BLACKROCK INVESTMENT INSTITUTE

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Key points

1. The populist policies of Italy's new government may lead to tensions with European partners and a sustained shift in pricing for European assets.
2. Volatility spiked last week. Eurozone political risk returned and the U.S. announced tariffs on imports from China, the EU and NAFTA partners.
3. Eurozone data this week should show whether a first-quarter slowdown was temporary. Trade tensions will be in focus at the G7 summit.

1 European populism flares up

Italian politics have revived market attention to the risk of European fragmentation, adding to already heightened global economic uncertainty. Yet our base case is still that global growth will be sustained amid gradually rising interest rates. We see a structural discount on some European assets being confined to the region for the near term. We still like U.S. and emerging market (EM) stocks.

Chart of the week

10-year eurozone government bond spreads and U.S. yields, 2016-2018

Past performance is no guarantee of future results. Source: BlackRock Investment Institute, with data from Thomson Reuters, June 2018. Notes: The eurozone peripheral spread line shows a gross domestic product (GDP)-weighted average of the yields on 10-year Irish, Portuguese and Spanish government bonds over the yield on 10-year German bunds. The Italian 10-year spread line shows the spread between yields on Italian and German government bonds. U.S. yields are represented by 10-year Treasury yields.

The proposed nomination by Italian populist parties Five Star Movement (M5S) and the League party of a finance minister hostile to the euro and the prospect of new Italian elections prompted major market angst. See the chart above. Italian 10-year borrowing costs relative to German bunds soared (the light blue line). The contagion extended to the eurozone periphery, pushing bond yield spreads sharply wider (the green line), and to global markets. The U.S. dollar surged against the euro, and U.S. 10-year yields fell in a flight to safety. A last-minute agreement on a less overtly anti-euro cabinet restored confidence, and these moves mostly reversed late last week. See the far right of the chart. Yet we see political uncertainty holding down equity valuations and keeping credit spreads wider across Europe, including on peripheral sovereign debt. The prospect of new political leadership in Spain adds to the uncertainty.

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Confrontation time

After a rough few days, Italian politics are likely to settle into a state of uneasy steadiness. An anti-establishment government is happening under a M5S-League coalition, this time with a finance minister less openly critical of the European Union (EU) than the prior candidate. Yet the political situation in Italy remains a moving target, and confrontations with Brussels are likely to rise. Polls show a majority of Italians support staying in the euro, but views that the single currency and Europe have been negative for Italy are widespread. It's also likely the new potential government will have a confrontational attitude toward Europe and Germany, slowing momentum for further integration.

The risk of European fragmentation – one of the top 10 risks monitored in our recently launched Geopolitical risk dashboard – adds to rising global economic uncertainty. It comes amid the U.S. implementing tariffs against China, the EU, Mexico and Canada, triggering retaliatory actions. Other uncertainties include the impact of hefty U.S. fiscal stimulus on growth and the duration of this cycle. Yet unless European fragmentation risks intensify dramatically, we don't see European risks denting our outlook for the sustained global economic expansion to roll on. We see gradually rising inflation and central banks slowly normalizing rates.

The looming risk, however, is likely to keep credit and sovereign spreads elevated in Italy and peripheral Europe. It may also lead to sustained lower valuations for European equities versus global ones, particularly banks. European stocks have underperformed global stocks for the past several weeks, and earnings momentum in Europe was already lagging other regions. It's too early to assess the economic impact of this looming risk, but political uncertainty may slow regional economic activity and investment, further weighing on European earnings expectations. We retain a preference for U.S. and EM equities. Within Europe, we favor quality firms with exposure to global growth.

2 Week in review

- Equity volatility spiked and perceived safe havens rallied early in the week on worries about Italy's bumpy path to a new government. European stocks led sharp falls in global markets before retracing some of their move. Concerns about Brazil's oil worker strike helped extend an EM selloff. Spanish markets rallied with the rest of Europe on Friday despite the ousting of Spain's prime minister. Energy stocks outperformed, and U.S. small caps hit an all-time high.
- Trade tensions rose, as the U.S. announced it would implement tariffs on $50 billion of Chinese imports and impose steel and aluminum tariffs on imports from Canada, Mexico and EU. The U.S. allies announced retaliatory tariffs.
- In the U.S., the May unemployment rate hit the lowest level since April 2000, May non-farm payrolls growth beat expectations and April consumer spending came in strong. Eurozone inflation in May firmed from a month earlier.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.5%	2.3%	12.5%	2.0%
U.S. Small Caps	1.3%	7.8%	19.6%	1.1%
Non-U.S. World	-0.8%	-1.5%	9.8%	3.2%
Non-U.S. Developed	-1.0%	-1.2%	8.0%	3.3%
Japan	-1.5%	-0.3%	13.1%	2.2%
Emerging	-0.5%	-1.8%	14.6%	2.8%
Asia ex-Japan	-0.2%	0.6%	17.6%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.3%	-1.5%	-1.1%	2.9%
U.S. TIPS	0.4%	-0.8%	0.4%	3.0%
U.S. Investment Grade	0.0%	-3.1%	-0.3%	4.0%
U.S. High Yield	0.1%	-0.2%	2.3%	6.4%
U.S. Municipals	0.4%	-0.4%	1.1%	2.7%
Non-U.S. Developed	0.0%	-1.0%	3.4%	0.9%
EM $ Bonds	-0.8%	-4.4%	-1.0%	6.3%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	0.5%	14.8%	51.7%	$76.79
Gold	-0.7%	-0.7%	2.2%	$1,293
Copper	0.2%	-4.8%	21.0%	$6,896

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.1%	-2.9%	4.0%	1.17
USD/Yen	0.1%	-2.8%	-1.6%	109.54
Pound/USD	0.3%	-1.2%	3.6%	1.33

Source: Bloomberg. As of June 1, 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

June 5	Eurozone retail sales; U.S. ISM Non-Manufacturing Index	**June 8 - 9**	G7 Summit
June 8	Germany industrial production	**June 9**	China Consumer Price Index (CPI), Producer Price Index (PPI)

European data this week should provide more evidence regarding how temporary the first-quarter slowdown in Europe really was, following a recent weakening in economic activity data. Signs the slowdown is persisting would likely lead to speculation about a possible softening shift in the European Central Bank's stance next week. Markets will also look to the upcoming G7 Summit in Canada for clues as to whether trade tensions – and geopolitical risks in general – may ease going forward.

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 a sustained global expansion supporting cyclical sectors. The moderation in domestic growth and rise in political risks pose headwinds for earnings, especially for banks.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behavior and solid earnings. We see Bank of Japan policy buying as supportive. Any yen appreciation 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 further sharp rise in the U.S. dollar, trade tensions and elections. We see the greatest opportunities in EM Asia and India.
	Asia ex-Japan	▲	The economic backdrop is encouraging. China's growth and corporate earnings are solid. We like selected Southeast Asian markets but recognize a faster-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. 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, political risks in Italy and the prospect of the ECB reducing its asset purchases.
	European credit	▼	Recent spread widening driven by increased issuance has created some value, while ongoing ECB purchases should support the asset class. 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	—	Recent price moves have improved the valuations of hard-currency debt, increasing the relative attractiveness both to local currency bonds and to developed market corporates. Further support for valuations comes from slowing supply and strong EM fundamentals. Trade fears or geopolitical risks prompting a rapid tightening of global financial conditions represent downside risks.
	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	*	Declining global crude inventories underpin oil prices, with geopolitical tensions providing further support. We are neutral on the U.S. dollar. Factors driving its recent strengthening are likely temporary, but higher global uncertainty and a widening U.S. yield differential with other economies may provide support.

▲ Overweight — Neutral ▼ Underweight

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

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