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Key points

1 Trade tensions between the U.S. and China have broad economic implications. Our base case is that they will not escalate into a trade war.

2 Global equities experienced high volatility last week, government bonds rallied and the yield curve hit its flattest level since October 2007.

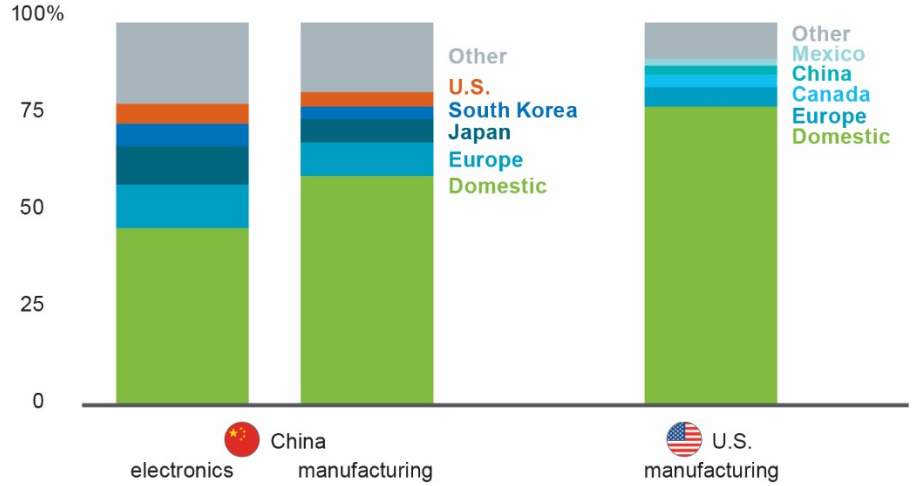
3 The March U.S. employment report is likely to show ongoing labor market strength and keep the Federal Reserve on track to push up interest rates.

1 China trade tensions: our take

Trade tensions between the U.S. and China have broad economic implications that go beyond bilateral trade. We see the trade actions implemented so far as limited and unlikely to derail the benign economic and market backdrop – as long as they do not escalate into a trade war that could harm global growth prospects.

Chart of the week

Origin of value added in Chinese and U.S. manufacturing exports, 2011



Sources: BlackRock Investment Institute, with data from the OECD Trade in Value Added database, March 2018.
Notes: The bars shows the value added by different countries in the production of Chinese and U.S. manufacturing exports. The domestic portion represents the value added by the exporting country from its production processes and domestic suppliers. The foreign portion captures the total value added into a good, including components and related services, coming from beyond the exporter of the final good. The 2011 data, released in October 2015, are the most recent available.

The chart above shows how deeply integrated global production and supply chains are, based on data from 2011 that we believe still captures the trade landscape today. Components from abroad represent nearly half of Chinese manufacturing exports. For Chinese electronics exports – a key sector likely to be affected by any U.S. tariffs - three-fifths worth of the value added is created beyond Chinese borders. The U.S., Europe and Japan are all big component and intellectual property suppliers to China for goods to be re-exported and sold elsewhere. On the flipside, the U.S. supply chain is much more homegrown. U.S. tariffs on China – and any resulting retaliatory measures – could cause widespread economic fallout by affecting such global supply chains if tensions escalate.

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No trade war for now

The U.S.'s new transactional trade approach runs counter to the rules-based global trade system it has long championed – and is a key risk to the global economy and markets. A trade war would likely have a knock-on impact on confidence and hurt emerging market (EM) exports, which stand to benefit from a business spending recovery underpinning global trade. See our March Global macro outlook.

Yet recent U.S. negotiating tactics have followed a consistent pattern: headline announcements spooking markets, followed by compromises and narrow implementation. Most major U.S. trading partners are now exempt from what were initially global steel and aluminium tariffs. U.S. President Donald Trump's tariffs on Chinese goods triggered another bout of market volatility. Yet the order contained no immediate action and left the door open for talks. We expect that China will negotiate to avoid a trade war, as it would challenge its growth outlook and undermine policy priorities such as deleveraging. A few options are available for making the trade relationship more reciprocal – a key U.S. demand – and helping trim the U.S. trade deficit. These include opening up service sector foreign ownership limits; reducing import taxes; loosening technology transfer requirements for direct investments; and increasing U.S. imports. Such measures may let the U.S. claim victory without hurting the global economy. Markets may breathe a sigh of relief and rally. Yet the path to such an outcome may be bumpy – and we see trade as both an upside and downside market risk.

What triggers would make us more worried? These include: the U.S. implementing broader trade actions; experienced trade pros at the helm of U.S.-China talks losing control of negotiations; or China retaliating with meaningful trade measures or – much less likely, in our view – with currency devaluation or selling of U.S. Treasuries. Trade tensions and U.S. fiscal stimulus widen the array of potential economic outcomes in 2018, yet our base case is a steady expansion underpinning risk assets. We outline our thinking, update our themes and detail our asset preferences in our new Q2 2018 Global Investment Outlook.

2 Week in review

- Global equity markets experienced a roller-coaster week, finishing higher on the back of positive trade developments. Tech stocks fell amid increasingly negative sentiment toward the sector, before ultimately climbing back later in the week. Defensive sectors rallied. Japanese stocks outperformed on a weaker yen.
- Government bonds rallied as the negative correlation between equities and yields returned. U.S. 10-year Treasury yields hit their lowest level since early February, and the yield curve between two- and 10-year Treasuries reached its flattest level since October 2007.
- Cooper and iron ore prices fell significantly on signs of rising inventories and renewed expectations for higher supply. Oil declined this week on the back of U.S. data showing higher production, inventories and imports.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.1%	-1.2%	11.8%	2.0%
U.S. Small Caps	1.3%	-0.1%	13.0%	1.2%
Non-U.S. World	0.6%	-1.3%	15.6%	3.2%
Non-U.S. Developed	0.9%	-1.7%	14.1%	3.4%
Japan	1.5%	0.1%	16.3%	2.2%
Emerging	-0.2%	1.3%	23.0%	2.8%
Asia ex-Japan	0.0%	0.5%	24.5%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.5%	-1.2%	0.4%	2.7%
U.S. TIPS	0.6%	-0.8%	0.9%	2.8%
U.S. Investment Grade	0.8%	-2.3%	2.6%	3.8%
U.S. High Yield	0.1%	-0.9%	4.2%	6.2%
U.S. Municipals	0.3%	-1.1%	2.6%	2.7%
Non-U.S. Developed	-0.5%	3.6%	11.4%	0.8%
EM $ Bonds	0.8%	-1.7%	4.1%	5.8%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-0.3%	5.1%	34.1%	$70.27
Gold	-1.6%	1.7%	5.7%	$1,326
Copper	0.8%	-7.4%	13.7%	$6,714

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.3%	5.1%	34.1%	$70.27
USD/Yen	-1.6%	1.7%	5.7%	$1,326
Pound/USD	0.8%	-7.4%	13.7%	$6,714

Source: Bloomberg. As of March 29, 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

April 2 U.S. ISM manufacturing index; Japan Tankan survey; China Caixin manufacturing PMI

April 4 Eurozone Consumer Price Index (CPI), unemployment rate; U.S. factory orders

April 5 U.S. trade balance

April 6 U.S. employment report; Deadline for U.S. Trade Representative list of proposed China tariffs

April 7 Brazil presidential election candidate declaration deadline

Economists expect the March U.S. employment report, set to be released Friday, to show a non-farm payroll gain of about 190,000 jobs last month. This would be down from February's gain of 313,000 but would still depict an economy with a strong labor market. The U.S. has gained more than 18.4 million new hires since the beginning of 2010, and we see no sign of this job growth trend slowing. This labor market strength, and associated wage pressures, should help keep the Fed on track for at least two more rate increases this year.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Extraordinarily strong earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like the momentum and value style factors, as well as financials and technology.
	Europe	—	We see economic expansion and a steady earnings outlook supporting cyclicals. Our neutral stance acknowledges that earnings momentum lags other regions. Euro strength also is a source of pain.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behavior and solid earnings. We see Bank of Japan policy and domestic investor buying as supportive. Further yen strengthening would be a risk.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks. Above-trend expansion in the developed world is another positive. Risks include a sharp rise in the U.S. dollar, trade tensions and elections. We see the greatest opportunities in EM Asia. We like Brazil and India, and are cautious on Mexico.
	Asia ex-Japan	▲	The economic backdrop is encouraging. China's growth and corporate earnings appear likely to remain solid in the near term. We like selected Southeast Asian markets but recognize a faster-than-expected Chinese slowdown would pose risks to the entire region.
Fixed income	U.S. government bonds	▼	We see rates rising moderately amid economic expansion and Fed normalization. Shorter maturities offer a more compelling risk/reward tradeoff. They and inflation-linked securities can be buffers against rising rates and inflation. We like 15-year mortgages relative to their 30-year counterparts and to short-term corporates.
	U.S. municipals	—	Solid retail investor demand and muted supply are supportive of munis, but rising rates weigh on absolute performance. A more defensive stance is warranted near term, we believe, though any material weakness due to supply may represent a buying opportunity. 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 prefer up-in-quality exposures as ballast to equity risk. Higher-quality floating rate instruments and shorter maturities are well positioned for rising rates, in our view.
	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 and the prospect of the ECB reducing its asset purchases.
	European credit	▼	Ongoing ECB purchases have compressed spreads across sectors and credit-quality buckets. Negative rates have crimped absolute yields — but rising rate differentials make currency-hedged positions increasingly attractive for U.S.-dollar investors. Subordinated financial debt looks less compelling versus equities after a strong 2017.
	EM debt	—	Gradual Fed rate rises favor local-currency exposures — particularly given their higher yields relative to major bond markets. A shift by EM central banks toward tighter policy reduces our return expectations. We see solid fundamentals and investor inflows limiting EM currency volatility.
	Asia fixed income	—	Regional growth and inflation dynamics are supportive of credit. China's rising representation in the region's bond universe reflects its growing credit market. Higher-quality growth and a focus on financial sector reform are long-term positives, but any China growth slowdown would be a near-term challenge.
Other	Commodities and currencies	*	A reduction in global oil inventories is supporting oil prices. We are neutral on the U.S. dollar. The factors driving its recent slide are likely temporary, but it's unclear when the U.S. yield differential with other economies will reassert itself as the main driver.

▲ Overweight — Neutral ▼ Underweight

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

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