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WEEKLY COMMENTARY • AUG. 5, 2019

Key points

1. We see the dovish pivot by global central banks supporting the economic expansion and risk assets, with rising protectionism the key risk.
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2. We see a wider range of Brexit outcomes—including no-deal, a snap election or a second referendum—and further British pound volatility.
3. Corporate earnings season winds down this week, with U.S. companies likely to eke out a small profit gain for a consecutive quarter.

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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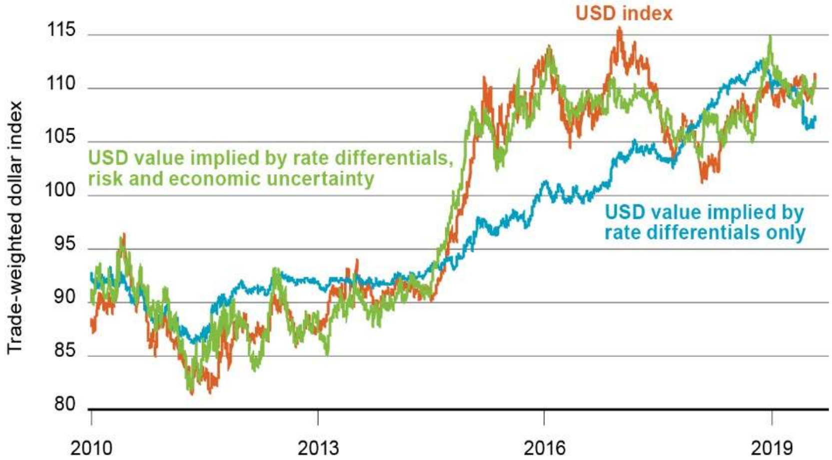
1 Policy pivot confirmed; underpins risk assets

The Fed confirmed global central banks' dovish pivot last week, as it cut rates for the first time since 2008, albeit by less than some market participants had foreseen. Its moderate easing stance was in line with our expectations—and we see easier global monetary policies stretching the current cycle and supporting risk assets. This buys investors time to fortify portfolios even amid a further spike in U.S.-China trade tensions.

Chart of the week

U.S. dollar trade-weighted index and BlackRock proxies, 2010-2019



Sources: BlackRock Investment Institute, with data from the Federal Reserve and Refinitiv Datastream, August 2019. Notes: The "USD index" line shows the Fed's trade-weighted U.S. dollar (USD) indexed to 100 in 2006. The "USD value implied by rate differentials only" line estimates the value of the trade-weighted dollar index using interest rate differentials alone, based on a regression of two-year U.S. yields spreads with major trading partners. The third line estimates the value of the trade-weighted dollar index implied by these yield spreads plus a basket of risk and economic uncertainty proxies – including the BlackRock Geopolitical Risk Index, our estimate of the term premium on long-term U.S. Treasuries, eurozone peripheral spreads, oil prices and the VIX index.

A narrowing interest rate differential between the U.S. and other countries would usually point to a weaker dollar. Yet the dollar has been surprisingly resilient in 2019. We see key reasons why. First, other global central banks are in easing mode too, so rate differentials have not moved as much against the dollar as headline changes in Fed expectations would have suggested. Second, rising macro uncertainty is leading to a "safe-haven" bid for the dollar. Our research suggests the trade-weighted dollar is currently around 4% higher than we would expect based on its historical relationship with rate differentials alone. Yet it is tracking where we would expect, after accounting for risk appetite and economic uncertainty. See the chart above. Third, we believe markets may still be overestimating the scope for further Fed easing.

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Ongoing dollar crosscurrents ahead

Evidence is strengthening for the dovish pivot in global monetary policy that we previewed in our recent midyear Global investment outlook. The Fed cut rates by a quarter percentage point last week, but appeared less committed to further rate cuts than some market participants had expected. The European Central Bank and Bank of Japan both stayed on hold in July, but the former confirmed it's planning a package of stimulus as soon as September and the latter said it would not hesitate to ease further if warranted. Chinese leaders also used mildly more dovish language in communication out of a Politburo meeting on the economy last week.

This renewed easing stance by global central banks is a reflection of rising global macro risks and, in some cases, persistent below-target inflation. In our view, protectionism is stoking greater macro uncertainty, widening the range of potential economic and market outcomes ahead. This led us to downgrade our global growth outlook in early July. Trade disputes and broader geopolitical frictions are now the key drivers for the global economy and markets. This was underscored by a fresh U.S. threat last week of a 10% tariff on $300 billion of Chinese imports starting September 1. U.S.-China tensions are likely to be structural and persistent, according to our Geopolitical risk dashboard. The prospect for elevated macro uncertainty suggests the bid for the U.S. dollar is likely to last. Conversely, if macro uncertainty were to ease and risk appetite returned to normal levels, the dollar could weaken. What are the other risks to the dollar outlook? The Fed cutting more than we expect or the U.S. administration taking steps to weaken the dollar could weigh on the U.S. currency.

Fed policy will be a key driver for markets, including exchange rates. We see the Fed lowering rates further but find market expectations of 0.75 percentage point in cuts by the end of 2020 as excessive, given what we see as limited near-term risk of recession. On balance, we do not foresee a disruptive strengthening in the dollar. This supports our overweight on emerging market (EM) debt, driven by attractive income and appreciation potential in some local EM currencies.

2 Week in review

New UK Prime Minister Boris Johnson has assembled a "pro-Brexit" Cabinet and pledged to leave the European Union on October 31—with or without a deal. The British pound has weakened sharply against the U.S. dollar and euro, as markets have become increasingly worried over the possibility of a no-deal Brexit. We now see a wider range of potential outcomes ahead—including no-deal, a snap election or a second Brexit referendum—with evenly-distributed probabilities. We see negative market sentiment also playing out through increased currency volatility, and worry about a shock to growth and confidence more broadly, as we note on our Geopolitical risk dashboard. We have a neutral view on UK equities, as the majority of UK corporate earnings are derived from international sources, and maintain our preference for UK nominal bonds over inflation-linked counterparts, given that Brexit uncertainty has already made inflation protection extremely expensive. The Bank of England remained on hold last week but kept a tightening bias that is conditional on an orderly Brexit. Rising chances of a no-deal have led to increased market expectations of BoE rate cuts by 2019's end.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-3.1%	18.3%	5.8%	2.0%
U.S. Small Caps	-2.8%	14.6%	-7.5%	1.7%
Non-U.S. World	-3.0%	10.2%	-2.5%	3.3%
Non-U.S. Developed	-2.6%	11.1%	-2.4%	3.4%
Japan	-0.3%	8.2%	-4.4%	2.5%
Emerging	-4.2%	6.0%	-3.2%	3.0%
Asia ex-Japan	-4.6%	5.6%	-3.9%	2.7%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	1.3%	6.1%	8.8%	1.8%
U.S. TIPS	0.7%	6.9%	6.3%	2.0%
U.S. Investment Grade	1.1%	11.3%	11.5%	3.1%
U.S. High Yield	-0.3%	10.2%	6.5%	6.0%
U.S. Municipals	0.5%	6.4%	7.9%	1.8%
Non-U.S. Developed	0.7%	4.8%	5.0%	0.5%
EM $ Bonds	0.0%	12.6%	11.5%	5.3%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-2.5%	15.0%	-15.7%	$ 61.89
Gold	1.6%	12.3%	19.3%	$ 1,441
Copper	-3.9%	-4.0%	-6.7%	$ 5,730

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.2%	-3.2%	-4.1%	1.11
USD/Yen	-1.9%	-2.7%	-4.5%	106.60
Pound/USD	-1.8%	-4.7%	-6.6%	1.22

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 Aug. 2, 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

Aug. 5	China Caixin Services PMI; U.S. ISM nonmanufacturing index
Aug. 6	Germany factory orders
Aug 7	BoJ summary of opinions; China foreign exchange reserves; Germany industrial production
Aug 9	Japan gross domestic product (GDP); China inflation rate; UK GDP

Second-quarter corporate earnings season winds down this week. Results so far in the U.S. and Europe have come in better than expected, following downward revisions in analysts' earnings expectations heading into the reporting season. Earnings revision ratios globally are tracking below one, meaning more analyst downgrades than upgrades. The U.S. is seeing a better mix. U.S. companies are reporting modest sales growth, somewhat offsetting hits to margins from rising costs and trade uncertainties. They look likely to eke out a small profit gain for a second quarter in a row. Yet analysts' expectations for 2% S&P 500 earnings growth this year rest on a strong fourth quarter showing, as the effect of the late-2017 U.S. corporate tax cut fades and year-on-year comparisons become easier.

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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