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Weekly Commentary

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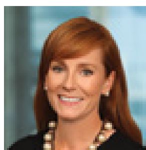

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AUGUST 1, 2016

Key points

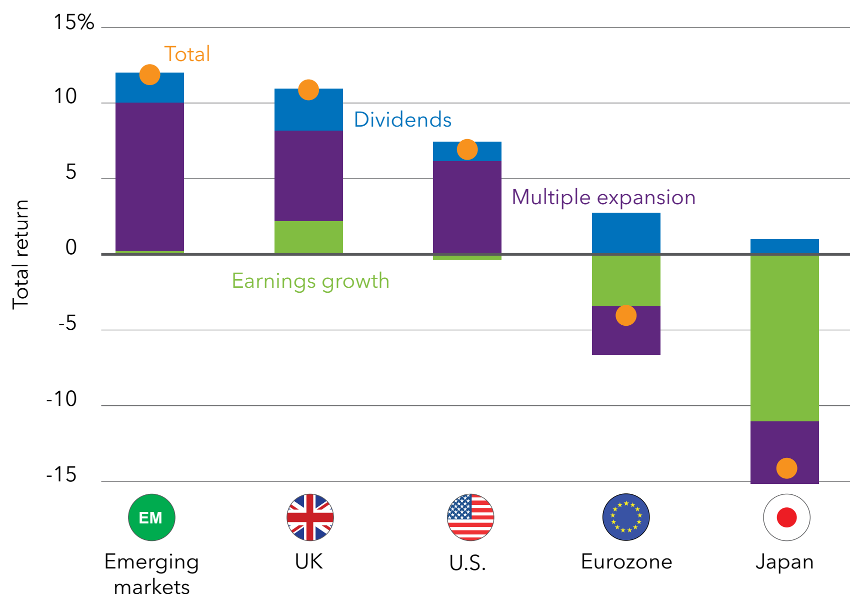
1. We believe further gains in global equities this year would require a meaningful improvement in earnings.
2. The Federal Reserve (Fed) stayed put last week but upgraded its economic view, keeping the door open for a 2016 rate rise.
3. U.S. labor and inflation data this week will be key for confirming our view that the Fed will likely raise rates just once this year.

1 Wanted: earnings growth

Global stocks are up year-to-date, having shaken off worries about the strength of the global economy in the wake of the UK's Brexit vote. But we believe further gains require a meaningful improvement in corporate earnings, particularly in developed markets.

Chart of the week

Equity returns by source, 2016



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, July 2016.
Notes: All returns are year-to-date. All returns are in local currency except emerging market returns, which are in U.S. dollars. Earnings growth is based on the change in aggregate 12-month forward earnings forecasts. Multiple expansion is calculated as the price change minus earnings growth.

Equity markets are running on fumes. The chart above shows how multiple expansion – or rising price-to-earnings ratios – has been the main driver of returns in many markets this year. Earnings growth has been flat to negative.

The main ingredient required for further gains

The worst of the U.S. profits recession appears to be over. Second-quarter earnings growth for the S&P 500 likely will still show contraction from last year's levels. Yet we find reasons to be marginally more optimistic about the second half. Sales growth has been better than expected, and is on track to turn positive for the first time since the fourth quarter of 2014. We also see the energy sector's drag on earnings fading by year-end. The problem? High U.S. valuations and strong flows into U.S. equities already appear to reflect part of the good news. A U.S. market overweight has become a consensus trade, our analysis shows, raising the risk of sudden reversals.

In Europe, analysts have slashed their expectations for 2016 earnings growth since the beginning of the year on a collapse in expectations for the banking sector. Earnings are set to contract in seven out of 10 European sectors in the second quarter. The bright spot: global multinationals with geographically diverse sales, in sectors such as health care, materials and technology. In Japan, many companies are budgeting for a weaker yen in the second half, surveys show. This increases the risk of downward earnings revisions if the yen stays strong and hurts the overseas earnings of Japanese companies.

The main takeaway for investors: Be selective. We prefer quality companies that can increase earnings in a low-growth environment or grow their dividends. U.S. stocks with high dividend payouts, by contrast, look expensive and offer limited earnings potential at this time, we believe.

2 Week in review

- The Fed stayed put but upgraded its near-term economic assessment, keeping the door open for a rate increase later this year.
- The Bank of Japan kept its policy rate and bond purchase program unchanged, but ramped up planned equity purchases. Japan also unveiled a large fiscal package.
- Oil prices slumped to three-month lows under the weight of unexpectedly high U.S. inventories.

GLOBAL SNAPSHOT

Weekly and 12-Month Performance of Selected Assets

EQUITIES	WEEK	YTD	12 MONTHS	DIV. YIELD
U.S. Large Caps	-0.1%	6.3%	3.1%	2.1%
U.S. Small Caps	0.6%	8.3%	0.7%	1.4%
Non-U.S. World	1.8%	3.9%	-4.8%	3.2%
Non-U.S. Developed	2.4%	0.4%	-6.6%	3.4%
Japan	3.2%	0.5%	-1.9%	2.4%
Emerging	0.5%	11.8%	-0.6%	2.6%
Asia ex-Japan	0.3%	7.1%	-1.4%	2.6%

BONDS	WEEK	YTD	12 MONTHS	YIELD
U.S. Treasuries	0.7%	5.8%	6.1%	1.5%
U.S. TIPS	0.9%	7.2%	5.4%	1.5%
U.S. Investment Grade	0.5%	9.3%	9.2%	2.8%
U.S. High Yield	-0.3%	12.0%	5.3%	6.7%
U.S. Municipals	0.3%	4.4%	7.1%	1.6%
Non-U.S. Developed	2.7%	12.9%	12.6%	0.5%
EM $ Bonds	-0.2%	12.3%	11.7%	5.2%

COMMODITIES	WEEK	YTD	12 MONTHS	LEVEL
Brent Crude Oil	-7.1%	13.9%	-20.5%	$42.46
Gold	2.2%	27.3%	23.2%	$1,351
Copper	0.1%	4.7%	-7.6%	$4,925

CURRENCIES	WEEK	YTD	12 MONTHS	LEVEL
Euro/USD	1.8%	2.9%	1.7%	1.12
USD/Yen	-3.8%	-15.1%	-17.7%	102.06
Pound/USD	0.9%	-10.2%	-15.2%	1.32

Source: Bloomberg. As of July 29, 2016. Notes: Weekly data through Friday. Equity and bond performance are measured in total index returns in U.S. dollars. U.S. large caps are represented by the S&P 500 Index; U.S. small caps are represented by the Russell 2000 Index; Non-U.S. world equity by the MSCI ACWI ex U.S.; non-U.S. developed equity by the MSCI EAFE Index; Japan, Emerging and Asia ex-Japan by their respective MSCI Indexes; U.S. Treasuries by the Barclays U.S. Treasury Index; U.S. TIPS by the U.S. Treasury Inflation Notes Total Return Index; U.S. investment grade by the Barclays U.S. Corporate Index; U.S. high yield by the Barclays U.S. Corporate High Yield 2% Issuer Capped Index; U.S. municipals by the Barclays Municipal Bond Index; non-U.S. developed bonds by the Barclays Global Aggregate ex USD; and emerging market $ bonds by the JP Morgan EMBI Global Diversified Index. Brent crude oil prices are in U.S. dollars per barrel, gold prices are in U.S. dollar per troy ounce and copper prices are in U.S. dollar per metric ton. The Euro/USD level is represented by U.S. dollar per euro, USD/JPY by yen per U.S. dollar and Pound/USD by U.S. dollar per pound. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

3 Week ahead

Aug. 1 Eurozone, UK, Spain, Italy, France and Germany manufacturing PMIs
Aug. 2 U.S. personal income and outlays (including Core PCE price index)
Aug. 4 Bank of England (BoE) monetary policy committee announcement and minutes
Aug. 5 U.S. employment report

Key to watch this week following the Fed's July meeting statement: U.S. jobs and inflation data. Jobs growth has been on a slowing trend, and inflation expectations and realized inflation remain fairly moderate. We expect to see only one Fed rate hike this year, unless we see a significant improvement in economic data, further stability in global financial markets and a meaningful pickup in inflation measures. Elsewhere, we could see the BoE announcing a rate cut. We expect it to clarify its thinking on further quantitative and credit easing measures after it surprised the market last month by standing pat. Lastly, markets will digest the results of the European Banking Authority's stress tests of European banks.

ASSET CLASS VIEWS

Views From a U.S. Dollar Perspective Over a Three-Month Horizon

ASSET CLASS		VIEW	COMMENTS
EQUITIES	U.S.	–	Consumption and labor markets are strong, but valuations are elevated. Further gains require a meaningful improvement in earnings. We like dividend growers and quality stocks.
	Europe	▼	ECB stimulus is supportive, but post-Brexit uncertainty challenges already poor profits. A weak pound helps UK exporters; we are cautious on UK domestic stocks and European banks.
	Japan	–	Attractive valuations and better corporate governance are not enough to offset a soft economy and rising yen. The BoJ is nearing the limits of monetary policy; structural reforms are needed.
	EM	–	Our conviction is growing. Currencies and trade balances have adjusted, and we see less risk of a sharp U.S. dollar rise. We like domestically oriented stocks and EMs with reform momentum.
	Asia ex-Japan	–	China's transition to a service economy is slowing growth, yet much of this is priced in. A China credit bust and currency devaluation are tail risks. We like India and ASEAN economies.
FIXED INCOME	U.S. Treasuries	–	A Fed on hold, risk-off sentiment and easy global monetary policy offer support near term. Long-maturity bonds have a structural bid amid low rates and are diversifiers.
	U.S. Municipals	▲	We favor munis for their tax-exempt income, low volatility and strong demand from investors seeking stability and yield. We prefer bonds tied to specific revenue streams.
	U.S. Credit	▲	We generally prefer investment-grade bonds. Yields offer compensation for the risks entailed, such as rising corporate leverage.
	DM ex-U.S. Fixed Income	–	We prefer selected sovereigns in the eurozone's periphery over the core due to higher yields and ECB support. The ECB's corporate bond purchases and muted UK issuance underpin investment-grade credit.
	EM Debt	▲	We prefer high yield hard-currency debt, but are cautious on commodity exporters. We like local-currency debt in Brazil, India, Indonesia and Poland for those who can stomach volatility.
COMMODITIES	Commodities	–	Commodity markets are oversupplied. Oil fundamentals have improved, but we see much of this as priced in. We like gold as a portfolio diversifier.

▲ Overweight – Neutral ▼ Underweight

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007103A-BII-0816 / BRB-0022

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