BLACKROCK
INVESTMENT
INSTITUTE

Richard Turnill
Global Chief Investment Strategist

Richard Turnill is BlackRock's Global Chief Investment Strategist. He was previously Chief Investment Strategist for BlackRock's fixed income and active equity businesses, and has also led the Global Equity investment team. Richard started his career at the Bank of England.

Share your feedback at
BlackRockInvestmentInstitute@blackrock.com

Isabelle Mateos y Lago
Chief Multi-Asset Strategist
BlackRock Investment Institute

Kate Moore
Chief Equity Strategist
BlackRock Investment Institute

Jeff Rosenberg
Chief Fixed Income Strategist
BlackRock Investment Institute

BLACKROCK®

WEEKLY COMMENTARY • AUG. 20, 2018

Key points

1 Turkey's woes have hit emerging markets. We expect further volatility, yet see long-term opportunities in markets with strong fundamentals.

2 EM equities lagged broader global markets, dragged in part by weak Chinese tech stocks. Copper prices hit a one-year low.

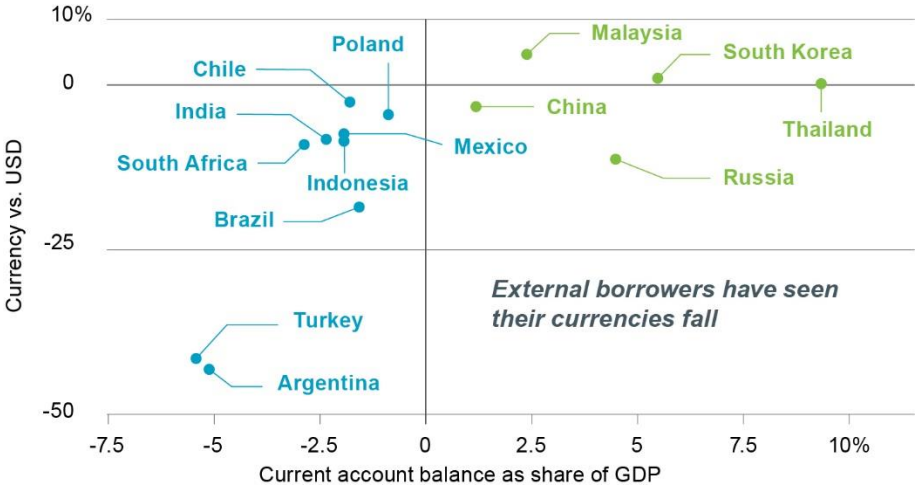
3 Minutes from the Federal Open Market Committee could signal an earlier end to the Federal Reserve's balance-sheet drawdown than expected.

1 Navigating EM turbulence

Worsening relations with the U.S. have spurred a sharp selloff in Turkish assets and exposed economic weaknesses such as large external debt loads and rampant inflation. We see many of these problems as unique to Turkey, yet other EMs have felt the heat. We remain wary of markets with high debt and deteriorating growth, and see long-term opportunities in regions with sound fundamentals, such as EM Asia.

Chart of the week

EM current account balances versus 12-month currency performance, August 2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, August 2018. Notes: The dots show the 12-month change in the spot currency exchange rate versus the U.S. dollar on the y-axis, and the IMF estimate of the current account balance as a share of gross domestic product (GDP) for 2018 on the x-axis. According to the terms agreed upon in Argentina's Stand-By Arrangement (SBA) with the IMF, its current account deficit is projected to be -3.6% for 2018. We have used the pre-SBA figure in the chart above for a fairer comparison with peers.

Rising macro uncertainty, higher interest rates and a strengthening U.S. dollar have led to a modest tightening of global financial conditions. This has laid bare vulnerabilities that had, until recently, been masked by plentiful global liquidity. Countries reliant on external borrowing to fund growth and large current account deficits — such as Turkey and Argentina — have suffered the most, as the chart above shows. Currencies of both have lost more than 40% against the U.S. dollar this year to date. Yet both Turkey and Argentina are relative outliers within the EM world. Many other EM countries, especially in Asia, appear healthier with improving current account balances. And structural reforms in countries such as China and India are likely to put economies on the path to more sustainable, long-term growth, in our view. See our emerging market marker to compare EMs across key metrics.

BII0818U/E-579005-1813773

Look east

Investors have latched onto Turkey' s weak fundamentals — bubbling under the surface for years — and rushed for the exits after the country's relations with the U.S. took a sharp turn for the worse. Turkey's woes have brought into sharp focus the dangers of a reliance on external debt-fueled growth. We believe the weakness could persist as markets are skeptical that Turkey will take the necessary steps to address these underlying issues.

The dent to broad EM sentiment is undeniable. Currencies, especially of countries dependent on borrowing in dollars, have sold off. Outflows from equity and debt funds have resumed, according to EPFR. Poor equities and debt performance in 2018 after two strong years has dampened investor appetite. Some safe-haven assets now offer positive real returns and investors see brighter prospects in markets such as the U.S. If the latest proposed U.S. sanctions come down hard on Russia, this could further dent sentiment on EMs.

Yet the risks of economic or financial contagion to other regions are low, we believe, as several of Turkey's challenges are unique. Geographical proximity has raised concerns about the impact on Europe. Turkey represents about 3% of eurozone exports, equivalent to less than 1% of eurozone GDP, according to the IMF. Turkish loans make up only a small proportion of eurozone bank lending. Turkish stocks constitute less than 1% of the MSCI EM equity index. And we believe strong earnings growth and attractive valuations overall in EM equities compensate for the risks. Strong growth in developed markets still supports EM economies.

The prospect of a bumpier road ahead for markets raises the importance of portfolio resilience, a key theme of our midyear Global Investment Outlook. We recommend sticking with markets with strong fundamentals and companies with strong balance sheets. China's growth is poised to benefit from policy support in the near term. China and India are two of our top EM Asia equity picks. We are neutral on EM debt, with a preference for selected hard- over local-currency debt.

2 Week in review

- EM equities lagged broader markets, hit by a combination of trade fears, worries about spillovers from Turkey and weakness in Chinese tech stocks. Copper hits its lowest level in a year as industrial metals suffered on the back of broad EM weakness and a stronger dollar. The S&P 500 recouped earlier losses to advance back near record highs.
- Chinese economic data underwhelmed. Fixed-asset investment growth and industrial output undershot expectations. The yuan weakened slightly against the U.S. dollar. News of China and U.S. resuming trade talks brightened sentiment.
- Italian bond yields jumped to four-year highs on growing investor concerns that the country's budget submission to the European Commission in October could lead to a showdown over fiscal responsibility.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.7%	6.6%	17.3%	1.9%
U.S. Small Caps	0.4%	11.1%	26.2%	1.2%
Non-U.S. World	-1.7%	-5.5%	2.0%	3.3%
Non-U.S. Developed	-1.1%	-4.0%	2.8%	3.4%
Japan	-0.8%	-3.1%	7.1%	2.3%
Emerging	-3.7%	-10.2%	-1.6%	2.9%
Asia ex-Japan	-3.5%	-8.1%	1.3%	2.7%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.0%	-0.9%	-1.3%	2.9%
U.S. TIPS	-0.2%	-0.1%	1.0%	3.0%
U.S. Investment Grade	0.1%	-2.0%	-0.6%	3.9%
U.S. High Yield	0.0%	1.6%	3.5%	6.3%
U.S. Municipals	0.1%	0.2%	0.8%	2.7%
Non-U.S. Developed	-0.1%	-2.8%	-1.6%	0.9%
EM $ Bonds	0.0%	-4.4%	-2.2%	6.5%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-1.3%	7.4%	40.8%	$71.83
Gold	-2.2%	-9.1%	-8.1%	$1,184
Copper	-4.3%	-18.2%	-8.7%	$5,926

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.2%	-4.7%	-2.4%	1.14
USD/Yen	-0.3%	-1.9%	0.8%	110.50
Pound/USD	-0.1%	-5.7%	-0.9%	1.27

Source: Bloomberg. As of Aug. 17, 2018. 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 Bloomberg Barclays U.S. Treasury Index; U.S. TIPS by the U.S. Treasury Inflation Notes Total Return Index; U.S. investment grade by the Bloomberg Barclays U.S. Corporate Index; U.S. high yield by the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index; U.S. municipals by the Bloomberg Barclays Municipal Bond Index; non-U.S. developed bonds by the Bloomberg 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

Aug. 20 U.S. public hearings begin on imposing 25% tariffs on $200 billion of Chinese imports

Aug. 22 U.S. Federal Open Market Committee (FOMC) minutes

Aug. 23 Eurozone flash PMI, Japan CPI, central bankers' conference in Jackson Hole kicks off

Next week's August FOMC meeting minutes will be watched for hints on whether the Fed has started discussions on ending its balance sheet drawdown sooner – and at a higher level than estimated. The Fed is taking a closer look at the technical implementation of monetary policy – how it sets short-term rates – as overall bank reserves decline with its balance sheet. The FOMC minutes could indicate some members see a need to maintain the current "floor system" for controlling the fed funds rate and may need a higher level of bank reserves to do so. This would imply an earlier end to the Fed's balance sheet normalization than many in the market expect.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Unmatched earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like momentum. We prefer quality over value amid steady global growth but rising uncertainty around the outlook. Financials and technology are our favored sectors.
	Europe	▼	Relatively muted earnings growth, weak economic momentum and heightened political risks are challenges. A market dominated by value sectors also makes the region less attractive in the absence of a growth upswing.
	Japan	—	The market's value orientation is a challenge without a clear growth catalyst. Yen appreciation is another risk. Positives include shareholder-friendly corporate behavior, solid company earnings and support from Bank of Japan stock buying.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks. Above-trend expansion in the developed world is another positive. Risks such as a rising U.S. dollar and escalating trade conflicts argue for selectivity. We see the greatest opportunities in EM Asia.
	Asia ex-Japan	▲	The economic backdrop is encouraging, with near-term resilience in China and solid corporate earnings. We like selected Southeast Asian markets but recognize a worse-than-expected Chinese slowdown or disruptions in global trade would pose risks to the entire region.
Fixed income	U.S. government bonds	▼	We see rates rising moderately amid economic expansion and Fed normalization. Longer maturities are vulnerable to yield curve steepening but should offer portfolio ballast amid any growth scares. We favor shorter-duration and inflation-linked debt as buffers against rising rates and inflation. We prefer 15-year mortgages over their 30-year counterparts and versus short-term corporates.
	U.S. municipals	—	Solid retail investor demand and muted supply are supportive, but rising rates could weigh on absolute performance. We prefer a neutral duration stance and up-in-quality bias in the near term. We favor a barbell approach focused on two- and 20-year maturities.
	U.S. credit	—	Sustained growth supports credit, but high valuations limit upside. We favor investment grade (IG) credit as ballast to equity risk. Higher-quality floating rate debt and shorter maturities look well positioned for rising rates.
	European sovereigns	▼	The ECB's negative interest rate policy has made yields unattractive and vulnerable to the improving growth outlook. We expect core eurozone yields to rise. We are cautious on peripherals given tight valuations, political risks in Italy and the upcoming end to the ECB's net asset purchases.
	European credit	▼	Increased issuance and political risks have widened spreads and created some value. Negative rates have crimped yields — but rate differentials make currency-hedged positions attractive for U.S.-dollar investors. We are cautious on subordinated financial debt despite cheaper valuations.
	EM debt	—	Valuations of hard-currency debt have become more attractive relative to local-currency bonds and developed market corporates. Further valuation support comes from slowing supply and strong EM fundamentals. Trade conflicts and a tightening of global financial conditions call for a selective approach.
	Asia fixed income	—	Stable fundamentals, cheapening valuations and slowing issuance are supportive. China's representation in the region's bond universe is rising. Higher-quality growth and a focus on financial sector reform are long-term positives, but a sharp China growth slowdown would be a challenge.
Other	Commodities and currencies	*	A healthy inventory balance underpins oil prices. Trade tensions add downside risk to industrial metal prices. We are neutral on the U.S. dollar. Rising global uncertainty and a widening U.S. yield differential with other economies provide support, but an elevated valuation may constrain further gains.

▲ Overweight — Neutral ▼ Underweight

*Given the breadth of this category, we do not offer a consolidated view.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) provides connectivity between BlackRock's portfolio managers; originates economic, markets and portfolio construction research; and publishes investment insights. Our goals are to help our portfolio managers become even better investors and to produce thought-provoking investment content for clients and policymakers.

BLACKROCK®

BII0818U/E-579005-1813773