BLACKROCK INVESTMENT INSTITUTE

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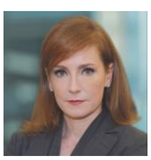

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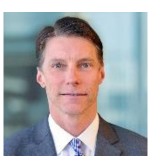

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WEEKLY COMMENTARY • JAN. 28, 2019

Key points

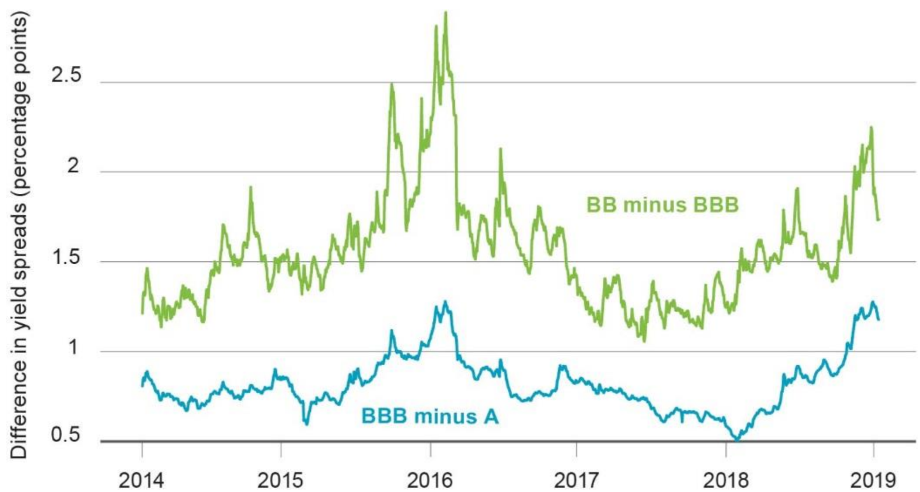
1. We see compelling relative value in BBB-rated European debt but maintain our neutral view of European corporate bonds overall.
2. Central banks in the eurozone and Japan indicated a more dovish outlook. Emerging market (EM) assets saw further strong demand.
3. The Federal Reserve is likely to keep interest rates on hold this week and may provide clues about future hikes. We expect an extended pause.

1 An opportunity in European credit

European corporate bonds sold off late last year amid a broad risk-off environment. Most risk assets have recovered since. One of the surprising exceptions: BBB-rated European debt. We now see compelling relative value in this segment of the European credit market, though we maintain our neutral view of the asset class overall.

Chart of the week

Difference in European corporate bond yields, 2014-2019



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Bloomberg and J.P. Morgan, January 2019. Notes: The lines show the difference in the yield spreads of euro-denominated corporate bonds of different ratings, in percentage points. The spreads for each rating level are calculated over equivalent German government bonds. J.P. Morgan A, BBB and BB All-Maturity Euro Credit indexes represent the corporate bonds.

BBB-rated bonds represent the bottom rung in investment grade (IG), so they typically suffer more than their higher-rated IG counterparts during broad market selloffs, and recover more quickly when markets rise. BBBs saw strong outflows into year-end 2018, driving yields higher – yet they have lagged the 2019 recovery in risk assets. The bottom line in the chart above illustrates the disconnect: The difference in spreads between BBBs and A-rated euro corporates (one rung higher on the ratings scale) has held steady around the wide levels seen at year-end – rather than tightening as it typically does during risk-on periods. At the same time, sub-investment grade bonds with a BB-rating (the top rung of high yield) have outperformed higher-quality BBB bonds, with the difference between their spreads dropping. See the top line in the chart.

A positive global backdrop

Concerns about slowing global growth fueled the December selloff in risk assets, with fears about the European Central Bank's (ECB's) asset purchase wind-down an additional weight on euro credit. The ECB is on track to buy only around 2% of European IG corporate issues this year, we estimate, down from 15% last year. We attribute the BBB cohort's lagging recovery partly to a surge in BBB issuance by euro-area financials looking to strengthen their balance sheets, rather than worries about ratings downgrades. The elevated issuance may be here to stay, but we see more room for the broad European corporate market, including BBBs, to recover.

Fears about a 2019 recession appear overblown (see our 2019 Global investment outlook). We see global growth slowing, not enough to end the expansion but enough to keep major central banks on hold. Eurozone growth should stabilize at low levels in 2019, helped by extra-easy ECB policy, fresh fiscal stimulus and the lifting of one-offs such as regulation-related disruptions to the auto industry. The ECB maintained its policy last week, as we expected. We agree with its assessment that growth risks have shifted to the downside. This makes ECB growth and inflation estimates seem optimistic, we believe, and a 2019 rate rise unlikely. We see the U.S. Fed on hold until at least September (see our recent Macro and market perspectives). This all makes for a positive global backdrop for credit.

Medium-term threats to European unity, the European economy's still-anemic growth and its dependence on trade do make us cautious toward European risk assets. We generally prefer U.S. fixed income over European bonds given the Fed has already tightened policy. Yet we see BBB-rated euro corporate bonds as an opportunity for currency-hedged U.S.-dollar-based investors and euro-based investors alike. The key risk: a re-emergence of risk-off sentiment and related outflows associated with recession concerns and geopolitical tensions. We would need to become more optimistic on the eurozone growth outlook or the potential for resolutions to political issues – including Brexit – to turn more positive toward European credit overall. Elsewhere in European fixed income, we are underweight European sovereigns, as we expect rates to gradually rise over the medium term from their current abnormally low levels.

2 Week in review

- Global equities traded flat, as investors digested an extended partial U.S. government shutdown. Fourth-quarter (Q4) earnings results were mixed, but the market reaction was resilient as expectations and valuations had already fallen coming into the year.
- The Bank of Japan maintained its stimulus program and cut its core inflation estimate by 0.5 percentage points, its largest revision in nearly six years. The ECB kept rates unchanged and noted risks to the growth outlook "moved to the downside." Manufacturing Purchasing Managers' Index (PMI) data for the eurozone and Germany disappointed, with German data signaling a manufacturing contraction.
- China's Q4 gross domestic product (GDP) growth of 6.4% was the lowest since 2009 but in line with expectations. EM equities and debt saw further demand. EM stocks notched 15 straight weeks of inflows, while EM hard currency debt spreads have tightened 50 basis points year-to-date to their lowest level since November 2018.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-0.2%	6.4%	-4.3%	2.1%
U.S. Small Caps	0.0%	10.0%	-6.2%	1.7%
Non-U.S. World	0.7%	6.2%	-14.8%	3.3%
Non-U.S. Developed	0.5%	5.5%	-14.7%	3.5%
Japan	0.6%	5.2%	-15.1%	2.5%
Emerging	1.4%	6.9%	-16.3%	2.7%
Asia ex-Japan	1.5%	5.8%	-16.0%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.2%	-0.2%	1.6%	2.8%
U.S. TIPS	0.0%	0.2%	-0.6%	2.9%
U.S. Investment Grade	0.7%	1.3%	-0.6%	4.1%
U.S. High Yield	0.0%	3.8%	0.8%	7.1%
U.S. Municipals	0.0%	0.3%	2.2%	2.7%
Non-U.S. Developed	0.7%	0.9%	-4.7%	0.9%
EM $ Bonds	1.0%	3.7%	-0.9%	6.4%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-1.7%	14.6%	-12.5%	$ 61.64
Gold	1.7%	1.6%	-3.3%	$ 1,303
Copper	0.1%	1.5%	-15.2%	$ 6,056

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.5%	-0.5%	-7.9%	1.14
USD/Yen	-0.2%	0.0%	0.1%	109.55
Pound/USD	2.5%	3.5%	-6.7%	1.32

Source: Thomson Reuters. As of Jan. 25, 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. 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

Jan. 29 UK Parliament vote on Brexit motion and associated amendments

Jan. 30 Fed monetary policy statement, U.S. Q4 GDP, core PCE (could be delayed because of shutdown)

Jan. 30-31 A delegation from China could travel to the U.S. for trade talks

Jan. 31 China NBS Manufacturing PMI; eurozone Q4 GDP

Feb. 1 U.S. employment report, manufacturing PMIs; Japan Nikkei Manufacturing PMI; China Caixin Manufacturing PMI

The Fed is likely to keep interest rates on hold this week, and market focus will be on the post-meeting statement. This will be Fed Chairman Jerome Powell's first post-meeting press conference outside the quarterly release of the central bank's economic projections. Investors will scrutinize Powell's comments on the economic outlook and recent market volatility for signs about when the Fed might lift rates next and its latest thinking on normalizing the balance sheet. We see slower growth, modest inflation and tightening financial conditions keeping the Fed at just one rate rise this year, likely not before September.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Solid corporate earnings and ongoing economic expansion underpin our positive view. We have a growing preference for quality companies with strong balance sheets as the 2019 macro and earnings outlooks become more uncertain. Health care is among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance. We prefer higher-quality, globally-oriented names.
	Japan	—	We see solid corporate fundamentals and cheap valuations as supportive, but the market lacks a clear catalyst for sustained outperformance. Other positives include shareholder-friendly corporate behavior, central bank stock buying and political stability.
	EM	▲	Attractive valuations, coupled with a backdrop of economic reforms and policy stimulus, support the case for EM stocks. We view financial contagion risks as low. Uncertainty around trade is likely to persist, though much has been priced in. 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	—	An expected pause in the Federal Reserve's policy normalization, and softening economic data in the near term, should support flows into Treasuries. We are modestly positive on longer maturities, but see 10-year yields range-bound. A more negative equity/bond correlation makes Treasuries an attractive portfolio diversifier.
	U.S. municipals	—	Solid demand for munis as a tax shelter and expectations for muted issuance should support the asset class. We prefer a long duration stance, expressed via a barbell strategy focused on two- and 20-year maturities.
	U.S. credit	—	Solid fundamentals support credit markets, but late-cycle economic concerns pose a risk to valuations. We favor an up-in-quality stance with a preference for investment grade credit. We hold a balanced view between high yield bonds and loans.
	European sovereigns	▼	Yields are relatively unattractive and vulnerable to any growth uptick. Rising rate differentials have made European sovereigns more appealing for global investors with currency hedges. Italian spreads reflect quite a bit of risk, but the upcoming European elections cycle is an important source of risk.
	European credit	—	We see compelling relative value in BBB-rated European credit, as it has lagged the recent rebound in other risk assets. A slowing, but growing global economy and major central banks on hold provide a positive backdrop for credit. Yet we remain neutral overall, given still-anemic eurozone growth and ongoing political risks.
	EM debt	—	Valuations remain attractive despite the recent rally, and limited issuance in recent months is supportive. A pause in U.S. monetary policy tightening and U.S. dollar strength removes a key drag on performance. Clear risks include deteriorating U.S.-China relations and slower global growth.
	Asia fixed income	—	We focus on quality credit, including investment grade in India, China and parts of the Middle East. We also favor high yield in Indonesia and in China's real estate sector. We have low conviction on local currency debt markets and see the Chinese yuan benefiting from any easing in U.S.-China trade conflicts.
Other	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could signal upside to industrial metal prices. We are neutral on the U.S. dollar. It maintains "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

▲ Overweight — Neutral ▼ Underweight

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

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