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Key points

1 Brexit-related sentiment swung wildly in a week of UK political upheaval. We take stock of recent Brexit headlines and the investing implications.

2 Economic data last week provided further evidence that trade disputes and broader geopolitical tensions are weighing on the global economy.

3 The European Central Bank this week may provide the latest sign of a dovish pivot by global central banks aimed at extending the expansion.

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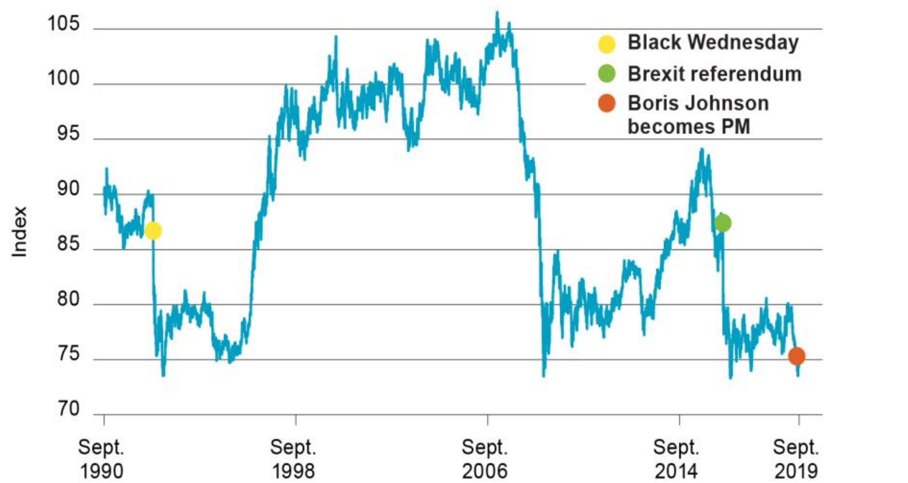
1 UK political upheaval: market implications

We identified geopolitical risk as the key market driver in the second half of 2019 in our midyear investment outlook. The UK is the latest example, where deep divisions over a potential Brexit have unsettled the political landscape, paving the way for a broader set of potential outcomes. This could over time become a bigger worry for investors and businesses, in our view. We provide our take on the implications.

Chart of the week

British pound effective exchange rate, 1990-2019



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and the Bank of England, September 2019. Notes: The line shows the exchange rate index for the British pound versus a trade-weighted basket of foreign currencies, rebased to 100 at Jan. 2005. Black Wednesday is when Britain was forced to withdraw from the European Exchange Rate Mechanism.

The UK parliament returned from recess early last week to upheaval, as lawmakers sought to force UK Prime Minister Boris Johnson to back down from his pledge to take the UK out of the European Union (EU) if no deal is reached by the October 31 deadline. That kicked off perhaps the most eventful week in British politics since the UK voted to leave the EU in 2016. Recent UK political upheavals have been reflected in a volatile pound, with the currency nearing multi-decade lows early last week before rebounding sharply. See the chart. We see further volatility ahead as UK political turmoil is likely to persist, with potential for fundamental realignments in the UK's political landscape. Other markets have been taking their cues from sterling, with the prospect of a weak currency leading investors to price in sustained higher inflation in the UK.

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A wider array of outcomes

The political situation in the UK remains very much in flux, yet recent developments have already changed the distribution of likely Brexit outcomes, in our view. We now see a wider array of potential outcomes, following a high likelihood of a UK general election in the near term. Six months ago, a negotiated deal looked most likely; now, the then-extreme outcomes – no-deal or a new referendum – look to have become more plausible. An election could boil down to a vote that is effectively split on Brexit lines – between leave (under the Conservative and Brexit Parties) or another referendum (under a Labour Party-led coalition).

A lot of contingency planning – including by the financial service sector – has been put in place and could potentially mitigate the impact of any no-deal Brexit. Yet the exit of an EU member would be unprecedented, making it a significant risk with uncertain outcomes. This scenario would also involve tough negotiations. Among other challenges, the UK would need to fashion a new trade agreement with a group it has left on bad terms. Importantly, we believe the main issue is no longer about a deal or no-deal, but about the possibility of new political equilibrium altogether that could stave off a Brexit outcome or bring about a return of a hard Brexit. It could entail fundamental changes to economic policy. Our conclusion: An unsettled UK political and economic landscape could be with us for some time.

The UK political turmoil is happening at a time when heightened market and business concerns about trade disputes and other geopolitical risks are already slowing global growth. The combination of domestic and international uncertainty has led to a near-collapse in UK business confidence, with data pointing to a possible contraction in economic activity. A deeply unsettled political backdrop in the UK could prolong such uncertainties, weighing on domestic business and investor sentiment. Against this backdrop, we do not see the Bank of England raising rates as it has guided. This underpins our positive view on UK gilts. We hold a neutral view on UK equities but see opportunities if Brexit-related fears lead to indiscriminate selloffs, particularly in UK companies that derive most of their earnings from global markets.

2 Week in review

- Geopolitical risks continued to drive global markets. Asian stocks rallied after Hong Kong's leader promised to withdraw the extradition bill that had triggered anti-government protests, and sentiment improved on Chinese stimulus. The People's Bank of China cut banks' reserve ratio by 50 basis points, with some banks qualifying for more reductions. Elsewhere, Argentina's new restrictions limiting capital outflow from pesos to U.S. dollars ahead of elections next month weighed on local assets.
- In the U.S., the August ISM manufacturing index dropped to 49.1, its first sub-50 level since August 2016, and U.S. August jobs growth came in below expectations, providing further evidence that trade disputes and broader geopolitical tensions are weighing on economic activity. Yet the ISM non-manufacturing index came in at 56.4, above expectations, showing service sector strength. A further increase in macro uncertainty led us to downgrade our growth outlook midyear.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	1.8%	20.5%	5.6%	2.0%
U.S. Small Caps	0.7%	12.6%	-10.9%	1.8%
Non-U.S. World	2.2%	11.6%	2.1%	3.2%
Non-U.S. Developed	2.2%	12.6%	1.8%	3.4%
Japan	1.3%	8.5%	-1.6%	2.6%
Emerging	2.4%	6.7%	1.9%	2.9%
Asia ex-Japan	2.4%	6.7%	-0.5%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.2%	8.4%	10.3%	1.5%
U.S. TIPS	-0.4%	8.7%	7.3%	1.7%
U.S. Investment Grade	-0.2%	13.7%	13.2%	2.8%
U.S. High Yield	0.3%	11.3%	6.9%	5.7%
U.S. Municipals	-0.2%	7.4%	8.7%	1.7%
Non-U.S. Developed	-0.1%	5.7%	5.6%	0.4%
EM $ Bonds	0.8%	14.4%	14.9%	5.1%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	1.8%	14.4%	-19.6%	$ 61.54
Gold	-0.9%	17.5%	25.6%	$ 1,507
Copper	2.8%	-2.2%	-1.6%	$ 5,833

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.3%	-3.8%	-5.1%	1.10
USD/Yen	0.6%	-2.4%	-3.5%	106.92
Pound/USD	1.0%	-3.7%	-5.0%	1.23

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. 6, 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. 10-13 China inflation data, new yuan loans, M2 money supply

Sept. 13 U.S. retail sales, consumer sentiment index

Sept. 12 ECB monetary policy announcement

The European Central Bank (ECB)'s meeting on Thursday will likely reflect one of our key midyear outlook themes – the dovish pivot by central banks that we see cushioning the global economic expansion. The ECB is expected to deliver a broad stimulus package. Markets are pricing in a 0.1 percentage point cut in the ECB's deposit rate to -0.5% and expect a restart of asset purchases. We see the ECB potentially delivering a larger rate cut while introducing a tiering system to limit the impact of negative rates on banks, and strengthening forward guidance. We see the central bank likely waiting before resuming asset purchases given recent opposition by some officials.

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 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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