BLACKROCK INVESTMENT INSTITUTE

WEEKLY COMMENTARY • JUNE 17, 2019

Key points

1. The firm's senior decision makers intensely debated the midyear market outlook last week in London. We share the gist of our debates.
2. Market expectations for Fed rate cuts in 2019 rose further last week and the 10-year Treasury yield hit lows near 2% as geopolitical tensions rose.
3. The Fed may use next week's meeting to manage down market expectations for a series of interest rate cuts this year and next.

The BlackRock Investment Institute (BII) leverages the firm's expertise to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. As a unique center of excellence, BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

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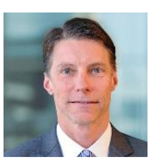

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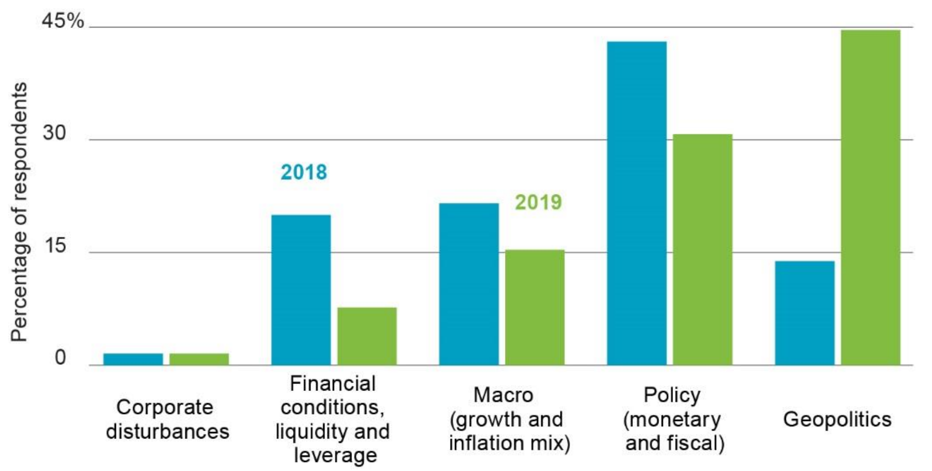
1 Our midyear outlook debates

Twice a year we gather BlackRock's senior decision makers for a two-day forum on the market outlook and its investment implications. We debated many topics at our meeting last week in London, including what could spark a change in the macro backdrop and how to prepare portfolios for a wider range of possible outcomes. The implications will be reflected in our updated tactical asset allocation views, to be published in our midyear outlook on July 8. Below we give a glimpse of our debates.

Chart of the week

Poll of BlackRock decision makers on dominant market drivers in 2018 and 2019



Source: BlackRock Investment Institute, June 2019. Notes: Twice a year we gather around 100 of the firm's investors and senior decision makers for a two-day forum on the market outlook: in London midyear and in New York in November. Our online poll ahead of this year's early June meeting asked the attendees which of five forces was the dominant market driver in 2018 and will be in 2019. The bars show the percentage of the 59 respondents in the May 31 to June 4 poll who picked each driver.

The majority of midyear forum attendees saw the current benign environment for risk assets as having room to run. Most felt it could persist for at least 12 more months, given easy monetary policies and few signs of financial imbalances. Yet we saw a wider range of outcomes the current macro regime could eventually break into. A recession was just one of the possibilities debated. One risk scenario: a reversal of the globalization trend of past decades. This could disrupt global corporate supply chains, sap potential growth and lead to sticky inflation. Forum attendees generally agreed that worsening trade relations have heightened macro uncertainty and widened the range of potential scenarios. In a pre-forum poll of meeting attendees, nearly half of respondents said they see geopolitics as the dominant market driver in 2019, taking the reins from policy. See the highest 2019 line in the chart above.

A changing backdrop

Our conviction in a slowing expansion with more room to run has become stronger over the last six months. In the pre-forum poll, more than 60% of respondents said they expect a moderate growth slowdown and low inflation over the coming 12 months, versus just 40% foreseeing that scenario last November. We entered 2019 with a consensus expectation of a modest global growth slowdown with little near-term risk of a U.S. recession, though rising risks – including escalating trade tensions and fears of a recession – called for carefully balancing risk and reward via building portfolio resilience, in our view. (See our 2019 outlook). At the end of the first quarter, these risks remained, yet a Fed on hold; a slowing but still growing global economy; and a perceived reduction in geopolitical risks informed our expectation of a positive near-term backdrop for risk assets. (See our Q2 outlook). Since then, the risk of a trade war has intensified.

Escalating trade tensions and the uncertain knock-on effects on global supply chains are making many of us ponder the possible consequences. We now see this rising geopolitical confrontation as the greatest risk to the global expansion rather than traditional late-cycle concerns such as building financial imbalances. The sharp rise in trade and strategic tensions between the U.S. and many countries – including China and Mexico more recently – tilts growth risks to the downside, in the near term as well as the long term, according to many forum attendees. We debated exactly how it could play out; some saw a risk of weaker growth with higher inflation, and others expected weaker growth to remain disinflationary. Some BlackRock investors now expect G7 growth to slow more sharply in 2019 than we had anticipated coming into the year. Also creating uncertainty and adding to the range of possible outcomes: markets are currently pricing in significant interest rate cuts by the Fed – pricing that we see as aggressive.

To refresh our market outlook, the conversations among the 100 BlackRock investors and decision makers gathering in London centered on certain crucial topics: the outlook for the Chinese economy; central banks' likely path forward and their policy toolkit to face the next downturn; the future trajectory of inflation; and how to build resilient portfolios. The latter remains a key focus: A majority of BlackRock investors said they see portfolio resilience as more important than usual now. We will publish our midyear outlook on July 8.

2 Week in review

- Global equities traded flat amid a mixed batch of news. Mexico narrowly averted U.S. tariffs for now, while the trade situation between U.S.-China remained gridlocked. Oil prices bounced on news that two oil tankers were attacked in the Strait of Hormuz. The U.S. dollar strengthened. A heavy volume of mergers & acquisition activity whipsawed software and industrials stocks.
- Mainland and offshore China stocks rallied after the Chinese finance ministry announced a new economic stimulus plan. Offshore China H-shares then fell following protests in Hong Kong over a controversial extradition bill, but still finished the week higher.
- U.S. core inflation came in softer than expected in May, as range-bound U.S. inflation persisted. Our Inflation GPS signals U.S. core inflation should remain close to the Fed's 2% target, potentially allowing the central bank to maintain its patient approach to rates. Market expectations built for Fed rate cuts this year and next. The three-month U.S. Treasury bills rallied, and the U.S. 10-year Treasury yield hit a 2019 low amid rising geopolitical tensions.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.5%	16.3%	5.9%	2.0%
U.S. Small Caps	0.6%	13.6%	-8.4%	1.6%
Non-U.S. World	0.1%	10.4%	-4.5%	3.2%
Non-U.S. Developed	-0.3%	11.3%	-3.9%	3.4%
Japan	0.6%	6.5%	-8.0%	2.5%
Emerging	0.9%	6.2%	-7.1%	2.8%
Asia ex-Japan	0.9%	5.7%	-10.1%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.0%	4.6%	7.3%	2.1%
U.S. TIPS	-0.8%	4.9%	4.4%	2.2%
U.S. Investment Grade	0.1%	7.9%	8.8%	3.4%
U.S. High Yield	0.4%	8.9%	5.8%	6.1%
U.S. Municipals	-0.1%	4.8%	6.7%	2.1%
Non-U.S. Developed	-0.6%	3.2%	2.3%	0.7%
EM $ Bonds	0.3%	9.5%	10.4%	5.8%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-2.0%	15.3%	-18.3%	$ 62.01
Gold	0.1%	4.6%	3.0%	$ 1,342
Copper	0.4%	-2.4%	-18.9%	$ 5,822

Currencies	Week	YTD	12 Months	Level
Euro/USD	-1.1%	-2.3%	-3.1%	1.12
USD/Yen	0.3%	-0.9%	-1.9%	108.57
Pound/USD	-1.1%	-1.3%	-5.1%	1.26

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 June 14, 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

June 18 Eurozone inflation; Germany ZEW Economic Sentiment Index; U.S. President Donald Trump launches re-election campaign in Orlando

June 19 Federal Open Market Committee (FOMC) meeting

June 20 Bank of England meeting, UK retail sales; Bank of Japan meeting

June 21 Japan Nikkei manufacturing PMI flash; eurozone and Germany manufacturing flash PMIs; Fed releases results of U.S. bank stress tests

We see this week's FOMC meeting providing an opportunity for the Fed to manage market expectations, as the market's pricing of rate cuts has materially diverged from the central bank's patient policy stance. Amid rising geopolitical trade tensions, markets are now expecting a nearly 70% chance that the Fed will cut rates at its July meeting, up from just under 20% back in May. We will also get a refreshed "dot plot" of median interest rate projections based on Fed officials' views. The dot plot path may flatten further, as the 2020 median interest rate projection is dragged down by Fed officials now expecting no increase.

Asset class views

Views from a U.S. dollar perspective over a three-month horizon

Asset class		View	Comments
Equities	U.S.	▲	A slowing but still growing economy underlies our positive view. We prefer quality companies with strong balance sheets in a late-cycle environment. Health care and technology are among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are still challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance, such as a global growth rebound. We prefer higher-quality, globally oriented firms.
	Japan	—	Cheap valuations are supportive, along with shareholder-friendly corporate behavior, central bank stock buying and political stability. Earnings uncertainty is a key risk.
	EM	▲	Economic reforms and policy stimulus support EM stocks. Improved consumption and economic activity from Chinese stimulus could help offset any trade-related weakness. 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 are cautious on U.S. Treasury valuations, but still see the bonds as important portfolio diversifiers. We see recent moves lower in yields as excessive and advocate patience before increasing exposure. We prefer shorter-dated and inflation-linked bonds and expect a gradual yield curve steepening, driven by still-solid U.S. growth and the Fed's stated willingness to tolerate temporary inflation overshoots.
	U.S. municipals	▲	We see coupon-like returns amid a benign interest rate backdrop and favorable supply-demand dynamics. New issuance is lagging the total amount of debt that is called, refunded or matures. The tax overhaul has made munis' tax-exempt status more attractive in many U.S. states, driving inflows.
	U.S. credit	—	Increased demand for income amid stable monetary policy, signs of more conservative corporate behavior and constrained supply remain supportive. We prefer an up-in-quality stance overall, but recent spread widening may also offer an attractive opportunity in BBB-rated credits. We favor bonds over loans in high yield.
	European sovereigns	▼	Low yields, European political risks, and the potential for a market reassessment of pessimistic euro area growth expectations all make us wary on European sovereigns, particularly peripherals. European sovereign bonds offer an attractive income opportunity for U.S.-dollar based investors on a currency-hedged basis.
	European credit	▼	"Low for longer" ECB policy should reduce market volatility and support credit as a source of income, yet valuations are relatively rich after a rally this year. We prefer high yield credits, supported by muted issuance and strong inflows. Euro high yield also offers a significant spread premium to its U.S. counterparts.
	EM debt	—	Prospects for a Chinese growth turnaround and a pause in U.S. dollar strength support both local- and hard-currency markets. Valuations are attractive despite the recent rally, with limited issuance adding to positives. Risks include worsening U.S.-China relations and slower global growth.
	Asia fixed income	—	We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia. Portfolio rebalancing could cause material capital inflows into China, as the country opens its markets to foreign capital.
Other	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could boost industrial metal prices. We are neutral on the U.S. dollar. It has perceived "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

▲ Overweight — Neutral ▼ Underweight *Given the breadth of this category, we do not offer a consolidated view.

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