BLACKROCK'S INSIGHTS ON MARKETS AND INVESTMENT GUIDANCE

BLACKROCK®

FEBRUARY 2016

Here are notes from the most recent meeting of the BlackRock Investment Council (BIC), whose membership has expanded to include chief investment officers as well as our most senior investors and strategists. Our mission is to drive toward a "Best of BlackRock" view on the issues most important to our portfolio managers and our clients.

- **Rising Negativism:** Anxiety among investors and in the market is greater than it has been for some time, despite the lack of substantive change in global fundamentals. Volatility has gone up, but not dramatically, and remains well below panic levels. While our portfolio positioning still reflects a broadly constructive view of the long-term outlook, we, like all investors, are feeling the effects of sentiment that has clearly deteriorated. As with any market in which there are big price drops, opportunities are opening up, but having the conviction to act is another matter. Central banks remain key drivers of sentiment and asset prices so will probably need to provide further support via lower or even negative rates before buyers return to the market.
- **(One of) The Big Question(s):** Is the U.S. About to Enter a Recession? Based on growing evidence, we're lowering our expectations for both economic growth and earnings but by no means believe a recession is inevitable. The consumer and the services sector are still doing reasonably well, and the manufacturing recession seems to be bottoming out. Overall we still see the risk of recession in the next year at less than 50%. Our thinking: Were the U.S. to dip into recession it would be garden variety and not like the extended painful downturn that came in the wake of the financial crisis.

Other Risks

- **Oil:** While no one has the crystal ball that can tell where oil will end the year, we think the risk of sharply lower oil prices is more of a derivative of the other key risks facing the global economy as opposed to a substantial "tail risk" in and of itself. That said, the oil price decline continues to spook nervous traders who see crude as a proxy for economic growth.
- **China:** Definitely one of the other Big Questions: We see higher risks around the management of the renminbi, which could lead to a foreign-exchange devaluation or more government capital controls. The associated knock-on effects globally – through trade and financial channels – would likely be large. As long as the RMB is expected to depreciate, pressures on the capital account will continue. The Chinese authorities' best hope is that the Federal Reserve continues to hold rates, which would discourage further dollar appreciation. On the positive side, the "growth crash" scenario that became prominent last year wasn't a major concern in our latest discussions.

- **European Banks:** We strongly believe that as yet there is no broad-based funding crisis in this important sector. The stomach-churning price movements seen in share prices seem to be driven by a limited number of trades in what's become a deeply illiquid market. That said, given the prospect for both short- and long-term rates to remain low, or even become more negative, and the downward revisions to economic activity, the ability of these banks to generate profits looks poor. This means they likely will need to undertake additional rights offerings to meet the regulatory requirements to increase capital buffers, and in some cases may find themselves unable to pay coupons on the large amounts of contingent-convertibles bonds (Cocos) and other subordinated debt they've issued. These problems are without a quick fix.

Portfolio Positioning

- **Risk assets:** On balance, we continue to have a positive view on both equity and credit markets. As painful as the ticker watching is these days, stocks are becoming increasingly appealing for investors with a long time horizon who can bear high short-term volatility. But even the more optimistic among our portfolio managers are awaiting additional signals to buy, such as further central-bank support. There is also a feeling that we haven't seen the classic capitulation from most investors that usually precedes a meaningful, sustained recovery in stocks. Instead, the market is getting whipped around by isolated and sometimes forced sales. All this mean prices could drop further in the short term on bad headlines. Regarding specific stock sectors, we're clearly seeing better value outside the U.S., although consumer-discretionary (recall that the consumer is still holding up) and technology sectors are still worth watching for opportunity Stateside. In general we prefer high-quality companies with high profitability, low earnings volatility and limited debt.
- **Bonds/Credit:** As mentioned, the pause in the U.S. rate normalization takes some of the wind out of the dollar and is leading us to look to non-dollar debt for opportunity. Meanwhile, the weaker commodity prices continue to weigh on the high-yield market, and quality is becoming even more critical in credit.
- **EM debt and commodities:** Our view on emerging markets has shifted significantly: We are now on balance neutral toward the sector given that EM debt and commodities both are suffering from structural issues, most notably overcapacity that needs to be worked down. Heroic trades in these asset classes are not warranted. Again, there are pockets of value for investors with long horizons.

Issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975 AFSL 230 523 (BIMAL), for the exclusive use of the recipient who warrants by receipt of this email that they are a wholesale client as defined under the Corporations Act 2001 (Cth). This email is intended only for wholesale clients and must not be relied or acted upon by retail clients.

This email provides general information only and has not been prepared having regard to your objectives, financial situation or needs. BIMAL, its officers, employees and agents believe that the information in this email and the sources on which the information is based (which may be sourced from third parties) are correct as at the date of this email. While every care has been taken in the preparation of this email, no warranty of accuracy or reliability is given and no responsibility for this email or the information contained in the email is accepted by BIMAL, its officers, employees or agents. Except where contrary to law, BIMAL excludes all liability for this information.

Any investment is subject to investment risk, including delays on the payment of withdrawal proceeds and the loss of income or the principal invested. While any forecasts, estimates and opinions in this email are made on a reasonable basis, actual future results and operations may differ materially from the forecasts, estimates and opinions set out in this email. BIMAL does not guarantee the repayment of capital or the performance of any product or rate of return referred to. Past performance is not a reliable indicator of future performance.

No part of this email may be reproduced or distributed in any manner without the prior written permission of BIMAL.

© 2016 BlackRock, Inc. All Rights Reserved. BlackRock® is a registered trademark of BlackRock, Inc.

BLACKROCK®