

BLACKROCK INVESTMENT INSTITUTE



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Key points

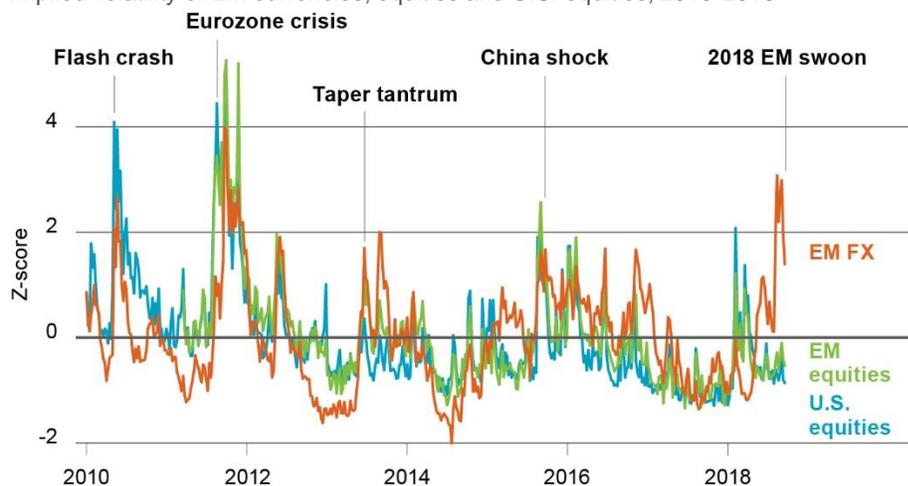
- 1 We see room for a further recovery in emerging market (EM) assets, particularly equities, after an unexpectedly prolonged selloff.
- 2 The Fed raised rates last week, and Italy released a draft budget that was more expansionary than expected. Brent crude hit a four-year high.
- 3 Polls suggest Brazil's election on Sunday will result in a second round with two far-from-center candidates. Local assets look set for volatility.

1 The prospects for emerging markets

We see room for last week's EM recovery to persist, especially in equities. The rebound came after an unexpectedly persistent selloff in EM assets this year, despite a solid near-term global growth outlook. Country-specific shocks and tightening global financial conditions have pressured EMs with the greatest external vulnerabilities. Yet we do not see the EM swoon as a broader threat to global markets.

Chart of the week

Implied volatility of EM currencies, equities and U.S. equities, 2010-2018



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 Thomson Reuters, September 2018. Notes: The lines show the number of standard deviations from the average (z-score) since 2010. Volatility of EM FX (currencies) is based on a simple average of implied volatility for the Brazilian real, Turkish lira, South African rand, Polish zloty, Thai baht, Mexican peso, Indonesian rupiah and Indian rupee to dollar rates. Volatility of U.S. equities is based on the CBOE VIX Index, and EM equities on the CBOE Emerging Markets Volatility Index (data available from March 2011). "Flash crash" is the U.S. market crash of May 6, 2010; "eurozone crisis" marks the peak of Europe's sovereign debt crisis; "taper tantrum" is the 2013 market selloff on fears of the Fed winding down its asset purchase program; "China shock" is China's summer 2015 stock market crash.

EM currencies have borne the brunt of the recent selloff. Volatility in EM currencies recently spiked to higher levels than the 2013 "taper tantrum" — when then Federal Reserve Chair Ben Bernanke signaled the beginning of the end of new central bank asset purchases. See the orange line above. Yet volatility in other asset classes has remained more muted, both in EMs and developed markets, as the chart shows. Currencies have also shown some signs of stabilization, with emergency rate hikes in Turkey stemming a sharp selloff in the lira. We see this as a positive sign for EM assets overall.

A canary in the coalmine?

This year's EM troubles stem from a potent cocktail of negatives, as we write in our [Global Investment Outlook Q4 2018](#). Catalysts include country-specific factors (Turkey's credit-fueled growth running out of steam; Argentina's policy missteps); worsening trade tensions; a crowded EM election calendar; and moderately tighter global financial conditions. Higher U.S. interest rates are adding to the EM stress by creating competition for capital and leading investors to reset their return expectations for riskier assets, especially EM assets and equities. The biggest casualties: currencies of EM economies with the largest current account deficits and highest external debt burdens. Countries with surpluses, such as South Korea and Thailand, have largely been spared a currency crunch.

We see this year's EM selloff more as a series of idiosyncratic accidents masking stronger EM fundamentals rather than a canary in the coalmine for global markets. EM economies are holding up, and recessions in trouble spots like Turkey and Argentina should have limited impact. Our research shows developed markets are the key drivers of the global expansion and EMs' fortunes, with China the linchpin for transmitting growth to EM broadly. Our [BlackRock Growth GPS](#) points to steady economic activity in China. EM fundamentals are generally robust, and economic strength is starting to translate into sustained strong EM earnings growth for the first time in a decade. We may also be near a peak in country-specific risks. With much of the steam let out of valuations, a robust growth backdrop, and potential for the Fed to start to slow its balance sheet wind-down next year, we see room for a further rebound. Risks include escalating trade frictions, hefty portfolio outflows, and a hawkish Fed pushing up global rates and the U.S. dollar.

EM assets overall appear to offer attractive compensation for these risks, especially in equities, where we stick to our overweight. We are positive on the hard-hit tech sector, even as some high-flying tech shares remain expensive. In fixed income we prefer selected hard-currency EM debt. It provides some insulation against currency declines and looks relatively cheap versus local-currency debt.

2 Week in review

- The Fed raised rates, with most of the FOMC supporting another hike by year end. The Fed chairman said the economy remains strong, with further gradual rate increases appropriate despite risks to the outlook. U.S. 10-year Treasury yields fell. The curve between two and 10 years flattened. U.S. consumer confidence hit an 18-year high.
- Italy's bonds and bank stocks came under pressure after Italy released a draft budget targeting a fiscal deficit of 2.4% for 2019 to 2021, higher than expected and much larger than EU limits.
- Brent crude prices hit a four-year high. OPEC signaled it won't increase output preemptively, and concerns grew about supply shortfalls related to U.S. sanctions on Iran. Global equities fell. The president of Argentina's central bank resigned, and the IMF increased its credit line to Argentina.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-0.5%	9.0%	16.1%	1.9%
U.S. Small Caps	-0.9%	11.5%	15.4%	1.2%
Non-U.S. World	-0.7%	-3.1%	2.3%	3.2%
Non-U.S. Developed	-0.9%	-1.4%	3.3%	3.4%
Japan	0.4%	1.6%	10.2%	2.2%
Emerging	-0.3%	-7.7%	0.1%	2.9%
Asia ex-Japan	-0.7%	-6.3%	2.2%	2.7%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	5.0%	23.7%	44.1%	\$82.72
Gold	-0.8%	-8.6%	-7.5%	\$1,191
Copper	-1.7%	-13.6%	-4.0%	\$6,258

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.1%	-1.7%	-1.7%	3.1%
U.S. TIPS	0.0%	-0.8%	0.2%	3.2%
U.S. Investment Grade	0.2%	-2.3%	-1.1%	4.1%
U.S. High Yield	0.2%	2.6%	3.1%	6.2%
U.S. Municipals	0.2%	-0.4%	0.3%	2.9%
Non-U.S. Developed	-1.1%	-3.0%	-1.2%	1.0%
EM \$ Bonds	0.7%	-3.0%	-1.7%	6.4%

Currencies	Week	YTD	12 Months	Level
Euro/USD	-1.2%	-3.3%	-1.5%	1.16
USD/Yen	1.0%	0.9%	1.2%	113.70
Pound/USD	-0.3%	-3.6%	-3.1%	1.30

Source: Bloomberg. As of Sept. 28, 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. dollars 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

Oct. 1	U.S. ISM Manufacturing PMI	Oct. 5	U.S. September employment report
Oct. 3	U.S. ISM Non-Manufacturing PMI; UK Conservative Party Conference (Sept. 30 to Oct. 3)	Oct. 7	Brazil presidential election (first round)

Brazil's election comes after a drawdown in EM assets this year and amid rising support for populist agendas across Latin America (see our [geopolitical risk dashboard](#)). Polling suggests no candidate will win more than 50% of the vote in the first round. This would likely lead to an Oct. 28 runoff between right-wing Jair Bolsonaro and left-wing Fernando Haddad. Local assets look set for volatility in the weeks ahead. Brazil's economy, South America's largest, is fiscally fragile and still recovering from a sharp recession. The winning candidate's approach to pension reform and public spending will likely be a key driver of market expectations around Brazil's growth potential.

Asset class views

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

Asset class	View	Comments
Equities	U.S.	▲ Strong earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like the momentum factor and see a role for quality exposures amid steady global growth but rising uncertainty around the outlook. Technology tops our list of favored sectors.
	Europe	▼ Relatively muted earnings growth, weak economic momentum and political risks are challenges. A value bias makes Europe less attractive without a clear catalyst for value outperformance. We prefer higher-quality, globally-oriented names.
	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	▲ Attractive valuations, along with a backdrop of economic reforms and robust earnings growth, support the case for EM stocks. We view financial contagion risks as low. Uncertainty around trade is likely to persist, though a lot of it has been priced in. We see the greatest opportunities in EM Asia on the back of strong fundamentals.
	Asia ex-Japan	▲ The economic and earnings backdrop is encouraging, with near-term resilience in China despite slower credit growth. 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. We believe 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. Valuations in the periphery appear tight. The exception is Italy, where spreads are reflecting simmering political risks. The upcoming end to the ECB's net asset purchases could dampen appetite for the asset class.
	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	— We prefer hard-currency over local-currency debt and developed market corporate bonds. Slowing supply and broadly strong EM fundamentals add to the relative appeal of hard-currency EM debt. Trade conflicts and a tightening of global financial conditions call for a selective approach.
	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	* A healthy inventory balance underpins oil prices. Trade tensions add downside risk to industrial metal prices. 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. BII1018U/E-616063-1914605

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