



Global Investment Outlook

MIDYEAR 2018



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We refresh our 2018 investment themes against a backdrop of steady global growth and strong corporate earnings, but rising uncertainty in the macro outlook. We highlight key debates from our recent Outlook Forum, such as the implications of trade tensions.

- **Themes:** Our base case sees strong U.S. growth extending positive spillover effects to the rest of the world, sustaining the global economic expansion. Yet the range of possibilities for the economic outlook has widened. On the downside: trade war and overheating risks. On the upside: U.S. stimulus-fueled surprises. This greater uncertainty – along with rising interest rates – has contributed to tightening financial conditions and argues for building greater resilience into portfolios. A rising U.S. dollar squeezes dollar-funded entities including emerging markets (EMs) with large external debt loads.
- **Outlook debate:** The market regime that brought outsized risk-adjusted returns in 2017 is changing. Rising leverage in pockets of the credit markets is a concern, but we see no flashing red lights yet – and view liquidity as a greater risk. Global trade disputes pose risks to market sentiment and growth. A populist Italian government and immigration tensions have raised the risk of European fragmentation, but we expect the eurozone to muddle through this year. We see China’s economy as steady in the near term, even as deleveraging poses slowdown risks.
- **Market views:** We remain pro-risk but have tempered that stance given the uneasy equilibrium we see between rising macro uncertainty and strong earnings. We prefer U.S. equities over other regions. We still see momentum equities outperforming, and prefer quality exposures over value. In fixed income, we favor short-term bonds in the U.S. and take an up-in-quality stance in credit. Rising risk premia have created value in some EM assets. We like selected private credit and real assets for diversification. We see sustainable investing adding long-term resilience to portfolios.



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Wider range of growth outcomes
Tighter financial conditions
Greater portfolio resilience



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Market regime change
Global trade risks
European fragmentation
China’s balancing act



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Fixed income
Equities
Commodities and currencies
Thematic investing
Assets in brief



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Setting the scene

Market sentiment has shifted markedly. 2017 was a year of upside growth surprises and muted inflation – and unusually low volatility. That set the stage for outsized risk-adjusted returns across markets.

Fast forward to 2018: Sentiment on many of these key market drivers has shifted. The *Market moods* graphic tells the story. The growth picture is still bright overall. Inflation risks look more two-way, and financial conditions are tightening as U.S. rates rise. Monetary policy is shifting, with the Fed pushing on with normalization and the European Central Bank (ECB) set to wind down its asset purchases by year-end. The Bank of Japan looks poised to keep its ultra-easy policy on hold as it awaits a sustainable increase in inflation. The big change in 2018: a rise in macro uncertainty, with potential trade wars and U.S. overheating risks. How dark is the mood? Not nearly as bad as 2015, as the graphic seeks to capture.

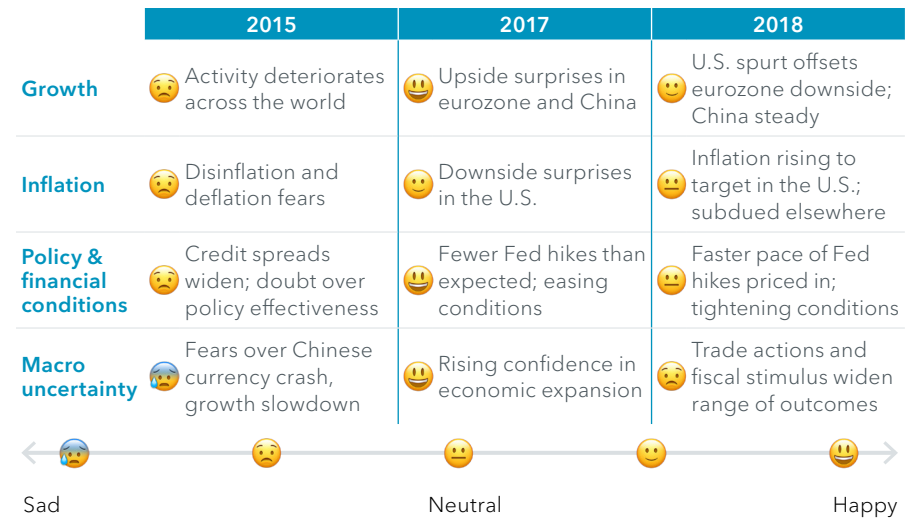
Market sentiment has turned cautious in 2018 as macro uncertainty grows.

Returns reflect markets facing macro uncertainty and tightening financial conditions. See the *Leaderboard* chart. The rising cost of U.S. dollar financing has hurt EMs, especially those dependent on external funding. The range of asset price moves (the lines in the chart) reflect increased volatility. This spurred debate on market regime changes at our Outlook Forum. See [page 7](#). Macro uncertainty could yet increase further. A potential upside: If uncertainty lifts, equities could rip. Copper prices – a barometer of industrial demand – have weakened on global trade tensions that we see persisting. See [page 8](#). Idiosyncratic risks are key return drivers. Italian government debt has suffered as a new populist government refocused market attention on the risk of European fragmentation. See [page 9](#). U.S. stocks have outpaced other global markets on strong earnings growth and a more favorable market composition. See [page 12](#). Crude oil topped the scorecard for the first half, fueled by falling net supply that we see lasting in the second half. See [page 13](#).

The change in market mood has led to muted or negative returns.

Market moods

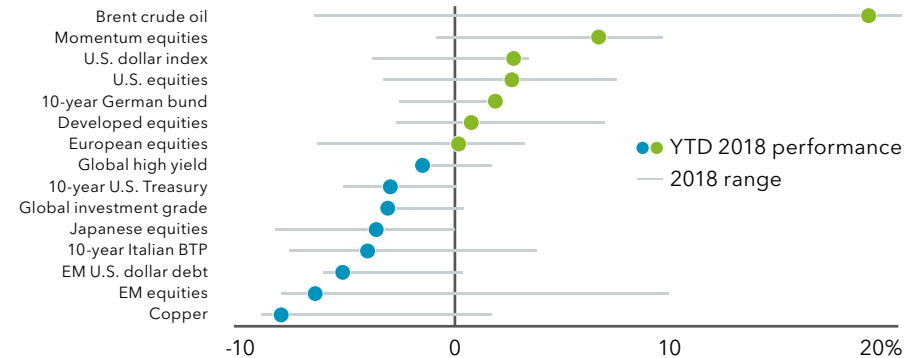
Main themes in global economy, 2015-2018



Source: BlackRock Investment Institute, July 2018. Note: For illustrative purposes only.

Leaderboard

Asset performance in the first half of 2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from Thomson Reuters, July 2018. Notes: Data are through June 29. The dots show total returns of asset classes in local currencies. Exceptions are commodities and emerging, DM and momentum equities, which are denominated in the U.S. dollar. Indexes or prices used are: Brent crude spot, MSCI World Momentum, DXY, S&P 500, Datastream 10-Year Benchmark Government Bond (Germany, Italy, U.S.), MSCI World, MSCI Europe, Bank of America Merrill Lynch Global High Yield, Bank of America Merrill Lynch Global Broad Corporate, Topix, JP Morgan EMBI Global Composite, MSCI Emerging Markets and copper spot price.

Theme 1: Wider range of growth outcomes

We see steady global growth ahead – but a broader set of possible

outcomes. The U.S. is the growth engine, propelled by fiscal stimulus.

Our **BlackRock Growth GPS** – which combines traditional macro indicators with big data insights – points to real U.S. GDP growth beating consensus and pushing up G7 growth. See the *Uneven growth* chart. We see positive spillover effects, especially to EMs.

Our GPS suggests modest downside risk in eurozone growth estimates – but a stabilization at above-trend levels. We see China’s economy as resilient in the near term, as outlined on [page 10](#). Inflation looks poised to rise near the Fed’s target in the U.S. but remain far below target in other developed economies. Economic growth boosts corporate earnings. Yet the risks are two-sided: U.S. stimulus could accelerate capex and lift potential growth – or trade wars and/or inflation-driven overheating could incite a downshift.

Global growth is becoming uneven, with some upside potential in the U.S.

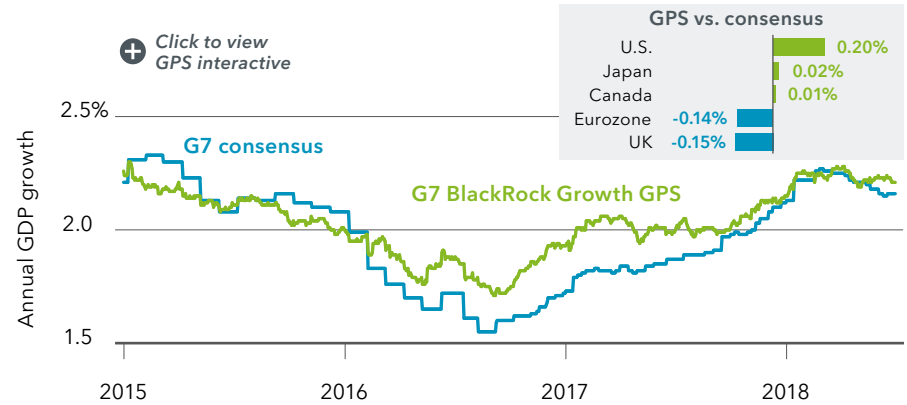
The range of possibilities for the economic outlook is widening. This is the most significant development in the macro environment this year. A rising dispersion in consensus forecasts for U.S. GDP growth provides evidence. Economists see a wider range of potential outcomes by 2020, and the tails (outliers) of the distribution have widened. See the *Fatter tails* chart.

On the upside, there is a chance for U.S. stimulus-fueled surprises. On the downside, that same stimulus could spark economic overheating. Resulting inflationary pressures could prompt a quicker pace of Fed tightening and bring forward the end of the current business cycle. Any further escalation in tit-for-tat trade actions also could have a knock-on effect on business confidence, hitting growth. See [page 9](#). The market’s adjustment to these higher levels of uncertainty will be a key theme for the remainder of 2018, we believe, and is already being mirrored in higher risk premia across asset classes. See [page 5](#) for details.

Hefty U.S. fiscal stimulus and rising trade tensions muddy the macro outlook.

Uneven growth

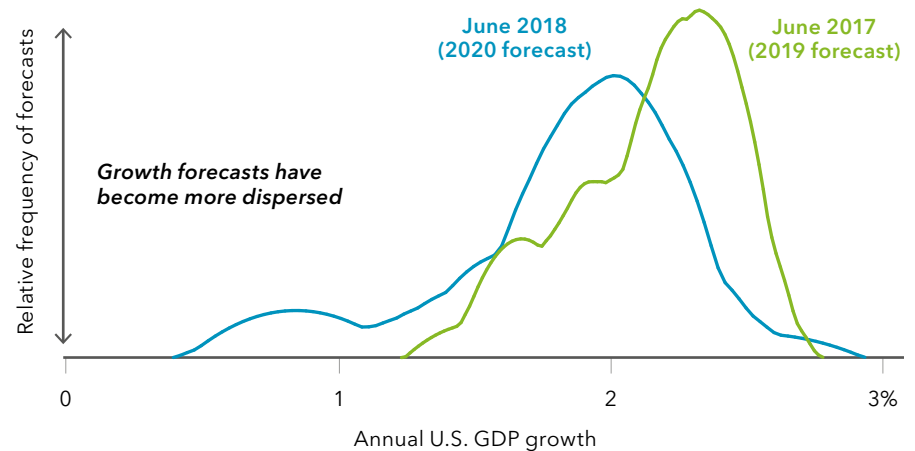
BlackRock Growth GPS vs. G7 consensus, 2015–2018



Source: BlackRock Investment Institute, with data from Bloomberg and Consensus Economics, July 2018. Notes: The BlackRock Growth GPS shows where the 12-month forward consensus GDP forecast may stand in three months’ time. The G7 consensus is the 12-month consensus GDP forecast as measured by Consensus Economics. The inset chart shows the current difference in percentage points between the BlackRock GPS and consensus for the countries/regions shown. The eurozone is a GDP-weighted composite of Germany, France, Italy and Spain. Forward estimates may not come to pass.

Fatter tails

Distribution of two-year forward U.S. GDP forecasts, 2018 vs. 2017



Source: BlackRock Investment Institute, with data from Consensus Economics, June 2018. Notes: The lines show the distribution of two-year forward U.S. GDP forecasts as of June 2018 and 2017. The vertical axis shows the relative frequency of each forecast. Forward-looking estimates may not come to pass.

Theme 2: Tighter financial conditions

Financial conditions have started to tighten. Higher interest rates, a stronger U.S. dollar and less-easy monetary policy crimp the flow of money through the financial system. U.S. real (inflation-adjusted) yields are grinding higher as the Fed presses on with its normalization. The bulk of the change in yields since mid-2016 has been driven by rising growth expectations. See the green area in the *Uncertainty premium* chart. Yet in 2018, markets have been building an extra risk premium into bond yields – reflecting increasing uncertainty. See the light blue area. Some important context: Real yields are ticking higher – but are yet to break out of the top end of their five-year historical range.

Tighter funding conditions have played a role in this year's EM hardships – including Argentina and Turkey, countries with big external financing needs. See [page 6](#) for details. Further gains in the U.S. dollar could cause more pain, including for global banks that rely on dollar funding.

Rising interest rates and a strengthening U.S. dollar are tightening financial conditions, with ripple effects across markets.

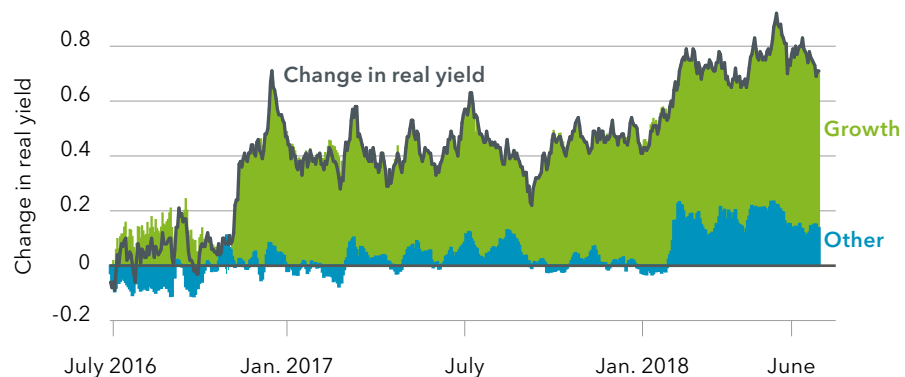
Investors are demanding more compensation for risk in 2018. This is serving up some opportunities. Equity valuation multiples have fallen in all major regions as prices have lagged strong earnings growth. See the *Derating* chart. This affirms our preference for equities within a diversified portfolio, even as our enthusiasm is more tempered. Read more on [page 12](#).

Higher U.S. short-term rates – hovering around 2.5% on the two-year Treasury as of midyear – have big implications across markets. There is renewed competition for capital and less need to stretch for yield when (U.S. dollar-based) investors can get above-inflation returns in short-term “risk-free” debt. See [page 11](#). The result is higher risk premia all around. Beyond equities, we believe the repricing has made selected hard-currency EM debt look attractive again, both relative to EM local debt and to alternatives such as developed market credit.

Higher risk premia are creating value in pockets of the capital markets.

Uncertainty premium

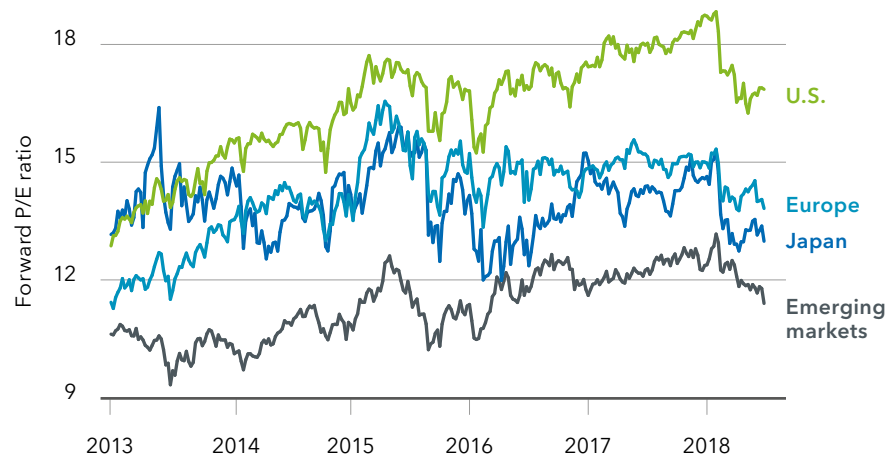
Drivers of 10-year U.S. Treasury real yield, 2016–2018



Source: BlackRock Investment Institute, with data from Bloomberg, June 2018. Notes: The chart shows the estimated breakdown of the drivers of the U.S. 10-year real yield since July 2016 in percentage points. The green area shows the share attributed to changes in market expectations of economic growth. The blue area shows the rest of the yield movement explained by non-growth factors. The gray line shows the change in the 10-year real yield, based on the yield of 10-year U.S. Treasury Inflation-Protected Securities. The breakdown is estimated using a statistical model similar to that outlined in this [IMF research paper](#). Growth is attributed as the key driver when real yields and equity prices move in the same direction.

Derating

Equity market forward price-to-earnings ratios, 2013–2018



Source: BlackRock Investment Institute, with data from Thomson Reuters, July 2018. Note: The lines show the 12-month forward price-to-earnings (P/E) ratios for the MSCI USA, MSCI Europe, MSCI Japan and MSCI Emerging Market indexes. Indexes are unmanaged. It is not possible to invest directly in an index.

Theme 3: Greater portfolio resilience

Tighter financial conditions have been felt most acutely in EM assets. A rising U.S. dollar has hit the currencies of countries most dependent on borrowing in hard currency – those with large external deficits. See the *EM vulnerabilities* chart. The good news: Many EMs are in better shape today than in past crises, with improved current account deficits, willingness to tighten monetary policy and – in some cases – appetite for structural reforms to unleash growth.

Other bouts of volatility this year underscore the need for portfolio resilience. Think of the VIX tantrum in February, 2018 tied to leveraged short positions in equity volatility, the explosive selloff in Italian government bonds, and the tech sector suffering a brief shake-out of popular long positions. How to make portfolios more resilient? Consider shortening duration in fixed income, going up-in-quality across equities and credit, and increasing diversification.

As uncertainty picks up, so does the importance of portfolio resilience.

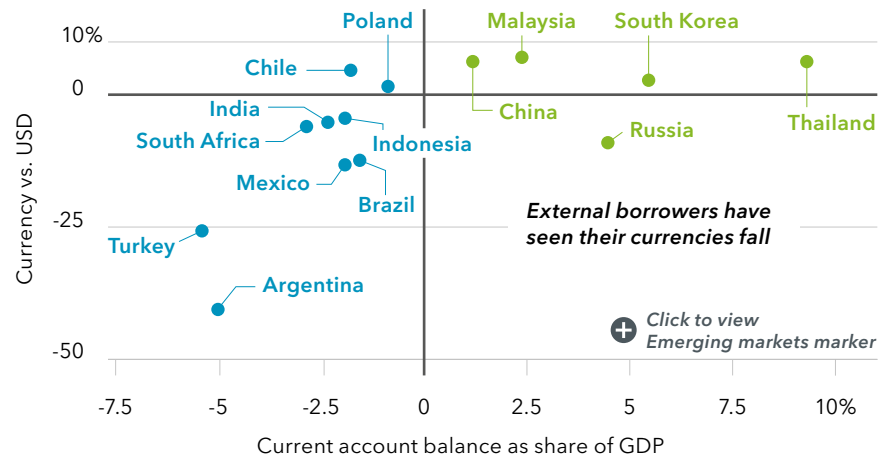
We prefer to take risk in equities and still favor momentum. We prefer quality over value amid steady global growth but rising uncertainty around the outlook. Momentum has been the market leader, but quality companies demonstrating high profitability and low leverage have also outperformed global equities broadly. See the *Quality time* chart. This was evident as trade fears ratcheted up. We see higher-quality stocks outperforming in times of rising macro uncertainty and risk aversion. We find many such companies in the U.S., where earnings growth fueled by the tax overhaul offers an edge.

We favor U.S. short duration in fixed income but longer-term U.S. Treasuries and German bunds should play their traditional role cushioning any growth shocks. See *Summer of '69*. We prefer an up-in-quality stance in credit. Thematic investing such as focusing on companies that excel on environmental, social and governance (ESG) metrics can also lend long-term resilience to portfolios, we believe. See *page 14*. For investors who can access private markets, we favor selected real assets and private credit with low correlations to market swings.

We see quality exposures bringing a measure of resilience to portfolios.

EM vulnerabilities

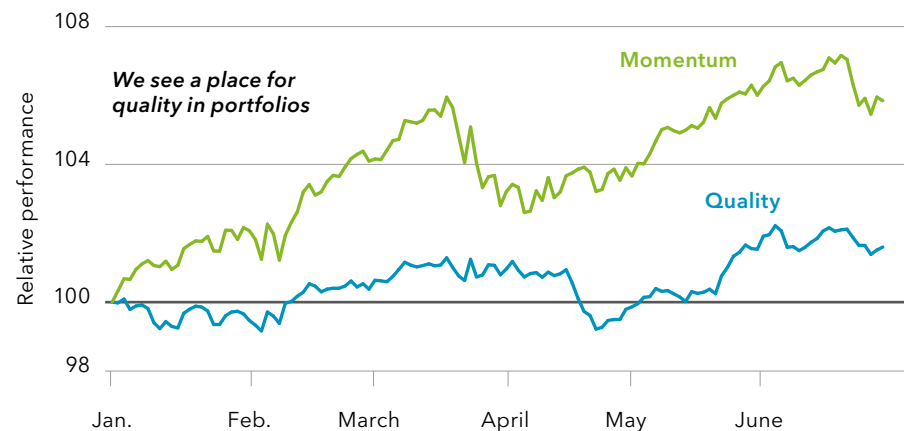
EM current account balances versus currency performance, June 2018



Source: BlackRock Investment Institute, with data from Thomson Reuters and IMF, June 2018. Note: The dots show the 12-month change in the spot currency exchange rate versus the U.S. dollar on the vertical axis, and show the IMF estimate of the current account balance as a share of gross domestic product (GDP) for 2018 on the horizontal axis.

Quality time

Performance of momentum and quality relative to global equities, 2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from MSCI, July 2018. Note: The lines represent the performance of the MSCI ACWI Momentum Index and the MSCI ACWI Quality Index relative to the MSCI ACWI, rebased to 100 at the start of 2018. Data are through June 29.

Outlook debate: Market regime change

Ultra-easy monetary policies nudged investors out of “risk-free” assets – and into riskier ones. Investors’ move out the risk spectrum, in some cases applying leverage to meet return goals, inflated valuations. The process may be shifting into reverse. Higher returns on short-term bonds and other cash-like investments have attracted flows and provided a lower-risk alternative to equities and other risk assets. Short-term U.S. credit yields top 3% for the first time in years. See the *Competition for capital* chart, and [page 11](#).

The competition for capital from rising U.S. short-term rates is a sea change for U.S. investors – but not all markets have been affected. Consider euro-based investors who face 3% hedging costs to buy U.S. assets due to interest rate differentials and other factors. This makes eurozone credit more attractive to them.

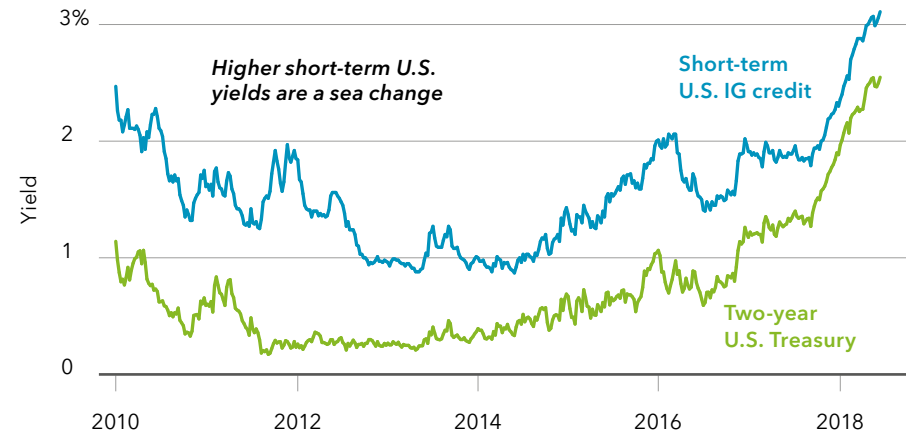
Rising U.S. short-term rates represent a sea change for U.S. investors after years of stretching for yield.

Rising leverage, looser lending standards and tight credit spreads often have signaled equity bull markets near a peak. Where are we today? U.S. non-financial leverage has risen to record highs, yet corporate high yield default rates are relatively subdued. See the *Rising leverage* chart. We see some signs of concern, such as a glut of debt issued by companies at the bottom rung of the investment grade (IG) ladder – some to finance mergers and acquisitions in key sectors. Tightening financing conditions could tighten the screws on more leveraged issuers, but we see no flashing red lights yet. Earnings growth is keeping pace with debt issuance (IG companies) or exceeding it (high yield). Poor market liquidity in times of market stress is our bigger worry. A recent sharp selloff in Italian government bonds showed that in some popular trades the doors are wide open going in, but really narrow going out. The worst-case scenario: Holders of illiquid bonds turn to their more liquid assets to raise cash, causing a chain reaction from IG credit to equities.

Corporate leverage is rising, but we see poor liquidity as the greater risk.

Competition for capital

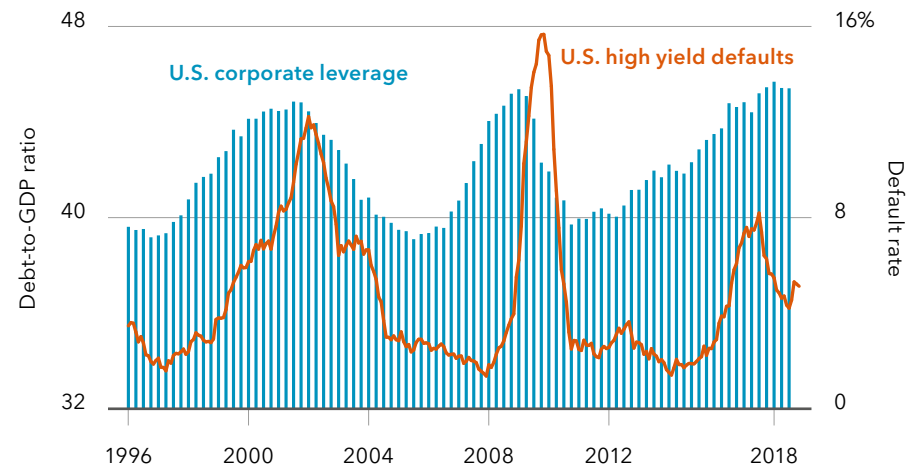
Short-term U.S. Treasury and credit yields, 2010-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from Thomson Reuters and Bloomberg Barclays, June 2018. Note: The lines show the yield on the Datastream 2-year Benchmark U.S. Government Bond Index and Bloomberg Barclays U.S. Credit 1-3 Year Index.

Rising leverage

U.S. corporate leverage vs. default rates, 1996-2018



Source: BlackRock Investment Institute, with data from Moody's, June 2018. Note: U.S. corporate leverage is defined as the stock of non-financial corporate debt divided by GDP.

Outlook debate: Global trade risks

Trade risks weigh on our outlook. U.S.-China economic tensions have been heating up, our *BlackRock Geopolitical Risk Indicator* shows, with trade the hot button. See the *Growing angst* chart. The tensions go far beyond the bilateral trade gap; the real rivalry centers on China's technology development program – and its competitive and national security implications for the U.S. Negotiating on tariffs and imports will likely prove easier than getting China to compromise on tech and other strategic initiatives. We see a prolonged period of tensions as a result, including around restrictions on Chinese investments in the U.S. and transfer of technology to China. Importantly, there is bipartisan support in the U.S. Congress to be tough on China when it comes to trade.

A further sharp escalation in trade actions globally could derail the economic expansion. First, falling business confidence may lead companies to delay or cancel investment plans. Second, tariffs can push up costs and depress demand. Integrated global supply chains risk amplifying this impact.

Neither the U.S. nor China wants a full-blown trade war, in our view. Yet structural rivalry means tensions are likely to heat up and persist.

U.S.-China disputes are front and center, but part of a broader trend.

The U.S. administration's willingness to challenge the rules of the post-war global trade order has put it at odds with traditional allies as well. A key sore point: the persistent U.S. trade deficit – offset by surpluses elsewhere. See the *Imbalancing act* chart. The White House has shown an aversion to multilateral deals, instead looking to address imbalances bilaterally.

This is reflected in the U.S. withdrawal from the Trans Pacific Partnership trade pact and efforts to retool the North American Free Trade Agreement (NAFTA). U.S. tariffs on steel and other imports have sparked retaliation by some large trading partners. With no easy fix, trade actions are likely to carry on, stoking bouts of volatility and feeding macro uncertainty.

See *Macro uncertainty on the rise*.

We see trade disputes feeding uncertainty about the global growth outlook.

Growing angst

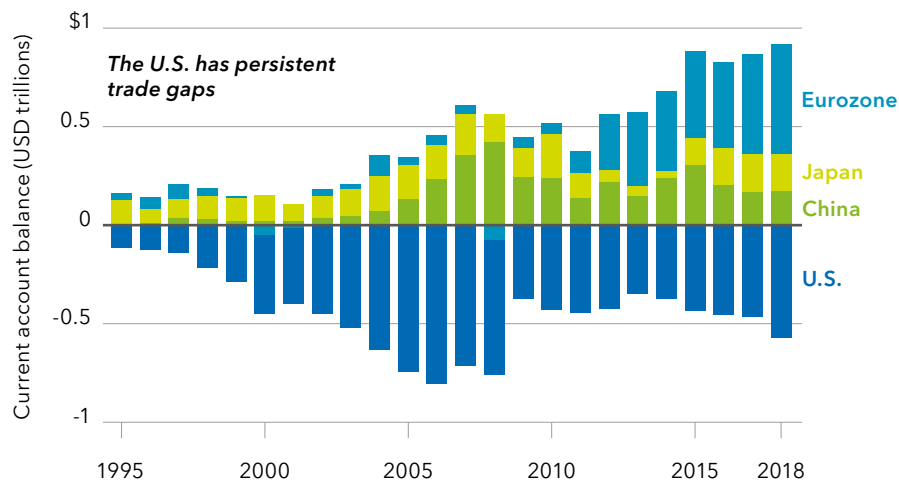
U.S.-China economic tensions BGRI, 2008-2018



Source: BlackRock Investment Institute, with data from Thomson Reuters, June 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes, as geopolitical risks are ever-evolving.

Imbalancing act

Current account balance for major economies, 1995-2018



Source: BlackRock Investment Institute, with data from OECD, June 2018. Notes: The bars show the annual current account balance for each economy. 2018 numbers are based on OECD forecasts. Forward-looking estimates may not come to pass.

Outlook debate: European fragmentation

Italy's new anti-establishment government has upped the risk of European fragmentation. A post-election standoff and fears of a euro exit shook regional bond markets. Spreads between Italian and German government bonds soared. See the *Spread out* chart. The fear is that Italy will break EU rules on fiscal spending. Its 2019 budget will be a key signpost. Migration is adding to tensions in the EU; a recent stop-gap deal papers over the cracks for now. We believe peripheral bond markets are too sanguine about Europe's vulnerabilities. The European Union (EU) is not ready to deal with systemic bank failures or stress in a large sovereign bond market, in our view. High debt-to-GDP ratios and non-performing loans again become a stress if growth falters. U.S. hostility toward global trade may have a silver lining if it pushes regional leaders to recognize a stronger EU is in their interests. French and German leaders have pledged to deepen integration, including around a common eurozone budget. The problem: There is a lack of consensus within the EU.

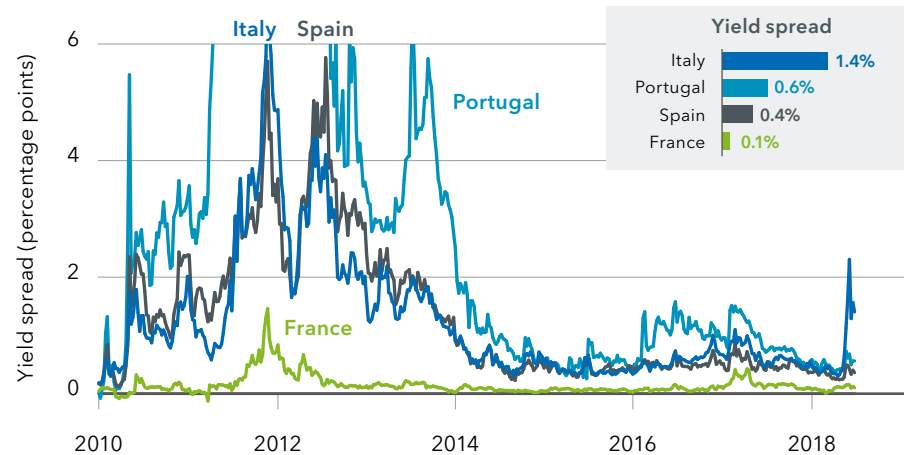
We expect Europe to muddle through this year, with no breakup but also dim prospects for further integration in the near term.

The outlook for European assets has soured. Disappointing growth partly reflects an inventory build-up in the latter half of 2017. Recent manufacturing surveys point to stabilization, yet we find consensus growth expectations need to temper further. Investor sentiment has soured. See the *Jumping ship* chart. We see brighter equities prospects elsewhere, especially in the U.S. Value sectors, which appear less compelling absent a cyclical upswing, dominate in Europe. Banks are a source of worry – still grappling with shaky balance sheets, rising U.S. dollar-funding costs and limp loan demand. All of this underpins our underweight of European stocks. Looming risks and sluggish core inflation are likely to keep the ECB on its slow path to normalization. The central bank is set to wind down its bond buying this year but hold off on rate rises until after mid-2019. Financial fragilities make the risk of a policy misstep more acute.

We are underweight Europe because we see brighter prospects elsewhere.

Spread out

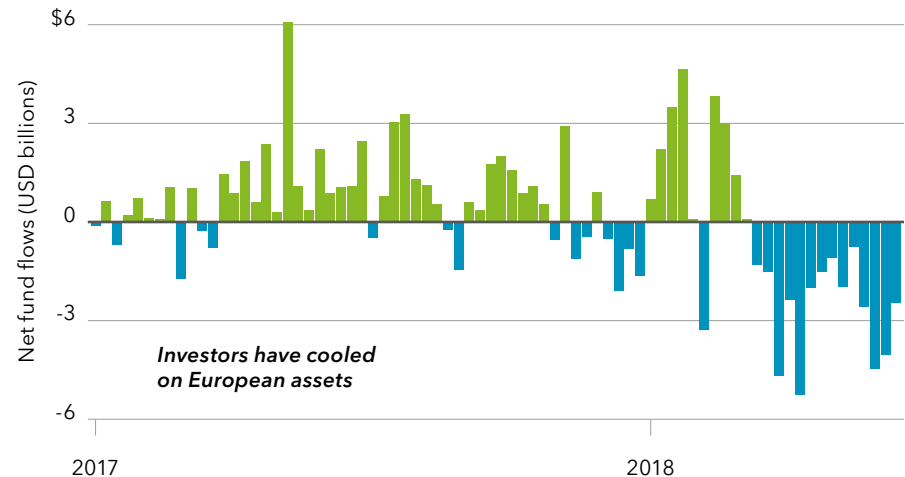
Eurozone two-year government bond spreads vs. German bunds, 2010-2018



Source: BlackRock Investment Institute, with data from Thomson Reuters, July 2018. Notes: The lines show the difference between the yield on the benchmark two-year government bond of each country and the German equivalent in percentage points. The vertical axis is capped at 6%. Portuguese spreads climbed as high as 19.5% in late 2011.

Jumping ship

Net fund flows to European equity funds, 2017-2018



Source: BlackRock Investment Institute, with data from EPFR, June 2018. Note: The bars show weekly net flows to mutual funds and exchange-traded funds in billions of U.S. dollars.

Outlook debate: China's balancing act

Trade tensions with the U.S. and elevated domestic debt levels are concerns. Yet we see China's near-term outlook as resilient. The country aims to improve the quality of its growth, not just the quantity. It is pushing for more consumption – and less investment as a share of economic activity. All of this comes amid reform progress, financial de-risking and slower credit growth. Getting this transition right is tricky, and any missteps could lead to bursts of volatility in Chinese asset prices. The rest of the world will have to adjust to a slower but more sustainable Chinese growth rate. The transition could be painful if China's growth slows more sharply than markets expect. The *BlackRock China GPS* shows growth steadying in the short run. See the *Holding firm* chart. The big data signals that power our GPS include earnings guidance from Chinese firms and the language used in global earnings calls. These paint a slightly rosier growth picture than traditional data suggest.

We see China in a balancing act: aiming to delever without a big growth hit.

Beijing has stepped up efforts to shore up its financial system.

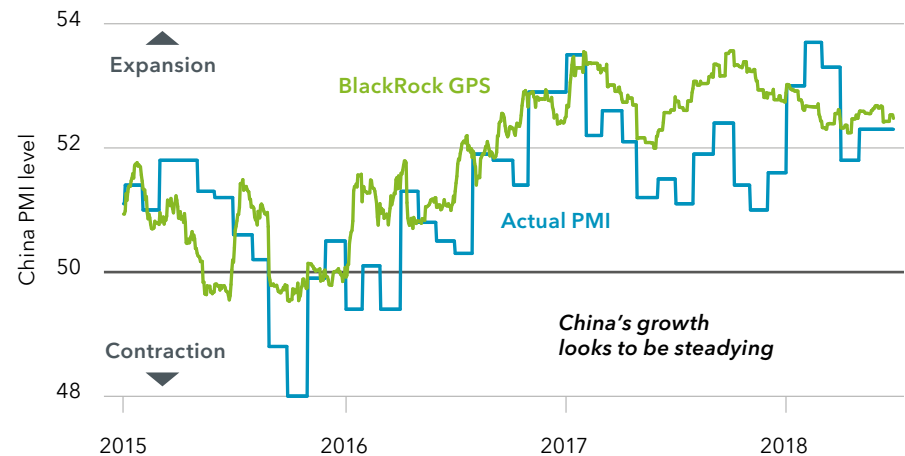
Key developments: a newly operational Financial Stability and Development Committee, work toward a unified regulatory framework and a crackdown on non-bank financing. Non-bank lending has slumped as a result. See the *Credit crackdown* chart. These are steps in the right direction, but the stability of China's opaque financial system remains a key medium-term risk.

The People's Bank of China is likely to keep injecting liquidity into the economy to offset the economic drag from deleveraging. Growing monetary policy divergence with the U.S. is likely to push down on China's currency. A weaker yuan may ease the trade-off between deleveraging and growth – but also could become a sticking point in trade talks and a catalyst for capital outflows. China's equity and debt markets are slowly opening up. The gradual addition of China A-shares to global indexes is a key step that we see offering investors broader exposure to China's market.

Financial stability remains a key risk for China in the medium term.

Holding firm

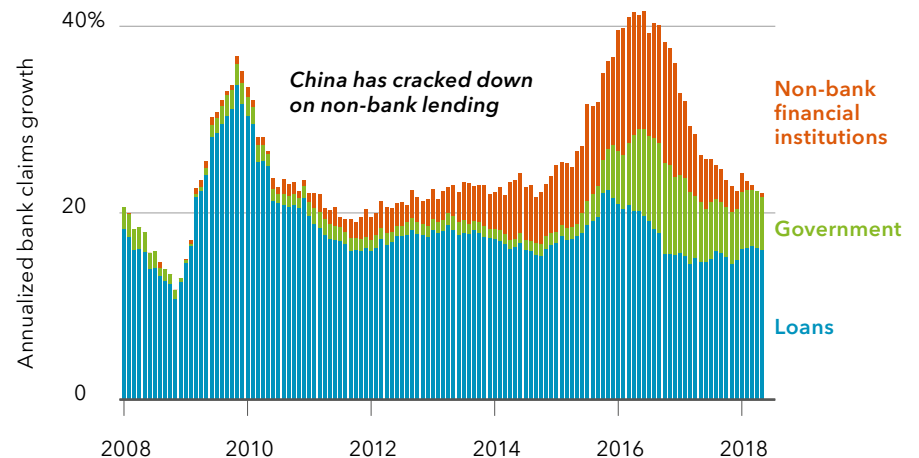
China Growth GPS vs. composite PMI, 2015–2018



Source: BlackRock Investment Institute, with data from Caixon/Markit and Thomson Reuters, July 2018. Notes: The green line is the GPS showing where the Caixon composite PMI may stand in three months' time. The blue line shows the current PMI level. Data are through June 29.

Credit crackdown

Annual growth in China bank claims as a share of GDP, 2008–2018



Source: BlackRock Investment Institute, with data from the People's Bank of China, June 2018. Notes: The chart shows the annualized monthly growth in various China bank claims as a share of GDP. Bank claims include loans as well as claims on the government and non-bank financial institutions.

Fixed income

Unprecedented monetary policy accommodation is slowly giving way to normalization – with big investment implications. For U.S. dollar-based investors, normalization brings a restoration: Cash makes a comeback to portfolios. The *Moving on up* chart highlights the increase in flows to cash-like instruments as short rates have risen. Yields for two-year Treasuries and short-maturity IG corporates are now well above the level of inflation. That means these assets can once again play their traditional portfolio role – preservation of principal.

The renewed appeal of cash is primarily a U.S. story for now. Eurozone investors, for example, still face negative interest rates at home and a hefty cost of hedging for venturing into U.S. dollar assets. European corporate debt is looking more attractive for euro-based investors after a recent selloff. A big spike in rates is the key risk – a development that we view as unlikely given the ECB is likely to keep rates on hold into the second half of 2019.

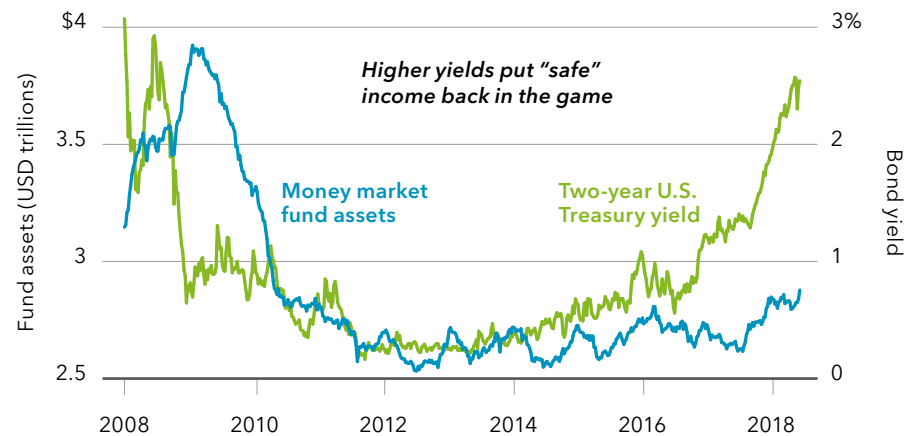
Higher short-end rates make cash-like investments more attractive to U.S.-dollar-funded investors – and raise the bar for riskier assets.

With higher U.S. short rates has come dollar strength. This, along with the heightened competition for capital, hit the most vulnerable areas: EMs with large U.S. dollar debt financing requirements. A repricing of risk in Argentina, Turkey and Brazil shows the potential fallout of higher yields. These dynamics also flipped a switch in EM debt: As U.S. rates rose and dollar-denominated EM bond spreads widened, the historical yield advantage of local- over hard-currency EMD vanished. Relative value now favors hard-currency EM bonds. There's also a case for favoring hard-currency EMD over U.S. credit. Spreads have tightened in the latter asset class, paced by the outperformance of the riskiest portions of the market. Wider spreads in EMD make valuations more attractive. See the *Diverging fortunes* chart. We also see floating-rate bank loans having an edge over high yield bonds. The former have lower duration and benefit from rising income as short rates reset higher.

In credit, we prefer hard-currency EMD and floating-rate bank loans.

Moving on up

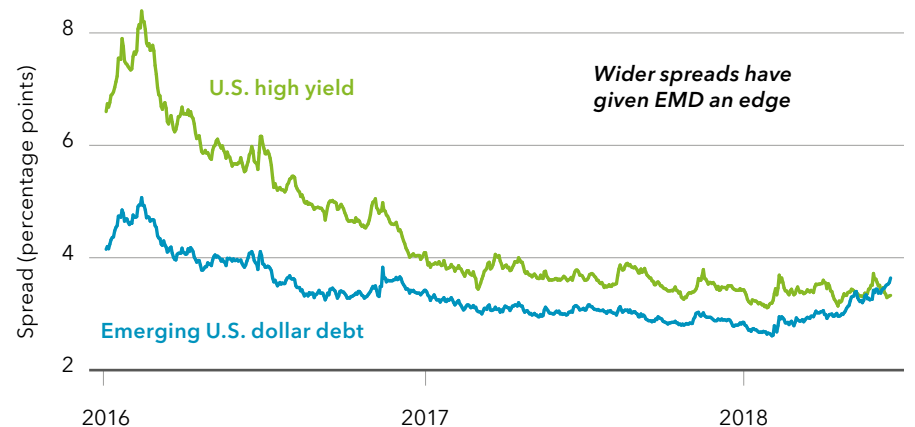
U.S. money market fund assets and two-year Treasury yields, 2008–2018



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 the Investment Company Institute (ICI) and Thomson Reuters, June 2018. Notes: The blue line represents the total assets under management of U.S. money market funds. The green line represents the two-year Treasury yield.

Diverging fortunes

Emerging debt and U.S. high yield spreads vs. U.S. Treasuries, 2016–2018



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 JP Morgan and Bloomberg Barclays, June 2018. Note: The lines show option-adjusted spreads versus U.S. Treasuries for the JP Morgan EMBI Global Diversified Index and Barclays Bloomberg U.S. High Yield Index in percentage points.

Equities

Capex is picking up globally – with tech leading the charge. See the *Spending upswing* chart. Years of policy uncertainty and low confidence kept company purse strings tight. Their re-opening in an age of technology and evolving consumer behaviors has much of the spending directed at intellectual property and innovation – a boon for tech firms. The spending uptick could spill into 2019 as companies adjust to new U.S. tax laws – provided trade tensions do not pinch confidence. We see some notes of caution rearing.

The story is not U.S.-only. High capacity utilization rates and aging assets in Europe point to room for spending. In China, investment in strategic initiatives is set to accelerate even as it declines in heavy industries. History shows big spending can eat into stock returns. Yet spending discipline among many companies gives us confidence that profit margins and earnings could be well insulated. Read more in *Capex: The good, the bad and the murky*.

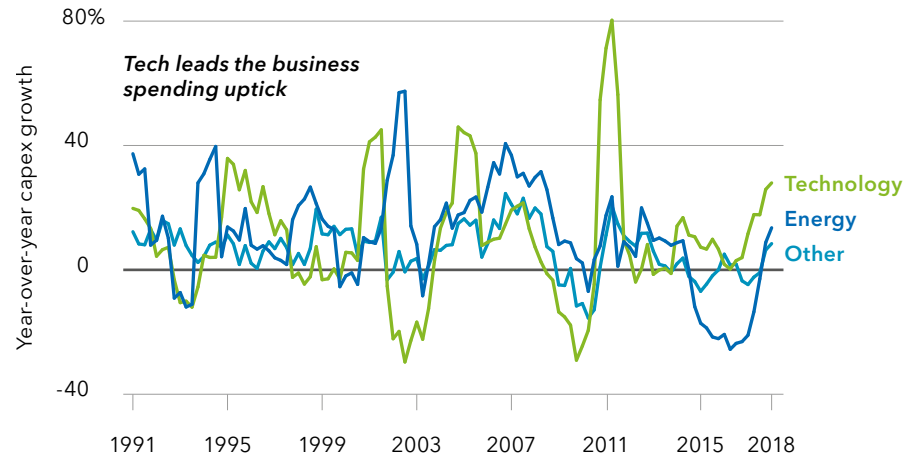
Unmatched earnings growth and spending discipline underscore our preference for U.S. over other developed market equities.

Where do equity investors look for resilience today? High-yielding “bond proxy” stocks earned their stripes as defensive picks for much of the past decade as bond yields were slow to revert back to pre-crisis levels. But upward rate and inflation momentum challenges the prevailing thinking, as we discuss in *Building the right defense in equities*. A good defense today requires stocks with the potential to weather volatility and outrun inflation. To us, this means a focus on quality and dividend growth. “Quality” companies, by our definition, are able to generate and grow free cash flow while maintaining healthy balance sheets. Companies able – and willing – to increase dividends appear better poised to withstand volatility. See the *Cash cushion* chart. We see a tougher go for highly bid “stable” dividend stocks as higher U.S. rates make “risk-free” bonds bigger competition.

We favor an allocation to quality companies that can increase dividends while maintaining healthy balance sheets.

Spending upswing

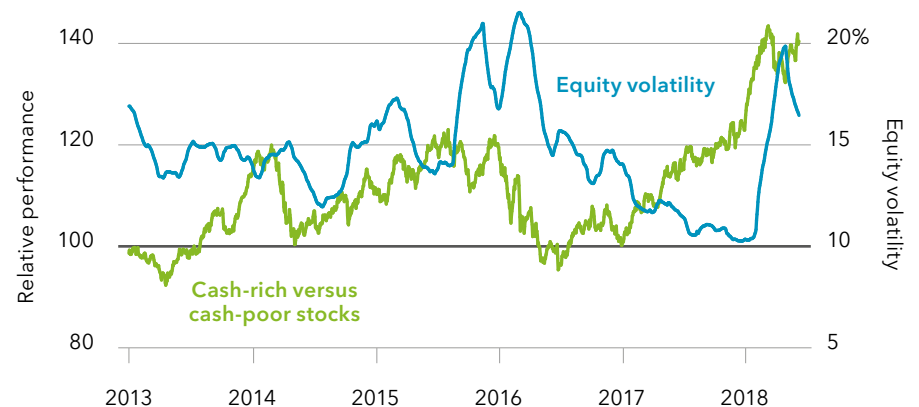
Global capex growth by sector, 1991-2018



Source: BlackRock Investment Institute, with data from Thomson Reuters, June 2018. Note: The lines show the year-over-year growth in capital expenditures on a trailing 12-month basis for the energy and technology sectors within the MSCI All-Country World Index (ACWI) and for the ACWI excluding energy and technology.

Cash cushion

Relative performance of cash-rich stocks and equity market volatility, 2013-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from Bloomberg, June 2018. Notes: The green line shows the relative performance of cash-rich stocks versus cash-poor stocks in the Russell 1000 Index, rebased to 100 as of January 2013. It is calculated by dividing the performance of the stocks with the top decile of cash-to-assets ratios by the stocks with the bottom decile of the ratio. Volatility (blue line) is represented by a three-month rolling average of the CBOE Volatility Index (VIX).

Commodities and currencies

Oil prices have been on a tear – and we see them well supported in the second half. A rise in Middle East-related geopolitical risks, along with favorable supply-demand dynamics, has been driving the gains. We see a recent decision by the Organization of Petroleum Exporting Countries (OPEC) to ease oil output restrictions doing little to knock oil off its solid footing.

The most likely scenario, in our view: Production losses from key OPEC members, potential U.S. supply outages and strong global appetite keep demand ahead of supply into year-end – supporting prices. We expect this even in an “upper-end” scenario where supply disruptions ease. See the blue line in the *Sizing up supply and demand* chart. Yet we see oil-related equities as the shinier proposition. Share prices of energy companies have lagged the run-up in oil itself. It’s been a tougher slog for other commodities. Industrial metals began to trail off along with softer economic data earlier in the year. We keep a favorable view given our outlook for sustained global growth.

Oil prices look well supported, but we see greater opportunities in oil-related stocks that have yet to catch up to the rise in spot prices.

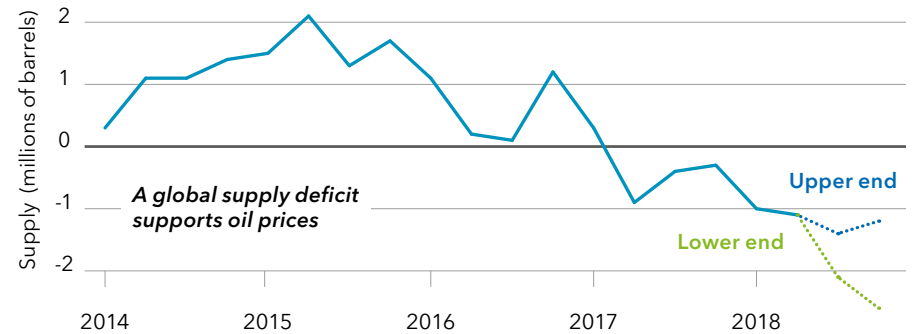
U.S. dollar strength is tightening global financial conditions – with implications for EM assets in particular. The performance of EM equities and local-currency debt has flagged since the dollar’s April turnaround. See the *Dented by the dollar* chart. With both oil and the U.S. dollar climbing of late – an atypical scenario – oil-importing countries in EM and beyond are dealt a double whammy.

The U.S. dollar is aided by attractive interest rate and growth differentials versus other economies. Higher short-end U.S. rates also make the greenback appealing just as geopolitical uncertainty has investors more willing to dial back risk and sit tight in cash. Our fair value metrics suggest the U.S. currency is looking expensive, limiting its upside. But we see the U.S. dollar catching a bid in any global risk-off episode sparked by risks such as a global trade war.

The U.S. dollar has support in higher global uncertainty and a widening yield differential versus other economies. But we see its rise capped.

Sizing up supply and demand

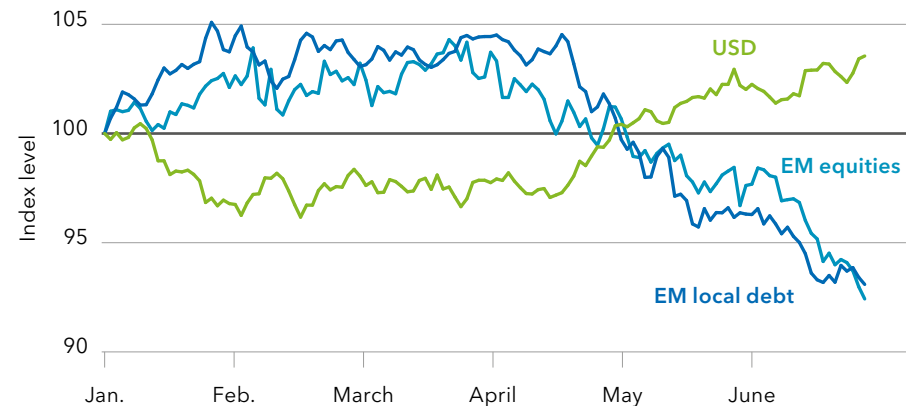
Global oil net supply, 2014-2018



Source: BlackRock Investment Institute, with data from the International Energy Agency, June 2018. Notes: The chart shows the quarterly balance between global oil supply and demand. The solid line represents historical data, and the dotted lines the upper and lower ends of an estimated range for the second half of 2018. We assume an OPEC output increase of 1 million barrels a day (mb/d) and the growth in non-OPEC nations' oil supply and demand at levels consistent with the average of the second halves of the past four years. The “upper end” scenario assumes production losses of 0.5 mb/d in Venezuela, 0.3 mb/d in Iran, 0.2 mb/d each in Libya and West Africa. The “lower end” scenario assumes production losses of 0.5 mb/d in Venezuela, 0.6 mb/d in Iran, 0.4 mb/d each in Libya and West Africa. These assumptions are based on BlackRock’s market analysis.

Dented by the dollar

U.S. dollar and EM asset performance, 2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from Thomson Reuters Datastream, June 2018. Notes: The U.S. dollar is represented by the DXY U.S. dollar index. EM local debt represents the total return performance of the JP Morgan GBI-EM Global Diversified Composite Unhedged USD Index. EM equities represents the performance of the MSCI EM Index relative to that of the MSCI ACWI Index, excluding dividends. The data are rebased to 100 at the start of 2018.

Thematic investing

Portfolio resilience rises in importance amid macro and market uncertainty.

One way to achieve it, in our view, is via sustainable investing. Our research suggests entities with high ESG scores may be more resilient to perils ranging from ethical lapses to climate risks. This implies a focus on ESG may offer some cushion during market downturns. We believe ESG can be implemented across asset classes without compromising long-term risk-adjusted returns, as we show in *Sustainable investing: a “why not” moment*.

The caveats: ESG data are patchy, and headline scores paint only a partial picture. Investors need to look at how the individual components can affect returns. One eye-opener in the “E” category: We found companies that reduced their carbon footprint the most outperformed the carbon laggards. The rate of change mattered more than absolute emission levels, even in polluting industries. See the *Carbon efficiency* chart.

ESG’s quality bent can add resilience to portfolios, we believe.

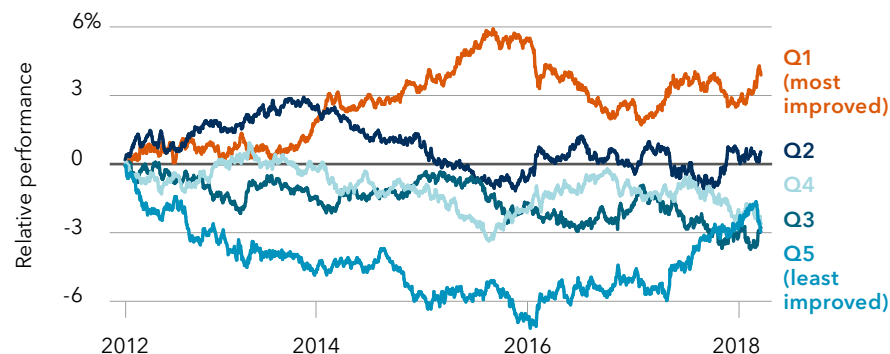
Artificial intelligence (AI) strikes notes of both fear and fascination. Yet the illusion of a robot revolution is tempered by a more mundane reality: AI’s greatest value today is in enhancing existing functions. The payoff is efficiency gains and cost savings across industries, and it’s a subject of much discussion. Mentions of AI, machine learning and big data on company conference calls have more than doubled since 2010. See the *Talk of the town* chart.

It’s not all lip service, and it goes beyond tech. In banking, chat bots are assisting with transactions. In consumer sectors, AI-powered marketing helps segment customers for better targeting and sales promotions. Potential in health care ranges from improvements in imaging and diagnostics to remote patient monitoring. Yet it’s very early days, and speed of AI adoption will separate winners from losers. Talent is also scarce. For now, the opportunities reside with entities that can facilitate and propagate AI to other industries.

We see opportunity in AI “processors” – companies providing the intelligence and infrastructure to enable AI application across industries.

Carbon efficiency

Equity performance by carbon intensity, 2012–2018

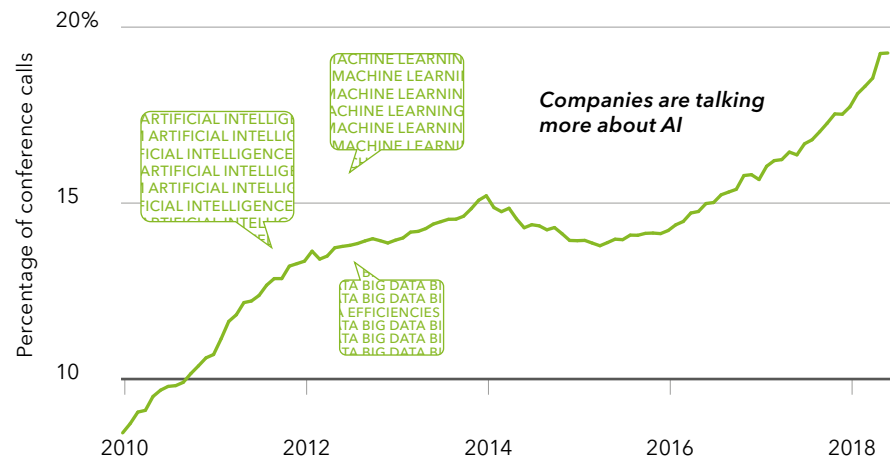


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Sources: BlackRock Investment Institute, Thomson Reuters Asset4 and MSCI, April 2018. Notes: The analysis above calculates the carbon intensity of global companies in the Asset4 database by dividing their annual carbon emissions by annual sales. Companies are ranked and bucketed in five quintiles based on their year-over-year change in carbon intensity. We then analyze each quintile’s stock price performance versus the MSCI World Index. Most improved means the 20% of companies that posted the greatest annual decline in carbon intensity. Data are from March 2012 through March 2018. The example is for illustrative purposes only.

Talk of the town

Percentage of global corporate conference calls that mention AI terms, 2010–2018



Sources: BlackRock Investment Institute, with data from FactSet’s CallStreet, as of June 2018. Note: The chart shows the percentage of English-language transcripts of global conference calls that have mentioned keywords in the field of artificial intelligence, machine learning or big data on a 12-month rolling basis.

Assets in brief

Tactical views on assets from a U.S. dollar perspective, July 2018

Asset class		View	Comments
Equities	U.S.	▲	Unmatched earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like momentum. We prefer quality over value amid steady global growth but rising uncertainty around the outlook. Financials and technology are our favored sectors.
	Europe	▼	Relatively muted earnings growth, weak economic momentum and heightened political risks are challenges. A market dominated by value sectors also makes the region less attractive in the absence of a growth upswing.
	Japan	—	The market's value orientation is a challenge without a clear growth catalyst. Yen appreciation is another risk. Positives include shareholder-friendly corporate behavior, solid company earnings and support from Bank of Japan stock buying.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks. Above-trend expansion in the developed world is another positive. Risks such as a rising U.S. dollar, trade tensions and elections argue for selectivity. 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	▼	We see rates rising moderately amid economic expansion and Fed normalization. Longer maturities are vulnerable to yield curve steepening but should offer portfolio ballast amid any growth scares. We favor shorter-duration and inflation-linked debt as buffers against rising rates and inflation. We prefer 15-year mortgages over their 30-year counterparts and versus short-term corporates.
	U.S. municipal bonds	—	Solid retail investor demand and muted supply are supportive, but rising rates could weigh on absolute performance. We prefer a neutral duration stance and up-in-quality bias in the near term. We favor a barbell approach focused on two- and 20-year maturities.
	U.S. credit	—	Sustained growth supports credit, but high valuations limit upside. We favor investment grade (IG) credit as ballast to equity risk. A temporary surge in M&A-related issuance has cheapened IG valuations. Higher-quality floating rate debt and shorter maturities look well positioned for rising rates.
	European sovereigns	▼	The ECB's negative interest rate policy has made yields unattractive and vulnerable to the improving growth outlook. We expect core eurozone yields to rise. We are cautious on peripherals given tight valuations, political risks in Italy and the upcoming end to the ECB's net asset purchases.
	European credit	▼	Increased issuance and political risks have widened spreads and created some value. Negative rates have crimped yields – but rate differentials make currency-hedged positions attractive for U.S.-dollar investors. We are cautious on subordinated financial debt despite cheaper valuations.
	EM debt	—	Valuations of hard-currency debt have become more attractive relative to local-currency bonds and developed market corporates. Further valuation support comes from slowing supply and strong EM fundamentals. Trade disputes and a tightening of global financial conditions are downside risks.
	Asia fixed income	—	Stable fundamentals, cheapening valuations and slowing issuance are supportive. China's representation in the region's bond universe is rising. Higher-quality growth and a focus on financial sector reform are long-term positives, but a sharp China growth slowdown would be a challenge.
Other	Commodities and currencies	*	Declining global crude inventories underpin oil prices, with geopolitical tensions providing further support. We are neutral on the U.S. dollar. Rising global uncertainty and a widening U.S. yield differential with other economies provide support, but an elevated valuation may constrain further gains.

Note: Views are from a U.S. dollar perspective as of July 2018. *Given the breadth of this category, we do not offer a consolidated view.

▲ Overweight

— Neutral

▼ Underweight

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