BLACKROCK INVESTMENT INSTITUTE

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WEEKLY COMMENTARY • FEB. 25, 2019

Key points

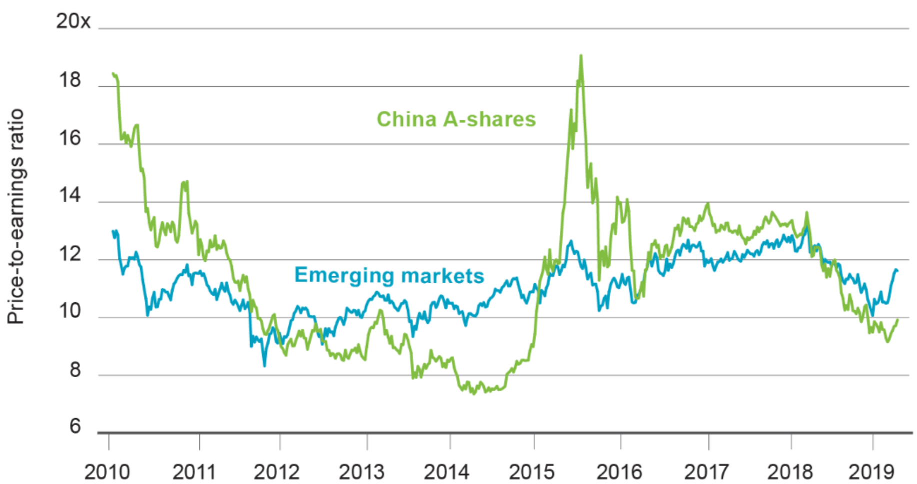
1. We are positive on China's stock market, even after this year's rally, but favor a selective approach amid growth and trade risks.
2. Global stocks edged higher last week, while oil prices rose. Meeting minutes confirmed the Fed's willingness to be patient on rates.
3. Ongoing U.S.-China trade negotiations could move markets this week, after news an increase of U.S. tariffs on Chinese goods will be delayed.

1 Is China's stock turnaround for real?

The Chinese stock market has rallied sharply this year, becoming a top performer among global markets after finishing 2018 near the bottom. Is there still opportunity left? We have a positive view on China's stock market, but see rising risks and reason for greater selectivity.

Chart of the week

Price-to-earnings ratios of China A-shares and EM equities, 2010-2019



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 Thomson Reuters, February 2019. Notes: The lines show the price-to-earnings ratios of the Shanghai Stock Exchange A-Share Index and the MSCI Emerging Markets (EM) Index, based on consensus 12-month forward earnings estimates.

The mainland China market – the world's second-largest by market capitalization – includes shares (called A-shares) of Chinese companies trading in yuan. A-shares became more accessible to global investors last year when MSCI incorporated eligible A-shares into its indexes. The chart shows how A-share valuations took a big hit in 2018, when they experienced their largest annual percentage drop since 2010. Behind the derating: the U.S.-China trade conflict compounding a growth slowdown and ongoing Fed policy tightening. Some of those factors have turned supportive: Chinese monetary stimulus is arriving, hopes are running high for a trade deal and the Fed has hit the pause button. Yet A-shares still trade at a hefty discount to other emerging market (EM) equities, as the chart shows, and to their own history. This suggests potential for further gains.

Behind the turnaround

We see three drivers of the turnaround in China A-shares after a tough 2018. First, international flows into A-shares have accelerated amid improving sentiment toward China – and EMs more broadly. Second, the policy environment has become more supportive. Material policy easing in China, including ample credit growth and fiscal stimulus, is particularly helpful for A-shares given issuers' domestic consumer focus. The Fed's pause on policy tightening has stabilized the U.S. dollar, and other major central banks have taken on a dovish tone. Third, our indicator shows market concerns around U.S.-China trade tensions have eased. Reports suggest progress in meetings between U.S. and Chinese officials, with a planned delay of a significant tariff increase at the end of this week.

We see these drivers persisting in the near term and remain positive on the A-share equity market. Global investor positioning in China is still light. Official data suggest international investors hold only 3% of A-shares, and we could see this figure increasing. An upcoming change by index provider MSCI could quadruple the weighting of A-shares in its EM equity index to nearly 3% from 0.7%. Finally, valuations are still attractive, though a large unwind of negative sentiment means the value isn't as big as it was in late 2018.

We see two risks: First, China's economic and earnings momentum are weak. We see scope for consensus growth expectations to drop further in the near term, but expect economic and earnings growth to both bottom out next quarter at levels still above those of many developed markets. Investors are currently looking through such downgrades, but fundamentals will need to turn for a sustained rally. The second risk: a significant escalation in the U.S.-China conflict. A meeting between the countries' leaders may be required for a meaningful trade deal. There is a danger of market complacency over the prospects for such a deal, even as we see a low near-term risk of a flare-up. Bottom line: We see potential for positive returns for Chinese stocks, but would be more selective. In the short term, we favor market segments likely to benefit from further local policy easing such as brokers and companies related to the domestic consumer.

2 Week in review

- Global stocks edged higher last week, led by gains in EMs. Materials was the best performing global sector, while health care and consumer staples lagged. Oil prices rose further, and bond yields moved sideways across the globe.
- The Federal Open Market Committee's January meeting minutes signaled the Fed's balance sheet may stop shrinking in the third quarter and indicated central bank officials' willingness to keep interest rates stable "for a time." U.S. durable goods orders fell short of expectations.
- The eurozone composite Purchasing Managers' Index (PMI) surprised to the upside as did composite measures in France and Germany, both rebounding from prior months' weakness. But the eurozone manufacturing PMI fell to its lowest level in nearly six years at 49.2. Japan's manufacturing PMI fell below 50, signaling a contraction, for the first time since August 2016.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.7%	11.7%	5.4%	2.0%
U.S. Small Caps	1.3%	18.1%	5.3%	1.6%
Non-U.S. World	2.0%	9.6%	-6.4%	3.2%
Non-U.S. Developed	1.6%	9.0%	-6.1%	3.4%
Japan	1.9%	6.9%	-8.0%	2.4%
Emerging	2.8%	9.8%	-9.3%	2.7%
Asia ex-Japan	3.2%	10.1%	-7.3%	2.5%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.1%	0.5%	3.8%	2.7%
U.S. TIPS	0.4%	1.6%	2.6%	2.8%
U.S. Investment Grade	0.0%	2.7%	3.0%	3.9%
U.S. High Yield	0.3%	5.8%	4.1%	6.7%
U.S. Municipals	0.2%	1.2%	4.1%	2.5%
Non-U.S. Developed	0.6%	0.9%	-3.7%	0.9%
EM $ Bonds	0.5%	5.1%	3.1%	6.2%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	1.3%	24.8%	1.1%	$ 67.12
Gold	0.5%	3.5%	-0.3%	$ 1,328
Copper	4.7%	8.6%	-9.6%	$ 6,478

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.4%	-1.1%	-8.0%	1.13
USD/Yen	0.2%	1.0%	3.7%	110.70
Pound/USD	1.3%	2.3%	-6.5%	1.31

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Thomson Reuters. As of Feb. 22, 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

Feb. 26	U.S. consumer confidence index
Feb. 27	UK parliamentary Brexit vote; Trump-Kim summit (Feb. 27 and Feb. 28)
Feb. 28	U.S. gross domestic product (GDP); China NBS Manufacturing PMI, MSCI announcement on further A-share inclusion; Germany inflation
March 1	Original deadline for U.S.-China three-month trade truce expiration; U.S. PCE; Japan CPI, Nikkei Manufacturing PMI; China Caixin Manufacturing PMI
March 2	U.S. debt ceiling deadline

Ongoing U.S.-China trade negotiations could again move markets this week. The mood music surrounding the talks has been positive, with U.S. President Donald Trump stating that the planned increase of U.S. tariffs on Chinese goods to 25% from 10% will be delayed. The original deadline for a deal was the end of this week, following the late 2018 meeting between President Trump and China President Xi Jinping. Another meeting between the two leaders will likely be needed to seal any substantial agreement on trade, and we believe markets are becoming complacent of trade risks.

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	—	A negative correlation with risk assets makes Treasuries attractive portfolio diversifiers. We see modestly soft economic news, positive fixed income flows and a first-half pause in Fed rate hikes as supportive. The impact of Fed balance sheet reduction should be muted. The front end has the most appealing risk-adjusted income, but we favor going out on the curve on any material backup in yields.
	U.S. municipals	—	We prefer long-intermediate maturities for their attractive carry amid a steeper yield curve. We see supply-demand dynamics supporting the asset class in the near term as we expect new issuance to lag the total amount of debt that is called, refunded or matures.
	U.S. credit	—	Solid fundamentals are supportive, but late-cycle economic concerns pose a risk to valuations. We favor BBB-rated bonds in the investment grade space and emphasize credit selection. We generally see healthy fundamentals, supportive supply-demand and valuations in high yield, and prefer bonds over loans.
	European sovereigns	▼	We steer away from most euro peripheral debt amid rising political risks, slowing economic momentum and fewer policy levers to counter any downturn. We see a no-deal Brexit as unlikely, but expect a bumpy road. We favor the British pound and underweight UK gilts in the medium term as a result.
	European credit	—	We are overall cautious on euro investment grade credit — but see attractive relative value and income potential in the BBB segment. Yields compare favorably when hedged back to the U.S. dollar. We are neutral on European high yield but note significantly wider credit spreads versus equivalent U.S. peers.
	EM debt	—	Valuations are 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 remove a key drag on performance. Clear risks include deteriorating U.S.-China relations and slower global growth.
	Asia fixed income	—	Easing U.S.-China trade tensions would increase the appeal of the Chinese yuan. A focus on quality is prudent in credit. We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia and in Chinese real estate.
Other	Commodities and currencies	*	We see oil prices underpinned by the effort of major oil-producing countries to eliminate global oil oversupply. Any relaxation in trade tensions could signal upside to industrial metal prices. We see the U.S. dollar's outlook as balanced. We prefer the dollar among developed market peers and could see it weakening further against high-yielding EM currencies.

▲ Overweight — Neutral ▼ Underweight

*Given the breadth of this category, we do not offer a consolidated view.BIIM0219U-748153-3/4

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