Weekly Commentary

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Our market commentary is now authored by Richard Turnill, BlackRock's Global Chief Investment Strategist. Share your feedback at *blackrockinvestments@blackrock.com*.

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Key Points

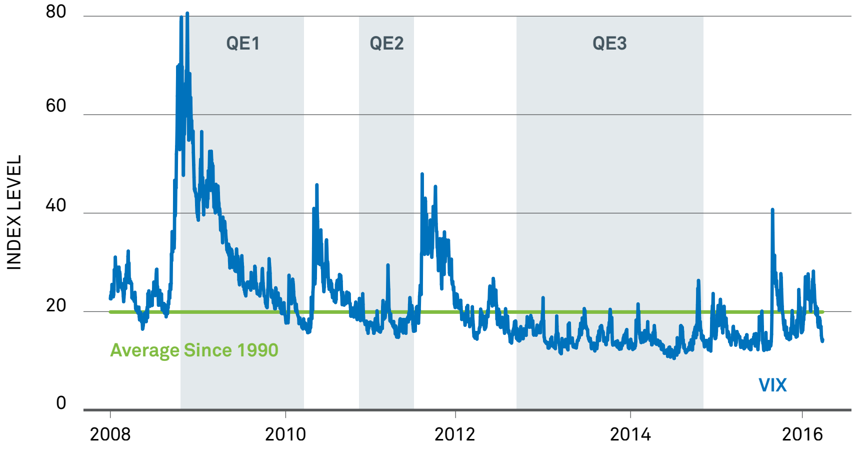
1. Low volatility and inflation expectations look unsustainable. We like inflation-linked bonds and gold as diversifiers.
2. Safe-haven currencies such as the U.S. dollar and yen rose after the tragic events in Brussels in a holiday-shortened week.
3. Stabilizing oil prices and a tighter labor market could contribute to rising actual, and expected, U.S. inflation this week.

1 IT'S BEEN TOO QUIET OUT THERE

Central bank asset purchases have played a role in suppressing market volatility over the past six years. See the chart below. But current low levels of volatility look unsustainable.

CHART OF THE WEEK

U.S. Equity Market Implied Volatility, 2008-2016



Sources: BlackRock Investment Institute and Thomson Reuters, March 2016.
Notes: The CBOE Volatility Index (VIX) represents expectations of 30-day volatility calculated from S&P 500 options. QE refers to the U.S. Federal Reserve's quantitative easing programs. The shaded areas represent the beginning and end of each QE period.

The Federal Reserve's (Fed) quantitative easing (QE) program — twinned with liberal doses of QE by other central banks — dulled market volatility to unprecedented low levels between 2012 and 2014. This period of exceptionally low volatility ended last year, as the Fed wound down its QE purchases and began to raise rates. However, markets have become eerily quiet recently.

Preparing Portfolios for Higher Volatility

U.S. equity market volatility is hovering around its lowest level since August 2015 and is well below its long-term average. This unusual calm follows declining market concerns about sliding oil prices, and the health of China's economy and European banks. We do not expect this to last, and see a return to the higher-volatility regime that was the norm prior to QE.

The future path of monetary policy remains uncertain and tail risks remain. A big Chinese yuan devaluation isn't our base case, but it's a downside risk. Geopolitics, particularly as Europe confronts terrorism and migration, could spark volatility.

So, too, could rising global and U.S. inflation expectations. A modest upward trend in inflation expectations, as recession fears fade, would initially support riskier market segments like emerging market (EM) stocks and commodities that have been pushed down by deflation concerns. However, these assets could suffer in the longer term if the Fed were seen to be falling behind the curve, raising expectations of sharper rate hikes.

Now is a good time to prepare portfolios for higher volatility. Gold can be an effective hedge if volatility spikes due to rising U.S. inflation fears, according to our research. We also like Treasury Inflation-Protected Securities (TIPS) and similar instruments. Foreign-currency exposure can act as a diversifier as well.

2 WEEK IN REVIEW

- Safe-haven currencies such as the U.S. dollar and yen strengthened after the Brussels terror attacks.
- Inflows into global EM equity exchange-traded product funds surged to $8.6 billion so far this month, according to BlackRock research, a monthly record since January 2013.
- U.S. economic data were mixed. The 12-month moving average of initial unemployment claims relative to employment hit a record low, signaling possible upward wage pressure.

GLOBAL SNAPSHOT

Weekly and 12-Month Performance of Selected Assets

EQUITIES	WEEK	12 MONTHS	DIV. YIELD
U.S. Large Caps	-0.2%	-0.5%	2.3%
U.S. Small Caps	-1.1%	-13.3%	1.7%
Non-U.S. World	-2.2%	-13.2%	3.4%
Non-U.S. Developed	-2.6%	-12.5%	3.5%
Japan	-1.7%	-9.8%	2.3%
Emerging	-0.3%	-14.8%	2.9%
Asia Ex Japan	0.3%	-13.3%	2.9%

BONDS	WEEK	12 MONTHS	YIELD
U.S. Treasuries	0.1%	1.6%	1.9%
U.S. TIPS	0.1%	-0.4%	1.9%
U.S. Investment Grade	0.5%	-0.1%	3.3%
U.S. High Yield	-0.1%	-3.8%	8.3%
U.S. Municipals	0.1%	3.4%	2.0%
Non-U.S. Developed	-1.2%	3.9%	0.8%
Emerging Market $ Bonds	0.1%	3.5%	6.0%

COMMODITIES	WEEK	12 MONTHS
Brent Crude Oil	-2.6%	-26.6%
Gold	-3.3%	2.0%
Copper	-2.5%	-19.5%

CURRENCIES	WEEK	12 MONTHS
Euro/USD	-1.3%	2.3%
USD/Yen	1.4%	-5.7%
Pound/USD	-2.3%	-4.7%

Source: Bloomberg. As of March 24, 2016. Notes: Weekly data through Thursday. 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. Treasury by the Barclays U.S. Treasury Index; U.S. TIPS by the US 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. municipal 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. 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

March 28	U.S. Core Personal Consumption Expenditures (PCE) Price Index
March 31	Eurozone Flash Consumer Price Index (CPI)
April 1	U.S. Nonfarm Payroll Employment Report
April 1	Bank of Japan (BoJ) Tankan Survey (Q1)

This week's U.S. economic reports are key for gauging future inflation and inflation expectations. The Fed this month signaled it was willing to tolerate higher inflation in the short run, sending inflation expectations higher. But the discrepancy between actual inflation and inflation expectations is large, as evidenced by five-year, five-year forward breakevens trading near 2008 lows.

The core personal consumption expenditures (PCE) index, the Fed's preferred gauge of U.S. inflation, and other inflation data this week may show to what extent the effect of stabilizing oil prices is broadening out. Firming oil prices and a tighter labor market, as reflected in wage growth, could further boost both actual and expected inflation.

ASSET CLASS VIEWS

Views on selected asset classes over a three-month horizon.

ASSET CLASS		VIEW	COMMENTS
EQUITIES Overweight	U.S.	▲	The U.S. consumer and housing sectors are strong, and growth appears to be stabilizing. We see peak margins and payout ratios limiting returns, however.
	Europe	▲	Reasonable valuations and supportive ECB policy, but weak growth and a challenged banking system. Domestic UK equities look vulnerable to Brexit fears.
	Japan	—	Attractive relative value and improving corporate governance are positives. But much is priced in, and the BOJ may have reached its limits in weakening the yen.
	EM	—	Structural challenges such as excess debt persist. Yet we see value for long-term investors. Slower expected Fed rate increases are a positive.
	Asia ex Japan	—	Long-term headwinds persist as imbalances are unwound. While we view Chinese devaluation as unlikely, the tail risk remains. Prefer India.
FIXED INCOME Underweight	U.S. Treasuries	▼	Improving data are a short-term risk. Long bonds have a structural bid amid low rates and are diversifiers, but vulnerable to upticks in inflation in the short run.
	U.S. Municipals	▲	We like relatively attractive (tax-exempt) yields and low volatility. We see potential for inflows after recent strong performance.
	U.S. Credit	▲	Fading fears of recession or rapid rate increases are near-term positives. We prefer going down in capital structure within higher-quality sectors to capture yield.
	DM Sovereigns ex U.S.	▲	We expect eurozone peripheral yields to converge with the core and curves to flatten on ECB purchases and demand for income. We like Portugal and Spain.
	DM Credit ex U.S.	—	ECB asset purchases underpin demand for European credit. We expect rising investment-grade issuance, but see value in subordinated financials and high yield.
	EM Debt	—	We lean toward local EM debt. Currencies have adjusted and yields have risen to attractive levels.
COMMODITIES Neutral	Commodities	—	Commodity markets are oversupplied and sensitive to downward global growth revisions. A strategic allocation to gold makes sense for diversification.

▲ Overweight — Neutral ▼ Underweight

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