BLACKROCK INVESTMENT INSTITUTE

WEEKLY COMMENTARY • JULY 8, 2019

Key points

1. We downgrade our growth outlook and prefer a modestly more defensive investing stance amid rising macro uncertainty.
2. Global stocks rose last week, with the U.S. benchmark marching to a new record. Global bond yields sank further.
3. Markets are expecting a Federal Reserve rate cut this month. Next week's U.S. inflation data may have implications for the magnitude.

The BlackRock Investment Institute (BII) leverages the firm's expertise to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. As a unique center of excellence, BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

Jean Boivin
Head
BlackRock Investment Institute

Elga Bartsch
Head of Macro Research
BlackRock Investment Institute

Michael Pyle
Global Chief Investment Strategist
BlackRock Investment Institute

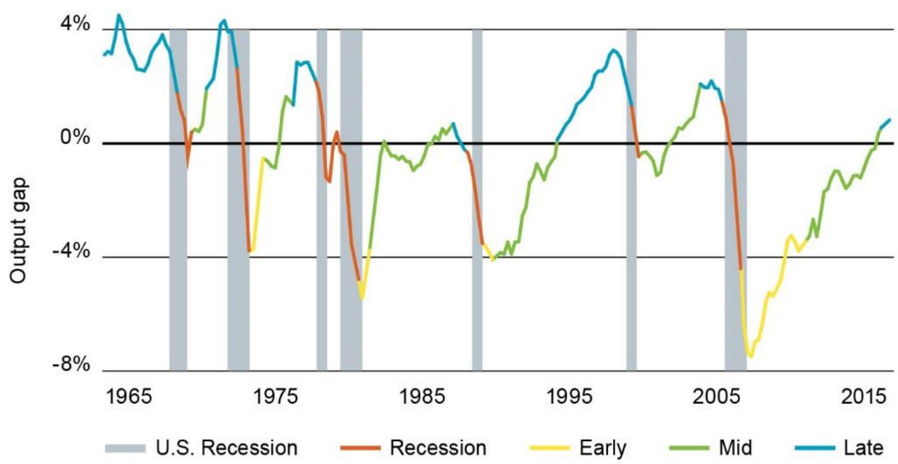
Scott Thiel
Chief Fixed Income Strategist
BlackRock Investment Institute

1 Summary of our midyear outlook

We see challenging crosscurrents ahead. Macro uncertainty is rising amid geopolitical frictions, and asset prices are up. Yet monetary policy has pivoted toward easing and many risk asset valuations still look reasonable. This leads us to lower our growth outlook and become modestly more defensive while still favoring selected risk assets.

Chart of the week

Output gap and stages of the U.S. business cycle, 1965-2019



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2019. Notes: This chart shows an estimate of the U.S. output gap (that is, GDP as a percentage of potential GDP). We have classified different time periods as belonging to certain stages of the business cycle. The classification of the stage is done via a 'cluster analysis' that groups together time periods where economic series have behaved in similar ways.

We are downgrading our growth outlook as trade disputes lead to a wider range of potential economic and market outcomes. Tough rhetoric from both the U.S. and China, tit-for-tat tariffs and tensions over U.S. restrictions on Chinese tech signal an economic conflict that will be difficult to meaningfully resolve — temporary trade truces, such as the one at the G20 summit, notwithstanding. Trade tensions have already caused global growth to slow. The U.S. economy is transitioning into a later stage of the cycle, as shown in the chart above. Yet we see limited near-term risk of the traditional catalysts – overheating or financial imbalances – that bring expansions to an end. We expect a significant dovish shift by central banks to help cushion the slowdown and extend the long expansion. Importantly, this buys investors time to make their portfolios more resilient to downside scenarios in the near and long term.

BLACKROCK®

Geopolitics take center stage

Against this backdrop, we see trade and geopolitical frictions as the key driver of the global economy and markets. We offer three new investment themes in our midyear 2019 global investment outlook. Here's an overview:

- **Protectionist push**: We are downgrading our global growth outlook as trade disputes and broader geopolitical tensions stoke greater macro uncertainty. The range of potential economic and market outcomes further ahead has widened. We see a lull in China's growth due to the fallout of U.S. tariffs.
- **Stretching the cycle**: The decisively dovish shift by central banks has depressed long-term yields and should help extend the long expansion. This makes for a benign near-term environment for risk assets, in our view, although uncertainty around the outlook has risen.
- **Raising resilience**: We believe portfolio resilience is crucial at a time of elevated macro uncertainty. We define resilience as the ability of a portfolio to withstand a variety of adverse conditions –both on a tactically defensive basis and strategically across cycles.

Investment implications: We remain positive on U.S. equities against a backdrop of reasonable valuations. Coupon income is key in a low-yield world, and we upgrade emerging market (EM) debt as a result. We believe markets are overly optimistic about China's efforts to boost growth, however, leading us to downgrade China-linked EM and Japanese equities. We expect the ECB to deliver on stimulus expectations spurring a closing out of our underweight in European equities and an upgrade for the region's bonds. By contrast, we view the degree of Fed easing that markets are pricing in as excessive, given that we see limited near-term risks of recession. We could see yields snap back. This leads us to downgrade U.S. Treasuries in the short run. We prefer to dial down overall risk by raising some cash but still see an important role for long-term government bonds as portfolio stabilizers, especially on a medium-term horizon.

2 Week in review

- Bond yields ploughed fresh lows and U.S. stocks hit a record on expectations central banks globally are poised to ease monetary policy. Christine Lagarde, head of the International Monetary Fund since 2011, was nominated to replace Mario Draghi as the next President of the European Central Bank
- The U.S. economy added 224,000 jobs in June, a sharp rebound from the prior month, tempering market expectations of a 50 basis point rate cut by the Federal Reserve this month. Yet tepid wage growth alongside sluggish inflation data could still encourage an "insurance" 25 basis point cut.
- Concerns over demand weighed on crude oil prices with both Brent and WTI falling sharply. Oil prices clawed back some losses after the Organization of the Petroleum Exporting Countries (OPEC) reached a deal to extend production cuts to March 2020 to offset increasing production from the U.S.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.5%	20.8%	12.7%	1.9%
U.S. Small Caps	1.7%	17.4%	-4.0%	1.6%
Non-U.S. World	1.7%	15.5%	3.9%	3.2%
Non-U.S. Developed	1.9%	16.1%	3.7%	3.3%
Japan	2.0%	10.3%	0.0%	2.5%
Emerging	1.1%	12.0%	4.0%	2.7%
Asia ex-Japan	0.9%	12.0%	2.6%	2.5%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.3%	5.4%	7.4%	2.0%
U.S. TIPS	0.1%	6.3%	4.7%	2.1%
U.S. Investment Grade	0.7%	10.5%	11.1%	3.1%
U.S. High Yield	0.4%	10.3%	7.9%	5.8%
U.S. Municipals	0.2%	5.2%	6.8%	2.0%
Non-U.S. Developed	0.4%	5.1%	4.2%	0.6%
EM $ Bonds	1.0%	12.3%	13.0%	5.4%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-4.9%	17.7%	-19.1%	$ 63.30
Gold	0.4%	10.4%	12.6%	$ 1,416
Copper	-1.2%	-0.8%	-7.3%	$ 5,920

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.7%	-1.6%	-3.2%	1.13
USD/Yen	0.0%	-1.6%	-2.4%	107.81
Pound/USD	-0.8%	-1.4%	-4.9%	1.26

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Thomson Reuters. As of July 5, 2019. 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.

3 Week ahead

July 8	German industrial output	**July 11**	U.S. CPI, ECB minutes, Fed Chair testimony before U.S. Senate
July 10	FOMC minutes, Fed Chair Powell testifies before U.S. Congress	**July 12**	IEA oil market report

U.S. CPI data for June will be a key factor for the Fed's rate decision on July 31. Analysts expect the monthly rate of price increases for items excluding food and energy to rebound to +0.2%. If realized, this would help reinforce our belief that the recent shortfall in inflation is largely transitory. An upside surprise could make current market pricing for the path of Fed policy over the next 12 months look even more extreme. Our Inflation GPS still suggests that US core inflation is hovering close to the Federal Reserve's 2% target. Actual inflation should recover back near there in coming months.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective, we like momentum and min-vol, but have turned neutral on quality due to elevated valuations.
	Europe	—	We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼	We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	—	We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We seethe greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support across the board, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼	We have downgraded Asia ex-Japan equities to underweight due to the region's China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region's debt instruments instead.
Fixed income	U.S. government bonds	▼	We have downgraded U.S. Treasuries to underweight from neutral. Market expectations of Fed easing seem excessive, leaving us cautious on Treasury valuations, particularly in shorter maturities. Yet we still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	▲	Muni valuations are on the high side, but the asset class has lagged the U.S. Treasuries rally. Favorable supply-demand dynamics, seasonal demand and broadly improved fundamentals should drive muni outperformance. The tax overhaul has also made munis' tax-exempt status more attractive.
	U.S. credit	—	We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. Investment-grade credit remains a key part of our income thesis.
	European sovereigns	▲	We have upgraded European government bonds to overweight because we expect the ECB to deliver –or even exceed –stimulus expectations. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential. A relatively steep yield curve is a plus for eurozone investors. We generally favor credit for eurozone investors as income is key in region where many rates are negative.
	European credit	—	We have upgraded European credit to neutral. Fresh ECB policy should include corporate bond purchases. "Low for longer" ECB policy should reduce market volatility and support credit as a source of income. European bank balance sheets have improved after years of repair, underpinning fundamentals. Yet valuations are rich. We prefer high yield credits, supported by muted issuance and strong inflows. Euro high yield also offers a significant spread premium to U.S. counterparts.
	EM debt	▲	We have upgraded EM bonds to overweight on their income potential. The Fed's dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We believe local-currency markets have further to run and prefer them over hard-currency markets. We see opportunities outside Asia, such as in Latin America, in countries not directly exposed to U.S.-China trade tensions.
	Asia fixed income	—	The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing . We have reduced overall risk and moved up in quality across credit as a result.

▲ Overweight — Neutral ▼ Underweight

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. As a unique center of excellence, BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BLACKROCK®