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Broadening reflation

BlackRock Investment Institute:
Key Market Themes, Q2 2017

Broadening reflation

Low returns ahead

Different diversification

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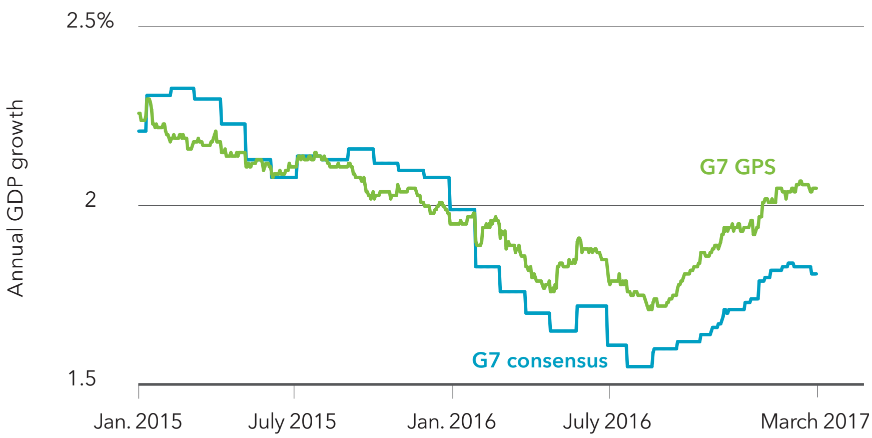
Reflation is going global. The signs include a rebound in inflation expectations, a bottoming out in core inflation and wages, and a synchronised pick-up in economic activity indicators and corporate earnings estimates. We believe the reflation trade – overweighting cyclical equities – has room to run, especially outside the US.

Background

Liftoff at last

Global growth expectations are on the rise – and we see room for more upside surprises. Our ***BlackRock GPS*** – which combines traditional economic indicators with big data signals such as Internet searches – points to a rise in G7 growth estimates in the months ahead. See the gap between our gauge (green line) and consensus forecasts (blue line) in the chart below.

BlackRock GPS vs. G7 consensus, 2015-2017



Sources: BlackRock Investment Institute and Consensus Economics, March 2017.
Notes: the BlackRock GPS shows where the 12-month consensus GDP forecast may stand in three months' time for G7 economies. The blue line shows the current 12-month economic consensus forecast that we calculate by using GDP-weighted Consensus Economics data.

Click here to view the latest BlackRock Macro GPS.

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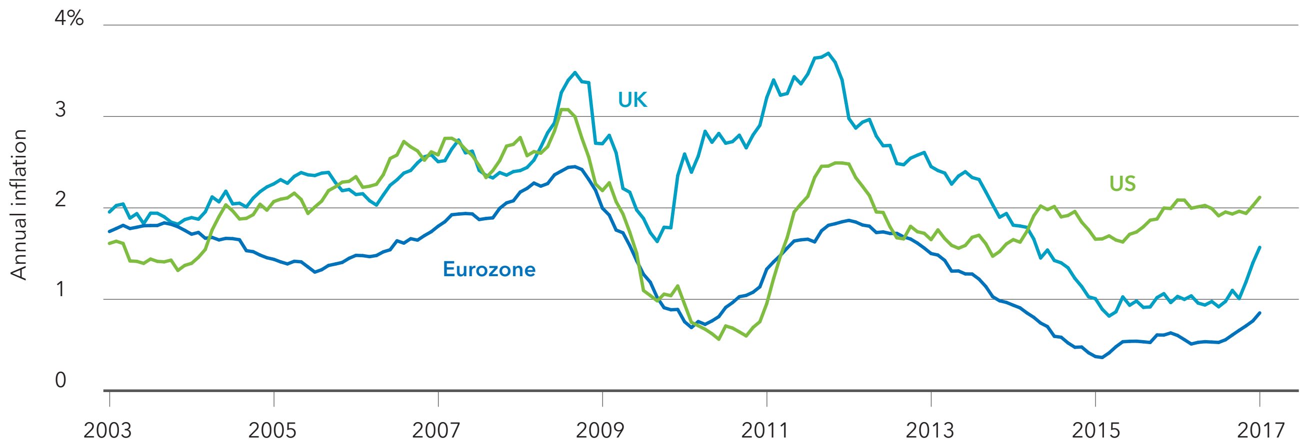
US, eurozone and UK trimmed mean inflation rates, 2003-2017



Sources: BlackRock Investment Institute and Thomson Reuters, March 2017. Notes: the chart uses trimmed mean inflation, which aims to provide a more accurate picture of underlying inflationary pressures. We take the official CPI basket for each country and each month exclude the largest and smallest movers by price volatility.

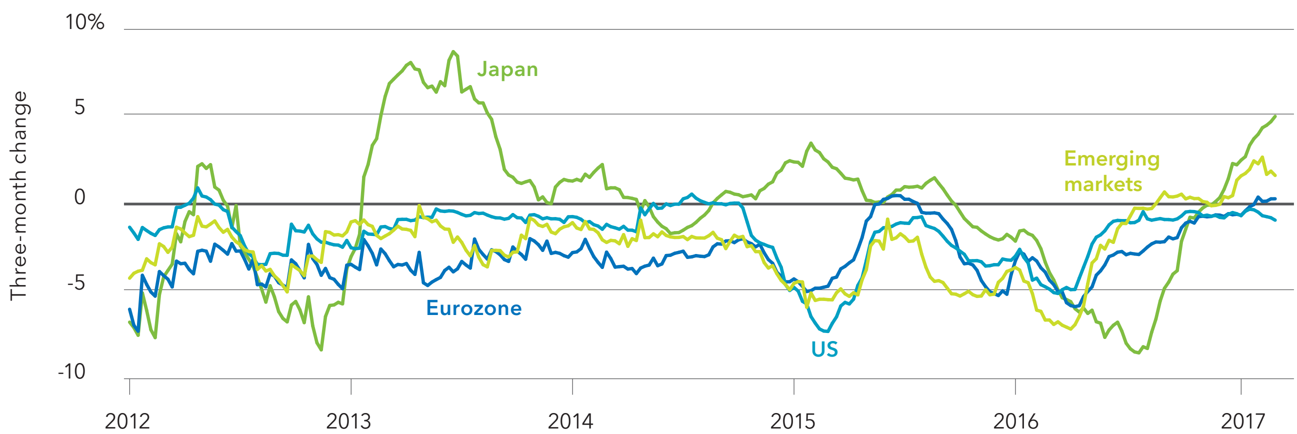
What is different since our ***2017 global investment outlook*** of December 2016? Reflation is becoming synchronised: non-US economies have contributed as much as the US to the rise in our G7 GPS this year. This marks a reversal from 2016, when the US was the locomotive. Our China GPS is also elevated, as detailed in ***China's role in global growth*** of February 2017. Yet some of us caution that China's lather, rinse and repeat cycle of credit stimulus followed by some monetary tightening is again in rinse mode. This could cause temporary hiccups in funding markets.

An awakening of inflation

Inflation expectations have rebounded from lows in mid-2016, and actual inflation is slowly following. It has bounced in the UK – driven by a weak sterling – and is creeping higher in the eurozone, albeit from much lower levels (see the chart above). Energy has driven much of the rebound, but inflation is also broadening. A rising percentage of consumer price index components are clocking increases, our analysis shows. In China, wholesale prices have shot up after sliding for five straight years.

What are the risks to our reflation thesis? First would be an overshoot in expectations of monetary tightening leading to a sharp rise in the dollar, tightening global financial conditions. Second, wage growth and corporate investment could be slower to materialise than surveys have indicated. This could set markets up for disappointment, particularly in the US. Lastly, any rise in protectionism could curb growth and lift inflation.

Changes in corporate profit estimates, 2012-2017



Sources: BlackRock Investment Institute, MSCI and Thomson Reuters, March 2017. Notes: the lines show the three-month change in the aggregate 12-month forward earnings estimates. The data is based on the MSCI US, EMU, Japan and EM indexes.

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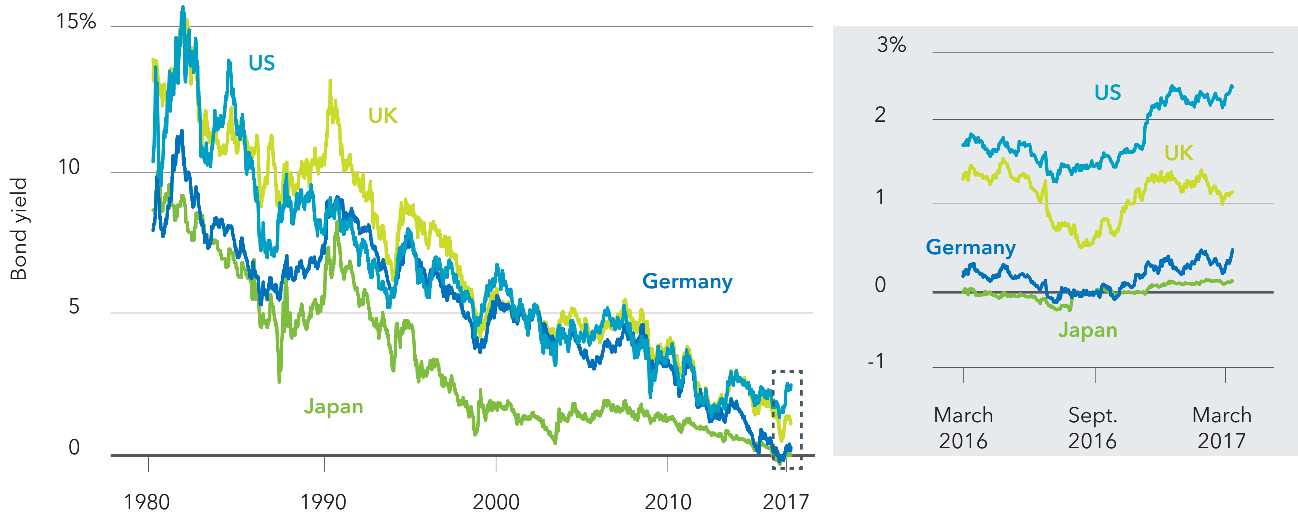
10-year government bond yields, 1980-2017



Sources: BlackRock Investment Institute and Thomson Reuters, March 2017.

Investment implications

Earnings upswing

We see an inflection point in growth, inflation and monetary policy. Markets are catching up to these fast-changing dynamics. Case in point: a synchronised global recovery in corporate earnings is supporting equities. This is not only about reflation. Cost discipline (resources), hopes for regulatory easing (financials) and innovation (tech) are all contributing to strong 2017 earnings' expectations. Earnings' momentum is particularly strong in Japan and emerging markets (EMs), while solid in Europe. This supports our preference for stocks in those regions (see the *Changes in corporate profit estimates* chart).

In the US, the 'Trump trade' appears to be taking a breather. US small caps and value stocks such as banks have been underperforming this year after a post-election run-up. Yet strong equity returns globally, including Japan small caps, suggest our reflation theme is intact.

Coming up for air

Strengthening reflation reinforces our view that we have seen the bottom in bond yields globally after a multi-decade slide (see the chart above). As a result, we see most government bond markets challenged this year. Many lack the buffers to defend against capital losses as yields rise. Yet we do see limits to how high yields can go. Central banks in Europe and Japan appear set to keep running ultra-easy policies. Many investors are ready to jump on higher yields to lock in income. Ageing populations and historically weak rates of economic growth also act as brakes.

Our expectation of higher yields underpins our overall preference for equities over bonds. Stocks have historically done well in reflationary environments because they are geared to global growth and offer diversification benefits, in our view. We do believe US Treasuries and similar government bonds still have a key role to play in helping stabilise portfolios during 'risk-off' episodes, when downside surprises roil markets.

Summary

- The global economic recovery is broadening, and we see room for consensus estimates to ratchet even higher as reflation gains traction.
- Our reflation thesis has risks: market expectations of faster monetary tightening, lacklustre investment or wage growth, and protectionism.
- Spreading global reflation is driving a long-awaited rebound in global corporate earnings, with the sharpest recoveries seen outside the US.
- Yields look poised to rise, but there are limits to how high they can go. We see risks to fixed income, and prefer Japanese, European and EM equities.

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