Life after zero

BlackRock Investment Institute | June 2014

SUMMARY

Risk assets are grinding higher and volatility is extraordinarily low. Nominal economic growth is subdued (but rising) and monetary stimulus still plentiful.

What are the implications of the first post-crisis divergence in central bank strategy? And what does life after zero (rates) look like? We debated this at a New York gathering in mid-June, and updated our 2014 outlook "Squeezing Out More Juice". Our conclusions:

- Our overall views on markets are essentially unchanged. We again give our mainline scenario - Low for Longer - the highest probability for the second half of the year. (See below for details.) This does not necessarily mean yesterday's winning trades will work again tomorrow, as market leadership can change quickly.
- Valuations are becoming stretched across markets and investor complacency is high. Many asset owners hold similar investments - long credit, long momentum and short emerging markets (EM) risk. This sets markets up for more volatility, especially as the focus shifts from the end of US quantitative easing (QE) to worries about the timing and magnitude of US interest rate hikes.
- The biggest change over the past six months? A brewing crisis in emerging markets has stabilised. Many economies have adjusted and started closing current account deficits, setting the stage for an economic and market rebound. Selection is key, as countries develop at very different speeds.
- The US Federal Reserve has stuck to the mantra of keeping rates low with great conviction - despite mounting evidence the US economy is set to improve. The risk? When it shifts gears, markets are going to notice. Think steeper (and earlier) rate hikes than the market currently expects, but a lower peak Federal Funds Rate than in previous cycles. Also watch out when QE ceases by year-end. The Fed's reduced bond buying still gobbles up an outsized portion of net debt issuance.
- The European Central Bank's (ECB) resolve to prevent the eurozone from falling into a deflationary spiral is likely good news for European risk assets. Watch current account balances to gauge competitiveness and the ECB's manoeuvring room to start an asset purchase programme.
- We are bullish on Japanese equities, despite recent underperformance. Reasons include Godzilla-like QE by the Bank of Japan (BoJ), cheap valuations, structural

reforms to boost economic growth, and a rise in domestic investor interest. Expectations on China's GDP growth may edge down further. Its investment-fuelled economic model is not sustainable. Structural reform is the only way out - but it may push down growth in the short term. Worries about a credit blowout look overdone.

3 key points

- Growth - We expect growth to tick up steadily but to remain below trend.
- Markets - Many assets are pricey, but we do not think there is a market bubble (yet).
- Risks - The end of US QE and anticipation of rate hikes are key risks.

So what do I do with my money?

- We generally prefer equities over bonds, particularly in our Low-for-Longer base-case scenario.
- Equities are not cheap but they are not (yet) in bubble territory. We favour Europe and Japan on valuation and asset-price-boosting central bank policies.
- Volatility is unnaturally low and set to rise. Stock up on downside (and upside) protection while it is cheap.
- Many bonds look expensive and risky (especially government debt). Stick to select yield plays and relative-value investments.

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Figure 1: Investment scenarios 2014

	Imbalances Tip Over	Low for Longer	Growth Breakout
Description	A downturn delivers zero nominal interest rates but rising real ones. Markets sell off on (expectations of) a rate hike or an exogenous shock. Risk assets fall, volatility spikes. Safe-haven government bonds get a second life.	Real rates and overall volatility stay subdued. Momentum can easily propel equities higher. The hunt for yield intensifies. Low investor conviction in trades and lofty valuations leave little room for error.	Real rates move up gradually, driven by rising inflation expectations. This is mostly bad for bonds and mixed for stocks (growth trumps income). Cyclical assets (including commodities) should do well before rate fears kick in. Volatility rises.
Probability	16% (-4%)	57% (+2%)	27% (+2%)
What's new	Markets have mostly ignored growing geopolitical risks such as the Ukraine standoff and Middle East sectarian strife. Which dog that is yapping now will become the one that actually bites? Ending ultra-low rates is tricky, and so is navigating increasing central bank policy divergence.	Low for Longer has buoyed risk assets but valuations are no longer cheap. Trades that worked in the past may not work in the future. Equity leadership is becoming fitful. Watch out for sharp reversals in internal market dynamics (small vs. large, growth vs. value)	Be careful what you wish for. Faster growth is not necessarily good for equity prices. Rising rents look set to boost US core CPI, magnifying a growing disconnect between Fed policy and market expectations. The market may do the tightening itself (ugly for bonds).

	Downside	Upside
Risks	Valuations become over-extended. UK and US rate expectations rise too fast. Deflation hits the eurozone.	EM economies and asset prices rebound. Global growth beats (low) expectations. Companies switch from buybacks to capex.

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1. MARKETS

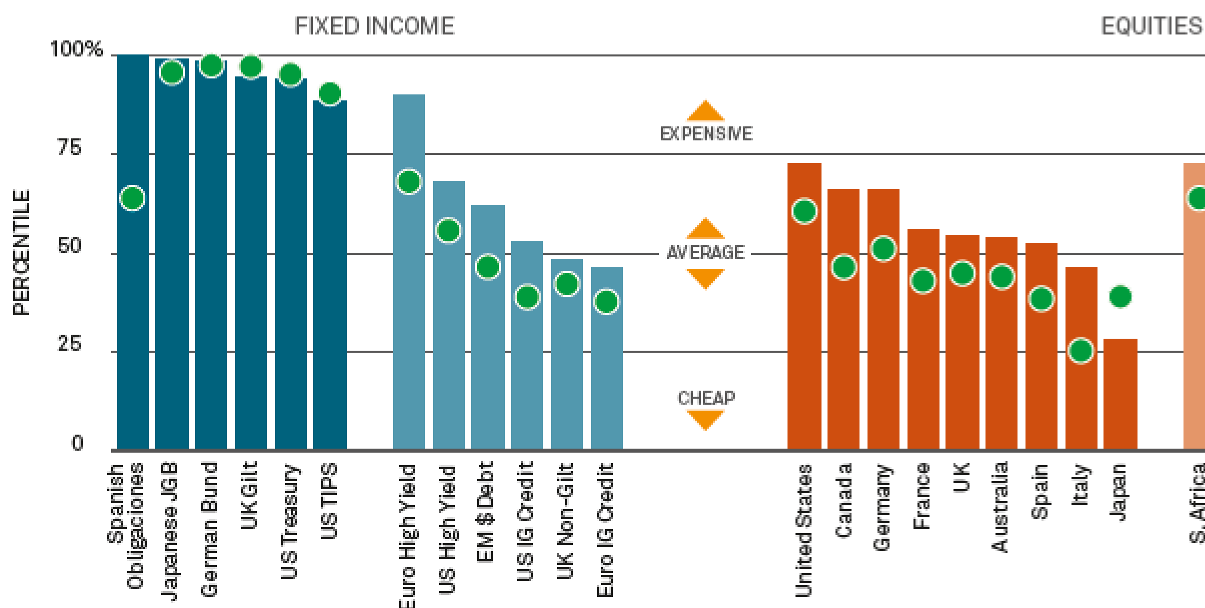
Easy monetary policies by central banks have pushed down bond yields, encouraging risk taking and inflating asset valuations. Volatility is suppressed in equities, bonds and currencies.

Government bonds look particularly dear and credit markets appear to be moving in the same direction (see Figure 2 below). Note, corporate bonds would look a lot more expensive if measured on an absolute yield basis. Dispersion in credit markets is unusually low, with a rising tide lifting all bonds. These markets have essentially become rate, not credit, plays.

The fall in yields has had many reaching for their history books. Spanish 10-year bond yields recently fell to their lowest levels since 1789, while French yields plumbed the lowest levels since 1746, according to Deutsche Bank. Equity valuations look more reasonable, particularly outside the US.

Easy financial conditions are pushing asset owners into look-alike yield-seeking trades, as detailed in "A Disappearing Act" of May 2014. The longer monetary policy smothers volatility and underwrites heady valuations, the bigger the eventual recoil. Geopolitical risks bubbling to the surface add to the potential for volatility spikes. The market response to political crises is often Hobbesian - nasty, brutish and short.

Figure 2: In search of value
Asset valuations by percentile versus historic norms, May 2014



Sources: BlackRock Investment Institute and Thomson Reuters, 30 May 2014.
Valuation percentiles are based on an aggregation of standard valuation

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measures versus their long-term history. Government bonds are 10-year benchmark issues. Credit series are based on Barclays indexes and the spread over government bonds. Treasury Inflation Protected Securities (TIPS) are represented by nominal US 10-year Treasuries minus inflation expectations. Equity valuations are based on MSCI indexes and are an average of percentile ranks versus available history of earnings yield, cyclically adjusted earnings yield, trend real earnings, dividend yield, price to book, price to cash flow and forward 12-month earnings yield. Historic ranges vary from 1969 (developed equities) to 1998 (TIPS).

Battle of the acronyms: ZIRP versus QE

Many investors braced for rising rates and volatility as the Fed reduced its monthly bond buying. Why did the opposite happen? Markets have overemphasised the impact of QE and underclubbed the importance of zero-interest-rate policy (ZIRP).

QE-created liquidity leaked beyond US borders. This is why the Fed's signaling of the end of bond buying was such a big deal in emerging markets. ZIRP is likely to stick around for a while if we take Fed Chair Janet Yellen at her word. What does this mean for volatility and markets?

- The anticipation of a ZIRP reversal could cause market angst on the timing and magnitude of future rate hikes. The result? A greater chance of (spikes in) volatility. Caveat: Cycles of low US volatility (both interest rate as well as realised and implied equity market volatility) have tended to last until higher rates started to inhibit growth. Volatility and credit cycles have gone hand-in-hand, ending simultaneously when growth jitters led to a rise in expected defaults.
- Pricey asset markets, low dispersion of returns and lack of investment conviction are part of the ZIRP furniture. This is unlikely to change soon. The first rate hike in a major developed economy (likely the UK) will not necessarily upset this status quo. The trick will be to navigate the impact of divergence between the tighteners (Bank of England (BoE) and, eventually, the Fed) and looseners (BoJ and ECB).

Bubbling along

The longer Low-for-Longer lasts, the more stretched valuations become as risk taking is rewarded. Equity markets are at risk of becoming disconnected from earnings growth. Multiple expansion (investors paying a higher price for the same level of earnings) drove gains in all major markets last year with the exception of Japan.

This factor has been behind gains in emerging markets, the eurozone and the UK this year, even as earnings shrank in the latter two (Figure 3 below). By contrast, Japanese and US equity returns have been underpinned by earnings growth. Rising earnings may not translate

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into positive returns in the short term, but they are usually rewarded in the long run, as detailed in "Risk and Resilience" of September 2013.

Are we in a market bubble? We introduced a couple of bubblemeters this year – a high yield complacency gauge (see "A Disappearing Act") and a US market gauge that takes into account volatility and corporate leverage (see Squeezing Out More Juice" December 2013). The latter has crept higher over the past six months but is still short of pre-crisis highs.

In other words, we do not believe we are in a bubble – yet. We would get worried if we were to see leverage rise much further. In the meantime, brace for shifts in internal market dynamics (think the equity momentum reversal earlier this year).

There is one complication – market liquidity has lagged the pace of debt issuance. Prices could gap down in case of a wave of reallocations out of areas such as corporate bonds. Ravenous appetite for yield by long-term asset owners is a stabiliser. See "The Liquidity Challenge" June 2014 for further details.

Paltry yields pose a challenge for institutions with long-term liabilities. At the millennium, 10 major fixed income sectors yielded over 4%. Since 2011, just two have met this hurdle (high yield and EM debt) as shown in Figure 4 below. Asset owners need to take more risk just to keep standing still.

Low yields underpin equity valuations. Takeovers, corporate issuance and share buybacks have been booming. Debt holders essentially are subsidising return-on-equity growth. This can last a long time. The problem? It makes equities as vulnerable as bonds to rising rates. It also means bond and equity correlations could rise, making diversification harder.

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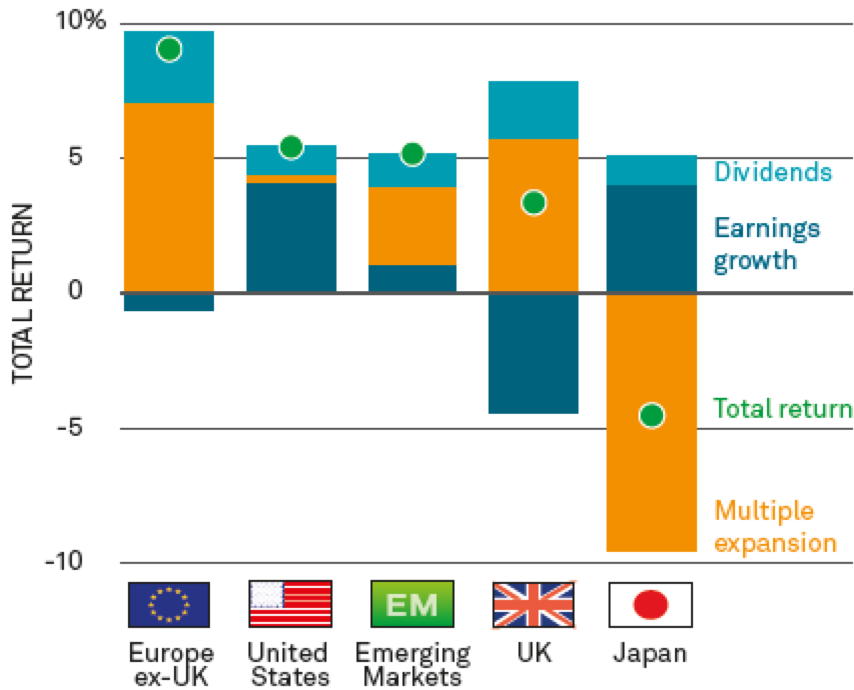
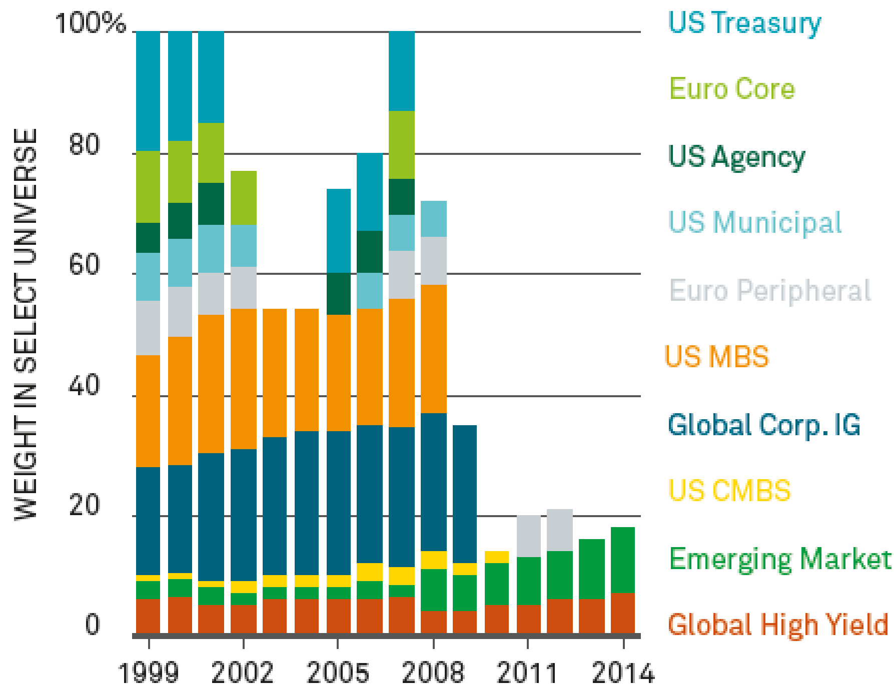
Figure 3: 2014 equity returns by source
June 2014



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, June 2014. All returns are in local currency terms. Multiple expansion is represented by the change in the price-to-earnings ratio. Earnings growth is based on aggregate 12-month forward earnings forecasts. 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 returns.

Figure 4: Yielding little

Fixed income assets yielding over 4%, 1999-2014



Sources: BlackRock Investment Institute, Barclays and Thomson Reuters, June 2014. The bars show market capitalisation weights of assets with an average annual yield over 4% in a select universe that represents about 70% of the Barclays Multiverse Bond Index. Euro core is based on French and German government debt indexes. Euro peripheral is an average of government debt indexes for Italy, Spain and Ireland. Emerging markets combine external and local currency debt.

2. ECONOMIES

The US economy has been cruising below its speed limit for years, yet it could be on the verge of a cyclical pick-up.

- **Housing**: This key sector's recovery has slowed but remains intact.
- **Fiscal**: The fiscal drag from spending cuts and tax hikes is fading this year and is set to virtually disappear by 2015, according to Goldman Sachs.
- **Capex**: Goldman's capex tracker (which tracks 16 capital spending gauges) points to a near-term capex pick-up.

What does this mean for US monetary policy? The answer depends on how much slack there is in the economy. A recent rise in the long-term unemployed could point to structural factors like skills shortages. Yet the Fed appears to believe that temporarily discouraged

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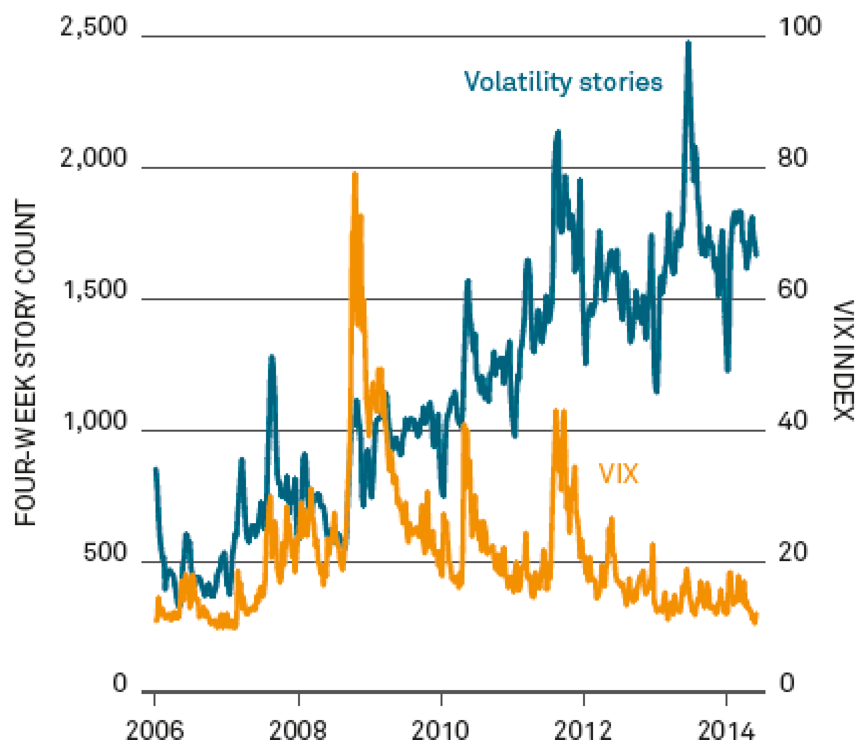
workers will come out of the woodwork once job openings rise. See our interactive BlackRock Jobs Barometer for key labour market trends around the world.

If US unemployment has a structural component, faster growth could push up wages quickly. The Fed uses core personal consumption expenditures (PCE) as its preferred gauge of inflation, not the consumer price index (CPI). Core PCE has been lower than core CPI, primarily because it gives less weight to the ‘cost of shelter’ such as rent (15% versus 33%). Our analysis suggests the usual spread of 50 basis points between the two could widen significantly given housing supply shortages. This could magnify a growing disconnect between the Fed’s policy and market conditions (and expectations).

The bottom line: The Fed looks set to stick to its 'low for longer' policy with great conviction despite signs the economy is improving. Markets are going to take notice when the Fed shifts gears. Brace for steeper (and earlier) rate hikes than currently expected, but a lower peak federal funds rate than in previous cycles.

Could this awaken volatility from its long slumber? Cross-sectional volatility in the S&P 500 recently hit the lowest point in our quantitative guru's lifetime (he was born in July 1960). We are not the only ones worrying about this. Media chatter about volatility has risen as implied volatility limped toward record lows as well. See Figure 5.

Figure 5: Much ado about nothing
VIX and Bloomberg volatility stories, 2006-2014



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Sources: BlackRock Investment Institute and Bloomberg, June 2014. The blue line shows the four-week average of the number of Bloomberg stories mentioning the word 'volatility.'

Europe: low bar

The bar is low for European growth to surprise on the upside. And asset values are supported by a (perhaps complacent) belief ECB President Mario Draghi is ready and able to do whatever it takes to preserve the monetary union and prevent the eurozone from going into a deflationary spiral.

The key is to watch current account balances. A turnaround in Spain's showed the economic adjustment Southern-tier nations made and foreshadowed a rally in peripheral assets. A falling surplus in Germany could lead to renewed efforts by the ECB to push down the euro and a 'melt-up' in European equities. By contrast, the BoE has signaled it could hike rates sooner than markets expect.

Japan: all in

Japanese equities have underperformed so far this year, yet we remain believers (in the hedged variety). Our reasoning includes an 'all-in' BoJ flooding the market with liquidity, cheap valuations, structural reform efforts, and an asset allocation shift (fewer bonds, more equities) at the $1.2 trillion Government Pension Investment Fund (GPIF). See "Rising Sun, Setting Sun" of March 2014 for further details.

China and EM: a bounce back?

China's GDP growth expectations have fallen over the past years but could edge even lower. The country's investment-fuelled growth is not sustainable, in our view. Reform is the only way out but it may dampen growth in the short term. Can policymakers deliver on their long to-do list? A lot depends on China's export machine which makes up a quarter of GDP. If exports hold up, the government has manoeuvring room. Any downside surprises to export growth could cause the government to stall or even dial back reforms.

Angst about a credit blowout looks overdone. Absolute leverage is daunting but containable. We do worry about the torrid growth in credit, especially in the shadow banking system of (often unregulated) securitised corporate loans. There are good arguments to bank on a Xi Jinping put, a belief China's leadership has the ammunition and determination to prevent any systemic financial market crisis. The outcome may be secure, but the journey is likely perilous.

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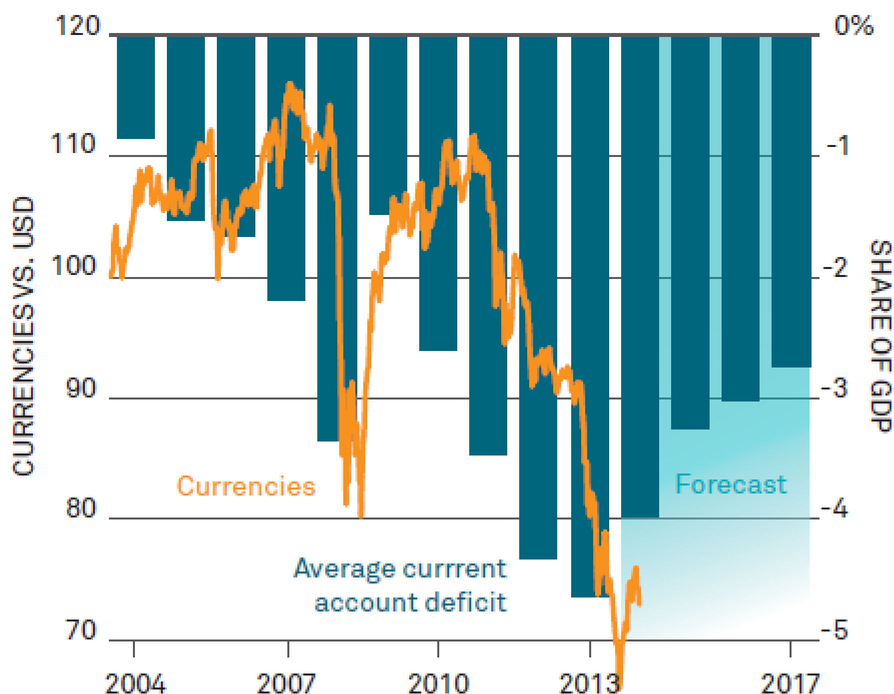
The property market may be Beijing's hardest nut to crack. Property makes up an outsized share of the economy. The challenge? To engineer a slowdown without hurting growth (too much).

EM growth and markets have been weak in recent years, setting the stage for a cyclical rebound over the next year. The currencies of the Fragile Five (Brazil, India, Indonesia, South Africa and Turkey) declined sharply as the market punished countries with large external deficits.

There are signs this bitter medicine may be making them more competitive again. Current account balances are forecast to recover (see Figure 6). Divergence among EM countries is our main theme, and we favour countries with strong balance sheets that are implementing reforms to make their economies more competitive (think Mexico). See "Emerging Markets on Trial" of January 2014.

Figure 6: EM re-emergence

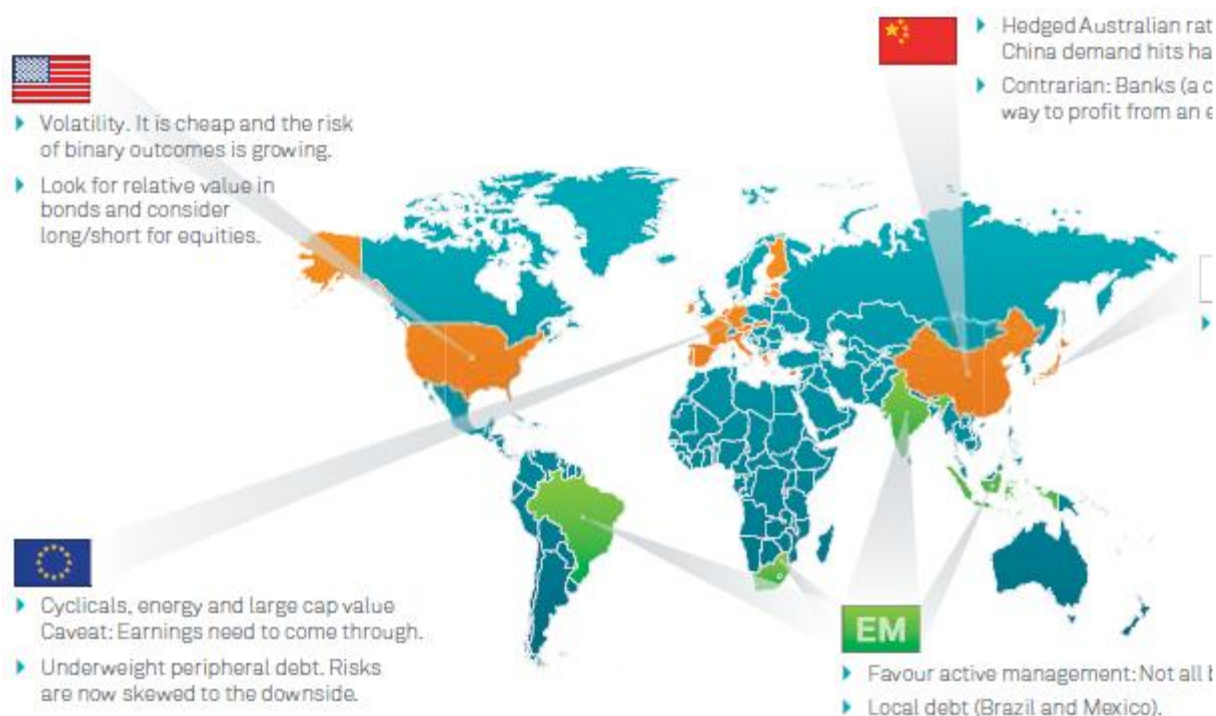
Fragile five external deficits and currencies, 2004-201



Sources: BlackRock Investment Institute, Oxford Economics and Thomson Reuters, June 2014. The currencies line shows an equally weighted basket of spot rates vs the US dollar for the Brazilian real, Indian rupee, Indonesian rupiah, South African rand and Turkish lira (rebased to 100 in June 2004).

Figure 6: Worldly picks

BlackRock investment preferences for the second half of 2014



Source: BlackRock Investment Institute, June 2014. Investment strategies mentioned may not be suitable for all investors, depending on investor guidelines and market conditions at the time of investing.

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