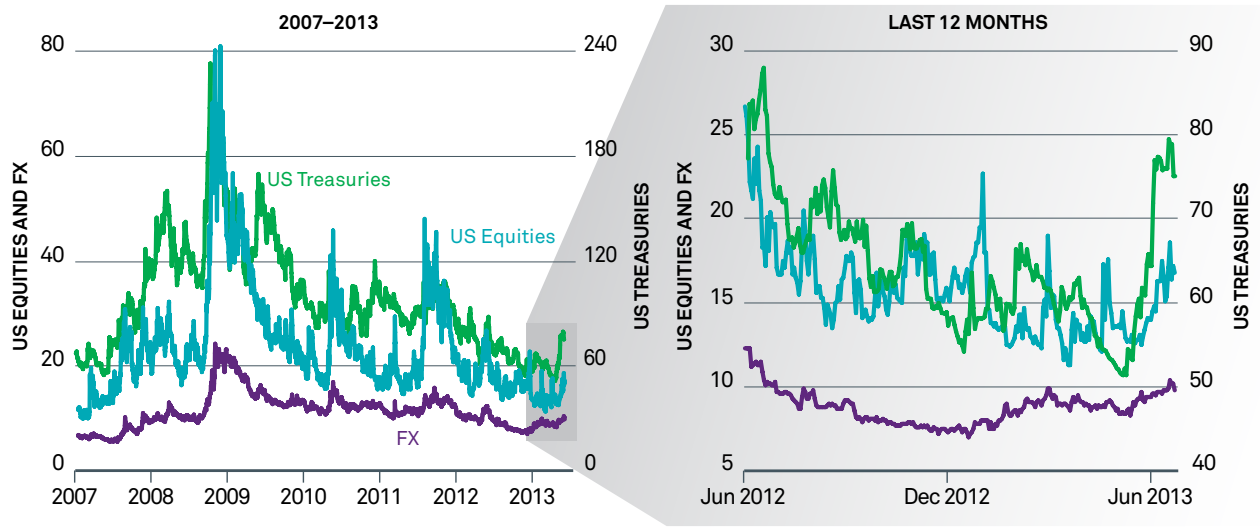


Sources: Thomson Reuters and CFTC, 12 June 2013.
Notes: Yen futures positioning reflects the net position of non-commercial contracts.

FASTEN YOUR SEATBELT

Market volatility is likely to rise. Investors got a taste of this in June, and we believe there is more to come. Blame dealer retrenchment from markets and (investor fears of) the end of easy money.

Volatility is still near historic lows, as the chart below shows. This means opportunities for volatility strategies, including option plays to capture upside, protect against downside or generate income.



Sources: Thomson Reuters and Bloomberg, 17 June 2013.
Notes: The volatility indices are Merrill Lynch's MOVE index (US Treasuries), Deutsche Bank's currency volatility index and the Chicago Board Options Exchange's VIX Index.

Japanese investors have yet to jump on the bandwagon. This could soon change. Japan's banks receive a pile of cash each month as their JGB holdings mature. This money usually gets ploughed straight back into JGBs. With the BoJ gobbling up much of the new issuance, there simply are not enough bonds to go around. The hope: Banks will start lending. The reality: Credit demand is likely to lag economic activity.

Banks would have to start buying other assets, including foreign ones. Markets already have taken an advance. French bonds, in particular, have rallied this year in expectation of a Japanese wall of money. Actual funds, however, have yet to surface. The good news: Japanese institutional investors are starting to show an interest in buying global, multi-asset funds. We expect this shift to be gradual – if not glacial.

The same is true for the yen's decline. Domestic investors are dominant owners of yen assets. Unless they lose confidence in the yen, the currency has a steady bid.

Japan's consumption tax is set to rise 3 percentage points in 2014 – and a further 2 percentage points in 2015. Higher taxes will be needed to cut Abe's deficit, but could choke the economy. This is why the third arrow is critical. Structural reforms would raise Japanese productivity and boost growth, making the deficit more sustainable.

Abe has only revealed sketchy details of his third arrow (announcing painful reforms before the upper house elections in July would amount to political hara-kiri). Markets will expect him to deliver in the second half.

The worst-case scenario? An "Abegeddon:" Japan's politics return to their dysfunctional past, and the BoJ goes at it alone – and effectively monetises the deficit. This could entail a fiscal crisis, with soaring JGB yields and a currency collapse. A 3 percentage point rise in JGB yields would wipe out the capital base of Japan's regional banks, UBS estimates.

This doomsday scenario appears unlikely but does bring home an important point: The long Japanese equities/ short yen trade is not for the faint of heart.

Regime Change?

Markets were an investor nirvana in 2013 – until very recently. The era of assets moving in lockstep appeared over, making markets prime hunting ground for stock and bond pickers. Volatile assets started to perform better, meaning investors finally got paid for taking additional risk.

For many investors, it almost felt like the 2008-2009 financial crisis and aftershocks never happened. The bottom right chart below bears this out.

Markets this year spent most of their time in the sweet spot of investing where correlations are low and risk taking is rewarded (the top left quadrant of each chart). The preceding years felt – and looked – very different indeed.

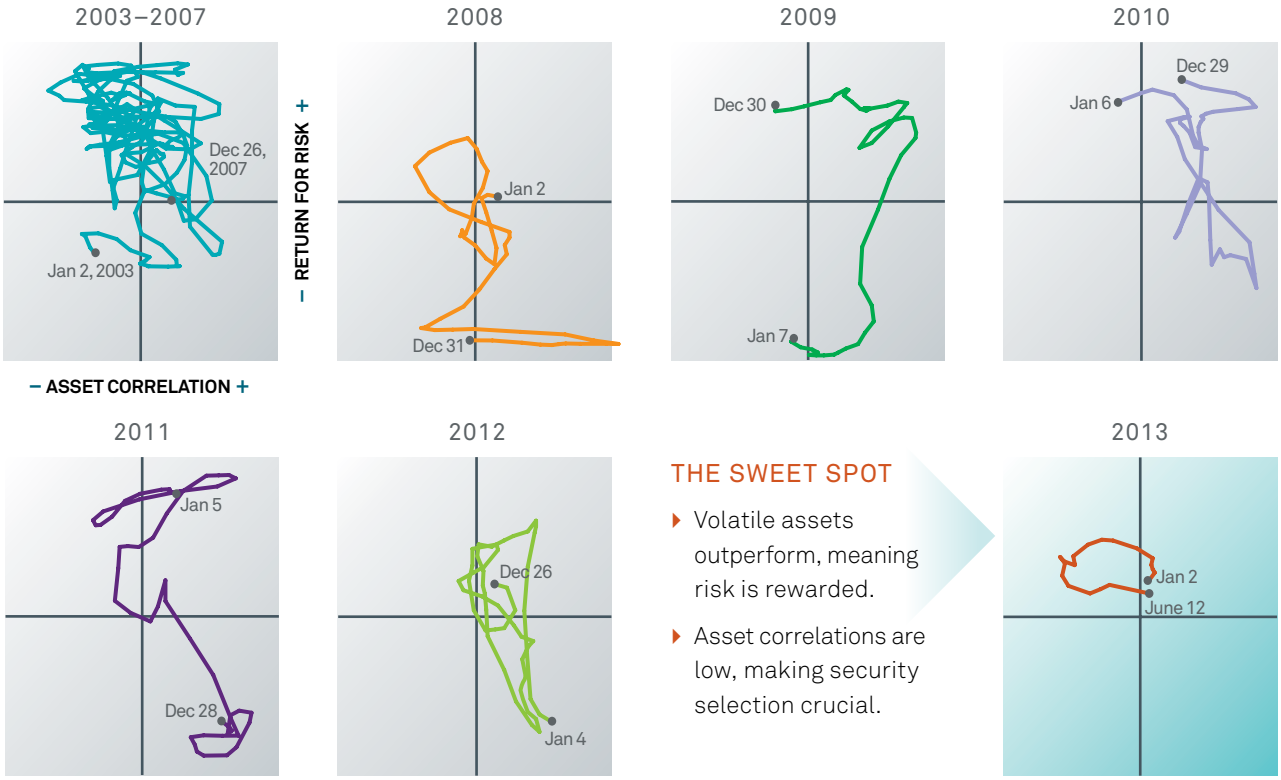
Correlations started to increase again during June's market stress. This is dangerous: Portfolios that looked bulletproof and/or sedate, may once again become enveloped in risk-on/risk-off moves.

This year started off a bit too well. Monetary policy pushed investors up the risk curve, distorting values in markets that were mistakenly seen as safe income plays. These markets offered an enticing combination of juicy yields and steady price appreciation. Risk premia all but disappeared.

Draghi ignited a risk rally after he vowed to "do whatever it takes" to preserve the euro on July 25, 2012 in London. June's market swoon wiped out some of these gains, but most risk assets are far above last summer's levels. See the chart at the top of the next page. To keep and extend gains in the second half, financial markets will likely need economies to show more strength or policymakers to deliver structural reforms.

THIS TIME IS DIFFERENT... OR IS IT?

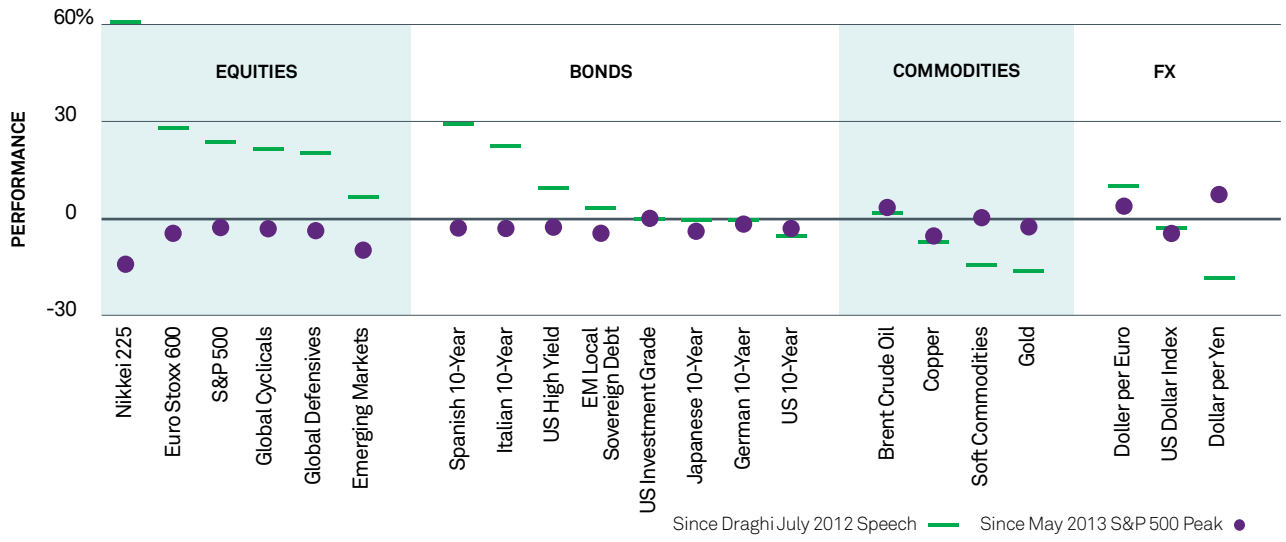
Asset Correlations and Risk Appetite, 2003–2013



Source: BlackRock, June 2013.
Notes: Based on correlations between 14 asset classes. Risk sentiment measures performance of more volatile assets. Time series are smoothed 20-day averages.

POWER OF SPEECH

Asset Performance Since Draghi 2012 Speech and 2013 S&P 500 Peak



Source: Thomson Reuters, 19 June 2013.
Notes: Local currency total returns (dividends or coupons reinvested) for equities and bonds. Spot performance for commodities and foreign exchange. ECB President Mario Draghi vowed to preserve the euro in a speech in London on 25 July 2012. The S&P 500 peak was on 21 May 2013

WHEN BONDS LOSE MONEY

	YTD RETURN	CURRENT YIELD	SAFETY CUSHION (BASIS POINTS)	PEAK-TO-TROUGH RETURN	YEARS OF YIELD TO RECOVER
US TREASURIES	-2%	1.2%	23	-3%	2.5
GERMAN GOV'T	-1.5%	1.1%	16	-2.7%	2.5
JAPANESE GOV'T	0.4%	0.7%	9	-3.5%	4.9
ITALIAN GOV'T	1.9%	3.6%	61	-3.3%	0.9
SPANISH GOV'T	4.5%	3.8%	71	-4%	1.1
UK GILTS	-2.6%	2.2%	23	-4.9%	2.3
EM GOV'T (LOCAL)	-7.2%	5.6%	114	-10.5%	1.9
EM GOV'T (USD)	-6.9%	5.1%	73	-7.8%	1.5
US CORP	-3.3%	3.3%	48	-5.3%	1.6
US HIGH YIELD	1.7%	6.6%	149	-3.8%	0.6
UK CORP	0%	4.1%	53	-5.2%	1.3
EURO CORP	0.2%	2.3%	52	-2.1%	0.9
EM CORP (USD)	-4.5%	5.8%	113	-6.3%	1.1
US CMBS	-1.1%	2.3%	70	-2.5%	1.1
US MBS	-1.9%	3.1%	60	-2.4%	0.8

Sources: BlackRock and Barclays Capital, 20 June 2013.
Notes: The safety cushion represents how large a yield rise (in basis points) would trigger a price decline that would wipe out one year's worth of income. Years of yield required to recover from peak-to-trough loss assumes constant prices and is for illustrative purposes only.

Markets that had attracted swaths of investors eager for yield in the zero-rate world fell particularly hard in June. Think emerging market debt, high yield and other credit sectors. The moves were quick and merciless. Most fixed income markets were in the red by midyear, and peak-to-trough price losses were in the double digits in emerging local debt. For most fixed income, it takes more than a year's worth of income to make up for these losses. See the final column of the table on the left.

Illiquidity magnified the moves as investors stampeded toward the exits. Many bonds quickly become museum pieces after their debut (nice to look at but tough to take home or sell), as detailed in *Setting New Standards* in May 2013.

Where does this leave us? Valuations are resetting to levels where expectations (about safety and the length of the easy-money era) are better aligned with realities (risk premia used to be wider for a reason and central bankers will take away the punch bowl at some point).

The big picture: Most assets are still priced reasonably compared with their own history. Safe-haven government bonds are the exception. They still hover between the top 96th to 98th percentiles of their historic nominal valuations. See the chart at the bottom of the next page. As such, they are not just expensive but carry a lot more price risk than most investors suspect, as detailed in *Forget Rotation; Think Risk Mitigation* in February 2013.

Generally speaking, we prefer equities over bonds. Most equity valuations look reasonable – with notable exceptions in Southeast Asia and Mexico. These look pricey against their own histories on both 10- and five-year horizons, as the chart on the right shows. US stocks look dear against a five-year horizon, especially considering corporate margins are near record highs.

How about the equities debate *du jour:* Stick with expensive defensive stocks or shift to cheap cyclicals?

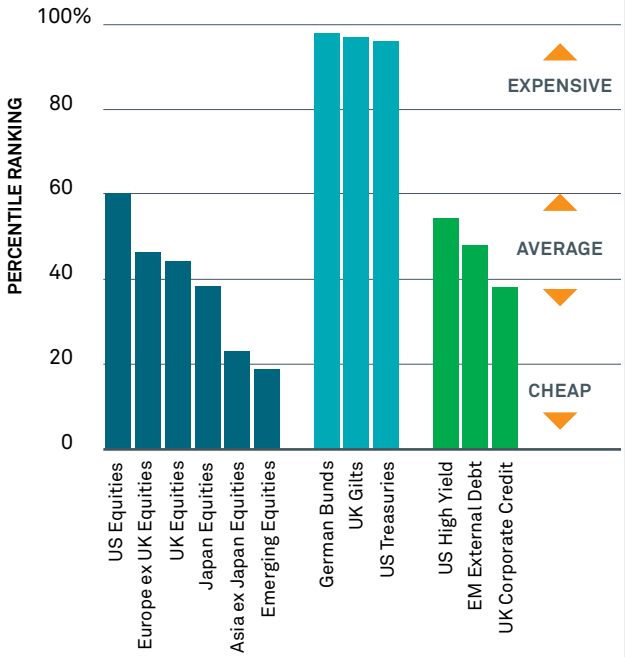
Many defensive stocks are at their peaks of profitability and valuation – and have outperformed cyclical stocks. The reason: record-low bond yields. Investors bought quality companies with predictable earnings and dividend income. This led to the *bondification* of the equity market.

Valuations of consumer brands and other defensives now look stretched. US defensives (minus healthcare) are in the top valuation decile of the past 35 years on a price/earnings basis, our research shows. As a result, these stocks may not provide the downside protection investors have come to expect (the recent sell-off in utilities gives a taste of this).

So is the equity income investment theme dead? Not by a long stretch. Structural demand for yield is here to stay – unless you believe bond yields will move a lot higher any time soon (we do not).

EYE OF THE BEHOLDER

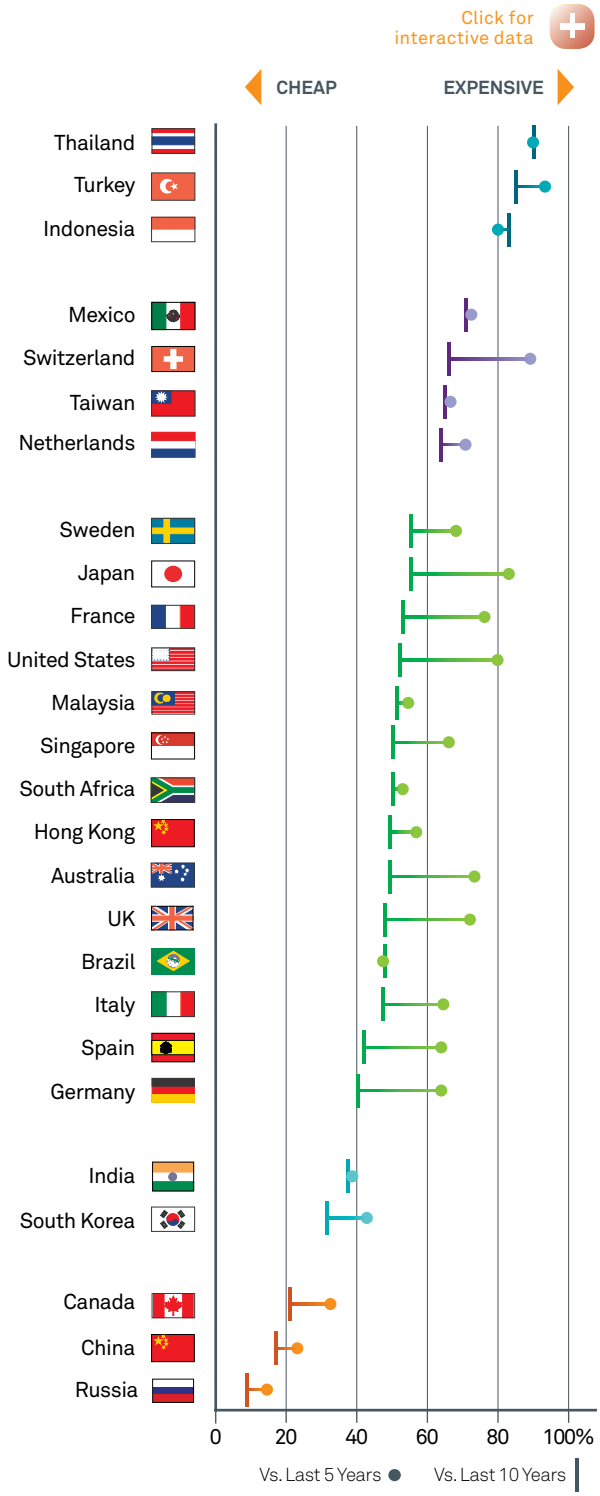
Valuations by Percentile vs. Historic Norm



Sources: BlackRock, Thomson Reuters and Bloomberg, June 2013.
Notes: Time periods range from seven to 30 years. US Treasuries, UK gilts and German bunds represent the real yield. Equity valuations based on average of dividend yield, book values and price/earnings ratios.

WORLD STOCK INEQUALITY

Equity Valuations vs. 10- and 5-Year Averages



Sources: BlackRock, MSCI and Thomson Reuters, June 2013.
Note: Current percentile rankings versus the average of price to forward earnings, price to cashflow, price to book value and dividend yield in the past 10 and five years.

Bottom line: Be wary of sectors with extreme positioning. This is why we prefer to slowly swap some crowded income plays and expensive high-quality stocks for cheaper cyclicals at this time.

Real Rates Riddle

June provided a reality check. The word "tapering" quickly became part of the financial lexicon. See the bottom chart on the right. Real US yields climbed above zero for the first time in two years as inflation expectations came down.

A further decline in inflation would be a bad omen for the global economy. It would signal economic activity is turning down again – at a time when the Fed and other central banks (and governments) look to have run out of bullets to re-ignite growth.

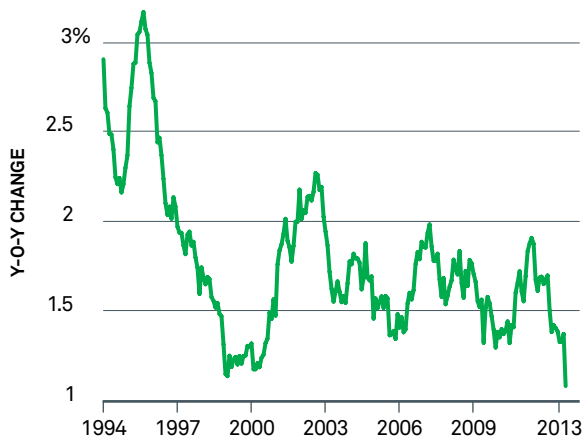
For now, the jury is out, as the top right chart shows. The rise in US real yields is driven by both falling inflation expectations and an uptick in nominal yields.

Real rates are still very low around the developed world by historic standards. But the move up has surprised market pundits in its intensity and reach. The sell-off in prices has thrown up some bargains in short-term rates (anything below five-year bonds) if you believe markets may have overestimated the pace of rate rises (we do).

Real rates are key to watch in the second half. It is okay if they go up modestly because of a strengthening growth outlook. This would likely be good news for equities. It is not okay if the primary driver is (a fear of) deflation. Consumer price inflation in G7 nations has dropped to its lowest level since the late 1990s, as the chart below shows. This excludes the realm of deflation, Japan. Scary stuff.

DEFLATION DEMON

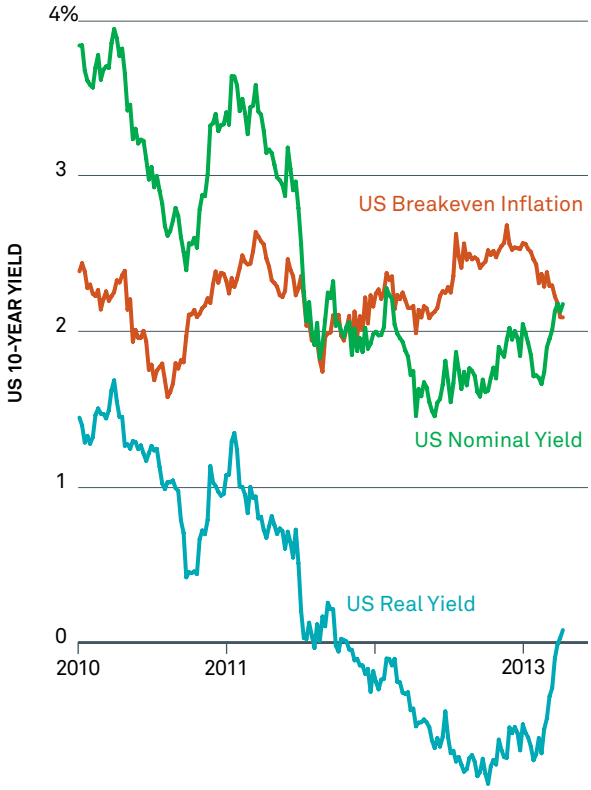
Core Inflation in G7 ex-Japan, 1994–2013



Sources: Thomson Reuters and OECD, June 2013.
Notes: Core inflation excludes food and energy prices. The measure is an equally weighted average of the United States, UK, France, Germany, Italy and Canada.

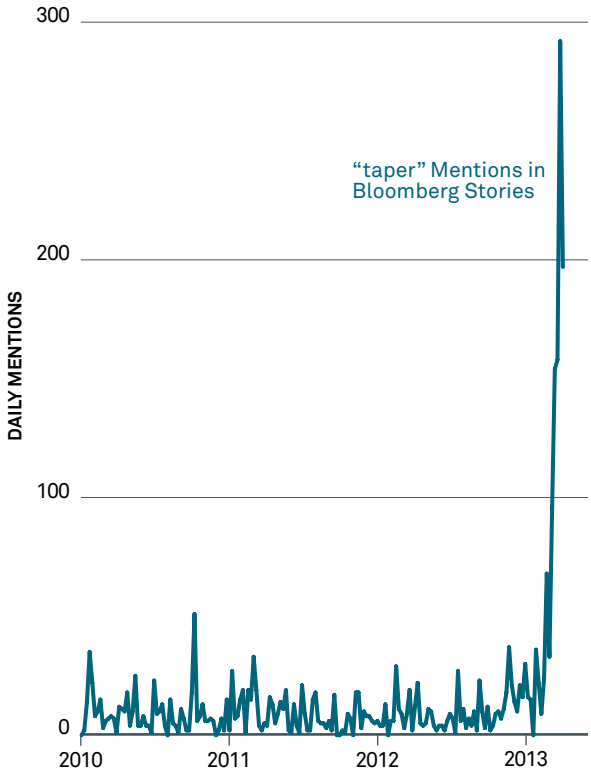
REAL RATES = REAL RISKS

US Real Rate Breakdown, 2010–2013



TALES OF TAPERING

Daily "Taper" Mentions, 2010–2013



Sources: Thomson Reuters and Bloomberg, June 2013.
Note: US yield breakdown uses inflation-linked US bonds to calculate a breakeven inflation rate.

Emerging Strains

Emerging market investors got a rude awakening in June, with currencies, debt prices and shares tumbling on fears of a funding crisis. They were once again reminded these markets are ultimately currency plays. Is a repeat of the 1997–1998 crisis in the cards? We do not think so. Countries with structural funding issues – South Africa, Turkey, Indonesia and India – are well-known. Plus, most emerging markets have a stash of reserves to buffet them from the storm.

Funding strains are the result of both internal weaknesses (some countries had been waving the red flags of rapid credit growth and worsening current account deficits) and fears of an abrupt end to the era of easy money (which underpinned emerging currencies and ever-lower debt yields). The self-inflicted wounds are real, we believe, but fears of a 1997–1998-style funding crisis are overdone.

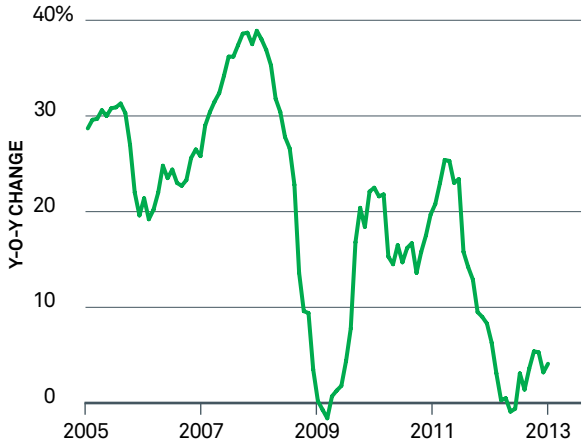
Sure, emerging markets are far from bulletproof. Challenges abound for the second half:

- The prospect of the end of easy money and rising real interest rates in the developed world make emerging market assets less attractive.
- Global growth locomotive China is slowing, as are other large emerging markets. Anaemic growth in most of the developed world offers little help to exporters.
- Current account surpluses are falling – and deficits are rising in countries such as Egypt, Turkey, Indonesia and South Africa. These countries have dropped to the bottom two quintiles in our *BlackRock Sovereign Risk Index*.
- Weak currencies could stoke inflation and raise the risk of a credit crunch in countries relying on external funding.
- Investor appetite bolstered issuance of risky debt at scarily low yields. Care for some Rwandan bonds issued at 6.9% or Bolivian debt at 5%? (Recall US Treasuries were yielding 5% as recently as 2007.)
- Most emerging markets have squirrelled away sizable foreign exchange kitties. Most are still adding to these stashes – but at a slower pace. See the chart above.
- Using FX reserves to defend local currencies risks killing off domestic growth. Interventions withdraw local currency from the economy, effectively tightening monetary conditions.
- Necessary but painful reform measures (for example, Indonesia's fuel hikes) are triggering popular protests that could morph into larger government backlashes (for example, Brazil's widespread demonstrations that started with a protest against bus fare increases).

Most emerging markets are better equipped than ever to counter these challenges, as described in *What's Developing* in April 2013. Highlights include low debt levels, fiscal health, deeper markets and self-propelled growth.

STASHING AWAY LESS

Growth in Emerging Market Reserves, 2005–2013



Source: BlackRock Investment Institute and Thomson Reuters.
Notes: Countries included are Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Peru, Phillippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. Data through 29 March 2013.

The sell-off may not have fazed seasoned veterans. It is a different story for those investors who thought emerging market debt produced steady returns. Drawn by double-digit annual gains since the crisis, they piled into the market. See the table at the top of the next page.

Portfolio inflows reached scary proportions, as did foreign ownership of local debt. Emerging markets have fat FX buffers, but most local currency markets are too small to enable a quick foreign exit.

Holders of local currency debt are especially smarting. The very engines that produced the souped-up returns of the past – currency appreciation and tightening yield spreads – shifted into full reverse. Sobered by losses and volatility, short-term emerging debt investors may look for any opportunity to sell. Couple this with full price valuations, and we are generally cautious on most emerging market debt, especially the local variety.

WHAT GOES IN...

Emerging Market Portfolio Inflows, Bond and Currency Markets, 2009–2013

		CHINA	INDIA	INDONESIA	S. KOREA	PHILIPPINES	THAILAND	HUNGARY	POLAND	RUSSIA	S. AFRICA	TURKEY	BRAZIL	MEXICO
EQUITY PORTFOLIO INFLOWS	Billions	$183	$76.5	$4.7	$57.7	$1.7	$9.4	$1.4	$17.1	$-8.6	$8.8	$12	$87.6	$6.7
	% GDP	2.2	4.1	0.5	5.1	0.7	2.5	1.1	3.5	-0.4	2.2	1.5	3.9	0.6
BOND PORTFOLIO INFLOWS	Billions	$64.5	$14.8	$39.3	$87.2	$3	$20.9	$4.6	$63.3	$33.6	$34.7	$70	$64.9	$167.9
	% GDP	0.8	0.8	4.5	7.7	1.2	5.7	3.6	12.9	1.7	8.8	8.9	2.9	14.3
FOREIGN BOND HOLDINGS	Billions	NA	$15.3	$29	$55.6	NA	$18.4	$20.4	$63.3	$8.5	$37.5	$59.1	$138.1	$95.9
	% of Total	NA	2.7	32.6	16.1	NA	17.6	40.7	36	7	36	26.7	14.8	58.2
INT'L RESERVES	Billions	$3,443	$259	$105	$328	$83	$166	$46	$101	$480	$41	$109	$376	$167
	% GDP	41.8	13.9	12	29.1	32.3	45.1	36.5	20.5	23.9	10.4	13.8	16.6	14.2
FX DAILY TURNOVER	Billions	$20	$5	$1	$6	$1	$1.1	$5	$6	$7.5	$7.5	$11	$15	$15
	Days to Exit	NA	3.1	29	9.3	NA	16.7	4.1	10.6	2.4	6	5.4	9.2	6.4
FX VS. USD	% 2013 YTD	1.7	-2.9	-1.9	-5.4	-4.6	-0.4	0.7	-2.6	-5.4	-15	-5.3	-5.8	0.9
	% Since S&P Peak	0.2	-1	-1	-1.3	-3.9	-2.9	3.7	2.7	-1.5	-3	-1.1	-5.3	-2.8

Sources: Bank of America Merrill Lynch and Thomson Reuters, 19 June 2013.
Notes: Portfolio inflows are gross aggregates from Q2 2009 to Q4 2012. Foreign bond holdings are as of March 2013 and taken from domestic central banks. International reserves as of March 2013. FX daily turnover data taken from the 2010 BIS Triennial survey. Days to exit represents the number of days it would take foreign bond holders to sell their holdings at the daily FX turnover rate. The S&P 500 peak was on 21 May 2013.

The future of emerging market stocks is closely tied to local currencies. Markets that saw the largest capital inflows are now suffering the most. Valuations in most markets are cheap and global investor outflows have accelerated, setting the stage for a potential bottom. No better time to buy than when the last emerging market investor turns off the generator. Just remember patience is a friend in bear markets.

At the same time, emerging equities are cheap for a reason: They lag developed stocks in cash-flow generation – a key indicator if monetary conditions tighten further in the emerging world. Investors on average paid 43 times cash flow for non-financial emerging market stocks at the end of 2012, our research shows. Earnings often do not translate into cash for non-controlling shareholders because of heavy investment.

In the mayhem, anomalies and cases of relative value are likely to emerge. Differences between emerging markets are growing – and investors need to become more discerning. Currency overshoots could be the sign of opportunity.

China's credit has been growing at an alarming pace, and the government now faces a stark choice: Clean up the mess now and face some market disruption, or wait and confront an even bigger problem later. Beijing (smartly) appears to take the first route.

Steps such as liberalising interest rates and letting companies default offer long-term gains – but lots of short-term pain.

What happens when credit starts to dry up? The challenges are big and risks are clearly rising – especially considering China's GDP growth is slowing.

China injected RMB 18 trillion of credit into its economy in the year through March 2013, equivalent to 34% of its 2012 GDP. That's not quite as big as the fire hose it trained on markets following the global financial crisis. China spent 40% of 2009 GDP in the year through March 2010. Back then, the credit flood almost doubled real GDP growth. This time around, the patient is not just failing to recover – but looking frailer. Real GDP growth slumped to 7.7% in the first quarter of 2013, down from 8.1% in the first quarter of 2012.

Non-bank finance is making up a growing share of China's "total social financing" (a broad measure of total credit in the economy), as the left chart below shows. This includes trust loans, bank acceptance bills and corporate bonds. Banks have shifted much of their lending off balance sheet to bypass regulations capping loan-to-deposit ratios.

They are wrapping many of these loans (as well as equities, commodities and other unknown substances) into high-yielding structured notes with an enticing name: wealth management products (WMPs). Yield-starved retail investors are flocking to WMPs like bees to honey.

These products have an average duration of just four months, whereas the assets backing them span several years. The party goes on as long as banks can keep selling new WMPs and rolling over existing ones. Financial market history, however, shows duration mismatches often end in tears: When the music stops playing, liquidity dries up and prices crash.

There are recent signs of a liquidity squeeze in China's interbank market. Short-term rates have spiked to multi-year highs, as the right chart below shows. One possible reason: A regulatory crackdown on accounting gimmicks that involve borrowing US dollars in Hong Kong and swapping those into RMB to buy WMPs on the mainland.

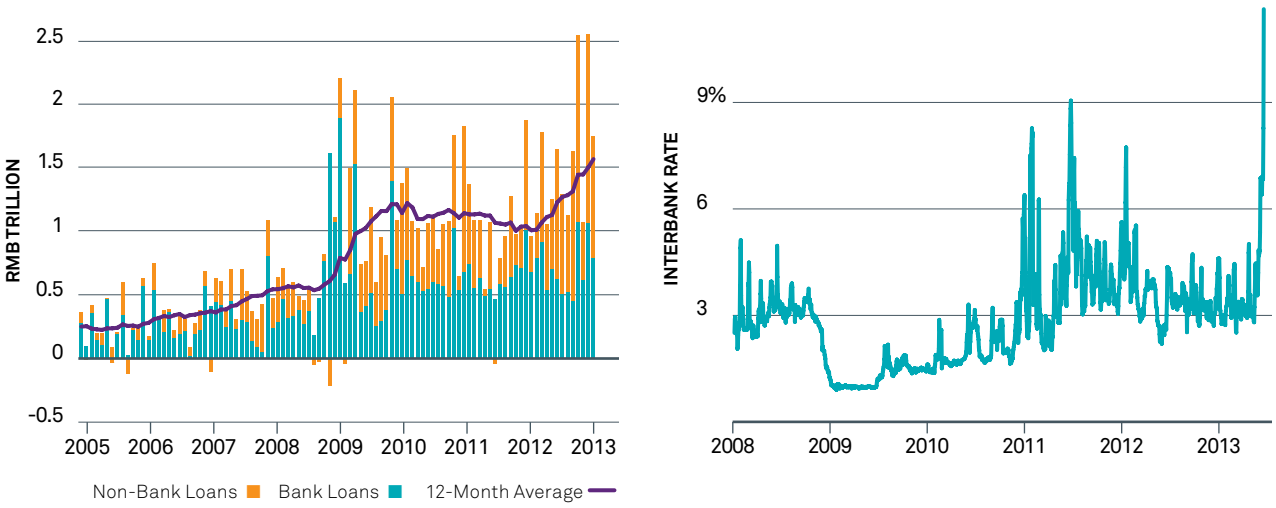
Ultimately, Beijing's decision to stay tight is a political one. Rising unemployment would sap political will more than any short-term market distress. In other words, expect more volatility ahead.

While the future of China's opaque financial system is tough to predict, consider the following points:

- China is a credit-hungry dragon – and the cutoff from external credit markets and tighter domestic credit will slow economic growth.
- Beijing has deep pockets (a $3.4 trillion FX reserve kitty) and a closed (although increasingly leaky) financial system. A popping of China's credit bubble would not pose a systemic risk to the global financial system.
- In the case of a crisis, China is almost certain to bail out and recapitalise its banks. It has done so before, and the big banks remain instruments of policy rather than commercial entities.
- Regulators are not asleep at the wheel. They are cracking down on WMPs, making sure issuers have to shoulder the risk in the case of losses. This is a positive sign: knowing the problem is a first step in fixing it.
- Further rises in interbank rates would be a warning sign for a real liquidity crunch (and have already triggered intervention by the People's Bank of China to calm markets). Any spike in capital outflows would point to greater distress.
- Do not expect a monster fiscal stimulus. China's new leadership appears willing to tolerate slower growth if it helps rebalance the economy toward consumer spending. The new leaders are in no great hurry: They are appointed for a decade.

LAST CREDIT BANQUET?

China's Total Social Financing and One-Week Interbank Rates



Sources: Thomson Reuters and People's Bank of China. Note: Data on left chart through 15 April 2013; on right chart through 20 June 2013.

Why BlackRock

BlackRock was built to provide the global market insight, breadth of capabilities, unbiased investment advice and deep risk management expertise these times require. With access to every asset class, geography and investment style, and extensive market intelligence, we help investors of all sizes build dynamic, diverse portfolios to achieve better, more consistent returns over time.

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