OUTLOOK 2015

LOOKING GLASS

STAY ALERT AND CARRY ON

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If one thing is certain about today's investment landscape, it's uncertainty. Good value is increasingly difficult to find and it's unclear how the impact of central bank actions will be felt.

Our 2015 outlook highlights the key themes that we believe could affect your clients' portfolios over the coming year and how you can help them through what looks set to be a complex 12 months.

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OUR CENTRAL THEMES

Central bank and economic divergence

Central bank and economic divergence has come to the fore in recent months and will continue to play out in 2015 as the major driver of relative returns, especially in fixed income. If anything, the disparity between economies – and the respective central bank policies – looks set to widen.

Search for value in an increasingly fully-valued world

The providers of liquidity may be changing, but the safety net that stretched valuations in 2014 has not been completely removed. Our preference for equities holds, but finding value in an increasingly full-valued world and the hunt for yield following 2014's bond rally are key drivers of our investment calls.

SO WHAT DO I DO WITH MY MONEY?™

Search for value in equities	Europe, Japan and EM Asia
Be unconstrained in fixed income	EM hard currency debt and European financial bonds
Generate a higher income	High yield and dividend payers

Looking Glass

CENTRAL BANK DIVERGENCE... QUESTIONS REMAIN

The Bank of England (BoE) and the Fed may be stepping back from loose monetary policy, but the Bank of Japan (BoJ), European Central Bank (ECB) and now the People's Bank of China (PBOC) are stepping up with more easing.

We expect the Fed to hike by mid-2015 and the yield curve to flatten. A number of questions remain for the ECB and the BoJ.

For the ECB:

- Will existing measures be enough to reach its ambitious balance sheet goal (€1 Trn increase in 2 years)?
- Is fully-fledged, sovereign quantitative easing (QE) inevitable? If so, will it be enough to jump-start the Eurozone economy?

For the BoJ:

- Will its latest QQE (Quantitative and Qualitative Easing) bazooka finally achieve its inflation target?

WHAT ELSE WILL SHAPE MARKETS?

Stretched valuations, crowded trades and volatility

Many asset class valuations are stretched, trades are crowded and volatility will likely rise. Investors need to have both the flexibility to take advantage of the opportunities that bouts of volatility bring and the safeguards in place to exit crowded positions when the time comes.

Diversification getting harder

Diversification will enable investors to ride out volatility and eke out returns, but true diversification will become increasingly difficult as traditional assets become more correlated.

EM reform

There are likely to be selective opportunities within emerging markets (EM) as their economies echo developed markets divergence. A lot rests on the success of reforms in China and India.

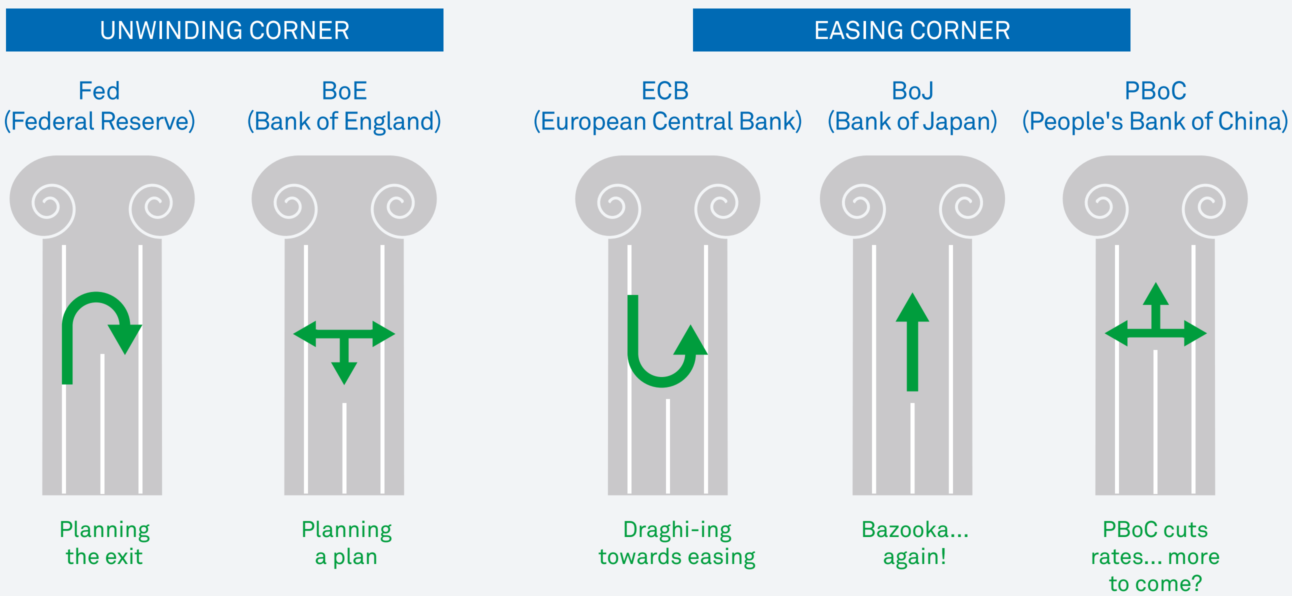
Dollar strength

Divergence means dollar strength: good for Japan and Europe but bad for commodities and EM.

Oil prices and geopolitics

Lower oil prices could provide a boost to global growth, but if the conflict between the West and Russia escalates, growth may slow, particularly in Europe.

FIGURE 1: CENTRAL BANK DIVERGENCE CENTRE STAGE



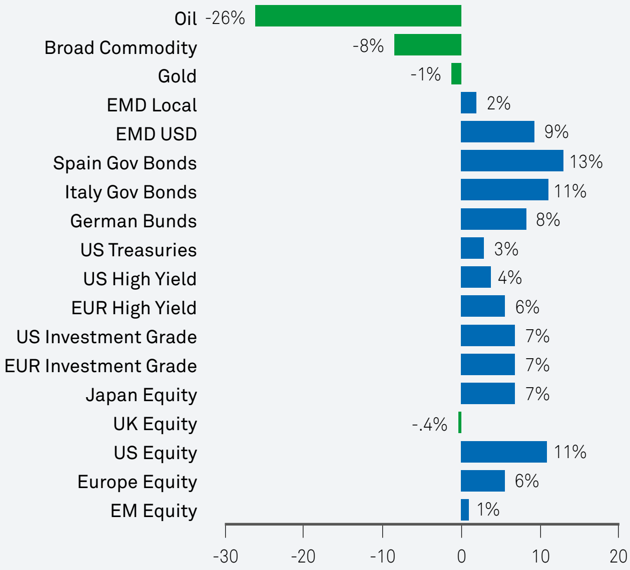
Source: BlackRock, as at December 2014.

LEARNING FROM THE PAST

At the start of 2014, we expressed a preference for stocks and corporate bonds over government bonds. Within equities we thought that developed markets – especially Japan and Europe – were better positioned to perform and kept EM investing tactical.

- Japan and Europe equity calls played out for the most part, helped by a Q4 rally. We believe these calls will continue to apply in 2015.
- Our hard currency EM debt and credit calls have done well, but we (along with the wider consensus view) were surprised by such a strong year across fixed income. Can fixed income repeat the trick in 2015?
- Crowded trades were punished: Japan in January, the US tech sector in March, High Yield in July. In October, this culminated in a broad spike in market volatility. While absolute levels of volatility are still low, these episodes serve as an early warning signal for the world post-Fed QE.

FIGURE 2: 2014 FIXED INCOME SURPRISE



Source: Bloomberg, data as at end of November 2014. For fixed income segments, numbers represent total returns in percentage terms.

VOLATILITY RETURNS AMIDST CROWDED TRADES

After an extended period of calm, concentration in crowded positions brings with it the risk of bouts of greater volatility ahead. Volatility in October 2014 highlighted the dangers of crowding. A broad market sell-off was compounded by hedge funds hitting the same sell triggers all at once.

Diversification will become tougher. The balance between reaching out for returns and staying liquid will be crucial but difficult to maintain.

In this type of nervous, crowded environment, it will be important to keep an eye on how political events unfold. Table 1 contains the key events to watch for in 2015.

TABLE 1: 2015 SIGNPOSTS

JAN	**29-30 January –** Fed meeting
FEB	Greek presidential elections (note the rise of Syriza) **26 February –** India budget release
MAR	**15 March –** US debt ceiling **19-20 March –** Fed meeting (then major ones in June, September and December)
MAY	**7 May –** UK general election
JUN	**13 June –** Turkey national assembly election
JUL	Mexico congress elections
OCT	US government runs out of money if debt ceiling not extended General elections in Canada, Portugal, Poland, Argentina China Fifth Central Committee Plenum
DEC	**20 December –** Spain general election (note the rise of Podemos)

Source: BlackRock, data as at November 2014.

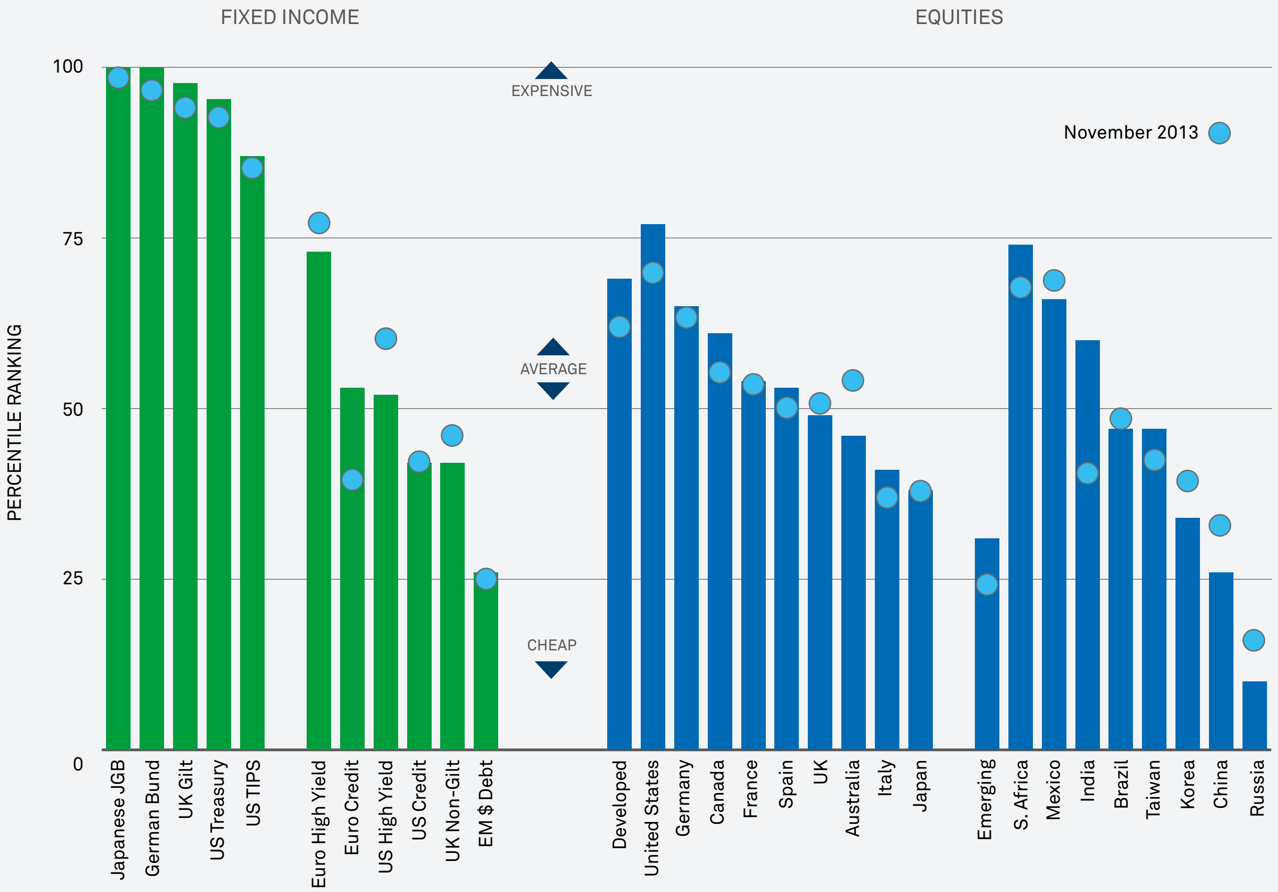
STRETCHED VALUATIONS AND THE HUNT FOR YIELD

The providers of liquidity may be changing, but the safety net that stretched valuations in 2014 has not been completely removed.

Our preference for equities holds, but finding value in an increasingly full-valued world is a key driver of our investment calls (Figure 3).

The hunt for yield following the bond rally in 2014 will drive investors to look for multi-asset solutions in an effort to extract the income they need from their portfolios.

FIGURE 3: FINDING VALUE IN AN INCREASINGLY FULLY-VALUED WORLD



Source: BlackRock Investment Institute, Thomson Reuters, data as at November 2014.
Notes: Valuation percentiles are based on an aggregation of standard valuation measures and show where current valuation stands 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. 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 2004 (EM$ Debt).

See our 'BlackRock Investment Institute 2015 Outlook' for more analysis on these themes.

SO WHAT DO I DO WITH MY MONEY? ™

1. Search for value in equities

- **The outlook for European equities is improving**

  While fairly-valued, European stocks are still cheaper than their US counterparts, which is attractive in a world of relative, rather than absolute, bargains. With investor sentiment on Europe negative, there is potential for a sentiment bounce on better economic data and improving earnings. We see some of the best bargains in European cyclicals, which may have been excessively marked down due to pessimism over Europe's recovery. Autos and German stocks offer export-oriented exposures that benefit from the weaker euro.

- **Japan equity valuations still look relatively cheap**

  There are significant tailwinds for Japanese stocks, including more QE, Japan's Government Pension Investment Fund shifting its asset allocation to 25% in domestic stocks and Prime Minister Shinzō Abe's delay of an unpopular sales tax hike. The caveat: keep watch of the current consensus positioning build-up.

- **In EM, Asia is our preferred region**

  Broad EM stocks remain cheap and under-owned, but differentiation is key. On a country level, Korea and Taiwan are well geared to the US recovery. India, while well-owned, should continue its strong momentum, helped by the falling oil price and easing monetary policy.

- **Selective opportunities in the US: tech for growth**

  While expensive, we find selective opportunities in US equities: tech stocks look attractive for their growth potential and benefit from the reinvestment of capital.

2. Be unconstrained in fixed income

A stellar 2014 for fixed income creates a challenge for the coming year: where to find returns while avoiding excessive valuations. Such circumstances necessitate a flexible approach to fixed income investing. However, we do see specific opportunities:

- **European financial bonds**

  European financials should remain supported by bank deleveraging and the ECB.

- **Hard currency EM debt**

  We continue to have a preference for hard currency EM debt given its attractive and supportive supply outlook. Local EMD remains vulnerable to currency weakness on a tighter Fed.

3. Generate a higher income

- **High yield**

  HY bonds will continue to be a source of income in diversified portfolios and underlying default rates remain low. Volatility will create tactical opportunities, but as with this year it's about coupons not capital gains.

- **Global dividend equities**

  Given absolute yield levels, especially in Europe, those needing income will need to go beyond fixed income. Dividend equities outside the US – with a focus on earnings quality – look well-positioned to deliver income even if valuations are no longer cheap.

WHY BLACKROCK®

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*AUM as at 30 June 2014. † Source: Pensions & Investments as at 31 December 2013.

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