BLACKROCK **INVESTMENT** INSTITUTE

Richard Turnill
Global Chief Investment Strategist

Richard Turnill is BlackRock's Global Chief Investment Strategist. He was previously Chief Investment Strategist for BlackRock's fixed income and active equity businesses, and has also led the Global Equity investment team. Richard started his career at the Bank of England.

Share your feedback at ***BlackRockInvestmentInstitute@blackrock.com***

Isabelle Mateos y Lago
Chief Multi-Asset Strategist
BlackRock Investment Institute

Kate Moore
Chief Equity Strategist
BlackRock Investment Institute

Jeff Rosenberg
Chief Fixed Income Strategist
BlackRock Investment Institute

BLACKROCK®

WEEKLY COMMENTARY • JULY 16, 2018

Key points

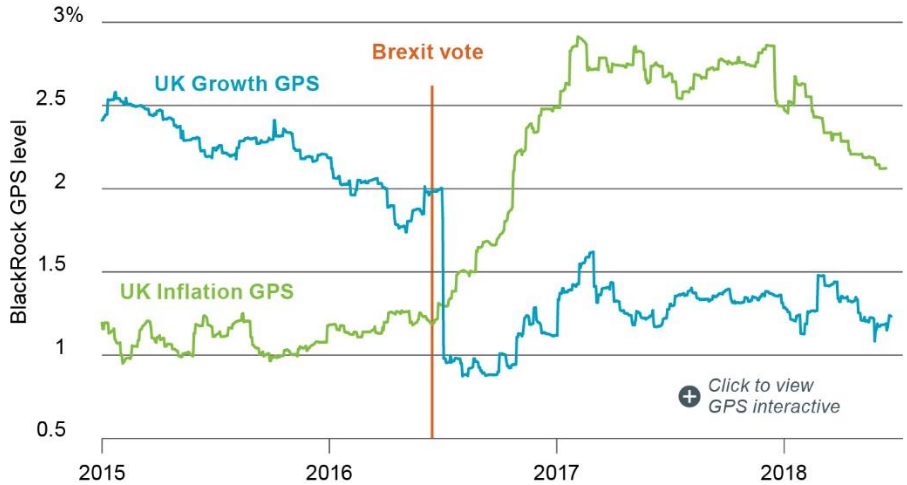
1. We see the road ahead for Brexit negotiations as rocky, and investors in UK assets should expect a bumpy ride as UK-EU talks unfold.
2. Equities rose and stock market volatility fell despite escalating global trade tensions. The U.S. dollar strengthened and commodity prices fell.
3. The bar is high for second-quarter earnings results to beat analysts' expectations. A key focus now: how firms are weathering trade disputes.

1 Investing amid Brexit uncertainty

The UK's new Brexit white paper should allow negotiations over the terms of its future relationship with the European Union (EU) to move forward. Yet we could see UK-EU relations deteriorating before improving. Investors in UK assets should expect a bumpy ride.

Chart of the week

BlackRock's gauge of UK growth expectations and inflation, 2015-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, July 2018. Notes: The blue line shows where the 12-month consensus gross domestic product forecast for the UK may stand in three months. The green line shows where UK core (excluding food and energy) consumer price inflation may stand in six months. The BlackRock GPS aims to give a read on the growth and core inflation outlooks for major economies. It combines new sources of information – including internet searches and text mining of corporate calls – with a daily nowcast of traditional economic data for the Growth GPS and a daily nowcast of inflation based on a wide variety of price and wage data for the Inflation GPS.

Our BlackRock Growth GPS for the UK shows growth expectations have only modestly recovered from the heavy blow the Brexit vote dealt to the UK economy. See the blue line above. Meanwhile, our UK Inflation GPS (green line) shows inflation ticking lower but remaining much higher than before the Brexit vote, mostly due to a weaker British pound pushing up import prices. UK growth has been significantly lagging the rest of the G7, but may have recovered enough to allow the Bank of England to raise rates in August, we believe. Subdued growth combined with elevated inflation is typically a challenging backdrop for risk assets. UK stocks have been resilient recently, aided by domestic stocks' global orientation and an M&A uptick. Yet political uncertainty looks set to stay elevated in the second half.

BII0718U/E-547693-1716042

Our Brexit base case

The UK's Brexit proposal would see the country effectively retaining full access to the EU single market for goods but losing access for services. It is closer to a "soft Brexit" than many had anticipated, angering some in the pro-Brexit camp. The proposal reflects the UK government's gradual realization that any alternative would be highly disruptive for the manufacturing sector and would leave issues surrounding its land border with EU member Ireland unresolved. The UK has shifted its stance on previously non-negotiable issues, such as accepting alignment with European regulations and judicial rulings. This allows talks to move forward for now. Yet there's a major unresolved problem: The EU has stated that "cherry-picking" EU-membership principles to abide by would be unacceptable.

We see Brexit noise getting louder as the March 2019 date for the UK's exit nears. The EU will need to decide if it's willing to accept a tailored agreement. The alternative is forcing the UK to choose between a limited free-trade deal or full adherence to the EU's four freedoms, including free movement of people, at the risk of a negotiation breakdown. Our base case: Pressure to avoid a no-deal outcome leads to a compromise later this year. We expect an extended transition period starting in March 2019, with key future-relationship decisions kicked down the road. We see nearer-term wildcards too, such as a possible leadership contest in the UK's ruling Conservative Party.

Greater resiliency in portfolios is key amid Brexit volatility and other risks (see our midyear outlook). We are underweight UK equities, and favor overseas earners that can benefit from faster-growing economies and currency weakness. We would avoid UK banks, which tend to be sensitive to Brexit news. We prefer U.S. and emerging market (EM) equities on higher earnings growth. We do not expect UK government bond yields to rise materially amid political uncertainty. We see UK real estate fundamentals staying strong, but focus on the highest-quality assets. We expect the pound to be volatile, with potential downward pressure until a Brexit resolution nears.

2 Week in review

- Equities rose and market volatility fell despite rising trade tensions. The U.S. initiated a process likely to lead to tariffs on up to an additional $200 billion of Chinese imports by the end of August. The Chinese yuan weakened as the U.S. dollar strengthened. Read more on global trade tensions at our BlackRock geopolitical risk dashboard.
- Commodities bore the brunt of heightened trade disputes. Metal and oil prices fell sharply, with Brent crude prices experiencing their worst day since February 2016 on Wednesday. Oil's drop was most likely due to profit taking after strong gains year to date. Energy equities lagged, but credit markets held up.
- Chinese inflation surprised to the upside for the first time this year, with both Consumer Price Index (CPI) and Producer Price Index (PPI) increases accelerating. The Bank of Canada raised rates for the fourth time since mid-2017.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	1.5%	4.8%	14.4%	1.9%
U.S. Small Caps	-0.4%	10.6%	19.8%	1.2%
Non-U.S. World	0.6%	-3.0%	6.4%	3.2%
Non-U.S. Developed	0.2%	-2.0%	6.4%	3.4%
Japan	0.7%	-3.0%	10.0%	2.3%
Emerging	1.7%	-5.8%	5.7%	2.8%
Asia ex-Japan	1.8%	-4.5%	7.4%	2.7%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.1%	-0.9%	-0.2%	2.8%
U.S. TIPS	0.0%	0.4%	2.6%	3.0%
U.S. Investment Grade	0.4%	-2.4%	0.1%	4.0%
U.S. High Yield	0.5%	0.7%	3.0%	6.4%
U.S. Municipals	0.2%	0.1%	1.8%	2.6%
Non-U.S. Developed	-0.9%	-1.6%	3.0%	0.9%
EM $ Bonds	0.9%	-3.1%	0.7%	6.2%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-2.3%	12.7%	55.6%	$75.33
Gold	-0.9%	-4.5%	2.2%	$1,244
Copper	-0.7%	-13.9%	6.1%	$6,237

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.5%	-2.7%	2.5%	1.17
USD/Yen	1.7%	-0.3%	-0.8%	112.38
Pound/USD	-0.5%	-2.2%	2.2%	1.32

Source: Bloomberg. As of July 13, 2018. 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. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

3 Week ahead

July 16	U.S. retail sales; Trump-Putin meeting; EU-China summit	**July 18**	U.S. housing starts; UK CPI
July 17	U.S. industrial production; Fed Chair Powell semi-annual testimony	**July 20**	Japan CPI

Nearly one fifth of the S&P 500 market cap and 11% of the STOXX 600 market cap are scheduled to report second-quarter earnings this week. Analysts see U.S. firms posting exceptionally strong earnings growth of 20% from the prior year period. These expectations reflect tax reform and are already baked into prices, setting a high bar for firms to get rewarded for their results. We will be focusing on corporate guidance, especially any signs of how firms are weathering escalating trade tensions and political uncertainty. Higher commodity prices may be a headwind for some companies' margins, but analysts expect them to contribute to particularly strong sales and earnings for global energy firms. The tech sector is expected to lead in top- and bottom-line growth, continuing a recent trend.

Asset class views

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

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. municipals	—	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.

▲ Overweight — Neutral ▼ Underweight

*Given the breadth of this category, we do not offer a consolidated view.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) provides connectivity between BlackRock's portfolio managers, originates market research and publishes insights. Our goals are to help our fund managers become better investors and to produce thought-provoking content for clients and policymakers.

BLACKROCK®

BII0718U/E-547693-1716042