Weekly Commentary

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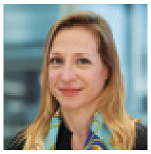

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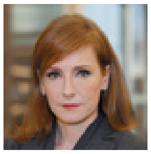

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Key points

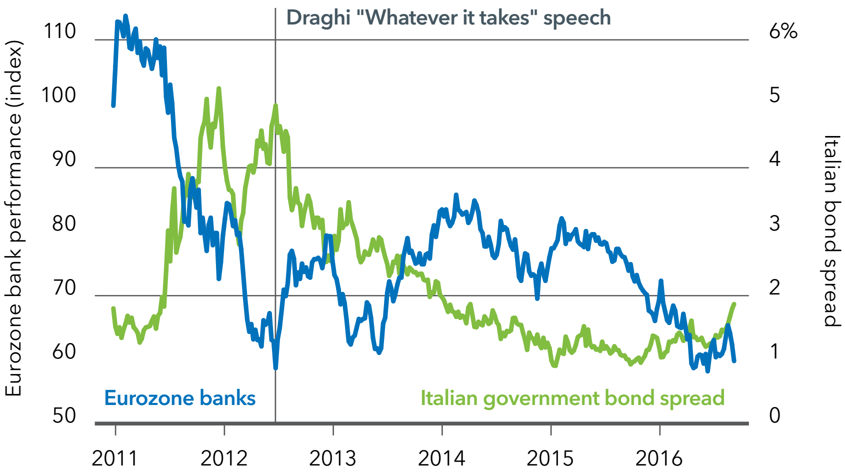
1. We see a low risk of Europe's populist parties winning power near term but expect them to stay on the political radar screen.
2. U.S. equity indexes hit records. The U.S. dollar index surged to nearly 14-year highs. The spread of U.S. 10-year yields over German yields touched a 27-year peak.
3. This week's data on U.S. jobs and wages should reinforce the reflationary picture.

1 Gauging Europe's political risks

Key European political events are now in focus as investors look for another potential populist backlash. The Italian constitutional referendum on Dec. 4 comes as the conservative candidate in France's presidential election next year is being finalized.

Chart of the week

Eurozone banks relative performance and Italian government bond spreads, 2011-2016



Sources: BlackRock Investment Institute, Thomson Reuters and MSCI, November 2016.
Notes: The eurozone banks line shows the ratio of the MSCI EMU Banks Index to the MSCI World Banks Index rebased to 100 at the start of 2011. The Italian government bond spread line shows the Italian 10-year government bond yield minus German 10-year government bond yield in percentage points. The vertical line denotes ECB president Mario Draghi's July 2012 speech in which he said the central bank would do "whatever it takes" to preserve the euro.

Deeper structural problems are the backdrop to Europe's political challenges. As the chart shows, investors have shunned eurozone banks relative to global counterparts. Italian bond yields have risen versus German yields before the referendum, yet the narrow spread also highlights the European Central Bank's (ECB) efforts to calm the 2010-12 debt crisis and revive growth.

Stagnation fuels populism

Italy's referendum as well as presidential elections in Austria and France should show whether populist parties are gaining greater sway. Election polls have wrong-footed investors this year, yet we see a limited risk of populist governments arising.

Polls currently suggest the Italian referendum, supported by Prime Minister Matteo Renzi, is likely to be voted down. Any Renzi resignation afterwards should result in a caretaker government that is likely to focus on reforming Italy's electoral law. A yes vote could spark a brief relief rally in regional bonds and bank shares, in our view. We see a strong "no" vote delaying any fixes to the country's sick banking system and emboldening populist parties. In France, polls show the successful conservative candidate for president as the favorite in any contest with far-right populist Marine Le Pen in the final round next May.

Even if populists don't win now, the economic stagnation and political frustrations driving their rise are still at play. Europe's leaders face other big challenges: managing Brexit, the anti-trade backlash and the migration crisis.

We expect investors to remain pessimistic on Europe relative to upbeat U.S. reflation prospects. We are neutral on European government bonds and favor investment-grade debt due to the ECB's ongoing purchases. We are underweight European equities on concerns about the growth outlook.

2 Week in review

- Major U.S. stock indexes hit all-time peaks, led by small-cap shares, on hopes Donald Trump's economic policies would add fuel to growth. U.S. equities saw further inflows after a record week.
- The U.S. dollar's surge extended but emerging markets and commodity prices mostly proved resilient due to the global economy's upbeat outlook.
- Major government bond yields rose further. But the U.S. Treasury yield curve flattened as the market grew more confident of a Federal Reserve rate hike next month and beyond.

Global snapshot

Weekly and 12-month performance of selected assets

EQUITIES	WEEK	YTD	12 MONTHS	DIV. YIELD
U.S. Large Caps	1.4%	8.3%	6.0%	2.1%
U.S. Small Caps	2.4%	20.2%	14.2%	1.3%
Non-U.S. World	1.3%	1.9%	-0.5%	3.2%
Non-U.S. Developed	1.3%	-2.1%	-3.3%	3.4%
Japan	0.5%	2.0%	0.9%	2.1%
Emerging	1.3%	10.0%	4.8%	2.7%
Asia ex-Japan	1.3%	6.7%	4.0%	2.6%

BONDS	WEEK	YTD	12 MONTHS	YIELD
U.S. Treasuries	-0.2%	1.1%	1.0%	2.4%
U.S. TIPS	-0.2%	4.4%	3.5%	2.3%
U.S. Investment Grade	-0.1%	5.2%	4.5%	3.4%
U.S. High Yield	0.5%	14.7%	12.0%	6.6%
U.S. Municipals	-0.4%	-0.1%	0.7%	2.6%
Non-U.S. Developed	-0.4%	2.5%	3.5%	0.8%
EM $ Bonds	-0.1%	8.6%	6.9%	5.9%

COMMODITIES	WEEK	YTD	12 MONTHS	LEVEL
Brent Crude Oil	0.8%	26.7%	2.3%	$47.24
Gold	-2.0%	11.5%	10.5%	$1,184
Copper	8.4%	25.0%	29.2%	$5,879

CURRENCIES	WEEK	YTD	12 MONTHS	LEVEL
Euro/USD	0.0%	-2.5%	-0.3%	1.06
USD/Yen	2.1%	-5.8%	-7.8%	113.22
Pound/USD	1.1%	-15.3%	-17.5%	1.25

Source: Bloomberg. As of Nov. 25, 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

Nov. 30 OPEC meeting, U.S. October PCE inflation and consumer spending
Dec. 1 Global November manufacturing PMIs
Dec. 2 U.S. November non-farm payrolls

Global PMIs should show the economic pick-up is broadening, highlighted by the eurozone flash manufacturing PMI hitting a three-year high in November. Another upbeat U.S. jobs report would focus the market's attention on the number of Fed rate increases in 2017.

Asset class views

Views from a U.S. dollar perspective over a three-month horizon

ASSET CLASS		VIEW	COMMENTS
EQUITIES	U.S.	–	A shift toward fiscal policy should support economic expansion, but a lack of detail on the incoming Trump administration's policies may dampen capex. Valuations are elevated. We like structural growth stories, value stocks and dividend growers.
	Europe	▼	Post-Brexit, upcoming election and U.S. trade policy uncertainties challenge already poor profits. We see only modest prospects for an earnings acceleration despite a supportive ECB.
	Japan	–	Attractive valuations and improved corporate governance are not enough to offset a soft economy and the BoJ nearing the limits of monetary policy.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks, we believe. Barring a major shift in trade policies, we see room for further investor inflows.
	Asia ex-Japan	▲	Financial sector reform and rising current account surpluses are encouraging. China's economic transition is ongoing, but we believe lower growth rates are priced in. We like India and selected ASEAN markets.
FIXED INCOME	U.S. Treasuries	–	We see a post-election reflationary trend and a Fed willing to let inflation run hotter putting pressure on longer-term bonds. We prefer TIPS over nominal bonds.
	U.S. Municipals	–	Higher U.S. Treasury yields challenge the near-term outlook. Munis' tax-exempt income makes them a core holding longer term.
	U.S. Credit	▲	We generally prefer investment grade bonds. Yields offer compensation for the risks entailed, such as rising corporate leverage.
	European Sovereigns	–	We prefer selected peripheral bond markets due to higher yields and ECB support. Upcoming political events in Italy, France and Germany keep us neutral.
	European Credit	▲	ECB and BoE corporate bond purchase programs support investment grade credit. We prefer selected financials and non-QE eligible industrials.
	EM Debt	▲	Rising volatility since the U.S. election keeps us cautious overall. We see opportunities in the front end of the curve of selected countries against underweights in low-yielding countries in Eastern Europe and Asia.
	Asia Fixed Income	▲	Muted net issuance and positive fundamentals such as stabilizing leverage support Asian hard-currency credit despite challenging valuations. Any U.S. policy shifts that dampen global trade would pose a risk to export-dependent EMs.
OTHER	Commodities and Currencies	–	Prospects of U.S. fiscal expansion, rising inflation and a Fed rate increase are improving the outlook for commodities and are likely to put some upward pressure on the U.S. dollar. We see other major currencies mostly stable.

▲ Overweight – Neutral ▼ Underweight

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