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WEEKLY COMMENTARY • JULY 30, 2018

Key points

1 EM equity valuations have become disconnected from strong fundamentals, we believe, and offer attractive compensation for risk.

2 U.S.-EU trade strife eased after a White House meeting that led to a vow to work toward cutting tariffs and addressing unfair global trade practices.

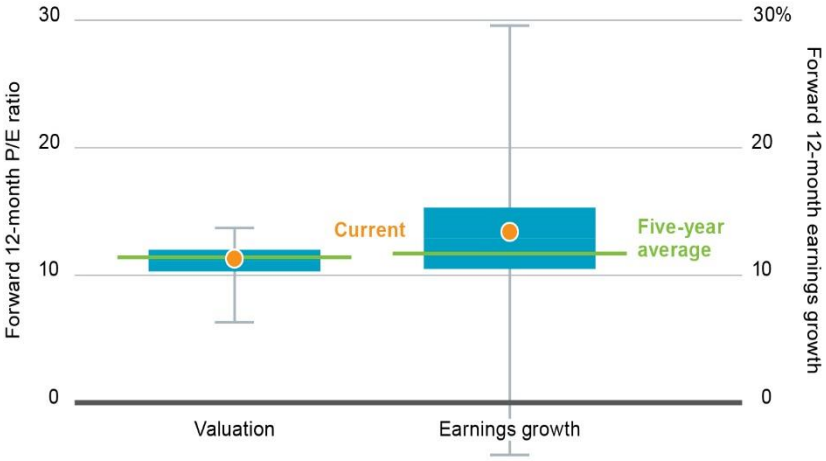
3 A slew of global central bank meetings this week is set to confirm market expectations of an overall gradual tightening of monetary policies.

1 EM equities on sale?

A shakeout in emerging market (EM) equities has created value in a world where good quality value is scarce. EM equities do face increased tail risks such as tightening financial conditions and ripples from U.S.-China trade tensions. Yet we believe current valuations and strong earnings growth offer investors ample compensation for these risks.

Chart of the week

EM valuations and earnings growth, 2008-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters , July 2018. Notes: The boxes denote the 25th-75th percentile of weekly observations for 12-month forward price-to-earnings ratio and 12-month earnings-per-share growth forecasts for the MSCI Emerging Markets Index from 2008-2018. The whiskers show the minimum and maximum values. The orange circles mark the current values as of July 2018 and the green horizontal bars denote the five-year averages.

This year's weakness in EM equities has opened up a disconnect between prices and fundamentals. EM equities have recovered somewhat in recent weeks, yet are still down almost 15% from January peaks. This has left valuations at 11.3 times forward earnings, a shade below their five-year average, as shown in the chart above. Yet forward earnings-per-share (EPS) growth estimates of 13.4% are running well ahead of the average over the same period. EM EPS growth forecasts for both this year and 2019 have been revised up since the start of 2018, implying the outlook for EM stocks may be brighter than what current valuations suggest.

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Finding value

Our base case of steady global growth, led by the U.S. and China, a gradual pace of Federal Reserve rate increases and double-digit corporate earnings growth provides a favourable backdrop for markets. Yet uncertainty around the outlook has increased. Escalating trade tensions and fears of U.S. overheating, along with rising interest rates, have contributed to a stronger U.S. dollar and tightening financial conditions. This has hit EM assets the hardest and created pockets of value, in our view.

EM earnings momentum is solid and increasingly broad-based. The median earnings growth for stocks in the MSCI EM Index for 2018 and 2019 is forecast to be 10.1% and 13.6%, respectively. EM earnings growth was disproportionately concentrated in the tech sector in 2017, but eight of 11 sectors are forecast to deliver double-digit earnings growth in 2018. Several other trends underpinning the appeal of EM equities are intact. Our BlackRock Macro GPS points to the global expansion carrying on through 2018. China has shifted from a tightening stance to explicit stimulus – both fiscal and monetary – to stave off any sharp slowdown.

The dollar's moves have delivered a double-whammy to EM equities this year. Tighter financial conditions stemming from a stronger dollar and higher U.S. rates have hurt assets in countries dependent on dollar funding the hardest, such as in Latin America. See our Emerging market marker. And depreciating EM currencies have dented the appeal of EM equities for dollar-based investors who generally take unhedged positions. There are some signs that pressures from a firmer dollar are abating: Latin American stocks are up 13% from their recent trough and broader EM equity outflows have slowed in recent weeks. Yet EM equities are much more than a dollar play. The EM equity selloff is set against a backdrop of strong fundamentals: Attractive valuations, robust earnings growth and the highest return on equity in four years. Any de-escalation in trade tensions would brighten beaten-down sentiment. Bottom line: We still like EM equities, with a preference for Asia. Potential further tightening in financial conditions calls for greater selectivity.

2 Week in review

- World stocks rose as global trade tensions came down a notch after U.S. President Donald Trump and European Commission president Jean-Claude Juncker vowed to lower or scrap tariffs related to non-auto industrial goods and work to reform World Trade Organization rules to address unfair trade practices.
- The U.S. corporate earnings season rolled on with strong profits and sales growth. Guidance from companies was generally upbeat except for major auto companies, which said higher steel and aluminum prices are starting to bite. U.S. GDP growth totaled 4.1% for Q2, while an upward revision in the savings rate bodes well for future consumption.
- The Bank of Japan was reported to be mulling a more flexible approach to its yield curve control policy – as well as a review of its ETF purchases. The European Central Bank affirmed its plan to halt net asset purchases this year.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.6%	5.4%	13.9%	1.9%
U.S. Small Caps	-2.0%	9.0%	17.5%	1.2%
Non-U.S. World	1.5%	-1.2%	6.1%	3.2%
Non-U.S. Developed	1.3%	-0.1%	6.7%	3.3%
Japan	2.2%	0.4%	11.6%	2.2%
Emerging	2.1%	-4.2%	4.6%	2.8%
Asia ex-Japan	1.8%	-3.4%	5.6%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.3%	-1.5%	-1.1%	3.0%
U.S. TIPS	-0.4%	-0.6%	1.2%	3.1%
U.S. Investment Grade	0.2%	-2.6%	-0.7%	4.0%
U.S. High Yield	0.3%	1.1%	2.5%	6.3%
U.S. Municipals	-0.2%	0.0%	1.0%	2.7%
Non-U.S. Developed	-0.2%	-1.6%	0.6%	0.9%
EM $ Bonds	0.6%	-2.7%	0.2%	6.2%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	1.7%	11.1%	44.3%	$74.29
Gold	-0.4%	-6.0%	-2.8%	$1,224
Copper	2.4%	-13.1%	-0.5%	$6,297

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.6%	-2.9%	-0.2%	1.17
USD/Yen	-0.3%	-1.5%	-0.2%	111.05
Pound/USD	-0.2%	-3.0%	0.3%	1.31

Source: Bloomberg. As of July 27, 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

July 31 Bank of Japan policy meeting, U.S. Conference Board consumer confidence

Aug 1 U.S. Federal Reserve policy meeting, U.S. and Japan manufacturing PMI

Aug 2 Bank of England policy meeting

Aug 3 U.S. payrolls, Bank of Japan minutes

Developed market central banks take the spotlight next week with the Federal Reserve, the Bank of England and the Bank of Japan all scheduled to hold policy meetings. The Fed is expected to reiterate its upbeat view on the economy and hint at a September rate hike. Markets are pricing close to two more quarter percentage point hikes through the end of 2018. The Bank of England is expected to almost certainly raise rates, with inflation running ahead of its target and the domestic economy holding firm. The Bank of Japan could modestly tweak its yield curve control policy by allowing long-term rates to move more flexibly. It may also cut its inflation forecast.

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, trade tensions and elections 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. A temporary surge in M&A-related issuance has cheapened IG valuations. 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 disputes and a tightening of global financial conditions are downside risks.
	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	*	Declining global crude inventories underpin oil prices, with geopolitical tensions providing further support. 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.

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