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WEEKLY COMMENTARY • JULY 1, 2019

Key points

1 Oil and related securities have lagged despite a spike in Gulf tensions. We see selected opportunities, but expect oil to be range-bound.

2 Global stocks edged lower ahead of a key meeting between U.S. President Donald Trump and Chinese President Xi Jinping.

3 This week's U.S. nonfarm payrolls data will help investors better gauge the strength of the labor market after the May data had disappointed.

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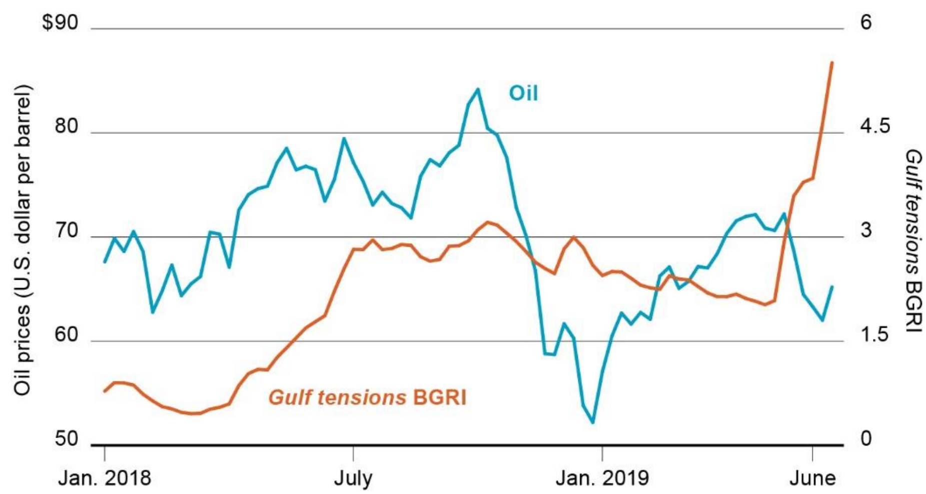
1 The gulf between oil and geopolitics

Tensions in the Persian Gulf – the world's key oil exporting region – have risen sharply. Yet oil trades well below its late-2018 peaks — and oil-related equities have lagged the broader market. What explains the disconnect? We delve into both short-term and long-term oil market fundamentals, geopolitics and the macro outlook.

Chart of the week

Oil prices and *Gulf tensions* BGRI, 2018-2019



Sources: BlackRock Investment Institute, with data from Refinitiv, June 2019. Notes: Under the BGRI framework we identify specific words related to geopolitical risk in general and to our top-10 risks, including Gulf tensions. We then use text analysis to calculate the frequency of their appearance in the Refinitiv 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. Oil is represented by Brent crude oil futures.

Market attention to Gulf tensions has been on a steep climb since the start of May, when U.S. President Donald Trump imposed new sanctions on Iran and ended waivers for countries to buy Iranian oil. Our BlackRock geopolitical risk indicator (BGRI) on Gulf tensions, which scans and analyzes broker reports, financial press and tweets for keywords related to this risk, has spiked to 5.5 standard deviations above its historical average. See the chart above. The downing of a U.S. drone and a series of attacks on shipping vessels in the Gulf and off the coast of Yemen have increased tensions, and sent oil prices rallying in recent weeks. Yet Brent crude oil prices, an international benchmark, are still down 6% since early May.

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A confluence of drivers

What could be holding oil back? Fears of a global downturn – which would hit oil demand – are one reason cited for the muted oil price reaction. The International Energy Agency (IEA) has trimmed the global oil demand outlook for two months straight, citing weakening economic sentiment. Yet we see a limited near-term risk of the usual catalysts that bring economic expansions to an end – financial vulnerabilities leading to a deleveraging, or overheating that prompts central banks to overtighten policy. And we see a dovish pivot by global central banks extending the lifespan of this economic expansion, even as trade disputes have increased macro uncertainty.

The Organization of the Petroleum Exporting Countries (OPEC) members and their allies are expected to roll over the current output cuts at a policy meeting this week, as the market is faced with moderate oversupply. Yet OPEC output curbs can do only so much to prop up oil prices. The U.S. – thanks to the rise in shale production – has become one of the key swing producers alongside the likes of Russia and Saudi Arabia, and is not subject to the OPEC production cuts. Shale producers have historically tended to ramp up production when prices are high, effectively capping oil price gains. This phenomenon may be less prominent today, as even shale producers have come under pressure to curb capital spending and to deliver positive free cash flow. We see these forces likely to keep oil prices in a range, with Brent oil trading between $60 and $70 a barrel in the near term.

What does this mean for investors seeking opportunities in the energy space? Global energy stocks have risen about 12% year to date, below the nearly 15% performance of the broader market. We still see opportunities, and favor companies with the ability to generate income and withstand late-cycle volatility. One example: integrated oil companies in Europe, for their income-generating ability and capital discipline. Their dividend yields are even more attractive for those investors hedging back into U.S. dollars, thanks to the hefty U.S.-eurozone yield differential. We also like midstream companies (transportation and storage) for their strong free cash flow yields and income potential. We caution against U.S. shale names in the high yield credit space due to few positive catalysts including limited upside in oil prices.

2 Week in review

- Global stocks edged lower last week ahead of a meeting between Trump and Xi amid rising U.S.-China tensions. Perceived safe-haven assets rallied: Gold prices climbed to a six-year peak, and the Japanese yen rose to the highest in 2019 against the U.S. dollar. The U.S. and China on Saturday agreed to restart trade talks.
- The tensions between Iran and the U.S. rose further. Last-ditch talks between Iran and the signatories of the nuclear deal to persuade Iran to stay within limits of its enriched uranium holdings appeared headed for failure. The U.S. put new sanctions on Iran and threatened to sanction any country that imports Iranian oil.
- Eurozone core inflation (excluding volatile food and energy prices) rebounded in June to 1.2%, but still fell short of the target near 2% set by the European Central Bank. U.S. consumer spending edged up in May. The core personal consumption expenditures (PCE) index, the Federal Reserve's preferred inflation measure, gained 1.5% on the year and still undershot the Fed's 2% target.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-0.3%	18.5%	10.5%	2.0%
U.S. Small Caps	1.2%	17.0%	-3.4%	1.6%
Non-U.S. World	0.6%	14.0%	3.2%	3.2%
Non-U.S. Developed	0.7%	14.5%	2.6%	3.4%
Japan	0.5%	8.0%	-4.0%	2.5%
Emerging	0.4%	10.8%	3.8%	2.8%
Asia ex-Japan	0.8%	10.8%	1.6%	2.5%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.4%	5.2%	7.2%	2.0%
U.S. TIPS	0.2%	6.2%	4.8%	2.1%
U.S. Investment Grade	0.7%	9.9%	10.7%	3.2%
U.S. High Yield	0.0%	9.9%	7.5%	5.9%
U.S. Municipals	0.1%	5.1%	6.7%	2.0%
Non-U.S. Developed	0.5%	5.0%	4.1%	0.6%
EM $ Bonds	0.1%	11.3%	12.4%	5.6%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	2.1%	23.7%	-14.5%	$ 66.55
Gold	0.7%	9.9%	12.9%	$ 1,410
Copper	0.4%	0.5%	-9.5%	$ 5,993

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.0%	-0.9%	-1.7%	1.14
USD/Yen	0.5%	-1.5%	-2.4%	107.90
Pound/USD	-0.4%	-0.5%	-2.9%	1.27

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 28, 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

July 1	Japan, China manufacturing Purchasing Managers' Index (PMI); US ISM manufacturing PMI	**July 4**	Eurozone retail sales
July 3	Japan services PMI; China Caixin services PMI	**July 5**	U.S. nonfarm payrolls; Germany industrial orders

The June U.S. nonfarm payrolls data will be in focus this week. Markets are eager to learn whether the unexpectedly low number in May was a blip or a genuine sign of a weakening labor market. Any upside surprise – potentially perceived as evidence of a solid growth outlook – could weigh on risk assets. We expect the Fed to cut rates as insurance against the risk of escalating global trade conflicts. Yet we view market expectations of Fed easing as excessive, given the still benign economic backdrop and potential for higher inflation.

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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