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WEEKLY COMMENTARY • SEPT. 16, 2019

Key points

1 We see little near-term risk of recession, but trade tensions pose a risk of lower growth and higher inflation, challenging stock and bond valuations.

2 An attack on Saudi Arabia's oil facilities disrupted 5% of global supply. A European Central Bank stimulus package exceeded market expectations.

3 The Federal Reserve is expected to cut interest rates this week, underpinning the expansion under pressure from trade tensions.

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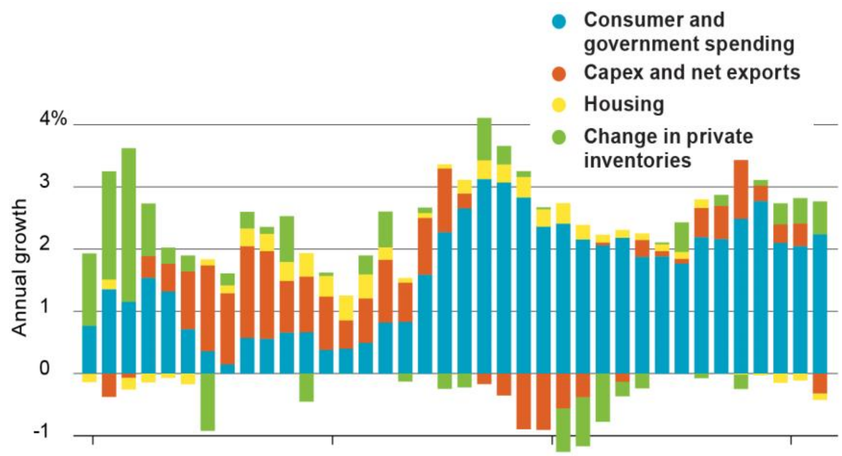
1 Lower growth, higher inflation

Markets breathed a sigh of relief last week on signs of easing U.S.-China trade tensions. We see ongoing policy support, the absence of obvious financial system vulnerabilities and resilient consumer spending helping extend the U.S. economic expansion. Yet trade tensions pose ongoing risks – threatening to weigh on growth and pressure inflation. This could call for a more defensive investing stance.

Chart of the week

Composition of U.S. gross domestic product, 2010-2019



Sources: BlackRock Investment Institute, with data from the U.S. Bureau of Economic Analysis, September 2019. Notes: The chart shows the annual rate of U.S. GDP growth broken down by components through the second quarter of 2019. Personal and government spending refers to a combination of personal consumption expenditures; government consumption expenditures and gross investment. Capex refers to non-residential domestic gross investment, and housing refers to residential investment.

Rising global trade tensions are spilling over into the U.S. manufacturing sector. This is reflected in the makeup of U.S. GDP growth. The contribution by capital expenditure and net exports turned negative in the second quarter, as the chart shows. The pace of inventory building is still on the rise, as businesses stock up ahead of expected further rises in tariffs. Yet consumer spending – making up over two thirds of the U.S. economy – is holding up well. Household leverage is limited, and there are no indications of over-extended spending on big-ticket goods as cars and appliances. This dynamic resembles 2015 and 2016, when strong consumer spending and services sector activity offset a contraction in industrial production. Yet there are key differences: Back then, we saw a deflationary combination of a strong U.S. dollar, overtightened policy in China and a collapse in oil prices. Today the shock is likely to be inflationary as it stems from tariffs and supply chain disruptions.

An uncomfortable mix

A protectionist push has become the key driver of the global economy and markets, as we highlighted in our Midyear 2019 Global investment outlook. Escalating tit-for-tat actions by the two countries in late August helped push the U.S. Treasury yield curve to invert (shorter-term yields rise above longer-term ones) – a phenomenon that has historically often preceded a recession and spooked investors. Yet structural forces such as a glut of global savings are suppressing long-term yields, making the yield curve's shape a less reliable signal than in the past. And yields rebounded last week on signs of a more conciliatory approach by both the U.S. and China to trade talks. We reiterate our view that tensions between the two countries are structural, reducing the likelihood of a comprehensive deal. If all tariffs announced by the U.S. and China were implemented, U.S. growth could fall materially below trend in coming quarters.

The U.S. economy is unlikely to get much help from the rest of the world. Many economies are digesting the fallout from the rapid-fire protectionist measures and the potential for further escalation in trade tensions. We see China's economy slowing further and Beijing likely to roll out additional stimulus to blunt bigger downside surprises, but a material boost to growth is unlikely. The eurozone economy could be stabilizing at best, with Germany in a technical recession and a range of Brexit-related risks still looming large. Meanwhile in the U.S., we see inflation set to pick up, thanks to more tariffs and faster wage growth in the face of a tight labor market. A mix of lower growth and higher inflation complicates the Fed's effort to achieve maximum employment and stable prices. A key question: Can U.S. consumers keep supporting overall growth in the face of manufacturing headwinds, slowing job growth and tariffs on consumer goods?

Bottom line: The health of the U.S. consumer spending will be key for U.S. and global economic growth. Our base case points to a global growth slowdown cushioned by additional policy easing. Our moderate pro-risk stance – including an overweight in U.S. equities and exposures to government bonds as portfolio shock absorbers – has worked well thus far. Yet trade tensions pose the risk of slowing growth and rising inflation – a potential threat to stock and bond markets alike.

2 Week in review

- An attack on Saudi Arabia's oil facilities over the weekend knocked out 5% of global crude supply, sending oil prices surging nearly 20% on early Monday.
- The ECB announced a broad package of easing measures including cutting the deposit rate by 0.1% to minus 0.5% and restarting asset purchases at a pace of 20 billion euro per month, with a commitment to run the program until its inflation target was met. The market reacted positively with inflation expectations and European equities rising on the announcement.
- China said it would exempt some products from additional tariffs and the U.S. delayed a tariff increase on some Chinese goods. China's August exports fell more than expected, highlighting the pressure on the export sector from ongoing trade frictions. U.S. retail sales grew more than expected in August, underlining the resilience in consumer spending. University of Michigan's consumer sentiment index also beat expectations, rebounding from a nearly three-year low in August.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	1.0%	21.7%	5.7%	1.9%
U.S. Small Caps	4.9%	18.2%	-6.6%	1.8%
Non-U.S. World	1.9%	13.7%	3.4%	3.2%
Non-U.S. Developed	2.0%	14.8%	3.0%	3.3%
Japan	3.5%	12.2%	1.4%	2.5%
Emerging	1.9%	8.8%	3.9%	2.8%
Asia ex-Japan	2.1%	8.9%	2.1%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-2.1%	6.1%	8.4%	1.9%
U.S. TIPS	-1.8%	6.8%	5.9%	2.1%
U.S. Investment Grade	-2.2%	11.1%	10.8%	3.1%
U.S. High Yield	0.2%	11.5%	6.8%	5.7%
U.S. Municipals	-1.1%	6.3%	7.8%	1.9%
Non-U.S. Developed	-1.2%	4.5%	4.5%	0.5%
EM $ Bonds	-1.4%	12.7%	12.9%	5.3%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-2.1%	11.9%	-23.0%	$60.22
Gold	-1.2%	16.0%	23.9%	$1,489
Copper	2.4%	0.2%	-1.0%	$5,975

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.4%	-3.4%	-5.3%	1.11
USD/Yen	1.1%	-1.4%	-3.4%	108.09
Pound/USD	1.8%	-2.0%	-4.6%	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 Sept. 13, 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

Sept. 16	China industrial output, retail sales	**Sept. 18**	Fed's rate decision; Bank of Japan's two-day policy meeting starts
Sept. 17	German ZEW Indicator of Economic Sentiment; U.S. industrial output	**Sept. 20**	Eurozone flash consumer confidence

The Fed's policy meeting this week is the key event. The central bank is expected to cut interest rates by 0.25 percentage points, reflecting one of our key investment themes: a dovish pivot by central banks that should help extend the economic expansion. Markets are pricing in around one percentage point of easing over the next 12 months. We see the likelihood of another rate cut in the fourth quarter. Yet we view the amount of Fed easing priced in by markets as excessive, given our view that near-term recession risks are low. And the personal consumption expenditure (PCE) price index, the Fed's preferred inflation gauge, is expected to move above the Fed's 2% target early next year.

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 min-vol, which has historically tended to perform well during economic slowdowns.
	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 see the 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	▲	The resumption of asset purchases by the ECB supports our overweight stance, particularly in peripherals. 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	—	Renewed ECB purchases of corporate debt and a "lower for even longer" rate shift are supportive. 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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