BLACKROCK INVESTMENT INSTITUTE

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Key points

1 A slowing but growing U.S. economy, coupled with a Federal Reserve on hold, should boost the appeal of inflation-linked U.S. bonds.

2 China A-shares outperformed global stocks after the U.S. delayed its plan to further raise tariffs on Chinese goods.

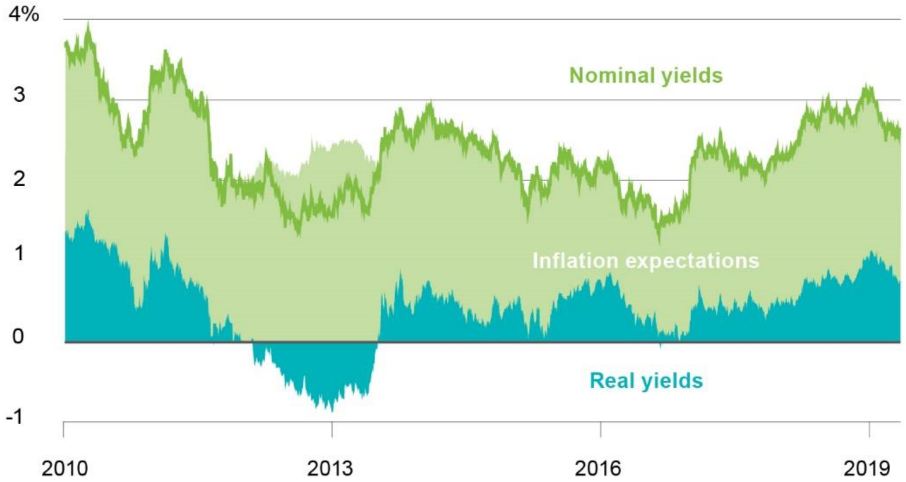
3 We expect no policy change at this week's European Central Bank (ECB) meeting. Policymakers' read on the economy is set to be the main focus.

1 Time to get real on inflation-linked bonds

It may be time to add exposure to inflation-protected U.S. government bonds (TIPS). Why? The Fed has confirmed its intent to be patient with its next rate move and may let inflation temporarily breach its 2% target. Along with a slowing but growing economy, we believe this makes TIPS an attractive alternative to nominal bonds.

Chart of the week

Nominal and "real" yields of 10-year U.S. government bonds, 2010-2019



Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, with data from Bloomberg, March 2019. Notes: Nominal yields are based on 10-year U.S. government bond yields. Real (inflation-adjusted) yields are based on those of 10-year U.S. Treasury Inflation-Protected Securities. Inflation expectations reflect the difference between nominal and real yields. The data are as of Feb. 28, 2019.

U.S. interest rate expectations have declined in recent months – as the Fed has put its monetary policy normalization on hold. We use 10-year U.S. government bond yields as a proxy for interest rates: Nominal yields and "real" yields (nominal minus inflation) have both fallen since late 2018, as the chart shows. We expect the Fed to hold off on any rate moves until at least the second half of 2019, after it pledged a more patient stance on policy. Combined with still solid economic growth, this is likely to further weigh on both nominal and real yields. The likely result: support for bond prices, as we describe in Bonds are back. Fed officials have also signaled they may be willing to allow for modest overshoots above the central bank's inflation target to make up for past undershoots. This could lead inflation-protected bonds to outperform their nominal counterparts – underlining our call for adding some TIPS exposure to portfolios at the expense of nominal bonds.

The odds favor TIPS

We see TIPS performing well in our base case of a Fed pause and ongoing, albeit slower global growth. But what if this call is wrong? Take the scenario of an economy faring better than expected and the Fed raising rates sooner. Higher inflation expectations would likely be a critical driver of the Fed's gear shift. This scenario could bode well for fixed income instruments indexed to inflation, such as TIPS. Markets are pricing in a big undershoot of inflation versus the Fed's target – as has been the case for much of the post-crisis period. The Fed's favored gauge – which measures the expected inflation rate over the five-year period that starts five years from today – points to inflation of just above 1.8%. The recent change in the Fed's commentary around inflation suggests the central bank would likely want to see inflation slightly exceed its target before considering a resumption of policy tightening – for fear of choking off economic growth.

We also find opportunities in inflation-linked bonds in the eurozone. We expect the region's inflation to remain well below the target set out by the ECB. Yet we see the current pricing of the macroeconomic outlook in inflation-linked product markets as overly pessimistic, particularly in comparison with recent rebounds in riskier European assets. We view inflation-linked debt as expensive in the UK. Fears about a no-deal Brexit and its potential hit to the British pound have driven up inflation expectations – even though we see the likelihood of such an outcome as low.

What is the case against inflation-protected securities within a fixed income portfolio? The risk would be a renewed spike in U.S. recession fears – and growing market expectations that the Fed may cut rates. TIPS would likely underperform nominal bonds in such a scenario, although we would still anticipate positive absolute returns. We see this scenario as unlikely in 2019, however, given the strength of the U.S. economy. Bottom line: We see potential for TIPS to play a valuable role in portfolios in the near term.

2 Week in review

- China A-shares scored their biggest weekly gain since mid-2015 after the U.S. announced it would hold back on a planned tariff increase on Chinese goods. Better-than-expected factory activity data and MSCI's confirmation on raising index weighting of Chinese domestic shares also helped. Global stocks steadied. A summit between U.S. President Donald Trump and North Korean leader Kim Jong Un ended without any agreement. Ten-year U.S. government bond yields hit a one-month high.
- The British pound rallied on diminished perceived risks of a no-deal Brexit. UK Prime Minister Theresa May promised lawmakers a chance to vote on a no-deal Brexit and on asking the European Union to delay the deadline, if her revised Brexit deal is voted down.
- U.S. gross domestic product (GDP) grew faster than expected in the last quarter of 2018, underlining the strength in the economy. China's factory activity contracted in February, but there were signs of improving domestic manufacturing demand.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.5%	12.3%	6.8%	2.0%
U.S. Small Caps	0.0%	18.1%	6.9%	1.6%
Non-U.S. World	0.2%	9.9%	-4.8%	3.2%
Non-U.S. Developed	0.6%	9.6%	-4.0%	3.4%
Japan	-0.8%	6.1%	-8.2%	2.4%
Emerging	-0.6%	9.1%	-9.3%	2.7%
Asia ex-Japan	0.0%	10.1%	-7.5%	2.5%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.5%	-0.1%	2.6%	2.8%
U.S. TIPS	-0.5%	1.1%	1.3%	2.9%
U.S. Investment Grade	-0.3%	2.4%	2.3%	4.0%
U.S. High Yield	0.5%	6.3%	4.5%	6.6%
U.S. Municipals	0.0%	1.2%	3.9%	2.6%
Non-U.S. Developed	-0.3%	0.5%	-3.6%	0.9%
EM $ Bonds	0.1%	5.2%	2.9%	6.2%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-3.1%	21.0%	1.9%	$ 65.07
Gold	-2.6%	0.8%	-1.7%	$ 1,294
Copper	0.0%	8.6%	-6.4%	$ 6,478

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.3%	-0.8%	-7.3%	1.14
USD/Yen	1.1%	2.1%	5.3%	111.92
Pound/USD	1.2%	3.5%	-4.2%	1.32

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 March 1, 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

March 5 Eurozone retail sales; U.S. non-manufacturing ISM Report on Business

March 7 ECB monetary policy meeting

March 8 U.S. employment situation

March 9 China Consumer Price Index (CPI) and Producer Price Index (PPI)

We expect no policy change at this week's ECB meeting. But any further signs of policymakers acknowledging a weakening growth outlook would be notable, following the recent shift in tone from some of the traditionally hawkish Governing Council members. The ECB staff will also release updated macroeconomic forecasts which could see downgrades of both growth and core inflation projections. We expect the ECB to keep rates on hold at least through 2019, and see a high likelihood it will renew a key liquidity provision program later in the year.

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 front end has the most appealing risk-adjusted income, but we favor going out on the curve on any material backup in yields. We see the risk/reward balance tilted toward inflation-protected securities.
	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.

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