BLACKROCK INVESTMENT INSTITUTE

WEEKLY COMMENTARY • JULY 22, 2019

Key points

1 We have upgraded European assets because we see the European Central Bank (ECB) shifting decisively dovish in coming months.

2 The British pound touched a 27-month low against the U.S. dollar as Brexit returned to the fore ahead of a new prime minister announcement.

3 The ECB is likely to use this week's policy meeting to lay the ground for the fresh stimulus package to be deployed over coming months.

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.

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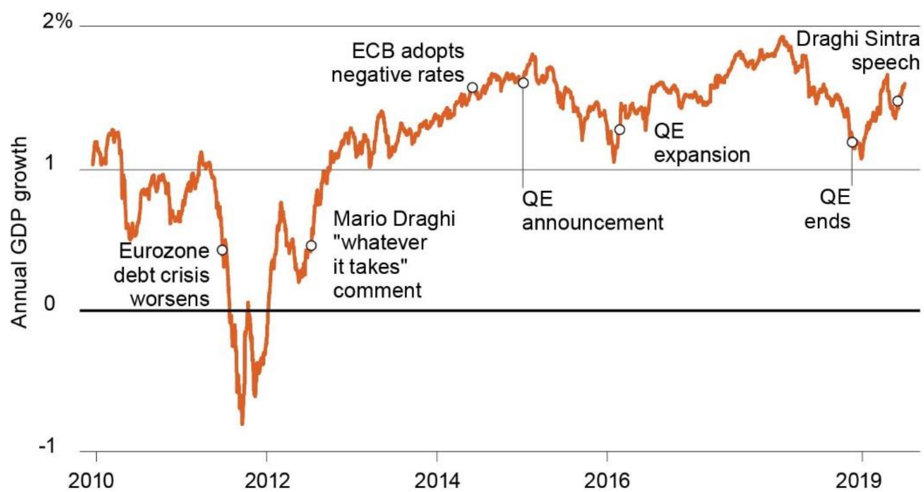
1 Why we upgrade European assets

We have closed our underweight in European equities and credit, and upgraded government bonds to overweight. The impetus? We see the European Central Bank (ECB) delivering fresh stimulus over coming months, against a backdrop of a stabilizing growth outlook and persistent inflation undershoots.

Chart of the week

BlackRock financial conditions indicator for eurozone, 2010-2019



Sources: BlackRock Investment Institute and Bloomberg, July 2019.. Notes: The line shows the rate of gross domestic product growth implied by our financial conditions indicator (FCI) for the eurozone, based on its historical relationship with our Growth GPS. The BlackRock Growth GPS shows where the 12-month forward consensus GDP forecast may stand in three months' time. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates. Forward-looking estimates may not come to pass.

Eurozone financial conditions, as measured by our financial conditions indicator (FCI) in the chart above, have already improved. Importantly, the ECB is likely to announce new stimulus in coming months in an effort to lift stubbornly low inflation. The package we expect is not yet fully reflected in markets, in our view, and should help further ease financial conditions and support European assets. The ECB may outline its thinking at this week's policy meeting and take action later in the year. Measures could include further cuts to its already negative 0.4% deposit rate and a new round of purchases of financial assets including corporate bonds.

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A benign environment for now

We have recently downgraded our global growth outlook as trade and geopolitical tensions are stoking macro uncertainty. The growth outlook has weakened primarily in the U.S. and China recently, but steadied in the eurozone albeit at below-trend levels. The decisively dovish shift by central banks should make for a relatively benign environment for risk assets in the near term. China's growth looks to stabilize as policymakers stand ready with additional fiscal stimulus, easing concerns about a potential drag on the European economy.

The easing we expect the ECB to deliver is not yet fully reflected in markets, we believe. This has prompted us to upgrade European government bonds to overweight and close our underweight in equities and credit. In government debt, we expect peripherals, or government bonds of mostly southern-tier countries, to benefit most from the fresh stimulus. A "lower for longer" environment should support credit as a source of income in a region where many government bond yields of core countries are negative. We favor high yield corporates for their muted issuance, strong inflows and spread premium to U.S. counterparts.

Our ECB view supports closing the underweight in European equities. European equity funds have seen the longest stretch of outflows in 10 years, according to EPFR data, meaning many investors are under-invested in the region. Earnings expectations have largely priced in risks of slower growth, and we see potential for an earnings rebound next year. Equity risk premia (the expected return advantage of holding equities over government bonds) in Europe are now similar to those of riskier emerging markets. We prefer the quality factor and defensive sectors that feature high profitability, stable earnings and low indebtedness, such as pharmaceuticals. We like companies with sustainable and relatively high dividend yields. These stocks, as well as European high yield credit and peripherals, are particularly attractive for hedged U.S. dollar-based investors because of the hefty U.S.-euro interest rate differential. We generally dislike the consumer discretionary sector due to its vulnerability to trade conflicts, and avoid banks given negative rates.

2 Week in review

- Global equities edged lower, led by energy stocks that were dragged down by a slump in oil prices. The U.S. second-quarter corporate earnings reporting season kicked off with mixed results.
- The British pound touched a 27-month low versus the U.S. dollar and a 2019 low against the euro as Brexit returned to the fore. Brexiteer Boris Johnson is widely expected to win the Conservative Party leadership contest this week and become the next prime minister. We see many twists and turns leading up to the Oct. 31 Brexit deadline.
- China's second-quarter gross domestic product (GDP) grew 6.2% on the year, in line with our view that growth is stabilizing. Industrial production, retail sales and investment beat expectations. U.S. data were mixed, with June retail sales surprising to the upside and industrial production in line with expectations.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-1.2%	20.1%	8.3%	1.9%
U.S. Small Caps	-1.4%	15.6%	-7.7%	1.7%
Non-U.S. World	0.1%	14.1%	1.5%	3.2%
Non-U.S. Developed	-0.1%	14.3%	0.8%	3.4%
Japan	-0.4%	8.8%	-2.6%	2.5%
Emerging	0.8%	11.5%	2.6%	2.7%
Asia ex-Japan	1.0%	11.4%	1.4%	2.5%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.4%	4.9%	6.9%	2.0%
U.S. TIPS	0.3%	6.5%	5.2%	2.1%
U.S. Investment Grade	0.5%	9.9%	9.8%	3.2%
U.S. High Yield	-0.2%	10.0%	6.9%	6.0%
U.S. Municipals	0.2%	5.6%	6.8%	1.9%
Non-U.S. Developed	0.5%	4.6%	4.5%	0.6%
EM $ Bonds	0.5%	12.1%	11.0%	5.5%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-6.4%	16.1%	-13.9%	$62.47
Gold	0.7%	11.1%	16.6%	$1,425
Copper	2.2%	1.7%	0.0%	$6,065

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.4%	-2.2%	-3.6%	1.12
USD/Yen	-0.2%	-1.7%	-4.2%	107.72
Pound/USD	-0.6%	-2.0%	-3.9%	1.25

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Refinitiv Datastream. As of July 19, 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 23	The UK announces its new prime minister	**July 25**	ECB monetary policy meeting
July 24	Japan, France, Germany, eurozone, U.S. composite Purchasing Managers' Index (PMI)	**July 26**	U.S. advance second-quarter GDP

The ECB will likely use Thursday's policy meeting to lay the groundwork for the fresh monetary stimulus in coming months. Forward guidance issued at the meeting could help lock in market pricing of lower rates. Our base case is a 10-basis point cut in September. We see the ECB then reviving its purchases of government and corporate bonds, with the emphasis on the latter, and expand its asset purchases to bank debt. We believe the market is underestimating how much stimulus the central bank is prepared to provide.

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. High-yield and investment-grade credit remain 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.
	European credit	—	We have upgraded European credit to neutral. Fresh ECB policy easing should include corporate bond purchases. The ECB's "lower for even longer" rate shift should help limit market volatility. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	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 in Latin America and 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

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